

Weekly Insight

Consumer inflation accelerates

Key messages of the today's comments

Domestic liquidity and bonds market

Yield curve for T-bills normalizes

Last week in the primary auction, the Mo F increased interest rates for 2.5-year bills, bringing them closer to the secondary market. However, we do not anticipate further changes in rates soon.

Liquidity remains steady

Last week, the total amount of banking-sector liquidity remained steady above UAH160bn due to active budget expenditures. This source of inflows will determine liquidity this week too.

Foreign exchange market

Hryvnia weakens slightly

The hryvnia exchange rate continues to weaken gradually, mostly without intervention by the NBU. Assuming the NBU continues to remain on the sidelines, this week hryvnia may weaken to a bit more than UAH28/US\$.

Economics

Consumer inflation accelerates to 2.5% YoY

In August, annual changes in CPI accelerated marginally; however, seasonally adjusted indicators show growing inflationary pressure amid UAH weakening, rapid recovery of consumer demand, wages, and energy prices. Looking ahead, annual inflation will rise gradually and return to NBU's target range in the fall.

MONDAY, 14 SEPTEMBER 2020

Banks' reserves market (11 September 2020)

| | Last | Weekly chg (%) | YoY chg (%) |
|------------------------------|---------|----------------|-------------|
| NBU rate (%) ¹ | 6.00 | +0bp | -1,050bp |
| ON rate (%) | 5.21 | +9bp | -1,060bp |
| ON \$ swap (%) | N/A | ... | ... |
| Reserves (UAHm) ² | 15,372 | -70.20 | -72.89 |
| CDs (UAHm) ³ | 110,718 | -1.35 | +156.35 |

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 gov't bond holders (UAHm) (11 September 2020)

| | Last | Weekly chg (%) | YoY chg (%) |
|-------------------------|----------------|----------------|--------------|
| NBU | 324,577 | +0.00 | -3.71 |
| Banks | 420,564 | +0.68 | +25.18 |
| Residents | 28,060 | -1.30 | +8.71 |
| Individuals | 7,850 | +2.01 | -17.03 |
| Foreigners ¹ | 86,494 | -0.93 | -2.31 |
| Total | 867,544 | +0.21 | +8.87 |

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (11 September 2020)

| | Last | Weekly chg (%) | YoY chg (%) |
|----------------------|---------|----------------|-------------|
| USD/UAH | 27.9499 | +0.85 | +12.09 |
| EUR/USD | 1.1846 | +0.07 | +7.59 |
| DXY | 93.333 | +0.66 | -5.38 |
| UAH TWI ¹ | 121.204 | -1.12 | -9.12 |

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (14 September 2020)

| Maturity | Bid | Ask |
|----------|-------|-------|
| 6m | 10.00 | 8.00 |
| 12m | 10.50 | 9.00 |
| 2y | 11.00 | 10.00 |
| 3y | 11.50 | 10.50 |
| 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

Yield curve for T-bills normalizes

Last week in the primary auction, the MoF increased interest rates for 2.5-year bills, bringing them closer to the secondary market. However, we do not anticipate further changes in rates soon.

Last Tuesday, the Ministry of Finance took an important step toward market sentiment and increased the cut-off rate for 2.5-year bills by 50bp to 10.5% or 25bp above rates for 1.5-year bills (see details in [auction review](#)). This decision finalized normalization of yield-curve in the primary market. The range is now between 7% for three-month bills and 10.5% for 2.5-year paper, which will also be the rate for three-year maturity.

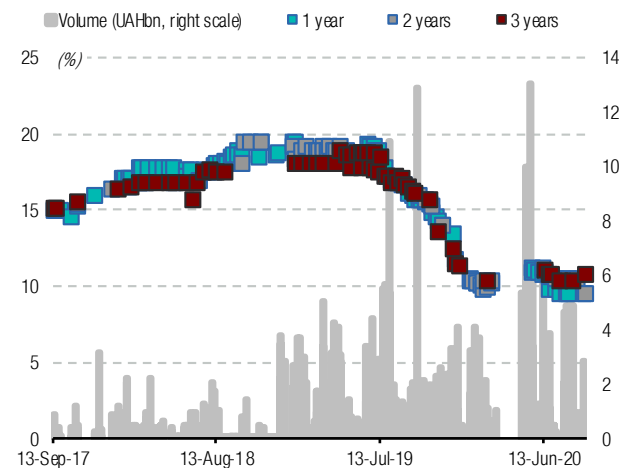
These changes in rates in the primary market did not have an impact on the secondary market and bonds continued to be concentrated in banks' portfolios. However, foreigners were not in a hurry to sell bills. Last week, they decreased portfolios just by UAH421m (US\$15m) to UAH86.5bn (US\$3.1bn) with their share in total bonds outstanding sliding by 6bp to 9.97%

ICU view: Tomorrow, the Ministry is going to offer bills with seven-month and two-year maturities. In addition, they will offer 13-month USD-denominated paper. We do not expect any material changes in interest rates this week in the primary bond market.

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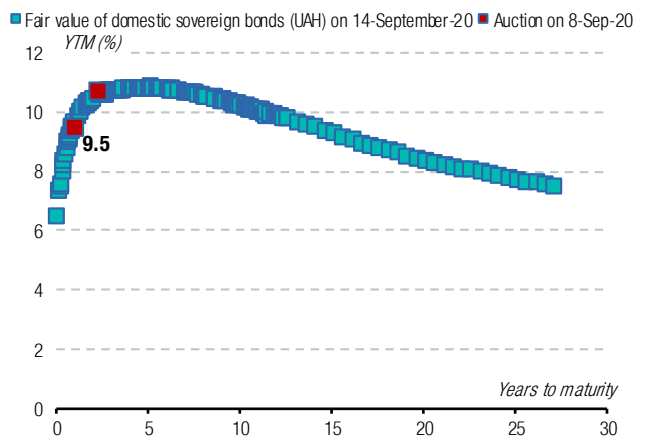
Chart 1. Local-currency bonds

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.

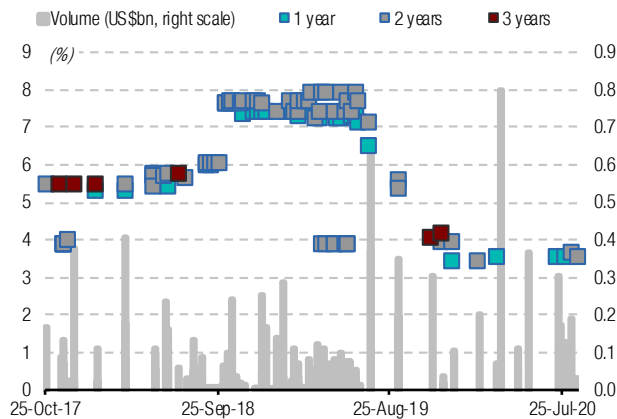
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

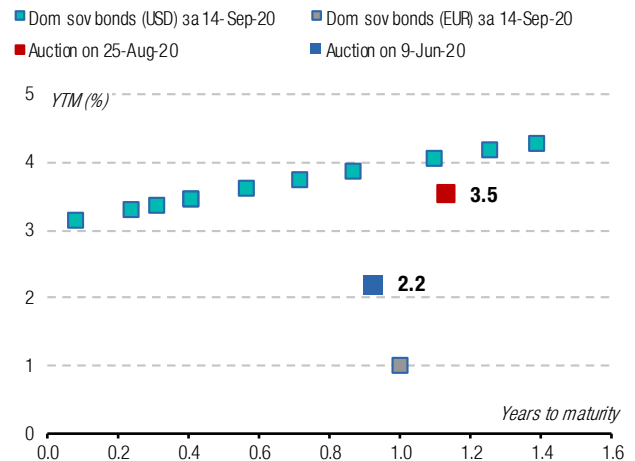
Chart 2. FX-denominated bonds

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 remains steady

Last week, the total amount of banking-sector liquidity remained steady above UAH160bn due to active budget expenditures. This source of inflows will determine liquidity this week too.

The government became active in budget expenditures, gradually increasing outflows from budget accounts into the banking system. NBU did not absorb any funds due to the restrained weakening of hryvnia. On the contrary, NBU purchased some hard currency to replenish international reserves. Together with the Treasury, the NBU created UAH3.8bn of inflows into liquidity.

Only reserves exchange in cash caused outflows from liquidity. Banks increased exchange of reserves in cash to UAH5.8bn from zero seen a week before. Therefore, the banking system ended last week with UAH163bn of liquidity.

ICU view: Generally, liquidity remains steady with fluctuations around UAH160bn. With slight hryvnia weakening and a high level of budget expenditures, liquidity can remain steady despite outflows in cash, which is usual for this part of the month.

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

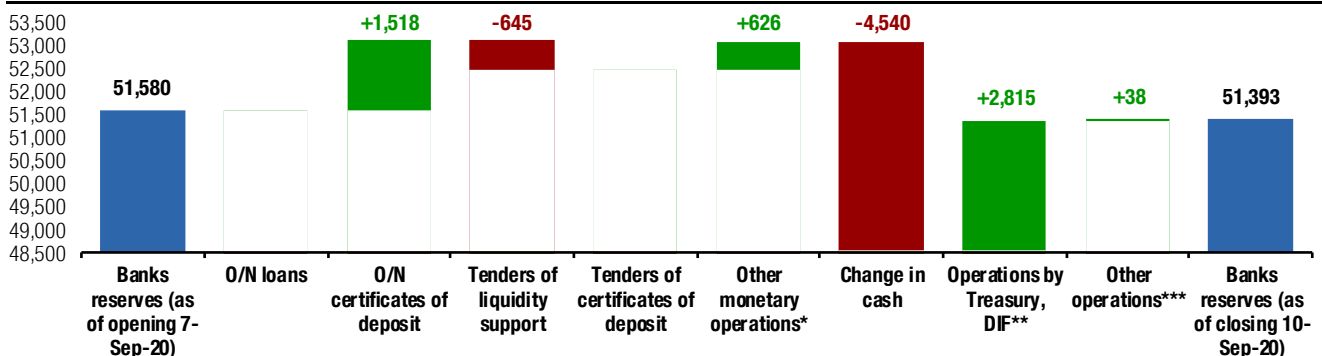
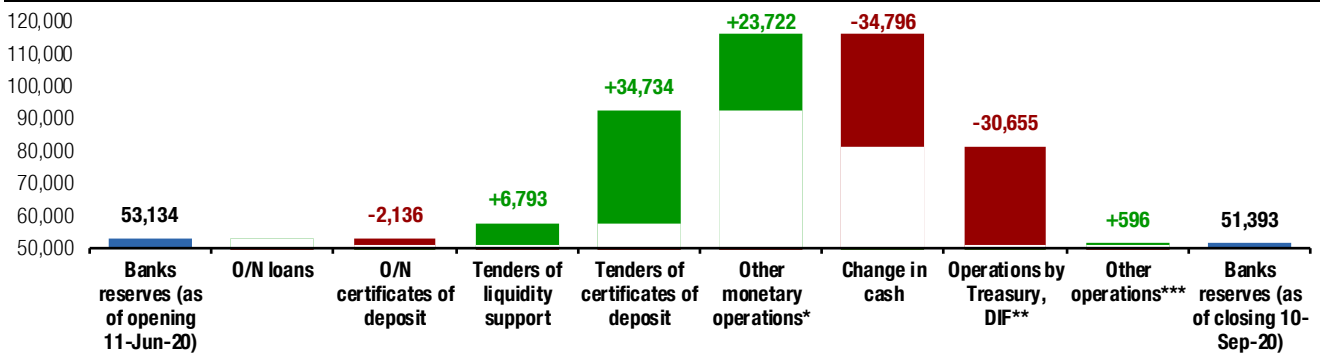


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 weakens slightly

The hryvnia exchange rate continues to weaken gradually, mostly without intervention by the NBU. Assuming the NBU continues to remain on the sidelines, this week hryvnia may weaken to a bit more than UAH28/US\$.

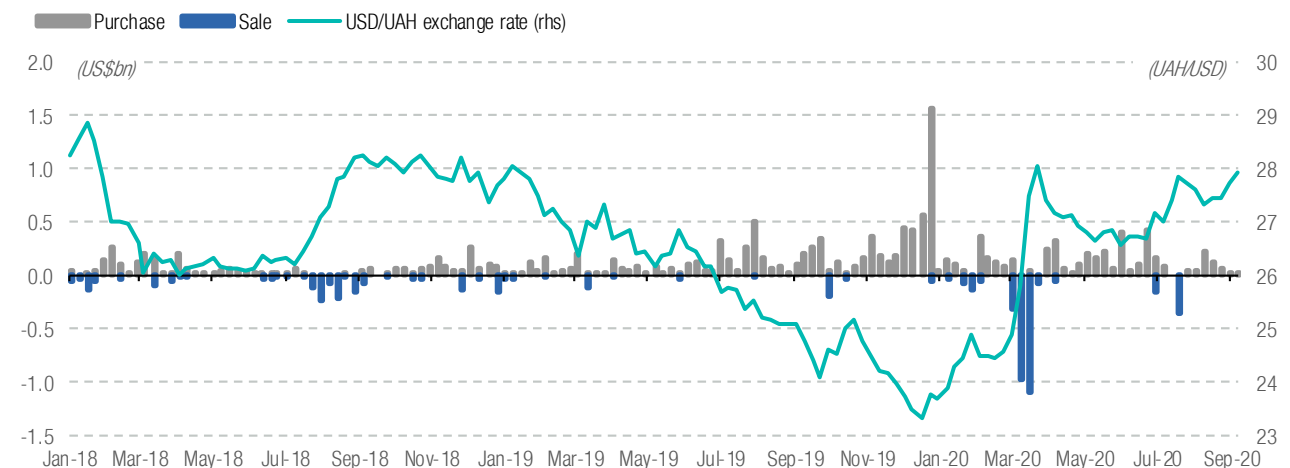
The NBU had low impact in the FX market last week, purchasing just US\$22.5m. Such interventions to replenish international reserves indicate that the market has been self-balanced with a slight weakening of hryvnia and its movement to UAH27.95/US\$ at the end of last week.

ICU view: *This week will be similar to the last one, and the hryvnia will continue to weaken slightly. Without NBU's interventions or only to purchase hard currency, the hryvnia can weaken to slightly above UAH28/US\$.*

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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 accelerates to 2.5% YoY

In August, annual changes in CPI accelerated marginally; however, seasonally adjusted indicators show growing inflationary pressure amid UAH weakening, rapid recovery of consumer demand, wages, and energy prices. Looking ahead, annual inflation will rise gradually and return to NBU's target range in the fall.

Consumer prices fell by 0.2% MoM in August, and annual inflation only slightly accelerated to 2.5% YoY. The outcome was close to our expectations of 2.4% YoY, and a little lower than Bloomberg consensus of 2.7% YoY. Core inflation also increased to 3.2% YoY, remaining almost unchanged since January, while core CPI grew by 0.1% MoM in August.

As in previous months, low annual inflation was caused largely by the fall in global energy prices over the year, leading to lower prices for fuel and utilities in August than a year ago, by 17.9% YoY and 3.1% YoY, respectively. However, compared with previous months, the rate of decline decreased thanks to both the recovery of global prices and the weakening of the hryvnia.

In addition, prices for a number of non-food products (clothing and footwear, home textiles, household appliances, audio equipment, and cameras) are lower than last year, reflecting the impact of both low demand due to the quarantine and the strengthening of the hryvnia at the end of last year. Recent depreciation was not reflected in the prices of previous purchases.

Food inflation is low, 2.3% YoY in August. This year, vegetables, sugar, and meat are cheaper than last year, and egg prices fell sharply again in August. Instead, prices for fruit, bread, and bakery products are rising rapidly.

As expected given the conditions of pandemic and social distancing, the growth of prices for hospitality, recreation, and culture services is slowing. At the same time, inflation in the sectors "health care" and "transport services" is accelerating.

Although annual inflation remained low when measured by the MoM seasonally adjusted annualized rate (SAAR), in the last few months, price growth accelerated to 8–9% both for headline and core inflation. This growing inflationary pressure was caused by UAH weakening, rapid recovery of consumer demand and wages, and raising global energy prices.

ICU view: Low YoY inflation is mainly a legacy of last year's disinflation process and hides growing inflationary pressures in recent months. As the effect of last year's statistical base is exhausted, annual inflation will accelerate.

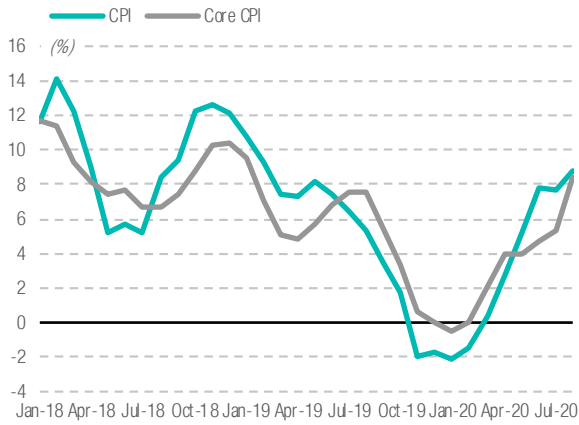
Given the faster recovery of domestic demand and wages, as well as the expected further weakening of the exchange rate, we revised our forecast of consumer inflation at the end of this year to 5.3% YoY, compared with 4.2% YoY in our June projection. In 1Q21, consumer inflation will exceed 6%, the upper limit of the NBU's target range.

Therefore, despite low current annual inflation rates, we believe that the cycle of NBU key rate cuts is over, and after a certain "wait-and-see" period, the NBU will be forced to hike the rate again. This is likely to happen early next year, a half a year earlier than scheduled at NBU's July forecast, which, however, did not take into account the sharp rise of the minimum wage next year.

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

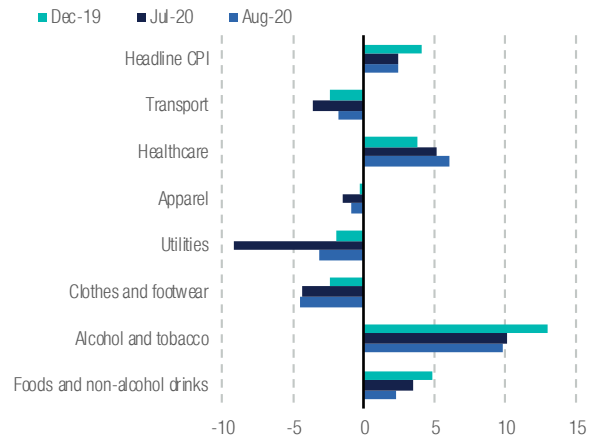
(Three-month moving average of seasonally adjusted annualized rate of growth compared with the previous month)



Source: Ukrstat, ICU.

Chart 7. CPI and its main components, YoY, %

(Slowdown in food inflation offset lower pace of decrease in gas and fuel prices) and acceleration of healthcare-prices growth)



Source: Ukrstat, ICU.

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