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GOVERNMENT DEBT MARKET

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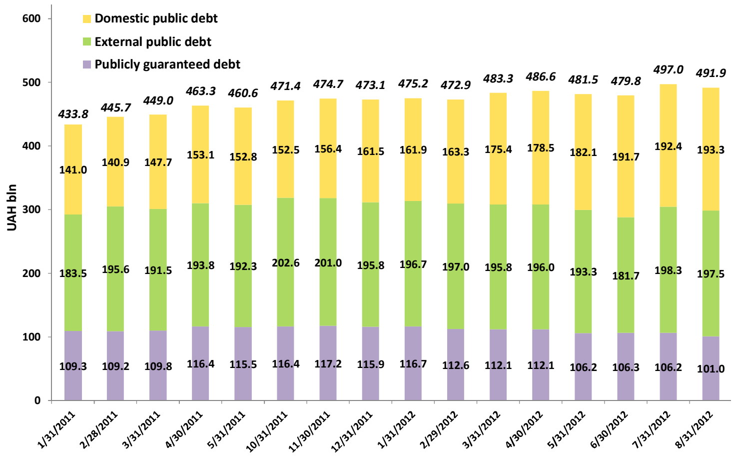
The MoF borrowing plan for the fourth quarter, published last week, contained no surprises, stipulating the borrowing target of UAH 6.9 bln. The bulk of this amount (UAH 4.9 bln) is planned to be raised through medium-term instruments, while the remaining UAH 2 bln falls on long maturities. According to the plan, only hryvnia denominated and FX indexed OVDPs will be issued during the quarter. The only FX issuance stipulated is dollar retail bonds whose placement starts on October 10 through Oschadbank. Quarterly debt repayments are estimated at UAH 16.4 bln (including FX bonds and IMF repayments), suggesting that the Ministry has already accumulated funds for this purpose.

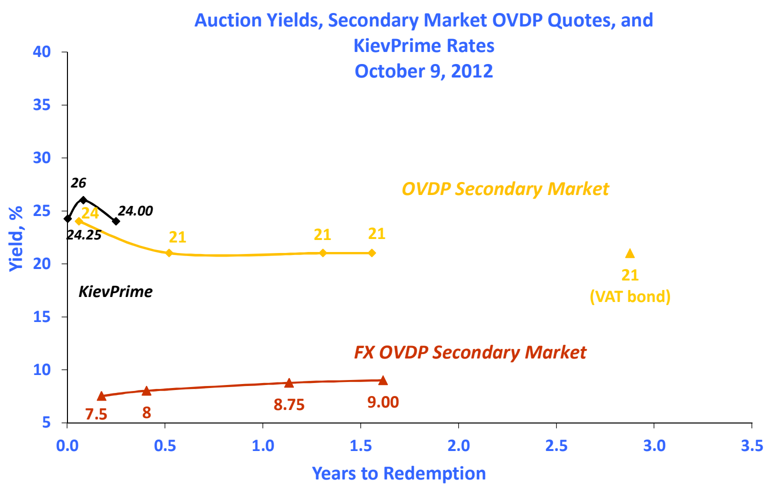
Verkhovna Rada passed amendments to the Budget Code allowing CabMin to exceed the established borrowing ceiling to cover temporary cash gaps in the single treasury account, while total debt outstanding as of year end should be within the ceiling stipulated in the budget law (draft law #11220, dated 10/2/2012). This enables the MoF to issue debt above the plan not only to deal with funding gaps, but also for the purposes of active debt management to perform buy-backs and other similar transactions.

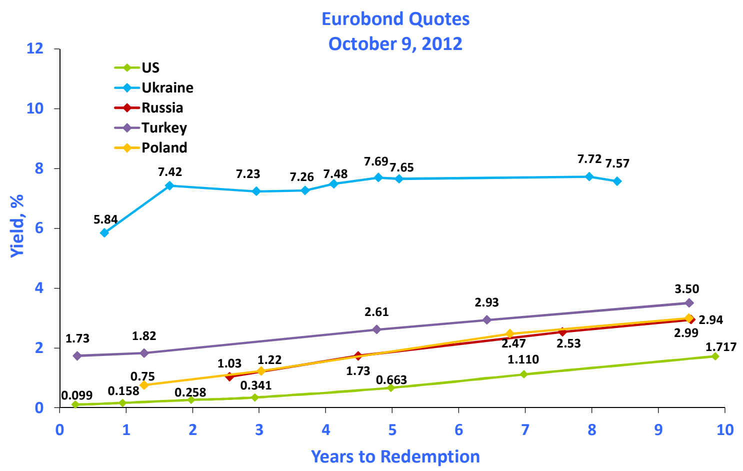
The MoF adhered to its pre-announced October borrowing schedule and did not hold an auction this week. The Ministry is set to resume auctions over the coming two weeks by offering hryvnia denominate 5- and 7-year notes. The schedule does not include any FX debt, denominated or indexed. The need for FX is anticipated to be met through the sale of the recently announced 2-year U.S. dollar denominated notes in increments of USD 500 targeted at the retail investor.

Russia became yet another country whose capital market is now connected to the pan-European settlement and clearing system Euroclear, making Russian government bonds, amongst other securities, Euroclearable. This simple technical adjustment opens large pools of capital to Russia, making it easier for the Russian government to finance the budget with ruble-denominated debt, rather than issuing FX debt in the international markets. Ukraine might consider this example as an effective and easily implemented means of increasing the attractiveness of its domestic government bonds and decreasing borrowing costs without incurring additional risks.

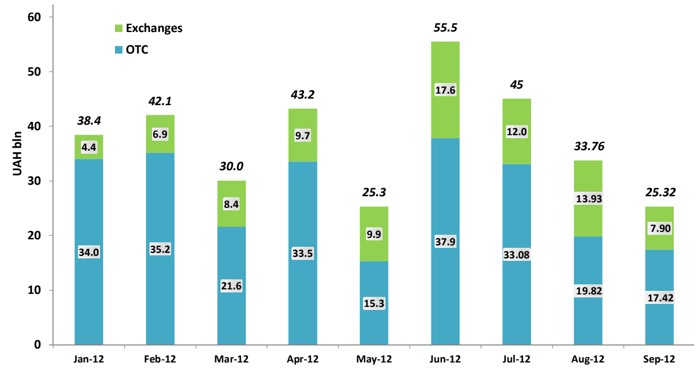
Ukraine's Public and Publicly Guaranteed Debt in 2011-2012







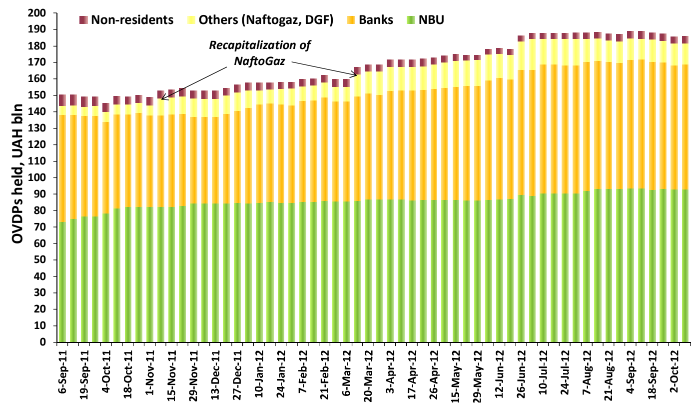
OVDP Secondary Market Trades in 2012



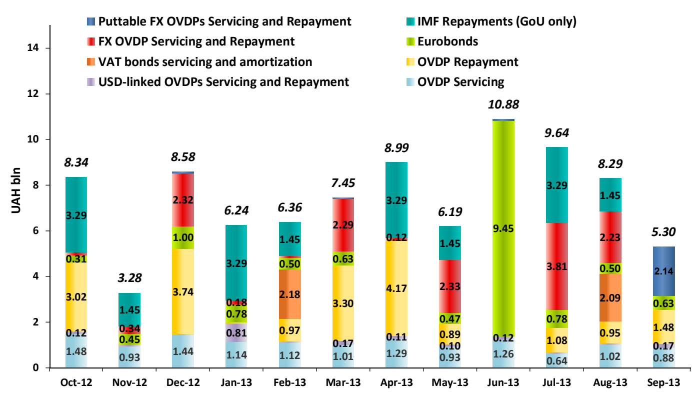
Dynamics of Domestic Government Bond (OVDP) Holders

UAH bln

Date	Bonds Held by				Total
	NBU	Banks	Others	Non-residents	
10/2/12	92.91	75.4	13.21	4.19	185.72
10/9/12	92.91	75.96	12.56	4.31	185.74



Domestic and External Government Bonds Servicing and Repayment and IMF Repayments in 2012-2013



A clever staffer of the Wall Street Journal recently opined that the call "Let's Go Yankees" could be as easily uttered by an erstwhile investor in search of higher yielding investment as it could be by a rabid New York baseball fan. European corporate issuers were only too eager to respond, accommodating investors with near record issuance of Yankee Bonds. These are bonds issued by European corporations denominated in U.S. dollars, eliminating foreign exchange risk, and usually higher in yield than available from domestic issuers. Yankee bonds issued YTD total EUR 37 bln (USD 46 bln), the highest total since EUR 48.5 bln issued in 2009. This issuance was endorsed by investors as average yields, excluding financials, fell to 2.08% from 3.28% at the start of 2012. Investors were forced to look for new sources of issuance as U.S. high grade debt traded at a four decade low yield of 2.75% and its spread to U.S. Treasuries reflected a fourteen month narrow of 153 bps. This search for yield was further corroborated by the record withdrawal of investments from equity mutual funds and ETFs. This reached USD 138 bln, while over the same time period bond funds had inflows of USD 1 trillion. The response to this massive reallocation of assets was met by issuance of 30-year bonds not seen since 1995 with 166 issues totaling USD 91.9 bln, exceeding 2011 issuance of USD 73.2 bln composed of 145 bond deals.

Euro Zone Finance Ministers meeting to ratify the ESM on October 8 resulted in disagreement over whether it could be retroactively applied to relieve current crisis conditions, or would be earmarked for future imbalances. German, Finland and the Netherlands were opposed to applying funds to past conditions, while those Ministers representing Southern Europe were in favor of that. There was also disagreement over the role of the proposed central regulator, number and type of banking institutions that would fall under its aegis. The ESM has yet to face its first hurdle of raising capital through bond issuance and market acceptance. It is still viewed negatively by some investors as the first step in the mutualization of Euro Zone debt.

The minutes of the last FRB Open Market Committee meeting were made public. The salient point was the opinion that a calendar date should be substituted by an economic metric as a signal for a potential increase in Fed benchmark interest rate. This, in the minds of many participants, would negate the need for constant adjustments and provide additional clarity regarding conditionality and a more formal guidance.

A new class of mortgage securities is soon to be launched by the U.S. Federal National Mortgage Agency, FNMA, named Risk Sharing Bond. This bond will offer investors a higher yield than attainable on standard FNMA mortgage securities in return for risk sharing by the investor in cases of default. This deviation from standard issuance, where the bond was guaranteed by the U.S. Government, is an attempt to lessen the overwhelming influence that FNMA and Federal Home Loan Mortgage Corporation currently have on the U.S. mortgage market. The concept, if successful, should bring about a revival in the private label mortgage bond market, which are those mortgage securities issued by commercial banks/mortgage brokers, rather than two government mortgage behemoths. Issuance was originally scheduled for September 30, but the need to comply with certain provisions of the Dodd-Frank Bill has delayed it until later this fall.

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