Focus

Ukraine

Markets

Domestic liquidity, government bonds, FX market, and macro

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Weekly Insight

NBU cuts rate by 250 bps to 11%

Key messages of the today's comments

MONDAY, 3 FEBRUARY 2020

Domestic liquidity and bonds market

Government bonds rates below 10%

At January's last auction, interest rates for the seven-year notes were set below 10%. This level was reached due to high demand, and the MoF's decision to reject most of it. This month, the decline in rates should continue.

Liquidity stays above UAH230bn

Despite VAT refunds and the NBU's absorption of liquidity, the total amount of liquidity in the banking system remained above UAH230bn, declining last week just by UAH1.7bn. This week, the main impact on liquidity will be the NBU's operations with hard currencies, but liquidity should stay around UAH230bn.

Foreign exchange market

Hryvnia will continue weakening

Under impact from different factors, last week, the hryvnia lost 1.9%. We expect continued weakening this week as a reaction to high demand for hard currencies and low demand for new bills from foreigners. The exchange rate could weaken to UAH25.5/US$, with possible reversing of exchange rate movements to appreciation.

Economics

NBU cuts rate by 250 bps to 11.0%

The decrease in the key rate exceeded consensus.

C/A deficit fell to 0.7% of GDP in 2019

The main contributor to the C/A deficit contracting was the compensation received by Naftogaz of Ukraine from Russian Gazprom under a ruling of the Stockholm Arbitration Court. Lower world energy prices and agricultural exports will keep supporting the C/A balance in 2020.

Banks' reserves market (31 January 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	11.00	-250bp	-700bp
ON rate (%)	11.39	-21bp	-512bp
ON $ swap (%)	8.71	-156bp	-618bp
Reserves (UAHm)[2]	45,496	-17.44	-8.41
DepCerts (UAHm)[3]	187,952	+6.73	+174.52

Notes: [1] NBU's key policy rate; [2] stock of banks' reserves held at NBU; [3] stock of NBU's short-term bonds.
Source: NBU, Bloomberg, ICU.

Breakdown of govt bond holders (UAHm) (31 January 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	332,377	-0.66	-2.85
Banks	326,951	-0.97	-11.48
Residents	24,628	+1.14	+8.89
Individuals	9,289	-4.55	+38.65
Non-res[4]	124,979	+1.25	+938.69
Total	**818,223**	**-0.48**	**+8.72**

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

FX market indicators (31 January 2020)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	24.8952	+1.86	-9.81
EUR/USD	1.1093	+0.62	-3.10
DXY[2]	97.390	-0.47	+1.90
UAH TWI[3]	132.579	-1.36	+13.47

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

Gov't bond quotes[1] (3 February 2020)

Maturity	Bid	Ask
6m	**12.00**	**10.00**
12m	**11.50**	**9.75**
2y	**11.00**	**9.50**
3y	**11.00**	**9.50**
12m ($)	**4.00**	**2.75**
2y ($)	**4.50**	**3.20**

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

Domestic liquidity and bonds market

Government bonds rates below 10%

At January's last auction, interest rates for the seven-year notes were set below 10%. This level was reached due to high demand, and the MoF's decision to reject most of it. This month, the decline in rates should continue.

Offering of seven-year notes last week was the first in recent years and was expected by the market as an indicator of demand for such maturities from both local and foreign investors. Demand was 1.5x larger than the offering, but the Ministry decided to accept only bids with rates up to 9.95% (see auction comment for details).

This decision was likely a demonstration of what rates the MoF wanted for budget, but on the other hand, rates were close to the least attractive level, so there is almost no room left for further reductions. Further decline in rates will be minimal based on the NBU's recent decision to reduce the key policy rate to 11%.

After last week's auction, most local-currency bond portfolios rose, except those of the NBU and individuals, which saw declines after redemptions. However, taking into account redemptions and revaluation of FX-denominated bills, banks' share slid below 40%, while foreigners' share rose to 15.3% (par value). In nominal terms, foreigners' portfolios rose by UAH1.3bn last week, while local-currency bills portfolio rose by UAH2.1bn.

ICU view: We expect that interest rates for local-currency bills will slid by 30-50bp as a reaction to the larger-than-expected decrease in the key policy rate. A decline can be seen for all maturities and will depend on foreign investors' participation as they will take into account real rates and inflation.

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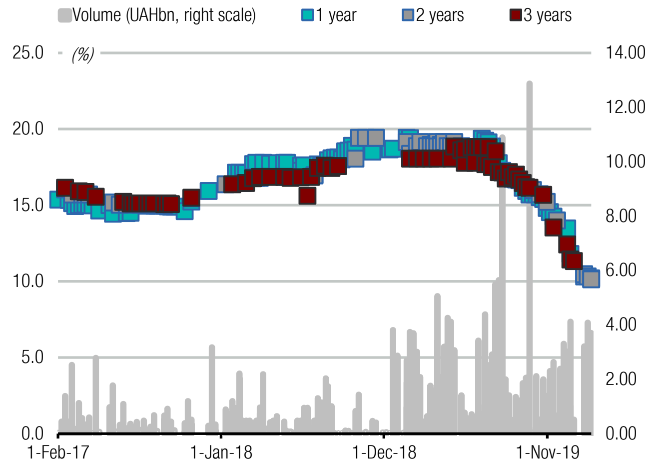
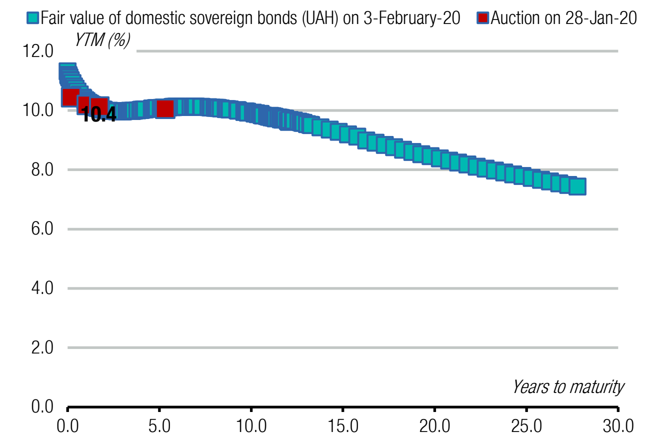
Chart 1. Local-currency bonds

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.

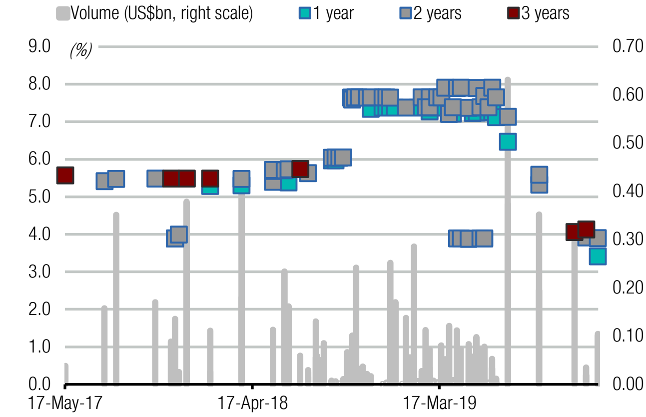
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

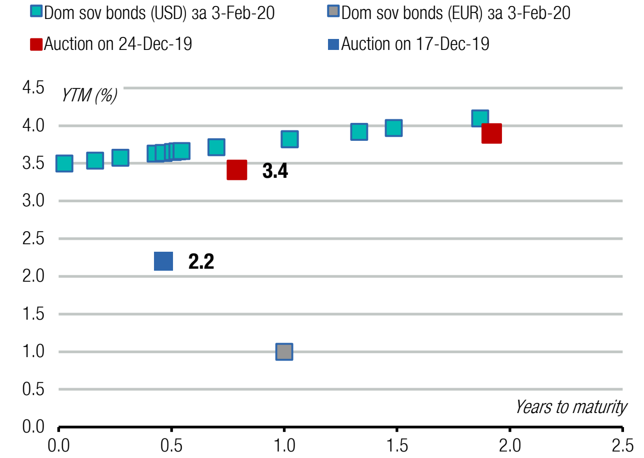
Chart 2. FX-denominated bonds

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.

Liquidity stays above UAH230bn

Despite VAT refunds and the NBU's absorption of liquidity, the total amount of liquidity in the banking system remained above UAH230bn, declining last week just by UAH1.7bn. This week, the main impact on liquidity will be the NBU's operations with hard currencies, but liquidity should stay around UAH230bn.

Last week, the main impact was NBU's operations with hard currencies and Treasury operations. These two components caused outflows from liquidity, UAH3.6bn and UAH5.9bn, respectively. These absorptions could decrease liquidity below UAH230bn, but a large part of outflows was compensated by cash exchange in reserves of UAH7.1bn.

As the result, liquidity declined by just UAH1.7bn, and was mostly invested in NBU CDs. A week ago, UAH143.5bn was invested in two-week CDs, while last week, the amount of ON CDs declined to UAH25.7bn. At the same time, the balance in banks' correspondent accounts rose to UAH66.2bn.

ICU view: This week, we anticipate that the NBU will continue to sell hard currency from FX reserves, absorbing local-currency liquidity from the banking sector. On the other hand, the budget can increase expenditures. So, liquidity will depend on banks' operations with cash and new government bill purchases, which should be larger than repayments, keeping liquidity close to UAH230bn.

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Chart 3. Banks reserves usages over last week(UAHm)

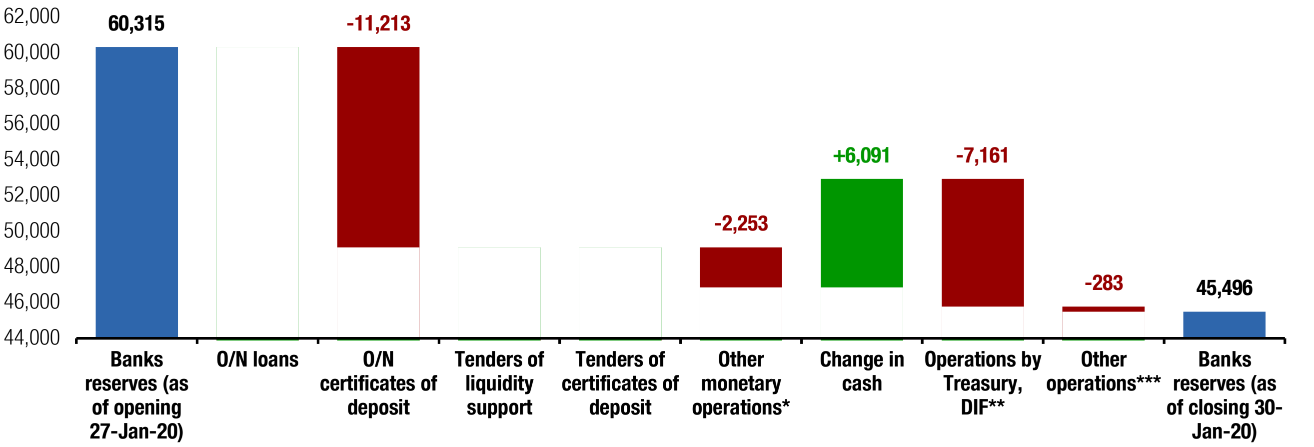
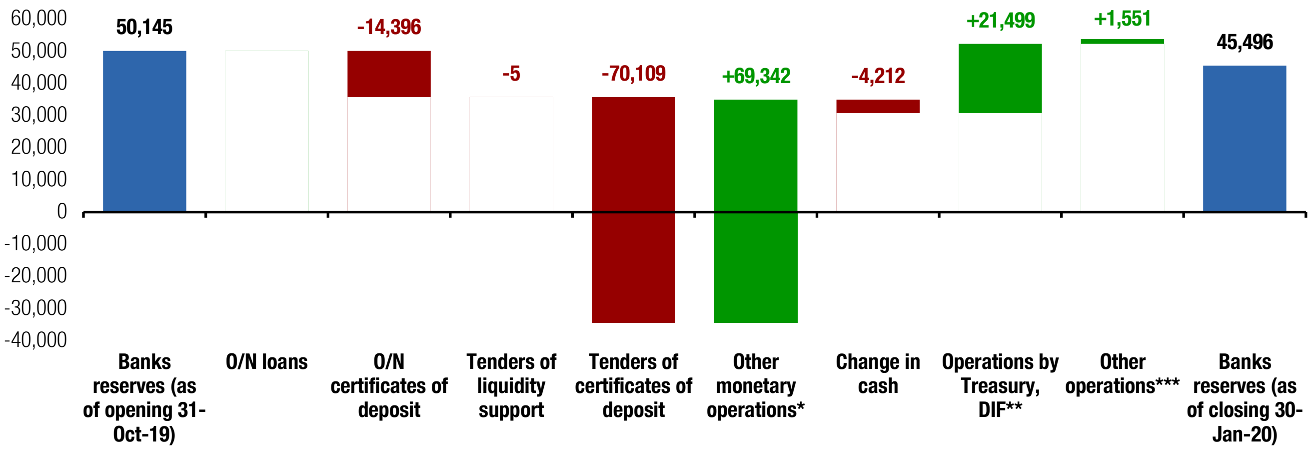


Chart 4. Banks reserves usages over last 90-day period (UAHm)



Notes: [1] data from the NBU's daily reporting https://bank.gov.ua/control/uk/publish/article?art_id=38643651&cat_id=40807142 ;
* operations repo, purchase and sale of government bonds, FX market interventions, stabilisation loans, FX swap agreements; ** DIF – deposit insurance fund;
*** interest payments on NBU's loans and on NBU's certificates of deposit, other operations. Source: NBU, ICU.

Foreign exchange market

Hryvnia will continue weakening

Under impact from different factors, last week, the hryvnia lost 1.9%. We expect continued weakening this week as a reaction to high demand for hard currencies and low demand for new bills from foreigners. The exchange rate could weaken to UAH25.5/US$, with possible reversing of exchange rate movements to appreciation.

Last week, the NBU sold hard currencies, which restrained weakening, and they accepted extra demand for FX. According to the NBU, demand included dividend withdrawals. In total, last week, the NBU sold US$143.5m.

High demand for FX was not compensated by supply from exporters, as they decreased selling of hard currency due to seasonality and large amounts of VAT refunds. As a result, last week, the hryvnia lost 1.9%, and weakened to UAH24.8952/US$. The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) declined 1.4% to 132.6, while in YoY terms, it was up 13.5%.

ICU view: This week, the hryvnia should continue weakening due to low activity of foreigners and exporters, and high demand from importers and companies for dividends. NBU will restrain weakening and probably not allow the hryvnia to weaken

below UAH25.5/US$. But in case of market balance changes to supply side, hryvnia can reverse its movements to appreciation.

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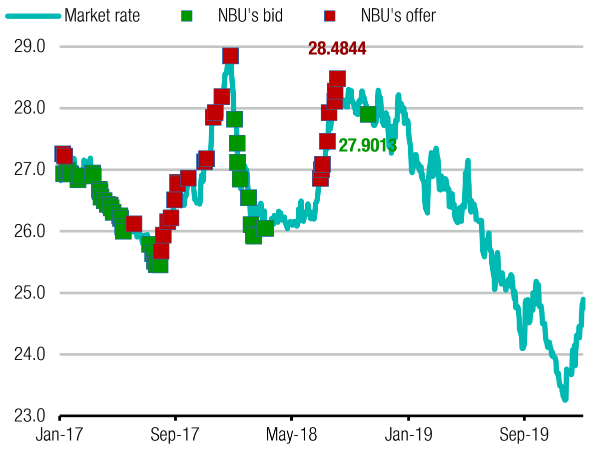
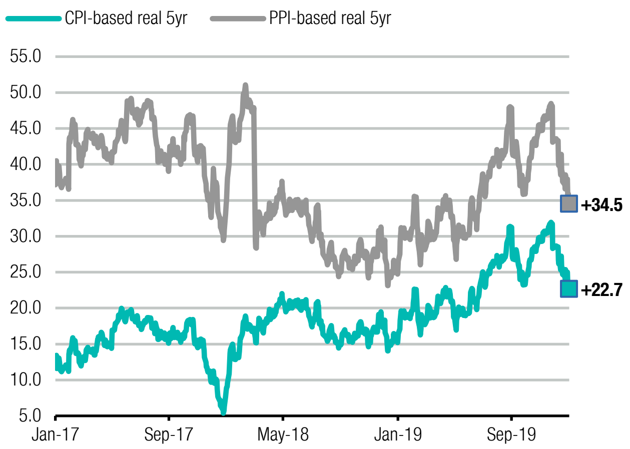
Chart 5. FX market indicators, 3-year history

Ukraine hryvnia UAH exchange rate per US dollar at the interbank market



Notes: the chart provides labels for the average exchange rate at last two NBU auctions (one on buying FX from the market and one on selling it). Source: NBU, Bloomberg, ICU.

UAH exchange rate misalignment[1] from fundamental level[2] (%)



Notes: [1] "+" overvalued, "-" undervalued; [2] based on the UAH's CPI- and PPI-based real TWIs. Source: ICU.

Economics

NBU cuts rate by 250 bps to 11.0%

The decrease in the key rate exceeded consensus.

Following the drop in inflation, which fell below the desired 5±1% band, the NBU decreased its key rate to the lowest level since 2014. NBU revised the macro forecast and expects the key rate to reach 7% by the end of 2020, while previously it forecast 9%.

ICU view: The NBU became much less hawkish for the long term. It forecasts the real interest rate for 2021-2021 to be in the range of 1.0-2.0%, significantly lower than the current 6.6% level (based on December CPI). However, the regulator remains conservative for the current year, as it has increased the expected real rate for most of the year when compared to the previous forecast.

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C/A deficit fell to 0.7% of GDP in 2019

The main contributor to the C/A deficit contracting was the compensation received by Naftogaz of Ukraine from Russian Gazprom under a ruling of the Stockholm Arbitration Court. Lower world energy prices and agricultural exports will keep supporting the C/A balance in 2020.

In 2019, the C/A deficit contracted to 0.7% of GDP (US$1.1bn) from 3.3% of GDP (US$4.4bn) in 2018. Merchandise exports rose 6.4% YoY to US$46.1bn, driven by an increase in exports of food products (+19% YoY to US$22.1bn), ores (+13% YoY to US$4.4bn), and machinery and equipment (+14% YoY to US$3.4bn). On the flip-side, exports of metals dropped 12% YoY to US$10bn. Imports of goods rose 7.1% YoY driven primarily by a 21% YoY growth in machinery and equipment (US$19.3bn), while energy imports fell 7% YoY to US$12.6bn.

Thus, 2019 merchandise trade balance deficit rose to 7.9% of GDP (US$12.1bn, +6.6% YoY), while the services-trade-balance surplus soared 36% YoY to US$1.8bn. Private remittances rose 7.7% YoY to US$12bn (ICU estimate based on the NBU's data).

ICU view: The main contributor to the C/A deficit contracting was the compensation (US$2.9bn) received by Naftogaz of Ukraine from Russia's Gazprom under a ruling of the Stockholm Arbitration Court. Without this compensation, the 2019 C/A deficit amounted to 2.6% of GDP, which is close to our forecast of 2.7% of GDP. For 2020, we expect further decrease in prices for steel and iron ore as well as lower transit volumes of Russian gas will cause trade-deficit widening. This should be partially compensated by lower imports of natural gas and a further decline of prices for energy products, which combined with economic growth, will result in the C/A deficit widening to 2.7% of GDP.

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