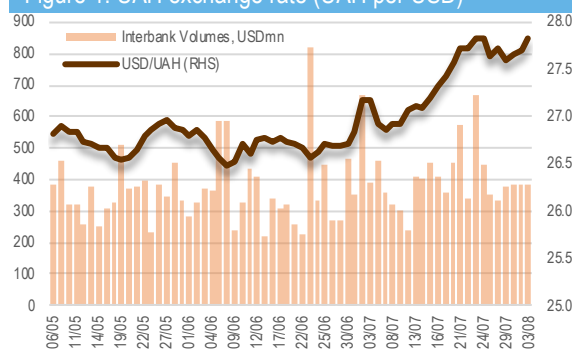


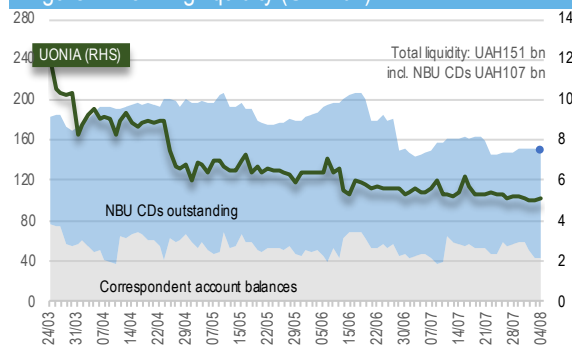
	Rating	Outlook	Last update	This week in focus: Abundant liquidity and cash to test UAH strength in Q4
Fitch	B	STABLE	22.04.2020	The banking sector liquidity stood the test of another financial crisis, having increased by 61.8% in y/y terms. Both household and corporate deposits perform well, but the structure of liquidity is very much skewed to short durations. A sharp growth of cash is the new reality and we see growing risks for local currency coming from eventual cash FX demand.
S&P	B	STABLE	13.03.2020	
S&P (N)	uaA	-	13.03.2020	
Moody's	B3	STABLE	12.06.2020	

Figure 1. UAH exchange rate (UAH per USD)

FX and interest rates: Hryvina remains trapped in falling channel

USD/UAH pair extends last week bearish bias and touched a six-month low at 27.86 amid continuous speculative pressure. Despite agri producers start to tentatively express their need in local currency funding as harvesting season intensifies, some irregular but notable demand for foreign currency keep curbing export revenue sales.

Bearish market participants, presumably, exploit the factor of upcoming sizable local public debt redemption. The FinMin is to redeem on Aug 5 UAH15.8bn worth of local currency bonds, which are included in GDR program by Citi.

Last week the NBU purchased in the market some USD38mn against USD348mn during a preceding week. In general, the central bank has notably narrowed its appearance in the market since beginning of the month. It seems that the NBU is undergoing some internal transformation amid recent changes in the board, and a new intervention policy is yet to be seen.

Figure 2. Banking liquidity (UAH bn)


Banking liquidity recovered by some UAH4bn to UAH152.6bn. Central bank's FX interventions and gradual returning of physical cash into banking system were the major contributors.

CB's monetary operations for UAH12.4bn primarily reflects reallocation of excess funds into NBU certificates of deposits. As a result, the banks' positions in NBU CDs increased to UAH102bn.

Published on Monday (Aug 3) **minutes of the last Monetary Policy Committee meeting suggest strong arguments against another policy rate cut through the end of 2020.** Though it was not our working assumption, addressed by the policymakers factors reduce downside risks to our forecast.

Figure 3. Correspondent account balances (UAH bn)


In addition to inflation acceleration, mentioned during the monetary briefing, the NBU has pointed out that inflation expectations are prone to deterioration. A further policy rate reduction might signal to the market, that the real rate would enter negative territory, and hence cause FX rate adjustment with subsequent dollarization of the economy. Moreover, a low policy rate might erode banks' profitability and limit efficiency of monetary transmission or even reverse the dynamics of interest rates

Should the identified risks materialize, the NBU will most likely be forced to switch to a tighter monetary policy to return consumer inflation to the target range, the central bank mentioned in the summary.

Figure 4. Local UAH bonds market

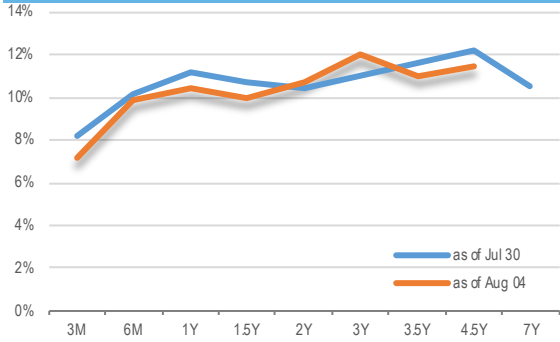
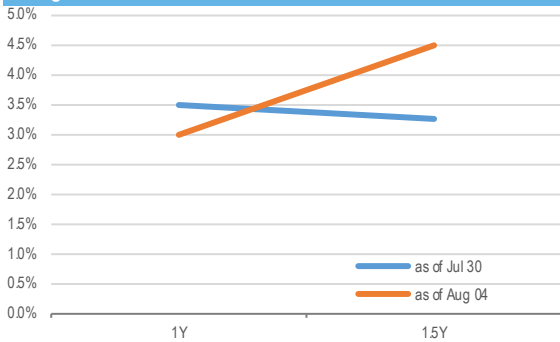


Figure 5. Local USD bonds market



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	6M	7.74%	7.74%	7.74%	7.74%	1	1	2 000.00	2 000.00
UAH	1Y	9.20%	9.20%	12.50%	9.00%	3	2	3 100.99	3 000.99
UAH	2Y	10.25%	10.25%	11.00%	10.25%	6	5	5 099.96	5 049.96

FinMin secured itself with UAH10bn of fresh liquidity before coming due on Wednesday UAH15.8bn debt redemption. This week, the ministry has auctioned solely local currency bonds with a term ranging from 6m to 2y.

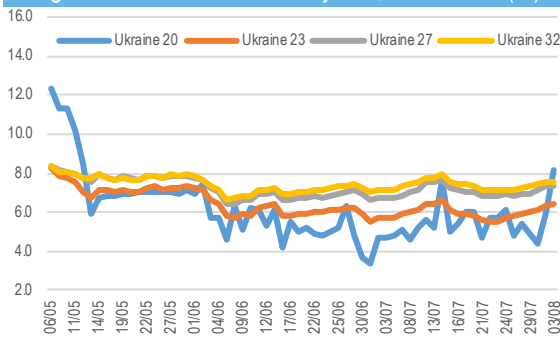
The cut-off rates for UAH7bn worth of 1y and 2y bonds remained unchanged at 9.2% and 10.25% respectively, for UAH3bn worth of 6m notes was lifted by 64 basis points to 7.74%.

At first glance, all the securities attracted a decent demand. **A billion worth bids, however, might be indicative of a participation limited to friendly banks only.**

Though the ministry has managed to attract again investors interest to its Eurobonds, a reported a few days later message by media about likely delays in IMF program implementation has dented this achievement.

The market, which price government bonds with relative tenors 1-3 percent points above FinMin's cut-off rates seemed to expect that the ministry, which requires financial support to make up the budget deficit, will agree to increase yields as soon as state-owned banks run out of excess liquidity.

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



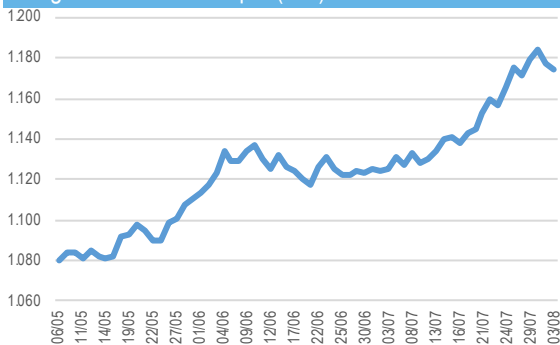
EUR/USD retrace to 1.176 within a corrective rebound

After hitting two-year high in the 1.185 neighbourhood, EUR/USD came under selling pressure as investors unwound some recent short positions following the currency's weakest monthly performance in a decade.

Corrective rebound was inevitable after the sharp fall last month, with dismal statistics on a 12.1% q/q Eurozone economy contraction in the second quarter of 2020 serving as a formal catalyst.

The region's largest economies contracted by two-digits during the period due to strict lockdown measures brought about by the coronavirus pandemic. Besides, there's still a lot of uncertainty going forward, with some countries reporting an increase in Covid-19 infections in recent weeks.

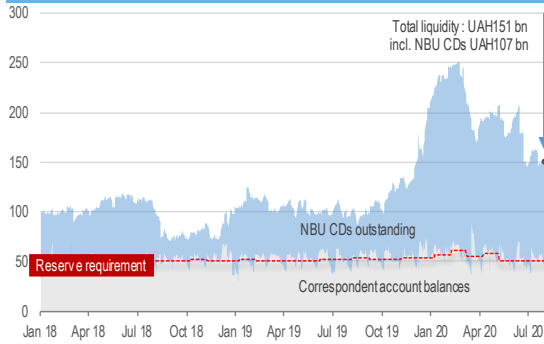
Figure 7. EUR USD spot (mid)



The US economy is no better off and investors braced for a bumpy ride to economic repair. Apart from developments from the unremitting pandemic and the performance of fundamentals in the region, investors keep also closely watching headlines from the U.S. political scenario, where congress struggles to find a middle ground on a new fiscal spending package.

As the latest coronavirus relief package got bogged down in Congress, Treasury yields continue falling, with the yield on the benchmark 10-year Treasury note dipped 2 basis points to 0.539%. Yields move inversely to prices.

Figure 8. Banking liquidity evolution, UAHbn

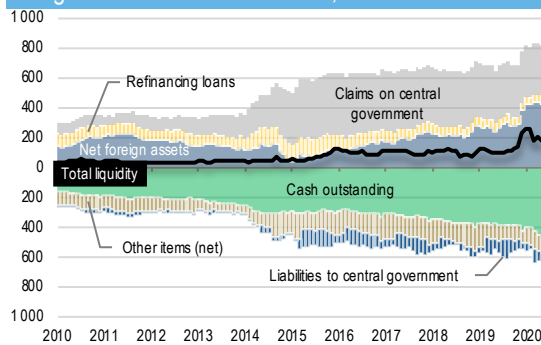


Abundant liquidity and soaring cash levels to test UAH strength in Q4

The banking sector liquidity stood the test of another financial crisis, having increased by 61.8% in y/y terms. Both household and corporate deposits perform well, but the structure of liquidity is very much skewed to short durations. A sharp growth of cash is the new reality and we see growing risks for local currency coming from eventual cash FX demand.

According to our expectations, total hryvnia liquidity in 1H2020 has seen a 20% contraction to UAH160bn (correspondent accounts plus position in central bank certificates of deposits, CDs). Increased demand for cash money, extensive government expenses, and some outflow of funds from public debt shortening central bank's net foreign position, were the major factors behind the change.

Figure 9. NBU's balance sheet, UAHbn



Widely introduced containment measures apart from contracted consumption have led to massive hoarding of physical cash. By the end of July, the total cash outstanding reached a record high at UAH498bn, or 12.5% of last year's nominal GDP.

Strikingly, the most of withdrawn notes - circa UAH50bn - were denominated in large bills, according to the NBU. **The outflow might be partly associated with tightening of a cash transaction control**, as new rules have been introduced in late April. This part of the money in hands, being the most vulnerable to political situation, carry some FX and inflationary risks.

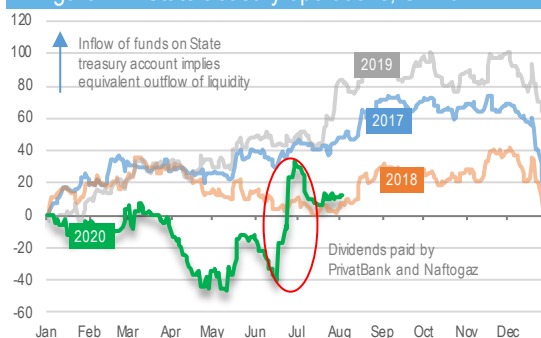
Figure 10. Cash outstanding, UAHbn



The further spending of accumulated local currency notes and their subsequent returning into the banking system will remain constrained by still in place selective lockdown measures, lost returns by many households, and high uncertainty regarding further evolution of the pandemic (at the moment of writing this, we note record levels of new COVID cases in Kyiv and in Ukraine in general).

Acceleration of cash withdrawals was accompanied by increased government spending. While the balance of government accounts with the NBU remain more or less stable, the flow of state budget spending was exceptionally strong vs previous years while revenue has suffered materially from the economic shock caused by the virus outbreak. Revised tax revenues and introduced stimulus package resulted in the increased state budget deficit to UAH298bn or 7.5% of GDP in 2020.

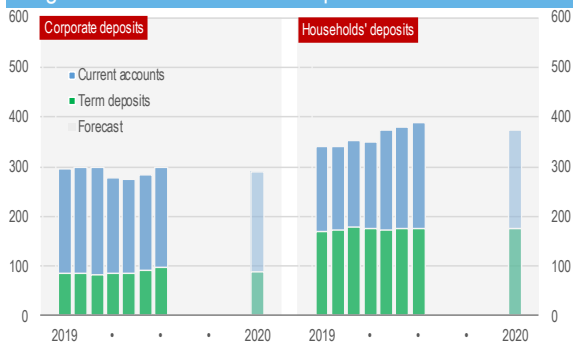
Figure 11. State treasury operations, UAHbn



In June, the overall state budget deficit narrowed to UAH19bn from UAH49, mainly due to profit remittances by the state-owned PrivatBank and Naftogaz. **Huge dividend payouts by state owned entities were the second main driver behind liquidity contraction in 1H 2020.**

Going forward, we expect State treasury operations to remain a negative contributor up until November and reverse sharply around end of the year. Ongoing big road construction being implemented by Ukrainian authorities is likely to amplify this expected evolution.

Figure 12. Balance of UAH deposit

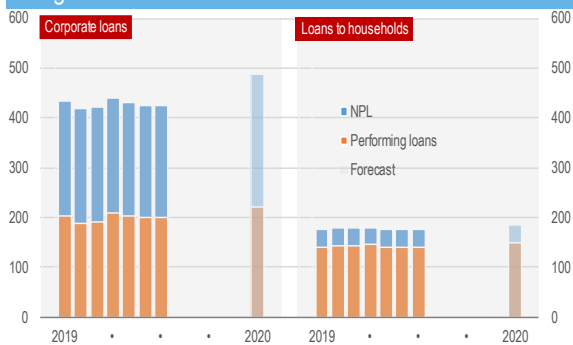


Household deposits have increased by 24% y/y in 1H2020. We view involuntary savings of white-collars, coupled with a mild impact of COVID on Ukraine's economy as the key reason for this evolution.

Corporates have also increased local currency savings both on current and term deposit accounts. We expect, however, that impact of fiscal stimulus for businesses will be offset by revenue shortfalls, resulting in a nearly flat growth rate in local currency deposits in 2020 (we forecast a negative growth at 2.7%).

Lending in 2020 looks bleak. Demand for fresh retail loans remains constrained by limited availability of services and weak consumer confidence against the growing number of coronavirus cases. Assuming the general level of interest rates remain low, **retail lending hold potential for quick recovery as soon as consumer confidence improves.**

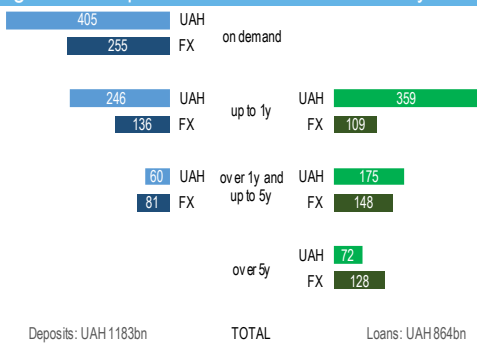
Figure 13. Balance of UAH loans



Corporate lending remains muted against the struggling economy loaded with risks. Prolong pandemic causing trade chain disruptions forced businesses to cut hastily their capital expenditures. But for agri, pharma companies, and several other businesses, which have been less hit by the coronavirus pandemic, emergency liquidity needs in the context of declining revenues are likely to generate the major demand for loans in 2020.

Announced by the new NBU head initiative towards boosting lending activity still lack details.

Figure 14 Deposits and loans breakdown by maturity



On the one hand, such tendency corresponds with the one in European countries, many of which have introduced unprecedented programs of loan guarantees and other forms of credit support for their businesses in response to the COVID-19 shock.

On the other hand, unlike European banks, **Ukrainian credit institutions remain short of long hryvnia liquidity**, as most of deposits are actually current accounts. This short-term nature of funding, however, provides a few opportunities for transformation into loans. For this reason, initiated by the NBU percent swaps are also of little use in shifting maturity mismatch risks.

We expect government and government-backed loan programs to produce the major demand for funding in 2020, with central bank's long-term refinancing (5y refinancing loans introduced by the NBU in May) being the major source of long hryvnia.

Moreover, **despite the banking system keep running surplus FX liquidity, FX swaps do not attract banks' interest too for their short tenure and high prices.**

We do not rule out, however, some recovery in government-guaranteed bank lending, as well as changes to lending rules and bank supervision on account of the support measures introduced by governments.

UKRAINIAN CAPITAL MARKETS WEEKLY

Key Macroeconomic Indicators

	2014	2015	2016	2017	2018	2019	2020E	2021F
Real sector								
Real GDP (%YoY)	-6.6	-9.8	2.4	2.5	3.4	3.2	-4.5	3.8
Industrial production (%YoY)	-15.0	-5.1	6.6	-0.5	1.1	-6.7	-1.8	0.0
Retail sales (%YoY)	-11.0	-25.0	4.0	8.8	6.2	10.5	-10.9	9.2
Unemployment rate end of year (ILO, working age)	9.3	9.1	9.3	9.5	8.8	8.2	10.1	9.3
Nominal GDP (UAH bn)	1 587	1 989	2 385	2 983	3 559	3 975	4 117	4 633
Nominal GDP (USD bn)	131	90	93	112	131	150	144	154
Prices								
CPI (average %YoY)	12.1	48.7	16.5	14.4	10.5	7.9	4.9	5.4
CPI (end of year %YoY)	24.9	43.3	12.4	13.7	9.8	4.1	5.9	5.0
Real average wage growth (%YoY)	-6.5	-35.0	10.0	18.9	9.7	9.8	-5.5	3.5
Fiscal balance (% of GDP)								
State budget deficit (without Naftogaz)	4.9	2.3	2.9	1.6	2.4	1.8	7.5	3.0
Total public debt (% of GDP)	69.4	79.4	81.0	71.8	61.0	51.6	64.4	64.6
External balance								
Exports of goods and services (USD bn)	65.4	47.9	46.0	54.0	59.0	63.4	50.5	55.6
Imports of goods and services (USD bn)	70.0	49.6	51.8	60.8	70.5	75.5	59.5	66.6
Current account balance (USD bn)	-4.6	5.0	-1.9	-3.5	-6.5	-4.2	1.0	-0.6
Current account balance (% of GDP)	-3.5	5.6	-2.0	-3.2	-4.9	-2.8	0.7	-0.4
Net FDI (USD bn)	0.3	-0.4	3.8	3.7	4.5	5.2	3.0	2.0
Foreign exchange reserves (end of year)	7.5	13.3	15.5	18.8	20.8	25.3	23.5	26.5
Imports coverage (months of imports of goods)	1.5	4.4	3.7	3.6	3.4	3.9	4.7	4.8
Interest and exchange rates								
NBU discount rate (% end of year)	14.0	22.0	14.0	14.5	18.0	13.5	6.0	5.0
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

Mon	Tue	Wed	Thu	Fri	Sat	Sun
03.08.2020	04.08.2020	05.08.2020	06.08.2020	07.08.2020	08.08.2020	09.08.2020
NBU: Minutes				NBU: FX Reserves (deadline - 7th day)		
10.08.2020	11.08.2020	12.08.2020	13.08.2020	14.08.2020	15.08.2020	16.08.2020
Ukrstat: Price Indexes	NBU: Monetary Statistics (Preliminary)					



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