TRIP NOTE: UKRAINE

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Global Evolution

GLOBAL EVOLUTION TRIP NOTE

Before visiting Kiev in September 17, we were optimistic on Ukraine's structural economic transformation under the current IMF program. Following our visit, we remain constructive. Although we understand market skepticism that Ukraine will complete its IMF program, after all previous programs collapsed once market access was restored, we believe the commitment to reform is much firmer this time around. We remain comfortably overweight Ukraine's hard currency debt in our EMD strategy and we have moved the local currency debt to a very high conviction trade in our frontier strategy.

Political risk: all about reforms

There are few doubts that since Ukraine lost sovereignty over Crimea, Luhansk and Donetsk, the residual state has become increasingly aligned with the EU. The conflict with Russia is no longer seen as the key focus for policy makers. Importantly, the key policy challenges are now seen as domestic and can be solved with the right reforms.

The IMF program should probably still be viewed as an important anchor for the reform process. The fact that Ukraine has abandoned previous IMF programs on regaining market access is clearly a concern. We think it will be different this time given Ukraine's important geopolitical status for US and EU.

Recently there has been some reform fatigue which has led to a finger-wagging from IMF first deputy head David Lipton. Important reforms to look out for in coming months include: pension reform, setting up an anti-corruption court, further normalization of energy prices and more vigorous privatization. The IMF is not expected to approve the next USD1.9bn loan tranche without reform progress.

The domestic political landscape is very fluid and in most recent polls all politicians score very poorly. It is fair to assume that the reform effort will wane as we approach the presidential election in 2019. The base/best case scenario is that President Poroshenko secures public support for another term without jeopardizing the IMF program.

Economic outlook: rule of law

The economy is starting to emerge from an extended period of extreme stress. Growth is expected to be around 1.8% in 2017 (with risk to the upside), increasing to 3.0% in 2018 based on improved consumer sentiment, lending, investment and recovery in metals export earnings.

Improving the overall rule of law is seen as essential to raising the growth rate. Corruption and cronyism are at least partially responsible for the low level of foreign direct investment (FDI is 1.5% of GDP).

Land reform to enable more flexibility it the sale of land is also seen as vital to raising growth rates. Not least it would enable agribusiness to use land as collateral. The EBRD estimate land reform alone could unlock USD40-50.0bn in agribusiness lending.

Ukraine's competitive advantage is not only seen in agriculture. It also has a very large, well educated, cheap work force (with noted specialism in engineering benefitting the artificial intelligence sector). There are also significant underexplored oil and gas opportunities.

BOP: looks healthy

The NBU's FX reserves are presently around USD18bn or 4.5 months import cover. They intend to further slowly build these and target

USD20bn by end 2017 and USD27bn by end 2018. Despite reasonable import cover, FX reserves may come under pressure from high external liabilities in coming years. Despite the sensible liability management deal (issuance of 2032s) the government is still facing challenging redemptions of USD5.2bn (USD6.4bn before the 32s deal) in 2019 and USD5.4bn (USD5.8bn before the 32s deal) in 2020. The redemptions represent around 10% of total debt and may place pressure on bond prices as we approach 2019. Short-term external repayments are more manageable with USD1.3bn by the end 2017 and USD3.4bn in 2018.

The current account of 4.0 to 4.5% of GDP is fully covered by capital inflows, thus facilitating reserves' build-up. Other financing, including official flows and de-dollarization, have also made a positive contribution to flows. The overall BoP is estimated to reach 1.8% of GDP in 2017 and rise to 2.5% in 2018.

When and if the pension reform is concluded it could open a new chapter for Ukraine in terms of creating a new wave of natural buyers for the UAH bonds.

Fiscal policy: revenue bonanza

The budget deficit was registered at 2.3% of GDP in 2016 and the idea is to register a deficit of 3.0% of GDP in 2017, although the budget was actually in small surplus in H1:17. The deficit is then set to decline to 2.0% in 2020 in order to keep the debt levels (81.0% of GDP) from growing any further.

The budget consolidation has been assisted markedly by the turnaround in the fortunes of Naftogaz. After being a huge drain on the fiscal position, gas price normalization has enabled the company to return a profit. Revenues were up 48% y/y in January-July, with non-tax revenues as the main contributor.

On the expenditure side, spending growth has slowed due to reduced transfers to local budgets for subsidies to households, lower transfers to the pension fund and slower capital expenditure growth.

Monetary policy: sticky inflation

A new era of monetary policy has started with the latest IMF program and the introduction of inflation targeting. NBU expect disinflation and target 5% +/- 1% in 2020, 6% +/- 2% in 2018 and 8% +/- 2% in 2017. Inflation expectations are in general trending lower but the headline inflation has proved sticky and is currently at 16.2% (Aug). The NBU believes much of the pressure is due to food (meat, diary, fruit, vegetable and tobacco prices) and will reverse shortly. If the NBU is not correct, the credibility of their inflation mandate will start to be questioned and they will need to raise the policy rate from its present 12.5%.

NBU does not target a currency level, but they can clearly not afford significant Hryvnia depreciation. Interestingly, the government draft budget was based on a USD/UAH estimate average of 29.3 in 2018 and 30.1 at end-year. Such an outcome would place significant pressure on the NBU delivering its 6.0% +/-2.0% target for the 2018.

Conclusion: short-term fine

We believe the short term risk premium in the HC bonds is attractive given our base case scenario of limited external repayment 2017 and 2018 and continued economic reform under an IMF program.

From a local currency debt perspective we like duration based on our view that inflation is about to come structurally lower in line with the NBU's inflation target.

We are not convinced that the government's budget estimates for USD/UAH are compatible with the NBU's inflation target. Our core scenario is that USD/UAH continues to trade fairly close to current levels. This is more likely if the market for local bonds opens up along with the changes in the pension system.

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