ECONOMICS | INTEREST RATES STRATEGY | FX

6 October 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: Evergrande likely to induce pressure on UAH in the mid-run

Evergrande's story is by far in focus across capital markets. Although Ukraine has no direct exposure to the story, a rippling effect from the likely default of the company, could in some way be similar to that of the Lehman Brothers crash. Extreme evolution could result in a worldwide crisis. But an orderly resolution, with Chinese authorities taking control over the situation, is still on the cards.

Figure 1. UAH exchange rate (UAH per USD)

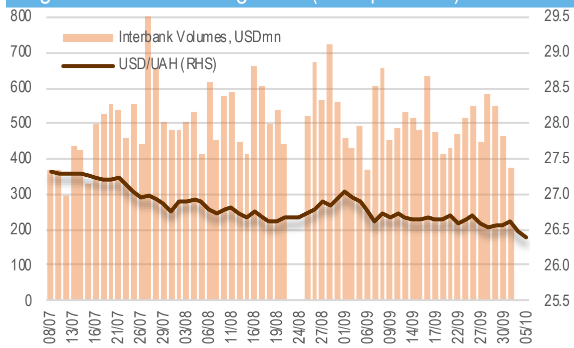


Figure 2. Banking liquidity (UAH bn)

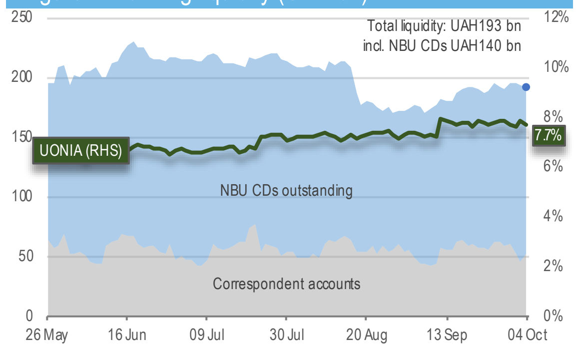
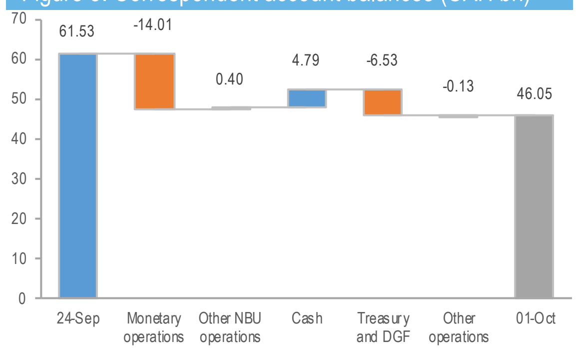


Figure 3. Correspondent account balances (UAH bn)



FX and interest rates: USD/UAH plumbs fresh year low

The Ukrainian hryvnia has remained well supported over the last several weeks, thanks to the sustainable supply of U.S. dollars. The USD/UAH pair was last seen heading towards 26.4 mark, down 0.8% on Friday (October 1), marking fresh year to date low.

Export returns remain the major source of FX liquidity, with argi-food producers substituting steel and iron ore exporters in supply. There is also a sustainable inflow of FX from the IT industry and work migrants.

The FX offer remains well in excess of demand, covering not only business needs but also the central bank's interventions and recurring demand from foreign investors. Worth pointing out, however, that the latter have rebuilt their position in the public debt at the previous auction (September 28), thereby offsetting the corresponding net outflow over the month. In turn, the former have recently announced intention to cut back FX purchases in the interbank market for the sake of curbing inflation.

While demand for FX appears to be strong, it is still surprisingly below our expectations, given accelerating energy imports. We also see no signs of a seasonal upsurge in FX demand from small and medium agri producers. This could suggest a little potential for a change in trend in the short run.

Looking into 4Q21, however, the picture appears less promising, with a strong downside correction in iron ore prices and continuing energy price surge auguring a considerable expansion in CA deficit.

Banking liquidity recovered to UAH194bn by the end of last week. As of Friday (October 1) balance of banks' correspondent accounts with the NBU was UAH46.1bn, down 25.2% from a week ago, banks' position in central bank's CDs amounted to UAH147.5bn, increasing by 10.2% over the week.

Last week some UAH4.8bn returned into system via the cash channel. Decline in cash outstanding to July's levels could indicate a waning tourism-related demand for paper money.

Meantime the State treasury withdrew from the system circa UAH6.5bn. And gross outflow could have been at least twice that amount, considering scheduled for last week redemption of government bonds worth about UAH12bn, roughly half which were not rolled over.

Figure 4. Local UAH bonds market

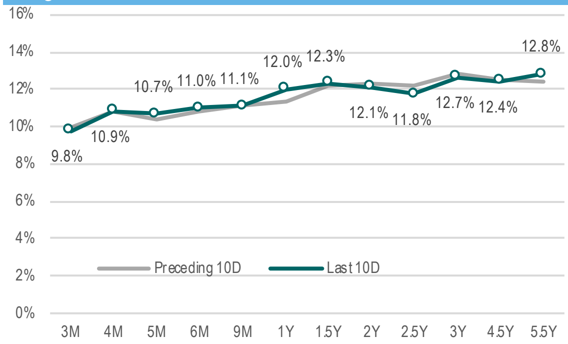
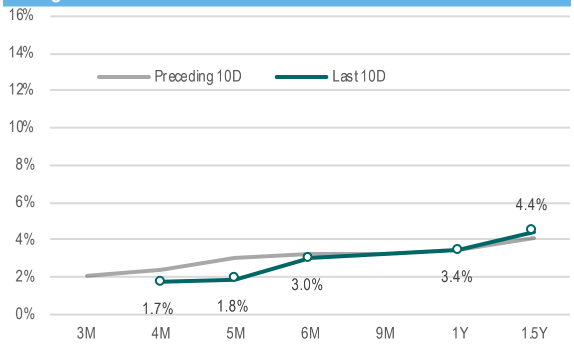


Figure 5. Local USD bonds market



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	9.70%	9.70%	11.00%	9.70%	8	6	365.53	61.16
UAH	9M	11.50%	11.50%	11.50%	11.50%	22	22	728.19	728.19
UAH	1Y	11.60%	11.57%	11.60%	11.53%	10	10	668.26	668.26
UAH	2Y	12.40%	12.40%	12.60%	12.40%	23	21	788.32	638.32
UAH	2.5Y	12.49%	12.49%	12.49%	12.49%	6	6	18.93	18.93
UAH	4.5Y	12.75%	12.75%	12.99%	12.60%	9	6	377.64	297.64

Demand for government bonds returned to a low level as FinMin pulled back from other rate hikes. This Tuesday the ministry again offered hryvnia denominated bonds only, with maturity ranging from 5m to 4.5y. Unlike a week ago, this time cutoff rate for most bonds was held unchanged. This resulted in a cool response from the market, with no issue drawing total bids in excess of UAH1bn. As a result, the ministry raised circa UAH2.4bn, which is 2.8 times less than a week ago.

Slow FinMin's response to rising inflation is likely the major reason behind a tepid local appetite for public debt. In turn, the depth of foreign interest depends on the outcome of the ongoing revision of the stand-by arrangement with the IMF and the generosity of the government in the long end of the yield curve. A 16bp marginal rate hike for the 4.5y maturity appears to be not enough to garner extra foreign demand.

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

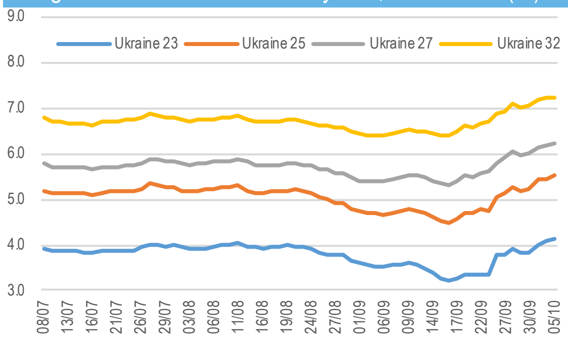
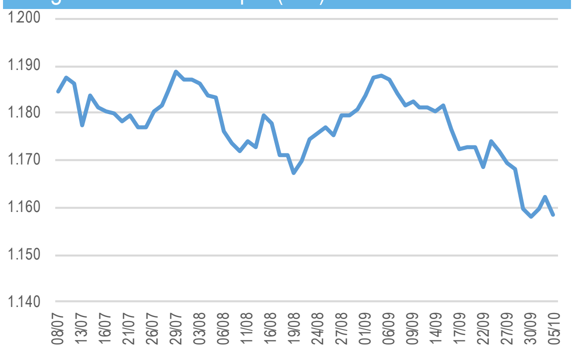


Figure 7. EUR USD spot (mid)



EUR/USD bounces off 2021 lows near 1.1580

The EUR/USD retreated above 1.1600 level after a bull run in the greenback last week pushed the rate to the fresh year low near 1.1580 mark. The safe-haven dollar, however, seems to keep holding ground as the market mood remains volatile.

The safe-haven greenback was buoyed by an increased risk-averse sentiment, driven by rising expectations that the Federal Reserve will start to taper bond purchases over the coming months. This triggered a rally both in the U.S. dollar and the US Treasuries. The yield on the benchmark 10-year Treasury note added about 20 basis points over the last two weeks, rising above 1.48% by Wednesday (October 6).

Another factor weighing on investment sentiment and boosting the safe-haven dollar is China's indebted property developers. Netted out of cash Evergrande was joined by Fantasia Holding Group, which missed a debt payment, and Sinic, rating of which was downgraded by Fitch Ratings.

In turn, lower for longer European Central Bank monetary policy against an increasingly hawkish Federal Reserve, as well as the likely loss of momentum in the economic recovery in the euro area, as per some weakness seen in key fundamentals, capped the upside potential in the single currency.

Figure 8. Evergrande operations and business interests

Evergrande Real Estate Group
Evergrande Automotive Group
Evergrande Power Technology Group
Guanghui Industry Investment Group
Evergrande New Energy Technology Group
Evergrande Tourism Group
Evergrande Health Group
Evergrande Hi-tech Agriculture
Evergrande Life Insurance
China Calxon Group
HengTen Networks Group
The total assets RMB2.3tn (circa USD360bn)

Figure 9. Bond price performance

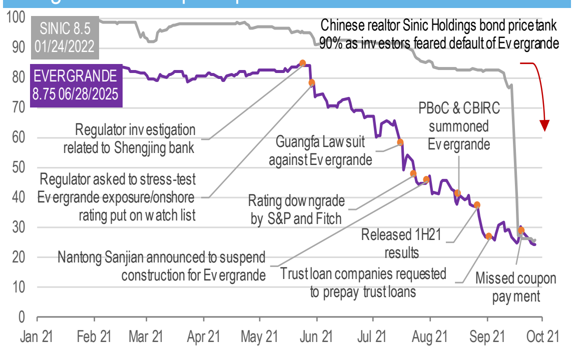
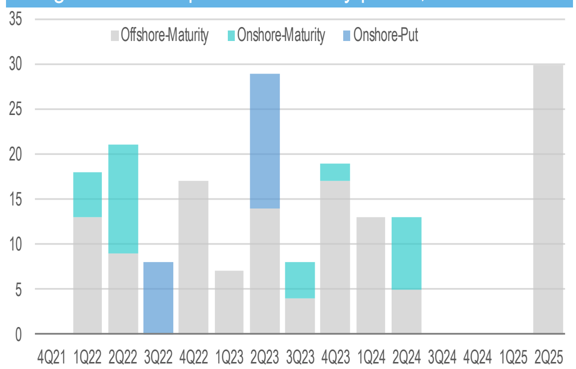


Figure 10. Group's bond maturity profile, RMBbn



Evergrande likely to induce pressure on UAH in the medium run

Evergrande's story is by far in focus across capital markets. Although Ukraine has no direct exposure to the story, a rippling effect from the likely default of the company, which accounts for approximately 2% of the second largest global economy, let alone the multiplier effect, could in some way be similar to that of the Lehman Brothers crash. Extreme evolution could result in a worldwide financial crisis. But an orderly resolution, with Chinese authorities taking control over the situation, is still on the cards. Political lessons from the Asian financial crisis could also provide substantial ground to a soft landing. That said, so far the issue remains open, and the Evergrande saga may well hold attention to the very end of the ongoing grace period.

Evegrande missed coupon payments on its bonds, coping with a massive liquidity crisis. Evergrande is one of China's largest real estate developers. The company is part of the Global 500 — meaning that it's also one of the world's biggest businesses by revenue. Outside housing, the group has invested in electric vehicles, sports, and theme parks. It even owns a food and beverage business, selling bottled water, groceries, dairy products, and other goods across China.

The company has in total USD305bn of liabilities outstanding, including loans from Chinese banks and onshore and offshore bonds, as well as amounts owed to suppliers. This amounts to nearly 2% of China's annual GDP. The company's off-balance-sheet obligations add up to as much as another 1%.

Triggered by an investigation of related-party transactions, the Evergrande story has been unfolding since early June. The company has followed typical self-reinforcing liquidity issues, with tightening access to funding and arriving early calls to prepay liabilities. So far, the story has culminated in the company's failure to make two coupon payments on September 23 and September 30, amounting to USD131mn in total. There is, however, a 30-day grace period to deal with each obligation.

Contagion in financial markets looks unlikely but cannot be fully excluded provided the scale of company operations and the size of its debt.

Luckily, developments around Evergrande have little similarities to the Asian financial crisis or the more recent collapse of Lehman Brothers.

Unlike the former event, which largely resulted from the poor performance of regulatory functions in the context of rising pressure from international actors, the rapid development of real estate and related industries, including by means of high financial leverage, is rather a product not a problem for China's command economy. Construction used to contribute about a third of the country's GDP growth and about a tenth of global growth. And Chinese authorities clearly have the tools for containing a crisis.

Regarding the latter, capital markets' exposure to Evergrande is limited to the company's obligations, unlike Lehman Brothers, which was deeply entrenched in the core of capital markets.

That said, Evergrande is a very big and very leveraged company. Considering a multiplier effect, the real implications to the Chinese economy can far exceed the nominal amount of the company's liabilities. And that is just considering Evergrande's construction business. The group's units are at risk to follow the same pattern of self-reinforcing liquidity tightening in case of default announcement. A wide degree of diversification of business makes it difficult to evaluate the full range of consequences. A rippling effect could be of no less strength than the foregoing events.

Figure 11. Group's bonds monthly coupons, RMBmn

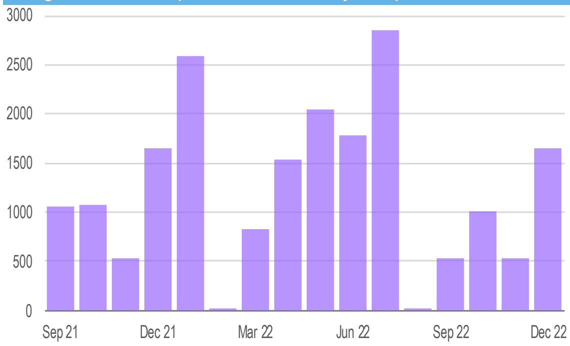
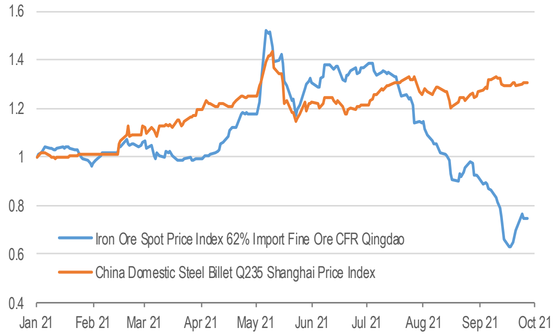


Figure 12. Iron Ore and Steel price indices



Evergrande likely to induce pressure on UAH in the medium run

Our base case scenario is orderly resolution, with Chinese authorities taking control over the situation. Some news reports suggest the government has started to do this. Though not explicitly relating to Evergrande's story, China's central bank vowed to protect consumers exposed to the housing market on September 28 and injected more cash into the banking system. Besides, the company announced a sale of a USD1.5bn stake in Shengjing Bank to a state-owned asset management company.

Worth also pointing out, Chinese citizens are extraordinarily dependent on real estate for their nest eggs. Allowing the situation to escalate could threaten the social stability in the country. This, along with political lessons from the Asian financial crisis could also provide substantial ground to a soft landing.

This situation is likely to have an impact on Ukraine's economy. Although Ukraine has no direct exposure to the story, the country might still experience some implications. Even under a best-case scenario, it is hardly likely the Evergrande will avoid restructuring its debt obligations. And the complexity of the company's capital structure could potentially disadvantage foreign investors, and thereby spark a loss of confidence in the financial markets. This, along with a string of hawkish signals from major central banks, may hinder access to the global debt market for Ukraine.

Under less plausible scenarios, but still eliminating a full-blown crisis, disruption to Evergrande's operations are very likely. The foregoing figures on the scale of the company's business mean, even a short-term interruption in the work of such a large player could have a material impact on other markets. Steel and therefore iron ore producers will certainly take a huge hit in such cases.

Worth also noting, that September-October is typically the year's second peak season for steel and iron ore producers. The price of iron ore has fallen by more than half since May, in the wake of Chinese curbs on steel production. Failure in the sales season could send global iron ore prices even lower, which would have negative implications for Ukraine's exports and budget revenues.

Having said that, as a minimum we expect negative influence on Ukrainian exports (further worsening terms of trade) that are already under pressure following recent increase in gas prices. The second round effects stemming from reduced access of Ukraine issuers to international capital markets seem to be a risk at the moment too. In this light we continue to expect light devaluation of UAH in the medium term even though prospects of higher domestic rates and positive news on IMF will continue to support local currency in the short run.

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	3.1	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	4 750	5 355
Nominal GDP (USD bn)	90	93	112	131	155	156	171	188
Prices								
CPI (average %YoY)	48.5	14.9	14.4	11.0	7.9	2.7	9.4	8.5
CPI (end of year %YoY)	43.3	12.4	13.7	9.8	4.1	5.0	10.5	6.5
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	2.0	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	6.0
Exchange rate (USD/UAH) end of year	24.0	27.2	28.1	27.7	23.7	28.3	28.0	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
04.10.2021	05.10.2021	06.10.2021	07.10.2021	08.10.2021	09.10.2021	10.10.2021
	IMF SDR 61.2mn Ukrstat: Busines confidence	LGB* % UAH 305.7mn LGB % UAH 77.5mn	LGB % USD 2.5mn NBU: FX Reserves (deadline - 7th day)	Ukrstat: Price indices		
11.10.2021	12.10.2021	13.10.2021	14.10.2021	15.10.2021	16.10.2021	17.10.2021
NBU: Monetary Statistics		LGB* % UAH 524.1mn LGB % UAH 1,117.8mn	LGB % USD 7.9mn			
18.10.2021	19.10.2021	20.10.2021	21.10.2021	22.10.2021	23.10.2021	24.10.2021
		LGB* % UAH 394.9mn LGB % UAH 951.7mn	LGB % USD 11.6mn LGB P USD 661.3mn NBU: MPC Ukrstat: Retail trade	LGB* % UAH 62.5mn Ukrstat: Industrial Production		
25.10.2021	26.10.2021	27.10.2021	28.10.2021	29.10.2021	30.10.2021	31.10.2021
		LGB* % UAH 895.1mn LGB P UAH 12,422.7mn	Ukrstat: Nominal & Real Wage ECB: MPC	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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