



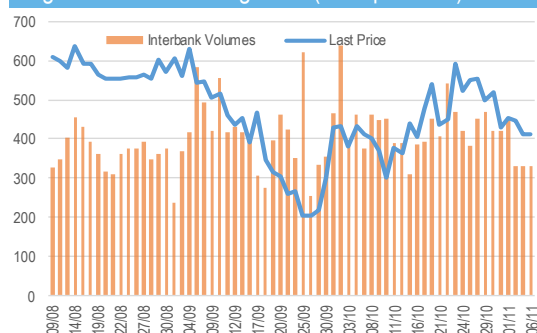
ECONOMICS | INTEREST RATES STRATEGY | FX

6 November 2019

UKRAINIAN CAPITAL MARKETS WEEKLY

	Rating	Outlook	Last update	This week in focus: Fresh stats confirm mixed trends in the economy
Fitch	B	POSITIVE	06.09.2019	Another portion of Ukrainian statistical data confirmed divergent trends in the economy: while real and nominal wages hold positive momentum, feeding further expansion of consumer spending, industrial production index took yet another step down, supporting our expectations of zero change through the year -end.
S&P	B	STABLE	27.09.2019	
S&P (N)	uaBBB	-	12.04.2019	
Moody's	Caa1	STABLE	21.12.2018	

Figure 1. UAH exchange rate (UAH per USD)



FX and interest rates: UAH gains positive momentum on fresh FX inflow

The USD/UAH pair has accelerated recovery as increasing participation of foreign investors in local government debt boosts FX liquidity supply in the market. As of 6th of November non-residents held UAH99.9bn (USD4.05bn) of local government bonds - a UAH0.37bn increase since beginning of the month - but results of the last FinMin's primary auction, which took place on Tuesday, will show up a few days later, and we expect non-residents' participation will exceed UAH100bn.

Exporters are definitely not happy with such developments, and their hopes of having more favorable exchange rate were clearly seen in the second decade of October, when lacking external support hryvnia fell against the dollar as low as 25.2 after the trade session on October 23. But now the pair is in the vicinity of 24.5 figure and the current trend in the market push exporters to sell more foreign currency in order not to avoid bigger losses.

Given the low resistance of local currency to depreciation when financial inflows into public debt decline, reversal in the trend of the pair is still possible. Worth mentioning, however, that export oriented businesses lately increasingly consider instruments of hedging against similar situations in the future.

Though decreased by UAH4.7bn to UAH123.6bn in the week ending November 1, banking liquidity remains at the record-high for this year levels.

The negative change during the last week has mostly to do with State treasury operations, which drained from the system circa UAH12bn. All the other channels had positive contribution, with central bank's interventions in the FX market bringing UAH3.6bn and cash money deposits another UAH3.2bn.

Worth also noting that banks continue expending their positions in central bank's CDs. Specifically, their portfolio of 2-week CDs increased by UAH5bn to UAH57.7bn.

On the background of declining interest rates in the money market and the sharp drop in government bonds' yields following the last primary auction, the central bank's certificates of deposit nowadays provide the highest return.

Figure 2. Banking liquidity (UAH bn)

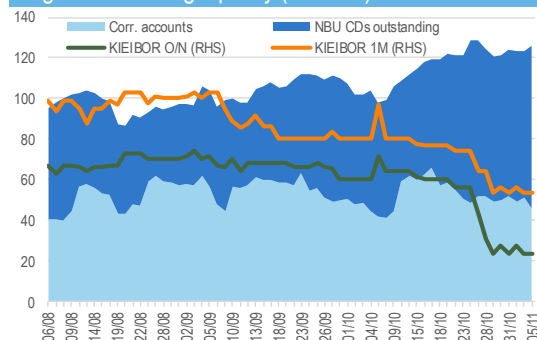


Figure 3. Correspondent account balances (UAH bn)

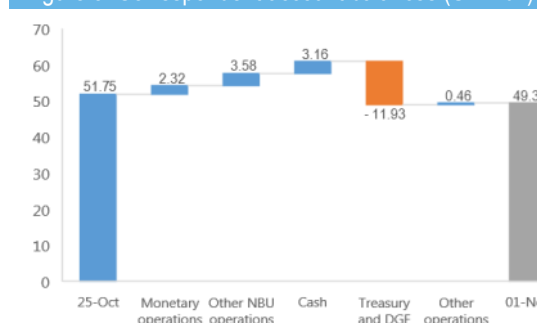


Figure 4. Local UAH bonds market

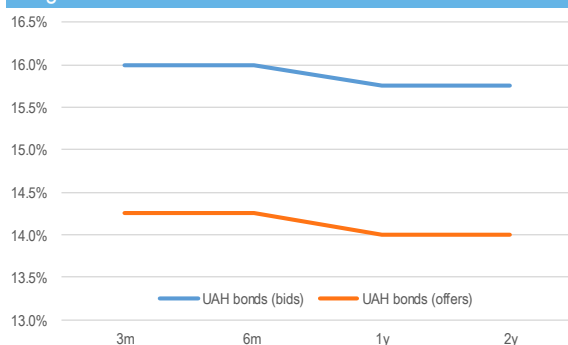
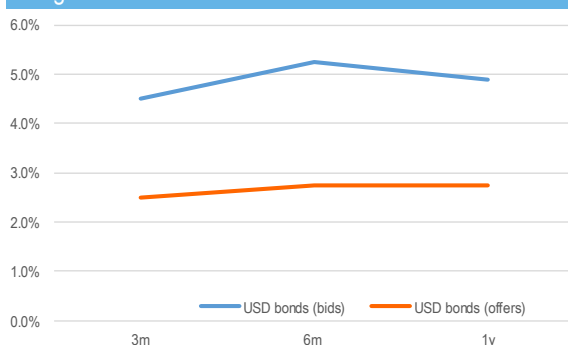


Figure 5. Local USD bonds market



Government bond market

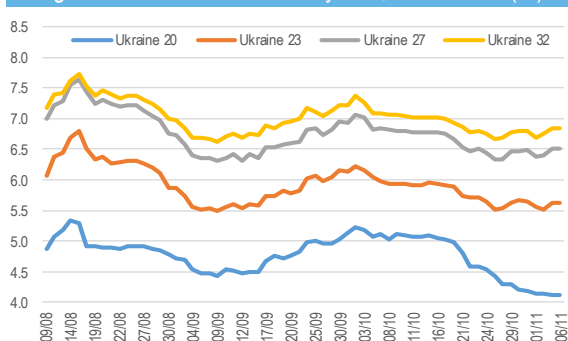
CCY	Maturity	Cut-off rate	WA rate	Max bid rate	Min bid rate	Number of bids	Bids accepted	Bid size, mn	Placement size, mn
UAH	3m	14.35%	14.35%	15.33%	14.35%	13	10	707.75	300.00
UAH	1y	14.00%	14.00%	14.00%	14.00%	7	7	708.83	500.00
UAH	4y	13.38%	13.30%	14.60%	13.13%	78	31	12 471.12	2 500.00

This week's primary auction of 4-year bonds drew the most aggressive bidding for the limited offer in the current year. Investors submitted bids for 4.99 times the UAH2.5bn of bonds offered by the Finance Ministry. The cut-off rate was set at 13.38%, but taking into account, that weighted average rate was below it by 8 basis points (bps), further squeezing of the bonds' yield should be expected. During the previous auction these securities were offered (on May 21) there was no threshold and the cut-off rate was set at 16%.

Together with 4y bonds FinMin auctioned 3m and 1y notes. The shortest one also attracted warm reception: the so-called bid-to-cover ratio - a gauge of demand - for that maturity rose to 2.36 from 0.06 at the auction a week ago. Being satisfied with demand, the ministry turned to aggressive reduction of cut-off rate - by 100bps, to 14.35%. Worth also noting, that the threshold for 3m bonds was reduced by UAH200mn - to UAH300mn.

Regarding 1y notes, total bids submitted 1.42 times exceeded UAH0.5bn of the bonds offered. The Ministry compressed the yields to 14%, from 14.3% last week.

Figure 6. Ukraine's Eurobond yields, bid/ask mid (%)



Dollar slips on US-Sino trade deal

The U.S. dollar drift lower and by the end of Wednesday was seen near 1.1067 mark against the euro as optimism that the United States and China will reach a deal to end their trade war reduced safe-haven demand for the greenback. Signs of progress in negotiations, in particular statements of U.S. officials that a Phase-1 deal could be signed this month, have boosted sentiment across world markets.

In turn, the euro benefit from data released on Wednesday showing German industrial orders rose more than expected in September, offering a glimmer of hope for an export-powered economy hit hard by global trade tensions.

Figure 7. EUR USD spot (mid)



Besides, EU yearly retail sales beat expectations to print a rise of 3.1%. Consumer spending in the EU is an important part of the EU's overall issues. After a long period of monetary stimulus, the reading is a good indicator of economic health.

U.S. Treasury yields move lower as investors await a preliminary reading of third-quarter productivity data and primary auctions. The U.S. Treasury is set to auction USD27bn in 10-year notes later in the session. Market participants are also likely to closely monitor speeches from policymakers at the U.S. central bank on Wednesday.

By the end of Wednesday, the benchmark 10-year Treasury note, which moves inversely to price, was lower at around 1.825%.

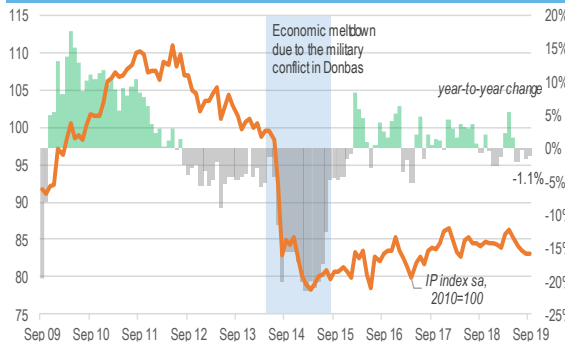


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Figure 8. Industrial production (IP) index

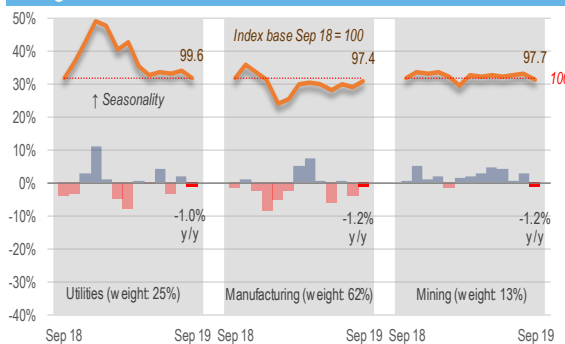
Fresh stats confirm mixed trends in the economy



Another portion of Ukrainian statistical data confirmed divergent trends in the economy: while real and nominal wages hold positive momentum, feeding further expansion of consumer spending, industrial production index took yet another step down, supporting our expectations of zero change through the year-end.

The recent data on industrial production brought no change to the negative trend we have seen since May: September's reading on IP declined by 1.1% y/y, seasonally adjusted figure moved down by 0.1%. Deceleration in industrial production was broad based: performance of mining and manufacturing segments worsened by 1.2% y/y, utility supply decreased by 1% y/y.

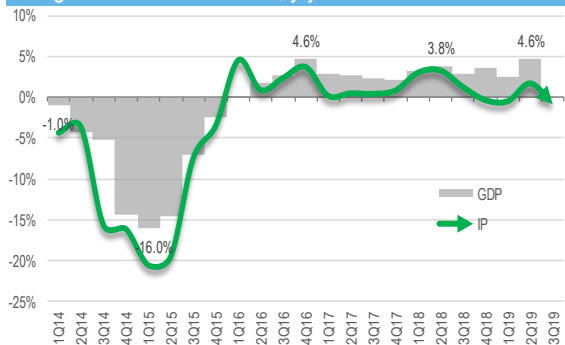
Figure 9. IP breakdown



Developments in mining sector suggest little optimism. The seven months' positive annual growth we saw before decline in September had mostly to do with a low base effect of the previous year, when transportation challenges in the Sea of Azov (in 2H18) and repair works at several metallurgy plants negatively impacted total output. This year mining sector shows no signs of improvement. While situation with logistics have improved somewhat, price conditions at the global markets have been unsupportive in 2H19. Besides, some businesses have faced difficulties with renewal of their mining licenses, and hence were forced to put off or halt works.

Looking forward, worth pointing out early discussions in the parliament regarding a revision of royalty rate for iron ore mining (increase to 10% from 8% is being mulled over, according to a draft bill dated August 30). Though specific rates are still under negotiation, an increase seems inevitable. An impact of this action on the sector is not clear yet as there also were some compromise solution proposed by market participants to avoid drastic consequences for their business.

Figure 10. GDP vs IP 3M, y/y



Manufacturing and utilities to rebound since late Autumn. Unlike mining, manufacturing made a step to recovery. In spite of another decline in annual basis, manufacturing index rose 6.2% in September, erasing negative change in the preceding month. Pharmaceuticals and food industry took the lead in the movement, though continually improving consumer spending sentiment is supportive of having a more robust growth going forward. The only hinder we see for the trend to outperform the last year's one is strengthening hryvnia, increasing demand for imported products.

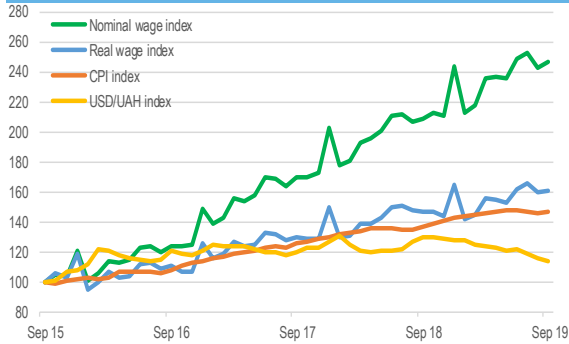
Given that all the other sectors show slight changes this year, the major factor driving utilities is seasonality. Usual for cold season increase in demand for electricity and natural gas should push the utilities' index up in 4Q19. Annual growth, however, might stay in red as warm late autumn is likely to reduce energy consumption.



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Figure 11. Wages growth, Sep 2015 = 100



Tight labor market push wages up

Wages keep up positive momentum: being pushed by consumer prices and tight labor market, real wages rose by 9.8% y/y in September and nominal wages showed another double digit growth – by 18.2% y/y.

To be more specific about driving forces in the labor market, the main factor is work migration to foreign countries, largely to the Central Eastern Europe, enhancing competition for work resources within Ukraine.

An increasing export of services, in particular IT, as well as growing proportion of self-employment and small and medium businesses in the economy, draining skilled employees, should push labor costs higher in medium-term and long-run.

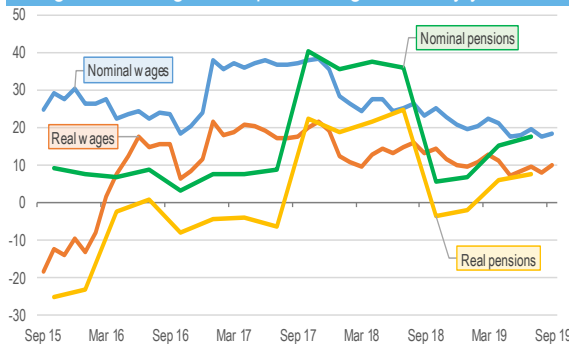
Nominal pension, though with some time lag, should also advance following the change in nominal wages.

Given weak investments in the economy, productivity growth is likely to be slow. **Taking this factor into account, expected steady wages growth coupled with appreciation of hryvnia pose a serious headwind to businesses, especially to export oriented ones.**

In the bottom, industrial production this year clearly renders little support to the economy. With 3-month average index down in September by 0.9% y/y, the GDP growth is likely to lower to 3.5% in 3Q19. Though seasonal improvement in IP is very likely, having year-to-year growth is in question due to reasons mentioned above. Softening of monetary policy, though supportive, might become visible in a lead of 5-6 months.

Conversely, with sustained growth in wages and pension payments, private consumption is likely to remain buoyant. Hence we reiterate our 2019 forecast for IP at 0% and for GDP at 3.5%.

Figure 12. Wages and pensions growth, % y/y



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Key Macroeconomic Indicators

	2013	2014	2015	2016	2017	2018	2019E	2020F
Real sector								
Real GDP (%YoY)	0.0	-6.6	-9.8	2.3	2.5	3.3	3.5	3.5
Industrial production (%YoY)	-4.3	-10.7	-6.0	2.4	-0.1	1.6	0.0	1.2
Retail sales (%YoY)	6.1	-11.0	-25.0	4.0	8.8	6.1	5.0	4.0
Unemployment rate end of year (ILO, working age)	7.7	9.7	11.5	9.3	8.7	8.5	8.5	8.4
Nominal GDP (UAH bn)	1 466	1 587	1 980	2 383	2 983	3 393	3 830	4 321
Nominal GDP (USD bn)	184	134	91	93	112	125	145	152
Prices								
CPI (average %YoY)	-0.2	12.1	48.7	16.5	14.4	10.5	9.2	8.1
CPI (end of year %YoY)	0.5	24.9	43.3	12.4	13.7	9.8	7.9	7.2
Real average wage growth (%YoY)	8.2	-6.5	-35.0	10.0	18.9	9.7	8.0	6.0
Fiscal balance (% of GDP)								
State budget deficit (without Naftogaz)	4.2	4.9	2.3	2.9	1.6	2.4	2.4	2.3
Total public debt (% of GDP)	39.9	69.4	79.4	81.0	71.8	61.0	60.0	61.0
External balance								
Exports of goods and services (USD bn)	81.7	65.4	47.9	46.0	54.0	59.0	57.2	59.5
Imports of goods and services (USD bn)	97.4	70.0	49.6	51.8	60.8	70.5	69.1	71.8
Current account balance (USD bn)	-16.5	-4.6	1.6	-1.3	-2.4	-4.7	-4.4	-4.5
Current account balance (% of GDP)	-9.0	-3.4	1.8	-1.4	-2.1	-3.3	-3.3	-3.2
Net FDI (USD bn)	4.1	0.3	3.0	3.4	2.3	2.5	2.3	2.4
Foreign exchange reserves (end of year)	20.4	7.5	13.3	15.5	18.8	20.8	22.5	23.5
Imports coverage (months of imports of goods)	2.9	1.5	4.4	3.7	3.6	3.4	3.5	3.5
Interest and exchange rates								
NBU discount rate (% end of year)	6.5	14.0	22.0	14.0	14.5	18.0	15.5	13.0
Exchange rate (UAH/USD) end of year	8.2	15.8	24.0	27.2	28.0	27.7	26.5	28.5
Exchange rate (UAH/EUR) end of year	11.3	23.0	26.2	28.3	33.5	31.8	29.2	31.4

Two Weeks Ahead

Date/Deadline	Event	Notes
07-Nov (Thu)	NBU: FX Reserves	by 7th day
08-Nov (Fri)	Ukrstat: Consumer & Production Price Indexes	October
11-Nov (Mon)	NBU: Monetary & Financial Statistics	October
13-Nov (Wed)	ECB: Non-Monetary Policy Meeting	
14-Nov (Thu)	Ukrstat: Gross Domestic Product (Operative)	Q3 2019

Upcoming pay offs related to local government bonds

Date	Payment	Amount
06-Nov (Wed)	Principal UAHmn	4 583.6
	Coupon UAHmn (capital notes)	535.0
	Coupon UAHmn	10.8
08-Nov (Fri)	Coupon UAHmn (capital notes)	203.1
13-Nov (Wed)	Coupon USDmn	8.9
	Coupon UAHmn (capital notes)	116.7
	Coupon UAHmn	797.0

*capital notes - government bonds, which were issued for recapitalization of state-owned banks



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