ECONOMICS | INTEREST RATES STRATEGY | FX
21 January 2021

UKRAINIAN CAPITAL MARKETS WEEKLY

	Rating	Outlook	Last update
Fitch	B	STABLE	04.09.2020
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)

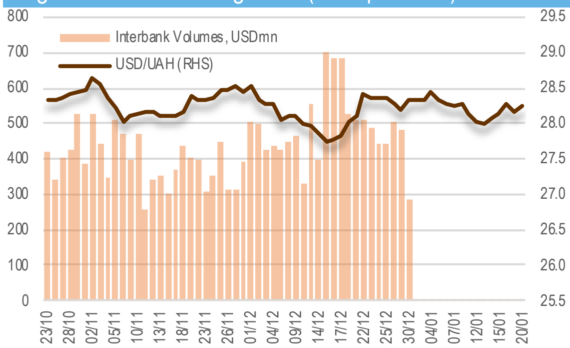


Figure 2. Banking liquidity (UAH bn)

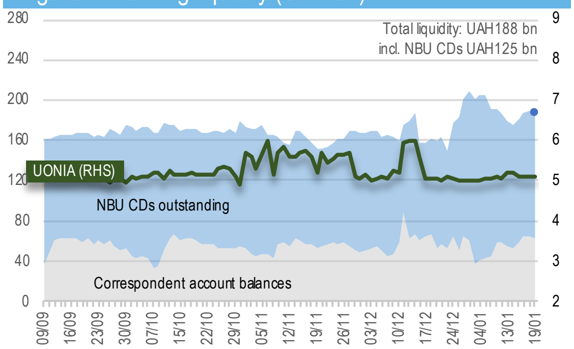
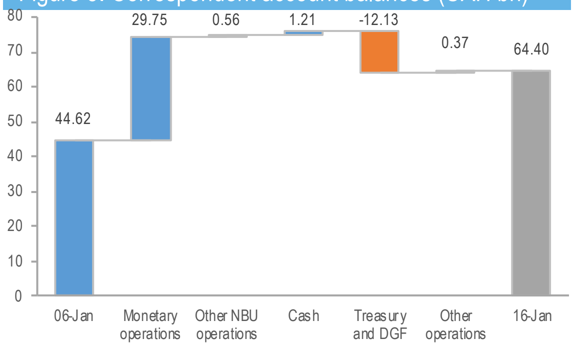


Figure 3. Correspondent account balances (UAH bn)



This week in focus: NBU leaves key rate unchanged, holds dovish tone

The National bank of Ukraine decided to leave the key policy rate unchanged at 6%, as widely expected by the market. Though worsened its inflation expectations, the NBU expects the decision will contribute to preserving favourable financing conditions over the pandemic period, while safeguarding price stability.

FX and interest rates: USD/UAH crawls back as US dollar gets stronger

USD/UAH has crawled above the 28.26 level in recent trades, up about 0.8% on the level a week ago. The move has primarily been driven by USD strength; the Dollar Index has risen back above the 90.50 mark from earlier weekly lows close to 90.00.

Though persistent, local demand for USD doesn't appear to be aggressive to drive the rate up. On the contrary, there was a strong FX supply coming from both exporters and non-residents. The former shifted into local currency to meet their running costs and payments to the state treasury in particular. The latter continued increasing their position in local public debt but demanded higher rates amid resurgent US dollar demand across its main competitors.

The NBU has not shown up in the market since January 12, when USD20mn was purchased.

The future **pare movement will largely depend on progress in talks between the IMF and Ukrainian authorities**. Though admitting lengthy negotiations, we are positive about the mission's outcome regarding the first review of the program.

Banking hryvnia liquidity balance slid to UAH188bn by the end of last week (January 16).

Though the amount of funds on correspondent accounts rose to UAH64.4bn, a 44.3% increase on the preceding week, it is mostly the result of banks' liquidity pull out from NBU's certificates of deposits. Therefore, banks' position in NBU's CDs contracted by 15.9% to UAH123.4bn.

On top of this, the NBU injected UAH560mn via FX purchase and some UAH1.2bn returned into the system via cash channel.

The liquidity decline resulted from State treasury operations, which drained around UAH12.1bn, including UAH9.2bn following last week's primary debt auction. The four-day outflow, which started at the beginning of the week, pushed the interbank interest rate above 5.2% for a while.

Figure 4. Local UAH bonds market

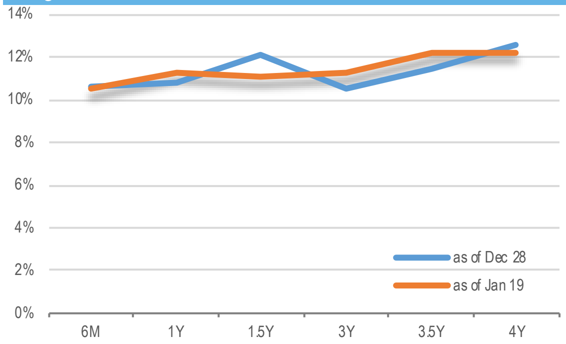
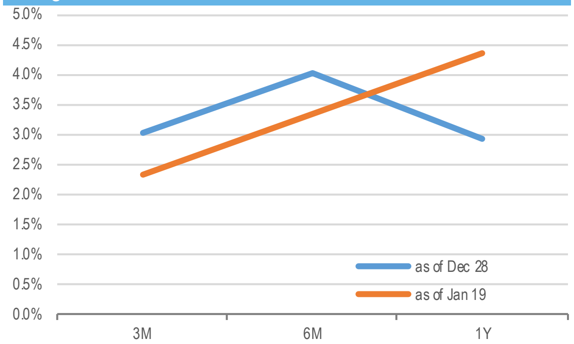


Figure 5. Local USD bonds market



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	3M	9.45%	9.18%	10.00%	9.00%	31	22	1 208.51	500.00
UAH	2Y	11.95%	11.94%	12.00%	11.80%	16	15	3 987.80	3 962.80
UAH	3.5Y	12.15%	12.15%	12.25%	12.15%	15	13	654.14	604.14
UAH	1Y	11.75%	11.73%	11.90%	11.69%	42	38	6 405.40	5 885.40
UAH	6.5Y	12.50%	12.49%	12.60%	12.40%	20	19	1 332.71	1 282.71

Government bonds gain a broader appeal. This week the FinMin offered only hryvnia-denominated securities with a life span ranging from 3 months to 7 year. And strong market demand was seen for all the securities in offer.

The most of funds were risen by the sale of 1- and 2-year bonds. They attracted a total bid of UAH10.4bn. Having lifted cut-off rate by 5bp to 11.75% and by 10bp to 11.95% respectively, the ministry rejected only 5 applications for UAH545mn in total.

Bids for the UAH500mn of 3-month bonds exceeded the offering 2.42 times. This allowed the FinMin to pull marginal rate lower by 55bp to 9.45%.

Worth also noting an auction of reissued seven-year bonds, which fetched UAH1.25bn amid strong demand from investors.

The FinMin awarded all but one of 20 applications submitted during the auction. The cut-off rate was set right in the middle of the bid rate range of 12.4%-12.6%. Last time the issue was in offer back in February 2020 with cut-off rate set at 9.95%.

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

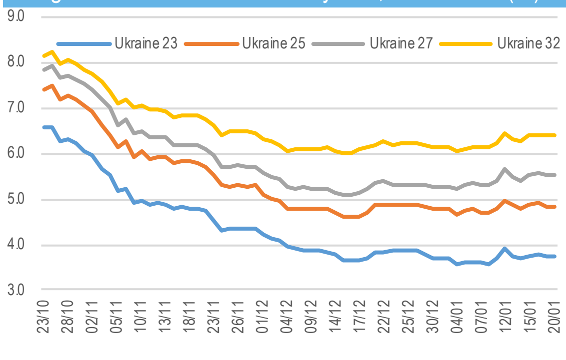
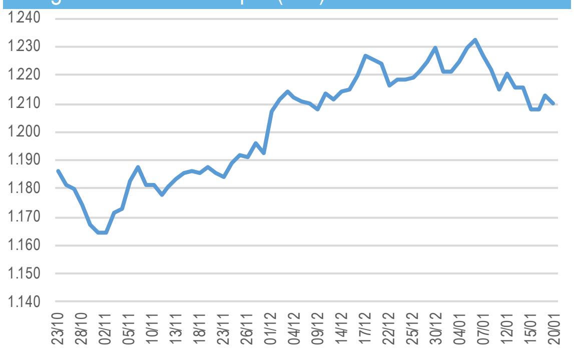


Figure 7. EUR USD spot (mid)



EUR/USD remains offered around 1.21

The EUR/USD returned above 1.21 mark after the recent corrective downside.

The optimism over COVID-19 vaccine rollouts, as well as expectations for a strong recovery in the euro region underpinned by extra fiscal stimulus by the ECB continued boosting investors' confidence. And the ongoing strong rally in the equity markets is seen as one of the key factors that continued weighing on the greenback's relative safe-haven status against its European counterpart.

In addition, real interest rates continue to favour the euro area vs. the U.S., which is also another factor supporting the EUR along with the huge, long positioning in the speculative community.

That said, the risk of recession in the Eurozone economy due to the worsening coronavirus situation and political tensions in Italy and other nations should not be underestimated.

The yield on the benchmark 10-year Treasury note fell to 1.084%, as investors piled into stocks following the inauguration of Joe Biden as U.S. president. Biden signed a number of executive orders on his first day in office and is expected to start working on his proposed USD1.9bn economic stimulus plan right away.

Figure 8. Key rate and CPI evolution

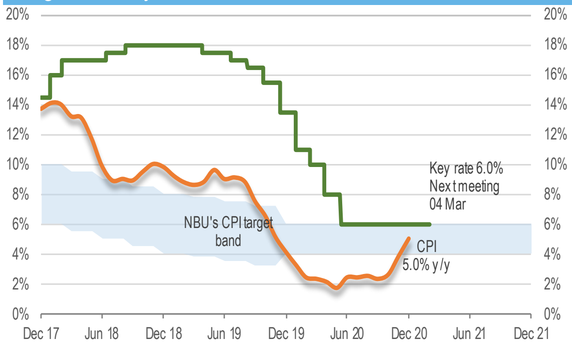


Figure 9. Monthly change in CPI

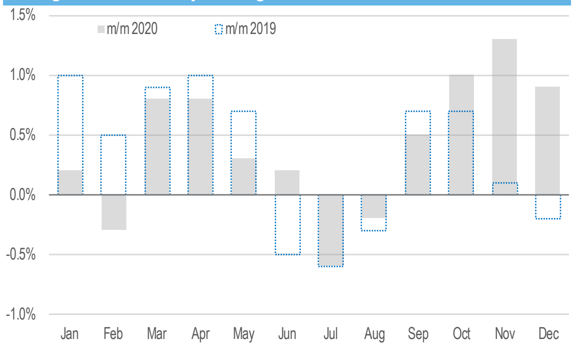


Figure 10. Contribution to monthly change in CPI

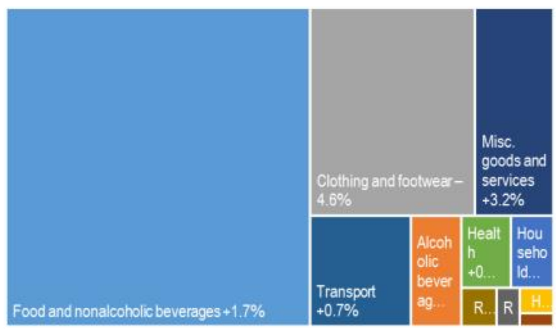
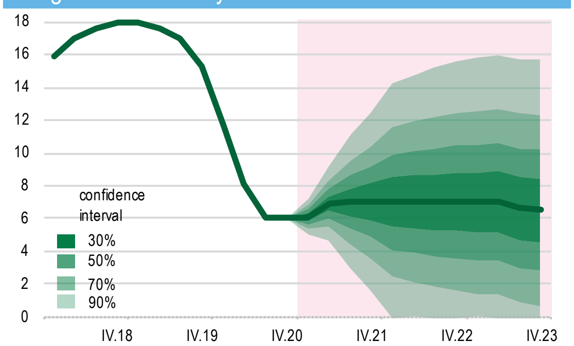


Figure 11. NBU Key rate forecast



NBU leaves key rate unchanged, holds dovish tone

The National bank of Ukraine decided to leave the key policy rate unchanged at 6%, as widely expected by the market. Though worsened its inflation expectations, the NBU expects the decision will contribute to preserving favourable financing conditions over the pandemic period, while safeguarding price stability.

Consumer prices increased solidly in December. Consumer price index increased 0.9% last month after gaining 1.3% in November. And continuous growth in food prices largely stemming from weak crops, but also hryvnia depreciation in the first half of the month, accounted for more than 70% of the rise in the CPI. In the 12 months through December the CPI advanced 5% after accelerating to 3.6% in November.

We expect inflation to remain in an uptrend in the coming months, with rising energy costs being the major driver. First hitting producers, the recent energy price hike is likely to be passed through to final consumers, driving inflation out of NBU's target range of 5% +/- 1pp.

According to the NBU's revised estimates, annual inflation will accelerate this year to 7%, remaining out of the target range through the whole year amid sustainable growth in consumer expenses, wage hike, rising prices for energy commodities, and poor last year's grains harvest.

That said, **the central bank doesn't see a need for a sharp key rate hike in 2021**, pointing out that inflation should return into target range in 1H22.

Moreover, because the central bank reckons the price shock will be less pronounced than expected earlier, but rather could push up the prices of nearly everything for a longer time, the NBU revised down forecast of future policy rate to 7% from 7.5%. But it might remain there till the end of 1H23, a year longer than previous forecast implied.

Potential inflation risk is hiding in a large amount of money sitting in savings. If everybody starts spending at once amounts accumulated during the lockdowns, demand for goods and services is likely to face a notably narrowed number of suppliers, resulting in another inflation surge.

But it is hardly likely such price-level increases to be sustainable. Firstly, the situation across households is not even. With pandemic strongly hitting the labour market and private entrepreneurship, many have seen a notable drop in personal incomes. Secondly, there is an important distinction between a potential broad-based surge of demand and the pent-up demand effects on certain segments. Finally, yet importantly, the policy rate is a too powerful tool to be applied in the current economic conditions. A potential key rate hike could backfire with an inflation spiral and deeper economic slump as many businesses continue suffering from revenue shortfalls following COVID outbreak. They could start to come out of hibernation in 2Q21, provided households become more confident in the economy and the coronavirus spread gets under control. The price growth for energy commodities in the global markets, drawing support from extensive fiscal stimuli introduced by foreign governments, could also undermine the NBU's efforts.

Figure 12. Voices distribution at past MPC meetings

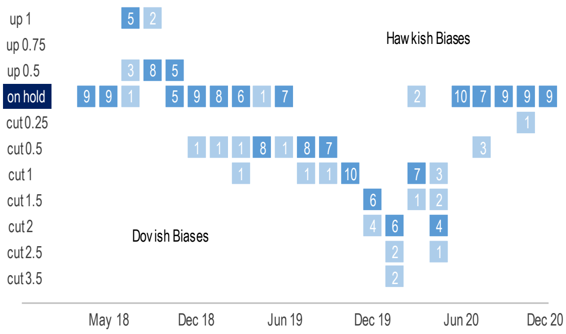


Figure 9. USD/UAH rate evolution

NBU leaves key rate unchanged, holds dovish tone

IMF to help smooth FX effect on inflation. Although discussions between Ukrainian authorities and the IMF staff are still ongoing and many tough issues are on the table we are positive about the outcome of the mission on the first review of the loan programme. The gas price cap issue arisen recently could be foregone given authorities' strong commitment to go on with gas market reforms and a solid record of accomplishment on this front. In turn, the corruption-fighting issue, though remaining an important pillar of the program, is unlikely to require urgent measures.

Progress in cooperation with the IMF will help preserve local currency stability and hence positively reflect on inflation expectations across households, which continue closely watching USD/UAH rate movements.

The recent **NBU tightening of requirements for unsecured consumer loans seems to be the right step towards preventing undesirable inflation** pressure in the aftermath of the COVID crisis. The central bank has introduced increased risk weights for unsecured consumer loans of 125% starting from July 1 and of 150% starting from January 1, 2022. The action, which is primarily aimed at prompting banks to hold enough capital for covering unexpected losses caused by a deterioration in the quality of the unsecured consumer loan portfolio, should also help curb consumer lending activity in the most price-sensitive segments.

We expect the NBU to remain dovish in 1H21, fine-tuning future steps according to the mixed economic environment.

Key Macroeconomic Indicators								
	2014	2015	2016	2017	2018	2019	2020	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	5.0	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	29.1	27.5
Imports coverage (months of imports of goods)	1.5	4.4	3.7	3.6	3.4	3.9	4.8	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	28.3	31.0
Exchange rate (EUR/UAH) end of year	23.0	26.2	28.3	33.5	31.8	26.4	34.7	34.7

**estimates, no official data yet available*

FOUR WEEKS AHEAD

Mon	Tue	Wed	Thu	Fri	Sat	Sun
18/01/2021	19/01/2021	20/01/2021	21/01/2021	22/01/2021	23/01/2021	24/01/2021
		LGB* % UAH 1,400.1mn LGB* P UAH 11,948.3mn	NBU: MPC Ukrstat: Retail trade ECB: MPC	Ukrstat: Industrial Production		
25/01/2021	26/01/2021	27/01/2021	28/01/2021	29/01/2021	30/01/2021	31/01/2021
		LGB* % UAH 725.5mn FGB % EUR 54.7mn LGB P UAH 5,603.9mn Fed: FOMC	LGB* % USD 9.6mn Ukrstat: Nominal & Real Wage			
01/02/2021	02/02/2021	03/02/2021	04/02/2021	05/02/2021	06/02/2021	07/02/2021
IMF SDR 49.7mn FGB % USD 33.7mn NBU: Minutes		LGB* % UAH 1,542.5mn	IMF SDR 98.5mn			NBU: FX Reserves (deadline - 7th day)
08/02/2021	09/02/2021	10/02/2021	11/02/2021	12/02/2021	13/02/2021	14/02/2021
Ukrstat: Busines confidence	Ukrstat: Price indices	LGB* % UAH 1,399.0mn LGB* P UAH 2,500.0mn	LGB* % USD 13.4mn LGB* P USD 378.3mn			

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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