ISSN: 2241-4851

Eurobank Research

GLOBAL & REGIONAL MONTHLY

The international transmission of the COVID-2019 has fueled concerns that the virus may become a global pandemic with larger economic repercussions than previously expected. High frequency indicators point to a severe Chinese economic fallout in Q1, with the global manufacturing PMI falling to an 11-year low in February. The pandemic-induced nervousness in financial markets has prompted central banks to ease monetary policy further to cushion the economic impact of the virus. Our global 2020 real GDP growth projection has been downgraded to 2.5%.

Macro Picture

USA: Should the COVID-19 outbreak be contained by end-March, 2020 GDP is projected at 1.7%

EA: GDP growth is projected at 0.8% in 2020, provided that the negative impact on the economy is confined to Q1

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March 2020

Special thanks to the Global Markets team (Global_Markets_Trading@eurobank.gr), Eurobank Bulgaria and Eurobank Serbia, as well as Economic Analyst Mrs. Anna Dimitriadou, for their invaluable contribution in this issue

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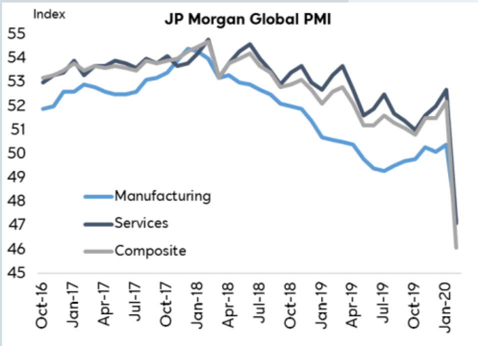

Source: Refinitiv Datastream, Eurobank Research

The rapid increase in the number of new COVID-19 cases outside of China in late February has fueled concerns that the virus may become a global pandemic with larger economic repercussions than previously expected. Against this backdrop, G7 Finance Ministers and Central Bank Governors held a conference call on 3 March so as to have a coordinated global policy action to offset the negative impact of the coronavirus outbreak, while the World Bank Group made available an initial package of up to $12bn in immediate support to assist countries coping with the health and economic impact of the virus. Although the absolute infection numbers in Hubei province and generally in China have recently slowed, high frequency indicators point to a severe Chinese economic fallout in Q1, with the manufacturing PMI index plumping to a new record low of 35.7 in February from 50.0 in January, even below its November 2008 trough of 38.8. China's record-low manufacturing PMI dragged the global manufacturing PMI to an 11-year low of 46.1 in February, from 52.2 in the prior month (Figure 1), as excluding China, the aggregate manufacturing PMI held almost steady. Meanwhile, factory closures in China have raised fears for supply chain disruptions elsewhere, which in turn could take a toll on the global goods-producing sector.

The pandemic-induced nervousness in financial markets led to equity market losses and increased demand for safe haven assets, with government bond yields falling to new lows and inflation expectations sliding. Markets moved aggressively to price in more accommodative monetary policy, with the Fed deciding an unexpected intermeeting insurance 50bp fed funds rate cut on 3 March. Additional monetary easing is expected by other major central banks, such as the ECB and the PBoC, along with central banks in a number of countries in the emerging market space. The OECD highlighted the major economic disruption from the COVID-19 outbreak by stating that "the global economy faces its biggest danger since the financial crisis". Hence, it downgraded its global GDP growth forecast to 2.4% for 2020 (from 2.9% previously), vs. 2.9% in 2019, before bouncing back to 3.3% in 2021. The said forecast incorporates a severe but short-lived deceleration in China, with GDP growth falling to 4.9% in 2020 (from 5.7% previously) before recovering to 6.4% in 2021 (from 5.5% previously). Under an adverse scenario, global GDP growth could even slow to 1.5%, if the coronavirus does not peak before end-Q1.

Developed Economies

US: Supply chain disruptions related to China were evident over the past month in the delivery performance of suppliers to manufacturing organizations. Should the COVID-19 outbreak be contained and Chinese production activity normalizes by end-March, we expect a modest impact on US Q1 GDP growth that would be fairly reversed in Q2, leaving our 2020 GDP projection at 1.7% from 2.3% in 2019. Risks are skewed to the downside, in case extending production disruptions weigh further on supply chains and tourism inflows reduction and tighter financial conditions take their toll on overall growth. The sharp tightening in financial market conditions on the back of the virus spread prompted the Fed to deliver an emergency 50bp rate cut leaving the fed funds target range at 1.00-1.25%. We expect an additional 25bp rate cut at 28-29 April FOMC meeting, although an earlier action at the 17-18 March FOMC meeting cannot be ruled out.

Euro area: Longer delivery times point to supply chain disruptions caused by the outbreak of COVID-19 so we retain a cautious stance regarding euro area economic activity in the coming months. We expect real GDP growth to average ca. 0.8% in 2020, based on the assumption that real economic activity moves gradually back into positive territory in Q2 as the virus fears abate. Following the Fed's unexpected inter-meeting rate cut, President Lagarde's statement released on 3 March opens the door for further ECB monetary policy easing. In our view, liquidity provision in the form of favorable LTROs to support SMEs in affected regions is likely, and this could be accompanied by a temporary rise in the pace of QE.

Periphery: Italy, the biggest southern European peripheral economy and the Eurozone's third biggest economy, is the EU country most affected by the COVID-19 outbreak, with nearly 3,100 total cases and more than 100 deaths. Protective actions by domestic authorities to address the spread of the coronavirus and its economic impact, including the closure of theatres, cinemas and bars, are expected to have a negative impact on Italy's GDP growth in the short-term. Furthermore, Italy is relatively more exposed compared to other Eurozone member states to the weakness in global manufacturing and potential supply disruptions. Against the backdrop of a more subdued Eurozone (and global) economy, Spain is also expected to continue slowing in 2020 for the fifth consecutive year, with its tourism sector (a major contributor to growth and employment) particularly vulnerable to the COVID-19 outbreak.

Emerging Economies

BRICS: Brazil's economy expanded by 0.5% YoY in Q42019, setting the FY2019 rate at 1.1%. GDP growth prospects for 2020 are not much brighter given the Covid-2019 repercussions. That said, the country's central bank stated in early March that the effects of the epidemic are closely monitored and additional interest rate cuts in the foreseeable future will be adopted if necessary. The previous easing cycle ended in last February with an additional 25bps that set the key policy interest rate at the ultra-low of 4.25% from 6.50% one year ago. In **Russia** hard data for January pointed to consumption recovery. Retail sales and consumption of services picked up to 2.7% YoY and 1.9% YoY respectively. The main drivers are improved income on the back of nominal wage growth by 10% YoY in December amid lower inflation pressures (2.4% YoY in January vs 4.5% YoY on average in 2019). From the supply side, industrial and agricultural production came in weaker and manufacturing activity remained flat in January, pointing to some softening of the production. Meanwhile, **India**, with only 28 confirmed covid-2019 cases, appears relatively insulated from the outbreak. Still, given the strong economic interdependency between India and China, the Governor of the country's central bank expressed his readiness to proceed with monetary easing. **China**'s soft data plunged in February, as broadly expected. The depth of the dive was indeed a negative surprise as PMI manufacturing data fell at historic lows, last seen in November 2008 when the Great Financial Crisis burst out. Looking forward, high frequency data, such as coal consumption by factories and property sales have started to pick up. Still, the Q12020 growth print, expected in late April, will most possibly show a hard landing compared to 6.1% YoY in Q42019. To sum up, China is expected to employ a plethora of policy tools in order to keep FY2020 economic growth above 5%.

CESEE: The coronavirus epidemic adds to the more challenging world environment the region is confronted with. Ceteris paribus, further downward revisions to our baseline forecasts in 2020-21 cannot be ruled in the period ahead. However, our baseline scenario is still for the CESEE region to continue expanding at a more moderate pace than in previous years in response primarily to rising external and internal headwinds. The outbreak of the coronavirus finds the broader region in a position of relative growth strength but also rising inflationary pressures when compared to the rest of the world. Rising inflationary pressures leave less room for regional Central Banks' maneuvers at this point, bringing fiscal policy to the forefront in case things worsen.

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Special Topic

2019 Global Economic Overview & 2020 Global Economic Outlook

2019 Global Economic Overview

Global economic activity slowed from 3.6% in 2018 to 2.9% in 2019, the weakest pace of growth since the global financial crisis. The deceleration was evident across both advanced and emerging-market economies amid rising trade barriers and heightened uncertainty around trade and geopolitics that weighed on demand for capital goods. Hence, there was a sharp, synchronised and broad-based deceleration in global manufacturing and trade, mirroring a divergence between manufacturing and services, with the latter holding up for much of the year. Trade volume growth (goods plus services) stalled at the end of 2018 and has remained subdued in 2019 with higher trade restrictions, weak investment prospects and subdued import demand from China taking an increasing toll on global trade, with the latter growing by a mere 0.5%YoY in December vs. -1.1%YoY over the same month a year earlier.

US economic growth decelerated to an annual rate of 2.3% in 2019, from 2.9% in 2018, amid slowing business fixed investment (+2.1%YoY from +6.4%YoY in 2018) and exports (0.0%YoY from 3.0%YoY in 2018). Higher tariffs on imported goods have increased trade costs while high trade tensions and heightened trade policy uncertainty have weighed on confidence, investment decisions and industrial production. Strong employment growth has helped drive down unemployment to rates that have not been seen since 1969 (3.5% in Q4 2019). Wage growth has picked up only modestly, but coupled with strong asset prices has helped support household income and private consumption growth (+2.6%YoY from 3.0%YoY in 2018). Residential investment picked up in H2 2019 following a contraction for six consecutive quarters, with both new and existing home sales edging higher and suggesting that the mortgage rates decline has started to pass through to markets and economic conditions. Concerns about the global outlook and persistent below-target inflation (core PCE at 1.6%YoY in 2019 from 1.9%YoY in 2018) have resulted in the Federal Reserve delivering three consecutive 25bp reductions to the federal funds rate at the July, September, and October FOMC meetings -taking the target range for the fed funds rate to 1.50-1.75%- and ending the reduction of its aggregate securities holdings two months earlier than previously indicated. As a result, Fed's total assets increased from $4.1trn at the end of 2018 to $4.2trn in December 2019, below its peak of $4.5 trn in January 2015 but well above the pre-crisis level of $0.9trn. On the fiscal front, US federal budget deficit as a percent of GDP increased to a seven-year high of -4.6% in 2019, from -3.8% in 2018.

Economic activity in the **Euro area** slowed further in 2019, with annual GDP growth moderating to 1.2% from 1.8% in 2018, following a decade peak of 2.4% in 2017. The slowdown reflected primarily continued external headwinds as persistent global trade tensions, mainly between the US and China, slowing global economy, enduring uncertainty surrounding Brexit and continuing deterioration in external demand severely hampered world trade flows. Country and sector specific factors in some member states, that have been in place since 2018 and turned out to be longer-lasting, also contributed to the slower growth momentum. Private consumption remained the main growth engine, buoyed by a healthy labor market, growing disposable income and favourable financing conditions. In addition, after over a decade of fiscal tightening, 2019 marked the first year of fiscal easing in several member states, mostly focused on supporting domestic demand. Manufacturing has been hit hard, while the services sector held up relatively well thanks to strong domestic demand, proving largely immune to spillover effects from manufacturing recession and slowing employment growth. Countries with strong reliance on manufacturing and high propensity to exports, especially to markets outside the euro area, like Germany, were the most affected by the slowdown. On the flipside, countries much less exposed to the external sector, like France, resisted better to the slowdown with robust domestic demand providing a good buffer. On the inflation front, Eurozone headline HICP dropped to 1.2%YoY from 1.8%YoY in 2018, below the ECB's inflation target for the seventh consecutive year. However, core inflation edged up to a three-year peak of 1.1%YoY from 1.0%YoY in the prior year, providing tentative evidence of a stronger pass-through of higher wages. In terms of monetary policy, the ECB loosened further its policy stance in an attempt to counter the Eurozone's economic slowdown and preserve accommodative financial conditions. The deposit facility rate was cut by 10bps to a new record low of -0.50%, a new series of TLTRO III operations with attractive conditions and a tiered reserve system were introduced, while the QE programme was resumed as of November at a monthly pace of €20bn.

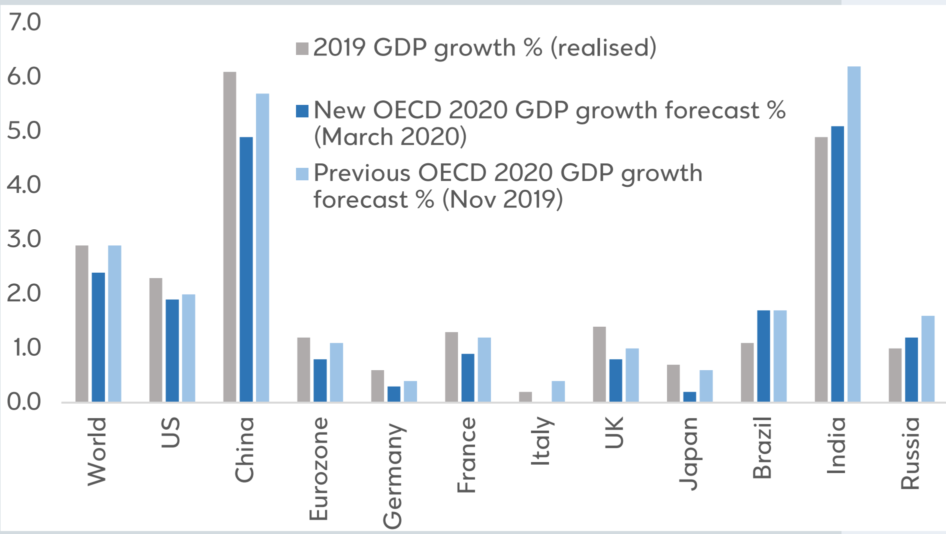
2020 Global Economic Outlook

Global growth is projected to decelerate around 2.5% in 2020, ca. 0.8pps below estimated global potential output growth, based on the assumption that the COVID-2019 outbreak peaks in Q1 with a gradual recovery in Q2 on the back of significant global policy easing. Although there are few signs of a turning point in global economic activity suggesting that global trade may have bottomed out, the balance of risks is skewed to the downside as the tentative recovery in the goods sector is expected to be interrupted somewhat by the outbreak of the COVID-2019 in China, the economic effect of which depends crucially on the severity and duration of the disruption caused. To contain the potential impact of the coronavirus, Asian central banks have shifted to an easing bias, while the Fed and the ECB have both signalled that they are poised to stay on hold in the foreseeable future, with the risks skewed towards further easing in case growth dynamics decelerate more than expected.

In the **US**, real GDP growth is projected to decelerate to 1.7% in 2020, from 2.3% in 2019, amid anticipated waning support from expansionary fiscal policies and further loosening of financial conditions. Nevertheless, a solid underlying trend in consumption -which has generally stayed at 2.5% or stronger for the past five years- is expected to more than offset soft investment momentum, constrained by uncertainty around international trade and presidential elections. Although the Phase One trade deal agreement signed on 15 January 2020 was an important step towards a comprehensive US/China trade deal, trade policy uncertainty could persist well into 2020 as progress on Phase Two deal is expected to be only gradual while reaching an agreement will depend, inter alia, on the assessment over the implementation of the Phase One deal. On the inflation front, we do not envisage much of a change in inflation trends over the year ahead, with CPI inflation averaging 2.0% in 2020, up from 1.8% in 2019, and core CPI inflation edging slightly higher to 2.3% from 2.2% in 2019. The monetary authorities are expected to leave the federal funds rate unchanged throughout 2020 unless there is a material reassessment to the outlook. The Fed's shift in inflation language at its January meeting could mean that the hurdle for rate hikes is higher than that for insurance cuts later in the year barring any considerable improvement in inflation dynamics from current levels, given that coronavirus is a new downside risk to the growth outlook.

The **Euro area** economy is projected to stay on a path of steady and moderate growth in 2020, with annual GDP growth slowing further around 0.8%, given our expectations that the external environment will remain challenging. The US/China Phase One deal trade agreement reduced trade war concerns to some extent. Nevertheless, a comprehensive deal has yet to come, and the threat regarding higher US tariffs on EU car imports is still real, suggesting that the peak in the trade war is not necessarily behind us. Uncertainty around US trade policies and concerns about a no-trade deal Brexit is expected to remain high, continuing to hamper exports and investment. In addition, the outbreak and spread of the COVID-2019 has been a source of mounting concern since the onset of the year. The longer it lasts, the higher the likelihood of knock-effects on global demand and global supply chains. Favored by improving labor market conditions, dynamic wage growth and accommodative financial conditions, private consumption is expected to remain the main growth engine. However, the challenging external environment is expected to increasingly test the resilience of domestic drivers of Eurozone growth. Fiscal policy is anticipated to remain mildly expansionary, led by the Netherlands, Italy, France and Germany. In spite of the domestic fiscal impulse, Germany is expected to continue to underperform the rest of the Euro area, while France and Spain will likely record GDP growth rates above the Eurozone average. In terms of monetary policy, the ECB is expected to stay on hold throughout the year, continuing its call for further fiscal easing, especially as the bar for additional monetary policy easing measures seems to be very high given fierce opposition from part of the Governing Council. New ECB President Christine Lagarde confirmed earlier this year the launch of a review of the ECB's monetary policy strategy, which is due to finish before the end of the year. The subdued Eurozone growth outlook is expected to keep inflation below the ECB's definition of price stability, with headline CPI averaging 1.2%YoY.

Figure 2: OECD: 2020 GDP growth forecasts revised downwards due to COVID-19 impact



Source: OECD, Eurobank Research

Global Macro Themes & Implications

Market and economic developments triggered by the COVID-19 outbreak warrant a global monetary policy response

The rapid speed of the COVID-2019 transmission has raised investors' anxiety and uncertainty, with markets aggressively pricing in more monetary easing by central banks so as to cushion the economic impact of the virus outbreak. Following the G-7 statement that global central banks are standing ready to use policy tools as appropriate, the Fed unanimously decided an emergency 50bps interest rate cut on 3 March in its first extraordinary monetary policy meeting since the 2008 financial crisis. According to the relevant Fed's press release, although the US economic fundamentals remain "strong", COVID-2019 poses evolving risks to economic growth, so the Committee will closely monitor economic and market developments, use available tools and "act as appropriate to support the economy". Following the Fed's surprise rate cut, the ECB and the BoE are expected to follow suit with additional liquidity insurance measures. ECB President Christine Lagarde's statement released on 3 March highlighting that "the ECB is closely monitoring developments and their implications for the economy... and stands ready to take appropriate and targeted measures, as necessary and commensurate with the underlying risks" is a clear indication towards that direction. Furthermore, the RBA cut its cash rate by 25bp to a new record low of 0.50% on 3 March, and another rate cut is expected in Q2 2020 given Australia's close trade links with China. In New Zealand, a rate cut is expected as well at the March meeting, while a number of EM central banks are also expected to ease monetary policy in the coming months (i.e. Turkey, Russia, India, Korea, Thailand, Vietnam, Malaysia).

Lingering no-deal Brexit fears

After being a member of the EU for 47 years, the UK formally left the Union on 31 January, following the ratification of the Withdrawal Agreement. In line with the terms of the above agreement, the UK entered as of 1 February a transition period set to last until 31 December 2020 (unless the two sides agree by 1 July 2020 for an extension of up to 2 years) during which very little will actually change for the UK. More specifically, the UK will maintain privileges and obligations (such as the single market, customs union access, and the four freedoms of movement) as if it were an EU member state but will lose representation (and voting rights) in European institutions. The next stage in talks, related to the future UK/EU trading relationship, commenced on 2 March. The two sides aim to negotiate a full free (Canada type) trade agreement (quota free/tariff free trade on goods), with a view to reaching a comprehensive agreement on their long-term economic relationship that will include trade in both goods and services. According to the EU, an agreement should be sealed by 26 November 2020 in order for it to be fully ratified by the end of the year when the transition period expires. However, finalizing and ratifying a comprehensive trade deal within such an incredibly tight timeframe seems highly ambitious.

Indeed, based on the trade agreement objectives both the UK and the EU have published, the two sides appear to adopt opposite positions on key conditions attached to a full free trade agreement. Importantly, the EU is aiming for a Canada-plus type free trade agreement, contingent on the UK abiding by the EU's level playing field (i.e., the UK signing up to basic EU rules) and the continuation of current fishing rights in

UK fishing waters. On its part, the UK is aiming for a purer Canada-style free trade agreement, rejecting any commitments to a regulatory level playing field on "competition policy, subsidies, social protection, the environment or anything similar" and pushing, instead, for full sovereign control. It also aims to become an independent coastal nation, offering merely an annual review on the EU fishing access and quotas to UK fishing waters. To that end, UK PM Boris Johnson has publicly threatened that, if such a trade agreement is not feasible, the UK could revert to a relationship with the EU like that of Australia's - essentially trading on WTO rules - indicating that his government is preparing the country to incur any economic cost rather than become a rule-taker. The role for the European Court of Justice in dispute resolution, the free movement of people and Gibraltar, are among other issues of contention.
Meanwhile, the UK has repeatedly said that it does not intend to extend the transition period and has threatened that, if not enough progress in trade talks has been achieved by June – when the two sides have scheduled to take stock of the negotiations – it would likely ramp up domestic preparations for a UK exit on WTO terms. Evidently, EU/UK trade negotiations are not going to be easy and the threat of a WTO Brexit at the end of the year is not negligible, unless the two sides agree to extend the transition period or, under the most positive scenario, manage to reach a permanent trade agreement by end-2020.

With COVID-19 in the forefront, geopolitics will probably make a come-back at a later stage

Whilst in the last two months COVID-2019 and its social and economic repercussions are the major concerns for markets and investors, geopolitical risks around the globe remain vibrant and tilted to the downside. Geopolitics and trade tensions proved as key economic and market drivers in 2019 and they are expected to hold a pivotal role in the global output and markets' performance in the current year as well. Political and social unrest in Latin America, namely in Venezuela and Mexico, act as headwinds to the economic recovery of the region. Moving to the east, geopolitical tensions in the Gulf region keep piling up in the background. Specifically, following the surge in last January with the killing of the Iranian General Qassem Soleimani by the US Government and Iran's retaliation with 15 missiles firing at the US military base in Iraq, the US and Iran have signaled a pause in escalation and a step back from major confrontation. Still, the likelihood of asymmetric actions on behalf of Iran remains high with consequent resurgence of the existing rivalry, as several analysts believe. Further, what started as a civil war in Syria back in 2011 has resulted into a rampage between the underlying state, Turkey and Russia while it is felt by the EU as well. While Turkey and Russia have just reached to an accord to halt fighting in Syria, the EU still needs to defend its borders with Turkey attempting to pass over the pressure from the refugee stream from Syria to Greece that, marks, along with Bulgaria, the EU's borderline with Turkey. Finally, the recent agreement between the Turkish and the Tripoli based government in Libya fosters destabilizing dynamics in the Mediterranean Sea. In a nutshell, ongoing and escalating turmoil in several places of the world is a fact and the outcome of the elections in the US later this year could act as a game changer for the course of events in the near future.

Macro Themes & Implications in CESEE

The outbreak and spread of the coronavirus puts an additional test for the resilience of growth in the broader CESEE region in 2020. Rising inflationary pressures leave less room for regional Central Banks' maneuvers at this point, bringing fiscal policy to the fore in case things worsen

As we are already in the third month of 2020, it becomes more and more apparent that the outbreak and spread of the coronavirus will dominate the economic agenda of the year. The spread of the virus beyond China and into Europe and the announcement of new fatalities on a daily basis casts a shadow on world economic prospects. Having said that, the impact will depend on how soon the peak of the epidemic is reached. In any case, it is highly likely that the coronavirus will disrupt the supply-chains or, at best, be limited to increasing production costs. Firstly, the pressure on global trade flows is expected to intensify as a result of the measures against the transmission of the coronavirus. Secondly, if the Chinese factories remain closed for a prolonged period and unable to deliver on their orders, their customers may have to turn to more expensive substitutes.

The initial reaction of the markets was very anxious, panicking investors and prompting many governments to adopt restrictive measures to contain it. However, the economic impact is yet to be seen. The direct impact can come through the channels of trade, investment and tourism. The indirect can come through the region's integration into the supply chain of Germany and thus cause a more pronounced impact on world economic growth. Furthermore, to the extent that Chinese authorities will be required to change their FDI priorities, the economies that are more dependent on it could suffer significantly. The similar, previous experience with SARS proved that the most vulnerable sector is tourism. Even though in most regional economies the percentage of incoming Chinese tourists is single-digit, their spending is above average. As a result, prolonged restrictions for Chinese travelers, will cause a number of economies to feel the heat this year. On the other hand, the region as a whole could benefit from lower commodity prices. The decline in oil demand from China in particular has pushed prices by ca. 20% lower in one month supporting disposable incomes. If lower commodities prices persist in the coming months, that could also act as a disinflationary factor.

The outbreak of the coronavirus finds the broader region in a position of relatively strong growth but also rising inflationary pressures compared to the rest of the world. Inflation rates have been rising in recent months across the region, with the rise becoming more visible in the CEE-4. In fact, inflation has surged above the upper bound of the Central Bank target bands in Czechia, Hungary, Poland and Romania. At the same time, as of January, inflation rates in Bulgaria and Serbia stand at the highest point of the last twelve and eight months respectively. Inter alia, the inflation trajectory leaves less degrees of freedom for regional Central Banks' maneuvers at this point, urgently bringing fiscal policy to the forefront in case things worsen.

In any case, the coronavirus epidemic adds to the more challenging world environment the region is confronted with. Ceteris paribus, further downward revisions to our baseline forecasts in 2020-21 cannot be ruled out in the period ahead. However, our baseline scenario is still for the CESEE region to continue expanding at a more moderate pace than in previous years in response primarily to rising external and internal headwinds. Having passed their cyclical peak, GDP growth dynamics in the regional economies are expected to slow down further in most cases due to weaker net exports and domestic demand dynamics.

Net exports are expected to come under more pressure in a less friendly global economic environment due to persisting trade tensions, disrupted supply chains and less tourism flows. At the same time, domestic demand will remain the key source of growth. However, it is not expected to make a higher contribution, as households' and corporates' incomes growth decelerates, and the room for domestic fiscal & monetary policy responses becomes more limited. Although each case is different and uncertainties remain high, improved EU funds' absorption – a pivotal factor behind public investment if used wisely – coupled with healthy credit expansion, can make a positive difference in each individual country's output performance next year. With the end of the programming period 2014-2020 approaching, governments will eventually have to step up spending for a number of mature projects.

CESEE Markets Developments & Outlook

Bulgaria

Bulgarian Eurobond yields exhibited a mixed month, with the short end of the curve experiencing yield drops of 2-4 bps, mid-curve tenors such as 2027 and 2028 saw yields rising by 1-2 bps and the longest maturity, namely the 2035 paper saw its yield sliding by 3 bps. Local currency denominated papers also remained largely unchanged, with all maturities with the exception of the 10 year tenor, seeing modest yield gains of 2-4 bps. The 10 year yield on the other hand, dropped by 2 bps. The Ministry of Finance held an auction at the beginning of January, kicking off the year with a €100mn issue of a new 5 year BGN bond yielding -0.11%. Despite the negative interest rate, local market players such as banks and various pension funds showed keen interest, which in terms resulted in the issue being oversubscribed by 2.5 times.

Serbia

Serbia has ended 2019 with lots of positive data announcements. Strong GDP growth, stable FX rate & inflation, significantly lower unemployment rate and modest wage growth. Can all benefits from 2019 spill into 2020? We think that a lot of it can. Now let's elaborate on why. Lots of infrastructure projects have started in 2019 and a significant number will start in 2020 that will keep the pace of public invest-ments at the strong rate (railway Belgrade-Budapest, Belgrade – Bar and 6 highways that will connect Sarajevo, Pristina and Podgorica with Serbia). The National Bank of Serbia (NBS) has already strength-ened FX re-serves in 2019 with the hefty amount of Euros bought (€2.7bn) which is going to be a strong "insurance policy" if the global environment somehow starts to change. Speaking of global growth, we don't see how 2020 could bring any U-turns in policies as almost all predictions are indicating that we are going to stay in the environment of zero and negative rates in developed countries. In terms of FX rate, we think that in a large part of the new year we are going to see a repeat of 2019 as we expect NBS to be fully involved in any activity that could bring excessive currency rate movement (that should be the case not only if Dinar starts to depreciate but also appreciate). In the realm of fixed income, we anticipate curve to steepen a bit. In our view, the short end of the curve could have another 50bps drop while long end could fall for another 25bps. Anyhow, it is highly likely that there is significantly less movements on the bond market this year given that the rally in the past year was overwhelming. In turn, it could be similar to the Hungary and Romania government yield curve where the drop in 2019 was less than 20bp on average. There are head-winds also. 2020 could be a turbulent and dynamic po-litical year as many things have been left unfinished in front of election (which includes even a precise date of elections). In the current "battle" between the ruling party and opposition, there isn't too much hope that those two paths could cross-over any time soon. Finally, the Kosovo issue still remains one of the biggest bumps on the road towards EU accession.

Markets View

Foreign Exchange

EURUSD: The pair remains within its recent range, having only a short break below 1.1050. The technical picture as well as the consensus for "stronger EURUSD" trade seems to be breaking down on the back of the coronavirus developments, a dovish Fed and strong ISM number from the US. The 1.1116 level is now the first resistance with the 1.10 level being the support. Should the 1.10 level give way, the next level to watch is 1.09.

GBPUSD: The GBP traded in the 1.30-1.32 range making a high of 1.3215 on the back of Brexit day and a "no cut" from the BoE, against market expectations, but the gains were quickly wiped out following "tough talk" on the upcoming trade negotiations. The 1.29 and 1.28 are key support levels and below that 1.26 will become a major target. On the upside a close above 1.32 is required to negate the recent reversal.

USDJPY: JPY is trying to finally act as the traditional safe haven on the back of the coronavirus risk off market action. The pair reversed from a high of 110.29 to a low of 108.31 and remains in the range of the past few months. The 109 level is a key resistance now and 107.50 an important support. It all depends on how the virus headlines come out.

Rates

EU: One way street for EU yields since mid-January due to a combination of risk off (core bonds) and positive news from the periphery (Italy's political uncertainty subsided post local election results, Greece was upgraded to BB+ and positive outlook by Fitch). Bunds traded from a high of -0.15% to a low of -0.44% as European stocks dipped and general risk off sentiment prevailed. The technical picture has reversed and yields are expected to be under pressure in the near term as the coronavirus story unfolds.

US: Similarly to the EU yields, US yields collapsed by 30bps to reach a low of 1.51% before reversing mildly. The technical picture points to lower yields in the medium term and a potential retest of the Sep19 (1.42%) and Jul16 (1.31%) lows is possible. The 3m/10yr curve is again inverted at -1.7bps, after spending the last four months on positive territory

Emerging Markets credit

EM credit after a positive start to the year followed the repricing of all asset classes on the back of the coronavirus outbreak. The JPM EMBI+ Sovereign index widened by 25bps since mid-January to 323bps before taking back some of that widening to trade at 314, all driven by the virus news and the impact this might have on Chinese growth. LatAM was the big underperformer with EMEA and surprisingly Asia faring much better. We consider any further widening a buying opportunity for EM credit spreads, but expect volatility in the short term.

Corporate credit

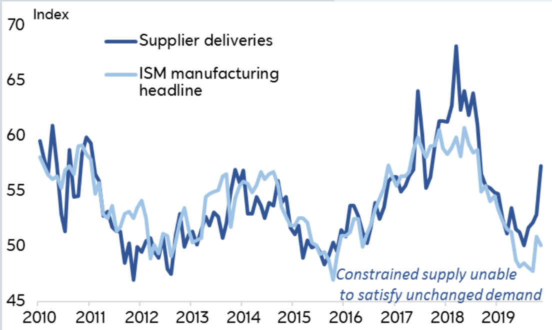
Investment grade credit saw minor widening and if we factor in the significant supply from the primary market overall the move was insignificant. Notable is though the underperformance of US IG versus EU, given the latter's support by the ECB, that widened 3bps more one an index level. High Yield on the other hand had a more significant reaction to the coronavirus and the collapse of oil prices (US HY). US HY underperformed EU HY (+50bps vs +30bps), as the former is heavily weighted on oil related companies. Financials held well under the circumstances. HY at current levels looks much more attractive and as with EM credit we consider any significant widening an opportunity to buy credit spreads. From current rates levels it is difficult to see IG posting positive total returns for the year.

US

Coronavirus prompts a sudden shift from Fed's "wait-and-see" stance to further easing

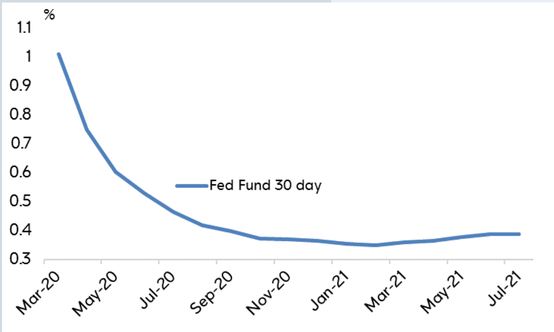
The ISM manufacturing fell by 0.8pt to 50.1 in February, reversing part of January's improvement on the back of the Phase One US/China trade deal. Supply chain disruptions related to China were evident in the delivery performance of suppliers to manufacturing organizations, which lengthened by 4.4pts to 57.3 (Figure 3). Production also moderated by 4.0pts to 50.3 after surging 9.5pts in January, new orders dropped back into the contractionary territory (-2.2pts to 49.8) and the imports component declined to its lowest level since May 2009 (42.6), with respondents citing supply chain issues and new orders reductions related to COVID-2019, the extended Lunar New Year and the Boeing 737 Max production stoppage. Indeed, according to US Customs daily bills-of-lading data, commodity trade volume between the US and China slowed significantly in February mirroring production-related disruptions in China. Should the coronavirus outbreak be contained and Chinese production activity normalize by end-March, we expect a modest impact on Q1 GDP growth that would be fairly reversed in Q2, leaving our 2020 GDP projection at 1.8% from 2.3% in 2019. Risks are skewed to the downside, in case extended production disruptions weigh further on supply chains and tourism inflows reduction and tighter financial conditions take their toll on overall growth.

Figure 3: Supply chain disruptions in China weigh on business confidence



Source: Thomson Reuters, ISM, Eurobank Research

Figure 4: Futures markets price in additional rate cuts over the next 12 months



Source: Bloomberg, Eurobank Research

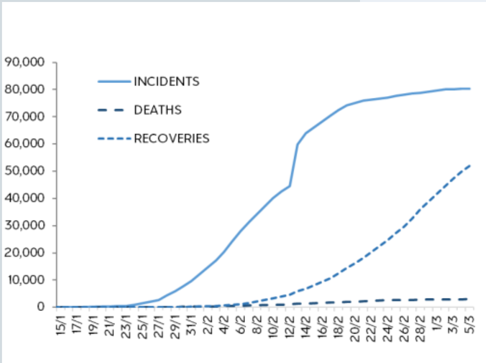
Following the sharp tightening in financial market conditions and the G-7 statement that global central banks were standing ready to use policy tools as appropriate, the Fed delivered an emergency 50bp rate cut on 3 March bringing the fed funds target range at 1.00-1.25%. Although the economic fundamentals remain "strong", COVID-2019 poses evolving risks to economic growth, and the Committee will closely monitor economic and market developments, use available tools and "act as appropriate to support the economy". Following the Fed's unexpected emergency intermeeting rate cut, it's quite difficult to project the size and the timing of further cuts depending on the spreading of the virus and its impact on the economy and markets. We expect an additional 25bp rate cut at the 28-29 April FOMC meeting, although an earlier action at the 17-18 March FOMC meeting cannot be ruled out.

China

Balancing between economic activity restart and Covid-19 containment

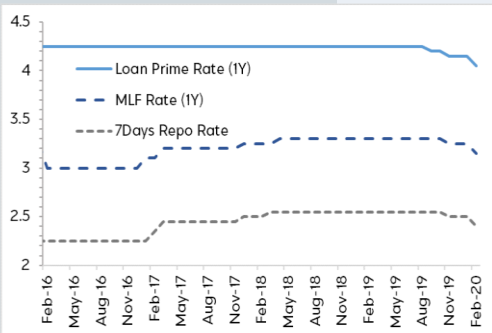
It's been three months since the starting point of the Covid-19 outbreak in Wuhan, the capital of the Hubei province, located at the mainland of China. At the time of writing, total incidents within China count to 80,409 and the death toll has reached 3,012 people. On a positive note, new confirmed cases on 03 March are 125 from 406 a week ago, signalling that the worse may be behind us regarding the outbreak inside China. However, the epidemic continues to have a severe impact on the economic activity and will weigh heavily on the economic growth in the Q1 2020. Manufacturing and non-manufacturing PMIs, while standing above 50 in January, plunged in February to lows last observed during the global financial crisis back in late 2008. While the dive was broadly anticipated, the depth was a negative surprise. Looking forward, high frequency gauges that point to the extent at which economic activity has recovered, such as coal consumption in power plants on the supply side and property sales on the demand side, suggest that activity is gaining speed compared to the previous two months, when the economy appeared to be in an idle mode. Still, in order for China to achieve all of the current year's development goals, including the GDP growth target, as President Xi Jinping stated in late February, brave and differentiated policy stimuli will have to be infused, based on the severity of the outbreak in each region. Before the virus outbreak, the official annual target was expected to be set somewhere around 6.0%, but as things stand, 2020's GDP growth print is expected to stand 1 pp lower, and that is assuming that the virus is fully contained by end-Q1. On the monetary policy front, the People's Bank of China (PBOC) reacted with a series of interest rate cuts in February, namely the 7 days reserve repo rate to 2.40% from 2.50%, the medium term lending facility rate to 3.15% from 3.25% and the one year loan prime rate to 4.05% from 4.15%. While the average lending rate is expected to continue declining in H12020 and therefore provide the borrowed companies with some additional liquidity, domestic credit growth is anticipated to pick up only moderately given the excessive levels of leverage (~ 300% of GDP as of Q12019).

Figure 5: Signs of virus containment inside China



Source: Bloomberg, Eurobank Research

Figure 6: Monetary easing in support of GDP growth



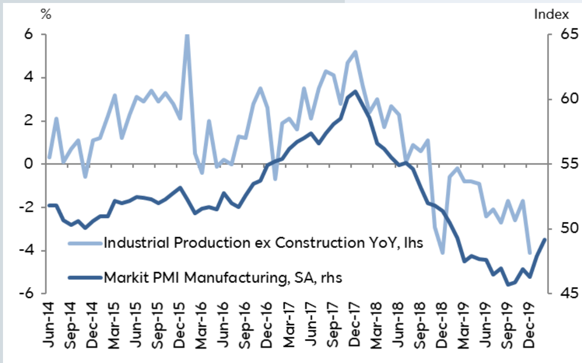
Source: Bloomberg, Eurobank Research

Euro area

The virus outbreak pushes for further monetary and fiscal policy easing

Following a sharp contraction of 0.3%QoQ sa in Q4 2019, IP declined by -2.1%MoM in December, following a downwards revised 0.0%MoM growth rate in November, on the back of a synchronized industrial activity drop across major euro area economies. Leading indicators point to a rebound in 2020, with the final February composite output PMI rising by 0.3pt to 51.6, driven by increased momentum in both the manufacturing (+1.3pt to 49.2) and services sectors (+0.1pt to 52.6). Nevertheless, longer delivery times point to supply chain disruptions caused by the outbreak of COVID-19 -instead of stronger demand coupled with constrained capacity as was the case in 2017- so we retain a cautious stance regarding euro area economic activity in the coming months, given that the number of the virus' cases in Europe, and in particular in Northern Italy, has recently increased. The lack of macroeconomic data mirroring the effect of the virus outbreak so far makes it difficult to gauge with accuracy the size of the negative impact. Following a downward growth revision in Q1 euro area GDP growth into contractionary territory due to the rapid spread of the virus, we expect real GDP growth to average ca. 0.8% in 2020, based on the assumption that real economic activity moves gradually back into positive territory in Q2 as the virus fears abate.

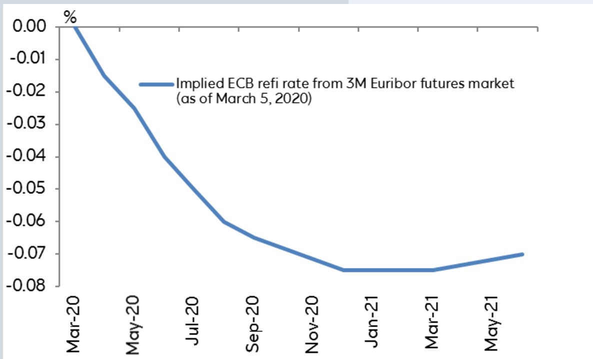
Figure 7: We remain cautious regarding the EA economic outlook despite the recent PMI uptick



Source: IHS Markit, Bloomberg, Eurobank Research

Following the Fed's unexpected intermeeting rate cut, President Lagarde's statement released on 3 March opens the door for further monetary policy easing by the ECB. In our view, liquidity provision in the form of favorable LTROs to support SMEs in affected regions is likely, and this could be accompanied by a temporary rise in the pace of QE. Although interest rates are already at very low levels and there is little ECB room for manoeuvre, a 10bp deposit rate cut to -0.60% cannot be ruled out, if the Committee sees increasing risks to the economic and market outlook. We also anticipate some targeted fiscal action, given Ecofin policy agreement to fiscal stimulus to contain a negative shock to the economy. The Italian government's recent tax relief measures to support residents of contaminated regions and the French government's targeted support measures to mitigate the short-term impact of the virus outbreak are the first moves towards that direction.

Figure 8: Markets await further monetary policy easing by the ECB



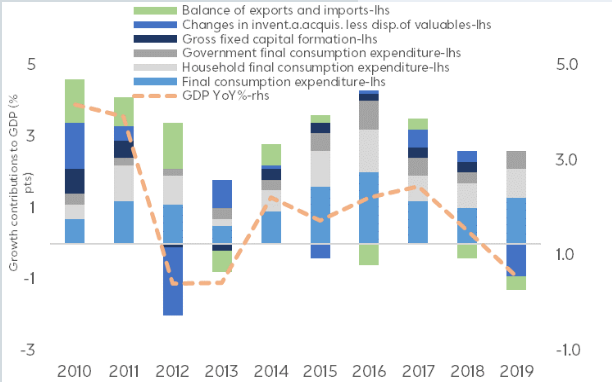
Source: Bloomberg, Eurobank Research

Germany

Particularly exposed to supply chains, Q1 2020 GDP decline likely

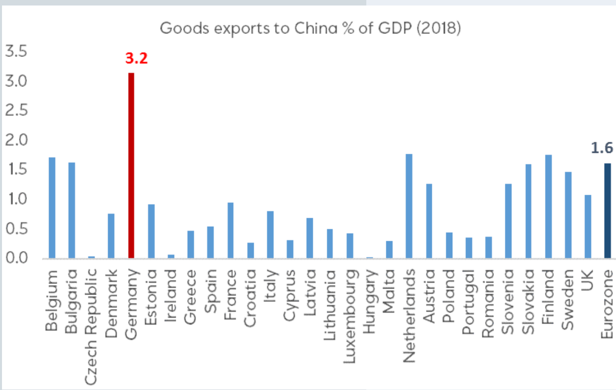
Germany's GDP growth was unchanged in Q4 2019 compared to 0.2%QoQ in the prior quarter and a 0.1%QoQ average in Q1-Q3 2019. Private and public consumption slowed sharply (0.0%QoQ and 0.3%QoQ vs. 0.5%QoQ and 1.3%QoQ in Q3, respectively), and investment in machinery and equipment recorded the biggest drop in three years (-2.0%QoQ), while net exports were a drag on growth (exports -0.2%QoQ, imports +1.3%QoQ). Construction and other investment rose (0.6%QoQ and 1.1%QoQ, respectively), while inventories rebounded. For 2019 as a whole, GDP growth rose 0.6%, the lowest since 2013. Key drivers of weak growth were net exports, inventory drawdowns and investment, which partially offset stronger private and public consumption as well as construction (Figure 9). Looking ahead, Q1 GDP 2020 growth will largely depend on how the COVID-2019 will affect German exports to China and supply chains to which Germany is particularly exposed. Among Eurozone member states, Germany had by far the largest goods exports exposure to China in 2018, both in absolute terms (€93bn) and relative to GDP (3.2% vs. 1.6% Eurozone average, Figure 10). In addition, sentiment surveys and hard data do not yet point to a clear rebound in Germany's manufacturing sector. The flash manufacturing PMI for the month of February improved by 2.7pts to a one-year high of 48.0, but new export orders, which tend to lead actual exports, deteriorated sharply, while the higher suppliers' delivery times sub-index was probably mostly due to coronavirus-related disruptions to global value chains. In addition, manufacturing dropped in December in annual terms for the 14th consecutive month, echoing disappointing factory orders, which remained in a downward trend over the same month for more than a year. All in all, we do not rule out a decline in Q1 2020 GDP but expect a rebound in Q2 (on the assumption that COVID-2019 will peak by end-Q1/early Q2) and only an anemic economic upswing in the full year amid continued external headwinds.

Figure 9: GDP growth slowed to six-year lows in 2019



Source: Federal Statistical Office (Destatis), Eurobank Research

Figure 10: Among EA member states, Germany has the largest goods exports exposure to China



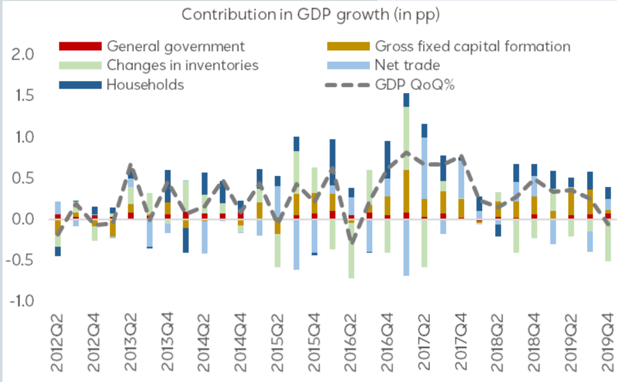
Source: Federal Statistical Office (Destatis), Eurostat, Eurobank Research

France

COVID-19 outbreak poses risks to a likely Q1 2020 GDP rebound

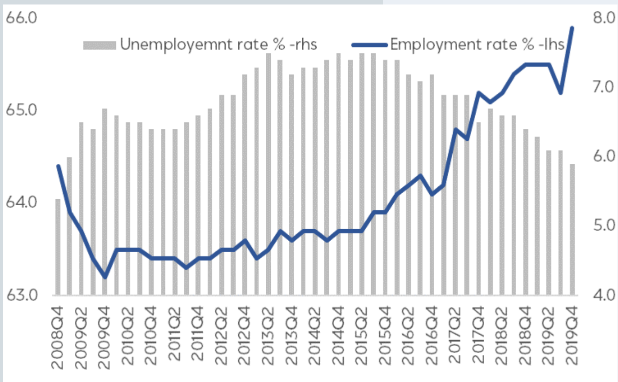
France's annual GDP growth decreased to 1.3% in 2019 from 1.7% in 2018, following a 0.1%QoQ contraction in Q4, the first negative growth rate in 3-½ years, as several sectors were affected by temporary factors including strikes against the government's proposed pension reforms. The main 2019 GDP growth driver was final domestic demand, which contributed 2.1pp, out of which 0.7pp came from private consumption thanks to increased households' purchasing power on the back of significant household tax cuts (estimated at c. €21bn for 2018-2020) and the continuing improvement in labour market conditions, while gross fixed capital formation added 1.0pp supported by favourable financial conditions. Inventories were a drag on 2019 GDP growth, along with net trade as exports grew by a slower pace compared to imports (1.9%YoY vs. 2.2%YoY, respectively). Looking ahead, we are cautiously optimistic for a GDP growth rebound in Q1 2020 after the downward surprise in the prior quarter. Given the cumulative inventory drawdown of 0.6pp in the last three quarters, it would be surprising if Q1 2020 does not see a positive contribution from stocks rebuild. The end of the public transport strike, after the Prime Minister Edouard Philippe announced the government's willingness to withdraw a contested clause on raising the retirement age by two years to 64, and somewhat easing US/China trade tensions following the signing of the Phase One trade deal, should also be reflected in slightly faster Q1 GDP growth. Supporting the above, the INSEE consumer confidence increased in February for the second consecutive month to a three-month high of 104.4, supported by a decline in the ILO unemployment rate to an 11-year low of 8.1% in Q4 2019. Along these lines, the INSEE business climate summary indicator improved in February to a three-month peak of 105.4, coming at odds with a renewed drop in the February PMI manufacturing below the critical level of 50.0 for the first time in around a year (49.5). The key downside risk to our forecast for a GDP growth rebound in Q1 2020 is related to the coronavirus outbreak which could lead to a drop in economic activity, particularly through transport, tourism and global supply chains.

Figure 11: Final domestic demand was the main engine of growth in 2019



Source: BINSEE, Eurobank Research

Figure 12: Steady improvement in France's labor market conditions



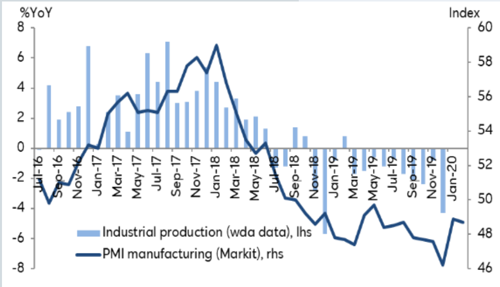
Source: INSEE, Eurobank Research

Italy

Increase in Italian COVID-19 cases pose new downside risks to growth

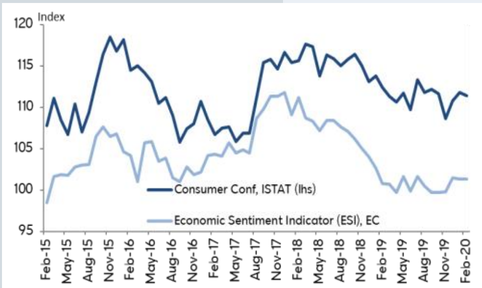
Following a negative Q4 2019 GDP growth of -0.3%QoQ, the increase in COVID-19 cases in Italy, and especially in the regions of Lombardy and Veneto that together account for about 30% of Italian GDP and ca. 40% of the country's manufacturing GVA, introduces new downside risks for the Italian economic outlook, increasing the risk of a technical recession. Operating conditions in the Italian manufacturing sector deteriorated further in February for a 17th consecutive month (Markit Manufacturing PMI down by 0.2pt to 48.7), with further reductions in output and new orders. Production fell at one of the fastest rates in the current 19-month declining-streak, while selling prices declined at the sharpest pace since early-2015. Nevertheless, the Italian services sector recorded a further increase during February, with the respective Business Activity Index rising for the ninth month in a row (+0.7pt to 52.1) and actually reporting the quickest pace of growth since October 2019. With increasing risks for a more damaging impact on Italian economic growth due to the sharp virus spread, we expect zero growth for 2020 from 0.2% in 2019, 0.3bp down from our previous forecast, with risks skewed to the downside in case the negative impact extends further into Q2 via supply chain disruptions and possibly pre-cautionary behavior in other Italian regions. Fiscal policy should play a key role to offset the negative impact of the coronavirus outbreak. Indeed, the Italian government's tax relief measures introduced in February to support residents of contaminated regions provide a significant fiscal stimulus boost in the face of the coronavirus disruption.

Figure 13: PMI manufacturing point to further IP contraction of a potentially greater magnitude



Source: Bloomberg, Markit, Eurobank Research

Figure 14: Confidence has deteriorated following the increase in Italian COVID-19 cases



Source: Bloomberg, Eurobank Research

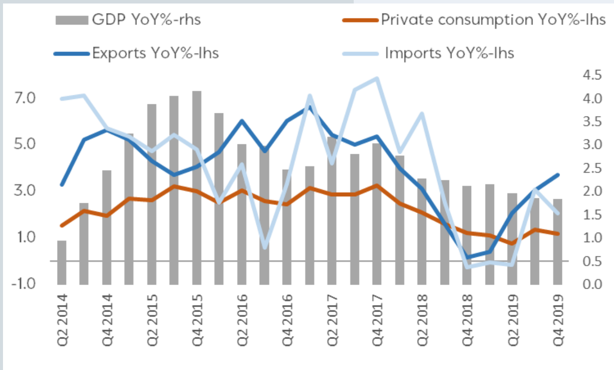
On the political front, although uncertainty has recently softened, tensions within the coalition are set to remain high. Ahead of the Five Star's leadership contest in mid-March and parliamentary discussions of a new proportional electoral law, the risk of a breakdown of the Five Star/Democratic Party coalition and an early election has not completely disappeared, although this is not our baseline scenario as no party appears to have an interest in triggering a crisis. Nevertheless, the coalition government is backed by a very thin majority, especially in the Senate where - in contrast to the Chamber of Deputies - the external support of smaller parties is of vital importance.

Spain

Economic activity to lose momentum further this year, albeit continuing to grow faster than Eurozone peers

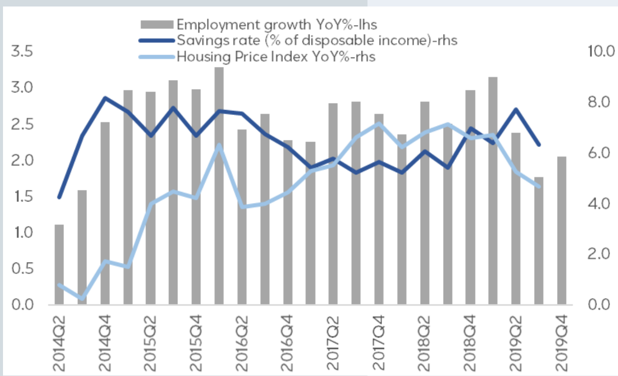
After a milder-than-intially expected slowdown in H2-19 on the back of an upbeat external sector, Spain's annual GDP growth came in at 2.0% in 2019, outperforming its major Eurozone peers. Nevertheless, the 2019 GDP growth rate was the lowest in the last five years as domestic activity continued slowing amid a maturing business cycle with limited spare capacity left (in fact, the unemployment rate of 13.7% in January 2020, the lowest in more than ten years, has already fallen below its structural rate which is officially estimated close to 15%). Despite a subdued global trading backstop, the contribution of net exports to 2019 GDP growth was positive as exports grew robustly (2.3%YoY), outperforming imports, which rose by a relatively more moderate pace (1.2%YoY) mirroring a slowdown in private consumption. Indeed, after years of 2-3% annual growth rates, private consumption dropped to 1.1%YoY in 2019, amid rising household savings rates (probably reflecting a precautionary attitude against an increasingly challenging external environment and prolonged domestic political uncertainty), signs of cooling in employment growth following a 22% increase in the minimum wage and a weakening construction sector (Figure 16). For 2020, GDP growth is expected to continue slowing towards the 1.5% potential, partly due to a more subdued global economy, with the coronavirus outbreak and a lacklustre tourism performance (a major contributor to growth and employment) posing key external risks. Domestic political uncertainty could also weigh on Spain's medium-term growth outlook amid risks for a less flexible labor market and higher labor costs following an additional 5% hike in the minimum wage agreed for 2020. Meanwhile, the parliamentary approval of the 2020 Budget, which could potentially determine the longevity of Spain's coalition government comprised of the socialist party PSOE and the left-wing Podemos, the first coalition government since the country's return to democracy in 1975, is still pending.

Figure 15: Spain outperformed its major Eurozone peers in 2019 mainly thanks to the external sector



Source: INE, Eurobank Research

Figure 16: Private consumption has lost momentum amid slowing employment growth, higher household savings rates and weakening construction sector



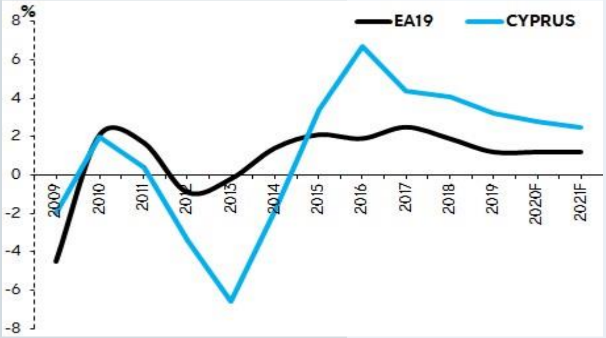
Source: INE, Eurostat, Eurobank Research

Cyprus

Investments will be a key determinant of output performance in 2020

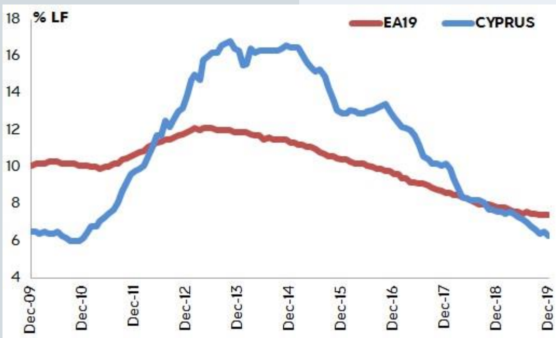
According to the revised estimate, real GDP advanced by 0.8% QoQ/ 3.2% YoY in Q4-2019 on a seasonally adjusted basis compared to 0.5% QoQ/3.3% YoY in Q3-2019 vs. 1.0% QoQ/3.8% YoY in Q4-2018. Domestic demand has had the lion's share in the full year GDP growth reading, while net exports have come under pressure driven by the negative performance of exports in the 1H-2019. Overall, real GDP growth expanded by 3.3% in 2019 down from 4.1% YoY in 2018 vs. 4.4% YoY in 2017, compared to 6.7% YoY in 2016, up from only 3.4% YoY in 2015, and after three years of recession and a cumulative drop of 11.5% over the period 2012-2014. Looking ahead, in our view it is crystal clear that the economy has passed its cyclical peak. The growth dynamics are expected to remain relatively strong – yet still below 3% for the first time after graduation from the economic adjustment programme – at 2.8% in 2020 driven primarily again by still strong domestic demand dynamics. Among other factors, the performance of investments will most probably turn out to be a key determinant of GDP performance. Investments as a percentage of GDP has climbed to 19.1% in 2019 unchanged from 2018 and a decade high of 19.9% in 2017 compared to only 12.9% in 2013, receiving strong support from the real estate market recovery, itself supported by a stream of ongoing residential and tourism infrastructure construction projects. The Cypriot investment program has been instrumental in attracting foreign investment in the real estate sector in the form of high-rise residential towers. Even though the latest high frequency real estate and construction activity indicators are strong, concerns for the future of this activity - stemming from the amendments to the program, which already led to a decline in applications post May2019 - remain. The external risks stem from the slowing Euro area growth performance, geopolitical and Brexit-related uncertainty and the challenges for the tourism sector both from the rising competition with neighboring destinations as well as from the outbreak of the Coronavirus epidemic. Internally, the main risk source remains the financial system due to the still large amount of NPEs and high private sector indebtedness. The anticipated Supreme court rulings on public wage cuts and on the amendments to the insolvency and repossesions framework as of July 2019 are also a source of concern.

Figure 17: Cyprus' turn-around growth story has been impressive so far



Source: CYSTAT, Eurostat, Eurobank Research

Figure 18: Unemployment in Cyprus now stands below euro area



Source: Bloomberg, Eurobank Research

Eurobank

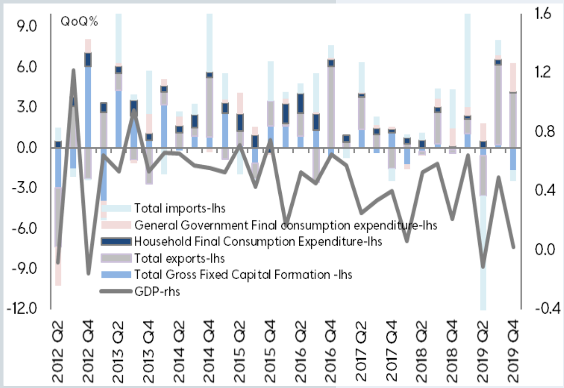
Eurobank Research

UK

COVID-19 outbreak poses risks to an expected Q1 2020 GDP rebound

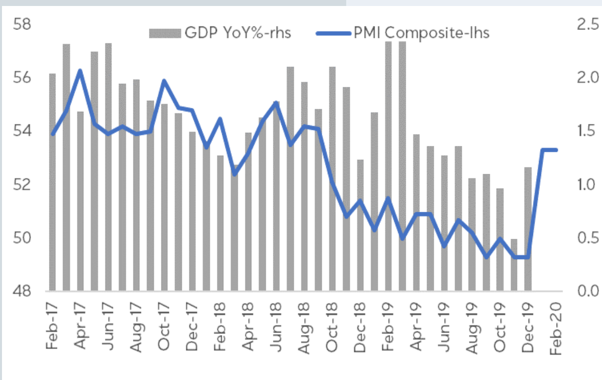
UK GDP stagnated in Q4 2019 with 0.0%QoQ growth, following a period of volatility throughout the year, partly due to changes in the timing of the UK's originally planned exit dates from the EU in March and October 2019. For the full year, upward revisions in the prior quarters lifted the 2019 annual GDP growth rate to 1.4%, a tad higher from 1.3% in 2018 and above the BoE's estimated potential growth rate of 1.1%, but still the second lowest since the global financial crisis. The Q4 GDP expenditure breakdown showed that household consumption and gross fixed capital formation slowed sharply, mainly due to prolonged Brexit uncertainty. In more detail, household consumption remained in a declining trend growing by a subdued 0.1%QoQ, the slowest pace in four years, while for the full year it grew by 1.4%YoY, its weakest growth rate since 2011. Gross fixed capital formation fell by 1.6%QoQ, the worst performance since Q1 2013, and rose by just 0.6% in the full year, the slowest pace in ten years, with manufacturing investment particularly weak. Government consumption grew by a seven-year high of 2.1%QoQ in Q4 2019, and a hefty 3.6%YoY in the full year. Imports and exports have been volatile throughout 2019. Exports rose by 4.1%QoQ in Q4 2019 and imports dropped by 0.8%QoQ, but for the full year they both contracted by 3.6%YoY and 3.5%YoY, respectively. Looking ahead, business surveys pertaining to the early months of 2020 have generally surprised to the upside, suggesting a rebound in Q1 GDP as the sharp improvement in sentiment following December's general election is probably continuing to feed through. The Composite PMI held most of its post-election gains in February easing slightly by 0.3pts to 53.5, still the second highest level since September 2018, and consistent with the BoE's Q1 2020 growth forecast of 0.2%QoQ. But the COVID-2019 outbreak and persisting no-deal Brexit-related concerns raise uncertainty regarding the sustainability of the expected Q1 2020 rebound later this year. With respect to the future EU/UK trading relationship, negotiations begun on 2 March, with the two sides adopting opposite positions on key issues, including, among others, the level playing field provisions, fishing quotas and the role of the ECJ in dispute resolution.

Figure 19: UK GDP stagnated in Q4 2019…



Source: ONS, Eurobank Research

Figure 20 :… but sentiment surveys point to Q1 2020 rebound

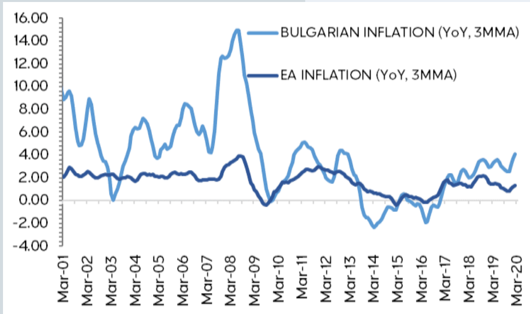


Source: ONS, Bloomberg, Eurobank Research

Bulgaria

Heading towards the ERM II with solid growth, despite some loss of steam

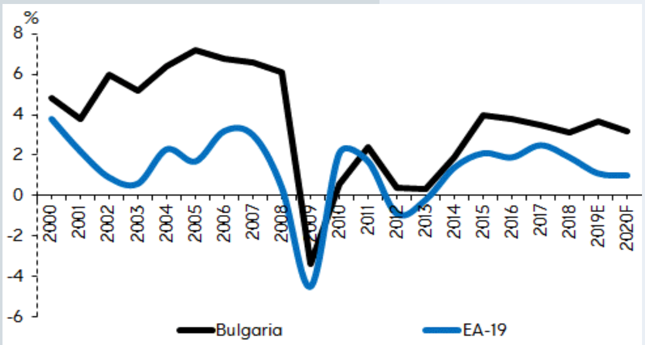
Figure 21: Gap between Euro area and Bulgaria's inflation widens



Source: Bloomberg, Eurobank Research

In mid-February, the European Commission (EC) revised downwards the GDP growth forecast to 2.9% for 2020 in its winter forecast, a tad lower compared to 3.0% projected in autumn. Prior to this, the World Bank (WB) kept the GDP growth forecasts at 3.0% for 2020 in January, while both the government and the Bulgarian National Bank stood more optimistic. Specifically, the government projected 3.3% in early January while the National Bank of Bulgaria forecasted in its latest economic review released in early March economic growth for FY2020 at 3.5%, having taken into account the Q42019 flash estimate. All in all, GDP is expected to grow above 3% in 2020 - we stick to our forecast at 3.2% - resulting in a slowdown of the economy compared to 2019, broadly attributed to the weakening of the domestic demand. Private consumption will remain the main growth engine, but milder labour market conditions will undermine its contribution and so will any impact from the Covid-2019 on net exports. February has been a noisy month regarding the developments in the ERM II accession, primarily at the level of official statements, rather than the level of actual progress. In brief, EC Vice-President, Valdis Dombrovskis stated that it is extremely unlikely that any of the ERM-II member states will demand a change in the EUR/BGN exchange rate and that the target date for the application review will be most probably moved from April to July. Taking into account the above, along with other factors such as cemented fiscal discipline, Fitch Ratings maintained Bulgaria's long-term foreign-currency rating at BBB with a positive outlook. Despite the latest public debate forthe ERM II accession, the agency foresees that Bulgaria will join the adjustment path in H2 2020 and is willing to upgrade the rating by one notch upon ERM II entry and by one more when Bulgaria adopts the Euro, which, however will not take place before 2023. To conclude, the EC's decision to remove Bulgaria from the list of EU member states experiencing macroeconomic imbalances in its latest European Semester Winter Package conclusions, released in late February, may have brought Bulgaria a step closer to the ERM II.

Figure 22: The GDP growth of Bulgaria has been three times higher than Euro area in 2019-2020



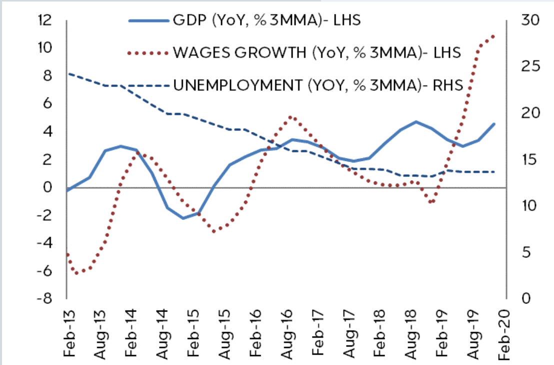
Source: National Authorities, Eurobank Research

Serbia

Economic performance in Q4 surprises to the upside

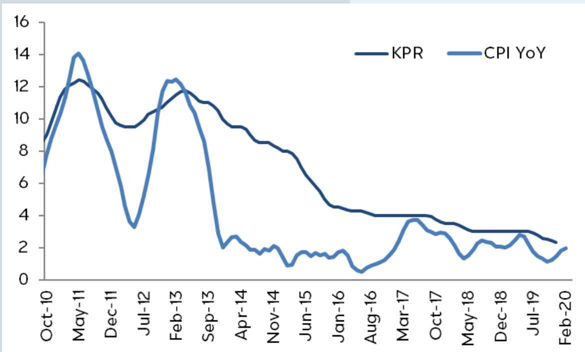
The Q4 GDP print that came in earlier in March outperformed market expectations. GDP expanded by 6.2%YoY in Q4, from 4.8%YoY in Q3 and 2.7%YoY in Q2 and Q1 respectively, setting the annual economic growth rate at 4.1%, above the preliminary estimation of 4.0%. From the production side, ca 5 out of 6.2 pps were contributed by construction activity (2.4%) and services (2.6%), while turning to the demand side the key drivers remained investments (7%) and private consumption (3%) with net exports weighing negatively as imports grew stronger compared to exports. Regarding our view for 2020, we revise upwards our forecast to 4% taking into account the positive carry over effect from Q42019 and the ambitious investments agenda under the Serbia 2025 initiative, which will fuel generously the current year's output. Our forecast is aligned with the one released by the National Bank of Serbia (NBS) in the February Inflation Report. The NBS expects GDP growth to remain unchanged at 4% in 2021 as well. Regarding the downside risks for 2020, we outline the Covid-2019 impact, which is expected to be felt by the Serbian economy both from the supply and the external and internal demand side. Had it not been for such downward pressures, which are hard to quantify yet, our estimate for 2020 could lie above 4%. In the banking sector, the sale of Komercijalna Banka to the Slovenian Nova Ljubljanska Banka (NLB) lured market attention, following the IMF's persistent advices in all of its reports, either under the PCI review or the Article IV consultation, for at least the past two years to speed up the progress in reforms, especially those related to the State Owned Enterprises. That said, the government's decision to sell its 83.23% of the 3rd (in terms of total assets) bank's ordinary shares to the NLB that placed the best bid in last December is considered a flagship transaction that underlines the strong commitment of the Serbian government to proceed on quick footing with the reforms agenda, despite the different view expressed publicly by the NBS governor on the aforementioned sale.

Figure 23: Solid economic growth and labor market



Source: Bloomberg, Eurobank Research

Figure 24: Monetary easing amid subdued inflationary pressures



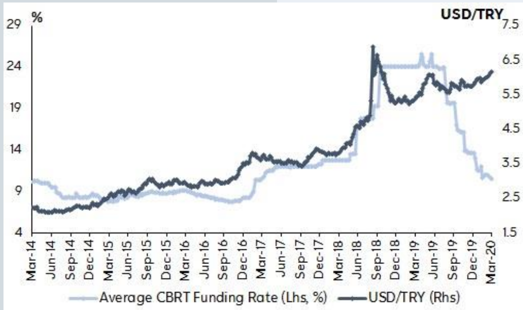
Source: Bloomberg, Eurobank Research

Turkey

Lira trading at multi-month lows

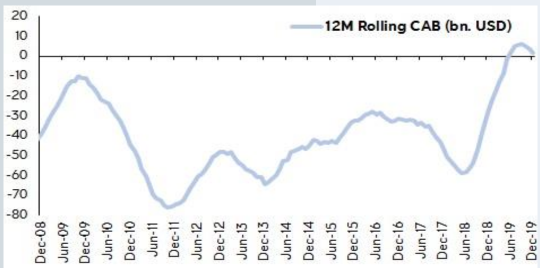
The Central Bank of Turkey (CBRT) cut its key polict rate (KPR), the 1-week repo rate, by 50bps from 12.0% to 10.75% in mid-to late February, delivering its sixth consecutive cut. The outcome met the expectations of half of the market consensus, while the other half was anticipating no change, bringing the cumulative easing since July to 1,325bps. In the statement released thereafter, the CBRT, emphasized that the current policy stance remains consistent with the projected disinflation path, taking note of the mild trend in core inflation indicators as a result of the latest developments in inflation expectations, domestic demand conditions and producers prices. Moreover, the CBRT statement contained two important comments. Firstly, the Central Bank monitors closely credit growth developments and its composition. Secondly, in the CBRT's view, sustaining a moderate course in the current account balance is a crucial element in the macroeconomic policy mix. Having reached a multi-month low at 8.5% YoY in October, inflation has been on an increasing trend in recent months. Inflation climbed to 12.4% YoY in February up from 12.2% YoY in January –still within the forecast path but very far away from the year-end inflation CBRT projection of 8.2%-up from 11.8% YoY in December. The recent inflation trajectory, which has pushed real interest rates into negative territory, divergent agents' prices expectations, a relatively weaker lira as a result of the external environment concerns following the outbreak of the coronovirus and the geopolitical jitters from the events in Syria argue against further easing in the short-term. Yet, CBRT is widely seen and most likely will proceed with further modest rate cuts in 1H-2020 in an attempt to support growth, bringing the KPR below 10% thus increasing downside risks for the lira. As of late February the lira had reached 6.17/$, by 3.8% lower, at the lowest point since last May. Meanwhile, the latest balance of payment (BoP) data in December signal a change in direction in external accounts. The current account deficit (CA) widened to $2.8bn in December, which is the largest reading in the last 18 months, up from $365mn in November compared to $1.07bn in the same month a year ago. Thus, the CA registered a surplus of $1.7bn in 2019 compared to a $28.3bn deficit in 2018. As a percentage of GDP, the current account closed with a small surplus of around 0.2% in FY2019 compared to -3.7% in FY2018 and -5.6% in FY2017 illustrating an impressive unwinding of macroeconomic imbalances.

Figure 25: Lira on a weakening trend in recent months, trading at multi-month lows



Source: Bloomberg, Eurobank Research

Figure 26: 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)		
	2019	2020f	2021f	2019	2020f	2021f	2019	2020f	2021f	2019	2002f	2021f	2019	2020f	2021f
World	2.9	2.5	3.2	3.4	3.1	3.0									
Advanced Economies															
USA	2.3	1.7	2.0	1.8	2.0	2.1	3.7	3.7	3.7	-2.4	-2.4	-2.4	-4.7	-4.7	-4.7
Eurozone	1.2	0.8	1.1	1.2	1.2	1.3	7.6	7.5	7.5	2.8	2.7	2.6	-0.9	-1.1	-1.1
Germany	0.6	0.4	1.2	1.4	1.4	1.5	3.2	3.4	3.5	7.0	6.8	6.4	1.2	0.8	0.5
France	1.3	1.0	1.3	1.3	1.3	1.4	8.5	8.4	8.3	-0.8	-0.7	-0.7	-3.1	-2.4	-2.3
Periphery															
Cyprus	3.2	2.8	2.6	0.5	0.7	1.3	7.2	6.0	5.5	-6.0	-5.5	-5.0	2.8	2.7	2.4
Greece	2.0	2.3	2.0	0.5	0.6	0.9	17.3	15.4	14.0	-2.0	-2.1	-2.0	1.2	1.2	1.1
Italy	0.2	0.3	0.5	0.7	0.8	1.0	10.0	10.0	10.0	2.9	2.8	2.7	-2.2	-2.5	-2.4
Portugal	2.2	1.5	1.5	0.3	0.9	1.1	6.5	6.2	6.0	-0.7	-0.7	-0.6	-0.2	-0.1	0.1
Spain	2.0	1.6	1.6	0.8	1.0	1.4	14.1	13.5	13.0	2.4	2.5	2.6	-2.3	-2.2	-2.0
UK	1.4	1.0	1.2	1.8	1.6	1.9	3.8	3.9	4.0	-4.3	-4.0	-3.8	-1.9	-2.4	-2.6
Japan	08	0.2	0.6	0.5	0.6	0.6	2.4	2.4	2.4	3.5	3.3	3.3	-2.6	-2.9	-2.7
Emerging Economies															
BRICs															
Brazil	1.1	2.1	2.5	3.7	3.8	3.7	11.9	11.3	10.2	-2.5	-3.0	-3.1	-6.1	-5.5	-5.3
China	6.1	5.3	5.8	2.9	3.1	2.2	4.2	3.8	3.8	1.1	0.6	0.5	-5.4	-4.8	-4.6
India	6.1	5.0	6.0	3.7	4.4	4.3		*NA*		-2.0	-1.3	-1.6	-3.4	-3.7	-3.5
Russia	1.3	1.7	1.8	4.5	3.3	4.0	4.6	4.6	4.5	5.0	3.9	3.8	1.5	1.1	0.7
CESEE															
Bulgaria	3.4	3.2	2.9	2.5	2.5	2.3	4.4	4.1	4.0	7.5	5.5	5.0	-2.0	0.0	0.0
Romania	3.8	3.3	2.8	3.8	3.4	3.7	4.0	4.2	4.8	-5.0	-4.5	-4.0	-4.1	-4.5	-4.5
Serbia	4.8	4.0	4.0	2.2	2.0	2.2	13.1	11.0	10.5	-5.8	-6.0	-6.1	0.2	-0.5	-0.5
Turkey	0.7	2.5	3.0	15.2	12.5	12.0	13.8	13.7	12.9	0.5	-1.0	-2.5	-3.0	-4.0	-4.5

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

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Eurobank Fixed Income Forecasts

Current	Current	March 2020	June 2020	September 2020	December 2020
USA					
Fed Funds Rate	1.00-1.25%	1.19-1.45%	1.31-1.55%	1.43-1.70%	1.36-1.65%
1 m Libor	1.02%	1.82%	1.79%	1.80%	1.78%
3m Libor	1.00%	1.79%	1.76%	1.77%	1.75%
2yr Notes	0.48%	1.53%	1.58%	1.62%	1.66%
10 yr Bonds	0.76%	1.74%	1.81%	1.87%	1.92%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.47%	-0.42%	-0.45%	-0.46%	-0.46%
2yr Bunds	-0.88%	-0.62%	-0.61%	-0.61%	-0.60%
10yr Bunds	-0.73%	-0.36%	-0.34%	-0.30%	-0.30%
UK					
Repo Rate	0.75%	0.70%	0.65%	0.65%	0.65%
3m	0.50%	0.71%	0.68%	0.69%	0.71%
10-yr Gilt	0.26%	0.71%	0.72%	0.77%	0.82%
Switzerland					
3m Libor Target	-0.79%	-0.74%	-0.72%	-0.72%	-0.71%
10-yr Bond	-0.86%	-0.62%	-0.61%	-0.55%	-0.54%

Source: Bloomberg (market implied forecasts)

Eurobank

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