

# Weekly Insight

## The state budget is in deficit

### Key messages of the today's comments

#### Domestic liquidity and bonds market

##### Non-residents' portfolios slid to UAH10bn

Last week, portfolios of foreign investors declined to UAH10bn after UAH162m of bonds were sold last Monday. This week, portfolios could decline further.

##### Liquidity decline

Last week's negative impact from Treasury operations caused a decline in banking-sector liquidity, which should continue this week.

#### Foreign exchange market

##### Weaker UAH against a backdrop of VAT refund

This week, the hryvnia's exchange rate will remain volatile due to redemptions of domestic government bonds and repayment of dividends to foreign investors.

#### Economics

##### Sovereign debt outstanding declines

During May 2018, the total amount of state and state-guaranteed debt declined once again. But later this year after external borrowings and seasonal weakening of the hryvnia, the debt dynamic could be in the opposite direction.

##### The state budget is in deficit

At the end of May, the state budget deficit was UAH9.2bn, and its general-fund deficit was UAH14.2bn. At the same time, the amount of the deficit declined for both during May from UAH20.6bn and UAH25.5bn, respectively.

TUESDAY, 3 JULY 2018

#### Banks' reserves market (2 July 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) <sup>1</sup>	17.00	+0bp	+450bp
ON rate (%)	15.80	-10bp	+410bp
ON \$ swap (%)	15.55	+15bp	+386bp
Reserves (UAHm) <sup>2</sup>	46,359	-10.35	-14.12
DepCerts (UAHm) <sup>3</sup>	63,279	+0.98	+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) (2 July 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	350,325	+0.00	-5.57
Banks	359,085	+0.26	+27.46
Residents	23,159	-1.38	+2.94
Individuals	3,234	+1.17	+377.55
Non-res <sup>4</sup>	10,045	+0.46	+3,027.39
<b>Total</b>	<b>745,849</b>	<b>+0.09</b>	<b>+10.29</b>

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

#### FX market indicators (2 July 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	26.2770	+0.24	+1.05
EUR/USD	1.1639	-0.08	+1.86
DXY <sup>2</sup>	94.871	+0.21	-0.79
UAH TWI <sup>3</sup>	123.562	+0.23	+8.56

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

#### Gov't bond quotes<sup>1</sup> (3 July 2018)

Maturity	Bid	Ask
6m	17.50	17.00
12m	17.85	17.25
2y	17.75	16.75
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](http://www.icu.ua).  
Source: ICU.

# Domestic liquidity and bonds market

## Non-residents' portfolios slid to UAH10bn

Last week, portfolios of foreign investors declined to UAH10bn after UAH162m of bonds were sold last Monday. This week, portfolios could decline further.

Last Monday, the total amount of domestic bonds declined UAH229m, including a decline of foreign investors' portfolios by UAH162m. This decline was not due to debt redemption, but rather it was due to selling of bonds to banks. Last week, the MoF repaid just UAH6m with insufficient impact on portfolios. The decline in total bonds outstanding was due to hryvnia strengthening.

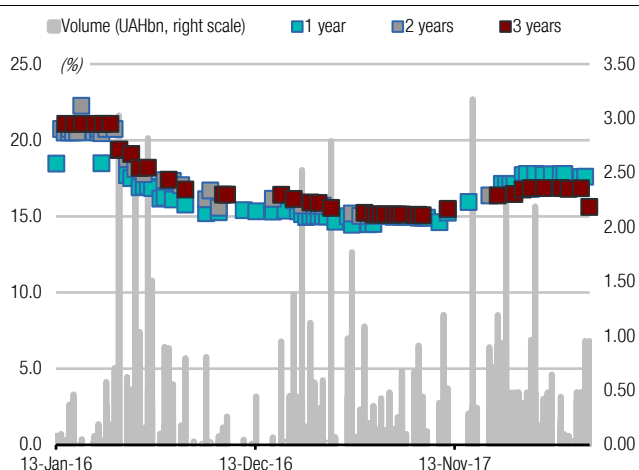
As a result, non-banks' and individuals' portfolios declined mostly due to exchange-rate movements, by UAH91m and UAH7m, respectively. At the same time, banks' portfolios rose despite a large portion of FX-denominated bonds in their portfolios. The increase was caused by purchase of bonds.

**ICU view: Changes in the exchange rate caused changes in portfolios in local-currency terms, but foreign investors' investments in bonds over the summer could see withdrawal before maturity through the secondary market. This week, debt redemption will amount to UAH3.1bn, but according to our estimates, a large portion will be paid to the NBU. Foreign investors did not purchase bonds with maturity this week, so the decline in their portfolios could be due to selling bonds in the secondary market.**

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

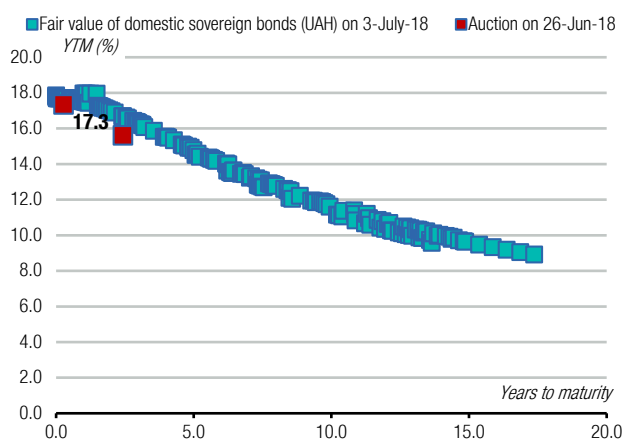
**Chart 1. Local-currency bonds**

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.

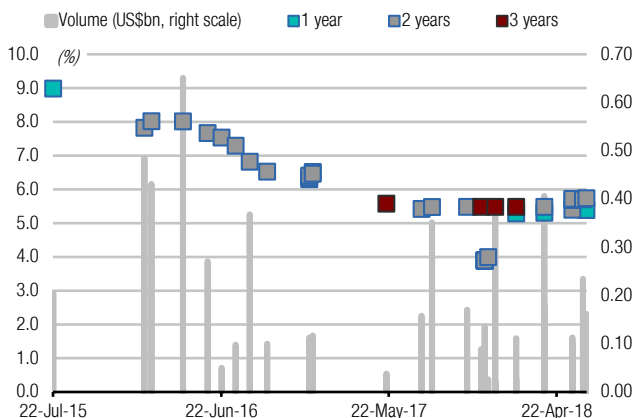
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

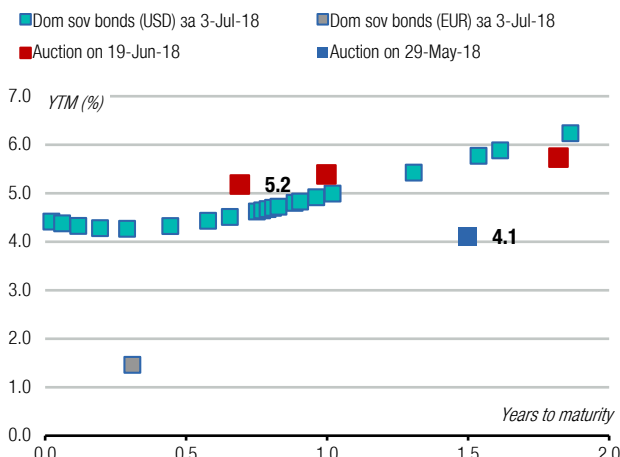
**Chart 2. FX-denominated bonds**

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 decline**

Last week’s negative impact from Treasury operations caused a decline in banking-sector liquidity, which should continue this week.

The Treasury’s impact on liquidity was unsteady last week. On Monday, outflows via non-monetary operations were UAH3.5bn, including UAH3.3bn of outflows to the Treasury, and UAH0.2bn was exchanged in cash.

Last Tuesday, banks continued to exchange reserves into cash, causing an outflow UAH1.2bn, but with an inflow from the Treasury of UAH0.5bn, the negative impact was reduced to UAH0.7bn. The positive impact from the Treasury was due to a large amount of VAT refunds, which compensated outflows from the budget with a positive balance of daily operations. But last Wednesday, the Treasury impact once more was negative with UAH2.8bn of outflow.

As a result, last week, liquidity fell to UAH109.6bn after more than a month of having stayed above UAH110bn. At the end of last week, UAH46.4bn was in banks’ correspondent accounts with the NBU, and UAH63.2bn was invested in CDs.

**ICU view: Liquidity remained close to UAH110bn. With a large number of CDs, it will probably stay at this level for this week, when liquidity will be under the impact from operations with cash and NBU’s operations with FX, causing additional volatility.**

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

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

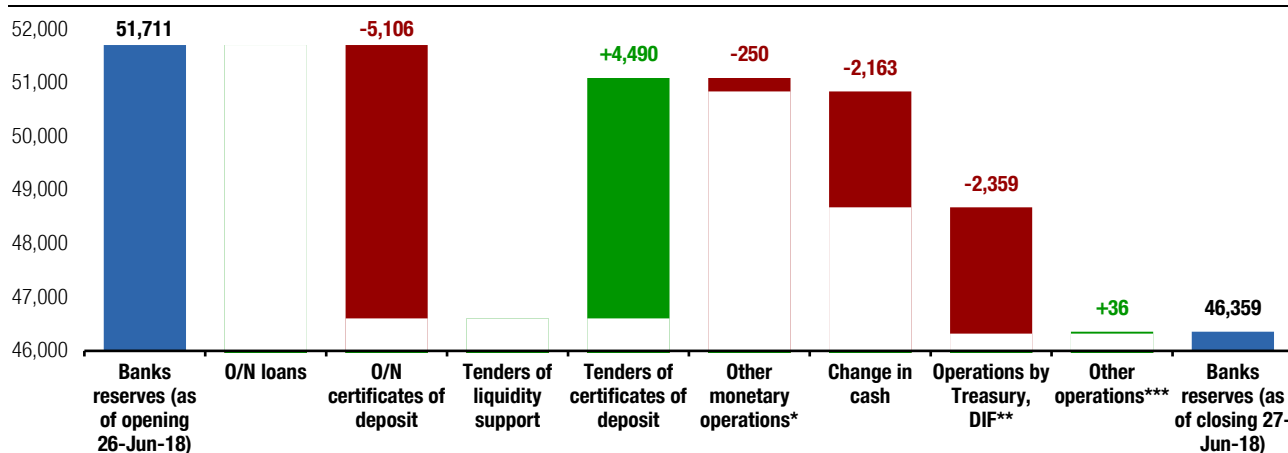
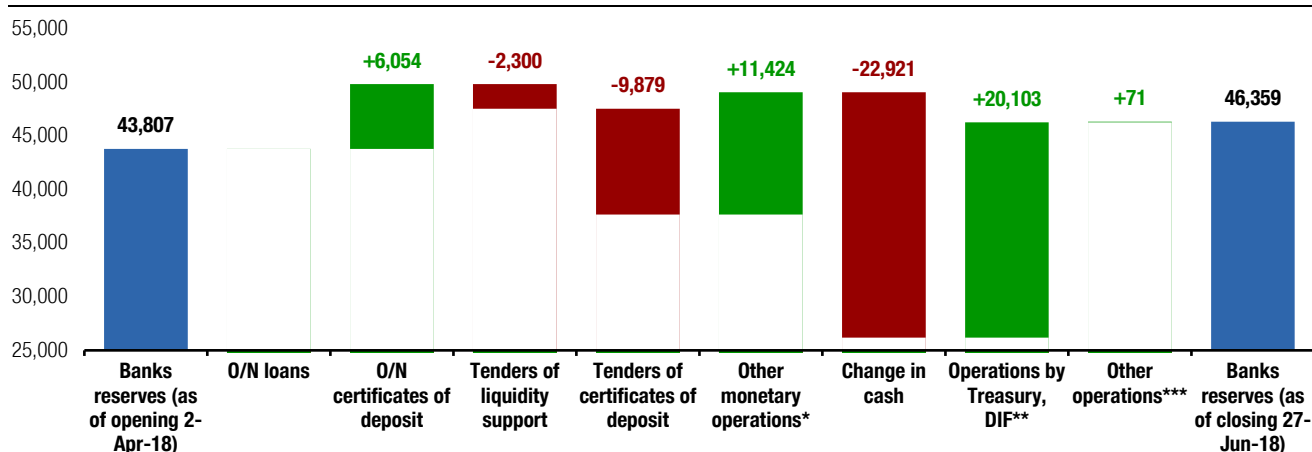


Chart 4. Banks reserves usages over last 90-day period (UAHm)



Notes: [1] data from the NBU's daily reporting [https://bank.gov.ua/control/uk/publish/article?art\\_id=38643651&cat\\_id=40807142](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

### Weaker UAH against a backdrop of VAT refund

This week, the hryvnia's exchange rate will remain volatile due to redemptions of domestic government bonds and repayment of dividends to foreign investors.

The hryvnia started last week strengthening 0.2% to 26.1736 UAH/USD, and remained stable on Tuesday. However, due to the VAT refund of UAH5.4bn during the first two days of the week (the largest refund was on Tuesday), which led to a contraction of foreign currency supply, on Wednesday, the hryvnia opened the trading session with a decline of 0.5%, and did not manage to recover losses by the end of the trading session.

Thus, last week, the Ukrainian currency weakened 0.3% to 26.3085 UAH/USD.

The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries trade partners of Ukraine) increased 0.2% to 123.48 for the period. In year-on-year terms, real trade-weighted indices (CPI and PPI based) increased 8.2% and 15%, respectively, which implies faster prices growth in Ukraine compared with its main trade partners.

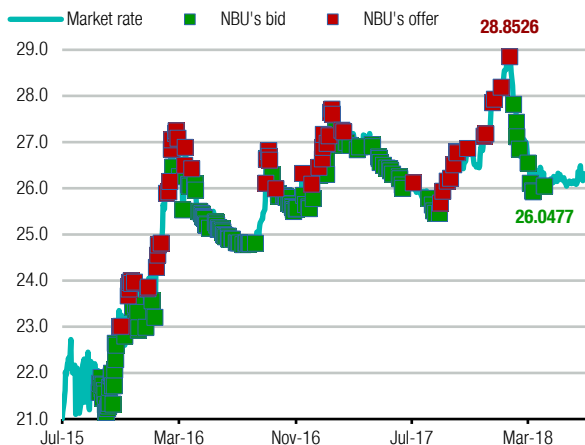
**ICU view:** This week, we expect the retirement of domestic government bonds in the amount of UAH3.1bn, and increased demand for foreign currency for dividend

repayments to foreign investors. This implies that the hryvnia will remain under pressure from increased FX demand.

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

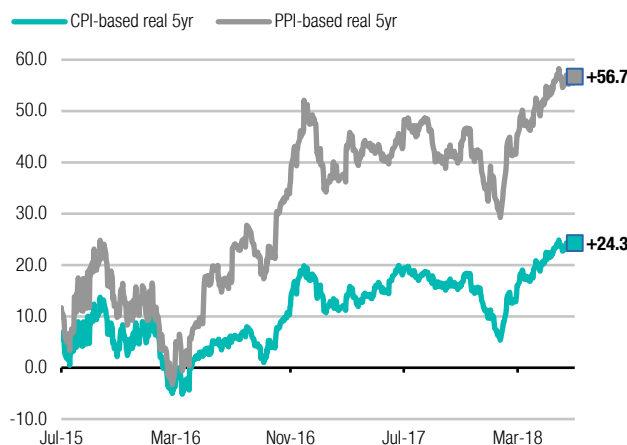
**Chart 5. FX market indicators, 3-year history**

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<sup>1</sup> from fundamental level<sup>2</sup> (%)



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

## Economics

### Sovereign debt outstanding declines

During May 2018, the total amount of state and state-guaranteed debt declined once again. But later this year after external borrowings and seasonal weakening of the hryvnia, the debt dynamic could be in the opposite direction.

During the first five months of this year, the total amount of sovereign debt was at the highest level at the end of March at US\$77.4bn if calculated in US dollars. In local-currency terms, sovereign debt was the highest at the beginning of the year at UAH2.14tn. Thanks to the hryvnia strengthening, as exchange-rate appreciation was 7% during this five-month period, and a low level of financing in FX, as actual new borrowings were lower than principal repayments including repayments of state-guaranteed debt. Taking into account all these factors, at the end of May 2018, total debt outstanding calculated in US dollars was US\$77.3bn, and in local-currency terms, debt declined to UAH1.99bn.

In dollar terms, debt is at the same level as at the beginning of the year. The largest decline this year was in external debt: US\$0.9bn of state debt and the same amount from guaranteed debt, while domestic debt rose by US\$1.8bn. At the same time, in hryvnia terms, total debt outstanding declined UAH148bn including UAH97bn of state debt and UAH46bn of guaranteed debt. Key drivers of the decline were redemption of external debt denominated in FX, and the low amount of new FX-denominated borrowings, and also the positive impact of the exchange rate.

Due to the abovementioned factors, the FX structure of debt changed, and the share of debt in hryvnia rose to 32.2% from 30% at the beginning of the year. Shares of foreign currencies mostly declined: the SDR share fell to 17.1% from 18.4%, the USD declined 76bp to 41.95%, the EUR slid by 12bp to 7.6%, and the CAD declined just by 2bp to 0.4%. Of foreign currencies, only the JPY share rose by 3bp to 0.76%.

**ICU view: According to the state budget for 2018, US\$3bn of new external borrowings is planned, which will increase the FX-denominated portion of debt. Also, after the new tranche from IMF is received, the amount of guaranteed debt also will rise. So, the total amount of sovereign debt should increase with an increase in the FX share. This will increase sensitivity to exchange rate movements.**

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

### **The state budget is in deficit**

At the end of May, the state budget deficit was UAH9.2bn, and its general-fund deficit was UAH14.2bn. At the same time, the amount of the deficit declined for both during May from UAH20.6bn and UAH25.5bn, respectively.

According to the Ministry of Finance's report, the state budget collected UAH369.7bn of revenues with UAH379.9bn of expenditures during this five-month period. During the same period in 2017, the state budget had a surplus, due to the high level in the special budget funds, although the general fund had a UAH6.6bn deficit.

This year, the main source of revenues was VAT, which came in at a net UAH147.4bn. Also, corporate taxes brought in UAH50.6bn, and UAH40.4bn of excise taxes were collected. But due to the strengthening of the hryvnia since February, excise tax, and other taxes collected by custom services, were lower than planned.

Additional support for revenues was provided by funds transferred by the NBU, as its profit from last year amounted to UAH32bn, including UAH17bn in May, and UAH7.9bn of revenues from licenses for 4G mobile networks.

Inter-budget transfers recorded the largest expenditures for a 37.4% share (UAH142.1bn), social expenditures were 17.2% (UAH65.4bn), and 13.4% (UAH50.8) were debt-service payments.

**ICU view: Budget performance in May improved due to quarterly tax payments and revenues from NBU. In June, NBU paid the next tranche to the budget, which amounted to UAH6bn. More than UAH15bn was received to the budget from other government institutions, which were primarily payments from Naftogaz as dividends from recent years. Finally, in 1H18, the budget performance should be in line with the first five-month period of this year. However, for 2H18, we expect fewer resources from non-tax revenues.**

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

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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](http://www.icu.ua)



## INVESTMENT ADVISORY

**Makar Paseniuk, CFA**, Managing Partner  
[makar.paseniuk@icu.ua](mailto:makar.paseniuk@icu.ua)

**Ivan Shvydanenko**, Director  
[ivan.shvydanenko@icu.ua](mailto:ivan.shvydanenko@icu.ua)

**Roman Nikitov, ACCA** Director  
[roman.nikitov@icu.ua](mailto:roman.nikitov@icu.ua)


**Yuriy Kamarytskyi**, Vice President  
[yuriy.kamarytskyi@icu.ua](mailto:yuriy.kamarytskyi@icu.ua)

**Ruslan Kilmukhametov**, Director  
[ruslan.kilmukhametov@icu.ua](mailto:ruslan.kilmukhametov@icu.ua)


**Ruslan Patlavsky**, Director  
[ruslan.patlavsky@icu.ua](mailto:ruslan.patlavsky@icu.ua)

## ASSET MANAGEMENT

**Grigoriy Ovcharenko**, Director  
Head of Local Asset Management  
[grigoriy.ovcharenko@icu.ua](mailto:grigoriy.ovcharenko@icu.ua)

**Liliya Kubytovych**   
Head of Marketing and Sales  
[liliya.kubytovych@icu.ua](mailto:liliya.kubytovych@icu.ua)


## TRADE OPERATIONS

**Konstantin Stetsenko**   
Managing Partner  
[konstantin.stetsenko@icu.ua](mailto:konstantin.stetsenko@icu.ua)

**Vlad Sinani**, Director  
Strategy and Business Development  
[vlad.sinani@icu.ua](mailto:vlad.sinani@icu.ua)


**Sergiy Byelyayev**  
Head of Fixed-Income Trading  
[sergiy.byelyayev@icu.ua](mailto:sergiy.byelyayev@icu.ua)

**Yevgeniya Gryshchenko**  
Head of Brokerage Services Department  
[yevgeniya.gryshchenko@icu.ua](mailto:yevgeniya.gryshchenko@icu.ua)

**Vitaliy Sivach**   
Trader, Fixed-Income & Forex  
[vitaliy.sivach@icu.ua](mailto:vitaliy.sivach@icu.ua)


**Bogdan Vorotilin**   
[bogdan.vorotilin@icu.ua](mailto:bogdan.vorotilin@icu.ua)

## RESEARCH

**Alexander Valchyshen**   
Head of Research  
[alexander.valchyshen@icu.ua](mailto:alexander.valchyshen@icu.ua)

**Taras Kotovych**   
Senior financial analyst (Sovereign debt)  
[taras.kotovych@icu.ua](mailto:taras.kotovych@icu.ua)

**Alexander Martynenko**   
Head of corporate research  
[alexander.martynenko@icu.ua](mailto:alexander.martynenko@icu.ua)

**Mykhaylo Demkiv**   
Financial analyst (Banks)  
[mykhaylo.demkiv@icu.ua](mailto:mykhaylo.demkiv@icu.ua)

**Dmitriy Dyachenko**  
Junior financial analyst  
[dmitriy.dyachenko@icu.ua](mailto:dmitriy.dyachenko@icu.ua)

**Artem Gladchenko**  
Junior financial analyst  
[artem.gladchenko@icu.ua](mailto:artem.gladchenko@icu.ua)

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