

Ukraine: It's Only the End of the First Period

"A good hockey player plays where the puck is. A great hockey player plays where the puck will be"

Wayne Gretzky

- Petro Poroshenko's first priority will be to suppress the para-military groups in East Ukraine. His second priority is to establish economic pragmatism with Moscow. The Kremlin is open to such an approach but has stipulated that it is closely monitoring the actions against the pro-Russia separatists in the East. This may yet be a deal breaker which would keep investment risk high in both countries. The worse the TV pictures from the East and the longer they last, the greater the pressure on markets in both countries.
- There are conflicting messages about a possible EU brokered gas deal. It is still very possible that a deal will be struck by the weekend (very positive for all sides and for Gazprom's cash flows) but threats are still being exchanged against a tense political backdrop. As we have noted previously, a gas deal (or not) will provide the clearest signal of the hoped for pragmatic relationship between Russia and Ukraine and the start of an improvement in Moscow's relations with the EU.
- We expect Ukraine to pay down \$2 bln of the debt up-front and another \$500 mln in June and Gazprom to revise its price to the European average (or close to it) which is currently \$380 p/1'000 cm. Naftogaz is report to be still unhappy with the terms (probably on the volume off-take) but the EU is pushing Kiev to reach a deal. That may be ahead of this weekend's deadline or in the coming weeks. Kiev has received \$3.2 bln from the IMF, plus has raised \$1 bln via the US loan guarantee and is expecting at least \$1 bln from the EU shortly. It has enough to cover Gazprom plus other scheduled debt obligations.
- Apart from the gas talks and news report from East Ukraine, the other important event will be President Putin's attendance at next week's anniversary of the Normandy landings. This will be the first time he has met with EU leaders and President Obama since Crimea was admitted to the Federation. The June 6th anniversary will come directly after the rearranged G7 meeting in Brussels at which, most likely, the threat of further sanctions will be voiced.
- President elect Poroshenko has confirmed that he will orientate Ukraine towards the EU/West but wants to retain positive trade and investment links with Russia. He has said he plans to meet President Putin in June by Russia's Foreign Minister – probably reflecting concerns about the military actions in the East - said that there are currently no talks about such a meeting.



- Opinion polls show that 53% of people (mostly in the west) favour joining the EU while 33% (mostly in the East) are opposed. 37% would vote to join NATO while 42% would not. The same west versus east divergence was also clear in this poll.
- Assuming a gas deal and signs of economic pragmatism from both sides will be positive for both Russian and Ukraine markets. But any additional relief rally may be short lived in Ukraine. The economic indicators, most of which have been less bad than expected, are set to deteriorate in the summer and through the 2nd half.
- The main event in Ukraine, i.e. after the gas deal and possible economic engagement with Moscow, through the summer and/or autumn will be the highly contentious and fractious Rada elections. The unpopular IMF austerity measures will also be part of the election backdrop and will keep the risk premium elevated until the process is completed.
- Petro Poroshenko does not belong to any party in the current Rada although he has the full backing of Vitaly Klitchko's UDAR party which, after the recent musical chairs, has a 9.3% share of the vote. The biggest party remains the Yanukovich aligned Party of the Regions and despite defections cutting its vote share from 42% to 28%. Non-aligned Rada members now account for a 20% vote share. That means that the new president may find it very difficult to get legislation passed without the support of parties such as Yulia Tymoshenko's Fatherland. Expect a lot of bartering ahead of the Rada elections.
- The \$27 bln pledged by the IMF, the EU and other governments is expected to be well short of the total required to both meet obligations and stimulate recovery. Debt restructuring may again be a risk coming into the 4th quarter or early 2015.

Relief rally is running out of steam

Sunday's election, which brought Petro Poroshenko to the presidency with a 54% share of the vote, only marks the end of the first period in the effort to stabilize Ukraine's governance and economy. Investors in the debt and equity markets have correctly bet that the financial aid from the IMF and western governments plus the pragmatic approach to relations with Russia promised by the new president greatly improves the investment climate compared to the position in early March.

But there are a number of very serious obstacles still to be overcome this year and assumptions that political risk is now greatly reduced are premature. The economic data published so far, which is less bad than had been feared, will be subject to significant revision and full year indicators are still set for serious deterioration. There are still a great many situations to be resolved, and scenarios to unfold, before the optimism that growth will resume in 2015 is justified.

Over the short term we may still see further gains in the equity and debt markets and even a modest rally in the Hryvnia. That assumes a near term deal on the gas dispute with Gazprom and political engagement between Poroshenko and Putin.



There is scope for further gains in the Sovereign and Corporate Debt market, i.e. perhaps back to end March yields. There is no default risk for this year but with major question markets flashing over the sufficiency of the external aid promises, i.e. the bailout cost is likely to be closer to \$40 bln than \$27 bln when stimulus measures are taken into account, restructuring concerns may re-emerge in the autumn/winter. After that the greater risk is for disappointment and raised concerns as the new president must press ahead, not only with engagement in East, but with forcing through the austerity measures insisted on by the IMF and overseeing what is expected to be a highly contentious parliamentary election process.

The Hryvnia is now at our year end target of 12.0 against the US Dollar and while there is scope for trading volatility around this level, we don't see any reason for optimism for a better rate in the 2nd half.

The local currency equity index (UX) has surged 32% since the start of April as a reaction to the IMF deal and the likelihood of a Poroshenko victory. But the more actively traded (by international investors) foreign currency denominated WIG-Ukraine Index is off 32% year to date. Most of that is currency related as the Hryvnia is down 45% against the US dollar so far in 2014.

Ukraine's foreign listed food sector companies are still the safe way to play the market amidst so much domestic uncertainty. MHPC (one of Europe's biggest poultry producers), Kernel (grain and sunflower oil producer) and Avangarde (eggs) have the largest investible free float.

Ukraine: Benchmark Yields, Currency and UX Index

	May 27	May 23	April 30	Mar 31	Mar 14	Jan 31	Jan 1
<u>Sovereign Debt Yields</u>							
Ukraine 15, 6.875	11.56	11.96	14.30	10.7%	17.9%	14.3%	8.4%
Ukraine 21, 7.95	9.08	9.26	10.75	9.1%	11.6%	10.8%	9.3%
<u>Corporate Debt Yields</u>							
Naftogaz Ukraine 14, 9.5	23.22	25.73	33.89	22.9%	35.1%	17.6%	9.9%
Ukreximbank 15, 8.375	19.60	18.69	29.45	18.5%	20.0%	16.4%	11.6%
Metinvest 18, 8.75	12.80	12.66	13.05	11.7%	12.9%	11.2%	10.3%
Hryvnia-US\$	11.98	11.95	11.60	11.01	9.70	8.62	8.24
UX Equity Index	1 208.2	1 176.3	1 103.3	993.4	1 003.6	889.5	910.0
WIG - Ukraine Index	345.4	315.4	329.4	364.9	298.7	471.5	510.2

Source: Bloomberg



End of Period 1

The election of Petro Poroshenko ends the political vacuum which prevented any dialogue between Moscow and Kiev governments/leaders. Now at least there is a point of contact at the highest level of government. The Kremlin has not yet officially recognised Sunday's result but still has time. The official result, i.e. when the votes have all been counted and validated, is not expected until later next week. Before that President Putin will attend the Normandy Landings (D-Day) anniversary in France along with EU leaders and President Obama. Undoubtedly that event will afford an opportunity for informal talks and, hopefully, an understanding as to how to deescalate the political and sanctions threats.

Poroshenko is expected to be legally inaugurated on the weekend of June 7-8, although he has already started work as the president-elect. The key issues he will have to deal with through the next two "periods" over course of this year will include:

Gas:

One of the two urgent issues on his list is to resolve the threat of a gas shut-off from Gazprom and to reach a deal over a new tariff and the payment of the outstanding debt. If there is no agreement then the economy will face further disruption and recovery delayed. No gas deal will also make it harder to resolve political issues with Moscow. However, a deal is expected over the short term (see below)

East Ukraine:

The president-elect has promised to bring all parts of the country under direct control and rid the East of the para-military groups ahead of talks with political representatives in the region. As has already been seen since Monday, that task will not be easy.

Trade Talks:

Primarily that means repairing political links with Moscow which, in turn, will allow for a resumption of the previous cross-border between the two countries. Russia accounted for approximately 25% of Ukraine's exports before the crisis and almost one-third when transit exports are taken into account.

Maidan:

The new president will not only have to engage in a dialogue with representatives in the East but he will also have to clear the protest camps from Maidan Square in Kiev. Many of those still on the square have been the cause of criticism in the Russian media and suspicion in the west. There will be concern amongst investors, businesses and foreign politicians about political stability so long as the camps remain.

Austerity:

The IMF has only dispersed \$3.2 bln of the pledged \$17 bln to date. Disbursement of the balance is dependent on the government pushing through the package of measures insisted on by the IMF (see below). As previous government's found out, pushing through tough austerity measures will be hugely unpopular.



Rada:

The protest movement which successfully ousted the previous president promised a return to 2004 constitution, which will cut the powers of the president in favour of parliament, and committed to hold elections to the Rada in the summer. Coming against the backdrop of austerity and the inevitable repercussions of the crisis at local levels, the elections will be much more contentious than was the case for Sunday's election.

Economy:

The economic indicators for the first four months have been much less bad than had been feared. There has been a collapse in investment spending and industrial production but consumer activities and budget execution have been above expectations. However, that is expected to be temporary and the IMF's forecast of a 5% GDP decline fits our assumptions which also include 10% inflation and 7% budget deficit for the year. Turning that around to the promised 2% growth and 5% inflation in 2015 will be very tough and will require very unpopular measures.

Period 2

There are three priorities for this second period:

- Suppressing the para-militaries in the East
- Resolving the gas dispute
- Engaging in talks with the Kremlin

Poroshenko was interviewed by NovayaGazeta (Russian newspaper) last weekend. The key message is that political differences are likely to remain between Kiev and Moscow for a very long time but these should not be allowed get in the way of resolving economic issues. He was unequivocal on his strategy for moving Ukraine more towards the west and doesn't see the basis for "much" autonomy in any part of the country.

Other notable comments in the interview:

- Russia has, de-factor, acted as the aggressor in Ukraine
- Relations between the two countries suffered irreparable damage...and is only at the beginning
- Ukraine will never accept the situation in Crimea and will refer to it as occupied territory. An international legal case will be opened against Russia seeking the return of Crimea and compensation
- But, Crimea is an issue of sovereignty and should not be allowed damage economic and trade relations...he was quite insistent on that point, asking the journalist "You understand the difference? Please convey that to your readers"
- His first trip as president will be to Donbass where he will meet and discuss issues with "ordinary people" but never the para-military separatists
- He prefers a return to the "status-quo" but will listen to the people
- He has vowed to wipe out the para-military "bandits" as quickly as possible...he accused them of wanting to establish a sort of war lord run Somalia in the East



- He promised to resolve Ukraine's dependency on imported Russian gas in two years
- When pressed about Tymoshenko's threat to stage a third Maidan Square protest he said "I do not know who you are talking about"
- Asked about accusations that he may only represent some of the people's interests or that of the oligarchs or even of western governments he was very clear "who says that? It's bullsh**" He only has one priority and that is the national interest of Ukraine
- He promised a full investigation – using external experts – of all of the events in Kiev, Odessa and elsewhere in recent months and promised to bring to justice all those found responsible for wrong doing.

Poroshenko has promised that his first trip as president will be to Donbass which, one assumes, will be after the para-militaries have been suppressed. After that the next important meeting will be with President Putin. Poroshenko told news agency AFP last week "I know Putin: I have had experience in discussions with him; he is a strong and tough negotiator" He confirmed that he plans to "meet the Russian leadership" next month. He added "We will get ready for this meeting and will not just shake hands"

Since Sunday's election Putin's spokesman has confirmed that the president sticks by the comments he made at last week's St. Petersburg Forum when he said Russia would "respect the choice of the Ukrainian people" in order to assuage tensions in the country. Putin did, however, also say at last week's event that he hoped the new Ukrainian leadership would cease its military operation against pro-Russian groups in the East.

Foreign Minister Lavrov, cited by RIA Novosti, also indicated that a dialogue is now likely. He said "*The opportunity to establish a mutually respectful dialogue in light of these results — which, I repeat, Russia is ready to respect — should not be missed,*"

However, possibly reflected concerns over the latest fighting in the East, the Foreign Minister, speaking at a press conference on Tuesday played down any prospect of a quick meeting "A Russian trip of Poroshenko is not being considered or discussed by diplomatic or any other channels,"

Period 3

Period 3 will also be very tough and more likely to have a restraining impact on investor sentiment and activity until the issues are clarified. The key issues will be;

- Completing the RADA (parliamentary) elections
- Resolving constitutional issues with the RADA
- Forcing through the austerity measures insisted on by the IMF
- Balancing difficult political relations with Moscow while maintaining economic / trade ties



The Rada elections are expected to expose greater political divisions across the country than was seen in the presidential campaign. The table below shows how the party membership lists changed during the past four months. The big shift was the defection of 58 members of the Party of Regions, previously aligned to ex President Yanukovich. Many went to set up the Economic Development Party while most decided to stay independent.

The next will be particularly contentious in the East and South, areas which were traditionally strongholds of Yanukovich and of the Party of the Regions.

Structure of Ukraine Parliament (Rada)

Party	Headed by	At end 2013		Current	
		Seats	% of Votes	Seats	% of Votes
Party of Regions	Mykola Azarov (former PM)	185	42%	127	28.2%
Fatherland	Yulia Tymoshenka (former PM)	101	23%	88	19.6%
UDAR (Reforms)	Vitaliy Klychko (Mayor of Kiev)	40	9%	42	9.3%
Svobada	Oleh Tyahnybok	37	8%	36	8.0%
Communist Party	Petro Symonenko	32	7%	32	7.1%
Economic Development	Anatoliy Kinakh (formerly PoR)	0		33	7.3%
Independents - pro government		43	10%	51	11.3%
Independents - anti-government				40	8.9%
Disputed		7	2%	1	0.2%
Total		445	100%	450	100%

Source: RADA Information

The election result will be much more important this time because of the reversion to the 2004 constitution which shifts many powers from the president back to the parliament. That will be particularly important as many of the political parties will go for the populist vote and oppose the toughest terms of the IMF austerity plan.



Economic Trends to Deteriorate

Although some of Ukraine's macro indicators fell sharply through the first four months of the year, other indicators have held up much better than expected. However, in almost all instances, there is an element of once-off in the "better than expected" numbers and we retain our full year forecasts unchanged (table below).

The trend for 2015 is for improvement and, undoubtedly after such a traumatic 1st half of 2014 and the disruptive parliamentary elections to come, 2015 will almost guaranteed to be better. Especially if the external aid is paid as pledged.

But our numbers for 2015 are as a guide only for now. There are still far too many variables and scenarios which may play out this year which will have a direct impact on the numbers next year.

Ukraine - Macro Trends

	2007	2009	2011	2012	2013	2014 (F)	2015 (F)
GDP, Real growth	7.9%	-14.8%	5.2%	0.2%	-0.3%	-5.0%	1.5%
Inflation	16.6%	12.3%	4.6%	0.0%	0.5%	10.0%	6.0%
Unemployment Rate	6.4%	8.8%	7.9%	8.0%	7.5%	9.0%	7.0%
Budget Execution, % GDP	-1.1%	-8.7%	-4.2%	-3.6%	-4.5%	-7.0%	-5.0%
Current Account, % GDP	-4.2%	-1.5%	-6.1%	-8.2%	-9.1%	-6.0%	-6.0%
Hryvnia/US Dollar EOP rate					8.24	12.00	11.00

Source: State Statistics Agency, National Bank, Macro-Advisory estimates

Positive indicators to date

- Total public debt fell \$2.5 bln to \$65.8 bln (circa 50% of GDP) by end March. The reason is because of the Hryvnia impact on the translation of local current debt
- The 1st Quarter trade balance was in surplus to the amount of \$1.3 bln for the 1st quarter. Mainly that was due to a 24.4% YoY drop in exports to Russia and the fact that Ukraine benefitted from the cheaper gas price in Qtr 1 (\$286 p/1,000cm).
- The state budget ran a surplus in March due to transfers from the National Bank. That brought the surplus for the 1st quarter to approximately 0.3% of GDP. But the National Bank will not be able to make further transfers under the terms agreed with the IMF. Hence we retain our forecast of a 7% budget deficit for the year as tax revenues, especially from the East, remain well short of target.



Negative indicators to date

Industrial production fell 6.0% YoY in April, bringing the four month decline to -5.3%.

- Ukraine's grain harvest is expect to decline 12% this year to 55 million tonnes. Partly that is due to the social disruption and the currency impact but also the loss of Crimea affects the numbers.
- The State Statistics Service reported that fixed asset investment fell 23.1% YoY in the 1st quarter. The worst sectors were utilities (-57%), food production (-22%) and mining (-21%) while metal production rose 10%.
- Inflation is running at 6.8% on an annualized basis at end April. The National Bank expects a full year gain of almost 12% this year but is confident it can pull that back to 3-5% in 2015 or 2016. The weaker Hryvnia will accelerate inflation in the 2nd half in combination with the IMF measures (see below).

IMF Aid Terms

There is no need for a debt restructuring "at this stage" The IMF believes that the \$27 billion loan is sufficient to prevent a default or the need for restructuring of existing debt.

The price gas tariff charged to domestic and commercial customers is to rise by 50%.

The IMF statement said the staff-level deal breaks down into five broad categories:

I Monetary Policy:

Ukraine Central Bank (NBU) has already been forced – by the market – to abandon the Hryvnia-Dollar peg (previously set at 8.0). The NBU will stick with the flexible exchange rate.

The NBU will adopt an inflation targeting framework over the next twelve months. In practice that probably means that the NBU accepts that inflation will spike this year, e.g. the May 1st gas tariff increase, so it will look to stabilize the currency only after the market finds a comfortable level and the inflationary impact of the austerity measures have been accounted for.

II Financial Sector:

The general text simply talked adopting best regulatory and balance sheet practices for the banks but also that the NBU will ensure the banks are well-capitalized and that non-performing loans are properly accounted for.

It is almost certain that the rate of non-performing, if not bad, loans will rise sharply after a proper review, based on international standards, is completed. Many of Ukraine's banks will need to raise extra capital after that review.



III Fiscal Policy:

The statement said that the government has agreed to prioritize spending over the course of this year and then to “implement deeper fiscal adjustment over the medium-term” The statement further said that the focus will be on “expenditure-led fiscal adjustment” from 2015. The government will be required to agree to cut the budget deficit to 2.5% of GDP by 2016.

What that means is that the proposed tax income tax and VAT rate adjustments are likely to be cancelled or greatly curtailed. Currently the top rate of corporation tax is 19% but had been scheduled to fall to 16% this year and to 10% from 2015. VAT had been set to fall from a 20% rate to 17% this year. The top marginal rate of personal income tax in Ukraine has been 17% but is set to rise to 20%.

IV Energy Sector:

The IMF clearly stated that the first step towards energy sector reform is a commitment to move retail gas and heating tariffs to “full cost recovery”. The IMF asked for an early first-step in that process and that, according to a Naftogaz official cited by various media groups, means a 50% tariff rise this year.

It is not known what assumption Naftogaz or the IMF are making about the Russian gas price.

V Business Climate:

The IMF statement talked about the need for specific measures to improve transparency, improve governance and to improve the business climate. Two specific measures mentioned were a) a quarterly independent audit of the Naftogaz accounts and, b) a new procurement law.

One word covers what the IMF is getting at; corruption. It is assumed that latter disbursements of aid will be linked to concrete evidence that corruption is being dealt with.



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