

Weekly Insight

Consumer inflation accelerated

Key messages of the today's comments

Domestic liquidity and bonds market

New T-bills meet tiny interest

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Budget returns liquidity

As it turned out, last week's debt repayments were the main inflow into banking-sector liquidity. This week, the Treasury may continue large expenditures, which will further support the recovery of liquidity.

Foreign exchange market

Hryvnia exchange rate stabilizes

The resignation of NBU Governor Smoliy caused just a short-lived increase in demand for hard currency, and the exchange rate stabilized at around UAH27/US\$ last week. But this week, volatility may return due to the process of new NBU governor appointment.

Economics

Consumer inflation rising from May's bottom

In June, after a prolonged period of downward trend, Ukrainian inflation reversed and accelerated to 2.4% YoY. Looking ahead, inflation will continue rising gradually, while remaining below NBU's target range almost to the end of the year. That justifies a slight cut in the interest rate by the NBU.

MONDAY, 13 JULY 2020

Banks' reserves market (10 July 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	6.00	+0bp	-1,150bp
ON rate (%)	5.15	-47bp	-1,108bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	39,656	-12.91	+11.86
CDs (UAHm) ³	117,515	+19.15	+64.67

Notes: [1] NBU's key policy rate; [2] stock of banks' reserves held at NBU; [3] stock of NBU's certificates of deposit.

Source: NBU, Bloomberg, ICU.

Breakdown of govt bond holders (UAHm) (10 July 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.72
Banks	402,572	-4.38	+16.87
Residents	28,180	-7.92	+19.35
Individuals	6,955	-10.53	-23.84
Foreigners ¹	96,676	-3.46	+50.30
Total	858,960	-2.84	+10.32

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (10 July 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.0167	-0.63	+4.55
EUR/USD	1.1300	+0.46	+0.44
DXY	96.652	-0.54	-0.47
UAH TWI ¹	126.194	+0.22	+0.60

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (13 July 2020)

Maturity	Bid	Ask
6m	12.50	9.00
12m	13.00	10.50
2y	13.25	10.75
3y	13.50	11.00
12m (\$)	5.00	3.00
2y (\$)	6.00	3.50

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

Source: ICU.

Domestic liquidity and bonds market

New T-bills meet tiny interest

Last week, the Ministry of Finance made large debt repayments, but it was not able to borrow the sizable amount. Therefore, all portfolios (except the NBU's) declined. This week, we expect to see a decline mostly in foreigners' portfolios.

In total last week, the MoF repaid UAH7.2bn (US\$0.3bn) and US\$672m, mostly in principal repayments. These redemptions, therefore, impacted all bondholders' portfolios. Nonetheless, they were not in hurry to purchase new bills in local currency. The Ministry was able to borrow just UAH313m (US\$11.6m) at last week's auction (more details in [our auction review](#)).

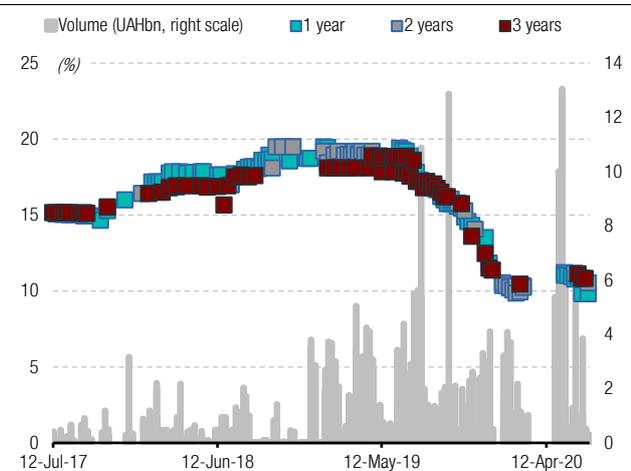
The largest decline was seen in banks' portfolios, as they hold most of both the UAH and USD-denominated bills redeemed last week. Banks' portfolios declined by UAH18.6bn (US\$0.7bn), while non-banks and individuals decreased their portfolios by just UAH2.4bn (US\$88m) and UAH0.8bn (US\$30m), respectively. Foreigners likely hold not only local-currency bills, but also bills in US dollars, which were redeemed last week. Their portfolios declined by UAH3.2bn (US\$119m).

ICU view: Uncertainty about the next NBU governor may further encourage non-residents to sell UAH-denominated bills, but, in general, this will occur without a sharp reduction in portfolios. However, whether domestic investors return to the primary market will depend on the yields offered by non-residents as they exit hryvnia debt. We expect the volume of new bills sold this week to be small. The Ministry of Finance does not need to raise rates to attract more funds, since there was UAH75.7bn (US\$2.8bn) balance in Treasury accounts at the beginning of July.

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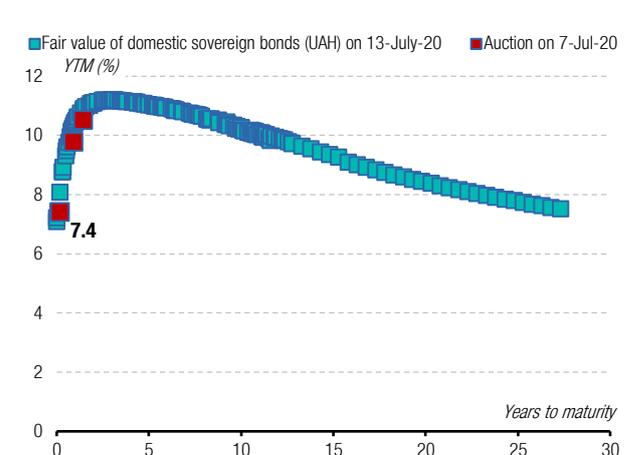
Chart 1. Local-currency bonds

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.

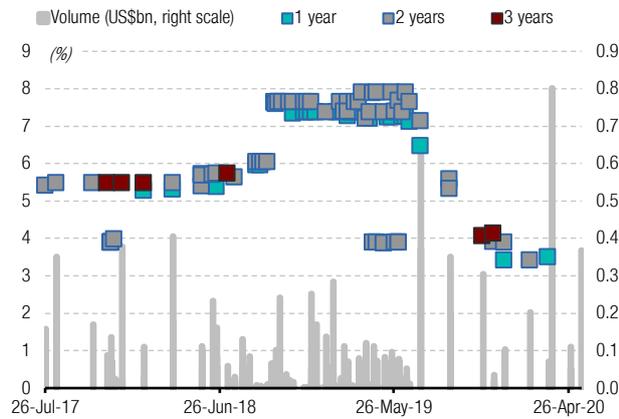
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

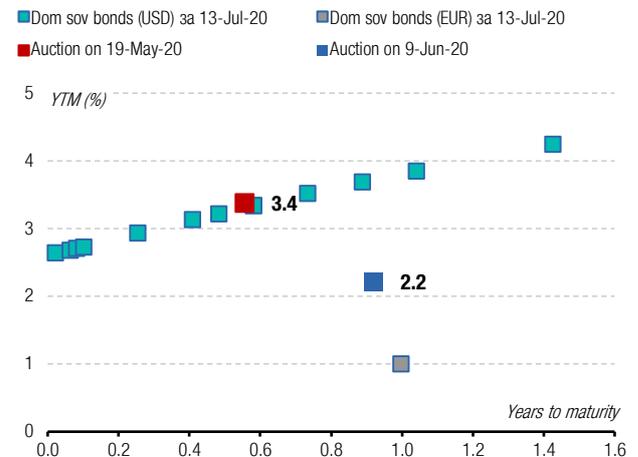
Chart 2. FX-denominated bonds

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.

Budget returns liquidity

As it turned out, last week's debt repayments were the main inflow into banking-sector liquidity. This week, the Treasury may continue large expenditures, which will further support the recovery of liquidity.

Last week, the NBU purchased more hard currency, spending UAH2.5bn with low impact on liquidity in the banking system. Additionally NBU provided seven banks with new 5-year loans amounted to UAH5.1bn.

The key inflow in liquidity was provided by the Treasury. The balance of its operations last week was positive for liquidity in the banking system with UAH19.5bn of inflow. Mostly it was due to debt repayments in local currency of UAH7.2bn, while new borrowings were a mere at UAH313m (see comment above). This repayment increased inflows last Wednesday to UAH9.7bn.

Fluctuations in the FX market were not positive for liquidity, as banks had to increase reserves exchange in cash, and exchanged UAH9.7bn last week.

ICU view: With UAH75.7bn of funds in Treasury accounts at the beginning of July, the government increased budget expenditures, and supported liquidity increasing to UAH162bn last week. This week, without debt repayments, budget expenditures may remain supportive for liquidity. Together with NBU purchases of hard currency, which is likely this week, the total amount of liquidity will continue to recover.

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

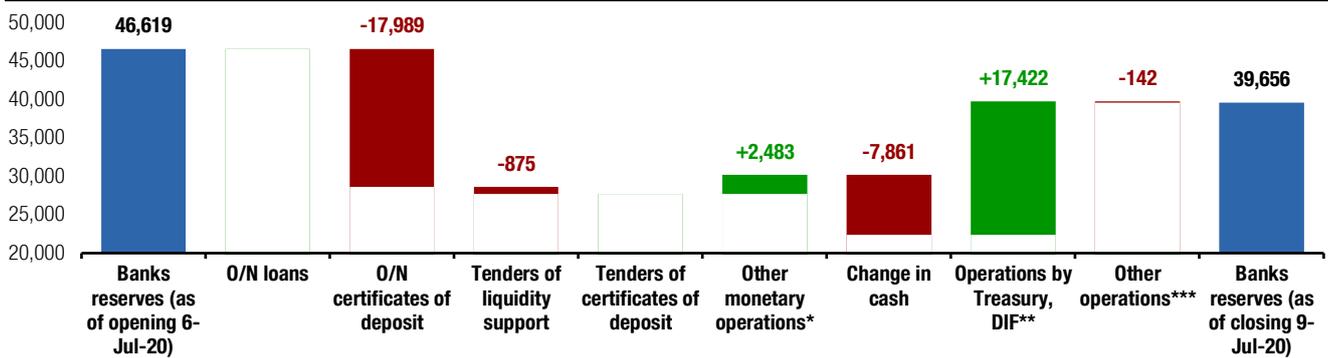
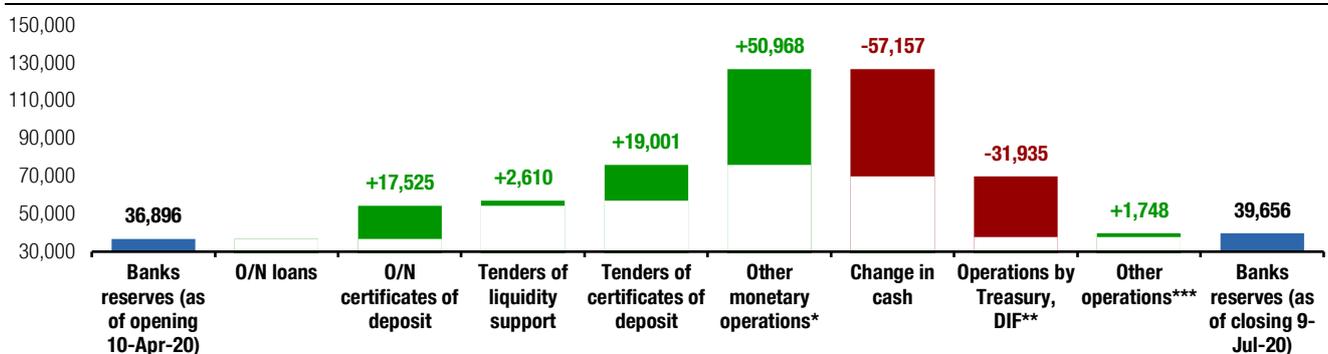


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 exchange rate stabilizes

The resignation of NBU Governor Smoliy caused just a short-lived increase in demand for hard currency, and the exchange rate stabilized at around UAH27/US\$ last week. But this week, volatility may return due to the process of new NBU governor appointment.

The hryvnia exchange rate fluctuated last week at around UAH27/US\$, mostly below this level. Just at the end of last week, hryvnia weakened to UAH27.02/US\$ or just 0.6% during a week.

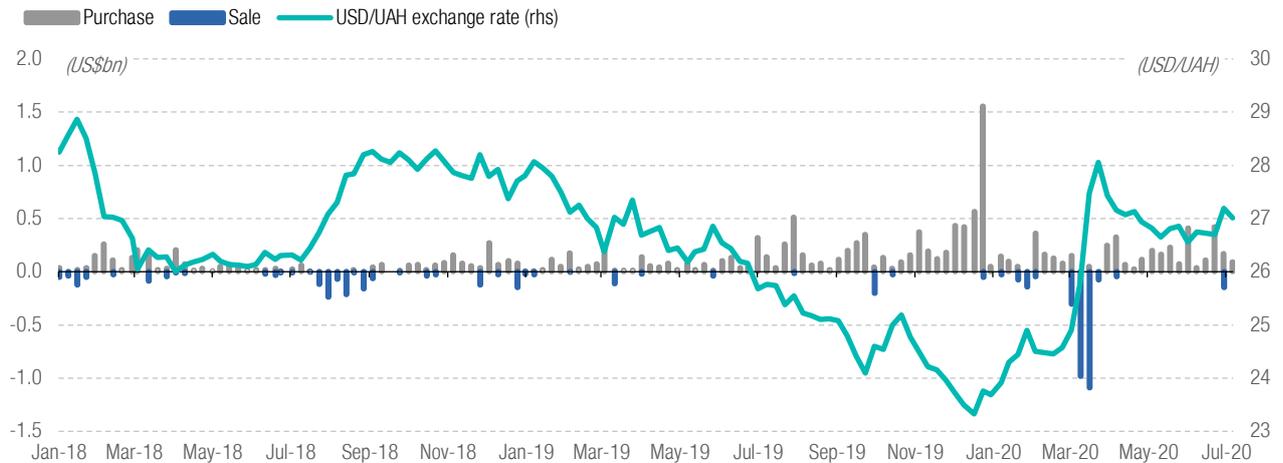
After a large amount of hard currency was sold the next day after the resignation was announced, the NBU increased net purchases of hard currency in FX reserves to US\$92m.

ICU view: This week, the exchange rate should fluctuate around UAH27/US\$ within the range of UAH26.7-27.3/US\$. The main impact will be generated by the appointment of new NBU governor, including announcement of a candidate and voting for him/her in Parliament.

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Chart 5. FX market indicators, 3-year history

Ukraine hryvnia UAH exchange rate per US dollar at the interbank market and NBU interventions (weekly data)



Source: NBU, Bloomberg, ICU.

Economics

Consumer inflation rising from May's bottom

In June, after a prolonged period of downward trend, Ukrainian inflation reversed and accelerated to 2.4% YoY. Looking ahead, inflation will continue rising gradually, while remaining below NBU's target range almost to the end of the year. That justifies a slight cut in the interest rate by the NBU.

Consumer prices grew by 0.3% MoM in June and annual inflation accelerated from the six-year minimum of 1.7% in May to 2.4%. Published figures slightly exceeded both our estimates and the Bloomberg consensus forecast (both - 2.0% YoY). Meanwhile, core inflation stood at 3.0% YoY, remaining almost unchanged since January. Both indicators continued to undershoot NBU's target range of 5% +/- 1 pp for a half a year.

The surge of headline inflation can almost completely be explained by an increase in food inflation to 4.5% YoY from 2.3% YoY in May on the back of a speed up in volatile egg prices growth to 55% YoY from 13% YoY in May and deceleration of the decline in vegetables prices to 12% YoY from 21% YoY in May. These CPI components are highly volatile and changes in their prices in June reflect mostly the low comparison base of last year.

The decomposition by components shows that the key role in low inflation was still played by the fall in prices for gas and utilities (-12.2% YoY), fuel (-26.5% YoY), and clothing and footwear (-4.0% YoY).

Although annual inflation remained low, when measured by the MoM seasonally adjusted annualized rate (SAAR), in the last few months, price growth accelerated to 7–8% for headline inflation and to 4–5% for core inflation.

ICU view: Slightly exceeding our expectations, the June figures are generally in line with our forecast of inflation accelerating to 4.2% YoY by the end of 2020. In our opinion, larger risks are associated with potential changes in the NBU's monetary policy after the governor's resignation.

Nevertheless, the current low values of both headline and core inflation provide additional arguments for a further cut of the NBU's key policy rate at the next monetary policy meeting, which will be held on 23 July. At the same time, we expect the next

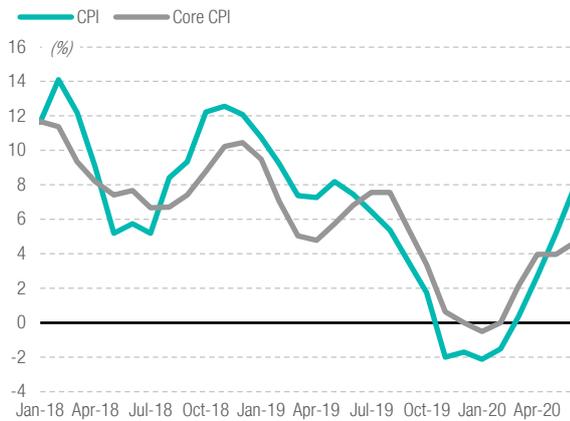
step in cutting the rate to be quite cautious—by 25–50 bp—as the policy rate is already below neutral estimates (7%), and seasonally adjusted annualized growth rates in recent months have been already exceeding the inflation target of 5%, albeit due to the most volatile components of the CPI.

However, this forecast is based on an assessment of the reaction function of the incumbent NBU board members and is subject to significant uncertainty due to the process of appointing a new central bank governor.

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Chart 6. CPI and Core CPI, 3MA MoM SAAR, %

Three months moving average of seasonally adjusted annualized rate of growth compared with the previous month



Source: Ukrstat, ICU.

Chart 7. CPI and Core CPI, YoY, %

Growth rate compared with the corresponding month of the previous year



Source: Ukrstat, ICU.

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