Eurobank

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

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I. Snapshot

Overview

Macro Picture

- **USA:** Strong near-term growth momentum as business cycle matures
- **EA:** Continued economic strength in spite of political risks
- **UK:** Growth to remain lackluster on lingering Brexit uncertainty and real household income squeeze from higher inflation
- **Japan:** Firm growth supported by both domestic and external demand
- **EM:** Growth to pick up pace in 2017and 2018, thanks to recovery in commodity exporters, most notably Brazil and Russia
- **CESEE:** Regional economies poised to reach a new post-Lehman high

Policy Outlook

- **USA:** Interest rate tightening cycle beyond December largely dependent on the underlying trend rate of inflation
- **EA:** Differences in views among GC members may lead to a re-formulation of the ECB's forward guidance
- **Japan:** BoJ on hold amid subdued inflationary pressures
- **UK:** Further BoE rate tightening "at a gradual pace and to a limited extent" amid prevailing Brexit-related uncertainty
- **CESEE:** Limited room for more supportive monetary and fiscal policies in 2018

Summary

Highly synchronized global upswing gains momentum, allowing a number of G10 CBs to gradually withdraw accommodative monetary policy, in spite of persistently subdued inflation. US politics remain on the front seat, amid increased optimism on the enactment of US tax reform legislation

Markets

- **FX:** Better economic data from the EU are supporting the EUR and have moved the trading range into year end to 1.17-1.20 despite an almost certain rate hike by the Fed
- **Government bonds:** Strong bearish flattening pressure in both EU and US during November to reverse in the short term, but in the US it is expected to resume
- **EM external debt:** Remains strong on the back of global upswing and name specific stories have not managed to derail the rally in spreads. Keep an eye on Turkey and Middle East developments
- **Credit:** Constructive into year end but global CB purchase reductions start taking their toll on spreads. Prefer higher rated names in both IG and HY

Key Risks

- **US fiscal stimulus falls short of expectations:** The House and the Senate still some way off a "compromise" tax bill
- **Sharper than expected slowdown in China:** Weaker fiscal stimulus, total non-financial sector debt continues to rise strongly
- **Central banks illusion:** Too much optimism on inflation leads to a more aggressive monetary policy stance by major CBs
- **Policy shift toward protectionism:** Trade and currency war reduce global trade and cross-border investment flows
- **Heightened political jitters:** Pro-independence parties in Catalonia secure parliamentary majority; UK/EU fail to agree on a transitional Brexit deal by early 2018; Repeated election in Germany

Macro Views

Latest Macroeconomic Developments & Outlook

World Economic Outlook		The global economy is advancing at its fastest pace since 2010, exhibiting a synchronized upturn across regions. Global growth pickup in 2017 is attributed to a large extent to a wider commodity rebound, the US shale production and the Chinese property market. We expect 2018 to be another year of strong global economic momentum, with marginally less accommodative monetary policies by the major central banks. Overall, global GDP growth is expected to accelerate to c. 3.6% in 2017 and 3.7% in 2018 from 3.2% in 2016.
Developed Economies	**US**	The US economy continues to expand at a solid pace recording one of the longest recoveries on record, underpinned by a strong labor market and an ongoing rebound in business investment. The economy is expected to sustain its robust underlying performance and even showing additional momentum into 2018, assuming that the House of Representatives and the Senate will eventually agree on a "compromise" tax reform bill by early next year.
	Euro Area	The Euro area economy has shown strong performance in recent quarters, with household consumption being the key driver and government expenditure and fixed investment also adding to GDP growth. Despite the EUR appreciation, the favorable global environment has led to a positive contribution of net exports to overall growth as well. The broad-based recovery is set to continue in 2018-19, although some growth deceleration seems likely, mainly driven by a weaker contribution from foreign trade.
	Periphery	Periphery euro area economies' positive economic momentum remains intact, with private consumption presenting the key driver of growth. Portugal has been the top performer in recent quarters, supported by a faster growth in private consumption and an improved performance in net exports. Market focus is on December 21st election in Catalonia amid risks of negative repercussions on the Spanish economy in case of prolonged political uncertainty.
	Japan	Economic activity has remained well supported by robust global demand and supportive fiscal policy stance, with 2017 representing a year of marked acceleration in growth. Overall, real GDP growth is projected to decelerate to 1.2% in 2018 from an expected 1.5% in 2017 on the back of fiscal stimulus withdrawal and a gradual renewal of fiscal consolidation.
Emerging Economies	**BRICS**	China's real GDP growth averaged 6.9%%YoY in Q1-Q3, vs. 6.7%YoY in 9M 2016. Full-year growth is penciled in at 6.8% from 6.7% last year, but is expected to slowdown in the next couple of years on gradually decelerating domestic demand. Economic recovery in Russia continued 9M 2017 thanks to increasing oil prices and rising domestic demand. Full year growth is seen near 1.7%, though a modest slowdown is anticipated in the years ahead. In Brazil, most recent data signal a further improvement in economic activity in Q3, thanks to low inflation and accommodative monetary policy. Risks primarily lie on domestic political uncertainty, ahead of next year's presidential elections. Economic activity in India is likely to pick up pace from next year, following this year's temporary slowdown, as the impact of the Goods and Services Tax (GST) and demonetisation gradually wanes.
	CESEE	The flash GDP growth estimates for Q3-2017, released for most of the countries of our focus (Bulgaria, Romania, Cyprus and even in Serbia where GDP growth had slowed down on one-offs) and the broader CESEE region were bullish and in some cases surpassed the most optimistic forecasts. It would be fair to say that 2017 is likely to prove another very good year for the region, most probably the best since 2008.

Global Macro Themes & Implications

Theme	Implications
Increased optimism over enactment of US tax reform legislation; lingering uncertainty over the ultimate form of the bill	The 435-seat US House of Representatives approved its version of the Tax Cuts and Jobs Act on November 16, 2017 allowing an increase of up to $1.5trn in the US deficit over a 10-yr budget window. Taking a further step towards the enactment of the tax bill, the Senate Budget Committee approved its own version of the draft legislation on November 28, sending reconciliation legislation to the full 100-seat Senate which is reportedly on track for a final vote on December 1st. However, there is still significant market uncertainty about the form of the ultimate tax reform bill and its potential impact on the US growth outlook, the budget deficit and the federal debt. As things stand at this point, the two draft bills differ on a number of key areas including, among others, SALT deductions, mortgage interest deductibility, individual tax brackets and the timing of implementation of a reduced corporate tax rate. A conference committee between the House and Senate will be necessary to resolve differences between the two bodies and a new "compromise bill" to be submitted for another round of voting in both the House and Senate, expected not earlier than early 2018, before the bill is signed into law by the US President.
Increased uncertainty over the path of rate hikes beyond December 2017	The FOMC minutes from the October 31-November 1 policy meeting provided further support to the prevailing market view for a 25bps rate hike at the next meeting scheduled for December 12-13, revealing a general agreement that a rate hike is likely to be warranted "near-term" on optimism over the US economy's growth prospects. However, some members expressed concerns that, despite of the tight labor market, weakness in inflation may not be due to just transitory factors with persistently low inflation risking a decline in long-term inflation expectations, fueling market uncertainty over the path of future rate hikes beyond December. Market uncertainty over the Fed's medium-term policy deliberations is also related to the still vacant four posts in the Fed's Board of Governors (without including the post of the Fed Chair as Ms. Yellen is widely expected to be replaced by Mr. Powell when her term expires in early February 2018).
Prevailing Brexit uncertainty; all eyes on the December 14-15 EU Council	The EU Council convenes on December 14-15 to discuss, among others, whether the UK has made "sufficient progress" on the issues of the first phase of Brexit discussions covering the rights of EU citizens in the UK, the UK's financial liabilities and the Northern Ireland Border allowing negotiations to move on to the next phase related to the future EU/UK relationship and transitional arrangements. Admittedly, Brexit negotiations are proceeding slowly while time is running out. As things stand at this point, the two sides may not reach an agreement on the new EU/UK relationship by Q3 2018 – as the EU27's plan envisions— for the European parliament, the UK Parliament and the EU Council to have enough time for the completion of the necessary approval process by March 2019 when the 2-year time-frame allowed in Article 50 comes to an end. That said, the UK government will have to secure an agreement on a transitional deal by early 2018 in order to reduce the need for businesses to start implementing contingency plans for a "cliff edge" Brexit.

Global Macro Themes & Implications

Theme	Implications
Euro area on track this year for its fastest pace of growth in a decade	Soft and hard data pertaining to Q4 2017 suggest continuing improvement in euro area growth dynamics with the economy poised for a growth rate of around 2.2% for the whole year, the fastest in a decade. A recovering labor market, healthy external demand, improving lending conditions, modest inflation and the ECB's accommodative monetary policy comprise the underlying drivers. The ongoing growth improvement supports the ECB's argument for a gradual increase in underlying inflation towards the medium-term objective of a rate which is below but close to 2% (prediction based on a standard Phillips Curve argument), justifying its decision at the October 26 monetary policy to halve the monthly pace of asset purchases to EUR 30bn as of January 2018.
Dissenting views among ECB Governing Council members on the future course of monetary policy; risks of future guidance changes in the coming months	The account of the October ECB monetary policy meeting sent a dovish message revealing that, although there was a broad agreement on a 9-month extension of the APP programme until September 2018 at EUR 30bn per month starting in January, there was a divergence of view among participants over whether a clear end date to asset purchases should be announced or an open-ended formulation remained appropriate. Dissenting views were also expressed on the APP forward guidance with "several" members arguing that, over time, the criteria for a sustained adjustment in the path of inflation should be disentangled from the continuation of the programme. To sum up, the October ECB minutes and related recent comments by ECB Governing Council member Benoît Cœuré suggest risks of future guidance changes in the months ahead, well before the end of the APP program in September 2018. In this respect, in case the euro area economy continues its cyclical recovery in the coming months and inflation pressures build up gradually, the prospect of the APP programme not to be extended again or/and the ECB to disentangle the end of the APP horizon with the beginning of a hiking cycle, cannot be ruled out.
Reduced political jitters in the euro area	Following the collapse of the three-party "Jamaica" coalition talks, the Conservative Christian democratic political alliance consisting of Angela Merkel's centre-right Christian Democratic Union (CDU) and the Bavarian sister-party Christian Social Union (CSU) reached an agreement with the Social Democrats (SPD) to hold exploratory talks on the formation of a new "grand coalition" in an attempt to break the political impasse and avert repeated election. As things stand at this point, it is yet unclear whether the SPD intends to participate in a renewed full fledged grand coalition or tolerate a minority government under Chancellor Angela Merkel. Moving to Spain, pro-independence parties in Catalonia will not run as part of a coalition at the December 21st snap election while recent opinion polls suggest a slightly lower popularity rate compared to that achieved at the 2015 ballot. Their election campaign has somewhat shifted from a unilateral declaration of independence focusing instead on a demand for the imminent suspension of Article 155 and the release of members of the Catalan government currently in custody.

Macro Themes & Implications in CESEE

Theme	Implications
Bullish flash GDP estimates in Q3-Regional growth heading for a new post-Lehman high in 2017	The flash GDP growth estimates for Q3-2017, released for most of the countries of our focus (Bulgaria, Romania, Cyprus and even in Serbia where GDP growth had slowed down on one-offs) and the broader CESEE region were bullish and in some cases surpassed the most optimistic forecasts. It would be fair to say that 2017 is likely to prove another very good year for the region, most probably the best since 2008. Growth dynamics are broadly driven by improving private consumption. In line with our expectations, public investments rebound on improved EU funds absorption related projects.
Consumer spending revival continues unabated in the region	Private spending revival continued unabated so far this year, feeding a strong imports rise on the external side. Sustained consumer sentiment gains, eased financial conditions, tighter labor markets combined with robust real wage dynamics boost consumer spending, a trend that will most likely continue, albeit at a smaller extent and from a high base, in 2018.
Small timid steps towards monetary policy normalization	Following a rise in recent months, headline inflation data across the region have stabilized in H2 close to but still below multi-month highs and are expected to remain well anchored within their individual target range by the end of the year. Similarly core inflation is creeping up albeit in different steps and from different initial levels across CESEE. From a policymaking point of view, although there is significant degree of divergence between them, some local Central Banks (Romania, Czech Republic) are taking gradually small timid steps towards policy normalization, getting ready to tighten further in the coming months.
Limited room for more supportive economic policies in 2018	Regional economies are about to or have reached their cyclical peak in 2018. The outlook looks more challenging from a policymaking point of view, as lax monetary policies from both major and regional central banks have embarked on a normalization course which is expected to unfold fully next year. Moreover, fiscal policy is constrained by pre-crisis legacies, idiosyncratic factors and institutional commitments. The targets' overachievement of the past years in some cases (Bulgaria, Serbia and Cyprus) allows for more flexibility in 2018. In contrast, the expansionary policies followed have stretched the budgets' capacity in Romania.

CESEE Markets Developments & Outlook

Country	CESEE Markets Developments & Outlook
Bulgaria	Bulgarian local-currency bonds stayed well supported over approximately the past month. The bull flattening of the yield curve continued, with the long-end decreasing by a maximum of 12 bps against the timid increase of 4 bps in short-term notes. Meanwhile, the Ministry of Finance reopened in late October a 7.5 year BGN-denominated issue maturing in 2025 raising BGN 85mn and bringing the total amount issued to BGN 170mn. Separately, Bulgarian Eurobonds followed the developments in the local market with the belly of the curve outperforming.
Serbia	After remaining range-bound for almost four months, the dinar strengthened anew in November breaking below a key resistance level of 119.00/€ to reach a new 3-year high near 118.50/€. This move came despite two surprise interest rate cuts by the National Bank of Serbia, which appeared to have had a rather negligible impact on the currency. At the same time, investor confidence for future positive macroeconomic developments supported inflows towards government bonds. In support of the aforementioned, the latest 7Y RSD-denominated bond auction held in October attracted bids worth RSD 41bn vs. an initial offering of RSD 19bn, with the average accepted yield falling to 5.0% from 5.6% when the paper was last auctioned two months before. A similar picture was evidenced in the 2Y bond auction, which also resulted in a 60 basis drop in the yield to 4.05%. The key policy rate cuts have also pushed the Belibor lower curve by 45 basis points (on average). Meanwhile, inflation pressures remain relatively subdued with the latest readings (2.8%YoY in October and 3.2%YoY in September) still within the NBS inflation tolerance band target of 3+/-1.5%. Additionally, amongst the main reasons for the two Central Bank interest rate cuts most likely lie behind the weaker than previously expected GDP growth trajectory, falling inflation expectations and still low interest rate environment in Europe. However, the next ECB monetary meeting and potential hints on the future monetary policy deliberations ahead and a potential tapering may prove game changers. Seasonal factors, including intensified demand for hard currency from state owned gas and oil enterprises, could push the EUR/RSD higher in the next month or two. However, the dinar will likely continue performing well in 2018, conditional on strong GDP and employment and a contained current account deficit.

The Trader's View

Asset Class	Outlook
Foreign Exchange	**EUR/USD:** The pair reached a high of 1.1960 in November underpinned by stronger European PMIs and fading German political risk. The move towards the top of recent ranges came after recent dovishness from Fed speakers amid light liquidity surrounding the Thanksgiving holiday; however was not sustained as many investors were caught behind the move. Decreasing liquidity will be an issue going towards the end of the year and market expectations implied by the options market point towards further euro appreciation. Higher range 1.1750 – 1.2000 is expected until the end of the year. **USD/JPY:** The pair has been a big mover in the G10 space approaching the mid-September levels of 111. Increasing market expectations of an earlier BOJ tightening combined with soft US data and medium-term negative themes surrounding the dollar (heavy legislative agenda risks tax disappointments and even a government shutdown as the budget deadline approaches) will put pressure on the pair. A range of 110 – 113 is expected until the end of the year. **GBP/USD:** Brexit headlines continue to dominate and GBP enjoyed solid gains following reports that the UK and the EU reached an outline deal on the financial settlement issue late last week. The favourable outcome of the UK banks stress tests with no bank ordered to raise additional capital or change their strategies sent cable to a two month high of 1.3400. Technical picture now points to 1.3600 and support is found at 1.3200.
Government Bonds	**US:** The GOP Tax Bill was passed by the Senate Budget Committee and Fed Chair Nominee Jay Powell's Senate Banking Committee hearing proceeded smoothly with the new Fed Chair striking a cautious tone. The main play for November was the aggressive bear flattening of the curve and a by now 90% priced December hike by the FOMC. 2s/10s is at the time of writing at 62bps having lost almost 16bps in November and 63bps YTD. Most of the move was driven by the front end with term premiums collapsing and the 10y UST yield sitting at 2.38%, trading in a tight 10 bps range throughout the month. The weakness (or rather lack) in duration trading has been accompanied by a collapse in implied vol with the market increasingly positioned for a slow year end. The recent flattening looks overdone for now and a retracement is expected in the near term. **EU:** The collapse of the German coalition talks renewed political concerns for Europe driving yields lower. Coeure's interview in Handelsblatt further supported the view stating the ECB now buys from "buy and hold" EA investors, such as pension funds and insurance companies driving prices even higher. 2s/10s flattened taking its cue from across the US but a constrained front end allowed for a much more controlled move with the 2yr pretty much fixed until 2019 (the first rate hike) and 10y term premiums heavily constrained. Cautious guidance by the ECB has squashed volatility with some resteepening of the curve looking like the most probable scenario into a muted year end.
EM hard currency debt	Emerging market spreads had a rough first half in November with the JPM EMBI Global Spread index widening by 25bps before retracing 15bps to 315bps. The continually improving global macro backdrop, the subdued inflation pressures and the low volatility environment is making any widening a buying opportunity as spreads remain 70bps wider than the past decades tightest levels. Idiosyncratic risks have generally been ignored by the markets (South Africa political risk, Turkey/US relationship turmoil, political developments in Saudi Arabia and Lebanon, Venezuela default (?), NAFTA negotiations, North Korea). Inflows in the asset class have remained supportive, with hard-currency bonds attracting significant capital in November, therefor EM credit looks set to have a second stellar year in a row. We remain constructive on the market though with increasingly neutral stance, especially in the EUR denominated space where valuations are richer than USD. Name differentiation will be the theme in the coming year as volatility is expected to rise. Middle East and Turkey developments will need to be monitored closely.

The Trader’s View

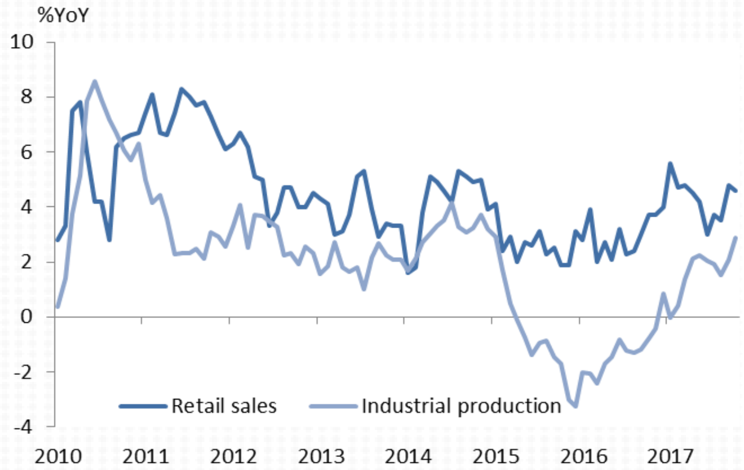
Asset Class	Outlook
Corporate credit	European IG credit remains strong as improving fundamentals, low defaults rates and improving economic outlook combined with low inflation and the CSPP support give a hard time to credit bears. Senior and subordinated financials continued to outperform, and despite a minor wobble in global credit spreads at the begging of the month, IG closed tighter with HY marginally wider. US credit (IG and HY) also retraced most of its widening during the month but underperformed European credit. In the short term the carry trade will persist in both IG and HY but the $1tn question for credit (and other asset classes) is with net central bank asset purchases at a global level set to fall by $1tn next year and both spreads and yields at multi year tights, will demand be replaced by other market participants? We had been, incorrectly, cautious on the asset class in 2017 but we will remain so in 2018 as we see little space for further tightening with breakeven levels at extremely low levels. CSPP will still provide some insulation to the credit market in the near term, but we believe not enough to prevent a widening in spreads. Overall we favor a move into the higher end of the ratings spectrum in both EUR and USD credit. Name differentiation will be a key theme in the month ahead.

II. Advanced Economies

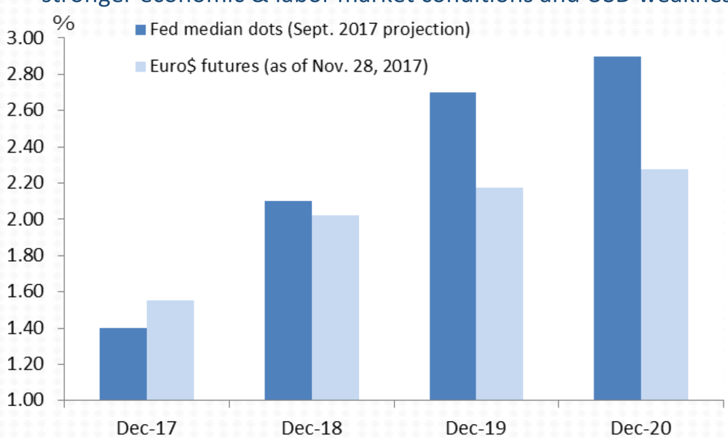
- USA
- Euro Area
    - ❖ Periphery (Italy, Spain, Portugal, Cyprus)
- Japan
- UK

USA: strong near-term growth momentum as business cycle matures

High-frequency indicators point to solid growth outlook



Fed dots still above market expectations in 2018-20 amid...
stronger economic & labor market conditions and USD weakness



Source: Bloomberg, Federal Reserve, Eurobank Economic Research

Latest Economic Developments

The US economy continues to expand at a solid pace, with Q3 real GDP growth surprising on the upside despite the hurricane-related damage in late summer. High frequency indicators point to sustained expansion in the near term, with industrial production surging in October (+0.9%MoM) capitalizing on strong manufacturing production growth (+1.3%MoM), and retail sales exceeding expectations in October coupled with an upward revision for September. Overall, real GDP growth is projected at 2.2% in 2017 from 1.5% in 2016 underpinned by strong labor market conditions, an ongoing rebound in business investment and enhanced business and consumer confidence.

Central Bank Watch

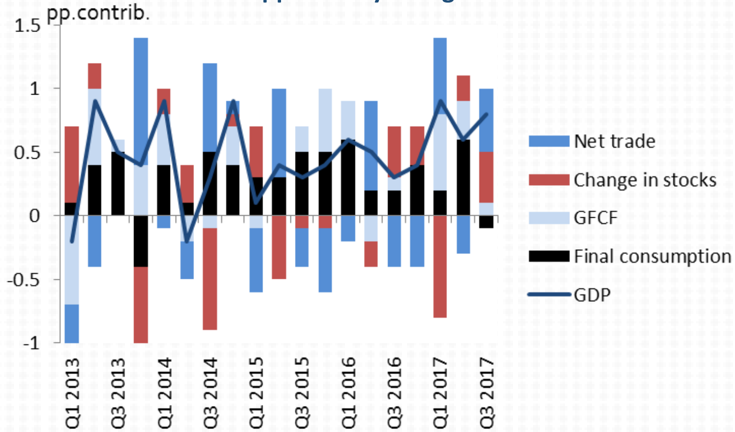
In line with the November FOMC minutes indicating that many participants view a rate hike in the short term as appropriate (should economic activity evolves as expected), we anticipate a third 25bp interest rate increase at the December meeting, which is fully priced in by market participants. Looking ahead, the Fed will continue to gradually withdraw policy accommodation as Fed Chair nominee Jerome Powell is expected to continue his predecessor's policy course, at least in the near term. The interest rate hike cycle beyond December 2017 will be largely dependent on the underlying trend rate of inflation, and on whether the recent slowing in inflationary pressures will prove transitory or persistent. Adding to this, further improvement in the US labor market conditions and/or the introduction of fiscal stimulus could potentially warrant a faster pace of normalization in 2018.

Risks

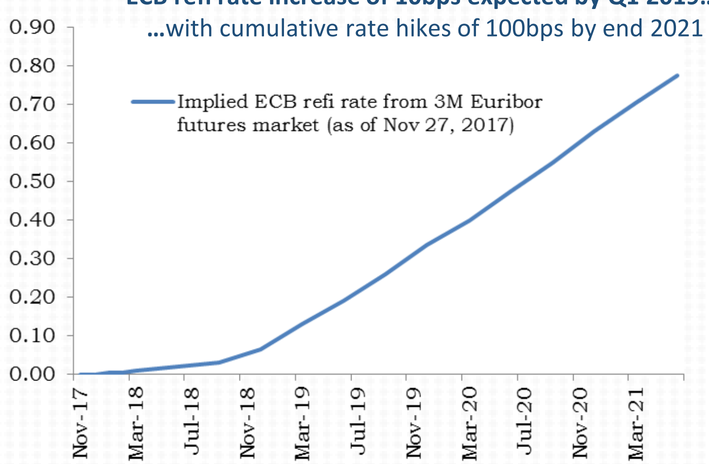
A marked protectionist shift in US trade policy could reduce global trade and cross-border investment flows, weighing on the US and, consequently, global growth momentum. Fiscal stimulus could create upside or downside risks for the US 2018 economic outlook, related to a more or less expansionary shift in fiscal policy than currently assumed.

Euro area: continued economic strength despite political risks

Strong growth momentum in Q3 German GDP, supported by foreign trade



ECB refi rate increase of 10bps expected by Q1 2019…
…with cumulative rate hikes of 100bps by end 2021



Source: Eurostat, Bloomberg, Eurobank Economic Research

Latest Economic Developments

Euro area flash Q3 17 GDP increased by 0.6QoQ, slightly decelerating from the upwardly revised 0.7%QoQ in Q2 17. Although the expenditure breakdown will not be released until Dec 5, the marginal slowing was probably driven by domestic demand and, particularly, by some moderation in investment growth. High frequency data suggest that private consumption has remained strong, buoyed by easy credit conditions, increased confidence and improving labor market conditions with the unemployment rate at its lowest level in nearly 9 years. Latest economic and business surveys signaled further economic strength ahead, with the October EC economic sentiment indicator posting the strongest reading since end 2000 and the November "flash" PMI composite index reporting the highest print since April 2011.

Central Bank Watch

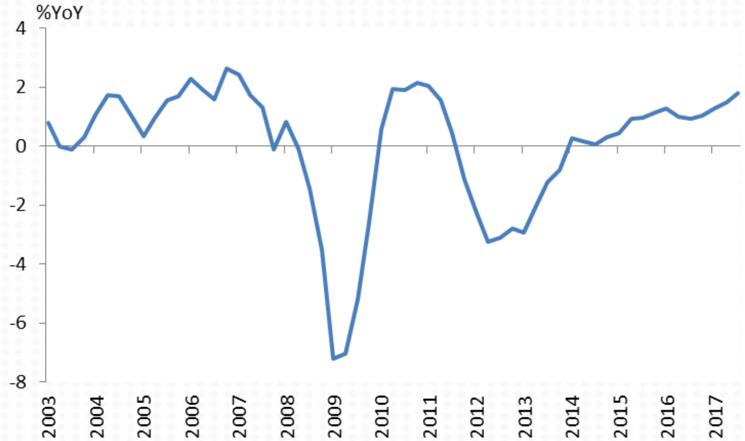
The account of the October ECB meeting revealed a more positive growth outlook while still showing concerns about the medium-term outlook for inflation. Despite a wide-ranging agreement among participants on the decision to extend QE until Sep 18, there were clear differences in views concerning the horizon of QE and whether an open-ended formulation remained appropriate vs. an announcement of an end date for the APP. Concerns were expressed that a 9m extension is a long horizon that could limit the policy's responsiveness to dynamic economic conditions, while other members feared that an open ended QE could create expectations for another extension. Said that, a re-examination of the ECB's forward guidance is expected before Sept 18, likely providing some clarity about the horizon of the APP and key policy rate outlook in the medium term.

Risks

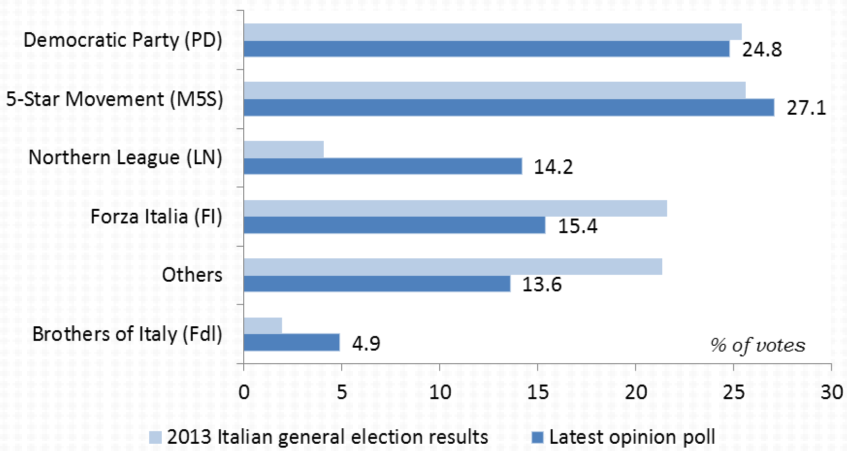
Brexit related uncertainty could weigh on sentiment and investment, while a stronger EUR and/or higher long-term interest rates could pose downside risks to the economic outlook. Political uncertainty in Germany after "Jamaica" coalition talks came to a deadlock takes centre stage, while, in the periphery, risks also stem from Italy (economic, fiscal and political outlooks) and Spain (Catalonia issue).

Italy: strong cyclical recovery, but general election a potential headwind

Italian real GDP growth on a clear upward trend since 2013



General Election in 2018: No single party is to win absolute majority



Source: Wikipedia, Bloomberg, Eurobank Economic Research

Latest Economic Developments

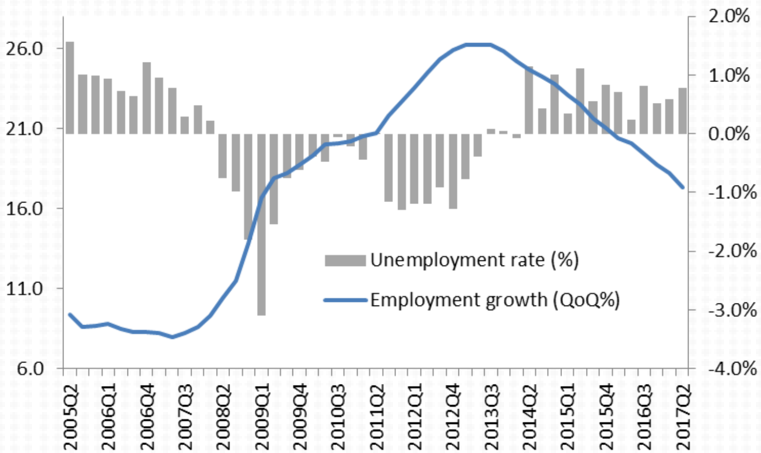
Italy's economic recovery is continuing vigorously and has gained some speed lately, with an average quarterly growth rate in Q1-Q317 twice the 2014-16 average. Real GDP growth is fueled by both external and domestic demand, with private consumption helped by an improving labor market coupled with a decline in the household savings rate, and export growth being supported by a favorable external environment. Real GDP growth is projected at 1.5% in 2017 from 0.9% in 2016, before decelerating towards 1.3% in 2018. Looking ahead, business fixed investment is expected to contribute more to growth, while fiscal policy will likely be less restrictive than previously expected (2018 budget envisions fiscal consolidation of 0.3% of GDP vs. 0.5% planned earlier in the draft budget).

General Election in 2018: Hung parliament and stalemate the most likely income

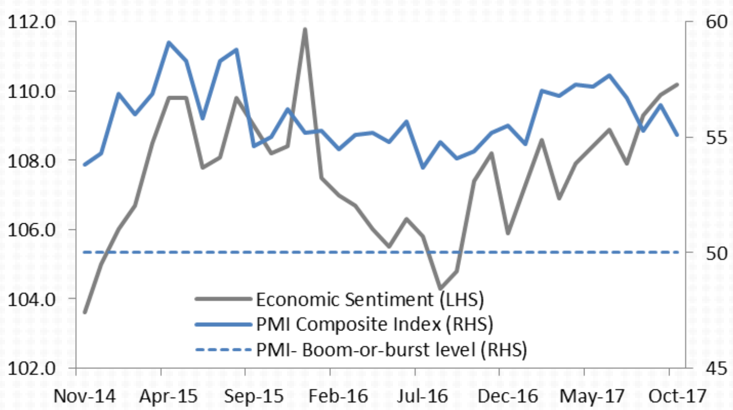
Italy will likely have a general election in early March 2018, under the new voting system which will be applied to both the Lower House and the Senate; 64% of seat to be allocated with a fully proportional system vs. 36% in first-past-the-post constituencies. Candidates in these constituencies can be supported by a pre-election coalition, without requiring ex-ante a common coalition program or a PM candidate. The latest opinion polls (15-26/11) indicate that the M5S has the highest chance of becoming the leading party in parliament. However, given its unwillingness for pre-election coalition, it will be rather difficult to have a final vote share above the 35% popularity rate, required to secure enough seats in parliament in order to form a single-party government. A pre-election coalition between center-right parties (FI, LN and FdI) is highly likely, with recent polls assessing its vote share at ca. 35% (no absolute majority). On the center-left front, the PD (~25%) and some other center and left-wing parties (~10%) could potentially form a wide pre-election alliance and become very competitive. In any case, a hung parliament is the most probable outcome, urging political parties to form post-election alliances that could differ significantly from the pre-election ones.

Spain: Positive economic momentum remained intact in Q3 2017; limited effects of Catalonia crisis thus far

Improving labor market conditions support private consumption



Limited impact of Catalonia crisis on Spanish economy thus far



Source: Eurostat, Markit, European Commission, Eurobank Economic Research

Latest Economic Developments

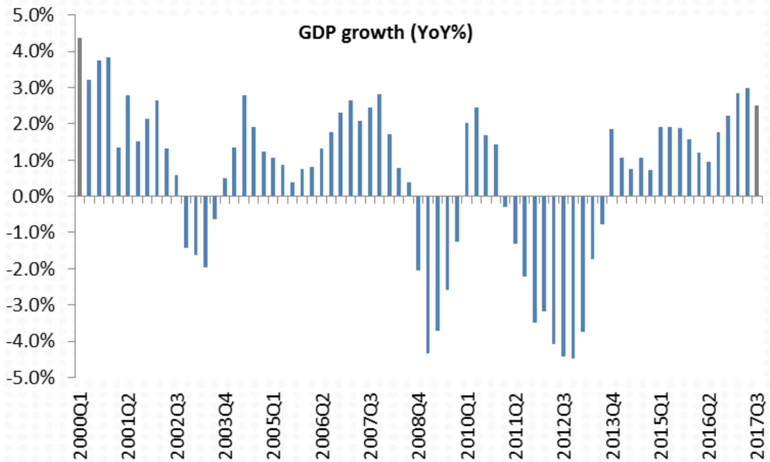
Spain's positive economic momentum remained intact in Q3 2017 with real GDP growing by 0.8%QoQ, slightly below 0.9%QoQ in the prior quarter that was the strongest since Q3 2015. Though the expenditure breakdown is not yet available, private consumption is expected to have been the main growth driver supported by ultra-loose monetary conditions, elevated consumer sentiment and an ongoing improvement in labor market conditions. Employment grew by 0.8%QoQ in Q2 2017, the strongest pace over the last three quarters while the unemployment rate remained on a steady declining trend in September for the 45th straight month coming in at 16.7%, 9.6ppts lower from the July 2013 peak. With respect to the Catalonia crisis, although it is too early to assess the economic implications, the impact has proved limited thus far. Indicatively, economic sentiment improved in November for the 4th consecutive month rising to 110.8, the highest since early 2001. On the flipside, although still above the boom-or-bust level of 50.0, the Markit PMI composite output index dropped from 56.4 in September to 55.1 in October, the lowest in the last nine months. The October drop was entirely driven by an ease in the Markit services PMI partly attributed to uncertainty surrounding the Catalonia crisis. However, in a sign that Catalonia remains a threat for the Spanish economy, Minister of Economy Luis De Guindos said earlier this month that in 2108 the economy is now expected to grow by 2.3% quantifying the potential impact of the crisis at between 0.4ppts and 0.5ppts under "conservative" assumptions (i.e. the crisis to be of short duration).

Catalonia crisis: Risks of prolonged uncertainty

Since the call for early elections in Catalonia on December 21st, opinion polls indicate that pro-independence and pro-unity parties are neck to neck, suggesting risks of a parliament with a thin MP majority for pro-independence parties. Such a scenario would imply risks of prolonged uncertainty with potential negative repercussions on the Spanish economy. Catalonia accounts for about 20% of Spain's GDP while protracted uncertainty could weigh on market sentiment as well as tourism, one of the key drivers of the Spanish economy.

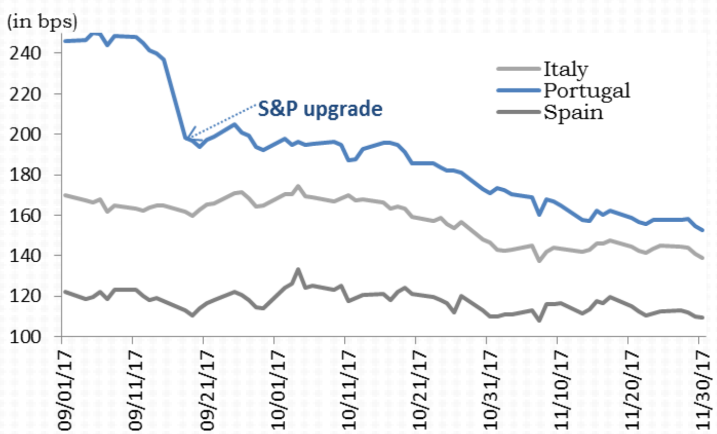
Portugal: The economy continues to grow at a solid pace but significant vulnerabilities prevail

Portugal on a steady recovery path



Portugal among main outperformers in EMU sovereign space

(EMU 10-yr yield spread vs. their German counterpart)



Source: Ameco, Bloomberg, Eurobank Economic Research

Latest Economic Developments

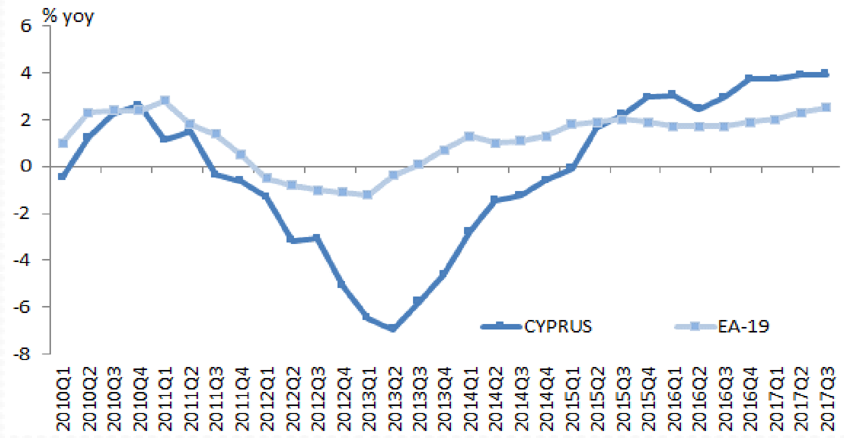
According to a flash estimate, Portugal grew by 0.5%QoQ in Q3 2017, up from 0.3%QoQ in the prior quarter with faster growth in private consumption and an improved performance in net exports expecting to have been the main growth drivers. In annual terms, Q3 GDP slowed to 2.5% from 3.0% in Q2 2017, albeit still the highest annual growth rate since 2000 for the period July-September. Meanwhile, labor market conditions continued to recover, supporting private consumption. Employment grew faster than GDP in H1 2017, particularly in construction and in services related to tourism while the unemployment rate came in at 8.5% in October, the lowest in 9½ years and unchanged from the prior month, having declined by 9ppts from the January 2013 peak. Reflecting the continuing buoyant moment for the Portuguese economy, economic sentiment improved further in November rising to 100.8, the highest since early 2000 mainly supported by a hefty increase in consumer confidence. Improving economic growth has helped Portugal to further narrow the government's budget deficit from 4.4%-of-GDP in 2015 to 2.0%-of-GDP in 2016, the lowest since democracy was restored in 1974, while expectations are for a further decline to 1.4%-of-GDP this year. In reaction to the above, S&P became the first rating agency to restore the investment grade status of the country's credit rating in mid-September while other agencies are likely to follow suit in the foreseeable future. The key date is the December 15th when Fitch is scheduled to review its credit rating for Portugal, currently at BB+ with positive outlook.

Portugal remains vulnerable to significant vulnerabilities medium-term

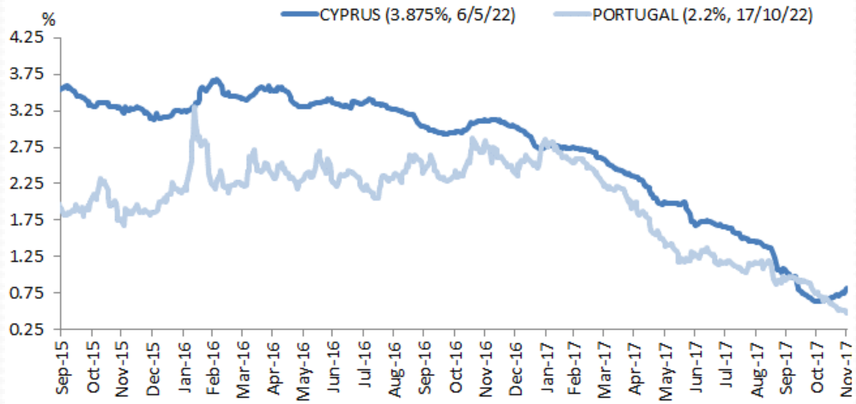
While Portugal is expected to remain on a recovery path in the coming quarters, downside risks prevail medium-term due to significant vulnerabilities. High public and private debt has made Portugal a key beneficiary of the ECB's highly accommodative monetary policy suggesting that the country could be hit hard when interest rates start moving higher. In addition, important challenges prevail for the banking sector. Although they have steadily declined in the last four consecutive quarters, NPLs are still among the highest in the euro area (15.5% of total loans in Q2 17).

Cyprus: Solid economic performance in Q3

Cyprus turn-around growth story has been impressive so far



Cypriot five year bond yields on a declining trend trading almost at par with those of Portugal



Source: Eurobank Research, National Authorities, Bloomberg

Latest Economic Developments

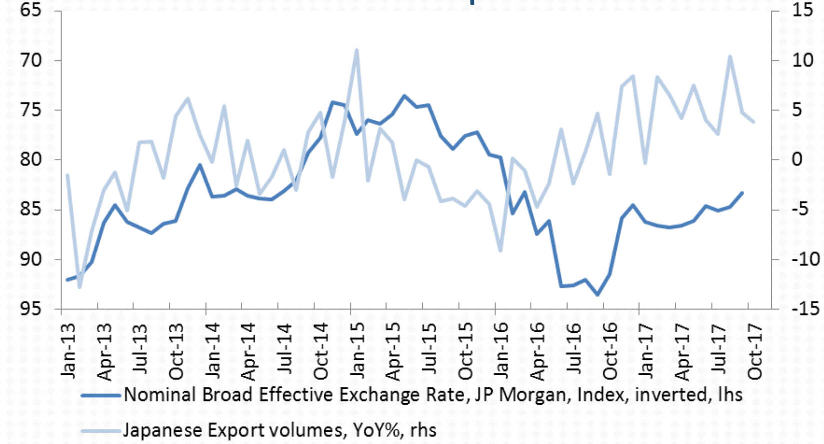
According to the flash estimate release, real GDP on an unadjusted basis expanded by 3.8% YoY in Q3-2017 bringing the year to date performance at 3.8% in 9M-2017. On a seasonally adjusted basis, growth expanded by 0.9% MoM/3.9% YoY in Q3-2017 compared to 1.0% QoQ/3.9% YoY in Q2-2017 and 0.7% QoQ/3.7% YoY in Q1-2017, up from 0.8% QoQ/2.9% YoY in Q3-2016. The GDP growth rate of Q3 is among the second highest in EA-19 and the fifth highest in EU-28 and, for an eighth consecutive quarter in a row, above that of EA-19. The consumption rebound has most probably continued in Q3 driven by sustained sentiment improvement, a flourishing tourism sector, improved labor market conditions, further property market stabilization, the impact from the fiscal relaxation, and the further normalization of banking sector conditions. During 2015 and 2016 the Cypriot economy expanded much faster than previously perceived, with the Statistical Service revising the GDP growth rate up to 2.0% and 3.0% respectively. As a result, the level of GDP in 2016 stood only 5% below that in 2011 and is expected to surpass the level of 2008 by the end of 2018 under the assumption of real GDP growth averaging 3.5% YoY in 2017-2018.

Risks & Challenges

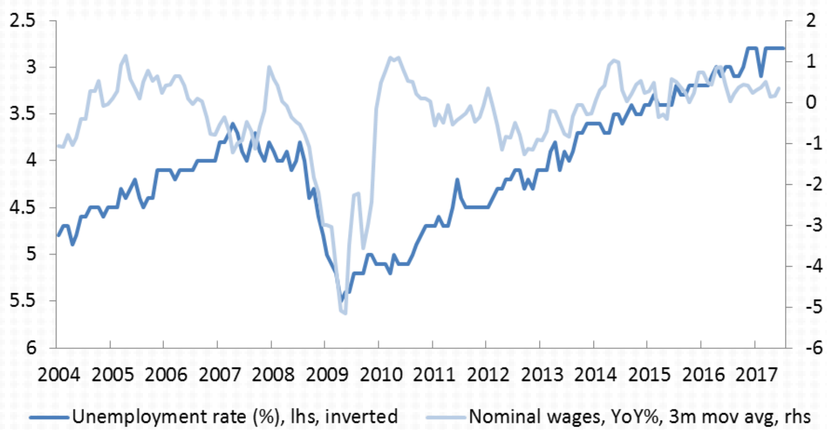
On the domestic front, the reform momentum seems to have stalled ahead of the Presidential elections in 2018. Still, a handful of unfinished structural reforms need to progress in the areas of privatizations, public and health sectors, while addressing the challenges of a still high bad loans stock (NPEs ratio at 45% in June2017). According to the Central Bank monitoring statistics, banks were lagging behind their restructuring targets in Q1-2017. In late November, Moody's didn't update the sovereign rating of Cyprus leaving it unchanged. Currently, the distance from investment grade status is: one notch for S&P (currently at BB+), two notches for Fitch (currently at BB) and three for Moody's (currently at Ba3).

Japan: firm growth supported by both domestic and external demand

External demand on an upward trend



Tight labor market and rising wages support consumption



Source: Ministry of Internal Affairs & Communications, Ministry of Health, Labour and Welfare, Bloomberg, Eurobank Economic Research

Latest Economic Developments

Real GDP in Japan recorded positive growth for the seventh straight quarter in July-September 2017, the longest improving streak in 16 years, with both domestic and external demand being on an upward trend. Consumption remains well supported by a very tight labor market and rising wage pressure, while capex capitalizes on record profits and capacity constraints. Although high frequency data suggest that exports to the US could slow somewhat towards year end, total Japanese exports should probably continue to strengthen amid strong exports to Asia, particularly China.

Central Bank Watch

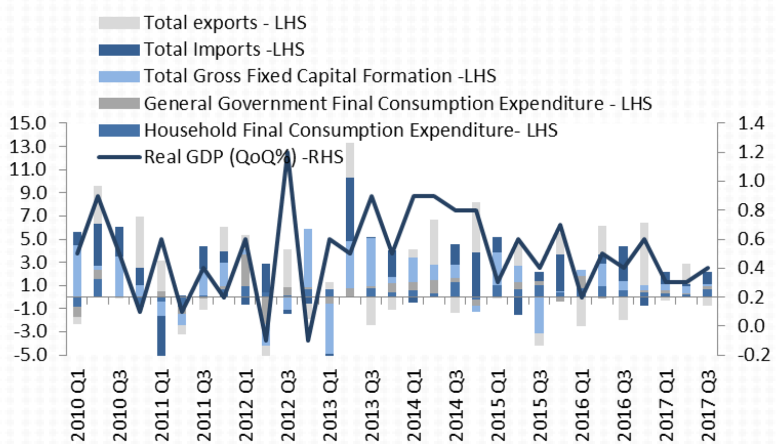
As recently stressed by BoJ Governor Haruhiko Kuroda, while there is evidently marked improvement in domestic economic activity, as in Europe and the US, inflation remains noticeably weaker than in both these major economies. Hence, the BoJ sees no need to think through any concrete steps toward an exit strategy. Said that, we share the view that the path to interest rate normalization is still a long way off given Mr. Kuroda's declaration that domestic inflation rates are considered by far the most important aspect in terms of Japan's monetary policy stance. Although there is a good chance the BoJ to begin normalizing interest rates before inflation reaches its 2% target so as not to fall behind the curve, in our view, inflation rate should at least stabilize above 1.0% in order to justify such normalization. Consequently, it would be rather difficult for the Central Bank to raise interest rates before 2019, although the BoJ's annual purchase amount of JGBs should be gradually reduced.

Risks

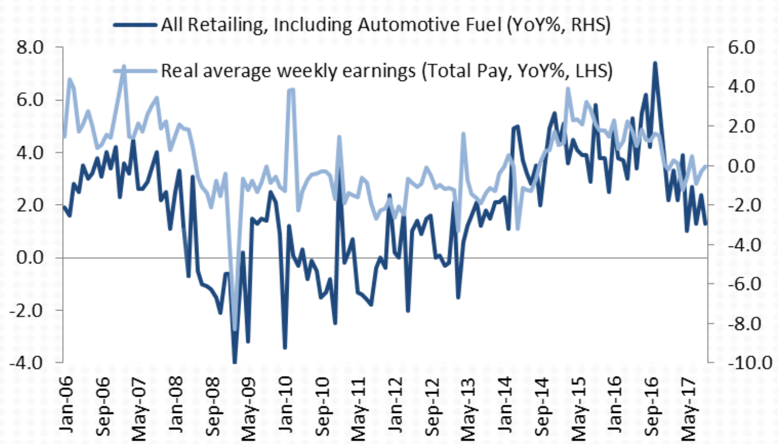
Risks have become more balanced on an improved global economic outlook. On the domestic front, deteriorating terms of trade due to an accelerated increase in commodities or JPY depreciation could weigh on the corporate sector-led economic recovery. On the external environment, geopolitical tensions may entail negative investor sentiment effects and repercussions on trade and investment dynamics.

UK: GDP growth likely to remain subdued as Brexit-related uncertainty takes a toll on economic activity

UK GDP growth & expenditure components (QoQ%)



Negative real wage growth weighs on retail sales



Source: ONS, Eurobank Economic Research

Latest Economic Developments

According to the 2nd estimate, UK real GDP growth for Q3 2017 was confirmed at 0.4%QoQ from 0.3%QoQ in Q2 2017 with the annual rate coming at 1.5%, unchanged from the prior quarter and the slowest since Q2 2012. Investment grew by 0.2%QoQ, the weakest since Q4 2015 while net trade weighed on growth with total imports rising by 1.1%QoQ and total exports dropping by 0.7%QoQ in spite of the GBP's recent weakness. Growth was driven by private consumption which grew by the fastest pace in a year of 0.6%QoQ helped by a recovery in car sales which were hurt in the prior quarter after a tax increase. But the overshoot in consumption is likely to prove short-lived with retail sales volumes declining by 0.3%YoY in October, the biggest fall in 4½ years as real wage growth (total pay) remained in negative territory for the third consecutive month.

Central Bank Watch

As expected, the BoE decided to raise the Bank Rate by 25bps to 0.50% at the November policy meeting, the first hike in over a decade, making clear that the need for tighter monetary policy was the result of reduced productive capacity of the economy. However, the BoE explicitly noted that future rate tightening "would be expected to be at a gradual pace and to a limited extent" mainly due to considerable risks to the growth outlook largely stemming from Brexit negotiations. That said, with Brexit-related uncertainty continuing to dominate the UK growth outlook, another rate hike is unlikely any time soon as the BoE awaits more clarity on Brexit negotiations.

Brexit update

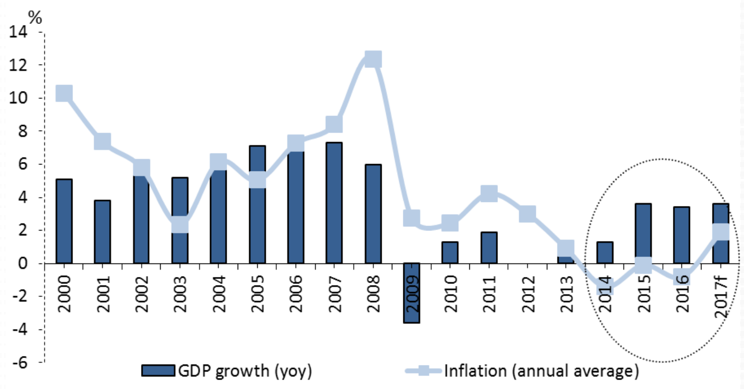
The UK and the EU are reportedly close to an agreement on the Brexit divorce bill. The latter has raised hopes that, although negotiations on the remaining two issues (Irish border and rights of EU citizens in the UK) remain challenging, the EU Council will likely come to the conclusion at its Dec14-15 meeting that sufficient progress has been achieved on the withdrawal agreement and Brexit negotiations could move on to the next phase related to a future EU/UK relationship and transitional arrangements.

III. Selected CESEE economies

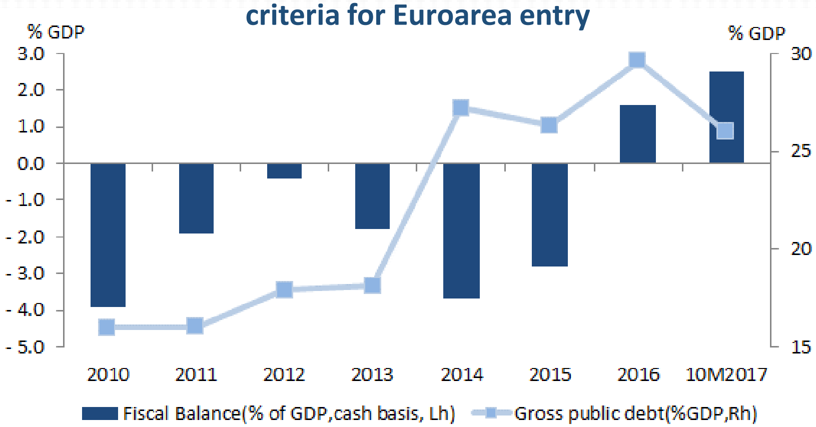
- Bulgaria
- Romania
- Serbia

Bulgaria: Strong GDP growth in Q3

Growth dynamics are set to remain strong in 2017



Bulgaria's fiscal position is sound and fulfills the nominal criteria for Euroarea entry



Source: Eurobank Research, National Authorities

Latest Economic Developments

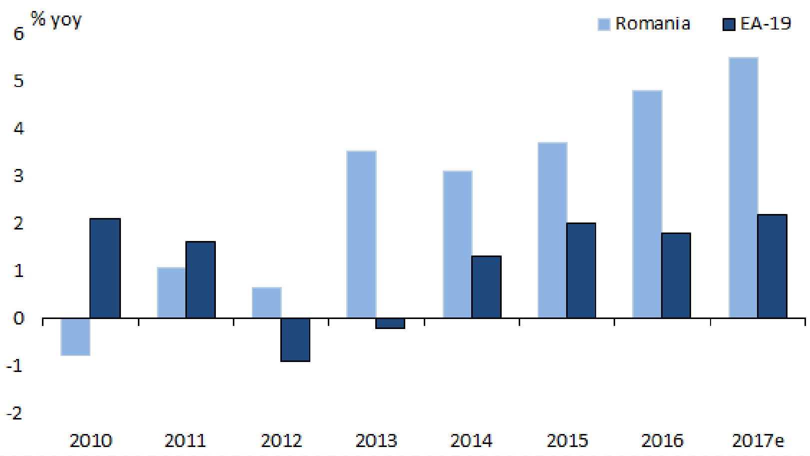
Real GDP expanded by 0.9% QoQ/3.9% YoY in Q3 compared to 1.0% QoQ/3.7% YoY in Q2. Final consumption expanded by 1.1% QoQ/4.6% YoY in Q3 vs. 0.5% QoQ/3.8% YoY in Q2. Final consumption received support from sustained labor market improvement coupled with still high real wage growth, a more expansionary fiscal stance, accelerating credit activity and increased tourism revenues in Q3. The unemployment rate declined further down to 6.1% in Q3-2017, the lowest level since Q1-2009. Real wage growth dynamics accelerated to 8.6% YoY in Q3 vs. 7.6% YoY in Q2. Credit to the non-government sector accelerated to 4.9% YoY in Q3 vs. only 1.5% YoY in 2016, compared to -1.2% YoY in 2015 and -8.2% YoY in 2014. In addition, the net travel services surplus had reached 3.8% of GDP in 9M up from 1.1% in H1. In contrast, investments were in the black on an annual basis in Q3 after five consecutive quarters (GFCF: -0.5% QoQ/+2.3% in Q3 vs. QoQ/-1.0% YoY in Q2). The rise mirrors partial progress in infrastructure spending implementation after the transition period of the caretaker government plus the low EU funds absorption in the two-year period after the closing of the programming period 2007-2013. Finally, net exports had a negative contribution in Q3 (Exports: +4.4% YoY & Imports: +6.5%) driven by the strong imports rise in response to private consumption dynamics.

Risks & Challenges

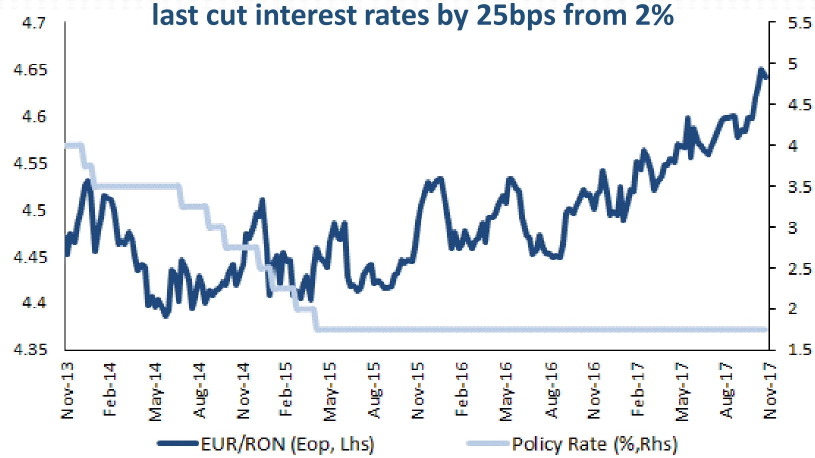
Currently, Bulgaria fulfills most of the nominal convergence criteria for Euroarea entry. On the other hand, real convergence criteria are not satisfied, although officially these are not part of the evaluation procedure. The living standards are the lowest in EU-28, productivity is equally the lowest in EU-28. The country is still subject to the Co-operation and Verification mechanism, which was set up in 2007 to monitor progress in the fields of judicial reform, corruption and organized crime. Even after accounting for the fast GDP growth trajectory in 2015-2018, GDP per capita in PPS terms will have only climbed to 50% by the end of 2018.

Romania: Record GDP growth in Q3

Romania has been growing faster than EA-19 in 2013-2017



NBR has been on hold in the KPR since May 2015 when it last cut interest rates by 25bps from 2%



Source: Eurobank Research, National Authorities, Bloomberg

Latest Economic Developments

Real GDP skyrocketed to 2.6% MoM/8.6% YoY in Q3-2017 bringing the 9M performance at 7.0% YoY compared to 4.8% in 2016, surpassing the most optimistic forecasts. Growth is largely driven by private consumption, financed by an overly expansionary fiscal policy, and leads to a revival of macroeconomic imbalances. (CAD17e: -3% of GDP)

Central Bank Watch

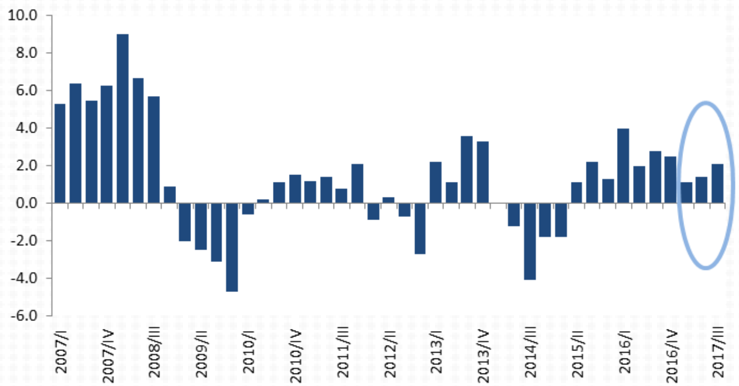
Inflation accelerated to 2.6% YoY in October entering further within the band of NBR's target interval (2.5%+1%). The adjusted Core CPI climbed further to 1.95% YoY in October the highest level since November2013. Given the projected inflation trajectory and the elevated fiscal risks, NBR was inclined to narrow further the standing facilities corridor from ±125bps to ±100bps in a step towards policy normalization instead of the KPR, which currently stands at 1.75%. More importantly, NBR changed its rhetoric on the issue of liquidity management pledging to ensure firm liquidity conditions in the banking system" instead of "adequate liquidity management" previously. The rhetoric change and the Governor's hints for more FX flexibility in the press-conference have increased the market pressure on the domestic currency.

Risks & Challenges

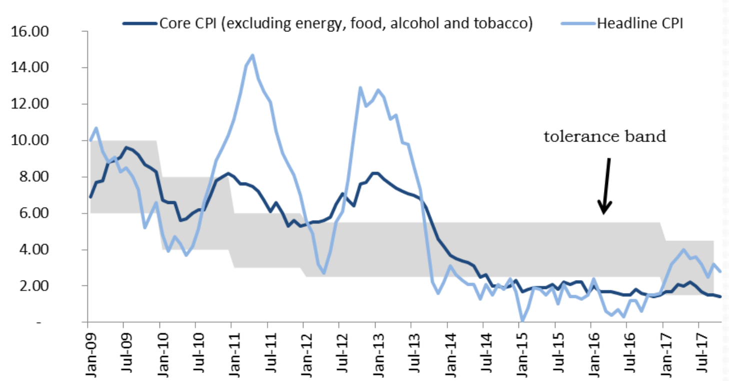
Romania failed to take effective action to correct its significant deviation from the adjustment path towards the medium-term budgetary objective. The EU Council had issued recommendation of an annual structural adjustment of 0.5% of GDP to Romania under the Significant Deviation Procedure (SDP) in last June. As a result, the EU Commission has upwardly revised the previous annual structural adjustment estimate to at least 0.8% of GDP. On the positive side, in an assessment of last year's developments, the EU Commission report identifies no macroeconomic imbalances in Romania, so that it does not deem necessary to prepare IDRs for the country.

Serbia: Fiscal consolidation continues unabated

Economic activity picks up pace in Q3 after a temporary slowdown in H1 2017



Inflation expected to remain within target band; MPC held fire in November after two surprise rate cuts



Source: Eurobank Research, National Authorities

Latest Economic & Political Developments

Following a slowdown to 1.2%YoY in H1 2017, that primarily came on the back of adverse weather conditions, real GDP growth picked up pace in Q3 coming in at 2.1%YoY. The breakdown of the data showed that the annual pace of increase in investments accelerated to its highest reading in a year (+6.2%YoY), providing the highest contribution to economic activity. A similar input was provided by private consumption. Meanwhile, and inventories provided a comparably smaller, albeit positive contribution, and exports' growth remained robust (+11.4%YoY), thought their net contribution remained negative in view of strong growth in imports (+10.7%YoY). From the production side, the agricultural sector continued to contract as the negative impact from the summer drought continued to weigh. Taking into account that a further acceleration is anticipated in economic activity in Q4 2017, as the underlying growth trend remains strong, and that growth averaged 1.6%YoY in Q3, the full year reading is likely to come in around the 2% area. Higher growth of ca. 3.0% is likely in 2018 thanks to robust investment activity, and a further improvement in private consumption.

Central Bank Watch

Following two unexpected interest rate cuts over the two prior months, the NBS Executive Board kept the key policy rate at a new lifetime low of 3.50% in November, as economic activity regained some momentum in Q3. The Central Bank reiterated, during the meeting as well as in its updated Inflation Report, that it expects annual inflation to remain within the target tolerance band of 3.0%±1.5 ppts until the end of the forecasted period. Our baseline scenario remains for stable interest rates for December's MPC meeting as well as for next year as economic activity recovers further and external risks linger.

Risks

Possible delays in the implementation of reforms and lack of a new IMF policy anchor as current deal expires in 2018. Domestic political jitters amid speculation for another snap election. Major Central Banks' policies.

IV. Eurobank Macro Forecasts

Eurobank Macro Forecasts

	GDP (YoY%)			CPI (YoY%)			Current Account (% of GDP)			General Budget Balance (% of GDP)		
	2016	2017	2018	2016	2017	2018	2016	2017	2018	2016	2017	2018
World	3.2	3.6	3.7	2.8	3.1	3.3						
USA	1.5	2.5	2.3	1.3	2.1	2.1	-2.4	-2.4	-2.6	-4.4	-4.3	-3.8
Eurozone	1.8	2.2	2.0	0.2	1.5	1.4	3.5	3.0	3.0	-1.5	-1.1	-0.9
Germany	1.9	2.2	2.1	0.4	1.7	1.5	8.4	7.8	7.5	0.8	0.9	1.0
France	1.2	1.6	1.7	0.3	1.1	1.2	-1.2	-3.0	-2.8	-3.4	-3.0	-3.0
Periphery												
Cyprus	3.0	3.5	3.1	-1.2	1.0	1.5	-4.9	-5.4	-6.2	0.5	1.1	1.4
Greece	-0.2	1.5	2.3	0.0	1.1	1.0	-1.1	-0.2	0.4	0.5	-1.2	0.9
Italy	0.9	1.5	1.3	-0.1	1.4	1.2	2.7	2.5	2.5	-2.5	-2.1	-1.8
Portugal	1.6	2.6	2.1	0.7	1.5	1.4	0.7	0.1	0.2	-2.0	-1.4	-1.4
Spain	3.3	3.1	2.3	-0.4	2.0	1.4	1.9	1.7	1.9	-4.5	-3.1	-2.4
UK	1.8	1.5	1.3	0.7	2.7	2.5	-4.4	-3.6	-3.3	-2.9	-2.9	-2.3
Japan	1.0	1.5	1.2	-0.1	0.4	0.8	3.8	3.9	4.0	-5.7	-4.3	-3.8
Emerging Economies												
BRIC												
Brazil	-3.6	0.7	1.5	8.7	3.7	4.0	-1.3	-1.4	-1.8	-9.0	-9.2	-9.3
China	6.7	6.8	6.5	2.0	1.8	2.4	1.8	1.4	1.2	-3.7	-3.7	-3.7
India	7.1	6.7	7.4	4.5	3.8	4.9	-0.7	-1.4	-1.5	-6.6	-6.4	-6.2
Russia	-0.2	1.8	1.6	7.1	4.2	3.9	2.0	2.8	3.2	-3.7	-2.1	-1.5
CESEE												
Bulgaria	3.9	3.8	3.5	-0.8	1.6	1.5	5.3	4.0	3.0	1.6	0.0	-1.0
Romania	4.6	5.5	4.4	-1.6	1.4	3.3	-2.1	-3.0	-2.9	-2.4	-3.0	-4.4
Serbia	2.8	2.0	3.0	1.1	3.0	3.0	-4.0	-4.0	-3.9	-1.2	0.5	-0.6
Turkey	3.2	5.2	3.5	7.8	10.9	9.4	-3.8	-4.6	-4.6	-2.3	-3.2	-2.4

Eurobank Fixed Income Forecasts

	2017		2018		
	Current	**December**	**March**	**June**	**September**
USA					
Fed Funds Rate	1.00-1.25%	1.25-1.50%	1.25-1.50%	1.50-1.75%	1.50-1.75%
1 m Libor	1.36%	1.44%	1.62%	1.70%	1.77%
3m Libor	1.48%	1.52%	1.72%	1.87%	1.96%
2yr Notes	1.77%	1.76%	1.85%	1.90%	1.94%
10 yr Bonds	2.39%	2.35%	2.39%	2.45%	2.50%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.33%	-0.33%	-0.32%	-0.31%	-0.29%
2yr Bunds	-0.69%	-0.67%	-0.65%	-0.62%	-0.55%
10yr Bunds	0.37%	0.40%	0.47%	0.53%	0.60%
UK					
Repo Rate	0.50%	0.50%	0.50%	0.75%	0.75%
3m	0.52%	0.60%	0.73%	0.82%	0.90%
10-yr Gilt	1.34%	1.35%	1.40%	1.45%	1.50%
Switzerland					
3m Libor Target	-0.75%	-0.75%	-0.75%	-0.70%	-0.65%
10-yr Bond	-0.14%	-0.08%	-0.05%	-0.03%	0.00%

Source: Bloomberg (market implied forecasts)

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