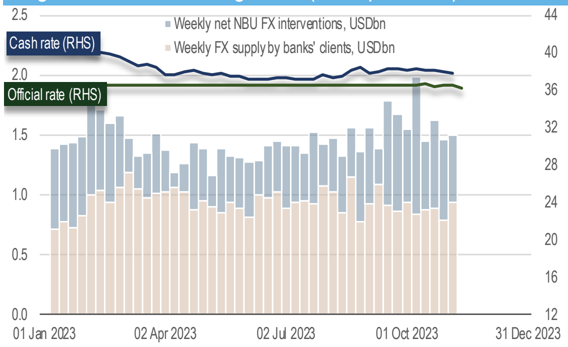
UKRAINIAN CAPITAL MARKETS REVIEW

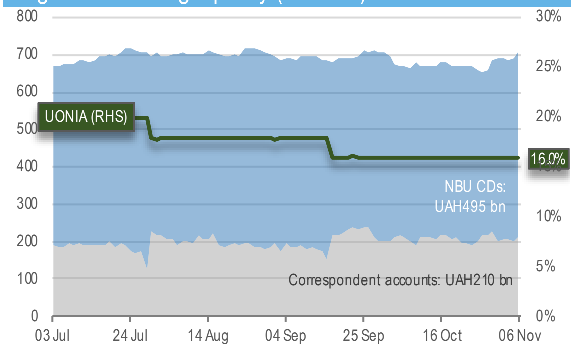
	Rating	Outlook	Last update
Fitch	CC	-	23.06.2023
S&P	CCC	NEGATIVE	08.09.2023
Moody's	Ca	STABLE	10.02.2023
R&I	CCC	NEGATIVE	27.07.2022

Figure 1. UAH exchange rate (UAH per USD)



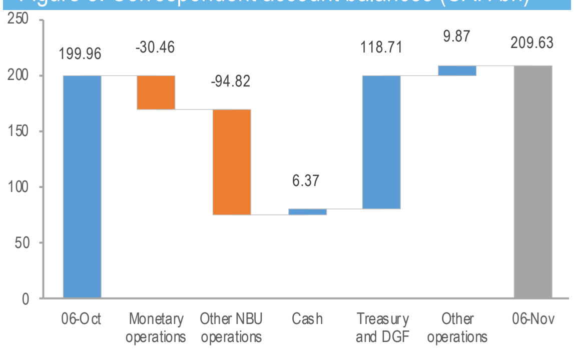
Sources: NBU, MinFin (media)

Figure 2. Banking liquidity (UAH bn)



Source: NBU

Figure 3. Correspondent account balances (UAH bn)



Source: NBU

This week in focus: A bold walk amid rising uncertainty

The NBU has made a surprising move setting the policy rate below its earlier forecast. The softened policy seems good for good times. At the same time, the accelerated policy easing may lack sufficient safeguards against rapid changes in perceived risks, particularly in the context of deteriorating forecasts about the length of military operations.

FX and interest rates: USD/UAH holds firm despite the key rate cut

The Ukrainian hryvnia continues displaying notable resilience, appreciating by 1.1% against the U.S. dollar since the transition to the managed flexibility of exchange rate regime in early October, peaking at 36.17 by the close of last week.

As the NBU FX interventions remain the only game in town, the USD/UAH pair trend has remained unaffected by the recent key rate reduction.

But the latest move might have long-term implications. Despite existing restrictions on cross-border currency transactions, the accelerated key rate reduction against elevated international interest rates might deter Ukrainian exporters from relying on FX sales for their capital needs, favouring new loans, particularly with access to the government-backed lending program. Traditionally, seasonal FX sales by farmers ahead of the sowing campaign boosted the hryvnia in spring.

To counterbalance this, the NBU is considering shortening the export revenue return period from 180 days to 90 days. Such a move however raises concerns in the market as it contradicts prior central bank's assurances of avoiding further tightening in cross-border trade transactions following the currency regime transition.

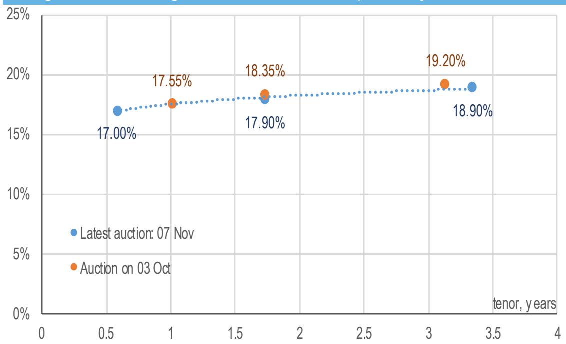
In recent weeks, **hryvnia liquidity in the banking system showed signs of recovery, rebounding to UAH704.5bn** after dropping below the UAH660bn mark at the end of October.

The earlier decline in liquidity was attributed to heightened FX interventions, with the NBU selling over USD3.7bn last month, marking a 14% increase from the previous month.

Demand for paper hryvnia appears to have waned, possibly due to the rise in non-cash FX exchange transactions permitted by the NBU in late August. Net cash inflow over October amounted to UAH6.4bn.

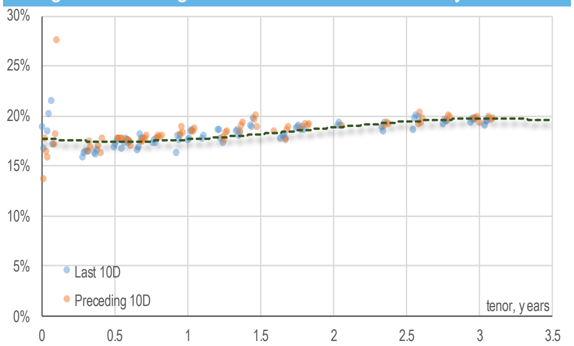
As of the end of last week, banks' correspondent account balance stood at UAH209.6bn, reflecting a 9.31% increase over the month. Concurrently, positions in NBU CDs increased by 1.80% to UAH495.3bn. Notably, there was a 6.33% increase in 3-month CDs holdings to UAH195.1bn, in spite of the NBU's tightening of access to this instrument.

Figure 4. UAH government bonds primary market



Source: FinMin

Figure 5. UAH government bonds secondary market



Source: NBU

Government bond market

The public debt yields experienced a marginal decline following the NBU's bold policy easing on 26 October. Notably, the yield curve shifted downwards by 45bp in the mid- and 30bp in the long end, in contrast to the substantial 4pp rate cut implemented by the NBU.

Demand for government bonds remains robust, with the last primary auction (7 November) witnessing a bid-to-cover ratio of 3.76 for 6-month bonds, indicating demand significantly exceeding supply.

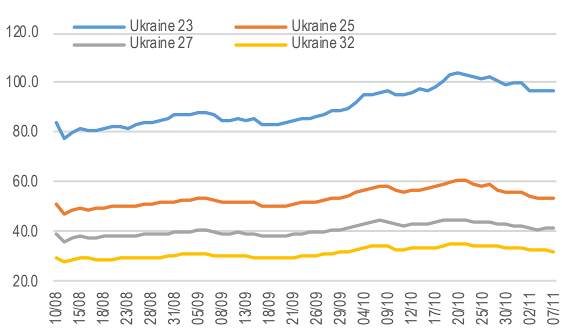
Similarly, bid-to-cover ratios for 1.5-year and 3-year bonds stood at 1.39 and 1.15, respectively.

The market may have heightened demand for bonds in anticipation of another key rate cut at the upcoming meeting of policymakers in December, as signaled by the NBU.

However, this expectation along with the central bank's intent to maintain a stable rate through the end of the next year could potentially impact future demand. The floored rate may curtail the price appreciation potential of long-term bonds, consequently redirecting demand to short-end of the yield curve.

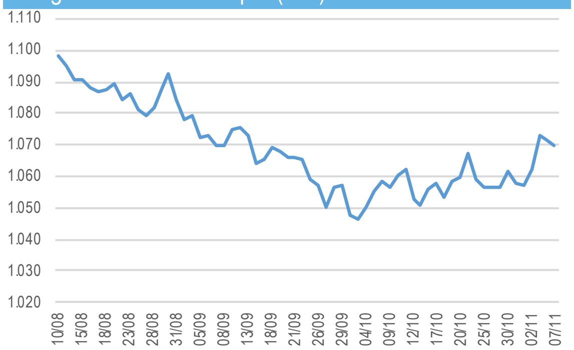
Worth noting, however, that both the future monetary policy and the bonds performance remain heavily dependent on the situation on the battlefield.

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



Source: Bloomberg

Figure 7. EUR USD spot (mid)



Source: Bloomberg

EUR/USD rebounds to 1.0700 on dovish Fed tilt

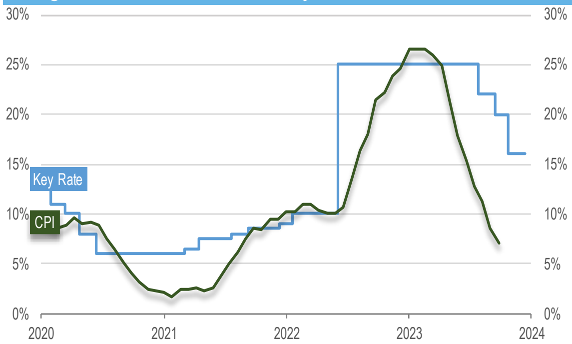
The European currency rebounded, hovering near the 1.0700 level against the U.S. dollar, propelled by a shift in the Fed's stance towards a more dovish approach and indications that the tightening cycle may be approaching its end.

The market's confidence in the Fed's commitment to dovish stance was reinforced by the recent release of Nonfarm Payrolls data for October, which fell below expectations, suggesting a potential slowdown in the labour market. Cooling the jobs market has been a key objective for the central bank throughout its rate-hiking cycle, initiated in March 2022, aimed at supporting the broader economy and curbing inflation.

Regarding the ECB, investors are leaning towards a prolonged pause in its rate-hiking cycle, likely extending into the second half of the coming year. This shift in sentiment is driven by easing inflationary pressures and a deteriorating economic outlook in the euro area.

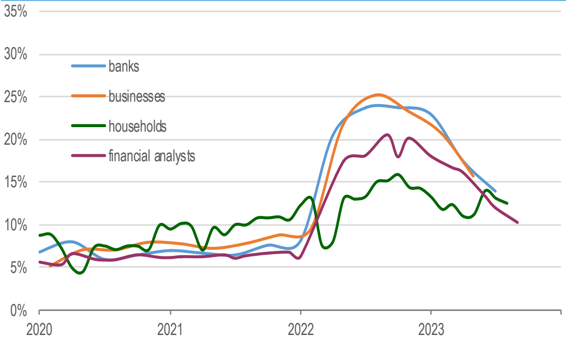
The 10-year Treasury was last trading with yield at 4.585%, losing 16bp over the month. Investors are currently evaluating the interest rate outlook following the jobs report, and are preparing for a week with limited economic data.

Figure 8. Evolution of the key rate vs inflation



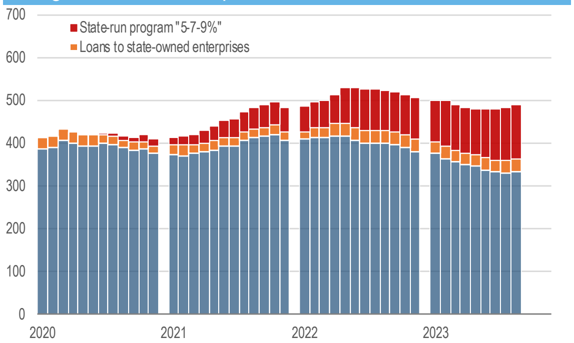
Sources: NBU, Ukrstat

Figure 9. Inflation expectations, 12 months ahead



Source: NBU

Figure 10. Total corporate loans in UAH, UAHbn



Sources: NBU, BDF

A bold walk amid rising uncertainty

The NBU has made a surprising move setting the policy rate below its earlier forecast. Furthermore, the NBU has outlined its intention to further lower the key rate to 15% at the upcoming meeting in December, with the commitment to maintaining this level throughout 2024. The softened policy seems good for good times. But it is likely to have a moderate effect on lending activity given the persistent war-related risks. At the same time, the accelerated policy easing may lack sufficient safeguards against rapid changes in perceived risks, particularly in the context of deteriorating forecasts about the length of military operations.

The NBU reduced policy rate to 16% from 20% on 26 October. The rates on central bank's transactions with banks remained unchanged, as together with the rate cut the central bank has changed its monetary policy design. According to the NBU, the new design improves the signalling role of the key policy rate while maintaining the sufficient attractiveness of hryvnia savings.

The NBU has also outlined plans to lower the key rate to 15% at the upcoming December monetary policy meeting and maintain this level throughout the next year.

But the lending landscape continues to be constrained by the lingering effects of the ongoing conflict. Security risks, rising production costs, insufficient demand, and tightening of the labour market owing to continuing migration are currently standing well above such issues as insufficient working capital or limited loan opportunities. Both monthly and quarterly business sentiment polls echo these concerns.

While banks express expectations of increased lending activity over the next 12 months, the specifics regarding the timing and basis of this increase - whether solely based on banking activity or inclusive of state-run lending program - are not specified.

Since its launch in mid-2020, the state-run lending program "5-7-9" has been continuously eclipsing commercial lending in corporate sector. While corporate loans in UAH have seen a 16.7% y/y contraction in September 2023, the state-run program has gained 31.2% over the year, now representing around 26% of the total corporate loan portfolio in local currency. And it will remain beyond competition even assuming the policy rate cut to 15%.

The latest monetary policy decisions align with a sharp deceleration in inflation this year. Nonetheless, the policy transmission remains constrained by implied war risks. While the accelerated policy softening may be good for currently benign macroeconomic situation, it risks lacking robustness in case of a rapid change in perceived risks, which may have implications for FX stability. The central bank's 2024 outlook worsening, with the length of the war extended until at least the end of the next year and inflation forecast lifted by 1.3pp to 9.8%, doesn't add to confidence over the central bank's ability to maintain 15% through the end of 2024.

Key Macroeconomic Indicators	2017	2018	2019	2020	2021	2022	2023E	2024F
Real sector								
Real GDP (%YoY)	2.5	3.4	3.2	-3.8	3.4	-29.1	3.0	5.0
Industrial production (%YoY)	1.1	3.0	-0.5	-4.5	1.9	-36.9	NA	NA
Retail sales (%YoY)	6.5	6.2	10.3	8.4	10.7	-21.4	NA	NA
Unemployment rate end of year (ILO, working age)	9.5	8.8	8.2	9.5	9.8	NA	NA	NA
Nominal GDP (UAH bn)	2 984	3 561	3 975	4 222	5 460	5 191	NA	NA
Nominal GDP (USD bn)	112	131	155	157	201	161	NA	NA
Prices								
CPI (average %YoY)	14.4	11.0	7.9	2.7	9.4	20.0	14.5	8.9
CPI (end of year %YoY)	13.7	9.8	4.1	5.0	10.5	26.6	7.0	10.0
Real average wage growth (%YoY)	19.1	12.5	9.8	7.4	11.9	NA	NA	NA
Fiscal balance (% of GDP)								
State budget deficit (without Naftogaz)	1.6	2.4	1.8	5.2	3.6	17.6	NA	NA
Total public debt (% of GDP)	71.8	61.0	51.6	60.8	48.9	78.4	NA	NA
External balance								
Exports of goods and services (USD bn)	53.9	59.2	63.6	60.7	81.5	57.1	NA	NA
Imports of goods and services (USD bn)	62.7	70.6	76.1	63.1	84.5	81.5	NA	NA
Current account balance (USD bn)	-3.5	-6.4	-4.1	5.3	-2.1	8.4	NA	NA
Current account balance (% of GDP)	-3.1	-4.9	-2.7	3.4	-1.0	5.2	NA	NA
Net FDI (USD bn)	3.7	4.5	5.2	-0.1	6.0	0.6	NA	NA
Foreign exchange reserves (end of year)	18.8	20.8	25.3	29.1	30.9	28.5	38.0	30.0
Imports coverage (months of imports of goods)	3.6	3.5	3.9	4.8	4.1	3.7	4.9	3.8
Interest and exchange rates								
NBU discount rate (% end of year)	14.5	18.0	13.5	6.0	9.0	25.0	15.0	15.0
Exchange rate (USD/UAH) end of year	28.1	27.7	23.7	28.3	27.3	36.6	40.0	46.0
Exchange rate (EUR/UAH) end of year	33.5	31.7	26.4	34.7	30.9	39.0	44.0	52.9

**estimates, no official data yet available*

NA – data is not available because of continuing military operations

FOUR WEEKS AHEAD

Mon	Tue	Wed	Thu	Fri	Sat	Sun
06.11.2023	07.11.2023	08.11.2023	09.11.2023	10.11.2023	11.11.2023	12.11.2023
NBU: Minutes	NBU: FX Reserves (deadline - 7th day)	LGB % UAH 1 980.9mn	NBU: Monetary Statistics Ukrstat: Price indices			
13.11.2023	14.11.2023	15.11.2023	16.11.2023	17.11.2023	18.11.2023	19.11.2023
		LGB % UAH 692.9mn				
20.11.2023	21.11.2023	22.11.2023	23.11.2023	24.11.2023	25.11.2023	26.11.2023
		LGB % UAH 889.8mn LGB P UAH 15 248.8mn LGB % UAH 1 125.9mn LGB % UAH 1 998.1mn				
27.11.2023	28.11.2023	29.11.2023	30.11.2023	01.12.2023	02.12.2023	03.12.2023
		LGB % UAH 748.0mn	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

Contacts

Investment Business Group

Viktoriia Nebeska
Market Making Government Bonds
(+38044) 298-83-36
viktoriia.nebeska@ukrsibbank.com

Olha Koval
Fixed Income Dealer
(+38044) 298-83-35
olha.koval@ukrsibbank.com

Mykhailo Kharchuk
Market Analysis
mykhailo.kharchuk@ukrsibbank.com

FX Business
Kostiantyn Rupchev
Head of FX Sales
(+38044) 298-83-34
kostiantyn.rupchev@ukrsibbank.com

Corporate Business
Ievgen Kulikov
Head of MNC team
(+38044) 201-22-43
ievgen.kulikov@ukrsibbank.com

Distribution:
macro@ukrsibbank.com

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