



This week in focus:

UAH appreciation trend likely to persist

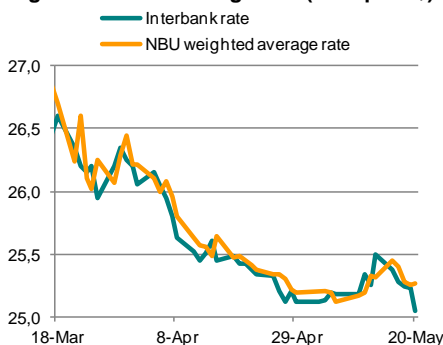
Despite the fact that UAH has potential to appreciate in the short-term, Q3-Q4 estimates remain conservative due to concerns regarding the performance of the Ukrainian current account.

Please see page 4 for more details.

Currency market:

USD/UAH to test 25 level

Figure 1. UAH exchange rate (UAH per 1\$)



Source: Bloomberg

Local currency has been strengthening progressively for the last two months, with a one-week period of depreciation from 6th to 13th of May, when USD/UAH peaked off at 25.45. UAH has been appreciating for the whole last week with the spot USD/UAH rate closing at 25.12 on Tuesday the 24th.

Throughout last week the market has been abundant with USD – sale volumes increased by USD 50mn comparing to the prior week (USD 199mn vs USD 148mn).

NBU intervened in the market 4 times on the 17th, 18th, 19th, 20th, 23rd and 24th of May with a total amount of USD 165.6mn.

Over the next weeks USD/UAH is likely to test the 25.0 level, under mixed signals from global markets.

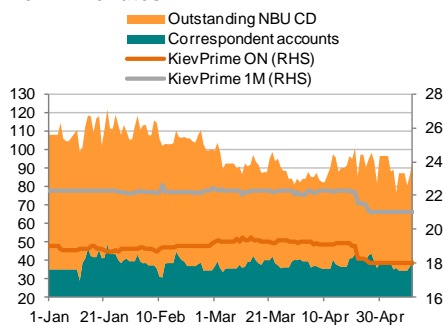
The technical mission of the IMF left Kyiv on May 18th after a Staff Level Agreement (SLA) with the government had been reached. It's expected that the second review under the EFF program will be concluded in July 2017 after the meeting of the IMF Board. A tranche amounting to USD 1.7bn is to be disbursed shortly afterwards.

Ron van Rooden, IMF mission chief for Ukraine, praised Ukraine's progress in restoring macroeconomic stability and stressed the necessity of turning the recovery into growth through comprehensive reforms and prudent policies. ([Reference to the 18th of May press release](#))

Money market:

MPC meeting likely to deliver a modest rate cut

Figure 3. Banking liquidity (UAH bn) vs. KievPrime rates



Source: Bloomberg, NBU, UkrSibbank, MinFin

Banking liquidity fell slightly below UAH 100bn last Friday and landed at UAH 98.3bn this week. This decrease can be attributed to tax payouts, which are due to be reversed in early June. Total liquidity slid down compared to nearly UAH 120bn as of mid-January 2016.

Money market rates have not changed, since the NBU has maintained its policy stance. Cost of ON funds is around 17/19%, while indicative 1 week is 17/19% and indicative 1M is 19/22%, according to our data.

Throughout May 2016 NBU held several auction and purchased USD 77mn in order to increase its international reserves.

The next meeting of the NBU Monetary Policy Committee will be held on May 26th. A moderate rate cut could be on card, since the regulator gained more ground for rate cuts since inflation slowed down to 9.8% in April 2016. More substantial monetary policy moves could be anticipated after the July 2016 tranche from the IMF.

The Ministry of Finance continued to decrease cut-off interest rates for local currency bonds. At the previous auction cut-off rate for 2Y notes was 18.3%.

- UAH bonds were issued at 17.3% yield while USD-denominated bonds were issued at 7.52% yield.
- Total amount of proceeds from the May 24th placement were UAH 9 205 mn. (per NBU FX rate)

Figure 5. OVDP auction results, 24 May 2016

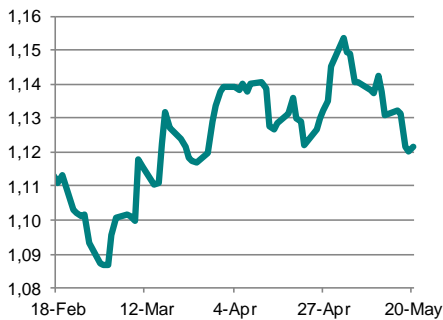
CCY	Maturity	Cut-off rate	WA rate	Max bid rate	Min bid rate	Number of bids	Bids accepted	Bid size	Placement size
UAH	2Y	17.3%	17.3%	17.9%	17.3%	18	5	3 008mn	2 397mn
USD	1.5Y	7.6%	7.52%	7.75%	7.18%	15	16	272mn	271mn

Figure 4. OVDP auction schedule, 2Q 2016

Date	Currency	Maturity
31.05.16	UAH	3M, 6M, 9M, 1Y, 3Y
07.06.16	UAH	3M, 6M, 9M, 1Y, 2Y
14.06.16	UAH	3M, 6M, 9M, 1Y, 3Y
21.06.16	FX	3M, 6M, 9M, 1Y, 2Y

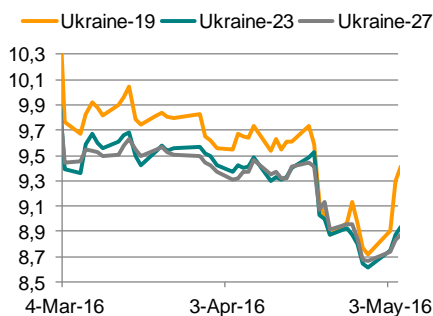


Figure 6. EUR/USD spot (mid)



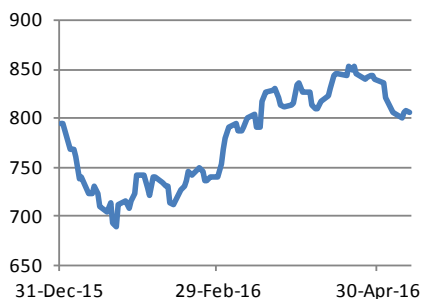
Source: Bloomberg

Figure 7. Ukraine's sovereign Eurobond yields, bid/ask mids (%)



Source: Bloomberg

Figure 8. MCSI Emerging Markets index



Source: Bloomberg

A rally in the Emerging Markets that began in February has slowed down as prices are retreating. The rally was driven largely by an excessive destocking and stronger than expected economic figures from China that spurred commodity prices. Analysts have been asserting that the rally wasn't supported by fundamentals, and that asset prices froth has developed on the market. Predictions have largely turned out to be true and **prices retreated closer to fundamentals.** Steel mills are reducing production, while ports report of overstocking of commodities. The China Securities Regulatory Commission introduced a set of new restrictions and limits in order to rein in speculative activities, commodities futures among others. Nevertheless, **long term assessment remains positive**, with Chinese regulators poised to introduce stimuli in order to keep the economy transition as soft as possible, while aiming for an annual growth target of 6.5%

Crude oil rebounded slightly but couldn't beat the USD 50 mark. Consensus is that the market will correct itself completely till Q4 2016, but oil is not expected to trade above USD 60 per barrel.

FED's dovish sentiment that had made the EM rally possible changed recently. **US economic data is rather decent and the recent FOMC meeting minutes reconfirmed that the FED may be on a track to increase the rate in 2016.** Strong USD will case capital outflow from the Emerging Markets and will weight down the EM currencies. Probability of a hike on June 15, which is priced in by the market, increased to 30% from 4%. Even though the actual hike is completely contingent upon the economic data that is yet to come, and some indicators are signaling of a possible slowdown (such as consumption growth, income growth and corporate profits), **USD will now be more aligned with current economic readings**, some of which due to be released next week, whereas FED Chairwoman J. Yellen will give a speech on Friday the 27th of May.

As for Europe, **Hungary was upgraded to investment category by Fitch on the 20th of May.** Now the country is rated Ba1 Pos/BB+/BBB-. However a notch-up from another international rating agency is required to fully move to the investment grade benchmark. An interest rate cut is expected to be announced shortly as the CB sees an appropriate opportunity.

The Eurozone growth remains sluggish demonstrating a meager 0.5% growth in Q1 2016 which is expected to decrease slightly to 0.4% in Q2. So far the ECB stimulus package has not been able to boost output and inflation as it had been intended to.

On Monday the 23rd **Russia issued USD 1.7bn of its first Eurobonds since the imposing of international sanctions.** The deal attracted USD 6.3 bn bids and was completely managed by the state-owned bank VTB Capital. Yield premium over US 10-year treasuries is 248 b.p. which is only 28 b.p. richer than the premium on the previous Eurobond issue in 2013, meaning that risk wise Russia has almost return to pre-sanctions levels.



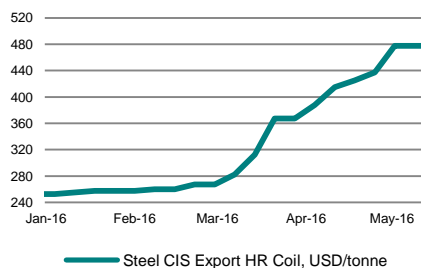
This week in focus:

UAH appreciation trend is likely to continue over next months

Figure 9. Prices of Iron Ore in 2016, USD/tonne



Figure 10. Steel CIS export HR Coil in 2016, USD/tonne



Source: Bloomberg,

Figure 11. Current account, , monthly volumes

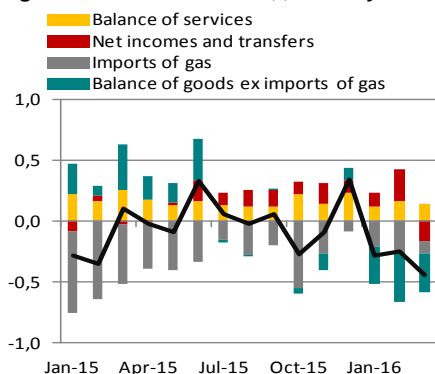
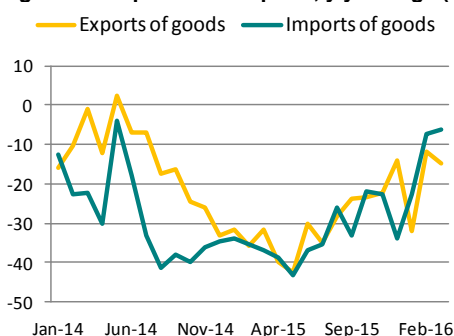


Figure 12. Exports and imports, y/y change (%)



Source: NBU

Month-on-month improvements in the **current account** in Q1 2016 coincided with a commodities rally in the Emerging markets. The rally was kicked off by an excessive **destocking after the Chinese New Year** in February. The rally has largely lost its steam with **prices of commodities correcting** to levels that are justified by fundamentals.

As for the iron ore, prices have slipped to USD 51 per metric ton as of May 23rd, down from average USD 56 and USD 60 in March and April respectively. The **median price forecast is USD 45** per dry tonne of ore, which is a **20% decline** from March 2016 levels. Chinese ports report of an overstocking of more than 100mn tons, while Australia and Brazil – world's second and third largest iron ore producers – are planning to produce more in 2016 than they did in 2015. This may cause a global glut, the same way it happened to crude oil in 2015.

Additionally, **Emerging Markets are being undermined by appreciating USD** due to a possible FED rate hike. Markets price in a more than 30% possibility of the June hike (up from 4% in the beginning of May), whereas chances of rate increases later during the year in Q3 and Q4 are deemed to be 65% and 75% respectively. FED officials' claims notwithstanding, one should be careful in assessing the probability of a hike, since some US economy readings signal of a possible slowdown, such as slipping corporate profits, slowing real income and payroll growth and a decline in US consumption growth. Poor values of economic indicators might **defer the FED from increasing the rate in 2016 whatsoever**.

With global commodities demand in decline, **there are fewer opportunities for the Ukrainian current account to materially improve**, however, since the Chinese government is poised to implement more stimuli to assure smooth transition processes in the economy and to prevent market shortfalls akin to the meltdown of the Summer 2015, commodity prices are somewhat cushioned from downside risk.

If export-import dynamics will deteriorate in line with commodity prices, **total deficit of the current account for 2016** is projected to reach USD 2bn in our baseline scenario. Another important point is that next **coupon payments on international government bonds**, which sapped the current account in March, **are due only in September**, giving some time for improvement.

The ailing performance of the current account is expected to be mitigated by **inflows into the capital account**, which are anticipated in 2016. **The second review under the EFF program is anticipated to be concluded in July** after the IMF Board meeting. The tranche will amount to USD 1.7 bn. Aside from future tranches from the IMF, there is **anticipated USD 3.1 bn. of inflows into the economy**, including USD 0.4bn tranche from the World Bank, USD 0.7bn of loans from the EU and approximately USD 2.0bn in loans from development organizations such as European Investment bank and EBRD. Additionally, it is expected that Ukraine, backed by US loan guarantees, will **tap into international capital markets** in order to raise up to USD 1bn at some point in 2016. These injections should cause sizable **appreciation pressure on UAH** due to an increase of FX supply in interbank market.

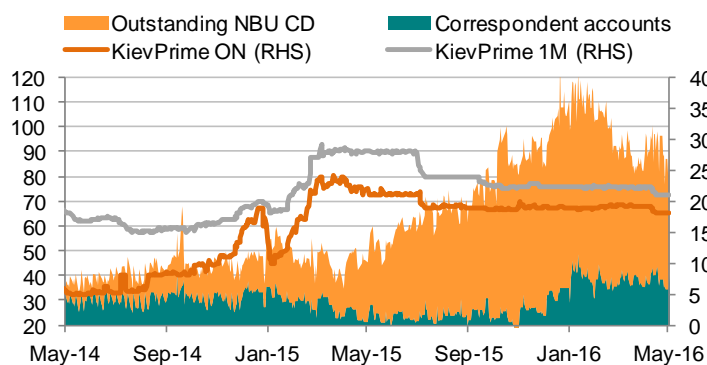
Furthermore, policy choices of the NBU will affect the rate substantially. Provided the downside outlook for commodities and not yet approved IMF disbursements, the regulator is likely to continue efforts to increase FX reserves in May-June, allowing for only marginal appreciation (approximately to 24.5 level or so). Moreover, NBU is waiting for an opportunity **to relax capital controls** to allow influx of capital into the country and to **decrease the key interest rate**, in order to put it in line with the rate of inflation, which was 9.8% y/y in April 2016. Opportunity to decrease the key rate should arise after the acquisition of funds from the IMF in July.

In our view, **UAH has a potential to appreciate** to 24.5 and possibly more in July, following the tranche from the IMF. However, we are still **conservative on USD/UAH rate evolution in Q3-Q4 2016** since the appreciation pressure is likely to be formed by financial inflows rather than fundamental improvements in the country's current account.

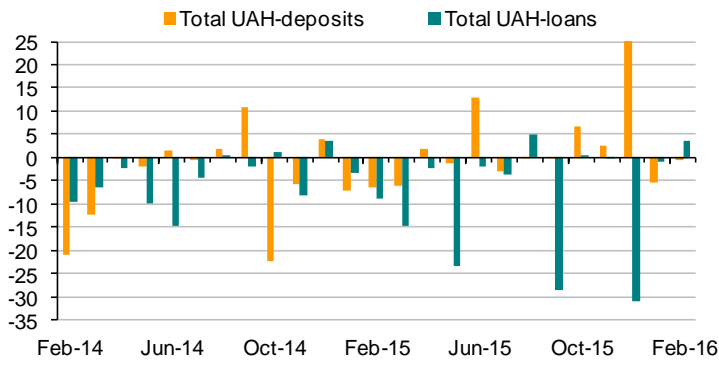


Money market

Banking liquidity vs. money market rates, %

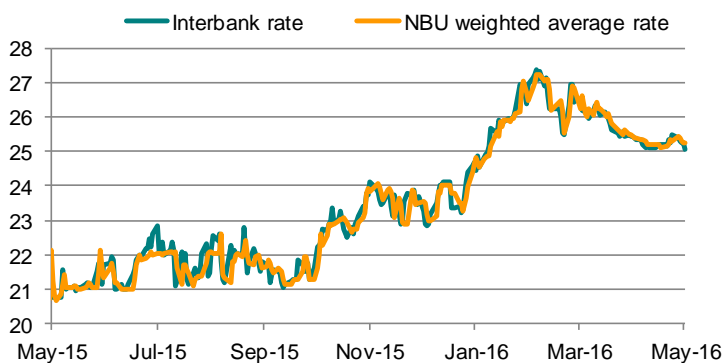


Change in local currency loans and deposits, UAHbn

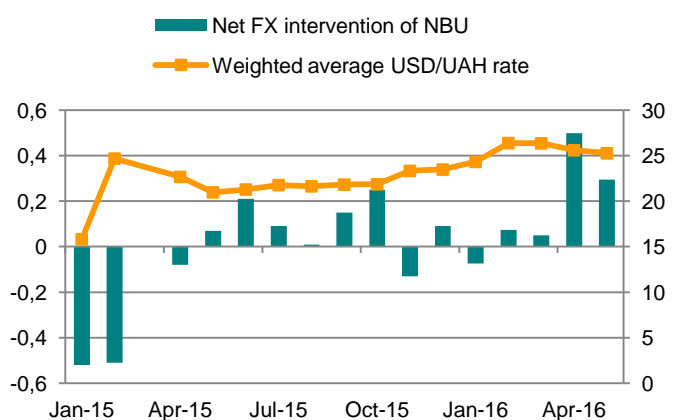


Currency market

UAH exchange rate, UAH/\$1

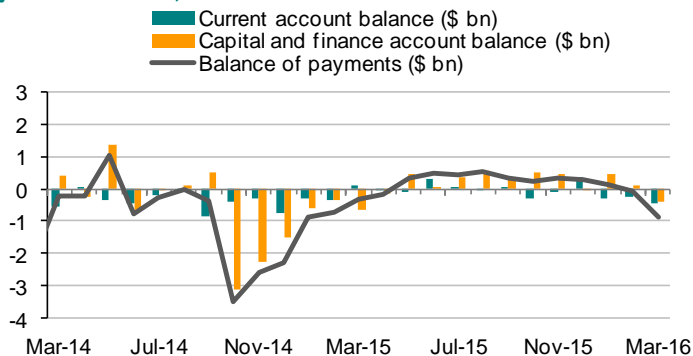


Net retail FX interventions of the NBU in 2015-2016, USDbn

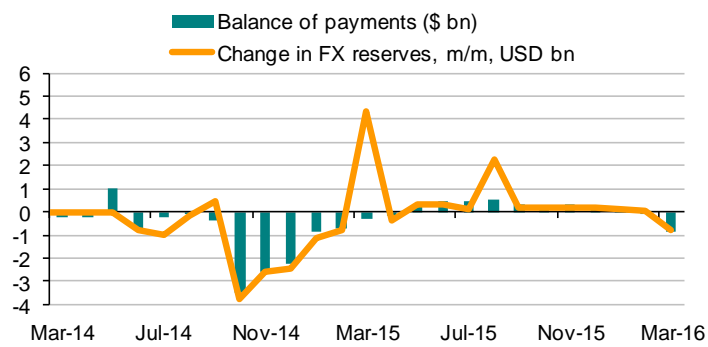


Balance of payments

Major BoP accounts, USDbn

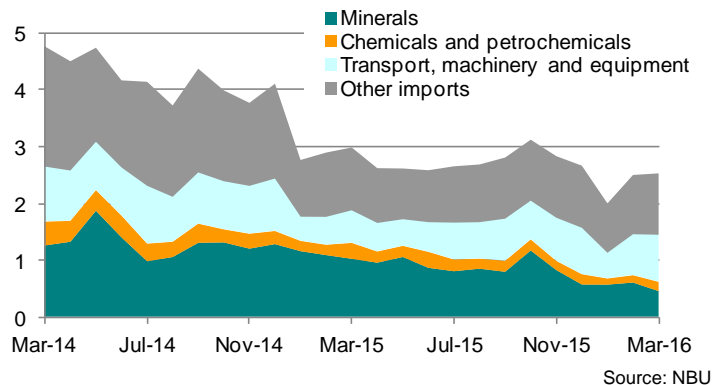
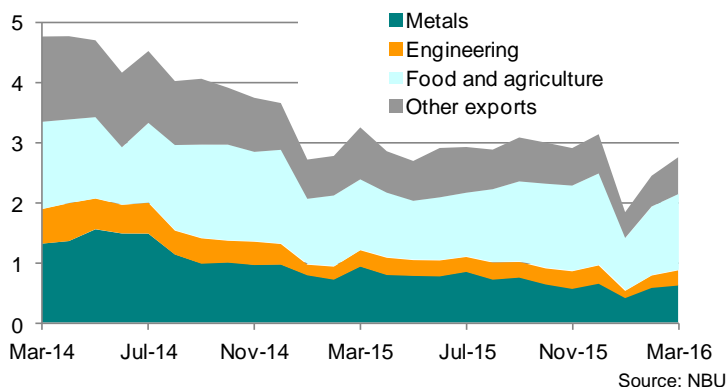


BoP vs change in foreign reserves, USDbn



Exports components dynamic, USDbn

Imports components dynamic, USDbn



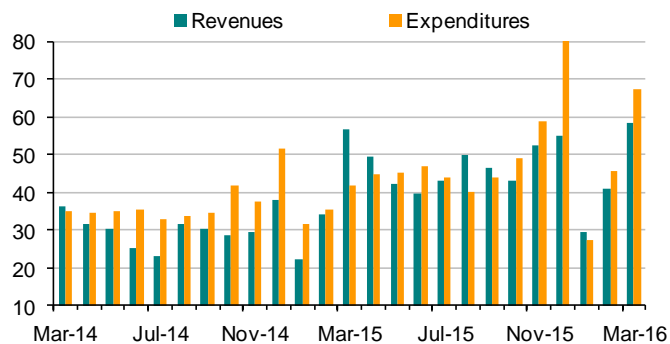
Budget performance

Budget performance, UAHbn

	Jan-Mar 2015	Jan-Mar 2016
Budget revenues	113.21	129.15
VAT proceeds	29.89	39.70
Corporate income tax	14.9	14.52
Budget expenditures	113.19	140.2
Deficit / Surplus	+4.43	-11.0

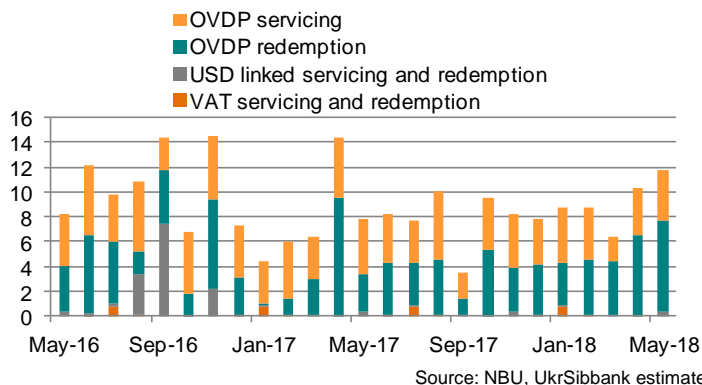
Source: NBU

General budget revenue and expenditures, UAHbn

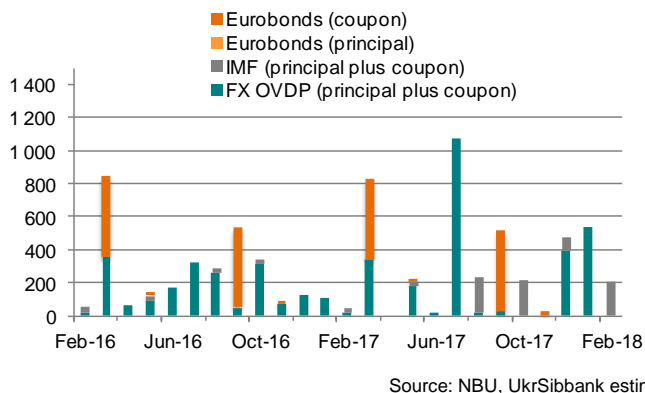


Sovereign debt

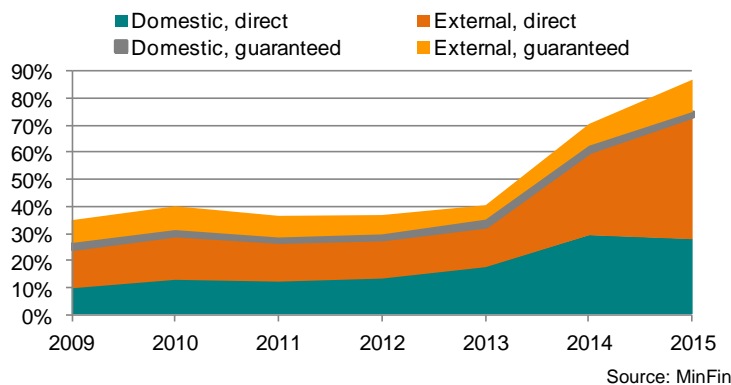
UAH-denominated debts' repayments schedule, UAHbn



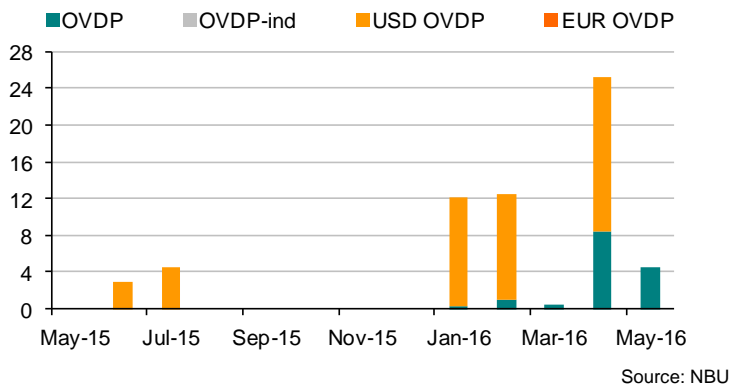
FX-denominated debts' repayments schedule, USDmn



Total government debt, % GDP

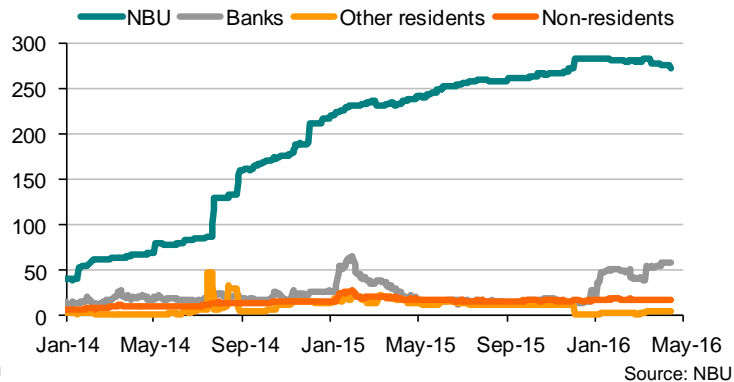
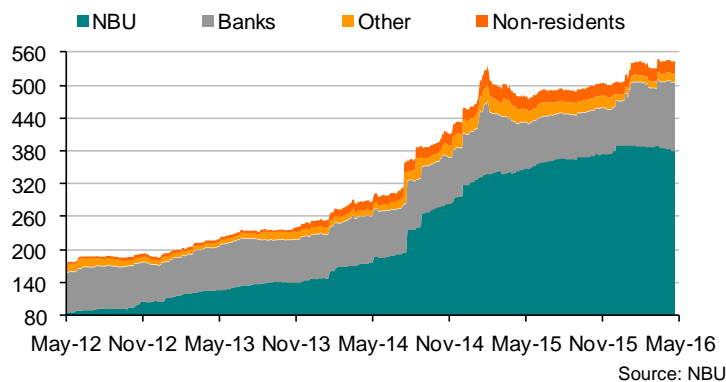


Local borrowings, UAHbn



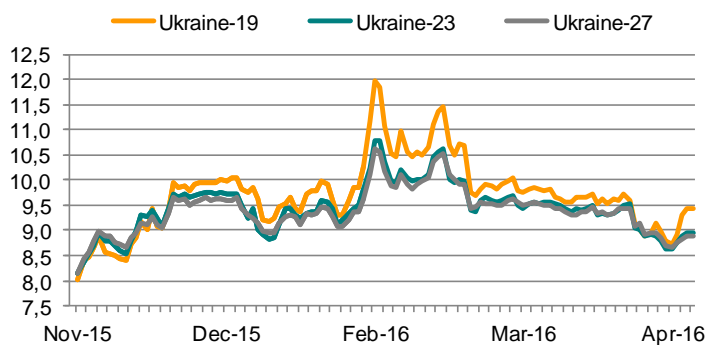
Outstanding OVDP owners structure, UAHbn

Outstanding OVDP changes in holding since start 2013, UAHbn

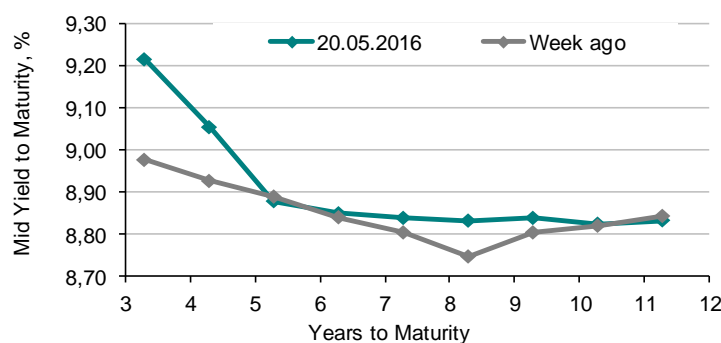


Eurobond market

Ukraine's sovereign Eurobond yields, %

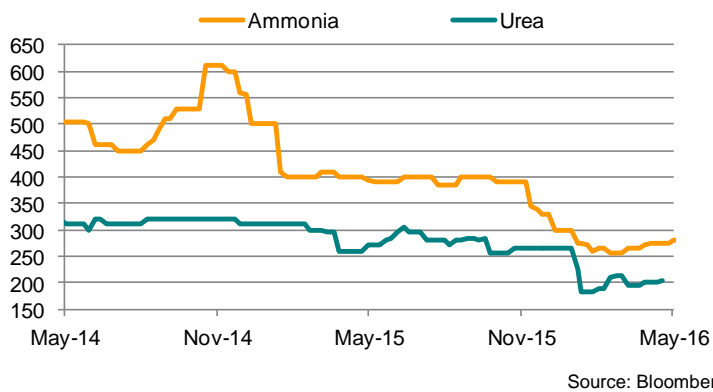


Ukraine's sovereign Eurobond yield curve, %



Commodity markets

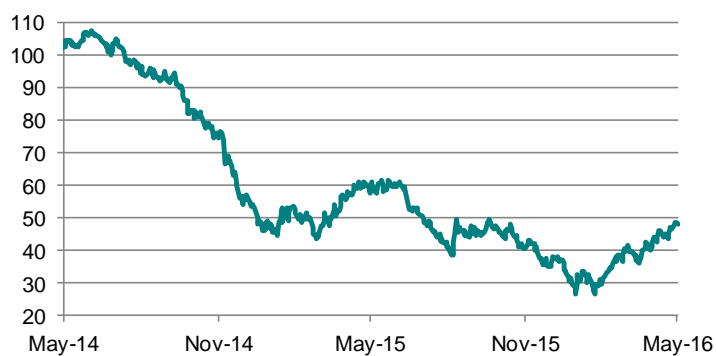
Fertilizers (Black Sea), USD per ton



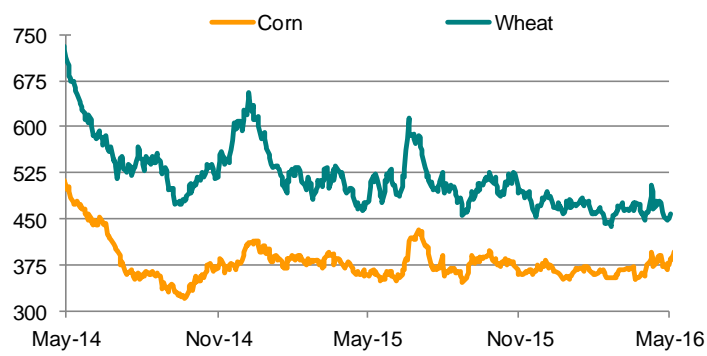
Steel CIS export HR coil (Black Sea/Baltic Sea), USD per ton



WTI oil (nearest active future at NYMEX), USD per barrel



Corn and wheat (nearest active future at CBT), USD per bushel





Key Macroeconomic Indicators									
Ratings (M/S&P/F) Ca/B-/RD	2008	2009	2010	2011	2012	2013	2014	2015	2016F
Real sector									
Real GDP (%YoY)	2.3	-14.8	4.1	5.2	0.3	0.0	-6.8	-10.0	1.2
Industrial production (%YoY)	-5.2	-21.9	11.2	8.0	-0.7	-4.3	-10.7	-6.0	1.0
Retail sales (%YoY)	17.3	-20.9	10.1	13.2	12.3	6.1	-11.0	-25.0	0.4
Unemployment rate end of year (ILO, working age)	6.9	9.6	8.8	8.6	8.1	7.7	9.7	11.5	10.3
Nominal GDP (UAHbn)	948.1	913.3	1082.6	1302.1	1411.2	1454.9	1566.7	2031.3	2394.1
Nominal GDP (\$bn)	178.9	112.8	135.3	162.8	174.2	177.4	131.3	88.7	86.0
Prices									
CPI (average %YoY)	25.2	15.9	9.4	8.0	0.6	-0.2	12.1	48.7	18.0
CPI (end of year %YoY)	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	43.3	14.0
Real average wage growth (%YoY)	6.3	-9.2	10.2	8.7	14.4	8.2	-6.5	-35.0	5.0
Fiscal balance (% of GDP)									
State budget deficit (without Naftogaz)	1.3	3.9	5.9	1.8	3.8	4.4	5.0	3.0	2.5
Total public debt	20.0	34.8	39.9	36.3	36.5	40.2	70.3	91.4	96.4
External balance									
Exports of goods (\$bn)	67.7	40.4	52.2	69.4	70.2	65.0	50.5	35.4	33.2
Imports of goods (\$bn)	-83.8	-44.7	-60.6	-85.7	-89.7	-84.6	-56.7	-38.7	-38.1
Current account balance (\$bn)	-12.8	-1.7	-3.0	-10.2	-14.3	-16.4	-5.2	-0.2	-2.1
Current account balance (% of GDP)	-7.1	-1.5	-2.2	-6.3	-8.2	-9.2	-4.0	-0.2	-2.5
Net FDI (US\$bn)	9.9	4.7	5.8	7.0	7.2	4.1	0.3	2.3	3.9
Foreign exchange reserves	31.5	26.5	34.6	31.8	24.5	20.4	7.5	13.3	16.4
Imports coverage (months of imports of goods)	4.5	7.1	6.8	4.5	3.3	2.9	1.5	4.4	5.3
Interest and exchange rates									
NBU discount rate (% end of year)	12.00	10.25	7.75	7.75	7.50	6.50	14.0	22.0	14.0 *
Exchange rate (UAH/\$) end of year	8.1	8.0	7.9	8.0	8.1	8.2	15.8	24.0	27.0 *
Exchange rate (UAH/EUR) end of year	10.9	11.5	10.5	10.4	10.6	11.3	23.0	26.2	30.7 *

Source: UkrStat, NBU, MinFin, UkrSibbank

* Broad estimate

Economic calendar 2016												
Source:	UkrStat								NBU			State Treasury
	GDP growth	Fixed capital investments	Industrial production	Retail trade	Construction works	Agricultural output	Inflation rate	Jobless rate	Balance of payments	NBU reserves	Monetary / FX statistics	Balance of Treasury account
Date of release (actual / indicative)	act	act	act	act	act	act	act	act	ind	ind	ind	act
May												
May 2												V
May 6							V					
May 9										V		
May 10										V		
May 11										V	V	
May 12											V	
May 13						V					V	
May 16	V											
May 17								V				
May 19				V								
May 26			V		V							
May 27												
May 30		V							V			
May 31									V			
June												
June 3										V		
June 4										V		
June 5							V			V		
June 10											V	
June 11											V	
June 12											V	
June 16				V		V						
June 17					V							
June 18			V									
June 19	V											
June 23								V				
June 29									V			
June 30									V			V



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