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

June 2019

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I. Snapshot

Overview

Macro Picture

- **USA:** Weakness in globally-exposed economic data, while domestically-oriented indicators remain solid
- **EA:** Weaker economic data and increased economic uncertainty point to slower growth in 2019
- **UK:** Q2 GDP growth is expected to slow mainly due to unwinding of Brexit related stockpiling seen in the prior quarter
- **EM:** Economic growth is set to continue in 2019, but at slower pace compared to 2018
- **CESEE:** The broader region remains resilient to the deterioration of the world growth outlook

Policy Outlook

- **USA:** First rate cut most likely in July, with a total of 50-75bps of cumulative rate cuts in H2 2019
- **EA:** First deposit rate cut likely in September; Deposit tiering and QE relaunch are also possible
- **UK**: The BoE is expected to stay on put on rates awaiting more clarity on the domestic political and global outlook
- **CESEE:** ECB's recent dovish tone provides regional central banks with time to battle inflationary pressures

Summary

The global economic outlook has worsened lately, dragged down by uncertainty amid escalating US/China trade tensions and prolonged Brexit-related woes. Central banks' dovish shift, combined with healthy labor markets and personal consumption in major economies, are expected to underpin the global economy

Markets

- **FX:** Currency wars on the back of trade wars led to a lower USD in June. But with central banks across the globe joining the dovish chorus, a renewed USD uptrend cannot be ruled out completely
- **Rates:** The drop in yields across the globe continued as dovish comments/statements by major central banks were the key drivers, pushing 10yr USTs below 2.0% and the German curve to negative levels all the way to the 17 years tenor
- **EM:** Central banks to the rescue of EM credit as they boost the "hunt for yield". Even negative idiosyncratic stories like Turkey and Mexico were not enough to halt buying pressure in June
- **Credit:** Tighter spreads and lower yields despite a busy primary market. Talk of a new CSPP by the ECB is the main highlight for EUR credit. Idiosyncratic stories on the rise especially in the high yield space

Key Downside Risks

- **Renewed escalation of trade war:** Re-escalation of US-China trade dispute; the US imposes EU auto tariffs
- **Increased EU political uncertainty:** Delay in the formation of consensus in the European Parliament for the appointment of the next European Commission President; renewed confrontation between Italy and the European Commission
- **No-deal Brexit:** The next Conservative Party leader is more open to a no-deal Brexit; the UK House of Commons fails to reach consensus on Brexit by the 31 October deadline and the EU leaders do not agree to delay Brexit further
- **EM sensitivity:** Should the US-Sino trade war continue to linger, EM's economic growth could be hampered
- **China:** In case of further tariffs escalation, domestic demand may weaken

Macro Views

Latest Macroeconomic Developments & Outlook

World Economic Outlook		The global economic outlook has worsened over the last month, dragged down by elevated uncertainty amid escalating US/China trade tensions and prolonged Brexit-related woes. This protracted economic and political uncertainty has weighed on business and consumer confidence, curbing the propensity of households and businesses to consume and invest. Given the ongoing weakness in trade and manufacturing, major central banks have shifted to a more dovish stance to sustain global economic expansion and limit downside risks to the outlook. The Fed is currently the leader in this dovish shift, expecting to cut interest rates by 50-75bps in H2 2019, with the ECB following suit and standing ready to proceed with additional stimulus in the absence of improvement. Signals for monetary policy accommodation, which induce other major central banks to move towards policy easing as well, combined with healthy labor market conditions and solid personal consumption in most major economies, are expected to support the ongoing global expansion, with real GDP global growth projection at 3.3% in 2019 from 3.6% in 2018.
Developed Economies	**US**	Economic weakness is mainly concentrated in globally-oriented data while domestically-centred indicators remain relatively firm. We maintain our real GDP growth projection at 2.4% in 2019 down from 2.9% in 2018, with the main headwinds to the economic outlook being at this point external rather than internal. The potential for higher tariffs could add to policy uncertainty and adversely affect business investment and, hence, overall economic growth.
	Euro Area	Latest economic indicators pertaining to Q2 2019 point to a loss of momentum following a higher than expected 0.4%QoQ growth rate in Q1, with the June Composite PMI being consistent with a quarterly real GDP growth rate of approximately 0.25%QoQ in Q2. Expansion is expected to continue in the medium term, albeit at a lower pace mainly due to fading global trade growth, with our 2019 real GDP growth projection coming in at 1.1%, from 1.2% previously, as increased economic uncertainty on the back of mounting trade war frictions and weaker investment spending should constitute a drag on domestic demand.
	Periphery	Though data pertaining to early Q2 point to a slightly lower pace of GDP growth compared to 0.7%QoQ in Q1, the fastest rate since Q4 2017, Spain remains the star performer among all EU periphery economies and the fastest growing economy among eurozone's big four countries. On the flipside, Italy remains the weak link among big eurozone economies, with heightened political uncertainty constituting a major risk to its growth outlook. The risks surrounding the growth prospects of all periphery economies are 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.
Emerging Economies	**BRICS**	In Brazil, GDP growth slowed down to 0.5% YoY in Q1 2019 compared to 1.1% YoY in Q4 2018 while available data for Q2 points to further loss of steam. In line with market expectations, the Central Bank of Russia (CBR) cut the key policy interest rate by 25bp to 7.5%. In India, GDP growth eased to 5.8% YoY in Q1 2019 from 6.6% YoY in Q4 2018. The slowdown will probably persist in the current quarter as the long election duration in May seems to have weighted on economic activity. China's Premier Xi Jinping is heading towards a meeting with his counterpart President Donald Trump at the sidelines of the G20 meeting in order to recap on the trade negotiations amid a mixed momentum for the Chinese economy according to hard data released in June.
	CESEE	The broader CESEE region remains defiant to the deteriorating global economic environment on solid domestic demand dynamics. The second Q1-2019 GDP estimates in the broader CESEE region confirmed the positive picture portrayed by the flash estimates. The CEE3 economies are leading the pack expanding on average by 4-5% YoY, while the SEE (Bulgaria-Serbia) economies are lagging behind growing on average by 3.0-3.5%.

Global Macro Themes & Implications

Theme	Implications
Dovish messages by major central banks fuel expectations of monetary policy easing	The FOMC decided to maintain the target range for the federal funds rate at 2.25-2.50% at its 18-19 June monetary policy meeting, but the said decision was not unanimous as St. Louis Fed President James Bullard dissented, voting in favor of a 25bps rate cut. The Committee adopted a more dovish tone compared to that in the prior meeting, in line with market expectations for lower interest rates in the coming months. According to the accompanying policy statement, the Committee will no longer be "patient" but instead "it will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion". Economic growth was assessed as "moderate" versus "solid" in the May statement, while the Fed also acknowledged that "uncertainties" about the growth outlook " have increased" and market-based measures of inflation compensation "have declined" rather than "have remained low" that was stated previously, with Fed Chair Jerome Powell emphasizing that both market-based measures of inflation compensation and survey-based measures of inflation expectations "are near the bottom of their historic ranges." Adding to the Committee's shift to a more dovish stance, the updated interest rate projections revealed that 8 FOMC members moved their dots lower to endorse one or more rate cuts before year-end, with 7 of those now calling for 50bps easing and 1 for 25bps. The remaining 8 members predicted no interest rate change while just one member assumed a rate hike. Furthermore, the Fed revised lower its longer-run neutral rate to 2.5%, the lowest since January 2012, from 2.8% previously, while the median of the Fed's dot plot moved down, as expected, suggesting 30bps of cumulative rate easing in 2020 (to 2.1% from 2.4%) and a 30bps rate hike in 2021 (to 2.4% from 2.1%). On the inflation front, the median projection for PCE inflation for 2019 and 2020 was revised lower to 1.5% and 1.9%, respectively, from 1.8% and 2.0% in March, while core PCE inflation experienced a smaller downward revision by two-tenths to 1.8% in 2019 and by one-tenth to 1.9% in 2020. Nevertheless, comments by St. Louis Fed President James Bullard, the most dovish FOMC member who dissented at the June meeting preferring a 25bps rate cut, noted that although the Committee should proceed with an "insurance rate cut," the current environment does not call for an immediate 50bps rate cut and such a move would be "overdone." Following the outcome of the June FOMC meeting, we expect the Fed to cut policy rates in 2019 to support the economy, likely starting in July or September, and delivering 50-75bps of cumulative rate cuts in the second half of the year, with the easing path highly dependent on developments relating to the trade dispute between the US and China and the incoming economic data. In the euro area, at its 6 June policy meeting, the ECB (i) extended the forward guidance by six months to envisage unchanged interest rates "at least through H1 2020". ECB President Mario Draghi clarified that the reason behind that decision was the fact that uncertainty related to protectionism, Brexit and the vulnerabilities of certain emerging markets are more persistent than the GC though to be the case at the March policy meeting; and (ii) announced further details about TLTRO-III that were less generous than those of TLTRO-II (the maximum interest rate was set at MRO+10bps rather than simply the MRO rate and the lowest possible rate was set at deposit rate +10bps instead of the deposit rate). Reinforcing the dovish signal indicated in its June press conference, in his annual Sintra's speech, President Mario Draghi stated clearly that additional stimulus "will be required" in the absence of improvement, emphasizing that the Governing Council has tools available: (i) adjusting the forward guidance; (ii) cutting rates and mitigating any side effects on banks' profitability; (iii) re-launching QE. Following the ECB's more dovish shift, we expect the ECB to pave the way for further monetary policy easing at its July meeting, enhancing its rates forward guidance by adjusting its bias from "at present levels" currently to "at present or lower" levels. The first deposit rate cut should not come before the September meeting, along with downward revisions in the ECB's macro forecasts and mitigating measures to reduce the effect of negative interest rates on banks' profitability.

Global Macro Themes & Implications

Theme	Implications
US/China trade war enters a decisive phase	US/China trade war enters a decisive phase with market participants awaiting a crucial meeting between US President Donald Trump and his Chinese counterpart Xi Jinping, scheduled around noontime on Saturday (29 June), on the sidelines of the 28/29 June G20 summit in Osaka, Japan. With both sides expressing a desire to resume trade talks, investors see increasing chances for a trade war ceasefire and the resumption of negotiations that could lead to some reduction in trade tensions, removing a cloud for the global growth outlook. The most optimistic scenario would be the two leaders to signal that a trade deal is possible in the coming months. That outcome could entail an imminent or gradual removal of all US tariffs imposed on Chinese imports during the trade war, while the US administration would not follow through on the US President's threat to impose tariffs on the remaining c. $300bn worth of imports from China. However, negotiations will be difficult and reviving trade talks do not guarantee a positive outcome. 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. The risk is the US President to exert maximum pressure to secure a more favourable deal for the US, ignoring China's demands when it has been clear since the May breakdown that there are three points where it cannot compromise: (i) removal of all US tariffs imposed during the trade war; (ii) agreement on a realistic amount of purchases of US goods; and (iii) a balanced agreement text. In addition, China may also request a withdrawal of the export ban on Chinese technology giant Huawei. In the absence of a mutually fruitful outcome, China is likely to retaliate by imposing restrictions on rare earth exports to the US. However, amid weakening of the Chinese economy and as the US President is heading into an election year, it is in the best interest of both sides to not extend the trade war for much longer.
Mounting no-deal Brexit fears	In the fifth and final ballot of Conservative MPs for the party leadership on 20 June, fervent Brexit campaigner Boris Johnson and foreign minister Jeremy Hunt emerged as the only two candidates left in the race to replace outgoing PM Theresa May. The around 160,000 Conservative party members will determine the winner in a postal ballot on a "one member one vote" basis, with the result expected to be announced in the week commencing 22 July, shortly before the summer parliamentary recess. Jeremy Hunt has said that he would consider a short extension to the UK's Brexit deadline, if necessary, and while he would prefer the UK to leave the EU with a deal, he believes that a no-deal exit is better than no-Brexit. Adopting a harder Brexit stance, Boris Johnson, who comfortably topped all five ballots of Conservative MPs, has cast himself as the only candidate who can deliver Brexit on 31 October. He has publicly stated that he wants to renegotiate with the EU27 the Withdrawal Agreement but, if discussions prove unsuccessful, the UK will have to exit on 31 October with or without a deal. However, taking into account that the main controversial issue for the majority of UK MPs is the Irish backstop, which is part of the Withdrawal Agreement, the new party leader is unlikely to be engaged in meaningful negotiations with the EU27.The EU has repeatedly said that it is open to changing the wording of the non-binding Political Declaration but has refused to renegotiate the legally-biding Withdrawal Agreement. It is unlikely to change its position, especially if the new UK PM is pro-Brexit. The bookies' odds and recent polling suggest that Boris Johnson would likely win due to his appeal to Leave voters, the predominant group among the Conservative Party membership who will make the final decision for the new Prime Minister and party leader. But investors are of the view that a victory for Boris Johnson might mean a higher chance of a no-deal Brexit, unless the UK House of Commons reaches consensus on Brexit by the 31 October -which seems highly unlikely for the time being- or the EU27 grants another extension. It is reminded that in early April, soon after the EU granted a six-month Brexit extension until 31 October, French President Emmanuel Macron adopted a hard line, warning that there should be no further extension. Meanwhile, a couple of high level EU officials hinted recently that the EU would not grant another extension, except for a general election or a second referendum.

Macro Themes & Implications in CESEE

Theme	Implications
The broader CESEE region remains defiant to the deteriorating global economic environment	The second Q1-2019 GDP estimates in the broader CESEE region confirmed the positive picture portrayed by the flash estimates. In the vast majority of countries, the statistical services announced second GDP estimates that had minimal revisions to the flash estimates. 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 were among the most resilient in the broader CESEE group. The CEE3 economies are 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 accelerated by 1.3% QoQ/5.1% YoY in Q1-2019 above consensus (4.1% YoY). In contrast, fiscal, credit and monetary stimulus pushed the economy out of the technical recession (+1.3% QoQ/-2.6% YoY) yet outlook risks are still skewed to the downside. Now that the breakdown of the national accounts is available, it would be fair to say that once again domestic demand was the main driver of economic activity 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.
The accession in the Eurozone for the six CEE countries turns out to be a two gear journey; Bulgaria & Croatia have the lead, Poland, the Czech Republic, Hungary and Romania have a bumpy road to cross	All EU Member States, except Denmark and the UK which is likely to exit the EU by 31 October, are required to adopt the euro and join the euro area. That said, there are six Central Eastern European (CEE) countries that joined the European Union in the 2004, 2007 and 2013 enlargements that currently use their local currencies but eventually will have to participate in the European Monetary Union with, however, no specific deadline. These countries are the Czech Republic, Hungary, Poland, Bulgaria and Croatia. To start with, in order for a country to be eligible to enter the Eurozone, according to the 1991 Maastricht Treaty it has to fulfill four nominal convergence criteria such as price and exchange rate stability, sound public finance and long term interest rates not exceeding 2.0%. Moreover, each country preparing towards entering the Eurozone must have in place a well-functioning and independent central bank, which upon accession will become a part of the Eurosystem. In terms of competence and criteria fulfillment, Bulgaria is the most prominent country. In detail, Bulgaria agreed with EU institutions on a roadmap to join the ERM-II Mechanism in July 2018, with the latter expected to reply within the next six months after the Asset Quality Review (AQR) in six systemic banks is completed. Croatia has progressed substantially and fulfills all criteria apart from that concerning the exchange rate stability, which, however, according to the Prime Minister Mr.Plenkovic's recent statements, is about to be pursued as Croatia intents to apply anytime soon to the ERM-II so as for the Croatian Kuna to be pegged to the Euro for at least two years. Regarding the other four countries, we discern a more blur picture; Poland wishes to postpone indefinitely the respective decision and all efforts entailed as the Euro adoption is diachronically receiving poor public support. Regarding the Czech Republic, Hungary and Romania, all three have failed to meet, inter alia, the price stability criteria as their inflation is more than 1.5 percentage points above the average rate of the three best performing Member States. Particularly, Romania, despite its expressed willingness to pursue accession in the Eurozone by 2024, will have to put extra effort in order to comply with the public finance requirements as the European Commission witnessed a 3.0% of GDP fiscal deficit in FY2018 with deteriorating outlook according to the budget execution for the first four months of 2019.

CESEE Markets Developments & Outlook

Country	CESEE Markets Developments & Outlook
Bulgaria	The Bulgarian Ministry of Finance sold 10.5-year government bonds worth BGN200mn and 20-year government bonds worth BGN100.6mn at a local market auction that took place in the previous week. Following the broadly unexpected public debt offering, Bulgarian Eurobond yields posted significant drops ranging from 9-11 bps for the shorter maturities to 22-23 bps for the 2028 and 2035 tenors. Local bond yields followed the same pattern, even though yield drops were significant only in the long end of the curve, namely the 7 and 8 year tenors with 10 and 16 bps respectively. The government attributed the unexpected tap in the local debt market to the forthcoming purchase of eight new F-16 jet fighters from the United States, which will be financed primarily by the existing budget surplus of nearly EUR1bn and the newly issued debt.
Serbia	Both the FED's and the ECB's shift towards a more accommodative stance amid plethora of uncertainties around the globe provides the National Bank of Serbia (NBS) with the required space so as to preserve or even go harder on the easing cycle. Moreover, inflation eased to 2.2% in May resulting in increasing appetite for Serbian Government Bonds. The indications of a monetary policy shift in the US brought back into the government bonds market lots of investors. The latest 7 year notes auction attracted RSD38.0bn (EUR320mn) worth of bids out of which a large portion came from foreign investors. The same trend was also visible in the FX market. At the beginning of June, the NBS intervened in an unprecedented for a single week standards amount. From June 3rd to June 10th, the NBS bought EUR360 mn from local banks without increasing the volatility on the EUR/RSD as the pair barely moved. Normally, such a big demand for Euros is always followed by a brave drop in yields. As such, the 7 year notes fell by 13bps, to 4.37% from 4.5% a month earlier. The dip in the 3 year notes was even more pronounced, with the yield slashing by 24 bps.

Markets View

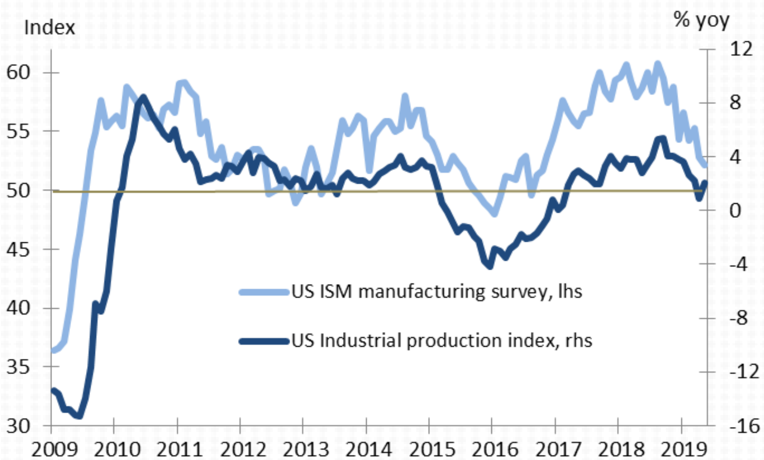
Asset Class	Outlook
Foreign Exchange	***EURUSD***: Currency wars are on with central banks across the globe joining the dovish chorus. The pair defended its key support of 1.1100 in early June and breached above 1.1350 major resistance that had capped any up moves in the past few months to reach a high of 1.1412. A sustained move above 1.1450 will open the way towards 1.1550 or even higher. ***GBPUSD:*** There has been a lot of noise recently around Boris Johnson as the next prime minister and certainty of Brexit by October 31st but nothing to sustain a further move lower post the large May sell off. The pair reached a 1.2506 low on selling climax before reversing higher and reaching a month high of 1.2784 on the back of a generally weaker USD. A break above recent highs will open the way towards 1.2950 ahead of 1.3025. ***USDJPY:*** The pair continues to face selling pressures and downside risk remains significant amidst uncertainty over the US-China trade dispute as well as the general USD weakness and the market's interest for safe haven assets (e.g. CHF, Gold). May's sell off continued in June and the pair reached a low of 106.78. Key support stands at 105 .00 but some consolidation around current levels is expected in the short term.
Rates	***EU:*** Global QE (ex. Norges Bank), trade wars and geopolitical tensions have been the name of the game in June as major central banks came out with extremely dovish statements despite already dovish market expectations. The ECB announced details of TLTRO III and there is talk of further PSPP, despite the constraints due to limited availability of Bunds. The market is pricing-in a deposit rate cut by the end of the year and 10yr German rates reached an all-time low of -0.335% with significant flattening of the curve and maturities up to 17 years trading in negative territory. We are of the view that too many negatives are incorporated in the current yield levels and we expect a retracement higher but the low for longer will likely remain the main theme. ***US:*** Treasury yields continued to fall on the back of very dovish Fed talk even before the 18-19 June meeting. 10yr Treasury yields fell to as low as 1.97% and the curve continued its year-to-date steepening trend. The market has run ahead of the Fed to price-in three rate cuts by end-2019 which seem excessive and a lot depends on the outcome of the meeting between US President Donald Trump and his Chinese counterpart Xi Jinping on the sidelines of the June 28-29 G-20 summit in Osaka. Tweets by Trump that "the US needs rates cuts" added to the downtrend for Treasury yields. We view current levels of US yields to be at the lower end of this year's expected range.
Emerging Markets credit	Emerging market hard currency debt had a blast in June, with the J.P. Morgan EMBI Global Spread Index recovering almost fully the widening of the previous month (-28bps in June). The global easing trend (in both Developed and Emerging markets) and the weaker USD outweighed any trade war related headlines and the "hunt for yield" was the main driver for yields/spreads. Even widenings triggered by negative idiosyncratic stories like Turkey (downgraded to B1 by Moody's with Negative outlook), Mexico (threat of new tariffs from the US and downgrade by Fitch to BBB) were bought and drove spreads tighter (but still off June-tights). The performance was mainly driven by the underlying rate moves in both EUR and USD with spread curves in EUR bull steepening and in USD moving in parallel. Overall there was demand for duration and we expect the sector to remain in vogue throughout the year despite headwinds to growth and increased commodity price volatility. We prefer to trade the sector opportunistically rather than hold longer term positions as event risk remains high at the moment.
Corporate credit	USD and EUR credit spreads recovered strongly in June, taking back more than fully the May widening as dovish central banks had a positive effect on most asset classes. Talk of CSPP 2.0 from the ECB increased the pressure for tighter spreads in EUR credit but in the long run we do not share the view that this is going to be healthy for an already stressed market (we think non ECB eligible credit will benefit more in that case). This also brings EU bank profitability in the foreground again. New issuance was strong with good demand and low allocations in general. The June performance was driven by both rate and spread moves. The yield of the Bloomberg Euro Aggregate Corporate Index reached an all time low of 0.53%!. Despite this development and given funding levels and the cross currency basis, EUR credit continues to look more attractive than USD. We expect cash to outperform CDS as the latter has already rallied significantly. Rally in investment grade is also supported by very positive technicals, as the market is generally underinvested in credit. The number of idiosyncratic stories is increasing, especially in the High Yield space, therefore, name selection is important at the current part of the credit cycle.

II. Advanced Economies

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

USA: Weakness in globally-exposed economic data, while domestically-oriented indicators remain solid

Persistent weakness in the globally-exposed manufacturing sector



Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, June 2019

	Median* (percent)			
USA	2019	2020	2021	Longer run
Change in real GDP	**2.1**	**2.0**	**1.8**	**1.9**
March projection	2.1	1.9	1.8	1.9
Unemployment rate	**3.6**	**3.7**	**3.8**	**4.2**
March projection	3.7	3.8	3.9	4.3
PCE inflation	**1.5**	**1.9**	**2.0**	**2.0**
March projection	1.8	2.0	2.0	2.0
Core PCE inflation	**2.0**	**2.0**	**2.0**	
March projection	2.0	2.0	2.0	
Fed Funds Rate	**2.4**	**2.1**	**2.4**	2.5
March projection	2.4	2.6	2.6	2.8

Source: Federal Reserve, ISM, Bloomberg, Eurobank Research

Latest Economic Developments

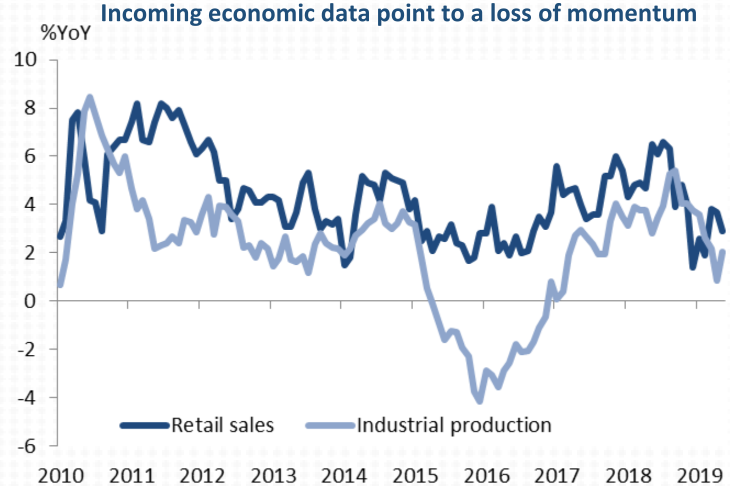
Economic indicators paint a rather mixed picture in Q2, with weakness mainly concentrating in globally-oriented data while domestically-centred indicators remain relatively firm. The ISM manufacturing index fell 0.7pts to 52.1 in May, continuing its downward trend since its recent peak in November 2018, with survey respondents expressing worries over mounting trade frictions. Nevertheless, the ISM non-manufacturing index rose 1.4pts to 56.9 in May, consistent with a solid pace of growth in the US services sector. Meanwhile, May retail sales increased 0.5%MoM while the April data were revised markedly higher, pointing to stronger momentum in personal expenditures than earlier expected. Overall, we maintain our real GDP growth projection at 2.4% in 2019 down from 2.9% in 2018, with the main headwinds to the economic outlook being at this point external rather than internal. The potential for higher tariffs could add to policy uncertainty and adversely affect business investment and, hence, overall economic growth.

Central Bank Watch

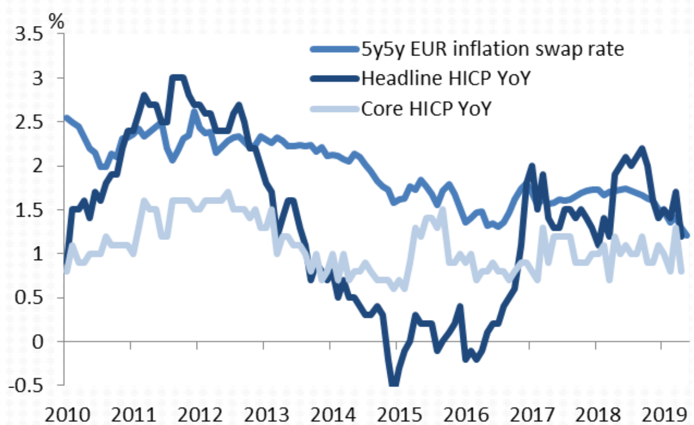
At its 18-19 June monetary policy meeting, the FOMC decided to maintain the target range for the federal funds rate at 2.25-2.50%. The Committee adopted a more dovish tone compared to that in the prior meeting, in line with market expectations for lower interest rates in the coming months. According to the accompanying policy statement, the Committee will no longer be “patient” but instead “it will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion”. Meanwhile, the updated interest rate projections revealed that 8 FOMC members moved their dots lower to endorse one or more rate cuts before year-end, with the median of the Fed’s dot plot moved down, suggesting 30bps of cumulative rate easing in 2020 and a 25bps rate hike in 2021. We expect the Fed to cut policy rates in 2019, likely starting in July or September, and delivering 50-75bps of cumulative rate cuts in the second half of the year, with the easing path highly dependent on the ongoing trade negotiations and the incoming economic data.

Euro area: Weaker economic data and increased economic uncertainty point to slower growth in 2019

Incoming economic data point to a loss of momentum



Inflation expectations have continued to trend downwards in recent weeks



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

Latest Economic Developments

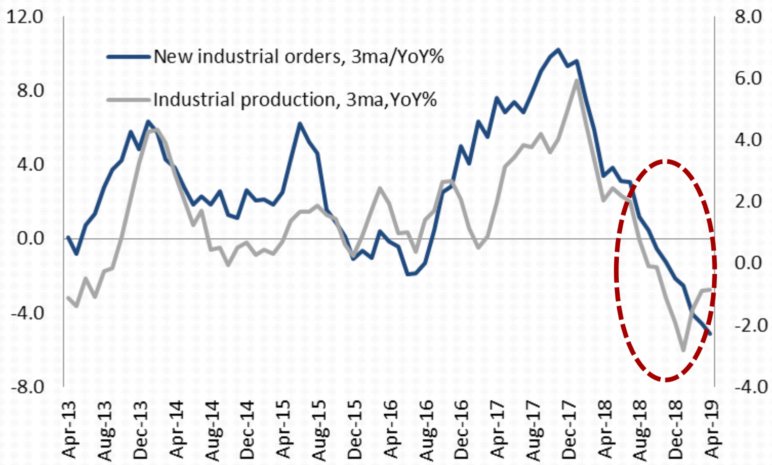
Latest economic indicators pertaining to Q2 2019 point to a loss of momentum following a higher than expected 0.4%QoQ growth rate in Q1. Retail sales fell by 0.4%MoM in April after having stagnated in the prior month, while industrial production declined for the second consecutive month in April (-0.5%MoM), creating a negative carry-over for Q2 (-0.7%QoQ) and, suggesting that the industrial sector is unlikely to repeat its strong performance in Q1. Meanwhile, the Composite PMI index rose by a mere 0.3p to 52.1 in June, as services output increased by 0.5p to 53.4 while the manufacturing sector remained in contractionary territory (47.8). The June Composite PMI is consistent with a quarterly real GDP growth rate of approximately 0.25%QoQ, highlighting downside risks to Q2 growth figure compared to Q1's growth rate of 0.4%. Expansion is expected to continue in the medium term, albeit at a lower pace mainly due to fading global trade growth, with our 2019 real GDP growth projection standing at 1.1%, from 1.2% previously, as increased economic uncertainty on the back of mounting trade war frictions and weaker investment spending should constitute a drag on domestic demand.

Central Bank Watch

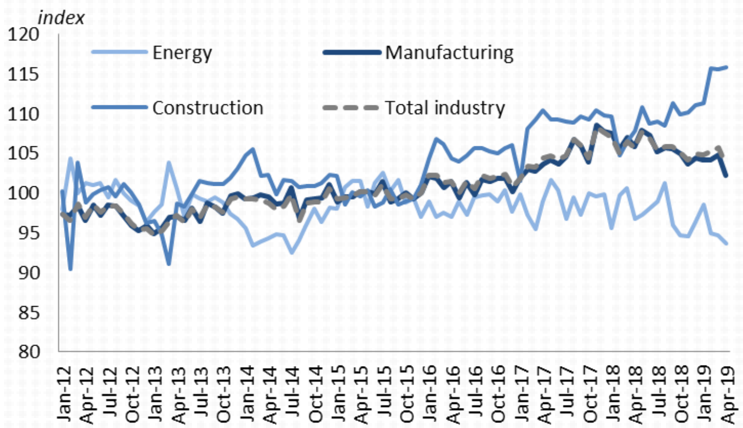
At its 6 June policy meeting, the ECB extended the forward guidance by 6 months to envisage unchanged interest rates "at least through H1 2020" and announced further details about TLTRO-III that were less generous than those of TLTRO-II. Reinforcing a more dovish stance, in his annual Sintra's speech, President Mario Draghi stated clearly that additional stimulus "will be required" in the absence of improvement, emphasizing that the GC has tools available: (i) adjusting the forward guidance; (ii) cutting rates and mitigating any side effects on banks' profitability; (iii) re-launching QE. We expect the ECB to pave the way for further monetary policy easing at its July meeting, enhancing its rates forward guidance. The first deposit rate cut should not come before September, along with downward revisions in the ECB's macro forecasts and mitigating measures to reduce the effect of negative interest rates.

Germany: Hard and soft data pertaining to early Q2 2019 point to risks of a slowdown in economic activity

Manufacturing sector activity likely to drop further



April's IP dropped sharply as buoyant construction not enough to compensate for manufacturing and energy weakness



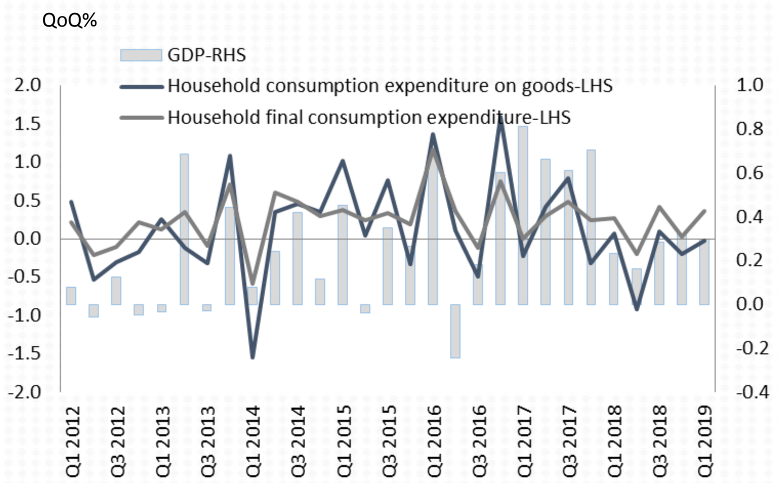
Source: Germany's Federal Statistical Office (Destatis), Eurobank Research

Latest Economic Developments

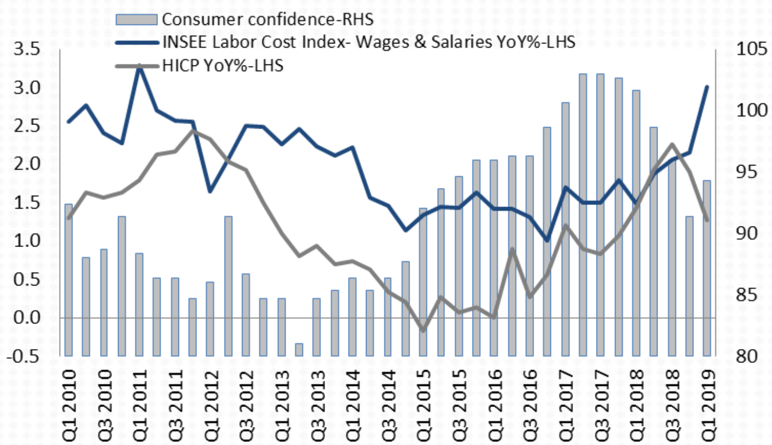
German real activity and sentiment indicators pertaining to the early months of Q2 2019, point to risks of less dynamic economic growth or even stagnation following a higher than expected 0.4%QoQ growth rate in Q1, the first positive quarterly growth rate after stagnation in Q4 2018 and a 0.2%QoQ contraction in Q3 2018. Industrial production (IP) dropped by a hefty 1.9%MoM in April, the first decline after two consecutive increases in the previous two months (March: +0.5%MoM, February: +0.4%MoM) and the biggest fall since August 2015. The main driver behind the surprisingly poor performance was manufacturing, which plunged by 2.5%MoM, primarily due to a 5.6%MoM drop in the auto sector. Energy fell by 1.1%MoM, marking the third consecutive monthly decline. On the flip side, construction provided a small silver lining as production rose by 0.2%MoM, showing no signs of payback after a strong performance in Q1 (+1.9%QoQ, the biggest quarterly rise in two years) thanks to unusually mild weather. The April IP figure puts the Q2 carry-over at -1.5%QoQ following a growth rate of 0.5%QoQ in Q1, pointing to further industrial weakness ahead. Undoubtedly, the sharp decline in April IP looks odd relative to industrial orders which rose 0.3%MoM over the same month, the second consecutive monthly improvement. Presumably, the significant decline in orders in the early months of Q1 has not yet fully impacted IP, while, as was signaled by latest business surveys (manufacturing PMI, IFO), sentiment remains depressed amid the ongoing global trade slowdown, bilateral EU-US tensions over auto tariffs and fears over a no-deal Brexit. Elevated domestic political uncertainty amid concerns about the possibility of a ruling coalition breakdown following the resignation of SPD leader Andrea Nahles, may also dent business sentiment. Trade data also disappointed at the start of Q2 2019, with exports dropping by 3.7%MoM in April, the biggest fall in 3 ½-years, while imports declined but at a softer pace of 1.3%MoM. All said, an increase of real GDP growth in Q2 2019 seems unlikely, while, looking ahead, a sustained uptrend in economic activity is not expected until foreign demand picks up again.

France: Private consumption likely to gain further momentum in Q2, providing a shelter to the economy from external headwinds

Goods consumption to support further private consumption in Q2 2019



Strong wage growth, low inflation and improving consumer confidence bode well for private consumption



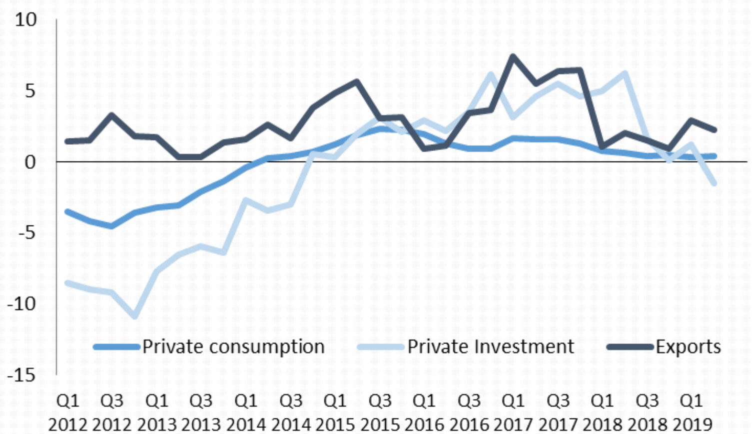
Source: INSEE, Eurobank Research

Latest Economic/Political Developments

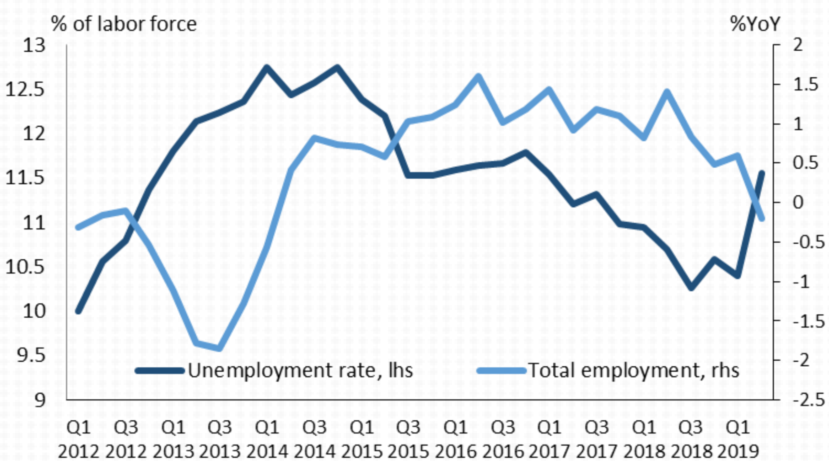
France's household consumption seems poised to gain further momentum in Q2 2019 after rising by 0.4%QoQ in Q1 2019 and recovering from Q4 2018 stagnation, supported by President Emmanuel Macron's fiscal measures (amounting to around € 17bn or 0.7% of GDP) unveiled to quell the "yellow vest" protests which erupted late last year. April household goods consumption rose by a three-month high of 0.4%MoM in April, taking the Q2 carry over at 0.4%QoQ, up from Q1's 0.0%QoQ. Furthermore, INSEE consumer confidence rose by 3 points to 99 in May, approaching its long-term average of 100 for the first time in a year and recovering further from late 2018 lows. Continuing improvement in labor market conditions also supports private consumption and, thus, France's GDP growth prospects. Wages and salaries rose by 3.0%YoY in Q1 2019, the highest growth level in the last eight years and up 0.8pp from the prior quarter. The mainland unemployment rate declined by 0.1points to 8.4% of the labour force over the same quarter, the lowest level in ten years, while the number of people in the halo of unemployment (people wished to work without being considered as unemployment) fell sharply to the lowest level since Q2 2014 (1.4mn). Adding to the above positive factors for private consumption, HICP slowed down in May to a 1-1/2 year low of 0.9%YoY from 1.3%YoY in April, taking the January-May annual average at 1.2% vs. 1.6% in the same period a year earlier, with the 2019 rate expected to drop to 1.3%YoY from a six-year high of 2.1%YoY in 2018. All in all, fundamentals of private consumption look strong, supporting the view that, after slowing sharply in 2018 (+0.9%YoY vs. 1.4%YoY in 2017), it is likely to be the main GDP growth driver this year, providing a shelter to the economy from external headwinds. Barring another episode of social unrest and/or further deterioration on the external sector that could weigh on private consumption, GDP growth is expected to rise 0.3/0.4%QoQ by end-2019 and 1.3%YoY for the year. On the policy front, with the European Parliament elections out of the way, President Emmanuel Macron is expected to push for the implementation of the outstanding items in his reform agenda, including constitutional revisions.

Italy: Increased uncertainty offsets the positive effect of fiscal expansion on economic activity

Broad-based weakness across domestic and external demand



Sluggish employment growth weigh on personal consumption



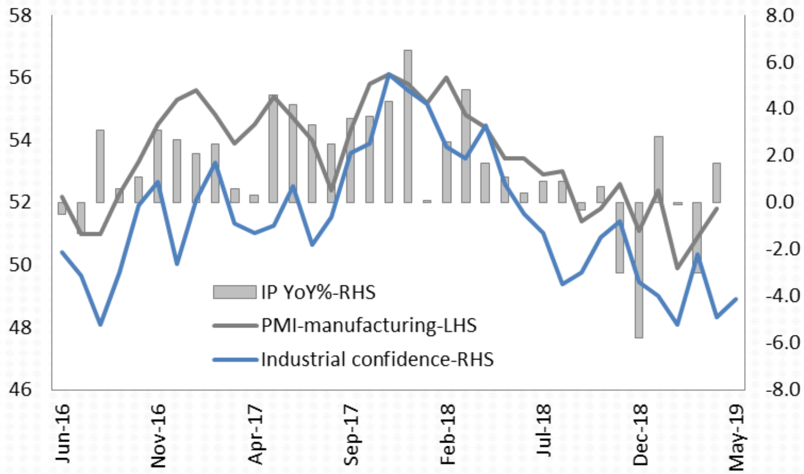
Source: ISTAT, OECD, Eurobank Research

Latest Economic & Political Developments

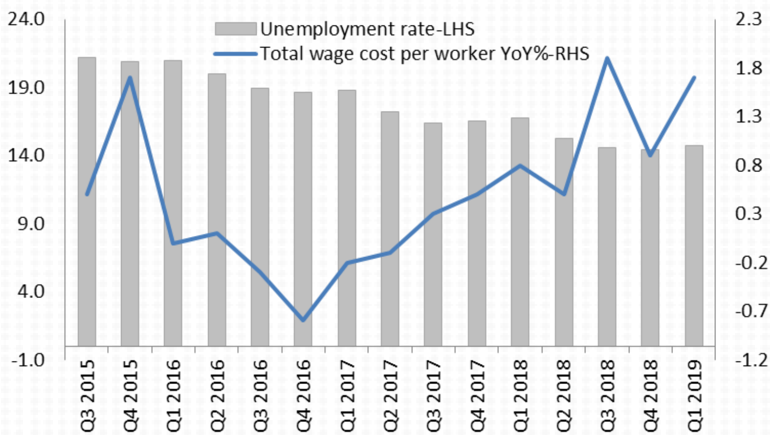
Having edged out of a technical recession in Q1 2019, expanding by 0.1%QoQ following two consecutive negative growth prints, Italy seems to be experiencing risks of less dynamic growth in the following quarters. Subdued external demand and trade war frictions are holding back the country's export sectors, while weak employment growth and a growing household saving rate weigh on personal consumption expenditures. Indeed, the consumer confidence index fell to a two-year low of 109.6 in June from 111.6 in the prior month, while retail sales stagnated in April, following a 0.3%MoM contraction in March. Meanwhile, industrial production declined for the second consecutive month in April (-0.7%MoM), following a decrease of 1.0% in the prior month, with broad based weakness across manufacturing sectors. The Composite PMI index rose by a mere 0.4p to 49.9 in May, remaining below the 50-threshold that distinguishes expansion from recession, as the services sector declined by 0.4p to 50.0 while the manufacturing sector remains in contractionary territory (49.7). Overall, we maintain our 2019 GDP forecast of 0.2% from 0.9% in 2018, with increased economic and political uncertainty offsetting the positive effect of expansionary fiscal measures on economic activity. Adding to the above, there are concerns that the European Commission (EC) might trigger an Excessive Deficit Procedure (EDF) against Italy in violation of debt reduction benchmarks later this year. The Italian government's latest fiscal plans currently envisage a deficit target of 2.1% of GDP in 2020, down from an estimated deficit of 2.4% for 2019, embedding a VAT increase (~1.3pp of GDP) as a safeguard clause agreed with the EC in December 2018. It is doubtful whether the Italian government will finally implement this fiscal tightening, so negotiations between Italy and the EC on the next budget are expected to be tough, at a rather fragile time for the Italian economy. This could result in persistent large increases in sovereign bond spreads, increasing funding costs for the banking sector and, therefore, weighing on bank lending and investment.

Spain: Economic growth seems to have lost some traction in Q2 2019; Political deadlock continues

Slower activity growth in the manufacturing sector



Improving labor market conditions bode well for private consumption



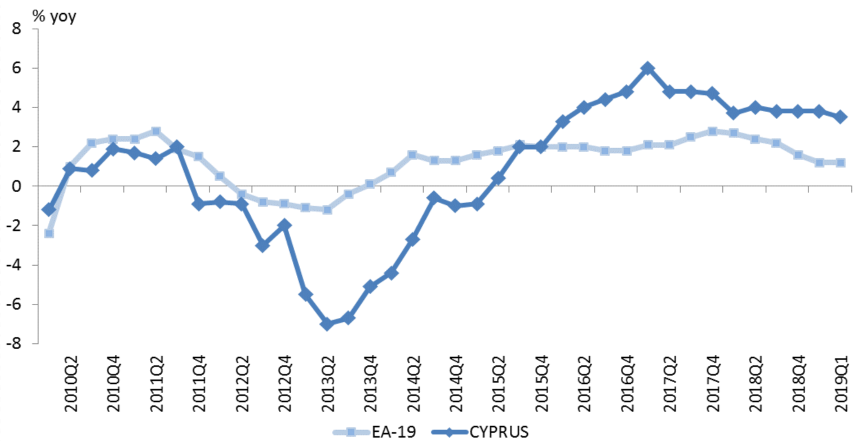
Source: INE, Eurobank Research

Latest Economic/Political Developments

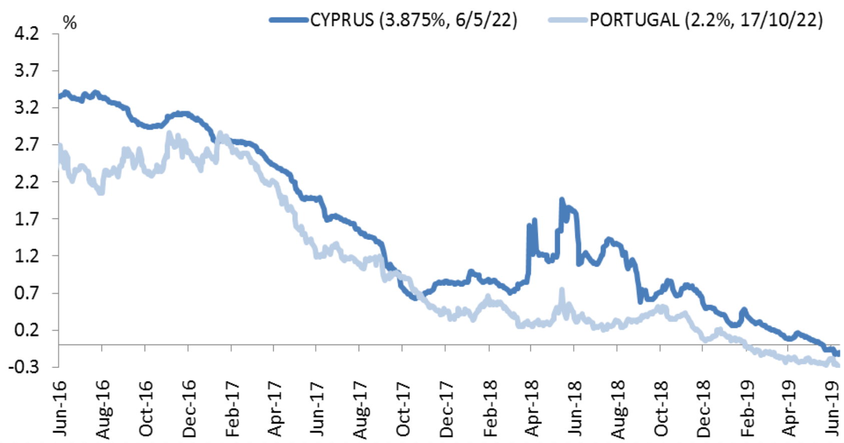
After rising by 0.7%QoQ in Q1 2019, the fastest pace since Q4 2017, real economic activity data and sentiment indicators suggest that the Spanish economy has lost some traction in Q2 2019 as the business cycle matures. Following a 3.0%YoY contraction in March, industrial production rebounded in April rising by a three-month high of 1.7%YoY, reflecting improved dynamics in most major sectors. Production rebounded strongly for consumer, intermediate and capital goods, while energy output contracted for the third consecutive month. Despite the April hefty increase, the annual average variation in industrial output stood at -0.3% in April, after turning negative in the prior month for the first time in five years. Reflecting slower activity growth in the manufacturing sector, the HIS Markit Manufacturing PMI dropped from April's 51.8 to a three-month low of 50.1 in May, approaching February's 49.9 trough and indicating broad stagnation in the sector. New orders fell, albeit modestly, for the first time in three months and employment dropped marginally for the first time since end-2013. However, providing a cushion to the Spanish economy, domestic demand, and particularly private consumption, retained a firm tone, supported by favourable financial conditions, continued solid employment growth, moderate inflation and some recent social policy measures including a 22% rise in the minimum wage, the largest increase since 1977, from €735 per month to €900. Overall, FY-2019, GDP growth is likely to slow to 2.3% from 2.6% in 2018, but still comfortably above the estimated potential growth rate of 1.5% and our projection for 1.1% euro zone annual average. On the political front, following the inconclusive outcome of the 26 April general election, incumbent PM Pedro Sanchez has made little progress so far in securing the necessary votes in the Congress so as to be re-appointed. Spain's new parliament will vote in mid-July on who will become prime minister (investiture vote). But even if Pedro Sanchez is re-elected, the lack of solid parliamentary majority for the Socialist Workers' Party (PSOE), suggests that the room for substantial economic policy changes will be limited.

Cyprus: The revised GDP estimate of Q1-2019 confirmed that the soft landing has started

Cyprus turn-around growth story has been impressive so far



Cypriot medium term bond yields have improved in recent months after CCB's market exit



Source: Eurobank Research, National Authorities, Bloomberg

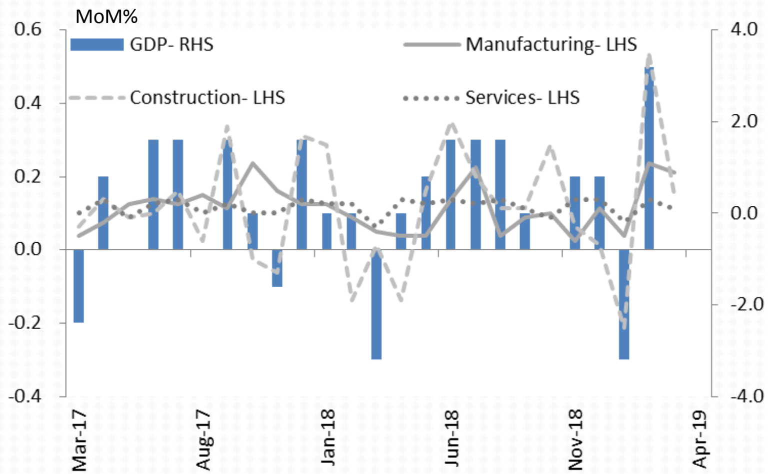
Latest Political & Economic Developments

The second estimate of CYSTAT on the seasonally adjusted Q1-2019 GDP reading, trimmed by 0.1ppts on an annual basis off the flash, confirmed that economic activity has embarked on a decelerating path. Real GDP expanded by 0.7% QoQ (down from 0.9% in the flash) bringing the annual rate of expansion to 3.4% YoY in Q1-2019 on a seasonally adjusted basis, lower than 3.8% YoY in Q4-2018 & Q3-2018, vs. 4.0% YoY in Q1-2018. Real GDP growth marked the seventeenth consecutive positive reading both on a quarterly and annual basis after a previous three-year recession. However, it marks the end of a period of buoyant growth and – ceteris paribus – suggests that the soft landing of the economy has already started. Domestic demand has had the lion's share in the GDP growth reading of Q1, while net exports are most likely to have come under pressure echoing the deterioration in the world economic environment.

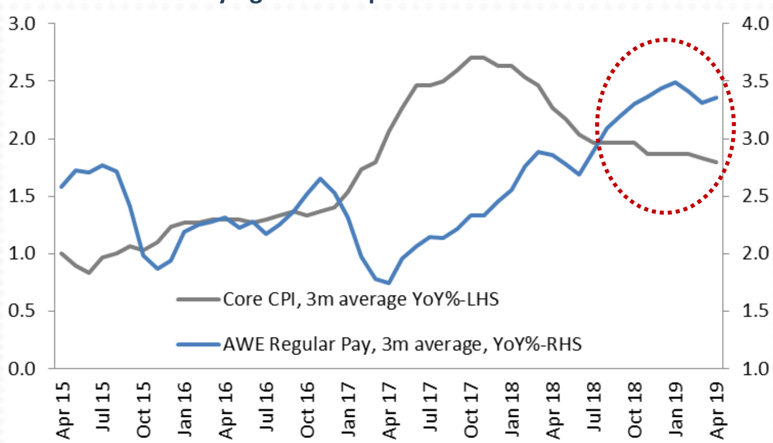
Final consumption (+3.1ppts contribution to GDP growth) is rallying underpinned by a number of factors, which all boil down to the rise of disposable incomes and the propensity to consume, namely: sustained sentiment improvement, tightening labor market conditions (unemployment now standing below EA-19 levels), further property market stabilization (RPPI index in positive territory in the last seven quarters), the impact from the fiscal relaxation after the graduation from the economic adjustment programme and the acceleration of public consumption in 2H-2018. Investments (+7.9ppts) have so far received strong support from 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. On the other hand, the positive investments' performance was more than offset by the net exports' negative contribution (-8.5ppts), a trend we witnessed again in Q1-2018. That was the combined effect of both exports contracting by +2.8% QoQ/-9.1% YoY, and imports remaining contained at -2.4% QoQ/+3.0% YoY.

UK: April GDP weakness signals poor start to Q2 economic activity

Disappointing April GDP signals poor start to Q2 economic activity



In spite of higher earnings, underlying inflation pressures remain muted



Source: ONS, Eurobank Research

Latest Economic Developments

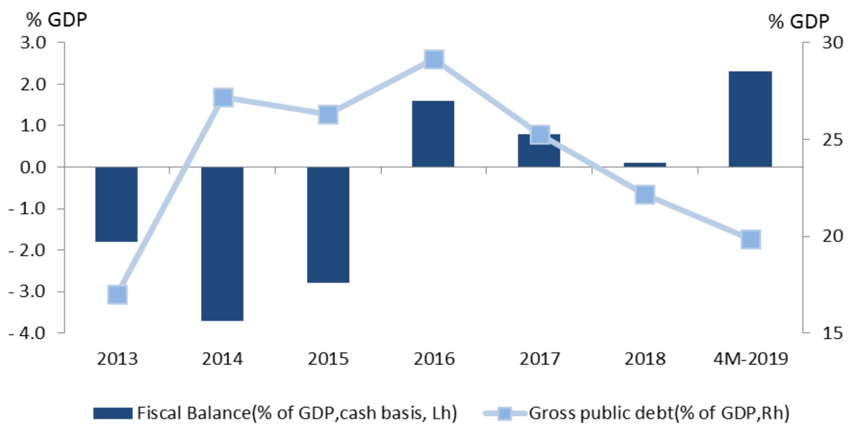
After a relatively strong Q1 2019 with real GDP growth expanding by 0.5%QoQ driven by stockpiling (8.5%QoQ) ahead of the initial scheduled Brexit date on 29 March 2019 and increased household consumption (0.7%QoQ) mainly thanks to a resilient labor market and looser fiscal policy, April GDP growth surprised mostly to the downside, pointing to a poor start to Q2 2019 economic activity. Specifically, GDP growth contracted by a higher than expected 0.4%MoM following a 0.1%MoM decline in the prior month. The greatest drag on growth came from industrial production (-2.7%MoM) due to unwinding of Brexit related stockpiling seen in Q1. Among sub-sectors, manufacturing was particularly hit (-3.9%MoM) by factory shutdowns in the auto sector ahead of the original Brexit deadline, while mining sectors were also behind IP weakness as warmer weather pushed down demand for energy. The services sector came to a standstill (0.0%MoM), whereas typically volatile construction fell for the second consecutive month (-0.4%MoM). Amid weak April GDP growth, the labour market remains strong. The unemployment rate was held at 3.8% record low in March for the second month in a row, while core average weekly earnings (ex. bonuses) picked up a tenth to 3.4% (3-month annual average), close to January's 11-year peak of 3.5%, mainly driven by one-off factors such as a strong increase in public sector pay (2.8% from 2.4%). In spite of a considerable pick up in earnings, inflation pressures remain muted. Headline CPI fell to 2.0%YoY in May from 2.1% YoY in April, while core CPI also dropped to a near 1-1/2 year low of 1.7%YoY from 1.8%YoY, reassuring the BoE that there is no urgency to tighten monetary policy. At its 19 June monetary policy meeting, the BoE MPC left its Bank Rate unchanged at 0.75% and, while it stuck to its message that rates would need to rise in a limited and gradual fashion assuming that the UK avoids no-deal Brexit, the Committee erred on the side of caution amidst rising external risks and ongoing Brexit uncertainty. Its Q2 GDP growth projection was cut from 0.2%QoQ to 0.0%, pointing to a likely downgrade of its 1.5% annual growth forecast for 2019 at the upcoming August Inflation Report.

III. Selected CESEE economies

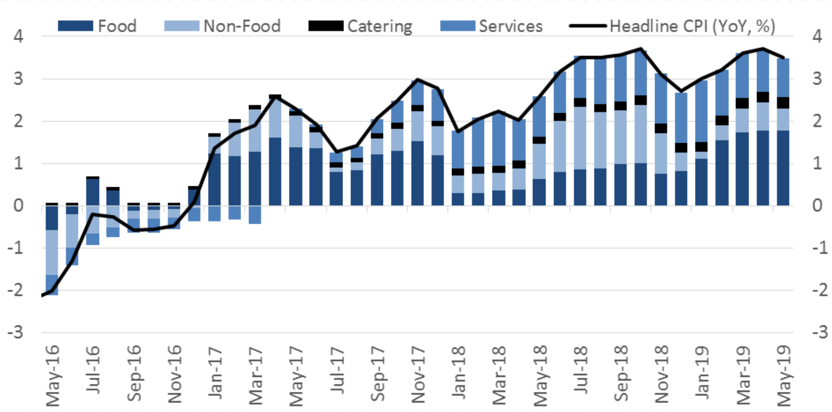
- Bulgaria
- Serbia
- Turkey

Bulgaria: Economic activity accelerated in Q1-2019 in defiance of an unfavorable world economic environment

Bulgaria's fiscal position is sound



Inflation has rebounded in recent months on higher food prices



Source: Eurobank Research, National Authorities

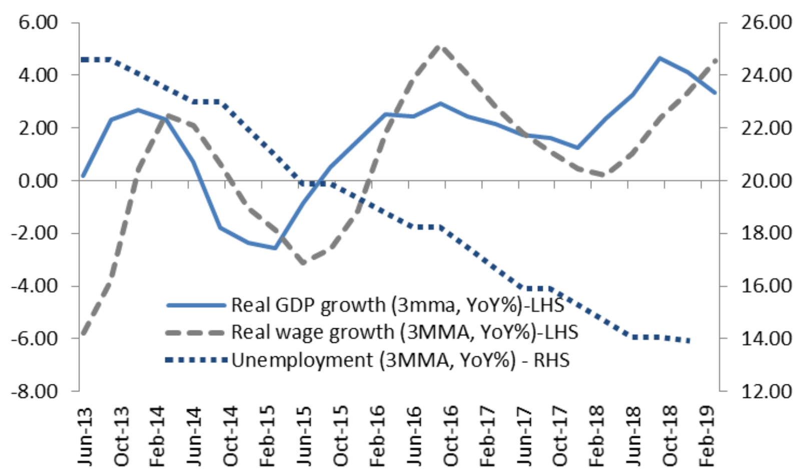
Latest Political & Economic Developments

The seasonally adjusted Q1-2019 revised GDP growth estimate was raised by 0.1ppts on an annual basis from a flash reading, with economic activity coming in at 1.1% 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: 1.9% QoQ/+5.1% YoY vs imports: 1.5% QoQ/+3.9% YoY). Final consumption had a still very strong, yet smaller than in previous quarters positive contribution (0.3% QoQ/3.5% YoY in Q1-2019 vs -0.1% QoQ/5.0% YoY in Q4-2018), which would have been even smaller notwithstanding the acceleration 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 yet the spike in inflation (from a monthly average of 2.0% in Q1-2018 to 3.3% YoY in Q1-2019) erodes some of these spending gains. Investments appeared to be losing momentum in Q1-2019 despite wide expectations for the opposite (0.2% QoQ/2.6% YoY in Q1-2019 vs. 2.8% QoQ/6.6% YoY in Q4-2018).

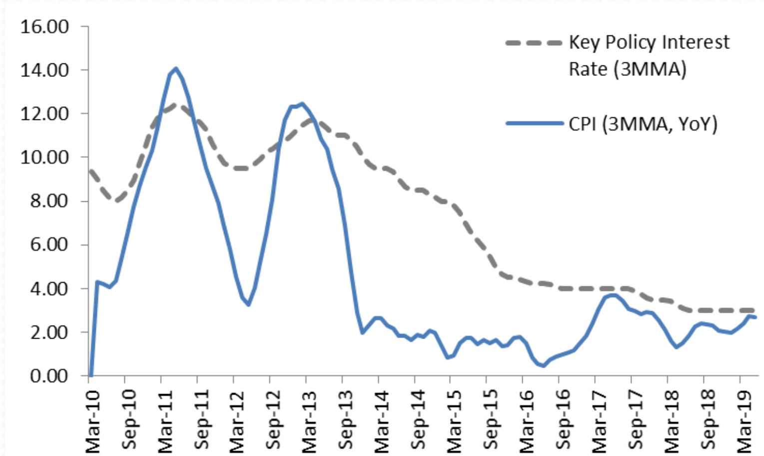
In our view, solid growth momentum is expected to continue in 2019 – our forecast stands at 3.5% unrevised since last year – driven by sound domestic demand dynamics. Private consumption will be in the driver's seat, receiving support from a tighter labor market, relatively low energy prices, convergence 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 6.9% YoY in April down from 7.8% in March not very far from 8.7% YoY in February – the highest rate since June 2009 – compared to 8.5% YoY in January.

Serbia: 10y euro bond issuance amid positive regional momentum

Modest GDP growth and firm labor market…



…amid price stability and firm interest rate environment



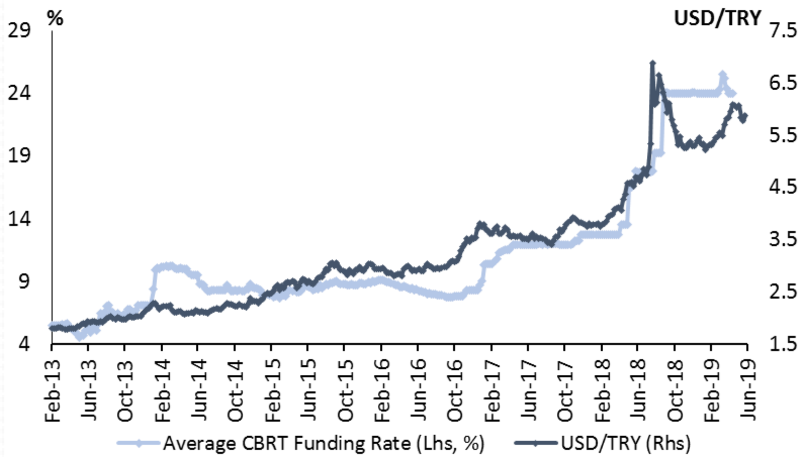
Source: Bloomberg, Eurobank Research

Latest Economic Developments

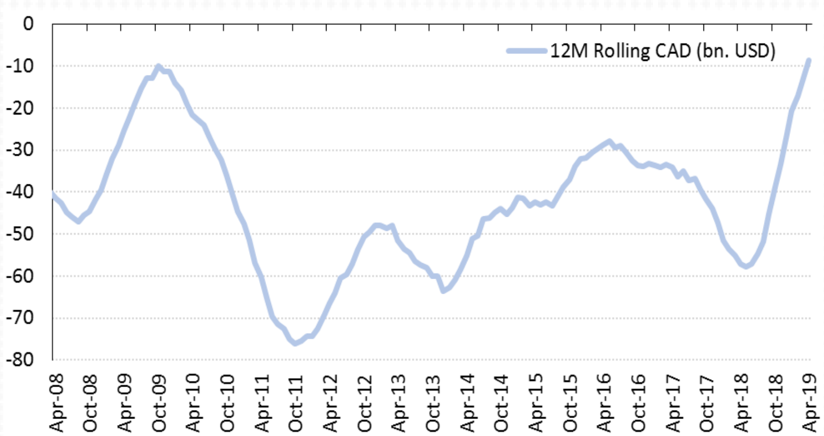
Following Standard and Poors (S&P) rating agency's recent credit rating affirmation of the Republic of Serbia at BB, Serbia tapped the euro bond market after nearly six years. Seeking to take advantage of the benign economic conditions, Serbia offered in late June EUR1bn of 10 year bonds in its first publicly syndicated euro deal, led by BNP Paribas SA, Citigroup Inc, Deutsche Bank AG and JP Morgan Chase & Co. The issuance was positively embraced by the markets, given the investors' orders solid oversubscription by almost 6 times of the finally issued amount. Serbia set the pricing of the 10y year bond at 140 bps and aims at using the proceeds of the issuance to refinance bonds denominated in USD maturing in 2020 and 2021, both carrying much more lucrative coupons, i.e. 4.875% and 7.250% respectively. Serbia's premiere in the euro market signals a switch from dollar notes which were the main financing vehicle at the last five international bond deals between 2011 and 2013. Apparently, there is some positive momentum in the CESEE region that Serbia decided to exploit with the respective syndication as within June euro notes were also offered by Croatia, Ukraine and Lithuania. Referring to country specific reasons, the current transaction was broadly backed not only by the S&P rating affirmation but also by the positive outlook and the increased likelihood that ratings might go up to BB+ in the next 6 to 12 months, as mentioned in the official S&P press release. Inter alia, according to S&P, Serbia's GDP growth in 2019 will rise 3.0%, slightly less than the previous estimate, largely due to expectations for lower growth in the Eurozone, especially in Italy and Germany, which are the main trading partners of the Republic of Serbia but will rebound in 2020 to 3.2%, owing to the solidity of domestic demand on the back of a buoyant labor market and continued investment activity supported by strengthening bank credit and improved monetary policy credibility. Finally, the final Q1 2019 GDP print was released. The real growth rate was revised slightly upwards from 2.3% YoY to 2.5% YoY albeit lower from 3.4% YoY in Q4-2018. Still, the National Bank of Serbia (NBS) estimates that 2019 GDP growth will come in at 3.5% YoY while our estimate stands slightly lower at 3.3% YoY.

Turkey: The inflation outlook improvement allows Central Bank to make rate cuts plans

Turkish Lira rebounding from multi-month lows in May



Macroeconomic imbalances have been unwinding rapidly in 2018-19



Source: Eurobank Research, National Authorities, Bloomberg

Latest Political & Economic Developments

In a broadly expected move, the Central Bank of Turkey (CBRT) stayed put on rates in the MPC meeting of mid-June. More specifically, CBRT left the key policy rate (KPR) unchanged –the 1-week repo as of late May2018 – at 24.00% and the Overnight and Late liquidity window lending rates at 25.5% and 27% respectively. In the statement released thereafter, the CBRT acknowledged that tight monetary policy and domestic demand conditions support the disinflation process and grounded its decision in order to contain the risks to the pricing behavior and reinforce the disinflation process. Thus, even though CBRT appears cautious in order to avoid any premature move, it is now widely seen as looking for a window of opportunity in the next months to deliver the first rate cut, provided that global & domestic economic conditions are conducive to it.

Headline inflation declined to 18.7% YoY in May – down to an 8-month low – compared to 19.5% YoY in April down from 19.7% YoY in March coming significantly below analysts' consensus expectations (Actual: +0.95% MoM vs Bloomberg:+1.32% MoM). Headline inflation has retreated from its historic highs in recent months ending at 20.3% YoY in December down from 21.6% YoY in November and 25.2% YoY in October. Despite lira renewed depreciation pressures in early May, core inflation (which excludes food, alcohol, tobacco, energy and gold prices) eased further to 15.9% YoY in May down from 16.3% YoY in April vs. 17.5% YoY in March down from 19.5% YoY in December. Looking ahead, weak domestic demand dynamics and favorable base effects in the food prices segment are expected to support the disinflation process in H2-2018. On the other hand, markets' concerns over the predictability & efficiency of the government policy and renewed tensions with the US due to the S-400 missile purchases from Russia coupled with investors' concerns over the Central Bank independence could put the lira under pressure further increasing the disinflation process downside risks. Recall that in early May, the lira had reached as high as 6.24/$ in May 10 compared to 5.16/$ in late January, against an all-time low of 6.86/$ in August of 2018. Ever since, lira pared back some of its previous weeks' losses on tightened domestic liquidity conditions and the win of the opposition candidate in the re-run of Istanbul mayor elections.

IV. Special Focus:

Trip Notes Cyprus, June 2019

Trip Notes: Key notes from our recent trip to Nicosia

Eurobank

Synopsis: Having expanded buoyantly on average by 4% in 2016-2018 after a three year recession in 2012-2015, Cyprus has embarked on a lower, but more sustainable, growth path of 2.5%-3% on average in 2019-2021

Downside growth risks are on the rise

- The external environment is less friendly than in the previous period for Cyprus putting downward pressure on some of the country's key industries, namely tourism, logistics, shipping and the professional services industry, some of the most important locomotives of the island economy
- The growth outperformance of the Cypriot economy in the past three years has been underpinned by the strong rebound of the construction sector. The program of granting citizenship through inward investment (an investment of €2mn in real estate enables the beneficial owner to acquire the Cypriot passport, an amount that can be reduced down after 3 years to just €500,000) has enabled the attraction of foreign funded investment in the real estate sector in the form of high-rise residential towers, which are located in the Limassol & Paphos areas
- The program "citizenship through investment" has received a lot of attention from both the media and EU institutions, as well as criticism. As a result, the integrity of the selection process is about to be strengthened further, the minimum investment criteria have been raised and a cap on the number of passports awarded per year has been set
- Thus, the contribution from construction-related projects is about to become less pronounced in the medium term, although there is a stream of projects in the pipeline to support the construction sector in the short-term
- Having rallied by 4.1% on average in 2016-2018, private consumption currently stands for 67% of GDP; private consumption dynamics are about to become more realistic in the medium-term

Medium-term fiscal risks are mounting:

- Fiscal discipline and prudence were maintained in 2016-2018, despite the State support to the banking system and the rising public pressure for more spending. Excluding the fiscal burden of the sale and orderly winding down of Cyprus Co-operative Bank (CCB) to Hellenic Bank, the general government recorded a surplus on an accrual basis of 2.9% of GDP surplus in 2018, up from a surplus of 1.8% of GDP in 2017 compared 0.3% of GDP in 2016.
- According to the Ministry of Finance official forecasts in the Stability & Growth program, the general government surplus is estimated to reach 3% of GDP this year and is projected to decline marginally to 2.6% in 2020 and 2.4% and 2.2% in 2021 and 2022 respectively. The primary surplus, from an estimated 5.3% in 2019, is projected to decline to 4.8% in 2020 and stabilize at 4.4% and 4.1% of GDP in 2021 and 2022.
- Strong fiscal performance and robust economic growth has given rise to wage demands in both the public and private sector. The private sector has not benefited so far due to the large pool of unemployed persons and the flexibility of foreign workers
- In the public sector the situation is more complicated. In late March2019, the administrative court rulings in three separate decisions ruled that the legislation upon which public wage cuts were imposed in 2012-2013 was unconstitutional. Although there is an appeal on behalf of the State, uncertainties are still very high. Depending upon the outcome of the appeal, there is a realistic probability that the State may be inclined to spend an additional amount €800mn-€1bn in the case public wages are restored to the pre-MoU period levels upfront
- Finally, the introduction and implementation of a general health system poses additional fiscal challenges in the medium term

Trip Notes: Key notes from our recent trip to Nicosia

Synopsis: Having expanded buoyantly on average by 4% in 2016-2018 after a three year recession in 2012-2015, Cyprus has embarked on a lower, but more sustainable, growth path of 2.5%-3% on average in 2019-2021

Banking sector risks have subsided but they remain a material source of concern

- NPEs decreased by the sizeable amount of 10.3bn in 2018, reflecting the carve out of the Cyprus Cooperative Bank (CCB) bad loans and the securitization of a large bad loans portfolio by the Bank of Cyprus to Apollo (widely known as project Helix) bringing the stock of NPEs down by 62.4% over the period from December2014 to December 2018. Meanwhile, the process of deleveraging continues rapidly with loan exposures (performing plus non-performing) declining by €13.2bn in 2018- which is a higher decrease than that in their non-performing component alone
- As a result, the ratio of NPEs (non-performing to total exposures) declined to 30.3% in December, compared to 43.7% in December2017, 47.2% in December 2016, 45.8% in December 2015 and 47.8% in December 2014. Recall that according to the EBA conservative definition, a restructured NPE is still classified as an NPE for a probation period of at least 12 months, even if it is properly serviced without incurring new arrears. As a result, a large fraction of the restructured loans are still classified as NPEs (€4.6bn out of €6.5bn in February 2019)
- Further progress on the NPEs issue hinges upon three game-changing factors: 1)the implementation of the reformed insolvency and foreclosures frameworks, 2)the government-subsidized ESTIA plan, and 3)further sales of bad loans to private funds. Regarding the first factor, the results so far are not encouraging at first sight. According to recent media reports, the number of foreclosures and successfully completed auctions has showed little improvement. However, the reformed frameworks have increased the bargaining power of creditors thus resulting in an increase of debt-to-asset swaps. On the negative side, there are underway individual political parties' initiatives to partially or completely reverse some of the provisions of the reformed frameworks. If these gather enough parliamentary support, they could result in the backtracking of the NPEs cleaning up process
- According to the latest information available, the ESTIA plan implementation is about to begin in July. To that end, domestic banks have already checked the eligibility and communicated it to their respective customers. In late January of this year, the parliamentary committee on budgetary and financial affairs approved the release of the funds designated for the ESTIA government plan in 2019. However, the implementation of the scheme had encountered further delays as the MoU draft between the banks and the State was under the scrutiny of the Legal Service for a prolonged period of time. Finally, a similar to last year's securitization of a bad loans portfolio is underway in the Bank of Cyprus (Helix 2). If that is completed on time, then the NPEs ratio could drop to single digit levels by the end of 2019-early 2020.

V. 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)		
	2018	2019f	2020f	2018	2019f	2020f	2018	2019f	2020f	2018	2019f	2020f	2018	2019f	2020f
World	3.6	3.3	3.4	3.6	3.2	3.1									
Advanced Economies															
USA	2.9	2.4	2.0	2.5	1.9	2.1	3.9	3.7	3.6	-2.4	-2.5	-2.9	-3.8	-4.5	-4.5
Eurozone	1.9	1.1	1.3	1.8	1.3	1.4	8.2	7.7	7.5	3.0	2.9	2.8	-0.6	-1.0	-1.0
Germany	1.4	0.6	1.2	1.9	1.5	1.5	3.4	3.2	3.2	7.3	6.9	6.6	1.7	1.0	0.6
France	1.7	1.3	1.4	2.1	1.3	1.5	9.1	8.7	8.6	-0.3	-0.5	-0.3	-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	1.9	2.0	0.8	0.9	1.3	19.3	17.8	16.5	-2.9	-2.6	-2.4	1.1	0.5	-0.1
Italy	0.9	0.2	0.6	1.3	0.9	1.0	10.6	10.5	10.5	2.6	2.9	2.6	-2.1	-2.7	-3.0
Portugal	2.1	1.7	1.6	1.2	0.8	1.4	7.0	6.4	6.2	-0.6	-0.7	-0.5	-0.5	-0.5	-0.3
Spain	2.6	2.3	1.9	1.7	1.1	1.4	15.3	13.9	12.8	0.9	0.9	0.8	-2.5	-2.3	-2.0
UK	1.4	1.2	1.4	2.5	1.9	2.0	4.1	4	4.1	-3.9	-3.9	-3.5	-1.5	-1.5	-1.4
Japan	0.8	0.7	0.5	1.0	0.8	1.1	2.4	2.4	2.4	3.5	3.5	3.5	-3.2	-2.8	-2.1
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	6.3	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	3.3	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	-1.5	2.5	16.3	16.0	13.0	10.9	13.0	12.5	-3.6	-1.5	-2.0	-2.1	-3.0	-2.5

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

Eurobank

Eurobank Fixed Income Forecasts

		2019		2020	
	Current (as of 27 June)	September	December	March	June
USA					
Fed Funds Rate	2.25-2.50%	2.25-2.50%	2.11-2.39%	2.02-2.25%	1.95-2.20%
1 m Libor	2.40%	2.54%	2.47%	2.44%	2.42%
3m Libor	2.31%	2.45%	2.38%	2.35%	2.33%
2yr Notes	1.75%	1.90%	2.02%	2.08%	2.11%
10 yr Bonds	2.02%	2.62%	2.72%	2.77%	2.81%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.05%
3m Euribor	-0.34%	-0.33%	-0.33%	-0.34%	-0.34%
2yr Bunds	-0.75%	-0.62%	-0.56%	-0.52%	-0.48%
10yr Bunds	-0.32%	-0.16%	-0.06%	0.03%	0.11%
UK					
Repo Rate	0.75%	0.75%	0.75%	0.80%	0.85%
3m	0.77%	0.85%	0.88%	0.95%	1.00%
10-yr Gilt	0.81%	1.00%	1.10%	1.18%	1.25%
Switzerland					
3m Libor Target	-0.73%	-0.73%	-0.72%	-0.72%	-0.73%
10-yr Bond	-0.53%	-0.41%	-0.36%	-0.32%	-0.22%

Source: Bloomberg (market implied forecasts)

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