Focus
**Ukraine**

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

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# Weekly Insight

# Foreigners return to the bond market

**Key messages of the today's comments**

**TUESDAY, 15 DECEMBER 2020**

## Domestic liquidity and bonds market

### Ukraine successfully taps Eurobond market

Last Friday, the MoF was able to successfully tap the Eurobond market, pricing US$600m of bonds due 2033 at a 6.2% yield.

### Foreigners return to bond market

Last week, the MoF offered investors notes due 2025, which last year were in demand by foreigners. This allowed the MoF to attract new demand from foreigners. This week, we expect another increase in foreigner's portfolios since the MoF will offer the same tenor.

### Liquidity up with NBU support

Expectedly, restrained budget expenditures increased outflows from liquidity and only NBU loans allowed banking-sector liquidity to rise slightly at the end of last week. This week, budget expenditures will be more active with NBU's support through loans and in the FX market.

## Foreign exchange market

### Hryvnia appreciates

Last week, hryvnia continued to appreciate due to both external and local impact, ending a week at UAH27.96/US$. This week, appreciation can continue due to foreigners' demand for local-currency debt.

## Economics

### Consumer inflation accelerates to 3.8% YoY

In November, headline inflation expectedly accelerated due to UAH weakening, and rapid recovery of consumer demand, wages, and energy prices in previous months. Inflation is likely to return to target range in December and approach its upper bound at the end of 1Q21.

### NBU keeps the rate on hold at 6%

Expectedly, NBU's Board decided to leave the key policy rate unchanged. We predict that the NBU will postpone the first hike in the new cycle until July 2021 due to spreading COVID-19, a stronger UAH amid solid external accounts, and restoring official financing.

**Banks' reserves market (14 December 2020)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| NBU rate (%)[1] | 6.00 | +0bp | -750bp |
| ON rate (%) | 7.13 | +217bp | -490bp |
| ON $ swap (%) | N/A | ... | ... |
| Reserves (UAHm)[2] | 88,985 | +72.21 | +135.45 |
| CDs (UAHm)[3] | 86,391 | -23.39 | -6.97 |

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 December 2020)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| NBU | 324,577 | +0.00 | +9.59 |
| Banks | 461,027 | -0.15 | +411.74 |
| Residents | 37,384 | +5.93 | +57.17 |
| Individuals | 8,791 | -1.36 | +784.35 |
| Foreigners[1] | 77,302 | +3.12 | +256.49 |
| **Total** | **909,204** | **+0.40** | **+110.12** |

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

**FX market indicators (14 December 2020)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| USD/UAH | 27.7882 | -1.14 | +18.30 |
| EUR/USD | 1.2144 | +0.33 | +9.20 |
| DXY | 90.711 | -0.28 | -6.65 |
| UAH TWI[1] | 119.640 | +0.96 | -14.26 |

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

**Gov't bond quotes[1] (15 December 2020)**

| Maturity | Bid | Ask |
|---|---|---|
| 6m | **10.50** | **9.00** |
| 12m | **12.00** | **10.50** |
| 2y | **12.25** | **11.00** |
| 3y | **12.50** | **11.25** |
| 12m ($) | **4.50** | **3.00** |
| 2y ($) | **5.00** | **3.25** |

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

# Domestic liquidity and bonds market

## Ukraine successfully taps Eurobond market

Last Friday, the MoF was able to successfully tap the Eurobond market, pricing US$600m of bonds due 2033 at a 6.2% yield.

The announcement slightly weakened market conditions, as the day opened in the secondary market at 6.17%. YTMs increased slightly, but without material impact on the final price.

Initial guidance was set at US$500m at a 6.4% YTM. But during the deal, the YTM fell to 6.2%, the same level as the bid yield in the secondary market, allowing the issue amount to be increased to US$600m (par value).

Our estimate is that total borrowings amounted to about US$670m. Together with the EU loan received a few days prior and the WB loan, the MoF's ability to finance budget expenditures has considerably strengthened.

***ICU view: Ukraine used the window for the new issue created by demand for the EM assets. YTMs have declined since November, then stabilized during December slightly above 6%. Apparently, the MoF felt it was too risky to wait for the better conditions, especially with the holidays looming. EU macro financial aid has added the positive sentiment of the market for Ukraine allowing it to enter the Eurobond market.***

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

## Foreigners return to bond market

Last week, the MoF offered investors notes due 2025, which last year were in demand by foreigners. This allowed the MoF to attract new demand from foreigners. This week, we expect another increase in foreigner's portfolios since the MoF will offer the same tenor.

While locals are interested in short-term bills, foreigners have greater interest in four-year paper, and likely bought most of it last week.

In total, the MoF sold UAH16bn of new instruments, where UAH10bn was denominated in local currency (see auction review). More than one-quarter of UAH-denominated borrowings were from the four-year note with most of that demand from foreigners. https://bit.ly/3nyJXbS

Last year, foreigners were very active in this maturity, buying most of the UAH34bn raised at par value. Therefore, another offering received large demand since it is liquid and can be traded abroad.

At the end of last week, foreigner's portfolios were up UAH2.2bn to UAH77bn.

***ICU view: Today longer notes offerings will attract additional foreign demand, causing an increase in their portfolios. Likely, total portfolios will rise above UAH80bn this week, as the Ministry can meet higher rates for this paper than they did a week ago.***

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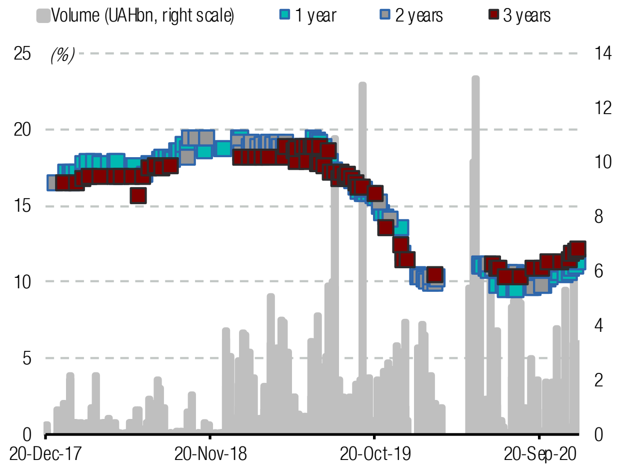
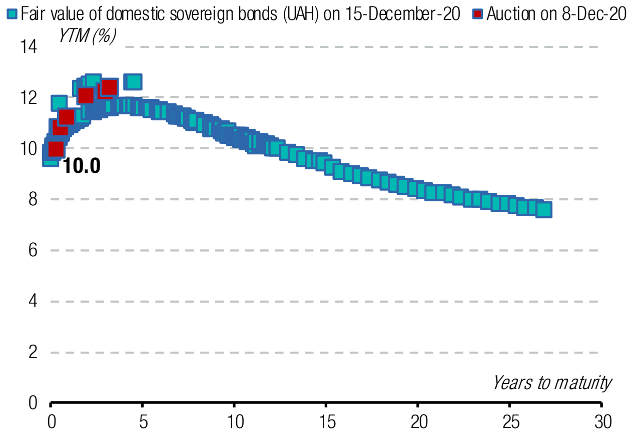
**Chart 1. Local-currency bonds**

*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.

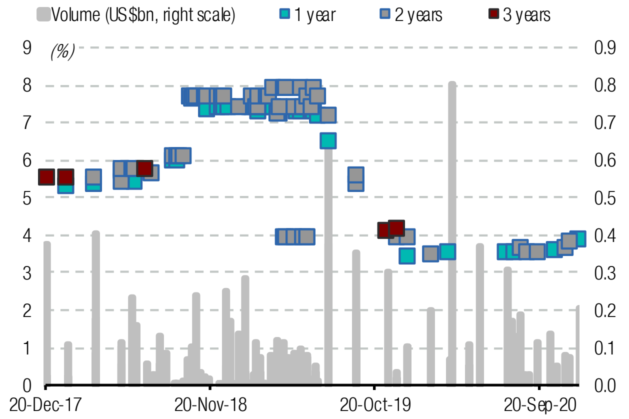
*Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions*




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

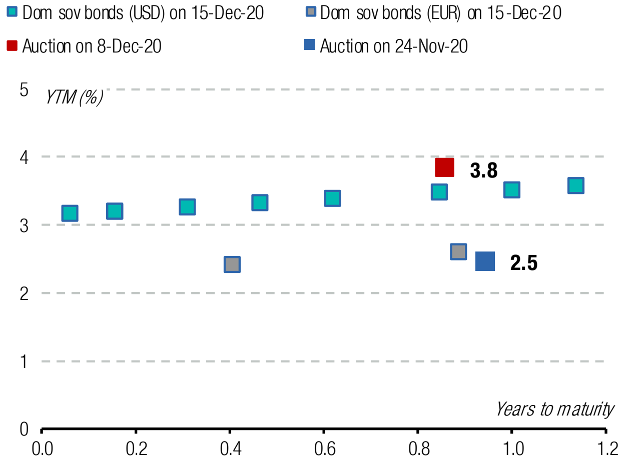
**Chart 2. FX-denominated bonds**

*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 up with NBU support

Expectedly, restrained budget expenditures increased outflows from liquidity and only NBU loans allowed banking-sector liquidity to rise slightly at the end of last week. This week, budget expenditures will be more active with NBU's support through loans and in the FX market.

For most of last week, there was an outflow of funds to budget accounts, and reserves exchange in cash amounted to UAH4.7bn and UAH4.9bn, respectively, during four days of last week. But finally, last week, the Treasury absorbed just UAH0.9bn of liquidity and banks exchanged UAH6.5bn of reserves in cash.

There were two ways how the NBU compensated these outflows. Banks received UAH11bn of loans from the NBU for up to five years, and through the FX market, the NBU injected UAH2.2bn into banking-sector liquidity.

Therefore, liquidity rose by UAH5.9bn to UAH175bn at the end of the week.

***ICU view: Restrained expenditures from the state budget will not take place this week after about US$1.7bn or about UAH50bn of external financing was attracted last week (see comment above). Therefore, budget expenditures will accelerate this week with inflow to liquidity, in addition to debt repayments in local currency.***

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

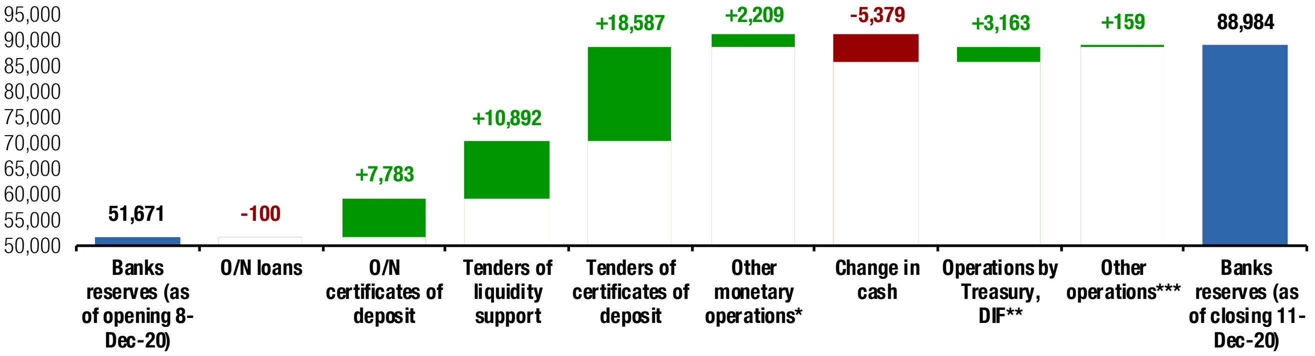
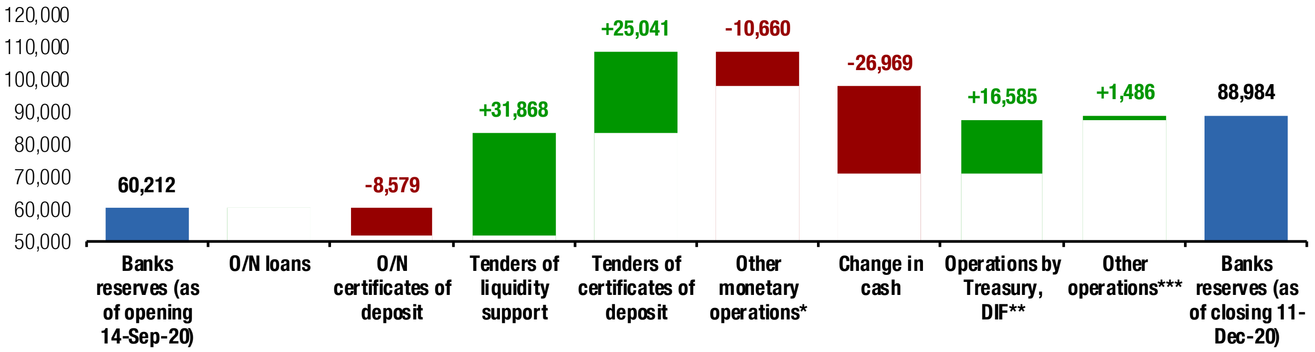



**Chart 4. Banks reserves usages over last 90-day period (UAHm)**




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

Last week, hryvnia continued to appreciate due to both external and local impact, ending a week at UAH27.96/US$. This week, appreciation can continue due to foreigners' demand for local-currency debt.

The positive impact from external factors was mostly due to US dollar weakening against other hard currencies. But there cannot be further appreciation without the recovery of foreign demand for UAH-denominated bills (see comment above), which caused additional supply of hard currency to the Ukrainian FX market.

Extra supply induced the NBU to intervene in the market with hard currency purchase to restrain appreciation, especially last Friday when it purchased US$70m. However, there could be funds for this week's auction too.

***ICU view: We anticipate that this week, the FX market will be impacted by foreigners' demand for UAH-denominated debt. Therefore, the hryvnia can appreciate further this week, but it will remain just slightly below UAH28/US$. However, with budget expenditures accelerating and lower activity from foreigners in the bond market, the hryvnia will weaken later this year to about UAH28.5/US$.***

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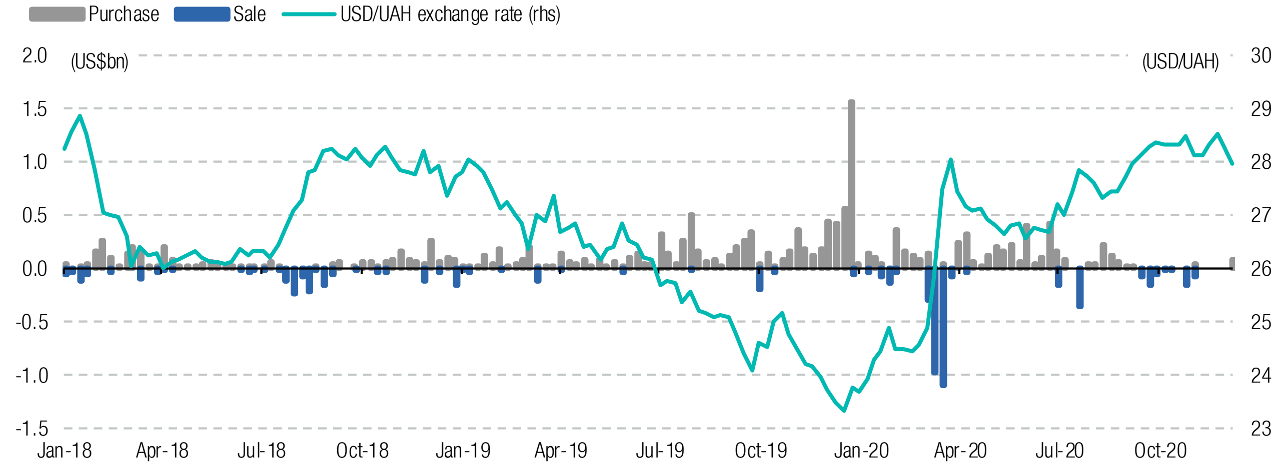
**Chart 5. FX market indicators, 3-year history**

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




Source: NBU, Bloomberg, ICU.

# Economics

## Consumer inflation accelerates to 3.8% YoY

In November, headline inflation expectedly accelerated due to UAH weakening, and rapid recovery of consumer demand, wages, and energy prices in previous months. Inflation is likely to return to target range in December and approach its upper bound at the end of 1Q21.

In November, consumer prices grew by 1.3% MoM and annual inflation accelerated to 3.8% YoY from 2.6% YoY in October. The figure was higher than Bloomberg consensus and our own nowcast, both 3.4% YoY. Core inflation also rose to 3.9% YoY as core CPI increased by 0.7% MoM.

Almost completely, the acceleration of YoY inflation was provided by two groups. First, food price growth accelerated to 3.4% YoY from 1.6% YoY in October. Acceleration was observed for almost all categories of food. Second, the growth rate for prices of gas and utilities increased to 10.8% YoY from 5.5% YoY in October.

***ICU view: The monthly growth rate of prices was the highest since the autumn of 2018 and slightly exceeded consensus estimates. However, in general, the acceleration of annual inflation in the autumn was quite expected against the background of the fading statistical effect of last year's low inflation, the weakening of the exchange rate in previous months, and the rapid recovery of wages and retail trade.***

***We expect inflation to continue to drift higher, and in December, both headline CPI and core CPI are likely to return to the NBU's target range and approach its upper bound of 6% at the end of 1Q21. We expect it will hover around 6% for the most of 2021. For this rise of inflation, we factor in not only the fading effects of low MoM inflation prints at the beginning of 2020, but also a 20% minimum wage hike in January, a surge in***

***global commodity prices including those for food, and the ongoing upturn of energy prices along with their pass-through to domestic prices for fuel, gas, and utilities.***

***Meanwhile, there are several reasons why our current projection of inflation in 2021 is slightly lower compared with September when we expected inflation to exceed the NBU target range. First, stricter lockdown measures in 4Q20 and 1Q21 will restrain prices growth, especially for contact services, and clothes and footwear. Second, we improved our estimates on the UAH exchange rate to account for more benign global financial conditions for EMs and more favourable terms of trade. Third, not-disbursed official financing and limited ability to borrow domestically restrain the government from massive fiscal spending at the end of the year, at least compared with amounts envisaged by the Budget Law. Fourth, the government delayed the next round of the minimum wage hike to UAH6,500 to December 2021 from July. And finally, we note the prudent stance of NBU's monetary policy and the lower chances of strong monetary accommodation next year. The latter fact is also confirmed by relatively anchored inflation forecasts and expectations of different groups of economic agents.***

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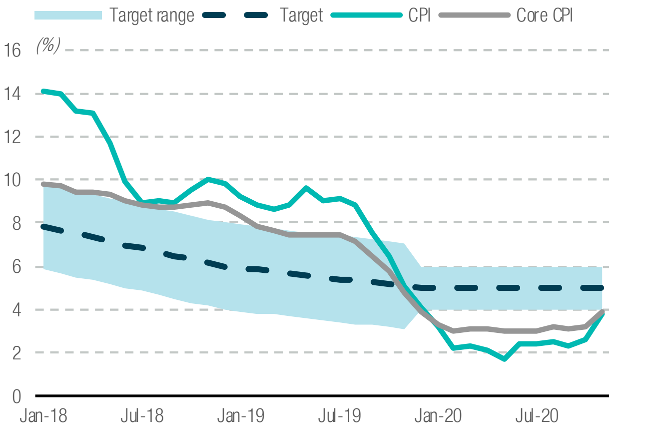
**Chart 6. CPI, core CPI and target, YoY, %**

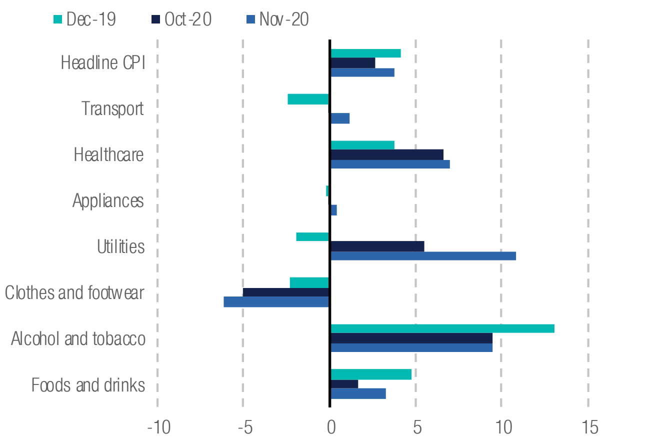
*(Both headline and core inflation move towards target range quickly last month)*




Source: Ukrstat, ICU.

**Chart 7. CPI and its main components, YoY, %**

*(Prices of food, gas, and utilities accelerated sharply compared with October)*




Source: Ukrstat, ICU.

## NBU keeps the rate on hold at 6%

Expectedly, NBU's Board decided to leave the key policy rate unchanged. We predict that the NBU will postpone the first hike in the new cycle until July 2021 due to spreading COVID-19, a stronger UAH amid solid external accounts, and restoring official financing.

The NBU's decision was in line with our expectations and those of most experts and participants of different surveys. According to the NBU, a 6% rate provides an expansionary stance of monetary policy, which is important for economic recovery, and simultaneously keeps inflation moderate.

Forward guidance was balanced. The NBU pointed out the possibility of a rate hike in case the epidemiological situation stabilizes quickly and the economy continues to revive, stimulated by fiscal policy, in particular via an increase in the minimum wage. On the other hand, the NBU mentioned a likelihood to provide the economy with additional monetary stimulus if negative impact from pandemic on economic activity and inflation is more severe.

***ICU view: First, inflationary pressures are growing relatively slowly. Second, in 4Q20 and 1Q21, aggregate demand is expected to be weaker than was anticipated earlier due to the deteriorating situation with the COVID-19 pandemic. Third, the global low-***

***inflation environment and some strengthening of the exchange rate due to improved external accounts will be important headwinds for inflation. Fourth, world interest rates will remain low at least through next year. And finally, the resumption of official funding reduces medium-term risks to external sustainability and financial stability.***

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