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

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I. Snapshot

Overview

Macro Picture

- **USA:** Solid growth despite a temporary slowdown on devastating hurricanes
- **EA**: Stronger growth momentum on resilient consumption and an upturn in investment
- **UK:** Growth to remain lackluster on weaker consumption, unlikely to be offset by other components of demand
- **Japan**: Above trend pace of growth, politics in spotlight
- **EM:** Q2 economic activity confirms ongoing recovery. First positive annual reading in 3 years in Brazil. Growth in Russia exceeds expectations; disappoints in India
- **CESEE:** Consumption spending revival continues unabated

Policy Outlook

- **USA:** Balance sheet reduction to start in October, likely followed by another interest rate hike in December
- **EA:** Expected to announce QE program extension in October through H12018, albeit at less accommodative levels than in 2017

Japan: BoJ on hold amid subdued inflationary pressures

- **UK:** BoE likely to deliver a rate hike in November but doubtful whether it will signal the commence of a rate tightening cycle amid lingering Brexit uncertainties
- **CESEE:** Central Banks retain accommodative monetary policies amid relatively subdued inflation

Summary

Broad-based global economic recovery still on track, paving the way for gradual withdrawal of monetary stimulus from a number of G10 CBs, in spite of subdued inflation. US politics take centre stage, with the release of the long-awaited Trump's tax reform encouraging investors to start repricing the so-called "reflation theme"

Markets

- **FX:** EUR weaker post German elections and short term trend reversal in place targeting 1.15
- **Government bonds:** USTs, Bunds to head lower as CBs signal the end of the easing cycle, but recent range needs to be broken for more upside. Inflation still elusive. We favor selling the rallies
- **EM:** Rich valuations but supportive global economic backdrop caution for more selective approach going forward
- **Credit:** Pockets of value in sub financials and US high yield but YTD rally limits capital appreciation upside in the asset class ahead of removal of accommodative policies by CBs. Carry is the king
- **Commodities:** We remain moderately bullish on commodities and in particular oil and base metals that we believe bottomed in 2016. A strong USD and political changes in China a potential risk to our view

Key Risks

- **Trump's proposed tax cuts scaled back significantly to meet fiscal constraints:** Senate Budget Committee agrees on a final budget resolution envisioning revenue-neutral tax reform
- **Central banks illusion:** Too much optimism on inflation leads to a more aggressive monetary policy stance
- **Heightened geopolitical risks:** Escalation of tension between the US and North Korea
- **Mounting Euro area political jitters:** Coalition talks in Germany come to a deadlock; Catalan government makes unilateral declaration of independence

Macro Views

Eurobank

Latest Macroeconomic Developments & Outlook

World Economic Outlook		The global economic recovery continues well into 2017, supported by a synchronous recovery in both developed and emerging economies. The global expansion is benefitting from a sizeable global investment upswing, capitalizing on rising corporate profit growth and receding global risks. Core central banks remain cautious on subdued inflationary pressures, while they are determined to normalize monetary policy gradually. Overall, global GDP growth is expected to accelerate to c. 3.5% in 2017 from 3.1% in 2016.
Developed Economies	**US**	Following a period of increased volatility in the higher frequency real activity data due to the negative impact of Hurricane Harvey, growth momentum is expected to rebound in the post-storm period towards year-end and in H12018. Overall, real GDP growth is projected at 2.2% in 2017 from 1.5% in 2016 on robust capex and solid personal consumption.
	Euro Area	Business and consumer surveys continue to point to solid growth, with activity mostly vigorous in the manufacturing sector on the back of buoyant demand. Real economic activity is expected to continue increasing at a solid pace in the coming quarters, with resilient domestic demand counterbalancing a moderation in net trade. We expect real GDP growth to pick up to 2.2% in 2017 from 1.8% in 2016, with consumer spending supported by favorable fundamentals and business investment capitalizing on extremely accommodative financial conditions.
	Periphery	Soft and hard data from the majority of periphery euro area economies pertaining to Q3 2017 suggest that the improving economic momentum remained intact mainly supported by private consumption and strong external demand. Spain and Portugal continue to outperform both poised to grow at a healthy pace of 2.8% and 1.8% respectively in 2017, ranking among the fastest growing euro area economies.
	Japan	The current economic uptrend over the last six quarters constitutes the longest upturn in the post WWII expansions so far. Above-trend growth is expected to continue throughout 2017, supported by a strong labor market, increasing support from investment and a broadening export recovery on the back of a synchronized upswing in the global economy.
Emerging Economies	**BRICS**	In China, real GDP growth came in at 6.9%%YoY in Q2; a modest slowdown is anticipated ahead but a hard landing scenario remains rather unlikely. Growth in Russia gained momentum in H1 2017, with a 2.5%YoY rise in Q2 beating market expectations and prompting upward revisions in the country's consensus forecasts. This year's reading is anticipated to be first positive since 2014 thanks to rebounding private consumption and investments as well as recovering oil prices since June. Economic activity in Brazil is also recovering in a faster than expected pace, with growth swinging into positive territory of 0.3%YoY in Q2 from -0.4%YoY in Q1. Political risks are still high with elections looming in 2018. In India, GDP growth surprised to the downside in Q2 (5.7%YoY) on temporary factors. Yet, it is expected to pick up some pace in H2 2017 and come in amongst the highest globally.
	CESEE	Q2 GDP growth estimates confirmed a solid footing for the CESEE region & countries of our focus. The data confirmed that the revival in private spending continued unabated. Sustained consumer sentiment gains, eased financial conditions, tighter labor markets combined with robust real wage dynamics boost consumer spending, a trend that will likely continue throughout 2H.

Global Macro Themes & Implications

Theme	Implications
Several G10 Central Banks on course to remove gradually monetary policy accommodation…	On the back of the improved state of US economic activity, the FOMC announced on September 20th the start of its balance sheet normalization as of October 2017, in line with market expectations. In addition, they left their assessment of the appropriate policy rate over the next two years unchanged, suggesting that they still expect an additional rate hike in December and further cumulative tightening of 75bps by end-2018, expressing confidence that inflation will accelerate as much of the recent weakness is due to “idiosyncratic” factors. Following suit, despite persistently weak inflation, the ECB is expected to announce a reduction in the monthly flow of asset purchases in October, with President Mario Draghi stressing that the Central Bank is becoming more upbeat on the euro area growth outlook and confidence, patience and persistence are needed until inflation eventually converges. Hungering to join other G10 central banks in the race to exit from accommodative monetary policy, the BoE stepped up its hawkish rhetoric at the last monetary policy meeting, paving the way for an imminent rate hike on the view that slower supply growth leaves the economy potentially more exposed to inflation.
… but global financial conditions are expected to remain favorable for some time	Even though several G10 central banks are on course to remove monetary policy accommodation, but such steps will be gradual, implying that global monetary policy and financial conditions will likely remain favorable for some time. The Fed’s balance sheet will shrink at a moderate pace and is not expected to return to pre-crisis levels for a number of years. The ECB is likely to opt for a slow taper on the back of low inflation pressures. In the UK, even if the BoE delivers a 25bps rate hike by the end of this year, such a move is unlikely to signal the commencement of a rate tightening cycle amid prevailing Brexit uncertainties.
President Donald Trump proposes tax overhaul encouraging investors to start repricing the odds of an expansionary US fiscal policy	The “Big Six” Republicans published the framework of the eagerly awaited tax reform, envisioning a reduction in the number of tax brackets from 7 to 3 (12%, 25% and 35%) and a corporate tax cut from 35% to 20%. Meanwhile, the said proposal includes a maximum “pass through” business tax rate of 25%, and a territorial system for overseas earnings by imposing a one-time “tax holiday” at a low rate on past earnings already accumulated overseas by US businesses. Although there are details missing, that make it hard to estimate the total cost of the plan, the Committee for a Responsible Federal Budget (CRFB) estimates the proposal will cost ca. $2.2trn over 10 years (based on specific assumptions), equivalent to approximately 1% of GDP over that period. Nevertheless, the Senate draft budget makes room for just $1.5trn in tax cuts over 10 years, so the plan may need to be scaled back to fit within the fiscal constraints Congress is likely to impose. Nevertheless, tax reform is eventually starting to move and recent developments suggest increased probability that tax legislation will be enacted by early 2018, encouraging investors to start repricing the odds of an expansionary fiscal policy in the US.

Global Macro Themes & Implications

Theme	Implications
Euro area political jitters take the front seat	Political fragmentation has become a feature of German politics with six political parties entering into Bundesbank following the September 24th federal election outcome, the most since 1953. The most likely post-election outcome is a “Jamaica coalition” made up by Markel’s CDU, their Bavarian sister party CSU, the Green party and pro-business FDP. Coalition talks are likely to prove lengthy and difficult in view of the well-known ideological differences between the potential coalition partners. In addition, the presence of the FDP in a coalition government will likely hinder Merkel and French President Emmanuel Macron’s task for ambitious euro area governance reforms. Furthermore, a far-right party made it into Bundestag for the first time in more than half a century raising market worries that this development could be perceived as heralding a shift in the euro area’s status quo. If coalition talks come to a deadlock, a minority CDU/CSU government tolerated by the SDP or snap elections, cannot be ruled out entirely. Adding to euro area political jitters, the prospect of Catalonia’s government declaring unilateral independence following the October 1st referendum cannot be ruled out. Under such a scenario, the Spanish government could invoke Article 155 of the Constitution and remove the local government, a development that would undoubtedly lead to a further escalation of conflict between the regional and the Spanish government.
Likelihood of ‘cliff-edge’ Brexit has probably diminished but still a possibility	In a closely-watched speech in Florence in mid-September, UK PM Theresa May adopted undoubtedly a more conciliatory tone on the UK’s Brexit position compared to that she delivered at Lancaster House in early 2017. Importantly, she acknowledged for the first time the UK’s financial liability and offered to write legal protections for EU citizens living in the UK into the actual exit treaty. She also accepted a role for the ECJ in settling rights disputes and proposed for the first time Britain to have a transition of “around two years” after Brexit that would include continued access to the single market and freedom of movement. However, she fell short of clarifying certain key details including, inter alia, the size of the UK’s financial obligations to the EU. Overall, the UK’s clearer commitment on securing a transition deal, stronger commitments on protecting the rights of EU citizens resident in the UK and the acknowledgement of the financial liability, have diminished the likelihood of a disorderly ‘cliff-edge’ Brexit. But it is still a possibility amid concerns whether the European Council will agree that a deal on a transition period is possible without a firm agreement on the outline of a future UK/EU trade relationship.

Macro Themes & Implications in CESEE

Theme	Implications
Solid growth start for the region in 2017	From a growth point of view, the economies of our focus (Bulgaria, Romania, Cyprus, and Serbia) and the broader CESEE region had a solid start in Q2-2017. Growth dynamics are broadly driven by improving private consumption. The underperformance of EU funds related projects held investment spending below expectations, a trend that we anticipate to change in the 2H. 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	The revival of consumer spending continued unabated throughout H1-2017 despite political uncertainties and the spike of headline inflation. Sustained consumer sentiment gains, eased financial conditions, firmer labor markets combined with robust real wage growth dynamics boost consumer spending, a trend that will most likely continue throughout the rest of the year.
Accommodative monetary policymaking outlook	This year's headline inflation data across the region have so far exceeded expectations thus reaching or standing close to multi-month highs, reflecting the pass through of rising world commodity prices, base effects and rising price pressures globally. From a policymaking point of view, core inflation pressures remain relatively muted. Unless there is a supply-side shock, price pressures are set to remain subdued in the coming months, still allowing local Central Banks to maintain an accommodative stance and delay the tightening process further.
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 the Korean peninsula, as well as 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	• Yields on the Bulgarian sovereign debt market continued to slide during the summer on the back of positive economic data and state budget surplus. The yield curve continued to bull-flatten, with 10-year sector spreads reaching levels of 65 bps versus benchmark swap rates. This bull run was further supported by the lack of supply on the primary market and abundant liquidity stored into the pension funds. We expect this trend to remain until the end of the year supported by the lack of new issuance on the primary market and the improvement of state finance. That said, we would prefer to remain in the sidelines on the Bulgarian local-currency debt market as the current rally may eventually prove overdone and any potential up-side is likely to prove limited and would only be realizable in the very short term. • Bulgarian Eurobonds followed developments in the local market with the longest end of the yield curve, Bulgaria 35 being the biggest beneficiary of this price adjustment. At current levels, Bulgarian credit spreads appear very tight and valuations look stretched.
Serbia	The dinar staged an impressive performance in summer period, having strengthened by 1.15% against the euro since June and 3.5% on a year-to-date basis, being placed among the best performers in the EMEA space. On top of that, the National Bank of Serbia has bought €1.08bn over a period of five months to ease upside pressures and halt the dinar's rapid appreciation. Overall, the main drivers of this trend have been the strong credit expansion in the banking sector and traditionally weak hard currency demand during summer lull. Remittances from abroad and steady demand for government bonds have also supported the dinar's rally. However, intensified Central Bank presence near 119.00 recently, indicates that the EUR/RSD is likely to have reached a near-term bottom around that level. Also, demand for hard currency should re-emerge in the coming weeks, while a relatively thin bond auction schedule will keep foreign investors away from FX (in most cases they are funding their bond investment via pure FX position). All these factors argue in favor of a correction in the EUR/RSD pair ahead.

The Trader's View

Asset Class	Outlook
Foreign Exchange	**EUR/USD:** extended losses, after a significant summer rally. The USD staged a broad-based rally pre Trump's tax plan reveal. Next target the 23.6% Fib level at 1.1680 of the YTD rally. Broad-based USD strength should persists on the "feel good" factor of Trump's tax reforms and EUR weakness stemming from the German election results as the potential of a "Jamaica " coalition is seen less pro European, putting a break on Macron's ambitious reforms. **USD/JPY:** continues to track the real rates differential with broader USD strength reflected in the pair's ascent. JPY remains a global funding currency and as such remains more sensitive to global events (safe haven flows on increased aggression from N. Korea) than domestic developments. The call of early elections will be important as a result that weakens the current government will be interpreted as a threat to "Abenomics" strengthening the JPY **GBP/USD:** Reached new post Brexit highs at 1.3657 and is retracing on due the broader USD strength. BREXIT and September's UK downgrade (Moody's) are also weighing on the pair. May's speech failed to convince markets that the UK has a plan for a successful EU exit and the EZ seems to be playing for time. The next BoE meeting will be closely watched along with the next phase of negotiations.
Government Bonds	**US:** Fed Chair Yellen's speech pushed further a brutal repricing of the assigned probability of a December hike despite a largely uneventful September FOMC. The improved global growth environment provides supports to the Fed's normalization path with markets still underpricing the rate hike path. September saw 10y yields sell off by 30bps from peak to trough with relentless bull flattening as the short end has been revised higher. Fed speakers have recognized that inflation pressures are likely to remain subdued but full employment and solid fundamentals guarantee the path to higher rates. The tax reform announced by President Trump has further dented fixed income boosting equity valuations. **EU:** Eurozone data has continued the positive streak with Draghi pretty much announcing that in the October meeting the ECB will announce its tapering plan largely expected to start in 2018. 10y German yields have rallied 20 bps MTD despite the German elections result creating doubts on EZ's further reform. Volatility remains at extremely low levels with 2s/10s aggressively steeper as the market starts pricing in the reduction in the future pace of purchases pushing term premium higher.
EM hard currency debt	Positive global macro backdrop and subdued inflation with a slow withdrawal of stimulus from the major CBs continues to support EM flows. A "rising tide lifts all boats" market has prevailed with new countries coming to the market (like Tajikistan) and momentum leading valuations to very tight levels. Recent spots of idiosyncratic, political and fundamental divergences will be an ongoing issue and a reason for increased caution. Investors should start looking into fundamentals and relative valuations now more than ever. The US policy path is the key issue regarding EM, and recent developments suggest a moderate transition is in place down the road. A gradual reduction of exposure and profit taking at any EM outperformance seems justified medium term.
Corporate credit	We started the year rich and after a significant rally we are even richer in global credit despite the talks about a maturing cycle. Global QE has obviously played a significant role that we underestimated at the start of the year. The increasingly joined-up chorus of central bankers is shifting in the direction of tighter policy, albeit at a slow pace. This should keep valuations stable, but further spread compression looks limited. We find pockets of value in Financials, especially subordinated debt, and higher rated US High Yield (excluding Retail and cautious on Autos) on a relative value basis. Overall risk/reward is increasingly unattractive and carry now is all that investors can aim for in most sectors. Overall cautious on corporate credit at current levels.
Commodities	We maintain the view that commodities bottomed in 2016. WTI is again testing the upper bound of its one year trading range and expect it to eventually break higher despite headwinds from US shale production. Industrial metals have had a significant year to date rally and expect some consolidation at current levels before moving higher. Overall energy and base metals are expected to perform well in a moderate rising rates/synchronised global economic growth environment. In precious metals gold was helped by a declining USD and increasing geopolitical tensions but to move lower going forward as normalization of extremely accommodative policies begins.

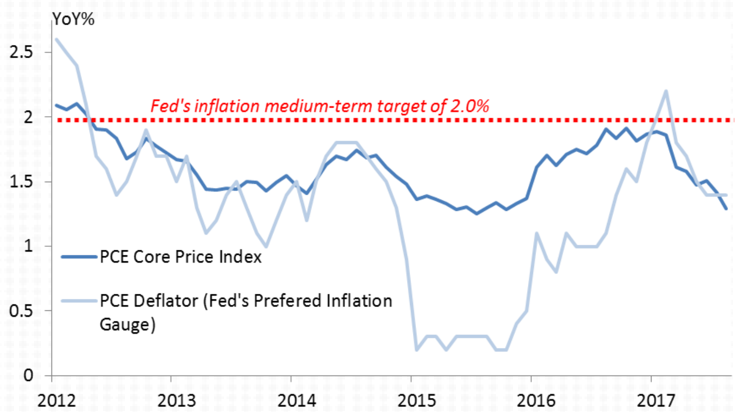
II. Advanced Economies

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

USA: temporary growth slowdown on devastating hurricanes

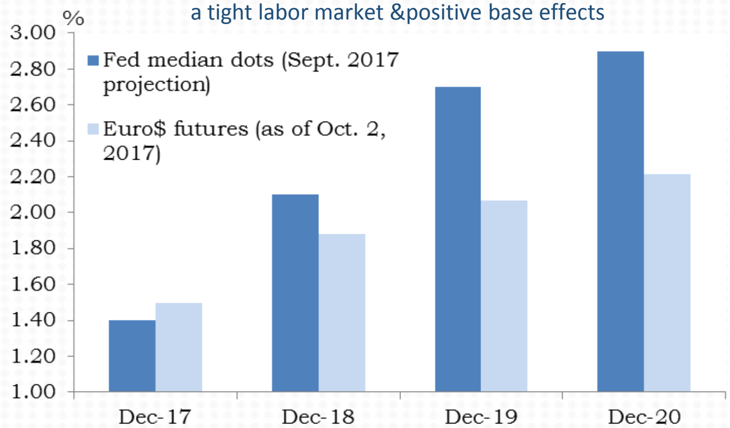
US inflation target still out of reach, but...

...the Fed attributes the recent weakness to transitory factors



Fed dots still above market expectations on a medium/long term horizon...

...on stronger growth, recent USD weakness, a tight labor market &positive base effects



Source: Bloomberg, Federal Reserve, Eurobank Economic Research

Latest Economic Developments

According to the BEA's Q2 third estimate, real GDP growth accelerated to 3.1%QoQ saar from 1.2% in the prior quarter, pointing to solid momentum in domestic demand. Historical evidence suggests that there will be a short-term negative impact of Hurricane Harvey on US growth through consumption, inventories, housing and the energy sector, estimated to subtract ca. 0.2-0.3pps in line with other large storms. Volatility in the higher frequency real activity data is poised to pick up markedly in the months ahead, with industrial production and retail sales data for August already distorted by the negative impact of Hurricane Harvey. Nevertheless, there is normally a rebound in the post-storm period, expected to commence towards year-end and continue into H12018. Overall, real GDP growth is projected at 2.2% in 2017 from 1.5% in 2016 on robust capex and solid personal consumption.

Central Bank Watch

The Fed announced the start of the balance sheet normalization process starting in October with monthly caps of $10bn initially, rising by $10bn every three months until they reach a limit of $50bn. We expect the Fed to resume its gradual pace of hiking at its December meeting, with most Fed officials focusing on labor market rather than inflation data. Future implied probability currently stands at 70% for a 25bps Fed rate hike in December, up from ca. 50% before the September FOMC meeting and less than 2 hikes by year-end 2018. Nevertheless, it is difficult to assess the Fed's hiking path in the next couple of years in view of the increasing number of vacant seats in the Board of Governors and uncertainty regarding economic and inflation developments, especially ahead of upcoming discussions in Congress on tax reform and the Fiscal 2018 Budget.

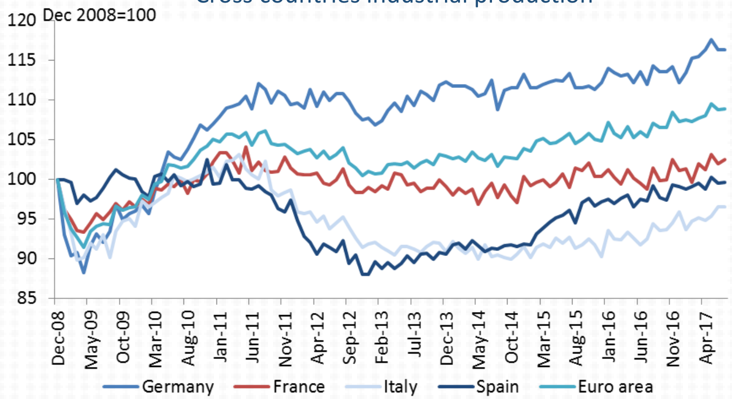
Risks

Fiscal stimulus could create upside or downside risks for the US 2018 economic outlook, depending on the budget resolution expected to be endorsed in the coming days, and the specific amount it targets for tax cuts over the next ten years.

Euro area: economic activity on a firm footing amid resilient consumer spending and a broader upturn in investment

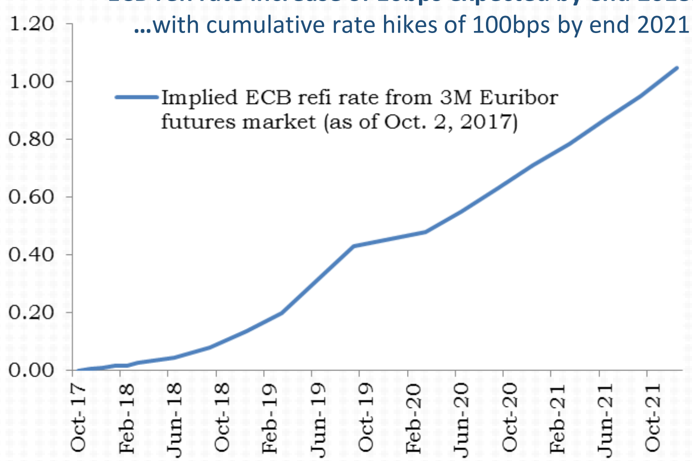
Broad-based recovery, with both core and periphery adding to growth

Cross countries industrial production



ECB refi rate increase of 10bps expected by end 2018…

…with cumulative rate hikes of 100bps by end 2021



Source: Eurostat, Bloomberg, Eurobank Economic Research

Latest Economic Developments

Euro area GDP growth was confirmed at 0.6%QoQ in Q2, supported by robust personal consumption on improving labor market conditions and rising consumer confidence. Business surveys continue to point to solid growth, with PMI Composite Index surging to a four-month high of 56.7 in September, while activity was mostly vigorous in the manufacturing sector on the back of buoyant demand. Real economic activity is expected to continue increasing at a solid quarterly pace of ca. 0.5%QoQ in H2 2017, with resilient domestic demand counterbalancing a moderation in net trade.

Central Bank Watch

We expect the ECB to announce at the 26th October meeting its decision to extend its asset purchase program though H1 2018 at a reduced pace of ca. €40bn per month starting in January 2018. The current forward guidance on policy rates is not expected to change before H2 2018, while the prospect for higher rates will be largely dependent on the development of the euro exchange rate, partially affected by US policies and Fed's future monetary stance. Should the euro appreciate further in the coming months due to -among others- a more dovish-than-expected stance by the Fed, then the ECB might not be willing to proceed with a deposit rate increase before 2019. All in all, the recent appreciation of the euro and subdued inflationary pressures suggest that the risks are skewed towards a more gradual exit strategy.

Risks

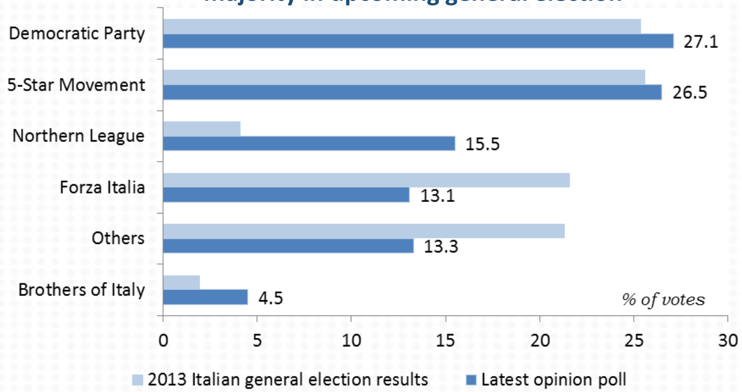
Following the German election result, Europe may face a period of political uncertainty as coalition talks will last several weeks. Chancellor Merkel will soon have to face major challenges concerning potential eurozone reforms initiated by French President Emmanuel Macron, including the creation of a joint euro zone budget and the establishment of a euro area finance ministry. With fundamental differences between potential coalition partners in the so called "Jamaica" coalition -which is currently the most likely joint scenario- on major European topics, supporting noteworthy reforms seems less likely than before.

Italy: stronger economic growth, elections looming

Stronger economic growth envisaged by the Italian government, with less fiscal consolidation should its debt-reduction target be met

	Italian government forecasts - Sept 2017			EC
	2016	**2017**	**2018**	**2018**
GDP % YoY *April 2017*	0.9	1.5 *1.1*	1.5 *1.0*	1.1
CPI % YoY *April 2017*	-0.1	1.5 *1.2*	2.0 *2.1*	1.3
Public Balance (%GDP) *April 2017*	-2.5	-2.1 *-2.1*	-1.6 *-1.2*	-2.3
Debt (%GDP) *April 2017*	132.0	131.6 *132.7*	129.9 *131.5*	132.5

No single party is expected to win absolute majority in upcoming general election



Source: Bloomberg, Eurobank Economic Research

Latest Economic Developments

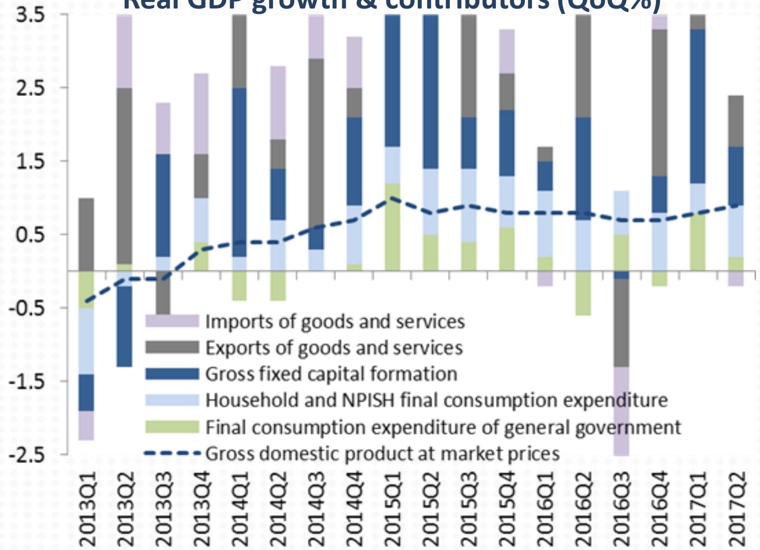
Italy's GDP growth came in stronger than expected in Q2 (+0.4%QoQ), repeating the robust growth pattern recorded in Q1. Domestic demand contributed positively to Q2 GDP growth, while net trade had a limited negative impact. Household spending is expected to continue its solid pace of growth in H2 2017, supported by enhanced labor market conditions. The overall investment outlook has improved on the back of the ongoing recovery in the residential sector. Furthermore, recent progress in restructuring the domestic banking system should also remove a key source of uncertainty, helping bank lending to correspond with rising demand amid increased appetite for investment. Looking ahead, whether there will be an extension beyond 2017 for tax credits for construction and non-construction investment (approved over the past few years) will be a determinant factor for future business spending growth.

Fragmented political landscape

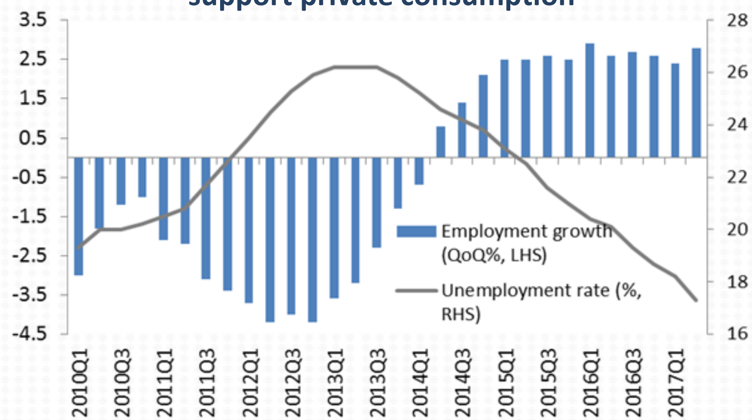
As suggested by PM Paolo Gentiloni, the resumption of parliamentary discussions over reform of the electoral law is tentatively scheduled for 9-12 October, in order to avoid overlapping with the parliamentary approval of the 2018 budget by 20 October. The so-called "Rosatellum 2.0", expected to be submitted soon by the Democratic Party (DP) to the relevant parliamentary committee, proposes 66% of the seats (i.e. 389 out of 630 seats in the lower house) to be allocated by proportional representation, and the remaining 34% (231 seats) to allocated by a first-pass-the-post voting method, with a 3% threshold for parliamentary representation. Although the DP, Forza Italia, the Lega Nord and some smaller centrist political parties are reportedly in favor of "Rosatellum 2.0", nothing seems guaranteed yet as a similar attempt back in June to reform the electoral law failed shortly after discussions began. Even if finally approved, the new electoral law cannot diminish the fragmentation of the next parliament, where three political blocs (the PD, the M5S and the combination of Northern League, Forza Italia and Brothers of Italy) poll around 30%.

Spain: Q2 2017 GDP growth accelerates to highest in nearly two years; risks of unilateral declaration of Catalan independence

Real GDP growth & contributors (QoQ%)



Improving labor market conditions support private consumption



Source: Eurostat, Eurobank Economic Research

Latest Economic Developments

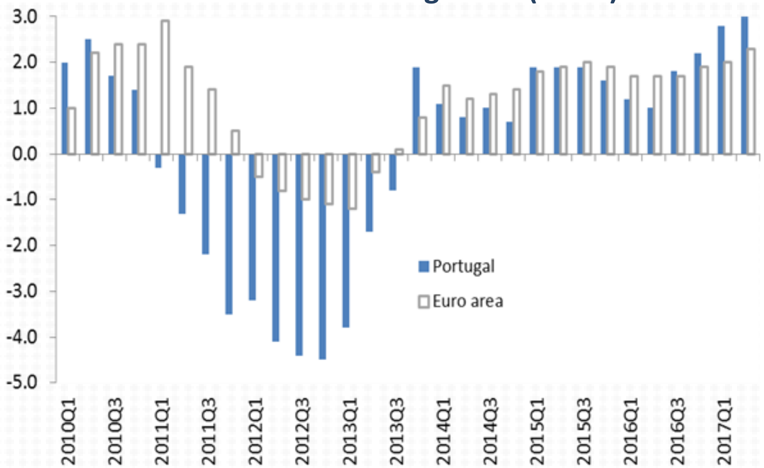
Spanish GDP growth accelerated to 0.9%QoQ in Q217, the strongest since Q315 and slightly above 0.8%QoQ recorded in the prior quarter. Private consumption was among the main growth drivers accelerating to 0.7%%QoQ, the highest in a year, from a two-year low of 0.4%QoQ in Q117. Strong credit growth, elevated consumer sentiment and an ongoing improvement in labor market conditions, especially in the construction sector, seem to be the main drivers behind private consumption's resilience. After peaking at 26.3% in July 2013, the unemployment rate embarked on a downward trend thereafter standing at 17.1% in July 2017, the lowest in near 8 ½ years, supported by boosting job creation. Net trade also contributed positively to Q2 GDP growth thanks to a slowdown in both exports and import growth. Imports swung from a 3.1%QoQ expansion in Q1 to a 0.2%QoQ contraction in Q2, mainly due to base effects, while exports grew by 0.7%QoQ, below 3.0%QoQ recorded in the prior quarter. This positive economic growth momentum is anticipated to carry over into H217 thanks to resilient domestic demand and solid performance of net exports. On the fiscal front, the strong economic growth is expected to help the government to bring this year's fiscal deficit close to 3.1%-of-GDP, down from 4.3%-of-GDP in 2016.

Risks of unilateral declaration of Catalan independence

The Catalan referendum was held on October 1st, in spite of the central government's legal efforts to prevent it. According to the Catalan government, the turnout stood at c. 42% with a 90% support for independence, with President Carless Puigdemont leaving the door open for a unilateral declaration of independence, unless the international community intervenes on Barcelona's behalf following publicized clashes between the policy and voters the day of the referendum. Should the Catalonia government proceed with unilateral declaration of independence, the Spanish government could invoke the Article 155 of the Constitution, a development that would undoubtedly lead to a further escalation of conflict between the regional and Spanish government.

Portugal: Economic growth gains further momentum in recent quarters but significant vulnerabilities remain

Real GDP growth (YoY%)



Portugal's 10-yr sovereign yield spreads vs. German counterpart narrows significantly post-S&P upgrade

Source: Eurostat, Bloomberg, Eurobank Economic Research

Latest Economic Developments

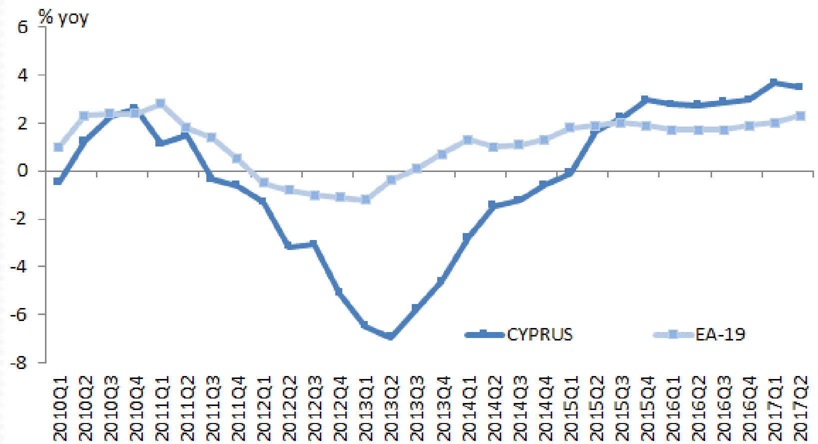
Portugal's cyclical uptrend has gained momentum in recent quarters with real GDP growing by 3.0%YoY in H117, above the euro area average of 2.0% over that period. Booming tourism industry, and a broad-based pick up in net exports on the back of robust demand among key euro zone trading partners, were the key drivers of growth. Meanwhile, the labor market continues to recover. Employment grew by a multi-year high of 3.6% in Q2 2017, and the unemployment rate declined at a steady pace over the last few years coming in at a 8 ½ year low of 9.1% in July 2017, providing a boost to consumers' purchasing power. Improving economic growth has helped Portugal to further narrow the government's budget deficit from 4.4% in 2015 to 2.0%-of-GDP in 2016, the lowest since democracy was restored in 1974. As a consequence the EC removed the country from the Excessive Debt Procedure this summer and S&P became the first of the three major rating agencies to restore the investment grade status of Portuguese sovereign credit rating in mid-September. In reaction to the above and on the view that other major rating agencies may follow suit in the foreseeable future, Portugal's bonds outperformed in the EMU sovereign space with the spread of the 10-yr PGB against its German counterpart moving below the 200bps area for the first time in more than a year.

Portugal remains vulnerable medium-term to persisting structural weaknesses

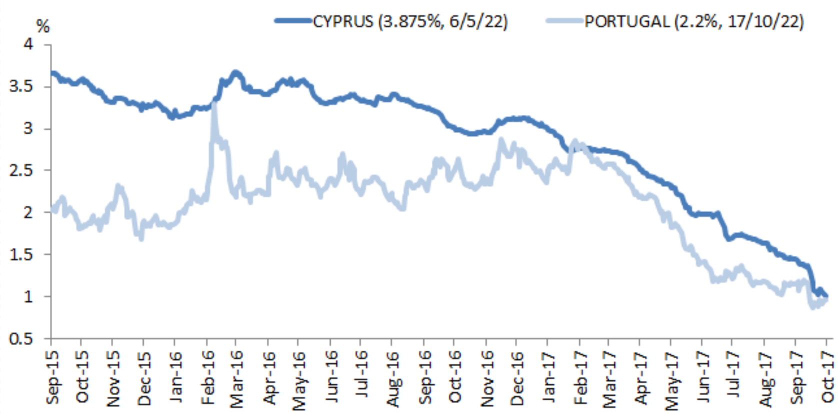
While Portugal's near-term growth outlook has improved, downside risks remain amid persisting structural weaknesses. Undoubtedly, confidence towards the banking sector has improved over the past year following, among others, the public recapitalization of Caixa Geral de Depósitos and a large capital injection to Banco Commercial Português. However, important challenges prevail including weak asset quality, low profitability and contained capital buffers. NPLs have decreased steadily over the last three quarters (Q316-Q117), but they are still among the highest in the euro area 16.4% of total loans in Q1 2017). Furthermore, the country's high public and private debt leave it vulnerable to a range of shocks over the medium-term as the ECB is expected to start tapering in January 2018.

Cyprus: New round of sovereign rating upgrades

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

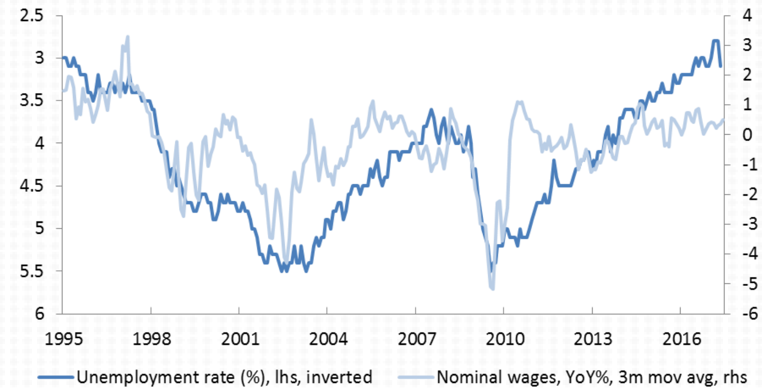
The Q2-2017 GDP growth reading was the second strongest -after that of the first quarter- since 2008, amongst the highest in EA-19 and EU-28, and above EA-19 average for seventh consecutive quarter in a row. On a seasonally adjusted basis, growth expanded by 1.0% QoQ/3.5% YoY in Q2-2017 an inch down from 1.0% QoQ/3.7% YoY in Q1-2017 vs. 1.2% QoQ/2.8% YoY in Q2-2016. The consumption rebound continued in Q2 driven by strong 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 8M-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 10.8% in July 2017, down from 12.5% in March 2017 vs. 13.0% in July 2016. Finally, the number of real-estate market sale contracts has risen by 20% YoY in 1H-2017. Property prices were on a stabilizing/increasing path in Q1-2017. The Residential Property Price Index (RPPI) recorded its first annual increase in Q1-2017 (+0.3% QoQ/+0.2% YoY) since 2009.

Risks & Challenges

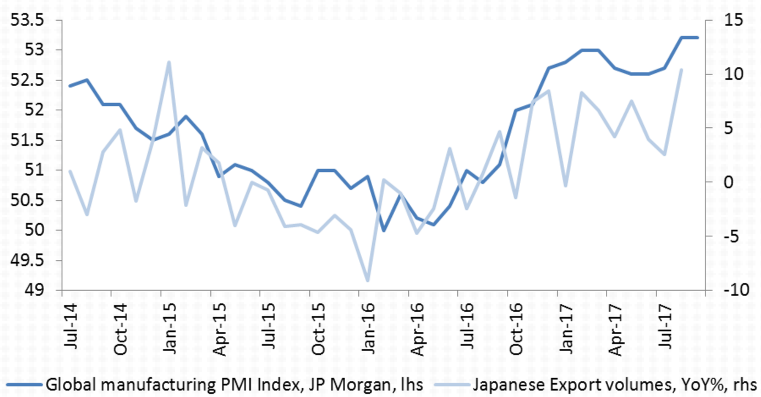
DBRS and Moody's were the last rating agencies to upgrade the sovereign rating of Cyprus. Moreover, S&P affirmed the current rating but changed the outlook from stable to positive. Major rating agencies still appear to continue having divergent views on Cyprus. Currently, the distance from investment grade status is: one notch for S&P (currently at BB+), three notches for Moody's (currently at Ba3), and Fitch (currently at BB-). 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 47% in Dec2016).

Japan: above potential pace of growth, politics in spotlight

Strong labor market not yet translated into wage growth



Export volumes continue to recover, supported by an upturn to Asia



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

Latest Economic Developments

The Japanese economy accelerated in Q2, growing at an annualized pace of 2.5%QoQ saar from 1.2%QoQ saar in Q2, primarily on the back of strong private consumption and investment. The current economic upswing over the last six quarters seems to constitute the longest upturn in the post WWII expansions so far. Above-trend growth is expected to continue throughout 2017, supported by a strong labor market, an upturn in investment (amid higher corporate earnings and urban redevelopments ahead of the 2020 Tokyo Olympic game) and a broadening export recovery on the back of the global economic upswing.

Central Bank Watch

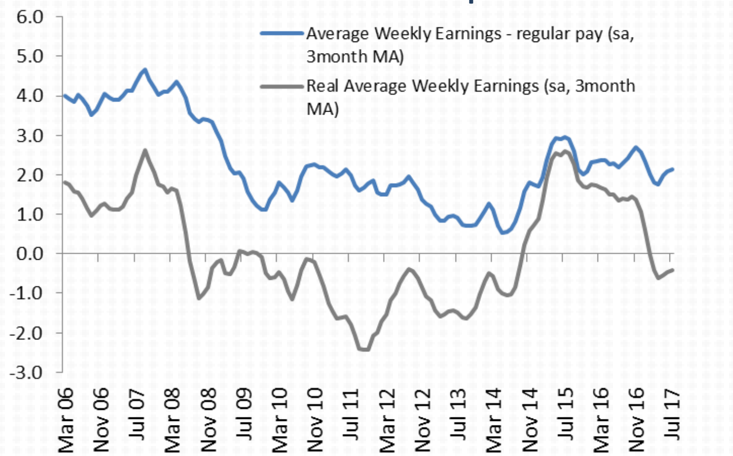
The BoJ decided at its September 20-21 MPM with an 8-1 majority to keep its current yield curve controls (YCC), with one of the two new Policy Board members (Goshi Kataoka) dissenting and questioning the effects of YCC in favor of the effectiveness of QQE. Looking ahead, we expect the BoJ to keep its accommodative monetary policy stance unchanged throughout 2017, as headline CPI inflation has remained well below the BoJ's 2.0% target. Besides, the BoJ is likely to downgrade its CPI forecasts at its quarterly Outlook Report at its 30-31 October MPM. In our view, the first step towards monetary policy accommodation won't come before H2 2018, with a gradual rate hiking cycle dependent on price and economic developments.

Risks

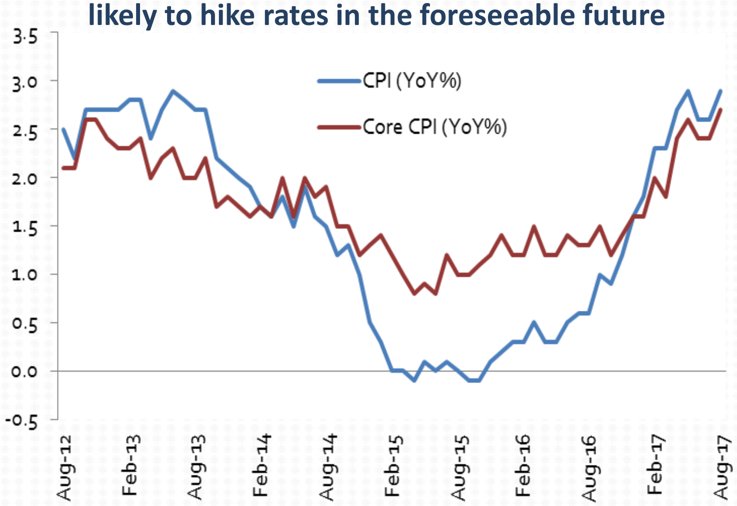
Following PM Shinzo Abe's announcement of a snap election for the Lower House expected on 22 October, a grand coalition among opposition parties - led by Tokyo Governor Yuriko Koike's new Party of Hope - is gaining momentum. An election defeat for the Abe administration, or a significant loss of seats, could introduce political uncertainty sparking significant market volatility.

UK: GDP growth likely to remain subdued driven by consumer spending weakness

Inflationary pressures on real wage earnings weigh on household consumption



Should inflation remain on a rising path, the BoE is highly likely to hike rates in the foreseeable future



Source: ONS, Eurobank Economic Research

Latest Economic Developments

The UK economy grew by 1.5%YoY in Q217 (0.3%QoQ), the slowest annual pace in more than four years. The expenditure breakdown confirmed the existing trend of slowing consumer growth with household consumption growing by 0.2%QoQ from 0.4%QoQ in Q1, the weakest since Q4 2014 as inflation squeezes real income. On a positive tone, net trade was revised higher providing the largest contribution to GDP growth (+0.4pps) and confirming the boost provided by the weaker currency (total trade exports increased by 1.7%QoQ, while total imports rose by just 0.2%). Overall, the UK economy is expected to slow to 1.5% in 2017 from 1.8% in 2016, below the BoE's forecast of 1.7%, on the prevailing view that the other components of demand will not be able to offset household consumption's weakness.

Central Bank Watch

The BoE stayed put on its monetary policy at the Sept. 13 MPM, as expected. However, the tone of the minutes was surprisingly hawkish, signaling that a rate hike could be imminent, if the economy continues to follow a path "consistent with the prospect of a continued erosion of slack and a gradual rise in underlying inflationary pressures". The MPC expects real GDP growth of 0.3%QoQ in Q3 2017 and inflation to rise further climbing above 3% in October (from a four-year high of 2.9%YoY in August). Bearing an unexpected event, the prospect of a rate hike at the next meeting scheduled for November 2nd, now seems highly likely. However, amid lingering Brexit uncertainties, it is doubtful whether such a move would signal the start of a tightening cycle.

Brexit update

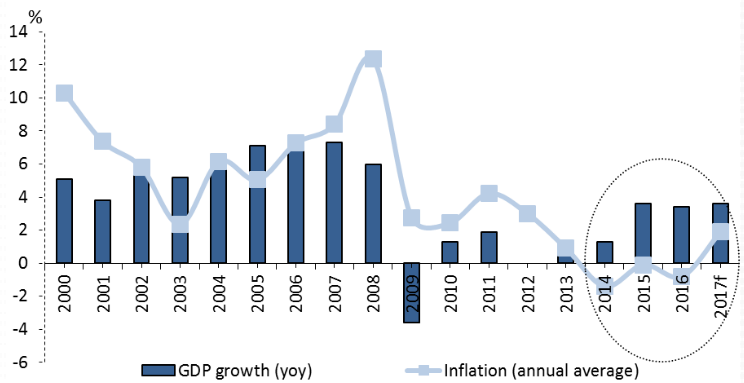
Brexit talks are progressing slowly and risks of a 'hard Brexit' are far from over. As things stand at this point, it is uncertain whether the EU27 assess by the Oct. 18th EU Council summit that "sufficient progress" has been made on divorce issues so as to move onto the second phase of talks about the transition period and future UK/EU relationship. Market focus is on the UK PM's keynote speech to the Conservative Party conference on Oct. 4th for more signals over the UK's Brexit position.

III. Selected CESEE economies

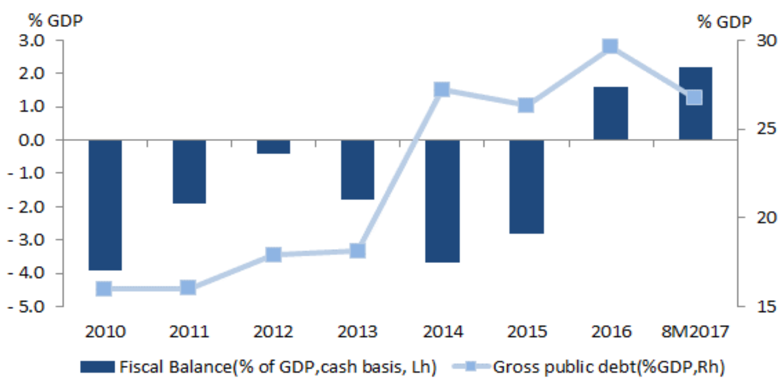
- Bulgaria
- Romania
- Serbia

Bulgaria: Strong growth dynamics in Q2-2017

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

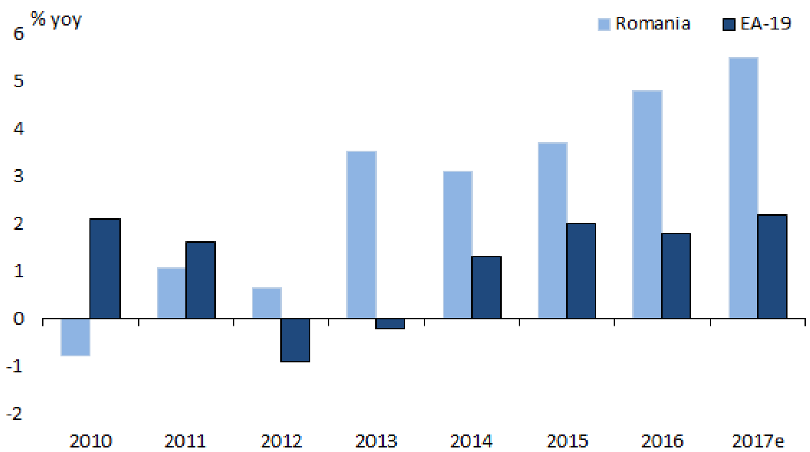
Real GDP expanded by +1.0% QoQ/+3.6% YoY in Q2-2017 vs. +0.9% QoQ/+3.5% YoY in Q1-2017 and +0.9% QoQ/+3.5% YoY in Q2-2015. Despite lower public expenditure and the prevailing political uncertainty ahead of the early parliamentary elections in late April, final consumption expanded by +0.4% QoQ/+4.2% YoY in Q2-2017 vs. +1.9% QoQ/+4.3% YoY in Q1-2017 up from +0.4% QoQ/+1.2% YoY in Q2-2016. The unemployment rate declined sharply to 6.0% in Q2-2017, the lowest level since Q1-2009, as the economy adds new jobs in the areas of specialized business and IT services. In contrast, investments were in the red on an annual basis for the fifth consecutive quarter in Q2 (GFCF: +2.3% QoQ/-1.0% YoY). The decline mirrors the slow progress in infrastructure spending implementation during the transition period of the caretaker government plus the low EU funds absorption in the two-year period after the closing of the programming period 2007-2013. Finally, net exports had a negative contribution in Q2 (Exports: +6.5% YoY vs. +5.8% YoY in Q1 & Imports: +7.7% vs. +7.1% YoY in Q1) driven by the strong imports rise in response to private consumption dynamics

Risks & Challenges

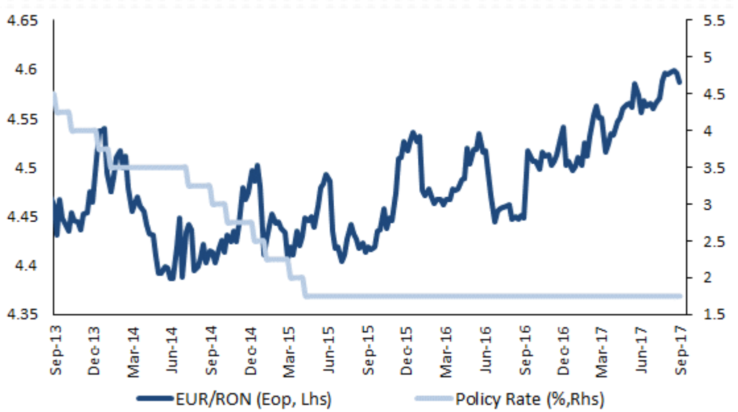
Joining the ERM2 mechanism for a period of at least two years is a formal prerequisite for Euroarea membership. According to press reports, Prime Minister Borissov has received support from both Chancellor Merkel and President Macron to go ahead with ERM2 application membership. Currently, Bulgaria fulfills 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: Growth outperformance in Q2-2017

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



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



Source: Eurobank Research, National Authorities, Bloomberg

Latest Economic Developments

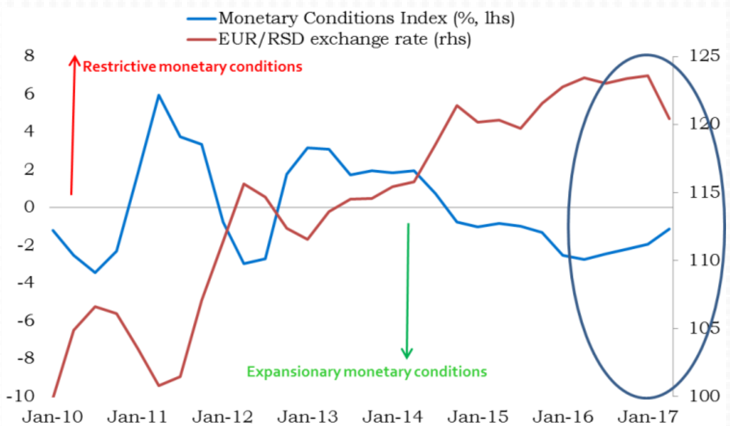
The revised estimate on the seasonally adjusted Q2-2017 GDP reading confirmed the flash estimate of +1.6% QoQ/+5.7% YoY, +5.9% YoY in unadjusted terms. The stronger than expected print-above analysts' call for +1.2% QoQ/+5.2% YoY- compares to +1.8% QoQ/ +5.7% YoY in Q1-2017 and +1.6% QoQ/+5.0% YoY in Q4-2016. Private consumption jumped by +2.6% QoQ/+7.4% YoY in Q2 up from +4.3% QoQ/+7.1% YoY in Q1, driven by higher disposable income as a result of the VAT rate cut and the rapid rise in real wages plus the strong consumer sentiment readings, thus making a hefty contribution of 5.2ppts to growth. Overall, real GDP expanded by 5.9% YoY in 1H-2017 compared to 4.8% in 2016, outperforming regional peers for a fourth consecutive year and 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. Hence, the economy is driven close to, if not above, its potential growth rate at the expense of pushing government finances off consolidation track and deteriorating the external position (CAD17e: -3% of GDP).

Risks & Challenges

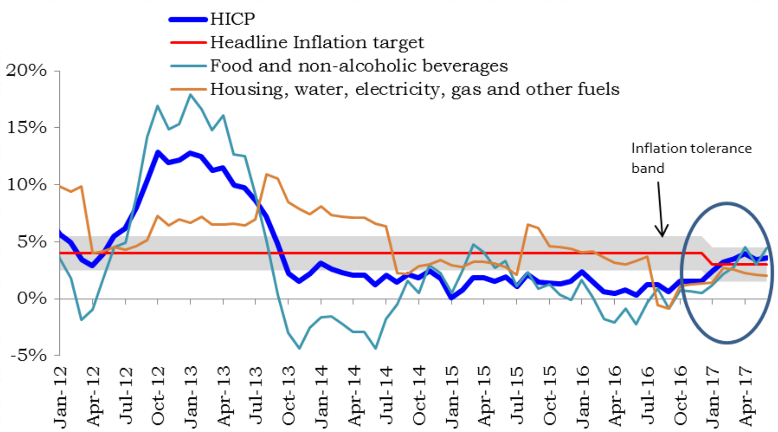
The government has revised the budget in order to bring the revenues and expenditures figures closer to reality, maintained the fiscal deficit target of 3% unchanged, but also adopted compensatory measures-in line with our expectations- in order to maintain fiscal performance in check. Thus, the government increased excise taxes for fuels as of September (that will bring prices back to the levels of 2016) and also facilitated the distribution of additional dividends from the state-owned enterprises. Nevertheless, we still doubt if those will be enough to attain the target given the public expenses dynamics. If this proves to be the case, practice has shown that this usually results in the under execution of the public investments program (4.2% of GDP in 2017) at the expense of neglecting infrastructure.

Serbia: One-off factors in H1 2017 prompt downward revisions in full-year growth forecasts

Monetary tightening pressures instigated by firmer dinar



Inflation pressures remain subdued



Source: Eurobank Research, National Authorities

Latest Economic & Political Developments

Final Q2 GDP data confirmed that growth came in at 1.3%YoY, in line with the preliminary estimate. Albeit having slightly picked up pace from 1.0%YoY in Q1, the data indicates that economic activity in H1 2017 slowed down to 1.2%YoY from 2.9%YoY in H1 2016 and 2.6% in H2 2016. Adverse weather conditions in the first half of the year appear to have taken a significant toll on economic activity. From the production side, very cold temperatures in the winter weighed on agriculture, construction, mining and energy. Subsequently, the summer drought decimated cops and resulted in significant contraction in agricultural output. From the expenditure side, household consumption gained momentum in H1 2017, while growth in investments and government expenditure slowed down. Strong imports dynamics, reflecting strengthening domestic demand and higher energy imports, counterbalanced the positive impact from robust exports' growth. Despite an expected pick up in H2 2017, official forecasts were revised lower recently (IMF: 2.3%, government 2.5%) due to the weak H1 2017 data.

Central Bank Watch

The recent slowdown in growth in tandem with a firmer dinar provided leeway to NBS to resume cutting interest rates in September, after more than a year of inertia. Confounding our and market expectations for stable rates, the MPC cut the key policy rate by 25bps to a new lifetime low of 3.75%. Also supporting the case for the cut were low inflation pressures, less aggressive than earlier anticipated Fed monetary tightening and continuous accommodative ECB stance. Given the recent deceleration in inflation, further monetary easing cannot be ruled out ahead, though is likely to prove modest, as private consumption is recovering and external risks linger.

Risks

Delays in the implementation of reforms. The current IMF deal expires in 2018. If a new precautionary programme is secured, it implies continuation of reforms and fiscal consolidation. Major Central Bank policies may affect capital flows towards risky assets.

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	3.5	3.6	2.9	3.5	3.4						
USA	1.6	2.2	2.4	1.3	2.1	2.2	-2.5	-2.8	-3.3	-4.8	-4.7	-5.2
Eurozone	1.8	2.2	1.8	0.2	1.5	1.2	3.5	2.9	2.5	-1.5	-1.3	-1.0
Germany	1.9	1.9	1.8	0.4	1.5	1.4	8.5	8.0	7.6	0.8	0.5	0.3
France	1.2	1.6	1.7	0.3	1.0	1.1	-2.3	-2.4	-2.5	-3.4	-2.9	-2.6
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	-1.2	0.5
Italy	0.9	1.5	1.5	-0.1	1.4	1.1	2.6	2.2	2.0	-2.4	-2.3	-2.2
Portugal	1.4	1.8	1.6	0.6	1.4	1.5	0.5	0.5	0.5	-2.0	-1.8	-1.9
Spain	3.2	2.8	2.4	-0.3	2.0	1.4	1.9	1.6	1.6	-4.5	-3.2	-2.6
UK	1.8	1.5	1.3	0.7	2.6	2.6	-4.4	-3.9	-3.2	-3.0	-3.0	-2.3
Japan	1.0	1.6	1.0	-0.1	0.5	0.7	3.8	3.7	3.6	-5.7	-4.5	-4.8
Emerging Economies												
BRIC												
Brazil	-3.6	0.6	2.5	8.8	3.5	4.0	-1.3	-0.7	-1.4	-9.7	-8.1	-7.2
China	6.7	6.7	6.4	2.0	1.7	2.2	-3.5	-3.5	-3.5	1.8	1.6	1.5
India	7.9	6.3	7.4	4.9	3.5	4.5	-0.6	-1.2	-1.4	-3.7	-3.5	-3.2
Russia	-0.2	1.7	1.7	7.1	4.0	4.0	1.9	2.2	2.0	-3.9	-2.1	-1.5
CESEE												
Bulgaria	3.4	3.6	3.5	-0.8	1.6	1.7	5.4	3.5	3.0	1.6	-1.3	-1.0
Romania	4.8	5.5	4.0	-1.6	1.4	3.1	-2.2	-3.0	-2.8	-2.4	-3.7	-3.8
Serbia	2.8	2.0	3.0	1.2	3.0	3.0	-4.0	-4.0	-3.9	-1.3	-0.5	-0.6
Turkey	2.9	5.2	3.3	7.8	10.5	8.0	-3.8	-4.7	-4.5	-1.3	-2.5	-2.3

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

Eurobank FX Forecasts

	2017			2018	
	Current	October	December	March	June
EUR-USD	1.1750	1.1700	1.18	1.20	1.19
USD-JPY	113.00	113.00	112.00	112.00	111.00
EUR-JPY	132.75	132.21	132.00	132.00	132.00
GBP-USD	1.32	1.34	1.33	1.35	1.35
EUR-GBP	0.89	0.87	0.89	0.90	0.89
USD-CHF	0.97	0.98	0.99	0.98	0.98
EUR-CHF	1.15	1.15	1.16	1.18	1.18
USD-CAD	1.25	1.25	1.25	1.24	1.24
AUD-USD	0.7810	0.79	0.79	0.78	0.75
NZD-USD	0.7170	0.71	0.72	0.72	0.71
EUR-SEK	9.57	9.57	9.57	9.60	9.62
EUR-NOK	9.39	9.37	9.38	9.40	9.42

Source: Eurobank FX Trading

Eurobank Fixed Income Forecasts

	2017			2018	
	Current	October	December	March	June
USA					
Fed Funds Rate	1.00-1.25%	1.00-1.25%	1.25-1.50%	1.25-1.50%	1.50-1.75%
1 m Libor	1.24%	1.24%	1.41%	1.47%	1.60%
3m Libor	1.34%	1.34%	1.52%	1.63%	1.73%
2yr Notes	1.48%	1.61%	1.60%	1.72%	1.80%
10 yr Bonds	2.35%	2.41%	2.52%	2.60%	2.65%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.33%	-0.33%	-0.32%	-0.30%	-0.28%
2yr Bunds	-0.70%	-0.69%	-0.64%	-0.59%	-0.55%
10yr Bunds	0.48%	0.50%	0.58%	0.65%	0.70%
UK					
Repo Rate	0.25%	0.25%	0.50%	0.50%	0.75%
3m	0.34%	0.34%	0.57%	0.70%	0.78%
10-yr Gilt	1.37%	1.39%	1.48%	1.53%	1.58%
Switzerland					
3m Libor Target	-0.73%	-0.73%	-0.75%	-0.70%	-0.66%
10-yr Bond	-0.01%	0.00%	0.05%	0.08%	0.11%

Source: Bloomberg (market implied forecasts)

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