

Weekly Insight

GDP falls by 11.4% YoY in 2Q20

Key messages of the today's comments

Domestic liquidity and bonds market

Primary bond market predominates

Last week, banks preferred short-term bills in the primary market over purchasing bonds from foreigners. This week, since more longer-term instruments will be offered in the primary market compared with last week, the focus may shift to the secondary market.

Liquidity remains steady

With the start of quarterly tax payments, liquidity in the banking system has remained stable above UAH150bn. This week, liquidity may decline to about this level due to the absorption of funds into budget accounts.

Foreign exchange market

Hryvnia appreciates

The need for funds in hryvnia for tax payments prompted taxpayers to sell hard currency more actively. This provided additional support for the hryvnia and led to its strengthening. This week, activity in the FX-market will depend on the sale of hard currency for tax payments, as well as on the activity of foreigners in the bond market selling UAH-denominated bonds.

Economics

Consumer inflation unchanged at 2.4% YoY

In July, annual changes in CPI and core CPI remained low; however, seasonally adjusted indicators show growing inflationary pressure. Looking ahead, annual inflation will rise gradually and return to NBU's target range in the fall.

GDP falls by 11.4% YoY in 2Q20

A plunge of this magnitude was expected due to the effects of the coronavirus pandemic and lockdown restrictions. Going forward, the economy will gradually recover.

MONDAY, 17 AUGUST 2020

Banks' reserves market (14 August 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	6.00	+0bp	-1,100bp
ON rate (%)	5.00	-18bp	-1,073bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	27,652	-40.89	-52.09
CDs (UAHm) ³	99,111	-9.17	+114.11

Notes: [1] NBU's key policy rate; [2] stock of banks' reserves held at NBU; [3] stock of NBU's certificates of deposit.

Source: NBU, Bloomberg, ICU.

Breakdown of govt bond holders (UAHm) (14 August 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.72
Banks	422,715	+1.26	+23.53
Residents	26,897	+0.50	+0.90
Individuals	7,551	+2.76	-22.05
Foreigners ¹	89,441	-1.40	+0.09
Total	871,180	+0.50	+8.22

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (14 August 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.3350	-0.97	+7.94
EUR/USD	1.1842	+0.47	+6.31
DXY	93.096	-0.36	-4.99
UAH TWI ¹	122.863	+0.60	-5.60

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (17 August 2020)

Maturity	Bid	Ask
6m	10.00	9.00
12m	10.50	9.75
2y	11.00	10.00
3y	12.00	10.50
12m (\$)	5.00	3.00
2y (\$)	6.00	3.50

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

Source: ICU.

Domestic liquidity and bonds market

Primary bond market predominates

Last week, banks preferred short-term bills in the primary market over purchasing bonds from foreigners. This week, since more longer-term instruments will be offered in the primary market compared with last week, the focus may shift to the secondary market.

At the auction on 11 August, the Ministry of Finance placed UAH5bn (US\$180m) of bills with one participant. These bonds mature this year, which could be more attractive to banks than medium-term issues frequently offered by foreigners. More about this auction in [our review](#).

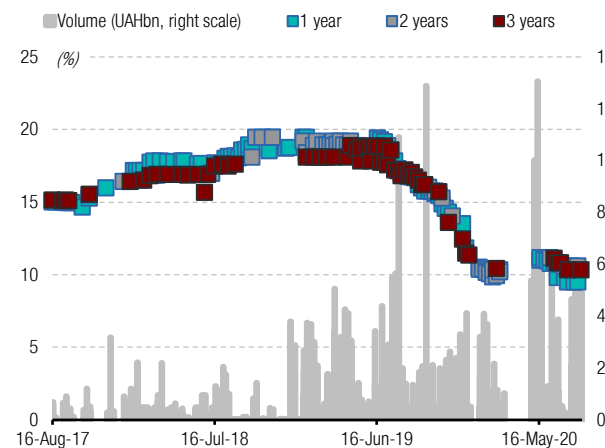
As a result, banks increased their government bond portfolios last week by 1.2% to UAH422bn (US\$15.4bn), taking into account FX-denominated bonds. At the same time, the foreigners' portfolios decreased by only UAH0.8bn to UAH89bn (US\$29m and US\$3.2bn respectively, giving them 10.3% of total bonds outstanding.

ICU view: This week, the Ministry plans to offer bills starting with a 189-day tenor, which may be less attractive to banks. Therefore, we expect an increase in their purchase of bills from foreigners, as these investors may become more active selling local-currency bills due to hryvnia appreciation.

Taras Kotovych, Kyiv, (044) 377-7040 ext.724

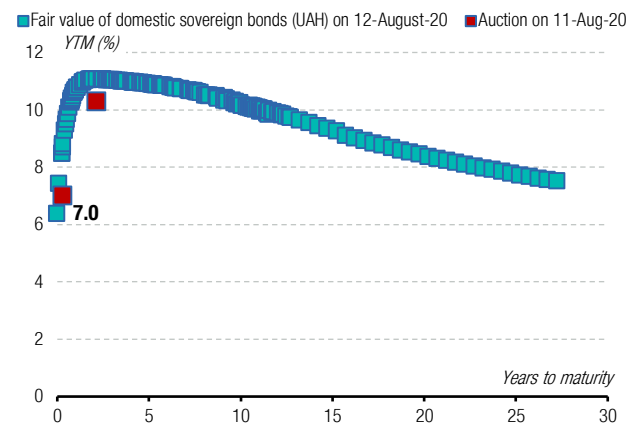
Chart 1. Local-currency bonds

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.

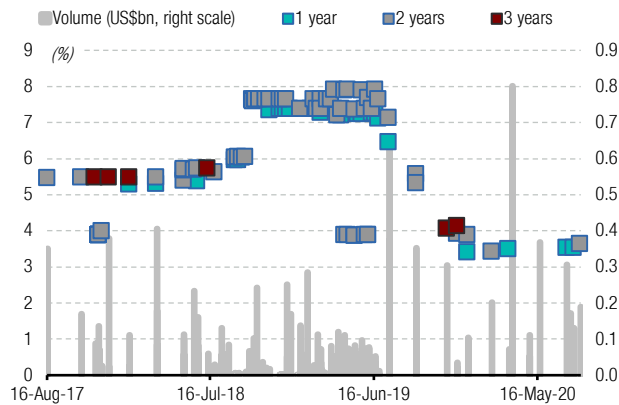
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

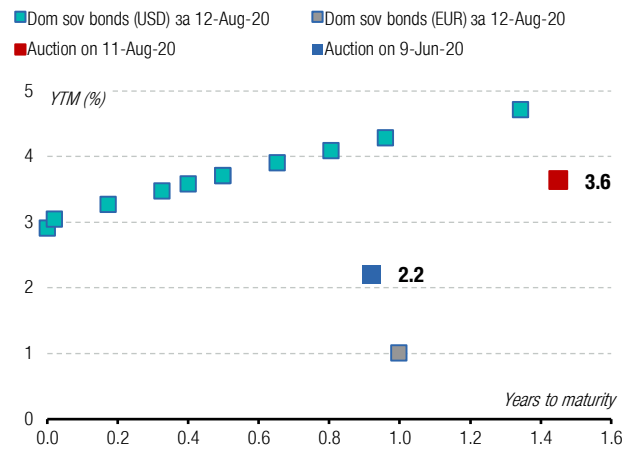
Chart 2. FX-denominated bonds

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 steady

With the start of quarterly tax payments, liquidity in the banking system has remained stable above UAH150bn. This week, liquidity may decline to about this level due to the absorption of funds into budget accounts.

Last Thursday, payments of quarterly taxes intensified, mainly on Thursday and Friday, when the budget received UAH3.2bn and UAH2.9bn, respectively, through the tax authorities. Due to acceleration of budget expenditures, in total, just UAH0.8bn was absorbed into budget accounts per the week. The largest outflow was seen due to the exchange of banks' reserves in cash in the amount of UAH6.9bn.

This outflow of funds was mainly offset by the NBU's operations in the foreign exchange market for the purchase of hard currency through which the banking system received UAH6.1bn of funds. As a result, total liquidity in the banking system fluctuated within UAH151-157bn, and on Friday increased to UAH159.6bn.

ICU view: Quarterly taxes will continue to be paid this week and may be even higher, so the total amount of liquidity may decrease, and will depend on whether hard currency is used and how much of it will be bought by the NBU. Placement of T-bills and their volume will have an additional impact. Therefore, we expect a slight reduction in liquidity close to UAH150bn.

Taras Kotovych, Kyiv, (044) 377-7040 ext.724

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

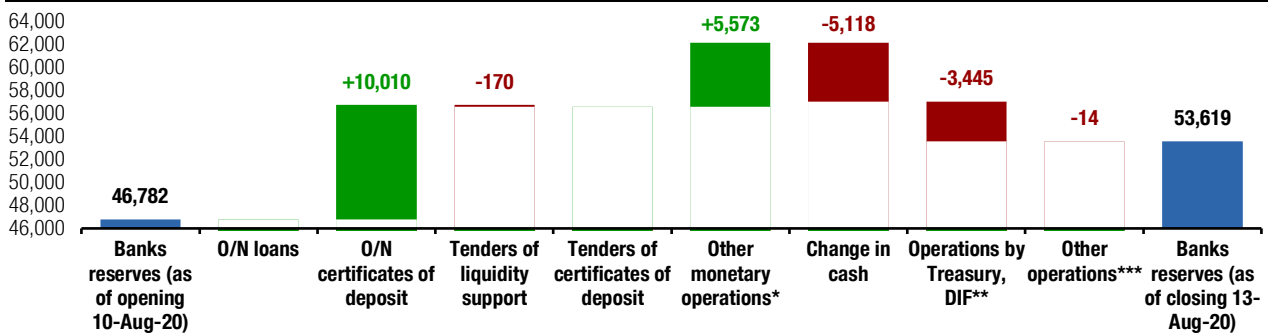
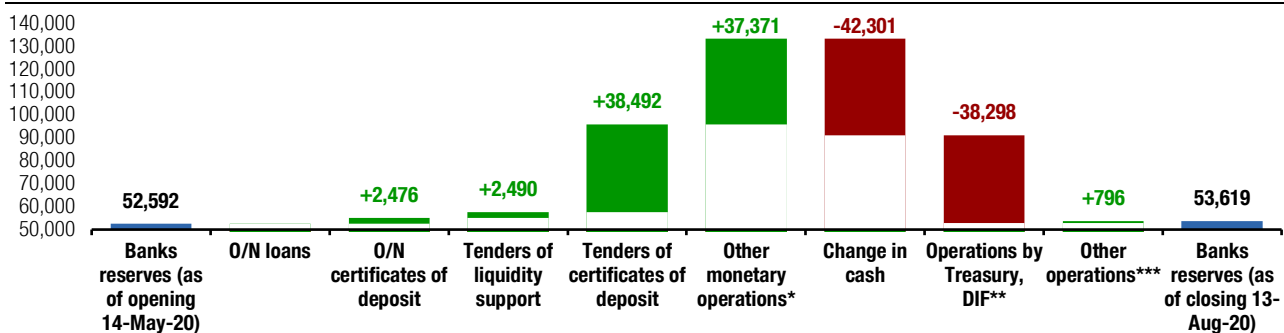


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

The need for funds in hryvnia for tax payments prompted taxpayers to sell hard currency more actively. This provided additional support for the hryvnia and led to its strengthening. This week, activity in the FX-market will depend on the sale of hard currency for tax payments, as well as on the activity of foreigners in the bond market selling UAH-denominated bonds.

The beginning of the quarterly tax period prompted the NBU to buy more hard currency in the market, and increase their purchases above the usual amount to replenish reserves of US\$20m per day, to US\$223m last week, including US\$143m last Thursday. The main sellers of hard currency are likely large taxpayers, among which could be NJSC "Naftogaz of Ukraine", and large agricultural companies that received foreign currency from the sale of this year's harvest for export.

The additional supply of hard currency gave another impetus to strengthening the hryvnia, and purchases by the National Bank restrained this movement. Therefore, by the end of the week, the hryvnia appreciated by 0.97% to UAH27.335/US\$.

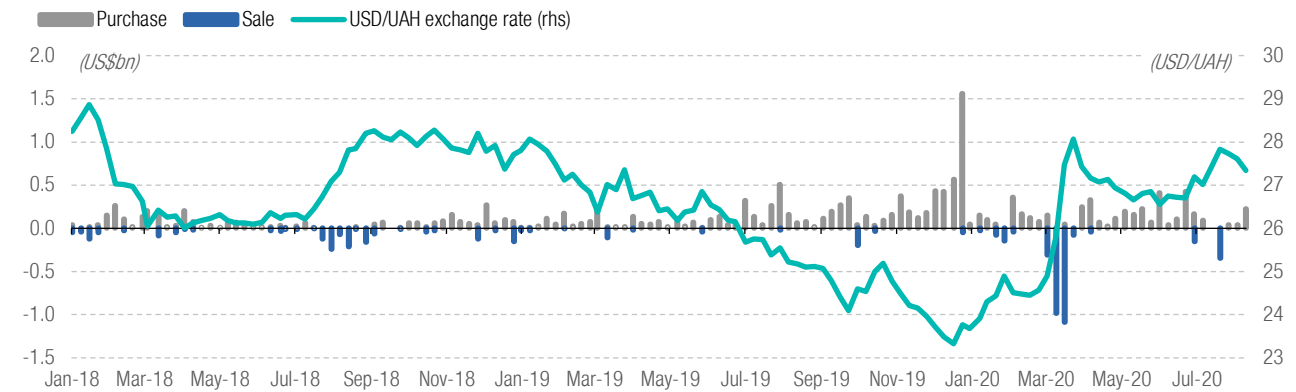
ICU view: *This week, we expect the hryvnia exchange rate will continue to appreciate due to tax payments and the sale of receipts of hard currency from sale of this year's harvest by agricompanies. On the other side will be demand for hard currency from foreigners who will be active with local-currency bill offerings in the secondary market; however, the market balance will be in favour of supply. Therefore, the NBU will buy at*

least US\$20m a day, and on some days even more. As a result, the hryvnia exchange rate will moderately strengthen, but it is unlikely to cross the level of UAH27/US\$.

Taras Kotovych, Kyiv, (044) 377-7040 ext.724

Chart 5. FX market indicators, 3-year history

Ukraine hryvnia UAH exchange rate per US dollar at the interbank market and NBU interventions (weekly data)



Source: NBU, Bloomberg, ICU.

Economics

Consumer inflation unchanged at 2.4% YoY

In July, annual changes in CPI and core CPI remained low; however, seasonally adjusted indicators show growing inflationary pressure. Looking ahead, annual inflation will rise gradually and return to NBU's target range in the fall.

Consumer prices fell by 0.6% MoM in July and annual inflation remained unchanged of 2.4% YoY. Core inflation did not change, remaining at 3.0% YoY as core CPI decreased by 0.1% MoM in July. Both indicators continued to undershoot NBU's target range of 5% +/- 1 pp for a half year.

Unchanged annual inflation was determined by two groups of factors offsetting each other. On the one hand, due to a rebound of global prices of oil and gas, local prices for fuel and gas grew by 3.4% MoM and 7.5% MoM, correspondingly. As a result, the annual pace of decline decelerated to 21.5% YoY from 26.5% YoY in June for fuel and to 43.0% YoY from 52.5% YoY in June for gas. On the other hand, food inflation slowed to 3.5% YoY after surge to 4.2% YoY in June. Such outcome was mainly caused by a sharp deceleration of egg prices to 14% YoY from 55% YoY in June, while inflation of other food stuffs such as meat, fish, dairy, and sugar slowed as well.

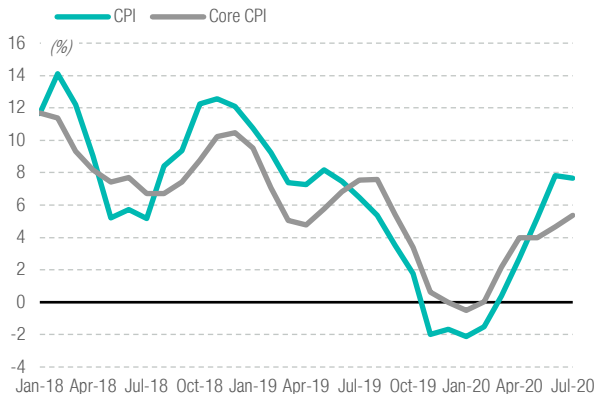
Although annual inflation remained low, when measured by the MoM seasonally adjusted annualized rate (SAAR), in the last few months, price growth accelerated to 7–8% for headline inflation and to 5–6% for core inflation.

ICU view: In general, inflation figures so far remain close to our June forecast, which envisaged gradual acceleration of CPI to 4.2% YoY by the end of the year. However, the July print does not reflect the effects of UAH depreciation relative to both the USD and the currencies of trade partners that happened in the last decade on the month. This may hasten expected CPI acceleration. At the same time, July inflation confirms our view that demand pressure remains subdued and recovery of wages and retail sales in June might be short-lived.

Sergiy Nikolaychuk, Kyiv, (044) 377-7040 ext.721

Chart 6. CPI and Core CPI, 3MA MoM SAAR, %

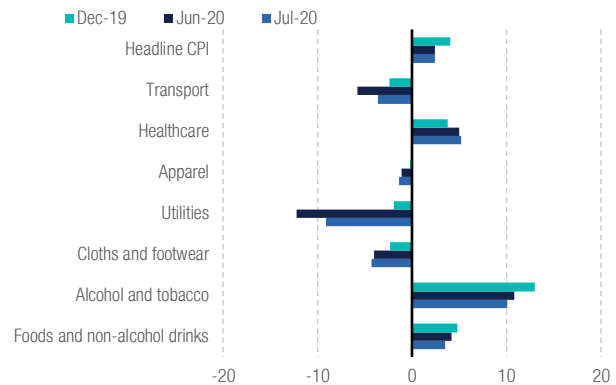
(Three months moving average of seasonally adjusted annualized rate of growth compared with the previous month)



Source: Ukrstat, ICU.

Chart 7. Average wages, YoY, %

(Slowdown in food inflation offset lower pace of decrease in gas and fuel prices)



Source: Ukrstat, ICU.

GDP falls by 11.4% YoY in 2Q20

A plunge of this magnitude was expected due to the effects of the coronavirus pandemic and lockdown restrictions. Going forward, the economy will gradually recover.

As expected, flash GDP estimates for 1Q20 showed the negative impact of the pandemic and the containment measures: GDP plummeted by 9.9% QoQ SA and 11.4% YoY. As a result, seasonally adjusted GDP fell to the level of the previous local minimum in 2Q15.

According to our estimates, the largest decline in GDP was observed in April, about 13% YoY. Afterwards, economic activity recovered as the economy opened, and in June, the rate of decline in GDP fell to 8% YoY.

UkrStat will publish the breakdown for GDP and the nominal values on 18 September.

ICU view: The flash GDP reading was close to the estimates of Ministry of the Economy and NBU (11.0% YoY), and slightly worse than our estimate and the Bloomberg consensus forecast (both a YoY decline of 10.5%).

The main factor in such a sharp decline in GDP was containment measures, which in Ukraine were one of the toughest in the world during April–May. However, in June, restrictions were eased rapidly and economic activity recovered. At the same time, more than 1 p.p. in the quarterly GDP decline was due to a later start of the grain harvest.

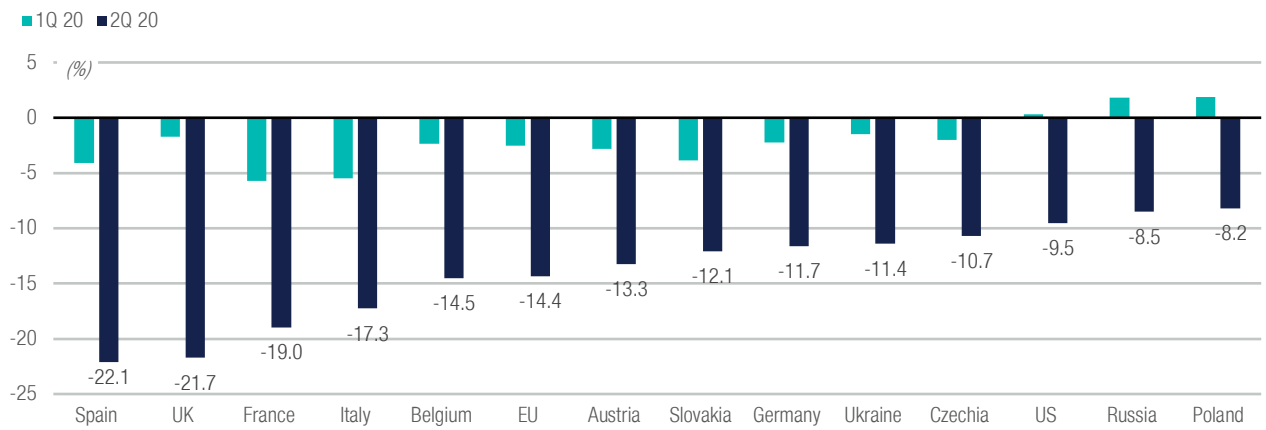
Despite the severity of quarantine restrictions, relatively limited fiscal stimulus, and the late harvest factor, the decline in GDP was not as deep as the EU average of 14.4% YoY. However, Ukraine was behind most countries of Central and Eastern Europe, and Russia.

The key factors of such stability of the Ukrainian economy, which contrasts sharply, for example, with the crisis of 2008-09, were its structural characteristics, in particular, a low share of “locked” services, improved terms of trade (sharp fall in energy prices against more stable prices for iron ore, steel and agricultural products), the lack of macroeconomic imbalances due to prudent monetary and fiscal policy in previous years, and the like.

Given the rapid lifting of quarantine restrictions, we expect a relatively strong economic recovery and see more upside risks to our June forecast of a 6.7% drop in GDP this year, even as COVID-19 cases have been increasing in recent weeks.

Sergiy Nikolaychuk, Kyiv, (044) 377-7040 ext.721

Chart 8. Real GDP (YoY, %)



Source: OECD, State Statistics Service of Ukraine, ICU.

This page is intentionally left blank



11th floor, LEONARDO Business Centre
19-21 Bogdan Khmelnytsky Street
Kyiv, 01030 Ukraine
Phone/Fax +38 044 3777040

WEB www.icu.ua



RESEARCH

Sergiy Nikolaychuk

Head of macro research
sergiy.nikolaychuk@icu.ua

Taras Kotovych

Senior financial analyst (Sovereign debt)
taras.kotovych@icu.ua

Dmitriy Dyachenko

Junior financial analyst
dmitriy.dyachenko@icu.ua

Alexander Martynenko

Head of corporate research
alexander.martynenko@icu.ua

Mykhaylo Demkiv

Financial analyst (Banks)
mykhaylo.demkiv@icu.ua

Investment Capital Ukraine LLC is regulated by Securities and Stock Market State Commission of Ukraine (license numbers: dealer activity AE 263019, broker activity AE 263018, underwriting activity AE 263020 dated 11 April 2013).

DISCLAIMER

This research publication has been prepared by Investment Capital Ukraine LLC solely for information purposes for its clients. It does not constitute an investment advice or an offer or solicitation for the purchase or sale of any financial instrument. While reasonable care has been taken to ensure that the information contained herein is not untrue or misleading at the time of publication, Investment Capital Ukraine makes no representation that it is accurate or complete. The information contained herein is subject to change without notice. Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of Investment Capital Ukraine LLC. All rights are reserved. Any investments referred to herein may involve significant risk, are not necessarily available in all jurisdictions, may be illiquid and may not be suitable for all investors. The value of, or income from, any investments referred to herein may fluctuate and/or be affected by changes in exchange rates. Past performance is not indicative of future results. Investors should make their own investigations and investment decisions without relying on this report. Only investors with sufficient knowledge and experience in financial matters to evaluate the merits and risks should consider an investment in any issuer or market discussed herein and other persons should not take any action on the basis of this report.

Additional information is available upon request.

