CEE Quarterly

Macro Research
Strategy Research
Credit Research

"Qualitative easing"

4Q 2019

"Your Leading Banking Partner in Central and Eastern Europe"

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Qualitative easing

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- Economic growth will remain below potential in CEE, hovering at 1.7% in 2019 and 2020 as Turkey's exit from recession offsets weaker growth in EU-CEE[1].
- GDP growth in EU-CEE could slow to 2.8% in 2020 from 3.8% in 2019, falling below potential for the first time in a decade.
- Western Balkans are more vulnerable to supply shocks, and economic convergence could be temporarily suspended in 2020.
- External woes will drive the slowdown, with weakness gradually seeping into investment, employment, wage growth and private consumption.
- Public policies became more inefficient in CEE as monetary stimulus from the ECB and Fed eased investor scrutiny. This is likely to change if global growth risks come to the fore.
- Despite a potential breach of inflation targets in 1Q20, we expect central European central banks to remain on hold in 2019-20. The NBS is likely to keep rates on hold as well.
- The CNB could be the first EU-CEE central bank to cut rates, while monetary stimulus will continue in Hungary at the expense of the HUF if economic growth weakens further.
- We expect the CBRT to cut the real interest rate to zero before year-end. The CBR has room to lower the key rate to 5.75-6% by the end of 2020.
- ECB's QE may help anchor yields and extend debt maturity in CEE. We do not expect an increase in foreign holdings of CEE bonds.
- We continue to prefer ROMANI EUR and RUSSIA USD in the credit space. OFZ, SERBGBs and ROMGBs may be more stable if risk appetite wanes.
- CEE bonds (excluding Turkey) are likely to outperform other EM bonds in a risk-off scenario.

Monetary easing from the ECB and the Fed…

The approaching end of the business cycle moved firmly into the spotlight during the summer. Faced with slowing growth and high uncertainty, both the Fed and the ECB eased in the third quarter. The ECB over-delivered, committing to open-ended QE and setting the stage for EUR interest rates to remain very low for longer in a bid to boost flagging economic growth (Chart 1).

…reinforced the dovish stance of CEE central banks…

The dovish tone set by developed-market central banks partly vindicated the inaction of their CEE counterparts in the past couple of years. Despite widening demand surpluses and rising core inflation, only the CNB raised interest rates in 2019, with other central European central banks remaining on hold, while the CBR and the CBRT cut rates. Rates are unlikely to rise before the end of 2020, no matter how high or resilient inflationary risks will be.

…and allowed public policies to become more accommodative in CEE

More generally, public policies turned more accommodative due to the prospect of economic growth falling below potential throughout CEE. Monetary easing abroad is not helping, since it supports risk appetite for EM assets and allows policy slippages that would have otherwise been penalized by investors. However, risk appetite is likely to wane as growth woes take center stage and the risk of further trade barriers continues to weigh on global trade.

[1] EU-CEE includes Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Slovakia and Slovenia, all CEE countries that are members of the EU.

1. Domestic demand partly offset external risks in 2Q19 and 3Q19…

Corporate credit supported by easy monetary conditions

With currencies under pressure and real interest rates falling due to higher inflation or cuts, real monetary conditions eased throughout CEE in the second and third quarters of the year. The main beneficiary was the corporate sector, which ramped up local-currency borrowing, especially in Hungary and Russia. In Czechia, Poland, Romania and Serbia, where local-currency rates remained significantly higher than EUR rates and central banks did not ease, FX lending rose faster than local-currency lending.

Weaker investment in 2Q19 and 3Q19…

Despite better support from long-term corporate lending and a late-cycle surge in real estate, investment lost speed into the beginning of autumn and is unlikely to recover. Poor export prospects led companies to postpone or scale down capex, with some of the largest projects in car manufacturing under threat from plummeting European demand.

…but resilient consumption

Consumer demand continued to power ahead, being the main contributor to GDP growth in the second and third quarter of the year. Income growth supported additional spending, but new retail lending failed to accelerate in most countries.

Poor exports the main reason for lower GDP growth

Yet the most important story since the end of spring remains lower export growth (Chart 2), with the slowdown in the eurozone and the outright contraction in Germany weighing on foreign trade in a majority of CEE countries. Thus, the benefit of a temporary rebound in global trade in 3Q19 was completely offset in CEE by weak industrial production in Germany.

FOREIGN DEMAND LED THE GROWTH SLOWDOWN IN CEE OVER THE SUMMER

Chart 1: Manufacturing weakened further in the eurozone…

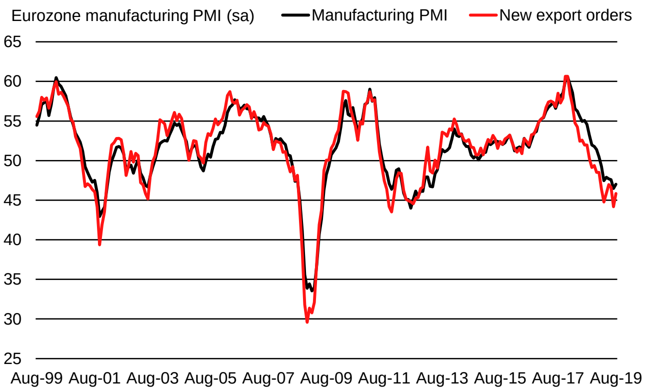
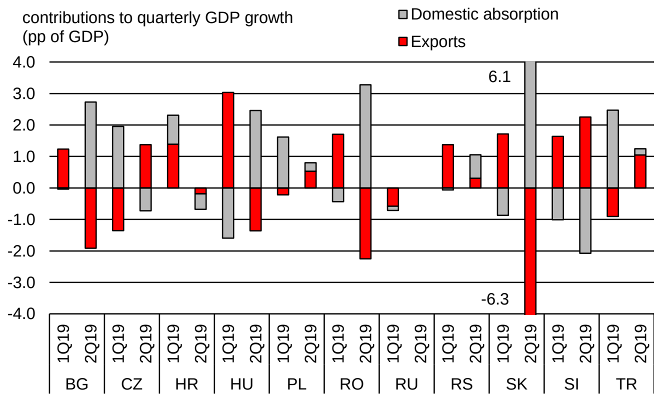


Chart 2: …weighing on CEE exports in 2Q19



2Q19 GDP data for Russia not available at time of publication.

Source: Markit, Eurostat, national statistical offices, UniCredit Research

2. …but the export-driven slowdown will accelerate in 4Q19 and 2020

GDP growth expected at 2.8% in 2020, below potential

2020 is likely to be the first year in a decade with sub-potential growth throughout CEE, with EU-CEE likely to grow by 2.8% compared to 3.8% in 2019. CEE will benefit from Turkey's emergence from recession, with region-wide growth hovering at 1.7% in 2019 and 2020.

Export weakness to affect domestic demand in EU-CEE and the Balkans

In EU-CEE, the main story in 4Q19 and 2020 is of export weakness gradually seeping through to domestic demand (Chart 4). The starting point for the latter is a very strong one, so it will probably take at least until next spring before GDP growth slows below potential.

The western Balkans will face a similar situation as governments and companies cannot boost domestic demand enough to offset weak exports. While these countries should continue to catch up to EU living standards, convergence could end temporarily in 2020.

Growth momentum to weaken in Russia in 2020

Russia and Turkey seemed to be heading in the opposite direction to EU-CEE, with growth strengthening over the summer. In Russia, this apparent good growth momentum stems from negative base effects that slowed economic dynamics in the first half of the year. Exports, fiscal spending and the credit impulse will all contribute to faster growth in the remainder of 2019 but will fail to push annual growth above 2% in 2019. The situation could be similar in 2020 if structural issues remain unaddressed and public investment does not accelerate.

Growth to accelerate in Turkey only if financial conditions ease

In Turkey, growth exceeded expectations in 1H19 as the government managed to increase public spending by burning through reserves and CBRT profits. Even so, the recent revival is mainly based on a sizeable external adjustment, rather than better growth momentum at home (Chart 3) and may lose steam before year-end. In 2020, the exit from recession will need support from looser financial conditions. In our opinion, this would require financial support from abroad, since the external environment is unlikely to remain as favorable as in 2019.

ECONOMIC GROWTH TO FALL BELOW POTENTIAL BY 2020 THROUGHOUT CEE

Chart 3: GDP growth forecasts for 2019

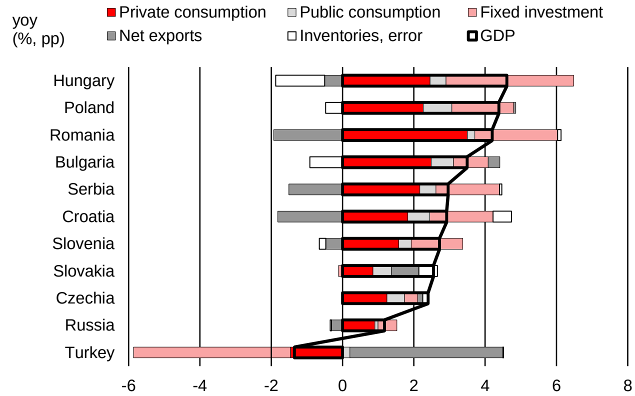
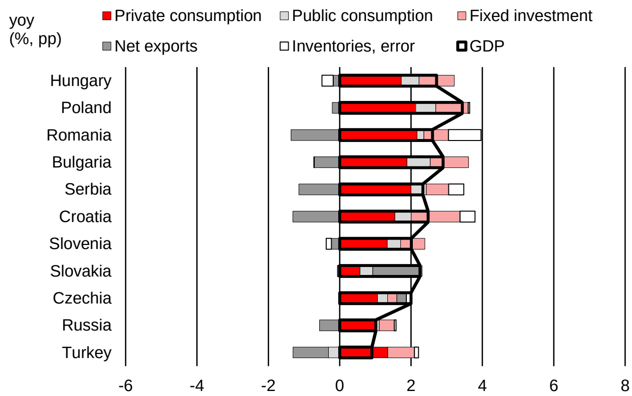


Chart 4: GDP growth forecasts for 2020



Source: Eurostat, national statistical offices, UniCredit Research

Labor shortages are easing in EU-CEE, slowing wage growth

In EU-CEE, household spending will benefit from fast wage growth and resilient consumer optimism. Yet wage bargaining in 2020 could be affected by poor export prospects, with labor shortages already easing from all-time highs (Chart 5). Lack of available workers continues to put pressure on wages, especially in construction, but fewer manufacturing companies complain about not being able to fill vacancies than six months ago.

The first waves of layoffs will affect migrant workers more than local labor

Towards the end of 2020, private employment could start falling in countries that are more dependent on foreign demand, like Czechia or Hungary. However, in both this countries and in Poland and Slovakia, unemployment will start rising with a delay because the first waves of layoffs will affect mostly migrant workers.

Governments will boost spending…

Governments will step in with wage and pension increases (in Croatia, Czechia, Poland, Romania, Serbia and Slovakia) or with large handouts (in Hungary and Poland) to smooth the adjustment in income growth. However, consumer confidence and spending are expected to dip with wage growth in the private sector. Since most wage bargaining takes place in the first quarter, the biggest impact on consumption and retail growth could be seen from 2Q20 onwards.

…with companies likely to foot the bill

Even if wage growth slows (Chart 6), margins will decline in the corporate sector due to weaker demand, higher labor costs and, in some countries, a higher tax bill as governments shift the tax burden away from voters (like in Poland and, very likely, Romania). Excessive currency undervaluation in central Europe will hit the suppliers of large exporters, since most of them are price takers and their production is dependent to a large extent on imports. As a result, capex is likely to weaken further in EU-CEE.

Households are also driving a late-cycle boom in real estate, the only widely available investment opportunity in a region where capital markets are underdeveloped compared to other EM. The only exception is Hungary, where the MAP Plusz retail bond yields 5% on average for five years, comparable to an investment in housing or office space but with better liquidity.

Western Balkans more vulnerable to supply shocks

Weak foreign demand leaves the western Balkans more vulnerable to idiosyncratic supply shocks, such as production disruptions. Thus, growth could be more volatile than in EU-CEE, increasing precautionary savings at both companies and households.

WAGE GROWTH TO SLOW AS LABOR MARKET TENSIONS EASE

Chart 5: Labor shortages are easing in EU-CEE…

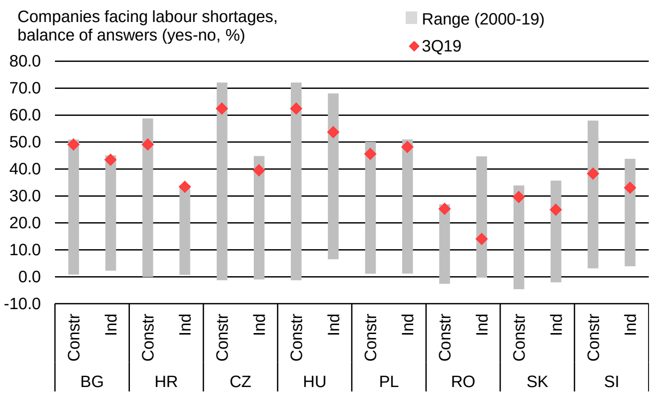
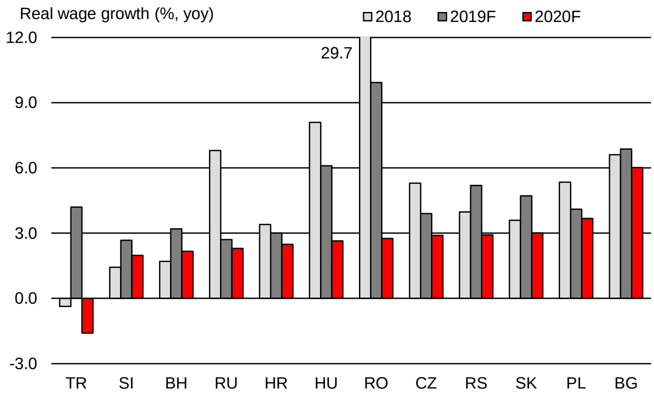


Chart 6: …and will contribute to lower wage growth in 2020



Source: Eurostat, statistical offices, UniCredit Research

Credit growth, fiscal spending and a better harvest will keep growth above 1%

In Russia, growth will benefit from a better harvest than in 2018 and higher fuel exports after disruptions were fixed at the Druzba pipeline. The credit impulse is the highest across CEE for households and one of the highest for companies. While the CBR will act to slow credit growth, momentum is sufficient to keep annual growth above 1% in 4Q19 and 1Q20. In case Saudi oil production fails to recover quickly, Russia could increase oil exports, offsetting part of the expected decline in other commodity exports. Otherwise, commodity exports are likely to feel the late-cycle blues.

The external adjustment is driven by lower imports in Turkey

In Turkey, the external adjustment is heavily reliant on falling imports, with exports affected by poor demand from Europe and the Middle East. Looking through volatile data over the summer (caused by the timing of religious holidays), it is clear that export growth suffers from weak growth in Europe and tensions in the Middle East. Both risks will persist in 2020.

WEAK EXPORT DYNAMICS IN RUSSIA AND TURKEY

Chart 7: Export growth unlikely to recover in Russia…

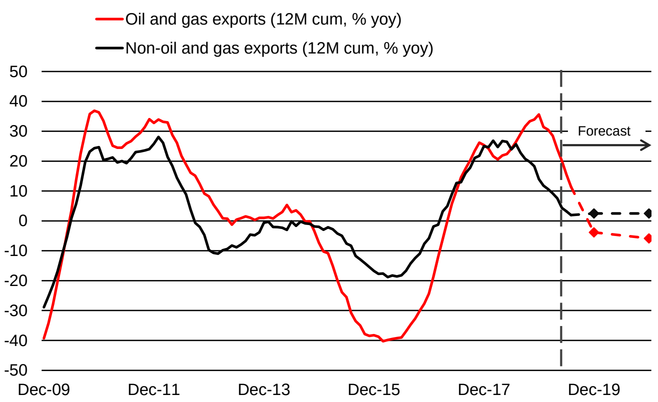
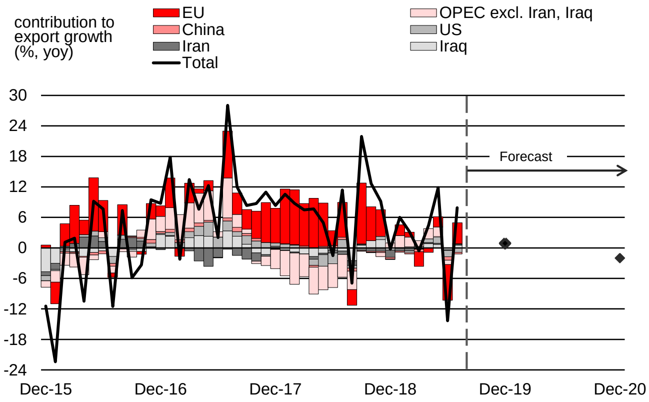


Chart 8: …or Turkey



Source: central banks, Eurostat, national statistical offices, ministries of finance, UniCredit Research

3. Central banks losing sight of inflation

Inflation could temporarily exit target ranges in central Europe

Inflation is yet to peak in EU-CEE, but central banks are already looking through potential target breaches. A combination of high core inflation and base effects in fuel prices is likely to push inflation outside target ranges in Hungary (in December 2019 or January 2020), Poland (in January 2020), while keeping it well outside the target range in Romania (Chart 9). Czechia may follow the regional trend, although inflationary base effects are smaller than in the rest of central Europe. From 2Q20 onwards, consumer prices could rise at a slower pace, narrowing the gap to eurozone inflation as demand pressure on prices starts to ease.

Central banks are reacting differently to the upcoming inflation spike.

The CNB remains the most cautious CEE central bank…

...but could be the first one to cut in central Europe if the outlook worsens

The CNB is postponing a dovish turn that markets are already expecting, with the FRA curve pricing in two rate cuts next year. While MPC communication has changed from outright hawkish to neutral (but with room for additional hikes), a more dovish stance may be warranted once inflation starts to fall in 2Q20. Compared to the moment when the CNB hiked for the last time, both monetary and economic conditions changed. Back in May, the Czech central bank expected the ECB to return the deposit rate to zero by the end of 2019. Instead, a cut to -0.50% and the resumption of QE led to much easier monetary conditions in the eurozone. In addition, the CNB expected exports to accelerate in 2020, a forecast maintained in the August inflation report. With growth likely to disappoint due to both domestic and external demand, a revision of appropriate monetary conditions – including interest and exchange rates – is likely in 2020. If demand from the eurozone does not recover, the CZK is unlikely to need further appreciation, since it is already close to fair value. Of all EU-CEE central banks, the CNB is the likeliest to cut first and it may act already in 2020 if economic growth slows significantly at home and abroad.

Monetary stimulus will continue in Hungary…

…at the expense of the HUF

The NBH prefers to focus on core inflation, ignoring the likely rise in headline inflation towards year-end. The stated goal remains monetary stimulus via low interest rates and liquidity provisions to banks in order to boost lending. In addition, the NBH needs to offset tighter liquidity caused by pre-spending on EU-funded projects and strong demand for high-yielding retail bonds. The likely victim is the HUF, whose undervaluation could increase, supported by its low carry. Rate cuts from current levels would be inefficient, so potential easing would take the shape of further liquidity injections.

NBP on hold in 2019-20 amid resilient inflation

The NBP has ignored so far short and medium-term risks to inflation. Its July forecast acknowledged that a target breach in 1Q20 carries a high probability, but official communication has looked through this spike. In addition, the central bank has downplayed significant fiscal spending that will boost household income and consumption in 2020 and beyond. We expect core inflation to trend higher next year. As a result, unexpected supply shocks could threaten the inflation target, even if inflation imported from the eurozone is low. Thus, we expect the NBP will remain on hold this year and next. As long as headline inflation stays above or close to 3%, the Polish central bank is unlikely to cut (Chart 10).

NBR on hold with the wrong mix of monetary conditions

The same is valid for the NBR, expected to remain on hold in 2019-20. A likely re-liberalization of gas and electricity prices threatens target misses for three years in a row (2019-21), as mentioned in the country section. Even so, the Romanian central bank will favor real currency appreciation and negative real interest rates (but high nominal rates), a combination of real monetary conditions that is not conducive to stabilizing inflation or supporting lending in the local currency.

NBS on hold with questions surrounding target level

The NBS may have to reconsider the level of its target if inflation fails to return to 3%. The output gap will not match that of EU-CEE as long as fiscal policy remains prudent and does not try to cushion household income against the global slowdown. Additional rate cuts are unlikely, especially if risk appetite for EM assets falls.

NO ROOM FOR MONETARY TIGHTENING

Chart 9: Inflation likely to fall by end-2020 throughout CEE…

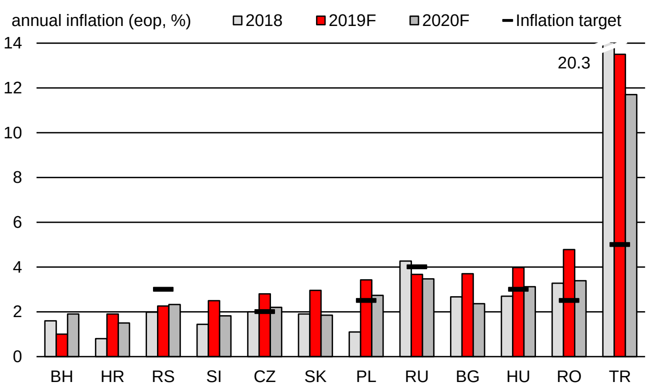
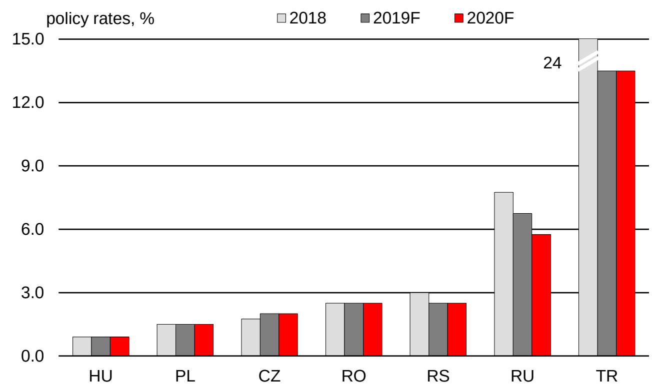


Chart 10:… helping central banks to remain on hold or cut rates



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Source: Eurostat, national statistical offices, UniCredit Research

CBRT could cut real rates to zero

The CBRT looks determined to reduce the real interest rate close to zero, in a repeat of past behavior. Thus, further rate cuts to 13.5% before the end of 2019 are in the cards, in our opinion. They will be palatable to investors for as long as capital continues to flow to EM. Any reversal in flows would expose Turkey's incomplete adjustment in foreign borrowing and could reignite pressure on the TRY.

CBR has room to cut to 5.75-6%

The CBR is facing a long-term target undershoot due to weak domestic demand and a successful dilution of the correlation between RUB and commodity prices. Negative terms of trade expected as the global business cycle draws to an end may not result in significant depreciation. Adding lower risk premia for Russian financial assets and a potential reassessment of long-term equilibrium interest rates in the US and Europe, the CBR has room to cut rates to 5.75-6% by the end of next year. Rate cuts combined with tighter prudential regulation may extend the positive credit impulse into 2020, without threatening financial stability.

4. Throwing good policies after bad

Public policies are worsening the loss of external competitiveness

Public policies tend to become less efficient towards the end of the business cycle and CEE is no exception. Authorities know that economic success is paramount to lasting electoral success and are ready to reverse past macroeconomic adjustments in an attempt to mend what is not yet broken. The deterioration affects both the structure and size of stimuli.

Few central banks concerned with financial stability issues

In normal circumstances, authorities would focus on improving competitiveness at a time when exports are threatened by rising trade barriers and poor demand from abroad. Instead, the focus is firmly on consumers and fostering credit growth to the point where questions of adverse selection and market saturation arise.

Few central banks moved to address the credit boom, despite the late phase of the business cycle and the risk of house price bubbles and excessive debt accumulation, with Czechia, Slovakia and Russia the exceptions. At the opposite end, the NBH is doling out liquidity to fuel the credit impulse as an antidote to weaker investment (Chart 11). In between are countries where lending in EUR is rising fast, increasing companies' FX risks while currencies are facing higher risks of depreciation (Chart 12).

CORPORATE LENDING IS RISING FAST AT THE COST OF HIGHER FX RISKS

Chart 11: Corporate credit impulses are positive in most countries…

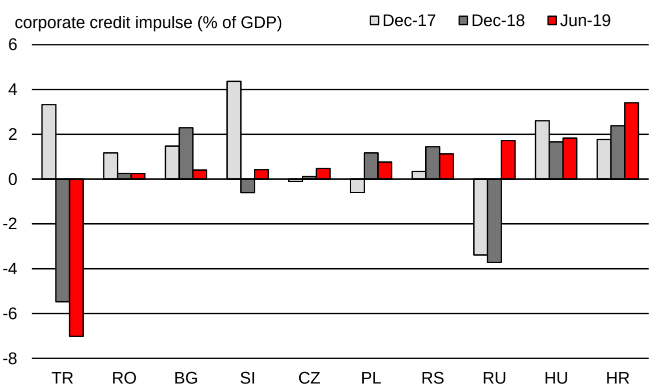
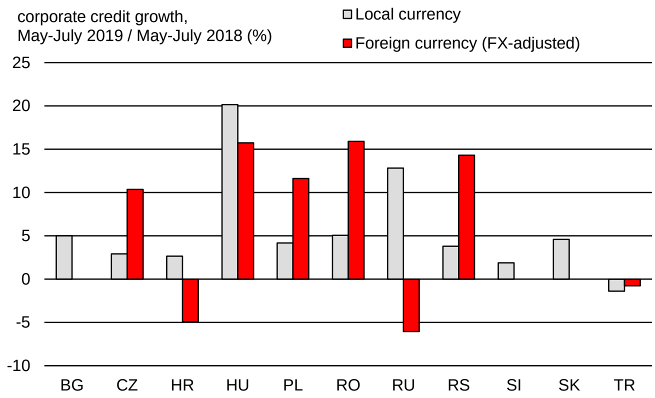


Chart 12: …and rely in many countries on a revival of FX lending



Source: statistical offices, central banks, Bloomberg, UniCredit Research

Fiscal easing amid upcoming elections

Monetary easing is doubled by fiscal easing in many countries (Chart 13). Upcoming elections are a trigger for fiscal profligacy in Poland, Romania and Slovakia, with the Czech government also trying to boost its support by loosening its purse. The focus on non-discretionary spending – social transfers, pensions and wages – reduced the government's room to act in case of a more pronounced downturn and is affecting even countries that have implemented more cautious fiscal policies in the recent past, such as Croatia and Bulgaria. The lower interest bill brought about by cheaper borrowing will be completely offset by rising expenditure before year-end.

Fiscal stimulus peaked in 2019, too early

As noted before, fiscal impulses are probably peaking too early – in 2019 – with little scope for a spending boost in 2020 (Chart 14). This is the case primarily in Poland, Romania and Turkey, where structural budget deficits will exceed 3% of GDP in 2019 and beyond. Romania's pension law is a time bomb that may not be defused before next year's parliamentary elections. Thus, Romania could be the first EU-CEE country to be downgraded to junk status in the current cycle. Croatia, Hungary, Serbia, Slovakia and Slovenia have little room to increase budget deficits next year due to strict debt rules and/or the need to reduce debt in order to ease pressure on issuance and secure rating upgrades.

Little room to spend more in EU-CEE…

Bulgaria, Czechia and Russia will have room to spend more, but none of the three is expected to increase spending significantly in 2020. Nevertheless, Czechia seems affected by the common EU-CEE move to more social spending. Russia will sharply increase its non-oil budget deficit but public investment will remain constant in percent of GDP.

…or in Turkey

Turkey burned through fiscal reserves and CBRT profits in an attempt to prop up domestic demand. From here on, the scope for public support may be limited by poor foreign demand for Turkish bonds and the need to replenish bank capital if NPLs continue to rise. Thus, the budget deficit is likely to fall next year, with the fiscal impulse being just a fraction of this year's stimulus.

FISCAL POLICY BECAME ACCOMMODATIVE TOO SOON

Chart 13: Budget deficits widened already in 2019…

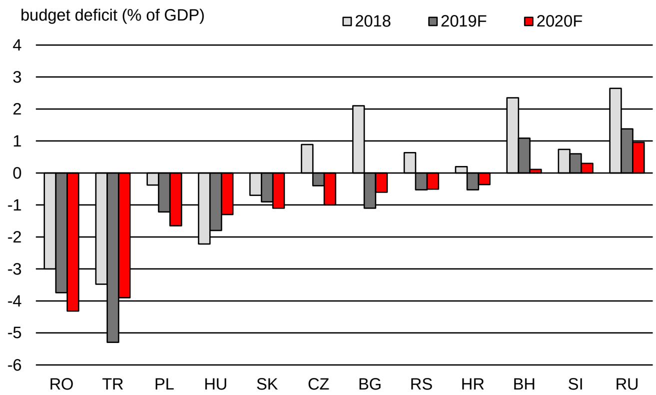
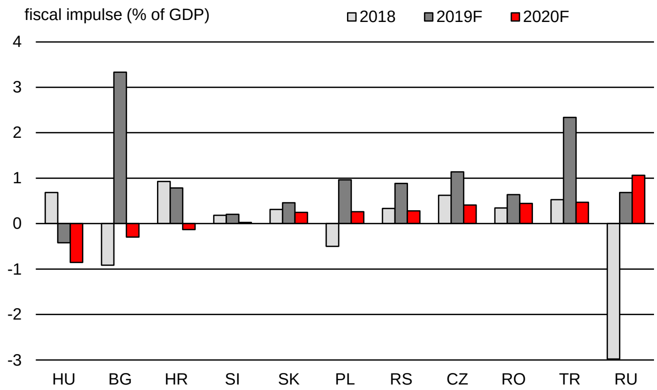


Chart 14: …reducing the scope for large fiscal impulses in 2020



Source: statistical offices, Eurostat, ministries of finance, UniCredit Research

5. Qualitative easing

ECB's QE could help anchor yields and extend debt maturity in CEE…

Seen by many as a panacea to poor economic prospects, the ECB's renewed asset purchases may have little impact on European growth. In CEE, past experience shows that the latest round of QE may help anchor borrowing costs and allow for further extending debt maturity, rather than boost the quantity of foreign bond purchases. Thus, qualitative easing – the rise in risk appetite among foreign investors – may be more important for CEE issuers than the rise in EUR liquidity.

…but not increase foreign purchases of bonds

The lack of a clear quantitative benefit may be related to the change of investor structure as yields fell in CEE. EM-dedicated accounts reduced their exposure to the region, with global mandates increasing theirs. While these accounts would have more room to buy bonds in CEE, purchases are capped by low liquidity in terms of size of outstanding bonds and market transactions. Neither is likely to improve because lower financing costs pushed governments to issue less in FX and longer-term in local currency. Moreover, the size of each bond is capped at around EUR 1-2bn in most countries to avoid spikes in redemptions.

Lower foreign holdings not a protection against volatility

There are two main results from the point of view of CEE sovereign borrowers:

1. Foreign ownership of local-currency bonds fell since the ECB launched QE (Chart 15). In theory, this reduces the risk of volatility in times of market stress. In practice, CEE bond markets tend to remain more liquid than EM counterparties when EM financial assets sell off. As a result, CEE bonds can be affected by forced selling when investors face redemptions.

There are two exceptions to the downward trend in foreign ownership. The first is Czechia, where foreign holdings increased after the CNB imposed a floor on EUR-CZK in November 2013 (due to arbitrage opportunities) and after CZGBs were re-included in EM indices in 2017. The second exception is Russia. With access to foreign funding sharply curtailed by sanctions, Russia increased RUB issuance. Investors rushed to buy RUB bonds owing to attractive currency valuation, external deleveraging, prudential fiscal and monetary policies, and lower correlation with core rates than in other large EM. The only big risk to foreign holdings of OFZ is additional sanctions, but it may be postponed until after US elections in November 2020.

Lower annual financing needs as maturities lengthen

2. Gross financing needs continue to decline or remain very low in CEE (Chart 16), with local currency issuance prevalent. The most successful local currency issuers, such as Czechia, Hungary and Poland, depopulated their FX curves to the point where outstanding bonds match those of frontier markets rather than those of more established EM. Any of these countries may return opportunistically to the EUR market, in most cases to refinance maturing or more expensive FX debt. Russia finds itself in a similar situation, although with a much reduced pool of investors due to US sanctions. The only net issuers in FX are Romania and Turkey.

QE IN THE EUROZONE AND THE US REDUCED THE RELIANCE ON SHORT-TERM DEBT AND FOREIGN INVESTORS

Chart 15: Foreign holdings of CEE bonds fell since ECB's QE1

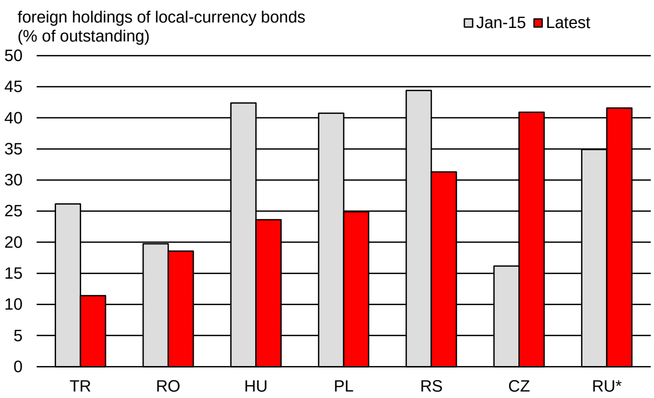
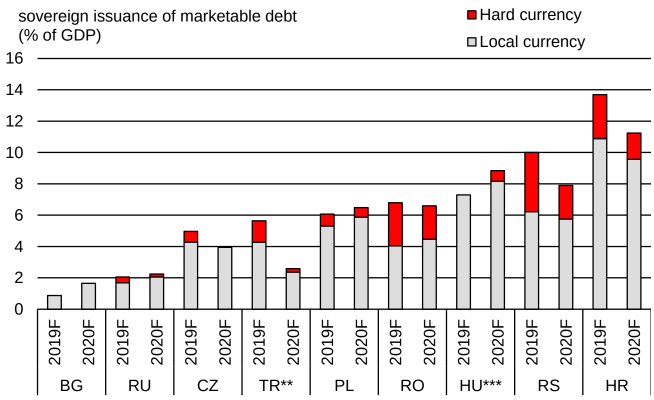


Chart 16: Sovereign issuance stable or falling in CEE



*percent of fixed-coupon OFZ; **assuming an IMF agreement in 2020; ***excluding retail issuance Source: ministries of finance, Bloomberg, UniCredit Research

QE helped lower FX yields in CEE…

The qualitative effects of previous rounds of QE from the ECB and the Fed are evident in credit spreads However, the picture is not uniform. EUR credit spreads to Bunds (and USD spreads to USTs) fell in countries where ratings were maintained or improved (Chart 17). However, idiosyncratic factors apply.

…but credit spreads depend on quality of domestic policies

1. The strongest tightening happened in Croatia, which managed to return to investment grade. Spread tightening preempted rating upgrades and is excessive at the moment. This brings fiscal policy into the spotlight as prudence is required to maintain current valuation.

2. The strongest widening happened in Turkey, where last year's BoP crisis and ensuing fiscal easing led to repeated sovereign downgrades and to wider spreads. Spreads widened further in 2019 amid large net issuance.

3. Russia's return to investment grade was not accompanied by spread tightening, most likely due to sanctions affecting investors' access to RUSSIA FX bonds, especially to the primary market.

ROMANI EUR and RUSSIA USD remain the top picks amid tight spreads elsewhere

4. ROMANI EUR spreads to Bunds widened by 50bp in 2019 due to large net supply, political noise and fiscal risks. However, spread widening was not enough to lead to higher yields.

5. POLAND EUR trade at negative yields up to 10Y, showing that a combination of strong local fundamentals and proximity to the eurozone can have similar effects to being part of ECB bond purchases.

Our picks in the credit space remain ROMANI EUR and RUSSIA USD. Neither offer good perspectives for capital gains but are cushioned by higher spreads against potential corrections in core yields.

CEE HARD-CURRENCY AND LOCAL-CURRENCY YIELDS BENEFITED FROM QE

Chart 17: Credit spreads fell in EU-CEE thanks to ECB's QE

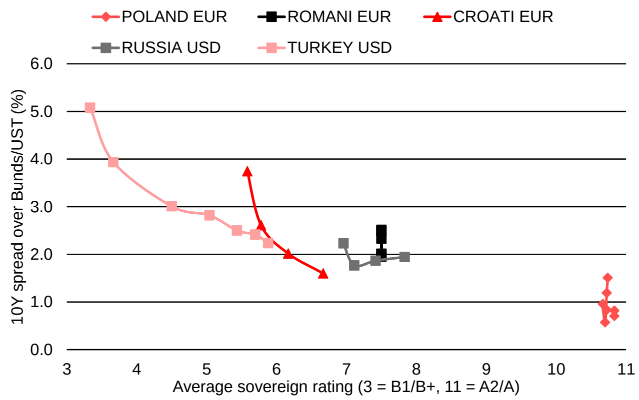
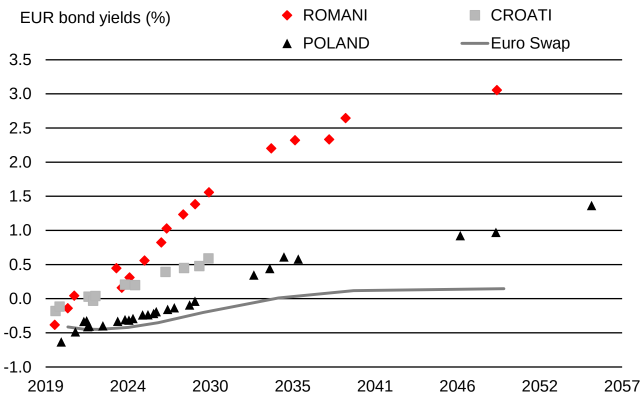


Chart 18: Negative EUR yields up to 10Y in central Europe



Source: Bloomberg, UniCredit Research

Local-currency yields benefited more from QE…

…with real yields lower in CEE than in other EM

The effect of previous QE rounds is more obvious in local-currency yields. Adjusted for inflation, CEE LC yields are significantly lower than in other EM. While inflation is likely to fall next year, the improvement in real yields will be marginal. Better fundamentals than in other EM are part of the explanation for the good performance. Another reason is lower FX hedging costs than in other EM, with HGBs and ROMGBs ranking close to much higher-yielding bonds in South Africa or South-East Asia once currency risk has been hedged away.

CZGBs and HGBs more vulnerable if risk appetite declines…

…with OFZ, ROMGBs and SERBGBs better cushioned

If global growth risks take precedence over monetary easing in shaping investor decisions, central European bonds could sell off temporarily, with CZGBs and HGBs more at risk. ROMGBs are better cushioned by high yields but are exposed to currency risk early next year if the NBR allows EUR-RON to move to a higher range of 4.80-90. SERBGBs remain a pick for investors who prefer illiquid markets in risk-off episodes. There is scope for OFZ to rally if the CBR continues to cut rates, as we expect. This is also valid for short-term RUB rates. If Bund yields do not sell off, long-end CZGBs and POLGBs will remain a pick for risk-averse eurozone real money accounts.

CEE likely to outperform other EM in a risk-off environment

More generally, CEE (excluding Turkey) will outperform other EM local-currency bonds in times of stress. Despite their lower yields, returns could be attractive if higher-yielding bonds sell off due to (geo)political and economic risks. As shown in the strategy section, the correlation between yields and returns has already turned negative.

CEE HARD-CURRENCY AND LOCAL-CURRENCY YIELDS BENEFITED FROM QE

Chart 17: Credit spreads fell in EU-CEE thanks to ECB's QE

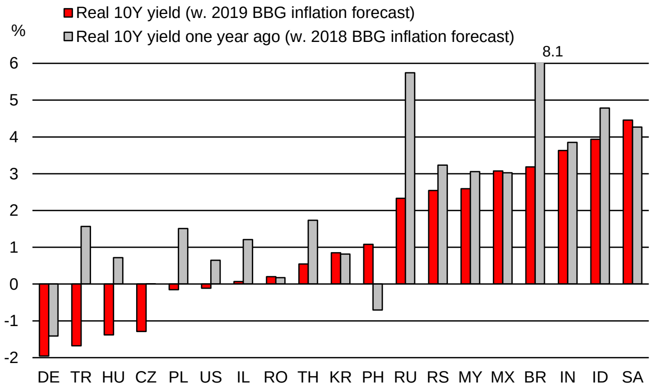
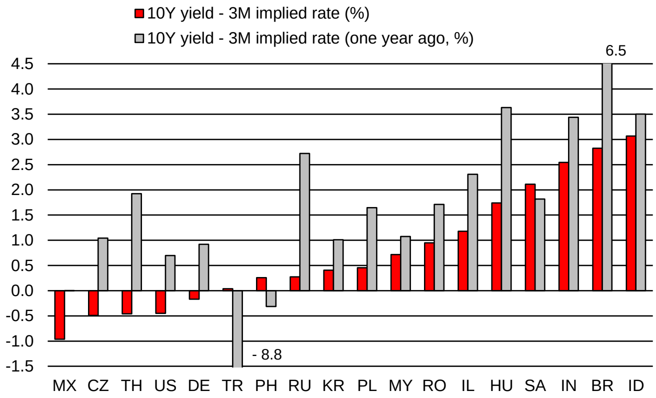


Chart 18: Lower real local-currency yields in CEE than in other EM



Source: Bloomberg, UniCredit Research

OUR GLOBAL FORECAST

	GDP growth, %			CPI (Avg), %			Policy rate (%)			10Y bond yield (EoP), %			Exchange rate LC vs. USD		
	2018	2019F	2020F	2018	2019F	2020F	2018	2019F	2020F	2018	2019F	2020F	2018	2019F	2020F
Eurozone	1.9	1.2	0.9	1.8	1.3	1.2	0	0	0	-	-	-	1.15	1.14	1.18
Germany	1.5*	0.6*	0.9*	1.8	1.4	1.4	-	-	-	-0.02	-0.4	0	-	-	-
France	1.7	1.3	0.9	1.9	1.2	1.3	-	-	-	-	-	-	-	-	-
Italy	0.7	0	0.3	1.1	0.8	1.0	-	-	-	2.51	2.35	2.25	-	-	-
UK	1.4	1.1	0.8	2.5	1.9	1.7	0.75	0.75	0				1.28	1.29	1.39
USA	2.9	2.2	0.7	2.4	1.9	1.7	2.50	1.75	1.25	2.42	1.75	2.25	-	-	-
Oil price, USD/bbl	-	-	-	-	-	-	-	-	-	-	-	-	54	67	60

*Non-wda figures. Adjusted for working days: 1.5% (2018), 0.6% (2019), 0.5% (2020)

Source: Bloomberg, UniCredit Research

THE OUTLOOK AT A GLANCE

Real GDP (% change)	2017	2018	2019F	2020F
EU-CEE	4.8	4.3	3.8	2.8
Bulgaria	3.8	3.1	3.5	2.9
Czechia	4.5	2.9	2.4	2.0
Hungary	4.1	4.9	4.6	2.7
Poland	4.9	5.1	4.4	3.4
Romania	7.0	4.1	4.2	2.6
Croatia	2.9	2.6	2.9	2.5
Russia	1.6	2.3	1.2	1.0
Serbia	2.0	4.3	3.0	2.3
Turkey	7.5	2.8	-1.3	0.9

CPI (EoP) (% change)	2017	2018	2019F	2020F
EU-CEE	2.3	1.9	3.5	2.6
Bulgaria	2.8	2.7	3.7	2.4
Czechia	2.4	2.0	2.8	2.2
Hungary	2.1	2.7	4.0	3.1
Poland	2.1	1.1	3.4	2.7
Romania	3.3	3.3	4.8	3.4
Croatia	1.2	0.8	1.9	1.5
Russia	2.5	4.3	3.7	3.5
Serbia	3.0	2.0	2.3	2.3
Turkey	11.9	20.3	13.5	11.7

C/A balance (% GDP)	2017	2018	2019F	2020F
EU-CEE	0.4	-0.6	-0.4	-0.5
Bulgaria	3.5	5.4	5.5	4.5
Czechia	1.7	0.3	0.9	1.1
Hungary	2.3	-0.5	-1.3	-0.6
Poland	0.2	-0.6	-0.1	-0.8
Romania	-3.2	-4.7	-4.4	-4.0
Croatia	3.5	2.5	1.2	1.0
Russia	2.1	6.9	6.3	6.3
Serbia	-5.2	-5.2	-5.6	-5.6
Turkey	-5.6	-3.5	0.1	-1.9

Extended basic balance (% GDP)	2017	2018	2019F	2020F
EU-CEE	3.1	2.7	3.0	2.5
Bulgaria	6.9	6.9	8.2	7.4
Czechia	3.4	2.3	2.6	3.0
Hungary	4.9	4.2	4.2	3.6
Poland	2.6	3.4	3.7	2.6
Romania	0.5	-1.3	-1.0	-1.9
Croatia	7.1	5.3	5.5	5.3
Russia	1.6	5.5	4.9	4.7
Serbia	0.9	2.3	0.6	-0.3
Turkey	-4.7	-2.3	1.3	-0.6

External debt (% GDP)	2017	2018	2019F	2020F
EU-CEE	74.7	70.5	65.9	62.6
Bulgaria	65.5	60.4	55.0	50.5
Czechia	86.5	81.6	79.8	77.9
Hungary	84.9	80.2	75.2	71.5
Poland	67.7	63.0	57.0	51.6
Romania	51.9	48.7	46.2	47.7
Croatia	82.1	75.4	70.3	68.5
Russia	30.9	28.2	26.2	26.2
Serbia	65.3	62.8	59.1	56.6
Turkey	53.4	57.2	57.9	64.4

General gov't balance (% GDP)	2017	2018	2019F	2020F
EU-CEE	-1.0	-0.6	-1.4	-1.7
Bulgaria	1.2	2.1	-1.1	-0.6
Czechia	1.6	0.9	-0.4	-1.0
Hungary	-2.2	-2.2	-1.8	-1.3
Poland	-1.5	-0.4	-1.2	-1.6
Romania	-2.9	-3.0	-3.7	-4.3
Croatia	0.8	0.2	-0.5	-0.4
Russia	-1.4	2.6	1.4	1.0
Serbia	1.1	0.6	-0.5	-0.5
Turkey	-2.3	-3.5	-5.3	-3.9

Gov't debt (% GDP)	2017	2018	2019F	2020F
EU-CEE	48.6	46.7	45.6	44.7
Bulgaria	25.4	22.1	20.8	20.5
Czechia	34.7	32.7	31.2	30.8
Hungary	71.5	69.1	69.5	66.8
Poland	50.4	48.5	46.5	45.6
Romania	35.2	35.1	36.0	36.8
Croatia	77.8	74.6	72.3	69.8
Russia	12.6	12.1	12.5	13.7
Serbia	58.7	54.5	51.7	49.2
Turkey	28.3	30.4	31.4	32.9

Policy rate (%)	2017	2018	2019F	2020F
EU-CEE	-	-	-	-
Bulgaria	-	-	-	-
Czechia	0.50	1.75	2.00	2.00
Hungary	0.90	0.90	0.90	0.90
Poland	1.50	1.50	1.50	1.50
Romania	1.75	2.50	2.50	2.50
Croatia	-	-	-	-
Russia	7.75	7.75	6.75	5.75
Serbia	3.50	3.00	2.50	2.50
Turkey	8.00	24.00	13.50	13.50

FX vs. EUR (EoP)	2017	2018	2019F	2020F
EU-CEE	-	-	-	-
Bulgaria	1.96	1.96	1.96	1.96
Czechia	25.5	25.7	25.7	25.2
Hungary	310.1	321.5	330.0	335.0
Poland	4.2	4.3	4.3	4.3
Romania	4.66	4.66	4.78	4.85
Croatia	7.51	7.42	7.43	7.45
Russia	68.9	79.7	75.8	82.2
Serbia	118.5	118.2	117.8	118.6
Turkey	4.56	6.07	7.04	8.26

Source: National statistical agencies, central banks, UniCredit Research

EM VULNERABILITY HEATMAP

	BG	CZ	HR	HU	PL	RO	RS	RU	SK	TR	UA	MX	BR	CL	SA	ID	IN	CN	AG
External Liquidity																			
Current account (% of GDP)	8.5	0.7	2.0	-1.1	-0.1	-5.0	-5.6	6.8	-2.5	0.2	-2.8	-0.9	-1.7	-3.6	-3.2	-3.1	-2.1	1.3	-3.7
Extended Basic Balance (% of GDP)	10.4	2.5	4.6	4.0	3.8	-1.0	1.9	6.2	1.1	1.4	-1.2	0.9	-0.4	-2.7	-1.1	-1.5	-2.1	1.8	-3.3
FX Reserves coverage (months of imports)	8.1	7.9	8.1	2.6	4.3	4.0	6.1	14.4	-	4.1	3.2	4.3	17.4	5.5	5.0	6.8	7.5	15.1	11.5
External Debt (excl.ICL, % of GDP)*	35.9	80.5	64.1	56.8	44.8	35.0	62.6	20.8	89.2	61.1	83.5	36.9	69.6	65.8	49.1	36.7	20.0	14.5	46.2
Short-term debt (% of GDP)	14.4	46.8	20.8	10.3	8.1	7.2	2.9	3.3	47.1	17.2	11.6	3.9	4.4	7.6	10.3	4.7	7.8	9.2	10.9
REER (Index, 2010=100)	102.0	98.7	97.3	88.4	90.2	97.3	123.6	84.1	-	62.9	93.4	84.6	104.7	90.9	85.2	92.9	107.8	117.4	-
Domestic Finances																			
Corporate debt (% of GDP)	48.6	52.1	58.0	57.3	45.9	38.5	42.2	55.2	54.9	98.3	72.5	38.1	41.8	79.3	57.8	36.3	46.0	154.7	16.1
Household Debt (% of GDP)	20.1	34.2	35.5	20.6	35.6	18.9	20.3	16.6	44.3	13.6	5.8	16.3	44.3	36.1	33.8	16.2	11.6	53.6	5.8
Nonresident holdings of gov.debt (% total)	0.9	40.9	-	23.6	24.9	18.6	31.3	39.4	51.8	11.4	-	28.6	10.3	-	37.9	37.7	-	8.4	-
Banking System																			
Credit Impulse (% of GDP)	0.3	0.5	3.4	1.8	0.8	0.2	1.2	4.7	-1.4	-8.3	-6.8	-0.5	6.7	0.9	1.8	0.5	-0.8	3.2	-1.6
Loans/deposit ratio (%)	73.1	68.3	80.7	68.7	98.2	75.0	92.6	103.5	103.0	110.1	188.1	102.5	97.9	109.6	105.5	103.8	112.5	72.9	158.5
NPL (% of total loans)	6.9	2.8	9.4	2.4	4.0	4.7	5.2	10.7	2.9	4.6	50.8	2.1	3.0	1.9	3.7	2.6	9.5	1.8	4.6
Domestic Banks CAR (%)	20.5	18.4	22.6	17.5	18.3	19.6	23.2	12.5	18.7	18.2	17.5	15.7	17.8	13.3	16.1	22.6	12.9	14.2	16.1
Domestic Banks RoE (%)	14.3	16.5	11.1	13.6	7.3	11.3	9.9	11.1	9.8	12.0	42.5	20.9	15.2	15.5	19.8	14.5	-0.2	11.7	-

*External debt incl. ICL for CZ, RS, TR, MX, CL and SA

Source: Haver, Bloomberg, National Statistics Offices, Central Banks, IMF, UniCredit Research

Legend
Low vulnerability
Moderate vulnerability
Significant vulnerability
High vulnerability

EM VULNERABILITY HEATMAP (CONTINUED)

	BG	CZ	HR	HU	PL	RO	RS	RU	SK	TR	UA	MX	BR	CL	SA	ID	IN	CN	AG
Policy																			
Policy Rate, nominal (%)	-	2.00	-	0.90	1.50	2.50	2.50	7.00	0	16.50	17.00	8.00	6.00	2.50	6.50	5.50	5.40	4.25	83.26
Real policy rate (%)	-	-0.9	-	-2.1	-1.3	-1.3	1.2	2.5	-2.8	1.3	7.5	4.7	2.5	0.2	2.1	1.7	2.1	-2.7	18.6
Real Money market rate (%)	-	-0.8	-0.8	-2.8	-1.2	-0.9	0.7	2.9	-3.2	2.3	6.5	4.8	0.9	-0.4	1.9	2.3	2.9	0.6	-6.1
Headline inflation (% yoy)	2.9	2.9	1.1	3.1	2.9	3.9	1.3	4.3	2.8	15.0	8.8	3.2	3.4	2.3	4.3	3.7	3.2	2.8	54.5
Core Inflation (% yoy)	1.8	2.4	1.5	3.2	2.2	3.4	1.2	4.3	2.5	13.6	7.2	3.8	3.0	2.3	4.3	4.0	4.6	1.7	57.1
GG Fiscal balance (% of GDP)	1.2	0.8	0.2	-2.0	-1.1	-3.3	0.4	3.3	-0.7	-2.7	-2.3	-1.8	-6.5	-1.8	-4.9	-1.9	-3.4	-4.8	-4.4
GG Primary balance (% of GDP)	1.8	0.8	2.6	0.5	0.2	-1.8	2.6	2.1	-0.1	-0.4	-	0.8	1.4	-0.9	-1.2	-0.3	-0.4	-3.8	-
Government Debt (% of GDP)	20.5	34.0	74.5	70.1	49.1	35.0	54.3	12.0	48.9	31.8	62.0	39.0	75.6	34.6	58.3	35.2	45.5	50.5	61.0
Markets																			
External Debt Spread (10Y, bp)**	72.6	38.3	102.2	78.2	52.2	195.5	159.6	164.9	52.5	515.3	518.7	160.4	185.6	59.9	288.9	141.5	127.2	42.4	1940.0
Local Currency Curve (5Y, %)***	0	1.0	0.8	0.9	1.8	3.9	3.8	6.8	-0.4	15.0	6.0	6.7	9.1	2.2	8.0	6.6	6.4	2.9	58.5
Local currency bond spread (2s10s)****	55.9	11.6	38.1	156.0	58.8	76.9	-35.8	41.0	34.3	-7.0	184.5	-10.0	177.2	270.0	206.1	90.2	95.8	41.9	-8131.5
CDS (5Y, bp)	90	49	94	85	74	97	97	83	17	386	454	113	134	38	188	89	79	46	3853
FX 3m implied volatility (%)	-	3.6	4.0	5.4	5.5	2.3	-	9.5	-	15.4	-	9.9	13.0	9.3	15.1	6.3	6.6	5.4	13.5
Structural***																			
IBRD Doing Business	59	35	58	53	33	52	48	31	42	43	71	54	109	56	82	73	77	46	119
WEF Competitiveness Ranking	51	29	68	48	37	52	65	43	41	61	83	46	72	33	67	45	58	28	81
Unemployment (%)	4.5	2.2	8.1	3.3	3.2	5.3	10.8	4.5	5.7	13.9	9.2	3.7	11.8	7.2	29.0	5.3	7.3	5.3	9.6

**Spread between 10Y EUR government bond yields and the corresponding German government bond yields for BG, HR, HU, PL, RO. For CZ, the spread refers to the 5Y yield. For the other countries, the spread is computed with respect to US government bond yields; ***Data for UA refer to the generic USD bond. Data for HR refer to the 4Y bond; ****Data for UA refer to the generic USD bond. Data for CL refer SA to the spread between 8Y and 2Y bond and 9Y and 2Y bond respectively. Data for HU refer to spread between 10Y and 3Y bond.; *****IBRD and WEF indicators for 2018;

Source: Haver, Bloomberg, National Statistics Offices, Central Banks, IMF, UniCredit Research

Legend
Low vulnerability
Moderate vulnerability
Significant vulnerability
High vulnerability

CEE Strategy: Thickening left tail

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- EM bonds have underperformed risk-free bonds, albeit still delivering a positive performance over the past three months. A few large outliers dragged EM indices down, and a more unstable risk appetite picture added to that.
- Monetary accommodation will continue to support EM bonds over the coming months, and yield hunting will push investors to hold increasing duration and credit risk. However, deteriorating global growth and the prospect of a US slowdown threaten risk appetite. We suggest caution with respect to high yield exposure and local currency bonds.
- We have a fresh look at selected CEE currencies REER valuations: we see the PLN and the HUF as undervalued, while the CZK is closer to fair value. The TRY has reduced its gap with fair value but risks linger, while RUB's strength is likely to persist.

Faltering performance and looming challenges

Decent overall performance, low credit risk, and long duration prevail

EM bond indices have delivered a positive return over the past three months, in the 0.5-1% area (Bloomberg Barclays indices), but not outstanding considering that US Treasuries' and Bunds' returns have been 1.5-2%. Large swings in risk appetite have contributed to increased volatility across the EM universe, with idiosyncratic risks adding to a varied performance across geographies. The LatAm region underperformed, delivering a negative return on aggregate, while EMEA did better than Asia. The unstable risk picture favored higher-rated bonds vs. lower-rated ones: on USD denominated EM indices, A-rated bonds delivered a 6pp higher total return than B-rated bonds since the beginning of the year. Three months ago, the gap was 3pp in favor of B-rated paper. In spite of the recent uptick in risk-free rates, long duration positioning added to the overall performance of hard-currency bonds. 5-7Y tenors would have proved the best pick in risk adjusted (realized volatility) terms.

Consequently, in spite of global financing conditions remaining overall accommodative, picking higher yielders did not deliver better results in 3Q. Chart 2 plots the total return of the past three months scaled by realized volatility along with the starting yield level for the components of broad local and hard-currency EM bond indices. A few outliers contribute to give a U-shape to the scatter plot, which otherwise depicts a negative correlation between starting yield and subsequent risk-adjusted performance. Focusing on total returns (unadjusted) and on credit spreads provides similar evidence: a cautious approach would have paid off this quarter.

CHART 1: PERFORMANCE AT A GLANCE

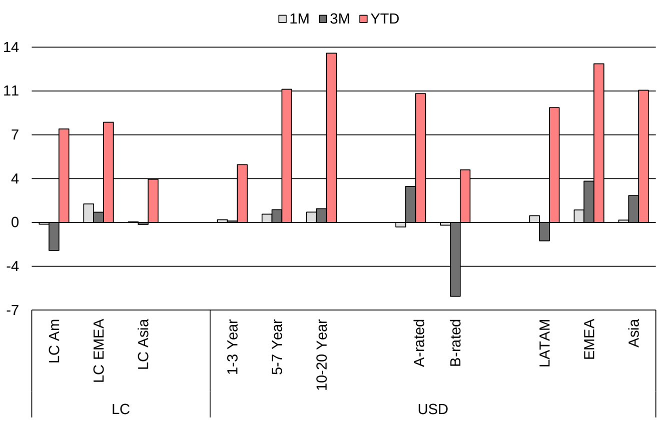
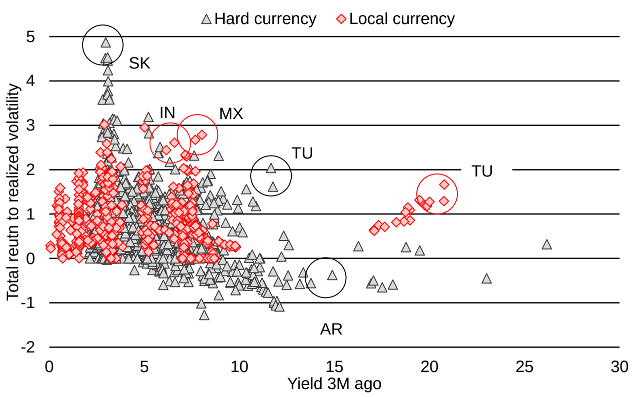


CHART2: YIELD AND RETURN (LAST 3 MONTHS)



Source: Bloomberg, UniCredit Research

Global growth developments threaten risk appetite

Indeed, while yield hunting was and will be a key driving force in the market, recent performance is a reminder of how fragile are current valuations in the face of swings in the global risk picture. Monetary easing has kept volatility at historically low levels, while limiting the magnitude and duration of the stress episodes on risky markets, thereby sustaining risk appetite. Major central banks are currently in easing mode or hold a dovish bias. Markets expectations for Fed's action on official rates run high, but we think the Fed will deliver. The tide has turned for liquidity too. The amount of central bank liquidity in the system has been slowly dropping over recent quarters, mainly on the back of Fed's balance sheet reduction. However, such trend might be soon inverting. The ECB has recently announced another round of QE and the conditions for its long term refinancing operations have been improved. The Fed is looking to restart the organic growth of its balance sheet to improve liquidity flows.

While monetary accommodation and abundance of liquidity will be lingering tailwinds for EM bonds, the threat of weaker global growth outlook can still have sizable implication for the performance of EM bonds, and can thicken the left tail of the return distribution of broad indices while exposing specific weaknesses. Chart 3 plots Global Manufacturing PMI along with the average credit spread for EM hard currency bond (Bloomberg-Barclays index). Easy financing conditions are keeping spreads tighter than where they should be based on macroeconomic fundamentals. And this might continue if the risk appetite picture does not deteriorate materially. Still, a weak global growth outlook poses significant risks in this respect, and poses the threat of a sudden adjustment in the level of the spread for the riskiest segment of the market. Moreover, confidence indicators in the eurozone, particularly sensitive to global dynamics have softened further through the summer. And the latest update of the global leading indicator by UniCredit (GLI) suggests that growth in global trade will remain sub-par over the coming months, albeit positive. An escalation in trade tensions, a hard Brexit and/or a quicker than expected slowdown in US growth would all weight on such prospects, potentially triggering sizable adjustments in risk appetite.

Therefore, we believe that yield hunting strategies will continue to characterize global fixed income markets over the months to come, pushing investors to hold more of duration and credit risk. However, deteriorating global growth outlook and the prospect of a US slowdown threaten the riskiest segments of the market. We suggest caution with respect to high yield exposure and local currency bonds.

CHART 3: FINANCING CONDITIONS

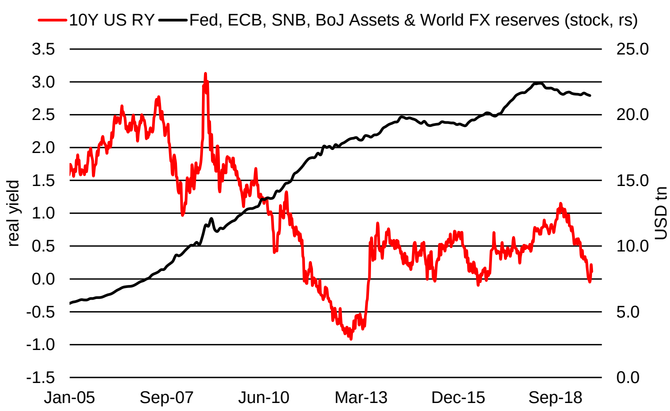
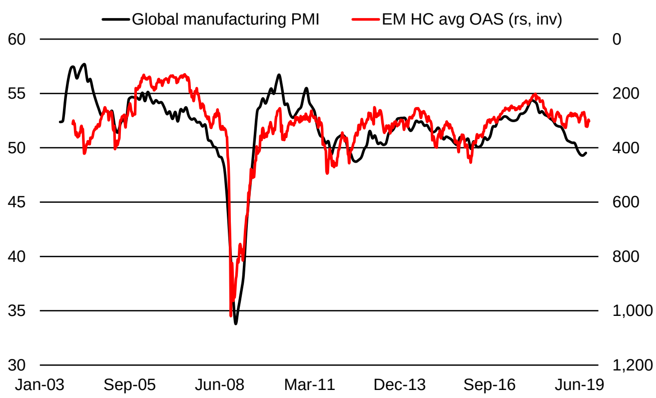


CHART4: GLOBAL PMIS AND CREDIT SPREADS



Source: Markit, Haver, Bloomberg, UniCredit Research

Shaky flows

The increase in risk aversion in August has triggered large outflows from EM assets. Chart 5 shows net flows into EM equities and bond portfolios (IIF data). Each bar shows the cumulative flow over the previous four weeks in USD bn. Flows started to weaken as we entered the 3Q and became increasingly negative during August. Only very recently did inflows in both equity and bond portfolios turn positive again. The magnitude and speed of the outflow was quite sizable and comparable to the weakest four outflow trends of the past ten years. In this respect, the actual performance of the asset class could have been worse.

A fatter left tail

What differed compared to past outflow episodes is the distribution of the losses within the broad index: extremely low returns have been more frequent than in the past, due to the weak performance of LatAm names. Chart 6 compares the left tail of the return distribution for hard currency bonds over the past three months to past episodes 4Q11, 3Q13 and 4Q16, all characterized by large outflows of funds from EM bonds and equities. Specific factors involving limited names dragged down the EM bond index, which otherwise did not perform too differently from developed market benchmarks. The worst 3% delivered more negative returns this quarter compared to the past large outflow episodes, and only in 2013 was the worst performing 1% as bad as this time. Meanwhile, a look at less extreme percentiles (5-30th, still within the left tail but not as extreme) shows that returns were less negative this time. Hence, the extent of negative spillovers was more limited than in the past. If this means that the market is more selective than in the past, it is good news. However, we are less convinced that spillovers could be avoided in case of more prolonged and less isolated tensions for two reasons: **1**. Nearly half of the widening (normalization) in credit spreads we have seen in 2018 has been offset this year. Low risk free yields and abundant liquidity took EM yields/spreads to historically stretched levels. **2**. The role of ETF has increased in recent years and adjustment in passive exposure in case of negative performance can contribute to a more indiscriminate selloff.

CHART 5: PORTFOLIO FLOWS INTO EM

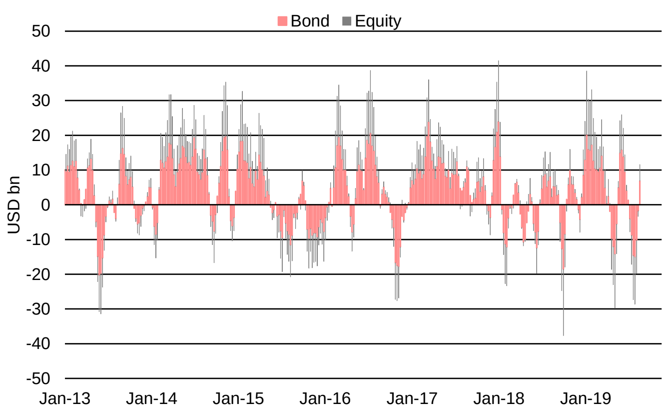
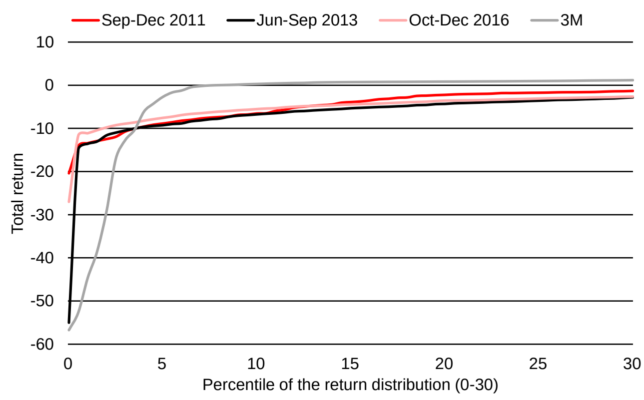


CHART 6: LEFT TAIL PERFORMANCE



Source: IIF, Bloomberg, UniCredit Research

What does ECB QE mean for CEE exposure?

ECB asset purchases can have significant implications for fixed income markets also outside of the euro area, with spillovers set to be particularly significant for CEE. Market developments at the time of the launch of the public-sector purchase program (PSPP) in January 2015 are an important benchmark in this respect.

Portfolio flows

A recent note published on the CEPR Policy Portal[2] investigates how investors reacted to the ECB's asset purchase program (APP), looking into portfolio holdings by investor type and region. The authors show that foreign (non-euro area) investors played a key role in selling assets to the ECB from March 2015 to December 2017. Moreover, there is evidence that they did not reinvest the proceeds in euro area securities. Hence, they did not contribute to portfolio allocation within the euro area, but might have affected asset prices outside of the currency union. Data on portfolio investments show that domestic investors also contributed to net outflows from the euro area, especially for long-term debt securities. Hence, given the above and the sizable APP flows (e.g., the stock of APP holdings is EUR 2.6tn[3]), spillovers to other regions might have been significant. The geographical breakdown of euro area investors' net purchases of foreign bonds suggest that US, UK, Japan, Sweden and Canada benefited the most. In other words, the reallocation targeted predominantly safe issues and close substitutes (government bonds with comparable liquidity). Chart 7 shows data from the international investment position of a number of euro area countries[4]: investments in long-term securities for Poland, Romania, Hungary and Czechia during and after the ECB's APP are positive but overall moderate. Poland and Romania benefited the most. Assuming also that non euro area investor outflows followed a similar path, CEE countries might have benefited modestly from direct inflows during ECB's QE. The lower size of monthly purchases for the second round of the ECB's APP (EUR 20bn/month) suggest that such effects might be less significant going forward.

That said, developments in euro area securities affected the performance of CEE bonds before and during QE. Even within the euro area, the bulk of the move in asset prices related to the ECB's APP happened before actual purchases began. Easing expectations started to run high already in the latter part of 2014, driving bond yields lower, credit spreads tighter and the EUR weaker against trading partners. Chart 8 shows 10Y yields across four CEE countries (Poland, Romania, Czechia, Hungary) alongside those of Bund and BTP yields. Yield levels are rescaled to zero in mid-September 2014, when APP expectations were building up. Changes in the yield level are shown in basis point terms. The evolution of CEE rates matches closely those of Bund and BTPs until 1Q15, just before the selloff in EUR rates.

CHART 7: IIP ASSETS LONG-TERM SECURITIES FROM EZ

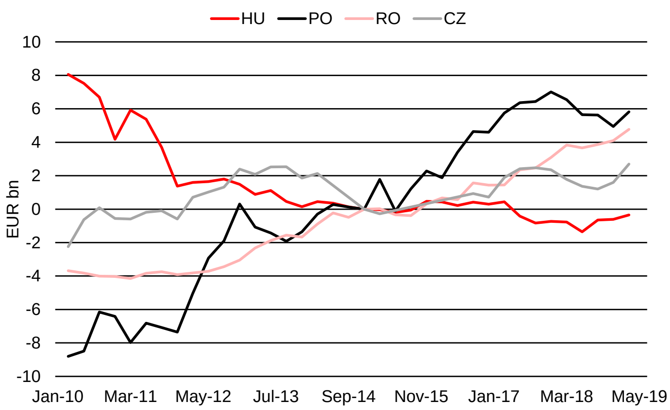
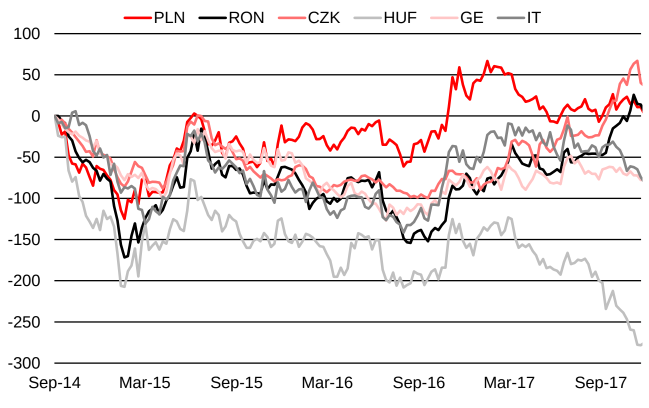


CHART 8: BUND AND CEE YIELDS (SEPT 14=0, BP)



Source: Bloomberg, UniCredit Research

[2] *Restarting asset purchases in the euro area: Lessons from €2 trillion of ECB purchases* by Ralph Koijen, François Koulischer, Benoît Nguyen, Motohiro Yogo. https://voxeu.org/article/restarting-asset-purchases-euro-area

[3] https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html

[4] We included Germany, Italy, the Netherlands, Austria, Ireland and Belgium

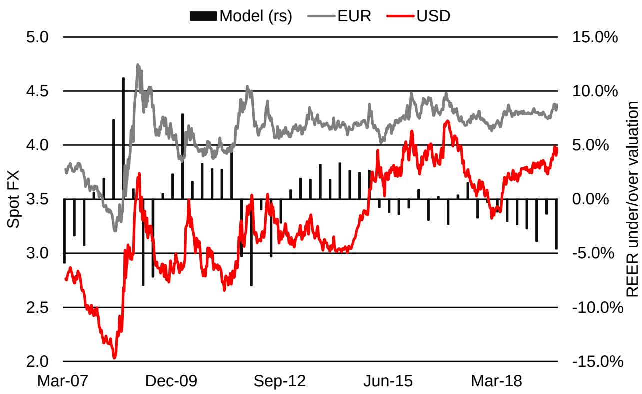
In the following quarters, while Romani and Czech yields matched moves in Bunds and peers, Hungarian and Polish ones started to display asynchronous moves. Local factors supported a stronger performance in HUF bonds and a weaker one in PLN bonds compared to Bunds and BTPs. This seems to support the idea that there were spillovers from euro area to CEE yields, but those were stronger during the time when QE expectations were rising rather than during the actual implementation of the ECB's APP. Flows and portfolio rebalancing did not play a great role across the entire region. Rather than actual flows, it is the benchmarking effect that matters, and this might not be strong enough to totally override local issues over a multi-week horizon.

Local currency risk

Increasing uncertainty with regard to the global growth outlook and the rising specter of a US recession should keep investors on their toes in the last quarter of the year. In such an environment, local-currency bonds will likely be more exposed than hard-currency ones. We have updated our models for the PLN, CZK, HUF, RUB and TRY. We highlight for which currencies valuations are more off-track and thus deserve close monitoring.

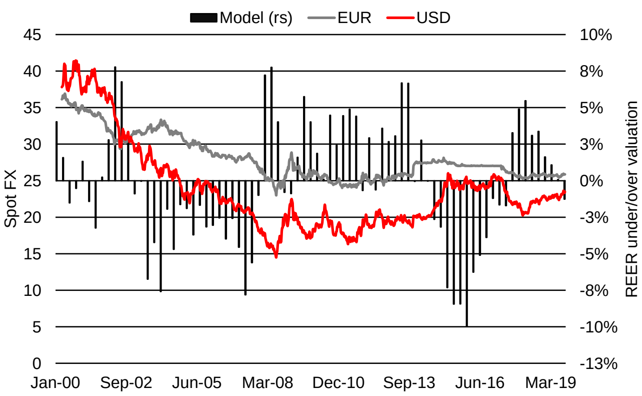
PLN

- The recovery in PLN valuation was short-lived. The currency remains broadly in undervalued territory in REER (real effective exchange rate) terms.
- The PLN has been under pressure recently, weakening against the USD and the EUR. Volatility was especially high in September, with EUR-PLN swinging between 4.32 and 4.39.
- The European Court of Justice ruling and still-weak readings from euro area confidence indicators pose risks in the short term, but they might lead to more interesting medium-term opportunities.



CZK

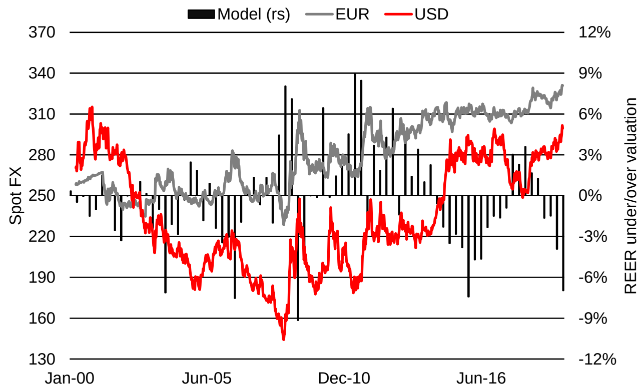
- The CZK appears fairly valued to slightly undervalued in REER terms. The overvaluation cycle, which started in early 2018, appears to be over.
- Spot USD-CZK was hit over the past two months, moving from 22.35 to over 23.55. EUR-CZK stabilized in September after a weak 3Q beginning.
- The CZK remains supported by the most hawkish central bank in the region. However, it remains exposed to a weakening growth outlook. Some improvement in eurozone confidence indicators, especially in those pertaining to Germany, seems needed to sustain Czechia's growth outlook and a more sanguine recovery by the CZK.



Source: Haver, Bloomberg, UniCredit Research

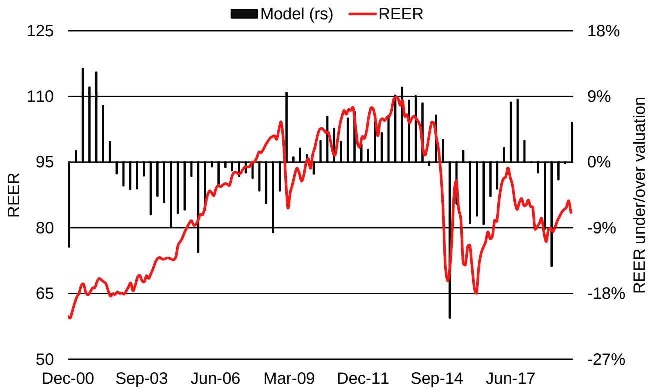
HUF

- In REER terms, the HUF's valuation has been inching lower over the past few quarters and back to the average prevailing since 2015. This has resulted in misalignment with our estimates, which project a fair value of about 5-7pp higher.
- A long-lasting decline in Hungary's productivity relative to that of its trading partners halted in 2016, and gains have been made since then. Improvements in fiscal policy have also contributed to the increase in valuations, which still leaves however the currency below our fair value.
- We believe that risks are for a weaker currency over the coming months. The NBH may ramp up monetary stimulus to offset external risks to growth, sacrificing the HUF in the process.



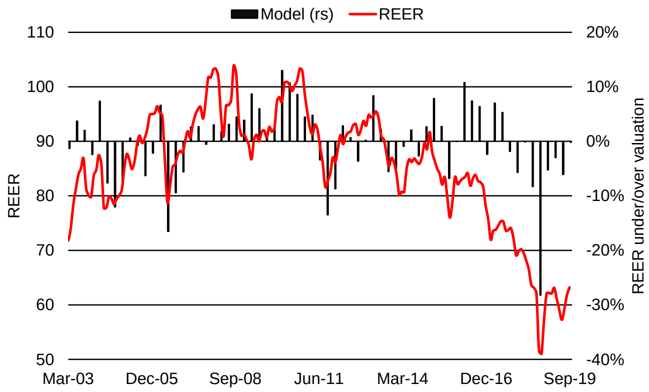
RUB

- The RUB REER has been very volatile over recent months, swinging from under- to overvaluation according to our model. The magnitude of recent moves suggests caution in the interpretation of such results. Since the RUB's correlation with terms of trade has been weakening, the RUB is probably closer to fair value than overvalued.
- After recovering from the recent selloff, the RUB is nearly 8% stronger than at the beginning of the year compared to the USD (and over 11% stronger against the EUR).
- Given Russia's stable inflation outlook, the CBR will likely push for more rate cuts. BoP flows could cushion the currency.



TRY

- The Turkish lira has been weakening steadily in REER terms over the past five years. Its sharp depreciation in summer 2018 led to a deep fall in the REER. This has been reabsorbed, but the trend has held.
- Our model shows that the REER is still undervalued, but the REER downward move has slowed slightly, so the gap with our fair value has been narrowing.
- The growth outlook remains challenging, while inflationary and financing risks linger. This leaves the TRY exposed to swings in risk appetite.



Source: Haver, Bloomberg, UniCredit Research

Acronyms and abbreviations used in the CEE Quarterly

- BNB – Bulgarian National Bank
- C/A – current account
- CBR – Central Bank of Russia
- CBRT –Central Bank of the Republic of Turkey
- CE – Central Europe
- CEE – Central and Eastern Europe
- CNB – Czech National Bank
- DM – developed markets
- EA – euro area
- EC – European Commission
- ECB – European Central Bank
- EDP – Excessive Deficit Procedure of the European Commission
- EM – emerging markets
- EMU – European Monetary Union
- EU – European Union
- FCL – Flexible Credit Line (from the IMF)
- FDI – foreign direct investment
- IFI – international financial institutions
- IMF – International Monetary Fund
- MoF – Ministry of finance
- NBH – National Bank of Hungary
- NBP – National Bank of Poland
- NBR – National Bank of Romania
- NBS – National Bank of Serbia
- NBU – National Bank of Ukraine
- PLL – Precautionary and Liquidity Line (from the IMF)
- PM – prime minister
- PPP – public – private partnership
- qoq – quarter on quarter
- sa – seasonally adjusted
- SBA – Stand-by Arrangement (with the IMF)
- SOE – state-owned enterprise
- WB – World Bank
- yoy – year on year
- ytd – year to date

Countries

Bulgaria

Baa2 positive/BBB- positive/BBB positive*

Outlook

We expect growth to accelerate this year before the economy slows next year, as several external factors will weigh on its performance according to our global scenario. The ruling party GERB looks well placed to win local elections amid solid income growth and record low unemployment. The country has made solid progress in the implementation of its euro adoption plan, which was noted by rating agencies, with all three now having a positive outlook on their Bulgarian sovereign ratings.

Strategy

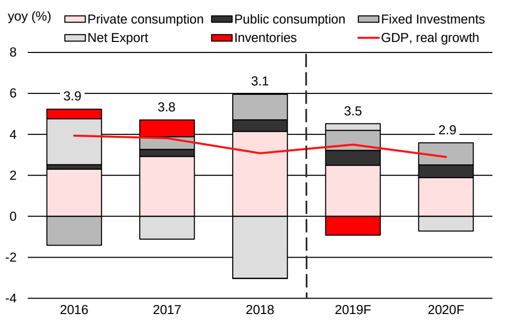
BGARIA EUR bonds remain a hold amid falling yields and low volatility. Market liquidity is likely to fall further as the government is unlikely to issue externally in 2019-20.

Author:
Kristofor Pavlov, Chief Economist (UniCredit Bulbank)

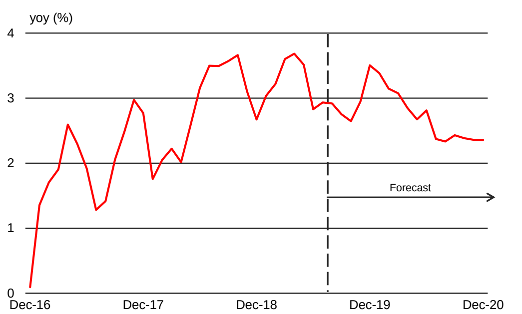
KEY DATES/EVENTS

- Oct/Nov: 2020 Government Budget
- 27 Oct: Municipal elections
- 3 Oct, 14 Nov, 5 Dec: GDP data (revised data for 2018, 3Q19 flash estimate, 3Q19 structure)
- 14 Oct, 13 Nov, 16 Dec: CPI inflation

GDP GROWTH FORECAST



INFLATION FORECAST



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2016	2017	2018	2019F	2020F
GDP (EUR bn)	48.1	51.7	55.2	58.8	62.1
Population (mn)	7.1	7.1	7.0	7.0	6.9
GDP per capita (EUR)	6,777	7,328	7,883	8,465	9,000
Real economy, change (%)					
GDP	3.9	3.8	3.1	3.5	2.9
Private Consumption	3.5	4.5	6.4	3.7	2.8
Fixed Investment	-6.6	3.2	6.5	5.0	5.4
Public Consumption	2.2	3.7	4.8	4.0	4.1
Exports	8.1	5.8	-0.8	4.0	2.8
Imports	4.5	7.5	3.7	3.3	3.7
Monthly wage, nominal (EUR)	485	530	580	638	694
Real wage, change (%)	8.8	7.3	6.6	6.9	6.0
Unemployment rate (%)	7.6	6.2	5.2	4.3	4.0
Fiscal accounts (% of GDP)					
Budget balance	0.1	1.2	2.1	-1.1	-0.6
Primary balance	1.0	2.0	2.9	-0.5	0
Public debt	28.6	25.4	22.1	20.8	20.5
External accounts					
Current account balance (EUR bn)	1.6	1.8	3.0	3.2	2.8
Current account balance/GDP (%)	3.2	3.5	5.4	5.5	4.5
Extended basic balance/GDP (%)	6.4	6.9	6.9	8.2	7.4
Net FDI (% of GDP)	1.2	2.5	0.6	1.5	1.5
Gross foreign debt (% of GDP)	71.1	65.5	60.4	55.0	50.5
FX reserves (EUR bn)	23.9	23.7	25.1	26.9	28.2
Months of imports, goods & services	9.4	8.1	8.1	8.4	8.4
Inflation/Monetary/FX					
CPI (pavg)	-0.8	2.1	2.8	3.1	2.7
CPI (eop)	0.1	2.8	2.7	3.7	2.4
Central bank target	-	-	-	-	-
Central bank reference rate (eop)	0	-0.39	-0.50	-0.49	-0.49
3M money market rate (Dec avg)	-	-	-	-	-
USD/BGN (eop)	1.86	1.63	1.71	1.72	1.66
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.77	1.74	1.66	1.75	1.69
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: BNB, Eurostat, NSI, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Bulgarians go to the polls amid record low unemployment

Two positive developments were behind the upward revision in our 2019 GDP forecast

We upwardly revised our real GDP growth forecast for this year to 3.5% from 3.3%, while downwardly revising our 2020's estimate to 2.9% from 3.1%. The upward revision of growth this year reflects a combination of stronger-than-expected export growth and solid improvement in labor market conditions, amid a marked rebound in job creation and wage growth.

External factors will weigh on growth next year

However, GDP growth is set to slow in 2020, as external factors including weaker eurozone demand, global trade and US growth would act as a drag according to our global scenario. These three factors would not only lead to weaker demand for Bulgarian exports, but also to increased uncertainty, which will likely weigh on business investment growth. The latter was already visible in recent sentiment surveys, where global uncertainty topped the list of industry managers' concerns after a prolonged period when labor shortages were the number one factor constraining Bulgarian companies' expansion plans (see chart).

Domestic demand will remain resilient next year

Domestic demand will remain robust next year, although it might not fully mitigate the impact of the external shocks envisaged in our global scenario. The ruling GERB party plans another 10% increase in public sector wages and salaries in 2020, which in the context of tight labor market conditions should spill over onto the rest of the economy, triggering a private sector wage increase of a broadly similar proportion. Improvement in the purchasing power of households is anticipated to draw support not only from the ongoing labor market strength, but also from the acceleration of retail credit which could peak this or next year. Another factor that will likely support private consumption growth in 2020 would be easing inflation, due to cheaper oil prices and the EUR-USD exchange rate moving higher in our global scenario.

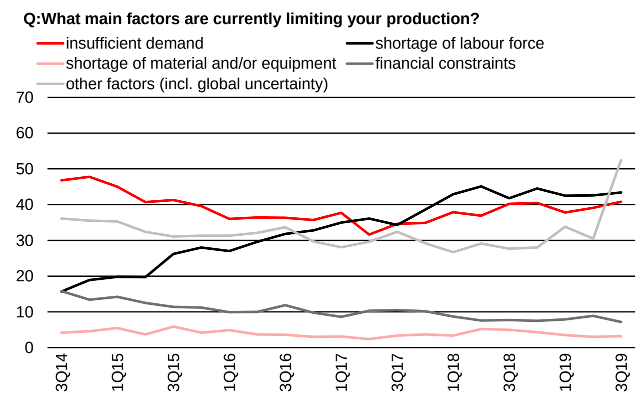
Fiscal policy will also help the economy avoid a sharper growth deceleration

Fiscal stimulus in the form of stronger infrastructure anticipated next year will also help to mitigate the impact of the external shocks. Three large infrastructure projects will be of particular importance. These are the Hemus motorway (for the completion of which BGN 1.2bn was already set aside from the budget surplus last year), reconstruction of the Sofia-Plovdiv railroad (an EU funded project already awarded to an international consortium which is likely to start in 2020 when all appealing procedures are over), and completion of the most complex sections of the Struma highway (another EU funded project that remained blocked for years by a dispute about the selection of the final route before a compromise emerged early this year).

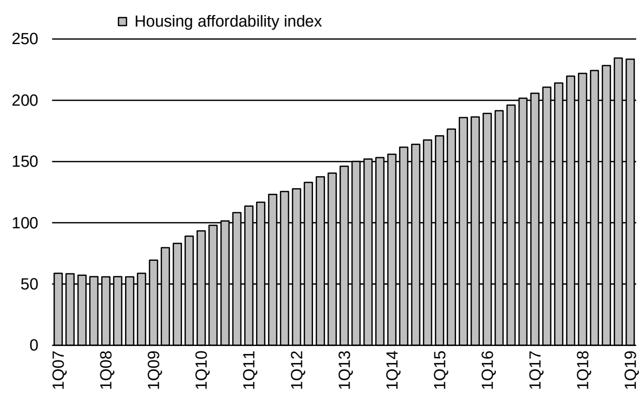
Despite rising wages and scarce labor, the real estate contribution to investment is set to increase

Investment will also be spurred by real estate. Demand for housing remains very strong as affordability ratios (reflecting housing prices, wages and price of credit) improved to their highest levels since joining the EU (see chart). Demand is unlikely to weaken even if economic growth slows moderately next year, as housing prices are likely to rise further, while regulators do not seem inclined yet to tighten prudential regulations via introduction of caps on prudential ratios.

FACTORS LIMITING PRODUCTION IN INDUSTRY



HOUSING AFFORDABILITY REACHED ITS HIGHEST LEVEL



Source: Eurostat, NSI, UniCredit Research

Solid progress was achieved in the implementation of the euro adoption road map

The comprehensive review which the ECB conducted on six Bulgarian banks offered no surprises. All six banks met the minimum own funds requirements of Art.92 of Regulation (EU), No 575/2013 of the European Parliament and the Council (see chart). At the same time, the comprehensive review came to the conclusion that two lenders need to strengthen their capital positions. In response to the follow-up actions undertaken by the BNB the two banks are currently in a process of preparation and coordination of capital plans, which should address the capital shortages identified during the asset quality review and the stress tests. Tangible progress was also made in other areas which are part of the road map to euro adoption. These include strengthening the implementation of the anti-money laundering framework, improving the governance of state-owned enterprises, and developing a macro-prudential framework. All these have boosted Bulgaria's chances to soon join simultaneously ERM II and the Banking Union, in line with the agreement signed with the finance ministers of EA member states and the ECB in June 2018. The latter was noted by credit rating agencies, with all three now having a positive outlook on their long-term foreign currency ratings of the Bulgarian sovereign.

GERB is well placed to keep control over local administrations

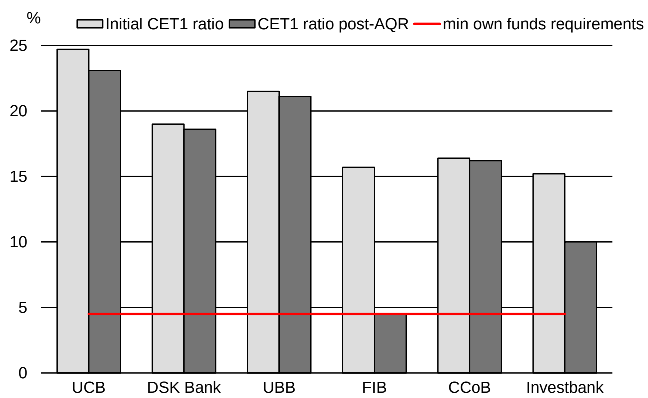
Bulgarian voters will go to the polls for municipal elections on 27 October (with a run-off on 10 November). The vote comes at a time when the economy is in its fifth year of expansion, while unemployment is at its lowest level in 30 years. Surveys available in early September suggest that there are no major changes in voters' preferences when compared with the EU parliamentary elections in May. The most likely scenario is that GERB will keep its control over local administrations, although some losses can be expected, especially in the northern parts of the country where incomes, employment and public infrastructure investment are lagging.

The vote in the capital city Sofia is likely to be the most polarizing and unpredictable…

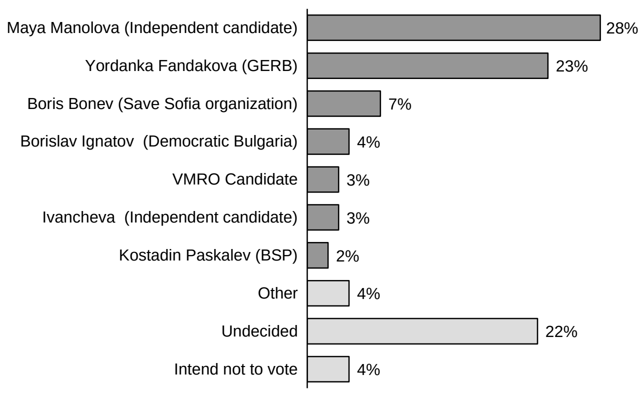
…it will be a testing ground for a potential change in the balance of political power on a national level

The election outcome in Sofia is particularly hard to predict (see chart). Sofia has traditionally been a stronghold of right-wing parties. In the last decade, it has been ruled by the second most prominent figure in the GERB party, Mrs. Yordanka Fandakova, who announced her decision to run for a third term. It is hard to say whether the pragmatic and results-oriented approach of Mrs. Fandakova will prove appealing to voters once again. The problem is that the scandal with the purchases of luxury apartments at below market prices by GERB leaders which erupted in May and already led to the resignation of one of the party's deputy chairmen, will hurt her. It is still fresh in voters' memory and may weigh heavily not only on her but also on the GERB's performance in the rest of the country, particularly if the size of the protest vote proves significant. Her opponent, former Ombudsman Maya Manolova, understands this and is likely to turn the election campaign into a morality play, promising to provide an alternative to the mainstream political culture. Such a strategy may backfire, however, given some controversial episodes in her own political career and particularly her involvement in the nomination of Delyan Peevski, a local oligarch and media mogul, as head of the powerful state agency for national security back in 2013, which sparked widespread anticorruption protests that eventually led to the resignation of Prime Minister Oresharski's left-wing government.

ALL BANKS MET THE MINIMUM OWN FUNDS REQUIREMENTS



THE CAPITAL CITY SOFIA BRACES FOR CRUNCH ELECTIONS



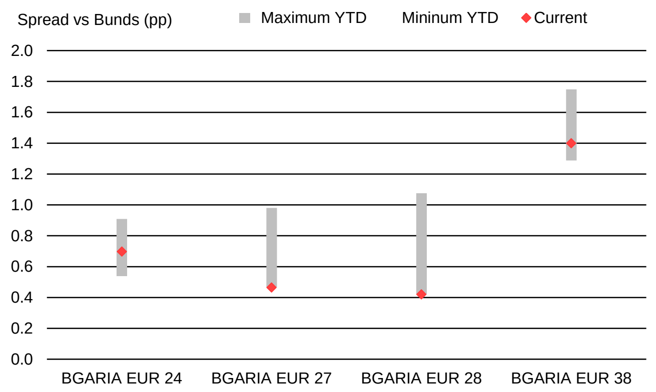
Source: Bulgarian polling agency Gallup International, ECB, UniCredit Research

Low yields and low volatility

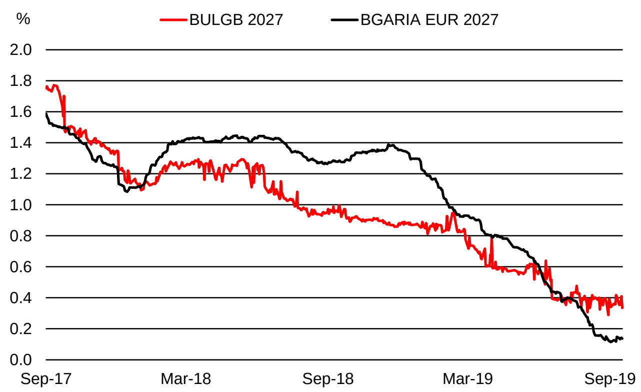
BGARIA bonds are by now too tight to elicit the attention of all but the most risk-averse European buyers. BGARIA EUR 2027 and 2028 spreads to Bunds are the tightest on record. What sets BGARIA EUR bonds aside from regional counterparties is its low volatility to market jitters. Most other credit spreads tend to rise if Bunds sell off. Local demand and extremely thin liquidity help BGARIA EUR bonds to weather these episodes better than its peers.

With domestic bond demand unlikely to subside even if the government increases spending in 2020, BGARIA EUR bonds remain a solid hold. We prefer the BGARIA EUR 2038 owing to its better spread to Bunds. Finding offers, though, may not be very easy. The government does not intend to issue abroad this year or next, so liquidity will tighten further.

BGARIA 27 AND 28 YIELDS AT MINIMUM VS BUNDS



YIELDS COMPRESSED AMID STRONG DOMESTIC DEMAND



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**0.8**	**1.6**	**1.3**
Budget deficit	-0.1	0.9	0.6
Amortization of public debt	0.8	0.7	0.7
Domestic	0.6	0.5	0.5
Bonds	0.6	0.5	0.5
Bills	0	0	0
Loans/Other	0	0	0
External	0.2	0.2	0.2
Bonds and loans	0	0	0
IMF/EU/Other IFIs	0.2	0.2	0.2
Financing	**0.8**	**1.6**	**1.3**
Domestic borrowing	0	0.5	1.0
Bonds	0	0.5	1.0
Bills	0	0	0
Loans/Other	0	0	0
External borrowing	0.3	0.1	0.1
Bonds and loans	0	0	0
IMF/EU/Other IFIs	0.3	0.1	0.1
Privatization/Other	0	0	0
Fiscal reserves change (- =increase)	0.4	1.0	0.2

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**8.6**	**8.0**	**7.5**
C/A deficit	-3.0	-3.2	-2.8
Amortization of medium and long term debt	3.7	3.1	3.0
Government/central bank	0.2	0.2	0.2
Banks	0.4	0.5	0.5
Corporates/Other	3.1	2.4	2.4
Amortization of short-term debt	7.9	8.2	7.3
Financing	**8.6**	**8.0**	**7.5**
FDI (net)	0.3	0.9	0.9
Portfolio equity, net	-1.5	-0.7	-0.8
Medium and long-term borrowing	3.3	2.4	2.2
Government/central bank	0.3	0.1	0.1
Banks	0.5	0.4	0.4
Corporates/Other	2.4	1.9	1.7
Short-term borrowing	8.2	7.3	7.1
EU structural and cohesion funds	0.5	0.7	0.9
Other	-0.7	-0.8	-1.4
Change in FX reserves (- = increase)	-1.4	-1.8	-1.4
Memoranda:			
Nonresident purchases of LC govt bonds	0	0	0
International bond issuance, net	0	0	0

Source: BNB, MoF, UniCredit Research

Croatia

Ba2 positive/BBB- stable/BBB- positive*

Outlook

GDP growth at 2.9% in 2019. Before year-end, strong investment, public and private consumption should offset moderate growth in 2Q19. Growth could decelerate to 2.5% in 2020 due to weaker external demand. Domestic economic policy will likely remain focused on joining ERM II, with Asset Quality Review and stress tests for systemically important banks.

Strategy

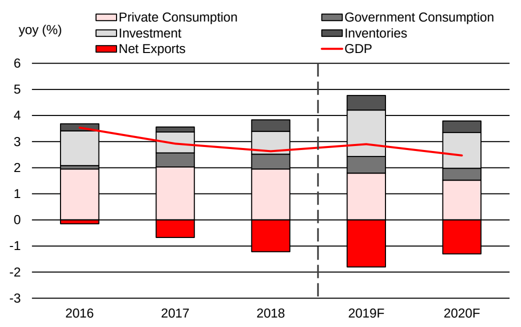
CROATI EUR bonds continued to tighten, helped by strong local demand. A potential spread widening in 4Q19 amid higher supply of HRK bonds and/or risk-off episodes on foreign markets would provide attractive entry points.

Author:
Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

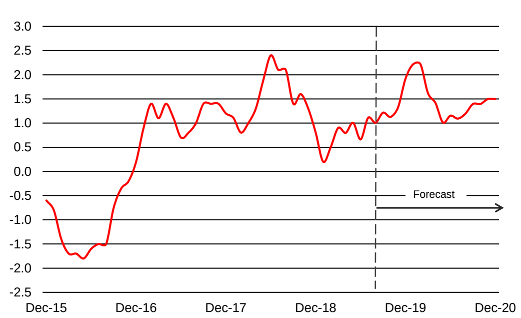
KEY DATES/EVENTS

- 18 Oct: Moody's rating assessment
- 23 Oct: EDP Notification
- 27 Nov, 29 Nov: 3Q19 GDP (flash, details)
- 6 Dec: Fitch rating assessment
- Dec: 2020 Budget approval

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CNB, Crostat, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	46.7	49.0	51.5	53.6	55.7
Population (mn)	4.2	4.1	4.1	4.0	4.0
GDP per capita (EUR)	11,177	11,881	12,592	13,242	13,888
Real economy, change (%)					
GDP	3.5	2.9	2.6	2.9	2.5
Private Consumption	3.4	3.6	3.5	3.2	2.7
Fixed Investment	6.5	3.8	4.1	8.2	6.0
Public Consumption	0.7	2.7	2.9	3.1	2.3
Exports	5.6	6.4	2.8	2.8	2.5
Imports	6.2	8.1	5.5	6.5	5.0
Monthly gross wage, nominal (EUR)	1,029	1,080	1,139	1,186	1,233
Real wage, change (%)	3.0	2.8	3.4	3.0	2.5
Unemployment rate (%)	13.1	11.2	8.4	7.5	7.0
Fiscal accounts (% of GDP)					
Budget balance	-1.0	0.8	0.2	-0.5	-0.4
Primary balance	2.1	3.5	2.5	1.8	1.8
Public debt	80.5	77.8	74.6	72.3	69.8
External accounts					
Current account balance (EUR bn)	1.2	1.7	1.3	0.7	0.5
Current account balance/GDP (%)	2.5	3.5	2.5	1.2	1.0
Extended basic balance/GDP (%)	8.3	7.1	5.3	5.5	5.3
Net FDI (% of GDP)	4.3	2.6	1.4	2.1	2.1
Gross foreign debt (% of GDP)	89.3	82.1	75.4	70.3	68.5
FX reserves (EUR bn)	13.5	15.7	17.4	19.2	20.4
Months of imports, goods & services	7.6	7.8	8.0	8.1	8.0
Inflation/Monetary/FX					
CPI (pavg)	-1.1	1.1	1.5	1.0	1.5
CPI (eop)	0.2	1.2	0.8	1.9	1.5
3M money market rate (Dec avg)	0.82	0.55	0.49	0.45	0.45
USD/FX (eop)	7.17	6.27	6.47	6.29	6.11
EUR/FX (eop)	7.56	7.51	7.42	7.43	7.45
USD/FX (pavg)	6.81	6.62	6.28	6.50	6.18
EUR/FX (pavg)	7.53	7.46	7.41	7.41	7.41

Source: CNB, Eurostat, NBS, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Sustainable fiscal position despite growth deceleration

We keep growth projections unchanged at 2.9% for 2019 and 2.5% for 2020…

Despite the weaker-than-expected 2Q19 growth rate, we are sticking with our GDP forecast of 2.9% for 2019 and a further deceleration to 2.5% in 2020, driven by slower global growth. Data for 3Q19 signal a solid performance (in line with our expectations) despite complaints from tourism service providers (mostly small) that tourism is underperforming. Preliminary tax-collection data hinted at continued solid growth.

…with domestic demand, primarily investment, as the main driver of growth versus weaker external demand

Domestic demand is likely to remain solid and drive GDP for the remainder of the year and into 2020. Investment growth should maintain a strong pace, though moderate in 2020, boosted by implementation of EU funded infrastructure projects, with private investment staying at a more modest pace and facing challenges related to uncertainties about the global outlook. Private consumption is expected to remain solid but moderate to healthier levels compared to 1Q19 or the previous three years as the rise in wages is lower. Finally, public consumption growth is accelerating but we expect increased spending to be well covered by the increase in revenues.

Growth risks for 2019 and, more, for 2020 are skewed to the downside following developments in global trade and tourism performance

Growth risks for 2019 and 2020 are skewed to the downside. We expect growth in tourism to moderate due to improvements in competing markets (Greece, Turkey, Africa's Mediterranean coast), local capacities being tested by fast-growing tourist numbers in the previous four years and tourist numbers facing a potential decline from countries where the economic situation is weakening, such as Germany, Austria and Italy. In addition, exports of goods could suffer from slower global trade and European demand weakening.

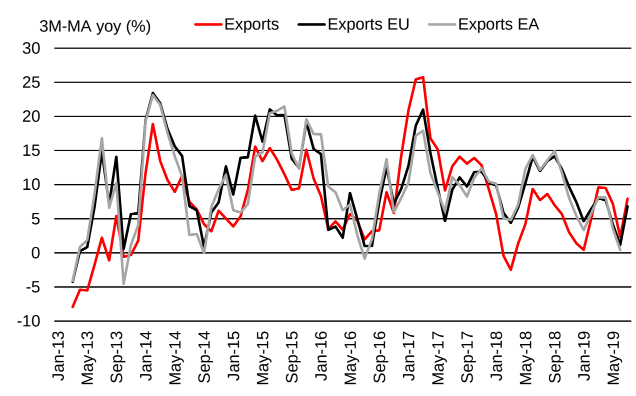
Government is unlikely to try to boost public spending in order to offset slower economic growth

The government is unlikely to try to boost public spending in order to offset slower economic growth. Croatia's fiscal position remains solid despite increasing requests for larger government spending through wage hikes in public services and support in some areas (e.g. remaining shipyards where the state's stake is still notable, railways, hospital debt). Croatia's good fiscal performance in 2017 and 2018 (surplus in both years), despite challenges created by guarantee payments for the shipbuilding industry, triggered more pressure on the Croatian government to speed up spending. However, government spending has remained under control so far. Preliminary data for 1H19 suggest that growth in spending is balanced with growth in revenues (without EU funding triggered flows, both increased by a similar growth rate of around 7% yoy).

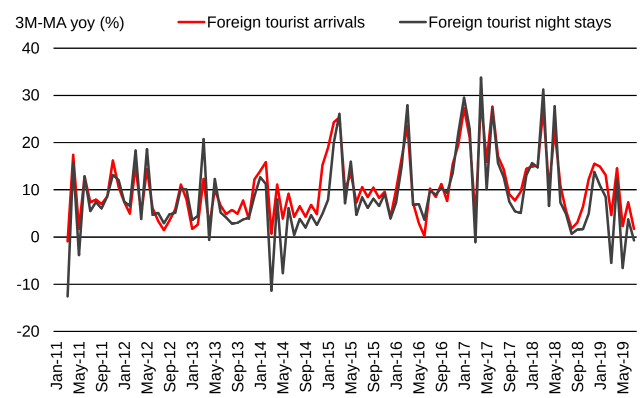
Ministry of finance is eager to hit its targets…

The finance ministry is targeting a mild deficit of 0.3% of GDP in 2019, which we see as feasible as long as the government resists growing pressure from emerging vested interests (our view is 0.5% of GDP). In 2020, the target of a mild surplus (0.2%) seems less achievable when assessing requests for increasing public sector wages and challenges with gaps in the health sector. We expect a 0.5% deficit, considering also the envisaged cut in the general VAT rate to 24%, from 25%.

EXPORTS ARE SLOWING, DRIVEN BY EU MARKETS...



…WHILE DECELERATION IS VISIBLE IN TOURISM TOO



Source: Corstat, UniCredit Research

...following agenda for ERM II entry

Overall, such a fiscal scenario should result in a further reduction in the public debt ratio from 74.5% in 2018 to 72.3% in 2019 and further to below 70% in 2020, in our view. The government is eager to maintain a fiscal position that allows a persistent decline in public debt towards Maastricht criteria in light of the intention to join the EU's exchange rate mechanism (ERM II) in 2020 in order to adopt the euro. This creates a tight schedule for all participants in the process.

Therefore, Croatia is already pursuing commitments associated with its application to join ERM II and its request to establish close cooperation with the ECB by joining the EU's banking union.

AQR and stress tests for the five most important banks are already on track

The participation in the banking union is firmly on track, as one of the commitments taken by Croatia, with Croatia's five largest systemically important banks – Zagrebačka banka/UniCredit, Privredna banka Zagreb/Intesa Sanpaolo, Erste Bank, OTP Bank and Hrvatska poštanska banka (Croatian Postal Bank) – having begun the required asset-quality review and stress-testing processes.

Despite heated public discussion and debates, the run up to election year is not yet posing major fiscal risks

Presidential and parliamentary elections expected in 2020 do not pose a major fiscal risk, in our opinion. The run up to the presidential (early 2020) and to general elections (expected in late 2020) is likely to lead to a more confrontational political climate. This is already visible in public and media exchanges among Croatia's main political players, the Croatian Democratic Union (HDZ), the leader of the governing coalition, the Social Democratic Party (SDP), the largest opposition party, and representatives of far-right nationalist groups that currently lack a coherent, common platform.

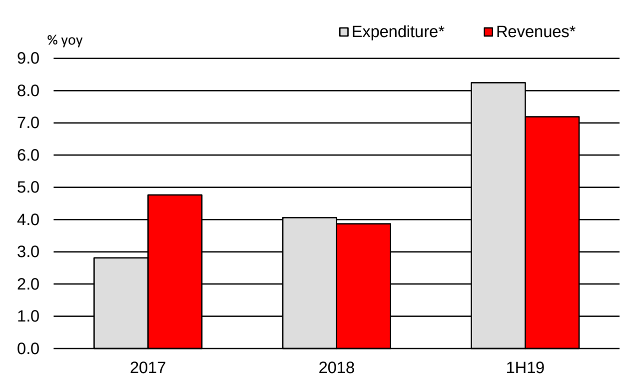
Some potential fiscal risks remain, with the possibility of implementation of populist measures if the government feels threatened ahead of elections…

A potential fiscal risk arises if the government reverts to populist measures and a looser fiscal stance in 2020 to boost its chances in elections. In 1H19, the government's popularity weakened steadily, with HDZ's advantage over SPD shrinking. To address this, the government replaced most of the ministers suspected of inappropriate conduct. This improved the government's standing in the latest polls, thus restoring some confidence. However, rising pressure by public employee unions (health workers, teachers and police forces recently demanding higher wages) is an example of challenges for the fiscal policy stance where requests are built on awareness of the current solid fiscal position and coming closer to an election year where the government's stance might be tested.

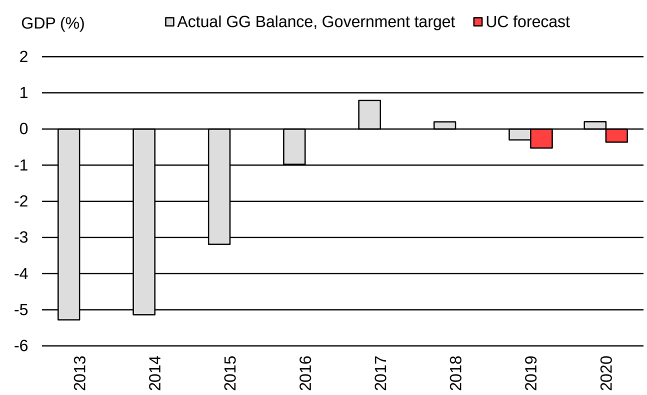
…but incentives to avoid collision with the EU are strong

In addition, the prospects of a Croatian EU presidency in 1H20 and the goal to join the Schengen area and ERM II before general elections could reduce the incentive for populist spending that could set the government on a collision course with the European Commission.

REVENUE GROWTH IS OFFSETING HIGHER SPENDING...



…BUT NEW REQUESTS MAY AFFECT ENVISAGED TARGETS



*adjusted for EU funds flows and HZZO reclassification

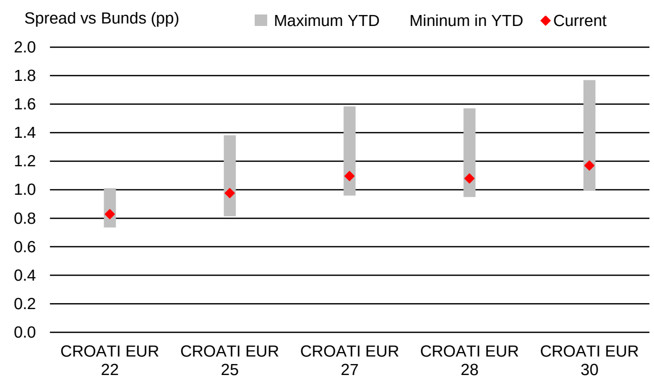
Source: Crostat, MoF, UniCredit Research

Yield decline driven by global trends

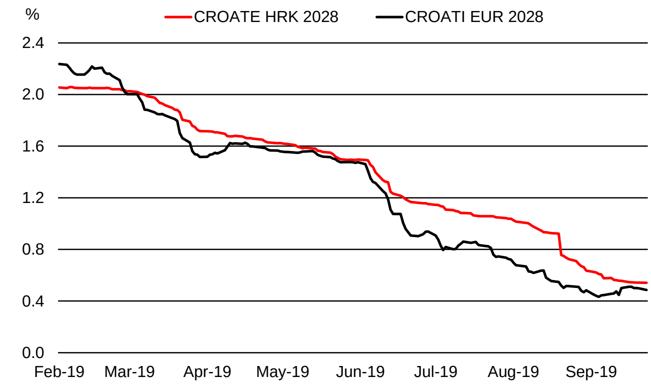
In light of this fiscal picture, we do not expect Croatia to undertake further issuance in international markets this year, despite significant spread tightening and a yield decrease following rating upgrades and a global contraction in yields. The external borrowing plan was fulfilled with the issuance of a EUR 1.5bn Eurobond in June. Consequently, remaining funding needs are focused on the local market where maturing local bonds (EUR 1bn in November) will have to be refinanced.

The rally in Croatian sovereign bonds has compressed spreads versus Bunds close to all-time lows. A potential correction in 4Q19 due to higher local issuance and/or lower risk appetite on external markets could just provide a new entry point to cash-rich local institutional investors.

SPREADS TO BUNDS TIGHTENING



…AS THE DECLINE IN YIELDS CONTINUES



Source: Bloomberg, Ministry of Finance, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**7.4**	**9.3**	**8.6**
Budget deficit	-0.1	0.3	0.2
Amortization of public debt	7.5	9.0	8.4
Domestic	6.0	6.7	6.7
Bonds	0.8	1.0	1.7
Bills	2.4	4.1	3.6
Loans	2.8	1.6	1.4
External	1.5	2.3	1.8
Bonds and loans	1.4	2.2	1.7
IMF/EU/Other IFIs	0.1	0.1	0.1
Financing	**7.4**	**9.3**	**8.6**
Domestic borrowing	6.1	7.4	7.3
Bonds	1.4	2.3	1.8
Bills	2.4	3.6	3.6
Loans	2.3	1.6	1.9
External borrowing	1.1	1.6	1.2
Bonds	0.8	1.5	0.9
IMF/EU/Other IFIs	0.4	0.1	0.2
Privatization/Other	0.1	0.2	0.2

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**12.6**	**11.2**	**10.3**
C/A deficit	-1.3	-0.6	-0.6
Amortization of medium and long term debt	5.4	4.9	4.3
Government/central bank	1.5	2.3	1.8
Banks	0.5	0.5	0.5
Corporates/Other	3.4	2.1	2.0
Amortization of short-term debt	8.5	6.9	6.5
Government/central bank	4.3	4.1	4.0
Banks	3.1	1.5	1.5
Corporates/Other	1.1	1.0	1.0
Financing	**12.6**	**11.2**	**10.3**
FDI (net)	0.7	1.1	1.2
Portfolio equity, net	-0.7	0.5	0.5
Medium and long-term borrowing	4.2	4.0	3.6
Government/central bank	1.1	1.6	1.2
Banks	1.0	0.8	0.8
Corporates/Other	2.0	1.6	1.6
Short-term borrowing	6.9	5.3	4.2
EU structural and cohesion funds	0.7	1.1	1.2
Other	2.4	1.0	0.8
Change in FX reserves (- = increase)	-1.6	-1.8	-1.2
Memoranda:			
Nonresident purchases of LC govt bonds	n.a.	n.a.	n.a.
International bond issuance, net	0	0.2	-0.3

Source: CNB, MoF, UniCredit Research

Czechia

A1 positive/AA- stable/AA- stable*

Outlook

GDP growth is set to slow in 2H19 and 2020. We stick to our forecast of 2.0% growth for 2020 with downside risks if global demand does not recover. Inflation appears to be rather sticky, making the CNB hesitant to cut the repo rate even if external factors justify easing. Fiscal impulse may stay low despite sizeable spending rise, as tax burden will go up in 2020 versus 2019.

Strategy

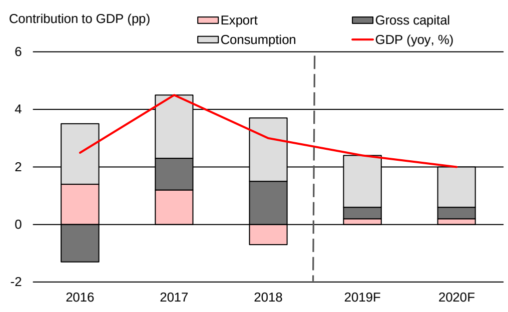
CZGB yields have tightened to the point where EM investors find little value on the curve. Thus, we expect risk-averse, EUR-based investors to target the long end of the curve for a pick-up over Bunds. Both the currency and yield levels offer a good entry point after respective selloffs.

Author:
Pavel Sobíšek, Chief Economist (UniCredit Bank Czech Republic and Slovakia)

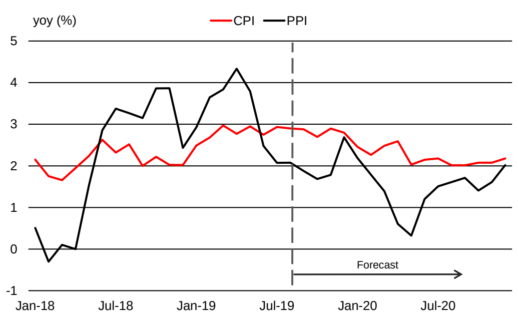
KEY DATES/EVENTS

- 25 Sep, 7 Nov, 18 Dec: CNB policy meetings
- 14 Nov, 29 Nov: GDP (flash, structure)
- 10 Oct, 11 Nov, 10 Dec: CPI
- 11 Oct: sovereign rating review from Moody's

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	176.3	191.9	208.0	219.4	232.5
Population (mn)	10.6	10.6	10.6	10.7	10.7
GDP per capita (EUR)	16,687	18,125	19,578	20,561	21,729
Real economy, change (%)					
GDP	2.4	4.5	2.9	2.4	2.0
Private Consumption	3.6	4.4	3.3	2.6	2.2
Fixed Investment	-3.2	4.0	7.1	1.4	1.0
Public Consumption	2.7	1.3	3.9	2.6	1.5
Exports	4.1	7.1	4.4	1.0	1.8
Imports	2.6	6.3	5.9	0.9	1.6
Monthly wage, nominal (EUR)	1,027	1,126	1,243	1,325	1,410
Real wage, change (%)	3.7	4.2	5.3	3.9	2.9
Unemployment rate (%)	5.5	4.2	3.2	2.8	3.1
Fiscal accounts (% of GDP)					
Budget balance	0.7	1.6	0.9	-0.4	-1.0
Primary balance	1.6	2.3	1.6	0.4	-0.1
Public debt	36.8	34.7	32.7	31.2	30.8
External accounts					
Current account balance (EUR bn)	2.7	3.2	0.6	1.9	2.5
Current account balance/GDP (%)	1.6	1.7	0.3	0.9	1.1
Extended basic balance/GDP (%)	6.6	3.4	2.3	2.6	3.0
Net FDI (% of GDP)	3.9	0.9	1.7	1.2	1.4
Gross foreign debt (% of GDP)	73.4	86.5	81.6	79.8	77.9
FX reserves (EUR bn)	81.3	123.4	124.5	131.0	133.0
Months of imports, goods & services	7.7	10.7	10.0	10.3	10.1
Inflation/Monetary/FX					
CPI (pavg)	0.7	2.5	2.1	2.8	2.2
CPI (eop)	2.0	2.4	2.0	2.8	2.2
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	0.05	0.50	1.75	2.00	2.00
3M money market rate (Dec avg)	0.28	0.75	2.01	2.14	2.14
USD/FX (eop)	25.64	21.29	22.47	22.54	21.36
EUR/FX (eop)	27.02	25.54	25.73	25.70	25.20
USD/FX (pavg)	24.43	23.38	21.74	22.95	21.90
EUR/FX (pavg)	27.03	26.33	25.64	25.70	25.40

Source: CZSO, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

A tale of two halves

Resilience to external headwinds is expected to fade

The resilience in the face of external headwinds, which helped the economy in 1H19, is expected to fade in the remainder of 2019 and in 2020. Exports will be losing momentum as global value chains may start de-stocking after keeping high levels of inventories in the run-up to the 31 October Brexit deadline. Weaker exports are set to affect manufacturers' performance, prompting them to be less generous towards their employees from 2020 onwards. Subsequently, private consumption may slow in 2020, following with some delay other demand-side components of GDP in their reaction to weaker global sentiment. We expect GDP growth to ease below 2% yoy in 4Q19, reaching 2.4% for the full year. For 2020, we stick to our GDP forecast of 2.0%, but stress that a recovery in global demand is probably needed to achieve that.

Investment in machinery and transport equipment already affected by global slowdown

Global uncertainty has already hit companies' willingness to invest in machinery and transport equipment. Nevertheless, in 3Q19, the slump in capex was probably softened by Korean tire producer Nexen completing in August the first phase of a EUR 900m greenfield investment. As a result, corporate capex may avoid an outright decline until 4Q19.

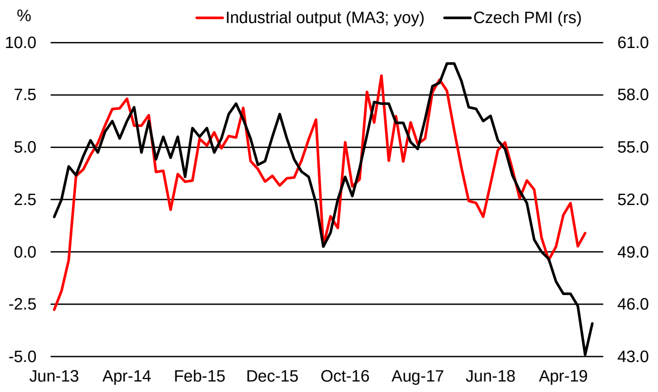
Public construction to support fixed capital formation

What may bolster overall fixed capital formation is the pipeline for construction-related investment. The value of pending orders has been on the rise since the start of 2018 and now exceeds the previous cyclical peak from 2015, measured in constant prices. Admittedly, future growth in the construction sector stands only on one leg, as the value of public orders is sharply up but private orders stagnate. We see restrictions in the sector affecting supply more than demand. In order to overcome those, companies are gradually running down their foreign orders to benefit from domestic ones. While in mid-2015, foreign orders accounted for 16% of the total, their weight fell to only 6.5% in 2Q19. The shift from foreign to domestic projects is set to make the overall construction output look worse than its actual contribution to GDP. We expect domestic value added in construction to rise by 5% yoy in 2H19 and by 4% in 2020.

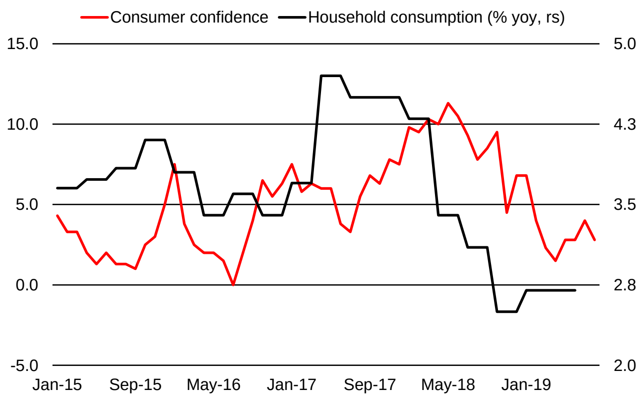
Industrial output affected by weak global trade and by a cyclical slowdown

Compared to construction, there are fewer reasons to be optimistic about industrial output. This is not only due to specific factors such as Brexit or US-China trade tensions but also because of a mature phase in the global investment cycle. As a bright spot in a generally gloomy outlook, Škoda Auto may still boost industrial output. Unlike its sales in China, which are less relevant from the domestic value-added viewpoint, its EU sales have been on the rise despite the overall market moderately contracting. Considering waiting lists for its new models, the output of Škoda Auto could expand until at least mid-2020. Admittedly, car manufacturing is one of the sectors to be potentially hit the most by a hard Brexit and by tariffs imposed by the US administration.

NOT ALL PESSIMISM FROM PMI REFLECTED IN INDUSTRIAL OUTPUT



SLOWDOWN IN PRIVATE CONSUMPTION JUSTIFIED BY CONSUMER CONFIDENCE



Source: CZSO, Markit, Macrobond, UniCredit Research

Consumption growth supported by labor market conditions in 2020

Household consumption is likely to remain strong for several quarters. Lower demand for labor in the sectors most exposed to external woes has been offset by firing agency workers who were mostly foreigners. Some companies in the service sector continue to increase employment. Unless industrial output plummets, the unemployment rate is unlikely to face more than a mild correction. Wage growth has barely started to slow, as corporate financial results looked solid until 2Q19. We expect a visible deterioration for the latter in 2H19 but it will take a while for a knock-on effect on wages to emerge. Negotiations on a public-sector salary package have just started and the Finance Ministry has already retreated from its initial stringent proposal of a 2% hike. We see this as a reason to slightly revise upwards our former 5% estimate of 2020 nominal wage growth. Real wages are thus likely to rise 3%, allowing for solid private consumption growth in 2020.

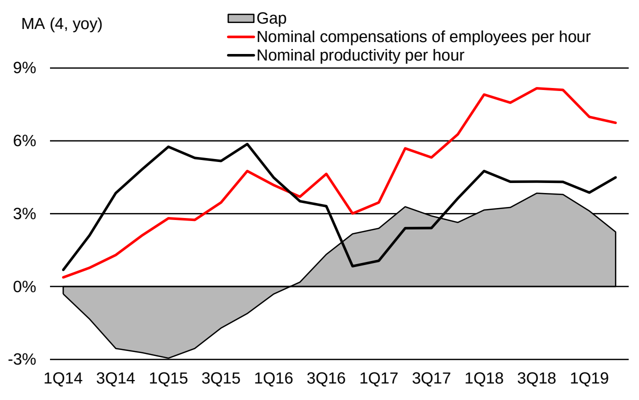
With domestic inflation pressures and CZK weaker than projected, we expect CNB policy to stay on hold in 2019-20

Inflation appears to be a bit stickier than we expected three months ago, with prices of services acting as the main cause. Price pressure has thus originated largely from domestic demand, linked to fast and resilient wage growth, as well as rising house prices. In fact, price indicators broader than CPI confirm this. In 2Q19, the GDP deflator added 3.5% yoy, with only a minor contribution from terms of trade. A similar situation has not been observed since 2004. Under the circumstance, we expect the CNB to hesitate on cutting the repo rate even with the ECB's additional policy easing. In this vein, a weaker-than-projected koruna serves as yet another argument for monetary policy inaction. A weaker EUR than previously expected (by the CNB and by us) means that the koruna may not strengthen in line with the central bank's forecast in effective terms either. For those reasons, several CNB board members have lately indicated a longer period ahead with rates on hold and we think their call is credible. In our view, this is very likely to remain the case until mid-2020. Thereafter, policy easing would be conceivable in reaction to adverse external shocks, rather than to the domestic macroeconomic situation.

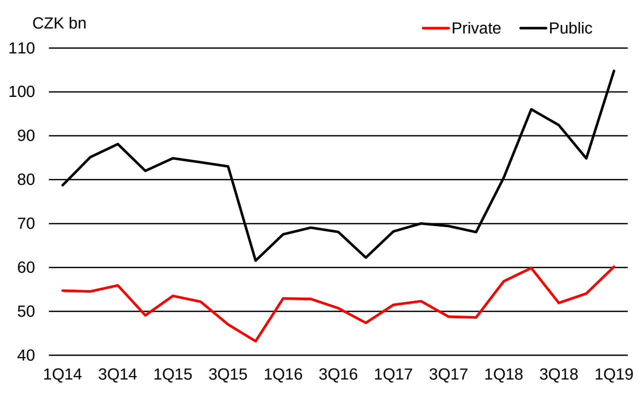
2020 government spending growth will raise the tax burden by 0.7 pp of GDP versus 2019

The 2020 state budget was drafted with a cash deficit of CZK 40bn, the same as in 2019. When introducing the bill, the Ministry of Finance highlighted that spending on pensions will rise at the fastest pace on record, while investment is also expected to increase. Meanwhile, negotiations within the government coalition have raised budget expenditures by at least CZK 19bn above the initial proposal, with an additional increase of CZK 4.3bn likely arriving from a higher-than-proposed wage bill. Nevertheless, the deficit forecast remained unchanged. In our view, this is due to revenues from tax hikes that are yet to be implemented. With a likely consensus in the coalition, the tax burden is estimated to go up by 0.7 pp of GDP versus 2019, translating into a moderate fiscal impulse in 2020. A more profound GDP slowdown could widen the public-sector deficit above 1% of GDP next year.

GAP BETWEEN PRODUCTIVITY AND WAGE GROWTH DIMINISHING BUT STILL WIDE



CONSTRUCTION ORDERS HIT MULTI-YEAR HIGH, PUBLIC SECTOR DOMINATES



Source: CZSO, UniCredit Research

CZGBs: A play for risk-averse, EUR-based investors

CZGB a play for risk-averse, EUR-based investors

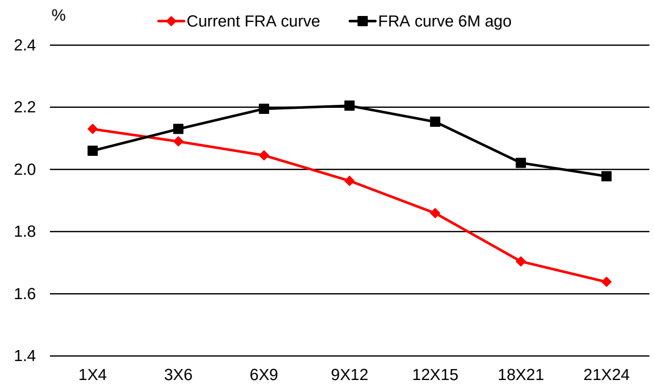
CZGB yields have tightened to the point where EM investors find little value on the curve. Thus, we expect crossover, risk-averse investors to target the long end of the curve for a pick-up over Bunds. Both the currency and yield levels offer a good entry point after respective selloffs.

Attractive entry point after the CZK and CZGBs sold off

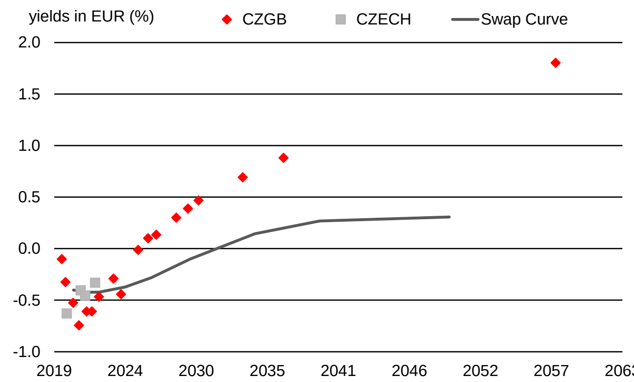
The CZK is now fair to undervalued and remains strongly supported by the most hawkish central bank in the region. While the CNB may be moving gradually to a more dovish stance (anticipated by the market, which expects two rate cuts in the next two years), this may not happen before inflation starts falling in 2Q20.

At the same time, the correction in Bund yields over Aug-Sep lifted CZGB spreads to attractive levels, in our opinion.

THE MARKET IS PRICING IN CUTS IN THE COMING YEARS



CZGBS OFFER A PICK-UP OVER CORE FOR RISK-AVERSE INVESTORS



Source: CNB, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**10.4**	**11.0**	**9.2**
Budget deficit	-0.1	1.6	1.6
Amortization of public debt	10.5	9.4	7.6
Domestic	8.5	9.4	6.6
Bonds	7.8	9.2	6.4
Bills	0.7	0.3	0.2
Loans	0	0	0
External	2.0	0	1.0
Bonds and loans	2.0	0	1.0
IMF/EU/Other IFIs	0	0	0
Financing	**10.4**	**11.0**	**9.2**
Domestic borrowing	10.3	9.4	9.1
Bonds	11.0	9.1	8.9
Bills	-0.8	0.2	0.2
Loans	0.1	0.1	0
External borrowing	0.1	1.6	0.1
Bonds	0	1.5	0
IMF/EU/Other IFIs	0.1	0.1	0.1
Privatization/Other	0	0	0

Source: CNB, MoF, CZSO, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**110.2**	**108.3**	**104.5**
C/A deficit	-0.6	-1.9	-2.5
Amortization of medium and long term debt	11.4	9.5	7.1
Government/central bank	7.5	4.4	3.9
Banks	1.4	3.1	1.5
Corporates/Other	2.5	1.9	1.7
Amortization of short-term debt	99.4	100.7	100.0
Government/central bank	7.5	7.5	6.0
Banks	59.1	59.6	59.0
Corporates/Other	32.8	33.7	35.0
Financing	**110.2**	**108.3**	**104.5**
FDI (net)	3.6	2.7	3.4
Portfolio equity, net	-1.0	-0.9	-0.9
Medium and long-term borrowing	11.7	8.3	7.0
Government/central bank	7.9	3.3	3.8
Banks	1.4	3.1	1.5
Corporates/Other	2.5	1.9	1.7
Short-term borrowing	95.2	102.6	94.8
EU structural and cohesion funds	1.8	2.0	2.2
Change in FX reserves (- = increase)	-1.1	-6.5	-2.0
Memoranda:			
Nonresident purchases of LC govt bonds	0.3	-1.1	0
International bond issuance, net	0	1.5	-1.0

Hungary

Baa3 stable/BBB stable/BBB stable**

Outlook

Economic growth could slow to 4.6% in 2019 and to 2.7% in 2020 due to global trade risks, the exhaustion of EU fund allotment, tax changes and limited scope for a credit impulse. Fiscal policy might support growth next year after a negative impulse in 2019. The NBH may ramp up monetary stimulus to offset external risks to growth, sacrificing the HUF in the process. Inflation could miss the target this year if oil prices remain above USD 65/bbl. Fidesz is favored to win local elections.

Strategy

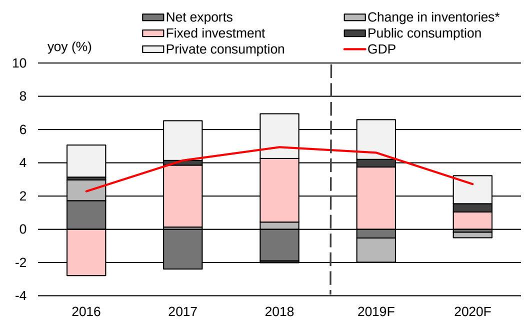
We recommend short HUF positions via forwards due to inflation and trade risks, as well as the accommodative monetary policy. Due to very tight spreads, HGBs are interesting only for the rolldown (24/B) or at the long end of the curve, FX hedged.

Authors:
Dan Bucșa, Chief CEE Economist (UniCredit Bank, London)
Ágnes Halász, Head of Economics & Strategic Analysis (UniCredit Bank Hungary)

KEY DATES/EVENTS

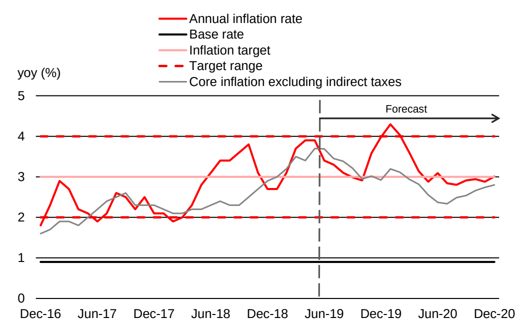
- 8 Oct, 8 Nov, 10 Dec: CPI
- 13 Oct: local elections
- 22 Oct, 19 Nov, 17 Dec: monetary policy decisions
- 25 Oct: rating update from Moody's
- 14 Nov, 29 Nov: 3Q19 GDP (flash, structure)

GDP GROWTH FORECAST



*Adjusted for the statistical error

INFLATION FORECAST



Source: HCSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	113.8	124.0	132.0	141.4	148.1
Population (mn)	9.8	9.8	9.8	9.7	9.7
GDP per capita (EUR)	11,555	12,637	13,492	14,505	15,244
Real economy, change (%)					
GDP	2.3	4.1	4.9	4.6	2.7
Private Consumption	4.0	4.8	5.4	5.4	4.6
Fixed Investment	-11.7	18.2	16.5	16.5	4.3
Public Consumption	0.7	1.3	-0.5	1.8	2.1
Exports	5.1	4.7	4.7	5.5	3.9
Imports	3.9	7.7	7.1	6.6	4.3
Monthly wage, nominal (EUR)	795	851	932	1,014	1,093
Real wage, change (%)	7.0	8.9	8.1	6.1	2.6
Unemployment rate (%)	5.3	4.2	3.7	3.5	3.8
Fiscal accounts (% of GDP)					
Budget balance	-1.6	-2.2	-2.2	-1.8	-1.3
Primary balance	1.6	0.6	0.3	0.8	1.2
Public debt	73.9	71.5	69.1	69.5	66.8
External accounts					
Current account balance (EUR bn)	5.2	2.8	-0.7	-1.8	-0.8
Current account balance/GDP (%)	4.6	2.3	-0.5	-1.3	-0.6
Extended basic balance/GDP (%)	6.8	4.9	4.2	4.2	3.6
Net FDI (% of GDP)	2.3	1.7	2.1	2.5	1.5
Gross foreign debt (% of GDP)	97.0	84.9	80.2	75.2	71.5
FX reserves (EUR bn)	24.0	22.6	25.8	27.8	27.6
Months of imports, goods & services	3.2	2.7	2.9	2.9	2.7
Inflation/Monetary/FX					
CPI (pavg)	0.5	2.5	2.9	3.6	3.5
CPI (eop)	1.8	2.1	2.7	4.0	3.1
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	0.90	0.90	0.90	0.90	0.90
3M money market rate (Dec avg)	0.34	1.35	0.13	0.27	0.30
USD/FX (eop)	294	259	281	287	284
EUR/FX (eop)	311	310	322	330	335
USD/FX (pavg)	282	274	270	289	284
EUR/FX (pavg)	312	309	319	325	332

Source: Eurostat, HCSO, NBH, UniCredit Research

**Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Preparing for tougher times ahead

Fiscal thrift in 2019…

2019 is a year of fiscal restraint after 2018's significant stimulus. One reason for this is the exhaustion of available EU funds, with the frantic pace of cash spending slowing this year. A second reason is a respite to build up reserves before another increase in spending: a raft of support programs for families that encourage natality and home purchases, and aim to prevent emigration will add to expenditure in the coming years. More broadly, this year's fiscal thrift shows the government's concern with an upcoming economic downturn driven by external factors that cannot be fully offset by domestic policies.

…justified by looming external risks in 2020

The concern is justified. Activity grew at a slower pace in many sectors over the summer, with exports and construction standing out. We signaled in the previous CEE Quarterly the likelihood of slower growth in real estate due to tax changes. The extent of export weakness was a surprise, given the support from new production capacity, but mirrored the poor performance of German manufacturing. We do not expect a recovery in 4Q19 and 2020. In addition, consumer spending is likely to slow as well, given that wage growth and employment continue to fall in the public sector, a mid-election cycle feature since Fidesz took power.

Retail bond issuance helps replenish public coffers

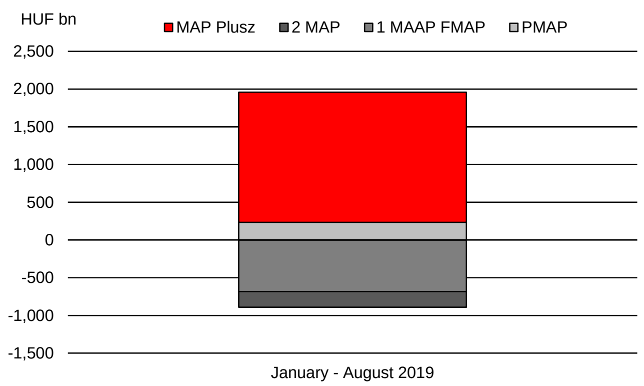
The government reconciled the need for reserves with a higher reliance on local borrowing by selling retail bonds. The new 5Y bond attracted HUF 2.1tn, with net retail borrowing rising in 8M19 by HUF 1053.5bn, exceeding the entire net borrowing planned for the year. As a result, government deposits at the NBH increased to the highest level in two years. Retail borrowing is too expensive, has too short a duration (most bonds are redeemable annually) and is dangerously crowding out local investment funds. In our opinion, the sustainable solution is a return to private pension funds, potentially mimicking the Polish reform.

GDP growth expected to slow to 4.6% in 2019 and 2.7% in 2020

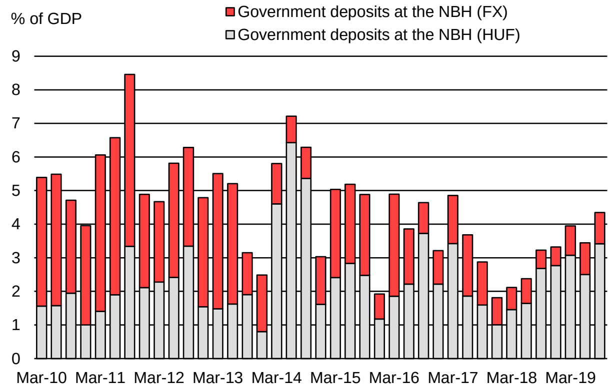
Fidesz is favored to win local elections. Opposition tests common candidate in Budapest

GDP growth is likely to slow in 2H19, with FY growth expected at 4.6%, weakening further next year to around 2.7%. The biggest risks are external, including a further reduction in global trade due to tensions between the US on the one hand and China and Europe on the other. In addition, uncertainty surrounding Brexit will continue to weigh on British purchases of more expensive cars, with Hungary one of the worst hit in EU-CEE. Tariffs imposed by the US on car imports from the EU could plunge Hungary into recession becasue the eurozone economy is slowing and the support of EU funds will end before absorption recovers in 2022-23. To avoid it, the government would have to increase public debt by breaching its pledge to reduce it below 60% of GDP. Local elections, scheduled for 13 October, will not trigger larger spending. Voters are happiest about cuts in utility prices and spending on social programs. These have been delivered already and will remain a focus for public policies. The opposition will test Fidesz's popularity by running a common candidate in mayoral elections for Budapest, where the opposition last year won a majority of MPs. A surprise could be in the cards. Opinion polls are inconclusive due to the bias of most polling companies.

5Y MAP PLUSZ IS CROWDING OUT OTHER RETAIL BONDS



GOVERNMENT DEPOSITS AT TWO-YEAR HIGH



Source: HCSO, Ministry of Finance, UniCredit Research

The inflation target could be missed in 2019

Inflation to fall from 2Q20 onwards

Inflation probably fell below 3% in September but is expected to rise strongly towards year-end and in 1Q20 due to base effects in fuel prices and resilient core inflation. The probability of a target miss in 2019 will increase if supply disruptions persist in the oil market. From 2Q20 onwards, inflation is likely to fall, gradually narrowing the gap with the eurozone. Tensions are easing in the labor market, with shortages past their peak. A further decline would lead to lower wage hikes in 2020 and these, in turn, would ease pressure on core inflation.

The NBH focused on easing

Stimulus via lending could lead to higher NPLs in the future

The NBH remains firmly focused on delivering more stimulus. However, its constantly dovish tone may upset markets if reflation is not met with more hawkish communication. The likely victim is the HUF, which could remain undervalued for longer, underperforming peers due to its low carry cost. Both corporate and retail lending continue to rise at a fast pace, with the FGS Fix adding HUF 350bn in loans to SMEs in the first eight months of 2019. Additional stimulus for corporate/SME lending could affect the quality of the loan portfolio in the longer term if banks try to meet aggressive lending targets. Corporate loan delinquencies are rising faster than in EU-CEE and precede the end of the business cycle, despite several rounds of the Funding for Growth Scheme allowing for the refinancing of past due loans. The NBH's push to boost corporate lending is also driving the closing of the C/A surplus by eliminating companies' net lending position.

C/A under pressure from forced lending to companies…

…and large energy imports

The C/A was revised to a small deficit in 2018 and we expect the balance to remain negative in 2019-20. The most important reason is weak exports of goods, especially to Europe. This happens in combination with aggressive policies to boost domestic demand and with a widening energy trade deficit. Energy imports far exceed the country's consumption as Hungary is becoming a hub for competing gas pipelines linking Europe to Russia and the Caspian Sea. Longer term, the economy's structural surplus of savings is likely to hold, returning the C/A to a surplus. In order for a structural deficit to arise, the government should breach its pledge to reduce debt annually while continuing to push SMEs to borrow.

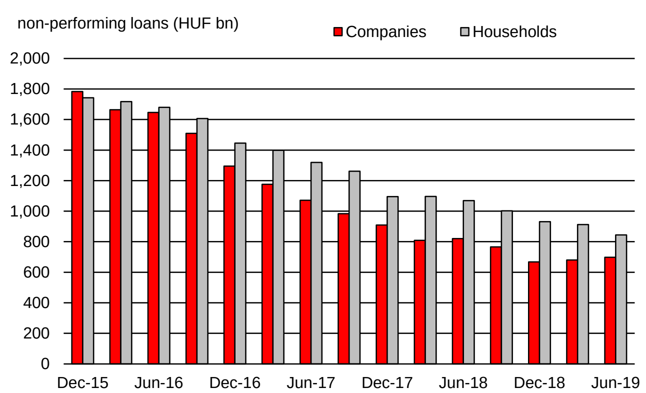
The EBB will remain large

While the EU continues to delay disbursements to Hungary, annual structural and investment funds are likely to exceed EUR 3bn this year and next, keeping the extended basic balance above 3.5% of GDP in 2019-20. At the same time, FDI in car and car part manufacturing is already slowing significantly due to poor foreign demand.

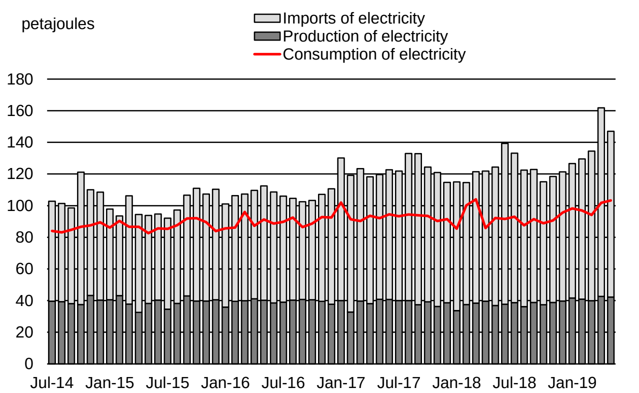
Banks' liquidity deficit

Thus, pressure on the currency is stemming mostly from volatile flows and the central bank's recycling of EUR via FX swaps to keep BUBOR rates low. The amount of FX swaps rose back to HUF 2tn in July as the banks' aggregate liquidity deficit swelled to around HUF 1.7tn. Besides pre-spending on public investment projects, strong demand for retail bonds MAP Plusz disrupted liquidity in the banking system. The NBH acknowledged the need for more liquidity injections in September, vowing to maintain or increase the current amount of FX swaps. Unless liquidity recovers in the banking sector, BUBOR rates will remain volatile.

NPLS ARE RISING IN THE CORPORATE SECTOR



ENERGY IMPORTS FAR EXCEED DOMESTIC CONSUMPTION



Source: Bloomberg, HCSO, NBH, UniCredit Research

The short-term anchored at the HUF's expense

HUF vulnerable due to loose monetary policy and external risks

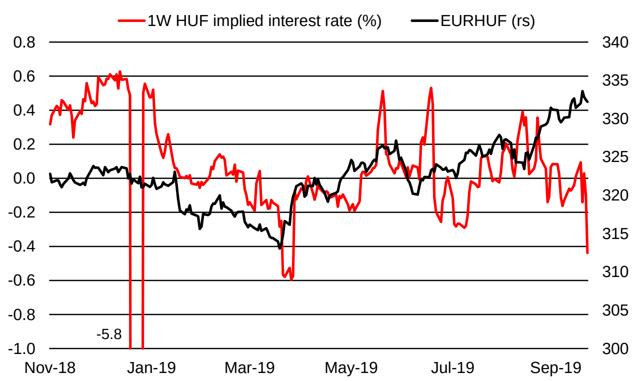
The NBH's focus on keeping interest rates low is obvious in low implied interest rates that persisted even while the HUF was selling off. A short HUF position via forwards is attractive given the expected rise in inflation, trade woes and a potential dip in risk appetite for EM.

Given tight valuation, HGBs are attractive due to rolldown (24/B) or at the long of the steep curve

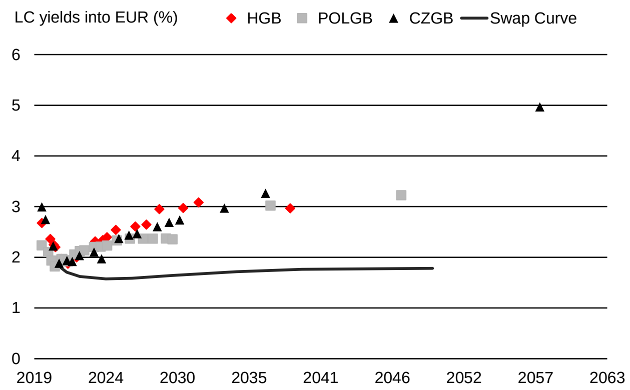
HGBs are not affected by HUF depreciation since most positions are FX hedged. However, attractive FX-hedged returns have been sapped by the recent rally and are now in line with the region. Yields could rise if Bund yields head north, as spreads remain below the 4-year average. Adjusted for volatility, HGBs are less attractive than CZGBs and POLGBs.

The government could counteract a potential increase in wholesale borrowing costs by reducing issuance in 4Q19, although a further accumulation of fiscal reserves could be more desirable. HGB 24/B look attractive in terms of rolldown, while bonds with maturities longer than nine years are more attractive in terms of ASW and their yields could be more stable in case of market turbulence owing to curve steepness.

FOCUS ON LOW RATES LEAVES HUF VULNERABLE



HEDGED HGBS ARE NOT A STAND-OUT TRADE ANYMORE



Source: AKK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**28.0**	**28.8**	**31.6**
Budget deficit	4.5	3.1	2.7
Amortization of public debt	23.4	25.7	28.9
Domestic	21.4	23.6	25.7
Bonds	5.2	5.3	5.7
Bills	3.4	3.9	3.0
Retail bonds	12.8	14.4	17.0
External	2.0	2.1	3.3
Bonds and loans	1.6	0.8	1.5
IMF/EU/Other IFIs	0.4	1.3	1.8
Financing	**28.0**	**28.8**	**31.6**
Domestic borrowing	26.4	29.8	30.6
Bonds	8.0	8.3	8.3
Bills	2.7	3.0	2.8
Retail bonds	15.7	18.5	19.5
External borrowing	1.5	0	1.0
Bonds	1.3	0	1.0
IMF/EU/Other IFIs	0.2	0	0
Fiscal reserves change (- =increase)	0.1	-1.0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**20.2**	**20.7**	**21.0**
C/A deficit	0.7	1.8	0.8
Amortization of medium and long term debt	7.5	8.4	10.1
Government/central bank	2.3	3.0	3.7
Banks	3.6	4.0	5.4
Corporates/Other	1.6	1.5	1.1
Amortization of short-term debt	12.0	10.5	10.1
Financing	**20.2**	**20.7**	**21.0**
FDI (net)	2.8	3.6	2.2
Portfolio equity, net	-0.5	0	0
Medium and long-term borrowing	6.4	3.9	6.2
Government/central bank	3.3	0.9	1.8
Banks	1.5	1.6	3.3
Corporates/Other	1.6	1.5	1.1
Short-term borrowing	10.5	10.1	8.0
EU structural and cohesion funds	3.5	4.1	4.0
Change in FX reserves (- = increase)	-2.4	-1.0	0.6
Memoranda:			
Nonresident purchases of LC govt bonds	1.8	0.9	0.8
International bond issuance, net	-0.3	-0.8	-0.5

Source: HCSO, NBH, GDMA, UniCredit Research

Poland

A2 stable/A- stable/A- stable**

Outlook

The ruling PiS is likely to remain in power after parliamentary elections scheduled for 13 October. Large fiscal spending will continue to support private consumption but investment could be affected by higher tax and labor costs for companies and by poor foreign demand. GDP growth is expected to slow to 4.4% in 2019 and 3.4% in 2020, with industrial production and exports being the main drags. The inflation target range could be breached temporarily in 1Q20 due to base effects in fuel prices and strong core inflation, returning below 3.5% in 2Q20. We expect the NBP to remain on hold this year and next.

Strategy

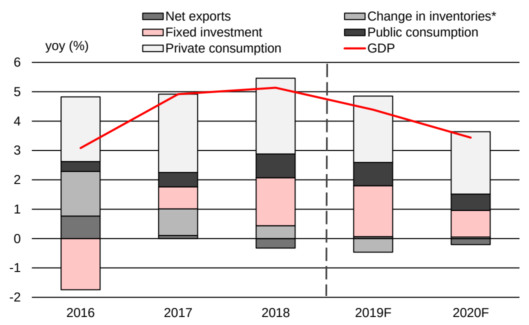
PLN and POLGBs remain attractive, with a potential selloff following the ECJ ruling offering better entry points. POLGBs are less volatile than regional peers, with net purchases coming mostly from local banks in the 2024-28 sector of the curve.

Author:
Dan Bucșa, Chief CEE Economist (UniCredit Bank, London)

KEY DATES/EVENTS

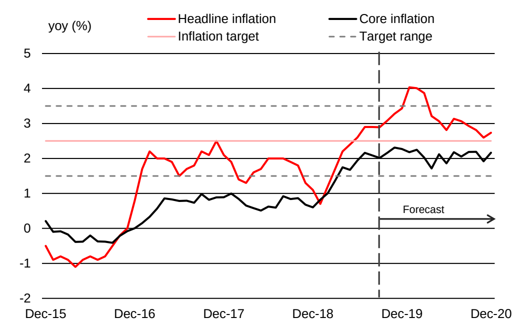
- 2 Oct, 6 Nov, 4 Dec: monetary policy decisions
- 1/15 Oct, 31 Oct/14 Nov, 29 Nov/13 Dec: CPI
- 27 Sep, 11 Oct: rating update from Fitch, Moody's and S&P
- 14 Nov, 29 Nov: 3Q19 GDP (flash, structure)
- 13 October: parliamentary elections

GDP GROWTH FORECAST



*Adjusted with the statistical error

INFLATION FORECAST



Source: Statistics Poland, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	426.5	467.6	496.3	527.3	562.8
Population (mn)	38.4	38.4	38.4	38.4	38.4
GDP per capita (EUR)	11,097	12,166	12,912	13,719	14,643
Real economy, change (%)					
GDP	3.1	4.9	5.1	4.4	3.4
Private Consumption	3.8	4.5	4.4	3.9	3.7
Fixed Investment	-8.1	3.9	8.6	8.8	4.4
Public Consumption	1.9	2.8	4.7	4.7	3.3
Exports	8.9	9.6	6.3	4.3	2.7
Imports	7.6	9.8	7.2	4.3	3.2
Monthly wage, nominal (EUR)	979	1,061	1,134	1,195	1,281
Real wage, change (%)	4.7	3.6	5.3	4.1	3.7
Unemployment rate (%)	8.9	7.3	6.1	5.5	5.7
Fiscal accounts (% of GDP)					
Budget balance	-2.2	-1.5	-0.4	-1.2	-1.6
Primary balance	-0.5	0	1.2	0.1	-0.3
Public debt	54.2	50.4	48.5	46.5	45.6
External accounts					
Current account balance (EUR bn)	-2.2	0.7	-2.9	-0.6	-4.5
Current account balance/GDP (%)	-0.5	0.2	-0.6	-0.1	-0.8
Extended basic balance/GDP (%)	1.4	2.6	3.4	3.7	2.6
Net FDI (% of GDP)	0.9	1.2	1.9	1.9	1.2
Gross foreign debt (% of GDP)	72.6	67.7	63.0	57.0	51.6
FX reserves (EUR bn)	103.5	90.2	96.5	93.1	93.3
Months of imports, goods & services	6.0	4.6	4.5	4.2	4.1
Inflation/Monetary/FX					
CPI (pavg)	-0.6	2.0	1.7	2.4	3.2
CPI (eop)	0.8	2.1	1.1	3.4	2.7
Central bank target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	1.50	1.50	1.50	1.50	1.50
3M money market rate (Dec avg)	1.73	1.72	1.72	1.72	1.75
USD/FX (eop)	4.18	3.48	3.76	3.74	3.64
EUR/FX (eop)	4.42	4.17	4.30	4.30	4.30
USD/FX (pavg)	3.95	3.78	3.61	3.83	3.68
EUR/FX (pavg)	4.36	4.26	4.26	4.31	4.31

Source: Eurostat, Statistics Poland, NBP, UniCredit Research

**Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Electioneering

A second PiS government is in the cards

The ruling Law and Justice Party (PiS) and its partners in the United Right (ZP) coalition are heading into parliamentary elections as the clear front runner. A second PiS government in a row looks possible after 13 October's poll, if ZP wins more than 42% of the vote and only two more political alliances enter parliament, namely the Civic Coalition (KO) led by the largest opposition party, the Civic Platform (PO), and Left, whose largest parties are the Democratic Left Alliance and Spring. The Polish Coalition (KP) formed by the Polish People's Party and Kukiz '15 is currently polling below the threshold of 8% required for coalitions.

Fiscal easing will not be offset by higher public revenues

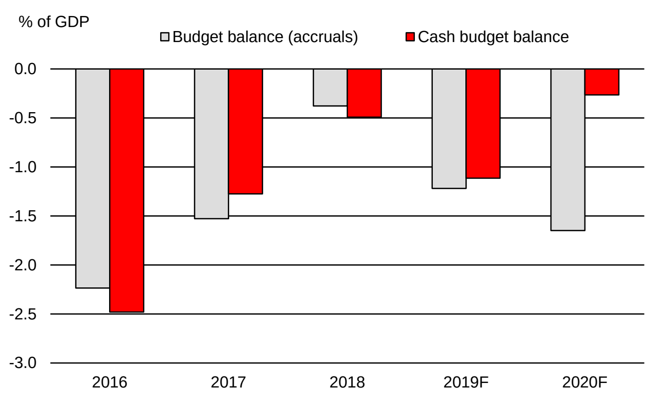
2020 budget deficit close to 1.6% of GDP on accruals, just 0.3% of GDP on cash

ZP seems to have good momentum heading into the polls, owing to PiS's strong economic record. A raft of fiscal easing measures targeted pensioners via large transfers, families with children through 500+ child subsidies and people younger than 26 years of age through exemptions from the personal income tax and for the corporate tax for their firms. These measures are expected to widen the budget deficit in 2019 to 1.2% of GDP from 0.4% of GDP in 2018. While the government pledged to run a balanced budget in 2020, this is unlikely even on cash accounting. The reasons are: **1.** The one-off transfer to pensioners of PLN 1,100 (for a total of PLN 11bn or 0.5% of GDP per year) was promised by PM Mateusz Morawiecki but not included in the budget; **2.** When computing the accrual-based deficit, Eurostat is likely to ignore the PLN 19bn revenue from the 15% tax applied on the transfer from Open Pension Funds to Individual Retirement Accounts planned for 1 July 2020; **3.** Revenue from auctioning 5G frequencies will be distributed over several years, although they will be added fully to the 2020 cash budget; **4.** The ambitious revenue targets may not be met for PIT (due to exemptions), VAT (for which tax compliance has already improved to eurozone levels) and CIT (that might be affected by a downturn in economic activity). At the same time, removing the cap for social contributions (currently at 30 times the average wage) could bring in PLN 5bn in additional revenues per year. Thus, we expect a cash shortfall of around 0.3% of GDP and an accrual-based deficit of 1.6% of GDP in 2020.

Minimum wage increases will reduce cost competitiveness

Electioneering does not stop here. PiS promised to increase the minimum wage by 15.6% in 2020 to PLN 2,600, with a target of PLN 4,000 by 2023, which would make it the second highest in CEE. The cost for companies is estimated at PLN 6.2bn in 2020, and more than 1.6mn people are likely to benefit from the measure. Polish companies are likely to lose cost competitiveness against peers in the coming years, albeit from a good starting point. PiS's inclusive policies seem to be confined to economics, its divisive social stance and the long-term plan to undermine juridical independence leading to a backlash from liberal urban voters. As a result, support for the KO has been rising in opinion polls since April. Inclusive social policies and support for independent justice are the main points of difference between the KO's and the ZP's election programs, with planned economic policies being similar.

LOWER CASH BUDGET DEFICIT IN 2020, WIDENING ON ACCRUALS



POLISH MINIMUM WAGE TO RISE WELL ABOVE CEE AVERAGE

Source: Eurostat, MinFin, Statistics Poland, UniCredit Research

Growth slowdown cushioned by lower dependency on exports

We expect GDP growth to slow to 4.4% in 2019 and 3.4% in 2020, the decline being less steep than in the rest of EU-CEE only due to Poland's less open economy and significant fiscal impulse (in cash terms). Rapid household income growth will help consumer spending, with the government expected to increase outlays until presidential elections, probably held in May 2020. Capex is likely to slow further due to weak foreign demand and higher tax and labor charges following announced fiscal measures. On the bright side, EU fund inflows will continue to rise as the end of the 2014-20 EU budget approaches. Both construction permits and started projects could decline by mid-2020 if house price growth decelerates. Real estate activity is driven by projects destined for sale or rent and demand could be affected by the cyclical downturn. This is already occurring in Warsaw and second-tier cities and is likely to affect other first-tier cities in 2020.

Investment likely to slow gradually

Poor IP growth due to weak eurozone demand

Industrial production may contract further, with intermediate goods leading the way due to poor demand from the eurozone. This is also triggering a fall in demand for capital goods. The very resilient working capital loans are also decelerating in a sign that activity will weaken further. Exports to EM are likely to outperform those to the eurozone for several quarters, as EM domestic demand (especially in EU-CEE) remains resilient.

NBP on hold…

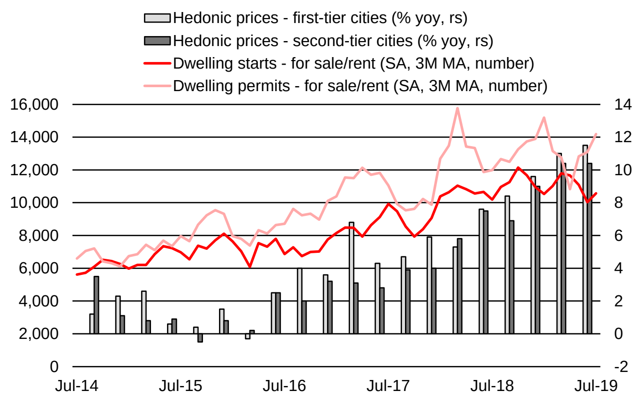
The NBP continues to sound sanguine about future inflation, despite significant inflationary risks ahead. A base effect in fuel prices could add to high and resilient core inflation from November 2019 onwards to push headline inflation outside the target range in 1Q20. The target miss is likely to be temporary. Low imported inflation and weaker pressure from domestic demand should push inflation back inside the target range from 2Q20 onwards. Thus, the year-end target is likely to be met in both 2019 and 2020. We expect inflation to remain above the 2.5% target throughout next year, forcing the NBP to remain on hold.

…despite temporary inflation target breach in 1Q20

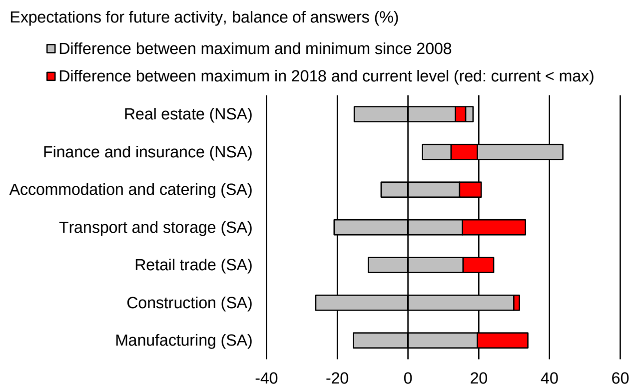
ECJ ruling could lead to tighter financial conditions

The biggest domestic risk to growth comes from tighter financial conditions triggered by the ECJ ruling on FX mortgages expected on 3 October. The ECJ is likely to side with borrowers affected by the arbitrary reset of interest and exchange rates used in loan repayments. FX-indexed mortgages are more at risk, with the volume estimated by local analysts at 55% of outstanding housing loans. In our opinion, the Bank Association overestimates losses. Considering an average penalty for banks of 20% for each loan, in line with the fixed haircut applied in Hungary in a similar situation, and the fact that pure FX mortgage loans may be less affected, total losses could be less than PLN 20bn. In addition, borrowers may be reimbursed over several years, spreading out bank losses. If the final cost is closer to our estimate, the risk may be concentrated on banks that already struggle to make a profit. However, the threat of a market-wide selloff is non-negligible if investors believe that losses will be mutualized through the deposit insurance scheme or if authorities react with a delay or fail to collaborate smoothly, since the NBP is not in charge of banking supervision.

PROJECTS FOR SALE/RENT DRIVE REAL ESTATE ACTIVITY



MANUFACTURING AND TRANSPORT – THE HARDEST HIT BY WEAK GLOBAL TRADE



Source: Statistics Poland, Ministry of Finance, Bloomberg, UniCredit Research

PLN assets attractive after the ECJ ruling

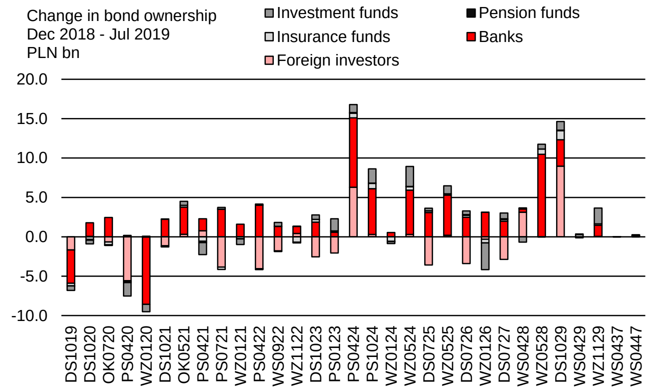
PLN cushioned by fundamentals and EU fund inflows

The PLN remains undervalued according to fundamentals and despite support from BoP flows. A small C/A deficit will be completely offset by EU fund inflows and FDI. Moreover, EUR-PLN could be capped by the conversion of EU fund receipts in the market. If the ECJ rules in favor of mortgage borrowers, banks are likely to find support at the NBP, which could benefit from the NBH's experience with CHF loan conversion. Thus, potential PLN depreciation following such a ruling could be an attractive entry point into long PLN positions.

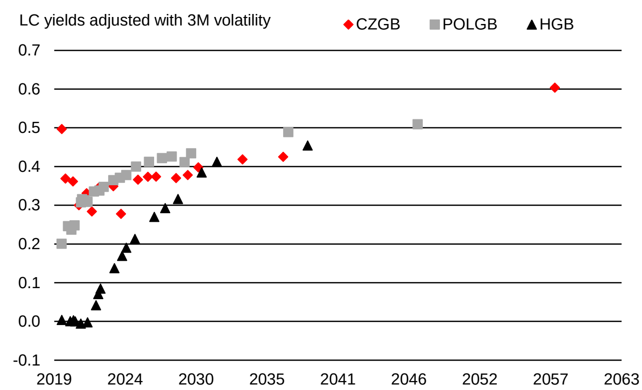
POLGBs helped by support from local banks

Banks continue to lend their unwavering support to POLGBs. If the ECJ ruling goes against them, bond purchases are likely to continue for several reasons. First, they are not subject to the bank tax and, thus, are the highest-earning non-taxable assets. Second, lending standards are likely to be tightened and, combined with the tax applied by authorities, it may lead to a further decline in the loan to deposit ratio. With POLAND EUR bonds closing out the spread to POLGBs (adjusted for funding costs), POLGBs may look more attractive that FX bonds. POLGBs are also less volatile than Visegrad peers in times of market corrections.

BANKS DROVE THE FLATTENING OF THE POLGB CURVE IN 2019



POLGBS LESS VOLATILE THAN PEERS



Source: MinFin, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**23.9**	**32.9**	**38.4**
Budget deficit	1.9	6.4	9.3
Amortization of public debt	22.1	26.5	29.1
Domestic	16.8	19.2	22.3
Bonds	16.8	19.2	22.3
Bills	0	0	0
Loans	0	0	0
External	5.3	7.3	6.8
Bonds and loans	3.5	5.9	5.3
IMF/EU/Other IFIs	1.8	1.4	1.5
Financing	**23.9**	**32.9**	**38.4**
Domestic borrowing	22.9	28.0	34.0
Bonds	21.9	28.0	33.0
Bills	0	0	0
Loans	1.0	0	1.0
External borrowing	2.2	5.2	5.0
Bonds	1.0	4.0	3.5
Loans, IFIs, other	1.2	1.2	1.5
Change in fiscal reserves/Other (-=increase)	-1.2	-0.3	-0.6

Source: Statistics Poland, NBP, Ministry of Finance, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**88.6**	**94.5**	**103.5**
C/A deficit	2.9	0.6	4.5
Amortization of medium and long term debt	43.2	49.8	50.0
Government/central bank	6.9	13.1	11.3
Banks	12.5	11.9	12.3
Corporates/Other	23.7	24.9	26.4
Amortization of short-term debt	42.5	44.1	49.0
Financing	**88.6**	**94.5**	**103.5**
FDI (net)	7.0	10.0	6.8
Portfolio equity, net	1.9	0.7	0.5
Medium and long-term borrowing	37.2	39.0	47.9
Government/central bank	1.1	6.2	9.6
Banks	10.0	7.1	11.1
Corporates/Other	26.1	25.7	27.2
Short-term borrowing	42.5	42.5	41.1
EU structural and cohesion funds	10.1	10.1	12.4
Other	-3.8	-11.2	-5.0
Change in FX reserves (- = increase)	-6.4	3.4	-0.2
Memoranda:			
Nonresident purchases of LC govt bonds	-2.6	-4.4	0.5
International bond issuance, net	-2.5	-1.9	-1.8

Romania

Baa3 stable/BBB- stable/BBB- stable*

Outlook

We upgrade the GDP growth forecast to 4.2% in 2019 and 2.6% in 2020 owing to rising output in construction and the unlikely tightening in fiscal policy. Inflation could miss the target in 2019-21 if gas and electricity prices are re-liberalized. The NBR is likely to remain on hold and the RON could continue to appreciate in real terms. President Klaus Iohannis is favored to win a new mandate on 24 November 2019. We believe that early parliamentary elections will be avoided due to insufficient support.

Strategy

The biggest risks for ROMGBs in the coming months are the Fitch rating update on 22 November, a rise in cross-currency swap rates and inflation before year-end, and the potential move of the EUR-RON range to 4.80-4.90 in early 2020.

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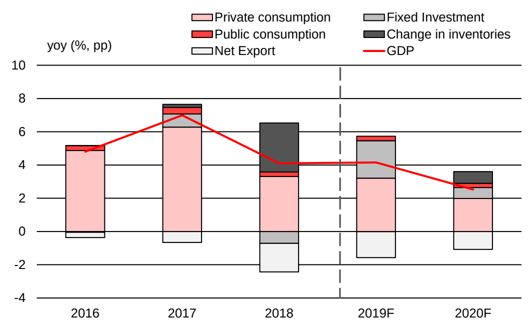
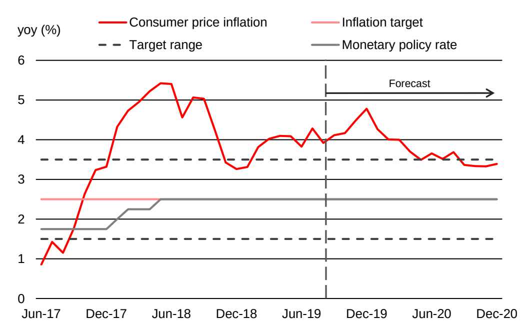
KEY DATES/EVENTS

- 3 Oct, 6 Nov: monetary policy decision
- 11 Oct, 12 Nov, 11 Dec: CPI
- 8 Nov: rating update from Fitch
- 14 Nov, 5 Dec: 3Q19 GDP (flash, structure)
- 10/24 Nov: presidential elections/runoff

GDP GROWTH FORECAST



INFLATION FORECAST



Source: NSI, NBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	170.4	187.5	202.1	217.3	235.0
Population (mn)	19.8	19.6	19.5	19.5	19.5
GDP per capita (EUR)	8,622	9,547	10,352	11,163	12,076
Real economy, change (%)					
GDP	4.8	7.0	4.1	4.2	2.6
Private Consumption	7.9	10.0	5.2	5.1	3.2
Fixed Investment	-0.2	3.5	-3.2	10.6	3.0
Public Consumption	2.2	2.6	3.8	1.7	1.5
Exports	16.0	10.0	4.7	2.6	2.0
Imports	16.5	11.3	8.6	5.9	4.2
Monthly wage, nominal (EUR)	643	724	965	1084	1,132
Real wage, change (%)	14.6	13.0	29.7	9.9	2.8
Unemployment rate (%)	5.9	4.9	4.2	3.9	4.4
Fiscal accounts (% of GDP)					
Budget balance	-2.9	-2.9	-3.0	-3.7	-4.3
Primary balance	-1.6	-1.7	-1.6	-2.4	-2.9
Public debt	37.3	35.2	35.1	36.0	36.8
External accounts					
Current account balance (EUR bn)	-3.6	-6.0	-9.4	-9.6	-9.4
Current account balance/GDP (%)	-2.1	-3.2	-4.7	-4.4	-4.0
Extended basic balance/GDP (%)	3.0	0.5	-1.3	-1.0	-1.9
Net FDI (% of GDP)	2.6	2.6	2.4	2.3	1.3
Gross foreign debt (% of GDP)	54.5	51.9	48.7	46.2	47.7
FX reserves (EUR bn)	34.2	33.5	33.1	35.6	36.9
Months of imports, goods & services	5.7	4.9	4.4	4.5	4.5
Inflation/Monetary/FX					
CPI (pavg)	-1.5	1.3	4.6	4.1	3.6
CPI (eop)	-0.5	3.3	3.3	4.8	3.4
Central bank target	2.50	2.50	2.50	2.50	2.50
Central bank reference rate (eop)	1.75	1.75	2.50	2.50	2.50
3M money market rate (Dec avg)	0.83	2.13	3.05	3.33	3.13
USDRON (eop)	4.30	3.89	4.07	4.19	3.98
EURRON (eop)	4.54	4.66	4.66	4.78	4.85
USDRON (pavg)	4.06	4.05	3.94	4.20	4.01
EURRON (pavg)	4.49	4.57	4.65	4.74	4.81

Source: Eurostat, NSI, NBR, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

To govern or not to govern

Populism is running aground in Romania, triggering a political crisis in the run-up to presidential elections that will be held on 10/24 November. Local elections will follow in May-June 2020, with parliamentary elections in November-December 2020. The government ran out of perks for voters, with hefty pension increases of 15% on 1 September 2019 and 40% on 1 September 2020 exhausting the fiscal room for any other expenditure increases.

Budget deficits expected to widen due to poor tax collection and large pension increases…

The budget deficit is likely to balloon to 3.7% of GDP in 2019. Tax revenue collection worsened in 7M19, with only VAT and social security receipts increasing in percent of GDP. The former benefits from strong consumption growth, rather than better tax collection. Without reforms to reduce tax evasion, this cyclical improvement could reverse when the economy slows. The rise in social security receipts is mostly explained by higher contributions paid by public employees and is fully offset by a higher public-sector wage bill.

…that could trigger rating downgrades in 2020

We do not expect early parliamentary elections

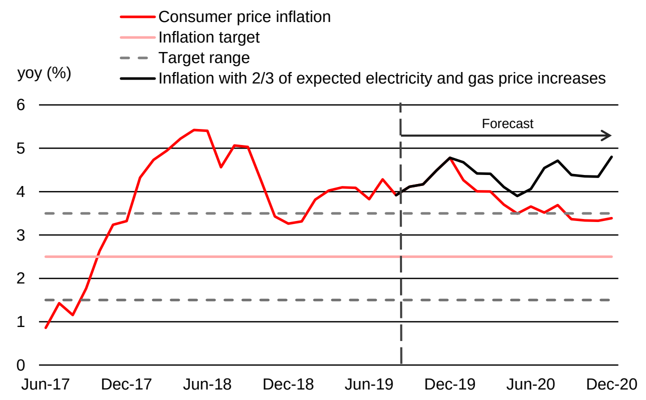
The budget deficit could exceed 4% of GDP in 2020 and 6% of GDP in 2021 – and Romania may lose its sovereign investment grade – if pensions increase next year. Some of this raise could be postponed – but not cancelled[5] – if parliamentary elections are brought forward to 1H20. Our baseline scenario is that elections will be held in late 2020 due to insufficient support for early elections. First, the ruling Social Democratic Party (PSD) benefits from the first-past-the-post (FPP) system used in local elections. The opposition National Liberal Party (PNL) and the alliance between the Save Romania Union (USR) and the Freedom, Unity and Solidarity Party (Plus) would switch to a two-round uninominal vote if they come to power. This may help them make inroads in PSD strongholds. If the FPP system is preserved, the opposition will have to run common candidates to win in large cities outside the Carpathians.

President Klaus Iohannis is favored to win re-election in November

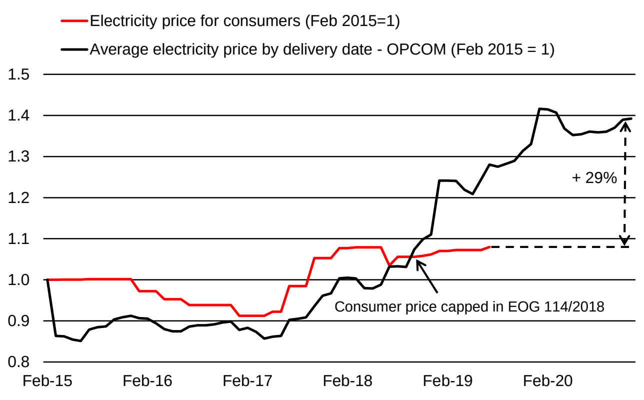
Second, PSD may want time to regroup if its candidate, PM Viorica Dăncilă, fails to qualify for the presidential election run-off. President Klaus Iohannis is the overwhelming favorite to win a second mandate in November, leading in polls with more than 40% of the first-round vote intentions. Dan Barna, candidate of USR-Plus and Mrs. Dăncilă are fighting for the second spot. Former PM Victor Ponta, head of PSD-splinter Pro Romania, could try to return as party leader in case of a PSD crisis and early elections might derail his plans.

Third, the opposition may be expressing its desire to govern in order to motivate its base, rather than out of conviction. The fiscal situation could require spending cuts and tax increases as soon as next year and could affect the popularity of a new government[6]. Thus, a weak government led or backed by PSD with support from Pro-Romania and other MPs is likely lead Romania until next year's parliamentary elections.

INFLATION COULD MISS THE TARGET IN 2020-21…



…IF GAS AND ELECTRICITY PRICES ARE RE-LIBERALIZED



Source: NSI, OPCOM, the Association of Utility Companies, UniCredit Research

[5] For details, please see the EEMEA Macro Flash - Romania repeats pre-crisis mistakes with foreseeable results from 6 July 2019.
[6] For details, please see the EEMEA Macro Flash - Romania: Reluctance to govern muddles political outlook from 27 August 2019.

GDP growth expected at 4.2% in 2019 and 2.6% in 2020…

…with exports a major drag…

…while consumption, construction and fiscal policy will contribute in 2019-20

Economic growth is expected at 4.2% in 2019 and 2.6% in 2020, gradually falling behind the rest of EU-CEE. Besides weaker European demand, exports could be affected by higher input prices and wages, with chemicals and low-value added sectors hit the most. In addition, high-value orders for shipyards fell compared to an exceptional 2018 and the drag could extend to 2020. Three major factors will limit the economic deceleration. **1.** Pension and public wage increases will keep private consumption growing above potential in 2019-20, doubled by a temporary acceleration in consumer lending. **2.** The late-cycle boom in real estate could continue for a few quarters. Neither building permits nor mortgage lending seem to support a longer rebound. **3.** Fiscal policy is unlikely to be tightened significantly before next year's parliamentary elections. Larger budget deficits in 2019-20 will affect economic performance in 2021 and beyond if rating downgrades and higher spreads for Romanian bonds lead to tighter financial conditions.

Inflation target could be missed in 2019-21 if energy and gas prices are re-liberalized…

Inflation is likely to remain below 4% until October 2019, only to rise subsequently due to a base effect in fuel prices and the expected re-liberalization of gas and energy prices. The latter could add 2.4pp to headline inflation over 18 months. A calendar of hikes is unavailable at the time of writing this Quarterly, but leaving too much to be done in 2020 would threaten next year's target after an almost certain miss in 2019. The 2021 target is not safe either if authorities wait for parliamentary elections before bringing energy prices to market levels.

…but the NBR will remain on hold

FX risk increasing again in the corporate sector…

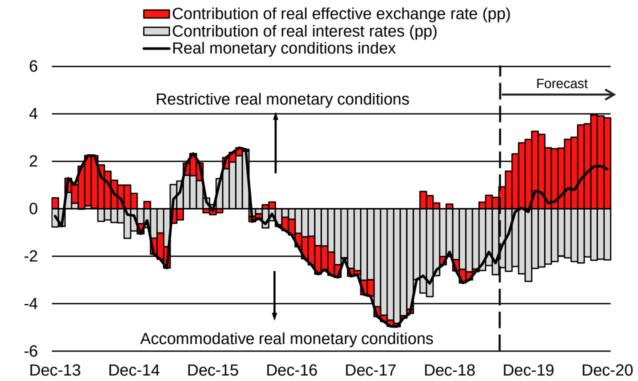
The NBR is unlikely to increase policy rates, although it should react to the second-round effects of energy and gas price increases. Dovish monetary policy in Europe and the US, low imported inflation and lower domestic demand pressure on prices are reasons to remain on hold. Real monetary conditions have been tightening in 2019, albeit with the wrong mix: the RON appreciated in real terms while ROBOR interest rates were allowed to fall towards 3% by maintaining excess liquidity in the banking system. As a result, corporate and consumer borrowing in RON and EUR accelerated. Lending to companies bodes well for investment, but FX risks are rising as EUR loans outpaced RON loans.

…as the NBR prevents rapid RON depreciation

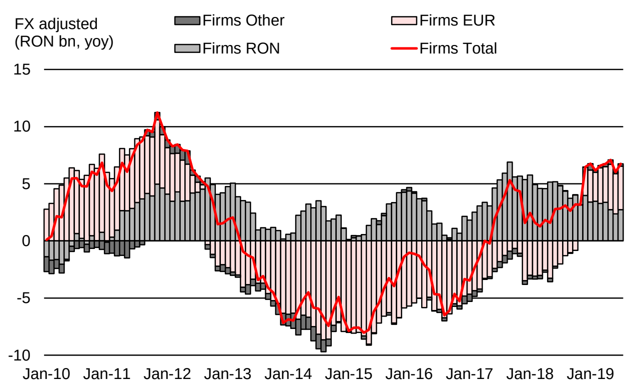
C/A deficit could remain above 4% of GDP in 2019-20

This may prove relevant if EUR-RON increases in 4Q19 and exceeds 4.80 in 1Q20, when we expect the range to shift to 4.80-90. The RON remains one of the most overvalued currencies in CEE and this step-by-step weakening will not eliminate overvaluation. The NBR may have to use its reserves to defend the currency next year if appetite for EM assets weakens and EU fund inflows remain modest due to co-financing being crowded out by other types of fiscal spending. We expect the C/A deficit to peak this year and remain above 4% of GDP in 2020, with consumer spending and weaker global trade the biggest risks for a wider shortfall. Romania's industry is the hardest-hit in EU-CEE by weak global trade, with a loss of competitiveness through labor cost increases and currency appreciation contributing to the downfall. After removal of energy price caps for consumers, energy imports are likely to fall. This may be the single biggest contributor to an improvement in the seasonally-adjusted C/A deficit in 4Q19 compared to the first nine months of the year.

REAL MONETARY CONDITIONS TIGHTENING DUE TO REAL RON APPRECIATION



CORPORATE LOANS IN EUR ARE RISING, INCREASING FX RISKS



Source: EC, Eurostat, NBR, NSI, UniCredit Research

Romanian bonds: a yield, not a capital gain story

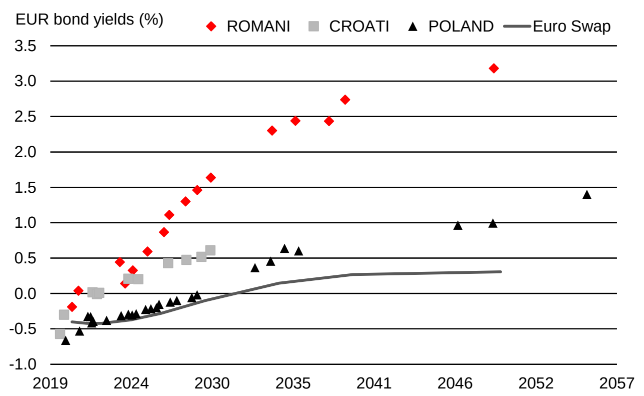
ROMANI EUR and ROMGBs have attractive yields compared to the region

With the ECB announcing a new, open-ended round of QE, ROMANI could well be the only investment-grade EUR bonds in the EU with positive yields below 10Y by the end of the year. ROMANI EUR already price in a downgrade to junk status when compared to regional peers. Moreover, the curve is very steep and offers good value at maturities beyond 2030.

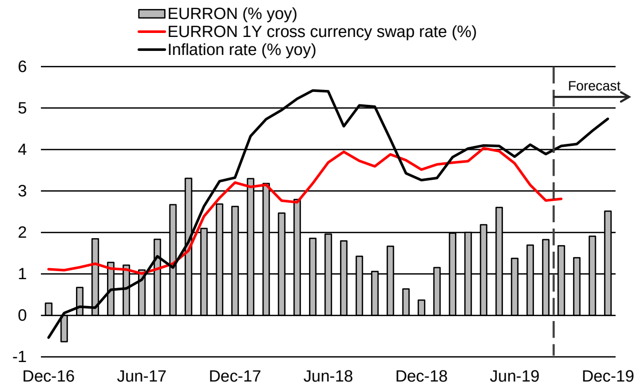
Risks for capital gains for ROMGBs in the coming months

The biggest risks for capital gains for ROMGBs in the coming months are (chronologically): **1.** Fitch's review on 10 November. Recent comments suggest that this could be the first agency to put Romania on the brink of a junk rating. **2.** Higher cross-currency swap rates and inflation before year-end. A weaker RON could force the NBR to sterilize excess liquidity. This is relevant especially for the 3-5Y segment of the curve, where bonds looked more attractive than in the past 18 months when FX hedged and real yields will turn more negative. **3.** RON depreciation in 1Q20 if the NBR decides to move the EUR-RON range. While ROMGBs do not offer the prospect of significant capital gains due to fiscal and inflationary risks, they remain less prone to corrections in Bund yields than HGBs and POLGBs.

ROMANI EUR ARE ATTRACTIVE, ESPECIALLY AT MATURITIES OVER 2030



CROSS-CURRENCY SWAP RATES COULD RISE TOWARDS YEAR-END



Source: Bloomberg, NBR, NSI, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**14.2**	**18.8**	**19.4**
Budget deficit	5.9	8.1	10.2
Amortization of public debt	8.4	10.7	9.2
Domestic	5.5	8.2	7.2
Bonds	3.5	5.9	5.7
Bills	1.8	2.0	1.2
Loans	0.2	0.3	0.3
External	2.9	2.5	2.0
Bonds and loans	1.5	1.5	2.0
IMF/EU/Other IFIs	1.4	1.0	0
Financing	**14.2**	**18.8**	**19.4**
Domestic borrowing	8.3	10.0	11.4
Bonds	6.2	7.6	8.5
Bills	2.0	1.2	2.0
Loans	0.1	1.2	0.9
External borrowing	5.4	7.6	6.0
Bonds	5.0	6.0	5.0
IMF/EU/Other IFIs	0.5	1.6	1.0
Privatization/Other	0	0	0
Fiscal reserves change (- =increase)	0.5	1.3	1.9

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**31.2**	**38.6**	**36.3**
C/A deficit	9.2	9.6	9.4
Amortization of medium and long term debt	9.6	16.9	14.0
Government/central bank	5.0	3.8	3.7
Banks	3.2	4.7	2.1
Corporates/Other	1.4	8.4	8.2
Amortization of short-term debt	12.4	12.1	12.9
Financing	**31.2**	**38.6**	**36.3**
FDI (net)	5.0	5.0	3.1
Portfolio equity, net	0.1	0.1	0.1
Medium and long-term borrowing	10.4	20.4	15.2
Government/central bank	6.0	7.8	6.4
Banks	3.1	4.2	1.9
Corporates/Other	1.3	8.5	7.0
Short-term borrowing	12.9	14.6	16.0
EU structural and cohesion funds	1.8	2.5	3.0
Change in FX reserves (- = increase)	1.0	-4.1	-1.1
Memoranda:			
Nonresident purchases of LC govt bonds	1.8	0	0.3
International bond issuance, net	3.5	4.5	3.0

Source: NBR, NSI, Ministry of Finance, UniCredit Research

Slovakia

A2 positive/A+ stable/A+ stable*

Outlook

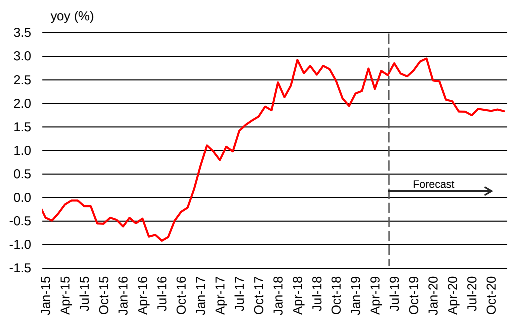
Economic growth is expected to moderate in 2019 and 2020 due to weaker external demand, with low growth in Germany, Brexit and trade wars as the main threats. New production capacity in the automotive sector will mitigate a slowdown, but is unlikely to reach full capacity before the end of 2020, as planned. Unemployment will stabilize, but wage growth will remain strong, boosted in the run-up to parliamentary elections, expected in February 2020. This will support household spending temporarily. The fiscal stance is likely to ease, although room for sizeable fiscal stimulus is limited by the debt brake. The political landscape remains fragmented ahead of parliamentary elections.

Author:
Ľubomír Koršňák, Chief Economist (UniCredit Bank Czech Republic and Slovakia)

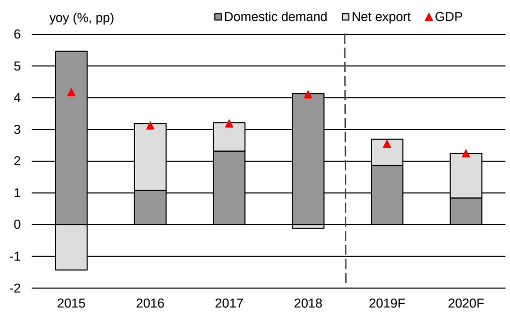
KEY DATES/EVENTS

- 10 Oct, 11 Nov, 10 Dec: Industrial production
- 14 Oct, 14 Nov, 13 Dec: CPI
- 14 Nov: flash 3Q19 GDP
- 5 Dec: 3Q19 GDP structure

INFLATION DRIVEN BY STRONG DEMAND



GDP GROWTH TO SLOW DOWN IN 2019-20



Source: SORS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	81.2	84.9	90.2	95.0	98.5
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	14,957	15,600	16,569	17,436	18,087
Real economy, change (%)					
GDP	3.1	3.2	4.1	2.6	2.3
Private Consumption	2.9	3.5	3.0	1.7	1.1
Fixed Investment	-9.4	3.4	6.8	-0.5	0
Public Consumption	1.6	1.7	1.9	2.9	2.0
Exports	5.5	5.9	4.8	2.2	1.2
Imports	3.4	5.3	5.3	1.5	-0.1
Monthly wage, nominal (EUR)	912	954	1,013	1,089	1,144
Real wage, change (%)	3.8	3.3	3.6	4.7	3.0
Unemployment rate (%)	9.6	8.1	6.5	5.8	6.0
Fiscal accounts (% of GDP)					
Budget balance	-2.2	-0.8	-0.7	-0.9	-1.1
Primary balance	-0.6	0.6	0.6	0	-0.2
Public debt	51.8	50.9	48.9	48.0	47.3
External accounts					
Current account balance (EUR bn)	-1.8	-1.7	-2.3	-1.9	-1.0
Current account balance/GDP (%)	-2.2	-2.0	-2.5	-2.0	-1.1
Extended basic balance/GDP (%)	0.6	1.0	-0.7	-0.1	1.2
Net FDI (% of GDP)	0.8	2.0	0.2	0.2	0.5
Gross foreign debt (% of GDP)	92.2	111.0	113.0	107.4	102.0
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Months of imports, goods & services	-	-	-	-	-
Inflation/Monetary/FX					
CPI (pavg)	-0.5	1.3	2.5	2.6	2.0
CPI (eop)	0.2	1.9	1.9	3.0	1.8
Central bank reference rate (eop)	EUR	EUR	EUR	EUR	EUR
USD/FX (eop)	EUR	EUR	EUR	EUR	EUR
EUR/FX (eop)	EUR	EUR	EUR	EUR	EUR
USD/FX (pavg)	EUR	EUR	EUR	EUR	EUR
EUR/FX (pavg)	EUR	EUR	EUR	EUR	EUR

Source: Eurostat, SORS, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Export-driven slowdown not offset by higher car production

Economic growth is set to slow due to weaker external demand

Economic growth surprised on the downside in 2Q19, confirming the strong dependency of local industry on German demand. Idiosyncratic factors such as the end of investment in Jaguar Land-Rover's new plant and planned maintenance work in oil refining hit growth figures as well. These one-offs will be less of a drag in the coming quarters, but weakening external demand will further weigh on exports, keeping overall GDP growth below 3%. We foresee growth to slow to 2.6% in 2019 and to 2.3% in 2020 from 4.1% in 2018.

Manufacturing showing the first signs of weakness

Overreliance on the car sector increased

US tariffs on car imports and Brexit could affect growth

Sentiment in industry deteriorated significantly in 1H19, suggesting an imminent downturn. Manufacturing output is already falling in important sectors like basic metals or rubber and plastic. In contrast, the output of machinery and electrical equipment remains resilient, although new orders suggest that strength is unlikely to last. The car sector continues to grow, driven by recent investment. However, car sales in Europe, the US and China may weaken in 2H19 and 2020. This would affect local car producers and slow production growth in the new car plant of Jaguar Land-Rover, which may not reach full capacity in 2020. Higher US tariffs on car imports from the EU and Brexit remain major threats, with 10% of car exports heading to the US market and 9% to the UK. The direct impact is unlikely to exceed 0.5% of GDP for each due to the high import dependency of car exports. Indirect effects via slower growth of the European economy could be at least twice as large.

Labor market remains tight but is already turning

Wage growth could remain strong in the run-up to elections

Economic growth remains labor intensive, pushing unemployment to a new historical low and supporting household spending. With labor market conditions expected to cool off from 2H19 onwards, household spending is likely to grow at a slower pace. The unemployment rate could stabilize at just above 6%, and demand for foreign workers is expected to ease, although wages will still rise at a fast pace. Furthermore, income growth will be supported by the government's decision to increase public-sector wages by 10% in both 2019 and 2020 and the minimum wage by 11.5% in 2020 (to EUR 580).

Public investment to recover, driven by EU funds, contrasting weak capex

Worsening of sentiment will be a drag on growth of private investment in 2H19 and 2020. Public investment slowed recently due to recurring issues in highway construction, but it is expected to recover in 2H19 and 2020, supported by EU funds, partly offsetting weak private capex. The booming residential real estate sector started to cool off due to tighter central bank regulations introduced in 2018 and the trend is likely to continue. This may fully offset the positive impact of low interest rates.

Inflation to slow after peaking at the end of 2019

Inflation will temporarily accelerate towards 3% at the end of 2019 due to base effects in fuel prices. It is likely to slow to 2% in 2020 as household spending slows and pressure from energy prices falls.

Political cycle to widen fiscal deficit, but a large fiscal impulse is unlikely due to debt brake

There is limited scope for a sizeable fiscal impulse as public debt remains close to the debt brake threshold, falling below it only in 2018. Furthermore, debt brake thresholds are set to decline by 1pp each year until 2027. Nevertheless, we anticipate some fiscal stimulus before parliamentary elections, expected in February 2020. The cash deficit in 1H19 suggests that a balanced budget is unlikely in 2019, with no tightening in sight due to approaching elections. Thus, the budget deficit could remain close to the 2018 level. The deficit is likely to expand further in 2020 due to ad-hoc populist measures driven by declining support for coalition parties.

Parliamentary elections expected in February 2020. Fragmentation will hamper the emergence of a ruling coalition

The outcome of 2020 parliamentary election remains unclear. Several parties are on the edge of the 5% threshold needed to enter parliament, including the junior coalition party of Hungarians (Most-Hid) or newly-formed opposition party of former President Andrej Kiska (For People). The political landscape may fragment further in the autumn, when new parties are expected to be formed. Among them, one supported by former Prime Minister Vladimír Mečiar could threaten support for the ruling SMER-SD. The latter's support is stable at around 20%, despite the outcry following the murder of journalist Ján Kuciak and several disputes between former prime minister and party chairman Robert Fico and current Prime Minister Peter Pellegrini. The opposition is led by the pro-European coalition of Progressive Slovakia and Together (15%), which won presidential and European Parliament elections early in the year. The extremists of Marian Kotleba remain stable at 10-12%.

Slovenia

Aa1 positive/AA- stable/A- stable*

Outlook

GDP growth will likely slow below 3% in 2019 and to 2% in 2020, after growth above 4% in 2017 and 2018. Fiscal challenges are set to rise in 2019-20, with upward pressure on expenditures and downward pressure on revenues, the latter related to the economic slowdown. In the short term, the main challenge is to contain expenditures, while the long-term challenges are pension and healthcare reforms. Inflation could peak at around 2.5% yoy in December, before falling back to 2% in 2020. The risk of government bond yield spreads widening vs. German Bunds in a context of slowing growth and fiscal challenges has been reduced by the launch of new ECB purchases.

Author:
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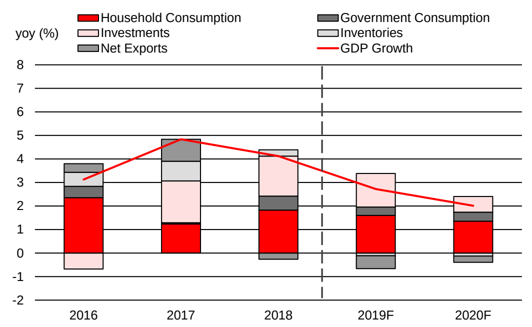
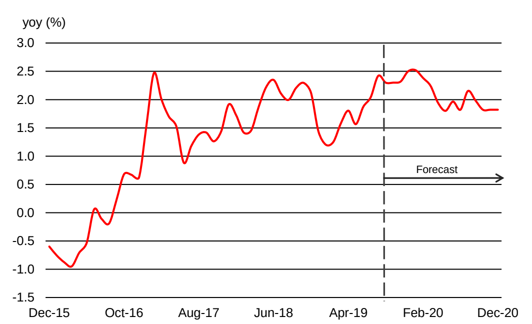
KEY DATES/EVENTS

- 29 Nov: 3Q19 GDP
- 10 Oct, 8 Nov, 10 Dec: Industrial production
- 18 Oct: rating update from Moody's
- 13 Dec: rating update from S&P

GDP GROWTH FORECAST



INFLATION FORECAST



Source: SURS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2016	2017	2018	2019F	2020F
GDP (EUR bn)	40.4	43.0	45.8	47.9	49.8
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	19,551	20,809	22,089	23,090	24,008
Real economy, change (%)					
GDP	3.1	4.8	4.1	2.7	2.0
Private Consumption	4.4	2.3	3.4	3.0	2.5
Fixed Investment	-3.7	10.4	9.4	7.5	3.4
Public Consumption	2.5	0.3	3.2	2.0	2.1
Exports	6.5	10.8	6.6	6.8	3.2
Imports	6.7	10.7	7.7	8.2	3.8
Monthly wage, nominal (EUR)	1,584	1,626	1,681	1,758	1,829
Real wage, change (%)	2.0	1.1	1.4	2.7	1.9
Unemployment rate (%)	8.0	6.6	5.1	4.2	4.0
Fiscal accounts (% of GDP)					
Budget balance	-1.9	0	0.7	0.6	0.3
Primary balance	1.1	2.5	2.7	2.3	1.9
Public debt	78.5	73.6	70.3	66.5	63.0
External accounts					
Current account balance (EUR bn)	1.9	2.6	2.6	2.5	2.6
Current account balance/GDP (%)	4.8	6.1	5.7	5.2	5.2
Extended basic balance/GDP (%)	7.2	7.6	8.4	8.1	8.3
Net FDI (% of GDP)	2.1	1.2	2.0	2.1	2.1
Gross foreign debt (% of GDP)	109.7	100.5	92.0	87.1	83.2
FX reserves (EUR bn)	0.7	0.7	0.8	0.8	0.8
Inflation/Monetary/FX					
CPI (pavg)	-0.2	1.6	1.9	1.9	2.1
CPI (eop)	0.6	1.9	1.4	2.5	1.8

Source: Eurostat, SURS, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Slower growth

GDP growth expected to slow below 3% in 2019 and to 2% in 2020

GDP growth will likely slow below 3% in 2019 and to 2% in 2020, after 4.1% in 2018. The slowdown in 2019 could reflect: **1.** a larger drag from net exports, due to slower economic growth in major trading partners and the strength of imports; **2**. investment growth coming off its close to double-digit highs; **3.** somewhat lower but still solid consumption; **4.** the absence of the boost from inventories experienced in 2018 (+0.3pp). We revised slightly down our forecasts, from 3.0% to 2.7%, reflecting the weaker-than-expected GDP figure in 2Q19 and lower assumed growth in the euro area in 2H19. In 2020, sub-potential growth in the EU will likely push the GDP expansion below potential to around 2%, mainly due to lower exports and investment.

The resilience of exports is unlikely to be sustainable

While export growth remained relatively resilient in 1H19 (8.6% yoy), we expect it to fall in 2H19 and 2020 due to weak growth in the rest of the EU. The resilience in 1H19 was in part related to a significant increase of exports to Switzerland, mainly pharmaceuticals, which accounted for 40% of total nominal export growth in 1H19, from 7% in 2H18, offsetting a decline of the contribution of EU countries (to 50%, from 80% in 2H18, half of it due to Germany). We expect the drag from exports to the EU to be more visible in 2H19, and most recent export data are in line with our assumption.

Investment growth: still good in 2019, slowing down in 2020

Investment growth will likely remain solid in 2019, at around 7.5%, but is set to slow to below 4% in 2020. Investment growth was strong in 1H19 (8.4% yoy) as a significant weakening in capex was in good part offset by higher investment in construction, driven by both the private and public sector (government capital expenditure increased by around 30% yoy). This trend could continue in 2H19; but in 2020, capex could weaken further and construction investment might slow amid a cooling economy and more government budgetary constraints.

Consumption likely to remain more resilient

Private consumption will probably remain more resilient. Growth in 2019 could reach 3%, thanks to: **1.** solid wage increases, due to public sector wage increases and labor shortages, and **2.** rising employment. A slowdown to 2.5% in 2020 is in the cards as both wage and employment growth moderate.

Inflation is expected to slow in 2020

Inflation could peak at around 2.5% yoy in December, before falling back to around 2% in 2020. Inflation rose from 1.2% yoy at the beginning of the year to 2.4% yoy in August, mainly driven by core inflation (up from 1.3% yoy to 2.3% yoy), amid strong domestic demand, wage growth, and food prices. Inflation might accelerate further in November and December, driven by a base effect in oil prices; however, it could then gradually return to close to 2% in 2020 as domestic demand weakens and imported inflation from the rest of the euro area remains low.

Fiscal challenges

As growth slows, fiscal challenges are set to rise in 2019-20. In the short term, the main challenge is to contain expenditures in a context of a slowing economy, especially in 2020, with related pressure on revenues. On a positive note, the government reaffirmed its commitment to stick to the fiscal rule in 2019 and 2020, and will prepare a supplementary budget for 2019 to take into account the new IMAD forecasts published on 19 September, in which growth for 2019 was revised down from 3.4% to 2.8%. Overall, the main risk is that the different agendas of parties in the large government coalition could lead to an expansive fiscal policy, larger structural deficits and a slower reduction of public debt. On a longer-term perspective, progress in addressing the long-term challenges of pension and healthcare reforms has been limited.

General government debt to fall further

In our forecast, the small government budget surpluses in 2019 and 2020 (0.6% and 0.3% of GDP, respectively) should allow public debt to fall to 66.5% of GDP by the end of 2019, and further to 63% of GDP in 2020, from around 70% in 2018.

ECB asset purchases should support Slovenian bonds

The risk of government bond yield spreads widening vs. German Bunds in a context of slowing growth and fiscal challenges has been reduced by the launch of new ECB purchases, which are likely to support Slovenia government bonds. Based on some simplifying assumptions, we estimate that the ECB could buy around EUR 50mn of Slovenian government bonds per month. In addition, in July the government reopened its 10Y benchmark for an additional EUR 350mn (in January it issued EUR 1.5bn), therefore the 10Y bond issuance covered around 85% of total financing needs for 2019.

Bosnia and Herzegovina

B3 stable/B positive/not rated*

Outlook

GDP growth in 2019 and 2020 is likely to slow down to 2.6% and 2.7%, respectively, primarily due to the expected deterioration in the external environment. We revised down our forecasts for both years (from 2.8% and 2.9%, respectively) as we now expect a less pronounced pickup in investment due to the impact of protracted domestic political uncertainty. After almost a year since the general elections (October 2018), there is still uncertainty about when the central government and the government of the Federation of B&H will be formed as the political stalemate among the main political parties continues. This, in turn, postpones the possibility of the resumption of IMF financing. However, external financing is available for some big infrastructure projects from several other IFIs, and therefore we continue to expect a pickup in investment activity in 2H19 and in 2020. Private consumption is expected to remain the main driver of GDP growth on the back of a substantial rise in employment, wages, remittances and households' disposable income. Downside risks result from both the external environment and domestic political developments.

Authors:
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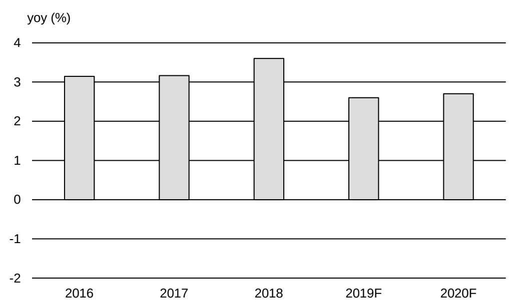
Nenad Golac, Senior Economist (Zagrebačka banka)

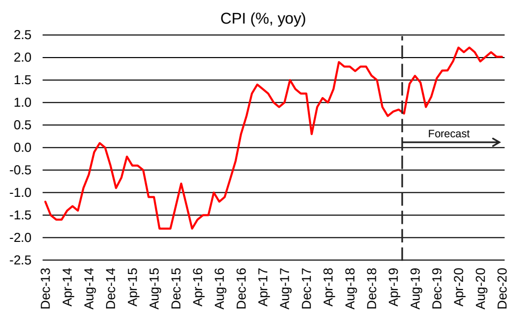
KEY DATES/EVENTS

- 20 Dec: CPI November 2019
- 20 Dec: Foreign trade Jan-Nov 2019
- 27 Dec: Industrial Production November 2019
- 30 Dec: Balance of payments 3Q19
- 30 Dec: GDP 3Q19

GDP GROWTH FORECAST



INFLATION FORECAST



Source: Agency for statistics, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	15.29	16.04	17.08	17.65	18.45
Population (mn)	3.51	3.50	3.50	3.49	3.48
GDP per capita (EUR)	4,355	4,578	4,886	5,061	5,307
Real economy, change (%)					
GDP	3.1	3.2	3.6	2.6	2.7
Monthly wage, nominal (EUR)	665	676	697	724	753
Real wage, change (%)	2.0	0.3	1.7	3.2	2.2
Unemployment rate (%)	41.7	38.4	36.0	32.9	30.0
Fiscal accounts (% of GDP)					
Budget balance	0.3	1.8	2.4	1.1	0.1
Primary balance	1.2	2.6	3.2	1.8	0.9
Public debt	43.7	39.2	36.5	36.3	35.9
External accounts					
Current account balance (EUR bn)	-0.7	-0.7	-0.7	-1.0	-1.3
Current account balance/GDP (%)	-4.7	-4.7	-4.1	-5.9	-6.9
Extended basic balance/GDP (%)	-1.8	-1.7	-0.7	-2.4	-3.0
Net FDI (% of GDP)	1.8	2.1	2.5	2.6	2.9
Gross foreign debt (% of GDP)	62.5	61.3	58.2	58.7	59.3
FX reserves (EUR bn)	4.9	5.4	5.9	6.4	6.8
Months of imports, goods & services	7.3	7.2	7.5	7.7	7.8
Inflation/Monetary/FX					
CPI (pavg)	-1.1	1.3	1.4	0.7	1.8
CPI (eop)	0.3	1.2	1.6	1.0	1.9
1M money market rate (Dec avg)	-0.37	-0.37	-0.36	-0.45	-0.45
USD/FX (eop)	1.86	1.63	1.71	1.72	1.66
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg)	1.77	1.74	1.66	1.73	1.68
EUR/FX (pavg)	1.96	1.96	1.96	1.96	1.96

Source: Agency for statistics, CBBH, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Higher political uncertainty

GDP growth likely to slow from an upwardly corrected 3.6% in 2018 to 2.6% in 2019 and 2.7% in 2020 due to a deterioration in the global environment and internal political uncertainty

GDP growth is likely to slow from an upwardly revised 3.6% in 2018 to 2.6% in 2019 and 2.7% in 2020 due to the expected deterioration in the external environment. First data for 2019 appear consistent with our view and highlight the external challenges. GDP growth slowed to 2.2% yoy in 1Q19 (from 3.0% yoy in 4Q18), and industrial production contracted 4.2% in the first seven months of the year compared to the same period in 2018. The substantial slowdown in industrial production is in part due to the very high base in electricity generation from 2018, but also due to the deterioration of economic growth in major B&H export markets (Germany, Italy and Turkey). The export performance of the economy was very weak in recent months (-5.6% and -6.6% yoy in June and July, respectively), dragging cumulative exports in the first seven months into negative territory (-1.1% yoy).

The slowdown may be cushioned by domestic demand, in particular consumption

The negative impact from the external environment is likely to remain partly offset by domestic demand, in particular the robust growth of consumption, and slower import growth. Recent data continue to point to solid growth in private consumption. Retail trade turnover (as a proxy for private consumption) remained very strong with 6.2% yoy growth in real terms in July and cumulative yoy growth of 5.5% in the first seven months of 2019. We expect private consumption to continue to be the main driver of economic growth, given the continued rise in employment, real wages and households' disposable income, but we also anticipate a recovery in industrial production in 2H19 and 2020.

The pickup in investment growth might be less pronounced than expected due to political uncertainty

However, we now expect a less pronounced pickup in investment, implying lower GDP growth for both years (around 0.2pp), in light of protracted political uncertainty, After almost a year since the general elections (October 2018), there is still uncertainty about when the central government and the government of the Federation of B&H will be formed as the political stalemate among the main political parties continues. The stalemate is due to the parties' different views about the country's international relations, namely the relation with NATO, and domestic issues, for example the electoral legislation.

There is already some evidence of a postponement of investment projects. For example, construction activity in the first two quarters of 2019 showed signs of faltering due to delays of ratification of financial agreements with several IFIs and other creditors for important infrastructure projects as Parliament is still not functioning due to the political stalemate. Some big investment projects (corridor Vc motorway sections, bridges) expected in 2H19 and 2020 could be further delayed without the resumption of IMF financing under an EFF program, which does not appear likely to happen anytime soon. However, external financing is available for other infrastructure projects from some other IFIs and therefore we still see some pickup in investment activity in 2H19 and in 2020.

C/A deficit is likely to widen considerably due to weakening exports, but it should mostly be covered by FDI and other foreign funding

The current account deficit is likely to widen from its historical low in 2018 (4.1% of GDP) to at least 6% of GDP in 2019 and 2020. Export growth is expected to remain weak in 2020 as a result of the continued decline in demand in major EU markets, while imports may be less affected due to the highly import-dependent structure of the economy and expected persistent strong domestic demand. The global slowdown and the suspension of IMF disbursements will also result in somewhat lower external financing than previously expected. Remittances and FDI inflows could also be slightly lower, but they, along with available foreign borrowing, will likely continue to ensure that the current account deficit is covered.

The fiscal position likely to remain stable

Despite the suspension of IMF financing due to the political stalemate, BH's fiscal position remains stable, with an expected small surplus during this and next year. Blocked central political institutions in this respect have a positive impact on the financial sustainability of the country by preventing imprudent public spending. In March, Standard and Poor's upgraded the outlook on the country's sovereign B rating, from stable to positive, the first upgrade in the outlook since 2012.

North Macedonia

Not rated/BB- stable/BB+ stable**

Outlook

We reaffirm our GDP growth forecast of 3.2% for 2019, which is likely to remain driven by domestic demand in 2H19. In 2020, the expansion will likely moderate to 2.5%, reflecting our assumption of a global slowdown. The budget deficit might widen from 1.8% of GDP to 2.7% of GDP in 2019, in good part as a result of an increase in capital expenditure that was postponed in 2018 and higher social transfers. The European Council is expected to take a decision on starting accession negotiations with North Macedonia in mid-October. Our baseline scenario is that a calendar of negotiations will be agreed on this year. A negative outcome of the decision or further postponement would likely trigger early elections.

Author:
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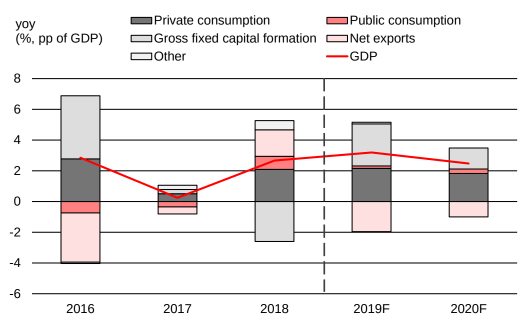
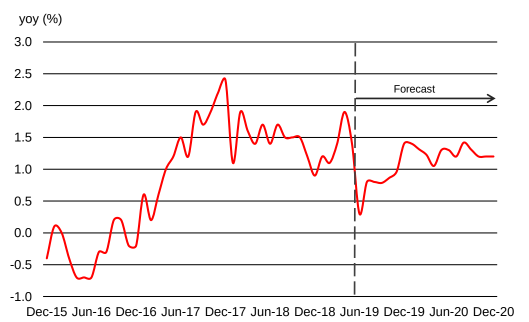
KEY DATES/EVENTS

- 8 Oct, 12 Nov, 10 Dec: central bank meetings
- 6 Dec: 3Q19 GDP
- 13 Dec: sovereign rating update from Fitch

GDP GROWTH FORECAST



INFLATION FORECAST



Source: State statistical office, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	9.7	10.0	10.7	11.2	11.6
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	4,598	4,766	5,112	5,331	5,530
Real economy, change (%)					
GDP	2.8	0.2	2.7	3.2	2.5
Private Consumption	3.9	0.7	2.9	3.0	2.5
Gross capital formation*	12.5	0.8	-7.2	8.4	4.0
Public Consumption	-4.9	-2.5	6.2	1.1	2.1
Exports	9.1	8.1	15.3	9.2	4.0
Imports	11.1	6.4	9.0	9.3	4.2
Monthly wage, nominal (EUR)	534	548	579	611	636
Real wage, change (%)	2.3	1.3	4.2	4.4	2.7
Unemployment rate (%)	23.8	22.4	20.7	18.5	17.5
Fiscal accounts (% of GDP)					
Budget balance (central government)	-2.7	-2.7	-1.8	-2.7	-2.7
Primary balance (central government)	-1.6	-1.4	-0.6	-1.4	-1.4
Government debt (general government)	39.6	39.3	40.5	42.4	43.2
External accounts					
Current account balance (EUR bn)	-0.3	-0.1	0	-0.2	-0.2
Current account balance/GDP (%)	-2.9	-1.0	-0.3	-1.5	-1.5
Extended basic balance/GDP (%)	0.5	1.0	5.6	2.1	2.0
Net FDI (% of GDP)	3.3	1.8	5.8	3.6	3.4
Gross foreign debt (% of GDP)	74.7	73.6	73.7	78.0	80.0
FX reserves (EUR bn)	2.6	2.3	2.9	3.1	3.1
Months of imports, goods & services	4.9	4.0	4.4	4.3	4.1
Inflation/Monetary/FX					
CPI (pavg)	-0.3	1.4	1.5	1.1	1.3
CPI (eop)	-0.2	2.4	0.9	1.4	1.2
Central bank target	-	-	-	-	-
Central bank reference rate (eop)	3.75	3.25	2.50	2.25	2.25
USDMKD (eop)	58.8	51.5	53.7	53.9	52.1
EURMKD (eop)	61.48	61.50	61.50	61.5	61.5
USDMKD (pavg)	55.9	54.4	52.2	53.8	53.0
EURMKD (pavg)	61.6	61.6	61.5	61.5	61.5

*Gross capital formation also includes inventories. The national statistics office does not publish a separate quarterly series for gross fixed capital formation

Source: State Statistical Office, ministry of finance, National Bank of the Republic of North Macedonia, Bloomberg, UniCredit Research

**Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Focus on growth, external risk, and political developments

We reaffirm our GDP growth forecast for 2019

We reaffirm our GDP growth forecast of 3.2% for 2019, with domestic demand remaining the main driver in 2H19. We expect private consumption growth to remain close to 3% on the back of rising wages (the 12-month average increased above 5% yoy in July), which will be also supported by a 4% increase in public sector wages in November, and bank lending. The recovery in gross capital formation which started in 4Q18 is likely to continue, with public investment now also adding to growth, both through the central government capital expenditure, which increased 24% yoy in Jan-Jul and could pick up in 2H19, and state-owned enterprises, which are responsible for a good part of public infrastructure work. Net exports will likely remain a drag due to weak growth in main trading partners and still solid imports. Downside risks prevail, with the main risks relating to delays in the investment recovery and weaker-than-expected external demand.

The negative impact of slower EU growth on exports might become more visible in 2H19

Exports remained resilient in 1H19 but the impact of weak growth in the EU, the main trading partner accounting for 80% of North Macedonia's total exports, might become more visible in 2H19. Exports remained solid in 1H19, although slowing somewhat, from 15% yoy in 1Q19 to 11% yoy in 2Q19, with exports to EU countries accounting for most of the slowdown (although net exports to Germany accelerated from around 20% yoy to 24% yoy in nominal value). Assuming economic growth remains weak in Germany, which receives almost 50% of North Macedonia's exports growth (in good part related to the automotive sector), North Macedonia exports could weaken in 2H19.

Growth might moderate in 2020, reflecting a global slowdown

In 2020, the economic expansion will likely moderate to 2.5%, in line with an expected global slowdown. In particular, North Macedonia will likely be affected by sub-potential growth in the EU, the country's main trading partner. Lower exports and deteriorating business confidence are likely to slow investment, and consumption growth might also decelerate slightly if the pace of wage growth eases.

Fiscal deficit at around 2.7% in 2019-20

The budget deficit might widen from 1.8% of GDP to 2.7% of GDP in 2019, as a result of an increase in capital expenditure that was postponed in 2018 (when capital expenditure contracted by 40%, leading to a reduction of the budget deficit from 2.7% % of GDP in 2018 to 1.8% % GDP in 2019), and higher social transfers, and remain at a similar level in 2020. The increase in expenditure in 2019 might be below what was originally planned, as execution has lagged in the first part of the year (expenditure increased by 24% yoy, against a plan of doubling such expenditure for the full year), while current expenditure could be higher. The government will publish a supplementary budget in October which might include these changes. General government debt might continue to increase from 40.7% of GDP in 2018 to 42.2% in 2019 and 43.2% in 2020. The main fiscal risk relates to a potentially weaker increase in revenues if economic growth disappoints. On the other hand, further delays in implementing investment might keep capital expenditure more contained.

The EU is expected to take a decision on starting accession negotiation in mid-October

The European Council is expected to take a decision on starting accession negotiations with North Macedonia in mid-October. The decision, initially expected in June, was postponed to "no later than October", presumably reflecting different views among EU countries. At the end of May, the European Commission had recommended to open accession negotiations in light of its positive evaluation of the progress made by the country and the fulfillment of conditions identified by the European Council. Our baseline scenario is that a calendar of negotiations will be agreed on this year. A negative decision or further postponement would likely trigger early elections, as it would represent a significant setback to the government's agenda and therefore the government might lose its support in parliament.

Russia

Baa3 stable/BBB- stable/BBB stable*

Outlook

We expect economic growth below 2% this year and next, with a slight pickup in 2H19 compared to 1H19 led by private consumption, exports and fiscal spending. National Projects should be one of the main sources of investment in the coming years, but their impact on GDP growth will be small. Disinflation will continue, with headline inflation expected below 4% in 2019 and close to 3% by 1Q20, undershooting the target for most of 2020. The CBR could cut the policy rate to 5.75-6% by the end of next year due to a reassessment of the neutral rate and to cyclical factors.

Strategy

The RUB could receive support from better BoP flows before year-end. The short end of the curve can rally much more, as it currently prices in no policy rate cuts before the end of 2020. RUSSIA USD bonds remain more attractive than OFZ.

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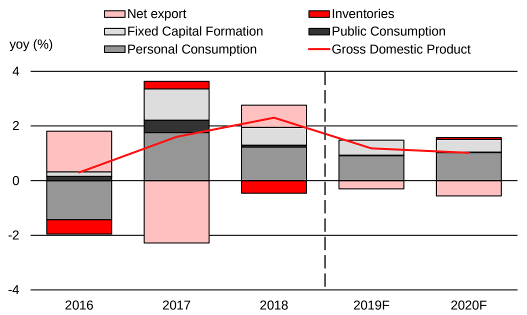
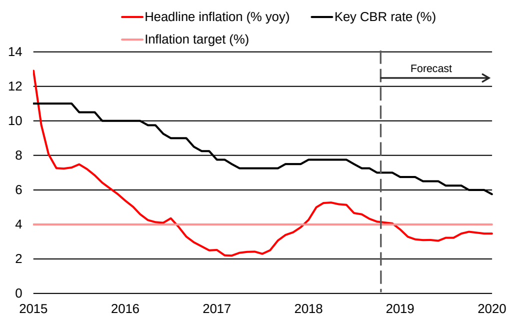
KEY DATES/EVENTS

- 4 Oct, 6 Nov, 6 Dec: CPI
- 25 Oct, 13 Dec: monetary policy meetings
- 18-22 of each month: monthly economic data
- 13 Nov, 12 Dec: 3Q19 GDP (flash/structure)

GDP GROWTH FORECAST



INFLATION FORECAST



Source: CBR, Rosstat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	1,156.2	1,398.0	1,406.5	1,481.5	1,412.2
Population (mn)	146.8	146.9	147.0	147.0	147.0
GDP per capita (EUR)	7,876.2	9,516.8	9,569.6	10,078.4	9,608.2
Real economy, change (%)					
GDP	0.3	1.6	2.3	1.2	1.0
Private Consumption	-1.9	3.2	2.2	1.7	1.9
Fixed Investment	0.7	5.5	2.3	2.4	2.0
Public Consumption	1.4	2.5	0.9	0.5	0.5
Exports	3.2	5.0	6.3	1.5	1.5
Imports	-3.6	17.4	3.8	3.0	4.0
Monthly wage, nominal (EUR)	493.5	594.6	589.1	635.4	612.3
Real wage, change (%)	0.8	2.9	6.8	2.7	2.3
Unemployment rate (%)	5.5	5.2	4.8	4.7	4.7
Fiscal accounts (% of GDP)					
Budget balance	-3.4	-1.4	2.6	1.4	1.0
Primary balance	-2.7	-0.7	3.4	2.1	1.7
Public debt	12.9	12.6	12.1	12.5	13.7
External accounts					
Current account balance (EUR bn)	22.1	29.4	96.4	93.5	88.8
Current account balance/GDP (%)	1.9	2.1	6.9	6.3	6.3
Extended basic balance/GDP (%)	2.7	1.6	5.5	4.9	4.7
Net FDI (% of GDP)	0.8	-0.5	-1.4	-1.4	-1.6
Gross foreign debt (% of GDP)	42.1	30.9	28.2	26.2	26.2
FX reserves (EUR bn)	292.9	288.6	324.2	377.4	406.0
Months of imports, goods & services	13.2	10.6	11.3	13.0	14.3
Inflation/Monetary/FX					
CPI (pavg)	7.1	3.7	2.9	4.6	3.3
CPI (eop)	5.4	2.5	4.3	3.7	3.5
Central bank target	-	4.0	4.0	4.0	4.0
Central bank reference rate (eop)	10.00	7.75	7.75	6.75	5.75
3M money market rate (Dec avg)	10.6	8.1	8.6	7.00	6.00
3M money market rate (year avg)	11.1	9.4	8.3	7.78	6.50
USD/RUB (eop)	60.66	57.60	69.47	66.50	69.66
EUR/RUB (eop)	63.81	68.87	79.66	75.81	82.20
USD/RUB (pavg)	67.07	58.29	62.68	65.01	69.06
EUR/RUB (pavg)	74.39	65.87	73.68	72.82	80.11

Source: CBR, Rosstat, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

When better falls short of good

Economic growth in 1H19 was weaker than potential…

Russia remains an attractive destination for bond investors owing to a combination of low financing needs, focus on price stability, lower RUB dependency on commodity prices and tight fiscal policy. Another factor is low growth, which continues to plague Russia due to potential growth remaining close to 1-1.5%. Thus, sovereign rating upgrades (Fitch's BBB with a stable outlook being the highest since the global financial crisis) reward the orderly external deleveraging, rather than progress in improving the economic outlook. There are three main reasons for the current poor economic performance: weak domestic demand, falling exports and tight fiscal policy. All three are likely to improve in 2H19 and 2020.

…but could rebound slightly in the coming quarters, helped by…

…stronger retail sales…

First, real retail sales growth is likely to accelerate slightly from here to around 2-2.5% yoy as nominal wage growth picks up, helped by falling labor supply, rising productivity and persistent efforts to support public sector wages. In addition, disinflation will continue, accelerating in early 2020, once the effect of the VAT increase leaves the base.

…better oil and non-oil exports…

Second, both non-oil and oil exports are likely to rebound after falling in 2Q19 by 8-12% (value terms). Oil exports fell due to pollution affecting the Druzba pipeline. Technical problems were resolved by July and oil exports are recovering. If Saudi production takes a longer time to recover, Russia could increase output. The volume of oil product exports fell after a ban on shipments to Ukraine was introduced in April. This decrease will negatively impact annual growth rates until May 2020, without causing lasting damage.

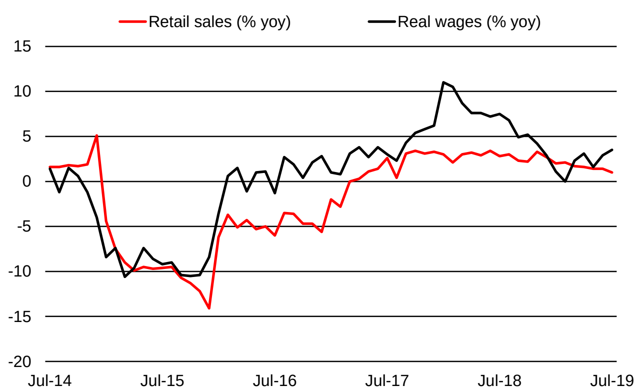
Non-oil exports will rebound, helped by a better harvest in 2019 compared to 2018. As a result, wheat exports are likely to rise compared to the year ending in mid-2018. At the same time, other commodity exports, especially those of ferrous metals, could be hit by a global economic slowdown. As a result, we expect the C/A surplus to remain at about 6% GDP in 2019-20, ending the negative contribution to growth from 1H19.

Third, the government is likely to increase spending before year-end. Fiscal tightening was partly to blame for lower investment in 1H19. The non-oil consolidated budget deficit of RUB 1.5tn in 1H19 was almost RUB 1tn (0.9% GDP) lower than in 1H18. Public expenditure was merely 40% of the 1H19 plan, with less than 25% of allocation spent for investment-intensive items. In contrast, budget revenues were ca. RUB 900bn above the initial budget forecast in 1H19. Revenues from profit tax increased by about 30% yoy, in line with corporate profits, while income from VAT rose by 18%, much faster than implied by domestic demand growth and the 2pp tax rate increase from January.

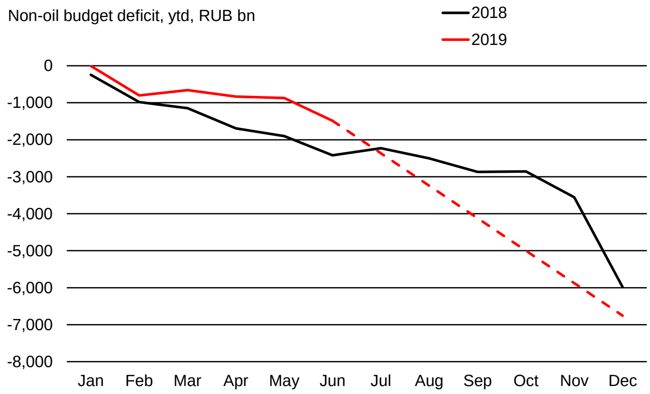
…and higher public spending in 2H19

This year's planned budget income and expenses were revised upward in July, with the non-oil deficit expected to increase by RUB 500bn to about RUB 6.8tn. This commitment is credible, since budget execution exceeded 95% of the plan over the past five years. The efficiency of significant spending over a short time is questionable.

WAGES STARTED TO PICK UP AGAIN



FISCAL POLICY WILL EASE IN 2H19



Source: MinFin, Rosstat, UniCredit Research

GDP growth expected at 1.2% in 2019…

However, the large volume will suffice to boost GDP growth in 2H19, bringing the full-year figure to our unchanged forecast of 1.0-1.2% from 0.7% yoy in 1H19, but below the official forecast of 1.7%.

…and 1.0-1.5% in 2020

National Projects are likely to be the main source of investment…

…but the impulse to growth will be small

GDP growth is expected at 1.0-1.5%% in 2020, undershooting the government's forecast of 3.1%. The same is true for investment growth, expected by authorities at 5% in 2020 and 6.5% in 2021. Public spending on infrastructure and related public-private partnerships will need to offset weak private investment, which is unlikely to rebound at the end of the cycle. The government focuses on the 13 National Projects launched in 2018 and which are expected to be completed by the end of the current presidential mandate at a cost of RUB 26tn for 2019-24 (24% of 2019 GDP), three quarters of which is public spending. However, the National Projects are just a name for a part of already planned budget expenses, and their role is limited. During 2019-21, the Projects will account for some 15% of overall federal budget spending and only up to half of investment spending. Even if spending on investment and subsidies to companies increases further, the fiscal impulse will remain small, as overall expenditure could be flat in real terms in 2020-21.

Disinflation likely to continue...

Weak domestic demand, falling real incomes and a good harvest are weighing on inflation. As a result, inflation is likely to fall to 3.8% by year-end, approaching 3% by the end of 1Q20, when the impact of recent VAT increase will leave the base. In the absence of large supply shocks, inflation could remain below the 4% target throughout 2020, since demand pressure is unlikely to increase significantly.

...leading to interest rate cuts down to 5.75-6%...

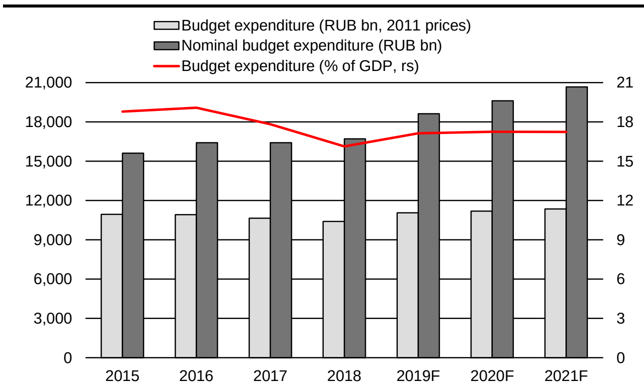
...amid a likely reassessment of the neutral rate...

We expect the CBR to continue cutting the policy interest rate to 5.75-6% by the end of next year[7] due to structural and cyclical reasons. Among the former, the most important one is a reassessment of the neutral rate. The CBR's current estimate of country risk and neutral interest rates in developed markets are well above market expectations. Russia's risk premium declined to levels better correlated with the country's strong external and fiscal positions. At the same time, both the Fed and the ECB seem could reassess long-term equilibrium interest rates. Finally, the CBR's assessment of the long-term equilibrium real interest rate far exceeds the country's potential growth. Considering all these factors, the long-term interest rate may well be below our optimistic expectation of 5.75%.

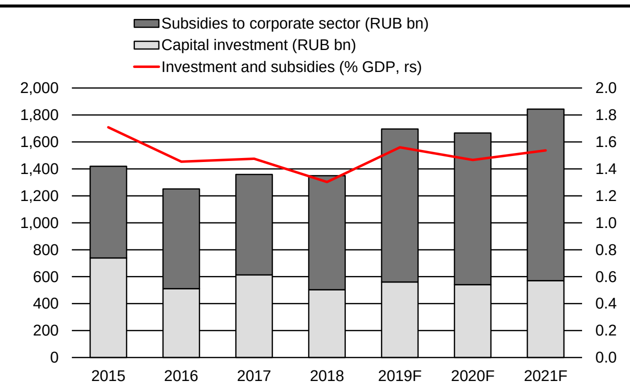
...and cyclical factors

The cyclical reasons for additional cuts pertain to Russia's weak economic growth. Looming external risks could further affect the growth outlook, requiring looser monetary conditions. With the RUB fairly valued (if not undervalued) compared to fundamentals, real interest rates may have to fall further. Sluggish corporate loan growth suggests that interest rate levels are already an issue for borrowers, and real rates will have to fall further if corporate and household balance sheets are affected by a global downturn in the coming years.

TOTAL BUDGET EXPENSES STABILIZE IN REAL TERMS…



…AND SO DO PUBLIC INVESTMENT AND SUBSIDIES TO COMPANIES



Source: CBR, InfraONE, MoF, Rosstat, UniCredit Research

[7] For details, please see the EEMEA Macro Flash - Russia: CBR delivers rate cut, with more to come from 6 September 2019.

Room for rally as short end does not price in more easing

RUB probably supported by better BoP flows

After the RUB retraced most of the losses incurred in August, it is now much closer to fair value. With exports expected to pick up due to seasonal reasons and a good harvest in 2019, support from BoP flows could cushion the currency even if the central bank decides to cut further.

Short-term rates expected to rally due to CBR cuts

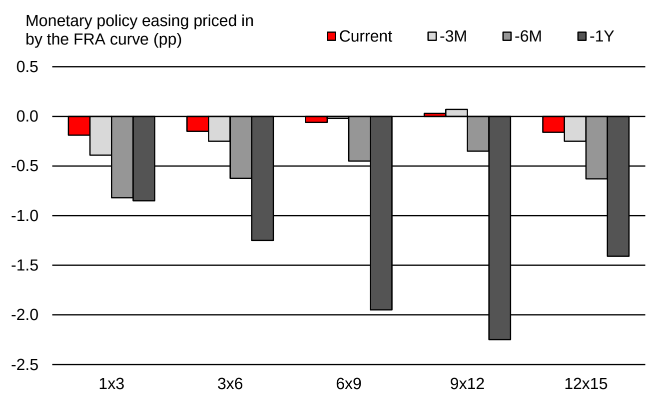
In our view, receiving the short end of the RUB curve makes sense, as it is not pricing in any significant easing before end-2020. As stated previously, we believe that the CBR can deliver at least 100bp in cuts before the end of next year.

OFZ continue to have little domestic support due to negative carry

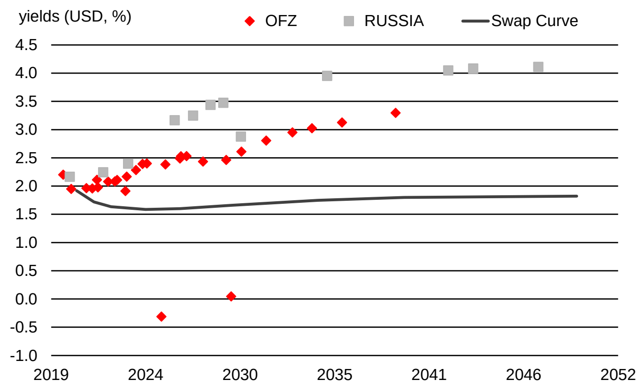
RUSSIA USD offer better value than OFZ

OFZ continue to be supported by Russia's status as a safe haven in EM. The large budget deficit expected in 2H19 (RUB 5.3tn) is likely to come mostly out of reserves, rather than put pressure on issuance. While foreign investors continue to purchase OFZ, local banks are reluctantly adding to positions as carry remains negative for most of the curve. RUSSIA USD bonds remain cheaper than OFZ and continue to trade at a premium to their rating.

A BULL-STEEPENING OF THE SWAP CURVE WOULD SUPPORT BONDS



RUSSIA USD CONTINUE TO BE CHEAPER THAN OFZ



Source: Ministry of Finance, CBR, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**-36.4**	**-7.7**	**-0.8**
Budget deficit	-37.2	-20.4	-13.5
Amortization of public debt	12.2	12.6	12.7
Domestic	7.2	10.7	8.3
Bonds	7.2	9.5	6.7
Bills	-	-	-
Loans	0	1.2	1.7
External(bonds and loans)	5.0	2.0	4.3
Other	-11.4	0	0
Financing	**-24.6**	**-7.7**	**-0.8**
Domestic borrowing	15.1	25.8	30.1
Bonds	14.1	24.9	29.1
Bills	-	-	-
Loans	1.0	0.9	1.1
External borrowing	3.2	5.6	2.6
Bonds	4.1	5.6	2.6
Other	-1.0	0	0
Privatization/Other	0.2	0	0
Revaluation	12.4	0	0
Change in fiscal reserves (- = increase)	-55.4	-39.1	-33.5

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**14.2**	**4.1**	**-19.6**
C/A deficit	-95.4	-92.5	-87.9
Amortization of medium and long term debt	66.4	53.9	28.3
Government/central bank	3.5	3.4	2.2
Banks	11.5	12.8	-2.8
Corporates/Other	51.3	37.7	28.9
Amortization of short-term debt	43.2	42.6	40.0
Financing	**14.2**	**4.1**	**-19.6**
FDI (net)	-19.6	-21.5	-21.9
Portfolio investments (net)	-1.8	-2.0	-2.0
Medium and long-term borrowing	31.4	59.5	22.3
Government/central bank	-1.4	18.8	2.3
Banks	-11.6	-1.1	-12.7
Corporates/Other	44.4	41.8	32.7
Short-term borrowing	40.8	41.3	39.2
other investment (net)	-4.3	-21.5	-15.2
Change in FX reserves (- = increase)	-32.4	-51.8	-41.9
Memoranda:			
Nonresident purchases of LC govt bonds	-4.5	13.3	0
International bond issuance, net	-0.6	-0.4	-0.4

Source: CBR, Rosstat, MoF, UniCredit Research

Serbia

Ba3 positive/BB positive/BB stable*

Outlook

We reaffirm our GDP growth forecast of 3.0% for 2019 amid higher external risks. Growth is likely to slow below potential in 2020, in the context of a global economic slowdown. The commitment to small deficits in 2019 and 2020 (0.5% of GDP) in order to reduce public debt further is positive; however, it means limited room for stimulus in 2020. Rating agencies might upgrade Serbia's sovereign rating if government debt falls below 50% in 2020. The government is increasing social transfers in view of the upcoming elections. While these measures are unlikely to threaten the fiscal target, such spending increases are not likely to be sustainable, especially given the expected economic slowdown. With inflation likely to remain in the target range, we expect the National Bank of Serbia to remain on hold. EUR-RSD could depreciate moderately in 2020 if FDI and FX-indexed lending weaken due to cyclical reasons.

Strategy

At the end of 3Q19, Serbia completed around 90% of planned issuance for 2019 in local currency and 78% in euros. Yields on 7Y and 10Y bonds offer sufficient pickup over inflation. Index inclusion for the 7Y bond could occur this year.

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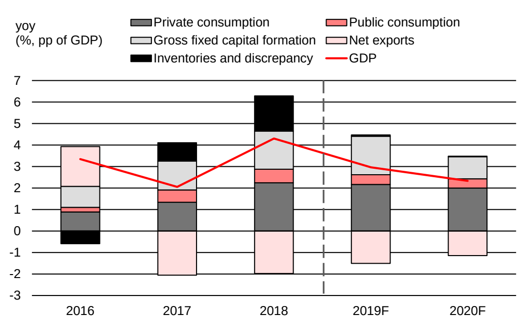
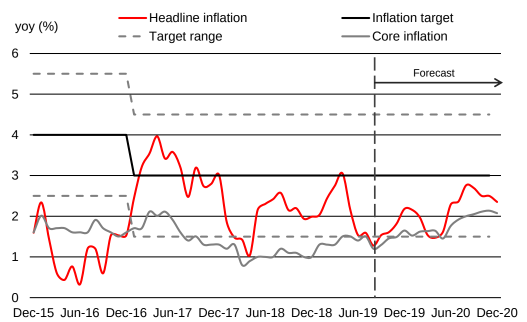
KEY DATES/EVENTS

- 10 Oct,11 Nov, 12 Dec: NBS monetary policy meetings
- 31 Oct, 2 Dec: 3Q19 GDP (flash, structure)
- 11 Sep, 12 Nov, 12 Dec: CPI inflation
- 1 Dec: IMF expected to publish its third review after the policy coordination instrument (PCI)
- 27 Sep, 13 Dec: sovereign rating update from Fitch and S&P

GDP GROWTH FORECAST



INFLATION FORECAST



Source: SORS, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	36.7	39.2	42.7	45.0	46.9
Population (mn)	7.1	7.0	7.0	6.9	6.9
GDP per capita (EUR)	5,203	5,577	6,117	6,478	6,787
Real economy, change (%)					
GDP	3.3	2.0	4.3	3.0	2.3
Private Consumption	1.3	1.9	3.3	3.2	2.9
Fixed Investment	5.4	7.3	9.2	8.8	4.8
Public consumption	1.2	3.3	3.6	2.6	2.5
Exports	11.9	8.2	8.9	8.2	4.0
Imports	6.7	11.1	11.1	9.4	5.1
Monthly wage, nominal (EUR)	515	533	580	625	655
Real wage, change (%)	2.6	-1.1	4.0	5.2	2.9
Unemployment rate (%)	15.9	14.1	13.3	11.2	10.7
Fiscal accounts (% of GDP)					
Budget balance	-1.2	1.1	0.6	-0.5	-0.5
Primary balance	1.7	3.6	2.8	1.6	1.7
Public debt	68.8	58.7	54.5	51.7	49.2
External accounts					
Current account balance (EUR bn)	-1.1	-2.1	-2.2	-2.5	-2.6
Current account balance (% of GDP)	-2.9	-5.2	-5.2	-5.6	-5.6
Extended basic balance/GDP (%)	2.2	0.9	2.3	0.6	-0.3
Net FDI (% of GDP)	5.2	6.2	7.5	6.2	5.3
Gross foreign debt (% of GDP)	72.1	65.3	62.8	59.1	56.6
FX reserves (EUR bn)	11.1	10.4	12.1	13.3	14.0
Months of imports, goods & services	6.8	5.6	5.7	5.6	5.5
Inflation/Monetary/FX					
CPI (pavg)	1.1	3.1	2.0	2.0	2.2
CPI (eop)	1.5	3.0	2.0	2.3	2.3
Central bank target	4.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	4.00	3.50	3.00	2.50	2.50
3M money market rate (Dec avg)	3.45	3.09	3.04	2.00	2.00
USD/FX (eop)	117.1	99.1	103.4	102.4	100.5
EUR/FX (eop)	123.5	118.5	118.2	117.8	118.6
USD/FX (pavg)	111.3	107.8	100.2	104.5	101.2
EUR/FX (pavg)	123.1	121.4	118.3	117.9	118.3

Source: Bloomberg, Eurostat, SORS, NBS, Public Debt Agency, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

Growth losing momentum ahead of elections

We reaffirm our GDP growth forecast of 3.0% for 2019 amid higher external risks

GDP growth could still match our forecast of 3.0% in 2019 despite rising external risk. First, recent data are broadly in line with our forecasts, with GDP growth at 2.9% yoy in 2Q19, slightly above our expectations, and growth for 1Q19 was revised up from 2.5% yoy to 2.7% yoy. Second, growth in 2H19 might benefit from a rebound in the chemicals and refined-petroleum products sectors, which subtracted 2.8pp from manufacturing growth in 1H19 due to planned maintenance. Third, the weakness in external demand could be mitigated by solid consumption growth on the back of strong wage growth and a further pickup in investment. The latter assumes that public investment continues to rise by more than 30% yoy, matching the pace from 1H19. This would allow GDP growth to reach 3.0% yoy in 2H19.

GDP growth to slow further in 2020

In 2020, GDP growth might slow to 2.3%, in the context of a global economic slowdown. Serbia will be affected by sub-potential growth in the EU, Serbia's main trading partner that receives almost 70% of Serbia's exports of goods. Lower exports and deteriorating business confidence are likely to slow investment growth, while private consumption could remain relatively solid if public wage and pension increases continue to support disposable income.

Commitment to small fiscal deficits means limited room for stimulus in 2020

The commitment to low fiscal deficits means that there is limited room for fiscal stimulus. The government set a target for the 2020 budget deficit of 0.5% of GDP, which should contribute to reducing public debt further to below 50% in 2020, from 54.5% in 2018. This commitment is planned to be reinforced by a new fiscal rule currently under discussion.

The government is increasing social transfers in view of elections

The government is increasing social transfers in view of the upcoming elections. It plans to use the fiscal space created by stronger-than-expected revenues to increase public sector wages on 1 November and to distribute a one-off bonus of RSD 5000 to pensioners on 1 December (RSD 8.6bn, 0.2% of GDP). Public-sector wage and pension bills are planned to rise by 8% and 6.5%, respectively, in 2019, faster than our estimated nominal GDP growth of 5%. While these measures are unlikely to threaten the fiscal target, such spending increases are not likely to be sustainable, especially given the expected economic slowdown.

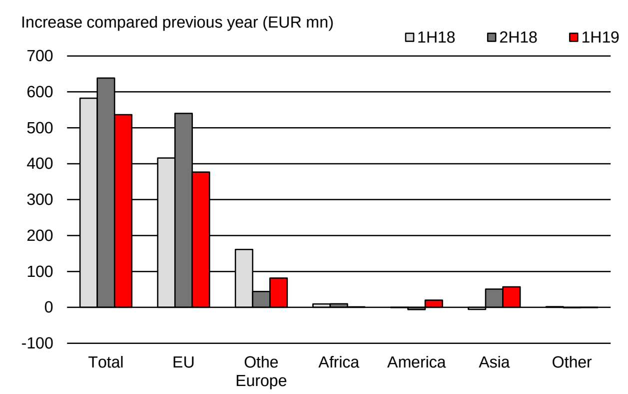
Pension indexation should limit ad-hoc pension spending in 2020

On a positive note, the government plans to introduce a so-called Swiss formula for pension indexation from January 2020, whereby the increase in pensions will be linked to a combination of inflation and growth salary which will replace the current ad-hoc approach. Given the relatively high dependency ratio in Serbia (52%), the indexation should be complemented with a limit on government expenditure on pensions as % of GDP. On the other side, the introduction of the single pay grade system has been further postponed to mid-2020.

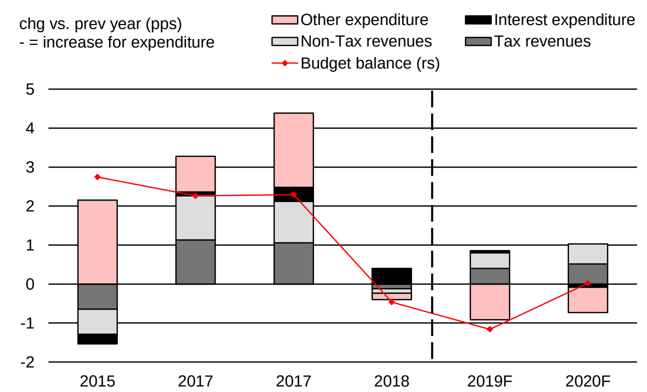
Further privatization amid delays

The privatization of Komercijalna Banka, the country's second largest bank by assets, progressed further with binding bids expected to be submitted in mid-November. The start of the privatization of petrochemicals producer Petrohemija was delayed to year-end.

PACE OF INCREASE OF EXPORTS TO EU SLOWED IN 1H19



LIMITED ROOM FOR FISCAL STIMULUS IN 2020



Source: SORS, ministry of finance, UniCredit Research

Mixed news on the EU accession process

There were mixed developments regarding the EU accession process. On one hand, Serbia opened a new chapter at the end of June, bringing the total number of opened chapters to 17 out of 35. On the other hand, Serbia's plan to extend the free-trade agreement with Russia to the Eurasian Economic Union was not welcomed by EU institutions. In response, EU institutions highlighted that in the context of the EU negotiations Serbia committed to withdraw from all bilateral free trade agreements on the day of its accession to the EU. In addition, a custom union between the EU and Serbia would also conflict with other free-trade agreements, as Serbia would be required to harmonize its commercial policy with the EU.

No progress in normalizing relations with Kosovo

The main hurdle in the EU accession process remains the normalization of relations with Kosovo, which showed no progress in the past few months. According to Serbian President Aleksandar Vučić, negotiations could restart in December after general elections in Kosovo were triggered by the resignation of the prime minister.

Inflation likely to remain at the lower end of the target range

Inflation will likely remain in the 1.5-4.5% yoy target range in 2019-20, but we revised down slightly the path for inflation due to a less pronounced increase in core inflation and greater drag from fresh vegetable prices than previously envisaged. We now expect inflation to increase gradually towards 2.3% yoy by year-end, driven by: **1.** a gradual acceleration in core inflation, **2.** a pickup in food prices, and **3.** a base effect in energy prices in 4Q19. In 2020, inflation will likely remain in the target range, but below the inflation target of 3%.

Further policy rate cuts unlikely in our base-case scenario

We believe that interest rate cuts have ended for 2019. The NBS cuts its policy rate from 3.00% to 2.50% and FX interventions provided additional easing by increasing liquidity and pushing the interbank market below the policy rate. Further easing is unlikely as, while the economy could be weaker than the NBS expects, the central bank has to consider potential capital outflows from EM if the global growth outlook worsens. The currencies of countries with large C/A deficits, like Serbia's, may be affected in such a situation. This risk is mitigated in part by the fact that the C/A deficit has been more than covered by FDI since 2016. However, a global downturn could slow FDI inflows, threatening the financing of Serbia's C/A. Under such circumstances, investors are likely to demand positive real returns. The NBS could resume cuts in 2020 if a global economic slowdown leads central banks to ease more than currently expected, and as long as capital flows do not push EUR-RSD higher.

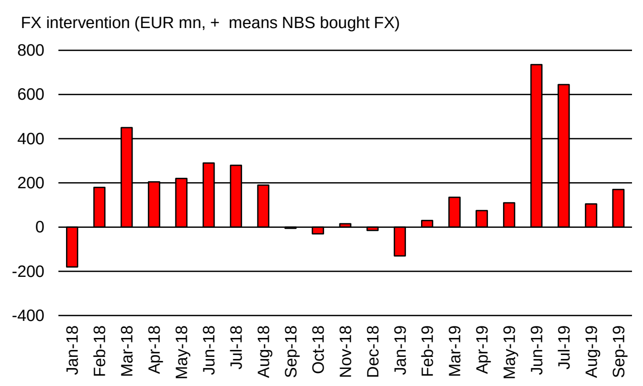
The dinar might depreciate moderately in 2020

Despite the continued strength of the dinar and appreciation pressure related to FDI inflows, FX-indexed lending, and portfolio flows, the dinar might depreciate moderately in 2020 (around 0.7%), if FDI does not cover the C/A deficit and if FX-indexed lending in the corporate sector slows in line with the economy. A more pronounced slowdown in Europe or larger capital outflows from EM would trigger more pressure, which could be offset by FX interventions.

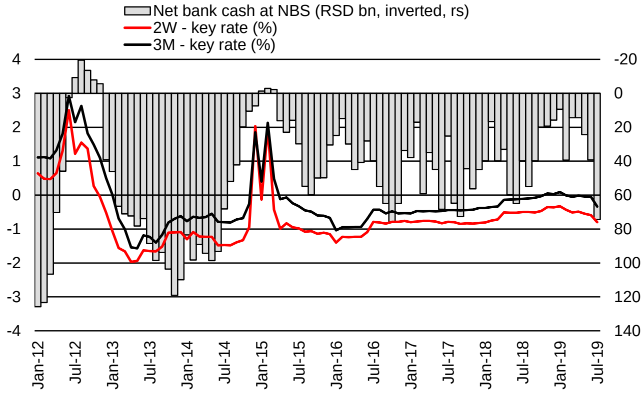
Elections: ruling coalition likely to retain the majority amid the threat of boycott

General elections will take place between March and May 2020. Opinion polls continue to show that the ruling coalition would retain a majority, with the opposition group Alliance for Serbia being the second political force with around 10-15% of the votes. Alliance for Serbia announced it will boycott elections.

APPRECIATION PRESSURE HAS WEAKENED IN AUG-SEPT



INCREASED LIQUIDITY PROVIDED ADDITIONAL EASING

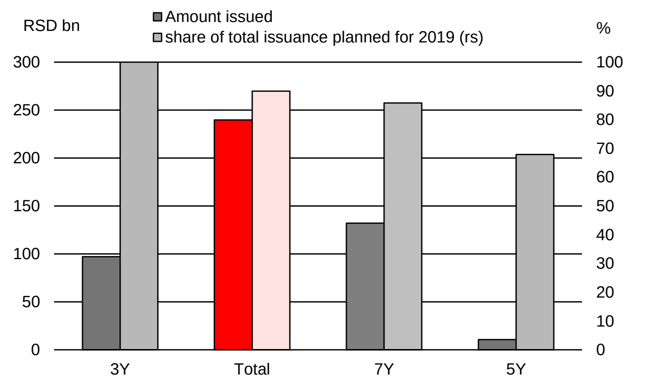


Source: NBS, SORS, UniCredit Research

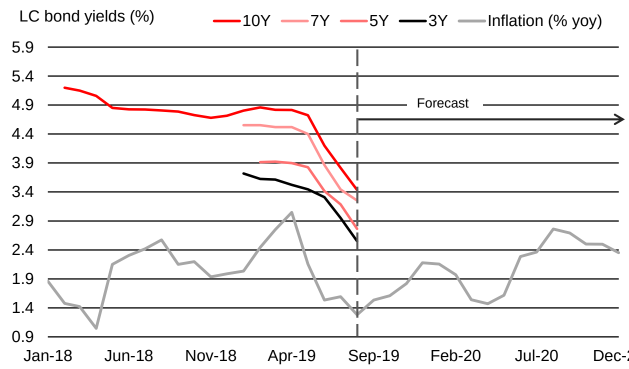
Yields on 7Y and 10Y attractive

At the end of 3Q19, Serbia completed around 90% of planned issuance for 2019 in local currency and 78% of planned issuance in euros. In addition, in June it issued the first Eurobond since 2013 to buy back more expensive debt in dollars (4.875% 2020 and 7.250% 2021). In 4Q19, Serbia plans to issue RSD 26.9bn in local currency (re-openings of the 7Y and 5Y bonds, RSD 21.9bn and 5bn, respectively) and EUR 87.9mn in euros (re-openings of the 3Y and 10Y bonds, EUR 57.6bn and EUR 30.3bn respectively). In addition, it will re-tap the Eurobond issued in June for EUR 700mn probably to buy back more expensive dollar debt. Yields on 7Y and 10Y bonds offer sufficient pickup over inflation, and muted RSD depreciation risks in the coming months make them attractive for investors. Index inclusion for the 7Y bond could happen this year (probably at the end of the year once issuance is completed).

CLOSE TO 90% OF LC ISSUANCE COMPLETED



7Y AND 10Y OFFER SUFFICIENT PICKUP OVER INFLATION



Source: NBS, Ministry of Finance, Public Debt Agency, SORS, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**3.1**	**4.9**	**2.2**
Budget deficit	-0.3	0.2	0.2
Amortization of public debt	3.4	4.6	2.0
Domestic	2.0	2.3	1.8
Bonds	1.8	2.0	1.6
Bills	0.1	0.1	0.1
IFIs/others	0.2	0.2	0.1
External	1.4	2.3	0.2
Bonds	0.9	1.7	0
IFIs/others	0.5	0.6	0.2
Financing	**3.1**	**4.9**	**2.2**
Domestic borrowing	2.8	2.8	2.7
Bonds	2.6	2.7	2.6
Bills	0.2	0.1	0.1
Others	0	0	0
External borrowing	0.6	2.2	1.2
Bonds	0	1.7	1.0
IFIs/others	0.6	0.5	0.2
Fiscal reserves change (- =increase)	-0.4	-0.1	-1.7

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**6.4**	**7.4**	**5.2**
C/A deficit	2.2	2.5	2.6
Amortization of medium and long term debt	2.9	3.7	1.5
Government/Central Bank	1.6	2.3	0.2
Banks	0.6	0.6	0.6
Corporates	0.8	0.8	0.7
Amortization of short-term debt	1.3	1.3	1.2
Government/Central Bank	0	0	0
Banks	1.2	1.1	1.0
Corporates	0.1	0.1	0.1
Financing	**6.4**	**7.4**	**5.2**
FDI (net)	3.2	2.8	2.5
Medium and long-term borrowing	3.3	4.6	3.2
Government/central bank	1.7	3.5	2.5
IFIs/others	0.6	0.5	0.2
Banks	0.8	0.6	0.3
Corporates	0.9	0.5	0.3
Short-term borrowing	1.1	1.2	0.9
Change in FX reserves (- = increase)	-1.2	-1.2	-1.4
Memoranda:			
Nonresident purchases of LC govt bonds	1.0	1.8	1.5
International bond issuance, net	-0.9	0	1.0

Source: Bloomberg, NBS, Ministry of Finance, Public Debt Agency, SORS, UniCredit Research

Turkey

B1 negative/B+ stable/BB negative*

Outlook

The economic contraction was less dramatic than we expected so far, leading us to revise our 2019 GDP growth forecast upward to -1.3%. Nevertheless, the external deleveraging of the private sector continues and the pickup in domestic lending might not be large enough to support a meaningful recovery despite sizable monetary easing. Accordingly, we revised our 2020 growth forecast to 0.9%. We think the need for an external backstop remains, while a formal request is not likely until next year.

Strategy

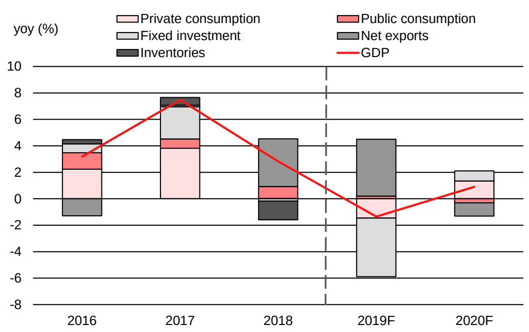
The TRY remains undervalued from a fundamental point of view, but we do not expect the gap to fair value to be closed in 2019-20 as inflationary and financing risks, and lower appetite for EM assets, could lead to nominal TRY depreciation.

Author:
Gokce Celik, Senior CEE Economist (UniCredit Bank, London)

KEY DATES/EVENTS

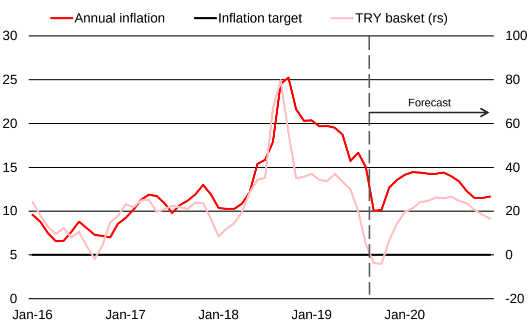
- 3 Oct, 4 Nov, 3 Dec: CPI
- 31 Oct: CBRT Inflation Report
- 2 Dec: 3Q19 GDP
- 24 Oct, 12 Dec: MPC meeting
- 1 Nov: Fitch rating update

GDP GROWTH FORECAST



Source: Turkstat, UniCredit Research

INFLATION FORECAST (%)



Source: Bloomberg, CBRT, Turkstat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2016	2017	2018	2019F	2020F
GDP (EUR bn)	778.6	757.6	654.4	653.8	601.5
Population (mn)	79.8	80.8	82.0	82.9	83.9
GDP per capita (EUR)	9,860	9,498	7,980	7,887	7,170
Real economy, change (%)					
GDP	3.2	7.5	2.8	-1.3	0.9
Private Consumption	3.7	6.2	0	-2.5	2.3
Fixed Investment	2.2	8.2	-0.6	-15.4	3.1
Public Consumption	9.5	5.0	6.6	1.5	-2.2
Exports	-1.9	12.0	7.8	4.2	-0.3
Imports	3.7	10.3	-7.8	-15.4	5.0
Monthly wage, nominal (EUR)	1143	1073	902	952	855
Real wage, change (%)	11.4	4.1	-0.4	4.2	-1.6
Unemployment rate (%)	10.9	10.9	11.0	13.9	14.5
Fiscal accounts (% of GDP)					
Budget balance	-2.5	-2.3	-3.5	-5.3	-3.9
Primary balance	-0.5	-0.5	-1.5	-2.9	-1.5
Public debt	28.3	28.3	30.4	31.4	32.9
External accounts					
Current account balance (EUR bn)	-29.0	-41.8	-23.0	0.4	-11.7
Current account balance/GDP (%)	-3.8	-5.6	-3.5	0.1	-1.9
Extended basic balance/GDP (%)	-2.5	-4.7	-2.3	1.3	-0.6
Net FDI (% of GDP)	1.3	1.0	1.2	1.2	1.3
Gross foreign debt (% of GDP)	47.6	53.4	57.2	57.9	64.4
FX reserves (EUR bn)	86.3	74.3	63.5	62.7	70.0
Months of imports, goods & services	4.9	4.1	3.6	3.9	4.2
Inflation/Monetary/FX					
CPI (pavg)	7.8	11.1	16.3	15.7	13.3
CPI (eop)	8.5	11.9	20.3	13.5	11.7
Central bank target	5.0	5.0	5.0	5.0	5.0
Central bank reference rate (eop)	7.5	8.0	24.0	13.5	13.5
3M money market rate (Dec avg)	10.0	14.4	24.7	14.5	14.5
USD/TRY (eop)	3.5	3.9	5.3	6.2	7.0
EUR/TRY (eop)	3.7	4.6	6.1	7.0	8.3
USD/TRY (pavg)	3.0	3.6	4.8	5.8	6.9
EUR/TRY (pavg)	3.4	4.1	5.7	6.5	8.1

Source: Bloomberg, CBRT, MoF, Turkstat, UniCredit Research

*Long-term foreign currency credit rating provided by Moody's, S&P and Fitch, respectively

More pro-growth policies but not necessarily faster growth

We revised our GDP forecast for 2019 upward to -1.3%…

…and the one for 2020 downward to 0.9%

We revised our 2019 GDP growth forecast up to -1.3% from -5% as economic activity proved more resilient than we initially expected, global conditions were more supportive for EM and political risks subsided in the short term. These risks have not been eliminated but rather postponed, and they could weigh on 2020 growth. Moreover, economic activity might lose momentum once again before end-2019 due to weaker external demand and purchasing power of households, implying a lower carryover into 2020. As a result, we revised our 2020 GDP growth forecast down to 0.9% from 1.8%[8].

The government will likely push more stimulus measures…

Anemic growth is unacceptable for the government. Local elections proved that economic woes cost the ruling party significantly. The recent poor economic record led AKP senior figures such as former economy czar Ali Babacan (with former President Abdullah Gul) and former Prime Minister Ahmet Davutoglu to form breakaway parties. The government responded with more economic stimulus.

…but fiscal spending is not a long-term solution

Fiscal easing is not a long-term solution, since it is already crowding out private-sector borrowing and spending. The government increased fiscal spending again during the summer, financed by depleting fiscal buffers (TRY 40bn transfer of the CBRT's retained earnings) and by increasing regulated prices significantly. Even so, the Ministry of Finance had to exceed the planned borrowing limit. A similar increase in borrowing may be impossible if risk appetite for EM assets weakens. Moreover, the structural deficit will be rising in 2020 and cyclical factors will not be supportive for tax revenues and the budget performance.

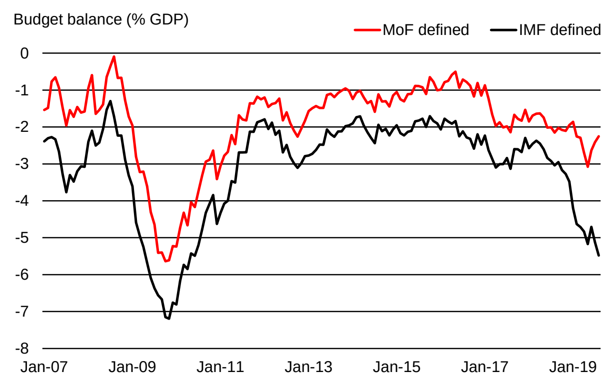
Monetary easing would help loan growth…

…although bad loans could be a drag

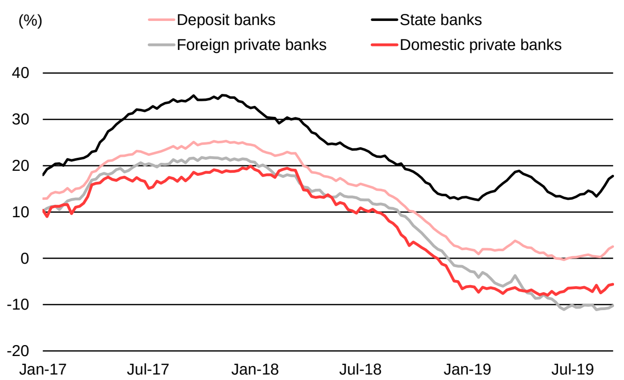
In the absence of fiscal room to maneuver, the government's efforts will likely concentrate on boosting loan growth. The central bank already delivered 7.5pp in rate cuts, with 3pp more likely to come before year-end. The CBRT also reduced reserve requirements (RR) and differentiated their remuneration to favor the banks whose loan growth exceeds 10% yoy. State banks already qualify, but significantly faster loan growth would need private banks (both local and foreign) to match that feat. Although banks' funding costs eased due to interest rate and RR cuts, asset quality concerns (reflected in the rapid rise in NPLs even before the banking regulator asked banks to write off USD 8.1bn of loans, which would have pushed the sector's official NPL ratio to 6.3%, from 4.6% in July) might curb private banks' appetite to lend. Loan demand is also weak or affected by adverse selection and this could also put a brake on credit growth, despite falling loan rates.

A meaningful and sustainable credit recovery would require better external borrowing conditions for the private sector, in addition to the improvement in domestic ones. However, the rollover ratio for long-term external debt of banks was down to 52 in July.

BUDGET DEFICIT WIDENS EVEN FURTHER



STATE BANKS ARE ELIGIBLE FOR RRR AND REMUNERATION INCENTIVES



Source: BRSA, Haver, MoF, UniCredit Research

[8] For details, please see EEMEA Macro Flash - Turkey: GDP contraction to be more muted in 2019, yet risks could weigh on 2020 growth published on 3 Sept 2019.

Global outlook could be challenging for financing and trade

The global outlook may hinder the recovery by affecting financing and trade. So far, dovish decisions by the ECB and the Fed supported the appetite for EM assets, cushioning the impact of unexpected measures taken by Turkish authorities, such as the firing of CBRT Governor Murat Cetinkaya and the large rate cuts from July and August. However, weaker global growth could increase volatility in financial markets and hurt demand for high yielders. Additionally, slower growth in the eurozone would also weigh on the contribution of exports to growth.

An external backstop would help restart growth sustainably

An IMF deal would still be the best option to restart growth while the private sector adjusts its borrowing needs, although an agreement is unlikely before year-end. Although the economic contraction turned out to be less dramatic than we had expected, deleveraging in the private sector continues and so does the risk of liquidity shortages turning into insolvency issues. Securing an external backstop would not only provide the government with the financial resources to address these issues but also would help lower the risk premium and encourage more resilient capital inflows by offering a credibility anchor. If the government opts to deal with the situation on its own, GDP could contract again in 2020 if global growth slows, with a weak recovery following in 2021.

Disinflation probably ended in September

Inflation could drop towards 10% in September as strong base effects from TRY depreciation in 3Q18 will comfortably offset the first-round inflationary impact of sharp price increases for alcohol and tobacco products, energy, and public transportation. Inflation may re-accelerate in the final two months of 2019, ending the year at 13.5% as the effect of the sharp TRY appreciation in September-November 2018 leaves the base. Annual inflation could stay in a 13-14.5% range for most of 2020 before falling close to 11.7% by year-end [9].

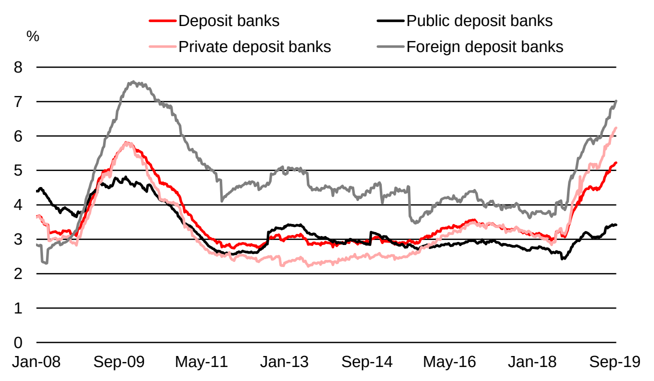
The CBRT frontloaded monetary easing by reducing the policy rate by 7.5pp, to 16.5% in 3Q19. The stickiness of inflation and the persistence of political risks would call for a real interest rate of 2-3% by maintaining the policy rate at around 16%. However, the CBRT might aim for deeper rate cuts to support economic activity. The bank can cut rates to 13.5% by the end of 2019, keeping them at that level throughout 2020.

Political risks subsided for now

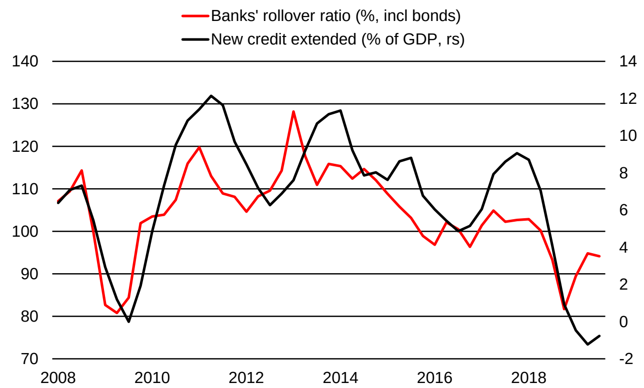
…but may return in 2020 at the latest

Political risks were alleviated in 3Q19 as Turkey avoided US sanctions following the delivery of S-400 missiles from Russia. However, Turkey was expelled immediately from the Pentagon's F-35 jet program. Given bi-partisan support in Congress, Turkey may face sanctions under the Countering America's Adversaries Through Sanctions Act if it decides to activate the Russian missile system in 2020. In addition, the rising possibility of direct involvement in Idlib against the Syrian regime could lead to a standoff with Russia. These risks would make it more difficult for Turkey to obtain financial support if it requests it.

NON-PERFORMING LOANS CONTINUE TRENDING UP



BANKS' EXTERNAL DEBT ROLLOVER RATIO STANDS BELOW 100%



Source: BRSA, CBRT, Haver, UniCredit Research

[9] For details, please see EEMEA Macro Flash - Turkey: The CBRT is not done with rate cuts yet, published on 12 Sept 2019.

Excessive rate cuts could leave TRY exposed

TURKGBs attracted limited foreign inflows in 3Q19

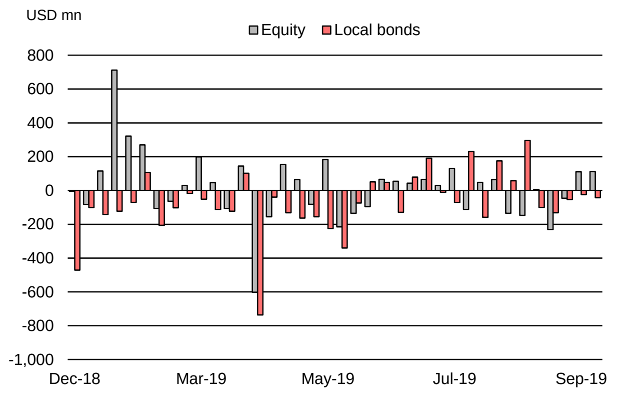
TRY-denominated assets strengthened in 3Q19 as the risk of Turkey facing imminent sanctions from the US diminished significantly and the expectations of monetary easing from the Fed and ECB supported capital inflows to emerging markets. Despite the rally prospects afforded by CBRT rate cuts, foreign investors did not rush to buy TURKGBs. The local bond market attracted only USD 0.2bn of inflows from foreign investors in this period (following USD 2.5bn in outflows in 1H19). However, local-currency bonds fared better than other EM counterparts, as did the TRY.

The CBRT could try to push rates too low

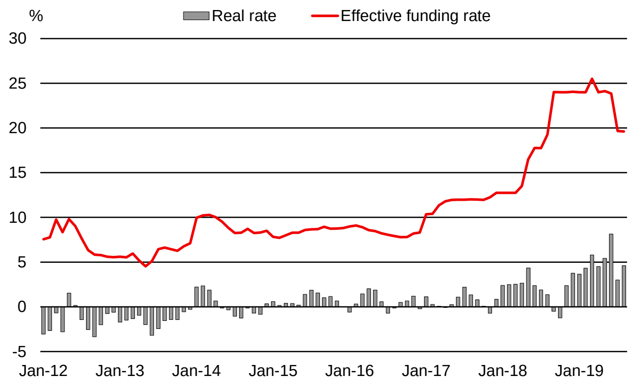
The bulk of the easing is now behind us but the CBRT could aim to reduce real interest rates toward zero to support lending, as it did for most of 2012-18.

The TRY remains undervalued from a fundamental point of view, but we do not expect the gap to fair value to be closed in 2019-20. With interest rates not pricing in inflationary and financing risks, lower appetite for EM bonds could lead to nominal TRY depreciation, with real appreciation continuing at a slower pace.

LIMITED INFLOWS INTO TURKGBS IN 3Q19



THE CBRT MIGHT OVERDO EASING TO SUPPORT GROWTH



Source: CBRT, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**40.9**	**53.8**	**47.4**
Budget deficit	22.8	34.6	23.5
Amortization of public debt	18.2	19.2	24.0
Domestic	12.9	13.3	18.3
Bonds	12.3	12.2	16.5
Bills	0.6	1.1	1.7
Loans	0	0	0
External	5.3	5.9	5.7
Bonds	3.1	3.9	4.1
Loans	2.2	2.0	1.5
Financing	**40.9**	**53.8**	**47.4**
Domestic borrowing	21.8	27.9	14.2
Bonds	20.4	25.8	14.2
Bills	1.4	2.1	0
Loans	0	0	0
External borrowing	8.1	10.3	29.5
Bonds	6.4	8.9	1.3
Loans	1.7	1.3	28.2
Privatization/Other	11.1	15.7	3.7

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2018	2019F	2020F
Gross financing requirement	**173.8**	**156.8**	**143.9**
C/A deficit	23.0	-0.4	11.7
Amortization of medium and long term debt	58.7	55.7	41.8
Government/central bank	5.3	5.9	5.7
Banks	35.1	33.7	18.9
Corporates/Other	18.4	16.0	17.2
Amortization of short-term debt	92.1	101.5	90.4
Financing	**173.8**	**156.8**	**143.9**
FDI (net)	7.9	8.0	8.1
Portfolio equity, net	-0.9	0.7	0.3
Medium and long-term borrowing	57.4	48.7	61.3
Government/central bank	7.3	8.3	29.5
Banks	27.0	27.0	16.4
Corporates/Other	23.1	13.4	15.5
Short-term borrowing	83.6	92.8	81.5
Other	16.2	5.7	0
Change in FX reserves (- = increase)	9.7	0.9	-7.3
Memoranda:			
Nonresident purchases of LC govt bonds	-0.8	-2.0	0
International bond issuance, net	3.3	5.0	-2.8

Source: CBRT, MoF, UniCredit Research

Notes

Notes

Notes

Legal Notices

Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: link

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