

December 9, 2019

Ukraine Under Zelensky

Because of the congressional impeachment inquiry into President Trump, people are hearing a lot about Ukraine and its new president, Volodymyr Zelensky. However, it's important to remember that Ukraine and its new leader are significant in their own right. Russia has been keeping Ukraine under intense geopolitical pressure for the last five years, seizing part of its territory and supporting ethnic Russian separatists in the country's east. These developments have created an important test of the world's resolve in maintaining geopolitical order. They have also created a test for Ukraine's ability to reform and strengthen itself.

In this week's report, we'll review the history of Ukraine since its independence from the Soviet Union in 1991, and we'll discuss the challenges President Zelensky faces in terms of national security and sovereignty, domestic corruption and the rule of law, and economic reform. As always, we'll end with a discussion of the implications for investors.

Soviet Rule and Independence

The Ukrainian Soviet Socialist Republic was the second-largest and second-most important constituent of the Soviet Union, although its subordination to the central government in Moscow was always clear. Ukraine's key geopolitical role was to serve as a buffer state on the Soviet Union's southwestern flank. Indeed, during World War II, much of the fighting on Soviet territory involved Nazi Germany trying to

cross and control Ukraine on the way to Russia (see Figure 1).

Figure 1.



(Source: GameSpot)

To ensure Ukraine's loyalty, Moscow tried to stamp out the Ukrainian language and culture through a policy of Russification starting in the 1930s. The Soviet collectivization of agriculture in the 1930s led to a famine that killed millions, with an especially heavy toll on Ukraine. On the other hand, the government actively encouraged Russians to resettle in Ukraine, bolstering the existing Russian-speaking population prevalent in the republic's east. Throughout the Soviet period, Ukrainian agriculture and industrial might were directed and planned largely from Moscow. The most important benefit for Ukraine came in 1954, when Soviet leader Nikita Khrushchev transferred the Crimean Peninsula from Russia to Ukraine for administrative and political reasons.

As the Soviet Union disintegrated in the early 1990s, Ukraine finally became

independent, but its birth as a sovereign nation was marred by political, economic, and social challenges. Russian leaders initially demanded that Crimea be returned on the grounds that its transfer to Ukraine wasn't legal. That argument was eventually debunked, but the dismantling of communism and the severing of Ukrainian-Russian supply chains sent the economy into a steep, multi-year slide. In fact, Ukrainian gross domestic product (GDP) has never regained its 1992 levels (see Figure 2). Finally, as in Russia, the privatization of formerly state-owned enterprises was often manipulated by insiders, creating a class of ultra-wealthy, powerful “oligarchs” who controlled much of Ukraine’s economy and ensured a continuing problem with corruption.

Figure 2.



Since gaining independence, the Ukrainians have struggled to decide whether to orient themselves toward the European Union and the West or toward their cultural brothers and sisters in Russia. In the presidential election of 2004, for example, then Prime Minister Viktor Yanukovitch argued for closer ties to Russia, while opposition candidate Viktor Yushchenko called for joining the EU. Official results showed Yanukovitch narrowly won the election, but allegations of vote-rigging and intimidation (especially in the ethnically Russian areas) sparked massive protests known as the

“Orange Revolution.” The Supreme Court ordered new elections, which Yushchenko won.

Despite the breakup of the Soviet Union, the Russian government maintains a strong interest in keeping Ukraine as a buffer state on its southwest frontier and exploiting its agricultural, mineral, and industrial resources. During the pro-Western administration of President Yushchenko, this situation played out through a series of disputes over Russian natural gas sold to Ukraine and shipped to Europe. When Ukraine resisted Russian price hikes, Russia responded by cutting off shipments, creating painful gas shortages in parts of Europe before a settlement was reached.

After gaining power in the 2010 election, Yanukovitch and his Party of Regions tried to create a more controlled democracy and re-orient Ukraine toward Russia. In November 2013, he decided not to sign the pending Ukraine-EU Association Agreement, sparking renewed protests – the “Maidan Revolution” – which drove Yanukovitch from power in early 2014.

Russian Incursion

Yanukovitch’s ouster infuriated Russian President Putin and many of Ukraine’s ethnic Russians. Pro-Russian protests broke out in parts of eastern Ukraine and in Crimea, providing Putin with a chance to test his concept of “hybrid warfare” – the flexible blending of conventional warfare, special operations, irregular tactics, cyberwar, and propaganda to control or harm other nations without generating a symmetrical response. Russian troops in uniforms without insignia seized Crimea’s parliament building and other strategic sites, installing a puppet government that conducted a sham referendum on

independence and joining the Russian federation, which took effect in March 2014.

Shortly thereafter, pro-Russian separatists in Ukraine's industrial heartland around Donetsk and Luhansk began military operations to split the region off from the rest of Ukraine and join it to Russia, relying heavily on covert Russian troops and equipment. By the time Ukraine's new president, Petro Poroshenko, was elected in May 2014, a long battle line separating the pro-Russian forces and the Ukrainian military had formed (see Figure 3). At a meeting in the Byelorussian capital of Minsk, the Russian and Ukrainian governments did agree to a truce and pullback of forces, but the agreement has been moribund due to the pro-Russian forces' failure to pull back. To date, some 13,000 have reportedly been killed in the continuing standoff.

Figure 3.

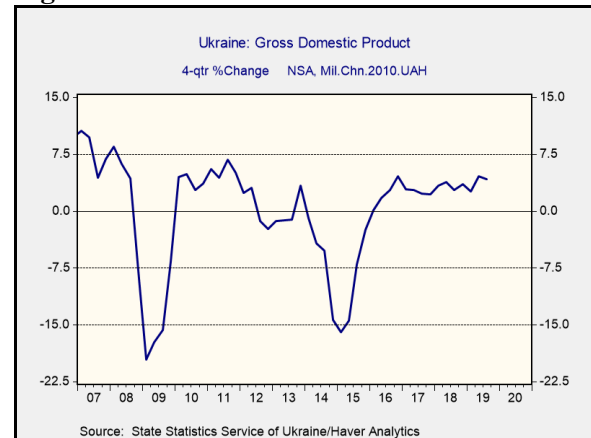


(Source: Financial Times)

Ukraine under President Poroshenko took a hardline approach to the conflict with Russia and the separatists. The government not only refused to cede ground to the separatists, but also showed little concern for civilians caught in the crossfire. At the same time, Poroshenko allowed corruption to flourish in Ukraine, even as Russian antagonists staged covert operations within Ukraine itself in an effort to destabilize the

government. Economic growth fell sharply immediately following the loss of Crimea and the separatists' actions, but growth actually rebounded fairly quickly (see Figure 4). The key problem is that the benefits of Ukrainian growth remain captured largely by the oligarchs and members of their circle. By the time of the 2019 presidential election in April, Ukrainians were fed up with the war, bad relations with Russia, corruption, and inequality.

Figure 4.



Meet Volodymyr Zelensky

Just as voters in many other countries have recently rejected traditional establishment elites in favor of political newcomers, the Ukrainians in early 2019 threw their support to someone whose only political experience was playing the nation's president in a television comedy. [Born in 1978, Volodymyr Zelensky obtained a law degree from Ukraine's Kryvyi Rih Institute of Economics but, rather than practicing law, he embarked on a career as a comedic actor.](#) He eventually launched an entertainment production company, Kvarstal 95, which allowed him to travel and perform extensively throughout Russia and the former Soviet Union. He [rose to fame playing the lead role in his company's hit television show, *Servant of the People*,](#) about a high school history teacher who

wins the presidency after a viral video shows him ranting against government corruption.

Figure 5.



Volodymyr Zelensky (sitting).
(Source: *Kvartal-concert.com*)

Members of Kvartal 95 formed the Servant of the People Party in March 2018 to capitalize on Zelenskiy’s surging popularity and image as a reformer. Vowing to “bring professional, decent people to power,” Zelensky ran an almost entirely virtual campaign via social media and YouTube. He handily won both the first round of the presidential election in March 2019 and the final round in April. [His party also won a strong majority in the parliamentary elections of July 2019, giving him a strong mandate to lead.](#) Now that Zelensky and his party have been in power for six months, it’s possible to give an initial assessment of how he’s doing in two key areas:

National Security. [Zelensky has said he wants to make more progress in eventually bringing Ukraine into the European Union and the North Atlantic Treaty Organization, but his more immediate concern is to push back against Russia’s seizure of Ukrainian territory and efforts to dominate the country.](#)

The key tension arises from the fact that Zelensky has also said he wants to end the war with the Russian-backed separatists in eastern Ukraine. To date, Zelensky has had some trouble finding the right balance between pushback against Russia and the separatists versus good will measures to end the war.

- **Good Will Measures.** Zelensky has agreed to [at least one prisoner swap with Russia, and he has pulled Ukrainian troops back from the battle line](#) in certain areas near Donetsk and Luhansk. He has also [agreed to grant special autonomy to those regions once they have held elections that are certified as free and fair.](#) However, in the face of pushback from Ukrainians who don’t want to give in to Russia, he also insisted that the offer is contingent on the Ukrainian government first regaining control of its border and making sure that all militants are eradicated from the areas.
- **Disquieting Russian Response.** At first glance, Zelensky’s initiatives seem to be producing positive results, but things look less rosy in detail. In a September prisoner swap, the Russians returned Ukrainian sailors detained in November 2018, along with their ships, but the ships [had been stripped down to their lamps, light sockets, and even toilets.](#) Even worse, the deal [required Ukraine to return the notorious separatist leader Volodymyr Tsemakh, who has been](#)

[implicated in the 2014 downing of a civilian airliner over Ukraine.](#)

Domestic Reforms. Zelensky's domestic agenda is to cut corruption in government, strengthen the rule of law, implement growth-friendly economic reforms, and land a new IMF financial aid package.

- **Economic Reforms.** Zelensky's government has already introduced or passed multiple legal changes to liberalize the economy and boost growth. For example, the government has [introduced a draft bill allowing the sale of agricultural land and speeding the privatization](#) of government-owned assets. Parliament has [already passed reforms touching on port and infrastructure concessions, resource extraction, securities regulation, consumer protection, and other areas.](#)
- **Corruption and the Oligarchs.** The biggest question for Zelensky's domestic agenda is how strongly he'll attack corruption and the power of Ukraine's oligarchs. Legislators have [already passed a bill to end their immunity from prosecution](#), but there are concerns that Zelensky may be more beholden to Ukraine's oligarchs than previously realized. The concerns arise from the fact that Zelensky has a close relationship with Ukrainian oligarch Igor Kolomoisky, who owned the television network that aired *Servant of the People*. Indeed, Kolomoisky provided major financial and in-kind support for Zelensky's presidential campaign.
- Zelensky's relationship with Kolomoisky is especially problematic because the oligarch also previously owned a major Ukrainian financial institution, PrivatBank, which

regulators declared insolvent and nationalized at huge cost in 2016.

[Kolomoisky claims the nationalization was a bold asset grab by the previous government and has been fighting to get his prized bank back.](#)

- As it turns out, Zelensky has named Kolomoisky's lawyer on the PrivatBank matter as his chief of staff and has hinted that the institution may be returned to him. Not only would that discredit Zelensky as a corruption fighter, but the IMF says it would also preclude it from offering renewed financial support to Ukraine.

Ramifications

Presidents Putin and Zelensky will meet directly for the first time today in Paris, along with French President Macron and German Chancellor Merkel. However, given Putin's behavior to date, we are doubtful that he can be convinced to keep his hands off Ukraine. We suspect Putin will continue working to destabilize Ukraine and keep it out of the West's orbit. At the same time, we think the Zelensky government will make more progress on economic reforms, but the jury is still out on whether the new president will be coopted by Kolomoisky and the oligarch class. Prospects for reduced corruption and better rule of law in Ukraine remain unclear.

Because of Ukraine's relatively small economy and limited connection with developed countries, investors would probably feel little direct impact if it fails to reverse Russian encroachment or implement effective political and economic reforms. There is little sign of an impending economic collapse or financial crisis at the moment. For investors in the United States or elsewhere in the developed countries, the

principal risk may be that continued Russian-Ukrainian tensions could prompt Moscow to once again shut off gas shipments to Ukraine and Western Europe. The European economy is already near stall speed, so such a cutoff in the midst of winter could help push Europe into a recession and bear market for stocks.

Although we don't see it as likely, the worst-case scenario would probably be that a severe economic or financial crisis in Ukraine, or some new political crisis, might tempt Moscow into using increased, direct military force against the country as a way

to consolidate its influence over its "near abroad." Such a move would have the potential to draw in the United States or other Western powers, creating a broader crisis. In that event, we would expect a boost for safe haven assets such as government bonds, precious metals, and crude oil, while global equities would likely be driven lower.

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December 9, 2019

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