



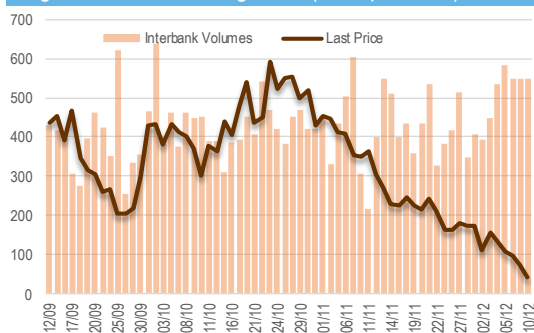
ECONOMICS | INTEREST RATES STRATEGY | FX

12 December 2019

UKRAINIAN CAPITAL MARKETS WEEKLY

	Rating	Outlook	Last update	This week in focus: NBU ventures to a heavy cut in main rate
Fitch	B	POSITIVE	06.09.2019	The NBU today has cut its main lending rate to 13.5% from 15.5%. After inflation figure came in significantly below expectations, the action was not surprising. Moreover, current developments in the public debt and interbank FX markets, which are closely related to the tight monetary policy, might push the NBU to go ahead of its policy rate forecast for 1H20.
S&P	B	STABLE	27.09.2019	
S&P (N)	uaBBB	-	12.04.2019	
Moody's	Caa1	POSITIVE	22.11.2019	

Figure 1. UAH exchange rate (UAH per USD)

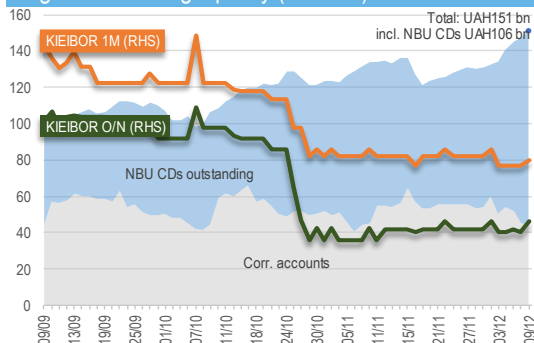


FX and interest rates: USD/UAH drops to fresh 3-year low

The USD/UAH pair rate has declined to 23.63 this week as foreign investors continue increasing positions in local government debt (govies).

Another successful FinMin's primary debt auction on December 10, with total bids for 4y bonds 3.8 times exceeding amount offered, confirmed strong appetite among non-residents to still yielding government debt. Moreover, the weekends' statement by the IMF managing director on reaching agreement with the Ukrainian authorities on the policies to underpin a new 3-year USD5.5bn arrangement – which is likely was the reason for the FinMin to set a UAH3bn threshold for 4y bonds over the weekend – and moderately positive results of talks in the so-called Normandy format on December 9, cemented expectations in the market about another inflows going forward.

Figure 2. Banking liquidity (UAH bn)



Thanks to a flurry of positive news flow, the USD/UAH pair rate could have fallen even lower, according to the market participants, but for the actions of the central bank mopping up excess FX liquidity.

The NBU purchased USD436.6mn in the foreign currency market during the last week, a 2.4 increase compared with the total FX interventions a week earlier. Besides, according to a preliminary data the central bank has bought more than USD130mn in the first two days of the current week.

Total liquidity in the banking system increased to record high UAH147.5bn during the last week. While amount of funds in banks' correspondent accounts with the NBU declined to UAH45bn, investments in central bank's certificates of deposits grew by UAH25bn to UAH102.5bn, another historical record. Along with mentioned above massive NBU's interventions in the FX market, injecting into system UAH10.4bn, State treasury's operations – mostly related to redemption of public debt - brought in another UAH7.6bn.

Figure 3. Correspondent account balances (UAH bn)

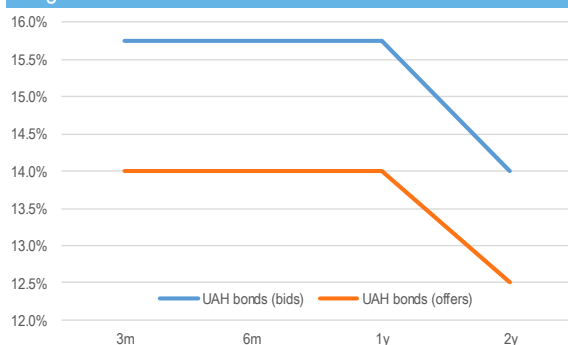


Monetary operations totaling to UAH25.4bn represent reallocation of funds on correspondent accounts into NBU's CDs.

With record high banking liquidity and reduction of the central bank's key rate by 200 basis points we expect to see a sharp downside of rates in the interbank money market.



Figure 4. Local UAH 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	6m	0.00%	0.00%	14.75%	14.10%	5	0	348.49	0.00
UAH	1y	13.00%	13.00%	14.20%	13.00%	5	3	230.94	212.94
UAH	2.5y	12.05%	12.01%	13.25%	12.00%	14	8	2 017.00	1 000.00
UAH	4y	11.70%	11.67%	12.50%	11.55%	57	22	11 355.42	3 000.00

Another FinMin's primary debt auction saw strong demand for Ukraine's local government debt among foreign investors. This Tuesday the ministry offered a wide range of instruments, starting from 6m to 4y bonds. The main interest was clearly concentrated in the long end of the offer. Bids for the UAH3bn of 4-year notes exceeded the offering by 3.8 times. Worth also mentioning that the FinMins initially didn't set a limit for this offer and changed its mind over the weekend. An announcement of a staff level agreement with the IMF on a new arrangement likely was the main reason for such an action. Being secure with FX liquidity – a new IMF's programme will also unlock a EUR500mn macro-financial assistance from the European Union – the ministry seems to have decided to split its December's borrowings into several tranches with main funds attracted after the today's sharp key rate cut. As a result, a cut-off rate for 4-year bonds was reduced by 94 basis points (bps) to 11.7%.

A UAH1bn 2.5-year bond auction drew a bid-to-cover ratio of 2 and a weighted average yield of 12.01%. Since the last time bonds with similar tenure were offered in late September, decrease in cut-off rate accounted to 345 bps.

Short-term 6m and 1y bonds drew cool reception.

Figure 5. Local USD bonds market

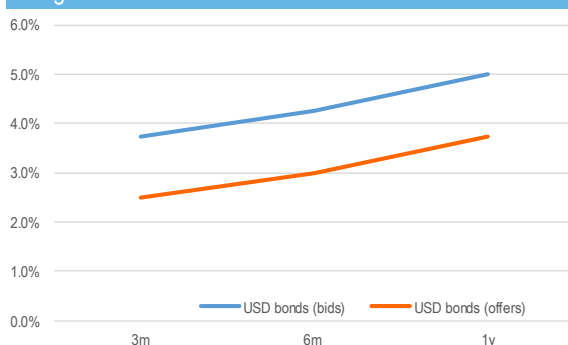
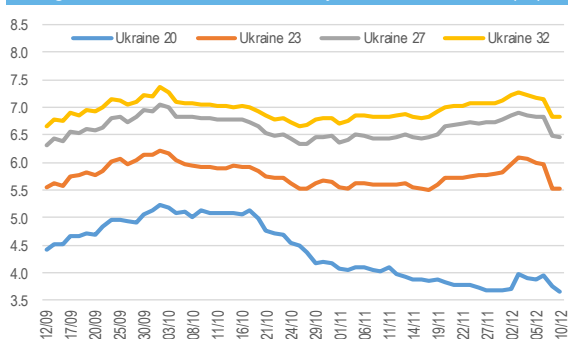


Figure 6. Ukraine's Eurobond yields, bid/ask mid (%)



USD slips to 4-month low against EUR as Fed holds rates

The U.S. dollar fell on Wednesday to a four-month low against the euro at 1.113 figure after the Federal Reserve (Fed) left its monetary policy unchanged and signaled of no rate hikes in 2020.

The Fed left the benchmark overnight lending rate in its 1.50% to 1.75% target range, and the U.S. central bank's chief made it clear that he would have to see a "significant and persistent" move up in inflation to consider a rate hike. The Fed's forecasts sparked an unwinding of long positions in the greenback.

Now the major focus will be on Christine Lagarde's first monetary policy meeting as the European central bank (ECB) chief and the general election in the United Kingdom (UK), contributing to the risk sentiment. The ECB isn't expected to alter its current monetary policy but could reiterate the push for fiscal stimulus. With regard to developments in the UK, although major polls favor the ruling Conservative Party to keep the help of Britain, a clear majority in the Parliament is what the Tories need to achieve their Brexit goals.

U.S.-Sino trade negotiations have gone off the screen, but not for long. U.S. President Donald Trump is expected to meet with top advisers on Thursday about the tariff deadline, according to media reports.

U.S. Treasury yields tick higher after Fed's meeting. The benchmark 10-year Treasury yield, which moves inversely to price, was around 1.8069% on Thursday.

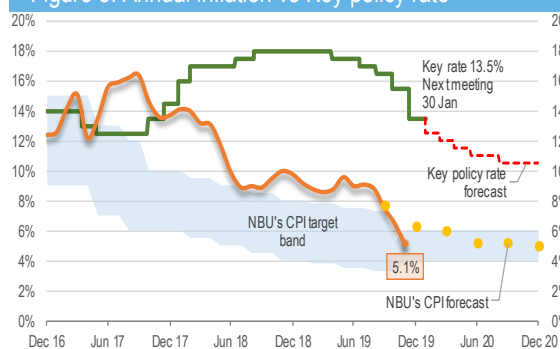
Figure 7. EUR USD spot (mid)



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Figure 8. Annual inflation vs Key policy rate



NBU ventures to a heavy cut in main rate

Ukraine's central bank today has cut its main lending rate for the fifth time this year: the key rate was reduced to 13.5% from 15.5%. After inflation figure came in significantly below expectations, the action was not surprising. Moreover, current developments in the public debt and interbank FX markets, which are closely related to the tight monetary policy, might push the NBU to go ahead of its policy rate forecast for 1H20. At the same time, as of today we see no reason for a quick key rate decline into a single digit area as drivers for current disinflation – record harvest and strong UAH – might reverse.

Ukraine's underlying consumer prices inflation moderated to surprising 5.1% y/y in Nov amid strengthening of UAH and supporting energy prices. All the CPI components contributed to inflation deceleration, with transportation costs and prices for apparels posted a decline (minus 1.4% y/y and minus 3.2% correspondingly). Assuming that the underlying factors to continue feeding into lower forward inflation, we revised down our year-end forecast to 4.8%.

Fundamentals are such that strong hryvnia, contributing to cheaper imports, and favorable energy prices at global markets helped to quell prices growth more than it could be expected under a sole tight monetary policy. Moreover, we see that slowdown in prices for fast moving goods has not reached its potential yet due to retailers' reluctance to adjust to hryvnia's appreciation. We expect, however, to see more notable decline in prices for imported goods in 1Q20 following the entry into force of budgets for a new fiscal year.

Figure 9. Month-to-month change in CPI

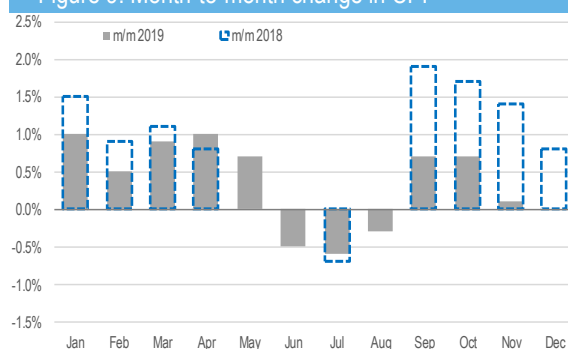


Figure 10. USD/UAH spot rate

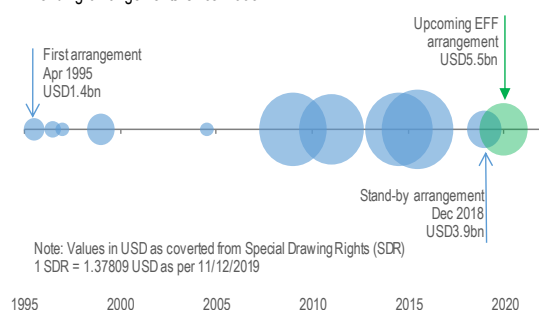


With regard to world energy prices, they have stayed subdued this year against growing worries about slowing global demand. Further support, however, is in question. While expectations for oil prices for 2020 have been continually revised down this year by market participants, natural gas consumption continues to grow, supporting stable prices into 2020. Taking also into account a risk of material reduction in volumes of transportation of Russian natural gas through Ukraine following ongoing negotiation between Ukraine's Naftogaz and Russia's Gazprom, **adverse developments in natural gas market might outweigh positive expectations in other energy commodities prices.**

Returning to the monetary policy, the NBU, which has a 6.3% inflation target for 2019, has been under pressure lately to boost lending activity after inflation hit a 5-year low in Nov. Indeed, **some key inflationary risks have sputtered out**, with recently agreed new IMF programme (staff level agreement on a three-year extended arrangement under the Extended Fund Facility for about USD5.5bn was announced on December 7) helping to preserve macroeconomic stability and supporting further progress on structural reforms. On this background and taking into account that CPI index is likely to undershoot NBU's target, we expect the central bank to press on with monetary policy softening through 1H20.

Figure 11. History of Lending Arrangements

Lending arrangements since 1995



At the same time, **reduction of key rate to a single digit in 2H20 is in question**, from our point of view. While inflation slowdown is underway, it is still far from robust. First, mentioned above main disinflation drivers are of a non-permanent nature, with UAH strengthening widely dependent on volatile foreign investment sentiment. Second, evolution of inflation in early autumn will be dependent on the next year's crops. And the last, we estimate it could be difficult for the central bank to keep inflation within its 4-6% target range through 2020 due to high wage inflation (nominal wages rose 16.4% y/y and in October) and high base effect of the current year. In view of the above, we expect policy decisions in 2H20 will be guided by inflation dynamics, exchange rate developments and progress on implementation of the IMF programme.

The next policymakers decision will be released on 30th of January 2020.



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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	4.8	5.5
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	13.5	10.5
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
12-Dec (Thu)	ECB: Monetary Policy Meeting	
	NBU: Monetary Policy Meeting	
18-Dec (Wed)	ECB: Non-Monetary Policy Meeting	
19-Dec (Thu)	External Debt	Q3 2019
	Ukrstat: Gross Domestic Product	Q3 2019
20-Dec (Fri)	Ukrstat: Retail trade turnover	November
23-Dec (Mon)	NBU: Minutes	
	Ukrstat: Industrial Production Index	November

Upcoming pay offs related to local government bonds

Date	Payment	Amount
12-Dec (Thu)	Principal USDmn	160.0
18-Dec (Wed)	Coupon UAHmn (capital notes)	1 214.1
	Coupon UAHmn	273.6
23-Dec (Mon)	Principal UAHmn	5.5
	Coupon UAHmn	0.3
25-Dec (Wed)	Coupon UAHmn (capital notes)	655.1
19-Dec (Thu)	Coupon USDmn	6.0

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



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