Ukraine. Monthly Market Overview

September 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

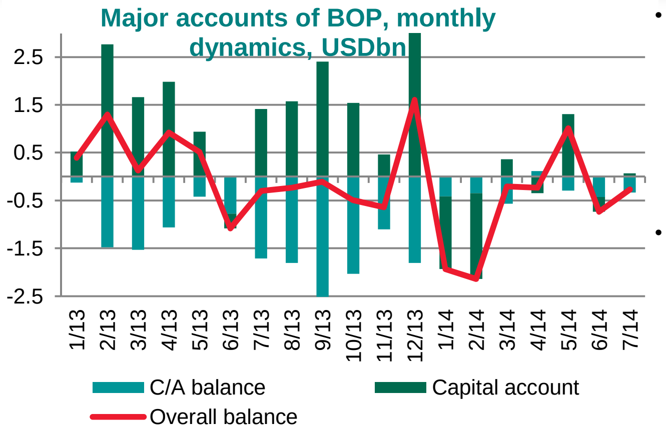
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014F*	2015F*
Nominal GDP (USDbn)	38.0	42.4	49.5	64.9	86.2	107.7	142.7	129.0	117.4	136.2	165	174	178	138	161
Real GDP growth (%)	9.2	5.2	9.4	12.1	2.7	7.3	7.9	2.1	-14.8	4.2	5.2	0.2	0.0	-6.3	0.8
Inflation CPI, eop (%)	6.1	0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	17.3	9.1
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	-8.5	1.1
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	59.2	62.6
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	60.4	61.3
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	58.4	60.1
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	-3.7	-3.4
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	1.4	2.6

EXCHANGE RATES - evolution

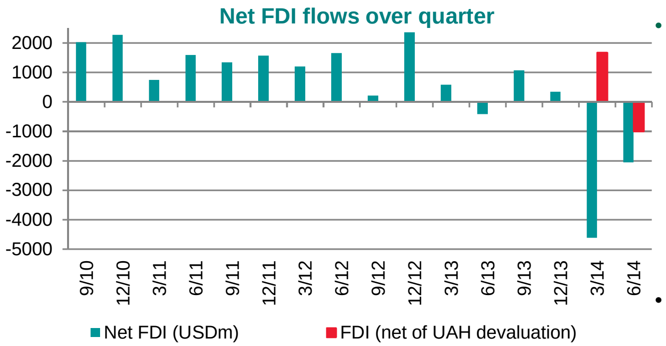
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014F*	2015F*
USD/UAH eop	5.30	5.33	5.33	5.31	5.05	5.05	5.05	7.70	7.98	7.96	7.99	8.04	8.24	12.40	12.10
USD/UAH average	5.37	5.33	5.33	5.31	5.12	5.05	5.05	5.32	7.79	7.93	7.97	8.02	8.16	11.48	12.25
EUR/UAH eop	4.70	5.05	6.70	7.20	6.00	6.70	7.42	10.86	11.45	10.57	10.30	10.54	11.04	16.52	15.50
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	15.30	16.00
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	5.7	3.5

- ***Geopolitical risks became even sharper in August***. In fact, the indirect support of separatists in Ukraine by one of its neighbouring countries resulted in the direct incursion of its troops into Ukrainian territory. This definitely raised the conflict to a new level and extends the time frame required for Ukraine to liquidate the terrorists. Hence, we should see ***a longer-lasting negative effect from the conflict on the economic performance and stability of financial markets in Ukraine in the coming months. We also consider the recent ceasefire agreement a temporary action in the conflict, while an escalation may start quite soon.***
- It was not a surprise ***that the president dismissed the parliament and called for early parliamentary elections, scheduled for 26 October***. The news is in line with the strategy to re-launch all the branches of power in Ukraine in order to prepare them for new challenges, the changing power elites and the new geopolitical orientation of the country. We think the ***pre-election campaign will not add greater uncertainty*** in the coming months because both the government and the parliament will continue their ordinary operations until after a new parliament is elected.
- ***Ukraine finally received the second tranche (USD1.4bn) of its IMF stand-by loan*** in early September. The decision was expected by the market. This is a clear demonstration of the readiness of the government to follow the path of reforms and to implement the IMF's requirements. Additionally, on providing the second tranche of its loan, the IMF agreed to some concessions for Ukraine (like budget parameters and FX policy as well as softer performance criteria in memorandum) taking into consideration the negative pressure on the economy coming from the conflict in Eastern Ukraine. ***The probability of the disbursement of the next tranche of USD2.85bn in December is high.***

Ukraine. Monthly Market Overview. September 2014
Major Macroeconomic Trends



Sources: NBU, Credit Agricole



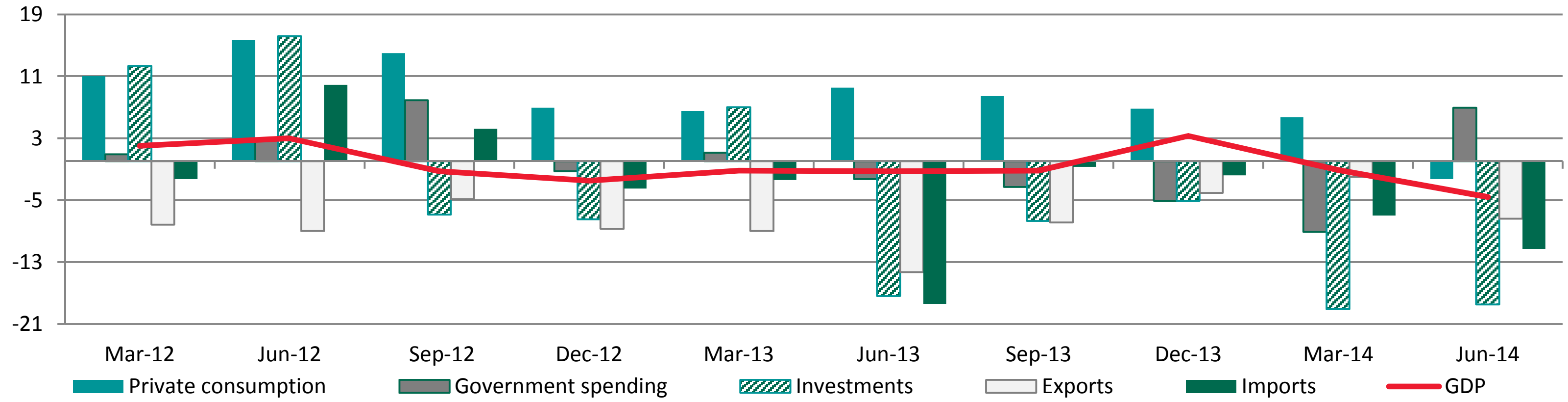
Sources: State Statistics Committee, Credit Agricole

Forecast	GDP, YoY
Q314	-6.8%
Q414	-11.5%
Q115	-3.8%
Q215	1.1%

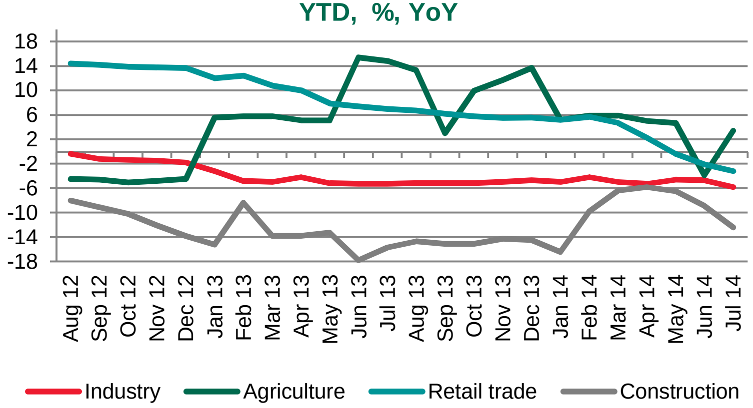
Source: Credit Agricole

- The active military conflict in Eastern Ukraine continues to negatively impact Ukraine's economic performance this year. In fact, ***almost all sectors showed a worsening in their YoY indicators in July*** versus the previous month, with construction demonstrating the most dramatic drop. However, ***a rather good grain harvest turned agriculture's dynamics to positive territory*** in July (11.3% versus -17.6% in June). We are quite sure that the continuing conflict will negatively impact the performance of economic sectors at least in the coming months. Any ***more serious impact may force us to downgrade our full-year forecast*** (currently at -6.3%).
- It was no surprise that a rating agency made another downgrade of the Ukrainian sovereign rating. In particular, ***Fitch reduced the local currency rating by one notch from B- to CCC***. We again treat the action of the agency – as well as the lack of new explanation given – as an ungrounded action made 'in anticipation'. The agency did not take into consideration the rather high probability of the receipt of around USD1.9bn from both the IMF and the World Bank in the coming days. In addition, the ability of the Ukrainian government to service its local currency obligations is theoretically unlimited as the NBU is ready to provide financial resources to the government. In any case, ***we treat the news as unimportant, thus having no material impact on the country risk level***, as most of the factors mentioned by the agency have already been priced-in by the market.
- ***Solid hryvnia depreciation negatively affected FDI inflows in H114 due to FC adjustments***. In particular, net FDI reached -USD6.67bn over January-June, while losses due to the currency devaluation effect (USD7.34bn) even exceeded net FDI outflows. Hence, the net effect was still slightly positive. We think this figure was achieved mostly thanks to the replenishment and development of existing investments, while new investors prefer to wait until the geopolitical crisis is resolved. We consider that ***a reduction of the conflict in Eastern Ukraine and successful parliamentary elections will be the catalysts for any further increase in FDI in H214***. However, the negative effect of hryvnia devaluation in February-April will outweigh any positive inflows this year, thus leaving net FDI inflows in negative territory for the full year. In any case, the ***BOP data shows net FDI inflows in July for a third month in a row***.
- As a significant portion of Ukrainian industrial facilities are located in Eastern Ukraine (or tied to supplies from this region), the ***active conflict there is negatively affecting budget revenues.*** Hence, the government has had to implement additional measures to compensate for the shortfalls in budget revenues by raising existing charges and introducing new ones. In particular, the government has increased the mineral resources tax, postponed VAT refunds on exports, introduced a 1.5% 'war tax' on individual income, etc. We think ***these measures will restrict the expansion of the budget deficit in 2014.***
- ***The BOP looked better in July than in previous months***, with the major reason being the absence of gas imports from Russia. As a result, the CA deficit YTD (USD2.26bn) looks considerably better than the same figure last year (USD7.10bn). ***We also consider the increase in the foreign currency loans' rollover ratio in July to 96% from 63% in June as positive news. However, geopolitical risk and the conflict in Eastern Ukraine may weigh on steel and chemical exports*** due to the location of production facilities in the zone of the conflict.

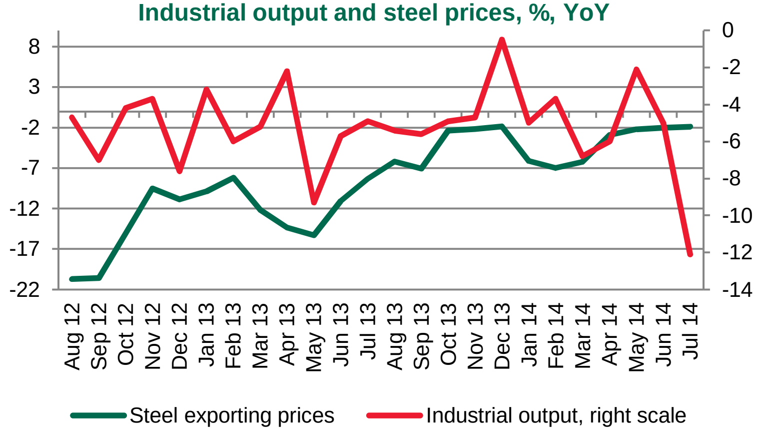
Ukraine. Monthly Market Overview. September 2014
Major Macroeconomic Trends



Sources: State Statistics Committee



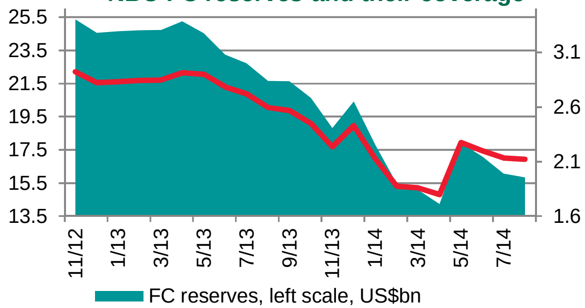
Source: State Statistics Committee



Sources: State Statistics Committee, Bloomberg, Credit Agricole

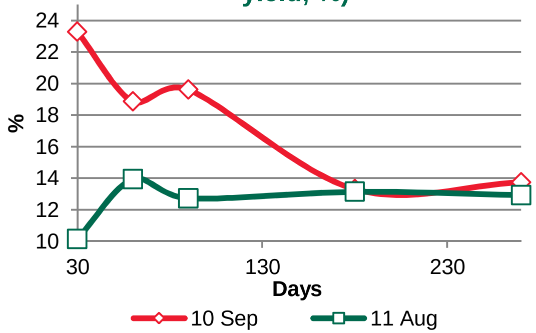
FX Market

NBU FC reserves and their coverage



Sources: NBU, Credit Agricole

USD/UAH NDF curve (implied yield, %)



Source: Bloomberg

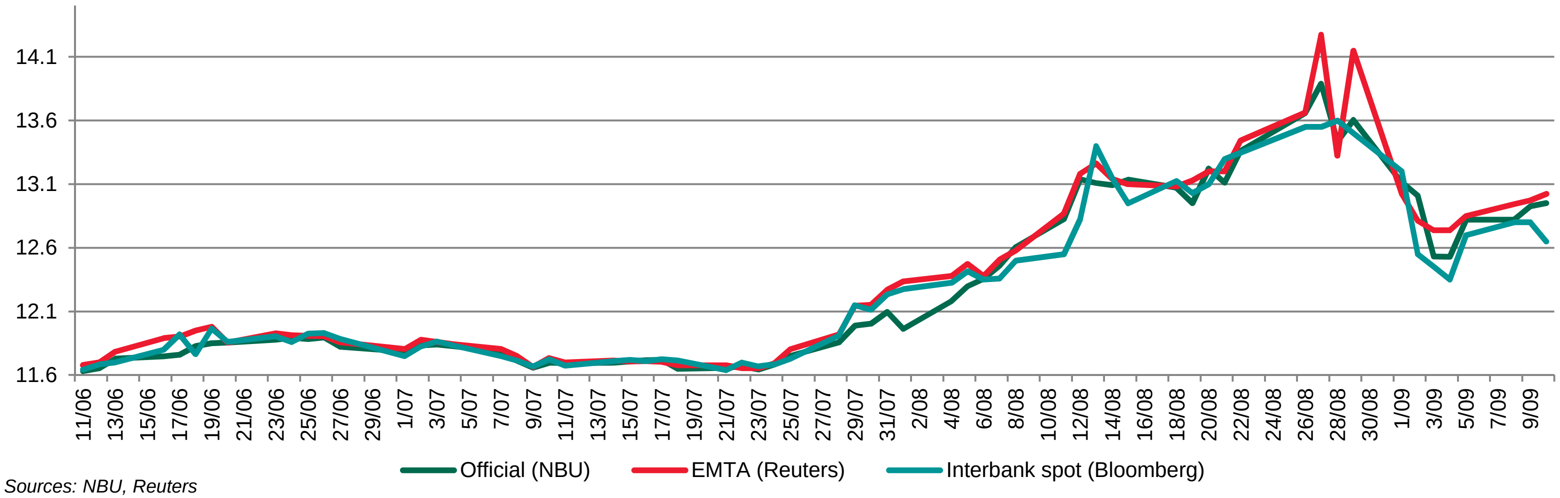
Forecast, eop	USD/UAH	EUR/UAH
Q3'14	12.60	16.88
Q4'14	12.40	16.37
Q1'15	12.30	15.99
Q2'15	12.15	15.67

Source: Credit Agricole

- As market measures to control the FX market have had little effect due to the sharp geopolitical concerns, ***the NBU has had no other option than to impose more administrative restrictions.*** First of all, it increased the ratio of mandatory foreign currency sales from 50% previously to 100%; however, this effect did not influence the market greatly. Already after a few weeks this action has done more harm than good by artificially limiting export inflows into the country, Hence, the NBU became more certain of imposing additional restrictions on FX market operations. In fact, the NBU reduced banks' FX open positions from 5% to 1% and implemented one to two days' delay between orders to purchase or sell foreign currency and the date of actual operation. This strategy ***proved to be effective by allowing the trend in the USD/UAH to be broken*** when the rate reached its all-time high of 14.30 at the end of August. However, ***a few weeks of tight NBU administrative control should pass before the equilibrium market rate moves below 13.00.***
- Because the market started to become concerned about medium-term hryvnia stability in late July already, by increasing foreign currency demand in both the interbank and cash FX markets, we think the ***seasonal growth in demand expected from September will be smoother than in previous years***. In fact, most of the risks that traditionally accompany the FX market in September have already appeared in July-August. In its turn, NBU has already increased its administrative pressure on the FX market, thus minimising the influence of additional risks and fears on exchange rate dynamics in September.
- Current NBU actions indicate that it is trying to ***maintain an unofficial USD/UAH band of 12.50-13.00 as a temporary equilibrium for the near future***. At the same time, additional negative factors like the resumption of gas imports from Slovakia, possible purchase of foreign currency to pay Naftogaz bonds, etc should remain concerns for market participants in September. On the other side, ***the redemption of Naftogaz Eurobonds (USD1.6bn) should not disturb the FX market considerably*** as the bulk of foreign currency may be obtained from the second IMF tranche (USD1.4bn) that reached Ukraine in late August.
- ***NBU FC reserves fell rather marginally in August (by USD0.24bn)*** mostly as a result of NBU interventions to support hryvnia stability. ***We think NBU FC reserves are likely to be only marginally lower over September*** due to the rather tight external debt schedule in the near future. In particular, the government will have to redeem USD2.13bn this month, with the bulk of payments going to the redemption of Naftogaz bonds. The latter issue was backed by a government guarantee. The inflow of foreign currency under the IMF and WB programs (around USD1.90bn) will not be enough to fully cover the outflow.
- ***We consider the thin FX market a core reason for the sharp USD/UAH fluctuations***. And it seems we are not alone in our concerns, as ***NBU expects a special IMF group to come to Ukraine soon in order to reform the FX market.*** We think it might be the proposals to increase access to the market by other participants behind banks, widening its liquidity and flexibility, as well as the introduction of additional derivative instruments. However, this is still a matter of at least six months.
- The threat of the conflict being prolonged, direct Russian invasion into Ukraine, as well as a potential reduction in steel and chemical exports due to military operations force us to ***downgrade our year-end USD/UAH forecast to 12.40.***

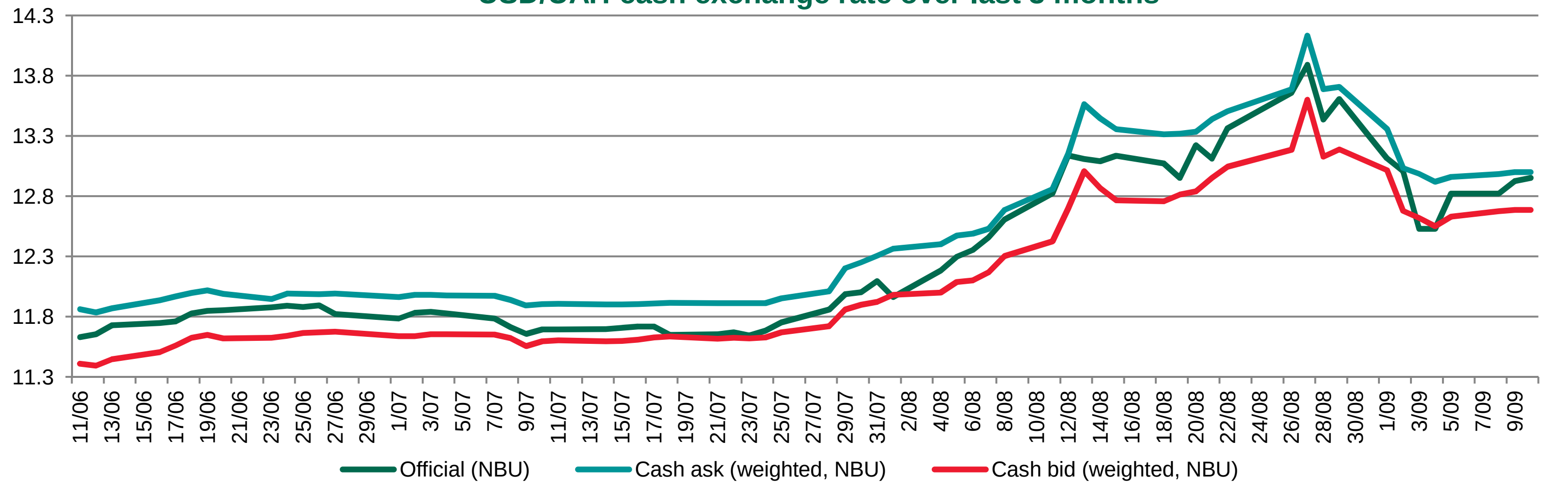
Ukraine. Monthly Market Overview. September 2014
FX Market

USD/UAH interbank exchange rate over last 3 months



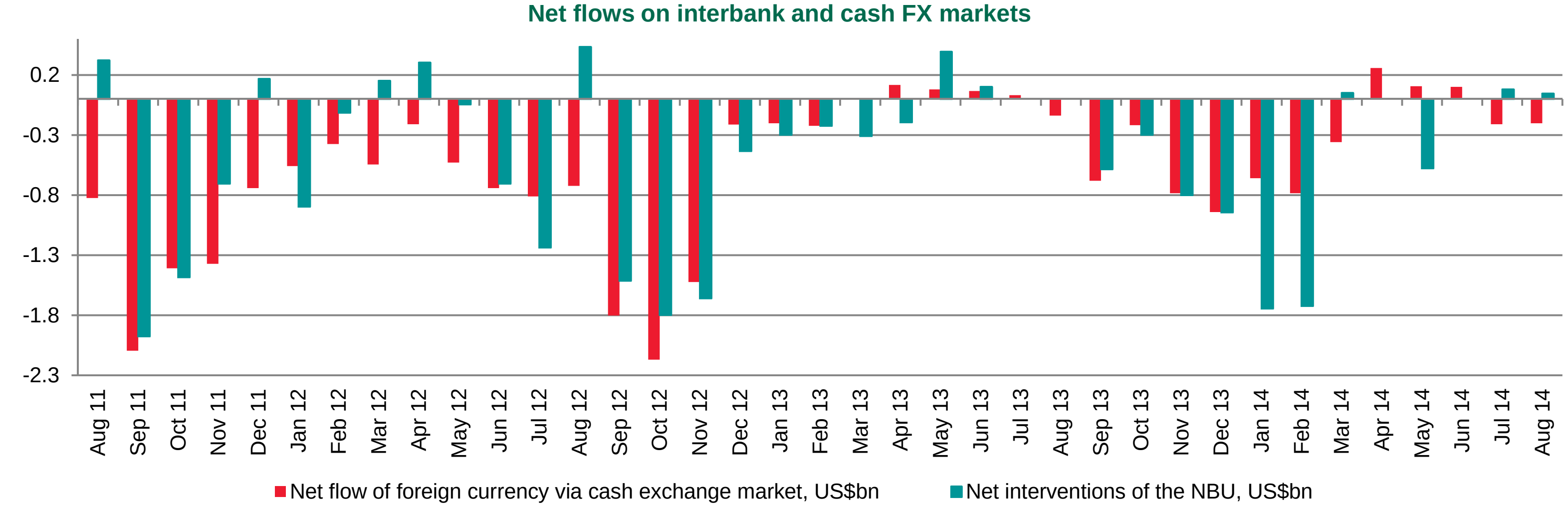
Sources: NBU, Reuters

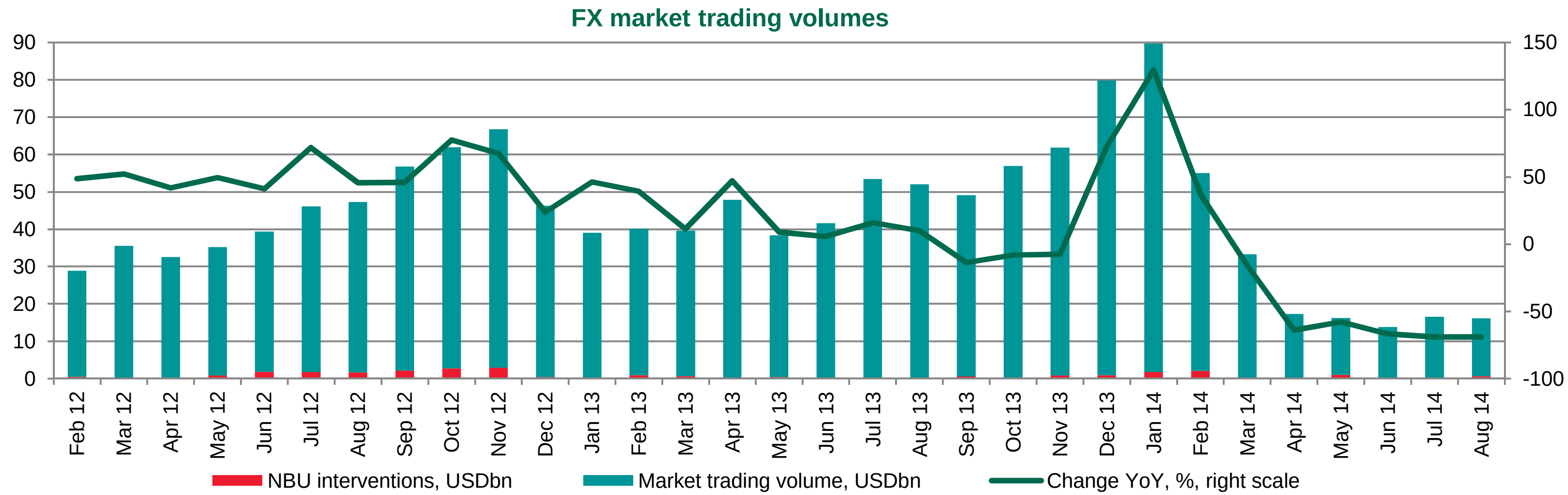
USD/UAH cash exchange rate over last 3 months



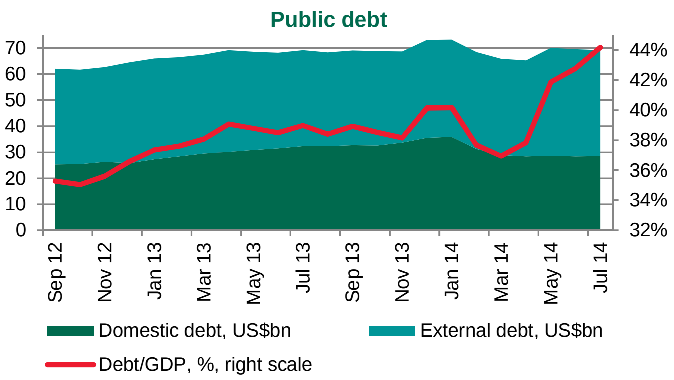
Source: NBU

Ukraine. Monthly Market Overview. September 2014
FX Market

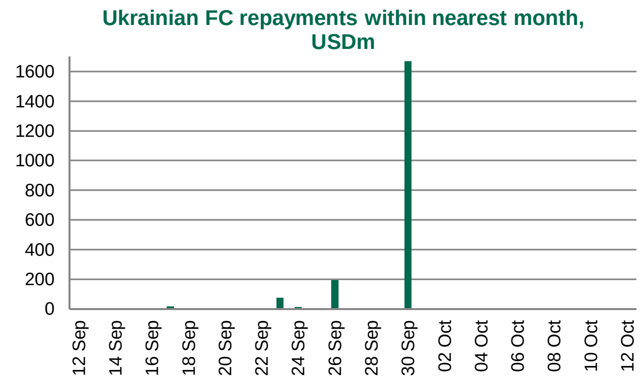




Ukraine. Monthly Market Overview. September 2014
Debt indicators



Sources: Finance Ministry, Credit Agricole

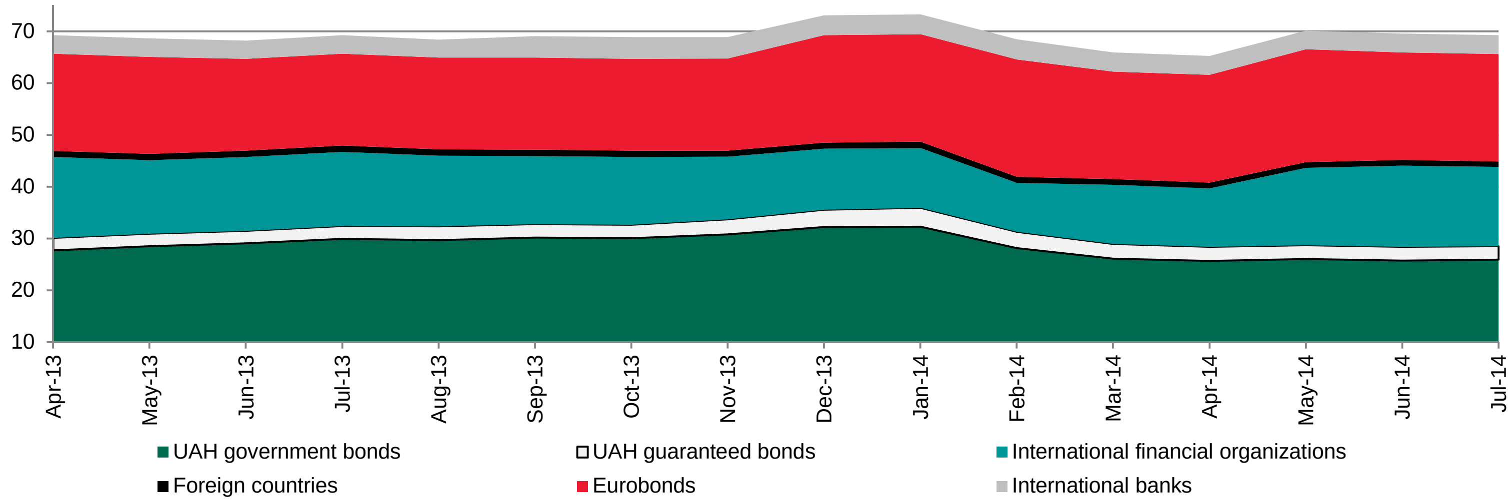


Sources: Finance Ministry, Credit Agricole

- ***Public debt fell slightly (by 0.4% MoM) in July*** thanks to more active repayments of external debt (-0.97% MoM), while domestic debt increased by 0.41%. The repayment of debt to the IMF in late July and the postponement of the provision of the next tranche was a major reason behind the dynamics in external public debt in July. However, the active issuance of government bonds (mostly for the needs of Naftogaz, State deposit guarantee fund and the issuance of VAT bonds) drove domestic debt up. ***The rather inactive business environment will keep public debt mostly flat in August.*** However, we can see a moderate increase in domestic debt due to the issuance of government bonds worth UAH43.5bn for the recapitalisation of Naftogaz.
- The decline in public debt did not save the ***debt-to-GDP ratio from a further increase in July to 45.3% from 43.9% the month before.*** We think the economic decline as well as the hryvnia devaluation effect mostly impacted this trend. We think the same reasons will drive ***the ratio up further to 58.4% of GDP for the full year***, according to our forecasts.
- ***The government was moderately active in placing local currency government bonds*** via primary auction in August, receiving UAH4.94bn, with the bulk of funds received from the placement of bonds under non-market parameters. However, ***a bright spot in August was the placement of 2.5Y bonds of UAH2.03bn to foreign investors under 18.98%*** as well as continuing issuance of VAT bonds worth UAH0.95bn. This should add some liquidity to the secondary market for government bonds. However, ***we are not sure yet that a new phase of interest from investors has been started.*** In fact, geopolitical instability and the threat of further hryvnia devaluation are weighing negatively on investors' attitude towards hryvnia government bonds.
- The cost of servicing existing hryvnia obligations over August (UAH3.61bn) was less than the volume of bonds sold, thus providing a net inflow of funds of UAH1.33bn to state coffers. Almost ***the same burden for the government is expected in September, with the cost of servicing domestic debt at UAH3.34bn***. We think this is a manageable amount to be raised through the primary market this month.
- ***After the repayment of USD1.60bn on Naftogaz Eurobonds in late September, the government will have a calm repayment schedule for the coming 12 months*** with monthly repayments not exceeding USD0.79bn. The total repayment of external debt over these months will reach USD6.92bn, while the debt net of IMF repayments is USD5.15bn. As we assume the government will receive at least the next tranche of USD2.85bn from the IMF in late 2014, we think ***the repayments to the IMF will be fully refinanced in 2015. Hence, the overall external debt burden for the government is quite moderate for the next 12 months, thus reducing any probability of default.***
- Contrary to external debt repayments, ***the redemption of domestic debt in the coming year seems rather large (UAH47.4bn).*** However, as more than 75% of existing domestic debt is in the ownership of either the NBU or state-owned banks, ***the probability of this debt refinancing is quite high***. Hence, it is not a concern for the country.

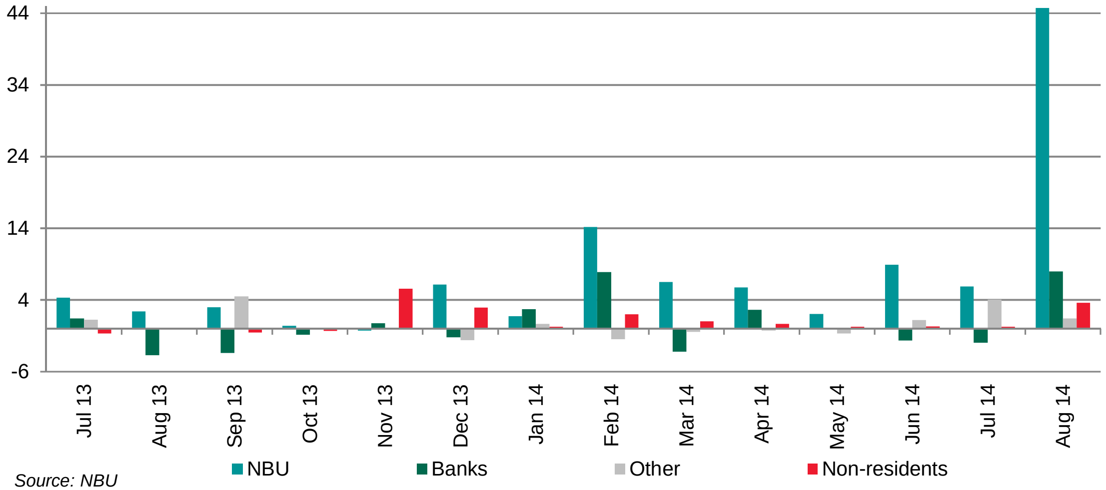
Ukraine. Monthly Market Overview. September 2014
Debt indicators

USD nominated public debt by components, USDbn



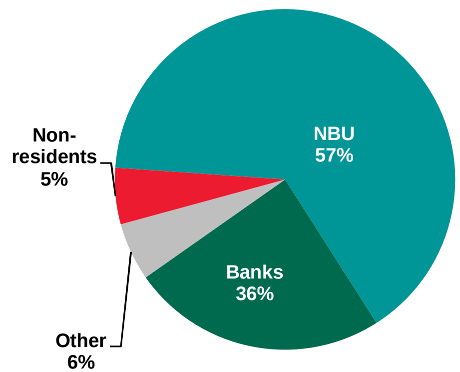
Source: Finance Ministry

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



Source: NBU

Breakdown of OVDP by owners (as of 9 Sep)
Total volume - UAH366bn

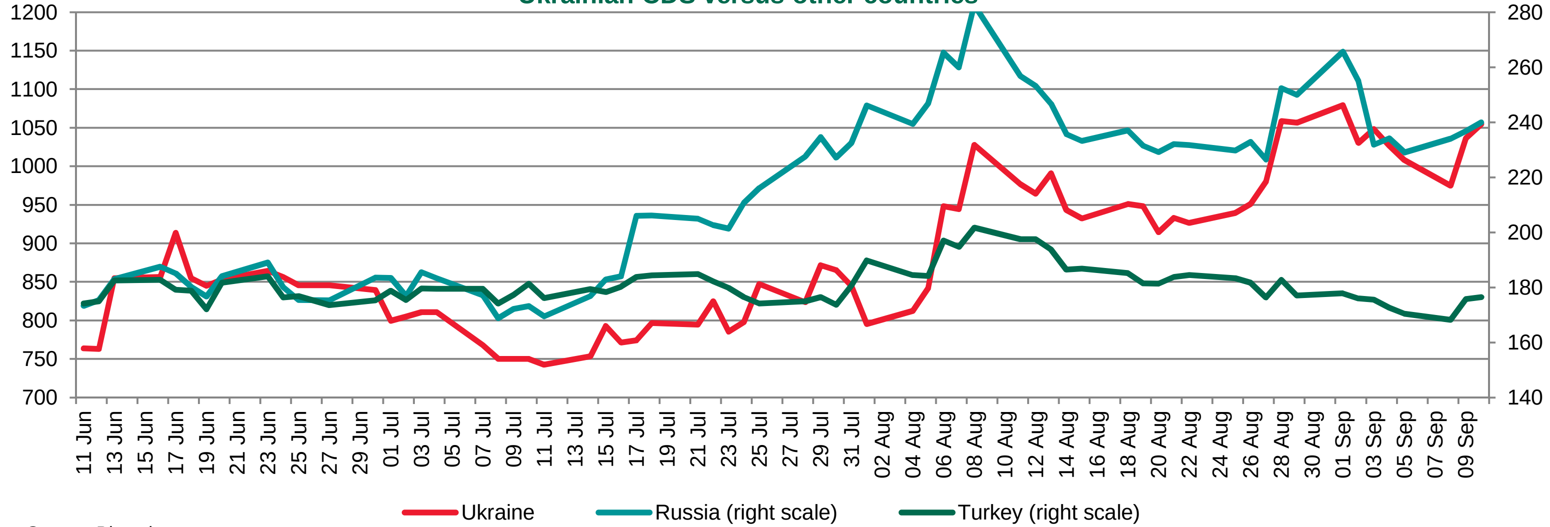


Source: NBU

Ukraine. Monthly Market Overview. September 2014

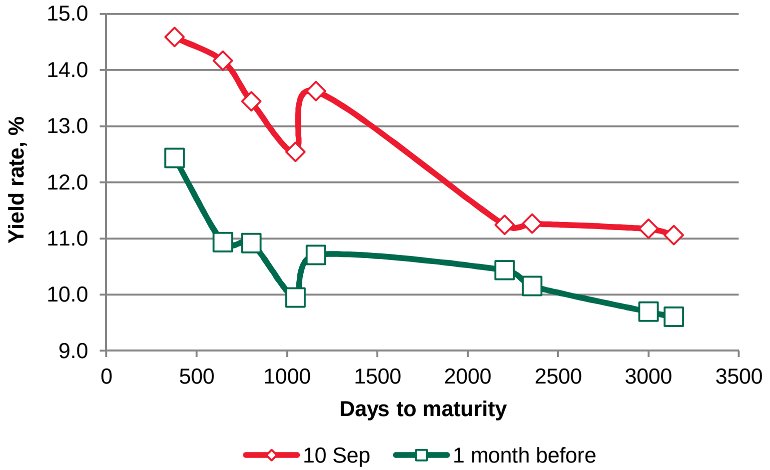
Debt indicators

Ukrainian CDS versus other countries



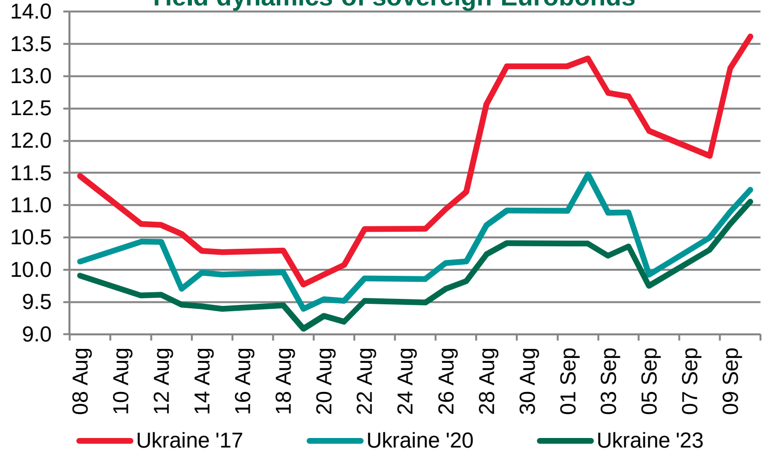
Source: Bloomberg

Ukraine's sovereign Eurobonds yield curve



Source: Bloomberg

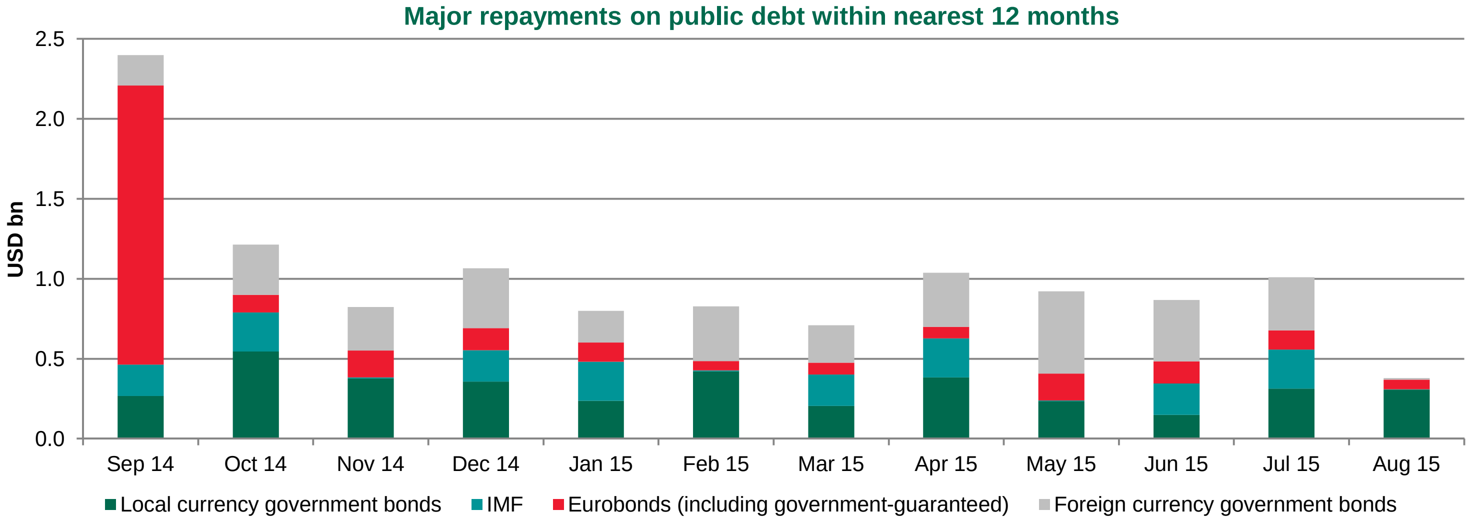
Yield dynamics of sovereign Eurobonds



Source: Bloomberg

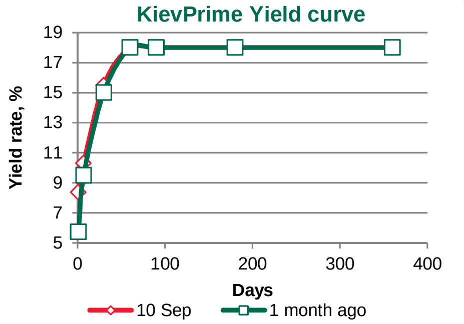
Ukraine. Monthly Market Overview. September 2014
Debt indicators

USDbn	Q314	Q414	Q115	Q215	2014
Repayment of FC-denominated public debt	**3.7**	**1.9**	**1.7**	**2.3**	**11.0**
Foreign currency local government bonds	0.5	1.0	0.8	1.2	2.2
IMF debt	0.9	0.4	0.4	0.4	3.7
Eurobonds (including state-guaranteed)	1.9	0.4	0.3	0.4	4.1
Other	0.3	0.1	0.2	0.3	1.0

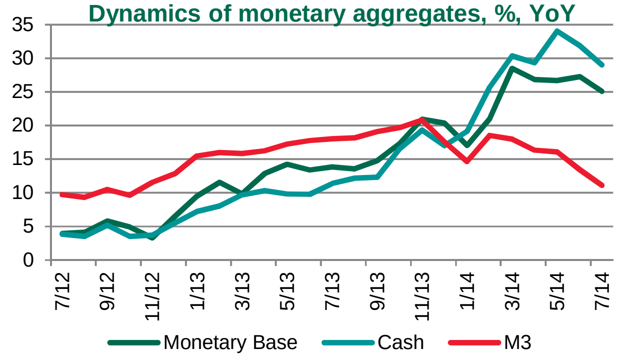


Source: Credit Agricole

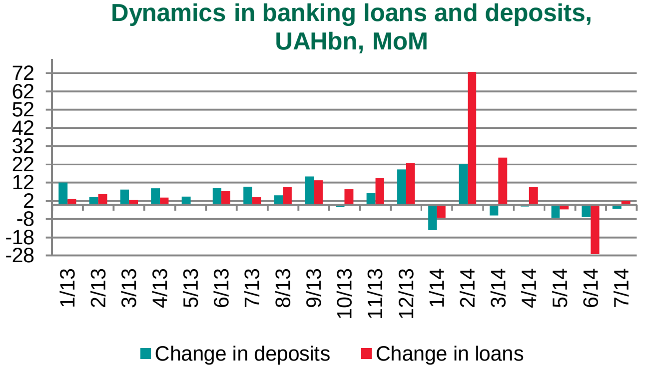
Money Market



Source: Bloomberg



Source: NBU



Source: NBU

- ***Interest rates have been relatively stable throughout August,*** while a decision by the NBU to increase its refinancing and CD short-term rates led to a one-off upward correction in O/N and 1W rates. Banking system quick liquidity was sufficient to keep rates from any hikes last month. However, growing inflationary threats and hopes of monetary tightening by the NBU prevented interest rates from declining further.
- ***The NBU announced in August that it will regulate money market liquidity entirely by market mechanisms.*** These mechanisms include an O/N credit line and weekly refinancing tenders for resources up to 14 and 30 days. In order to move to more market-oriented mechanisms of monetary policy, the NBU is trying to adjust its regulation correspondingly. In particular, the NBU decided to remove special accounts of banks' reserves at the NBU. This theoretically should have increased banking system liquidity, while the NBU almost simultaneously hiked short-term CD rates (mostly O/N rates) by 250bp. This removed the pressure of excessive liquidity on short-term rates slightly, while longer-term rates remained flat due to high inflationary pressure on the economy continuing in the coming few months.
- ***We do not rule out the possibility that the NBU will increase its short-term CD refinancing rates further*** in order to reduce the potential demand for foreign currency in the FX market. Additionally, ***the rates may go up in September on the back of higher business activity and more demand for hryvnia from business entities.***
- We think that recent devaluation concerns in the FX market have ***forced the NBU to suspend its policy of inflation-targeting temporarily,*** thus switching back to exchange rate policy. The recent view of NBU officials that a further hike in the key rate is unnecessary currently may be a supporting argument for the change in NBU strategy. However, ***we do not think the NBU will ignore its long-term goal of inflation-targeting,*** while growing inflation concerns will force the National Bank to tighten its monetary policy quite soon. Hence, ***our view regarding an increase in interest rates in the coming month or two remains valid.***
- ***The government has issued hryvnia bonds since mid-August (UAH43.5bn***) in order to recapitalise Naftogaz by securing its ability to redeem its Eurobonds in late-September as well as to pay for ordinary supplies of reverse gas from Eastern Europe. At the same time, ***this issuance does not threaten money market liquidity as the bonds will be mostly circulated in the state sector.***
- ***The acceleration of inflation in August (14.2% YoY*** versus 12.5% in July) and the break of the seasonally declining trend were tied entirely to the continuing adjustment of public utility tariffs and a pass-through effect of the recent hryvnia devaluation on consumer prices and services.
- The effect of easy monetary policy is strengthening its influence on CPI. In fact, core CPI accelerated to 11.1% in August. Hence, all these effects coupled with the expected further inflation acceleration should ***force the NBU to increase its monetary tightening quite soon.***

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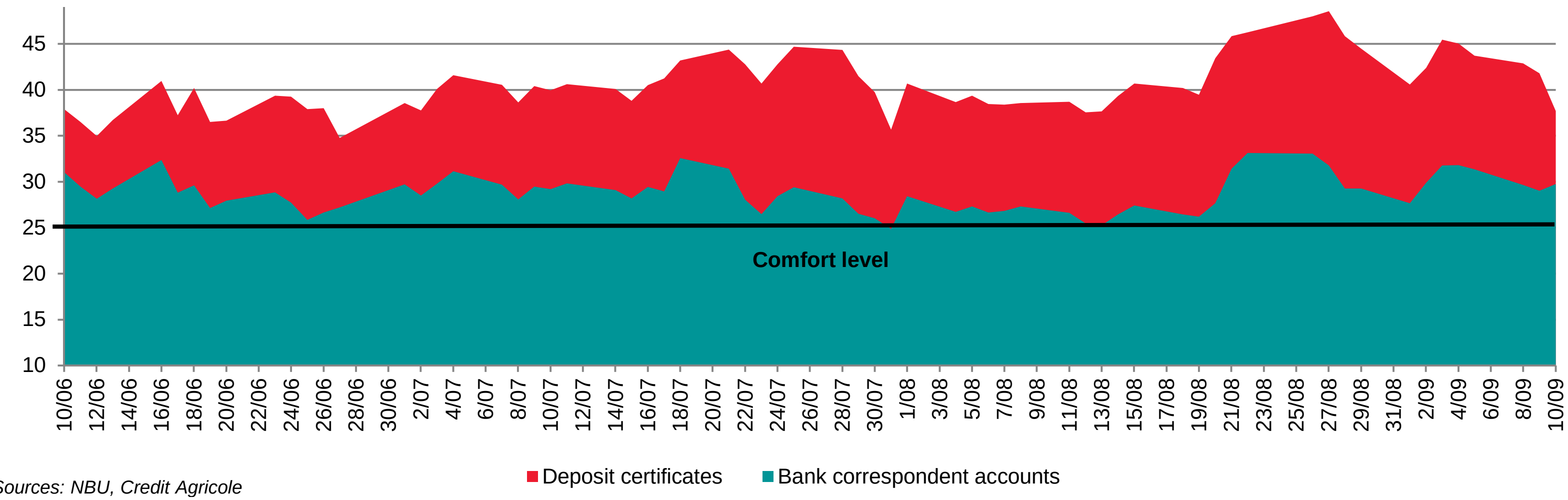
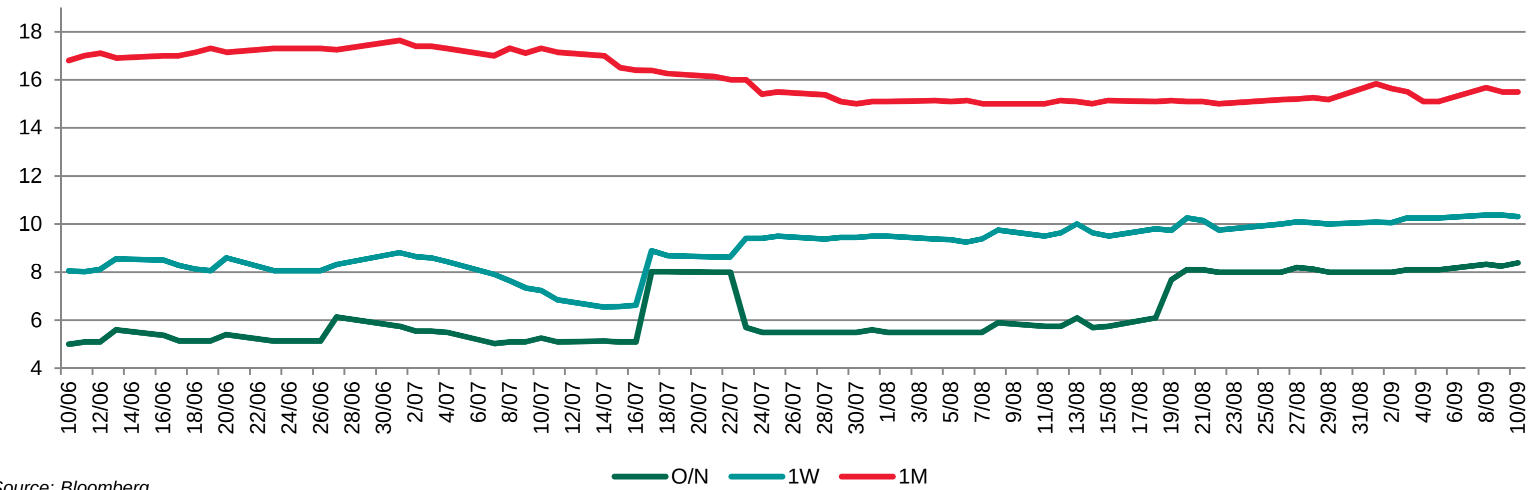
Money Market

Money market liquidity over last 3 months



Sources: NBU, Credit Agricole

KievPrime rates over last 3 months



Source: Bloomberg

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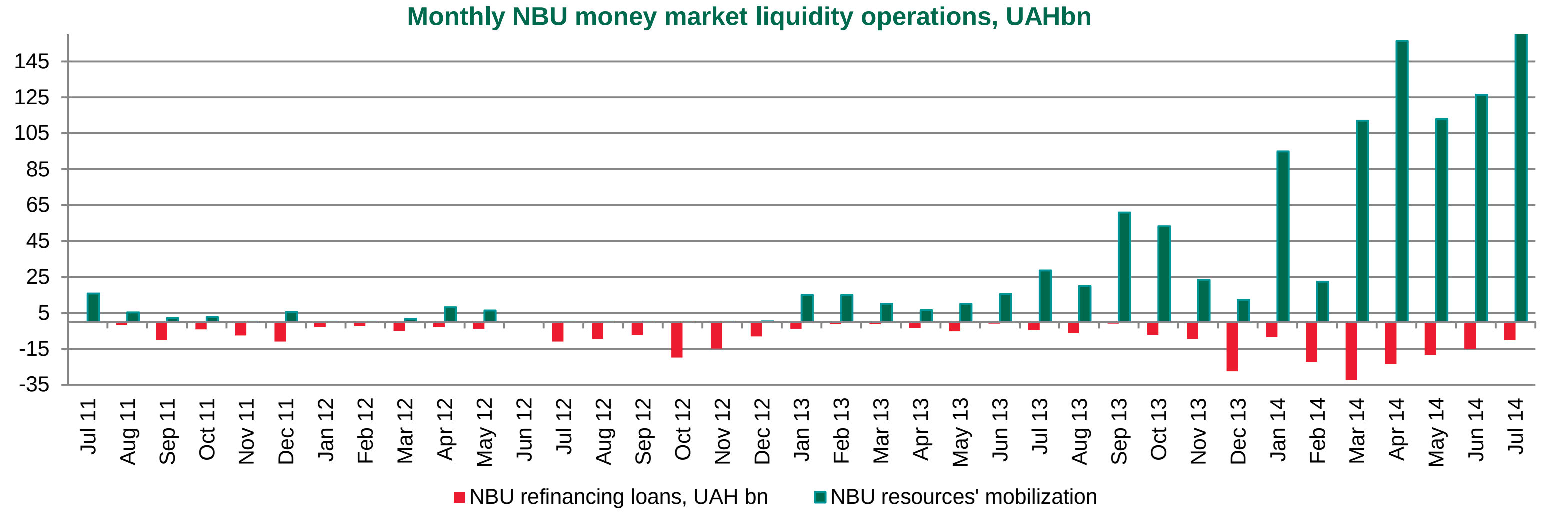
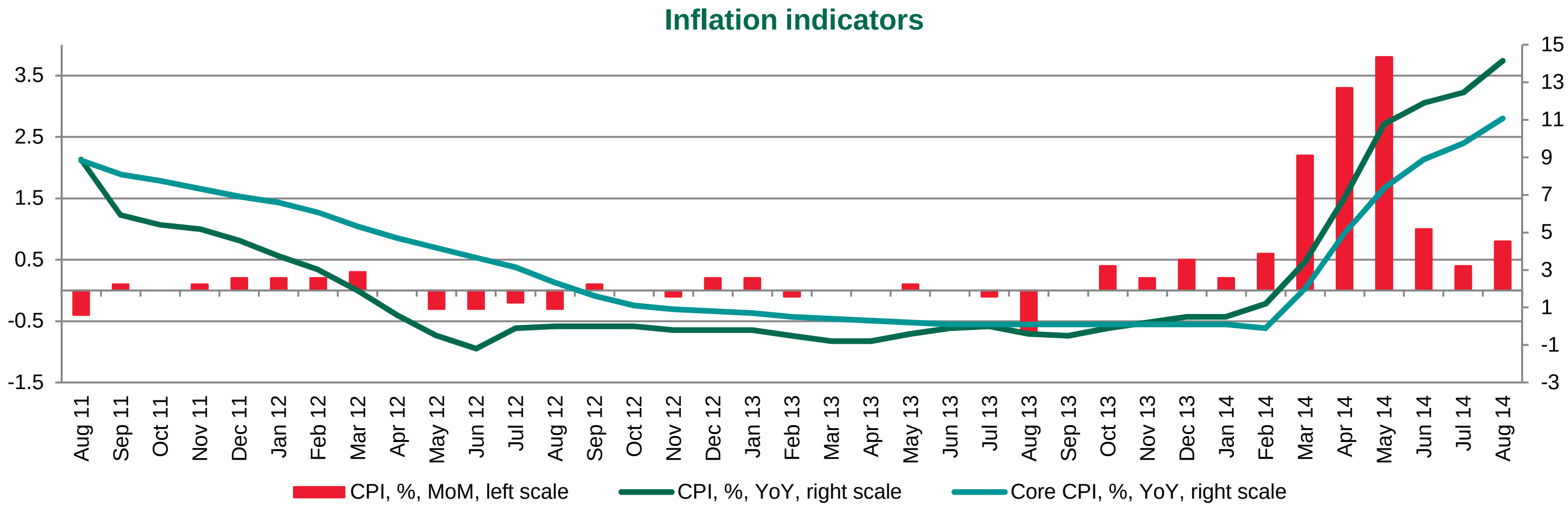
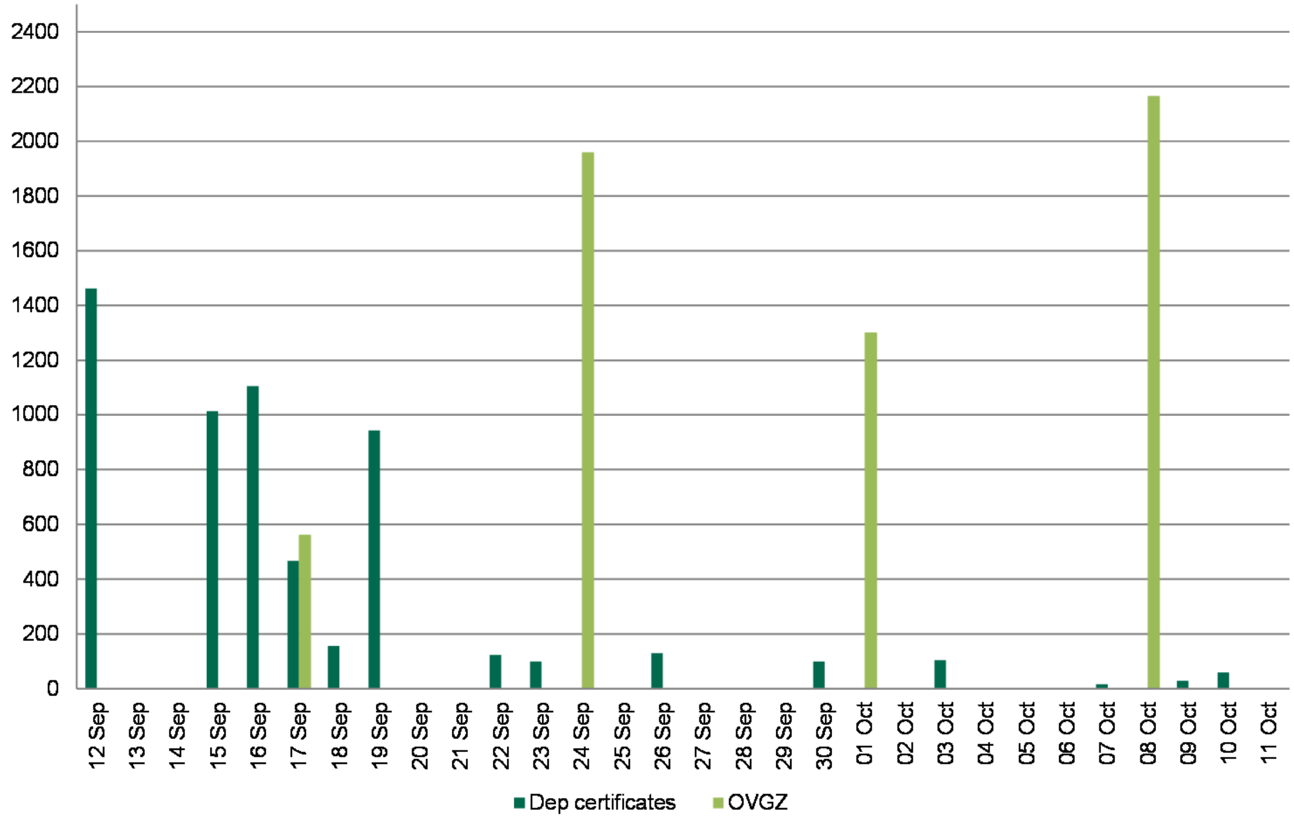




Source: State Statistics Committee

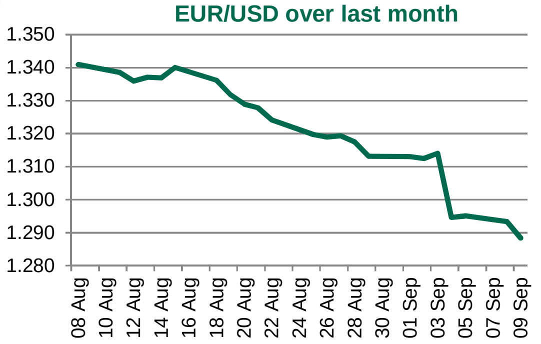
Ukraine. Monthly Market Overview. September 2014
Money Market

Liquidity inflow during upcoming month, UAH mn

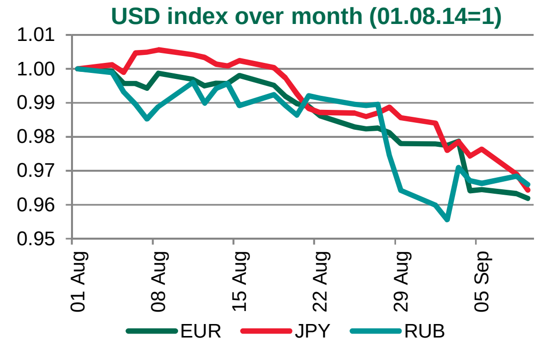


Sources: NBU, Finance Ministry, Credit Agricole

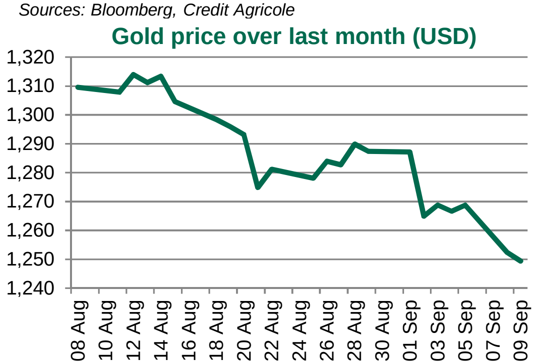
Ukraine. Monthly Market Overview. September 2014



Source: Bloomberg



Sources: Bloomberg, Credit Agricole



Source: Bloomberg

- On a trade-weighted basis, EUR has fallen more than 3.5% to trade at its most competitive level since its March 2014 peak. While this drop remains small compared to EUR's 15% gain from its July 2012 low, this recent weakness will provide some relief from both a business and policy maker perspective.
- The most recent fall has mainly been on the back of rising expectations of the ECB considering additional policy action as soon as this week.
- We believe it is too early for the ECB to implement additional aggressive measures. This combined with elevated speculative EUR short positioning should increase upside correction risk considerably from the current levels.
- As such patience may be needed before considering selling the EUR again. A rebound towards 1.33 and above cannot be excluded in the short-term.
- From a broader angle, however, we expect the EUR to remain a sell on rallies, in particular against higher yielding currencies such as the AUD. As such we remain short the cross as a trade recommendation from 1.5115.

The following are adjusted market forecasts:

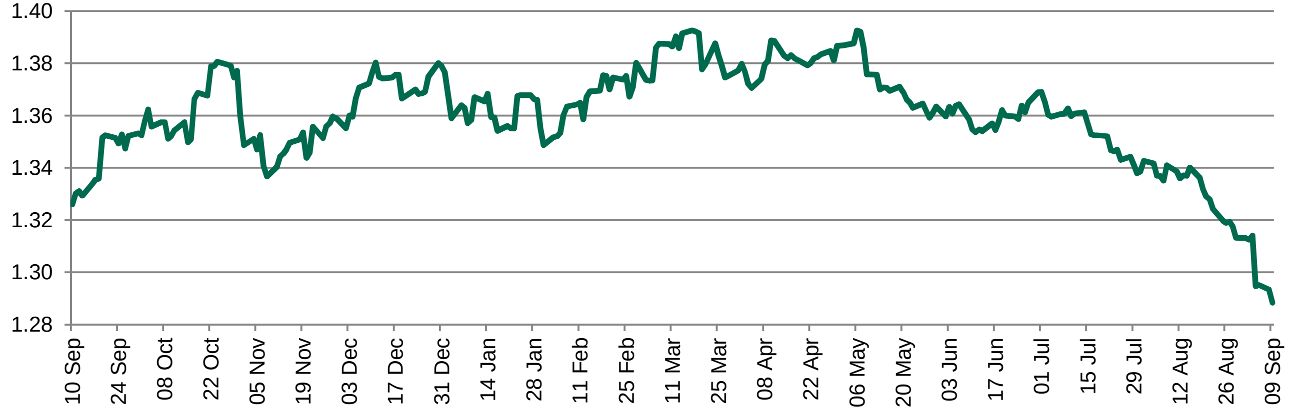
Crédit Agricole CIB EUR/USD forecast:

Q314	***Q414***	***Q115***	***Q215***
1.3200	***1.3000***	***1.2900***	***1.2800***

Consensus forecast (Bloomberg FC Poll by 91 strategists average)

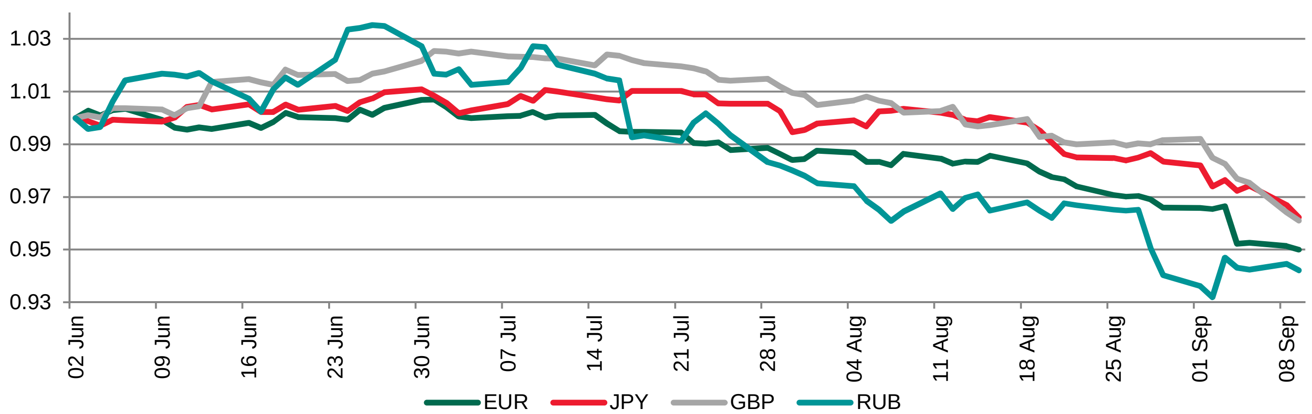
Q414	***Q115***	***Q215***	***Q315***
1.3000	***1.2900***	***1.2800***	***1.2700***

EUR/USD over last 12 months



Source: Bloomberg

Index of currencies against USD over last 3 months (01.05.14=1)



Sources: Bloomberg, Credit Agricole

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