



Focus
Ukraine

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

Research team
**Alexander Martynenko
Taras Kotovych**

Weekly Insight

The hryvnia under pressure due to VAT refunds

Key messages of the today's comments

MONDAY, 1 NOVEMBER 2021

Domestic liquidity and bonds market

Foreigners reformatting UAH portfolios

Foreign investors have accelerated the reduction of their portfolios of UAH-denominated bonds and just last Friday purchased some six-year notes. We do not expect them to change their sentiment toward UAH-denominated assets in the near future.

Liquidity is close to a record high

The total amount of banking sector liquidity rose again above UAH222bn last month, although it was short of a record high for this year. In November, it is unlikely that a new record will be set due to the large amount of tax payments expected.

Foreign exchange market

The hryvnia under pressure due to VAT refunds

Last week, the hryvnia tried to return to the level of early October, but eventually strengthened again and ended the month at UAH26.27/US\$. The hryvnia exchange rate will remain close to this level this week as well, with further prospects for another strengthening during the quarterly tax payment period.

Banks' reserves market (29 October 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	8.50	+0bp	+250bp
ON rate (%)	7.90	-60bp	+246bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	50,529	-1.81	-5.15
CDs (UAHm) ³	171,336	+5.15	+46.23

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) (29 October 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU	312,606	+0.00	-3.69
Banks	496,988	+0.66	+10.81
Residents	51,448	+2.09	+60.23
Individuals	22,388	+5.36	+169.45
Foreigners ¹	93,281	-0.34	+19.13
Total	976,711	+0.53	+9.53

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (29 October 2021)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	26.2702	-0.04	-7.37
EUR/USD	1.1558	-0.73	-0.99
DX	94.123	+0.51	+0.18
UAH TWI ¹	129.711	+0.54	+6.03

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (1 November 2021)

Maturity	Bid	Ask
6m	11.00	10.00
12m	12.00	11.50
2y	13.00	12.00
3y	13.50	12.50
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 reformatting UAH portfolios

Foreign investors have accelerated the reduction of their portfolios of UAH-denominated bonds and just last Friday purchased some six-year notes. We do not expect them to change their sentiment toward UAH-denominated assets in the near future.

Last week, a large amount of bills were redeemed, mostly those sold in December last year when foreign investors were active. But last week, they were in no hurry to invest in new bonds. On the contrary, due to the repayment, the reduction of their portfolios accelerated. Just last Friday foreigners purchased a portion of six-year paper, reduced withdrawal of funds to just UAH0.4bn last week.

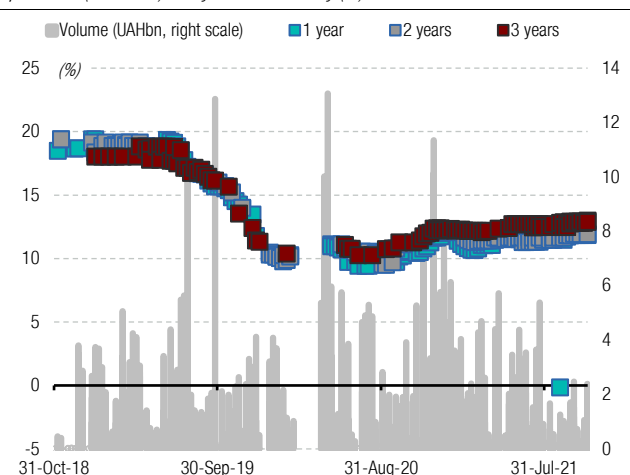
The amount of funds raised at the auction increased to UAH17.2bn in total and UAH6.8bn in local currency (see the [auction review](#)). Accordingly, the volume of trading in the secondary market increased. In general, the volume of transactions almost doubled to UAH14.2bn of deals with bonds denominated in local currency, and to UAH3.9bn with bonds denominated in hard currency. Of course, bills sold by the Ministry of Finance at Tuesday's auction were traded actively on the secondary market, including the six-year note, which most likely was bought by foreigners in the secondary bond market.

ICU view: A slight increase in interest rates does not currently compensate the strong hryvnia exchange rate and does not encourage foreigners to make new investments, just to replace short-term bills with longer notes. On the contrary, it motivates them to reduce their positions at a highly attractive exchange rate and wait for a better time to buy new securities, especially with a weaker hryvnia and at higher interest rates. This may happen in December, when the need for borrowing may increase. Therefore, we expect that foreigners' portfolios will continue to shrink, albeit at a slower pace due to the lack of UAH redemptions this week and next.

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

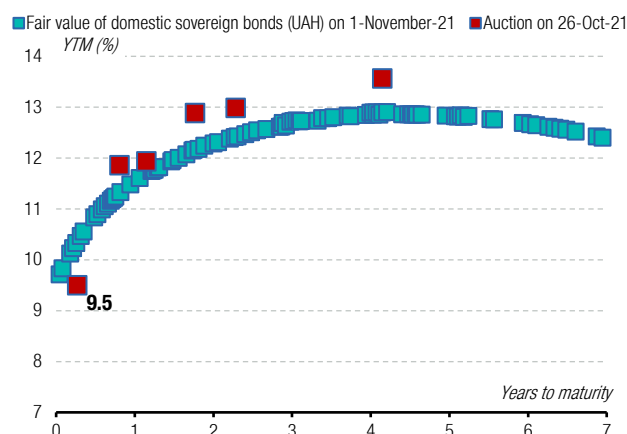
Chart 1. Local-currency bonds

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.

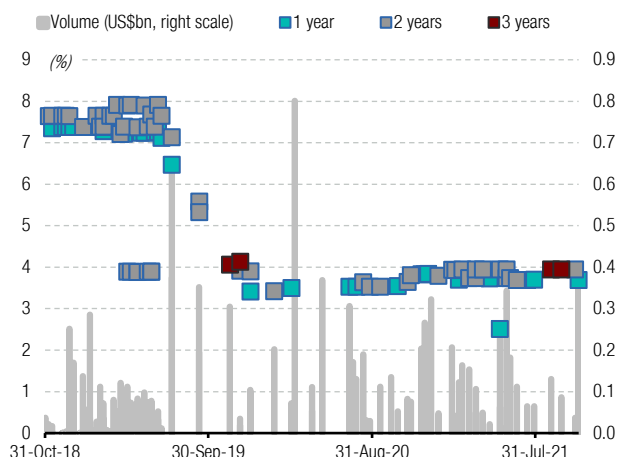
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

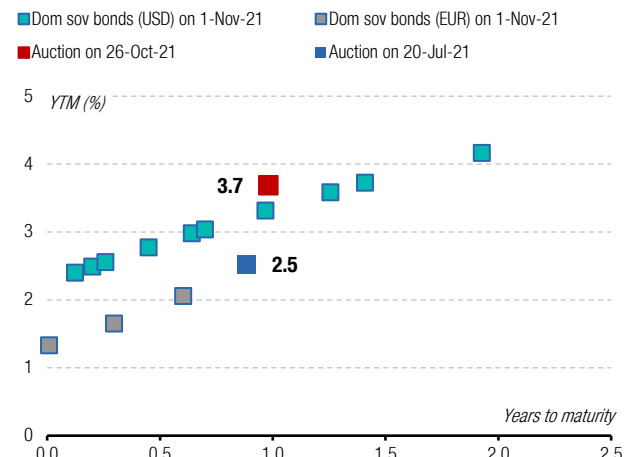
Chart 2. FX-denominated bonds

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



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

Liquidity is close to a record high

The total amount of banking sector liquidity rose again above UAH222bn last month, although it was short of a record high for this year. In November, it is unlikely that a new record will be set due to the large amount of tax payments expected.

In October, the National Bank of Ukraine intensified the purchase of hard currency in the market, increased the total amount of liquidity in the banking system by almost UAH20bn, and became a key liquidity provider for banks. After all, through budget expenditures, banks received only UAH4.5bn of additional liquidity, and only UAH3bn was exchanged into cash.

At the same time, in October, the NBU barely lent to banks through its liquidity support instruments, while banks held between UAH125bn and UA172bn of free funds in NBU's certificates of deposit.

ICU view: In November, the NBU will continue to be the largest source of liquidity for the banking system, but there will be no significant increase in liquidity. Most of the funds received from hard currency selling by exporters will gradually be spent on tax payments, first on quarterly and then on monthly taxes. And these payments will be higher than the VAT refunds, which will prevent liquidity from continuing to grow.

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

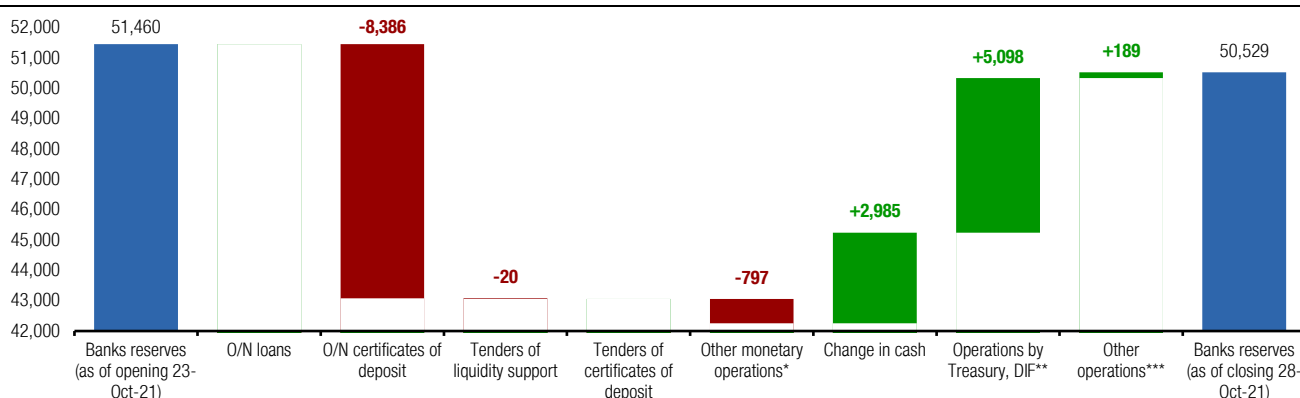
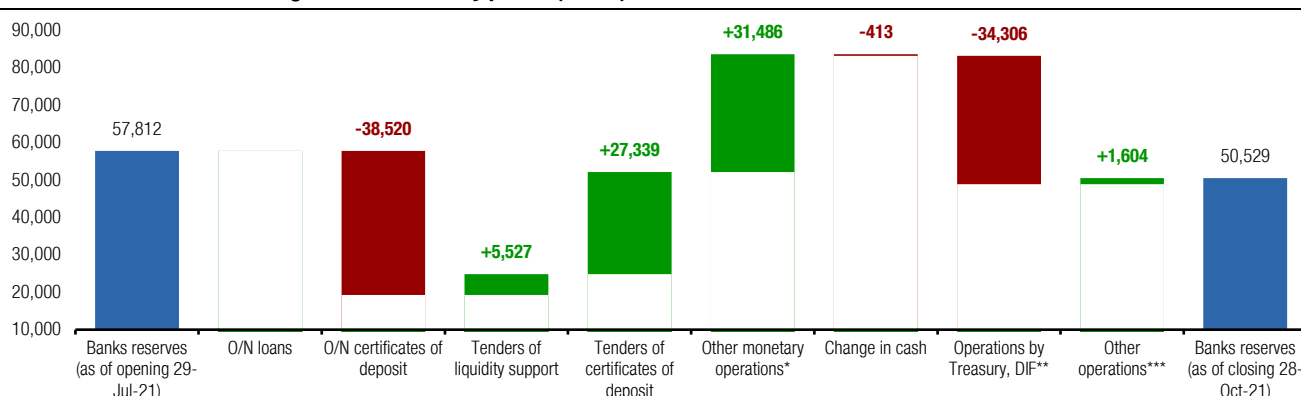
Chart 3. Banks reserves usages over last week(UAHm)

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

The hryvnia under pressure due to VAT refunds

Last week, the hryvnia tried to return to the level of early October, but eventually strengthened again and ended the month at UAH26.27/US\$. The hryvnia exchange rate will remain close to this level this week as well, with further prospects for another strengthening during the quarterly tax payment period.

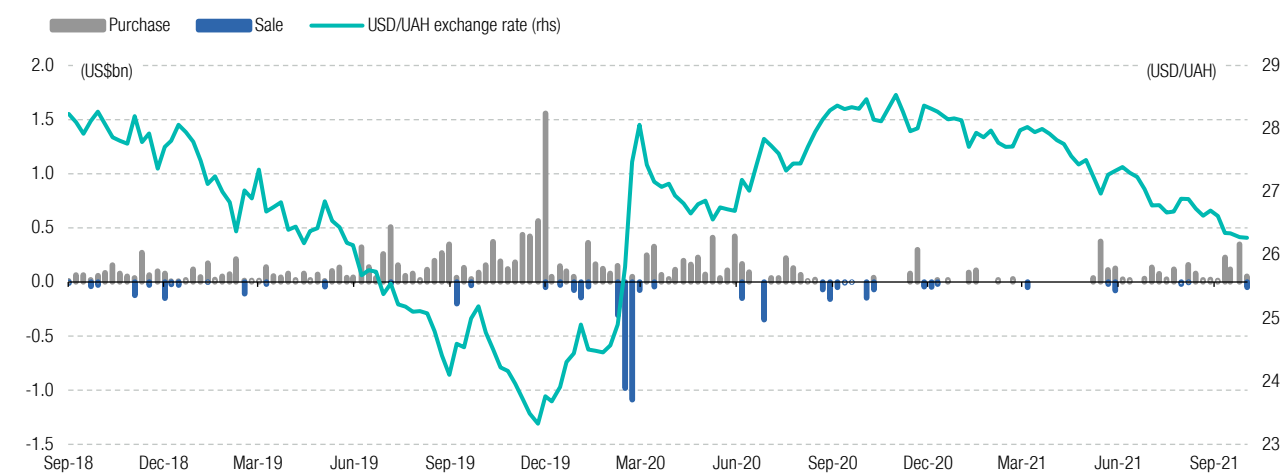
Last week began with the weakening of the hryvnia to UAH26.42/US\$ after another record of strength for 2021 was set on 20 October at UAH26.18/US\$. This was due to two key factors: the Ministry of Finance increased VAT refunds to more than UAH3bn on Monday, and foreigners were preparing to withdraw funds from UAH-denominated debt after redemption on Wednesday. Therefore, the demand for hard currency exceeded supply and caused the weakening and even prompted the NBU to sell the hard currency from reserves.

On Tuesday, the situation did not improve much, but the understanding that the NBU will intervene in the market if necessary again helped the market to self-balance. However, excess of the demand from bank customers for hard currency over supply continued to increase.

But on Wednesday, without the inflow of funds from the budget through VAT refunds and reduced demand for hard currency from foreigners, the balance in the FX market shifted again in favour of hard currency supply by bank customers and later returned the hryvnia exchange rate closer to UAH26.3/US\$. Therefore, in general, during the week, the hryvnia exchange rate strengthened by 0.04%, during October by 1.3%, and since the beginning of the year by 7.3%.

ICU view: *This week, we do not expect active withdrawal of funds by foreign investors, and there will be small amounts of VAT refunds. Therefore, the hryvnia exchange rate will continue to fluctuate in the range of UAH26–26.5/US\$ with further prospects of strengthening in the second half of the month due to the sale of hard currency to pay taxes by exporters. The impact of imports will now be smaller and will only restrain strengthening, helping the NBU to smooth out the peak imbalances in the market.*

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

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.

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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

Alexander Martynenko

Head of corporate research
alexander.martynenko@icu.ua

Mykhaylo Demkiv

Financial analyst (Banks)
mykhaylo.demkiv@icu.ua

Taras Kotovych

Senior financial analyst (Sovereign debt)
taras.kotovych@icu.ua

Dmitriy Dyachenko, CFA

Financial analyst
dmitriy.dyachenko@icu.ua

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