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CEE

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Credit Research
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Cross Asset Research

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"Your Leading Banking Partner in Central and Eastern Europe"

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CEE: Differentiating adjustment

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- The recovery in activity in the developed world and the beginning of a related normalisation of interest rates presents opportunities and risks for CEE. Within Central Europe, those opportunities already began to materialise in 2013 in the form of stronger external demand. In 2014 we should see this continue, supported by a stronger Germany and EMU more broadly, and feed into the beginning of a long-awaited recovery in dometic demand. With this in mind, we have revised upwards our growth forecasts for most of the newer EU states. We remain of the view that many of the newer EU states are better positioned than most other emerging markets to weather an increase in financing costs in the coming quarters, in large part because of reform efforts undertaken since the 2008 crisis. Progress on banking union within EMU over the coming 12 months should also bring positive spillovers to the newer EU states.
- In contrast Turkey enters 2014 under adjustment pressure. 2013 represented an inflection point as C/A deficit financing weakened. Currency depreciation and stronger external demand are aiding that adjustment but the economy has yet to fully adapt to a less favourable external financing environment. Further downward pressure on domestic demand is unavoidable, in part because the CBT finds itself forced to retain a procyclical monetary stance. The combination of the impact of tapering on external liquidity to EM and fiscal policy choices next year will be central in determining the extent of the adjustment required. Our macro scenario envisages that much of the hard work will be done by the end of H1-14, allowing the economy to return to a (more moderate) growth path thereafter.
- Russia will continue to struggle with much more moderate rates of growth amidst stable, instead of rising, oil prices. Monetary policy took some important steps forward on inflation targetting in 2013 but has limited room for manoeuvre to aid a recovery in activity. 2014 will prove a key test of the government's willingness to adhere to tight fiscal policy and push ahead with a series of much needed structural reforms to anchor long term growth potential, albeit with a short term cost. In the absence of this, domestic capital outflows are likely to persist, with a risk of further acceleration, adding to downward pressures on growth and RUB.
- For a number of reform laggards in the region, pressure for change is on the increase. In Slovenia the pending bank stress test results should represent a turning point but progress on privatisation would be a further step forward in working down public debt. Serbia has taken a series of measures to contain the budget deficit but much more remains to be done to stabilise public debt to GDP. Within SEE, Croatia is a clear laggard on the fiscal front, though entry into the excessive deficit procedure should increase discipline. In Ukraine the authorities' desire to delay much-needed macro adjustment serves only to escalate already severe vulnerabilities.

Working through the portfolio flow excesses of QE…

From battling portfolio inflows to battling portfolio outflows

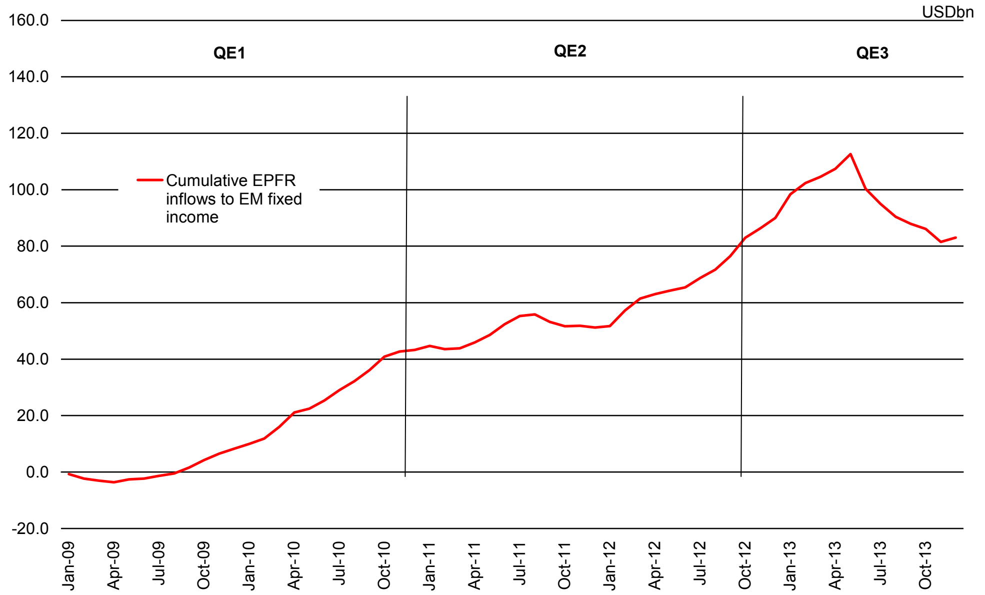
What a difference a year makes! Entering 2013 much of the debate on emerging markets centered on the management of record portfolio inflows to the asset class, generated for the most part over 2010 to early 2013. As we enter 2014, the primary challenge facing emerging markets is the management of outflows amidst a normalisation of interest rates in the developed world, a process that looks set to play out over a multi year horizon.

Both reform momentum in EM and the pace of Fed tightening will play a role

The extent to which past inflows reverse remains uncertain but, when considering the coming quarters, should prove a function of a combination of domestic and external factors. From a domestic perspective, the busy election schedule in EM in 2014 is a risk but also an opportunity in terms of re-igniting reform momentum. Elections are scheduled not only in Turkey (March, August) and Hungary (April/May) but also in Indonesia (April, July), South Africa (July), India (May) and Brazil (4Q). From an external perspective, the Fed's decision to delay tapering in September acts as a valuable reminder of its willingness to take action to contain any sudden tightening of monetary conditions.

RETAIL FLOWS TO EM FI HAVE REVERSED ALL OF THEIR QE3 INFLOWS

Cumulative change in fixed income portfolio flows since the Fed began QE



Source: EPFR, UniCredit Research

The magnitude of outflows that have already materialised signals progress

There is good news in the fact that almost all inflows to EM, as measured by the weekly EPFR data, since the beginning of QE3 in Sep-12 have now reversed. This is equivalent to over half of all inflows since early 2012, when this final bout of portfolio flows to EM gathered pace. This metric captures only a subset of a much broader set of portfolio capital to EM but the stickiness of institutional capital in the face of retail outflows over recent quarters is encouraging. We are convinced that a return to the magnitude of inflows experienced between 2011 and early 2013 is not likely while flows are likely to remain characterised by greater volatility than in the past. Nonetheless the worst in terms of outflows may be done by end-1Q next year after the market digests the Fed' initial tapering steps.

…as the region benefits from stronger industry…

The rebound in industry has been a stand-out positive for CEE in 2013….

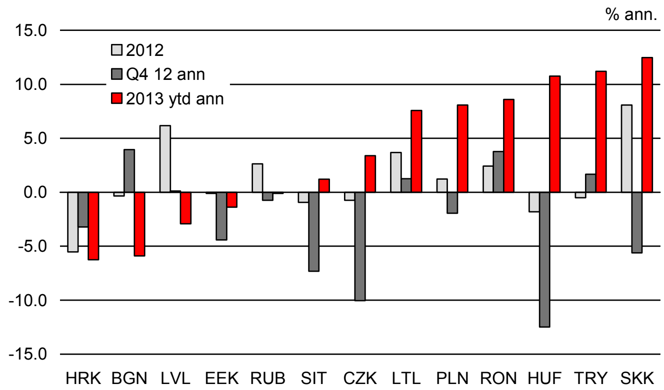
In the face of this less certain external financing environment, the most obvious positive macro trend to emerge across CEE in 2013 was the rebound in industry, a trend which we expect to continue in 2014. Over the first 9-10 months of the year, industrial production gained more than 10% on an annualized basis in Hungary, Slovakia and Turkey, in excess of 8% in Romania and Poland. Czech Republic lags but with a number of Skoda's product lines now re-modelled, it should show improvement from here.

…and should continue into 2014…

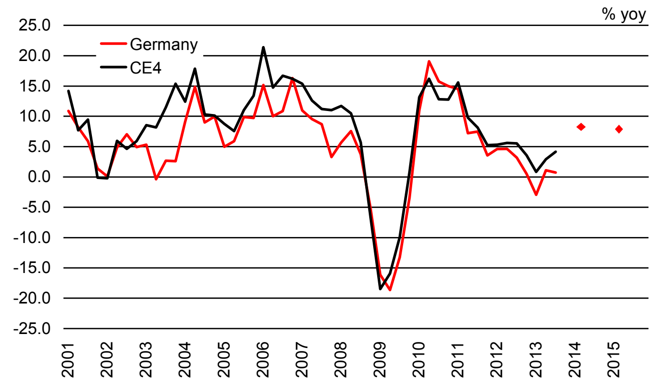
Part of this improvement captures payback for a particularly weak finish to 2012 and as such suggests that this current pace of industry growth will not be maintained. But there is also a genuine recovery in industry at play, capturing strong production links between some of Central Europe and EMU. Turkey is also benefitting, despite more of a diversification in export partners in recent years. Given our house view of continued export growth in Germany next year (7%), followed by a recovery elsewhere in EMU, we expect further gains in industry ahead.

SOME COUNTRIES SHOULD CONTINUE TO ENJOY ROBUST INDUSTRY/EXPORT GROWTH

Industrial production (and exports) has rebounded (1Q-3Q13)…



…while our upbeat view on German exports bodes well for 2014/15



Source: National statistics offices, UniCredit Research

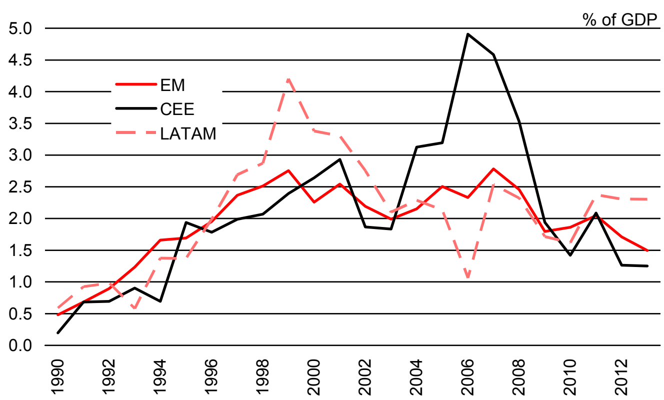
…and continued FDI to manufacturing

…accompanied by FDI to manufacturing…

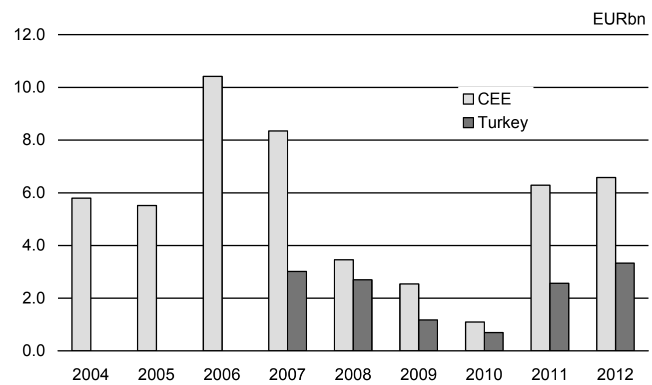
There is also good news to be found in FDI trends to many parts of the region. The downward adjustment in FDI to CEE since 2008 is more pronounced than in other EM regions but from a much higher starting point. Over 2011-12 FDI to CEE was only 0.2pp below the EM average. Moreover FDI to manufacturing has shown recovery since 2011. Manufacturing FDI represented over 22% of total FDI over 2011-12 and in nominal terms is broadly in line with its average over 2004-08. Czech, Poland and Serbia lead in terms of their ability to attract manufacturing FDI over 2011-12 relative to pre-crisis times. Bulgaria, Croatia and Lithuania lag. We have only a shorter time series for Turkey but that shows FDI to manufacturing at 30% of total FDI over 2011-12. The first 9 months of this year showed further inflows. This trend is re-inforced by the fact that Hungary, Romania, Serbia and Slovakia all benefited from new car production facilities coming on line this year.

WHILE HEADLINE FDI HAS SLUMPED, MANUFACTURING IN CEE CONTINUES TO ATTRACT FOREIGN CAPITAL

FDI to CEE has declined…



….but manufacturing FDI continues to enjoy support[1]



Source: IMF, WIIW, UniCredit Research

[1]CEE refers to Bosnia Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Latvia, Lithuania, Poland, Serbia and Slovenia

…which we expect to continue in 2014…

Continued gains in German GDP, accompanied by signs of recovery in EMU and a smooth slowdown in China, should see FDI to manufacturing sectors across the region continue in 2014. The case for Germany and elsewhere in EMU to continue to take advantage of competitive labour costs and, by some metrics, more flexible labour markets to expand production capacities in CEE remains strong. The sluggishness in global trade is the primary risk to this view.

…while being supplemented by the next round of EU funds

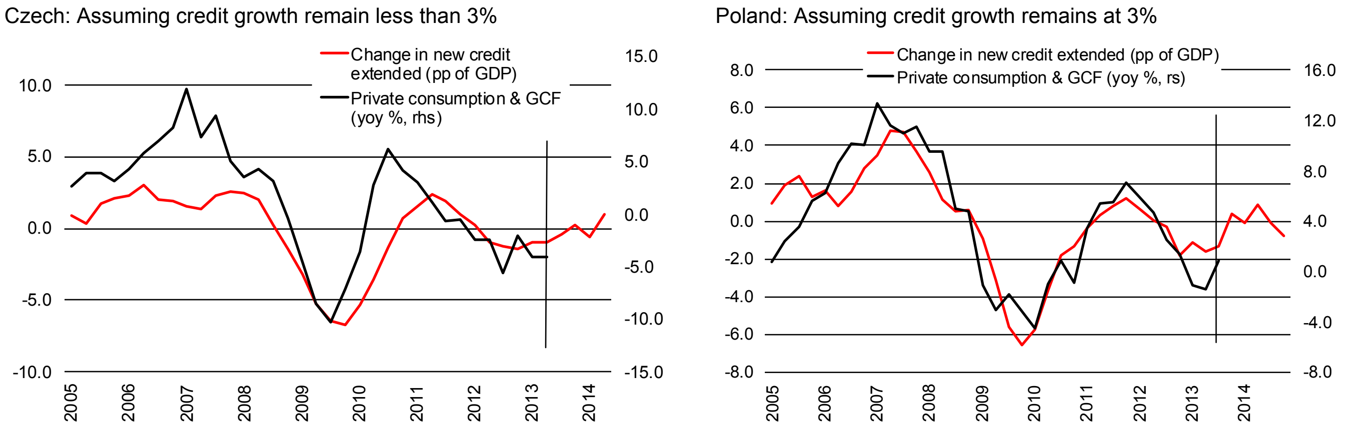
For those in the EU, the next round of EU funds from the 2014-20 budget will be a further source of financing for investment. As this was only recently approved, these funds are likely to materialise only towards the end of 2014 or early 2015. Slow initial absorption means Romania and Bulgaria have seen an improvement in inflows this year. As such, just as EU fund inflows played an important role in smoothing the downturn post 2008 in a number of economies (e.g. Poland, the Baltics), they also have the potential to boost a recovery this time around. Croatia will benefit for the first time.

Towards a new steady state for banking systems

In the newer EU states, credit growth has already adjusted lower and should be more supportive of domestic demand from here…

As well as support from industry, GDP growth will also benefit from stronger support from credit in some countries. Credit growth across the newer EU states has already slowed well below deposit growth. Banking systems continue to repay funding to mother banks but the ECB's potential willingness to provide another LTRO further reduces the risk that this accelerates. Even assuming that credit growth does not accelerate but stays stable from here, Poland and Czech Republic in particular should enjoy stronger domestic demand growth. That the transmission mechanisms in both economies functions well is also supportive. A more positive credit impulse is also materialising in Hungary, but largely due to the NBH's funding for growth scheme, generating near term gains but at the risk of lax lending and higher NPLs at a later date.

CREDIT IMPULSES FOR CZECH AND POLAND: EVEN IF CREDIT GROWTH DOES NOT RISE, DOMESTIC DEMAND WILL BENEFIT



Source: CSO, CNB, NBP, GUS, UniCredit Research

…while progress on banking union should bring positive spillovers over time

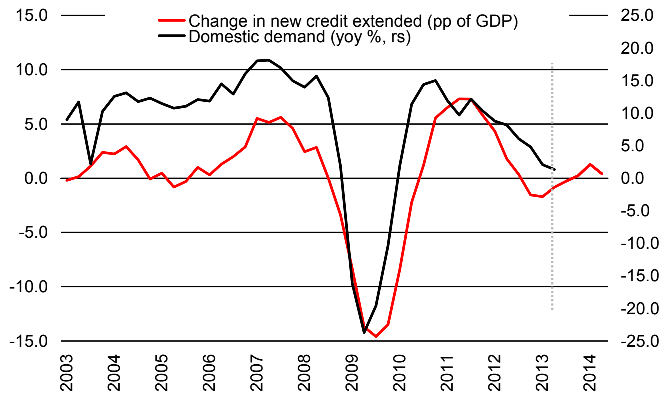
More broadly, progress on banking union within EMU should provide some positive spillovers for those countries in CEE where foreign ownership of banking systems is high. 2013 has been disappointing to the extent that plans on banking union have progressed without notable progress on the inclusion of the newer EU states that remain outside of EMU. Moreover other challenges persist, including the need for Greek banks to dispose of assets across CEE and high NPLs in some countries. That said, progress on reducing banking fragmentation within EMU at a minimum reduces tail risks for CEE.

It also has the potential to act as a much-needed policy anchor

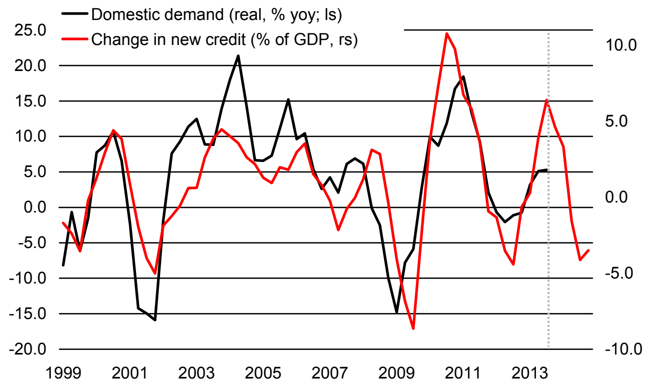
Once the SSM has been established within EMU, both EMU member states and other EU states outside of EMU may prove more open to renewed discussion on future inclusion. EMU bank exposure to CEE remains significant, bolstering the case for stronger co-operation for both sides. Moreover closer banking cooperation could be viewed as the first step towards discussion on setting out a realistic path for EMU entry, even if most involved are not interested in rapid expansion. Having experienced two crises in the last five years, the region stands to benefit from any efforts aimed at re-establishing a much-needed anchor for policy.

TURKEY AND RUSSIA CREDIT IMPULSES: A MORE MIXED OUTLOOK

Russia: Credit should be slighly more supportive



Turkey: Assuming credit growth eases to 15%



Source: CBR, CBT, UniCredit Research

Turkey faces a contraction in domestic demand…

While Central Europe faced a forced credit slowdown beginning late 2011 and is now emerging from this, 2H this year saw tighter external financing conditions prompt a turn in the cycle in Turkey. Credit growth has slowed by over 15pp (3m/3m sa & ann.) over the four months to end-November. A further slowdown ahead is unavoidable, given that credit growth remains above deposit growth. 2Q13 marked the peak in domestic demand as a result, with both the consumer and investment growth set to turn negative in yoy terms next year.

…while in Russia credit may prove more neutral for domestic demand

In Russia, to the extent that a further slowdown in consumer credit looks inevitable, the credit impulse in 2014 will depend to a large extent on corporate credit. To maintain overall credit growth broadly unchanged and generate a slightly positive credit impulse, corporate credit will need to accelerate to close to 20% yoy (currently 13% yoy). We see the risk to this scenario as to the downside, given the weak investment climate.

A sweet spot for Central Europe

A combination of factors has prompted us to increase our growth forecasts for most of the newer EU states

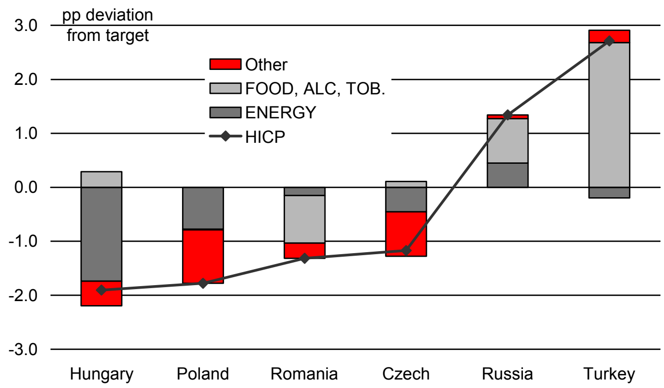
This combination of stronger external activity and a gradual recovery in domestic demand will be aided by a shift in fiscal policy and an accommodative monetary stance, marking a sweet spot in the cycle for CEE. With all of this in mind, we have increased our growth forecast for most of the newer EU states. At 2.9% next year, Poland should post its fastest pace of growth in 3 years while at 2.5% Hungary should enjoy its fastest pace of growth since 2008.

Acros the newer EU states, most of the hard work on fiscal policy has been done…

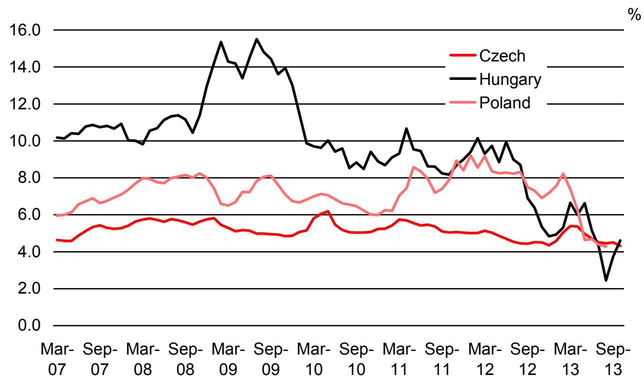
After an extended period of fiscal tightening over 2008-12, much of the hard work is now done while in some cases governments are drawing off fiscal policy to anchor tentative signs of a recovery in economic activity. Czech Republic, Poland and Romania were amongst the world's top consolidators following the collapse of Lehman brothers, as measured by changes in structural budget balances. However, the combination of political cycles and uncertainty on the pace of overall recovery has dissuaded policy makers against any further significant measures, at least for now. Hungary and Bulgaria have already taken measures to support domestic demand. Meanwhile Poland's OFE reform removes a key tail risk to recovery there.[2]

INFLATION IS LOW FOR A VARIETY OF REASON, KEEPING ACTUAL LENDING RATES CLOSE TO RECORD LOWS

Deviation of inflation from target by component[3]



Lending rates to corporate (1-5 year maturity) are low



Source: ECB, Eurostat, UniCredit Research

…while monetary policy is set to be tightened only very gradually

In monetary policy space, we see scope for some more modest easing of policy rates in Hungary and Romania but the combination of rising inflation and a recovery in activity means that debate will slowly shift to the timing of a tightening of monetary conditions in the second half of 2014. Below-target inflation is common-place across Central Europe's inflation targetters, capturing the impact of a stabilization in global commodity prices, various regulatory measures which have lowered energy prices, good harvests which lowered food price inflation and negative output gaps. While our inflation forecasts assume broadly stable oil prices going forward, another improvement on this year's harvests across much of the region is less likely while, as activity across both CEE and EMU begins to gather pace, central bank concerns about the impact of negative output gaps on inflation should ease. All this said, we see rate hikes as an issue for 2015 rather than 2014.

Russia & Turkey: Policy can offer limited near term relief

In contrast with Central Europe, policy levers to support activity in Turkey and Russia are more limited as we enter 2014. It is for this reason that we see real GDP growth at approximately 2% in each country next year.

Turkish monetary policy is forced to remain procyclical while…

The sharp slowdown that is materializing in domestic demand in Turkey looks set to continue through at least the early part of next year but just as interest rate policy was pro-cyclical in nature during the upturn, it has also been forced towards a pro-cyclical stance as the cycle turned. The Bank has taken a number of measures to deliver a positive real interest rate but the risk that insufficient external financing forces further interest rates increases remains.

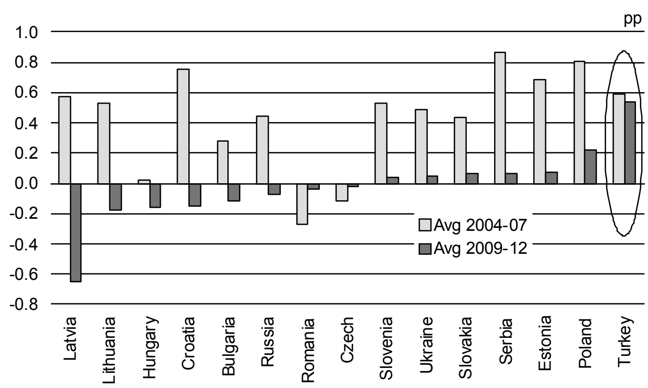
[2] For further discussion, please refer to our CEE Navigator of 21st November, "CEE fiscal and financing: Challenges and opportunities".
[3] Data for Czech Republic, Hungary, Poland, Romania and Turkey are based on Eurostat's HICP data.

…the government cannot support growth as it has in the past without putting its budget targets at risk

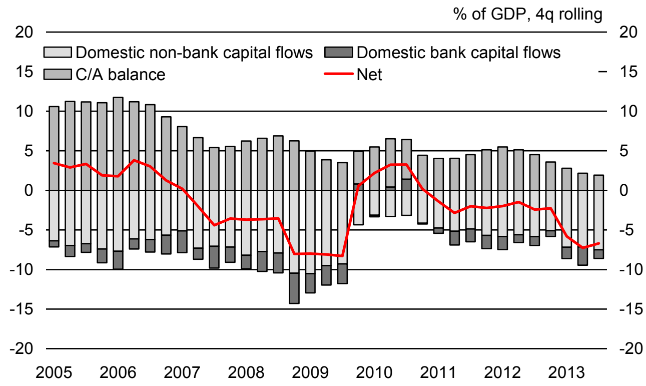
In terms of fiscal policy, Turkey was the only country in the region where the government was in a position to deliver the same sort of fiscal support to activity in recent years as was the case prior to the collapse of Lehman brothers but this also now needs adjustment. Consistently higher than expected revenue and a lower than expected interest bill have allowed the government to boost expenditure while containing the budget deficit. In the absence of continued upside surprises on revenue, the government will be forced towards a more conservative fiscal stance or a wider budget deficit. The former represents short-term pain but can prove effective in helping to narrow the C/A deficit. The latter strategy may help government popularity ahead of a busy election schedule but must be balanced against the risk of further currency depreciation, its pass-through to inflation and implications for interest rates.

TURKEY AND RUSSIA: IMPEDIMENTS TO FISCAL AND MONETARY POLICY

Public consumption contributions to growth



Russia: The C/A & domestic capital flows turn negative



Source: National statistics offices, CBR, UniCredit Research

Russia had made important progress on inflation targetting but…

2014 for Russia will be a key test of the government's willingness to address a variety of vulnerabilities that are undermining the economy's growth potential. 2013 forced Russia to acknowledge a structurally lower rate of growth. Amidst this adjustment, Chairwoman Nabiullina's decision against interest rate cuts represents a step forward in anchoring inflation while the CBR's continued commitment to increasing currency flexibility provides an important cushion to protect the economy against a decline in oil prices. Consumer credit is also being lowered to a more sustainable rate with the help of macro-prudential measures.

…low growth means it is under pressure to use fiscal policy for the sake of short term gain

But a dwindling C/A surplus has been accompanied by escalating domestic capital outflows, capturing weaknesses in the investment environment and generated at least in part by a halt of structural reforms over the past decade. While in Turkey exchange rate depreciation brings benefits in the form of import compression and a narrower C/A deficit, in Russia it risks further escalating domestic capital outflows, at a time when GFCF growth is already weak. The obvious temptation is for the government to increasingly circumvent its fiscal rule by drawing further off its cash stockpile to support activity but in the absence of structural measures this risks fuelling further currency depreciation and domestic capital outflows.

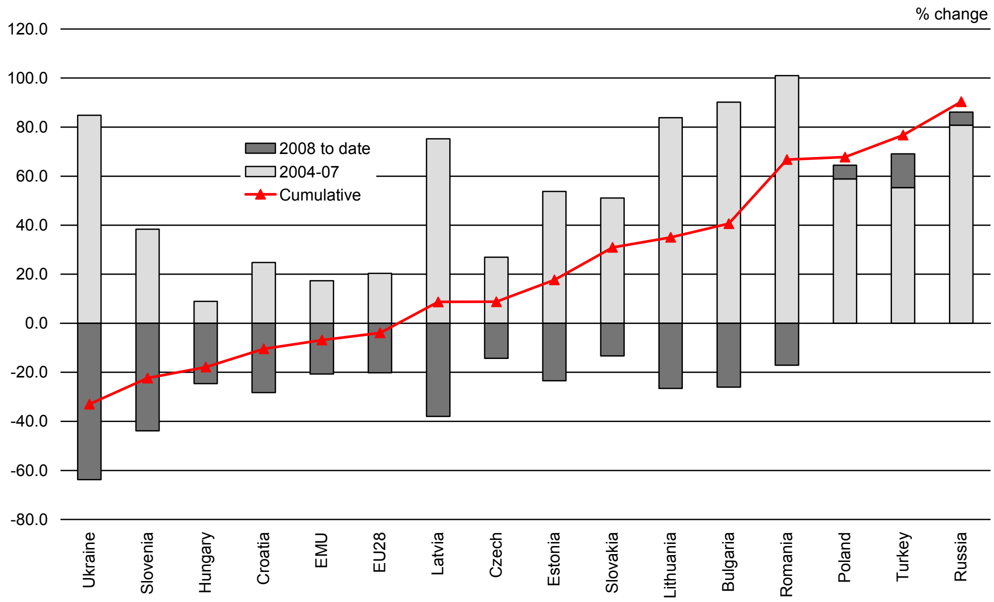
CEE periphery economies: Time for change

Croatia, Serbia, Slovenia and Ukraine are being forced towards change

In a number of smaller economies across the region, the combination of lagging reforms and tighter external financing conditions will increasingly force change in 2014. We include Croatia, Serbia, Slovenia and Ukraine within this group. As per the chart below, Ukraine, Slovenia and Croatia are amongst the worst performers in terms of investment since the 2008 crisis, with the decline more than eroding all gains over 2004-07, in Ukraine' case lowering investment by more than 60%. It is these sort of investment trends that re-inforce the need for reform, if convergence is to resume.

INVESTMENT LEADERS AND LAGGARDS

Cumulative changes in gross fixed capital formation in real terms



Source: National statistics offices, UniCredit Research

There are signs of positive reform momentum in Serbia and Slovenia but more needs to be done. Croatia is lagging…

Within South East Europe, recent months have produced evidence of reform momentum in Serbia and Slovenia:

- Slovenia's bank stress tests are being conducted under ECB watch and, once announced in mid-December, should provide a realistic estimate of the shortfall. The sovereign has already built a cash pile which should cover a sizeable chunk of the burden. Progress has also been made on fiscal consolidation in the face of escalating public debt and we believe that the government is on track to narrow next year's deficit within 3% of GDP. Delivery on privatization will determine the government's ability to reverse the increase in public debt;
- In Serbia government progress on privatization and an IMF programme will act as important measures of commitment to reform. Measures to narrow the budget deficit are welcome but under current plans will still leave next year's budget deficit at 7.0% of GDP, with public debt to remain on an upward trajectory toward 70% of GDP;
- Croatia represents the laggard, with the government significantly overshooting this year's fiscal target while putting forward little in terms of consolidation for next year. This is particularly disappointing given that the government is more than half way through its term. Entry into the excessive deficit procedure will help to introduce some discipline but it is the absence of more wide-ranging reform which keep the economy in recession.

…while Ukraine has hit a stage where change is no longer optional

At the time of writing, developments in Ukraine remain fluid and as such our forecasts remain subject to significant change. It is clear that we have reached a stage where a shortage of hard currency, prompted in part by increased demand for FX from locals, is forcing the government to choose between East and West. An EU free trade agreement remains a possibility and would provide the economy with a new business model but will have to be accompanied by a new IMF programme. President Yanukovych's reaction to protestors and rhetoric surrounding discussions with Russia make a deal on gas prices and customs union more likely. This will deliver near term liquidity support but leave the economy destined to a multi year period of low growth.

CEE Strategy: Differentiation in a "Normalising" World

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- We expect the higher G4 yields resulting from the "great normalisation" in major bond markets to make investors more discriminating about allocating their capital to EM debt. Against this backdrop, we see merit in both directional and relative-value themes across CEE fixed income and FX, as we expect sustained higher G3 yields to be accompanied by an improving European and global growth backdrop and rising equity markets.
- **Sovereign Credit**: We recommend overweight allocations to sovereigns presenting opportunities for spread compression (Romania and Hungary) in the face of prospective higher core yields as well as credits supported by solid sustainability metrics (Russia). We prefer underweight allocations to more vulnerable and externally exposed credits (Turkey) and sovereigns with heightened near-term uncertainties (Ukraine). We like the local stories like Slovenia (a potential convergence theme) and Serbia (institutional reform). In relative value, while USD sovereign debt has underperformed EUR sovereign debt (for Poland, Hungary and Turkey), our G10 rates strategists see the Treasury-Bund differential widening further and accordingly we recommend an overweight in EUR sovereign paper.
- **Local Rates**: We recommend an overweight allocation to Russia and underweight allocation to Hungary given the relative betas to global financial conditions. While fundamentally constructive on Poland, we are market-weight duration in Poland given near-term risks on account of the pension reform, which might lead to local-market outflows. In relative value, while a shock rise in core yields will mean steeper local curves in most markets (except in Turkey), we take multi-pronged approach based on macro-cyclical, monetary-policy, liquidity and demand-supply considerations to select our curve positions: we see the most natural steepener in Hungary if tapering begins early, and the best flattener in Poland on delayed tapering. We prefer short-end steepeners in Czech rates in anticipation of rising inflation expectations following FX intervention.
- **FX**: FX is likely to remain volatile ahead of tapering. We look for relative-value opportunities to express our key views in a beta-hedged and carry-efficient manner. On cyclical, policy and relative-liquidity considerations, we continue to look for PLN outperformance relative to HUF where we have a medium-term target of 73, but we see long-term potential for a move up to 75 and beyond. Initially during tapering, we expect TRY to underperform RUB and look for selling opportunities above the 16.50 level, which we expect will materialize given seasonal patterns in year-end price action. Longer term, however, we will look to buy TRY-RUB on attractive fundamental valuations.

SUMMARY OF KEY ASSET-ALLOCATION VIEWS AND TRADE RECOMMENDATIONS

Asset Allocation			
	Credit	Local	FX
Poland	M-W	M-W	O-W
Hungary	O-W	U-W	U-W
Czech	M-W	M-W	U-W
Romania	O-W	O-W	O-W
Turkey	U-W	U-W	U-W
Russia	O-W	O-W	M-W
Croatia	M-W	-	-
Ukraine	U-W	-	-
Serbia	O-W	-	-
Slovenia	O-W	-	-

Trade Recommendations			
Trade	Rationale	Entry	Target
Buy Serbia Dec 2018 USD	reform initiatives, adequate 2014 funding, attractive carry	420bp	300bps
Buy Slovenia May 2023 USD	manageable bank recapitalisation costs, potential convergence to Eurozone peers	5.82%	5.4%
Long Jan2028 OFZ FX hedged (entered 2 Dec)	indexed inflows, +ve C/A and high reserves, lower term premia owing to inflation-targeting policy	8.20%	6.85%
Rec 2y HUF Pay 2y PLN (FX hedged)	dovish NBH, excess HUF liquidity, NBP on hold, strong Polish growth	35bps	0bps
Pay CZK 1y1y	rising inflation expectations with FX intervention	0.58%	0.90%
Long PLN-HUF (entered 25 Oct at 69.75)	stronger Polish growth to drive Polish equities and FX higher; falling carry on HUF, less risk-positive	72	75
Sell TRY-RUB	TRY to suffer from from tapering given C/A deficit; RUB more resilient with C/A surplus, FX reserves	16.50 (Dec end)	15.75

Source: UniCredit Research

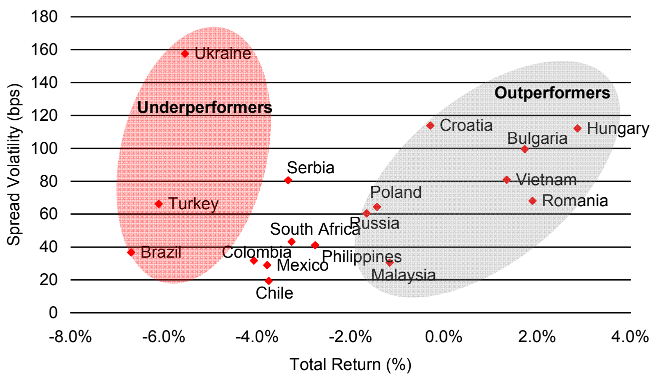
Sovereign credit: search for tighter spreads in the face of higher core yields

CEE has provided many sovereign-credit outperformers

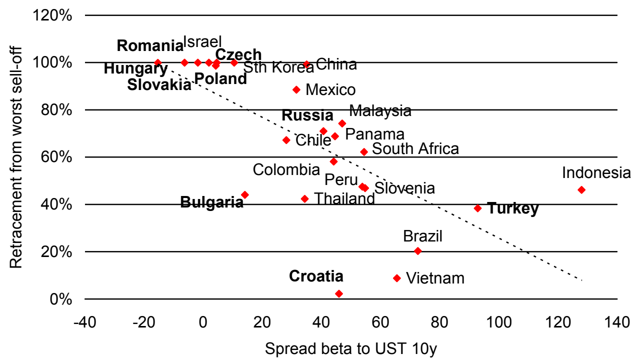
CEE has provided many of the sovereign outperformers of the year as spread compression has served to offset, at least partially, the negative impact of higher core yields. The first chart below shows that four out of the five best sovereign-credit performers are in CEE and, of the three markets to see an overall positive performance year to date, two are in CEE (namely Hungary and Poland). Also, looking at relative resilience to tapering, we see in the second chart that many major CEE sovereigns have shown a low beta on average to US Treasury yields and have fully retraced the worst of the spread-widening seen during the May-August period when tapering first appeared as a major risk.

MANY CEE SOVEREIGNS HAVE OUTPERFORMED GLOBALLY AND SHOWN A LOWER SENSITIVITY TO US TREASURY YIELDS

Estimated year-to-date sovereign market return (per unit duration; on-the-run paper) and annualised spread volatility for 2013



CDS-spread beta to UST10y and % spread retracement from the worst sell off during May-August 2013 (CEE sovereigns in bold)



Source: Bloomberg, UniCredit Research

We look for further spread compression in Romania and Hungary with deleveraging and growth…

Asset Allocation: In a world with tapering risks but an improving growth outlook, we choose our overweights in the light of **1.** resilience to tighter global financial conditions, **2.** potential for further spread compression on account of a cyclical recovery and potentially improved external-sustainability metrics and **3.** interesting local stories based on positive impulses coming from institutional reform.

We recommend overweight allocations to Romania, Hungary, Russia, Slovenia and Serbia and underweight allocations to Turkey and Ukraine. We prefer a market-weight in Poland and Czech debt despite strong fundamentals as opportunities for spread compression remain limited given already low spreads.

Despite significant outperformance during much of 2013, Hungary and Romania continue to look interesting to us, as we believe that the net international investment position (NIIP), the broadest measure of the indebtedness of an economy, should continue to improve for both with deleveraging and a cyclical recovery will reduce credit risk premia further. As the first chart below shows, spreads for Hungary, Romania and Slovenia look elevated relative to their NIIPs. Also, as the second chart shows, in recent quarters (to 2Q13), Hungary and Romania have improved their fiscal balances (though the balance for Hungary is expected to worsen in 2013 to 2.9%) and reduced their stocks of external debt.

In terms of local stories, we especially like Slovenia and Serbia. We have already noted how Slovenian spreads look high relative to the NIIP. Slovenia remains investment grade according to two of the three ratings agencies. While bank recapitalisation will worsen the NIIP, Slovenia's public-debt metrics will still compare favourably with Eurozone peers. As the second chart below shows, Slovenia's net external debt stock has fallen. Finally, Slovenia has a large current-account surplus (we expect 5.7% of GDP for 2013). Therefore, on balance, we remain comfortable recommending an overweight allocation to Slovenia.

…and like the local stories in Slovenia and Serbia, given the positive impulses from reform

Serbia looks interesting to us in view of institutional reform. The arrival of technocratic ministers clearly bodes well for governance and the fiscal package introduced in October is a step in the right direction. Serbia's funding requirements are manageable and the government has started building liquidity buffers for next year. Finally, external funding for 2014 has improved with USD 3.5bn likely from various sources (including UAE, EBRD, Russia and the World Bank).

While Turkey has underperformed, it still remains vulnerable to tapering…

Given the dominance of tapering as a global risk factor, we have an underweight allocation to Turkey. Turkey has been an underperformer this year, as a large current-account deficit, a high stock of short-term debt relative to reserves and low real rates in the face of tapering fears led to investor sentiment souring. While we remain confident of the long-term creditworthiness of the Turkish sovereign, we are conscious that market-pricing of credit risk remains very sensitive to global financial conditions for highly externally-leveraged sovereigns like Turkey. Along with Turkey, Brazil, Indonesia and South Africa are among the other sovereigns that have failed to retrace significantly the worst of the spread-widening that occurred during the May-August period (see the second chart above on spread retracement).

…and Croatia remains a structural laggard with few macro or policy positives…

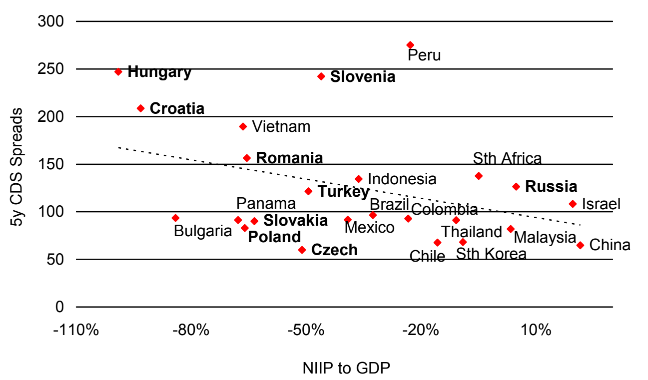
We keep a market-weight in CROATIs. While Croatia is a reform laggard with weak cyclical activity, a large current deficit and little urgency by the authorities to address structural issues, the sovereign spread looks quite elevated relative to NIIP. Also, CROATIs tend to co-move with REPHUNs and we are constructive on the latter.

…while the situation in Ukraine is highly uncertain and politically tense and thus warrants caution

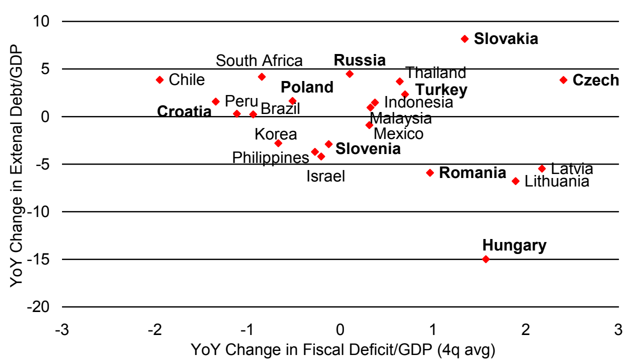
Finally, we recommend an underweight in Ukraine. The political situation remains highly uncertain and tense after the government decided not to sign the EU deal. While we do not see a significant probability of a disorderly adjustment, any solution offering even short-term stability could be some time into the future, before which we could see further spread widening and significant spread volatility.

SPREAD COMPRESSION LIKELY FOR SOVEREIGNS WITH NEGATIVE BUT IMPROVING NIIP

5-year CDS spreads relative to net international investment position looks high for Hungary, Slovenia and Romania



…especially given the improvements external debt to GDP ratios and/or fiscals balances relative to GDP



Source: IMF, Haver, Bloomberg, UniCredit Research

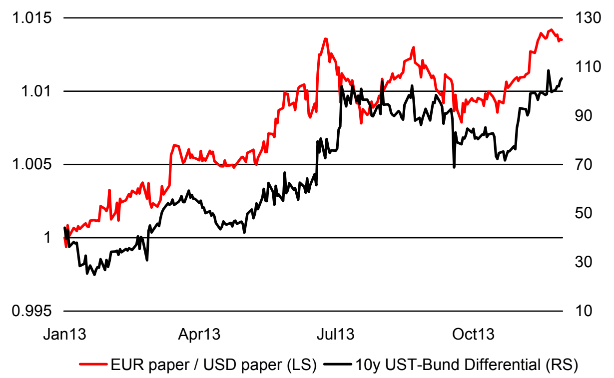
We expect EUR sovereign paper to continue outperforming USD paper

Relative value: Two types of sovereign relative-value themes are interesting to us. The first is based on our G10 rates forecasts. As the first chart below illustrates, the duration-adjusted outperformance of EUR sovereign paper over USD sovereign paper this year has been closely associated with the widening of the US Treasury-Bund yield differential. The outperformance this year for a unit-duration allocation to 10-year EUR paper over 10-year USD paper has been 1.34% in Poland and 1.61% in Hungary. We believe this theme has further to run in view of tapering, which our G10 strategists forecast will lead to the UST-bund differential widening by 30 bps over the course of next year.

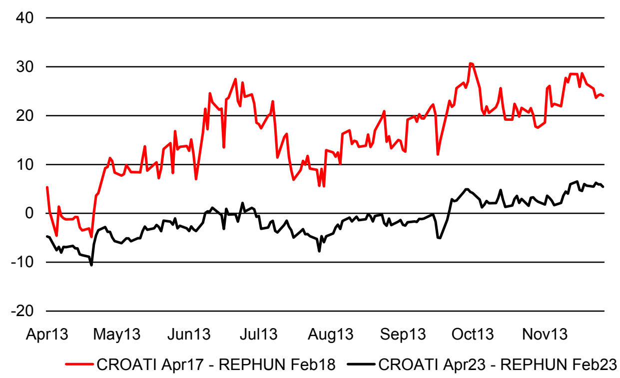
The other type of relative-value theme is based on spread variations among correlated credits. CROATIs and REPHUNs tend to co-move over time with CROATIs typically providing a yield pick-up over REPHUNs. While we are not overweight CROATIs outright, from the perspective a yield pick-up over REPHUNs on positions held to maturity, we see relatively more value in the belly of the CROATI curve, as per-unit-duration spread differentials relative to REPHUNs are higher and have risen more over 2013 for CROATI Apr17 than for Apr23.

RELATIVE VALUE THEMES BASED ON CORE YIELDS AND SPREAD CO-MOVEMENTS

Duration-adjusted outperformance of Poland Jul24 EUR relative to Mar23 USD closely related to UST-Bund differentials



CROATIs offer better yield pick-up over REPHUNs in the belly than at the long end based on duration-adjusted spread differentials



Source: Bloomberg, UniCredit Research

Local markets: not all about curve steepening

We look for OFZs to outperform with falling inflation, policy easing and inflows…

We see in the first chart below that, as in the case of sovereign credit, CEE has provided several rates outperformers (Hungary, Romania and Russia) which are mostly countries with strong and/or improving external positions, positive real rates and falling inflation. At the other extreme are the fragile five (Brazil, India, Indonesia, South Africa and Turkey), all with external deficits, rising inflation and, except for Brazil, negative real rates at the time of the first "taper shock" in May this year. Investor discrimination about EM local-rates markets will continue to be informed by these considerations going forward.

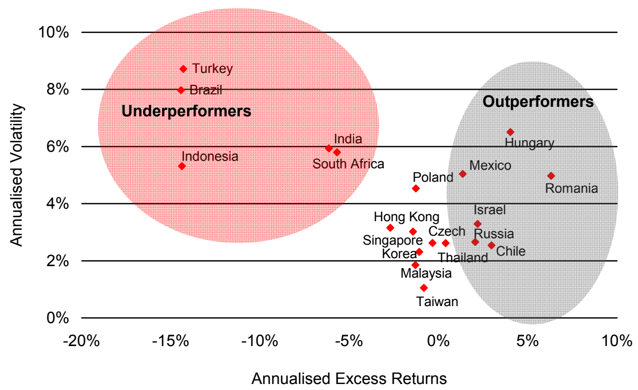
Asset Allocation: We recommend an overweight allocation to long-end OFZs and prefer to express the view using the new 15-year on-the-run benchmark (Jan2028) in anticipation of relative resilience to tapering given an external surplus and large reserves, ongoing switches into the new benchmark and especially inflows on account of inclusion into Barclays Global Aggregate Index (expected on 31 March 2014). While we now expect only modest easing by CBR next year, resisting rate cuts in view of sticky inflation will boost their inflation-targeting credentials and reduce the term-premium in the long end. Also, since a weaker RUB in the wake of tapering will weigh on investor interest in OFZs, we believe our position should perform well with the FX exposure hedged. Year to date, the RUB basket has depreciated more than 10%. However, as we see in the first chart below, FX-hedged return on the local Russian debt has still been positive.

…but remain cautious about HGBs in the near term given that investor positioning is no longer underweight

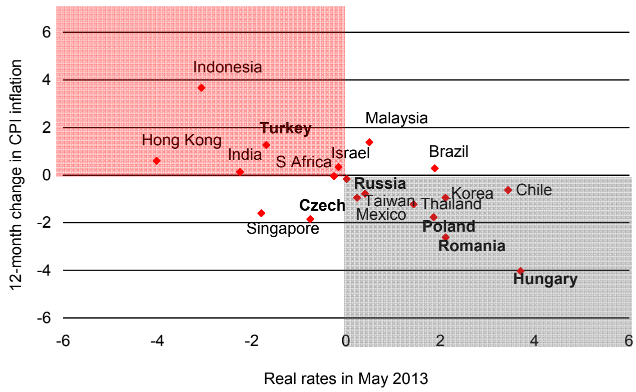
While HGBs have outperformed this year, we recommend an underweight allocation in the near term given that investor positioning now is no longer underweight (as was the case in May this year), HGBs have the highest share of foreign ownership in the region and Hungary has the highest gross government financing requirements relative to GDP in the region, even though it has pre-financed partially next-year's financing requirements. However, once tapering has begun, we believe we will see value in HGBs after the initial sell-off and will be looking to go overweight, especially if the 10-year benchmark breaches the 2013 highs (6.84%).

RATES OUTPERFORMERS MOSTLY EXTERNAL-SURPLUS COUNTRIES WITH POSITIVE REAL RATES AND FALLING INFLATION

FX-hedged excess returns on 5-year par interest-rate and cross-currency swaps



Short-term real rates versus YoY changes in CPI inflation (CEE countries in bold)



Source: Haver, Bloomberg, UniCredit Research

We are also cautious about TURKGBs…

We recommend an underweight in TURKGBs in view of Turkey's heightened sensitivity to tighter financial conditions and continued need for capital inflows to finance a large current-account deficit. Also, in order to attract inflows and tame still high and sticky inflation, we believe CBT will need to tighten policy further implying an adverse mark to market for long duration positions. We note that Turkey has not suffered large-scale outflows since May relative to the global EM debt markets. For perspective, we note that the total outflows for dedicated EM-debt funds, as recorded by EPFR, stand at a 140% of the cumulative flows till 22 May, while the equivalent figure for Turkey is only 22%. Turkey has suffered far less in terms of outflows. However, arresting outflows is not enough for Turkey. It needs continued inflows to finance its large current-account deficit.

…constructive on POLGBs, but market-weight given the pension reform uncertainties…

While we are fundamentally constructive on POLGBs given the steadily improving basic balance and robust growth fundamentals, we currently recommend a market-weight allocation given the uncertainty surrounding the pension reform which may lead to portfolio outflows in the near term, even though there are positive supply impulses owing to the cancellation of debt held by OFEs (mostly in the belly of the curve).

…and positive about ROMGBs on ample liquidity and dovish policy

Finally, we recommend an overweight allocation to ROMGBs, as we believe that during H1, factors such as liquidity, monetary policy, modest financing needs and relatively low foreign ownership will remain supportive. However, we acknowledge potential political risks before presidential elections next year and rising inflation.

In relative value, Hungary is the most natural curve steepener for an early taper surprise…

Relative value: In the local-markets space, while the obvious implication of higher long-end core yields would be a steepening of the local curves, we see meaningful differentiation among the various markets. In a tapering scenario, we see Hungary as the most natural steepener as domestic factors (easy monetary policy, excess liquidity) add to the steepening impulse from tapering, while, in a delayed tapering scenario, we see Poland as the most natural flattener given that the robust cyclical recovery and lack of any excess money-market liquidity will put an upward pressure on short-end rates. Also, the supply dynamics resulting from the Polish pension reform will put flattening pressure at the margin (mainly 2s5s).

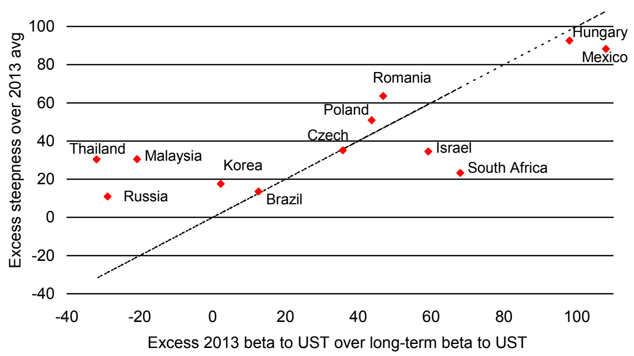
…while Poland is the most natural flattener in a delayed taper scenario

We further illustrate this theme using the charts below. In the first chart, we plot the excess regression beta of 2s10s curves in 2013 (relative to previous 12 months) to 10-year US Treasury yield against the excess steepening this year relative to the 12-month average slope. Simply on the basis of sensitivity to Treasuries and the actual (excess) steepening that has occurred so far on that account, the chart shows that while Hungarian curve is historically steep it does not look excessively steep given the sensitivity to Treasuries. On the other hand, Poland's curve may already have steepened too much.

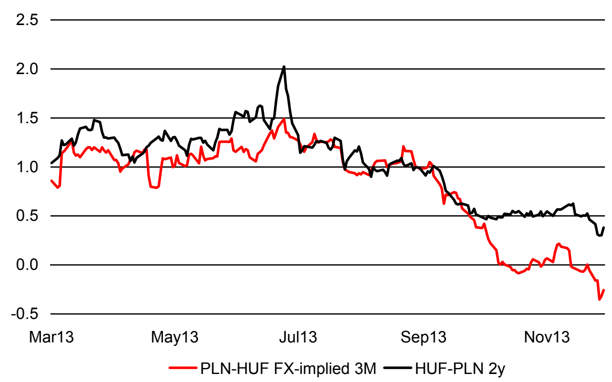
As a derivative of the same theme, we compare the 2-year rates differential between Hungary and Poland against the 3M FX-implied differential. While near the lows for the year, the 2-year differential still looks too high compared to the relative liquidity and monetary-policy dynamics, especially with the NBH recently suggesting that the actual policy cuts may be deeper than being priced in the market. Hence, we believe the trade receiving 2-year HUF against 2-year PLN (FX-hedged) has further upside. We look for the differential to move down to zero by 1Q14.

HUNGARY IS THE MOST NATURAL STEEPENER WHILE POLAND WILL SEE FLATTENING IF TAPERING IS DELAYED

Poland looks too steep even relative to the increased sensitivity in 2013 to US Treasury yields (also shown is the 45 degree line)



2-year HUF-PLN rates differential looking wide relative to impact of easier policy in Hungary priced in 3M FX-implied differential



Source: Bloomberg, UniCredit Research

Any steepening of the TURKGB curve will be an opportunity to initiate flatteners…

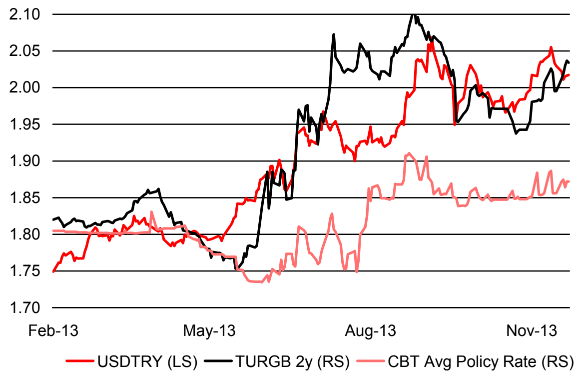
Two other curve themes are interesting to us, largely driven by monetary-policy considerations. First, we look for medium-term flattening in the TURKGB curve as we believe CBT will have to tighten policy to stem capital outflows, support the currency and eventually attract capital inflows to finance the current-account deficit. As the first chart below shows, in recent times a TRY sell-off has typically led to a short-end TURKGB sell off which anticipates policy tightening by CBT (by raising the weighted-average cost of funding to the banking system). We view any steepening in the benchmark 2s10s curve as an opportunity to enter flatteners and could see an inversion of the curve to the levels in May 2012 (-32bs)

… but the CZK short end should steepen with rising inflation expectations

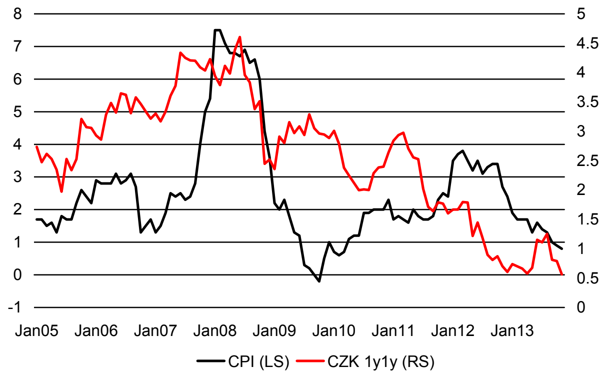
Secondly, we look for short-end curve steepening in the Czech curve by paying 1y1y. The second chart shows that inflation and inflation expectations are an important driver of the 1y1y. FX intervention by CNB should lead to rising inflation expectations leading to a higher 1y1y.

WE SEE A CASE FOR A FLATTENER IN TURKGBS BUT SHORT-END STEEPENERS IN THE CZECH REPUBLIC

Short-end TURKGBs are highly sensitive to TRY and cause curve flattening anticipating CBT policy tightening



Rising inflation expectations in the wake of FX intervention should lead to short-end CZK curve steepening



Source: Haver, Bloomberg, UniCredit Research

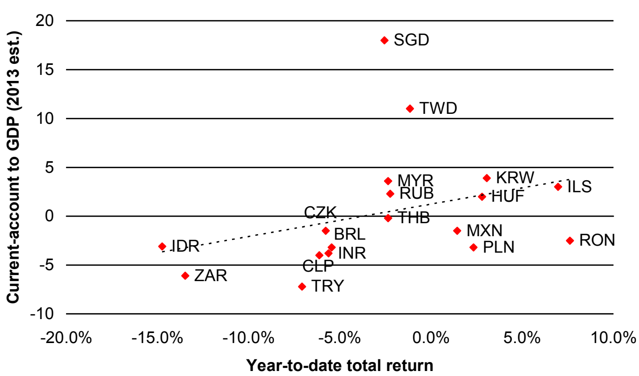
FX: the obvious pressure release valve

Currencies with current-account deficits and low real rates are vulnerable

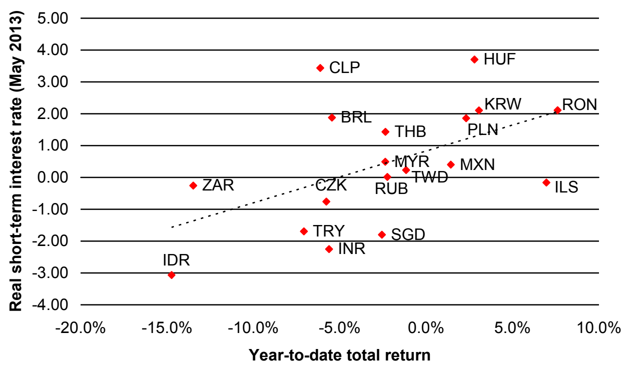
FX has served as the natural pressure release valve during the first Fed-taper episode from May to August. As the two charts below show, the biggest negative moves in EM FX have been for currencies with large current account deficits and/or negative real interest rates in May 2013. On the other hand, currencies with either strong or improving external positions have outperformed. From CEE, PLN, RON, HUF and RUB are outperformers. The underperformance of CZK is largely a consequence of FX intervention, while TRY has clearly underperformed in line with the performance metrics for sovereign credit and local rates.

BIGGEST FX MOVES HAVE BEEN A FUNCTION OF EXTERNAL POSITIONS AND REAL RATES

YTD total FX returns against current-account balances



YTD total FX returns against real rates



Source: Haver, Bloomberg, UniCredit Research

…but valuations in deficit currencies are already a bit stretched…

The vulnerabilities to tapering are clear from the charts above: watch out for negative-real-yield FX with external deficits. However, we think it is important to trade outright FX very tactically, given the recent retracement patterns in spot and vol and fundamental valuations. The first chart below shows that for many spot FX underperformers (TRY in CEE), implied volatilities have retraced a more significant chunk of the move over the May-August period than spot, i.e., for many currencies, spot has stabilized for some time at a lower level, probably because markets think countries like Turkey and South Africa, with large external deficits, need a permanently weaker currency: so the Fed "non-taper" in September did not benefit currencies like TRY and ZAR proportionately to the drop in US 10-year yields, which means a lot of medium-term bad news from tapering is already in the price. Moreover, as the second chart shows, currencies like TRY (along with BRL, IDR, INR and ZAR) are now cheap on valuation metrics like PPP (which we gauge by comparing the latest BIS real effective exchange rate (REER) index with its 5-year average).

…so, further downside will be proportionately less…

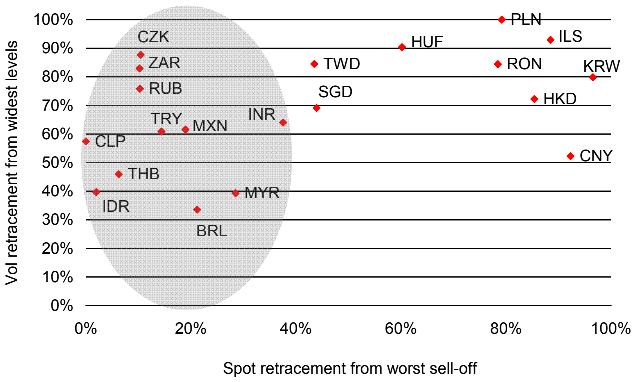
More encouragingly for CEE FX, we see that PLN, HUF and RON have retraced most of their worst moves (in both spot and vol) and look good on valuations with all three screening as close to fair, while RUB looks modestly overvalued.

…making us focus on relative-value themes

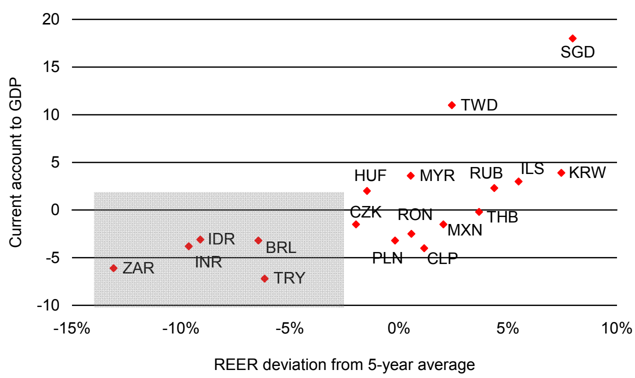
On balance, USD-CEE and EUR-CEE do not offer the most obvious risk reward from a tapering perspective. Therefore, we focus our attention on relative value.

MANY UNDERPERFORMING CURRENCIES HAVE STABILISED AT WEAKER LEVELS AND LOOK CHEAP FUNDAMENTALLY

Spot and 3M implied vol retracement from the worst sell-off levels seen during May-August 2013



Deviation of real effective exchange rate from 5Y average (approximate PPP valuation) and current account balance to GDP



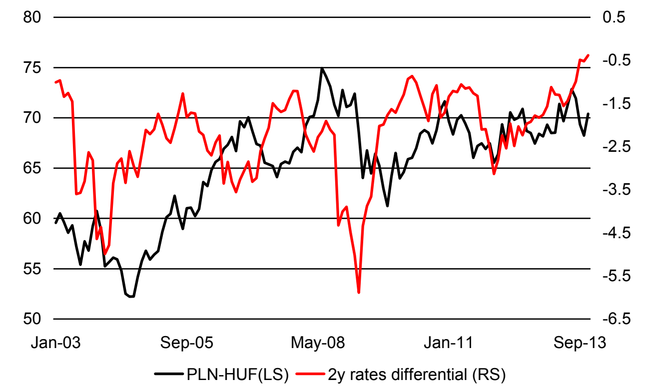
Source: BIS, Bloomberg, UniCredit Research

We expect PLN to continue to outperform HUF in the medium term

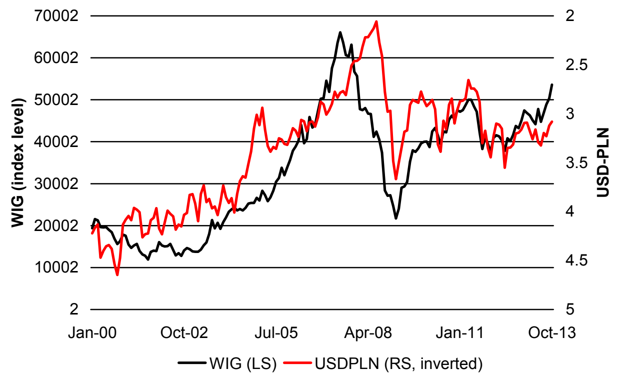
PLN Outperformance: While we have had this theme on for some time (we went long PLN-HUF on 25 October at 69.75 targeting 73.000 initially with a stop at 68.000), we believe the trade has much further to run, especially with the NBH sounding more dovish recently, eroding further the carry on HUF after the adverse impact of the funding-for-growth scheme on HUF yields. While raw PPP valuations look neutral, our BEER model, which maps fundamental valuations to factors such as terms of trade, bond yields and cyclical-macro factors, suggests that PLN is significantly cheaper than HUF. Also, as we have shown in our recent research, PLN has benefitted consistently from positive portfolio-balance effects (i.e. stronger Polish equities predict a stronger PLN), whereas HUF has not, at least in the recent past when Hungary has been beset with a banking and external-debt crisis as a result of which external financial conditions have become the dominant driver of HUF.

PLN TO OUTPERFORM HUF ON IMPROVING RELATIVE CARRY AND MORE ROBUST GROWTH

With rates differentials moving in favour of PLN, we expect the cross to move higher in the medium term



Strong and consistent portfolio-balance effects make PLN a growth-positive currency allowing it to benefit from growth outperformance



Source: Bloomberg, UniCredit Research

While we expect TRY to underperform RUB in the near term...

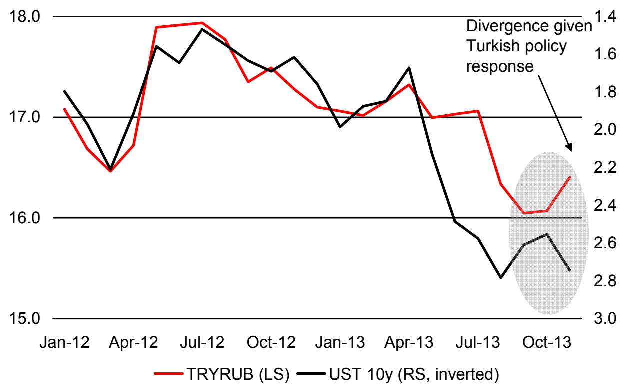
TRYRUB – a tapering sell, but a long-term buy: We have noted above how Turkey is the most vulnerable in our universe to any sharp tightening in global financial conditions (proxied by higher UST yields). In comparison, RUB will be more resilient given its modest external financing needs and large reserves. We have observed this dynamic over the last couple of years (see the first chart below). Falling UST yields benefit TRY more. However, over recent weeks we have seen TRY outperform despite a rise in 10y UST, as it has benefitted from monetary tightening by CBT. RUB, on the other hand, has been soft in view of little foreign-investor interest in the local market and continued domestic capital outflows. However, we believe once tapering genuinely becomes an imminent prospect and we see a move in 10-year UST yields towards 3%, we will see TRY underperform. For a tapering related rise in Treasury yields, we aim to sell above the 16.50 handle and then look for a move below the 16 handle. Given RUB-negative and TRY-positive seasonal patterns we believe we will get our selling level during December just in time for January which is when our economists think the Fed is going to start tapering asset purchases.

...we will look for buying TRY-RUB on attractive long-term valuations

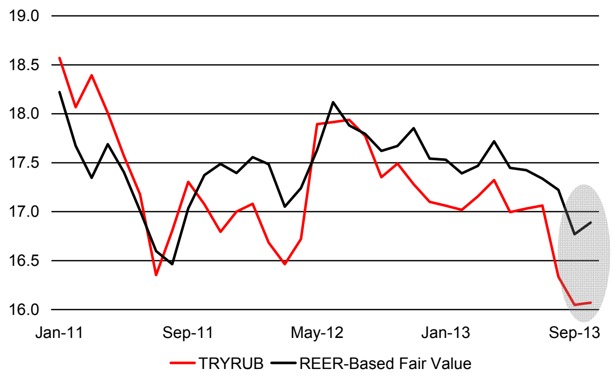
However, even at current levels, as the second chart below demonstrates, TRY is fundamentally cheap relative to RUB. Hitting our target below 16 will cheapen it further. Aside from the short-term tapering related vulnerabilities, structurally we regard long Turkey as a better bet than long Russia. Moreover, we also see a structural softening in oil prices which should benefit TRY more than RUB. Therefore, longer term, once tapering has begun, TRY-RUB is a fundamental buy for us.

TRY VULNERABLE RELATIVE TO RUB NEAR TERM, BUT FUNDAMENTALLY CHEAPER LONGER TERM

TRY-RUB has tracked moves in 10Y UST closely, but diverged recently



TRY-RUB cross is undervalued from a fundamentals perspective (based on a regression of spot on relative REER index)



Source: BIS, Bloomberg, UniCredit Research

Countries

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

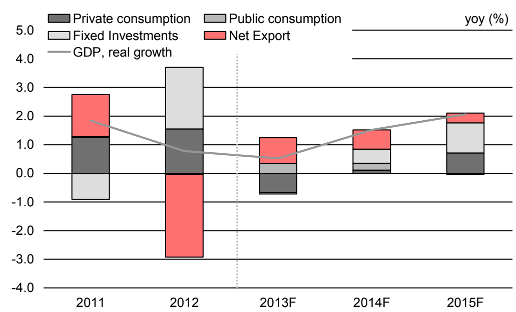
Outlook – Increased exports and some one-offs, like a solid grain harvest and higher government spending, helped GDP growth to rebound by 0.5% qoq in 3Q13. Labor market data showed a mixed picture in the last three months, while consumer prices demonstrated some signs for stabilization in September and October, after falling to a record low in the first eight months of 2013. Importantly, the external position gained more strength in 3Q13, while growth prospects in the country's key trading partners for 2014 has improved further. All in all, we think that the economy will show more signs of recovery next year, but any meaningful acceleration in GDP growth is not yet in sight. Against this backdrop, we decided to keep our real GDP growth forecast for 2013 unchanged at 0.5%, while raising 2014 to 1.5%.

Author: Kristofor Pavlov, Chief Economist for Bulgaria (UniCredit Bulbank)

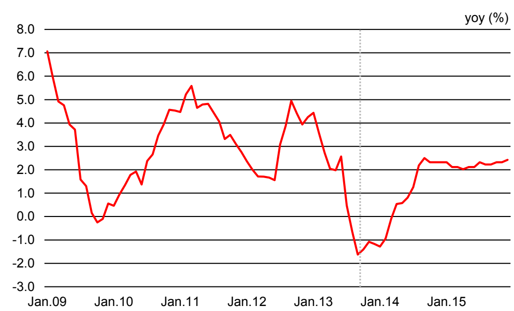
KEY DATES/EVENTS

- Mid-Feb– Number of employees under labor contract for 4Q13
- Mid-Feb – Flash estimates for swda real GDP for 4Q13
- February – redemptions of 43% of domestic GBs maturing in 2014

GDP GROWTH WILL REMAIN SLUGGISH



THE CPI WILL EXIT DEFLATION IN 2014



Source: NSI, BNB, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	38.5	39.7	40.3	41.3	43.1
Population (mn)	7.3	7.3	7.2	7.2	7.2
GDP per capita (EUR)	5.255	5.445	5.559	5.733	6.015
Real economy yoy (%)					
GDP	1.8	0.8	0.5	1.5	2.1
Private Consumption	1.7	2.0	-0.9	0.1	1.0
Fixed Investment	-6.5	0.8	1.9	2.4	4.8
Public Consumption	0.3	-0.4	4.3	2.9	-0.5
Exports	12.3	-0.4	8.8	7.6	6.5
Imports	8.8	3.7	6.6	6.0	5.5
Monthly wage, nominal (EUR)	351	397	413	431	454
Unemployment rate, avg (%)	11.3	12.3	13.0	13.2	12.9
Fiscal accounts (% of GDP)					
Budget balance	-2.1	-0.5	-2.0	-2.4	-2.2
Primary balance	-1.4	0.3	-1.1	-1.5	-1.3
Public debt	15.3	17.6	18.3	22.9	23.5
External accounts					
Current account balance (EUR bn)	0	-0.5	1.0	0.9	0.3
Current account balance/GDP (%)	0.1	-1.3	2.4	1.5	0
Basic balance/GDP (%)	3.2	1.7	4.9	4.3	3.3
Net FDI (EUR bn)	1.2	1.2	1.0	1.2	1.4
Net FDI (% of GDP)	3.1	3.0	2.5	2.8	3.3
Gross foreign debt (EUR bn)	36.2	37.6	35.3	34.4	33.3
Gross foreign debt (% of GDP)	94.1	94.8	89.2	85.6	79.8
FX reserves (EUR bn)	13.3	15.6	15.5	16.7	17.4
Inflation/Monetary/FX					
CPI (pavg)	4.2	3.0	1.0	1.0	2.2
CPI (eop)	2.8	4.2	-1.2	2.3	2.4
Central bank reference rate (eop)	0.22	0.04	0.04	0.22	0.93
USD/BGN (eop)	1.51	1.48	1.45	1.40	1.35
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.41	1.52	1.47	1.43	1.39
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

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

Economy to show more signs of recovery next year

GDP growth in 3Q13 accelerated to its strongest qoq reading since 2Q12

We keep our GDP growth forecast for this year unchanged at 0.5%, while raising 2014 to 1.5%

Reforms aimed at reducing rent-seeking behavior and reinforcing institutions important for the efficient functioning of the market are urgently needed to put the economy on a better growth trajectory

The outlook for the Bulgarian economy is balanced between the positives of improving growth prospects in the country's key trading partners, which will boost exports and a large part of industry, and the need to address the difficult institutional and broader structural challenges after years of policy neglect. GDP growth endured a roller-coaster ride so far this year. Growth deceleration in 1H13 (to just 0.2% yoy in 2Q13) was followed by a 0.5% qoq rebound in 3Q13, which on top of a rise in exports was aided by the solid grain harvest and more public spending, after the new socialist-led government decided to increase this year's budget deficit to 2.0% of GDP (from 1.35%). Looking ahead, the economy should display a path of slow recovery, prompting an improvement of real GDP growth from 0.5% yoy in 2013 to an upwardly revised 1.5% in 2014 (from 1.3%). But the fragility and lopsidedness are likely to remain among the main characteristics of the Bulgarian recovery. There is little doubt that the genuine recovery in exports seen so far this year will carry over into 2014, while better EU funds absorption will continue to provide some stimulus for investment. But these two can hardly be enough to compensate for the broad-based weakness on the domestic front. Investment and stronger private consumption will lag behind, as ongoing political instability adds to uncertainty and prolongs the time in which companies will abstain from starting major new projects and hiring more staff. After the budget deficit was increased to 2% of GDP in 2013, fiscal space available to support further economic activity is now smaller. And above all, the deep mistrust is likely to paralyze almost every effort of this administration to press ahead with the reforms which are needed to put the economy on a better growth trajectory.

Labor market data in Bulgaria has been mixed

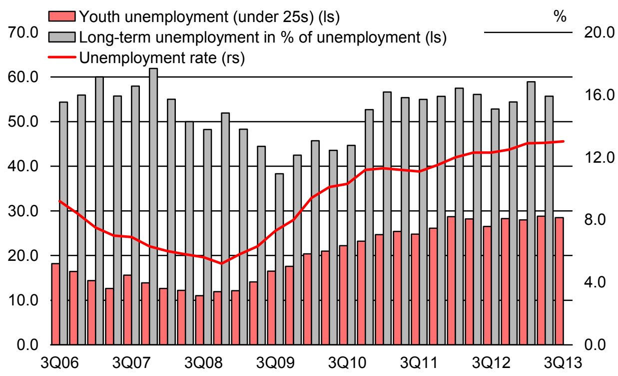
Although employment expectation saw some marginal improvement so far this year, they remain far from the levels consistent with a solid rise in the number of jobs

The ongoing political tension is another setback for the labor market recovery in the short-run, as it makes business wary which, in turn, weighs on hiring decisions

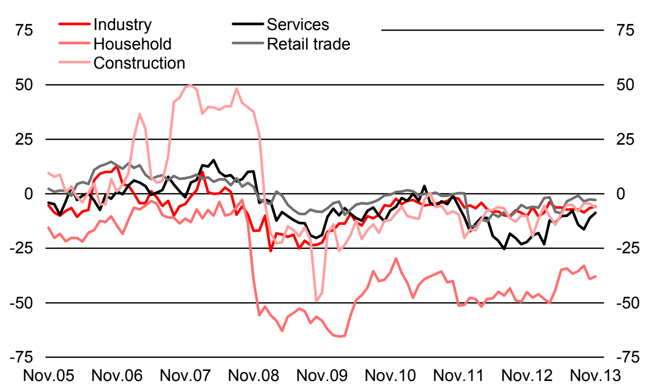
After the labor market has shown some tentative signs of improvement in 1Q13 and 2Q13, most data released in 3Q13 failed to impress on the positive side. The unemployment rate increased by one notch to 13.2% in October, which is its worst monthly reading since August 2003. In line with the discouraging headline unemployment number, both youth unemployment (28.5%) and long-term unemployment (55.7%) remained dangerously elevated. Even more disappointingly, the economy lost 4K jobs in 3Q13 when compared with the same period a year ago, after 2K and another 27K people were back to work in 1Q13 and 2Q13. But the big picture was not uniformly negative. The share of the population (aged 15-64) that is working or looking for work (a measure known as the participation rate) inched higher to 69.6% in 3Q13, from 68.6% in 3Q12 and 66.7% in 3Q11. Real household disposable income also added to the flow of positive headlines after rising 12.7% yoy in 3Q13, although it was hard to rationalize the massive 12.5% yoy increase in salary income and especially the 44.4% rise in other income, which when combined were behind roughly two-thirds of the total upswing. Looking ahead, these data seem to suggest that the worst is over and employment will begin gradually to regain the ground lost in the crisis years.

THE LABOUR MARKET SEEMS TO BE MAKING THE FIRST STEPS DOWN A LONG AND UNEVEN RECOVERY PATH

The unemployment rate looks to be close to its peak



Employment expectation components of ESI have improved



Source: Eurostat, National Statistical Institute, UniCredit Research

But any convincing labor market recovery will be a very slow process. This is not only because a non-negligible part of the reason for the labor market weakness is structural (which is reflected in sky-high youth and long-term unemployment), but mostly because any meaningful acceleration of GDP growth is not yet in sight.

Deflation is one of the key downside risks to our baseline macroeconomic scenario

Deflation concerns eased in October, after mom CPI increased for a second consecutive month, underpinned by a seasonal uptick in food and clothing prices. Thus, ytd deflation moved to -1.7% in October, from a record low of -2.2% in August 2013. We see deflation as negative news as it raises the real value of debt and reduces already weak stimuli for consumption. Moreover, if inflation expectations remain anchored in negative territory for too long, the risk of a self-perpetuating deflationary spiral is likely to rise. For us, deflation is driven by the significant slack in the economy, which continues to operate far below its full potential for a fifth consecutive year, and a number of one-off factors, such as weak import prices and a politically motivated 5% cut in household electricity prices in August. But the outlook is more favorable and we are not particularly worried that Bulgaria will plunge into a classic self-perpetuating deflationary spiral that derails the economic recovery. For a start, the one-off factors which have contributed to the fall in CPI so far this year are gradually fading. Perhaps even more importantly, inflation expectations have begun to tick up recently for both CPI and PPI, after the independent regulator announced that it doesn't see room for further cuts in electricity and heating costs in 2014. Even if internationally determined prices of foods and primary energy resources remain broadly flat next year, which is part of our global baseline scenario, a tad stronger domestic demand recovery should also help to bring the negative price dynamics to an end.

We estimate eop and avg CPI at -1.2% and 1% this year

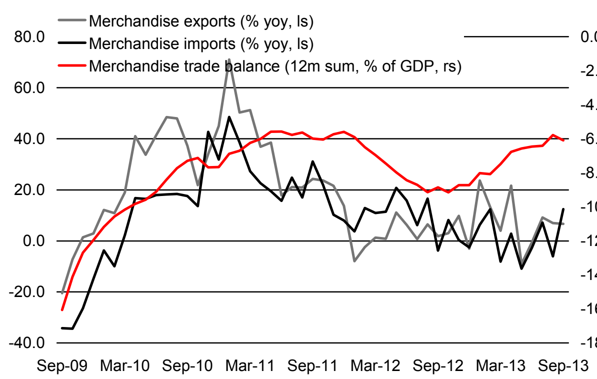
The solid improvement in external position indicates that the downturn adjustment in economic activity is over

Merchandise exports have drawn support from a double digit increase in the export of raw materials for the food industry, medicine and cosmetics, refined petroleum products, and investment goods

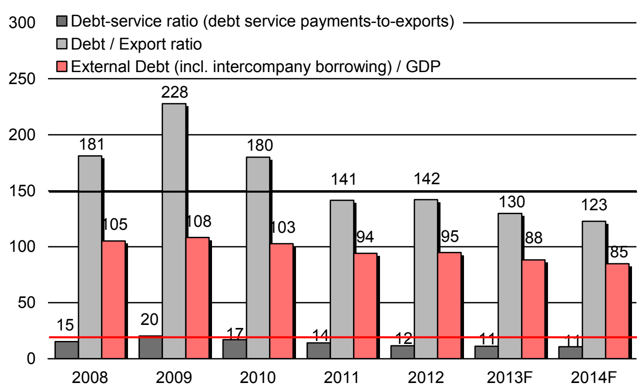
Bulgaria's external position has seen a marked improvement so far this year. This was led by the merchandise exports (7.8%) increase and EU funds transfers (36.3%) improvement, which helped to shift the CA to its strongest surplus ever in the first nine months of the year (3.4% of GDP). This strengthened the external position, which is good news, given the still high foreign debt of the country that most recent data put at 92.4% of GDP in September 2013. The stronger external position was also reflected in the improvement of the country's debt sustainability indicators, including debt-to-exports and debt service payments-to-exports ratios, which are now far from the dangerous area where they were in 2008, and particularly in 2009 when export volumes contracted sharply. These results not only imply that there has been a solid improvement in the competitiveness of the Bulgarian economy, but also that there is now a cushion in case of further shocks, which hasn't been the case in the past. In addition, there is comfort in the fact that the country's total foreign funding needs, calculated as the CA balance plus debt that needs rolling over, have declined markedly. More precisely, they have shrunk from the still elevated EUR 16.1bn (41% of GDP) reading last year to a sizeable but more manageable EUR 14.8bn (37% of GDP) and EUR 13.1bn (32% of GDP) estimated over this and next year.

THE CONTINUED POSITIVE DEVELOPMENTS IN EXTERNAL TRADE HAVE SUPPORTED THE ECONOMY IN MORE THAN ONE WAY

Trade balance has improved due to sustained export growth



Debt sustainability indicators saw a marked improvement



Source: NSI, BNB, MinFin, UniCredit Research

2014 issuance: an attempt to override the political noise

The MinFin will have to tap the Eurobond market to pre-finance a USD bond maturing in early 2015

2014 debt management will be heavily influenced by one-off factors. Pre-financing the maturity of USD 1.271bn of sovereign paper in January 2015 is key for the 2014 issuance plan which we see being tackled by tapping the Eurobond market with a EUR-denominated paper exceeding the immediate requirements of the issuer. Our scenario envisages a 5Y bond in the size of EUR 1.7bn with a cap of EUR 1.994bn set by the Budget Law. The timing of the issuance will be crucial against the background of domestic political developments, and we have penciled this in for 3Q14, following the elections for the EU Parliament in May.

Domestic issuance will see significant frontloading again in 2014

On the domestic front, the issuer will need to frontload issuance heavily in 1Q in an attempt to smoothen the seasonality of both the revenue and expenditure side of the budget balance. Moreover, the maturity profile of domestic debt due in 2014 (43% in February, 29% in June and 28% in September) further supports the case for building sufficient fiscal buffers at the start of 2014 to provide for uninterrupted budget dynamics during the year.

Abundant liquidity in the financial sector will support GB prices despite exceptionally high supply

Despite exceptionally high supply for Bulgarian standards which we envisage at 2.2% of GDP for the domestic market and 4.1% on the Eurobond market, we see this as being met by similar demand mainly due to elevated liquidity in the banking sector, in effect keeping GB prices stable. Given the combination of weak demand for new loans and the banking sector's external adjustment that has nearly come to an end, Bulgarian banks are likely to use the increase in resident deposits next year (estimated at 4.6% yoy) to pay off some of their most expensive funding and to increase their exposure in fixed income securities.

Author: Nikola Georgiev, Economist (UniCredit Bulbank)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F	2015F
Gross financing requirement	**0.9**	**2.6**	**2.2**	**2.4**
Budget deficit	0.2	0.8	1.0	0.9
Amortization of public debt	0.5	1.6	1.0	1.2
Domestic	0.4	0.6	0.9	0.4
Bonds	0.4	0.2	0.5	0.2
Bills	0	0.4	0.4	0.2
External	0.1	1.0	0.1	0.8
WB/EIB/JBIC/Others	0.2	0.2	0.2	0.2
Financing	**0.9**	**2.6**	**2.2**	**2.4**
Domestic borrowing	0.6	1.1	0.9	1.2
Bonds	0.6	0.6	0.8	1.0
Bills	0	0.6	0.1	0.2
External borrowing	1.3	0.7	2.2	0.6
Bonds	1.0	0	1.7	0
WB/EIB/JBIC/Others	0.4	0.7	0.5	0.6
Privatization	0	0	0.1	0.1
Fiscal reserves change (- = increase)	-1.1	0.7	-0.9	0.6

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2012	2013F	2014F	2015F
Gross financing requirement	**16.1**	**14.8**	**13.1**	**13.4**
C/A deficit	0.5	-1.0	-0.9	-0.3
Amortization of medium to long term debt	5.5	6.2	4.7	5.0
Government/central bank	0.3	1.2	0.3	1.0
Banks	0.8	0.8	0.8	0.7
Corporates	4.4	4.2	3.7	3.3
Short term debt amortization	10.1	9.7	9.3	8.7
Financing	**16.1**	**14.8**	**13.1**	**13.4**
FDI	1.2	1.0	1.2	1.4
Portfolio flows	-0.9	-0.9	0.6	0
Borrowing	6.9	5.6	6.2	4.3
Government/central bank	1.3	0.7	2.2	0.6
Banks	0.8	0.7	0.5	0.5
Corporates	4.7	4.2	3.5	3.3
Short term	9.7	9.3	8.7	8.2
EU transfers	1.0	1.3	1.2	1.3
Other	0.3	-1.5	-3.4	-1.1
Change in FX reserves	-2.2	0.1	-1.2	-0.7

Source: BNB, MinFin, UniCredit Research

Croatia (Ba1 stable/BB+ negative/BB+ stable)*

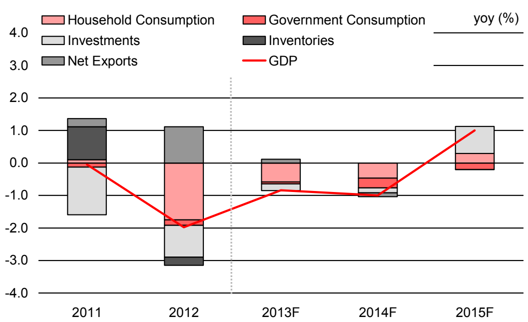
Outlook – The prolonged weak economic performance is reflected in unchanged forecasts for both 2013 and 2014, with GDP growth at -0.8% and -1.0% yoy, respectively. Lack of reforms and a widening fiscal gap are increasing the drag on the rest of the economy. Therefore, entry into the excessive deficit procedure (EDP) in the coming months will provide a much-needed fiscal anchor. As long as Croatia maintains market access, this will help it avoid an IMF program, but the government's focus will have to be well beyond a headline deficit number, and towards re-building a viable growth model for the economy, including a comprehensive overhaul of public finances.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

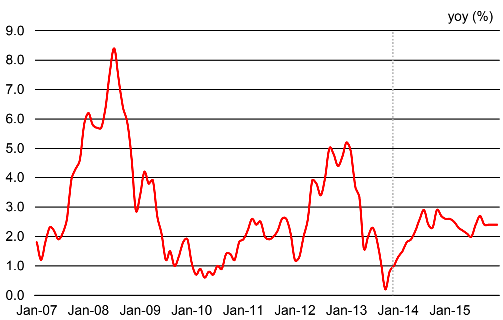
KEY DATES/EVENTS

- 30 December: BoP for 3Q and foreign debt for 3Q
- 10 February: Redemption of domestic FX linked bond issue – EUR 650mn
- 10 February: First results – Foreign trade in 2013
- 11 February: Tourism in 2013
- 28 February: GDP flash estimate 4Q 2013 and FY 2013
- 26 March: First results – Labor Force Survey 4Q and FY 2013

GDP GROWTH



INFLATION OUTLOOK



Source: IMF, MinFin, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	44.4	43.9	44.3	45.0	46.8
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	10,089	10,007	10,103	10,300	10,745
Real economy yoy (%)					
GDP	0	-2.0	-0.8	-1.0	1.0
Private Consumption	0.2	-3.0	-1.0	-0.8	0.5
Fixed Investment	-7.2	-4.6	-1.0	-0.7	4.0
Public Consumption	-0.3	-0.8	-0.3	-1.5	-1.0
Exports	2.0	0.4	-1.9	-0.5	3.4
Imports	1.2	-2.1	-2.1	-0.2	3.3
Monthly wage, nominal (EUR)	1,049	1,048	1,050	1,060	1,084
Unemployment rate (%)	13.5	15.8	17.2	17.5	16.8
Fiscal accounts (% of GDP)					
Budget balance	-7.8	-5.0	-5.7	-6.2	-5.3
Primary balance	-5.5	-2.3	-2.5	-2.7	-1.7
Public debt	51.6	55.5	61.9	65.3	68.5
External accounts					
Current account balance (EUR bn)	-0.4	0	0	0.1	-0.3
Current account balance/GDP (%)	-0.9	0.1	0.1	0.2	-0.6
Basic balance/GDP (%)	1.6	2.7	2.6	2.8	2.2
Net FDI (EUR bn)	1.1	1.2	1.1	1.2	1.3
Net FDI (% of GDP)	2.4	2.7	2.5	2.6	2.8
Gross foreign debt (EUR bn)	45.9	44.8	46.6	47.1	48.7
Gross foreign debt (% of GDP)	103.3	102.1	105.4	104.7	103.8
FX reserves (EUR bn)	11.2	11.2	11.8	12.8	13.4
Inflation/Monetary/FX					
CPI (pavg)	2.3	3.4	2.3	2.2	2.3
CPI (eop)	2.1	4.7	1.0	2.6	2.4
1W money market rate	1.28	1.39	0.70	0.90	1.30
USD/HRK (eop)	5.66	5.71	5.63	5.39	5.17
EUR/HRK (eop)	7.53	7.55	7.60	7.55	7.50
USD/HRK (pavg)	5.31	5.85	5.73	5.50	5.30
EUR/HRK (pavg)	7.43	7.52	7.57	7.53	7.48

Source: UniCredit Research

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

Excessive Deficit Procedure as a fiscal anchor

GDP decline continues as growth drivers are still missing

GDP growth remains on a downward path. We expect a GDP contraction of 0.8% in 2013. EU accession and ongoing recovery in the EMU were insufficient to reverse the trend. During the summer months, tourism contributed to the economy in line with its capacity, while retail sales finally recorded a period of a growth. However, construction, industrial production and exports of goods continued to weaken, with unemployment expected to surge towards the end of year. Investment in fixed assets recorded a modest recovery, driven by increased public spending due to local and regional elections which extended well into the summer. However, there are still no signs of a private investment revival. Improvements in the business environment has remained limited due to non-coordinated regulatory and tax policy changes. This translated into a poor rating for Croatian competitiveness in the field of institutional and regulatory setting. In addition, reforms are necessary in health care, education, public and local utilities sector. Delay in reforms leads to downside risks in terms of attraction of investment and GDP recovery. It also affected our expectations of both exports and imports forecasts for 2014. Namely, despite we see a strong recovery in EMU countries, Croatian exports of goods potential remains very limited as industry is experiencing a challenging restructuring process while Croatia, becoming an EU member, exited CEFTA and saw decline of exports, especially in agriculture and food processing industry. Exports of services will continue to expand, but requires bigger investments to raise capacities and growth potential. Therefore, we continue to expect a GDP decline of 1% in 2014, followed by a mild recovery in 2015. An increase in public investment, supported by improved EU funding absorption and continued growth in Croatia's main export markets should be exploited by sectors currently affected by restructuring.

Implementation of reforms remains a necessary precondition to re-build business confidence

European Commission announced its intention to recommend EDP activation for Croatia

Fiscal outlook: One of the biggest risks for the Croatian economy is linked to the sustainability of public finances. This topic dominates discussion as the government presented a large 2013 budget revision and 2014 budget draft. The European Commission announced that it intends to recommend activation of Excessive Deficit Procedure for Croatia, which will first undergo a deeper review in line with Europe's budgetary surveillance package. Eurostat released the ESA95 aligned data for Croatia for 2012 with the general government deficit and public debt at 5.0% and 55.5% of GDP, respectively. The 2013 budget revision acknowledged the widening deficit during 2013 to the amount of up to 5.7% of GDP. Forecasted revenues have been reduced by 2.5% versus the previous plan, while expenditures have been increased by 2.6%. Compared to the plan from March, the central government deficit was increased by almost 60% (to 5% of GDP from the target set at 3%). This resulted in rising funding needs for the government in 2013. With such a burden, public debt is climbing above the 60% level. The 2014 budget proposal, based on expectations of an economic recovery, does not bring any change to recent developments. It envisages a further increase in expenditures by 3%, alongside revenues increasing by a modest 2%, resulting in a widening deficit, possibly above 6%. We are currently not aware of recommendations within the EDP mechanism which could impose firmer austerity measures. The widening deficit increases funding needs for the government, hence raising pressure on funding costs for the whole economy. As the capacity of domestic financial markets is limited, Croatia tapped the international market in November 2013 by issuing a 10-year USD 1.75bn bond, claiming it belongs to the pre-financing activities of increased 2014 funding needs. The debt redemption profile for 2014 is already demanding, while a widened deficit will require further government borrowing in international markets. If market access were to become difficult, it could mean discussions on an IMF program become a viable option.

Government will enter a challenging period to finance its debt redemption requirements and widening fiscal gap

Credit rating deterioration is reflected in increasing funding costs in international markets

Rating outlook: The Croatian credit rating is now set at one notch below investment grade, meaning further risks to stability if the medium-term consolidation strategy would further impair public debt sustainability.

Czech Republic (A1 stable/ AA- stable/A+ stable)*

Outlook – A more constructive economic environment in Europe and a rebound in the automotive industry are expected to bolster the Czech economy in 2014. A weaker CZK and fiscal stimulus may be of partial help as well. Domestic demand will lag external demand. The CNB will likely keep its EUR/CZK intervention floor level unchanged at 27.0 until mid-2015, maybe longer. The first repo rate hike may be synchronized with the ECB's, coming in 2H15.

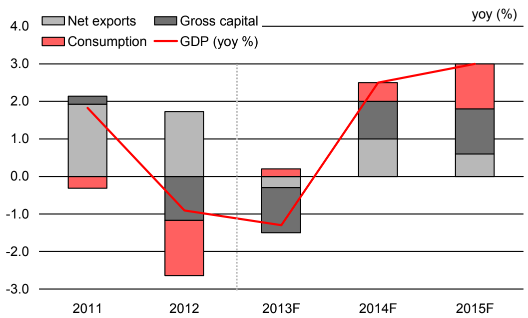
Strategy outlook – Excess of CZK liquidity, created by FX intervention, is pushing down CZK yields across the curve. Higher inflation expectations will cause short-end curve steepening.

Authors: Pavel Sobisek, Chief Economist (UniCredit Bank)
Patrik Rozumbersky, Economist (UniCredit bank)

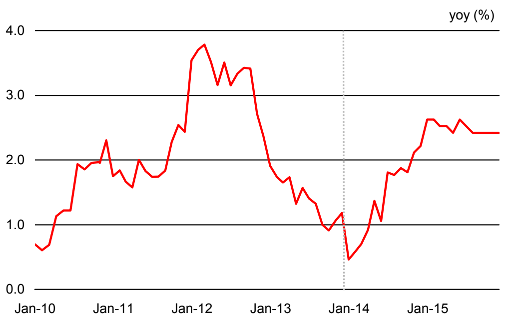
KEY DATES/EVENTS

- CNB policy meetings - early Feb, late March
- Manufacturing PMI – Jan 2, Feb 3, March 3
- State budget draft approval – late Dec or Jan

ALL GDP COMPONENTS TO CONTRIBUTE TO 2014 GROWTH



INFLATION TO ACCELERATE IN 2H14



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	155.4	153.0	148.4	148.0	155.8
Population (mn)	10.5	10.5	10.5	10.5	10.5
GDP per capita (EUR)	14,804	14,557	14,111	14,072	14,813
Real economy yoy (%)					
GDP	1.8	-0.9	-1.3	2.5	3.0
Private Consumption	0.5	-2.1	-0.3	0.8	2.1
Fixed Investment	0.4	-4.3	-5.0	1.7	4.5
Public Consumption	-2.7	-1.9	1.8	1.0	1.0
Exports	9.6	4.7	-0.2	7.2	6.9
Imports	7.0	2.5	0.2	6.6	7.0
Monthly wage, nominal (EUR)	995	999	972	954	992
Unemployment rate (%)	6.7	6.8	7.7	7.8	7.3
Fiscal accounts (% of GDP)					
Budget balance	-3.2	-4.4	-2.5	-2.9	-2.9
Primary balance	-1.9	-2.9	-1.0	-1.3	-1.3
Public debt	41.4	46.2	47.4	48.3	48.8
External accounts					
Current account balance (EUR bn)	-4.2	-3.7	-0.7	-0.4	-0.8
Current account balance/GDP (%)	-2.7	-2.4	-0.5	-0.3	-0.5
Basic balance/GDP (%)	-1.5	2.3	0.7	1.8	1.6
Net FDI (EUR bn)	1.9	7.2	1.7	3.1	3.3
Net FDI (% of GDP)	1.2	4.7	1.2	2.1	2.1
Gross foreign debt (EUR bn)	72.8	77.2	75.7	80.9	85.7
Gross foreign debt (% of GDP)	46.8	50.5	51.1	54.7	55.0
FX reserves (EUR bn)	31.1	34.0	42.0	42.0	42.0
Inflation/Monetary/FX					
CPI (pavg)	1.9	3.3	1.4	1.4	2.5
CPI (eop)	2.4	2.4	1.2	2.2	2.4
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	0.75	0.05	0.05	0.05	0.50
3M money market rate	1.19	1.00	0.46	0.40	0.50
USD/CZK (eop)	19.40	19.04	20.15	19.43	18.76
EUR/CZK (eop)	25.80	25.14	27.20	27.20	27.20
USD/CZK (pavg)	17.56	19.55	19.70	19.85	19.29
EUR/CZK (pavg)	24.59	25.14	26.00	27.20	27.20

Source: UniCredit Research

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

Stronger exports central to recovery

External environment to be supportive, FX interventions to help marginally in 2014

A more constructive environment in Europe and a cyclical rebound in the automotive industry are expected to bolster the Czech economy in 2014. The domestic environment is to be shaped by the new, post-intervention currency regime. We find the interventions to be GDP-supportive at the margin and, importantly, game-changing in terms of the growth structure. It will also overshadow 2014 policy changes of a new government just being formed. Fiscal stimulus is going to be of significance but a deeper policy overhaul will arrive no earlier than 2015.

Weaker CZK to bolster exports but curb private spending; the new currency regime to remain in place even after the initial shock fades

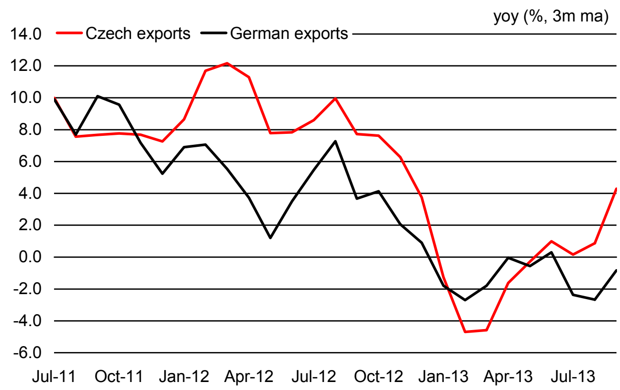
In our estimate the CNB (verbal and market) interventions have moved EUR/CZK up 8%. The CNB commitment to keeping EUR/CZK at or above 27.0 over the period of at least 18 months (which we regard as credible) makes our forecast of CZK nominal effective FX rate weaker by 6% for 2014 on annual average. This is set to boost export profits but also reduce real household income via higher inflation, the key result being a shift in the demand structure in favor of an external component. The overall impact of a weaker CZK on 2014 GDP is seen as positive but probably to a lesser extent than predicted by the CNB (+0.6 p.p.). However, the currency regime will remain in place even after the initial economic shock fades. The quasi-fixed EUR/CZK rate is something completely new for the general public, which may have a number of consequences. Most importantly, we expect them to react by revising up their inflation and nominal wage expectations for 2015.

3Q GDP contraction not consistent with improving short-term indicators

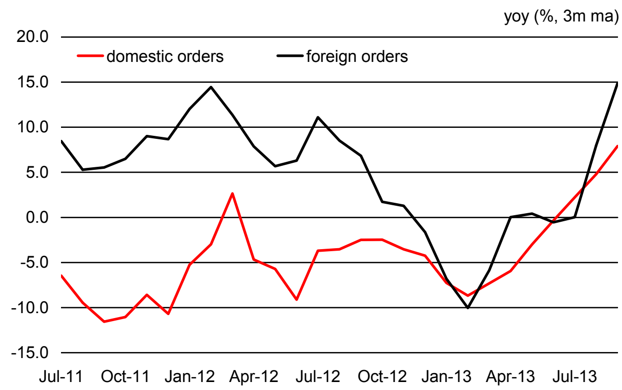
Meanwhile, sequential GDP data for 1Q13 to 3Q13 have been marked by surprising volatility (-1.4%, +0.5%, -0.1%). Apparently, the swings contradict short-term and leading indicators which pointed to an ongoing recession in 2Q, but a gradual recovery in economic activity since mid-2013. The recent high-frequency data have also signaled that GDP will resume positive qoq growth in 4Q. The boost seems to be coming from both GDP components which are key for the economic recovery – export-reliant industry and household consumption. Within industry, car production was a main driver of a resurgence of total manufacturing output, benefitting from a combination of stronger demand for cars in Europe and the kick-start of new Skoda Auto models. Overall, external demand was again crucial, with growth of direct export sales significantly outpacing domestic sales. The substantial pick-up of domestic new orders, tracking those from abroad (see chart below), suggests that the industrial recovery might soon become broader-based. Moreover, the manufacturing PMI rose to 55.4 in November, the highest level since May 2011, opening up room for further gains in industrial production ahead.

EXTERNAL DEMAND IS PICKING UP NICELY

Czech exports are expanding again, overtaking Germany



Both export and domestic industrial orders are accelerating



Source: DataStream, CZSO, UniCredit Research

Improving consumer sentiment to be dragged down by CNB FX interventions

Unlike manufacturing, the revival of household spending proved to be less pronounced. The pick-up of retail sales over 3Q was mainly attributable to higher sales in the auto segment, while stabilization of sales in a core segment appeared consistent with a continuation of flat household spending in 3Q yoy. Going forward, a further improvement in the November consumer confidence index to the highest level since end-2010 bodes well for consumption to resume yoy growth in 4Q (see chart below). Stabilizing unemployment, expected for 1H14, should be supporting consumer sentiment further. However, the CNB's FX interventions are seen as a drag from December on. Whether and when they will also reduce actual spending remains to be seen, as households may react by moving forward their spending before imported goods become more expensive. On balance, we assume that more robust Christmas shopping may contribute to 4Q GDP reaching a hefty 1.0% qoq, but in 1Q14, a more cautious approach of consumers will prevail.

Inflation is set to hit a trough as low as 0.5% yoy in January before past FX interventions become a leading a factor

Indeed, lessons learnt from the recent past suggest that private consumption reacts sensitively to a boost in inflation in the pipeline. This time around, this appears to be relevant from 2H14 onwards. Following a drop in inflation to a 3.5-year low of 0.9% yoy in October, the low base and the first wave of FX intervention effects will likely lift CPI back above the 1% level by end-2013. In January, we expect the fading tax effects from 2013 and lower energy prices to bring inflation to as low as 0.5%. Afterwards, past FX intervention will become a leading factor again, gradually pushing yoy inflation above the CNB's 2% target. Admittedly, the 2014 average inflation rate is unlikely to differ much from that expected for 2013 (1.4%). Stabilization of food prices after a good 2013 harvest and a persisting lack of demand-driven pressures are contain any increase.

Capital spending to first involve a reversal in inventory rundown, only later fixed investment

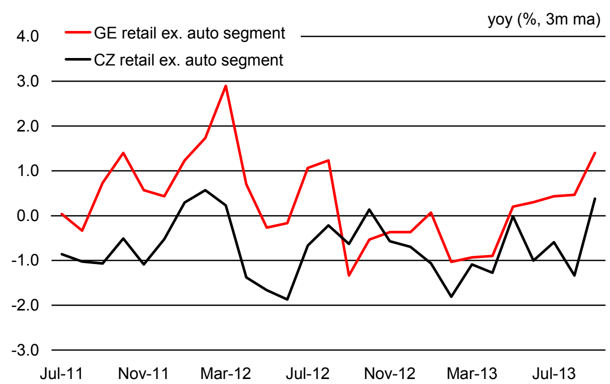
As to capital spending, we foresee some stabilization but no fast track in 2014. On a positive note, improvements in business sentiment are believed to lead corporations to reverse the persisted inventory rundown. However, slack in the economy will keep them more reserved as regards new fixed capital, where we expect investment to start picking up only from 2H14. Overall capex will in addition be influenced by government policy. The 2014 state budget deficit has already been fixed at CZK 112bn, up from the CZK 100bn planned for 2013. This will allow fiscal policy to support GDP growth by 0.5 p.p. in 2014, when also taking into account that not all of the capital spending budgeted for 2013 may actually materialize before end-2013.

27/EUR to remain until 2H15, CNB could move in sync with ECB

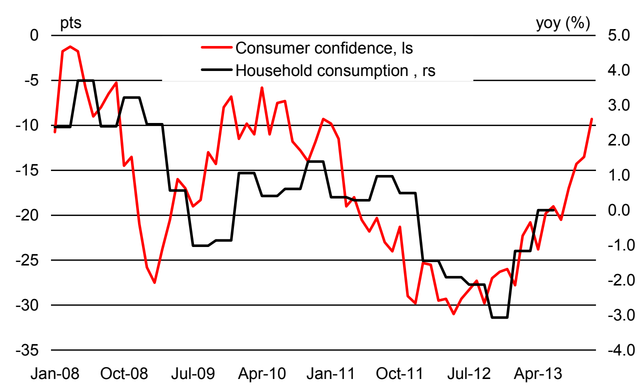
The CNB will likely keep its EUR/CZK intervention floor level unchanged at 27.0 until mid-2015, maybe longer. We don't expect the level to be moved further up. An exit strategy from the adopted currency regime remains unclear and surely difficult to pursue. Being aware of this, the CNB may opt to delay the exit even after the need arises to tighten monetary conditions. A hike to the repo rate synchronized with the ECB is an option, with the first step coming in 2H15.

HOUSEHOLD DEMAND IS STILL LAGGING BEHIND

Retail sales are clearly picking up in Germany but stagnating at best in Czech



Private consumption seen growing in 4Q; CZK weakening may render this short-lived



Source: CZSO, UniCredit Research

Strategy: Short end to steepen, long end to stay stable

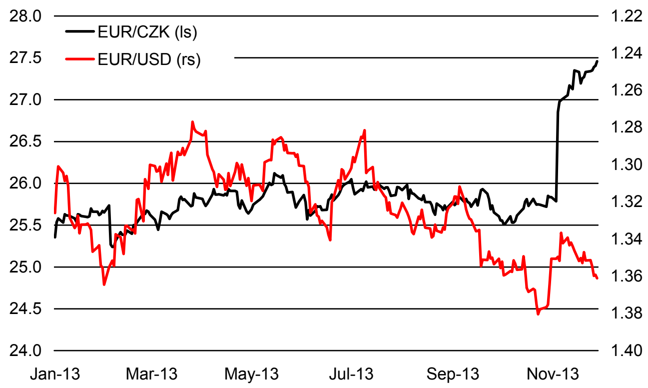
Excess of CZK liquidity, created by the FX interventions, is pushing down CZK interest rates across the curve

We look for the short-end of the CZK curve to steepen to reflect rising inflation expectations after the central bank intervened to weaken the currency. We choose to express the view through paying 1y1yfwd (entry 0.58%; initial target 0.90%, stop 0.25%)

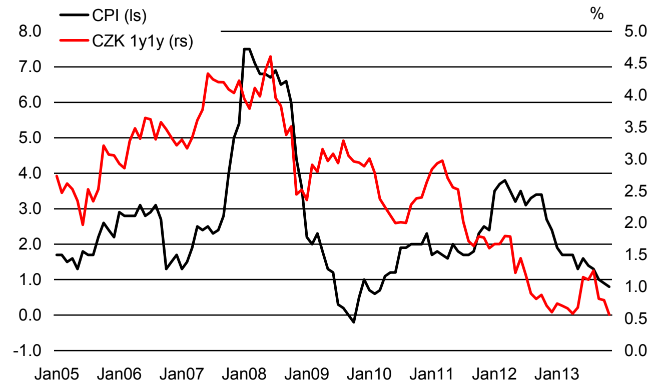
Firstly, excess CZK liquidity has continued to weigh on money-market rates. FX-implied yields are actually negative. Secondly, markets should begin to price in the pass-through of a weaker currency into higher future inflation and the short end of the curve should steepen to reflect rising inflation expectations.

As for the long end of the curve, we note that 5s10s is already the steepest it has ever been and FX intervention is unlikely to matter for that segment of the curve. However, we will probably see further steepening in 5s10s on tapering.

The CNB (verbal and market) interventions have pushed EUR/CZK 8% higher to date



CZK 1y1y and YoY CPI inflation



Sources: CNB, Bloomberg, UniCredit Research

Author: Gaurav Saroliya, Senior CEE Strategist (UniCredit Bank London)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**8.9**	**9.2**	**9.2**
Budget deficit	3.9	3.4	2.9
Amortization of public debt	5.0	5.8	6.3
Domestic	4.5	5.4	5.8
EIB loans	0	0.1	0.1
Other	0.4	0.4	0.4
Financing	**8.9**	**9.2**	**9.2**
Domestic borrowing	4.0	7.3	7.4
Bonds	6.5	7.3	7.4
Bills	-2.5	0	0
External borrowing	0.9	1.8	1.8
Bonds	0.9	1.8	1.8
EIB/IMF	0	0	0
Change of cash reserve	4.0	0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**10.2**	**9.9**	**5.9**
Banks	0.8	0.7	0.7
Government and central bank	1.6	3.8	1.4
Other sectors	7.8	5.4	3.9
Financing			
Banks	**10.2**	**9.9**	**5.9**
Government and central bank	4.6	2.2	1.3
Multilateral institutions	0	0	0
Companies	0.7	0.8	0.8
Other investors	2.3	1.9	0.7

Source: UniCredit Research

Hungary (Ba1 negative/BB negative/BB+ stable)*

Outlook – Public policies aim to boost consumption and help exporters and SMEs. So far, interventionist policies paid off, with broader-based GDP growth in 3Q13 and a recovery of fixed investment. The positive impact is expected to continue in election year 2014. Further rate cuts (at least to 2.50%) and HUF depreciation in 2H14 will also help growth. But a larger reliance on state policies to increase the GDP will cap potential growth due to limited scope for higher public spending.

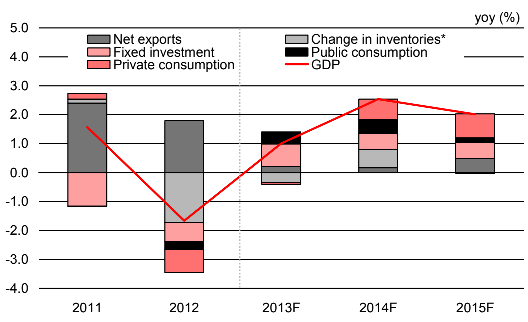
Strategy – We prefer the short end of the HGB curve to the long end in a tapering-risk scenario, but we see value returning in long-end HGBs once the initial impact of the taper shock is over. In REPHUNS, we like EUR Jan2019s relative to USD Jan2020s. We expect HUF to underperform PLN near term and look to achieve our initial target of PLN-HUF 73.000.

Author: Dan Bucşa, Economist (UniCredit Bank London)

KEY DATES/EVENTS

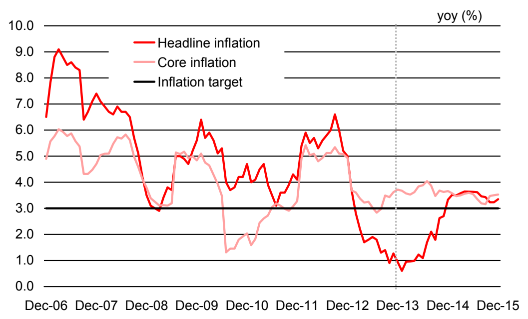
- NBH rate meetings: Dec 17th, Jan 21st, Feb 18th, Mar 25th
- 1H14: solution for converting FX mortgage bonds to HUF
- Apr-May 2014: general elections

GDP DRIVERS



*Adjusted for statistical error

HEADLINE INFLATION VS. TARGET



Source: CSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	99.9	97.6	98.4	101.0	104.2
Population (mn)	10.01	10.00	10.00	10.00	9.99
GDP per capita (EUR)	9,975	9,762	9,845	10,101	10,435
Real economy yoy (%)					
GDP	1.6	-1.7	1.0	2.5	2.0
Private Consumption	0.4	-1.9	-0.1	1.4	1.7
Fixed Investment	-3.6	-3.8	4.4	3.0	3.0
Public Consumption	-0.3	0	1.9	2.2	0.7
Exports	6.3	2.0	4.6	5.6	5.4
Imports	5.0	0.1	5.0	6.1	5.5
Monthly wage, nominal (EUR)	763	771	778	782	792
Unemployment rate (%)	10.9	11.0	10.1	9.8	9.6
Fiscal accounts (% of GDP)					
Budget balance	4.3	-1.9	-2.9	-2.9	-2.9
Primary balance	-2.8	2.1	1.0	1.1	1.1
Public debt	81.6	79.8	81.7	82.5	79.9
External accounts					
Current account balance (EUR bn)	0.8	1.7	2.1	1.8	1.9
Current account balance/GDP (%)	0.8	1.7	2.1	1.8	1.8
Basic balance/GDP (%)	3.2	4.4	4.8	4.9	4.1
Net FDI (EUR bn)	0.7	2.0	0.3	0	-0.4
Net FDI (% of GDP)	0.7	2.1	0.3	0	-0.4
Gross foreign debt (EUR bn)	131.7	131.2	127.5	124.7	122.0
Gross foreign debt (% of GDP)	131.9	134.4	129.5	123.5	117.0
FX reserves (EUR bn)	37.8	33.9	33.0	31.5	31.5
Inflation/Monetary/FX					
CPI (pavg)	3.9	5.7	1.7	1.6	3.3
CPI (eop)	4.1	5.0	0.9	3.3	3.0
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	7.0	5.75	3.0	2.5	3.5
3M money market rate	6.2	7.0	4.3	2.7	3.5
HUF/USD (eop)	240.7	220.9	222.2	217.4	224.6
HUF/EUR (eop)	311.1	291.3	300.0	308.0	315.0
HUF/USD (pavg)	201.1	225.1	224.4	217.4	221.0
HUF/EUR (pavg)	279.3	289.3	297.0	305.2	310.6

Source: CSO, NBH, UniCredit Research

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

Stronger domestic demand, higher macro vulnerability

Public policies help consumers (and the government's election chances)…

Public policies continue to favour voters, who seem to be responding accordingly. While the outcome of the general elections (to be held in April-May 2014) seems more and more certain, the plethora of measures aimed at pleasing households is getting larger by the month. After a flat personal income tax (PIT), public employment schemes, minimum wage hikes, higher household subsidies, price cuts for electricity, gas and utilities, and measures aimed at reducing the debt service for households, the government mulls the same kind of policies going forward, albeit with a more radical tinge: a non-profit utilities sector, a definitive solution to the FX mortgage lending problem, a flat PIT below 10%.

…but also support exporters and SMEs…

Exporters and SMEs also receive government support. The former enjoy bilateral agreements that probably reduce their tax burdens and shield them from regulatory surprises. In June, the government launched the Funding for Growth Scheme (FGS), aimed at boosting lending to SMEs and at reducing their FX exposure. The FGS had no effect on the volume of outstanding loans because falling FX lending offset new HUF lending. But the FGS had several qualitative effects: longer average maturity and higher size of SME loans, lower borrowing costs, FX risk and NPLs. Yet the central bank overestimates the impact of the FGS on 2014 growth, since SMEs can't absorb additional funding of 6.5% of GDP in just one year[4].

…resulting in better domestic demand

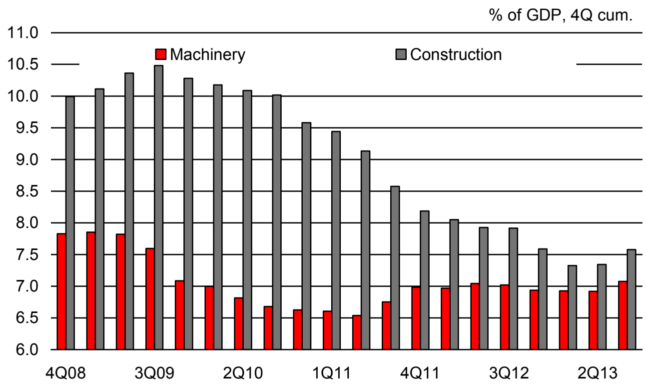
The larger economic interventionism has a positive short-term impact. The decline of private consumption stopped in 2Q13 and 3Q13. Higher nominal wages, falling inflation and lower debt service pushed consumer confidence to the highest level in three years. In addition, private fixed investment[5] recovered to +9.6% yoy in 3Q13 on the back of the FGS[6]. Private consumption is expected to accelerate to 1.4% yoy in 2014 due to pre-election spending and to grow by 1.7% yoy in 2015. Fixed investment might drag on growth from 2H14 onwards, due to no new large investment projects and possible disinvestment in services.

The scope of growth-boosting public policies is limited…

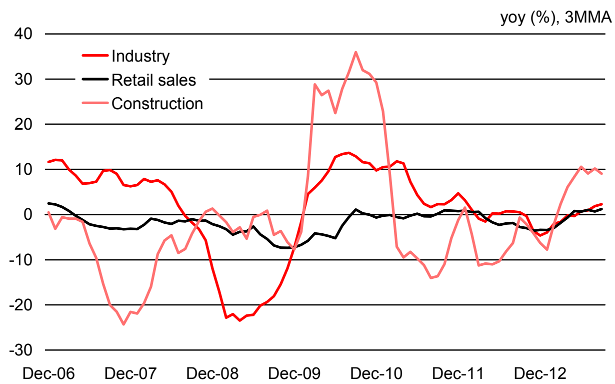
…meaning that growth is unlikely to recover sustainably

Interventionist policies can't be expanded for long due to limited fiscal space. Public spending and consumption are at 50% of GDP and 20% of GDP respectively, both being the highest in CEE. Ad-hoc sectoral taxes reduced the scope for additional taxation. Moreover, the government mulls taking over companies (with potential targets in services and metallurgy), thus threatening the sustainability of budget deficits and capping the government's support for the economy in the medium term. We believe that the budget deficits will remain close to 3% of GDP, but the debt to GDP will hover at 80%. Even though growth could accelerate to 2.5% in 2014, it is expected to return to 2% in 2015, since the current structure of growth drivers keeps potential GDP growth below 2%.

Investment recovered in 3Q13 boosted by FGS and public spending



The economic recovery is more broad-based than in 1H13



Source: National Statistic Office, AKK, NBH, UniCredit Research

[4] Please see the Country note "Hungary – Assessing the impact of the Funding for Growth Scheme" published on 9 December 2013.
[5] Industry, agriculture and private sector services. Constructions are not included, since currently most fixed investments come from the public sector.
[6] Nevertheless, fixed investment between 4Q12 and 3Q13 remained 11.5% below the 2008 level (-21.5% in EUR).

The HUF is well supported by BoP flows…

Balance of payments (BoP) flows will support the HUF into 1H14. Export performance will help accelerate economic growth in 2H13 and 1H14 amid recovering demand from Europe and a large positive base effect (Germany's soft patch weighed on export growth in 4Q12). Net exports grew 7.9% yoy in 3Q13 after having a -1.4pp negative contribution to GDP growth in 2Q13. Our expectations of strong demand from Germany and the euro area periphery bode well for Hungarian exports in 2014 (+6.2% yoy) and 2015 (+6.1% yoy).The basic balance[7] exceeded 7% of GDP in 2Q13 (4Q cumulated data), but bank deleveraging subtracted 6.7% of GDP. Nevertheless, the deleveraging slowed down to 4.4% of GDP at the end of September, while the trade surplus widened again. Strong export momentum in 4Q13 helped the HUF appreciate below EUR-HUF 300 in September – November.

…due to resurging exports…

…but support will decline once a definitive solution to FX mortgage loans is found before elections

A comprehensive solution to FX mortgage loans, expected before elections in 1H14, might re-accelerate the deleveraging process. A gradual approach seems the most likely outcome and might include several elements, e.g. broadening the usage of the FX cap/buffer account scheme and increasing the margin ceiling with banks. Banks, households and the government could share in the burden. Banks might seek a government-backed solution to rising NPLs, combining currency conversion, haircuts and tax relief for restructured loans.

The HUF is expected to depreciate gradually…

While an FX loan conversion will be HUF-positive, **we expect the currency to depreciate after elections, touching EUR-HUF 315 in 2015**. The reasons are: lower BoP support due to rising imports and weak FDI, the negative cross-currency basis[8] and Hungary's loss of external competitiveness – evident in the declining share in world and CEE exports – which clashes with the government's industry-driven growth strategy. Government financing requirements of 18% of GDP in 2014 reduce the price sensitiveness of Hungarian authorities and threaten the HUF amid tapering expectations. After a negative initial reaction to tapering, high yields are likely to support HGBs, although this remains the steepest curve in the region. External redemptions of EUR 5.3bn (5.2% of GDP) and government FX reserves of EUR 3.1bn in November mean that Hungary will borrow in FX at least EUR 3bn in 2014.

…while the issuance schedule will remain busy

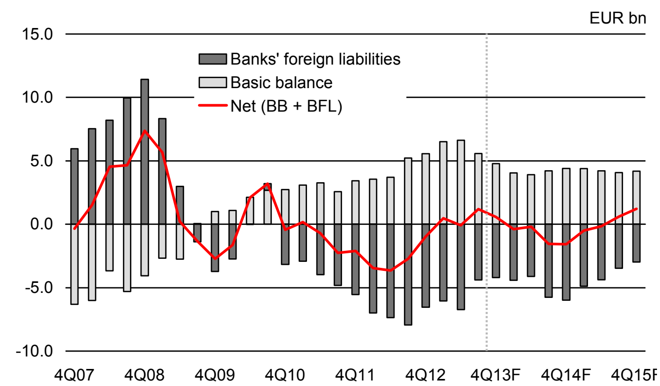
Rate cuts are likely to continue at least to 2.50%...

The monetary policy easing cycle could continue in 2014, aiming at first for 2.50% in steps of 10bp, but remaining flexible on the pace and end of rate cuts. Advantages such as a strong anchor for the short end of the HGB curve, lower lending rates and FGS costs offset the potential negative impact on the HUF of the shrinking carry. Inflation will probably remain below the medium-target of 3% until November 2014 due to another price cut for energy, gas and/or utilities in 1H14, supporting further cuts. In case of a drastic worsening of risk appetite, the NBH will have to hike aggressively to defend the HUF, but this is not our baseline scenario in 1H14. After elections, the domestic costs of depreciation will be much lower, since, by then, most of the FX risk of unhedged borrowers (local administration, SMEs, households) will be covered.

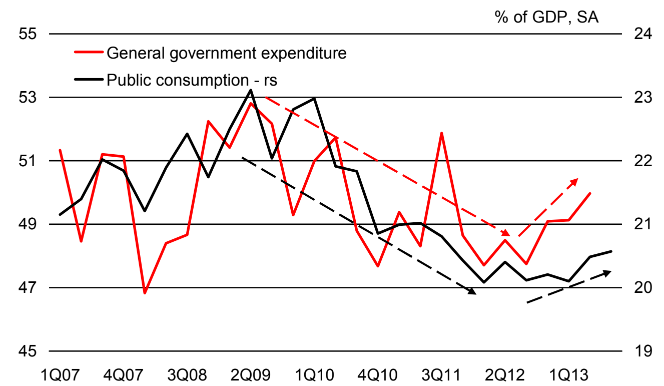
…since they help the NBH and the government…

…and HUF depreciation won't be a concern after elections

The HUF will receive less support from the basic balance in 2014



General government expenditure rises again before elections



Source: National Statistics Office, AKK, NBH, UniCredit Research

[7] Basic balance = current account surplus + foreign direct investment + EU fund inflows + positive errors and omissions position in the BoP
[8] While the cross-currency basis might narrow after the FX loan conversion, it will probably remain more negative than in other CEE countries.

Strategy: Steeper curve near term, but post-taper value

The HGB curve is a natural steepener in a tapering risk scenario…

…but the long end will look attractive once the tapering starts

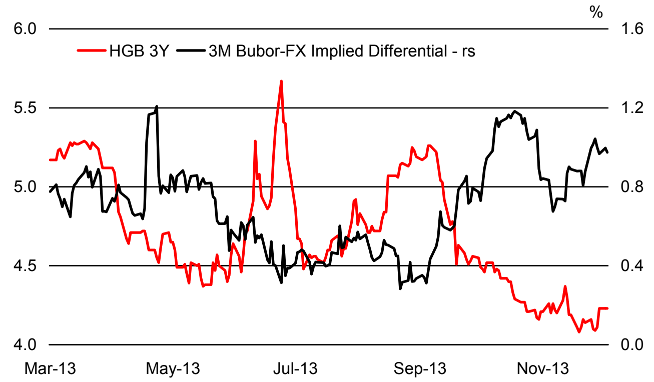
We prefer EUR over USD REPHUNS…

…and the PLN over the HUF

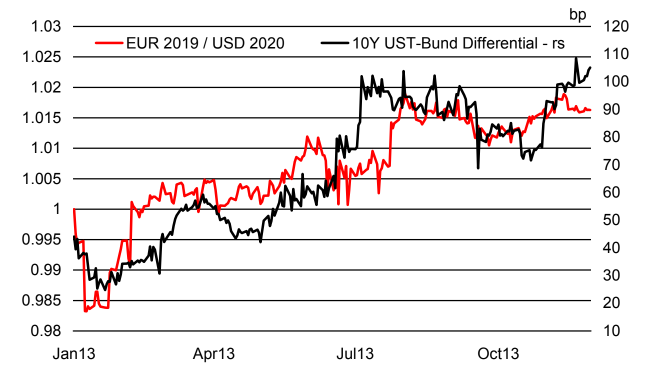
In HGBs, we prefer the short end to the long end given excess short-end liquidity, ongoing policy easing and a high beta to global financial conditions. We argued over recent weeks that Hungary is the most natural steepener in a tapering-risk scenario. However, we see value returning in long-end HGBs once the initial impact of the taper shock is over. Over November, the 10-year HGB yield has already risen by around 60bps to above 6%, while 10-year UST has risen by only 17bps (the rises in the two series since May 22 is 106bps and 75bps respectively). So the recent rise in the 10-year HGB looks higher relative to its beta to UST. We believe a move up to the 7% level will represent good value and attract overseas investors back to the long end once markets have absorbed the initial sharp rise in UST yields. **In REPHUNS, we would recommend being overweight the belly of EUR paper (Jan2019s) relative to USD paper (Jan2020s)**, as our G10 rates strategists are looking for UST-Bund differential to widen further by 30bps.

We expect HUF to underperform PLN near term and look to achieve our initial target of PLN-HUF 73.000. Longer term, we see PLN-HUF moving beyond the 74 handle, with a move up to 75 likely, as we expect rates differentials to turn decisively in favour of PLN.

Higher liquidity and dovish policy will drag short-end HGB yield lower



REPHUN Jan19 EUR to outperform REPHUN Jan2020 USD



Source:Bloomberg, UniCredit Research

Author: Gaurav Saroliya, Senior CEE Strategist (UniCredit Bank London)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**18.1**	**18.2**	**16.1**
Budget deficit	2.9	2.9	3.0
Amortization of public debt	15.2	15.2	13.1
Domestic	9.5	9.2	10.8
Bonds	3.8	3.2	5.7
Bills	5.7	6.0	5.1
Other	3.4	0.8	0.2
External	2.4	5.2	2.1
IMF/EU and other loans	0.9	2.5	0.2
Bonds	1.4	2.7	1.9
Financing	**18.1**	**18.2**	**16.1**
Domestic borrowing	14.2	14.5	12.6
Bonds	5.6	5.8	5.7
Bills	8.6	8.7	6.9
External borrowing	3.5	3.7	3.5
Bonds	3.5	3.0	3.0
Other	0	0.7	0.5
Pension funds	0.4	0	0

Source: AKK, IMF, NBH, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**31.6**	**31.7**	**24.6**
C/A deficit(+)/ surplus(-)	-2.1	-1.8	-1.8
Amortisation of medium to long term debt	11.0	13.5	7.7
Government/central bank	6.8	8.4	4.1
Banks	2.8	2.9	1.8
Corporates	1.4	2.1	1.8
Amortisation of short term debt	22.6	20.0	18.7
Government/central bank	5.6	4.5	4.3
Banks	10.7	8.5	7.3
Corporates	6.3	7.0	7.2
Financing	**31.6**	**31.7**	**24.6**
FDI	0.3	0	-0.4
Equity	0.8	-0.4	-0.3
Long-term borrowing	6.7	8.7	5.6
Government/central bank	3.2	4.0	2.5
Banks	2.3	2.6	1.5
Corporates	1.2	2.0	1.6
Short-term borrowing	20.0	18.7	17.2
Government/central bank	4.5	4.3	4.1
Banks	8.5	7.3	6.3
Corporates	7.0	7.2	6.8
EU transfers	2.8	3.2	2.5
Change in FX reserves (reduction(+)/increase(-))	0.9	1.5	0

Source: AKK, IMF, NBH, UniCredit Research

Poland (A2 stable/A- stable/A- stable)*

Outlook – The recovery in activity should continue to gain momentum, supported by stronger domestic demand while exports remain buoyant on the back of rising orders from abroad. Since the domestic demand recovery will be gradual, inflationary pressure should be well contained, with headline inflation close to the National Bank of Poland (NBP) target of 2.5%. The Monetary Policy Council (MPC) may prolong the period of policy rate stability until end-2014. Changes to the pension system will generate a one-off surplus of the general government and permanently reduce the public debt by about 9%.

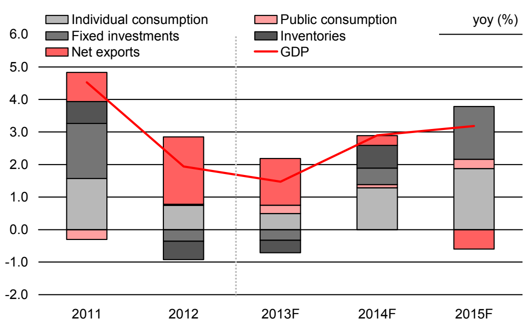
Strategy outlook – Strong cyclical activity is a flattening impulse, but tapering will likely cause near-term steepening. Zloty will outperform regional peers as well as EUR.

Author: Marcin Mrowiec, Chief Economist (Bank Pekao)

KEY DATES/EVENTS

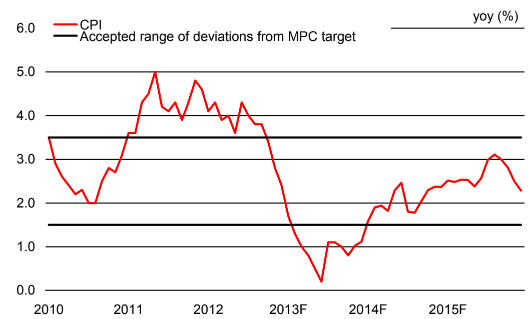
- Mid-December 2014 – Parliament to vote on changes to the pension system
- February 3 – 51.5% of Open Pension Funds (OFE) assets to be transferred to Social Security Enterprise (ZUS)Apr-May 2014: general elections
- MPC decision-making meetings 7-8 Jan, 4-5 Feb

GDP DRIVERS



*Adjusted for statistical error

HEADLINE INFLATION VS. TARGET



Source: StatOffice, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	370.9	381.2	389.5	420.6	455.2
Population (mn)	38.1	38.1	38.1	38.0	38.0
GDP per capita (EUR)	9,740	10,013	10,234	11,057	11,974
Real economy yoy (%)					
GDP	4.5	1.9	1.5	2.9	3.2
Private Consumption	2.6	1.2	0.8	2.1	3.1
Fixed Investment	8.5	-1.8	-0.5	2.7	8.8
Public Consumption	-1.7	0.2	1.8	0.4	1.6
Exports	7.7	3.9	4.1	7.8	7.5
Imports	5.4	-0.7	1.1	7.5	9.1
Monthly wage, nominal (EUR)	874	890	910	981	1,058
Unemployment rate (%)	12.4	12.8	13.6	13.5	13.1
Fiscal accounts (% of GDP)					
Budget balance	-5.0	-3.9	-4.9	4.5	-3.0
Primary balance	-2.3	-1.1	-2.2	6.7	-0.8
Public debt	56.2	55.6	58.2	49.6	48.9
External accounts					
Current account balance (EUR bn)	-18.5	-14.2	-7.3	-11.3	-15.8
Current account balance/GDP (%)	-5.0	-3.7	-1.9	-2.7	-3.5
Basic balance/GDP (%)	-1.0	-2.5	-1.8	-1.0	-1.3
Net FDI (EUR bn)	14.9	4.8	0.4	7.0	10.0
Net FDI (% of GDP)	4.0	1.2	0.1	1.7	2.2
Gross foreign debt (EUR bn)	250.1	277.3	279.2	310.4	324.5
Gross foreign debt (% of GDP)	67.4	72.7	71.7	73.8	71.3
FX reserves (EUR bn)	75.7	82.6	75.8	75.6	75.2
Inflation/Monetary/FX					
CPI (pavg)	4.3	3.7	1.0	2.0	2.5
CPI (eop)	4.6	2.4	1.1	2.2	2.3
Central bank target	2.5±1pp	2.5±1pp	2.5±1pp	2.5±1pp	2.5±1
Central bank reference rate (eop)	4.50	4.25	2.50	2.50	3.00
3M money market rate	4.54	4.91	3.02	2.73	3.12
USD/PLN (eop)	3.42	3.10	3.20	3.38	3.31
EUR/PLN (eop)	4.42	4.09	4.12	4.05	3.90
USD/PLN (pavg)	2.96	3.26	3.19	3.22	3.28
EUR/PLN (pavg)	4.12	4.19	4.20	4.05	3.93

Source: CSO, NBH, UniCredit Research

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

Short-term fiscal relief from pension system overhaul

GDP is set to accelerate to 2.9% in 2014, after 1.5% expected in 2014

Economic growth is set to accelerate: in 2014 we look for 2.9%, after 1.5% in 2013. Private consumption is set to recover next year (up by 2.1% from 0.8% in 2013) on the back of the recent improvement in household purchasing power due to rapid disinflation. Encouraging signs from the labor market (high PMI-employment, continued rise in real wages) indicate that the household sector should soon be back on solid footing and play an important role in driving the economic recovery. While public investment is seen to continue shrinking in 2014, albeit moderately (down by 1%), as projects financed from the EU 2014-20 financial plan will not fully kick in yet, private investment should go up by 3.6%. In 2Q13, four-quarter cumulative private investment was close to an all-time low of 14% of GDP. The balance of risks for private investment is skewed to the upside due to rising capacity utilization, a solid increase in new orders and the expected expansion of replacement investment due to depreciation of machinery and equipment. Upward revision of EU (and especially Germany) exports forecasts will help Poland export performance, with 0.3pp positive impact from net exports expected in 2014, revised up from 0.1pp previously.

The Cabinets plans to shift T-bonds held in private pension funds to the Social Security Fund

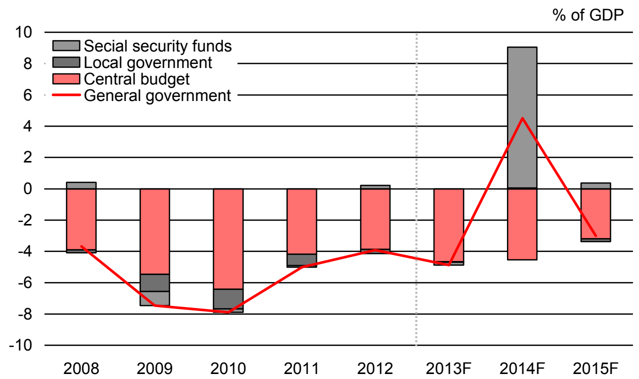
PM Tusk's cabinet is pursuing a substantial change in the pension system, which will provide some short-term fiscal relief, but will not solve the structural problems in public finances. According to the bill presented by the government, on 3 February 2014 OFE will transfer 51.5% of its non-equity assets (roughly PLN 150bn i.e. ~8.8% of 2014 GDP) to the Social Security Fund (ZUS). Transferred portfolios will consist mostly of government bonds, and OFE will be banned from investing in securities issued or guaranteed by the state treasury in the future. In addition, assets in OFE will gradually be moved from OFE to ZUS starting 10 years before reaching retirement age. The insured will need to decide whether or not they want to continue saving for a pension in OFE or move to ZUS. Changing to ZUS is set as a default option.

The planned changes in the pension system will lower debt/GDP ratio by 9pp in 2014, and will lower deficits in the future. Debt servicing costs will be lower due to T-bond write-offs. However, the real effort to curb spending is low

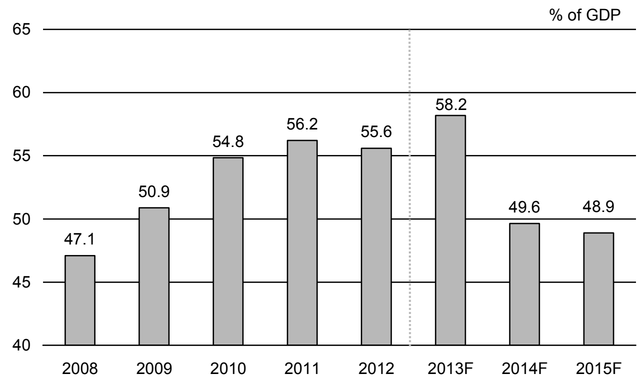
The planned pension system overhaul will have a substantial impact on public finances in the coming year. The effect will be twofold. First, the general government sector will benefit from a one-off transfer of nearly 9% of GDP from the private sector (OFE). According to the ESA95, the planned shift of assets from the private sector (OFE) to the general government sector is treated as a capital transfer increasing social security sub-sector revenues. Second, there will be some permanent gains, including higher contributions to the first pillar of the pension system and lower debt servicing costs as T-bonds transferred from OFE to ZUS will be written off. As a consequence, the general government will post a surplus of 4.5% of GDP in 2014 vs. 4.9% of GDP deficit estimated for 2013, while the public debt will decline from 58.2% of GDP in 2013 to 49.6% of GDP in 2014. Nevertheless, the central budget sub-sector shortfall is foreseen to remain high (4.7% of GDP in 2014 vs. 4.5% of GDP in 2013) despite lower debt servicing costs. The changes in the pension system will make headline deficit and debt numbers look better, but the real fiscal effort in 2014 is negligible. In 2015, we forecast a deficit of nearly 3% of GDP.

PENSION SYSTEM OVERHAUL WILL GENERATE ONE-OFF FISCAL SURPLUS IN 2014

Changes in pension funds will create "artificial" budget surplus in 2014…



…lowering debt/GDP statistics from 2014 onwards



Source: National Statistics Office, AKK, NBH, UniCredit Research

CPI hit bottom in June at 0.2% yoy, and is likely to rise towards 1.2% yoy in December 2013, to 2.5% by mid-2014 and stabilize thereafter

CPI inflation hit its trough in June at 0.2% yoy, and is set to increase towards 1.2% in end-2013 and towards the 2.5% MPC target by mid-2014, where it should stabilize until end-2014. The main reason for the CPI increase in early 2014 will be the usual increases of regulated prices (gas and electricity) which will be compared with a low base from 2013 (when gas prices were cut and telecommunications' prices were reduced as well). A 15% hike in excise tax on alcohol will come into place in January and also push inflation higher.

The MPC is sending clear signals that it wants to keep rates unchanged at least until mid-2014. The real discussion on tightening will likely start in 4Q14

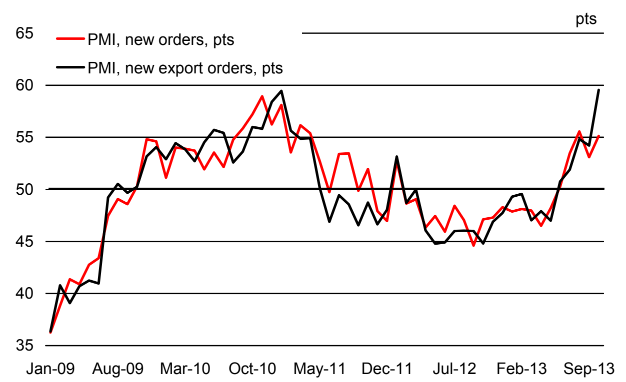
The MPC announced that it will keep interest rates unchanged at least until mid-2014. The November Inflation Projection assumes the central path of inflation forecasts is 1.0% in 2013 (as compared to 0.9% in the July projection), 1.7% in 2014 (1.2%) and 1.9% in 2015 (1.6%). The central forecast of GDP growth is 1.3% in 2013 (1.1%), 3.0% in 2014 (2.4%) and 3.3% in 2015 (2.9%). The MPC said in the statement: "*Considering the current statistical data as well as the projection of GDP and inflation that confirm low inflationary pressure and the expected moderate economic recovery, the Council assesses that NBP interest rates should be kept unchanged at least until the end of the first half of 2014.*" The NBP forecast assumes that inflation will not reach the target until the end of the horizon of the projection. In our opinion, however, CPI inflation will steadily increase in the coming months and, at the end of the first half of 2014, may temporarily return to the target of 2.5%. We expect that, at the end of the second half of 2014, inflation will not exceed the inflation target significantly, thanks to base effects. In our opinion, in 2015 inflation will exceed the inflation target. However, the MPC will not rush to increase interest rates, as the pace of economic recovery will be very gradual, and most probably the MPC will not be willing to start hiking rates prior to the ECB. However, the discussion on when to start tightening will likely start in H2 2014, and may become serious in 4Q14.

2014 will see a widening of the C/A deficit to ca. 2.7% of GDP, after it narrowed to 1.7% in 2013

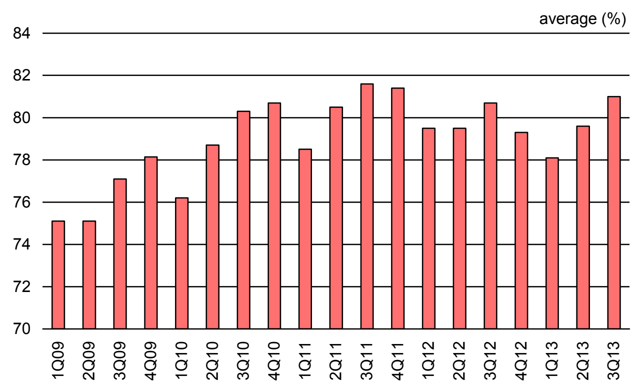
3Q13 saw Poland's C/A return to deficit after a slight surplus in 2Q13, mainly due to the seasonal drop in EU funds. The trade account stayed in surplus. 4Q13 should see a considerable reduction of the trade surplus (or even a slight trade deficit) as a result of both the gradual recovery of imports and seasonal effects. According to our estimates, in 2013 the C/A deficit will drop to around 1.7% GDP from 3.7% GDP in 2012. In 2014, in turn, the C/A deficit should widen to ca. 2.7% GDP, primarily due to a significant revival of imports (growth of ca. 11% in zloty terms, supported by the improving labor market situation and domestic industry's demand for goods) along with single digit export growth (ca. 9%). Lower FDI and portfolio inflows accompany a narrower C/A deficit this year but just as the C/A deficit is likely to widen next year, we also expect some recovery in FDI.

PRIVATE INVESTMENT SHOULD RECOVER AS ORDERS RISE BUOYANTLY AND CAPACITY UTILIZATION IS INCREASING

Recent months saw a sharp rise in new orders, especially from abroad



NBP data point to rapidly rising capacity utilization



Source: MarkIt, StatOffice, UniCredit Research

Strategy: Pension reform jitters, but PLN to outperform

The POLGB curve would be flattening in a non-taper-risk environment

The POLGB curve is the most natural candidate for flattening in a world without tapering risks. With robust growth and a steep curve, we would most definitely see a case for duration extension, especially as policy is on extended hold. Even with tapering, from a relative-value perspective, we see less value in a POLGB steepener, especially given a favourable supply effects of OFE debt cancellation (implying a 2s5s flattener at the margin).

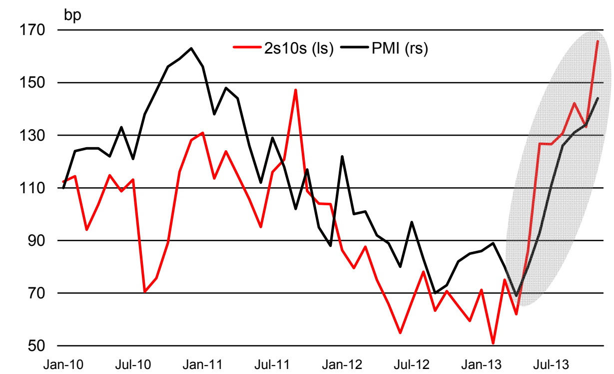
We see better opportunities in Poland EUR paper (Sep2024) and recommend a switch from the USD paper (Mar2023)

We look for continued EUR-paper outperformance relative to USD paper in view of our G10 rates strategists' forecast of a widening in UST-Bund differential by 30 bps over 2014. We recommend a switch from Mar2023 USD into Sep2024 EUR to express the view. We may even get mark-to-market gains on the switch if ECB does an LTRO early next year putting downward pressure on core yields.

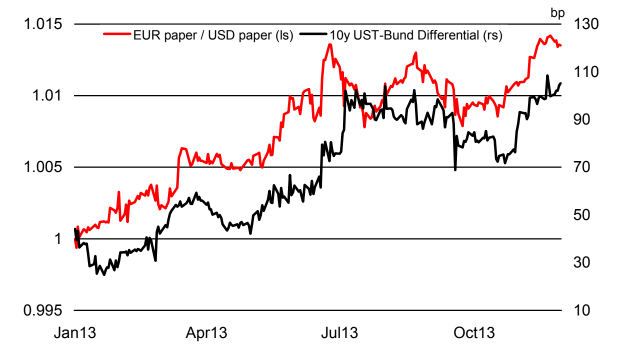
PLN is a growth-positive currency and should outperform given Poland's robust growth. We are already long PLN against HUF. We expect this outperformance to continue given the relative monetary-policy, cyclical-recovery and liquidity considerations.

POLGB CURVE

Sustained growth should eventually exert curve-flattening pressure



EUR paper to continue to outperform with a wider UST-Bund differential



Source: Markit, Bloomberg, UniCredit Research

Author: Gaurav Saroliya, Senior CEE Strategist (UniCredit Bank London)

REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**40.2**	**35.3**	**41.4**
Budget deficit	15.8	14.9	13.1
Amortization of public debt	24.4	20.4	28.3
Domestic	20.9	16.4	23.7
Bonds	19.4	16.4	23.7
Bills	1.5	0	0
External	3.5	4.0	4.6
IMF/EU	0	0	0
Financing	**40.2**	**35.3**	**41.4**
Domestic borrowing	32.9	26.2	31.6
Bonds	33.3	26.2	31.7
Bills	1.5	0	0
Other	-1.8	0	-0.2
External borrowing	7.3	9.1	9.9
Bonds	4.1	7.5	8.2
IMF/EU	0	0	0
Other	3.1	1.6	1.7

Source: AKK, IMF, NBH, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**71.0**	**80.8**	**84.1**
C/A deficit	7.3	11.3	15.8
Amortization of medium to long term debt	12.7	19.8	19.9
Government/central bank	3.5	4.0	4.6
Banks	2.4	3.3	3.2
Corporates	6.8	12.5	12.1
Short term debt amortization	51.0	49.7	48.4
Financing	**71.6**	**80.9**	**84.3**
FDI	0.4	7.0	10.0
Equity	1.2	2.8	2.8
Borrowing	68.2	68.1	67.3
Government/central bank	7.3	9.1	9.9
Banks	14.9	15.4	15.0
Corporates	46.0	43.6	42.5
EU transfers	9.9	11.8	11.8
Other	-8.1	-8.9	-7.7

Source: AKK, IMF, NBH, UniCredit Research

Romania (Baa3 negative/BB+ positive/BBB- stable)*

Outlook – Romania's GDP growth will slow down in 2014 since domestic demand is affected by weak lending, rising inflation and political noise and 2013's positive supply shocks fade away. Despite risks of fiscal slippages, the budget deficit and public debt to GDP ratio will remain low. The RON is expected to trade flat in 2014 as bank deleveraging will offset the positive basic balance. The NBR will probably deliver another rate cut to 3.75%, but a second one to 3.50% looks less likely due to inflation outlook, investor appetite and local politics.

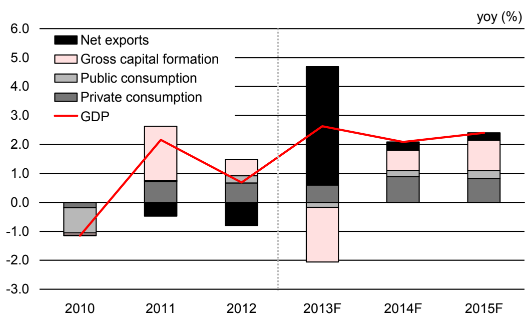
Strategy – We remain overweight ROMGBs given policy easing and a relatively low foreign ownership of the local market. While the RON might depreciate initially during tapering, we favour long RON positions in 1Q14 due to supportive seasonal flows and look to sell EUR-RON above 4.50.

Authors: Dan Bucşa, Economist (UniCredit Bank London)
Mihai Pătrulescu, Economist (UniCredit Ţiriac Bank)

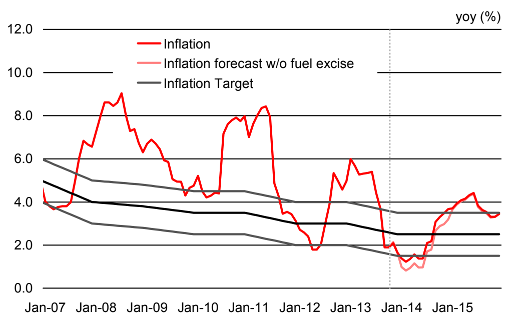
KEY DATES/EVENTS

- January 8th, February 4th – NBR rate decisions
- January: IMF mission returns to Romania for negotiations
- February: 4Q GDP (flash estimates)
- March: IMF board votes on Romania's SBA

GDP COMPONENTS



INFLATION OUTLOOK



Source UniCredit Research, NBR, Statistical Office

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	131.4	131.8	141.5	147.6	156.5
Population (mn)	21.4	21.4	19.0	19.0	19.0
GDP per capita (EUR)	6,139	6,161	7,448	7,769	8,235
Real economy yoy (%)					
GDP	2.2	0.7	2.6	2.1	2.4
Private Consumption	1.1	1.1	0.7	1.4	1.4
Fixed Investment	7.3	4.9	-3.5	0	2.5
Public Consumption	-0.3	2.4	-1.0	1.4	1.8
Exports	10.3	-3.0	13.5	6.5	6.8
Imports	10.0	-0.9	2.9	5.8	6.1
Monthly wage, nominal (EUR)	348	347	368	384	408
Unemployment rate (%)	7.4	7.0	7.3	7.2	7.0
Fiscal accounts (% of GDP)					
Budget balance	-5.6	-2.9	-2.8	-2.8	-2.4
Primary balance	-4.1	-1.1	-1.0	-1.0	-0.7
Public debt	34.7	37.8	37.8	38.0	36.9
External accounts					
Current account balance (EUR bn)	-5.9	-5.8	-1.2	-1.3	-0.8
Current account balance/GDP (%)	-4.5	-4.4	-0.9	-0.9	-0.5
Basic balance/GDP (%)	-3.1	-3.1	0.2	0.5	0.9
Net FDI (EUR bn)	1.8	1.7	1.5	2.0	2.2
Net FDI (% of GDP)	1.4	1.3	1.1	1.4	1.4
Gross foreign debt (EUR bn)	98.7	99.7	99.0	101.3	103.5
Gross foreign debt (% of GDP)	75.2	75.6	70.0	68.6	66.2
Fx reserves (EUR bn)	33.2	31.2	31.1	28.8	30.2
Inflation/Monetary/FX					
CPI (pavg)	5.8	3.3	4.1	2.4	3.5
CPI (eop)	3.1	5.0	1.7	3.7	3.5
Central bank target	3.0	3.0	2.5	2.5	2.5
Central bank reference rate (eop)	6.00	5.25	4.00	3.75	3.75
3M money market rate	5.28	5.22	4.10	2.97	3.40
USD/RON (eop)	3.25	3.35	3.30	3.18	3.02
EUR/RON (eop)	4.32	4.43	4.45	4.45	4.38
USD/RON (pavg)	3.05	3.47	3.33	3.26	3.03
EUR/RON (pavg)	4.24	4.46	4.42	4.45	4.39

Source: UniCredit Research

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

Blurry domestic outlook

Romania's is the best growth performer in Central Europe this year…

Romania managed in 2013 to grow at the fastest pace in Central Europe for the first time since 2007 due to positive base effects in industry (+5.1%yoy expected for 2013) and agriculture (+16.1%yoy forecasted for 2013) that managed to offset poor domestic demand, especially weak fixed investment. Yet growth is expected to slow down to 2.1%yoy in 2014, returning to the 2011-2013 pace excluding agriculture. Exports (6.5%yoy) and industry (5.0%yoy) will remain the biggest growth drivers, helped by demand from Germany and improved labour competitiveness. But the positive base effect on industrial output growth from higher production capacities will disappear in 2014 since no major project follows recent investment in manufacturing. Fixed investment in machinery plummeted 22.3%yoy in 3Q13 and might decline further in 4Q13. Non-manufacturing investment will be affected in 2014 by lower green energy subsidies and higher taxes on utility and energy companies.

…but growth might slow down in 2014…

…due to weak domestic demand…

In the medium term, domestic demand remains a drag on growth. While the adjustment of unit labour costs since the financial crisis keeps Romania at the forefront of cheap CEE manufacturing, it also limits the future expansion of private consumption (1.4%yoy in 2014, 1.3%yoy in 2015). Several other factors will weigh on domestic demand in 2014: a 'Hungarisation' of fiscal policies, problems in the banking sector and resurgent inflation. The 2014 budget draft contains controversial ad-hoc taxes that lack a thorough impact assessment. Measures such as increasing the excise duty on fuels and levying a tax on constructions other than buildings were implemented because tax collection remains the worst in the EU, with fiscal evasion estimated by the Fiscal Council at 14% of GDP in 2012. The focus on elections (for EU parliament in May and president in November-December) increases the scope for populist spending and the threat of crowding out public investment.

…affected by higher taxes…

…lack of structural reforms…

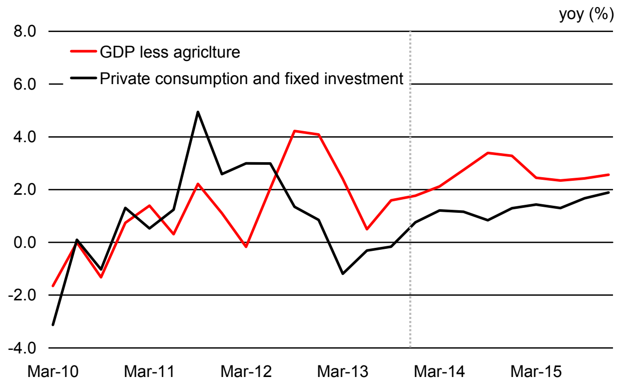
Public finances remain sustainable under IMF/EU monitoring, but the reform fatigue has risen. In fact, politics might have a negative impact on economic stability through political volatility (e.g. the stand-off between the president and the government regarding higher fuel excise duties), government dissolution and pressure from local on central politicians. The government dissolution seems imminent and it may occur either in 1Q14 or after EU elections. The Social Democratic Party (PSD) is able to gather a slim majority in parliament, but will need the full support of its local apparatus to ensure party discipline, thus increasing the sway of regional political leaders on central politicians. Hence, the new decentralisation laws pose a danger to the deficit threshold of 3% of GDP, although the fiscal responsibility laws adopted at the IMF's recommendation should in theory prevent spending slippages. Even when accounting for mild fiscal risks, public debt will remain below 40% of GDP in the medium term and the government's annual financing needs will fall to 10.2% of GDP in 2014 and 8.8% of GDP in 2015.

….and political noise

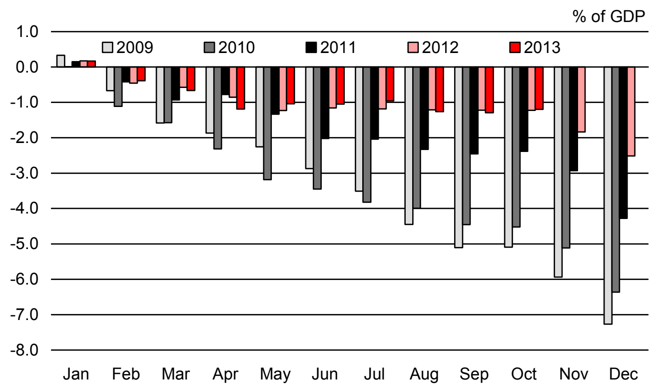
The public debt to GDP ratio is capped at 40%...

…and financing needs are expected to decline

Domestic demand fails to recover substantially…



…although the budget deficit reduction (fiscal adjustment) is done



Source: Statistical Office, MinFin, UniCredit Research

Bank deleveraging weighs on lending…

Another drag on domestic demand is weak lending amid fast bank deleveraging, tight lending standards and deterioration of asset quality. All these indicators are lagging the economic recovery. The foreign liabilities of the banking sector fell EUR 3.4bn (2.4% of GDP) between November 2012 and October 2013 and will adjust further as several foreign banks with a small market share in Romania want to disinvest. New lending is very weak, driven only by RON mortgage loans backed by state guarantees. In 2014, the government will initiate a similar scheme for SMEs to the tune of RON 4.0bn (0.6% of GDP). The National Bank of Romania (NBR) is finally addressing the high NPL ratio (21.6% in September 2013) by improving the tax treatment of incentives offered to borrowers who reactivate impaired loans.

…which will be supported in 2014 only by public lending schemes

The RON is dependent on portfolio flows…

The RON remains dependent on portfolio inflows, as the positive basic balance (2.7% of GDP between 4Q12 and 3Q13) is offset by bank deleveraging. Financing requirements were easily covered in 2013 due to the strong performance of ROMGBs, with foreign bond investors holding 24.8% of outstanding local bonds in September 2013 vs. 14.2% in December 2012. Moreover, Romania managed in 2013 to sell the equivalent of EUR 3.1bn in FX bonds, refinancing on the market two thirds of IMF redemptions. According to government officials, the MinFin has a buffer of EUR 5.0bn[9], covering at least 4 months of gross financing requirements.

…driven in 2013 by strong appetite for ROMGBs.

Local bonds might underperform in 2H14…

Yet in 2H14, the situation might change due to political noise and rising inflation. The latter is expected to bottom out at 1.5% in February 2014 (0.9% if the excise duty on fuels is not implemented), remain below 2% until June next year and then spike to 3.8% (3.2%) in December amid negative basis effects from food prices. Yet ignoring the two-year cycles generated by food prices and tax changes, consumer price inflation remained on a downward path since 2008 and is now much closer to the annual target of the NBR than ever before. Core inflation fell to 0% in October 2013, but will return to the medium-term target of 2.5% in 2014 on the back of higher food prices.

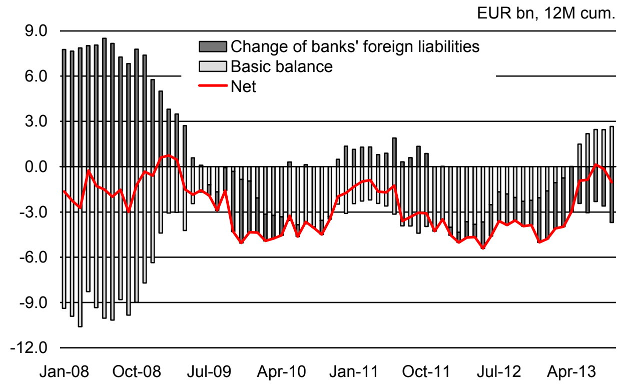
…due to political noise and rising inflation

The NBR will most likely deliver another cut…

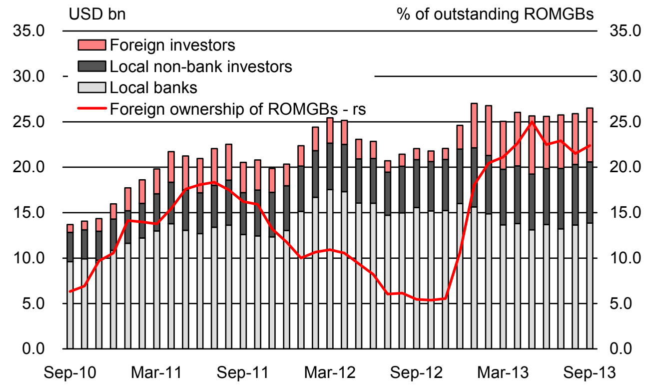
Future monetary policy decisions are tied to the evolution of inflation and asset prices. The unexpected excise hike already toned down the dovish stance of NBR officials. While a first cut to 3.75% on 8 January is still on cards, a second one on 4 February is less likely since it will bring the policy rate close to the inflation forecast for end-2014 and will come six days after a potential decision from the FOMC to start tapering asset purchases. The NBR has mentioned lowering minimum reserve requirements as another tool to ease liquidity conditions, but the timing depends on when the Fed starts tapering. The central bank has fought against past currency weakness by draining liquidity, but this is not an option anymore since it might trigger bond outflows and additional pressure on the RON. Hence, allowing for good liquidity conditions and temporary higher FX volatility might be a better option.

…but a second one is dependent on risk appetite

Bank deleveraging is wiping out the positive basic balance



ROMGB holdings increased for foreigners, but fell for local banks



Source: MinFin, NBR, UniCredit Research

[9] According to NBR data, government deposits amounted to EUR 9.0bn at the NBR and EUR 1.3bn at local banks at the end of October. Removing the average daily liquidity balance, the actual reserves should be significantly higher than EUR 5.0bn.

Overweight duration, look for RON gains in 1Q13

ROMGBs might outperform regional peers…

We see ROMGBs outperforming the regional peers (especially Hungary and Turkey) in the coming quarter, as the central bank remains in an easing mode, short-end liquidity is plentiful and the share of foreign ownership of the local market is lower by regional standards, implying less vulnerability to tapering.

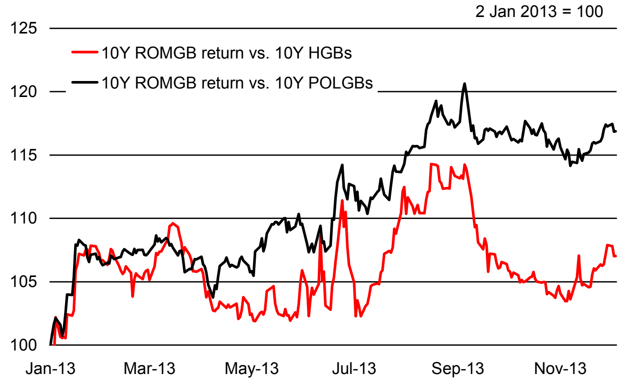
…unless the central bank tightens liquidity once tapering starts

The risk to our view would come from any sudden tightening of liquidity by the central bank once tapering begins. Yet the central bank might benefit from not intervening in the market, as stronger fundamentals should help Romanian assets recover.

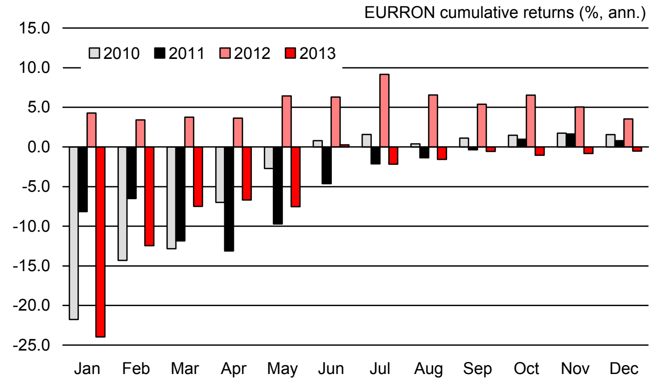
Seasonality should benefit the RON in 1Q14

While the RON might depreciate initially **after tapering starts, we favour long RON positions in 1Q14 due to supportive seasonal flows**. We would be looking to sell EUR-RON close to 4.50, targeting 4.35 before the end of 1Q14. Improving C/A metrics, low borrowing needs and a mild slowdown of bank deleveraging in 1Q13 should support our call.

ROMGBs have outperformed HGBs and POLGBs in 2013



The RON outperforms in 1H due to favourable seasonal flows



Source: NBR, MinFin, Bloomberg, UniCredit Research

Author: Gaurav Saroliya, Senior CEE Strategist (UniCredit Bank London)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**16.9**	**14.8**	**13.9**
Budget deficit	4.1	3.8	3.5
Amortisation of public debt	12.8	11.1	10.4
Domestic	11.3	9.1	7.2
Bonds	4.7	6.1	4.1
Bills	6.1	2.5	2.6
Loans	0.5	0.5	0.5
External	1.5	2.0	3.2
Bonds and loans	0.5	1.0	1.5
IMF/EU	1.0	1.0	1.7
Financing	**16.9**	**14.8**	**13.9**
Domestic borrowing	13.1	11.3	11.4
Bonds	10.0	7.8	7.9
Bills	2.4	3.0	3.0
Loans	0.7	0.5	0.5
External borrowing	3.8	3.5	2.5
Bonds	3.1	2.5	2.5
IMF/EU/WB	0.7	1.0	0
Other	0	0	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**39.5**	**39.7**	**36.8**
C/A deficit	1.2	1.3	0.8
Amortisation of medium to long term debt	18.0	19.1	17.6
Government/central bank	4.9	7.1	6.0
Banks	5.5	5.2	5.2
Corporates	7.6	6.9	6.4
Amortisation of short term debt	20.3	19.3	18.4
Government/central bank	1.2	0.6	0.7
Banks	5.2	4.4	3.3
Corporates	13.9	14.3	14.4
Financing	**39.5**	**39.7**	**36.8**
FDI	1.5	2.0	2.2
Equity	0.9	0.6	0.1
Borrowing	36.0	33.1	32.6
Government/central bank	8.2	4.5	5.0
Banks	7.9	7.2	6.2
Corporates	19.9	21.4	21.4
EU Funds - capital transfers	2.2	2.9	3.7
NBR FX reserve change (- = increase)	-1.1	1.1	-1.8

Source: UniCredit Research

Slovakia (A2 stable/ A stable/A+ stable)*

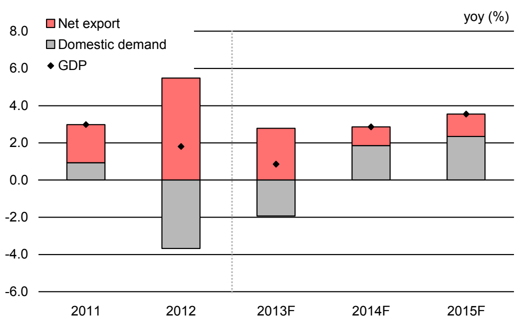
Outlook – Economic growth is expected to rebound in coming quarters driven by a recovery in external demand, mainly in Germany. Domestic demand remains relatively weak but will recover slowly in 2014 following labour market stabilisation and a positive fiscal impulse. The government propose to a pause in fiscal tightening in 2014 – fulfilling the deficit criteria of 3%/GDP deficit but widening the structural deficit. Consolidation is expected to continue in the coming years as public debt is approaching politically painful triggers set by Fiscal Responsibility Law. The trade balance continues to move to a new all-time surplus driven by decreasing imports. Foreign trade will remain the main driver of the CA surplus also in coming years.

Author: Ľubomír Koršňák, Chief Economist (UniCredit Bank Slovakia)

KEY DATES/EVENTS

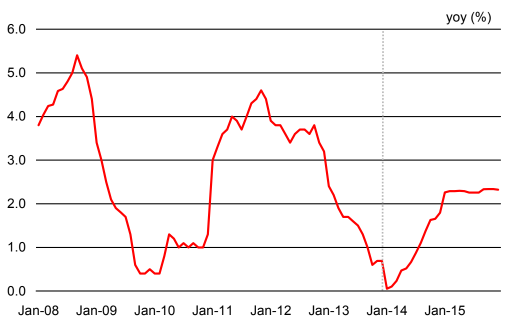
- Dec 10, Jan 10, Feb 10 – Industrial production
- Dec 12, Jan 14, Feb 13 – CPI
- Feb 14 – flash GDP
- Mar 5 – GDP and its structure

NET EXPORTS AS MAIN GROWTH DRIVER



*Adjusted for statistical error

INFLATION CLOSE TO BOTTOM



Source: Statistical Office SR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	69.0	71.1	72.3	74.8	78.2
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	12,700	13,091	13,305	13,769	14,394
Real economy yoy (%)					
GDP	3.0	1.8	0.9	2.9	3.6
Private Consumption	-0.5	-0.2	0	1.5	2.6
Fixed Investment	14.2	-10.5	-6.1	4.3	3.8
Public Consumption	-4.3	-1.1	0	0.5	1.0
Exports	12.2	9.9	3.9	6.4	7.1
Imports	9.7	3.3	1.1	6.4	7.0
Monthly wage, nominal (EUR)	786	802	823	846	878
Unemployment rate (%)	13.5	14.0	14.3	14.0	13.4
Fiscal accounts (% of GDP)					
Budget balance	-5.1	-4.5	-3.0	-2.9	-2.6
Primary balance	-3.5	-2.5	-1.1	-1.0	-0.5
Public debt	43.4	52.4	55.0	56.6	56.7
External accounts					
Current account balance (EUR bn)	-1.4	1.6	2.5	2.4	2.2
Current account balance/GDP (%)	-2.1	2.3	3.5	3.2	2.8
Basic balance/GDP (%)	0.2	5.4	4.6	4.7	4.9
Net FDI (EUR bn)	1.5	2.2	0.8	1.1	1.6
Net FDI (% of GDP)	2.2	3.1	1.1	1.5	2.1
Gross foreign debt (EUR bn)	52.9	53.8	55.9	58.8	62.5
Gross foreign debt (% of GDP)	76.7	75.6	77.4	78.7	79.9
Inflation/Monetary/FX					
CPI (pavg)	3.9	3.6	1.4	0.9	2.3
CPI (eop)	4.4	3.2	0.7	1.8	2.3
EURIBOR 3M	EUR	EUR	EUR	EUR	EUR
EUR/USD (eop)	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR

Source: UniCredit Research

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

Fiscal tightening to pause in 2014

2014 – Year of elections

November's regional election confirmed strong support for ruling social democrats, wining in 6 out of 8 regions. Right-wing opposition took victory in the Bratislava region, as is tradition, while right-wing extremist Kotleba surprisingly won in the central Slovakia region Banská Bystrica. However, the results of the regional election cannot be over-emphasised as the turn-out was extremely weak at close to 20%. The next elections will take place in 2014 – Presidential (spring), European Parliament (May) and municipalities (autumn). Several right-wing candidates already announced candidacy for President while Prime Minister Fico still has not decided. If he will run for President and succeed (polls suggest 2nd round would be tight), it could bring some new instability to the ruling party, but the probability of early election remains low.

A less ambitious 2014 budget amidst a pause in fiscal consolidation

Corporate tax to be decline, compensated by new tax licenses

This busy election calendar helps to explain a less ambitious budget proposal for 2014. The government proposes a temporary stop to fiscal tightening in 2014 to support growth, keeping the budget deficit close to its 2013 ratio, while the structural deficit is projected to rise. Budget revenues will be supported by several one off measures like "superdividends" (earlier payments of dividends) or income from selling mobile operators licenses. On the other side, the government a decrease in the corporate tax from 23% to 22%, while the revenue gap is expected to be fully compensated for by new "tax-licence" for corporates (a kind of minimum tax). On expenditure, 2014 savings should be delivered mainly via healthcare and public administration reform. The European Commission sees some implementation risks and as such does not expect deficit targets to be met. Nevertheless, unlike the EC we do not expect the 2014 deficit to exceed the government's projection given the debt break law. A deficit wider than 3%/GDP in 2014 will see public debt breech 57%/GDP (public debt) and force a budget balance in 2016, a general election year. As such, the government has a strong motivation to approve additional measures (most likely income or one-offs), if necessary, to ensure public debt remains below 57% of GDP.

2013 public finance deficit on track to meet target

YTD budget performance is on track to meet a deficit target of 3%/GDP. Tax revenue, in particular VAT, is better than expected. A question mark remains over local government budgets, but the cushion created by state budget should be sufficient. The debt Agency (ARDAL) covered almost all 2013 financing needs already before summer and so focus on optimization of debt costs via several buy-backs (total volume of EUR 547 mn. in July-October). Financial needs for 2014 are expected at EUR 7.5 bn, similar to 2013.

Economy continues to grow, driven by net exports

The economy continues to grow, gaining 0.2% qoq/0.9% yoy in 3Q. GDP is still driven mainly by net exports, while domestic demand suffers. We have revise our 2013 GDP forecast slightly downwards from 1.0% to 0.9% yoy driven mainly by current revision of 1H results from 0.8% to 0.7% yoy. We continue to expect growth to accelerate in coming quarters driven by recovering external demand and a gradual rebound in domestic demand. We forecast 2014 growth at 2.3%.

Foreign trade reaching all-time surplus

The trade balance recorded an all-time surplus of 6.7% of GDP, driven mainly by subdued growth of imports. This is also captured in low investment activity and considerable de-stocking of local companies. The trade balance is expected to remain the main driver of CA surplus in coming years, driven by increasing export performance of manufacturing and still relatively weak domestic demand (consumer and investment).

Unemployment expected to remain high, inflation low

Real GDP gains are not sufficient to cut unemployment rate, which is expected to remain at relatively high levels or close to 14%. Nevertheless, real wages growth stays in positive territory, supported by lower than expected inflation. Looking ahead, planned electricity price cuts in January will bring inflation close to negative, only gradual acceleration in 2H due to recovering demand-pull inflation.

Slovenia (Ba1 negative/A- stable/BBB+ negative)*

Outlook – The Slovenian economy is facing a challenging period, amid weakening domestic demand prospects, rising banking sector recapitalization costs and large debt redemptions next year. While the planned fiscal stance for 2014 is appropriate, we believe additional measures will be required to meet the budget deficit objective of 2.9% of GDP. Banking sector recap stress tests, whose results will be known on December 13, will weigh significantly on the sovereign's public finances, although we view these as manageable thanks to the government's strong cash buffer. Should we prove wrong, a Troika program is expected to follow, entailing further fiscal consolidation but reducing debt issuance.

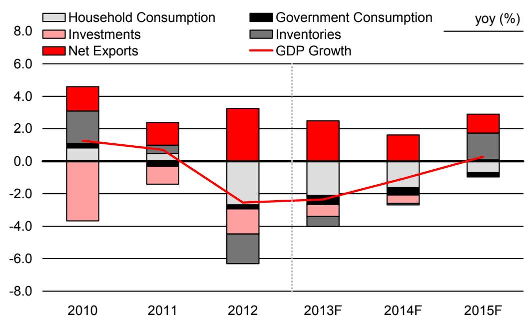
Strategy – We are overweight Slovenian USD paper given manageable recap costs and scope for further convergence with the Eurozone periphery.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

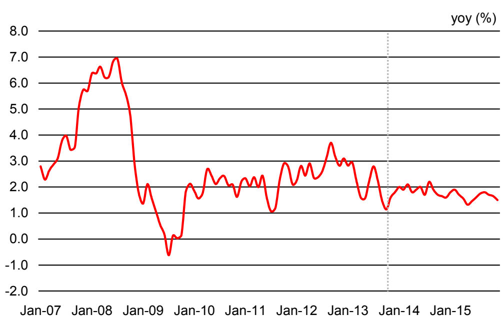
KEY DATES/EVENTS

- 10 Dec, 10 Jan, 10 Feb – Industrial Production
- 30 Dec, 30 Jan, 28 Feb – Consumer Price Index
- 31 Dec, 31 Jan, 28 Feb – Retail Sales

GDP GROWTH TO RESUME IN 2015



INFLATION TO REMAIN STABLE



Source: Bank of Slovenia, MinFin, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	36.2	35.3	35.1	35.1	35.7
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	17,610	17,183	17,024	16,977	17,230
Real economy yoy (%)					
GDP	0.7	-2.5	-2.4	-0.9	0.7
Private Consumption	0.8	-4.8	-3.8	-3.0	-1.0
Fixed Investment	-5.5	-8.2	-4.1	-2.9	0.5
Public Consumption	-1.6	-1.3	-2.9	-2.3	-1.4
Exports	7.0	0.6	2.7	3.7	4.2
Imports	5.6	-4.7	0.6	1.7	2.9
Monthly wage, nominal (EUR)	1,525	1,526	1,535	1,553	1,563
Unemployment rate (%)	8.2	8.9	11.1	11.5	11.4
Fiscal accounts (% of GDP)					
Budget balance	-6.3	-3.9	-5.8	-12.3	-3.6
Primary balance	-4.4	-1.7	-3.1	-9.3	-0.4
Public debt	47.1	54.4	63.2	79.1	81.5
External accounts					
Current account balance (EUR bn)	0.1	1.2	2.0	2.2	2.3
Current account balance/GDP (%)	0.4	3.3	5.7	6.1	6.4
Basic balance/GDP (%)	2.2	3.8	3.9	6.5	7.0
Net FDI (EUR bn)	0.6	0.2	-0.6	0.2	0.2
Net FDI (% of GDP)	1.8	0.5	-1.9	0.4	0.6
Gross foreign debt (EUR bn)	40.1	40.8	41.9	45.4	47.4
Gross foreign debt (% of GDP)	110.9	115.7	119.4	129.1	132.7
Inflation/Monetary/FX					
HICP (pavg)	2.1	2.8	2.0	1.9	1.6
HICP (eop)	2.1	3.1	1.8	1.6	1.5
EURIBOR 3M	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR

Source: Unicredit Research

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

Positive despite challenges

Despite a mild 3Q13 GDP contraction, the economy is expected to contract in FY13 by 2.4% yoy

Slovenia's weakening domestic demand will limit the recovery ahead, constrained by the deleveraging of the banking sector, increasing fiscal consolidation needs, and delayed restructuring of its ailing (and inter-linked) firms and banks. While it is true that headline GDP fell by just 0.6% yoy in 3Q13 (vs. -3% yoy in 1H13), domestic demand contracted for the eighth consecutive quarter by a further 2.7% yoy (-4.7% YTD). Not surprisingly, the biggest hit was seen in gross fixed capital formation (-4.4% yoy), mainly attributed to the ongoing de-stocking and persistent credit contraction to non-financial corporates (10.8% YTD). Similarly, final domestic consumption weakened further (-3.1% yoy), due to both declining government (-3.4% yoy) and private (-2.9% yoy) consumption. In contrast, export growth saw its best performance since 3Q11, increasing by as much as 4.4% yoy. By year-end, we expect the positive contribution from net external demand to be close to 2.5pp of GDP, which should place the FY13 contraction at -2.4% yoy.

Weakened domestic consumption is behind the 0.9% GDP drop next year…

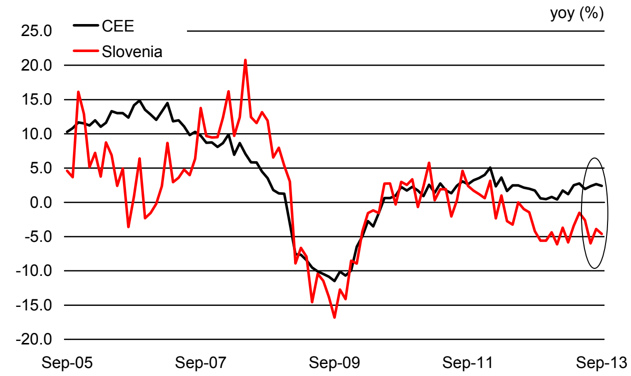
But the recession is expected to bottom out in 2014, with a slow but steady export-led recovery expected from mid-2H14 onwards. In particular, the FY14 GDP contraction is expected at 0.9% yoy, with most of the downside (ca. 2.1pp of GDP) attributed to weakened private consumption following: **1.** worsening labor market prospects, **2.** tightened household consumption credit (8.6% down YTD) and **3.** increased tax payments from the VAT rate hike and introduction of the real estate tax. Public consumption is also set to contract as per the 2014 budget plan, particularly on capital expenses and subsidies. Note that the reason for our lower government consumption estimates (UC FY14 at -2.3% yoy vs. -1.5% yoy by IMAD) corresponds to our expectation that further budget expenditure cuts will have to be introduced as soon as next spring to curb the deficit. As for fixed capital investment, it will decline at a slower pace in 2014 (-2.9% yoy), as firms start rebuilding their production capacity, but is expected to return to growth in 2015. Net external demand will continue to improve throughout the entire forecast horizon on the back of improving EMU economic conditions which should help the C/A deficit be in excess of 5.5% of GDP in the medium-term. As for inflation, it is expected to remain close to 2% next year because of the VAT and real state tax effects, but should return towards the 1.5% euro area average by mid-2015.

…taking also its toll on unemployment, expected to fall only from 2015 onwards

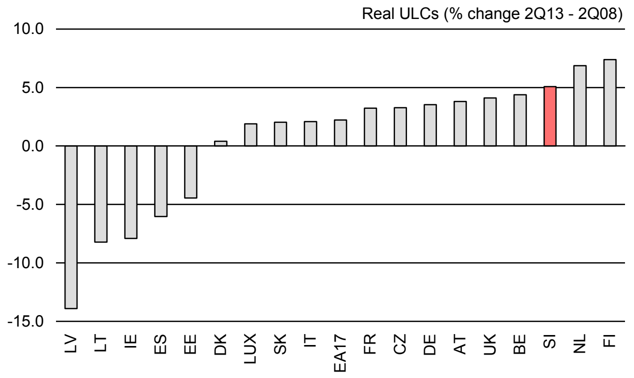
Private and public sector deleveraging will continue to weigh negatively on the unemployment rate, expected to increase by 0.4pp to 11.5% in 2014. Note that the government has already agreed to cut the number of public sector employees by 1% next year, and the total wage bill by close to 2.6%. In our view, both cuts should be deeper (and extended) in 2015, as this would help Slovenia regain the loss in competitiveness seen since 2007, caused primarily by the rapid surge of the minimum wage between March 2010 and January 2013 (+33.1% to EUR 784/month). That said, and despite the expected fall in real ULCs (FY14 contraction at 1.3% yoy), we view the country's cost competitiveness reaching 2007 levels only by 2016, assuming a restrictive wage policy is maintained.

WEAK DOMESTIC CONSUMPTION AND COMPETITIVENESS BEHIND THE CONTINUING RECESSION

Retail activity continues to lag CEE peers…



…while competitiveness is in need of improvement



Source: Bank of Slovenia, MinFin, UniCredit Research

Speeding up the privatization process of loss-making SOEs will be essential to limit contingent expenditures and foster growth

A prompt and efficient recapitalization is crucial to guarantee financial stability. As of June 2013, banking-system NPLs soared to 17.5% of total loans, up from 12% at end-2011. Of these, the highest and most rapid deterioration was seen among non-financial firms, with 40 of the largest loans accounting for over 1/3 of the total NPL portfolio. Not surprisingly, system-wide capital adequacy ratios remained well below the EU average (11.4% vs. 14.1% in the EU), particularly among small (10%) and large domestic banks (10.9%). Note that the sizeable NPL portfolio at domestic banks comes as a result of their inter-linkages and cross-ownership of financially-troubled SOEs, which are beneficiaries of as much as 25% of GDP in state guarantees. Breaking this link via privatizations will be the key going forward, but so far progress has been slow, with only Helios being sold since May. While the State Holding Company is expected to speed up the process once it is up and running in January of next year, we view its plan to sell the full 15-company list (excl. Unior) by end-2014 as challenging due to vested interests. On a more positive note, the effective implementation of the insolvency law should allow a speedier winding down of nonviable firms as well as facilitate the rehabilitation and deleveraging of viable ones thorough debt-equity swaps.

The government's EUR 4.7bn bank recap capacity limit should prove ample enough to manage recap costs…

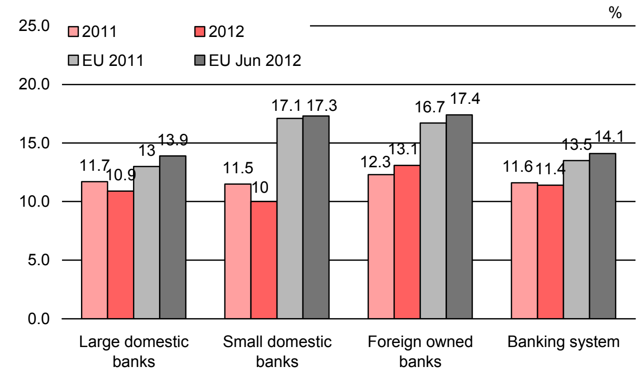
Banking sector recap needs will be known on December 13, with the government now leaving the door open for a material deviation from its EUR 1.2bn estimate following Parliament's approval last November of a bill boosting the government's bank recapitalization capacity limit to EUR 4.7bn (from EUR 3.5bn). Of this extra buffer, the government expects EUR 1bn to come from another Eurobond, while EUR 0.2bn comes from a re-organization of budget savings. According to our calculations, even if recap costs deviate to the capped EUR 4.7bn, the government would still be able to accommodate them thanks to its strong cash buffer (EUR 5bn). Note that this scenario would still be true even if we assume a 0% rollover in the upcoming maturing T-bills and payment of the quarterly deficits until end-1Q14. However, the EUR 1.6bn bond redemption in April makes another USD 2-3bn Eurobond issuance in 1Q14 inevitable. That said, a bailout scenario cannot be excluded, as the sovereign could be forced to request foreign assistance if bank recap needs exceed EUR 5bn. Even so, and irrespective of the bailout template, this would also force the sovereign into further fiscal, corporate and banking sector consolidation.

...although this will come at the expense of a higher deficit and public debt

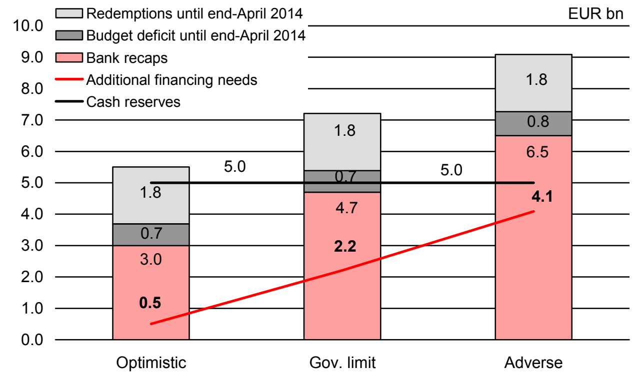
We welcome the 2014 fiscal package, but further fiscal efforts will be required to bring public finances into balance. In particular, we estimate the budget deficit next year ballooning to around 12.3% of GDP (vs. 5.8% of GDP in 2013), after penciling in an optimistic EUR 3bn in bank recapitalization costs (ca. 8.5% of GDP). Excluding these, the deficit is expected at 3.8% of GDP, still considerably higher than the government's target of 2.9% of GDP. The revenue-enhancing measures introduced last October are positive, particularly as regards the introduction of the real state tax. However, we view the government's revenue-increasing estimate of 1.7% of GDP as overly optimistic, while more spending-based cuts should have been introduced. All in all, we think authorities need to prepare contingency measures next spring of around 1pp of GDP, even though this will not prevent public debt from soaring to around 82% by 2016.

THE BANKING SECTOR IS IN NEED OF URGENT RECAPITALIZATION

Capital adequacy ratios remain well below the EU average…



…but should improve considerably following the recap exercise



Source: Bank of Slovenia, MinFin, UniCredit Research

Strategy – Spread compression on bank capitalization

We recommend to buy the SLOVEN 5.85% May 2023 USD paper

We recommend to buy the SLOVEN 5.85% May 2023 USD paper (currently trading at 5.82%), targeting a yield level of 5.4% in view of our expectation that the bank-recapitalization costs will be manageable (i.e. below EUR 4.7bn). This however will come at the expense of a ballooning of the public debt ratio though will still compare favorably with several peripheral eurozone peers. While for Slovenia we expect a public debt to GDP ratio of 79.2% in 2014 (post recapitalization), for Portugal and Ireland the equivalent numbers are 126.7% of GDP and 120.8% of GDP, respectively.

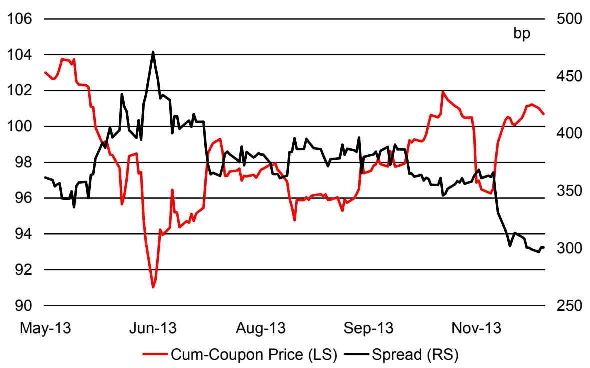
We think bank-recapitalization costs will be manageable…

…and Slovenia will benefit from spread convergence to Eurozone peers

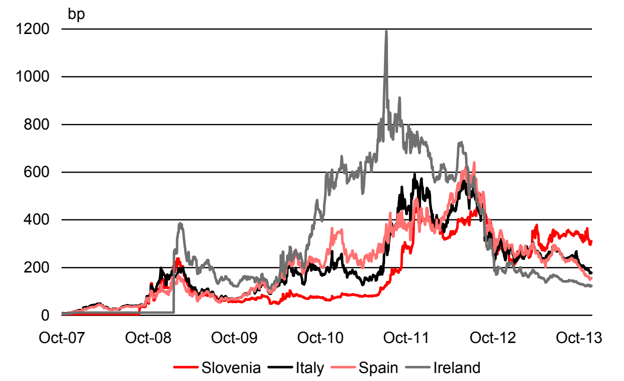
We are conscious of the risks coming from higher-than-budgeted recapitalization costs, which will become a trigger for a troika program. However, as we illustrate in the chart below, eurozone sovereigns that have been in troika programs in the past have performed very strongly subsequently. In our baseline case of manageable recapitalization costs, we think the spread on the 10-year benchmark has scope to compress and bring the yield down to our target level of 5.4%.

WHILE SLOVENIAN PAPER HAS PERFORMED WELL, WE SEE SCOPE FOR FURTHER CONVERGENCE WITH EUROZONE PEERS

Cum-coupon price and spreads on May 2023 USD paper



5-year CDS spreads: Slovenia elevated relative to peripheral peers



Source: Bloomberg, UniCredit Research

Author: Gaurav Saroliya, Senior CEE Strategist (UniCredit Bank London)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**4.1**	**8.1**	**4.1**
Budget deficit	2.0	4.3	1.3
Amortization of public debt	2.0	3.8	2.8
Domestic	2.0	3.8	2.8
Bonds	0.2	1.8	1.0
Bills	1.9	2.0	1.8
External	0	0	0
IMF/EU	0	0	0
Financing	**4.1**	**8.1**	**4.1**
Domestic borrowing	2.2	2.4	2.1
Bonds	0	0	0
Bills	2.2	2.4	2.1
External borrowing	4.1	3.5	2.0
Bonds	4.1	3.5	2.0
IMF/EU	0	0	0
Other	0	0	0
Fiscal reserves change (- = increase)	-2.2	2.2	0

Source: MinFin, NBS, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**11.8**	**11.2**	**10.5**
C/A deficit	-2.0	-2.2	-2.3
Amortization of medium to long-term debt	3.4	4.5	3.6
Government	0	0	0
Central Bank	0.6	1.6	1.1
Banks	1.7	1.6	1.3
Corporates	1.1	1.3	1.2
Amortization of short-term debt	10.4	8.8	9.2
Government	0	0	0
Central Bank	4.5	3.6	3.8
Banks	1.3	1.1	1.2
Corporates	4.6	4.1	4.2
Financing	**11.8**	**11.2**	**10.5**
FDI	-0.6	0.2	0.3
Medium to long-term borrowing	4.6	3.9	2.4
Government	4.1	3.5	2.0
Central Bank	0	0	0
Banks	0.3	0.2	0.3
Corporates	0.2	0.2	0.2
Short-term borrowing	7.2	6.3	7.0
Government	0	0	0
Central Bank	4.5	3.6	3.8
Banks	0.5	0.6	0.7
Corporates	2.2	2.1	2.5
EU Funds	0.7	0.8	0.8

Source: UniCredit Research

Bosnia and Herzegovina (B3 stable/ B stable)*

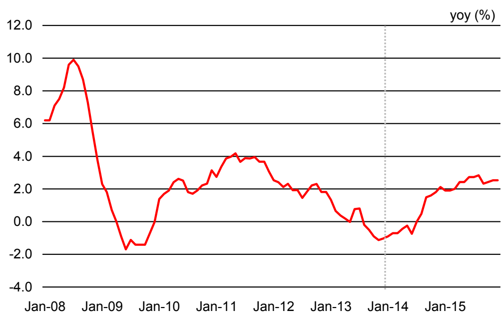
Outlook – Following the recovery in economic activity in 1H, we increase our GDP growth forecasts to 0.9% yoy (from 0.6% yoy), and to 1.5% yoy (from 0.9% yoy), for 2013 and 2014, respectively. Although private domestic consumption and investment are still subdued, there is a considerable pick-up in exports and industrial production. Private consumption remains constrained by high unemployment and declining real disposable income, while the government has limited room to increase public spending if it is to comply with fiscal consolidation performance criteria set in a pending Stand-by Agreement. However, the government initiated discussion on a one-year extension of the SBA, facing the challenges of general elections set for October. It should increase its credibility by exercising fiscal discipline during 2014.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

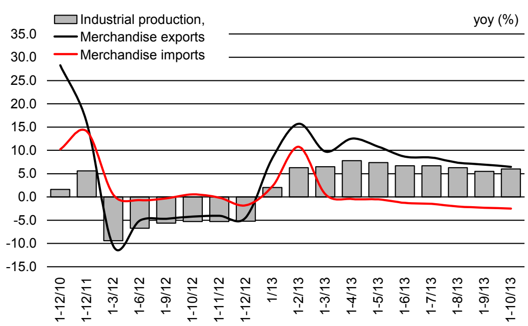
KEY DATES/EVENTS

- 10 Dec, 10 Jan, 10 Feb – Industrial Production
- 30 Dec, 30 Jan, 28 Feb – Consumer Price Index
- 31 Dec, 31 Jan, 28 Feb – Retail Sales

CPI EXPECTED TO SLOW



MERCHANDISE EXPORTS



Source: IMF, MinFin, Eurostat, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	13.7	13.9	14.0	14.3	15.0
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,565	3,625	3,659	3,725	3,910
Real economy yoy (%)					
GDP	1.8	-0.9	0.9	1.5	2.5
Monthly wage, nominal (EUR)	650	660	660	675	691
Unemployment rate (%)	43.3	44.1	44.6	44.3	44.0
Fiscal accounts (% of GDP)					
Budget balance	-1.2	-1.9	-2.2	-2.0	-1.5
Primary balance	-0.4	-1.2	-1.3	-1.1	-0.7
Public debt	38.8	39.7	40.3	40.7	40.6
External accounts					
Current account balance (EUR bn)	-1.3	-1.3	-1.1	-1.2	-1.1
Current account balance/GDP (%)	-9.5	-9.2	-7.7	-8.4	-7.2
Basic balance/GDP (%)	-7.0	-7.2	-4.1	-4.2	-2.9
Net FDI (EUR bn)	0.3	0.3	0.5	0.6	0.6
Net FDI (% of GDP)	2.5	2.0	3.6	4.2	4.3
Gross foreign debt (EUR bn)	6.7	6.9	7.0	7.2	7.4
Gross foreign debt (% of GDP)	49.1	49.5	49.7	50.2	49.6
FX reserves (EUR bn)	3.3	3.3	3.5	3.6	3.6
Inflation/Monetary/FX					
CPI (pavg)	3.7	2.1	0	0.3	2.4
CPI (eop)	3.1	1.8	-1.0	2.1	2.5
3M money market rate	1.18	0.33	0.12	0.13	0.75
USD/BAM (eop)	1.51	1.48	1.45	1.40	1.35
EUR/BAM (eop)	1.96	1.96	1.96	1.96	1.96
USD/BAM (pavg)	1.41	1.52	1.48	1.43	1.39
EUR/BAM (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

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

A modification of the SBA on the table

GDP growth forecasts are raised due to strong recovery in exports and industrial production

Our GDP forecast for both 2013 and 2014 has been revised upward to 0.9% and 1.5% yoy, respectively (previously 0.6% and 0.9% yoy). An unforeseen and strong economic recovery, especially during 1H, was driven primarily by industrial production and export growth. Exports of goods increased by 6.5 % yoy by October, while industrial production rose by 6%. However, growth rates were higher during 1H, largely due to exceptionally favorable conditions for the production of electricity and the low base for both categories set last year. The construction sector growth also contributed to the revival of overall economic activity due to infrastructure projects in road construction, mining and energy. However, housing construction remains subdued due to low demand. Despite certain improvements in economic activity, unemployment is still very high (27.5% according to ILO methodology; registered around 45%). It confirms that deeper structural reforms in labor market regulation are needed to stimulate a higher degree of labor activity and employment.

Low domestic demand and decline of food and energy prices brought inflation down

Real disposable income is still declining despite deflationary developments. The end-of-year headline consumer price index is now expected to decline 1%. Such a development is mainly the result of a significant decrease in energy and food prices. However, there has also been a strong one-off effect in the CPI decline at the beginning of the year due to some methodological adjustments introduced according to IMF suggestions. For the following year, we think that inflation will gradually increase to 2.1%, while the average CPI change in 2014 should moderate at 0.3%. The current account deficit should shrink to an estimated 7.6% of GDP from 9% in 2012, due to a combination of the strong growth of merchandise exports and decline of merchandise imports.

SBA remains on track – another tranche was drawn in October, next tranche should be disbursed in December/January

SBA agreement: The fourth IMF staff review was finalized in October with a positive assessment resulting in a new tranche of SDR 42.3mn (EUR 48mn), increasing the total disbursement to 62.5% of the existing program. Compliance with the requirements of SBA is particularly important considering the fact that the repayment obligations to the IMF amount to SDR 151.1mn (EUR 173mn) in 2014. The IMF launched a procedure to accept the government's request for a one year program extension to support the government through 2014, which is an election year (general elections are set for October), while noting that financing needs by the end of 2014 could create some pressure on the budget performance. The IMF assessment confirms satisfactory progress on reform implementation, especially on the strengthening of tax administration and overall public financial management.

Despite lower indirect tax revenues, fiscal deficit remains sustainable

Fiscal Outlook: Fiscal adjustments on the expenditure side of the budget in 2012 resulted in a lower fiscal deficit, 1.9% of GDP. Despite improved fiscal discipline, this year should see a modestly higher deficit at 2.2% of GDP, primarily as a consequence of the decline in net revenues from indirect taxes. Rising government debt, as a result of borrowing from supranational financial institutions and commercial banks, was unexpected. It raises the uncertainty around the IMF requirement for a significant long-term decline in public debt to a targeted 30% of GDP by 2017, now seen as very hard to be reached, even though we see a modest decline of public debt to levels below 40% of GDP on the back of debt repayments in 2013 and 2014 – planned up to 3.6% of GDP or EUR 500mn.

Sovereign rating remains stable, while lack of agreement on high level policy agenda continues to affect reform dynamics

Sovereign rating and political environment. The sovereign rating was kept stable by both Moody's (B3, stable) and S&P (B, stable) with SBA compliance as a main anchor. Political developments continue to be marked by disagreements among leading political actors as they are still not able to reach an agreement on constitutional changes, inevitable after the Sejdić-Finci ruling on the introduction of equal rights in the election process for ethnic minorities. Even the intermediation efforts by EU Commissioner for Enlargement since October did not help to resolve it. Therefore, the progress report of the European Commission published in mid-October just confirmed that this deadlock does not allow the B&H government to submit an application for EU candidate status, creating a potentially adverse effect for reforms.

Russia (Baa1 stable/BBB stable/ BBB stable)*

Outlook – Capacity constraints, tight labor market conditions and weak business sentiment are weighing on growth and sluggish economic activity in 2H13 is likely carry over to 1Q14. Above-target inflation diminishes the chances of rate cuts but global economic recovery and prudential monetary and fiscal policy should bring long term benefits, although the risk of authorities deviating from its conservative fiscal policy remains.

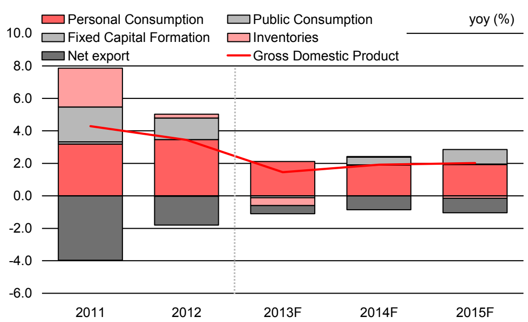
Strategy – We remain long Jan2028 to benefit from indexed inflows, Russia's relative resilience to tapering and reduced term premium owing to inflation targeting policy.

Authors: Artem Arkhipov, Head of Macroeconomic Analysis and Research (UniCredit Bank Russia), Anna Bogdyukevich, CFA (UniCredit Russia)

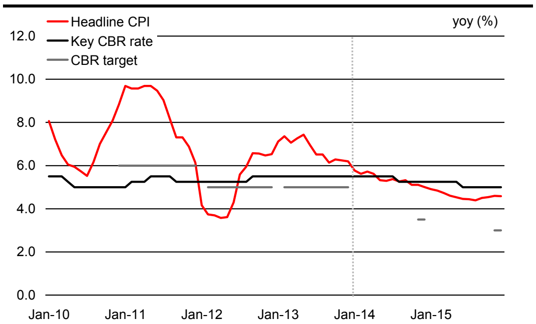
KEY DATES/EVENTS

- January – corporate bond Euroclearability
- February – completion of the refinancing system reform
- February-March – Sochi Winter Olympics 2014
- 18-23 of every month – short-term statistical overview
- 10-15 of every month – CBR decision on rates

DOMESTIC DEMAND WEAKENS



INFLATION ABOVE TARGET FOR NOW



Source: Federal Statistical Service, CBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	1,336	1,556	1,602	1,636	1,666
Population (mn)	143.1	142.9	142.7	142.5	142.3
GDP per capita (EUR)	9 336	10 893	11 232	11 486	11 711
Real economy yoy (%)					
GDP	4.3	3.4	1.5	2.0	2.1
Private Consumption	6.4	6.8	4.0	3.5	3.5
Fixed Investment	10.2	6.0	-0.5	2.3	4.5
Public Consumption	0.8	-0.2	0	0.1	0.2
Exports	0.3	1.4	1.5	1.5	1.5
Imports	20.3	9.5	4.0	5.3	5.3
Monthly wage, nominal (EUR)	580	675	697	710	711
Unemployment rate (%)	6.6	5.3	5.4	5.5	6.4
Fiscal accounts (% of GDP)					
Budget balance	0.8	0	-0.7	-1.0	-1.2
Primary balance	1.3	0.2	-0.4	-0.6	-0.9
Public debt	9.8	10.2	11.7	13.0	14.2
External accounts					
Current account balance (EUR bn)	79.5	63.2	33.0	16.2	8.4
Current account balance/GDP (%)	6.0	4.1	2.1	1.0	0.5
Basic balance/GDP (%)	5.3	3.5	1.9	0.7	-0.6
Net FDI (EUR bn)	-11.8	-4.7	-14.7	-5.7	-2.5
Net FDI (% of GDP)	-1.2	-0.3	-0.9	-0.3	-0.1
Gross foreign debt (EUR bn)	424.3	485.1	528.6	552.7	562.6
Gross foreign debt (% of GDP)	31.9	31.2	33.0	33.8	33.8
FX reserves (EUR bn)	384.7	407.3	398.2	385.1	389.3
Inflation/Monetary/FX					
CPI (pavg)	8.6	5.1	6.8	5.6	4.5
CPI (eop)	6.1	6.6	6.4	5.0	4.5
Central bank inflation target	6 - 7	5 - 6	5 - 6	5.00	4.50
Central bank reference rate (eop)	5.25	5.50	5.25	5.00	4.75
3M money market rate	6.6	7.45	6.75	6.00	5.50
USD/RUB (eop)	32.20	31.07	32.58	33.63	34.11
EUR/RUB (eop)	41.67	39.92	43.98	46.42	49.11
USD/RUB (pavg)	29.39	30.37	31.97	33.10	33.71
EUR/RUB (pavg)	40.87	40.23	42.33	45.06	47.26

Source: UniCredit Research

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

Time to reboot growth

In 2013, the Russian economy faced tough capacity constraints…

The drivers of the growth slowdown in 2013 means that 2014 is set to see GDP growth remain below its long term average. Russia continues to struggle in the face of stable to negative, rather than improving, terms of trade as oil price gains over the past decade turn to oil price stability in this decade. Second, the economy is facing tough capacity constraints. Capacity utilization in industry exceeded 75% while in those sectors with the highest contributions to GDP (refinery, metals, chemicals), it exceeded 80-85%. The actual degree of utilization is even higher due to distortions caused by obsolete capacity, accounting for ca. 40% of fixed assets. Third, labour market indicators show little slack. Unemployment reached a historical low of 5.2%. The ratio of vacancies to officially unemployed workers has increased to 1.5 while in previous years this stood below one. Completion of projects related to the Olympics may free up some capacity but there is a risk that growth suffers initially due to delays in replacement projects.

…and low business confidence

These capacity constraints are accompanied by weak business confidence, at least in part due to government policies. The authorities have taken a number of commendable steps, including the introduction of inflation targeting, the ongoing transition to a flexible RUB and the budget rule, but measures to address the weak investment climate and diversify the economy away from energy have lagged. The impact of this is clearly visible in the slump in capital investment, lower corporate profits and the differential between corporate (13% yoy) and personal credit (31.2% yoy).

Slowing credit growth has weighed on domestic demand

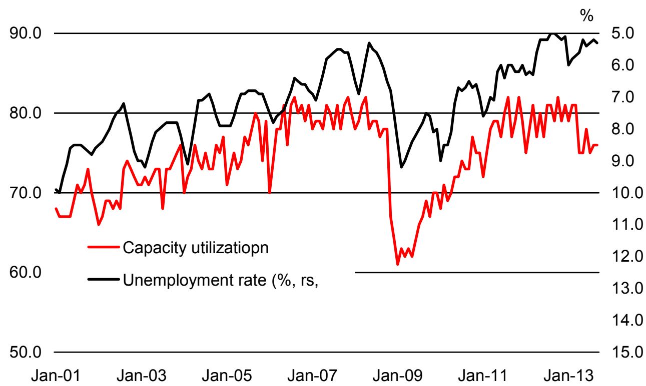
Credit has the potential to at least not drag on domestic demand next year. Over the 12 months to September consumer credit growth slowed by over 10pp, corporate credit by over 6pp, bringing aggregate credit growth down by 7pp. A further slowdown in consumer credit is unavoidable (in part due to regulatory changes) but we see some potential for corporate credit growth to accelerate, keeping overall credit growth stable to slightly stronger.

Russian CBR adhered to inflation targeting, high inflation lowers the potential for key rate cuts during 2014 to 25bp

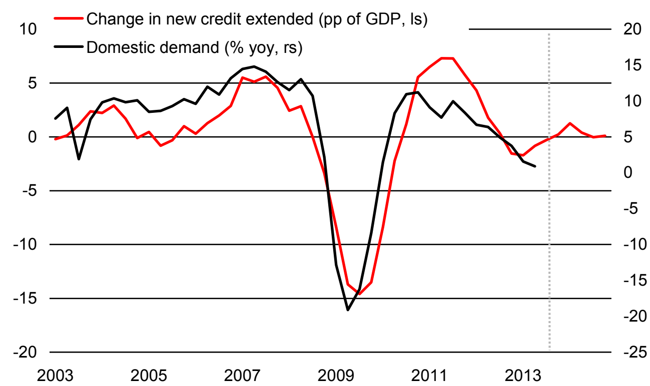
Despite the weak performance of the real economy, the CBR adhered to inflation targeting, refusing to cut rates. Deputy Chairwoman Ksenia Yudaeva reported that CPI is likely to exceed the 2013 target by 0.2pp due to "accidental factors" (most of which are related to agriculture and tariffs set by the government), but the target for 2014 is quite ambitious as well at 5%. We assume that it is achievable, although only if the CBR sticks to its conservative policies. In this respect, we think that the potential for key rate cuts during 2014 is no longer 75bp, but only 25bp. Other less important rates (e.g. refinancing, etc.) may decline by more.

GROWTH STALEMATE IS LINKED TO CAPACITY CONSTRAINTS AND LOW BUSINESS OPTIMISM

Spare capacities are more than scarce in Russia...



...but domestic demand might be supported by better credit impulse, assuming credit growth stabilises



Source: Rosstat, CBR, UniCredit Research

The CBR is likely to be less active in influencing the FX market in 2014, but we are quite conservative about the ruble due to the weak economy, and balance of payments and fiscal risks

Plans for a free floating RUB by 2015 remain on track. Therefore, the CBR will gradually decrease interventions throughout 2014, resulting in more frequent shifts in bi-currency basket band. The Olympics may offer support to RUB early next year due to an increased number of tourists, as well as the introduction of Euroclearability of corporate bonds in January and corporate shares in 2H14. However, these factors are unlikely to be sufficient to override domestic capital outflows throughout the year, because fundamentals (the weak economy, balance of payments and fiscal risks) will continue to dominate, exerting pressure on Russian markets.

Capital outflows will diminish, but not cease, because the business climate remains weak

While the influence of the balance of payments on the ruble is likely to be better than we anticipated a quarter ago – mostly due to an increase in the expected oil price from USD 103 to 105/bbl – it still contains risks due to the high role of capital flows. Russia's upward leap in the *Ease of Doing Business* Index and the marginal rank improvement in *Corruption Perception Index* may help to diminish capital outflows. However an aggregation of the C/A surplus and domestic capital outflows is likely to remain notably negative.

The budget for 2014-2016 implies only a rather small deficit, but the budget system in general is becoming more risky

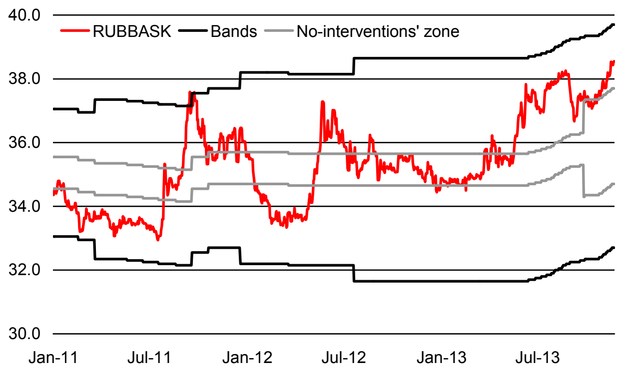
On the fiscal side, the budget for 2014-2016 implies a small deficit – within 1% of GDP, and is based on the fiscal rule. But in the face of weak growth the authorities are exploring other ways of supporting activity. This includes using money from state funds to finance large-scale projects, e.g. in the area of rail-road construction and transferring an increasing burden from the federal to other levels of the budgetary system, e.g. non-budget state funds, regional budgets, etc. Any deterioration in the commodity markets will create a pressure on the RUB to depreciate to ensure stability and/or a low deficit of the federal fund.

Slow growth in 2014 will bring the economy to a point of bifurcation, but acceleration of growth might require the authorities to be even more open to changes

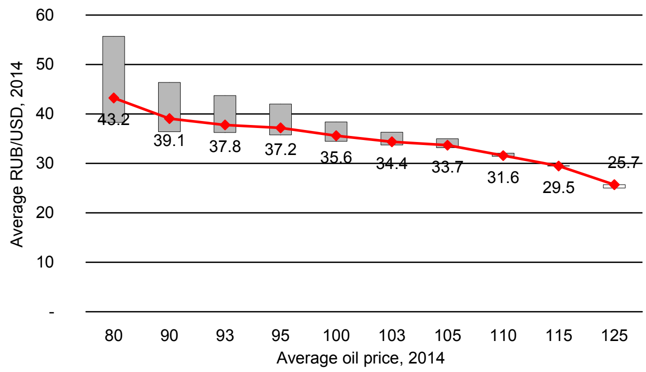
In a recent interview, EconMin A. Ulyukaev said that economy is likely to "stagnate" in 2014, although the official forecast for 2014FY is an optimistic 2.5%. This ambiguity is likely to persist at least through 1Q14. We expect growth in 2014 at a quite bleak 1.9% yoy (+0.1pp to our previous forecast – mostly to reflect the weaker base of 2013). In our view, 2014 is a point of bifurcation: either the new model of growth is launched, or for the next five years average growth will be capped at 2%. Acceleration will require the authorities to take the reform-momentum surrounding efforts such as inflation targeting and the budget rule and expand this towards efforts to diversify the economy and improve the business environment.

GROWTH STALEMATE IS LINKED TO CAPACITY CONSTRAINTS AND LOW BUSINESS OPTIMISM

The ruble became more flexible and depreciated in 2013…



…with more possibly to come in 2014 due to fiscal and other risks



Source: CBR, UniCredit Research

Strategy: Long-end OFZs and belly of USD paper to outperform

Long-end OFZs to benefit from policy easing and indexed inflows

We are long the Jan 2028 OFZ benchmark (from 8.20%) with an ultimate yield target of 6.85% (FX hedged). Russia should be relatively resilient to tapering given a positive current-account balance and a large stock of FX reserves. Inflows on account of inclusion into Barclays Global Aggregates Index should support the local market further. While we expect only modest policy easing, stronger inflation-targeting credentials should reduce the long-end term premium.

The belly of the USD curve to outperform the long end

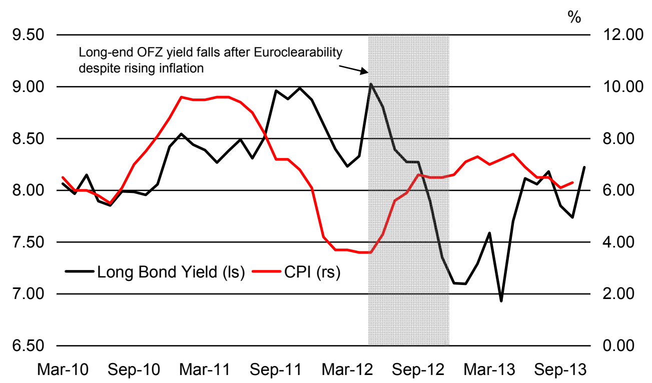
In sovereign credit, we stay overweight Russia and prefer the belly of the Russia USD curve (Jan2019s) to the long end (Sep2023) since the latter will be more vulnerable to the US Treasuries curve steepening as a result of tapering.

RUB to outperform TRY during tapering

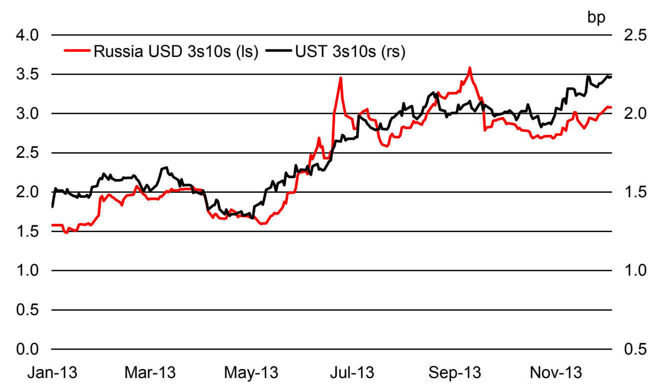
We look to buy RUB against TRY at the 16.50 level on the TRY-RUB cross in late December to target 15.75. While RUB will be vulnerable to tapering against USD and EUR, it should outperform TRY given the relative external exposures of the two countries.

GROWTH STALEMATE IS LINKED TO CAPACITY CONSTRAINTS AND LOW BUSINESS OPTIMISM

Long end yield should fall with a fall in inflation and inflation expectations



Russia USD curve strongly driven by the US Treasury curve in the medium term



Source: Rosstat, CBR, Bloomberg; UniCredit Research

Author: Gaurav Saroliya, Senior CEE Strategist (UniCredit Bank London)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**39.5**	**40.2**	**48.0**
Budget deficit	11.2	16.4	20.0
Amortisation of public debt	19.6	15.7	20.8
Domestic	18.1	14.8	18.5
Bonds	18.1	14.8	18.5
Bills	0	0	0
External	1.6	0.9	2.3
Sovereign Fund	8.7	8.2	7.2
Financing	**39.5**	**40.2**	**48.0**
Domestic borrowing	26.8	29.5	29.1
Bonds	26.8	29.5	29.1
Bills	0	0	0
External borrowing	5.4	5.0	8.9
Bonds	5.4	5.0	8.9
Other	7.4	5.7	10.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**26.3**	**43.3**	**58.2**
C/A deficit	-33.0	-16.2	-8.4
Amortisation of debt	52.1	53.9	62.3
Government/central bank	1.6	0.9	2.3
Banks	21.50	18.00	22.00
Corporates	29.00	35.00	38.00
Errors and omissions	7.24	5.56	4.20
Financing	**26.3**	**43.3**	**58.2**
FDI	-14.7	-5.7	-2.5
Equity	0	0	0
Borrowing	125.9	96.6	86.7
Government/central bank	5.4	5.0	8.9
Banks	33.5	34.5	33.5
Corporates	87.0	57.1	44.3
Domestic investments abroad	-75.8	-34.5	-30.2
Officiial reserves change/other	-9.0	-13.1	4.2

Source: Rosstat, CBR, UniCredit Research

Serbia (B1 stable/BB- negative/BB- negative)*

Outlook – The Serbian economy has emerged from recession but continues to face a weakening domestic consumption outlook that will drag growth next year. However, exports will continue to outperform which, alongside weak import demand, should maintain the C/A deficit below 5% until 2015. On the fiscal front, we welcome October's fiscal package, though see it as insufficient to prevent the deficit widening to 6.9% of GDP following higher interest and below-the-line expenditures. The good news is that external funding has improved considerably next year, though this does not diminish the need to secure an IMF deal to ensure fiscal consolidation.

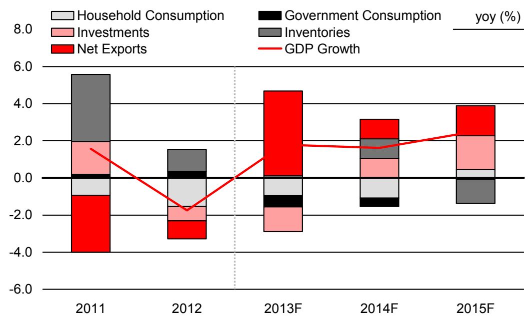
Strategy – Institutional reform to drive spread compression. We buy the USD 2018s looking for a spread compression down to 300bps (from the current 410bps).

Author: Carlos Ortiz, Economist (UniCredit Bank London)

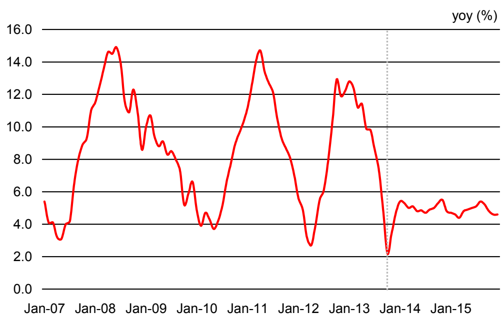
KEY DATES/EVENTS

- 30 Dec – 3Q13 GDP (final)
- 20 Dec, 20 Jan, 20 Feb – Current Account Balance
- 10 Jan, 12 Feb, 12 March – Consumer Price Index
- 30 Dec, 30 Jan, 28 Feb – Retail Sales
- 30 Dec, 30 Jan, 28 Feb – Industrial Production

GDP GROWTH TO EASE IN 2014



CPI SET TO MODERATE



Source: NBS, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	31.5	29.9	32.7	34.0	35.6
Population (mn)	7.6	7.6	7.6	7.6	7.6
GDP per capita (EUR)	4,160	3,945	4,298	4,461	4,676
Real economy yoy (%)					
GDP	1.6	-1.7	1.8	1.6	2.5
Private Consumption	-1.1	-1.9	-1.2	-1.4	0.6
Fixed Investment	8.4	-3.4	-6.1	5.2	8.7
Public Consumption	-0.1	1.8	-2.9	-2.3	-0.4
Exports	3.4	4.5	12.8	5.8	7.2
Imports	7.0	2.3	1.2	2.4	2.7
Monthly wage, nominal (EUR)	518	508	528	433	374
Unemployment rate (%)	23.0	23.9	24.0	24.6	24.4
Fiscal accounts (% of GDP)					
Budget balance	-4.9	-6.4	-6.6	-6.9	-5.5
Primary balance	-3.5	-4.4	-4.0	-3.8	-2.5
Public debt	46.0	59.0	64.2	65.3	67.8
External accounts					
Current account balance (EUR bn)	-2.9	-3.2	-1.6	-1.5	-1.7
Current account balance/GDP (%)	-9.1	-10.5	-4.9	-4.4	-4.8
Basic balance/GDP (%)	-3.3	-9.8	-2.6	-1.2	-1.4
Net FDI (EUR bn)	1.8	0.2	0.8	1.1	1.2
Net FDI (% of GDP)	5.8	0.8	2.3	3.2	3.4
Gross foreign debt (EUR bn)	24.1	25.7	27.8	30.8	30.5
Gross foreign debt (% of GDP)	76.7	85.9	85.1	90.7	85.6
FX reserves (EUR bn)	12.1	10.9	11.0	11.3	10.7
Inflation/Monetary/FX					
CPI (pavg)	11.6	7.3	8.2	5.1	4.8
CPI (eop)	7.0	12.2	4.7	4.8	4.6
Central bank target	4.5±1.5%	4.0±1.5%	4.5±1.5%	4.5±1.5%	4.5±1.5%
Central bank reference rate (eop)	9.75	11.25	9.75	9.25	10.00
BELIBOR 3M	12.88	11.64	10.30	9.80	10.63
USD/RSD (eop)	80.86	86.17	85.18	84.28	83.44
EUR/RSD (eop)	104.64	113.72	115.00	118.00	121.00
USD/RSD (pavg)	73.34	87.95	86.31	85.40	84.92
EUR/RSD (pavg)	101.95	113.13	113.93	117.00	119.75

Source: Unicredit Research

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

Adjustment underway, but in need of a fiscal anchor

GDP growth in 2014 to reach 1.6% yoy, but expected to accelerate from 2015 on as domestic demand recovers

The Serbian economy is set for a strong export-led recovery this year, although it is expected to slow down in 2014 due to weakening domestic demand. Based on preliminary data, 3Q13 GDP grew by 3.2% yoy, up from 0.2% yoy in 2Q13. While details on the growth composition will be given on December 30, we believe much of the growth rebound was led once again by rising exports, up 11% YTD. Going forward, the strong push from agriculture and Fiat should help net external demand add as much as 4.5pp of GDP this year, while close to 1pp in 2014 on account of EMU recovery. In contrast, domestic demand is expected to weaken further, with the biggest hit likely to be seen in government expenditures (2014F at -2.3% yoy). The planned reduction of public sector pay by 20-25%, lower wage and pension indexations and worsening labor market prospects will also take their toll on private consumption (2014F at -1.4% yoy), expected to recover only by mid-2015. As for investment expenditure, the strong underperformance seen in 1H13 (-11.8% yoy) was mainly due to the strong adjustment in the construction sector (-42.5% in 2Q13; -40.4% YTD), but this is expected to recover going forward on account of rising FDI, increasing UAE-funded projects and the start of construction on the South Stream gas pipeline.

Inflation expected to remain within the NBS 4±1.5% yoy target band in 2014 due to lower food prices and weak domestic demand

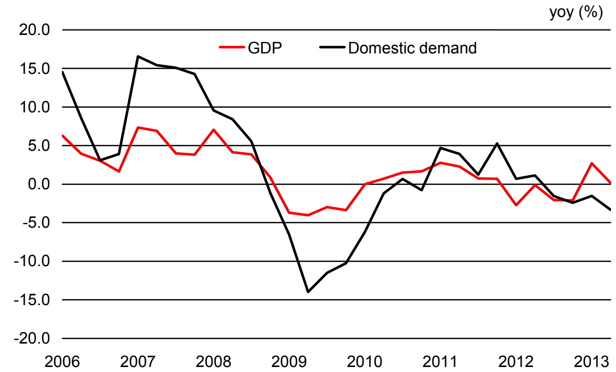
Easing inflationary and dinar pressures have translated into looser monetary policy, with the easing cycle expected to continue in the coming months. As expected, the dissipation of last year's high base effects from food and administered prices has led to a significant downward adjustment to yoy inflation, with the 2.2% yoy reading in October at a historical low. Looking ahead, the main disinflationary factors will be lower costs in the production of food and frail domestic demand, which should keep inflation within the Central Bank's 4±1.5% yoy target tolerance band. The expected upward revision of the special VAT rate by 2pp to 10% in January will have a one-off impact on next year's inflation, but in any case is expected to be limited (one-off estimate of 0.6pp). The key from here will be the evolution of the dinar, as Fed tapering and uncertainties over the increase of the US debt ceiling could exert some depreciation pressure in 1Q14. However, we remain confident that these are likely to remain limited as the NBS has ample FX reserves (EUR 10.2bn as of October) to continue intervening in the FX market (EUR 285mn in interventions between July and October). Keeping all this in mind, we see the NBS easing rates further in the coming months, although the pace and size of the easing cycle will remain dependent on external market sentiment and degree of monetary policy pressure coming from the IMF.

The C/A deficit is expected to narrow significantly this year following the strong export boost from automobile industry

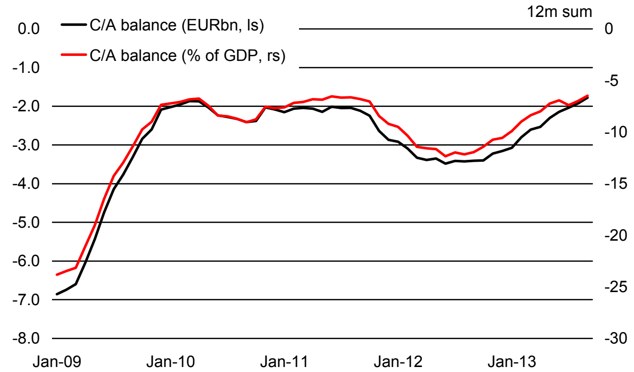
External imbalances are improving at a rapid pace, with the current account deficit between Jan-Sept narrowing 56% vis-à-vis the same period of last year to EUR 1.08bn (or 3.3% of GDP). For year-end, we expect the ongoing strong export push from the automobile sector to continue narrowing the trade deficit which, together with higher inflow of remittances (up 20% YTD), should narrow the C/A deficit to around 4.9% of GDP. However, the room for further improvement in the C/A deficit is likely to be exhausted by the end of the forecast horizon, as domestic demand and imports start to recover.

STRONG EXPORT GROWTH BEHIND THE GDP RECOVERY AND C/A DEFICIT REDUCTION

Domestic demand continues to be a drag on economic activity…



…but exports are narrowing the C/A deficit at a rapid pace



Source: National Bank of Serbia, MinFin, UniCredit Research

The fiscal package aims to cut the budget deficit by 5% of GDP by 2017…

On the fiscal front, the government presented a supplementary fiscal package on 8 October. Effective next year, the fiscal package aims to cut the budget deficit by close to EUR 1.6bn (or 5% of GDP) by 2017, with the biggest savings to be obtained (approximately 2/3 of total savings) from the planned reduction in subsidies, public sector pay, and cheaper refinancing of expensive debt. These measures include: **1.** An increase in the VAT rate on food and other items from 8% to 10%, **2.** The reduction in public sector wages by 20% and 25% for salaries above RSD 60,000 and RSD 100,000 per month, respectively, **3.** The reduction in wage and pension indexations to 0.5% per year in 2015-16, **4.** Cancellation of the investment tax credit in 2015, and **5.** Reduction of subsidies by 10% (or 0.2% of GDP). As for pension system reform, the early retirement age was raised from 58 to 60 years, while that of female retirement was raised from 60 to 63 years. Moreover, changes were made to existing regulations to improve Serbia's business climate, namely by adopting the Labor Law to enhance labor market flexibility and changing the framework for infrastructure investment to allow partnerships between the public and private sectors.

…but high interest and below-the-line payments will limit the contraction of Serbia's deficit and public debt

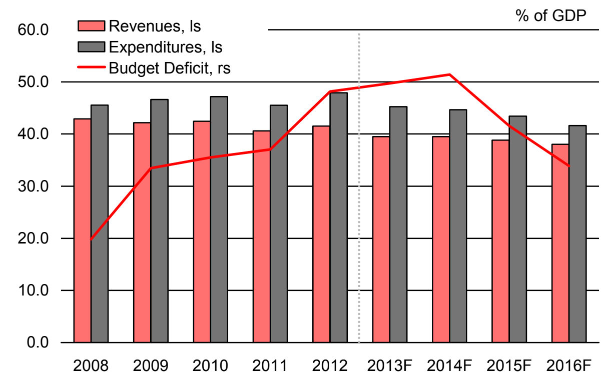
While a step in the right direction, additional fiscal measures will have to follow to bring public finances into balance. In particular, we maintain our view that the budget deficit this year will widen to 6.6% of GDP, mainly on account of large interest expenditures (2.6pp of GDP) and below-the-line contingent payments (0.9pp of GDP). While it is true that the provisional 3Q13 GDP growth estimate (+3.2% yoy) points to an encouraging recovery by year-end, we remain skeptical that it will increase tax revenues enough to counter the elevated budget expenditures. Going forward, and despite the measures, we view the budget deficits remaining unsustainably high, with the 2014 and 2015 projections at 6.9% and 5.5% of GDP, respectively. Again, we expect most of the deviation to come from higher interest expenditures (avg. 2014F-15F at 3.1pp of GDP) and contingent payments to loss-making SOEs (namely on Srbijagas, Semedrevo steel, and Galenika). Moreover, we view the savings impact of the solidarity tax as limited, since the public sector remains too large, while uncertain privatization proceeds cap the income potential to repay expensive loans. All in all, and despite the measures, public debt will remain on an upward trajectory, and is not expected to improve until 2020 unless further austerity is applied.

External funding to be increased in 2014, but IMF loan still in need to anchor fiscal consolidation

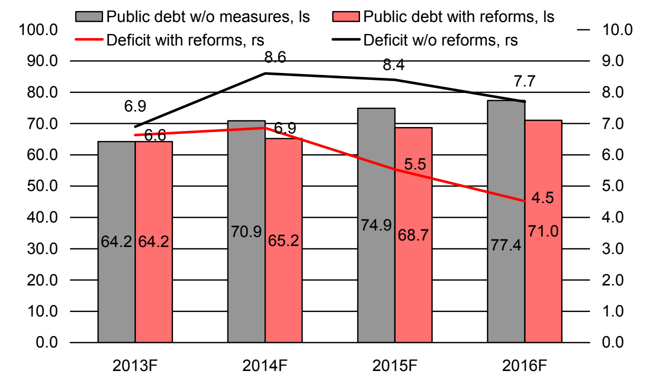
The good news is that funding has improved, with the USD 1bn Eurobond on 21 November allowing the government to cover its remaining funding for the year as well as to add close to EUR 0.5bn to its cash reserves (now at EUR 1.57bn). Serbia's external funding prospects also look good for next year, as USD 3.6-4.6bn looks set to be secured: more precisely, **1.** USD 2-3bn will come in the form of a UAE loan, **2.** USD 0.7bn from the World Bank (o/w USD 0.2bn will go to the Deposit Insurance Agency), **3.** USD 0.2bn from Russia, and **4.** USD 0.5bn from the EBRD. That said, we expect the sovereign to come back to the Eurobond market in 2H14 as the USD 0.5bn in World Bank loans (2x USD 250mn) remains conditional on an effective resolution of Serbia's highly ambitious 153-company restructuring plan. As for the IMF loan, we expect negotiations to continue well into 1H14, with a deal likely to be reached by end-2014, assuming stricter fiscal conditionality is agreed upon.

PUBLIC FINANCES ARE IN NEED OF FURTHER CONSOLIDATION

Falling expenditures to reduce the deficit by 2014…



…but will remain insufficient to curb the rising public debt trend



Source: NBS, MinFin, UniCredit Research

Strategy – Upside on reform and funding adequacy

We are overweight Serbian USD paper…

We see upside potential in Serbian sovereign debt and choose to express the view through the newly-issued USD Dec2018 (offering 421bp above the US Treasuries of equivalent maturity; we look initially for a move down to 300bp, with a stop at 480bp). Apart from being attractive in an outright sense for a yield pick-up over Treasuries, Serbia is an important local story for us offering potential for spread compression on account of several near-term favorable drivers.

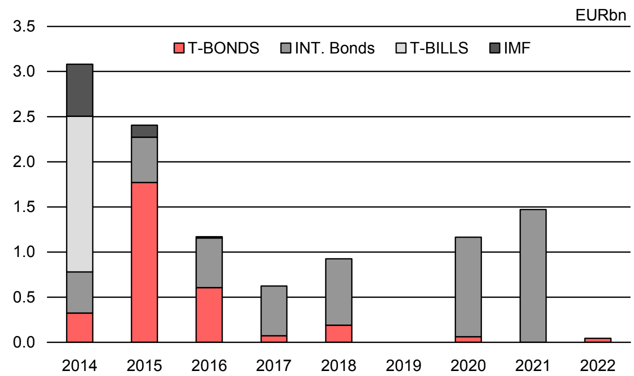
…and look for spread compression in USD Dec2018 in view of positive reform impulses

First, the new technocratic appointments to the ministries of economics and finance and the budget-consolidation plan introduced in October offer positive reform impulses. Second, Serbia has already met its financing needs for 2013 and begun pre-financing for 2014 in order to build liquidity buffers. Thirdly, while the 2014 redemption profile looks heavy, the sovereign looks to be adequately funded for 2014 in view of USD 3.6-4.6bn of prospective external funding. The risk to our view comes from potential political instability coming from early elections (possibly in 2Q14) and any lack of progress on securing an IMF deal by end-2014.

WE SEE SCOPE FOR SPREAD COMPRESSION GIVEN REFORM MOMENTUM AND FUNDING ADEQUACY

Per-unit duration average spread over benchmark on Serbian USD sovereign debt

Debt redemption profile as of December 2013



Source: NBS, IMF, Bloomberg, UniCredit Research

Author: Gaurav Saroliya, Senior CEE Strategist (UniCredit Bank London)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**5.4**	**6.0**	**6.2**
Budget deficit	2.2	2.4	2.0
Amortization of public debt	3.2	3.1	4.1
Domestic	2.6	2.0	3.5
Bonds	0	0.3	1.8
Bills	2.6	1.7	1.7
External	0.6	1.0	0.6
IMF	0.2	0.6	0.1
Financing	**5.4**	**6.0**	**6.2**
Domestic borrowing	3.8	2.8	3.3
Bonds	2.2	1.5	1.8
Bills	1.5	1.3	1.5
External borrowing	2.2	3.6	2.9
Bonds	1.8	0.7	1.0
IMF/EU	0	0.5	1.5
Other	0.3	2.4	0.4
Change in cash reserves (+ = decline)	-0.5	-0.4	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**7.1**	**7.5**	**6.8**
C/A deficit	1.6	1.5	1.7
Amortization of medium to long term debt	5.0	5.8	4.9
Government/Central Bank	0.6	1.0	0.6
IMF	0.2	0.6	0.1
Other	0.4	0.5	0.5
Banks	1.0	1.0	0.9
Corporates	2.8	2.8	2.7
Amortization of short term debt	0.5	0.1	0.2
Government/Central Bank	0	0	0
Banks	0.4	0.1	0.1
Corporates	0.1	0	0.1
Financing	**7.1**	**7.5**	**6.8**
FDI	0.8	1.1	1.2
Equity	0	0	0
Borrowing	5.9	6.9	5.9
Government/Central Bank	2.2	3.6	2.9
IMF	0	0.5	1.5
Bonds	1.8	0.7	1.0
Other	0.3	2.4	0.4
Banks	1.1	0.7	0.6
Corporates	2.7	2.6	2.5
Change in FX reserves (+ = decline)	0.5	-0.5	-0.3

Source: MinFin, NBS, UniCredit Research

Turkey (Baa3 stable/BB+ stable/BBB- stable)*

Outlook – Economic activity is slowing, as captured by credit growth and import volumes. Fiscal policy may not be able to support activity as it has in the past, though the busy election period ahead poses a risk to fiscal performance. We forecast GDP growth of 2.1% next year, considerably below the government's projection. The CBT is increasingly spreading the adjustment across FX, interest rates and foreign reserves but more remains to be done.

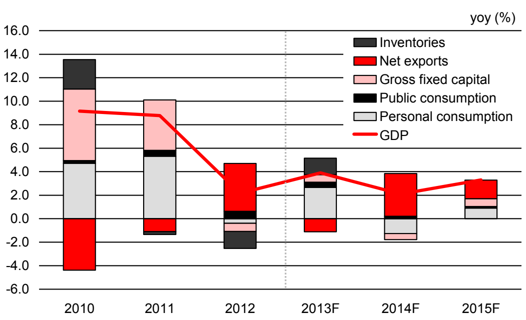
Strategy – We are underweight Turkey in sovereign credit and local bonds and look for curve flattening with a weaker TRY and tighter policy in response.

Author: Gillian Edgeworth, Chief EEMEA Economist (UniCredit Bank London),
Carlos Ortiz, Economist (UniCredit Bank London)

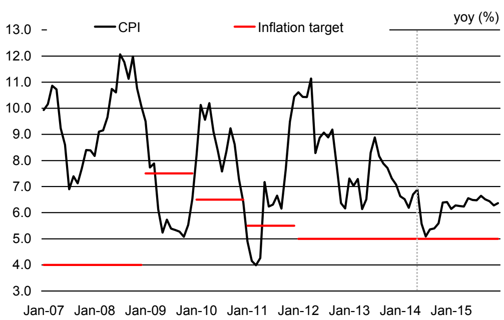
KEY DATES/EVENTS

- 17 Dec – Policy rate decision
- 31 Dec – Nov Trade balance
- 10-14 Jan – Nov C/A balance
- 30 Mar – Local elections

GDP GROWTH TO MODERATE IN 2014



CPI SET TO MODERATE



Source: TurkStat, CBT, Unicredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	558.6	611.5	625.8	585.6	597.7
Population (mn)	74.0	74.9	75.8	76.7	77.6
GDP per capita (EUR)	7,553	8,166	8,255	7,634	7,701
Real economy yoy (%)					
GDP	8.8	2.2	3.9	2.1	3.3
Private Consumption	7.7	-0.6	4.0	-1.9	1.4
Fixed Investment	18.0	-2.7	2.6	-2.1	2.9
Public Consumption	4.7	6.1	4.2	2.0	1.3
Exports	7.9	16.7	4.1	10.9	7.7
Imports	10.7	-0.3	8.0	-2.2	2.5
Monthly wage, nominal (EUR)	788	922	954	923	966
Unemployment rate (%)	9.8	9.2	9.5	9.5	9.3
Fiscal accounts (% of GDP)					
Budget balance	-0.7	-1.6	-0.7	-2.3	-2.7
Primary balance	2.0	1.2	1.9	-0.1	-0.3
Public debt	39.1	36.2	34.5	34.8	34.8
External accounts					
Current account balance (EUR bn)	-54.0	-37.1	-49.5	-31.1	-25.9
Current account balance/GDP (%)	-9.7	-6.1	-7.9	-5.3	-4.3
Basic balance/GDP (%)	-7.9	-5.0	-6.8	-3.8	-2.6
Net FDI (EUR bn)	9.8	6.6	6.8	8.6	10.3
Net FDI (% of GDP)	1.8	1.1	1.1	1.5	1.7
Gross foreign debt (EUR bn)	235.8	255.3	295.2	312.4	322.6
Gross foreign debt (% of GDP)	42.2	41.8	47.2	53.4	54.0
FX reserves (EUR bn)	59.4	74.5	82.8	77.9	77.2
Inflation/Monetary/FX					
CPI (pavg)	6.5	8.9	7.5	6.1	6.4
CPI (eop)	10.4	6.2	7.1	6.4	6.4
Central bank target	7.5	6.5	5.5	5.0	5.0
Central bank reference rate (eop)	5.75	5.50	4.50	6.00	7.50
3M money market rate	8.55	7.69	6.25	6.88	7.15
USD/TRY (eop)	1.87	1.79	2.04	2.20	2.25
EUR/ TRY (eop)	2.46	2.35	2.74	3.08	3.26
USD/ TRY (pavg)	1.68	1.80	1.90	2.14	2.23
EUR/ TRY (pavg)	2.34	2.32	2.53	2.92	3.15

Source: UniCredit Research

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

Adjustment underway but more to go in 2014

Economic activity has slowed rapidly in Turkey as the EM risk environment deteriorated

Within CEE, economic activity has suffered more in Turkey since discussions of tapering have materialised and portfolio flows to EM changed direction, leaving the authorities' growth projections for next year looking unrealistic. Turkey's reliance on cheap capital inflows to finance domestic demand has been central this.

The slowdown in credit growth is healthy but has been rapid and more is required

Credit growth has slowed rapidly, from a peak of over 40% in August to 25% by end-November (3m/3m SA and annualised basis) but the adjustment is not yet done. Credit growth remains well above deposit growth. There is good news in the fact that over recent months the banking sector has increased its external rollover ratios impressively but credit growth may be constrained by renewed bank purchases of domestic government debt. Banking sector exposure to the central government has fallen from 30% of total assets in 2009/10 to 16.5% of total assets currently. Assuming credit growth slows to 15% (CBT's reference rate), domestic demand has peaked and will contract next year.

Fiscal policy will not be able to support activity, as it has in the past

Fiscal will not be able to support activity to the extent it has over recent years. Public consumption has contributed over 0.5pp to real GDP growth per annum on average over 2009-12. Public investment in Q2 this year accounted for 1.4pp of the 4.4pp increase in real GDP. This fiscal stance has been accompanied by strong headline budget performance as revenue surprised on the upside while the interest bill has fallen. This meant that expenditure could increase without endangering budget targets. But we believe there is little scope for revenue to surprise on the upside next year while the government's interest bill risks proving higher than expected. This will constrain government expenditure.

We forecast GDP growth next year at 2.0%

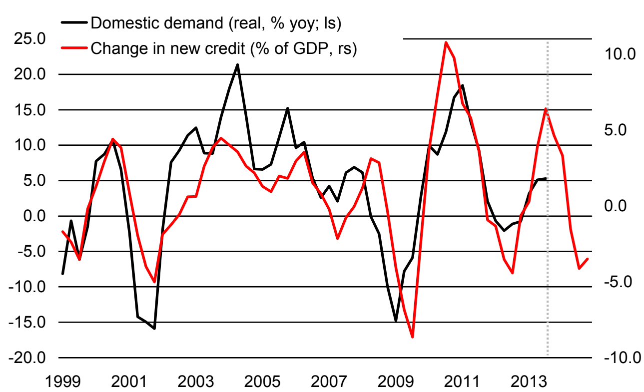
This slowdown in credit and domestic demand has slowed means that we see 2014 growth at just over 2%, i.e. half of the government's 4%. Over 4Q this year to 2Q next year we assume flat GDP in SA real terms, recovery from 2Q14. The good news is centered on industry and export performance, which is already benefitting from a stronger EMU and should continue to do so over 2014. This corresponds with a forced narrowing of the C/A deficit amist an absence of sufficient financing and an assumed improvement in the gold balance.

The risks are centered around C/A deficit financing

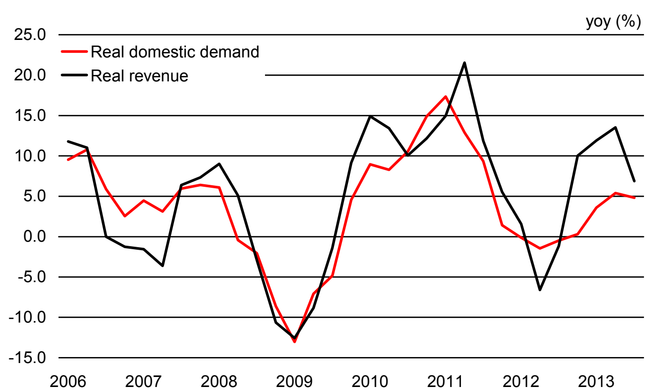
The risks to our forecasts are centered around C/A deficit financing. We see Turkey's C/A deficit narrowing to 5.3% of GDP next year, more than 2.5pp of GDP narrower than this year, but remain wide. Portfolio flows will continue to play a crucial role. This assumes some modest portfolio inflows combined with continued, albeit more muted, FX sales by the CBT. Should past portfolio inflows reverse, a further C/A and growth adjustment will be required.

CHALLENGES TO GROWTH

If credit growth slows to 15%, domestic demand will turn negative



Government revenue will feel the pinch



Source: Turkstat, CBT, Treasury, UniCredit Research

We are entering a busy election period

Politics will dominate headlines more and more. Local elections are scheduled for the end of March, Turkey's first Presidential election August. General elections are currently scheduled for 2015 but may be brought forward. The role of PM Erdogan in future administrations will be closely watched. From a fiscal perspective, recent government rhetoric decreases our concerns of more populist policies, though we continue to watch this carefully. Finance Minister Simsek has acknowledged a need to adjust to a slower pace of growth until the C/A deficit narrows to a more sustainable ratio. Recent macro-prudential measures aimed at capping retail credit growth also suggest some adjustment in the authorities' growth expectations.

The CBT is increasingly spreading the adjustment across FX, interest rates and foreign reserves…

There is positive news in the fact that the CBT is showing willingness to distribute the adjustment more evenly across FX reserves, interest rates and TRY, in contrast with the summer period. Having stepped away from its stable currency policy in mid-May, the CBT tightened monetary conditions in November by halting 1 month liquidity provision to the banking sector. This pushes the banks into overnight liquidity provision at a more punitive rate. FX sales by the CBT have slowed, though at USD 13bn since June, FX sales this year have been significant. While the CBT has been reluctant to hike its policy rate, bank lending rates have in any case adjusted. The cost of consumer and commercial loans has increased over 200bp since the end of May. FX reserve loss YTD has been significant at USD 13bn but has slowed. Moreover the CBT's policy of FX sales is no longer being accompanied by increased liquidity provision to the banks, as was the case during the summer.

…but there is a risk that the Bank is forced to facilitate further adjustment

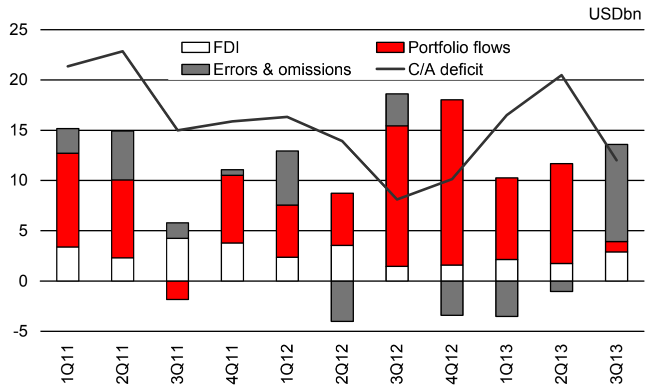
But as with expectations for real GDP growth, we believe that scope also remains for further adjustment in short end interest rates and TRY. Despite the surprise delay to tapering, the absence of any significant TRY rally is telling. While we do not expect tapering, once it does begin, to prove as disruptive for EM as an asset class as was the case over 2Q this year, the risks surrounding portfolio capital in Turkey remain significant. We do not exclude that the renewed currency pressure forces the CBT to aggressively absorb liquidity, as it did in late 2011, but this will also likely be met with some more TRY adjustment. Though we see inflation as secondary to financial stability for the authorities, the CBT will also be forced to revise upwards its inflation projections once again for next year and we expect inflation to remain above target throughout 2014.

Longer term, Turkey's low savings ratio is its primary challenge

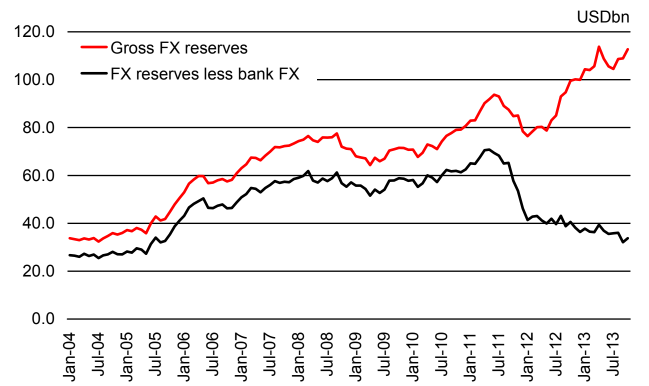
From a longer term perspective, Turkey's primary challenge remains an increase in its savings rate. Some steps have been taken, including progress on pension reform. But the government missed its opportunity to contribute in recent years, having failed to push its structural budget deficit into surplus. On a more positive note, a solid starting point on debt stocks means that we do not see material impedi-ments to recovery, once the necessary adjustment is done.

BOP VULNERABILITIES REMAIN SIGNIFICANT

C/A financing is not convincing…



…while a shortage of net FX reserves remains problematic



Source: CBT, Turkstat, UniCredit Research

Strategy: Positioning for near-term vulnerabilities

W prefer the long end of TURKGBs to the short end as a weaker TRY will require tighter policy and flatten the curve

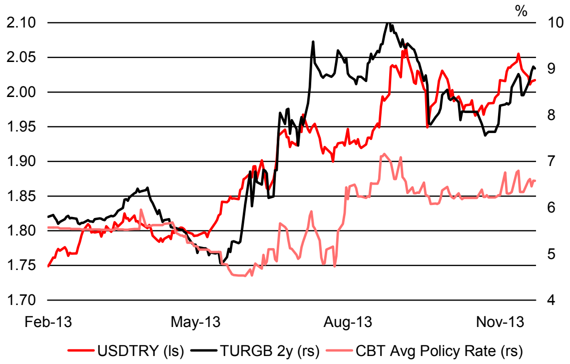
We are underweight duration in TURKGBs and along the curve prefer to hold long-end TURKGBs (March 2023) to the short-end benchmarks (Jan 2016s), given Turkey's near term vulnerabilities to a tightening in global financial conditions. The short end will be more vulnerable to TRY weakness, capital outflows and the policy tightening required in response. In FX, we look to sell TRY-RUB (above 16.50) to position for tapering in a carry-efficient way.

In sovereign paper, we prefer Jan41s to Sep22s, as the latter are more vulnerable to higher 10Y UST

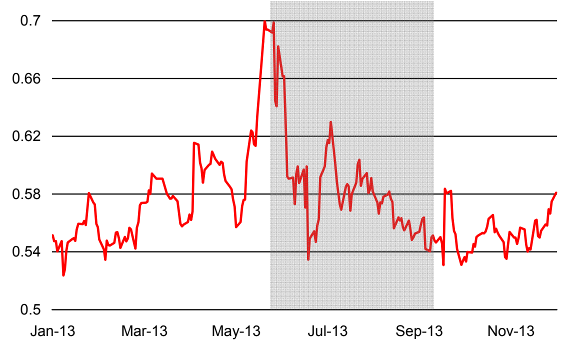
We recommend positioning for tapering risks by switching into the ultra long end of the Turkey USD curve (Jan 2041) relative to the long end (Sep 2022), which is more directly influenced by a higher 10-year UST yield. However, the ultra long-end outperformed the long end in duration-adjusted terms during the previous sell-off from May to August.

SHORT-END RATES VULNERABLE TO A WEAKER TRY; ULTRA LONG-END USD PAPER TO OUTPERFORM DURING TAPERING

Short-end TURKGBs vulnerable to a weaker TRY during tapering, leading to potential curve flattening



Ratio of duration-adjusted USD-paper spreads: Jan2041s to Sep2022s



Source: Bloomberg, UniCredit Research

Author: Gaurav Saroliya, Senior CEE Strategist (UniCredit Bank London)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**55.2**	**55.8**	**55.3**
Budget deficit	4.3	13.6	15.8
Amortisation of public debt	51.0	42.2	39.6
Domestic	47.8	39.9	37.6
Bonds	47.8	39.9	36.6
Bills	0	0	1
External	3.2	2.3	2.0
Financing	**55.2**	**55.8**	**55.3**
Domestic borrowing	55.0	34.9	32.9
Bonds	55.0	34.9	32.9
Bills	0	0	0
External borrowing	4.9	6.0	6.0
Bonds	4.9	6.0	6.0
Other	8.9	8.5	9.1
Change in cash reserves(+ = decline)	-13.6	6.3	7.3

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013	2014F	2015F
Gross financing requirement	**197.3**	**197.0**	**186.2**
C/A deficit	65.3	42.7	36.5
Amortisation of medium to long term debt	36.7	29.0	24.4
Government/central bank	3.6	2.8	2.8
Banks	11.7	11.6	9.0
Corporates	21.4	14.7	12.7
Short term debt	101.0	125.3	125.3
Government/central bank	12.1	17.5	17.5
Banks	58.5	73.3	73.3
Corporates	30.4	34.4	34.4
Errors & omissions	-5.7	0	0
Financing	**197.3**	**197.0**	**186.2**
FDI	9.0	11.7	14.0
Portfolio	11.0	5.0	5.0
Borrowing medium to long term	49.9	38.2	32.8
Government/central bank	4.9	6.0	6.0
Banks	15.0	11.6	9.0
Corporates	30.0	20.6	17.7
Short term borrowing	114.5	127.0	128.9
Government/central bank	17.5	19.3	21.2
Banks	65.0	73.3	73.3
Corporates	32.0	34.4	34.4
Other	-0.4	10.1	5.5
Reserve accumulation	13.3	5.0	0

Source: CBT, Treasury, Bloomberg, UniCredit Research

Ukraine (B3 negative/B negative/B negative)*

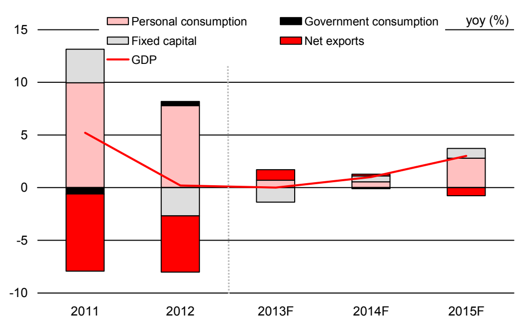
Outlook – The domestic authorities are being pushed to take fundamental choices amidst an unviable growth model, large twin deficits and unsustainably tight monetary conditions. Foreign reserves are low and declining while public debt to GDP has risen sharply. The authorities are reluctant to take a choice but domestic political developments are forcing the situation. A free trade agreement with the EU boosts long term growth potential but also forces an IMF programme in the near term. A deal with Russia delivers more upfront funding but without the growth boost.

Author: Gillian Edgeworth, Chief EEMEA Economist (UniCredit Bank London)

KEY DATES/EVENTS

- 30th January: Preliminary 4Q GDP
- 17th Dec, 16th Jan, 17th Feb: Industrial production
- March 2014: EU scheduled to sign
- March 2015: Presidential elections

MEANINGFUL RECOVERY OUT OF SIGHT



ADJUSTING TO FOOD PRICE SHOCK

Source:State Statistics Service of Ukraine; UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2011	2012	2013F	2014F	2015F
GDP (EUR bn)	117.1	135.5	128.6	120.5	114.8
Population (mn)	45.6	45.5	45.4	45.3	45.2
GDP per capita (EUR)	2,568	2,979	2,832	2,660	2,540
Real economy yoy (%)					
GDP	5.2	0.2	-1.4	0	1.5
Private Consumption	15.7	11.7	3.5	-0.5	0.7
Fixed Investment	7.1	0.9	-10.0	0	0
Public Consumption	-3.0	2.2	-1.5	-0.5	-0.6
Exports	4.3	-7.7	-12.5	1.2	3.0
Imports	17.7	1.9	-9.5	-0.6	0.8
Monthly wage, nominal (EUR)	237	292	294	290	303
Unemployment rate (%)	8.2	7.8	7.5	7.6	8.0
Fiscal accounts (% of GDP)					
Budget balance	-2.8	-4.5	-5.7	-5.6	-4.2
Primary balance	-0.8	-2.6	-3.2	-3.0	-1.6
Public debt	36.8	37.4	43.9	49.5	52.0
External accounts					
Current account balance (EUR bn)	-7.4	-11.5	-10.6	-7.3	-5.6
Current account balance/GDP (%)	-6.3	-8.5	-8.2	-6.0	-4.9
Basic balance/GDP (%)	-2.0	-4.7	-6.5	-3.3	-2.2
Net FDI (EUR bn)	5.0	5.2	2.3	3.3	3.2
Net FDI (% of GDP)	4.3	3.8	1.8	2.7	2.8
Gross foreign debt (EUR bn)	97.4	102.4	106.3	111.4	116.6
Gross foreign debt (% of GDP)	83.2	75.5	82.7	92.5	101.6
FX reserves (EUR bn)	23.4	17.2	14.4	13.2	12.1
Inflation/Monetary/FX					
CPI (pavg)	8.0	0.6	-0.1	4.7	4.5
CPI (eop)	4.6	-0.2	1.8	5.4	4.0
Central bank reference rate (eop)	7.75	7.50	6.50	7.00	7.00
3M money market rate (Dec avg)	9.92	19.82	11.27	16.00	8.50
USD/UAH (eop)	8.0	8.1	8.4	9.2	9.6
EUR/UAH (eop)	10.37	10.62	11.27	12.86	13.98
USD/UAH (pavg)	7.98	8.08	8.15	8.77	9.41
EUR/UAH (pavg)	11.12	10.39	10.80	12.07	13.42

Source: UniCredit Research

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

Time for action

The domestic authorities are being pushed to take fundamental choices…

Ukraine's government is in search of an easy solution to large macro imbalances that will avoid a near term contraction in economic activity while boosting the President's chances of re-election in Mar-15. But given the bleak macro backdrop, this is not an easy task. Our forecasts assume an unchanged status quo, given the uncertainty surrounding the authorities' decisions in the near term but significant revisions will likely be necessary in the next 1-2 months:

…amidst an unviable growth model…

- Ukraine's growth model has been based on two sectors, namely agriculture and steel, but the latter is proving increasingly unviable in the absence of price gains and an inefficient structure. Metal exports in yoy terms have shown double-digit contraction for 11 consecutive months. This leaves agriculture to carry the burden but even a series of bumper harvests have not been sufficient to keep real GDP growth in positive territory;

…large twin deficits…

- A contraction in real GDP combined with low inflation has brought nominal GDP growth to a halt and weakened budget performance significantly. Over the first 9 months of the year, the general government budget deficit is almost 60% wider than was the case for the same period last year (full year deficit of 3.6% of GDP in 2012). This does not capture the shortfall from Naftogaz and government guarantees that are being written to support activity. The central bank holds 60% of all domestic government paper, up from 51% over the 12 months to October. With the C/A deficit wider YTD compared with the first 9 months of last year and at risk of remaining in excess of 8% of GDP for the year as a whole, Ukraine runs some of the widest twin deficits globally;

…and unsustainably tight monetary conditions

- Monetary conditions are unbalanced. As of October, the banking system was offering 10.2% on UAH deposits, 5.8% on FX deposits, all designed to protect the UAH peg.

Foreign reserves are low while public debt to GDP has risen sharply…

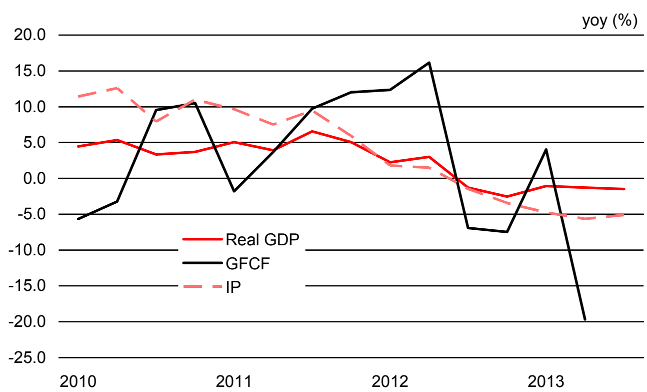
All of the above has left this fixed currency country with a large shortfall of foreign reserves. As of October, foreign reserves stood at USD18.8bn, down USD6.6bn in the past year and equal to less than 3 months of imports and less than 1/3 of short term external debt. All of these metrics are at multi year lows and weaker than the ratios posted during the 2008/09 crisis. Public debt has more than trippled since 2007 to over 40% of GDP this year.

…while the authorities are reluctant to take difficult decisions

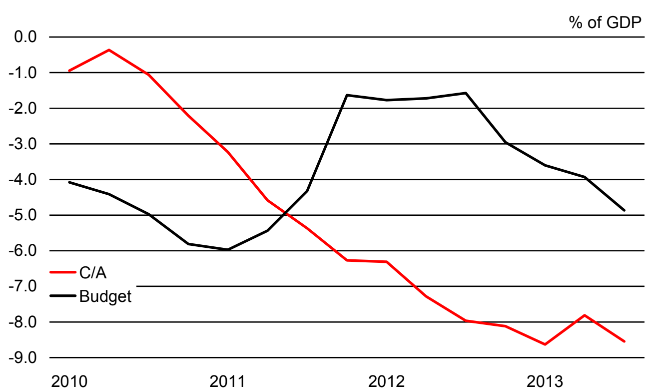
The authorities' objective is to minimise the impact of macro vulnerabilities on their popularity ahead of the Presidential election. In particular currency depreciation is a concern given that the last time UAH depreciated in 4Q08, it was associated with a collapse in economic activity and limitations on deposit withdrawals from some banks.

AN EXCEPTIONALLY WEAK MACRO BACKDROP

The economy remains at a standstill…



…amidst wide twin deficits



Source: NBU, national statistics office, UniCredit Research

The government's 'muddle-through' strategy is being increasingly tested…

But the elevated size of Ukraine's financing needs between now and the Presidential election makes it almost impossible for the government to 'go it alone' for another 5-6 quarters. Sovereign eurobond (incl. Nafto) and IMF repayments over that period stand at USD 8.1bn or 40% of total foreign reserves, with payments in 2Q and 3Q next year being particularly lumpy. This is before C/A deficit financing (incl. gas payments) and domestic demand for FX are taken into account. The latter is typical during the winter and ahead of election periods in Ukraine. More recently, political developments have prompted significant escalation. For a more detailed analysis of Ukraine's financing needs, please refer to our publication of 1st August, "Ukraine: No easy options".

…forcing the authorities to choose between the EU/IMF and Russia

At least in theory Ukraine still has two options:

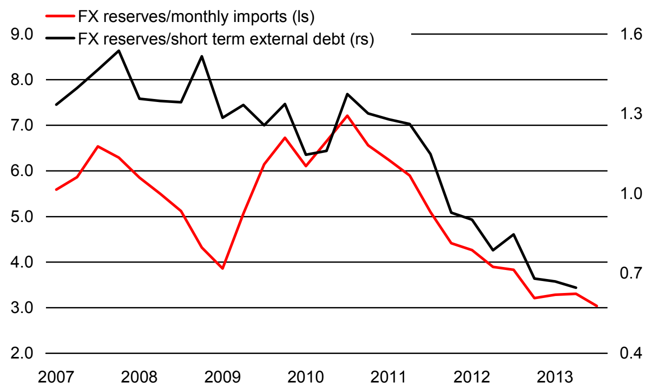
- The EU is offering a solution to Ukraine's primary challenge, namely the absence of a viable growth model, in the form of a Deep and Comprehensive Free Trade Agreement (DCFTA) but the benefits will take time to materialise while Russia will likely take measures which further impede economic activity, if it is signed. As such Ukraine will be forced towards an IMF programme. Given such large macro imbalances for an extended period of time, conditionality has moved well beyond any trade-off between fiscal consolidation and currency depreciation – upfront action on both is now required;
- Local press reports suggest a deal with Russia could be worth USD 10-20bn, including re-negotiation of the gas contract. If we assume little to no access to eurobond markets for the sovereign, any deal will have to lie at the mid to upper end of that range to give the domestic authorities any comfort that currency stability can be maintained at least until the Presidential election. Such an outcome alleviates near term financing concerns and maintains a stable UAH for longer.

Recent political developments increase uncertainty significantly

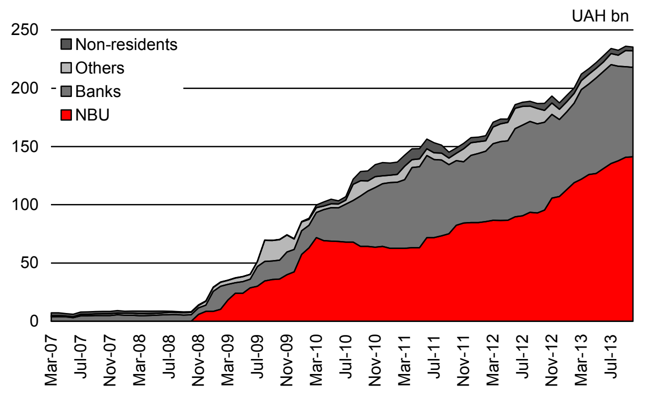
In practice the deterioration in the domestic political environment heightens uncertainty significantly. Assuming President Yanukovych and his government maintains power, we see a deal with Russia as more likely. From the President's perspective, a Russia deal helps him avoid the release of former PM Tymoschenko and a difficult macro adjustment, including a large currency move. Domestic political constraints and EU criticism of Ukraine may deter an upfront announcement on any large loan/pipeline sale but instead see funds feed through very gradually. Some currency adjustment may still prove unavoidable. Georgia and Moldova will return next year for a formal DCFTA signing, giving Ukraine another opportunity to sign a free trade agreement with the EU. To the extent that this would also require an IMF deal, however, President Yanukovych will have to depart from past trends and move in favour of an upfront sharp macro adjustment for the sake of long term gains.

A VULNERABLE FINANCING SITUATION

Foreign reserves cover less than 3-months of imports



Holdings of domestic debt



Source: NBU; MinFin; UniCredit Research

Strategy: Too soon to enter longs

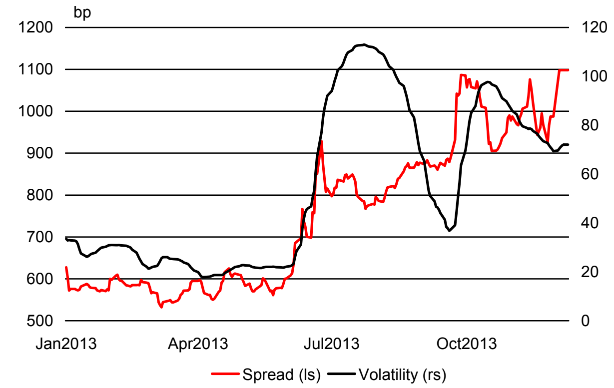
The UAH will depreciate on an IMF deal

We see little upside to long positions in Ukrainian bonds in the near term. Any decision on an IMF deal will materialize only after a further increase in market stress while if for some reason Ukraine manages to secure sufficient market financing, new issuance will in any case provide an entry window to the market.

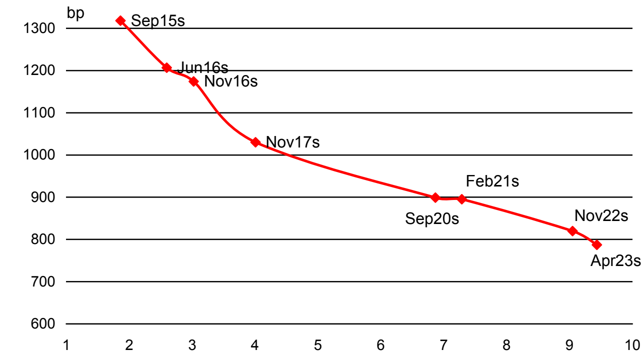
- In our most likely scenario, the government agrees to the conditions of an IMF deal but this may not materialize before mid-2014. This, combined with an IMF/EU deal, would be a clear signal to initiate a long bond position. We suggest entering local currency positions only after at least some initial steps towards currency flexibility.
- If the government agrees to a deal with Russia, it should secure the UAH peg for at least another year, depending on the detail of the deal. Short-dated bonds should also benefit given an improved government cash cushion but curve steepening is likely unavoidable.

HIGH SPREADS AND VOLATILITY INDICATE HEIGTENED UNCERTAINTY

5-year CDS spreads are high, and so is spread volatility



USD curve is pricing in a high near-term probability of default



Source: Bloomberg, UniCredit Research

Author: Gaurav Saroliya, Senior CEE Strategist (UniCredit Bank London)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**17.7**	**18.2**	**15.2**
Budget deficit (excl Nafto)	4.8	4.3	2.5
Amortisation of public debt	13.0	13.9	12.7
Domestic	8.3	9.1	10.1
Short term	0.7	0.8	1.0
Medium to long term	7.5	8.3	9.1
External	4.7	4.8	2.6
of which IMF	3.1	2.6	1.0
Financing	**17.7**	**18.2**	**15.2**
Domestic borrowing	10.8	9.0	9.0
of which NBU	4.3	2	1
Short term	0.8	1.0	1.0
Medium to long term	10.0	8.0	8.0
External borrowing	2.2	3.6	3.4
Bonds	2.2	1.0	1.0
IMF	0	2.6	2.4
Other	4.7	5.6	2.8

Source: MinFin, NBU, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2013F	2014F	2015F
Gross financing requirement	**61.7**	**56.6**	**51.8**
C/A deficit	10.6	7.3	5.6
Medium to long term amortisation	19.2	17.4	14.3
Banks	5.5	4.4	3.5
Corporates	8.2	8.2	8.2
Government/central bank	5.5	4.8	2.6
Short term debt amortisation	24.6	24.6	24.6
Banks	3.2	3.2	3.2
Corporates	21.4	21.4	21.4
Government/central bank	0	0	0
Other (incl. intercompany lending, capital flight)	7.3	7.3	7.3
Financing	**61.7**	**56.6**	**51.8**
FDI	2.3	3.3	3.2
Portfolio flows	2.2	1.0	1.0
Medium to long term borrowing	16.4	19.1	23.5
Banks	3.1	3.1	6.0
Corporates	11.0	14.0	14.0
Government/central bank	2.2	2	3.5
Short term borrowing	24.6	24.6	24.6
Banks	3.2	3.2	3.2
Corporates	21.4	21.4	21.4
Government/central bank	0	0	0
Other	13.6	7.3	-1.6
Change in reserves	2.7	1.2	1.1

Source: UniCredit Research

Notes

Notes

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