Focus

Ukraine

Markets

Domestic liquidity, government bonds, FX market, and macro

Research team

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Weekly Insight

Ukrainian parliament enacts martial law

Key messages of the today's comments

Domestic liquidity and bonds market

Bonds outstanding declined

Last week, total government bonds outstanding declined by about UAH2bn, but this week should remain steady and there is a chance for an increase.

Liquidity remains low

Last week, quarterly tax payments continued, and other cash flows were insufficient to cover outflows to budget. This caused liquidity to decline. However, it could start to recover this week.

Foreign exchange market

Hryvnia holds

Last week, the hryvnia remained steady at around UAH27.8/USD due to low liquidity in the banking system and a higher supply of FX than demand. But this week these factors could reverse and decrease support for hryvnia.

Economics

Ukrainian parliament enacts martial law

We do not foresee significant economic losses due to the introduction of martial law or a possible blockade of Russia trade routes through the Azov Sea. Given further escalation is not likely, negative impact from the conflict and the introduction of martial law on the hryvnia and Ukrainian Eurobonds will fade away.

Rada voted for 2019 budget

Budget deficit remained unchanged after the final reading.

Industrial production rose 1.4% YoY in October

After two months of contraction, industrial output returned to growth, increasing 1.4% YoY in October, bringing the 10M18 reading to growth of 1.8% YoY. Acceleration of budget expenses, resumption of work of several metallurgical plants, and still-solid consumer demand will be key drivers of growth in the following months.

Retail trade turnover rose 5% YoY in October

Household consumption will remain the key driver of economic growth in 2018 and 2019 being supported by further growth of real incomes.

WEDNESDAY, 28 NOVEMBER 2018

Banks' reserves market (27 November 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	18.00	+0bp	+450bp
ON rate (%)	18.86	+45bp	+666bp
ON $ swap (%)	18.65	+0bp	+667bp
Reserves (UAHm)[2]	59,009	+14.10	+7.72
DepCerts (UAHm)[3]	17,808	-21.98	-32.37

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) (27 November 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	348,100	+0.00	-3.46
Banks	359,358	-0.08	+16.17
Residents	19,533	-1.54	-8.25
Individuals	5,657	+1.58	+405.67
Non-res[4]	6,624	-5.87	+35.31
Total	**739,271**	**-0.12**	**+6.04**

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

FX market indicators (27 November 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	28.1275	+1.46	+4.89
EUR/USD	1.1289	-0.83	-5.12
DXY[2]	97.369	+0.68	+4.81
UAH TWI[3]	116.684	-0.62	+3.71

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

Gov't bond quotes[1] (28 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

Bonds outstanding declined

Last week, total government bonds outstanding declined by about UAH2bn, but this week should remain steady and there is a chance for an increase.

Over the three weeks, the MoF borrowed UAH3.6bn, including proceeds from FX-denominated bills, while repaying sufficiently larger amount of funds—UAH5.3bn in local-currency and US$130.8m (UAH3.6bn) in FX—for principal repayments. Also, the hryvnia remained steady last week below UAH28/USD, which also decreased outstanding of FX-denominated debt. For these reasons, total bonds outstanding declined UAH5.9bn so far November.

Bondholders' portfolios (excluding NBU) mostly declined, except individuals, who continued to increase their portfolios. Foreign investors decreased their portfolios in November by UAH0.6bn, including the UAH0.3bn decline seen last week due to selling local-currency bills and redeeming FX-denominated.

ICU view: This week, the MoF has not scheduled redemptions of FX-denominated bills, and only UAH0.3bn will be repaid in local-currency debt. So, with offering only local-currency bills, bonds outstanding can stay at current levels with a possible increase due hryvnia weakening. We do not expect sufficient demand for local-currency debt that is acceptable at MoF rates.

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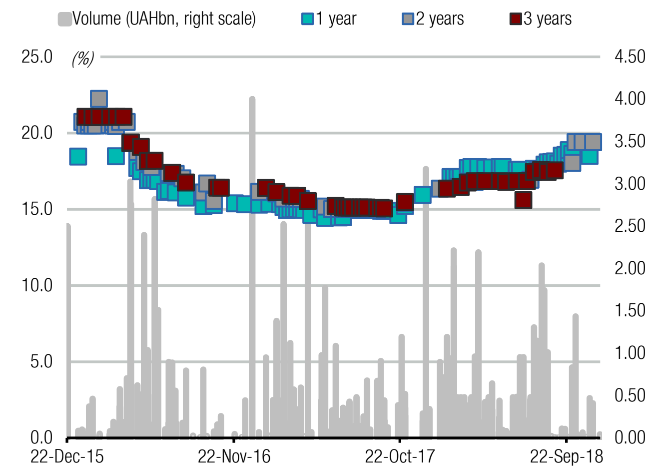
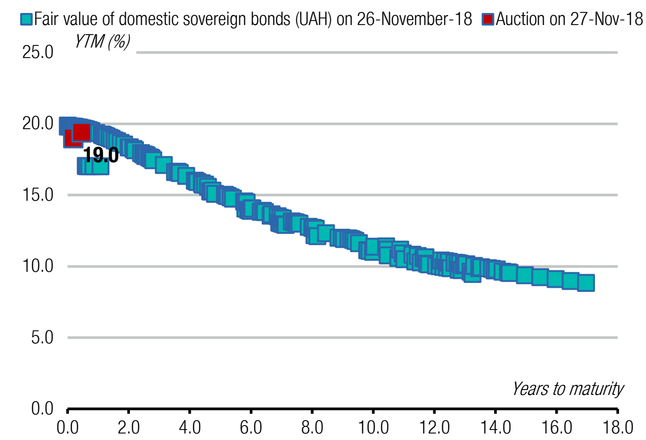
Chart 1. Local-currency bonds

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.

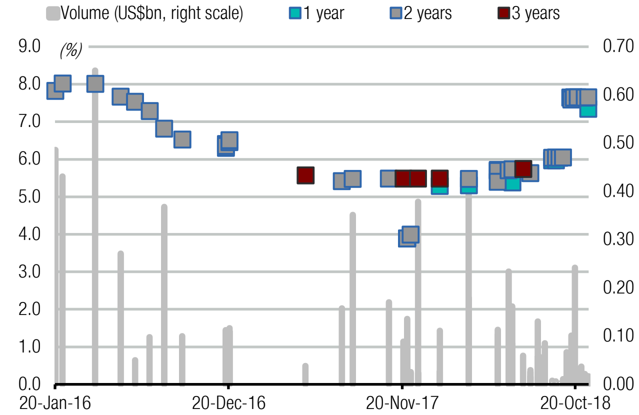
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

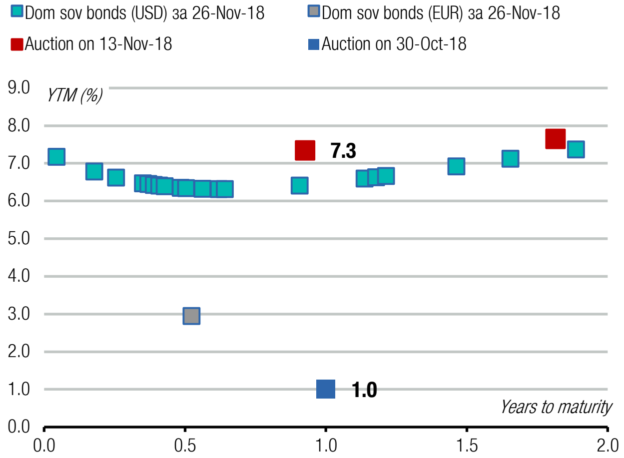
Chart 2. FX-denominated bonds

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

Last week, quarterly tax payments continued, and other cash flows were insufficient to cover outflows to budget. This caused liquidity to decline. However, it could start to recover this week.

Last week, the total amount of banking-sector liquidity declined and main pressure was caused by the Treasury, which absorbed about UAH4.5bn. Quarterly tax payments continued last week along with other payments to the budget, while VAT refunds were insufficient—just UAH4.5bn since the beginning of the month, including UAH1.5bn repaid last Thursday. This supported liquidity, but was not enough to compensate outflows. At the same time, the NBU decreased FX purchases and injected just UAH1.5bn.

Banks were forced to borrow from NBU, and decreased outstanding in CDs. Actually, liquidity balanced at about UAH71-75bn last week thanks to FX purchases by the NBU and small inflows via cash exchange in reserves.

ICU view: Possible increase in VAT refunds (about UAH5bn) should allow liquidity to recover slightly, but likely, liquidity will stay below UAH80bn.

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

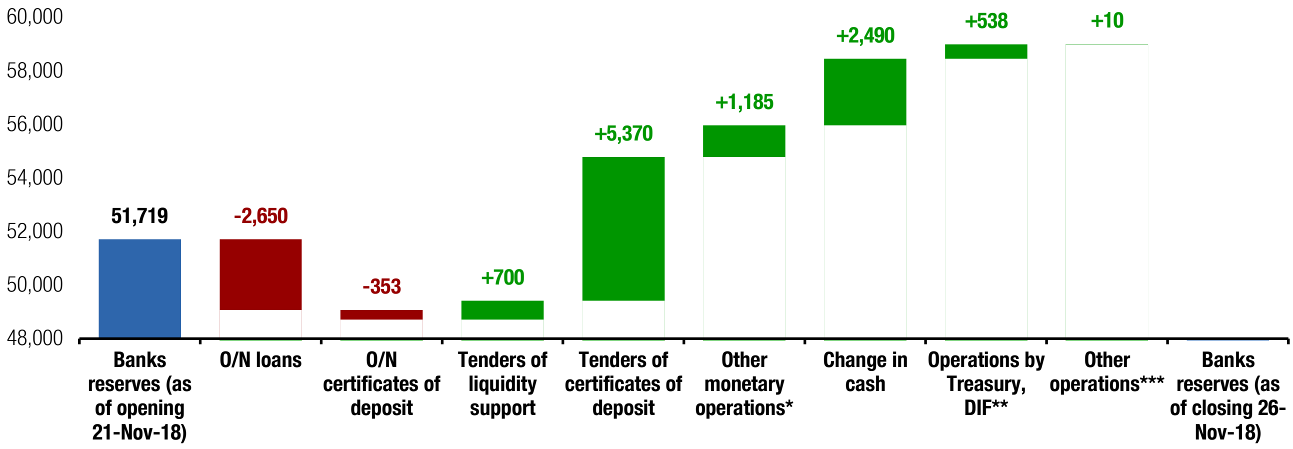
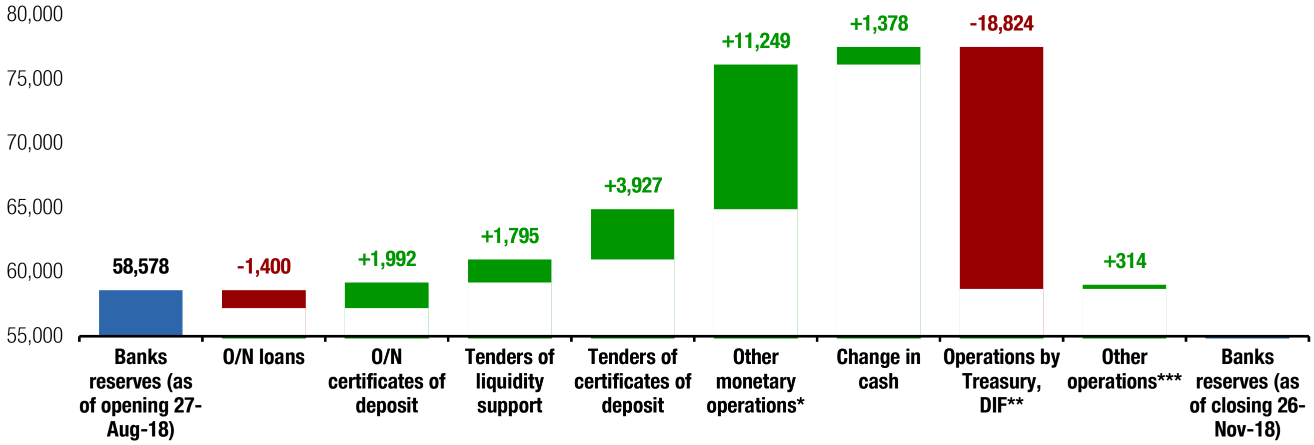


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 holds

Last week, the hryvnia remained steady at around UAH27.8/USD due to low liquidity in the banking system and a higher supply of FX than demand. But this week these factors could reverse and decrease support for hryvnia.

Low liquidity increased FX selling to cover current needs and to fulfil tax payments. But the market was mostly balanced last week compared with the two previous weeks, and NBU purchased just US$52.7m from the market.

In total, last week, the hryvnia gains 0.2% appreciated to UAH27.76/USD. The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) rose 0.4% to 117.6 while in YoY terms, it was up 4.35%.

ICU view: This week, the hryvnia will be volatile and poised for weakening. Psychological factor related to the introduction of martial law caused FX spread widening and exacerbated pressure on the hryvnia. However, the current version of martial law has a very limited impact on doing business and the overall economy. This leads us to expect that the hryvnia is not going to suffer significantly and should remain closer to UAH28/USD by the end of the week. We maintain our hryvnia forecast of UAH29/USD for the end of 2018.

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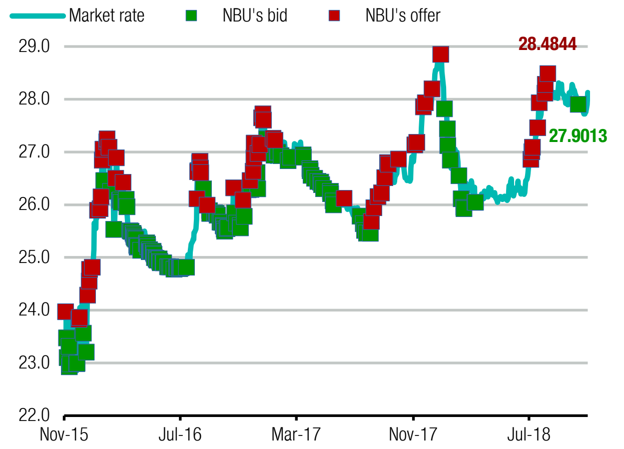
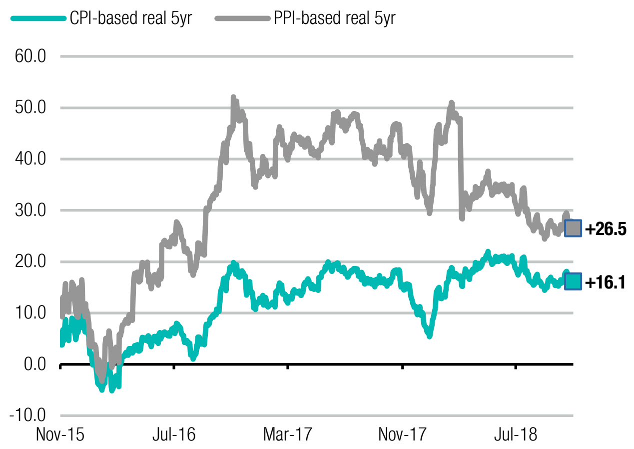
Chart 5. FX market indicators, 3-year history

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

Ukrainian parliament enacts martial law

We do not foresee significant economic losses due to the introduction of martial law or a possible blockade of Russia trade routes through the Azov Sea. Given further escalation is not likely, negative impact from the conflict and the introduction of martial law on the hryvnia and Ukrainian Eurobonds will fade away.

President Petro Poroshenko issued a decree, which was adopted by the Verkhovna Rada, to begin martial law as of November 28. This decree is in accordance with the decision of the National Security and Defense Council of Ukraine, and comes after Russia's attack on a group of Ukrainian Navy ships near the Kerch Strait.

Martial law went into force on 26 November for 30 days. It does not limit the rights and freedom of citizens. The law does not provide for mobilization and is not a declaration of war against Russia. Martial law will cover Ukraine's regions that are located along the Russian border, the area of the Moldavian border, and on the shores of the Black and Azov Seas.

The NBU stated that it does not see risks that will affect the continuous operation of the banking sector during martial law. According to Head of the NBU Yakov Smoliy, the liquidity of the banking sector, currently UAH75bn, is sufficient for smooth and proper functioning. Therefore, the NBU sees no reason for the introduction of administrative measures in the credit and FX markets of Ukraine.

According to the IMF representative in Ukraine, Goesta Ljungman, the Fund does not have legal restrictions preventing it from continuing cooperation with Ukraine during martial law. At the same time, Ukraine Railways stated that it is ready, if necessary, to redirect freight flows for exports from Azov ports to Black Sea ports.

The market quickly reacted to the news with prices for both Ukrainian and Russian Eurobond prices declining. However, Ukrainian sovereigns' prices stabilized by the middle of Monday after having slipped 130-260bps.

ICU view: The current version of martial law has a substantially limited impact on the economic situation in Ukraine. We expect that without further escalation of the conflict

Ukrainian Eurobonds prices may start recovering to their pre-incident levels even before martial law expires. Likewise, despite the initial volatility, the hryvnia should stay closer to UAH28/USD by the end of the week.

Introduction of martial law in Ukraine should not change the current conditions for the approval of the new agreement by the IMF's Board: these remain the adoption by the Parliament of the state budget for 2019 in accordance with the recommendations of the Fund, and the introduction of higher tariffs for natural gas for the population.

Currently, we have no reason to expect a blockade of transportation through the ports of the Azov Sea, because Russia has declared the restoration of navigation in normal mode through the Kerch Strait. In the case of blocking export routes through the Azov Sea, Ukrainian exports should not incur significant losses. Steel is the only product, which was exported through the Azov Sea in substantial volumes: in 2017, steel shipments via Mariupol amounted to 4.5mt, or 23% of the total volume of exports. This represented approximately $2.3bn or 4% of the total export revenue of Ukraine. In 1H18, Azov sea ports Berdyansk and Mariupol reduced their cargo turnover by another 12% p/p to 4mt, i.e. 6% of the total cargo turnover by seaports of Ukraine. The main user of the Azov Sea transportation routes, Metinvest, now supplies all raw materials to its steel mills in Mariupol. The railway capacity should allow the company to fully redirect its steel shipments from Azov ports to Black Sea ports.

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Rada voted for 2019 budget

Budget deficit remained unchanged after the final reading.

Rada voted for the 2019 budget on 22 November, as planned. It was constrained by the IMF requirement to abstain from increasing the budget deficit, which stood at 2.3% of the GDP. Parliament has indefinitely postponed the introduction of the Capital Exit Tax, which could have led to a dramatic decrease of tax revenues in 2019. Corporate income tax revenues in 2019 are planned at UAH95.5bn or 9.3% of the state budget revenues.

ICU view: The IMF will review the adopted budget, and we expect its Board to approve the first tranche of the new stand-by programme before year end. Technically, the National Commission for State Regulation of Energy and Public Utilities has to come up with a formula to increase the gas tariffs hike, a decision that the government adopted back in October. We don't expect this to be an impediment for tranche disbursement.

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Industrial production rose 1.4% YoY in October

After two months of contraction, industrial output returned to growth, increasing 1.4% YoY in October, bringing the 10M18 reading to growth of 1.8% YoY. Acceleration of budget expenses, resumption of work of several metallurgical plants, and still-solid consumer demand will be key drivers of growth in the following months.

In SA terms, industrial output rose 0.6% compared with September. The processing industry, which accounts for 57% of total industrial output, rose 1% YoY, driven by an increase in production of coke and refined petroleum products (+5.4% YoY), and the pharmaceutical industry (+12.1% YoY). In seasonally adjusted terms, the processing industry expanded 0.8% MoM.

The utilities sector fell 3.6% YoY (-2.6% MoM SA) in October, having contracted for the third consecutive month. The key driver of industrial output was the mining sector (+5.2% YoY), primarily thanks to resumed growth in mining metal ores (+2.5% YoY in October).

ICU view: Industrial production growth will somewhat accelerate in the following months thanks to solid domestic consumption (see the next comment), acceleration of budget expenditures, and resumption of work of several metallurgical plants. We retain our full-year forecast of 2% growth.

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Retail trade turnover rose 5% YoY in October

Household consumption will remain the key driver of economic growth in 2018 and 2019 being supported by further growth of real incomes.

Although retail turnover growth slowed to 5% YoY in October, down from 6.4% YoY in September, it still remains robust. However, according to our estimates, in MoM SA terms, it declined 0.1%. In 10M18, growth was 5.4% YoY. By region, the highest growth in retail trade in 10M18 was observed in the Luhansk region (+27% YoY), the Donetsk region (+12.9% YoY), the Zakarpattya region (+11.5% YoY), and the Poltava region (+11.4% YoY).

ICU view: Consumer demand will remain the key driver of economic growth for the rest of 2018 and 2019 thanks to rising real disposable income of households against the backdrop of a further increase of remittances, a 12% minimum wage hike since January 2019, and a tight labour market.

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