

# Weekly Insight

## Consumer inflation surprises on downside

### Key messages of the today's comments

TUESDAY, 13 OCTOBER 2020

### Domestic liquidity and bonds market

#### Higher rates attract larger borrowings

The MoF was able to borrow UAH7.2bn (US\$255m) in October's debut auction, which was almost four times larger than last week. But this result came with the decision to increase rates. In the coming weeks, an increase in rates is also possible, but it will depend on demand.

#### Liquidity increases to UAH176bn

Banking-sector liquidity rose at the end of last week due to an increase in budget expenditures and loans provided by the NBU. However, this week, liquidity can slide to about UAH170bn.

### Foreign exchange market

#### Hryvnia exchange rate stabilizes

Last week, pressure on the hryvnia exchange rate eased, with stabilization at around UAH28.3/US\$. This week, we should see similar dynamics and fluctuations around this level.

### Economics

#### Consumer inflation surprises on downside

In September, both headline and core inflation slowed, to 2.3% YoY and 3.1% YoY correspondingly, against an atypical-for-this-month decline in food prices. Adding slowing demand amid the new outbreak of coronavirus cases, downside risks to our YE2020 forecast (5.3% YoY) prevail. But we still believe that the NBU will keep its policy rate on hold at 6% by the end of this year.

### Banks' reserves market (12 October 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) <sup>1</sup>	6.00	+0bp	-1,050bp
ON rate (%)	5.21	+11bp	-1,018bp
ON \$ swap (%)	N/A	...	...
Reserves (UAHm) <sup>2</sup>	50,348	+29.03	+188.04
CDs (UAHm) <sup>3</sup>	126,122	-2.12	+151.36

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) (12 October 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	+251.71
Banks	438,854	+1.61	+460.58
Residents	30,505	+2.50	+203.70
Individuals	8,331	+1.45	+7,982.67
Foreigners <sup>1</sup>	80,966	-1.46	+1,221.94
<b>Total</b>	<b>883,232</b>	<b>+0.76</b>	<b>+372.59</b>

Notes: [1] non-residents

Source: NBU, ICU.

### FX market indicators (12 October 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	28.2961	-0.11	+15.33
EUR/USD	1.1813	+0.67	+6.98
DXY	93.065	-0.66	-5.33
UAH TWI <sup>1</sup>	120.582	-0.68	-10.51

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

### Gov't bond quotes<sup>1</sup> (13 October 2020)

Maturity	Bid	Ask
6m	10.00	8.00
12m	10.50	9.50
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](http://www.icu.ua).

Source: ICU.

# Domestic liquidity and bonds market

## Higher rates attract larger borrowings

The MoF was able to borrow UAH7.2bn (US\$255m) in October's debut auction, which was almost four times larger than last week. But this result came with the decision to increase rates. In the coming weeks, an increase in rates is also possible, but it will depend on demand.

At last week's auction, interest rates were increased for all offered UAH-denominated instruments, and only a small portion of demand was rejected. An increase was seen for three-month bills, which were up 20bp to 7.2%. But for longer bills, the increase in rates was a bit more substantial: for 12-month bills, the rate was up 50bp to 10%, and for two-year paper up by 45bp to 10.95%. The Ministry kept interest rates unchanged only for six-month USD-denominated bills. More details in the [auction review](#).

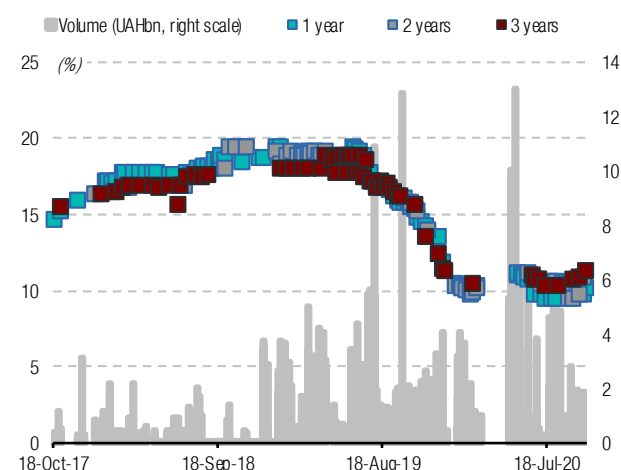
New bills were purchased mostly by banks, which were reflected on bondholders' structures. Banks purchased most of the bills in the primary market, and a portion of bills from foreigners. Banks thereby increased their share in total bonds outstanding to 49.6% at par value of portfolios to UAH439bn (US\$15.5bn). However, foreigners slowed selling bills to just UAH1bn (US\$35m), which is less than the UAH2.2bn (US\$76m) of a week before. Therefore, the main impact on banks' portfolios came from the primary auction.

**ICU view: In the coming weeks, bids in the primary auction may again come in with higher rates, and we anticipate further gradual increase for some maturities. Such decision will be made to attract additional financing and to try and create reserves for debt repayments in November and December.**

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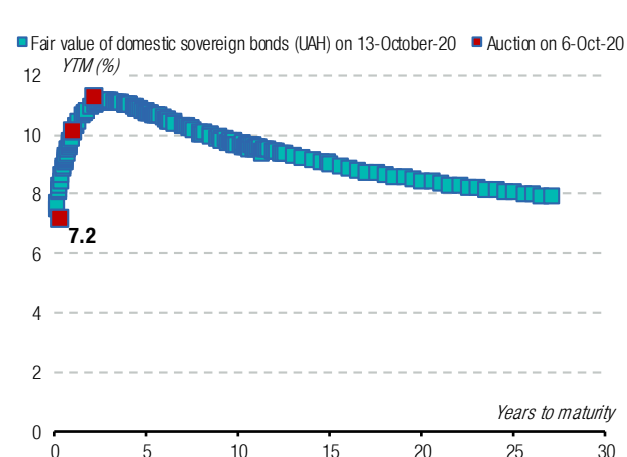
**Chart 1. Local-currency bonds**

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.

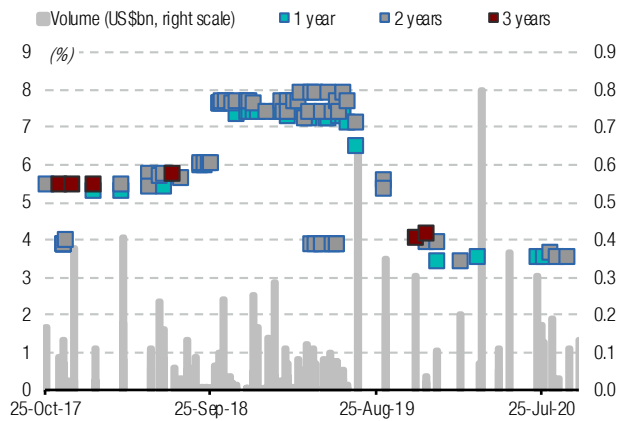
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

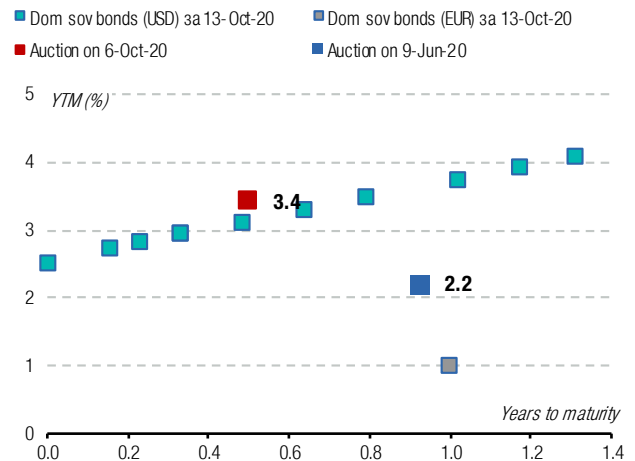
**Chart 2. FX-denominated bonds**

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 increases to UAH176bn**

Banking-sector liquidity rose at the end of last week due to an increase in budget expenditures and loans provided by the NBU. However, this week, liquidity can slide to about UAH170bn.

A greater increase in liquidity was restrained by demand for cash. Banks exchanged reserves in cash last week for about UAH6.5bn. However, the NBU absorbed a mere UAH0.2bn through the FX market, and sold US\$8.7m.

On the other hand, the Treasury generated large inflows of liquidity. After absorption of funds on Wednesday, when borrowings in local currency were larger than debt repayments (UAH3.4bn vs UAH0.2bn), expenditures accelerated later in the week. Therefore, the net impact of Treasury operations was UAH8.6bn of inflows into liquidity.

Additionally, the NBU provided 14 banks with UAH5bn of five-year loans, which caused banking-sector liquidity to increase by UAH6.1bn to UAH176bn.

**ICU view:** This week, banks will continue to exchange reserves in cash, as is usual for this part of the month, while inflows from the Treasury likely will be low to cover this outflow. With low NBU intervention in the FX market (see comment below), liquidity can decline gradually to about UAH170bn.

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

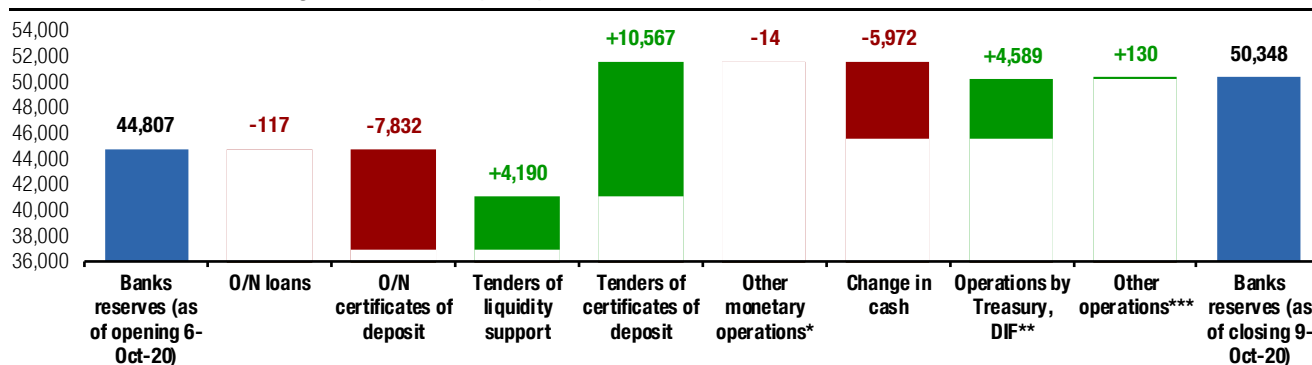
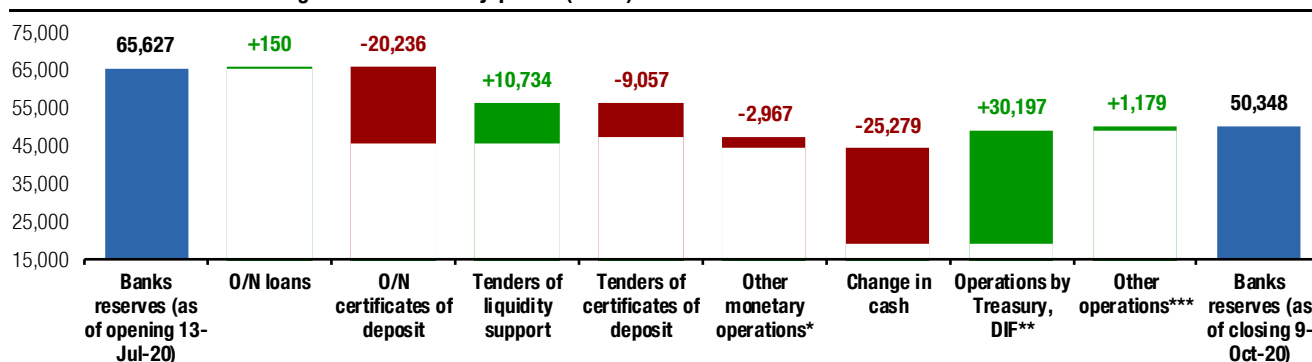


Chart 4. Banks reserves usages over last 90-day period (UAHm)



Notes: [1] data from the NBU's daily reporting [https://bank.gov.ua/control/uk/publish/article?art\\_id=38643651&cat\\_id=40807142](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

Last week, pressure on the hryvnia exchange rate eased, with stabilization at around UAH28.3/US\$. This week, we should see similar dynamics and fluctuations around this level.

NBU's interventions in the FX market continued to decline, and amounted to US\$8.7m of hard currency selling last week, most on Monday. So, the FX market was largely self-balanced and did not require NBU's interventions during most of last week. The NBU allowed slight appreciation of the hryvnia and did not purchase any hard currency to avoid further fluctuations.

The hryvnia exchange rate fluctuated in the range of UAH28.14-28.4/US\$ last week, ending the week at UAH28.3/US\$ or 0.2% stronger than a week before.

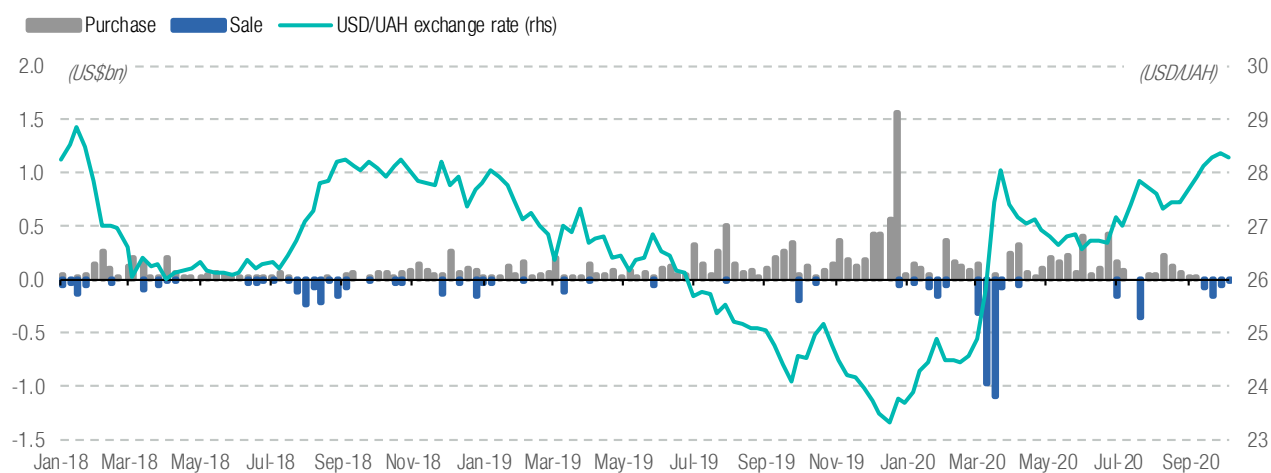
**ICU view: The FX market was self-balanced most of last week, but this week due to a holiday on Wednesday, we expect some imbalances. So, we anticipate the NBU will intervene to smooth fluctuations, but the amount of interventions will be low, up to US\$20m in either direction. Because of the holiday, interventions may be needed on Tuesday and Thursday, in particular, to accommodate settlements that would have been done on Wednesday. Under such conditions, the hryvnia exchange rate will fluctuate at around UAH28.3/US\$. Taking into the account a decline in foreigners'**

**outflows from local-currency debt (see comment above), their impact on the FX market will be very low and their demand will be satisfied by exporters.**

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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 surprises on downside

In September, both headline and core inflation slowed, to 2.3% YoY and 3.1% YoY correspondingly, against an atypical-for-this-month decline in food prices. Adding slowing demand amid the new outbreak of coronavirus cases, downside risks to our YE2020 forecast (5.3% YoY) prevail. But we still believe that the NBU will keep its policy rate on hold at 6% by the end of this year.

In September, consumer prices grew by 0.5% MoM and annual inflation decelerated to 2.3% YoY compared with 2.5% YoY in August. The figure was much lower than Bloomberg consensus of 2.9% YoY, our estimates of 3.3% YoY, and NBU's July forecast of 3.1% YoY. Core inflation also slightly slowed to 3.1% YoY as core CPI increased by 1.1% MoM. Both indicators continued to undershoot NBU's target range of 5% +/- 1 pp since the beginning of the year.

September's outcome was mostly determined by an atypical-for-this-month decline of food prices by 0.7% MoM. The last time a decline of food prices in September was observed in 2013. As a result, food inflation decelerated to 1.4% YoY vs 2.5% in August. The main contribution was ensured by prices of fruit (-8.9% MoM, +19.0% YoY vs 33.7% YoY in August), vegetables (-7.0% MoM, -19.8% YoY), and bakery products (+0.2% MoM, 7.3% YoY vs 8.3% YoY in August).

Meanwhile, expectedly inflation in utilities prices returned to positive values (0.6% YoY) amid a surge in gas prices by 18.4% MoM.

In addition, it is worth noticing the acceleration of educational and healthcare prices growth, to 14.1% YoY and 6.5% YoY correspondingly, as well as a deceleration of hospitality prices growth to 4.2% YoY.

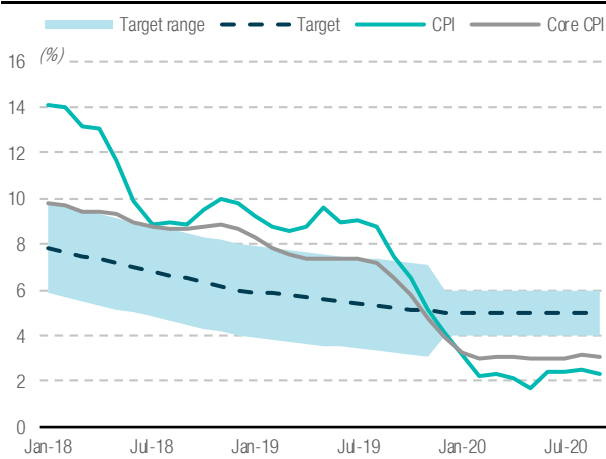
**ICU view:** Despite UAH depreciation, a fast rebound of real wages and retail sales, and a surge in global energy prices in recent months, consumer inflation remained subdued in September. Mainly, it can be explained by a sharp decrease in prices of very volatile components like fruit and vegetables. This factor may be offset in coming months against rising concerns about the harvest of grain, sunflower seeds, and other agro cultures. However, slowing demand amid a new outbreak of coronavirus cases may put an additional drag on prices growth. As a result, risks to our YE2020 forecast (5.3% YoY) shift to the downside.

The same goes for our forecast for the key policy rate. The low-inflation print adds to arguments for a return to rate cuts at the next NBU monetary-policy-decision meeting scheduled for 22 October. But accounting for pro-inflationary factors in the short and medium-run—fiscal spending at the end of the year, a pause in IMF and other IFIs financing, continuing depreciation pressure, concerns about the harvest, minimum wage hikes, and the like—we still believe that the NBU will take a “wait-and-see” approach and keep the rate on hold at 6% by the end of this year.

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**Chart 6. CPI, core CPI and target, YoY, %**

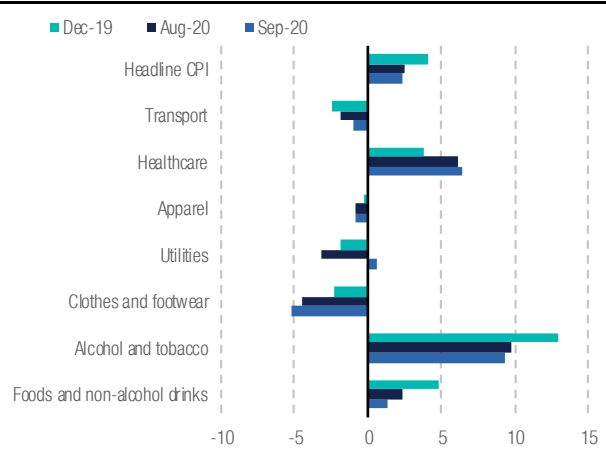
(Both headline and core inflation are below target range since the beginning of the year)



Source: Ukrstat, ICU.

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

(Sharp slowdown in food inflation overweight changes in other CPI components)



Source: Ukrstat, ICU.

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