Focus	Markets	Research team
Ukraine	**Domestic liquidity, government bonds, FX market, and macro**	**Sergiy Nikolaychuk** **Alexander Martynenko** **Taras Kotovych**

Weekly Insight

Yields continue to decline

Key messages of the today's comments

MONDAY, 22 FEBRUARY 2021

Domestic liquidity and bonds market

Yields continue to decline

A combination of active demand for UAH-denominated bonds and the MoF's caps for some of them caused interest rates to decline at the primary market, which we expect to continue this week.

Liquidity down as expected

There were outflows of funds to budget accounts last week, causing liquidity to decline to UAH190bn, where it should fluctuate this week.

Foreign exchange market

Seasonal hryvnia appreciation delayed

Last week, the FX market was self-balanced without NBU interventions, resulting in a delay of seasonal hryvnia appreciation. This week we expect that the exchange rate will stay within the range of UAH27.5–28.0/US$ with gradual appreciation.

Economics

GDP: Strong recovery in 4Q20 despite "second wave" of pandemic

The contraction in Ukrainian GDP eased sizably in the final quarter of the year despite the deteriorating pandemic situation and the tightening of quarantine restrictions. With the economic impact of the "second wave" fading and both external and domestic demand picking up further, the recovery is set to continue over the coming quarters.

Banks' reserves market (19 February 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	6.00	+0bp	-500bp
ON rate (%)	5.15	-14bp	-398bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	62,662	+8.95	-4.43
CDs (UAHm)[3]	127,924	-6.39	-29.99

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) (19 February 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU	322,077	+0.00	-1.93
Banks	523,540	+0.98	+62.61
Residents	61,032	+0.65	+142.95
Individuals	13,345	+7.20	+49.42
Foreigners[1]	102,864	+2.84	-20.29
Total	**1,023,125**	**+0.92**	**+25.77**

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

FX market indicators (19 February 2021)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.8615	-0.26	+14.14
EUR/USD	1.2119	-0.01	+12.16
DXY	90.364	-0.13	-9.37
UAH TWI[1]	119.001	+0.26	-13.16

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

Gov't bond quotes[1] (22 February 2021)

Maturity	Bid	Ask
6m	**10.00**	**9.00**
12m	**11.50**	**10.50**
2y	**12.00**	**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

Yields continue to decline

A combination of active demand for UAH-denominated bonds and the MoF's caps for some of them caused interest rates to decline at the primary market, which we expect to continue this week.

Last week, the MoF extended the list of capped bills by adding 16-month paper. This decision caused a sizable decline in rates for this maturity, as well as short-term bills with maturities up to one year. For this near 1.5-year paper, the Ministry accepted less than one-third of received demand. More details in the latest auction review.

Caps induce investors to submit bids with lower rates and allow the MoF to accept the cheapest bids within the cap, decreasing cut-off rates and the weighted-average cost of borrowing.

The decline in rates did not diminish investors' interest in purchasing new UAH-denominated paper. An increase in portfolios was seen for all groups, with the largest increase for banks and foreigners.

ICU view: Despite the lack of a staff-level agreement after the IMF mission ended, foreigners continue to invest in UAH-denominated sovereign debt. A delay in seasonal hryvnia appreciation makes new investments attractive for foreigners. Therefore, we expect that in February, a net increase in their portfolio will amount to about UAH10bn (US$360m), similar to the previous two months.

However, interest rates will continue to decline, although probably less actively. Scheduled debt repayments amount to almost UAH12bn (USD430m), and the MoF will try to refinance most of them. Therefore, the Ministry is going to raise the amount of caps for 12-month and 16-month bills, decreasing the competition for new purchases. In addition, the current level of interest rates at the primary bond market is still attractive for most of investors. For banks, the premium to the NBU key policy rate continues to exceed 300bp making a possible increase in NBU key rate not crucial. For foreigners, interest rates at 9-12% are still attractive in comparison with less risky assets, especially with expectations of hryvnia appreciation.

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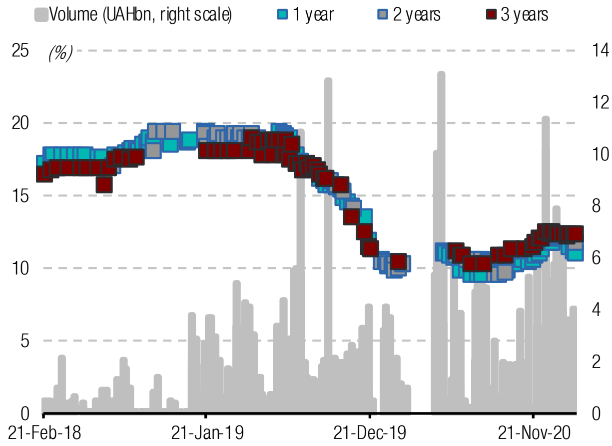
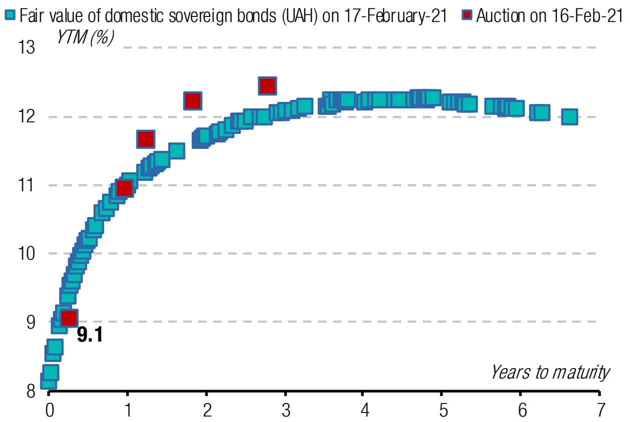
Chart 1. Local-currency bonds

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.

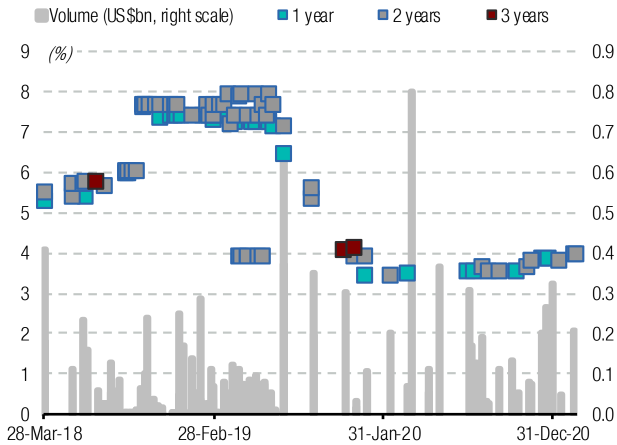
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

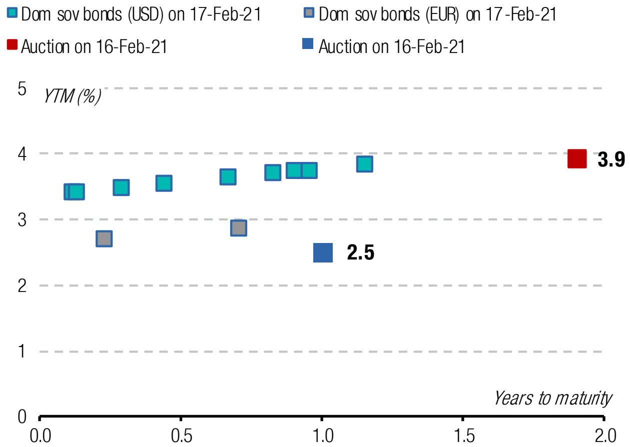
Chart 2. FX-denominated bonds

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 down as expected

There were outflows of funds to budget accounts last week, causing liquidity to decline to UAH190bn, where it should fluctuate this week.

Last week, the Treasury absorbed UAH14bn due to tax collection and new issues of UAH-denominated bills (see comment above), and lower expenditures than a week before. Meanwhile, tax collection was not large, just UAH6.3bn during the week, although there was acceleration on Thursday and Friday.

NBU had low impact on banking sector liquidity, providing banks with just UAH660m of new loans and did not intervene in the FX market.

Overall, last week, liquidity declined by UAH13bn to UAH190bn.

ICU view: The period of quarterly tax payments ends without extra outflows from liquidity. We may see increased fluctuation in liquidity this week due to unmatched month-end tax payments and VAT refunds.

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

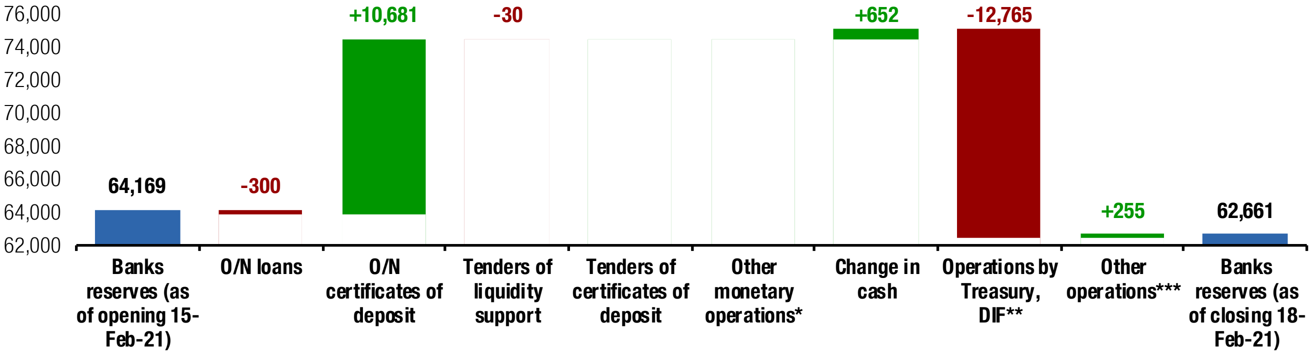
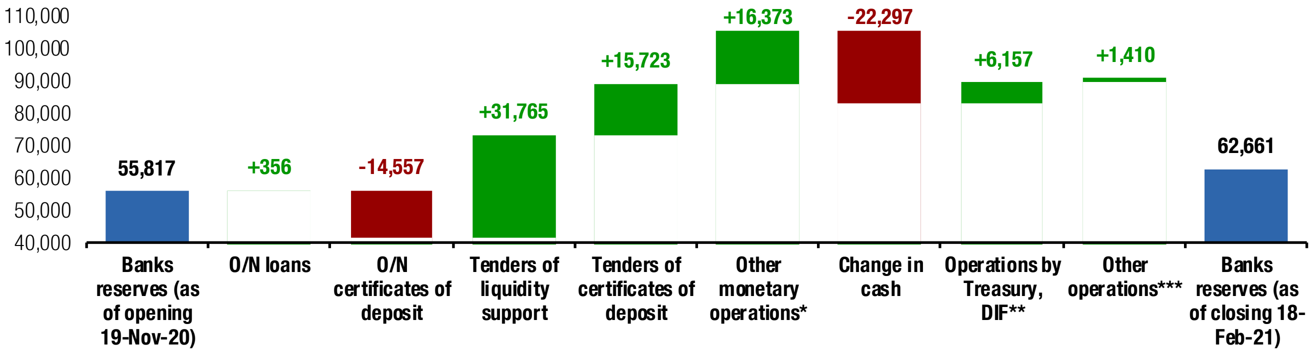


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

Seasonal hryvnia appreciation delayed

Last week, the FX market was self-balanced without NBU interventions, resulting in a delay of seasonal hryvnia appreciation. This week we expect that the exchange rate will stay within the range of UAH27.5–28.0/US$ with gradual appreciation.

After very active purchases during the previous two weeks, last week, the NBU did not intervene in the FX market. The market was self-balanced at around UAH27.8/US$. Among the reasons for this balance were: a low level of tax payments that did not require extra exchange of hard currency; shrank sale of hard currency by foreigners to pay for new bills due to caps on the issues (more details are above); an increase in energy imports and demand for hard currency; and worsened market sentiment due to lack of a staff-level agreement with the IMF.

Therefore, over the past week, the hryvnia strengthened somewhat, but mostly hovered in a fairly narrow range. By the end of the week, the hryvnia had appreciated by just 0.3% to UAH27.86/US$.

ICU view: The lack of a staff-level agreement with the IMF will continue to weigh on market sentiment. Nonetheless, foreigners will continue to take advantage of the current exchange rate for new investments in UAH-denominated debt, and on Tuesday

and Wednesday, they will sell hard currency for purchases at Tuesday's primary auction. Therefore, we expect some appreciation of the hryvnia, albeit exchange rate should stay within the range of UAH27.5–28.0/US$.

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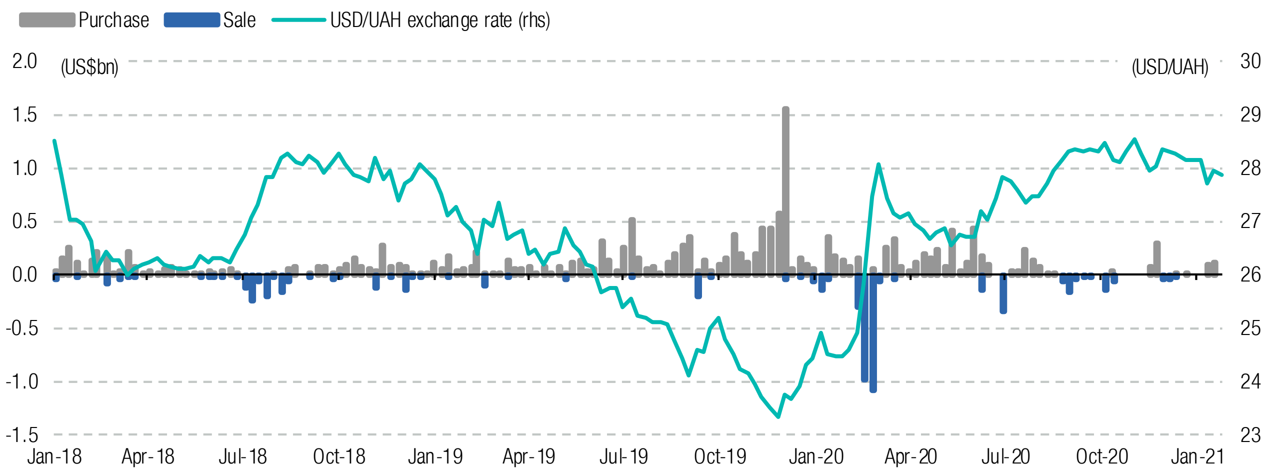
Chart 5. FX market indicators, 3-year history

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



Source: NBU, Bloomberg, ICU.

Economics

GDP: Strong recovery in 4Q20 despite "second wave" of pandemic

The contraction in Ukrainian GDP eased sizably in the final quarter of the year despite the deteriorating pandemic situation and the tightening of quarantine restrictions. With the economic impact of the "second wave" fading and both external and domestic demand picking up further, the recovery is set to continue over the coming quarters.

Figures published last week show that Ukrainian GDP grew by 0.8% QoQ SA and contracted by 0.7% YoY in the final quarter of the year. This represents a strong improvement from the 3.5% YoY contraction recorded in 3Q20 and exceeded most expectations. For the full year, GDP contracted by an est.4.2%, following four sequential years of growth with an average pace of 2.9%.

UkrStat will publish the breakdown for GDP and the nominal values on 22 March.

ICU view: A rebound in 4Q20 was driven by improved terms of trade, public investments into infrastructure, and the resilience of domestic consumer demand against the background of a higher minimum wage in September and a significant increase in budget expenditures in December. As a result, the growth of real wages and retail trade accelerated respectively to 9.6% YoY and 13.6% YoY on average in 4Q20. The situation in industry also improved rapidly, with production growing by 4.8% YoY in December. The situation in agriculture also made a significant contribution: due to the late corn harvest, output in December increased by 26% YoY.

As a result, in 4Q20, the Ukrainian economy performed much better compared with most peers (see Chart 6). As we stressed earlier, it was caused by structure of the Ukrainian economy, favourable terms of trade, and improved macrofinancial resilience, as well as fast adaptability of domestic firms and households to new conditions.

Looking ahead, growth looks strong this year. We have pencilled in 5.6% expansion, which would leave GDP around 5% below its pre-crisis trend assuming 3% growth in 2020–21. Consensus is for growth of around 4%.

In addition to the favourable comparison base and growth momentum at the beginning of the year even despite January's lockdown, we factor in current elevated export prices, expected rebound of agricultural output, and still supportive fiscal policy and monetary conditions. Moreover, lifting of the remaining restrictions in transportation and contact services may provide an additional boost for the economy if the pandemic risks are contained due to vaccination of the most vulnerable groups in 2H21.

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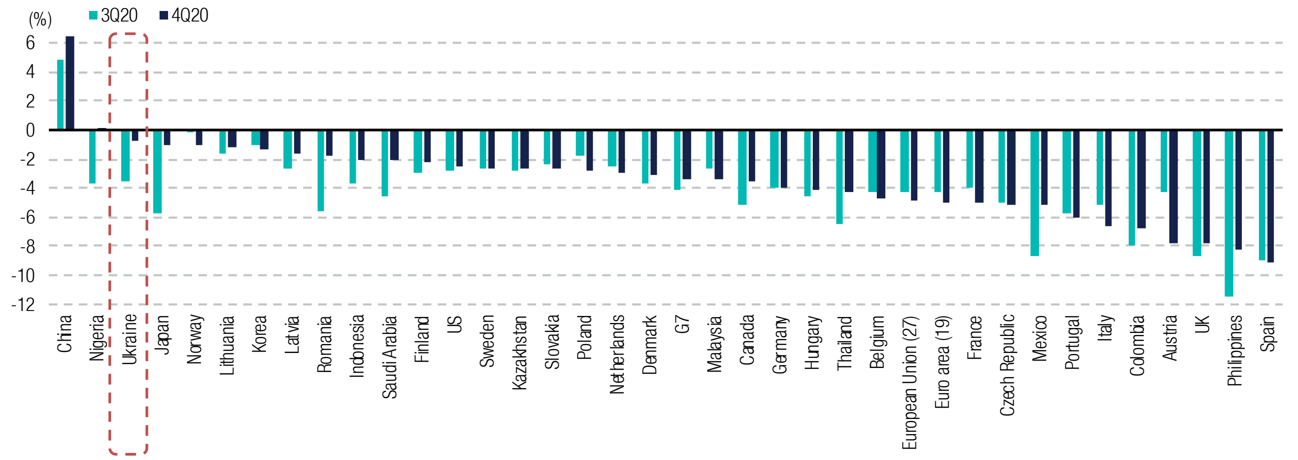
Chart 6. Real GDP (YoY, %)



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

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