

Ukraine. Monthly Market Overview

May 2016



Ukraine Sovereign Ratings

FCY rating	S&P	Moody's	Fitch
Long-term	B-	Caa3	CCC
Short-term	B	NP	C
Outlook	Stable	Stable	
LCY rating			
Long-term	B-	Caa3	CCC
Short-term	B	-	-
Outlook	Stable	Stable	
Latest assessment	20/10/15	19/11/15	13/05/16



Financial Markets team

Ukraine. Monthly Market Overview. May 2016

Major Macroeconomic Trends



MACROECONOMIC INDICATORS - evolution

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015E	2016F	2017F
Nominal GDP (USDbn)	49.5	64.9	86.2	107.7	142.7	129.0	117.4	136.2	165	174	178	130	90	93	101
Real GDP growth (%)	9.4	12.1	2.7	7.3	7.9	2.1	-14.8	4.2	5.2	0.2	0.0	-6.8	-9.9	1.0	3.0
Inflation CPI, eop (%)	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	43.3	14.1	8.7
Industrial production (%)	15.8	12.5	3.1	6.2	10.2	-3.1	-21.9	11.0	7.6	-1.8	-4.7	-10.7	-13.4	2.4	3.5
Merchandise exports (USDbn)	28.9	41.3	44.4	50.2	64.0	78.7	39.7	51.4	68.4	68.8	63.3	55.3	35.4	32.2	34.9
Merchandise imports (USDbn)	27.7	36.3	43.7	53.3	72.1	92.2	45.4	60.7	82.6	84.6	77.0	61.3	38.7	38.7	36.8
Public debt (% of GDP)	29.0	24.8	18.0	14.8	12.0	13.7	32.2	39.7	36.2	36.6	41.0	70.5	79.5	87.3	91.6
Current account (% of GDP)	5.8	10.7	2.9	-1.5	-3.6	-7.1	-1.5	-2.2	-5.5	-8.4	-9.3	-3.5	-0.2	-1.4	-0.1
Net FDI inflow over year (USDbn) NBU methodology	1.4	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	7.2	4.1	0.2	3.0	4.1	4.7

EXCHANGE RATES - evolution

USD/UAH eop	5.33	5.31	5.05	5.05	5.05	7.70	7.98	7.96	7.99	8.04	8.24	15.82	24.03	26.0-29.0	27.3-33.3
USD/UAH average	5.33	5.31	5.12	5.05	5.05	5.32	7.79	7.93	7.97	8.02	8.16	12.02	21.92	25.2-27.5	26.7-31.2
EUR/UAH eop	6.70	7.20	6.00	6.70	7.42	10.86	11.45	10.57	10.30	10.54	11.04	19.14	26.12	29.1-32.5	30.6-37.4
EUR/UAH average	6.02	6.61	6.38	6.26	6.92	7.78	10.88	10.52	11.09	10.31	10.81	15.87	24.29	28.2-30.8	29.9-34.9
UAH O/N average	6.5	5.3	3.5	4.0	3.5	11.3	8.4	1.5	5.7	11.9	2.7	8.1	19.26	14.5	8.0

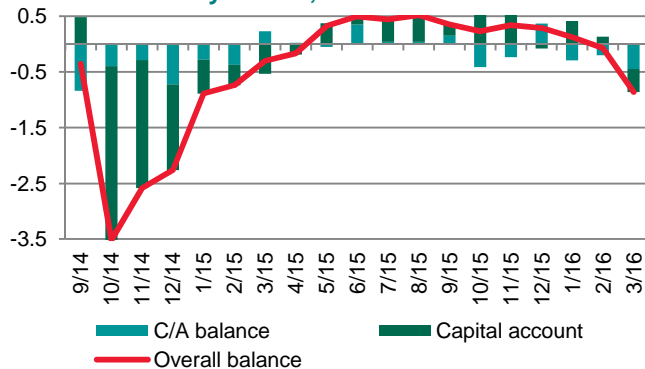
- Even though parliament failed to create fully technocratic government (as it was widely expected by external investors), **the fact of creation of the government in mid-April was perceived by financial markets as positive signal**. And this indicated to the end of active stage of political crisis. It is early yet to make estimates on the efficiency of new government and its path, while its first steps made (eg. hike in public utility tariffs, attempts to de-monopolise some markets, appointment of independent directors to large state-owned companies, start of privatisation) point to intention of the government to remain reform-oriented, to intensify reforms and to adhere IMF program. In any case, **appointment of the new government was already positively assessed by largest economic partners of Ukraine**. Therefore, we think **the political scope should have minor negative impact on economic performance**, at least in the coming few months.
- **A sporadic activity of terrorists in the zone of conflict remained almost same last month, while any attempts to destabilise situation are effectively prevented** by Ukrainian army and by solid pressure of international community on terrorists and their sponsors. At the same time, international partners intensified pressure on Ukraine to solve the conflict by political methods, including special status of Donbass and elections there. In any case, **we do not expect any solid growth in risk from geopolitics in the coming month**.
- As new government renewed negotiations with IMF, and it tries to follow all necessary requirements, **we estimate the chances for next EFF tranche in the coming two months as rather high**. This should positively affect sentiment of financial markets in the near-term.

Ukraine. Monthly Market Overview. May 2016

Major Macroeconomic Trends

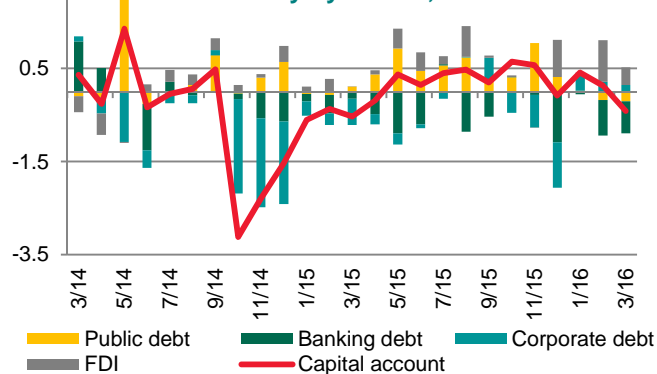


Major accounts of BOP, monthly dynamics, USDbn



Sources: NBU, Credit Agricole

Major accounts of capital account, monthly dynamics, USDbn



Sources: NBU, Credit Agricole

Forecast	GDP, YoY
Q216	1.2%
Q316	1.1%
Q416	0.9%
Q117	2.5%

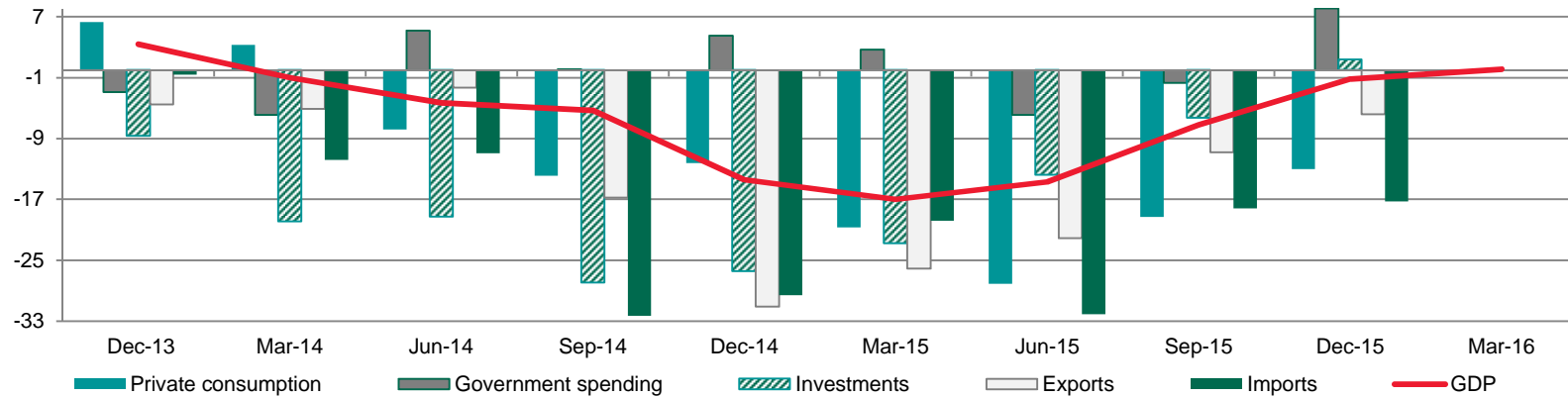
Source: Credit Agricole

- Fitch rating agency affirmed sovereign long-term rating at CCC.** This is the first review of Ukrainian ratings after their upgrades in November 2015 as a reaction to successful restructuring of sovereign debt's obligations made by Ukrainian government last year. The rationale for Fitch decision is based on the lack of progress on the reform programme needed to unlock donor support. Fitch analysts argue that this negatively affects the dynamics of NBU FC reserves. In any case, **we consider decision to affirm Ukrainian rating as rather cautious** taking into consideration improvement in economic indicators, stabilisation of FX market and reduction of country risks after the approval of new government. And the chances to receive the next EFF tranche from IMF in the coming two month look rather high to us. Hence, **the news would have a neutral effect on country risk level.** We also do not expect any rating actions from other agencies, at least until the decision of IMF on new loan tranche is announced.
- Preliminary estimate of GDP over Q116 shows a small growth of 0.1% YoY.** This is first positive GDP figure over recent two years. At the same time, the figure was slightly weaker than our forecasts (0.3%) and considerably weaker than consensus one (1.0%). We think that more significant negative impact of external trade sanctions imposed by country-aggressor as well as low world commodity prices impacted weak GDP YoY dynamics last quarter. We also estimate that low comparison base effect of last year has impacted improvement in GDP performance mostly. We think same effect as well as recovery in world commodity prices in March-April **should further improve GDP YoY dynamics, thus raising our projections of growth to 1.2% over Q216. Our whole-year forecast is maintained at 1.0% in 2016.**
- The performance of economic sectors over March demonstrates a solid improvement in their YoY figures.** And the only negative dynamics in March was recorded in agriculture (-1.0% YoY), while this decline was the lowest in the sector over last five months. **The most significant growth in March was seen in trade sector – 13.4% YoY,** while low comparative base of last year remained the core factor of growth in the sector. We think quite solid figures of car sales this year (57.6% growth YoY over Q116) contributed greatly to retail sector's performance in March. **We expect positive YoY figures in most of economic sectors in April,** mostly on low comparison base effect. At the same time, **a recovery in world steel and iron ore prices in March-April would support the performance of metallurgy correspondingly.**
- BOP dynamics over March was the worst over last 14 months (-USD0.86bn).** And it again returned into double deficit for both current and capital accounts. In particular, current account deficit has risen to USD0.45bn in March from USD0.20bn the month before. **Low world commodity prices and externa trade sanctions imposed by a country-aggressor worsened exports YoY decline** to 15.9% in March comparing to 12.0% the month before. At the same time, a **hike in car sales as well as additional temporary increase in demand** backed by fears of hryvnia devaluation during political crisis have improved dynamics in imports (to -6.2% versus -8.8% in February).
- We expect improvement in BOP already in April on the back of restoration of exports in core Ukrainian commodities** (ie. grains, steel and iron ore) due to corresponding increase in world prices. **We also expect worse dynamics of imports** due to lower demand domestically after UAH devaluation fears weakened. **Capital account dynamics should also look better in April** amid improvement in net FC flow in public sector and still positive flows in cash segment of FX market.

Ukraine. Monthly Market Overview. May 2016

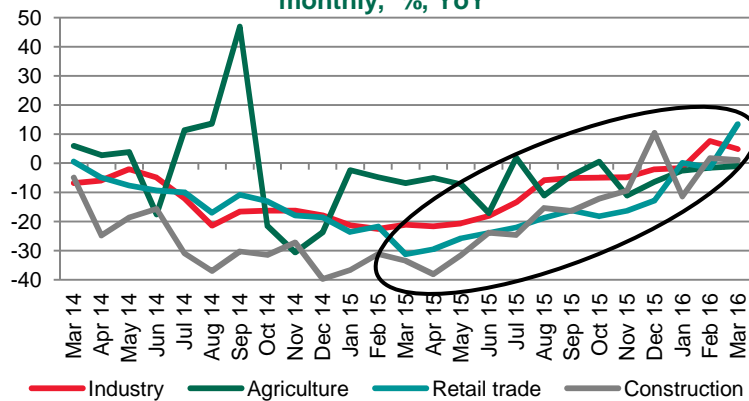
Major Macroeconomic Trends

Quarterly GDP dynamics by expenditure components, %, YoY



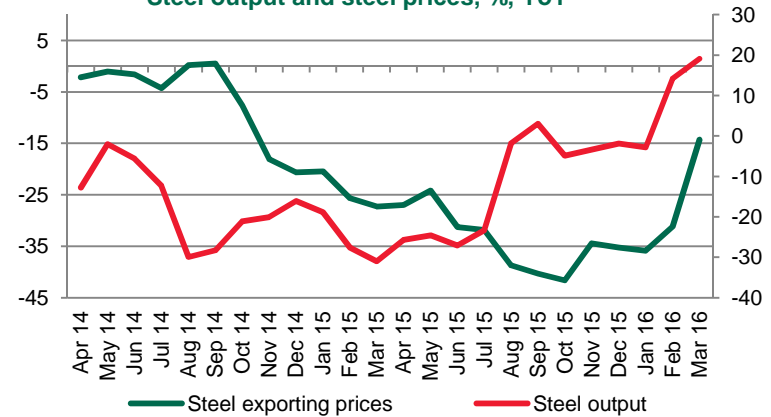
Sources: State Statistics Committee

Performance of major economic sectors, monthly, %, YoY



Source: State Statistics Committee

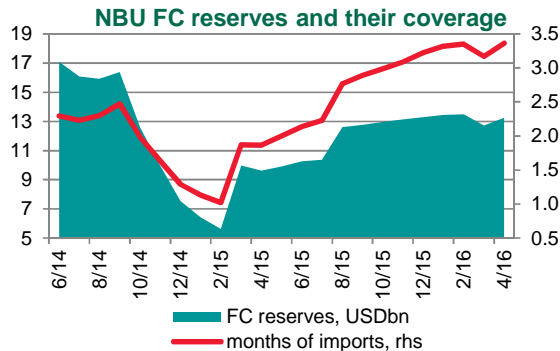
Steel output and steel prices, %, YoY



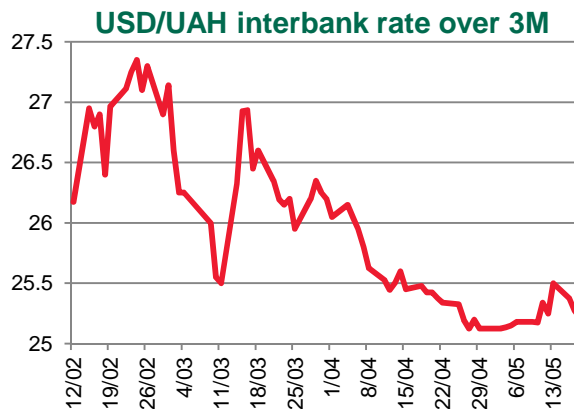
Sources: State Statistics Committee, Bloomberg, Credit Agricole

Ukraine. Monthly Market Overview. May 2016

FX Market



Sources: NBU, Credit Agricole



Source: Bloomberg, Credit Agricole

Forecast, eop	USD/UAH	EUR/UAH
Q2'16	25.5-26.5	28.6-29.7
Q3'16	25.5-27.5	28.3-30.5
Q4'16	26.0-29.0	29.1-32.5
Q1'17	26.5-29.0	29.4-32.2

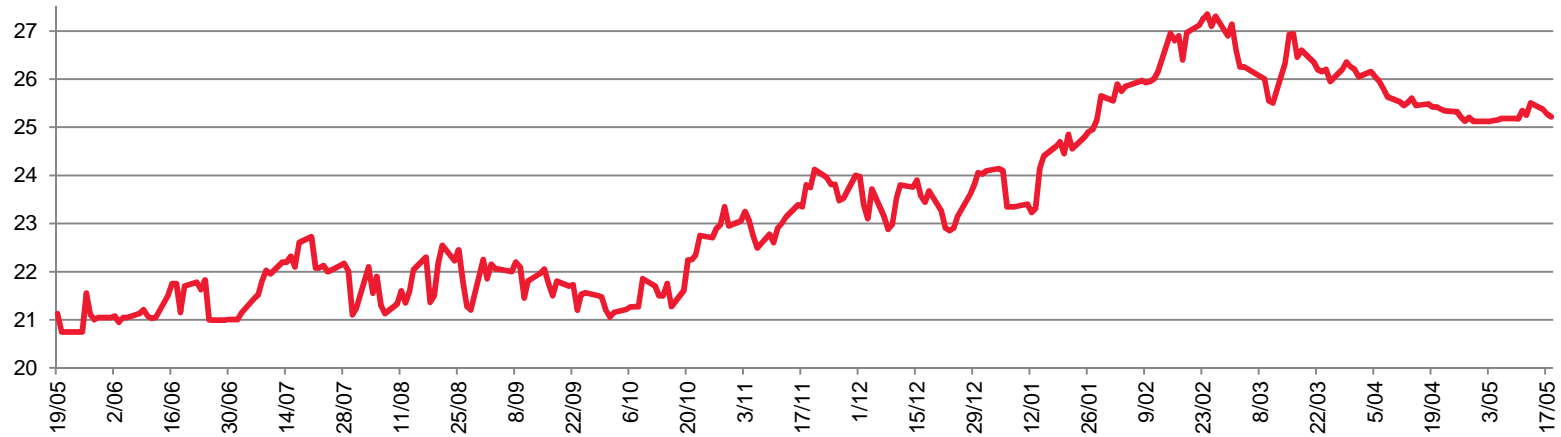
Source: Credit Agricole

- Improvement in sentiment of world commodity market (including growing prices for core exporting goods for Ukraine) as well as adjustment of Ukrainian exporters to trade restrictions imposed by neighboring country have **changed the situation on FX market to the opposite in April-May**. And creation of new government with corresponding reduction of political risks have diminished the risk of further hryvnia devaluation in the near-term **This created constant excessive FC surplus, thus pressuring hryvnia towards strengthening** and approaching the USD/UAH towards 25.00 by the end of April.
- **A declining trend in the USD/UAH in April was artificially weakened by the NBU**, because a solid portion of excessive FC supply was absorbed by the NBU through its auctions. In particular, the NBU was purchaser of USD at all its auctions in April, thus replenishing its reserves by USD0.68bn (including USD0.15 via direct intervention). The main purpose of FC auctions was to restrict the downside potential of the USD/UAH, thus smoothing its dynamics on FX market. This allows us to think on **main task of the NBU not to strengthen hryvnia by any cost but rather to stabilise exchange rate dynamics on FX market. Therefore, we predict low volatile market and relatively stable rate in the coming month.**
- Improvement in the sentiment of FX market, as well as frequent purchase of foreign currency by the NBU via its auctions coupled with the requirements of IMF **induced NBU officials to think recently on abolishing (or at least solid softening) in its capital controls**. In particular, on May 5 the NBU abolished the requirement on mandatory sale of FC directed for FDIs, reduced the delay between intention to purchase FC and its actual purchase from three to two days. **The NBU also started collection of information on potential FC demand of non-residents willing to repatriate their dividends**. After collection of bids, the NBU would define the schedule and procedure of dividends' repatriation. We think the ability to do this in summertime (when hryvnia traditionally strengthens on the back of seasonal factors) should limit the negative impact of additional FC demand on exchange rate stability. In any case, **we expect solid softening in capital controls on June 03.**
- From one point of view, hryvnia should be further strengthened in the coming few months backed by seasonal factor, ie. higher inflows of foreign currency from grain traders due to their preparation to harvesting season. And a risk further hike in money market hryvnia rates would keep foreign currency supply rather high in the near-term. At the same time, **we downgrade our mid-year USD/UAH forecasts (from 24.50 to 25.50 under base-case scenario) as we see some additional factors the could restrict the strength of hryvnia revaluation in the coming month or two**. First of all, a return of world steel and iron ore prices on the declining track may negatively affect FC supply from steel and extracting sectors. Secondly, recent announcement of NBU officials on their plans to allow (at least partially) repatriation of dividends would strengthen FC demand, thus preventing the USD/UAH from going down and preserving it at current rate. At the same time, **we do not expect the rate to go up considerably because the process would still remain under NBU control.**
- After one-month outflow, **NBU FC reserves returned on a growing path in April** (by USD0.52bn to USD13.2bn). And the bulk of inflow was secured by NBU FC purchase from FX market (USD0.68bn). Foreign currency outflow was relatively small (USD0.88bn) comparing to the figure a month ago, and included local FC bonds' servicing (USD0.06bn) and the return of swaps (USD0.76bn). A growth in NBU FC reserves has improved their coverage ratio to 3.4 months of imports – maximum over 3.5 years. **We expect a slight increase in NBU reserves in May backed by small external payments and purchase of FC by NBU from FX market.**

Ukraine. Monthly Market Overview. May 2016

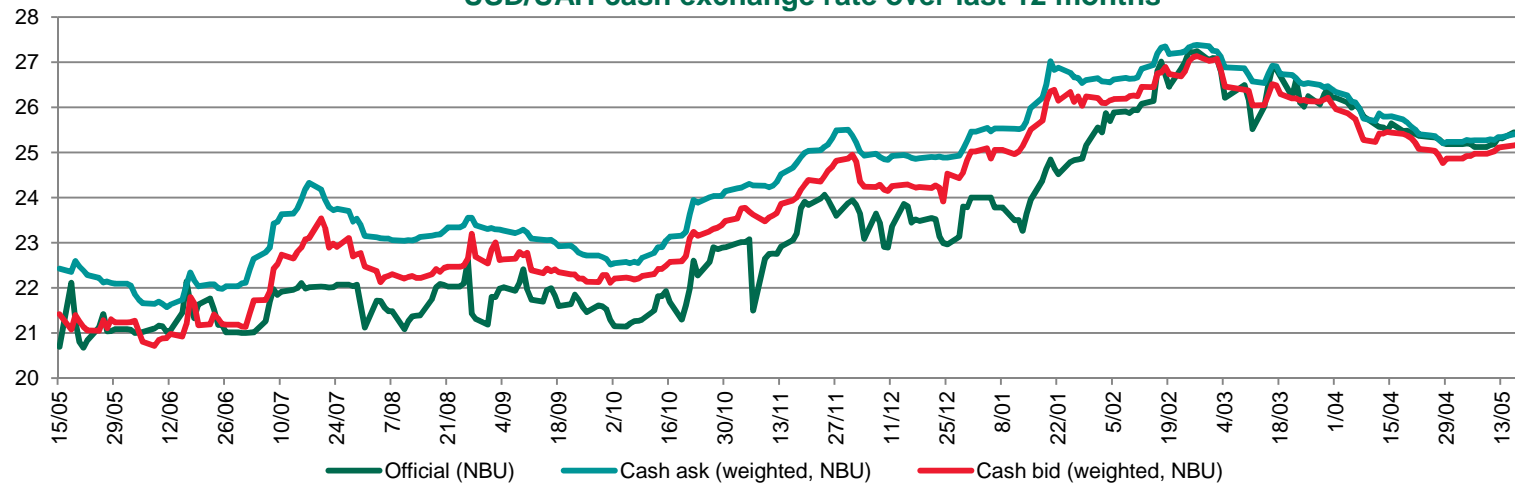
FX Market

USD/UAH interbank exchange rate over last 12 months



Source: Bloomberg, Credit Agricole

USD/UAH cash exchange rate over last 12 months



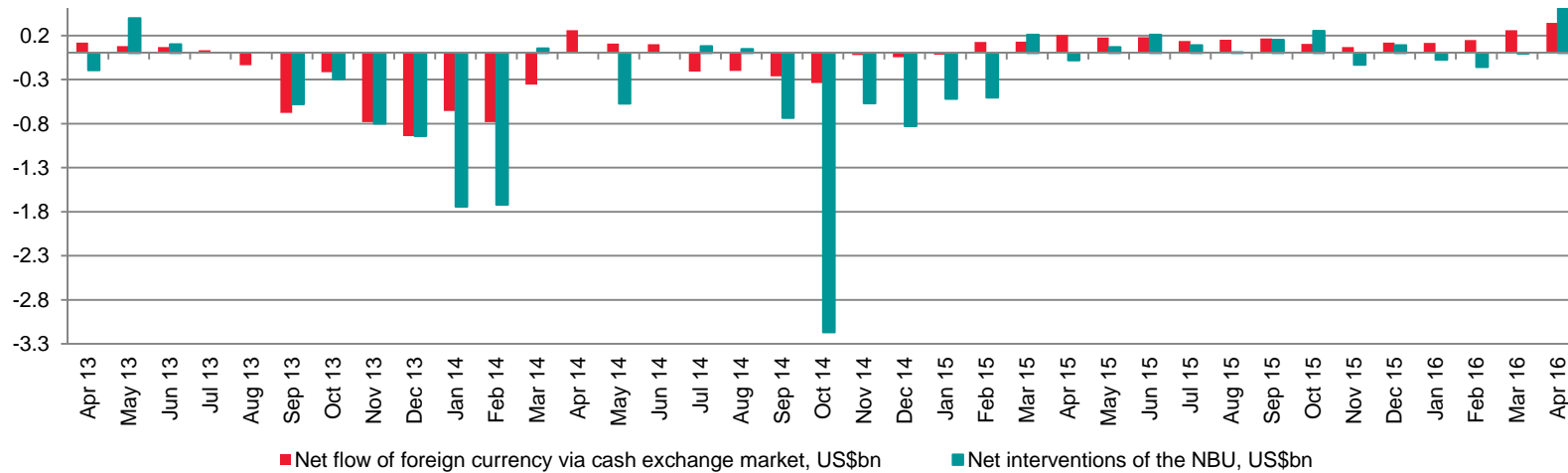
Source: NBU

Ukraine. Monthly Market Overview. May 2016

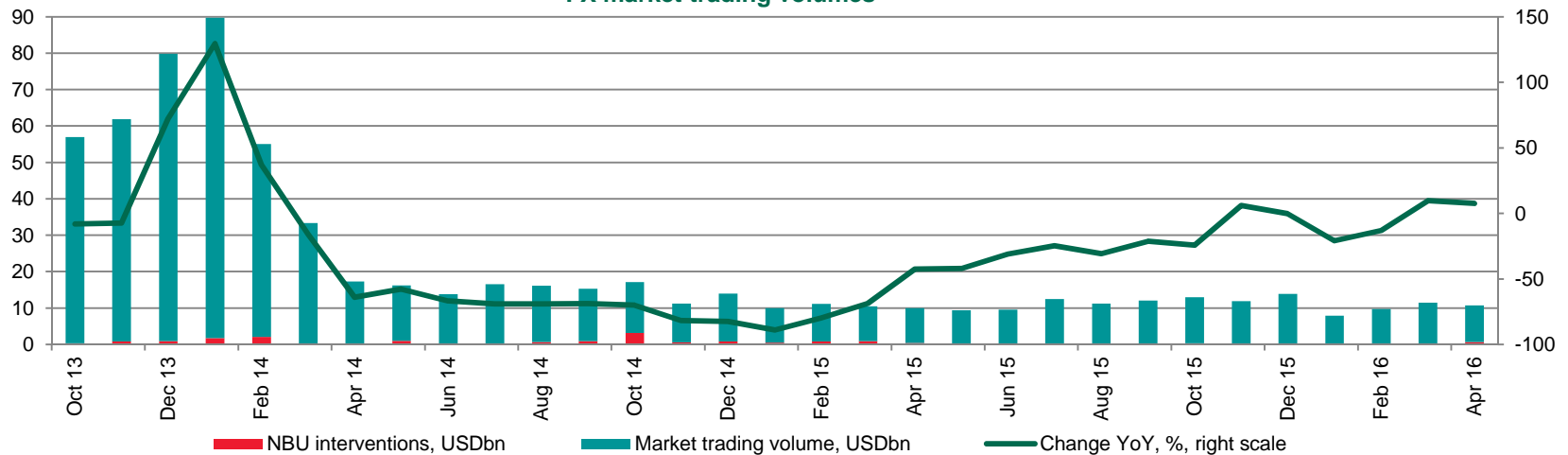
FX Market



Net flows on interbank and cash FX markets

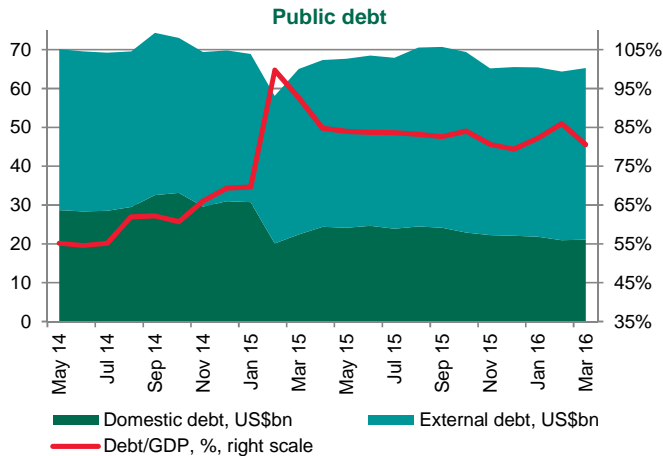


FX market trading volumes

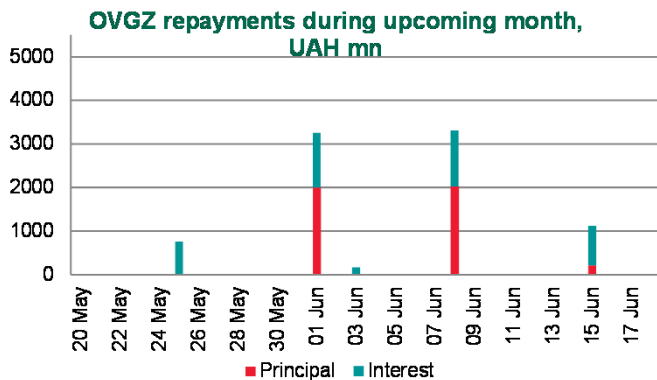


Ukraine. Monthly Market Overview. May 2016

Debt indicators



Sources: Finance Ministry, Credit Agricole



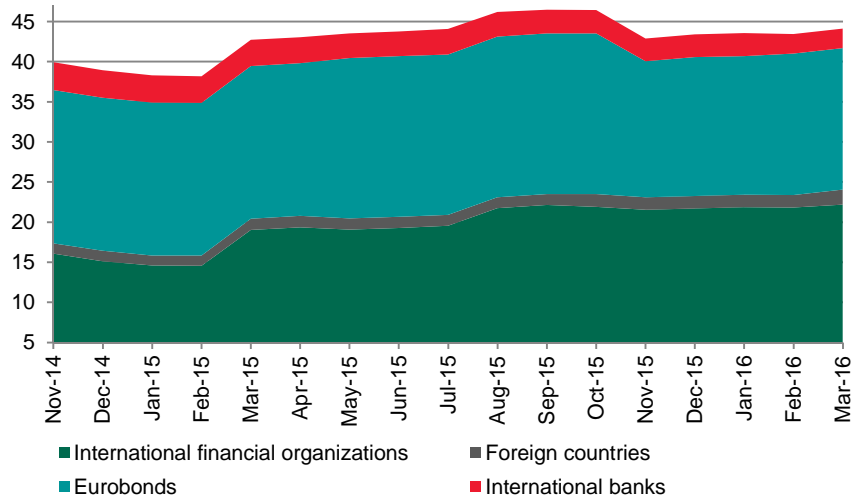
Sources: NBU, Finance Ministry

- **The dynamics of public debt in March was slightly negative (-2.3% MoM to USD62.9bn).** Taking into consideration that the net stock of local debt has slightly reduced in March due to small new borrowings (UAH0.49bn) and slightly higher repayments (UAH1.31bn), the USD value of domestic debt has grown by 1.0% MoM entirely due to hryvnia strengthening. And the volume of external debt has increased by 1.6% MoM partially on the receipt of USD0.33m from Japan and partially on the back of growing EUR/USD rate and corresponding increase in value of EUR debt nominated in USD.
- Event though public debt demonstrated positive dynamics, **debt-to-GDP ratio has improved considerably in March (to 80.5% comparing to 85.9% the month before)** on the back of hryvnia strengthening and corresponding increase in USD value of GDP.
- Because the government had neither solid external payments nor significant FC inflows, **we expect relatively flat public debt in April.** At the same time, **we expect a further improvement in debt-to-GDP ratio on the back of additional UAH strengthening.**
- As IMF mission arrived in Kiev in mid-May 2016 and taking into consideration recent actions of the government on following Fund's requirements, **we raise the probability of positive decision of IMF on disbursement of its next tranche in July,** while a positive decision of IMF mission on loan to Ukraine may be announced already in June.
- **Finance ministry was quite active in April in offering its local LC bonds** with a wide variety of securities with maturity from 90 days to 3 years. However, the market was rather selective in bonds, thus choosing just several of them. We think the yield offered by Finance ministry might be a crucial attractiveness indicators for investors in participating in primary auctions. And just cessation of the sale of NBU deposit certificates with maturity of one to three months has not induced automatic switch of investors' interest into government bonds with same maturity.
- **Still inactive primary government bonds market has not prevented the government from borrowing a solid UAH8.56bn into its coffers** comparing to just UAH0.49bn the month before. We estimate that such success of the government is tied to purchases of two- and three-year bonds by selective investors (presumably, state-owned banks). In fact, two- and three-year bonds acquired 94% from the total volume of government bonds sold at primary market over April.
- Even though the volume of domestic borrowing was rather considerable in April (UAH8.56bn), **net position of the government remained still negative.** In particular, it had to spend UAH11.01bn to service its existing obligations in April, including UAH5.89bn of principal and UAH5.13bn of interest. **We estimate that the volume of domestic bonds' servicing would be milder this month (UAH7.87bn).**
- **We think the government will remain active in offering new bonds in the near-term.** In particular, according to borrowing schedule it will offer same range of bonds. Taking into consideration activity of investors recently, we still may see some sporadic deals with two- and three-year bonds. At the same time, **most attractive auction in the coming month will be on May 24 when the government will offer foreign currency bonds with 1.5-year maturity.**

Ukraine. Monthly Market Overview. May 2016

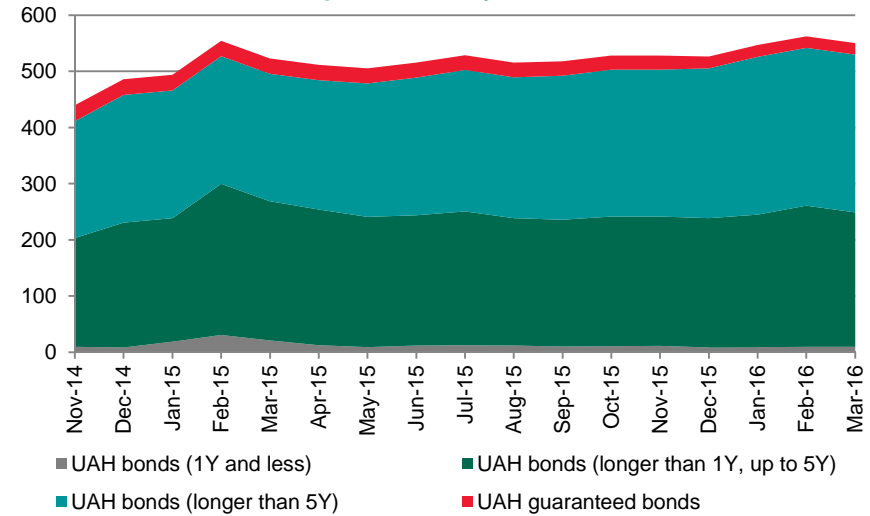
Debt indicators

External public debt dynamics, USDbn



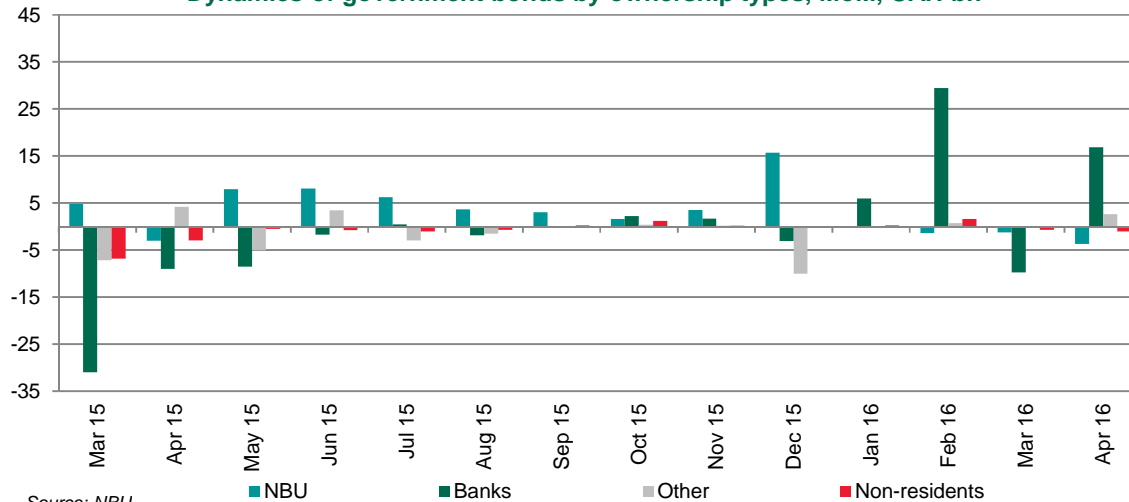
Source: Finance Ministry

Domestic public debt dynamics, UAHbn



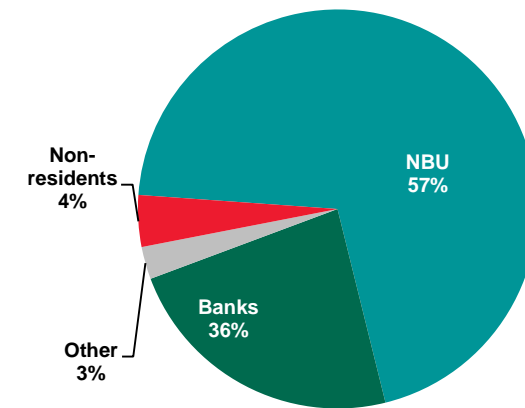
Source: Finance Ministry

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



Source: NBU

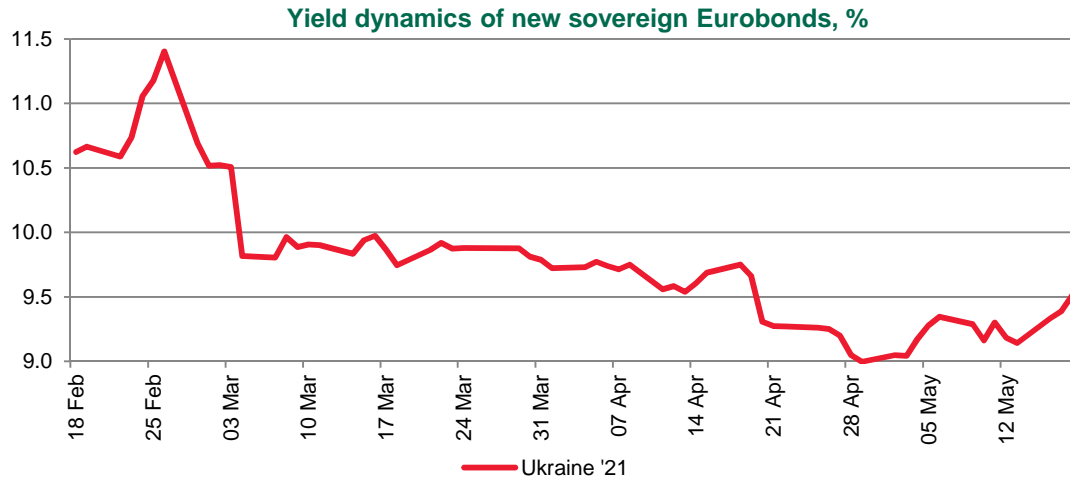
Breakdown of OVDP by owners (as of 19 May)
Total volume - UAH542bn



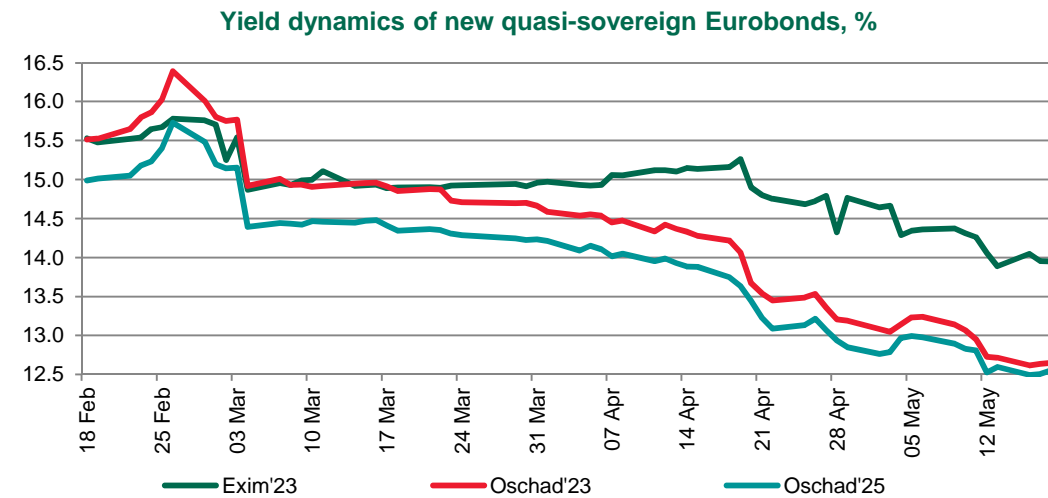
Source: NBU

Ukraine. Monthly Market Overview. May 2016

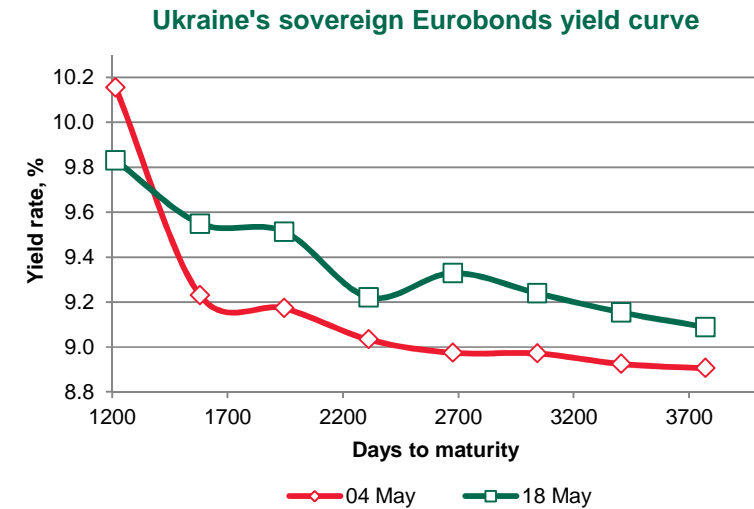
Debt indicators



Source: Bloomberg



Source: Bloomberg

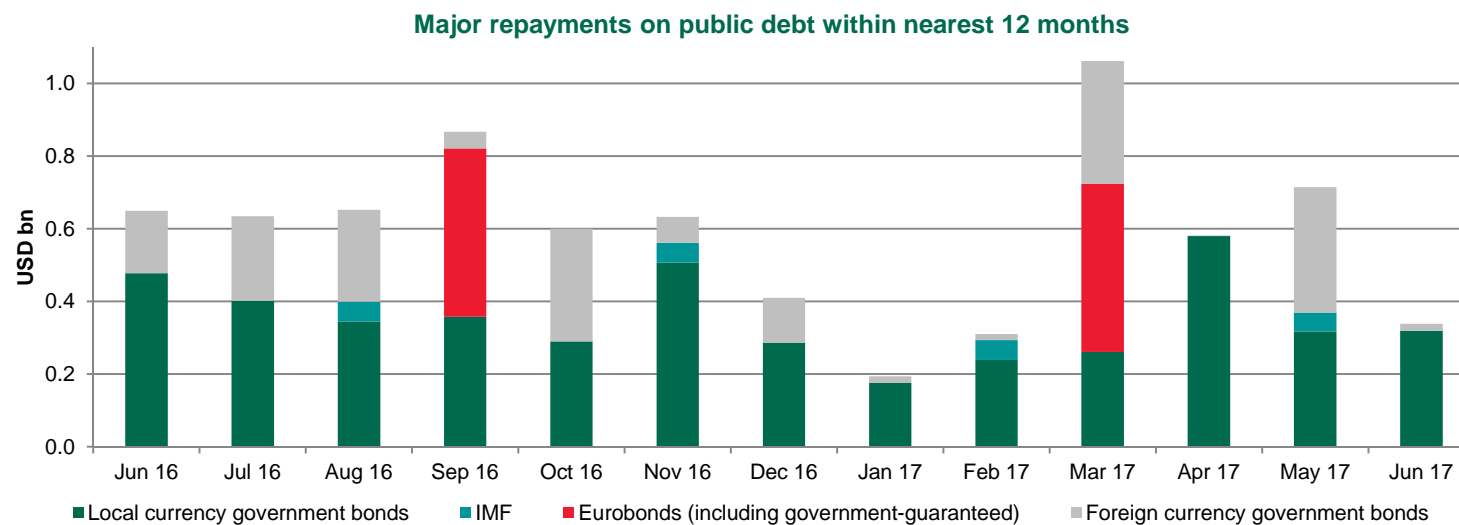


Source: Bloomberg

Ukraine. Monthly Market Overview. May 2016

Debt indicators

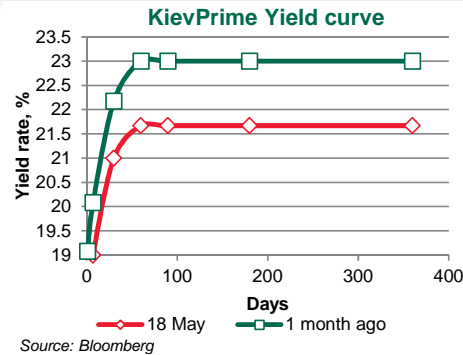
USDbn	Q216	Q316	Q416	Q117	2016
Repayment of FC-denominated public debt	0.6	1.3	0.9	1.4	4.3
Foreign currency local government bonds	0.4	0.5	0.5	0.4	2.0
IMF debt	0.0	0.0	0.1	0.1	0.2
Eurobonds (including state-guaranteed)	0.0	0.5	0.0	0.5	0.9
Other	0.2	0.3	0.3	0.4	1.1



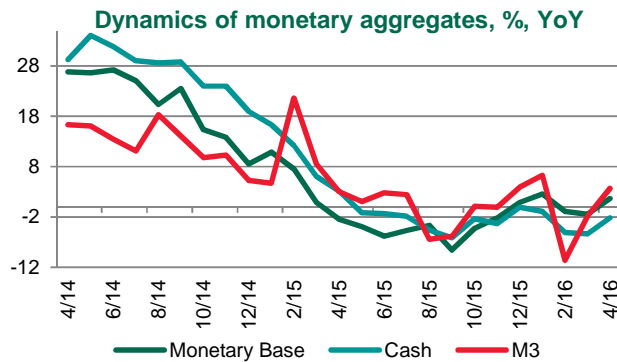
Source: Credit Agricole

Ukraine. Monthly Market Overview. May 2016

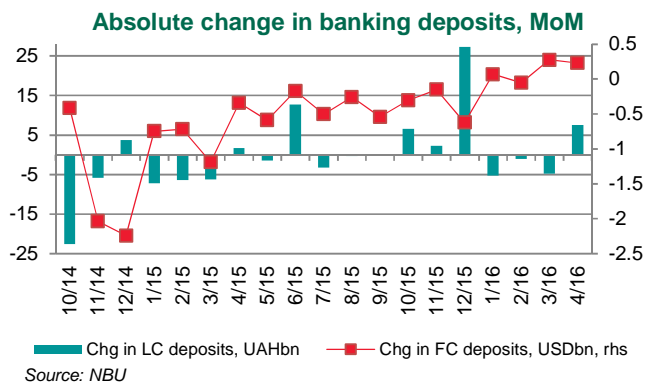
Money Market



Source: Bloomberg



Source: NBU



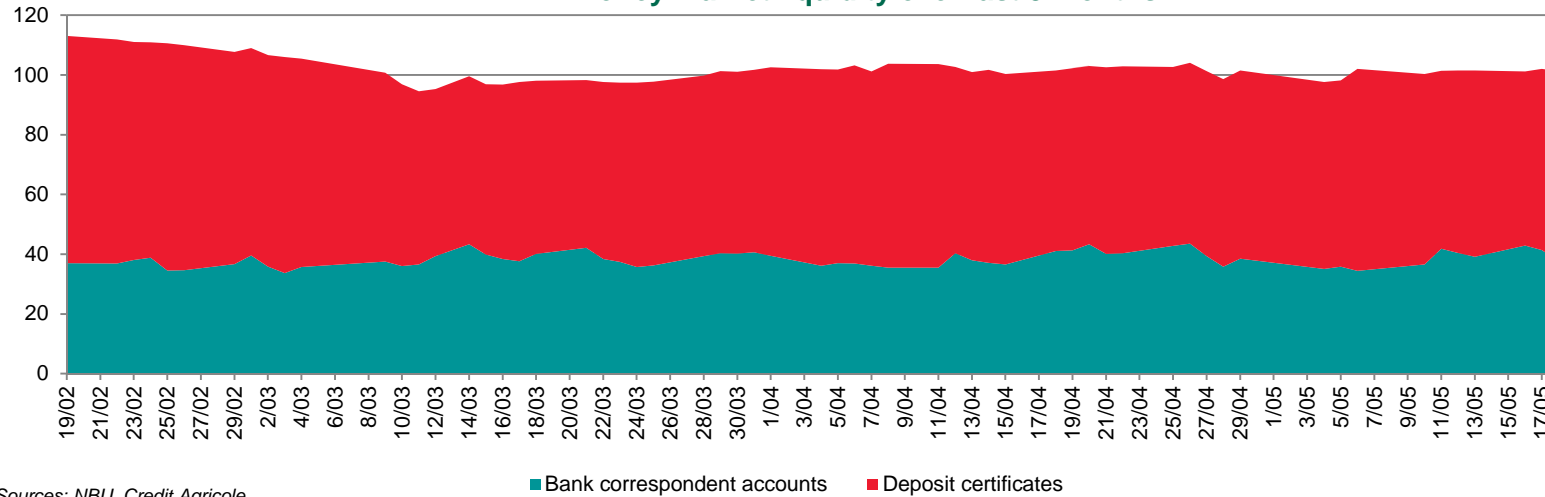
Source: NBU

- **Interest rates' dynamics was considerably different in different market segments.** In particular, benchmark rate (ie KeivPrime) was fully flat over the whole month, thus following entirely the path of rates of NBU deposit certificates. And only a cut in NBU key rate (with corresponding decline in NBU deposit certificates' rates) has moved KievPrime rates down in one day, thus preserving them unchanged at new level for the remaining days. **We do not expect to see any changes in these rates unless the NBU would decide to change its key rate at the end of May.**
- **Contrary to KievPrime rates, actual money market rates (especially in their short-term segment) demonstrated an upward pattern in April.** And the movement was backed by higher demand for hryvnia from corporate segment on the back of revival in some economic sectors. And the cut in NBU key rate has not impacted them anyhow. Even though the NBU returned around UAH17bn to the banking system in April (due to purchase of USD0.68bn from FX market) this was not enough to prevent increase in money market rates.
- **Money market interest rates stabilised slightly in May, while we do not see any reasons for their decline in the near-term.** First of all, the demand for hryvnia from business entities remains rather strong. Second, the reduction of reservation period for UAH between intention to buy FC and its actual purchase (from three to two days) in early May already removed a portion of free funds from banking accounts. And intention of the NBU to narrow this period further in early June would diminish excessive hryvnia stock. And finally, in case NBU would allow non-residents to buy foreign currency for their dividends' repatriation, we will see additional squeeze in hryvnia liquidity in the coming 2-3 months. Therefore, **we expect a gradual hike in money market rates in the near-term.**
- **NBU cut its key rate by 200bp to 19% at the end of April.** The decision of the National Bank was predicted by the market. However, the magnitude of key rates' decline was quite moderate comparing to our estimates. In fact, recent drop in YoY headline CPI (from 32.7% in February to 20.9% in March) and core CPI (from 25.1% in February to 15.0% in March) indicates on a solid reduction of inflation in Ukraine. And current NBU key rate already much higher than core CPI. Therefore, we think **NBU key rate still remains as weak instrument of monetary policy in Ukraine.** In any case, **as inflation is evidently going further down (ie in April), we should see additional cut in NBU key rate already in the coming few weeks.**
- **Inflation in April (3.5% MoM)** has beaten even most pessimistic forecasts and left consensus forecast (0.9%) far behind. And the core reason for difference between actual and forecasted figures was abolishment of discount in residential gas tariff since April. As a result, gas tariff was increased by 48.4% MoM. Other sources of high inflation last month came from alcoholic and tobacco products (by 2.8% thus reflecting a recent increase in excise charges for them) as well as in price of fuel (by 5.4% on the back of recovery in the price of oil). At the same time, the prices of food products have remained almost flat (0.1%) due to seasonal decrease in the prices of vegetables, sugar and dairy products.
- Even though monthly CPI was moderately high, **YoY inflation has diminished tremendously (from 20.9% in March to 9.8% in April).** This occurred especially after April 2015 tariffs' hike was excluded from the base for calculating YoY inflation. We still **expect moderately high YoY inflation in May 2016 backed by recent decision of the government to adjust further public utility tariffs.**

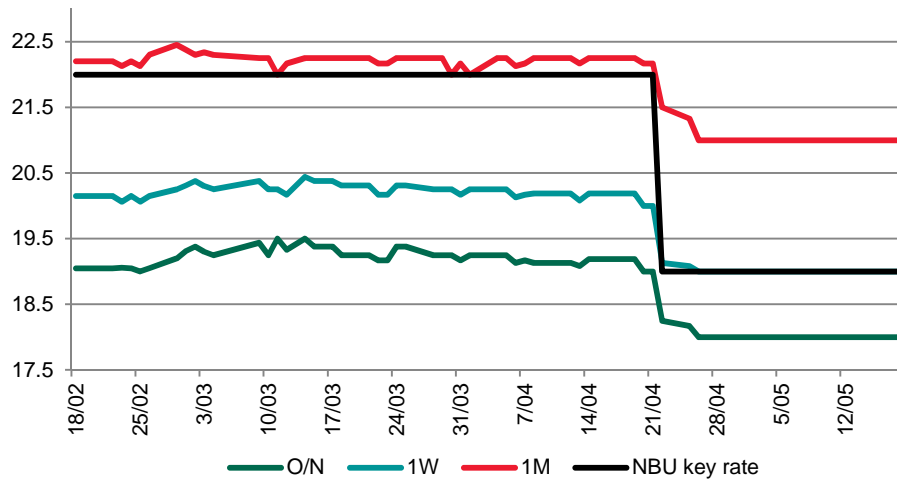
Ukraine. Monthly Market Overview. May 2016

Money Market

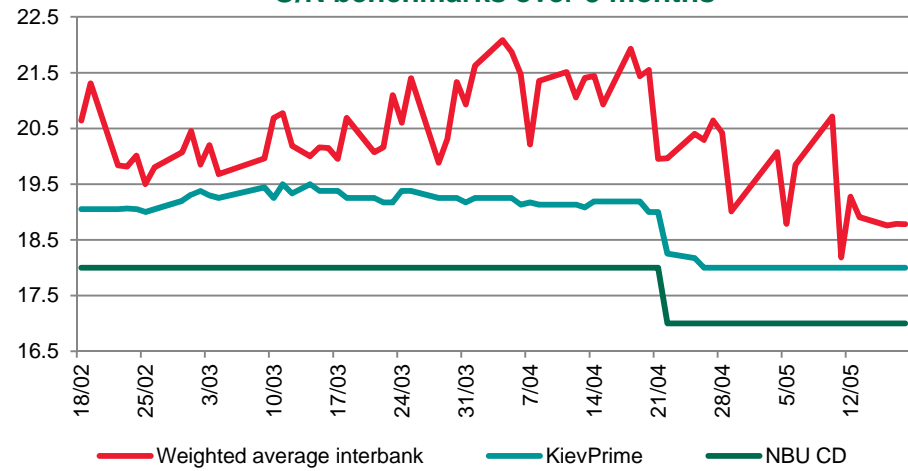
Money market liquidity over last 3 months



KievPrime rates over last 3 months



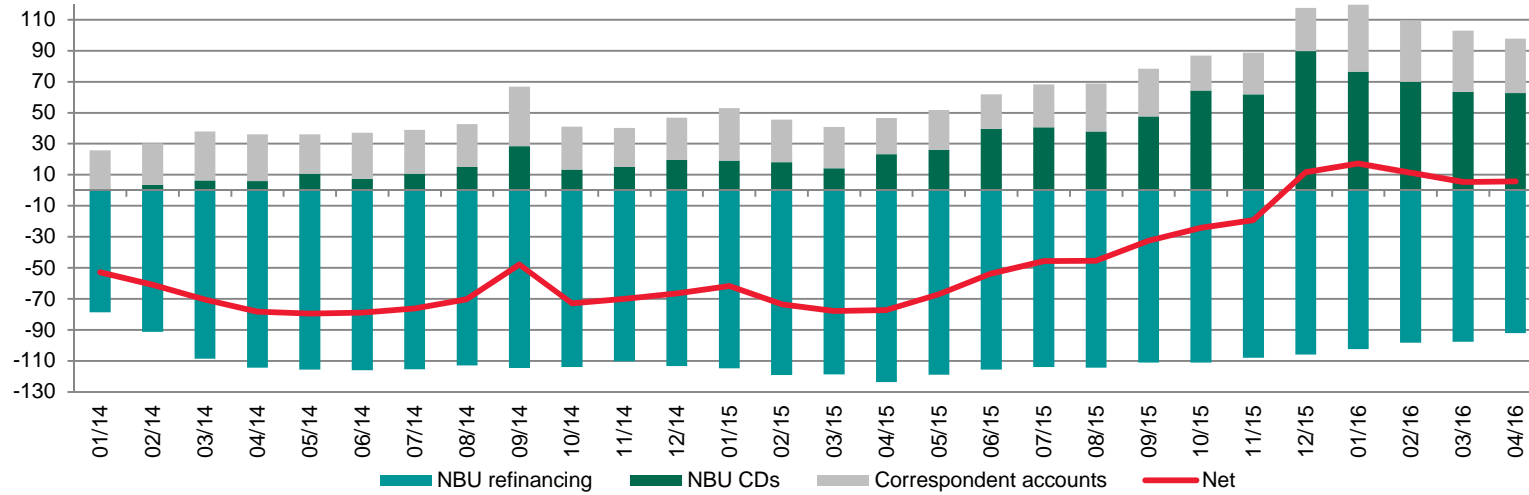
O/N benchmarks over 3 months



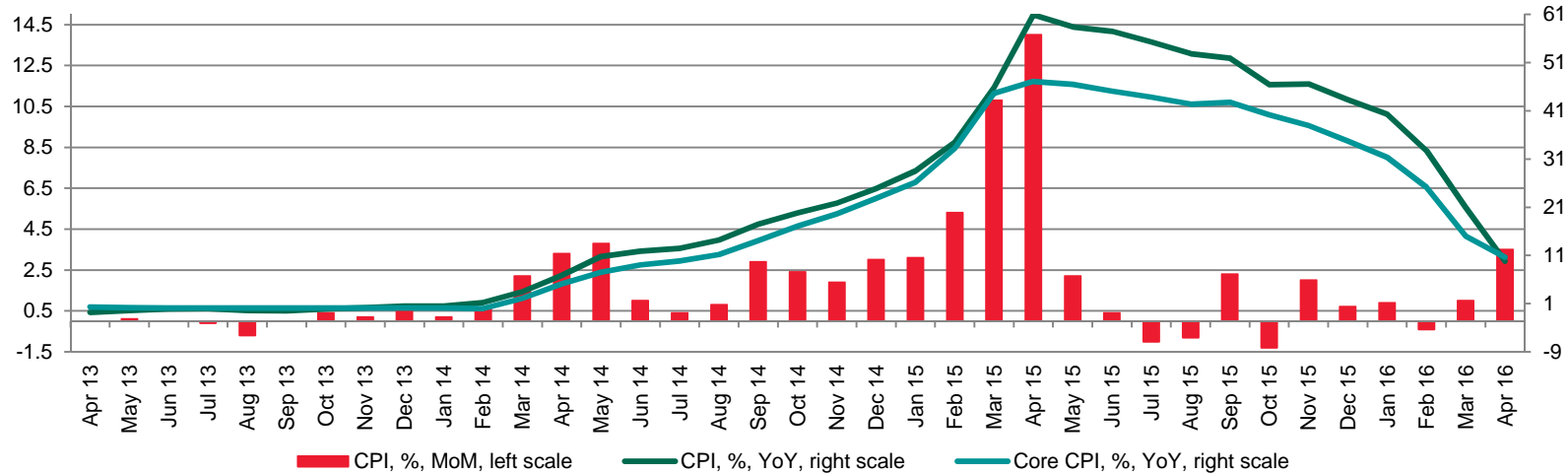
Ukraine. Monthly Market Overview. May 2016

Money Market

Net position of banking system vs NBU, UAHbn



Inflation indicators



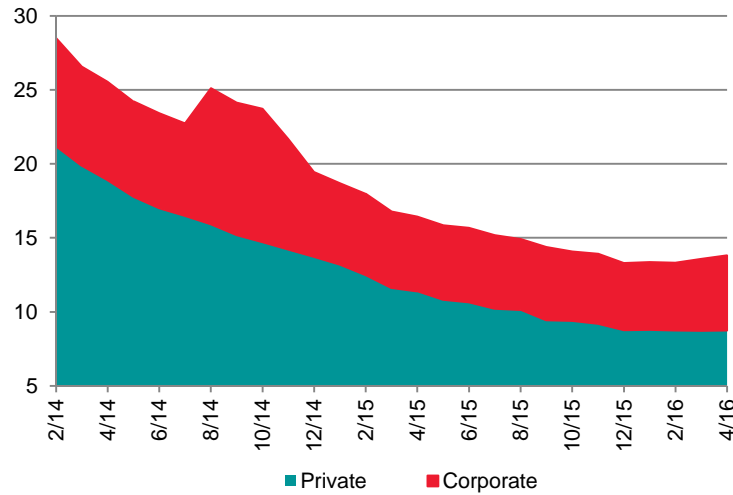
Source: State Statistics Committee

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Banking sector

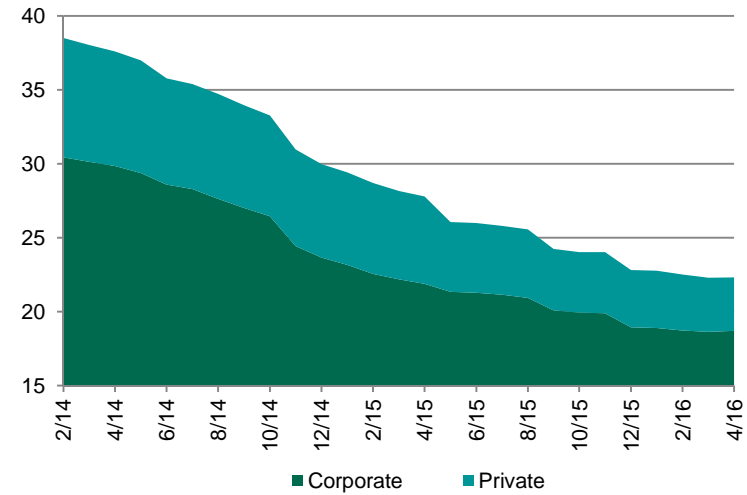


Banking FC deposits, USDbn



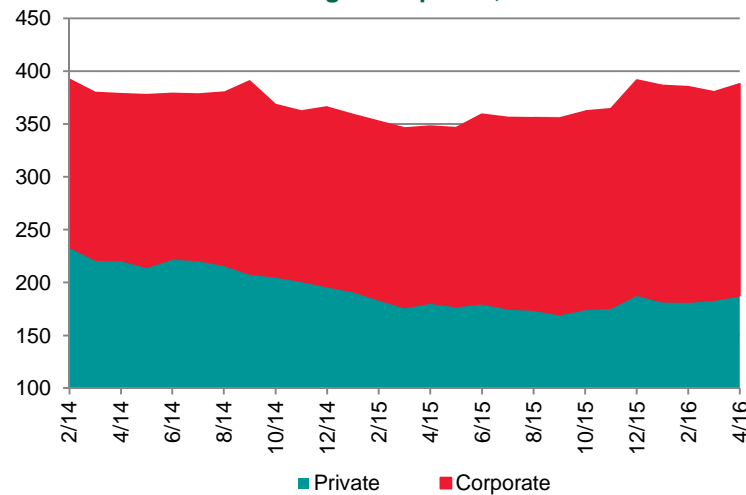
Sources: NBU, Credit Agricole

Banking FC loans, USDbn



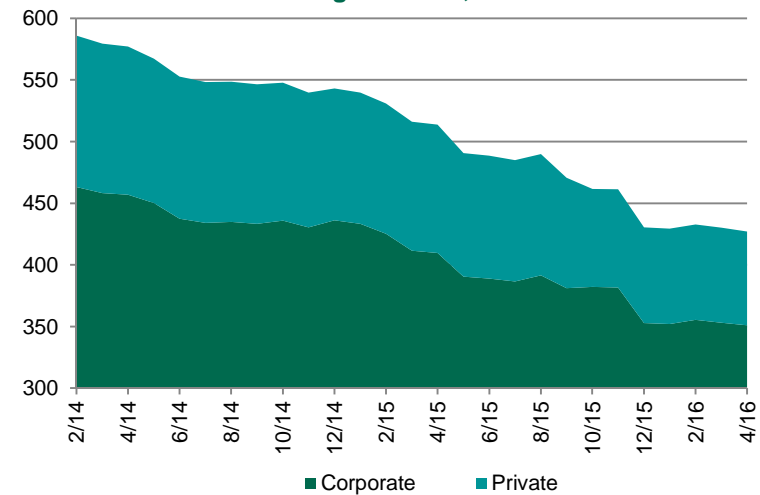
Sources: NBU, Credit Agricole

Banking LC deposits, UAHbn



Sources: NBU, Credit Agricole

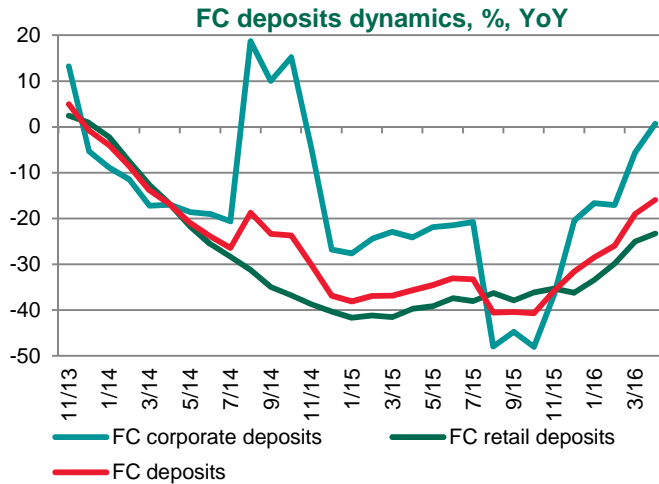
Banking LC loans, UAHbn



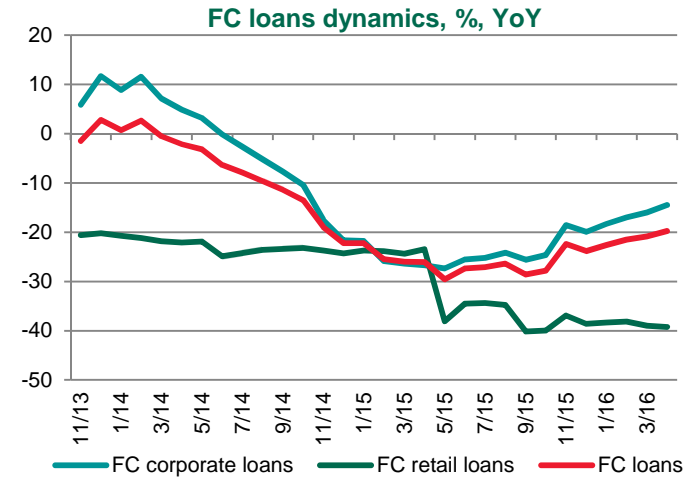
Sources: NBU, Credit Agricole

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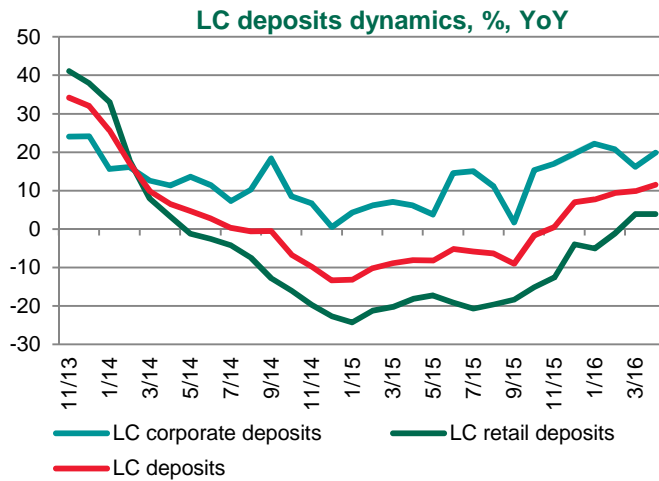
Banking sector



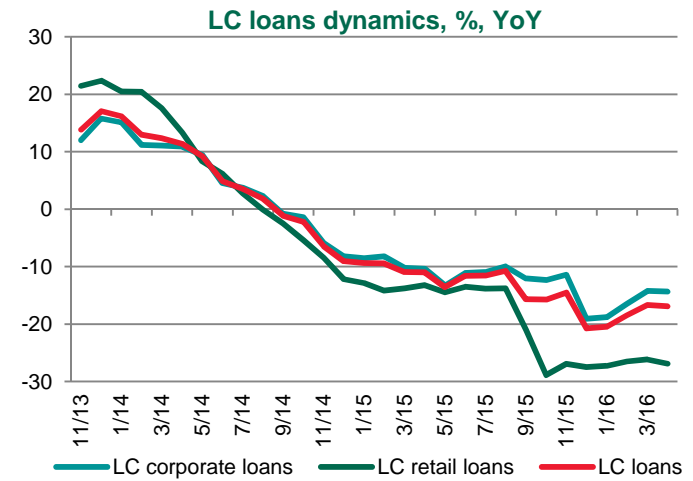
Sources: NBU, Credit Agricole



Sources: NBU, Credit Agricole



Sources: NBU, Credit Agricole

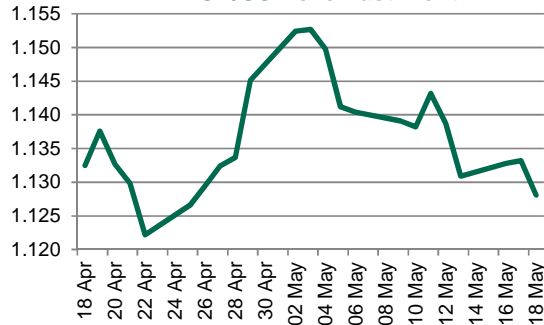


Sources: NBU, Credit Agricole

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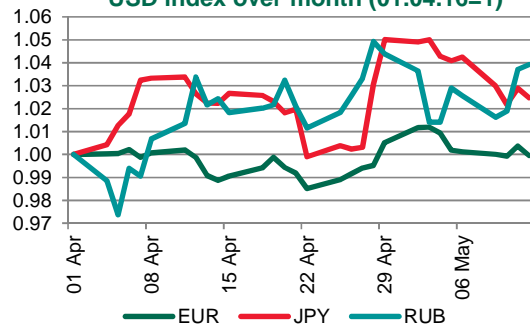


EUR/USD over last month



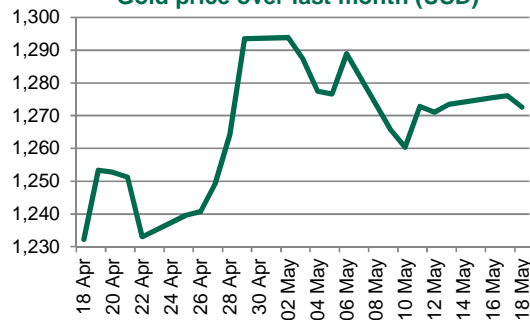
Source: Bloomberg

USD index over month (01.04.16=1)



Sources: Bloomberg, Credit Agricole

Gold price over last month (USD)



Source: Bloomberg

- The EUR/USD shocked markets in the last days of April after Eurozone GDP surprised to the upside and the weaker USD sent the EUR to trade at 1.1454. The EUR saw a gain of 0.65% on the month and is up 5.47% YTD.
- The April preliminary Consumer Price Index showed headline inflation in the red for the month. CPI came in at -0.2% YoY, comparing unfavorably to the Thomson Reuters consensus analyst estimate for an index value of -0.1% and the March figure of 0%.

The following are recent market forecasts:

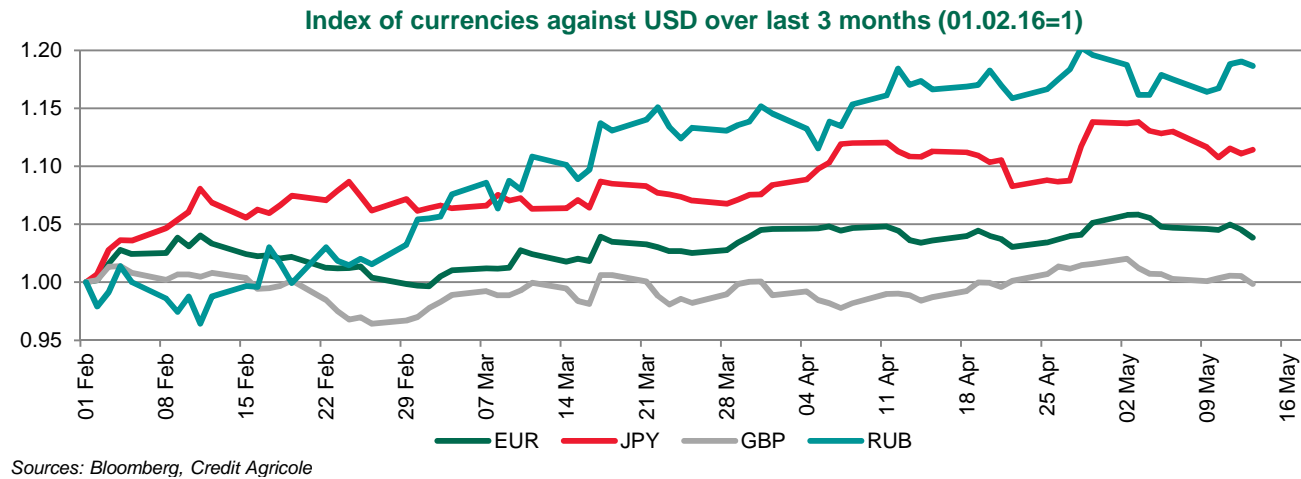
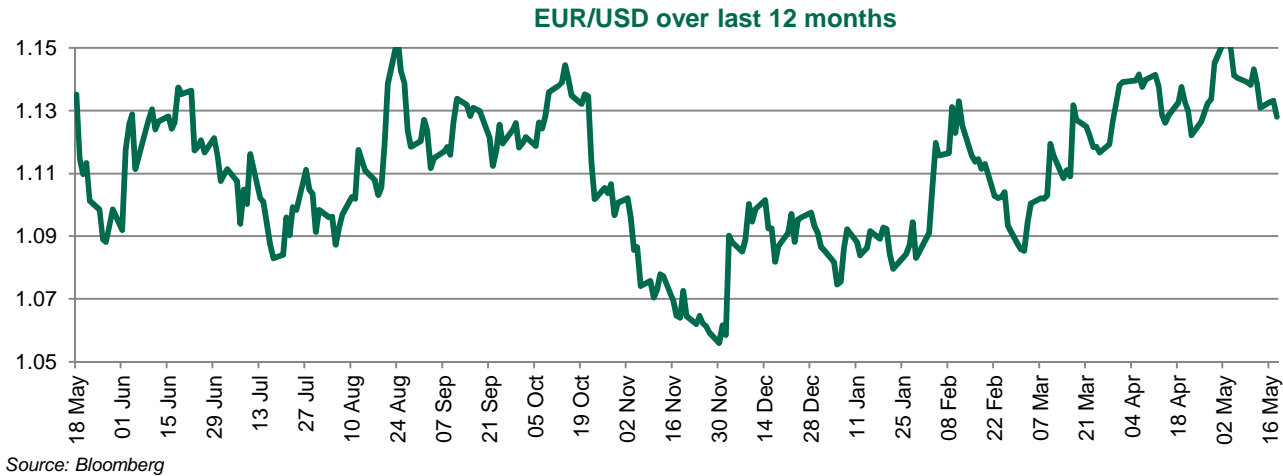
Crédit Agricole CIB EUR/USD forecast:

Q216	Q316	Q416	Q117
1.1400	1.1300	1.1200	1.0700

Consensus forecast (Bloomberg FC Poll by 100 strategists average)

Q216	Q316	Q416	Q117
1.1200	1.1100	1.1200	1.1200

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Alexander Pecherytsyn

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