Focus	Markets	Research team
Ukraine	**Domestic liquidity, government bonds, FX market, and macro**	

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Weekly Insight

Real GDP rises 3.8% YoY in 2Q18

Key messages of the today's comments

WEDNESDAY, 26 SEPTEMBER 2018

Domestic liquidity and bonds market

MoF keeps rates steady

Last week, the cut-off rate at the primary auctions remained steady and borrowings were low. Attempts to find a compromise will continue.

Liquidity steady thanks to the NBU

Last week, liquidity became steady, and with loans from NBU, rose above UAH76bn, keeping volatility risk at bay for this week.

Foreign exchange market

Hryvnia is set to remain stable

In the absence of external shocks, the hryvnia will remain stable this week thanks to balanced FX supply and demand.

Economics

Real GDP rises 3.8% YoY in 2Q18

The State Statistics Service improved its estimate of the real GDP growth in 2Q18 by 0.2ppt to 3.8% YoY and 1% QoQ SA. Ukraine's economy will expand 3.5% in 2018 thanks to solid domestic demand, further growth of investments, and favourable external conditions.

Industrial production fell 0.5% YoY in August

Industrial output contracted for the first time this year in YoY terms after 2.9% YoY growth in July. Growth of the industrial sector will resume in the following months thanks to robust domestic consumption and higher investments in the mining sector.

Retail trade increased 7.5% YoY in August

Increasing household incomes and growing consumer demand will continue to support retail sales.

Banks' reserves market (25 September 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	18.00	+0bp	+550bp
ON rate (%)	17.82	-32bp	+662bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	51,971	-2.49	+5.84
DepCerts (UAHm)[3]	24,274	+16.70	-30.14

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) (25 September 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	348,104	+0.00	-3.90
Banks	369,738	+0.04	+20.24
Residents	20,289	+0.53	-10.48
Individuals	4,754	+2.82	+534.00
Non-res[4]	7,282	-2.38	+171.82
Total	**750,167**	**+0.03**	**+7.81**

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

FX market indicators (25 September 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	28.0200	-0.08	+6.42
EUR/USD	1.1767	+0.81	-0.68
DXY[2]	94.133	-0.43	+1.60
UAH TWI[3]	115.167	-0.52	+2.44

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

Gov't bond quotes[1] (26 September 2018)

Maturity	Bid	Ask
6m	**19.75**	**18.00**
12m	**19.75**	**18.00**
2y	**19.50**	**17.50**
3y	**19.50**	**17.25**
12m ($)	**6.00**	**5.00**
2y ($)	**6.00**	**5.15**

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

READ FIRST THE DISCLOSURES SECTION (ON LAST PAGE) FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

Domestic liquidity and bonds market

MoF keeps rates steady

Last week, the cut-off rate at the primary auctions remained steady and borrowings were low. Attempts to find a compromise will continue.

Market players of recent weeks are still trying to get higher rates for FX-denominated bills, but considering the low amounts involved, the Ministry decided to keep rates steady. As we surmised, the reason for the decision to reject bids was that small amount cannot be expensive, and last week, the Government Commissioner for Public Debt Management confirmed our assumption. So, the cut-off rate remained at 5.95%, which could be the benchmark for all USD-denominated bills following weeks.

For local-currency bills, rates rose immediately after the NBU changed its key rate. For maturities up to one year, the MoF set the cut-off rate at 18.5%. For longer maturities, the MoF's view could be that yields should be lower, at about 17.0–17.1% for 3-year bills, or 20-30bp above the level seen in August, and a similar increase could be seen for five-year paper to about 16.2%.

ICU view: In our view, the MoF's expectations are that next year interest rates will slide as inflation declines. The MoF is not going to borrow expensive funds. So, it is more likely that expensive demand will be rejected instead of increasing rates significantly.

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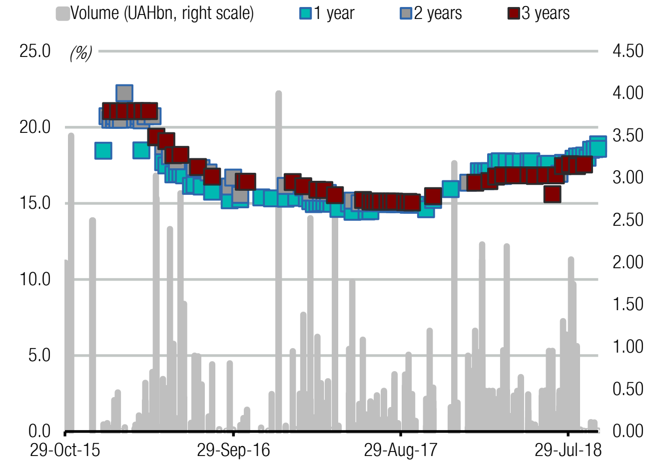
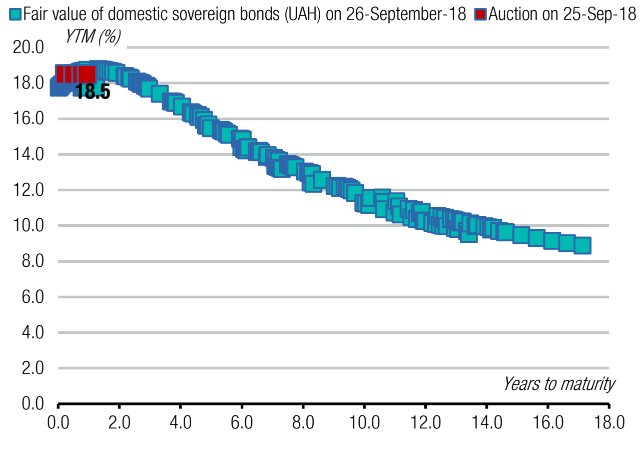
Chart 1. Local-currency bonds

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.

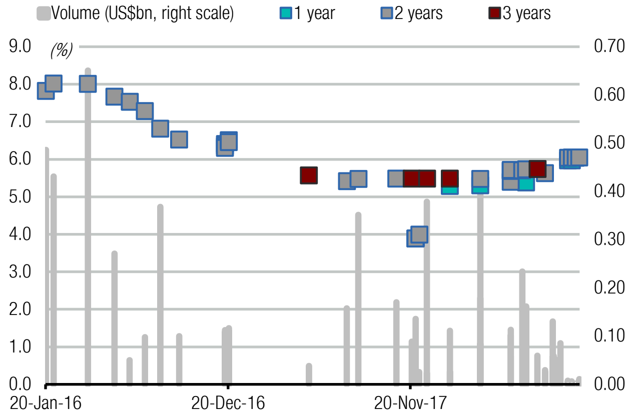
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

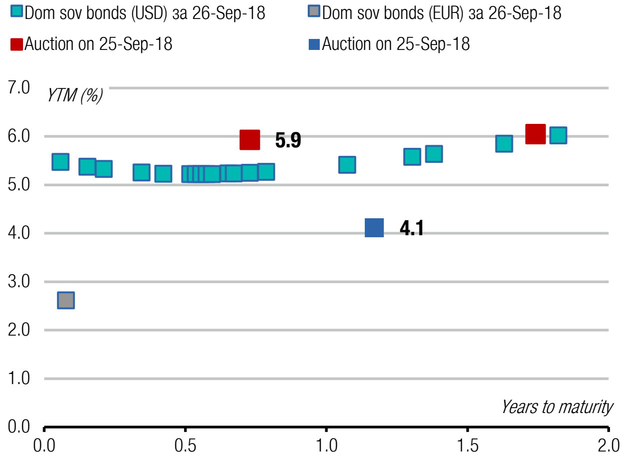
Chart 2. FX-denominated bonds

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 steady thanks to the NBU

Last week, liquidity became steady, and with loans from NBU, rose above UAH76bn, keeping volatility risk at bay for this week.

After liquidity fell a few times to UAH70bn, the high cost of funding forced one bank to take ON loans amounting to UAH2.9bn, and last Wednesday it requested a three-month loan. This brought liquidity above UAH76bn, as the NBU did not deal in FX last week, and the net impact from non-monetary operations was low at UAH748m of inflows. At the same time, inflows were mostly at the beginning of last week while at the end of the week, there were outflows in cash and treasury operations bringing net funds to a near-zero balance.

ICU view: This current week could see a new wave of volatility caused by a mismatch of cash flows from tax payments and VAT refunds. Without NBU participation in the FX market, liquidity should remain at the current level.

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

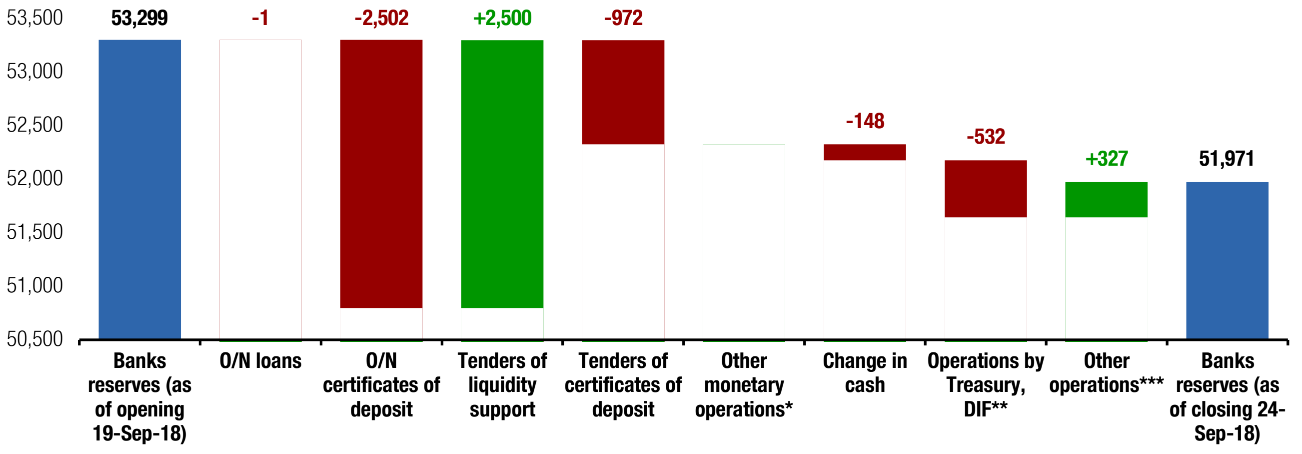
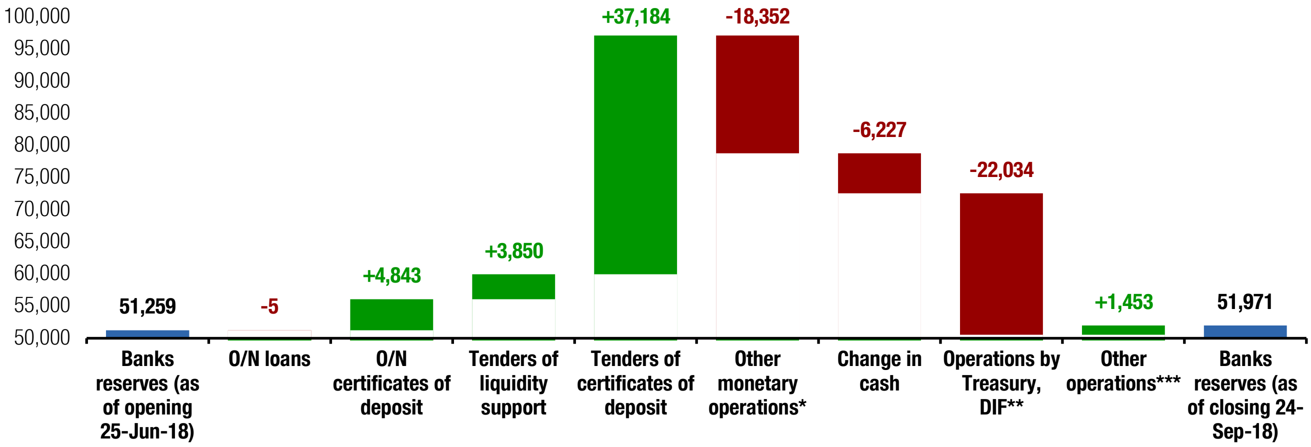


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

Hryvnia is set to remain stable

In the absence of external shocks, the hryvnia will remain stable this week thanks to balanced FX supply and demand.

Last week, a number of positive factors supported the UAH including: 1) a low level of liquidity in the banking system (see the comment on liquidity), 2) the absence of negative news on the results of the IMF mission, and 3) an improvement in Ukraine's real GDP growth by 0.2ppt to 3.8% YoY (see the next comment). Thus, against this background, the hryvnia strengthened 0.2% to 28.05 UAH/USD.

The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) decreased 0.7% to 115.4 for the period, while in YoY terms it was up 3%.

ICU view: We do not expect significant UAH volatility this week. On the one hand, there will be increased demand for the hryvnia to make monthly tax payments, but on the other hand, about UAH6bn of VAT will be refunded from the budget, which will allow exporters to retain FX currency. This implies that FX supply and demand will be balanced, which should support the stability of the hryvnia.

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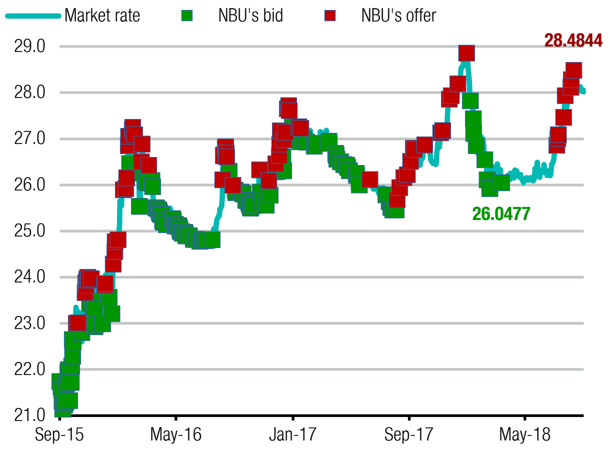
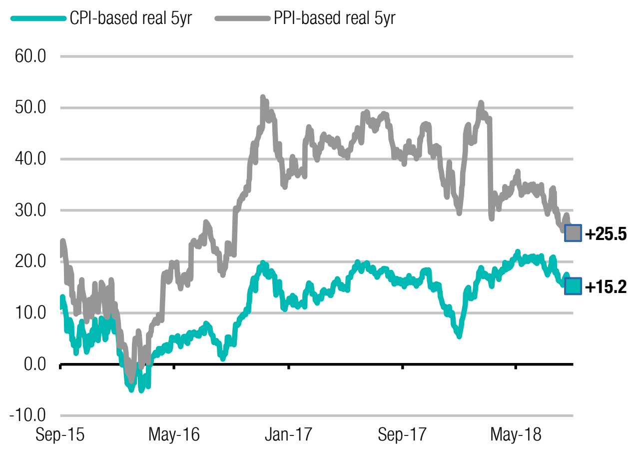
Chart 5. FX market indicators, 3-year history

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

Real GDP rises 3.8% YoY in 2Q18

The State Statistics Service improved its estimate of the real GDP growth in 2Q18 by 0.2ppt to 3.8% YoY and 1% QoQ SA. Ukraine's economy will expand 3.5% in 2018 thanks to solid domestic demand, further growth of investments, and favourable external conditions.

On the production side, almost all sectors posted growth except for education (-1.9% YoY). The key drivers were 1) the agricultural sector (+19.3% YoY), thanks to an early start of harvesting this year, which added 0.9ppt to the total reading of 3.8% growth, and 2) wholesale and retail trade (+3.4% YoY) against the backdrop of rising real incomes and remittances, which added 0.5ppt to the total reading.

On the demand side, solid growth was posted in fixed investments (+14.2% YoY), and government consumption (+11% YoY). However, the key driver remained household consumption (+4.2% YoY), which accounts for the largest part of GDP. Real exports remained almost unchanged, while real imports grew 3% YoY, constraining real GDP growth.

Nominal GDP rose 21.4% YoY to UAH807bn, while the GDP deflator was 17% YoY. On a 12-month-rolling basis, nominal GDP increased to UAH3.24tn, which is the equivalent of US$122bn.

ICU view: Ukraine's economy is set to expand further thanks to 1) solid domestic demand against the backdrop of rising real incomes, remittances, and further expansion in consumer lending, 2) a further increase in private and government investment, and 3) favourable external conditions. We retain our forecast of 3.5% real GDP growth for 2018.

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Industrial production fell 0.5% YoY in August

Industrial output contracted for the first time this year in YoY terms after 2.9% YoY growth in July. Growth of the industrial sector will resume in the following months thanks to robust domestic consumption and higher investments in the mining sector.

In SA terms, industrial output declined 0.7% MoM. The processing industry, which accounts for 57% of total industrial output, declined 0.5% YoY, not least due to the high base effect of the last year, when growth was 5.6% YoY. Only the chemical industry (+10.3% YoY), and metallurgy (+1.7% YoY) grew. In seasonally adjusted MoM terms, the processing industry remained practically flat.

A significant decrease was posted in the utilities sector (-6.4% YoY and -3.5% MoM SA), while the mining and quarrying sector expanded 2.3% YoY, but declined 0.1% MoM SA.

ICU view: Industrial production will resume growth in the following months thanks to 1) robust domestic consumption (see the next comment), 2) higher investments in the mining sector, 3) an increase in gas production—the number of new gas wells in the private sector rose 65% YoY in 1H18. We maintain our forecast of 3% growth for the industrial sector in 2018.

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Retail trade increased 7.5% YoY in August

Increasing household incomes and growing consumer demand will continue to support retail sales.

Retail turnover increased by 7.5% YoY in August and by 5.4% over the 8M18. According to seasonally adjusted data, retail turnover of retail trade enterprises grew by 1.8% MoM in August. By region, the highest growth of retail trade in January–August 2018 was observed in Luhansk (27.9% YoY), Donetsk (13.3% YoY), Poltava (10.8% YoY), Zakarpattya (10.2% YoY), and Kyiv (10% YoY).

ICU view: The growth of retail sales is supported by rising incomes (through wage and pension growth) and remittances of migrant workers, which should continue.

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