

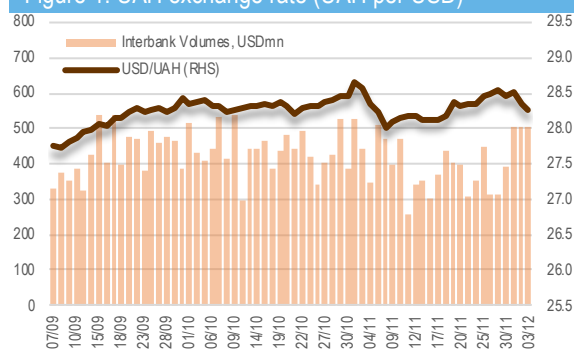
ECONOMICS | INTEREST RATES STRATEGY | FX

3 December 2020

UKRAINIAN CAPITAL MARKETS WEEKLY

| | Rating | Outlook | Last update | This week in focus: Expect higher liquidity but modestly weaker UAH |
|---------|--------|---------|-------------|---|
| Fitch | B | STABLE | 04.09.2020 | State budget saw a notable improvement in taxes and income receipts in November. But the government continues experiencing difficulties with funding planned deficits, as slow progress in dealing with IMF weigh on FinMin's performance at debt markets. Built up state arrears leave may push the ministry to borrow heavily in December, again brining about a liquidity upsurge. |
| S&P | B | STABLE | 11.09.2020 | |
| S&P (N) | uaA | - | 11.09.2020 | |
| Moody's | B3 | STABLE | 12.06.2020 | |

Figure 1. UAH exchange rate (UAH per USD)



FX and interest rates: USD/UAH snaps uptrend on momentary demand for UAH

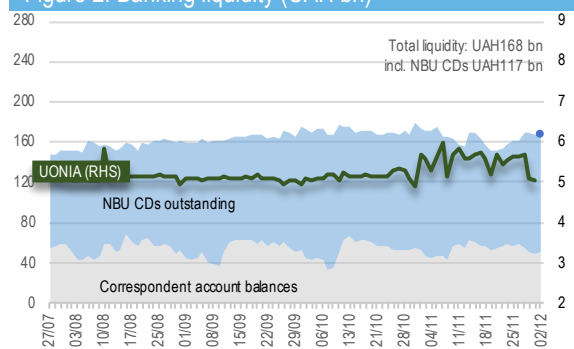
USD/UAH pair eases from the recently marked three-week high of 28.54 to 28.51 amid a temporary upsurge in foreign currency sales.

An increase in demand for the local currency followed recent month-end outlays. Although this factor is typically muted by other fundamental drivers, a low activity among buyers allowed speculative traders to dip the pair as low as below 28.3 level.

Even the central bank did not show up in the market with interventions, likely because of realizing how thin the FX flow is.

Moreover, the situation had no effect on exchange rates in the cash market. Since November population has become a net buyer of foreign currency.

Figure 2. Banking liquidity (UAH bn)

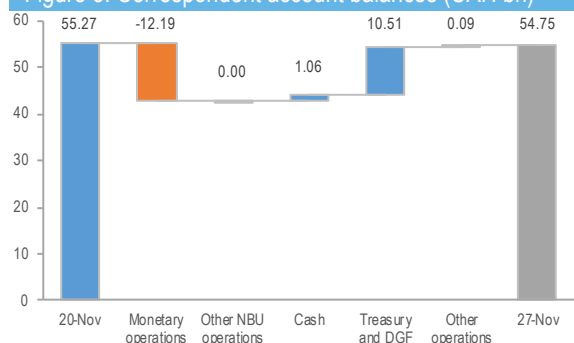


With the government struggling to raise financing for meeting state budget expenses and inflation likely reaccelerating since November (the reading to be announced next week), **hryvnia will remain under pressure through the end of the year.**

Banking liquidity balance again around UAH170bn mark. This was preceded by a drop to UAH150bn area and interbank overnight loan rate rise above 5.6% mark. An outflow of liquidity at the end of the second decade of November has mostly to do with quarterly tax payments, represented as State treasury operations.

During the last week, however, the treasury brought back to the banking system some UAH10.5bn through VAT refunding.

Figure 3. Correspondent account balances (UAH bn)



The NBU third week in a row does not carry out interventions in the FX market.

Typically for the second half of the month, demand for physical cash weakened. We expect, however, it to recover as the Christmas holidays approach.

By the end of last week, total funds at banks' correspondent account with NBU declined by 0.9% to UAH54.7bn, while liquidity allocated in central bank's CDs rose 18.4% to UAH115.2bn.

Figure 4. Local UAH bonds market

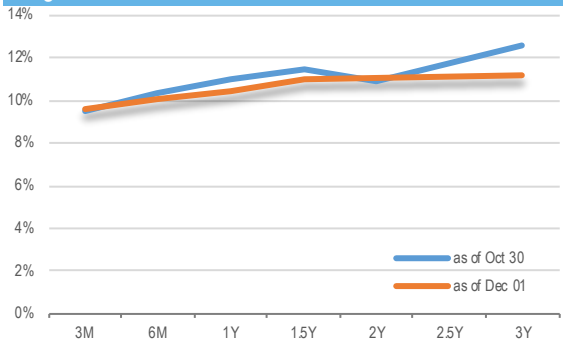
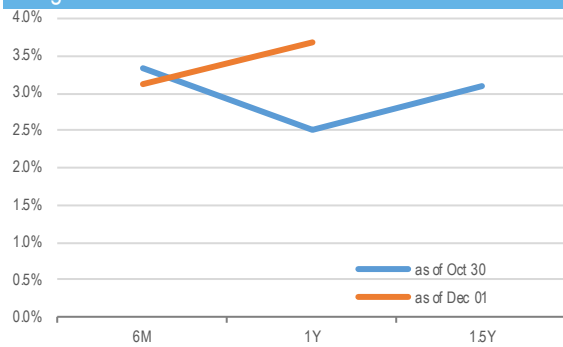


Figure 5. Local USD bonds market



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 | 10.00% | 9.89% | 11.00% | 9.50% | 19 | 18 | 2 009.47 | 2 008.47 |
| UAH | 1Y | 11.00% | 10.93% | 11.20% | 10.80% | 18 | 17 | 784.02 | 584.02 |
| UAH | 3Y | 11.63% | 11.62% | 12.00% | 11.50% | 13 | 8 | 473.10 | 173.10 |

FinMin continues adjusting interest rates for government bonds to market appetite.

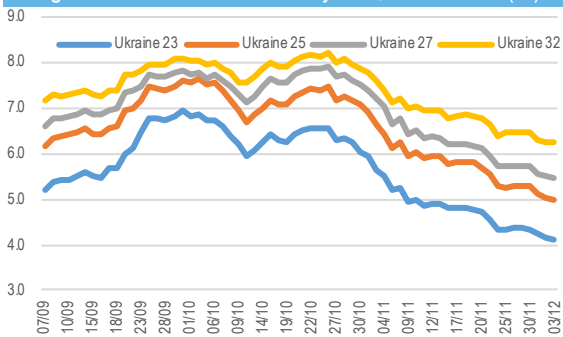
This week the ministry auctioned only local currency bonds with maturity ranging from 3 months to 3 years. And the shortest maturity appeared to be the most interesting to investors. There were 19 applications submitted with bid rate 9.5% -11.0%. Surprising the market with a 250bp hike of cut-off rate to 10.0% the ministry accepted nearly all applications and attracted some UAH2bn. Last time securities with a similar tenor were offered at the beginning of November, with accepted yield set at 7.5% per year.

Relatively strong demand was also seen for 1y bonds, drawing 18 applications for UAH0.78bn in total. With a 20bn rate hike to 11%, 17 bids were satisfied.

The 3y bonds received 13 applications for UAH0.47bn. Although the maximum bid rate was in line with yield at the secondary market (around 12% per annum), the ministry rejected to move above 11.63%, sacrificing UAH300mn in demand.

The reluctance to sell 3y bonds at a lower price might reflect FinMin's expectations for long-end rates to remain anchored, while covering financial needs with a mix of local short-term instruments and foreign financing.

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



EUR/USD breaks another barrier at 1.2 on optimism about vaccines

The EUR/USD pair pushes higher towards the 1.22 mark as recent developments towards the roll-out of COVID-19 vaccines play against the safe-haven dollar.

Solid risk-on sentiment driven by hopes that coronavirus vaccines will be approved for emergency use as soon as this month keeps fueling the selling mood in the greenback and push the EUR/USD to new highs. And the UK could be the first Western country to approve a COVID-19 vaccine, giving the green light to the Pfizer/BioNTech jab, which could be administered as early as next week.

An increasing likelihood of extra stimulus in the U.S. adds to the positive mood among investors. According to the media, former Federal Reserve Chair Janet Yellen is expected to be nominated as Treasury Secretary, which has increased expectations of large fiscal stimulus. Previously, she has called for increased government spending to lift the economy out of a coronavirus-induced recession.

Across the pond, **the euro derives support from positive developments in trade talks between the UK and the EU**, pushing parties to the final stages of a deal.

In addition to that, markets increasingly hope for further ECB easing, which might be announced as soon as at the December meeting.

The yield on the benchmark 10-year Treasury note again entered the 0.9% region as markets closely watching the progress around the vaccines.

Figure 7. EUR USD spot (mid)

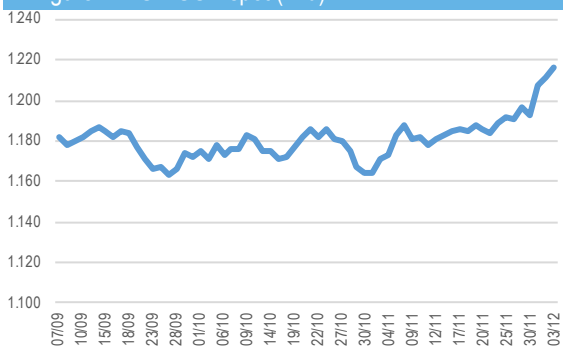
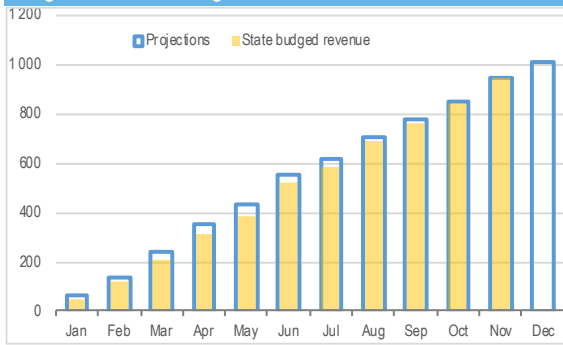


Figure 8. State budgeted total revenue, UAHbn

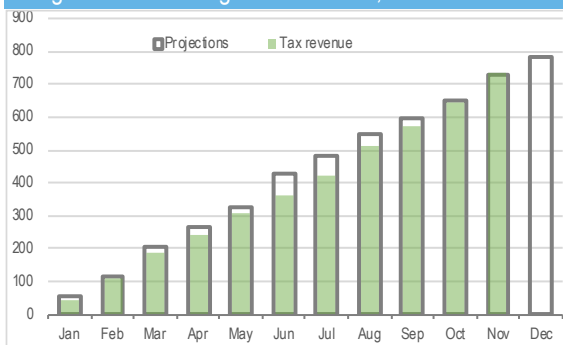


Fiscal flows in December: higher liquidity but not necessarily weaker UAH

The state budget saw a notable improvement in taxes and income receipts in November, putting 11-month revenue in line with projections. But the government continues experiencing difficulties with funding planned deficits, as slow progress in dealing with IMF weigh on FinMin's performance both at foreign and local debt markets. Moreover, built up state arrears leave little room for slashing expenses and may push the ministry to borrow heavily in December, again brining about a liquidity upsurge.

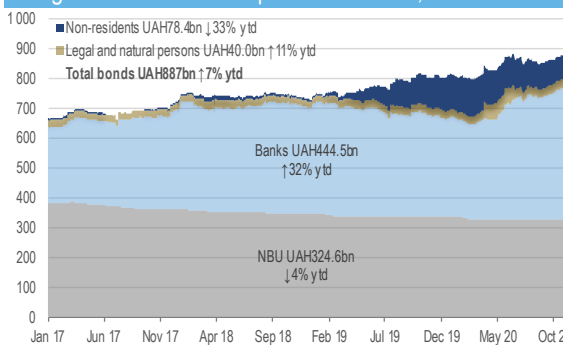
Weak hryvnia - strong profits. State Treasury reported recently that the overall budget revenue for 11 months of 2020 is currently running just shy of projected UAH944.7bn. But the headline figures likely do not yet fully reflect the real impact of the coronavirus pandemic. While no detailed picture is available yet, a gradual local currency devaluation since mid-August is seen as the major driver behind the improvement of fiscal metrics. Despite pandemic-induced economic downturn still in place, with many businesses scaled down operations, tax revenue in January-November was UAH737.2bn, 0.9% higher than projected and 5.3% above collections for the same period of 2019. Worth pointing out, that VAT on imported goods is the major component behind tax receipts.

Figure 9. State budgeted tax revenue, UAHbn



At the same time, **FinMin continues experiencing difficulties with funding budget deficit.** So far, the ministry has managed to rise UAH275.6bn in the local market, lagging 21.7% behind projections, and UAH179.9bn (in hryvnia equivalent) abroad (28.2% below projected amount). While gradually devaluing hryvnia was helping to boost tax revenues, fixed income investors were losing appetite to local public debt still priced at pre-pandemic yields. Delays in dealing with the IMF and news flow behind the stalled consultations added to market pressure and de-facto closed external markets.

Figure 10. Evolution of positions in LGB, UAHbn



With first delays in state budget payments starting to appear in late summer, we reckon accumulated so far arrears allow little room for heavy cuts in government spending. The budget deficit requires heavy borrowing in December. And limited sources of financing might require FinMin to trade price-maker status.

External funding remains contingent on the IMF. While global debt markets continue enjoying monetary stimuli introduced by leading central banks, contributing to rising risk appetite, Ukraine's prospects for tapping into that movement remain dependent on the IMF. At this point, we believe the date of the next review could be enough to assure markets of positive developments under the programme and unlock external markets for Ukraine.

Internal sources are limited to the central bank's financing. Though banking liquidity remains around UAH160bn, a short-term nature of financing doesn't provide opportunities for developing this source. Unlocking NBU's funding, which could be reached by the government via state-owned banks, is seen as the only available option.

At the end of the day, our key scenario is a combination of external borrowing unlocked by some sort of verbal interventions from the IMF (USD1 bn+) and domestic bond placements. We do not rule out a return of international investors to the local primary market following recent rate hikes, as Ukraine remains one of few high yield opportunities. Also, Ukrainian state-owned banks are likely to provide support by buying in more local securities. As a result, we expect a notable increase in domestic liquidity by UAH50-60bn in December and subsequent pressure on local currency, likely pushing UAH above the 29.0 mark. At the same time, likely return of foreign accounts to local market can prevent UAH from further weakness.

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 | -5.8 | 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 | 3 926 | 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 | 4.5 | 5.0 |
| CPI (end of year %YoY) | 24.9 | 43.3 | 12.4 | 13.7 | 9.8 | 4.1 | 4.9 | 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 | 56.2 | 62.6 |
| Imports of goods and services (USD bn) | 70.0 | 49.6 | 51.8 | 60.8 | 70.5 | 75.5 | 64.3 | 72.5 |
| Current account balance (USD bn) | -4.6 | 5.0 | -1.9 | -3.5 | -6.5 | -4.2 | 3.5 | -0.6 |
| Current account balance (% of GDP) | -3.5 | 5.6 | -2.0 | -3.2 | -4.9 | -2.8 | 2.4 | -0.4 |
| Net FDI (USD bn) | 0.3 | -0.4 | 3.8 | 3.7 | 4.5 | 5.2 | 1.0 | 2.0 |
| Foreign exchange reserves (end of year) | 7.5 | 13.3 | 15.5 | 18.8 | 20.8 | 25.3 | 27.0 | 27.5 |
| Imports coverage (months of imports of goods) | 1.5 | 4.4 | 3.7 | 3.6 | 3.4 | 3.9 | 5.0 | 4.5 |
| Interest and exchange rates | | | | | | | | |
| NBU discount rate (% end of year) | 14.0 | 22.0 | 14.0 | 14.5 | 18.0 | 13.5 | 6.0 | 6.0 |
| Exchange rate (USD/UAH) end of year | 15.8 | 24.0 | 27.2 | 28.0 | 27.7 | 23.7 | 29.5 | 31.0 |
| Exchange rate (EUR/UAH) end of year | 23.0 | 26.2 | 28.3 | 33.5 | 31.8 | 26.4 | 33.0 | 34.7 |



UKRAINIAN CAPITAL MARKETS WEEKLY

FOUR WEEKS AHEAD

| Mon | Tue | Wed | Thu | Fri | Sat | Sun |
|---|------------|--|----------------------|--------------------|------------|------------|
| 30.11.2020 | 01.12.2020 | 02.12.2020 | 03.12.2020 | 04.12.2020 | 05.12.2020 | 06.12.2020 |
| NBU: BoP | | LGB* % UAH 1,094.3mn LGB % UAH 178.6mn | LGB* % USD 14.6mn | | | |
| 07.12.2020 | 08.12.2020 | 09.12.2020 | 10.12.2020 | 11.12.2020 | 12.12.2020 | 13.12.2020 |
| NBU: FX Reserves (deadline - 7th day) | | LGB* % UAH 398.4mn LGB* P UAH 0.1mn Ukrstat: Price indices NBU: Monetary Statistics | NBU: MPC ECB: MPC | | | |
| 14.12.2020 | 15.12.2020 | 16.12.2020 | 17.12.2020 | 18.12.2020 | 19.12.2020 | 20.12.2020 |
| | | LGB* % UAH 1,487.7mn LGB P UAH 10,265.3mn Fed: FOMC | LGB % USD 8.7mn | NBU: External Debt | | |
| 21.12.2020 | 22.12.2020 | 23.12.2020 | 24.12.2020 | 25.12.2020 | 26.12.2020 | 27.12.2020 |
| NBU: Minutes Ukrstat: GDP Ukrstat: Retail trade | | LGB* % UAH 655.1mn Ukrstat: Industrial Production | | | | |

MOST COMMON TERMS AND ABBREVIATIONS

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



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