Eurobank Research

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Global Macro Themes & Market Implications for the EA Periphery and the CESEE

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I. Snapshot

Overview

Macro Picture

- **USA:** Q1 deceleration probably temporary amid expectations for a positive impact of expansionary fiscal policy
- **EA:** Temporary headwinds to Q1 GDP growth to fade from Q2 onwards
- **UK:** Growth to remain lackluster; Brexit jitters prevail, weaker house prices should offset the expected improvement in real income growth inflation
- **EM:** Growth momentum remains strong as recovery in Russia and Brazil picks up pace; modest deceleration in India and China
- **CESEE:** Economic sentiment near recent highs in 4M-2018

Policy Outlook

- **USA:** Continuation of gradual monetary tightening, with at least two more rate hikes expected by year end
- **EA:** Gradual normalization process to continue, QE likely to end by end-2018. No exit announcement before July
- **UK:** The long awaited May BoE rate hike likely to be postponed
- **CESEE:** Different inflation paths allow for divergent monetary policies across the region

Summary

Q1 GDP data from several countries around the world reported a slowdown in economic activity. However, this may be due to adverse temporary factors that should fade in Q2. Protectionism and geopolitics have moved centre stage. Higher oil prices pose upside risks to global inflation

Markets

- **FX:** EUR/USD broke below 1.20 with the USD rally having further legs on rising US real yields and global growth concerns
- **Government bonds:** US rates sold off with a dovish ECB and weak EZ data pushing the yield differential to new highs. FOMC was a nonevent but the Fed acknowledged its inflation target is practically met allowing for some overshooting
- **EM:** EM spreads moderately widened in April, reflecting the rally in US rates and FX moves, as well as potential US-China "trade war" thematic. Strong data/growth should be supportive going forward
- **Credit:** Credit spreads mostly stabilized in April though supply also receded helping cash to find a floor. HY was the main performer with spreads tightening across the spectrum, especially in EUR space

Key Downside Risks

- **Higher than expected rise in inflation:** Steeper path of monetary policy tightening
- **Persistent surge in volatility:** Significantly tighter financial conditions push the global economy into a downturn
- **Sharper than expected slowdown in China:** Investment continues to slow on deleveraging measures in SOEs while fiscal policy remains tight
- **Escalation of trade frictions:** US imposition of tariffs fuels global trade war with negative repercussions on the world economy

Macro Views

Latest Macroeconomic Developments & Outlook

World Economic Outlook		Global leading indicators have softened since the beginning of 2018, with global manufacturing confidence surrounded by increased trade war fears and geopolitical risks. Adding to this, global trade growth has likely peaked at the start of the year partially due to the completion of the inventory accumulation. Nevertheless, global leading indicators are still consistent with a robust growth pace in most advanced and emerging economies. Inflation pressures have been persistently low, although there is scope for a gradual acceleration. Overall, global GDP growth is expected to accelerate to 3.9% in 2018 and 2019 from 3.7% in 2017, supported by accommodative financial conditions and expansionary US fiscal policy, with the main downside risks coming from the escalation of trade disputes.
Developed Economies	**US**	Q1 GDP growth deceleration was likely a payback following the post-hurricane surge in autos sales late last year. We view this downtrend as transitory, as the significant fiscal stimulus –incl. the US Tax Cuts & Jobs Act and the rise in government spending limits over the next two years- should give a boost to US real GDP growth in the coming quarters. Overall, we maintain our forecast of 2.8% in 2018 from 2.3% in 2017, before moderating slightly to 2.6% in 2019.
	Euro Area	Temporary factors -bad weather conditions, strikes and residual calendar effects due to the impact of a late Lunar New Year in Asian economies - have taken their toll on Q1 real economic activity. We expect the effect of temporary headwinds to fade from Q2 onwards, with Euro area GDP growth expected to accelerate marginally from 2.4% in 2017 to 2.5% in 2018 -its fastest annual pace in over a decade- with both monetary and fiscal policies supporting the recovery.
	Periphery	Favored by strong global growth and the ECB's ongoing accommodative monetary policy stance, periphery euro area economies continued to expand in Q1 2018 but at a slower pace than in late 2017. Spain was a star performer despite the Catalan political situation and the broader Eurozone slowdown thanks to a wide range of structural reform. In Italy, political crisis deepened after the latest developments raised the risk of snap elections to be held in July or in autumn under the current voting system.
Emerging Economies	**BRICS**	Last year's positive growth trends continued in the onset of 2018 in China, with Q1 GP coming in at 6.8%YoY. Some deceleration later in the year is expected to push full-year growth towards the official target of ca. 6.5%, as the pace of increase in the property sector and exports decelerates. Trade tensions with the US remain a key risk for the Chinese economy. Economic recovery to gain momentum in Russia on higher oil prices. Growth in India to slowdown this year but pick up pace in the next, while Brazil's seen modestly accelerating after returning to positive readings in 2017.
	CESEE	With the visible exception of Romania, economic sentiment releases for the economies of the region either reached new or stayed close to multi-month highs in the first four months of the year on average. Those readings reinforce our earlier views that regional economies are about to or have already reached their cyclical peak. The rising trend of headline and core inflation is uneven across the region allowing for divergent regional Central Bank monetary policies.

Global Macro Themes & Implications

Theme	Implications
Growth in both the US & euro area likely to remain strong despite Q1 GDP slowdown	Q1 GDP data from several countries, including the US and Eurozone, reported a slowdown in economic activity. According to the advance estimate, US Q1 GDP decelerated to 2.3%QoQ saar from 2.8% in the prior quarter largely due to a slowdown in household spending on durable goods following a surge in auto sales late last year related to storm-induced damages. In the euro area, flash GDP decelerated to 0.4%QoQ, the slowest growth since Q3 2016, compared to a quarterly average growth of 0.7% in 2017 (expenditure breakdown due on 15 May). However, the softness in growth is likely to prove transitory. US fiscal stimulus is looming and is expected to be felt as soon as in Q2, while, in the euro area, surveys data for April suggest room for continuing solid growth above potential rates.
Higher oil prices pose upside risks to global inflation	Posing upside risks to global inflation, Brent crude oil price hit a fresh 3 ½ year peak of $77.20/br on 9 May amid a fresh flare up in geopolitical concerns in the Middle East. US President Donald Trump announced in a televised speech his decision to withdraw the US from the Joint Comprehensive Plan of Action (aka Iran nuclear deal) that was agreed in July 2015, calling it a "decaying and rotten structure". He also announced the re-imposition of a wide range of sanctions that were waived under the accord in January 2016, most notably on the petroleum sector, after the expiry of 90-and 180-day wind-down periods (ending on August 6 and November 4, respectively). In addition, Venezuelan has lowered oil production much more than the oil output cut agreement envisioned while Saudi Arabia insists on strict adherence to the cuts, explicitly seeking oil as high as $80 or even $100 a barrel.
US inflation has begun to pick up	US inflation has begun to pick up over the last few months, while higher wages, above trend economic growth and highly expansionary fiscal policy suggest that the rising pace in inflation is likely to maintain through year-end. Among others, the Employment Cost Index — carefully tracked by the Fed as a gauge of underlying pay pressures—rose to a ten-year peak of 2.7%YoY in Q1 2018 compared to an increase of 2.4%YoY in the same quarter a year earlier. Wages and salaries, which make up about 70% of compensation costs, increased 0.9%QoQ -the highest in a year- and 2.7% in annual terms -the highest since Q3 2008. Reinforcing confidence that inflation is moving back to target, core PCE price index soared from 1.6%YoY in March to 1.9%YoY in April, the biggest increase since February 2017, and within distance from the Fed's 2.0% inflation target.

Global Macro Themes & Implications

Theme	Implications
Fed remains on a gradual tightening path	The Fed left unchanged the federal funds target rate and balance sheet policies at the 1-2 May monetary policy meeting, as expected, while tweaks to policy-relevant references in the accompanying statement were modest. Language on economic activity was modified to acknowledge the slowdown in Q1 economic activity. On the inflation front, the wording was adjusted to mirror the committee's increased confidence that inflation is moving back to target. The Fed removed the sentence saying that it is monitoring inflation development closely and acknowledged that year-on-year headline and core PCE inflation have "*moved close*" to 2%, a significant departure from the previous statement saying that these measures "*have continued to run below 2%"*. More importantly, the Fed introduced the term "*symmetric*" target, recognizing the potential inflation to move above target and suggesting that it could tolerate a modest overshoot of inflation above target after years of underperformance. The forward guidance part of the statement was left unchanged, with the Fed reiterating that "*economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate*". All in all, modestly higher rates of inflation alone will not alter the Fed's gradual pace of policy normalization, while persistent and upside surprises in inflation are probably needed for the Fed to accelerate its rate tightening path.
ECB: Euro area Q1 GDP warrants monitoring **QE exit announcement not likely before July**	As expected, the ECB retained its monetary policy stance at the 26 April policy meeting and kept unchanged the forward guidance on interest rates, QE and reinvestment. In the press conference, President Mario Draghi acknowledged that "*the latest economic indicators suggest some moderation in the pace of growth since the start of the year*" stating that this may partially reflects slowdown in growth indicators from a strong acceleration late last year or may be driven by adverse temporary factors. He cautioned that the soft patch recorded in Q1 warrants monitoring but the ECB's overall assessment was little changed, with Mario Draghi expressing the Governing Council's confidence that growth deceleration will prove temporary and economic recovery will remain solid and broad-based, ultimately pushing inflation back towards target. That said, the ECB needs time to assess whether the Q1 slowdown is just a normalization from late last year's fast growth or is the beginning of a more pronounced decline in economic activity. Against this background, the ECB may wait until the July 26 policy meeting to announce its intentions for the asset purchases programme beyond September 2018.
Persistently subdued euro area inflation pressures; short extension of QE highly likely	Euro area March inflation came in weaker than expected, supporting the view that underlying inflation pressures remain subdued. Headline inflation confounded expectations for an unchanged reading in April falling to 1.2%YoY from 1.3%YoY in March in spite of higher energy price inflation and a rise in food, alcohol and tobacco inflation. More importantly, the core inflation rate dropped by 0.3ppts to a lower than expected 0.7%YoY, the lowest since March 2017, probably mainly due to temporary factors (i.e. Easter effects) as the major downward pressure came from services inflation. Persistently weak inflation pressures and uncertainty over whether the loss of growth momentum in Q1 2018 is temporary, or due to more fundamental factors, suggest that the ECB will retain a dovish tone for the time being, and a short and smaller taper of asset purchases beyond September 2018 remains a highly likely scenario.

Macro Themes & Implications in CESEE

Theme	Implications
Economic sentiment near recent highs in Q1-2018	The economic sentiment index (ESI) releases of Q1-2018 for most of the economies of the region were relatively strong. With the visible exception of Romania, economic sentiment releases for the economies of the region either reached new or stayed close to multi-month highs in the first months of the year on average. As ESI readings are highly correlated with economic activity, those readings reinforce our earlier views that regional economies are about to or have already reached their cyclical peak
Private spending revival will most likely extend in 2018	Private consumption is expected to make a key-yet smaller than last year-contribution to GDP growth as real disposable incomes are expected to continue rising at a lower rate than last year reflecting reflecting the higher inflation and the moderation of wage growth against the backdrop of further labor market tightening, loose financial conditions, sustained consumer sentiment gains.
Trade wars: The risk of an escalation could have meaningful consequences on the growth prospects for the broader CESEE region	After having the best year in the post-Lehman brothers period in 2017, the economies of the broader CESEE region have come against a less favorable external environment in Q1-18. Currently, the exemption of EU from the US trade tariffs on steel and aluminum puts a cap on the direct consequences on the region's trade relationships and limits it down to non EU members (Russia, Turkey and Ukraine). Yet, the risk of an escalation in trade wars could put more pressure on world trade having more meaningful consequences on the growth prospects of the small open economies in the CESEE region.
Different inflation paths allow for divergent regional Central Banks monetary policies	The rising trend of core and headline inflation metrics is uneven across the region allowing for different degrees of freedom in the respective Central Banks' monetary policies. The majority of Central Banks in the region maintain their cautiously accommodative stance. From that point of view, the Central Bank of Serbia (NBS) cut interest rates further to 3.0% in mid-April. On the other hand, Romania is an outlier. NBR has already delivered 3 hikes of 25bps in the first four months of the year bringing the KPR at 2.5% given the inflation (expectations) jump, tightened liquidity and is expected to deliver at least one more in the next months.

CESEE Markets Developments & Outlook

Country	CESEE Markets Developments & Outlook
Bulgaria	• Bulgarian local-currency bonds have stayed well supported since the beginning of 2018. The corresponding yield curve experienced modest movements during April with the yield of the 8 year tenor increasing by 2.8 bps, while that of 9 year paper dropped by 2.6 bps. On the short end the 3 and 4 year yields dropped by 1.6 and 2.1 bps, respectively. The Bulgarian Ministry of Finance continued its recent policy and did not hold any auctions in April, while also not providing any indications of an offering in May. • Meanwhile, Bulgarian Eurobond yields experienced strong increases across the board over the last month or so with the exception of the 2023 paper, which saw their yield dropping by 1.3 bps. The longest maturity, namely, the 2035 paper, continued to see its yield rising by a hefty 8.1 bps increase, while the 2024 and 2027 papers showed a more modest spike of 1.9 and 2.8 bps, correspondingly.
Serbia	• As has been the case so far this year, the EUR/RSD remained bound within a tight range over the last couple of months. The pair continued to hover around 118.00-118.60 in most of March and April as ongoing interventions by the National Bank of Serbia (NBS) hindered any attempt below the range's lower bound, which would have been otherwise justified by the country's improving domestic macroeconomic fundamentals. In that respect, it has bought an amount slightly in excess of €700mn on a year-to-date basis in order to halt the dinar's upside momentum. The macroeconomic improvement is compatible with a stronger dinar, in theory. However, recent history suggests that Central Bank interventions will most likely be extended in the weeks ahead, with the NBS continuing to have very active role in the FX market and the EUR/RSD remaining bound within tight ranges. That said, NBS is unlikely to stand against some fundamentally backed trend appreciation. However, a fast pace of dinar gains may trigger a more dovish policy shift (although its already stretched) given the recent weak inflation, which currently stands just below bottom of the official inflation target band. • A quiet picture has also been evidenced over the last two months in fixed income, with trade in the front end of the yield curve appearing very thin. The recent NBS rate cuts appear to have had an impact mostly on paper of longer maturity, while yield increases were observed at the belly of the curve. We would not exclude another cut in the Central Bank's key policy rate, as we expect inflation to bottom out in April/May. This will especially holds should inflation ease further below the lower bound of the tolerance band target of 3.0+/-1.5%. That said, a move back within this range is likely to materialize late this year, which argues for stable interest rates in H2 2018.

Markets View

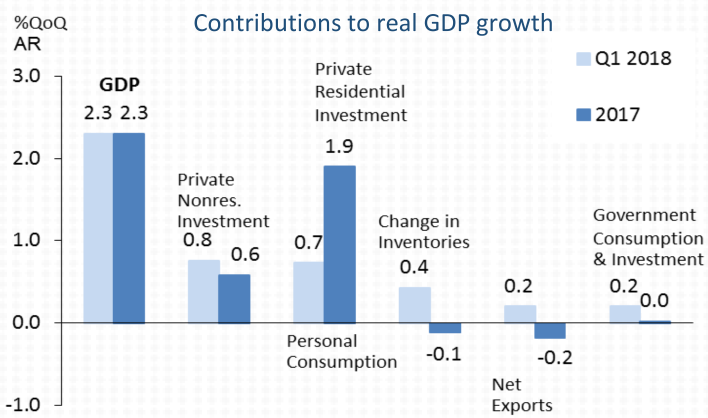
Asset Class	Outlook
Foreign Exchange	**EUR/USD**: Broke below 1.20 as rising UST yields and waning EZ economic data rotated into focus. The move was further exacerbated by the squeeze in short USD positions against a backdrop of negative realized returns. The flattening of the USD yield curve and the relative steepening of the EUR one has rendered a currency hedged investment in US bonds unprofitable offering further legs to the USD rally. **USD/JPY**: Rallied, taking out its 100 week MA at 109.51 and extending up to 109.92. Thin liquidity conditions also supported the move with the FOMC a nonevent and reports circulating that Mueller is considering the possibility of a Trump subpoena. In a broader sense, the JPY could find support amidst lingering risk aversion. This is on the basis of Abe/Trump's political scandals, US-Sino trade tensions (Nikkei reported that US wants to push China to address trade imbalance), NAFTA concerns and a the potential of a re-escalation of tariffs and trade wars. **GBP/USD**: Posted a strong first half in April only to pare gains and move to a 4 month low of 1.35 on renewed Brexit worries and a patch of soft economic data. PM May faced revolt from pro-Brexit ministers who sided with Tory hardliners to demand a clean break from the customs union. This was essentially a rejection of Brexit negotiator Robbins' hybrid UK-EU customs partnership plan, which May hoped would help solve the Irish border issue. With a May rate hike probability diminished to below 30% GBP looks likely to find little support.
Government Bonds	**US:** FOMC was a non event with the Committee for the first time acknowledging that inflation is virtually at target allowing for the potential of an overshoot. April saw USD rates selling off sharply with the 10y UST breaching 3.00% for the first time since 2013. The curve continued its aggressive flattening - more evident in swaps than cash – with some bear steepening timidly seen in the past few days due to the Fed's higher funding requirements and rising real yields. Increased supply, corporate repatriation and the rising costs of USD funding turning foreign investors to EZ assets should support the already sky high spreads between USD and EUR rates with faltering EZ growth and inflation posing a problem for the ECB. **EU:** The ECB meeting failed to halt the bull flattening in Bunds. Draghi appeared dovish not only in his comments on recent macro developments, but also in his response to the question on a potential rise in yields driven by USTs. A disappointing inflation print fueled the latest leg lower in yields with the ECB facing a weaker environment as it approaches the end of its QE. The forward swap curve still looks steep but the pricing of a 0 depo rate has been pushed from Nov 2019 to Jun 2020 with 28bps of hikes currently priced for 2019.
EM hard currency debt	Spreads tried to recover but ended wider in April. Specific stories like Russia, Turkey, Argentina and Ukraine, Hungary led the way with material widening, affected by name specific stories, increased volatility in developed markets and higher US rates/stronger USD. However, geopolitical and global policy risks though on the spotlight, have somewhat subsided, which has led to supportive flows mostly towards the end of month. Fundamentals remain supportive, while updated data on global growth and commodity prices should provide support for better sentiment going forward. Potential risk on the geopolitical front is any "trade war" escalation between US and China as well as EU, especially on manufacturing oriented EM economies. Overall EM credit remains rich but post recent widening we see tactical long trade opportunities. Further USD strength and increasing US rates remain the main risk for EM sovereign credit.
Corporate credit	After a poor first quarter, markets stabilized in April, led by a recovery in higher-beta paper; overall IG spreads were in € and $. The performance financial and non-financial sectors was very similar. HY outperformed on the back of a return to inflows, which led to a significant tightening as the global risk environment improved, albeit a reversal of some of the tightening in late April. Worries over a full-blown trade war receded, and there was a significant reduction of concerns on the Korean peninsula. Sanctions on Russia provoked turmoil in the EM corporate market, but the spillover was limited and country specific. The White House refrained from further escalation which helped the partial recovery of Russian corporate spreads. April's ECB meeting had little impact on spreads, while Draghi dismissed the reduction in purchases under the CSPP as seasonal variation, although it remains to be seen. Although we expect temporary tightening in spreads, our main view that the general trend is for moderate widening into year end. The short end of the USD corporate curve (1-5 years) remains our favorite place for taking credit risk.

II. Advanced Economies

- USA
- Euro Area
  - Periphery (Italy, Spain, Portugal, Cyprus)
- UK

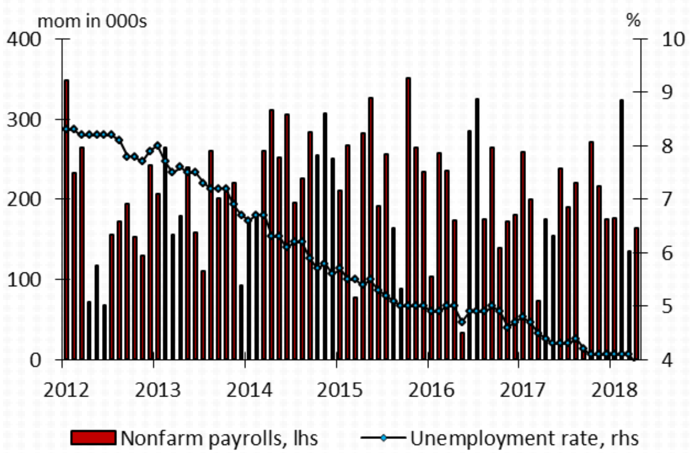
USA: Q1 deceleration probably temporary amid expectations for a positive impact of expansionary fiscal policy

Q1 deceleration largely concentrated in domestic activity



Strong April US employment report …

…bodes well for a June rate hike



Source: Bloomberg, BEA, BLS, Eurobank Research

Latest Economic Developments

Q1 GDP growth decelerated to 2.3%QoQ saar from 2.8% in Q4 2017, with domestic activity slowing to 1.6%QoQ saar from 4.5%. Consumer spending's reduced speed, mainly driven by a decline in durable goods consumption, was likely a payback following the post-hurricane surge in autos sales. On the flipside, net exports and inventories had a significant positive contribution to growth (+0.6pp), following a negative contribution of 1.7pp in the prior quarter. We view this trend as transitory, as the significant fiscal stimulus –incl. the US Tax Cuts & Jobs Act and the rise in government spending limits over the next two years- should give a boost to US real GDP growth in the coming quarters. On the inflation front, core CPI accelerated to 2.1%YoY in March from 1.8% in February, as the downtrend in wireless services fades, and we expect this trend to continue in the following months. Overall, we maintain our GDP forecast of 2.8% in 2018 from 2.3% in 2017, before moderating slightly to 2.6% in 2019.

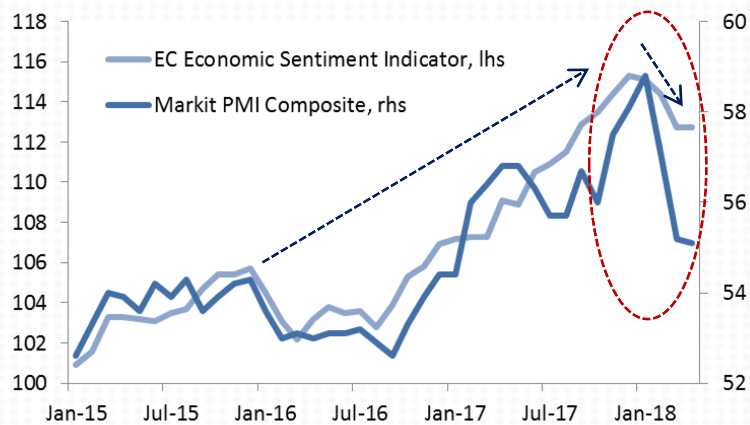
Central Bank Watch

The Fed maintained the target range for the fed funds rate unchanged at 1.50-1.75% at its May meeting, with the overall tone of the accompanying policy statement suggesting that the committee is inclined to gradually normalize monetary policy. Changes in the language regarding economic growth were consistent with the Q1 deceleration in domestic activity, with the Fed expressing its optimism over the US growth medium-term outlook and reiterating its assessment that risks appear "roughly balanced". Moreover, the statement that "the Committee is monitoring inflation developments closely" was omitted, while acknowledging that inflation rates "have moved close to 2%" and are "expected to run near the Committee's symmetric 2% objective over the medium term". The introduction of the word "symmetric" suggests that the Fed is probably willing to tolerate a modest overshooting of inflation above the target. Against this background, the Fed is widely anticipated to continue with a policy of gradual tightening monetary conditions, with at least two more rate hikes expected by year end.

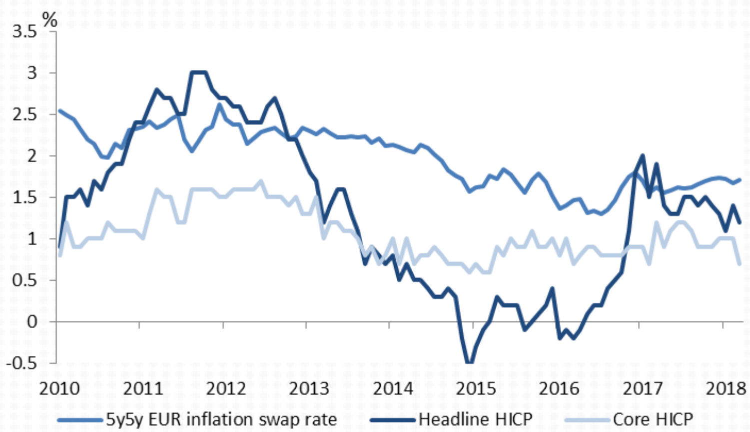
Euro area: The economy hits a soft patch in Q1; temporary or long-lasting?

Eurobank

Leading indicators have corrected from their late 2017 highs, but still consistent with well-above trend growth



Core inflation largely disappointed in April, mostly due to base effects on volatile components



Source: ECB, EC, Eurostat, Markit, Bloomberg, Eurobank Research

Latest Economic Developments

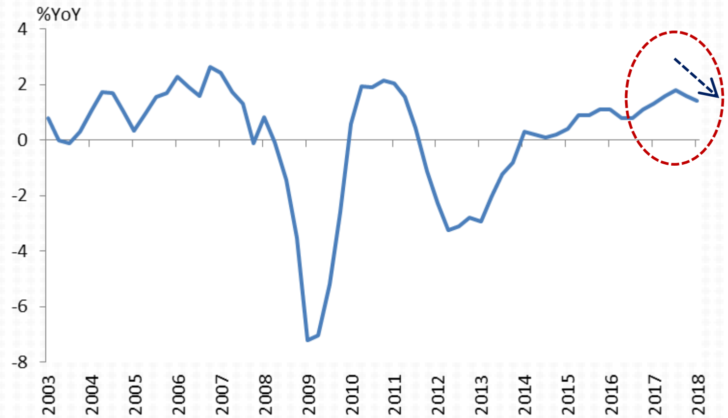
Euro area Q1 18 flash estimate revealed a growth deceleration to 0.4%QoQ from 0.7% in the prior quarter. Although a detailed breakdown of the components of GDP is not available yet (due on May 15), we believe that temporary factors such as bad weather conditions and strikes have taken their toll on real economic activity. Adding to this, euro area exports and industrial output data in Q1 have probably been artificially depressed by residual calendar effects due to the impact of a late Lunar New Year in Asian economies. Leading indicators -including PMIs and EC ESI- have recently corrected from their highs in late 2017 but are still consistent with well-above trend growth. We expect the effect of temporary headwinds to fade in Q2, with euro area economic growth rebounding towards 0.6-0.7%QoQ. Overall, we expect Euro area GDP to accelerate marginally from 2.4% in 2017 to 2.5% in 2018, its fastest annual pace in over a decade, with both monetary and fiscal policies supporting the recovery. Risks seem broadly balanced with protectionist US trade policy and geopolitics potentially weighing on confidence in the course of the year.

Central Bank Watch

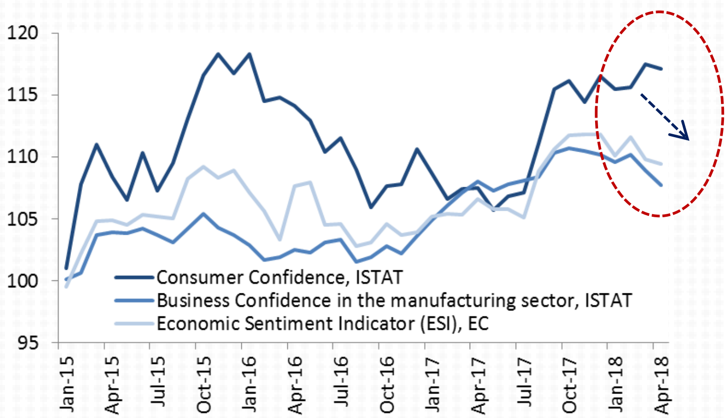
In line with market expectations, the ECB maintained its monetary policy stance i.e. forward guidance on interest rates, QE and reinvestment unchanged at its April meeting. In the press conference, President Mario Draghi acknowledged the moderation of Q1 economic growth and noted that this may be mostly driven by several adverse temporary factors, such as weather, strikes and the timing of Easter holidays. Nevertheless, the ECB President expressed uncertainty over whether much of this slowdown is more supply or demand driven and warned that, although risks surrounding the euro area growth outlook remain broadly balanced, risks related to trade protectionism have become more prominent. In sum, we expect that the ECB will likely provide at its July meeting a plan to taper its asset purchases to zero in the last three months of 2018, with an interest rate hike expected no earlier than mid-2019 following weaker-than-expected Q1 GDP and inflation data.

Italy: Politics take centre stage, with rising probability of snap elections

Real GDP growth has decelerated from its peak in Q3 2017



Leading indicators off their recent highs



Source: ISTAT, European Commission (EC), Bloomberg, Eurostat, Eurobank Research

Latest Economic Developments

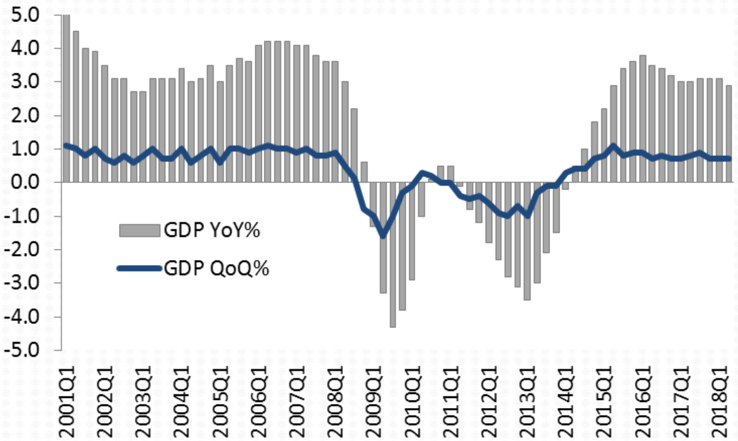
Real GDP increased by 0.3%QoQ in Q1, a similar pace as in the prior quarter, with domestic demand contributing positively and external demand being a drag on overall growth (the final breakdown to be released on 1 June). By sector, services and agriculture supported the overall print, while the manufacturing contribution was nearly flat. Italian composite PMI index softened gradually to a 15-month low of 52.9 in April from its recent high of 59.0 in January, albeit still pointing to steady but modest expansion. Services activity consolidated at 52.6 for a second consecutive month, while manufacturing activity slowed to 53.5 from 55.1 in March. Overall, we retain our view that real GDP is expected to decelerate to 1.4% in 2018 and 1.2% in 2019 from 1.5% in 2017, given the fact that there is no room left for fiscal expansion as the expected gradual tapering of the ECB's QE towards zero by the end of 2018 that could lead to an increase in the country's borrowing costs.

Italian politics update

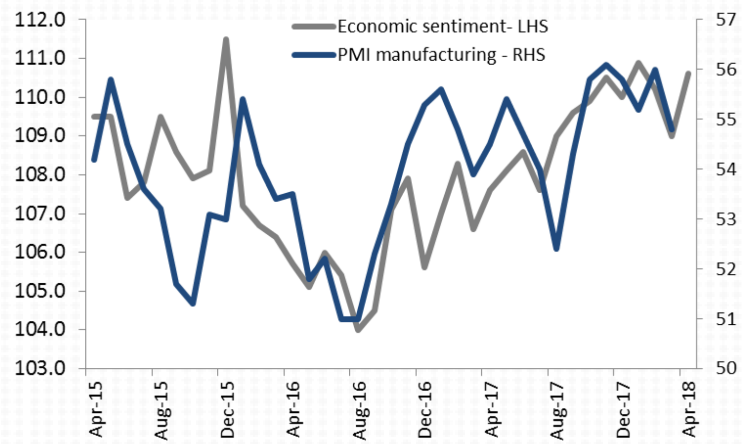
Following the failure of a third round of consultations between political leaders to form a government, President Mattarella announced on 7 May his decision to appoint a government of national unity. The primary aim of such a government would be to approve the 2019 budget law in the fall so as to avoid the VAT increase effective from 1 January 2019 (worth about €15bn), with President Mattarella emphasizing that the technocrat government would remain in office until year end at the latest and will resign if a political majority is achieved in the meantime. However, a temporary government may not get enough parliamentary support to win confidence votes in both Lower and Upper Houses after the two anti-establishment political parties -Lega (L) and M5S- have made clear that they'd prefer early elections. That said, the probability of snap elections over the next few months under the current voting system is rising, in July at the earliest, as the Italian constitution sets that elections for a new parliament can take place within 70 days from the end of the previous Houses' term.

Spain: Preliminary Q1 GDP data confirm continuing solid expansion

Spain's solid expansion continues



Survey data point to continuing healthy economic growth



Source: Eurostat, EU Commission, Bloomberg, Eurobank Economic Research

Latest Developments

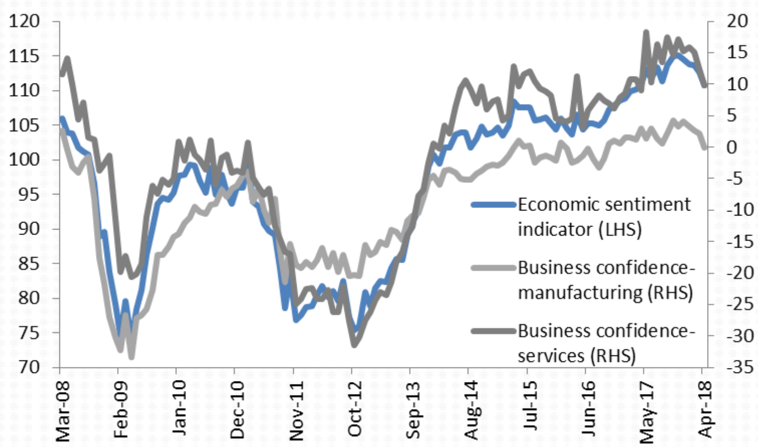
Spain's Q1 GDP grew by a preliminary 0.7%QoQ, a similar pace of growth to Q4 and Q3 2017 GDP, despite the Catalan political situation and the broader Eurozone slowdown over the same period thanks to a wide range of structural reforms, easier fiscal policy, highly expansionary ECB monetary policy and a stronger banking sector. The expenditure breakdown will be released on 31 May but domestic demand is expected to continue to be the main driver of growth mostly supported by rising real disposable income, easy financial conditions and improving labor market conditions. The unemployment rate rose in Q1 2018 for the second quarter in a row to 16.7% from 16.6% in Q4 2017 on the back of a slowdown in permanent job creation in the services sector, but still close to a nine-month low of 16.5% recorded in Q3 2017. The European Commission's economic sentiment improved in April by 1.6 to 110.6, within distance from January's 17-yr high of 110.9. In a similar vein, the Markit Composite PMI slipped to 55.8 in March from a seven-month high of 57.1 in February, but still well above the 50-point threshold pointing to an ongoing improvement in business activity. Meanwhile, trade data released so far suggest that the external sector also contributed to Q1 2018 GDP growth after an anemic performance in Q4 2017.

Catalonian Politics Update

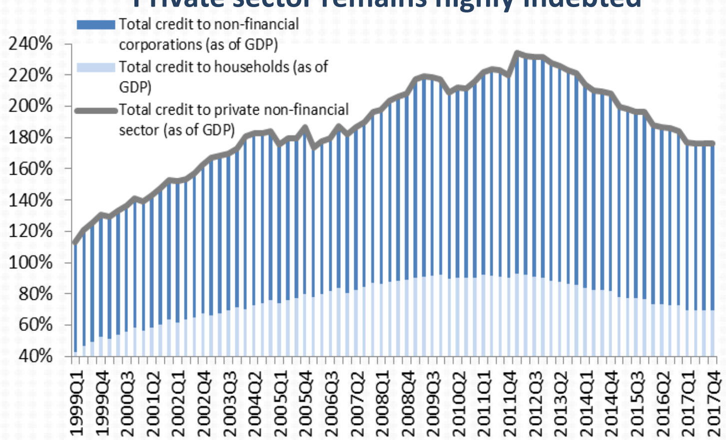
With less than two weeks to go to the deadline for the new elections in Catalonia (22 May), pro-independence parties that secured a majority of seats in the regional parliament have not yet agreed on whom to elect as the next first minister. The arrest of former First Minister Carles Puigdemont in Germany in late March, and a German court's rule thereafter not to extradite him on rebellion charges, did not help to break the political deadlock in the region. Meanwhile, Spain has been left without a budget for 2018 as the PP-led minority government lacks the necessary support in parliament. Whereas the Cuidadanos party has signaled that it may vote in favour, the Basque Nationalist Party (PNV) is also likely to cast a positive vote on 24 May when the final vote is scheduled on the view that by then, the Catalan impasse will have been resolved.

Portugal: Q1 2018 economic growth likely moderated slightly

Leading indicators signal a moderation of growth



Private sector remains highly indebted



Latest Economic Developments

Data for Q1 2018 suggest that economic growth remained strong, though at a somewhat slower pace than 0.7%QoQ in Q4 2017 and a 0.6% quarterly average growth rate in 2017 (Q1 2018 GDP preliminary data scheduled for 15 May). With respect to hard data, the most notably sign of moderation came from industrial production growth which decelerated to 2.0%YoY in Q1 2018 from 2.5%YoY in Q4 2017. Survey-based data also support the view that the underlying growth has probably eased. Economic sentiment dropped in April for the fifth month in a row to a one-year low of 110.8 and 4.3 points below last November's 17 ½- yr peak. Along these lines, the business climate indicator in the manufacturing sector moved into negative territory in April for the first time since September 2016 and business confidence in the services sector deteriorated for the third month in a row coming in at an one-year trough of 9.8. However, albeit more moderate, 2018 is expected to be another year of solid growth. The external environment remains supportive, including Spain, one of Portugal's major trading partners while private consumption holds up well (retail trade up 5.1%YoY in Q1 vs. 4.4%YoY in Q417) mainly thanks to easy financing conditions and an improving labour market. The unemployment rate remained in a downward trend in March for the 18th consecutive month falling to 7.4%, the lowest since April 2004 after hitting a multi-year peak of 17.5% in early 2013. Strong economic performance has been accompanied by strong fiscal performance with budget deficit –ex. bank recap- falling at 0.9%-of-GDP in 2017, below 0.5%-of-GDP official target. In 2018, the budget deficit is expected to narrow further to 0.2%-of-GDP. According to its stability program for 2028-2022 presented in mid-April, the government expects a budget surplus of 0.7%-of-GDP in 2020 that, if achieved, would end 25 consecutive years of uninterrupted deficits.

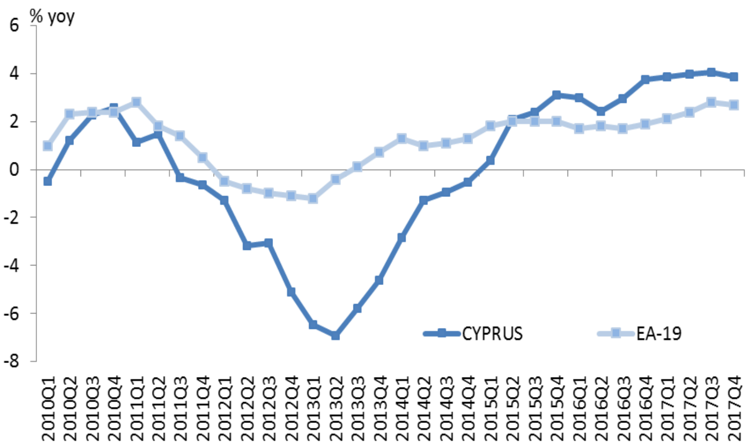
Private debt & banking sector : Portugal's key medium-term downside risks

Portugal's private sector —especially corporations— remains highly indebted despite having deleveraged over the past five years. Challenges also remain for the banking sector mainly due to the elevated level of non-performing loans and weak profitability.

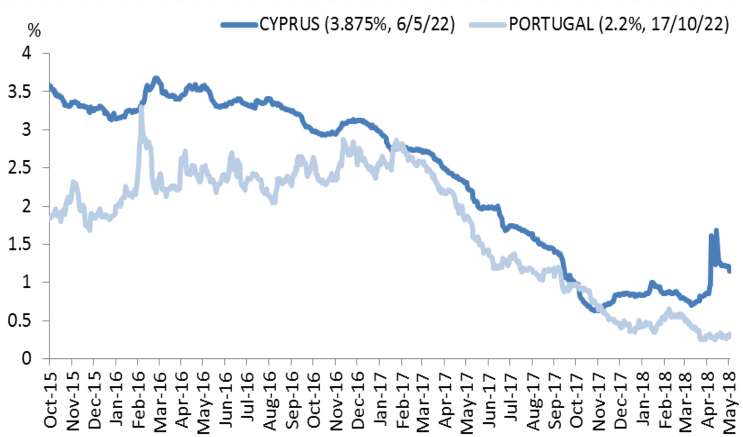
Source: European Commission, ECB, Statistics Portugal, Eurobank Economic Research

Cyprus: Banking sector woes resurface

Cyprus turn-around growth story has been impressive so far



Cypriot medium term bond yields spiked in mid-April on renewed banking sector concerns



Source: Eurobank Research, National Authorities, Bloomberg

Latest Political & Economic Developments

Market attention has turned to the rapidly evolving case of Cyprus Co-operative Bank (CCB), the second largest bank in terms of assets. The State initiated the privatization of CCB and placed a sizeable deposit in the bank to increase its liquidity. On March 19th, CCB provided access to a virtual data room in order to attract private investors. Recall, that CCB was the only bank which received €1.5bn state aid in 2013 plus another €175mn in 2015. On April 4th, Cyprus issued a number of 15-20Y government bonds of total nominal value of €2.35bn at market terms with the right for early redemption. Thereafter, the government placed a deposit of €2.5bn in the CCB and took in exchange €7.6bn in collateral (mostly NPEs) for the deposit. The transaction aimed at fully guaranteeing all deposits from any theoretical risk.

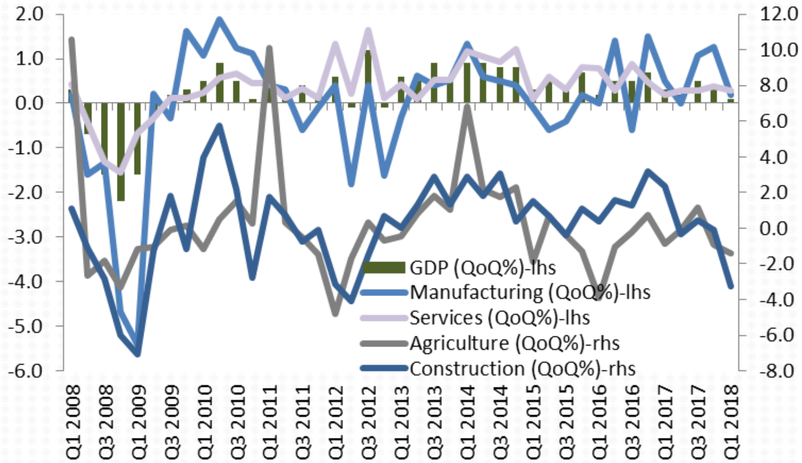
Despite the intense restructuring efforts of the banks, the NPEs ratio still remains at relatively high levels, the second highest in the Euro Area behind Greece. The stock of NPEs declined by €3.2bn in FY2017 compared to €2.9bn in FY2016, bringing the stock of NPEs down by 24.5% between Dec2014-Jun2017. At the same time, total exposures decreased by €3.3bn (to €47.1bn in 2017), resulting in the ratio of NPEs to total facilities decline to 43.7% in Dec2017 compared to 47.2% in Dec2016. The NPEs as a percentage of GDP stood at 107.1% in Dec2017 down from 130.7% in Dec2016.

Risks & Challenges

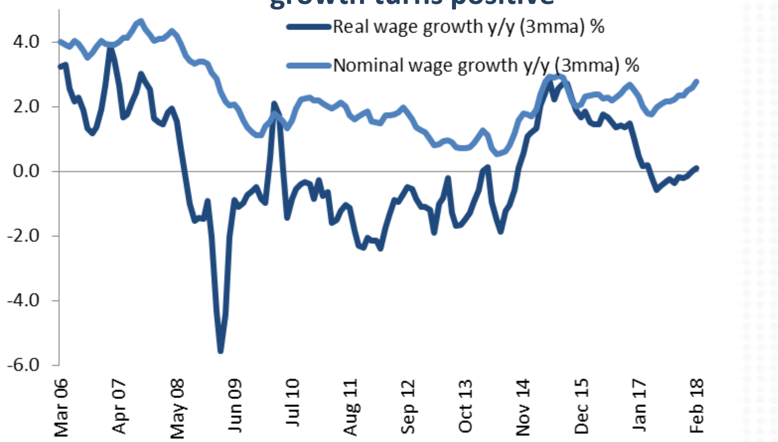
Given that no party enjoys absolute parliamentary majority, the new President will have to achieve concessions from other parties in the 56-seat parliament in order to pass legislation. This is not very reassuring given that there is a number of important pending structural reforms in the areas of privatizations, public and health sectors, while addressing the challenges of a still high bad loans stock. From that point of view, the government is under increasing pressure to strengthen the insolvency and foreclosures framework.

UK: Q1 2018 GDP slows to the lowest since end-2012

Q1 2018 GDP slows to the lowest since end-2012



Nominal wage growth continues to accelerate, real wage growth turns positive



Source: ONS, Eurobank Economic Research

Latest Economic Developments

According to the preliminary estimate based on the output approach, Q1 GDP 2018 slowed from 0.4%QoQ in Q4 2017 to 0.1%QoQ, the slowest since end-2012 and below the BoE's projection of 0.3%QoQ. The largest downward pressure came from construction while the services sector was the largest contributor to GDP growth with the ONS highlighting that the overall effect of adverse weather conditions was generally limited. Adding to the recent string of disappointing UK data, retail sales recorded in Q1 the biggest quarterly decline in a year, services PMI bounced less than expected in April and consumer confidence remained in April in negative territory for the 28th month in a row. On a positive note, the unemployment rate dropped by 0.1pp to a new 42-year low of 4.2% in the three months to February, the 3-month average of regular pay growth (average weekly earnings ex. bonuses) continued to accelerate rising by 0.2pp to 2.8%, the highest since August 2015, and real wage growth turned positive at 0.1%YoY for the first time in a year. While Q2 GDP growth is likely to improve as weather effects fade and Eurozone growth is anticipated to reaccelerate –the UK's main trading partner— for the whole year 2018 we expect UK GDP growth to drop to 1.5% from 1.8% in 2017. Tightening credit conditions should dampen domestic consumption and weaker house price growth should offset the expected slight improvement in real income growth, while Brexit jitters are expected to continue to exert a negative impact on investment. Whereas the two sides reached a consensus on large parts of the withdrawal agreement at the 23 March European Council summit, a number of difficult issues have yet to be resolved including the Northern Ireland border (Brexit negotiations resumed on 2 May).

BoE Watch

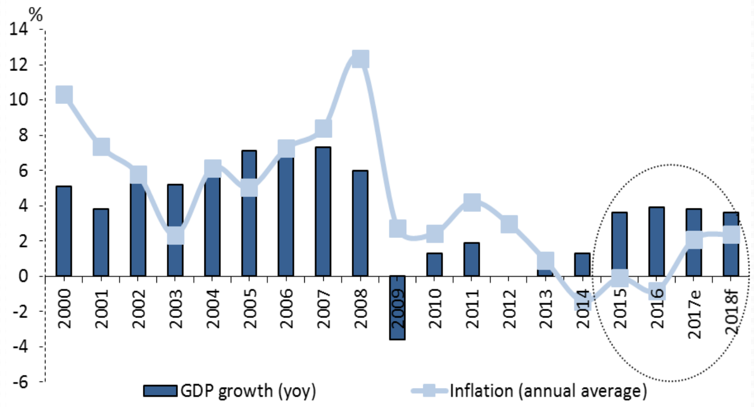
The recent string of disappointing UK hard and soft data, a bigger than expected drop in CPI inflation to 2.5%YoY in March and dovish comments by BoE Governor Mark Carney in mid-April suggest that the long-awaited rate hike at the 10 May MPC meeting may be postponed to a later date. The likelihood of a 25bps hike in May is now priced in (as of early May) with a probability of around 10% compared to 90% about a month earlier.

III. Selected CESEE economies

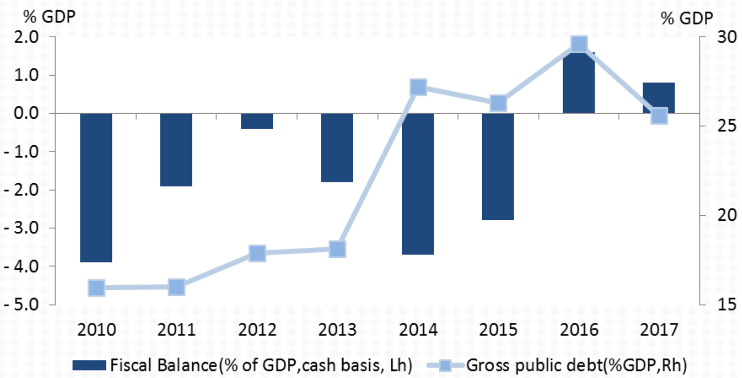
- Bulgaria
- Romania
- Serbia

Bulgaria: Further labor market tightening in Q4-2017

Growth dynamics are set to remain strong in 2018



Bulgaria's fiscal position is sound and fulfills the nominal criteria for Euro area entry



Source: Eurobank Research, National Authorities

Latest Economic Developments

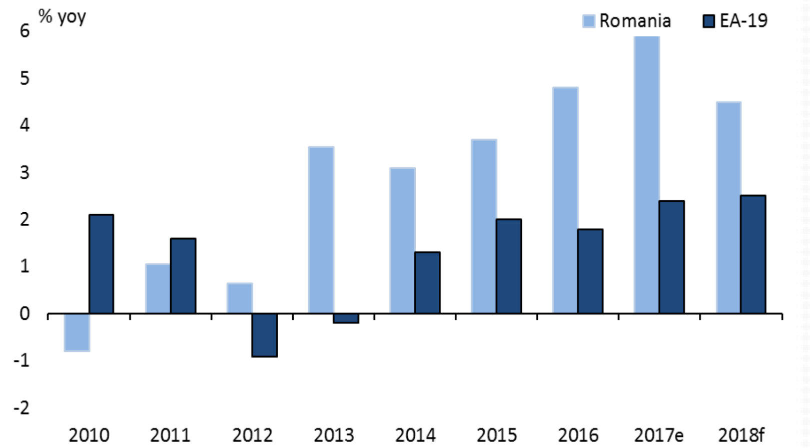
Unemployment declined to 5.6% in Q4-2017 (down to comparable levels back in Q2-2008) vs 6.1% in Q3-2017 and 6.9% in Q4-2016. At the same, time employment has been expanding briskly by 5.1% YoY in Q4 vs. 5.2% YoY in Q3 compared to -1.7% YoY in Q4-2016. Overall, the economy has added another 133,5 thousand more jobs in 2017, the highest number in the post-Lehman period. From a sectoral point of view, the labor-intensive international non-tradable sectors such as construction (+19.5k), retail and whole sale trade (+26.6k) took the lead in job creation. Yet, tradable sectors such as manufacturing (+12.9k), agriculture (+17.3k), logistics (+14.4k) and accommodation services (+11.7k) recorded also sizeable gains. Although from a cross-country comparison, Bulgaria is still lagging behind its peers, the employment rate of people aged 20-64 climbed to 71.5% in 2017 against a national target of 76% in 2020, 3.6 ppts higher than in 2016 compared to only 63.0% in 2012. The economy is operating at or close to full employment (the relevant % of companies reportedly confronted with labor scarcity in the EU survey has climbed to 40% in Q4-2017 up from only 13% in Q4-2013). The labor market tightening has led wages to rally-albeit from a very low base-by 5.6% QoQ/+10.6% YoY in Q4.

Risks & Challenges

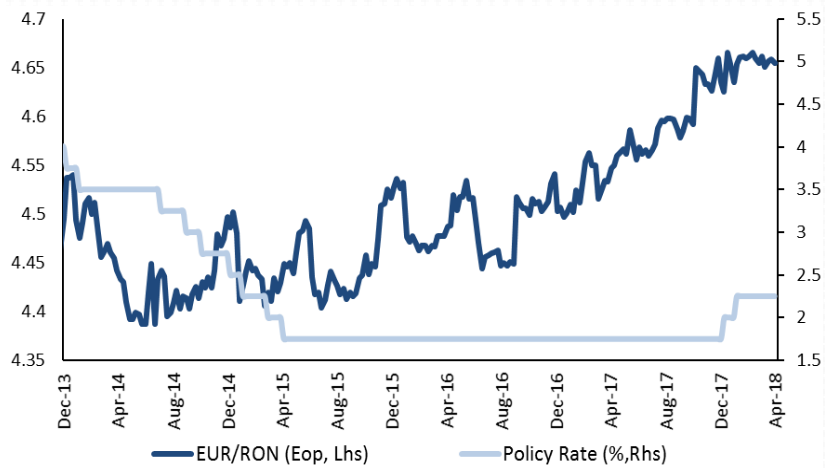
Currently, Bulgaria fulfills most of the nominal convergence criteria for Euroarea entry. Real convergence criteria are not satisfied, although officially these are not part of the evaluation procedure. The living standards and productivity are the lowest in EU-28. The country is still subject to the Co-operation and Verification mechanism, which was set up in 2007 to monitor progress in the fields of judicial reform, corruption and organized crime. Factoring in the fast GDP growth trajectory in 2015-2018, GDP per capita in PPS terms will have only climbed to 50% in 2018. Finally, IMF in its latest Article IV report sees GDP growth moderating to 2.75% over the medium, reflecting capacity constraints and unfavorable demographics.

Romania: NBR tightened monetary condition further

Romania has been growing faster than EA-19 in 2013-2018



NBR hiked the KPR by 75bps cumulatively so far in 2018



Source: Eurobank Research, National Authorities, Bloomberg

Latest Economic Developments

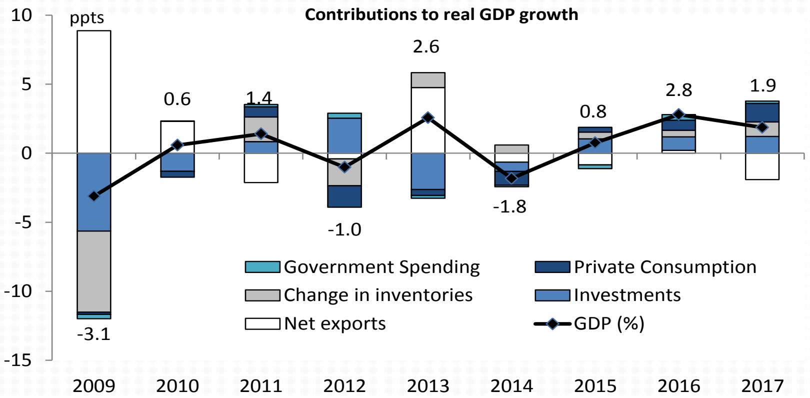
In early May, the NBR decided to increase the key policy rate (KPR) by another 25 bps to 2.50%, maintained MRRs for both FX and RON denominated liabilities at 8% in an unanimously endorsed by board members decision. The NBR decision came in the aftermath of headline inflation reaching a new five year high (5.0% YoY in March up from +4.7% YoY in February), in a move further above the upper bound of the NBR's target interval (2.5+1%). The adjusted Core CPI (excluding administered and volatile prices, alcohol and tobacco) index also increased over the same month, to 3.0% YoY from 2.9% YoY in February, marking the highest level since June 2013, in an illustration of underlying demand side pressures. NBR has delivered three 25bps rate hikes so far this year, having surprised market expectations in the previous meeting in early April staying put on its monetary policy. Nevertheless, the NBR announced and held in mid-April a one week tenor deposit tender for banks for the first time since Jan2011. The liquidity absorbing operation, a de-facto tightening tool, had mopped out RON18.7bn from the money market at a rate of 2.55%. At that time, we had thought that this move would be enough to buy some more time for NBR to assess the situation and deliver more KPR hikes later in the year. In the wake of yesterday's decision, we see room for one more hike by the end of the year, provided that there is no other unexpected supply side shock.

Risks & Challenges

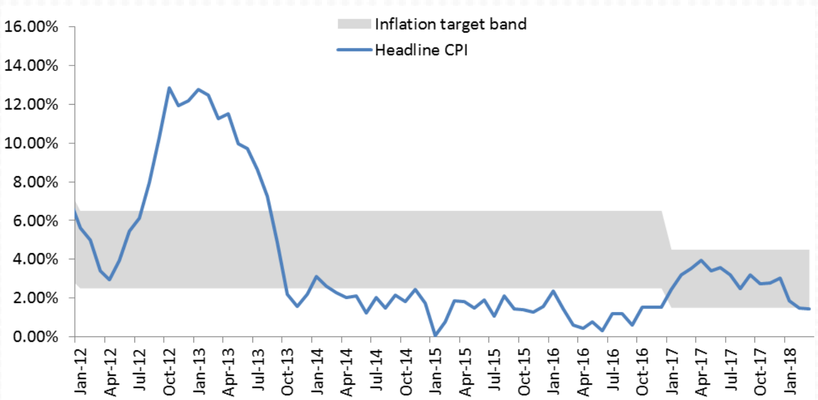
Risks are centered around the impact of current pro-cyclical and pro-consumption expansionary fiscal policies on the medium-term prospects. Running sizeable fiscal deficits coupled with low public investment spending is exacerbating inflationary pressures undermining not only the competitiveness and the growth potential of the country but also its ability to withstand an external shock. To make things worse, the tensions within the ruling PSD party threaten political stability and have a negative impact on the consistency and efficiency of implemented policies.

Serbia: Real GDP growth of 4.5%YoY in Q1 the highest in a decade

Economic recovery driven by domestic demand



Inflation pressures remain subdued



Source: Eurobank Research, National Authorities

Latest Economic & Political Developments

As most recent high frequency macroeconomic data and sentiment indicators for Q1 2018 had suggested, economic activity kicked off the year on a positive footing, with real GDP growth of 4.5%YoY, the fastest rate of annual growth in a decade. The data exceeded expectations and outpaced a 2.5%YoY increase in Q4 2017. It also marks a reversal of last year's H1 2017 soft patch that came primarily on the back of adverse weather conditions. The positive trends witnessed in Q1 2018 will likely remain in place in the coming months, boosting domestic demand. Taking into account the strong Q1 GDP reading, risks to our full year 3%YoY forecast appear tilted towards the upside.

Central Bank Watch

The National Bank of Serbia cut the key policy rate (KPR) by 25bps to a new record low of 3.00% at its meeting in April, confounding expectations for stable rates and narrowed the interest rate corridor from ±1.5 to ±1.25ppts maintaining the deposit facility rate unchanged. Behind its decision, the MPC cited weak inflationary pressures, anchored inflation expectations and a stronger than earlier anticipated slowdown in inflation over the last three months, adding that the move will provide additional support to credit activity and economic growth. Indeed, headline CPI eased to a 1 ½-year low of 1.4%YoY in March, below the 3.0±1.5% tolerance band, while the corresponding core index reached a new record low over that month and the dinar recently hit 3 ½ year highs, providing some indirect tightening effect on monetary conditions. The MPC noted that it anticipates inflation to stay around current levels in the months ahead and move closer to the target midpoint in 2019 amid strengthening domestic demand dynamics albeit risks linger. The MPC will likely stay put on its monetary policy until year-end, as the recent retreat in inflation is mostly driven by temporary factors – namely, base effects – and is expected to eventually move higher.

IV. Eurobank Forecasts

Eurobank Macro Forecasts

	Real GDP (YoY%)			CPI (YoY%, avg)			Unemployment rate (% of total labor force)			Current Account (% of GDP)			General Budget Balance (% of GDP)		
	2017	2018f	2019f	2017	2018f	2019f	2017	2018f	2019f	2017	2018f	2019f	2017	2018f	2019f
World	3.7	3.9	3.9	3.0	3.4	3.3									
Advanced Economies															
USA	2.3	2.8	2.6	2.1	2.3	2.2	4.4	3.9	3.5	-2.4	-2.7	-2.8	-4.9	-5.3	-5.9
Eurozone	2.4	2.5	2.0	1.5	1.5	1.6	9.1	8.4	7.9	3.5	3.4	3.4	-0.9	-0.7	-0.6
Germany	2.2	2.3	2.1	1.7	1.6	1.8	3.8	3.6	3.5	8.0	7.9	7.6	1.3	1.2	1.4
France	1.8	2.0	1.8	1.2	1.7	1.4	9.4	8.9	8.3	-3.0	-2.9	-2.7	-2.6	-2.3	-2.8
Periphery															
Cyprus	3.9	3.9	3.6	0.7	0.5	1.0	11.1	9.5	8.0	-6.7	-7.1	7.8	1.8	1.7	1.7
Greece	1.4	1.8	1.8	1.1	0.7	1.1	21.5	19.8	18.0	-0.8	-0.4	-0.5	0.8	0.4	0.2
Italy	1.5	1.4	1.2	1.3	1.2	1.4	11.2	10.8	10.6	2.8	2.6	2.6	-2.3	-1.7	-1.7
Portugal	2.7	2.1	1.9	1.6	1.4	1.4	9.0	8.0	7.5	0.4	0.7	0.5	-1.4	-1.2	-1.2
Spain	3.1	2.8	2.3	2.0	1.7	1.3	17.2	15.0	13.5	1.7	1.3	1.0	-3.1	-2.4	-2.0
UK	1.8	1.5	1.2	2.7	2.5	2.3	4.4	4.5	4.5	-4.1	-4.3	-4.1	-2.7	-2.4	-1.7
Japan	1.7	1.3	1.0	0.5	1.0	1.1	2.9	2.8	2.7	4.0	3.8	3.7	-4.2	-3.3	-2.8
Emerging Economies															
BRICs															
Brazil	1.0	2.4	3.0	3.5	4.0	4.2	12.9	11.8	11.0	-0.5	-1.5	-1.8	-8.9	-7.5	-6.8
China	6.9	6.6	6.3	1.6	2.5	2.5	3.9	4.0	4.0	1.4	0.8	0.7	-3.7	-2.6	-2.5
India	7.1	6.6	7.4	3.3	3.7	4.5		*NA*		-1.5	-1.7	-1.8	-3.5	-3.5	-3.3
Russia	1.5	1.8	1.7	3.7	3.7	4.0	5.4	5.2	5.0	2.2	3.0	2.5	-1.7	-0.8	-0.5
CESEE															
Bulgaria	3.6	3.7	3.5	2.1	2.4	2.7	6.3	5.5	5.3	4.5	3.0	3.0	0.8	-1.0	-0.5
Romania	7.0	4.5	4.0	1.3	4.5	3.5	4.9	4.5	4.4	-3.5	-4.0	-4.0	-3.0	-3.5	-3.8
Serbia	1.9	3.0	3.2	3.2	2.0	3.0	12.5	11.5	11.0	-5.7	-5.3	-5.2	1.2	0.6	0.5
Turkey	7.4	4.5	4.1	11.1	10.0	9.0	10.3	10.0	9.5	-5.6	-6.0	-5.7	-2.0	-2.1	-2.0

Source: EU Commission, IMF, OECD, Bloomberg, Eurobank Research

Eurobank

Eurobank Fixed Income Forecasts

	2018				2019
	May	June	September	December	March
USA					
Fed Funds Rate	1.50-1.75%	1.75 -2.00%	1.75-2.00%	2.00-2.25%	2.25-2.50%
1 m Libor	1.92%	2.13%	2.21%	2.36%	2.65%
3m Libor	2.36%	2.37%	2.52%	2.65%	2.75%
2yr Notes	2.48%	2.55%	2.65%	2.75%	2.80%
10 yr Bonds	2.95%	3.00%	3.05%	3.10%	3.15%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.33%	-0.32%	-0.31%	-0.30%	-0.27%
2yr Bunds	-0.58%	-0.53%	-0.49%	-0.45%	-0.39%
10yr Bunds	0.53%	0.58%	0.63%	0.75%	0.78%
UK					
Repo Rate	0.50%	0.50%	0.75%	0.75%	0.75%
3m	0.69%	0.73%	0.81%	0.90%	0.97%
10-yr Gilt	1.39%	1.45%	1.50%	1.55%	1.64%
Switzerland					
3m Libor Target	-0.75%	-0.71%	-0.70%	-0.66%	-0.61%
10-yr Bond	0.03%	0.08%	0.12%	0.16%	0.18%

Source: Bloomberg (market implied forecasts)

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