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Weekly Insight

NBU satisfied with stress tests

Key messages of the today's comments

TUESDAY, 9 OCTOBER 2018

Domestic liquidity and bonds market

MoF hike rates

Interest rates of government bonds moved up last week, and today they could continue to rise, especially for FX-denominated paper.

Liquidity remains low

Without refinancing loans from the NBU, the total amount of banking-sector liquidity remained below UAH80bn. An increase this week is unlikely.

Foreign exchange market

Imbalance towards higher FX supply supported UAH

This week, the hryvnia will remain relatively stable thanks to balanced FX supply and demand. A slight strengthening of the hryvnia is possible thanks to the lack of cheap UAH funds in the market.

Economics

NBU satisfied with stress tests

NBU is satisfied with the results of the 2018 stress tests (ST) and assets quality review (AQR) of the Ukrainian banking system. Only eight banks require capital injections totaling UAH6.1bn under the base-case scenario.

C/A deficit on the rise

The 12-month rolling C/A deficit widened to 3% of GDP or US$3.7bn (+2.2x YoY) in August. Despite rising energy and consumer imports, the C/A balance will be close to the current level thanks to higher-then-expected steel prices and rising inflows of remittances.

Banks' reserves market (8 October 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	18.00	+0bp	+550bp
ON rate (%)	18.03	-12bp	+613bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	48,349	+0.61	+9.63
DepCerts (UAHm)[3]	24,479	-1.05	+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) (8 October 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	348,100	+0.00	-3.46
Banks	367,148	-0.69	+18.69
Residents	21,111	+0.24	-6.84
Individuals	4,635	-3.96	+507.32
Non-res[4]	7,240	-0.18	+158.61
Total	**748,233**	**-0.36**	**+7.48**

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

FX market indicators (8 October 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	28.0800	-0.69	+4.93
EUR/USD	1.1492	-0.48	-2.03
DXY[2]	95.761	+0.27	+2.09
UAH TWI[3]	116.885	+1.65	+3.82

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

Gov't bond quotes[1] (9 October 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 ($)	**7.00**	**5.00**
2y ($)	**7.00**	**5.15**

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

Domestic liquidity and bonds market

MoF hike rates

Interest rates of government bonds moved up last week, and today they could continue to rise, especially for FX-denominated paper.

At last week's primary auction, the Ministry of Finance received new proceeds of budget financing, and has significantly increased borrowings since September. The last auction provided the budget with local-currency funds 2.5x more than last month, and 1.4x more funds in FX after increasing cut-off rates for some maturities. More details are in last week's auction review.

However, funds received only allowed the MoF to refinance a fifth of last week's repayments, since it received UAH0.9bn while repaying UAH4.7bn. As the result, total bonds outstanding fell UAH3.6bn, which takes into account the impact from hryvnia appreciation.

ICU view: Last week, the MoF refinanced only a small part of repayments, but demonstrated its readiness to increase rates in order to attract large amounts of funds. As a result, this week, the Ministry could accept higher rates to refinance repayments, and collect FX for the large debt repayments that come due during the following weeks. At the same time, current repayments could be partially refinanced, as this week, redemptions of CLN are scheduled, and foreign investors will probably withdraw their funds from local-currency bills.

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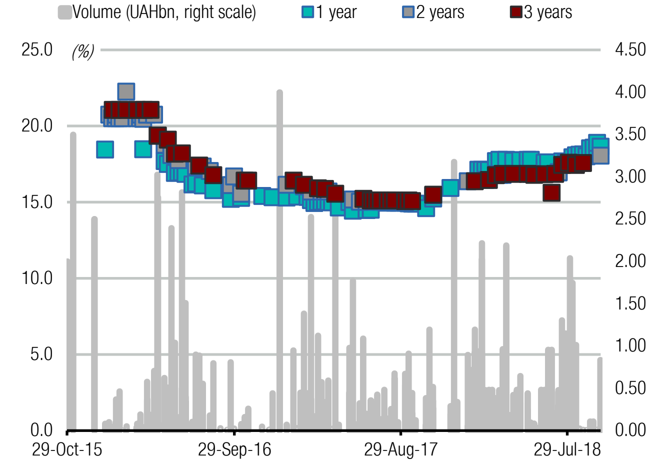
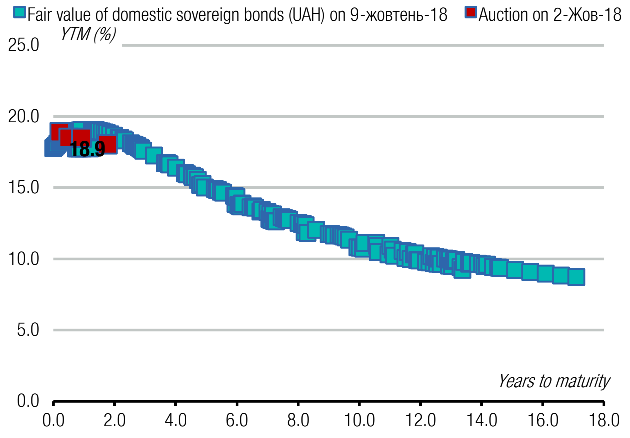
Chart 1. Local-currency bonds

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.

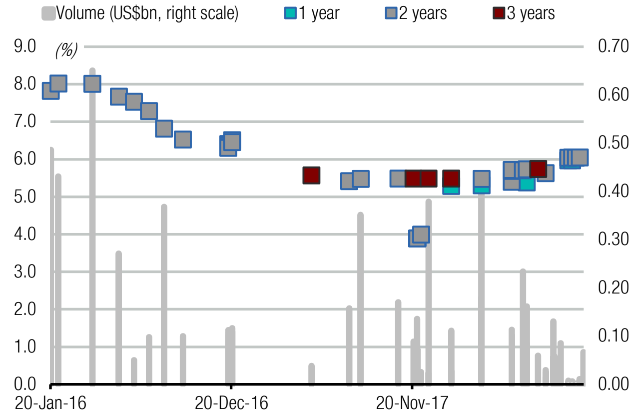
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

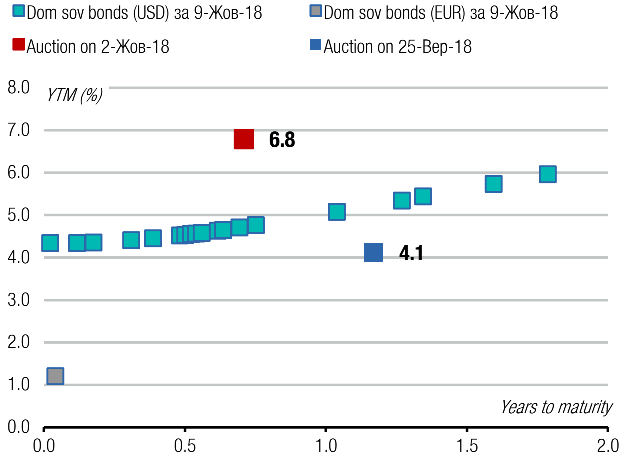
Chart 2. FX-denominated bonds

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 remains low

Without refinancing loans from the NBU, the total amount of banking-sector liquidity remained below UAH80bn. An increase this week is unlikely.

Last week began with a UAH3bn loan repayment to the NBU and funds outflow to state budget. By the end of the day on Monday, liquidity fell below UAH73bn. But with bond redemptions and a low refinancing ratio (see comment above) liquidity received important support. At the end of last week, new support came when the NBU purchased US$65m of FX from the market, but liquidity still remained at around UAH75bn.

ICU view: Hryvnia appreciation should continue this week (see comment below) and NBU could support liquidity with additional FX purchases. So, liquidity should receive new inflows from NBU, and with debt repayments, it could stay at around the current level with slight volatility.

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

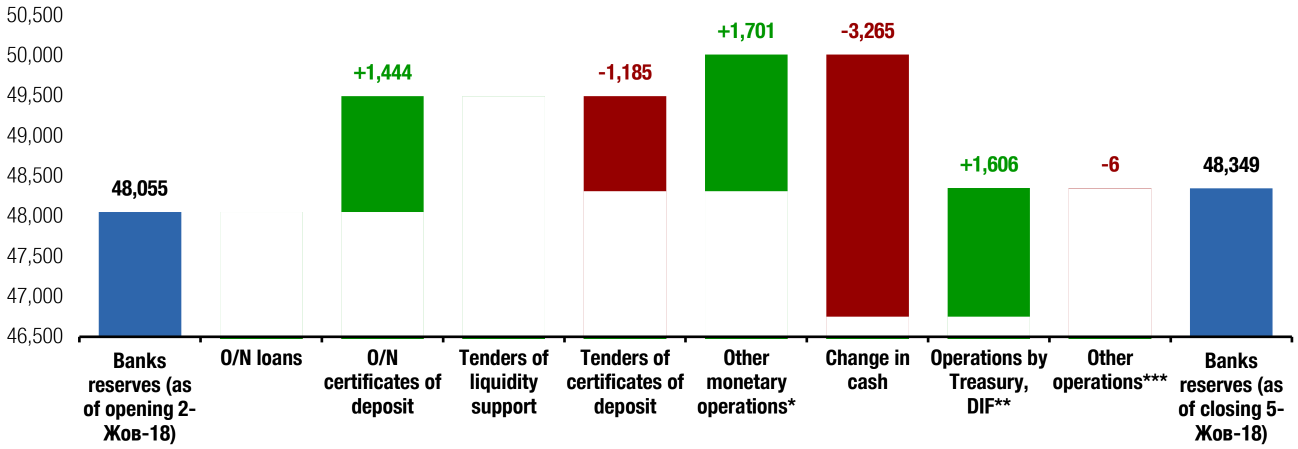
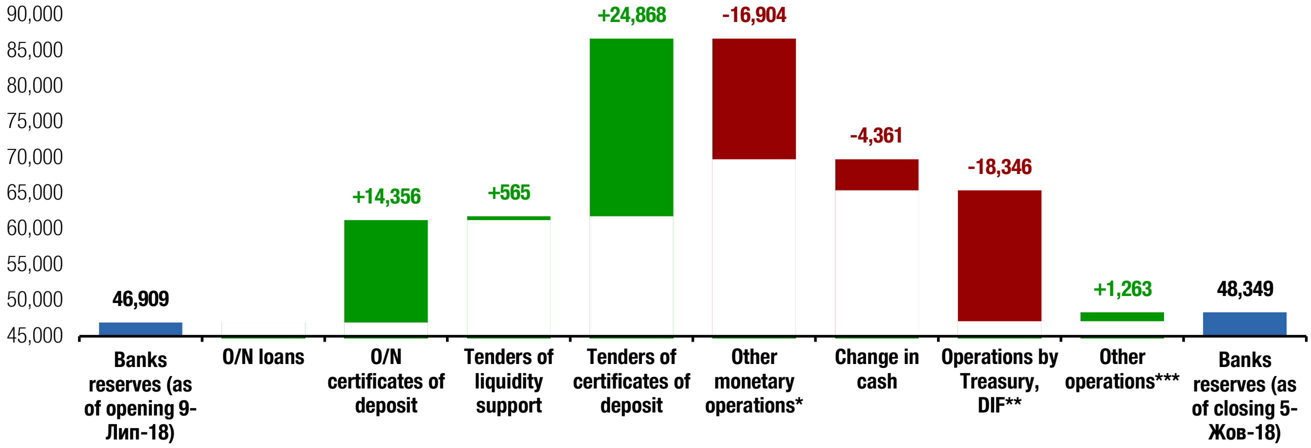


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

Imbalance towards higher FX supply supported UAH

This week, the hryvnia will remain relatively stable thanks to balanced FX supply and demand. A slight strengthening of the hryvnia is possible thanks to the lack of cheap UAH funds in the market.

Last week, FX demand was slightly lower than supply, which had a positive impact on the UAH. There was no increased demand for foreign currency for dividend payments, as most foreign investors had been paid earlier. Also, despite significant volumes of T-bill redemptions, there was no reduction in the portfolio of foreign investors. Thus, last week, the hryvnia strengthened by 0.5% to 28.10 UAH/USD. It is also worth noting that the NBU prevented a more substantial strengthening of the hryvnia by redeeming about US$65m in the market.

The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) rose 1.4% to 116.5 for the period, while in year-on-year terms, it was up 3.6%.

ICU view: This week we expect the hryvnia to be stable, as FX supply and demand will be balanced. There is a likelihood of continued strengthening of the UAH, as due to UAH sell-off in August-September, investors now face a lack of cheap UAH funds. Still, further strengthening could be hindered by the NBU, which can redeem excess currency from the market to replenish its reserves. Starting at the end of October, pressure on the UAH will increase, and it may weaken to 28.5–29.0 UAH/USD by the end of 2018.

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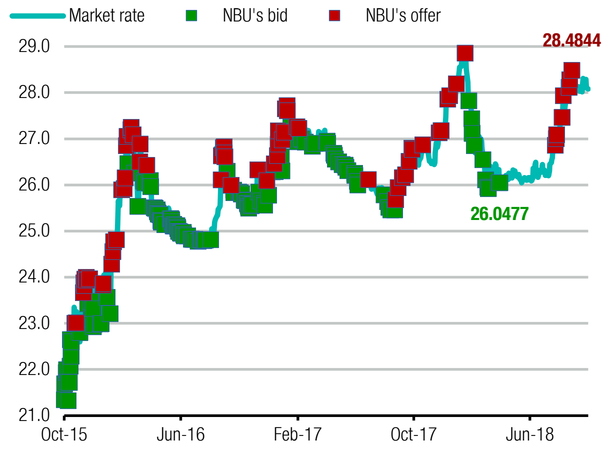
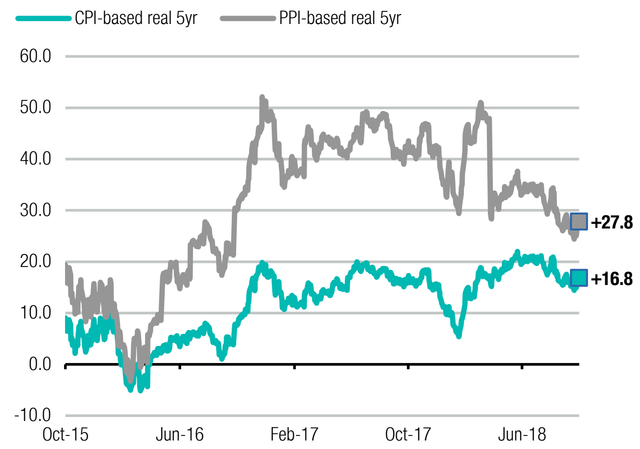
Chart 5. FX market indicators, 3-year history

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

NBU satisfied with stress tests

NBU is satisfied with the results of the 2018 stress tests (ST) and assets quality review (AQR) of the Ukrainian banking system. Only eight banks require capital injections totaling UAH6.1bn under the base-case scenario.

NBU's assessment of the current status of the banking sector revealed positive if not optimistic results. The absolute majority of the banks do not require capital injections under the base-case scenario. Only eight banks have a total recapitalization need of UAH6.1bn after the ST. Two smaller banks require a recapitalization program as the result of the assets quality review. Banks will have until the end of March 2019 to raise the necessary capital.

These findings are better than the previous tests in 2015 that revealed a massive (8% of GDP) need for capital. A large number of banks have been either recapitalized or went bankrupt, while the largest, PrivatBank, was nationalized.

Neither banks with European capital nor state-owned Ukrainian banks require additional capital injections under the base-case scenario. In particular, there is a difference of views regarding Oschadbank. Some believe it should create additional provisions for bad loans, which will require a capital injection from the principal shareholder, the Ministry of Finance. NBU seems to be skeptical of this necessity, and advocates for more effective debt collection. Capital injection might be a key issue for the Oschadbank to get the EBRD as its minority shareholder.

ICU view: There is a likelihood that one or several banks from the list will fail to get the necessary capital injections. However, failure of one or all of those institutions won't threaten the current stability of the banking sector. Detailed per-bank results will be released at the end of 2018.

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C/A deficit on the rise

The 12-month rolling C/A deficit widened to 3% of GDP or US$3.7bn (+2.2x YoY) in August. Despite rising energy and consumer imports, the C/A balance will be close to the current level thanks to higher-then-expected steel prices and rising inflows of remittances.

According to the NBU, the C/A gap was US$2.1bn (+2.5 times YoY) in 8M18, having increased from US$1.5bn in 7M18, primarily due to higher growth rates of imports compared with those of exports.

Imports of goods into Ukraine rose 15.3% YoY to US$35.5bn. The key growth drivers were machinery and equipment (+15% YoY), energy imports (+13% YoY), and chemical products (+12% YoY). Ukraine's exports of goods rose 11.6% YoY and amounted to US$28.2bn. The main contributors to export growth were metals (+28% YoY), which account for 60% of the increase in exports, chemical products (+26% YoY), and wood and wood products (+28% YoY).

In 8M18, the merchandise-trade-balance deficit surged 32% YoY to US$7.3bn, while the services-trade-balance surplus fell 8% YoY to US$0.5bn, bringing the total trade-balance deficit to US$6.8bn (+36% YoY). Still, an increase of 34% YoY of remittances to US$7.7bn (ICU estimate) gave significant support to C/A balance.

ICU view: C/A will continue to be under pressure from rising energy and consumer imports. On the flip side, it will be supported by higher-than-expected steel prices and rising inflows of remittances. We maintain our C/A balance forecast at US$3.8bn or 3% of GDP in 2018.

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