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

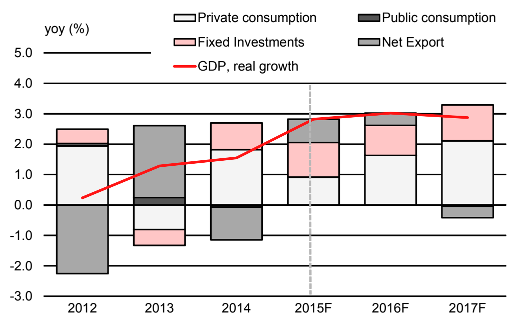
Outlook – GDP growth is expected to continue at a reasonably healthy pace over the next two years, after accelerating rapidly to perhaps 2.8% in 2015. However, the growth drivers at play in 2016 and 2017 are likely to differ from those seen in 2015. Individual consumption will provide most of the support for GDP growth over the next two years, while tailwinds from lower energy prices and EU funds absorption are set to fade away. Demand side conditions in the euro area, where most of the country's merchandise export is shipped, will remain favorable next year, but are forecast to soften in 2017, reducing exports' contribution to growth. Given that our GDP forecast implies a relatively slow narrowing of the output gap, we see average headline CPI rising only very gradually from here, to 0.5% in 2016 and 1.4% in 2017.

Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)

KEY DATES/EVENTS

- Mid-Feb: GDP flash estimate 4Q15
- Mid-Feb: Number of employees 4Q15
- 1Q: New Eurobond sale

GDP GROWTH TO STABILIZE AT A HIGHER LEVEL



INFLATION TO REMAIN SUBDUED

Source: NSI, BNB, MoF, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2013	2014	2015F	2016F	2017F
GDP (EUR bn)	41.9	42.8	43.9	45.5	47.4
Population (mn)	7.2	7.2	7.2	7.1	7.1
GDP per capita (EUR)	5,784	5,936	6,138	6,387	6,697
Real economy, change (%)					
GDP	1.3	1.5	2.8	3.0	2.9
Private Consumption	-1.1	2.5	0.9	2.7	3.3
Fixed Investment	0.3	3.4	5.5	1.8	5.0
Public Consumption	3.1	-0.8	0.4	1.4	0.9
Exports	9.2	-0.1	6.7	4.5	2.4
Imports	4.9	1.5	5.1	3.5	3.3
Monthly wage, nominal (EUR)	396	423	452	478	507
Real wage, change (%)	5.1	8.2	6.9	5.2	4.8
Unemployment rate (%)	12.9	11.4	9.5	8.3	7.4
Fiscal accounts (% of GDP)					
Budget balance	-1.8	-3.6	-3.0	-2.7	-2.5
Primary balance	-0.9	-3.0	-2.1	-1.7	-1.5
Public debt	17.9	26.4	26.3	28.8	28.9
External accounts					
Current account balance (EUR bn)	0.8	0.5	1.0	0.9	0.7
Current account balance/GDP (%)	1.8	1.2	2.3	1.9	1.5
Extended basic balance/GDP (%)	4.8	3.1	5.7	5.5	5.2
Net FDI (% of GDP)	3.0	2.0	3.4	3.6	3.7
Gross foreign debt (% of GDP)	88.1	92.1	80.6	76.3	72.6
FX reserves (EUR bn)	14.4	16.5	18.9	20.9	23.2
Months of imports, goods & services	5.7	6.6	7.5	7.8	8.2
Inflation/Monetary/FX					
CPI (pavg)	0.9	-1.4	-0.1	0.5	1.4
CPI (eop)	-1.6	-0.9	0	0.9	1.9
Central bank reference rate (eop)	0.07	0.02	0.01	-0.13	-0.10
USD/BGN (eop)	1.42	1.61	1.86	1.75	1.66
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.47	1.47	1.78	1.81	1.68
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	143.8	139.6	144.8	143.3	143.8
Change (%)	0.3	-3.0	3.7	-1.0	0.4

Source: BNB, NSO, MoF, UniCredit Research

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

Growth to stabilize at healthy levels in both 2016 and 2017

The main growth impulses in both 2016 and 2017 are forecast to come from individual consumption

After gaining strength markedly in 2015, GDP growth is likely to stabilize at reasonably healthy levels in both 2016 and 2017. We forecast GDP to expand 3% next year and 2.9% in 2017, up from 2.8% expected in 2015. This above-consensus growth outlook will be powered by individual consumption, which should make up for somewhat weaker exports and gross fixed capital formation growth in 2016. Individual consumption will also provide most of the fuel to the recovery in 2017. But less supportive external environment in 2017, as EU slows, the euro firms and energy prices begin to recover, will constrain the growth momentum to 2.9% yoy.

Improving labor market should be positive for consumption in both 2016 and 2017

Stronger labor market and more favorable price and availability of credit next year should be more than enough to replace this year's boost to real disposable income from lower energy prices

Inflation will start to creep higher next year, thus eroding household purchasing power somewhat

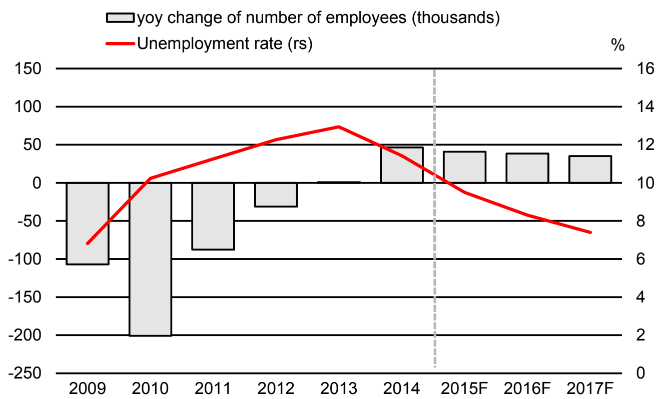
We expect individual consumption to accelerate from 0.9% in 2015 to 2.7% in 2016. This will be above all attributable to the improving labor market, which will help households to become more confident about their jobs and incomes prospects. After 46K employees were added to the payroll in 2014, the economy is on course to add broadly the same number of new jobs in 2015 and perhaps also in 2016. Wage growth is expected to be another support factor to labor market recovery next year, especially having in mind that the bulk of new hiring over the past two years comprised well-paid jobs in the services offshoring sectors. In an environment of a continuing decline in perceived job insecurity, we also see households using more credit to finance consumer durables. Both the availability and the price of retail credit are set to improve, in our view, as the domestic banks' loan-to-deposits ratio at 79.9% in Oct 2015, is already one of the lowest in the CEE region, which suggests that local banks are increasingly under pressure to add more customers on the lending side. The BNB's decision to introduce negative interest rates on excess reserves should further provide incentives to expand lending. Non-negligible pent-up demand will be another factor underpinning retail credit, at the same time, as the economy is slowly emerging from a prolonged period of painful households' balance sheets repairment. Still low inflation, on the other hand, will continue to support the purchasing power of households' income, although not in the proportions seen so far this year, as the tailwind from lower energy prices is set to fade away.

Not only growth is projected to pick-up in the euro area next year, but the likely ECB's QE2 and the accompanying euro weakness, should prop up Bulgarian exports volumes

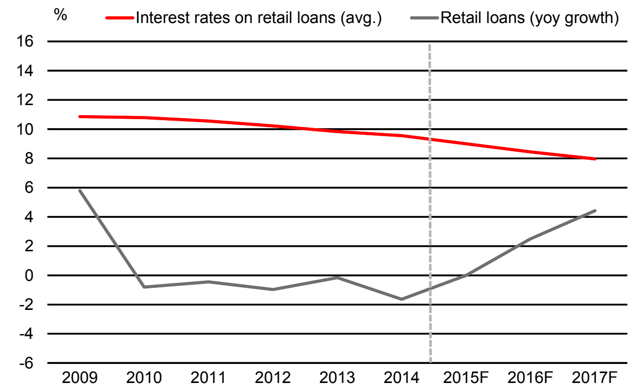
But Fed's liftoff will hurt EM as it will lead to assets re-pricing, capital flows re-alignment and a liquidity crunch in many of them

The sharp acceleration of export volumes to an increase of perhaps 6.7% this year will be followed by some softening to 4.5% growth next year. Demand side conditions will remain favorable in the euro area where the bulk of the country's exports is shipped. Bulgarian export-oriented companies will also be supported by the ECB's QE2 and the accompanying euro depreciation in 2016. But elsewhere the situation is less encouraging, as the anticipated Fed's interest rates hikes will lead to a deterioration in demand in many EM outside the EU area. Although indirectly, China's growth slowdown will become another drag on exports. In 2017, our baseline macroeconomic scenario envisages further deceleration of export volume growth to 2.4%, as EU slows, the euro gets firmer and energy prices begin to recover.

Decent job gains will push unemployment down…



…while slowly improving lending conditions will prop-up retail credit



Source: NSI, BNB, UniCredit Research

We think that structural decline in residential investments, which was one of the main reasons for the overall weakness in investment spending, has largely run its course

After gaining strength last year on the back of a solid improvement in EU funds absorption, we expect fixed investment to take a breather next year. On accruals basis, EU funds absorption should peak in the last months of 2015 before going markedly lower early in 2016. However, the underlying construction activities will be much more evenly distributed, in our view, providing solid support to GDP growth and jobs creation not only this but also next year. What further reinforces this view is that, at 7% of GDP, public sector capex in the consolidated fiscal program for 2016 are envisaged to remain only a tad weaker than those anticipated for the whole 2015 (7.3% of GDP). Importantly, we expect private sector fixed investments to gain some momentum in both 2016 and 2017, after growing slightly negative for the most part so far this year. The latest data on newly issued housing permits indicate that the contraction of residential investments, which has been a heavy drag on fixed investment over the past several years, may have bottomed out. We expect that residential investments will return to positive yoy growth rates at some point next year. Rising housing permits, improved price and availability of mortgage loan, and the more favorable prospects for household income should, in our view, clear most of the remaining hurdles to the recovery in residential investment.

Given that our GDP forecast implies a rather slow narrowing of the output gap we see headline inflation rising only very gradually

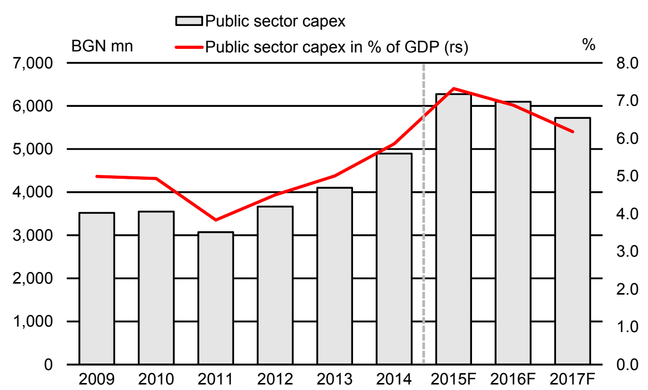
Inflation is set to remain very subdued and rise toward 0.5% on average next year. This will mostly reflect large base effect from energy prices. The core CPI will see very limited upward dynamics, given that our GDP forecast implies a rather slow narrowing of the output gap. Most of the acceleration in the core CPI will perhaps come from the services sectors, where the labor market has been very vibrant already, and wage growth has taken pronounced proportions. Given that we expect energy prices to increase in 2017, and with the acceleration in core prices moderate, we forecast average headline inflation of 1.4% in 2017.

Solid improvement in external position made Bulgaria one of the most resilient EM to the effect of Fed tightening…

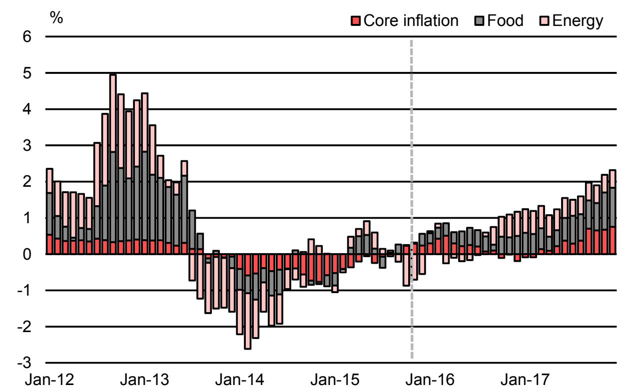
…but the indirect impact via some trading partners with heightened external vulnerabilities needs to me closely monitored

Despite the favorable outlook, significant downside risks remain. A major slowdown in the eurozone is the key risk on the external front, given the close integration of the country with western Europe. On the other hand, the potential fallout from the Fed's liftoff is unlikely to affect Bulgaria directly, as US investors control only a small part of country's external liabilities, while its CA is running a surplus in excess of 2% of GDP. However, there is a sizeable indirect impact as some of Bulgaria's key trading partners are EM with high dependence of foreign funding and large external borrowing needs, such as Croatia, Serbia and especially Turkey. A sharper-than-expected slowdown in China also requires close attention, given the sizable indirect impact via the supply chains to west European exporters. On the domestic front, the key downside risk involves possible negative surprises associated with the upcoming bank stress tests and AQR. Potentially large contingent liabilities of the public sector stemming from still unresolved NEK's and the state-owned railway company BDZ financial woes also need to be closely watched.

Public sector capex will reach a historical high



Inflation normalization will take place only very gradually



Source: NSI, MoF, UniCredit Research

Strategy: In wait of more Eurobond issuance

2016 issuance policy will closely follow the 2015 pattern

We expect bond supply in 2016 to be similar to 2015 with a few exceptions. Gross domestic bond issuance should decline marginally to around BGN 1.1bn from BGN 1.35bn expected in 2015. This should keeping net issuance neutral in contrast to the negative BGN 665mn (0.8% of GDP) expected for 2015. The average weighted maturity is planned to remain unchanged at just under 4.5 years, the third lowest in the past 12 years. Most funding however should come via the Eurobond market. In 1Q16, the extension of the ECB's monetary easing should result in low yields (which may well trough in the quarter), spurring decent Eurobond issuance. We expect the hunt for yield in Europe, portfolio reallocation and spread compression versus core rates, to continue to drive Eurobond yields lower.

Planned Eurobond issuance will further strengthen the fiscal buffers

The domestic market should take further Eurobond issuance well. Banking sector liquidity is expected to rise beyond already alleviated levels, while in 2016 there is expected to be lower debt supply due to the lower sovereign funding requirements compared to 2015. We therefore expect Eurobond issuance to be in the lower end of the EUR 1.25-1.5bn range, further strengthening the healthy liquidity buffers ahead of the banking sector AQR and stress-tests.

Strong domestic demand will drive yields lower…

We think the 12Y Eurobond is an attractive segment to be tapped in 1Q16 and think EUR 1.25bn could easily be absorbed. We think the shorter-term (7Y) and ultra-long-term buckets (20Y), which the Ministry of Finance utilized in 2015, may be avoided. Any re-tap should receive sizable support from domestic investors as abundant banking sector liquidity, constrained by weak credit demand and investment portfolio limitations, chases limited supply. While additional demand could come via European investors looking for yield pick-up.

…providing excellent positioning opportunities in the primary market

Against this background we see Bulgarian paper moving in line with regional peers until the expected Eurobond issue. We recommend buying the BGARIA EUR 24s. However, domestic investors will likely wait on the sideline before moving aggressively to adding to their already large BGARIA EUR positions (at 43% of all outstanding paper and on a strong upward trend since hitting 24% in January). We recommend buying BGARIA EUR paper on the primary market, as domestic investors are likely to push yields lower on the secondary market in the first few weeks of active trading.

Author: Nikola Georgiev, Economist (UniCredit Bulbank)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2015F	2016F	2017F
Gross financing requirement	**5.1**	**2.0**	**2.8**
Budget deficit	1.3	1.2	1.2
Amortization of public debt	3.6	0.6	1.4
Domestic	1.1	0.6	0.4
Bonds	0.1	0.6	0.4
Bills	1.1	0	0
Loans	0	0	0
External	2.6	0.2	1.1
Bonds and loans	2.4	0	1.0
IMF/EU/Other IFIs	0.2	0.2	0.2
Financing	**5.1**	**2.0**	**2.8**
Domestic borrowing	0.8	0.6	0.5
Bonds	0.7	0.6	0.5
Bills	0.1	0	0
Loans	0	0	0
External borrowing	3.3	1.4	1.6
Bonds	3.2	1.3	1.5
IMF/EU/Other IFIs	0.1	0.1	0.1
Privatization/Other	0	0	0
Fiscal reserves change (- =increase)	1.0	0	0.6

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2015F	2016F	2017F
Gross financing requirement	**16.1**	**10.9**	**11.6**
C/A deficit	-1.0	-0.9	-0.7
Amortization of medium and long term debt	7.2	4.0	4.7
Government/central bank	2.6	0.2	1.1
Banks	0.8	0.7	0.6
Corporates/Other	3.7	3.2	2.9
Amortization of short-term debt	10.0	7.7	7.6
Financing	**16.1**	**10.9**	**11.6**
FDI (net)	1.5	1.6	1.8
Portfolio equity, net	0.4	0.6	0.3
Medium and long-term borrowing	7.5	5.0	4.9
Government/central bank	3.3	1.4	1.6
Banks	0.5	0.5	0.4
Corporates/Other	3.7	3.1	2.9
Short-term borrowing	7.7	7.6	7.7
EU structural and cohesion funds	1.7	1.3	1.3
Other	0	-3.2	-2.3
Change in FX reserves	2.7	2.1	2.1
Memoranda:			
Nonresident purchases of LC govt bonds	0	0	0
International bond issuance, net	2.2	1.8	0.5

Source: BNB, MoF, UniCredit Research

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