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ECONOMICS | INTEREST RATES STRATEGY | FX

1 August 2019

UKRAINIAN CAPITAL MARKETS WEEKLY

	Rating	Outlook	Last update
Fitch	B-	STABLE	08.03.2019
S&P	B-	STABLE	12.04.2019
S&P (N)	uaBBB	-	12.04.2019
Moody's	Caa1	STABLE	21.12.2018

This week in focus: Key trends in Ukraine local debt

Foreign accounts accumulated 50% of local bonds' free float*, according to our estimates. These are mostly long term UAH-denominated securities, where 6Y notes have an opportunity to be included in international indices. Against this backdrop, MinFin is to reduce supply of FX-denominated bonds to the local market, allowing mostly roll over of existing maturities.

Figure 1. UAH exchange rate (UAH per USD)

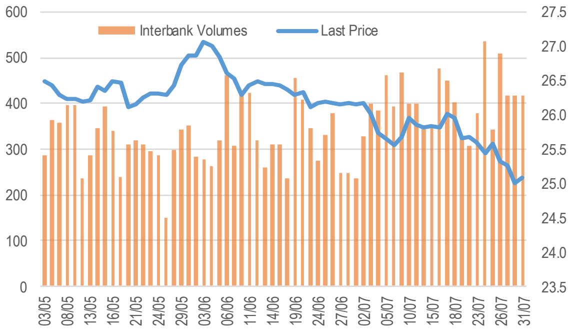


Figure 2. Banking liquidity (UAH bn)

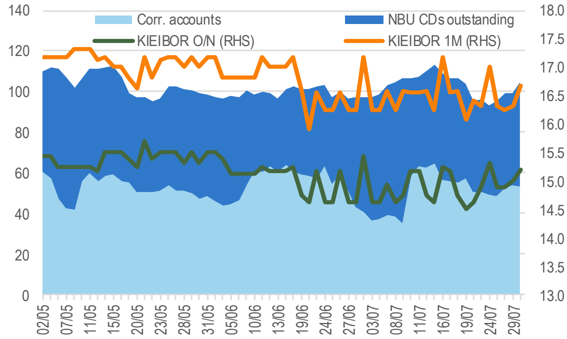
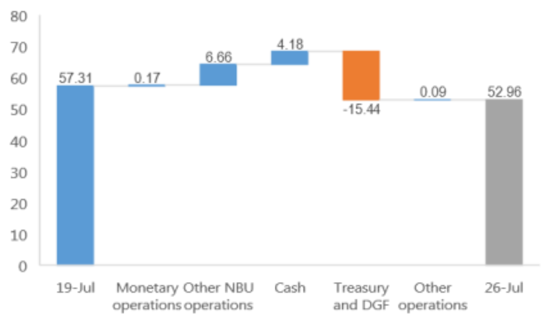


Figure 3. Correspondent account balances (UAH bn)



FX and interest rates: UAH touched thee-year high vs USD

The hryvnia has tested 25 key level against the greenback in spite of substantially increased foreign currency (FX) purchases by the National bank of Ukraine (NBU).

As before, the local currency derives support mainly from growing inflow of fresh FX from non-residents, actively investing in UAH-denominated government bonds. This week the Finance Ministry has placed securities on UAH17.2bn (USD0.69bn), of which UAH10.9bn (USD0.43bn) were 5.5y bonds popular among non-residents. It would be fair to expect that similar amount of FX has come on the market.

The NBU has increased interventions on the market to above USD100mn per day since beginning this week, but these purchases had limited impact on the general trend. Despite growing complains in the market about central bank's insufficient activity, allowing for UAH to grow above 25 vs USD instead of boosting FX reserves, the NBU stays firm on its strategy not to influence the general trend while to pick up only excess supply of foreign exchange.

By the end of Wednesday (July 31) the UAH/USD pair has rebounded below 25 mark. It looks like market participants are reassessing their expectations of how long lived might be current interest of foreign investors to Ukraine, and how high the hryvnia may climb against the greenback.

While such an unparalleled appreciation poses a substantial risk of no less strong correction, there are some positive expectations in the market that it might be manageable if promised reforms be delivered.

Banking system liquidity declined by 4.35% below UAH100bn (by the end of Friday, July 26) with funds on banks' correspondent accounts at the central bank decreased by 7.6% to UAH53bn.

The change was due to large amount transfers of funds from banks' accounts to the State treasury, totalling UAH15.4bn, which were partly offset by the NBU FX interventions and cash deposits, bringing in total UAH10.5bn.

Investments in CD's decreased by a marginal 0.4% to UAH46.5bn, with investments in O/N CD's rose by UAH2.4bn to UAH11.9bn and in CDs placed through tenders fell by UAH2.59bn to UAH34.5bn.

**free float defined as total local government bonds outstanding net of securities in portfolio of the NBU (UAH337bn) and of bonds issued under state banks capitalization programs (UAH308bn)*

Figure 4. Local UAH bonds market

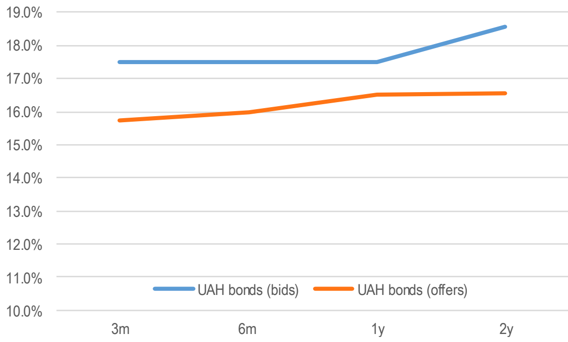
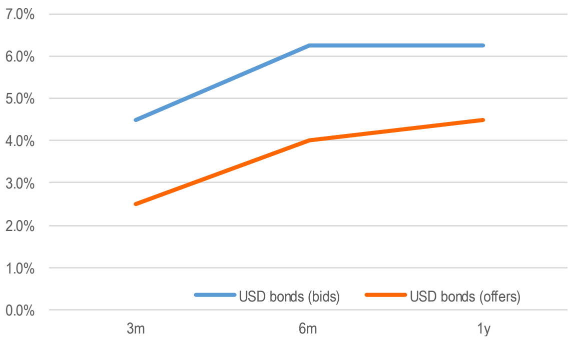


Figure 5. Local USD bonds market



Government bond market

CCY	Maturity	Cut-off rate	WA rate	Max bid rate	Min bid rate	Number of bids	Bids accepted	Bid size, mn	Place-ment size, mn
UAH	3m	16.40%	16.23%	16.40%	16.20%	6	6	20.12	20.12
UAH	6m	16.52%	16.41%	16.52%	16.25%	11	11	434.04	434.04
UAH	1y	16.59%	16.51%	17.00%	16.40%	39	22	1 847.72	500.00
UAH	2.5y	16.75%	16.42%	17.55%	16.29%	45	32	5 964.29	5 234.29
UAH	5.5y	15.50%	15.45%	15.85%	15.19%	36	32	11 113.27	10 112.26

The Finance Ministry has placed UAH-denominated domestic loan bonds for a record high amount of UAH17.2bn on the primary auction on July 30. The highest demand was seen for 6y (aka 5.5y) debt, amounting to UAH11.1bn. The bonds were placed at a weighted average rate of 15.45% with the cut-off rate reduced by 0.35 basis points (bps) to 15.5% per annum. So strong demand likely came from foreign accounts after FinMin announced its intention to list this issue in one of widely recognized indices.

A strong demand was also seen for 2.5y bonds, which were last offered two weeks ago, and for 1y tap. The cut-off rate for the former fell by 100bps to 16.75% per annum and for the latter – by 40bps, to 16.55% per annum.

As for short-term bonds, of the UAH1bn the FinMin offered, investors submitted bids for just half of that amount. Nevertheless, the ministry managed to push rates down by 20-50bps, compared to the auction a week ago. In particular, cut-off rate for 3m securities was reduced by 23bps to 16.4% per annum while cut-off for 6m debt was reduced by 21bps to 16.52% per annum.

Figure 6. Ukraine's Eurobond yields, bid/ask mid (%)

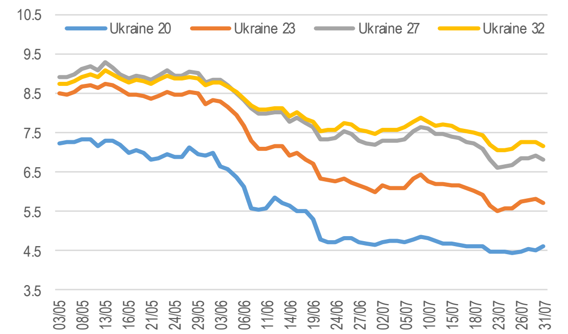
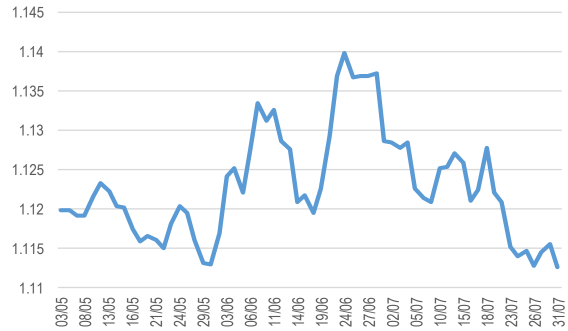


Figure 7. EUR USD spot (mid)



USD hit two-year high vs EUR on Fed rate cut

The U.S. dollar rose below 1.11 against the euro by the end of Wednesday (July 31), its highest level since May 2017. As was widely expected, the Federal Reserve lowered its benchmark interest rate by 25 bps for the first time since December 2008 but the lack of commitment of future rate cuts turned out to be one of the key triggers behind a strong USD rally.

The greenback got an additional boost after the Fed Chair Jerome Powell, in the post-meeting press conference, described the rate cut as a mid-cycle adjustment of policy and not necessarily the beginning of a series of rate cuts. While acknowledging the higher risk of global slowdown and trade war uncertainty, the Fed Chair improved confidence about the U.S. economic outlook.

Also lending support to the greenback, the Committee's decision to cut rate was not unanimous.

U.S. government debt yields went down on Fed's decision, with the yield on the benchmark 10-year Treasury note settled lower to trade at 2.061% (as of end of July 31).

Figure 8. Local government bonds (UAH bn)

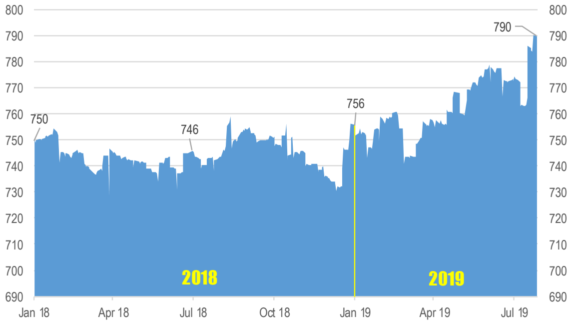


Figure 9. Government debt breakdown

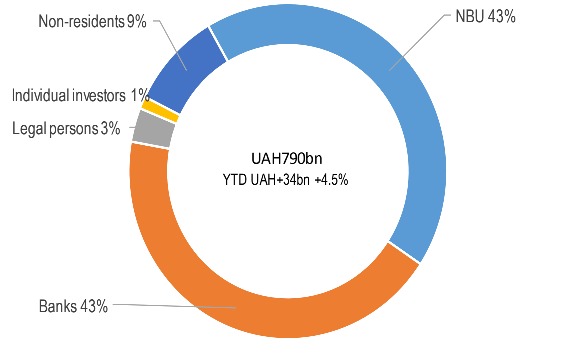
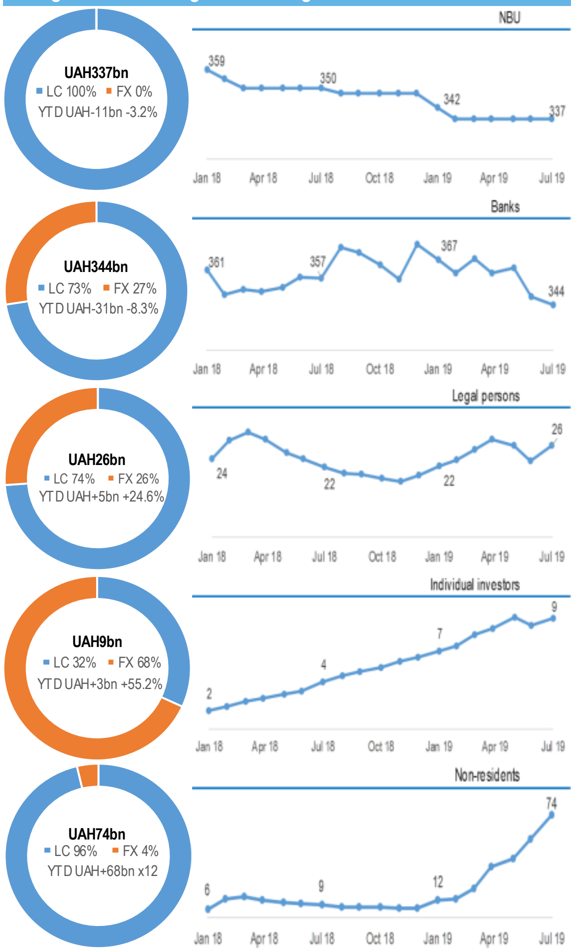


Figure 10. Change in holdings



Key trends in Ukraine local debt

Switch in focus from FX to local currency. While growing risk appetite among international investors plays in favour of new taping into the international debt market, we see the Finance Ministry the ministry has little incentive to take new FX-debt with over UAH81bn (circa USD3.2bn as of July 8) piled on its FX accounts vs UAH70bn (USD2.8bn) payouts to be made on foreign government debt in 2H19. The recent ministry's decision to reduce the number of primary auctions in August, where FX-denominated bonds were planned to be offered, supports this assumption.

We expect USD-denominated bonds which will be auctioned by the end of the year will largely be aimed at refunding of maturing securities and little new cash raising. A major portion of maturing bonds are held by the state owned banks and they have little alternatives to reinvest this foreign currency.

Apart from state owned banks, the major demand for USD-denominated notably comes from individual investors. As there is some stigma associated with past sharp depreciations of the hryvnia, individual investors have some incentive to hold hard-currency securities.

EUR investors are taking closer look on Ukraine. We expect new FX debt instruments will be offered next year with main focus set on EUR-denominated securities, both local and Eurobonds. We base our assumptions on the government's recent successful placement of EUR-denominated Eurobonds where unexpectedly high interest from European funds appeared. Combined with growing trade turnover between Ukraine and the European Union (EU) in EUR currency, the ministry is likely to be interested in increasing portion of EUR debt (currently 10.5% of total state and state guaranteed debt vs 40.9% in USD).

Support from EU and the WB hold relevance. If negotiations with the International Monetary Fund (IMF) be on track, the Ukrainian government will be able to attract USD500mn micro financial aid from the EU and initiate talks with the World Bank (WB) about a new government-secured guarantee program. The WB country director for Belarus, Moldova and Ukraine Satu Kahkonen in the beginning of this year confirmed the bank's readiness to start such negotiations with new authorities if there be progress in reforms implementation.

Focus on long-term debt to be included in index basket. After FinMin announced its ambition for 6Y local currency government bonds (aka 5.5Y) to be listed in the JPMorgan Government Bond Index-Emerging Markets (JPM GBI -EM), we expect this debt will be the longest for this year. The index tracks local currency government bonds issued in Emerging Markets. According to its inclusion criteria, to be deemed as eligible an instrument face amount must exceed USD1bn. So far the face amount of the issue exceeded UAH20bn (USD800bn) with over UAH10bn (USD400bn) of bonds placed during the recent auction on July 30 allowing for expecting breaching the threshold in the nearest months.

Despite there is a growing interest to longer bonds, we expect FinMin will stay focused on meeting the index requirement and only then might consider offering any longer debt.

NOTE: There are local currency government bonds with tenure exceeding 6Y. These are non-marketable bonds, however, which were issued under program of capitalization of the state owned banks.

Figure 11. UAH bonds cut-off yield curve

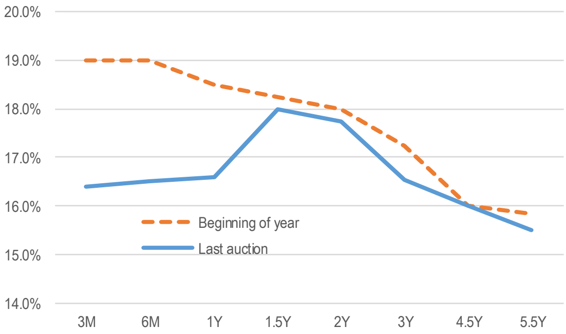
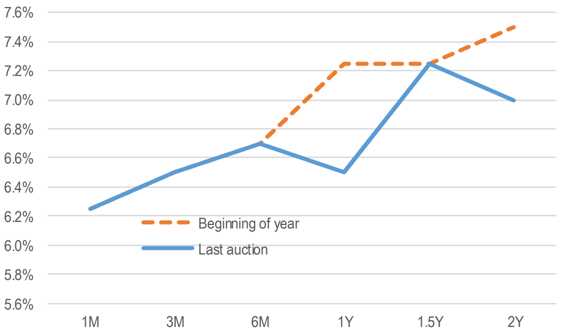


Figure 12. USD bonds cut-off yield curve



Foreign accounts accumulated about 50% of local currency bonds free float. According to the NBU the non-resident's portfolio of the government local bonds exceeded UAH80bn (USD3.2bn) as of July 30, what accounts to 8% of total bonds outstanding. On the other hand, if take into account amount of government bonds which were contributed to capital of state owned banks and securities in portfolio of the NBU, the foreign accounts' share will be equal to about 50% of total bonds outstanding.

Rating action might bring new impetus. The nearest rating review comes in September, with Fitch rating action is scheduled for September 4 and S&P for September 27. The Moody's rating agency is to revise Ukraine's credibility in late November. Provided the negotiations with the IMF be on track we see a potential for upgrade of Ukraine's credit rating.

Entangled risks. While foreign investors are largely interested in mid- and long-term securities, worth mentioning, that prospects for rollover will be dependent on external situation, unlike the previous situation, when local banks held the major portion of bonds outstanding.

Key Macroeconomic Indicators								
	2013	2014	2015	2016	2017	2018	2019E	2020F
Real sector								
Real GDP (%YoY)	0.00	-6.60	-9.80	2.30	2.50	3.30	2.70	3.00
Industrial production (%YoY)	-4.30	-10.70	-6.00	2.40	-0.10	1.60	0.00	1.20
Retail sales (%YoY)	6.10	-11.00	-25.00	4.00	8.80	6.10	5.00	4.00
Unemployment rate end of year (ILO, working age)	7.70	9.70	11.50	9.30	8.70	8.50	8.50	8.40
Nominal GDP (UAH bn)	1466	1587	1980	2383	2983	3393	3830	4321
Nominal GDP (USD bn)	183.50	133.70	91.20	93.10	112.10	125.00	134.40	141.50
Prices								
CPI (average %YoY)	-0.20	12.10	48.70	16.50	14.40	10.50	9.20	8.10
CPI (end of year %YoY)	0.50	24.90	43.30	12.40	13.70	9.80	8.50	7.20
Real average wage growth (%YoY)	8.20	-6.50	-35.00	10.00	18.90	9.70	8.00	6.00
Fiscal balance (% of GDP)								
State budget deficit (without Naftogaz)	4.20	4.90	2.30	2.90	1.60	2.40	2.40	2.30
Total public debt	39.90	69.40	79.40	81.00	71.80	61.00	60.00	61.00
External balance								
Exports of goods and services (USD bn)	81.70	65.40	47.90	46.00	54.00	59.00	61.50	63.70
Imports of goods and services (USD bn)	97.40	70.00	49.60	51.80	60.80	70.50	74.30	76.80
Current account balance (USD bn)	-16.50	-4.60	1.60	-1.30	-2.40	-4.70	-4.70	-4.80
Current account balance (% of GDP)	-9.00	-3.40	1.80	-1.40	-2.10	-3.30	-3.50	-3.40
Net FDI (USD bn)	4.10	0.30	3.00	3.40	2.30	2.50	2.30	2.40
Foreign exchange reserves (end of year)	20.40	7.50	13.30	15.50	18.80	20.80	19.50	20.50
Imports coverage (months of imports of goods)	2.90	1.50	4.40	3.70	3.60	3.40	3.30	3.30
Interest and exchange rates								
NBU discount rate (% end of year)	6.50	14.00	22.00	14.00	14.50	18.00	16.00	13.00
Exchange rate (UAH/USD) end of year	8.20	15.80	24.00	27.20	27.95	27.70	28.50	30.50
Exchange rate (UAH/EUR) end of year	11.30	23.00	26.20	28.30	33.50	31.80	33.60	36.30

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