

Weekly Digest

- Macro outlook update for 2019
- The NBU has retained the discount rate at 18.0%, adjusted monetary policy, and prolonged mandatory sales of export revenue
- Fitch has upgraded Ferrexpo's rating to 'B+' (two notches above the sovereign)

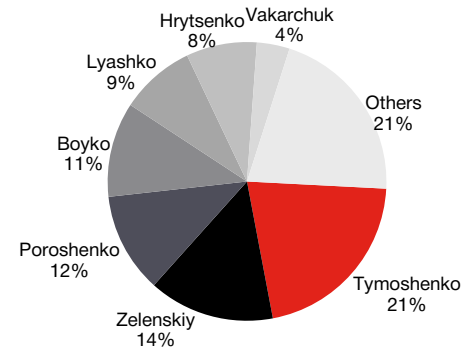
Macro outlook update for 2019. Given that the current year is coming to a close, we provide our views and estimates for the coming 12 months in the Ukrainian economy. Key figures to look out for: real GDP at 2.8%, inflation at 6.5%, NBU reserves at \$18.6bln, CA and budget deficit at 3.4% and 2.3% of nominal GDP, respectively.

Our view: The upcoming year is likely to be marked by significant turbulence on the political front, but moderate macro and fiscal risks.

Presidential elections, scheduled for March 31, currently look quite unpredictable. According to a late November poll conducted by the Kyiv International Institute of Sociology (KIIS) Tymoshenko seems to be the most popular candidate overall (21% of those that have decided upon a candidate would vote for her), but is lacking support for a single-round victory. In case of a runoff she is closely matched by Hrytsenko, Zelenskiy, Vakarchuk (though the last two are yet to officially declare their intent to run). Poroshenko's chances to stay on for a second term look slim, as he is significantly disfavoured versus almost all other contenders (including the pro-Russian Boyko). That said, almost 30% of those asked said they were undecided. A possible distribution of votes for Parliamentary elections, which are slated for October 27, follows along similar lines. Of those that have made up their mind 23% would cast their ballots for Tymoshenko's block and the rest would split their support among 5 more parties (from 8% to 13% for each). Predictability here is a bit higher, however, given the differences in the selection process. Unless sentiment changes significantly, the makeup of the country's main legislative body is heading towards a high degree of fragmentation.

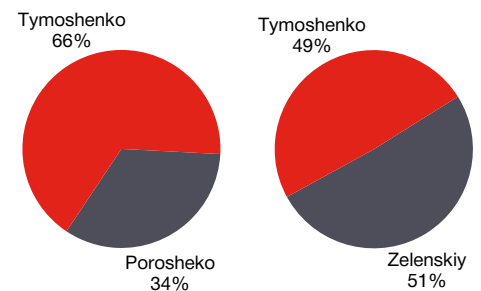
Irrespective of shifts in the political landscape, however, we think that the amount of external payments over 2019 and 2020 practically guarantee Ukraine's participation in the IMF program, unless new authorities choose to default. According to our estimates, over the next 24 months the state along with the NBU will need to spend over \$10bln on servicing and redemptions of foreign borrowings (including interest), while also allowing quasi-sovereign issuers (specifically Oschad and Ukreximbank) to pay more than \$2.0bln on their own obligations, and rolling over \$4.5bln of local FX bonds. Deciding to derail its cooperation with international donors would severely limit Ukraine's possibilities of refinancing, which are a necessity given that the National Bank's reserves remain just slightly above 3 month of import coverage (\$20.1bln at YE18). A decision to default on all payments seems unlikely for two reasons: (1) it would alienate the country from Western support, which it requires in face of its standoff with Russia, and (2) private business (which has a large political influence) would also lose access to external capital. In our base case macroeconomic scenario, we expect the authorities to borrow \$1.5bln via eurobonds in 1Q19, and to fulfill the requirements for an additional IMF tranche in 4Q19 totaling \$1.3bln. This would bring year-end reserves to \$18.6bln. Although the current account may demonstrate a deficit of up to \$4.8bln (3.4% of nominal GDP), most of it should remain covered by private sector funding, just like in 2018 (we think that a large portion of investment-related purchases are paid for either via corporate savings in FX or related-party loans from abroad).

2019 presidential elections poll results, 1st round



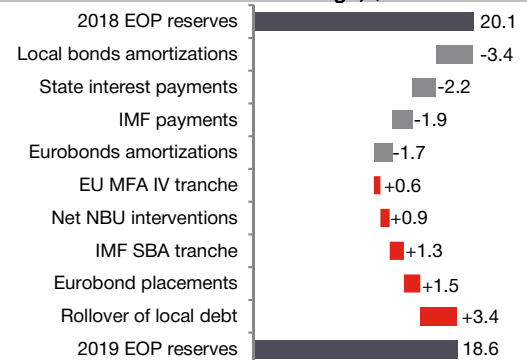
Note: Share of votes of those that have decided upon a candidate (questionnaires conducted over November 23 – December 3)
 Source: Kyiv International Institute of Sociology (KIIS)

Second round poll results for 2 pairs



Note: Share of votes of those that have decided upon a candidate (questionnaires conducted over November 23 – December 3)
 Source: Kyiv International Institute of Sociology (KIIS)

2019 to 2018 EOP reserves bridge, \$bln



Source: NBU, Bloomberg, IMF, Ministry of Finance, Adamant Capital estimates

In 2019 we expect Ukraine's economic growth to slow to 2.8%, largely on the back of a high base effect in the agricultural sector (2018 was 5-year trailing averages by 7% and 14% respectively). Domestic trade, which still stands some 10-15% below pre-crisis (2013) levels in real terms should remain a key driver, along with industrial production, which was hampered in 2018 by relatively weak performance of steel and iron ore extraction businesses. High capex levels over the past 4-6 quarters (the 2Q18 figure stood at 19% of real GDP, which is 300bps above the 2010-13 average), should start to see at least a degree of conversion into new projects.

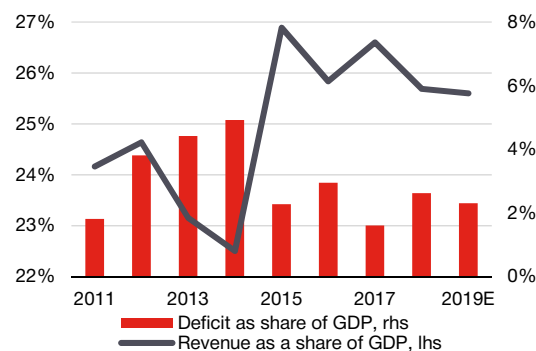
End of period inflation over the next 12 months is likely to slow to c. 6.5% YoY, despite demand pressures still persisting on the back of rising disposable income. In contrast to 2018, we expect these to be less significant, given that wage growth already started to decelerate, possibly along with labor migration. We think that the NBU will adhere to a strict monetary policy (and keep the key rate unchanged at 18%) at least until 4Q19, given the usual volatility and enlarged social spending surrounding election campaigns. Big ticket items in the consumer basket may include another bump to household heating tariffs – possibly twice (in April and October), but full details will only be revealed when the IMF's memorandum with Ukraine on the new SBA is published. Given the significant amount of external payments, the regulator is likely to continue purchasing currency from the interbank market aggressively, which is bound to put at least some pressure on the hryvnia. We anticipate the average exchange rate slipping to c. 28.5/\$. Taking into account our other forecasts, nominal GDP should thus reach \$141bln, with public debt landing at 58% of this figure.

As mentioned previously in our comments, the state budget for 2019 looks relatively conservative. Planned revenue as a share of nominal GDP has been set at a similar level to 2018 (25.6%), and the latter is likely to slightly outperform its target. The document has also been closely tracked and eventually approved by the IMF. We thus think that a deficit of 2.3% of nominal GDP is entirely realistic.

The NBU has retained the discount rate at 18.0%, adjusted monetary policy, and prolonged mandatory sales of export revenue. According to official press releases, the regulator believes the current rate to be sufficiently high to bring inflation down to $5\pm 1\%$ by the end of 2020. Key forward looking CPI growth risks named include rising domestic demand due to increasing wages, negative expectations on the back of the upcoming elections, and further tensions with Russia in the Kerch Strait. Main changes to the monetary policy comprise a cancellation of all refinancing loans with maturity longer or shorter than 14 days (except overnights), with a simultaneous removal of volume restrictions. Tenders will now be held on a biweekly basis and the lending rate will be set equal to the discount one (+200bps previously). Mandatory export revenue sales (at 50%) have been prolonged until February 6.

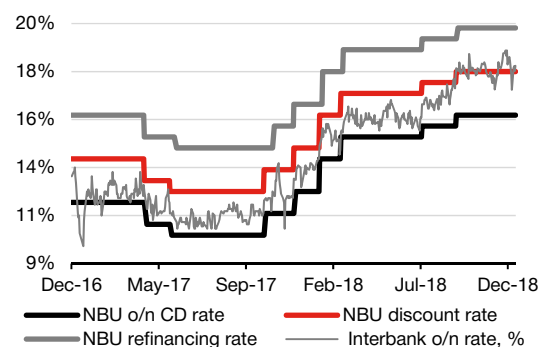
Our view: We find the regulator's decision on the key rate to be unsurprising, given relative stability on the interbank FX market since the beginning of December and upcoming financing from IFIs. That said, we think that a decrease in the NBU's biweekly lending rate by 200bps may actually lead to a softening of monetary policy, as banks will now be able to roll over funds borrowed at 18% to invest in higher-yielding domestic government bonds and even to avoid refinancing at a 20% overnight rate at a later date. If such a scenario indeed materializes, the regulator may be forced to introduce additional adjustments, especially if inflation expectations do not fall from the 11.5% for banks reported in mid-October.

State budget revenue and deficit as % of GDP



Source: NBU, State treasury, Adamant Capital estimates

Local interest rate dynamics



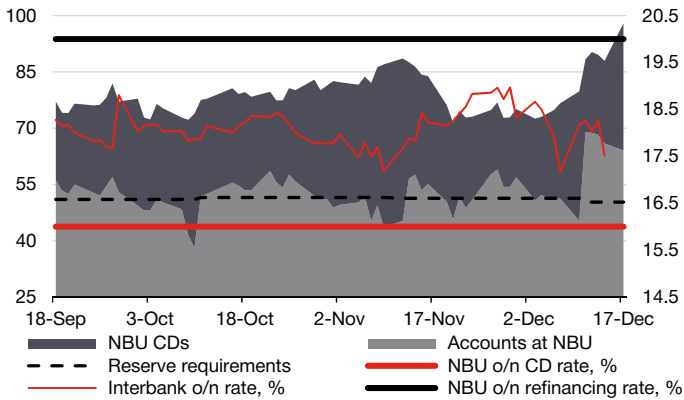
Source: NBU

Fitch has upgraded Ferrexpo's rating to 'B+' (two notches above the sovereign). According to the agency's press release, the change reflects the company's improved liquidity following a pre-funding of 2019 maturities, limited debt on the balance sheet, and flexibility to reduce capital expenditure and/or dividends under less supportive market conditions. The report also cited intelligence from CRU Group (a commodity focused advisory) that suggests that ongoing negotiations for the pellet premium in 2019 indicate a slightly higher level compared with 2018. Fitch also noted that it assesses Ferrexpo's business and financial profile in the 'BB' category.

Our view: The report falls largely in line with our own views, especially with regard to eurobond debt, the remaining portion of which the company should have no trouble refinancing via the undrawn \$205mln part of its 2017 PXF facility. Moreover, given that the operating environment for next year looks strong, we do not exclude that a large portion of funding for the amortization could come from operating cash flow. Somewhat surprisingly, Ferrexpo 2019 still trades at a 9.5% yield, but we attribute this to a lack of market activity, given that only \$173mln remains outstanding.

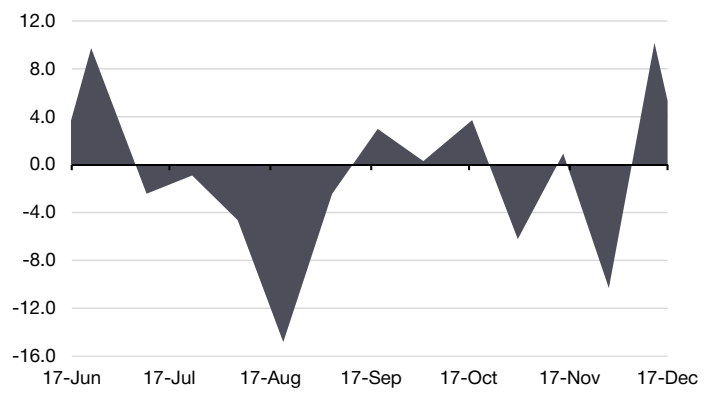
Appendix

Banking system 3m liquidity (lhs, UAHbln) vs NBU CD rates (%)



Source: NBU, Adamant Capital estimates

Banking system 6m inflows from the state treasury and the DGF

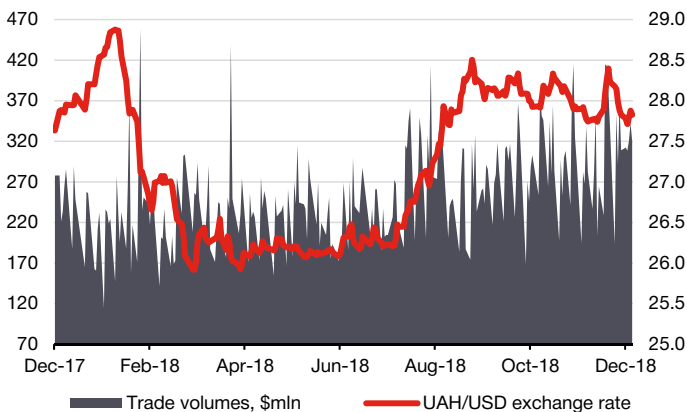


Note: in UAHbln, where each point represents a biweekly sum
Source: NBU

Local market liquidity (as measured by the aggregate amount of NBU correspondent accounts and investment CDs) has increased by UAH 18.2bln to UAH 98.0bln over the last week. On December 18 the Ministry of Finance conducted local hryvnia denominated placement maturing in March, April, June, September and November 2019 with yields of 20.5%, 20.5%, 18.5%, 18.5% and 18.5%, respectively, and USD denominated placement maturing in January 2019, October 2019 and February 2020 with yields of 6.5%, 7.25% and 7.5%, respectively. A total of UAH 11.4bln and \$0.3bln was raised as a result.

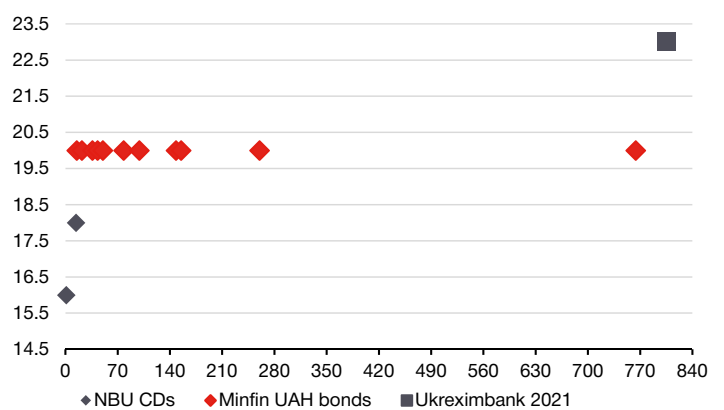
The **UAH/USD interbank rate** depreciated by 0.5% over the week starting out with 27.71 and ending at 27.86.

FX interbank trade volume (lhs) and FX rate (rhs), past 12 months

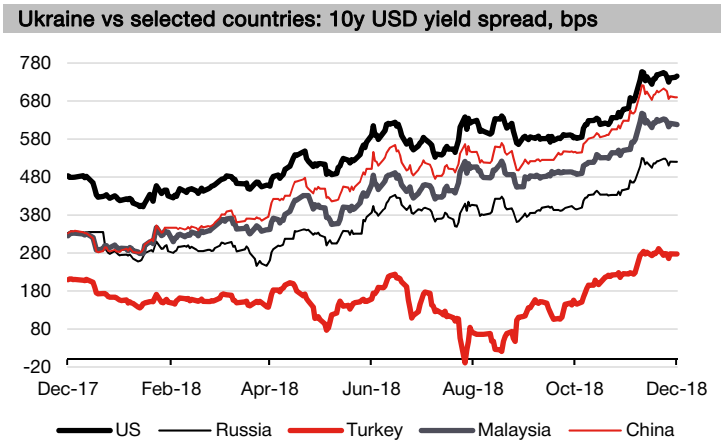


Note: Exchange rate figures are from official interbank data
Source: NBU

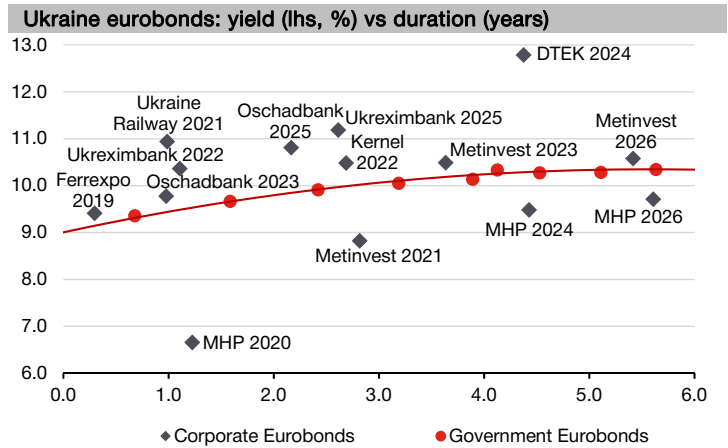
Local market yield curve: yield (lhs, %) and maturity (rhs, days)



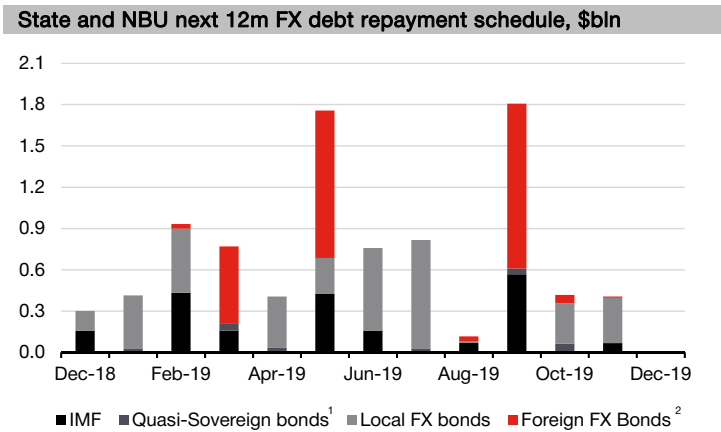
Source: NBU, Bloomberg, Adamant Capital estimates



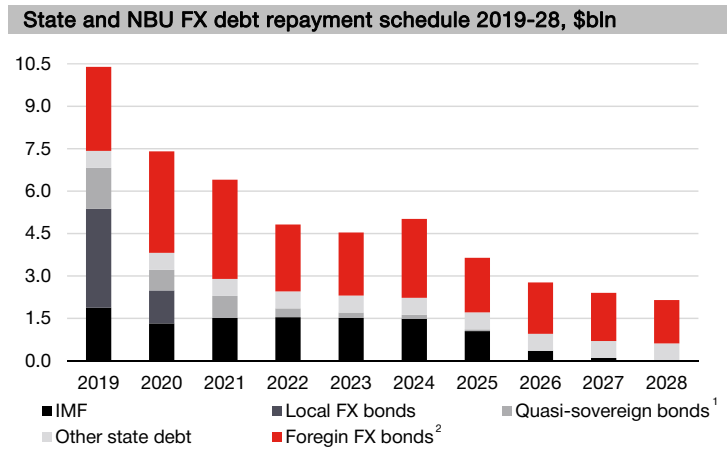
Source: Bloomberg, Adamant Capital estimates



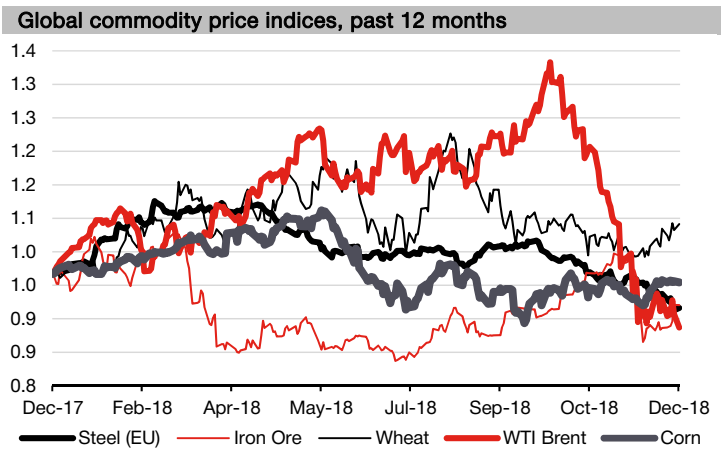
Source: Bloomberg, Adamant Capital estimates



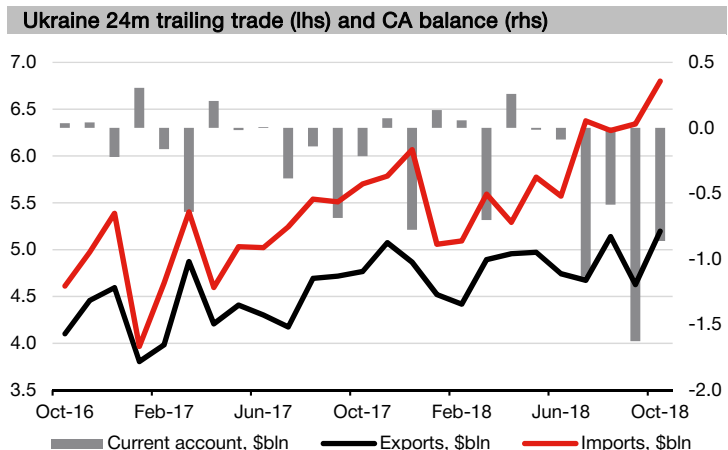
Note: Interest included in each category
 (1) Debt of state owned enterprises
 (2) Includes USAID guarantees
 Source: Bloomberg, Adamant Capital estimates



(1) Debt of state owned enterprises
 (2) Includes USAID guarantees
 Source: Bloomberg, Adamant Capital estimates



Note: Rebased to 1. Indexes used: Platts TSI HRC N Europe; China Iron Ore 62% Fe; Wheat Futures (CBT); WTI Crude Oil Futures; Corn Futures (CBT)
 Source: Bloomberg, Adamant Capital estimates



Source: NBU

Key macroeconomic indicators								
	4Q17	2017	1Q18	2Q18	3Q18E	4Q18E	2018E	2019E
Real GDP growth, YoY	2.2%	2.5%	3.1%	3.8%	2.8%	4.9%	3.7%	2.8%
Nominal GDP, UAHbln	894	2,983	700	807	969	1,073	3,550	4,015
Nominal GDP, \$bln	33	113	26	31	35	38	130	141
GDP deflator growth YoY, %	20.9%	22.0%	14.9%	17.0%	13.2%	14.4%	14.9%	10.0%
Period average CPI YoY, %	14.0%	14.5%	13.8%	11.6%	8.9%	9.8%	11.0%	8.5%
End of period CPI YoY, %	13.7%	13.7%	13.2%	9.9%	8.9%	10.0%	10.0%	6.5%
Consolidated budget deficit, % of GDP ¹	9.4%	1.4%	0.4%	-1.7%	-0.4%	9.2%	2.6%	2.3%
Broad public sector deficit, % of GDP ²	12.7%	4.1%	0.4%	-1.2%	-0.4%	9.2%	2.7%	2.3%
Public debt as % of LTM GDP, UAH	71.8%	71.8%	66.4%	61.8%	62.7%	62.9%	62.9%	57.9%
Public external debt as % of LTM GDP, \$ ³	43.5%	43.5%	41.7%	38.7%	38.0%	38.3%	38.3%	34.5%
Total external debt, \$bln	115	115	115	114	114	117	117	116
Export of goods and services, \$bln	14.7	53.9	13.8	14.7	14.4	15.2	58.1	64.2
Import of goods and services, \$bln	17.6	62.5	15.7	16.6	19.1	18.9	70.4	77.2
Trade balance, \$bln	-2.9	-8.6	-1.9	-2.0	-4.7	-3.7	-12.3	-13.0
Current account, \$bln	-0.9	-2.4	-0.5	0.2	-3.5	-1.5	-5.4	-4.8
Financial account, \$bln ⁴	-1.6	-5.0	-0.2	-0.4	-2.8	-4.3	-7.7	-3.9
End of period NBU reserves, \$bln	18.8	18.8	18.2	18.0	16.6	20.1	20.1	18.6
Average interbank exchange rate, UAH/\$ ⁵	26.9	26.5	27.3	26.2	27.4	28.5	27.3	28.5
EOP interbank exchange rate, UAH/\$	28.1	28.1	26.3	26.3	28.3	29.0	29.0	30.0
EOP key policy rate NBU, %	14.5%	14.5%	17.0%	17.0%	18.0%	18.0%	18.0%	17.0%

(1) Includes net loans given out to state enterprises from the central budget

(2) Includes quasi-fiscal expenditures such as the recapitalization of Naftogaz, state banks, and the DGF. Also accounts for state guarantees.

(3) GDP calculated in \$ according to the average UAH/\$ exchange rate for the year

(4) As per the 6th edition of the IMF's Balance of payments and international investment position manual

(5) Based on official NBU data of average daily interbank rates. Not weighted by volume traded

Source: NBU, SSSU, State treasury, Ministry of Finance, IMF, Adamant Capital estimates

Indicative Eurobond prices, yields, and recommendations									
Bond name	Recommendation	Rec date	Coupon	Maturity	Bid Yield	Bid Price	1 week Δ	Dur, yrs	Out, \$mln
Ukraine 2019	Hold	-	7.8	Sep-19	9.4	98.9	0.1	0.7	661
Ukraine 2023	Hold	-	7.8	Sep-23	10.1	91.3	0.2	3.9	1,355
Ukraine 2024	Hold	-	9.0	Feb-24	10.3	94.8	0.6	4.1	750
Ukraine 2027	Hold	-	7.8	Sep-27	10.4	85.3	0.5	6.1	1,307
Ukraine 2028	Hold	-	9.8	Nov-28	10.6	95.1	0.9	6.4	1,250
Ukraine 2032	Hold	-	7.4	Sep-32	10.0	80.6	0.6	7.9	3,000
MHP 2024	Hold	20-Nov-18	7.8	May-24	9.5	92.8	-0.3	4.4	500
MHP 2026	Hold	20-Nov-18	7.0	Apr-26	9.7	85.8	0.0	5.6	550
DTEK 2024	Hold	4-Dec-18	10.8	Dec-24	12.8	91.5	-0.3	4.4	1,344
Ferrexpo 2019	Hold	9-Oct-18	10.4	Apr-19	9.4	100.2	0.0	0.3	173
Metinvest 2023	Hold	11-Dec-18	7.8	Apr-23	10.5	90.6	0.1	3.6	945
Metinvest 2026	Hold	11-Dec-18	8.5	Apr-26	10.6	89.6	-0.1	5.4	648
Ukrlandfarming in default	Sell	13-Jun-17	10.9	Mar-18	nm	12.9	-0.1	nm	543
Avangard in default	Sell	5-Jun-18	10.0	Oct-18	nm	20.6	-0.1	nm	214
FUIB 2018	Buy	6-Nov-18	11.0	Dec-18	nm	99.6	-0.1	nm	59
Privatbank in default (10.250)	Not rated	-	10.3	Jan-18	nm	20.9	-0.1	nm	160
Privatbank in default (10.875)	Not rated	-	10.9	Feb-18	nm	21.0	0.0	nm	175
Oschadbank 2023	Buy	6-Nov-18	9.4	Mar-23	9.8	98.6	0.1	1.0	700
Oschadbank 2025	Buy	6-Nov-18	9.6	Mar-25	10.8	94.7	-0.3	2.2	500
Ukreximbank 2021 (UAH)	Buy	6-Nov-18	16.5	Mar-21	24.1	87.4	0.0	1.8	150
Ukreximbank 2022	Buy	6-Nov-18	9.6	Apr-22	10.4	97.9	0.1	1.1	750
Ukreximbank 2025	Buy	6-Nov-18	9.8	Jan-25	11.2	93.8	0.0	2.6	600
Ukrainian Railway 2021	Buy	9-Oct-18	9.9	Sep-21	10.9	97.5	-0.3	1.0	500
Kernel 2022	Buy	4-Dec-18	8.8	Jan-22	10.5	95.5	-0.5	2.7	500

Note: all bonds are rated in relation to the sovereign, which is assumed to have a 'Hold' rating

Source: Bloomberg, Adamant Capital estimates

Fixed Income 2 week event calendar		
Event	Type	Date
SSSU - Q3 2018 GDP	Exact	19-Dec
SSSU - Wholesale and retail turnover monthly data	Exact	20-Dec
SSSU - Transportation monthly data	Exact	20-Dec
SSSU - Industrial production monthly data	Exact	21-Dec
Treasury - Monthly state budget performance	Indicative	26-Dec
Metinvest - Monthly report for October	Indicative	27-Dec
NBU - Balance of payments monthly data	Exact	29-Dec

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