

Economic Insight

Hryvnia prospects appear distressed

FX rate. Yesterday, the NBU committed to liberating the hryvnia to trade on the FX market in accordance with true market principles, i.e. free floating. While the currency closed at 22.645/USD (according to Bloomberg), it hit as low as 25/USD in intraday trading, which appeared to attract FX supply. According to our calculations, hryvnia at 25/USD is negatively misaligned or 35% below today's fundamental value. This is in line with the peak seen in the last sizable devaluation that occurred in late 2008 and early 2009.

Inflation. A pass-through effect of FX rate devaluation into domestic inflation appears much stronger this time than it was in the 2008-09 economic crisis. Hence, with the above-mentioned measure of the FX rate liberalisation, inflation is likely to increase further during 1H15. The NBU's forecast of CPI at 17.2% YoY at the end of 2015 could be in doubt. Our preliminary assessment is that CPI may end up this year at 20-22% YoY, staying well in double-digit territory in 2016-17.

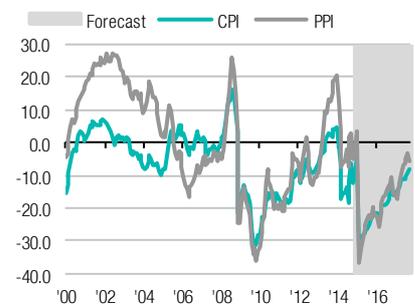
Key policy rate. Also, the NBU yesterday raised its key policy rate by 5.5ppts from 14% to 19.5%, aiming to carry out a more restrictive policy and to curb inflation to single digits in 2016. In our view, this is optimistic. Given the above-mentioned remark on inflation, it is still likely that another 5.5ppt rate increase could be required.

Growth. The NBU forecasts a real GDP decline in 2015 in the range of 4-5%, and provided no guidance on growth beyond this year. We tend to see a recession beyond the current year, because of Russian aggression (in a slowly flaming conflict rather than a frozen one), ongoing banking and sovereign debt crises, and fast-paced external deleveraging of banks and corporations. In this regard, external leveraging by authorities is likely to be a weak compensation to the balance cross-border financial flows over 2015.

Going forward. The FX market is unlikely to see a boost from expected FX financial inflows (IMF and some donors) which otherwise could encourage positive momentum to the distressed UAH. At this moment, macroeconomic conditions say the UAH will continue to be in distress in 2015-17. In a base-case scenario, negative misalignment in real trade-weighted terms will be 30-35% in 2015 and gradually narrow to 10% in 2017. In a worst-case scenario, negative misalignment will remain at 20-35% throughout 2015-17. See the charts on the side bar.

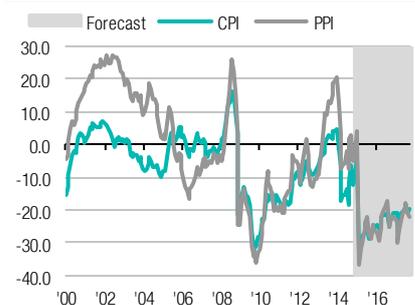
FRIDAY, 6 FEBRUARY 2015

Hryvnia misalignment (Base-case) '15-17
Measured through CPI- and PPI-based real trade-weighted indices



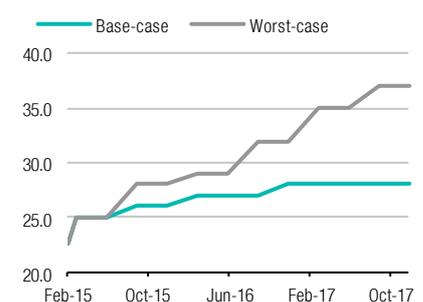
Source: ICU.

Hryvnia misalignment (Worst-case) '15-17
Measured through CPI- and PPI-based real trade-weighted indices



Source: ICU.

Preliminary FX rate projections 2015-17
as envisaged by above-mentioned scenarios



Source: ICU.

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Buy: Forecasted 12-month total return greater than 20%

Hold: Forecasted 12-month total return 0% to 20%

Sell: Forecasted 12-month total return less than 0%

Note: total return is share price appreciation to a target price in relative terms plus forecasted dividend yield.

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