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Eurobank Research

GLOBAL & REGIONAL MONTHLY

Risk sentiment improved further in December, as major downside risks to the global economy appear to have receded. Market resilience to US/Iran conflict likely reflected investors' unwillingness to abandon risk-on positions in the face of tentative signs of stabilization in the global business cycle and continuing policy accommodation. We envisage a modest acceleration in global growth in 2020 to 3.1% from an estimated 2.9% in 2019 as global trade and investment gradually recover

Macro Picture

USA: Manufacturing weakness has not spilled over into the broader economy

EA: Tentative signs of improvement but high levels of uncertainty prevail

UK: The downward trajectory of economic activity continued in the first two months of Q4 2019

EM: Firmer headline economic growth driven by the expected 2020 recovery in large developing economies

CESEE: The broader region's growth resilience to be tested in a more challenging international economic environment in 2020

Markets

FX: Volatility continues to drop as range bound trading continues. USDJPY is attempting a break higher, while GBPUSD has returned at its post-election support on weak economic numbers

Rates: Rates in both Europe and US to remain range bound in the near term as risks are balanced on both sides

EM: EM credit remains strong and unaffected by the recent geopolitical developments. Inflows remain strong but caution is advised at current levels

Credit: Rally in spreads continues despite a very busy primary market with High Yield outperforming. We see opportunity for cheap hedges

Policy Outlook

USA: On hold in the foreseeable future

EA: Unchanged policy, focusing on strategic review and maintaining an easing bias

UK: Increased risks for a BoE rate cut in the near future after MPC members' dovish comments

CESEE: Limited room for more expansive fiscal and monetary policies in 2020

Key Downside Risks

Rising geopolitical tensions: Potential oil supply disruptions; deteriorating business sentiment

Further escalation of trade tensions: Potential re-imposition of US tariffs on China; US tariffs on EU cars

EM & China sensitivity: China's further shift towards consumption could weigh on the GDP growth of dependent developing economies

Themes in this issue

Special Topic: EM 2020 Economic Outlook

CESEE region: **Growth outlook** in 2020

US/China **trade uncertainty** to remain elevated

Modest **acceleration** in **2020 global growth**

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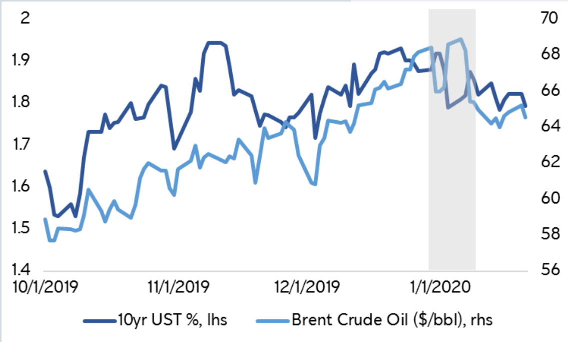
Latest Macroeconomic Developments & Outlook

World Economic Outlook

Risk sentiment improved further in December, as major downside risks to the global economy have receded creating a positive environment for equities and bond yields. The US and China agreed on a Phase One deal avoiding a further escalation in the trade war, while at the 12 December UK election PM Boris Johnson's conservative party won a 80-seat majority in the House of Commons assuaging hard Brexit fears at least for now. Tentative signs of stabilization in the global business cycle and continuing monetary policy accommodation from global central banks have also added to the positive sentiment. In the meantime, the escalation of US-Iran tensions at the start of 2020, with the US killing of Iranian military leader Suleimani and the subsequent Iran bombing of a US base, proved to have a short-lived effect on financial markets as both sides signaled a desire to avoid further military confrontation. Hence, risk gauges such as oil prices, the VIX, the JPY and the 10yr UST experienced a relatively brief and contained reaction before quickly reversing their early-January movements (Figure 1). Market resilience could reflect investors' unwillingness to abandon risk-on positions as long as signs that manufacturing activity and global trade are bottoming out persist, coupled with a broad-based shift towards monetary policy accommodation.

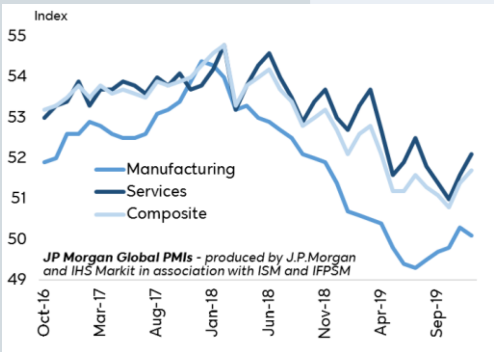
Figure 1: Brief market reaction to US/Iran tensions amid growth stabilization & accommodative policy



Source: Bloomberg, Eurobank Research

In the meantime, some of the incoming data have recently disappointed -with the global manufacturing PMI falling modestly in December and, hence, breaking a 4-month rising streak - but services have tended to surprise on the upside with the global services PMI advancing further to a five-month high of 52.1 (Figure 2). Although there are still few signs of turning points in global economic activity, we envisage a modest acceleration in economic growth in 2020 to ca. 3.1% from an estimated 2.9% in 2019, with the potential for a somewhat synchronized upturn as global trade and business spending gradually recover. Nevertheless, the balance of risks remains skewed to the downside amid continuing trade uncertainty and rising geopolitical tensions that could lead to rapidly weakening investor sentiment with adverse effects on the global economy.

Figure 2: Global services have proved resilient, although manufacturing has disappointed



Source: Refinitiv Datastream, Eurobank Research

Developed Economies

US: High frequency growth indicators have been sending conflicting signals over the past month regarding the short-term US growth momentum. Employment growth seems to be decelerating, though still remains at a rather solid pace, while wage growth -albeit softening- is strong enough to continue supporting a healthy pace of consumer spending growth. The pattern in hiring is actually in line with the broad weakness in manufacturing and the robust services sector. According to the Atlanta Fed's GDPNowcast model, real Q4 GDP growth is expected at 2.3%QoQ saar from 2.1% in Q3, with strong personal consumption growth more than offsetting weak business investment. Our GDP growth forecast for 2020 remains unchanged at 1.8% from an estimated 2.3% for 2019.

Euro area: In spite of a fairly upbeat industrial momentum across the big four euro area economies in November, December PMIs suggest that the region remained close to stagnation at the end of 2019. A noticeable divergence between the manufacturing and the services sectors continues to prevail. Nevertheless, the order-to-inventory ratio, a useful indicator of manufacturing momentum looking ahead, points to some improvement in the coming months. Our 2020 real GDP growth forecast stands at 1.0% from an estimated 1.1% in 2019, with the high level of uncertainty still weighing on growth prospects albeit having declined from its September peak amid a positive tone around Brexit and US/China trade policy.

Periphery: The 2020 economic growth outlook for both Spain and Italy, the two biggest southern European peripheral economies, does not look so promising. Spain is projected to remain on a growth moderating path this year partially due to carryover from stronger-than-initially estimated deterioration in domestic demand, while the formation of the PSOE-Unidas Podemos minority coalition government with the support from regional parties including Catalan pro-independence Esquerra Republicana de Catalunya (ERC) has raised questions over its longevity and has increased concerns in terms of possible fiscal slippage. Meanwhile, although recession risks for Italy have been reduced, anemic economic growth is likely to continue this year, while political events including regional elections in Emilia Romagna at the end of January might put at risk government stability.

Emerging Economies

BRICs: In Brazil, recent high-frequency indicators have started to pick up, pointing to a more favorable outlook for the economy in 2020. While 2019 full year's economic growth print is expected at 1.1%, the central bank raised its 2020 GDP growth forecast to 2.2% in its quarterly inflation report released in late December from 1.8% previously, underlining, however, that the upward revision depends on ongoing economic reforms. In Russia, GDP grew by 1.7% YoY in Q3 2019, the same as in the previous quarter, setting the ground for FY rate of 1.2%, given that hard data released by now point to a loss of momentum in the economy. Economic growth is expected to pick up to 1.7% in 2020. On the politics front, Prime Minister

Dmitry Medvedev resigned from his post in mid-January after President Vladimir Putin announced proposed constitutional amendments that could keep the latter in power well past the end of his term in 2024. In India, recent PMI manufacturing and industrial production data in the last two months of Q3, December and November respectively, came in on a positive tone, suggesting that the GDP growth print will improve compared to 4.5% YoY in Q2 (July to September) and 5% YoY in Q1 (April to June). In late December, the IMF released its Article IV consultation underlining that despite the slowdown in 2019, the economy can be back on track and regain economic growth rates close to 7% by 2022, under the condition that the government coalition that recently renewed its term will implement an ambitious reform agenda. Finally, China's GDP growth came in at 6.0% YoY in Q4, the same as in Q3, setting the economic growth rate at 6.1% for FY2019. In terms of growth drivers, the full year's reading was split into 60% consumption and 30% investment with the remaining 10% coming from net exports. Moreover, China succeeded in inking the Phase I trade agreement with the US in mid-January after almost two years of negotiations. However, the thorniest issues among the two economies are left to be agreed in the Phase II deal, which is highly possible to be completed following the US elections in November 2021.

CESEE: The broader CESEE region outperformed initial official forecasts in terms of GDP growth in 2019. In 2020, the CESEE region will 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. From a geographical point of view, having led the pack in the broader CESEE group in the past year, CEE-4 economies (Czechia -Hungary-Poland-Slovakia) are expected to slow more visibly in 2020, feeling the pain of intensifying trade protectionism.

Special Topic

Emerging Markets and Developing Economies 2020 Outlook

- **Economic Growth Prospects**

  Recently both the IMF and the World Bank have published their outlook for the global economy and the emerging markets and developing economies (EMDE). With the first being a tad more optimistic and forecasting EMDE GDP growth in 2020 at 4.4% and the latter a bit more conservative projecting 2020 economic growth at 4.1%, both financial institutions highlight that risks to EMDE's outlook are tilted to the downside. Although a third of EMDEs are expected to decelerate, the EMDE GDP forecast in 2020 is standing higher compared to that of 2019 due to the rebound in 7 large developing countries, most of which are recovering from deep recessions but still remain vulnerable. Namely, those are Argentina, Brazil, India, Mexico, Russia, Saudi Arabia and Turkey. Had it not been for these countries whose rebound contributes almost 90%[1] to the EMDE's GDP growth forecast in 2020, there would probably be no acceleration in the EMDE economic performance.

- **Risks titled to the downside**

  ⇓ Geopolitical uncertainty: With US and China having reached to a Phase I trade deal agreement and Brexit risks appearing contained, one could assume that global risks have retreated. However the surge in tensions between the US and Iran has hit market sentiment, forcing - only temporarily for the time being - commodities prices higher, especially oil and gold. The killing of Iranian General Qassem Soleimani by the US Government, Iran's retaliation with 15 missiles firing at the US base in Iraq and unintentionally shooting down of an Ukrainian jet have led to a re-escalation of tension between the two nations, rendering geopolitical uncertainty one of the key determinants regarding EMDE's 2020 outlook. The latest developments have not had a severe impact on EM that kicked 2020 on a positive footing. EM assets prices have rebounded after the initial negative shocks and recent gains in oil and gold have been reversed. However, the risk of further escalation cannot be excluded along with consequent disrupt in global oil supply, increases in commodities prices, hurt sentiment and weigh on investment decisions.

  ⇓ Climate change: Extreme weather phenomena such as tropical storms, floods and droughts endanger economic outcome. EMDE are substantially more vulnerable to such occurrences, firstly because the majority (and especially the low income countries) have poorer infrastructure and less ability to confront extreme weather conditions and rebuild the damages after such incidents. Moreover, the economic activity in EMDE is adjacent to the use of fossil fuels usage and consequently CO_2 emissions. As such, the emerging world neither can confront effectively the side effects of the climate change, such as more frequent extreme physical phenomena, nor can easily adapt a different energy profile that would help in preventing in the long run the adverse climate change.

  ⇓ China's economic rebalancing from net exports and investment to consumption: EMDE used to enjoy the fruits that China's GDP growth tree would bear for at least the past 30 years.

[1] Global Economic Prospects, January 2020, World Bank

Eurobank

Economic growth was broadly investment driven, creating a surge in commodities and intermediate goods that EMDE offered. Since China has decided to shift its economic model towards consumption so as to, inter alia, increase its people's living standards, shadows have casted over the EMDE's GDP growth that was primarily fueled by this eroding demand. EMDE's commercial ties with China are at a crossroads where their economic model and its capacity to fulfil China's newly breaded consumption needs has to be reassessed. Prior to that challenge, another risk is mapped, that of China deciding to gradually alter its importing profile and swift to industrial policies that will equip the country with more autonomy, taking into account the country's declining current account surplus and the rising uncertainty and world trade tensions in the past two years.

- **Asia**

  Asia's two largest economies, China and India, jointly contribute ca 80% of the region's GDP and both are forecast to face challenges. China continues to slow gradually, approaching its potential growth rate. India is under a more severe slowdown, with GDP growth forecasts 12 months earlier failing to address the magnitude of the deceleration. At the beginning of 2019, India was expected to grow the year 2019/2020 by 7%, continuing the solid track of expansion, ongoing for at least the past 5 years. Albeit, India's economy is expected to have grown until this April by 5% and return to growth rates above 6% in 2021.

- **Latin America**

  2020 is widely expected to be a recovery year for many Latin American countries, among which Argentina, Brazil and Mexico. As a matter of fact, the recovery of Latam economies is very likely to fuel the growth engine of the EMDE, following a year of social unrest and plethora of riots. However, protests and political upheaval seen in the final part of 2019 are likely to persist or rekindle, amid growing, but still subdued economic growth across much of the region.

- **CESEE**

  2020 may prove a more challenging ride for CEESE and the Western Balkans in particular. The eastern side of the region is at risk of delayed convergence towards the EU average. The decision not to provide Albania and Northern Macedonia with a green light towards EU accession will overhaul politics in the region while it will weigh on the reform momentum. Although not directly affected by the decision, Serbia has also been affected by stalled European integration, with political noise increasing in the last quarter of 2019. While countries in the region need the integration process to resume as soon as possible, other issues preoccupying the EU – among which the 2021-27 budget and a common defense mechanism – could push this topic further down on the agenda. If this is the case, 2020 could be a year with no substantial, but much needed, progress.

Global Macro Themes & Implications

US/China Phase One trade deal formally signed but trade uncertainty likely to remain elevated

After a one-and-half years of trade war escalation and 13 rounds of negotiations, the US and China signed on 15 January the Phase One trade deal agreement that was made back in mid-December 2019. Among others, the said deal contains the rollback on part of the existing US tariffs as well commitments by China to increase imports of goods and services from the US as well as the agreed terms on topics including intellectual protection property, technology transfer, financial services, currency practices and dispute resolution mechanism. However, some of the thornier issues have yet to be addressed.

Undoubtedly, the said deal is a significant, albeit small, step towards a comprehensive US/China trade deal in the future, underpinning business confidence and, ultimately, implying a better global growth outlook. But it is probably not enough to eliminate trade policy uncertainty and fully restore business confidence.

The magnitude of the tariff rollbacks was smaller-than-expected. The US agreed to suspend tariffs on c. $160bn of Chinese imports that were due to come into effect on December 2019, the 15% tariff rate on c. $120bn of imports that mostly include consumer goods will be halved but the 25% tariffs on c. $250bn worth of imports that are used mainly by manufacturers will remain in place, while any further tariff reduction is frozen for the time being. According to US Trade Representative Robert Lighthizer, there will be no further tariff reduction before an agreement on the Phase Two deal is reached while the amount of tariff reduction will depend on what additional concessions China will make. Meanwhile, under the terms of the deal, China is requested to increase purchases of US goods and services in the coming two years by $200bn based on 2017 figures. But there are doubts whether China will be able to implement all of its Phase One obligations, not only in structural issues but also in the trade area, at a time it faces a number of domestic headwinds. Last but not least, discussions for the Phase Two deal will involve some of the most contentious issues, including subsidies for Chinese state-owned enterprises. That means progress on Phase Two deal will be slow and success of negotiations is by no means guaranteed as reaching an agreement will depend, inter alia, on the assessment over the implementation of the Phase One deal (the deal will come into effect in mid-February and dispute resolution officers will meet on a quarterly basis). Consequently, concerns over the US/China trade relations will likely linger in the coming weeks; the threat of renewed escalation will remain while a significant rollback of existing US tariffs is unlikely any time soon.

Global manufacturing activity and trade growth have likely bottomed out, paving the way for a modest acceleration in 2020 global growth

Global economic activity decelerated noticeably in 2019, to an estimated growth rate of 2.9% from 3.6% in 2018, with widespread weakness in both advanced (notably the euro area) and emerging market economies that was evident in global trade and business spending. Recent high-frequency indicators point to some tentative stabilization in global economic growth. According to the JP Morgan Global Composite PMI, the rate of global economic expansion accelerated for the second successive month in December, hitting its highest level since April 2019. Although the global manufacturing PMI remained lacklustre at the end of 2019 with marginal growth in production and new orders, global manufacturing output rose for the fourth month in a row. Meanwhile, business confidence increased to a seven-month high, albeit still remaining low by the survey's historical standards. The services sector continued to surprise on the upside despite manufacturing weakness, with the respective index advancing further by 0.5pts to 52.1 as growth in output, new orders and employment all accelerated to five-month highs. In the face of substantial monetary policy easing around the world as well as fiscal easing in several countries, financial conditions continue to be supportive across advanced and emerging market while sentiment indicators (business and consumer confidence) point to improved market conditions, with equities advancing and core sovereign bond yields rising from their September lows. Overall, although there are still few signs of turning points in global economic activity, we envisage a modest acceleration in global growth in 2020 to ca. 3.1% from an estimated 2.9% in 2019, with the potential for a somewhat synchronized upturn as global trade and business spending gradually recover. The upturn in emerging market economies will likely be sharper compared to advanced economies, mirroring a vigorous recovery from deeper downturns in 2019. Nevertheless, the balance of risks remains skewed to the downside as several major risks that have weighed on the global outlook (i.e. trade policy uncertainty, geopolitical tensions) have not entirely dissipated, and could potentially lead to rapidly weakening investor sentiment with adverse effect on the world GDP growth.

Macro Themes & Implications in CESEE

Mission accomplished for the broader CESEE region in 2019. The growth resilience of these economies' will be tested against a more challenging international economic environment in 2020

Looking back at the past year, it would be fair to say that broader CESEE region outperformed initial official forecasts in terms of GDP growth. This outperformance has its roots in the resilience of domestic demand in most cases, but also net exports held up relative well despite conventional wisdom for the opposite. At the same time, the broader CESEE region outperformed core-euro area economies for yet another year. Yet, in contrast to the previous years, the CESEE region's GDP over-performance is becoming less pronounced, less visible, and even more heterogeneous within individual groups of economies, heading into a more challenging year 2020.

The CESEE region will 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. 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.

From a geographical point of view, having led the pack in the broader CESEE group in the past year, CEE-4 economies (Czechia-Hungary-Poland-Slovakia) are expected to slow more visibly in 2020. Those economies, which specialize in automotive industry are expected to feel the pain of intensifying trade protectionism this year. In addition, the slowdown for the SEE (Bulgaria-Serbia-Romania-Turkey) economies who were already lagging behind in the previous year is expected to be less pronounced as this group of economies is more heterogeneous and less correlated with the performance of the euro area.

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 investments 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 strengthened FX reserves 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 headwinds also. 2020 could be a turbulent and dynamic political 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 continued to trade in a very tight range (1.1050-1.1250) as it could not sustain the upside break of its 200 day MA (1.1140) despite reaching a four month high of 1.1239 in late December. The start of the year saw a mild risk off on the back of the US/Iran tensions that reversed the upward trend and weak numbers from the EA added to the pressure for further downside as the pair retested the low of the month at 1.1085. Big events for the EUR are Lagarde's second ECB meeting and the Italian regional elections. Important support stand at 1.1070 and a break opens the way to 1.0981 and 1.0879. On the upside hold of 1.1070 support should lead to a retest of the recent highs.

GBPUSD: General dollar strength as well as weak economic numbers from the UK, leading to a potential rate cut at the end of January BoE meeting, has seen the pair trading down from 1.3284, at the start of the year, to 1.2965 but holding onto its breakout support since the UK election results last month. The uptrend remains intact as long as the 1.2750/1.2850 holds. The BoE and negotiations for a trade agreement with the EU post 31/01 will be the driving factors for GBP and we expect volatility on the pair to rise. A break of 1.2750 would lead to a test of 1.25 and erase post-election gains.

USDJPY: The US/Iran tensions created a bit of excitement in the pair as it reached a low of 107.65 before reversing strongly on the back of the stage 1 trade war sign off and the general USD strength to reach a high of 110.23. The weekly close above 109.75 turns us bullish on the pair in the short term with 112.5 and 115 as the next big targets.

Rates

EU: Following the hawkish minutes from the ECB December meeting, the latest upbeat Eurozone data and the reduction in tail risks from Brexit and trade data, the risk balance has shifted towards a hawkish surprise for the first ECB meeting of 2020. So far the 10y swap rate has not breached the 20 bps resistance area which is the critical level for a move higher. We favor a steepening position as we expect the changes in policy mix to be perceived as hawkish by the market.

US: The 10y swap rate stayed in a tight range so far this year (1.75%-1.90%). We expect the range to persist in the immediate future as the Fed guidance is stable. On the one hand the latest US data have surprised to the upside, on the other hand the US elections, geopolitics and lingering risks around global growth balance the risks between higher and lower US rates. We prefer positions that perform with a range bound market.

Emerging Markets credit

The US-China Phase One deal conclusion has brought some temporary relief to the trade tensions saga. The stage is now open to the phase 2 negotiations, which will likely focus on more structural issues. The reduction in trade uncertainty and the more constructive global environment is likely to continue to favor carry and relative value trades in the space. Technicals are also favorable as cash levels globally are very high. In EM sovereign external debt Bank of America has been pointing out that it would only take 1% (of AUM) of inflow into the asset class to cover the net issuance through April. Hard currency sovereigns are clearly getting rich. The EMBI+ Sovereign index stands at 298bps, 162bps tighter form the Aug19 wides, with the geopolitical tensions in the Middle East temporarily stopping the trend. Significant further tightening, despite the positive monetary conditions, will require larger inflows into the asset class. We are cautious at current levels and trade opportunistically.

Corporate credit

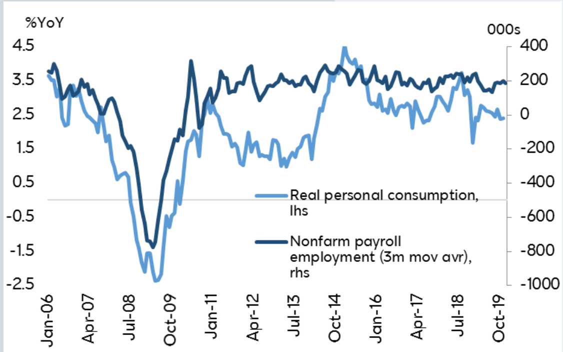
Credit remained strong in the past month and continued its inexorable trend towards lower spreads as the global environment remains supportive of the asset class. Only the massive new issuance so far in January has prevented spreads from moving even tighter. High Yield outperformed Investment Grade on both sides of the Atlantic with credit curves bull steepening and significant ratings compression with B in Europe and CCC in the US the big winners. In Investment Grade, spreads tightened across the curve with the exception of Financials in Europe that were flat on supply. We remain defensive in our outlook for the credit market. The year started from tight levels and we are even tighter now. We believe carry will be the main source of return this year but this can evaporate quickly on a total return basis if rates move higher on a recovery of economic activity. Hedges via CDS options, CDS indices and tranches are cheap.

US

Weakness in manufacturing has not spilled over into the broader economy

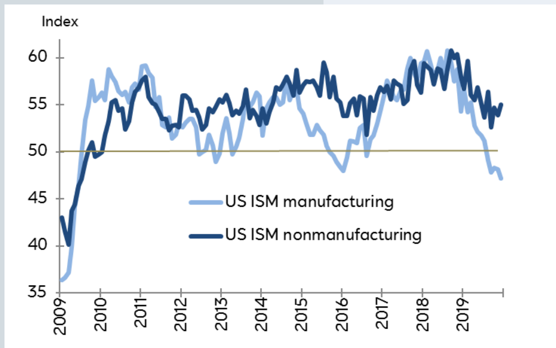
Following two months of better-than-expected employment reports, nonfarm payrolls advanced less than expected in December, with an increase of 145k and net downward revisions to the prior two months of -14k. Although employment growth seems to be decelerating, the 3m moving average job growth currently stands at 182k (6m at 169k), which is a rather solid pace of hiring. Meanwhile, average hourly earnings are softening, but a wage growth around 3.0%YoY is strong enough to continue supporting robust consumer spending. The pattern in hiring is in line with the broad weakness in manufacturing (-12k) and the still robust services sector (+140k). Against this backdrop, the ISM manufacturing index fell by 0.9pts to 47.2 in December, its lowest level since mid-2009, while the non-manufacturing ISM rose 1.1pts to 55.0 proving so far resilient to the protracted softness in domestic manufacturing activity. High frequency growth indicators have been sending conflicting signals. Although the domestic banks' willingness to lend to consumers has softened significantly in Q4 2019 (to 1.7% from 14.0% in the same quarter over the previous year), consumer expectations have largely remained buoyant, albeit at relatively lower levels compared to 2018. The Atlanta Fed's GDPNowcast model currently expects real Q4 GDP growth of 2.3%QoQ saar from 2.1% in Q3, with robust personal consumption growth more than offsetting weak business investment. Our GDP growth forecast for 2020 remains unchanged at 1.8% from an estimated 2.3% for 2019. On the monetary front, December FOMC minutes suggested that downside risks have diminished, highlighting however the need for an accommodative policy stance to provide insurance against adverse outcomes. The said minutes also included an extensive discussion of Fed operations, suggesting that an upward adjustment in IOER may be needed to push the Fed effective rate (currently at just 1.55%) closer to the middle of the target range. Our call for the Fed to remain on hold in the foreseeable future remains intact, with the fed funds futures market pricing in an almost even probability of a rate cut towards year-end (around 50% in November and ca. 58% in December 2020).

Figure 3: Labor market conditions are strong enough to support personal consumption



Source: Federal Reserve, Eurobank Research

Figure 4: Some weakening in still-resilient services sector activity



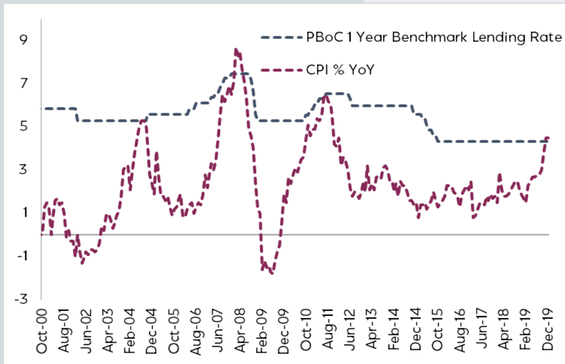
Source: ISM, Bloomberg, Eurobank Research

China

Economy at an inflection point after the 3-decade low GDP growth print in 2019

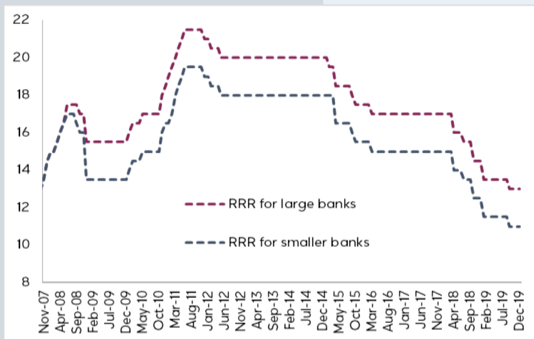
GDP growth came in at 6.0% YoY in Q4, the same as in Q3, setting the economic growth rate at 6.1% for FY2019. From a growth drivers perspective, the full year's reading was split into 60% consumption and 30% investment with the remaining 10% coming from net exports. Through a sectoral prism, even though the services sector expanded by 6.6% YoY in Q4 compared to 7.2% in Q3 the manufacturing sector picked up by 5.8% YoY from 5.2% YoY. As hard data pointed in December, the economy appears to be stabilizing; Fixed assets investments picked up from 5.2% YoY in November to 5.4% YoY in December. Retail sales grew by 8% YoY in December, flat from November and auto sales picked up for the first time in the past six months. Moreover, the PMI index of new export orders came in above the 50 benchmark that signals expansion for the first time since May 2018. On the economic policy front, fiscal policy is anticipated to remain proactive, focusing primarily on investment, while the People's Bank of China (PBoC) is expected to maintain its cautiously monetary easing mode. That said, already in early January, the PBoC proceeded with a 50bps Reserve Ratio Requirement (RRR) cut and additional cuts within the year will be broadly data driven, ensuring that the required liquidity for maintaining economic growth to ca 6% YoY is channeled to banks and corporates. In mid-January, China and US succeeded in inking the Phase I trade deal according to which China has agreed to increase its imports from the US by $160bn in goods and $40bn in services in 2020 and 2021. Almost half of the goods increase refers to manufacturing goods, such as machinery, pharmaceuticals and aircraft with the remaining $80bn coming from agricultural goods ($30bn) and energy ($50bn). China has also consented to increased market access and to a streamlined process for American companies to address complaints for intellectual property rights abuse that should be quicker than the current World Trade Organization process.

Figure 5: Surging inflation leaves little room for monetary easing



Source: Bloomberg, Eurobank Research

Figure 6: RRRs in a downward path



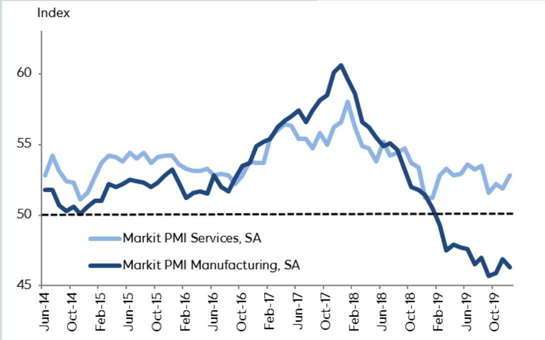
Source: Bloomberg, Eurobank Research

Euro area

Tentative signs of improvement but high levels of uncertainty still exists

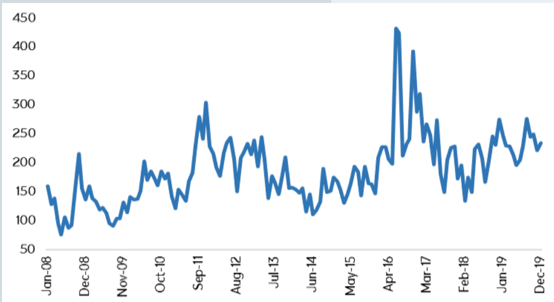
Industrial production rose by 0.2%MoM in November, mirroring a fairly upbeat momentum across the big four euro area economies, after a downwards revised 0.9%MoM drop in October. Although the negative carry-over eased to -0.5%QoQ in Q4 from -0.8%QoQ in Q3, December PMIs suggest that the euro area economy remained close to stagnation at the end of 2019. The PMI Composite Output improved slightly by 0.3pts to a four-month high of 50.9 in December, a level amongst the lowest recorded since H1 2013, pointing to a Q4 GDP growth rate of around 0.1%QoQ. The EC's Economic Sentiment Indicator (ESI) painted a similar picture, edging up marginally to a four-month high of 101.5 in December from 101.2 in the prior month. A noticeable divergence between the manufacturing and the services sectors continues to prevail, with the December services PMI rising by 0.9pts to 52.8 but the respective manufacturing PMI output index falling back to the October's cyclical low of 46.1. Nevertheless, the order-to-inventory ratio, principally a useful indicator of manufacturing momentum looking ahead, points to some improvement in the coming months. Our 2020 real GDP growth forecast still stands at 1.0% from an estimated 1.1% in 2019, with the high level of uncertainty still weighing on growth prospects albeit having declined from its September peak reflecting a positive tone around Brexit and US/China trade negotiations.

Figure 7: Noticeable divergence between manufacturing and services



Source: IHS Markit, Bloomberg, Eurobank Research

Figure 8: European policy-related economic uncertainty off its Sept peak, though still elevated



Source: www.policyuncertainty.com, Eurobank Research

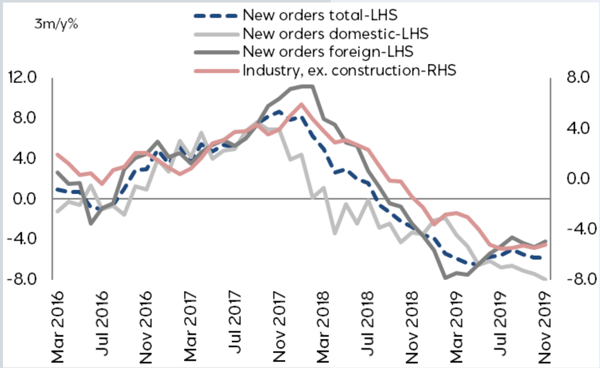
As far as monetary policy is concerned, the December ECB minutes did not discuss any details of the upcoming strategy review, and the ECB is broadly expected to officially launch the review at its 23 January monetary policy meeting. The ECB will likely repeat its easing bias, acknowledging its downside risk assessment, while highlighting the diminishing downside risks to growth. We do not expect big market movements on the meeting. We continue to expect that the ECB will stay on hold in the forthcoming quarters, provided that the euro area GDP growth will continue to hover around trend. Nevertheless, the Central Bank could consider either reducing monetary accommodation in case there is an unexpected rebound in economic and/or wage growth, or else introducing another round of monetary policy measures if there is a significant deceleration in the euro area growth outlook and/or a sharp drop in inflation expectations.

Germany

Positive soft indicators raise hope for some improvement in economic growth

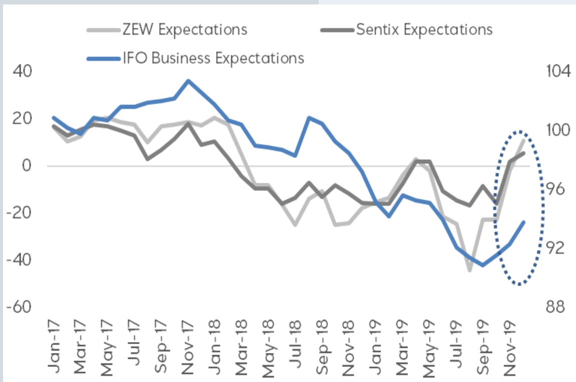
According to Germany's Federal Statistical Office (Destatis), GDP growth disappointed in 2019 rising by 0.6%YoY, the lowest rate since 2013, down from 1.5% in 2018 and a 1.3%YoY average in the last ten years. The slowdown was primarily driven by the export-oriented manufacturing sector which continues to be suffering from external headwinds such as the US/China trade dispute and the UK's exit from the EU as well as a switch to new emission test procedures in car manufacturing. Due primarily to a dip in manufacturing, industrial production dropped by 4.5%YoY in January to November 2019, the biggest decline since the financial crisis, implying the sixth consecutive quarterly decline at year-end 2019. Meanwhile, industrial orders point to risks of further sluggishness ahead as both domestic and foreign orders have dropped near multi-year low levels (Figure 9). The main GDP growth driver in 2019 was consumption expenditure, assisting the services sector to remain relatively immune to the manufacturing recession, as household spending gains support from a resilient labor market (unemployment at a record low of 3.1% in November for the seventh month in a row), positive wage growth (gross wages and salaries +4.9%YoY in 2019) and ample household disposable income (+2.8%YoY in 2019). Looking ahead, some of the closely watched soft indicators recorded robust gains over the last few months, raising hope for a modest improvement in economic growth, probably favored by the Phase One US/China trade deal agreement and a lower probability of a no-deal Brexit following the conclusive outcome of the December UK general election (Figure 10). Indicatively, the Ifo business climate index rose in December for the third month in a row, the ZEW expectations indicator swung back into positive territory for the first time since early 2018 and the Sentix economic expectations index improved in January 2020 for the third month in a row to the highest level since late 2017. However, surveys more closely linked to industry such as the PMIs have been less encouraging, with manufacturing remaining into contractionary territory in December for the 12th month in a row and the Composite index barely above the boom-or-bust level of 50. Overall, we expect German economic growth to accelerate moderately to an annual growth rate of 0.8% in 2020, barring renewed US/China trade escalations and higher US tariffs on EU cars.

Figure 9: Germany's industrial production and orders remain depressed...



Source: Federal Statistical Office (Destatis), Eurobank Research

Figure 10: but expectations have improved over the last few months



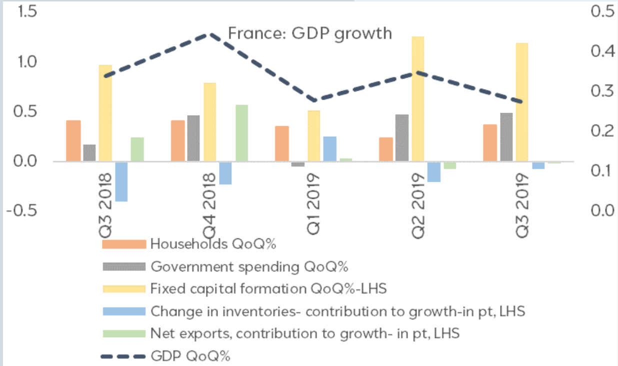
Source: Bloomberg, Eurobank Research

France

GDP growth supported by business investment and domestic demand

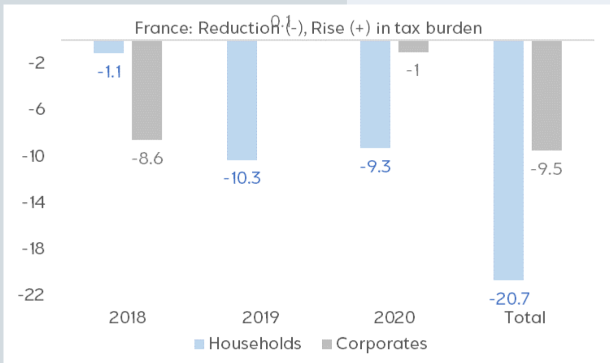
The French economy has remained on solid footing since mid-2018, recording a 0.3%QoQ growth rate in four out of the five latest quarters, including the first three quarters of 2019 (Figure 11). Business investment growth has accelerated since the beginning of 2019 to 1.4%QoQ in Q3 from 0.5%QoQ in Q1, as France remains less exposed to trade than other major Eurozone countries such as Germany. Private consumption has also been a growth driver, but to a lesser extent than business investment, expanding by an average growth rate of just 0.3%QoQ in Q1-Q3 2019, failing to improve more significantly in an environment of improving labor market conditions (unemployment rate at 8.6% in Q3, close to a more than ten-year low of 8.5% in Q2), low inflation pressures, improving INSEE consumer confidence (102 in December, above the long-term average of 100 for the seventh consecutive month) and generous tax cuts for households, estimated at €10.3bn for 2019 (Figure 12). In Q4 2019, the French economy has likely lost some momentum due to the nationwide strike that started in early December against the government's proposed overhaul of the pension system that is expected to be submitted to parliament in H2 2020 and aims, among others, to replace the existing 42 special public or private pension schemes with a single, universal pension regime, so as to improve fairness and the sustainability of the system. Thanks to positive disposable income fundamentals (gross disposable income average at a multi-year peak of 0.6% in Q1-Q3 2019), the expected Q4 GDP slowdown is likely to be limited, with growth projected to stabilize at 1.3% in 2019 and 2020. The main downside risks to France's growth outlook are related to the external environment, while on the domestic front, fiscal policy is likely to be a headwind for economic activity. The 2020 budget envisions a deficit of 2.2%-of-GDP from an estimated 3.1%-of-GDP in 2019. However, if the government scales back its pension reform plans ahead of the upcoming local elections on March 2020, it could potentially exert upward pressure on this year's fiscal deficit target, leading to risks for French public finances.

Figure 11: French economy mainly supported by business investment and domestic demand



Source: National Institute of Statistics and Economic Studies (INSEE), Eurobank Research

Figure 12: French fiscal loosing has shifted more towards households



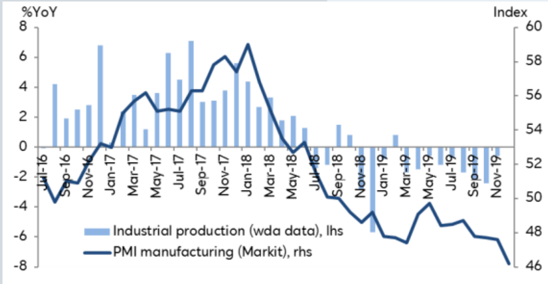
Source: National Institute of Statistics and Economic Studies (INSEE), Eurobank Research

Italy

Political uncertainty prevails ahead of the 26 January regional elections

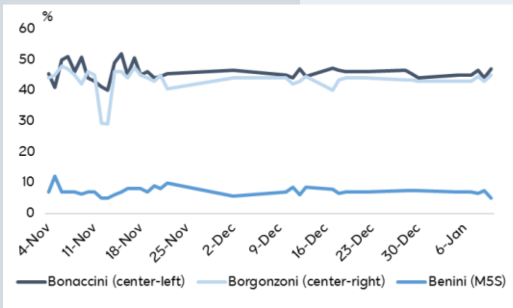
In line with the 2nd estimate of Q3 real GDP growth which revealed that the Italian economy grew by 0.1%QoQ, economic activity has likely remained weak around 0.1%QoQ in Q4. Industrial production rose slightly by 0.1%MoM in November, following a negative print of -0.3%MoM in the prior month and bringing the Q4 carry-over to -0.4%QoQ from -0.6%QoQ in Q3. Nevertheless, the HIS Markit PMI manufacturing fell by 1.4 pts to 46.2 in December, marking the fifteenth monthly contraction in a row and the sharpest deterioration in the health of the Italian manufacturing sector since April 2013. On the other hand, Italian service sector rose for the seventh consecutive month in December, with the respective PMI increasing by 0.7 pts to 51.1 on the back of a further rise in new orders. Overall, the Composite Output Index came in at 49.3 in December from 49.6 in the previous month, reporting the second decline (albeit marginal) in Italian private sector output since May. [2] Real GDP is expected at 0.5% in 2020, modestly higher from an estimated 0.2% in 2019, amid to somewhat stronger domestic demand and a mild recovery in the industrial sector. A volatile political environment creates a downside risk to our forecast. The outcome of the 26 January regional election in Emilia-Romagna, one of Italy's largest regions and a traditional left-wing stronghold could be crucial for the already-fragile PD-M5S coalition government. Latest polls suggest that Bonaccini, the center-left candidate has a very small lead (~2pp) over Borgonzoni, the right wing candidate backed by Salvini's League (Figure 14). In case there is an unprecedented win of the right, this could undermine the PD-Five Star government's stability and provide an argument for the League to push for snap elections in the spring, likely to be won by the nationalist parties. Nevertheless, this is not our base case scenario, as the incentives among MPs remain in favor of continuing cooperation and avoiding new elections so as to keep their seat rather than risking not being re-elected in a snap ballot.

Figure 13: Manufacturing conditions deteriorate at fastest rate since Apr 2013



Source: Bloomberg, Eurobank Research

Figure 14: Voting intentions in Emilia-Romagna



Source: Sondaggi Demopolis, EMG, Ipsos, Ixe, IZI, Noto, Piepoli, SWG, Tecne, Eurobank Research

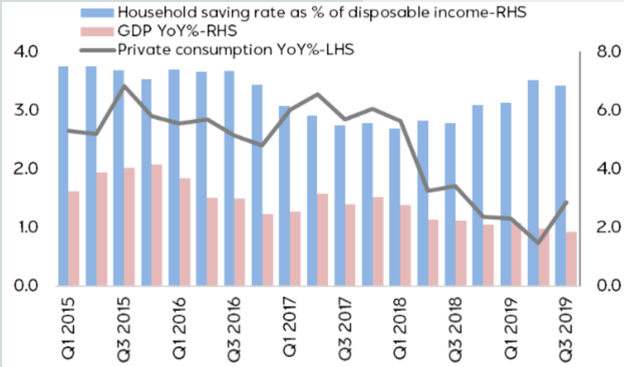
[2] For more details see the HIS Markit PMI's press release https://www.markiteconomics.com/Public/Home/PressRelease/cb6aa214ff264c42bec76053b89ebfd4

Spain

Slowing growth momentum as domestic demand is cooling amid rising savings

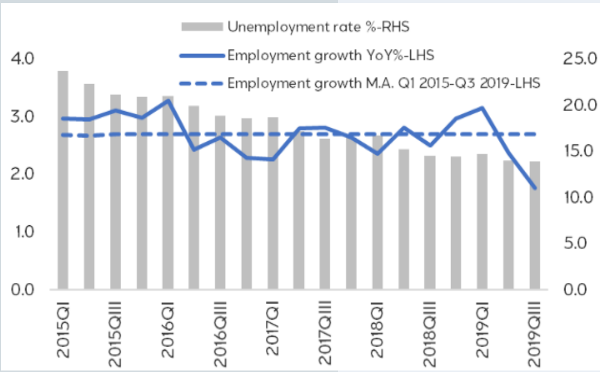
The Spanish economy has lost momentum over the last quarters, growing by 1.9%YoY in Q3 2019, down from 2.0%YoY and 2.2%YoY in Q2 2019 and Q1 2019, respectively, following an average 2.4% in 2018 and 3.0% in the last four years. Growth was primarily driven by private consumption which has averaged 1.1%YoY in the first three quarters of 2019, having though slowed down from an average 2.6% in the last four years. Rising saving rates and slowing employment growth are probably two of the main factors behind Spain's slowing private consumption (Figures 15 & 16). Over the last three quarters, households have increased significantly their savings rate to 7.0% of disposable income from c. 5.5% in mid-2018, probably reflecting precautionary motives against a more challenging external environment and prolonged domestic political uncertainty. In addition, employment growth is cooling, potentially as a result of the global downturn and the 22% increase in the minimum wage introduced in January 2019, the largest in more than 40 years, which has pushed wage growth to 2.0%YoY vs. an average 0.5%YoY in the last four years. Incoming data point to a further slowdown in economic growth towards year-end with retail sales decelerating to an average 2.8%YoY in the first two months of Q4 2019 compared to a 3.9%YoY average in Q3, while industrial production growth slowed to 0.4%YoY, half the Q1–Q3 2019 annual average. We expect GDP growth to moderate to 1.9%YoY in 2019 from 2.4% in 2018 and to keep slowing towards its potential rate of 1.5% in 2020 against the backdrop of weaker past data (the Spanish Statistical Institute revised growth data going back to 1995 as a result of slower-than-initially estimated domestic demand). On the political front, after weeks of intense negotiations, the leader of the socialist party PSEO Pedro Sanchez managed to form a minority government with left-wing Podemos thanks to the abstention of the Catalan party Republican Left of Catalonia (ERC) and other smaller secessionist parties. But the coalition government's spending commitments financed by higher taxes could lead to a further growth slowdown, especially if households increase further saving rates.

Figure 15: Private consumption has slowed over the last quarters partially due to rising household saving rates



Source: National Statistics Institute (INE), Eurobank Research

Figure 16: Employment growth is cooling down



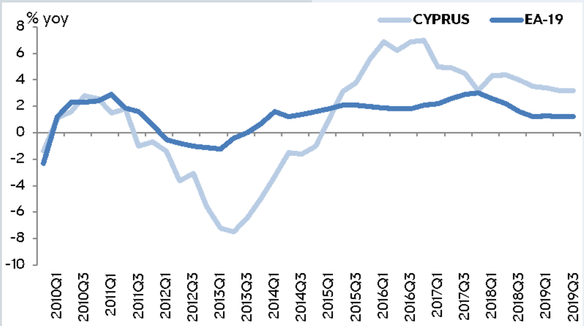
Source: National Statistics Institute (INE), Eurobank Research

Cyprus

Property market recovery continues

The latest building permits release predisposes for a continuation in the construction output rally. According to CYSTAT, the total value of building permits issued during the period January-October 2019 increased by 73.6% YoY vs. 19.5% YoY in FY2018. Accordingly, the total area of building permits rose by 54.1% YoY in the same period vs. only 11.9% YoY in FY2018. During the period Jan-Oct. 2019, 4,216 building permits were issued, up from 3,703 in the corresponding period of the previous year. Having expanded with double digits throughout 2017-2018, construction output still increased by 10.5% YoY in Q3-2019 vs. 15.6% YoY in Q2-2019 and 14.0% YoY in Q1-2019. Real estate prices were on an increasing trend throughout late2018-mid2019. On a quarterly basis, the residential property price index (RPPI) increased by 0.5% QoQ in Q2-2019 down from 0.7% QoQ in Q1-2019, compared to 0.9% QoQ in Q4-2018. The quarterly rise reflects the combined effect of an increase in flat apartments' prices and house prices by 1.1% QoQ and 0.3% QoQ respectively. On an annual basis, the RPPI Index expanded by 2.8% YoY in Q2-2019, an inch lower than 2.7% YoY in Q1-2019 vs. 2.5% YoY in Q4-2018, recording the tenth consecutive quarterly increase for the first time since 2008. The House Price Index (HPI), another metric calculated and published by CYSTAT, recorded the highest increase in the post-MoU era. The HPI expanded by -5.9% QoQ/+2.3% YoY in Q3-2019 compared to 4.2% QoQ/+8.0% YoY in Q2-2019 vs. +0.8% QoQ/+4.3% YoY in Q1-2019 up from +3.5% QoQ/+1.6% YoY in Q4-2018. The Cypriot reading – now above that of EA-19 (+4.1% YoY) in this quarter for the third time since 2013 – bodes well with the ongoing rebound in the property market.

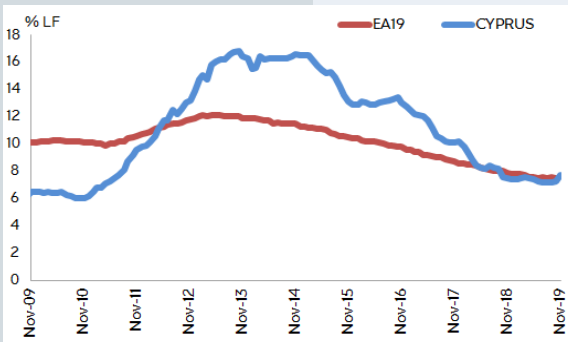
Figure 17: Cyprus' turn-around growth story has been impressive so far



Source: CYSTAT, Eurostat, Eurobank Research

The real estate market recovery is supported by a stream of ongoing residential and tourism infrastructure construction projects underpinned by the program "citizenship by investment", which has helped to attract foreign investment. High profile cases of program misuse have necessitated government changes aiming to make the program more targeted and trustworthy in response to EU institutions' criticism that the transparency of the program should be bolstered. At the same time, concerns for the prospects of this activity in the future remain and are anticipated to become more pronounced in 2020.

Figure 18: Unemployment in Cyprus now stands very close to euro area



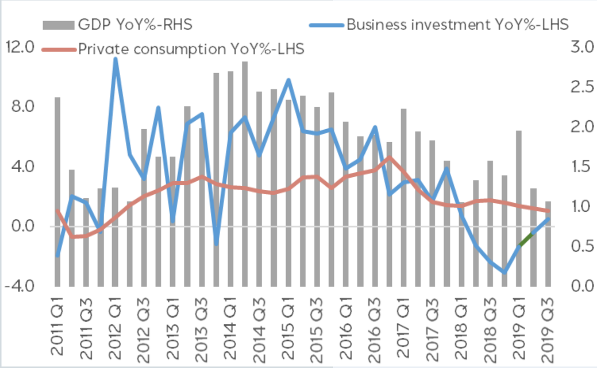
Source: Bloomberg, Eurobank Research

UK

Economic activity continues its downward trajectory

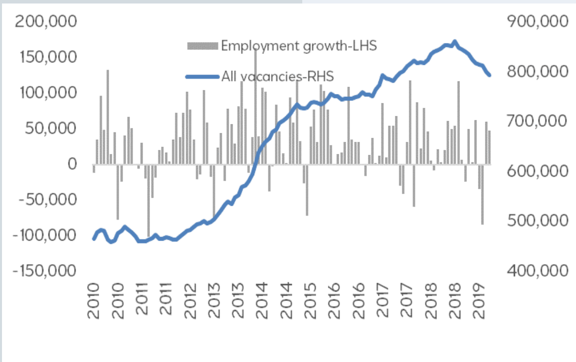
External headwinds and, primarily, Brexit uncertainty continue to take a toll on the UK economy, with GDP growth expanding by 1.1%YoY in Q3, matching the Q1 2018 annual growth rate which was the lowest in seven years, down from 1.3%YoY in Q3 2018 and an average 1.6YoY% in H1 2019. Business investment has been hit the most, while private consumption has remained the main growth driver although the pace of growth has declined significantly to an average 1.4% in recent quarters compared to c. 3.0% a couple of years ago (Figure 19). Meanwhile, employment growth has also weakened since summer 2019, with the number of vacancies falling in November for the tenth consecutive month to below 800k for the first time in two years (Figure 20). The downward trajectory of domestic economic activity continued in the first two months of Q4 2019 amid prolonged Brexit uncertainty and heightened political woes ahead of the December general election. Driven by weak services and industrial production prints, November GDP grew by 0.6%YoY, the lowest pace in more than seven years, after rising by 1.0%YoY in October, still well below the 1.6%YoY January-September average. The November GDP took the Q4 carry-over to -0.1%QoQ but we do not rule out growth close to stagnation in the last quarter of 2019 on the view that we may witness a modest rebound in December as the landslide victory of the Conservative party in the general election provided some clarity on Brexit. For the full year, we expect GDP to expand by 1.3% and then moderate to 1.2% in 2020, as Brexit uncertainty is likely to persist throughout the year. Negotiations on the future UK/EU relationship will start after the UK leaves the EU, but finalizing and ratifying a comprehensive trade deal in the 11-month transition period that expires on 31 December 2020 seems highly ambitious given that trade negotiations typically take a number of years to be reached. The biggest risk to the UK outlook is probably a scenario under which the two sides do not reach a full free trade deal by end-2020 and do not agree to extend the implementation period, leaving the UK to trade under WTO terms. Meanwhile, risks for a BoE rate cut in the near future have increased lately, after a number of MPC members adopted a notably more dovish tone.

Figure 19: Brexit uncertainty has mainly hit business investment



Source: Office for National Statistics (ONS), Eurobank Research

Figure 20: As of mid-2019, Brexit has also started taking a toll on the labor market 12 December 2019 general election



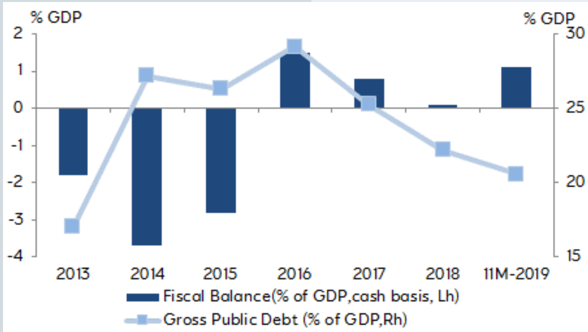
Source: Office for National Statistics (ONS), Eurobank Research

Bulgaria

Solid growth momentum is expected to continue in 2020

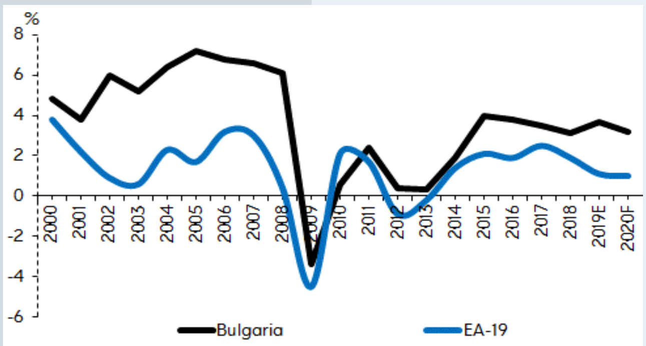
Provided that on a quarterly basis the output performance of Q3 is self-repeated in Q4, GDP growth is expected to have expanded briskly by 3.7% in FY2019 up from 3.1% in FY2018, more than three times higher than the expected EA-19 average. In contrast to its regional peers, the outgoing year has been a year of GDP growth acceleration and over-performance, factoring in the 2015-2019 period in which GDP growth averaged 3.6% up from only 1.1% in 2010-2014. The outperformance of the outgoing year is rooted in the solid domestic demand dynamics, which have been fueled by tighter than ever before labor market conditions and improved business and consumer sentiment along with a better than expected net exports outcome. The unemployment rate has reached a historical low – standing at 3.7% as of November and wages are rising rapidly amid increasing skill shortages. In our view, solid growth momentum is expected to continue in 2020, albeit at a slower pace given the rise of external risks. Consequently, our FY forecast stands at 3.2%, 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, and increased tourism flows. Net exports' contribution is expected to exert a more negative impact in 2020, reflecting the weakness of the main trade partners of Bulgaria as well as the still elevated global trade tensions, weighing thus on next year's growth prospects. Investment, especially the public component, will receive a boost from improved EU funds' absorption, which is also expected to rise further from the current level of 43.0%. With the end of the 2014-2020 programming period approaching, the government will need to step up spending. The impact of EU funds is about to become more pronounced and visible in the official statistics as well. According to the Ministry of Finance calculations, the GDP level of 2019 is 5.5% higher than that without the impact of EU funds, up from 4.0% in 2018 and only 2.1% in 2017. Moreover, domestic credit conditions have turned more growth-supportive. Credit activity accelerated to 9.0% YoY in November, the highest rate of the last ten years, up from 7.3% YoY in October compared to 7.1% YoY in September and still close to 8.4% YoY at the end of 2018.

Figure 21: Bulgaria's fiscal position is sound



Source: National Authorities, Eurobank Research

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



Source: National Authorities, Eurobank Research

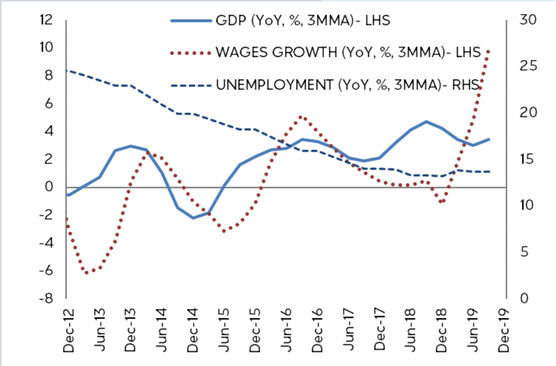
Serbia

Serbia

Serbia 2025 investment plan aims at real convergence with rest EU peers

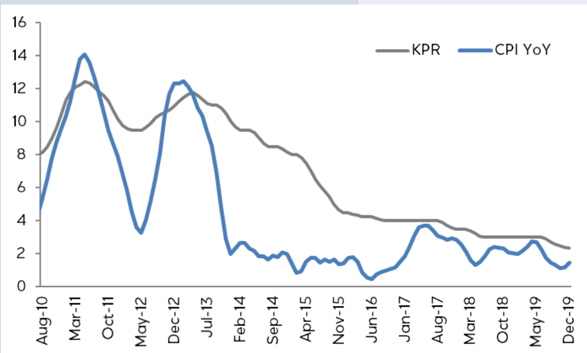
Following Q3's GDP growth print at 4.8% YoY from 2.9% YoY and 2.7% in the two previous quarters respectively, an first estimate of 4.0% over 2019 full year's economic growth was released by the National Statistics Office in late December. The full year estimate surprised to the upside forecasts around 3.5% by the National bank of Serbia, the IMF and the market consensus. While private consumption has been contributing ca 2% in the GDP growth prints at least for the past 8 quarters, Q3's sizable GDP increase came on the back of investments as they contributed almost 75% of it. In our view, the fixed investments' robust contribution will continue at least until 2025, in line with the National Investment Plan projections. At the end of 2019, President Aleksandar Vucic with Prime Minister Ana Brnabic presented the Serbia 2025 plan, worth 14bn euros or 30% of Serbia's 2019 GDP which the World Bank helped Serbia to develop and envisages public investment of around 9 billion euros in infrastructure projects such as road and rail. Although recent GDP growth rates are above average, the country's per capita income does not converge to the average EU standards fast enough. In order to bypass this impasse, a strategic investment plan was conceived, which if implemented by simultaneously maintaining the recently cemented macroeconomic stability, the World Bank has reckoned that Serbia could grow, on average, at 7% YoY, compared to the recent 3-4 % GDP growth per year which is at the upper end of Serbia's current potential growth. On the politics front, President Aleksandar Vucic stated recently that parliamentary elections will take place on April 19 or 26, with the second date more probable. Serbia will also hold local elections in 2020. Although the ruling Serbian Progressive Party (SNS) is expected to submit a legislative bill in support of its reelection, the latter appears likely as according to the latest poll, the SNS gathers almost 53% of the votes.

Figure 23: Solid economic growth and labor market



Source: Bloomberg, Eurobank Research

Figure 24: Monetary easing amid subdued inflationary pressures



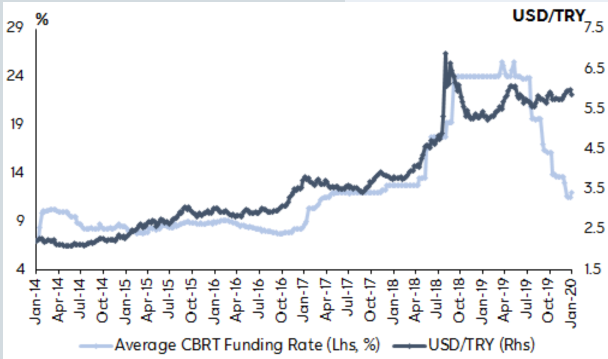
Source: Bloomberg, Eurobank Research

Turkey

Moderate key policy rates cuts ahead

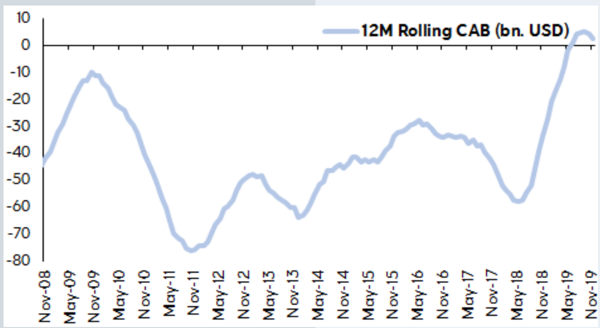
The Central Bank of Turkey (CBRT) cut its key policy rate (KPR), the 1-week repo rate, by 75bps from 12.0% to 11.25% in mid-January. The outcome was deeper than the market consensus of 100bps, bringing the cumulative easing since July to 1,275bps. The inflation outlook improvement, despite the slightly stronger than anticipated year-end reading (December: 11.8% YoY vs. November: 10.6% YoY, still below the year-end inflation CBRT projection of 12%), improved agents' expectations and, along with a relatively stable lira, constitute the main drivers behind the Central Bank's decision. Provided that inflation remains on a declining trajectory and there are no other unpleasant geopolitical or other external environment concerns arising, CBRT is widely seen and most likely will proceed with further modest rate cuts in 1H-2020 bringing the KPR down to 10%. Recent data announcements provide more evidence that the economy is exiting the recession in a V-shaped manner (Q3: 0.9% YoY, the first positive reading in a year) while unemployment has improved further (October: 13.6% vs. 13.9% in September). Meanwhile, the latest balance of payment (BoP) data in November signal a change in direction in external accounts. Underpinned by the rise of imports (+10.5% YoY on a monthly basis) mirroring domestic demand's partial recovery and the rise of non-monetary gold imports plus a lower services surplus as a result of lower transportation receipts, the current account (CA) recorded a deficit in November. After four months of surplus, the CA switched to a deficit of $518mn in November compared to $1bn surplus in the same month a year ago and a $1.6bn surplus in October, bringing the Jan-Nov surplus down to $4.2bn compared to a $25.6bn deficit in the same period of 2018. On the financing side, BoP relies heavily on portfolio inflows (the net amount stood at $2.05bn) while net FDI inflows remained weak at $236mn (down by $1bn vs. a year ago). The increase in the financial account surplus ($3.1bn), combined with the small current account deficit plus the contribution of net errors and omissions ($1.8bn), gave a small boost to the FX reserves by $743mn, which increased for a fifth consecutive month. The current account is expected to close with a small surplus of around 0.5% of GDP in FY2019 compared to -3.5% in FY2018 and -5.5% in FY2017 illustrating an impressive unwinding of macroeconomic imbalances.

Figure 25: Central Bank slashed interest rates by 1275bps in the last four policy meetings



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)		
	2018	2019f	2020f	2018	2019f	2020f	2018	2019f	2020f	2018	2019f	2020f	2018	2019f	2020f
World	3.6	2.9	3.1	3.6	3.4	3.1									
Advanced Economies															
USA	2.9	2.3	1.8	2.5	1.8	2.0	3.9	3.7	3.7	-2.4	-2.5	-2.6	-3.8	-4.5	-4.5
Eurozone	1.9	1.1	1.0	1.8	1.2	1.2	8.2	7.6	7.5	2.9	2.6	2.5	-0.5	-1.0	-1.0
Germany	1.5	0.6	0.8	1.9	1.3	1.2	3.4	3.2	3.4	7.6	7.0	6.8	1.9	1.5	0.8
France	1.7	1.3	1.3	2.1	1.3	1.3	9.1	8.5	8.3	-0.6	-0.4	-0.5	-2.5	-3.1	-2.4
Periphery															
Cyprus	3.9	3.3	2.9	0.8	0.5	1.3	8.4	7.2	6.0	-4.4	-7.2	-6.5	3.4	3.8	2.7
Greece	1.9	2.0	2.0	0.8	0.5	0.6	19.3	17.3	15.9	-2.8	-2.0	-2.1	1.0	1.2	1.2
Italy	0.8	0.2	0.5	1.3	0.7	0.8	10.6	10.3	10.3	2.5	2.8	2.9	-2.1	-2.0	-2.5
Portugal	2.4	2.0	1.7	1.2	0.3	1.1	7.0	6.3	6.0	0.1	-0.4	-0.7	-0.4	-0.1	0.0
Spain	2.4	1.9	1.5	1.7	0.9	1.1	15.3	13.9	13.3	1.9	2.4	2.5	-2.5	-2.3	-2.2
UK	1.3	1.3	1.2	2.5	1.8	2.0	4.0	3.8	4.0	-4.3	-4.3	-4.2	-2.3	-2.2	-2.4
Japan	0.3	1.0	0.4	0.9	0.6	0.6	2.4	2.4	2.4	3.5	3.5	3.5	-3.7	-4.2	-3.5
Emerging Economies															
BRICs															
Brazil	1.1	1.1	1.2	3.7	3.6	3.8	12.3	11.9	11.1	-2.2	-1.7	-2.0	-7.3	-6.3	-5.8
China	6.6	6.1	5.9	2.1	2.6	2.6	3.8	4.0	4.0	0.4	1.0	1.8	-4.1	-4.5	-4.8
India	7.2	5.0	5.8	4.0	3.4	3.9		*NA*		-2.0	-1.8	-1.9	-3.4	-3.6	-3.5
Russia	2.3	1.1	1.7	2.9	4.5	3.5	4.8	4.6	4.5	7.0	5.0	3.9	2.6	2.1	1.3
CESEE															
Bulgaria	3.1	3.7	3.2	2.6	2.5	2.3	5.2	4.4	4.1	5.4	5.2	4.1	0.1	-2.0	0.0
Romania	4.0	4.1	3.6	4.6	3.8	3.5	4.2	3.9	4.2	-4.4	-5.2	-5.9	-5.0	-3.6	-4.4
Serbia	4.4	3.7	4.0	2.0	2.0	2.1	12.7	11.0	10.5	-5.2	-6.0	-5.5	0.6	-0.5	-0.5
Turkey	3.3	-0.5	2.5	16.3	15.2	13.0	10.9	13.0	12.5	-3.6	0.5	-1.0	-2.1	-3.0	-2.3

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

Eurobank Research

Eurobank Fixed Income Forecasts

	Current	March 2020	June 2020	September 2020	December 2020
USA					
Fed Funds Rate	1.50-1.75%	1.47-170%	1.41-1.65%	1.39-1.65%	1.35-160%
1 m Libor	1.65%	1.69%	1.63%	1.62%	1.58%
3m Libor	1.80%	1.84%	1.78%	1.77%	1.72%
2yr Notes	1.55%	1.61%	1.61%	1.61%	1.59%
10 yr Bonds	1.80%	1.87%	1.90%	1.92%	1.94%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.39%	-0.45%	-0.46%	-0.47%	-0.47%
2yr Bunds	-0.58%	-0.66%	-0.68%	-0.68%	-0.65%
10yr Bunds	-0.22%	-0.38%	-0.38%	-0.37%	-0.30%
UK					
Repo Rate	0.75%	0.75%	0.70%	0.70%	0.75%
3m	0.70%	0.74%	0.72%	0.74%	0.75%
10-yr Gilt	0.65%	0.78%	0.85%	0.92%	0.99%
Switzerland					
3m Libor Target	-0.68%	-0.77%	-0.77%	-0.79%	-0.79%
10-yr Bond	-0.60%	-0.55%	-0.54%	-0.51%	-0.50%

Source: Bloomberg (market implied forecasts)

Eurobank

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