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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:** Solid growth momentum, but trade uncertainty could weigh on the economic outlook
- **EA:** Growth has peaked, with the slowdown in the global trade cycle weighing on economic activity
- **UK:** Growth to remain lackluster; Brexit uncertainty prevails, risks of a leadership challenge against UK PM Theresa May
- **EM**: Trade wars' concerns & Higher world energy prices weigh on the growth outlook of the 2H-2018
- **CESEE**: Economic activity poised to moderate in coming quarters across the region

Policy Outlook

- **USA:** Continuation of gradual monetary tightening, with two more 25bps rate hikes expected in 2018
- **EA:** QE to conclude in Dec 2018; Interest rates to remain at their present levels "at least through the summer of 2019"
- **UK:** Markets assign a higher-than-even probability of a 25bps BoE hike in August
- **CESEE:** Monetary policies remain broadly accommodative across the region

Summary

Global growth seems to have peaked, with a less synchronized recovery. The US economy is gaining speed, but growth projections for other advanced economies have been revised downwards. Trade tensions continued to escalate, posing a key downside risk to the global growth outlook.

Markets

- **FX:** The USD rally has continued, supported by data, Fed Chair Powell, repatriation flows and more European political woes. Trade wars seem to be on everybody's mind for now with EM jitters and the drop in commodity prices hampering sentiment
- **Government bonds:** July saw safe haven rallies and tight ranges, as risk assets underperformed amidst trade wars rhetoric and summer markets lull. CB divergence continues unabated with Fed on track and ECB erring on the dovish side
- **EM:** Small reprieve from the year to date sell off with trade wars and tightening US monetary conditions remaining the biggest risk. Commodity importers helped by the sell off in energy and metals
- **Credit:** Credit spreads rallied outperforming stocks with cross over and high yield names in the forefront. The summer rally is expected to continue and we see this as an opportunity to reduce risk and add hedges

Key Downside Risks

- **Further escalation of trade tensions with the US:** US import tariffs spread to a wider range of goods and possibly services, trading partners respond with tit-for-tat retaliation measures
- **Higher than expected rise in inflation:** Steeper path of monetary policy tightening, faster than expected tightening of financial conditions
- **Increased political uncertainty in a number of EU countries:** Collapse of Germany's coalition government, new election in Italy, leadership challenge against UK PM Theresa May, disruptive UK exit
- **Policy inaction**: Reversibility of key structural reforms, violation of EU fiscal rules

Macro Views

Latest Macroeconomic Developments & Outlook

World Economic Outlook		Global growth seems to have peaked and the global recovery appears to have become less synchronized. While the US economy is gaining speed boosted by the fiscal stimulus, growth projections have been revised downwards for other major advanced economies (Euro area, Japan, UK). Meanwhile, the growth outlook for major emerging economies has become more uneven, given intensifying trade war tensions, higher crude oil prices and rising US bond yields. Higher US import tariffs and retaliatory measures by major trading partners could dampen global economic and market outlook. Assuming no further escalation of trade dispute, global GDP growth is expected to accelerate to 3.8% in 2018 from 3.7% in 2017 supported by still accommodative financial conditions and strong domestic demand growth.
Developed Economies	**US**	Economic momentum accelerated in Q2, with private consumption the major growth driver and business fixed investment expected to continue lifting real GDP growth in the quarters ahead as various provisions of the enacted tax programme have come into effect. Meanwhile, in line with the Bipartisan Budget Act, federal government spending should expand at a faster pace, contributing positively to overall GDP growth. Nevertheless, trade tensions create a high degree of uncertainty, with the potential to dampen business investment spending growth for those industries directly affected by the new import tariffs and quotas.
	Euro Area	The economic slowdown in the first quarter of the year, mainly attributed to a deterioration in the global trade cycle, looks set to continue in Q2. Looking ahead, solid domestic demand is expected to continue contributing positively to overall growth, with improving labour market conditions supporting private consumption growth and accommodative financing conditions and strong profit margins boosting business investment growth. Nevertheless, mounting trade tensions, together with political uncertainty in Germany and Italy, pose downside risks to European growth outlook.
	Periphery	Available data so far suggests that Q1 softness extended into Q2 in a number of periphery euro area economies. However, fundaments remain consist with above trend growth. Meanwhile, political concerns in Italy prevail while the risk of renewed tensions in Catalonia remains.
Emerging Economies	**BRICS**	In China, GDP growth slowed by 0.1ppts to 6.7% in Q2-2018, at the slowest rate of expansion since late-2016. The growth momentum is likely to slow further in the coming quarters due to global as well as local headwinds. In Russia, GDP growth is expected to have risen further to 1.6%YoY in Q2-2018 up from a revised 1.5%YoY in Q1-2018 on higher consumer spending reflecting strong wage growth ahead of the Presidential elections and stronger industrial production data in April-May. In Brazil, local factors such as the intensifying elections uncertainty and the trucks strike have raised concerns on the pace of economic recovery. In India, growth accelerated to 7.7%YoY in Q1-2018 from 7.0%YoY in Q4-2017 supported by government consumption and construction amid rising external environment headwinds.
	CESEE	Economy activity poised to show further signs of moderation in the coming quarters across the region. Those readings reinforce our earlier views that regional economies most probably are just 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
Escalating trade tensions	In response to China's retaliatory measures following the US imposition of an additional 25% duty on Chinese goods with an annual trade value of c. $34bn, effective from 6 July, and the US administration's consideration of an additional 25% tariff on products of China worth c. $16bn in the coming months (subject to public comment ending 31 July), the US Trade Representative proposed on 11 July further action in the form of an additional 10% duty on targeted imports from China worth c. $200bn. A public consultation on the latest round of US tariffs is already underway and will conclude by 30 August. In addition, speaking on the sidelines of the NATO summit that was held on 11 & 12 July, the US President reiterated his threat of increased tariffs on EU autos and auto parts imports (to 25% from 2.5% currently compared to EU tariffs of 10%), a threat especially for the most open euro area economies, likely Germany. Whereas under law the US decision on EU car tariffs could be announced by May 2019, at the latest, the US President made publicly known in late June that he intends to take a decision on the issue by the end of July. At this stage, the prevailing market view is that there is a decent chance the US and China to return to the negotiating table and reach a mutually satisfactory deal in the foreseeable future as both parties have hinted their respective willingness to engage in further dialogue. However, the likelihood of at least a brief period of a further escalation of trade dispute with additional tariffs and protectionist measures ahead of the mid-US elections in early November with a more negative impact on business and consumer confidence, global trade and investment, has certainly increased.
Fed Chair reiterates the case for gradual rate hikes in Congressional Testimony	During his semi-annual testimony before the Senate Banking Committee and the House Financial Services Committee on 17 & 18 July, respectively, Fed Chair Jerome Powell sounded optimistic on the US growth outlook pointing to the continued strong performance of the labor market. On the inflation front, the Fed Chair cited that the recent higher momentum is "encouraging" and expects inflation to hover around the 2% medium-term target over the next several years. While he acknowledged downside risks and uncertainty stemming from escalating trade tensions, he also mentioned upside risks from expansionary fiscal policy, which he sees as potentially supportive to domestic economic activity over the next three years. In this environment, Mr Powell said that "for now" gradual hikes in the federal funds rate is the best way forward. As regards its monetary policy deliberation in the medium-term, the Fed has already adopted a more neutral policy stance amid concerns that a potential escalation of tit-for-tat trade protectionism could create a puzzle as regards its monetary policy path on the view that it would have to balance rising inflation pressures and a slowdown in domestic economic activity.
US data pertaining to Q2 point to GDP growth rebound	Fed Chair Jerome Powell's positive comments on the US growth outlook in his congressional testimony followed a recent string of positive US sentiment surveys and hard data (i.e., ISM manufacturing, manufacturing output, retail sales) which have increased market optimism for a rebound in Q2 GDP to an annualised growth rate of around 4% from 2% in Q1 mainly on the back of improved consumption growth and a bigger contribution from net exports (Q2 US GDP advance estimate due for release on 27 July)

Global Macro Themes & Implications

Theme	Implications
June ECB accounts: rates at record lows for as long as needed	In line with the ECB statement following the conclusion of the 14 June monetary policy meeting, the accounts of the meeting suggested that the asset purchase programme will conclude in December 2018 with the Central Bank retaining the optionality to extend it into next year if macro conditions were to worsen significantly. Furthermore, the ECB adopted a more dovish forward guidance citing that interest rates are expected to remain at their present levels at least "through" the summer of 2019 and as long as it is necessary for inflation to converge towards target. In our view, key risks to this scenario are, among others: (i) a significant slowdown in growth below potential on a sustainable basis (e.g. further escalation in trade war); and (ii) a stronger EUR that would probably prevent the ECB from raising interest rates in September 2019, at the earliest. As of mid-July, 3M Euribor are assigning a 15bps rate hike by October 2019 and an additional 25bps hike by mid-2020.
Market consensus for euro area 2018 GDP growth has been revised downwards to 2.2% from 2.4% earlier this year; core CPI trend remains subdued	The sudden slowdown in euro area GDP growth to 0.4%QoQ in Q1 2018, below the average quarterly performance of 0.7%QoQ in 2017, as well as poor Q2 2018 sentiment surveys and economic indicators, have prompted a downward revision in 2018 GDP growth market consensus to 2.2% from 2.5% earlier this year. Though domestic expenditure is expected to remain supported by ongoing employment gains and the ample degree of ECB monetary policy accommodation, the Q1 slowdown in external trade will probably continue mainly on the back of the threat of increased protectionism. Furthermore, although the EUR has depreciated in recent weeks, it remains stronger than it was a year ago. In spite of the anticipated slowdown, 2018 GDP is expected to remain above the region's potential growth rate, which is estimated at around 1.5% according to the European Commission. On the inflation front, core inflation stood at 0.9%YoY in June, down from 1.1%YoY in the same month a year earlier and well below the ECB's 2% medium-term target, supporting the view that an ECB rate hike remains distant.
Rising political noise in the UK; risks of a "no deal" Brexit	In protest against UK PM Theresa May's Chequers plan on the future UK/EU relationship which suggested a shift towards a softer form of Brexit, two high profile cabinet members resigned, Foreign Secretary Boris Johnson and Brexit Secretary David Davis, raising the risk of a challenge to Mrs. May's leadership. A leadership challenge could be triggered if 48 Conservative MPs (15% of Conservative MPs) write a letter to the Chairman of the party's so called "1922 committee" expressing no confidence in Mrs May. Given that the hard-Brexit group has been rumored to contain around 70-80 Conservative MPs, it is reasonable to assume that there are enough MPs in favour of triggering a confidence vote. Meanwhile, the EU is likely to have reservations on the proposed Chequers plan and further concessions and compromises from the UK side are likely to be requested. At the same time, the risk of the final Brexit deal being rejected by the UK Parliament —expected to be submitted by the end of this year— has also risen, as the UK Premier faces the difficult task of balancing the opposing demands of pro- and anti-Brexit Conservative MPs. UK PM Theresa May narrowly avoided a defeat in parliament on 17 July from pro-EU MPs in her own party on an amendment to the Trade and Customs Bill that would have required the government to negotiate a customs union arrangement with the EU, should there be a failure by 21 January 2019 to reach a deal with the block that would offer a free trade deal for goods.

Macro Themes & Implications in CESEE

Theme	Implications
Real GDP growth poised to moderate further in the coming quarters in most economies of the CESEE region	Economy activity poised to show further signs of moderation in the coming quarters across the region. In most cases, high frequency and sentiment indicators point to further weakening on a quarterly basis and annual basis. Those readings reinforce our earlier views that regional economies most probably are just about to or have already reached their cyclical peak. A less favorable growth outlook for the EA-19, mounting global trade risks, higher commodity and global energy prices on top of the cyclical slowdown weigh on the growth prospects of the CESEE region. To that end, the economies of our focus continue to be among the top performers in EU-28.
Intensifying downside global trade risks will most probably have a negative impact on the growth outlook of the region	Currently, the direct consequences from US trade tariffs have been limited to the steel and aluminum industries. The threat of protectionism has also a negative indirect impact on business sentiment and subsequently on investment decisions. From a regional point of view, the economies which are affected are mostly non-EU members (Russia, Turkey and Ukraine). Escalating trade risks through higher US tariffs on the European car manufacturing industry would have a more detrimental direct and indirect impact on the trade relationships of the CESEE economies. The impact would not limited to the CEE-4 economies which specialize on automotive industry as conventional wisdom suggests but also have spillover effects to the broader region due to its integration to the European manufacturing and automotive industry supply chain.
The EU Commission Budget proposal for 2021-2027 envisages a 7% reduction in cohesion funding which matters for the CESEE region	The EU Commission Budget unveiled proposal for 2021-2027 envisages a 5% in agricultural and 7% reduction in regional & cohesion funding. The reduction in each country's allocation revealed that CEE economies (Czech, Hungary, Poland, Slovakia) are among the ones which are going to suffer significant funding cuts (around 25%). In contrast, SEE economies such as Bulgaria and Romania are going to receive more funding (around 8%). More importantly, the Commission proposed a new mechanism linking EU funding disbursements to additional criteria such as the rule of law adherence. The forthcoming negotiations among EU member states are going to be lengthy and contentious.
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 and remained put since then. On the other hand, Romania is an outlier. NBR has already delivered 3 hikes of 25bps so far this 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 yields slid across the board over the June-July period, with yield changes being well distributed along short and long tenors and ranging from 6-8 bps. The Ministry of Finance continued its recent policy and did not hold any auctions in June as well as in July and has not shown any indication of an offering in August. As a result of the ongoing government strategy, the public debt to GDP is expected to meet the target of 23%. Meanwhile, Eurobonds during the mid-June-July period saw significant changes. Yields of short term tenors dropped from 7 bps for the 2023 to 17 bps for 2024, while yields of longer maturities such as 2028 and 2035 dropped by 10-11bps.
Serbia	• The impact of a steady foreign capital inflows into Serbia over recent months has been supportive of dinar appreciation. For the time being, the EUR/RSD pair is still locked within narrow range of 117.90 – 118.25, looking like an long distanced island in the Pacific where global jitters hardly reach dinar coast. On the other side, further signs of strength in economy and strong FDI inflows certainly contributes to the stability. The dinar should have been the best performing currency if there wasn't the National Bank of Serbia (NBS) and its €1.45bn package of interventions this year. This way, the dinar lost momentum of firming further and as a consequence it continues hugging the 118.00 handle. Unlike free floating currencies in the region, dinar has been mostly stable recently. It's hard to say if a period of dinar depreciation will kick-in soon but we are pretty much convinced that NBS is ready to restrict depreciation momentum by spending those €1.45bn bought this year. • Although inflation has so far been flirting with lower bound of a NBS projected range (3+/-1.5%), the NBS has decided to take a conservative approach and make no further KPR cuts (3%) in their latest MPC meeting on July 12. The decision is primarily underpinned by higher inflation expectations in Q3 which has already started materializing in June (2.3%YoY). Moreover, uncertainties in global markets have also weighed, largely driven by trade war tariffs and ECB normalization path that should come during the 2019. • Serbia has almost filled up its borrowing needs meaning that the primary auction schedule will remain light. Their main goal, a full allotment of 5Y and 10Y T-bonds both in notional of RSD 110bn is going even better than expected. So far, Serbia raised RSD88bn from 5Y and RSD99bn from 10Y. According to the plan, the debt agency will have two auctions in August and one in September and most probably they are going to succeed in having two benchmark bonds that are going to be eligible for JPMorgan GBI-EM index. Meanwhile, the secondary market is very much aligned with the yields achieved on last primary auctions. In comparison, the 10Y is trading around 4.82-4.85% VS 4.85% achieved on latest reopening. Same goes with the 5Y, trading at 3.82% vs. 3.80% on primary. Trading volumes also do not get out from usual turnovers, hovering around RSD30bn per month. The agency aims a lower yield upon every reopening. For example, the latest 5Y auction had a bid to cover of 1.0 while the agency decided to go with 15 bps lower yield and scooped only RSD4bn (vs. RSD10bn offered initially)

Markets View

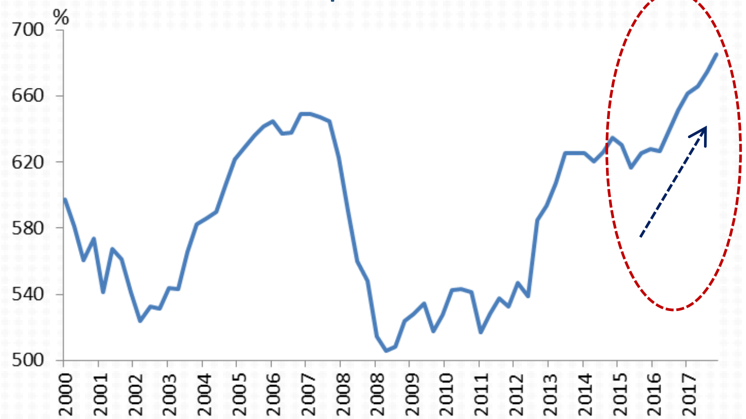
Asset Class	Outlook
Foreign Exchange	**EUR/USD**: USD has been the start performer on the back of strong data and Fed Chair Powell's vote of confidence on the resilience of US growth momentum. Trade concerns have become part of the market narrative with its effects not materialising as yet for the US economy. Month end repatriation flows could add some extra support. The market currently is bearish on the single currency, concerned about EU political risks and growth outlook. **USD/JPY**: USD/JPY declined the most in a month on equity flows and a stronger USD. Nevertheless concerns over the renewed weakness in Chinese equities/Yuan, negative trade headlines (Kudlow blamed President Xi for holding up a trade deal, US considering tariffs on uranium imports) and the BOJ's purchase cuts in super-long JGBs have created a bid for the JPY moving it away form the 113 handle. **GBP/USD**: GBP weakened as disappointing UK data releases pushed the prospect of a rate hike by the BoE further away and political turmoil on the back of Brexit ambiguity have come to the forefront. The term structure of the GBP/USD volatility curve has steepened beyond the 6mth tenor. Front-end GBP volatility has remained relatively well anchored which counters the market narrative that this week's political events have somehow been viewed as increasing the chance of a hard Brexit.
Government Bonds	**EU:** The deterioration in EZ data seems to have stopped for now but with downside risks to the Eurozone economy still prevalent – a deteriorating geopolitical backdrop and trade wars – some ECB members hinted at a continuation of stimulus through the lengthening in the maturity of QE reinvestments. A dovish ECB coupled with low, summer induced, liquidity and inherent market cautiousness has kept the Bund yield close the 0.30% level with forwards now pricing a painfully slow rates normalisation with one hike in 2019 and another one in 2020 as the front end of the curve flattened aggressively. The bias would be to pay rates at current levels. **US:** Yields remained at the low end of the past few months range with the curve flattening as trade wars escalation and worries over China's economic growth sustained the bid for safe haven assets. The 10y UST yield has established a 2.82%/2.88% range with risk/reward erring on the side of safety despite bullish sentiment underpinning US GDP and corporate earnings. Fed Chair Powell's semi-annual testimony was notable for its emphasis on the continued strength of the US economy (fiscal stimulus, favorable financial conditions, economy still below full employment) rather than on expressing mounting concerns over the threat of a global trade war. Tactical shorts on Treasuries with tight stops seems the way to play until September.
EM hard currency debt	A reversal of the USD strength and range bound US rates helped a small reprieve of the recent sell off. Turkey was in the spotlight once more with Erdogan's clear election win providing only a short term relief to Turkish assets. A rate hike by the CBT next week could provide some support. Trade wars and lower commodity prices remain the headwinds, despite the recent recovery. Tighter US monetary conditions will also continue to weigh on the space. On the other hand positive developments on the NAFTA negotiations and the low volatility summer environment give hope to sustain the recent rally in the near term. Overall EM credit seems fairly valued after the past few months sell off and name specific opportunities have appeared. We would be tactically long but medium term we remain cautious and would take risk off the table on any significant rallies in the next couple of months.
Corporate credit	Outflows continued in the European corporate credit space despite this month's rally where credit outperformed equities after a significant period of underperformance. The tightening in Italian sovereign spreads helped the market to stabilize and recover some of its recent loses. The primary market breath some new life, including a new four year Greek corporate bond (OTE) that performed well. Risk appetite was firm for US credit as well. On both sides of the Atlantic crossover and HY names were the outperformers given that they had taken the largest hit during this years' sell off (especially in Europe). Overall credit, especially US, seems to have shrugged off trade tensions and the energy sector ignored a significant oil sell off which bodes well near term for the market. We would be tactically long but medium term we remain cautious and would take risk off the table on any significant rallies in the next couple of months.

II. Advanced Economies

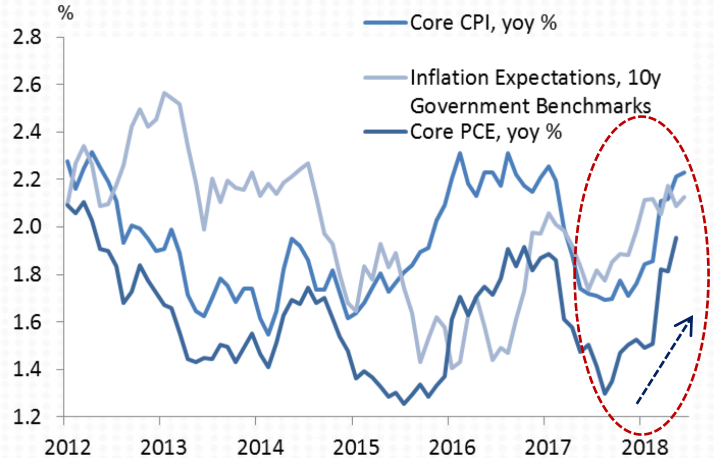
- USA
- Euro Area
  - ❖ Periphery (Italy, Spain, Portugal, Cyprus)
- UK

USA: Solid growth momentum, but trade uncertainty could weigh on the economic outlook

The strength of US consumer spending closely related to the sharp rise in household net worth



Increased inflationary pressures



Source: US Census Bureau, Federal Reserve, Bloomberg, Eurobank Research

Latest Economic Developments

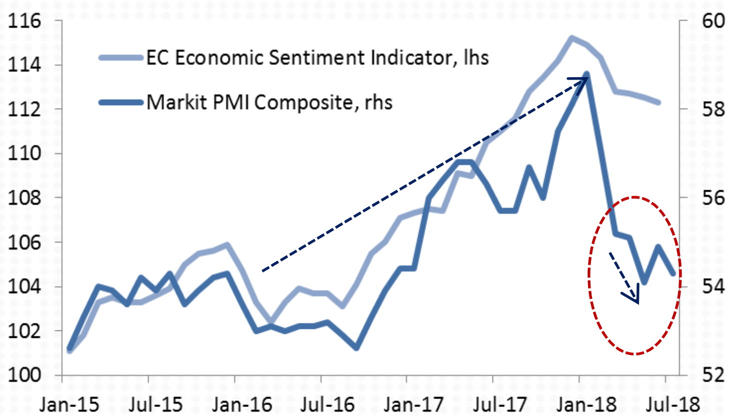
Economic momentum accelerated in Q2, with real GDP expected to almost double its relatively soft 2.0% growth rate in Q1, partially reflecting faster inventory accumulation and a bigger contribution from net exports (Q2 GDP data due on 27 July). In line with recent retail sales data (+2.1%QoQ in Q2 from 0.7%QoQ in Q1), private consumption has remained the major growth driver, with household disposable income being boosted by strong labor market conditions and lower taxes. Business fixed investment, which advanced in Q1 at its fastest pace since 2014 amid increased global demand and higher oil prices, is expected to continue lifting real GDP growth in the quarters ahead given that various provisions of the enacted tax cut have come into effect. Meanwhile, federal government spending should expand at a faster pace amid the Bipartisan Budget Act and contribute positively to overall GDP growth following a zero contribution in the first quarter of the year. Nevertheless, trade tensions create a high degree of uncertainty for firms that export their finished goods or import materials for production, with the potential to dampen business investment spending growth for those industries directly affected by the new tariffs and quotas.

Central Bank Watch

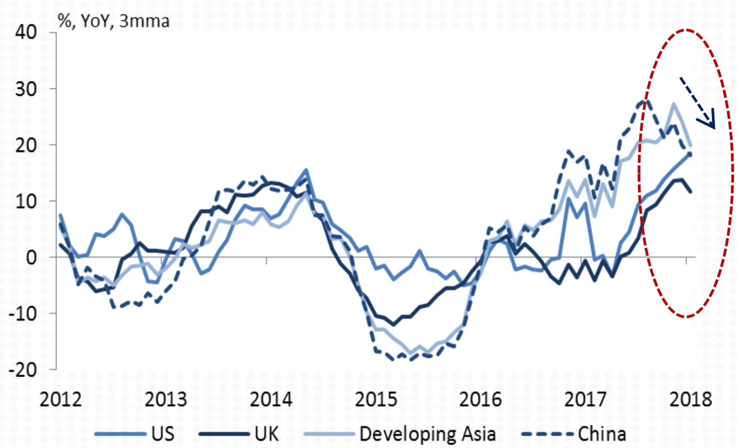
In response to improved labor market conditions and an uptrend in core CPI inflation (2.3%YoY in June from 2.2%YoY in May, Fed Chair Jerome Powell reiterated during his testimony before the Congress in mid-July that the FOMC believes that "for now the best way forward is to keep gradually raising the federal funds rate". Moreover, Mr Powell recognized that risks to the economic outlook are seen as "roughly balanced" clarifying that it is difficult to assess the size and timing of the effect from the fiscal stimulus as well as the ultimate impact of growing trade tensions. Reflecting concerns about trade frictions, Fed officials discussed at the June 12-13 FOMC meeting the probability of a recession, acknowledging rising global trade tensions that could weigh on the US economy. Following three rate hikes in 2017 and two so far in 2018 putting the target range at 1.75-2.00%, we expect two more 25bps rate hikes, in September and in December, in line with the Fed's updated Economic Projections.

Euro area: The slowdown in the global trade cycle weighs on growth

June Composite PMI surprised to the upside, but trimmed some of its gain in July



The recent slowdown reflects a deterioration in external trade



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

Latest Economic Developments

The economic slowdown in Q1 2018, mainly attributed to a deterioration in the global trade cycle, looks set to continue in Q2. Although June's composite PMIs surprised slightly to the upside (+0.8pts to 54.9 after four consecutive declines) with the services sector recovery more than offsetting the continuing downtrend in manufacturing, preliminary data for July showed that it actually trimmed some of its earlier gain declining to 54.3 while survey measures of export orders suggest that the export growth slowdown has not been reversed. Meanwhile, Euro area industrial production bounced in May increasing by 1.3%MoM, with the IP carry-over for Q2 in line with a similar pace of growth as in Q1 (+0.4%QoQ), much weaker that last year's average of 0.7% but well above the Euro area's potential growth rate. Looking ahead, solid domestic demand is expected to continue contributing positively to overall growth, with improving labour market conditions supporting private consumption growth and accommodative financing conditions and strong profit margins boosting business investment growth. Nevertheless, mounting trade tensions, together with political uncertainty in Germany and Italy, pose downside risks to European growth outlook.

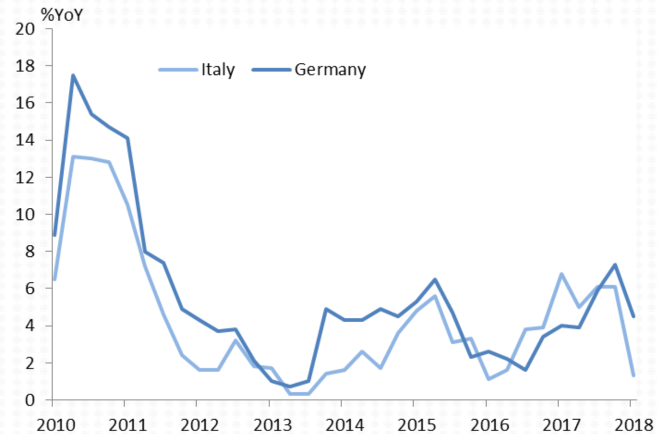
Central Bank Watch

In line with the ECB policy statement released after the conclusion of the June policy meeting, the accounts suggested that the asset purchases program could be extended beyond December 2018, if macro conditions were to worsen materially and the first rate hike is not expected before September 2019 at the earliest. The decision to end net asset purchases and extend forward guidance was unanimous, with the Governing Council highlighting that forward guidance on rates will have a crucial role for the ECB's monetary policy adjustment in the future, subject to incoming economic data. Should macroeconomic conditions were to surprise negatively (i.e. worsening external demand, trade tensions, political risks), the ECB could signal that it does not have the intention to increase rates before 2020 or even later. On the flipside, if macroeconomic conditions were to surprise to the upside, the ECB could adjust its forward guidance and signal a depo rate hike even before September 2019 .

Italy: Expansionary fiscal policy to boost economic activity in the short-term, but risks loom large in the medium-term

Private consumption in Italy much weaker than the rest of the euro area

Softer external demand and the lagged effect of the EUR's appreciation takes its toll on Italian exports



Source: Bloomberg, Eurostat, Eurobank Research

Latest Economic Developments

Real GDP growth decelerated to 0.3%QoQ in Q1 from 0.4% in Q4 2017. While private consumption accelerated to 0.4%QoQ from zero growth in Q4, business investment declined by 1.4%QoQ after three consecutive positive quarters with an average growth rate of 1.9%. Exports also dropped by 2.1%QoQ, but the fall in imports by 0.9%QoQ reduced the negative drag from external demand. High frequency indicators point to a possible further slowdown in the second quarter; industrial production fell 1.3%MoM in April, before recovering some of its losses in May (+0.7%MoM), while retail sales declined by 0.6% in April before increasing by 0.8%MoM in the following month. On the external front, total exports pulled back in May, falling 1.6%MoM and bringing the annual growth rate down to -0.1% from 3.3% in April, suggesting that softening external demand and the lagged effect of the EUR's appreciation may have started to take its toll on Italian exports. Although we might see a small boost to growth from looser fiscal policy, it would most likely be temporary. Overall, we have revised downwards our real GDP forecasts for both 2018 and 2019 to 1.2% in and 1.1%, respectively, from 1.5% in 2017.

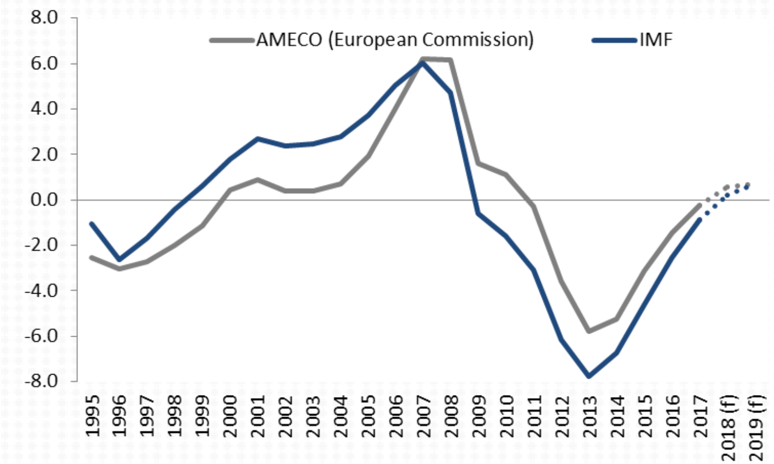
Italian politics update

The Five Start/League government programme envisions costly expansionary fiscal measures of c. €100bn, i.e. 6% of GDP. These include, among others, a "flat tax" for individuals and firms (15% for low incomes, 20% for the rest) with a cost of €50bn, i.e. 3.0% of GDP, a guaranteed minimum income (~€17bn, i.e. 1.0% of GDP), the abolition of the VAT hike scheduled for Jan 2019 (~ € 12.5bn) as well as cancellation of some parts of the 2012 pension reform programme. Nevertheless, it is highly unclear how the agreed government plan will be financed. Furthermore, some of the proposals in the government program (e.g. trade deals, sanctions against Russia) risk to put the new government on a collision course with European authorities. That said, investors will pay particular attention on the multi-annual budgetary plan (the basis of the 2019 budget law) that the government has to submit to parliament by 27 September and to Brussels by mid-October.

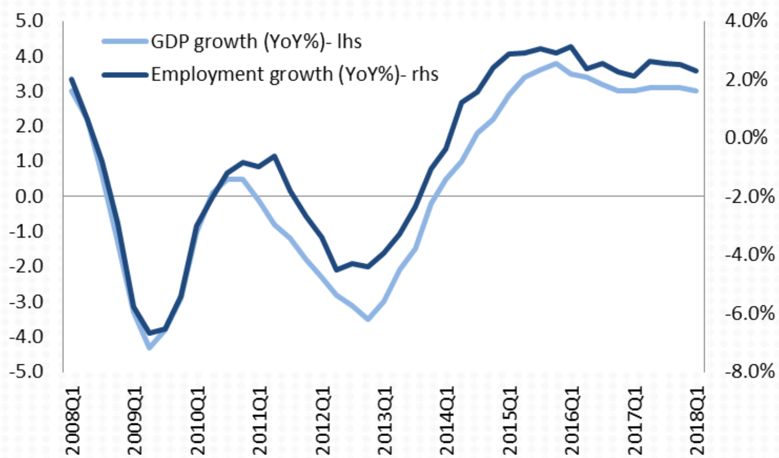
Spain: Positive growth momentum continues in Q2 but at a modestly slower pace

Spain's output gap is closing

Estimated output gap (% of potential GDP)



Employment growth is slowing down slightly



Source: AMECO, IMF, Eurostat, Eurobank Economic Research

Latest Economic Developments

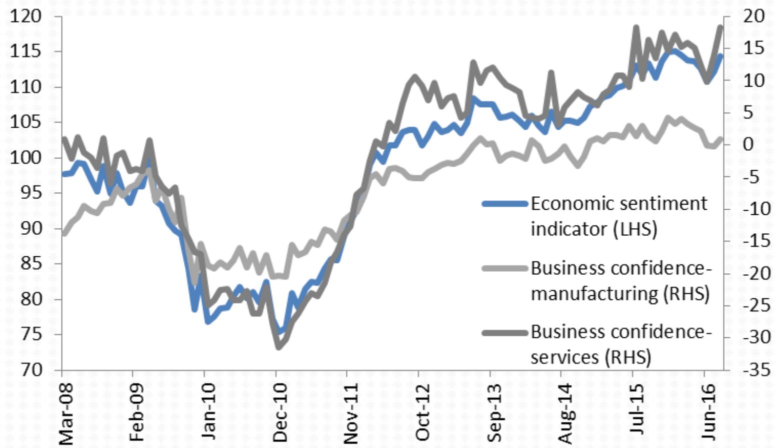
Barely affected by the slowdown in GDP growth in the euro area, Spain's GDP grew by a solid 3.0%YoY in Q1 2018, mainly on the back of private consumption and fixed investment. Since Q2 2015, Spain has returned to pre-crisis GDP growth levels and over the last three years it has been among the star performers in the euro area. However, hard data and sentiment surveys pertaining to Q2 GDP suggest that, although the positive momentum remains in place, the pace has slowed down slightly. Among others, industrial production grew by 1.6%YoY in May, the slowest pace in the last four months, moderating from April's 2.1%YoY rise. Similarly, the Markit composite PMI dropped to 54.8 in June from May's 55.9, albeit still above the 50.0 boom-or-bust level, indicating continuous healthy expansion in business activity. Looking further ahead into H2 2018, Spain's GDP growth is expected to continue easing modestly as the slack in the labor market is progressively being eroded while, according to major institutions, Spain's output gap is closing. In addition, the slowdown in the euro area does not bode well for Spain's exports outlook. Spain is heavily exposed to euro area demand in terms of goods exports (over the last ten years, an average of 65% of Spain's total goods exports go to the area area). Furthermore, higher oil prices could act as a drag on private consumption, the main growth driver over the last few years. Though we expect Spain to continue to outperform the rest of the euro area , we anticipate GDP growth to slow to 2.8% in 2018 from 3.1% in 2017.

Politics Update

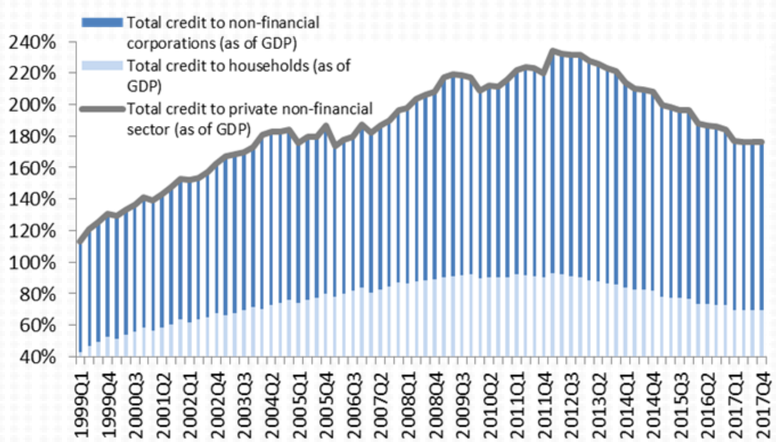
The minority government of the Socialist party (PSOE) announced its intention to submit a comprehensive tax reform package to parliament after the summer. It will reportedly include, among others, a tax on financial institutions aiming to increase funding for the social security system in the context of an ageing population. However, passage of the bill is highly uncertain given the fragility of the government which controls just 84 MPs in the 350-seat parliament. Meanwhile, the risk of renewed tensions in Catalonia remains as key judicial decisions on the fate of the secessionist politicians currently in prison are still pending.

Portugal: Economic activity expected to continue recovering but significant challenges prevail medium-term

Survey indicators point to a rebound in Q2 GDP



Private sector remains highly indebted



Latest Economic Developments

Q1 2018 slowed to 0.4%QoQ from 0.7%QoQ in the prior quarter, but survey indicators pertaining to Q2 have strengthened, pointing to a likely rebound. Domestic consumption, the main growth driver, remains supported by a continuous decline in the unemployment rate (7.3% in May, below pre-crisis levels). However, a slowdown in GDP growth from last year is likely, as the slack in the labor market is being eroded. Higher oil prices are also expected to weigh on real wages, without much room for households to reduce their savings rate further (-2.4% of disposable income in Q118). An expected a slowdown in the euro area's growth, especially in Spain where around 25% of Portugal's total goods exports go, is also anticipated to negatively affect Portugal.

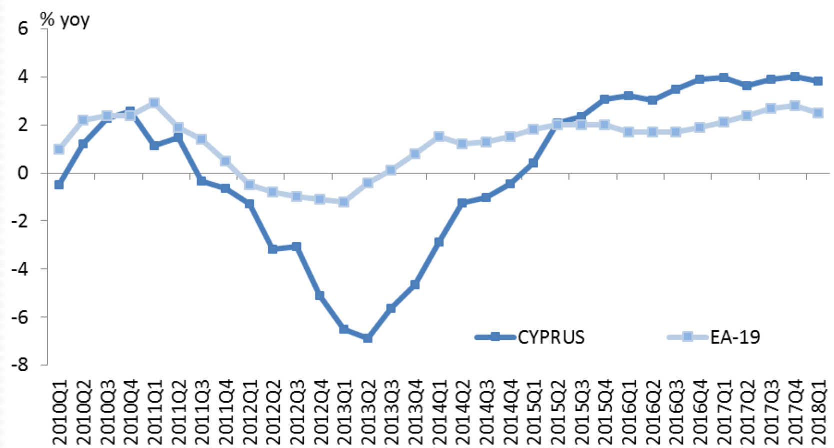
Public & private debt, banking sector; among the biggest challenges for Portugal

Portugal's high public debt (125.7% of GDP in 2017) leaves the country vulnerable to a renewed rise in sovereign yields and, thus, a renewed spike in borrowing costs. Though the contagion has proved to be more limited than through the euro area sovereign debt crisis in 2011, the recent period of increased political uncertainty in Italy pushed Portugal's 10-yr yield spread against its German counterpart to around 170bps, some 55bps higher compared to mid-March levels before stabilizing at around 140-150bps in July. The expected completion of the ECB's asset purchase programme in December 2018 also poses a challenge for Portugal from a borrowing cost perspective. High debt burden of the private sector, albeit on a declining trend, is another source of concern. Credit to the private sector dropped to 176.2% of GDP in Q4 2017 from a peak of 232.2% of GDP in Q2 2012. Credit to households stood slightly below 70% of GDP in late 2017, down more than 20pps from the Q2 2012 peak. Credit to non-financial corporations, c. 65% as a share of total credit to the private sector, came in at around 107%-of-GDP in Q4 2017, some 34pps below the Q2 2012 peak. Challenges also remain for the banking sector mainly due to the elevated level of non-performing loans and weak profitability. Non-performing loans to total gross loans stood at 13.3% in Q4 2017, below a peak of 17.9% in Q1 2016 but still well above the EU average.

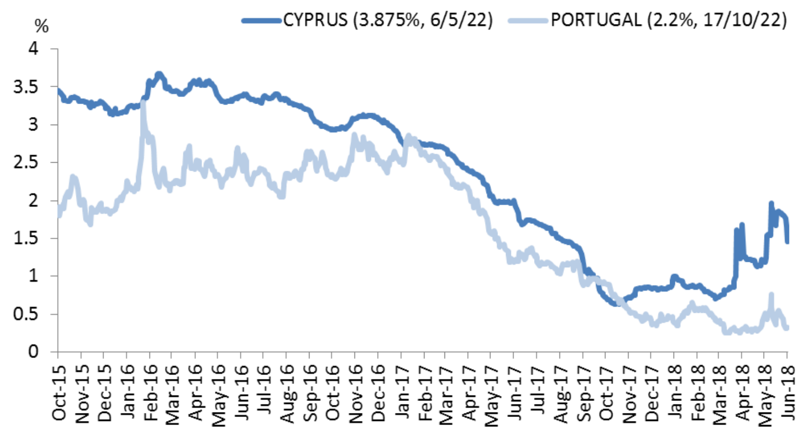
Source: AMECO, ECB, IMF, Bloomberg, Eurobank Economic Research

Cyprus: The CCB case is a game changer for the banking sector

Cyprus turn-around growth story has been impressive so far



Cypriot medium term bond yields have spiked on renewed domestic banking sector and EA periphery concerns



Source: Eurobank Research, National Authorities, Bloomberg

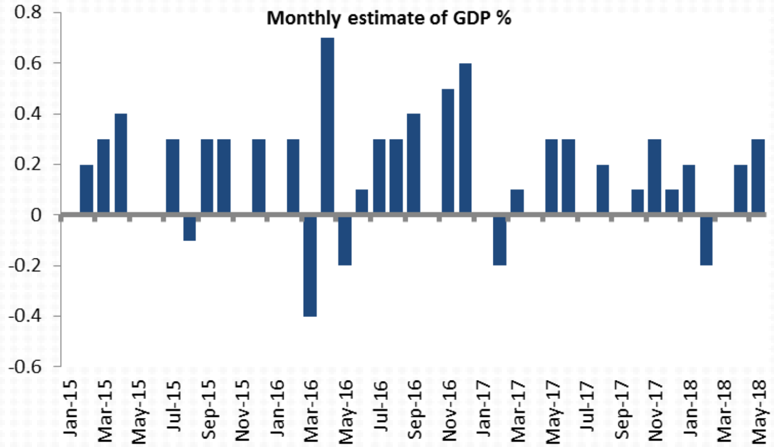
Latest Political & Economic Developments

The rapidly evolving case of the Cyprus Co-operative Bank (CCB) dominated the agenda in Q2-2018 and is expected to keep our attention in the medium-term. The privatization process of CCB, initiated by the government in late March, resulted in its ultimate liquidation. The liquidation involves the acquisition of its performing assets by Hellenic Bank (HB) and the transfer of NPEs to a state-owned entity, which is set up for that purpose. On top, the “ESTIA” subsidy scheme was introduced to help vulnerable groups of borrowers, while the insolvency and foreclosures frameworks were further reformed for the first time since 2014-2015. Rating agencies ignore earlier market concerns for CCB and maintain a positive outlook. In fact, FITCH and DBRS upgraded the long-term sovereign rating of Cyprus by one notch from BB to BB+ and from BB low to BB respectively.

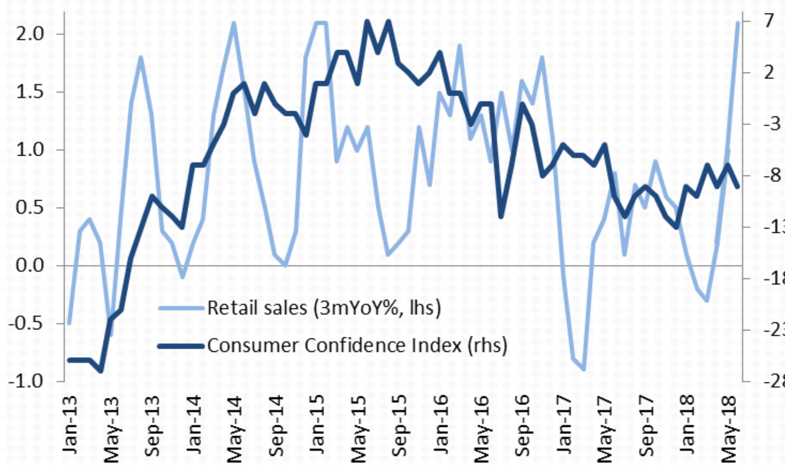
The CCB case is a game changer. First, in contrast to the “Laiki” or Popular Bank case of 2013, the liquidation of CCB takes place in an orderly fashion. CCB’s market exit occurs without any costs to its depositors, whether households or non-financial corporations. Second, the acquisition of new assets by HB changes the banking map, rendering HB the second largest bank in Cyprus in terms of assets, deposits and employees. The resolution of CCB’s NPEs - worth a bit less than €6bn - would now come under the responsibility of the Cypriot government, which will establish a separate entity for that purpose. As a result, once the transaction is completed, the NPE ratio of the banking system is expected to decline to 37% from 43% at the end of March 2018. The cost of CCB’s liquidation is transferred to the tax-payer. The general government gross debt is now expected to have reached 110% of GDP, up from 97.5% in 2017. Moreover, the annual cost of the ESTIA scheme will also weigh on the fiscal outcomes of the following years. Finally, the long-waited reform of the foreclosures and insolvency frameworks, are expected to improve the long-term viability of the banking sector ahead of the forthcoming SSM stress tests in autumn.

UK: April & May monthly GDP figures point to a rebound in Q2 GDP

April & May GDP figures point to a rebound in Q2 GDP



Retail sales bounced in Q2 in spite of subdued consumer confidence



Source: ONS, Bloomberg, Eurobank Economic Research

Latest Economic Developments

According to new monthly GDP data released by the Office for National Statistics (ONS), the UK economy expanded by 0.3% in May, above a growth rate of 0.2% in April. Rolling three-month data (calculated by comparing growth in a three-month period with growth in the previous three-month period) the economy expanded 0.2% in March to May compared to flat growth in December to February. The dominant services sector -and particularly wholesale retail trade- was the sole positive contributor. It grew 0.4% adding 0.34pps to overall GDP growth, presumably supported by one-off factors like the World Cup, warm weather and Royal Wedding. In contrast, the manufacturing sector declined 1.2% mainly on the back of weak exports, subtracting 0.12ppts from headline GDP. Construction was also a drag subtracting 0.1pps (monthly GDP data releases include solely GDP growth rates and economic output by industry). The April and May monthly GDP figures as well as improved survey data, particularly the June PMIs, point to a modest rebound in GDP growth in Q2 from an upwardly revised 0.2%QoQ in Q1. Although the UK economy is likely to gain some momentum in Q2, for the whole year 2018 we expect GDP growth to drop to 1.4% from 1.8% in 2017, continuing to underperform its G7 peers. Tightening credit conditions should dampen domestic consumption and weaker house price growth should offset the expected slight improvement in real income growth. Furthermore, Brexit jitters are expected to continue to exert a negative impact on investment.

BoE Watch

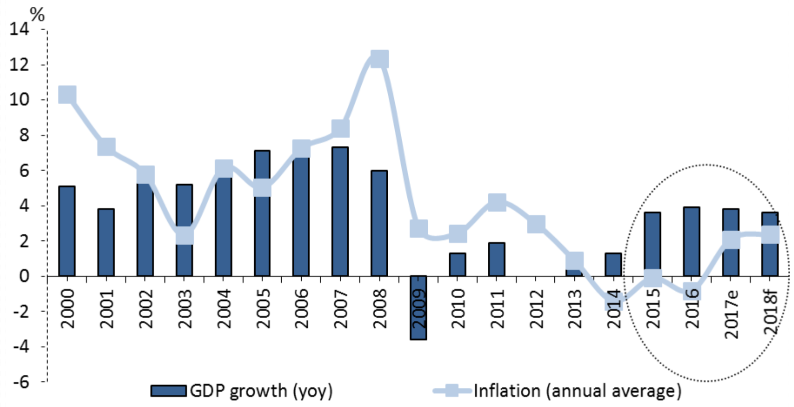
A likely rebound in Q2 GDP, the upward revision in Q1 GDP and hawkish comments from a number of BoE officials since the June monetary policy meeting, support the case for a rate hike at the next meeting on 2 August. Factors that could potentially derail an August hike is the risk of intensified political noise. A series of resignations from the UK cabinet in response to the Brexit Chequers plan which appears to suggest a shift towards a softer form of Brexit, have raised concerns about a likely challenge to Mrs May's leadership from anti-EU Conservative MPs.

III. Selected CESEE economies

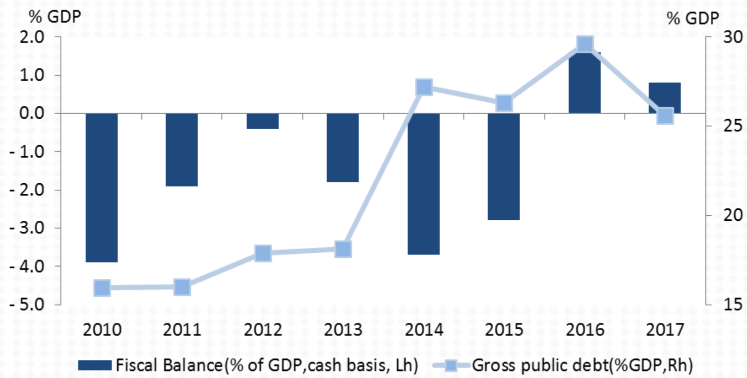
- Bulgaria
- Romania
- Turkey

Bulgaria: ERM2 and Banking Union application roadmap

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 Political & Economic Developments

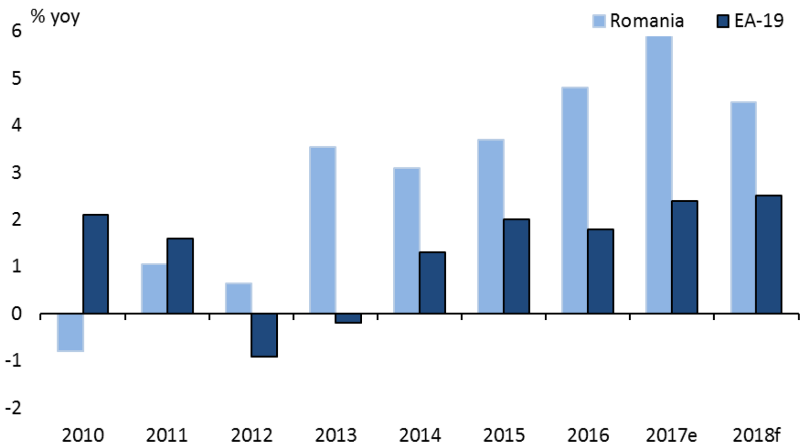
On July 12th, the European Council endorsed Bulgaria's strategy to simultaneously join the ERM2 mechanism and the Banking Union. In its letter to the European institutions, the Bulgarian government stated its firm intention to apply for ERM2 entry by July 2019. At the same time, the government committed to implementing a long list of reforms in a number of policy areas before joining the ERM2: to strengthen banking supervision by entering in close cooperation with the ECB, to enhance the supervision of the non-banking financial sector, to identify gaps in the insolvency framework and prepare a roadmap to address them, to strengthen the anti-money laundering framework, to improve the governance of state-owned enterprises.

The ECB and the EU Commission will supervise the implementation of these commitments. Once the two institutions have issued a positive assessment, the Parties to the ERM2 will decide upon Bulgaria's formal application. The ECB should simultaneously decide on Bulgaria joining the banking union in approximately one year from now, after concluding its comprehensive assessment. Bulgaria is also expected to participate in the SRM-SRF from the date of entry into force of ECB's decision. Finally, Bulgaria is also expected to undertake further commitments at the moment of joining ERM2 with the aim of achieving a high degree of sustainable economic convergence by the time of the introduction of the Euro.

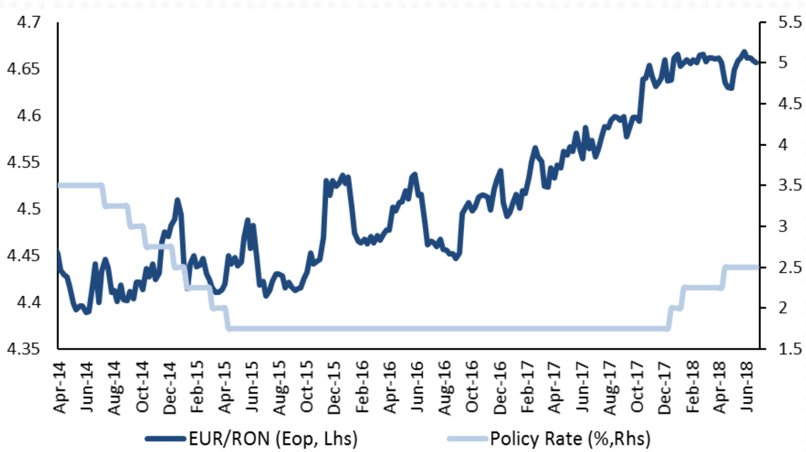
Inflation climbed further for a third consecutive month to 3.2% YoY in June vs. 2.6% YoY in May. The spike can mainly be attributed to the rise of non-food inflation (3.5% YoY in June vs. 2.4% YoY in May) which itself is driven primarily by higher transportation prices (8.2% YoY in June). Looking ahead, the sharp adjustment in the energy prices (gas prices up by 10.8%, electricity up by 2.0%) by the market regulator (KEVR) as of July and the volatility of food prices in the summer months are expected to maintain inflationary pressures intact in the coming months.

Romania: KPR unchanged at 2.5% in July

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

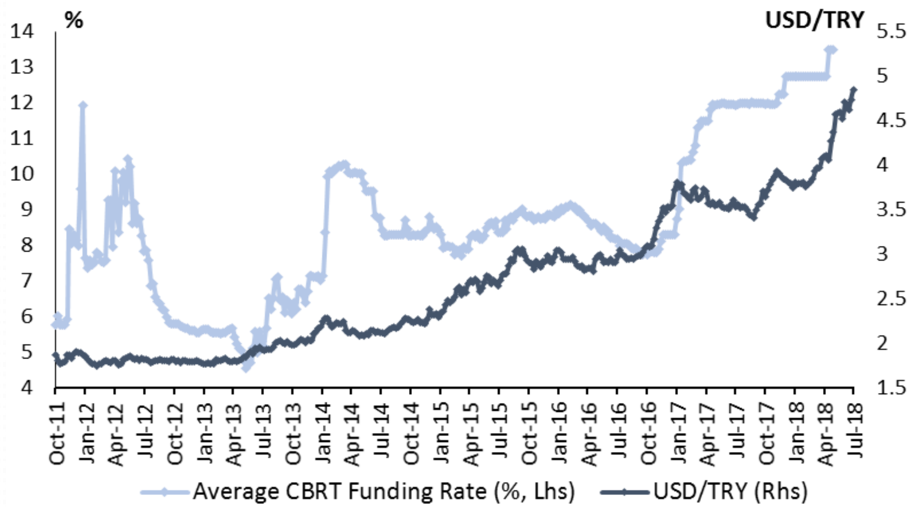
Latest Political & Economic Developments

On July 4th, the NBR maintained the key policy rate (KPR) unchanged at 2.5% and MRRs for FX and RON denominated liabilities at 8% respectively. At the same time, the NBR also decided to preserve the deposit facility rate at 1.50% and the lending facility rate at 3.50% leaving the interest rate corridor unchanged at 2%. The decision was not entirely anticipated by market participants as it met the expectations of a thin majority in Bloomberg survey (10 out of 18 participants) while the majority of analysts in the respective Reuters survey were expecting a 25bps hike. In the statement released thereafter, high inflationary pressures were attributed to supply side factors (such as the larger-than-expected hikes in fuel prices and tobacco product prices).

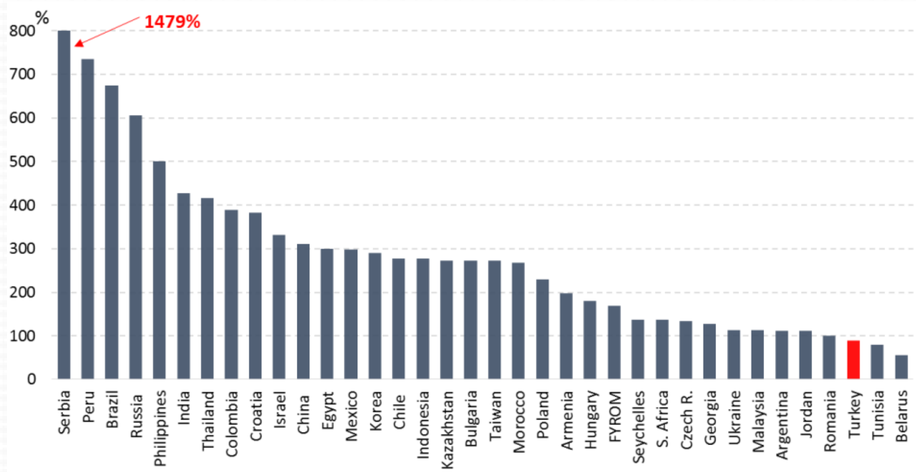
Headline inflation reached a new five year high in June (0.0% MoM/5.4% YoY in June) in a move further above the upper bound of the NBR's target interval (2.5+1%). However, the adjusted Core CPI (excluding administered and volatile prices, alcohol and tobacco) index also decreased over the same month to 2.9% down from 2.95% in May down from 3.09% YoY in April, which implies that demand side pressures could subside further in the near-term. To that end, the NBR governor suggested in the press-conference that during the summer months inflationary pressures are very low on a monthly basis, which could help the inflation rate and interest rates to converge at a relatively low level. Moreover, he added that the current monetary policy stance was less accommodative than the KPR was implying, suggesting thus little need for further aggressive hikes. The FX interventions of NBR have helped cushion the volatility of global capital flows, with other peer CESEE currencies coming under depreciation pressure, and RON remaining relatively stable. The NBR has hiked three times –each time by 25bps so far this year and we are still looking for one more by the end of the year- a view we hold since last April- provided that there is no other unexpected supply side shock.

Turkey: President Erdogan sworn in for another term in office

Turkish Lira has come under pressure so far in 2018



FX Reserves (%) of External Debt Repayments in 2018



Source: Eurobank Research, National Authorities, Bloomberg

Latest Political & Economic Developments

President Tayyip Erdogan won another term in office in the first round of dual snap elections, while his ruling AKP and partner MHP also secured parliamentary majority in a separate ballot. The incumbent President received 52.5% of the vote vs. 31% achieved by the runner up Muharrem Ince of the main opposition Republican People's Party (CHP). On the parliamentary front, AKP scored 42%, which reportedly corresponds to 293 MPs in the 600-seat parliament, while MHP amassed 11% of the vote estimated at 50 seats. The main opposition CHP achieved 23% of the vote, the pro-Kurdish HDP received 12% and IYI marginally passed the 10% threshold to enter parliament.

The elections mark the replacement of the existing parliamentary system into an executive presidency with sweeping executive powers for the new President following a referendum backed by the ruling AKP and the MHP in April last year. The presidential decrees issued so far set out on the new cabinet appointments and the Central Bank appointments regulations further exacerbated investors' concerns about the Central Bank's independence and disappointed investors' expectations for market-friendly appointments. Political pressure-driven by President Erdogan's staunch support for low interest rates aimed at boosting economic activity-has fanned worries in the markets.

Macroeconomic policies have been primarily guided by electoral considerations. An excessive emphasis has been placed on growth in an effort to increase the probability of the ruling party leader to get reelected in the President's post and concentrate more executive powers around him under the new constitutional amendments. Pro-cyclical government stimulus, which is bound to eventually fade away, supports growth at the expense of higher inflation. The latter erodes the purchasing power of households and corporates, undermines their confidence in domestic financial assets, deters them off their investment decisions, and increases external vulnerabilities at a time of a deteriorating global financing environment.

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	3.8	3.7	3.0	3.3	3.2									
Advanced Economies															
USA	2.3	2.9	2.6	2.1	2.5	2.3	4.4	3.9	3.5	-2.4	-2.7	-2.8	-4.9	-5.3	-5.9
Eurozone	2.4	2.1	1.9	1.5	1.6	1.6	9.1	8.4	7.9	3.5	3.4	3.4	-0.9	-0.7	-0.6
Germany	2.2	2.2	2.0	1.7	1.7	1.8	3.8	3.6	3.5	8.0	7.9	7.6	1.3	1.2	1.4
France	2.2	2.0	1.8	1.2	1.8	1.5	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	20.0	18.0	-0.8	-0.7	-0.6	0.8	0.4	0.2
Italy	1.5	1.2	1.1	1.3	1.2	1.3	11.2	10.8	10.6	2.8	2.6	2.6	-2.3	-1.7	-1.7
Portugal	2.7	2.2	2.0	1.6	1.4	1.6	9.0	7.6	6.7	0.5	0.6	0.6	-3.0	-0.9	-0.6
Spain	3.1	2.8	2.4	2.0	1.8	1.6	17.2	15.5	13.8	1.8	1.5	1.6	-3.1	-2.5	-2.0
UK	1.7	1.3	1.2	2.7	2.6	2.0	4.4	4.4	4.5	-4.1	-3.7	-3.4	-1.9	-2.1	-1.7
Japan	1.7	1.2	1.0	0.5	1.0	1.0	2.9	2.8	2.7	4.0	3.8	3.7	-4.2	-3.3	-2.8
Emerging Economies															
BRICs															
Brazil	1.0	2.3	2.5	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	6.4	1.6	2.5	2.6	3.9	4.0	4.0	1.4	1.2	1.2	-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	1.6	3.7	3.0	4.5	5.2	5.0	4.9	2.2	4.2	3.0	-1.5	1.5	1.7
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	3.5	3.5	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	4.0	3.5	11.1	13.5	13.0	10.9	11.5	12.0	-5.6	-6.5	-6.0	-2.4	-3.8	-3.5

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

Eurobank

Eurobank Fixed Income Forecasts

	2018			2019	
	Current (as of July 20, 2018)	September	December	March	June
USA					
Fed Funds Rate	1.75 -2.00%	2.00-2.25%	2.25-2.50%	2.25-2.50%	2.50-2.75%
1 m Libor	2.08%	2.23%	2.51%	2.54%	2.68%
3m Libor	2.35%	2.48%	2.68%	2.81%	2.90%
2yr Notes	2.60%	2.68%	2.75%	2.78%	2.82%
10 yr Bonds	2.85%	2.88%	2.90%	2.95%	3.00%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.32%	-0.31%	-0.30%	-0.29%	-0.26%
2yr Bunds	-0.63%	-0.61%	-0.58%	-0.50%	-0.47%
10yr Bunds	0.33%	0.36%	0.42%	0.50%	0.55%
UK					
Repo Rate	0.50%	0.50%	0.75%	0.75%	0.75%
3m	0.76%	0.83%	0.90%	0.95%	0.98%
10-yr Gilt	1.19%	1.30%	1.34%	1.39%	1.42%
Switzerland					
3m Libor Target	-0.75%	-0.75%	-0.75%	-0.70%	-0.70%
10-yr Bond	-0.01%	-0.01%	0.01%	0.05%	0.08%

Source: Bloomberg (market implied forecasts)

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