Ukraine. Monthly Market Overview

December 2014

Ukraine Sovereign Ratings

LCY rating	S&P	Moody's	Fitch
Long-term	B-	Caa1	CCC
Short-term	B	-	-
Outlook	Stable	Negative	Negative
FCY rating			
Long-term	CCC	Caa3	CCC
Short-term	C	NP	C
Outlook	Stable	Negative	Negative
Latest assessment	11/07/14	04/04/14	22/08/14

Financial Markets team

CRÉDIT AGRICOLE

Major Macroeconomic Trends

MACROECONOMIC INDICATORS - evolution

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014F*	2015F*
Nominal GDP (USDbn)	38.0	42.4	49.5	64.9	86.2	107.7	142.7	129.0	117.4	136.2	165	174	178	132	123
Real GDP growth (%)	9.2	5.2	9.4	12.1	2.7	7.3	7.9	2.1	-14.8	4.2	5.2	0.2	0.0	-8.5	-5.0
Inflation CPI, eop (%)	6.1	0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	23.1	11.0
Industrial production (%)	14.2	7.0	15.8	12.5	3.1	6.2	10.2	-3.1	-21.9	11.0	7.6	-1.8	-4.7	-11.2	-5.8
Merchandise exports (USDbn)	20.1	23.4	28.9	41.3	44.4	50.2	64.0	78.7	39.7	51.4	68.4	68.8	63.3	57.4	61.3
Merchandise imports (USDbn)	17.7	21.5	27.7	36.3	43.7	53.3	72.1	92.2	45.4	60.7	82.6	84.6	77.0	61.2	61.9
Public debt (% of GDP)	37.1	33.5	29.0	24.8	18.0	14.8	12.0	13.7	32.2	39.7	36.2	36.6	41.0	59.9	68.9
Current account (% of GDP)	3.7	7.5	5.8	10.7	2.9	-1.5	-3.6	-7.1	-1.5	-2.2	-5.5	-8.5	-9.1	-3.8	-3.2
Net FDI inflow over year (USDbn) NBU methodology	0.8	0.7	1.4	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	6.6	3.3	0.0	2.6

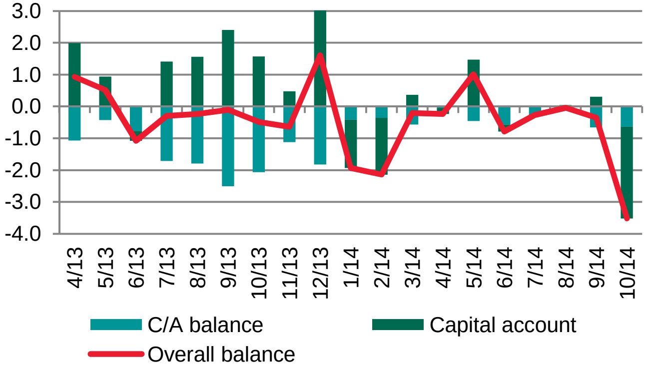
EXCHANGE RATES - evolution

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014F*	2015F*
USD/UAH eop	5.30	5.33	5.33	5.31	5.05	5.05	5.05	7.70	7.98	7.96	7.99	8.04	8.24	16.00	15.00
USD/UAH average	5.37	5.33	5.33	5.31	5.12	5.05	5.05	5.32	7.79	7.93	7.97	8.02	8.16	12.60	15.45
EUR/UAH eop	4.70	5.05	6.70	7.20	6.00	6.70	7.42	10.86	11.45	10.57	10.30	10.54	11.04	19.84	17.85
EUR/UAH average	5.1	5.02	6.02	6.61	6.38	6.26	6.92	7.78	10.88	10.52	11.09	10.31	10.81	16.07	18.85
UAH O/N average	16	3.5	6.5	5.3	3.5	4.0	3.5	11.3	8.4	1.5	5.7	11.9	2.7	8.2	6.5

- While the military conflict in eastern Ukraine has remained moderately frozen, the political scene has brought more news recently. It took just a few weeks for the newly elected parliament ***to form a coalition with a constitutional majority (302 votes), elect a prime minister and appoint ministers to the government. The government initially provided optimism*** regarding its future policy. It seems to be rather technocratic as it is made up of experienced foreigners as well as successful domestic managers. ***The major question still remains whether it will be able to break the corrupt and bureaucratic regime and launch reforms***.
- ***The visit of the IMF technical mission in mid-November brought no visible result.*** We think this mostly occurred because the new government had not yet been created. Therefore, the consultation will continue with the new government already in mid-December, as the newly appointed finance minister has promised to call the IMF mission back into Ukraine as soon as possible. In any case, the postponement of the IMF mission's visit ***raises the probability of the disbursement of the next IMF tranche (USD2.8bn) in early 2015, not in 2014*** as was previously expected. However, ***the postponement should not be critical in the coming months*** given moderate external funding needs. ***The probability of the IMF stand-by program continuing still remains high*** as this is the core source of external financing for the government for the coming half year. Additionally, the government has implemented the majority of IMF requirements this year.

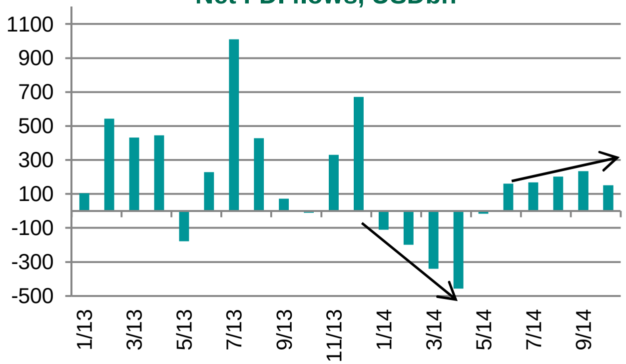
Ukraine. Monthly Market Overview. December 2014
Major Macroeconomic Trends

Major accounts of BOP, monthly dynamics, USDbn



Sources: NBU, Credit Agricole

Net FDI flows, USDbn



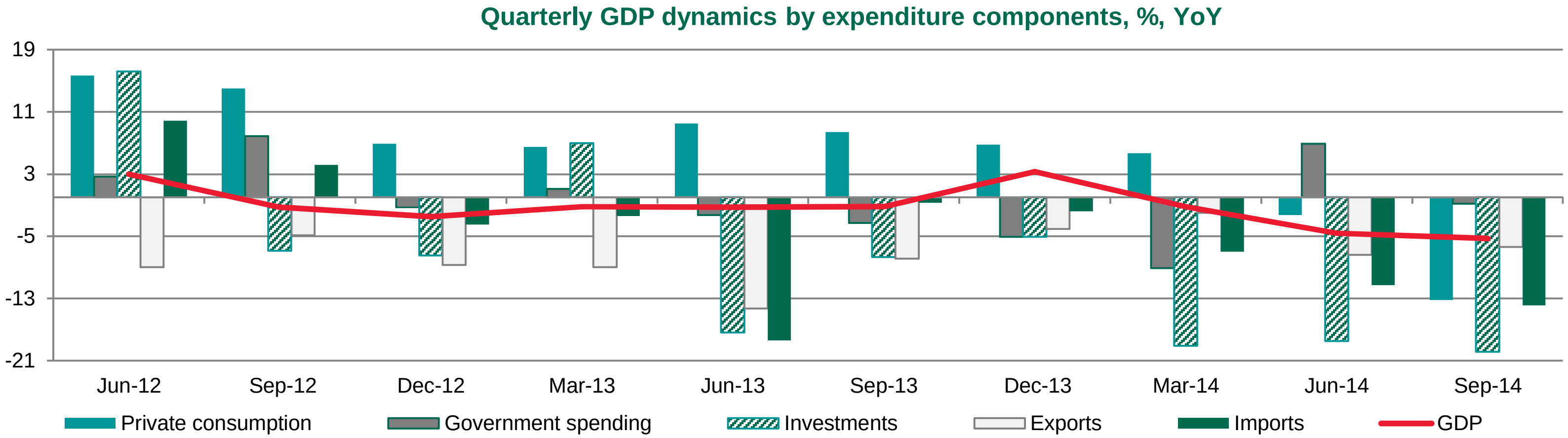
Sources: NBU, Credit Agricole

Forecast	GDP, YoY
Q414	-19.5%
Q115	-13.3%
Q215	-7.4%
Q315	-3.9%

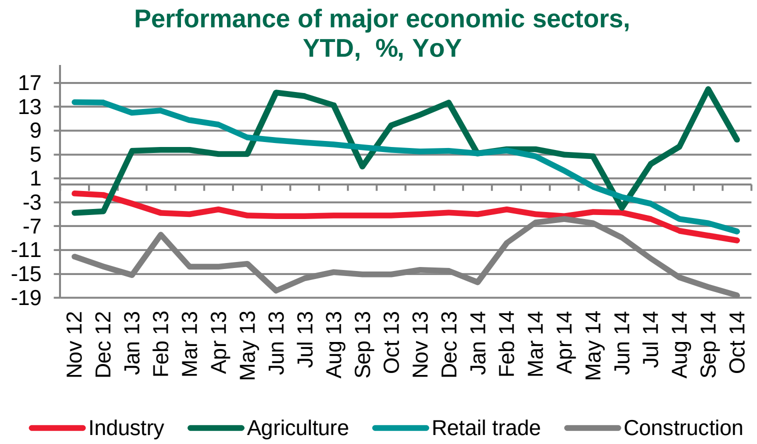
Source: Credit Agricole

- Preliminary estimates show a ***GDP decline of 5.1% YoY over Q314 – significantly better than the market consensus forecast (-9.3%)***. We think official statistics do not truly reflect the impact the conflict in eastern Ukraine had on economic performance last quarter. In any case, we ***think the Q414 figure will look considerably worse*** than the quarter before. We predict it to drop by 15.5% YoY.
- Even though most economic sectors improved their performance slightly in October, the ***general index of economic performance worsened visibly*** that month. We think a sudden YoY decline in agriculture (-21.5% in October) affected the dynamics mostly. We do not attribute this sudden decline to a sharp contraction in agricultural output but rather to a shift in the timing of the harvesting campaign and the production of major agriculture commodities. In fact, the ***grain yield this year was the highest since Ukraine gained its independence***. This will allow the volume of the grain harvest in 2014 to be quite close to last year's figure even though Ukraine has lost a portion of arable land since then.
- The improvement in the performance (in YoY terms) of major Ukrainian sectors in October was rather moderate, although ***in MoM terms most of them still showed growth***. In fact, the contraction in industrial output was slightly lower (-16.3% YoY) than September's figure (-16.6.%). At the same time, the sector demonstrated a solid improvement in MoM terms (7.5%), with the majority of core sectors (including food, steel, mining) following the same path.
- ***We could predict a further improvement in the performance of major economic sectors in the near term***, should there be no further seizure of Ukrainian territory by terrorists or the Russian army. The domestic economy is continuing its adjustment to current conditions by switching its output more to regions not directly involved in the war, by simultaneously targeting its external trade more towards Western markets.
- ***The BOP worsened considerably in October showing a USD3.52bn deficit.*** We attribute the bulk of this worsening to the repayment of Naftogaz Eurobonds. ***Other items of the BOP remained mostly unchanged compared to September.*** In particular, the CA deficit in October (USD0.63bn) changed little compared to September's figures, while the renewal of active gas imports on the eve of the heating season was the core reason behind the recent worsening in the CA balance compared to summer figures.
- ***In merchandise, external trade exports in October showed the largest YoY decline this year (-24.8%),*** reflecting the high existing risks, ie, the active conflict in eastern Ukraine and trade war initiated by Russia. In particular, chemicals and engineering showed the sharpest YoY decline. At the same time, ***the dynamics in the steel sector already returned to positive territory in October*** due to the adjustment of the sector to production in regions not involved in the conflict. Another positive is that ***FDI still remains positive in the BOP for a fifth month in a row***, albeit slightly lower than the month before.
- ***The rather gentle repayment schedule of government external debt in November should reduce the deficit of the BOP this month***, while active gas imports should keep the CA balance close to the level of October. We also think that more flexible exchange rate dynamics since November as well as growing hryvnia rates should raise the rollover ratio in the corporate segment, thus improving the BOP.

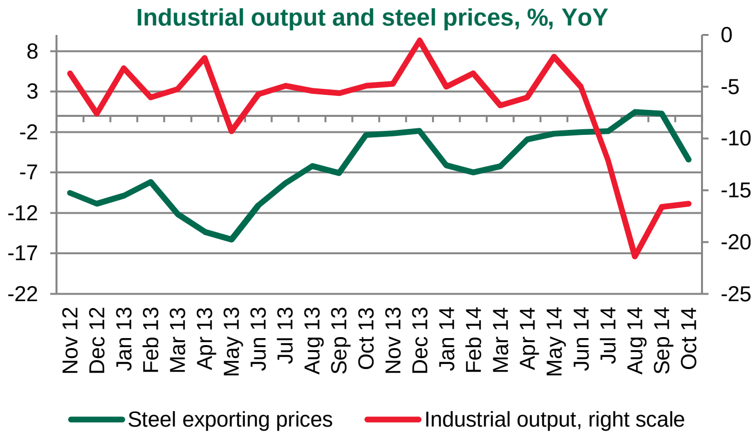
Ukraine. Monthly Market Overview. December 2014
Major Macroeconomic Trends



Sources: State Statistics Committee



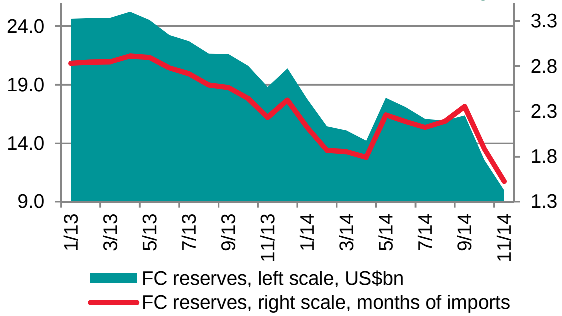
Source: State Statistics Committee



Sources: State Statistics Committee, Bloomberg, Credit Agricole

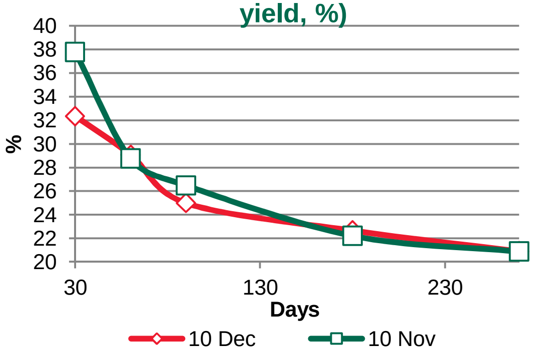
Ukraine. Monthly Market Overview. December 2014
FX Market

NBU FC reserves and their coverage



Sources: NBU, Credit Agricole

USD/UAH NDF curve (implied yield, %)



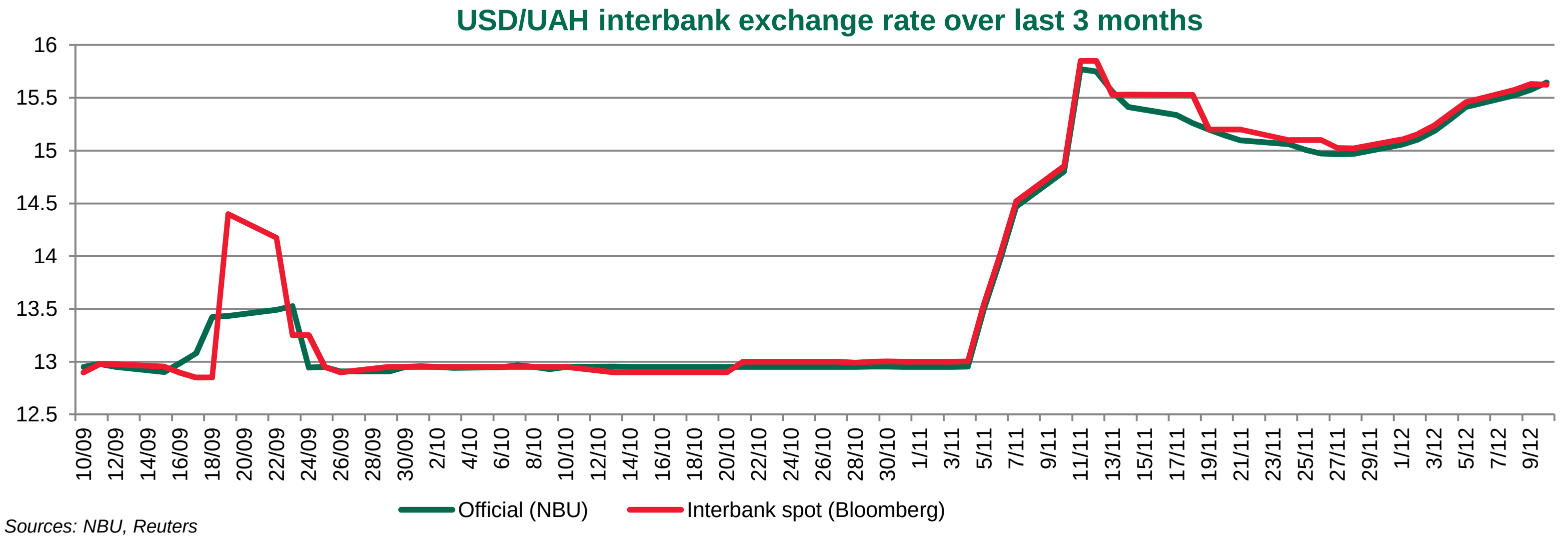
Source: Bloomberg

Forecast, eop	USD/UAH	EUR/UAH
Q4'14	16.00	19.84
Q1'15	15.50	18.91
Q2'15	14.20	17.04
Q3'15	14.80	17.76

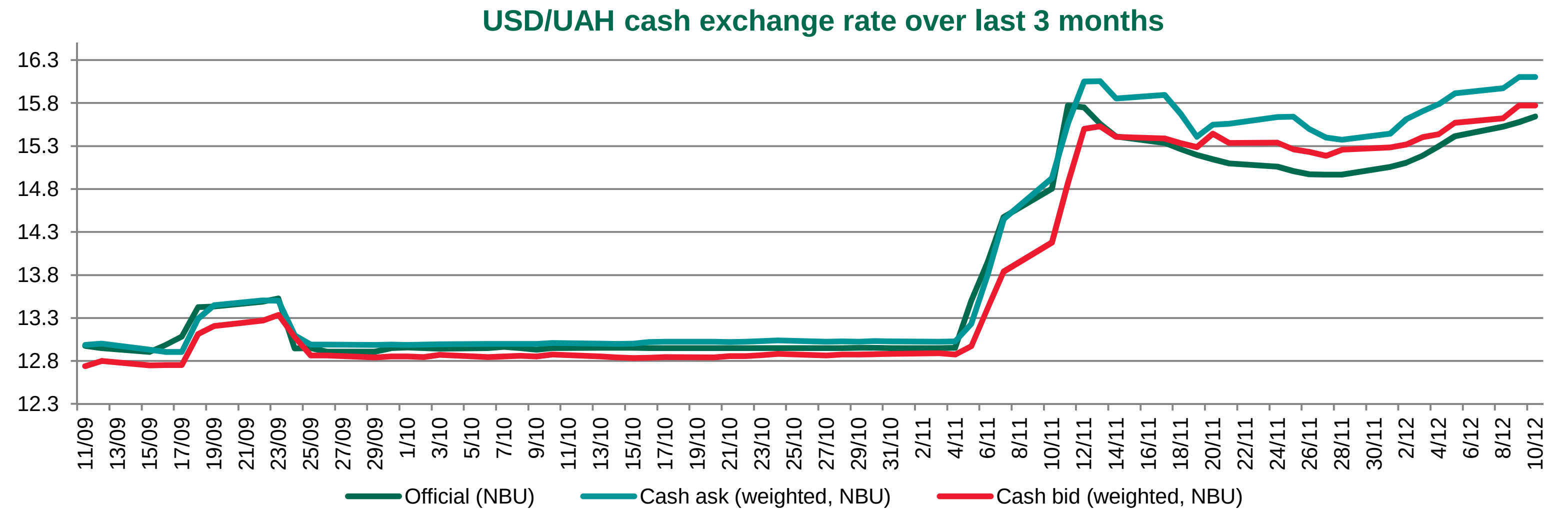
Source: Credit Agricole

- Closer to the expiry date of the requirement for 75% mandatory FX sales*, **the market expected the reduction of the ratio to 50%*** as well as a softening of other administrative FX market restrictions adopted by the NBU in early September. However, the market's hopes were not realised as, contrary to both market expectations and the recent statements of NBU officials on the liberalisation of the FX market in early December, ***the NBU decided to prolong all existing administrative requirements for three more months (ie, until early March 2015***). The news discouraged the market, reducing FC supply and correcting the USD/UAH upwards. Consequently, the rate moved in the range of 15.50-16.00 in the first half of December. However, as the macroeconomic environment as well as geopolitical risks have not worsened since then, ***the rate has followed just an 'emotional' upward correction***. Moreover, recent data on agricultural exports has shown the volume of exports 10% higher in YoY terms, thus providing no arguments for worsening fundamentals able to weaken hryvnia further.
- Even though the NBU again required banks not to quote the USD/UAH considerably above the level targeted by the National Bank (16.00 as of mid-December***), we should not see a rapid accumulation of postponed demand in the FX market*** in the manner of the month before. First of all, macroeconomic conditions have not worsened over the past month. Secondly, foreign currency demand follows a seasonal decline in December on the back of weaker business activity in the second half of the month and a reduction of pre-Christmas imports. Therefore*, **we do not predict any significant USD/UAH devaluation in December, although we downgrade our USD/UAH year-end forecast to 16.00*** as the market recently reacted negatively to the NBU's decision not to abolish the administrative exchange rate restrictions and extend them for another three months. As a result, ***we also downgrade our 2015 year-end USD/UAH forecast to 15.00***. In contrast, NBU still views USD/UAH at 13.00 as the fundamentally driven rate. Therefore, it recommends creating the budget for 2015 at this rate.
- ***A solid drop in NBU FC reserves in November (by USD2.62bn) to a ten-year low of USD10.0bn was no great surprise to the market***. In particular, in November the NBU had to spend USD1.45bn on the partial repayment of the Russian gas debt and USD0.45bn for servicing government external obligations. The National Bank also spent USD0.57bn for FX market interventions.
- The smaller volume of reserves reduced its import coverage ratio to 1.5 months. Even though the dynamics in NBU FC reserves had a negative emotional impact on the FX market, ***we estimate this reduction as moderately negative for the economy.*** In particular, the volume of external debt repayments is USD1.27bn for the coming two months, while we still expect the receipt of a new standby loan tranche of USD2.8bn from the IMF in January 2015. Nevertheless, ***we expect a further reduction in NBU FC reserves to around USD8.0bn in December*** due to the additional payment for gas to be delivered in early 2015 from Russia as well as due to the necessity to repay the arrears for Russian gas delivered in H114.
- ***The cash FX market showed a rather small imbalance in November*** (USD21m deficit) compared to the October figure (USD339m deficit). However, this improvement does not reflect any positive changes in market sentiment yet, but rather indicates the presence of NBU administrative restrictions, as well as the decision of the latter not to sell foreign currency from its reserves to banks' cash via their cash outlets. As the NBU has extended its administrative restrictions on the FX market, we ***think the imbalance of supply and demand in its cash segment will remain artificially low in the coming month.***

Ukraine. Monthly Market Overview. December 2014
FX Market



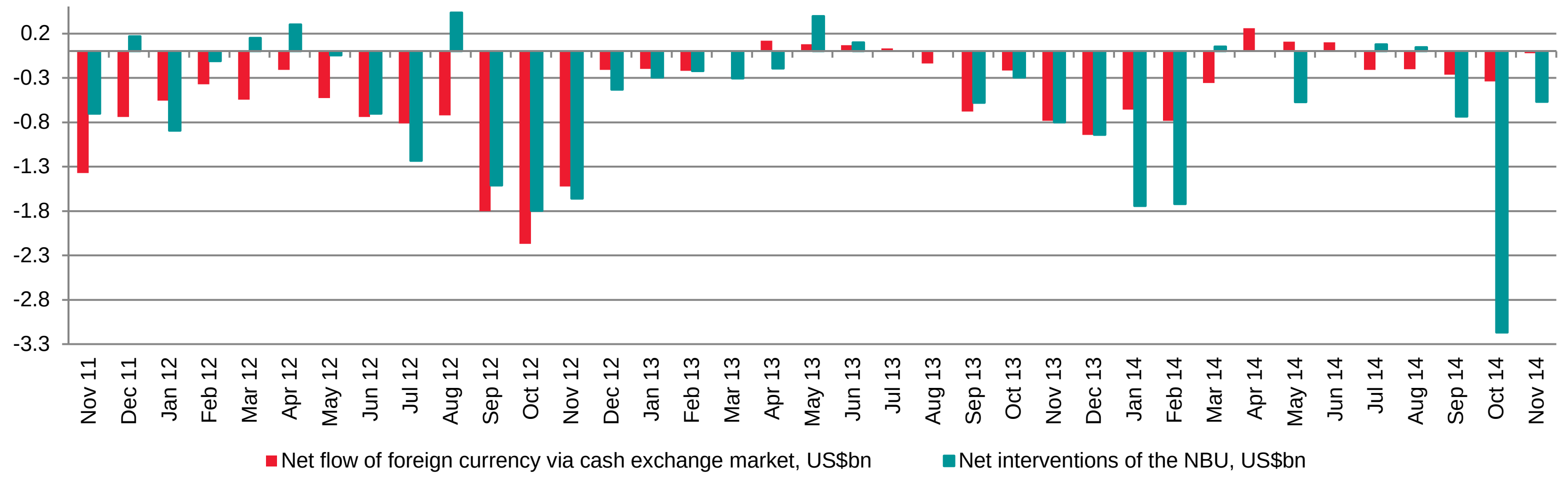
Sources: NBU, Reuters



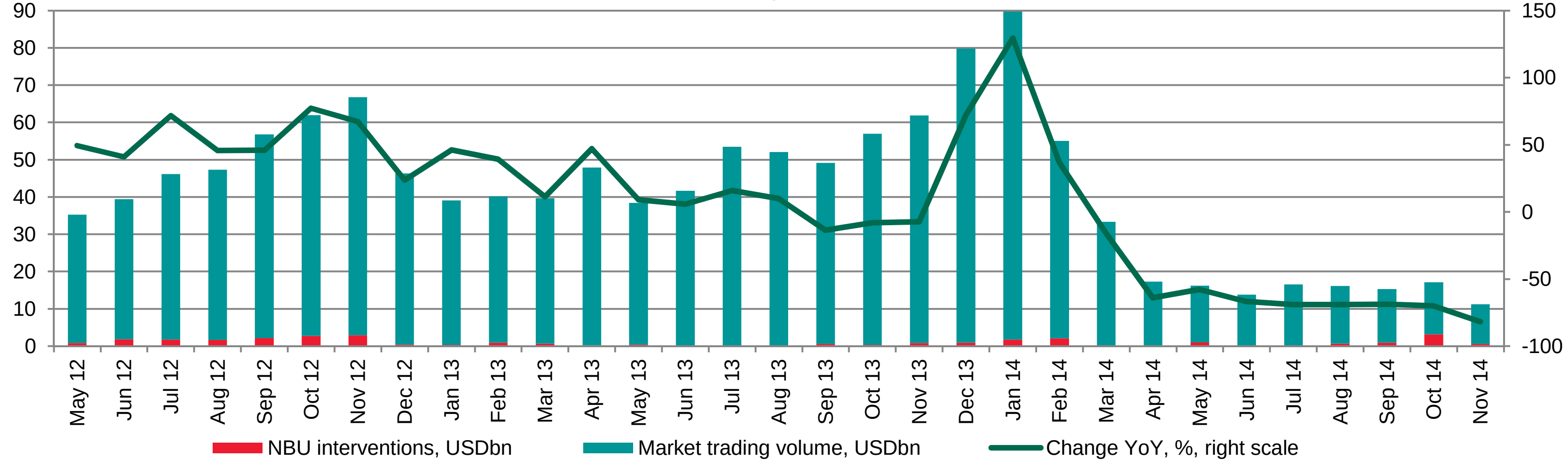
Source: NBU

FX Market

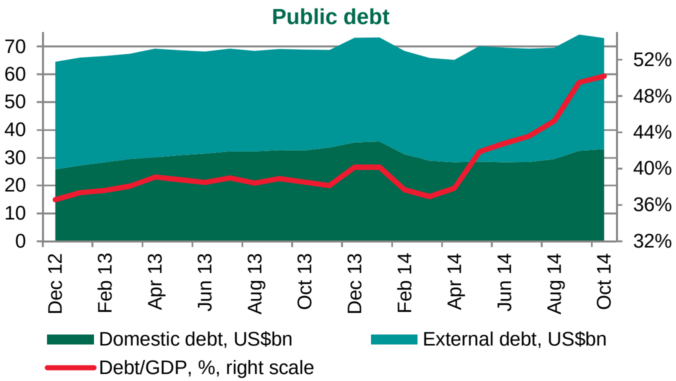
Net flows on interbank and cash FX markets



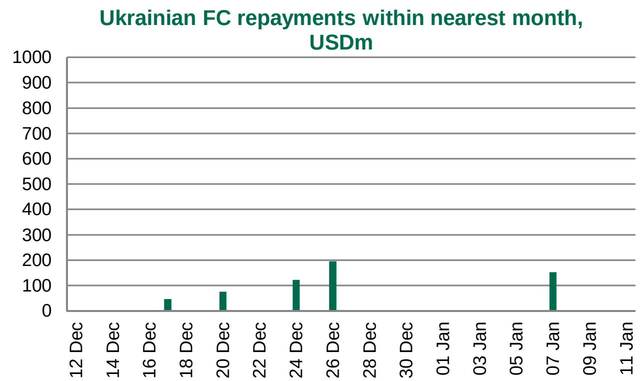
FX market trading volumes



Debt indicators



Sources: Finance Ministry, Credit Agricole



Sources: Finance Ministry, Credit Agricole

- As we expected, ***the redemption of Naftogaz Eurobonds of USD1.7bn reduced public debt in October (by 1.75% MoM) to USD73.0bn***. Nevertheless, this reduction did not prevent a further increase in the ***debt-to-GDP ratio, which grew to 50.2%*** (from 49.5% the month before) amid the continuing economic downturn with a simultaneous hryvnia devaluation.
- The rather small inflow of new debt and the redemption of Naftogaz ***Eurobonds caused external public debt to drop by 4.55% in October***. The absence of significant external repayments as well as the moderate inflow of new debt (especially the expected postponement of the IMF's stand-by loan tranche to early 2015) may allow ***external debt to decline slightly in the coming months***. At the same time, the EU commission recently stated that it would provide USD0.5bn via macro-financial assistance to Ukraine in December. This should stabilise external debt in December slightly.
- The situation with the IMF loan is not clear yet, although its mission already visited Ukraine in mid-December, ie, after the formation of the new government. Hence, ***our base-case estimate for the timing of the new loan provision is end-January 2015***. However, taking into consideration the melting NBU FC reserves and readiness of the government to follow all IMF requirements, ***it is possible that the new tranche of the stand-by loan will be provided earlier.***
- ***Unlike external debt, domestic public debt again advanced by 1.8% MoM in October***. The issuance of government bonds for Naftogaz's recapitalisation as well as ordinary government bond auctions were among the core reasons for the domestic debt increase. In particular, the government borrowed UAH11.38bn through the primary bond market in October, while repaying UAH7.17bn on earlier issued debt. We think the underfunded budget revenues, as well as the recently announced recapitalisation of state banks, ***will force the government to issue more government bonds, thus pressuring domestic debt to go up further this year***. For example, the government decided to recapitalise state-owned Oshchadbank to the tune of UAH11.6bn in November-December.
- ***The growing debt-to-GDP ratio and no hope of economic recovery this year threaten to increase this ratio towards 60% by the end of this year***. In particular, we predict a debt-to-GDP ratio at 59.9% by year-end. This might be quite a negative signal for the market as in this case Russian investors (state-owned banks) will receive a right to call for early redemption their Eurobonds worth USD3.0bn provided by Russia in late 2013. Taking into consideration the existing political tensions between the two countries, it is quite probable that Russian state investors will not miss the opportunity to call for the early redemption of Ukrainian Eurobonds. Under a pessimistic scenario, this may occur as soon as April 2015, thus providing the only threat to Ukraine's external obligations in the medium term. And due to rather low ability of the government to repay this Eurobond on its own in April 2015, we think ***the readiness of Western counterparts to provide additional financial assistance will be crucial in servicing this obligation***.

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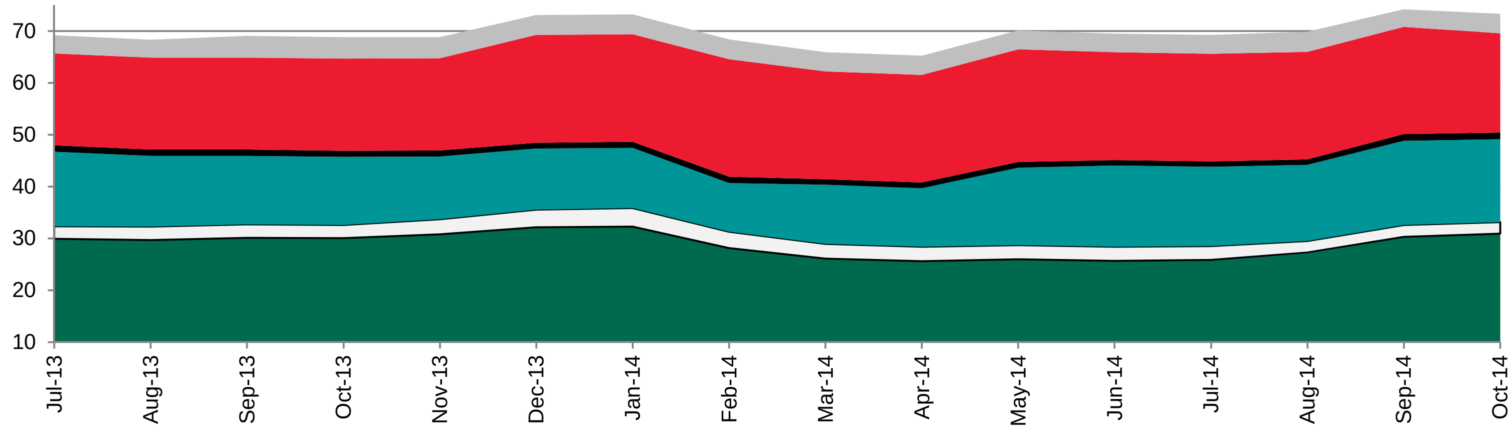
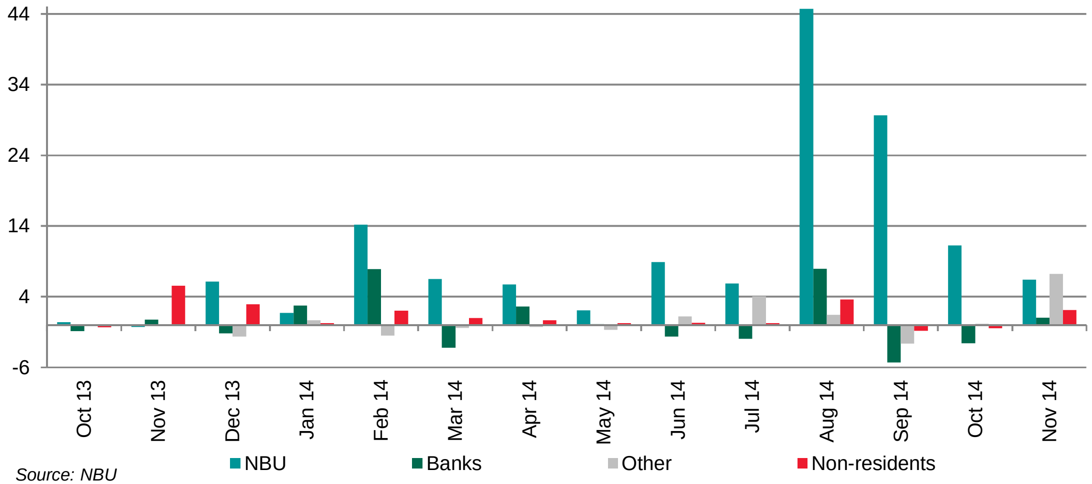
Debt indicators

USD nominated public debt by components, USDbn



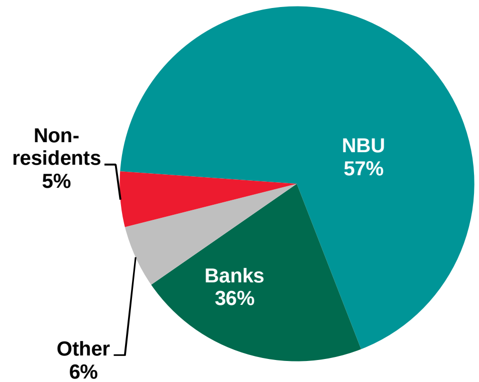
Source: Finance Ministry

Dynamics of government bonds by ownership types, MoM, UAH bn



Source: NBU

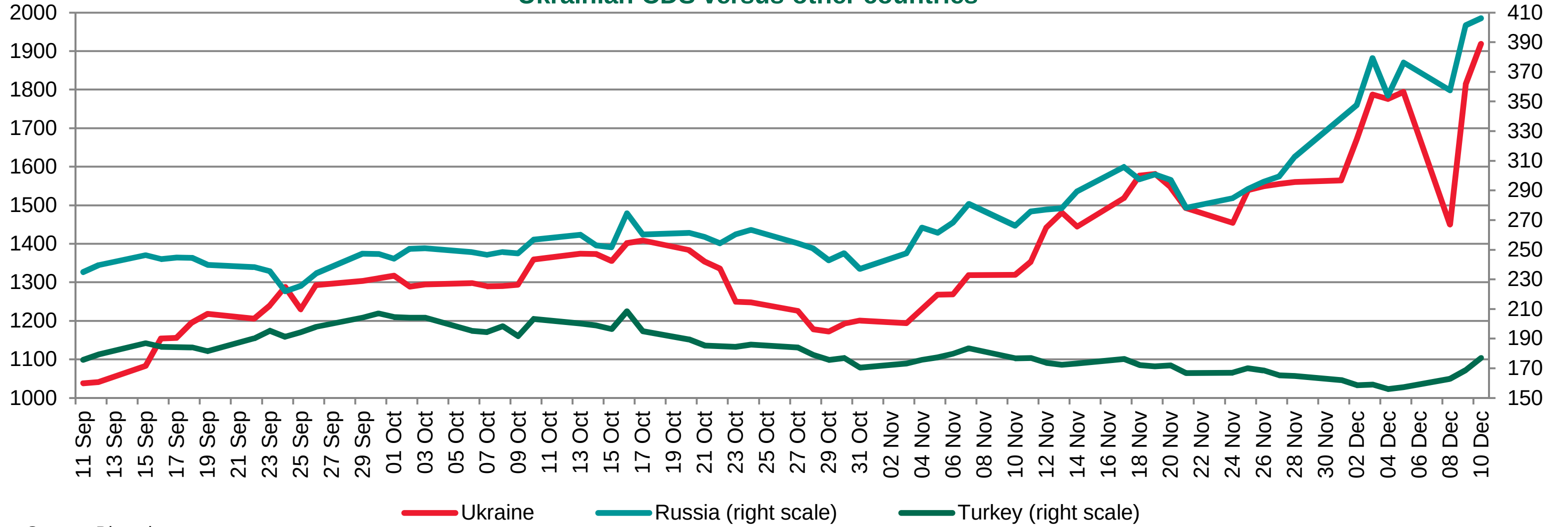
Breakdown of OVDP by owners (as of 09 Dec)
Total volume - UAH428bn



Source: NBU

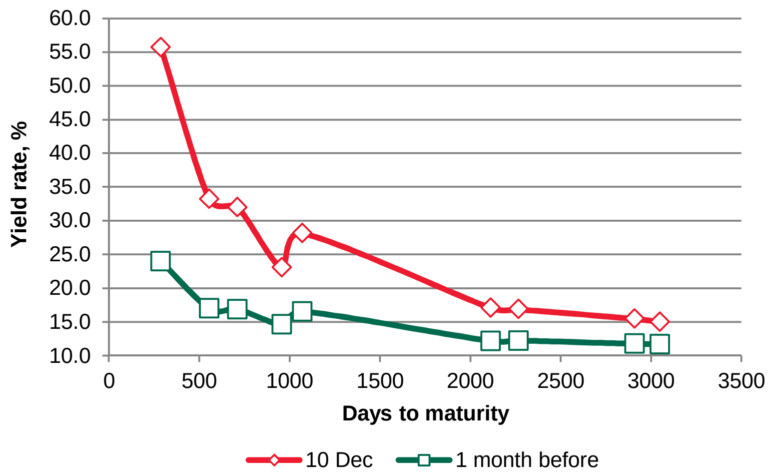
Debt indicators

Ukrainian CDS versus other countries



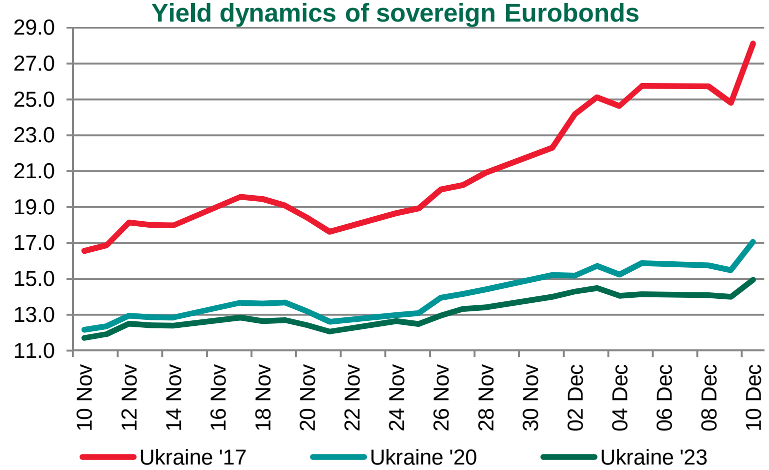
Source: Bloomberg

Ukraine's sovereign Eurobonds yield curve



Source: Bloomberg

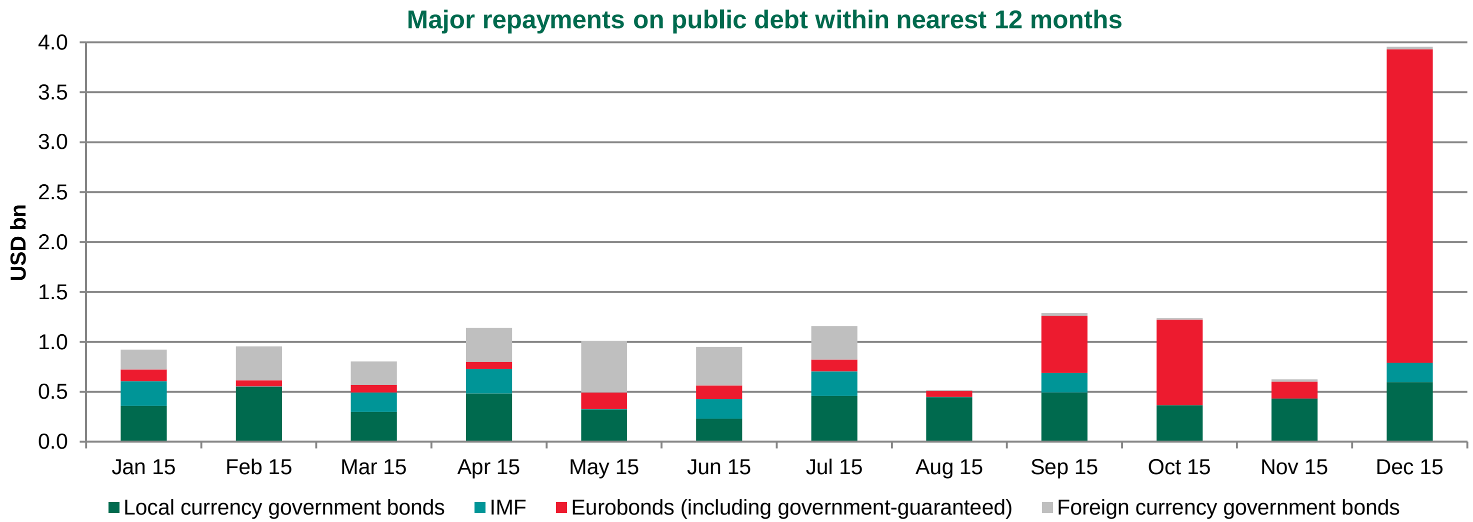
Yield dynamics of sovereign Eurobonds



Source: Bloomberg

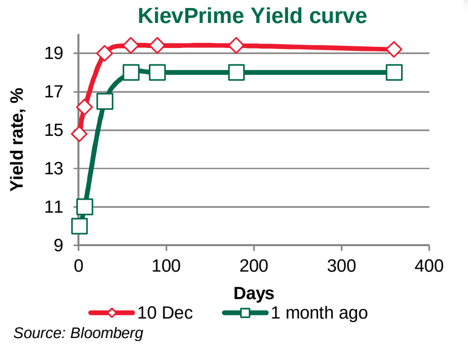
Ukraine. Monthly Market Overview. December 2014
Debt indicators

USDbn	Q414	Q115	Q215	Q315	2014
Repayment of FC-denominated public debt	**1.9**	**1.7**	**2.3**	**1.9**	**11.0**
Foreign currency local government bonds	1.0	0.8	1.2	0.4	2.2
IMF debt	0.4	0.4	0.4	0.4	3.7
Eurobonds (including state-guaranteed)	0.4	0.3	0.4	0.8	4.1
Other	0.1	0.2	0.3	0.3	1.0

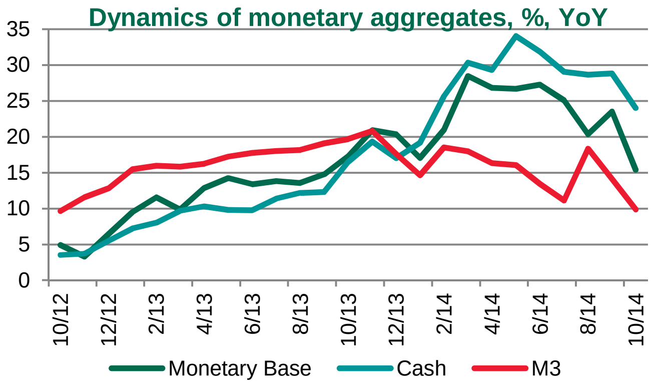


Source: Credit Agricole

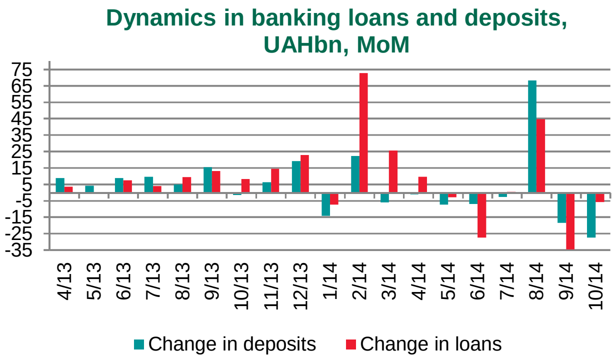
Ukraine. Monthly Market Overview. December 2014
Money Market



Source: Bloomberg



Source: NBU



Source: NBU

- ***A hike in the NBU discount rate and deposit certificates' rates in the first half of November led to a growing trend in money market rates.*** Already in early December NBU officials supported their intention to tighten excessive money supply further. In particular, NBU tightened the provision of its refinancing to banks and increased the volume of excessive money supply's sterilisation. This was also accompanied by growing seasonal demand for hryvnia coupled with uneven distribution of liquidity among banks and a sharp deficit of hryvnia in some of them. Consequently ***interest rates faced an additional hike across the whole yield curve, with short-term rates (up to one month) facing the sharpest increase.***
- As seasonal demand for hryvnia will grow further, ***we expect the dynamics of interest rates to continue growing in Decembe***r. At the same time, the still solid stock of NBU deposit certificates (UAH13.5bn) will smooth rates' hike and will prevent any sharp liquidity squeezes in the coming week or two. This could also be a factor for a slight liquidity and rates' recovery in the first half of January. Furthermore, liquidity shortages of individual banks will require additional support from the NBU.
- ***The recent decision of the NBU to recapitalise the state deposit guarantee fund to the tune of UAH10.0bn in December should support money market liquidity in the coming month or two*** as these funds will be used for the repayment of deposits of bankrupt banks. Taking into consideration that a significant portion of these resources are being returned to banks' deposits, we can see partial liquidity replenishment in the banking system, thus additionally softening the negative pressure on interest rates at the end of the year.
- ***NBU officials expected to raise reserve requirements on banking hryvnia accounts at the start of December.*** In particular, the hryvnia reserve requirement should have been increased to 3% for term accounts and to 6.5% for sight accounts. However, NBU later postponed this decision to early 2015. We think ***the liquidity problems of some large banks might be a reason for the NBU not to tighten money supply further in December***. If imposed, the new requirement should theoretically remove liquidity from the banking market, while the intention of the NBU to simultaneously reduce reserve requirements on foreign currency deposits will mitigate this effect. In any case, the ***intention of the NBU to carry out monetary tightening is evident for H115, thus paving the way for interest rates to remain at higher levels than in 2014***.
- The CPI in November in MoM terms (1.9%) was slightly lower than the month before (2.4%). However***, in YoY terms inflation accelerated in October to 21.8%***. We think another wave of hryvnia devaluation (started since late-October) was the core factor for rather high inflation last month. In particular, the sharpest growth was recorded in goods and services tied to exchange rates. At the same time, the heating season also affected the growth in tariffs for heating and hot water. We think ***the inflation pass-through effect should also keep inflation high in December***. As a result***, we downgrade our year-end inflation forecast to 23.1%***. We also predict higher (than initially expected) inflation in 2015 (10.99%) due to excessive hryvnia devaluation and the necessity to adjust energy tariffs accordingly.

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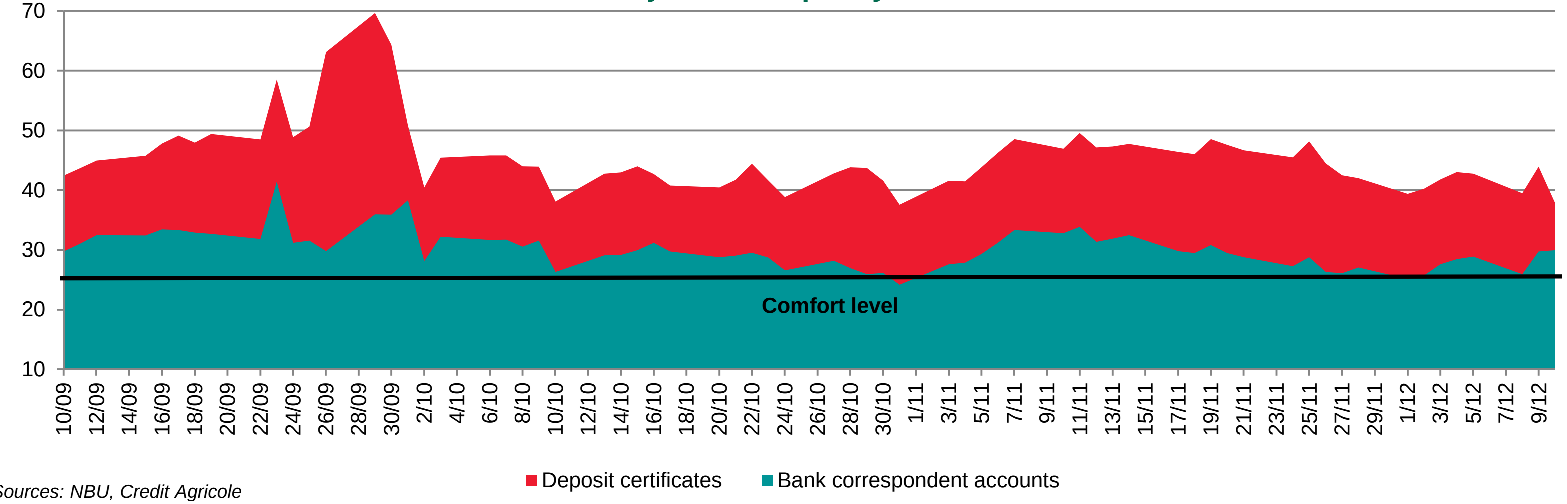
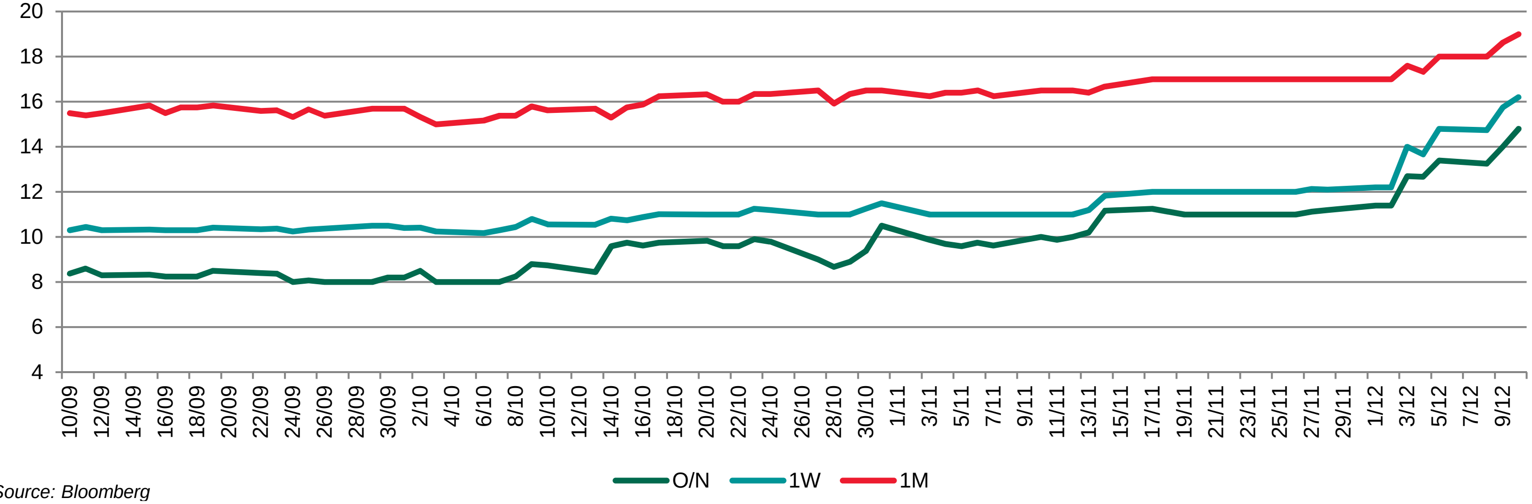
Ukraine. Monthly Market Overview. December 2014
Money Market

Money market liquidity over last 3 months



Sources: NBU, Credit Agricole

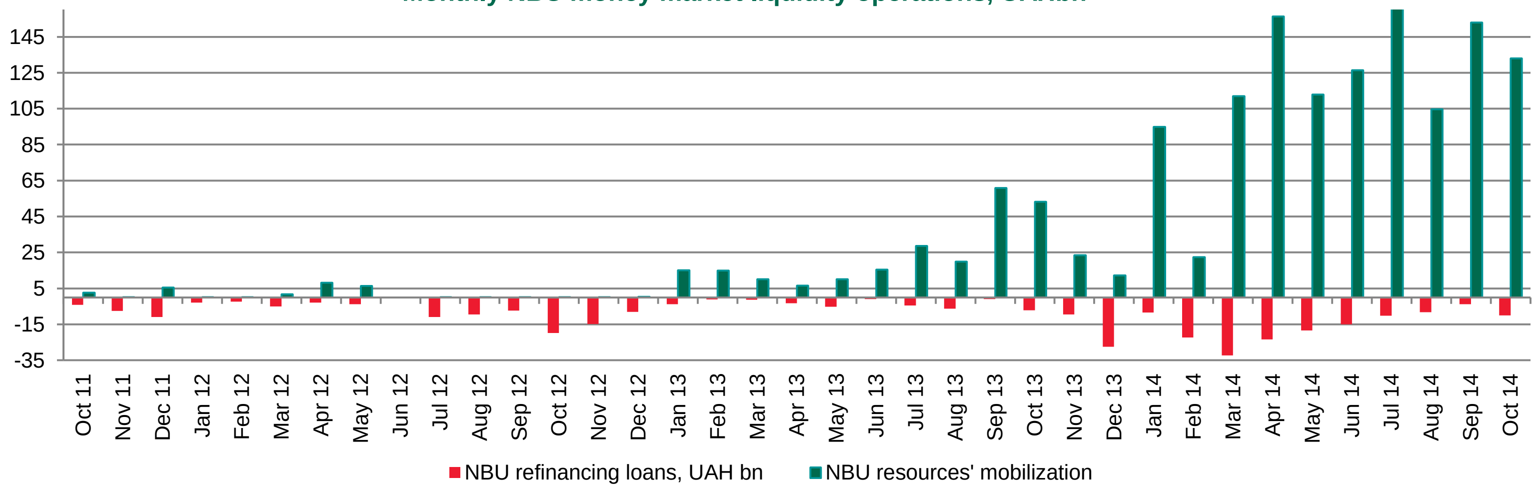
KievPrime rates over last 3 months



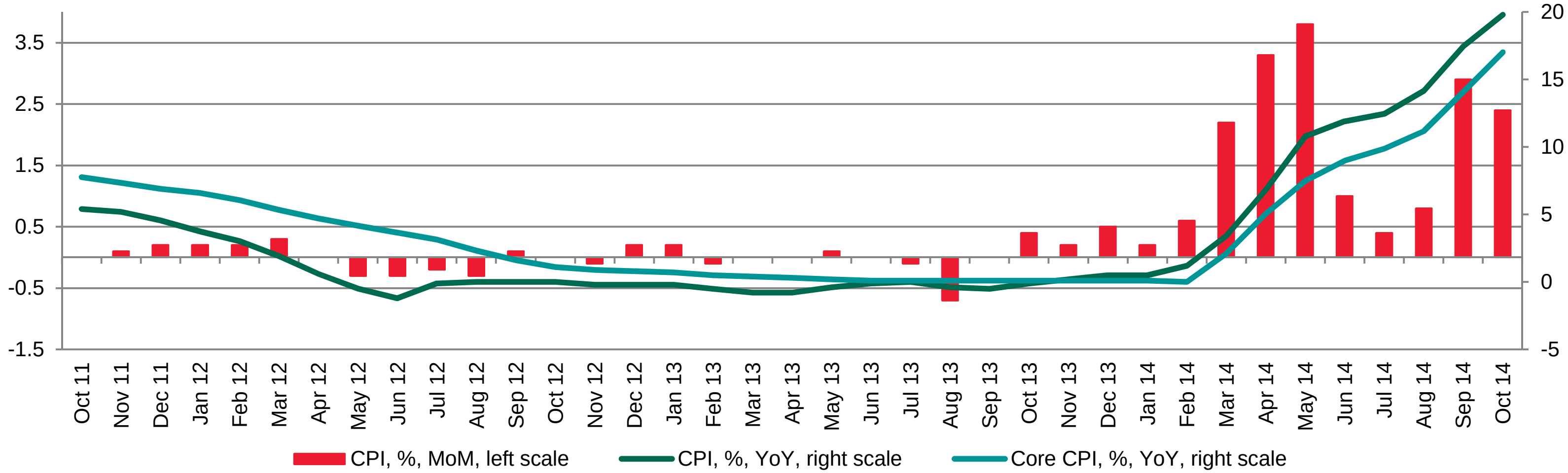
Source: Bloomberg

Money Market

Monthly NBU money market liquidity operations, UAHbn

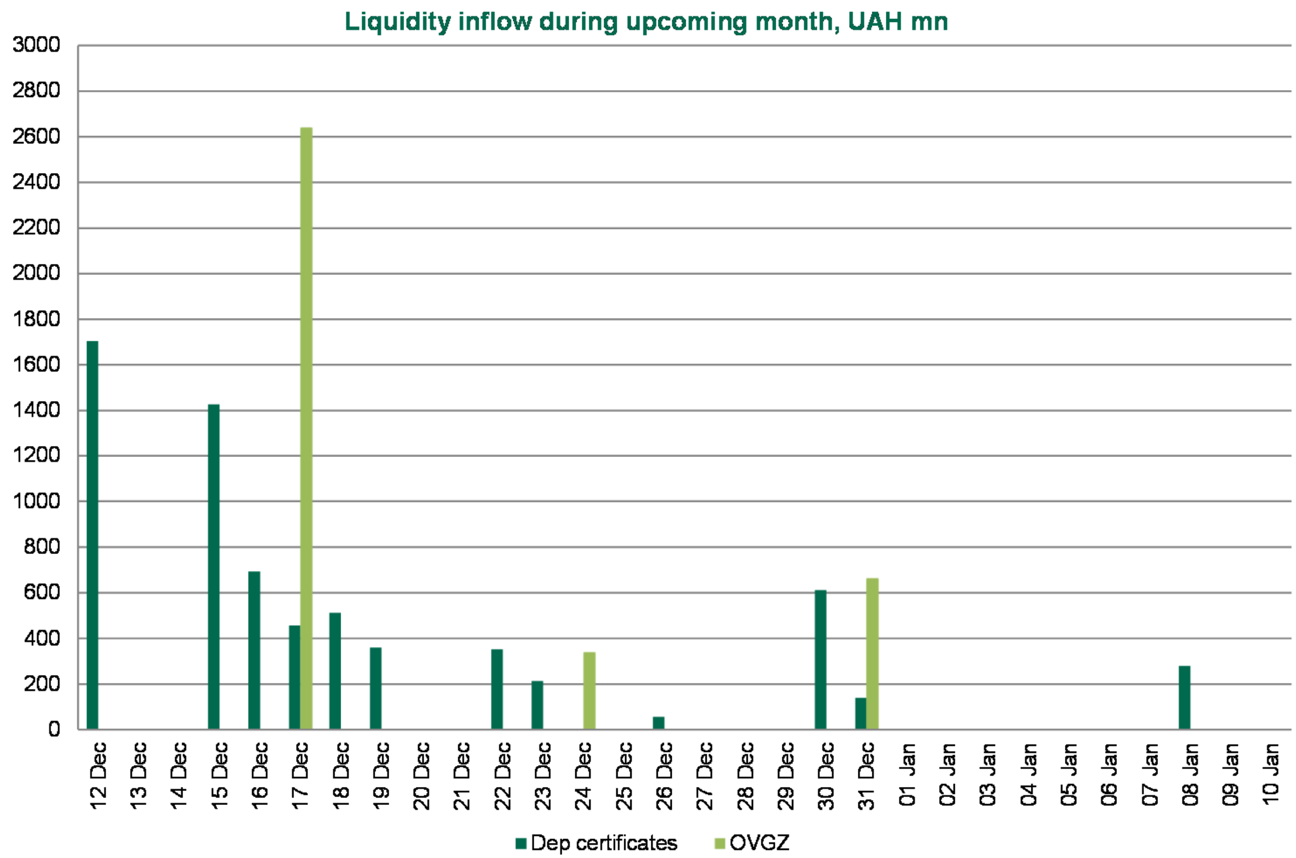


Inflation indicators



Source: State Statistics Committee

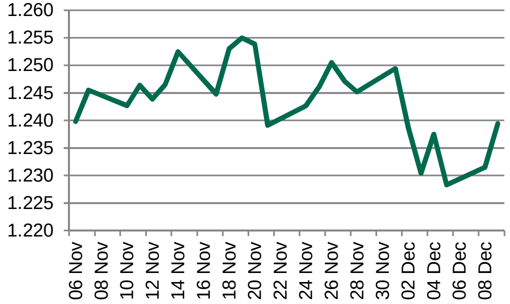
Money Market



Sources: NBU, Finance Ministry, Credit Agricole

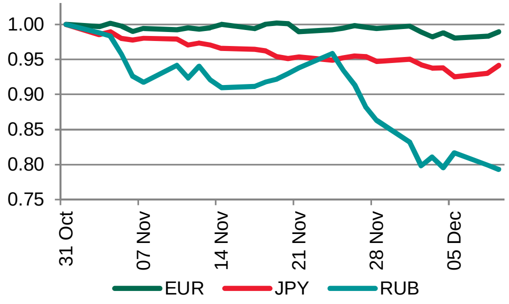
Ukraine. Monthly Market Overview. December 2014

EUR/USD over last month



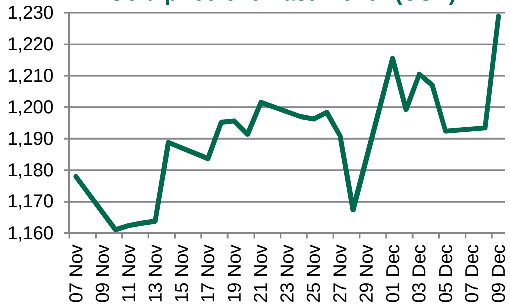
Source: Bloomberg

USD index over month (31.10.14=1)



Sources: Bloomberg, Credit Agricole

Gold price over last month (USD)



Source: Bloomberg

- The US economy is in good health, expanding by 3.9% at an annual rate in Q314, outperforming most countries in the developed world. We forecast annual real GDP growth of around 3% in 2015 as consumer spending is supported by strong job creation, low interest rates and low levels of household debt. The Republican Party won a Senate majority in the mid-term elections. Taking control of Congress could force Republicans to be less obstructionist in 2015-16.

- US growth will be relatively strong for an industrialized economy over the long term, as labour productivity growth remains healthy. Technological progress will be an important driving force, but the stimulus from labour force increases will fall. Although US growth will remain strong in comparison with other developed economies, emerging markets will close the gap and China's economy is forecast to overtake the US in the middle of the next decade, measured at market-exchange rates.

- Europe, by contrast, remains the sick man of the global economy. Mario Draghi, the president of the European Central Bank (ECB), is working actively to prevent another recession. The ECB cut its main interest rate in September and began an asset-purchase programme – measures that could help the economy around the edges but will not be game-changers. The Eurozone grew by 0.2% QoQ in July-September, narrowly avoiding recession. Europe's banking system is on the slow road to recovery, but lending is still falling in annual terms. Debt levels remain high, budgets are strained and the political mood is sour almost everywhere. The Russia-Ukraine crisis has badly damaged investor sentiment in northern Europe, which has drained some of the life out of the German economy.

The following are adjusted market forecasts:

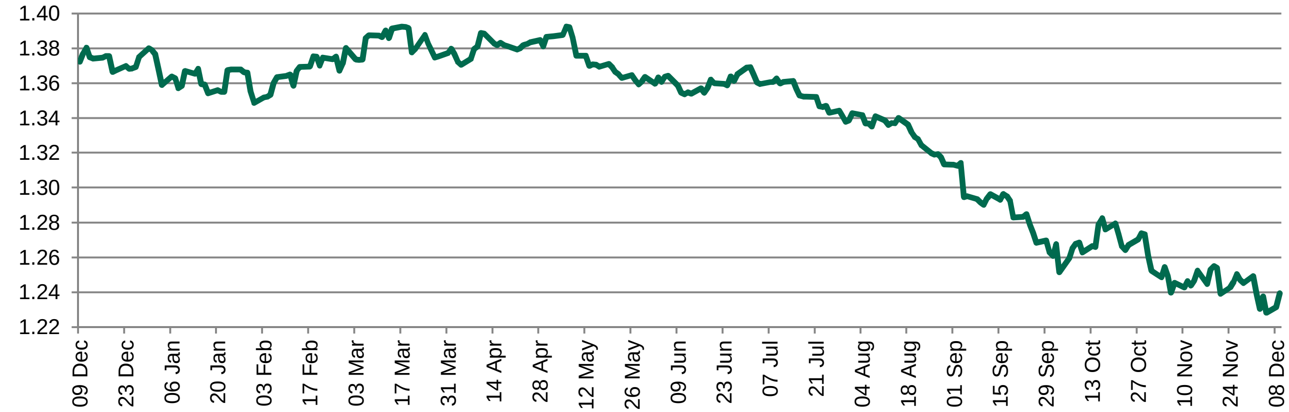
Crédit Agricole CIB EUR/USD forecast:

Q115	Q215	Q315	Q415
1.2800	1.2500	1.2300	1.2000

Consensus forecast (Bloomberg FC Poll by 88 strategists average)

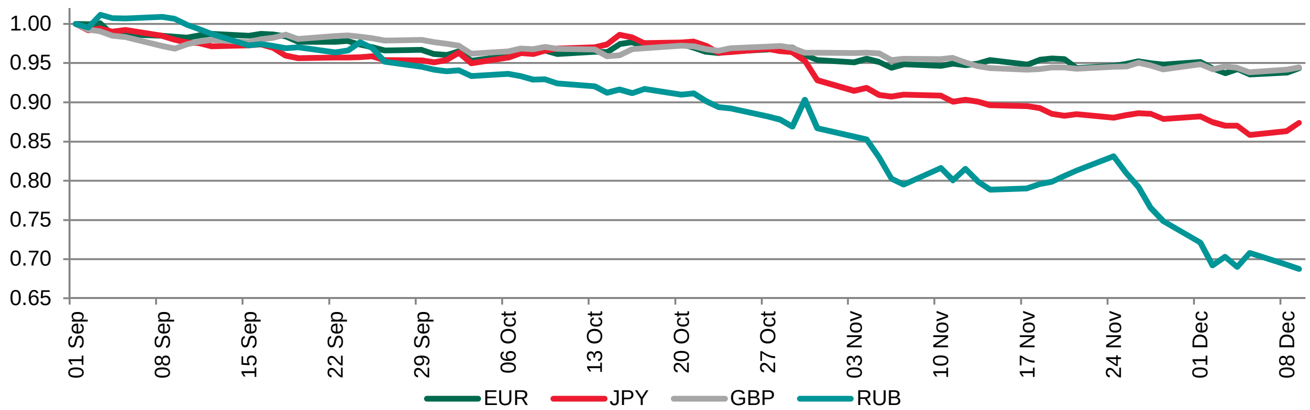
Q115	Q215	Q315	Q415
1.2200	1.2000	1.2000	1.1900

EUR/USD over last 12 months



Source: Bloomberg

Index of currencies against USD over last 3 months (01.09.14=1)



Sources: Bloomberg, Credit Agricole

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