Focus
Ukraine

Markets
Domestic liquidity, government bonds, FX market, and macro

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Weekly Insight

Key policy rate pushes bond yields up

Key messages of the today's comments

Domestic liquidity and bonds market

Key policy rate pushes bond yields up

Primary bond market yield curve mostly flat at around the key policy rate; could rise further.

Liquidity down to UAH94bn

After staying above UAH100bn for more than a week, total banking-sector liquidity fell to UAH94bn last Wednesday after significant outflows to budget and from cash. However, we see an opportunity for recovery.

Foreign exchange market

UAH boosted by NBU's interest rate hike

The increase of the key policy rate by another 100bps to 17% made investment in the hryvnia more attractive, increasing demand for the Ukrainian currency.

Economics

Greenback's prospects in light of tariffs, labour market statistics, and elections in Italy

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TUESDAY, 13 MARCH 2018

Banks' reserves market (12 March 2018)

	Last	Weekly chg (%)	YTD chg (%)
NBU rate (%)[1]	17.00	+0bp	+300bp
ON rate (%)	16.10	+60bp	+340bp
ON $ swap (%)	15.90	+39bp	+320bp
Reserves (UAHm)[2]	39,203	-5.23	+12.06
DepCerts (UAHm)[3]	35,408	-41.61	+0.00

Notes: [1] NBU's key policy rate; [2] stock of banks' reserves held at NBU; [3] stock of NBU's short-term bonds.
Source: NBU, Bloomberg, ICU.

Breakdown of govt bond holders (UAHm) (12 March 2018)

	Last	Weekly chg (%)	YTD chg (%)
NBU	352,697	-0.46	-8.29
Banks	342,100	-0.22	+24.45
Residents	26,684	+0.16	+22.57
Individuals	1,921	-0.12	+705.55
Non-res[4]	14,038	+1.72	+138.98
Total	**737,440**	**-0.28**	**+7.29**

Notes: [1] non-residents
Source: NBU, ICU.

FX market indicators (12 March 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	25.9000	-1.52	-3.18
EUR/USD	1.2334	-0.56	+15.56
DXY[2]	89.895	+0.31	-11.21
UAH TWI[3]	114.113	+2.01	+3.37

Notes: [1] UAH trade-weighted index.
Source: Bloomberg, ICU.

Gov't bond quotes[1] (13 March 2018)

Maturity	Bid	Ask
6m	**17.50**	**16.50**
12m	**17.50**	**16.50**
2y	**17.00**	**16.00**
3y	**17.00**	**16.00**
12m ($)	**5.10**	**4.70**
2y ($)	**5.30**	**5.00**

Notes: [1] Actual quotes you can see at www.icu.ua.
Source: ICU.

Domestic liquidity and bonds market

Key policy rate pushes bond yields up

Primary bond market yield curve mostly flat at around the key policy rate; could rise further.

At Tuesday's primary auction, the MoF had to increase its cut-off rates to or above 17% in order to borrow UAH1.22bn. For three-month bonds, the cut-off rate was up 150bp, to 17.50% with a weighted-average rate of 17.43%. At the same time, for bonds with 6-12 months maturity, the cut-off rate was set at 17.00%.

Those rates that were already low rose less significantly: three-month maturities were 17%, the six month was 16.60%, the nine month came in at 16.75%, and one-year maturities were at 16.50%. Weighted-average rates were in the range of 16.92–16.99%. Interest rates for two and three-year bonds also rose, but less significantly, to 16.15%.

ICU view: The Ministry of Finance had to increase rates to attract financing for the budget, especially to fund short-term requirements that are due this year. This week, we could see another increase in interest rates. The MoF has limited short-term offerings, any may only be able to attract financing by raising rates.

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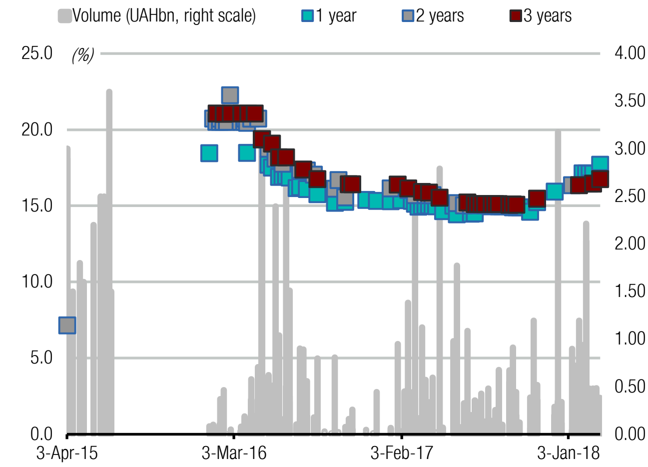
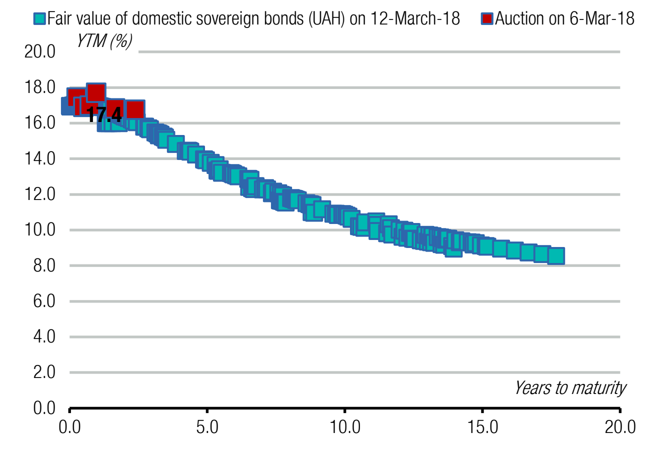
Chart 1. Local-currency bonds

Three-year history of domestic government bond placements at primary market: proceeds (in billions) and yields-to-maturity (%)



Source: Ministry of Finance of Ukraine, ICU.

Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



Source: National Bank of Ukraine, Ministry of Finance of Ukraine, ICU.

Liquidity down to UAH94bn

After staying above UAH100bn for more than a week, total banking-sector liquidity fell to UAH94bn last Wednesday after significant outflows to budget and from cash. However, we see an opportunity for recovery.

Before the four-day weekend holiday, exchange of reserves into cash accelerated. During first two days of last week, net exchange into cash amounted to UAH2.88bn. In the week prior, transactions were reversed in that banks exchanged cash into reserves. The additional outflow caused the Treasury to absorb UAH6.6bn on Monday and Tuesday. Also on Monday, banks repaid UAH2.0bn of loans to the NBU.

NBU supported liquidity by only UAH0.69bn on Tuesday. On Wednesday morning, liquidity was UAH94.08bn, including UAH42.46bn in banks' correspondent accounts with the NBU and UAH51.62bn of total CDs outstanding. Two-week maturity CDs stood at UAH33.61bn.

ICU view: Next week, we expect to see support from the NBU via the FX market. With more balanced Treasury operations, liquidity should stay at UAH90-100bn with a possible recovery above UAH100bn.

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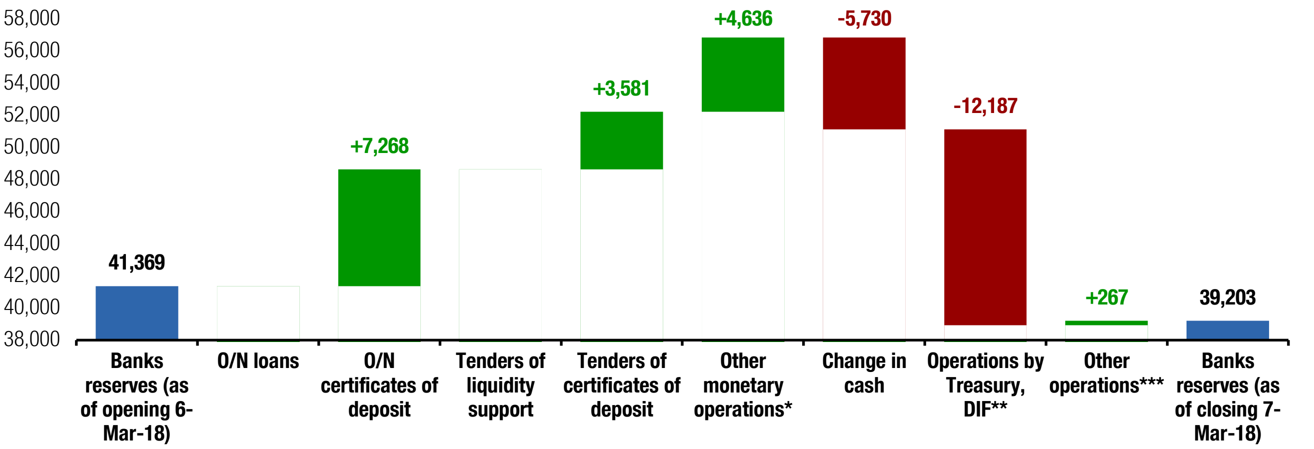
Chart 2. Banks reserves usages over last week(UAHm)



Notes: [1] data from the NBU's daily reporting https://bank.gov.ua/control/uk/publish/article?art_id=38643651&cat_id=40807142 ;
* operations repo, purchase and sale of government bonds, FX market interventions, stabilisation loans, FX swap agreements; ** DIF – deposit insurance fund;
*** interest payments on NBU's loans and on NBU's certificates of deposit, other operations. Source: NBU, ICU.

Foreign exchange market

UAH boosted by NBU's interest rate hike

The increase of the key policy rate by another 100bps to 17% made investment in the hryvnia more attractive, increasing demand for the Ukrainian currency.

Key drivers for the UAH's strengthening were the sale of foreign currency by non-residents to pay for purchases of local government bonds, the closing of banks' FX currency positions in order to capture profits on the back of expectations of further UAH strengthening, and investing in hryvnia-denominated assets.

Last week, the hryvnia strengthened by 2.3% in nominal terms, to 26.05 UAH/USD. Its CPI-based real trade-weighted index rose 1.81% to 113.05; in year-on-year terms, it is up 3.29% from 109.44 last year.

ICU view: The higher key policy rate, as well as the increased supply of US dollars on the local currency market helped the hryvnia to continue to strengthen last week. In our view, higher rates of local government bonds, seasonal demand from exporters, lower oil prices, and a weak US dollar on world FX markets will continue to support the hryvnia. However, the effect of these factors will gradually weaken, and the potential for further strengthening of the hryvnia appears to be limited.

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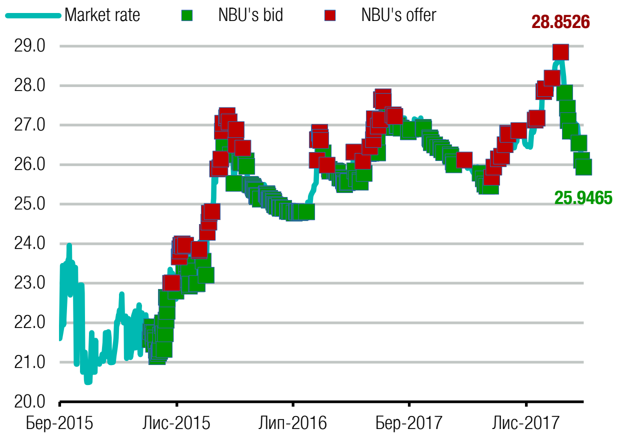
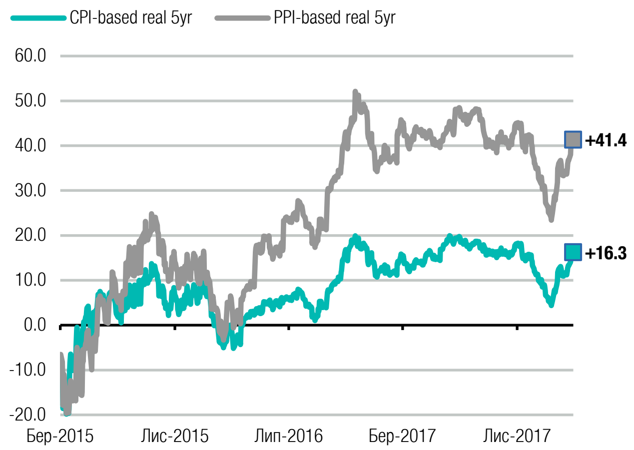
Chart 3. FX market indicators, 3-year history

Ukraine hryvnia UAH exchange rate per US dollar at the interbank market



Notes: the chart provides labels for the average exchange rate at last two NBU auctions (one on buying FX from the market and one on selling it). Source: NBU, Bloomberg, ICU.

UAH exchange rate misalignment[1] from fundamental level[2] (%)



Notes: [1] "+" overvalued, "-" undervalued; [2] based on the UAH's CPI- and PPI-based real TWIs. Source: ICU.

Economics

Greenback's prospects in light of tariffs, labour market statistics, and elections in Italy

The US dollar responded to Trump's decision to impose trade barriers, strong labour market data, and elections in Italy by weakening further. This may persist, and we see it as supportive for the UAH.

Last week, at the behest of the President Trump, the US imposed a 25 percent tariff on steel imports and a 10 percent tariff on aluminum imports. This attempt to force the adjustment of imbalances in current accounts of the world's leading countries is only the beginning of the Trump administration's efforts to support domestic production. It implies that the long-term prospect for the US dollar is a weakening against the euro and the Chinese yuan.

Statistics released on the number of new jobs created in February in the US, exceeded market expectations by 53%. This performance works in the Trump administration's favor, indicating that the full employment rate cannot yet be precisely determined. Real monthly wages increased by 2.2% YoY, which supported financial markets. The greenback responded to this solid labour market data with a 0.1% weakening, which is an atypical reaction, and indicates that there are other factors that are overwhelming what would otherwise be supportive news. At the same time, it should be noted that the Fed's plan to raise its rate on monetary reserves in three or four steps of 25bps each, may slow inflation and support the US dollar. However, due to the high level of indebtedness of businesses and households in the US, raising interest rates will increase their burdens. This step could have serious repercussions.

Another event of last week—elections in Italy that brought new parties into power—indicates that the economic problems of the recent debt crisis in the euro area is still putting pressure on southern member states. The broader representation of Eurosceptic politicians in the parliaments of EU countries should strengthen the euro to a level that is in line with the economic situation in Germany, the leader of the Eurozone. This will also put downward pressure on the US dollar.

ICU view: For the coming weeks, we hold to our view that there will be a gradual and cautious weakening of the US dollar. This creates additional support for the hryvnia. For a more detailed analysis of the impact of the new tariff policy and the US labour market, as well as the elections in Italy, for the dollar, see our blog (in Ukrainian).

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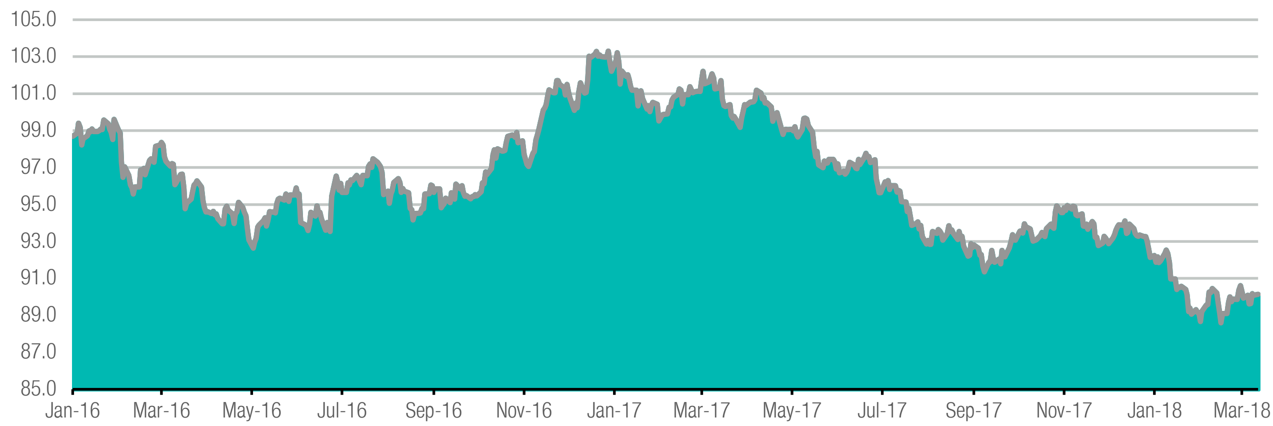
Chart 4. DXY index



Source: Bloomberg, ICU.

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