

Weekly Insight

Consumer inflation accelerates

Key messages of the today's comments

TUESDAY, 16 FEBRUARY 2021

Domestic liquidity and bonds market

Sound demand for UAH bonds despite decline in rates

Last week, the MoF refinanced most debt principal repayments thanks to strong demand for UAH-denominated bonds. This week, we expect investors to remain active despite caps on offerings and lower rates for short-term bills.

Liquidity up due to inflows from NBU and Treasury

The total amount of banking-sector liquidity remains high due to NBU's purchases of hard currency and budget expenditures. But, demand for cash slows the increase in liquidity. This week, tax payments and new bill purchases will increase outflows, but liquidity will stay above UAH190bn.

Foreign exchange market

NBU prevents hryvnia appreciation

Last week, the hryvnia weakened due to expectations of coming seasonal appreciation. NBU interventions rose and reversed the trend, weakening the hryvnia to almost UAH28/US\$. This week, the hryvnia exchange rate will return to appreciation trend due to large supply of hard currency from exporters and foreign investors, while NBU interventions can be restrained.

Economics

Consumer inflation accelerates as expected

Mainly due to the sharp rise in prices for food and housing services, inflation rose to 6.1% in January, exceeding the upper limit of the NBU's target range. Looking ahead, the impact of pro-inflationary factors will be partially offset by the strengthening of the exchange rate, keeping inflation not far from current levels. As before, we expect that at the next meeting on monetary issues on 4 March, the NBU Board will keep the rate on hold at 6%.

Banks' reserves market (15 February 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	6.00	+0bp	-500bp
ON rate (%)	5.30	+25bp	-399bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	64,169	+36.39	-0.85
CDs (UAHm) ³	138,605	-5.40	+0.00

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 gov't bond holders (UAHm) (15 February 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU	322,077	-0.77	-4.48
Banks	518,161	-0.19	+305.62
Residents	60,695	+0.54	+114.78
Individuals	12,511	-1.35	+1,906.01
Foreigners ¹	100,130	+1.88	+215.59
Total	1,013,761	-0.14	+92.90

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (15 February 2021)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.7757	+0.26	+13.46
EUR/USD	1.2129	+0.08	+11.98
DXY	90.480	+0.05	-8.72
UAH TWI ¹	119.135	-0.45	-12.58

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (16 February 2021)

Maturity	Bid	Ask
6m	10.00	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

Sound demand for UAH bonds despite decline in rates

Last week, the MoF refinanced most debt principal repayments thanks to strong demand for UAH-denominated bonds. This week, we expect investors to remain active despite caps on offerings and lower rates for short-term bills.

At last week's auction, the MoF sold more than UAH13bn (US\$474m) of new bonds against UAH15.5bn (US\$560m) of redemptions. However, new borrowings were mostly in local currency, while redemptions were mostly in hard currency. This is the main reason for the change in investor's portfolios.

Foreigners replaced most hard-currency repayments with new local-currency paper. At the end of last week, they held UAH100bn (US\$3.6bn) of domestic bonds. Individuals held UAH12.5bn (US\$450m) in total portfolios, where UAH5.7bn (US\$206m) or almost 46% were in local currency.

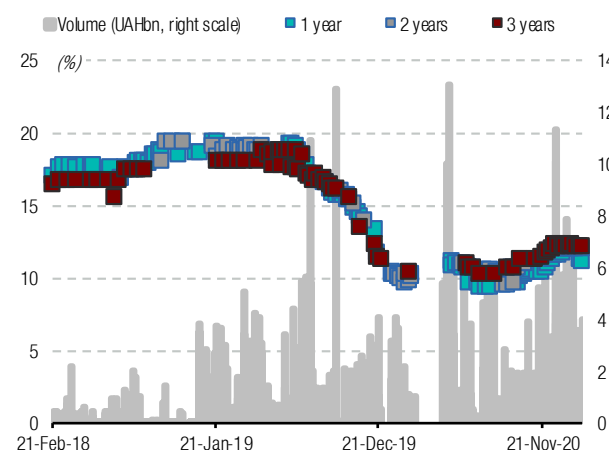
ICU view: Investors' demand is still high despite the gradual decline in interest rates for local-currency bills. The MoF caps the offering for short-term bills, which allows it to decrease rates for these bills (see [auction comment](#)).

This week, the Ministry decided to cap the offering for 1.5-year paper, too, which will increase pressure on interest rates and induce investors to submit bids with lower rates. Or, it may move demand to longer maturities. Therefore, we expect a further decline in rates, especially for 12-month and 1.5-year paper.

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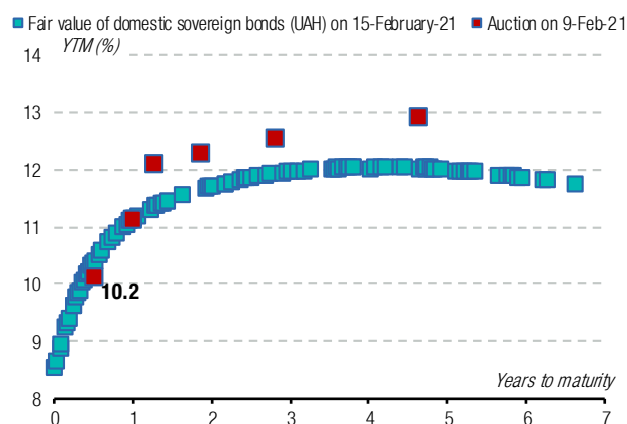
Chart 1. Local-currency bonds

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.

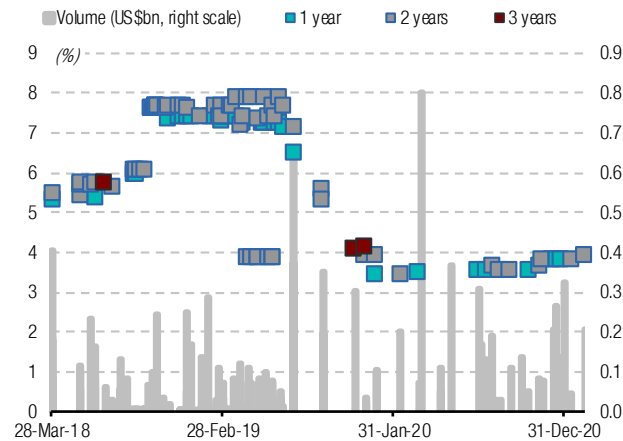
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

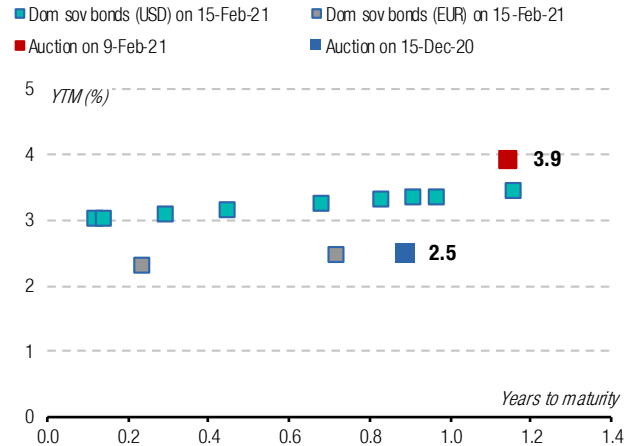
Chart 2. FX-denominated bonds

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 due to inflows from NBU and Treasury

The total amount of banking-sector liquidity remains high due to NBU's purchases of hard currency and budget expenditures. But, demand for cash slows the increase in liquidity. This week, tax payments and new bill purchases will increase outflows, but liquidity will stay above UAH190bn.

Last week the Treasury caused the most important inflows in liquidity, which amounted to UAH12.3bn. In addition, the NBU purchased UAH3bn of hard currency and provided banks with UAH10bn of new loans while they repaid UAH8bn of old loans. This allowed liquidity to rise to above UAH200bn.

However, demand for cash increased, and last week caused reserves exchange in cash at UAH4.2bn. As the result, outflows in cash YTD amounted to UAH1.3bn after last month when banks exchanged UAH3.3bn of cash in reserves.

Therefore, last week, liquidity was up UAH11.5bn to UAH203bn.

ICU view: *Despite considerable pressure on liquidity from reserves exchange in cash, liquidity in the banking system is still high and this week likely will not see material changes. Tax payments and new bill purchases will be mostly compensated by hard currency purchases by the NBU and by budget expenditures. Therefore, liquidity can decline slightly, but remain high above UAH190bn, allowing banks to invest most of these funds in NBU CDs.*

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

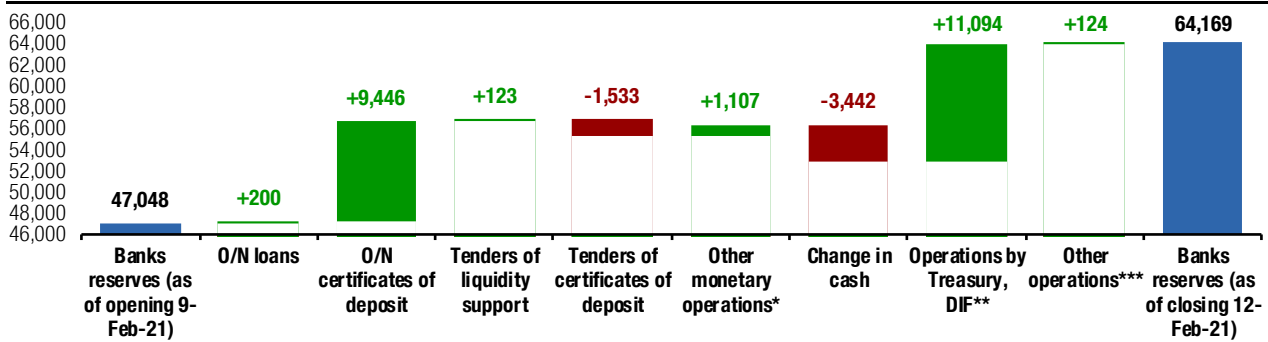
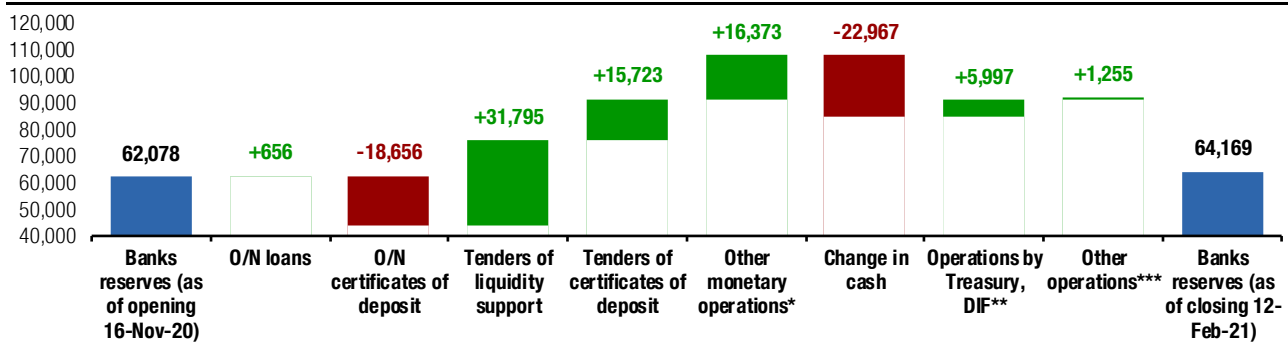


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

NBU prevents hryvnia appreciation

Last week, the hryvnia weakened due to expectations of coming seasonal appreciation. NBU interventions rose and reversed the trend, weakening the hryvnia to almost UAH28/US\$. This week, the hryvnia exchange rate will return to appreciation trend due to large supply of hard currency from exporters and foreign investors, while NBU interventions can be restrained.

With purchases of US\$110m last week, the NBU not only restrained hryvnia appreciation, but for a time, reversed the trend to weakening and moved the exchange rate to almost UAH28/US\$. Active interventions on Monday and especially on Tuesday absorbed extra supply of hard currency from foreigners. But lack of supply of hard currency from exporters preparing for tax payments moved the market balance to the demand side. Additional interventions on Thursday added pressure to the hryvnia and increased its weakening.

Therefore, last week the hryvnia lost 0.8%, weakening through the end of the week to UAH27.93/US\$.

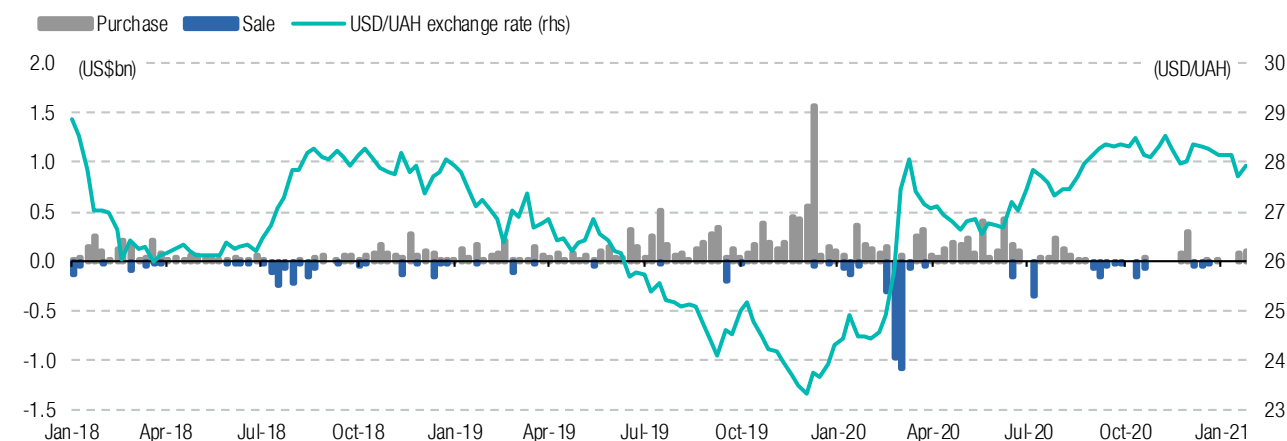
ICU view: Last week's short-lived weakening should provide additional stimulus for foreigners to buy new local-currency bills, and for exporters to sell hard currency for tax payments. Therefore, we anticipate that this week, hryvnia will return to appreciation. We expect that NBU interventions will become a bit more restrained and will be used to minimize fluctuations.

At the same time, without positive outcome of the IMF mission on the first review of Stand-by programme, investors will be a bit more restrained in their purchases of new local-currency bonds, decreasing the supply of hard currency in the market. Nevertheless exporters should keep the market balance in favor to the supply side. We expect slight appreciation of the hryvnia towards UAH27/US\$. It should end this month within the range of UAH27–27.5/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 as expected

Mainly due to the sharp rise in prices for food and housing services, inflation rose to 6.1% in January, exceeding the upper limit of the NBU's target range. Looking ahead, the impact of pro-inflationary factors will be partially offset by the strengthening of the exchange rate, keeping inflation not far from current levels. As before, we expect that at the next meeting on monetary issues on 4 March, the NBU Board will keep the rate on hold at 6%.

In January, consumer prices grew by 1.3% MoM and annual inflation accelerated to 6.1% YoY, compared with 5.0% YoY in December. The outcome came in between NBU's estimate and Bloomberg consensus (both 6.3% YoY) and our nowcast of 6.0% YoY. Thus, after hitting the NBU target in December, inflation overshoot NBU's target range of 5% +/- 1 pp. Core inflation rose to 5.0% YoY from 4.5% YoY in December, as core CPI increased by 0.3% MoM, fully in line with our expectations.

The upsurge in January was almost completely determined by food and utilities components where price growth accelerated to 6.3% YoY and 18.4% YoY correspondingly. For the former, an increase in prices was relatively broad-based; however, the main contribution was provided by rapid acceleration in volatile prices for eggs, sugar, and sunflower oil. For the latter, the rapid price increase was determined by one-off hikes of prices for electricity, sewerage, and water supply.

Fundamental inflation pressure remained relatively moderate as the MoM SA increase in core CPI was close to 5% in annualized terms last month. Outbreak of COVID-19 cases kept the price growth for many unessential goods and services muted, while the stronger exchange rate provided additional drag on prices growth.

ICU view: Looking ahead, further moves of food and energy prices and effects of a 20% hike in minimum wage will probably put additional upward pressure on inflation. However, the recent and ongoing strengthening of the UAH exchange rate together with still existing slack in the economy (large output gap) will help to offset this pressure. Thus, we continue to project that this year headline inflation will hover not far from the upper bound of target range, especially taking into account that the ongoing food price spike should unwind in the second half of year.

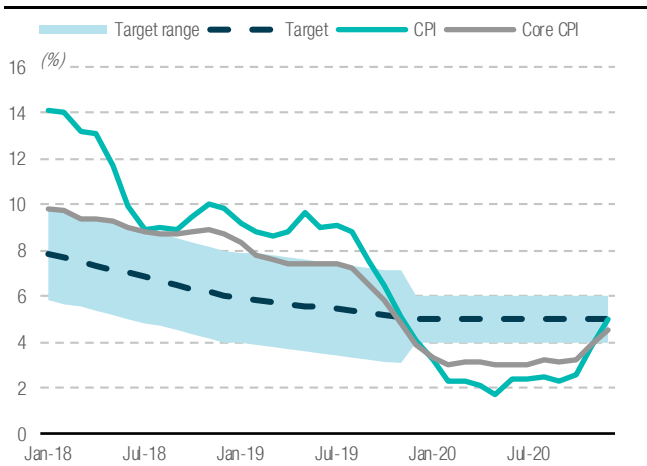
With that said, we held our view that the NBU will deviate from its interest rate projection announced two weeks ago, which assumes a 50 bp hike in early March. So, we expect that the NBU will restrain from raising the interest rate in March, and potentially even in 2Q21, if appreciation pressure remains and start the tightening cycle when the role of the main inflation driver moves from supply-side factors and administrative decisions to demand pressure.

In its forward guidance, the NBU pointed to capital inflows and the resulting exchange rate appreciation as potential reasons to postpone raising the interest rate. It looks to be a baseline scenario nowadays. Moreover, the NBU started to purchase FX relatively actively restraining appreciation pressure last week. Amid such FX policy of the NBU, providing additional support for UAH appreciation via a rate hike would be an inconsistent policy mix. And finally, we factor in a slightly lower January outcome for inflation compared with the NBU estimate (6.3% YoY) announced by the NBU Governor during the monetary press conference.

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

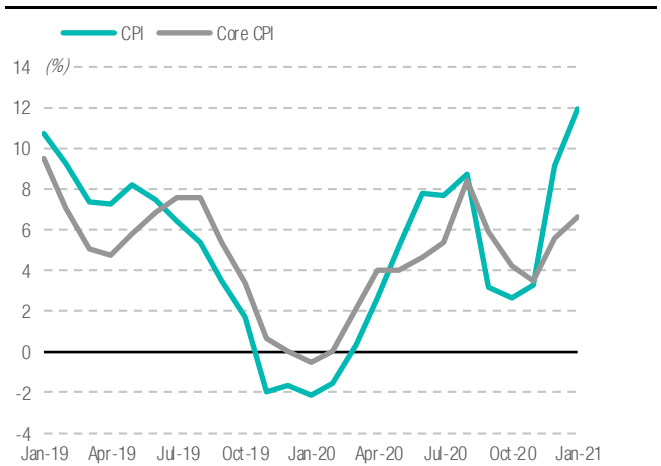
(In January, consumer inflation went beyond the target range, this time exceeding it)



Source: Ukrstat, NBU, ICU.

Chart 7. CPI and Core CPI, 3MA MoM SAAR, %

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



Source: Ukrstat, ICU.

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