| Focus | Markets | Research team |
|---|---|---|
| **Ukraine** | **Domestic liquidity, government bonds, FX market, and macro** | **Vitaliy Vavryshchuk**<br>**Alexander Martynenko**<br>**Taras Kotovych** |

# Weekly Insight

# Ukraine defers Eurobond payments

**Key messages of the today's comments**

**MONDAY, 15 AUGUST 2022**

## Ukrainian bond market

### Bond market looking to establish equilibrium

After trading in all domestic bonds was unblocked, the market segmented into two parts – one for military bills and another one for bonds issued before the russian invasion. Two independent yield curves are taking shape, although they have the prospect of converging.

### Ukraine defers Eurobond payments

Last Wednesday, the results of investors' voting were made public—75% supported deferring Ukrainian Eurobonds repayments for two years. The debts of Ukrenergo and Ukravtodor were also restructured on the same terms.

## Foreign exchange market

### FX market broadly unchanged

The FX market has mostly stabilized; nonetheless, the NBU had to carry out sale interventions in significant volumes.

## Economics

### Inflation accelerates to 22.2% in July

Monthly inflation stood at 0.7% in July, which is typically a deflationary month. Annual CPI rose further to 22.2% from 21.5% in June. Core CPI accelerated even more considerably to 16.7% YoY from 15.2% in June.

### Ukraine's public debt growth accelerates

Ukraine's public debt increased 3.9% in June to US$105.4bn.

**Banks' reserves market (12 August 2022)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| NBU rate (%)[1] | 25.00 | +0bp | +1,700bp |
| ON rate (%) | 9.76 | +0bp | +238bp |
| Reserves (UAHm)[2] | 63,660 | +24.75 | -0.01 |
| CDs (UAHm)[3] | 186,311 | -10.40 | +23.90 |

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) (12 August 2022)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| NBU | 559,570 | +0.62 | +77.02 |
| Banks | 515,862 | -0.97 | +3.97 |
| Residents | 65,670 | +0.50 | +35.71 |
| Individuals | 29,858 | +1.54 | +55.84 |
| Foreigners[1] | 69,950 | +0.86 | -30.80 |
| **Total** | **1,241,452** | **-0.01** | **+26.56** |

Source: NBU, ICU.

**FX market indicators (12 August 2022)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| USD/UAH | 36.8415 | -0.24 | +37.77 |
| EUR/USD | 1.0259 | +0.75 | -12.54 |
| DXY | 105.631 | -0.93 | +13.54 |
| UAH TWI[1] | 112.334 | -0.24 | -11.50 |

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

**Market gov't bond quotes[1] (15 August 2022)**

| Maturity | Bid | Ask |
|---|---|---|
| 6m | ... | ... |
| 12m | ... | ... |
| 2y | ... | ... |
| 3y | ... | ... |
| 12m ($) | ... | ... |
| 2y ($) | ... | ... |

Source: ICU.

# Ukrainian bond market

## Bond market looking to establish equilibrium

After trading in all domestic bonds was unblocked, the market segmented into two parts – one for military bills and another one for bonds issued before the russian invasion. Two independent yield curves are taking shape, although they have the prospect of converging.

The Ministry of Finance hardly reacted to the high yields in the secondary market after most restrictions on bond trading were removed, and they continue to offer military bills in primary auctions mostly at unchanged interest rates. An exception last week was the placement of five-month paper at a new rate of 12%, which is 200bp higher than before. See details in the auction review.

The secondary market, surprisingly, was less active than before the trading restrictions were lifted. A total of 4,121 deals were concluded with UAH bills in the amount of UAH2.3bn (US$62m), which is less than the 4,841 deals in the amount of UAH3.6bn (US$99m) a week before. But last week, the market clearly separated into two segments: one for bonds issued before the full-scale invasion, and the other is military bills issued after it.

In the secondary market military bills are traded at yields close to those at primary auctions. But in the segment of regular bonds, the yields are highly volatile for each issue since the number of transactions is currently tiny and the market has low liquidity.

In general, the activity was split as follows: with the military bills, 3,777 agreements for UAH674m (US$18m) were concluded, and with "pre-war" bonds, there were just 353 agreements but for UAH1.7bn (US$46m). Each of these segments currently forms its own independent yield curve: 10–16% for military bills, and within the range of 14–25% for regular local-currency securities.

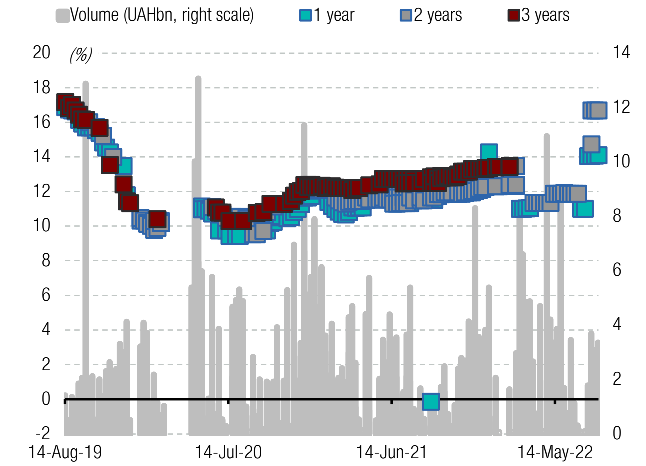
The curve for military bills has the normal shape, where shorter tenors have lower yields and longer ones have higher ones. For regular bonds, the shape of the curve has not yet fully formed, but there are already visible signs of an inverted yield curve with higher rates for shorter maturities and lower rates for longer ones.

***ICU view: The lifting of restrictions on domestic bond trading should lead to more active trading, but due to segmentation, activity has not increased so far. Yields on the secondary market of regular (non-military) securities will remain volatile for some time, as it will take several weeks to find equilibrium levels in a low trading environment. Currently, market participants trade in small volume to explore the market mood and expectations. So, the military bond segment is likely to dominate in the coming weeks, but it will definitely be influenced by the yield indicators of the regular bond segment. We continue to expect a gradual increase in yields at primary auctions because, at current levels, the Ministry of Finance cannot generate significant and stable demand for bonds from banks.***

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

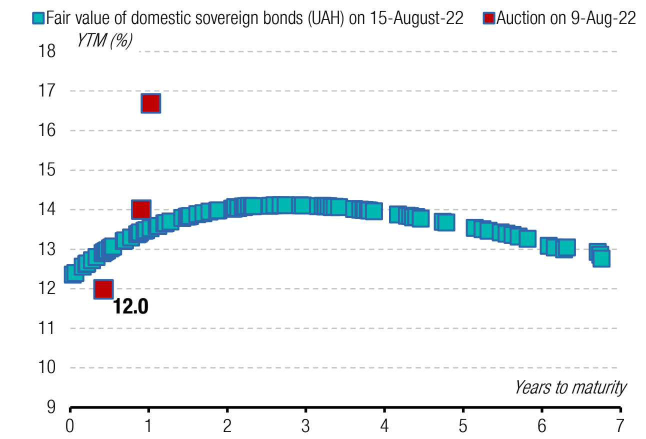
**Chart 1. Local-currency bonds**

*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.

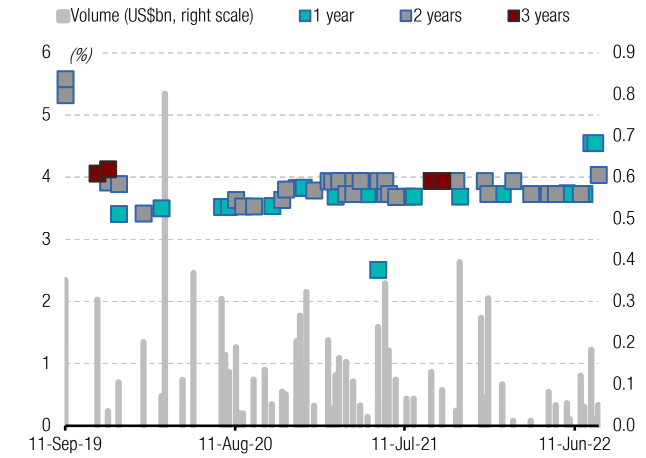
*Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions*




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

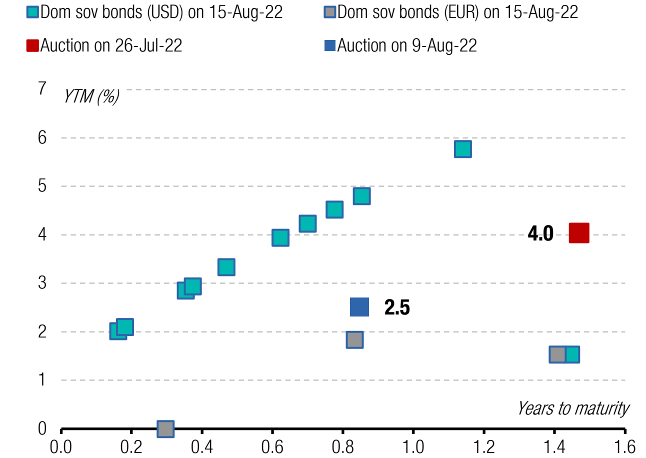
**Chart 2. FX-denominated bonds**

*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.

## Ukraine defers Eurobond payments

Last Wednesday, the results of investors' voting were made public—75% supported deferring Ukrainian Eurobonds repayments for two years. The debts of Ukrenergo and Ukravtodor were also restructured on the same terms.

Ukraine received significantly higher investor support than was needed to approve the restructuring. Thus, the maturity of all issues was extended by two years, coupons will continue to accrue, and interest will also be accrued on unpaid coupons. The accumulated coupons can be paid in part or in full at any time. The Ministry of Finance also managed to reserve the right to convert all accrued interest into new bonds of the same maturity as Eurobond after the end of the two-year period.

Ukraine also received consent to change the terms of VRIs. According to the amendments, the payment that was supposed to take place in May 2023 is deferred for one year until May 2024 and is limited to 0.5% of GDP, instead of 1% before, and the maturity of VRIs is also extended by a year. The issuer's right to buy back VRIs in the period 2024–27 at their notional value was also added.

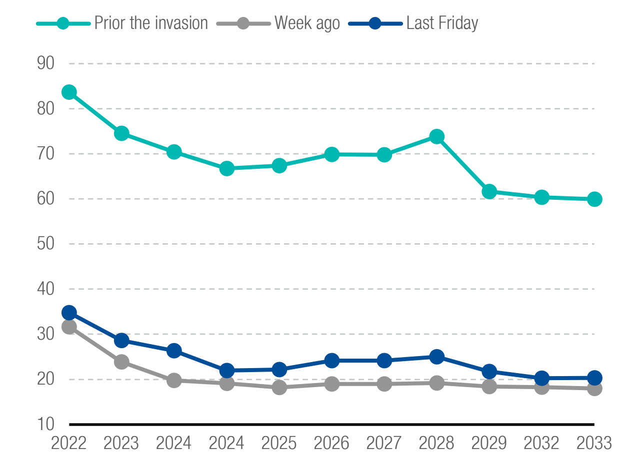
After the voting results were announced, the prices of Eurobonds and VRIs rose slightly. As a result, on the week, Eurobonds prices increased by 2-7 cents to 20-35 cents. Eurobonds due this year, now delayed to 2024, remain the most expensive at 35 cents on the dollar. VRIs rose in price by 6 cents to 33 cents per dollar of notional value.

***ICU view: The restructuring of Eurobonds went smoothly and without any negative surprises. Conditions were quite favourable for investors. Investors confirmed that they fully appreciate the economic and fiscal hardships that Ukraine is dealing with due to russian aggression. Ukraine certainly managed to maintain constructive relations with the vast majority of Eurobond holders. In general, the market expects that the government will be forced to review the terms of Eurobonds again after the end of the two-year period, when there will be a better understanding of the medium-term macroeconomic outlook and debt sustainability analysis will be possible. So far, timely restructuring has allowed Ukraine to avoid default risks, and thus one of the uncertainty factors for investors has disappeared. Therefore, the prices of Ukrainian Eurobonds may still rise moderately due to this. In the medium term, they will mostly be determined by Ukraine's successes on the battlefield and prospects for ending the war.***

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

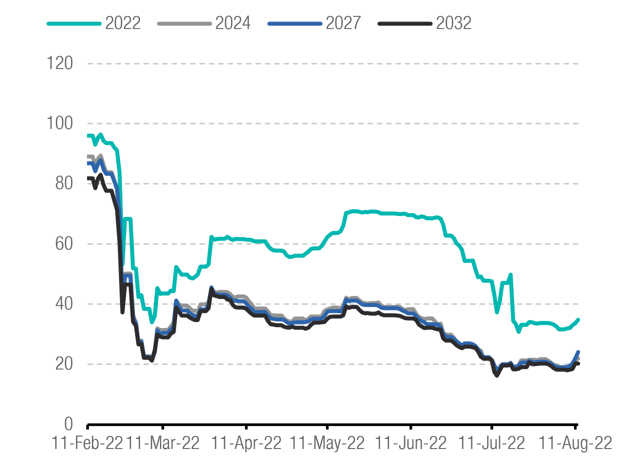
**Chart 3. Ukrainian Eurobonds prices**

*Prices of USD-denominated Eurobonds as of last Friday, prior the russian invasion and a week before*




Source: Bloomberg, ICU.

*Last six-month historical data*




Source: Bloomberg, ICU.

# Foreign exchange market

## FX market broadly unchanged

The FX market has mostly stabilized; nonetheless, the NBU had to carry out sale interventions in significant volumes.

Last week, the NBU sold hard currency from reserves, satisfying excess demand on the interbank market. It was only on Tuesday that the National Bank was a net buyer. We believe the NBU's purchase intervention was due to the MinFin selling currency from its FX account at Ukreximbank. In just one week, the NBU purchased US$93m on the market and sold US$522m of hard currency.

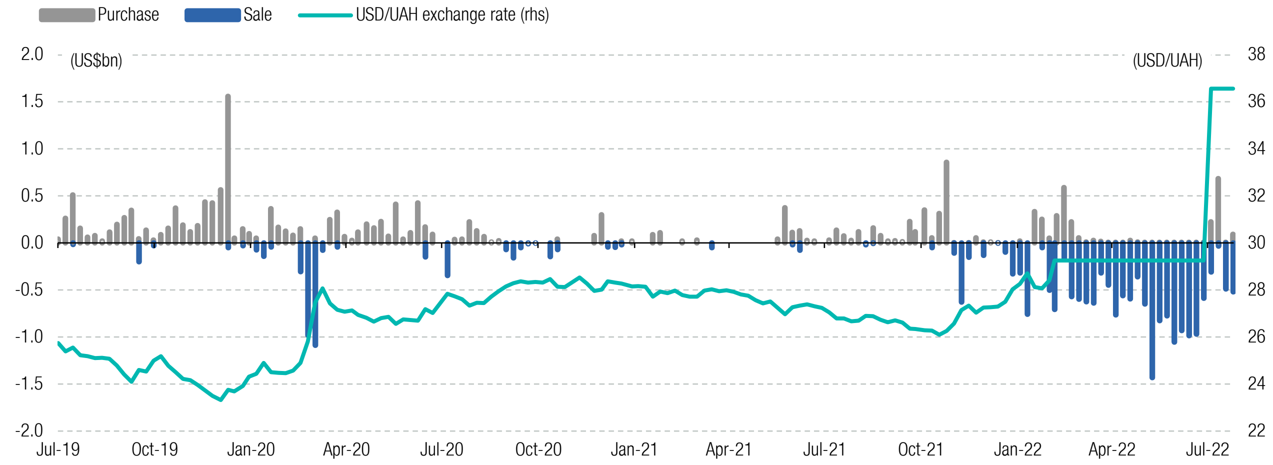
The cash market remains volatile. Over the past week, the exchange rate at local banks weakened again, although not as significantly as at the end of July: to UAH38.5–39.5/US$ last Friday from UAH38.1–39.3/US$ a week before.

***ICU view: The interbank market remains under demand-side pressure, which is already becoming a systemic factor despite significant hryvnia depreciation. FX supply from exporters remains insufficient while demand has proved to be robustly high. Therefore, we expect that the NBU will have to maintain its significant and regular FX sale interventions in the future.***

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

**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 accelerates to 22.2% in July

Monthly inflation stood at 0.7% in July, which is typically a deflationary month. Annual CPI rose further to 22.2% from 21.5% in June. Core CPI accelerated even more considerably to 16.7% YoY from 15.2% in June.

Prices accelerated across the board, with the only noticeable exception being gasoline as its price growth decelerated to 78% YoY in July from 91% in June, providing substantial relief to households and businesses. The situation improved, first and foremost, thanks to saturation of local market with imported fuel and against the backdrop of falling global energy prices. Utility tariffs inched up 0.5% MoM and only 3.6% YoY as the government and local authorities decided to delay revision of natural gas and electricity tariffs at least until 2023.

***ICU view: July statistics show inflationary pressures remain strong as economy continues to adjust to weaker hryvnia and growth in cost of goods and services. We reiterate our projection that the end-2022 CPI will reach nearly 30% and decelerate close to 25% in 2023. The key price drivers will be continued gradual depreciation of hryvnia vs. major global currencies and an upward revision of local state-regulated energy prices that looks inevitable in 2023.***

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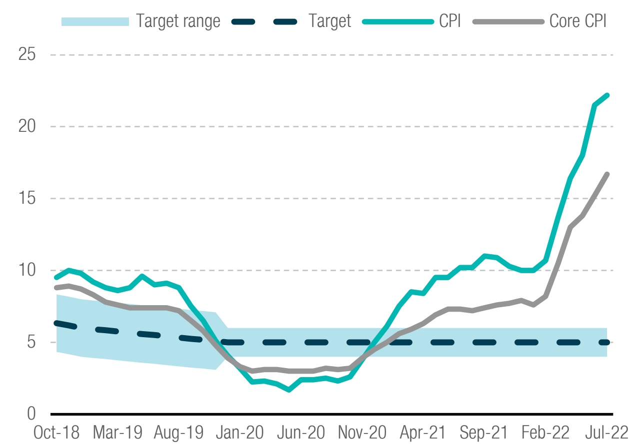
**Chart 5. CPI, core CPI and target, YoY, %**

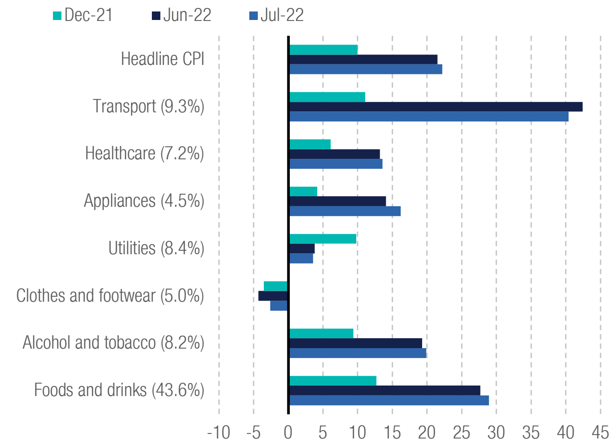
*Inflation accelerates notably in July*




Source: Ukrstat, NBU, ICU.

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

*Growth of transportation prices started to decelerate*




Source: Ukrstat, ICU.

## Ukraine's public debt growth accelerates

Ukraine's public debt increased 3.9% in June to US$105.4bn.

Almost two thirds of the increase were driven by domestic borrowings, largely by the purchases of the government debt by the NBU, which totaled UAH105bn (US$3.6bn at June's exchange rate). External borrowings were driven by loans from Canada and the World Bank.

***ICU view: In May and June, the growth in Ukraine's public debt has been mainly driven by the direct sale of government bonds to the NBU, rather than external borrowings. The composition of new borrowings may change for a while and become dominated by foreign loans in the coming months as Ukraine's international partners stepped up their support. However, there is a growing risk that printing of money by the NBU will remain the key source of budget deficit financing for the full 2022. Any further upward revision of government expenditures will likely imply new debt monetization by the NBU. We maintain out projection for the end-2022 public debt-to-GDP ratio at above 90%.***

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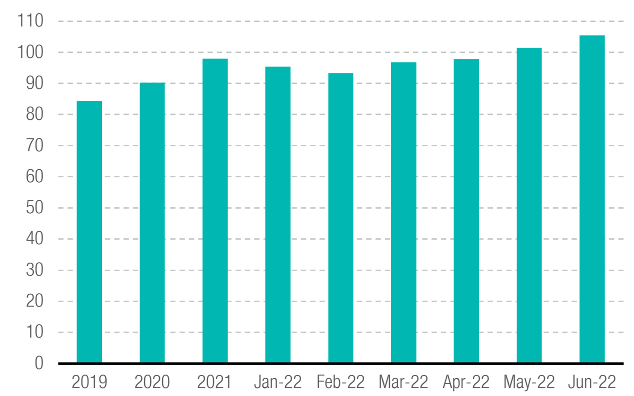
**Chart 7. Ukraine's public debt, $bn**

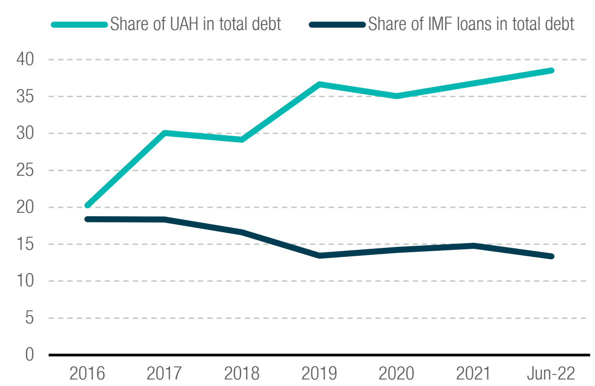
*Public debt increased 3.9% in June*




Source: MoF, ICU.

**Chart 8. Share of UAH and IMF loans* in total debt, %**

*The share of hryvnia slightly up in June on NBU's purchases of debt*




* includes IMF SDR allocation

Source: MoF, ICU.

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