



Focus
Ukraine

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

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Weekly Insight

Budget deficit persists

Key messages of the today's comments

Domestic liquidity and bonds market

Investors exchange hryvnia in FX

Upon maturity last week, investors exchanged local-currency bonds for new FX-denominated issues. We could see similar behaviour in the coming weeks.

Liquidity depends on Treasury operations

Due to the impact from Treasury operations, liquidity in the banking system was around UAH110bn and will probably rise due VAT refunds.

Foreign exchange market

Hryvnia remains under pressure

This week, the imbalance of demand and supply of foreign currency will persist because of continuing VAT refunds and payments on UAH-denominated domestic government bonds.

Economics

Budget deficit persists

Central government budget balance improved slightly in June, bringing the 1H18 budget balance to a deficit of UAH9.8bn.

IMF approved anticorruption law, still awaiting gas-tariff hike

The IMF finally approved a package of laws adopted by the Ukrainian Parliament on the establishment and functioning of the anti-corruption court (ACC). At the same time, the government has extended the action of current gas tariffs for the population until 1 September. Nevertheless, we expect that Ukraine will reach a final agreement with the IMF about the tariffs at the beginning of autumn.

Industrial production rose 2.2% YoY in June

Growth rates of industrial output slowed to 2.2% YoY in June, down from 2.5% YoY in May, bringing the 1H18 reading to a growth of 2.5% YoY. Solid households' consumption and higher investment activity will support industrial production in 2H18.

TUESDAY, 31 JULY 2018

Banks' reserves market (30 July 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	17.50	+0bp	+500bp
ON rate (%)	16.40	+10bp	+480bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	50,761	-12.34	+13.65
DepCerts (UAHm) ³	61,366	+19.44	+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) (30 July 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	350,323	+0.00	-4.78
Banks	357,222	-0.10	+20.44
Residents	22,281	+0.72	+5.00
Individuals	3,946	+8.97	+460.72
Non-res ⁴	8,765	-8.00	+270,427.16
Total	742,538	-0.09	+8.18

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

FX market indicators (30 July 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	26.7880	+0.93	+3.31
EUR/USD	1.1706	+0.16	-0.38
DXY ²	94.348	-0.28	+1.17
UAH TWI ³	117.393	-1.42	+3.52

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

Gov't bond quotes¹ (31 July 2018)

Maturity	Bid	Ask
6m	18.00	17.35
12m	18.25	17.40
2y	18.00	16.75
3y	18.00	16.75
12m (\$)	5.50	4.85
2y (\$)	5.70	5.00

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

Domestic liquidity and bonds market

Investors exchange hryvnia in FX

Upon maturity last week, investors exchanged local-currency bonds for new FX-denominated issues. We could see similar behavior in the coming weeks.

Having large debt repayments in FX in the near future, the Ministry of Finance offered a considerable amount of FX paper, which resulted in an exchange of local-currency repayments into new FX-denominated bonds. Last week, the MoF offered two bills in hryvnia and five in FX, selling two and four instruments, respectively. For more details see [our review of last week's auction](#).

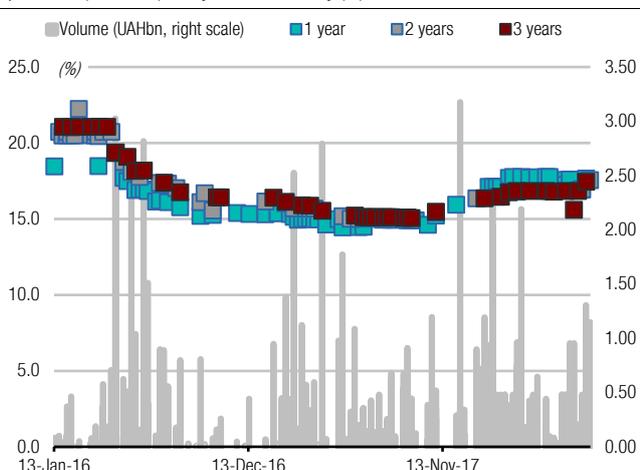
As the result, total outstanding of local-currency bonds declined by UAH3.1bn, and outstanding of FX-denominated debt rose by UAH2bn, taking into account the weakening of the hryvnia. Only individuals' portfolios of local-currency bonds rose last week. The largest decline was seen in banks and foreign investors' portfolios, by UAH1.6bn and UAH1bn, respectively. Non-banks' portfolios slid by UAH0.6bn. At the same time, for FX-denominated debt, portfolios rose for all groups of investors (except the NBU). But foreign investors' portfolio of FX-denominated bonds rose due to the exchange-rate movement, while other groups purchased additional bonds: banks by UAH1.2bn, UAH0.6bn for non-banks, and UAH0.14bn for individuals' portfolios.

ICU view: *This partial exchange of portfolios was expected, as large issues of UAH-denominated bills were maturing that had been sold at the beginning of this year when the hryvnia was the cheapest. Therefore, we saw the return to the FX and a partial withdrawal of funds by foreign investors. The same movements could be seen in the following weeks, but with smaller debt repayments in local currency and likely large offerings of FX-denominated bonds.*

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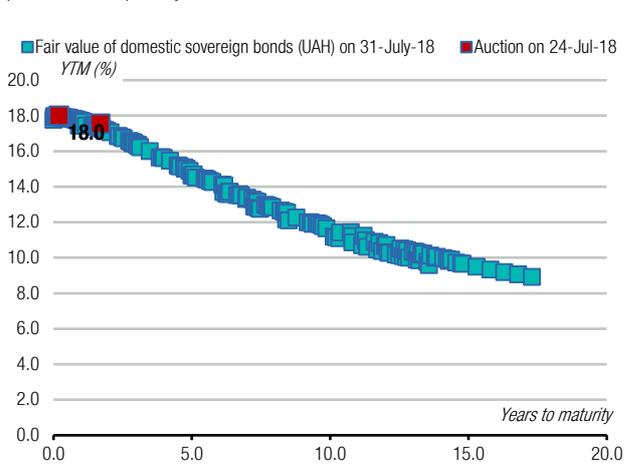
Chart 1. Local-currency bonds

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.

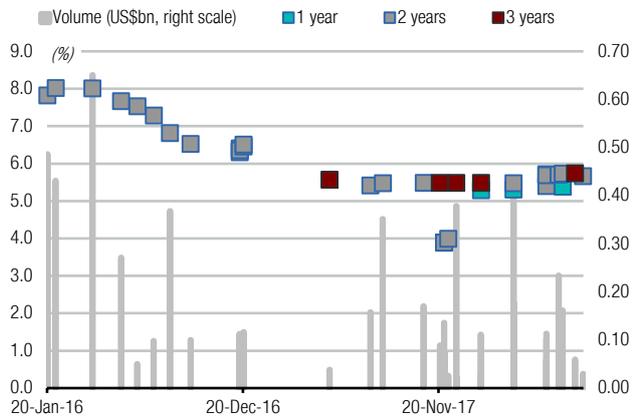
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

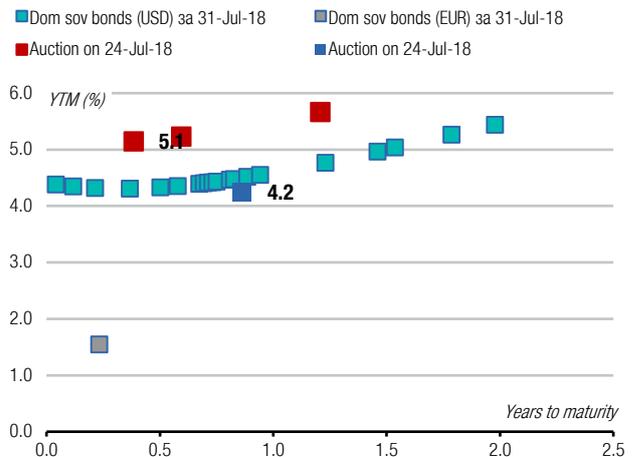
Chart 2. FX-denominated bonds

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 depends on Treasury operations

Due to the impact from Treasury operations, liquidity in the banking system was around UAH110bn and will probably rise due VAT refunds.

Last week, liquidity recovered to above UAH110bn after declining a week ago. The main impact was from the Treasury, which absorbed funds at the beginning of last week. Later, the Treasury paid UAH5.6bn in domestic-debt repayments, and at the end of last week paid UAH5.1bn in VAT refunds. NBU's operations in the FX market had a low impact, absorbing UAH1.9bn, which was mostly compensated with cash exchange into reserves at UAH1.7bn.

Banks held UAH50bn in their accounts at the NBU with a slight increase of total CDs outstanding to above UAH60bn after liquidity rose.

ICU view: This week, we have the end of month-end tax payments. Yesterday likely was the last tranche of VAT refunds, which amounted to UAH2.3bn. So, today's liquidity could rise slightly. Later this week, liquidity can decline due to reserves exchanged in cash and outflows to the NBU via the FX market if the NBU continues to sell FX from reserves.

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Chart 3. Banks reserves usages over last week(UAHm)

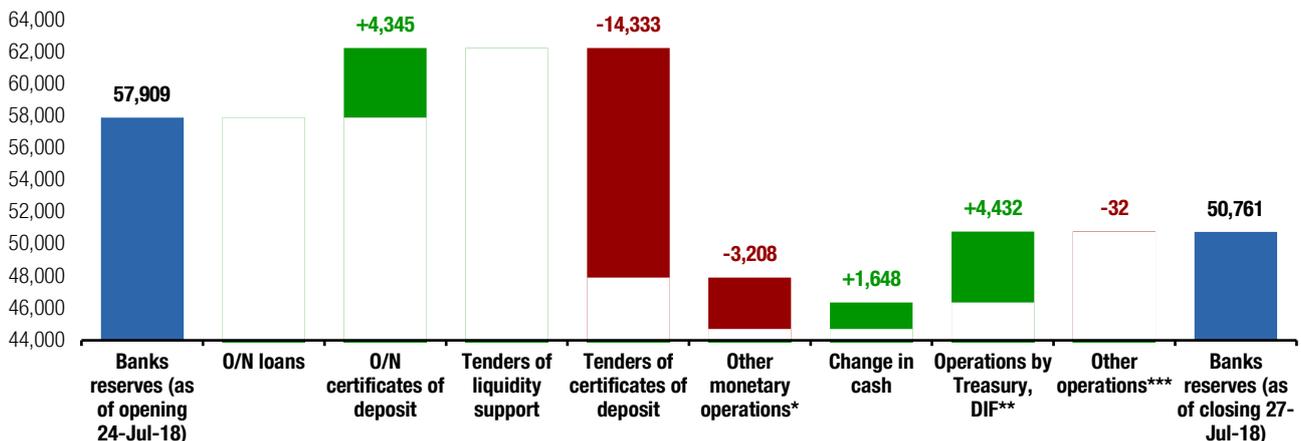
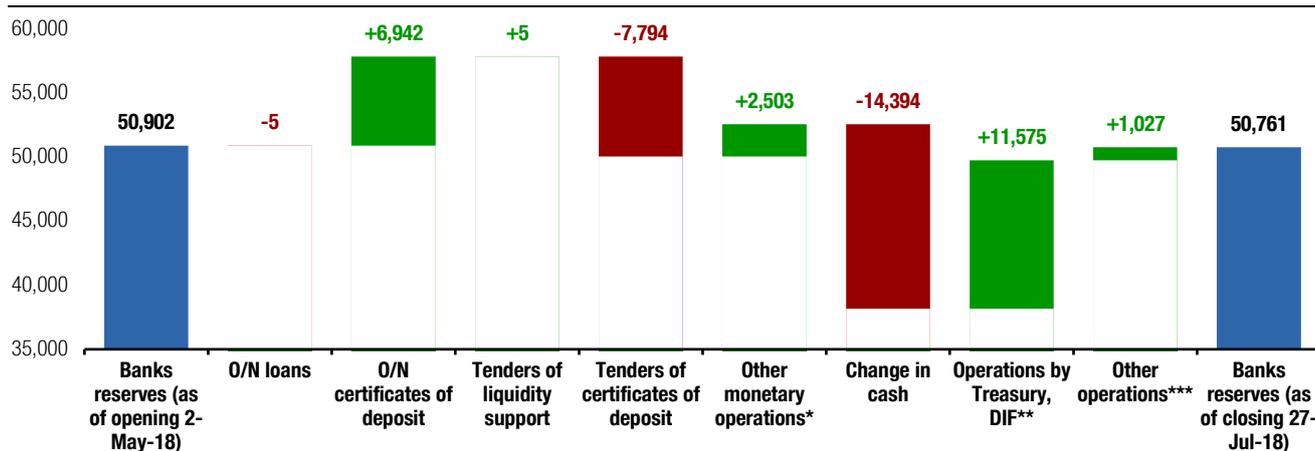


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

Hryvnia remains under pressure

This week, the imbalance of demand and supply of foreign currency will persist because of continuing VAT refunds and payments on UAH-denominated domestic government bonds.

The hryvnia weakened 1.1% last week to 26.73 UAH/USD. The reasons were both an increase in demand for the currency due to significant payments on UAH-denominated domestic government bonds (UAH5.6bn), as well as a decrease in the FX supply as a result of VAT refunds for UAH5.1bn on Thursday and Friday, which allowed exporters to retain foreign currency, thus reducing FX supply.

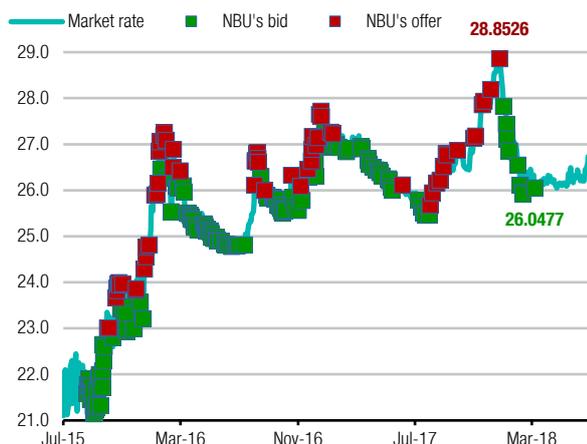
The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries trade partners of Ukraine) decreased 1.1% to 118.1 for the period. In year-on-year terms, real trade-weighted indices (CPI and PPI based) increased 3.8% and decreased 1.2%, respectively.

ICU view: The imbalance of FX demand and currency supply will remain, as VAT refunds will continue at the beginning of the week, implying a reduction in FX supply. On the other hand, there will be an increase in FX demand for dividend payments to foreign investors starting in August. Thus, we expect that the hryvnia will remain under pressure this week. At the same time, we do not rule out the possibility that the hryvnia may start strengthening after excess FX demand is satisfied.

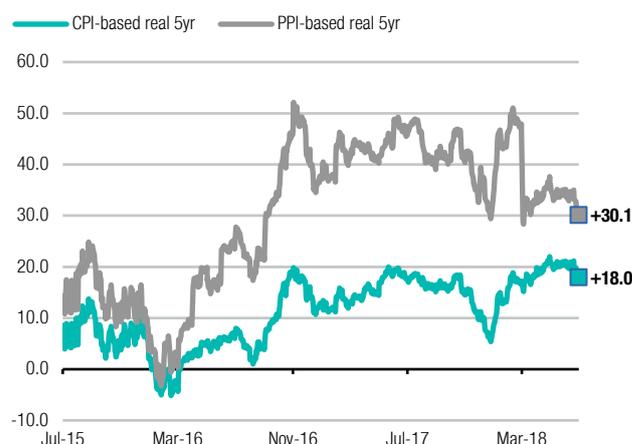
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Chart 5. FX market indicators, 3-year history

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 misalignment¹ from fundamental level² (%)

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

Economics

Budget deficit persists

Central government budget balance improved slightly in June, bringing the 1H18 budget balance to a deficit of UAH9.8bn.

According to the State Treasury, tax revenues decreased compared with May, when there were quarterly tax payments, and amounted to UAH51.3bn. At the same time, there was an increase in income-tax revenues, proceeds from excises and non-tax revenues. The proceeds from excises were boosted by taxation of domestically produced goods, while proceeds from imported goods decreased to UAH3.5bn, down from UAH4.6bn in May. Central budget revenues were boosted by non-tax revenues, primarily by transfers from the NBU and dividends from Naftogaz, which totaled UAH27.3bn in June.

Budget expenditures also decreased and were UAH0.2bn less than revenues. But this did not allow to reduce the budget deficit, which grew by UAH0.6bn due to the increase in budget lending, primarily because of providing loans to the State Road Agency of Ukraine.

ICU view: The central budget deficit increased by UAH0.6bn compared with May, but budget deficit as percentage of revenues it declined to 2.2%, down from 2.7%, which is quite positive dynamics. In addition, the primary surplus increased from UAH41.6bn to UAH45.6bn. However, the improvement was due to non-tax revenues, and further proceeds look rather insignificant -- UAH6bn from the NBU and UAH17.7bn from Naftogaz (according to Oksana Markarova, acting Minister of Finance). Thus, in August, performance can be improved thanks to quarterly tax payments, but in July, the situation may be less positive than in June.

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IMF approved anticorruption law, still awaiting gas-tariff hike

The IMF finally approved a package of laws adopted by the Ukrainian Parliament on the establishment and functioning of the anti-corruption court (ACC). At the same time, the government has extended the action of current gas tariffs for the population until 1 September. Nevertheless, we expect that Ukraine will reach a final agreement with the IMF about the tariffs at the beginning of autumn.

On 26 July, the IMF spokeswoman [told Reuters](#) that the legislative framework for the ACC, once the recently adopted amendments are signed into law, will be consistent with the authorities' commitments under Ukraine's IMF-supported programme. At the same time, the IMF representative said that discussions on other outstanding issues, including gas prices and the government budget, are ongoing.

The same day, the government adopted a decision on extending by one month the current tariffs for natural gas consumed by the population. Since July 2017, the Ukrainian government offered the IMF at least eight options to change the formula for gas prices, which would allow to avoid a significant rise in price, which the Fund insists on.

ICU View: With the approval of the ACC law by the IMF, Ukraine has made a significant step towards unlocking financial aid programmes of the Fund. At the same time, the government continues its efforts to minimize the hike in gas tariffs in the talks with the IMF. The government's main arguments are: 1) the major part of the population's consumption of gas is satisfied with domestic production, 2) the actual transportation costs are significantly lower than those used in the import parity formula, 3) future reforms of the gas sector, including unbundling of Naftogaz, will help to eliminate corruption caused by differences between gas tariffs for the industry and the population. To bring the gas tariffs for the population in line with the prices of the current import parity, the increase could range from 15-50%, depending on the agreed pricing methodology. We expect that the government will be able to agree on raising gas tariffs in the range of 20-25%, and thus open the way to obtain the IMF loan tranche in 4Q18.

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Industrial production rose 2.2% YoY in June

Growth rates of industrial output slowed to 2.2% YoY in June, down from 2.5% YoY in May, bringing the 1H18 reading to a growth of 2.5% YoY. Solid households' consumption and higher investment activity will support industrial production in 2H18.

In seasonally-adjusted terms industrial production rose 0.2% YoY in June. Processing industry growth slowed to 2.8% YoY, down from 3.2% YoY in May, while it rose 1.4% MoM SA. The highest growth rates posted chemical industry (+30.3% YoY) and manufacture of motor vehicles (+17.3% YoY).

Mining and quarrying sector contracted 0.6% YoY in June after a decline of 1.9% YoY in May. However, seasonally-adjusted data imply increase of 1.5% MoM in June. The utilities sector rose 4.8% YoY and contracted 2.5% MoM SA.

ICU view: Despite low base of comparison due to severance of economic ties with temporarily uncontrolled territories in early 2017 and high households' consumption, the growth rates of industrial output turned out to be lower than our baseline scenario of 3.3% YoY growth in 1H18. Still, higher output volumes in the mining industry against the backdrop of increased investments in the sector, acceleration of government expenditure on infrastructure projects and solid consumer demand will drive the growth of industrial production in 2H18.

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