What President-elect Trump's victory means for Ukraine's economy

Below, we offer our interpenetration of the rhetoric of US President-elect Donald Trump and his economic advisors[1] during the campaign (based on various media resources) and from his victory speech yesterday (based upon the transcript provided by *New York Times*[2]).

International trade

By many accounts, Trump's focus on criticizing existing trade deals is likely to hurt international trade. He wants to renegotiate [3] NAFTA (North American Free Trade Agreement) for the sake of 'better deals' that 'bring back jobs' as deemed necessary by Trump advisors[5] and supporters[6]. The spectacular decline of Mexico's currency, which kept step with Trump's progress toward the White House, indicates that financial markets singled out this economy as the main victim of the new administration's stance on international trade relations. Aside from Mexico, other likely targets for renegotiated deals are the large economies with which the US has sizable trade deficits. China and even Canada (a part of NAFTA) have been mentioned.

In our opinion, rhetoric like this will cast deflationary expectations on already-depressed global demand (see Chart 2-Chart 5 on p.5). Of course, a trade policy like this is nothing new for the global economy, which is still in a drawn-out recovery from Global Financial Crisis. In the recent past, many economies were quite devastated by a series of crises that effectively lowered aggregate demand and, hence, their imports. Examples include the Eurozone debt crisis-hit economies (from Greece to Italy) and once-proud BRICS members like Brazil and Russia, which went through humiliation of local currency devaluations and subsequent commitment to imposing fiscal austerity in the coming years (via freezing state budget expenditures for, respectively, a 20-year period in real terms and a three-year period in nominal terms). However, it is remarkable that an economic superpower like the US, which was the epicenter and architect of the international trade system, is on a path to negatively impact global trade by its own policy.

All in all, the above mentioned means that a Trump presidency locks the world economy into an extended period of global trade stagnation. This is our base-case scenario with 50-

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[1] Those who were highlighted in this article by Financial Times, 'Who are the team Trump players heading for Washington?' 9 November 2016 https://www.ft.com/content/6075447c-a53b-11e6-8898-79a99e2a4de6

[2] http://www.nytimes.com/2016/11/10/us/politics/trump-speech-transcript.html

[3] More on a NAFTA risk and Mexico's economy as prime victim is here: https://piie.com/blogs/realtime-economic-issues-watch/mexicos-economic-policy-hostage-us-volatility-blame-trump-and

[5] http://video.cnbc.com/gallery/?video=3000526009

[6] https://www.theguardian.com/us-news/2016/nov/09/donald-trump-ohio-youngstown-voters

60% probability. Our worst-case scenario, outright contraction, has a meaningful chance to materialize[7].

Monetary and fiscal policies

Trump's stance on federal government-devised stimulus (via monetary and fiscal policy) sounds quite sensible in some areas while in others it introduces controversy, in our view. There is a recognition in the Trump camp that the US economy is stuck in the low-growth, that monetary policy has not been successful, and that some sort of policy coordination between monetary and fiscal authorities is needed[8]. Hence, Trump's promise of a boost in infrastructure spending by the federal government.

However, here starts the above-mentioned controversy. Trump's fiscal stimulus includes a range of tax cuts, which is expected to benefit the wealthy more so than those with middle and lower incomes, whose support catapulted Trump into the White House. Other evidence suggests that sweeping deregulation is being prepared to boost the economy. Hence, there is a natural tendency by a Republicans-led administration to rely on the foundations of supply-side economics, which has as its backbone the concept of small government.

In addition, there is also the fact that the Republican party, which typically dislikes both increasing the federal budget deficit and public spending, now controls both houses of congress. This could put the Trump administration in a difficult position with regard to appropriate fiscal stimulus, which would be more about expenditures and less about cutting taxes. The GOP for sure will welcome the latter and restrict the former, in our view. That is likely to leave middle and lower-income voters dissatisfied over time, forcing Trump to resort to opportunistic tactics, challenging his own party and at the extreme turning to Democrats for a bipartisan solution in this and other issues.

The current hope that above-mentioned mix of fiscal stimulus will 'trickle-down' to the working man is likely to hit a wall of dismay, when it's realized that measures were centered toward supply-side economics and stimulus measures of demand-side economics (via federal government spending) were not bold enough.

Hence, the continuance of acute political polarization in the US—among those factors responsible for the anti-establishment vote this early November—is likely.

In our view, in today's financial markets, there is one major misallocation, and that is the US dollar, which has been the strongest currency out of major global currencies at least since 2015 (Chart 1, p.4). This dislocation has developed amid a promise of interest rate increases by the Fed, which have not taken place. Moreover, Trump's economic policy mix is not aggressive enough. Combine that with a profound aversion to increasing public debt by the GOP, this dislocation is not likely to change. Moreover, Trump's foreign policy views that put American interests first would not help when should the time comes for coordination with the other major economic powers for FX adjustment to make the US dollar less dear, which we see as quite likely.

[7] This means that our worst-case scenario has a probability that by far outweighs the probability of the best-case scenario with a global trade recovery. Hence, the former has 30-40% probability, while the latter has no more than 10% probability.

[8] http://video.cnbc.com/gallery/?video=3000526007

Geopolitics

It is widely accepted that a Trump presidency will be accommodative to the Kremlin. In our view, this move may prove naïve. As came out recently, outgoing President Obama initiated a reset policy toward Russia at the beginning of his presidency, and we see what that led to. Washington under Trump may be misreading geopolitics the same way the previous administration did.

Nevertheless, we expect the US State Department under President Trump to double down on trying to effect a peaceful solution to Crimea and eastern Donbas, Ukraine's territories affected by Russia military aggression. We expect at a Trump-Putin summit that the Kremlin will seek elimination of sanctions and an official recognition by the US that Crimea is part of Russia.

Our concern is these solutions will be sold to Ukraine's leaders on the grounds of ill-judged projection that after a Crimea and eastern Donbas settlement, Ukraine-Russia trade flows will be restore to the pre-war volumes, i.e. Russian imports from Ukraine restored. In our view, this is a mistaken approach, which would benefit Russia's economy rather than Ukraine's. As we mentioned above, Russia's aggregate demand has been cut, firstly by a macroeconomic adjustment that was well overdue. Contraction of the aggregate demand in Russia was sizeable, as depicted by collapsing imports in the group of countries in this region, where Russia is by far the largest economy by many measures including imports, see Chart 5 on p.5. It was not the result of Western sanctions, which were secondary and, if anything, helped Kremlin to convince the little people that Russia's economic woes were the result of unfriendly Western powers and not domestic policymaking failures.

Instead, in our view, a more likely scenario will be as follows. We expect the Trump–Putin honeymoon to last until the US administration realizes that Kremlin's meddling in the US's affairs does stop with the recent elections. The bigger prize for the Kremlin could be a furthering of internal political polarization inside the Western world, particularly in the US and EU. The key here is that modern authoritarian regimes long for foreign instability, as it pays off by strengthening their domestic situation despite a poor economy.

But we see a silver lining. The US presidential elections proved, once again, to be an excellent exercise in democracy. This fact is difficult to beat for authoritarian regimes, especially in the heavily controlled and democratically restrained parts of the world such as what borders Ukraine's north-east. In our opinion, despite the surprises and volatility in the process, democracy addresses popular concerns, hence, there is progress. This is not the case under authoritarian regimes. Hence, here lies the key risk going forward in terms of geopolitics.

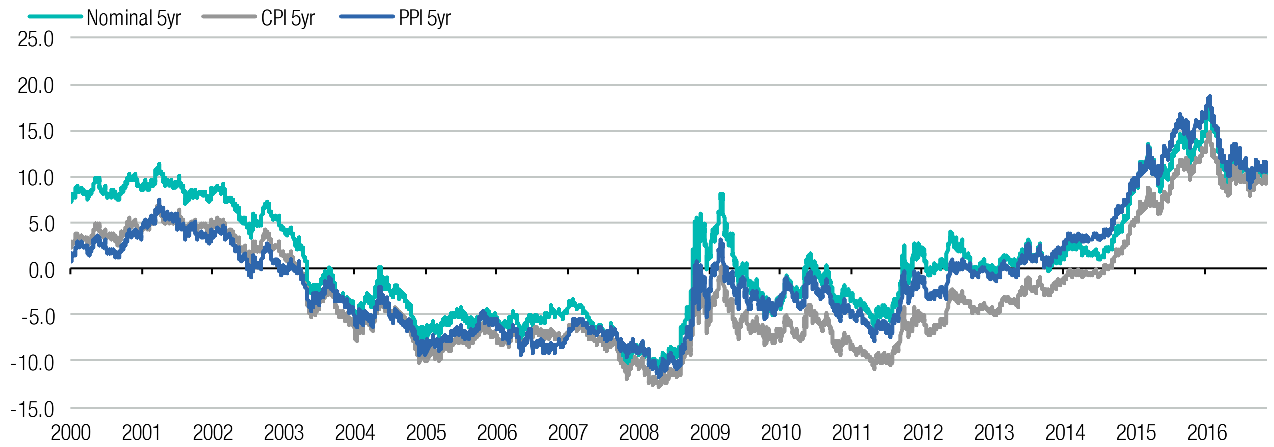
Above, we noted that Russia's authorities committed to fiscal austerity for the coming three-year period (via freezing government expenditures in nominal terms) despite the fact that the public debt level is low by international standards. A DC-based, economic policy think-tank analyst who we spoke to just recently acknowledged there is much 'more Washington consensus in Moscow than in Washington' itself. This is a striking reference to restrictive policies adopted by Russia against the backdrop of increasing talk of shifting from monetary to fiscal stimulus in the West. In our view, Russia's economy is bound for volatility including in financial markets and/or in government's response toward managing the economic transition. Restrictive economic policies are unlikely to survive long even in Russia. That is why the above-mentioned risk of geopolitics will remain.

Conclusions: Impact on Ukraine's economy

The results of the US election indicate there is low chance that global economy growth accelerates. Hence, there is little chance for Ukraine's net trade position—which is still in deficit after the sizable currency devaluation of 2014–15—to turn into a meaningful surplus anytime soon. For that to happen, it would require another sizeable devaluation of the local currency, the hryvnia. This step would be a no-go politically for Ukraine's policymakers. And that is why, in our view, they will stick with relatively restrictive monetary and fiscal policies for the near term. This implies Ukraine's central bank will be reluctant to aggressively cut the policy rate (i.e. through 10% and into single-digits). In our view, Ukraine's authorities will to stick to the IMF programme, and will take steps to meet the requirements of the next tranche in order to boost gross FX reserves. The flip side of this will be a sub-par growth environment, i.e. well below 3% and closer to 2%, indicating a very tepid recovery after an approximate 17% GDP loss in real terms over 2014 and 1H of 2015.

Chart 1. US dollar misalignment: positive area values mean currency is tending dearer, while negative ones cheaper as defined by ICU's in-house FX analysis methodology*

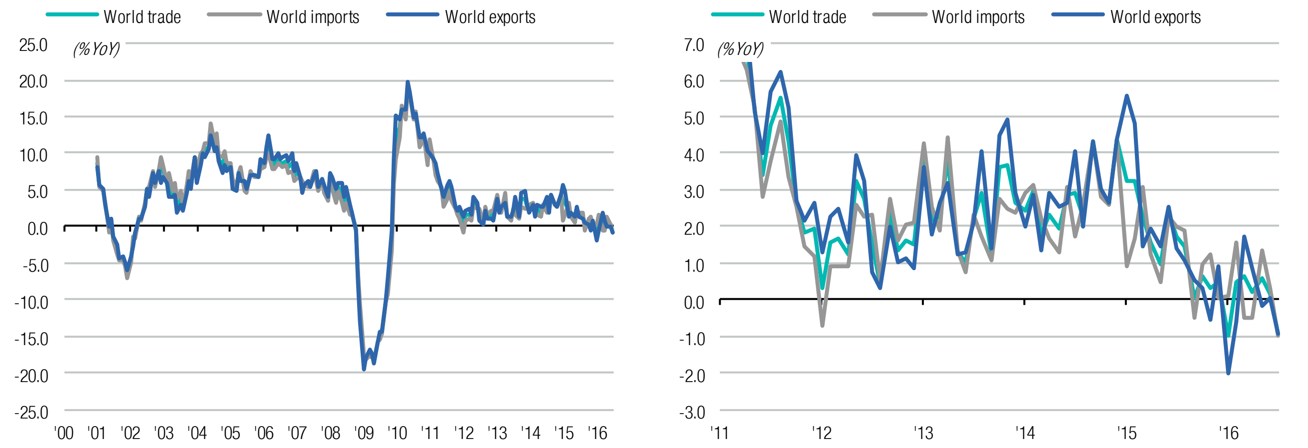
Daily history from 1 January 2000 through 8 November 2016



* A currency misalignment is defined by three trade-weighted indices (nominal and CPI- and PPI-based real ones) by subtracting five-year moving average of the index from its value at each point of time. Source: ICU.

Chart 2. Growth rates of global trade flows through July 2016 over last 16 years (left) and 6 years (right) (% YoY)

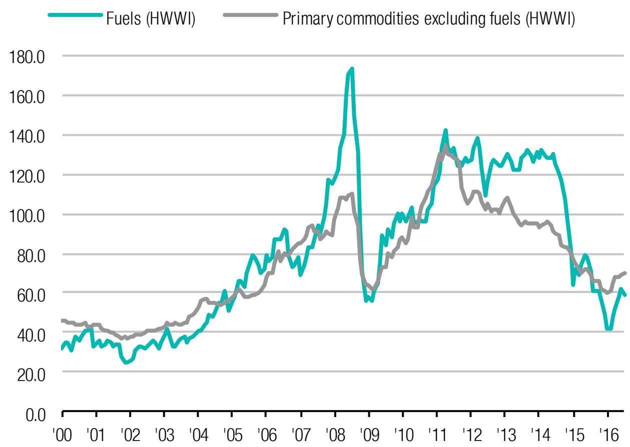
Monthly history since January 2000 *Monthly history since January 2011*



Note: developed and emerging economies. Source: CPB Netherlands Bureau for Economic Policy Analysis.

Chart 3. Price indices: breakdown by commodities (unit values in US$)

Seasonally-adjusted data. History from January 2000 through May 2016



Source: CPB Netherlands Bureau for Economic Policy Analysis.

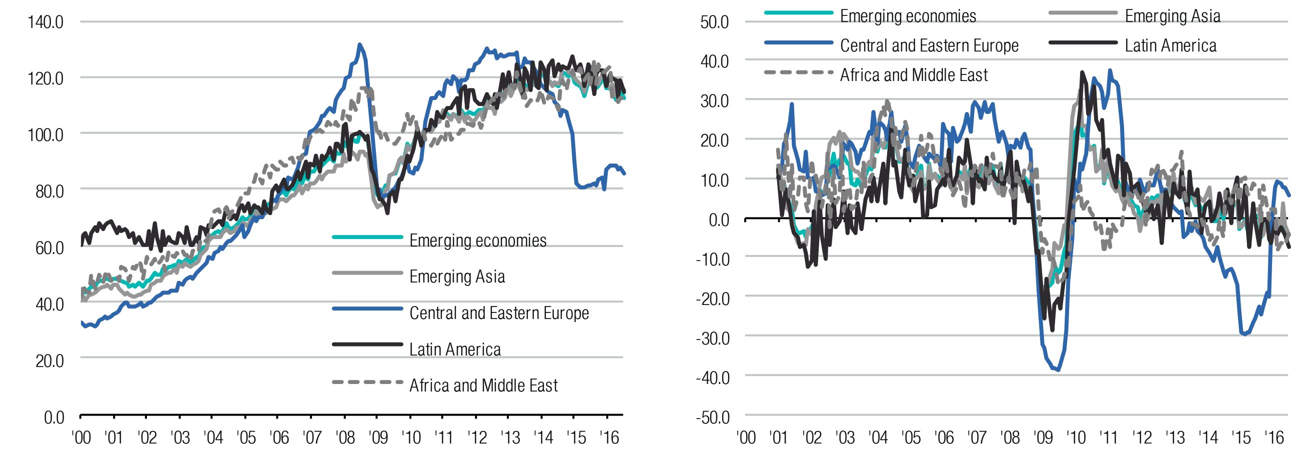
Chart 4. Price indices: breakdown by trade flow (unit values in US$) (%YoY)

Seasonally-adjusted data. History from January 2000 through May 2016

Source: CPB Netherlands Bureau for Economic Policy Analysis.

Chart 5. Emerging economies' imports data: indices (left) and growth rates (%YoY, right)

Seasonally-adjusted data. History from January 2000 through July 2016



Note: Central and Eastern Europe – the group of countries that comprises Russia, Kazakhstan, Ukraine, Belarus, Armenia. Source: CPB Netherlands Bureau for Economic Policy Analysis.

Disclosures

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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.

DEBT RATING DEFINITIONS

Buy: Forecasted 12-month total return significantly greater than that of relevant benchmark

Hold: Forecasted 12-month total return is in line with or modestly deviates from relevant benchmark

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

WEB www.icu.ua @ICU_UA

CORPORATE FINANCE

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

Ivan Shvydanenko, Director
ivan.shvydanenko@icu.ua

Roman Nikitov, ACCA Director
roman.nikitov@icu.ua

Yuriy Kamarytskyi, Vice President
yuriy.kamarytskyi@icu.ua

Ruslan Kilmukhametov, Director
ruslan.kilmukhametov@icu.ua

Ruslan Patlavsky, Director
ruslan.patlavsky@icu.ua

STRATEGY AND CORPORATE DEVELOPMENT

Vlad Sinani, Director
vlad.sinani@icu.ua

SALES AND TRADING

Konstantin Stetsenko
Managing Director
konstantin.stetsenko@icu.ua

Liliya Kubytovych
Asset Management Product Sales
liliya.kubytovych@icu.ua

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

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

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

RESEARCH DEPARTMENT

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

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

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

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

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

Lee Daniels, Rolfe Haas
Editors

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