



# Fixed Income Weekly

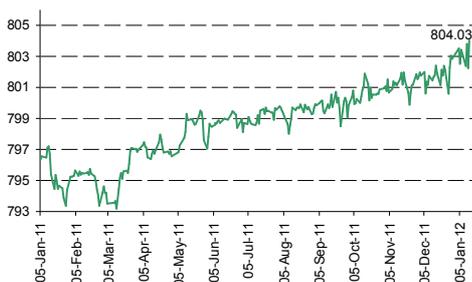
Ukraine Economics | Interest Rate Strategy | FX Strategy

January 17, 2012

	Today	Week ago*	Change
<b>Global indicators</b>			
UST 2Y, %	0.23	0.24	-2
UST 10Y, %	1.87	1.97	-11
LIBOR 3M, %	0.56	0.58	-1
EURIBOR 3M, %	1.22	1.27	-4
Oil (Brent), USD	111.22	113.28	-2.06
Baltic Dry (BDIY, pts)	1053	1258	-205
<b>Sovereign risk</b>			
CDS 1Y bp	872	807	64
CDS 5Y bp	916	867	49
Ukraine 13, YTM%	12.5	10.4	209
Ukraine 16, YTM%	11.5	10.6	92
Ukraine 20, YTM%	11.1	10.6	52
<b>Currency</b>			
USDUAH	8.0435	8.0390	0.0045
EURUSD	1.2674	1.2778	-0.0104
NDF 1M outright	8.21	8.25	-0.04
NDF 6M outright	9.1	9.17	-0.07
NDF 12M outright	10.05	10.12	-0.07
12M NDF Implied Yld%	26.2	28.3	-2.07
<b>Local interest rates</b>			
KievPrime, O/N %	1.31	1.37	-0.06
KievPrime, 1M %	13.34	14.15	-0.81
Wide interbank rate, % (UKIRAWIR)	16.1	16.1	0.00
1Y OVDP, YTM % (bid)	16.75	18.50	-1.75
VAT bonds, YTM % (bid)	18.50	18.75	-0.25
Liquidity, UAH bn	25.3	27.8	-2.5

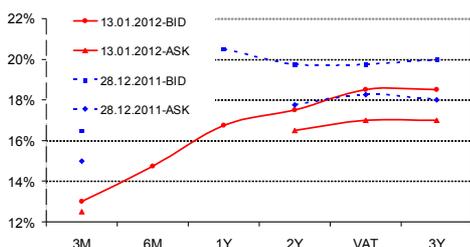
\*Change over the last 7 calendar days

## USDUAH Spot



Source: NBU

## OVDP Secondary Market



Source: traders' quotes

- S&P downgrades ratings of Eurozone countries
- Decrease in the NBU's reserves is surprisingly low in December
- Rada adopts an ambitious privatisation program
- Secondary market yields have been declining

## External environment gets gloomy for Ukraine: ratings downgrade, possible rise in natural gas prices

After the markets closed in the US on Friday, S&P lowered sovereign ratings for 9 countries of the European Union, in addition assigning negative outlooks to the new ratings. Only Germany, the Netherland, Luxembourg and Finland have retained the highest "AAA" ratings, with Germany being the only country among them keeping a "stable" rating outlook. It is practically inevitable that in coming days S&P will also downgrade the rating of the EFSF that currently has "AAA" rating. To add to Europe's problems, on Friday Greece's private creditors suspended negotiations on debt restructuring.

**It would be reasonable to expect a massive sell-off of European sovereign bonds in coming days/weeks** primarily for two reasons: first, many would want to be ahead of the "heard movement" to get higher prices for their bonds; second, a large number of fund investments will have to be brought in line with relevant investment declarations. The EUR/USD exchange rate will continue falling: on the anticipation of the S&P announcement it fell on Friday to 1.2623, the lowest level since August 2010 "Flight to quality" will intensify leaving the frontier markets like Ukraine with virtually no chances to raise market debt, at least, during 1H 2012 and, most likely, beyond this period. There was announcement two weeks ago that Moody's is going to downgrade Ukraine's rating by two notches. That means Ukraine's "B2" rating will be moved to the "Caa" category.

In addition, **the specter of a significant increase in instability in the Middle East, primarily in Syria and, what is most importantly, in Iran has been looming even large.** A potential military conflict, even if initially not a large-scale one, will bring about a surge of oil prices and then a significant increase in oil product prices in the Mediterranean that determine the price for natural gas supplied to Naftogaz by Gazprom.

The negotiations between Russia and Ukraine are to resume on January 17. Meanwhile, the Ukrainian authorities announced that Naftogaz was going to buy only 27 bn m3 of natural gas from Russia in 2012. This announcement caused a kind of irritation in Russia as the existing natural gas contract provides for Naftogaz' purchase of 41.6 bn m3 annually with a possibility to agree (with a 6-month notice) on a minimum of 33.3 bn m3.

Although these developments bode ill for the success of the gas negotiations and decrease its probability, **we do not yet change our base case scenario that an agreement will be reached.**



### NBU reserves decrease by just USD0.6bn

The NBU's reserves decreased in December by just USD0.6bn to USD31.8bn. **The drop in the NBU's reserves is surprisingly low** given that

- Ukraine redeemed USD600mn Eurobond in December
- currency revaluation effects were negative in December

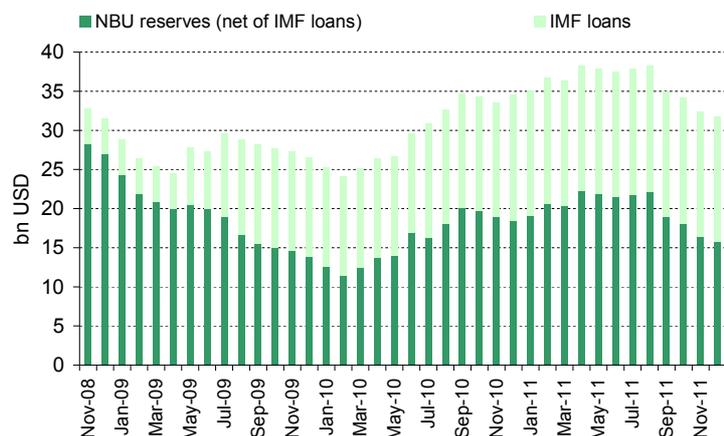
The latest data published by the NBU indicate that December was an unexpectedly calm month for the national currency:

- the NBU sold just USD456mn and bought the equivalent of USD626mn on the interbank market, resulting in positive net FX interventions in December
- net FX purchases by households decreased to USD740mn vs. USD1370mn in November

We attribute positive FX interventions and decrease in purchases of foreign currencies by households to several factors, among them:

- unstable banking liquidity conditions during December
- a conscious decision by the NBU to intervene less, allowing the USD/UAH exchange rate to increase (it was reported that the interbank exchange rate reached as high as 8.06 without the NBU's support)
- "December UAH purchases" effects produced by both businesses and households, coupled with a possible decrease in real income of households

#### NBU reserves



Source: NBU, IMF

### The government is planning an ambitious privatisation program for 2012-2014

Ukraine's Parliament adopted a privatisation program for 2012-2014 that provides for UAH50-70bn in revenues over the three coming years. If accomplished (and chances for that are high), the program will transfer a significant amount (as selling prices are not likely to be especially high in coming years) of state-owned property to private hands. **Although some of the coming**



**privatisations are likely to be not transparent enough, the government's determination to sell state-owned assets should ultimately bring about increase in productivity at the companies to be sold, as there will be a large-scale substitution of asset-stripping by profit maximizing incentives.**

In 2011 the privatisation revenues totalled UAH11.5bn (vs. UAH10bn planned). It is reported that the privatisation revenues in 2012 have already reached UAH2.4bn coming from sale of

- 40% in Kievenoenergo (producer and supplier of heat and electricity in the city of Kiev) for UAH468mn, and
- 45% in Zakhidenergo (electricity generating company with 4.8GWt installed capacity) for UAH1.932bn

The State Property Fund has ambitious plans for 2012. The largest companies slated for privatisations are:

- Odessa By-Port Plant (probably, Ukraine's best asset among nitrogen fertiliser producers)
- Turboatom (producer of electric machinery)
- state-owned electricity generation and distribution companies



### Primary OVDP market

The Ministry of Finance published the updated schedule for primary local bond auctions in January 2012. Investor interest should grow towards the end of the month so as the financing needs of the MinFin. The MinFin has to pay to OVDP holders UAH0.6bn, UAH6.1bn and UAH6.2bn in January, February and March, accordingly.

#### Primary auctions schedule for January 2012

Thursdays (12, 19 and 26 January) and Tuesdays (17, 24 and 31 January)					
12.01.2012	17.01.2012	19.01.2012	24.01.2012	26.01.2012	31.01.2012
12M	3M, 6M, 9M and 12M	12M	3M, 6M and 12M	12M	3M, 6M and 12Mc
2Y and 3Y	2Y	2Y and 3Y	2Y	2Y and 3Y	2Y
-	USD-linked 1.5Y and 3Y				
-	USD bonds 3Y	-	USD bonds 3Y	-	USD bonds 3Y

Source: MinFin. Note: on January 17 the MinFin is also auctioning 3Y UAH OVDPs

The Ministry of Finance arranged three auctions on January 12: for 1Y, 2Y and 3Y “plain vanilla” UAH-denominated OVDPs. It received a total of UAH170mn in bids. The MinFin decided not to accept bids at 14-15% for 1Y OVDPs and 20% for 2Y and 3Y OVDPs.

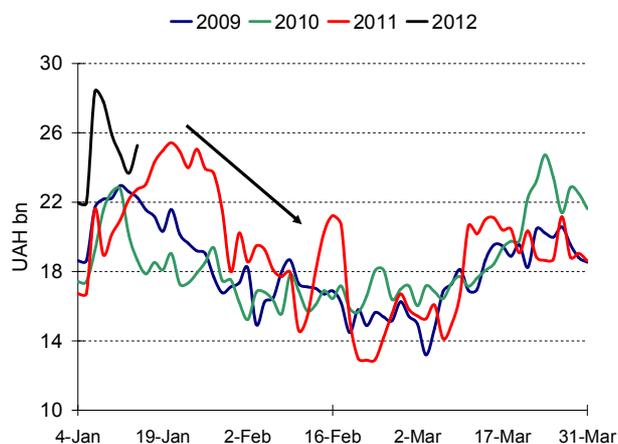
### Secondary OVDP market

Secondary market yields have been declining in the first two weeks of 2012, especially in the shorter end of the curve (see chart on the first page). This is caused by an abundance of liquidity at commercial banks. Market expectations are that a drop in the secondary market yields is temporary, the banking liquidity will start falling in late January after a seasonal spike at the beginning of the year, and the secondary market yields will adjust accordingly

### Money market

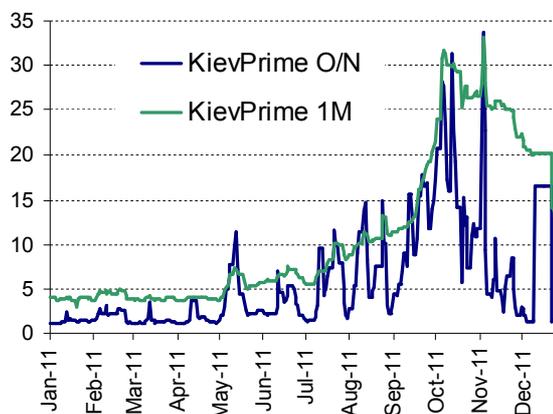
O/N rates have decreased to lower than 1% on the back of increased banking liquidity. 1M rates plunged to 9-13% over the last week. We expect that this decline in money market rates will not be long-lived as banking liquidity normally starts declining in late January and may get low (down to UAH15bn or less) again in February because of a seasonal increase in tax payments.

#### Banking liquidity



Source: NBU

#### Money market



Source: Bloomberg

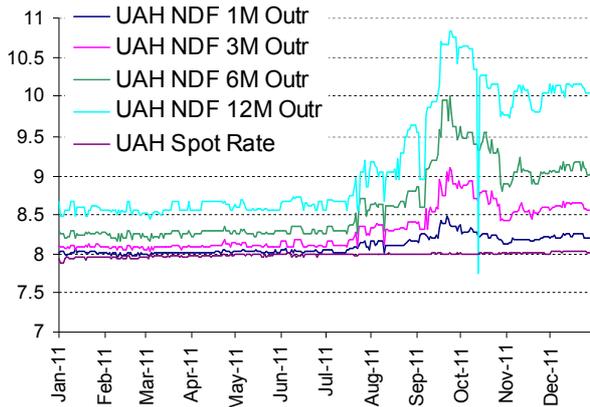


### FX market

The NBU allowed the interbank USD/UAH exchange rate to increase last week: from the weighted average of 8.0342 on January 6 to 8.0403 on January 13. Nevertheless, the NBU reportedly intervened heavily on the market.

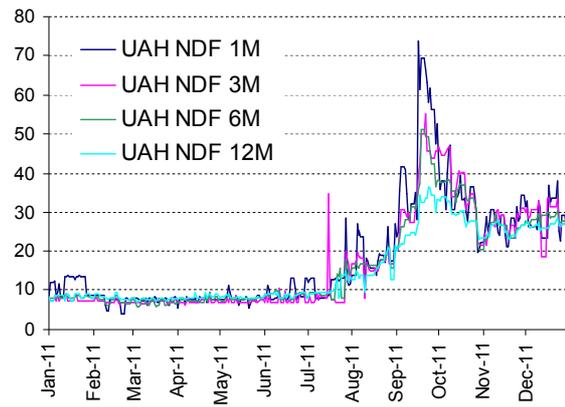
NDFs have been trading sideways: uncertainty over the timing of a devaluation remains.

#### NDF outright rates



Source: Bloomberg

#### NDF implied yields



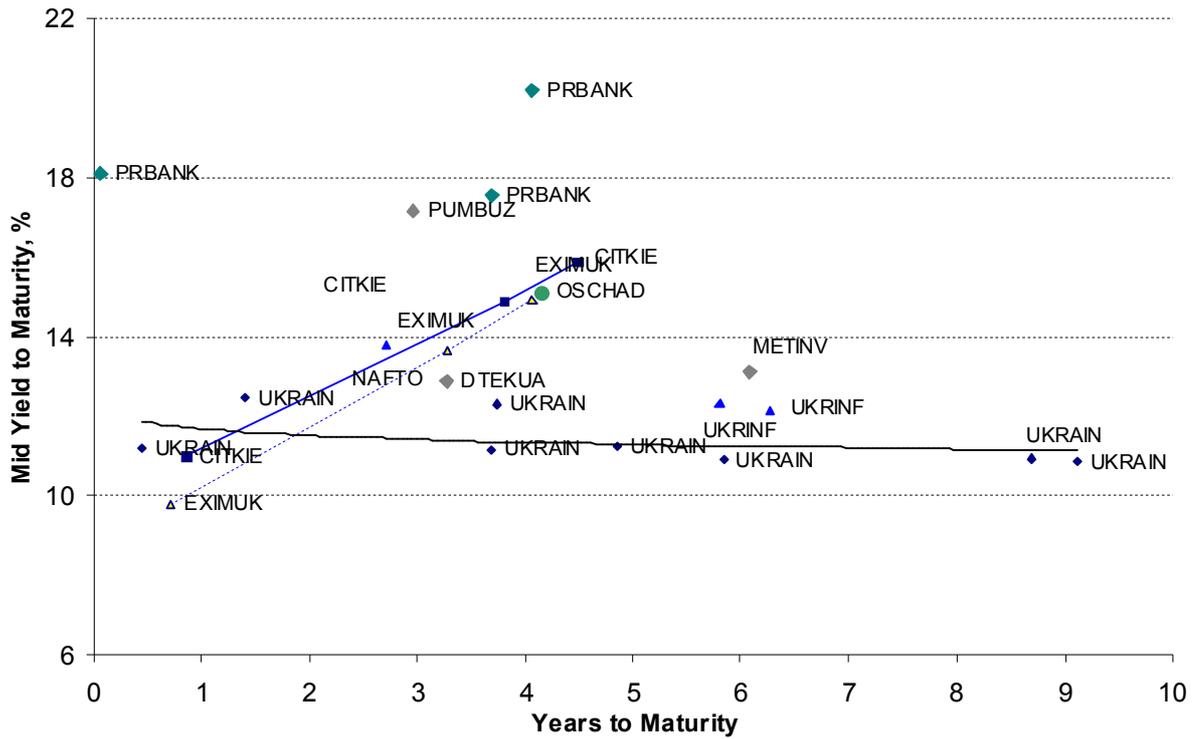
Source: Bloomberg

### Corporate bonds: Borispol International Airport

Borispol International Airport accepted loan conditions offered by Ukgazbank. It will take out a USD50mn loan. According to our estimates, Borispol Airport has sufficient cash and expected cash flows to redeem its UAH500mn bonds and complete the construction of "D" terminal to host Euro-2012 soccer events.

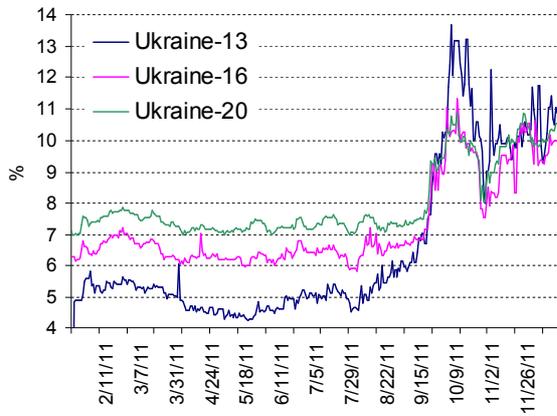


### Map of Ukrainian Eurobonds



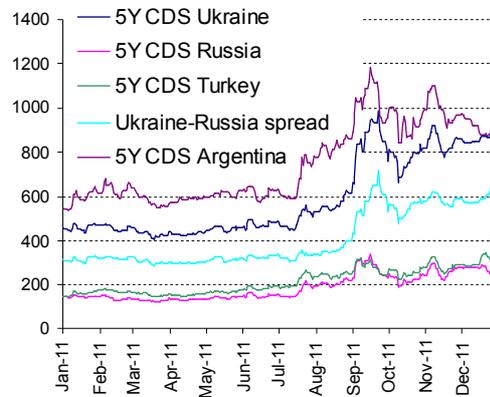
Source: Bloomberg

### Ukrainian sovereign Eurobonds



Source: Bloomberg

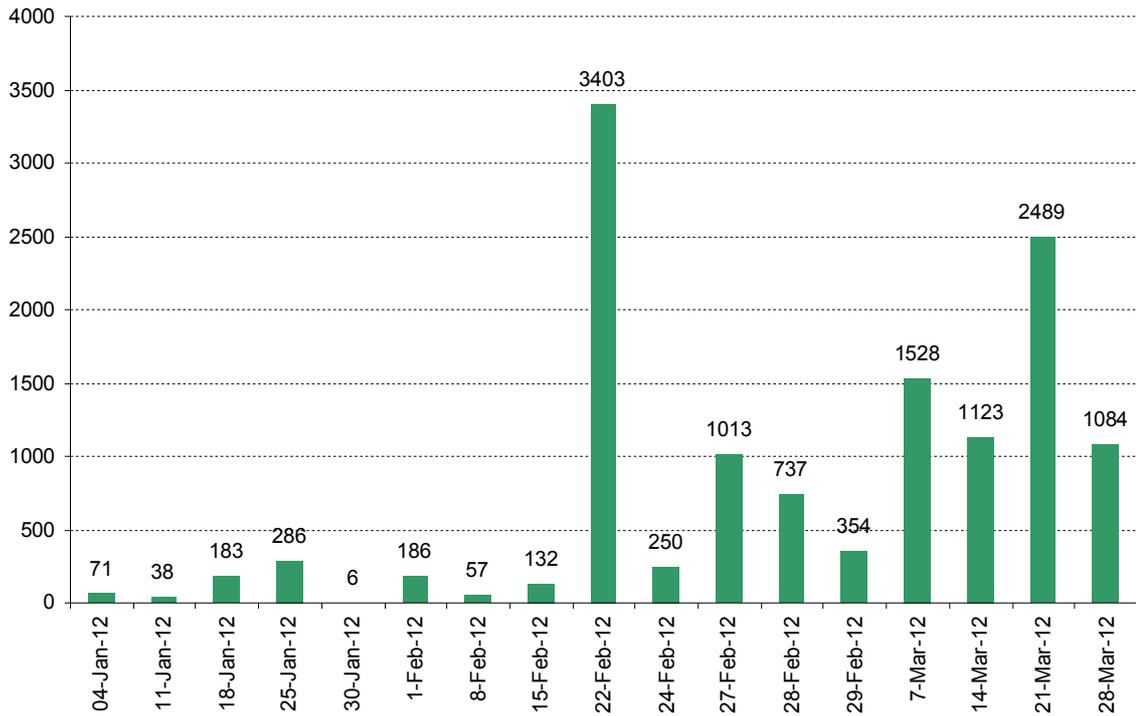
### Credit default swaps



Source: Bloomberg, UkrSibbank's calculations

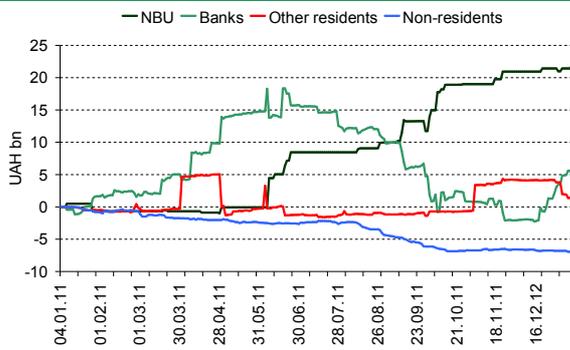


**OVDP redemptions in 1Q 2012 (principal + interest), UAH mn**



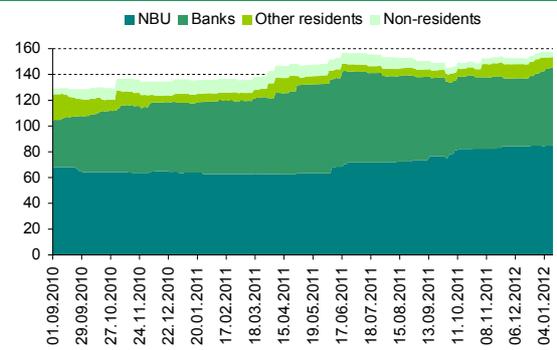
Source: MinFin, UkrSibbank

**OVDPs change in holdings (to Jan-4), UAH bn**



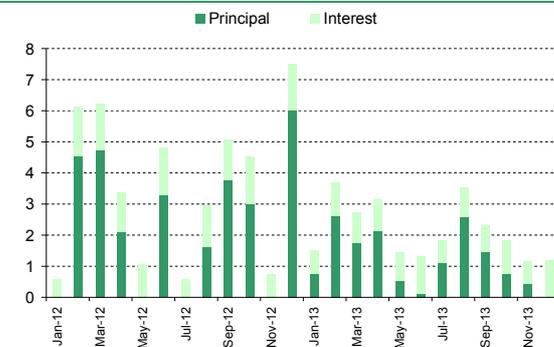
Source: NBU, UkrSibbank's calculations

**OVDP in circulation structure, UAH bn**



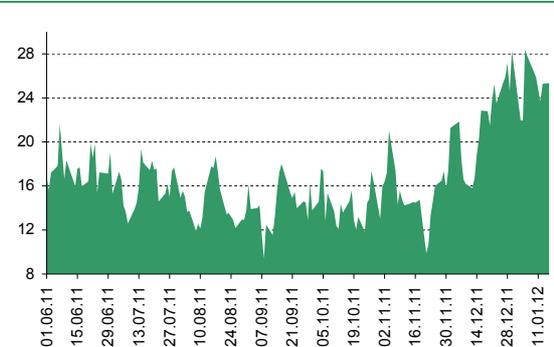
Source: NBUs

**OVDP principal and interest payments, UAH bn**



Source: MoF, UkrSibbank's calculations

**Banking liquidity, UAH bn**



Source: NBU



**Key macroeconomic indicators**

	Base case scenario				
	2009	2010	2011E	2012F	2013F
<b>Business Cycle</b>					
Real GDP growth (%)	-15,1%	4,2%	5,0%	3,8%	4,0%
Nominal GDP (UAH bn)	913	1095	1288	1484	1697
Nominal GDP (\$bn)	117	138	161	183	179
GDP per Capita (at F/X rate; \$)	2538	2998	3519	4017	3944
Real Industrial Output (% y/y)	-21,9%	11,2%	7,7%	3,5%	4,0%
<b>Prices</b>					
GDP Deflator	113,0%	115,0%	112,0%	111,0%	110,0%
CPI	112,3%	109,1%	104,6%	109,9%	115,0%
PPI	114,3%	118,7%	116,4%	111,5%	108,0%
<b>Public Finance</b>					
Revenues	210	241	322	345	372
Expenditures	242	304	341	370	400
Budget balance (% of GDP)	-4%	-6%	-1,5%	-1,7%	-1,6%
Budget deficit (UAH bn, "-" is deficit)	-33	-64,3	-19,0	-24,7	-27,8
Total Public Debt (USD bn)	40	54	61	63	66
Total Public Debt (% of GDP)	34%	39%	38%	34%	37%
Gross External Debt (USD bn), e-o-p	103	117	127	132	140
Gross External Debt (% of GDP)	88%	85%	79%	72%	78%
<b>External Balances</b>					
Exports (USD bn)	40,4	52,2	72,2	73,6	77,2
Imports (USD bn)	44,7	60,6	86,9	87	82,5
Merchandise trade balance	-4,3	-8,4	-14,7	-13,5	-5,3
Services Trade Balance (USD bn)	2,4	4,4	3,9	3,7	3,7
Current Account Balance (USD bn)	-1,7	-2,9	-9,4	-8,2	-0,8
Current Account Balance (% of GDP)	-1,5%	-2,1%	-5,8%	-4,5%	-0,4%
Capital and Financial Accounts Balance (USD bn)	9,9	7,9	4,1	5,1	8,0
Net FDI Inflow (USD bn)	4,7	5,8	5,9	6,0	9,0
Net FDI Inflow per Capita (\$)	101	125	129	132	199
Gross F/X Reserves (USD bn)	26,5	34,6	30,1	21,7	22,4
<b>FX</b>					
UAH:USD (rate; eop)	7,99	7,97	8,02	8,40	9,80
UAH:USD (avg.)	7,79	7,94	7,99	8,10	9,50

Source: UkrSibbank



## Contacts

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Francois Girod  
Director Capital Markets  
(+38044) 537 5013 [francois.girod@ukrsibbank.com](mailto:francois.girod@ukrsibbank.com)

Oksana Shveda  
Head of Investment Banking  
(+38044) 201 2254, [o\\_shveda@ukrsibbank.com](mailto:o_shveda@ukrsibbank.com)

Serhiy Yahnych  
Corporate Finance  
(+38044) 585 0175, [serhii.yahnych@ukrsibbank.com](mailto:serhii.yahnych@ukrsibbank.com)

Alexander Belozorov  
Research  
(+38044) 537 5082, [oleksandr.bielozorov@ukrsibbank.com](mailto:oleksandr.bielozorov@ukrsibbank.com)

Mykola Selexhman, CFA  
Trading and Brokerage  
(+38044) 585 0120, [mykola.selexhman@ukrsibbank.com](mailto:mykola.selexhman@ukrsibbank.com)

Alexey Litvinov  
Trading  
(+38044) 201 2274, [oleksii.litvinov@ukrsibbank.com](mailto:oleksii.litvinov@ukrsibbank.com)

Pavel Mishustin  
IB Services  
(+38044) 585 0132, [p\\_mishustin@ukrsibbank.com](mailto:p_mishustin@ukrsibbank.com)

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