Focus
Ukraine

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

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Weekly Insight

C/A deficit widened to 4.1% of GDP

Key messages of the today's comments

TUESDAY, 4 DECEMBER 2018

Domestic liquidity and bonds market

Foreign investors decreasing bond portfolios

Last week, foreign investors decreased their portfolios by UAH252m. We expect that portfolios will continue to decline, but slowly.

Liquidity slightly above UAH70bn

Liquidity remained close to UAH70bn last week. It could recover slightly this week, but it likely will stay below UAH80bn.

Foreign exchange market

Hryvnia repulsed by panic

The hryvnia was under significant pressure last week due to an increase in demand after news about martial law. But NBU sold enough FX to quell the panic, and last week ended at UAH28.1975/USD where we expect it to stay this week.

Economics

C/A deficit widened to 4.1% of GDP

The 12-month rolling C/A deficit widened to an estimated 4.1% of GDP or US$5.3bn (+2.8x YoY) in October. Lower world energy prices and accelerating growth of agricultural exports will support the C/A balance.

Banks' reserves market (3 December 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	18.00	+0bp	+450bp
ON rate (%)	18.97	+0bp	+687bp
ON $ swap (%)	18.00	-65bp	+468bp
Reserves (UAHm)[2]	50,774	-13.96	+17.48
DepCerts (UAHm)[3]	21,735	+22.05	+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) (3 December 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	348,100	+0.00	-3.46
Banks	355,865	-1.04	+8.90
Residents	19,722	+0.89	-7.52
Individuals	5,660	+0.06	+387.93
Non-res[4]	6,371	-3.82	+33.06
Total	**735,718**	**-0.52**	**+2.95**

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

FX market indicators (3 December 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	28.1730	+0.16	+4.27
EUR/USD	1.1354	+0.58	-4.56
DXY[2]	97.040	-0.34	+4.47
UAH TWI[3]	115.746	-0.80	+2.79

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

Gov't bond quotes[1] (4 December 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

Foreign investors decreasing bond portfolios

Last week, foreign investors decreased their portfolios by UAH252m. We expect that portfolios will continue to decline, but slowly.

During November, foreign investors decreased their portfolios by 3.77% or by UAH838m, including UAH252m of withdrawals seen last week. But instead of withdrawing funds early due to redemptions, last week, withdrawals came through the secondary market. Prior to debt repayments, portfolios fell by UAH148m. Over the next two days, they fell by an additional UAH100m, and on Friday portfolios remained unchanged. In total, at the beginning of December, foreign investors' portfolios amounted to UAH6.4bn, which was 33% larger than at the beginning of this year.

ICU view: Martial law and hryvnia weakening last week forced some investors to sell local-currency bonds. But this was not a rout, and just continued slight decline in portfolios to the current UAH6.4bn. Until the end of the year, portfolios can decline further, to about UAH6bn without sufficient impact on the FX or bond market.

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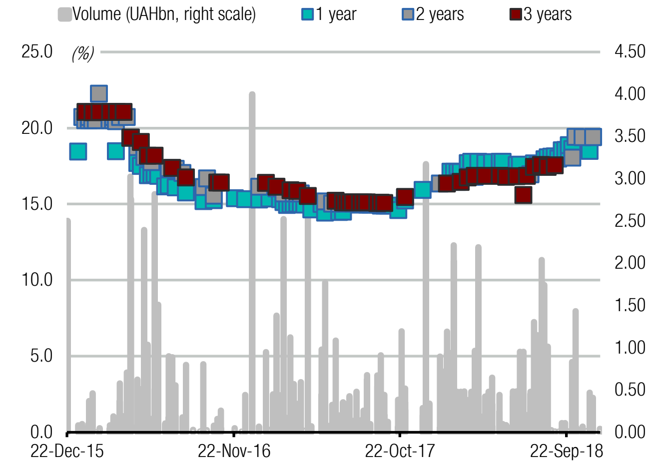
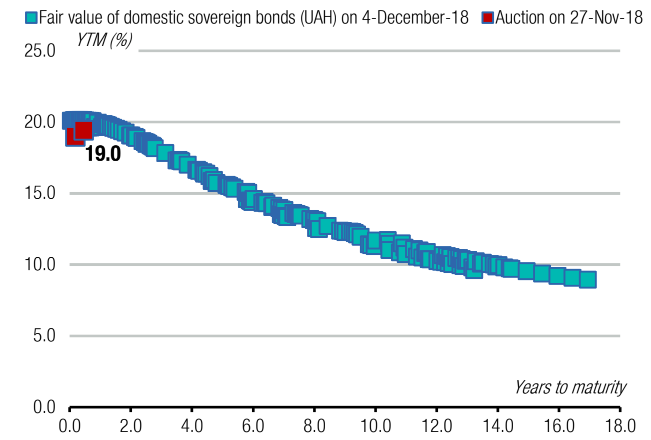
Chart 1. Local-currency bonds

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.

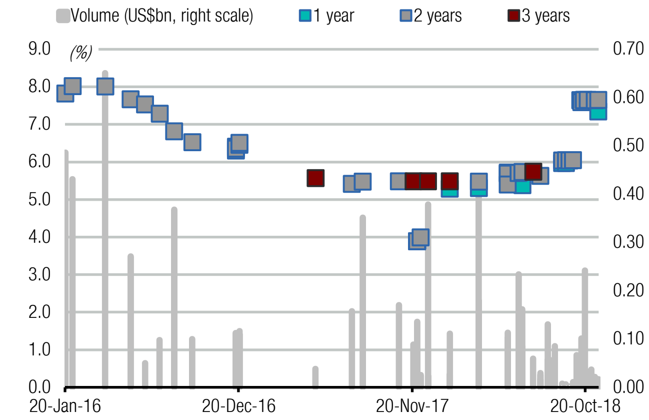
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

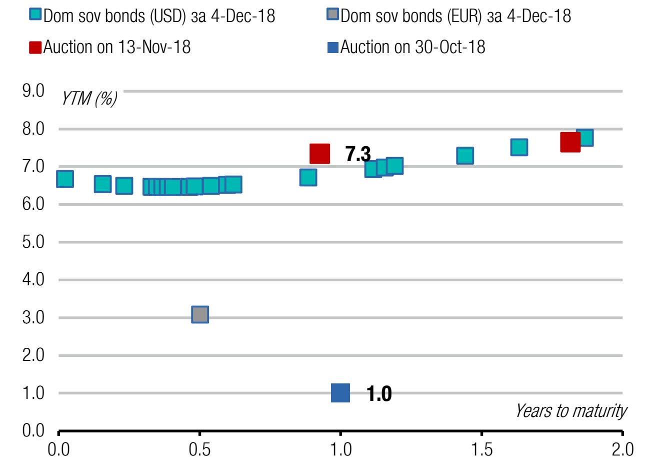
Chart 2. FX-denominated bonds

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 slightly above UAH70bn

Liquidity remained close to UAH70bn last week. It could recover slightly this week, but it likely will stay below UAH80bn.

During November, the Treasury increased balances in its accounts to UAH17bn, which had a somewhat negative impact on liquidity. Last week, only large debt repayments caused inflows of liquidity while on some days, the Treasury absorbed funds from the banking system. This was despite large amounts of VAT refunds paid last week in the amount of UAH9bn.

The main outflow was due to Naftogaz's dividends payment to the budget, which amounted to UAH8bn. Additionally, there were month-end tax payments, which increased outflows by larger amounts than budget expenditures. Also, due to FX selling, the NBU absorbed UAH2.4bn last week and received partial repayments of refinancing of loans from banks.

ICU view: This week, the NBU is not likely to sell FX and can buy some FX, as they did last Friday, causing injections into liquidity. Also, the Treasury can increase expenditures, adding to liquidity, but these funds will be insufficient to cause liquidity to increase above UAH80bn.

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

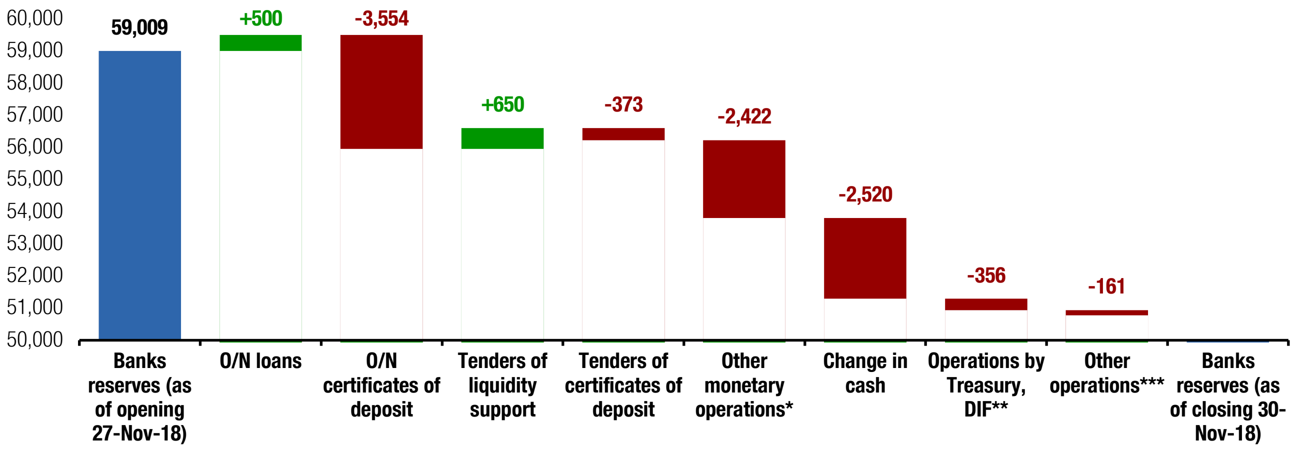
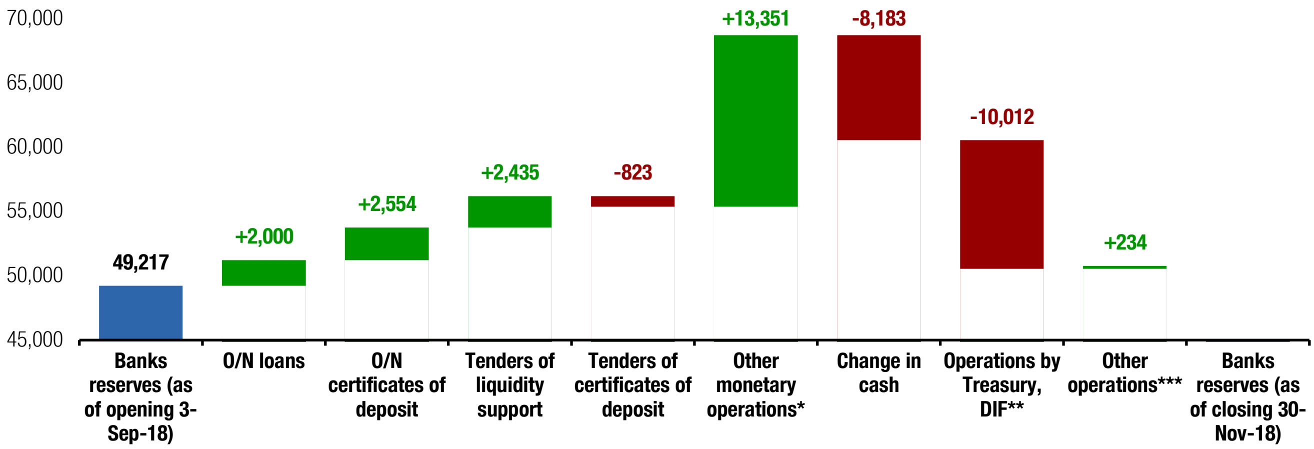


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 repulsed by panic

The hryvnia was under significant pressure last week due to an increase in demand after news about martial law. But NBU sold enough FX to quell the panic, and last week ended at UAH28.1975/USD where we expect it to stay this week.

Last week started with sufficient weakening of hryvnia when it jumped above UAH28/USD. The weakening continued until Wednesday. By Thursday, the hryvnia began to recover, and by the end of week, the hryvnia had weakened by only 1.58%.

Additionally, NBU interventions amounted to US$125m of FX selling, with additional and important support providing by very expensive liquidity, which forced some banks to take loans from the NBU.

Last week, the hryvnia depreciated by only 1.58% to UAH2.1975/USD. The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) declined 1.21% to 116.17 while in YoY terms, it was up 4.11%.

ICU view: Last Friday, the NBU renewed its FX purchases from the market, keeping the hryvnia above UAH28/USD. Sufficient selling of FX by NBU and market players covered extra demand quickly. This week, we expect the hryvnia to be steady, and its movements will mostly depend on needs for local currency. Our expectations are that hryvnia will be around UAH28.2/USD with a slight decline to UAH29/USD until the end of the year due to an increase in liquidity with larger budget expenditures, which can cause a decline in FX offerings.

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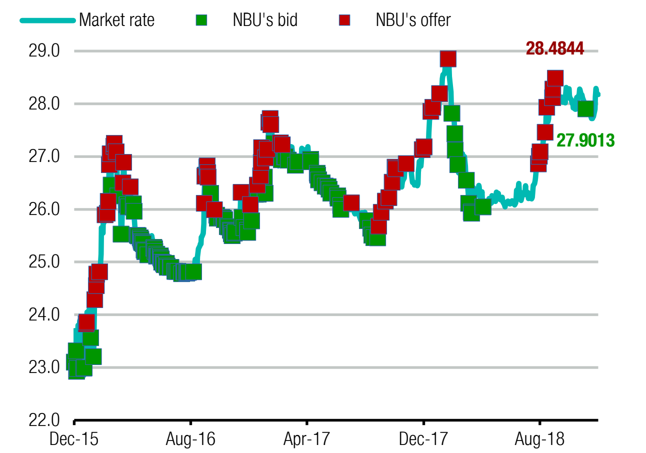
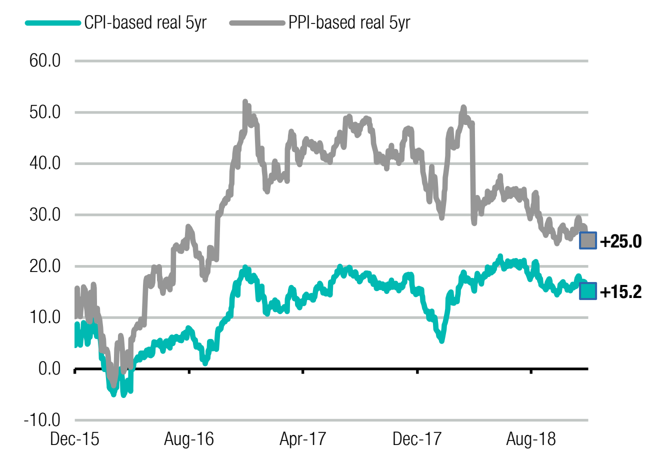
Chart 5. FX market indicators, 3-year history

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

C/A deficit widened to 4.1% of GDP

The 12-month rolling C/A deficit widened to an estimated 4.1% of GDP or US$5.3bn (+2.8x YoY) in October. Lower world energy prices and accelerating growth of agricultural exports will support the C/A balance.

According to the NBU, the C/A gap was US$4.6bn (+2.6 times YoY) in 10M18, having increased from US$3.7bn in 9M18, primarily due to higher growth rates of imports compared with those of exports.

Imports of goods into Ukraine rose 16% YoY to US$46.1bn. The key growth drivers were machinery and equipment (+18% YoY), energy imports (+17% YoY), and chemical products (+11% YoY). Exports grew 10% YoY to US$35.5bn driven by metals (+23% YoY), which account for 57% of the increase in exports, chemical products (+23% YoY), and timber and wood products (+22% YoY). It should be mentioned that growth rates of metallurgical exports declined for the fifth consecutive month to 3.2% YoY in October vs. the average of 43% YoY in 2Q18 due to lower production volumes and decreased metal prices. The services-trade-balance surplus dropped 25% YoY to US$0.6bn in 10M18.

ICU view: The C/A deficit continues to widen due to higher import growth rates against the backdrop of robust consumer and investment demand, and high world energy prices. However, in November, oil prices dropped 20% MoM, and are unlikely to return to October highs. Given dropped oil prices, as well as the end of the period of

accumulation of gas and coal for the heating season, and accelerating growth of agricultural exports against the backdrop of a better harvest of late crops, we retain our recently updated forecasts of a deficit at 3.8% of GDP in 2018.

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