

Weekly Insight

Ukraine and Russia agreed on gas transit

Key messages of the today's comments

TUESDAY, 24 DECEMBER 2019

Domestic liquidity and bonds market

Foreigners hold 14% of Ukrainian T-bills

As expected, last week, foreigners invested an additional UAH5bn (US\$0.2bn) in Ukrainian local-currency debt, increasing their share in total T-bills outstanding above 14%. This week, we do not expect any significant changes in portfolios.

Liquidity inflows continue

The government's decision to curtail some budget expenditures decreased inflows in banking-sector liquidity from the Treasury. But last Saturday, liquidity set a new record high, and this week may continue to increase.

Foreign exchange market

Hryvnia has highest appreciation among world currencies for 2019

According to Bloomberg, with appreciation of 19% this year, the hryvnia comes in first in the world in terms of appreciation. Since the NBU has purchased a significant amount of hard currency from foreign investors, the hryvnia exchange rate should remain in the range of UAH23-23.5/USD by the end of this year.

Economics

Real GDP rises 4.1% YoY in 3Q19

The Ukrstat revised down 3Q19 Ukraine's real GDP estimate by 0.1ppt to 4.1% YoY and 0.6% QoQ SA growth. Economic growth will slow into 4Q19 due to the lower YoY harvest and the weak performance of industrial production.

Economic growth will slow in 4Q19

While consumer and investment demand remained solid in October-November, a significant drop in agricultural output and industrial production point to deceleration of economic growth in 4Q19.

Ukraine and Russia agree on gas transit

The key points of this agreement—less reduction in transit volume than expected by the market, payment of fines from Gazprom, and eliminating the risk of transit disruption—improve Ukraine's macroeconomic outlook for 2020.

Banks' reserves market (23 December 2019)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	13.50	+0bp	-450bp
ON rate (%)	11.16	-79bp	-562bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	68,551	-3.35	+35.82
DepCerts (UAHm) ³	97,293	+4.41	+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) (23 December 2019)

	Last	Weekly chg (%)	YoY chg (%)
NBU	337,065	+0.00	-3.17
Banks	327,997	+1.42	-10.73
Residents	25,797	-0.48	+34.90
Individuals	9,473	+0.30	+61.85
Non-res ⁴	115,472	+5.11	+1,748.46
Total	815,804	+1.26	+9.28

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

FX market indicators (23 December 2019)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	23.2725	-0.82	-19.07
EUR/USD	1.1089	-0.55	-2.49
DXY ²	97.658	+0.45	+0.72
UAH TWI ³	140.989	+1.12	+17.58

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

Gov't bond quotes¹ (24 December 2019)

Maturity	Bid	Ask
6m	13.75	11.75
12m	13.75	11.50
2y	13.50	11.25
3y	13.50	11.00
12m (\$)	5.00	3.75
2y (\$)	5.00	4.00

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

Domestic liquidity and bonds market

Foreigners hold 14% of Ukrainian T-bills

As expected, last week, foreigners invested an additional UAH5bn (US\$0.2bn) in Ukrainian local-currency debt, increasing their share in total T-bills outstanding above 14%. This week, we do not expect any significant changes in portfolios.

Last week, the MoF sold UAH4bn of four-year notes and UAH0.9bn of 2.6-year paper (see auction [comment](#)). There is a high probability that most of these instruments were purchased by foreigners, as they usually are not interested in shorter maturities. It is possible that they also bought paper in the secondary market, as the total increase in portfolio was larger than above mentioned issues.

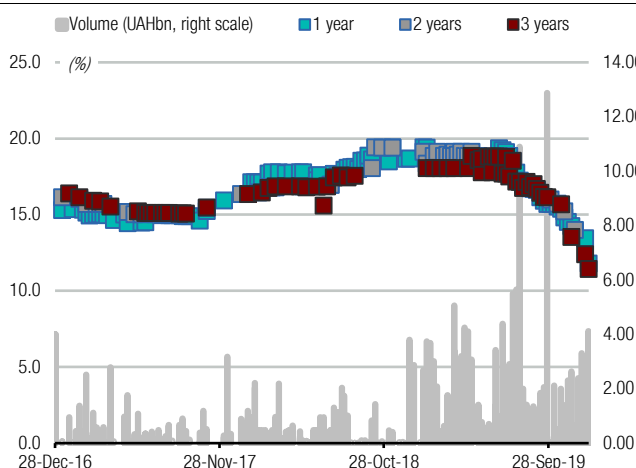
As a result, foreign investors' share in total domestic bonds outstanding rose to 14.15%, the highest level since August 2017, when foreigners started to invest in local-currency bills. Total foreigners' portfolios outstanding rose 17x to UAH115.5bn including 98.65% of local-currency paper.

ICU view: Most likely, foreigners will change their portfolios insignificantly as this week's offering is very low. Additionally, foreigners' activity will be lower due to the holiday season and finalizing the financial year. Therefore, a new wave of investments in Ukrainian debt will come next year when new auctions begin.

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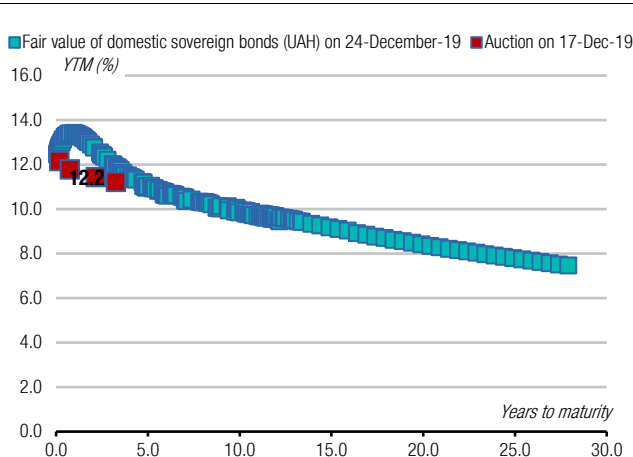
Chart 1. Local-currency bonds

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.

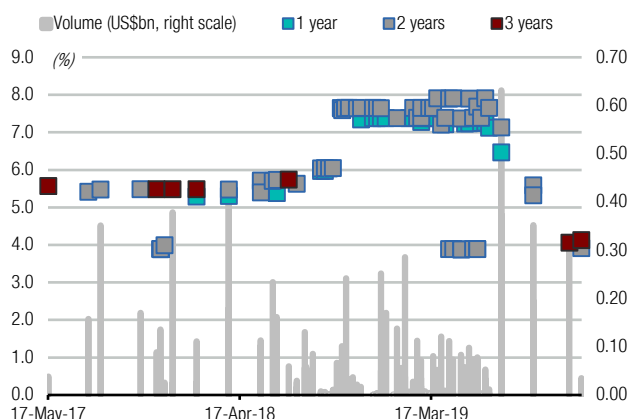
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

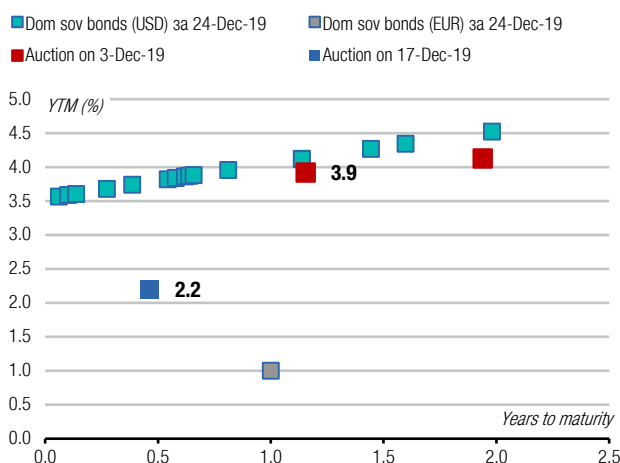
Chart 2. FX-denominated bonds

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 inflows continue

The government’s decision to curtail some budget expenditures decreased inflows in banking-sector liquidity from the Treasury. But last Saturday, liquidity set a new record high, and this week may continue to increase.

Last week, the government decided to curtail some expenditures, which caused a reverse in Treasury operations from injection to absorption of liquidity. After UAH2.8bn of inflows last Monday and Tuesday, on Wednesday, the Treasury started to absorb liquidity and by Saturday, outflows amounted to UAH16.3bn. This was the reason liquidity declined to UAH154.4bn last Friday. On Saturday (was a business day in Ukraine), budget expenditures significantly rose to UAH11.4bn and finally last week’s balance of Treasury operations was UAH2bn of outflows.

There has also been an outflow from reserves to cash, probably to satisfy demand for cash prior to the holidays. Outflow via this category was UAH7.7bn, so, with absorption to budget accounts, liquidity outflow through non-monetary operations was UAH9.8bn.

But the key support for liquidity was provided by the NBU, as the NBU purchased a large amount of hard currency from the market providing the banking system with UAH13.2bn of local-currency funds. This injection covered outflows via non-monetary operations and caused liquidity to increase to a new record high of UAH165.8bn. Most of these funds—UAH97.3bn—were invested in CDs. Only UAH25bn of the CDs had ON tenors, and UAH72.3bn had a 14-day tenor.

ICU view: Suspension of budget expenditures had a short-lived impact on liquidity. This week, we expect at least UAH5bn of VAT refunds along with other budget expenditures. So, a decline in liquidity has a very low probability, and banking-sector liquidity most likely will continue to increase to a new record high, especially with a large supply of hard currency.

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

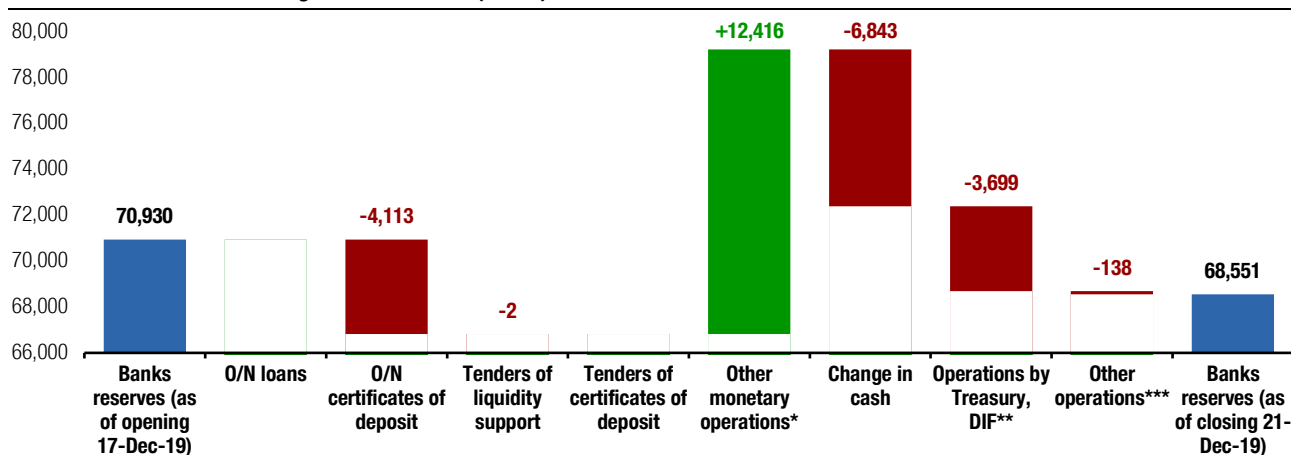
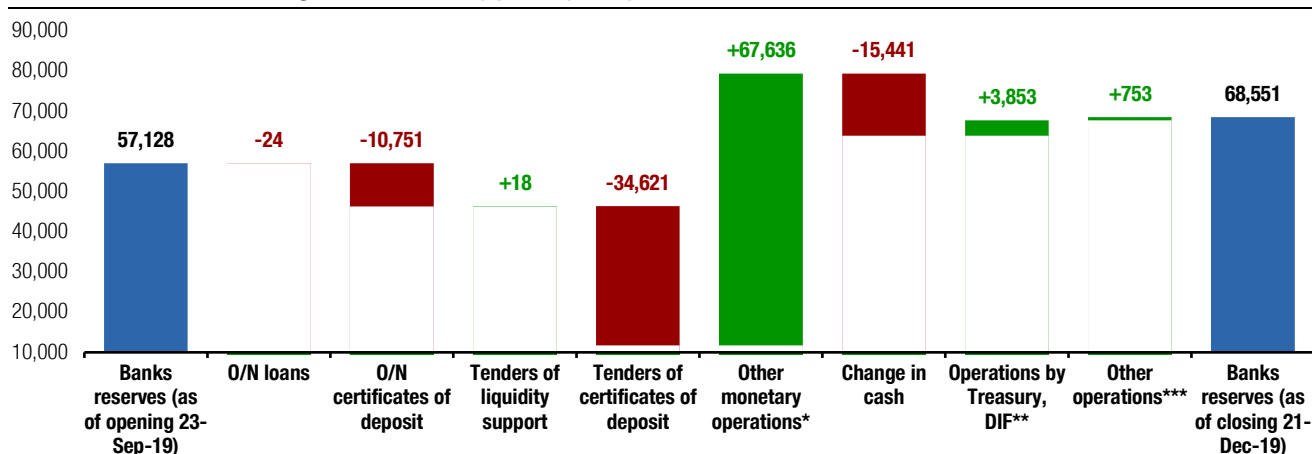


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 has highest appreciation among world currencies for 2019

According to Bloomberg, with appreciation of 19% this year, the hryvnia comes in first in the world in terms of appreciation. Since the NBU has purchased a significant amount of hard currency from foreign investors, the hryvnia exchange rate should remain in the range of UAH23-23.5/USD by the end of this year.

Last week, the NBU purchased US\$564.6m, the largest amount this year, more than what it purchased at the beginning of August 2019, the previous record. Importantly, last week, foreigners purchased new bonds for just US\$230m. This means that the hryvnia's appreciation of 0.7% last week was only partially caused by investments in local-currency notes.

As a result, the hryvnia appreciated to about UAH23.3/USD or 19% YTD. The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) rose 0.8% to 140.6, while in YoY terms, it was up 18.7%.

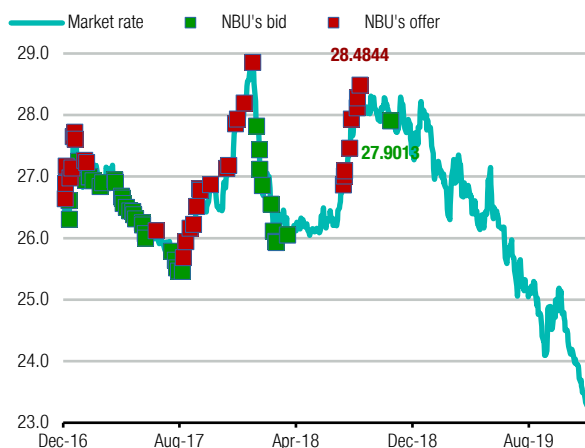
ICU view: Significant supply of hard currency at the market from different participants creates the prerequisites, if not for further strengthening, then for the stabilization of the exchange rate at current levels. Low caps at the auctions this week, offerings of

FX-denominated bills and VAT refunds can together decrease the supply of hard currency, but will not cause significant weakening, and hryvnia should stay between UAH23-23.5/USD by end-2020.

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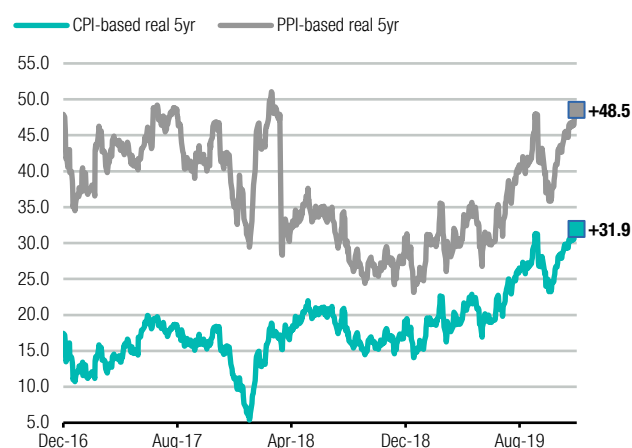
Chart 5. FX market indicators, 3-year history

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

Real GDP rises 4.1% YoY in 3Q19

The Ukrstat revised down 3Q19 Ukraine's real GDP estimate by 0.1ppt to 4.1% YoY and 0.6% QoQ SA growth. Economic growth will slow into 4Q19 due to the lower YoY harvest and the weak performance of industrial production.

Nominal GDP in 3Q19 amounted to UAH1,106bn (+11% YoY), while the GDP deflator was 6.8% YoY. In annualized terms, nominal GDP rose 14% to UAH3,889bn, which is equivalent to US\$146bn (+15.6% YoY). Household consumption remained the key driver of economic growth, but its growth slowed to 8.4% YoY vs 11.8% YoY in 2Q19. Other main drivers were exports of goods and services (+13.5% YoY) thanks to the record grain harvest and fixed capital investments, which accelerated to 13.9% YoY vs 7.9% YoY in 2Q19.

The production approach shows that the key drivers of growth were agriculture (+6% YoY), construction (+21% YoY), and trade (+4% YoY). Among services the highest contribution to economic growth was made by real estate activities (+7% YoY), the IT sector (+7% YoY), and financial and insurance activities (+4% YoY).

ICU view: Due to a lower YoY harvest of some agri products and weak industrial production performance, real GDP growth will slow to 3% in 4Q19, bringing the full-year 2019 reading to 3.6% growth. However, cooling global commodity markets, still-high external debt repayments, which will hinder the government from substantially stimulating consumer and investment demand, as well as lower transit volumes of Russian natural gas will cause economic growth to slow to 3.2% in 2020.

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Economic growth will slow in 4Q19

While consumer and investment demand remained solid in October-November, a significant drop in agricultural output and industrial production point to deceleration of economic growth in 4Q19.

Industrial production slowed for the sixth consecutive month. In November it dropped 1.9% MoM SA and 7.5% YoY. The decline was in all major subsectors — mining sector (-7.9% YoY), processing industry (-6.4% YoY), and utilities (-12.3% YoY). In addition, agricultural output plunged 18.5% YoY in November due to a lower YoY harvest. On the flip-side, retail sales growth accelerated to 12.8% YoY (vs. 11% YoY in October), and construction grew 18% YoY (vs. 14% YoY in October). The transport sector saw mixed dynamics, where cargo turnover rose 4.5% YoY, while passenger turnover fell 3.6% YoY, according to our estimates.

ICU view: Industrial production decline (-6% YoY) and lower agricultural output (-8% YoY) will have a negative impact on the 4Q19 real GDP reading. At the same time, accelerated growth in retail sales and construction imply that consumer and investment demand remain solid and will keep driving economic growth in 4Q19.

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Ukraine and Russia agree on gas transit

The key points of this agreement—less reduction in transit volume than expected by the market, payment of fines from Gazprom, and eliminating the risk of transit disruption—improve Ukraine's macroeconomic outlook for 2020.

Following the two-day meetings, representatives of Russia, Ukraine, the EU, as well as representatives of Gazprom, Naftogaz of Ukraine, and the Operator of the Ukrainian gas transportation system signed a protocol stating the parties' intentions to settle by 29 December all the controversial issues to continue gas transit from 1 January.

The parties agreed to conclude a contract within the framework of EU legislation on gas transit through the territory of Ukraine for five years, with the possibility of its extension on the same terms for another 10 years. The minimum guaranteed transit volume is 65bcm in 2020 and 40bcm each year for 2021-24.

The size of the tariff has not been announced yet. However, according to the Minister of Energy and Environment of Ukraine Oleksiy Orzhel, the parties agreed that the tariff should be increased, and the final figure will be defined by the Ukrainian regulator by the end of the year.

In addition, Russia has agreed to pay Ukraine almost \$3bn of debt under the Stockholm Arbitration decisions. Ukraine will receive the payment in cash by the end of 2019. Instead, Ukraine has agreed to withdraw all arbitrations and lawsuits against Gazprom, which are worth up to \$20bn in total.

ICU view: This preliminary agreement between Ukraine and Russia on gas transit will have a mostly positive effect on Ukraine's macroeconomic outlook in 2020. Although a reduction in the physical volume of transit would result in a decrease in Ukraine's earnings for transport-services exports, it will be significantly less than expected by many observers—28% against a 50% drop according to our forecasts, as well as the forecasts of the NBU. This will mean that our estimates of trade and current account deficits are reduced by \$0.6 billion each or by 0.3% of GDP in 2020. Obtaining \$3bn in penalties from Gazprom under the Stockholm arbitration order is also positive for the state budget. The conclusion of this preliminary agreement also eliminates the risk of gas transit disruption, and this has already caused a 8-11% fall in gas prices in the European market and thus provided additional support to Ukraine's trade balance.

Lower trade deficit and FX proceeds from Gazprom's fines will additionally support the hryvnia exchange rate.

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