

Weekly Insight

NBU keeps key rate at 18%

Key messages of the today's comments

Domestic liquidity and bonds market

Ukraine successfully placed US\$2bn of Eurobonds

Last week, the MoF held a roadshow and successfully placed US\$2bn of new Eurobonds. Part of the money raised will be spent on early redemption of short-term Eurobonds issued in August 2018.

MoF successfully navigates through FX repayments peak

During October, the Ministry of Finance raised US\$687.5m and EUR54.7m, taking it through the peak of domestic FX repayments during the second half of October. Going forward, the Ministry will offer FX-denominated bonds to refinance current repayments.

Liquidity up with budget expenditures

The total amount of liquidity at the end of last week rose to UAH82.9bn due to VAT refunds and cash exchange in reserves. But this week, month-end tax payments should decrease liquidity, as the Treasury will accumulate funds for debt repayments in November.

Foreign exchange market

Hryvnia weakens on VAT refunds

At the end of last week, the hryvnia lost 0.5% due to lower FX supply as a result of significant VAT refunds. This week, the hryvnia should strengthen somewhat due to the month-end tax payments and a more balanced FX market.

Economics

NBU keeps key rate at 18%

The key rate remains at 18% at least until 13 December amid positive developments in Ukraine-IMF cooperation.

Industrial production fell 1.3% YoY in September

Industrial output contracted for the second consecutive month by 1.3% YoY in September after a 0.5% YoY decline in August, slowing 9M18 growth to 1.8% YoY. Thanks to solid consumer demand and acceleration of budget expenses, industrial production will resume growth in 4Q18.

Retail trade turnover rose 6.9% YoY in September

Household consumption will remain the key driver of economic growth in 2018 and 2019 being supported by further growth of real incomes.

WEDNESDAY, 31 OCTOBER 2018

Banks' reserves market (30 October 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	18.00	+0bp	+450bp
ON rate (%)	17.78	-57bp	+558bp
ON \$ swap (%)	17.23	+15bp	+529bp
Reserves (UAHm) ²	50,938	-5.96	+16.98
DepCerts (UAHm) ³	29,180	+25.42	-13.98

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 October 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	348,100	+0.00	-3.46
Banks	364,243	-1.54	+15.82
Residents	20,159	-3.75	-9.22
Individuals	5,241	+0.50	+481.32
Non-res ⁴	7,211	+0.60	+56.84
Total	744,953	-0.85	+6.00

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

FX market indicators (30 October 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	28.1700	+0.11	+4.97
EUR/USD	1.1345	-0.41	-2.63
DX ²	97.011	+0.60	+2.59
UAH TWI ³	116.121	-0.03	+3.12

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

Gov't bond quotes¹ (31 October 2018)

Maturity	Bid	Ask
6m	19.75	18.50
12m	19.75	18.10
2y	19.50	18.00
3y	19.50	17.50
12m (\$)	7.50	5.00
2y (\$)	7.50	5.20

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

Domestic liquidity and bonds market

Ukraine successfully placed US\$2bn of Eurobonds

Last week, the MoF held a roadshow and successfully placed US\$2bn of new Eurobonds. Part of the money raised will be spent on early redemption of short-term Eurobonds issued in August 2018.

In total, the Ministry received US\$4.9bn of demand, which allowed it to decrease rates from initial guidance of 9.25% for the five-year and 10% for the 10-years bonds. Final terms were set at a 9% yield (8.994% coupon rate) for the 5-year bonds and 9.75% for the 10-years.

The final spreads to the benchmark were 602bp and 661bp for the five-year and 10-year Eurobonds, respectively. The MoF received a minor positive impact for pricing from the decline in US Treasury yields last week.

ICU view: Issuing new Eurobonds should allow the MoF to redeem short-term borrowings in November and get through debt repayments at least until March of 2019. Tranches expected from the EU and the WB guarantee should increase FX reserves in government accounts and allow enough time for new external borrowings. More details in our separate research [note](#).

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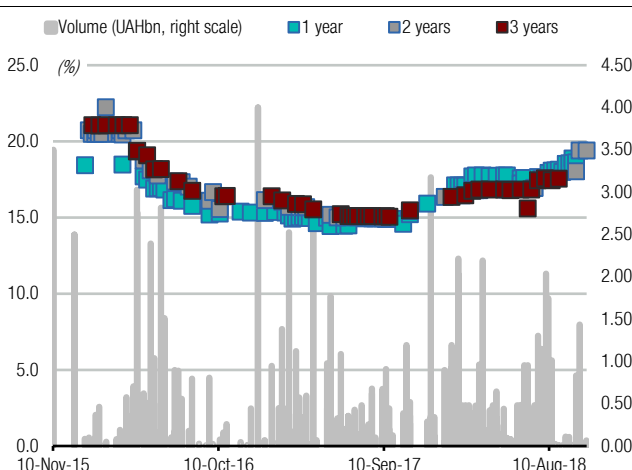
MoF successfully navigates through FX repayments peak

During October, the Ministry of Finance raised US\$687.5m and EUR54.7m, taking it through the peak of domestic FX repayments during the second half of October. Going forward, the Ministry will offer FX-denominated bonds to refinance current repayments.

The Ministry of Finance has offered FX-denominated bills twice a week to accumulate funds to make debt repayments in full. But last week, about half of the demand for bills in euros was rejected because it would have required raising the cut-off rate by 40 bp (please read auction [report](#) for more detail). Additional auctions were not held because of the expected revenues from Eurobonds.

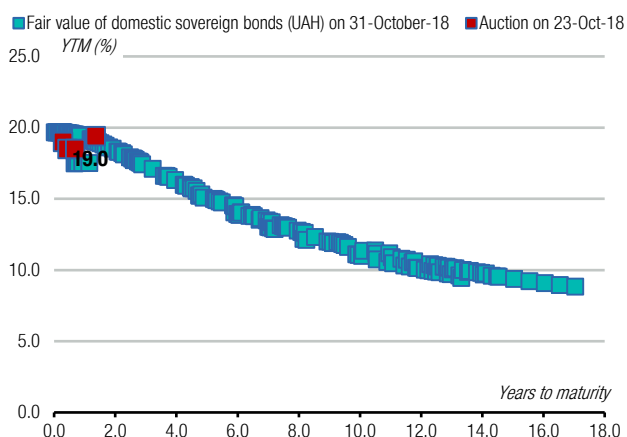
Chart 1. Local-currency bonds

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.

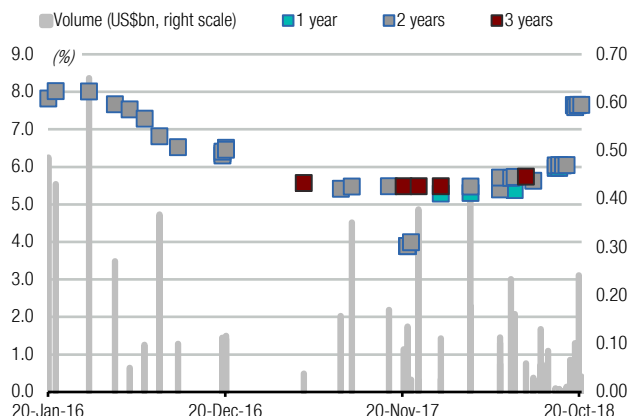
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

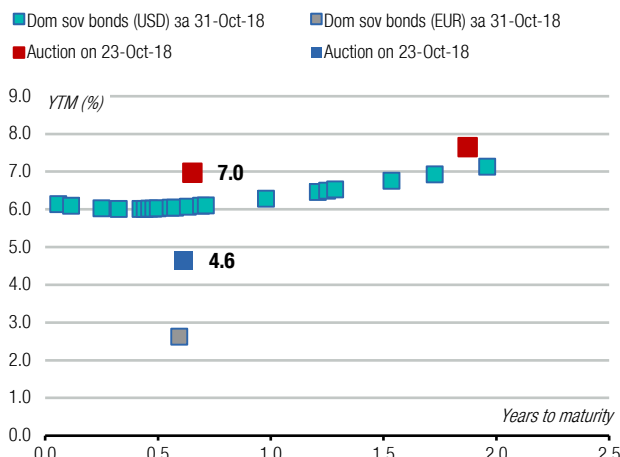
Chart 2. FX-denominated bonds

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.

ICU view: Domestic debt repayments in FX through the end of the year will amount to less than US\$300m. Since they fall in the second half of November through mid-December, there is enough time to accumulate FX funds, or funds from external borrowings could be used for repayments. When funds from Eurobonds are received at the end of this week, budget financing from borrowings will be completely fulfilled. The MoF will borrow from the domestic market to cover proceeds from privatizations yet to be received. So, primary auctions will take place every week, but with low probability of yield changes.

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Liquidity up with budget expenditures

The total amount of liquidity at the end of last week rose to UAH82.9bn due to VAT refunds and cash exchange in reserves. But this week, month-end tax payments should decrease liquidity, as the Treasury will accumulate funds for debt repayments in November.

Last week, liquidity began at UAH77.4bn. The Treasury subsequently provided inflows as debt repayments and VAT refunds, which was supported by cash exchange in reserves. The NBU provided additional inflows through transactions in the FX market.

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

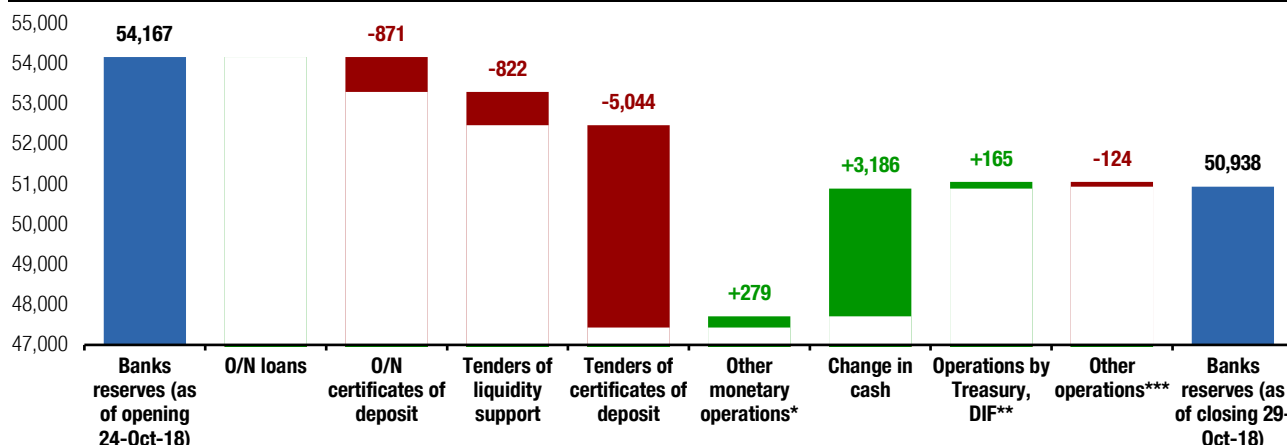
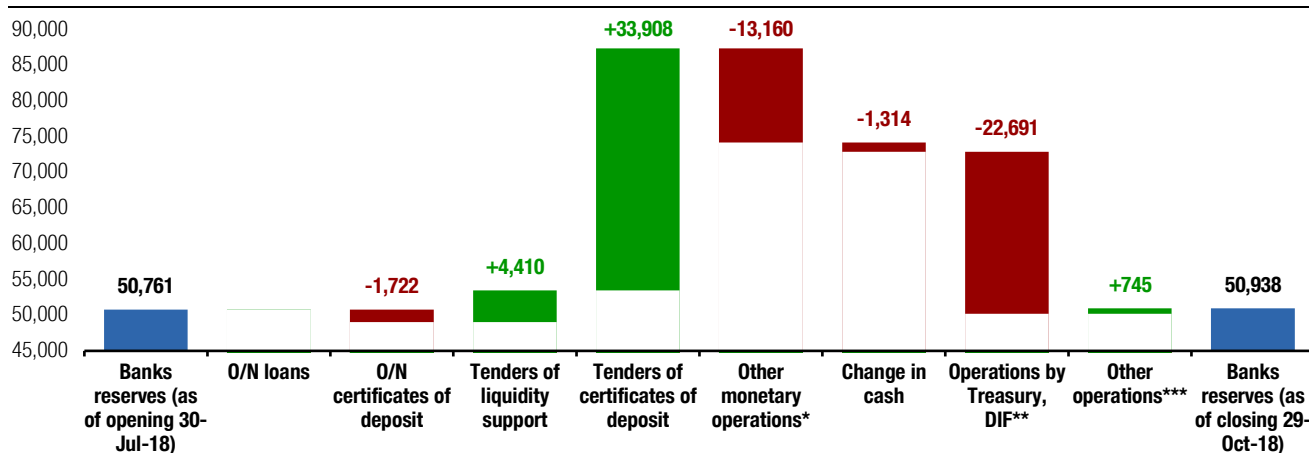


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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.

ICU view: Liquidity exceeded UAH80bn due to concentrated payments from the state budget. This week, liquidity will not receive such support, as funds will be accumulated in Treasury accounts for local-currency debt repayments starting in first half of November. To smooth hryvnia volatility, the NBU most likely will sell some FX and absorb funds from liquidity.

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Foreign exchange market

Hryvnia weakens on VAT refunds

At the end of last week, the hryvnia lost 0.5% due to lower FX supply as a result of significant VAT refunds. This week, the hryvnia should strengthen somewhat due to the month-end tax payments and a more balanced FX market.

Last week started with sluggish hryvnia weakening in anticipation of a push to accelerate the decline, which was came through at the end of the week through VAT refunds. Last Thursday and Friday, the Treasury paid more than UAH7bn of VAT refunds, which decreased the offerings of FX from large exporters and caused imbalance at the market. This was the main reason that the hryvnia weakened to UAH28.27/USD at Friday's close.

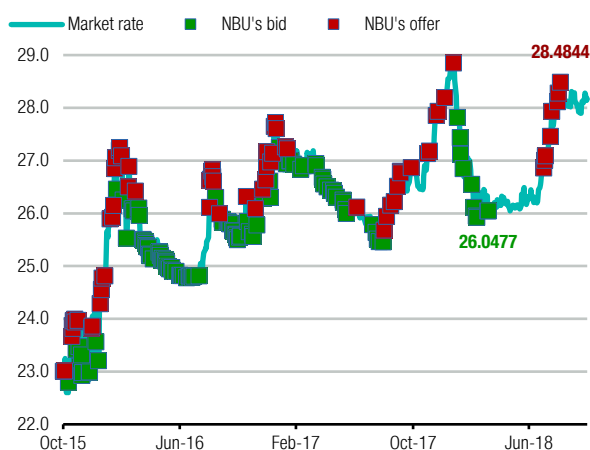
The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) remained steady at 115.5, while in YoY terms, it was up 2.5%.

ICU view: Actually, most VAT refunds have been paid, to they will not have sufficient impact on the hryvnia's exchange rate this week. The hryvnia should strengthen a bit, and rise to about UAH28.2/USD by the end of this week.

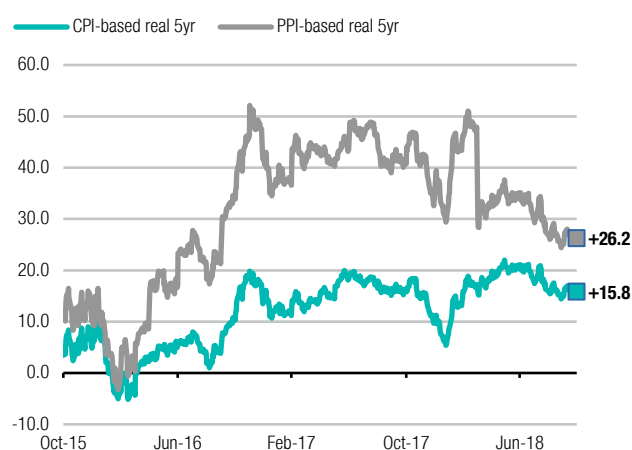
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Chart 5. FX market indicators, 3-year history

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

NBU keeps key rate at 18%

The key rate remains at 18% at least until 13 December amid positive developments in Ukraine-IMF cooperation.

The National Bank of Ukraine considers the current level of the key rate to be (18%) to be enough to lower inflation in the medium-term. The announcement of the staff-level agreement on the new stand-by loan from the IMF and subsequent bond placement are positive signals confirming the base-case scenario. However, the NBU's inflation forecast for 2018 was revised upward from 8.9% YoY to 10.1% YoY.

ICU view: *ICU view: We consider NBU's decision to be an expression of optimism despite the IMF deal not being finalized as it is still contingent on the budget adoption. In our view, Ukraine has not yet begun a downward inflation trend, and NBU could increase the rate during upcoming meetings.*

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Industrial production fell 1.3% YoY in September

Industrial output contracted for the second consecutive month by 1.3% YoY in September after a 0.5% YoY decline in August, slowing 9M18 growth to 1.8% YoY. Thanks to solid consumer demand and acceleration of budget expenses, industrial production will resume growth in 4Q18.

In SA terms, industrial output remained unchanged compared with August. The processing industry, which accounts for 57% of total industrial output, declined 1.6% YoY, primarily due to contraction in engineering (except repair and installation of machinery and equipment), which fell 4.5% YoY, and metallurgical output (-1.3% YoY). In seasonally adjusted MoM terms, the processing industry remained flat.

The utilities sector fell 3.9% YoY (+0.9% MoM SA) in September following a 6.4% YoY drop in August. The only sector that posted growth was mining (+0.7% YoY), albeit slowing from

2.3% YoY in August and 4.5% YoY in July due to a decline in mining metal ores (-3.2% YoY in September).

ICU view: Industrial production will resume growth in 4Q18 thanks to robust consumer demand and acceleration of budget expenses by year-end. However, due to the decline in industrial output in August and particularly in September, we cut our full-year forecast to growth of 2% YoY (vs. 3% YoY previously).

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Retail trade turnover rose 6.9% YoY in September

Household consumption will remain the key driver of economic growth in 2018 and 2019 being supported by further growth of real incomes.

Retail turnover increased by 6.9% YoY in September and by 5.5% over the 9M18. According to seasonally adjusted data, retail turnover of retail trade enterprises declined by 0.6% MoM in September (ICU est.) By region, the highest growth in retail trade in 9M18 was observed in the Luhansk region (+27.9% YoY), the Donetsk region (+13.7% YoY), the Poltava region (+11.1% YoY) and the Zakarpattia region (+11.1% YoY).

ICU view: Thanks to further increases in household real incomes against the backdrop of 1) rising volumes of remittances, 2) pension reform, and 3) further growth of real wages prompted by economic growth, the lack of qualified worker due to labour migration and increases of minimum wages in 2018 and 2019, household consumption will remain strong and will be the key driver of economic growth in 2018 and 2019.

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