Focus
Ukraine

Markets
Domestic liquidity, government bonds, FX market, and macro

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Weekly Insight

Real GDP rose 2.8% YoY in 3Q18

Key messages of the today's comments

Domestic liquidity and bonds market

Low activity in bond market

The primary bond auction did not attract sufficient demand last week, and the Ministry was in no hurry to accept demand that was expensive. Bidders found FX-denominated bonds more attractive than local currency, and they provided the main part of financing for the budget.

Liquidity down

Last week, local-currency liquidity in the banking system was under pressure from outflows to Treasury accounts. This could reserve this week due to the first tranches of VAT refunds.

Foreign exchange market

Hryvnia appreciates on liquidity outflows

The hryvnia continued to appreciate last week, and the NBU continued to purchase extra FX. But this week, the situation could reverse, and hryvnia will start to weaken.

Economics

Real GDP rose 2.8% YoY in 3Q18

Ukraine's real GDP growth slowed to 2.8% YoY in 3Q18, down from 3.8% YoY in 2Q18, while in SA terms, growth was 0.4% QoQ, per preliminary data from the State Statistics Service. Thanks to favourable solid consumer demand, rising investments, and a better harvest this year, real GDP growth will be close to 3.5% in 2018.

Trade-balance deficit surged 3.1 times YoY in 9M18

The trade-balance deficit of goods and services expanded to US$3.5bn in 9M18. Growth of consumer imports and higher YoY world energy prices will bring about a further widening of the deficit.

TUESDAY, 20 NOVEMBER 2018

Banks' reserves market (19 November 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	18.00	+0bp	+450bp
ON rate (%)	18.23	+34bp	+463bp
ON $ swap (%)	18.47	+116bp	+584bp
Reserves (UAHm)[2]	50,354	-10.94	-4.52
DepCerts (UAHm)[3]	25,773	-16.96	+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) (19 November 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	348,100	+0.00	-3.46
Banks	360,443	+0.21	+15.22
Residents	19,949	-0.73	-7.74
Individuals	5,540	+2.27	+515.56
Non-res[4]	6,879	-3.69	+29.83
Total	**740,910**	**+0.06**	**+5.66**

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

FX market indicators (19 November 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	27.7225	-0.46	+4.63
EUR/USD	1.1454	+1.45	-2.85
DXY[2]	96.193	-1.14	+2.70
UAH TWI[3]	117.164	-1.13	+2.20

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

Gov't bond quotes[1] (20 November 2018)

Maturity	Bid	Ask
6m	**19.75**	**18.50**
12m	**19.75**	**18.10**
2y	**19.50**	**18.00**
3y	**19.50**	**17.50**
12m ($)	**7.50**	**5.00**
2y ($)	**7.50**	**5.20**

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

Domestic liquidity and bonds market

Low activity in bond market

The primary bond auction did not attract sufficient demand last week, and the Ministry was in no hurry to accept demand that was expensive. Bidders found FX-denominated bonds more attractive than local currency, and they provided the main part of financing for the budget.

Last week, more than half of proceeds from the primary auction was from FX-denominated bills, which are more attractive to the MoF due to debt repayments in FX coming soon. This week, the MoF has to repay US$134m, so most likely it will issue mostly USD-denominated bills.

Local investors continued to prefer FX-denominated bills. They have partially decreased their local-currency bond portfolios, maintaining the level of FX-denominated instruments or adding new bills, especially the portfolios of non-banks and individuals. Foreign investors also purchased some FX-denominated bills prior to redemption, with the local-currency portion of their portfolios declining slightly.

ICU view: Demand for FX-denominated bills will be steady and probably rise due to expectations of the hryvnia's seasonal weakening during the next few months. So, non-banks and individuals will continue to prefer FX-denominated paper. This week, all portfolios could see significant volatility due to refinancing of FX-denominated bills on Wednesday (with actual settlement on Thursday), which means they will purchase fewer new bills. The Ministry of Finance could try to refinance most of this week's repayments, but likely won't if rates are higher, as the government has enough FX in its accounts, and received a significant amount of local-currency funds due to tax payments.

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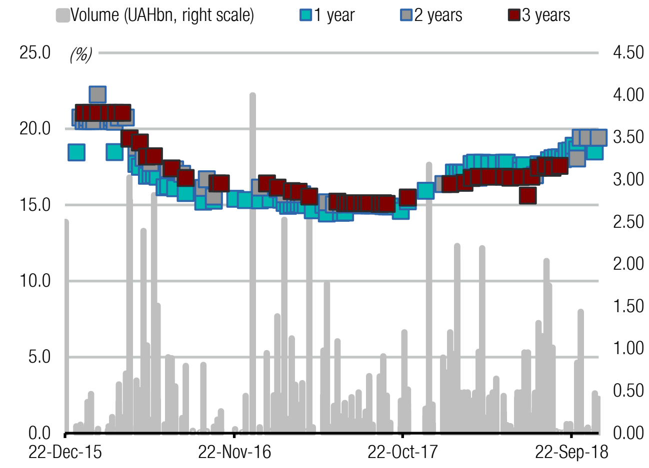
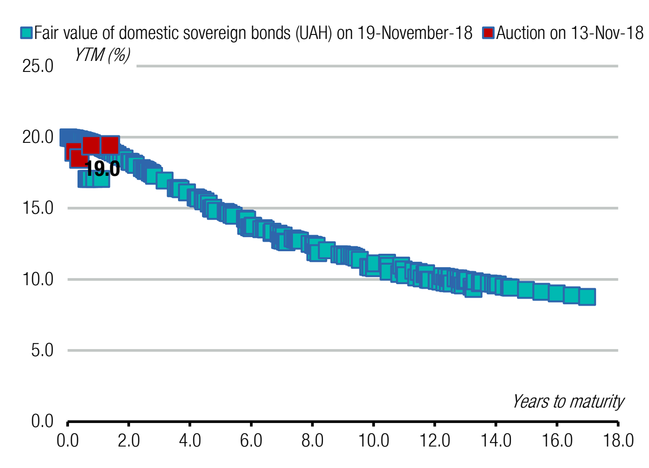
Chart 1. Local-currency bonds

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.

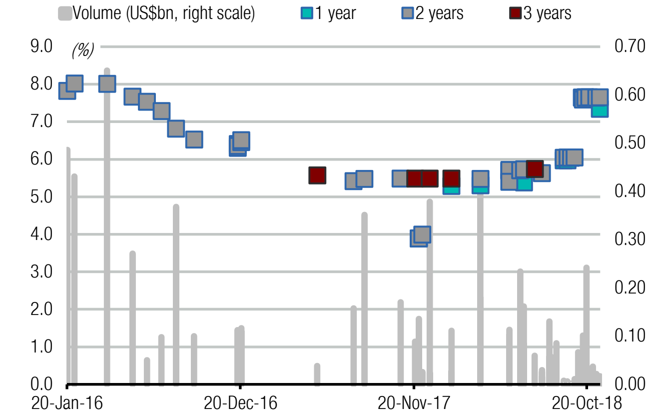
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

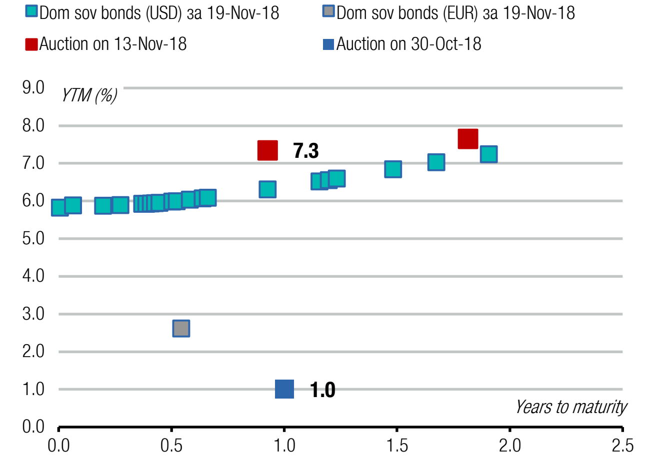
Chart 2. FX-denominated bonds

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 down

Last week, local-currency liquidity in the banking system was under pressure from outflows to Treasury accounts. This could reserve this week due to the first tranches of VAT refunds.

During previous weeks, liquidity was boosted from budget expenditures and from the NBU via the FX market. Last week began with a quite comfortable UAH88.6bn, but by the end of week, liquidity fell to UAH76.1bn. Inflows from NBU through FX purchases did not compensate outflows via non-monetary operations, which was more than three times lower, or UAH2.3bn, instead of UAH14.4bn of outflows to Treasury accounts and in cash.

ICU view: Quarterly corporate tax payments that were seen last week could continue this week, putting additional pressure on liquidity, and pushing it to slightly above UAH80bn. However, at the end of this week, the first payments of VAT refunds from the budget will be made, and liquidity should recover prior to month-end tax payments. At the same time, the NBU can purchase less FX at the market or could start to sell it, which will decrease its injections in liquidity.

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

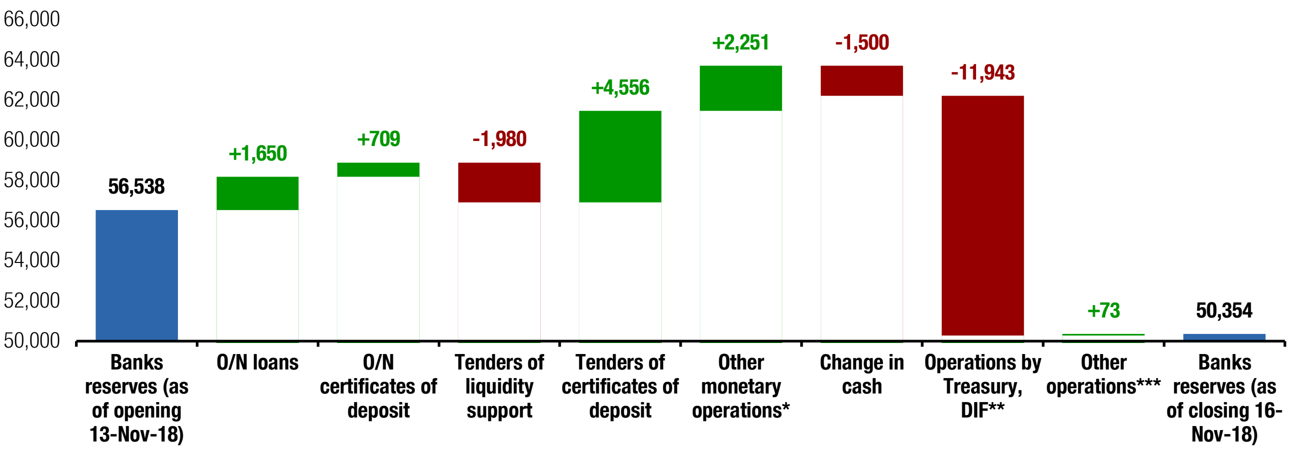
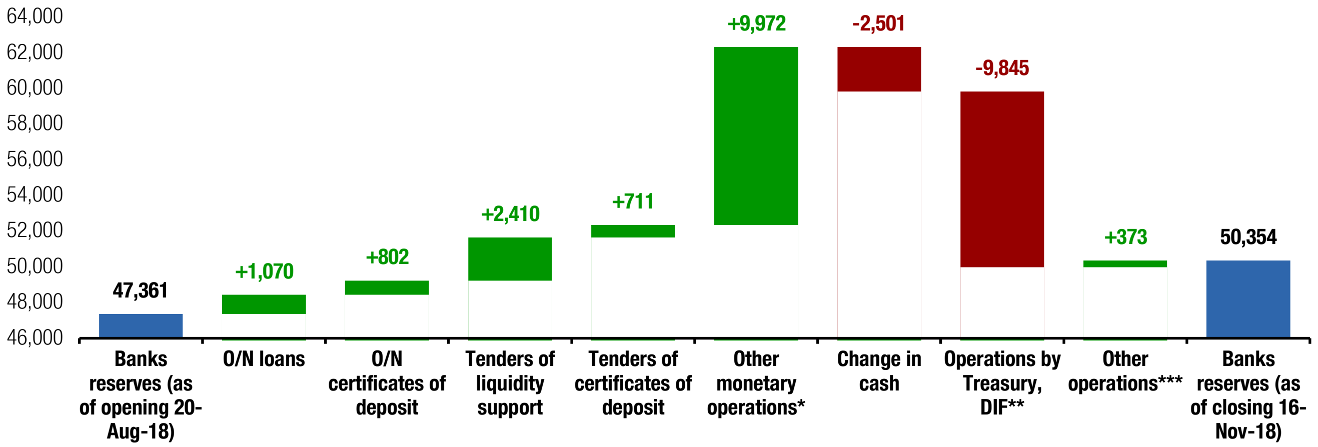


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 appreciates on liquidity outflows

The hryvnia continued to appreciate last week, and the NBU continued to purchase extra FX. But this week, the situation could reverse, and hryvnia will start to weaken.

Last week, the hryvnia appreciated by 0.2% to UAH27.808/USD despite the NBU purchasing US$81m of extra FX supply. This purchase did not stop hryvnia appreciation, since it wasn't sufficient, and kept the exchange rate closer to UAH28/USD. Extra FX offering at the market was caused by local-currency liquidity needs, which was quite expensive. Local-currency funds were needed for quarterly tax payments, and caused extra selling of FX last week.

ICU view: Short-term hryvnia appreciation seen during recent weeks was caused by large amounts of obligatory selling of FX by exporters of agrisector products, and continued due to low liquidity in banking system because of the need to accumulate funds for corporate tax payments to the budget. But this week, we could see hryvnia weaken, as the need for local-currency funds should decline, and the Treasury will increase expenditures and start paying VAT refunds in large amounts. So, this week the hryvnia could cross the UAH28/USD level.

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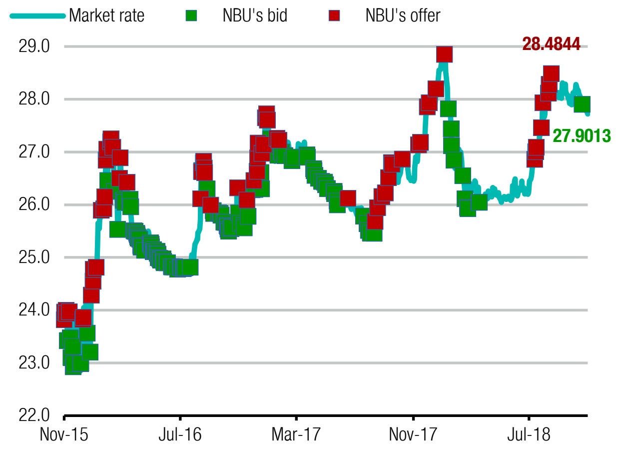
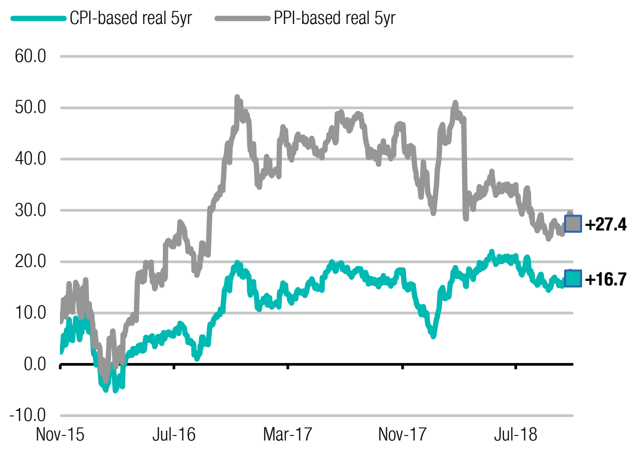
Chart 5. FX market indicators, 3-year history

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 rose 2.8% YoY in 3Q18

Ukraine's real GDP growth slowed to 2.8% YoY in 3Q18, down from 3.8% YoY in 2Q18, while in SA terms, growth was 0.4% QoQ, per preliminary data from the State Statistics Service. Thanks to favourable solid consumer demand, rising investments, and a better harvest this year, real GDP growth will be close to 3.5% in 2018.

According to our estimates, the key drivers of economic growth in 3Q18 remained 1) robust household consumption (retail sales rose 4.1% YoY) against the backdrop of rising real incomes and higher volumes of remittances, and 2) high investment activity (imports of machinery and equipment grew 19.7% YoY in US$ terms).

ICU view: Real GDP growth in 3Q18 was lower than both the NBU's estimate (+3.1% YoY), and ICU's forecast (+3.5% YoY), in large part due to the early harvest, which shifted some growth results from 3Q18 to 2Q18. Our base-case scenario also envisaged better services-sector performance, which along with robust household demand and high investments should have, to some extent, mitigated the impact from negative factors. In 4Q18, we expect real GDP growth to accelerate to 3.6% YoY thanks to 1) better yields of late crops (particularly corn), 2) acceleration of expenditures of central and local governments, and 3) further growth of consumer demand and investment activity. Thus, we maintain our forecast of 3.5% real GDP growth for 2018.

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Trade-balance deficit surged 3.1 times YoY in 9M18

The trade-balance deficit of goods and services expanded to US$3.5bn in 9M18. Growth of consumer imports and higher YoY world energy prices will bring about a further widening of the deficit.

The merchandise-trade balance deficit rose 61% YoY to US$6.5bn in 9M18, per data from the State Statistics Service of Ukraine. Export of goods rose 10.3% YoY or US$3.2bn, to US$34.5bn. The largest contributors to this increase were metals at 56% (US$1.8bn), electric machines at 11% (US$0.3n), and wood and articles made from wood at 8% (US$0.3bn).

Merchandise imports totaled US$41bn, which is 16.1% YoY or US$5.7bn higher compared with 9M17. The largest contribution to this increase was made by machinery and equipment (25%), energy imports (22%), and products of the chemical and allied industries (9%).

The services-trade surplus grew 18% YoY to US$4.6bn. Export of services rose 12% YoY to US$8.8bn, mainly thanks to processing of materials (+57% YoY), and IT services (+16% YoY). Imports of services rose 5% YoY, and amounted US$4.1bn. The drivers were travelling (+27% YoY), and transport services (+14% YoY).

ICU view: The trade-balance deficit is set to widen further in 4Q18 due to higher growth rates of imports against the backdrop of solid consumer imports, higher (YoY) world energy prices, and decreased steel prices (HRC prices fell 7.8% YoY in October and 8.5% YoY in the first 10 days of November). However, better yield of late crops and further growth of the services-trade-balance surplus will to some extent constrain a widening of the trade-balance deficit.

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