Focus	Markets	Research team
Ukraine	**Government bonds, FX market, and macro**	

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Weekly Insight

First round of negotiations with bondholders unsuccessful

Key messages of the today's comments

Ukrainian bond market

Reduction in bond rates slows

Last week, the Ministry of Finance continued to cut interest rates on UAH bonds, but at a slower pace than in previous weeks. In the coming weeks, this pattern may continue.

First round of negotiations with bondholders unsuccessful

The first round of talks between the Ministry of Finance and the ad hoc creditor committee ended on Friday. The parties could not agree on the key restructuring parameters and will continue consultations.

Foreign exchange market

NBU allows greater fluctuations in hryvnia exchange rate

Last week, the FX market deficit remained large, and the NBU allowed the hryvnia exchange rate to slip closer to UAH41/US$.

Economics

NBU delivers a 50bp rate cut

The rate-cutting cycle extended into June, with the regulator lowering the interest rate from 13.5% to 13.0%.

Annual inflation remains stubbornly low

Ukraine's annual inflation accelerated marginally to 3.3% YoY in May from 3.2% in April.

MONDAY, 17 JUNE 2024

Banks' reserves market (14 June 2024)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	13.00	-50bp	-1,200bp
ON rate (%)	13.02	-48bp	-697bp
Reserves (UAHm)[2]	177,978	-24.7	-11.6
CDs (UAHm)[3]	590,108	+8.8	+34.4

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 June 2024)

	Last	Weekly chg (%)	YoY chg (%)
NBU	677,606	+0.0	-2.4
Banks	698,070	+1.1	+27.3
Residents	164,911	+1.8	+40.0
Individuals	64,004	+3.0	+52.9
Foreigners	36,657	+0.4	-26.7
Total	**1,642,298**	**+0.8**	**+12.8**

Source: NBU, ICU.

FX market indicators (14 June 2024)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	40.6791	+1.1	+10.1
EUR/USD	1.0703	-0.9	-1.2
DXY	105.550	+0.6	+2.5

Source: Bloomberg, ICU.

Market gov't bond quotes (17 June 2024)

Maturity	Bid (%)	Ask(%)
6 months	15.00	13.00
12 months	16.00	15.00
2 years	16.50	15.50
3 years	17.50	16.50
12 months ($)	5.00	4.50
2 years ($)	N/A	N/A

Source: ICU.

READ FIRST THE DISCLOSURES SECTION (ON LAST PAGE) FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

Ukrainian bond market

Reduction in bond rates slows

Last week, the Ministry of Finance continued to cut interest rates on UAH bonds, but at a slower pace than in previous weeks. In the coming weeks, this pattern may continue.

At last week's primary bond auction, the Ministry of Finance placed a usual set of instruments that included one-year, two-year, and three-year bonds. The MoF received UAH21bn of demand, including UAH11bn for new two-year military paper. The rest of the demand was almost equally split between one-year and three-year securities. Therefore, the Ministry sold the planned amount of bonds, attracted UAH11.4bn to the budget, and lowered interest rates on all instruments by 9–19bp. See details in the auction review.

In the secondary bond market, trading almost halved to UAH6.5bn. Trading activity shifted to bills with maturities below 12 months, with 24% of the trading volume in bills maturing next February.

There were no bond redemptions last week. This week, the MoF will redeem US$303m of USD-denominated bills, and for the following week, redemption of UAH18bn of UAH bonds is scheduled.

ICU view: Last week, the bond market was waiting for the NBU's decision on the key policy rate and related signals about possible further changes in monetary policy. Investors were in no hurry to invest in longer bonds, expecting more clarity on possible rate dynamics by the end of the year. The NBU reduced the key rate by 50bp, but provided no new guidance about where interest rates may settle at year's end. New guidelines will likely be released only in July, when the NBU will publish an updated macroeconomic forecast. Therefore, in the coming weeks, interest rates for UAH bonds may continue to decrease slowly, by 5–10bp per week.

Tomorrow, the Ministry of Finance will offer new notes with a maturity of more than 3.5 years for the first time since the beginning of the full-scale war. It will replace three-year notes for at least a few following weeks. We expect the interest rate on this instrument to be slightly higher than the current yield on three-year instruments, as longer instruments require a higher term premium. Two-year bills offer a 75bp premium to 12-month bills, and three-year instruments an additional 70bp to the two-year instrument. For a paper with a maturity of 3.5 years, we expect a cut-off rate tomorrow of approximately 16.6% or higher.

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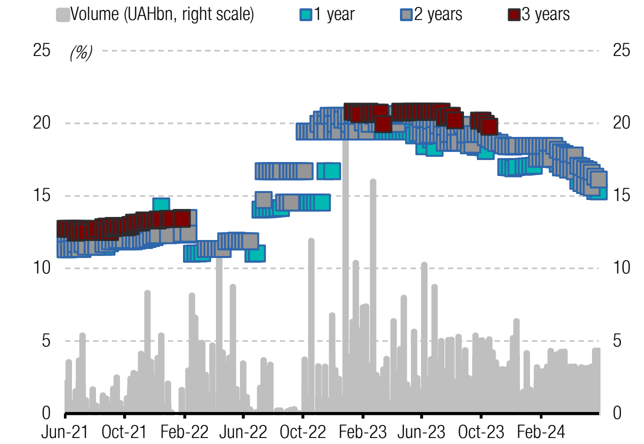
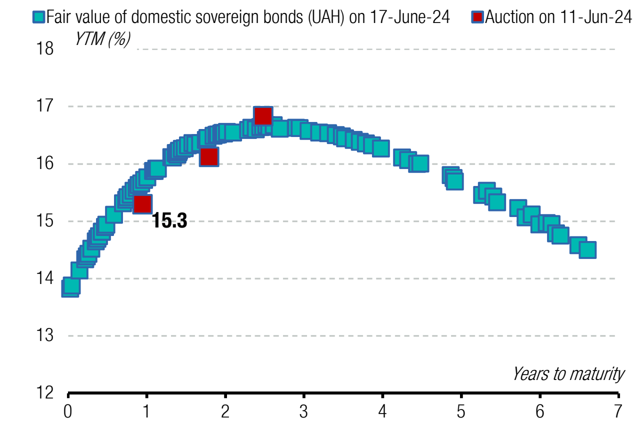
Chart 1. Local-currency bonds

Three-year history of domestic government bond placements at primary market: proceeds (in billions) and yields-to-maturity (%)



Source: MFU, ICU.

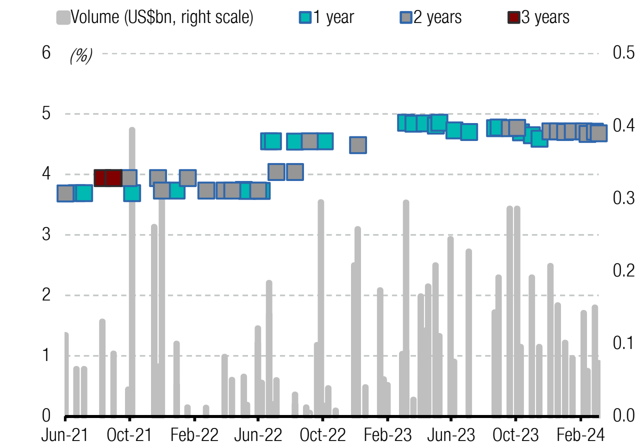
YTMs of domestic government bonds as calculated by NBU versus placements via primary market auctions



Source: NBU, MFU, ICU.

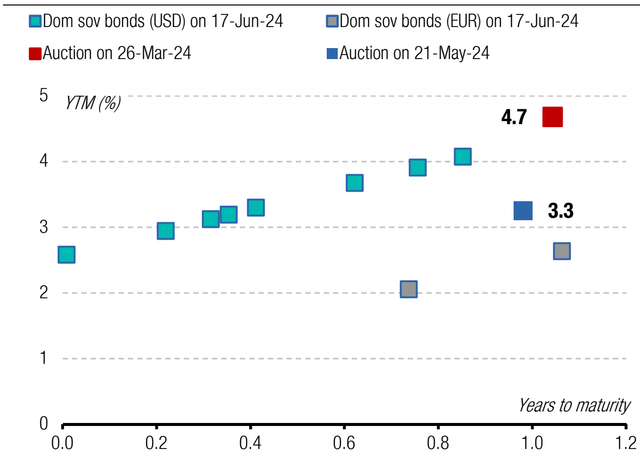
Chart 2. FX-denominated bonds

Three-year history of domestic government bond placements at primary market: proceeds (in billions) and yields-to-maturity (%)



Source: MFU, ICU.

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



Source: NBU, MFU, ICU.

First round of negotiations with bondholders unsuccessful

The first round of talks between the Ministry of Finance and the ad hoc creditor committee ended on Friday. The parties could not agree on the key restructuring parameters and will continue consultations.

The government's proposal included a 60% or a 52.5% haircut on outstanding Eurobonds and interest accrued during the deferral agreement. At the same time, creditors only offered a 20-22.5% haircut.

In the main government option, the haircut is 25%, while 75% of the debt should be exchanged into two new instruments. The first instrument, equivalent to 40% of the current debt, is split into five tranches due in 2034-2036, 2038 and 2040, with coupons at 1% in 2024-2025, 3% in 2026-2027, and 6% from 2028 onwards. The second instrument is a derivative (state-contingent instrument - SCDI) and is equivalent to 35% of the current debt. This instrument would not provide for any payments until 2027. In 2027, Ukraine can issue new Eurobonds to replace the SCDI or write SCDI off. The decision would be based on a comparison of actual budget revenues with the IMF forecast for 2025-2026. If the actual data are the same or worse than the forecast, the creditors receive nothing. If the data are better, then the difference would be increased by 10% and added to the volume of a new Eurobonds issue, i.e. distributed among all owners of the SCDI instrument.

The second government option was to immediately write off 52.5% and issue new Eurobonds, the same as the first instrument described above.

On the contrary, creditors offered only a 20% haircut. Half of the remaining amount (40% of the current debt) will be exchanged for new bonds due in 2030 and 2036 with a 7.75% coupon. The second half (40% of the current debt) will be exchanged for so-called recovery bonds, with a 0.5% coupon until 2027, 2.5% in 2028-2033, and 7.75% from 2034 onwards. The tranches will mature in 2032, 2034 and 2038. That is, the coupon will never exceed 2.5% for two tranches. Bondholders also propose an option to recover the written-off part of the debt after annual macro tests in 2027-2033.

During negotiations, bondholders partially changed their offer. In the updated version, the haircut is up to 22.5%, with the possibility of reinstating the write-offs based on the results of macro tests in 2027-2033. Bonds issued in exchange of 40% of the existing debt would also have a coupon of 7.75%, but by 2027, Ukraine would pay 7.25% in cash and 0.5% in new bonds. The volume of recovery bonds was lowered to 37.5% of the current debt. Recovery bonds would be in a single tranche due in 2036 and have a 0.5% coupon until 2027, 3.5% from 2028 to 2033 and 7.75% from 2034.

ICU view: Initial positions of both parties expectedly differed significantly. The government's proposals envisaged a possible irreversible loss of up to 60% of the current debt. In contrast, creditors' proposals included a possibility of recovering the written-off amount under favourable macroeconomic scenarios. In addition, the proposed debt servicing conditions differ significantly, especially during the period of the IMF EFF program. IMF and official creditors also did not support the bondholders' proposals, as they violated the targets set by the DSA. Such targets imply that during the IMF program, payments on Eurobonds should be symbolic and ensure comparability of treatment vis a vis the official debt. For now, the parties will remain in touch through their advisers to work out a new version of proposals. If the parties manage to narrow the gap, the next round of negotiations may take place as early as the end of June. There are 1.5 months left to complete negotiations without Ukraine going into default.

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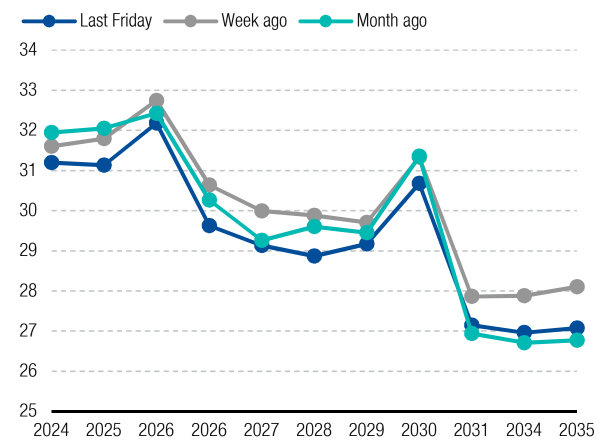
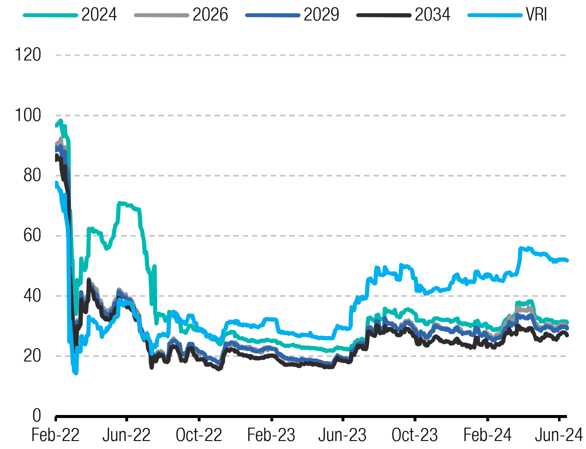
Chart 3. Ukrainian Eurobonds and VRI prices

Prices of USD-denominated Eurobonds as of last Friday, two weeks and a month ago



Source: Bloomberg, ICU.

Historical data since February, 2022



Source: Bloomberg, ICU.

Foreign exchange market

NBU allows greater fluctuations in hryvnia exchange rate

Last week, the FX market deficit remained large, and the NBU allowed the hryvnia exchange rate to slip closer to UAH41/US$.

In the interbank segment of the FX market, the foreign currency deficit widened. In four days, bank clients (legal entities) sold US$786m and bought US$1.2bn of foreign currency. So, the net purchase of hard currency increased to US$436m, almost twice higher WoW. At the same time, in the retail segment of the FX market, the net purchase of foreign currency by households decreased by 20% to US$195m.

In total, the hard currency deficit was up by 27% to US$631m in four days of the week. Therefore, NBU's interventions increased by almost a third to US$898m last week.

At the end of the week, the official hryvnia exchange rate weakened by 1% to UAH40.65/US$, and the cash exchange rate in systemically important banks also weakened by about 1% to UAH40.5–41.1/US$.

ICU view: The increase in the hard currency deficit in the interbank market forced the NBU to step up interventions, especially on Monday and Thursday. Meanwhile, the NBU tested the possibility of further hryvnia devaluation and let the official exchange rate slip below UAH40.5/US$. An important takeaway from NBU's communications last week is that the regulator is no longer focused on maintaining yields on UAH saving instruments high enough to ensure they are as attractive as FX instruments. Such changes in messages may indicate that the NBU will maintain moderate hryvnia devaluation in the foreseeable future. We confirm our forecast of the exchange rate at the end of the year at UAH42.3/US$.

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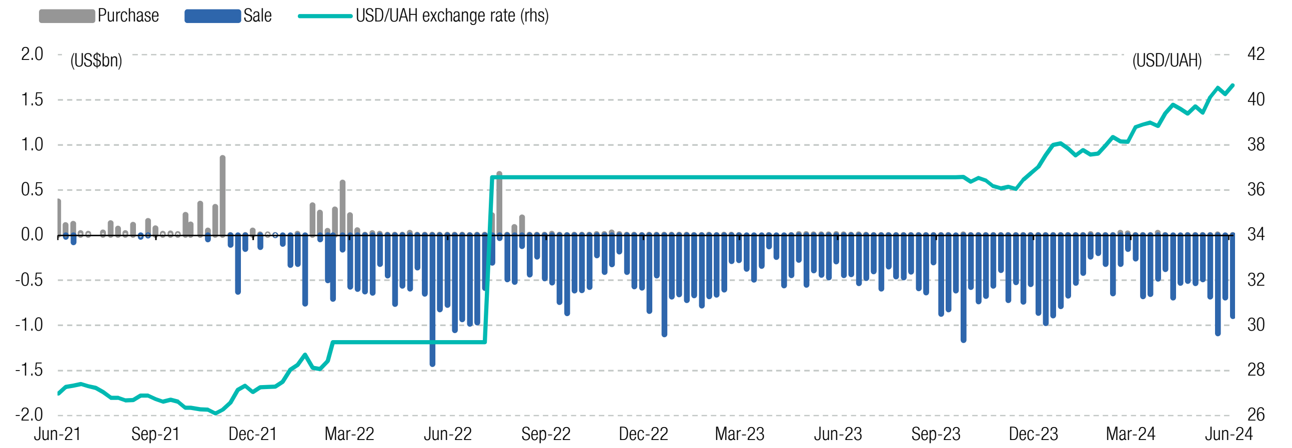
Chart 4. FX market indicators, 3-year history

Ukraine hryvnia UAH exchange rate per US dollar at the interbank market and NBU interventions (weekly data)



Source: NBU, Bloomberg, ICU.

Economics

NBU delivers a 50bp rate cut

The rate-cutting cycle extended into June, with the regulator lowering the interest rate from 13.5% to 13.0%.

This decision was in line with market expectations and NBU's macro forecast, which implies no more cuts in key policy rate until January 2025.

ICU view: We believe that the current CPI dynamics will allow for more cuts this year, lowering the rate to the 11.5%–12% area by December. NBU is also likely to change the existing design of monetary policy by narrowing the spread between the key rate and 3-month certificates of deposits, which currently amounts to 300bp.

The regulator aims to ensure that interest rates on hryvnia-denominated assets, such as government bonds and deposits, exceed the expected CPI. NBU sees inflation reaching 7.3% in the next 12 months. Yet, the NBU did not repeat its messages from previous communications that against the backdrop of depreciation it aims to ensure that yields on local-currency assets remain reasonably attractive compared with FX assets.

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Annual inflation remains stubbornly low

Ukraine's annual inflation accelerated marginally to 3.3% YoY in May from 3.2% in April.

Price growth remains weak nearly across the board. Yet, the prices of food (+0.9% MoM and -0.8% YoY) remain the largest factor behind low inflation. Two notable exceptions are prices for utilities (+13.0% YoY) and transportation (+11.2%). Their growth rates are expected to remain elevated in the coming quarters due to the revision of tariffs for electricity for households and a looming increase in excise tax on motor fuels.

ICU view: Inflation remains well below NBU projections and (temporarily) below the NBU target of 5%. Annual CPI is certain to accelerate above 5% in 3Q and above 6% in 4Q against last year's low base. Yet, we believe the end-2024 number will be at least 2pp below the NBU projection of 8.6%. This implies more room for monetary policy

easing through end-2024. We expect the key policy rate to reach 11.5–12.0% by the end of the year vs. the current 13.0%.

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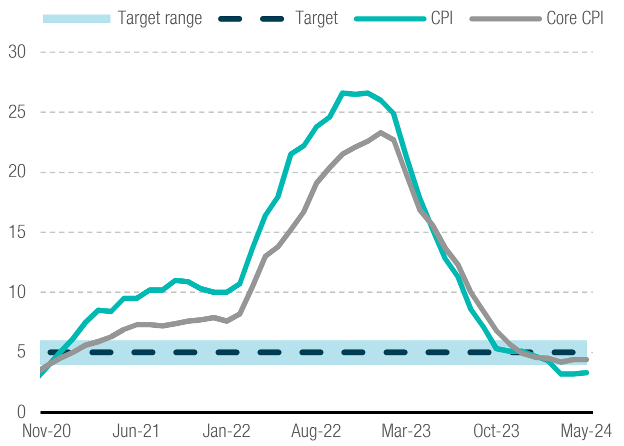
Chart 5. CPI, core CPI and target, YoY, %

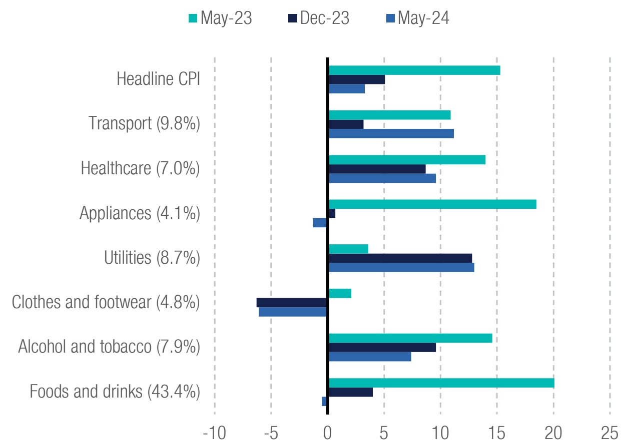
Annual inflation accelerates marginally in May



Source: Ukrstat, NBU, ICU.

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

Food prices decline YoY in May



* numbers in brackets indicate the share of the component in consumer basket

Source: Ukrstat, ICU.

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