Research team
Vitaliy Vavryshchuk
Alexander Martynenko
Taras Kotovych

Weekly Insight

Ukrainian Eurobond market in seasaw

Key messages of the today's comments

MONDAY, 17 JANUARY 2022

Domestic liquidity and bonds market

Local bond market under pressure

Negative news about a possible Russian invasion has affected the local bond market. Foreigners' withdrawal of funds from UAH-denominated debt has accelerated, but was not in critical amount yet.

Ukrainian Eurobond market in seasaw due to geopolitical tension

Statements made by Russian officials after talks with the US and NATO have led to a significant increase in fear of a possible Russian invasion of Ukraine and worsened Ukraine's credit risk assessments by local and international investors. All this was happening on the back of the expected tightening of the Fed's liquidity support. This led to a sell-off of Ukrainian Eurobonds, which is likely to continue this week.

Foreign exchange market

The hryvnia is weakening

Last week, the hryvnia weakened again, mostly under the influence of psychological factors caused by statements from Russian officials.

Economics

December consumer inflation 10.0%; continues to slow

Inflation decelerated for the third consecutive month in December and ended 2021 at 10.0% YoY.

Banks' reserves market (14 January 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	9.00	+0bp	+300bp
ON rate (%)	8.19	-1bp	+288bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	55,516	+33.64	+1.56
CDs (UAHm)[3]	169,912	-21.21	+37.16

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) (14 January 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU	312,606	+0.00	-3.69
Banks	542,481	+0.76	+3.49
Residents	81,969	+0.02	+41.73
Individuals	25,360	+1.60	+125.69
Foreigners[1]	88,351	-3.79	-1.29
Total	**1,050,844**	**+0.12**	**+4.33**

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

FX market indicators (14 January 2022)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	28.0297	+1.95	-0.22
EUR/USD	1.1411	+0.45	-6.12
DXY	95.165	-0.58	+5.46
UAH TWI[1]	125.888	-2.63	+6.65

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

Gov't bond quotes[1] (17 January 2022)

Maturity	Bid	Ask
6m	**12.00**	**10.75**
12m	**12.75**	**11.75**
2y	**13.75**	**12.75**
3y	**14.00**	**13.25**
12m ($)	**4.00**	**3.00**
2y ($)	**4.50**	**3.25**

Notes: [1] Actual quotes you can see at www.icu.ua.
Source: ICU.

Domestic liquidity and bonds market

Local bond market under pressure

Negative news about a possible Russian invasion has affected the local bond market. Foreigners' withdrawal of funds from UAH-denominated debt has accelerated, but was not in critical amount yet.

The Ministry of Finance sold only UAH3.9bn of new bonds after repaying three times more a week earlier. As last week there were no repayments, investors were in no hurry to purchase new bonds using the funds received a week before. Although to attract UAH3.9bn last week, the Ministry of Finance had to agree to slightly increase cut-off rates (see the auction review).

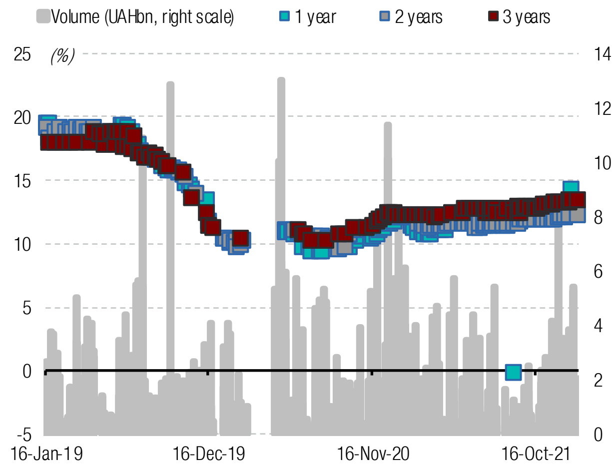
Foreigners reduced their portfolios by almost UAH3bn last week, more than in the first week of this year. Moreover, in the first week of this year reductions were mostly due to bonds redemption, while last week it was the sale of bonds mostly to Ukrainian banks. After all, banks have increased their portfolios of UAH-denominated bonds by UAH6.4bn.

ICU view: We expect that in current conditions foreigners will continue to leave the local-currency bond market and perhaps even more actively than before. Without redemptions it will be more difficult as foreigners will have to offer higher YTMs to induce banks to buy more bonds.

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

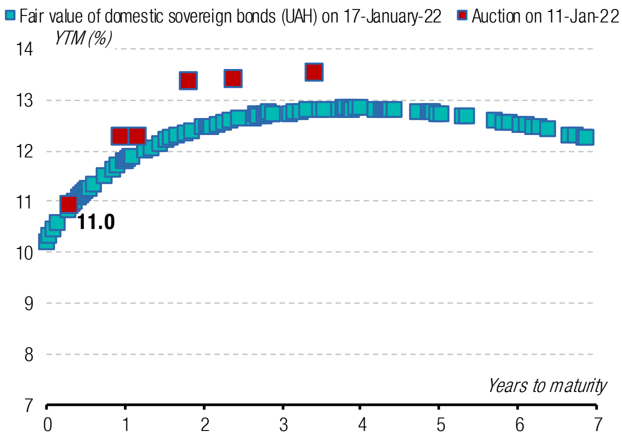
Chart 1. Local-currency bonds

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.

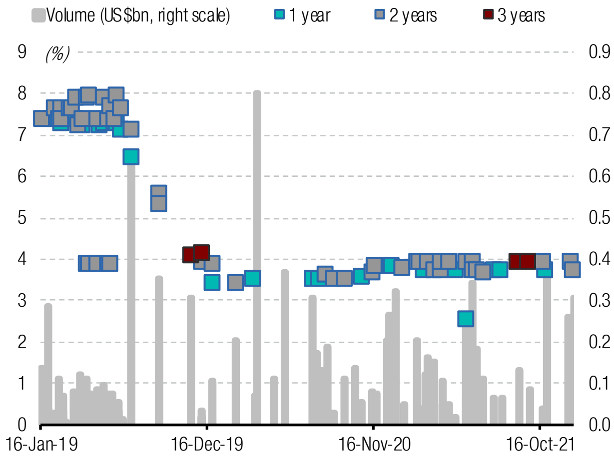
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

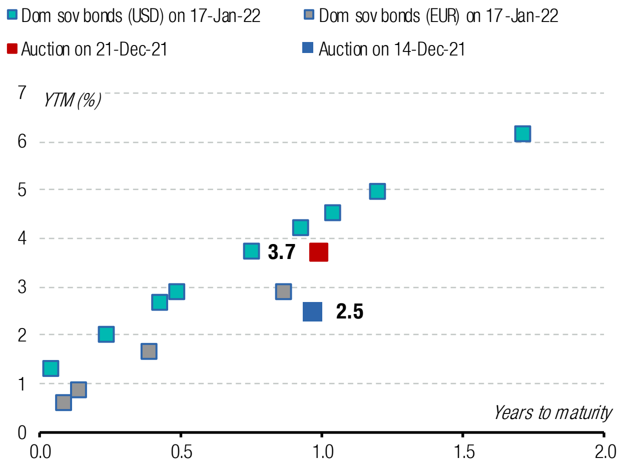
Chart 2. FX-denominated bonds

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.

Ukrainian Eurobond market in seasaw due to geopolitical tension

Statements made by Russian officials after talks with the US and NATO have led to a significant increase in fear of a possible Russian invasion of Ukraine and worsened Ukraine's credit risk assessments by local and international investors. All this was happening on the back of the expected tightening of the Fed's liquidity support. This led to a sell-off of Ukrainian Eurobonds, which is likely to continue this week.

Thus, the YTMs of bonds maturing in September 2022 reached 20%, and on instruments maturing in the next three years, YTMs increased to 14-15%. For longer bonds, the YTM was lower at 11-12%. Ukrainian CDS exceeded 1'000bp for up to three years, although at the end of last year it was 550-590bp.

ICU view: The reaction of the markets to the news from Russia was quick and very negative, and now supported by a high level of uncertainty. Therefore, the situation in the Eurobond market will remain difficult, and investors are likely to continue to reduce exposure to Ukraine.

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

Foreign exchange market

The hryvnia is weakening

Last week, the hryvnia weakened again, mostly under the influence of psychological factors caused by statements from Russian officials.

The weakening of the hryvnia lasted from the beginning of the week, but was quite moderate. However, after the news on Thursday, weakening accelerated and by the end of the week, the hryvnia exchange rate fell to UAH28.03/US$, losing 2% for the week and 2.7% since the beginning of the year. The NBU's interventions, which in fact only restrained this weakening, did not help either. Excluding last November's large interventions, which were caused by Ukrenergo Eurobonds issue and debt repayments to green energy producers, the last week's US$331m of hard currency sold from reserves is the largest intervention since July 2020. The NBU sold about US$103mn last Wednesday, the day after foreigners' large sell-off of local-currency paper for almost a billion hryvnias, and last Friday, another US$100m was sold.

There were interventions on Tuesday and Thursday too, in amount of US$35m and US$85m respectively.

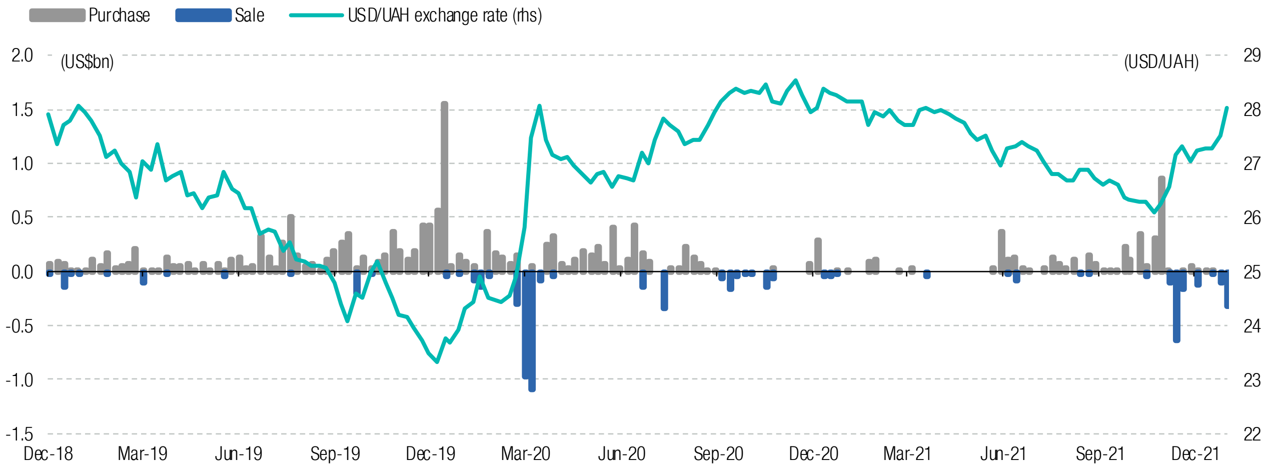
In general, the market remains dominated by demand for hard currency, which is created mainly by importers of energy resources and foreign investors in local-currency debt. At the same time, the supply of hard currency remains quite small compared with previous months. This causes a fairly large and constant excess in demand from bank customers, which has to be satisfied by the NBU and banks.

ICU view: This week FX market will remain under the impact for psychological factors, caused by news about Russian aggression, with addition of pressure from increased demand for hard currency. Under such conditions, the hryvnia exchange rate will fluctuate within the range of UAH28-28.5/US$. At this level of exchange rate, exporters can increase supply of hard currency, contributing to FX market balance improvements within the above mentioned range.

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

December consumer inflation 10.0%; continues to slow

Inflation decelerated for the third consecutive month in December and ended 2021 at 10.0% YoY.

Meanwhile, core inflation (that excludes raw food, energy materials, and components with regulated prices) continued to grow and reached 7.9% YoY, implying fundamental price pressures remain strong. The producer price index reached 62.2% YoY, which is more than a two-decade high, but energy prices contributed more than half to the total PPI.

The CPI continues to be primarily driven by food prices, which were up 13.3% in 2021. Paradoxically, utility tariffs were down 0.1% MoM and decelerated to 9.8% YoY in December despite surging energy prices. This is the direct effect of the administrative price regulation policy whereas gas and electricity tariffs for households are capped until the end of April.

ICU view: We expect inflation will continue to decelerate moderately in the coming months due to the base effect, as last year's prices growth in 1Q was particularly high.

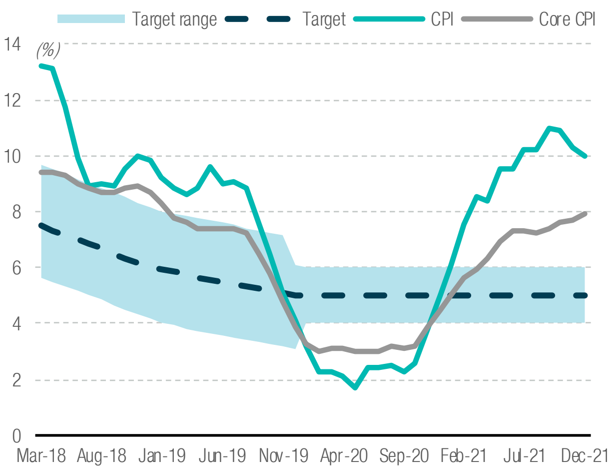
However, base effect aside, inflationary pressures will remain quite high in the coming months for two main reasons. First, surging energy prices for businesses imply they have to be eventually (at least partially) passed on the consumers. To mitigate the effect of surging energy prices the government forces local natural gas extraction companies to sell at least 20% of their gas to producers of certain food products at a huge discount. Second, the recent hryvnia weakening on the back of Russia's threats to invade Ukraine may lead to an increase in prices of imported goods. On the other hand, global food prices continue to decelerate as seen from the FAO food price index, and that bodes well for the prices of the local consumer basket in which food makes up more than 40%. With the above in mind, we remain of the view that the CPI is unlikely to be back to the NBU's target range of 5%±1% in 2022, and we expect end-2022 consumer inflation at 7.2% YoY.

Decelerating consumer prices (largely due to the statistical base effect) against the backdrop of still high inflationary pressures form a challenging context ahead of NBU's monetary policy committee meeting this week. We believe the NBU Board will be weighing a 50bps increase against keeping the current rate of 9.0% unchanged. The arguments in favor of the increase (on top of still elevated price pressures) include the tense situation in the debt and FX markets due to pressure from Russia. The key argument in favor of preserving the current rate is the gradual rise in the real interest rate. Declining headline CPI coupled with the unchanged key policy rate effectively result in tightening of monetary policy. We believe that in view of the ongoing escalation of Russia's aggression an increase of the key policy rate by the NBU is almost certain this week.

Vitaliy Vavryshchuk, Kyiv, (044) 377-7040 ext.721

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

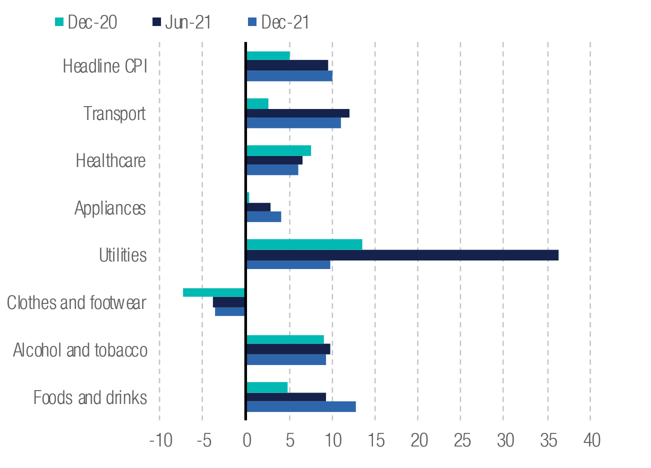
Headline inflation continues to decelerate, core CPI rises again



Source: Ukrstat, NBU, ICU

Chart 5. CPI and its main components, YoY, %

Food prices are the key inflation driver; utility tariffs decelerate



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

Vitaliy Vavryshchuk
Head of macro research
vitaliy.vavryshchuk@icu.ua

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

Dmitriy Dyachenko, CFA
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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