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CYPRUS

S&P sovereign review: long term sovereign rating at one notch below investment grade affirmed, outlook changed to positive

- On September 15th, in line with expectations, S&P affirmed the long-term sovereign rating of Cyprus at BB+ but at the same time it changed the outlook from stable to positive. According to S&P, the positive outlook reflects that the agency could raise the ratings on Cyprus over the next 12 months if budgetary consolidation continues unabated, and the economy continues to recover toward pre-crisis output levels. The agency currently forecasts GDP growth to average 3% in 2017-2020, as investments and employment recover, and services exports continue to perform well.

- As things stand now, the divergence of views between the rating agencies on the sovereign rating of Cyprus, remains. Currently, the distance from investment grade status is: one notch for S&P (currently at BB+, last upgrade in mid-March), three notches for Moody's (currently at Ba3, last upgrade in late July), for Fitch (currently at BB-) and DBRS (currently at BB Low, last upgrade in early June by two notches). The next round of reviews by the rating agencies is scheduled for autumn-winter of 2017: Fitch (October 20, 2017), Moody's (November 17, 2017), DBRS (December 1, 2017). It is worthwhile pointing out that S&P was the first rating agency to downgrade Cyprus to junk status in January 2012.

- As a result, ECB's waiver for government bonds' eligibility for Euro system financing has been lifted as of April 1st, 2016 and Cyprus no longer qualifies for the PSPP program. The waiver allowed these instruments to be used in Euro system monetary policy operations despite the fact that they did not fulfill minimum credit rating requirements. Nevertheless, the medium-term Cypriot bond yields have been on a declining trend since March2016, while Cyprus enjoys uninterrupted access to international markets. In late June, Cyprus tapped international markets with a new 7Y-Eurobond for the second time after exiting from the Economic Adjustment Programme in March 2016, at the lowest cost ever achieved in a benchmark bond issuance.

- In all past editions we have extensively discussed the progress of the Cypriot economy in the last three years. Based on our fact findings on the ground and our analysis, we always advocated that Cyprus is a solid turn-around economic story. After a three year recession in 2012-2014 and a cumulative drop of 10.5% of GDP, the economy expanded by +1.7% YoY in 2015, accelerated to +2.8% YoY in 2016 and is expected to further gain momentum to over 3% in 2017. From that point of view, the 1H-2017 GDP growth performance stood already at 3.6% YoY. More specifically, the Q2-2017 GDP growth reading was the second strongest-after that of the first quarter-since 2008. On a seasonally adjusted basis, growth expanded by 1.0% QoQ/3.5% YoY in Q-2017 an inch down from 1.0% QoQ/3.7% YoY in Q1-2017 compared to 0.7% QoQ/2.9% YoY in Q4-2016 vs. 1.2% QoQ/2.8% YoY in Q2-2016.

- From a demand point of view, the consumption rebound continued in 1H-2017 driven by strong sentiment improvement, a flourishing tourism sector, improved labor market conditions, further property market stabilization, the impact from fiscal relaxation, and the further normalization of banking sector conditions. The strong sentiment improvement - the highest in EU-28 in the last three years-mirrors the lasting progress within the expired adjustment program. In turn, the Economic Sentiment Index (ESI) now stands very close to the levels prior to Lehman Brothers international crisis. In addition, tourist arrivals grew by 14.7% YoY in Jan-Aug2017, with the corresponding levels over that period heading for a new all-time record high in the history of the Republic. Similarly, tourism revenues expanded by 19.9% YoY in 1H-2017. 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 (from 3,610 to 3,012). The reading of 843 in June 2017 only, was a new multi-year monthly high of the last six years (Department of Lands and Surveys). 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 (Central Bank of Cyprus).

- Even though Cyprus has made progress in a lot of areas, the risk of complacency following the exit from the Economic Adjustment Program is material. 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). Particularly, parliamentary approval of the Bill setting a cap on the public sector wage bill, essentially linking the expenditure expansion with the GDP growth performance, is still pending. And as time moves on and the economy improves, it becomes increasingly unlikely the Bill will be voted into Law ahead of next year's Presidential elections.

- Reflecting the significant improvement in sentiment towards Cypriot assets amid enhanced domestic macroeconomic fundamentals, medium-term Cypriot bond yields have remained on a sustainably downward path over the last couple of years (Figure 1). A recent string of upgrades on the country's sovereign credit ratings and outlook over that period have also favored lower yields. Meanwhile, 7-year Eurobond paper was successfully auctioned in late June, 2017- the second benchmark issuance following the country's exit from the EU/IMF Program - confirming that the country has uninterrupted access to capital markets. In support of the aforementioned, the yield of the 10-year benchmark paper that was issued in October 2015 has since fallen by around 180bps, outperforming a 40bps decline in the corresponding Portuguese paper over the same period. Meanwhile, the Portuguese bond appears to have caught up on a year to-date basis. That said, it is worth noting that Portugal's sovereign credit ratings currently stand above those of Cyprus, with S&P having even assigned investment grade status at BBB- since mid-September, 2017 (Figure 2).

Figure 1: Cypriot medium-term bond yields on a declining trend since graduation from the Economic Adjustment Program

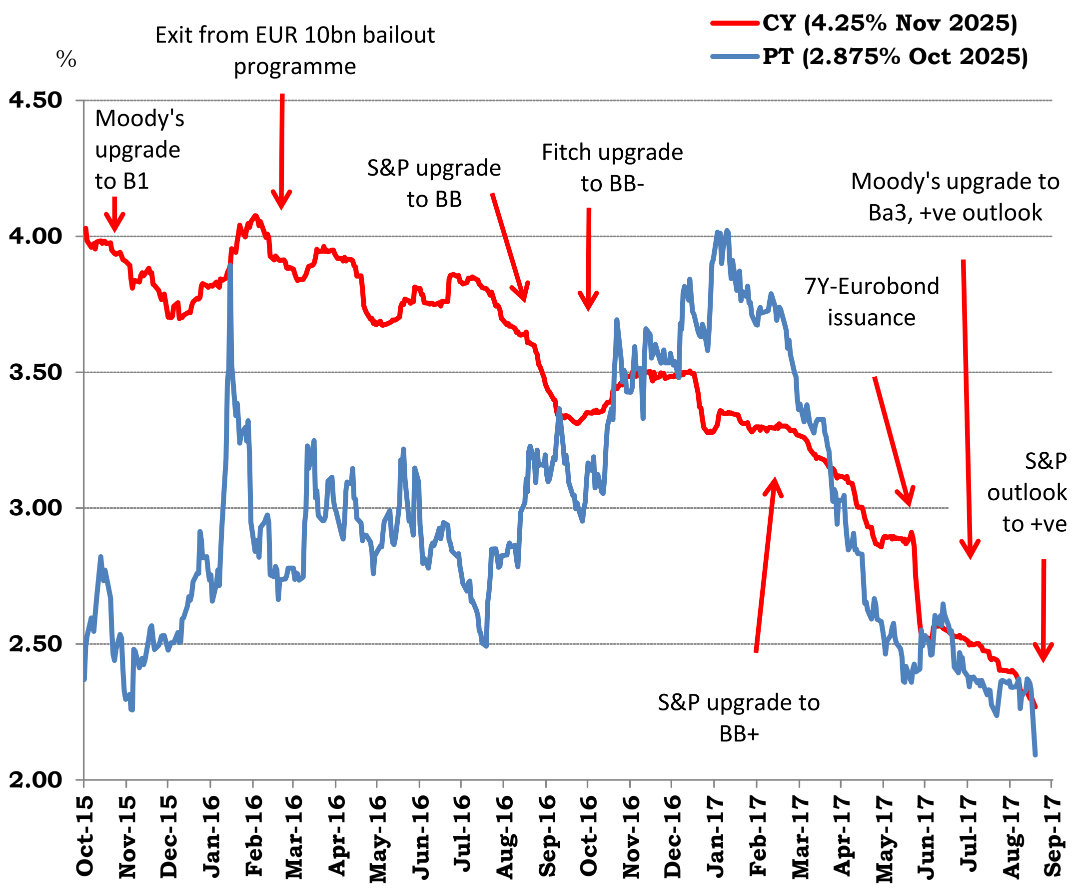
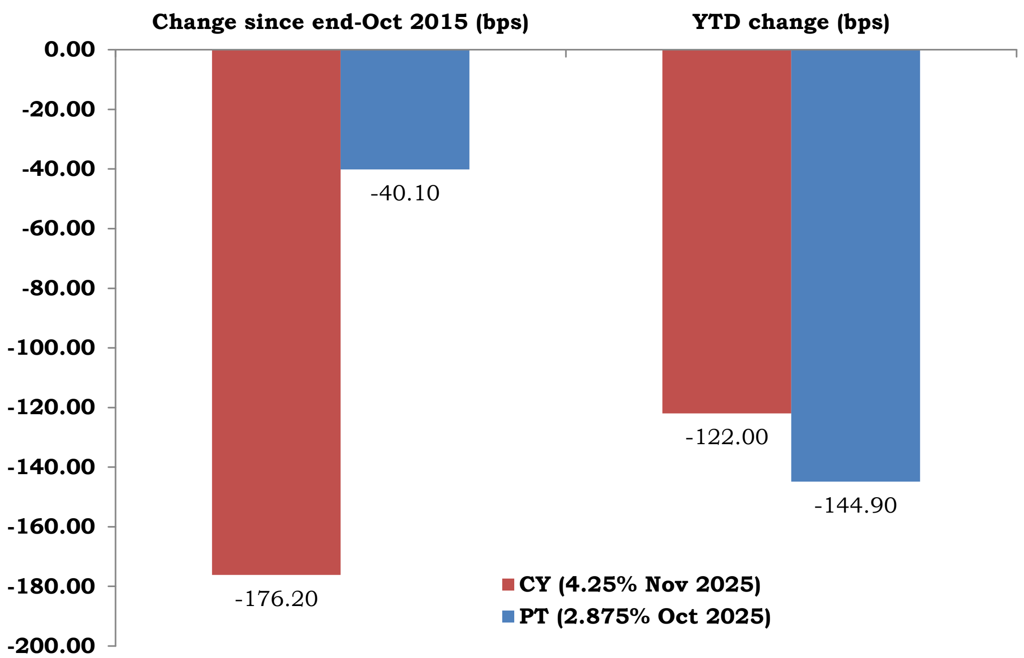


Figure 2: Cypriot medium-term bond YTD relative performance nearly in line with Portuguese paper



Source: Bloomberg, Eurobank Research

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