Bulgaria (Baa2 stable/BB+ stable/BBB- stable)*

Outlook – A jump in fiscal spending in 2H16, along with a record high wheat harvest and a surge in tourist arrivals, will help GDP growth to accelerate to 3.2% this year. Next year's growth is set to slow marginally, with Brexit likely to produce a net trade shock equivalent to 1% of GDP, while tailwind from lower oil prices starts to fade. Robust labor market recovery will be the main growth driver next year, while at the same time the solid fiscal position will help the government to mitigate most of Brexit's impact on growth. In addition, investment is also expected to contribute positively to growth next year, as more shovel-ready infrastructure projects enter the pipeline. The solid growth will be accompanied by a record-high C/A surplus, which not only points to improving competitiveness, but will also help push external debt to more manageable levels.

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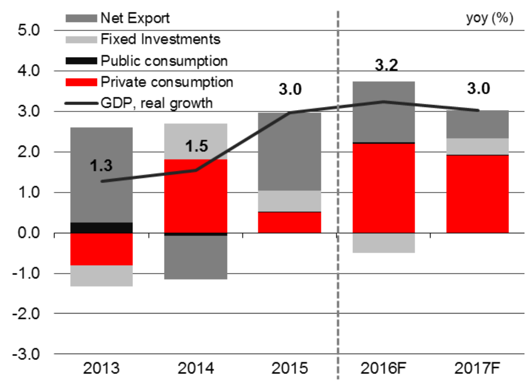
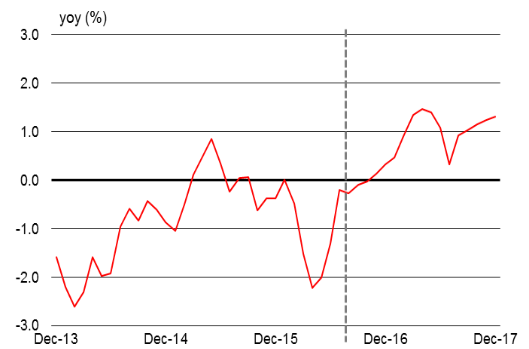
KEY DATES/EVENTS

- 30 Oct: Budget Act 2017 introduced in Parliament
- 6 Nov: Presidential elections
- 15 Nov: Flash GDP estimates for 3Q16

GDP GROWTH STABLE AT 3%



INFLATION TO RETURN TO POSITIVE TERITORRY



Source: BNB, NSI, MoF, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

EUR bn	2013	2014	2015	2016F	2017F
GDP (EUR bn)	41.9	42.8	44.2	45.3	47.2
Population (mn)	7.2	7.2	7.2	7.1	7.1
GDP per capita (EUR)	5 784	5 936	6 173	6 366	6 661
Real economy, change (%)					
GDP	1.3	1.5	3.0	3.2	3.0
Private Consumption	-1.1	2.5	0.7	3.1	2.7
Fixed Investment	0.3	3.4	2.5	-2.3	1.9
Public Consumption	3.1	-0.8	0.4	0.5	0.4
Exports	9.2	-0.1	7.6	4.6	3.5
Imports	4.9	1.5	4.4	2.3	2.5
Monthly wage, nominal (EUR)	396	420	458	492	528
Real wage, change (%)	5.1	7.4	9.0	8.0	6.3
Unemployment rate (%)	12.9	11.4	9.1	7.9	6.8
Fiscal accounts (% of GDP)					
Budget balance	-1.8	-3.6	-2.9	-1.4	-1.7
Primary balance	-0.9	-3.0	-2.1	-0.6	-0.9
Public debt	17.6	26.4	26.4	29.7	28.6
External accounts					
Current account balance (EUR bn)	0.5	0.0	0.2	1.6	0.9
Current account balance/GDP (%)	1.3	0.1	0.4	3.6	1.9
Extended basic balance/GDP (%)	5.5	4.4	6.9	8.1	6.6
Net FDI (% of GDP)	3.0	2.1	3.6	3.2	3.4
Gross foreign debt (% of GDP)	88.1	92.1	77.2	74.3	70.7
FX reserves (EUR bn)	14.4	16.5	20.3	23.6	26.2
Months of imports, goods & services	5.9	6.6	7.9	9.1	9.9
Inflation/Monetary/FX					
CPI (pavg)	0.9	-1.4	-0.1	-0.6	1.1
CPI (eop)	-1.6	-0.9	-0.4	0.3	1.3
Central bank reference rate (eop)	0.07	0.02	0.01	0.00	0.00
USD/FX (eop)	1.42	1.79	1.76	1.76	1.72
EUR/FX (eop)	1.96	1.96	1.96	1.96	1.96
USD/FX (pavg)	1.47	1.47	1.76	1.75	1.70
EUR/FX (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	153.9	152.6	151.0	150.2	148.4
Change (%)	0.3	-0.8	-1.0	-0.5	-1.2

Source: Eurostat, NSI, UniCredit Research

* Long-term foreign currency credit rating provided by Moody's, S&P and Fitch respectively

Growth to remain resilient next year

We keep our 2016-17 GDP growth projections unchanged

Brexit has materially altered the outlook for next year. Given its high dependence on foreign trade and deep integration in production chains of major EA exporters, Bulgaria faces a net trade shock on the order of 1% of GDP. But with domestic demand robust thanks mainly to the strongly improving labor market and with the government in a position to provide a sizeable fiscal impulse, we were not particularly worried in June and penciled in only a small downward revision to our above-consensus GDP growth projection for this and next year.

Our GDP growth forecasts of 3.2% in 2016 and 3.0% in 2017 are both above consensus (2.5% and 2.7%, respectively)

On top of a strengthening labor market recovery, growth in 2H16 will draw support from a solid rise in fiscal spending

Developments over the last three months have broadly reconfirmed these views. In 2Q16, GDP growth expanded at an annualized rate of 3%, the same as in the past five quarters. Private consumption remains the main driver, as households have become more confident about their income and job prospects and, to a lesser extent, exports, which offset a fall in fixed investment, with EU fund absorption slowing as forecasted. We expect the recovery to accelerate in 2H16, pushing full-year GDP growth to 3.2%. On the expenditure side, the drag from investment is likely to ease, as the public sector is set to produce a significant fiscal boost in the remainder of the year (when the budget balance is expected to shift from a 3.7% of GDP surplus in July to a 1.6% deficit by December) after the asset quality review showed that the banking sector didn't need financial support from the state budget. On the production side, GDP growth in 2H 2016 will be fueled by a favorable combination of a record-high surge in revenues from seaside tourism and a record-breaking rise in the wheat harvest.

Individual consumption is set to remain strong…

…while investment is about to recover…

… but some of the tailwinds which have propelled growth this year are starting to fade

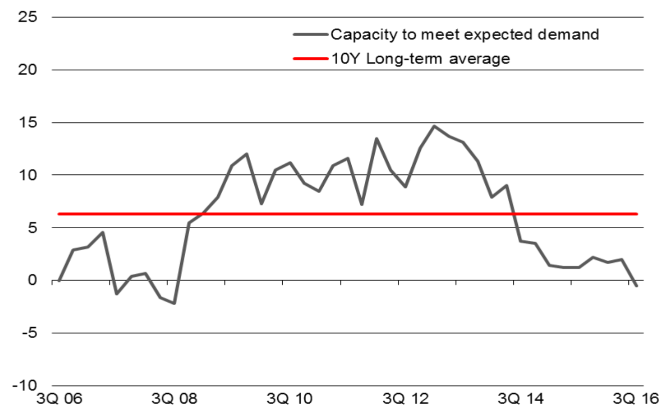
The fallout from Brexit will be felt in full next year

GDP growth is set to slow marginally to 3% next year. Private consumption will remain the key growth driver. With the unemployment rate at 8.1% in 2Q16, the economy seems far from full employment. At the same time, a C/A surplus at above 2% of GDP suggests that costs are well contained and that there is room for wage increases in the best-performing export-oriented sectors without risk to competitiveness. Although to a smaller extent, fixed investments are also expected to contribute positively to the domestic demand expansion in 2017. Solid profits and improving productivity, coupled with signs that companies have little spare production capacity to meet a further increase in demand (see lhs chart) bode well for investment. The outlook in the residential sector also looks more promising. Housing sales rose to the highest level since 2008, while slowly increasing construction permits and mortgage lending (see rhs chart) point to both more construction activity and moderately higher house prices. On the other hand, the external environment will become less supportive next year, as on top of the negative impact that Brexit will have on the pace of export expansion, tailwinds from lower energy prices and a weaker euro are also likely to fade.

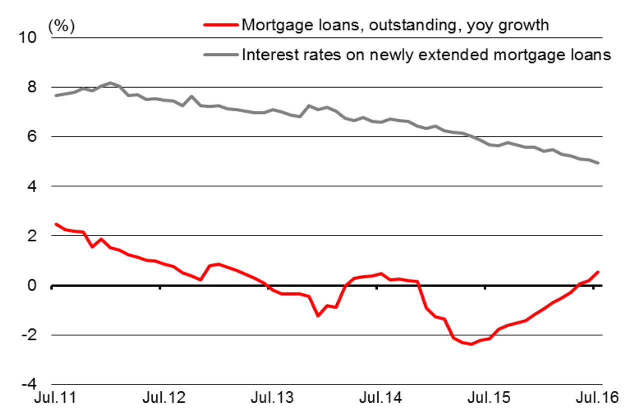
The prolonged period of abnormally low inflation is coming to an end

Headline inflation (-0.3% yoy in August 2016) has been rapidly exiting negative territory, after bottoming out in April (-2.2%) this year. This was mostly attributable to a much more

Existing capacity seems short to meet expected demand



Falling interest rates are slowly pushing mortgage lending higher



Source: Eurostat, BNB, UniCredit Research pronounced seasonal adjustment in unprocessed food and a large part of leisure services prices. We expect headline inflation to increase at a moderate pace in the coming months (to 0.3% in December 2016) before accelerating next year (to 1.3% in December 2017).

Job growth in the private sector continues at a decent clip…

…with most of new hiring in well-paid jobs from business services…

… where outsourcing has been most pronounced

Labor market data have been mixed recently, but the overall trend remains positive. The 2Q16 jobs report failed to impress on the positive side, as lower-than-expected 22K jobs were created (on a par with 25K jobs in 1Q16, but less than the 50K on average in 2015). A deeper look reveals that these two weak quarterly prints were almost entirely attributable to one-off employment drops in the public sector, while in the more vibrant private sector the pace of job creation was little changed from 2015. Other labor market indicators were more positive. The unemployment rate fell to 8.1% in 2Q16, down from 8.6% in 1Q16 and 9.9% in 2Q15, while the balance between hiring and firing intentions of business managers in different sectors of the economy continued trending higher (see lhs chart). Also positively, average wages rose 6.9% yoy in 2Q16, underpinning individual consumption and aggregate demand more generally. On balance, the labor market recovery seems to have progressed at a decent pace in 2Q16, but with more than 266K unemployed the economy looks far from full employment.

Widening C/A surplus suggests that competitiveness is improving

Looking ahead, the C/A surplus is set to continue breaking records

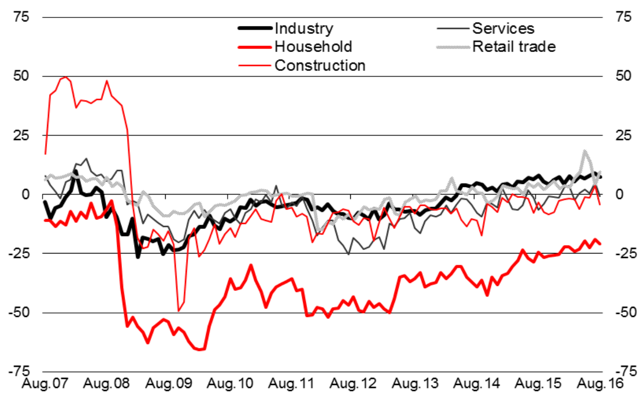
We expect a record-high C/A surplus this year. Stepped-up export expansion gave a pronounced boost to the C/A balance already last year, which also benefitted from lower oil prices and a jump in EU transfers. All these helped the C/A to post a small 0.4% of GDP surplus in 2015 (see rhs chart), despite marked terms of trade deterioration, with export prices dropping 2.5% yoy vs. a 1.4% decline in import prices. But terms of trade improved and the C/A surplus swelled to 2.4% on a 12-month basis in July, in spite of weaker EU transfers. It was particularly encouraging to see the 12-month deficit in merchandise trade shrinking to 4.6% of GDP (from 5.9% in 2015), in spite of higher domesic demand. Looking ahead, the C/A surplus is expected to peak at 3.6% in 2016, before softening marginally to 1.9% in 2017, when consumption and investment push imports up. The record-high C/A surplus this year will also draw support from an all-time high wheat harvest, which will help to fully offset the negative impact from falling grain prices, and the surge in tourism revenues, as geopolitical tensions redirected tourist flows to Bulgaria from some traditional destinations like Turkey.

The presidential elections will produce no major shift in the balance of power…

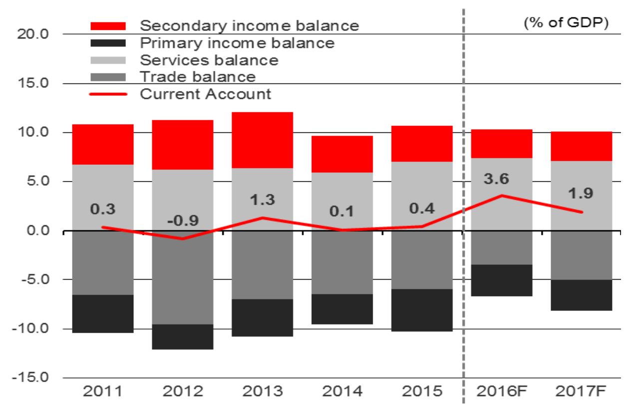
…but no major impact on reforms either

Right-wing, pro-European GERB party is ahead in the opinion polls for the next presidential elections, scheduled for 6 November. As things stands today, these elections are unlikely to produce any major shift in the balance of political power, which is also our baseline scenario. So far, the focus has been on the candidates' nomination, but as GERB had not yet nominated its presidential candidate, the time for any meaningful debates on future policy is likely to be shortened to less than a month. This raises concerns that the election campaign will be limited to the exchange of personal accusations and repetition of outworn slogans and dogmas, which risk to further frustrate already disenchanted voters, instead of building a stronger consensus for pressing ahead with the implementation of the key missing reforms.

Employment expectations are trending higher



CA surplus is breaking records



Source: Eurostat, BNB, NSI, UniCredit Research

Strategy: Bulgarian assets have upward potential left

Bulgarian EUR-denominated asset prices still offer upward potential despite the fact that the GB yield curve has moved to a substantially lower level in line with the tide in CEE during the summer months. Increased buying over 3Q has further flattened the curve, but yields remain attractive compared to those of regional rating peers and against the prospects of more downward pressure going forward.

The combination of lower sovereign funding needs and abundant liquidity in the banking sector will be the main drivers, going forward. Weak credit growth against the background of robust deposit expansion has pushed the loan-to-deposit ratio further down (forecast at 73% in eop 2016), pressuring banks and other local institutional investros to search for yield in the GB market. At the same time, budget execution has received significant support from cyclical factors, as well as tax compliance improvement, which will continue to benefit the revenue side in the short to medium run.

Funding needs will tighten significantly

That said, we have revised our estimates for sovereign issuance further down as downside risk associated with AQR and stress tests in the banking sector failed to materialize. Already accumulated buffers will be used for debt redemption in 2017 – the only year with a relatively elevated debt repayment profile up to 2022. Even in a scenario of deficits which are significantly larger than those forecast by the MinFin we don't see the issuer returning to the external market before 2019, raising the scarcity value of Bulgarian EUR-denominated assets. As a result, domestic debt supply will increase only slightly, but will still be in line with long-term averages and will be easily absorbed by the market.

We don't see new external debt supply before 2019

BGRIA EUR 2023s and BGRIA EUR 2028s look cheap

This should push the entire curve of Bulgarian EUR-denominated assets further down, providing opportunities for maturity extension as BGRIA EUR 2028 looks particularly attractive compared to similar paper of rating peer Romania. At the shorter end, BGRIA EUR 2023 looks cheap against the rest of the curve and compared to domestic market alternatives.

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2015	2016F	2017F
Gross financing requirement	**4.9**	**1.4**	**2.4**
Budget deficit	1.3	0.6	0.8
Amortization of public debt	3.6	0.7	1.6
Domestic	1.0	0.5	0.4
Bonds	0.1	0.5	0.4
Bills	1.0	0.0	0.0
Loans	0.0	0.0	0.0
External	2.6	0.2	1.1
Bonds and loans	2.4	0.0	1.0
IMF/EU/Other IFIs	0.2	0.2	0.2
Financing	**4.9**	**1.4**	**2.4**
Domestic borrowing	0.7	0.3	1.4
Bonds	0.6	0.3	1.4
Bills	0.1	0.0	0.0
Loans	0.0	0.0	0.0
External borrowing	3.3	2.1	0.1
Bonds	3.2	2.0	0.0
IMF/EU/Other IFIs	0.1	0.1	0.1
Privatization/Other	0.0	0.0	0.0
Fiscal reserves change (- =increase)	1.0	-1.1	0.8

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2015	2016F	2017F
Gross financing requirement	**16.8**	**10.2**	**10.8**
C/A deficit	-0.2	-1.6	-0.9
Amortization of medium and long term debt	7.0	3.9	4.7
Government/central bank	2.6	0.2	1.1
Banks	0.6	0.5	0.5
Corporates/Other	3.8	3.2	3.0
Amortization of short-term debt	10.0	7.9	7.0
Financing	**16.8**	**10.2**	**10.8**
FDI (net)	1.6	1.4	1.6
Portfolio equity, net	0.6	0.9	-0.5
Medium and long-term borrowing	4.0	5.0	3.7
Government/central bank	3.3	2.1	0.1
Banks	0.5	0.6	0.5
Corporates/Other	0.2	2.3	3.1
Short-term borrowing	7.9	7.0	6.7
EU structural and cohesion funds	1.9	1.0	1.2
Other	4.7	-1.8	0.7
Change in FX reserves (- = increase)	3.8	3.3	2.7
Memoranda:			
Nonresident purchases of LC govt bonds	0.0	0.0	0.0
International bond issuance, net	2.2	2.0	-1.0

Source: BNB, MoF, UniCredit Research

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