Eurobank

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

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

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I. Snapshot

Overview

Macro Picture

- **USA:** Growth outlook improves on President Trump's forthcoming fiscal stimulus
- **EA:** Moderate economic recovery at steady pace
- **UK:** Growth expected to slow on Brexit uncertainty
- **Japan**: Sizeable fiscal stimulus stabilizes growth outlook
- **EM:** Growth pickup, especially in LatAm as Brazil emerges out of recession
- **CESEE:** Economic activity outperforms EM peers

Policy Outlook

- **USA:** Two fed rate hikes in 2017, with risks towards additional tightening, if sizeable fiscal stimulus is delivered
- **EA:** ECB maintains easing bias; possible taper decision by year-end
- **Japan:** BoJ on hold. Modest normalization in case of rapid JPY appreciation and/or sharp oil price increase
- **CESEE:** Monetary policies remain accommodative, fiscal consolidation continues

Summary

Global growth to gain momentum, with deflation fears giving way to reflation expectations. A more balanced policy mix towards more fiscal stimulus has sparked expectations for a higher growth / higher inflation regime

Markets

- **Government bonds:** US Treasuries, Bunds under pressure on reflation hopes
- **FX:** USD well supported short-term but we favor EUR upside; Brexit developments to set the tone for the GBP
- **Commodities:** Turning up after a long bear market with industrial metals and energy leading the way
- **EM:** Higher DM rates should weigh short-term, but we see this as a buying opportunity

Key Risks

- **Trump disappointment:** Trump's fiscal stimulus falls short of expectations; protectionist stance triggers trade war; US fails to accelerate
- **A steeper Fed rate-hike trajectory ahead**: EM capital flows negative
- **EU political risks:** Populist parties increase popularity or even come into power in upcoming EU elections: bearish for EU periphery government bonds
- **(Hard?) Brexit**: Low direct exposure of the CESEE region, though impact likely to higher than in EM peers / Indirect impact through euro area interlinkages

Macro Views

Latest Macroeconomic Developments & Outlook

World Economic Outlook		Global growth is expected to accelerate modestly in 2017 to 3.4% after bottoming out in 2016 at 3.1%, the slowest pace after the global financial crisis, mainly driven by a growth pickup in the US and an economic recovery in emerging markets (CESEE region and Latin America). Market perception of the economic outlook has notably improved after the US elections, but uncertainty prevails as to the actual impact of Trump's policies on the US economy and the growth spill-over effect to the rest of the world.
Developed Economies	US	Real GDP growth is expected to accelerate to 2.3% in 2017 from 1.6% in 2016, boosted by sizeable fiscal stimulus under Trump's administration. Consumer spending and, to a lesser extent, business fixed investment to constitute the main growth drivers.
	Euro Area	The Euro area economy is expected to continue its moderate pace of recovery, with real GDP growth averaging 1.6% in 2017-18 from 1.7% in 2016. Domestic demand to remain in the driver's seat, but momentum may ease somewhat on a fading growth impulse originating from lower oil prices and government bond yields.
	Periphery	Periphery euro area economies are expected to grow faster than the core in 2017 for the fourth consecutive year, with real GDP averaging 2.2% from 1.9% in 2016. Italy will likely be a laggard as still tight financing conditions and uncertainty hold back a stronger recovery.
	Japan	Japan is projected to stabilize at around 0.8% in 2017 from 0.9% in 2016, supported by a pickup in industrial production amid a drop in inventory accumulation. Business capex and the unfolding fiscal stimulus should underpin stronger export growth, helped by improved global demand and a weaker domestic currency. Consumer spending is expected to recover modestly, helped by cyclical dissaving and a tightening labor market.
Emerging Economies	BRICS	Brazil and Russia are expected to exit from recession in 2017, more than offsetting the modest growth deceleration in China (to 6.5% in 2017 from 6.7% in 2016). India's GDP will continue to expand at the fastest pace among major economies, with growth forecasted at 7.2% in 2017 from 6.6% in 2016.
	CESEE	Broader region & economies of our focus among EM outperformers in 2016-2017, despite a riskier external backdrop.

Global Themes & Fundamental Drivers

Theme	Implications
Anticipated shift in the US policy mix	US fiscal policy is expected to become more expansionary under Donald Trump's administration. The implication of this is likely to be higher potential growth, along with rising inflationary pressures and a speedier normalization of US monetary policy. Stronger US growth momentum may provide an important boost to the global trade cycle, coupled with the continued recovery in emerging markets. Yet, US protectionist trade stance may be a reason for caution.
From deflation fears to reflation expectations	Following a low inflation environment in the post-crisis years, reflation dynamics post the US Presidential elections have come to the fore. Higher headline inflation (current and expected), largely driven by base effects and the recent rise in energy and commodity prices, could lead to a more hawkish/less accommodative monetary policy stance and steeper rate curves.
Rebalancing from monetary to fiscal policy	Rebalancing from monetary to fiscal policy was reinforced by the prospect of a sizeable fiscal stimulus under the new US administration, featuring personal income and corporate tax cuts, infrastructure spending and regulatory easing (mainly in the financial sector). In Europe, the European Commission (EC) called at the end of 2016 for a euro zone-wide fiscal expansion of 0.5% of GDP. In the UK, the government intends to provide some fiscal stimulus over the next three fiscal years beginning in 2017/18, mainly via corporate and income tax cuts. In Japan, the fiscal stimulus package adopted by the Diet in autumn of 2016 is anticipated to boost GDP growth by ca 0.6pps in 2017. A more balanced policy mix could be supportive of economic growth and inflation, leading to higher global rates.
UK ready to leave the single market and the customs union	Laying out her government's priorities for the Brexit negotiations, Premier Theresa May stated clearly that the UK will seek to leave the single market for the benefit of gaining control over immigration and withdrawal from the jurisdiction of the European Court of Justice. At the same time, she pledged a "new, comprehensive, bold and ambitious Free trade Agreement" with the EU, and appeared open to partial customs union membership. However, with several high-level EU officials warning that there will be no cherry picking, many questions about the future relationships between the UK and the EU remain open. The Brexit process could potentially influence negatively UK and euro area economic activity once Article 50 is triggered, expected by end-Q1 2017.

Macro Themes & Implications in EA Periphery

Theme	Implications
Political uncertainty	Looming elections in three core euro area members and related uncertainty is likely to weigh on the region's growth in 2017, potentially via consumer and corporate sentiment; General elections in the Netherlands (March 15), French Presidential & General election (second rounds on May 7 & June 18), German presidential election (September 24) and, possibly, in Italy in Q2. Fears over populism risk in Europe prevail, especially following the unexpected outcomes of the UK referendum and the US presidential election.
Banking woes	In addition to heightened political risks, ongoing banking sector problems in a number of EA peripheral economies may also weigh on economic growth. On the positive side, Spain and Ireland have already shown significant progress in facilitating bank consolidation and cleaning private sector balance sheets. However, bad loans remain a serious challenge for Italy, Portugal and Greece (respective NPL ratios at 17.5%, 12.7% & 37.0% in Q2 2016). Addressing this problem in an efficient manner would be of fundamental benefit to their economies as financial soundness of the banking system could improve, freeing-up capital that could be directed to productive sectors of the economy and, therefore, resulting in an increase of productivity and growth.
ECB stands ready to expand QE programme, if needed	Speaking at the January press conference (19 January), ECB President Mario Draghi emphasized that risks surrounding the euro area growth outlook remain tilted to the downside and that the Governing Council intends to look through the energy-driven increase in headline inflation as there are no signs yet of a convincing upward trend in underlying inflation. He dismissed any suggestions that a withdrawal of monetary accommodation was appropriate at this stage and stressed that the ECB stands ready to increase the asset-purchase programme in terms of size and/or duration beyond December 2017, if deemed necessary. ECB monetary accommodation is expected to remain in place in the quarters ahead, benefiting core and EA periphery bond markets. Risks for a further slowdown in the monthly pace of asset purchases could arise, if core inflation were to move above 1.5%, expected not earlier than late H2 2017, and issuer limits are reached.

Macro Themes & Implications in CESEE

Theme	Implications
Limited room for further monetary & fiscal policy stimulus	Lax regional and global monetary policies & low energy prices supported growth acceleration in 2015-2016. Scope for further expansionary fiscal and monetary policies is constrained by historic low interest rates, expectations for rising price pressures & major Central Banks' policy stance.
Reflation risks on the rise	Headline inflation rates across the region are trending higher. Rising energy prices and base effects are expected to push inflation higher in 2017-2018. Core inflation readings suggest that demand side pressures are broadly contained for the time being. Local yields appear to have bottomed out in 2016.
High liquidity to support government bonds	Accommodative domestic monetary conditions have been supportive for regional bonds. The prospect of higher global rates and steeper EUR and USD curves will likely have a negative impact on regional bond yields. Weaker foreign investors appetite for regional assets likely to be mitigated by domestic investor demand.
Brexit	Direct trade and FDI ties with the UK are modest, while there are no significant banking sector linkages. In the short-term, the broader region is exposed to a euro area slowdown due to the probability of a hard UK exit, given the EA's role as a key trade partner and a major capital flow generator for the region. In the long-term, the region could turn Brexit into an opportunity by attracting departing business from UK and improved trade integration with EA.
Euro skepticism/ Regional & Political Risks	**Turkey:** Stronger USD, heightened domestic political & economic concerns weigh on domestic asset markets. Pressures to persist in view of the upcoming referendum (spring 2017) & higher Fed rates; **Serbia:** Presidential elections in spring bear political stability risks; **Romania:** Fiscal concerns on the rise; **Bulgaria:** Early parliamentary elections take centre stage in late March. A heavy political events calendar in Europe & Trump's policies to remain in focus. Rise of populism & nationalism across Europe could delay the region's convergence process.

The Trader's View

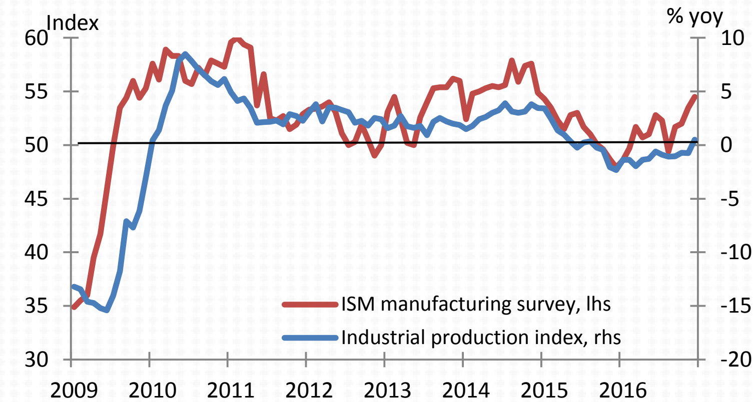
Asset Class	Outlook
FX Markets	**EUR/USD**: Market consensus favours the USD and positioning is quite stretched. USD is supported by the yield differentials and political uncertainty in Europe. However, what matters is the extend of what has already been priced in. Overall, we don't expect EURUSD to break parity and favour a trading range of 1.03 to 1.12 before EURUSD moves higher. **USD/JPY**: The pair tracks the 10y treasury yield and is also very sensitive to risk sentiment. A range of 110 to 120 is expected for 2017, on the view that treasuries will not move much higher than the 2.8% mark and rate differential with EU will compress. **GBP/USD**: Brexit hangover still looms over GBP. Again it's a matter of what has been priced in. Further GBP depreciation is expected, given the negative sentiment over sterling and the uncertainties that Brexit poses. UK is expected to face inflationary pressures from the depreciating currency and the central bank might have to respond by tightening its stance. Overall, we don't expect further significant downside of GBP vs USD and we expect a trading range of 1.20 to 1.30 for the first months of 2017.
Government Bonds	**US:** The Trump administration, initially fueled expectations for fiscal easing, providing an extra impetus to higher rates. Nevertheless, its erratic policies, along with Senate announcements that any planned tax changes will have to wait until 2018, could trap US rates in a range with the 10y UST yield struggling to reach the 3% consensus view by year-end. Thus, the so advertised reflation trade leading to higher and steeper curves could find hurdles ahead with the belly and the front end of the US curve moving higher, leading to flattening of the 2s/10s segment. **EU:** Fundamentals have remained solid and the latest inflation prints coming out of Germany and France could fuel another debate inside the ECB on QE programme tapering. However, with oil price effects slowly fading, we could see a stabilization of inflation expectations, which could, in turn, cap the 10y Bund yield at 0.70%. Insurance companies have traditionally moved further out the curve (30y – 50y), trying to leverage their receivable so we are not sure how much effect they will have on the most liquid part of the curve (i.e. up to 30y)
EM hard currency	We expect short-term headwinds for EM, but fundamentals should continue to improve and a Q1/Q2 widening in spreads/rise in yields should give an attractive medium-term buying opportunity. Idiosyncratic risks will remain a key driver for name selection and tactical entry points.
Credit	We expect wider spreads in IG and HY space, in both EUR and USD setting up a difficult year for credit total returns in 2017, particularly in the IG space. In Europe, given the CSPP, we prefer shorter dated lower quality credits and financials over non financials. In the US, again, we prefer financials over non-financials. On non-financials, we prefer higher quality credits as we expect significant ratings decompression. We would be placed in the mid to long end of the curve on any rates widening, as the short end of the curves remains extremely steep.
Commodities	After a multi year bear market, the asset class seems to have formed a long-term base in 2016, and with the global growth outlook improving upward price pressures should continue. We expect oil to break out of its two years range and head higher, while Gold will face headwinds with more Fed hikes ahead. Industrial metal prices should be boosted by the momentum of the new US government policies as well.

II. Advanced Economies

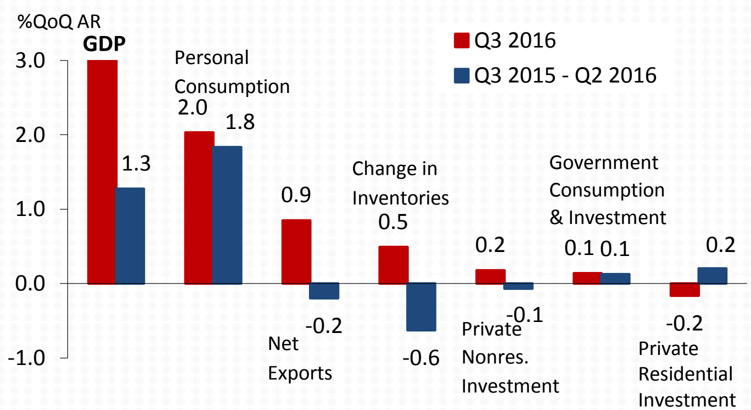
- USA
- Euro Area
  - ❖ Periphery (Italy, Spain, Portugal, Cyprus)
- Japan
- UK

USA: fiscal stimulus to boost GDP growth, but mind the risks

The US manufacturing sector is stabilizing…



…as the inventory cycle comes to an end



Source: US BEA, University of Michigan, Eurobank Economic Research

Economic Outlook

Real GDP growth is expected to accelerate to 2.3% in 2017 from 1.6% in 2016, with a sizeable fiscal stimulus under Trump's administration boosting domestic demand. The peak impact of the anticipated fiscal measures seems materializing in H2 2017 and H1 2018, provided that the bill is approved by Congress by mid-2017. Consumer spending is expected to remain the main driver of growth. Business fixed investment will also provide support, albeit to a somewhat lesser extent, given the relatively small multiplier for corporate tax cuts (CBO estimates: 0.2 compared to an average of 0.6 for total tax cuts and 1.4 for infrastructure spending).

Central Bank Watch

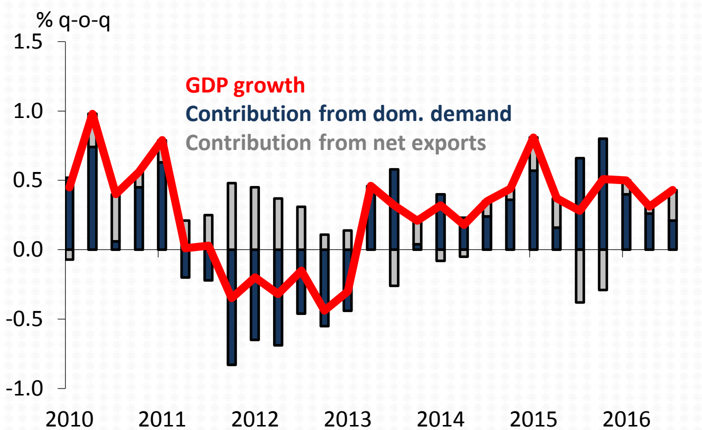
Following a 25bps rate hike in December 2016, the second in a year, Fed Chair Janet Yellen has adopted a more hawkish stance, arguing that the US economy is meeting the Fed's dual objective with the labor market approaching its longer-run normal level and inflation moving towards the 2.0% medium-tem target. Nevertheless, she kept on advocating a gradual pace of rate hikes, partly because of weak productivity growth. In her view, monetary policy had not fallen behind the curve as there is no convincing evidence that the labor market is overheated, given the moderation in employment growth and a more gradual decline in the unemployment rate over the past year. Our estimates call for two 25bps rate increases in 2017, leaving the target range for the fed funds rate at 1.00-1.25% by year-end. Nevertheless, we see risks skewed toward additional tightening, depending on the unpredictable timing of the unfolding of fiscal stimulus.

Risks

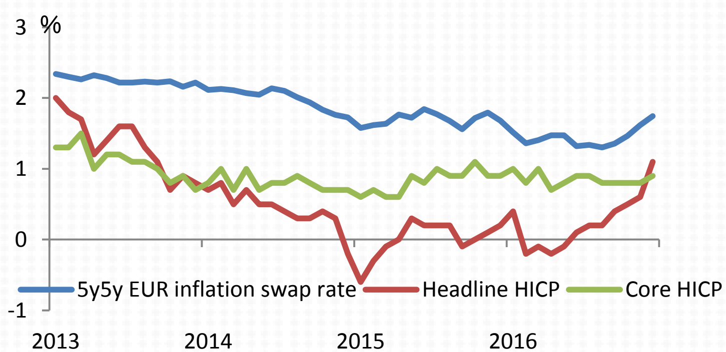
Trade policy constitutes a key risk to the outlook. Should Trump prioritize trade protectionism over growth-friendly policies, US growth could fail to accelerate. Moreover, risks for growth and inflation can also stem from a rapid USD appreciation if the Fed tightens monetary policy faster than currently expected. Excessive dollar strength could hurt US exports, squeeze profit margins and potentially offset the positive effects of fiscal expansion.

Euro area: moderate pace of growth continues; political risks on the upside

EA growth mainly driven by domestic demand



Unlike headline HICP, underlying core inflation remains weak on stagnating ULCs



Source: ECB, Eurostat, Eurobank Economic Research

Economic Outlook

Against the backdrop of severe market stress, Brexit woes and anemic global trade, Euro area economy has proven resilient in 2016, supported by solid domestic demand growth. The economy is expected to continue its moderate pace of recovery over the next couple of years, with real GDP growth averaging around 1.6% in 2017-18 from 1.7% in 2016. Domestic demand will probably remain in the driver's seat, although momentum may ease somewhat as the growth impulse originating from lower oil prices and lower government yields has vanished. Meanwhile, external demand should make a positive contribution in 2017, as euro area exports start capitalizing on strengthening global growth. The fiscal policy impulse should remain positive albeit modest, as a major fiscal loosening in countries that have the fiscal space (i.e. Germany) seems highly unlikely in a year with a heavy euro area political agenda. Long-term prospects remain fragile, with high corporate and private household debt levels and necessity for structural reforms.

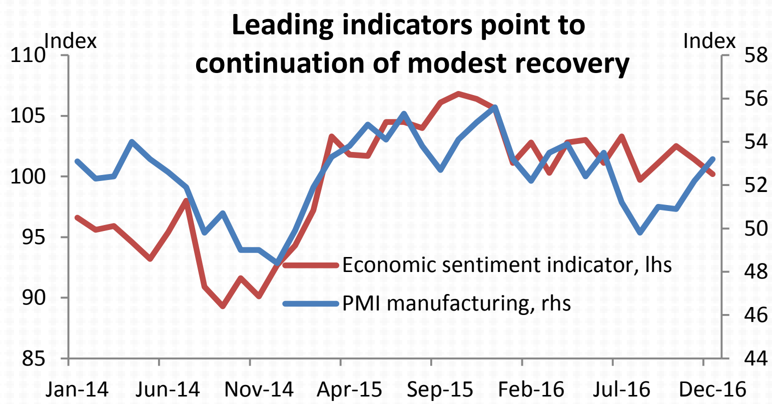
Central Bank Watch

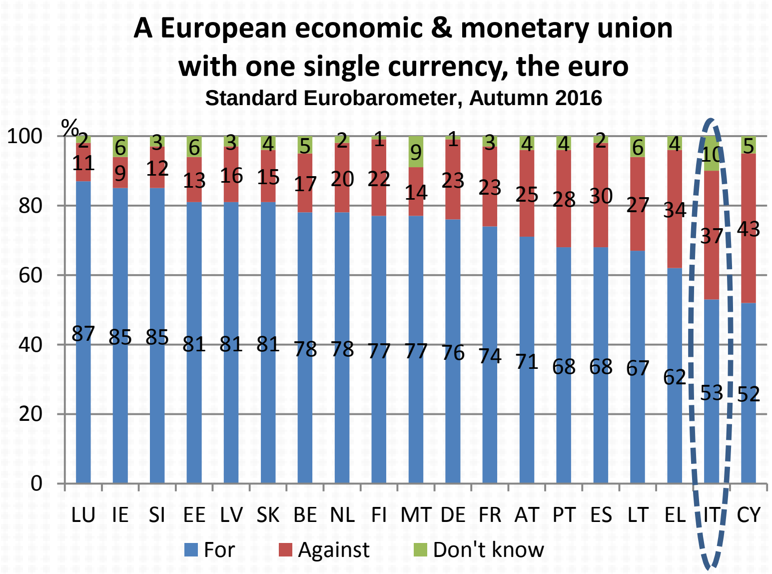
The ECB maintains an easing bias, with the pace of headline and core inflation dynamics being critical for future policy deliberations. Headline inflation is expected to move closer to the ECB's medium-term target of "below but close to 2.0%" by Q3 2017, supported by base effects from food and energy prices. Nevertheless, core prices will probably continue recovering relatively more slowly, as there is significant labor market slack which is likely to weigh on wage recovery in the coming months, leaving core HICP inflation at around 1.0% for most of 2017. We are of the view that monetary accommodation will persist well into 2018 but at a reduced pace (lower than the €60bn pace scheduled for April-December 2017), until a durable and self-sustained price convergence to the ECB's target for the euro area as a whole is ensured. Further ECB tapering could potentially be announced in H2 2017, as soon as the political agenda lightens, normalizing inflation generates pent-up demand and US fiscal stimulus boosts US growth.

Risks

Although markets in 2016 managed to brush aside a number of political shocks, the Brexit process could weigh on euro area sentiment and, consequently, activity once the UK actually triggers Article 50. Political risks take center stage in the Euro area as well, as populist parties are gaining public support in a year with general elections in the Netherlands, Germany, France and most likely in Italy.

Italy: moderate economic recovery on track; political uncertainty and banking jitters pose downside risks





Source: Markit, EC, Eurobank Economic Research

Economic Outlook

Real GDP surpassed expectations in Q3 2016 (+0.3%QoQ), outperforming both France and Germany for the first time in the past eleven years, partly on the back of a pickup in industrial production growth that accounts for about 20% of the Italian economy. For 2016 as a whole, real GDP growth is forecasted at 0.9%, while the modest economic recovery is expected to continue with rates of growth slightly below 1.0% for the next couple of years. Real economic activity might benefit from loose financing conditions and a modestly expansionary fiscal policy. The said policy will depend to a large extent on budget plans agreed with the EC, as the latter is requesting additional fiscal measures of up to 0.2% of GDP in 2017, in order for the country to achieve a deficit-to-GDP ratio of 2.2%, down from c. 2.4% in 2016. In line with its trend since 2015, private domestic demand is expected to remain the main driver of growth, with business capex helped by government incentives and private consumption supported by further employment growth. On the external front, the modest upside, amid stronger world demand, will probably be offset by the uncertainty over Donald Trump's trade policy stance.

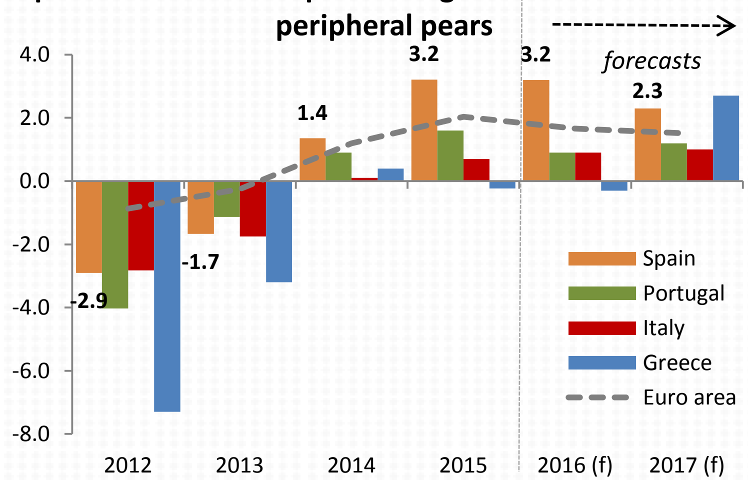
Risks

Political uncertainty: The domestic political situation remains fragile, as the Constitutional Court ruling, announced on the 25th of January, increases the likelihood for snap elections in 2017. The court deemed the 2nd ballot-runoff system unconstitutional, transforming the Italicum into an essentially proportional system with a 3% minimum threshold. Although the ruling leaves in place a working electoral framework, a functional electoral law is necessary in order to ensure a harmonisation between the voting systems of both Houses of Parliament. Political risk is expected to remain elevated in the following months, given the increasing support for populist and Eurosceptic parties and the relatively low support for the euro (the lowest among euro area member states).

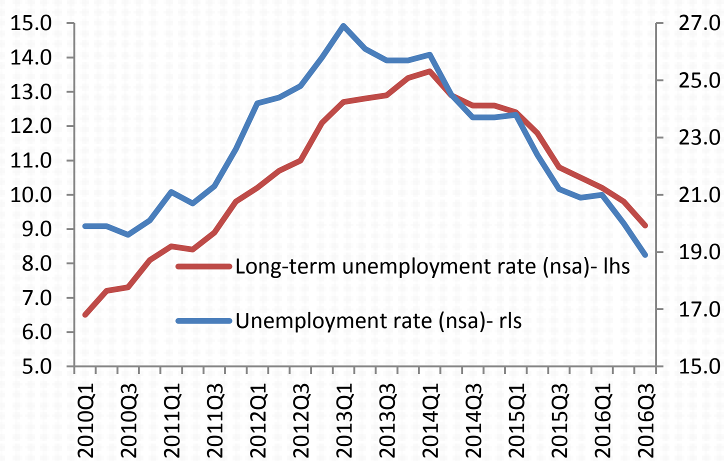
Banking sector: The large stock of NPLs weighs on the Italian banking sector, posing significant downside risks for Italy's economic recovery. It is of vital importance that a systemic solution on the banking front is found so as to contain investor related concerns, and contribute to a higher potential GDP growth.

Spain: 2017 GDP growth expected to decelerate, but remain higher than in most euro area peers

Spain to continue outperforming in 2017 most of its EA peripheral pears



Gradual improvement in labor market



Source: Eurostat, Eurobank Economic Research

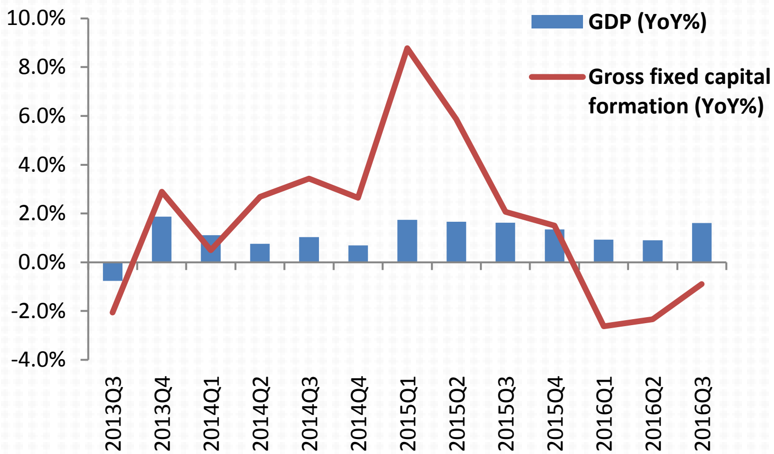
Economic Outlook

2017 real GDP growth is expected to moderate to 2.3% from 3.2% in 2016 as the positive effects of temporary factors that supported private consumption in the last two years will likely wane (i.e., oil prices, reduced income tax rates for 2015-2016). In addition, implementation of additional fiscal consolidation measures to help the government bring the 2017 budget deficit target down to 3.1%-of-GDP from an estimated 4.6%-of-GDP in 2016, will likely weigh on real household incomes, partially offsetting the positive effect from ongoing job creation and the gradual fall in the unemployment rate. Spain is also likely to be negatively affected this year from slightly weaker growth among its main trading partners in Asia, particular China, as well as slower growth in the Eurozone, the largest trading partner. However, Spain should again outperform most of its Eurozone peers partially thanks to the tourism sector, which is benefiting from political instability in Northern Africa, terrorism fears in France and other European holiday destinations. In spite of the expected continuation of solid growth momentum, elements of uncertainty prevail. These mainly include:

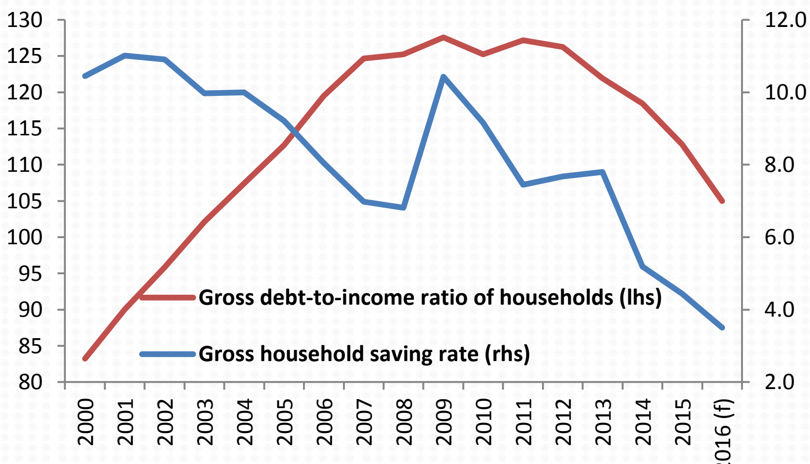
- ***Limited scope for major reforms.*** After an impasse lasting several months following the inconclusive outcome of the December 2015 and June 2016 general election, Marian Rajoy, the leader of the right-wing People's Party (PP), managed to gain a relative majority in parliament in October 2016 with the support of the centre-right Ciudadanos party and the CC-PNC coalition from the Canary islands, along with the abstention of the some PSOE lawmakers (Spanish Socialist Workers' Party). Arguably, the minority government is less stable than it was earlier the case, controlling 137 MPs in the 350-seat parliament. That said, it needs positive votes or abstention from PSOE lawmakers in order to pass legislation. In return, it may need to compromise for securing approval for further major reforms as was the case in late 2016 when the government agreed to an increase in the minimum wage. Spain avoided EU sanctions for repeated fiscal slippage last July in exchange for committing to implement fiscal consolidation measures amounting to 0.5%-of-GDP in both 2017 and 2018.
- ***Independence referendum in Catalonia***. Catalonia constitutes a major risk with the Catalan government remaining committed to holding a unilateral constitutional referendum in September 2017.

Portugal: 2017 GDP growth expected to pick up modestly, but structural challenges remain

Investment expected to pick up from its recent slowdown



Household debt ratio still relatively high



Source: Eurostat, Eurobank Economic Research

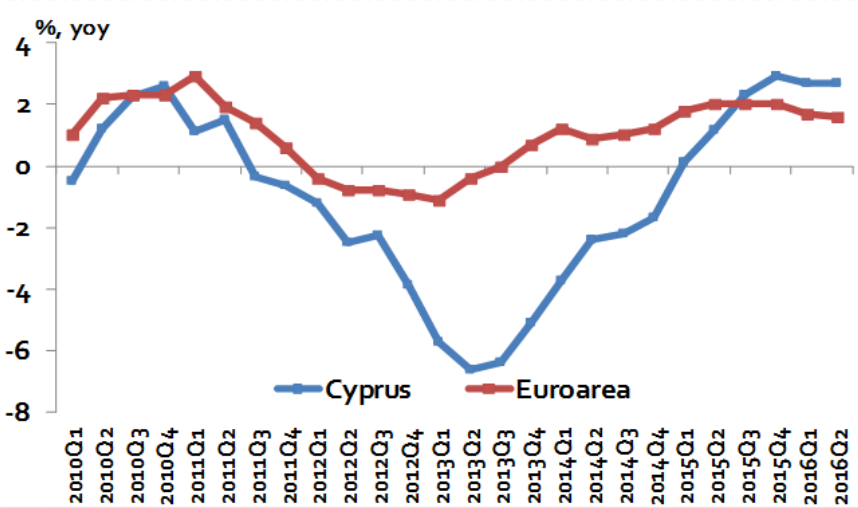
Economic Outlook

Real GDP growth is expected to gain some momentum in 2017 supported by a pick up in investment and improved export growth on the back of an anticipated recovery in traditional EM trading partners, including Brazil. On the flipside, public consumption is expected to slow if the government is to meet this year's 1.6%-of-GDP budget deficit target, drawn from an estimated deficit of 2.4%-of-GDP in 2016. The argument is further supported by household saving falling to a fresh historic low late last year and higher oil prices dragging down real consumer income. Overall, from an estimated 0.9% in 2016, real GDP growth is expected to accelerate to 1.2% this year, but to remain below the 1.5% rate projected for the euro area as a whole, with persisting structural challenges preventing a more dynamic recovery of domestic economic activity. These mostly include:

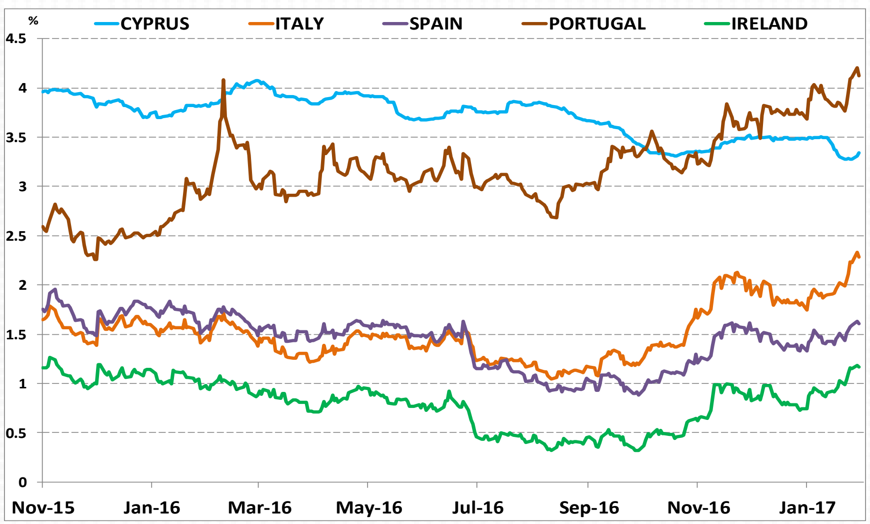
- ***Lingering headwinds to the domestic banking sector*.** After the government and the EU reached an agreement in principle in late summer 2016 on the recapitalization of Portugal's largest state-owned bank, Ciara Geral De Depositors, the prospect of renewed banking jitters cannot be ruled out. This holds especially in view of the subdued profitability outlook of the domestic banking sector and the elevated levels of NPLs (c. 12.7% of total gross loans in Q2 2016 from 5.2% in end-2010 and 1.3% in end-2006). Under such a scenario, a threat of a rating downgrade by DBRS could resurface ahead of its next semiannual review on April 2017. A potential downgrade could render PGBs ineligible for collateral in the ECB's regular refinancing operations and QE programme, creating liquidity pressures on the domestic banking system and potentially forcing Portugal into an ESM programme (DBRS is currently the only of the four major rating agencies to rate Portugal in investment grade).
- ***Private sector leveraging*.** Both household and corporate debt ratios continued to gradually decline in 2016 for the third year in a row. However, both still remain relatively high compared to historic standards, presenting a key obstacle to investment and growth.

Cyprus: a clear turn-around story

Real GDP growth %



10Y Generic Bond Yields



Source: Eurobank Research, National Authorities, Bloomberg

Macro Outlook

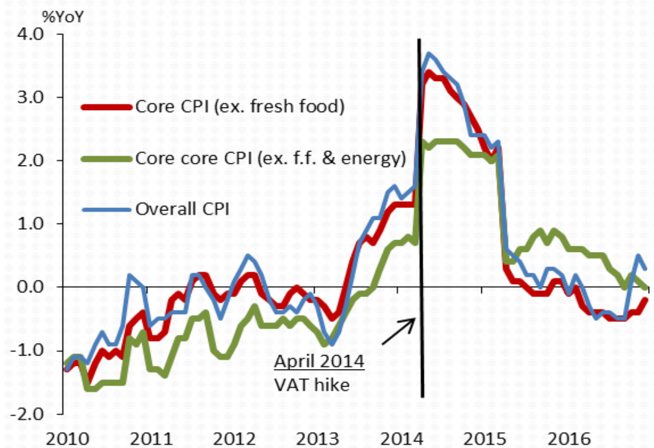
- Fast growth recovery– 2017f:3%, 2016e:2.8%, 2015:1.7%
- Strong sentiment improvement (close to pre-crisis high of Aug2007) & flourishing tourism sector (record high tourist arrivals in 2016)
- Impressive fiscal consolidation & room for more flexible fiscal policies: FY13:-4.9% /FY14:-0.2%/FY15: 0%/FY16:-0.4% PD17: 105.6%
- Achilles heel: Highest NPEs ratio in EU-28, close to 50%,138% of GDP, Intense restructuring effort
- Significant unemployment decline (2016e:13.2% vs. 2015:15%)
- Rating agencies upgrade (S&P:BB, 2 notches below investment grade), Moody's: B1, Fitch: BB-

Market Outlook

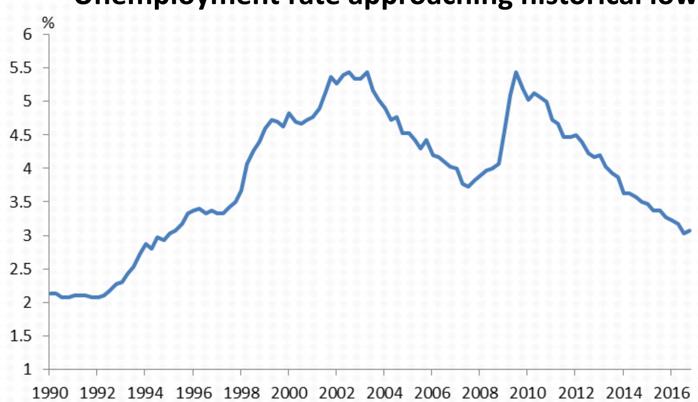
- The only EA-Periphery economy with a positive sovereign outlook
- Room for further sovereign upgrades provided that focus remains on reducing NPEs and commitment to pending reforms
- Access to the international markets in July 2016 (7Y @3.80%, first time after program graduation) & further issuance in 2017
- Cypriot bonds have outperformed Portuguese since last November
- Risks: Reforms fatigue / NPEs restructuring/ Hard BREXIT/ Solution to the Cypriot Issue

Japan: growth stabilization assisted by sizeable fiscal stimulus

Inflation well below the BoJ's 2.0% target



Unemployment rate approaching historical lows



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

Economic Outlook

The latest revision of national accounts (December 2016) revealed higher output growth than that reported earlier. High frequency indicators suggest that real GDP growth will stabilize at around 1.0% in the coming quarters, supported by a pickup in industrial production amid a drop in inventory accumulation. Adding to this, business capex and the unfolding fiscal stimulus could underpin stronger export gains, supported by stronger global demand and a weaker JPY. Consumer spending, which has been suffering in recent years in the wake of the VAT hike in April 2014, is expected to recover modestly, helped by cyclical dissaving and tightening labor markets. Mirroring a positive outlook for the Japanese economy, the BoJ has revised upwardly its real GDP growth forecasts to 1.5% from 1.3% for FY2017 and 1.1% from 0.9% for FY2018, partly on the back of the positive effects of fiscal spending under the FY16 supplementary budgets.

Central Bank Watch

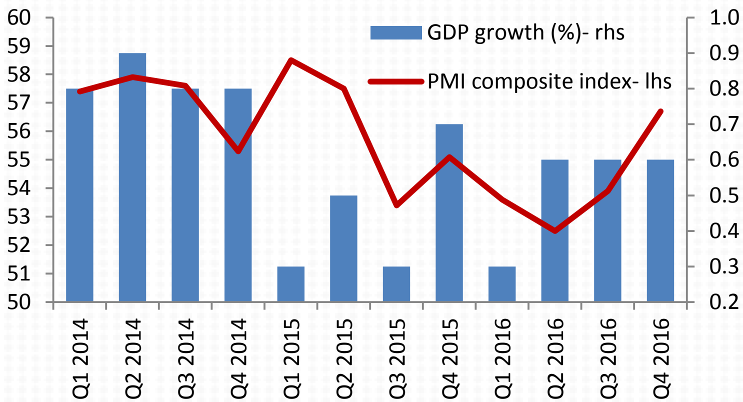
As expected, the BoJ kept unchanged its monetary policy at its 30-31 January MPM, i.e. (i) its target for 10y JGB yields intact at 0% (Yield Curve Control-YCC), (ii) its annual JGB purchases at a pace of JPY80trn (Quantitative Easing), and (iii) its annual equity-linked ETF and J-REIT purchases at a pace of JPY6trn and JPY90bn, respectively (Qualitative Easing). On the inflation front, the BoJ left core projections unchanged (1.5% for FY2017, and 1.7% for FY2018), expecting to hit the 2% target by around March 2019. We expect the BoJ to stay on hold during 2017, even though a modest "tightening" of its monetary policy cannot be ruled out in H2 2017 in case of pronounced JPY depreciation and/or further significant increase in oil prices that would exert upward pressure on inflation and yields. In this case, the BoJ could raise the target for 10y JGB yields under its YCC program to about 10-20bps and/or taper quantitative easing to JPY60trn/year from JPY80trn/year. Such a move could delay inflation reaching the 2% target, but it would contribute to a sustainable rise in inflation.

Risks

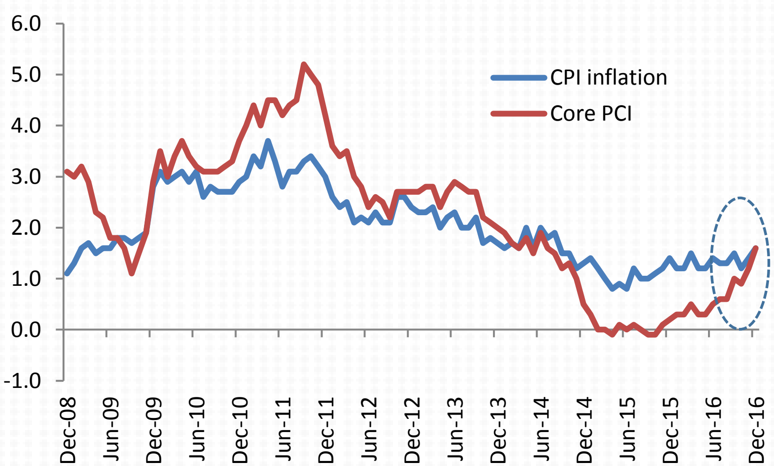
Growing trade protectionism in the US could have a negative impact on many Asian economies, including Japan. Meanwhile, unless the government adopts another supplemental budget for FY 2018, the economy might have to confront a modest "fiscal cliff" in 2018 that could lead to a sharp growth deceleration.

UK: 2017 GDP growth expected to slow as Brexit uncertainty intensifies

UK growth remarkably resilient to Brexit uncertainties in H2 2016



Building evidence of sterling-induced rise in inflation



Source: Eurostat, Eurobank Economic Research

Economic Outlook

The UK economy defied expectations for a sharp slowdown in the six months after the EU referendum in June 2016 as neither businesses nor consumers appeared to meaningfully adjust their behaviour to the Brexit vote. In fact, the UK was the fastest growing G7 economy in 2016 with GDP expanding by 2.0%, slightly below 2.2% in 2015 mostly due to weak growth in Q1. The BoE's speedy reaction with a more aggressive than expected easing package at the August policy meting, reduced political woes with the swift appointment of a new Prime Minister in July, postponement of Article 50 activation to 2017 and the GBP's post-referendum depreciation, appear to have been the main reasons behind the economy's remarkable resilience. However, the Brexit impact is expected to start being visible to the real economy in late Q1 2017 or very soon after —when the UK government intends to activate Article 50 of the Lisbon Treaty — mainly via a fall in business investment and hiring along with a hit to consumer confidence. That said, with the delayed economic adjustment expected to begin once the Brexit process commences, 2017 GDP is projected to slow to 1.5%YoY.

Brexit- the biggest risk factor for the UK economy

Presenting the government's objectives and priorities in relation to the UK's exit from the EU, Premier Teresa May accepted publicly that her priorities— i.e., the ability to restrict EU immigration and withdrawal from the jurisdiction of the European Court of Justice — are incompatible with membership of the EU single market and full membership of the Customs Union.

BoE expected to keep monetary policy on hold throughout 2017; risks in both directions

After launching a bigger than expected easing package in August, the BoE shifted from an easing to a neutral bias in November due to the resilient economic activity and the post-referendum GDP weakness. Looking ahead, the BoE is expected to keep monetary policy on hold with risks laying in both directions. Under a scenario of substantially slower growth, the likelihood of further BoE easing cannot be ruled out completely. On the flip side, should the sterling-induced rise in inflation starts feeding through to inflation expectations raising the risk of second round effects, BoE rate tightening may come to the fore, even at a time of increased Brexit-related uncertainty.

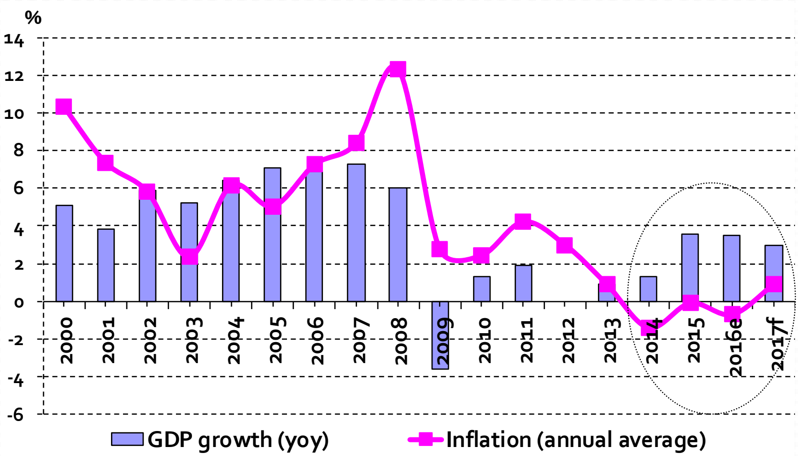
III. Selected CESEE economies

- Bulgaria
- Romania
- Serbia

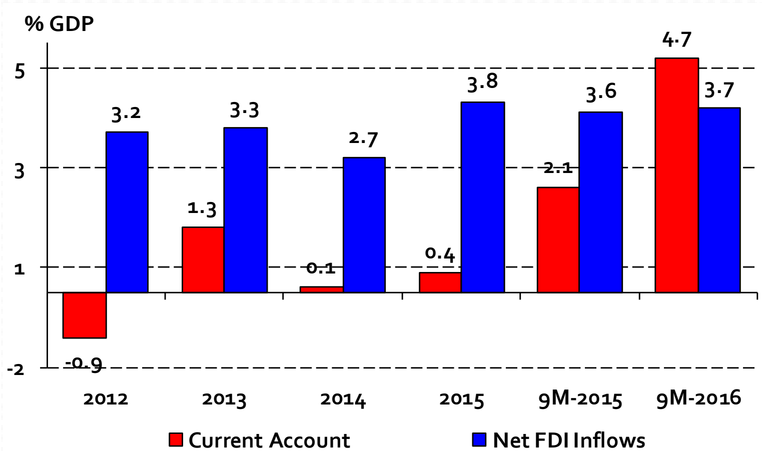
Special Focus: Turkey

Bulgaria: early parliamentary elections in late March

GDP Growth & Inflation



CA Balance & Net FDI inflows



Source: Eurobank Research, National Authorities

Macro Outlook

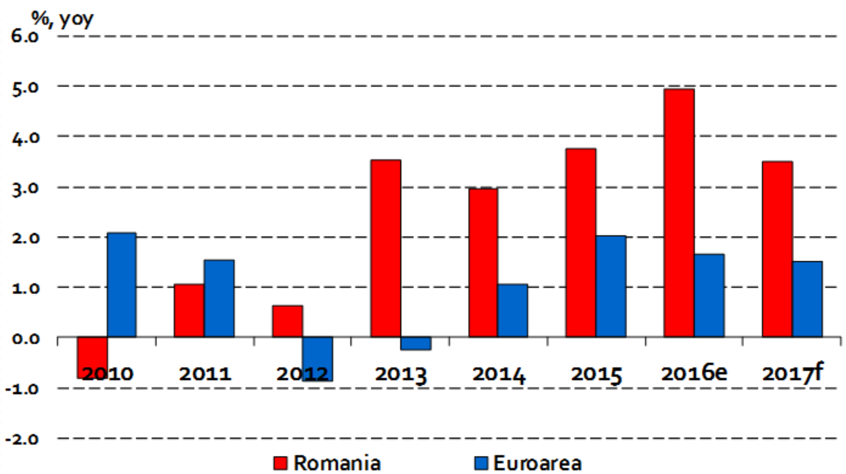
- Snap general elections take centre stage in late March
- Real GDP growth expected to decelerate to 3.1% in 2017 from a projected 3.4% in 2016, with private consumption remaining the main driver
- Strong external & fiscal positions- Twin surpluses
    - Sound fiscal position (2nd lowest Public to GDP ratio, FY16 surplus)
    - Earlier imbalances absorbed (CA of GDP FY16e>+4.0% vs. FY07: -25.2%)
- AQR & Stress Test results: strong banking sector capital position
- Visible improvement in labor market conditions (Unemployment:7.7% in FY16 vs. 9.2% in FY15)
- Currency Board: Solid & Strong
- Risks: Shift to more populist policies / Need to improve institutional quality / Low income convergence to EU average

Market Outlook

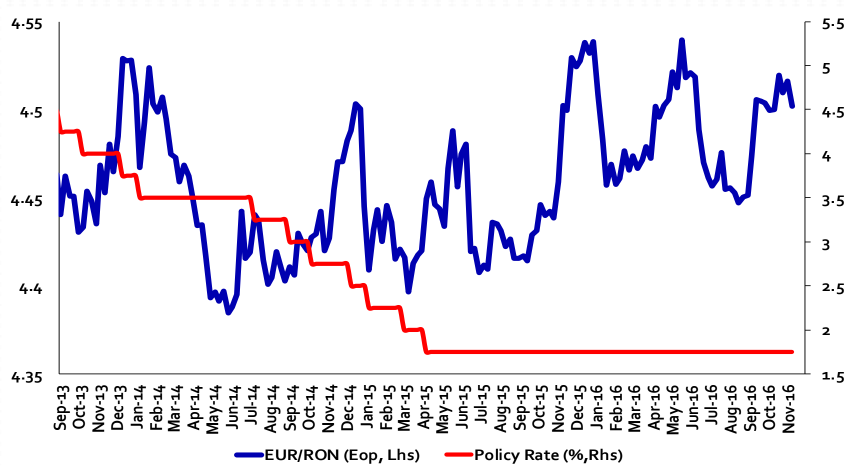
- Local bonds outperforming Eurobonds on lower primary market supply and a better than expected fiscal outcome
- Political uncertainty is the key downside risk

Romania: fiscal risks on the rise

GDP growth



Monetary Policy & FX Rate



Source: Eurobank Research, National Authorities, Bloomberg

Macro Outlook

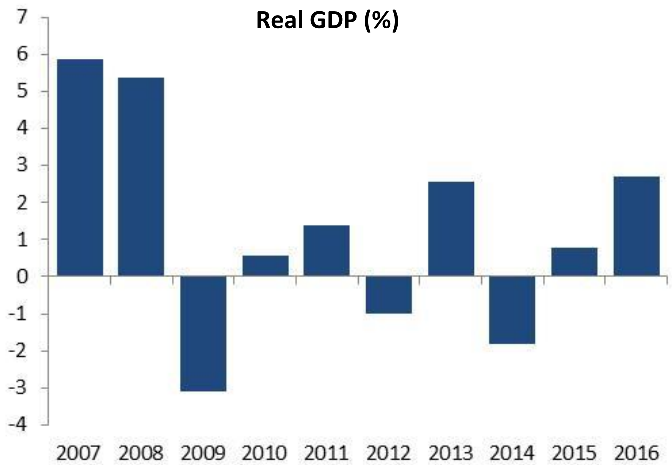
- Incoming PSD+ALDE coalition government adopts new expansionary measures and proceeds with a highly controversial judicial reform plan perceived as a setback to the anticorruption campaign
- Budget2017 assumptions overly optimistic, with downside execution risks
- Pro-cyclical and overly expansionary fiscal policy : FY16:-2.4%/ **FY17f> -4%** (under the assumption of no policy change) may put the government on a collision course with EU institutions
- Consumption boom driven by the highest real wage growth in EU-28 & positive private sector lending driven by new RON-denominated loan origination
- External imbalances revival (CA %GDP) FY16e:-2.2% less than initially feared vs. FY07: -13.8%)
- NBR on a wait and see mode at 1.75% & FX-MRRs down to 10% from 12%
- Risks: Political tensions/ Fiscal risks / Soft landing in 2017

Market Outlook

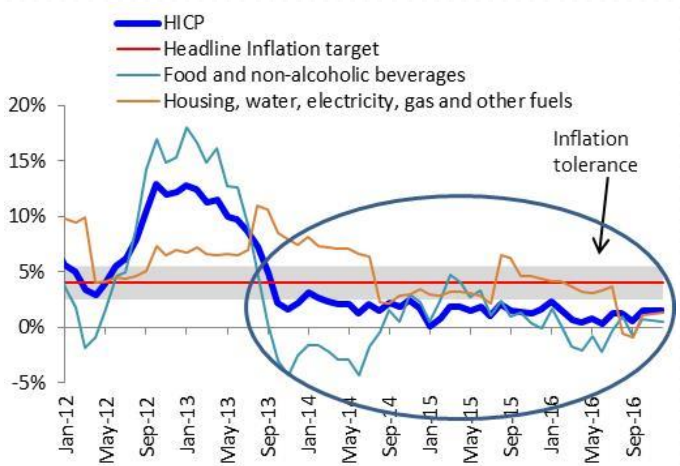
- Local rates have bottomed out in late 2016
- Eurobonds issuance on the cards in 2017
- EUR/RON under pressure amid increased political jitters and heightened fiscal concerns, risks skewed to the upside

Serbia: economic recovery to pick up pace in 2017

Economic activity picks up pace in 2016



Inflation remains below tolerance band (%YoY)



Source: Eurobank Research, IMF, National Authorities

Macro Outlook

- Real GDP growth came in at 2.5%YoY in Q4 2016, marking the 7th consecutive quarter of positive annual growth after floods-induced recession in 2014
- Full-year growth estimated at 2.7% in 2016 (vs. 0.8% in 2015), driven by higher investment spending, net exports and private consumption
- Economic activity to gain additional momentum in 2017 as last year's positive trends continue & private consumption recovers further on real wage growth and targeted increases in public wages and pensions
- Impressive fiscal consolidation witnessed since late 2014 continues; stronger than previously anticipated revenues & expenditure within program targets to have pushed general government deficit (% of GDP) to 1.4% in 2016 vs. 3.7% in 2015 & 6.6% in 2014; the shortfall is penciled in at 1.7% for 2017; public debt/GDP ratio likely to embark on a declining trend, ahead of schedule, after peaking last year
- IMF precautionary SBA remains on track proving a valuable policy anchor; EU accession path continues (6 chapters opened); external imbalances narrowing, current account deficit (% GDP) expected at 4.2% vs. 4.7% in 2015 & 21.1% in 2008; credit rating upgrades on improved macroeconomic fundamentals
- Inflation pressures remained subdued over the last three years; CPI below target on weak domestic demand dynamics & low energy prices (CPI at 1.6% in Dec16 vs. 2.5-5.5% NBS target); acceleration within the new target band (1.5-4.5%) anticipated early in 2017 amid increasing aggregate demand, higher oil prices and rising inflation internationally; monetary policy to remain accommodative for some time as price pressures remain subdued

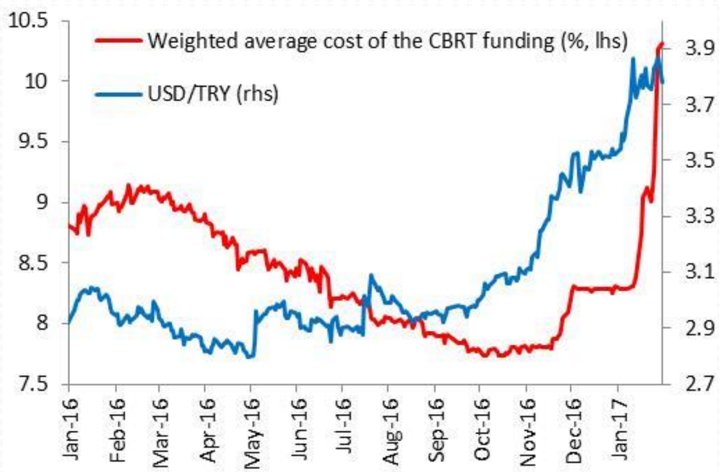
Market Outlook

- Dinar depreciation pressures likely to prevail in the weeks ahead amid increased hard currency demand mostly from the local industrial sector; but Central Bank interventions to keep EUR/RSD within tight ranges
- Higher Fed interest rates and the upcoming presidential elections – possibly to take place in tandem with snap general elections – to set the tone for Serbian markets ahead

Turkey: heightened domestic political and security concerns weigh on economic activity

Inflation persistently above target

CBRT tightens monetary conditions to support the lira



Source: Eurobank Research, National Authorities, Bloomberg

Macro Outlook

- Economic activity decelerated sharply in H2 2016 (-1.8%YoY in Q3) on heightened geopolitical jitters and domestic political & security worries
- The tourism sector, one of the main pillars of the economy has been hard hit due to a string of terrorist attacks (tourist arrivals -31%YoY in Jan-Nov 2016), resulting in a decline in exports of goods & services
- Real GDP growth expected to have slowed down to a 7-year low of 2.3% (market consensus) last year from 6.1% in 2015; slight pick up anticipated this year and the next as slowing consumption and improvement in export competitiveness thanks to the lira's weakening lessens the negative net exports' contribution; private investment to remain weak on deteriorating business climate
- Improving labor market conditions and fiscal expansion support consumption, which, despite the anticipated slowdown, is expected to remain the main driver of the economy
- Despite persistently high inflation (9.2% YoY in Jan 17 vs. 5.0% target) and significant lira depreciation, CBRT appears reluctant to aggressively tighten rates against a backdrop of political pressures for pro-growth & easing policies
- Recent liquidity adjustment measures and rate hikes have offered little respite to domestic asset markets as investors expected more aggressive policy action
- Increases in public sector wages, higher oil prices & FX pass-through to aggravate inflation pressures this year
- Large external financing requirements continue to pose a key downside risk; high CAD & private sector FX leverage, mostly financed by s-t capital inflows; ongoing lira weakness and higher oil prices to exacerbate market jitters

Market Outlook

- Ongoing domestic political jitters, in view of the looming referendum on Constitutional changes, and higher Fed interest rates are key risk factors for the lira's performance in the months ahead
- Along the same lines, and taking into account rising inflation pressures and deteriorating credit ratings dynamics, risks are skewed for higher local yields

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	3.1	3.4	3.6	2.9	3.3	3.3						
Advanced Economies												
USA	1.6	2.3	2.5	1.2	2.3	2.6	-2.5	-2.7	-2.8	-4.1	-3.7	-3.3
Eurozone	1.7	1.5	1.7	0.3	1.4	1.4	3.7	3.5	3.3	-1.8	-1.5	-1.5
Germany	1.9	1.5	1.7	0.4	1.5	1.5	9.0	8.7	8.5	0.6	0.4	0.3
France	1.3	1.4	1.7	0.3	1.3	1.4	-2.1	-2.3	-2.6	-3.3	-2.9	-3.1
Periphery												
Cyprus	2.8	3.0	2.8	-1.1	0.5	1.7	-2.8	-3.3	-3.4	-0.3	-0.6	-0.1
Greece	-0.3	2.7	3.1	0.0	1.1	1.0	0.0	0.2	0.3	-2.5	-1.0	0.9
Italy	0.7	0.9	1.0	0.0	1.2	1.4	2.8	2.5	2.1	-2.4	-2.4	-2.5
Portugal	0.9	1.2	1.4	0.7	1.2	1.4	0.5	0.8	1.2	-2.7	-2.2	-2.4
Spain	3.2	2.3	2.1	-0.4	1.6	1.5	1.7	1.5	1.5	-4.6	-3.8	-3.2
UK	2.0	1.5	1.4	0.7	2.5	2.6	-6.0	-4.3	-3.9	-3.3	-2.7	-2.2
Japan	0.9	0.8	0.5	-0.2	0.5	0.6	3.7	3.3	3.3	-5.2	-5.1	-4.4
Emerging Economies												
BRIC												
Brazil	-3.5	0.2	1.5	9.0	5.4	4.8	-0.8	-1.3	-1.5	-10.4	-9.1	-8.0
China	6.7	6.5	6.0	2.1	2.3	2.4	2.4	1.6	1.4	-3.0	-3.3	-3.0
India	6.6	7.2	7.7	5.5	5.2	5.3	-1.4	-2.0	-2.2	-6.7	-6.6	-6.2
Russia	-0.6	1.1	1.2	7.2	5.0	4.5	3.0	3.5	3.9	-4.0	-1.5	-0.8
CESEE												
Bulgaria	3.4	3.1	3.0	-0.8	0.6	1.2	4	1.4	1.2	1.6	-1.4	-0.7
Romania	5.0	3.8	3.6	-1.5	1.7	3.1	-2.2	-2.6	-2.8	-2.4	-3.4	-3.2
Serbia	2.7	3.0	3.5	1.2	2.4	3.0	-3.6	-3.8	-3.9	-1.4	-1.7	-1.3
Turkey	2.3	2.5	3.2	7.8	8.5	7.8	-4.6	-4.9	-4.9	-3.1	-2.5	-2.4

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

Eurobank Fixed Income Forecasts

	2017 (eop)				
	Current	March	June	September	December
USA					
Fed Funds Rate	0.50-0.75%	0.50-0.75%	0.75-1.00%	0.75-1.00%	1.00-1.25%
1 m Libor	0.78%	0.83%	1.01%	1.13%	1.33%
3m Libor	1.03%	1.12%	1.28%	1.42%	1.56%
2yr Notes	1.21%	1.41%	1.60%	1.72%	1.88%
10 yr Bonds	2.49%	2.60%	2.68%	2.74%	2.82%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.33%	-0.33%	-0.31%	-0.28%	-0.25%
2yr Bunds	-0.68%	-0.63%	-0.59%	-0.59%	-0.58%
10yr Bunds	0.47%	0.51%	0.57%	0.63%	0.70%
UK					
Repo Rate	0.25%	0.25%	0.25%	0.50%	0.50%
3m	0.36%	0.40%	0.44%	0.50%	0.57%
10-yr Gilt	1.46%	1.60%	1.67%	1.75%	1.80%
Switzerland					
3m Libor Target	-0.73%	-0.77%	-0.78%	-0.77%	-0.75%
10-yr Bond	-0.09%	-0.03%	0.01%	0.05%	0.09%

Source: Bloomberg (market implied forecasts)

Research & Trading Teams

Economic Analysis & Financial Markets Research

EurobankEA_FMR@eurobank.gr

Dr. Platon Monokroussos: Group Chief Economist
pmonokrousos@eurobank.gr, + 30 210 37 18 903

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

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

Ioannis Gkionis: Research 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

Arkadia Konstantopoulou: Research Assistant
arkonstantopoulou@eurobank.gr + 30 210 33 71 224

Paraskevi Petropoulou: Economic Analyst
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), Athanassios Markou, Maria Katrantzi, Dimitris Stamoulis, Nassos Assimakopoulos
FX_TRADING@eurobank.gr, DERIVS_TRADING@eurobank.gr

Credit, EM & Sovereigns

Magdalini Papadimatou (Head), Lambros Demertzoglou, Kostas Theodoropoulos
SOV_TRADING@eurobank.gr, EM_CORP_TRADING@eurobank.gr

Costas Katsileros: Head of Global Markets Trading
ckatsileros@eurobank.gr + 30 210 371 8764

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