

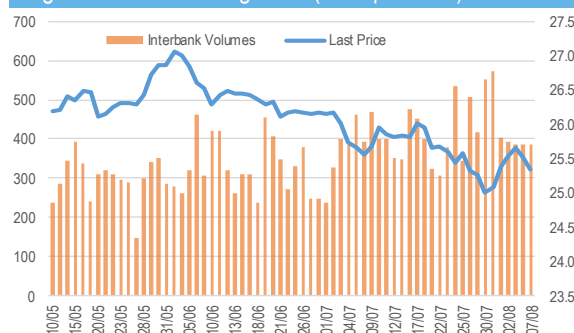
ECONOMICS | INTEREST RATES STRATEGY | FX

8 August 2019

UKRAINIAN CAPITAL MARKETS WEEKLY

	Rating	Outlook	Last update	This week in focus: CA deficit expands
Fitch	B-	STABLE	08.03.2019	12M rolling current account (CA) deficit expanded to USD3.86bn in June from USD3.55bn in May 2019 as deterioration of goods balance drove increase of monthly CA deficit to USD432mn in June 2019 from USD126mn in June 2018. The deteriorating CA over the next several months, coupled with weakening prospects of global trade, spells UAH weakness in Q4, in our view.
S&P	B-	STABLE	12.04.2019	
S&P (N)	uaBBB	-	12.04.2019	
Moody's	Caa1	STABLE	21.12.2018	

Figure 1. UAH exchange rate (UAH per USD)



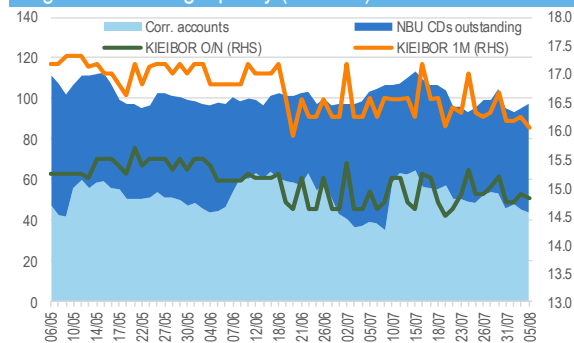
FX and interest rates: Hryvnia ran into 25.5 mark against the U.S. dollar

The rally of the UAH/USD pair in the wake of rampant foreign capital inflow into local government debt ran into resistance at 25.5 after the National bank of Ukraine (NBU) increased absorption of accompanying foreign currency (FX) liquidity.

Though sticking to position not to interfere in the market trend of the hryvnia consolidation, the central bank afforded to bend this rule and bought USD0.51bn in the interbank foreign exchange market in the period from July 29 to August 2, almost twice more than a week earlier.

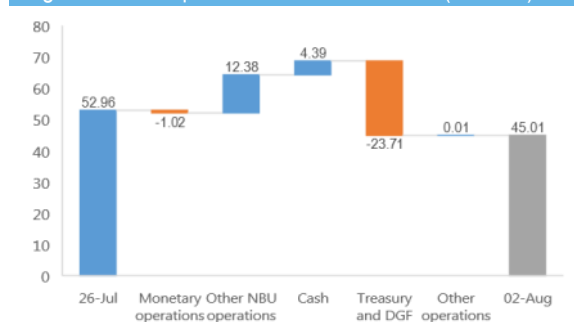
After follow-up corrective slide to vicinity of 25.5 by the end of last week, UAH has found support from active exports revenue sales, mainly rendered by agricultural producers. A season of salary repayments, boosting switches from foreign into local currency, also added support to the pair.

Figure 2. Banking liquidity (UAH bn)



Looking forward, we see current situation on the market as fragile. Hryvnia largely derives its strength from still high expectations of fresh foreign capital inflow into local debt. Such expectations did partially live up during the last FinMin's primary auction, where attractive to foreign investors 3y bonds were sold. On the back of post-auction FX sales, UAH moved up to 25.4 against the USD by the end of Wednesday (August 7). On the other side we see growing current account deficit is weighing on the local currency.

Figure 3. Correspondent account balances (UAH bn)

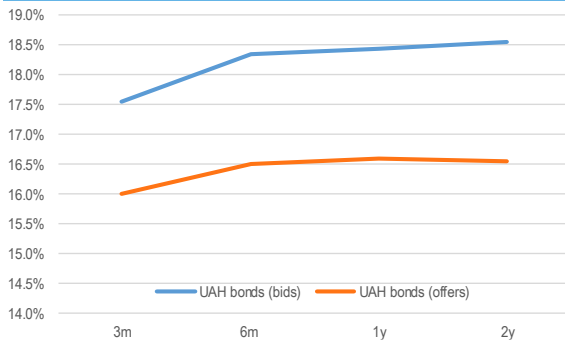


Banking liquidity balance narrowed by 4.5% to UAH95bn by the end of last week as record high FinMin's primary auction on July 30 combined with seasonal tax repayments drained about UAH23.7bn from the system.

In spite of NBU's active interventions in the interbank foreign exchange market, bringing about UAH12.4bn of fresh liquidity, and positive flow through cash channel, these factors have offset only half of total outflow.

The central bank's monetary operations, which resulted in net outflow of UAH1bn represent increase of banks' investments in central bank's O/N CDs by 29.4% to UAH 15.5bn and refinancing loans disbursement, totaling UAH2.5bn, to some commercial banks.

Figure 4. Local UAH bonds market

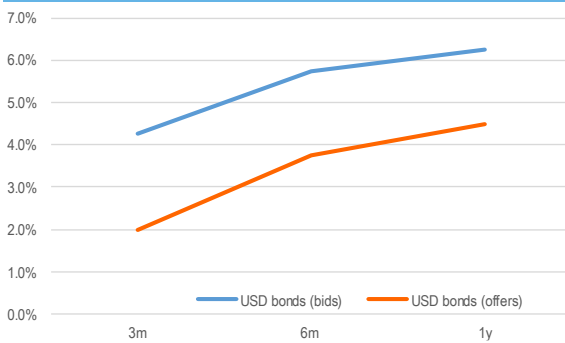


Government bond market

CCY	Maturity	Cut-off rate	WA rate	Max bid rate	Min bid rate	Number of bids	Bids accepted	Bid size, mn	Placement size, mn
UAH	3m	16.50%	16.49%	17.00%	16.00%	12	9	306.49	176.49
UAH	1y	16.28%	16.22%	16.99%	15.99%	34	25	1 214.19	500.00
UAH	3y	16.19%	16.06%	16.50%	15.93%	49	31	3 832.74	2 000.00

FinMin attracted modest UAH2.6bn on the primary bond auction held on August 6. Having outstripped its schedule of domestic bonds placement after a series of successful auctions the ministry has moderated its appetite for new debt and offered only volume-limited taps – 3m, 1y (both with the threshold of UAH500mn) and 3y securities capped at UAH2bn amount.

Figure 5. Local USD bonds market

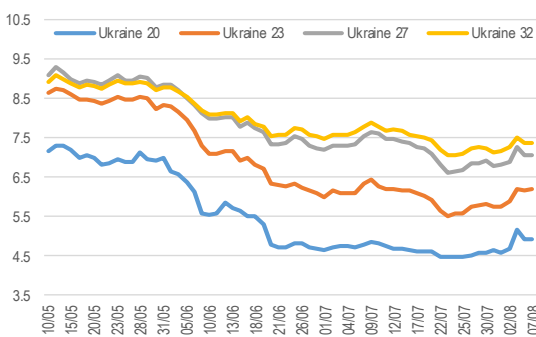


Demand for the government debt, but for 3m bonds, stays strong with amount of submitted bids about twice exceeded the offer. That helped the ministry to push cut-off rate down by 31 basis points (bps) to 16.28% per annum for 1y tap and by 36bps to 16.19% per annum for 3y bonds.

Notably most of yields tendered for the securities were below waged average yield of sale. That may signal about some room for further rate cut.

By the end of July, the ministry has covered more than 81% of its financing needs for this year (regarding local debt market). That implies that such small-amount auctions will be more frequent during the rest of the year with likely narrowing of threshold for 3y tap. We do not rule out however a few large-amount auctions. FinMin still has to meet one of global bonds' indices requirement regarding USD1bn volume of 5.5y (aka 6y) bonds. Besides, we assume some external financing might be substituted by local borrowings.

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



Sentiment sours with safe havens in demand

The USD fell against the EUR to 1.1229 mark as news of slower U.S. employment growth in July and heightened U.S.-China trade tensions fueled expectations that the Federal Reserve would cut interest rates again in September.

By the end of Wednesday (August 7) the greenback has stabilized as James Bullard, President of the Saint Louis branch of the Fed who is known as a dove, has said that the bank should not respond to every move in the trade war, implying the central bank may be less responsive than markets expect.

On the backdrop of intensified trade tensions safe-haven flows have picked up with EUR benefiting from the movement in spite of warning signs regarding German's economy - the euro zone's locomotive.

Figure 7. EUR USD spot (mid)



However, rallies in the pair are expected to remain short-lived as the unremitting deterioration of the economic outlook in the region and the lack of traction in inflation are seen limiting any occasional bullish attempts in EUR for the time being.

Global risk intolerance has pushed the 10-year Treasury rate to its lowest since 2016. The yield on the benchmark has hit a low of 1.595%.

Figure 8. Current account, 12M rolling (USD bn)

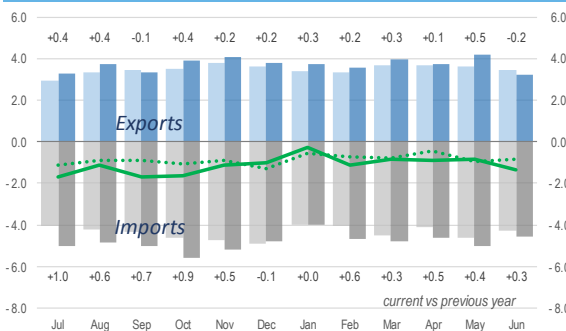


CA reacts inversely on improvement in economy

12M rolling current account (CA) deficit expanded to USD3.86bn in June from USD3.55bn in May 2019 as deterioration of goods balance drove increase of monthly CA deficit to USD432mn (3.6% of GDP according to the NBU estimates) in June 2019 from USD126mn (1.2% of GDP) in June 2018. The deteriorating CA over the next several months, coupled with weakening prospects of global trade, spells UAH weakness in Q4, in our view.

Tail wags dog: As we expected, a solid pickup in local currency on the back of improvement of investment appetite for Ukraine's debt and clarification of country's political situation strengthened demand for capital and consumer goods imports, leading to an overall deterioration in the CA deficit.

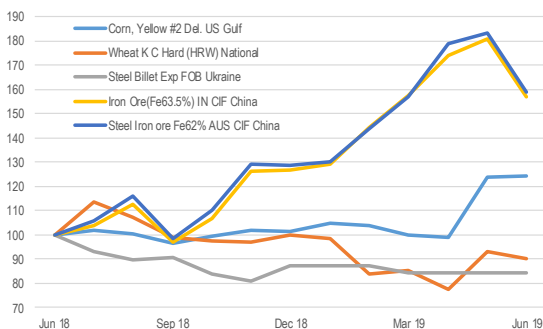
Figure 9. Net trade in goods (USD bn)



The factor of strong hryvnia, which had hit the three-year high against the U.S. dollar in July, has not yet fully played out and we might see further widening of machinery and equipment imports going forward after sharp increase by 28.2% y/y to USD1.5bn in June.

Weak metallurgy exports in spite of supportive external backdrop: External sales of ferrous and nonferrous metals, accounting for 25% of total exports, narrowed by 21.9% y/y to USD0.85bn. We see general trend towards gradual contraction of sectors' output dragged further by repair works as some production facilities as a main factor behind such a sharp decline in June. Moreover, we see escalation of international trade war tensions put a downside risk to metallurgy exports recovery in 2H19.

Figure 10. Key exports price change, June 18 = 100



Strong harvest may partially cushion the increase in the CA deficit: External sales of agricultural products – another major contributor to exports – increased by 3% y/y to UAH1.26bn in June and we see good yield of grain and leguminous crops during current harvesting campaign provides a basis for further improvement in exports readings.

Growing CA deficit implies risk of UAH weakness: Current inverse dependence between UAH and CA is likely to reverse as soon as foreign capital inflow into local government debt runs out. Provided risk aversion among investors towards Ukraine not changed the FinMin may meet its 2019 debt plan in early Autumn. Given the Ukraine's current account balance stay under pressure of strong private and investment expenses, after FinMin address its need for internal debt hryvnia may lose its artificial support.

UKRAINIAN CAPITAL MARKETS WEEKLY

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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