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*The authors wish to thank Dr. Tasos Anastasatos, Deputy Chief Economist, for his insightful comments*



# Risk sentiment improves in October on scaled back expectations of Fed rate tightening, likelihood of ECB QE programme extension

## REGIONAL MACROECONOMIC DEVELOPMENTS & OUTLOOK

- Better than expected **output readings** across the region in the second quarter of 2015
- Regional economies & markets appear relatively **insulated** from the ongoing **Emerging Markets storm**
- **Lower energy prices** maintain inflationary pressures subdued , provide **stimulus** to regional growth in the short-term

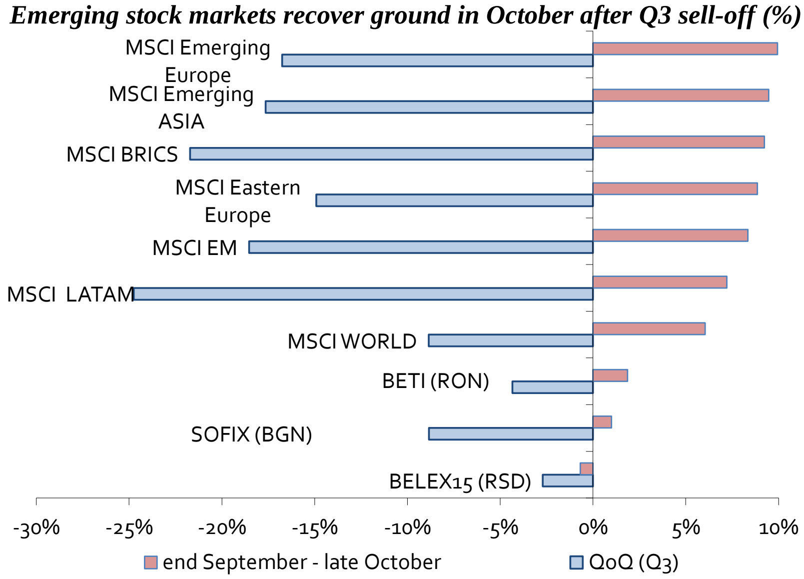
## REGIONAL MARKET DEVELOPMENTS & OUTLOOK

- Emerging stock markets have rebounded strongly since late September on scaled back expectations of an imminent Fed rate hike and extremely bearish positioning in EM assets
- Regional stock markets and currencies outperformed their EM peers during July-August sell-off, but underperformed in the most recent emerging markets recovery
- Government bonds outperform other asses classes
- Despite recent signs of recovery in emerging financial markets, October's impressive performance unlikely to be sustained for long

## COUNTRY FOCUS

- **Bulgaria:** Solid fiscal performance in the first eight months of 2015
- **Cyprus:** Recession finally over from a technical standpoint
- **Romania:** Pro-cyclical fiscal stimulus to be applied over two-year period 2016-2017
- **Serbia:** No snap general elections, for now

***Emerging stock markets recover ground in October after Q3 sell-off (%)***




*Source: Bloomberg, Reuters, Eurobank Research*

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# I. Regional Macroeconomic Developments & Outlook

## *The region appears to be relatively insulated from the on-going Emerging Markets turbulence*

*The region is looking like the safest port in the Emerging Markets storm*

The better than expected output reading of the first half of 2015 and the high frequency data releases in the third quarter of the year, are consistent so far with the view that full year growth of the region will most probably be higher than in 2014. Even though the emerging markets are being caught in the crossfire between world markets' fears of a Chinese economic slowdown and Fed's planned tightening, the region is looking like the safest port in the storm. Although there are some weak spots, regional currencies, markets and economies appear relatively insulated from the ongoing turbulence for the time being. Part of this resilience is explained by the earlier work on the correction of macroeconomic imbalances during the post-Lehman era. In addition, the region benefits from the resilient performance of Euroarea, its main trade partner and primary generator of capital flows, and the relatively low exposure to the Chinese economy.

*Low world energy prices continue providing a positive boost on growth momentum*

Another key element is the positive impact from lower world energy prices. Overall, the region's deficit in energy resources together with the much higher than the EU average energy intensity exacerbate the energy consumption bill. Lower-on an annual basis- energy costs continue to keep inflation pressures at bay, supporting real disposable incomes and providing more flexibility to household, corporate, and sovereign balance sheets. The positive boost on the growth momentum stemming from lower energy prices will extend in the next year as well but inevitably will fade away.

*The VW scandal and the surge of immigration refugees have had so far limited impact on the countries of our focus*

An illustration of all the above is that in contrast with other emerging markets peers, our growth forecasts for some of the economies of the region in 2015-2016 have been upgraded in this issue. Nevertheless, the countries of the region, particularly those of continental Southeast Europe need to accelerate structural reforms in order to generate sustainable growth in the medium term and speed up the convergence of living standards with EU-28 in the foreseeable future. There are two more evolving issues that may have an impact on the countries of the broader region. The first one refers to the VW scandal and the second to the surge of immigration refugees passing through Southeastern and Central Europe. In our understanding, both have had so far a very limited impact on the fiscal and growth metrics of the countries of our focus. Regarding the VW scandal, it entails more economic implications for Central Europe, which is more integrated into German auto manufacturing supply chain. As far as the refugee crisis is concerned, the countries of our focus tend to be a transit instead of a final destination for immigration refugees, thus containing the negative impact.

*The pro-cyclical fiscal stimulus threatens the medium-term fiscal outlook of Romania*

At a country level, factoring in the better than expected first half output performance, full year growth in **Bulgaria** is now projected to be higher than in 2014. Significant terms of trade gains stemming from lower energy prices have already translated into increased net exports activity. **Romania** already stands out of the pack from a growth point of view for a second consecutive year in 2015. Yet, the pro-cyclical fiscal stimulus ahead of the parliamentary elections next year threatens to put the medium-term fiscal outlook at risk. The endorsement of the new amended Fiscal Code plus generous wage rises in the broad public sector may cause a fiscal deficit overshoot close to 3% in 2016 and above that threshold in 2017. Economic activity in **Serbia** bounced back into positive rates of change in Q2, following five quarters of contraction. Low energy prices and euro area resilience have helped counterbalance the short-term fiscal consolidation effects. The positive assessment from IMF on the precautionary agreement's second review and the budget overperformance so far this year, provided room for further-more aggressive than envisaged by the markets- NBS monetary easing in a more predictable domestic environment.

*Cyprus has made the fastest come-back to the markets among all program countries*

The economy of **Cyprus**, a visible turnaround paradigm, will post the first annual positive growth rate in 2015 after three consecutive years of recession. The endorsement of the 8th review in late September, which focused mainly on the issue of making the new insolvency framework fully operational and untitled property sales, paved the way for the release of another tranche of official funding but also allowed Cyprus to take advantage of the ECB QE program. Finally, the consecutive sovereign upgrades of Cyprus by rating agencies in the last two months is an illustration of the progress achieved in the adjustment programme in the last two a half years in a number of areas. Taking advantage of the favorable market sentiment, Cyprus tapped international markets for the third time since June2014 with a new 10Y generic bond issuance at a very low yield (€1bn, 4.25%)

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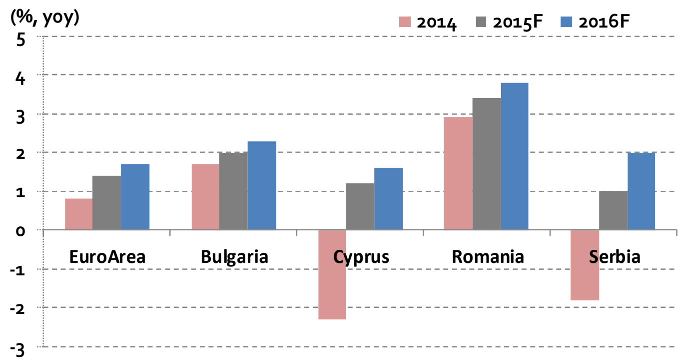
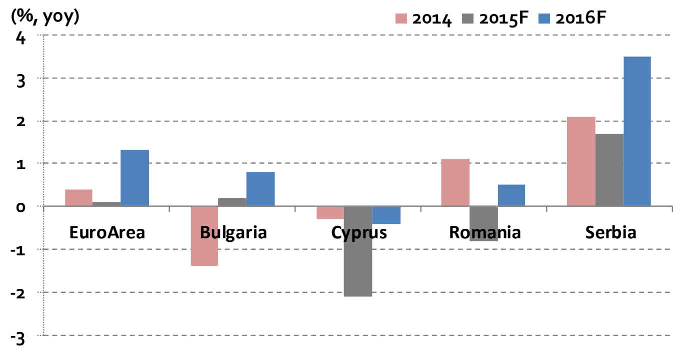
FIGURE 1: **Growth performance 2015-2016**



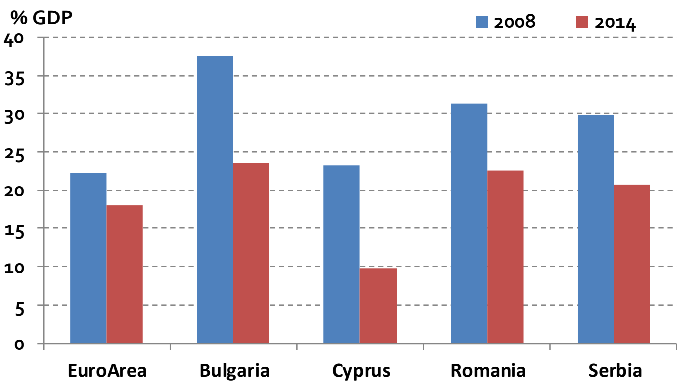

*Source: Eurostat, National Authorities, Eurobank Research*

FIGURE 2: **Annual average inflation 2015- 2016**



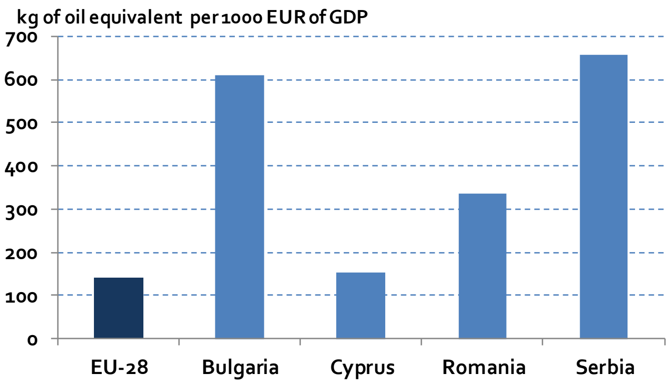

*Source: Eurostat, National Authorities, Eurobank Research*

FIGURE 3: **Investments to GDP ratios 2008 vs. 2014**



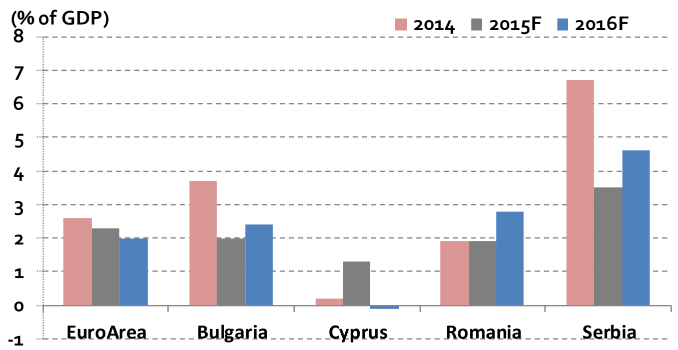

*Source: IMF WEO, Eurobank Research*

FIGURE 4: **Energy intensity of the individual countries, 2013**



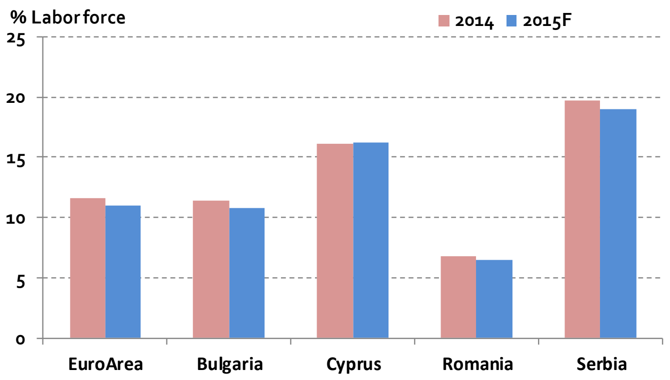

*Source: Eurostat, National Authorities, Eurobank Research*

FIGURE 5: **Fiscal Balance (% of GDP, Cash basis) 2015- 2016**




*Source: Eurostat, National Authorities, Eurobank Research*

FIGURE 6: **Annual average unemployment rates 2014-2015**




*Source: Eurostat, National Authorities Eurobank Research*

# II. Regional Market Developments & Outlook

## *Risk sentiment improves in October on scaled back expectations for Fed rate tightening, likelihood of ECB QE programme extension*

*Emerging stock markets rebound on scaled back expectations for imminent Fed rate tightening, recovery in Chinese markets*

Emerging stock markets have staged a strong rebound since early October, with most developing-nation indices recovering ground from their worst quarterly performance in years. The recent upswing in equity markets came primarily on the back of scaled back expectations for imminent Fed rate tightening and extreme bearish positioning in EM assets. At its last FOMC meeting in September, the Fed took a dovish turn, while downbeat US labour market data for the same month also encouraged a push back in expectations for the much anticipated inception of the FOMC's rate-tightening cycle this year. In addition, the recent recovery in Chinese markets - probably fanned by optimism about the prospect of further policy action by domestic authorities – also provided a lift for emerging market stocks. Against this backdrop, the MSCI Emerging Markets index rallied approximately 10% into the first three weeks of October, hovering near a 2-month peak. The said index is braced to snap a 5-month losing streak and record its best monthly performance since January 2012. Despite October's revival it is worth noting that the index remains approximately 10% weaker year-to-date. In Q3, it recorded its steepest quarterly downtrend in four years (-18.5%) primarily on the back of the Chinese stock market turmoil. Worsening EM fundamentals became more apparent, with idiosyncratic factors, such as mounting political risks in several EM countries (e.g. political dreadlock in Brazil, elections in Turkey, Poland, Argentina, PM's indictment in Romania), having also played a significant role in risky assets performance, while the renewed plunge in commodity prices has pressured related shares.

*Regional stock markets lag October's risk rally, having fared better than EM peers in Q3 sell-off*

Regional stock markets, which fared somewhat better than their EM peers in the third quarter sell-off, are consequently lagging October's risk rally. Major equity indices in the region posted modest gains in the first three weeks of October having endured relatively smaller losses compared to many of their EM peers in Q3 thanks to the prospect of further ECB easing. In more detail, Romania's BET index led the timid recovery rising by ca. 1.0% since the end of September after a 4.3% decline in Q3, recovering from a 1-year low hit in late August. Bulgaria's main SOFIX index and Serbia's BELEX15 returned into a marginally positive territory in October following losses to the tune of 8.8% and 2.7% in the July-September period, respectively, with the latter bouncing away from a 1-year trough touched in mid-September. Having broadly posted quarterly losses in the first nine months of the year - also weighed down by previously escalating Greece-related concerns - all indices remain in the red on a year-to-date basis.

*Regional currencies outperformed during Q3 sell-off but underperformed in the broader EM revival; government bonds outperform other asses classes*

In view of the recent improvement in sentiment towards risky assets, EM FX recovered some ground after a dire Q3. As has been the case in equity markets, regional currencies outperformed during the Q3 sell-off but underperformed in the broader EM revival, confirming their place as relative safe haven in the EM space. Arguably, accommodative monetary policy conditions, subdued inflation pressures and lingering growth risks do not bode well for a sustained recovery in this asset class. Both the Romanian leu and the Serbian dinar remained in tight ranges in recent weeks. The EUR/RON has been bound within 4.4035-4.4310 and the EUR/RSD remained around 119.30-120.35 so far in October, with repeated interventions by the National Bank of Serbia in the FX markets capping the latter cross around these levels. Government bonds broadly outperformed other asset classes in the region, with corresponding CESEE yields having recorded broad-based declines over recent weeks thanks to increased probability for further QE by the ECB and potential for some additional monetary easing in the region. Indicatively, Romania's 10-year benchmark yield stood ca 20bps lower at 3.50% on October 23, within distance from a 6-month low of 3.45% hit a couple of weeks earlier.

*Despite recent signs of recovery in emerging financial markets, October's impressive performance unlikely to be sustained for long*

Despite recent signs of recovery in emerging financial markets, October's impressive performance is unlikely to continue unabated for long. The relief rally on the back of the delay in the inception of the FOMC's rate-hiking cycle is likely to prove only temporary as Fed tightening remains in the pipeline and is likely to take a toll on capital flows towards EM assets. Only recently, Fed Chair Janet Yellen suggested that the door is open for a fed funds rate hike by year-end. Also, prolonged uncertainty as to the timing of the first FOMC rate hike is unlikely to allow a sustainable improvement in sentiment. Moreover, heightened EM growth concerns linger and the Chinese economy – the world's second largest – continues to display signs of further slowdown. That said, a further delay in the expected normalization of the Fed's monetary policy as well as potential signs of stabilization from China and the prospect of new economic stimulus measures by Chinese authorities are likely to provide an additional incentive for recovery for EM assets. Respite may also come in the face of further QE by the ECB. In this case, CESEE/regional assets are likely to benefit the most.

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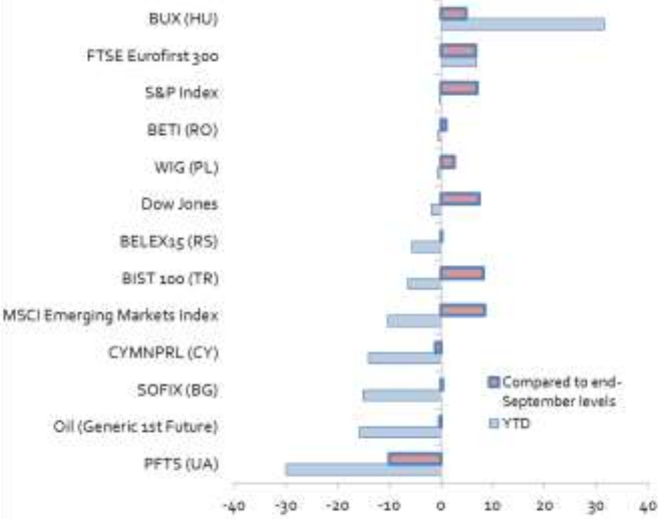
FIGURE 7: **Major world & CESEE stock markets performance (%)**

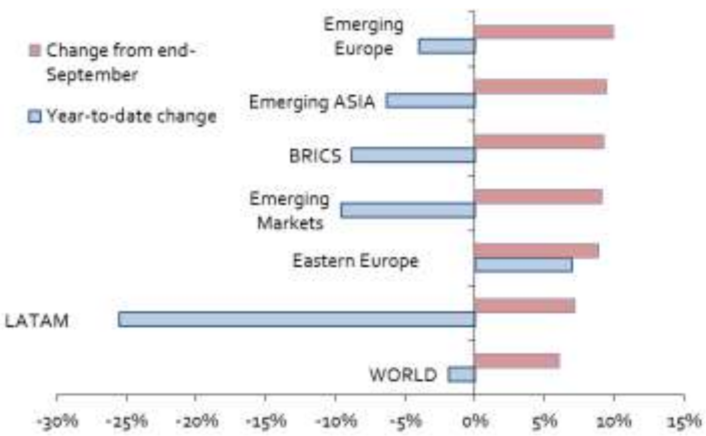



*Source: Reuters, Bloomberg, Eurobank Research*

FIGURE 8: **World & CESEE stock markets YTD performance**

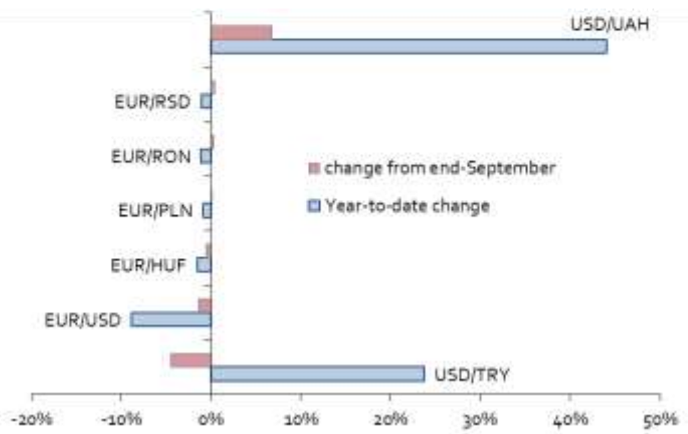

*Source: Reuters, Bloomberg, Eurobank Research*

FIGURE 9: **MSCI stock indices performance (by region)**



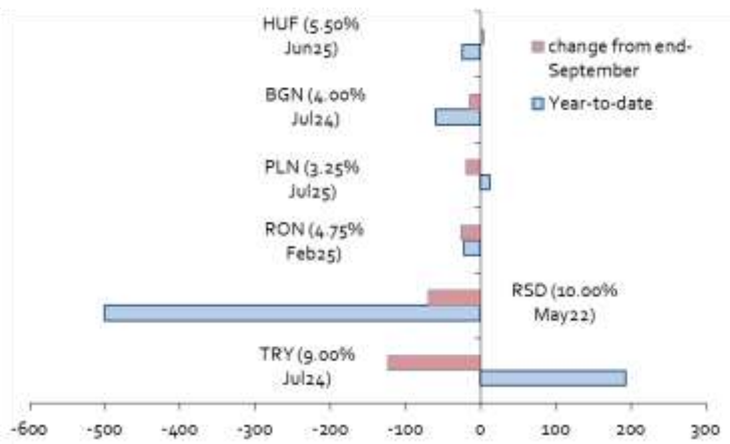

*Source: Reuters, Bloomberg, Eurobank Research*

FIGURE 10: **CESEE FX performance**



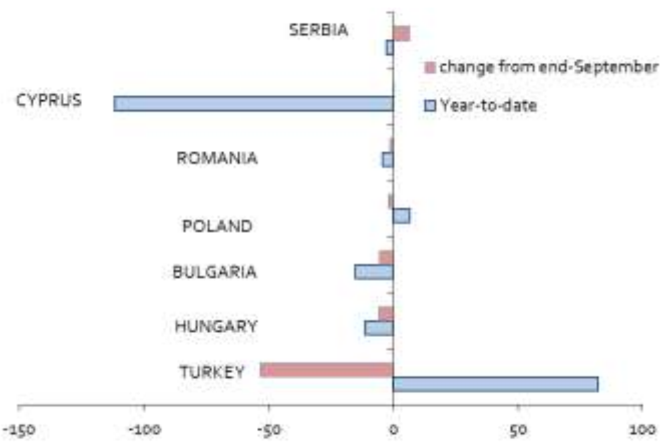

*Source: Reuters, Bloomberg, Eurobank Research*

FIGURE 11: **Change in CESEE government bond yields (in bps)**




*Source: Reuters, Bloomberg, Eurobank Research*

FIGURE 12: **Change in 5-Year CDS spreads (in bps)**




*Source: Reuters, Bloomberg, Eurobank Research*

# Trader's view

**FX**

*Bearish on the EUR/RSD but would refrain from establishing new trade positions at this junction*

The Serbian dinar remained bound within a range of 119.80-121.00 over recent weeks, with repeated Central Bank interventions in the FX markets capping any break attempt towards either side of the range. Since September, EUR/RSD's bias has been for a move towards the lower bound of the said range. The National Bank of Serbia has purchased around €900mn of euros so far in order to alleviate any further EUR/RSD decline beyond 119.80. Although the pressure appears to be abating of late the bearish sentiment for the pair remains rather intact, with weak hard currency demand likely to continue weighing on the pair for some time. At present, we would abstain from establishing new positions in FX, but we anticipate the EUR/RSD to hover within a 119.80-120.40 range in the coming weeks.

**Local Rates**

ROMANIA

*We anticipate our long ROMGB November 2018 target to be reached very soon.*

With ample RON liquidity in the money market remaining supportive of government bonds, we anticipate our earlier trade target of the long position on the ROMGB November 2018 to be reached very soon.

| Security | Position | Entry | Current Level | Carry | Target | Stop loss | P&L (MtM) | Comments |
|---|---|---|---|---|---|---|---|---|
| ROMGB 5.6% November 2018 | Long ⇧ | 2.20% | 1.82% | +140bps | 1.70% | 2. 50% | +0.50% | financed via 1M EUR/RON rolling swap (currently implied rate around 0.80%) |

SERBIA

*Rally in Serbian local rate paper likely to be extended*

At this junction, local currency government bonds remain attractive, with potential for further downside in corresponding benchmark yields lying ahead in view of the recent delay in the looming inception of the Fed's monetary tightening cycle and, most importantly, rising probability for further ECB QE. Additionally, Serbia's fiscal position is on the mend and the NBS's stance remains accommodative following hefty rate cuts in recent months, developments that are also favoring the local bond market. Despite the recent broad-based rally already seen in local bonds, we anticipate the slope of longer maturity to flatten by about 50-100 basis points further on average on primary auctions in the coming weeks.

| Security | Position | Entry/Current Level (Yield of prior auction of the paper in October, 2015) | Target | Stop loss | P&L (MtM) |
|---|---|---|---|---|---|
| RSMFRSD83827 | Long ⇧ | 4.89% | 4.00% | 5. 40% | +0.70% |

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# III. Country Focus

## Bulgaria (Baa2/BB+/BBB-)

### *Solid fiscal performance in the first eight months*

*The pace of improvement in high frequency data releases has slowed down in Q3*

The economy picked up further pace in Q2-2015, growing at the strongest rate since Q2-2011. GDP growth accelerated to +0.5% qoq/+2.2% yoy from 0.6% qoq/+2.3% yoy in Q1-2015, and +0.6% qoq/+1.8% yoy in Q4-2015. The hefty revisions in the national accounts data –announced in early October-revealed that net exports were once again the main contributor to growth in Q2.  Even though the pace of improvement in high frequency data has slowed down in Q3 yet they hold their year to date gains. The Economic Sentiment Index (ESI) eased to 104.8 in September down from 105.5 in August but up from 100.5 at the end of last year. On a seasonally adjusted basis, industrial production expanded by 0.1% MoM/+4.3% YoY in August2015, up from a revised -0.8%MoM/+3.4% YoY in July2015 but down from +2.3% QoQ/+4.3% YoY in Q2-2014. Retail trade sales (in volume terms) entered into red in August for the first time since March 2013 posting a -0.8% MoM/-1.9% YoY decrease down from -1.1% MoM/+0.1% YoY in July and -0.7% QoQ/+1.3%YoY in Q2-2015. Registered unemployment fell for the fifth month running in September coming in at 9.2% down 9.3% in August, recoiling further below an 8-month high of 11.09% hit in January and a 10.5% print in September 2014. All in all, the 1H growth performance coupled with the high frequency data releases is still supportive of our earlier expressed view that full year growth would expand at a higher pace to 2.1% in 2015 up from 1.6% in 2014 but still very far from the pre-crisis rates

*Fiscal consolidation continued at a fast pace in the first eight months of the year*

According to the Ministry of Finance, the consolidated budget surplus came at BGN 622mn in Jan-Aug compared to a BGN 1.27bn deficit in the corresponding period of 2014. As a percentage of projected GDP, the consolidated budget surplus stood at 0.7% in the first eight months, up from a 1.6% deficit a year ago. Total revenues came at BGN21.5bn in Jan-Aug, which represents 70.9% of the full-year plan, up by 11.8% yoy. On the other hand, total spending rose by only 1.8% yoy to BGN20.9bn in Jan-Aug, representing 63.4% of the full-year plan. Overall, the budget execution so far creates optimism that the full year fiscal deficit target – set at 3% of GDP in 2015, in cash terms, will be achieved comfortably. The fiscal deficit in cash terms had widened to 3.8% of GDP in 2014 up from 1.8% in 2013 surpassing the Maastricht threshold for the first time since 2010, primarily reflecting spending slippages from the electoral cycle and the bail-out costs from the banking sector. At the time of the writing, the Ministry of Finance was about to revise its full-year fiscal target  alongside the release of the 2016 budget draft which is complemented with an updated medium term fiscal framework of the period 2016-2018.

*The process of reforming banking sector supervision is underway*

The new governing council of the BNB adopted in early October the plan for the reform of the Central Bank's supervision. The 18-month detailed plan, in line with the commitments of the new BNB governor voted in office in mid-July, describes the time framework and the steps intended to bring supervisory practices in full compliance with the current international standards. The plan builds upon the assessment report by the World Bank and IMF on the effectiveness of the banking sector supervision. The assessment report identified weaknesses in six key areas of concern and classified the degree of compliance of the supervisory practice with the Basel principles as unsatisfactory. The reform process will culminate in an asset quality review and a bottom-up stress test of banks, the results of which will be made public no later than end-August2016. The process for the selection of an independent consultant is already underway. The banking sector turmoil following the collapse of the Corporate Commercial Bank in late June 2014, has raised public attention on the issues of banking supervision effectiveness and corporate governance. Although the collateral damage to the economy was minimized and the noise was short-lived, there has been a lot of media criticism on BNB.

*Bulgaria scored low in critical areas of the Global Competitiveness Index report*

Bulgaria ranked in the 54th position in the latest World Economic Forum Global Competitiveness report. The ranking of Bulgaria remained unchanged from last year, outperforming six other EU-28 members. Bulgaria scored best in the sub-sector of "technological readiness" (38th position). In contrast, Bulgaria recorded its worst performance in the sub-sectors of "institutions" (107th position). In more detail, Bulgaria received also very low rankings in many areas of the pillar "institutions", including "favoritism in decisions of government officials" (122nd)-"transparency of policymaking" (120) – "organized crime" (118th) – "judicial independence" (116th). Access to financing, corruption and inefficient government bureaucracy were identified as the most problematic factors for doing business in the report.

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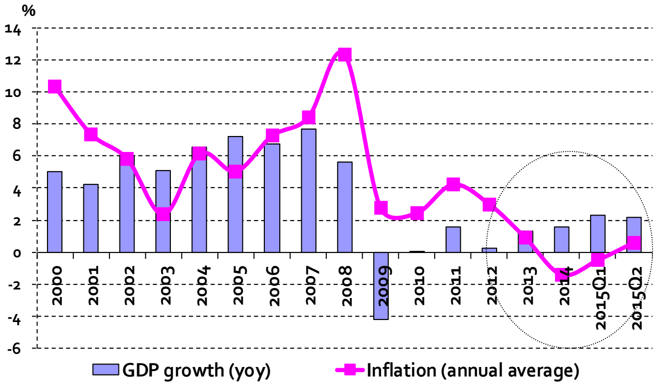
| Bulgaria: Macro & Market Data | 2013 | 2014 | 2015f | 2016f |
|---|---|---|---|---|
| **Real GDP (yoy%)** | 1.1 | 1.7 | 2.1 | 2.5 |
| **Inflation (yoy%)** | | | | |
| CPI (annual average) | 0.9 | -1.4 | 0.2 | 0.8 |
| CPI (end of period) | -1.6 | -0.9 | 0.3 | 1.2 |
| **Fiscal Accounts (%GDP)** - *Cash Basis* | | | | |
| General Government Balance | -1.8 | -3.7 | -2.0 | -2.4 |
| Gross Public Debt | 18.6 | 27.7 | 29.8 | 31.2 |
| Primary Balance | -1.0 | -3.0 | -1.5 | -1.4 |
| **Labor Statistics** | | | | |
| Unemployment Rate (LFS, %) | 12.9 | 11.4 | 10.8 | 10.2 |
| Wage Growth *(total economy)* | 6.0 | 6.8 | 7.0 | 6.0 |
| **External Accounts** | | | | |
| Current Account (% GDP) | 1.0 | 0.9 | 2.0 | 1.5 |
| Net FDI (EUR bn) | 1.4 | 1.3 | 1.5 | 1.5 |
| FDI / Current Account (%) | Na | Na | Na | Na |
| FX Reserves (EUR bn) | 14.4 | 16.5 | 19.0 | 21.5 |
| **Domestic Credit** | **2012** | **2013** | **2014** | **Q1-2015** |
| Total Credit (%GDP) | 72.3 | 72.9 | 67.7 | 65.9 |
| Credit to Enterprises (%GDP) | 47.7 | 47.7 | 41.8 | 41.1 |
| Credit to Households (%GDP) | 23.0 | 23.0 | 22.3 | 22.1 |
| FX Credit/Total Credit (%) | 64.0 | 60.9 | 57.0 | 55.9 |
| Private Sector Credit (yoy) | 3.8 | 0.6 | -6.7 | -7.5 |
| Loans to Deposits (%) | 99.4 | 92.1 | 84.2 | 86.4 |
| **Financial Markets** | **Current** | **3M** | **6M** | **12M** |
| Policy Rate | | Currency Board | | |
| EUR/BGN | 1.96 | 1.96 | 1.96 | 1.96 |

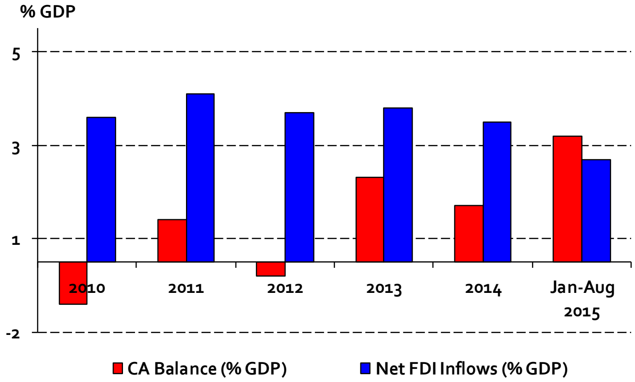
*Source: National Sources, Eurostat, IMF, Eurobank Research*

FIGURE 13: **GDP growth & Inflation 2000-2015**



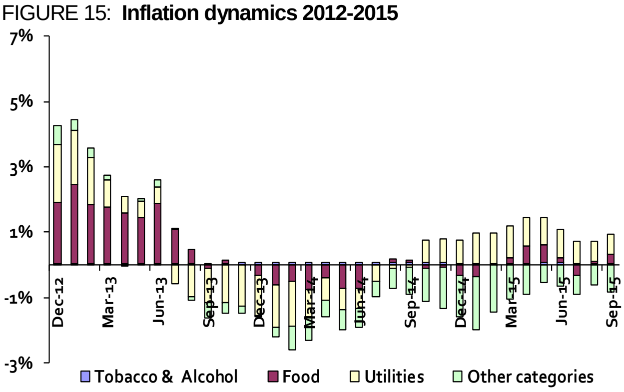

*Source: National statistics, Ecowin Reuters, Eurobank Research*

FIGURE 14: **CA Deficit & Net FDI inflows 2010-2015**



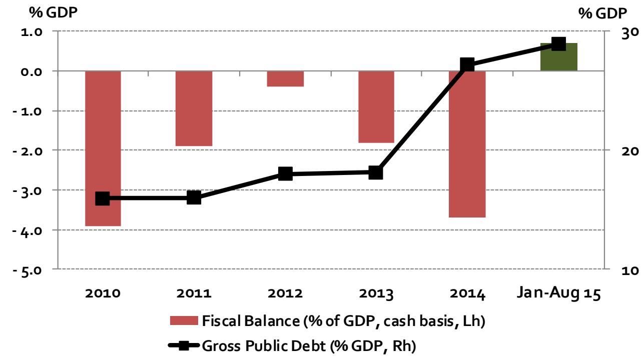

*Source: National statistics, Ecowin Reuters, Eurobank Research*

FIGURE 15: **Inflation dynamics 2012-2015**




*Source: National statistics, Ecowin Reuters, Eurobank Research*

FIGURE 16: **Fiscal deficit & Gross Public Debt 2010-2015**




*Source: Eurostat, Eurobank Research*

# Cyprus ((P)B3/BB-/B+)

*Recession finally over from a technical standpoint*

*The second quarter GDP reading confirmed the exit of the Cypriot economy from recession from a technical point of view*

In Q2-2015, Cyprus recorded the second positive growth rate on a quarterly and yearly basis since Q2-2011 confirming the exit of the economy from recession from a technical point of view. Real GDP grew by +1.2% yoy in Q2-2015 vs. +0.2% yoy in Q1-2015 up from -1.9% yoy in Q4-2014. On a seasonally and working days-adjusted basis, GDP growth expanded by +0.5% qoq/+0.8% yoy in Q2-2015 up from +1.2% qoq/+0.1% yoy in Q1-2015 and -0.2% qoq/-1.6% yoy in Q4-2014. The good news is that consumption moved into positive territory in Q2-2015 for the first time since Q2-2012 (+0.3% yoy in Q2-2015 up from 0% yoy in Q1-2015) making a positive contribution to growth (+0.3pps). The private consumption come-back (+1.3% yoy in Q2-2015 vs. +0.8% yoy in Q1-2015, +0.9pps contribution) offset the contraction of public consumption (-3.4% yoy in Q2-2015 vs. -3.0% yoy in Q1-2015, -0.6pps). In addition, gross capital formation made a strong contribution (+30.7% yoy in Q2-2015 vs. +3.6% yoy in Q1-2015, +3.0pps contribution) underpinned by the rise of investments in transport equipment, manufacturing and inventories. On the negative side, net exports deducted -2.5pps from growth. Exports declined (-2.4% yoy in Q2-2015 down from +1.7% yoy in Q1-2015), after five consecutive quarters of positive annual growth, while imports increased (+2.3% yoy in Q2-2015 down from +2.6% yoy in Q1-2015).

*The endorsement of the 8th review by official creditors allows for the usage of QE to continue*

Cyprus strong record of compliance with the program conditionalities continued during the 8th review as well. Authorities were able to meet all quantitative targets and achieve progress with most structural benchmarks albeit with some delay. Authorities adopted administrative acts and regulations to make the new insolvency framework fully operational, addressed the issue of untitled property sales by developers with partial success, introduced institutional arrangements to monitor and manage government guarantees, standardized the publication of the loan restructuring targets and performance by the Central Bank. Looking ahead, the next review will focus on the issue of legislation enabling the sale of loans. The law has already been adopted on the ministerial level but still has not been endorsed by the parliament. In addition, the issue of untitled property sales will have to be also settled for the new real estate transactions. By the end of the year, the government will also have to speed up the reform of the Public service (including the wage setting framework), the implementation of the privatization program and legislation facilitating the securitization of assets. So far, Cyprus has successfully completed eight reviews within the programme including the latest review endorsement by the IMF board on September 23rd. Upon the €500mn ESM disbursement, Cyprus will have made use of a combined €7.2bn out of the total €10bn package (€6.3bn by ESM and €882mn by IMF). More importantly, the approval of the reviews has allowed Cyprus to take advantage of the ECB's QE program. Even though the size of the expected ECB bond buy-backs seems not to exceed €500mn, it still represents a sizeable proportion of the outstanding stock (around 25%). The first ECB bond buy-back for the amount of €84mn took place in last July.

*The latest sovereign rating upgrades paved the wave for a new 10Y issuance in late October*

Cyprus raised €1bn by issuing a new 10-year benchmark bond before the end of the year, in line with the annual funding programme. The news comes on top of late September decision by S&P to raise the long-term sovereign rating of Cyprus by one notch (from B+ to BB-) with a positive outlook. In late October, FITCH upgraded the sovereign rating of Cyprus by two notches (from B- to B+) with a positive outlook. The rating agencies decision reflects the track record of fiscal consolidation and over-performance on fiscal targets. The high level of NPLs (47.4% of gross loans in August) and the implementation of banking sector reforms were identified as the main risks to the outlook. Cyprus has made the fastest come-back to international markets among other Euroarea programme countries. In late April, the Republic tapped international markets for the second time since June 2014 raising €1bn through a new 7Y bond at a yield of 4%.

*Motivated by the strong program performance and the better than expected macroeconomic outturns, we upgraded our full year GDP forecast to 1.2% and 1.6% in 2015 and 2016 respectively*

In all past editions we have extensively discussed the progress of the Cypriot economy in the last two and a half years. Based on our fact findings on the ground and our analysis, we always advocated that Cyprus is a solid turn-around economic story. The signs that the economy is coming out of the woods are becoming more visible. The improvement of many leading indicators of economic activity has continued during Q3 (retail trade, industrial production, construction activity, tourist arrivals). The Economic Sentiment Index (ESI) has been on an improving trend since May 2013, recovering close to pre-Lehman era levels (Sep 2015: 104.6). Unemployment has embarked on a decreasing path, reaching 15.3% in August down from a peak of 16.6% in November 2014. While Cyprus is set to graduate successfully from the program in March2016, authorities will have to deal in the medium term with the high stock of NPLs, credit scarcity and elevated unemployment, while ensuring high primary surpluses.

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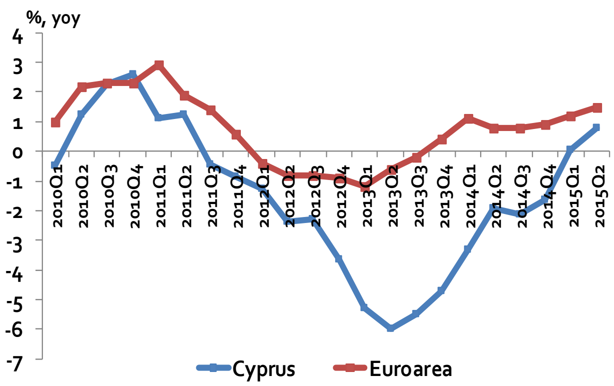
| Cyprus: Macro & Market Data | | | | |
|---|---|---|---|---|
| | 2013 | 2014 | 2015f | 2016f |
| **Real GDP (yoy%)** | -5.4 | -2.3 | 1.2 | 1.6 |
| Private Consumption | -6.0 | 0.4 | 1.1 | 1.3 |
| Public Consumption | -4.9 | -8.7 | -2.5 | -1.5 |
| Gross Capital Formation *(Fixed)* | -17.1 | -18.8 | 13.0 | 5.0 |
| Exports | -5.0 | 5.7 | 0.5 | 2.5 |
| Imports | -13.6 | 8.1 | 2.5 | 2.0 |
| **Inflation (yoy%)** | | | | |
| HICP (annual average) | 0.4 | -0.3 | -2.1 | -0.4 |
| HICP (end of period) | -1.3 | -1.0 | -2.3 | 0.9 |
| **Fiscal Accounts (%GDP)** | | | | |
| General Government Balance | -4.4 | -0.2 | -1.3 | 0.1 |
| Gross Public Debt | 102.2 | 107.5 | 106.4 | 98.4 |
| Primary Balance | -1.6 | 2.8 | 1.3 | 2.4 |
| **Labor Statistics** | | | | |
| Unemployment Rate (LFS, %) | 15.9 | 16.1 | 15.5 | 15.0 |
| Wage Growth *(total economy)* | -6.0 | -4.7 | -0.3 | 1.1 |
| **External Accounts** | | | | |
| Current Account (% GDP) | -3.0 | -5.1 | -5.5 | -4.5 |
| Net FDI (EUR bn) | 0.2 | 1.1 | 2.0 | 1.5 |
| FDI / Current Account (%) | 55% | 127% | 208% | 187% |
| **Domestic Credit** | **2012** | **2013** | **2014** | **Q2-2015** |
| Total Credit (%GDP) | 373.5 | 351.4 | 356.0 | 359.5 |
| Credit to Enterprises (%GDP) | 171.1 | 160.2 | 150.1 | 153.1 |
| Credit to Households (%GDP) | 138.9 | 140.0 | 143.5 | 137.3 |
| Private Sector Credit (yoy) | 5.1% | -12.1% | -3.1% | 2.0% |
| Loans to Deposits (%) | 103.3% | 135.3% | 133.5% | 136.6% |

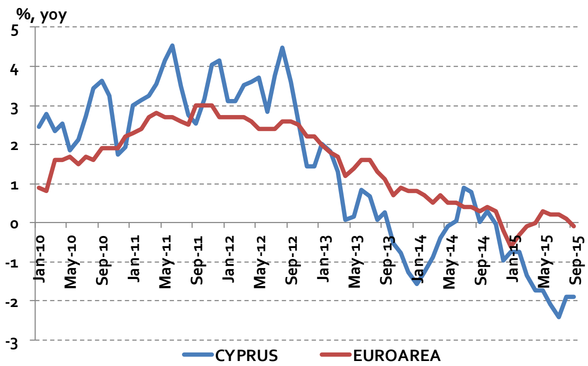
*Source: National Sources, Eurostat, IMF, Eurobank Research*

FIGURE 17: **Growth performance Cyprus vs. Euroarea 2010-2015**




*Source: Eurostat, Eurobank Research*

FIGURE 18: **HICP Cyprus vs. Euroarea 2010-2015**

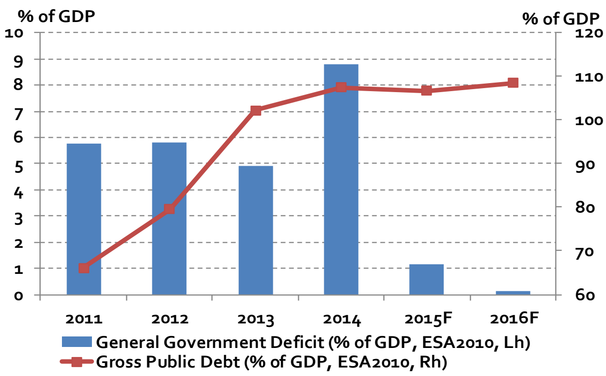



*Source: Eurostat, Eurobank Research*

FIGURE 19: **10Y Government Bond Yield**


*Source: Bloomberg, Eurobank Research*

FIGURE 20: **Fiscal deficit & Gross Public Debt 2011-2016**




*Source: Eurostat, Eurobank Research*

# Romania (Baa3/BBB-/BBB-)

## *Increased political noise as a result of the anticorruption campaign*

*Following the extraordinary performance of the first quarter, second quarter GDP growth disappointed consensus forecasts remaining robust*

According to the final estimate, real GDP growth slowed down to +0.1%qoq/+3.3% yoy in Q2-2015 compared to +1.4%qoq/+4.3%yoy in Q1-2015 and +0.9%qoq/+2.6%yoy in Q4-2014, undershooting consensus expectations (Bloomberg survey: +0.4% qoq/+4.8% yoy). On a seasonally adjusted basis, real GDP growth in Q2-2015 came at +3.8% yoy, equaling the rate of Q1-2015, but still up from +2.6% yoy in Q4-2014. Both private consumption (+5.0% yoy/ +3.5pps contribution to growth) and gross fixed capital formation (+9.7% yoy/+2.0pps contribution to growth) remained on an upward trend in Q2. On the other hand, net exports (-0.8pps) and inventories (-1.4pps) had a negative impact on growth dynamics. Overall, private consumption has taken over as the leading driver behind the growth rally concealing warning signs of an overheating scene in the making. Sustained improvement in private spending is primarily supported by solid wage growth momentum (+7.7% yoy in August vs. +7.6% yoy in July). In fact, given the negative CPI outcome in August underpinned by the front loaded VAT rate cut, real wage growth accelerated to +9.6% yoy in August vs. +9.2% yoy in July, the strongest pace since 2009. In addition, improved sentiment (ESI-Index is on climbing trend since October 2014, touching a new post-Lehman period high at 104.7 in last June) and labor market tightening (+115k yoy more jobs added in Q2 on a yearly basis) are supportive of domestic demand as well. In conclusion, the released Q2 estimate doesn't change our long standing full year growth forecast-3.4% in 2015-and assessment.

*Prime Minister Ponta survived his fourth no-confidence vote on Sep29th, but political uncertainty remains*

The fourth no-confidence vote initiated by the main opposition party PNL (National Liberal party) failed to bring down PM Ponta cabinet in late September. The no-confidence vote was initiated after his indictment by the National Anticorruption Directorate (DNA) prosecutors for his involvement in the so-called Rovinari-Turceni case with charges of forgery in documents, complicity to continued tax evasion and money laundering, in his capacity as a lawyer before assuming the post of the PM. The charges against PM Ponta are another blow to his prestige and raise the probability of an early step down. Mr. Ponta has already stepped down from the leadership of the ruling Social Democratic Party (PSD). Defections in the ruling camp, that may put the stability of the government coalition- led by PSD and two junior members -at risk, cannot be ruled out at some point in the near future contingent upon the court decision. Even if the political landscape changes radically in the coming months, the case against PM Ponta will not be a game changer as far as economic policies are concerned. In a pre-election year, it is highly unlikely that the shift to more populist policies that will be market and credit negative will be averted.

*The amended version of the Fiscal Code envisages that fiscal easing will be applied gradually over the two year period 2016-2017. Unnecessary pro-cyclical stimulus may put the medium-term fiscal outlook at risk*

After the President refused to endorse the Fiscal code initially voted by the parliament in last June, a watered down version of it was finally approved in early September. The headline VAT rate cut-from 24% to 20%- will be implemented in 2016 and VAT will further decline by 1pps in 2017 (to 19%). The rest of the tax cuts- which entail the elimination of the special excise duty on fuels, the abolishment of the tax on special construction permits and the reduction of the dividend tax were postponed to 2017. The gradual implementation of the fiscal stimulus will alleviate some pressure off the revenue side. Yet, the government's approval of generous wage hikes in the public health and education sectors will generate upside pressures on the expenditure side. As a result, the general government deficit is expected not only to overshoot the 1.2% of GDP official target in 2016 but to most likely end close to the 3% EU threshold up from a projected 1.8% in 2015. Besides the profound macroeconomic implications of this pro-cyclical fiscal policy, its implementation is at odds with the requirements of the expired IMF-EU agreement and makes an extension less likely in the foreseeable future.

*Central Bank maintained interest rates unchanged at 1.75% in end-September policy meeting*

At its monetary policy meeting on Sep30th, NBR stayed put on its monetary policy, in line with our and market expectations. In more detail, the key policy rate remained at the current record low of 1.75%, while the minimum reserve requirements for RON and FX denominated liabilities were left unchanged at 8% and 14% respectively. The latest inflation print (+0.3% mom/-1.7% yoy in September vs. -0.5% mom/-1.9% yoy in August) supports our view that headline inflation is most likely to stay below the NBR target range (2.5%±1%) until at least 2H-2016. On the other hand, there are some good arguments why NBR could refrain from further rate cuts, looking beyond the fiscally induced supply side shock. The sooner than expected closing of the output gap, downside risks stemming from the ambitious fiscal easing plan which has raised deep concerns, also voiced by the EU and IMF, plus worries over external risks on the radar. That said, there is still enough space for NBR to lower the domestic currency MRRs should the need arise.

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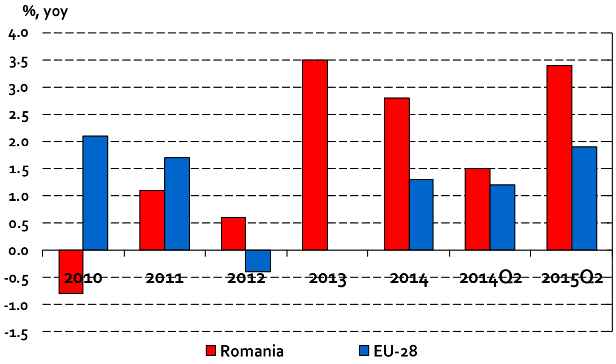
| Romania: Macro & Market Data | | | | |
|---|---|---|---|---|
| | 2013 | 2014 | 2015f | 2016f |
| **Real GDP (yoy%)** | 3.4 | 2.9 | 3.4 | 3.8 |
| Consumption | 0.4 | 3.0 | 4.2 | 4.5 |
| Investment | -7.9 | -3.6 | 5.0 | 6.5 |
| Exports | 16.2 | 3.5 | 7.5 | 5.0 |
| Imports | 4.2 | 7.7 | 10.5 | 9.0 |
| **Inflation (yoy%)** | | | | |
| CPI (annual average) | 4.0 | 1.1 | -0.8 | 0.5 |
| CPI (end of period) | 1.6 | 0.8 | -1.2 | 1.3 |
| **Fiscal Accounts (%GDP, Cash Basis)** | | | | |
| General Government Balance | -2.2 | -1.9 | -1.9 | -2.8 |
| Gross Public Debt (including guarantees) | 37.9 | 39.5 | 39.1 | 41.5 |
| **Labor Statistics (annual avg,%)** | | | | |
| Unemployment Rate (ILO, % of labor force) | 7.1 | 6.8 | 6.5 | 6.4 |
| Wage Growth (total economy) | 4.8 | 5.3 | 7.0 | 6.5 |
| **External Accounts** | | | | |
| Current Account (%GDP, BPM5) | -0.8 | -0.4 | -0.7 | -1.0 |
| Net FDI (EUR bn) | 2.9 | 2.5 | 3.0 | 3.5 |
| FDI / Current Account (%) | 250.1 | 385.0 | 272.0 | 211.8 |
| FX Reserves (EUR bn) | 35.4 | 35.5 | 31.0 | 33.0 |
| **Domestic Credit *(end of period)*** | **2012** | **2013** | **2014** | **Q2-2015** |
| Total Credit (%GDP) | 52.0 | 47.0 | 44.4 | 44.3 |
| Credit to Enterprises (%GDP) | 20.3 | 18.0 | 15.7 | 15.5 |
| Credit to Households (%GDP) | 17.8 | 16.5 | 15.4 | 15.4 |
| FX Credit/Total Credit (%, private) | 62.5 | 60.9 | 56.2 | 52.4 |
| Private Sector Credit (yoy) | 1.3 | -3.3 | -3.1 | 2.4 |
| Loans to Deposits (%) | 133.9 | 118.4 | 106.3 | 106.6 |
| **Financial Markets** | **Current** | **3M** | **6M** | **12M** |
| Policy Rate | 1.75 | 1.75 | 1.75 | 2.50 |
| EUR/RON | 4.44 | 4.45 | 4.45 | 4.40 |

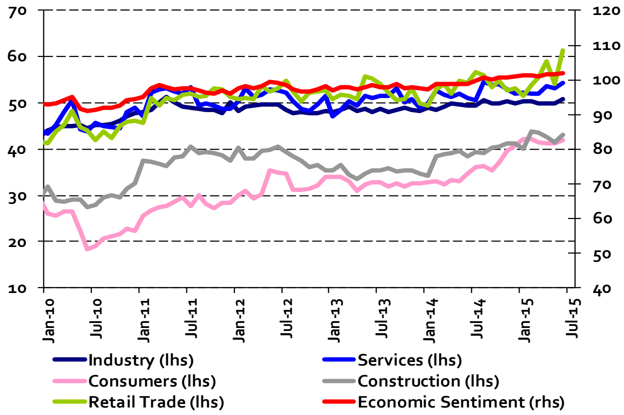
*Source: National Authorities, EC, IMF, Eurobank Research*

FIGURE 21: **Growth rates Romania vs. EU - 28 2005-2014**



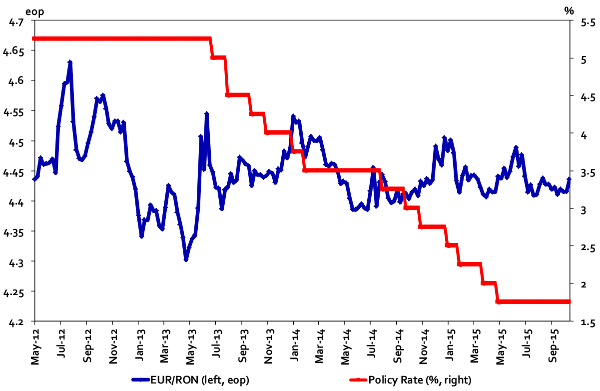

*Source: Eurostat, Eurobank Research*

FIGURE 22: **Sentiment indicators 2010-2015**



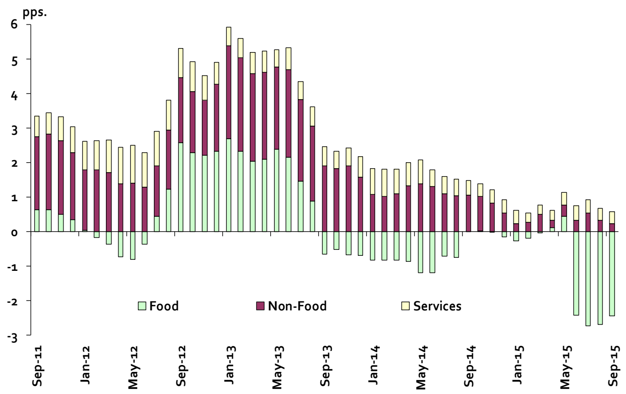

*Source: Eurostat, Ecowin Reuters, Eurobank Research*

FIGURE 23: **Monetary policy & FX rate 2012-2015**




*Source: Bloomberg, Eurobank Research*

FIGURE 24: **Inflation components 2011-2015**




*Source: National statistics, Eurobank Research*

# Serbia (B1/BB-/B+)

*No snap general elections, for now*

*Prime Minister decides against holding early general elections, but leaves door open for such an event in the coming months*

After weeks of speculation, Prime Minister Aleksandar Vucic announced in mid-October his decision against holding early general elections, despite pressures from his own party to cement another 4-year term, on the back of strong popular support. The Prime Minister justified his decision citing a series of high-importance events in the next six months, such as the opening of the first chapters under the country's EU accession process, as well as the crucial negotiations with Kosovo officials on the breakaway province's future status and relations between Belgrade and Pristina. That said, the Premier left the door open for snap elections in the coming months.

*Economic activity bounced back into a positive territory in Q2 2015*

Real economic activity bounced back into a positive territory, recording a 1.0% increase on an annual non-seasonally adjusted basis in Q2. This follows five consecutive quarters in contraction and a 2.0%YoY decline (revised from -1.8%YoY previously) in Q1 2015. The breakdown of the data confirmed that gross fixed capital formation and exports were the workhorses of this performance. Investment recorded a positive annual growth rate of (8.6%YoY), picking up pace for the third quarter running and recording the highest increase since Q3 2012. Simultaneously, exports' growth (8.7%YoY) was nearly in line with the prior quarter's (8.6%YoY) rise thanks to improving external demand. This came in tandem with a slowdown (3.0%YoY from 11.3% in Q1 2015) in imports' growth, while consumption continued to decline. In anticipation of a further recovery in the domestic economy in H2 2015 thanks to favorable base effects, monetary easing and low global oil prices we revise our previous 0.0% FY2015 forecast in line with the government's 1.0% projection. Investments and exports are likely to continue posing as the main pillars of economic activity in the coming quarters, while domestic spending will probably remain weak in view of ongoing fiscal restraint. We continue to envision a further recovery in 2016 as the fiscal consolidation impact wanes and external demand picks up further.

*Central Bank nearing the bottom of the current monetary easing cycle*

At its October monetary policy meeting, the National Bank of Serbia (NBS) cut its key policy rate by 50bps, for the 3rd month running, to a new record low of 4.50%, in line with our expectations and against a market median forecast for stable interest rates. In support of the said decision the NBS cited persistently below target inflation (at 1.4%YoY in September), expressing belief that CPI should move back within the 4±1.5% target tolerance band early next year and return to the 4% target mid-point from mid-2016. Notably, weak domestic demand is keeping inflation pressures at bay and the recent 12% hike in electricity prices that came into effect in August appeared to be having a smaller than previously expected impact on consumer prices. In the accompanying statement the Central Bank also noted the dinar's relative stability thanks to improving fiscal and balance of payments conditions as well as the global economic slowdown, which may result in a prolongation of accommodative monetary conditions in advanced economies. The Committee also expressed belief that past monetary easing will boost lending activity. Taking into account the latest cut, the NBS has delivered in total 725bps of rate cuts since May 2013, out of which 350bps have been rendered so far this year. Although the door appears open for another 50bps cut this year, the NBS seems to be nearing the bottom of the current monetary easing cycle as external and fiscal risks linger while inflation is anticipated to rebound within its target early next year.

*IMF staff-level agreement reached on the 2nd review under SBA; this year's fiscal improvement continues*

The IMF Executive Board completed in October the 2nd review under the country's precautionary Stand-By Arrangement, acknowledging that the program is delivering good results. Fiscal execution significantly exceeded expectations in 9M 2015, with the "Republic" deficit coming in under 2% of GDP annualized. The general government consolidated full year shortfall is now expected at 3-3.5% of GDP, or ca. €1.0-1.2bn, nearly equaling interest payments (primary deficit at 0.0%), poised to outperform the 5.9% target. The bulk of the savings, which account for half of the total annual reduction in the deficit this year (ca. €600mn), is anticipated to come from pension and wage cuts, as well as improved revenue collection. The rest is expected to be derived from lower-than-earlier-planned public investments and lesser expenditure in severance packages due to the lack of public sector redundancies. Several one-off dividend payments from the few successful state owned enterprises provided an additional income in the State's coffers. A key challenge is a repetition of this year's performance in 2016, as interest expenses grow, while the government attempts to negotiate with the IMF mild rises in pensions and salaries. A meeting between the Prime Minister and IMF officials is scheduled for October 29th, to iron out any pending issues before presenting next year's budget to Parliament.

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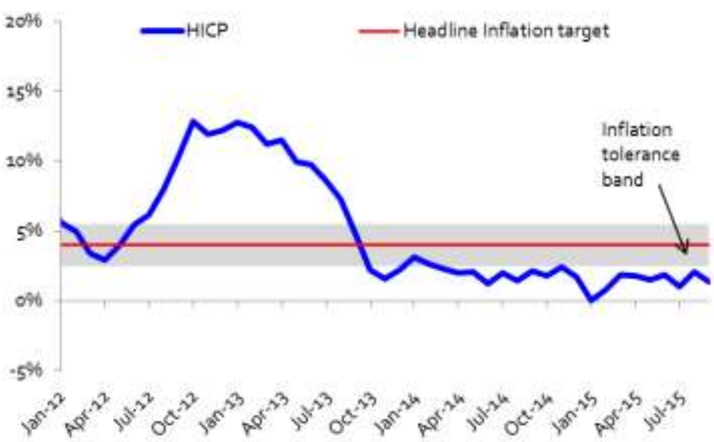
| Serbia: Eurobank Forecasts | | | | |
|---|---|---|---|---|
| | 2013 | 2014 | 2015 | 2016 |
| **Real GDP (yoy%)** | 2.6 | -1.8 | 1.0 | 2.0 |
| **Inflation (yoy%)** | | | | |
| HICP (annual average) | 7.9 | 2.1 | 1.7 | 3.5 |
| HICP (end of period) | 2.2 | 1.7 | 2.3 | 4.0 |
| **Fiscal Accounts (%GDP)** | | | | |
| Consolidated Government Deficit | -5.6 | -6.7 | -3.5 | -4.6 |
| Gross Public Debt | 61.4 | 72.4 | 77.3 | 78.8 |
| **Labor Statistics (%)** | | | | |
| Unemployment Rate (%of labor for | 23.0 | 19.7 | 21.3 | 20.9 |
| Wage Growth *(total economy)* | 5.7 | 2.0 | 0.0 | 0.0 |
| **External Accounts** | | | | |
| Current Account (% GDP) | -6.1 | -6.0 | -4.3 | -4.1 |
| Net FDI (EUR bn) | 1.2 | 1.2 | 1.3 | 1.3 |
| FDI / Current Account (%) | 57.1 | 60.0 | 92.9 | 92.9 |
| FX Reserves (EUR bn) | 11.2 | 9.9 | 10.6 | 11.5 |
| **Domestic Credit** | **2011** | **2012** | **2013** | **2014** |
| Total Credit (%GDP) | 58.3 | 62.8 | 57.0 | 61.5 |
| Credit to Enterprises (%GDP) | 29.9 | 31.2 | 26.1 | 25.0 |
| Credit to Households (%GDP) | 17.7 | 18.2 | 17.4 | 18.7 |
| Private Sector Credit (yoy%) | 5.7 | 9.5 | -4.8 | 0.5 |
| Loans to Deposits (%) | 137.6 | 141.3 | 132.6 | 130.6 |
| **Financial Markets** | **Current** | **3M** | **6M** | **12M** |
| Policy Rate | 4.50 | 4.00 | 4.00 | 4.00 |
| EUR/RSD | 120.00 | 122.00 | 123.00 | 124.00 |

*Source: National Authorities, EC, IMF, Eurobank Research*

FIGURE 25: **Austerity measures weigh on private consumption (3MMA)**


*Source: National Authorities, EC, IMF, Eurobank Research*

FIGURE 26: **Inflation remains below NBS target over recent months**

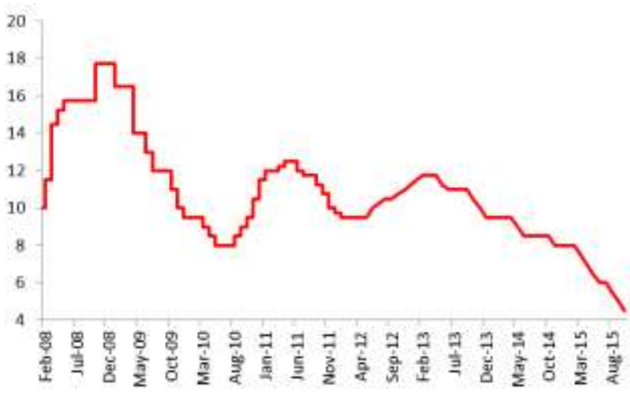



*Source: National Authorities, Eurobank Research*

FIGURE 27: **Industrial production recovery continues (3MMA YoY %)**


*Source: National Authorities, EC, IMF, Eurobank Research*

FIGURE 28: **NBS cuts interest rates to new record low in October**




*Source: National Authorities, EC, IMF, Eurobank Research*

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