Focus

Ukraine

Markets

Domestic liquidity, government bonds, FX market, and macro

Research team

Alexander Valchyshen
Alexander Martynenko
Taras Kotovych
Dmytro Dyachenko

Weekly Insight

Higher probability of a hike in the key policy rate

Key messages of the today's comments

TUESDAY, 5 JUNE 2018

Domestic liquidity and bonds market

Primary auctions – reoriented to FX

One step at a time, primary auctions are being reoriented toward FX-denominated bonds, especially in US dollars. As the result, auctions scheduled for 12 and 19 June will attract most of the demand this month.

Demand for local-currency bonds persists

During May 2018, foreign investors' and non-banks' portfolios declined, but other investors increased their investments in bonds, and foreign investors partially refinanced repayments.

Liquidity still high

Due to quarterly and month-end tax payments, the Treasury was able to increase its end-of-month balance with low impact on liquidity.

Foreign exchange market

UAH stable in the absence of significant drivers

This week, we expect FX demand and supply to remain balanced; thus, the UAH will not see significant fluctuations. Some strengthening of the national currency is possible thanks to seasonality.

Economics

C/A deficit at 1.8% of GDP in April

The C/A deficit slid to 1.8% of GDP in April, down from 1.9% of GDP at the end of 2017, primarily thanks to improved economic growth. Still, the C/A deficit is to widen to 2.6% of GDP this year due to higher growth rates for consumer imports, rising oil prices, and an expected decrease in steel exports.

Higher probability of a hike in the key policy rate

The NBU may tighten monetary policy and impose restrictions on FX operations in the absence of the next tranche from the IMF, according to Yakiv Smoliy, the governor of the NBU.

Banks' reserves market (4 June 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	17.00	+0bp	+450bp
ON rate (%)	15.90	-30bp	+460bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	48,539	-11.39	+7.32
DepCerts (UAHm)[3]	66,227	+7.17	+0.00

Notes: [1] NBU's key policy rate; [2] stock of banks' reserves held at NBU; [3] stock of NBU's short-term bonds.
Source: NBU, Bloomberg, ICU.

Breakdown of govt bond holders (UAHm) (4 June 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	350,325	+0.00	-6.61
Banks	354,445	+0.56	+26.06
Residents	24,677	-0.45	+12.40
Individuals	2,964	+2.86	+347.78
Non-res[4]	10,794	+0.25	+105.07
Total	**743,206**	**+0.27**	**+8.63**

Notes: [1] non-residents
Source: NBU, ICU.

FX market indicators (4 June 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	26.1100	-0.02	-0.65
EUR/USD	1.1699	+1.38	+3.72
DXY[2]	94.038	-0.82	-2.77
UAH TWI[3]	122.477	-1.02	+9.24

Notes: [1] UAH trade-weighted index.
Source: Bloomberg, ICU.

Gov't bond quotes[1] (5 June 2018)

Maturity	Bid	Ask
6m	17.50	16.75
12m	17.75	17.00
2y	17.50	16.50
3y	17.50	16.50
12m ($)	5.50	4.85
2y ($)	5.70	5.00

Notes: [1] Actual quotes you can see at www.icu.ua.
Source: ICU.

Domestic liquidity and bonds market

Primary auctions – reoriented to FX

One step at a time, primary auctions are being reoriented toward FX-denominated bonds, especially in US dollars. As the result, auctions scheduled for 12 and 19 June will attract most of the demand this month.

Initially, the MoF did not include FX-denominated bonds for May in the schedule. But low demand for local-currency instruments forced them to widen their offerings and increase budget financing using paper denominated in FX. Last month, the MoF received UAH1.5bn of financing from local-currency instruments, while US$272m (UAH7.1bn) and EUR64.6m (UAH2bn) were FX-denominated. Thanks to FX-denominated instruments, in May, the budget received two times more funds than in April.

For June, the MoF has scheduled two offerings of FX-denominated bills, as this month the MoF has to pay about US$550m. Most likely, the Ministry would like to refinance its debt repayments to minimize impact on FX accounts and FX reserves.

ICU view: This week, the MoF offers only local-currency bonds, hence, demand in the primary market will be moderate with partial refinancing of debt repayments. Interest rates are likely to stay close to the last week's levels, as the MoF prefers not to raise the cost of borrowings and will issue FX-denominated bonds later this month.

Taras Kotovych, Kyiv, (044) 377-7040 ext.724

Demand for local-currency bonds persists

During May 2018, foreign investors' and non-banks' portfolios declined, but other investors increased their investments in bonds, and foreign investors partially refinanced repayments.

Bondholders' structure was changed to banks' and individuals' portfolios increasing over non-banks. Banks' portfolio rose by UAH4.6bn to UAH354.5bn or 47.7% in total bonds outstanding. At the same time, individuals increased their portfolios to UAH3bn. Non-banks decreased their portfolios by decreasing investments in local-currency bonds.

Banks increased their portfolios by purchasing new FX-denominated bonds, while individuals purchased a bit both: bonds denominated in local and foreign currencies. Foreign investors still invested primarily in local-currency instruments.

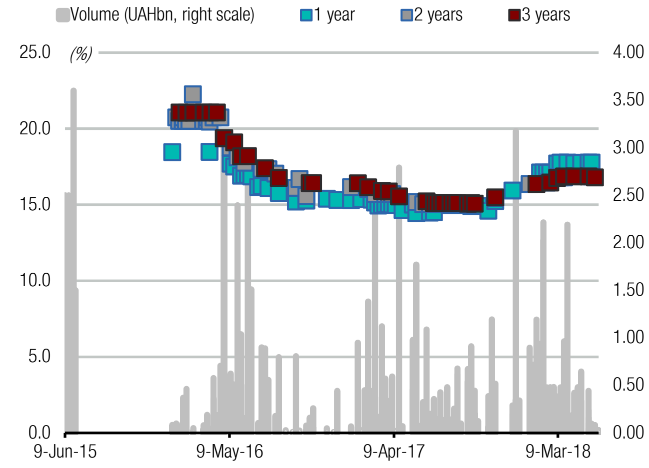
During May, there was redemption of three-month T-bills sold at the beginning of the year when demand for local-currency bonds was high. Also, there was redemption of UAH138m of CLN issued by ICBC Standard Bank PLC using the same bonds issued as a reference asset. After receiving the redemption, this bank made a new issue of CLN with a maturity in 2021 using a new, three-year, local-currency bond as a reference asset. So, with these cashflows, about 64% of foreign investors' portfolios used CLN, and more than 70% of CLN have redemption dates in years 2020–2023.

ICU view: Banks and non-bank investors preferred FX-denominated assets, while individuals continued to purchase bonds in different currencies. At the same time, foreign investors still prefer hryvnia-denominated bonds, and partially moved to longer maturities.

Taras Kotovych, Kyiv, (044) 377-7040 ext.724

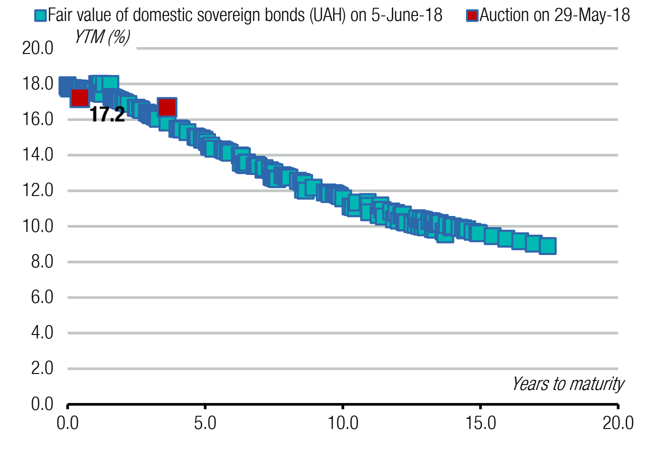
Chart 1. Local-currency bonds

Three-year history of domestic government bond placements at primary market: proceeds (in billions) and yields-to-maturity (%)



Source: Ministry of Finance of Ukraine, ICU.

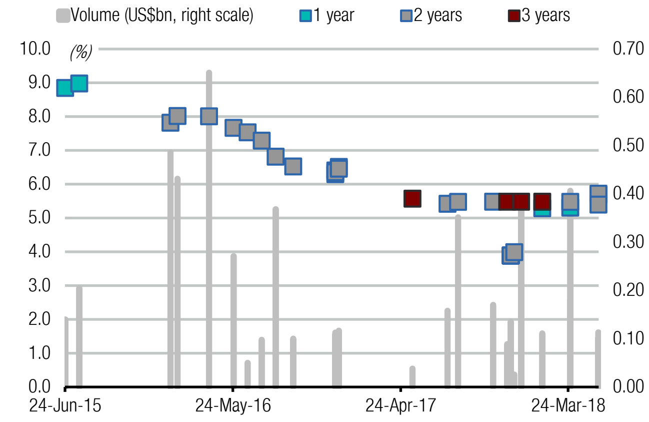
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



Source: National Bank of Ukraine, Ministry of Finance of Ukraine, ICU.

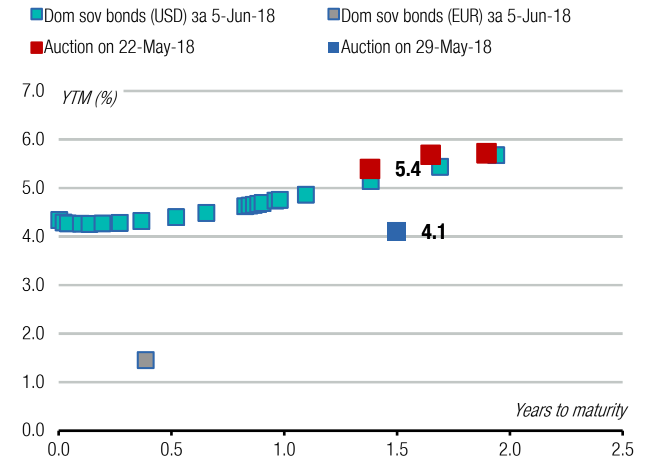
Chart 2. FX-denominated bonds

Three-year history of domestic government bond placements at primary market: proceeds (in billions) and yields-to-maturity (%)



Source: Ministry of Finance of Ukraine, ICU.

Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



Source: National Bank of Ukraine, Ministry of Finance of Ukraine, ICU.

Liquidity still high

Due to quarterly and month-end tax payments, the Treasury was able to increase its end-of-month balance with low impact on liquidity.

At the beginning of June, the Treasury had UAH11.5bn in its accounts, and it doubled this balance during May. At the same time, Treasury operations had a low impact on liquidity, just minus UAH0.4bn. The NBU supported the Treasury's balance providing a UAH7bn tranche from its 2017 profits. So, the NBU has already paid UAH32bn out of UAH44.6bn due this year.

Total liquidity rose UAH4.4bn mostly due to inflows from the NBU. About UAH4bn was injected through operations with FX. In the past seven weeks, the NBU only purchased FX at the market. Exchange of cash in reserves had a positive impact of UAH0.6bn, compensating outflows to the Treasury.

ICU view: Total liquidity remained above UAH110bn, and banks increased investments in CDs, which rose above UAH60bn last week. This week will not have large outflows to the budget, and the main negative impact will likely come from reserves exchanged into cash. Also, the Treasury will pay UAH3bn (except payments to the NBU), which should support stable liquidity.

Taras Kotovych, Kyiv, (044) 377-7040 ext.724

Chart 3. Banks reserves usages over last week(UAHm)

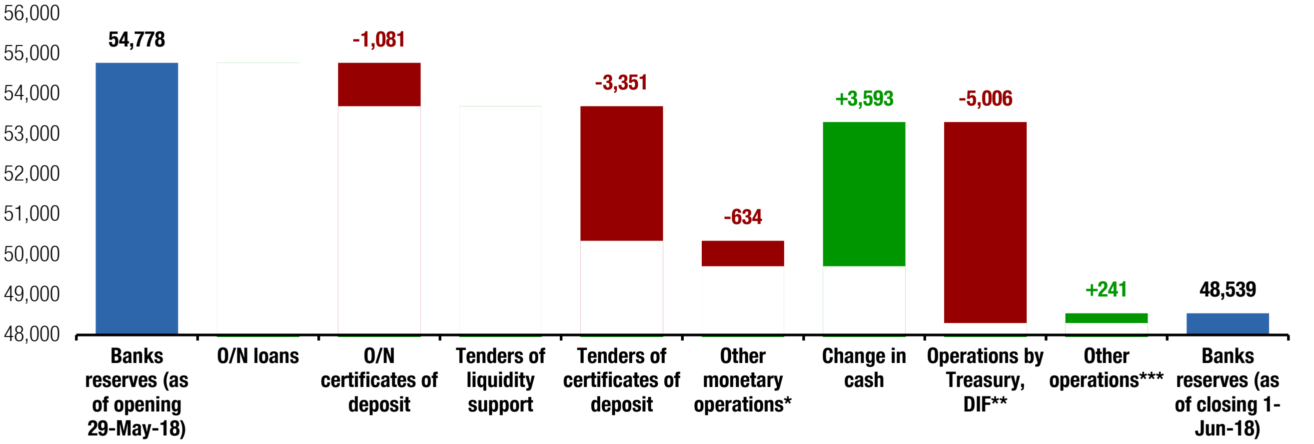
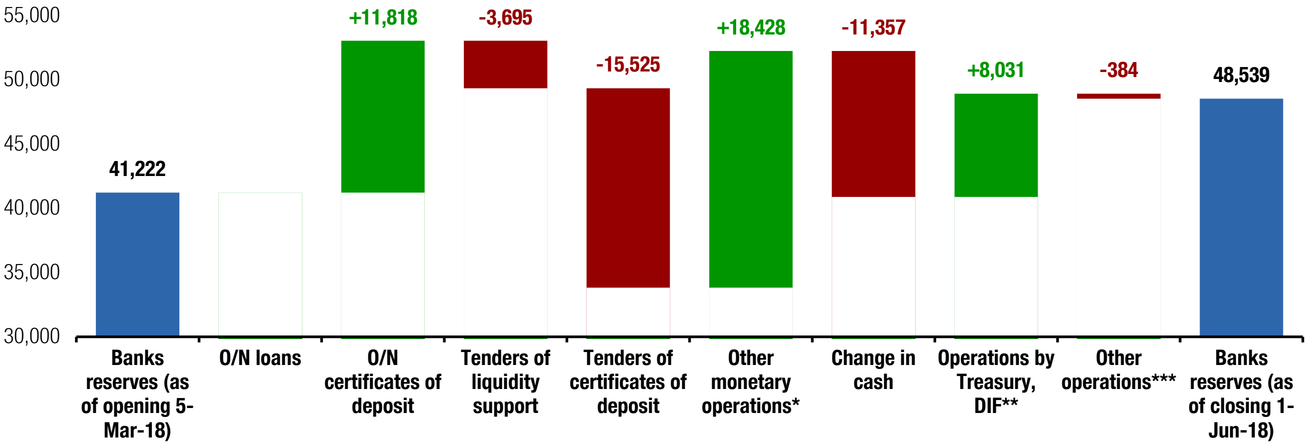


Chart 4. Banks reserves usages over last 90-day period (UAHm)



Notes: [1] data from the NBU's daily reporting https://bank.gov.ua/control/uk/publish/article?art_id=38643651&cat_id=40807142 ;
* operations repo, purchase and sale of government bonds, FX market interventions, stabilisation loans, FX swap agreements; ** DIF – deposit insurance fund;
*** interest payments on NBU's loans and on NBU's certificates of deposit, other operations. Source: NBU, ICU.

Foreign exchange market

UAH stable in the absence of significant drivers

This week, we expect FX demand and supply to remain balanced; thus, the UAH will not see significant fluctuations. Some strengthening of the national currency is possible thanks to seasonality.

The hryvnia remained stable last week against a backdrop of balanced FX demand and supply. The National Bank of Ukraine continued to purchase foreign currency in the interbank market, which, to some extent, kept the hryvnia from strengthening. However, volumes have dropped significantly to US$15m compared with an average of US$55m over the previous three weeks. Thus, last week, the hryvnia remained practically unchanged at 26.10 UAH/USD.

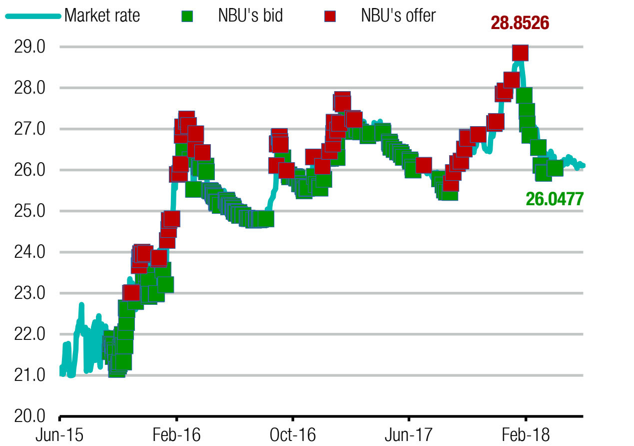
The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) remained unchanged at 123 for the period. In year-on-year terms, real trade-weighted indices (CPI and PPI based) increased 9.6% and 16.4%, respectively, which implies faster prices growth in Ukraine compared with its main trade partners.

ICU view: We do not expect significant fluctuations of the hryvnia exchange rate this week, as FX demand and supply will remain balanced. Repayments of domestic government bonds in the amount of more than UAH3bn will not have a significant negative impact on the hryvnia and will be offset by seasonal demand for the national currency by exporters. In the absence of significant external shocks in June, the hryvnia should continue its slight uptrend.

Dmytro Dyachenko, Kyiv, (044) 377-7040 ext.738

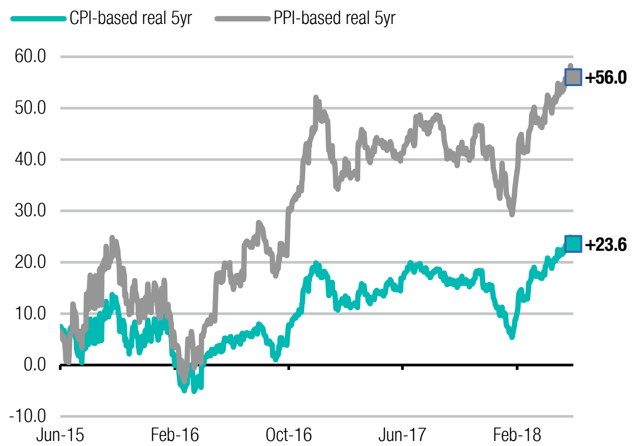
Chart 5. FX market indicators, 3-year history

Ukraine hryvnia UAH exchange rate per US dollar at the interbank market



Notes: the chart provides labels for the average exchange rate at last two NBU auctions (one on buying FX from the market and one on selling it). Source: NBU, Bloomberg, ICU.

UAH exchange rate misalignment[1] from fundamental level[2] (%)



Notes: [1] "+" overvalued, "-" undervalued; [2] based on the UAH's CPI- and PPI-based real TWIs. Source: ICU.

Economics

C/A deficit at 1.8% of GDP in April

The C/A deficit slid to 1.8% of GDP in April, down from 1.9% of GDP at the end of 2017, primarily thanks to improved economic growth. Still, the C/A deficit is to widen to 2.6% of GDP this year due to higher growth rates for consumer imports, rising oil prices, and an expected decrease in steel exports.

The merchandise-trade-balance deficit expanded to US$10bn (8.4% of GDP), up from US$9.4bn (7.7% of GDP) in December. Annualized imports rose 19% YoY to US$51.1bn. Import of machinery and equipment, which account for 27.8% of total imports, rose 25% YoY, while imports of mineral goods grew 25.4% YoY, accounting for 23.3% of total imports. Here, it is worth noting that in 4M18, imports of mineral products declined 1.3% YoY.

Annualized merchandise exports rose 13.2% YoY in April and totaled US$41.1bn. Export of food products rose 5.5% YoY, which is the lowest growth rate since December 2016, and accounted for 43.3% of total exports. This was partially offset by higher growth rates of metallurgical exports, which increased 24% YoY accounting for 26.4% of total exports.

The negative impact on the C/A balance was, to some extent, mitigated by the higher primary-income balance (+91.2% YoY, totaling US$3.3bn) and a 2.5x YoY increase in the services-trade-balance surplus to US$0.9bn.

ICU view: Higher growth rates of imports compared with exports due to rising oil and gas prices, higher imports of consumer goods, and an expected decrease in steel and iron ore prices will bring about a further widening of the C/A deficit, which, by our estimate, is to increase to US$3.3bn, or 2.6% of GDP.

Alexander Valchyshen, Kyiv, (044) 377-7040 ext.721
Alexander Martynenko, Kyiv, (044) 377-7040 ext.726
Dmytro Dyachenko, Kyiv, (044) 377-7040 ext.738

Higher probability of a hike in the key policy rate

The NBU may tighten monetary policy and impose restrictions on FX operations in the absence of the next tranche from the IMF, according to Yakiv Smoliy, the governor of the NBU.

If the next tranche from the IMF is delayed and, as a result, inflationary pressures increase, the NBU may make adjustments to current monetary policy, stated Yakiv Smoliy, according to Interfax-Ukraine. He added that the central bank is ready to "tighten monetary policy to curb inflation" and "impose certain restrictions on potential capital outflows."

The NBU has indicated that Ukraine will enter the Eurobond market should the IMF tranche be delayed, while "amounts borrowed will be smaller and somewhat more expensive than previous ones."

Additionally, in yesterday’s press release on the results of discussion on the key policy rate by members of the Monetary Policy Committee on 23 May of 2018, NBU stated that it may decide to raise the key policy rate again in order to bring inflation back to the target in the medium term.

ICU view: The NBU emphasizes its readiness to strengthen monetary policy through its main instrument, the key policy rate. According to our baseline scenario, the adoption of the Anti-Corruption Court Law in June will allow Ukraine to receive the next tranche from the IMF this year. At the same time, even in this scenario, there are high risks that actual inflation will exceed the NBU’s forecast, so the probability of an additional increase in the key policy rate this year is quite high.

Alexander Martynenko, Kyiv, (044) 377-7040 ext.726
Dmytro Dyachenko, Kyiv, (044) 377-7040 ext.738

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11th floor, LEONARDO Business Centre
19-21 Bogdan Khmelnytsky Street
Kyiv, 01030 Ukraine
Phone/Fax +38 044 3777040

WEB www.icu.ua

INVESTMENT ADVISORY

Makar Paseniuk, CFA, Managing Partner
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

ASSET MANAGEMENT

Grigoriy Ovcharenko, Director
Head of Local Asset Management
grigoriy.ovcharenko@icu.ua

Liliya Kubytovych
Head of Marketing and Sales
liliya.kubytovych@icu.ua

TRADE OPERATIONS

Konstantin Stetsenko
Managing Partner
konstantin.stetsenko@icu.ua

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

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

Yevgeniya Gryshchenko
Head of Brokerage Services Department
yevgeniya.gryshchenko@icu.ua

Vitaliy Sivach
Trader, Fixed-Income & Forex
vitaliy.sivach@icu.ua

Bogdan Vorotilin
bogdan.vorotilin@icu.ua

RESEARCH

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

Dmitriy Dyachenko
Junior financial analyst
dmitriy.dyachenko@icu.ua

Artem Gladchenko
Junior financial analyst
artem.gladchenko@icu.ua

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