UKRAINIAN CAPITAL MARKETS WEEKLY

	Rating	Outlook	Last update
Fitch	B	POSITIVE	06.03.2020
S&P	B	STABLE	13.03.2020
S&P (N)	uaA	-	13.03.2020
Moody's	Caa1	POSITIVE	22.11.2019

This week in focus: IMF deal is crucial to withstand COVID impact

We downgraded our macro forecasts, given further development of the COVID outbreak, now expecting 3.5% GDP decline in 2020. The country's limited dependence on global consumer demand will help to withstand external trade disruptions. Our expectations, however, hold true assuming the outbreak to subside in 6 weeks and Ukraine succeeds in securing cooperation with the IMF.

Figure 1. UAH exchange rate (UAH per USD)

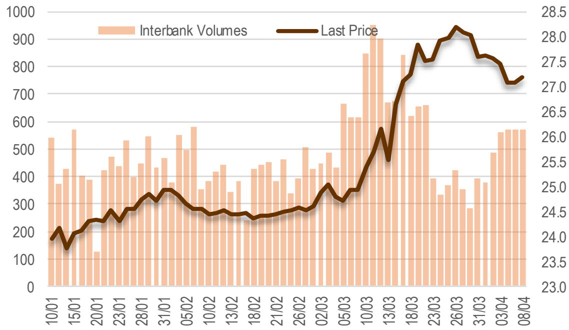


Figure 2. Banking liquidity (UAH bn)

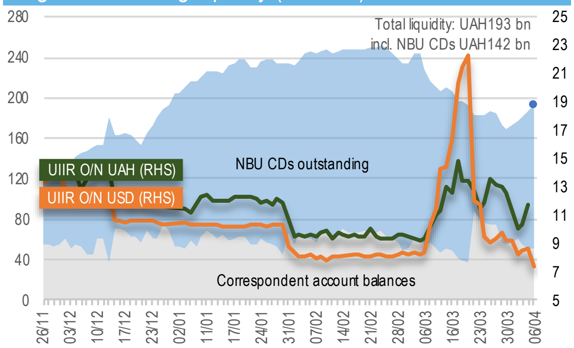
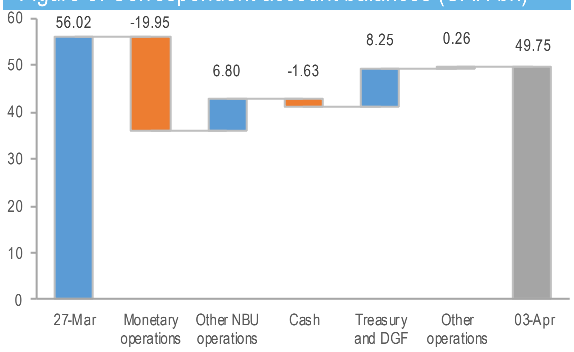


Figure 3. Correspondent account balances (UAH bn)



FX and interest rates: Hryvnia edges up after prolonged decline

The Ukrainian hryvnia seems gained ground after a prolonged devaluation against the U.S. dollar, commenced in late February. The pair ended trading session on Tuesday slightly above 27 mark. The market participants, however, notice that this level could have easily been breached, but for the central bank, intervening into the market with FX purchases.

The present in the market strong FX supply is related to the upcoming tax season, pushing exporters to increase FX revenue sales. According to market participants, the state company Naftogas has also contributed to supply increase, with the aim of subsequent transferring of funds into the requiring support state budget. In turn, demand for FX has subsided notably amid extensive containment measures in the country.

The local currency has gained 3.7% against the greenback since late March, when the upward trend has set up, and is likely to follow the tendency by the end of the week. Meantime the National bank of Ukraine (NBU) has rebuild its reserves via FX purchases by USD576mn. For information, the preceding net FX sales, which were aimed at tempering panic buying, amounted to circa USD2.2bn.

Looking ahead in the current month, **the risk of seeing another sharp hryvnia drawdown has not been mitigated, yet.** Further developments will largely depend on cooperation with the IMF, critically required for the state budged support, and final adoption of the law on nationalized banks in particular.

Last week total local currency liquidity in the banking system increased by 7.8% - to UAH187.1bn. Major factors that determined liquidity position were supportive FX interventions by the NBU and State treasury operations, likely related to VAT refunds.

Demand for cash money amounted to UAH1.6b, increasing from UAH0.14bn a week before. In total, since introduction of containment measures, continuing cash money outflow amounted to UAH22bn.

Monetary operations for circa UAH20bn represent reallocation of funds into NBU's certificates of deposit from correspondent accounts. As a result, banks' position in CDs increased to UAH137bn, while balance of correspondent accounts declined to UAH50bn.

Figure 4. Local UAH bonds market

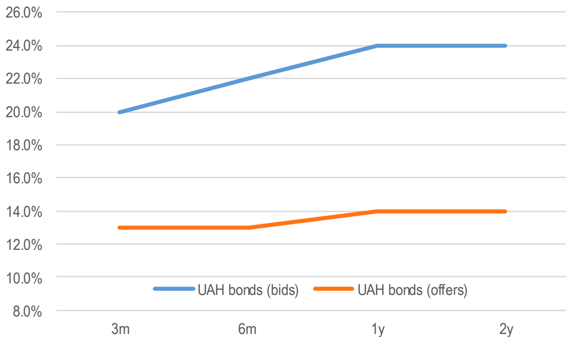
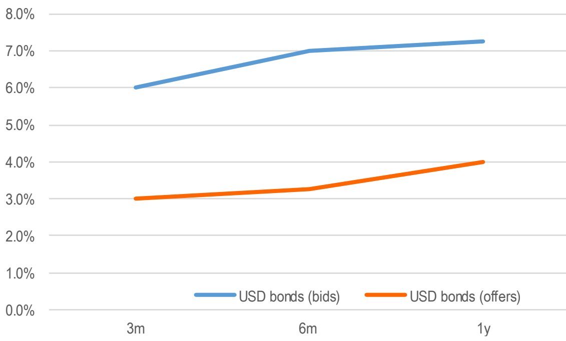


Figure 5. Local USD bonds market



Government bond market

Another primary debt auction of the Ministry of Finance, scheduled for Tuesday (Apr 7), was again canceled. Not surprisingly, taking into account actual yields for local debt on the secondary market and looming perspectives for covering state budget funding requirements by financing from the IMF and other official creditors.

Ukraine has agreed with the Fund to increase aid package to USD8bn, according to president Zelensky's statement. Besides, some USD2bn might come from other creditors. Total FinMin's external debt obligations, coming due this year, amount to about USD5.5bn. Some additional financing will also be needed to bridge its financing gap, related to expected income shortfalls and increased expenses.

Arrangement with the IMF is not a done deal yet. It is contingent on the approval of the bill preventing former owners of banks declared insolvent from regaining their assets or receiving compensation from the state budget. The bill needs to be voted on again after passing first reading last week. Meantime some lawmakers have proposed thousands of amendments to this legislation, threatening to derail IMF's aid package.

Secondary debt market shows moderate activity. Both sell and buy sides are reluctant to perform active deals.

Ukraine's Eurobonds saw yields stabilized around 9% per year. Adopted by leading governments and central banks extensive measures to alleviate the economic impact of the coronavirus (to be touched upon below) are seen as a major factor behind a tailed off volatility in the global financial markets.

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

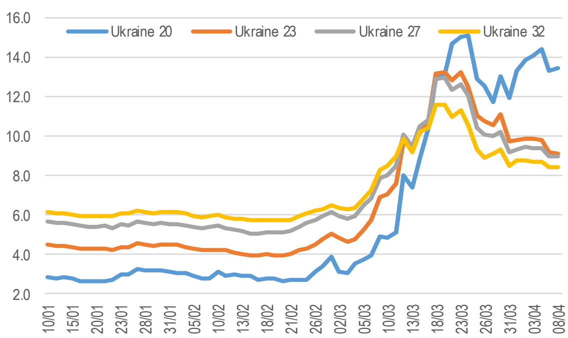
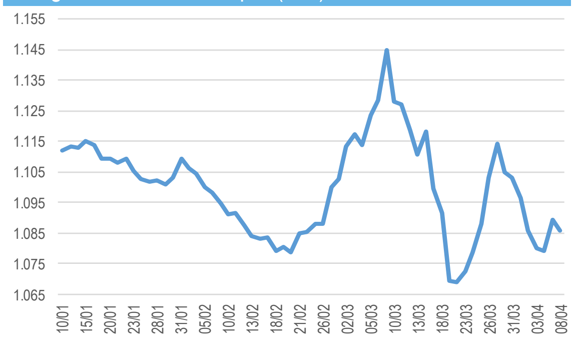


Figure 7. EUR USD spot (mid)



Support measures related to Covid-19 curb roller-coaster ride in EUR/USD

The EUR/USD rate appears to have regained stability after coronavirus market turmoil in March, when the pair saw its biggest jump in 12 years.

Introduced by global central banks extensive crisis-fighting campaigns aimed at keeping markets functioning and economies growing seems to have their impact. Among the tools deployed: interest-rate cuts, asset purchases, currency interventions and liquidity injections.

To recap, the Fed, just over a week since cutting interest rates in an emergency move, offered markets trillions of dollars in liquidity to counter signs of dysfunction. It said it would provide temporary loans to banks in coming weeks to relieve strains as investors sold government bonds to raise cash.

The ECB didn't cut its deposit rate further below zero, but it promised to buy more bonds, and enhanced a loan program with terms that effectively amount to an interest-rate cut for banks that use it to pump money into the economy.

No less impressive measures were introduced by the Bank of Japan, the Bank of England, and other leading regulators.

Markets reacted to these measures just as aggressively as to coronavirus-related news. Trading volatility spiked to levels not seen since the 2008 financial crisis.

The U.S. government-bond market wasn't immune. The yield on the benchmark 10-year Treasury note, which moves inversely to price, rebound from 0.498% to 0.997%. Currently the yield has settled near 0.75% per year.

Figure 8. Evolution of GDP

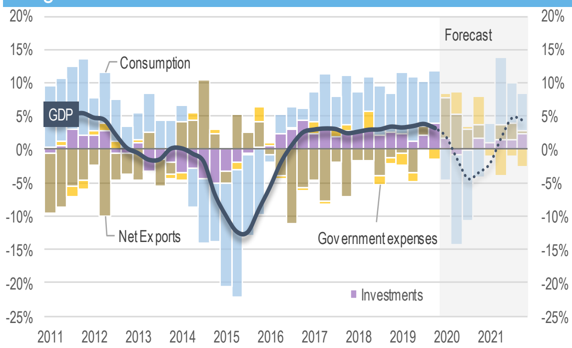
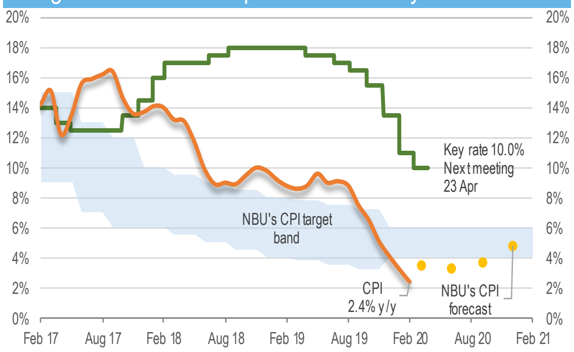


Figure 9. USD/UAH spot rate

Figure 10. Consumer price index vs Key rate



IMF deal is crucial to withstand COVID impact

We updated downside our macro forecasts on Ukraine given further development of the COVID outbreak, now expecting 3.5% GDP decline in 2020. Luckily, the country's limited dependence on global consumer demand will help to withstand the ongoing and incoming external trade disruptions. Our expectations, however, hold true assuming the viral outbreak to subside in six weeks and Ukrainian authorities succeed securing cooperation with the IMF.

No structural imbalances. Unlike structural issues (e.g. inappropriate monetary policy or financial imbalances), which usually produce a lasting effect , a direct epidemic-related impact is rather shocking by its nature. Demand and supply shocks are seen as the major risk factors related to COVID outbreak.

Demand shock is likely to have a material impact on consumption. We expect consumer spending to see a double-digit drop in 2020 and a relative rebound in 2021 on the back of a base effect. Returning work migrants and expected increase in state budget deficit, some part of which will be reflected in consumption prints, will help to cushion expected impact. Besides, demand shock is likely to have a statistically limited influence on GDP, given that consumer (non-food) goods are primarily imported and services are poorly recorded in official statistics.

The supply shock has only partially materialized in Ukraine so far. Given a county's primary focus on raw materials production with short supply chains, we expect no dramatic decline in total output and exports, with sustainable external demand for soft commodities helping to curb export sales slippage.

The banking sector holds resilience, but risks still cannot be dismissed entirely. Unless COVID-19 hits again in the next six weeks, we see limited risk of a potential shakeout in the financial sector. Low leverage of Ukraine's households and improved prudential supervision following banking sector reform will help to prevent stress scenarios. Nevertheless, the longer the virus develop the more businesses face cash flow strains, starting with small and medium enterprises. In this case, dynamic of corporate NPLs is to be watched.

Deal with the IMF is an absolute precondition. Since the viral outbreak risks have been priced so high in the financial markets, it is critically important for Ukrainian authorities to secure further cooperation with the International Monetary Fund (IMF) to cope with increasing expenses. The main destination of IMF money will be the state budget, to cover expected in 2020 income shortfalls. The agreement will also open the door for funding from other IFIs. The main condition for such cooperation is the law on nationalized banks. The bill has already passed the first reading, but its final approval is still under question, given that some deputies proposed circa 13 thousand amendments to the low. Developments in this front are to be closely watched in the coming weeks.

Provided IMF deal FX to remain in 27-28 area before weakening to 29.5 in the end of the year. An expected contraction in imports due to COVID-induced disruptions in global relations and decline in costs for energy commodities will help to reduce demand for FX liquidity through the year.

Inflation is likely to re-accelerate from current levels (2.4% y/y) following FX rate adjustment. We expect, however, that the growth of index will remain broadly in line with NBU target range (5% +/- 1 pp). Falling oil prices to contribute to price stability over the forecasted horizon.

All told, the NBU to continue gradual softening of monetary policy, although the anticipated easing will take more time than originally expected (to make sure that inflation remains under control).

Key Macroeconomic Indicators								
	2014	2015	2016	2017	2018	2019	2020E	2020F
Real sector								
Real GDP (%YoY)	-6.6	-9.8	2.4	2.5	3.4	3.2	-3.5	4.4
Industrial production (%YoY)	-15.0	-5.1	6.6	-0.5	1.1	-6.7	-2.0	1.0
Retail sales (%YoY)	-11.0	-25.0	4.0	8.8	6.2	10.5	-10.7	9.6
Unemployment rate end of year (ILO, working age)	9.3	9.1	9.3	9.5	8.8	8.2	9.0	8.5
Nominal GDP (UAH bn)	1 587	1 989	2 385	2 983	3 559	3 975	4 091	4 571
Nominal GDP (USD bn)	131	90	93	112	131	154	144	152
Prices								
CPI (average %YoY)	12.1	48.7	16.5	14.4	10.5	7.9	5.5	5.0
CPI (end of year %YoY)	24.9	43.3	12.4	13.7	9.8	4.1	5.5	5.0
Real average wage growth (%YoY)	-6.5	-35.0	10.0	18.9	9.7	9.8	6.0	5.5
Fiscal balance (% of GDP)								
State budget deficit (without Naftogaz)	4.9	2.3	2.9	1.6	2.4	1.8	8.0	2.3
Total public debt (% of GDP)	69.4	79.4	81.0	71.8	61.0	51.6	62.0	63.0
External balance								
Exports of goods and services (USD bn)	65.4	47.9	46.0	54.0	59.0	63.4	54.0	61.0
Imports of goods and services (USD bn)	70.0	49.6	51.8	60.8	70.5	75.5	60.0	65.0
Current account balance (USD bn)	-4.6	1.6	-1.3	-2.4	-4.7	-1.1	-2.0	-3.0
Current account balance (% of GDP)	-3.4	1.8	-1.4	-2.1	-3.3	-0.7	-1.4	-2.0
Net FDI (USD bn)	0.3	3.0	3.4	2.3	2.5	2.5	2.0	3.0
Foreign exchange reserves (end of year)	7.5	13.3	15.5	18.8	20.8	25.3	23.5	25.5
Imports coverage (months of imports of goods)	1.5	4.4	3.7	3.6	3.4	3.9	4.4	4.0
Interest and exchange rates								
NBU discount rate (% end of year)	14.0	22.0	14.0	14.5	18.0	13.5	9.0	7.0
Exchange rate (UAH/USD) end of year	15.8	24.0	27.2	28.0	27.7	23.7	29.5	31.0
Exchange rate (UAH/EUR) end of year	23.0	26.2	28.3	33.5	31.8	26.4	33.0	34.7

Two Weeks Ahead

Date/Deadline	Event	Notes
09-Apr (Thu)	Ukrstat: Consumer & Production Price Indexes	March
	NBU: Monetary & Financial Statistics (Preliminary)	March
21-Apr (Tue)	Ukrstat: Retail trade turnover	March

Upcoming pay offs related to local government bonds

Date	Type of debt	Payment	Amount
08-Apr (Wed)	Local bonds	Coupon UAHmn	188.9
		Coupon UAHmn (capital notes)	305.7
		Principal UAHmn	1 558.1
15-Apr (Wed)	Local bonds	Coupon UAHmn	704.2
		Coupon UAHmn (capital notes)	524.1
16-Apr (Thu)	Local bonds	Coupon USDmn	5.5

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

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