

Weekly Insight

NBU cuts rate amid turbulence

Key messages of the today's comments

MONDAY, 16 MARCH 2020

Domestic liquidity and bonds market

Bond holdings' structure changes

Investors most sensitive to hryvnia exchange-rate fluctuations slightly decreased their holdings of UAH-denominated bills last week. We expect this trend to continue this week, but we can also see some purchases by foreigners of new bills, as it happened last week.

Liquidity falls to UAH211bn

Selling of hard currency by the NBU and reserves exchange in cash by commercial banks decreased liquidity to the lowest level this month and slightly above the lowest level of this year. This week, liquidity will continue to decline, which will mean some banks will have to ask for NBU loans. They started to indicate the need for support last week.

Foreign exchange market

Hryvnia under pressure

There was a panic in the hryvnia market last week. UAH lost 3.7%, and weakened to UAH25.8/US\$ due to the pressure from locals, with some added by foreigners' withdrawal of funds from local-currency bills. This week, the FX market could look the same, with the hryvnia weakening to around UAH27/US\$.

Economics

Inflation slows to 2.4% YoY in February

Lower world energy prices will continue to constrain consumer-price growth in the following months. However, the weakening UAH heightens risks for inflation acceleration.

NBU cuts rate amid turbulence

Despite adverse markets, the regulator decreased its key rate by 100 bps to 10%, as it originally planned.

Banks' reserves market (13 March 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	11.00	+0bp	-700bp
ON rate (%)	11.28	+168bp	-523bp
ON \$ swap (%)	14.46	+617bp	-33bp
Reserves (UAHm) ²	46,303	-19.83	-21.86
DepCerts (UAHm) ³	160,138	-14.35	+261.71

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) (13 March 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	-0.29	-3.72
Banks	332,557	+1.71	-8.25
Residents	27,710	+1.70	+11.56
Individuals	8,940	+2.34	+19.77
Non-res ⁴	125,426	-0.85	+768.31
Total	819,209	+0.53	+9.70

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

FX market indicators (13 March 2020)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	25.8104	+3.67	-3.49
EUR/USD	1.1107	-1.57	-1.94
DX ²	98.749	+2.92	+2.28
UAH TWI ³	132.295	-1.04	+8.86

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

Gov't bond quotes¹ (16 March 2020)

Maturity	Bid	Ask
6m	18.00	13.00
12m	18.00	13.00
2y	18.00	13.00
3y	18.00	13.00
12m (\$)	4.00	2.75
2y (\$)	4.50	3.20

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

Domestic liquidity and bonds market

Bond holdings' structure changes

Investors most sensitive to hryvnia exchange-rate fluctuations slightly decreased their holdings of UAH-denominated bills last week. We expect this trend to continue this week, but we can also see some purchases by foreigners of new bills, as it happened last week.

Despite the lack of primary auctions last week, the total amount of bonds outstanding rose due to the revaluation of FX-denominated instruments. At the same time, the structure of bond holdings changed. The two groups of holders most sensitive to the hryvnia exchange rate—individuals and foreign investors—decreased their portfolios of UAH-denominated paper, while reallocating some funds to FX-denominated instruments.

Foreigners likely purchased a mere of FX-denominated paper, but some of them sold local-currency bills, and others bought new portion of UAH-denominated bills. Last Tuesday, foreigners sold UAH153m of bills, and last Wednesday purchased a portion of new bills, which amounted to UAH196m. Most likely these were different investors, but we saw deals in both directions.

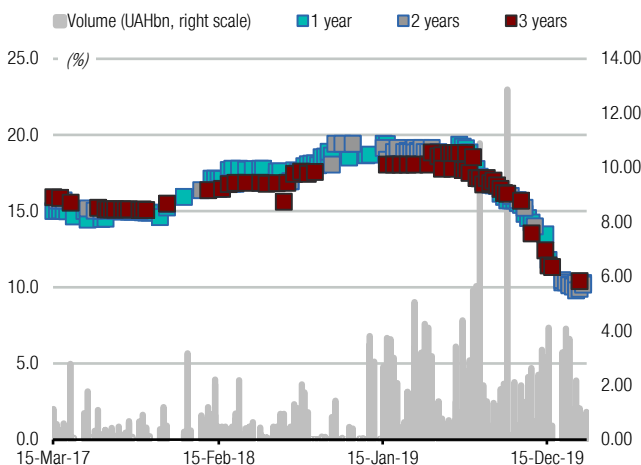
By the end of last week, foreigners decreased their portfolios of UAH-denominated paper by UAH444m to UAH122bn, while in total, their portfolios slid by UAH338m to UAH125bn. At the same time, banks' portfolios rose to UAH334bn, other residents to UAH28bn, while individuals' portfolios rose to UAH9bn. Important for these movements was the USD/UAH exchange rate, as FX-denominated bills were revaluated using a weaker hryvnia.

ICU view: We expect this general trend to continue this week. Hryvnia weakening will continue, increasing the total outstanding amount of FX-denominated bills. The MoF may issue new FX-denominated instruments, new UAH-denominated instruments, or none at all. Individuals and foreigners will continue to slightly decrease their UAH-denominated portfolios. Foreigners' portfolios may slide by a UAH1-2bn, if locals have enough free liquidity, they can take up the slack.

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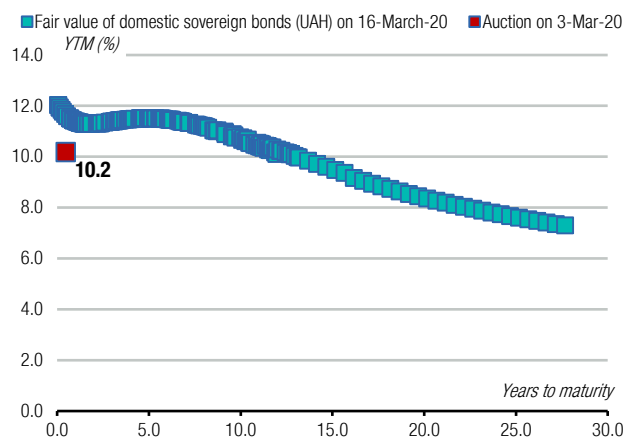
Chart 1. Local-currency bonds

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.

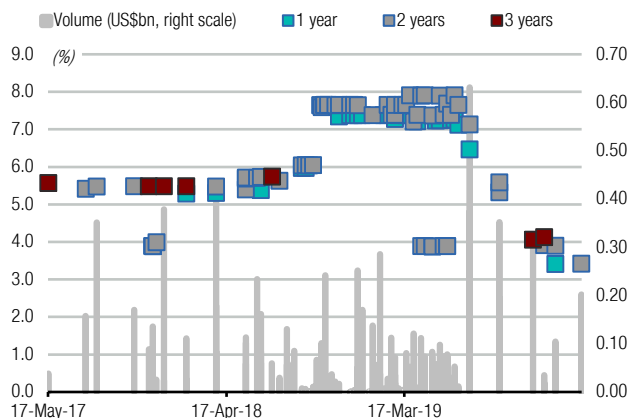
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

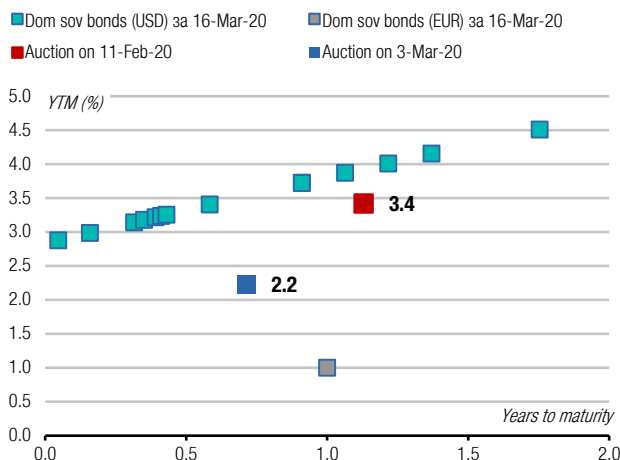
Chart 2. FX-denominated bonds

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 falls to UAH211bn

Selling of hard currency by the NBU and reserves exchange in cash by commercial banks decreased liquidity to the lowest level this month and slightly above the lowest level of this year. This week, liquidity will continue to decline, which will mean some banks will have to ask for NBU loans. They started to indicate the need for support last week.

Last week, the NBU absorbed liquidity of UAH24bn through the FX market from the banking sector, but started to provide banks extra funds. By the end of last week, banks borrowed UAH10bn from the NBU. Through reserves exchange in cash, banks also decreased liquidity by UAH3.5bn.

These operations caused significant liquidity outflow of UAH17.5bn, including UAH4.5bn of ON loans received from NBU. These ON loans were later replaced with two-week loans, which increased the NBU's support amount to UAH10bn for the last two weeks. This week started with UAH211bn of banking-sector liquidity, which was allocated as follows: UAH52bn in banks' correspondent accounts with the NBU and UAH159bn in NBU CDs, where UAH149bn of CDs have redemption this Friday.

ICU view: This week, we expect the NBU will continue to intervene in the FX market, absorbing an additional UAH20-25bn of liquidity from banking sector. The Treasury will support absorbing extra liquidity, keeping its balance of operations negative. Therefore, liquidity may decline to UAH180-190bn, a level seen during the last few business days of December 2019.

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

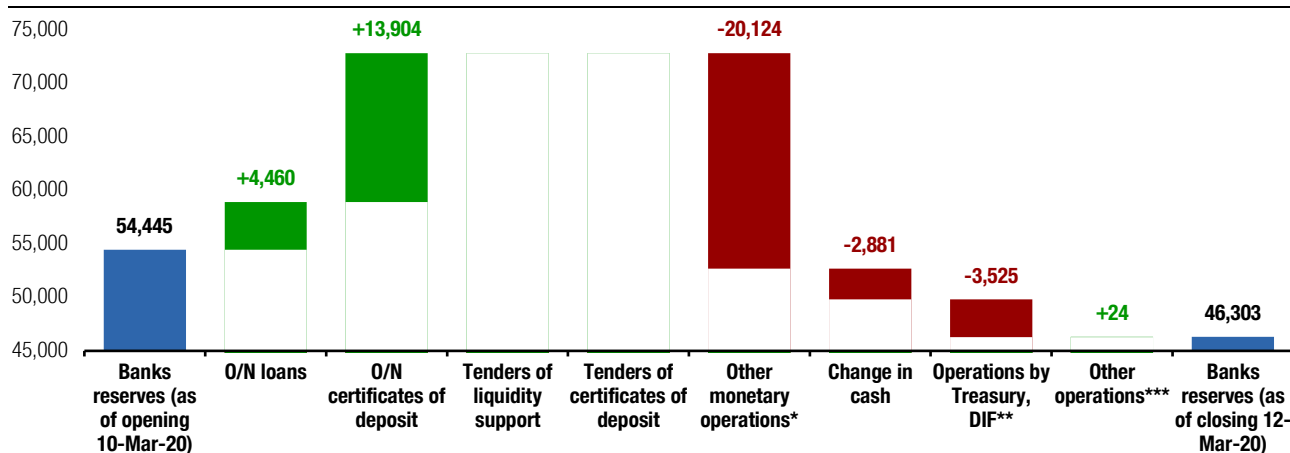
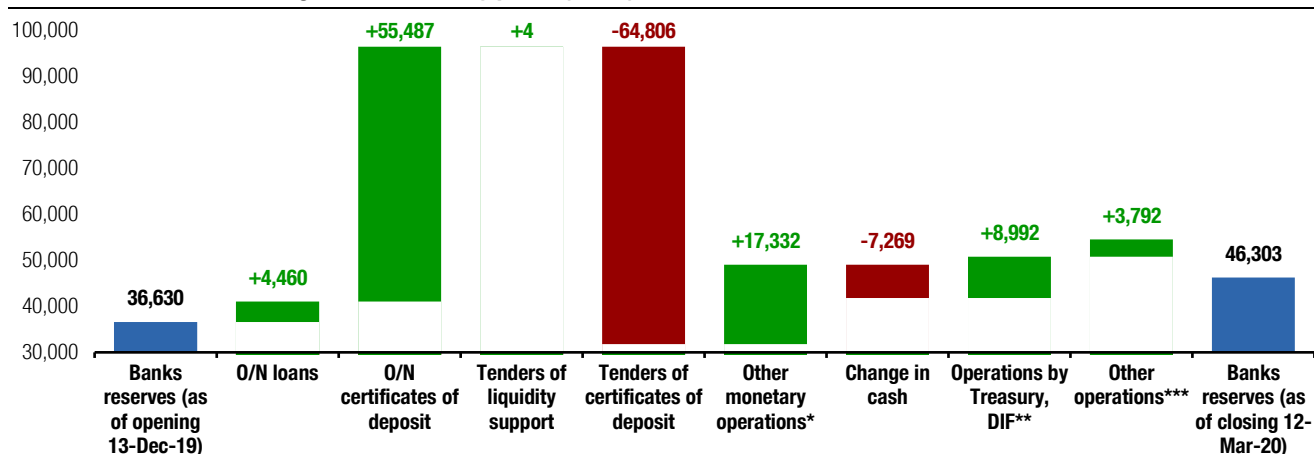


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 under pressure

There was a panic in the hryvnia market last week. UAH lost 3.7%, and weakened to UAH25.8/US\$ due to the pressure from locals, with some added by foreigners' withdrawal of funds from local-currency bills. This week, the FX market could look the same, with the hryvnia weakening to around UAH27/US\$.

The negative mood in global markets caused a decline in foreigners' presence in the Ukrainian bond market, in line with panic among locals. According to the NBU, through Thursday morning, foreigners purchased in March just US\$160m, while locals purchased US\$700m of hard currency sold by the National Bank. Foreigners slightly reduced their bond portfolios (see comment above). Hard currency was purchased mostly by locals, who created most of the demand and caused hryvnia weakening.

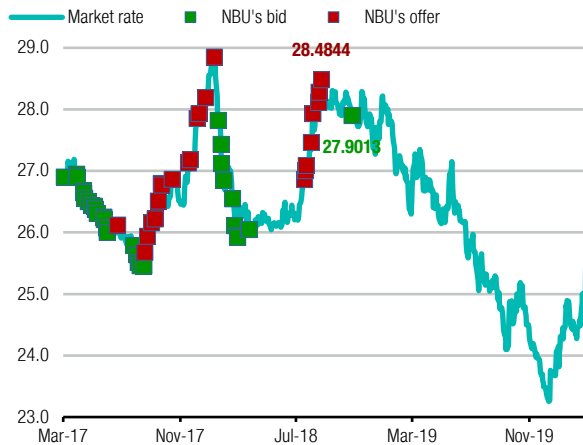
ICU view: This week, we do not anticipate changes in the hryvnia's weakening trend, partially due to the introduction of the health quarantine and restrictions at the border crossings. These decisions are likely to increase panic, and result in the hryvnia weakening to around or above UAH27/US\$ this week. This weakening cannot be stopped by NBU interventions, as they would just restrain weakening and flatten volatility. More likely, UAH depreciation will stop due to depletion of the hryvnia

resource from those who wish to purchase the hard currency and due to banks filling up their FX positions.

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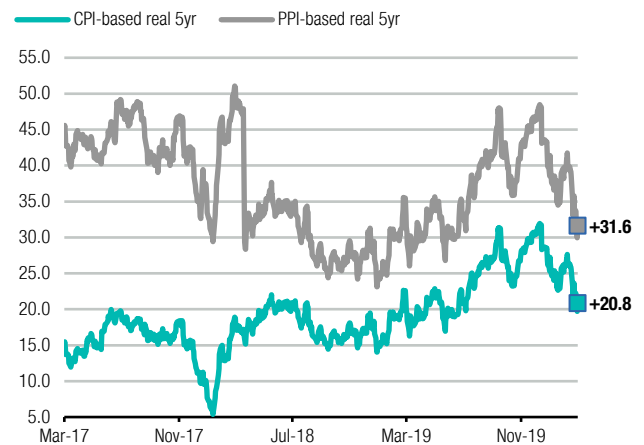
Chart 5. FX market indicators, 3-year history

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 misalignment¹ from fundamental level² (%)



Notes: [1] "+" overvalued, "-" undervalued; [2] based on the UAH's CPI- and PPI-based real TWIs. Source: ICU.

Economics

Inflation slows to 2.4% YoY in February

Lower world energy prices will continue to constrain consumer-price growth in the following months. However, the weakening UAH heightens risks for inflation acceleration.

In February, headline inflation slowed to 2.4% YoY from the 3.2% YoY seen in January; the slowdown continues for the seventh consecutive month. In MoM terms, prices fell 0.3%. Growth rates of consumer prices slowed in all major subcategories, but the main positive impact on the inflation slowdown was deceleration in the growth of food prices to 1.8% YoY. At the same time, prices on transport fell for the fifth month (-1.2% YoY), while prices on utilities fell for the third month (-5.2% YoY) thanks to a 31% YoY decrease in prices for natural gas for population. Core inflation fell to 3% YoY. NBU forecasts inflation of 4.8% YoY by YE20.

ICU view: Lower oil and natural gas prices will continue to constrain consumer-prices growth in the following months. However, the UAH weakening due to the poor sentiment in the external financial markets heightens risks for inflation acceleration. We currently maintain our YE20 inflation forecast at 5.3%.

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NBU cuts rate amid turbulence

Despite adverse markets, the regulator decreased its key rate by 100 bps to 10%, as it originally planned.

The March decision on the interest rate coincided with the worst week so far for the world financial markets, as the UAH started weakening. Despite this, the regulator decided to go

with the cut in the hope that inflation will get back to the target level (currently 160 bps below the lower threshold).

ICU view: NBU's decision surprised the market. However, against the backdrop of high uncertainty around the coronavirus pandemic and big capital outflows from emerging markets, this rate cut should have little impact.

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