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Eurobank Research

GLOBAL & REGIONAL MONTHLY

Global economic and policy fundamentals have deteriorated over the past three months, as escalating US/China trade concerns and Brexit-related uncertainty have taken their toll on confidence and investment. In response, major central banks have embarked on a monetary easing cycle, while governments seem more inclined to expansionary fiscal policies to support growth

Macro Picture

USA: Signs of weakening momentum call for more Fed accommodation

EA: Economy close to stalling as the industrial recession deepens

UK: Underlying growth momentum has been softening but imminent recession fears at bay thanks to supportive private consumption

EM: Economic growth is set to slow in 2019

CESEE: The broader region remained resilient in Q2 on sustained domestic demand dynamics. A weaker 2H growth print is on the cards

Markets

FX: Major central bank decisions have been the key drivers of FX pairs this month, with the USD so far the winner on the back of a dovish ECB and a marginally risk-off sentiment

Rates: European and US yields had reached all-time lows before retracing some of the capital gains on the back of positive trade war news. Bunds reached a record low of -0.74% and USTs 1.43%

EM: EM credit remains in a sweet spot, despite growth issues, as global monetary easing is boosting the appeal of the asset class

Credit: Supported by the renewed QE by the ECB, spreads were mixed as the primary market remained extremely busy. High yield is still driven by idiosyncratic stories

Policy Outlook

USA: Additional rate cuts, the next one likely by year-end

EA: Extra 10bp deposit rate cut possible in 2020

UK: The BoE adopted a slightly more dovish tone in September, increasing the odds of a rate cut in the near future

CESEE: The policy outlook remains accommodative across the board

Key Downside Risks

US/China trade war: Renewed escalation in US-China trade dispute; the US imposes EU auto tariffs

No-deal Brexit: The UK government does not abide by the Brexit delay law and does not ask for an Article 50 extension from the EU by 19 October or the EU leaders do not agree to delay Brexit further

(Geo) political risks: US-Saudi Arabia & Iran jitters may be a catalyst for higher oil prices

China: Risk of hard-landing lingers

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September 2019

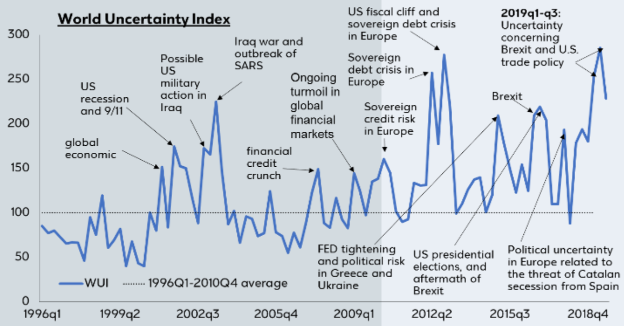
Macro Views

Latest Macroeconomic Developments & Outlook

World Economic Outlook

Global economic and policy fundamentals have darkened over the past three months, as growth prospects have continued to deteriorate and escalating US/China trade concerns and Brexit-related uncertainty have taken their toll on confidence and investment (Figure 1). As a result, business sentiment indicators such as PMI surveys have been on a downward trend, with the global manufacturing sector in recessionary territory for four consecutive months. In response to deteriorating global growth prospects and subdued inflationary pressures, major central banks have embarked on a monetary easing cycle since mid-2019, while governments in the advanced economies are more inclined to expansionary fiscal policies to support growth. A key question is the extent to which monetary easing can be effective enough so as to offset increased policy uncertainty and, therefore, prevent a further economic downturn. Risks to the global economic outlook seem tilted to the downside, as persistent manufacturing weakness could potentially weaken labor demand, household income and spending and, thus, weigh on the service sector output. With the broad-based moderation in global GDP and in trade growth prospects expecting to persist for longer, OECD has downgraded by 0.3pts its 2019 global GDP forecast to 2.9% from 3.6% in 2018, with downward revisions in most G20 countries. Should this forecast be realized, it would be the weakest global growth rate since the financial crisis.

Figure 1: Global uncertainty has increased further due to Brexit and US/China trade conflict



Source: Ahir, H, N Bloom, and D Furceri (2018), "World Uncertainty Index", Stanford mimeo, Eurobank Research

Developed Economies

US: Although the US consumer spending has remained buoyant so far, there are tentative signs of waning momentum spreading into the broader economy from weak IP and business capital spending. Consensus estimates currently attach a probability of around one-third for a recession within the next 12 months. Our real GDP growth projection remains at 2.3% in 2019 from 2.9% in 2018, with risks tilted to the downside amid a high degree of trade-related uncertainty that could lead to further slowing in business investment spending.

Euro area: High-frequency indicators suggest that the EA industrial recession continues amid a global underperformance of the manufacturing sector, heightened trade concerns and Brexit-related uncertainty. Our 2019 real GDP growth projection currently stands at 1.1% from 1.9% in 2018, with easier fiscal policy providing some offset to gloomier global economic and demand prospects. Key downside risks to the outlook mainly stem from the possibility of higher EU auto tariffs by mid-November 2019 and/or a no-deal Brexit.

Periphery: Q2 GDP growth performance was mixed in periphery economies with Spain and Italy being the weak links, affected negatively by domestic jitters as well as external factors and the global manufacturing slowdown. Risks surrounding the growth outlook of all periphery economies remain tilted to the downside, stemming from fears of a no-deal Brexit, higher US tariffs on the EU auto sector and a return to a tit-for-tat tariff war. A more pronounced slowdown could potentially lead to fiscal slippage and may also cause some concerns among rating agencies.

Emerging Economies

BRICs: The region is heading towards a segregation in terms of economic growth with China and India both recording economic growth rates above 6.5% YoY for the past five years while Russia and Brazil are lagging substantially, posting GDP growth rates just above 1.5% YoY and 1.0%YoY, respectively, in the past two years as they recover from the 2015 recession. Brazil's pension bill was finally approved in early September. The bill is expected to lead to savings for the federal government in the order of USD243bn over the next decade. In order to revive India's economy, which expanded by only 5% in Q2, Prime Minister Narendra Modi, implemented sizeable corporate tax cuts in order to attract investments and revive the economy.

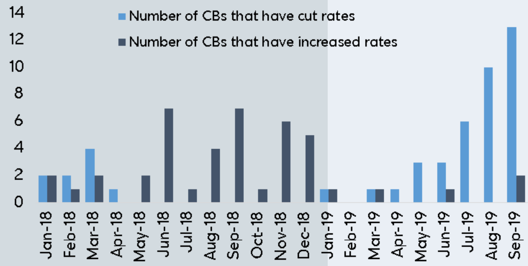
CESEE: Second quarter GDP estimates for the broader CESEE region: economies remain resilient supported by sustained domestic demand dynamics, namely investments in CEE-3 and private consumption mostly in SEE. In most cases, net exports were a negative contributor, more than in the previous quarters, driven by higher imports mirroring strong domestic demand but also lower exports in response to the deteriorating external environment.

Special Topic

ECB delivers a comprehensive stimulus package, in line with a global shift towards policy accommodation

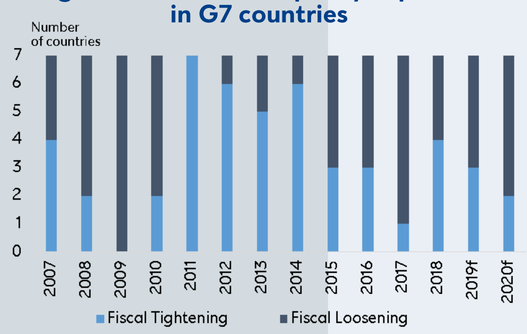
A large number of central banks seem to have engaged in a major monetary shift towards additional policy accommodation in order to respond to decelerating global momentum and lower-than-desired inflation (Figure 2). Among advanced economies, the Fed has already cut fed fund rates by 50bps in Q3 2019 and more rate reductions are expected by year-end while the ECB delivered a bold package of stimulus measures in September. At the same time, several emerging economies have also engaged in monetary easing, with China lowering reserve requirements and some lending rates. Meanwhile, heightened concerns about whether monetary policy is effective given that interest rates are already at very low levels and that there are lags between policy changes and real economic effects have also shifted attention to the greater role of fiscal policy (Figure 3). On the same wavelength, ECB President Mario Draghi highlighted the need for fiscal policy to support the euro area's long-term growth prospects, in line with the broader need for fiscal boost across the globe when faced with limited scope for further effective monetary easing.

Figure 2: A barrage of monetary policy easing since mid-2019



Source: Haver Analytics, Eurobank Research

Figure 3: Easier fiscal policy expected in G7 countries



Source: OECD, Eurobank Economic Research

In this section we take a closer look at the ECB's comprehensive monetary stimulus package in order to prevent a further deterioration in the growth and inflation outlook of the Euro area economy (see ECB macroeconomic forecasts in Table 1 below) which include: an open-ended QE program, easier terms for TLTRO-III, a 10bp cut in the deposit facility rate coupled with a strengthened forward guidance and a two-tier system for reserve remuneration.

QE and TLTRO-III: The ECB's asset purchase programme (APP) will be restarted on 1 November, at a monthly pace of EUR 20 billion. On the dovish side, the APP was left open-ended, with President Mario Draghi noting in the accompanying press conference that the new QE program will run "for as long as necessary to reinforce the accommodative impact of our policy rates", in contrast to previous ECB's announcements for an end date for its purchases. Net purchases of securities under the APP will end shortly before the ECB starts raising its key policy interest rates. Adding to the accommodative measures, the modalities of the new series of quarterly longer-term refinancing operations (TLTRO III) were improved to increase the attractiveness of banks' operations and, thereby, provide an incentive for them to increase lending. Removing the requirement of the 10bp spread over the average policy rate during the life of the operations, the interest rate in each operation will be set at the average of the main refinancing rate over the life of the respective TLTRO, and may fall to the average interest rate on the deposit facility over the life of the operation for banks if a certain target value of a bank's net lending is reached. Furthermore, the maturity of the operations will be extended from two to three years.

Rates and Forward Guidance: The ECB decided to cut the deposit facility rate by 10bp to a new-record low of -0.50%, leaving the main refinancing rate and marginal lending rate unchanged at 0.00% and 0.25%, respectively. The rate cut was combined with a strengthened interest rate forward guidance, with the Governing Council (GC) dropping the calendar-based component while reinforcing the state-contingent part; ECB policy interest rates will remain at their present or lower levels until the GC sees "the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics".

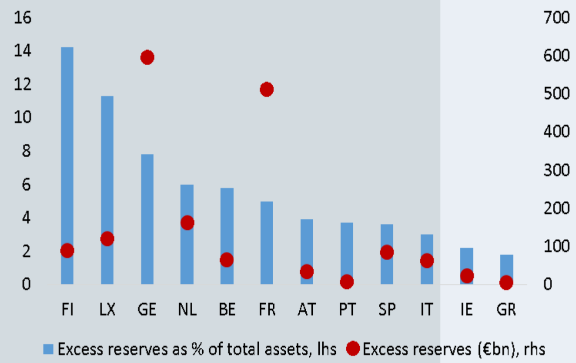
Table 1: Eurosystem/ECB staff macroeconomic midpoint projections for the euro area

		September 2019			June 2019		
	2018	2019	2020	2021	2019	2020	2021
Real GDP (%YoY)	1.9	1.1	1.2	1.4	1.2	1.4	1.4
Private consumption (%YoY)	1.4	1.3	1.3	1.3	1.4	1.4	1.3
Government consumption (%YoY)	1.1	1.5	1.5	1.4	1.4	1.4	1.4
Gross fixed capital formation (%YoY)	2.3	3.1	1.9	2.1	2.7	2.0	2.0
Exports (%YoY)	3.5	2.3	2.4	3.0	2.2	2.9	3.2
Imports (%YoY)	2.7	2.6	3.1	3.4	2.7	3.2	3.4
Unemployment rate (% of labor force)	8.2	7.7	7.5	7.3	7.7	7.5	7.3
HICP (%YoY)	1.8	1.2	1.0	1.5	1.3	1.4	1.6
Core HICP	1.0	1.1	1.2	1.5	1.1	1.4	1.6
ULCs (%YoY)	1.7	2.1	1.7	1.5	1.8	1.6	1.7
Compensation per employee (%YoY)	2.1	2.2	2.3	2.4	2.1	2.5	2.5
Labour productivity (%YoY)	0.4	0.1	0.7	0.9	0.2	0.8	0.9
General government budget balance (% of GDP)	-0.5	-0.8	-0.8	-1.0	-0.9	-0.9	-0.9
Structural budget balance (% of GDP)	-0.6	-0.8	-0.9	-1.1	-0.9	-1.1	-1.2
General government gross debt (% of GDP)	85.4	83.8	82.5	81.2	83.7	82.1	80.6
Current account balance (% of GDP)	2.9	2.6	2.4	2.3	2.4	2.4	2.4

Source: Eurosystem, Eurobank Research

Tiering: A two-tier system of reserve remuneration, which has features of the Swiss tiering system, was introduced in order to mitigate the impact of an extended period of negative rates on banks' profitability, coming into effect on 30 October 2019. It should be noted that since mid-2014 when the ECB cut its deposit rate to negative territory, the total negative impact on the Euro area banking system is estimated at c. €23.9bn (Table 2). The two-tier system will apply to excess liquidity held in current accounts with the Eurosystem but will not apply to holdings at the ECB's deposit facility. The volume of reserve holdings in excess of minimum reserve requirements that will be exempt from the deposit facility rate will be determined as a multiple of an institution's minimum reserve requirement. The multiplier will be set at 6 for all institutions and can be adjusted by the GC to ensure that short-term money market rates do not deviate from the deposit rate. The exempt tier of excess liquidity holdings will be remunerated at an annual rate of 0%. The non-exempt tier of excess liquidity holdings will continue to be remunerated at zero percent or the deposit facility rate, whichever is lower.[1]

Figure 4: Excess reserves in the euro area



*Data on Deposit facility and Current Accounts refer to July
Source: ECB, National Central Banks, Eurobank Research

According to the latest ECB and national central banks data, the two-tier system should provide exemption for c. €792bn (i.e. 6 times the reserve requirements of €132bn) out of the €1.8trn of the total liquidity surplus (~45%). The introduction of the tiering system is estimated to lead to a weighted average deposit rate of around -0.28%bp (c. €792bn at a deposit rate of 0.0% and c. €1.0trn at a deposit rate of -0.50%), a rate actually tighter than the previous weighted average deposit rate of -0.40%. Nevertheless, a key issue is that the excess liquidity in the system is distributed very unevenly in the euro area, with some banks mainly in northern European countries having excess reserves above the 6x tier, while other banks, primarily in the periphery, have excess reserves well below the 6x threshold. As is evident in Figure 4, a large share is located in core countries, particularly in Germany, France and the Netherlands and to some degree also in Luxembourg, so the benefits from the introduction of a tiering system are mainly enjoyed by those core economies, which have the highest current account and deposit facility holdings. It is estimated that the overall cost of the negative rate for

Table 2: Total negative impact of the negative deposit rate on the EA banking system (in €bn)

2019 (up to 18/9/2019)	-5.3
2018	-7.6
2017	-6.6
2016	-3.5
2015	-0.8
2014 (from 11/6/2014)	-0.1

Source: ECB, Bloomberg, Eurobank Global Markets

[1] For more details see the ECB's press release https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190912_2~a0b47cd62a.en.html

banks in Germany, France and the Netherlands following the introduction of a tiering system will be reduced by c. €1.0bn, €0.8bn and €0.6bn, respectively, which accounts for more than half of the overall projected reduced cost for the Euro area banking system. Italy, on the other hand, does not seem to benefit from a tiering system due to its low current account and deposit facility holdings, likely having a maximum allowance of 0% that is larger than its current amount of excess reserves. This could potentially have negative implications for the Italian repo market, fueling upward pressure on repo rates. Should Italian banks be able to park additional funds at the upper tier of the tiering system, which is higher than the domestic GC repo rate, this would be translated into lower demand for the repo market until the repo rate has converged to the upper tier. In other words, with the lower demand for GC repo an increase in the GC repo rate (close to the higher facility rate) may be expected, while core banks do not face the same challenge as the GC repo rate is already less attractive than the deposit rate. All in all, the potential upward pressure in repo rates for Italian and other banks that have less reserves than their exempted allowance should fade over time as QE and TLTRO III is gradually bringing further excess liquidity into the system.

Global Macro Themes & Implications

Signs of willingness from both the US and China to make progress in upcoming trade talks

The US administration's decision to delay the 1 October tariff hike for two weeks and China's decision to exempt a set of US goods from the first round of additional tariffs, effective 17 September, signal both sides' willingness to make progress in the next round of trade talks, starting on October 7 in Washington. Moreover, White House trade adviser Peter Navarro dismissed reports that the US administration is considering delisting Chinese companies from US stock exchanges as "fake news". Supporting market hopes that upcoming negotiations could lead to some reduction in trade tensions, recent press reports suggest that both sides are interested in striking an interim deal in the near future, whereby China would undertake commitments on intellectual property rights and buy US agricultural products like soybeans and pork while the US administration would postpone or roll back some tariff increases. However, even though both sides show a willingness to create positive conditions for the next round of talks, negotiations will be difficult and the prospect of a comprehensive trade deal that could satisfy both sides still seems distant as big differences remain. These include, inter alia, China's demand for the removal of all US tariffs imposed during the trade war and its refusal to make changes to its laws as part of the deal, while the US is strongly in favor of a strong enforcement mechanism. In addition, China may also request a removal of the export ban on Chinese technology giant Huawei. That said, a renewed escalation in the US/China trade dispute leading to another round of tit-for-tat tariffs or, under the worst case scenario, a full-blown trade war that would add meaningful risks to the global growth outlook, cannot be ruled out completely. However, amid weakening of the Chinese economy and as the US President is heading into an election year, it is undoubtedly in the best interest of both sides to strike a deal sooner than later.

Reduced odds for a no-deal Brexit on 31 October but risks may increase anew thereafter

Soon after his election as the new leader of the Conservative Party and UK PM in late July, Boris Johnson resumed talks with the EU aiming to renegotiate the Brexit agreement sealed by the EU and Theresa May last year and to remove the controversial Irish backstop arrangements. In that context, the UK PM submitted his final Brexit offer to the EU on 2 October following the close of the Conservative Party's conference.

As per the same sources, Boris Johnson's plan envisions a Northern-Ireland-only backstop that would keep Northern Ireland aligned with EU laws and regulations for all goods but would be part of the UK's (not the EU's) customs territory. The proposal for Northern Ireland with EU laws and regulations would be subject to the approval of the Northern Ireland Assembly and Executive before the transition period ends on 31 December 2020 and every four years thereafter. The EU reportedly expressed certain reservations on Boris Johnson's proposal as, inter alia, it fails to meet the hard Irish border objective, an issue which is likely to be discussed in detail at the upcoming European Council meeting on 17/18 October. But even if a Brexit deal with the EU were possible, it is questionable whether Boris Johnson's government, which has lost its working majority in the House of Commons, would be able to get the deal approved by the parliament. All the more so after his unexpected decision in early September to prorogue parliament for five weeks, in the height of the Brexit crisis, was ruled unlawful by the UK's highest court.

But even if no Brexit agreement is reached at the upcoming EU Council or if the UK MPs do not give their consent, the odds of a no-deal Brexit on 31 October, when the current Brexit deadline expires, have been reduced sharply. This is because the House of Commons recently passed legislation requiring the PM to ask for an Article 50 extension from the EU by 19 October, if a new Brexit deal has not been agreed with the EU by then or if the UK parliament has not approved to leave without an agreement. But, due to the political cost for the Conservative Party associated with an extension request, the PM has ruled out this possibility. Hence, unless Boris Johnson backs away from that position, he is left with the option to resign and ask the Queen to appoint a caretaker to make the extension request, opening the way for snap elections after 31 October, either in November or early December. According to recent opinion polls, Tories enjoy an 8-10 point lead while most seat projections point to an absolute majority for the Conservative party. Though we should not put too much weight on the polls given the complexity of the UK electoral system (note that Theresa May lost parliamentary majority in 2017 while polls were suggesting a lead of more than 15%), a no-deal Brexit would still be possible if Boris Johnson wins a majority on a mandate for a no–deal Brexit or comes first but has to rely on the support of DUP and/or the Brexit Party to form a government.

Macro Themes & Implications in CESEE

Second quarter GDP estimates for the broader CESEE region: economies remain resilient supported by sustained domestic demand dynamics

The second Q2-2019 GDP estimates in the broader CESEE region confirmed the positive picture portrayed by the flash estimates. As things stand, it would be fair to say that we are fully on track with our earlier stipulated full year forecasts for the economies of our focus. Despite conventional wisdom suggesting that rising external environment headwinds and the slowdown of their main trade partner Germany would have a detrimental impact on their growth prospects, CEE3 (Poland-Hungary-Slovakia) economies remained among the most resilient in the broader CESEE group. The CEE3 economies are still leading the pack expanding on average by 4-5% YoY, while the SEE (Bulgaria-Serbia) economies are lagging behind growing on average by 3-3.5%. Meanwhile, both Romania and Turkey were outliers in the SEE pack. Romania decelerated to 1.0% QoQ/4.6% YoY in Q2-2019 down from 1.2% QoQ/4.9% YoY in Q1-2019 with investments taking the lead from private consumption as the key driver. In contrast, fiscal, credit and monetary stimulus pushed Turkey further out of technical recession (+1.2% QoQ/-1.5% YoY in Q2-2019 vs. +1.6% QoQ/-2.4% YoY) outperforming market expectations for a deeper contraction. Now that the breakdown of the national accounts is available, domestic demand was the main driver of economic activity for yet another quarter across the board. In more detail, investments in CEE-3 and private consumption mostly in SEE. In most cases, net exports were a negative contributor, more than in the previous quarters, driven by higher imports mirroring strong domestic demand but also lower exports in response to the deteriorating external environment.

SOEs: A source of growth or a drag on the economies of the CESEE region?

Currently, state owned enterprises (SOEs) account between 2% and 15% of total employment in the CE-SEE countries and they are active in sectors such as mining, energy and transport. According to a recent study conducted jointly by the IMF and the EBRD, SOEs underperform compared to private sector counterparts almost across the entire CESEE region. They generate, on average, less revenue per employee than private sector peers but at the same time pay higher wages, thus being significantly less profitable. The key reason for this underperformance is the inefficient use of resources, primarily labor. Moreover, while addressing and handling with insufficient governance is a necessary step, it may not be sufficient for the optimum operation of such entities. The study suggests that it is time for CESEE countries to take a fresh look at the rationale of existence of some SOEs in particular sectors. Additionally, the operating objectives need to be clarified and cost-benefit analysis for all types of operations and production should be implemented. Given that the majority of SOEs is a legacy that most CESEE countries have inherited since the communist era, now that the region has gone some way towards markets' liberalization, maybe it is the right time for the establishment of a collaborative initiative between CESEE countries. On the footprint of the Vienna Initiative created back in 2009, under the pressing need for handling the NPLs problematic volume at that time, a respective scheme, whereby lessons from one country to another are exchanged and know-how is developed, could be considered.

CESEE Markets Developments & Outlook

Bulgaria

Bulgarian Eurobond yields posted significant drops across the entire curve ranging between 2 bps for the 2023 papers and 14 bps for the 2028 papers. Local yields followed, dipping within a 3-12 bps range. The Bulgarian Ministry of Finance reopened the 20-year bond issuance on the 26th of August raising EUR100mn. The Ministry has reiterated that the current tapping of the local market is triggered by the increased military spending.

Serbia

Overall, economic conditions have not changed recently pointing to prolonged stability on the EUR/RSD rate and continuation of the bullish sentiment on Serbian government bonds. Several indicators imply that changes in the accommodative monetary policy environment will not take place any time soon. First, FDIs in Serbia reached 2.32bn in the first seven months, increased by 43% in comparison to 2018. The nearly fully covered with FDIs current account deficit (ca 6.5% of GDP) will allow the National Bank of Serbia (NBS) to continue with interventions so as to keep the Serbian Dinar stable against the Euro. The 2019 budget will be in surplus, significantly above the initially planned deficit of 0.5% of GDP. Presumably, the expected fiscal surplus will lead to a further decrease of the public debt, which has already fallen to 51.9% from 53.8% at the beginning of 2019.

Slight deficiencies could be anticipated regarding the economic growth dynamics. GDP growth is expected to come in at ca 3%, below the projected by the IMF 3.5% and roughly 1% lower than the CEE average (around 4.2%). On the price level frontier, inflation is well below target with the latest reading standing marginally above the target zone low point (i.e. 3% ± 1.5%). That said, inflation is expected to move within the target corridor for the whole 2020, as stated in the latest inflation report by the NBS.

On the market developments front, Moody's has upgraded the outlook on Serbia's rating from "stable" to "positive", keeping the rating at Ba3 in mid-September while a few days later, Fitch upgraded the sovereign credit rating to BB+ from BB. Yields on Serbian Government Bonds have been massively depressed; in the last three months, the Serbian Government Bonds yield curve shifted lower by approximately 50 bps with the papers maturing on 2022, marking the steepest drop by 82 bps.

Markets View

Foreign Exchange

EURUSD: Continued weakness in global growth is supporting the dollar and we expect this to be the case into year-end. Short-term, the pair has reversed and closed above 1.09 on the back of the weak US ISM number, but the bearish trend remains targeting 1.0815 and 1.07, a level that we would be looking to build long position. On the upside 1.0968 and 1.1025 are immediate resistances.

GBPUSD: The pair had a volatile month on contradicting headlines, as hopes for a further delay in the Brexit deadline came and went. Prime Minister Boris Johnson insists that he will issue an ultimatum to the EU on the matter. The current range stands at 1.2582 and 1.1959. Immediate supports are at 1.22 and 1.1959, levels we believe will be broken in the near term.

USDJPY: A decline in the yield differential between the US and Japan is likely to act as an anchor on the pair as the spread in the 10yr notes has fallen back towards its 2019 lows. 108.48 with 104.46 remains the range with immediate supports at 107 and 106.20, while we see resistance above 108.48 at 109.15, the 200-day moving average.

Rates

EU: Depo rate cut, a tiered deposit rate, a sweetened TLTRO-III and open-ended QE were announced by the ECB in September as economic data from Germany and EA continue to deteriorate. 10yr bunds are trading 20bps off their recent yield lows (-0.74%) and we expect them to remain range bound for now. Rates low for longer is still the main market theme as fiscal stimulus is gaining traction. On EGBs we see further compression of spreads between core and periphery as the Italian story has gone quiet and focus is on the EA and global economy slowdown.

US: A strong retracement higher in yields in September on the back of some firmer data and positive trade war news but also technical reasons. Unfortunately there was no follow through as both started deteriorating again. We see another cut in 2019 by the Fed and expect 10yr US treasuries to retest and potentially break the recent low (1.4272%) by year-end. We also expect further flattening of the curve as growth and inflation expectations remain subdued. We also expect trade tensions to persist and put a cap on any significant yields increases.

Emerging Markets credit

Emerging market hard currency debt had a surprisingly quiet month given the Argentina news as well as the rally in oil post the drone attacks in Saudi Arabia's oil facilities. The J.P. Morgan EMBI Global Spread Index tightened by 24bps in September taking back most of the widening that took place in August. Overall, however, total returns have remained positive even when spreads widen as core rates tend to rally more. Despite the weak growth in the EM space and relatively expensive valuations capital flows remain solid as the hunt for yield continues. Monetary easing in both developed and emerging market countries provides a near term supportive outlook. The biggest risks are a significantly stronger USD and rise of geopolitical tensions, something we do not expect to happen currently. We remain tactical buyers of IG names on any widening.

Corporate credit

EUR Investment Grade (IG) and High Yield (HY) spreads, despite the small widening on a classic "buy the rumor sell the fact" case, remained resilient in the phase of the new QE by the ECB. On the other hand, US IG and HY credit posted a solid performance. Overall we remain defensive in our outlook for the credit market and prefer IG over HY on both sides of the Atlantic as we expect moderate widening into year-end. The renewed QE will again reduce liquidity in the secondary market and in combination with a slowing growth environment and rising credit risk/name dispersion as we are approaching the end of this credit cycle makes name selection very important. Idiosyncratic stories in the HY space are on the rise and extreme caution is recommended as default rates especially in the US seem to have bottomed, with lower rated HY names underperforming significantly. In the IG space we prefer the 7-10 year tenor as funding levels make shorter dated investments unattractive.

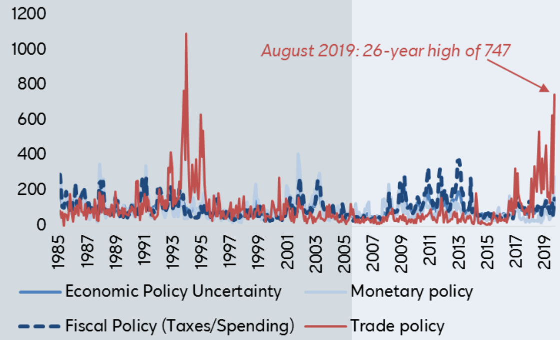
US

Signs of weakening momentum call for more Fed accommodation

With trade tensions dominating business and financial market sentiment, uncertainty around the US economic outlook has remained elevated. Consensus estimates currently attach a probability of around one-third for a recession within the next 12 months.[2]

Although the US consumer spending has remained buoyant so far, there are tentative signs of waning momentum spreading into the broader economy from weak IP[3] and business capital spending. To this end, the CB's index of consumer confidence dipped to 125.1 in Sept, though it seems that at this stage heightened trade uncertainty was a more likely culprit. Labor market tightness might have increased somewhat[4], but US labor market conditions continue to be favorable, supported by strong income expectations and healthy household balance-sheets, which should continue to be rather supportive for consumer confidence in the months ahead. Real GDP growth is projected to slow to 2.3% in 2019 from 2.9% in 2018 - before decelerating to 1.6% in 2020 as the fiscal policy boost gradually fades - with risks tilted to the downside amid a high degree of trade-related uncertainty that could lead to further slowing in business investment spending.

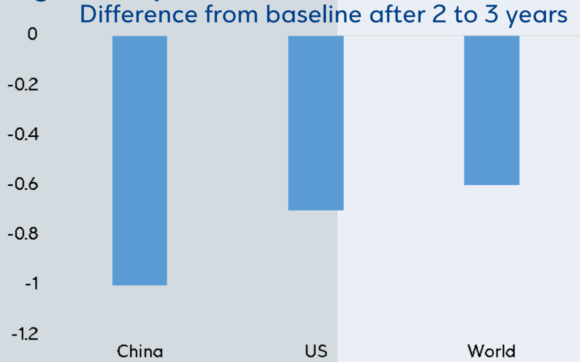
Figure 5: US Economic policy uncertainty indices



Source: PolicyUncertainty.com, Eurobank Research

Beginning an easing cycle in July, the Fed cut its target range for the federal funds rate by 25bps to 1.75-2.00% amid increased trade and geopolitical uncertainties, weaker global growth and muted inflation pressures. There were limited changes to the accompanying statement as well as the Fed's growth and inflation projections, while the "dots" of rate projections revealed that only 7 out of 17 members expected another 25bps cut by year-end and none of them expected further easing through 2022. Future monetary policy will depend on latest economic developments. We believe that additional rate cuts will probably be forthcoming given the softer outlook for domestic and external demand as well as inflation and employment, with further rate easing likely by year-end.

Figure 6: Impact of 2019 US/China trade restrictions
Difference from baseline after 2 to 3 years



Source: OECD, Eurobank Research

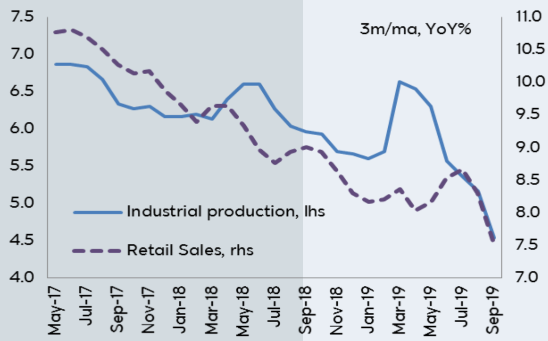
[2] New York Fed's probability model finds that the odds of a US recession in the next 12 months stand around 38% for August 2020, the highest level since 2009.
[3] Adding evidence to the manufacturing weakness in 2019, the ISM manufacturing index dropped further by 1.3pts to 47.8 in September, its lowest level since June 2009.
[4] The US labor differential -jobs plentiful less jobs hard to find among survey participants- fell to 33.2 in September from a cycle high of 38.3 in the prior month.

China

Signs of weakening momentum call for more targeted policy stimulus

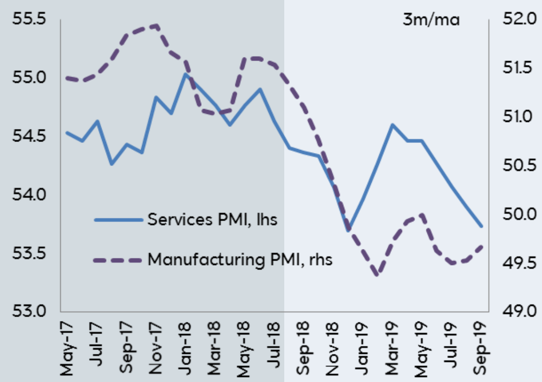
China's economy continues to slow down, following the 6.2% YoY GDP growth print in Q2 which is a 27 years low, easing further from 6.4% YoY in Q1. Prior to that, the average GDP growth rate stood at 7.4% in 2011-2018, substantially lower from 10.3% YoY in 2000 – 2010. The evident slowdown is broadly attributed to structural factors, such as the pursued transition towards a more balanced growth model along with weaker global demand and ongoing trade tensions. Recently released economic data surprised to the downside while the landscape remains unchanged at the time of writing. In brief, industrial production growth kept shrinking since June, moving streamlined with weakening exports, and so did retails sales, highlighting the subdued domestic demand. Moreover, the official manufacturing PMI data continued to remain in negative territory for the fifth consecutive month. In a nutshell, growth dynamics appear fragile with market consensus over Q3 economic growth print sliding further to 6.1% YoY; the US tariff measures have evidently hurt exports and while, in the last decade, private consumption holds an increasing portion in the economic growth composition, currently it remains under pressure. Policy makers are in a process of addressing the above challenges cautiously as both fiscal and monetary measures may come at a cost. Since credit conditions need to remain tight so as to reduce financial instability risks, liquidity measures, such as the RRR cuts and the recent 1-y Loan Prime Rate reduction are preferred. On the fiscal front, infrastructure spending and targeted tax reductions take the lead as wage increases may need to wait for productivity to catch up. Given the constraints in the fiscal and monetary arsenal, pushing for further macro prudential, transparency and regulatory reforms is rendered as of utmost importance so as for the country to attract higher quality, stable and diversified inflows, taking also into account the diminishing current account surplus. Consequently, we revise our GDP forecast downwards by one notch to 6.1% for 2019.

Figure 7: Industrial Production and Retail sales in fall



Source: Bloomberg, Eurobank Research

Figure 8: Manufacturing PMI gauge on a downturn



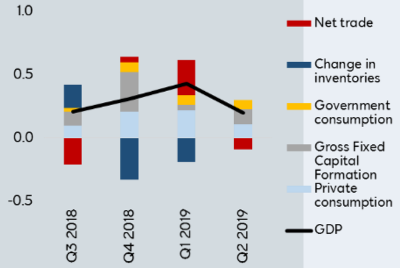
Source: Bloomberg, Eurobank Research

Euro area

The economy seems close to stalling speed as the industrial recession deepens

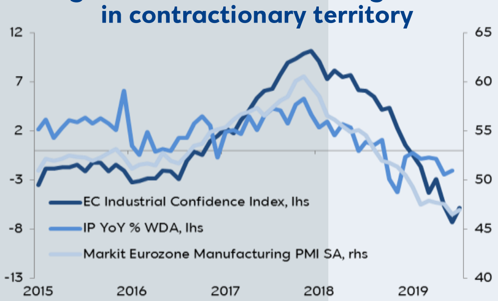
Real GDP increased by 0.2%QoQ in Q2 supported by buoyant domestic demand, reporting half the pace of Q1 growth due to a negative contribution from external trade. High-frequency activity data for Q3 suggest that the EA industrial recession continues amid a global underperformance of the manufacturing sector, heightened trade concerns, Brexit-related uncertainty and decelerating economic activity in major economies. Indeed, industrial production fell by 0.4%MoM in July, showing negative dynamics among core EA economies barring France and creating a negative Q3 carry-over of -1.1%QoQ. Moreover, the September Composite PMI index declined by 1.8pt to a more than a 6-year low of 50.1 driven by a deepening manufacturing recession (almost a 7-year low of 45.7 from 47.0) and a slower service sector expansion (8-month low of 51.6 from 53.5). [5] Falling new orders for goods and services and deteriorating expectations raise questions about how long services can remain resilient and relatively immune to the manufacturing downturn. The PMI Composite indicator is consistent with a GDP growth increase of just 0.1% in Q3, with risks tilted to the downside. Overall, we maintain our 2019 real GDP growth projection at 1.1% from 1.9% in 2018, with easing fiscal policy providing some offset to gloomier global economic and demand prospects. According to the ECB staff projection, in 2019 the EA general government budget deficit should increase to 0.8% of GDP from 0.5% in 2018 for the first time in a decade.[6] Unemployment should continue to fall in spite of the economic slowdown, while slow wage growth is being translated into subdued inflationary pressures. Key downside risks to the outlook mainly stem from the possibility of higher EU auto tariffs my mid-November 2019 and/or a no-deal Brexit. According to OECD estimates, a no-deal Brexit would subtract ca 0.4ppts from Eurozone 2020 GDP with further losses in output even in the long term.

Figure 9: Contributions to real GDP growth
(over the previous quarter, in pps)



Source: Eurostat, Eurobank Research

Figure 10: EA manufacturing sector in contractionary territory



Source: EC, IHS Markit, Bloomberg, Eurobank Research

[5] For more details see the HIS Markit PMI's press release https://www.markiteconomics.com/Public/Home/PressRelease/64d8fb3d4ccd4429860305883df4b1f3

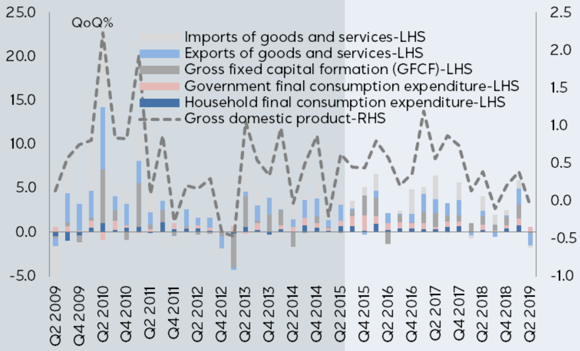
[6] see Table 1 Eurosystem/ECB staff macroeconomic midpoint projections for the euro area

Germany

Likely to head into technical recession for the first time since Q3 2013

After a strong start this year with Q1 GDP rising by 0.4%QoQ, double the Q4 2018 GDP growth rate, the German economy posted a 0.1%QoQ contraction in Q2 driven by weak net exports. Imports declined by 0.3%QoQ, while exports fell by a hefty 1.3%QoQ, confirming the economy's vulnerability to external demand slowdown on the back of lingering global trade uncertainty and Brexit jitters. Gross fixed capital formation shrunk by 0.1%QoQ, driven by a 1.0%QoQ decline in construction, partly a payback for the 2.5%QoQ weather-related surge in Q1. Positive contribution to GDP growth came from domestic demand, with private and public consumption expanding by 0.1%QoQ and 0.5%QoQ, respectively.

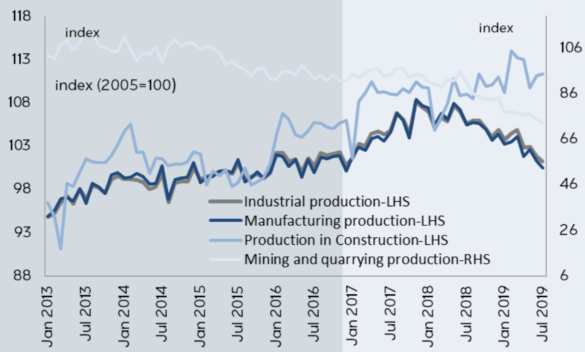
Figure 11: GDP contracted in Q2 on the back of weak net exports



Source: Federal Statistical Office (Destatis), Eurobank Research

Looking into Q3, hard data and sentiment indicators, particularly for manufacturing, suggest that the weak growth momentum is unlikely to fade, raising fears that the economy will likely post another mild contraction and, therefore, enter a technical recession for the first time since Q3 2013. Mostly pressured by an ongoing decline in new orders from countries outside the euro area, industrial production which has already declined for four consecutive quarters, dropped by a further 0.6%MoM in July while its downturn is likely to continue in the near future. As suggested by the HIS Markit survey, activity in the manufacturing sector contracted further in September with the respective index dropping to 41.7, the lowest level since the financial crisis in 2009. Worryingly, the service sector growth also lost momentum suggesting that the weakness in the manufacturing sector may have started to spill over to other sectors. The government unveiled a €54bn (c. 1.5% of GDP) package of measures for 2020-2023 aiming to fight climate change, but the impact on the economy is likely to prove moderate. With global trade tensions dragging down the German economy, we expect 2019 GDP to grow 0.5% followed by an acceleration to 1.2% in 2020 (vs. 1.4% previously) assuming that the global economy stabilizes.

Figure 12: Industrial woes raise fears over recession



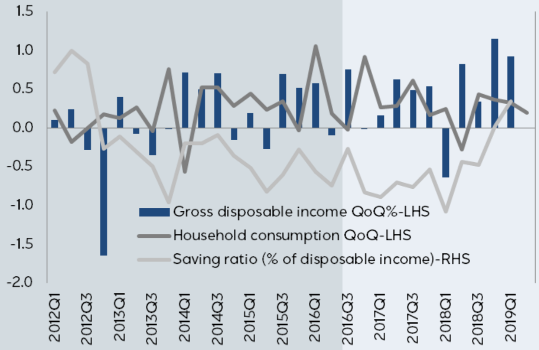
Source: Federal Statistical Office (Destatis), Eurobank Research

France

Economy continues to weather rather well the challenging external backdrop

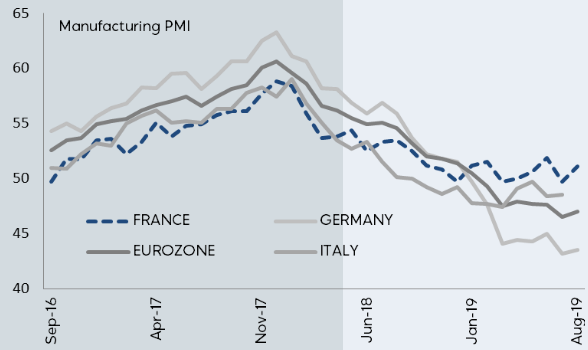
France's economic activity retained a firm tone in Q2, with GDP expanding by 0.3%QoQ for the second quarter in a row, upwards revised from a preliminary estimate of 0.2%QoQ, taking the annual rate at 1.4% from 1.3% in Q1. Business investment was a key growth driver (+0.9QoQ vs. +0.5%QoQ in Q1) adding 0.2ppt to GDP growth, supported by private sector investment activity. Export growth stalled, in line with slowing trade growth in the euro area on the back of lingering global trade jitters. But thanks to imports, which swung to contraction (-0.2%QoQ vs. +1.1% in Q1), net trade added 0.1ppt after subtracting 0.3ppts in Q1. Surprisingly, private consumption slowed to a one-year low (+ 0.2%QoQ), failing to capitalise on the fiscal measures announced by President Emmanuel Macron in December 2018 and in April 2019, amounting to c. 17bn in total (c. 0.9% of GDP). Encouragingly, household consumption is expected to rebound in Q3 and partially offset an expected modest slowdown in business investment as the external backdrop remains challenging. Boding well for private consumption, inflation pressures remain modest (Jan-Sep HICP average at 1.4%YoY vs 2.1%YoY in 2018), labor market continues to improve (ILO unemployment rate at an eight-year low of 8.7% in Q1 for the second consecutive quarter) and INSEE consumer confidence remains on a steady rising trend in recent months after plunging to four-year lows late last year at the height of the yellow vests movement protests (104 in September, above its long-run average for the fourth month in a row). Meanwhile, PMI data suggest that economic growth held up reasonably well in Q3 with the composite quarterly average standing at 50.8, the highest in the last four quarters, and well above that of the other core euro area countries. GDP growth is expected to rise c. 0.3%QoQ by end-2019 and 1.3% for the whole year 2019 before moderating to 1.1% in 2020 (down from 1.4% previously) due to a weaker global environment.

Figure 13: Higher disposable income translates into higher saving rate rather than higher household consumption



Source: INSEE, Eurobank Research

Figure 14: France's manufacturing PMI outperforms those of the other core euro area countries



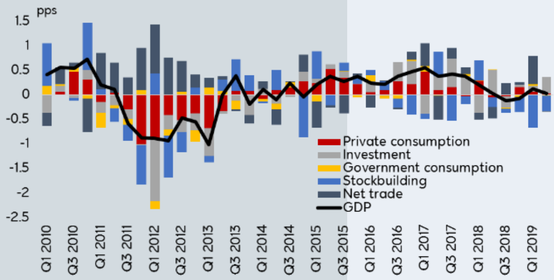
Source: Bloomberg, Eurobank Research

Italy

Soft and hard data point to an economy at a virtual standstill

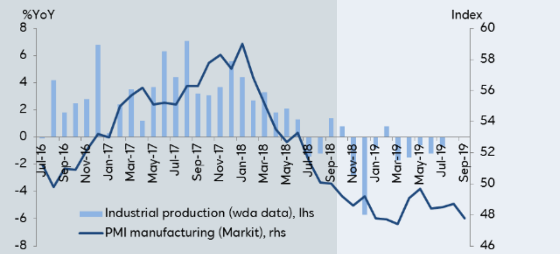
According to the 2nd estimate released by Italy's Statistical Institute, real quarterly GDP was marginally flat in Q2, down from 0.1%QoQ in Q1. Domestic demand (excl. stockbuilding) contributed 0.3pps to overall growth, with a 1.9%QoQ increase in gross fixed investment making up for flat consumer spending on the back of a decelerating consumer sentiment since last autumn. On the external front, net exports showing some resilience to the global slowdown likely on the back of a weaker exchange rate, making a null –instead of negative- contribution to growth. Underlying momentum at the beginning of Q3 remains weak, with IP data recording a 0.7%MoM fall in July following a decline of 0.3%MoM in the prior month. Meanwhile, business sentiment has recently weakened, with manufacturing conditions deteriorating at the fastest pace in six months during September (IHS Markit Manufacturing PMI down to 47.8 from 48.7 in August) and a marginal rate of expansion in the services sector that points to an economy at a virtual standstill. With the most recent data being consistent with an industrial recession, persistent external weakness and a fragile domestic demand, we maintain our 2019 GDP forecast at 0.1% from 0.7% in 2018. The current economic and political environment seems to favor Italy; The easier monetary policy by the ECB is leading to lower interest rates that improve the sustainability of the Italian public debt, reduce interest payments, and exert a positive impact on GDP growth. At the same time, the new EC is likely to be more inclined to expansionary fiscal policies while the Italian government, backed by M5S and PD is more pro-European. Passing the annual update to the Economic and Financial Document (NADEF) ahead of the 2020 budget plan to be submitted to the EC by mid-October, the government has set the deficit target at 2.2% of GDP for 2020. The NADEF delivers on the government's promise to prevent an automatic VAT hike in 2020 worth €23bn, absorbing most of the 2020 budget resources (~€30bn). It is worth noting that the structural deficit is forecast to increase to 1.4% from 1.2% in 2019, while the EC urged Italy in July to reduce its 2020 structural deficit by 0.6pps. Favorable conditions could help the Italian government to adopt a much less confrontational stance towards the EU, but the need for structural consolidation of public finances and non violation of EU rules remains of vital importance.

Figure 15: Contributions to real GDP growth
(over the previous quarter, in pps)



Source: Refinitiv Datastream, Eurobank Research

Figure 16: Industrial production keeps contracting



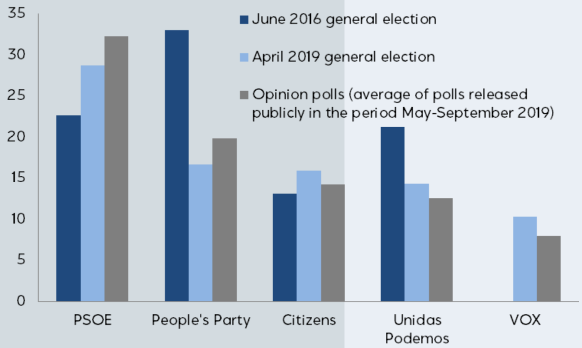
Source: EC, IHS Markit, Bloomberg, Eurobank Research

Spain

Heading into repeat election while signs of economic weakness are increasing

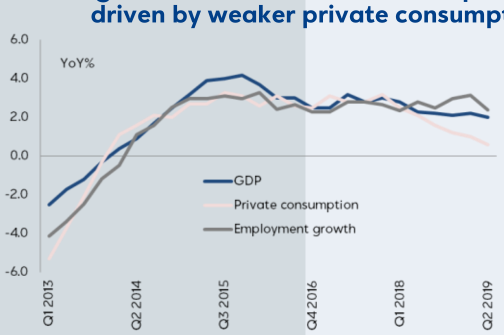
Spain returns to the polls on November 10 for the second time this year and the fourth in four years, as the PM and leader of the ruling Socialist Party (PSOE), Pedro Sánchez, failed to secure the backing of parliament to form a new government. PSOE came first in the April 2019 general election but fell well short of a majority in the 350-seat parliament. However, opinion polls suggest that the outcome of the next general election is unlikely to differ much from that of the previous one. PSOE and PP have gained some additional public support since the April election with the former still in the lead, but both seem far short of securing an absolute majority. Worryingly, political uncertainty mounts at a time when the economy has started to lose momentum after years of robust growth. Q2 2019 GDP slowed from 2.2%YoY (0.5%QoQ) in the prior quarter to 2.0%YoY (0.4%QoQ), the lowest pace in near five years, led by a sharp slowdown in private consumption (5-year low of 0.6%YoY vs. 1.0%YoY in Q1) and weaker gross fixed capital investment (near 3-year low of 1.0%YoY) mostly related to external factors. Employment, the main growth driver so far, is slowing with the annual growth rate easing to 2.4% in Q2, the lowest in more than a year, while consumer sentiment has been on a declining trend in the last three months, coming in at -6.2 in September, unchanged from the August print, which is the lowest level since February. Moreover, industrial production rose by 0.8%YoY in July, moderating from the Q2 average of 1.5%YoY, the IHS Markit manufacturing PMI has been below the 50 benchmark for four consecutive months (multi-year low of 47.7 in September), while the number of tourist arrivals contracted in annual terms in August (-0.5%) for the third time in the last four months. All in all, we now expect 2019 GDP to slow to 2.0% (from 2.3% previously) and 1.7% in 2020 (from 1.9%), while prolonged political uncertainty in a subdued external environment poses the risk of a more pronounced slowdown.

Figure 17: 10 November election unlikely to break the political deadlock



Source: Eurostat, INE, Eurobank Research

Figure 18: Q2 GDP slowed down partially driven by weaker private consumption



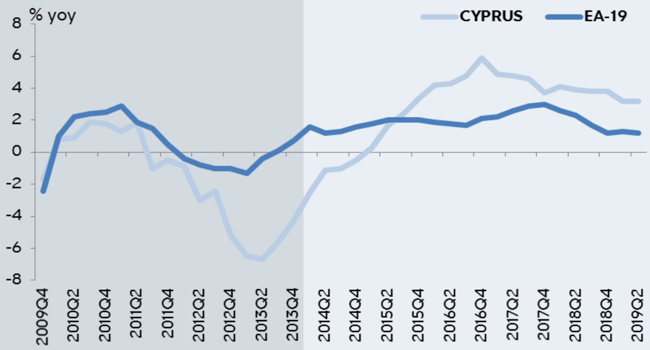
Source: INE, Eurobank Research

Cyprus

Second quarter GDP estimate confirmed that economic activity is on a decelerating path

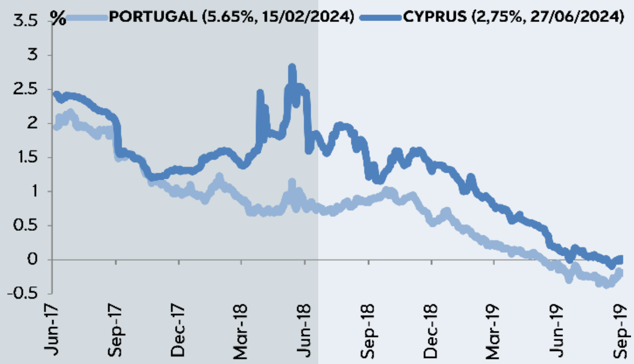
The second estimate of CYSTAT on the seasonally adjusted Q2-2019 GDP reading left the flash estimate unchanged. Real GDP expanded by 0.8% QoQ bringing the annual rate of expansion to 3.2% YoY in Q1-2019 on a seasonally adjusted basis, flat compared to Q1-2019 but still lower than 3.8% YoY in Q4-2018 & Q3-2018, vs. 3.9% YoY in Q2-2018. The reading marks the end of a period of buoyant growth and – ceteris paribus – suggests that the soft landing of the economy we penciled in all previous analyses has already started. Domestic demand has had the lion's share in the GDP growth reading. Final consumption dynamics were strong for yet another quarter, making a +5.2ppts contribution to GDP growth in Q2-2019. Final consumption expanded by +1.8% QoQ/+6.3% YoY in Q2-2019 up from +0.7% QoQ/+6.2% YoY in Q1-2019 and +1.6% QoQ/+3.6% YoY in Q2-2018. The final consumption strength was underpinned by a number of factors, which all boil down to the rise of disposable incomes and the propensity to consume, namely: sustained sentiment improvement (the ESI index still close to multi-month highs), tightening labor market conditions (unemployment at 7.3% in Q2-2019, now standing below EA-19 levels), further property market stabilization, the impact from the fiscal relaxation after the graduation from the economic adjustment programme and the acceleration of public consumption in 1H-2019. Moreover, investments' volatile performance continued in this quarter too. Investment spending in Q2-2019, at constant prices, was higher on an annual basis (+21.6% YoY) underpinned by the stream of ongoing residential and tourism infrastructure construction projects. The program "citizenship through inward investment" has helped to attract foreign investment in the real estate sector in the form of high-rise residential towers, particularly in the Limassol & Paphos areas. However, the negative inventories performance resulted in gross capital formation having a small negative contribution to GDP growth in Q2. Finally, net exports' contribution was less negative (-1.2ppts in Q2-2019 vs. -9.0ppts in Q1-2019). That was the combined effect from both exports contracting by -17.2% QoQ/-3.1% YoY, and imports dropping by -4.3% QoQ/-1.1% YoY.

Figure 19: Cyprus' turn-around growth story has been impressive so far



Source: CYSTAT, Eurostat, Eurobank Research

Figure 20: Cypriot medium term bond yields Have improved further in recent months



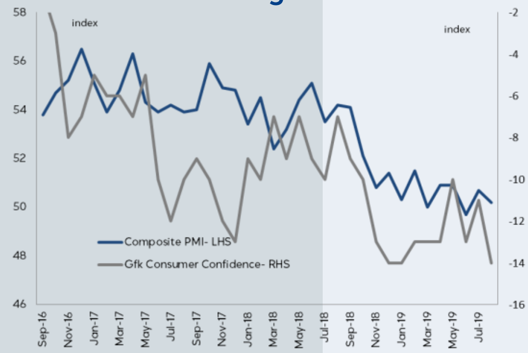
Source: Bloomberg, Eurobank Research

UK

Weak growth momentum behind July's GDP upside surprise

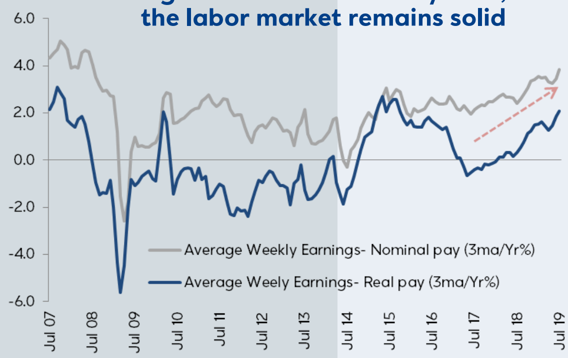
UK July's GDP surprised positively showing a growth rate of 0.3%MoM, the strongest increase since January, taking the 3M/3M growth pace up 0.2pp to 0.0% and the Q3 carry over at a solid 0.4%QoQ. However, the monthly GDP growth rate is volatile and, therefore, it should be read with caution. Admittedly, a key factor behind the July GDP boost was a multi-year high 1.1%MoM increase in the transport and storage services component, while there was no evidence of a similar manufacturing stockpiling which was the driver behind the Q1 GDP rebound. Furthermore, sentiment surveys paint a gloomy picture for the UK growth outlook, particularly those related to the manufacturing and construction sectors. The Markit/CIPS manufacturing PMI has weakened significantly since the beginning of the year (48.3 in September) and the breakdown of the latest survey did not provide hope for a clear stabilization any time soon, while the respective index for construction contracted in September for the fifth month in a row. On a rosy note, the ongoing tightening of the labor market suggests that private consumption should remain an anchor to GDP growth ahead, keeping imminent recession fears at bay after Q2 GDP contracted for the first time since 2012 (-0.2%QoQ). The employment rate hit a record high of 76.1%, with total pay growth rising by 4.0%YoY on a 3mma basis, the highest in more than ten years. However, at its 19 September policy meeting, the MPC BoE adopted a slightly more dovish tone, emphasizing the weak underlying growth momentum being transmitted by the sentiment surveys, the weaker global growth and persistent Brexit-related uncertainty. Under a baseline scenario of the UK avoiding a no-deal Brexit, we expect 2019 GDP to grow 1.2% supported by a possible resolution of some of the Brexit uncertainty before picking up modestly to 1.3% in 2020 on the back of the recently unveiled fiscal stimulus for FY 2020-2021 (GBP 11.7bn, c. 0.5% of GDP). Those forecasts are subject to revision in case of a Brexit deal in October or increased odds of a no-deal Brexit.

Figure 21: Sentiment surveys do not bode well for the UK's growth outlook...



Source: ONS, Bloomberg, Eurobank Research

Figure 22:... but on a rosy note, the labor market remains solid



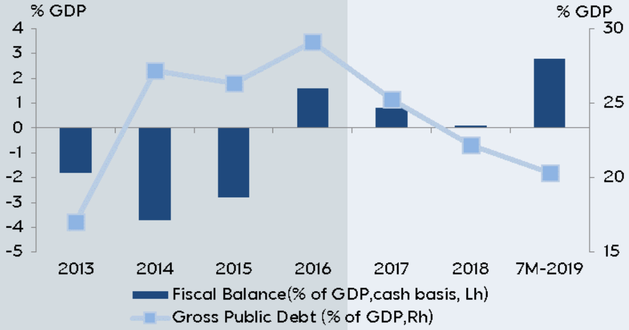
Source: ONS, Eurobank Research

Bulgaria

Second quarter GDP estimate confirmed that economic activity remains strong in an unfavorable world economic environment

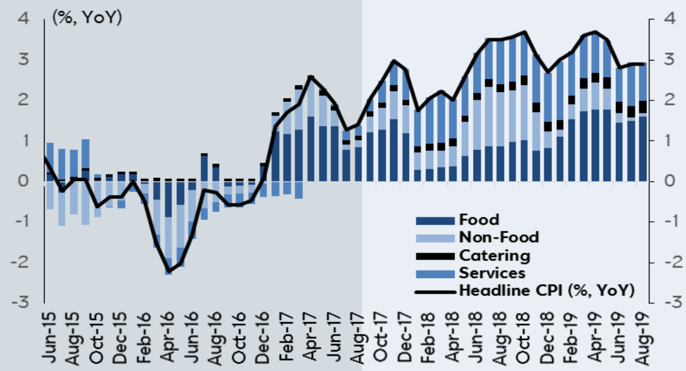
The seasonally adjusted Q2-2019 GDP growth estimate was raised by 0.2ppts on an annual basis from a flash reading, with economic activity coming in at 0.8% QoQ/3.5% YoY in Q2-2019 compared to 1.2% QoQ/3.5% YoY in Q1-2019 up from 0.8% QoQ/3.2% YoY in Q4-2018 and 0.7% QoQ/3.1% YoY in Q3- 2018. As things stand, net exports made a positive contribution against an unfavorable external backdrop (exports: -2.9% QoQ/3.7% YoY in Q2-2019 down from 1.9% QoQ/5.1% YoY in Q1-2019 vs imports: -5.0% QoQ/-2.0% YoY in Q2-2019 down from 1.5% QoQ/3.5% YoY in Q1-2019). Final consumption had a negative contribution (-0.1% QoQ/2.6% YoY in Q2-2019 vs 1.3% QoQ/4.5% YoY in Q1-2019), which would have been even smaller notwithstanding the strong contribution of public consumption. The tightening of the labor market conditions plus the rise of the minimum and average wages remain very supportive of private consumption. Investments appeared to be losing momentum in Q2-2019 despite wide expectations for the opposite (0.7% QoQ/2.2% YoY in Q2-2019 down from 0.2% QoQ/2.5% YoY in Q1-2019 vs. 2.8% QoQ/6.6% YoY in Q4-2018). In our view, solid growth momentum is expected to continue in H2-2019 – our full year forecast stands at 3.5% unrevised since last year – driven by sound domestic demand dynamics. Private consumption will be in the driver's seat, receiving support from a tighter labor market, relatively low energy prices, convergence of wages towards EU average, a vibrant manufacturing sector despite the increasing world trade tensions and increased tourism flows. Investment, especially public investment will receive a boost from improved EU funds' absorption (which will hopefully become visible in H2-2019). With the end of the 2014-2020 programming period approaching, the government will need to step up spending for a number of mature projects. Moreover, domestic credit conditions have turned more growth supportive. Credit activity expanded by a still strong rate of 6.0% YoY in August down from 6.5% in July not very far from 8.7% YoY in February – the highest rate since June 2009 – compared to 8.5% YoY in January.

Figure 23: Bulgaria's fiscal position is sound



Source: National Authorities, Eurobank Research

Figure 24: Inflation trending lower in recent months on lower services' prices



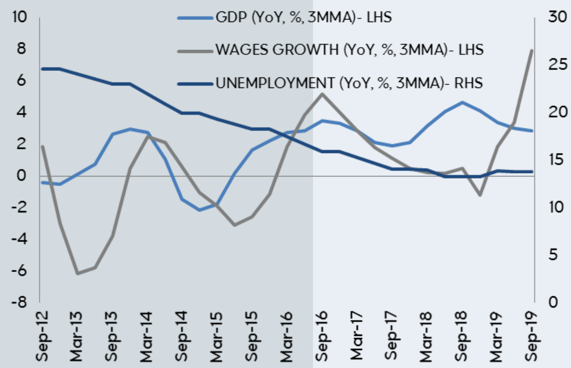
Source: National Authorities, Eurobank Research

Serbia

Solid macroeconomic performance but with GDP growth losing some steam

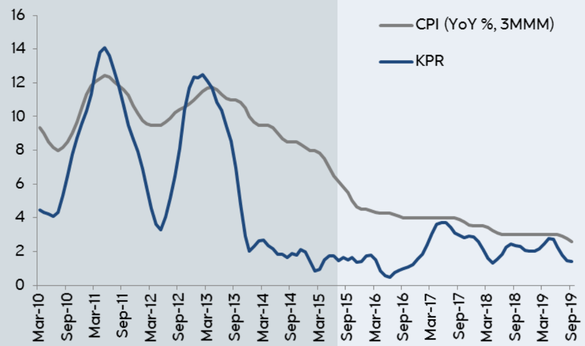
Following an upwards revised economic growth print of 2.7% YoY in Q1 from 2.5% initially, Serbia's GDP expanded by 2.9% YoY in Q2, setting economic growth at 2.8% YoY in H1. The key driver remains consumption while investment picked up on the back of solid construction activity (8.6% YoY in Q2 vs 7.8% YoY in Q1), absorbing sizably the drawback from net exports. According to the IMF and the National Bank of Serbia (NBS), GDP is expected to grow by 3.5% in FY2019, suggesting expectations for an acceleration in the next two quarters, broadly based on consumption and investment. Regarding the latter component, we outline the five year public investments plan of up to EUR12bn coming into effect in 2020 and focusing primarily on infrastructure projects. On the monetary front, as broadly expected, the National Bank of Serbia (NBS) kept the key policy interest rate stable at 2.50% in September's meeting, following two consecutive 25bp cuts in July and August. The NBS preferred to adopt a wait and see mode so as to assess the effects of the two previous cuts on the inflation trajectory, which after reaching the 3.0% midpoint in April is broadly on a downtrend ever since. In detail, the inflation print of August released a few days ago came in at 1.3% YoY from 1.6% YoY in July. The reading came below expectations (the relevant monthly survey stood at 1.8% YoY) while it remains at the lower side of the target band (3.0%, ±150bps). The economic outlook remains positive, mirrored in the recent upgrade of the long-term foreign currency debt to BB+ from BB by Fitch Ratings. In the same direction, Moody's affirmed Serbia's rating at Ba3 and revised its outlook to positive from stable. Both agencies ground their assessments on improved public debt metrics, robust medium term economic growth outlook and the implementation of structural reforms. However, Serbia, as a small economy is substantially exposed to external risks, which are tilted to the downside. In a nutshell, we revise our forecast for a 3.2% economic growth print in 2019 from 3.5% in July.

Figure 25: Solid economic growth and labor market



Source: Bloomberg, Eurobank Research

Figure 26: monetary easing amid subdued inflationary pressures



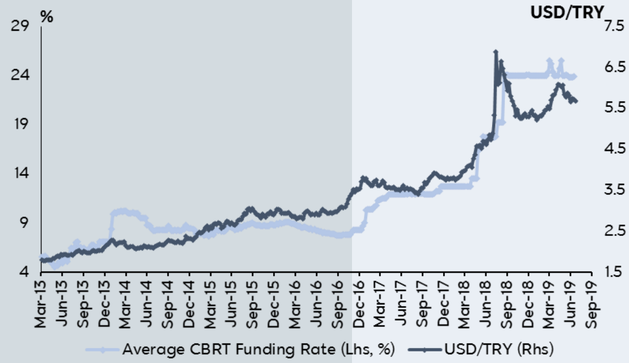
Source: Bloomberg, Eurobank Research

Turkey

The Central Bank of Turkey slashed interest rates again in September

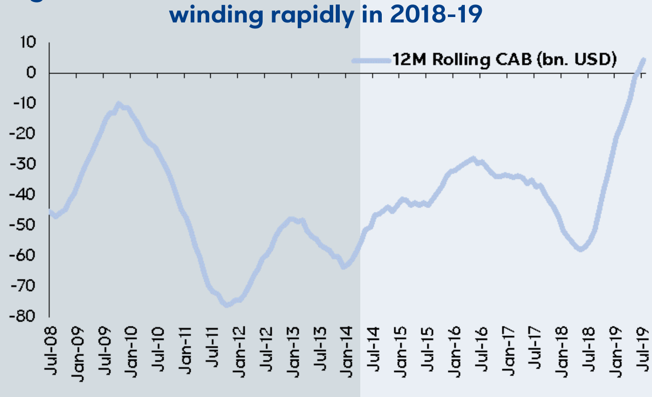
Headline inflation resumed its declining trend in August coming at 15.0% YoY in August down to a new twelve-month low, down from 16.7 YoY in July and 15.7% YoY in June vs. 18.7% YoY in May compared to 19.5% YoY in April coming again below analysts' consensus (Actual: +0.9% MoM vs Bloomberg: +1.30% MoM). Weak domestic demand dynamics, the appreciation trend of the lira since late May, favorable base effects in the food prices segment have supported the ongoing disinflation process in H2-2018. Headline inflation has retreated from its historic highs in recent months closing at 20.3% YoY in December down from 21.6% YoY in November and 25.2% YoY in October 2018. Core inflation (which excludes food, alcohol, tobacco, energy and gold prices) eased further to 13.6% YoY in August at the lowest level since June 2018 vs. 16.2% YoY in July. 14.9% in June, down from 15.9% YoY in May, compared to 16.3% YoY in April vs. 17.5% YoY in March down from 19.5% YoY in December. The inflation outlook improvement allowed the Central Bank of Turkey (CBRT) to deliver the second rate cut in early September. Having slashed the key policy rate (KPR) – the 1-week repo as of May 2018 – by 425bps from 24.00% to 19.75% in July, the CBRT cut interest rates by another 325bps down to 16.50%. The front-loaded move overshot the market consensus of 250-275bps, according to the Reuters and Bloomberg polls. The CBRT cited the inflation trajectory improvement driven by the stabilization of the domestic currency and inflation expectations plus the tangible results of the ongoing rebalancing of the economy underpinned by buoyant tourism revenues as well as the expansionary stance of the major Central Banks worldwide. More importantly, the communique of the Central Bank was enriched with forward guidance on the future policy rates path. The CBRT stated that "at this point, the current monetary policy stance, to a large part, is considered to be consistent with the projected disinflation path" adding that "the extent of the monetary tightness will be determined by considering the indicators of the underlying inflation trend to ensure the continuation of the disinflation process". The statement could largely be interpreted as a signal that the bulk of easing has been already delivered and that a more cautious stance could be warranted in the near-term.

Figure 27: Turkish Lira rebounding since late May



Source: Bloomberg, Eurobank Research

Figure 28: Macroeconomic imbalances have been unwinding rapidly in 2018-19



Source: National Authorities, Eurobank Research

Eurobank Macro Forecasts

	Real GDP (YoY%)			CPI (YoY%, avg)			Unemployment rate (% of total labor force)			Current Account (% of GDP)			General Budget Balance (% of GDP)		
	2018	2019f	2020f	2018	2019f	2020f	2018	2019f	2020f	2018	2019f	2020f	2018	2019f	2020f
World	3.6	3.2	3.1	3.6	3.1	3.0									
Advanced Economies															
USA	2.9	2.3	1.6	2.4	1.7	2.0	3.9	3.7	3.7	-2.4	-2.5	-2.6	-3.8	-4.5	-4.5
Eurozone	1.9	1.1	1.0	1.8	1.2	1.2	8.2	7.6	7.5	2.9	2.6	2.5	-0.5	-1.0	-1.0
Germany	1.4	0.5	1.2	1.9	1.4	1.4	3.4	3.2	3.2	7.3	7.0	6.5	1.7	1.0	1.5
France	1.7	1.3	1.1	2.2	1.3	1.5	9.1	8.7	8.5	-0.7	-0.6	-0.5	-2.5	-3.2	-2.5
Periphery															
Cyprus	3.9	3.3	3.0	0.8	1.0	1.5	8.4	7.5	7.0	-7.0	-7.5	-7.0	2.9	3.0	2.6
Greece	1.9	1.7	2.0	0.8	0.9	0.9	19.3	17.7	16.5	-2.9	-2.4	-2.4	1.1	0.5	-0.1
Italy	0.7	0.2	0.5	1.3	0.8	1.0	10.6	10.2	10.3	2.5	2.6	2.5	-2.1	-2.3	-2.8
Portugal	2.2	1.7	1.5	1.2	0.5	1.0	7.0	6.5	6.2	-0.6	-0.4	-0.3	-0.5	-0.4	-0.3
Spain	2.6	2.0	1.7	1.7	0.9	1.2	15.3	13.9	13.0	0.9	0.8	0.7	-2.5	-2.3	-2.0
UK	1.4	1.2	1.3	2.5.	1.9	2.0	4.1	4.0	4.0	-3.9	-4.2	-4.0	-1.5	-1.5	-1.4
Japan	0.8	0.9	0.3	1.0	0.7	0.7	2.4	2.4	2.4	3.5	3.5	3.5	-2.5	-2.3	-2.3
Emerging Economies															
BRICs															
Brazil	1.1	1.8	2.5	3.7	3.9	4.0	12.3	11.8	10.8	-0.8	-1.3	-1.7	-7.3	-6.6	-6.2
China	6.6	6.1	6.0	2.1	2.2	2.3	3.8	4.0	4.0	0.4	0.1	0.0	-2.2	-4.2	-4.2
India	7.2	7.0	7.2	4.0	3.4	3.8		*NA*		-2.2	-2.2	-2.2	-3.6	-3.4	-3.4
Russia	2.3	1.4	1.7	2.9	4.9	4.0	4.8	4.8	4.8	7.0	5.7	4.2	2.6	1.9	1.3
CESEE															
Bulgaria	3.1	3.5	2.8	2.7	2.8	2.5	5.2	5.3	5.7	4.6	1.0	1.0	0.1	-0.5	0.0
Romania	4.1	3.8	3.5	4.7	4.0	3.5	4.2	3.9	4.2	-4.7	-5.0	-5.2	-2.9	-3.4	-4.7
Serbia	4.3	3.2	3.8	2.0	2.6	2.8	12.7	11.0	9.0	-5.2	-6.0	-5.5	0.6	-0.5	-0.5
Turkey	3.3	-0.5	2.5	16.3	15.0	13.0	10,9	13,0	12,5	-3,6	0.5	-1.0	-2,1	-3.0	-2.3

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

Eurobank Fixed Income Forecasts

	Current	December 2019	March 2020	June 2020
USA				
Fed Funds Rate	2.25-2.50%	2.11-2.39%	2.02-2.25%	1.95-2.20%
1 m Libor	2.40%	2.47%	2.44%	2.42%
3m Libor	2.31%	2.38%	2.35%	2.33%
2yr Notes	1.75%	2.02%	2.08%	2.11%
10 yr Bonds	2.02%	2.72%	2.77%	2.81%
Eurozone				
Refi Rate	0.00%	0.00%	0.00%	0.05%
3m Euribor	-0.34%	-0.33%	-0.34%	-0.34%
2yr Bunds	-0.75%	-0.56%	-0.52%	-0.48%
10yr Bunds	-0.32%	-0.06%	0.03%	0.11%
UK				
Repo Rate	0.75%	0.75%	0.80%	0.85%
3m	0.77%	0.88%	0.95%	1.00%
10-yr Gilt	0.81%	1.10%	1.18%	1.25%
Switzerland				
3m Libor Target	-0.73%	-0.72%	-0.72%	-0.73%
10-yr Bond	-0.53%	-0.36%	-0.32%	-0.22%

Source: Bloomberg (market implied forecasts)

Eurobank

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