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

January 2018

Contributing Authors:
Olga Kosma, Research Economist
Paraskevi Petropoulou, Senior Economist
Ioannis Gkionis, Senior Economist
Galatia Phoka, Research Economist

The authors of this report would like to thank Costas Katsileros, Maria Katrantzi and Konstantinos Theodoropoulos, from Eurobank Global Markets, for their invaluable input to this report.

I. Snapshot

Overview

Macro Picture

- **USA:** Higher external demand and the recent overhaul of the US tax code boosts 2018 real GDP growth
- **EA:** Well above potential growth in 2018 despite EUR appreciation
- **UK:** Growth outlook highly dependent on the evolution of Brexit talks
- **Japan:** Longest expansionary period since 1999/2001
- **EM:** Growth to pick up modestly in 2018. Heavy political calendar and tightening of monetary conditions globally pose key risks
- **CESEE**: Promising growth prospects in 2018

Policy Outlook

- **USA:** At least three rate hikes of 25bps in 2018
- **EA:** QE likely to end in September 2018. Possible adjustment in ECB's forward guidance in March, but no rate hike before Q1 2019
- **Japan:** Reappointment of Kuroda. BoJ on hold amid subdued inflationary pressures, but net QQE purchases to slow
- **UK:** Lingering Brexit uncertainty likely to hinder further BoE rate tightening any time soon
- **CESEE:** Limited room for more supportive monetary and fiscal policies in 2018

Summary

Broad-based global recovery set to continue, leaving scope for a gradual withdrawal of monetary accommodation from a number of G10 CBs, even though inflation pressures still appear to be muted. Meanwhile, US administration appears to be shifting towards a more protectionist trade policy as a tool to rein in external imbalances

Markets

- **FX:** USD weakness the main theme of the month, as the world's reserve currency lost some of its status on diversification fears and a bulging US deficit
- **Government bonds:** US and EU rates aggressively higher with 10-yr yields breaching 2.70% and 0.70%, respectively, as global monetary tightening and improved growth momentum are picking up
- **EM:** The sharp decline in USD, despite the sharp increase in DM rates, helped the EM credit spreads to tighten as the asset class keeps recording significant inflows
- **Credit:** ECB remains the big player in IG EU credit. US and EU IG credit recorded negative total returns despite spread tightening. HY spreads mixed, but total returns positive despite rates move. EU HY struggling with outflows

Key Risks

- **Global trade war:** US imposition of tariffs and other trade barriers fuels global trade war with material negative repercussions to the world economy
- **Sharper than expected slowdown in China:** The housing market is heading for a hard landing and deleveraging measures in SOEs weigh heavily on investment growth
- **Faster than expected rise in inflation/wage growth:** Faster monetary policy tightening, leading to slower economic growth
- **Renewed political jitters:** Euro-sceptic Five Star Movement secures parliamentary majority in March general election; UK/EU fail to agree on a transitional Brexit deal in March; US Democrats gain control of one or both chambers in mid-term elections

Macro Views

Eurobank

Latest Macroeconomic Developments & Outlook

World Economic Outlook		Global economic activity accelerated in 2017 to its highest pace of growth in 6 years at 3.7% from 3.2% in 2016. Looking ahead, global recovery is set to continue in 2018, with real GDP growth gaining further momentum to 3.9% helped by easy financial conditions and more expansionary fiscal policy. The strength in global growth is expected to be broad-based across advanced and EMs, except for China, where structural reforms are set to lead to a mild real GDP growth deceleration. In advanced economies, the recent overhaul of the US tax code will likely boost US GDP growth, while Eurozone is expected to continue growing above potential on the back of a supportive monetary and fiscal mix and solid global momentum.
Developed Economies	**US**	We revised our US GDP growth estimate for 2018 up to 2.6% from 2.3% previously, on the back of a higher projected positive contribution from net trade and the expected macroeconomic impact of the tax reform. The latter is expected to add about 0.5bps to real GDP growth in 2018, while the IMF estimates that US real GDP will be 1.2% higher by 2020 compared to a no-tax policy reform scenario.
	Euro Area	High frequency data continue surprising on the upside. After rising to its fastest pace of 2.4% in a decade in 2017, real GDP growth is expected to accelerate marginally to 2.5% in 2018, albeit still above potential, on the back of a supportive monetary and fiscal mix and solid global momentum.
	Periphery	The positive economic momentum in the majority of periphery euro area economies remains intact mainly supported by robust private consumption. Spain has been among the top performers with 2017 GDP growth remaining above the euro area average for the fourth year in a row. However, given the ongoing stalemate regarding the formation of a government in Catalonia, risks of a renewed escalation of the crisis with negative effects on Spain's GDP growth, continue to exist.
	Japan	Japan experiences its longest expansionary phase since 2001. Our 2018 growth forecast has been revised slightly upward to 1.3% from 1.2% previously, reflecting the 2018 supplementary budget and carryover from stronger-than-previously-expected real economic activity in 2017.
Emerging Economies	**BRICS**	Growth of 6.9% in 2017 in China is the highest since 2015, marking the 1st acceleration since 2010 from 6.7% in 2016, above the government's 6.5% target. A slowdown to 6.6% is expected this year on domestic policy tightening. In Russia, 2018 growth is seen at similar levels to last year, amid higher consumer demand and spending due to the World Cup. Presidential elections in March don't appear to pose significant risks. Brazil returned to positive growth in 2017 after a 2-year contraction. The recovery is expected to gain further momentum this year on low inflation and monetary policy easing. Amid slow fiscal consolidation progress S&P downgraded in January Brazil's ratings to BB-. October's election is a key risk. Economic activity in India slowed to 7.1% in 2017 from 8.2% in 2016, due to GST and demonetization. Growth seen picking up pace in 2018 as their impact wanes.
	CESEE	High frequency data and the prospective national accounts releases of Q4-2017 are about to confirm that the economies of the region may have had the best year in the post-Lehman brothers period in FY2017. Even though the economies are about to or have already passed their cyclical peak, the growth prospects for 2018 look promising as well. Boosting investments is essential for the medium-term growth prospects of the region.

Global Macro Themes & Implications

Theme	Implications
Global recovery set to gain further momentum in 2018, supported by still accommodative monetary policy and more expansionary fiscal policy	Global economic activity accelerated in 2017 to its highest pace of growth in 6 years at 3.7% from 3.2% in 2016. Looking ahead, global recovery is set to continue in 2018, with real GDP growth gaining further momentum to 3.9% helped by a revival in global business investment. The strength in global growth is expected to be broad-based across advanced and emerging economies, except for China, where structural reforms are set to lead to a mild real GDP growth deceleration to 6.6% in 2018 from 6.9% in 2017. The recent overhaul of the US tax code will likely stimulate domestic economic activity adding about 0.5bps to real GDP growth in 2018, as corporate income tax cuts make a positive contribution to business investment growth. In the euro area, with the majority of both hard and survey data continuing to exceed market expectations, real GDP growth is expected to accelerate marginally to 2.5% in 2018 from 2.4% in 2017, on the back of a supportive monetary and fiscal mix and solid global momentum.
Modestly hawkish tilt to the January FOMC policy statement	The overall tone of the FOMC policy statement issued following the conclusion of the January 30-31 monetary policy meeting -the first since tax reform was passed in late 2017- was perceived as modestly hawkish, triggering an upward shift in short-term rate tightening expectations. The FOMC appeared more confident on the US growth outlook, characterizing recent gains in employment, household spending and business fixed investment as "solid". The committee also upgraded its language on inflation, noting that market-based measures of inflation compensation "have increased in recent months" and inflation is expected "to move up this year" on an annual basis . In addition, the FOMC said explicitly that "economic conditions will evolve in a manner that will warrant *further* gradual increases in the federal funds rate", giving the impression that last year's pace of rate tightening (i.e. three rate hikes) will continue. In response to the aforementioned, the Fed funds futures are now assigning almost fully a 25bps rate hike at the mid-March meeting and nearly three hikes by the end of 2018, compared to two hikes before the January FOMC meeting.
Gradual monetary policy normalization process by major central banks	Amid expectations for continuing expansion of the global economy in 2018, there seems to be scope for a gradual withdrawal of accommodative monetary policy by a number of G10 CBs, even though inflation pressures remain muted. With respect to the ECB, despite continued reinvestments of maturing securities for the next couple of years, it is likely to end its APP in September 2018, provided that the euro area remains on a recovery path and inflation shows clear signs of a sustainable upward trend since then. It is also likely for the ECB to adjust its forward guidance in Q2 18, after the release of the updated staff projections in March, perhaps removing the asymmetry to QE guidance, provided that economic indicators continue to surprise on the upside. In Japan, although we do not envisage any withdrawal of its current accommodative policy stance in the foreseeable future given subdued underlying price pressures, the BoJ's JGB purchases have slowed significantly (to JPY58trn in 2017 from around JPY80trn in 2016) since the introduction of Quantitative and Qualitative Easing (QQE) with Yield Curve Control (YCC) in September 2016. Last but not least, barring any negative surprises from Brexit talks/domestic political developments, the prospect of the BoE raising interest rates in the coming months cannot be ruled out entirely should the economy continue to grow above potential.

Global Macro Themes & Implications

Theme	Implications
US administration appears to be shifting towards a more protectionist trade policy	After signing the "Tax Cuts and Jobs Act" into law in late December, the US administration appears to be shifting towards a more protectionist trade policy as a tool to rein on external imbalances. Moving from tough talk to action, US President Donald Trump, announced tariffs of up to 50% on imported washing machines for the next three yeas and of up to 30% on solar cells for the next four years. According to media reports, the US administration is also expected to make a decision on steel and aluminum tariffs and/or quotas within the next three months, while another decision on possible intellectual property action against Chinese high-tech sectors is also pending. Undoubtedly, one-sided imposition of tariffs and other trade barriers by the US risks fueling a trade war, with material negative repercussions to the global economy. Both China and South Korea objected strongly to US anti-dumping action, with the latter warning that it intends to reinstate levies on imported US products.
Reduced odds for a "hard" cliff edge Brexit …	Reducing the odds of a "hard", cliff edge Brexit, the European Council concluded at its mid-December meeting that sufficient progress had been made on the withdrawal agreement and talks could move on to the next phase related to a transition period and the terms of the future EU/UK economic relationship. Subsequently, the EU27 released detailed negotiation guidelines for the transition talks in late January envisioning, among others, a 21-month duration of the transition period up to December 31, 2020 and UK obeisance with all existing EU regulations and budgetary arrangements while the country maintains all benefits of EU membership. Talks on the transition period are due to formally start in early February, with the objective of reaching an agreement in principle at the March 22/23 European Council. The latter marks a EU precondition for discussions moving forward to the terms of the long-term relationship, tentatively scheduled to run from March to October in order to allow time for parliamentary ratification by March 2019.
… but UK PM Theresa May's handling of Brexit raises talk of leadership challenge	While the terms for a transition period seem comparably uncontroversial, the main concern is the future EU/UK relationship. Whereas the EU is scheduled to publish draft guidelines on that issue at the March European Council, the UK government has yet to formulate a clear position due to disagreements within the Conservative Party. Indeed, recent news flow suggest that a number of Brexit-backing Conservatives MPs have grown disillusioned with PM Theresa May's handling of Brexit, insisting that she appears to be shifting towards a "softer" form of Brexit. As per the same sources, the likelihood of UK PM Theresa May facing soon a leadership challenge is not negligible, even though recent polls discourage a party rebellion amid fears of a change in government. Undoubtedly, such a development would risk significant negative economic costs for the UK as a number of firms could rush to trigger contingency plans by then. According to recent surveys, up to 60% of British businesses will trigger Brexit contingency plans by March 2018 if no transition period has been agreed by then.

Macro Themes & Implications in CESEE

Theme	Implications
Growth prospects for the broader CESEE region look promising in 2018	High frequency data and the prospective national accounts releases of Q4-2017 are about to confirm that the economies of region may have had the best year in the post-Lehman brothers period in FY2017. Even though, economies are about to or have already passed their cyclical peak, growth prospects still look very promising for most of the economies in the broad CESEE region.
Private spending revival will most likely extend in 2018	Private consumption is expected to make a key-yet smaller than last year-contribution to GDP growth as real disposable incomes are expected to continue rising at a lower rate than last year speed reflecting further labor market tightening, loose financial conditions, sustained consumer sentiment gains. A favorable external environment is going to allow those small open economies maintain their net exports contribution in check next year despite the uptick on the imports side.
Investments performance is key to a more balanced growth path in the medium term	The rise of investments is crucial for the regional medium term growth prospects. In order for this to happen, private sector will need to invest more to increase their production capacity given that utilization rates are already at comparably high levels. EU funds absorption, which has failed to impress in the past year for a number of reasons, is expected to accelerate providing a boost to public investments. The most obvious shortage of investments is evidenced in infrastructure bottlenecks. Despite some progress, the region still scores relatively low in infrastructure rankings.
Limited room for more supportive economic policies 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 in 2018. 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 have remained well supported since the beginning of 2018. The sovereign yield curve bear steepened with a short end rates rising 7bps and long term rates 11 bps. The Bulgarian Ministry of finance issued for the first time ever BGN 100mn worth of 25 year bonds, maturing in 2043. Despite interest from both prime dealers and institutional investors, the Ministry rejected all bids. • Underperforming the local-currency sovereign debt, Eurobonds have come under pressure so far this year, with yields moving significantly higher on the back of rising developed market yields. Nine and ten year yields rose by 18bps and 15bps, respectively in January. All in all, we prefer to remain neutral on Bulgarian credit as spreads appear tight and valuations remain stretched.
Serbia	• The Serbian dinar has remained relatively stable since the start of 2018, with the EUR/RSD range bound within 118.15-118.90, despite risks of depreciation skewed to the upside. This RSD resilience comes on the back of a number of National Bank of Serbia (NBS) interventions aimed at mitigating FX volatility. With the NBS resolute to mitigate depreciation pressures on the currency below a certain level, many market participants changed their bearish view on the dinar. Interventions took place when the EUR/RSD moved towards the upper bound of the aforementioned range. Looking ahead, the potential for dinar depreciation this year appears limited. To the contrary, a lot of arguments support the case for a firmer currency going forward; namely, strengthening economic recovery, steadily improving tax collection, robust FDI and favorable euro area growth. Credit expansion will likely continue as banks have significantly reduced bad loans from their portfolios over the last few years, while demand for Serbia's government debt was confirmed strong early in 2018. That said, risks to the dinar's performance do exist ahead. Major Central Bank policies are central; most importantly, the ECB's policy path. Serbia's budget is still heavily burdened by subsides earmarked towards unprofitable SOEs. Re-emergence of political and geo-political uncertainties also pose risks, with the Kosovo issue remaining in the spotlight. Overall though, the balance of risks appears skewed towards dinar appreciation, at least in H1 18. In H2 18, the aforementioned improving fundamentals as well as potential for the inception of a monetary tightening cycle by the NBS - as inflation pressures build up in tandem with strengthening domestic demand – are also likely to provide support to the domestic currency.

The Trader's View

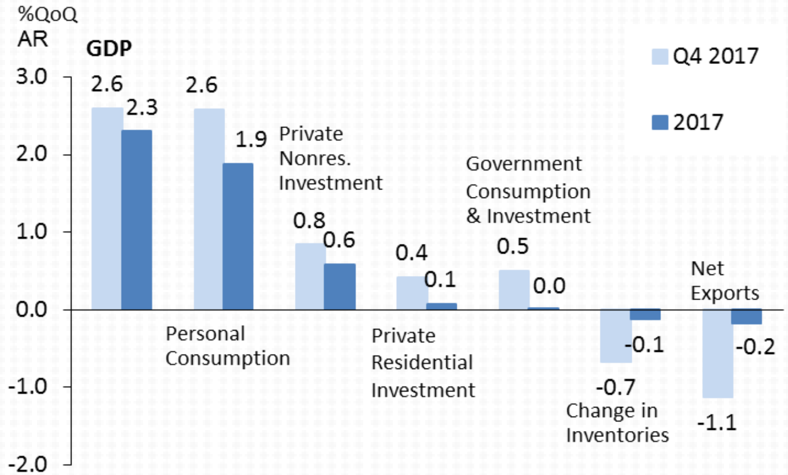
Asset Class	Outlook
Foreign Exchange	**EUR/USD**: USD weakness has been the main theme for 2018 on the back of the flattening of the US yield curve, lack of attractive returns in US assets promoting diversification in other markets, as well as the US government's large twin deficits coming into focus. A hawkish ECB saw the pair push to 1.2534 before paring some of the gains on expectations of Fed normalization and a pickup in US inflation, hovering around 1.25 at the time of writing where it should find strong resistance. **USD/JPY**: JPY strength has accompanied USD weakness on bullish investor sentiment and expectations the BoJ should normalize policy faster than market participants' expectations. The pair's strong correlation with the direction of UST yields seems to be slowly breaking as fundamentals start to take over. 108 remains very strong support. **GBP/USD**: rallied strongly in January on the back of general USD weakness and optimism over a soft Brexit. Renewed political uncertainty saw the pair retrace some of its recent gains. Tory rebels have reportedly triggered a fresh leadership challenge, while Tory donors are also reported to be increasing pressure on PM May to resign once she has negotiated an outline trade deal this autumn. Sterling spec longs are at their highest since Aug14, so there's plenty of room for a slide. 1.41 to 1.43 provide strong resistance and selling opportunity.
Government Bonds	**US:** The US 10y real yield has risen to 60bp, the highest point since July 2017, driven largely by the sell-off in nominal bonds as investors consider global monetary tightening, improved growth momentum and the pick up in oil prices. The US 10y yield broke above 2.70%, reaching the highest level since Apr14, a time before the BoJ expanded its monthly QE purchases and well before the ECB had even started. Next stop 2.81% and 2.94%. The aggressive flattening of the yield curve has slowed, with some room to see term premium repricing as inflation expectations rise. **EU:** No change from the ECB to its forward guidance or QE easing bias. Draghi left the door open to a potential extension of QE beyond Sep18, stating there are "very few chances" of rate hikes this year. However his more upbeat assessment of the state of the EZ economy and limited push-back against the market's pricing of rate hikes beyond 2018 despite EUR strength, resulted in an aggressive selloff with the Bund reaching 70bps. Heavy long positioning in the belly, in anticipation of a dovish press conference, likely also exacerbated the move with steepening in 2s/5s and 2s/10s. Long term rates remained range bound leading to a significant flattening in 5-30s (-25bps).
EM hard currency debt	EM external debt remained in good shape, with inflows continuing unabated, as the synchronized global growth and improved fundamentals provide good support for risk sentiment. January was a very strong month in terms of new issuance with investor demand remaining solid. Excess returns were good but total returns mixed to negative due to the strong sell off in developed market rates. USD weakness and the consequent increase in commodity prices as well as the US and EU rates moves remain a key focus for EM investors. Idiosyncratic risks have subsided, with market focusing on laggards in spread tightening. Increased rates volatility could be the trigger for a correction in the space but it is expected to be bought aggressively. We are cautious given the popularity of the long EM trade.
Corporate credit	In Europe, IG spreads tightened on the back of moderate new issuance that was well absorbed and was dominated by financials, in particular Non Preferred Seniors. Total returns though were negative on both sides of the Atlantic as the large sell off in rates could not be absorbed by spread tightening. Corporate hybrids, CoCos and AT1s had a stellar performance but valuations are rich post this month's rally. The ECB CSPP remains the major supportive factor for EU corporate credit as tapering has been focused on the PSPP. There was big divergence in the IG/HY relationship between EU and US as the former continued to decompress, while the latter remained stable. We are negative on credit spreads and favor the <10y USD IG space after the sell off in front end US rates.

II. Advanced Economies

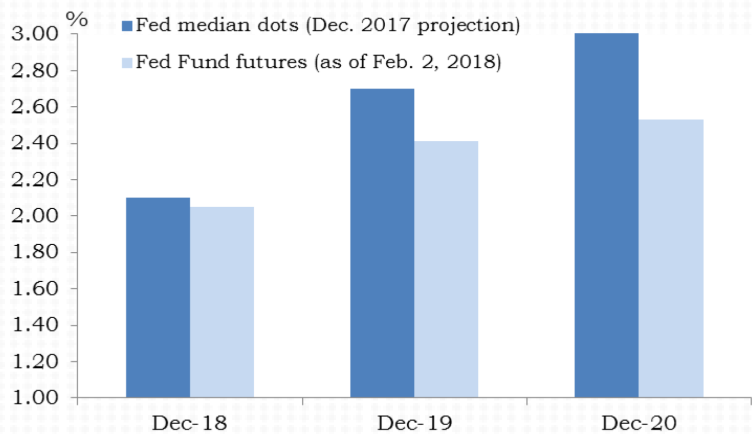
- USA
- Euro Area
    - ❖ Periphery (Italy, Spain, Portugal, Cyprus)
- Japan
- UK

USA: Upward revision for 2018 GDP growth on higher external demand and tax reform positive impact

Contribution to US real GDP growth



Fed fund futures currently assign three hikes of 25bps by Dec 2018 compared to two hikes before the January FOMC meeting



Source: Bloomberg, Federal Reserve, Eurobank Economic Research

Latest Economic Developments

According to the BEA's advance estimate of Q4 GDP, the US economy expanded by a robust 2.6%QoQ saar, with domestic demand finishing the year on a high note following a 4.3%QoQ saar increase in final sales to domestic purchasers (GDP less trade and inventories), the fastest growth in about three years. Net trade subtracted from overall growth amid strong imports growth, given the robust pace of domestic activity and a rising trend in consumer sentiment. Our US GDP growth for 2018 has been revised up to 2.6% from 2.3%, on the back of a higher projected positive contribution from net trade and the expected macroeconomic impact of the tax reform bill (~+0.5pp).The IMF estimates a 1.2% higher US real GDP by 2020 compared to a no-tax policy reform scenario.

Central Bank Watch

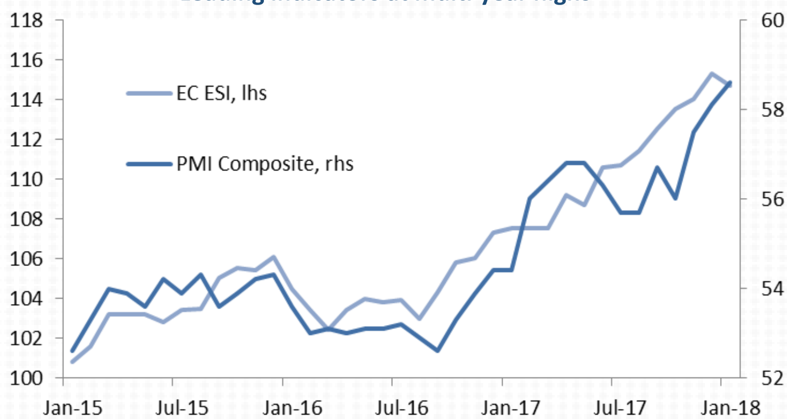
In line with market expectations, the FOMC kept the fed funds target range unchanged at 1.25-1.50% at its January meeting, with the accompanying statement having a slightly more hawkish tone compared that in the previous meeting. Recent gains in employment, household spending and business fixed investment were described as "solid", acknowledging that market measures of inflation had "increased in recent months". Importantly, the statement dropped the phrase about inflation "remaining somewhat below 2.0% in the near term", saying that it is expected "to move up this year". Markets currently assign almost fully a March 25bps hike and nearly three hikes by year end compared to two just before the Jan FOMC meeting. The interest rate hike cycle in 2018 will be largely dependent on the underlying trend rate of inflation, with at least two more hikes likely coming in June, Sep or Dec meetings accompanied with updated projections and a press conference.

Risks

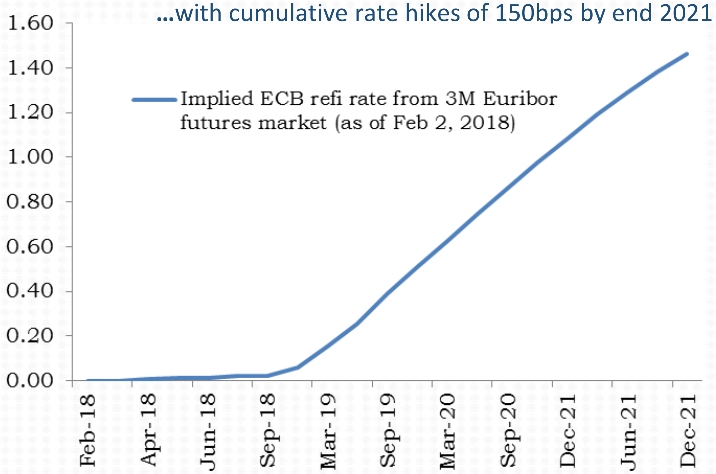
A more protectionist stance in US trade policy that could weigh on global trade and cross-border investment flows constitutes one of the biggest risks in 2018. Regarding fiscal tax policy changes, the response of investment could be more modest than currently assumed, resulting in slower-than-expected US growth.

Euro area: Stronger-than-expected growth despite EUR appreciation

Leading indicators at multi year highs



ECB refi rate increase no earlier than March 2019 …
…with cumulative rate hikes of 150bps by end 2021



Source: Eurostat, Bloomberg, Eurobank Economic Research

Latest Economic Developments

Euro area flash Q4 17 GDP increased by 0.6%QoQ from 0.7%QoQ in Q3, with the breakdown for major economies suggesting that growth was broad-based. High frequency data continue surprising on the upside, with both the EC's ESI and the composite PMI currently standing at their highest level in about 8 years. Rising to its fastest pace in a decade in 2017 (2.4%), real GDP growth is expected to accelerate marginally to 2.5% in 2018, on the back of a supportive monetary and fiscal mix and solid global momentum amid a revival in global capex.

Central Bank Watch

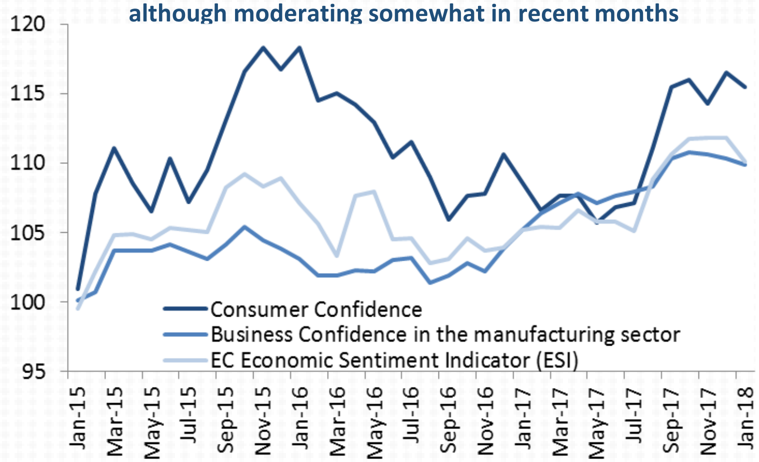
As widely expected, the ECB maintained key policy rates unchanged and its asymmetry to QE guidance intact, reiterating that it would be ready to increase the size/duration of the APP should the inflation outlook become less favorable. It also kept its forward guidance on rates, with President Draghi emphasizing that, given the current state of the economy, there are "very few chances at all" of a rate rise this year. He also revealed that the GC would need to have a discussion concerning the end of the QE, monitoring three options when the current QE programme expires at the end of Sep 2018: i)sudden stop; ii)extension; or iii)gradual taper. Although continuing reinvestments of maturing securities until 2020, it is likely for the ECB to end its APP in Sep, provided that the euro area remains on a recovery path and inflation shows clear signs of a sustainable upward trend since then. It is also likely for the ECB to adjust its forward guidance in Q2 18, after the release of the updated staff projections in March, perhaps removing the asymmetry to QE guidance, provided that economic indicators continue surprising on the upside. We don't envisage a rate hike before Q1 19 amid persistently subdued inflationary pressures.

Risks

Europe's political calendar in 2018 remains busy, with Brexit negotiations, government formation in Germany and the Italian election taking centre stage. Meanwhile, a stronger EUR and/or higher long-term interest rates could act as a drag on economic growth and pose downside risks to the euro area's economic outlook.

Italy: Political uncertainty ahead of the 4 March general election

Business and consumer surveys at historical highs, although moderating somewhat in recent months



Policy uncertainty on the rise ahead of the 4 March general election

Source: ISTAT, Bloomberg, www.policyuncertainty.com, Eurobank Economic Research

Latest Economic Developments

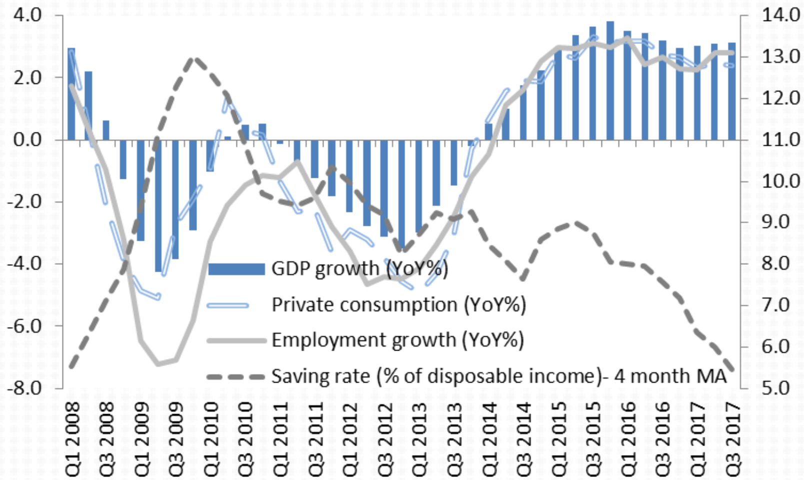
Recent economic indicators suggest that the economic recovery remained relatively firm in Q4 17, with both business and consumer surveys trending upward. Private consumption has benefited from improved labor market conditions, while business fixed investment has capitalized on increased firms' profitability and rising business confidence. Furthermore, exports have continued to accelerate since late 2015 on the back of a favorable external environment among Italy's main trading partners. Real GDP is expected to increase by about 0.4%QoQ in Q4, thus maintaining the same pace of expansion as in Q3 which was the strongest print since the beginning of 2011. Overall, real GDP is projected at 1.6% in 2017, before decelerating to 1.4% in 2018 as the lagged effect of the stronger EUR takes a toll on overall growth.

General Elections on 4 March 2018 on the spotlight

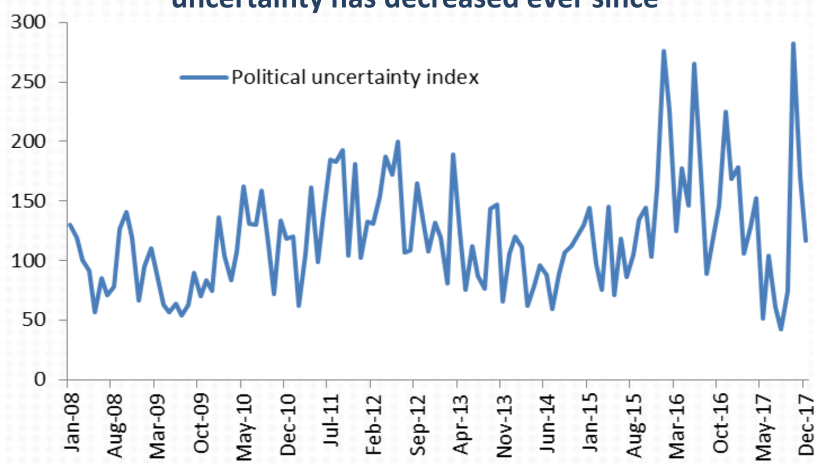
General elections will be held on March 4, under the new voting system which will be applied to both the Lower House and the Senate; 64% of seats to be allocated with a fully proportional system vs. 36% in first-past-the-post constituencies. There seems to be three main candidates: the centre-right coalition driven by *Forza Italia* and former PM Silvio Berlusconi, the anti-establishment *Five Star Movement (5SM)* party led by Luigi Di Maio and the centre-left coalition led by Matteo Renzi of the Democratic Party (PD). In order to have a working government majority in both chambers of the parliament, one of the above mentioned coalitions should win about 40% of votes. The latest opinion polls indicate that the centre-right coalition is leading with about 37-38% of the vote, while an extended version including the newly created *Noi con l'Italia* party might be able to win elections and secure the necessary votes for appointing a government. The centre-left and the 5SM are running neck and neck, expecting to receive about 26-28% of the vote each. The post-election political landscape will be largely dependent on whether any of the three coalitions will be able to win majority in both chambers. Thus, political turmoil following March elections could generate uncertainty and financial instability, in case none of the three political blocs manages to gain control of both the Senate and the Lower House.

Spain: Economic expansion expected to continue in 2018, albeit at a slower pace; Catalan crisis remains a source of concern

Economic expansion expected to continue in 2018



After reaching a record high in October, political uncertainty has decreased ever since



Source: Eurostat, www.policyuncertainty.com, Eurobank Economic Research

Latest Economic Developments

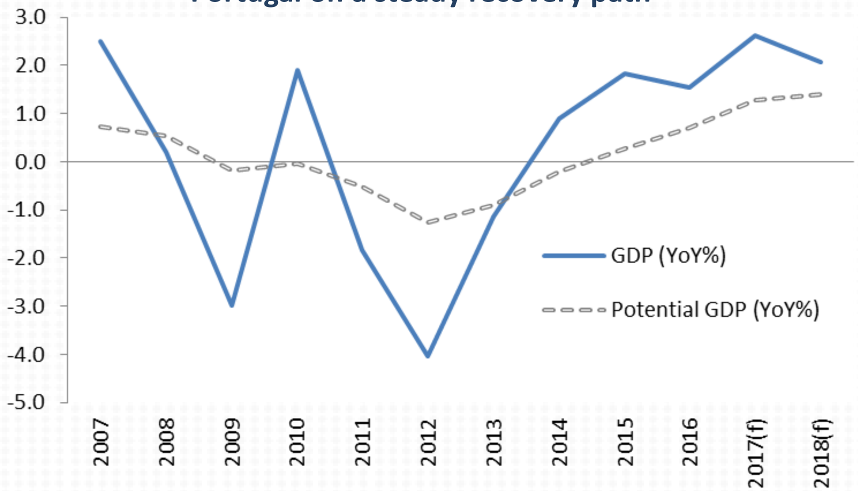
Spain's economic expansion is expected to continue in 2018, albeit at a slower pace. After three consecutive years of above 3.0% GDP growth, it is anticipated to decelerate to around 2.8% this year compared to 3.1%YoY in 2017, albeit still leaving Spain among the fastest growing euro area economies. Private consumption should remain the main driver but is expected to ease this year. Among others, employment growth is seen moderating after nearly 2mn employees were added to the labor force over the last three years, while higher oil prices could take a toll on household disposable income, especially in view of limited room for adjustment given the low savings rate. Investment, which benefits from buoyant external demand is expected to continue growing steadily while net exports are seen adding to the positive momentum as external demand offsets the drag from EUR appreciation.

Catalan Politics Update

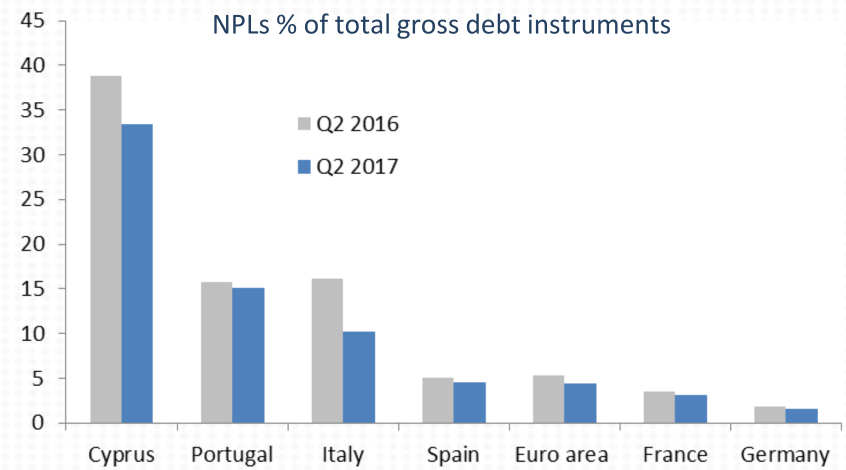
With respect to the political crisis in Catalonia, which accounts for about 20% of Spain's GDP, there is little evidence of a negative impact on the whole economy so far. Pro-independence parties secured an absolute majority at the December 21st regional elections and, according to the electoral law, the President has to be designated before February 8 in order for new elections to be avoided. The parliament of Catalonia formally proposed on January 22 the self-exiled and ousted former President, Carles Puigdemont, as the only candidate to form a new government. However, it is unclear whether he will manage to be reappointed, given certain legal obstacles. Puigdemont faces arrest if he comes back to Spain while, according to the chamber's book rule, the candidate should be physically present to read his investiture speech and ask for the confidence of the chamber. If Puigdemont or/and pro-independence parties (JxC, ERC, CUP) agree on an alternative candidate, political uncertainty could decrease. On the flipside, we might see a renewed escalation of uncertainty with a potentially larger than expected negative impact on Spain's GDP growth. Thanks to relatively strong economic recovery and "limited" economic impact from the Catalan crisis thus far, Spain returned to the A rating bucket for the first time since the eurozone debt crisis after Fitch upgraded in mid-January its sovereign credit rating by one notch to A-.

Portugal: Economic activity expected to continue recovering but significant vulnerabilities prevail medium-term

Portugal on a steady recovery path



NPLs decreasing but still at relatively high levels



Source: Ameco, ECB, Eurobank Economic Research

Latest Economic Developments

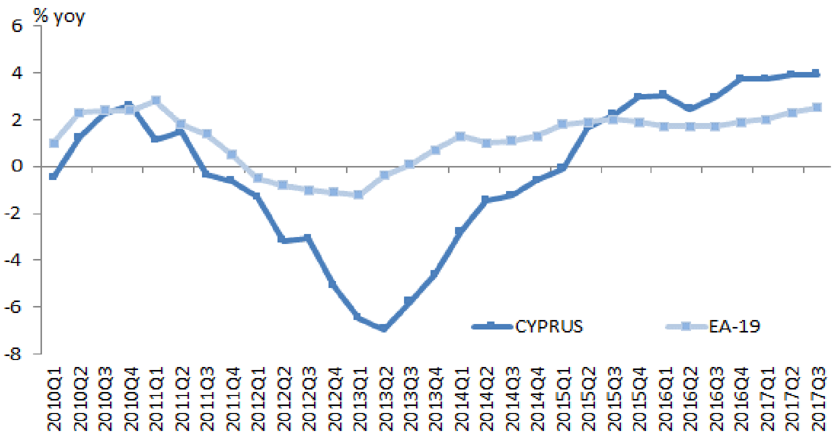
Available data for the final quarter of 2017 suggests that the economy ended the year on an upbeat tone with growth likely to expand by 2.5% for the year, the highest in a decade, rising from 1.5% in 2016. Private consumption was among the main growth drivers on the back of a further improvement in labor market conditions (unemployment rate at a nine-year low of 9.0% in 2017 from 11.2% 2016) and a lower saving rate. Continuing solid growth helped Portugal to repay in late January 2018 the final and most expensive tranche of the IMF bailout loan granted under an EFSF 3-year financial assistance programme in 2011, marking the final loan payment, repaid with the least favourable conditions. Upcoming debt payments will be subject to significantly lower interest rates thanks to credit rating upgrades by S&P and Fitch last year that restored the nation's investment grade status. Looking ahead, Portugal is anticipated to remain on a recovery path in 2018, with growth averaging 2.1% supported by solid private consumption and external demand on the back of stronger global recovery and further expansion of tourism. Imports are also expected to increase due to higher domestic demand, but at a lower pace than exports. As such, the current account balance is likely to remain firmly in positive territory for the fifth year in a row.

Significant vulnerabilities pose medium-term risks on Portugal's economic recovery

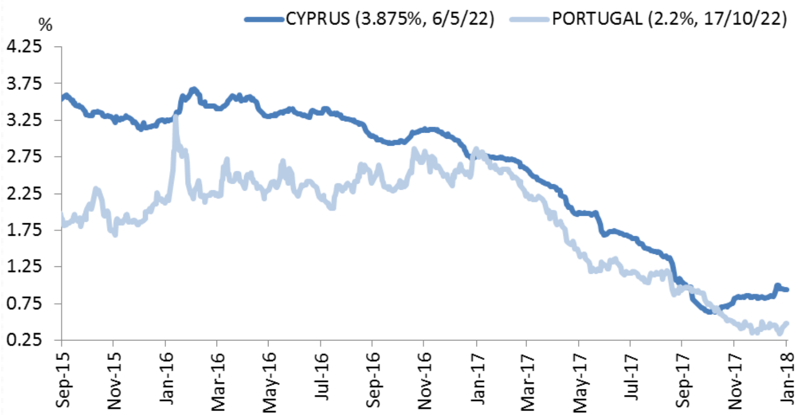
While the Portuguese economy is expected to continue recovering this year, significant vulnerabilities prevail over the medium-term. Despite improved fiscal prospects, government debt remained elevated in 2017 at c.130%-of-GDP, among the highest in the euro area, while private debt stood at c.190%-of-GDP, posing risks for adverse side effects on economic recovery. In addition, challenges still exist for the banking sector mainly due to weak asset quality, low profitability and contained capital buffers. Although they have steadily declined in the last four consecutive quarters, NPLs are still among the highest in the euro area (15.1% of total loans in Q2 17 from 15.8% in Q2 2016), impairing banks' capacity to finance the real economy.

Cyprus: Solid fiscal performance despite Presidential elections

Cyprus turn-around growth story has been impressive so far



Cypriot medium term bond yields trading above those of Portugal since mid-November



Source: Eurobank Research, National Authorities, Bloomberg

Latest Political & Economic Developments

As no candidate received 51% of the vote in the first round of the Presidential elections in Cyprus, a run-off election is going to be held on February 4th. The incumbent President Anastasiades, backed by the ruling right-wing DHSY, received 35.5% of the popular vote. The runner up, Stavros Mallas who was backed by left wing AKEL received 30.25% of the vote exceeding expectations. Nikolas Papadopoulos, whose candidacy received support from a coalition of centrist parties came third, receiving 25.75% of vote and was disqualified from the second round.

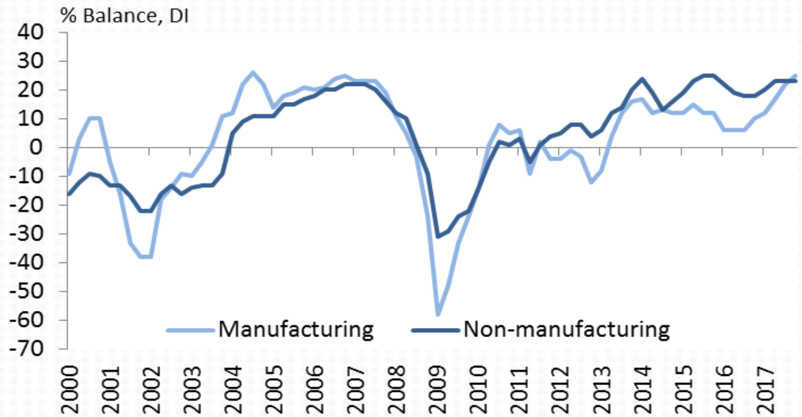
The 2017 budget execution has surpassed the most optimistic expectations for an election year. The general government recorded a surplus of 2.5% of GDP and a primary surplus of 4.9% of GDP in the first eleven months of the year. Taking into account an additional expenditure of 2% of GDP in the supplementary budget of the Ministry of Finance, the budget is still projected to end in a surplus above 1% of GDP in 2017, up from 0.4% of GDP in 2016 and a balanced position in 2015 (not including the Co-operatives capital injection). Next year’s budget plan targets a general government surplus of 1.3% of GDP and a primary surplus of 3.8% of GDP. The macroeconomic assumptions the budget is based on are within reach: GDP growth is forecasted at 3%, the annual average inflation at 1%, unemployment at 9.5%.

Risks & Challenges

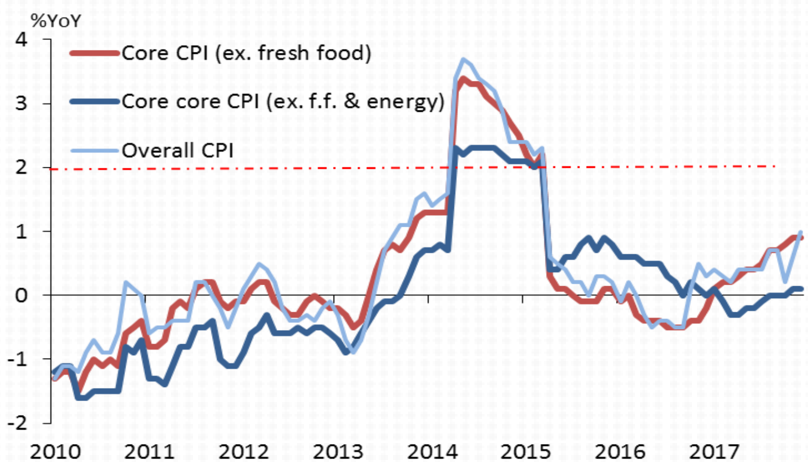
Given that no party enjoys absolute parliamentary majority, the new President will have to achieve concessions from other parties in the 56-seat parliament in order to pass legislation. This is not very reassuring given that there is a number of important pending structural reforms in the areas of privatizations, public and health sectors, while addressing the challenges of a still high bad loans stock (NPEs ratio at 44.2% in September 2017) in order to avoid backtracking on the economy.

Japan: Longest expansionary period since 1999/2001

Japan Tankan indices at historical highs



Inflation rate well below the BoJ's 2.0% target



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

Latest Economic Developments

The Japanese economy continued to expand for the seventh straight quarter in Q3 2017, the longest expansionary phase since 2001. Based on high frequency data, private consumption and business capex remained firm in Q4, while exports continue to be supported by the global synchronized upsurge. Our 2018 growth forecast for Japan has been revised upward slightly to 1.3% from 1.2% previously, reflecting the 2018 supplementary budget and carryover from stronger-than-previously-expected real economic activity in 2017.

Central Bank Watch

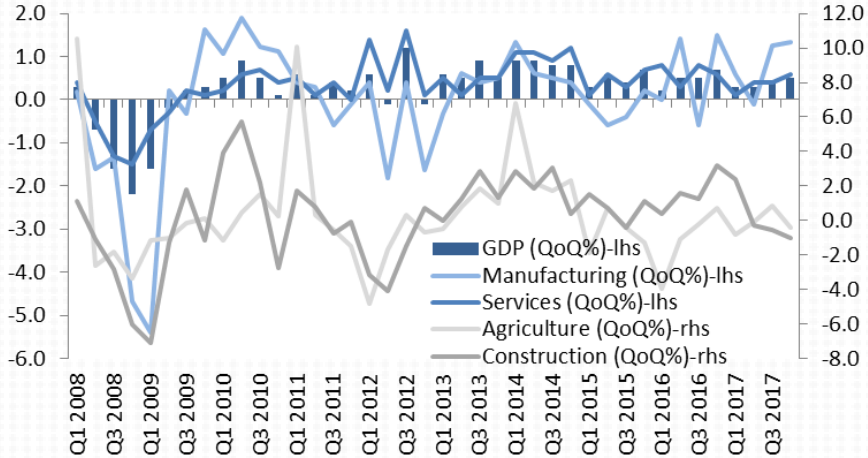
As widely expected, the Bank of Japan (BoJ) maintained its key balance rate unchanged at -0.1% at its January monetary policy meeting, while keeping the 10-yr JGB yield target at around 0.0%. As recently stressed by Governor Haruhiko Kuroda, the BoJ's marginal reduction in long-end JGBs purchases doesn't indicate an exit from its ultra accommodative monetary policy stance, and it is too early to discuss an exit given that inflation is still well below the 2.0% price stability target. Median forecasts for growth and core inflation were also left broadly unchanged from the BoJ's October economic outlook, with real GDP growth expected at 1.4% in FY2018 from 1.9% in FY2017 and core inflation at 1.4% in FY2018 from 0.8% in FY2017. In spite of the slowing pace of JGB purchases since the introduction of QQE with YCC, we do not envisage any withdrawal from its current accommodative policy stance anytime soon, given subdued underlying price pressures.

Risks

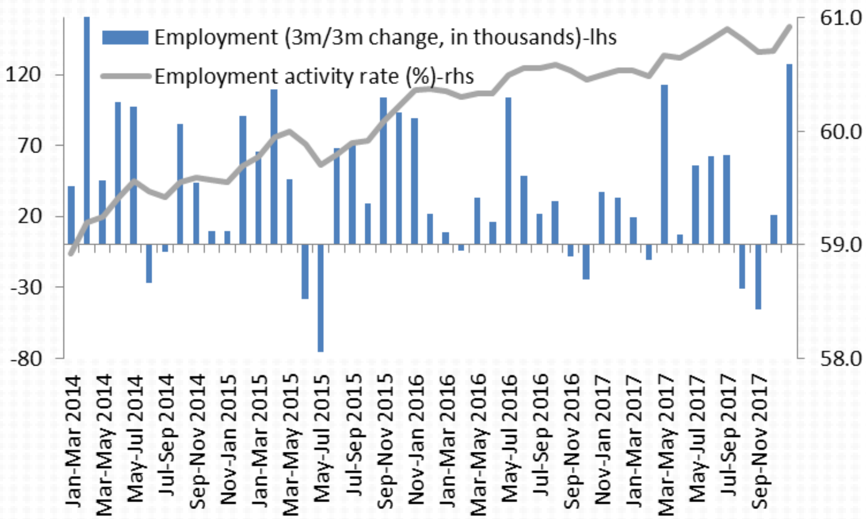
Geopolitical tensions, including the permanent conflict of North Korea with the US, could threaten Japan's trade links in East Asia, while a global shift towards a more protectionist stance could also pose a risk to the country's export sector. Elsewhere, a more pronounced than currently expected economic slowdown in China –an important destination for Japan's FDIs- could weigh on Japanese economic outlook.

UK: Growth outlook highly dependent on Brexit negotiations

UK GDP & main industry aggregates (QoQ%)



Labor market strengthens after slowing in recent months



Source: ONS, Eurobank Economic Research

Latest Economic Developments

According to the preliminary estimate calculated based on the output approach using around 45% of the data required for the final estimate, UK real GDP grew by a higher than expected 0.5%QoQ in Q4 2017, up from 0.4%QoQ in the prior quarter, albeit still below the 0.6-0.7%QoQ long-term average. Growth was driven by services and manufacturing, while construction contracted for the third quarter in a row. In 2017 as a whole, GDP grew by a higher than earlier expected 1.8% due to data revisions, the slowest since 2012 and a tad lower from 1.9% in the prior year. In 2018, risks are for a further slowdown, as Brexit related uncertainty is expected to continue to weigh on investment and real wage growth is anticipated to remain in a negative territory squeezing private consumption. Understandably, our forecast is surrounded by higher than usual uncertainty, as the UK GDP growth outlook is highly dependent on Brexit negotiations.

Central Bank Watch

The BoE raised the Bank Rate by 25bps to 0.50% in November and stated explicitly that further 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. With UK GDP growth expected to slow this year and both headline and core CPI inflation likely to fall slowly as the effect of the weaker GBP on prices starts to fade, our core scenario is for stable interest rates in the foreseeable future. However, with the latest labour data showing an upward movement in November's annual regular pay growth and an unexpected and significant increase in employment in the three months to November, the prospect of higher interest rates by end H1 2018 cannot be ruled out.

Brexit update

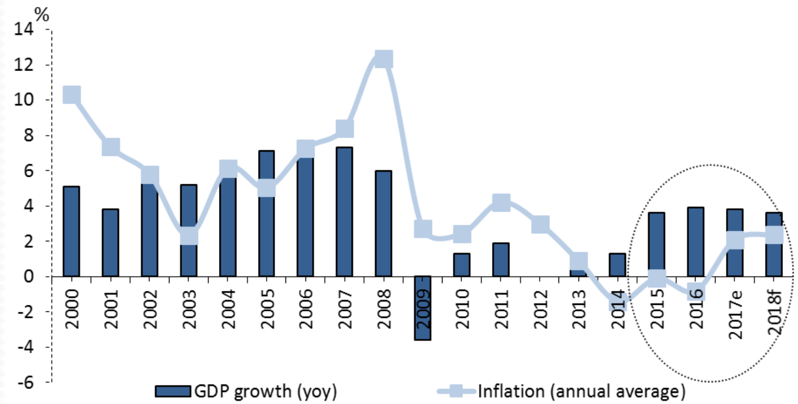
The EU Council concluded in mid-Dec that "sufficient" progress had been made on the withdrawal agreement and talks could move on to the next phase related to a transition period and the terms of the future EU/UK relationship, reducing the odds of a "hard", cliff edge Brexit. Relevant discussions are expected to start in early Feb, aiming a final deal to be sealed by October 2018 allowing time for parliamentary ratification by March 2019.

III. Selected CESEE economies

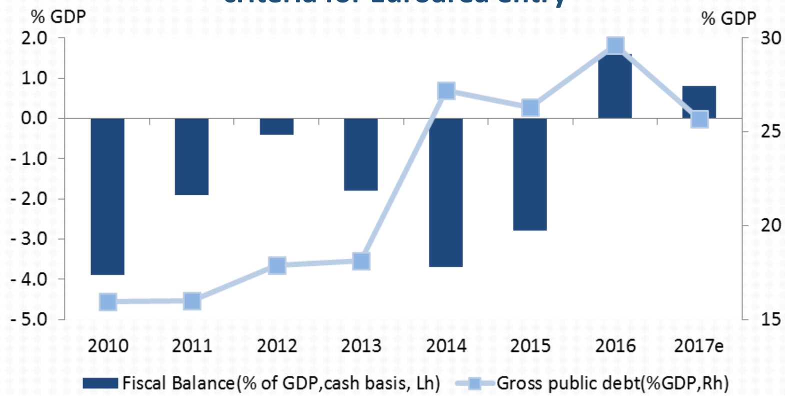
- Bulgaria
- Romania
- Serbia

Bulgaria: Investments performance will be key to a more balanced growth path in 2018

Growth dynamics are set to remain strong in 2018



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



Source: Eurobank Research, National Authorities

Latest Economic Developments

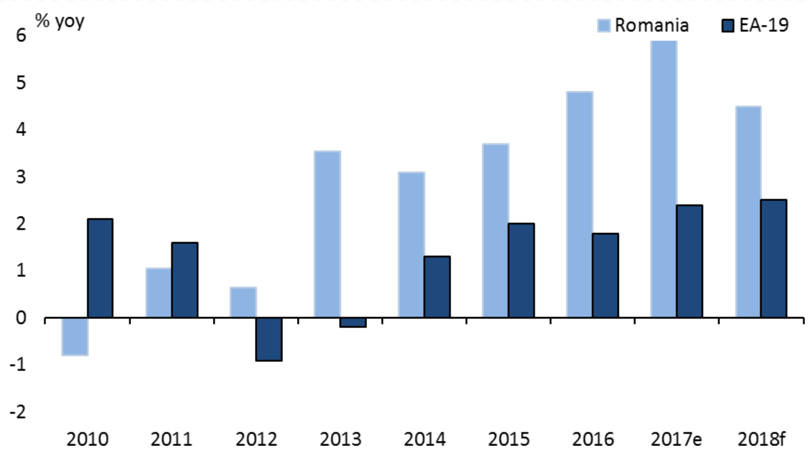
The improvement in the country's external position was rewarded by sovereign rating agencies in December. Fitch upgraded the long-term sovereign rating from BBB- to BBB with a stable outlook. S&P upgraded the long-term sovereign rating from BB+ to BBB- placing Bulgaria at the investment grade for the first time since December 2014. Having expanded by around 4% YoY in 2017, Bulgaria is now expected to register another year of strong-above potential-growth in 2018. The economy is expected to benefit from further labor market tightening, accelerating credit activity dynamics, a more expansionary fiscal policy stance, a vibrant export oriented manufacturing sector and an emerging tourism destination. The economy is operating at or close to full employment (the relevant % of companies reportedly confronted with labor scarcity in the EU survey has climbed to 40% in Q4 up from only 13% in Q4-2013). Fiscal policy is expected to be more growth-supportive provided that budget execution aligns with the 1% of GDP deficit target in 2018 vs. a 0.8% surplus in 2017. Credit to the non-government sector accelerated to 4.2% YoY last November vs. only 1.5% YoY in 2016. With capacity utilization standing at an all-time high, private companies will need to invest more in order to strengthen their productive capacity. Finally, investments are going to receive support from improved EU funds absorption.

Risks & Challenges

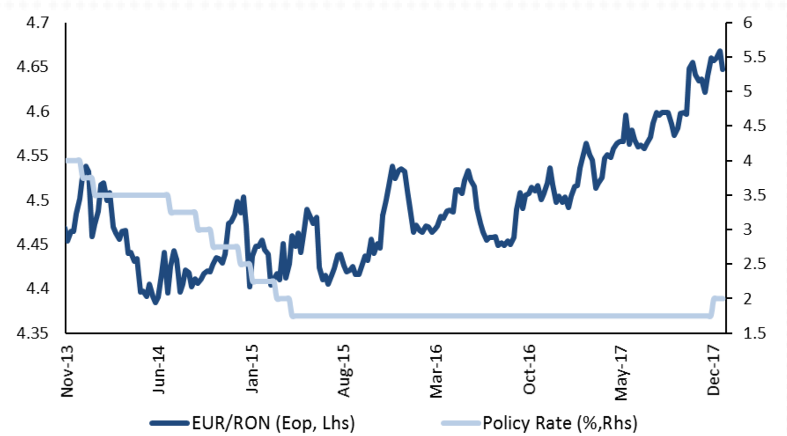
Currently, Bulgaria fulfills most of the nominal convergence criteria for Euroarea entry. On the other hand, real convergence criteria are not satisfied, although officially these are not part of the evaluation procedure. The living standards and productivity are the lowest in EU-28. The country is still 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. Factoring in the fast GDP growth trajectory in 2015-2018, GDP per capita in PPS terms will have only climbed to 50% in 2018.

Romania: Further monetary policy tightening in the pipeline

Romania has been growing faster than EA-19 in 2013-2018



NBR hiked the KPR by 25bps in January 2018



Source: Eurobank Research, National Authorities, Bloomberg

Latest Economic Developments

Consumer prices accelerated further to +3.3%YoY in December, driven by higher food prices on a monthly basis (+0.4% MoM/+4.1% YoY) up from 3.2%YoY in November close to the upper bound of the NBR's target interval (2.5+1%). The adjusted Core CPI (excluding administered and volatile prices, alcohol and tobacco) advanced further to 2.4% YoY in December, the highest level since August 2013. Supply-side factors such as the new regulated price increase for energy tariffs (as of January 2018) and the pass through from the upturn in oil prices globally, the rise in excise fuel duties in 2H-2017 plus the base effects from the phasing out of the VAT rate cut as of January this year are going to maintain inflationary pressures high above 3.5% in 1H-2018.

Central Bank Watch

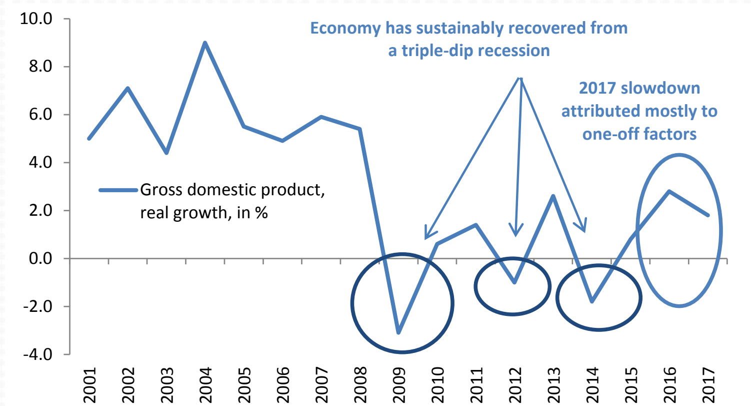
In January, NBR increased by 25bps the monetary policy rate to 2.00% for the first time in a decade. Given the elevated price pressures inflation is expected to overshoot the upper bound of the NBR interval for most of the year- we look for another 75-100bps on a cumulative basis delivered until the end of the year.

Risks & Challenges

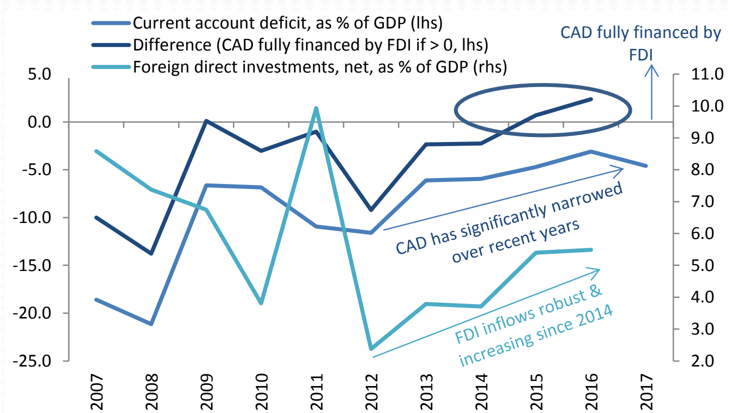
PM Mihai Tudose became the second executive, after Sorin Grindeanu, forced to resign following just a few months in office after the ruling Social Democrat Party (PSD) withdrew its support. The toppling of the previous two PMs came as a result of their personal conflicts with the PSD party leader. The latter has been refused an appointment in the PM post by President Iohannis because of his conviction over electoral fraud. Although the government coalition enjoys a safe parliamentary majority political instability persists. Viorica Dancila, the first woman PM in the history of Romania, will be confronted with tensions on critical issues such as the criminal justice reform and divergent views on fiscal policy.

Serbia: New IMF deal likely to be PCI

Economic activity has recovered from a triple-dip recession in 2009-2014



External imbalances have improved over recent years



Source: Eurobank Research, National Authorities

Latest Economic & Political Developments

Serbia's Q4 GDP growth vindicated expectations coming in at 2.5%YoY from 2.1%YoY in Q3, bringing the full-year reading to 1.8% vs. 2.8% in 2016. Last year's slowdown is mostly attributed to one-off factors, such as adverse weather conditions in H1 2017. Growth is expected to gain momentum towards 3% this year, with risks skewed to the upside, amid strengthening private consumption as well as robust exports and investments. However, rising imports - amid strengthening domestic demand - will likely neutralize net exports' positive input on economic activity. In other news, the 36-month €1.2bn IMF Stand-By Arrangement (SBA) expires in Feb. According to recent comments by FinMin Vujovic, a new arrangement will probably be agreed before the summer and likely entail the form of the non-financing Policy Coordination Instrument (PCI). Such a deal suggests continuation of reforms and provides a valuable policy anchor. The progress made under the current SBA has been significant, and acknowledged by rating agencies. Fitch and S&P were the last to upgrade Serbia's ratings in December.

Central Bank Watch

The Central Bank maintained the key policy rate at a 3.50% record low for the 3rd consecutive month in January vindicating expectations. The MPC reiterated that inflation (CPI at 3.0%YoY in Dec) will likely remain within the target band (3.0±1.5%) in the period ahead, adding that some weakening below the midpoint is to be evidenced in H1 2018 due to base effects, while increasing domestic demand will act in the opposite direction. We anticipate the MPC to hold its horses in H1 2018 and start hiking interest rates towards the end of 2018 as price pressures become more pronounced.

Risks

Lack of IMF policy anchor after current deal expires in Feb. Fiscal slippages following recent budget outperformance and spending plans this year. Domestic political jitters amid media speculation for snap national election possibly in tandem with city council elections in Belgrade scheduled for March. Major Central Banks' policies.

Eurobank

IV. Eurobank Macro Forecasts

Eurobank Macro Forecasts

	Real GDP (YoY%)			CPI (YoY%, avg)			Unemployment rate (% of total labor force)			Current Account (% of GDP)			General Budget Balance (% of GDP)		
	2017e	2018f	2019f	2017e	2018f	2019f	2017e	2018f	2019f	2017e	2018f	2019f	2017e	2018f	2019f
World	3.7	3.9	3.9	3.1	3.3	3.3									
Advanced Economies															
USA	2.3	2.6	2.5	2.1	2.3	2.2	4.4	4.1	4.0	-2.4	-2.6	-2.7	-4.3	-3.8	-4.0
Eurozone	2.4	2.5	2.2	1.5	1.7	1.7	9.1	8.5	7.9	3.0	3.0	2.9	-1.1	-0.9	-0.8
Germany	2.5	2.8	2.1	1.7	1.7	1.8	3.7	3.5	3.2	7.8	7.5	7.2	0.9	1.0	1.1
France	1.8	2.2	1.9	1.2	1.9	1.8	9.5	9.3	8.9	-3.0	-2.8	-2.6	-3.1	-2.8	-2.7
Periphery															
Cyprus	3.8	3.6	3.2	0.7	1.0	1.5	11.3	10.0	9.3	-5.4	-6.2	-6.8	1.1	1.4	1.9
Greece	1.4	2.3	2.5	1.1	1.0	1.2	21.6	20.0	18.5	-0.2	-0.1	-0.1	-1.2	0.9	0.8
Italy	1.6	1.4	1.2	1.3	1.2	1.3	11.2	10.9	10.5	2.5	2.5	2.3	-2.1	-1.8	-2.0
Portugal	2.5	2.1	1.9	1.6	1.4	1.4	9.0	8.0	7.5	0.2	0.5	0.4	-4.4	-2.0	-1.4
Spain	3.1	2.8	2.3	2.0	1.7	1.3	17.2	15.0	13.5	1.7	1.3	1.0	-3.2	-2.4	-2.0
UK	1.8	1.5	1.2	2.7	2.5	2.3	4.4	4.5	4.5	-5.9	-5.8	-5.2	-2.4	-2.0	-1.7
Japan	1.8	1.3	1.0	0.5	0.8	1.0	2.9	2.8	2.7	3.9	4.0	4.0	-4.3	-3.5	-3.0
Emerging Economies															
BRICs															
Brazil	0.8	1.5	2.0	3.5	4.0	4.1	13.1	11.8	11.0	-1.4	-1.8	-1.8	-9.2	-9.3	-8.9
China	6.9	6.6	6.3	1.6	2.4	2.5	4.0	4.0	4.0	1.4	1.3	1.2	-3.7	-3.7	-3.9
India	7.1	7.3	7.5	3.3	4.9	4.8		*NA*		-1.4	-1.5	-1.6	-6.4	-6.2	-5.9
Russia	1.5	1.7	1.6	3.7	3.6	4.0	5.5	5.5	5.5	2.8	3.2	3.6	-2.1	-1.5	-1.0
CESEE															
Bulgaria	3.9	3.8	3.6	2.1	2.4	2.7	6.3	6.0	5.7	5.0	4.5	4.0	0.0	-1.0	-0.5
Romania	7.0	4.4	3.8	1.3	3.5	3.1	4.9	5.0	5.2	-3.5	-4.0	-4.0	-3.0	-4.4	-4.5
Serbia	1.8	3.0	3.2	3.2	3.0	3.2	12.5	11.5	11.0	-4.0	-4.5	-4.1	0.5	-0.6	-0.5
Turkey	7.0	4.5	4.0	11.1	10.0	8.0	11.0	10.6	10.5	-6.4	-4.6	-4.4	-2.1	-2.3	-2.3

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

Eurobank Fixed Income Forecasts

	Current	Mar-18	Jun-18	Sep-18	Dec-18
USA					
Fed Funds Rate	1.25-1.50%	1.50-1.75%	1.75-2.00%	1.75-2.00%	2.00-2.25%
1 m Libor	1.57%	1.68%	1.95%	2.10%	2.20%
3m Libor	1.77%	1.89%	2.09%	2.25%	2.40%
2yr Notes	2.10%	2.20%	2.30%	2.40%	2.50%
10 yr Bonds	2.68%	2.75%	2.80%	2.80%	2.85%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.34%	-0.32%	-0.31%	-0.29%	-0.24%
2yr Bunds	-0.54%	-0.45%	-0.38%	-0.30%	-0.20%
10yr Bunds	0.67%	0.75%	0.79%	0.80%	0.90%
UK					
Repo Rate	0.50%	0.50%	0.50%	0.50%	0.50%
3m	0.43%	0.55%	0.67%	0.76%	0.83%
10-yr Gilt	1.44%	1.50%	1.55%	1.60%	1.65%
Switzerland					
3m Libor Target	-0.75%	-0.75%	-0.75%	-0.70%	-0.60%
10-yr Bond	0.08%	0.13%	0.19%	0.21%	0.25%

Source: Bloomberg (market implied forecasts)

Research & Trading Teams

Economic Analysis & Financial Markets Research
EurobankEA_FMR@eurobank.gr

Dr. Tassos Anastasatos: Group Chief Economist
tanastasatos@eurobank.gr, + 30 210 33 71 178

Anna Dimitriadou: Economic Analyst
andimitriadou@eurobank.gr, + 30 210 37 18 793

Ioannis Gkionis: Senior Economist
igkionis@eurobank.gr + 30 210 33 71 225

Stylianos Gogos: Economic Analyst
sgogos@eurobank.gr + 30 210 33 71 226

Olga Kosma: Research Economist
okosma@eurobank.gr + 30 210 33 71 227

Marianna Papoutsaki
mpapoutsaki@eurobank.gr + 30 210 33 71 224

Paraskevi Petropoulou: Senior Economist
ppetropoulou@eurobank.gr, + 30 210 37 18 991

Galatia Phoka: Research Economist
gphoka@eurobank.gr, + 30 210 37 18 922

Theodoros Stamatiou: Senior Economist
tstamatiou@eurobank.gr, + 30 210 33 71 228

Global Markets Trading Team
Global_Markets_Trading@eurobank.gr

FX & Derivatives
Stavros Daliakopoulos (Head), Maria Katrantzi, Dimitris Stamoulis, Nassos Assimakopoulos
FX_TRADING@eurobank.gr, DERIVS_TRADING@eurobank.gr

Credit, EM & Sovereigns
Magdalini Papadimatou (Head), Lambros Demertzoglou, Kostas Theodoropoulos, Andreas Lake, Konstantinos Livitsanos
SOV_TRADING@eurobank.gr, EM_CORP_TRADING@eurobank.gr

Costas Katsileros: Head of Global Markets Trading
ckatsileros@eurobank.gr + 30 210 37 18 764

V. Disclaimer

Disclaimer

This document has been issued by Eurobank Ergasias S.A. (Eurobank) and may not be reproduced in any manner. The information provided has been obtained from sources believed to be reliable but has not been verified by Eurobank and the opinions expressed are exclusively of their author. This information does not constitute an investment advice or any other advice or an offer to buy or sell or a solicitation of an offer to buy or sell or an offer or a solicitation to execute transactions on the financial instruments mentioned. The investments discussed may be unsuitable for investors, depending on their specific investment objectives, their needs, their investment experience and financial position. No representation or warranty (express or implied) is made as to the accuracy, completeness, correctness, timeliness or fairness of the information or opinions, all of which are subject to change without notice. No responsibility or liability, whatsoever or howsoever arising, is accepted in relation to the contents thereof by Eurobank or any of its directors, officers and employees.