ECONOMICS | INTEREST RATES STRATEGY | FX

8 December 2021

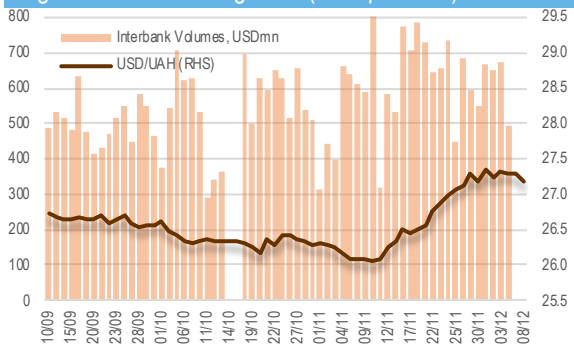
UKRAINIAN CAPITAL MARKETS WEEKLY

	Rating	Outlook	Last update
Fitch	B	POSITIVE	06.08.2021
S&P	B	STABLE	12.03.2021
S&P (N)	uaA	-	12.03.2021
Moody's	B3	STABLE	12.06.2020

This week in focus: Gas price crisis threatens to derail recovery in 2022

Ukraine's economy remains on a recovery track. Although 3Q annualized GDP rose by just 2.4%, we expect twice as high growth in 4Q driven by a pick-up in retail sales, an increase in government expenditures, and an improvement in trade balance. We are more concerned with the economic picture in 2022, as high natural gas prices and the new Covid variant threaten to derail recovery.

Figure 1. UAH exchange rate (UAH per USD)



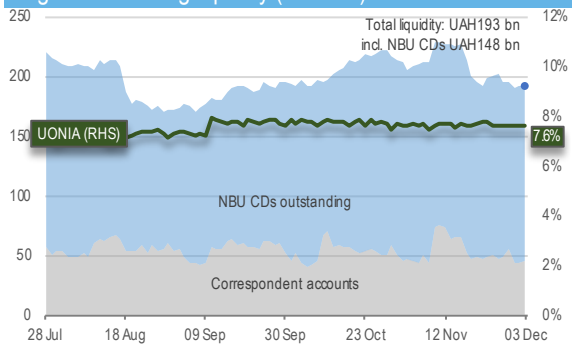
FX and interest rates: USD/UAH leaps above 27.00 barrier

The USD/UAH rate has expectedly reversed the steady trading around the low 26s and has jumped above the 27.00 barrier over a few trading sessions. **The pair was last seen rebounding from the four-month low of 27.33, but the pressure seems to have not moved yet.**

As we warned because "green" electricity producers are typically burdened with their FX liabilities, nearly all the debt repaid to them promptly flew to the FX market (see weekly of November 10 for details).

An extra demand equaling approximately to the par value of Eurobonds issued by Ukrenergo for appropriate needs was largely made up by the NBU's interventions.

Figure 2. Banking liquidity (UAH bn)

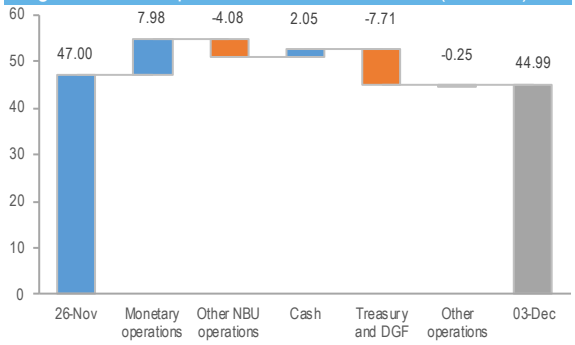


The pressure in the local currency, however, has persisted. The rising tension between Ukraine and Russia, with reports of a Russian troop build-up near Russia's borders with Ukraine, stimulated precautionary FX purchases.

The disbursement of USD700mn worth of financial tranche by the IMF had little impact on the pair movement, as it had already been played out by the market.

The USD/UAH decline appears to have met some contention near the 27.35 level. We find correction towards our year-end forecast of 27.00 still possible, considering stable FX supply by exporters of agricultural products . But, as long as the situation in the east of Ukraine remains tight, bearish sentiments about hryvnia will continue ruling the market.

Figure 3. Correspondent account balances (UAH bn)



Amount hryvnia liquidity in the banking system dropped below UAH200bn. As of the end of last week (November 3), banks' reserves held on correspondent accounts with the NBU amounted to UAH45bn, down 4.3% on the week earlier, position in central bank's CDs contracted by 4.8% to UAH147.6bn.

The liquidity decline resulted from fiscal flows and NBU's interventions in the FX market, withdrawing roughly UAH12bn from the system.

The drain, however, had little impact on the money market interest rates. The amount of liquidity in the banking system remains high. Besides, banks could expect a typical in December heavy spending by the government.

Figure 4. Local UAH bonds market

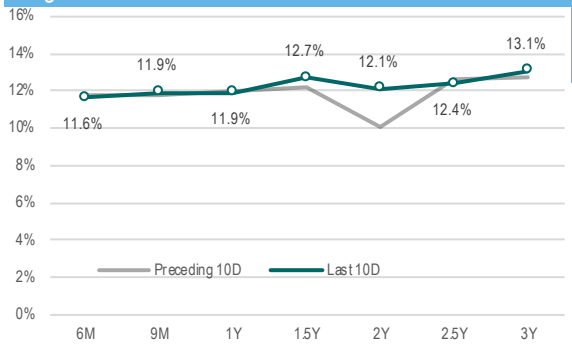
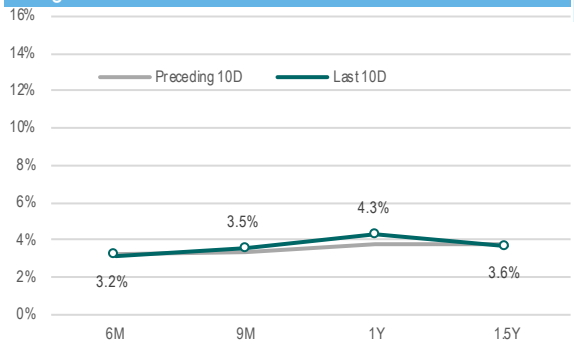


Figure 5. Local USD bonds market



Government bond market

CCY	Maturity	Cut-off rate	WA rate	Max bid rate	Min bid rate	Number of bids	Bids accepted	Bid size, mn	Place-ment size, mn
UAH	5M	10.70%	10.70%	10.70%	10.70%	2	2	1 166.51	1 166.51
UAH	6M	11.50%	11.49%	11.75%	11.45%	9	8	3 513.56	3 463.56
UAH	9M	11.70%	11.70%	11.75%	11.70%	20	19	2 599.20	2 579.20
UAH	1.5Y	11.80%	11.79%	12.00%	11.75%	6	5	513.02	454.02
UAH	2Y	12.65%	12.64%	12.65%	12.55%	20	20	525.03	525.03
UAH	2.5Y	12.85%	12.85%	12.85%	12.85%	5	5	14.76	14.76
UAH	4Y	0.00%	0.00%	13.25%	13.00%	8	0	16.78	0.00
EUR	3M	1.75%	1.75%	1.75%	1.75%	7	7	36.30	36.30
USD	5M	3.50%	3.50%	3.50%	3.50%	6	6	265.87	265.87

FinMin attracted over UAH16.7bn at the last primary debt auction, with FX-denominated securities accounting for roughly half of the amount.

Market demand was majorly concentrated in money market securities – with 5, 6, and 9 months to maturity. A 5-75bp concession in yield allowed the ministry to get demand for UAH7.3bn in total. Nearly all bids were accepted.

Demand for the rest of UAH-denominated securities fell short of UAH1bn.

Low acceptance in long maturities could result from rising expectations in the market of another rate hike by the NBU at the upcoming this Thursday MPC meeting.

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

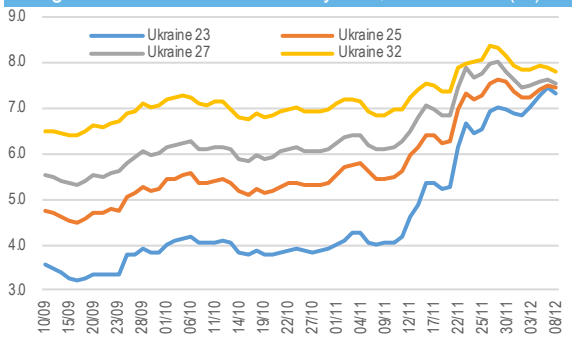
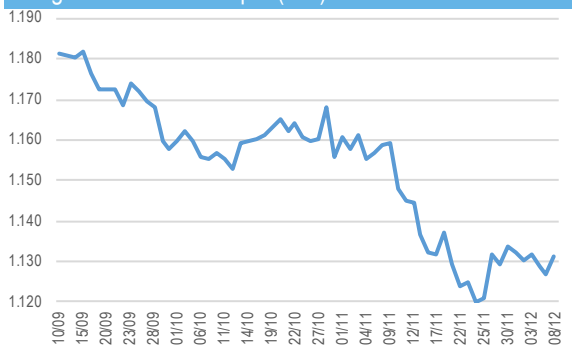


Figure 7. EUR USD spot (mid)



EUR/USD remains under pressure on hawkish Fed and dovish ECB

A tweak in Federal Reserve Chairman Jerome Powell's tone about inflation inducing a rise in bets for a sooner rather than later policy rate lift-off, and contrasting European Central Bank's reluctance to tighten its monetary policy in the face of spiking inflation keep pushing the EUR/USD down. The pair was last seen trading in the vicinity of the 1.13 level, down from the 1.16 level about a month ago.

Rising consumer prices have been a matter of growing concern for financial markets lately. And Powell's statement before U.S. lawmakers that "it's probably a good time to retire that word (transitory)" has resulted in growing market acceptance that the Fed would hike interest rates sooner rather than later to contain stubbornly high inflation.

High inflation is of no exception in the euro area. Despite the European Central Bank President Christine Lagarde's latest statement of "conditions to raise rates are very unlikely to be satisfied next year", there are growing concerns that inflation will last longer than the ECB anticipates.

Apart from this, the buck derived support from a further recovery in the U.S. Treasury bond yields and easing concerns about the economic fallout from the new Omicron variant. The yield on the benchmark 10-year Treasury note rose again above the 1.45% level by Wednesday (December 8).

Figure 8. GDP vs Key activity indicators, % y/y

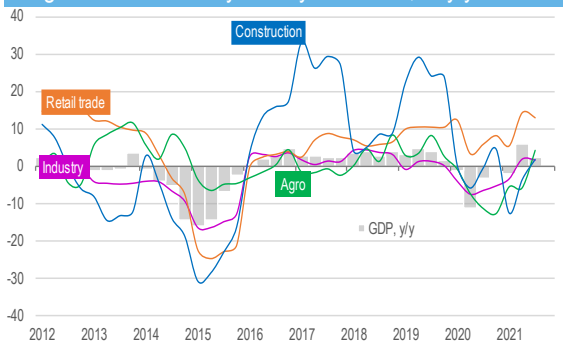


Figure 9. Consumer sentiment index

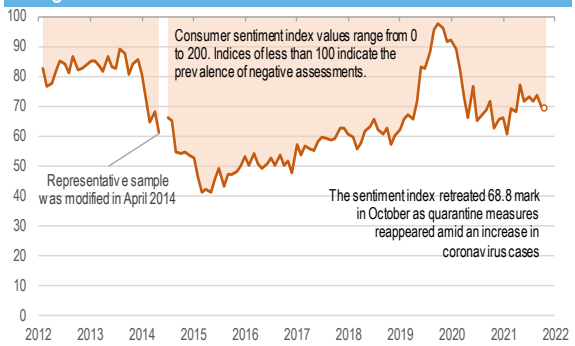


Figure 10. Covid cases in Ukraine

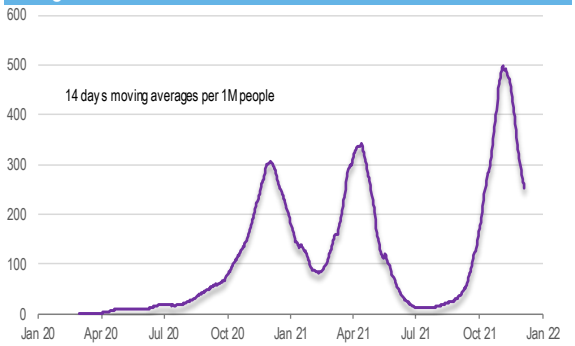
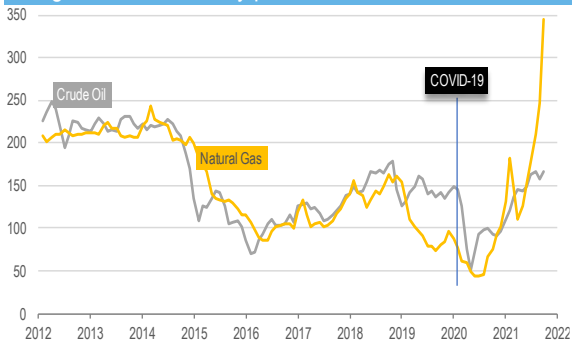


Figure 11. Commodity price indices, 2016 = 100



Gas price crisis threatens to derail recovery in 2022

Ukraine's economy remains on a recovery track, with agriculture and construction industries joining retail trade and industrial production in the uptrend. Although the third-quarter annualized GDP rose by just 2.4%, we expect twice as high growth in 4Q driven by a pick-up in retail sales, an increase in government expenditures, and a further improvement in trade balance on the back of strong crops. We are more concerned with the economic picture in 2022, as high natural gas prices and the emergence of the new Covid variant threaten to derail the recovery.

Ukraine's annualized GDP rose by just 2.4% in 3Q21, according to the preliminary flash estimate announced by the Ukrstat. The statistical office will release details on the third-quarter GDP on December 20.

According to monthly statistics, annual growth in retail sales, accounting for the major part of the private consumption, slowed to 11.5% in October from the year high of 14.3% seen in May. While deceleration in June-September could be attributed to a shift in spending from goods towards services, another weakening in October seems to be driven by new factors. We see the resurgence in COVID cases and the rising inflation pressure as the major ones. Despite continuing vaccination, which allows avoiding tough national-wide lockdowns, consumers seem to have turned skittish on news about alarming infection figures. And retreat in consumer sentiment index below the barrier of 70 by October supports the case.

The ongoing natural gas price shock could also make consumers pull back on their daily expenses as high energy bills could squeeze household budgets.

We hold our year-end GDP growth forecast at 3.1%, with risks to the downside. Apart from risking utility costs, which will likely have a statistical effect of a growing consumption in 4Q21, we expect an increase in government spending and a further improvement in trade balance driven by strong crops.

While Ukraine's state budget revenues over the ten months are above budgetary forecast, expenditures fall behind the projections by some UAH100bn. It is usual for FinMin, however, to accelerate spending at the end of the year to meet projections, hence giving a boost to consumption and likely to construction industry via the state-run program "Large construction".

Regarding the performance of the agricultural industry, we expect Ukraine to harvest in excess of 84mn tonnes of grains during the 2021-22 marketing year (July-June), up 28% from the prior year. This should entail an increase in both processing and exports.

But high natural gas prices and the emergence of the new Covid variant cast shadow on the sustainability of economic growth in 2022.

Rampant energy inflation, with natural gas being almost five times as expensive as it was a year earlier, weighs heavily on the expectations and investment sentiment of companies across all sectors, even of those with no direct exposure. Apart from energy-intensive businesses, this could affect the agricultural industry via expected rise in costs of fertilizers, as well as small and medium-sized enterprises in the services segment.

Although we keep our forecast for annual GDP growth in 2022 at 3.8%, we point out material downside risks, with future developments largely depending on evolution of the natural gas price after the end of the heating season (typically in mid-April).

Key Macroeconomic Indicators								
	2015	2016	2017	2018	2019	2020	2021E	2022F
Real sector								
Real GDP (%YoY)	-9.8	2.4	2.5	3.4	3.2	-4.0	3.0	3.8
Industrial production (%YoY)	-12.3	4.0	1.1	3.0	-0.5	-4.5	1.5	1.0
Retail sales (%YoY)	-19.8	4.3	6.5	6.2	10.3	8.4	9.2	10.0
Unemployment rate end of year (ILO, working age)	9.1	9.3	9.5	8.8	8.2	10.1*	9.3	8.5
Nominal GDP (UAH bn)	1 989	2 385	2 984	3 561	3 975	4 194	4 830	5 513
Nominal GDP (USD bn)	90	93	112	131	155	156	177	193
Prices								
CPI (average %YoY)	48.5	14.9	14.4	11.0	7.9	2.7	9.6	9.8
CPI (end of year %YoY)	43.3	12.4	13.7	9.8	4.1	5.0	11.5	8.9
Real average wage growth (%YoY)	-20.2	9.0	19.1	12.5	9.8	7.4	8.0	3.0
Fiscal balance (% of GDP)								
State budget deficit (without Naftogaz)	2.3	2.9	1.6	2.4	1.8	5.2	5.0	3.5
Total public debt (% of GDP)	79.4	81.0	71.8	61.0	51.6	60.9	64.6	61.5
External balance								
Exports of goods and services (USD bn)	47.9	46.0	53.9	59.2	63.6	60.6	62.6	65.0
Imports of goods and services (USD bn)	50.2	52.5	62.7	70.6	76.1	62.3	72.5	78.0
Current account balance (USD bn)	5.0	-1.9	-3.5	-6.4	-4.1	6.6	-0.6	-3.2
Current account balance (% of GDP)	5.6	-2.0	-3.1	-4.9	-2.7	4.2	-0.3	-1.7
Net FDI (USD bn)	-0.5	3.8	3.7	4.5	5.9	-0.4	5.5	3.0
Foreign exchange reserves (end of year)	13.3	15.5	18.8	20.8	25.3	29.1	31.0	32.5
Imports coverage (months of imports of goods)	3.4	3.7	3.6	3.5	3.9	4.8	5.1	5.0
Interest and exchange rates								
NBU discount rate (% end of year)	22.0	14.0	14.5	18.0	13.5	6.0	8.5	8.0
Exchange rate (USD/UAH) end of year	24.0	27.2	28.1	27.7	23.7	28.3	27.0	29.8
Exchange rate (EUR/UAH) end of year	26.2	28.4	33.5	31.7	26.4	34.7	32.3	36.1

**estimates, no official data yet available*

FOUR WEEKS AHEAD

Mon	Tue	Wed	Thu	Fri	Sat	Sun
06.12.2021	07.12.2021	08.12.2021	09.12.2021	10.12.2021	11.12.2021	12.12.2021
Ukrstat: Busines confidence	NBU: FX Reserves (deadline - 7th day)	LGB* % UAH 327.1mn	LGB % EUR 0.9mn NBU: MPC Ukrstat: Price indices NBU: Monetary Statistics			
13.12.2021	14.12.2021	15.12.2021	16.12.2021	17.12.2021	18.12.2021	19.12.2021
		LGB* % UAH 1 214.1mn LGB % UAH 883.2mn Fed: FOMC	LGB % USD 11.5mn LGB P USD 572.6mn ECB: MPC	NBU: External Debt		
20.12.2021	21.12.2021	22.12.2021	23.12.2021	24.12.2021	25.12.2021	26.12.2021
NBU: Minutes Ukrstat: GDP Ukrstat: Retail trade		LGB* % UAH 655.1mn Ukrstat: Industrial Production				
27.12.2021	28.12.2021	29.12.2021	30.12.2021	31.12.2021	01.01.2022	02.01.2022
	Ukrstat: Nominal & Real Wage	LGB* % UAH 553.0mn		NBU: BoP		

MOST COMMON TERMS AND ABBREVIATIONS

GDP	Gross domestic product
CPI	Consumer price index
FDI	Foreign direct investment
BoP	Balance of Payments
CA	Current account
FA	Financial account
IIP	International investment position
VAT	Value-added tax
CD	Certificate of deposit
FX	Foreign exchange, foreign currency
UAH	Ukrainian hryvnia
USD	U.S. dollar
EUR	Euro
SDR	Special drawing rights
UONIA	Ukrainian OverNight Index Average
WA	Weighted average
DGF	Deposit Guarantee Fund
Ukrstat	State Statistics Service of Ukraine
NBU	National Bank of Ukraine
ECB	European Central Bank
Fed	Federal Reserve System
FOMC	The Federal Open Market Committee
MPC	Monetary policy committee meeting
Minutes	Summary of MPC meeting
IMF	International Monetary Fund
IFI	International financial institutions
LGB	Local government bonds
FGB	Foreign government bonds (Eurobonds)
P	Principal due
%	Interests due
*	government bonds held by NBU or issued for recapitalization of state-owned banks

bp	basis point
pp	percentage point
y/y	in annual terms; year-on-year change
m/m	in monthly terms; month-on-month change
TTM	trailing twelve months
RHS	right-hand scale

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