



Focus
Ukraine

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

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Weekly Insight

Inflation unexpectedly jumps to 9.5% YoY

Key messages of the today's comments

Domestic liquidity and bonds market

Foreigners set new records of investment

After last week's auction, foreigners' portfolios grew by the largest amount this year and on record since September 2019. Without caps for the new five-year note this week, foreigners may set another new record increase in their portfolios.

Foreign exchange market

Hryvnia supported by investment from foreigners

Foreigners' activity in the Ukrainian bond market was the key reason for hryvnia appreciation in June, especially last week. This week, we expect foreigners to invest more funds in local-currency debt, causing the hryvnia to appreciate further toward UAH26.5/US\$.

Economics

Inflation unexpectedly jumps to 9.5% YoY

In May, inflation acceleration significantly exceeded expectations, primarily due to a sharp rise in prices for certain foodstuffs and natural gas. Fundamental inflationary pressure remains relatively moderate, although core inflation is also affected by the rapid rise in sunflower oil prices. Given the predominantly temporary nature of accelerating inflation and the strengthening of the exchange rate in recent weeks, we still consider that the NBU will keep the rate on hold at 7.5% this week.

MONDAY, 14 JUNE 2021

Banks' reserves market (11 June 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	7.50	+0bp	+150bp
ON rate (%)	7.18	+97bp	+30bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	58,930	+11.11	+10.91
CDs (UAHm) ³	141,936	-4.42	-0.96

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) (11 June 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU	317,277	-0.47	-2.25
Banks	505,687	+1.06	+27.40
Residents	47,363	+10.07	-7.50
Individuals	17,140	+6.30	+126.37
Foreigners ¹	108,475	+8.57	+5.38
Total	996,138	+1.81	+12.78

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (11 June 2021)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	26.9709	-0.98	+1.39
EUR/USD	1.2109	-0.48	+7.17
DXY	90.555	+0.46	-6.39
UAH TWI ¹	122.993	+0.84	-3.80

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (14 June 2021)

Maturity	Bid	Ask
6m	10.00	8.50
12m	12.00	11.00
2y	12.75	11.50
3y	13.00	12.00
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

Foreigners set new records of investment

After last week's auction, foreigners' portfolios grew by the largest amount this year and on record since September 2019. Without caps for the new five-year note this week, foreigners may set another new record increase in their portfolios.

In total last week, foreigners purchased almost UAH8.5bn (US\$315m) of new UAH-denominated bonds, including UAH6bn (US\$220m) on settlement day of last week's auction. Including transactions in the secondary market, it appears that foreigners purchased more than half of last week's issuance in local currency.

After the successful auction last week, the MoF made changes to the auction schedule. They will offer new five-year paper without caps both tomorrow and next week. However, there will be caps for the 12-month and 1.5-year instruments.

Huge issuance of new bonds in the primary auction caused increase in the secondary bond market turnover to UAH12.5bn from UAH4.9bn a week before, while the number of deals remained steady. The most activity was with bills due in May 2024 with 81 deals amounted to UAH2.3bn, while the largest amount of secondary market trading registered for bills due to July 2022, at UAH2.6bn. According to NBU data, weighted-average yields at the end of last week were within the range of 8.2–13.2%, without sizable changes compared with the previous week.

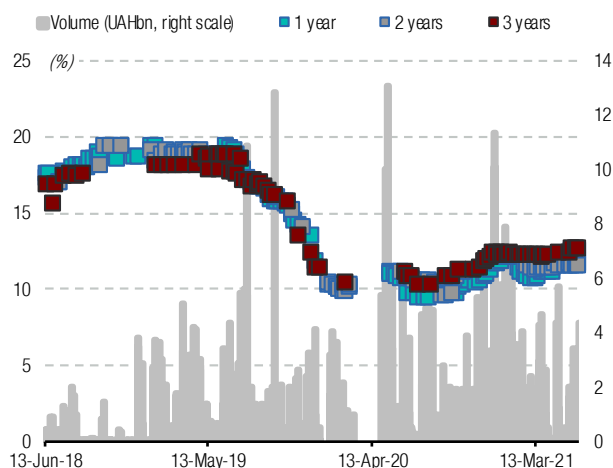
ICU view: Huge demand for new notes, which was only partially accepted last week, can be submitted tomorrow with new demand from both local and foreign investors. Caps for shorter maturities should cause decline in rates for these instruments and move demand to a longer paper. Therefore, we anticipate demand for the new five-year paper to be greater than UAH5bn with a large part of that demand coming from foreigners.

Since the MoF has to pay UAH17bn in debt repayments including UAH14bn in principal, this week, most of these funds can be reinvested in new bonds. Therefore, we expect debt principal repayments will be refinanced in full, which will increase net financing of the state budget deficit.

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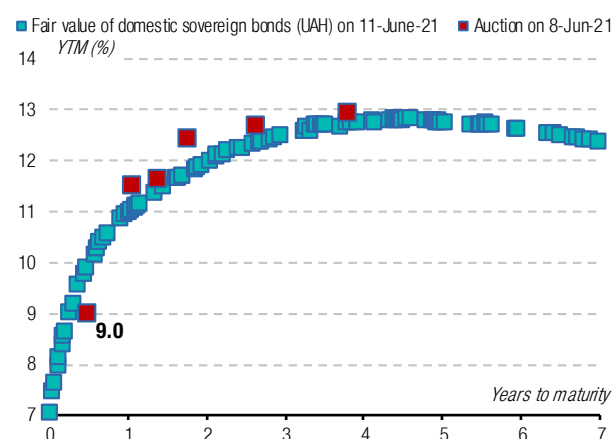
Chart 1. Local-currency bonds

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.

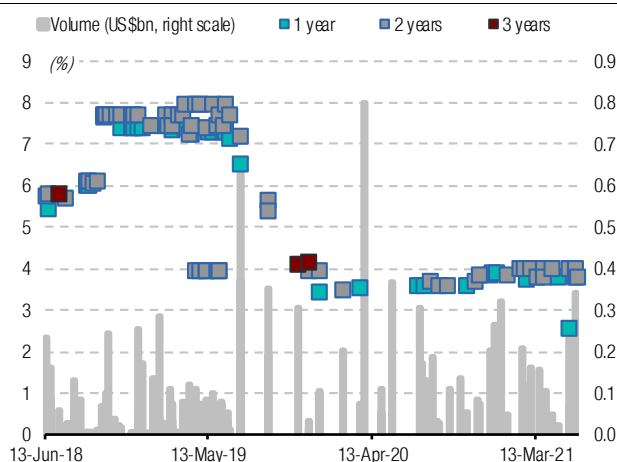
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

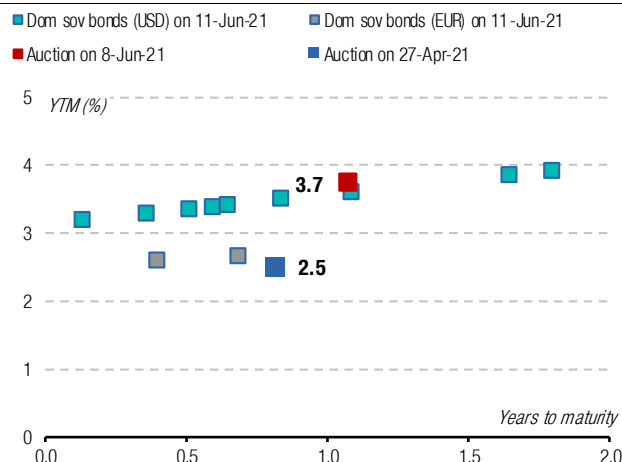
Chart 2. FX-denominated bonds

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.

Foreign exchange market

Hryvnia supported by investment from foreigners

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Purchases of UAH8.5bn of local-currency debt (see comment above) required selling hard currency, which moved the FX market to the supply side. The NBU intervened in the FX market most days last week and purchased US\$375m, exceeding the net purchase before that week YTD. Nevertheless, the hryvnia continued to appreciate, despite the NBU's efforts to restrain appreciation.

Last week, the hryvnia appreciated 1% to UAH26.97/US\$ and 5.2% YTD.

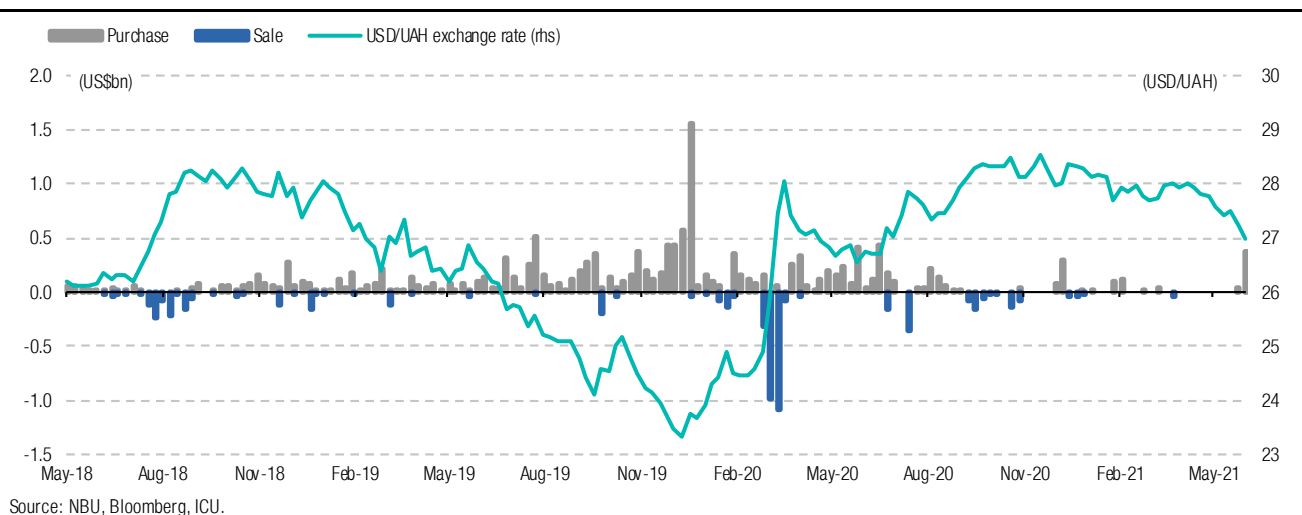
ICU view: Foreigners can sell at least US\$200-300m to finance purchases in the new auction. Increased positive sentiment toward Ukrainian bills should cause the FX market to stay at supply side, supporting hryvnia appreciation. The terms of trade in the commodities markets continue to be favourable for Ukraine. In addition locals will spend more for their current needs within Ukraine due to restrictions on traveling, which will decrease demand for FX and support hryvnia too.

We expect the hryvnia to continue to appreciate towards UAH26.5/US\$ during June.

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Chart 3. FX market indicators, 3-year history

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



Economics

Inflation unexpectedly jumps to 9.5% YoY

In May, inflation acceleration significantly exceeded expectations, primarily due to a sharp rise in prices for certain foodstuffs and natural gas. Fundamental inflationary pressure remains relatively moderate, although core inflation is also affected by the rapid rise in sunflower oil prices. Given the predominantly temporary nature of accelerating inflation and the strengthening of the exchange rate in recent weeks, we still consider that the NBU will keep the rate on hold at 7.5% this week.

In May, consumer prices grew by 1.3% MoM, while annual inflation accelerated to 9.5% YoY from 8.4% YoY in April, moving even further away from the NBU's 5% target. The obtained result exceeded the estimates of the vast majority of experts (Bloomberg consensus—8.8% YoY; ICU estimate—8.6% YoY). At the same time, the acceleration of core inflation to 6.9% YoY from 6.3% YoY in April met our expectations.

The key contribution to May inflation was provided by the increase in the price of natural gas by 15% MoM due to the expiration of the price restriction introduced this year and the transition of gas supply companies to the annual tariff. As a result, the price of gas turned out to be 2.6 times higher than a year ago, and, in general, the growth of utility prices accelerated from 26.5% YoY in April to 35.3% YoY.

Acceleration of prices in transport was also noticeable—to 12.2% YoY from 9.2% YoY in April—primarily due to a further increase in fuel prices and low base of comparison.

Food inflation continued to grow to 10.5% YoY. This may be partly explained by the late entry of berries and fruits into the market due to the cold spring. However, the growth of prices for meat and meat products accelerated the most (up to 10.3% YoY), reflecting the effects of higher costs due to rising wages and grain prices, as well as sunflower oil (up to 75% YoY).

The latter factor also contributed to the acceleration of core inflation, providing a contribution of 1.5 p.p. in the annual change of the Core CPI. The strengthening of the exchange rate restrained the fundamental inflationary pressure, which also hindered the deterioration of inflation expectations.

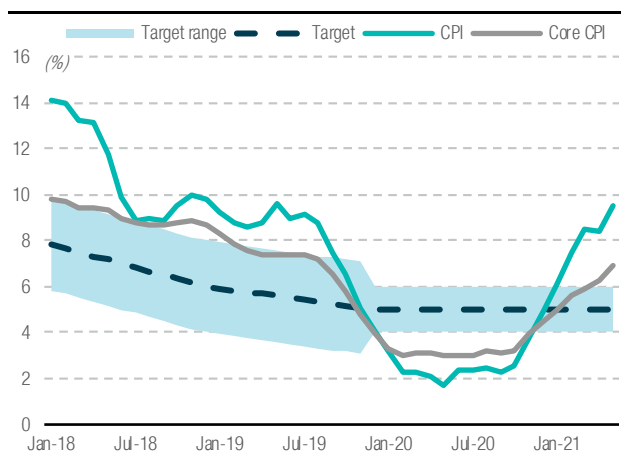
ICU view: The May data increase the risks of higher annual inflation during 2H21. However, we continue to view the current jump in inflation as temporary, as most of its factors are transitory. First, by the end of the next heating season, gas prices will remain largely stable, resulting in a decline of the annual growth to 5-10% by the end of the year. Second, the late entry of fresh berries and fruits into the market this year shifts the seasonal pattern somewhat and should increase summer deflation accordingly. And third, the expected good harvest of grain, oilseeds, and sugar beets should provide a strong disinflationary effect in 2H21.

Therefore, even given the NBU's aggressive response to inflation in the past, we do not expect the current figures to be a trigger for a rate change this week. Moreover, the previous and advanced rate hikes have already contributed to the inflows of portfolio investments into the country and exchange-rate strengthening. It is unlikely that an additional stimulus through this monetary transmission channel from the central bank is currently needed. Rather, the NBU may allow the exchange rate to strengthen more, only marginally smoothing currency appreciation through FX interventions as in previous months.

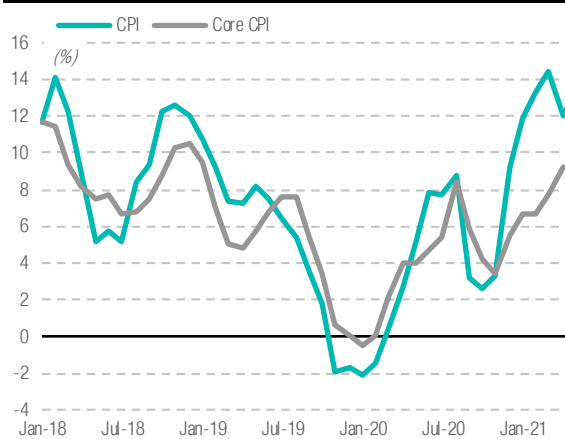
In addition, the reaction of bank rates to previous key policy rate hikes was rather sluggish. Probably, there is a potential for an increase in deposit rates without further hikes of the NBU rate. However, it is likely that the NBU may use other monetary instruments to stimulate a response from banks. First of all, we are talking about limiting the volume of long-term refinancing loans, something the NBU has already hinted at. Nowadays, this is becoming increasingly important as the economy opens up, given the "crisis nature" of this monetary instrument, and its distorting impact on the monetary system.

It is also likely that the NBU's communication will become more hawkish. However, a potential rate hike moving forward will be related not so much to the pass-through of global food and energy prices into domestic ones, but to increasing fundamental inflationary pressure as a result of a more rapid economic recovery after the recent lockdowns. But for the new decisive moves, the NBU must receive more strong signals from the real sector and the labour market than just an increase in sunflower oil prices and the introduction of annual natural gas tariffs.

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Chart 4. CPI, core CPI and target, YoY, %*(Both headline and core inflation accelerated sharply since October 2020)*

Source: Ukrstat, NBU, ICU

Chart 5. 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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