Ukraine. Monthly Market Overview
December 2015

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	18/11/15

Financial Markets team

CRÉDIT AGRICOLE

Ukraine. Monthly Market Overview. December 2015
Major Macroeconomic Trends

MACROECONOMIC INDICATORS - evolution

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015F	2016F
Nominal GDP (USDbn)	42.4	49.5	64.9	86.2	107.7	142.7	129.0	117.4	136.2	165	174	178	130	92	101
Real GDP growth (%)	5.2	9.4	12.1	2.7	7.3	7.9	2.1	-14.8	4.2	5.2	0.2	0.0	-6.8	-10.2	1.8
Inflation CPI, eop (%)	0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	45.6	13.0
Industrial production (%)	7.0	15.8	12.5	3.1	6.2	10.2	-3.1	-21.9	11.0	7.6	-1.8	-4.7	-10.7	-15.5	2.4
Merchandise exports (USDbn)	23.4	28.9	41.3	44.4	50.2	64.0	78.7	39.7	51.4	68.4	68.8	63.3	55.3	37.4	39.0
Merchandise imports (USDbn)	21.5	27.7	36.3	43.7	53.3	72.1	92.2	45.4	60.7	82.6	84.6	77.0	61.3	40.7	41.8
Public debt (% of GDP)	33.5	29.0	24.8	18.0	14.8	12.0	13.7	32.2	39.7	36.2	36.6	41.0	70.5	82.0	82.6
Current account (% of GDP)	7.5	5.8	10.7	2.9	-1.5	-3.6	-7.1	-1.5	-2.2	-5.5	-8.5	-9.1	-4.1	-0.7	-0.3
Net FDI inflow over year (USDbn) NBU methodology	0.7	1.4	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	7.2	4.1	0.2	2.5	3.4

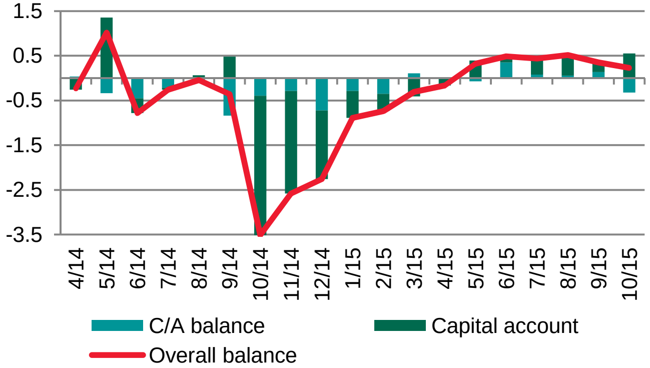
EXCHANGE RATES - evolution

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015F	2016F
USD/UAH eop	5.33	5.33	5.31	5.05	5.05	5.05	7.70	7.98	7.96	7.99	8.04	8.24	15.82	24.00	26.00
USD/UAH average	5.33	5.33	5.31	5.12	5.05	5.05	5.32	7.79	7.93	7.97	8.02	8.16	12.02	22.70	24.90
EUR/UAH eop	5.05	6.70	7.20	6.00	6.70	7.42	10.86	11.45	10.57	10.30	10.54	11.04	19.14	26.16	27.30
EUR/UAH average	5.02	6.02	6.61	6.38	6.26	6.92	7.78	10.88	10.52	11.09	10.31	10.81	15.87	24.74	25.78
UAH O/N average	3.5	6.5	5.3	3.5	4.0	3.5	11.3	8.4	1.5	5.7	11.9	2.7	8.1	20.9	9.5

- It is already evident that ***Minsk-II process should be prolonged for 2016***. This means that potential reduction of both geopolitical risks and the threat of terrorist conflict in eastern Ukraine would be postponed for few more months. Additionally, recent sporadic attacks of terrorists on positions of Ukrainian army negatively contribute to chances for full removal of geopolitical risks in the medium-term. Hence, ***the risk of renewal of war conflict at any time would be a sword of Damocles for Ukrainian economy and financial markets***, at least for 1H16.
- It seems, that growing temperature of conflict in Syria ***has not switched the attention of world leaders from Ukraine***. This could be seen in recent comments of US and EU state officials on low probability to soften any sanctions against Russia until the latter and terrorists in Donbass would not fully follow Minsk memorandum. Additionally, recent visit of US vice-president Joe Biden as well as a change of IMF policy towards its creditors have sent ***a strong signal that support Ukraine would remain rather solid in both economic and political aspects in the medium-term***.
- Even though Ukraine ceased the purchase of Russian gas since November, ***we do not see any sound risk of energy deficit in the coming months***. In particular, Ukraine continues to import gas from Europe. Additionally, warm weather reduces the rate of gas outflow from storages, thus raising probability to pass winter season even without additional supplies from Russia. In any case, ***Ukraine is currently in more privilege conditions than a year before, thus having potential to pressure Russian supplier with gas price***.

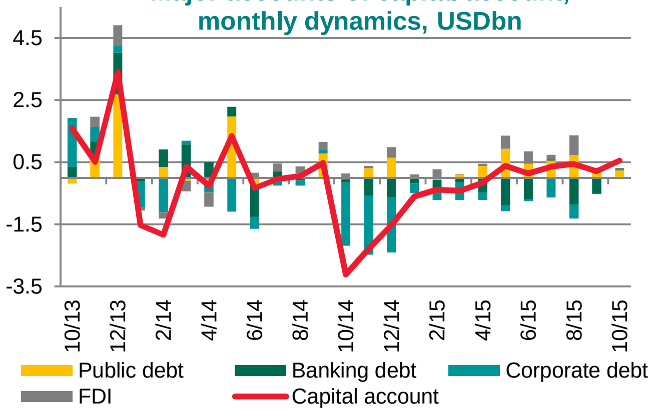
Major Macroeconomic Trends

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
Q415	-1.2%
Q116	2.5%
Q216	2.3%
Q316	1.4%

Source: Credit Agricole

- Few days after finalising the restructuring deal between Ukraine and its Eurobonds' creditors, ***Fitch rating agency*** decided to follow the pattern the S&P made a month ago, by ***upgrading sovereign rating from below (RD) by four notches to CCC***. The decision was more cautious that the one made by S&P (upgrade by six notches). Nevertheless, it reflects reduced risks of default of Ukraine under its external obligations, especially in the coming four years. ***We think the news is rather positive for country's image, while it had no evident positive impact on the price of Ukrainian risk, as it was already priced in after announcement on debt restructuring*** reached few months before.
- A day after Fitch upgrade, ***Moody's agency also made a one notch upgrade by sovereign rating (to Caa3) with a Stable outlook.*** Rationale for the upgrade is same as for S&P and Fitch actions. Following a wave of upgrades, ***Ukrainian sovereign rating looks rather dispersed*** . In particular, the difference between minimum and maximum estimates is currently three notches (from CCC- to B-). We think the difference is due to uneven estimates by rating agencies of near-term economic future as well as unsolved issue with debt to a neighboring country.
- ***Economy dynamics in October was mostly in line with the one a month before in majority of economic sectors***. The only visible improvement in YoY dynamics was seen in agriculture (0.5% in October versus -4.2% in September on the back of shifts in agriculture season due to weather conditions) and construction (-12.2% versus -16.4% on low comparison base effect). On the contrary, the dynamics in industrial sector was mostly flat (-5.0% versus -5.1%). ***Recent performance of economic sectors still point to the lack of sound growth and recovery drivers besides just comparison base effect***. Still, ***we expect a further small improvement in economic sector's dynamics*** influenced by low comparison base effect of last year.
- ***BOP remained in positive area in October (USD0.23bn) albeit it was the lowest over recent half a year***. The dynamics was predicted by us, while the core threat is coming from current account showing a solid deterioration in October (-USD0.32bn) comparing even to a month before (USD0.14bn). In particular, ***worsening in CA was induced by wide merchandise trade deficit (-USD0.63bn)*** on the back of seasonally higher imports of energy resources (mostly, gas and coal). In any case, this dynamics reflects a seasonality, thus ***allowing us to expect same pattern in the coming months***.
- ***Contrary to CA dynamics in October, capital account remained in positive area for the sixth month in a row***. And a figure for October (USD0.55bn) was the highest over recent 1.5 years. Of course, positive balance was achieved by continuing FC inflow under public account (USD0.24bn) and cash FX market (USD0.27bn). But it is also worth mentioning that ***net FC flows under both banking and corporate segments were both in tiny surplus last October – the phenomenon last time seen 13 months before***. In any case, we think this might be a signal of adjustments in external debt flows to reduced turnover in domestic economy. Hence, ***we should not see already large FC outflows in both corporate and banking segments in the manner they were recorded over recent year***. In any case, we expect relatively flat BOP in November backed by still negative CA and slightly positive capital account.

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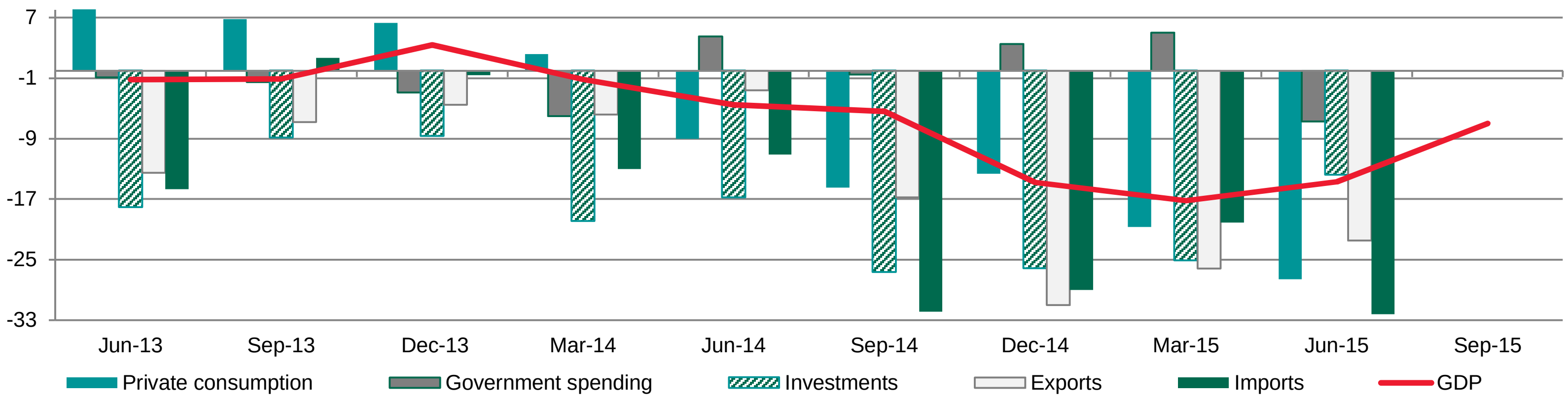
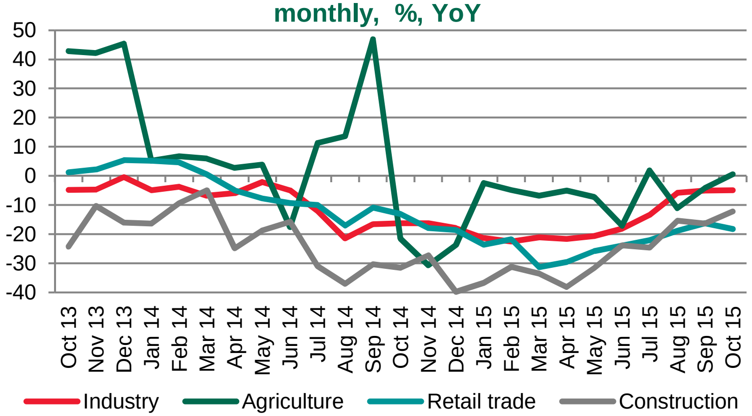
Quarterly GDP dynamics by expenditure components, %, YoY



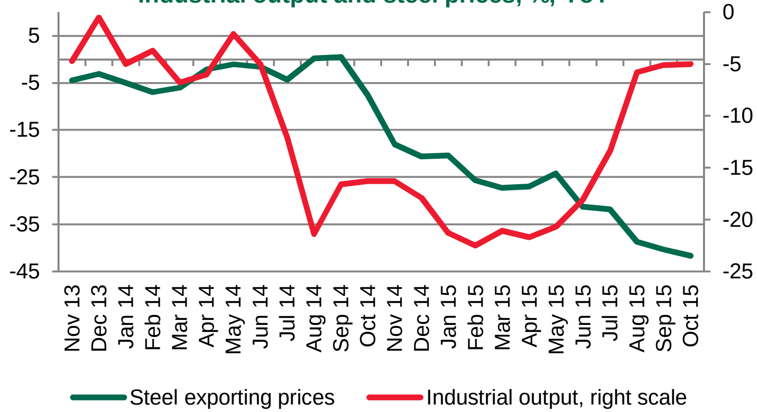
Sources: State Statistics Committee

Performance of major economic sectors, monthly, %, YoY



Source: State Statistics Committee

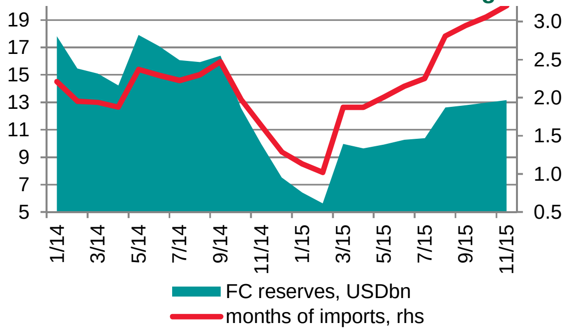
Industrial output and steel prices, %, YoY



Sources: State Statistics Committee, Bloomberg, Credit Agricole

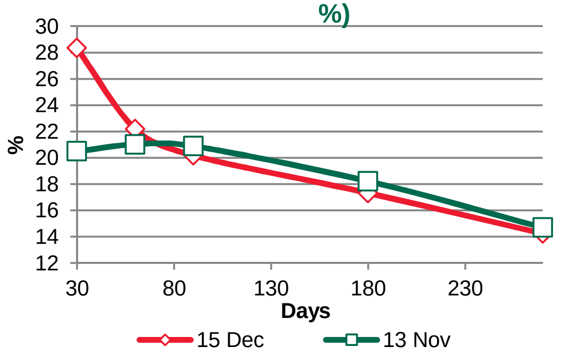
FX Market

NBU FC reserves and their coverage



Sources: NBU, Credit Agricole

USD/UAH NDF curve (implied yield, %)



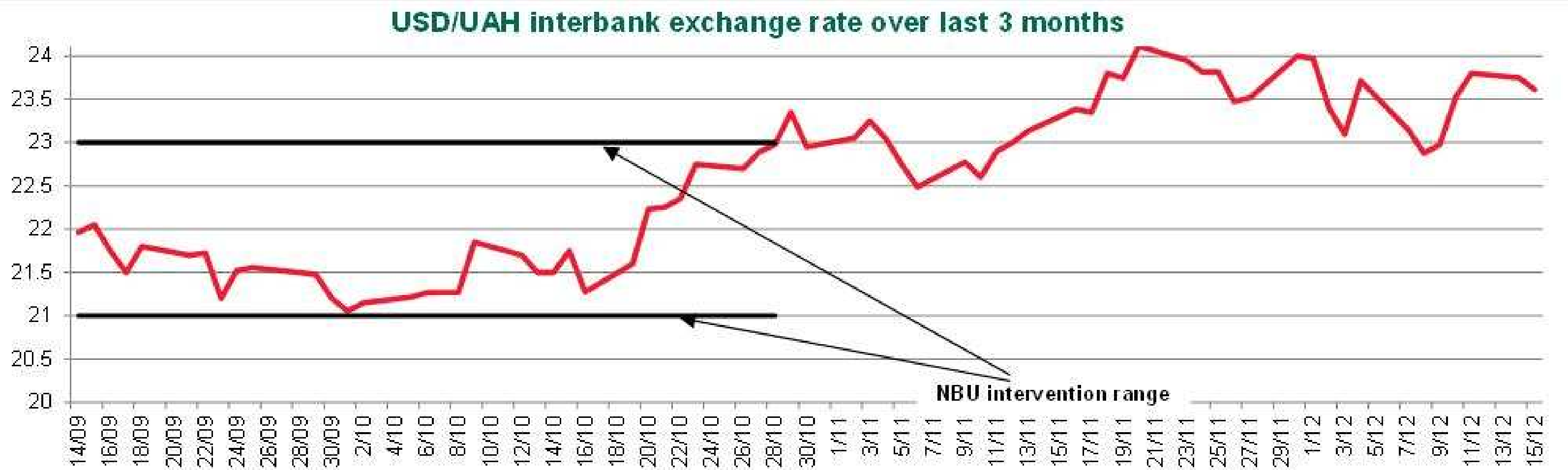
Source: Bloomberg

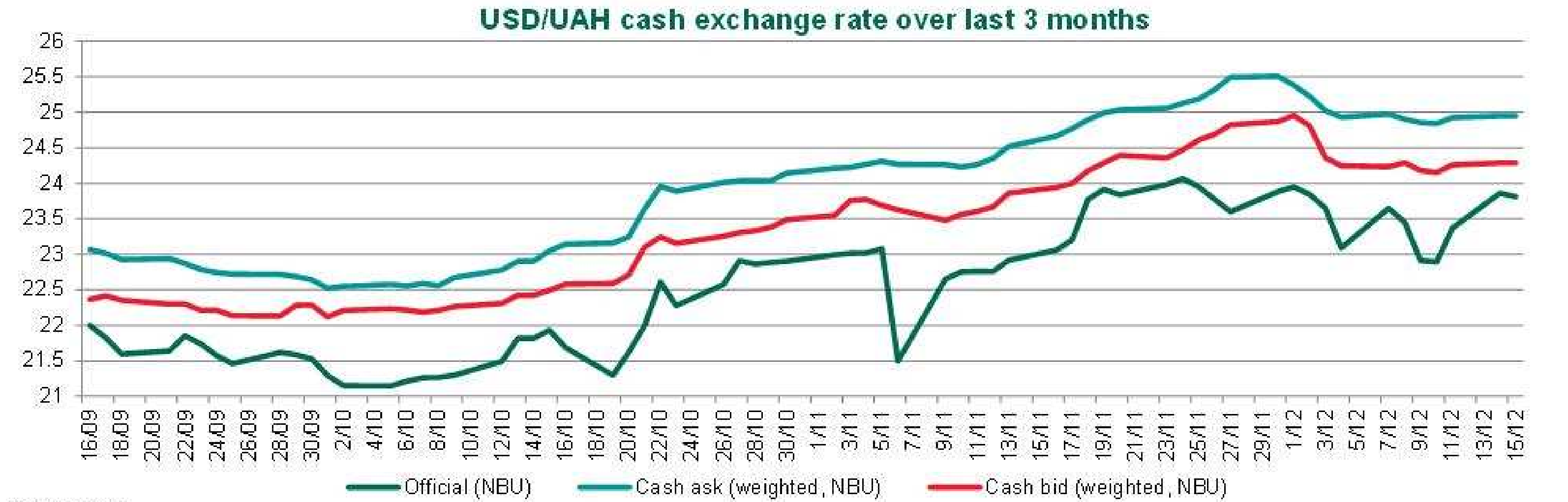
Forecast, eop	USD/UAH	EUR/UAH
Q4'15	24.00	26.16
Q1'16	25.00	26.25
Q2'16	24.00	24.96
Q3'16	25.00	26.25

Source: Credit Agricole

- Even though a month before the NBU was firm in its intention to defend the USD/UAH in the area of 21.00/23.00, it seems that ***NBU officials have recently changed their short-term view on exchange rate fluctuations***. In fact, they stated on absence of any benchmarks for exchange rate movements and for free currency regime. As a result, 23.00 is no longer an upward boundary for USD/UAH fluctuations, at least for near-term, thus ***fluctuating in a range of 22.50-24.10 over recent month***. However, because of low market volumes exchange rate fluctuations are not sometimes tied to market mood. In particular, local USD/UAH maximum of 24.06 was achieved by postponement of FC sale by exporters in the hope to see better rates, thus artificially restricting FC supply. On the contrary, recent drop in the USD/UAH to 21.50 occurred amid additional administrative measures of the NBU, thus artificially restricting FC demand.
- ***The reasons for recent hryvnia devaluation are obvious and are partially tied to seasonal factors***. First of all, imports grew seasonally, with most visible impact on FX market coming from gas imports. Additionally, new stages of repayments of deposits of bankrupt banks have induced FC deficit at cash FX market, thus affecting later interbank one. However, this situation was in line with forecasts, while ***we still consider such dynamics as non-sustainable and tied to seasonal factors***. And actions of NBU officials just supported our expectations. In particular, the NBU allowed previous intervention band of 21.00-23.00 to be violated, thus signalling on its abolishing. Instead, the NBU tried to restrict large fluctuations in the exchange rate by announcing on FC sale auctions and moderately restricting FC demand. At the same time, the volume of FC bid restrictions was not high, thus not allowing accumulation of postponed demand. Therefore, ***we should expect the USD/UAH fluctuating in the range of 23.50-24.50 in the coming few weeks. And the magnitude of further exchange rate fluctuations will depend on several factors***, including current demand for gas, criticality of food embargo from Russia, abolition of import charges, dynamics of imports after Ukraine enters into association agreement with EU, etc. Another potential risk may come from potential no-payment of Eurobonds of USD3.0bn on Dec 20. However, more likely this would be left by the market unnoticed most of creditors would not treat this as a case of default.
- ***NBU official stated on a removal of FX market restrictions by the middle of 2016***. According to his words, the National Bank is currently on a first stage of gradual currency liberalisation. However a reality is slightly different from official statements. And taking into consideration recent hike in the USD/UAH, it ***was not a great surprise for the market that NBU decided to keep almost unchanged its FX market restrictions*** and to prolong them for three more months. This does not necessarily mean that all these requirements will be valid until 3 March, but recent action is clear evidence of the ***non-readiness of the NBU to liberalise FX market, even despite it has declared it a month before***. Therefore, we still think NBU will keep FX market under its full control in the coming few months in order to exclude large imbalances there.
- ***NBU downgraded its year-end FC reserves forecast to USD13bn from previous one of USD18bn***. And the postponement of two tranches worth USD3.4bn from IMF EFF loan are the core reasons behind such change in forecasts. Even though the chances to approve the loan tranche this year are still moderate, we estimate that technically IMF would provide the loan in early 2016. Year-end forecast of USD13bn seems achievable to us taking into consideration NBU reserves at USD13.2bn (1.4% MoM) as of end of November and absence of sound reasons for reserves' outflow in December. In any case, such a downgrade in forecasts should not considerably increase UAH devaluation risks or undermine the ability of the NBU to control exchange rate environment. In fact, ***coverage of imports by NBU reserves would remain above the benchmark of three months by year-end***.

FX Market





Source: NBU

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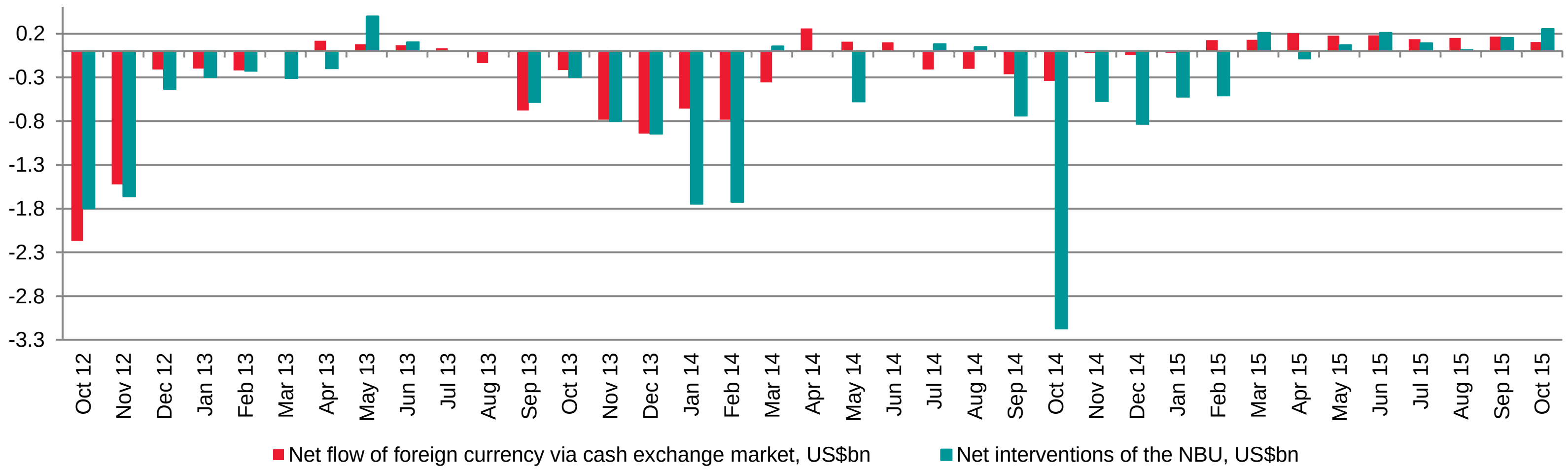
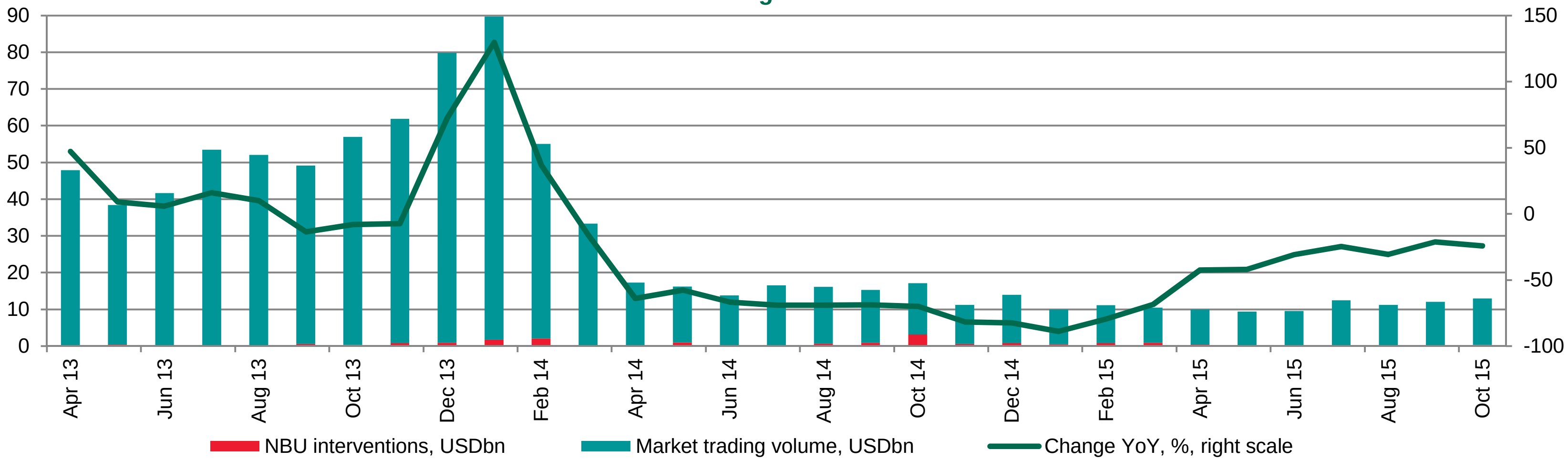
FX Market

Net flows on interbank and cash FX markets



FX market trading volumes



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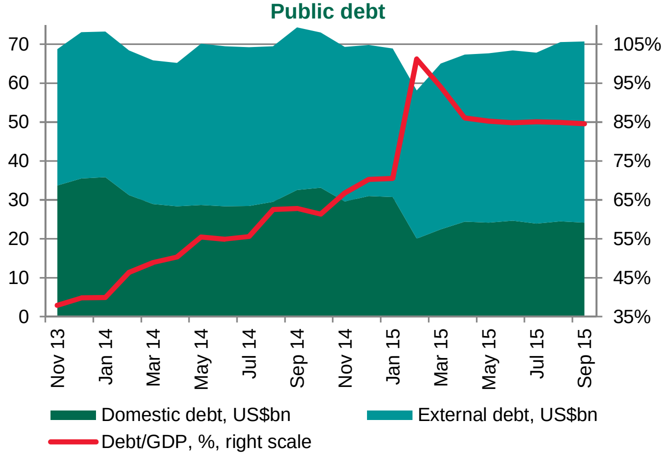
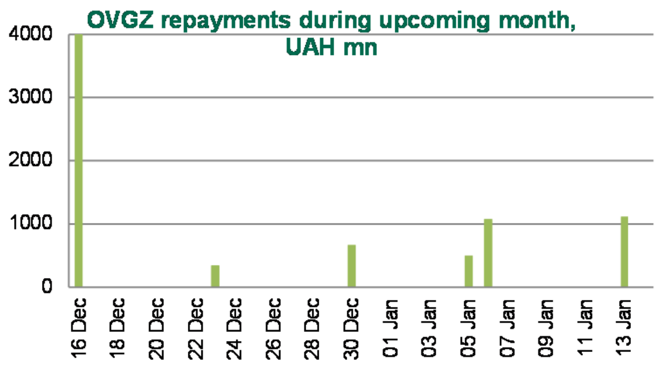
Debt indicators



Sources: Finance Ministry, Credit Agricole

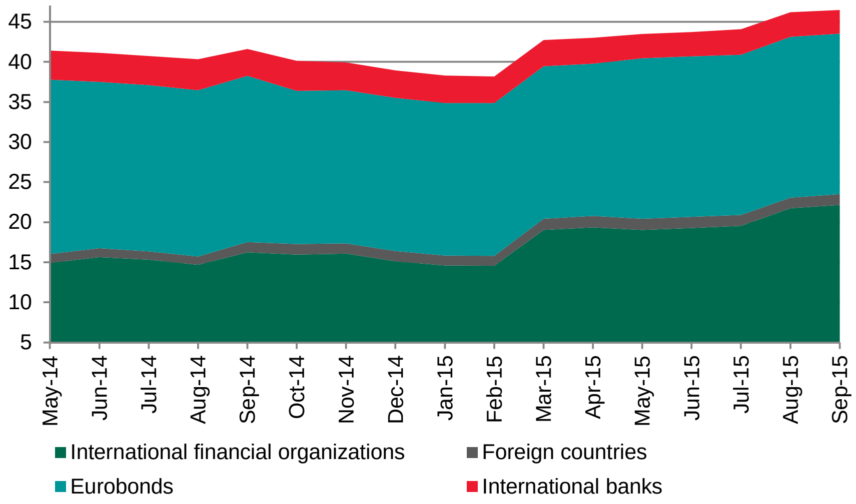


Sources: NBU, Finance Ministry,

- ***Successful restructuring of Ukrainian Eurobonds into new one returned Ukrainian debt onto world capital markets***. And they trade currently with a discount (9.5-9.6%) to their par yield (7.75%). In any case, we do not think this is a reflection of additional drop in Ukrainian credit quality, but rather reflects recent attitude of investors to emerging markets. ***We also could expect a small contraction in Ukrainian bonds' price closer to the date of repayment*** of USD3.0bn, while ***we do not think it could substantially undermine the price of new Ukrainian bonds***, as attitude of investors to non-payment of USD3.0bn is slightly different than a default in its classical meaning.
- In recent comments of Fitch rating agency on upgrade of sovereign rating we think the most valuable one is that "***Fitch assumes that non-payment of the USD3bn bond maturing on 20 December 2015… would not constitute a default under Fitch's Sovereign rating criteria***". It just supports our view that any default case on USD3.0bn debt should not be viewed as actual default by investors, ***thus making any negative impact on a country risks worthless***.
- After few months of reluctance to the issue of potential restructuring of Ukrainian debt, ***the government of a neighbouring country decided to be involved into talks with Ukrainian government on debt restructuring of USD3.0bn*** after president of this country has spoken with IMF managing Director Christine Lagarde on the issue. They included one year-grace period with USD1.0bn repayment in following three years. And they demanded a guarantee from international donors. The conditions of restructuring offer are yet far from the terms offered by Ukrainian government to all other creditors. And ***it was not a surprise that the parties have not reached any agreement***.
- As soon as the date of repayment of USD3.0bn Eurobonds approaches, the issue either Ukraine will pay or not becomes more controversial. Hence, ***recent decision of IMF on changes in its global policy on non-toleration of arrears to official creditors made a sharp turn in negotiations, thus substantially raising the chances that Ukrainian government will not repay the debt as scheduled*** (by December 20). In particular, Ukrainian government may apply its debt moratorium on the date of repayment, thus not having risks of discontinuing IMF program.
- Ukrainian government made recently another step in public debt restructuring by ***agreeing with investors on re-profiling of Eurobonds of City of Kyiv worth USD0.3bn***. According to the deal, the bonds will be re-packaged into new sovereign Eurobonds maturing in 2019-2010 together with warrants offering value recovery instrument (VRI). We ***think the deal is rather positive for potential debt profile of the country as well as for costs of external debt servicing in the coming three years***. At the same time, the issue of restructuring of other Kyiv Eurobonds of USD0.2bn is still on the track, while we do not expect other scenario rather than restructuring of it under general terms.

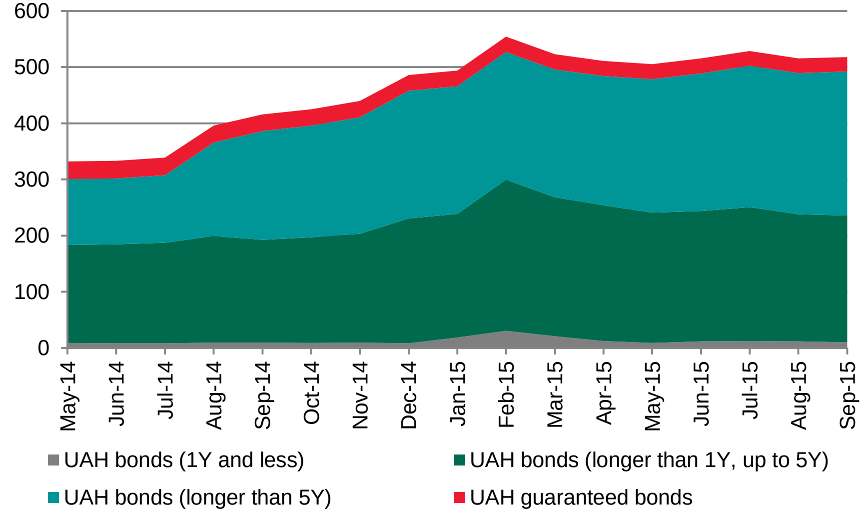
Debt indicators

External public debt dynamics, USDbn



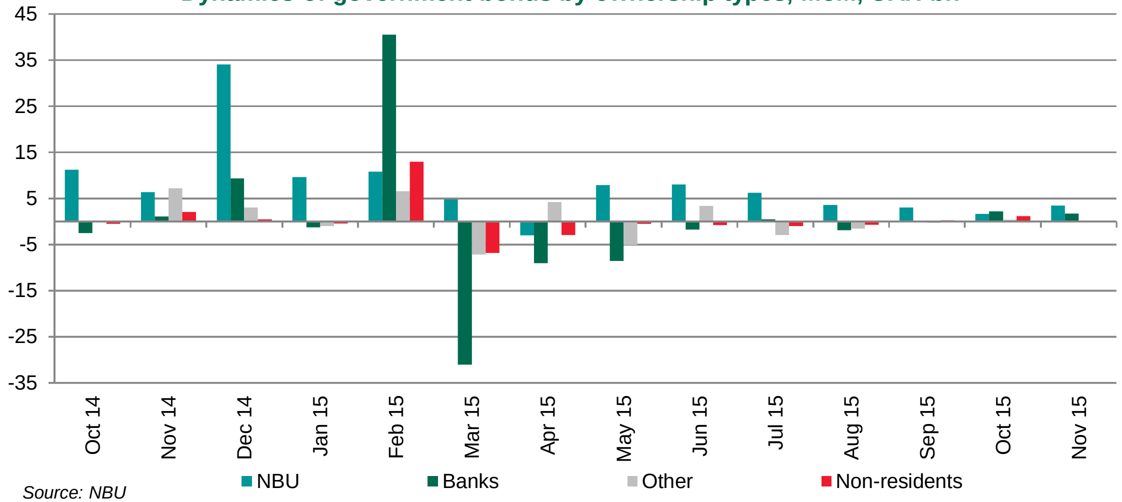
Source: Finance Ministry

Domestic public debt dynamics, UAHbn



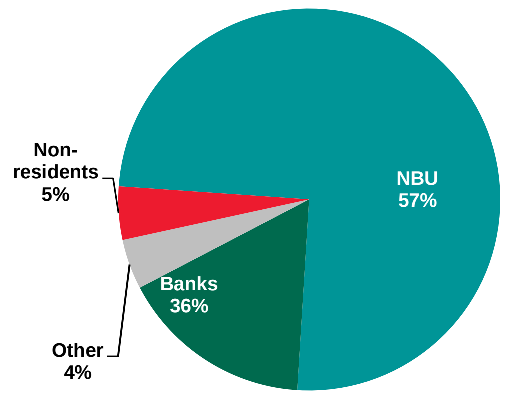
Source: Finance Ministry

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



Source: NBU

Breakdown of OVDP by owners (as of 15 Dec Total volume - UAH500bn



Source: NBU

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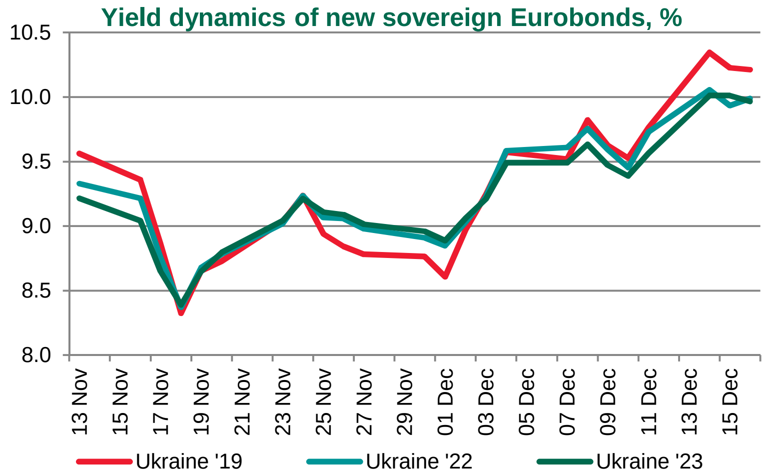
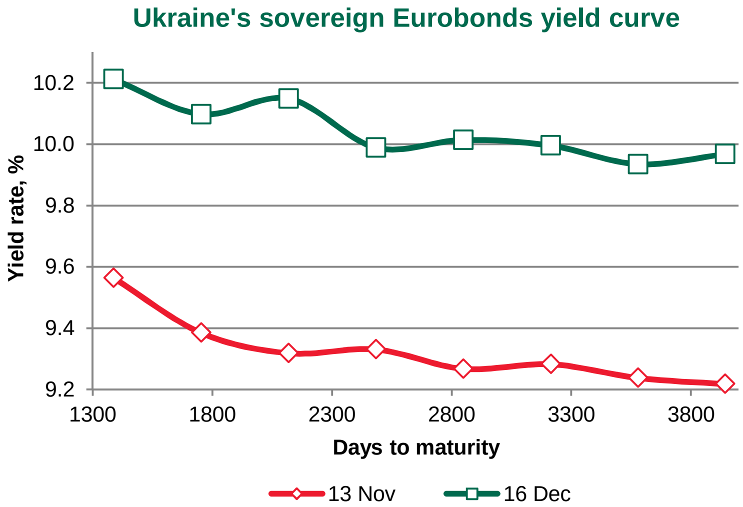
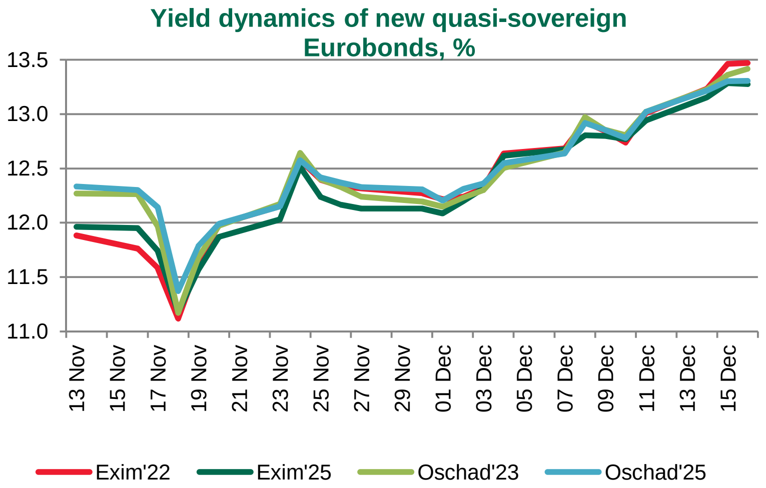
Debt indicators



Source: Bloomberg



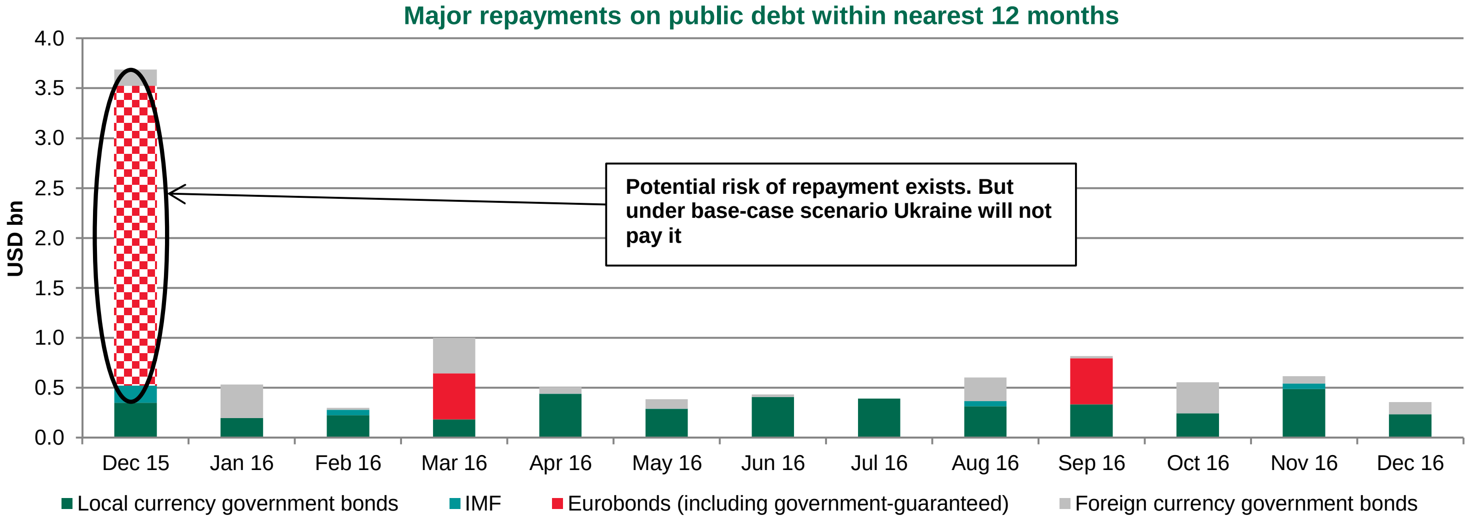
Source: Bloomberg



Source: Bloomberg

Ukraine. Monthly Market Overview. December 2015
Debt indicators

USDbn	Q415	Q116	Q216	Q316	2015
Repayment of FC-denominated public debt	**1.1**	**1.4**	**0.4**	**1.1**	**6.5**
Foreign currency local government bonds	0.2	0.8	0.2	0.3	2.6
IMF debt	0.2	0.0	0.0	0.0	1.5
Eurobonds (including state-guaranteed)	0.3	0.5	0.0	0.5	1.2
Other	0.4	0.3	0.2	0.3	1.2



Source: Credit Agricole

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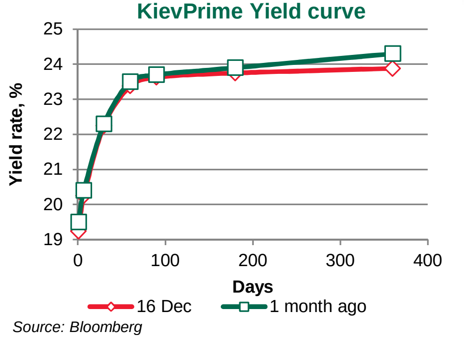
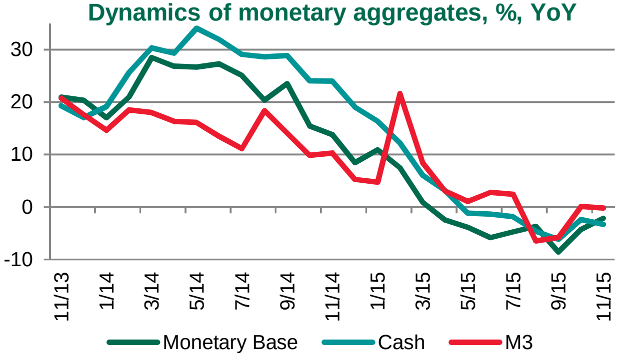
KievPrime Yield curve



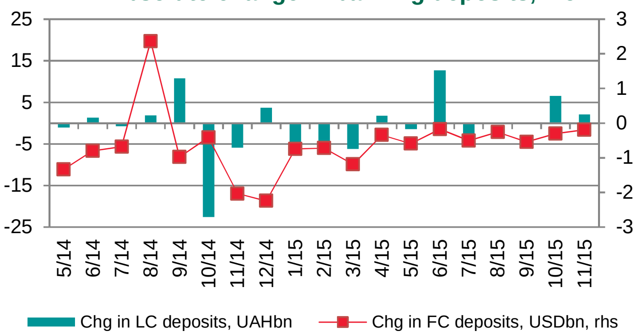
Source: Bloomberg

Dynamics of monetary aggregates, %, YoY



Source: NBU

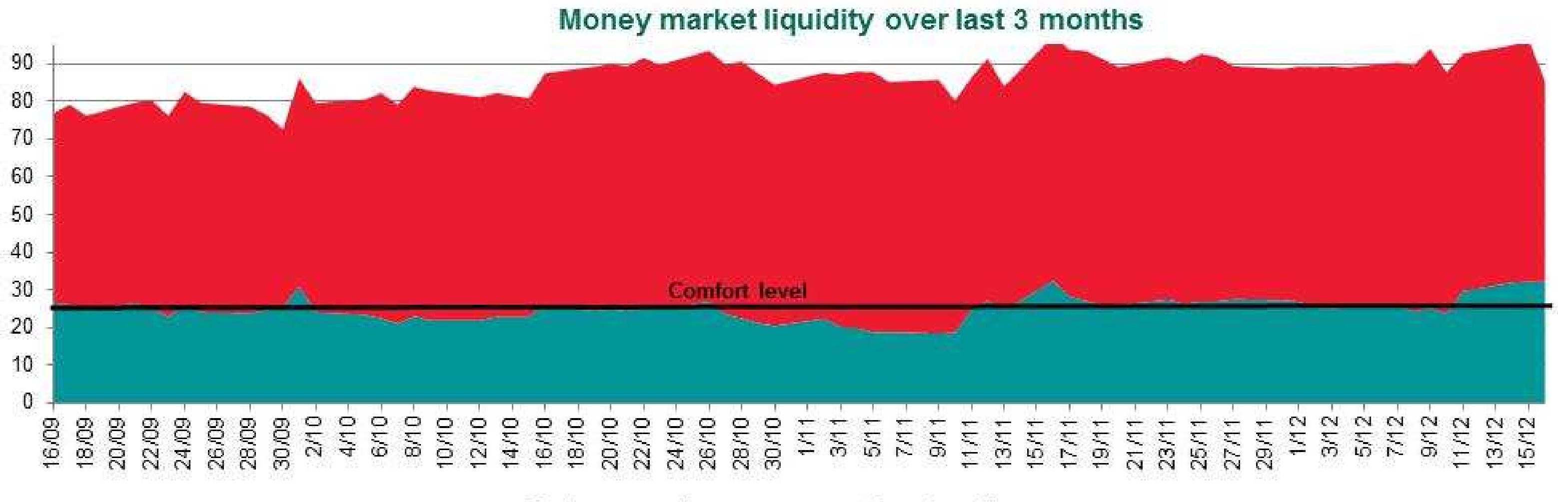
Absolute change in banking deposits, MoM



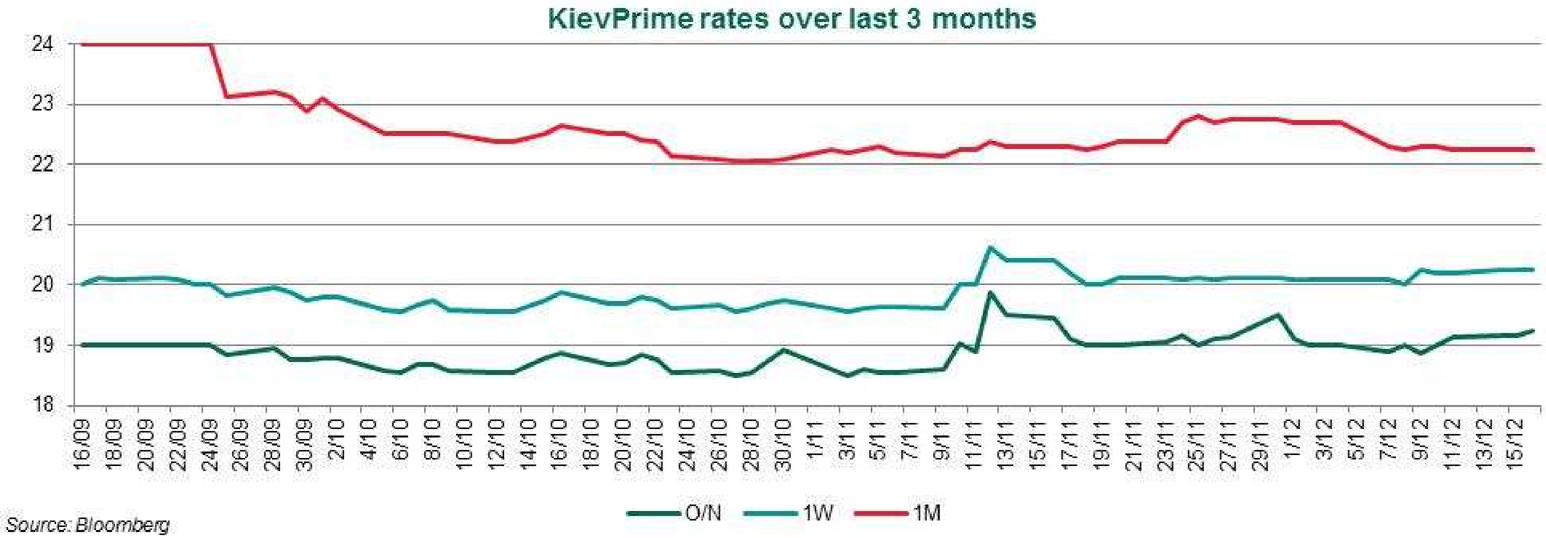
Source: NBU

- ***Interest rates have remained on relatively flat path over recent month***. And general situation with liquidity has not changed considerably. It was still enough for day-to-day banking operation. Banking system quick liquidity was supported by a huge stock of NBU short-term deposit certificates. And its stock recently (UAH64.0bn) was not considerably different from the one a month before (UAH64.2bn). Therefore, ***we could say on relative stability of banking liquidity in the coming month, thus preserving interest rates at almost unchanged level, correspondingly***.
- It seems that after more than 1.5 years of negative dynamics, ***banks finally managed to stabilise their resource base recently***. And the increase in banking UAH deposit base by UAH8.6bn over recent months just indicates on potential recovery in banks' deposits and on ability of banks to replenish them. This also means that ***a confidence to the banking system is restoring gradually (partially on the back of absence of other alternatives to invest),*** while depositors are switching more towards state-owned and western-owned banks. And even a slight outflow in foreign currency deposits (-USD0.19bn – among the lowest over recent 1.5 years) may be viewed as a sign of stabilisation. In fact, the bulk of this outflow occurred in banks that were recognised by the NBU as non-payable. Therefore, ***FC deposits outflow excluding non-payable banks was much smaller last month and reached just USD34m***.
- In case of no political and geopolitical shocks ***we should expect further stabilisation in the banking system, thus allowing top banks to replenish their deposit base***. At the same time, plans of the NBU on removal of around 40 small banks from the market may restrain upward deposits' dynamics in the banking system in the coming half a year.
- ***Money aggregates' YoY growth still remains in slightly negative area in November*** (-2.2% for monetary base and -0.2% for broad monetary aggregate M3). ***The dynamics still clearly demonstrates tight monetary policy*** the NBU applies currently. And even recent recapitalisations of Naftogaz and deposit guarantee Fund are not reflected in money supply as they are mostly absorbed through NBU deposit certificates. Therefore, taking into consideration seasonal expansion of monetary aggregates in December, ***we expect year-year monetary aggregates to be just marginally higher than the year before***.
- After a sudden decline in CPI in October due to statistical adjustments, ***inflation in November of 2.0% MoM looks quite logical*** and is quite close to consensus forecast of 1.8%. A seasonal increase in price of food products (2.5% MoM) mostly contributed to inflation dynamics last month. And seasonal adjustment to heating tariffs (17.2%) preserved index of public utility tariffs high (3.3% MoM). Rather sharp CPI in November increased YoY inflation (46.6% vs 46.4% the month before) for the first time since April. ***We again expect high CPI (2.3% MoM) in December*** backed by same seasonal factors for food products. ***This would keep inflation for the whole year at 45.6%.***
- Contrary to headline CPI, ***core YoY CPI showed a visible improvement in November (37.9%)*** versus the figure a month before (40.1%). This is a clear indication that tight monetary policy of the NBU influences consumer prices. However, ***we do not think the NBU is ready to cut its policy rate this month*** as inflation risks in December remain rather substantial.

Money Market



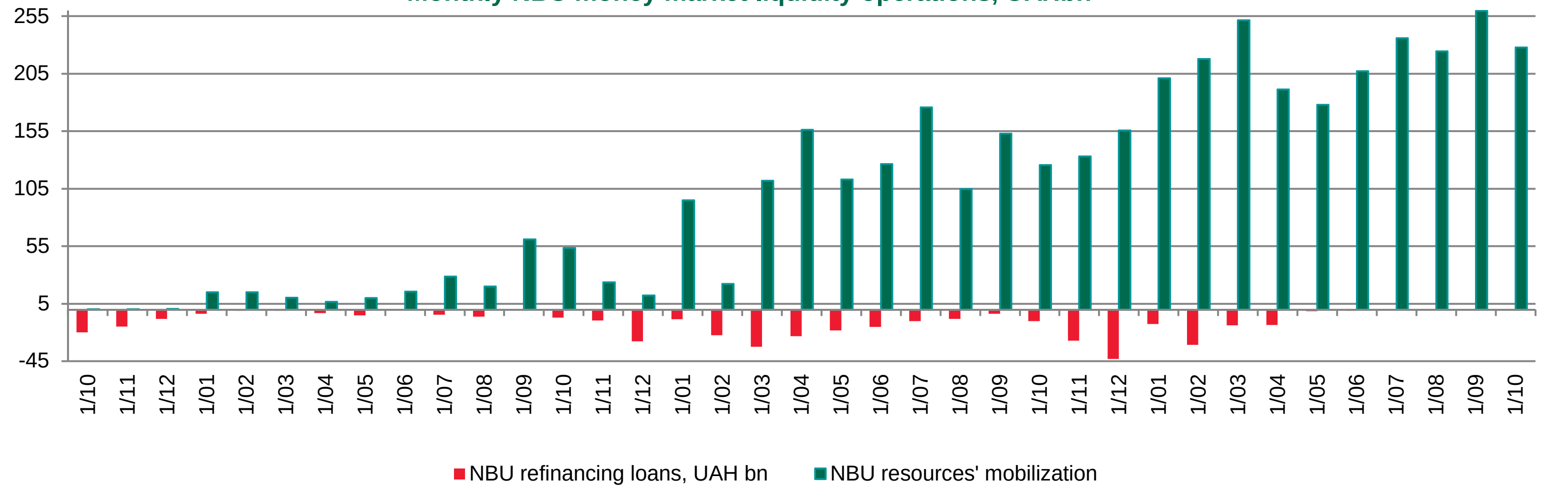
Sources: NBU, Credit Agricole



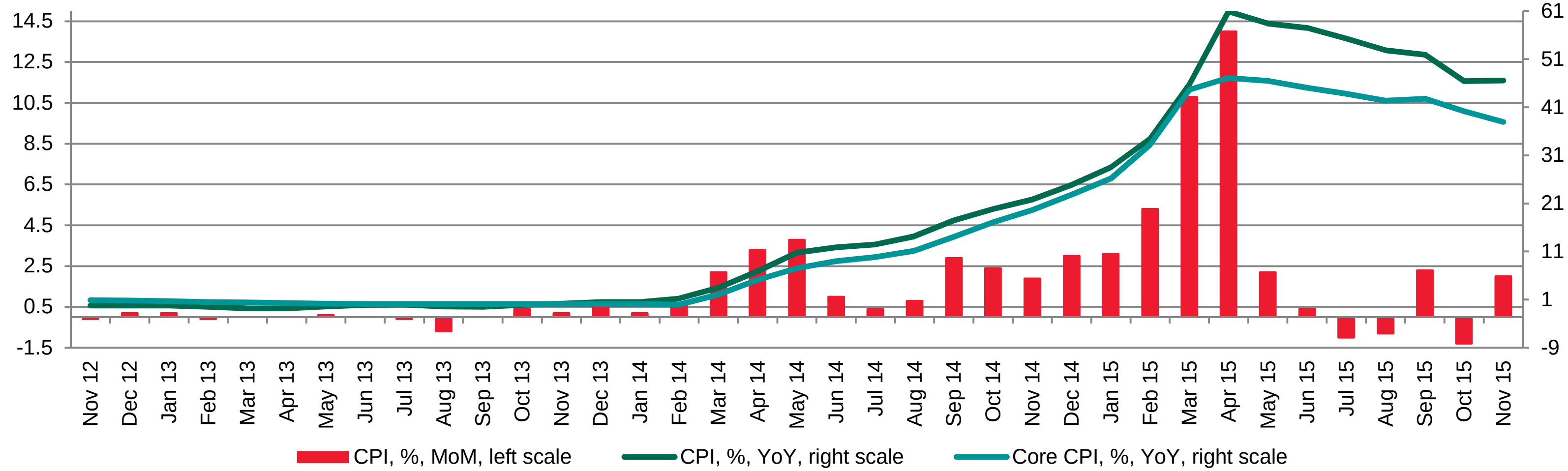
Source: Bloomberg

Ukraine. Monthly Market Overview. December 2015
Money Market

Monthly NBU money market liquidity operations, UAHbn



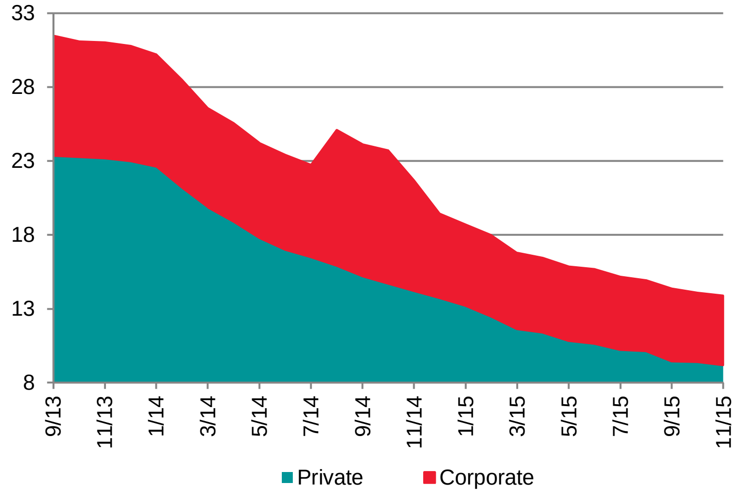
Inflation indicators



Source: State Statistics Committee

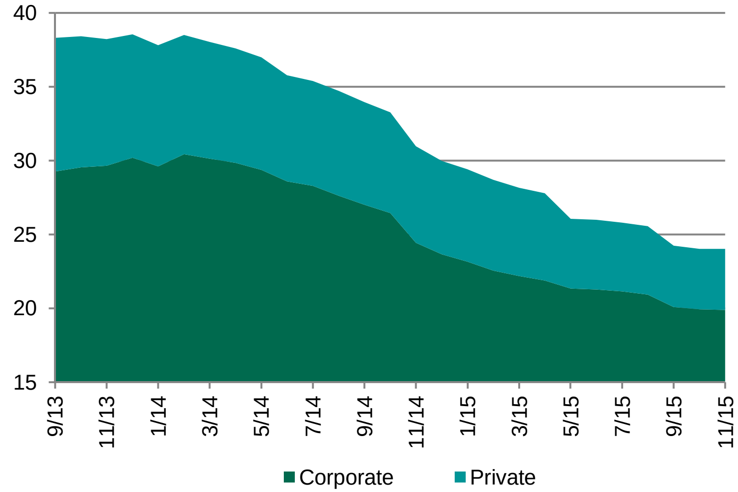
Banking sector

Banking FC deposits, USDbn



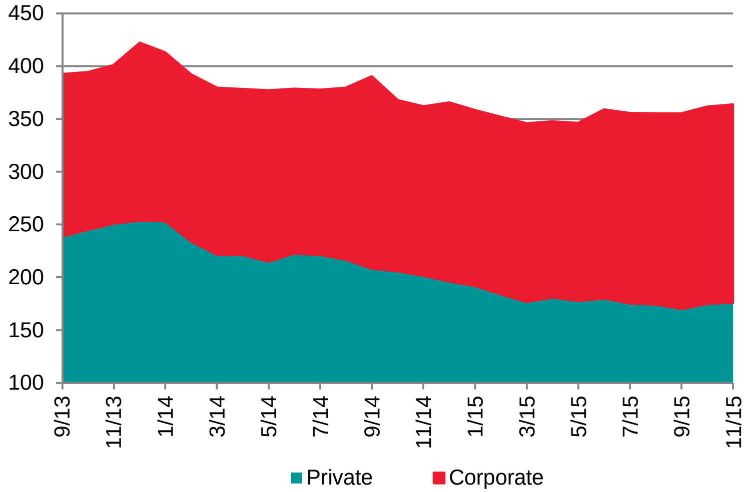
Sources: NBU, Credit Agricole

Banking FC loans, USDbn



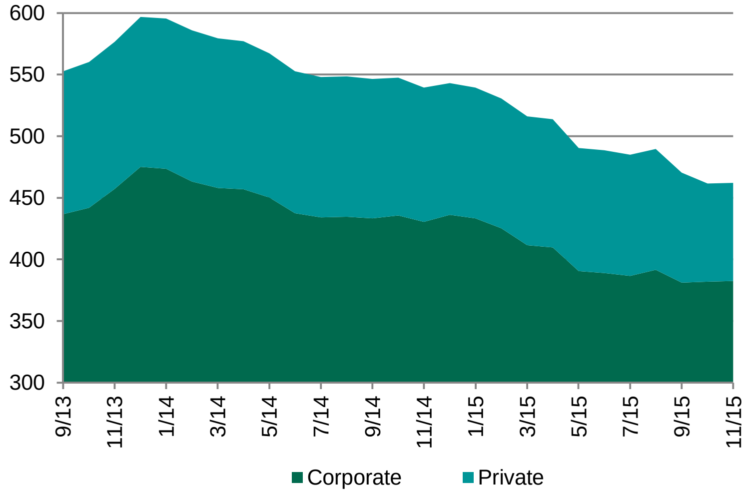
Sources: NBU, Credit Agricole

Banking LC deposits, UAHbn



Sources: NBU, Credit Agricole

Banking LC loans, UAHbn



Sources: NBU, Credit Agricole

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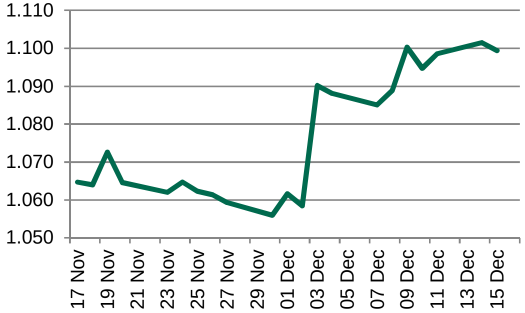
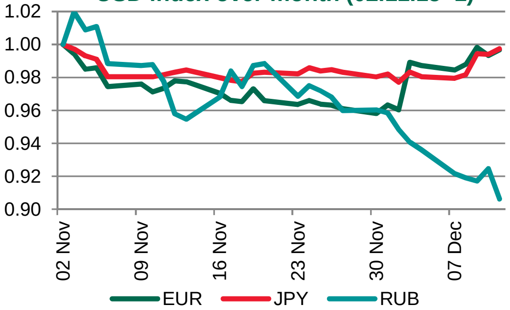
EUR/USD over last month



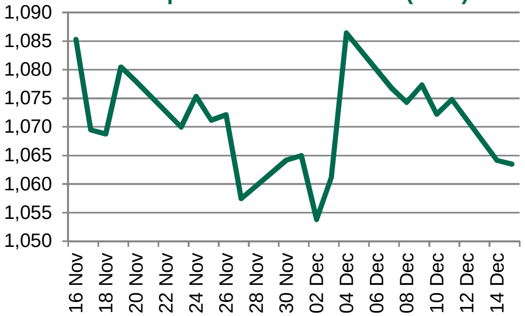
Source: Bloomberg

USD index over month (02.11.15=1)



Sources: Bloomberg, Credit Agricole

Gold price over last month (USD)



Source: Bloomberg

- The EUR/USD closed the month near its lowest trading price at 1.0573 after falling to 1.056. The pair lost almost 4% for the month. The euro (EUR) will under-perform broadly in the coming year against most major currencies. European Central Bank President Draghi strongly hinted that additional monetary stimulus may be introduced at the December policy meeting in response to persistently low euro zone inflation. Prospective action may include changes to the operational terms of the ECB's quantitative easing (QE) program as well as a cut in the key deposit rate (-0.20% currently). The revival of the euro zone/US policy divergence narrative that drove EURUSD 13% lower in the first quarter may provoke another sharp downward adjustment in the exchange rate in the next few months.

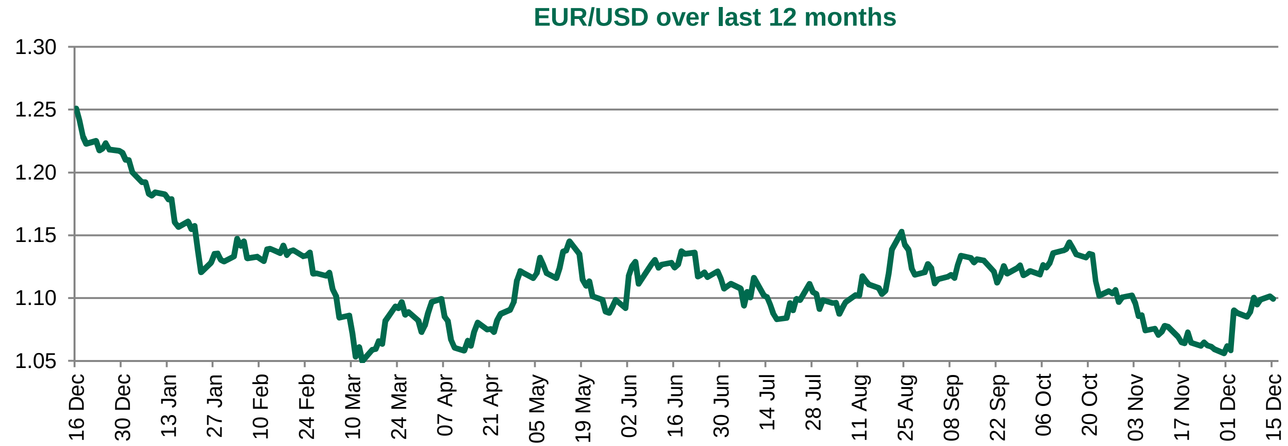
The following are adjusted market forecasts:

Crédit Agricole Bank EUR/USD forecast:

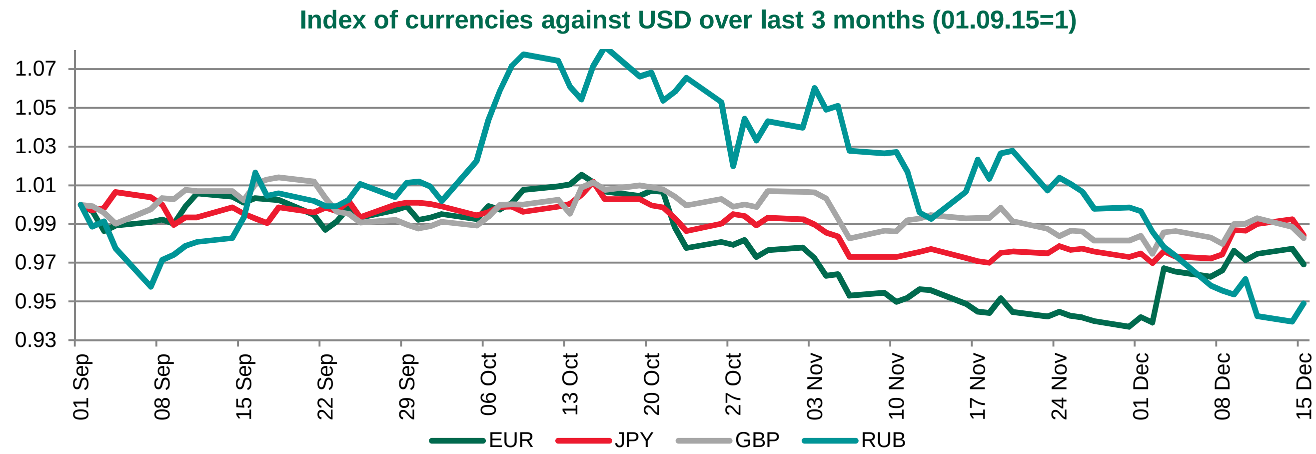
Q415	Q116	Q216	Q316
1.0600	***1.0400***	***1.0400***	***1.0500***

Consensus forecast (Bloomberg FC Poll by 96 strategists average)

Q415	Q116	Q216	Q316
1.0900	***1.0700***	***1.0600***	***1.0600***



Source: Bloomberg



Sources: Bloomberg, Credit Agricole

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