

Economic Insight

Economic activity: Recession lengthens, deepens

Because the Minsk 2 ceasefire agreement appears to have failed (or was just tactical manoeuvring by both sides), we expect prolonged Kremlin aggression towards Ukraine in the economic, information and military spheres. Also, as the restructuring of Ukraine's economy by government authorities depends on these factors, we prudently expect the economic recession to lengthen and deepen. A standoff between Ukraine's army and pro-Kremlin militants is included in our base-case scenario. The recent disappointing statistical data on key sector economic growth in January 2015 reinforces our pessimism. As industrial production and cargo transportation have hit historical lows, resulting in a 6.7% contraction in real GDP in 2014, we project more a severe decrease of 7.6% in 2015, then flat growth in 2016. Only in 2017 do we expect a recovery of near 3% YoY.

Key sectors of the economy

Given the most recent data from the state statistics office on the key sectors of the Ukraine economy (through January 2015), it is becoming evident that the economic contraction will deepen and a recovery will be postponed to 2017 rather than 2016 as we previously thought.

Industrial production fell 10.7% YoY in January 2015 and should contract another 8% YoY based on pro-Kremlin militants' occupation of Donbas and their refusal to uphold the ceasefire agreement. Because of this, economic activity in the Donbas region, where steel-making and coal mining has been the economic backbone of the entire Donbas region and a sizable part of Ukraine's economy, is unlikely to recover soon. Over the next two years, our base-case scenario envisages stabilisation of the sector with flat growth, followed by a 5% YoY recovery in 2017 (Chart 3, p.2).

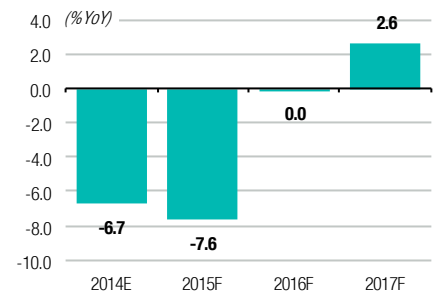
Agriculture, which has become a real backbone of the economy over the past few years thanks to substantial increase in production and a record high harvest in 2013-14, is projected to decline 2% YoY this year as it would difficult to sustain those volumes of production seen over the past two years. The chance of achieving another record-breaking harvest in 2015 is low. Moreover, the ongoing banking sector crisis and strained lending market are likely to leave agricultural firms underfinanced this spring during the sowing season. After this year's decline in production, the sector is forecast to post 5% growth each year in 2016-17 (Chart 1, p.2).

Retail trade, which recorded a 9.6% YoY decline over the past year, is forecast to recover gradually in the 2016-17 by posting a price-adjusted increase of 5% and 8%, respectively, while in the current year a 5% contraction is envisaged (Chart 2, p.2).

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Real GDP forecast 2015-17

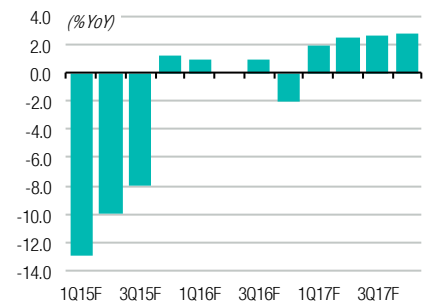
Percentage change on previous year



Source: ICU.

Quarterly real GDP forecast 2015-17

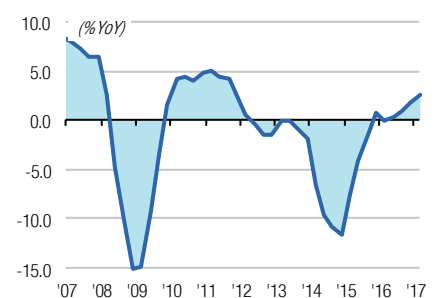
Percentage change on previous year



Source: ICU.

Real GDP (%YoY, 12 month running rate)

Percentage change on previous year



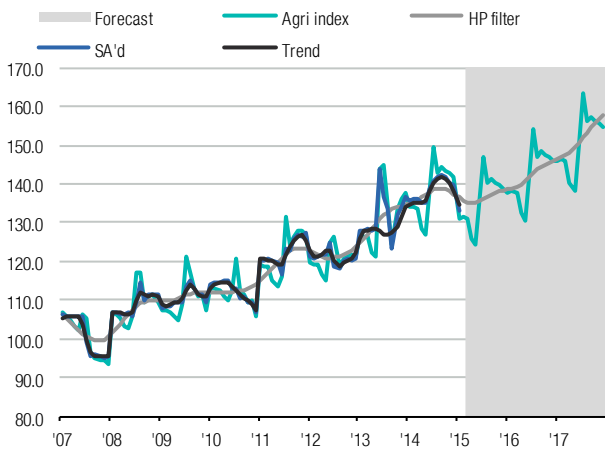
Source: ICU.

The construction sector is projected to suffer from the ongoing banking sector crisis and lacklustre financing via bank credit market and other investor sources such as wealthy and middle class individuals who would otherwise invest in real estate but now suffer from their own debt load as well as the recession at home and abroad. However, we expect a steady recovery of growth in this sector because of the low base effect established before 2014: for the current year, a real growth of 3% is forecast ,while for 2016-17 we anticipate 5% annual growth (Chart 4, p.2).

The transportation sector is set to recover after a deep contraction of 2H14 caused by the war. While the current level is likely to be at the bottom now, we foresee a recovery in 2016-17 when cargo and passenger turnover is forecast to increase by 8% and 10%, and 7% and 10%, each year, respectively. This year, transportation is expected to contract further because of the ongoing pro-Kremlin military aggression that prevents an economic recovery (Chart 5 and Chart 6, p.3)

Chart 1. Agriculture production index

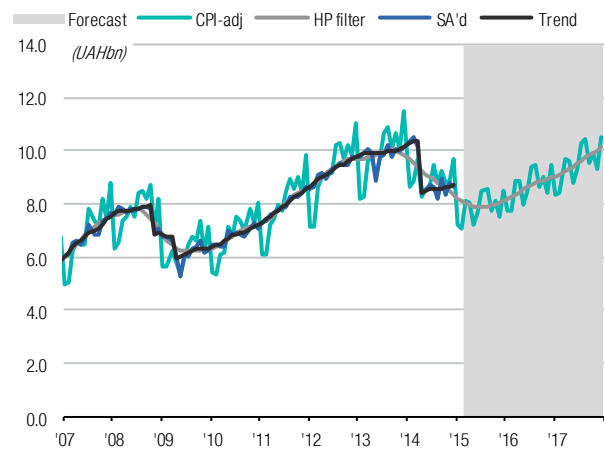
History (from January 2002 through January 2015) and forecast for 2015-17



Note: monthly data is seasonally adjusted.
Source: State Statistics Office of Ukraine, ICU.

Chart 2. Retail trade (UAHbn, at constant prices of Dec-1999)

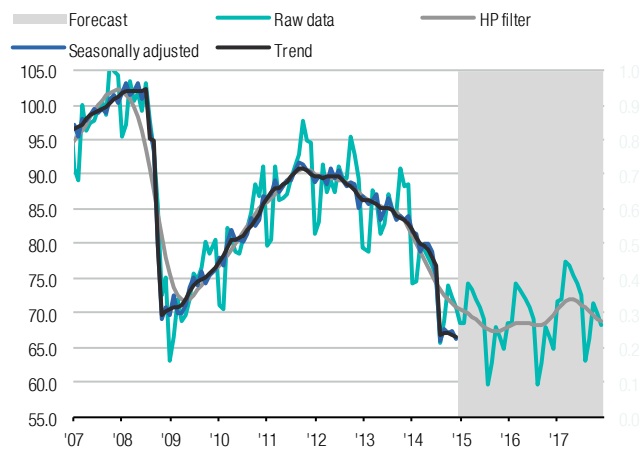
History (from January 2002 through January 2015) and forecast for 2015-17



Note: monthly data is seasonally adjusted.
Source: State Statistics Office of Ukraine, ICU.

Chart 3. Industrial production index

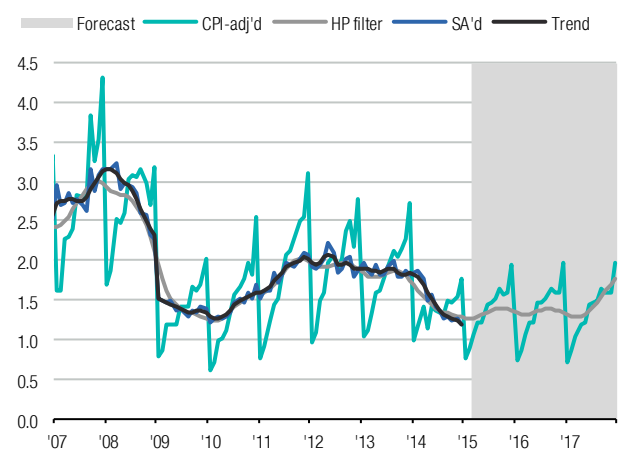
History (from January 2002 through December 2014) and forecast for 2015-17



Note: monthly data is seasonally adjusted.
Source: State Statistics Office of Ukraine, ICU.

Chart 4. Construction (UAHbn, at constant prices of Dec-2001)

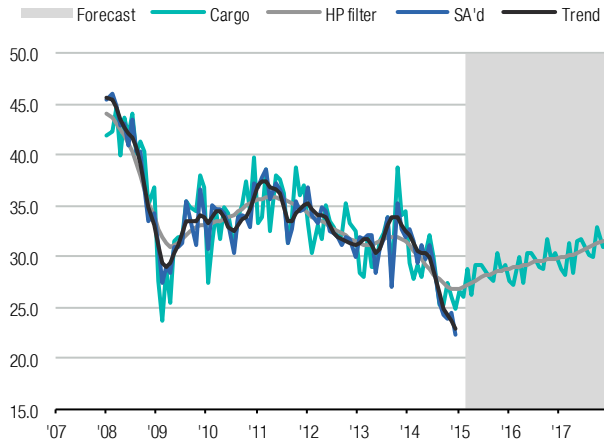
History (from January 2002 through December 2014) and forecast for 2015-17



Note: monthly data is seasonally adjusted.
Source: State Statistics Office of Ukraine, ICU.

Chart 5. Cargo transportation turnover (m tonne * km)

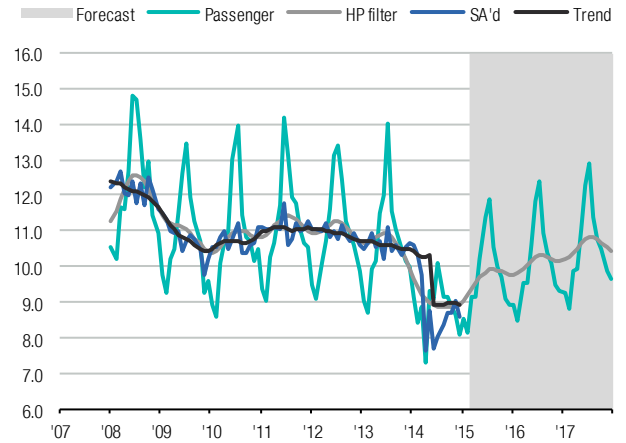
History (from January 2002 through December 2014) and forecast for 2015-17



Note: monthly data is seasonally adjusted.
Source: State Statistics Office of Ukraine, ICU.

Chart 6. Passenger transportation turnover (m * km)

History (from January 2002 through December 2014) and forecast for 2015-17



Note: monthly data is seasonally adjusted.
Source: State Statistics Office of Ukraine, 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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Buy: Forecasted 12-month total return significantly greater than that of relevant benchmark

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Sell: Forecasted 12-month total return significantly less than that of relevant benchmark



11th floor, LEONARDO Business Centre
19-21 Bogdan Khmelnytsky Street
Kiev, 01030 Ukraine
Phone/Fax +38 044 2200120

CORPORATE FINANCE TEL. +38 044 2200120

Makar Paseniuk, Managing Director
makar.paseniuk@icu.ua

Ruslan Kilmukhametov, Director
ruslan.kilmukhametov@icu.ua

SALES AND TRADING TEL. +38 044 2201621

Konstantin Stetsenko, Managing Director
konstantin.stetsenko@icu.ua

Sergiy Byelyayev, Fixed-Income Trading
sergiy.byelyayev@icu.ua

Vitaliy Sivach, Fixed-Income & FX Trading
vitaliy.sivach@icu.ua

Vlad Sinani, Director,
Strategy and Corporate Development
vlad.sinani@icu.ua

Julia Pecheritsa,
Ukraine and CIS International Sales
julia.pecheritsa@icu.ua

Yevgeniya Gryshchenko,
Fixed-Income Sales
yevgeniya.gryshchenko@icu.ua

RESEARCH DEPARTMENT TEL. +38 044 2200120

Alexander Valchyshen
Head of Research
alexander.valchyshen@icu.ua

Alexander Martynenko
Head of corporate research
alexander.martynenko@icu.ua

Bogdan Vorotilin
Financial analyst (Food & Agribusiness)
bogdan.vorotilin@icu.ua

Taras Kotovych
Senior financial analyst (Sovereign debt)
taras.kotovych@icu.ua

Mykhaylo Demkiv
Financial analyst (Banks)
mykhaylo.demkiv@icu.ua

Lee Daniels, Rolfe Haas
Editors

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