Eurobank

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

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I. Snapshot

Overview

Macro Picture

- **USA:** Delays in the passage of tax reform reduce the odds of a noticeable acceleration in 2018 GDP growth
- **EA**: Stronger growth momentum on supportive global growth and easing financing conditions
- **UK:** Growth to remain lackluster on weaker consumption, unlikely to be offset by other components of demand
- **Japan**: Above trend pace of growth
- **EM:** Growth pickup, especially in LatAm as Brazil emerges out of recession
- **CESEE:** Consumption spending revival continues unabated

Policy Outlook

- **USA:** Balance sheet reduction likely to be announced in September, followed by another interest rate hike in December
- **EA:** QE extension in 2018, albeit at less accommodative levels than in 2017
- **Japan:** BoJ on hold amid subdued inflationary pressures
- **UK:** BoE to remain on hold this year amid waning growth momentum, subdued wage growth and lingering political uncertainty
- **CESEE:** Muted price pressures allow for a continuation of monetary policy accommodation

Summary

Broad-based global economic recovery still on track, supporting expectations for a material shift in policy accommodation from a number of G10 CBs, in spite of subdued inflation. US politics continue to take centre stage amid concerns about possible further delay/cancellation of certain US President's campaign promises

Markets

- **FX:** EUR well supported after breaking important resistance levels. We favor buying dips as overall picture remains constructive
- **Government bonds:** USTs, Bunds to head lower as CBs signal the end of the easing cycle. We favor selling the rallies.
- **EM:** Performed well in a low volatility environment and global fundamentals remain supportive. We favour taking profit on long held external debt positions.
- **Credit:** Tight spreads and low yields signal for caution ahead, but greater optimism with respect to European growth, underpins improving corporate credit fundamentals.
- **Commodities:** We remain moderately bullish on commodities and in particular oil and base metals that bottomed in 2016, helped by the Chinese rebound

Key Risks

- **Trump disappointment:** The largely expected fiscal stimulus program falls short of expectations
- **Central banks illusion:** Too much optimism on inflation leads to a more aggressive monetary policy stance
- **US aggressive trade protectionism:** Trade & currency war likely, jeopardizing anemic global trade and, hence, weighing on the global growth momentum
- **Increased UK political woes:** Early elections/ Conservative party leadership challenge near-term following the inconclusive outcome of the June 8th general election would suggest increased risks for "disorderly" Brexit

Macro Views

Latest Macroeconomic Developments & Outlook

World Economic Outlook		Global growth has accelerated since Q3 2016, standing at its strongest level in more than a year (in annual terms), supported by a synchronous recovery in both developed and emerging economies. For advanced economies, the recovery in domestic demand is expected to offset any negative impact from the reduction in the monetary policy accommodation. Looking ahead, the global expansion should continue benefitting from a sizeable global investment upswing, the first signs of which were observed in Q4 2016. Overall, global GDP growth is expected to accelerate to c. 3.5% in 2017 from 3.1% in 2016.
Developed Economies	**US**	The global economic recovery and prospects for US tax reform and deregulation have led to a strong rebound in business investment after the sluggishness experienced in 2016. Real GDP growth is expected at 2.2% in 2017 on solid domestic demand, but delays in the legislation for tax reforms reduce the odds for a marked pickup in real economic activity in 2018.
	Euro Area	The euro area economy is expanding more firmly and broadly relative to its recent past, with real GDP growth accelerating to 1.9% in 2017 from 1.7% in 2016. The global cyclical recovery contributes positively to the euro area growth momentum, while expansionary monetary and fiscal policies are also supportive. Private consumption remains the major growth pillar, while business investment recovers gradually, though its trajectory continues to be sub-par.
	Periphery	Soft and hard data from the majority of periphery euro area economies pertaining to Q2 2017 suggest that the improving economic momentum remained intact mainly supported by private consumption on the back of improving labor market conditions.
	Japan	Japan's cyclical expansion remains on track amid solid export growth and buoyant domestic demand. Capitalizing on improving labor market conditions, consumer sentiment is expected to expand further and the savings rate to normalize from previous elevated levels. Furthermore, public investment will probably support domestic demand growth amid the fiscal stimulus package passed by the Diet last year.
Emerging Economies	**BRICS**	In China, economic activity appears to be modestly slowing down lately. However a hard landing scenario has moved to the backburner for now. Among commodity exporters, growth in Russia seems to have softened in Q217, but, is expected to pick up pace in H2 2017 and mark the first positive yearly reading since 2014. Private consumption and investments are seen supporting the recovery, while fiscal consolidation and moderate monetary policy tightening to constrain further upside on overall moderate growth. Brazil is also expected to emerge from recession this year. However, real GDP growth is seen rebounding only marginally, with domestic political uncertainty remaining a key risk. Despite some moderation due to the last year's demonetization, economic activity in India is expected to remain amongst the strongest globally.
	CESEE	From a growth point of view, the economies of our focus (Bulgaria, Romania, Cyprus, and Serbia) and the broader CESEE region appear to be in the best shape in the post-Lehman period. Growth dynamics are broadly driven by the improving private consumption. Consumer spending revival continues unabated driven by sustained sentiment improvement, eased financial conditions, firmer labor markets and robust real wage dynamics.

Global Macro Themes & Implications

Theme	Implications
Gradual withdrawal of monetary policy accommodation	Major central banks in advanced economies are beginning to convey a message of gradual removal of monetary policy accommodation. Apart from Fed which has raised interest rates twice so far this year and has prepared the markets for the formal announcement of balance sheet reduction in the following months, the ECB seems ready to follow suit removing policy stimulus, albeit gradually, over the course of 2017-18. Recent comments by ECB President Mario Draghi reflected the view that a constant monetary policy is becoming more accommodative as the economy continues to recover, so the central banks should tighten more in order to keep monetary policy stance unchanged. Given that central bank communications apparently reflect the improved state of economic activity rather the inflationary trends which remain relatively subdued, there may be a risk central banks are too optimistic on the inflation outlook, potentially losing their credibility and, therefore, creating disruptions in global financial markets.
Delays in the implementation of US tax reform; proposed 2018 budget plan envisions surprisingly low amount for new infrastructure development	The long-awaited tax system reform initially designed to promote a higher level of business investment has been delayed, raising uncertainty over the ability of US President Donald Trump to fulfill his pre-election promises. The priority for the Republican Party and President Trump has clearly been the healthcare reform, so the longer it takes for the Senate to approve the healthcare bill already endorsed by the House of Representatives, the longer it will take for the federal tax reform to be implemented. Adding to this, the proposed 2018 budget plan released on 23 May set aside only USD200bn for new infrastructure development over 10 years, much less than the initially planned USD1.0trn 10-yr infrastructure spending program. The delays in the passage of tax reform reduce the odds of a noticeable acceleration in household spending and business investment posing downside risks to real GDP growth outlook.
BoE MPC members appear split on the prospect of higher interest rates	BoE surprised markets at the June 14th monetary policy meeting with two MPC members, Ian McCafferty and Michael Saunders joining Kristin Forbes, the most hawkish member, and voting all three in favor of a 25bps rate hike. The minutes revealed that those three members argued in favor of higher interest rates on the grounds that, among others, inflation is likely to overshoot the BoE target by more than expected and to remain above that level throughout the three-year forecast period. Though the more hawkish than expected meeting outcome suggests increased risks for a rate hike, it would be hard to argue that the BoE would risk a rate hike any time soon. There are increasing signs over a slowing domestic economy, rising inflation continues to weigh on real earnings while Brexit-related uncertainty has undoubtedly increased after the June 8th snap elections ended in a hung parliament. According to the BoE, key considerations in judging the appropriate stance of monetary policy are the evolution of inflationary pressures, the persistence of weaker consumption and the degree to which it is offset by other components of demand.

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 Q1-2017. 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 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	• Domestic equities maintained their up-trend in June supported by the overall positive bias in major global bourses and a set of upbeat macroeconomic data domestically. All four major benchmarks on the BSE added value, with the blue-chip index SOFIX in the lead increasing its market cap by 6.4% and hovering near 9-year highs. On the other hand, the broader benchmark BG BX40 was 2.76% higher over the same period. Both of the said indices currently stand more than 50% higher compared to their levels a year earlier (June 2016). A catalyst for the positive movement was a set of positive GDP, industrial production, retail trade and labor market data. At the same time, the budget surplus increased, while the gross external debt declined. The local bond market marked no significant change except for the high-end of the curve with yields sliding by 4-8 bps in June.
Romania	• High redemptions in June and July kept yields for ROMGBs capped despite the political noise related to the new PM appointment; • NBR continues to be on a wait-and-see mode, looking for the right timing to narrow the interest rate corridor in a first phase of monetary policy tightening; • EUR/RON has been testing the 4.6 level in the past month. We remain RON bearish as Romanian fiscal position seems to deteriorate faster than anticipated.
Serbia	• The dinar's appreciation momentum, that has been on stage since May, is still very much active although we do see some early signs of exhaustion. Importantly, the pace appears to have slowed down significantly lately as the Central Bank intensified its intervention amounts (NBS bought €275mn over the last three weeks vs. to €340mn bought in the period from May until the last week of June). Furthermore, the most recent NBS interventions in the FX markets, may signal some sort of support for the EUR/RSD at 120.00, albeit further indication is needed. • NBS monetary policy meeting in July, did not bring any changes to the key policy rate. According to the statement, the decision was guided by inflation factors, inflation projections and the effects of past monetary easing. Inflationary pressures remain relatively subdued, as confirmed by low and relatively stable core inflation which has been moving around 2% YoY since early 2017. The NBS Executive Board expects inflation to continue moving within the target tolerance band of 3.0%±1.5 percentage points in the period ahead.

The Trader's View

Asset Class	Outlook
Foreign Exchange	**EUR/USD:** Positive data out of Europe and a lacklustre US performance has led a EUR rally driving the pair to a 1.1490 high. Volatility is slowly picking up from depressed levels with further EUR upside requiring more decisive action by the ECB. As such we are anticipating a 1.12 – 1.14 range with thin summer markets potentially exacerbating any swings. **USD/JPY:** The BoJ made it clear last week that it wanted no part of the global reflationary rise in yields, when it announced that it would buy unlimited amounts of 10 year bonds at 0.11%, in order to cap Japanese yields. USD/JPY hit 4 months high at 114.48 as the yield differential widened post the US fixed income selloff supported by hawkish Fed speak. The next technical resistance stands at the 115.20-62 region. A break above could see a move to 117.53. **GBP/USD:** Cable has pulled back from its late June top at 1.3030, when rate hike talks from the BoE were at their height. Weak data and the negative noises coming out of Brexit seem to be balanced by a hawkish central bank and lingering hopes of a "soft Brexit" keeping the pair hovering around the 1.30 mark even though markets remain unconvinced of why the MPC would choose to raise rates at this point
Government Bonds	**US:** Fed Chair Yellen pushed back on the recent dovish pricing of monetary policy (which had the next hike fully priced in only by mid-2018) and added some support to the view that the recent softness in data may be transitory steepening the USD curve - although the front end has more room to run - and signaling that the committee is willing to look past meagre inflation data. The 10y yield at the time of writing sits at 2.32% with 2.50% the next psychological level to be broken paving the way for a move towards 2.75% by year end. Some support could also be found in the US policy agenda with midterm elections in 2018, urging the implementation of some pro-growth measures. **EU:** Eurozone seems to be finally enjoying some calm as data has markedly improved and most political risks are out of the way. The break of 50bps on 10y Bund yields gave the selloff further legs. 5y5y real yields reached 11 bps, the highest since the end of the Bund tantrum, and the first foray into positive territory since the end of 2015, as 10s/30s has found a cap on its recent steepening, with the WAM of QE purchases of German debt dropping below 5 years. As the ECB announces its QE schedule for 2018 there is some space for a moderate increase in term premiums pushing the belly and the long end higher. Peripheral spreads were proven very resilient during the recent sell-off, and we expect this trend to continue during the summer.
EM hard currency debt	EM external debt appears poised to continue to strengthen in the coming months as the global growth recovery, while losing some momentum, remains broadly intact and US and EU central banks are not in a rush to remove monetary stimulus. We are still inclined to take profit at any further EM outperformance. EM carry trades remain attractive, but advocate emphasis on idiosyncratic political and fundamental divergences in asset selection
Corporate credit	In Europe, corporates and financials, continued to tighten aggressively on the back of senior debt not getting bailed in multiple bank failures with financials the clear outperformer. Impending ECB taper and supportive fundamentals should help European yields rise which make us cautious on corporate credit at current levels as we believe there is little space for further spread compression.
Commodities	We maintain the view that commodities have bottomed out. Medium term WTI sell offs remain a buy with a view to break on the upside of the recent wide range. Industrial metals will see increased demand as global growth picks up and the reflation trade strengthens, especially from a Chinese rebound in manufacturing. Overall energy and base metals are expected to perform well in a moderate rising rates/synchronised global economic growth environment. In precious metals, we expect gold to move lower going forward and silver to remain steady in 2017, while positive fundamentals should support palladium prices.

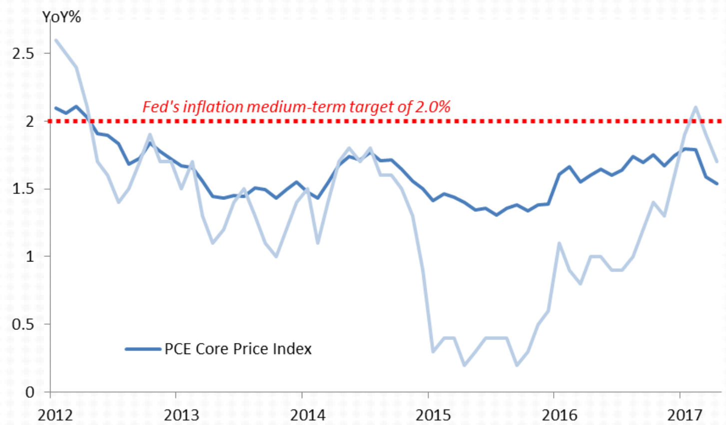
II. Advanced Economies

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

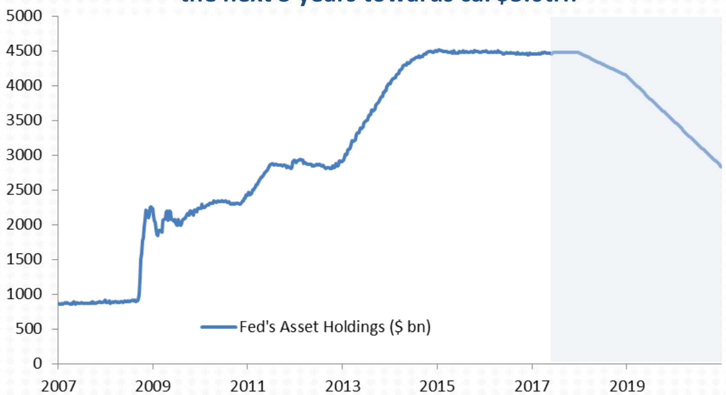
USA: tax reform delays pose downside risks to GDP growth outlook

US inflation target still out of reach

Since 2012, Fed's goal met only once (Feb. 2017)



Shrinkage of Fed balance sheet expected over the next 3 years towards ca. $3.0trn



Source: Bloomberg, Federal Reserve, Eurobank Economic Research

Latest Economic Developments

Q1 real GDP growth was revised higher to 1.4%QoQ saar from 1.2% in the second estimate, mainly on the back of stronger personal consumption growth, suggesting that the Q1 weakness is not as pronounced as previously stated. Incoming data on personal spending, external demand and inventories point to rebound in real economic activity in Q2. Consumer spending continues to be the major growth pillar, with household net worth reaching a new record level in Q1 2017 and reversing the losses during the 2008/09 financial crisis. Meanwhile, the positive global growth momentum, prospects for tax reform and deregulation and high corporate profits should be supportive for business capital spending.

Central Bank Watch

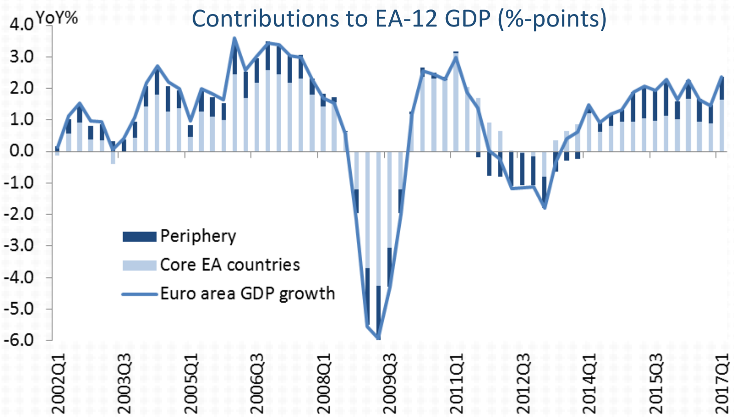
The Fed raised the target range for the fed funds rate by 25bps to 1.00-1.25% in June, downplaying recent softness in inflation. The stronger commitment to shrinking the balance sheet "this year" and "relatively soon" suggests September is more likely than December for announcing the beginning of balance sheet reduction, with the actual run-off starting in October provided that "the economy evolves as expected". Nevertheless, given that the Fed would probably not want to tighten policy with two policy tools in September simultaneously, we do expect the next rate hike in December as long as there is not a sustained decline in inflation or/and a slowdown in economic growth.

Risks

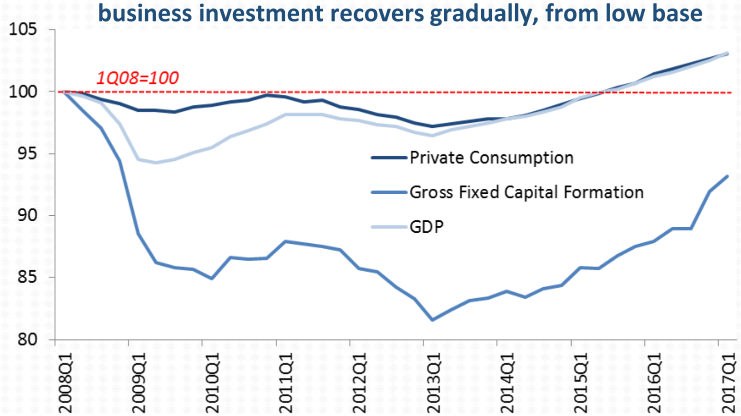
Uncertainty lingers over the endorsement of US administration's pre-election promises on fiscal policy. Difficulties over President Donald Trump's ability to enact pre-announced tax reform, tax cuts and increases in infrastructure spending pose downside risks to the US growth outlook. Adding to this, the IMF recently revised down its 2017 and 2018 GDP growth forecasts to 2.1% for both years from 2.3% and 2.5%, previously, amid fading prospects for any US fiscal expansion.

Euro area: broadening economic recovery on strengthening global growth and expansionary fiscal & monetary policies

More balanced economic recovery, with both core and periphery economies adding to growth



Household consumption the main growth engine; business investment recovers gradually, from low base



Source: Eurostat, Bloomberg, Eurobank Economic Research

Latest Economic Developments

Euro area activity has continued to surprise to the upside, with the pace of economic expansion broadening across countries and sectors. Improving labor market dynamics, expansionary monetary and fiscal policies and a more positive global growth outlook are key contributing factors to the euro area economic outlook. The consumption-led recovery has broadened to business investment, with the capital goods sector experiencing both stronger demand and expectations of stronger output. Meanwhile, favorable financing conditions and the ongoing credit recovery, particularly lending to the non-financial private sector, underpin the underlying growth momentum.

Central Bank Watch

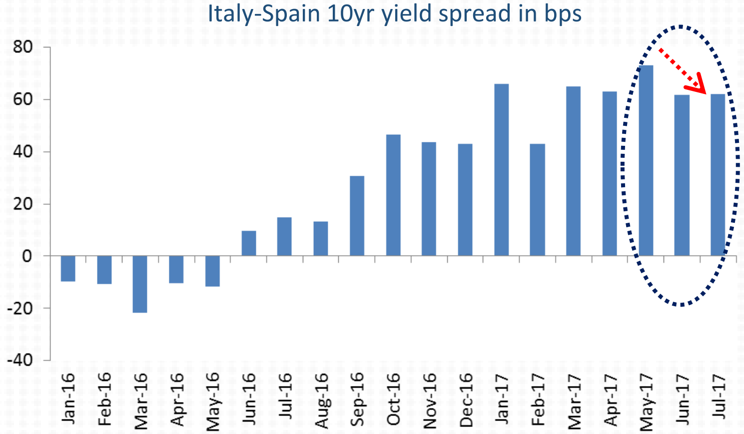
The ECB adopted a slightly less accommodative forward guidance at its June meeting, removing the reference to lower interest rates, and expecting them to “remain at present” levels for an extended period of time. The Governing Council seems open to a further step towards reducing monetary policy accommodation provided that there is improved confidence in the inflation outlook, characterizing the risks to the economic outlook as broadly “balanced” instead of “downward” previously. Baring any downside surprises, we expect the ECB to extend its QE programme into 2018, applying a reduction of its pace to EUR35-40bn per month starting from January 2018. The ECB’s exit strategy is expected to be very gradual given the sluggish pace of improvement in core inflation, with both asset purchases and negative deposit rates in place throughout 2018, albeit at less accommodative levels than in 2017.

Risks

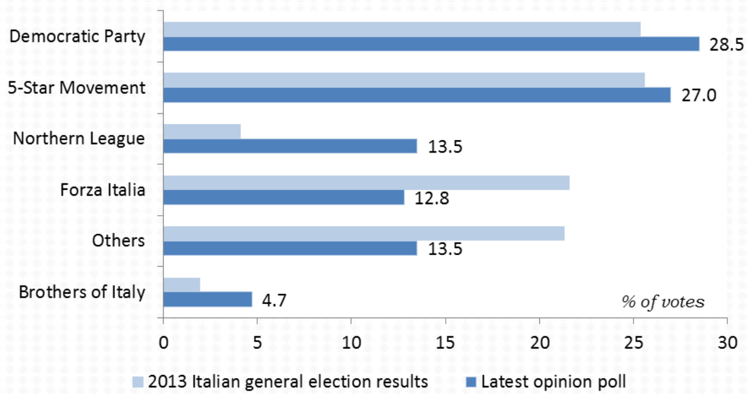
Although political risk has receded after Macron’s victory in French presidential elections, political uncertainty still takes centre stage. The Italian election no later than May 2018 is critical, while in Germany –where, according to recent opinion polls, Merkel’s CDU leads over the SPD for the Sept. 2017 general election- the election outcome will determine the country’s more or less growth-friendly fiscal policy.

Italy: fragmented political scene may hinter implementation of reform policy agenda

Risk of snap elections has receded following the collapse of the cross-party deal on electoral reform



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



Source: Bloomberg, Eurobank Economic Research

Latest Economic Developments

Italy's GDP growth was revised higher from the initial estimate (+0.4%QoQ), with private consumption rebounding after two quarters of sluggish growth. Net exports were a major drag on growth due to a sharp rise in imports, while business investment declined after two quarters of solid growth. Confidence in the manufacturing sector points to a rebound in manufacturing output ahead, while the momentum in overall investment has improved somewhat, amid a slow recovery in the residential sector and a pick-up in public investment in H1 2017 after a poor performance in the previous year. Nevertheless, economic recovery comes from a very low base and at a very slow pace, with Italy remaining an underperformer among other euro area member states on the back of firmly embedded structural issues.

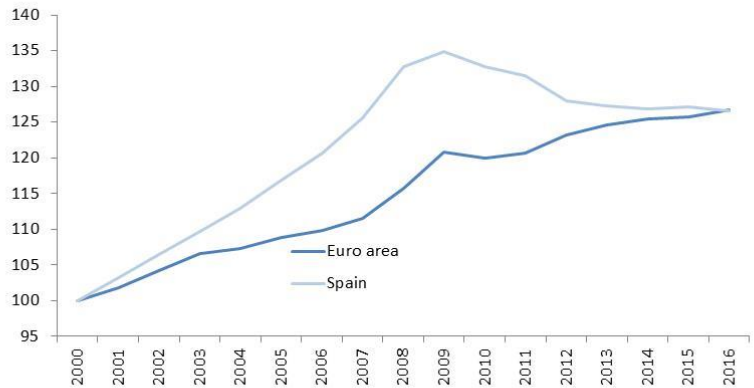
Political uncertainty continues to prevail

The second round of local elections in 111 municipal races across the country on 25 June resulted to a clear victory for center-right opposition parties, with Silvio Berlusconi's Forza Italia (FI) expected to have a key role in national politics in the way to upcoming general elections due by May 2018. Matteo Renzi's Democratic Party (PD) lost 9 out of 16 provincial capitals it held before the vote, including Genoa where the center-left had been the dominant power over the past 50 years. The outcome of the local elections is unlikely to have any significant ramifications on national politics, unless the current unbalanced electoral law is reformed to induce political parties to form pre-electoral coalitions. Should this be the case, a traditional centre-right alliance could challenge the leadership of centre-left parties. On the flipside, should Italy adopt a proportional representation system, we see a high risk of political instability in the post-election era given the ideological differences and disagreements between the three blocs (center-left, center-right and the M5S) that dominate Italian politics, potentially leading to a slowdown in structural reforms and further fiscal slippages, making the Italian economy vulnerable to shocks.

Spain: Real GDP to continue growing strongly throughout this year; limited risks for snap-elections near-term

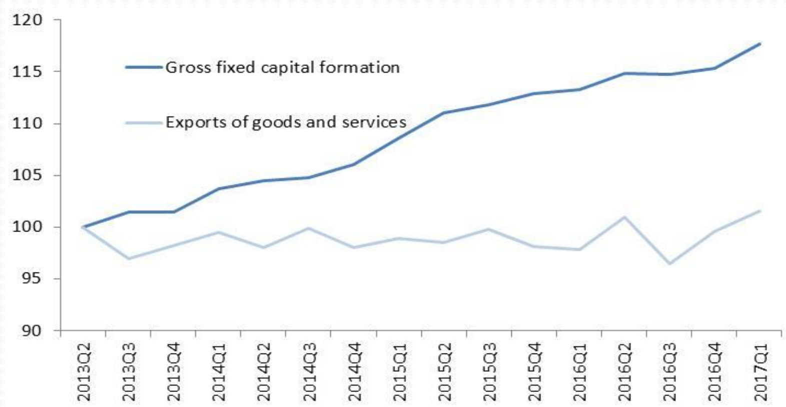
Competitiveness has improved over the last few years

Unit labor (index 2000=100)



Rebound in investment and signs of improvement in exports

(index Q2 2013=100)



Source: Eurostat, Eurobank Economic Research

Latest Developments

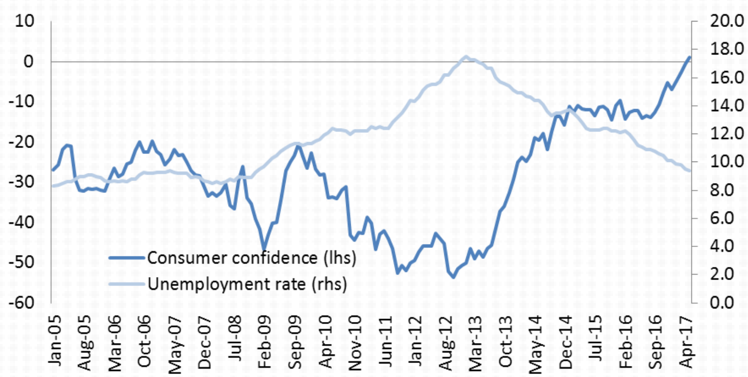
Spanish Q1 2017 GDP surprised positively accelerating at 0.8%QoQ from 0.7%QoQ in the prior two quarters, exceeding the euro area average for the 12th consecutive quarter. Domestic private consumption registered the slowest pace of growth since Q3 2013 (0.4%QoQ), as higher inflation dents households' purchasing power. However, this was more than offset by a hefty rebound in investment (2.0%QoQ) reflecting Spain's improved price competitiveness. Despite the 3.8%QoQ rise in imports, net trade also contributed positively to Q1 GDP growth thanks to a 4.0% QoQ increase in exports, the highest in 10 years. For the remainder of the year, the Spanish economy is expected to continue to grow strongly, supported by a hefty rebound in investment, particularly in machinery and equipment, a solid performance in exports and domestic demand's relative resilience as an improving labour market is expected to continue to shore up private spending in spite of a slowdown in real income growth due to higher inflation. The strong economic growth is expected to help the government to bring this year's fiscal deficit target close to 3.0%-of-GDP from 4.5%-of-GDP in 2016. Limited risks for snap elections short-term also bode well for the Spanish economy's growth prospects in the coming quarters. Recent opinion polls continue to suggest that despite corruption scandals currently under investigation, the People's Parity (PP) governing minority remains the strongest party albeit short of an absolute parliamentary majority, while the two major opposition parties, the Socialists (PSOE) and Unidos Podemos, remain far from leading an alternative government.

Political risks for Mariano Rajoy PP- minority government

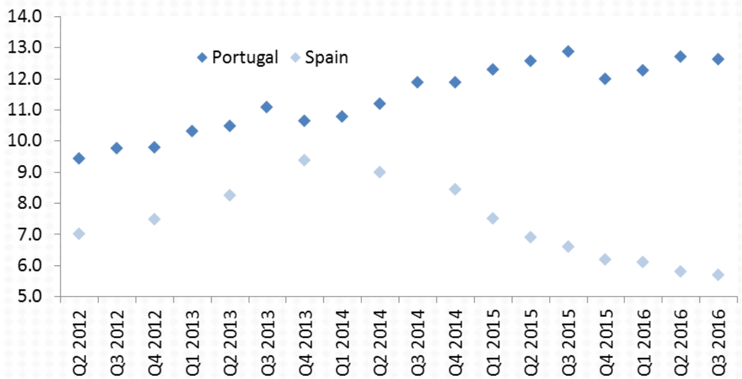
The Catalan regional government announced that it will hold an independence referendum on October 1 2017. The central government intends to prevent such a referendum at any cost, on the view that it would violate the Spanish constitution. The PP spokesperson replied to the announcement by asking for a dissolution of the regional parliament and early elections. According to recent polls, the majority of the Catalonian population are in favour of further autonomy but oppose an outright independence.

Portugal: Economic growth to remain on solid footing in the coming quarters

Private consumption to remain the main growth engine short-term, underpinned by improved labor market conditions and increased consumer confidence



Banking sector remains a key concern for Portugal's growth outlook



Source: Eurostat, IMF, Eurobank Economic Research

Latest Economic Developments

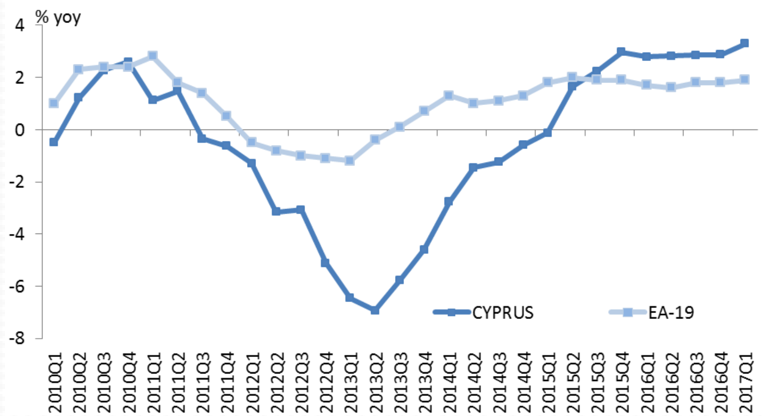
Portugal's GDP grew by 1.0%QoQ sa in Q1 2017, the strongest post-crisis quarterly figure, mainly on the back of robust private consumption growth and a booming tourist sector. Looking ahead, both soft survey and hard activity data suggest that economic growth remained solid in Q2. Consumer confidence improved in May for the fifth consecutive month, recording the highest level in more than 30 years. Industrial production increased by 0.4%MoM in May, up from 0.2%MoM in April, following a 5.8%QoQ rise in Q1. For the whole of 2017, real GDP is expected to accelerate from 1.4% in 2016 to levels above 2.0%, compared to an estimated euro area average of 1.7%. Private consumption is likely to remain the main growth engine, supported by solid consumer confidence (record high of 3.1 points in June), ongoing improvement in labor market conditions (the unemployment rate dropped at a 8 ½ year low of 9.4% in May) and increased minimum wage (10% cumulatively in 2016-2017). But downside risks prevail as Portugal remains vulnerable amid persisting structural weaknesses including banking sector vulnerabilities and elevated NPLs.

Portugal remains vulnerable to persisting structural weaknesses

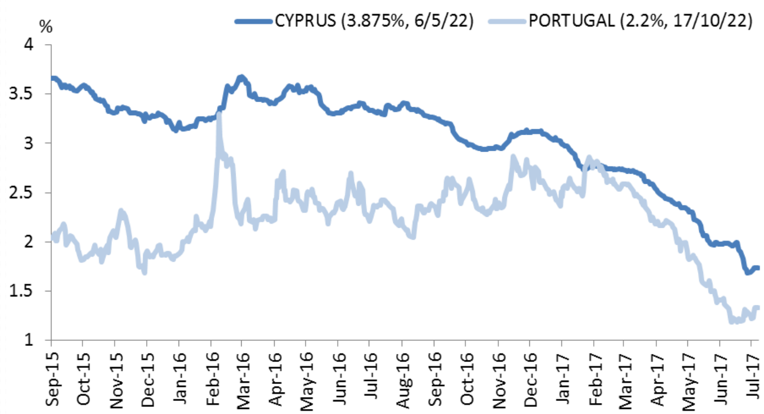
In spite of the smooth recapitalization of Caixa Geral de Depositors (CGD), the largest state-owned lender, and Banco Commercial (BCP) earlier this year, the prospect of renewed banking jitters cannot be ruled out. The government agreed to the sale a 75% stake in the "bad bank" Novo Banco to Lone Star, a US private equity firm, in return for injecting €1bn in capital into the lender. However, Bank of Portugal announced that the above agreement will be conditional on a liability management exercise aiming to strengthen the bank's capital ratios. The consortium of bondholders has reportedly opposed the planned sale of Novo Banco and the liability management exercise, raising the risk the government to be forced to put the lender into a liquidation process. In addition, unlike Spain and other euro area countries, NPLs in Portugal have actually increased in the past years despite improved economic conditions.

Cyprus: New bond issuance allows for streamlining of debt repayments in 2019-2020

Cyprus turn-around growth story has been impressive so far



Cypriot five year bonds have been on a declining trend but outperformed by Portuguese since February2017



Source: Eurobank Research, National Authorities, Bloomberg

Latest Economic Developments

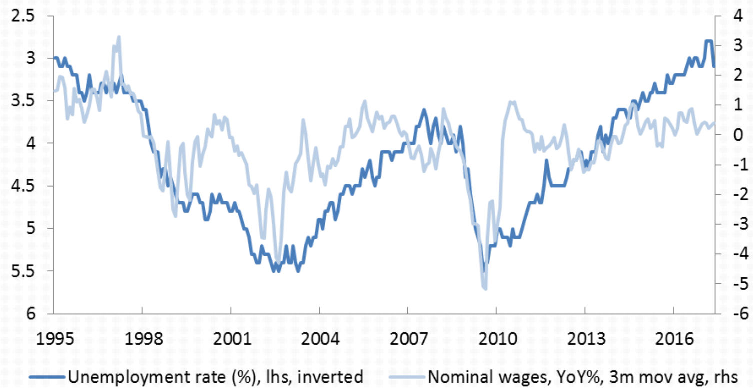
On June 21th, Cyprus tapped international markets for the second time after exiting from the Economic Adjustment Programme in March 2016, selling €850mn of a new 7Y-Eurobond and the corresponding yield came at 2.80%. From a historical point of view, this is the lowest yield the Republic ever achieved in a benchmark bond debt issuance and reflects strong investor confidence towards the country's improving macroeconomic fundamentals. The proceeds from the latest tender will be used to repay more expensive debt outstanding, including the buyback of three outstanding securities maturing in 2019-20. The Q1-2017 GDP growth reading was the strongest since 2008. On a seasonally adjusted basis, growth expanded by +0.6% QoQ/+3.3% YoY compared to +0.7% QoQ/+2.9% YoY in Q4. The consumption rebound continued in Q1 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.

Risks & Challenges

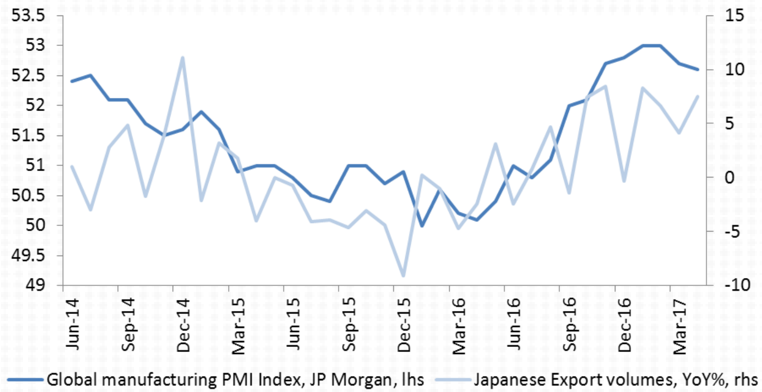
Following the latest round of sovereign rating assessments, major rating agencies appear to continue having divergent views on Cyprus. Currently, the distance from investment grade status is: one notch for S&P (currently at BB+), four notches for Moody's (currently at B1), and three notches for Fitch (currently at BB-). The lack of investment grade status currently prevents Cyprus from joining the ECB's PSPP program. Yet, five year Cypriot bond yields are on a declining trend since mid-2016 but outperformed by Portuguese since last February. 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, the second highest in EA).

Japan: above trend pace of growth set to continue throughout 2017

Tight labor market conditions not yet translated into wage growth



Japanese economy vulnerable to the global economic cycle



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

Latest Economic Developments

The Japanese economy continues to grow at an above-trend pace, boosted by stronger-than-expected private consumption growth. Recent solid exports and industrial production data suggest that the economy's cyclical expansion remains on track, capitalizing on the synchronized global economic recovery. Labor market conditions have tightened significantly, with the unemployment rate standing at its lowest level in more than two decades. Driven my improving employment, consumer sentiment is expected to improve and the savings rate to normalize. Meanwhile, the public sector is expected to add markedly to growth in the quarters ahead on the back of the fiscal programme passed by the Diet last year.

Central Bank Watch

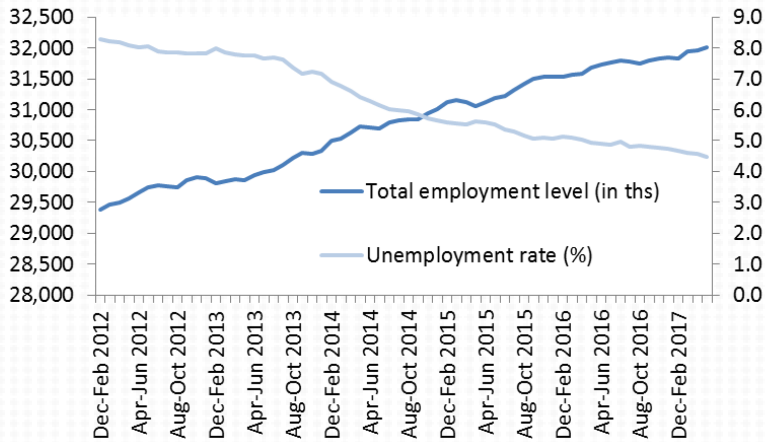
We expect the BoJ to keep its accommodative monetary policy stance unchanged throughout 2017, as headline CPI inflation has remained well below the BoJ's 2.0% target and is unlikely to rise rapidly in the near-term. Market focus will probably shift towards whether the Central Bank can keep the current pace of government bond purchases at JPY80trn per annum and maintain its yield curve control at current levels, given the wider yield spread versus the US. In our view, the first interest rate hike will come in Q1 2018 at the earliest, likely coupled with a rise in 10yr JGB yields to 0.25% with a +/-25bp range (0-0.5%).

Risks

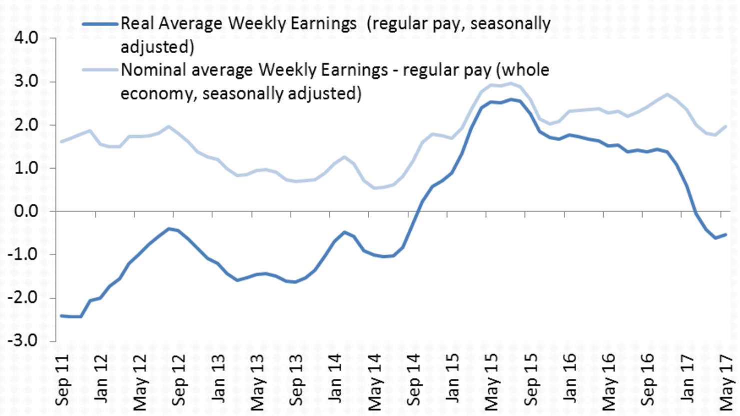
Following the fiscal measures adopted last year, which are expected to add ca. 0.6pp to 2017 GDP growth, it is of vital importance whether the government will adopt another supplemental budget for the upcoming fiscal year, or else Japan could experience a sharp economic slowdown again. As far as the external environment is concerned, the Japanese economy is largely vulnerable to global demand. Meanwhile, potential external disturbances, such as US protectionist policies, could have negative repercussions for the country's economic outlook.

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

Labor market conditions on an improving trend



Weak wage growth in spite of impressive labor-market recovery



Source: ONS, Eurobank Economic Research

Latest Economic Developments

Recent soft and hard data suggest that UK economic activity remained subdued in recent months with Q2 GDP likely to show growth of 0.2%QoQ, the same pace as in Q1 2017, marking a significant slowdown from the long-term average of 0.6%QoQ (Q2 GDP flash estimate due on July 26). Housing price data for May continued to suggest a general slowdown in the annual growth rate since-mid 2016, while construction output marked the sixth monthly fall of over 1% in the last eight months. Manufacturing data for May also disappointed while overall trade deficit rose more than expected in June mainly due to robust import growth. Furthermore, consumer confidence fell to a post-referendum low in June and the savings ratio reached a new historic low of 1.7% of gross disposable income in Q1. Adding to the above, real wage growth in the three months to May fell by 0.5%YoY, close to the biggest decline since mid-2014, squeezed by rising inflation pressures despite improved labor market conditions.

Central Bank Watch

BoE surprised markets at the June monetary policy, with three MPC members voting for a rate hike on the view that inflation is likely to overshoot the 2.0% target by more than expected. If inflation keeps rising, there could be more voters for higher rates in the coming months. However, in an environment of high political and economic instability, BoE hawks are likely to remain in the minority with interest rates stable this year.

Risks

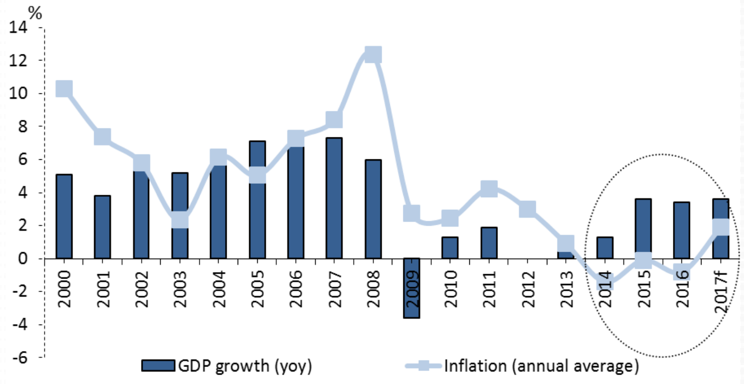
After coming first but short of a majority at the June 8th UK general election, the Conservative party reached a deal with the Northern Ireland's (DUP) for the formation of a coalition government on a "confidence and supply" basis. However, the fragility of this arrangement suggests that the prospect of another snap election or a Conservative party leadership challenge in the coming months cannot be ruled out. With respect to the Brexit process, a less stable and likely less coherent government opens up a wide range of potential outcomes; Brexit could end up softer, but the likelihood of a disorderly or a cliff-edge outcome remains a possibility.

III. Selected CESEE economies

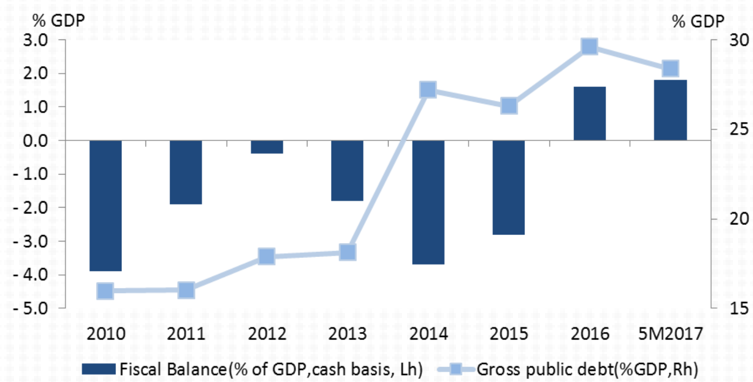
- Bulgaria
- Romania
- Serbia

Bulgaria: Incoming government vows to push for ERM2 application

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

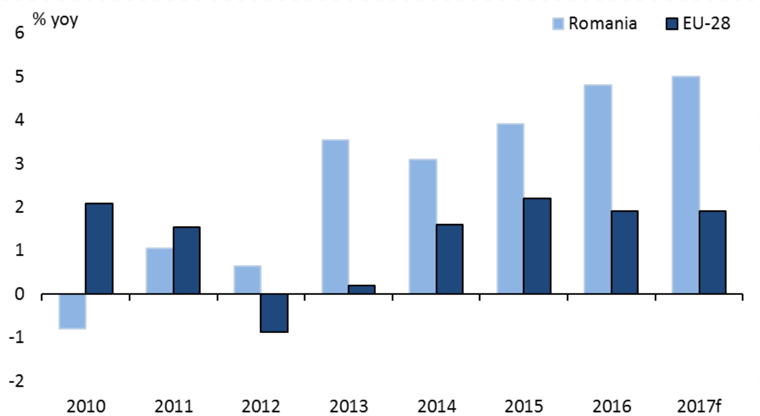
The Q1-17 GDP estimate (+0.9% QoQ/+3.5% YoY) demonstrated that growth remained on track. Private consumption was very strong (+2% QoQ/+5% YoY in Q1-2017). On the negative side, investments were in red territory for yet another quarter, the rate of decline (-0.6% QoQ/-5.4% YoY) was the largest in the last three years mirroring the lingering political uncertainty ahead of the elections, the under-execution of public investment program which is traditionally skewed to the last quarter of the year. The contribution of net exports turned negative as imports outpaced exports (+1.9% QoQ/+7.1%YoY vs. +0.9% QoQ/+5.8% YoY) for the first time since Q4-2015. Bulgaria is expected to register a second consecutive year of strong-above potential- growth in 2017. Private consumption dynamics are broadly set to remain strong as the economy benefits from a more expansionary fiscal policy stance, an improving labor market, catching up wages and still relatively low energy prices. Investments are going to receive support from improved EU funds absorption while a vibrant export oriented manufacturing sector and an emerging tourism industry boosts net exports.

Risks & Challenges

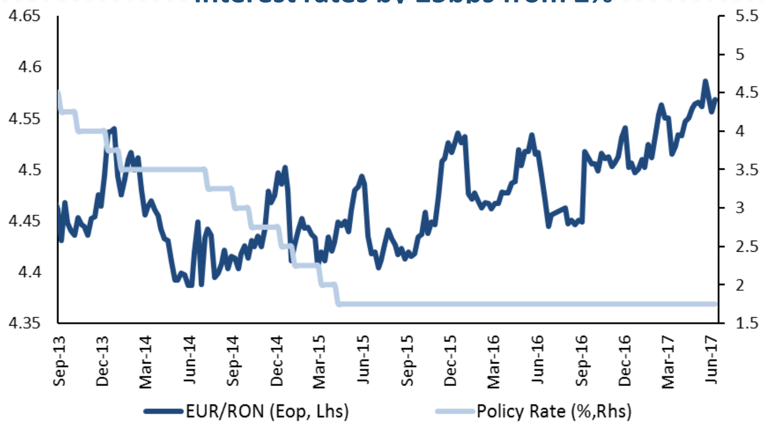
Joining the ERM2 mechanism for a period of at least two years is a formal prerequisite for Euroarea membership. According to press reports, Prime Minister Borissov has received support from both Chancellor Merkel and President Macron to go ahead with ERM2 application membership. Currently, Bulgaria fulfills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

Romania has been growing faster than EU-28 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

Politics came to the forefront once again

The ruling coalition toppled down PM Grindeanu with a vote of no-confidence in the parliament, just six months into his tenure for allegedly not delivering on the party's pre-election promises. Mihai Tudose, the minister for economy in the outgoing government, not a very prominent, or at least not well known, ruling party leader was nominated by the alliance of the PSD and ALDE for the post of the Prime Minister and received the tacit support of Ethnic Hungarians (UDMR).

Latest Economic Developments

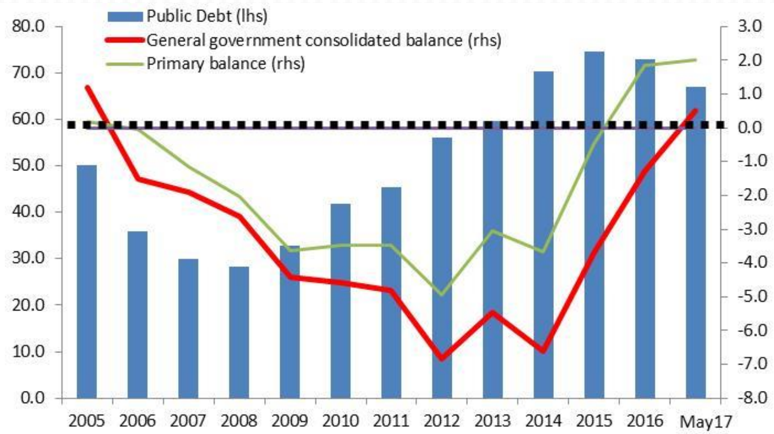
The Q1-2017 GDP estimate was a huge upward surprise. On a seasonally adjusted basis, real GDP growth stepped up to +1.7% QoQ/+5.6% YoY in Q1 –above analyst call for +1.0% QoQ/+4.5% YoY- up from +1.5% QoQ/+5.0% YoY in Q4-2016. It is common knowledge that growth is largely driven by private consumption, financed by an unsustainable overly expansionary fiscal policy, and leads to a revival of macroeconomic imbalances. *(CAD2017f: 3% compared to 2.2% in 2016)*

Risks & Challenges

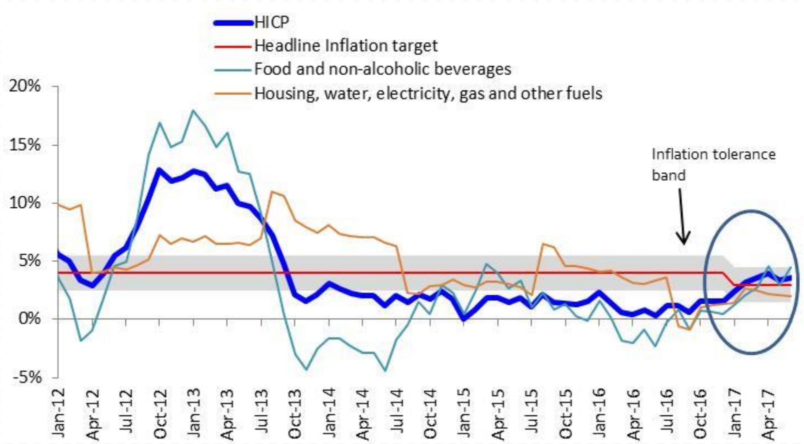
Despite the swift end to the looming political crisis, populist policies still cast a threat to macroeconomic outlook. The new government pledged to reform taxation in order to boost the labor share in the economy and increase the minimum wage by 38% in 2018, which may result in significant competitiveness losses. On top of that, the unitary public wage law will result in significant increases of wages in the public sector in the following years and is expected to have a detrimental impact on fiscal metrics. Fiscal risks have already started materializing in the budget execution: the deficit amounted to-0.3% of projected GDP in 5M2017. Assuming no policy change, the projected fiscal deficit is expected to swell to 3.7% and further to 3.9% in 2018, that may put the government on a collision course with EU institutions. The government has downplayed those concerns.

Serbia: New government expected to continue previous administration's policies

Fiscal consolidation continued thought to end H1 2017



Inflation on the rise but likely to remain within target



Source: Eurobank Research, National Authorities

Latest Economic & Political Developments

Following a slowdown in real GDP growth to 1.2%YoY in Q1, higher frequency data signal a rebound is in the making in Q2. This supports the view that for further pick up this year and the next as recent positive trends continue and private consumption strengthens. Budget over-performance continues. The President said that the general government budget is estimated at a surplus of up to RSD 28.0bn in H1 2017. Further narrowing in last year's 1.3% of GDP deficit towards 0.5% remains on the cards as is a small surplus in 2018, along with a further drop in public debt. Following a staff-level agreement of the 7th review under the country's SBA, the IMF acknowledged the major macroeconomic performance turnaround over the last two years. The domestic political landscape appears to have stabilized lately after the appointment of new cabinet and PM. The new government is expected to continue the prior administration's economic, fiscal, reform-oriented and pro-EU policies, while influenced by President Vucic.

Central Bank Watch

As also noted by the IMF recently the ongoing fiscal consolidation has provided leeway for the Central Bank (NBS) to substantially ease monetary conditions, with the key policy rate having remained at the current record low of 4.00% since July 2016. Despite higher readings in over the last few months (May's CPI at 3.5%YoY), the Central Bank has expressed belief that inflation will remain within target (3±1.5%) over the coming months - as one-off price pressures gradually wane and the base effect from global oil prices slows down, while upward pressures are seen from the recovery in domestic demand and inflation from abroad. This allows the MPC to maintain its accommodative monetary policy stance this year and hold the key policy rate at current levels.

Risks

Some reform fatigue is apparent, while there have been delays in the implementation of some reforms. The current IMF deal expires in 2018, but the government is mulling on a new programme. If secured, it implies continuation of reforms and fiscal consolidation. Major Central Bank policies will continue to affect capital inflows towards Serbia.

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	2.4	2.5	-2.6	-2.7	-3.3	-4.4	-4.0	-4.4
Eurozone	1.7	1.9	1.7	0.2	1.6	1.3	3.4	3.0	2.9	-1.5	-1.4	-1.3
Germany	1.9	1.6	1.9	0.4	1.7	1.4	8.5	8.0	7.6	0.8	0.5	0.3
France	1.2	1.4	1.7	0.3	1.4	1.3	-2.3	-2.4	-2.5	-3.4	-3.0	-3.2
Periphery												
Cyprus	2.8	3.0	3.0	-1.2	1.2	1.7	-5.3	-5.7	-5.9	0.4	0.2	0.7
Greece	0.0	1.5	2.2	0.0	1.0	1.1	-0.6	-0.3	-0.1	0.7	-1.2	0.6
Italy	0.9	0.9	1.1	-0.1	1.5	1.3	2.6	1.9	1.7	-2.4	-2.2	-2.3
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	1.7	1.3	0.7	2.6	2.6	-4.5	-3.9	-3.2	-3	-3.0	-2.3
Japan	1.0	1.3	1.0	-0.1	0.5	1.0	3.9	4.1	4.2	-3.7	-4.2	-3.6
Emerging Economies												
BRIC												
Brazil	-3.6	0.2	1.8	8.7	4.4	4.3	-1.3	-1.3	-1.7	-9.0	-9.1	-7.5
China	6.7	6.6	6.2	2.0	2.4	2.3	1.7	1.3	1.2	-3.7	-3.7	-3.4
India	6.8	7.2	7.7	4.9	4.8	5.0	-0.9	-1.5	-1.6	-6.6	-6.4	-6.3
Russia	-0.3	1.4	1.4	7.1	4.5	4.2	1.7	3.3	3.5	-3.7	-2.6	-1.9
CESEE												
Bulgaria	3.4	3.6	3.0	-0.8	1.9	1.8	4.2	2.0	1.2	1.6	-1.4	-0.7
Romania	4.8	5.0	3.6	-1.6	1.4	3.1	-2.2	-3.0	-2.8	-2.4	-3.7	-3.9
Serbia	2.8	3.0	3.5	1.2	3.3	3.5	-4.0	-4.0	-4.0	-1.3	-0.5	0.0
Turkey	2.9	3.7	3.1	7.8	10.5	8.0	-3.8	-4.7	-4.8	-1.1	-2.5	-2.3

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

Eurobank Fixed Income Forecasts

	2017			2018	
	Current	September	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	1.22%	1.24%	1.36%	1.45%	1.55%
3m Libor	1.18%	1.36%	1.48%	1.58%	1.67%
2yr Notes	1.39%	1.52%	1.60%	1.72%	1.80%
10 yr Bonds	2.39%	2.45%	2.52%	2.60%	2.65%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.33%	-0.32%	-0.28%	-0.25%	-0.19%
2yr Bunds	-0.60%	-0.53%	-0.47%	-0.40%	-0.35%
10yr Bunds	0.56%	0.62%	0.68%	0.72%	0.75%
UK					
Repo Rate	0.25%	0.25%	0.25%	0.50%	0.50%
3m	0.24%	0.38%	0.49%	0.56%	0.62%
10-yr Gilt	1.30%	1.35%	1.40%	1.48%	1.54%
Switzerland					
3m Libor Target	-0.78%	-0.73%	-0.70%	-0.66%	-0.61%
10-yr Bond	-0.01%	0.05%	0.08%	0.12%	0.15%

Source: Bloomberg (market implied forecasts)

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