

July 2011: not to lose momentum



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▶ Summer 2011: a temporary ease of concern

Leading indicators in June remained somewhat mixed. On the one hand, economic activity remained sluggish as sentiment among producers deteriorated. On the other hand, transportation volumes and power consumption growth rates strengthened, raising hopes for a rebound. Credit activity indicators point to higher demand for borrowed funds, which may as well be interpreted as a positive signal for the economy.

However, Russian economy currently operates at its full employment level of output. Therefore, any acceleration in the real sector is subject to demand outlook. We continue to think that investment in production capacity holds the key to providing an upside to both potential and actual GDP growth.

Inflationary pressure may ease a little over the summer months due to seasonal decline in the price of agricultural products. However, the CBR's forecast of 7.0–7.5% for 2011 still looks challenging as CPI YTD growth already stands at 5.0% and abundant liquidity is unlikely to ease pressure on the general price level. Cost-push inflation is also a threat: PPI YTD increased by more than 10%.

▶ ST forecasts:

- ◆ **External sector and exchange rates.** We expect oil prices to remain under pressure throughout July as IEA releases additional 2 million barrels daily from strategic reserves to compensate for supply disruption in Libya. As a result, Russian trade balance is likely to shrink further to an estimated total of \$14.1 bln (assuming that imports continue to grow at a steady pace as consumer and investment demand rebound). We therefore believe that there is little scope for ruble appreciation with respect to USD in July giving CBR an opportunity to temporarily halt forex interventions. USD/RUB exchange rate is most likely to average 28.0. Provided that risks in the Eurozone are unlikely to escalate during the summer, ruble may also depreciate slightly toward the euro, resulting in an average dual currency basket value of RUB33.8. However, the indicator's volatility is likely to remain low.

- ◆ **Real sector and price level.** Demand-side indicators seem to be gaining momentum, at least for the medium term. Consumption demand seems to be oblivious of falling RDI: increasing lending activity (perhaps, fuelled by expectations of rate increases by the end of the year), combined with a further improvement in consumer confidence on the back of subsiding unemployment may help sustain retail trade turnover growth at above 6.0% YoY in July. Higher capacity utilization (although uneven among different industries) is expected to result in higher capex. However, high base effect will limit the increase (+5.0% in July).

Seasonal factors are likely to contribute to further decline in inflationary pressure throughout the rest of the summer. Monthly CPI growth rate is expected to average 0.1–0.2% in July and August. However, yearly inflation over this period will most likely remain close to 9.0%, contributing to a further slump in real disposable incomes (by ca. 6.0% YoY).

Modest ruble depreciation in nominal terms, combined with a slowdown in inflation, may ease pressure on Russian manufacturers as their output will become more price competitive. However, this effect is unlikely to materialize in the short run, and we expect industrial output to grow at a steady pace of 6.4% YoY in July.

Key indicators: June forecast

Indicator	July 2011F	MED*	2011F GPB Research
Real sector			
GDP, YoY	-	4.2%	3.9%
Industrial production, YoY	6.4%	5.4%	3.5%
Capital investments, YoY	5.0%	6.0%	6.8%
Retail sales, YoY	6.2%	3.8%	4.3%
Private sector			
Real income, YoY	-6.0%	1.5%	4.4%
Accrued salary, RUB	-	23,940	23,784
External sector			
Trade balance, \$ bln	14.1	195.1	153.6
Average oil price (Brent), \$/bbl, av.	110	105	108
Exchange rate, inflation and rates levels			
Inflation (CPI), YoY	9.3%	7.0-7.5%	8.5%
Refinancing rate, eop	8.25%	-	-
Bicurrency basket, RUB (avg.)	33.8	33.38	32.72
Exchange rate, RUB/USD (avg.)	28.0	28.4	27.5

– no forecast available;

* latest available forecast

Source: MED, Gazprombank estimates

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Leading indicators

▶ Money and credit

Lending continued to expand in May. Commercial loan portfolio of banks rose by 16.6% YoY over the last 12 months, and consumer lending grew at an even higher pace of 22.9% YoY over the same period.

Monetary indicators suggest that this trend may continue throughout the summer. According to our estimates, the money multiplier increased to 2.8x in June, hitting an all-time high, which points to higher lending activity. At the same time, growth of monetary base continued in June: cash in circulation and required reserve balances at the CBR together increased by 2.1%. The combination of monetary base growth and an increase in the money multiplier, however, creates inflationary risks.

▶ Energy consumption

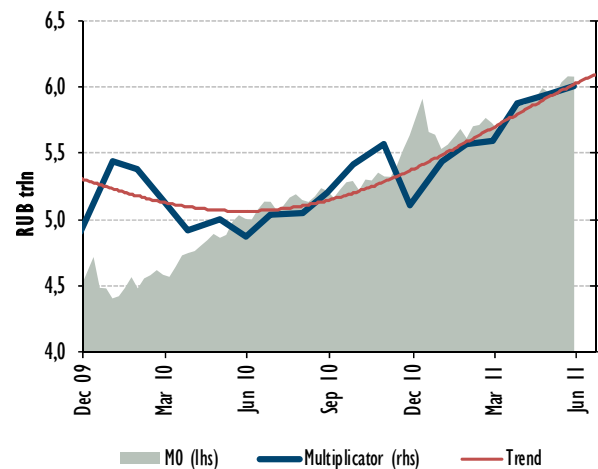
Energy consumption continued to grow at a steady pace of 2.4% YoY in June. Despite some divergence in the growth rates of power consumption and industrial production observed in the first 5 months of the year, sustained dynamics in the beginning of summer might point to increased economic activity offsetting the seasonal decline in energy utilization.

▶ Economic activity

Economic sentiment in June remained subdued. Manufacturing PMI declined to a 15M low of 50.6. Stumbling new orders contributed the most to the slowdown of economic activity as manufacturers were forced to adjust their production plans taking into account higher inventories. Sentiment in the non-manufacturing sector deteriorated in June, as well, although at a less dramatic pace: services PMI declined to 55.1 from 57.6 in May.

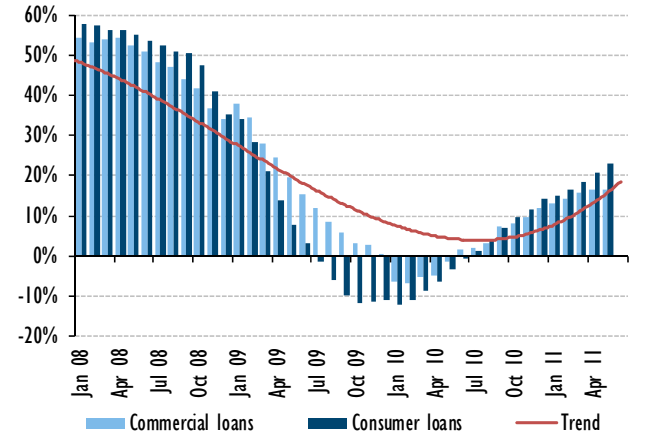
However, transportation rebound in May by 5.6% YoY after adding only 0.9% YoY a month before. This can be a sign of improving demand expectations, but may well lead to higher stocks of finished goods in the coming months if consumptions does not accelerate.

Monetary base and multiplier (M2/M0)



Source: CBR, Gazprombank estimates

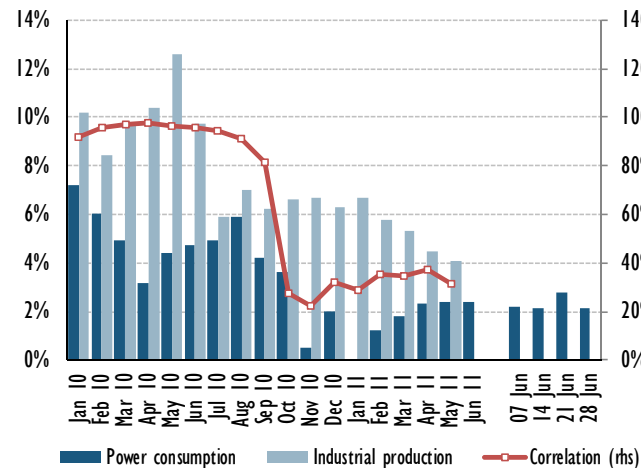
Lending volume*, % YoY



* Total loan portfolio increment over the last 12 months

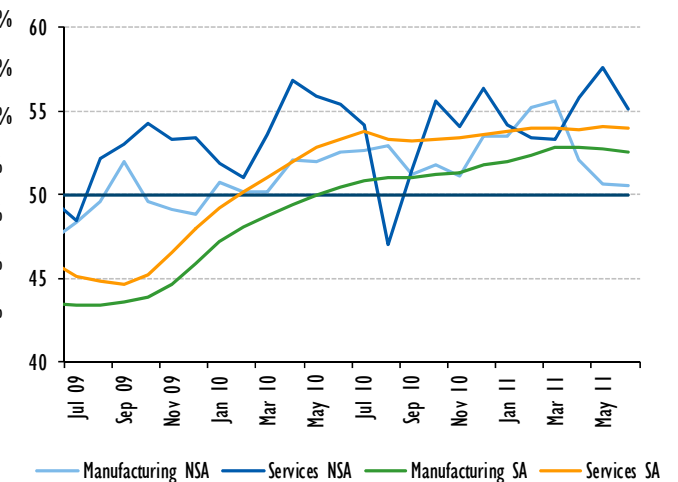
Source: CBR

Power consumption vs. industrial production, % YoY



Source: System Operator, Rosstat

Russia's PMI, points



Source: Bloomberg

Current economic environment

- ▶ **Russian GDP** in May, according to MED estimates, accelerated to 3.8% YoY from 3.3% in April. Total output grew 0.4% MoM, seasonally-adjusted figures show, following a 0.1% increase a month before.

Although real GDP (SA) in the 1Q remained well below its pre-crisis levels, the GAP (difference between actual and potential output), according to our calculations, shrunk almost to zero, which indicates that Russian economy currently utilizes full employment capacity. As a result, further economic expansion requires new stimuli in the form of sustainable consumption demand backed by higher investment activity. Ongoing decline in the RDI, as well as deteriorating producer confidence, however, pose some obstacles to GDP dynamics acceleration.

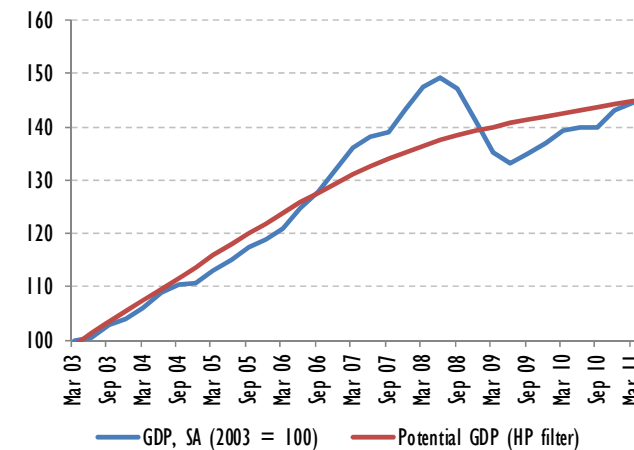
- ▶ **Investment in productive capacity** growth accelerated in May to an annual rate of 7.4% YoY after a modest increase of 2.2% YoY in April and a decline throughout the 1Q11. However, much of this acceleration can be attributed to the low base effect as seasonally adjusted data points to a modest slowdown: capex in May rose by 4.3% MoM after increasing by 5.3% a month before.

- ▶ **External sector and exchange rates**

Exchange rate volatility (as measured by dual currency basked standard deviation during the month) in June dropped to almost one third of an average YTD figure and reached a minimum since November 2008. We see three possible explanations of this.

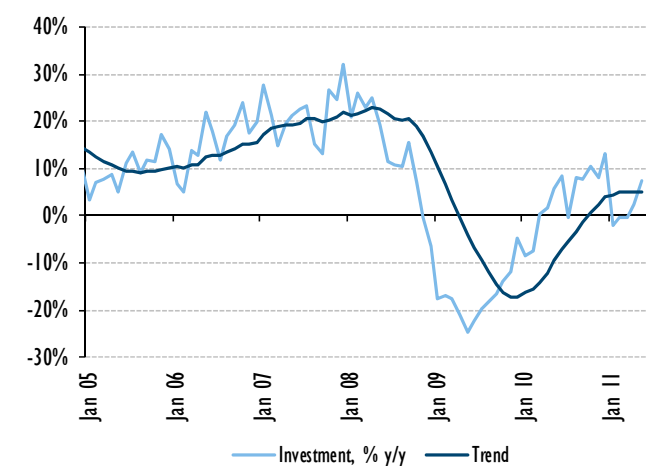
First, external pressure on ruble eased along with the decline in the oil prices. As a result, Russia's positive trade balance presumably shrunk to \$16.0 bln in June. The second explanation for the record low currency volatility may be the mutually offsetting RUB/USD and RUB/EUR movement. However, ruble volatility against USD also declined sharply in June. Finally, resumed accumulation of foreign exchange reserves by the CBR in June points to active interventions by the regulator in the FOREX, which, according to our estimates, amounted to \$3.7 bln.

Real GDP (2003 = 100) and potential GDP dynamics



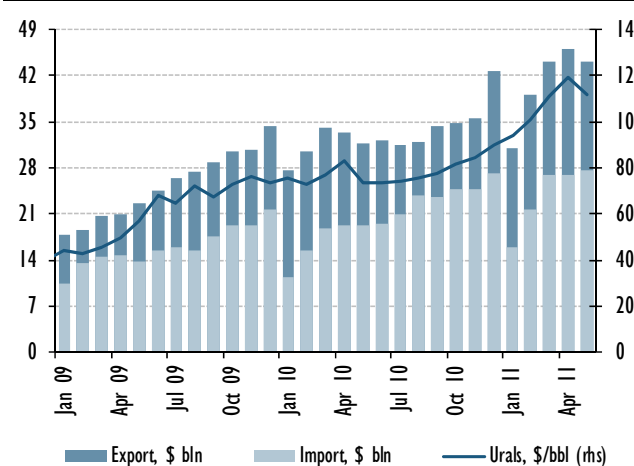
Source: Rosstat

Investment in working capital, % YoY



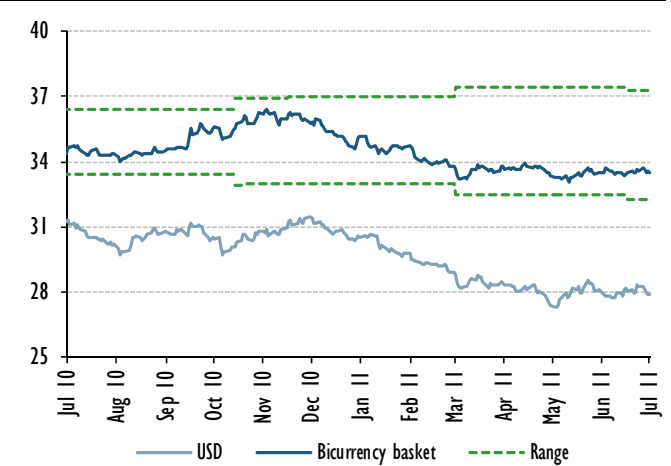
Source: Rosstat, Gazprombank calculations

Russia's trade balance vs. oil prices



Source: Bloomberg, CBR, MED

ruble exchange rates



Source: Bloomberg, CBR

▶ Consumer confidence

Retail sales dynamics in May point to firm consumer confidence: turnover increased by 5.5% YoY despite falling disposable incomes. The latter declined by 7.0% YoY in May, accelerating more than twice as compared to a 3.2% drop in April. This is a fearful dynamics as the propensity to save diminished to the minimum rate in two years, leaving little space for further increase in current consumption. A lending boom that accounts for a large share of household expenditures may result in higher delinquencies in the future when interest rates resume growth.

Weak labor market indicators may also limit consumption in the future. The unemployment rate fell to 6.4% in May. However, seasonal factors accounted for most of the decline: if their influence is neglected, the actual figure rises to 6.7%.

▶ Inflation

Inflation slowed down in June: monthly increase in CPI was limited to 0.2% while the YoY price change declined modestly to 9.4% after touching a local maximum at 9.6% YoY in April and May. However, much of the slowdown can be attributed to temporary factors, such as seasonal decline in prices of agricultural products (-3.2% MoM). This point of view is supported by the fact that core CPI rose by 0.3%, exceeding headline inflation.

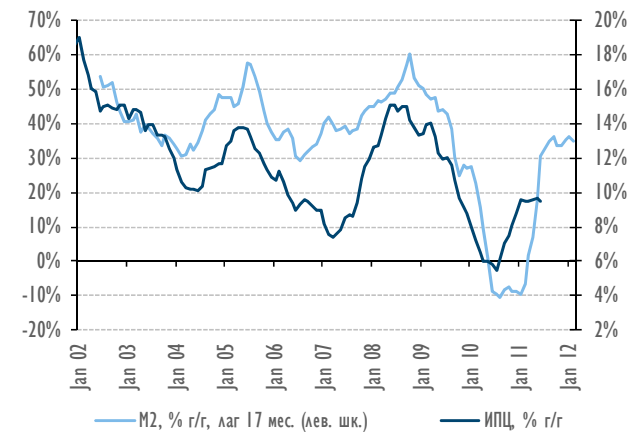
CBR's decision to leave interest rates intact implies that threats to economic growth and inflationary risks, in regulator's point of view, remain balanced. Thus we do not expect any change in the stance of monetary policy at least until the end of 3Q 2011.

▶ Capital markets

Rally in the last three days of June contributed to the overall monthly increase despite a severe drop during most of the month. RTS added 1.0% and MICEX was almost unchanged as compared to the last value of May (+0.02%), its increase being limited by ruble appreciation against the dollar.

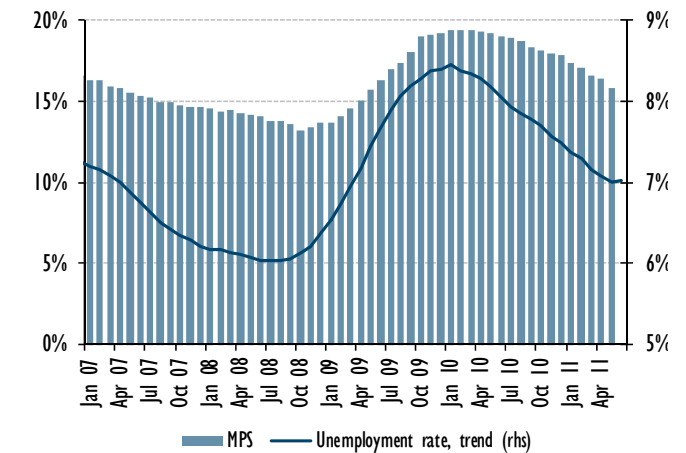
Minfin raised as much as RUB147.9 bln through OFZ issues in June (ca. 74% of the planned amount) and plans to borrow RUB110 bln in July.

Inflation and money supply dynamics: risks are evident



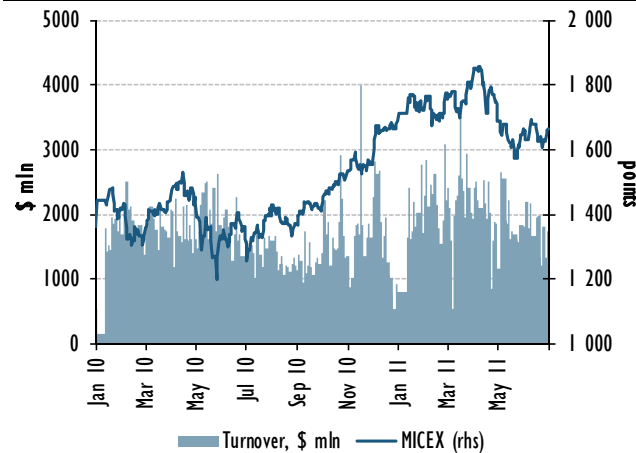
Source: Rosstat, MED, Gazprombank estimates

Consumer confidence indicators



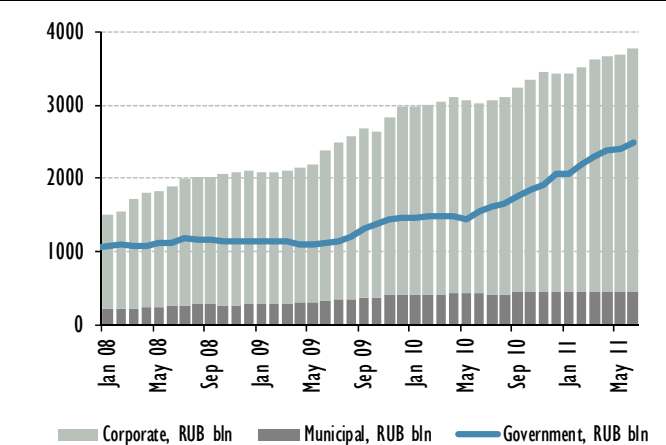
Source: Rosstat

Stock market dynamics



Source: Bloomberg

Bond market volume (at par value)



Source: Cbonds

Appendices

1. Economic situation abroad

▶ Europe

Sentiment within the Eurozone varied from extremely negative in the first half of June to rather positive lately. Risks of default by Hellenic Republic surged to a record high of 2185.5 bps, as indicated by 5-year sovereign CDS spread, after S&P lowered Greece sovereign rating to 'CCC' – the lowest in the world. Successful attempts of Papandreou's government to secure majority support in Parliament, however, spurred confidence in a favorable resolution of debt crisis.

The short-term decision was reached in the beginning of July, when EU Finance ministers approved the 5th tranche to Greece (EUR8.7 bln + EUR3.3 bln supplied by IMF) to finance July and August redemptions, as well as coupon payments over this period. Longer-term resolution, however, is still to be negotiated. Greece's refinancing needs over the following 2.5 years are estimated at EUR93.7 bln, while the country's ability to borrow in financial markets in 2012–13 remains faint. This implies that EUR110 bln program approved a year ago is insufficient to prevent default in the future, and therefore requires an extension of up to EUR85 bln, which is to be discussed during EcoFin summit on the 11th of July.

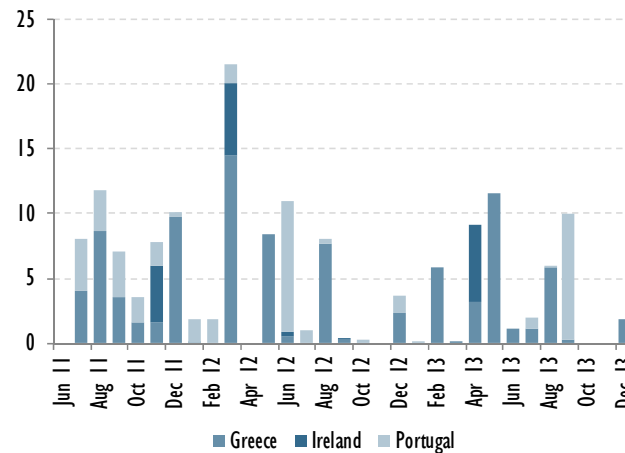
Euro remains strong (trades in the range \$1.42–1.47) on expectations of widening interest rate differential between Europe and USA. ECB may decide to raise borrowing costs by 25 bps as soon as July, 7th, while Fed is reluctant to tighten monetary policy any time soon.

▶ USA

Data on US economy in June was generally weak. FRS downgraded its forecast of GDP growth by 4 bps, lowering the range to 2.7–2.9% in 2011. Although 1Q slowdown is viewed by the authorities as temporary, labor market dynamics point to weak economic fundamentals,

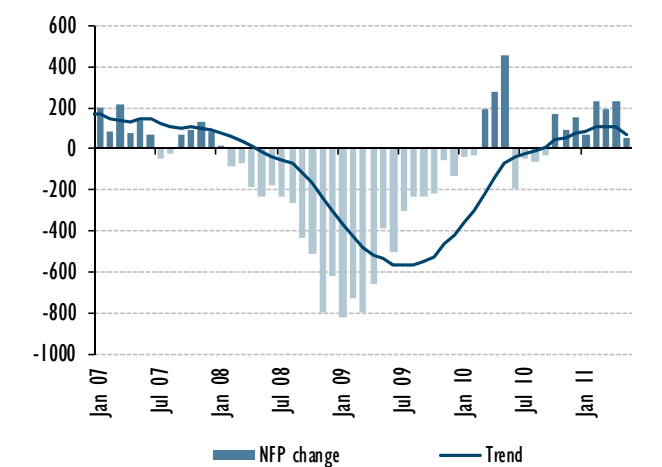
Taking this into account, we believe that FRS is likely to sustain its monetary policy stance by keeping base interest rates low and providing liquidity to the markets.

Debt redemption schedule, EUR bln



Source: Bloomberg

Change in non-farm payrolls, thousand



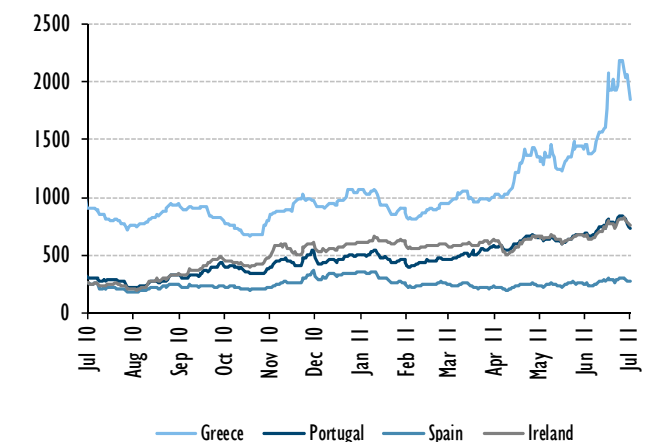
Source: Bloomberg, Gazprombank calculations

EUR/USD rate dynamics



Source: Bloomberg

5-year CDS spreads dynamics on Eurozone members' debt



Source: Bloomberg

2. Commodity markets

▶ China

Chinese data remained somewhat mixed in June. On the one hand, imports are no longer expected to decelerate dramatically. This might imply that risks of China destocking may be somewhat exaggerated. On the other hand, indicators of economic activity are not as strong as before. Notably, June PMI was estimated to decline to 50.1 points, only marginally exceeding the '50' threshold, which separates growth from stagnation. As a result, commodities prices remained volatile during the month.

▶ Oil

Oil prices are under pressure from IEA's decision to release as much as bbl 60 mln from member countries' strategic reserves in July. This implies extra supplies of ca. 2 mln bbl/day (+2.4% to the current daily volumes). We believe, however, that (1) a sharp correction of prices has already incorporated most of the impact from this decision and (2) level of support at \$100/bbl will be sustained. Longer-term effect from this measure will crucially depend on whether it would be able to stimulate oil-consuming nation's economies, resulting in a higher demand for fuel. Notably, oil futures no longer suggest a decline in oil prices over the next 12 months.

▶ Metals and other indicators

Shipping costs stabilized in June as the influence of overcapacity was partially offset by higher demand for steam coal for power stations and iron ore from China. Baltic Dry index during the period fluctuated in the range 1400–1490 points.

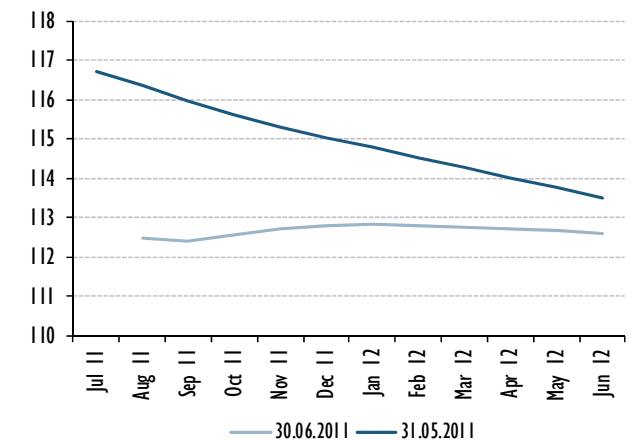
Acceleration of industrial production in Japan in May suggests that there might be a surge in demand for metals as the country struggles to rebuild its infrastructure after the devastating earthquake in March. However, by far base metals prices remained almost unchanged in June. Demand for gold subsided in the 2H of the month after risks of Greek default diminished: spot prices fell below \$1500/Oz (-2.3% over the month).

Urals price dynamics, USD/bbl.



Source: Bloomberg

Brent futures, USD/bbl.



Source: Bloomberg

Base metal price indices, points



Source: Bloomberg

Baltic Dry Index (shipping rates), points



Source: Bloomberg

3. Money and fixed income markets

▶ Money & FI markets abroad

UST yields fell below 3.0% in June as the wave of global risk-aversion, spurred by the escalation of fears over Greek debt failure, stimulated demand for safer assets. However, as the risks of sovereign default in Europe subsided, the yields rebound to ca. 3.1–3.2%.

We believe that there is a modest risk of further increase in yields as the Fed ends its QE-II. However, rollover of maturing debt into new UST issues is unlikely to let yields appreciate beyond 3.5% even after Congress negotiates a new public debt limit.

MM indicators in the US continued to indicate liquidity abundance: TED-spread ranged from 20 to 25 bps while 2-year swap spread averaged 23 bps.

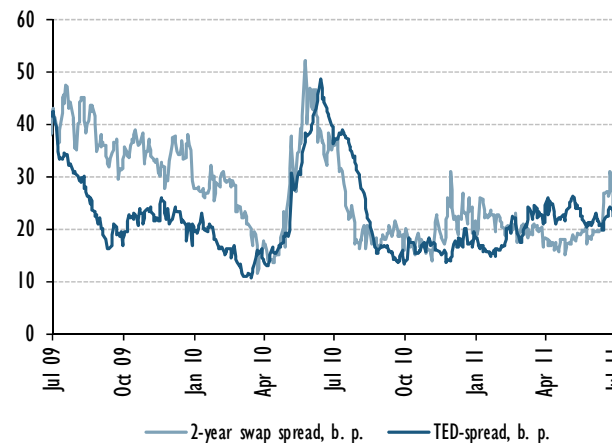
▶ Russian money & FI markets

ruble liquidity eased considerably last month as a series of redemptions provided a healthy inflow of cash to the banks' balance sheets. The largest addition to the stock of liquidity came from OBR-18 redemption on the 17th of June (RUB456 bln). The budget balance in June was most likely positive, which implies that it couldn't be a source of liquidity for banks. Tax payments were largely offset by Minfin's policy of providing the banking system with relatively cheap funding through depository auctions, while draining only a small fraction of it by issuing OFZ.

As a result of the combination of factors listed above, the amount of liquid assets on the banks' balance sheets (sum of correspondent accounts and deposits with the CBR) stood at ca. RUB1.3 trln, which is considered to be a sufficient security cushion. Therefore, we do not expect any tightening in the money market in July. O/n borrowing costs for Tier 1 banks are likely to remain in the range 3.3–3.8%.

Global EM Bonds-dedicated funds experienced a net inflow of ca. \$3.3 bln in June, and the Russian market seems to have jumped on the train as well. Yields of Russia-30 diminished by 6 bps to 4.39%, and the spread between them and UST yields shrunk by 22 bps (to 124 bps).

Key MM spreads



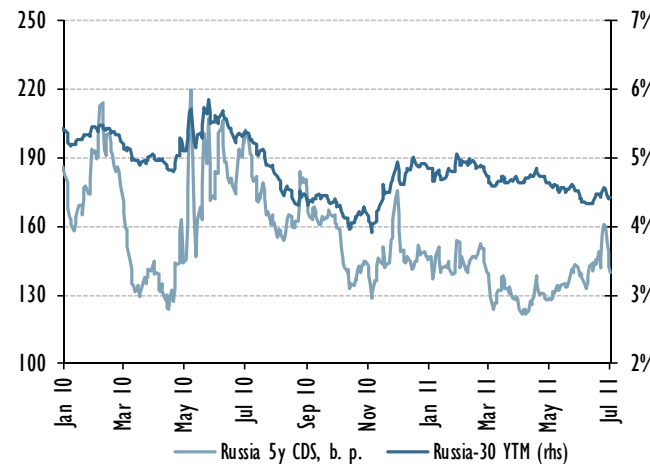
Source: Bloomberg

1y LIBOR and 10y US Treasuries yield



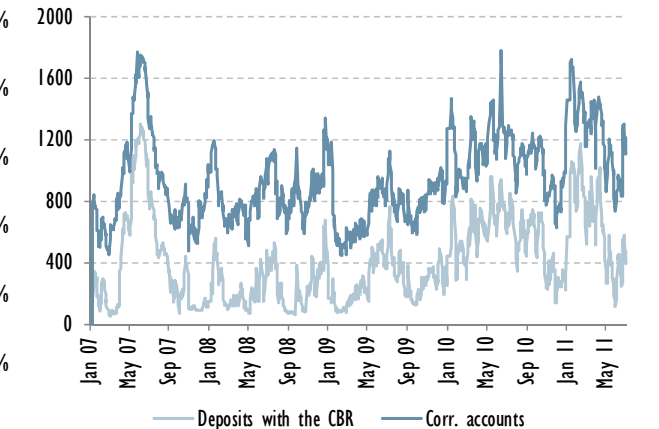
Source: Bloomberg

Russia credit quality indicators



Source: Bloomberg

Liquidity in the Russian banking system



Source: CBR

4. Stock markets

▶ Developed markets

Uncertainty over Greek debt problems resolution, combined with weak economic data, spurred high volatility in financial markets. VIX index of implied volatility rose to a 3-month high of 22.7 points before the Greek government voted on austerity plan. Lately, however, as short-term risks subsided and markets rallied, the index slumped to a pre-crisis level of 16 points.

During the 2H of the month most of the DM indices were on their way up to rebound from preceding losses. However, only a few of them managed to return to their end-of-May figures, while others ended up 1.0–1.5% lower. However, the trend seems to be shifting to positive as sentiment worldwide improves.

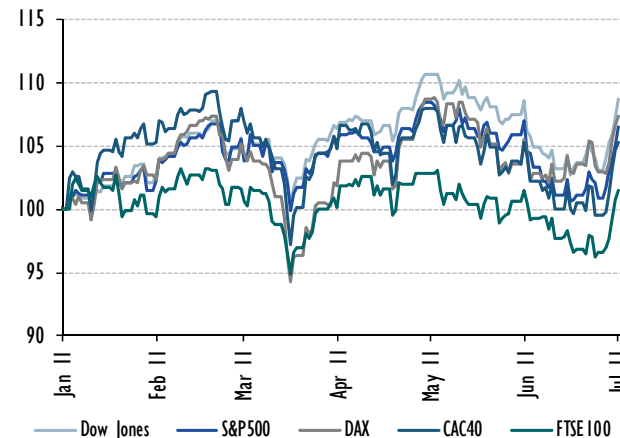
We expect that macro issues will temporarily give way to corporate events in determining the stock market dynamics in July, as corporates in US and Europe will be reporting 2Q11 results. Moreover, pan-European banking stress test results should be available by the end of the month: their publication has already been delayed due to higher scrutiny of banks' financial reports.

▶ Developing markets

Net outflow from EM equity funds extended into June, although at a smaller scale than a month earlier, draining only \$1.2 bln. Yet, EM indices generally outperformed DMs, adding on average 1.5–2.0% over the month. We see two reasons for such stock behavior: first is the general underperformance of EMs during the previous months, and the second one is their higher sensitivity to external factors. We expect EMs to do better than DMs in July, as well.

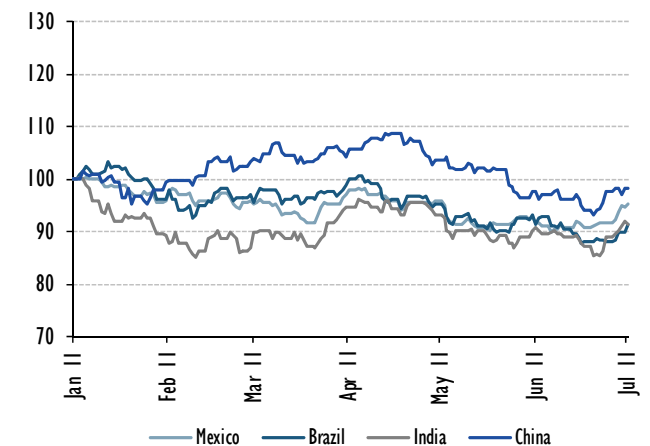
Despite high levels of ruble liquidity, Russian market was not the best performing one in June, but neither was it the worst performer. According to S&P ranking, it came 5th among the 20 markets for which the agency calculates S&P/IFCI indices.

DM stock markets dynamics, January 2010=100



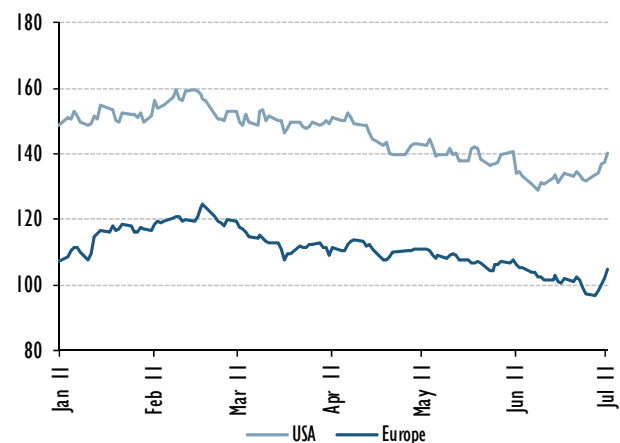
Source: Bloomberg

EM stock markets dynamics, January 2010=100



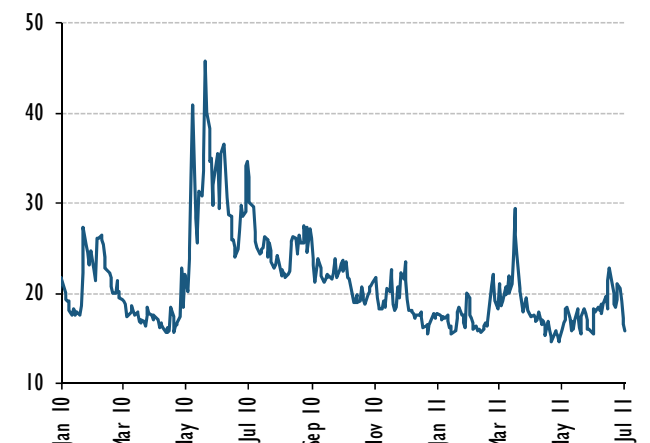
Source: Bloomberg, Gazprombank estimates

Banking stock dynamics, December 2008=100



Source: Bloomberg, Gazprombank estimates

VIX (implied volatility index)



Source: Bloomberg

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