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

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I. Snapshot

Overview

Macro Picture

- **USA:** Solid growth on positive global growth momentum; expected short-lived negative impact from major hurricanes
- **EA**: Robust growth on stronger domestic & external demand
- **UK:** Growth to slowdown on lingering Brexit uncertainty and real household income squeeze from higher inflation
- **Japan**: Continuation of loose policy measures to support growth following Abe administration's victory at Oct. 22 general election
- **EM:** Growth to pick up pace in 2017and 2018, thanks to recovery in commodity exporters, most notably Brazil and Russia
- **CESEE:** Economies remain on solid footing in H1-2017

Policy Outlook

- **USA:** Balance sheet normalization started in October, likely followed by another interest rate hike in December
- **EA:** APP extension until Sep 2018 at a reduced pace. Further extension at less accommodative levels likely
- **Japan:** BoJ on hold amid subdued inflationary pressures
- **UK:** In spite of the lack of a material increase in wages, BoE likely to deliver a rate hike at the Nov. 2 meeting amid higher inflation and solid employment growth
- **CESEE:** Small timid steps towards policy normalization from some Central Banks

Summary

Broad-based global economic recovery strengthens, triggering a material shift towards less accommodative policy from a number of G10 CBs, in spite of subdued inflation. US politics take centre stage, amid increased optimism on US tax reform plan and upcoming Donald Trump's choice for Fed Chair nominee

Markets

- **FX:** A dovish ECB has weakened the EUR with the USD gaining momentum on tax reforms and the potential of a hawkish Fed Chair. Stay tactically short EUR
- **Government bonds:** USTs, Bunds to head lower medium term as CBs signal the end of the easing cycle. We favor cautiously selling the rallies, buying downside protection and hedging interest rate risks
- **EM:** Idiosyncratic risks and rising rates /USD are beginning to take their toll. We are increasingly cautious on EM external debt
- **Credit:** Tighter credit spreads to get tighter as ECB holds firm on CSPP. USD vs EUR credit divergence should start to appear as policies diverge
- **Commodities:** We remain moderately bullish on commodities but prices could be due for a short term correction post China's Party Congress and on the back of a strengthening USD

Key Risks

- **Trump disappointment:** The largely expected fiscal stimulus program falls short of expectations
- **Sizable and rapid tightening of global financial conditions:** Too much optimism on inflation leads to a more aggressive monetary policy stance with adverse repercussions for vulnerable economies
- **Shift toward protectionism:** Trade and currency war could reduce global trade and cross-border investment flows, weighing on the global growth momentum
- **Increased political woes:** Growing Euroscepticism in the EU; UK conservative party leadership challenge amid disagreement within party over Brexit

Macro Views

Latest Macroeconomic Developments & Outlook

World Economic Outlook		Global economic activity accelerated in H1 2017, mirroring robust domestic demand in developed economies and improved economic fundamentals in China and other large emerging economies, while high frequency indicators suggest that robust growth momentum continues well into H2 2017. The global expansion is benefitting from a sizeable global investment upswing, which has spurred stronger manufacturing activity across the globe. Overall, global GDP growth is expected to accelerate to c. 3.6% in 2017 from 3.2% in 2016.
Developed Economies	**US**	Personal consumption has been helped by improving labor market conditions and rising incomes, while increasing business fixed investment has capitalized on faster global growth and higher commodity prices. Overall, real GDP growth is projected at 2.2% in 2017 from 1.5% in 2016 on robust capex and personal consumption as well as very supportive financial conditions.
	Euro Area	The broader recovery mostly reflects continued strength in domestic demand growth amid ultra-accommodative financial conditions and reduced political jitters, coupled with an acceleration in exports on the back of rising global trade growth. We expect real GDP growth to pick up to 2.1% in 2017 from 1.8% in 2016, with subdued inflationary pressures indicating remaining slack in the economy that has yet to be eliminated.
	Periphery	Soft and hard data from the majority of periphery euro area economies suggest that the improving economic momentum remains intact with private consumption the key driver of growth. Spain and Portugal continue to outperform supported by favorable financial conditions and an ongoing improvement in labor market conditions.
	Japan	Robust global demand and supportive fiscal policy stance have resulted in above potential pace of growth in H1 2017, which is expected to continue throughout the remainder of the year. Overall, real GDP growth is projected to decelerate to 1.0% in 2018 from 1.5% in 2017, with the expected investment boost ahead of the 2020 Tokyo Olympic game being offset by slower consumption and external demand growth.
Emerging Economies	**BRICS**	In China, real GDP growth came in at 6.8%%YoY in Q3, slightly decelerating from 6.9%YoY in each of the two prior quarters. For the whole of the year a slight pick up to 6.8% is anticipated from 6.7% in 2016. The Russian economy remains on an recovering phase having exited a two-year recession and absorbed the negative impact of sanctions imposed by USA & EU28 since 2014. The 1H-2017 GDP growth stood at 1.5% YoY up from -0.2% YoY in 1H-2016 and -2.8% YoY in 1H-2015. Despite ongoing political risks, economic recovery continues in Brazil, primarily led by household consumption. Economic activity has lost momentum in India due to the impact from the currency exchange initiative and uncertainty surrounding the introduction of the Goods and Services Tax.
	CESEE	From a growth point of view, most of the economies of our focus (Bulgaria, Romania, Cyprus) and the broader CESEE region remained on solid footing in H1-2017. Growth dynamics are broadly driven by the improving private consumption on the back of sustained sentiment improvement, eased financial conditions, tighter labor markets and robust real wage dynamics.

Global Macro Themes & Implications

Theme	Implications
Increased optimism on US tax reform	Discussions around US tax reform, one of the key campaign promises of US President Donald Trump, are gaining momentum. The US House and the Senate Budget Committee agreed on a single, common version of the budget resolution for the FY-2018, with certain spending levels and budget reconciliation instructions, envisioning up to $1.5trn in additional federal deficit over the next decade to accommodate the government's proposed US tax cuts. These include, inter alia, a reduction in the corporate tax rate and in the top income tax rate from 35.0% and 39.6% to 20.0% and 25.0%, respectively, estimated to boost 2018 GDP growth by about 0.5pp. The next step in the process is for the House and, at a later stage, the Congress to agree on a detailed legislation for the tax code reform, with relevant discussions expected to commence in early November. Assuming that things will evolve smoothly, the tax legislation could be enacted by late 2007/early 2018 before it is sent to the US President for signing.
Fed Governor Jerome Powell, a leading candidate for Fed Chair	US President Donald Trump's upcoming nomination for Chairman of the Fed hits headlines. Reportedly, he is "very, very close" to making a decision that is expected to be publicly announced before he leaves on this next trip abroad on November 3rd. Based on the most recent newsflow, Donald Trump is leaning towards Fed Governor Jerome Powell to be the next chairman of the Fed. Powell is viewed as most similar to incumbent Fed Chair Janet Yellen, whose term expires in early February 2018. As such, Power announcement would likely be taken in stride by market participants, on the view that he will not deviate much from current Fed monetary policy. Janet Yellen is seen as the most dovish among the four candidates while the remaining two, Stanford economist John Taylor and former Fed governor Kevin Warsh, are considered as the most hawkish choices.
ECB extends APP by nine months and halves monthly pace of asset purchases; further extension likely	As expected, the ECB decided at the October 26 monetary policy meeting to keep its key interest rates stable and extend the asset purchase programme (APP) by nine months to September 2018 at a reduced monthly volume of net asset purchases to €30bn as of January 2018 from €60bn currently. Amid persistently subdued inflation pressures in spite of improving economic recovery, the ECB made clear that "very substantial degree of accommodation" is needed to support a self-sustained durable convergence of inflation to the medium-term inflation target. Adopting a more dovish than expected tone, the ECB suggested that interest rates will remain at current levels for an extended period of time, it reiterated its willingness to increase the volume of monthly net asset purchases and/or extend the duration of the programme and left the programme open-ended, with President Mario Draghi stating clearly in the Q&A session that the programme will not "stop suddenly" in September 2018.
Escalating crisis in Catalonia	In reaction to the Catalonian parliament's vote in favor of a unilateral declaration of independence, the Spanish Senate approved on Friday, October 27 the activation of Article 155 of the Spanish Constitution, which effectively allows the central government to take control of the administrative, economic and budgetary functions of the region. In the context of the Article, Spain's Prime Minister Marianno Rajoy also called early elections in Catalonia for December 21, 2017. The election outcome could be crucial to determining how the political crisis in Catalonia will evolve, with market participants likely to pay particular attention on opinion polls results in the sessions/weeks ahead.

Macro Themes & Implications in CESEE

Theme	Implications
Solid growth performance for the region in H1-2017	From a growth point of view, most of the economies of our focus (Bulgaria, Romania, Cyprus) and the broader CESEE region remained on solid footing in H1-2017. In Serbia, the growth slowdown is largely attributed to one-off factors such as adverse weather conditions. Growth dynamics are broadly driven by improving private consumption. The underperformance of EU funds related projects has kept investment spending below expectations, a trend that we anticipate to change in the H2. The satisfactory growth performance of EA, key trade partner and capital flows generator for the broader region, maintains individual countries' external imbalances in check despite the uptick on the imports side.
Consumer spending revival continues unabated in the region	Private spending revival continued unabated despite local political-policymaking uncertainties plus the food prices induced increase of headline inflation, 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 throughout H2
Small timid steps towards monetary policy normalization	Following a rise in recent months, headline inflation data across the region have stabilized in Q3 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.
Heavy regional political events calendar behind-European political events had no meaningful impact so far	The region has left behind a heavy political events calendar in H1-2017: snap parliamentary elections in Bulgaria in late March, political upheaval in Romania during February and June, presidential elections in Serbia in early April, Cyprus reunification negotiations collapse etc. A series of key political events in Europe this year, mostly concentrated in the first half, had no meaningful impact on the region's growth prospects and asset performance so far (Brexit talks, elections in Netherlands, France, Germany, UK). Geopolitical tensions in the Middle East, and potential noise in the Balkans (e.g. related to the Kosovo issue) or frictions due to the ongoing refugee crisis are among other possible risk sources.

CESEE Markets Developments & Outlook

Country	CESEE Markets Developments & Outlook
Bulgaria	• Bulgarian local-currency bonds stayed well supported in 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. The next upcoming bond auction will be held on the November 13th and will offer 4-year notes, maturing in 2021 with a total indicative volume of BGN 30mn. • Bulgarian Eurobonds followed the developments in the local market with the belly of the curve outperforming.
Serbia	• The dinar has remained range-bound within its recent 119.0 - 119.80 range, that has been held approximately over the last four months. Notably, two surprise interest rate cuts by the National Bank of Serbia seem to have had a 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 ago. 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 cut has also pushed the Belibor curve by 45 basis points lower (on average). Looking into the remainder of the year, the dinar is likely to come under some depreciating pressures due to seasonal factors.

The Trader's View

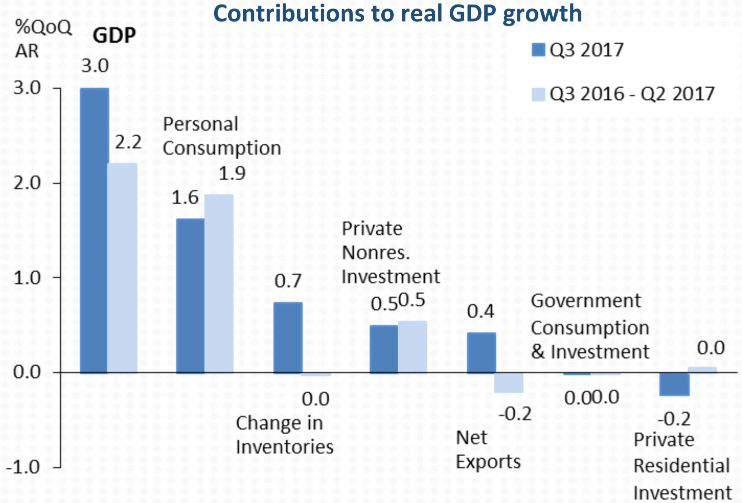
Asset Class	Outlook
Foreign Exchange	**EUR/USD:** US tax reforms, a potential hawkish Fed Chair and a dovish ECB fueled a Greenback rally that potentially targets 1.12. The dovish ECB was the catalyst for a breakout lower. Next short term support is at 1.16 as the pair kept a 1.1615 – 1.1850 range throughout the month. **USD/JPY:** JPY weakness has been a dominant theme driven by the selloff in USTs and Abe's election win which saw LDP and its coalition partner Komeito cruise to a landslide victory. The result has bolstered the prospect of another term for BOJ Gov Kuroda, which by consequence means continued loose monetary policy. The pair made a new three month high at 144.33 – post a dovish ECB - and is now eyeing the May highs at 114.37 and the July peak at 114.49. A break will open the way for 119. **GBP/USD:** Cable was range bound with a strong UK GDP print providing support. The cross remains to the lows of the month at 1.3094 at the time of writing. The EU summit provided for no conclusive break to Brexit negotiations with the next event in line the Nov BoE meeting where consensus is for a hike in response to tight labour markets and high inflation. Momentum is shifting lower and a break of 1.3050 will target 1.2850.
Government Bonds	**US:** 10y yield broke briefly important resistance of 2.39%/2.40% but found strong resistance at 2.50% and have retraced since. The move was helped by better market sentiment and positive economic data providing support. Yields were also helped by the US House passing the budget resolution that paves the way for a detailed debate on tax reforms. The race for the new Fed Chair is also worth looking at with US President Trump reveling his choice before Nov 3rd. The FOMC this week is looking like a non event with a December hike now pretty much fully priced in. Short term pull back is expected to give further steam more a move to 2.60%/2.65%. 5-30 s are expected to continue flattening. **EU:** A dovish QE tapering by the ECB has led to a significant periphery rally. Strong forward guidance and persistently low inflation are likely to keep EUR rates from a significant selloff and the front suppressed leading to further steepening. Market expectations that QE will finish by the end of 2018 will also keep the term premium from dissipating keeping the Bund in a range between 39-50bps. Peripheral bonds look set to continue their rally with spreads to core compressing further. Spain will catch up post its underperformance due the Catalonia induced political crisis.
EM hard currency debt	EM external debt remains surprisingly strong , especially in the low beta names, in the phase of rising US rates and a stronger USD. High beta names have shown some signs of fatigue and are trading in a more defensive mode. Idiosyncratic risks like SOAF and Turkey are trying to spoil the year to date party. The Fed this week will give direction and we expect a minor correction. EM carry trades have lost some attractiveness, and the emphasis is now more on idiosyncratic political and fundamental divergences and relative value trades.
Corporate credit	In Europe, corporates and financials, continued their tightening with significant new issuance well absorbed and ECB coming out very supportive for corporate credit. The short end is trading expensive and is likely to remain so therefor we see more value in the 10+ area as credit curves remain uncharacteristically steep. ECB is leading to prefer EUR over USD credit and financials over corporates. Overall though we are moderately cautious on corporate credit at current levels as we believe the space for further spread compression is getting progressively smaller.
Commodities	We maintain the view that commodities have bottomed out. Brent broke into new two year highs and we expect WTI to break 55 soon. Industrial metals will see increased demand as global growth picks up and the reflation trade strengthens, but Chinese growth remains a concern in the medium term. As we have mentioned repeatedly energy and base metals are expected to perform well in a moderate rising rates/synchronised global economic growth environment. A risk to our view remains a strong move high by the USD.

II. Advanced Economies

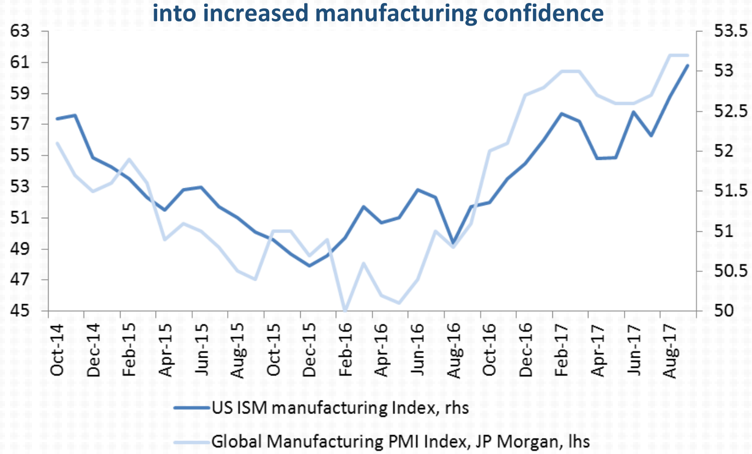
- USA
- Euro Area
  - ❖ Periphery (Italy, Spain, Portugal, Cyprus)
- Japan
- UK

USA: solid growth with limited negative weather effects

Contributions to real GDP growth



Synchronized global growth translates into increased manufacturing confidence



Source: Bloomberg, Markit, JP Morgan, BEA, Eurobank Economic Research

Latest Economic Developments

According to the BEA's Q3 advance estimate, real GDP increased by 3.0%QoQ saar from 3.1% in the prior quarter, surpassing consensus estimates for a quarterly increase of 2.6%. The trend for consumer spending growth has been helped by improving labor market conditions and increasing incomes, while rising business fixed investment has capitalized on faster global growth and higher commodity prices. Overall, real GDP growth is projected at 2.2% in 2017 from 1.5% in 2016 on robust capex and solid personal consumption and very supportive financial conditions.

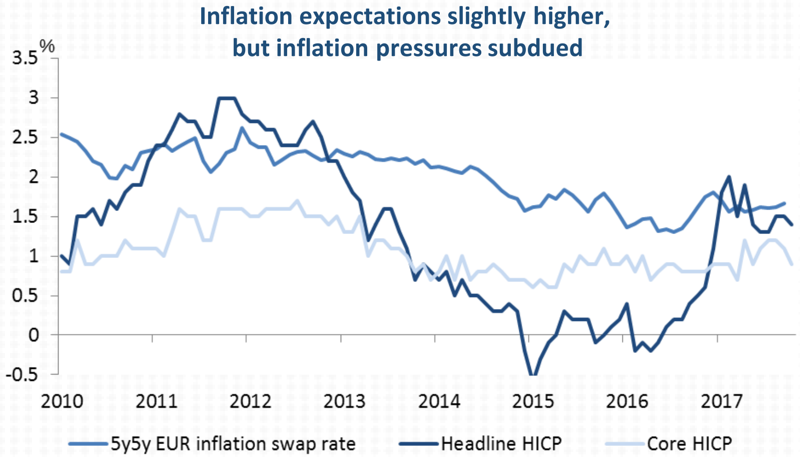
Central Bank Watch

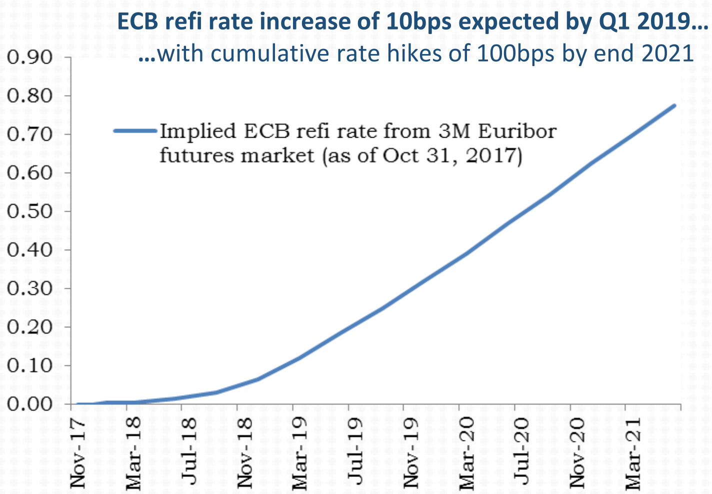
The minutes of the September FOMC meeting were largely in line with the key messages delivered in the relevant FOMC policy statement. Any distortion in real economic activity due to Hurricanes Harvey and Irma is expected to be transitory, with no medium-term implications. Furthermore, "many participants thought that another increase in the target range later this year was likely to be warranted if the medium-term outlook remained broadly unchanged", but several members noted that additional tightening was dependent on upcoming inflation data. Meanwhile, many participants were more concerned that the low inflation this year might reflect not only transitory factors but prove more persistent than anticipated, suggesting that committee's concerns over inflation remain elevated. All in all, the September minutes were consistent with our outlook for a third 25bp rate increase in the December FOMC meeting. Future implied probability for a 25bps Fed rate hike next month currently stands at 83%, up from ca. 70% a month ago. Nevertheless, uncertainty about monetary policy in 2018 prevails ahead of significant changes in terms of voting FOMC members.

Risks

Fiscal stimulus could create upside or downside risks for the US 2018 economic outlook, depending on the specific tax cut targets over the next ten years.

Euro area: broad based economic recovery on resilient domestic demand and rising global trade growth





Source: Eurostat, Bloomberg, Eurobank Economic Research

Latest Economic Developments

Euro area economy continues to show signs of recovery with high frequency data pertaining to Q3 suggesting that the positive momentum experienced H1 2017 should be maintained in the remainder of the year. The broader recovery mostly reflects continued strength in domestic demand amid accommodative financial conditions and diminished political jitters, coupled with an acceleration in exports on the back of rising global trade growth. Although improving economic conditions have helped inflation expectations to move higher lately and core inflation to recover from multi-year lows recorded earlier in 2017, domestic price pressures still remain muted.

Central Bank Watch

At the Oct 26 monetary policy meeting, the ECB maintained its key interest rates stable and extended its APP by 9 months to Sep 2018 at a reduced asset purchase pace of €30bn from €60bn currently. According to the ECB, "an ample degree of monetary stimulus remains necessary" in order to support a self-sustained durable price convergence to the 2.0% medium-term inflation target. Furthermore, the ECB pledged interest rates to remain at current levels for an extended period of time, with President Mario Draghi adding in the post-meeting press conference that the programme will not "stop suddenly" after September 2018. Said that, a further extension at less accommodative levels is possible, with the prospect of an interest rate hike pushed further away into 2019.

Risks

Banking sector conditions have improved in recent years with positive credit growth to the financial sector since mid-2015 and balance sheet repair since mid-2017. However, nonperforming loan ratios remain relatively high (5.7% average in Q1 2017). That said, an increase in long-term interest rates could weigh on public debt dynamics mainly in the most vulnerable euro area countries. Adding to the above, rising euroscepticism in some euro area countries represents a threat to the EU, while Catalonia jitters could exert a negative impact on the fourth biggest euro area economy, especially if the political crisis lasts for a prolonged period.

Italy: the newly approved electoral law could weigh on governance

Comparison between the two electoral systems that would apply if a general election were held now

	Consultellum Law		Rosatellum II Law
	Chamber of Deputies	**Senate**	**Both upper and lower house**
System	Proportional with a majority premium	Proportional	Mixed: 64% of seat allocated with a fully proportional system, 36% under a first-past-the post system (FPTP)
Majority premium threshold	40% for single parties only	-	-
Candidate list structure	Open (3-7 candidate max), excl.: a) Top candidate decided by the party, b) Candidates allowed to run up to 10 constituencies	Open	Open (3-6 candidate max)
Entry voting threshold	National level: 3.0%	Regional level: a) 3.0% for parties that join coalitions if reference coalition reached 20.0%, b) 8.0% for single parties	National level: a) 3.0% for single parties, b) 10.0% for coalitions

Source: La Repubblica, Reuters, Barclays, Eurobank Economic Research

Latest Economic Developments

Following robust GDP quarterly growth readings in H1 2017 of ca. 0.4%, hard data pertaining to Q3 2017 suggest that Italy's economic recovery is gaining some speed, mainly supported by solid domestic demand. Nevertheless, medium-term risks seem tilted to the downside due to uncertainty stemming from 2018 fiscal politics. As recently emphasized by the IMF, gradual fiscal adjustment accompanied by growth-friendly measures are appropriate for Italy.

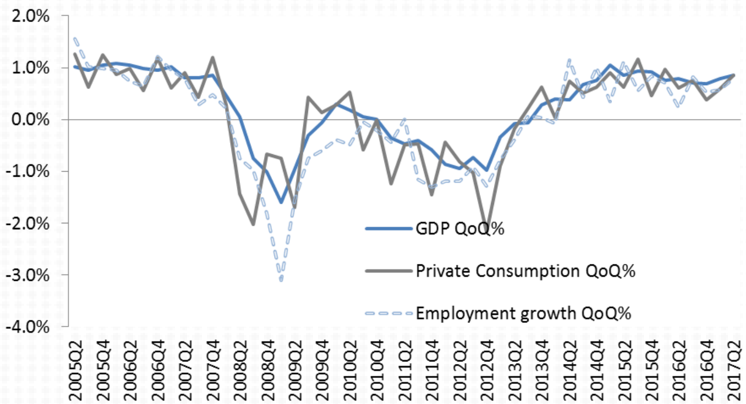
New electoral law not a guarantee for post-election governability

Following the approval by the Chamber of Deputies, the Senate overwhelmingly passed the new electoral law called "Rosatellum II" on 26/10, requiring only the formal approval from President Sergio Mattarella to become law. Given the government's thin majority in the Senate, the new law was backed by opposition parties Eurosceptic NL and Berlusconi's FI. Nevertheless, the anti-establishment 5SM opposed "Rosatellum II" protesting on the streets during the vote, as did several small left-wing parties that were split from Italy's ruling PD. The allocation of seats in the parliament for both houses is now split into two, 64% allocated with a proportional system and 36% under a FPTP system. Most importantly, it creates incentives for political parties to form pre-electoral alliances, with a centre-right coalition between NL, FI and FdI likely to be formed ahead of the next Italian election by May 2018 and possibly becoming the largest group in the next Italian coalition government. The new electoral law does not bode well for the 5SM, as under the FPTP system it could face competition not only from the PD but also form the centre-right alliance. Regarding the PD, forming pre-election alliances would be rather difficult, following the recent split of MDP from the DP and its opposition on labour market reform undertaken by Matteo Renzi. All in all the new electoral law could make it even harder to form a stable government, by providing incentives to centre-right parties to form pre-election alliances and, therefore, increasing the risk of a hung parliament with possible delays in reforms and fiscal slippage (three blocks with many ideological differences of roughly the same size will probably be formed).

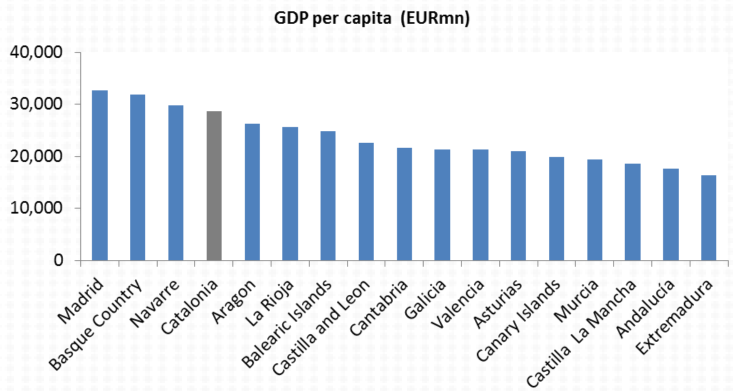
Spain: Economic activity on an improving trend in recent quarters; Catalonia crisis the main risk to short-term growth outlook

Eurobank

Economic activity on an improving trend in recent quarters mainly thanks to private consumption



Catalonia- Among the wealthiest Spanish autonomous regions



Source: Spanish Statistical Institute, Eurobank Economic Research

Latest Economic Developments

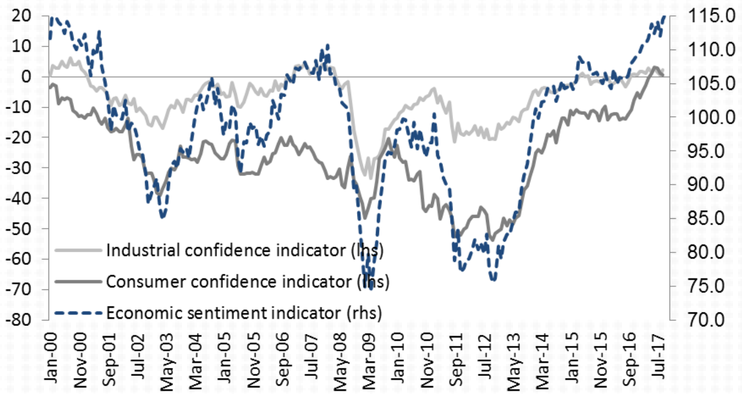
Spain's economic activity has remained on an upward trend so far this year with GDP growth rising by 0.8%QoQ in Q3 2017, decelerating slightly from 0.9%QoQ in Q2 2017 that was the strongest since Q3 2015. Though the expenditure breakdown will not be available before November 30, economic growth is expected to have been primary driven by private consumption mainly thanks to strong job creation. The unemployment rate fell to 16.4% in Q3 2017, the lowest in 8 ½ years and down from 17.2% in Q2 with the services industry accounting for the relatively higher pace of employment growth. Looking ahead, the positive economic growth momentum is expected to remain intact, on solid domestic demand and continued ECB accommodative monetary policy. The Catalonia crisis presents the main risk to the short-term growth outlook. On the fiscal front, Spain is on track to meet the 3.1%-of-GDP budget deficit target from 4.3%-of-GDP in 2016, assisted by hefty economic growth.

Catalonia: Prolonged political crisis could weigh on Spanish growth

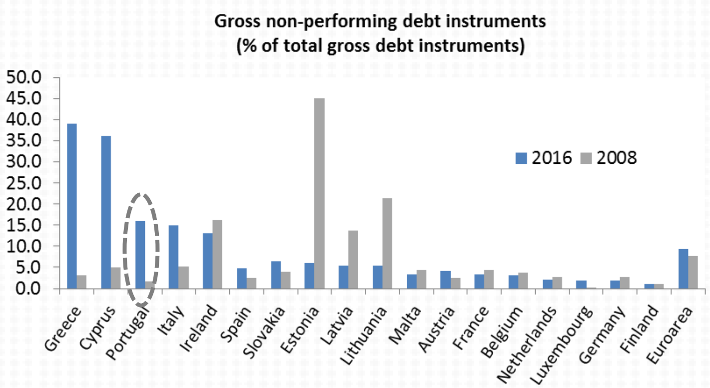
In reaction to the Catalonian parliament's vote in favor of a unilateral declaration of independence, the Spanish Senate approved the activation of Article 155 which effectively allows the central government to take control of the administrative, economic and budgetary functions of the region. It seems unlikely that the Catalan government will give up all these powers easily raising the risk of more radical demonstrations and disruptions in the sessions/weeks ahead. Under Article 155, PM Mariano Rajoy called regional elections in Catalonia for December 21, 2017. A victory of anti-independence parties would lead to a gradual normalization of the situation. However, in case pro-independence parties win, the political crisis could intensify as three of the four biggest political parties in Spain (PP, SPOE, Cuidadanos) are united against independence for Catalonia. That said, political uncertainty is likely to prevail until at least regional elections are held with potentially negative repercussions to Spain's economic growth outlook. Catalonia is one of the wealthiest autonomous regions and among the largest net contributors to the country's public finances.

Portugal: Positive growth momentum continues but structural weaknesses remain

Economic sentiment at the highest since early 2000



Portugal’s NPLs ratio among the highest in the euro area



Latest Economic Developments

Portugal’s cyclical uptrend has gained momentum in recent quarters with the economy appearing to be on track this year for the best annual growth performance since 2007, a year before the eruption of the crisis (would remove this), mainly supported by private consumption amid robust employment growth and increased minimum wage. Employment grew by 3.0%YoY in Q2 2017 for the second quarter in a row, the highest in more than two decades, after embarking on a steady declining trend since early 2013, and the unemployment rate fell at a 9 year low of 8.9% in August, compared to 10.9% on the same month a year earlier, dropping from a peak of 17.5% in January 2013. Investment was also a positive contributor to GDP growth in recent quarters, primarily assisted by the recent rebound in construction, while robust demand from key euro zone trading partners was the main driver behind improved exports. Survey data also bode well for Portugal’s economic growth outlook with economic sentiment rising to 115.6 in October, the highest since early 2000. Improving economic growth has helped 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. It is projected to decrease further to 1.8%-of-GDP in 2017, assisted by continued economic recovery and continued ECB accommodative monetary policy. Citing “expectations of solid economic growth and further budgetary consolidation”, S&P was the first of the three major rating agencies to restore the investment grade status of Portugal’s credit rating in September while other major rating agencies may follow suit in the foreseeable future.

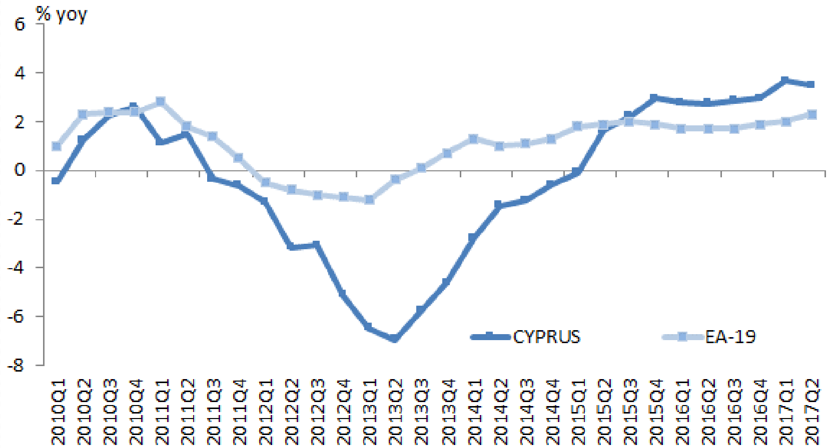
Portugal remains vulnerable to structural weaknesses medium-term

While Portugal’s near-term growth outlook has improved, downside risks remain amid persisting structural weaknesses. The banking system is still a source of concern on the back of weak asset quality and low profitability. NPLs have decreased steadily over the last few quarters but they are still among the highest in the euro area (16.1% of total loans in Q1 2017). Furthermore, the country’s high public and private debt are medium-term sources of vulnerability taking into account that the ECB tapers further in 2018.

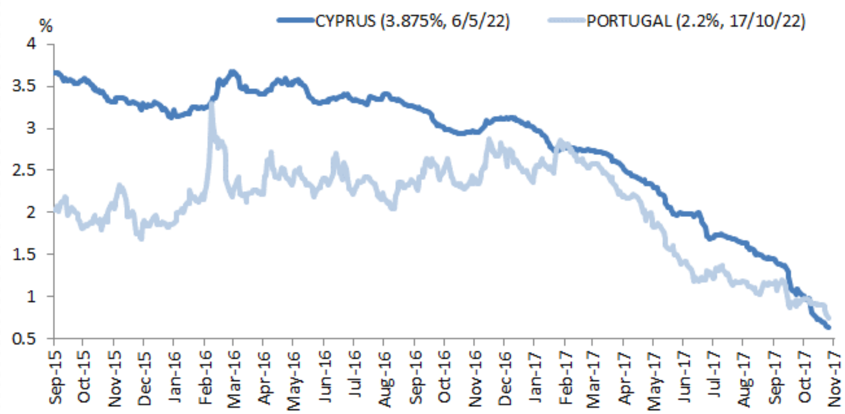
Source: Eurostat, ECB, Bloomberg, Eurobank Economic Research

Cyprus: NPEs remain the elephant in the room

Cyprus turn-around growth story has been impressive so far



Cypriot five year bond yields on a declining trend catching up with those of Portugal



Source: Eurobank Research, National Authorities, Bloomberg

Latest Economic Developments

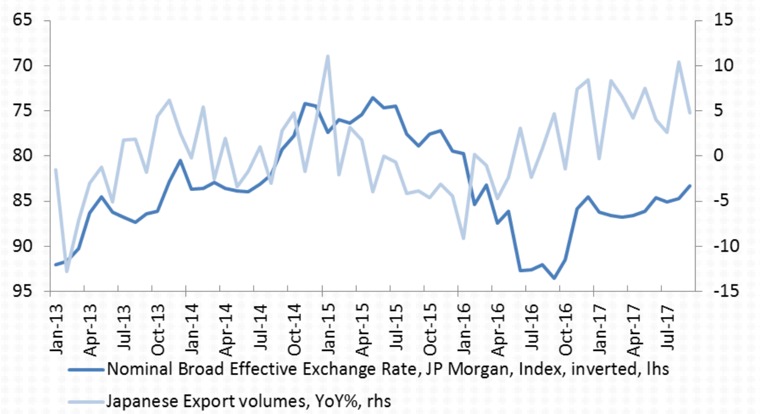
The consumption rebound has most probably continued in Q3 driven by sustained sentiment improvement, a flourishing tourism sector, improved labor market conditions, further property market stabilization, the impact from the envisaged fiscal relaxation, and the further normalization of banking sector conditions. Tourist arrivals grew by 14.7% YoY in 9M-2017, with the corresponding levels over that period heading for a new all-time record high in the history of the Republic. Unemployment in seasonally adjusted terms resumed its downward trend, declining further to 10.7% in August 2017, down from 17%. Finally, the number of real-estate market sale contracts has risen by 20% YoY in 9M-2017. The Residential Property Price Index (RPPI) recorded its first annual increase in Q1-2017 (+0.3% QoQ/+0.2% YoY) since 2009. 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, from the earlier estimates of 1.7% and 2.8%. 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

In late October, FITCH upgraded the sovereign rating of Cyprus by one notch to BB with a positive outlook. 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). 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.

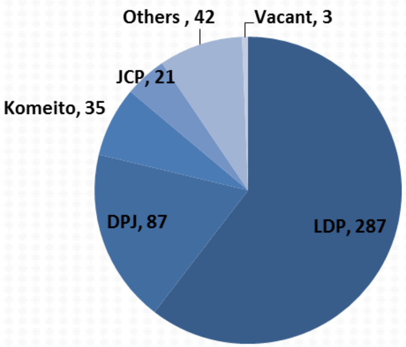
Japan: fiscal and monetary policies to remain in place given broad public support for the Abe administration

Japanese exporters have capitalized on a weakening JPY

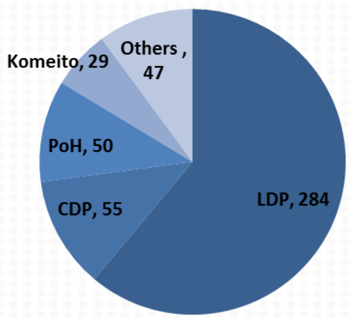


The balance of power largely unchanged in the lower house following October 22 general election outcome

Before lower house election
Total 475 seats



2017 lower house election
Total 465 seats



Source: Markit, Ministry of Finance, Ministry of Internal Affairs & Communications, Bloomberg, Eurobank Economic Research

Latest Economic Developments

Robust global demand and supportive fiscal policy stance have resulted in above potential pace of growth in H1 2017, which is expected to continue throughout the remainder of the year. Nevertheless, the pace of economic recovery is expected to lose some steam in the coming quarters, amid expectations for a rather slow withdrawal of fiscal support aiming to bring the primary balance to a debt-stabilizing level. Overall, real GDP growth is projected to decelerate to 1.0% in 2018 from 1.5% in 2017, with the expected investment boost ahead of the 2020 Tokyo Olympic game largely offset by slower consumption and external demand growth.

Central Bank Watch

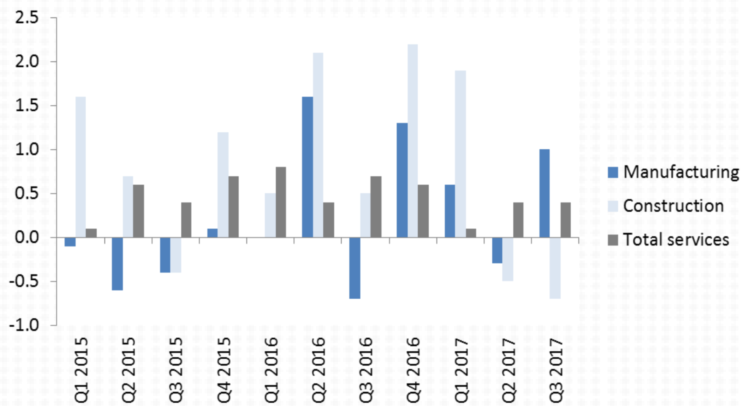
The BoJ decided at its October 30-31 MPM to maintain its current easing framework, implementing its YCC programme by targeting the 10yr JGB yield at 0.0% with a negative interest rate of 0.1%. Mr. Goshi Kataoka, one of the two new Policy Board members, dissented again, questioning the effectiveness of the current easing framework in order to meet the 2.0% price stability target. We expect the BoJ to keep its accommodative monetary policy stance unchanged in the coming months, as inflation is unlikely to hit the 2.0% target any time soon. Meanwhile, at its latest quarterly review, the BoJ downgraded its core CPI forecasts to 0.8% for FY17and 1.4% for FY18 from 1.1% and 1.5%, respectively. In our view, the first step towards monetary policy accommodation won't come before H2 2018, with an increase in its long-term yield target and/or a gradual rate hiking path dependent on price and economic developments.

Continuity for current fiscal and monetary policy management

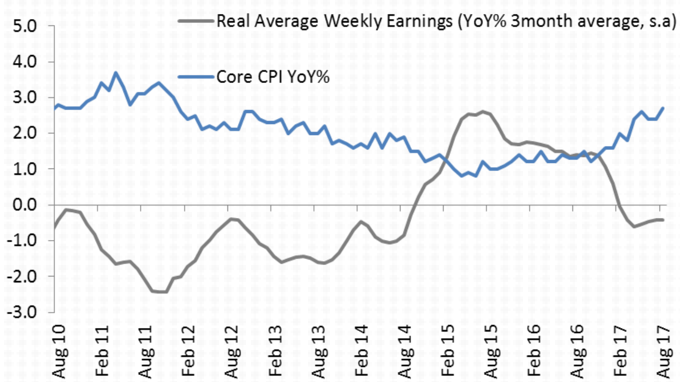
The lower house general election on 22/10 resulted in a two-thirds majority for the ruling coalition of the Liberal Democratic Party (LDP) and the Komeito Party (KP), pointing to broad public support for current fiscal and monetary policies. Reflationary policies (Abenomics), based upon three arrows of monetary easing, fiscal stimulus and structural reforms, are expected to continue taking centre stage.

UK: Q3 GDP surprised to the upside but downside risks prevail; slow progress in Brexit negotiations

Output components of GDP (QoQ%)



Rising inflation weighs on real wage growth



Source: ONS, Eurobank Economic Research

Latest Economic Developments

According to the preliminary estimate, UK GDP grew by 0.4%QoQ in Q3 2017 from 0.3%QoQ in the prior month, 0.1pp above market consensus and the MPC's forecast, thanks to a hefty increase in services output and industrial production. However, with negative real wage growth eroding consumers' purchasing power and Brexit-related uncertainty remaining high, market consensus argues for a slowdown in real GDP growth rate to 1.5% in 2017 from 1.8% in 2016 with risks laying to the downside on the back of a slow progress in Brexit negotiations and renewed political jitters.

Central Bank Watch

UK CPI rose to a 5 ½ year high of 3.0%YoY in Sep from 2.9%YoY in Oct, above 2.8%YoY the BoE penciled in at the latest Inflation Report. Meanwhile, the unemployment rate remained at a multi-decade low of 4.3% in August, below the BoE's 5.5% estimated equilibrium rate, offering scope for the MPC to raise interest rates at the Nov 2nd policy meeting following the more hawkish than expected tone adopted at the last meeting in mid-September. However, weakening economic fundamentals, subdued wage growth and prevailing Brexit uncertainty suggest that it may be difficult for the MPC to justify further rate hikes in the months ahead.

Slow progress in Brexit negotiations

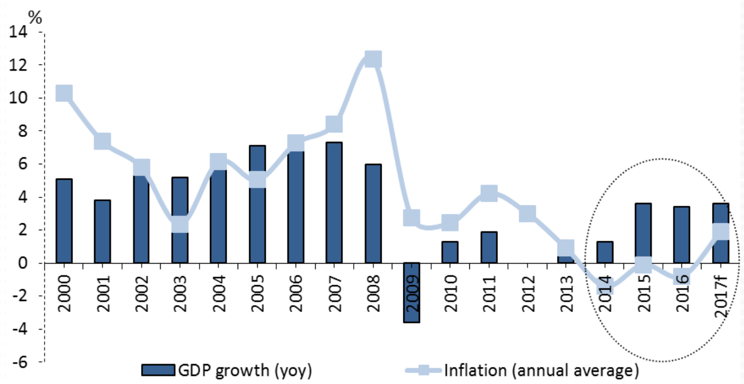
The EU Council acknowledged at the October 19-20 meeting that during the first phase of Brexit negotiations, progress has been made in two out of the three 'divorce' issues; the rights of EU citizens in the UK and the terms of the relationship between Northern Ireland and the Republic of Ireland. However, the UK's financial liabilities issue is far from being resolved. Adopting a more conciliatory tone, the EU Council agreed to start internal preparatory discussions on the issues of the second phase covering the framework of the future EU/UK relationship and transitional arrangements. Assuming that at the mid-December meeting the EU Council comes to the conclusion that "sufficient progress" has been achieved on the first phase's issues, Brexit discussions could move on to the second phase, diminishing risks of a 'cliff edge' in March 2019.

III. Selected CESEE economies

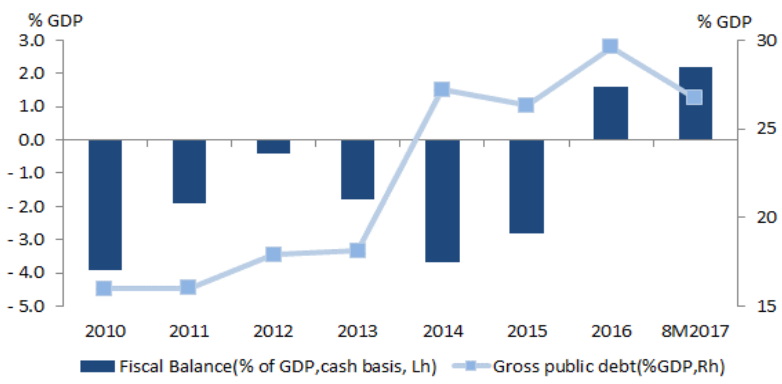
- Bulgaria
- Romania
- Serbia

Bulgaria: Credit activity has started accelerating in Q3-2017

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

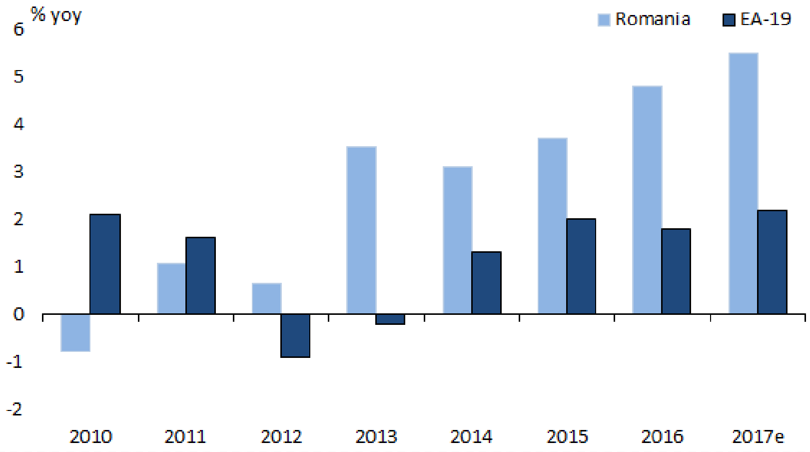
Credit to the non-government sector accelerated to 4.9% YoY in September vs. only 1.5% YoY in 2016, compared to -1.2% YoY in 2015 and -8.2% YoY in 2014. The data of 2014 reflect the dropping of assets of Corporate Commercial Bank (KTB) out of the official statistics in the aftermath of the bank run which eventually resulted in the bankruptcy of the fourth largest bank in terms of assets. Credit to households expanded briskly by 5.9% YoY in September, up from only 2.0% YoY in 2016, compared to -1.3% YoY in 2015 and -1.6% YoY in 2014. Credit to the non-financial corporations increased by 3.1% YoY in September, up from 2.0% YoY in 2016 down from -1.7% YoY in 2015 and -11.6% YoY in 2014. Financial institutions are now less reluctant to lend, as heavy regulatory requirements posed by the banking system-wide AQR and Stress test are behind, and are still confronted by the negative interest rates on excess reserves. The system's total loans-to-deposits ratio stood at 69.1% in August. This, together with the high liquid assets ratio (37.6% in July), illustrates the increased funding capacity and strong liquidity position of the banking system.

Risks & Challenges

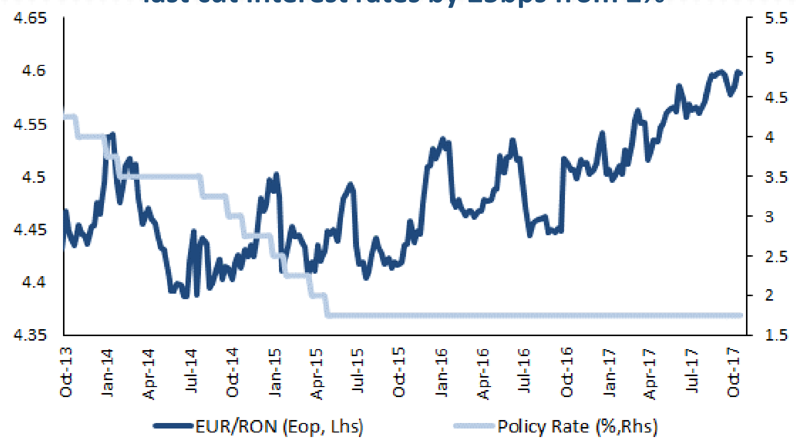
Joining the ERM2 mechanism for a period of at least two years is a formal prerequisite for Euroarea membership. According to press reports, Prime Minister Borissov has received support from both Chancellor Merkel and President Macron to go ahead with ERM2 application membership. Currently, Bulgaria fulfills 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: Policy inconsistency threatens macro-outlook

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 expanded by 5.9% YoY in 1H-2017 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

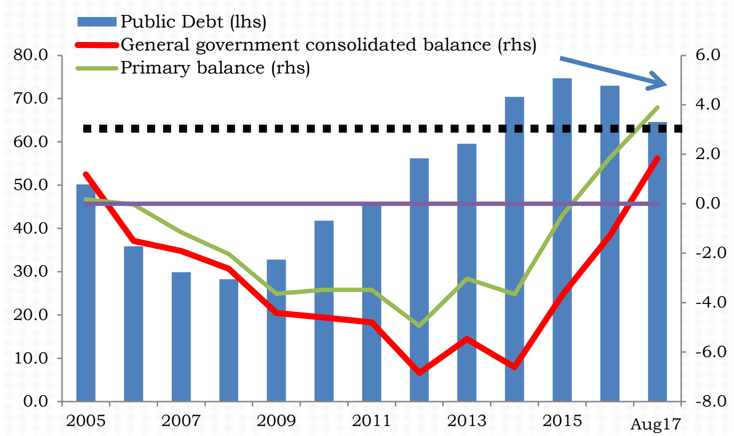
Inflation accelerated to 1.8% YoY in September entering within the lower band bound of NBR's target interval (2.5%+1%). The adjusted Core CPI climbed further to 1.8% YoY in September the highest level since November2013. Given the projected inflation trajectory and the elevated fiscal risks, NBR was inclined to initiate the tightening cycle in early October by narrowing the interest rate corridor by 25 bps to +/-1.25% from +/-1.50% instead of the KPR, which currently stands at 1.75%. Governor Isarescu signaled that another narrowing of the standing facilities corridor to +/-1.0% would be delivered in the following months.

Risks & Challenges

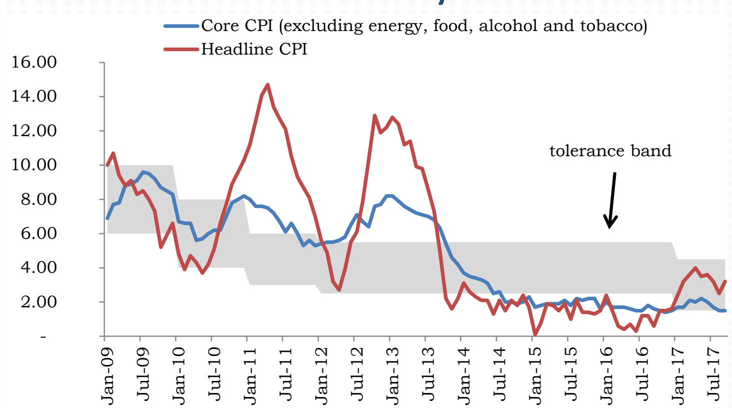
The consolidated government deficit in cash terms came at 0.8% of GDP in 9M-2017 on the back of generous public wage (+21.6% YoY) and pension hikes. The adopted corrective fiscal measures (reintroduction of excise fuel taxes–additional dividends from state-owned enterprises-postponement of an additional 10% pension hike) plus the under execution of the public investments program could probably maintain fiscal deficit close to but still above the threshold of 3%. Nevertheless, the announced fiscal easing measures for 2018 (PIT rate from 16% to 10%, mandatory Pillar II contributions from 5.1% to 3.7% of gross wage) may put additional pressure on the budget deficit. The political tensions within the ruling party PSD which culminated in the recent cabinet reshuffle plus policy inconsistency stemming from unanchored fiscal policies cast shadows on the macro-outlook.

Serbia: Fiscal consolidation continues unabated

Monetary tightening pressures instigated by firmer dinar



Inflation pressures remain subdued; both headline & core CPI stay within tolerance band



Source: Eurobank Research, National Authorities

Latest Economic & Political Developments

The economic slowdown has become visible by mid-year, as Q2 data showed a disappointing 1.3% YoY rise in real GDP, signaling that the previous full-year official forecast of ca. 3.0% is now out of reach. Growth remains fueled by private spending, while investments, net exports and government spending have proven weaker than earlier anticipated. Additionally, the severe summer drought hurt agricultural output. A solid rise in FDIs does not appear capable of outweighing the aforementioned headwinds. The low overall investment/GDP ratio, which is estimated to be at around 17.5%, lagging significantly behind the regional average of 23.5%, remains a key issue for the Serbian economy. Turning to the fiscal front, solid budget execution has been the highlight of Serbia's macroeconomic picture so far in 2017. The surplus totaled RSD 90bn in the first three quarters, with the FY 2017 surplus anticipated at around 0.5%-0.7% of GDP, the first surplus to be recorded since 2005. Some cautious fiscal expansion may emerge next year amid planned increases in public sector wages and pensions.

Central Bank Watch

Catching, once more, markets by surprise, the NBS Executive Board cut the key policy rate by 25bps to a new lifetime low of 3.50% in October. This marks the second consecutive reduction after the resumption of rate easing cycle in September. The market's median forecast was for stable interest rates in each of these last two meetings, but the Central Bank cited behind its decision benign inflation pressures. The dinar's recent strength also supported the case for such action. Our baseline scenario currently is for stable interest rates for the remainder of the year as private consumption is on a recovery mode 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	2.2	2.3	1.3	2.1	2.1	-2.4	-2.4	-2.6	-4.4	-4.3	-3.8
Eurozone	1.8	2.1	1.9	0.2	1.5	1.4	3.5	3.1	3.0	-1.5	-1.3	-1.0
Germany	1.9	2.0	1.8	0.4	1.6	1.5	8.3	8.1	7.7	0.8	0.7	0.7
France	1.2	1.6	1.8	0.3	1.2	1.3	-1.0	-1.1	-0.8	-3.4	-3.0	-3.0
Periphery												
Cyprus	2.8	3.5	3.1	-1.2	1.0	1.5	-5.7	-5.9	-6.3	0.4	0.2	0.4
Greece	0.0	1.5	2.2	0.0	1.2	1.1	-0.6	-0.3	-0.1	0.7	-0.8	0.6
Italy	0.9	1.5	1.2	-0.1	1.4	1.1	2.6	2.7	2.3	-2.4	-2.2	-1.3
Portugal	1.4	2.5	2.0	0.6	1.5	2.0	0.7	0.4	0.3	-2.0	-1.5	-1.4
Spain	3.2	3.1	2.5	-0.2	2.0	1.5	1.9	1.9	2.0	-4.5	-3.2	-2.5
UK	1.8	1.5	1.3	0.7	2.6	2.6	-4.4	-3.6	-3.3	-2.9	-2.9	-2.3
Japan	1.0	1.5	0.8	-0.1	0.4	0.5	3.8	3.6	3.8	-4.2	-4.1	-3.3
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	3.4	3.8	3.5	-0.8	1.6	1.5	5.4	4.0	3.0	1.6	0.0	-1.0
Romania	4.8	5.5	4.4	-1.6	1.4	3.3	-2.2	-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

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

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	1.24%	1.34%	1.50%	1.60%	1.75%
3m Libor	1.32%	1.52%	1.67%	1.80%	1.88%
2yr Notes	1.62%	1.70%	1.75%	1.85%	1.95%
10 yr Bonds	2.45%	2.50%	2.60%	2.70%	2.75%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.33%	-0.32%	-0.32%	-0.31%	-0.29%
2yr Bunds	-0.75%	-0.70%	-0.66%	-0.59%	-0.55%
10yr Bunds	0.37%	0.50%	0.55%	0.65%	0.70%
UK					
Repo Rate	0.25%	0.50%	0.50%	0.75%	0.75%
3m	0.43%	0.55%	0.67%	0.76%	0.83%
10-yr Gilt	1.34%	1.42%	1.48%	1.53%	1.58%
Switzerland					
3m Libor Target	-0.75%	-0.75%	-0.75%	-0.70%	-0.65%
10-yr Bond	-0.06%	0.00%	0.03%	0.06%	0.10%

Source: Bloomberg (market implied forecasts)

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