Focus
Ukraine

Markets
Government bonds, FX market, and macro

Research team
Vitaliy Vavryshchuk
Alexander Martynenko
Taras Kotovych

Weekly Insight

Inflation accelerates notably

Key messages of the today's comments

MONDAY, 16 SEPTEMBER 2024

Ukrainian bond market

Demand at primary auction spikes; secondary market trading falls

The MoF borrowed UAH20bn last week. The significant demand at the auction dampened activity in the secondary bond market.

Trading active in new Eurobonds this week

Investors started to trade new Ukrainian Eurobonds actively. However, their prices slightly declined last week.

Foreign exchange market

NBU tests more significant hryvnia weakening

Last week, the NBU allowed the hryvnia to weaken the most over the recent three weeks, while the FX market imbalances were little changed.

Economics

Inflation accelerates notably, exceeds expectations in August

Consumer prices increased 0.6% MoM in August, lifting annual inflation to 7.5% from 5.4% in July.

Ukraine, IMF successfully complete fifth review of EFF program

The IMF announced last week it reached a staff level agreement with the Ukrainian authorities on the fifth review of the EFF program.

Government targets US$39bn financial aid in 2025 draft budget

Last week, government approved and submitted a 2025 draft state budget law to the parliament.

Banks' reserves market (13 September 2024)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	13.00	+0bp	-900bp
ON rate (%)	12.99	+0bp	-501bp
Reserves (UAHm)[2]	236,923	+3.2	+33.9
CDs (UAHm)[3]	491,825	-4.4	-4.9

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) (13 September 2024)

	Last	Weekly chg (%)	YoY chg (%)
NBU	677,606	+0.0	-1.9
Banks	756,570	+1.5	+35.0
Residents	171,019	+1.6	+37.4
Individuals	67,445	+4.2	+36.7
Foreigners	26,308	-2.2	-46.6
Total	**1,699,719**	**+1.0**	**+15.1**

Source: NBU, ICU.

FX market indicators (13 September 2024)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	41.3735	+0.9	+12.0
EUR/USD	1.1075	-0.1	+3.2
DXY	101.114	-0.1	-3.5

Source: Bloomberg, ICU.

Market gov't bond quotes (16 September 2024)

Maturity	Bid (%)	Ask(%)
6 months	14.50	13.50
12 months	15.50	14.75
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.

Ukrainian bond market

Demand at primary auction spikes; secondary market trading falls

The MoF borrowed UAH20bn last week. The significant demand at the auction dampened activity in the secondary bond market.

In the two most recent weeks, the Ministry offered UAH and FX-denominated bonds at the auction, and they received almost equal demand. Investors purchased UAH22.6bn (US$550m) of local-currency bonds, and US$350m and EUR63m of FX-denominated bills, as demand significantly exceeded the supply caps. See details in the auction review.

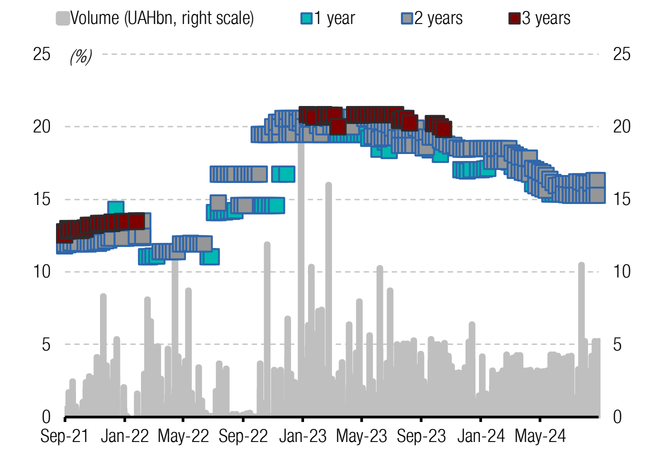
At the same time, secondary market trading almost halved last week as the volume of deals in UAH bonds shrank. Due to this fall and a 32% increase in trading in FX-denominated bills, the share of the former rose to 53%.

ICU view: We expect that this week the NBU will keep the key policy rate unchanged at 13% due to heightened inflation risks. Therefore, we expect yields on UAH bonds to remain little changed in the coming weeks. According to budget draft amendments, the MoF will need to borrow an extra UAH200bn by year end to cover this year's budget deficit. The bond market itself can't digest such a considerable amount of new securities. Therefore, we expect that this week the NBU will announce new administrative measures to encourage banks to increase investments in UAH bonds. We expect the NBU may indicate that there will be changes in mandatory reserve requirements and limits to the share of bonds that can be used to meet reserves requirements.

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

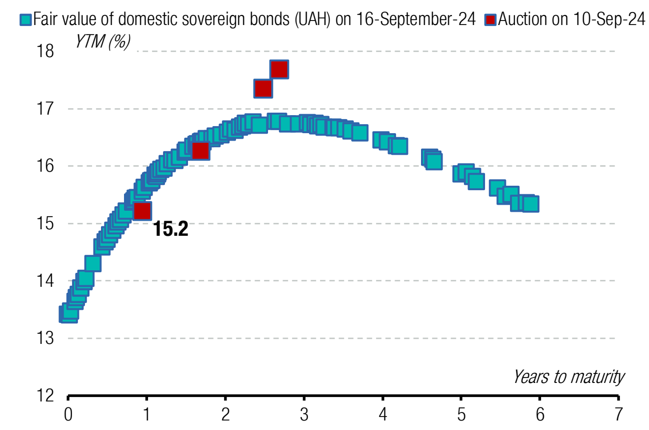
Chart 1. Local-currency bonds

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



Source: MFU, ICU.

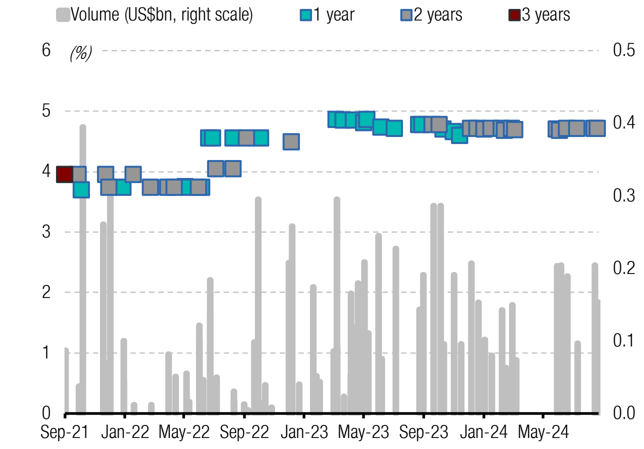
YTMs of domestic government bonds as calculated by NBU versus placements via primary market auctions



Source: NBU, MFU, ICU.

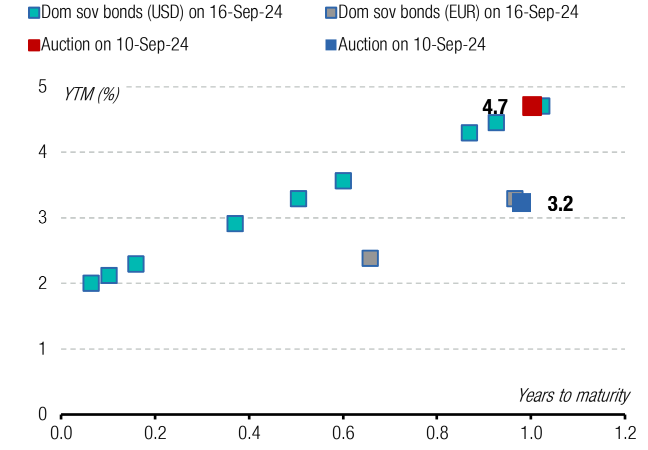
Chart 2. FX-denominated bonds

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.

Trading active in new Eurobonds this week

Investors started to trade new Ukrainian Eurobonds actively. However, their prices slightly declined last week.

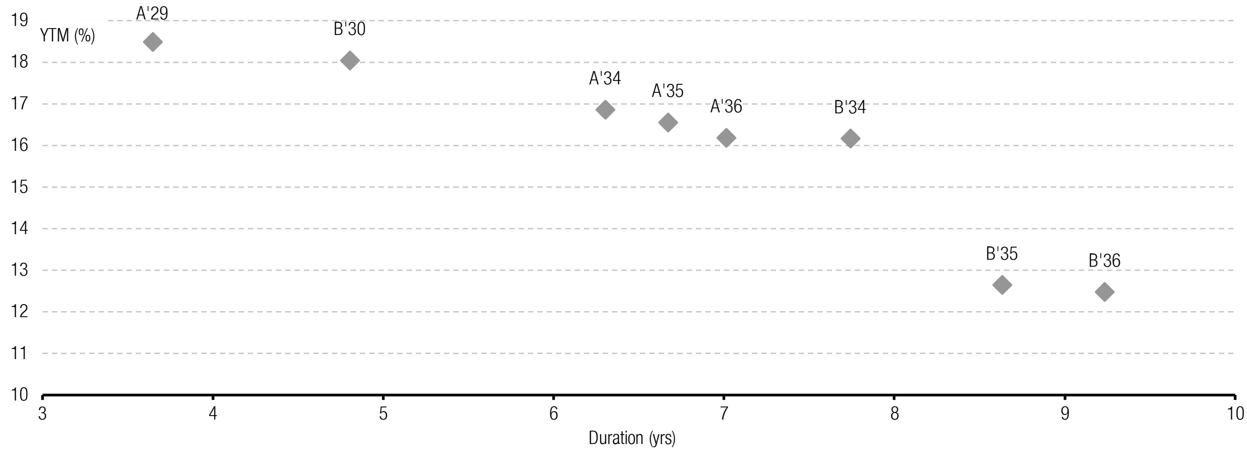
Last week, Eurobonds' price fluctuations were within a 5% range, but they ultimately slid by an average of 2%. The most significant decline was for Step Up Bond A, due in 2034-36, by 3.5%. However, two weeks after the exchange deal settlement, the prices of these three bond series slid insignificantly, by 0.2-0.4%. During these two weeks, the most significant decline was for Step Up Bond A, due in 2029, by 3.5%. At the same time, the prices for all four Step Up Bond Bs rose by 1.5%.

The price of VRIs slid by 2.5% in September to 68 cents per dollar of notional value. The EMBI index rose by 1.2% in two weeks.

ICU view: Due to active bond trading, prices reacted swiftly after JP Morgan announced that it would add papers to the EMBI Global Diversified Index when it does an "intra-month rebalance". The EMBI index gradually rose in recent weeks, indicating an improvement in global market sentiment toward EM bonds. However, early last week, this had little impact on Eurobonds prices. A small improvement in sentiment came on the back of Ukraine reaching a staff-level agreement with the IMF on the fifth revision of the EFF programme. S&P last Friday assigned CCC+ ratings to the new Eurobonds and Fitch assigned CCC earlier this month. Such decisions should support positive sentiment to post-restructuring Eurobonds.

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

Chart 3. New Ukrainian Eurobonds yield map



Notes: A-Step Up A Bonds, B – Step Up B Bonds

Source: NBU, ICU.

Foreign exchange market

NBU tests more significant hryvnia weakening

Last week, the NBU allowed the hryvnia to weaken the most over the recent three weeks, while the FX market imbalances were little changed.

The total FX market deficit (in four business days) fell by 28%. Bank clients (legal entities) decreased net hard currency purchases by 42% to US$265m while households increased net purchases by 7% to US$198m. NBU's interventions last week slid by 5% to US$746m.

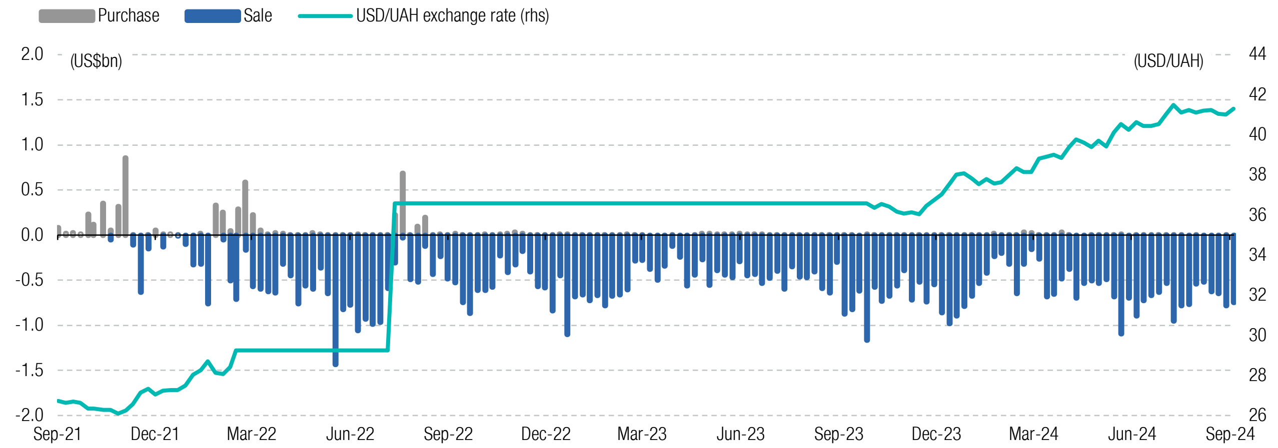
The official hryvnia exchange rate weakened by 0.7% to UAH41.32/US$, while the cash hryvnia in systemically important banks weakened by 0.5% to UAH41.1-41.6/US$.

ICU view: Last week, the NBU allowed the hryvnia to weaken to a three-week minimum as the market imbalance narrowed significantly. It looks like the NBU tested the market reaction to higher exchange rate volatility. We expect the NBU to renew hryvnia weakening soon.

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 notably, exceeds expectations in August

Consumer prices increased 0.6% MoM in August, lifting annual inflation to 7.5% from 5.4% in July.

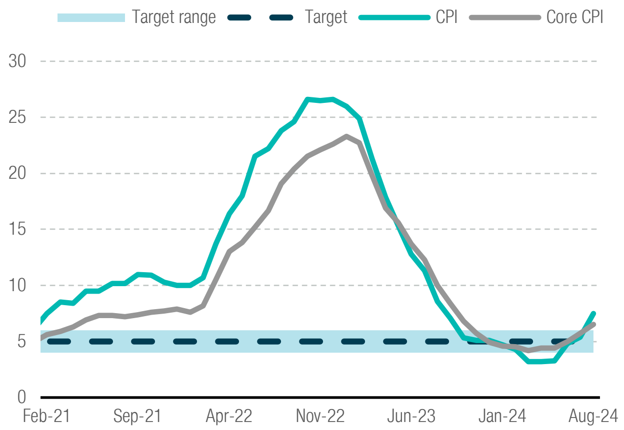
Inflation was primarily driven by food prices. They were up 0.9% MoM in August, which is extremely unusual as food prices normally decline during this month as the new agricultural harvest is being supplied to the market. This year, severe droughts hurt the supply of fruits, vegetables, grains, and oilseed to consumers and food producers, pushing prices up. Price growth for the two other most important consumer basket components—utilities and transportation services—did not add much concern about inflation risks. Annual growth in utility tariffs was 18.5% in August, nearly unchanged from July, while prices for transportation services (this category includes gasoline prices) decelerated to 8.2% YoY from 10.8% in July. Price growth for clothes and footwear remained in negative territory at -5.1% YoY.

ICU view: Acceleration of annual inflation in August was fully expected, but the impulse was more significant than we anticipated. Despite this, we don't think mid-term inflationary pressures are building substantially above our expectations. The summer acceleration in consumer inflation was first and foremost driven by unfavorable weather conditions. These negatively affected prices for both raw foods and processed foods. Growth of prices for other components of the consumer basket remain reasonable and there are no signs of them accelerating significantly. At this point we remain comfortable with our end-2024 inflation forecast of 7-8% YoY, and we expect nearly the same print at the end of 2025. Accelerating inflation, though expected, implies the NBU will maintain a cautious stance and is unlikely to move the key policy rate in the next couple of months.

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

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

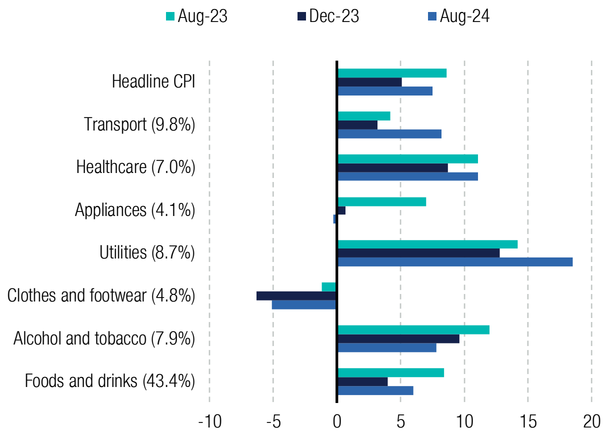
Annual inflation accelerates more than expected



Source: Ukrstat, NBU, ICU.

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

Food prices accelerating



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

Source: Ukrstat, ICU.

Ukraine, IMF successfully complete fifth review of EFF program

The IMF announced last week it reached a staff level agreement with the Ukrainian authorities on the fifth review of the EFF program.

In its press-release, the IMF noted that the program performance remains strong and all structural benchmarks have been met. However, the headwinds are significant and the outlook remains exceptionally uncertain. State budget deficit financing was one of the focuses of the press-release. The IMF said domestic revenue mobilization efforts are critical and tax revenues need to increase in 2025 and beyond to restore fiscal sustainability. In terms of monetary policy, the Fund believes the current NBU stance is appropriate and upside risks to inflation have reduced the scope for further policy easing. The managed flexible exchange rate regime will be maintained. Further FX liberalization measures will be taken in line with the NBU strategy.

ICU view: Successful review of the EFF program was broadly expected by the market. The IMF press-release does not provide any new insights into monetary and FX policies of the NBU. A key takeaway from the press-release is that government may need to look for more ways to raise tax revenues in the future and the current set of proposed changes to tax legislation may be not sufficient to ensure fiscal sustainability in the coming years. The press-release also does not provide more insights into the size of financial aid that Ukraine's external partners may be ready to provide in 2025.

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

Government targets US$39bn financial aid in 2025 draft budget

Last week, government approved and submitted a 2025 draft state budget law to the parliament.

The document envisages a relatively moderate fiscal consolidation as the state budget deficit is expected to narrow from 24% of GDP in 2024 to 19% of GDP in 2025. Outlays on defence and national security sector will make up more than 50% of total budget expenditures. Revenues are expected to cover only 59% of the expenditures, with the remainder, 41% of all expenditures, will represent a state budget deficit. The budget deficit if expected to be nearly fully financed with foreign financial aid. Government expects gross inflows of loans and grants at US$39bn, while net inflows are expected to be close to US$36bn.

ICU view: The lingering war made it impossible for the government to cut the budget deficit and there is very little room for fiscal consolidation in the foreseeable future. Expenditures on defence and national security sector will remain elevated in the years to come. This implies Ukraine will remain critically dependent on foreign financial aid and needs more clarity about future sources of funding from its international allies. At this point, only one sizeable external source of funds is available, which is Ukraine Facility from the EU. Ukraine financing risks can be substantially reduced only if the G7 countries approve a US$50bn financial aid packaged backed by frozen russian assets.

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

Table 1. Key parameters of 2024 and 2025 state budget, UAHbn

	2024 budget		2025 draft law
	Current	Proposed changes	
Total revenues (before grants)	1,768	1,911	2,336
incl. tax revenues	1,575	1,679	1,984
Expenditures	3,309	3,736	3,938
inlc. defence and security	1,673	2,177	2,223
Net lending	31	21	39
Budget balance (before grants)	-1,571	-1,846	-1,641
Total revenues / GDP	23%	25%	27%
incl. tax revenues / GDP	21%	22%	23%
Expenditures / GDP	44%	49%	45%
Budget balance (before grants) / GDP	-21%	-24%	-19%
Total revenues / expenditures	53%	51%	59%
Tax revenues / expenditures	48%	45%	50%
Defence, security / total expenditure	51%	58%	56%

Sources: MFU, ICU.

This page is intentionally left blank

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
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

Investment Capital Ukraine LLC is regulated by Securities and Stock Market State Commission of Ukraine (license numbers: dealer activity AE 263019, broker activity AE 263018, underwriting activity AE 263020 dated 11 April 2013).

DISCLAIMER

Additional information is available upon request.