



Focus
Ukraine

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

Research team
**Sergiy Nikolaychuk
Alexander Martynenko
Taras Kotovych**

Weekly Insight

Consumer inflation remains at 9.5% YoY

Key messages of the today's comments

Domestic liquidity and bonds market

Bond markets freeze awaiting signals

Despite a number of new placements, the bond market remained calm. It seems that investors are in no hurry to invest in Ukrainian sovereign debt, since they expect changes in both world markets and in Ukraine itself.

Foreign exchange market

FX market self-balances

After some fluctuations, the FX market in Ukraine has found balance near UAH27.3/US\$. Exchange rate should remain at that level with fluctuations within UAH27–27.5/US\$.

Economics

Consumer inflation remains at 9.5% YoY

After accelerating sharply in previous months, in June, headline inflation did not change amid a slowdown in the growth of food prices and rising fundamental inflationary pressures. As before, we expect that these trends will continue in the coming months and will call for the NBU to raise the key rate by 50bp to 8% next week.

MONDAY, 12 JULY 2021

Banks' reserves market (9 July 2021)

| | Last | Weekly chg (%) | YoY chg (%) |
|------------------------------|---------|-------------------|----------------|
| NBU rate (%) ¹ | 7.50 | +0bp | +150bp |
| ON rate (%) | 6.41 | -22bp | +126bp |
| ON \$ swap (%) | N/A | ... | ... |
| Reserves (UAHm) ² | 41,577 | -10.07 | +10.40 |
| CDs (UAHm) ³ | 173,269 | +0.86 | +44.97 |

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) (9 July 2021)

| | Last | Weekly chg (%) | YoY chg (%) |
|-------------------------|----------------|-------------------|----------------|
| NBU | 317,277 | +0.00 | -2.25 |
| Banks | 501,586 | -0.87 | +20.18 |
| Residents | 48,453 | +0.49 | +65.77 |
| Individuals | 17,945 | -1.37 | +144.18 |
| Foreigners ¹ | 110,123 | -0.25 | +11.77 |
| Total | 995,384 | -0.47 | +13.49 |

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (9 July 2021)

| | Last | Weekly chg (%) | YoY chg (%) |
|----------------------|---------|-------------------|----------------|
| USD/UAH | 27.3001 | -0.34 | +1.46 |
| EUR/USD | 1.1876 | +0.09 | +5.24 |
| DXY | 92.130 | -0.10 | -4.73 |
| UAH TWI ¹ | 124.207 | +0.75 | -2.06 |

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (12 July 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

Bond markets freeze awaiting signals

Despite a number of new placements, the bond market remained calm. It seems that investors are in no hurry to invest in Ukrainian sovereign debt, since they expect changes in both world markets and in Ukraine itself.

For several consecutive weeks, activity of investors in the domestic bond market has decreased, which reduced the volume of new placements of local-currency bonds. For two weeks in a row, the Ministry of Finance has only partially refinanced its debt repayments, and now has several weeks to improve budget financing. But investors will not rush this time either.

Last week, in the secondary market, the volume of transactions with UAH-denominated instruments doubled to UAH6bn (US\$0.2bn). So far, the YTM's have not seen material changes. The most traded instruments were those due 2022.

However, there was some interesting news in the Eurobond market. Ukrzaliznytsia priced US\$300m of five-year Eurobonds at 7.875%. Demand for this paper was double what was offered, which allowed the issuer to reduce the rate from the initial 8%.

Given the rather difficult company finances in the last year and the generally restrained attitude of investors to this issuer, obtaining new funding is a very positive result. But given that it is a quasi-sovereign issuer, the placement of approximately 270bp spread to sovereign Eurobonds is a rather large premium. The low liquidity of Ukrzaliznytsia's securities and the small volume of new issues could have played a negative role here too.

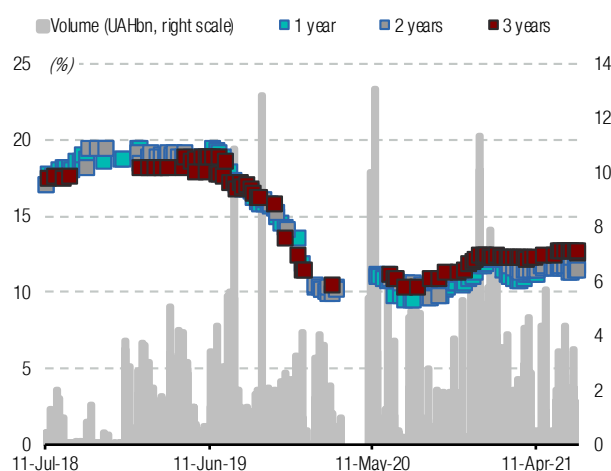
ICU view: *In general, the situation in the markets looks like investors are frozen in anticipation of further developments regarding the pandemic situation around the world, and in Ukraine in particular due to a low vaccination rate. Somewhat negative news about the incidence rate of COVID-19 in some countries and the likelihood of another quarantine in Ukraine discourages foreigners from investing in UAH-denominated debt. In addition, both foreigners and domestic investors expect a key policy rate increase in July, which may cause fairly low demand for UAH-denominated debt at tomorrow's auction.*

Negotiations with the IMF are currently underway to receive the next tranche of the Stand-By Program. Meanwhile, the IMF Executive Board has agreed to propose the largest SDR distribution in the fund's history, which will allow Ukraine to receive about US\$2.7bn and help replenish international reserves to meet large external debt redemptions this September. Therefore, in the absence of high-quality positive news, investors' interest in Ukrainian debt will still continue to be restrained, although we don't expect a sell-off. But the pause in investor activity will be extended that much more.

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

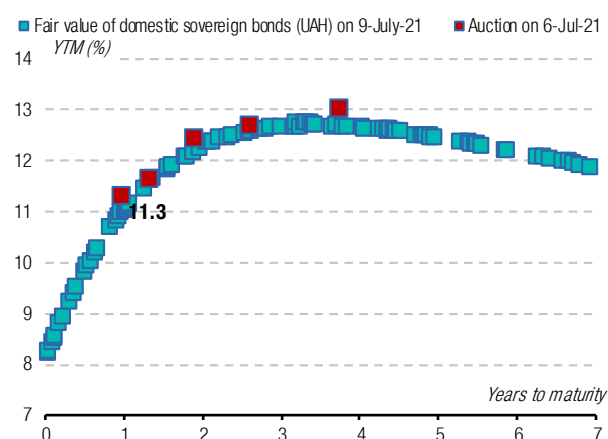
Chart 1. Local-currency bonds

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.

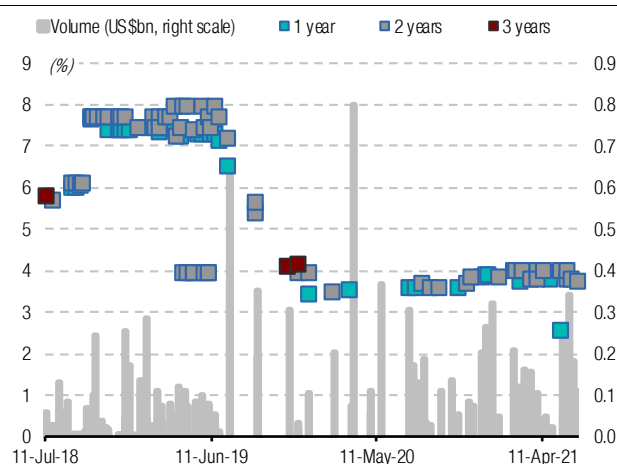
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

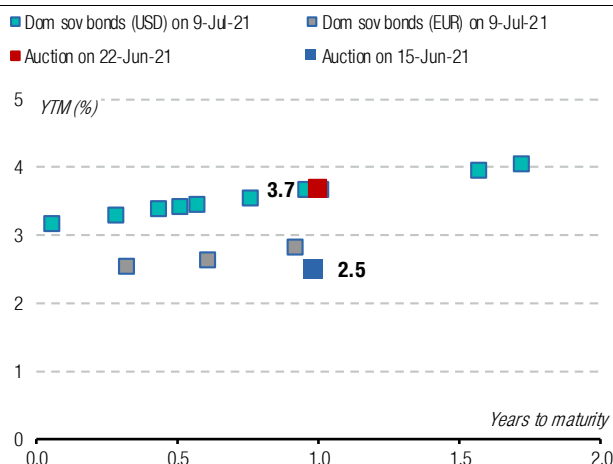
Chart 2. FX-denominated bonds

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



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Foreign exchange market

FX market self-balances

After some fluctuations, the FX market in Ukraine has found balance near UAH27.3/US\$. Exchange rate should remain at that level with fluctuations within UAH27–27.5/US\$.

After some imbalances between demand and supply from banks' clients in June, for the last two weeks, the FX market has been mostly self-balanced with small and infrequent NBU interventions. Last Tuesday, the NBU purchased just US\$20m without making a material impact on the market or its balance. Therefore, the hryvnia exchange rate remained near UAH27.3/US\$ and by the end of last week, it appreciated by 0.3%.

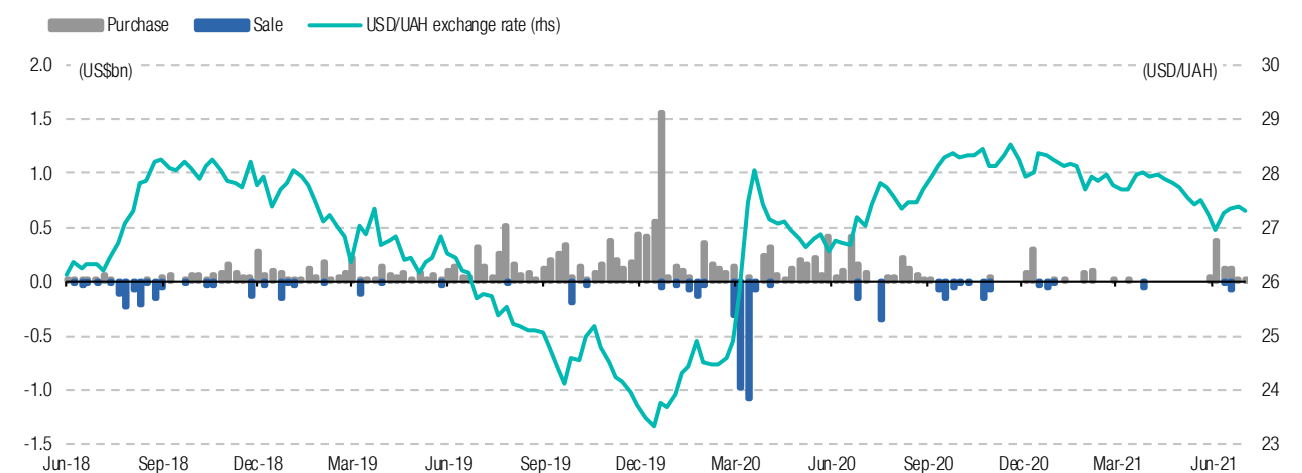
ICU view: Foreigners lack of activity in the local-currency bond market due to the general low activity in the global financial markets, actually allows the market to balance without the influence of the NBU. At present, foreigners are unlikely to become more active both with entry into or exit from hryvnia assets. Positive news about the

IMF funds would increase confidence. Foreigners may add to supply from farmers with grain exports and hard currency sales, but this will not happen for some time.

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

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)



Source: NBU, Bloomberg, ICU.

Economics

Consumer inflation remains at 9.5% YoY

After accelerating sharply in previous months, in June, headline inflation did not change amid a slowdown in the growth of food prices and rising fundamental inflationary pressures. As before, we expect that these trends will continue in the coming months and will call for the NBU to raise the key rate by 50bp to 8% next week.

In June, consumer prices rose by 0.2% MoM, while annual inflation remained at 9.5% YoY, in line with the Reuters consensus (and slightly exceeded our nowcast of 9.3%). The June result was slightly higher than the NBU's April forecast of 9.2%. Meanwhile, the deviation for core inflation was higher. Core inflation surged to 7.3% YoY (from 6.9% in May), sizably exceeding the NBU's April forecast of 6.7%.

This result was due to further increases in sunflower oil prices (up to 80% YoY) and accelerated price growth for a wide range of goods and services including transport services, recreation and culture, and the restaurant and hotel business. Likely, the key drivers were the switching of consumer demand to these services after the reopening of the economy and the high rate of wage growth.

Instead, price growth slowed for some components, which caused higher inflationary pressures in previous months. In particular, food inflation fell to 9.8% YoY from 10.5% YoY in May, primarily due to a sharp fall in egg and fruit prices. The growth of fuel prices also decelerated to 35% YoY.

ICU view: The reversal of food inflation amid the new harvest and the strengthening of fundamental inflationary pressures due to strong consumer demand and the opening of the economy were expected and are likely to continue in the coming months. In particular, in June, the FAO vegetable oil price index fell by 10% MoM, reaching a four-month low, and the overall FAO food price index fell by 2.5% MoM.

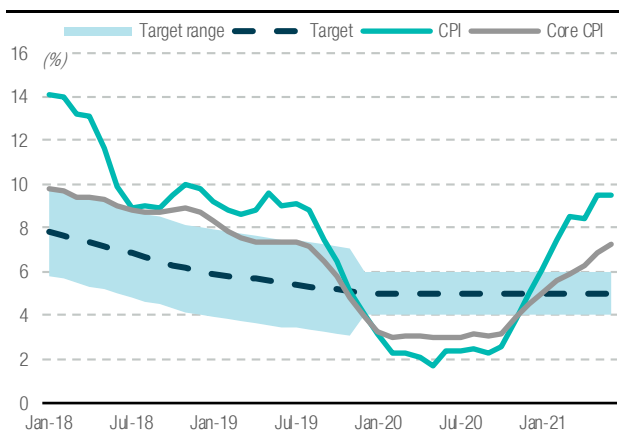
Accordingly, the further change of the headline CPI will be determined by the relative power of these factors. Given the high share of food in the CPI basket, favourable weather conditions and the potential impact of new quarantine restrictions on consumer demand, we expect inflation to slow by the end of the year, but remain well outside the NBU's target corridor.

Although the NBU left the rate unchanged at its June meeting, the persistence of pro-inflation factors, the weakening of portfolio investment inflows and the corresponding weakening of the exchange rate in recent weeks call for further rate hikes. As a result, we expect that next week the NBU will raise the rate by 50bp to 8.0%

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

Chart 4. CPI, core CPI and target, YoY, %

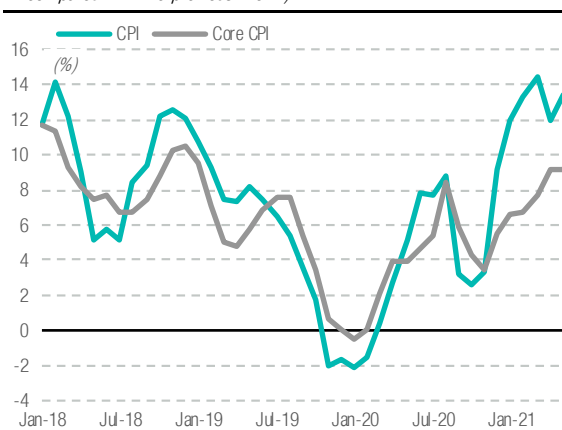
(Both headline and core inflation exceed the NBU's target range)



Source: Ukrstat, NBU, ICU

Chart 5. 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.

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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

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