

August 2011: the moment of truth



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Indicators stable, but tension persists

Most of the macroeconomic indicators hesitated in summer, unsure of the future dynamics. Any possible acceleration should be attributed to seasonal factors, while lack of internal drivers and overall uncertainty over the pace of the world recovery continued to weigh down on economic activity.

Historically, August has been a bad time for the Russian markets. The last month of the summer hoisted major economic and financial plunges, as well as escalation of political risks. However, over the last 13 years the resulting monthly change in stock market indices has only been negative 5 times, with the most severe declines occurring in 1998 (MICEX plunged 44.2% in August) and 2008 (-9.8%).

Leading indicators in July remained somewhat mixed, with a skew to the downside. Economic activity remained sluggish, judging by transportation dynamics and business climate indicators. However, the population's propensity to consume, presumably, continued to increase, providing producers with stronger demand for their products. The latter effect was partially eliminated by ruble appreciation (both in nominal and real terms), which contributed to imports growth acceleration.

Inflationary pressure eased further in July due to the seasonal decline in the prices 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 the core index has accelerated.

ST forecasts:

- External sector and exchange rates.** The first days of August indicate the possibility of further correction in oil prices, and we expect Urals to average at \$110/bbl (-4.8% below July average). As a result, Russian trade balance is likely to shrink further to estimated total of \$12.3 bln (assuming that imports growth rates remain high). We therefore believe that there is scope for ruble depreciation against USD in August, giving CBR an opportunity to temporarily halt interventions in the forex market. RUB/USD exchange rate is most likely to average at 28.2. The uncertainty over USD/EUR exchange rate may result in higher volatility of RUB/EUR exchange rate as well. As a result, we expect the dual currency basket value to fluctuate around RUB 33.5 in the last month of the summer.

- Real sector and price level.** Demand-side indicators seem to have gained momentum, at least for the medium term. The seasonal slowdown of inflation (to 0% MoM in July, and, presumably, August) might add to the resumption of positive RDI dynamics, while increasing lending activity and subsiding unemployment may help sustain retail trade turnover growth at above 6.0% YoY in August. We expect RDI to demonstrate an increment of 4.7% YoY, while retail sales will be 6.4% higher than a year ago.

Russian economy requires more investments in productive capacity in order to sustain existing growth rates, given that it is currently operating at full capacity. However, the uneven pace of capex so far provides little confidence in the ability of the economy to expand output in the long run. We expect resumption of working capital accumulation as demand indicators stabilize. However, diminishing low base effect will limit the increase in capex to 5.3% in August. In the short run, industrial production may grow at 5.0-5.5% YoY.

Key indicators: June forecast

Indicator	August 2011 F	2011 F	
		MED*	GPB Research
Real sector			
GDP, YoY	—	4.2%	3.9%
Industrial production, YoY	5.5%	5.4%	3.5%
Capital investments, YoY	5.3%	6.0%	6.8%
Retail sales, YoY	6.4%	3.8%	4.3%
Private sector			
Real income, YoY	4.7%	1.5%	4.4%
Accrued salary, RUB	—	23,940	23,784
External sector			
Trade balance, \$ bln	12.3	195.1	153.6
Average oil price (Brent), \$/bbl, av.	110	105	108
Exchange rate, inflation and rates levels			
Inflation (CPI), YoY	8.6%	7.0–7.5%	8.0%
Refinancing rate, eop	8.25%	—	—
Bicurrency basket, RUB (avg.)	33.5	33.4	33.0
Exchange rate, RUB/USD (avg.)	28.2	28.4	27.9

— no forecast available;

Source: MED, Gazprombank estimates

Leading indicators

▶ Money and credit

Lending decelerated marginally in June, but the trend remains positive and monetary indicators dynamics suggests that it is likely to continue. Persistent increase in the monetary base, accompanied by historically high value of the multiplier, indicates acceleration of the money transition mechanism through banks.

The latter is supported by the fact that there's been a slowdown in deposit dynamics, which might indicate a decline in the marginal propensity to save among population. Although consumer credit was extended by 2.5% YoY (down from 3.1% in May), over the 12M ending June 2011 YoY portfolio increased by 24%, which is 1.1 pps higher than a month before. Commercial lending was up 1.6% YoY in June.

▶ Energy consumption

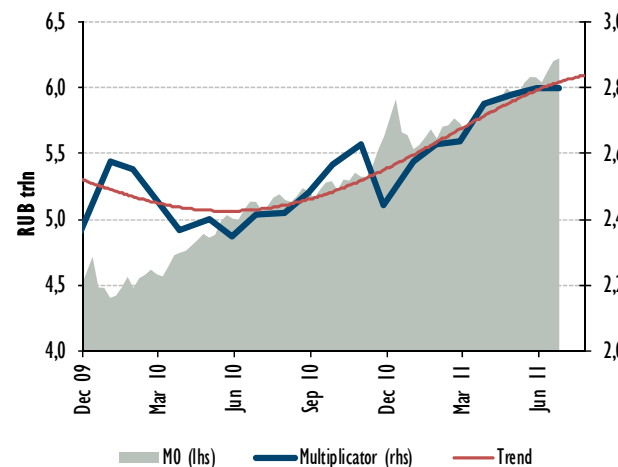
Power consumption in July demonstrated the highest growth in almost a year, increasing 4.9% YoY. Given that weather conditions in July were similar to those a year ago, the surge of energy utilization may signal faster growth in industrial production. Although the correlation (cumulative) between the two variables declined further in July, it is still reasonably high.

▶ Economic activity

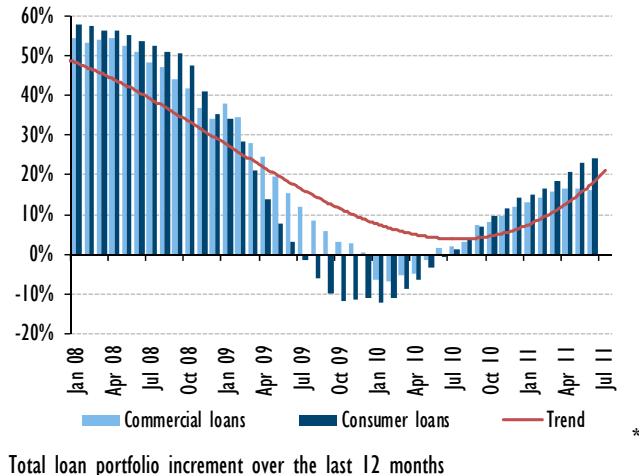
Business sentiment in July continued to deteriorate. Manufacturing PMI fell below the 50 points threshold for the first time since December 2009, indicating prevailing pessimism among producers. Output decelerated in July, and new orders declined at the fastest pace since May 2009.

Services PMI, however, rebounded in July to a healthy figure of 56.9 points, indicating acceleration of economic activity in the sector. Transportation surged 7.2% YoY in June, but this is likely attributed to the low base effect. This view is supported by the observed monthly decline in shipping volumes by 4.5%.

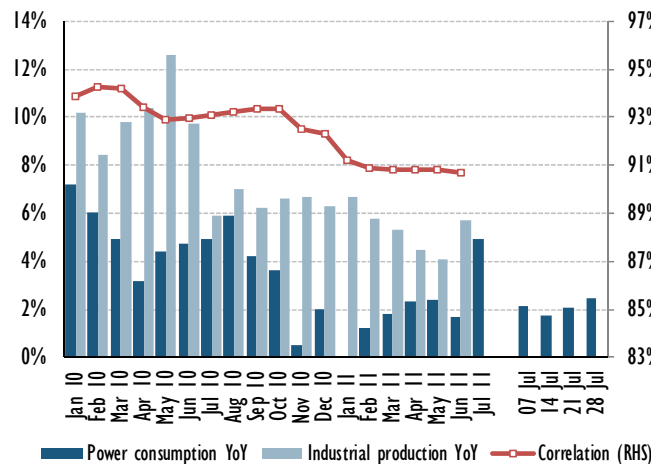
Monetary base and multiplier (M2/M0)



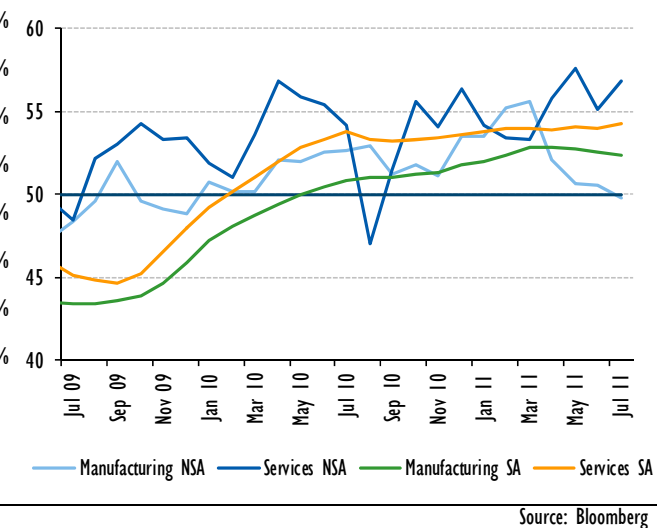
Lending volume*, % YoY



Power consumption vs. industrial production, % YoY



Russia's PMI, points



Current economic environment

- Russian GDP in June, according to MED estimates, rose by 3.9% YoY, adding to the overall increase of 3.7% in the 2Q11. Total output grew 0.3% MoM: the seasonally adjusted figures appeared to be marginally lower than a month before, but sufficiently higher than in April.

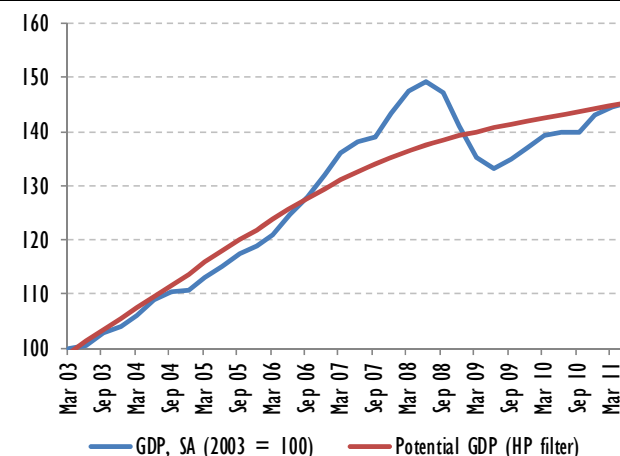
Output gap (calculated as the difference between actual and potential GDP) in the 2Q11 converged to zero, indicating that Russian economy is currently operating at its full capacity. Higher levels of output are attainable, but without extended capex they will inevitably result in higher inflation rates. The latter, however, lingers within a close range of its seasonally adjusted trend, which has been almost flat since the beginning of the year.

- Investment in productive capacity rose 4.7% in June after a 7.4% hike in May, indicating a return to its long-term trend. MoM dynamics also slowed down to 0.4% from 4.3% in May and 5.3% in April.
- External sector and exchange rates

External trade balance was almost unchanged in June at \$16.6 bln. Foreign currency purchases by the CBR were also in line with the previous month figure, and amounted to \$4.0 bln. This indicates, in our view, the ongoing outflow of capital, which has stabilized in the recent months.

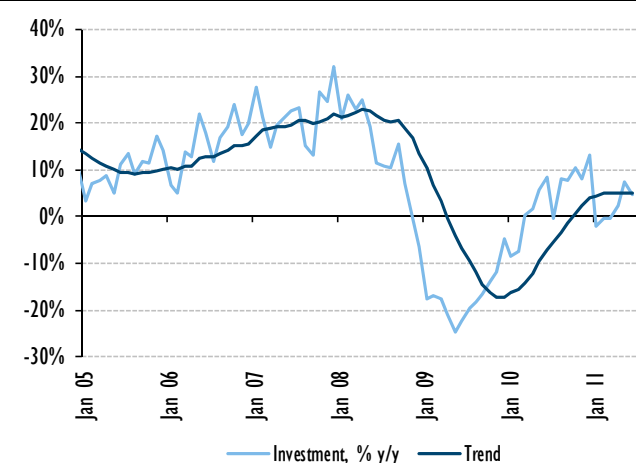
Exchange rate volatility (as measured by the dual currency basked standard deviation during the month) in July rebounded slightly from the minimum value since November 2008. However, our index of Exchange Market Pressure (EMP) for June indicates relative increase of the CBR's presence in the forex market. We believe that capital outflow might have intensified in July, presumably easing upward pressure on ruble, while a modest decline in oil prices is likely to diminish the trade surplus in August. Our assessment of the CBR's interventions, however, suggests that the pace of open market interventions remained high throughout July: official FX holdings at the CBR increased by \$7.3 bln to \$535 bln.

Real GDP (2003 = 100) and potential GDP dynamics



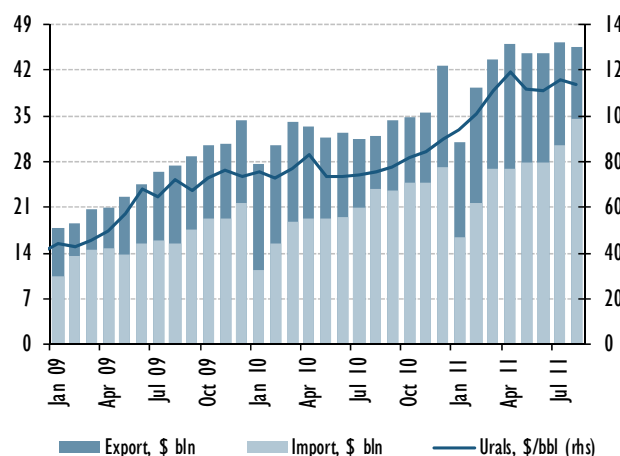
Source: Rosstat

Investment in working capital, % YoY



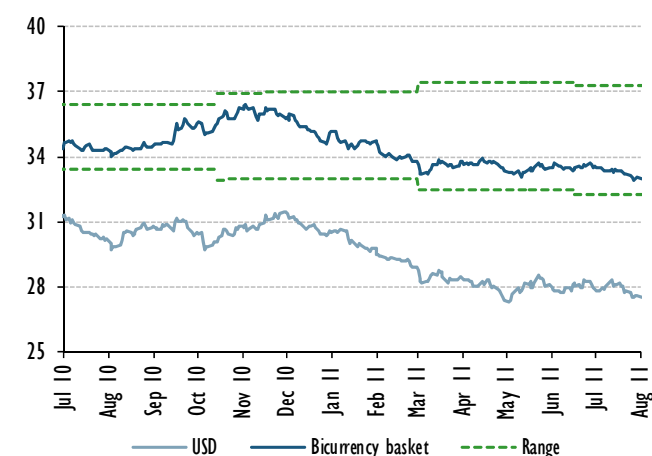
Source: Rosstat, Gazprombank calculations

Russia's trade balance vs. oil prices



Source: Bloomberg, CBR, MED

Ruble exchange rates



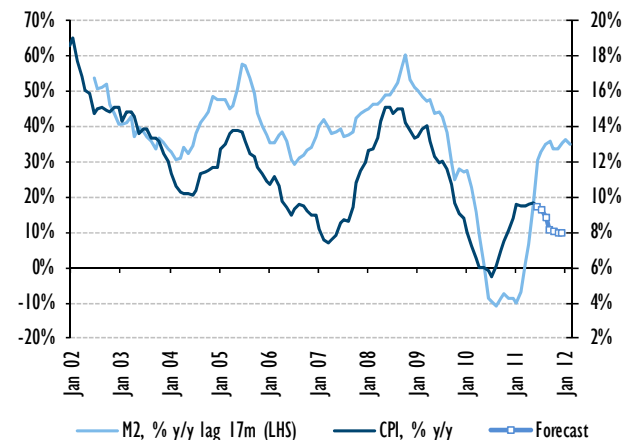
Source: Bloomberg, CBR

▶ **Consumer confidence**

RDI resumed growth in June, adding a modest 0.7% YoY after 3 consecutive months of decline. After accounting for seasonal influences, the indicator showed a 2.7% growth MoM, which is a strong positive improvement, but not enough so far to compensate for the plunge in the preceding months: over the 1H11 SA RDI declined ca. 3.1%, and the figure is 1.4% below the level of 1H10.

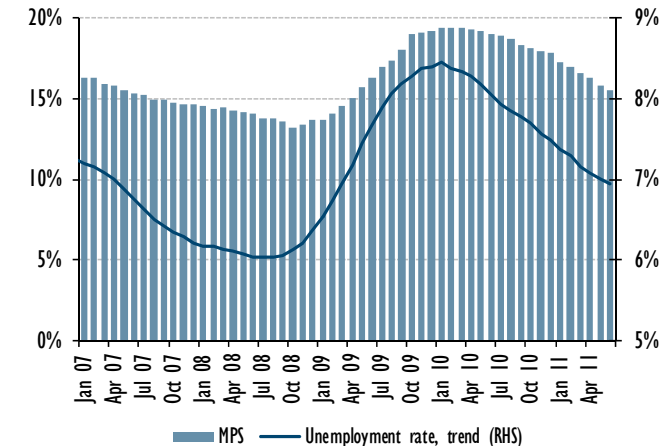
The confidence in 2Q improved somewhat, although the general indicator of consumer satisfaction remained in the negative territory, indicating prevalence of pessimism among population. Further decline in unemployment (although mostly attributed to seasonal factors) and improving personal incomes seem to support the view that marginal propensity to save is declining. This, combined with higher lending activity on behalf of banks, contributed to growth in retail sales. Turnover increased 5.6% YoY in June, which is slightly above the average figure YTD.

Inflation and money supply dynamics: risks are evident



Source: Rosstat, MED, Gazprombank estimates

Consumer confidence indicators



Source: Rosstat

▶ **Inflation**

Inflation slowed down further in July: prices actually fell during the last week of the month, resulting in zero growth over the whole period. Yearly inflation declined to 9.0% by the beginning of August as compared to 9.4% at the end of June.

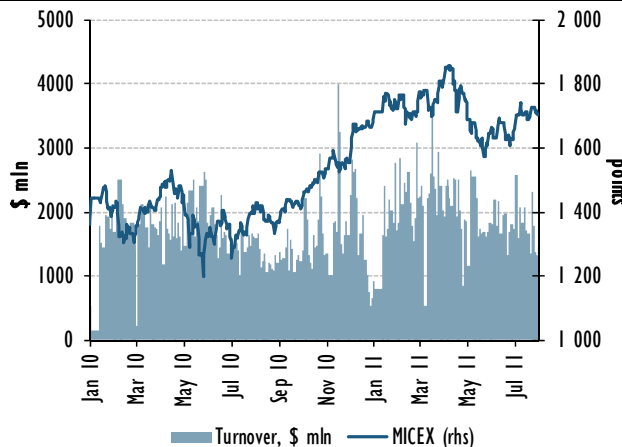
The seasonal decline in the price of agricultural products has been the key reason for the slowdown of inflation, and this effect is likely to persist in August, and, perhaps, September. Core CPI (this indicator is unaffected by seasonal influences) accelerated to 0.4% in June, outpacing the headline inflation.

▶ **Capital markets**

Russian stocks in July consolidated around 1700 points, as measured by MICEX index. The indicator rose by 2.3% over the month, and dollar gauge performed slightly better (RTS added 3.1%). The discrepancy resulted from ruble rise against USD.

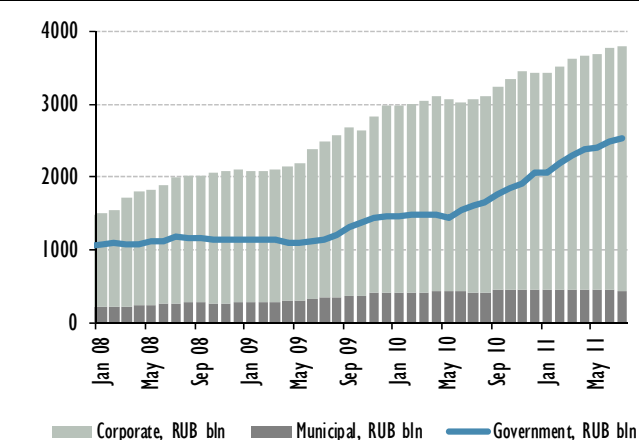
Minfin raised as much as RUB 77.5 bln through LT OFZ issues in July (ca. 70% of the planned amount) and OFZ yields on the far end of the curve generally declined (20-50 bps depending on duration).

Stock market dynamics



Source: Bloomberg

Bond market volume (at par value)



Source: Cbonds

Appendices

1. Economic situation abroad

▶ Europe

Fears of Greek default and contagion of the debt crisis to other countries in the region subsided in July after the parliament of Hellenic Republic approved new austerity measures. The EU leaders welcomed the compromise and presented the new aid package.

Given that Greece would be able to comply with the new budget parameters, it will gain access to additional EUR 109 bln provided by the EU members and IMF, and financial institutions will contribute another EUR 50 bln by accepting new bonds with longer maturity in exchange for maturing debt. In order to stem contagion the EFSF was granted the authority to purchase debt of troubled countries and provide liquidity assistance to financial institutions in the region.

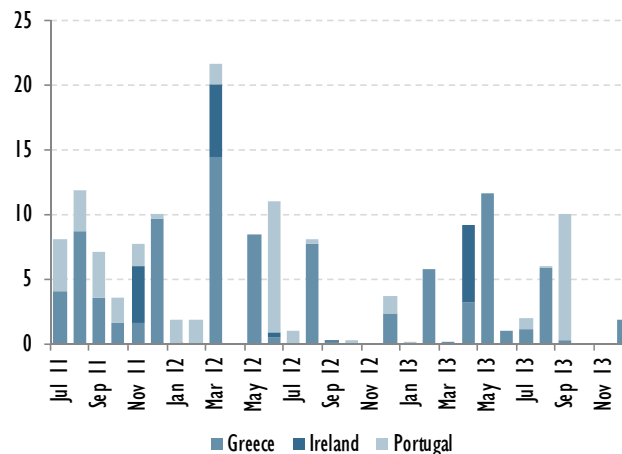
Although risks in the Eurozone remain (as implied by historically high yields on Italian and Spanish 10-year bonds), preventive actions seem to spur some confidence. Notably, 5-year CDS spreads on Greek bonds narrowed from the all-time high of 25 pps to ca. 17 pps. Cost of insurance against Irish and Portuguese default exhibited a similar dynamics.

▶ USA

USA has taken the lead in unnerving the market players during July as Congress members continuously failed to reach a consensus over raising the country's debt limit. The risk of a technical default was eliminated hours before the deadline (2 Aug), but as soon as it happened investors switched their attention to weak macro fundamentals and risks of a rating downgrade by the major rating agencies.

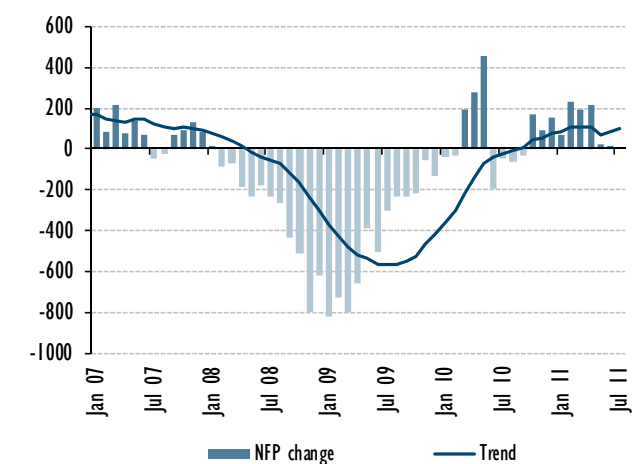
EUR/USD exchange rate remained volatile in July under the influence of mixed factors, fluctuating in the range 1.4–1.5. August is likely to see further volatility surge as Trichet signals slower pace of interest rate hikes while FRS may announce further measures to support sluggish economic growth in the US. Given debt problems in both regions, the EUR/USD exchange rate will likely remain within the given range.

Debt redemption schedule, EUR bln



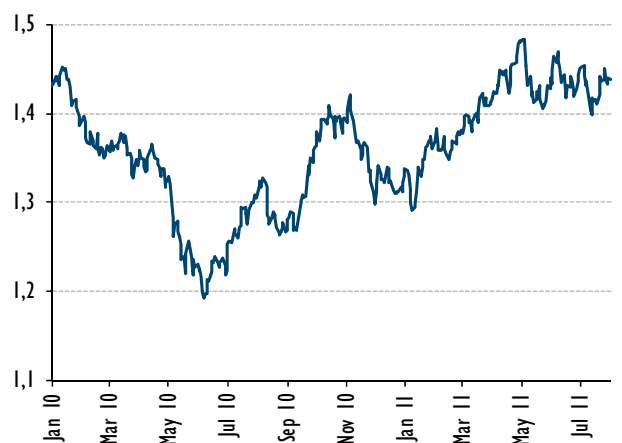
Source: loomberg

Change in non-farm payrolls, thousand



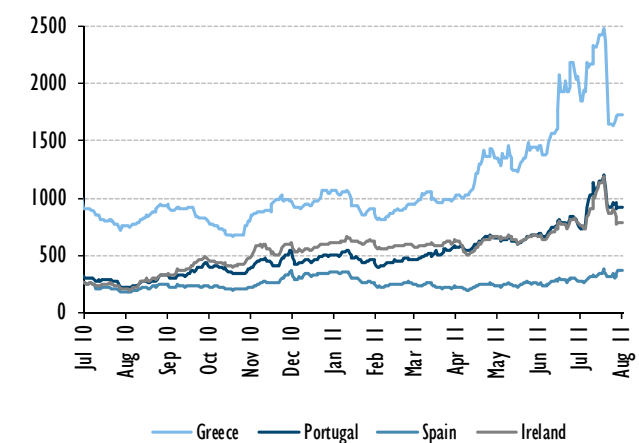
Source: Bloomberg, Gazprombank calculations

EUR/USD rate dynamics



Source: Bloomberg

5-year CDS spreads dynamics on Eurozone members' debt



Source: Bloomberg

2. Commodity markets

▶ China

Chinese data offers no consolation to investors as well. Business activity indicators declined in July, while inflation risks remained upbeat. Manufacturing PMI, according to the official statistics, marginally exceeded the 50-point threshold, while HSBC reported a figure of 49.3, which indicates a decline in economic activity. At the same time, CPI growth accelerated to 6.4% YoY, reaching a 3-year peak.

However, imports are expected to accelerate in July, which might be a positive sign for commodities.

▶ Oil

Despite some pressure from IEA's interventions, the average oil price in July increased by 3.7%, fuelled mostly by dollar depreciation. The latter's volatility, in our view, has also contributed to higher fluctuations in commodities markets.

The futures curve at the end of July had a small negative slope, indicating expectations of a modest decline in prices towards the end of the year. However, the general price level has increased \$3.5-4.5/bbl over the month, depending on the contracts' maturity.

▶ Metals and other indicators

Shipping costs continued to decline in July, sliding 10% MoM, as measured by the Baltic Dry index. The indicator remains under pressure from overcapacity, with vessels being hired at a rate covering only fuel costs (i. e., at a loss to the shipping company).

Gold surged in July as investors were looking for a safe haven in the midst of uncertainty. The precious metal gained 8.5% over the month, and continued to appreciate in the beginning of August, reaching an all-time high at \$1673.5/Oz.

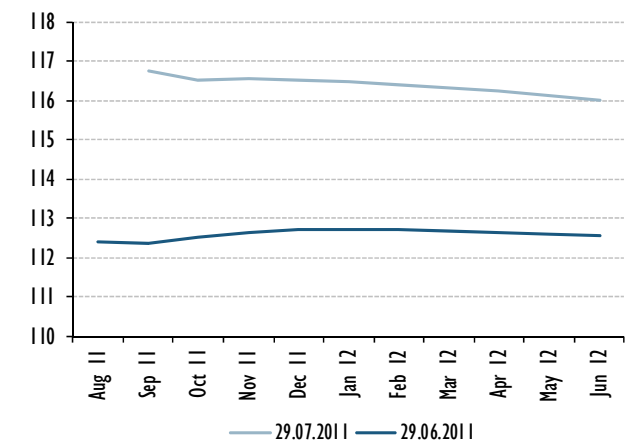
Industrial production in Japan slowed down a little in June (to 3.9% MoM from 6.2% in May). However, we expect economic activity to resume recovery in the months to follow as the country struggles to revamp the infrastructure.

Urals price dynamics, USD/bbl.



Source: Bloomberg

Brent futures, USD/bbl.



Source: Bloomberg

Bae 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, after surging to nearly 3.2% in the beginning of July, thereafter resumed decline, finishing the month at levels below 2.8%. The demand for Treasuries increased despite rating agencies' warnings about potential US downgrade and congressional impasse over the debt limit. Yields continued to fall in August (to 2.56%), following the deal on austerity measures and new borrowing capacity.

Key MM spreads shrunk in the beginning of August as weak macro fundamentals spurred talks of another round of QE by the FRS. The regulator may announce the likely schedule after FOMC holds its meeting on August, 9. TED-spread narrowed to 16.4 bps (the lowest level since the beginning of the year), and 2-year swap spread decreased to 23.4 bps.

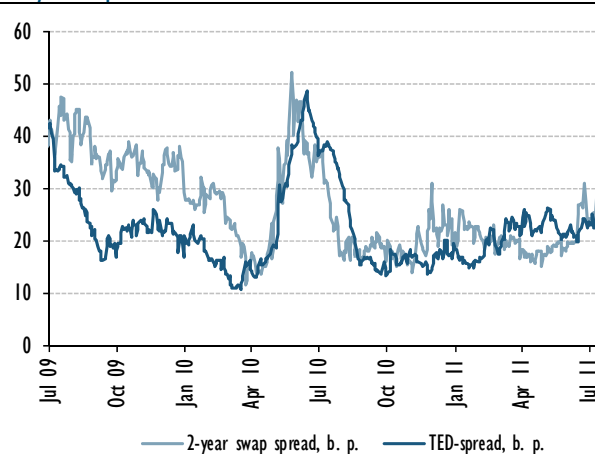
▶ Russian money & FI markets

Tax payments in July temporarily undermined the LT MM equilibrium. The amount of liquidity in the banking system declined by almost RUB 500 bln, reaching a local minimum at RUB 823.4 bln (as measured by the total amount of cash deposited with the CBR and other banks' correspondent accounts) on the 28th of the month. The federal budget was likely executed with a surplus in July, resulting in absorption of liquidity. Such situation is likely to persist until late autumn, when a seasonal acceleration of budget expenses is expected to provide the Russian MM with inflow of liquidity.

The level of interbank interest rates generally fluctuated within the range 3.5–4.5% (o/n loans for Tier 1 banks), with a temporary increase to 5.0% towards the end of the month.

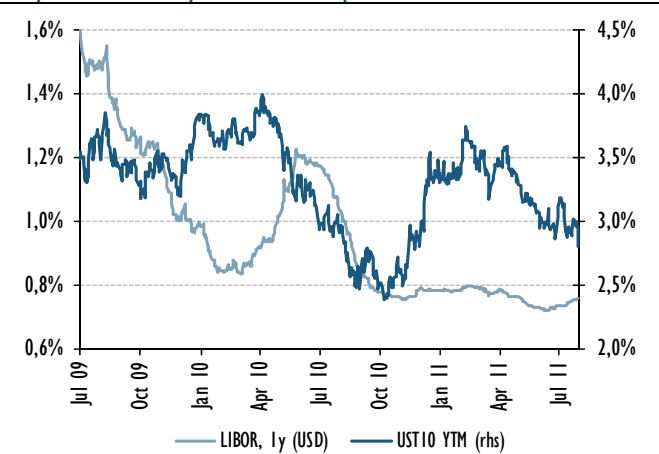
The flow of funds from equity-dedicated funds to the ones focused on bonds contributed to relatively better performance of the Russian Eurobond market. Yields on the most liquid issue (Russia-30) dropped 29 bps to 4.12%, and their spread to UST rates was almost unchanged at 125 bps.

Key MM spreads



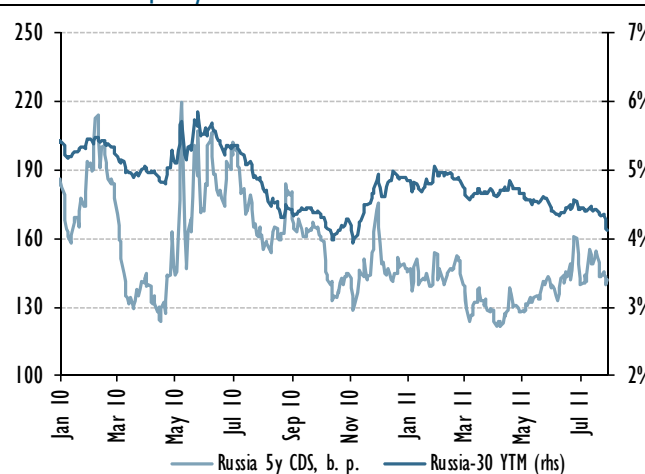
Source: Bloomberg

1y LIBOR and 10y US Treasuries yield



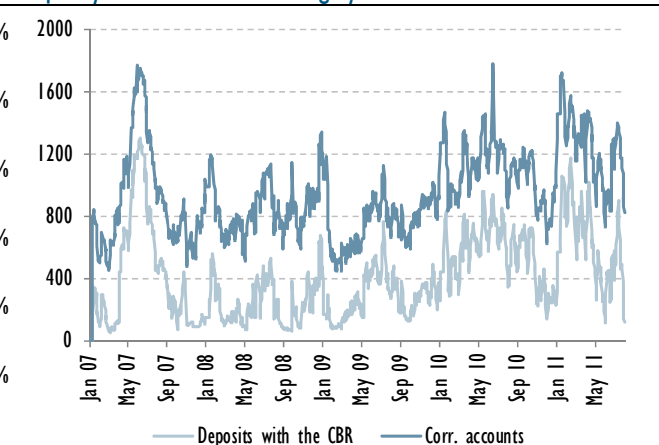
Source: Bloomberg

Russia credit quality indicators



Source: Bloomberg

Liquidity in the Russian banking system



Source: CBR

4. Stock markets

▶ Developed markets

Strong earnings results dissolved in the flow of weak statistics and escalated tensions over debt. Companies comprising S&P 500 stock market index reported a combined growth in EPS of 17.5% YoY in 2Q11, exceeding expectations by 5.5% on average, while only one in every four companies publishing financial results missed forecasts.

However, market sentiment in July was determined mainly by political tensions, both in the US and Europe. Rating agencies also contributed to the selloff by announcing potential credit downgrade of the US's 'AAA' rating. Although Moody's and Fitch affirmed the current grade for the largest economy, S&P still hesitates with the verdict. VIX index of implied volatility rose to 25 points, adding more than 50% since the end of June.

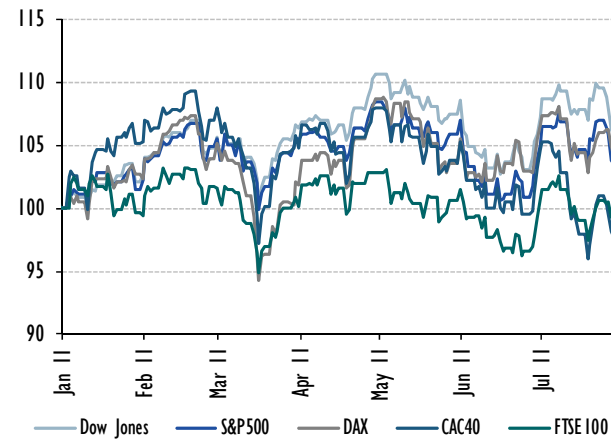
DM indices fell 2-3% over the month with industrial and consumer-oriented stocks leading the decline. Banks in Europe fell by ca. 8% after stress test results were published. Markets questioned the underlying assumptions, especially in the part concerning potential losses from holding sovereign debt.

▶ Developing markets

EM indices generally underperformed DMs in July, losing 1.5-5.5%. The net inflow into EM equity-dedicated funds over the first half of July did not turn into actual purchases: most fund managers preferred to keep cash on their balances rather than form positions in the volatile market. The sign of fund flows changed in mid-July, and a net outflow occurred over the last three weeks, amounting to \$2.0 trln. The bond markets appeared to be the key beneficiary, attracting most of the cash.

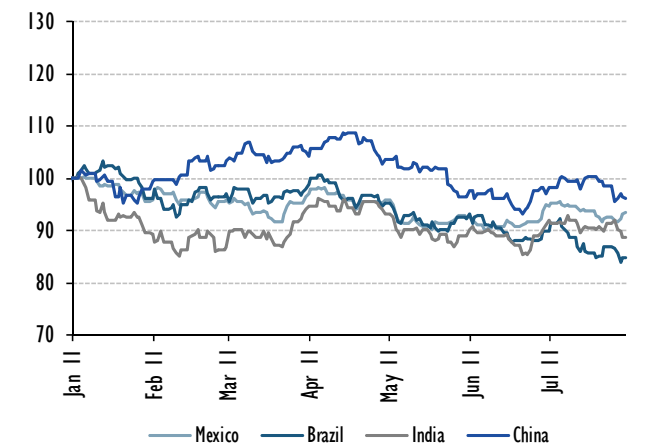
Once again, Russian market demonstrated the 5th best result among the 20 emerging markets for which S&P/IFCI indices are calculated. Notably, growth of the Russian stock indices overtook the dynamics of peer gauges in other BRIC countries.

DM stock markets dynamics, January 2010=100



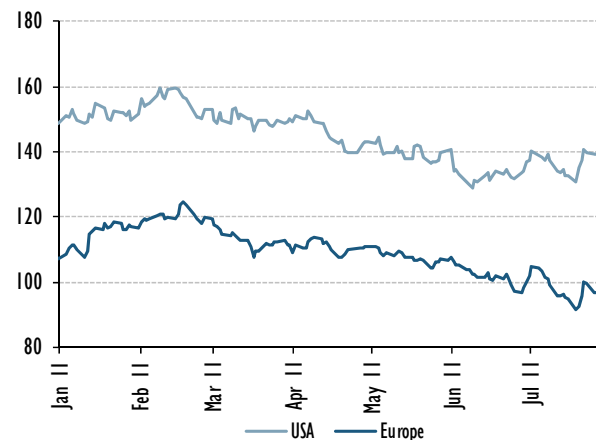
Source: Bloomberg

EM stock markets dynamics, January 2010=100



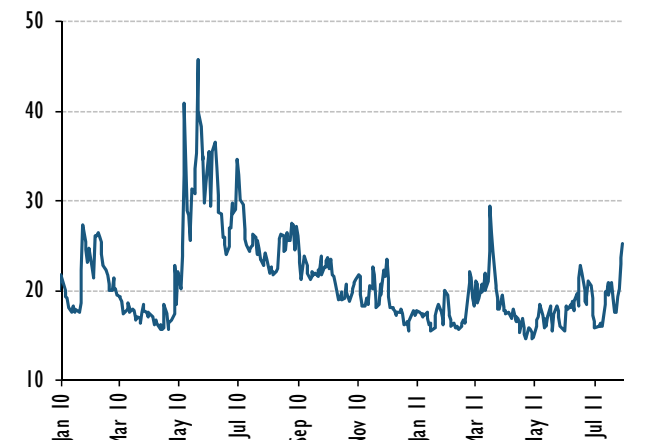
Source: Bloomberg, Gazprombank estimates

Banking stock dynamics, December 2008=100



Source: Bloomberg, Gazprombank estimates

VIX (implied volatility index)



Source: Bloomberg

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