

Weekly Insight

Consumer inflation accelerates

Key messages of the today's comments

TUESDAY, 17 NOVEMBER 2020

Domestic liquidity and bonds market

Bonds rates rise, but foreigners not in a hurry

Last week, foreigners' portfolios of Ukrainian bonds slid a mere UAH0.4bn (US\$13m), while banks continued to actively increase investments in domestic debt. This week, the market will stay the same with mostly banks' purchases of new bonds.

NBU supports liquidity

Quarterly tax payments caused liquidity volatility last week and this week will cause new fluctuations.

Foreign exchange market

Hryvnia exchange rate stabilizes

After appreciating a week ago, last week, the FX market was self-balanced without NBU participation at UAH28.1-28.2/US\$. This week, we expect the FX market stance to be the same due to strong supply of hard currency to pay taxes, which will support market balance.

Economics

Consumer inflation accelerates expectedly

In October, both headline and core inflation rose, to 2.6% YoY and 3.2% YoY, correspondingly, amid low comparison base and some recovery of food prices. Accounting for the outbreak of coronavirus cases and a stronger exchange rate, risks of inflation undershooting NBU's target range for longer are growing. But we still believe that the NBU will keep its policy rate on hold at 6% through the end of this year.

Banks' reserves market (16 November 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	6.00	+0bp	-950bp
ON rate (%)	5.71	+9bp	-807bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	62,078	+42.45	+9.89
CDs (UAHm) ³	107,750	-11.34	+0.00

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) (16 November 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.71
Banks	457,210	+1.51	+34.19
Residents	33,564	+3.45	+25.10
Individuals	8,637	+4.08	-16.01
Foreigners ¹	76,689	-0.33	-28.33
Total	900,676	+0.90	+9.58

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (16 November 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	28.1146	+0.01	+16.09
EUR/USD	1.1852	+0.31	+7.25
DXY	92.642	-0.12	-5.47
UAH TWI ¹	120.434	-0.59	-11.39

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (17 November 2020)

Maturity	Bid	Ask
6m	10.00	8.00
12m	11.00	10.25
2y	11.75	10.75
3y	12.25	11.25
12m (\$)	4.50	3.00
2y (\$)	5.00	3.25

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

Source: ICU.

Domestic liquidity and bonds market

Bonds rates rise, but foreigners not in a hurry

Last week, foreigners' portfolios of Ukrainian bonds slid a mere UAH0.4bn (US\$13m), while banks continued to actively increase investments in domestic debt. This week, the market will stay the same with mostly banks' purchases of new bonds.

Last week, foreigners did not change their portfolio for two days, and then probably with deals only within Clearstream, as, according to the NBU, last Wednesday and last Thursday their portfolios of local-currency instruments were unchanged. However, their share in bonds outstanding slid to 8.5%.

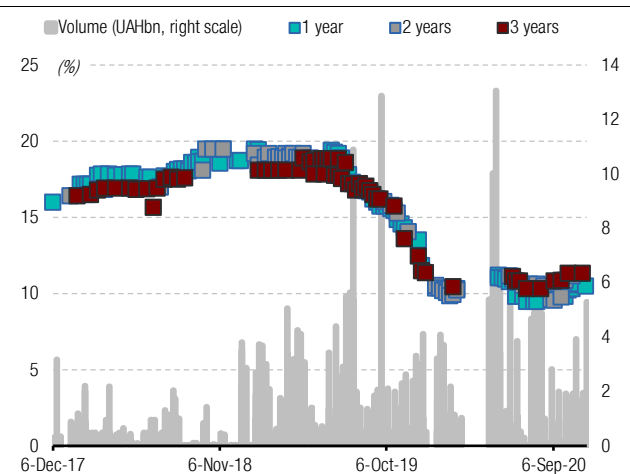
This decline in share was due to new bills purchased by banks, as they increased portfolios after the primary auction by UAH5.8bn (US\$206m), and last week by UAH6.7bn (US\$238m) to UAH457bn (US\$16bn). Banks purchased a large portion of new debt due to an increase in the rate for six-month bills to 9% in order to receive more than UAH5bn of proceeds for budget financing (see [auction review](#)).

ICU view: The increase in rates will continue this week and will depend on the amount of demand. As most bidders are interested in short maturities, interest rates can rise mostly for the three-month paper. At the same time, foreigners can keep a slow pace in bonds selling due to the steady hryvnia exchange rate and large debt repayments next week.

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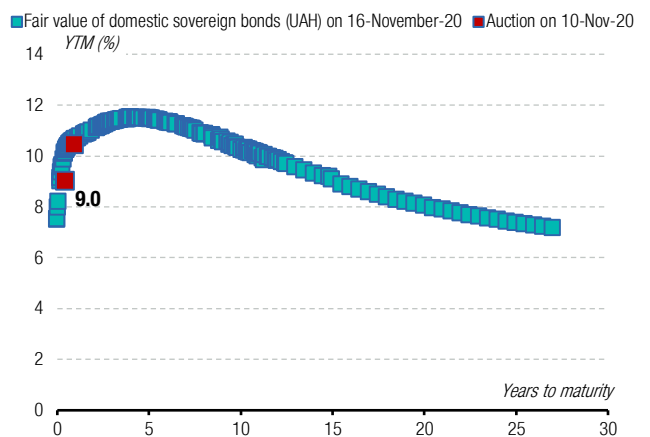
Chart 1. Local-currency bonds

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.

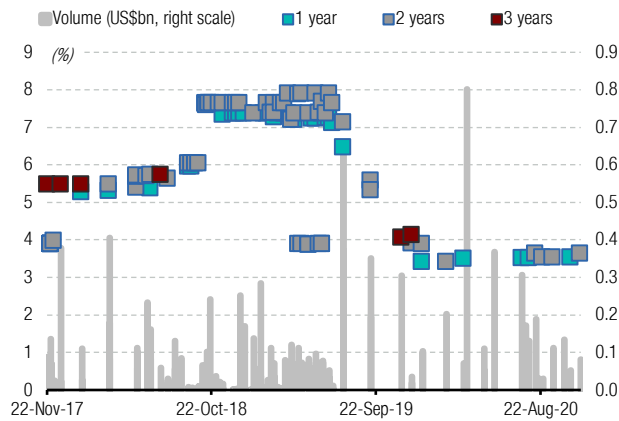
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

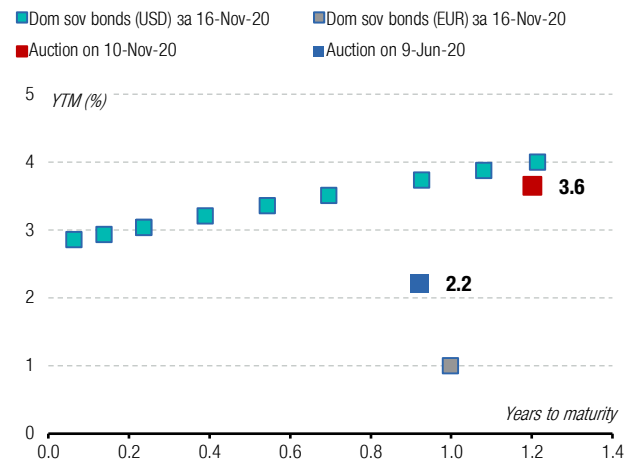
Chart 2. FX-denominated bonds

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.

NBU supports liquidity

Quarterly tax payments caused liquidity volatility last week and this week will cause new fluctuations.

The total amount of banking-sector liquidity continued to decline most days last week, falling to UAH156bn last Thursday, and recovered just last Friday due to the NBU loans. The need for funds for tax payments forced banks to decrease NBU CDs outstanding to below UAH100bn for the first time this year.

Outflows were caused by two types of transactions: the Treasury received part of quarterly tax payments and large payment for new bonds versus low repayment as debt service (UAH5bn vs UAH0.1bn), while banks exchanged an additional UAH5.2bn of reserves in cash. The NBU did not intervene in the FX market, but provided banks with UAH16bn of new loans last Friday, increasing liquidity to almost UAH170bn.

ICU view: This week, quarterly tax payments will continue, keeping pressure on liquidity through needs for local-currency funds. A large portion of liquidity will be absorbed by the Treasury, while expenditures can rise later this week.

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

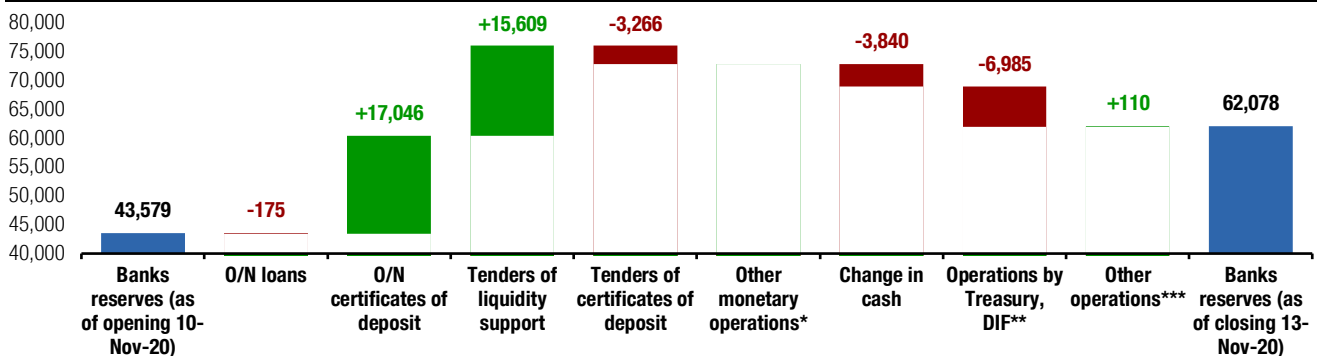
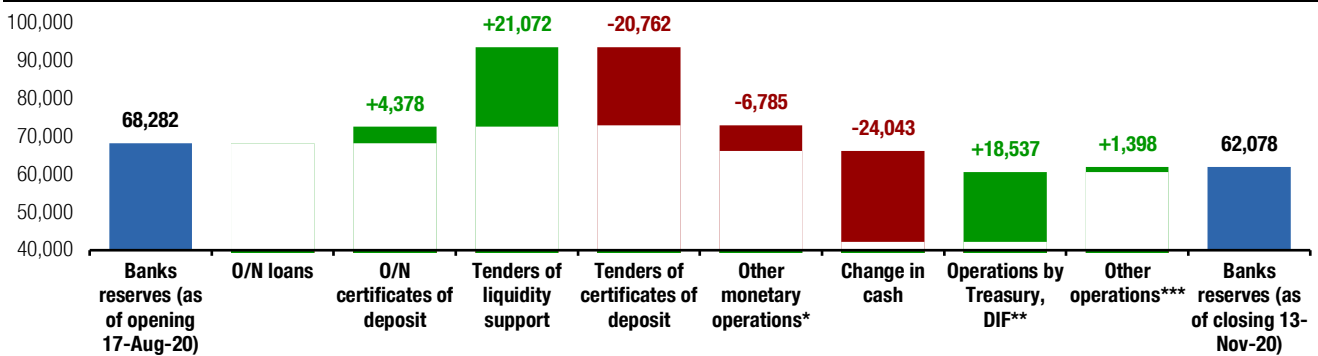


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

After appreciating a week ago, last week, the FX market was self-balanced without NBU participation at UAH28.1-28.2/US\$. This week, we expect the FX market stance to be the same due to strong supply of hard currency to pay taxes, which will support market balance.

Active tax payments require a large amount of local-currency liquidity, which was mostly absorbed by the Treasury's budget accounts. Additionally, foreigners decelerated selling of bonds and decreased demand for hard currency.

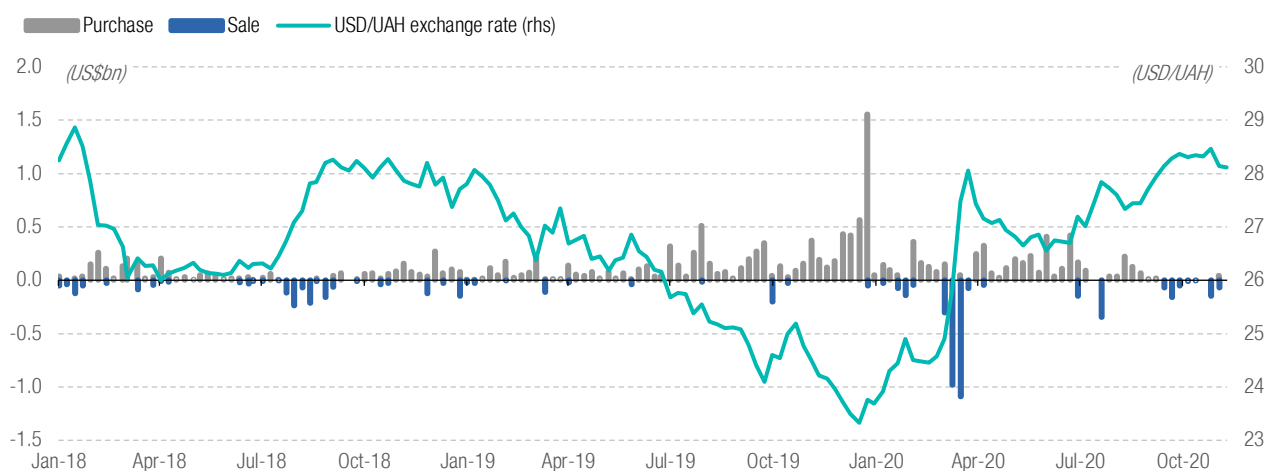
Therefore, hard-currency supply was enough to balance the market without NBU intervention. The hryvnia ended last week at UAH28.12/US\$ or just UAH0.02 or 0.1% weaker than a week before.

ICU view: Quarterly tax payments will end this Friday, which will cause an active supply of hard currency, balancing the FX market without NBU interventions to sell hard currency. To the contrary, NBU can intervene in the market with hard currency purchases in reserves in case of extra supply to restrain appreciation. Therefore, we do not expect that hryvnia exchange-rate fluctuations will be different from what was seen last 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 and NBU interventions (weekly data)



Source: NBU, Bloomberg, ICU.

Economics

Consumer inflation accelerates expectedly

In October, both headline and core inflation rose, to 2.6% YoY and 3.2% YoY, correspondingly, amid low comparison base and some recovery of food prices. Accounting for the outbreak of coronavirus cases and a stronger exchange rate, risks of inflation undershooting NBU's target range for longer are growing. But we still believe that the NBU will keep its policy rate on hold at 6% through the end of this year.

In October, consumer prices grew by 1.0% MoM and annual inflation accelerated to 2.6% YoY compared with 2.3% YoY in September. The figure was marginally lower than our estimate and Bloomberg consensus (both 2.7% YoY) and in line with the NBU's projection according to its comments. Headline inflation continued to undershoot NBU's target range of 5% +/- 1 pp since the beginning of the year.

The breakdown shows a mixed picture between categories. The increase in the headline rate last month was driven by some recovery in food inflation to 1.6% YoY after a surprising fall in September, a surge in utilities' inflation to 5.5% YoY, and almost disappearing deflation in transportation and appliances. But that was partially offset by a drop in communication inflation against the background of almost unchanged inflation rates in other categories.

Core inflation also slightly rose to 3.2% YoY as the core CPI increased by 0.8% MoM. Still slow annual growth reflects the legacy of UAH appreciation effects at the end of the previous year.

ICU view: Despite UAH depreciation, a fast rebound of real wages and retail sales, and a surge in global energy prices in previous months, consumer inflation remained subdued in October. In addition to a vast supply of fruit and vegetables, the economy's large output gap contained inflation pressure.

Looking ahead, we expect inflation to continue to drift higher over the coming months as the effect of the high statistical base of the previous year continues to unwind. By the end of the year, it is likely to approach the lower bound of the NBU's 5% +/- 1pp target range, but the risks of undershooting the target range for longer are growing.

Weak underlying price pressures, the outbreak of coronavirus cases, and recent stabilization of UAH exchange rate amid still elevated export commodity prices and

improved global sentiment toward the EM universe provides arguments for a rate cut at the next NBU meeting on monetary policy in December.

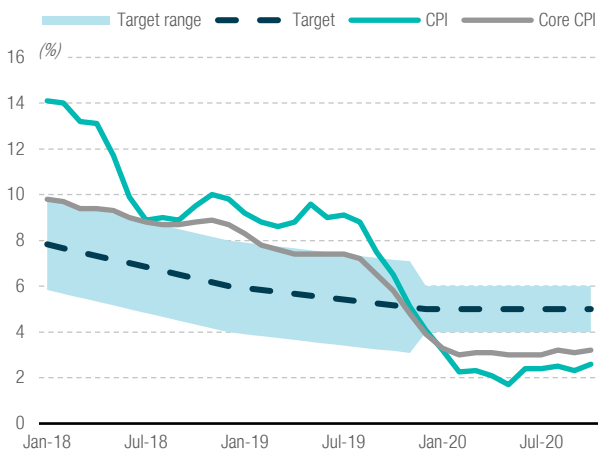
Nevertheless, we maintain our view that the NBU will keep the rate on hold taking into account short and medium-term pro-inflationary risks stemming from the anticipated surge in public spending at the end of the year, delay in disbursements from the IMF and other official funding, and a 20% minimum wage hike in January.

However, the pandemic has been a disinflationary force globally, and in Ukraine in particular. Thus, the new outbreak definitely strengthens downside risks for economic activity and inflation in 4Q20 and 1Q21 causing the return to rate hike now more likely in 2H21 rather than in 2Q20 as envisaged in the last NBU projection.

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

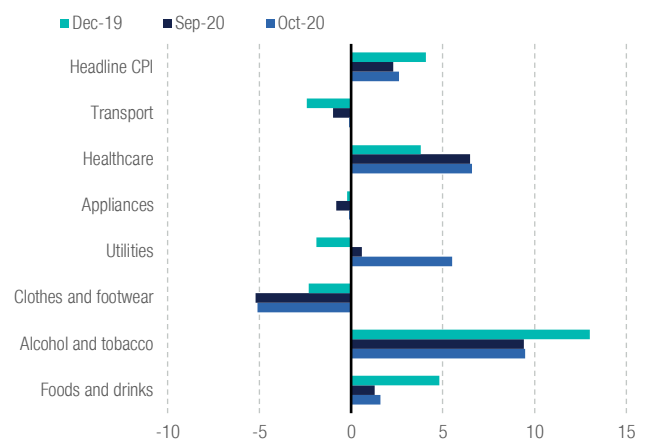
(Both headline and core inflation are below target range since the beginning of the year)



Source: Ukrstat, ICU.

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

(Low food inflation constrains and deflation in cloths & footwear keeps headline inflation subdued)



Source: Ukrstat, ICU.

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