

Weekly Insight

NBU reserves decline notably in June

Key messages of the today's comments

MONDAY, 11 JULY 2022

Ukrainian bond market

Activity in local bond market remains low

Last week, the MoF was only able to borrow UAH128m. Turnover in the secondary market remained very low, also.

Eurobonds prices approaching minimum

Last week, the prices of Ukrainian Eurobonds continued to fall and came close to their early-March minimums in response to a series of news.

Foreign exchange market

Hryvnia weakening again

During the past week, the hryvnia exchange rate against the US dollar weakened again both for cash and card transactions.

Economics

Inflation jumps to 21.5% in June

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NBU reserves continue to decline at an alarming rate

The NBU gross international reserves fell 9.3% in June to \$22.8bn, following a 6.8% contraction in May.

Banks' reserves market (8 July 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	25.00	+0bp	+1,750bp
ON rate (%)	9.76	+0bp	+344bp
Reserves (UAHm) ²	48,510	+7.77	+15.96
CDs (UAHm) ³	188,625	-1.38	+8.98

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) (8 July 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU	531,106	+0.00	+67.40
Banks	525,767	-0.16	+4.80
Residents	66,907	+0.09	+38.61
Individuals	29,042	+1.27	+62.65
Foreigners ¹	71,464	+0.31	-35.22
Total	1,224,724	-0.02	+23.04

Source: NBU, ICU.

FX market indicators (8 July 2022)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	29.5380	-0.02	+8.17
EUR/USD	1.0185	-2.20	-14.01
DXY	107.007	+1.78	+15.79
UAH TWI ¹	140.682	+1.36	+12.95

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Market gov't bond quotes¹ (11 July 2022)

Maturity	Bid	Ask
6m
12m
2y
3y
12m (\$)
2y (\$)

Source: ICU.

Ukrainian bond market

Activity in local bond market remains low

Last week, the MoF was only able to borrow UAH128m. Turnover in the secondary market remained very low, also.

At the primary auction last Tuesday, the Ministry of Finance invited bidders to disclose their desired interest rates for UAH bills. This occurred for the first time since the NBU increased the key policy rate to 25%. Therefore, the vast majority of bids were submitted at rates significantly higher than what the Ministry of Finance is ready to pay. As a result, less than 5% of demand was satisfied, with the vast majority of the bills were sold under non-competitive bids. See details in the [auction overview](#).

Activity in the secondary market also remains low. The trading in UAH bills increased by 26% and remained below UAH0.5bn. A total of 6,606 deals were concluded, which is just 581 more than the week before.

The most stable investors, who have been steadily amassing investments in military bills, are individuals. They increased their portfolios by UAH348m, but this is still significantly less than in May. Last Tuesday, foreigners bought slightly less than individuals, just UAH223m. Banks reduced their portfolios by UAH1bn, and non-banking institutions increased their investment in military bills by UAH59m only.

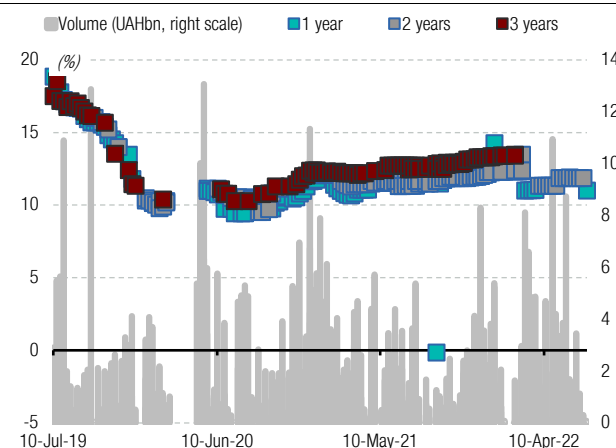
ICU view: The market expects that the Ministry of Finance may respond to participant’s demands after they disclosed their desired rates last week. Therefore, if yields do not increase, any significant demand for military bills is highly unlikely. The Ministry of Finance probably plans to compensate for the low volume of UAH-denominated instruments by placing FX-denominated securities. They will be offered tomorrow with three tenors from three to 11 months.

Insufficient volumes of market borrowing can again be compensated via direct sale of military bonds to the NBU at a floating interest rate

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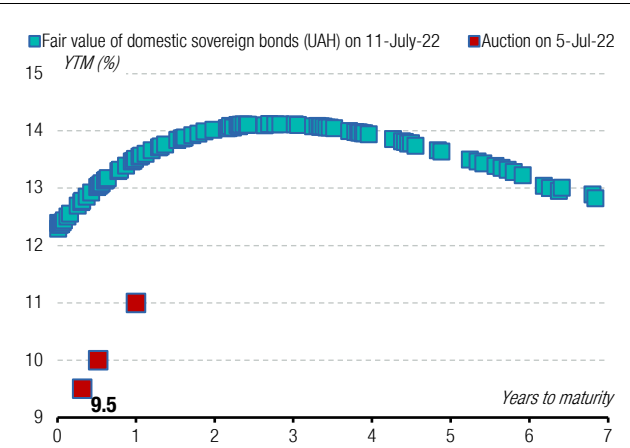
Chart 1. Local-currency bonds

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.

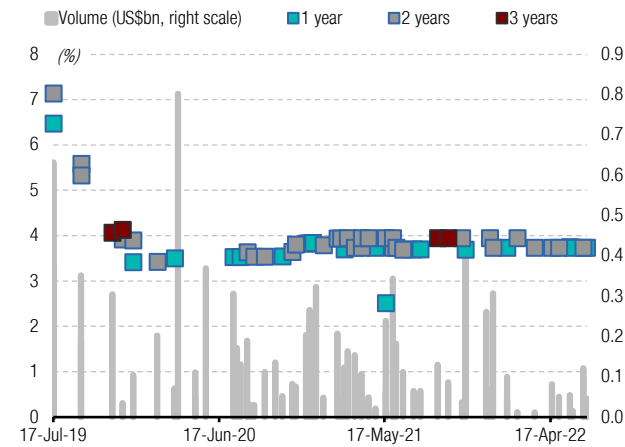
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

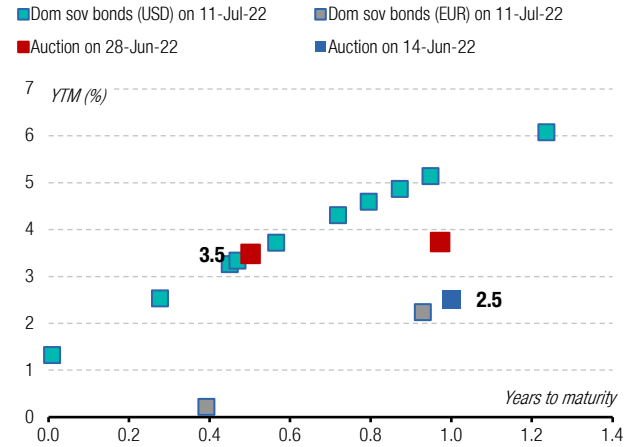
Chart 2. FX-denominated bonds

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.

Eurobonds prices approaching minimum

Last week, the prices of Ukrainian Eurobonds continued to fall and came close to their early-March minimums in response to a series of news.

On the one hand, last week, a Ukraine-dedicated conference was held in Lugano, where a plan for economic recovery was presented. A joint commitment by Ukraine’s allies was made to support Ukraine on its road toward recovery after Russia’s aggression.

On the other hand, rumours about the possible restructuring of Ukraine’s external debt continue to spread in the market. Rumours were reinforced by Naftogaz’s announcement that the company is currently assessing its liquidity and operational needs. Holders of the company’s bonds, due to be redeemed as soon as next week, interpreted the announcement as a signal of a potential debt restructuring. This news was taken extremely negatively, as just a few weeks ago, Naftogaz assured investors that the repayment of Eurobonds would be made on time and in full. Although Naftogaz Eurobonds are not covered by state guarantees, the possible restructuring of the company’s debt will send a clear and near unambiguous signal that sovereign Eurobonds, including the Eurobonds due in September of this year, are also in line for restructuring.

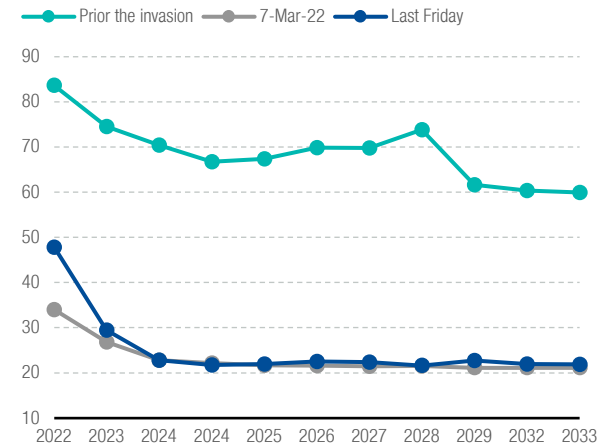
Against the backdrop of a practically unchanged situation in the battlefield, the pressure on prices of Ukrainian Eurobonds increased. By the end of the week, prices mostly fell to 21–23 cents per dollar, close to their lows recorded in early March after the full-scale Russian invasion. Only bonds maturing in September are significantly above their March levels, at nearly 48 cents on the dollar.

ICU view: Investors largely expect that rumours may materialize, and the government will initiate formal negotiations with bondholders. As we indicated in the [review of pros and cons of restructuring](#), developments around Naftogaz’s Eurobonds set the mood for the market last week and will remain indicative of government’s intentions to restructure sovereign debt.

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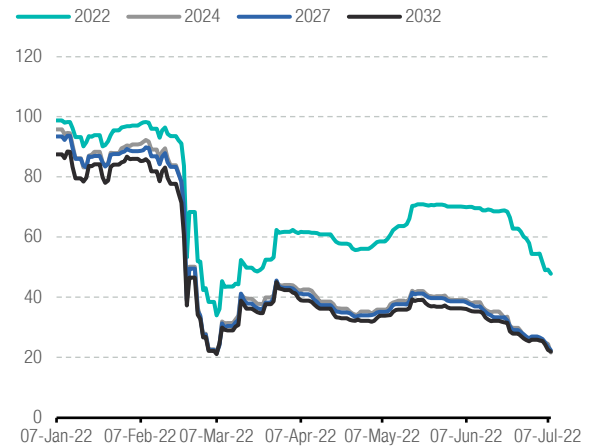
Chart 3. Ukrainian Eurobonds prices

Prices of USD-denominated Eurobonds as of last Friday, prior the russian invasion and the lowest prices seen on 7 March, 2022



Source: Bloomberg, ICU.

Last six-month historical data



Source: Bloomberg, ICU.

Foreign exchange market

Hryvnia weakening again

During the past week, the hryvnia exchange rate against the US dollar weakened again both for cash and card transactions.

Last week, Privatbank, followed by several other banks, increased their rates for card transactions, bringing them closer to the exchange rate in the cash market. Meanwhile, the exchange rate in the cash market weakened, too.

The average exchange rate for card transactions weakened from UAH30.1–32.9/US\$ to UAH31–33.6/US\$, and the exchange rate in the cash market weakened from UAH34.9–35.6/US\$ to UAH35.3–36.1/US\$.

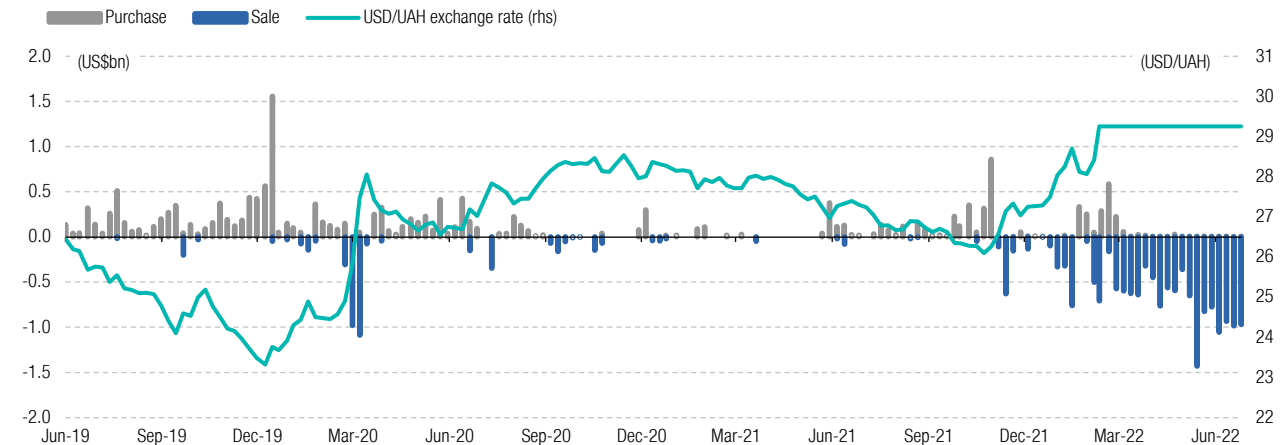
In the interbank market, demand for hard currency also remains high, and the NBU had to sell almost US\$1bn of reserves again last week. Moreover, almost half of this volume was sold on Tuesday, when the market closed deals delayed from Monday due to Independence Day in the US.

ICU view: The NBU expected that the reintroduction of import taxes and duties might weaken demand for hard currency. Unfortunately, these expectations have not materialize so far. Meanwhile, cash hryvnia started to weaken again last week probably driven by hikes in exchange rates on card transactions by the largest banks. All these combined implies that the expectations of gradual hryvnia depreciation will be reinforced. We, therefore, expect a turbulent FX market this week.

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Chart 4. 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

Inflation jumps to 21.5% in June

Annual inflation accelerated notably in June and reached 21.5%, up from 18.0% in May. Core CPI accelerated to 15.2% YoY from 13.8%.

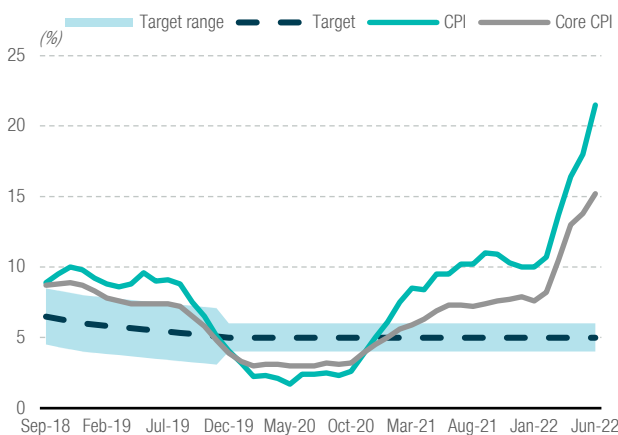
The MoM inflation reached 3.1% as food prices continued to accelerate and contributed nearly 1.4pp to monthly inflation. The growth in prices for food staples was broad-based and is largely a reflection of increasing producer input costs. Transportation was the second most significant inflation driver and contributed about 1.0pp to monthly inflation as fuel prices surged 21.3% MoM and 90.9% YoY.

ICU view: A surprisingly large acceleration of inflation in June implies the end-2022 CPI may be closer to the upper bound of our end-year CPI projection range of 25-30% YoY. Inflationary pressures in Ukraine remain high due to growing producer costs and significantly more expensive transportation. We expect inflation will remain high, in the range of 25-30%, as the economy will be adjusting to hryvnia depreciation and energy price shocks over the next 18-month horizon.

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Chart 5. CPI, core CPI and target, YoY, %

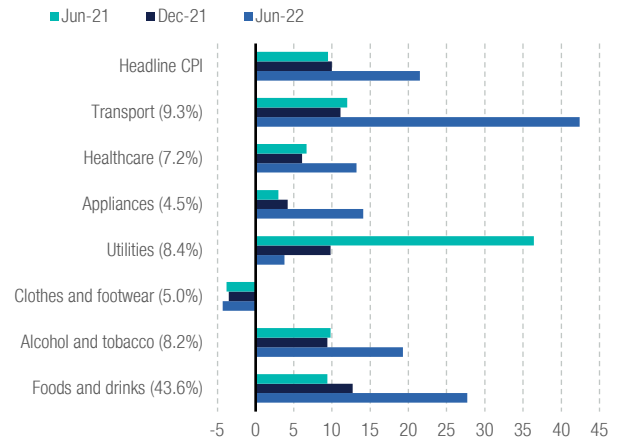
Inflation accelerates notably in June



Source: Ukrstat, NBU, ICU.

Chart 6. CPI and its main components, YoY, %

Food and transportation prices expectedly remain the key inflation driver



Source: Ukrstat, ICU.

NBU reserves continue to decline at an alarming rate

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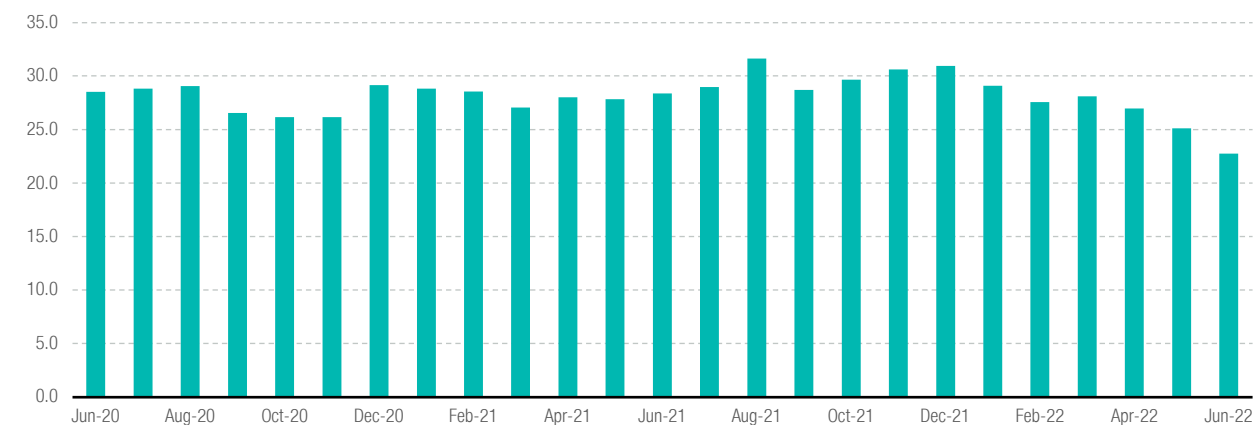
Heavy NBU interventions drove the decline of the reserves – the central bank had to sell almost \$4.0bn to meet the excessive demand in the FX market. The reserves were supported by the government borrowings in the amount of \$2.8bn while the government and the NBU jointly made \$1.0bn payments on their FX debts.

ICU view: The pace of decline of the NBU reserves is alarming. The need for sale interventions by the NBU has been much larger than we expected so far. Meanwhile, the inflows of international financial aid remain far below what is needed to maintain the central bank reserves flat. The significant and persistent FX market misbalances strengthen the case for a managed hryvnia depreciation. So far, the NBU has not provided any indication about when this may happen.

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Chart 7. NBU gross international reserves, US\$bn

NBU reserves continued to decline rapidly in June



Source: NBU, ICU.

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