

UAH Sovereign Bonds

Stronger fiscal position backs case for UAH treasuries

UAH government debt market: low liquidity

Liquidity in UAH government debt has dropped considerably since spring: average daily turnover in 1-3Y papers went from UAH 1.1 bln in early May to UAH 0.5 bln in early June, before rebounding to UAH 0.85 bln during the last week of June- first week of July. Volumes at primary auctions have also been weak. Backed by a favorable fiscal position, budget revenue coming in high and Eurobond placements (USD 1.3 bln in June), the Finance Ministry capped yields and has not accepted market bids that have been 150-200 bps higher.

We relate the drop in liquidity to low demand (after the rally in preceding months, many banks are now running into internal UAH debt holding limits) and the lack of available hryvnyas after the NBU moved to soak up excess UAH liquidity on the market. We see a gradual recovery in secondary market demand in July-August; however volumes are likely to be lower than in 1H11 given lesser potential from the banking system and a seasonal decline. We expect bonds yields to remain at current levels in the short-term.

With the outlook for FX risk stable, we recommend increasing exposure to UAH sovereign bonds with 12-18 month maturities, which currently offer 380-420 bps spreads over comparable Eurobond issues.

NBU tightens market regulations

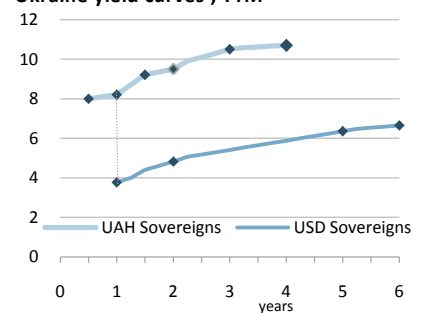
In 1H11, the Ukrainian banking system was flush with excess UAH liquidity, with an average overhang of UAH 4-5 bln (20-25% of total). The overhang, combined with partial FX liberalization (swaps, forwards, etc) led to increased demand for US dollars; the National Bank stepped in to support the UAH and sold USD 2.0 bln on the interbank FX market in June (up 70% m-o-m). This month the NBU: (1) raised requirements for bank reserves held by the NBU by 15-20% to ~UAH 3.0 bln; (2) adjusted regulations on open long currency positions to narrow speculative FX operations and encourage FX sales; and (3) increased rates on Certificate of Deposits by 25-35 pp and introduced 3M CDs, with 6.8% yield, as an additional instrument in line with ST treasuries for liquidity management.

The NBU's activities led UAH liquidity to decline by 20% in the first ten days of July to UAH 13 bln, since which it has picked back up slightly to UAH 17.0 bln. We think 'hryvnya repression' will continue to be the NBU's main monetary policy going forward and expect further tightening.

Report date

27 July 2011

Ukraine yield curves , YTM



Note: Prices as of July 25, 2011

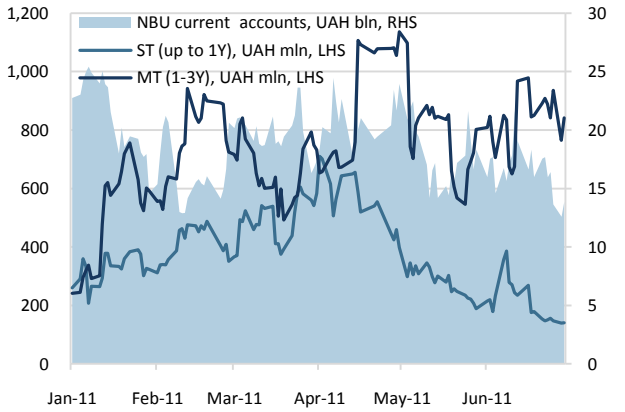
Source: Bloomberg, Concorde Capital

UAH/USD rate to stay at 8.0 in 2H11-1H12

We see the following grounds for a stable UAH/USD rate for the next year:

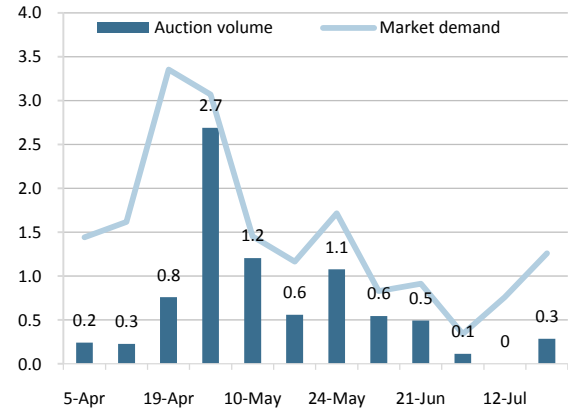
- Sufficient international reserves held by the NBU: USD 37.9 mln as of the end of May (roughly equal to five months of imports)
- Stable capital and financial account inflows fully offset the widening current account deficit (USD +4.5 bln. vs. USD -2.3 bln., respectively)
- The Finance Ministry is operating under the assumption Ukraine will renew its USD 16.5 bln IMF loan program (it expects to receive the next USD 1.5-3.0 mln tranche in September 2011)
- Next parliamentary elections in 2012 are slowly nearing – the government is eager to establish street credibility for ‘stable economic policy’

Secondary market turnover (10-days moving avg.), NBU accounts



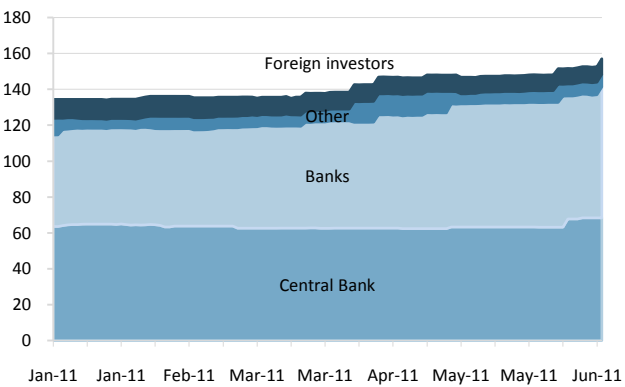
Source: NBU, Concorde Capital

Primary market liquidity, UAH mln



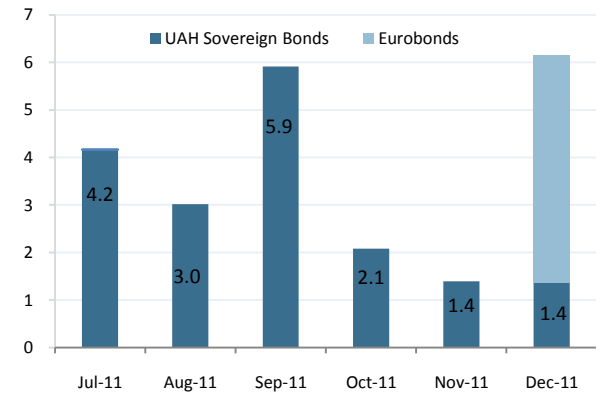
Source: Ministry of Finance, Concorde Capital

UAH government bonds ownership structure, UAH bln



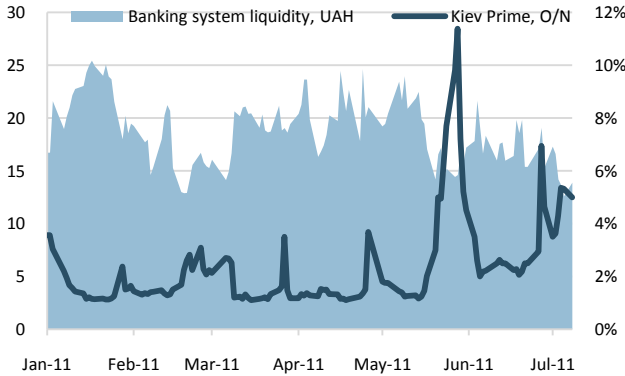
Source: NBU, Concorde Capital

Sovereign bonds 2011 redemption schedule, UAH bln



Source: Ministry of Finance, Concorde Capital

NBU current accounts balance (UAH mln), overnight KievPrime



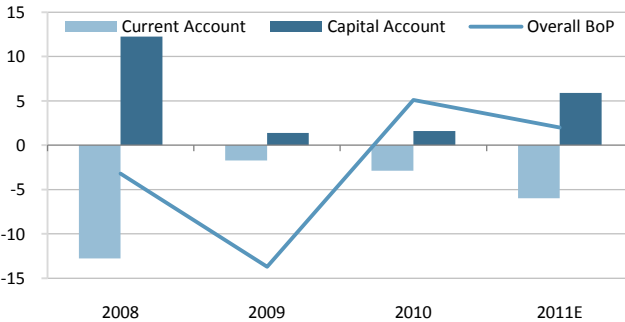
Source: NBU, Bloomberg, Concorde Capital

Average interbank USD/UAH rate, UAH



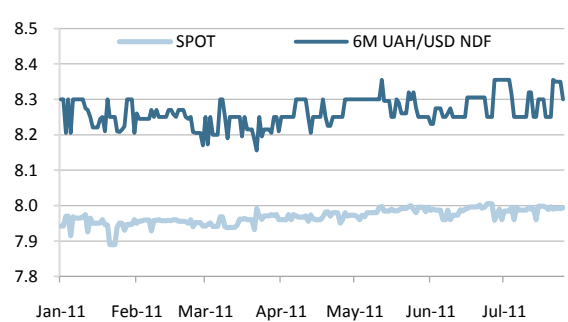
Source: Ministry of Finance, Concorde Capital

Balance of payments, USD bln



Source: NBU, Concorde Capital estimations

UAH spot exchange rate and 6M NDF, UAH/USD



Source: Bloomberg, Concorde Capital

Contacts

CONCORDE CAPITAL

2 Mechnikova Street, 16th Floor
 Parus Business Centre
 Kyiv 01601, Ukraine
 Tel.: +380 44 391 5577
 Fax: +380 44 391 5571
 www.concorde.ua
 Bloomberg: TYPE CONR <GO>

CEO

Igor Mazepa

im@concorde.com.ua

RESEARCH

Director of Research

Andriy Gerus

ga@concorde.com.ua

SALES

International Sales & Trading

Anastasiya Nazarenko

an@concorde.com.ua

Marina Martirosyan

mm@concorde.com.ua

Rostyslav Shmanenko

rs@concorde.com.ua

Dasha Vasilieva

vd@concorde.com.ua

Utilities, Agriculture, Consumer

Yegor Samusenko

syg@concorde.com.ua

Basic materials

Andriy Gerus

ga@concorde.com.ua

Energy, Chemicals

Antonina Davydenko

ada@concorde.com.ua

Industrial Machinery

Vitaly Gorovoy

vg@concorde.com.ua

Economics, Financials

Svetlana Rekrut

sr@concorde.com.ua

Fixed income

Andriy Gerus

ga@concorde.com.ua

Svetlana Rekrut

sr@concorde.com.ua

Politics

Brad Wells

bw@concorde.com.ua

Editor

Brad Wells

bw@concorde.com.ua

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