

October 23, 2017

## CYPRUS

### Fitch sovereign review: long term sovereign rating upgraded to two notches below investment grade, outlook still positive

**Ioannis Gkionis**

Senior Economist

Eurobank Ergasias

+30 210 3371225

igkionis@eurobank.gr

**Galatia Phoka**

Research Economist

Eurobank Ergasias

+30 210 3718922

gphoka@eurobank.gr

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- On Friday October 20th, Fitch upgraded the long-term sovereign rating of Cyprus by one notch from BB- to BB with a positive outlook. According to Fitch, the decision reflects primarily the strong improvement in public finances performance and outlook and outperformance of GDP growth forecasts over recent years. Fitch now anticipates GDP growth to average 3.5% in 2017-2018 up from 2.5% a year ago when Cyprus was last upgraded to BB-. On the other hand, Fitch warns that the banking sector's exceptionally weak asset quality remains a key weakness and a material downside risk to the ongoing recovery. Further on, the agency concludes that future developments on NPEs reduction and private sector indebtedness are key factors that may lead to a positive or negative rating action in the future.
- The new round of reviews by the rating agencies for autumn-winter of 2017 has already started: S&P (September 15, 2017), Fitch (October 20, 2017), Moody's (November 17, 2017), DBRS (December 1, 2017). On September 15<sup>th</sup>, 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 at 3% in 2017-2020, as investments and employment recover, and services exports continue to perform well.
- Earlier on, DBRS and Moody's were the last rating agencies to upgrade the sovereign rating of Cyprus in the previous round of reviews in spring-summer of 2017. On June 2, 2017, DBRS upgraded the long-term sovereign rating of Cyprus Republic by two notches (from B to BB low) with a stable outlook (trend). The DBRS rating decision-an upgrade by two notches-was more aggressive than anticipated so that DBRS is no longer the rating agency that assigns the lowest rating. More recently, on July 28, Moody's upgraded the rating of Cyprus by one notch to Ba3 from B1 with a positive outlook after having deferred its scheduled assessment of Cyprus in late last March.
- 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+), two for Fitch (currently at BB) and three notches for both Moody's (currently at Ba3) and DBRS (currently at BB Low). 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 March 2016, 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



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bond issuance for the country.

- 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 2% YoY in 2015 (revised from 1.7% YoY previously) in 2015, accelerated to 3% YoY (revised from 2.8% YoY previously) in 2016 and is expected to further gain momentum to around 3.5% 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-Sep 2017, 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 15.3% YoY in 7M-2017. Unemployment in seasonally adjusted terms resumed its downward trend declining further to 10.7% in August 2017 down from 12.5% in March 2017 and 17% at its peak in October 2013. Finally, the number of real-estate market sale contracts has risen by 19% YoY in 9M-2017 (from 4,644 to 5,523). 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 45% in June 2017, still the highest in EA according to EBA ranking). 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, 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 225bps, outperforming a near 60bps decline in the corresponding Portuguese paper over the same period, despite the latter bearing a higher investment status (Figure 2).



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

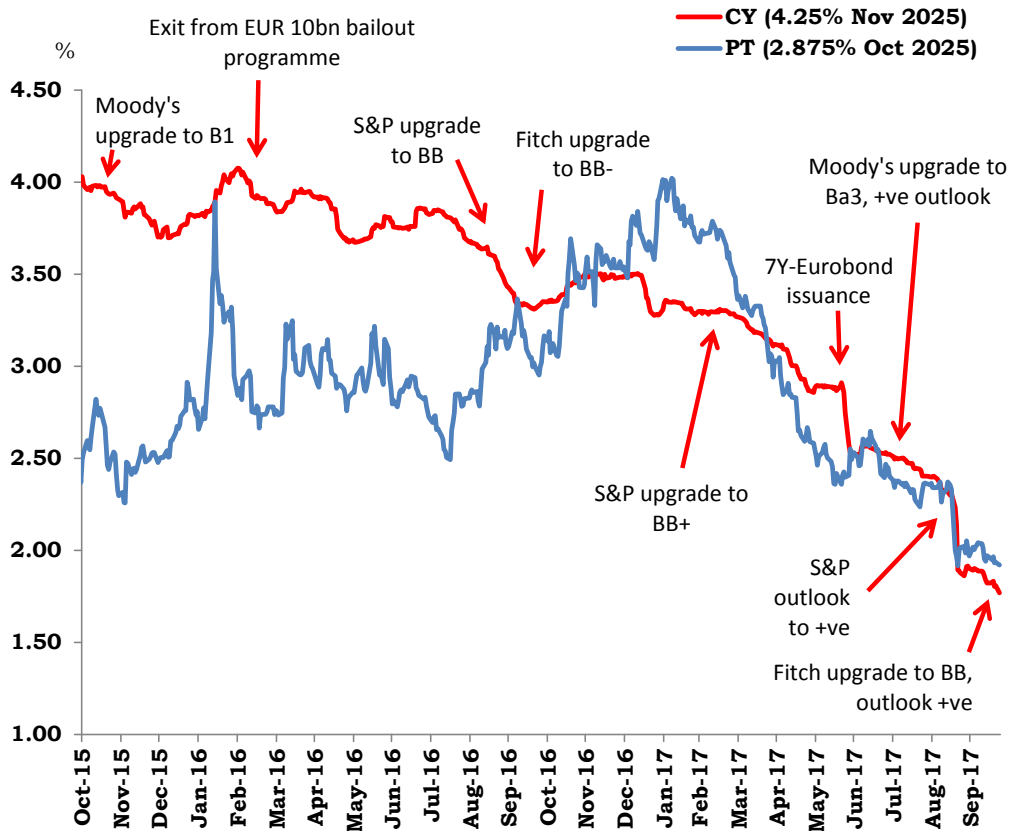
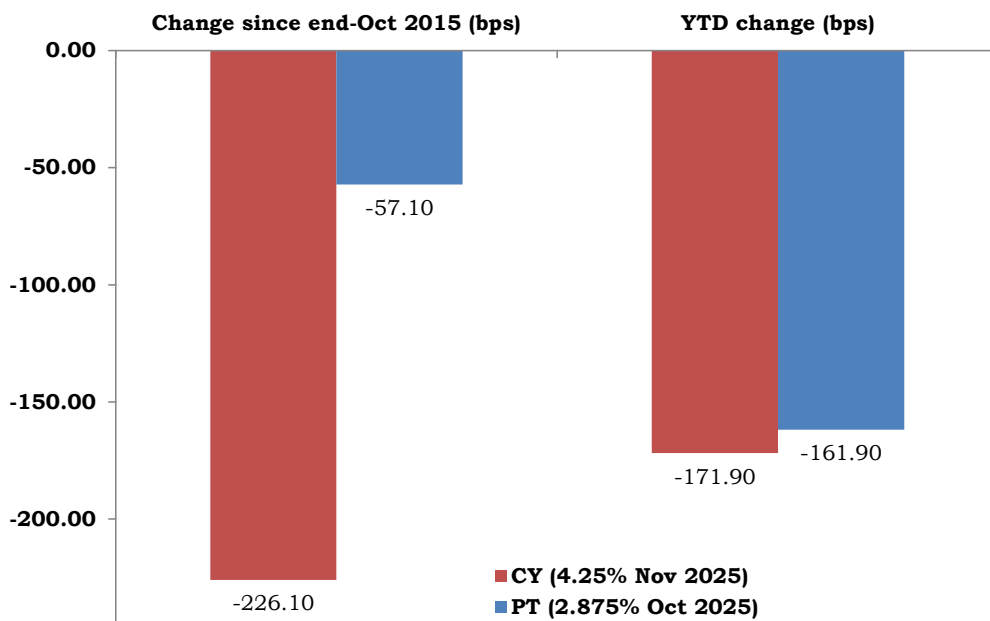


Figure 2: Cypriot medium-term bond outperforms relative YTD performance of Portuguese paper



Source: Bloomberg, Eurobank Research

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## Eurobank Economic Analysis and Financial Markets Research

**Dr. Platon Monokroussos:** *Group Chief Economist*  
[pmonokroussos@eurobank.gr](mailto:pmonokroussos@eurobank.gr), +30 210 37 18 903

**Dr. Tassos Anastasatos:** *Deputy Chief Economist*  
[tanastasatos@eurobank.gr](mailto:tanastasatos@eurobank.gr), +30 210 33 71 178

### Research Team

**Anna Dimitriadou:** *Economic Analyst*  
[andimitriadou@eurobank.gr](mailto:andimitriadou@eurobank.gr), +30 210 3718 793

**Ioannis Gkionis:** *Senior Economist*  
[igkionis@eurobank.gr](mailto:igkionis@eurobank.gr), +30 210 33 71 225

**Stylianios Gogos:** *Economic Analyst*  
[sgogos@eurobank.gr](mailto:sgogos@eurobank.gr), +30 210 33 71 226

**Olga Kosma:** *Research Economist*  
[okosma@eurobank.gr](mailto:okosma@eurobank.gr), +30 210 33 71 227

**Mariana Papoutsaki:**  
[mpapoutsaki@eurobank.gr](mailto:mpapoutsaki@eurobank.gr), +30 210 33 71 224

**Paraskevi Petropoulou:** *G10 Markets Analyst*  
[ppetropoulou@eurobank.gr](mailto:ppetropoulou@eurobank.gr), +30 210 37 18 991

**Galatia Phoka:** *Research Economist*  
[gphoka@eurobank.gr](mailto:gphoka@eurobank.gr), +30 210 37 18 922

**Theodoros Stamatiou:** *Senior Economist*  
[tstamatiou@eurobank.gr](mailto:tstamatiou@eurobank.gr), +30 210 33 71 228

**Elia Tsiampaou:** *Economic Analyst*  
[etsiampaou@eurobank.gr](mailto:etsiampaou@eurobank.gr), +30 210 33 71 207

Eurobank Ergasias S.A, 8 Othonos Str, 105 57 Athens, tel: +30 210 33 37 000, fax: +30 210 33 37 190, email: [EurobankEA\\_FMR@eurobank.gr](mailto:EurobankEA_FMR@eurobank.gr)

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