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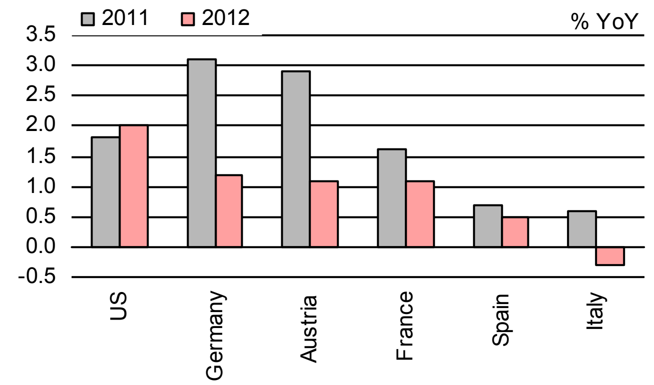
CEE: Testing times

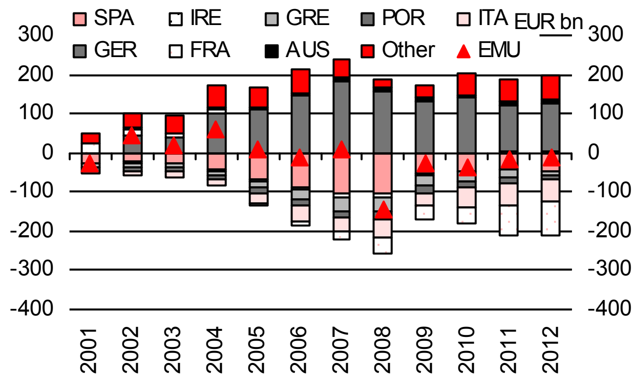
Lower growth, lower rates, narrower deficits

With much of the developed world in the midst of multi year adjustment process, we enter 2012 facing a lower growth environment, though downward pressure on economic activity arising from bank deleveraging and fiscal tightening will be partially offset by easier monetary policy. The Euro Area retains center stage but the US continues to stuggle with its own debt issues. At the time of writing, the Euro Area was working towards a series of initiatives to bolster fiscal integration and build firewalls. While we expect 2012 to prove a more constructive year for EMU than 2011, market pressures are likely to abate only gradually.

Leaders and laggards on EMU growth next year…



Borrowers must turn to savers and visa versa (EMU C/A deficits)



Source: Eurostat, UniCredit Research

2012: Another year of necessary growth divergence within EMU to address underlying imbalances

In more detail, we have lowered our forecast for EMU GDP growth in 2012 to 0.8%, a couple of tenths below our September forecast. Within EMU we see Germany and Austria continuing to post positive growth rates next year (1.2% and 1.1% respectively) but Italy will be firmly in recession, as well many of the periphery economies. The US looks set to lead EMU, posting growth of 1.6% next year.

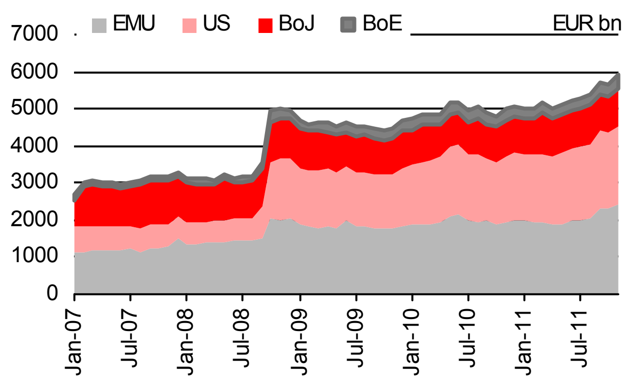
Fiscal targets are less flexible than growth projections, introducing downside risks to growth

The risks are weighted to the downside however. One of EMU's greatest challenges next year is balancing the need for fiscal consolidation and growth. The European Commission's latest forecasts put this year's budget deficit within EMU at 4.1%, 2pp narrower than in 2010. 2012 looks set to see a further 0.8pp of tightening, keeping the EMU budget deficit on track to reach 3.0% of GDP by 2013. Efforts taken by a number of countries on the fiscal front within EMU are sizeable. For example Italy is now targetting a deficit of 1.6% of GDP next year, down from 3.9% of GDP this year, despite a contraction in GDP. France has complemented Italy's efforts, with more likely to follow post election. While these budgets are based on relatively modest growth assumptions, fiscal targets in the current market environment are likely to prove much less flexible than growth assumptions, should growth surprise on the downside.

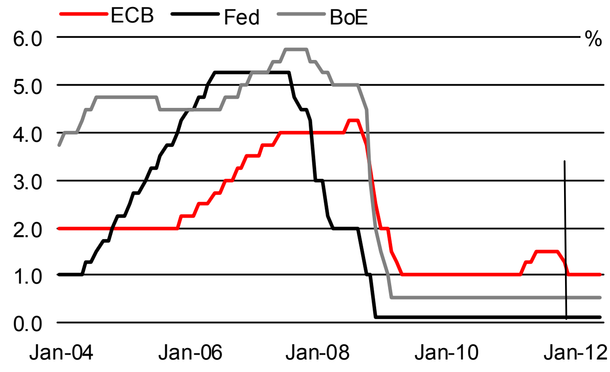
Monetary policy to help ease downturn

In this environment we expect monetary policy to turm more accommodative. The ECB has already acted to temper this downward pressure, having reversed its 50bp in rate hikes while also announcing the provision of 3 year liquidity and lowering collateral requirements. There is potential for it to cut rates further. We expect the Fed will follow up on the BoE and announce another round of QE.

Central bank balance sheets are growing & will continue to do so



Policy rates low and in EMU potentially heading even lower



Source: Bloomberg, national central banks, UniCredit Research

2012 for CEE: Most likely another year of two halves

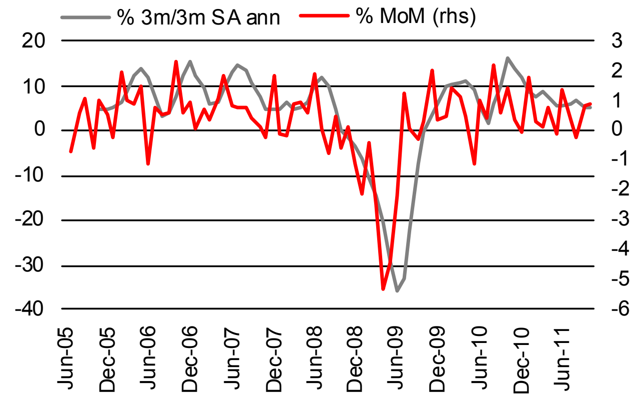
Risk channels from EMU to CEE

At least the start of 2012 will be a particularly testing period for the CEE region. The primary uncertainty at this stage stems from EMU via a number of channels. Weaker growth in EMU translates into weaker external demand for CEE exports. To the extent that EMU woes have translated into a significant decline in global risk appetite and slowed inflows to emerging markets as an asset class, CEE has also seen its primary source of capital inflows over recent quarters slow significantly. Lastly the banking sector within EMU must undergo a process of deleveraging which risks translating into an outflow of capital from CEE and a renewed downturn in economic activity.

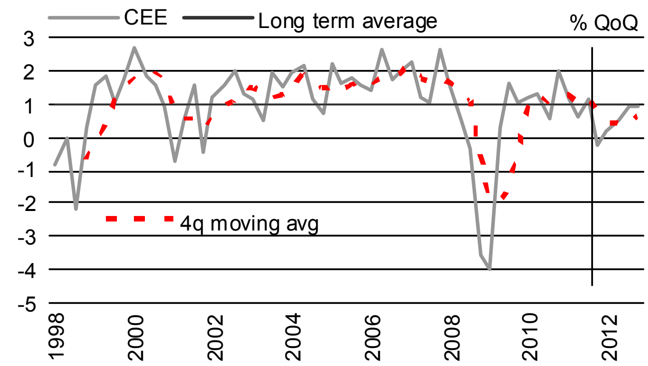
Economic activity has been impressively resilient to date – we retain our forecast of 4.4% for CEE growth for 2011, with upside risks

The good news is that to date economic activity in the region is holding up relatively well. We have opted to leave our full year forecast of 4.4% for the CEE region unchanged, allowing for a very sharp slowdown in the data over Nov-Dec. The vast majority of countries posted an expansion in GDP in 3Q, albeit with the help of some one offs such as agriculture. For example 3Q saw Hungary, Poland, Romania and Russia post qoq gains in GDP of 0.5%, 1.0%, 1.6% and 1.8% yoy respectively. Examining industrial production data in October, the data points to a region which is a long way from free fall in terms of economic activity. Relative to 1H the pace of gains in industrial production has weakened and in some economies in the region it has come to a halt but there is little to say that we are headed for a sharp outright contraction at this stage. Averaging IP gains for October where available, IP is up 0.2% mom SA, following a gain of 1.1% mom in September. Examining country specifics, Turkey (4.4%), Bulgaria (0.4%), Czech (0.1%), Kazakhstan (1.9%) and Russia (0.9%) all showed gains (mom SA). In Hungary IP fell 0.9% mom but this follows a bumper gain of 3.8% mom in September. In 3Q CEE industry fell 0.4% qoq, following gains of 0.9% qoq in 2Q. Should IP flatline between October and year end, 4Q will see a gain of 1.3%. That leaves us scope for downside surprises on the data in the next couple of months before industry shows a qoq contraction in 4Q.

Industrial production has held up well to date…



…but we pencil in a much slower growth path in 2012[1]

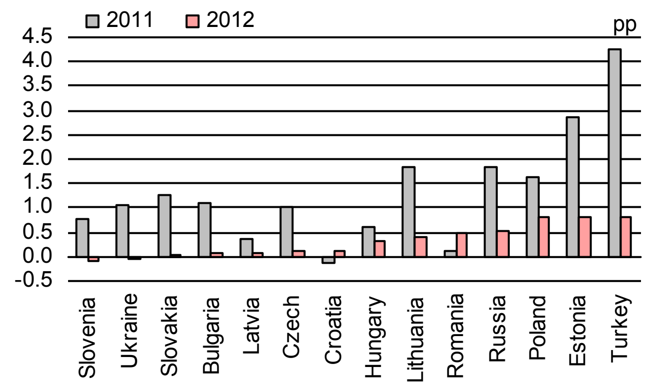


Source: National statistical agencies, UniCredit Research

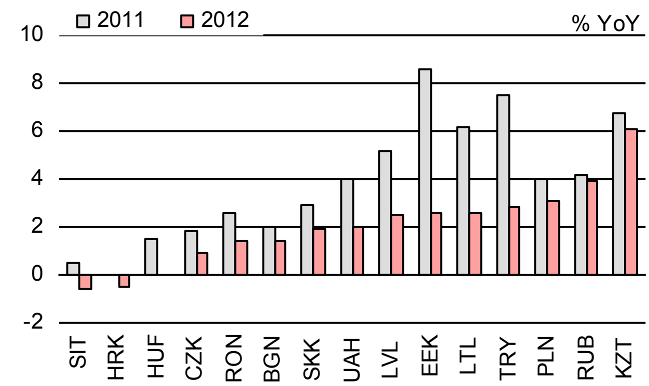
We reduce our 2012 growth forecast by 0.9pp to 3.0%

Though we have maintained our 2011 growth forecast, we have reduced our 2012 growth forecast by 0.9pp to 3.0%. For the region as a whole we expect a modest contraction in 4Q to be followed by a period of weak growth throughout 1H next year and a more robust recovery in 2H to bring qoq growth back to its long term average. Summing GDP growth over 2011-12 and excluding 2008, the region will not have seen a cumulative 8 quarter gain in GDP as low as what we currently project since 1998.

Carryover will be less helpful for all involved in 2012 than 2011



Sharp divergence in economic activity across the region



Source: National statistical agencies, UniCredit Research

The bigger economies look set to outperform the smaller economies

We expect a large divergence across the region in terms of growth next year. The larger economies, namely Turkey, Poland and Russia, will lead the pack, with Kazakhstan in first place. However Slovenia, Croatia and potentially also Hungary look set to slip back into recession. Many other countries (e.g. Czech, Romania, Bulgaria, Slovakia) will struggle to post real GDP gains in excess of 2%.

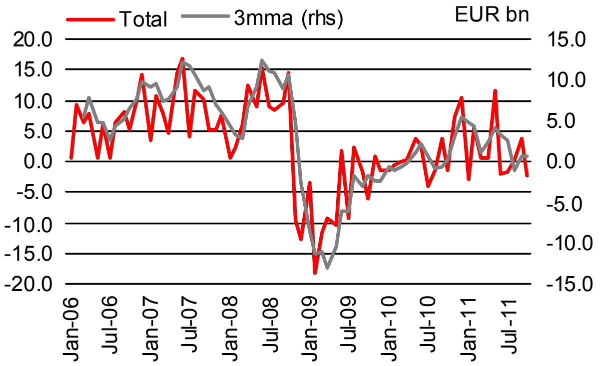
[1] Due to data limitations, our regional aggregate for quarterly QoQ GDP includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Russia, Slovakia, Slovenia and Turkey

Decomposing EMU bank deleveraging and its impact on CEE

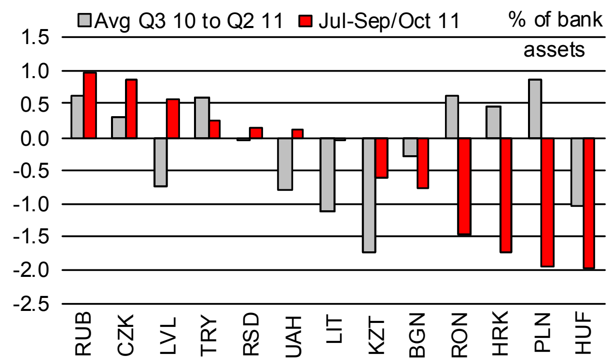
Our basecase is that EMU bank deleveraging is a manageable drag

Deleveraging by the banking sector within EMU risks weakening currencies and lowering GDP but some countries are more at risk than others. We have already reached a stage where the region is experiencing a renewed outflow of capital from its banking sector. Monitoring flows of foreign capital in and out of the region, these turned negative in October for the first month in four[2]. The total outflow amounted to EUR 2.4bn. If we exclude Russia, the banking system in the region has posted outflows in each of the 5 months to October, with the total amount over this period standing at EUR 8.8bn. Over the first 5 months of this year, foreign inflows to the CEE banking sector averaged EUR 3.1bn per month, having finally shown recovery, though this remains well below pre-crisis levels. In 2007 monthly inflows to the banking sector stood at EUR 8.4bn.

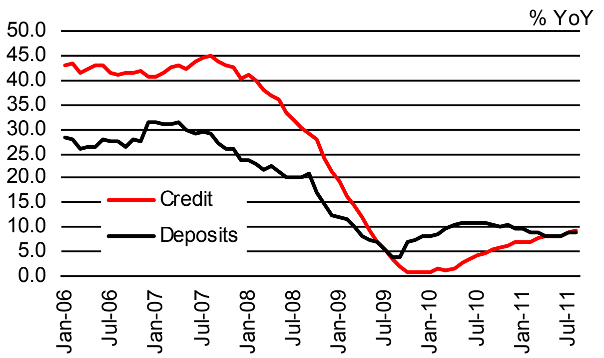
Foreign capital inflows to the CEE banking sector slow…



…albeit with some differentiation across countries



CEE credit growth is now capped by deposit growth



New credit extension in CEE has slowed

Source: National central banks & statistics agencies, UniCredit Research

Capital outflows are the norm for some already but these have accelerated

For a number of countries in the region an outflow of foreign capital is the norm already. For example banking sectors in Latvia, Bulgaria, Serbia, Ukraine, Lithuania, Kazakhstan and Hungary were all net repayers of foreign debt over the 12 months to June this year. Among these countries, it is only in Bulgaria and Hungary has the pace of outflow increase, reaching EUR 0.3bn and EUR 2.2bn over the past three to four months respectively. As a percent of bank assets, Hungary is the weakest performer, experiencing an outflow worth 2.0% of total bank assets.

[2] Our estimate of aggregate capital flows to and from banking sectors in the region is based on monthly changes in the value of external liabilities of individual banking sectors, adjusted for changes in FX

Poland, Croatia and Romania shift from inflows to outflows, Russia and Turkey continue to see inflows

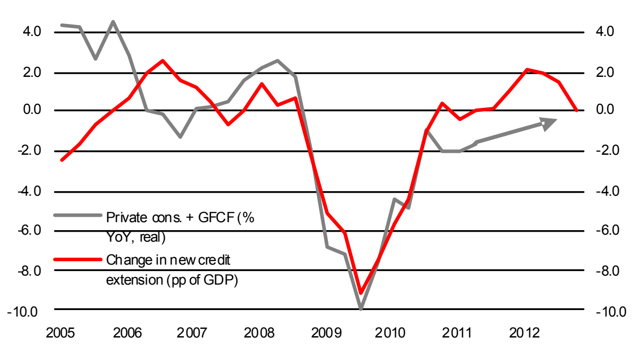
The largest shift from receiver to repayer is in Poland. Over the four quarters to 2Q-11, the banking sector received on average 0.8% of total bank assets in new external funding. Over the four months to October, this quickly turned to a net outflow worth almost 2% of total bank assets or EUR 5.6bn. Croatia and Romania also join this group, posting outflows of EUR 1.2bn and EUR 0.9bn over the past 4 months respectively. Russia and Turkey were net receivers of funds over the past three to four months, though in Turkey's case the pace of inflow has slowed.

1H to remain weak, 2H to look better for some

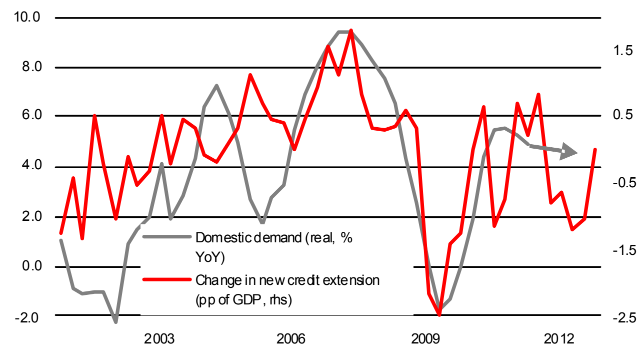
At this stage our baseline is that for at least 1Q and potentially 2Q, continued EMU uncertainty means that these outflows from the banking sector in the region will continue. For a number of countries in the region 2H should be better however. By that stage EMU banks will have been forced to meet new capital requirements and while there is likely to be much more differentiation between weak and strong in the region, at least some of the larger, stronger economies should be in a position to draw some limited funding from abroad once again.

Also important to note is that a sudden stop, as of 2008, is much less of a risk this time. Drawing off balance of payments data, in 2007 CEE banks and non-bank corporates borrowing a net EUR 141.2bn offshore but in 2008 this turned to an outflow of EUR 14.9bn. This represented a rapid EUR 151.6bn in capital flows that was central to the decline in economic activity that the region underwent. An aggregate outflow of this capital persisted up until last year. Over the course of 1H this year the region saw a miniscule inflow of EUR 8.1bn. A sudden stop would imply a much smaller shift in capital flows and economic activity

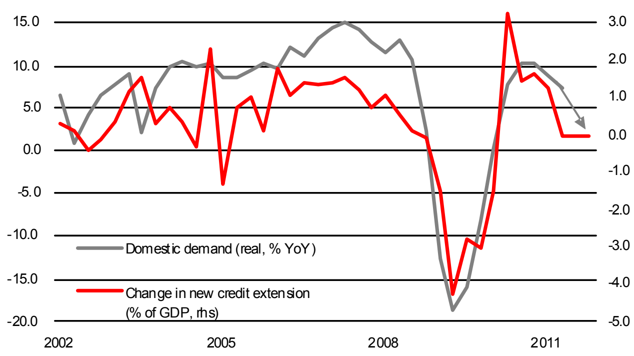
Hungary: Credit impact on domestic demand assuming new credit extension returns to zero



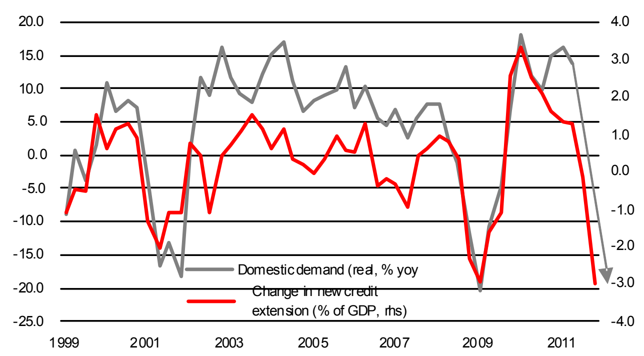
Poland: Credit impact on domestic demand if new credit extension returns to zero



Russia: Credit impact on domestic demand if new credit extension returns to zero



Turkey: Credit impact on domestic demand if new credit extension goes to zero



Source: National central banks & statistics agencies, UniCredit Research

Credit growth is slowing and will likely do so further

In the face of such capital outflows, new credit extension has shown only very modest signs of a slowdown but is far from showing outright contraction, at least on aggregate up until October. Hungary and Latvia stand out as the two countries in the region which persistently show credit contraction while in Croatia credit trends have turned noticeably more negative since August. Turkey continues to post positive new credit extension but at a slower pace. This resilience in new credit extension is in part due to the fact that most new credit extension over the last 2-3 years in the region has in any case been deposit financed. However it also seems reasonable to expect a further slowdown ahead given that it is often the case that credit is pledged a number of months ahead while the region as a whole next year is likely to see slower deposit growth in line with more gradual GDP growth.

For most countries a halt in new credit extension would be much less damaging this time around, Turkey is an exception

Examining what we consider to be a downbeat scenario whereby new credit extension collapses to zero and remains there until the end of next year, we estimate that the impact on domestic demand this time around would be considerly less muted than was the case in 2008/09. This is largely a function of fact that the recovery in credit in most economies has been much more muted than in the lead up to the 2008 crisis. Turkey is the exception.

To estimate this we chart the change in new credit extension as a % of GDP (rather than credit growth/the change in the stock of credit) against domestic demand. We can group the region into three different sets of countries:

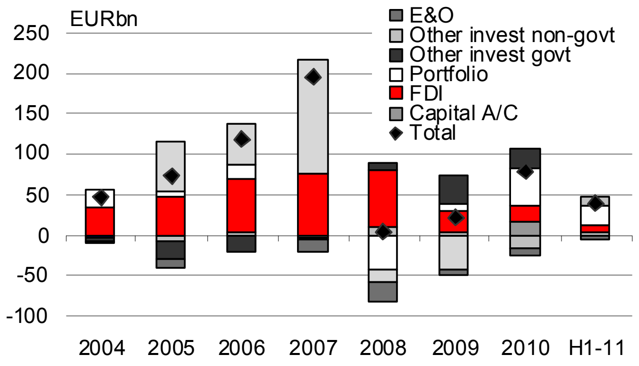
1. Hungary and Latvia would both see domestic demand increase rather than decrease in an environment whereby new credit extension went to zero, a shift from a current trend whereby new credit extension is negative. However in the case of Hungary we doubt that the stock of credit stops contracting, largely because foreign banks look set to continue to gradually run down their balance sheet.
2. Czech, Poland, Russia and Ukraine would see domestic demand growth come to a halt or contract marginally but in all cases would be much less impacted than was the case in 2008.
3. Turkey, having seen the most rapid gains in new credit extension, would see a double digit collapse in domestic demand, in line with what it experienced in late-08/early-09.

Portfolio flows to ease, IMF to fill some of the gap

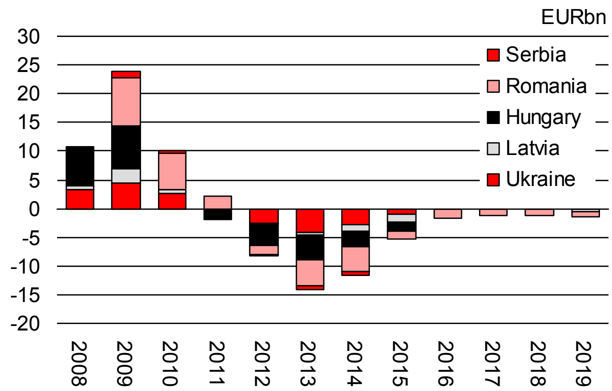
Weaning the region off portfolio flows

While CEE as a whole has adapted to an absence of new bank funding, it has quickly increased its reliance on portfolio funding. Of the EUR 119bn in capital flows to the region since end-09, EUR 72.3bn or 61% has been portfolio in nature. Last year's inflow was over double the previous annual high of EUR 23.1bn in 2004. Turkey and Poland were the primary recipients last year but over the course of this year there was more diversification into other economies such as Hungary, Romania, Ukraine and Serbia.

Portfolio flows dominate capital flows to the region



IMF scheduled to withdraw capital next year, though that will likely have to be revised



Source: National statistics agencies, UniCredit Research

IMF to increase its activity once again

More recently these inflows have slowed significantly but unlike 2008 have not reversed in any great size. It seems reasonable to expect that the aggregate inflow over the course of 2012 will be significantly smaller than in 2011, with divergence across economies, i.e. Poland and Turkey will probably continue to attract inflows but at a more moderate pace while countries such as Ukraine or Hungary are more at risk of outflows. Against a backdrop whereby FDI has shown little recovery since 2008, some countries in the region will find themselves once again reliant on IMF aid.

Precautionary programmes for Serbia, Romania and Latvia, new stand-by arrangements for Hungary and Croatia, re-engagement with Ukraine

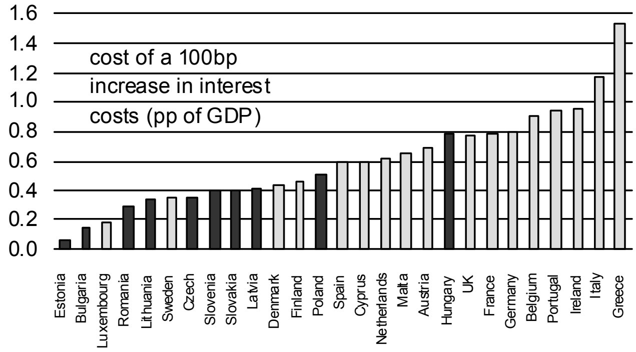
We expect Serbia and Romania to press ahead with their precautionary programmes over the course of next year, with Romania to draw funding from this and potentially request an increase in the size of the program. Once its stand-by arrangement rolls off this month, Latvia is also likely to request a precautionary program. Hungary has begun informal discussions and given limited FX and HUF government deposits, will have to make considerable progress towards a deal by the end of January. We see a traditional stand-by arrangement of at least EUR 15bn as necessary. With its general election now done, we expect the new government in Croatia to request a stand-by arrangement over the next couple of months. In Ukraine the sovereign's ability to 'go it alone' will depend on the size of the capital funding that is associated with its gas deal with Russia. Failure to secure a deal will require immediate action on a new IMF disbursement if the domestic authorities are to reduce pressure on UAH.

Fiscal challenges are manageble for most

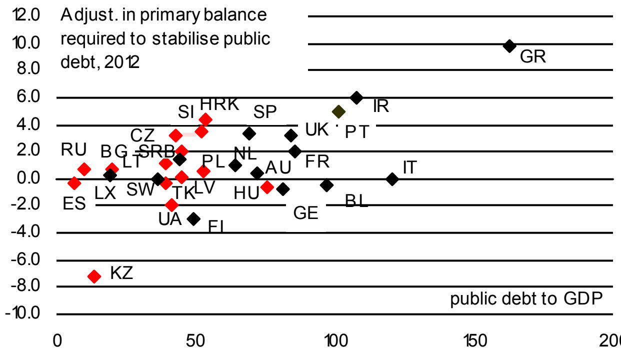
On the whole CEE in much better fiscal shape than EMU

CEE economies on the whole are in a more comfortable fiscal position than EMU economies. An increase in sovereign funding costs has more limited implications than in EMU. As show below, a 100bp immediate increase in the cost of funding in most cases does not translate into more than an extra 0.5pp of GDP in extra interest rate expenditure. Hungary is the exception where it translates into an extra 0.8pp of GDP in interest payments, in line with the EMU average. The region posts a public debt to GDP ratio which is half of that of EMU.

Much of new EU much less impacted by higher financing costs than old EU



Primary balance adjustment needed v public debt to GDP



Source: National statistics agencies, UniCredit Research

Hungary, Croatia and Slovenia stuggles, Poland presses ahead with necessary consoldation

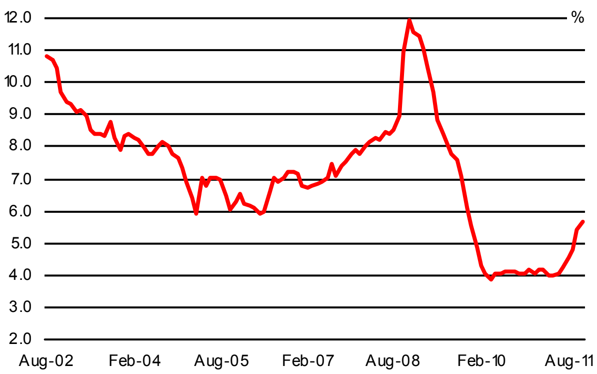
We see Hungary, Croatia and Slovenia as the weak links, with forced fiscal consolidation to contribution to a contraction in economic activity next year. Poland has outperformed its own targets in 2011 and is well on track for a continued narrowing of its deficit next year. A strong starting point gives Turkey scope to use fiscal policy to support economic activity next year if needs be. Russia is at risk of widening its non-oil budget balance even further given recent political developments.

Monetary policy: Limited scope to cut, more about balance sheet usage

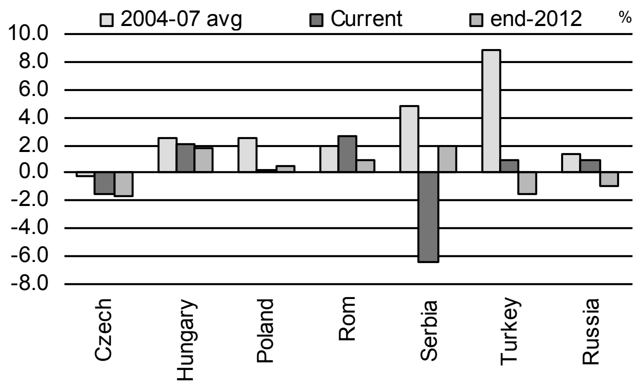
Scope for rate cuts is limited

With economic activity slowing, fiscal policy in many countries on a consolidation path and the ECB easing rates, official policy rates will not increase much if at all in 2012. However the low level of rates means that there is also limited scope for cuts. With the exception of Romania, real rates are currently below their long term average and will remain so throughout next year. We pencil in 50-75bp in rate cuts in Poland for next year, as well as some further rate reductions in Serbia over the first few months of 2012 but little beyond that in terms of rate reductions.

Interest rates (3 month interbank) in the region edging upwards due to liquidity pressures



Real rates are and will remain well below their long term average

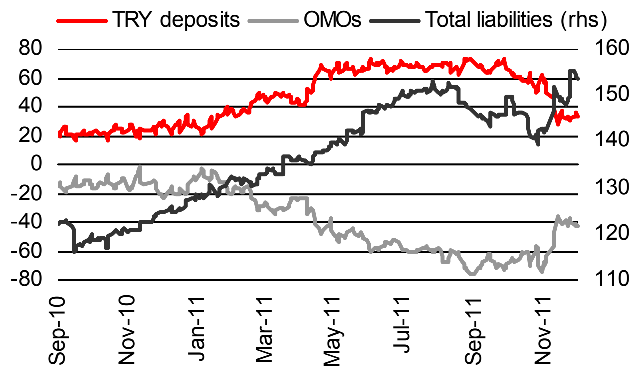


Source: Bloomberg, national central banks and statistics offices, UniCredit Research

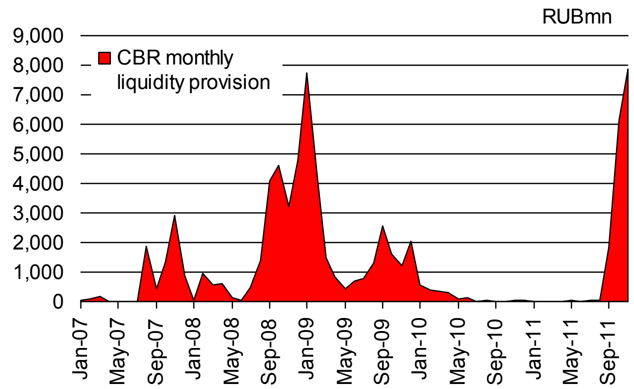
Short end of curves under liquidity pressure, to ease only gradually

However liquidity shortages are pushing short end money market rates higher in a number of countries, damaging the monetary policy transmission mechanism. In Turkey's case this is by design of the CBT as it attempts to stabilise TRY. This is also the case in Croatia, Ukraine and Romania. Russia has also seen money market rates just over 200bp since August, though in this case the CBR has reacted quickly to provide liquidity in large amounts to counteract this. This form of stress captured in the short end of curves is likely to ease gradually over the course of 2012 but only in line with an easing in EMU tensions.

In Turkey it is more about the CBT's balance sheet than it is the policy rate



In Russia CBR liquidity provision increased rapidly



Source: CBT, CBR, UniCredit Research

Expect continued central bank activity in markets in 2012

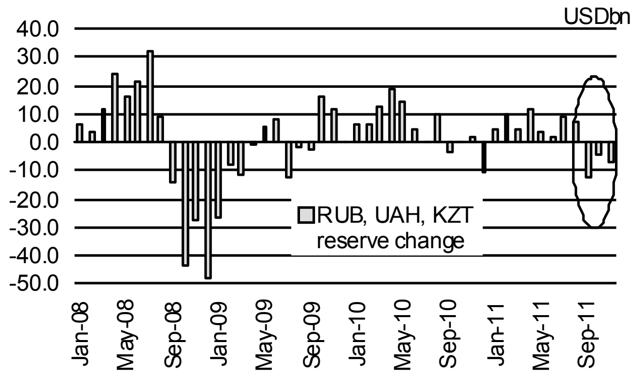
More broadly in 2012 at least some central banks are likely to remain more active, with a focus on both financial stability and inflation targetting. Poland and Turkey have quickly learned over recent months that though they accumulated a significant amount of FX reserves over 2010, this was not sufficient. As a result currency gains at a certain stage could well be met with FX intervention as part of a more active FX reserve accumulation policy. For at least the first half of next year, the CBT is set to continue to focus on changes in reserve requirements and adjustments in the size of its open market operations to control TRY. To date it has been reluctant to contract the size of its balance sheet – any decline in the size of open market operations has been offset by a decline in TRY on deposit at the CBT as banks cover TRY reserve requirements with FX deposits. If necessary, as part of a currency defence policy under a bout of renewed market pressure, the CBT could opt to hike TRY reserve requirements.

For CIS 2011 was a lost opportunity

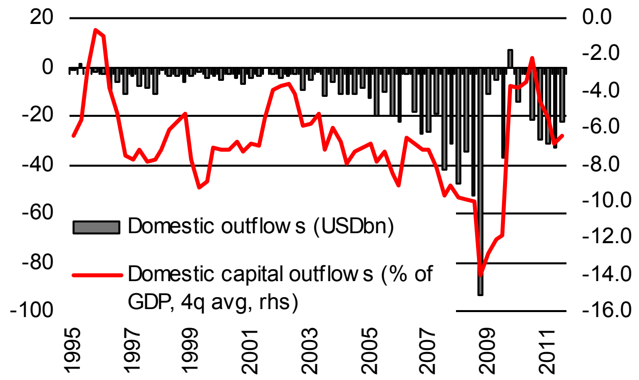
A halt to reforms leaves CIS currency confidence vulnerable

We entered 2011 anticipating currency gains across CIS which for the most part did not materialise but enter 2012 concerned about potential currency losses, primarily in Ukraine but also in Russia. September was a telling month in terms of determining domestic confidence in CIS currencies – despite three years since the onset of the crisis, the pace of FX reserve loss in CIS over the last three months shows that locals remain quick to demand FX. By November FX reserve loss in the region had reached its most rapid pace since Mar-09. Russia has lost USD 19.0bn in FX reserves since end-August, though CBR reserves FX-adjusted are still up USD 17.8bn on the year. Between September and November the NBU in Ukraine has spent 15.7% or USD 4.6bn of its FX reserves defending UAH. A scheduled eurobond repayment means that a further decline in December looks inevitable. Even in Kazakhstan, a country that looks set to boast a negative net external financing requirement next year, the NBK spent USD 1.9bn in FX reserves in September, though since then it has fully recouped these reserves.

FX reserve accumulation quickly shifts to FX reserve losses



Russia: Domestic capital outflows have increaesed once again



Source: CBR, NBK, NBU, UniCredit Research

The onus is on the authorities to regain reform momentum and improve domestic confidence

Even prior to latest political developments, Russia has seen an increase in domestic capital flight once again this year. Bank and non-bank entities removed USD 86.3bn from the country over the first three quarters of 2011 compared with outflows of USD 68bn for the entirety of 2010. In Ukraine 75% of the increase in the deposit base since the start of the year has been FX rather than UAH denominated. Last year only 47% of the increase in the deposit base was in hard currency. That said, at least the deposit base is increasing, not decreasing. In Russia WTO represents an important step forward in terms of structural reform but recent political events limit the scope for tackling issues such as the ever increasing reliance of both public and external accounts on the oil price. In Ukraine we continue to wait on the announcement of a gas deal with Russia, with particular interest in the size of capital flows linked to the deal. In Kazakhstan progress on banking sector reform has been at best muted.

Scope for convergence in currency regimes

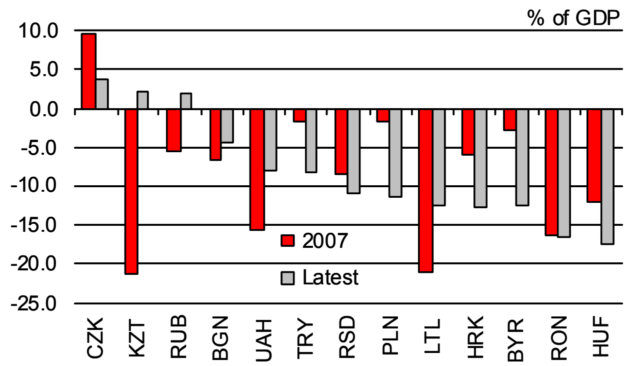
More broadly this latest episode re-inforces the need for some increase in currency flexibility across the region. Russia has shifted in that direction – latest political developments act at another important test. However Kazakhstan and Ukraine's decisions to remain steadfast under the current regimes carries implications for competitiveness, particularly in an environment of further RUB losses. In the near term this is not a concern for Kazakhstan but it does mean that any KZT gains, even if required to contain inflation, are likely off the table for a number of quarters. Kazakhstan would probably need to see loss in RUB against USD of 20%-25% before it moves KZT. In Ukraine the political cost of UAH losses at this stage is not something the government is willing to bear but any re-engagement with the IMF will entail at least a pledge to introduce more currency flexibility, probably after next October's parliamentary election.

2012: No scope for policy slippage

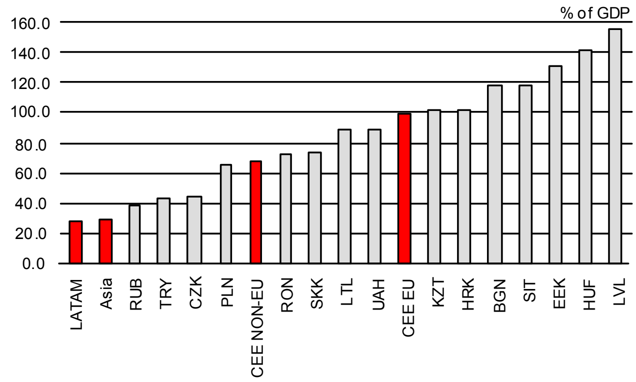
CEE needs to build buffers to protect against external shocks

Looking ahead the CEE region has to reckon with continued volatilty in global economic activity. To the extent that the CEE region is more heavily indebted from an external perspective than is the case for other developing regions globally, external shocks can have larger implications. 2009 saw economies in the region recover more rapidly than expected, in part because concerns about a large withdrawal of capital by foreign banks did not materialise as European banks pledged a long term commitment to the region. Most recent developments within EMU have rapidly prompted the market to question this once again.

Net external asset positions of banking sectors vary across CEE



Some countries much more indebted than others within CEE, though all more indebted than Asia or LatAm (gross external debt, 2010)



Source: BIS, UniCredit Research

For some foreign private capital will be more expensive, for others it could prove inaccessible, at least in the near term

Neither the plentiful capital inflows of 1H- nor the outflows of 2H-11 are likely to prove the norm in terms of external funding for CEE. In the near term developments in EMU will be central to determining developments within economies in CEE, with a clear risk of continued or escalating volatility. Over a multi quarter horizon, for stronger economies in the region that have built sufficient buffers, external funding for all sectors of the economy is likely to be more limited and expensive but accessible. We view Turkey, Poland, the Baltics and Czech Republic as part of this group. This will translate into more moderate growth rates and currency appreciation but the path on the whole should remain positive. On the other hand countries with poor policies or insufficient buffers will find themselves quickly punished. This is of most risk in Croatia, Hungary, Ukraine and potentially also Slovenia. In the case of the first three, multi year IMF involvement lies ahead. Russia and Kazakhstan are most protected from external developments, both in terms of growth and financing, and instead remain commodity plays. However as is obvious from recent events in Russia, an indefinite standstill in reforms is never immune to discontent.

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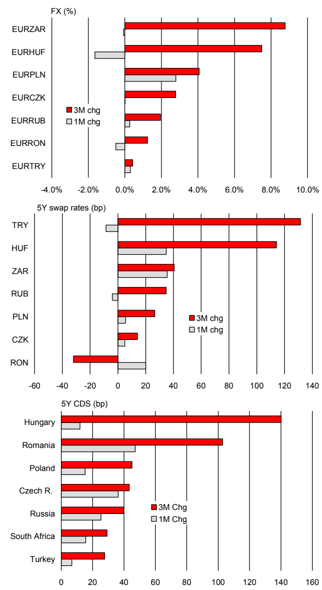
CEEMEA FI/FX: More constructive on non-EU

Performance overview



Source: UniCredit Research

- **We enter 2012 with a more constructive approach toward CEEMEA assets** due to relatively cheap valuations and a more decisive EMU solution framework. Given part of the CEEMEA region has significant exposure to the European bank deleveraging and trade linkages we focus on countries which are less close to EMU (particularly Turkey and partly Russia). This should also provide hedge in case the high level of EMU related uncertainty is sustained in the beginning of 2012. We are also selectively more constructive on countries which will potentially need external assistance (Hungary, Ukraine and potentially Croatia).
- **In FX** we recommend short on EUR/TRY as the risk characteristic of the TRY has improved significantly after the CBT started actively managing the available lira liquidity in the banking sector. We also see some logic in going short on the EUR/RUB, driven by our EUR/USD view and more limited scope for capital outflows in 2012. We see tactical value in buying EUR/HUF or CHF/HUF puts going into the 1Q12 IMF negotiations as the market is still short in HUF. While in case of Poland authorities prefer stronger PLN we think in the Czech Republic they would rather be ok with a stable CZK. Accordingly we recommend a long PLN/CZK position. We keep neutral stance on the RON.
- **In rates** we recommend mid to long part TURKGB, for investors who have access to OFZ market and long OFZ 18 due to the potential introduction of OFZs into the Euroclear system. We recommend a long ASW position in CZGBs while recommending paying 5Y PLN rates as a tail hedge and attractive risk reward. We would not jump on HGB even if there is a positive IMF outcome, given significant positioning overhang.
- **In credit** we recommend buying Rephun EUR paper due to the cheap valuation vs. USD paper, buying Ukraine 13 for high carry. We also see scope for Croatia Eurobonds to catch up, depending on IMF cooperation. We remain positive on Romania but would wait for the forthcoming USD deal, which should offer better pick up. As a hedge we recommend buying Russia 5Y CDS versus selling Turkey 5Y CDS.

CEEMEA REAL MONEY COUNTRY ALLOCATIONS

	FX	LC bond	Credit	Comment
Croatia	U/W	U/W	U/W	Wait for potential IMF announcement post elections to turn more positive
Czech	U/W	M/W	M/W	CNB not against FX depreciation, local bonds cheap but Bund is a risk
Hungary	U/W	U/W	M/W	Credit is the cheapest asset class, scale up in case positive IMF agreement
Kazakhstan	M/W	-	M/W	Solid economic backdrop and ongoing strong control on FX
Lithuania	-	-	O/W	Attractive spread vs. rating and economic outlook
Poland	M/W	U/W	M/W	Central bank intervention, local rates higher in both EMU outcomes
Romania	M/W	M/W	O/W	Cheap credit valuation vs. rating, wait for new Eurobond
Russia	O/W	O/W	M/W	Cheap local currency bonds (OFZ), credit remains a hedge tool
Turkey	O/W	O/W	O/W	Slowing economy, active CBT and solid public finances
Ukraine	U/W	M/W	U/W	Short end credit is cheap

CEEMEA LEVERAGED RECOMMENDATIONS

Recommendation	Entry	Target	Exp. return	Rationale
Short EUR/TRY	2.45	2.30	6.1%	Active TRY liquidity management should cap TRY losses
Long PLN/CZK	5.65	5.90	4.4%	Diverging central bank reaction functions
Buy EUR/HUF put, 285 strike, 3M	90bp	250bp	160bp	Bet on IMF-related short squeeze
Buy 10Y CZGB vs. pay 10Y CZK IRS	140bp	75bp	65bp	Widest ASW in CEE despite tightest CDS
Buy Jan 2020 TURKGB	10.0%	9.0%	100bp	Slowing economy and active CBT should see flatter curve
Pay 5Y PLN IRS	4.84%	6.0%	116bp	Rates should move higher either in v positive or v negative EMU outcome
Buy OFZ 03/2018	8.20%	7.50%	70bp	Potential introduction of Euroclear should see OFZ outperforming
Buy Rephun EUR 18 vs. USD 21	115bp	30bp	85bp	EUR papers are cheap vs. USD paper
Buy Ukraine USD 13	9.0%	8:0%	100bp	Near-term credit outlook is not in line with inverted curve
Pay Russia 5Y CDS vs. Turkey CDS	20bp	-150bp	170bp	Attractive tail hedge

Source: UniCredit Research

CEEMEA FX: TRY now, RUB later

CEEMEA FX
real money allocations

Croatia	U/W
Czech	U/W
Hungary	U/W
Kazakhstan	M/W
Lithuania	-
Poland	M/W
Romania	M/W
Russia	O/W
Turkey	O/W
Ukraine	M/W

Source: UniCredit Research

Top FX recommendations:

#1 Sell EUR/TRY
#2 Buy PLN/CZK
#3 Buy EUR/HUF and CHF/HUF put options
#4 Buy RUB following 1Q-2Q weakness

CEEMEA FX softened significantly in 2011 (avg. CEEMEA basket down 7% vs. USD) but we think 2012 will be better for some currencies in the region. With several local policymakers more active in controlling FX deprecation while G3 central banks continue to provide excess USD and EUR liquidity, we think risk-reward is improving even on EU-linked CEEMEA currencies. As opposed to one year ago when several EM central banks were against excessive currency appreciation and capital inflows, we now have several countries in the region actively supporting their currency to appreciate. In fact, we believe the CNB is the only central bank in the region that would not oppose FX weakness. Given potential further downside pressure on EUR/USD in the first half of the year even with a more lasting solution for the EMU debt problems, we see USD-referenced currencies outperforming EUR-referenced CEE currencies.

Our top pick against this backdrop is short EUR/TRY: As the CBT has started using its balance sheet more actively to control the TRY, we believe the risk outlook for the TRY has changed significantly compared to one year ago. In a recent analysis of the available tools at hand, we concluded the CBT has a reasonable chance of success while it looks convinced that the economic slowdown will largely contribute to the rebalancing of the Turkish economy. The price of the active balance sheet usage (via FX interventions, TRY liquidity control) is obviously a sharp rise in short-term rates. This in turn pushed TRY implied rates higher during 4Q011 and they are now the second highest among all EM countries. On a volatility-adjusted basis, the TRY also offers an attractive ratio. Although we do believe that the CBT might start rebuilding its FX reserves in case of strong appreciation (5%/10%), this is still decent risk-reward in our view. Moreover, as we express our view against the EUR while the CBT prefers to focus on the 50%/50% EUR and USD basket, our trade should perform in case EUR/USD moves lower. We target 2.30 (about 6.3% gain). The trade also provides about 70bp positive carry per month.

We look to add to RUB exposure in case the currency comes under more pressure in 1Q-2Q

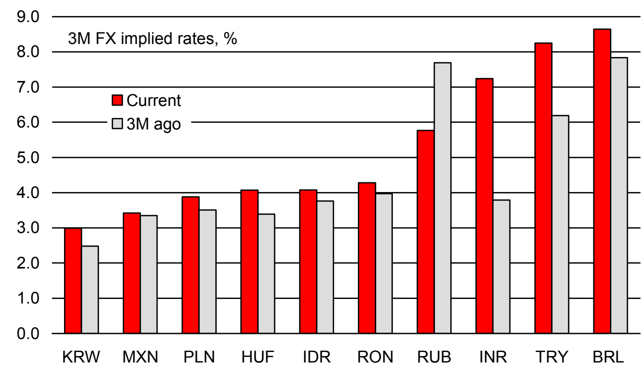
This backdrop should support the RUB as well, but we prefer to wait until 2Q-3Q12 before adding a short EUR/RUB position. Uncertainty about capital flows (although the bulk of it is probably behind us) and forthcoming election-related noise and potentially some fiscal loosening coupled with significant CBR liquidity injection mean to expect better levels to add to this trade. Our group currently forecasts oil prices at 120 USD p/b for 2012 compared to a USD 100 p/b assumption in the 2012 budget.

Buy PLN/CZK as central bank relative preference trade

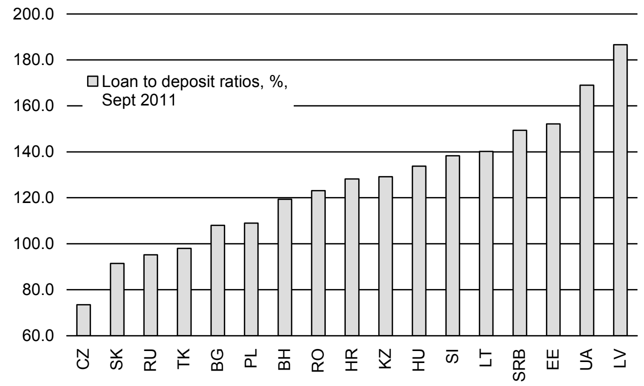
Buy EUR/HUF or CHF/HUF puts to bet on further short squeeze

Although we see CEE FX underperforming as a whole, we believe the CNB is the only central bank not against a more meaningful CZK depreciation from the current level, so outright shorts in the other countries could run into policymaker interference. On the other hand, given that the Czech banking sector is the least levered in the whole CEEMEA region (with a loan to deposit ratio of only 75%), we do not see a strong enough reason to go short on an outright basis. We do, however, see logic in adding a long PLN/CZK after the PLN seriously lagged the recent recovery. We enter around the 5.65 level and target 5.90 (4.3% profit). In the case of the HUF, we see scope for further short squeeze as market positioning is still excessively short (evidenced in risk reversal spreads). From a tactical perspective, we see logic in buying EUR/HUF and CHF/HUF puts. The latter provides additional benefit from a potential move in the EUR/CHF peg. As we do not see EUR/HUF moving sustainably below 285/280, we treat these trades as tactical. In the case of Romania, we see the NBR continuing its tight grip on RON liquidity and on the EUR/RON itself and hence we remain neutral for now.

TRY carry is restored



Loan to deposit ratio to shield the Czech banking sector



Source: National central banks, Bloomberg, UniCredit Research

CEEMEA rates: long Turkey and attractive technical

CEEMEA local currency bond recommendations

Croatia	U/W
Czech	M/W
Hungary	U/W
Kazakhstan	-
Lithuania	-
Poland	U/W
Romania	M/W
Russia	O/W
Turkey	O/W
Ukraine	M/W

Source: UniCredit Research

Top local rate recommendations:

#1 Buy 10Y CZGB vs. pay CZK IRS
#2 Pay 5Y PLN IRS
#3 Buy long end TURKGB
#4 Buy 2018 OFZ

Although CEEMEA rate markets could underperform global EM in the event of a negative EMU outcome, we think there are several local rate markets (outside of CEE) that offer attractive investment opportunities. With a positioning overhang creating a binary risk in some countries, we focus on countries where investor positioning is much lighter than a year ago while the economy is less prone to the potential deleveraging pressure from the Euro zone. In this environment, we think CEE yields could underperform (similar to our FX views) with potential pressure on Bunds creating an additional headwind.

Czech government bonds asset swap spread is too wide

We see POLGBs stop performing after good rally in 2011

Paying 5Y PLN is an attractive hedge

Romanian local currency bonds are expensive vs. credit

Within CEE, we consider **Hungarian** local currency bonds expensive versus credit and FX and would refrain from adding to long positions. Given a significant non-resident position overhang, we think these investors might exploit a potential IMF agreement in 1Q12 to reduce exposure. For the time being, we remain neutral on HGB duration and would only consider adding if positioning declines while the external assistance is indeed significant. In the **Czech Republic,** we consider the local currency credit risk, the spread between cash CZGB and CZK IRS, attractive (10Y spread around 140bp), which is not consistent with Czech CDS pricing (ASW widest in CEE while CDS the tightest). We would not add to outright positions here given potential pressure from the Bund side. In **Poland,** we expect POLGBs to stop performing (after tightening about 70bp in line with the JPM-GBI benchmark) as we believe they would underperform under both the positive and negative EMU debt crisis outcome while positioning is heavy. **1.** In case the EMU endgame surprises on the upside while the economic slowdown proves less powerful than feared by many market participants the PLN curve should start pricing in hikes again. Currently the 12x15 FRA is pricing in about a 25-50bp rate cut over the next 12 months and unchanged rates for the following 12M. The 1Y5Y forward is pricing in only about a 5bp higher rate over the next one year. Moreover, under this scenario we would expect stronger upside pressure on Bund yields, which are still very strongly correlated with POLGBs. **2.** In case the EMU backdrop disappoints more in the first half of 2012, the NBP might come under much more pressure from the FX side and hence upside pressure on rates starts building again. As this outcome will almost certainly lead to some outflows from EM bond funds, a high level of non-resident positioning will represent a key risk for PLN rates. We therefore recommend reducing duration to short. For leveraged investors, we recommend paying 5Y PLN IRS outright partly as a regional macro hedge. The carry of the 5Y PLN payer has improved significantly during the last 12M. It is now roughly flat, while the negative rolldown is only a marginal 0.5bp per month. We set a target at 6.0% (120bp upside) and a stop loss at 4.40% (40bp downside). **In the case of Romania**, similar to Hungary we see hard currency credit as a better place than local currency given an effective yield cap on ROMGBs. Consequently, we do not recommend buying ROMGBs at current levels and remain neutral.

The new CBT policy, significantly reduced positioning, should see long end TURKGB perform – buy TURKGB Jan 2020

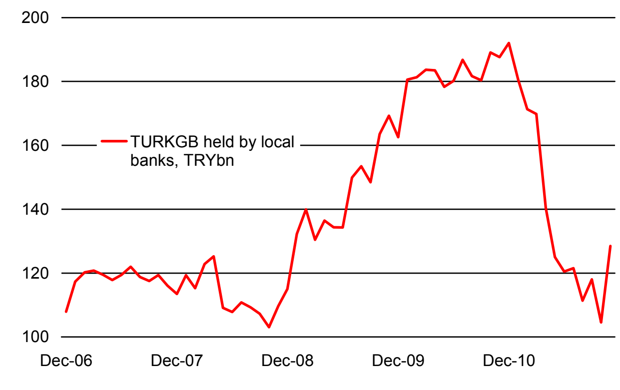
Outside CEE, we see the best outright potential in **Turkey** local currency bonds**.** We believe a more active CBT in liquidity management and significantly reduced positioning have improved the risk-reward characteristic of long TURKGB positions while Turkey is much less exposed to European bank deleveraging with a loan to deposit ratio below 100%. We also believe the curve should be much flatter from current levels while the short end could stabilize around current levels. We expect the 2013 benchmark to trade around the current 10.5%/11% level with some upside bias while the mid to long part of the curve (Jan 2016 and Jan 2020) to outperform and potentially move into single digits. Given our outlook for the TRY, we prefer to express this view via buying FX unhedged mid to long part TURKGB papers. Our key rationale is the following: **1.** The cash TURKGB curve is currently almost completely flat between the 2Y and 10Y segment at around 10.20%/50% yield. With this high level of yields, the curve should normally be much flatter (i.e. long yields lower than short yields) particularly where the central bank is using its balance sheet more actively to manage the FX and the economy is set to slow significantly. **2.** Another driver of TURKGB performance could be the fact that local banks' TURKGB holdings have declined significantly in 2011. Between December 2010 and October 2011 they sold TRY 87bn of TURKGBs as they needed cash for the higher reserve requirement. Importantly however, the Turkish banking sector was a net buyer of TURKGB in November (up by TRY 23bn). At the end of November, they still owned about 34% of the TURKGB market. **3.** Positioning of non-resident TURKGB holders also lightened up significantly recently. Currently they own about 16% (USD 34bn) of the TURKGB market, but their holdings declined since August by about 10%. We recommend buying Jan 2020 TURKGB.

Gap between OFZ and Russian RUB paper should finally disappear

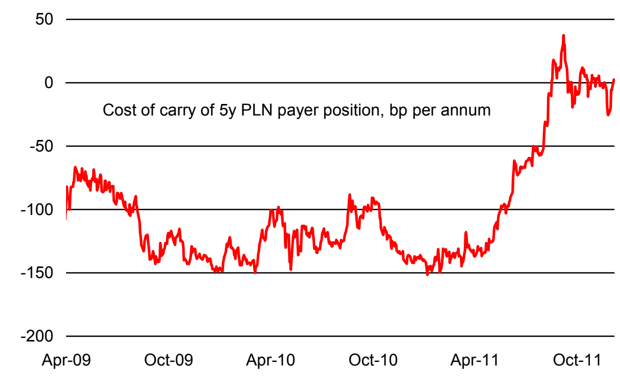
Due to expected technical changes **we are positive on Russian OFZs as well**. The fact that the central bank will let OZFs trade outside of the official MICEX suggests that these bonds could become Euroclearable relatively soon in 2012. Due to technical and settlement difficulties, the MICEX traded OFZs are currently trading about 100bp wider than the Russia RUB 18 paper. We think that following the change this gap is set to disappear. For investors who have access to the MICEX we recommend buying mid to long end OFZs.

POSITIONING IMPROVED IN TURKGB WHILE COST OF PAYING PLN CHEAPENED UP A LOT

Local banks strongly reduced TURKGB holdings



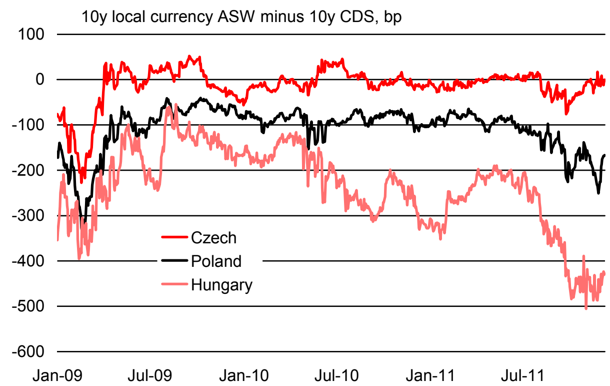
PLN rate payer has cheapened up a lot



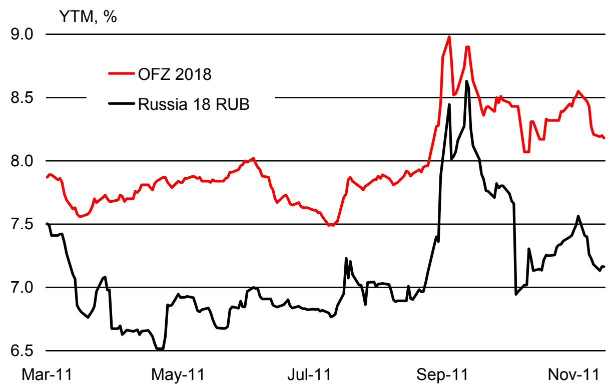
Source: CBT, Bloomberg, UniCredit Research

CZGB ASW AND RUSSIA OFZ LOOK RELATIVELY WIDE

CZGB ASW too wide vs. CDS and vs. region



OFZ offers a descent pick up versus Russian RUB 18



Source: Bloomberg, UniCredit Research

CEEMEA credit: focus on technicalities and hedge

CEEMEA credit recommendations

Croatia	M/W
Czech	M/W
Hungary	M/W
Kazakhstan	M/W
Lithuania	O/W
Poland	M/W
Romania	O/W
Russia	M/W
Turkey	O/W
Ukraine	U/W

Source: UniCredit Research

Top credit recommendations:

#1 Buy Rephun EUR vs. sell Rephun USD
#2 Buy new Romania Eurobond
#3 Buy Ukraine 12 and 13 Eurobonds
#4 Buy Russia 5Y CDS vs. sell Turkey 5Y CDS

The EMBI total return index gained 8% in 2011, which leaves it as the best performing asset class. This was, however, entirely due to the duration performance of UST, which gained almost 25% leaving the credit spread component losing 17%. Similar to the other asset classes, CEEMEA has underperformed. Looking at 2012 we see significant supply (CEEMEA will likely remain the biggest sovereign issuer, we estimate about USD 32bn sovereign issuance for the whole region, up from USD 23bn in 2011, which will likely represent about 50% of total EM sovereign issuance) and closer proximity to EMU bank sector deleveraging to start with a cautious tone on the asset class. The most evident sign of EMU bank deleveraging in several countries was the inversion of the credit curves (most notably Ukraine) in the last few months of the year, which was driven by the reduction of jump to default limits (limit on notional amounts that particularly hurts the short end). This backdrop has, however, created interesting trading and investment opportunities in our view.

Within CEE we think, by increasing our general **Hungary** allocation to M/W from U/W, the Rephun EUR papers are cheap versus Rephun USD papers and recommend a switch. The relative value has opened up since the Moody's downgrade, which hurt several EUR debt holders disproportionately. This saw the z-spread between Rephun EUR 18 and Rephun USD 21 widening to around 150bp, which offers an attractive switch opportunity. We estimate that Hungary needs to issue about USD 5bn in Eurobonds in 2012, which looks too much and underlines the need for an IMF agreement in our view. We therefore expect the actual issuance need to be lower depending on the IMF deal. Regarding **Poland** and **Czech Republic,** we remain market weight on both given unattractive valuations versus their rating and versus other asset classes. We estimate that Poland will need to issue about USD 4.5bn in Eurobonds, which is similar to the 2011 issuance. In **Romania** we see clear long-term value in Romanian credit (hence we retain our O/W country allocation) based on valuation versus other Romanian asset classes, our positive ratings outlook and good progress on IMF-driven reforms. We estimate that Romania will issue about EUR 1.5bn (but we expect the authorities will fill it partly with IMF assistance, probably around EUR 2.5bn) We would however prefer to wait for the upcoming Eurobond issuance, which will be the first USD paper from Romania and should attract strong demand from oversees investors.

Ukraine short end credit is cheap, buy Ukraine 12 and Ukraine 13 Eurobonds for positive carry

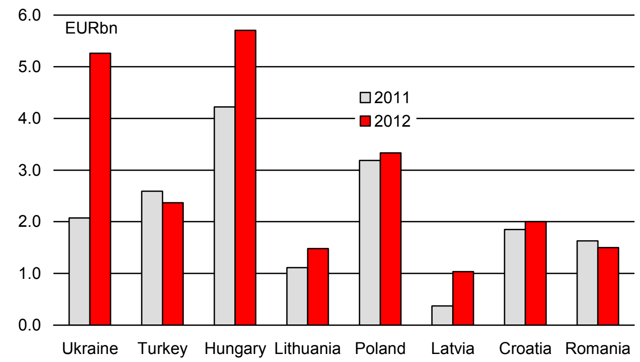
Ukrainian credit markets have underperformed in 2011 (5Y Ukraine vs. 5Y SovxCE widened to around 500bp from 300bp) due to the uncertain IMF outlook, high beta, and depreciation pressure on the currency with associated clear difficulty of government funding in the UAH market. The biggest casualty of the EMU bank deleveraging and cut in jump to default limits (limit of total notional exposure) has been the Ukrainian short end with Ukraine 12 and Ukraine 13 trading around 10% yields. We believe the near-term outlook for Ukrainian credit is not as bad. First and most importantly, the state does not have too much debt coming due in 2012: USD 1bn Euorobond maturity and USD 2.5bn IMF repayment, assuming that the VTB loan will be rolled over. In case the bond market remains completely shut and no other official financing arrives, we think worst case FX reserve could cover at least partly those maturities. On the other hand, the NBU has limited ability to smooth external pressure over the longer term if the Eurobond market remains closed while no deal is reached with Russia and/or the IMF. Moreover, the extremely poor domestic public funding (evidenced in continuous auction cancellations) puts some additional pressure on the government. Exactly because of these reasons we think Ukraine will need to secure some form of official funding (either IMF or Russia). The preferred solution at this moment appears to be a deal with Russia. We think FX devaluation is the less preferred option. Against this backdrop, we think the inverted credit curve does not reflect properly the Ukrainian credit risk and recommend buying Ukraine 12 and Ukraine 13 papers for about 10% yield.

Russia versus Turkey CDS offers attractive relative value opportunity

In the case of Russia and Turkey we recommend a relative value trade via buying 5Y Russia CDS versus selling 5Y Turkey CDS. We primarily see this trade as an attractive tail hedge with limited holding cost (30bp per year) and limited downside in our view. Following the poor performance of United Russia at the Russian parliamentary elections, we now see scope for looser fiscal policy in the runup to the 2012 presidential elections. This coupled with a very high breakeven oil price means that fiscal related risk could increase in Russia. Although the sovereign continues to have a strong balance sheet (public sector debt at 11.0% and net external debt -18.9%), we think this could weigh on Russian credit market sentiment. Increasing policy risk could also see more Russian corporate credit investors using Russia CDS as a hedge (as was the case in 2008-2009). On the Turkish side of our trade we note that Turkey has been penalized during 2011 due to its unorthodox monetary policy, fast lending growth and widening current account balance. This was also reflected in recent rating agency comments and the delay of the upgrade to investment grade. According to our forecast, Turkish economic growth should slow to 2.8% from 7.5% with risks to the downside depending on developments in Europe while the C/A balance is expected to narrow to 7.9% of GDP from 10.5%. This coupled with a very light positioning in the Turkish sovereign credit market by EM funds (Turkey remains the most U/W in their portfolios compared to benchmark) could see Turkey credit outperforming Russia. The spread has limited correlation with broader market variables such as SPX or VIX, which makes it an attractive tail hedge. More importantly, the day-to-day correlation versus oil prices is also very low. The current 20bp spread is on the high end of the recent range, which makes the entry attractive. We note that in 2008 the gap tightened by more than 400bp against Russia. We enter the trade at 30bp and target around negative 150bp. We set a stop loss at 80bp. We also express this relative value in our real money allocation as well by keeping Turkey O/W while keeping Russia credit at M/W.

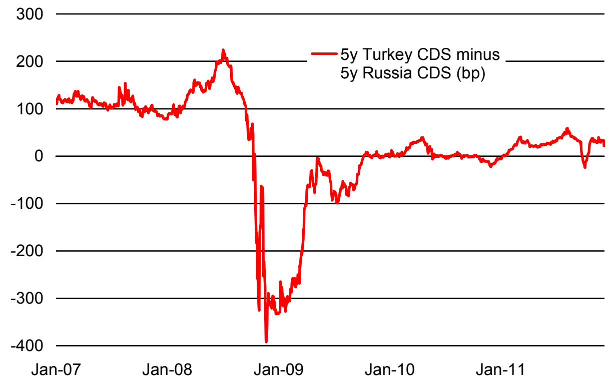
CEEMEA CREDIT OVERVIEW

Expected external bond issuance in 2012



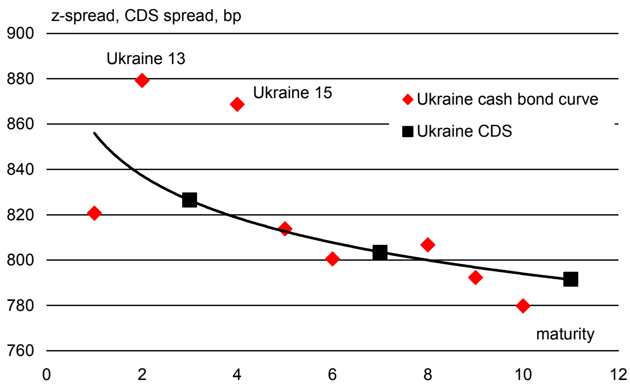
*Hungary and Ukraine numbers assume no IMF funding

Russia vs. Turkey 5Y CDS

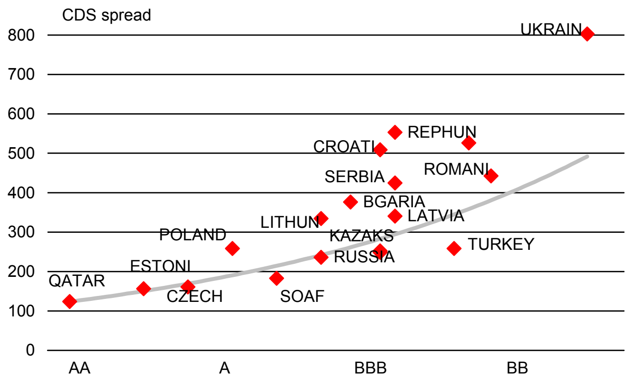


Source: Bloomberg, UniCredit Research

Ukraine short end is cheap



Credit spread versus rating fair value



Source: Bloomberg, UniCredit Research

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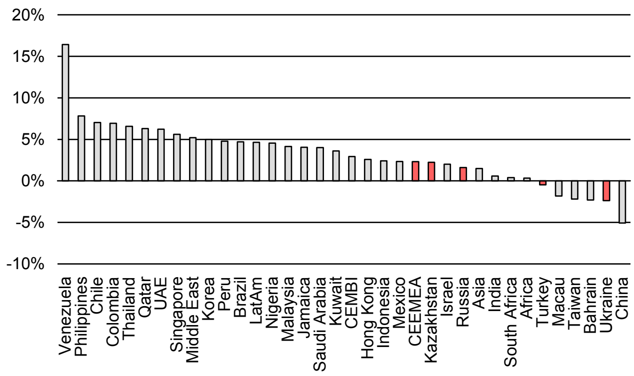
EEMEA Corporates: 2012 will be different from 2008

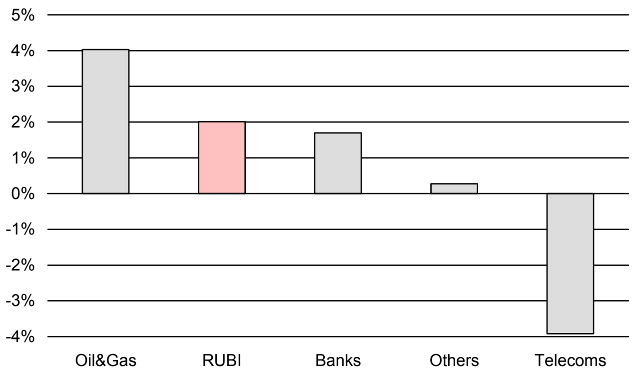
The euro zone debt crisis and the close economic links to the euro zone have led to the underperformance of Emerging European corporate credits vs. LatAm and MEA corporates in 2011 (YTD). Nonetheless, EEMEA corporates outperformed Asian corporates and sovereigns. In 2012, the performance of Emerging European corporate credits will depend on: 1. Progress with respect to a resolution of the euro zone debt crisis, 2. Regional issuers' credit fundamentals and 3. Regional issuers' technicals. While the latter two are expected to remain supportive, the former will constitute a source of volatility and remain a dominant spread driver.

EMERGING EUROPEAN CORPORATE CREDITS UNDERPERFORMED, RUSSIAN OIL & GAS CREDITS SHONE IN 2011

Total returns of select credit indices (2011YTD)



Total returns of Russian corporate credit sectors (2011YTD)

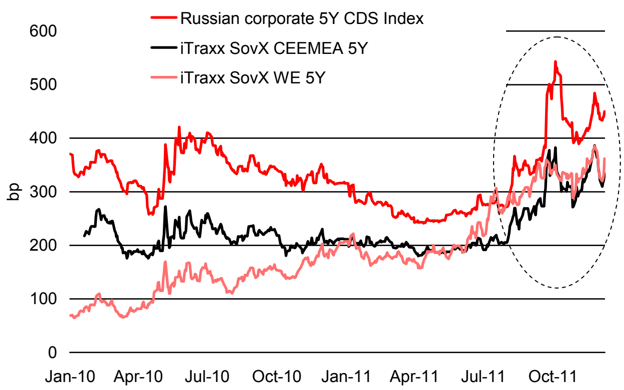


Source: Bloomberg, JPM, UniCredit Research

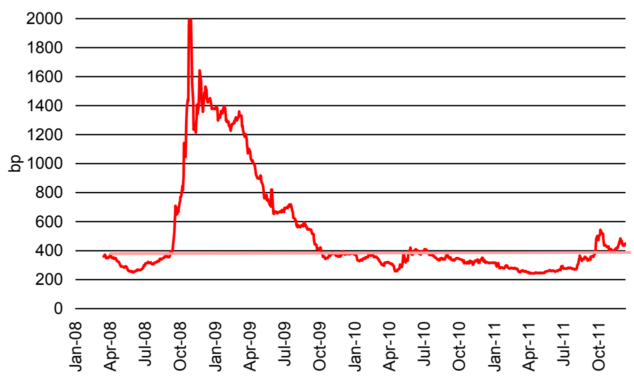
Since 2H11, credit risk premia have moved in line with Western European risk premia, ending the decoupling story in our asset class. Whether CEEMEA corporates will manage to decouple from the euro zone depends on the resolution of the euro zone debt crisis. Nonetheless, despite the pretty advanced stage of the crisis, and euro zone credit risk premia dislocations, a scenario comparable to that of 2008/09 in Emerging European credits – i.e. a sharp surge in credit risk premia and defaults – is not in the cards in 2012.

EURO ZONE DEBT CRISIS IS SITTING IN THE DRIVER'S SEAT, CORPORATE RISK PREMIA REMAIN AT PRE-LEHMAN LEVELS

Russian corporate CDS index* vs. SovX WE and SovX CEEMEA



Russian corporate CDS index*



*Equally-weighted 5Y CDS index includes: GAZPRU, LUKOIL, TMENRU, TNEFT, EVRAZ, CHMFRU, VIP, MOBTEL, SBERRU, VTB, GPBRU, RSHB, and ALFARU.

Source: Bloomberg, JPM, UniCredit Research

In 2012, we do not expect a repetition of the 2008 performance in Emerging European corporate credits due to the following:

Firm commodities should remain supportive for...

A recession similar to that of 2009 is not in the cards for the euro zone or for Emerging Europe. Our economists expect a pronounced growth deceleration in 2012 in the euro zone, and in Emerging Europe, which should still be supportive for regional credits. The oil price is expected to remain strong, averaging USD 120 per barrel in 2012, which should be supportive for EBITDA generation, notably in the case of Russian and Kazakh names. Although steel makers indicated a softer tone in steel prices, price changes are unlikely to be dramatic. Moreover, this is a sector that experienced significant deleveraging. The overall macro and commodity backdrop limits the risk of a sharp deterioration of credit metrics, covenant breaks and related defaults (including technical defaults) in the regional corporate universe. Only a deep and prolonged recession – which is not our core scenario – as a result of tail risk from the euro zone credit crisis, would lead to a substantial deterioration of credit metrics of regional corporates.

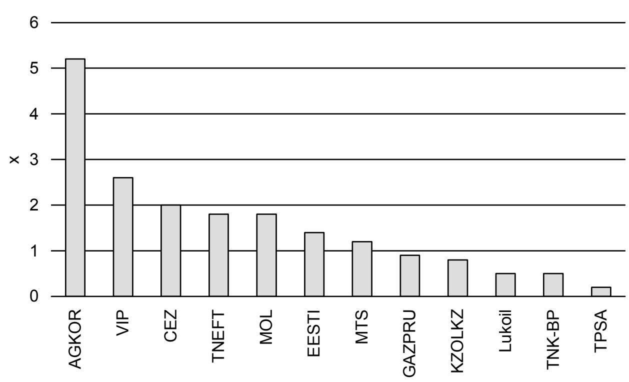
...corporate credit fundamentals

Emerging European corporate credits show solid fundamentals overall, which represents a major difference to the 2008 environment: While at the time, regional credits featured more leveraged balance sheets, during the last two years, they have repaired their balance sheets via credit investor-friendly policies. This has led to lower leverage and stronger cash positions. As our chart shows, most of the major Eurobond issuers have short-term debt covered by cash positions, which allows them to serve debt even if capital markets remain closed over the next few months. Dividend payments can be an ad hoc risk factor (e.g. Gazprom revealed a significant increase recently), but share buybacks should occur only sporadically while capex and M&A activity remains low, as economic growth visibility remains poor.

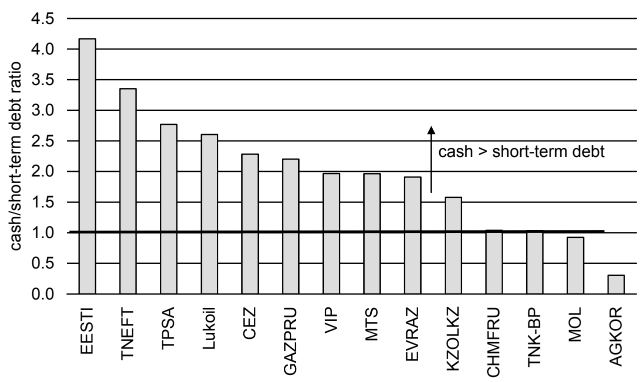
Emerging European financials recovered from the crisis, however not fully. Their capital ratios are stronger, but in most cases, non-performing loans have not been worked through, with the respective ratio still well above pre-2008 levels. However, structural weaknesses still persist, notably at CIS banks. Moreover, there is excess liquidity in the regional banking sectors. And the Russian central bank already reacted preemptively, scaling up liquidity provision to the sector and widening the collateral pool (reducing collateral rating requirements to B-/B3 from B+/B1; bonds are not automatically included in the list and require approval by the regulator), which also increases appetite for lower-rated debt.

EMERGING EUROPEAN ISSUERS ARE LESS LEVERAGED NOW THAN IN 2008

Net debt/EBITDA leverage ratios in select EEMEA credits



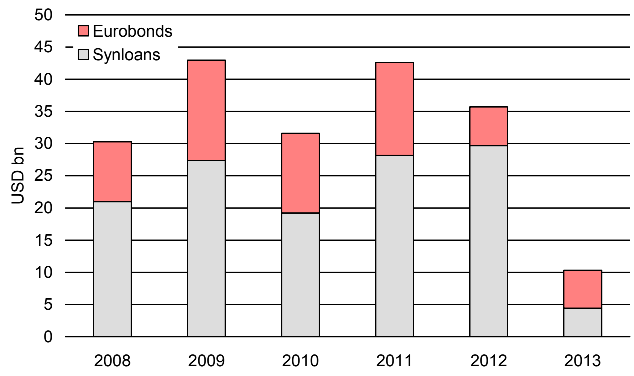
Cash/short-term debt ratios in select EEMEA issuers



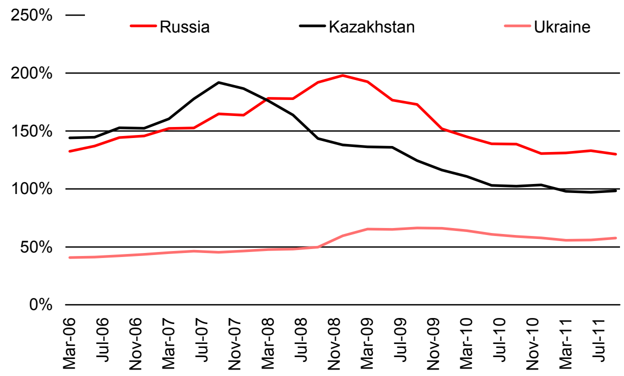
Source: Companies, UniCredit Research

DEBT REDEMPTIONS ARE EXPECTED TO DECLINE WHILE REGIONAL BANKS INCREASINGLY RELY ON RETAIL FUNDING

Expected Emerging European financials redemptions



Loans coverage by deposits in CIS 3 banking sectors



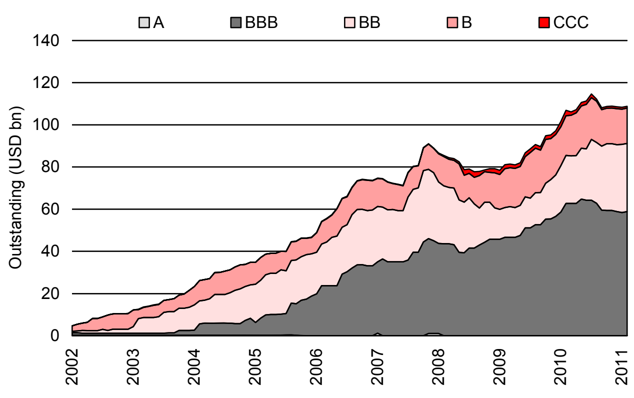
Source: Dealogic, BondRadar, Central Banks, UniCredit Research

Technical remain positive

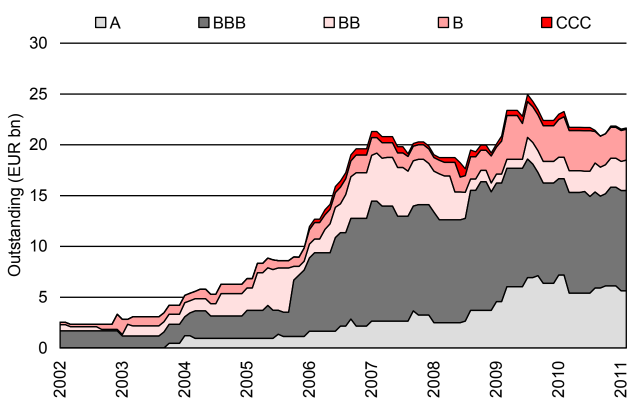
Positive technical factors present another important difference to 2008/09: EM funds saw only temporary outflows in 2H11, and YTD net inflows of USD 9bn compare favorably to net outflows of USD 14.5bn in 2008. Although Eurobond market activity has declined sharply over recent weeks, regional issuers' external debt maturities of USD 6.1bn (USD 12.4bn) and EUR 2.3bn (EUR 0.5bn) in 2012 (and 2013) are fairly manageable. This compares to expected coupon cash flows of USD 4.6bn and EUR 0.4bn in 2012. Even if external markets remain closed for regional issuers throughout 2012, we think that their strong balance sheets and the ability of domestic banks to provide funding should limit the risk of a substantial default rate increase. While in the run-up to the Lehman crisis, Emerging European financials relied significantly on wholesale funding, retail funding currently plays a more important role. As our chart shows, this is an important difference in the Russian and Kazakh banking sector compared to 2008/09. Moreover, until September 2008, regional corporates borrowed heavily on external markets, whereas during the last two years, Eurobond issuance has been more moderate (in 2007, Emerging European issuers placed USD 50.4bn on the Eurobond market vs. USD 35.7bn in 2011). This has reduced future dependency on external markets and, as depicted in the chart, debt maturities – both in the syndicated loan market and the Eurobond market – are actually expected to decline in 2012/13.

THE OVERALL CREDIT QUALITY OF EMERGING EUROPEAN CORPORATES REMAINED ON BALANCE STABLE DURING 2011

USD corporate bonds according to rating – 54% investment grade



EUR corporate bonds according to rating – 69% investment grade



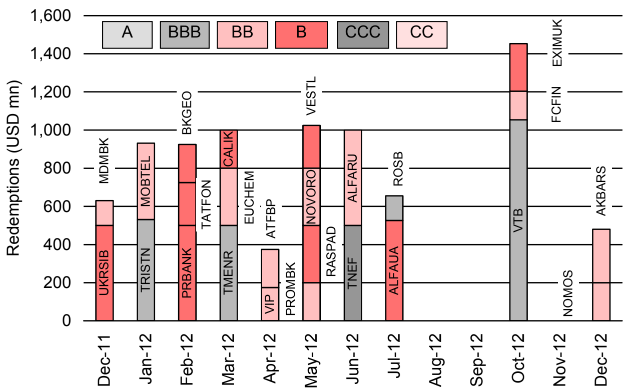
Source: Bloomberg, Reuters, UniCredit Research

Default rates to remain low

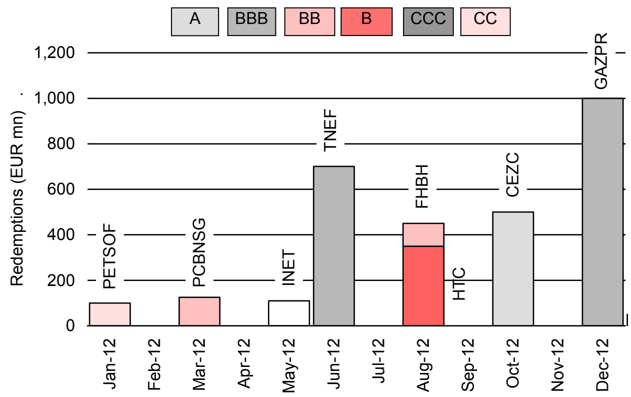
The limited redemptions next year – with the majority being self-funded by coupon payments – is important as external markets are only partly open. This reduces refinancing risk, as well as the risk of an increase in default rates. With Czech Sazka (EUR 200mn), there has been only one default in regional corporates this year, which translates into a total annual estimated default rate of 0.2%. The latest downgrade of the Kazakh BTA (from Caa2 to Ca with developing outlook) highlighted one important credit event risk for 2012. Nonetheless, against the backdrop of still solid fundamentals and technicals, we expect only a marginal increase in the default rate of regional credits overall.

FINANCIALS ARE BETTER PREPARED TO WEATHER EURO ZONE WOES

Expected corp. USD Eurobond redemptions in Emerging Europe



Expected corp. EUR Eurobond redemptions in Emerging Europe

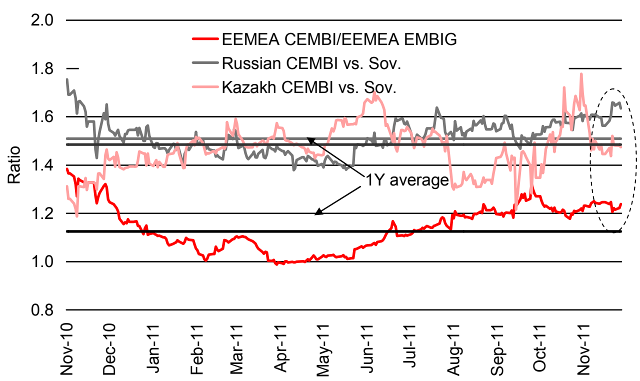


Source: Bloomberg, Reuters, UniCredit Research

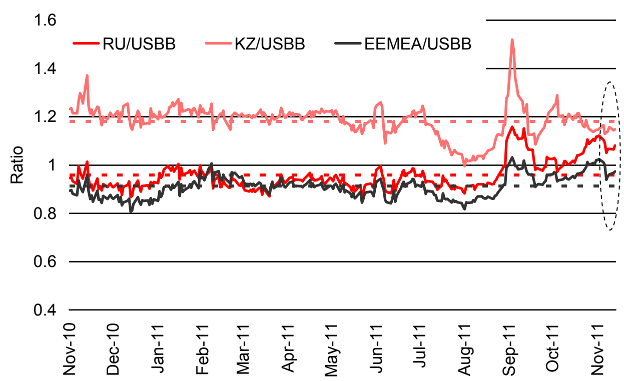
The recent sell-off in risky assets has led to a relative cheapening of Emerging European corporates vs. sovereigns, especially for Russian corporates. A similar pattern can be observed in terms of relative valuation vs. US HY credits, with Russian corporates having cheapened on a relative value basis. This means that a resolution of the debt crisis in the euro zone in 2012 implies recovery potential, particularly in Russian corporates. Nonetheless, elevated volatility in credit spreads is to be expected, depending on the further euro zone debt crisis development.

RUSSIAN CORPORATE CREDITS ARE CHEAP RELATIVE TO SOVEREIGN AND HY CREDITS

Relative value of EEMEA corporates vs. sovereign debt



Relative value of EEMEA corporates vs. HY debt



Source: Bloomberg, JPM, ML, UniCredit Research

In summary, as was the case during 2H11, the euro zone debt crisis is likely to remain a key driver for Emerging European credits. Nevertheless, even if the crisis in the euro zone deteriorates, taking into account the strong fundamental and technical factors, we do not expect Emerging European credit spreads to reach the 2008 peak levels. However, strategy-wise, given the low visibility, we advise to stay cautious as we enter 2012. We recommend positions primarily in high-grade names with strong fundamentals. The Oil&Gas sector, where we favor GAZPRU and TMENRU paper, remains our top choice, preferably at the front end and the medium-term section of the credit curve.

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Corporate credit recommendations

Country	Rating, (Moody's/ S&P/Fitch)	Recommendation	Recommended paper	Comment
AGROK	B2s/Bs/--	Sell	EUR 12/16	On 1 December, Agrokor reported impressive 9M11 results, reflecting the initiated measures to optimize costs as well as the first signs of an economic recovery and a strong tourism season in Croatia during 3Q11. 9M11 sales increased by 8.5% yoy (at constant FX rates) to HRK 21.7bn with the Retailing and Wholesale business contributing almost 76%. Regarding EBITDA, Agrokor was able to increase the figure by 10.8% yoy to HRK 1.9bn, resulting in a broadly unchanged margin of 8.9% vs. 8.8% in 9M11, although the Food Manufacturing and Distribution business suffered from higher costs for raw materials, with EBITDA margin declining by 188bp to 14.1%. Cash flow (before changes in working capital, interest payments and taxes) improved from HRK 1.5bn to HRK 1.8bn. However, the strong increase in working capital as well as higher interest payments led to an increase in reported net debt by HRK 0.9bn to HRK 10.1bn at 9M11. Apart from its strong operating performance in 9M11, the main driver for Agrokor's credit profile is the pending offer for the majority in listed Mercator (current market cap EUR 653mn). According to press reports, management of Mercator would support the selling process with Agrokor if the European Bank for Reconstruction and Development (EBRD) and the International Finance Corp. would be active parties in the transaction. The documentation of the bond and the loan agreement foresees a maximum net leverage (reported basis) of max. 4.0x (9M11: 3.8x). In case of the acquisition of the majority in Mercator (which would make sense from a strategic view), further equity would be required to keep the credit profile in line with the existing covenants. However, Agrokor stated in early October that it has already secured a syndicated loan of EUR 700mn from a banking group to acquire Mercator. Based on the existing uncertainties regarding Agrokor's pending acquisition of the majority in Mercator, we stick to our sell recommendation. However, we might revise our recommendation if further details of the planned transaction are announced. The AGROK 16 trades at a price of 92/93.
GAZPRU	Baa1s/BBBs/BBBp	Overweight	USD 11/15 EUR 2/15	Gazprom reported strong 2Q11 (1H11) IFRS results (ending 31 July), driven by the rising export gas price of Gazprom (linked to crude oil price). Credit ratios improved overall on the back of rising gas prices and sales volumes. We calculate a ratio of FFO/net debt (adj.) of 103% in 1H11 vs. 77% in 1H10. This is well above S&P's required ratio of >50% (S&P's calculation FY10: 99%). Gazprom recently announced a new 2011 investment program of RUB 1,28tn (USD 40bn), RUB 460bn (USD 14bn) higher than that announced in November 2010. The investments target Yamal, Eastern Siberia and the Far East, with a focus on expanding the Sakhalin plant (Russia's only LNG plant). As LNG demand in Japan (world's biggest LNG importer) soared after the nuclear catastrophe, the company plans to expand to the fast-growing Asian LNG market to diversify away from Europe. We stick to our overweight recommendation for the name due to the positive 3Q11 results outlook following a further rise in gas prices. Gazprom bonds also look appealing on a relative value basis as they offer the highest risk premium vs. the sovereign (around 50bp) compared to its quasi-sovereign peers in Latin America (Pemex 20bp, Petrobras 30bp). In addition, we note Gazprom's good regional diversification and proven resilience during challenging economic times.
LUKOIL	Baa2s/BBB-s/BBB-s	Hold	USD 11/14	Lukoil reported 3Q11 (9M11) results that were impacted by unsuccessful exploration in Ghana, lower production levels and higher taxes. Lukoil's credit profile improved overall and we calculate a ratio of FFO/net debt (adj.) of 238% vs. 217% in 1H11. This is well above S&P's expectation of >150% (S&P 1H11 calculation: 191%). Total debt/total capital (adj.) stood at 15% in 9M11 vs. 17% at 1H11, well in line with Moody's threshold of <30% (Moody's FY09 calculation: 20%). We expect further improvement in Lukoil's credit profile on the back of the high oil price level; however, we note that the company needs to invest in new resources in order to improve its reserve replacement.
MOLHB	--/BB+s/BBB-s	Hold	EUR 4/17	MOL reported 3Q11 (9M11) results that reflect the weak refining environment and a high FX loss in the Downstream segment, which was mitigated, however, by higher production levels and realized hydrocarbon prices in the Upstream segment. Credit ratios improved overall as the company is benefiting from the high oil price and improved production levels. FFO/net debt (adj.) stood at 46% in 9M11 (1H11: 44%), well above S&P's requirement for the rating (20%-25%; S&P 1H11: 35%). In 2Q11, Hungary (Baa3n/BBB-n/BBB-s) became the biggest shareholder of MOL (23.8%), but S&P said that MOL will not be regarded as a government-related entity (GRE) and thus does not receive a rating uplift for government support. We expect a slight improvement of credit ratios in 4Q11, as the Upstream segment will mitigate the negative refining impact. However, we note that in an environment of lower oil prices, profitability of the upstream business might be impacted and would further deteriorate MOL's downward trend in EBIT margins. In addition, the correlation of MOLHB spreads to the Hungarian 5Y CDS (which recently widened) has increased.
TNEFT	Baa1s/BBBs/--	Marketweight	USD 3/14	Transneft's 2Q11 sales increased 40% yoy (revenues: domestic tariff +29%, export tariff +15% yoy). EBITDA rose 44%, despite higher operating expenses (+30%). The operating profit margin has started to improve, reaching 38% vs. 32% in 2Q10 (FY09: 48%). 1H11 cash-flow generation picked up with 23% higher FFO yoy. In addition, cash was mainly used to fund higher capex and acquisitions, resulting in negative FCF. Net debt (adj.) increased from RUB 424bn (FYE10) to RUB 498bn in 1H11. Net debt (adj.) to EBITDA of 1.8x (1H11) is in line with S&P's requirement of 2x-2.5x for the rating. Transneft's credit metrics might weaken due to further investments and higher operating costs related to the ESPO pipeline project, but this is already reflected in current ratings. We thus keep our marketweight recommendation on the name.

Corporate credit recommendations (Cont'd)

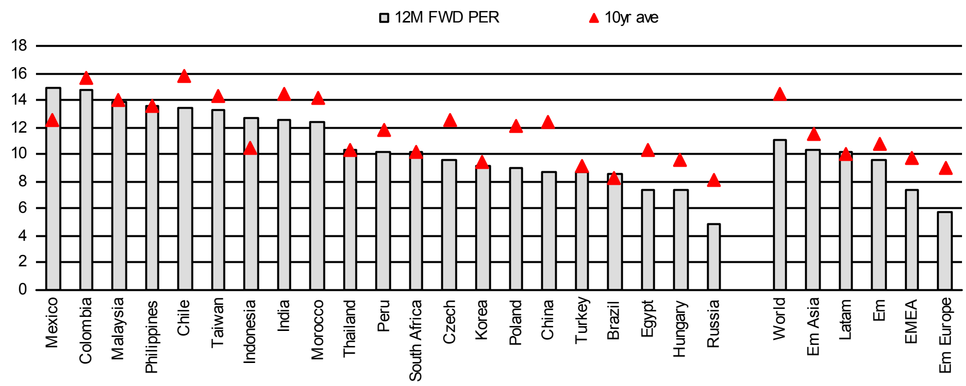
TMENRU	Baa2s/BBB-s/BBB-s	Buy	USD 7/16 USD 3/18	TNK-BP published strong 9M11 results (US GAAP), driven by higher crude prices (+38% yoy) and higher refining output (+7% yoy). We calculate RCF/net debt (adj.) of 98% vs. 82% 9M10, which is well above Moody's requirement of a ratio > 35%. Total debt/total capital (adj.) of 28% (9M10: 26%) remained below Moody's threshold of <35%. With regard to debt development, management said in the conference call that TNK will probably add some bilateral bank debt in 2011, but gave no details on bond issues in FY12. Based on TNK's strong operational performance and credit metrics, we stick to our buy recommendation on the name.
VIP	Ba3s/BBn/--	Hold	USD 4/13 USD 5/15	We keep our hold recommendation for VIP bonds. We expect an annual deleveraging potential of USD 1.0-1.5bn from 2012 onwards, which should mitigate growth ambitions and should help to keep the fully adj. net-debt-to-EBITDA ratio below 3.0x (S&P rating threshold). VimpelCom released solid 3Q11 results despite some EBITDA weakness in Russia (offset by growth in Africa and CIS). The company seems to progress well with regard to its negotiations with the Algerian government and released a strong commitment to its deleveraging path on its capital market day in November (net debt to EBITDA below 2.0x by YE14). The potential disposal proceeds from Djezzy (USD 5-7bn) could positively drive deleveraging going forward.
MOBTEL	Ba2wn/BBn/BB+p	Sell	USD 6/20	We keep our sell recommendation on the MOBTEL bonds as we see better value and lower event risks in VIP bonds. MTS expects revenues to grow by around 10% in 2011 due to the macroeconomic improvement in core markets, increasing data traffic, growing contributions from the retail business, higher usage, and further subscriber growth in CIS. The company had guided for an OIBDA margin (FY10: 43.1%) "in the low 40s" in FY11 due to competitive pressure and the potential need to promote SIM card sales more strongly. However, it also indicated that it sees further potential for margin improvements, while we assume that this will have only limited impact on its FY11 EBITDA margin. In 2011, capex as a percentage of sales is expected at 22%-24% due to investments in 3G and backbone networks, and the development of MTS' proprietary retail chain in Russia. Moreover, MTS will pay roughly RUB 21bn (USD 677mn) before YE11 for a 29% stake (via acquiring Sistema Inventure CJSC) in the voting stock of Moscow City Telephone Network, mitigating the relatively low leverage of the company (1.2x net debt to EBITDA).
TPSA	A3s/BBB+s/BBB+s	Marketweight	EUR 5/14	TP Group (TPSA) released 3Q11 results that revealed EBITDA moderately exceeding consensus expectations, while net income of PLN 376mn due to lower depreciation and a one-off tax break clearly exceeded the consensus of PLN 231mn.In 3Q11, group revenues decreased by 3.8% yoy to PLN 3,679mn, while decreasing qoq by 2.9%. This decline in revenues was mainly driven by fixed-line revenue reduction, while the mobile business was unable to offset the decline. The fixed-line revenue decline (between around 7%-8% annually) is being driven by fixed-to-mobile substitution and is likely to continue in 4Q11 and 2012, although fixed-line erosion has slowed down over the last three quarters. Restated EBITDA (excl. disposal gains and EU fine) declined yoy by 3.8% to PLN 1,402mn in 3Q11, mainly driven by top-line weakness. The adjusted EBITDA margin increased qoq to 38.1% in 3Q11, strongly benefitting from TPSA's cost optimization program. In 3Q11, net FCF declined yoy by 31.4% to PLN 586mn. However, net debt increased qoq from PLN 1,191mn to PLN 2,307mn at the end of 3Q11 (vs. PLN 3,817mn at YE10), mainly driven by PLN 2.0bn in dividend payments. The reported net-debt-to-adjusted-EBITDA (LTM) ratio climbed qoq from 0.2x to 0.4x, which is well below the company's own threshold of 1.5x. We note that TPSA's management board will use half of the Emitel proceeds, i.e. PLN 800mn, in a share buyback program. However, the related increase in net debt will only moderately reduce headroom under the company's own leverage threshold. TPSA confirmed its outlook for 2011. We keep our marketweight recommendation for TPSA bonds.
CEZCO	A2s/A-s/A-s	Overweight	EUR 10/21	CEZ released 3Q11 (9M11) results in line with expectations. The credit profile weakened slightly when compared to FYE10, as we calculate adj. FFO/net debt of 37.5% (FYE10: 44.3%) and adj. net debt/EBITDA of 2.3x (FYE10: 2.0x), which is still in line with the requirements for the current rating (S&P: adj. FFO/net debt above 25% [FY10: 45.71%]). CEZ has confirmed its guidance for FY11 EBITDA and EBIT (-5% yoy to CZK 84.8bn and -9% yoy to CZK 59.1bn) and for 2011 net income of CZK 40.6bn, with the decline being attributed to the negative impact of the newly introduced gift tax on CO2 allowances, lower achieved electricity prices and negative currency effects, as well as unfavorable hydrological conditions and an accounting effect resulting from the MIBRAG transaction. We continue to like CEZ due to its strong market position and low-cost generation portfolio, and think that considerable upside potential will result from the changing energy landscape in Germany post 2011/2012. Furthermore, we note the commitment of the Czech Republic (A1s/AA-s/A+p) to nuclear energy, leaving CEZ in a more comfortable position than its German peers.
ESTONE	A3s/BBB+s/--	Hold	EUR 11/20	We assign a hold recommendation to the name, which is based on strong support from the Estonian government and its dominant position in the Estonian energy market. In addition, the company's business profile also benefits from own full oil shale mining operations, reducing fuel price risk.

Source: UniCredit Research

Emerging Europe Equity

Visibility is low for 2012, and market performance is unlikely to be a straight line from here. Investors will continue to be focused on events in the euro zone: 2012 will be all about breaking the downwards spiral in markets being created by euro zone stresses. We believe that policymakers will be focused on keeping markets liquid (as we have already seen last week, when, in a concerted move, the six leading central banks flooded markets to re-activate the monetary transmission mechanism and avert a credit crunch). This should reduce event risk, and we expect ECB support will be made available to support banking sector rollovers in the euro zone in 2012, and ultimately to support the bond markets of those countries going through adjustment and structural reform programs, but where markets are not yet able to price in the likely success of such reforms. However, we are not there yet, and conditions are not fully in place in the euro zone for more than a short-term rally in markets. For now, the feedback into growth is still negative. On the positive side, we still see the political consensus in the euro zone as being largely pro-euro, and assuming policymakers do the right thing, we would expect markets to end 2012 significantly higher than current levels. Emerging Europe has had a poor year for performance in 2011: year to date, the MSCI Emerging Europe Index has declined by 20.3%, underperforming the 16.7% decline in MSCI Emerging Markets. Emerging Europe is the cheapest region in the EM universe, and has de-rated significantly from its ten year average (see graph), while emerging market equities continue to trade at a discount to the developed world, despite lower levels of sovereign and private sector debt in emerging markets, and an expected higher long-term growth rate. Our base case sees the MSCI Emerging Europe index at 550 by end 2012, 25% above current levels, with our base case suggesting returns for Russia of 30%, Turkey 25%, Poland 14% and sub-10% returns in Czech and Hungary. A simple return to April's high would see the index at 623, over 40% above current levels.

EMERGING MARKETS 12M FWD PER (CONSENSUS)



Source: Thomson IBES, UniCredit Research estimates

While our favored market for the year is Russia, we expect the coming months to see two phases. Entering 2012, we favor Turkey, after the market's recent de-rating – however, when the global growth picture picks sequentially up over 2012 as we anticipate, we believe Russia will take up the performance baton.

Contrary to recent sell-side consensus, we believe that investors should be overweight Turkey heading into 2012. We believe the market is overestimating the risk of a hard-landing for the economy in 2012, and we see a soft patch for the global economy combined with low global rates as a relatively better environment for Turkey than Russia and CE3. We see Turkish EPS forecasts as achievable, despite a slowing economy. A sudden closure of market funding would be a clear downside risk, however, but is not in our base case.

Our second favored market for the year is Russia, but not yet – we suggest that investors stay neutral on the market now, buying into the Russian market on dips if oil prices weaken during the coming quarters given pressures on global growth, the return of Libyan oil supply and supply coming back on-stream after maintenance – or if aggressive central bank action alters the growth outlook. The current market falls related to small-scale protests after the Duma elections are likely to be an opportunity to raise weightings.

Central Europe we still see as relatively less attractive, with PMI readings underperforming of late, and strong trade links to the EU leaving trade quite exposed to weakness in core Europe. Moreover, there are financial linkages and the potential for small markets to be increasingly overlooked by investors. Our favored market in CE3 is Poland, given the substantial de-rating the market has seen.

Sector allocation favors consumer-related names in the region. We are overweight consumer staples, consumer durables, utilities and telecoms withing the region. We are neutral on higher beta sectors such as financials, energy, and materials. We believe the risks are balanced in the materials and oil sectors where valuations are cheap, central bank action could be supportive, but where earnings could be at risk of further global weakness – and where USD strength might cause the sector to lag. Our underweights are healthcare and IT.

In our 2012 outlook note: *Emerging Europe, Breaking the downward spiral* we look at the regional equity markets in more detail:

1. **We highlight portfolios which should do well alternatively in a stress scenario and in a recovery scenario.** We show both analyst derived names and beta-screens.
2. **We prefer large cap stocks over small and mid-cap names.** Large cap stocks are trading at a significant valuation discount, which could start to erode given the rise of the ETF industry and growing dominance of GEMS over EMEA specialist accounts.
3. **We highlight the recent underperformance of "franchise names" that we think screen well.** Many international investor favored stocks have tended underperformed in 2011 as international investors have faced redemptions – we believe these many of these stocks can screen well for 2012.
4. **We look at the financial linkages to Western Europe and the risks of deleveraging,** and conclude that core markets such as Russia, Turkey and Poland (as well as the Czech Republic) are at less risk of European banks deleveraging.
5. **We look at the recent relative de-rating of the BRIC countries,** which may represent an opportunity for investors in 2012.
6. **Our country and sector strategists and analysts go through their views** on Russia, Turkey, CE3 and Romania.

Analyst highlighted top ideas

Our analyst team's highlighted stock ideas include:

UNICREDIT EMERGING EUROPE ANALYST TOP PICKS

Name	Country	Ccy	12M TP	Mcap (USD mn)	Rec
Komercni Bank	Czech	CZK	4,300	6,040	Buy
Bogdanka	Poland	PLN	128	1,084	Buy
Budimex	Poland	PLN	100	558	Buy
Cyfrowy Polsat	Poland	PLN	16.3	1,327	Buy
Netia	Poland	PLN	7.0	552	Buy
PGE	Poland	PLN	22.5	10,550	Buy
PZU	Poland	PLN	400	8,400	Buy
TPSA	Poland	PLN	17.1	7,071	Hold
Fondul Proprietatea	Romania	RON	0.91	1,862	Buy
SIF 2 Moldova	Romania	RON	1.77	145.4	Buy
CTC Media	Russia	USD	17.1	1,435	Buy
Evraz	Russia	USD	33.8	8,487	Buy
Lukoil	Russia	USD	81.5	44,875	Buy
Magnit	Russia	USD	32.0	9,075	Buy
Novatek	Russia	USD	166.9	40,656	Buy
Sberbank	Russia	USD	3.2	54,493	Buy
Severstal	Russia	USD	27.1	14,219	Buy
Sistema	Russia	USD	33.2	8,444	Buy
Akfen Holding	Turkey	TRY	17.6	694	Buy
Emlak Konut REIT	Turkey	TRY	2.75	2,773	Buy
Garanti	Turkey	TRY	7.69	13,051	Buy
Halkbank	Turkey	TRY	14.29	6,563	Buy
Sabanci Holding	Turkey	TRY	9.30	6,450	Buy
Trakya Cam	Turkey	TRY	5.15	856	Buy
Turkcell	Turkey	TRY	10.54	10,726	Buy

Source: UniCredit Research

Valuation

EMERGING MARKET CONSENSUS VALUATION TABLE

	P/E (x)					EPS Growth (%)				P/BV (x)		ROE (%)		MSCI Wgt
	2010	2011E	2012F	Trail	12M FWD	2010	2011E	2012F	12M FWD	Trail	12M FWD	Trail	12M FWD	%
Brazil	9.7	9.2	8.6	8.2	9.2	8.6	29.4	5.9	6.7	5.5	6.7	1.1	12.9	15.3
Chile	16.0	15.6	13.4	11.6	15.6	13.4	28.6	2.3	16.6	15.6	16.6	1.8	13.8	1.7
Colombia	21.1	18.7	14.8	12.8	18.7	14.8	49.4	13.0	25.9	1.0	25.9	1.8	12.1	0.9
Mexico	22.4	18.5	15.0	13.0	18.5	15.0	-7.8	21.2	23.5	15.6	23.5	2.8	18.9	4.8
Peru	15.4	11.3	10.2	10.1	11.3	10.2	25.8	36.2	10.3	1.2	10.3	2.8	27.5	0.6
Em LatAm	12.1	11.1	10.1	9.4	11.1	10.1	24.1	8.3	9.8	7.2	9.8	1.4	13.6	23.2
China	10.7	9.6	8.7	7.7	9.6	8.7	34.0	12.1	10.9	13.1	10.9	1.4	16.1	16.8
India	15.5	14.0	12.1	10.6	14.2	12.5	26.2	8.4	15.9	13.7	14.2	2.0	15.9	6.6
Indonesia	17.6	14.6	12.7	11.0	14.6	12.7	15.3	20.7	14.8	15.3	14.8	3.1	24.0	2.9
Korea	11.5	10.4	9.2	8.1	10.4	9.2	42.6	9.8	13.2	12.6	13.1	1.2	13.1	15.1
Malaysia	16.9	15.7	14.0	12.6	15.5	13.9	26.0	8.1	11.8	11.5	11.6	1.9	14.0	3.4
Philippines	16.3	15.2	13.6	12.3	15.2	13.6	45.0	7.5	11.8	10.0	11.8	2.2	16.4	0.6
Taiwan	12.6	16.6	13.3	10.7	16.6	13.3	85.1	-24.5	24.3	22.8	24.3	1.6	11.7	10.6
Thailand	13.4	11.6	10.3	9.1	11.6	10.3	33.1	15.3	12.5	12.4	12.5	1.8	17.2	1.9
Em Asia	12.4	11.7	10.3	9.0	11.8	10.3	41.3	5.2	13.9	14.2	13.7	1.5	14.5	57.9
Czech	8.8	10.5	9.6	9.3	10.5	9.6	-1.3	-15.5	8.7	3.7	8.7	1.6	16.4	0.3
Hungary	8.2	8.5	7.3	6.0	8.5	7.3	7.4	-2.8	15.3	22.5	15.3	0.8	10.9	0.3
Poland	10.7	8.4	9.0	8.9	8.4	9.0	34.9	25.4	-6.6	1.7	-6.7	1.1	12.6	1.5
Russia	5.8	4.5	4.8	4.5	4.5	4.8	42.7	28.2	-5.7	1.9	-5.7	0.6	13.4	7.0
Turkey	9.0	9.8	8.7	7.6	9.8	8.7	17.7	-8.1	13.2	13.6	13.2	1.3	15.2	1.3
Em Europe	6.8	5.6	5.8	5.5	5.6	5.8	35.8	21.8	-3.5	3.6	-3.5	0.8	13.5	10.5
Egypt	9.8	9.0	7.4	5.7	9.0	7.4	-2.8	12.5	21.8	30.6	21.8	1.0	13.9	0.3
Morocco	13.4	13.8	12.4	14.6	13.8	12.4	11.4	-3.2	11.0	0.9	11.0	3.4	27.0	0.2
South Africa	17.3	13.5	10.5	9.4	12.9	10.2	22.2	27.0	28.7	11.1	26.0	2.0	19.4	8.0
Em Emea	9.5	7.9	7.5	6.9	7.8	7.4	30.8	21.0	5.6	6.4	5.2	1.1	15.2	18.9
EM	11.6	10.6	9.6	8.6	10.6	9.6	34.6	9.5	10.9	10.8	10.7	1.4	14.5	100.0
DM	13.6	12.3	11.1	9.9	12.3	11.1	40.8	10.2	11.1	11.5	10.8	1.5	13.1	

Source: Thomson I/B/E/S, Thomson Datastream, MSCI, Bloomberg, UniCredit Research

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Countries

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

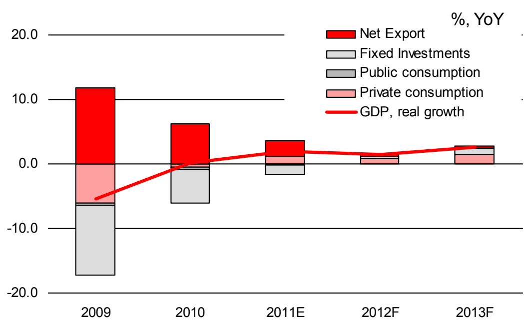
Outlook – We decided to cut our real GDP growth forecast for Bulgaria to 2.0% for this and 1.5% for the next year (from 2.3% and 2.6% in September). The headwinds facing the economy remain the same; namely weak housing and labor market revival, deleveraging in the corporate sector and slowing external demand. However given the recent deterioration in the outlook for the euro zone economy and unexpectedly steep fall in the private sector's investments in 3Q11, we now expect to see more pressure on corporate sector to shrink its balance sheet next year. What's more, deteriorating external conditions will not only weigh on exports, but are also likely to put in jeopardy the process of labor market stabilization that started taking shape in mid 2011.

Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)

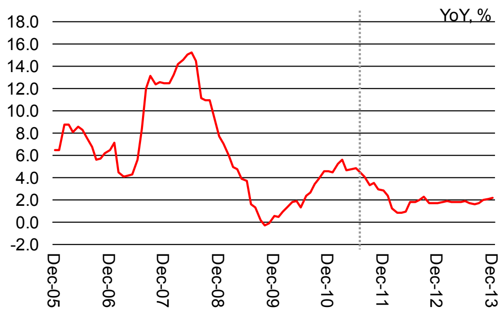
KEY DATES/EVENTS

- Mid-Feb – Flash estimate of 4Q11 swda GDP figures
- Mid-Feb – Number of employees under labor contracts for 4Q11
- 31 Mar – XIV annex for construction of Belene nuclear power plant with Russia's Atomstroyexport expires

GDP GROWTH AND CONTRIBUTION TO GROWTH



INFLATION (CPI) YOY



Source: NSI, BNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	34.9	36.0	38.3	39.5	41.3
Population (mn)	7.6	7.5	7.4	7.4	7.3
GDP per capita (EUR)	4,618	4,801	5,148	5,354	5,648
Real economy yoy (%)					
GDP	-5.5	0.2	2.0	1.5	2.7
Private Consumption	-7.6	-0.6	1.5	1.2	2.0
Fixed Investment	-17.6	-16.5	1.1	1.8	4.7
Public Consumption	-4.9	-5.0	-2.1	-1.6	-0.4
Exports	-11.2	16.2	9.3	-0.4	1.8
Imports	-21.0	4.5	6.8	-0.7	1.6
Monthly wage, nominal (EUR)	311	331	350	361	376
Unemployment rate (%)	8.4	11.3	12.3	12.2	11.7
Fiscal accounts (% of GDP)					
Budget balance	-0.8	-3.9	-1.7	-1.3	-0.5
Primary balance	0	-3.3	-0.9	-0.5	0.4
Public debt	15.5	16.7	17.2	19.8	18.7
External accounts					
Current account balance (EUR bn)	-3.5	-0.4	1.3	0.9	0.2
Current account balance/GDP (%)	-10.0	-1.2	3.4	2.2	0.5
Basic balance/GDP (%)	-1.9	-1.1	1.2	3.4	0.2
Net FDI (EUR bn)	3.4	1.6	0.7	0.9	1.0
Net FDI (% of GDP)	9.7	4.4	1.9	2.2	2.4
Gross foreign debt (EUR bn)	37.8	37.0	36.0	36.1	35.6
Gross foreign debt (% of GDP)	108.3	102.8	93.9	91.6	86.4
FX reserves (EUR bn)	12.9	13.0	13.5	14.8	14.9
Inflation/Monetary/FX					
CPI (pavg)	2.8	2.4	4.2	1.6	1.9
CPI (eop)	0.6	4.5	2.8	1.7	2.2
BGN/USD (eop)	1.37	1.47	1.47	1.43	1.40
BGN/EUR (eop)	1.96	1.96	1.96	1.96	1.96
BGN/USD (pavg)	1.41	1.48	1.41	1.49	1.42
BGN/EUR (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

Global risks and looming export weakness weigh on the Bulgarian growth outlook

Since our last Quarterly, we have seen a clear downward trend in economic activity. Most of housing market and balance of payment data also failed to impress on the positive side. At the same time, some labor market and survey data have held up much better, but were not enough to baffle the view that outlook for the economy has worsened

3Q GDP data points to growth weaknesses on several fronts

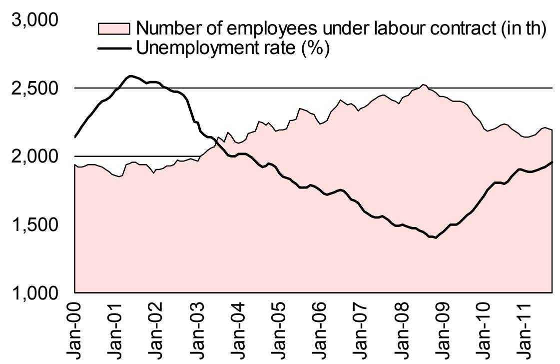
3Q GDP data (0.3% qoq and 1.6% yoy from 0.3% qoq and 2.0% yoy in 2Q11) suggest that the economy is beginning to suffer from the global risks' escalation. Despite some one-offs, such as the solid harvest and summer tourism output, GDP growth failed to impress on the positive side. Most alarmingly, GFCF was a hefty 13.5% down qoq (-2.8% yoy) after three consecutive positive qoq readings. It is true that this series is volatile and in yoy terms growth is negative only marginally, but it dented hopes that the raising share of highly liquid assets in the consolidated balance sheet of the corporate sector will soon translate into acceleration of capital spending and jobs. We think that the marked slowdown in GFCF can be primarily attributed to the escalation of the euro zone sovereign debt crisis, which prompted companies to take a more defensive stance by putting investment plans on hold and building cash reserves to meet more comfortably their elevated external funding needs. As expected, 3Q11 GDP data has reconfirmed the frustratingly slow pace of the final consumption recovery (up 0.3% qoq but still 7.1% below its pre-crisis mark). Apparently, final consumption expenditure has drawn some support from easing inflation but this was broadly balanced by a continued weak housing market recovery and rising concerns that slowing growth in Europe would affect negatively the number of jobs at home. The combination of all these has added to the evidence that households remain reluctant to put an end to cash hoarding and raise spending soon. After five consecutive quarters of double digit yoy growth, export slowed to just 2.0% yoy (from 12.2% yoy in 2Q11), as output growth of electricity and basic metals sharply lost momentum in September. On the positive side, net export contributed positively to GDP as import growth (up 1.1% qoq) was less modest than those of export (up 1.7 qoq). The upshot is that the corporate sector's deleveraging in combination with the persistent housing market weakness has put a lid on the domestic demand recovery in 3Q11, while at the same time export has lost ground even before the expectations for growth softening in Bulgaria's key trading partners have started to materialize.

Despite lackluster GDP growth outlook, Bulgarian authorities decided to press ahead with fiscal consolidation and structural reforms

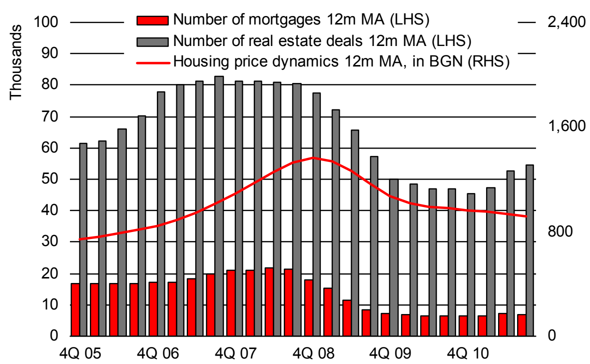
Mounting evidence that the euro zone debt crises may worsen has boosted political zeal for addressing the long-term risks for Bulgarian public finances. The government announced plans to implement earlier (existing law stipulates the process to start in 2021) the already enacted rise in the retirement age (65Y and 63Y for men and women from 63Y and 60Y currently) and to tighten the access to disability pensions and early retirement privileges for some professions. Also, authorities stepped up efforts to restructure and privatize, where possible, the few remaining state-owned loss-makers, in the rail road transportation and post services sectors. Importantly, public sector employees are now likely to start making contributions to the state funded pillar of the pension system (while only private sector employees make such contributions now), thus helping to cut persistently the hefty deficits in the state pension fund, which in the context of the rapidly aging population represents the key downside risk for the long-term sustainability of Bulgarian public finances.

LABOUR MARKET AND REAL ESTATE MARKET OVERVIEW

Number of employees under labour contract and unemployment rate (Jan 00-Sep 11)



Real estate prices, number of newly originated mortgages and real estate deals (4Q05-3Q11)



Source: Eurostat, NSI, Registration Agency

What's more, the MinFin intends to base 2012 Budget revenue projections on more conservative macro assumptions and build additional buffers (via raising contingency reserves) on the spending side, to ensure that the fiscal deficit target (set at 1.3% of GDP) remains under reach. We think that tight fiscal policy and accelerated implementation of some long-delayed structural measures should help the government to consolidate its position, by narrowing the platform for criticism from its political opponents at home. With fiscal consolidation likely to have already reached very advanced stage in the end 2011 (deficit seen at 1.7% of GDP), only a small extra push would be needed in 2012 (deficit target set at 1.3% of GDP), suggesting that the public sector would have either a neutral or small negative contribution to GDP growth next year. Also on the positive side, constantly improving absorption of EU funds should open up more room for investments in public infrastructure, offsetting the fall in the private sector's capital spending.

The drags on growth remained unchanged, relative to those in September's forecast, but the magnitude of their negative impact has now increased

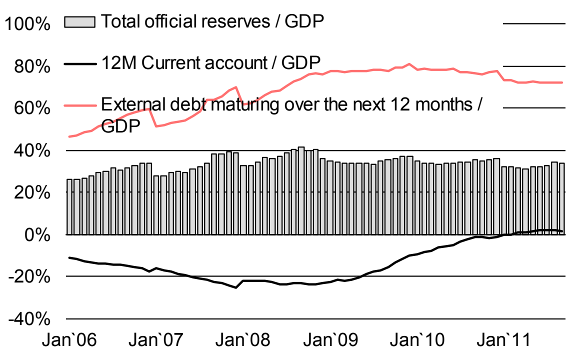
The return to more normal rates of growth would be a gradual process over the course of the next two or three years

But this, in our view, is unlikely to prove enough picking up the anticipated slump in export next year. In response, we now see GDP up 2.0% this year (previously 2.3) and 1.5% in 2012 (previously 2.6%). Fundamentally, the headwinds the Bulgarian recovery faces remain the same as the ones we already stressed in our September's forecast. These include the slowing external demand in combination with the corporate sector's deleveraging and weak housing market recovery. However, given the recent deterioration in the outlook for the euro zone economy and unexpectedly steep fall in private sector's investments in 3Q11, we now expect to see more pressure on corporate sector to shrink its balance sheet next year. In addition to that, deteriorating external conditions will not only cutback exports, but are also likely to put in jeopardy the process of labor market stabilization that started taking shape in mid 2011. The rational for avoiding a full-blown recession (defined as two quarters of negative qoq growth) is that the balance sheets of both public and household sectors remain strong, while external demand is slowing but is still far from falling off a cliff as in early 2009.

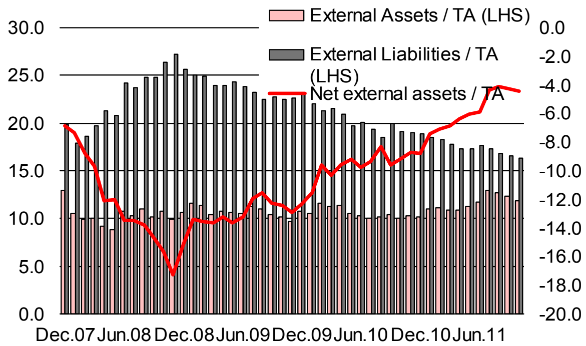
The banking sector reduced its reliance on external borrowing to 4.1% for the ratio of net external liabilities to total liabilities in October 2011 (see the chart below) from 17.3% in its pre-crisis peak in November 2008. However, given significant divergence among the individual players, Bulgarian banking sector remains vulnerable in case of sharp deterioration in external funding conditions

Capital flows have come under renewed pressure. Portfolio and FDI flows failed to impress in 3Q11 (EUR 159mn), while other sources of financing (including net errors and omissions) posted their second largest quarterly outflow (EUR 1.1bn) since the economic downturn began. But continued positive momentum in CA dynamics (EUR 1.4bn surplus) helped add EUR 470mn to the central bank reserves in 3Q11. Nevertheless, concerns over capital outflows seem justified to us because Bulgaria remains extremely dependent on external financing to rollover its maturing external liabilities in the corporate non-financial sector. Data on other sources of financing (including net errors and omissions) show that EUR 1.8bn left the country in the 9M to September, the largest capital outflow via this channel in more than a decade. Moreover, escalation of the euro zone debt crisis could cause further deterioration in the already quite tight monetary conditions at home. On the positive side, official reserves now stand at the comfortable 34% of GDP (see the chart below) as compared to 42% in their pre-crisis peak. What's more, their coverage is relatively high – FX reserves stand at EUR 13.2bn, while external debt maturing overt the next 12M amounts to EUR 15.8bn. While pressure is likely to remain in the near term, an improvement in the situation in EMU and in particular passage of the PSI and bank restructuring plan in Greece would be a clear positive for Bulgaria.

Official reserves, CA balance and external debt maturing over the next 12 months as % of GDP (Jan 06-Sep 11)



Bulgarian banking sector: External position (Dec 07-Oct 11)



Source: BNB, NSI, UniCredit Research

Strategy: 2012 debt management, driven by 2013 specifics

Policymakers are bracing for challenges to the economy and a debt repayment at the start of 2013

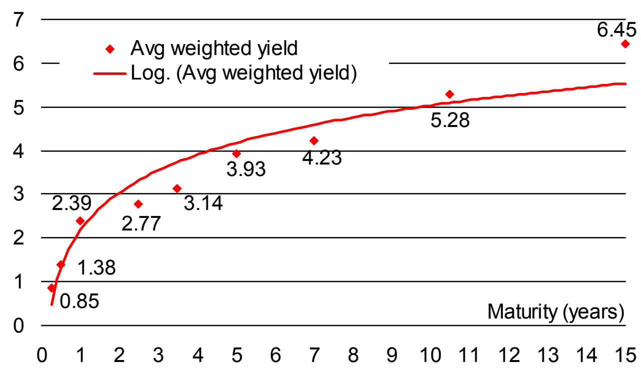
With deteriorating global market conditions and elevated volatility in asset prices Bulgarian policymakers have taken a defensive stance and are already bracing for both a softer economic patch and a key external debt repayment in 2013. Furthermore, monetary policy is being constrained by the existing currency board regime, leaving fiscal tools as the only potent means of safeguarding the economy. Against this background, the MinFin has limited the monthly budget deficits and is set to outperform the 2011 target of a 2.5% shortfall by a wide margin. Despite the ease with which the current financing needs are going to be met the government is taking advantage of favorable domestic issuance conditions and is amassing cash buffers in the form of a rising fiscal reserve. This should not only help deal with any challenges in the immediate future, but also help meet a debt repayment in January, 2013 worth EUR 0.818bn (or 2% of 2012 GDP).

A Eurobond issue will be the main tool of government financing in 2012

Against the backdrop of global uncertainty the MinFin has left all options for meeting this obligation wide open – the 2012 Budget law envisages a Eurobond issue circa EUR 1bn, while domestic markets will be tapped for a gross sum of EUR 0.625bn (a sum which could easily rise during the year, although concerns over banking sector liquidity might inhibit such a move), with healthy levels of fiscal reserves still standing as a last resort. It is not yet clear what combination of the three will be used, but our view is that the MinFin will aim at addressing the Eurobond market as soon as market conditions allow it, thus keeping domestic liquidity unchanged. With a one notch rating upgrade in the pipeline, but not seen around the corner (in our view – sometime in 2H2012 or early 2013) the government's priority will likely shift from the reduction of funding cost to a focus on volumes with a more aggressively biased issuance policy in external markets.

Author: Nikola Georgiev, Economist, Nikola.R.Georgiev@UniCreditGroup.bg

Primary domestic government bond market curve



Bulgarian 5Y CDS

Source: BNB, MF, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
Gross financing requirement	**1.3**	**1.2**	**1.5**
Budget deficit	0.7	0.5	0.2
Amortization of public debt	0.4	0.5	1.1
Domestic	0.3	0.4	0.2
Bonds	0.3	0.4	0.2
Bills	0.0	0.0	0.0
External	0.1	0.1	0.9
WB/EIB/JBIC/Others	0.2	0.2	0.2
Financing	1.3	1.2	1.5
Domestic borrowing	0.6	0.6	0.6
Bonds	0.6	0.6	0.6
Bills	0.0	0.0	0.0
External borrowing	0.1	1.3	0.3
Bonds	0.0	1.0	0.0
WB/EIB/JBIC	0.1	0.3	0.3
Other	0.6	-0.7	0.6

Source: Ministry of Finance of Rep. of Bulgaria, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
Gross financing requirement	16.4	15.7	16.6
C/A deficit	-1.3	-0.9	-0.2
Amortization of medium to long term debt	6.2	6.1	6.7
Government/central bank	0.3	0.3	1.1
Banks	0.8	0.7	0.7
Corporates	5.1	5.1	4.9
hort term debt amortization	11.5	10.4	10.1
Financing	16.9	17.0	16.7
FDI	0.7	0.9	1.0
Portfolio flows	-0.3	0.2	0.2
Borrowing	6.0	5.9	5.9
Government/central bank	0.1	1.3	0.3
Banks	0.7	0.6	0.8
Corporates	5.1	4.0	4.8
Short-term	10.4	10.1	9.6

Source: Bulgarian National Bank, UniCredit Research

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

Outlook – Manufacturing, until recently the single engine of economic growth, has got into trouble in November, which could lead to a 4Q GDP qoq contraction. Our baseline scenario reflecting UCG's upbeat view of Germany nevertheless counts on recession being mild and brief. Healthy supply side factors also make the 2013 outlook much more promising than 2012. The CNB repo rate is set to stay on hold for the most of 2012 but a hike looks more likely than a cut as a first change.

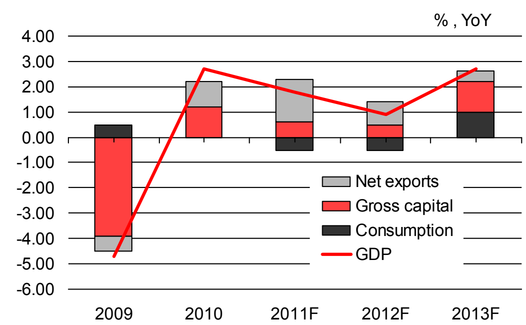
Strategy outlook – We see CZGB ASW spreads as too wide compared to credit risk and recommend adding to a long ASW trade via the 10y segment. We see the CNB as one of the few central banks in the region which is not against CZK weakness and we recommend going long PLN/CZK.

Pavel Sobisek, Chief Economist (UniCredit Bank)

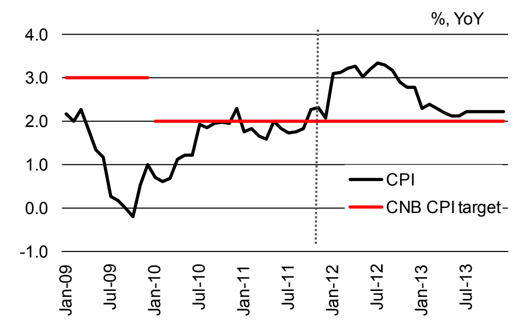
KEY DATES/EVENTS

- CNB Board meetings – 22 Dec, 3 Feb
- State budget amendment – some time in 1Q12 if at all
- Manufacturing PMI – 2 Jan, 1 Feb, 1 Mar

BREAKDOWN OF GDP GROWTH BY DEMAND COMPONENTS



CONSUMER PRICE INDEX – HISTORY AND OUTLOOK (% YOY)



Source: CSO, CNB, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	141.4	149.3	157.0	158.0	173.2
Population (mn)	10.5	10.5	10.6	10.6	10.6
GDP per capita (EUR)	13,478	14,194	14,883	14,934	16,331
Real economy yoy (%)					
GDP	-4.7	2.7	1.8	0.9	2.7
Private Consumption	-0.4	0.6	-0.5	0	2.0
Fixed Investment	-11.5	0.1	1.5	1.2	4.0
Public Consumption	3.8	0.6	-0.7	-0.5	1.0
Exports	-10.0	16.6	8.5	7.2	10.0
Imports	-11.7	16.2	6.6	7.2	10.5
Monthly wage, nominal (EUR)	883	941	995	990	1,077
Unemployment rate (%)	8.1	9.0	8.5	8.3	7.4
Fiscal accounts (% of GDP)					
Budget balance	-5.9	-4.8	-3.9	-3.4	-2.9
Primary balance	-4.5	-3.2	-2.4	-1.9	-1.4
Public debt	34.4	37.6	40.8	42.6	43.4
External accounts					
Current account balance (EUR bn)	-3.4	-4.6	-2.9	-1.7	-2.7
Current account balance/GDP (%)	-2.4	-3.1	-1.9	-1.1	-1.6
Basic balance/GDP (%)	-0.9	0.3	0.7	1.4	1.3
Net FDI (EUR bn)	2.1	5.1	4.1	4.0	4.9
Net FDI (% of GDP)	1.5	3.4	2.6	2.5	2.9
Gross foreign debt (EUR bn)	61.9	71.4	72.2	79.2	85.8
Gross foreign debt (% of GDP)	43.8	47.8	46.0	50.1	49.6
FX reserves (EUR bn)	41.6	42.5	39.9	41.1	42.0
Inflation/Monetary/FX					
CPI (pavg)	1.0	1.5	1.9	3.1	2.3
CPI (eop)	1.0	2.3	2.2	2.7	2.3
Central bank target	3.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	1.0	0.8	0.8	1.0	1.8
3M money market rate	1.9	1.1	1.0	1.0	1.6
CZK/USD (eop)	18.5	18.8	19.2	17.9	17.1
CZK/EUR (eop)	26.5	25.1	25.5	24.5	24.0
CZK/USD (pavg)	19.0	19.2	17.6	19.2	17.6
CZK/EUR (pavg)	26.5	25.3	24.5	25.3	24.3

Source: CSO, CNB, UniCredit Research

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

Falling victim to its openness

3Q GDP was flat qoq and slowing yoy according to flash estimate

The flash estimate saw real GDP flat qoq and slowing to 1.5% yoy in 3Q. Without any details available yet, net exports are assumed to contribute positively and consumption (both private and government) negatively to growth. On the production side, manufacturing turned out to be a single sector of the economy to boost its 3Q production in real terms (by 5.0% yoy).

A further loss of momentum is in the pipelines with soft data looking worse than hard ones

Signs of a further loss of momentum have been prevailing through 4Q. The manufacturing PMI dipped to 48.6 in November, posting the first sub-50 reading since October 2009. A broader leading indicator ESI showed declines in all components and in particular consumer sentiment. On a more positive note, hard data from October included a 2.5% yoy rise in industrial output and a double-digit yoy jump in new car registrations.

With manufacturing having lost momentum, GDP contraction in 4Q wouldn't be a surprise

With manufacturing acting as a single engine of growth over the first 3 quarters of the year, we wouldn't be surprised to see GDP contract qoq in 4Q. For that reason we have gone down with our full-2011 forecast to 1.8% (previously 2.0%). Poor demand could well cause GDP shrink again in 1Q12. That said, we don't envisage a depth of recession comparable with 2008-2009 when the economy braked suddenly from a high speed.

For the whole of 2012, our forecast relies on UCG's optimistic view for Germany and on fiscal consolidation staying moderate

A trickier question is whether recession will take shorter than the three quarters experienced then. Obviously, perception of the euro zone's debt crisis driving external demand will be key there. Our baseline projection for 2012 GDP at 0.9% relies on the UCG's rather optimistic view that Germany will avoid recession and will post full-year 1.2% GDP growth. Obviously, more dramatic scenarios are conceivable as well.

Fiscal consolidation is planned to reduce deficit by 0.5p.p. of GDP

Fiscal policy may also weigh on economic activity. The government targets a public sector deficit reduction by 0.5p.p. of GDP to 3.2% in 2012. While this is not a large adjustment, private spending will suffer from a reliance on increases in indirect taxes to achieve this target. Also, protracted recession would likely trigger a fiscal amendment for further consoldiation, weighing on domestic demand rather than boosting the deficit.

Inflation is set to exceed 3% on a VAT rate hike

On inflation, a hike in the reduced VAT rate from 10% to 14% should translate into a 1pp one off jump in CPI. With items of low elasticity in demand largely involved (food, medicines, housing related services), we expect to see the full passthrough to final prices, lifting the CPI just above 3% yoy on average next year. Poor economic activity and stagnating employment will not allow for immediate wage adjustments. In fact, we expect real wage growth as well as the overall disposable income of households marginally negative in 2012.

We have reduced the expected pace of CZK appreciation; final 2012 EUR/CZK is seen at 24.50

As learned from the 2009 epizode, CZK tends to react to mounting global risk aversion by depreciating not only versus USD but also against EUR. Such process can also be associated with elevated EUR/CZK volatility. This year's reaction has been the same but milder, arguably as the sell-off of local financial assets by non-residents has been limited (for instance, foreigners hold a mere 12% of CZK government bonds). Going forward, CZK is set to remain vulnerable to global rebalancing, with EUR/CZK variance staying closely correlated with EUR/USD fluctuations. The UCG's less upbeat view on EUR makes us reduce the pace of CZK appreciation versus EUR we have been projecting. Final 2012 EUR/CZK rate is now seen at 24.50. The weaker CZK is however set to help local exporters only marginally due to their existing long-term currency hedges.

CNB rates will stay on hold for the most of 2012

Our baseline scenario would be consistent with the CNB repo rate on hold for the most of 2012 and a hike rather than a cut as the first rate change. While the CNB has presented two different macro scenarios, both have in common a much more pronounced CZK firming than we currently foresee. That said, policy tightening is conceivable only once economic weakness is clearly overcome, i.e. hardly before the very end of 2012.

Healthy supply side fundamentals make the economy ready for a 2013 rebound

On balance, the gloomy short-term outlook for the Czech economy is the function of depressed external demand while the domestic supply side factors (financial conditions, macro stability, policies) remain rather healthy. The economy hence looks prepared to react swiftly once demand is back which makes the 2013 outlook much more promising than 2012.

Estonia (AA- negative/A+ stable)*

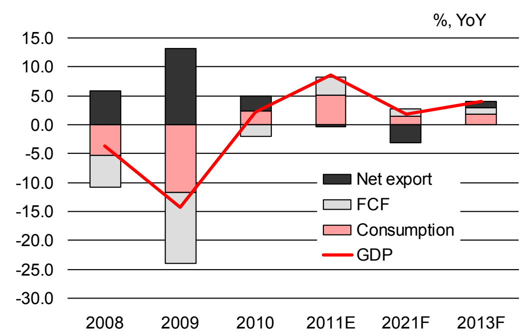
Outlook – Estonia's economy recorded another impressive quarter of growth in 3Q. However, we expect the pace of recovery to stabilize at a more sustainable and moderate figure in 2012. Decreasing unemployment and decelerating inflation support personal consumption and facilitate another expansion in domestic demand, albeit more gradually than previously. We see almost no internal risks to the economy – all potential downsides come from the external environment. The government is realistic in its vision of upcoming developments and is adjusting public finances accordingly.

Author: Dmitry Veselov, Ph.D., Economist (UniCredit Bank London)

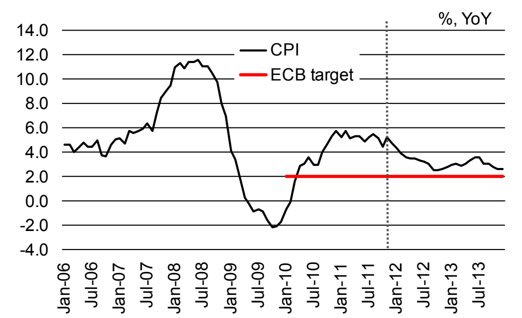
KEY DATES/EVENTS

- 30 Dec, 30 Jan, 1 Mar, 30 Apr – Retail trade
- 9 Mar – 4Q BoP
- 10 Feb /9 Mar – 4Q GDP (prelim/final)

GFCF AND CONSUMPTION TO DRIVE GROWTH



INFLATION TO DECELERATE



Source: Statistics Estonia, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	13.9	14.5	16.3	17.2	18.3
Population (mn)	1.3	1.3	1.3	1.3	1.3
GDP per capita (EUR)	10,344	10,871	12,245	12,936	13,771
Real economy yoy (%)					
GDP	-13.9	3.1	8.5	2.6	3.8
Private Consumption	-18.8	-2.1	6.7	2.1	2.6
Fixed Investment	-32.9	-9.6	15.7	5.4	4.5
Public Consumption	0	-2.0	0.6	0.1	0.9
Exports	-18.7	21.2	34.6	9.8	5.8
Imports	-32.6	20.5	38.8	10.8	7.5
Monthly wage, nominal (EUR)	782	788	820	845	878
Unemployment rate (%)	13.8	16.8	11.6	11.0	10.3
Fiscal accounts (% of GDP)					
Budget balance	-1.7	-0.8	0.2	0	0.5
Primary balance	-1.4	-0.4	0.4	0.3	0.9
Public debt	7.2	7.7	6.5	6.2	5.3
External accounts					
Current account balance (EUR bn)	0.6	0.5	-0.2	-0.3	-0.2
Current account balance/GDP (%)	4.5	3.6	-1.6	-1.7	-1.0
Basic balance/GDP (%)	6.0	11.0	5.4	0	0.4
Net FDI (EUR bn)	0.1	0.9	1.6	0.3	0.3
Net FDI (% of GDP)	1.5	7.4	9.8	1.7	1.3
Gross foreign debt (EUR bn)	17.4	16.6	17.3	18.0	18.5
Gross foreign debt (% of GDP)	125.5	114.2	106.2	104.8	106.0
FX reserves (EUR bn)	2.3	2.6	2.3	2.5	2.5
Inflation/Monetary/FX					
CPI (pavg)	-0.1	3.0	5.0	3.0	2.6
CPI (eop)	-0.8	3.9	4.2	2.8	3.0
Euribor 3M (since 2010)	5.7	4.9	EUR	EUR	EUR
USD/EEK (eop)	10.93	11.69	EUR	EUR	EUR
EUR/EEK (eop)	15.65	15.65	EUR	EUR	EUR
USD/EEK (pavg)	11.22	11.79	EUR	EUR	EUR
EUR/EEK (pavg)	15.65	15.65	EUR	EUR	EUR

Source: UniCredit Research

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

Impressing once again

Another quarter of impressive GDP growth

3Q preliminary GDP came in at 7.9% yoy (0.8 mom sa) – a reading that reveals that, despite some slowdown, the economic development in the country is little affected by external turmoil for the time being. This reading comes as a marginal slowdown after 9.5% yoy growth in 1Q and 8.4% yoy in 2Q, but at least the growth deceleration may partially be attributed to the base effect. At the same time, GDP has still not yet recovered to pre crisis levels – the 3Q GDP in real terms stands at only 90% of the maximum GDP reached in 4Q07, or 94% of 3Q of the same year. In 2012 we see the economy expanding further, although at a slower pace then recorded in 2011. Statistics Estonia mentioned "broader" recovery compared to previous quarters and a slowdown in export-oriented industries in press-release on preliminary 3Q GDP reading.

Unemployment stalled for a while, but substantial improvement to come in 2012 to support domestic demand

The unemployment rate in September came in at 7.2%, following a sharp reduction from over 10% in March 2011 and a peak of 14.6% in March 2010. Despite significant improvement in the indicator, there is still plenty of room for it to drop to the 1.5%-2.0% levels seen in 2006-2007. We see further positive and sustainable developments in the labor market, as the economy evolves into a growth model driven by domestic demand. Inflation deceleration also should positively affect consumer purchasing power. In October, inflation slowed to 4.4% yoy – the lowest reading in a year, which comes in as a result of gradual deceleration of the indicator. Wages, as in previous quarters, also showed positive dynamics even when CPI-adjusted.

C/A moves into positive zone with FDI still very strong

3Q C/A, based on monthly data, posted a surplus of EUR 238mn (narrowing 9.8% yoy). The surplus on the trade balance increased by over 4% yoy to EUR 439mn. On a 9-month accumulative basis, this brings the narrowing of the surplus to 36%. The financing side in 3Q showed very impressive results, with unprecedented FDI inflow of EUR 1.1bn (of which EUR 987mn was in July) – over 6.7% of expected annual GDP. This followed on from the cumulative FDI inflow of another EUR 0.6bn up to June, and we expect FDI to post very impressive results this year. However, already in September the FID inflow weakened to EUR 44mn – nearly a twofold decrease yoy. In part, the development of the Port of Muuga is responsible for the surge in FDI. As of October, a study was launched on the LNG terminal construction. If a positive decision is made, we see further inflow of FDI in Estonia in 2012 and 2013, but for a while we do not include this scenario in our forecast, and we expect a slowdown of FDI on the back of the global economic downturn. The current C/A reading brings the cumulative 9M11 C/A surplus to EUR 219mn – less than 1% of GDP for 3Q11. We expect Estonia's C/A to start moving into the red from here on the back of the slowdown in exports and stable imports stemming from improving domestic demand, and post a notch below zero as a percentage-to-GDP reading for 2011.

Fiscals are extremely strong with realistic 2012 budget

In terms of fiscal policy, Estonia remains the outperformer, on track to post yet another budget surplus this year (despite original expectations of a deficit of 0.5% of GDP). The 2012 budget has already been approved by parliament – the budget includes annual inflation at 2.0%, real GDP growth at 4.0% yoy with the budget deficit at 1.6%. While growth seems to be at least in line with 2011 figures (although IMF and we expect a more significant slowdown to below 3%), it is subject to downside risk. That said, inflation may surprise on the upside. On the financing side Estonia also faces few challenges. Given a much smaller GDP compared to other Baltic states of approximately EUR 17bn next year and a very small planned deficit of 1.6% of GDP (while execution may even bring it to surplus if the government decides to play safe), the financing need stands at around EUR 250mn, which can be financed locally either via borrowing or from the government's cash surplus.

Hungary (Ba1 negative/BBB - negative/BBB - stable)*

Outlook – Significant policy, growth and external financing uncertainty forced the government to a tight corner which pushed them to request IMF assistance. Although the government might still try to reduce the conditionality, we think Hungary would only qualify for a standby agreement. We estimate the size to be around EUR 10-15bn. Noise around the negations will peak in 1Q12. More fiscal tightening, weak external environment and basically no bank lending means we expect GDP to stagnate in 2012. Despite the fact that inflation will be above the NBH target, we see rates on hold during 2012.

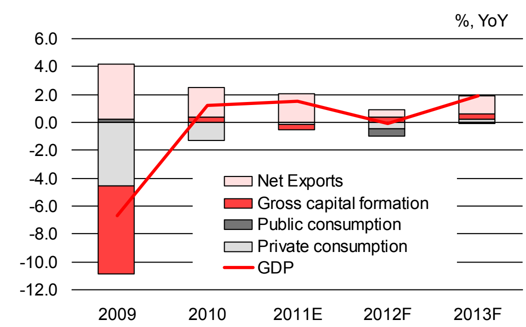
Strategy – We recommend buying EUR/HUF or CHF/HUF put options to position for further short squeeze. We see Rephun EUR paper as the cheapest fixed income asset class and recommend buying them.

Authors: Gyula Toth, Head of EEMEA FI/FX Strategy (UniCredit Bank)
Istvan Horvath, (UniCredit Bank Hungary)

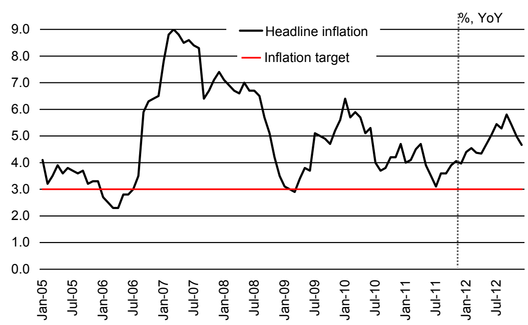
KEY DATES/EVENTS

- 24 Jan 2012 – NBH MPC meeting
- 28 Feb 2012 – NBH MPC meeting
- March 2012 – NBH – Inflation Report
- Apr 2012 – NBH – Report on Financial Stability

GDP DRIVERS



INFLATION TO STAY ABOVE TARGET



Source: CSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010E	2011F	2012F	2013F
GDP (EUR bn)	92.9	98.5	101.4	107.4	113.4
Population (mn)	10.04	10.02	10.01	10.00	10.00
GDP per capita (EUR)	9,249	9,831	10,129	10,743	11,342
Real economy yoy (%)					
GDP	-6.70	1.20	1.51	-0.04	1.89
Private Consumption	-6.80	-2.20	-0.27	-0.72	0.42
Fixed Investment	-8.00	-5.60	-3.92	0.91	0.89
Public Consumption	2.23	-0.60	0.09	-5.25	-0.50
Exports	-9.60	14.10	7.78	5.86	8.88
Imports	-14.60	12.00	5.92	5.82	8.57
Monthly wage, nominal (EUR)	712	736	758	777	826
Unemployment rate (%)	9.8	11.1	11.0	10.7	9.7
Fiscal accounts (% of GDP)					
Budget balance	-3.90	-4.17	1.00	-2.50	-3.20
Primary balance	0.29	0.07	-0.60	0.10	-0.05
Public debt	78.4	81.0	78.6	76.1	77.3
External accounts					
Current account balance (EUR bn)	0.3	1.8	2.6	2.8	3.6
Current account balance/GDP (%)	0.3	2.0	2.6	2.6	3.2
Basic balance/GDP (%)	3.73	5.57	8.74	6.76	6.59
Net FDI (EUR bn)	1.80	2.76	4.40	3.50	3.50
Net FDI (% of GDP)	1.93	2.81	4.34	3.26	3.09
Gross foreign debt (EUR bn)	136.1	137.3	120.2	121.9	112.5
Gross foreign debt (% of GDP)	146.6	139.4	118.6	113.4	99.2
FX reserves (EUR bn)	30.7	33.0	28.0	24.0	21.3
Inflation/Monetary/FX					
CPI (pavg)	4.2	4.9	3.9	4.9	3.1
CPI (eop)	5.6	4.7	4.0	4.7	3.3
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	6.3	5.8	6.5	6.5	6.5
3M money market rate	8.7	5.5	6.1	6.5	6.5
HUF/USD (eop)	189.4	209.6	221.8	202.2	200.0
HUF/EUR (eop)	270.8	278.8	295.0	277.0	280.0
HUF/USD (pavg)	201.9	208.6	200.9	215.3	203.0
HUF/EUR (pavg)	280.6	275.3	279.2	283.1	279.9

Source: CSO, NBH, UniCredit Research

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

In a tight corner…

Policy uncertainty rises

Uncertainty surrounding Hungarian policy and financial stability increased even further in 3Q-4Q as the government introduced a law which enables FX-denominated mortgage borrowers to repay their loans at an artificially low level, once again damaging the profitability of the banking sector. Meanwhile, amid difficult external financing conditions, the government faces EUR 2bn in repayments to the EU in 4Q, as well as EUR 3.7bn in repayments to the IMF next year. Unless compensated for by the issuance of Eurobonds, this will result in a significant run down in FX reserves. Following the Moody's downgrade in late November to sub-investment grade, we do not rule out another rating agency following suit, despite S&P having signaled it will wait till the conclusion of the IMF talks.

Underlying fiscal balance deteriorated

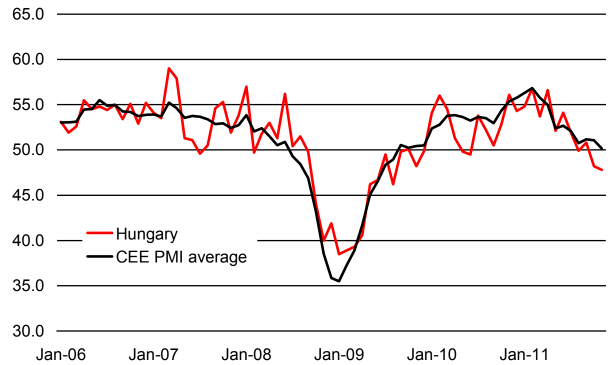
The underlying fiscal balance has been deteriorating during 2011 and there are significant risks attached to 2012 target. The cumulative ten month deficit reached HUF 1,327bn, almost two times higher than the original and 12% higher than the modified budget target. In order to offset this shortfall, the government initiated several measures worth approximately HUF 100bn. The feasibility of the 2.9% deficit target largely depends on whether the HUF 40bn contribution from "improved tax collection efficiency" will materialize. **Moving on to the 2012 budget**, the greatest concern with it is that it is based upon unrealistically strong 1.5% GDP growth, while it intends to implement around a HUF 600bn increase in taxation and a further HUF 600bn cut on the expenditure side. Additional risk is attached to the implementation, particularly the fact that the HUF 1,200bn correction equals 4.2% of the expected nominal GDP of 2011. Even if about 20% proportional import decline relative to the decrease in consumption is taken account and we accept that Hungarian exports can grow least as fast as Germany's, we do not think that the economy will stagnate in 2012, at best, while the risk is still firmly on the downside.

Public debt fails to decline despite pension fund nationalization

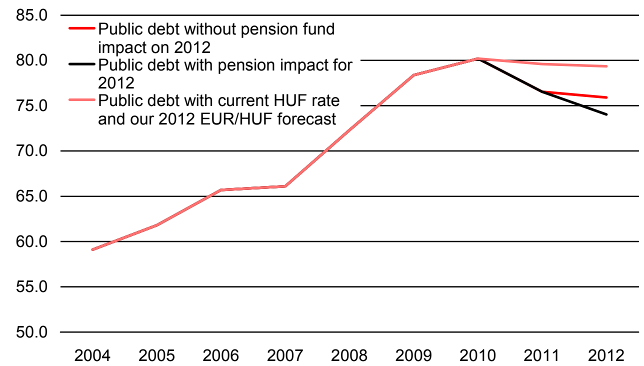
Debt sustainability also moving back to center stage underlying the need for external assistance: despite the nationalization of private pension funds and the cancellation of HUF 1,350bn of bonds (4.7%/GDP), public sector debt will likely fail to decline by end of 2011 versus 2010 largely due to the weakening HUF. Using the current FX rate we estimate that public sector debt will close the year at 79.6% of GDP vs. 80.2% of GDP in 2010. For 2012, assuming the deficit target is met, we also struggle to see a sustainable decline most driven by: **1.** higher than expected net interest expenditure and **2.** weaker than expected HUF FX rate. We forecast 79.4% of GDP public sector debt for 2012 with risks still on the upside given our concern regarding economic growth and potentially some budget slippage. The lack of any meaningful decline in public sector debt and risks associated with the 2012 outlook are the prime reasons why we think Hungary needs external assistance, not only in terms of actually financing the debt but also for the policy stability it provides.

ECONOMY IS SLOWING QUICKLY WHILE DEBT SUSTAINABILITY CONCERNS MOVE BACK TO THE RADAR AGAIN

Hungary PMI again started to underperform the region



Public debt with different scenarios: no decline on the horizon



Source: Markit, AKK, UniCredit Research

IMF agreement is sort of a "must" given high borrowing needs in 2012

As the negative external and internal developments saw a significant fall in demand for local currency debt, the government announced its intention to sign a new deal with the IMF. Although the government prefers a precautionary credit line, we believe, for reasons of policy credibility, that the IMF would only provide a proper standby agreement. We estimate the required size to be around EUR 16bn. We see the government as still some way from being ready to agree to a traditional standby arrangement, given that it will invoke regular monitoring and conditionality as well as submission to EU demands to cancel policies such as the bank mortgage plan. If there is to be agreement, 1Q12 appears to hold the greatest potential with respect to timing. The composition of the Hungarian side of the IMF delegation suggests some potential change in policy, namely it does not include EconMin, György Matolcsy. If this agreement is reached we would expect some clear stabilization on the longer term outlook for Hungarian assets as well. Given the sharp increase in Hungary's borrowing need in 2012 (we estimate around EUR 14bn) we see extremely limited room for maneuver from the government and our base case assumes an IMF agreement reached in 1Q12.

NBH is in a very challenging position

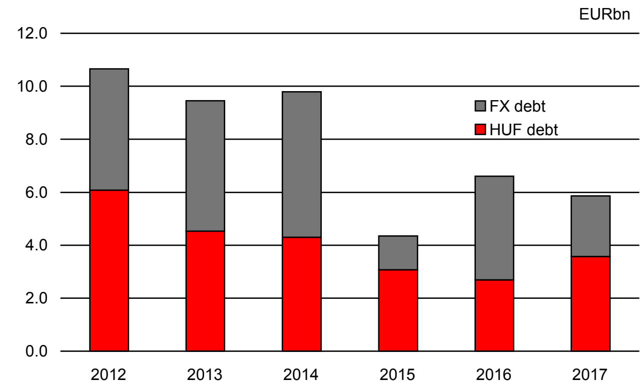
Against the above backdrop, the NBH is in a very challenging as of: against the backdrop of very weak domestic demand, inflation is clearly not a key concern in our view. Although on the back of the VAT hike inflation will remain above the 3% target (we currently estimate around 4.7% yoy headline and around 3.0% yoy core inflation in 2012), we think the central bank's prime concern is financial stability at the moment. At the November meeting the NBH MPC hiked rates by 50bp. In our view this was a compromise between the four dovish external members and the three more hawkish internal members (including the governor). We think at this stage the real game changer for Hungarian asset prices and monetary policy clearly lies in the hands of fiscal policy and the government's willingness to agree with the IMF. Against this backdrop, we think the NBH will prefer to wait and see how the IMF talks progress. If there are delays, we would expect further rate hikes, but given the divided nature of the MPC this will be rather gradual. Our base case assumes unchanged rates during the whole 2012.

Banking sector is not going to support growth

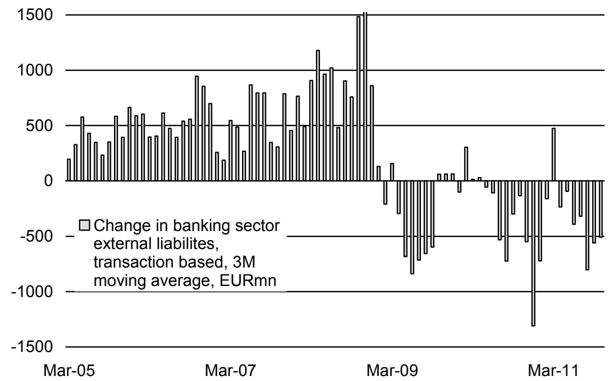
The banking sector is feeling the pain and is unlikely to be growth supportive. The FX mortgage early repayment scheme has so far cost the banking sector about EUR 300mn and we expect the total cost will reach about EUR 500-600mn. This represents about 0.6% of GDP. On the back of the significant policy uncertainty we do not expect the banking sector to be a meaningful supporter of growth and see lending activity to be extremely slow. We think only a meaningful policy change, which could come together with an IMF agreement, would change this outlook but even in this case, due to significant deleveraging pressure on the parent banks, this will rather be a support factor in 2013 only.

SIGNIFICANT BORROWING NEEDS COUPLED WITH WEAK BANKING SECTOR LEAVES NO ROOM FOR MANOUVERE

Public sector debt maturity: significant borrowing need in 2012



The banking sector losses external funding since 2008, the FX mortgage plan added to the pressure



Source: AKK, NBH, UniCredit Research

Strategy: a more constructive positioning

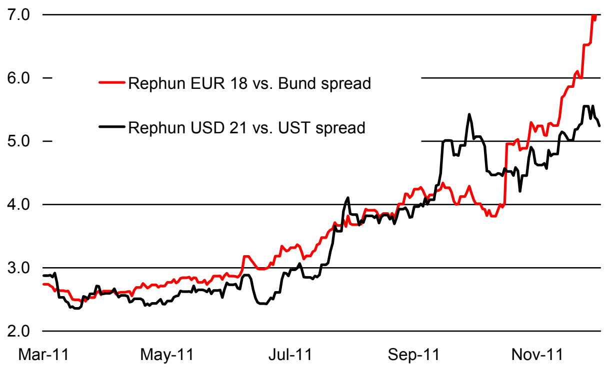
Buy EUR/HUF and CHF/HUF put spreads

Hard currency credit risk wider than local currency,

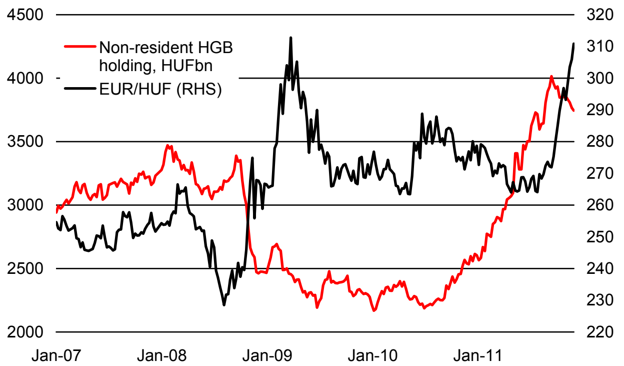
Buy Rephun EUR paper vs. Rephun USD paper

Given a very light positioning in Hungarian assets and pressure on the government to reach an agreement with the IMF we recommend establishing a more constructive approach toward Hungarian assets (vs. our bearish call in September 2011). We currently see that the market is most negatively positioned on the HUF, which has clearly decoupled from the behavior of non-resident HGB holders. Namely, unlike in 2008 when a similar level of EUR/HUF coincided with a significant outflow from the local HGB market, in 2011 several bond holders opted to hedge the FX exposure, in our view. The best way to express this view is via EUR/HUF put options, in our view, given that the risk reversal spread (difference between call and put option volatility) is still elevated. Given the well-known link between the CHF and HUF, for investors with a constructive view on EUR/CHF, we think CHF/HUF put options also offer value. In terms of fixed income instruments we see Eurobonds as cheaper than local currency bonds purely from the credit risk component. Following the Moody's downgrade, Rephun EUR papers particularly underperformed. We therefore recommend buying Rephun EUR papers vs. Rephun USD papers.

Rephun EUR papers looks cheap vs. Rephun USD paper



Unlike in 2008 non-resident bond holders hedged FX vs. selling bonds outright



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011	2012F	2013F
Gross financing requirement	**16.7**	**15.5**	**17.5**
Budget deficit	3.2	3.0	3.0
Amortisation of public debt	13.5	12.5	14.5
Domestic	9.6	7.9	9.5
Bonds	4.2	3.1	4.5
Bills	5.4	4.8	5.0
External	3.9	4.6	4.9
IMF/EU	2.0	3.3	3.5
Financing	**16.7**	**15.5**	**17.5**
Domestic borrowing	12.8	10.9	12.5
Bonds	7.4	6.1	7.5
Bills	5.4	4.8	5.0
External borrowing	3.9	4.6	4.9
Bonds	3.9	4.6	4.9
IMF/EU	0	0	0
Other	0	0	0

Source: AKK, IMF, NBH, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
Gross financing requirement	**37.7**	**37.2**	**40.1**
C/A deficit	-3.2	-3.7	-2.3
Amortisation of medium to long term debt	39.4	39.7	41.2
Government/central bank	7.4	9.1	10.3
Banks	18.5	17.1	16.3
Corporates	13.5	13.6	14.6
Financing	**37.7**	**37.2**	**40.1**
FDI	6.4	6.7	8.1
Equity	3.6	0.3	0.4
Borrowing	32.6	30.9	31.8
Government/central bank	9.5	6.2	7.1
Banks	15.6	17.0	16.2
Corporates	7.5	7.7	8.5
Other (IMF/EU repayment)	-6.9	-4.5	-4.6

Source: AKK, IMF, NBH, UniCredit Research

Latvia (Baa3 positive/BB+ positive/BBB - positive)*

Outlook – In terms of GDP, Latvia has played catch up with its Baltic peers in the last quarter. Though not at its current pace, we believe that both the domestic and external components of growth will continue to show sustainable gains. We see three downside risks for the coming year that have already hit the headlines in 4Q, namely the efficiency of the ruling coalition, the size of fiscal consolidation required to bring the deficit under 3% of GDP and a solution to the Krājbanka case, but none of these on a standalone basis are likely to push the economy into recession.

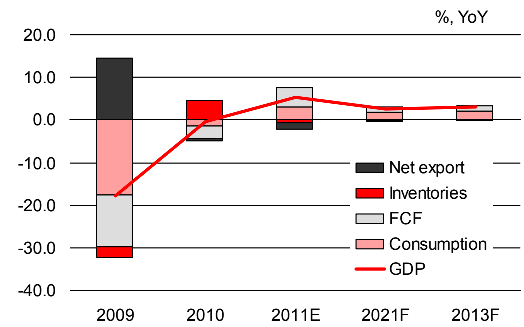
Strategy outlook – On the back of increasing supply pressure (in the form of Eurobond issuance) we think Latvian CDS could underperform Lithuanian CDS.

Author: Dmitry Veselov, Ph.D., Economist (UniCredit Bank London)

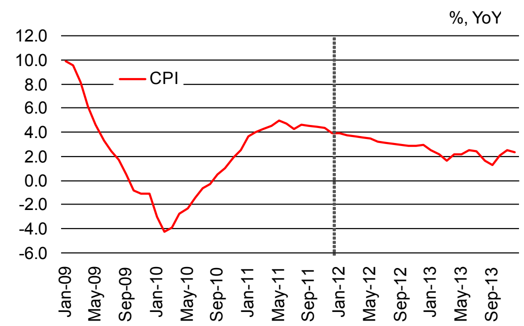
KEY DATES/EVENTS

- 10 Feb, 9-12 Mar – 3Q GDP (prelim., final)
- 5 Mar – 4Q Current Account
- 22-24 Feb – 4Q Unemployment

CONSUMPTION TO DRIVE GROWTH



INFLATION TO STABILISE IN 2012-2013



Source: Central Statistical Bureau of Latvia, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	18.5	18.0	19.7	20.8	21.9
Population (mn)	2.3	2.3	2.2	2.2	2.2
GDP per capita (EUR)	8,184	7,989	8,752	9,281	9,748
Real economy yoy (%)					
GDP	-17.8	-0.6	5.2	2.5	2.8
Private Consumption	-23.7	-0.2	3.7	2.1	2.4
Fixed Investment	-36.1	-21.7	20.3	5.5	4.5
Public Consumption	-8.9	-11.1	-0.2	1.2	0.8
Exports	-13.3	10.5	13.6	7.7	12.1
Imports	-32.9	7.1	12.6	8.0	12.9
Monthly wage, nominal (EUR)	651	629	660	684	695
Unemployment rate (%)	16.1	14.3	12.7	11.3	10.9
Fiscal accounts (% of GDP)					
Budget balance (incl. bank costs)	-6.4	-7.8	-4.0	-2.6	-2.5
Primary balance	-6.2	-9.9	-1.9	-1.8	-1.6
Public debt	36.7	44.7	44.9	45.1	45.4
External accounts					
Current account balance (EUR bn)	1.6	0.6	-0.3	-0.5	-0.6
Current account balance/GDP (%)	8.6	3.6	-1.4	-2.2	-2.5
Basic balance/GDP (%)	9.2	5.0	3.8	1.4	2.0
Net FDI (EUR bn)	0.1	0.2	1.0	0.3	0.4
Net FDI (% of GDP)	0.6	1.4	5.2	1.5	1.8
Gross foreign debt (EUR bn)	28.9	29.8	30.9	32.0	32.5
Gross foreign debt (% of GDP)	156.3	156.8	155.8	154.4	152.4
FX reserves (EUR bn)	5.2	6.9	7.4	7.5	7.4
Inflation/Monetary/FX					
CPI (pavg)	-1.3	2.5	4.4	3.2	2.3
CPI (eop)	3.5	-1.1	4.1	3.0	2.3
RIGIBOR 3M	3.9	1.0	1.0	1.4	1.6
USD/LVL (eop)	0.49	0.53	0.53	0.51	0.50
EUR/LVL (eop)	0.70	0.70	0.70	0.70	0.70
USD/LVL (pavg)	0.50	0.53	0.50	0.53	0.51
EUR/LVL (pavg)	0.70	0.70	0.70	0.70	0.70

Source: UniCredit Research

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

Catching up in a vulnerable environment

GDP growth has finally caught up with Baltic peers

Preliminary 3Q GDP figures available to date show continuing and accelerating recovery. GDP growth accelerated to 5.7% yoy (1.3% qoq SA) from 5.6% (2.0% qoq SA) in 2Q. These numbers disperse concerns of a strong economic slowdown in the country on the back of a deterioration in the external environment. Especially positive news here is that Latvia, which has so far lagged behind its Baltic peers in economic recovery, is now steadily catching up with a second above -5% yoy growth rate in a row – a pace of recovery quite comparable with that of Lithuania. In 2012 we expect to see an increasing share of domestic demand (personal consumption and fixed capital formation) in GDP, which would support the national economy through the period of international trade slowdown in 2012. Going further, we expect GDP growth in the next year to slow down on the back of the deteriorating environment, however avoiding a hard landing. We forecast 2012 GDP growth at 2.5%.

Both domestic and external demand components are very strong to date

Looking at the external demand component, we also see strong acceleration. Sep 11 total foreign trade turnover (exports and imports combined) reached LVL 1.2bn (around EUR 1.7bn) growing 17.0% yoy. On a 9M accumulated basis, the trade deficit widened further to 34.8% in absolute terms. However, relative to GDP this translates into a moderate widening from -6.3% to -7.7% of GDP, due to a strong GDP recovery. Overall, the reading comes as no surprise, and re-confirms that the Latvian economy maintains positions in international markets despite the deteriorating external environment, due to its specific niche concentration. At the same time, over the three quarters of 2011 the C/A moved back into deficit, reaching LVL73mn (-0.5% of FY11 GDP) in line with our forecast. On the financing side, things look very impressive. In 3Q11, the FDI increased to 2.5x that of 3Q10, nearly over 50% increasing FDI YTD to 5% of anticipated annualized GDP.

Domestic component also seems to be on a firm footing. Looking at individual consumption, retail sales growth in October only slowed to 4.9% yoy from 8.0% yoy two months before. Although this latest number represents some slowdown, it is still a strong reading given the deteriorating global environment. Also, as we progress closer to the end of the year, the base effect starts to play a negative role as the retail sales recovery only started in June 2010 and peaked in December at 8.1% yoy – the highest yoy growth recorded in the post crisis period. Partially the support for domestic demand would also come from decreasing inflation, which also started to slow down closer to the year end. November CPI came in at 4.2% yoy – one of the lowest readings this year. Going forward, we expect CPI in Latvia to follow the pattern of its regional peers and start to decelerate in the remainder of the year.

Monitoring the new government, negotiations with final IMF mission and Krājbanka developments

The governing coalition is comprised of of ZRP, Unity, National Alliance, and now also the "6 MPs" group (totaling 56 seats in the 100-seat parliament). Given its make-up, difficulties on reaching agreement on some key issues is an obvious risk. The biggest party in the parliament, the pro-Russian Harmony Center (31 seats), was left in opposition. Following tough talks with the IMF, Latvia's authorities agreed to further fiscal consolidation in 2012 of LVL 156.1mn – slightly above 1.0% of GDP – to ensure the deficit would be at 2.5% next year despite the projected slowdown. The government's initial consolidation target was LVL 100mn (around EUR 142mn, 0.7% of GDP) – based on 3.9% GDP growth. On 23 November Latvia suspended operations of Latvijas Krājbanka AS, an 89% subsidiary of Lithuania-based Snoras bank, which was nationalized a week before by Lithuania's government (the formal process still to be finalized). Latvijas Krājbanka holds 2.8% of Latvia's total banking assets and around 7.5% of total residents' deposits. The announcement does not come as unexpected news to us given the nationalization of Snoras. Following the announcement, the European Commission in Riga was cited as expressing confidence that the situation with Krājbanka is not complicated and will have minimal consequences.

Lithuania (Baa1 stable/BBB stable/BBB positive)*

Outlook – Despite external winds, Lithuania is on track to post a very strong recovery in 2011. Going further into 2012 we expect the growth to moderate to more sustainable rate, supported mostly by internal demand. The biggest risks to our forecast come from the public sector, however these risks are limited. The macroeconomic forecast in the budget implies GDP 2.5% yoy to bring the budget deficit to 3.0% of GDP. Also the situation with Snoras bank is awaiting final resolution.

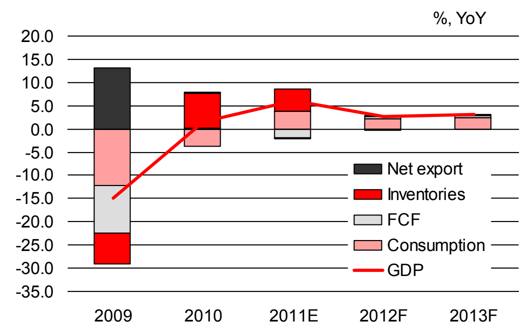
Strategy outlook – Lithuanian CDS continues to trade hand in hand with Lativa which we still think offers some relative value opportunity. As Latvia is coming back to the market we think Latvian CDS should underperform Lithuanian. On the other hand we see Lithuania USD 21 as relatively cheap vs. fundamental backdrop.

Author: Dmitry Veselov, Ph.D., Economist (UniCredit Bank London)

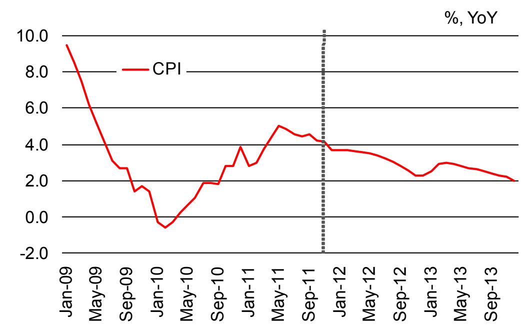
KEY DATES/EVENTS

- 16 Dec – Final voting on 2012 budget in Parliament
- 22 Dec – Deadline for Snoras insured deposits repayments
- 30 Jan, 28 Feb – 4Q GDP (prelim., final)

CONSUPTION TO SUPPORT GROWTH IN 2012



INFLATION TO SLOW DOWN



Source: Statistics Lithuania, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	26.5	27.4	30.3	31.8	33.5
Population (mn)	3.3	3.3	3.3	3.3	3.3
GDP per capita (EUR)	7,939	8,257	9,186	9,691	10,225
Real economy yoy (%)					
GDP	-14.7	1.2	6.2	2.6	3.2
Private Consumption	-17.7	-4.1	4.7	2.1	3.0
Fixed Investment	-39.2	-0.3	10.4	1.5	4.0
Public Consumption	-1.9	-3.0	0.9	0.1	0.3
Exports	-12.7	16.3	13.9	12.4	7.5
Imports	-28.4	17.6	16.5	13.9	8.6
Monthly wage, nominal (EUR)	625	600	608	622	645
Unemployment rate (%)	9.5	14.5	11.8	9.8	8.6
Fiscal accounts (% of GDP)					
Budget balance	-7.9	-7.5	-3.7	-3.2	-2.5
Primary balance	-6.7	-4.6	-2.6	-0.6	-1.2
Public debt	29.5	38.0	38.1	39.4	39.9
External accounts					
Current account balance (EUR bn)	1.1	0.3	-0.6	-0.5	-0.3
Current account balance/GDP (%)	4.3	1.6	-1.9	-1.4	-0.7
Basic balance/GDP (%)	4.1	4.3	3.6	3.4	3.7
Net FDI (EUR bn)	0	0.7	1.0	0.7	0.8
Net FDI (% of GDP)	-0.1	2.6	3.2	2.3	2.5
Gross foreign debt (EUR bn)	23.1	22.9	23.9	25.7	26.0
Gross foreign debt (% of GDP)	87.2	83.5	78.8	80.9	77.5
FX reserves (EUR bn)	4.5	4.9	5.2	5.5	5.3
Inflation/Monetary/FX					
CPI (pavg)	4.5	1.1	4.2	2.4	2.2
CPI (eop)	1.3	3.6	4.2	2.2	2.0
VILIBOR 3M	7.1	1.6	1.7	3.0	3.2
USD/LTL (eop)	2.41	2.59	2.59	2.52	2.46
EUR/LTL (eop)	3.45	3.45	3.45	3.45	3.45
USD/LTL (pavg)	2.48	2.61	2.48	2.62	2.50
EUR/LTL (pavg)	3.45	3.45	3.45	3.45	3.45

Source: UniCredit Research

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

Soft landing in sight

Economy is still posting very strong results

Growth in Lithuania accelerated to 6.7% in 3Q11 compared to 2Q11 at 6.5% – the highest pace in the post-crisis economic recovery period (given the revised 1Q yoy GDP growth of 5.9%). As we expected, the biggest contributor remains personal consumption, which added 3.6pp to the final yoy figure. In addition, net exports recorded a positive 0.6pp contribution, which combined with an inventories increase, compensated for a decrease in the contribution from GFCF (1.7pp) – the lowest reading since 2Q10 and potentially a reflection of the global financing tensions. We see full-year GDP gains this year in excess of 6.0%.

However it should slow down in the near future

2012 looks set to be softer – we forecast full year GDP growth next year at 2.6%. 4Q data already showed clear evidence of this. Industrial production growth in October in yoy terms slipped below zero. Exports slowed down to around 25% yoy in 3Q from over 50% yoy in 1Q further to 32% in 2Q, and 36% in 3Q. Retail sales showed some descent from the peak of above 25% yoy at the end of 2Q to 17.8% in the beginning of 4Q. Regarding the first component – unemployment, according to the labour force survey, fell to 14.2% at the end of 3Q compared to 17.1% at the end of 1Q11. Wages were also showing recovery, but at a much slower pace than inflation, at around 2% yoy from 1Q to 3Q inclusive. All in all, the major support to individual consumption we still see coming from decreasing unemployment, while decreasing real wages would support the competitiveness of Lithuanian production.

C/A slips into deficit, but financing is very strong

The C/A developments are in line with GDP breakdown dynamics. The BoP cumulative deficit of 2Q11 widened further to 1.6% or EUR 371mn in 3Q. We expect a modest full-year deficit this year, in line with progressing internal demand. However the financing side looks very strong – the balance of FDIs reached over EUR 800mn for the same period. So for the full year we may see FDI reaching over 3% of GDP.

Risks from Snoras takeover are limited

Following on from the takeover of Snoras bank, the country's fifth largest bank, holding approximately 10% of total banking system assets, the MinFin made some statements that imply that in the worst case scenario it was ready to step in to provide liquidity from the insurance fund to repay the insured deposits held in the bank. Later, in the beginning of December, the government approved a six year loan of LTL 3.3bn to the insurance fund, presuming that the additional borrowing may be needed for the government to finance the loan. However, we do not expect that it would be a big problem for the government to cover a gap between the cash in the insurance fund of LTL 1.4bn and the deposits of LTL 4.1bn currently insured under the deposits protection scheme – even assuming that all of the insured deposits are drawn. At the end of October, the government was holding over LTL 9bn on account with local MFIs and the central bank. Over a longer horizon, we expect that the potential government expenses of LTL 2.7bn would be covered from the sale of Snoras' assets, which have a current book value of LTL 3.6bn (the amount left on the total balance sheet after deducting LTL 3.4bn in missing assets).

But the 2012 budget may be somewhat optimistic

In October, after heated debates within the government, the draft 2012 budget was submitted to parliament. Initial macroeconomic forecasts in the budget implied CPI at 4.5% and GDP at 4.7% yoy to bring the budget deficit to 2.8% of GDP. Following discussions in the parliament and a revision of 2012 growth forecast to 2.5% in November, Lithuania scheduled additional extra measures for the course of next year to hold the deficit at 3% of GDP. The official growth forecast for 2013-2014 remained unchanged at 3.4%-3.7%.

On our forecast of tapping international markets for approximately EUR 2bn in new issues in 2012, Lithuania issued approximately EUR 500mn in 3Q11 for the 2012. The guidelines were set up initially at UST +420bp and later reduced to +390bp.

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

Outlook – The economy is on track to deliver solid (4.0-4.1%) GDP growth in 2011, and in 2012 growth should be around 3%, assuming stable global backdrop. The PM declared deep reforms in his expose, aimed at bringing debt/GDP to 47% in 2015 and 40% in 2020. As reforms are put into life, this will support both PLN and POLGBs. If all key reforms are implemented, this would likely mean a rating upgrade. Inflation is poised to decline towards 2.7-2.8% yoy in mid-2012, and hover around 3% in 2H2012. Falling inflation and weakening growth will prompt MPC to cut rates – we look for a total 75bp cuts next year, starting already in the first quarter.

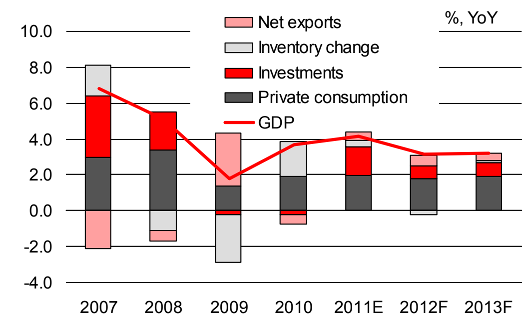
Strategy outlook – We recommend reducing POLGB duration to short as we struggle to see long POLGB performing in either the positive or negative EMU outcome. We think paying 5y PLN has also attractive risk characteristic as the curve is already pricing rate cuts.

Author: Marcin Mrowiec, Chief Economist (Bank Pekao)

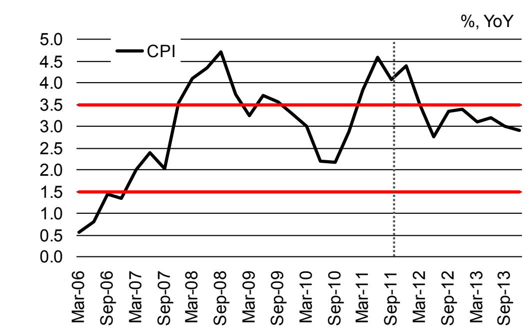
KEY DATES/EVENTS

- MPC rate decisions 11 Jan, 8 Feb, 7 March
- 1Q inflation report, post March MPC rate decision
- Increase in disability contribution rate for employers, likely in Feb
- Increase in excise tax on diesel, VAT rate on children's cloth

PRIVATE CONSUMPTION TO DOMINATE IN 2012



CPI TO REMAIN WITHIN TARGET BAND FOR 2012-2013



Source: GUS, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	310.4	354.4	368.3	388.0	421.0
Population (mn)	38.2	38.2	38.1	38.1	38.1
GDP per capita (EUR)	8,134	9,277	9,672	10,193	11,063
Real economy yoy (%)					
GDP	1.6	3.8	4.0	3.1	3.5
Private Consumption	2.1	3.2	3.4	3.1	3.4
Fixed Investment	-1.2	-1.0	8.7	3.4	3.9
Public Consumption	2.0	4.0	1.1	1.9	2.1
Exports	-6.8	10.1	5.9	4.1	4.8
Imports	-12.4	11.6	6.2	4.5	5.0
Monthly wage, nominal (EUR)	767	860	876	906	965
Unemployment rate (%)	11.0	12.1	12.4	12.6	12.9
Fiscal accounts (% of GDP)					
Budget balance	-7.3	-7.9	-5.8	-3.4	-2.9
Primary balance	-4.8	-5.2	-3.1	-0.6	0
Public debt	50.9	53.6	54.1	53.2	51.9
External accounts					
Current account balance (EUR bn)	-12.2	-16.5	-18.2	-13.2	-17.6
Current account balance/GDP (%)	-3.9	-4.6	-4.9	-3.4	-4.2
Basic balance/GDP (%)	-0.9	-2.8	-2.4	-1.3	-2.3
Net FDI (EUR bn)	9.3	6.7	9.3	8.0	8.0
Net FDI (% of GDP)	3.0	1.9	2.5	2.1	1.9
Gross foreign debt (EUR bn)	194.4	235.4	238.6	235.8	239.5
Gross foreign debt (% of GDP)	62.6	66.4	64.8	60.8	56.9
FX reserves (EUR bn)	55.2	70.0	76.4	81.5	88.9
Inflation/Monetary/FX					
CPI (pavg)	3.5	2.6	4.2	2.9	3.0
CPI (eop)	3.5	3.1	3.9	3.3	2.9
Central bank target	2.5	2.5	2.5	2.5	2.5
Central bank reference rate (eop)	3.5	3.5	4.5	3.8	4.0
3M money market rate	4.4	3.9	4.5	4.4	4.2
PLN/USD (eop)	2.87	2.98	3.23	2.99	2.82
PLN/EUR (eop)	4.11	3.96	4.30	4.10	3.95
PLN/USD (pavg)	3.12	3.02	2.96	3.16	2.94
PLN/EUR (pavg)	4.33	3.99	4.12	4.15	4.05

Source: UniCredit Research

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

PM declares reforms aimed at stabilizing fiscal performance

PM Tusk declared fiscal reforms aimed at bringing debt/GDP to 52% in 2012 and 40% in 2020

The PM declared serious reforms aimed at lowering debt/GDP in his expose to the newly elected Parliament in late November. The key question investors and rating agencies were asking themselves for most of 2011 was whether post-elections they would see much-needed and long-awaited fiscal reforms on top of what was already proposed (2.2%-2.5% of GDP of fiscal consolidation implemented in 2011 and planned for 2012). PM Tusk, in his expose prior to confidence vote for the new Cabinet, declared implementation of most of the reforms that were postulated by economists for many years. Marketwise the following are most important: **(1)** an increase of disability donation by 2pp (according to PM this should bring PLN 13bn per year, though this seems an optimistic number; ca 7-8bn looks more probable)), **(2)** an increase in pension age to 67 years and equalisation for men and women (vs. 60 years for women and 65 years for men currently), **(3)** removal of special pension treatment for police, army, judges and miners (except those actually mining), **(4)** removal of tax breaks on internet (circa PLN 0.4bn additional revenue per year), **(5)** changes in tax breaks on children (budget-neutral, aimed at higher tax breaks for thirds and further children, no tax break on first child in better off families), **(6)** farmers will have to pay healthcare donation, and in the coming years they will be gradually included into general tax system, **(7)** there will be new tax regulation on mining (copper, silver, but also with regard to shale gas), **(8)** excise tax on diesel and tobacco will be hiked in 2012 (this has already been formally voted down by the Cabinet). The bottom line is that the proposed changes are beneficial to public finances, reducing debt/GDP to 52% next year (from ca 53.8% in 2011), to 47% in 2015 and 40% in 2020. This would positively differentiate Poland on the European fiscal map, would support POLGBs and the zloty in the long run, and – assuming most of key declared reforms are fully implemented – would likely mean higher ratings. An important factor is the implementation risk. We remain cautiously optimistic, though, as opposition parties are not strong enough to stop the changes.

If key reforms are implemented, this will positively differentiate Poland on European fiscal map, and will likely support both POLGBs and the zloty

Finance Ministry seems well prepared for 2012 budget, with good chances of pushing deficit towards 3% even in less than optimistic macro scenario

The single most important change with regard to fiscal year 2012 is the increase in disability donation to the social security system by 2pp. This, along with other changes, should bring around 10-12bn of additional revenue in 2012, and makes it realistic that the 2012 budget deficit should near 3% of GDP, after ca. 5.8% in 2011. The changes that will have impact on next year's budget add up to 10-12bn PLN and should ensure a reduction in the deficit towards 3% of GDP even in the scenario of 2.5% GDP growth, as declared by the Finance Minister. Our forecast is 3.1% growth next year, very close to market consensus and NBP projections. Given the uncertainty of external conditions, the Ministry of Finance is preparing alternative budget drafts for various macro scenarios, ensuring a plan B is in place.

Ruling Civic Platform (PO) is in a relatively comfortable political situation

The political environment gives the ruling PO significant room for manoeuver. The Civic Platform (PO) won October elections, getting 207 seats in 460-members' Parliament (Sejm), and together with its coalition partner, farmers' PSL, they have 235 seats in the Sejm. The biggest opposition party (Law and Justice, PiS) won 157 seats, but a number of its newly elected MPs split from the party, after internal post-elections discussions. PO, apart from getting support from PSL, may also count on liberalization measures from the Palikot Movement (40 seats), e.g. with regard to implementation of changes in farmers' taxation, which might not be supported by PSL. Therefore, PO seems to have significant room for manoeuver when it comes to implementing reforms, and additionally its main opponent, PiS, seems to be having internal problems.

GDP growth is on its way for 4% growth in 2011, and "orderly slowdown" towards 3% in 2012

Our forecasts with regard to GDP growth seem well on track, with 4% expected in 2011 and 3.1% in 2012. 3Q GDP saw an increase of 4.2% yoy, after 4.5% in 1Q and 4.3% in 2Q. This confirms we're on good track for 4.0-4.1% for the full year this year, despite a more pronounced than expected slowdown in 4Q (we look for 3.7%). 3Q already saw the positive impact of a weaker zloty (1.0pp contribution of net exports, vs. 0.2pp in 1Q and -0.1pp in 2Q), and the private consumption slowdown was in line with expectations (3.0% yoy, after 3.7% in 1Q and 3.6% in 2Q) With regard to 2012, we expect a moderate slowdown, in particular in the coming quarters, with the full year figure around 3%.

The factors that will act towards weaker growth will be deterioration of the situation in the labor market (we still expect positive nominal wage growth but in real terms it will be only marginally positive, and employment growth will likely stall in 2H12), a slowdown in public investment (peak of investments will be in 2011 and 1H12) amid private sector reluctance to invest and a generally weak global backdrop.The positive factor is that the weak zloty enhances competitiveness of domestic production in foreign markets and the private consumption decline seems orderly. The key for next year's growth will be the global backdrop – assuming that slowdown will stay within the bounds of current UCI baseline scenario, Poland should see growth at around 3%.

CPI should continue down towards 2.7% in May 11

CPI inflation should continue to decline, esp in 1H12, amid base effects, but a weak zloty will moderate the scale of the decline. After topping at 5% in May'11, CPI continues to decline and we should see sub-4% reading at end-2011. We forecast a trough of 2.7%-2.8% in May'12, with inflation remains around 3.0% yoy by end next year. This path is a bit (0.2-0.3pp) higher than three months ago, mostly on the back of weaker zloty.

The MPC will likely deliver 75bp in total of rate cuts in 2012, starting in 1Q12

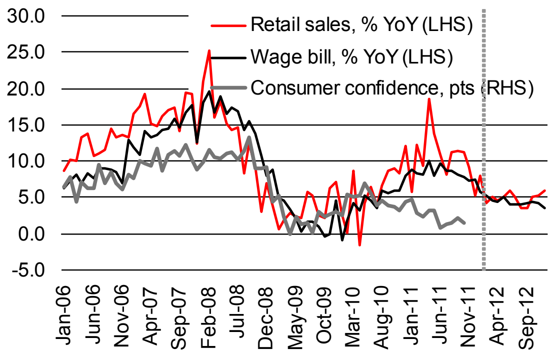
The MPC will likely start cutting rates at the beginning of 2012, and deliver three cuts of 25bp in total. The MPC's rhetoric in recent weeks was pretty balanced, but we are of the opinion that the pressure from weakening growth, the deteriorating situation in the labor market and falling CPI will prompt the MPC to act. We look for three cuts in total, with the first one likely in Feb-March 2012.

When global markets stabilize, zloty should gain

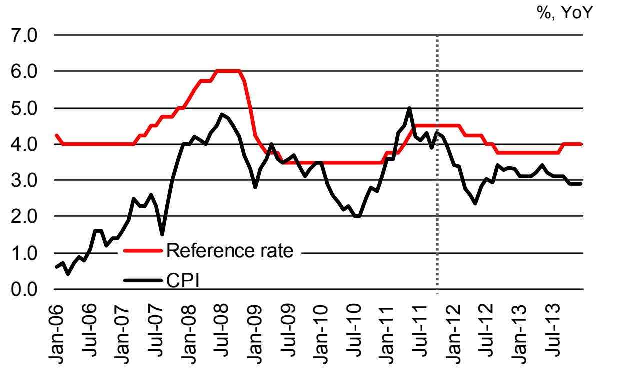
Domestic fiscal reforms, stabilization in global markets along with strong December PLN seasonal pattern should see domestic currency strengthening from current levels towards 4.30-4.35 at year-end. The key fundamental factors seem to be the determination of the Cabinet to push through implementation of the reforms proposed by the PM, and stabilization in international financial markets. The key "technical" factor is a strong seasonal pattern in PLN in favor of strengthening in December. In the past this was dictated mostly by selling of foreign currencies by those coming back from abroad for Christmas amid thin volumes from mid-December onwards. This year it will be additionally strengthened by Ministry of Finance (via BGK) selling of foreign currency (EU funds), as the year-end exchange rate is vital for the PLN value of Poland's foreign debt (and thus debt/GDP calculation for the whole year). Therefore, except for the scenario of further tensions in global financial markets (and risks abound, unfortunately), we look for the zloty to strengthen towards year-end, with EUR-PLN likely approaching 4.30-4.35 level. Regarding 2012, we are cautiously optimistic. Assuming that the Cabinet "forges" declaration of PM into reforms, the zloty should continue to strengthen, On the other hand, the economy is poised to slow down, and fiscal worries will likely stay with us, and so we would not expect EUR-PLN to break below 4.00 – we look for strengthening towards 4.10 in end-2012.

LABOR MARKET WILL STABILIZE, REAL WAGE BILL SLOW DOWN, AND RATES ARE LIKELY TO BE CUT IN 2012

Wage bill deceleration should be gradual, and should broadly stabilize retail sales at around 5% next year (both values in nominal terms)



NBP is likely to cut reference rate in 2012, amid economic slowdown and CPI headed towards central target (2.5%) in the first half of the year



Source: GUS, UniCredit Research

Strategy: reduce POLGB duration, pay 5y PLN

Reduce POLGB duration

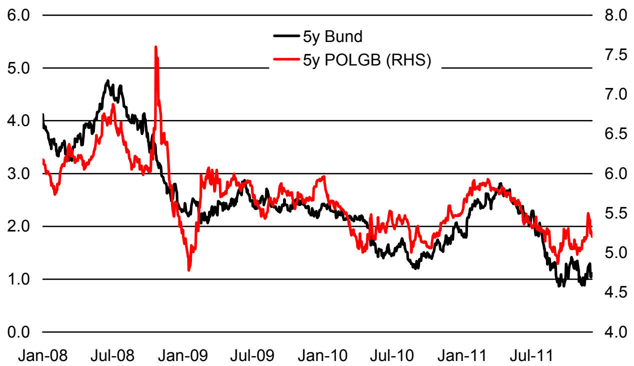
Reduce POLGB duration to short: As POLGBs failed to weaken at all during the 3Q-4Q sell-off period while non-resident bond holder positioning remains at all time high we would not chase POLGB duration any longer and recommend reducing duration allocation to short. Our key rationale is the following: **1.** in case the EMU endgame surprise on the upside while the economic slowdown proves less powerful than feared by many market participants the PLN curve should start pricing hikes again. Currently the 12x15 FRA is pricing about 25-50bp rate cut over the next 12months. In this case would expect a stronger upside pressure on Bund yields as well. **2.** In case the EMU backdrop disappoints the NBP might come under pressure from the FX side. In this case we think the high non-resident positioning represents a meaningful risk ask well.

Pay 5y PLN has attractive risk characteristic

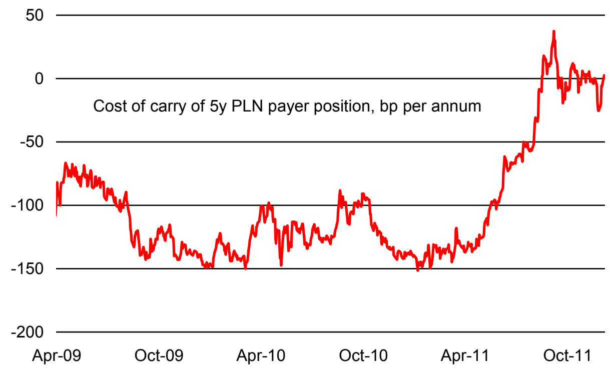
Paying 5y PLN rate is attractive hedge position as well: We believe paying 5y PLN rates is also an attractive tail hedge. The carry on a 5y PLN payer is roughly flat while the roll-down is about negative 0.5bp peer month. In FX we would remain neutral at current levels as the EUR/PLN cross is still driven by NBP/BGK interventions but next year they might reduce activity given a new debt calculation rule could be introduced.

POLGB STILL STRONGLY CORRELATED WITH BUND AND COST OF CARRY OF 5Y PLN PAYER CHEAPENED UP

Bund represents a risk for POLGB



Carry of PLN payer is attractive



Source: UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
Gross financing requirement	**48.4**	**52.7**	**47.2**
Budget deficit	20.2	16.2	17.1
Amortisation of public debt	28.2	36.5	30.1
Domestic	26.7	32.5	26.4
Bonds	20.3	28.3	22.9
Bills	6.3	4.3	3.5
External	1.5	4.0	3.6
IMF/EU	0	0	0
Financing	**48.4**	**54.5**	**49.0**
Domestic borrowing	36.7	44.3	38.5
Bonds	32.2	38.2	33.3
Bills	4.6	6.1	5.2
External borrowing	11.7	10.3	10.5
Bonds	6.3	5.8	5.9
IMF/EU	0	0	0
Other	5.3	4.5	4.6

Source: Ministry of Finance of Poland, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
Gross financing requirement	**88.8**	**81.1**	**88.4**
C/A deficit	18.2	13.2	17.6
Amortisation of medium to long term debt	17.2	14.4	12.9
Government/central bank	5.7	7.0	5.6
Banks	5.1	1.7	3.4
Corporates	6.4	5.6	3.9
Short term debt amortisation	53.5	53.6	57.8
Financing	**98.1**	**95.1**	**97.1**
FDI	9.3	8.0	8.0
Equity	4.3	4.0	4.0
Borrowing	82.1	80.6	83.8
Government/central bank	13.4	15.9	14.5
Banks	32.3	29.3	33.7
Corporates	36.3	35.4	35.6
EU transfers	8.5	8.5	7.3
Other	-6.0	-6.0	-6.0

Source: NBP, UniCredit Research

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

Outlook – The expected GDP growth for 2012 has been downgraded to 1.4% on the back of a negative base effect from agriculture, weaker foreign demand and a more feeble fiscal impulse. The main concern for the Romanian economy in 2012 will be external financing, both for the C/A deficit and for the public deficit. Banking sector risks are manageable, total foreign liabilities being covered 133.6% by the FX reserves of the central bank.

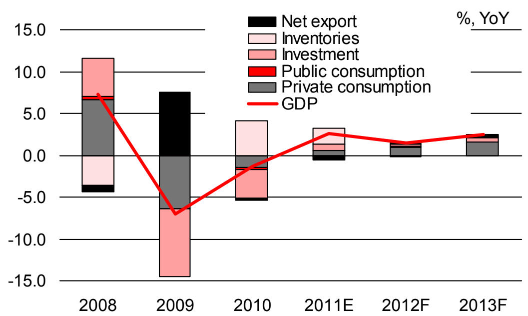
Strategy – We remain constructive on the multi quarter horizon. We believe the cheapest asset class remain the external credit but prefer to wait for the upcoming Eurobond issuance.

Author: Dan Bucsa, Ph.D., Chief Economist (UniCredit Tiriac Bank)

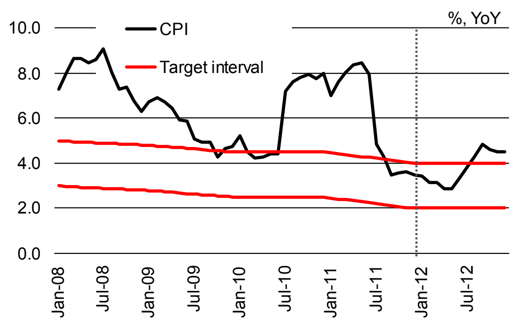
KEY DATES/EVENTS

- 5 January 2012 – NBR rate decision
- Late January 2012: IMF evaluation
- 2 February 2012 – NBR rate decision

GDP GROWTH TO FLATTEN



SHARP DISINFLATION



Source UniCredit Research, NBR, CSO

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011F	2012F	2013F
GDP (EUR bn)	117.5	122.0	130.2	133.4	142.0
Population (mn)	21.5	21.5	21.4	21.3	21.2
GDP per capita (EUR)	5,467	5,675	6,074	6,248	6,705
Real economy yoy (%)					
GDP	-7.1	-1.3	2.6	1.4	2.5
Private Consumption	-9.2	-2.0	0.9	1.4	2.9
Fixed Investment	-25.3	-13.1	0.6	1.3	3.0
Public Consumption	1.2	-3.2	-2.5	1.8	3.0
Exports	-5.5	13.1	11.3	8.7	8.9
Imports	-20.6	11.6	10.8	7.3	8.5
Monthly wage, nominal (EUR)	326	334	363	378	404
Unemployment rate (%)	6.3	7.6	7.7	7.5	7.0
Fiscal accounts (% of GDP)					
Budget balance	-7.3	-6.5	-4.4	-2.5	-2.5
Primary balance	-6.1	-5.1	-2.8	-1.0	-1.1
Public debt	27.4	41.9	39.0	38.3	35.0
External accounts					
Current account balance (EUR bn)	-4.9	-5.0	-5.6	-5.8	-5.1
Current account balance/GDP (%)	-4.2	-4.1	-4.3	-4.3	-3.6
Basic balance/GDP (%)	-3.6	-3.9	-4.1	-4.1	-3.3
Net FDI (EUR bn)	3.5	2.2	1.0	1.5	2.0
Net FDI (% of GDP)	3.0	1.8	0.8	1.1	1.4
Gross foreign debt (EUR bn)	65.7	72.8	79.8	80.2	80.2
Gross foreign debt (% of GDP)	55.9	59.7	61.3	60.1	56.5
FX reserves (EUR bn)	30.9	36.0	35.5	32.5	27.3
Inflation/Monetary/FX					
CPI (pavg)	5.6	6.1	5.9	3.8	4.1
CPI (eop)	4.7	8.0	3.5	4.5	4.0
Central bank target	3.5	3.5	3.0	3.0	2.5
Central bank reference rate (eop)	8.00	6.25	6.00	5.50	5.00
3M money market rate	10.43	6.25	6.30	5.80	5.30
RON/USD (eop)	2.96	3.22	3.23	3.14	3.06
RON/EUR (eop)	4.23	4.28	4.30	4.30	4.28
RON/USD (pavg)	3.05	3.19	3.05	3.29	3.12
RON/EUR (pavg)	4.24	4.21	4.24	4.33	4.30

Source UniCredit Research

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

Growth driver to switch from foreign to domestic demand

Stronger-than-expected domestic demand growth in 2H2011

Romania's economy grew an impressive 4.4% yoy in 3Q2011, accelerating to 1.8% qoq on seasonally adjusted data. The main growth drivers were agriculture (+22.1% yoy, 2.3pp contribution to annual growth), industry (5.9% yoy, 1.5pp contribution) and construction (6.9% yoy, 0.5pp contribution) on the supply side and consumption (up 3.1% yoy due to good crops – households own 53% of total farm land) and investment (+11.4% yoy) on the demand side. Agriculture and construction will contribute strongly to GDP in 4Q2011, the former owing to excellent crops (very much dependent on weather conditions), with the latter boosted by a positive base effect (the comparison with austerity-stricken 2H2010). We anticipated these growth factors in our September quarterly but underestimated their magnitude. The expected GDP growth for 2011 is now 2.6% from 1.9% previously. The main growth contributors are industry (1.5pp), agriculture (0.7pp), market services (0.3pp) and net taxes (0.3pp).

Downward correction to growth forecast driven by negative base effect, weaker foreign demand and lower fiscal impulse

Growth expectations for 2012 and 2013 have been corrected downwards to 1.4% and 2.5% respectively from 2.5% and 3.1% previously. On the one hand, bumper crops will boost net exports and construction will rise on the positive base effect in 1H2012. On the other hand, agriculture will probably affect growth in 2H2012 through a base effect (-0.3pp to annual growth). Another reason for downgrading growth is the slowdown in euro area economic activity, with impact on industry (0.6pp expected contribution to annual growth in 2012 and 1pp in 2013) and net exports (+0.4pp expected contribution in 2011, -0.2pp in 2012 and -0.3pp in 2013). If the euro area avoids recession in 2012 (our baseline scenario), industry could boost growth in 2H2012 and 2013. A final important correction to the GDP outlook in both 2012 and 2013 is a lower fiscal impulse. 2012 is an election year, but higher public expenditure will be curbed by low financing, with impact on public and private consumption (the cumulative contribution to growth is 0.3pp lower than in the previous forecast at 1pp for 2012 and 1.6pp in 2013).

Budget deficit targets corrected downwards on low prospective financing

The budget deficit was 2.4% of GDP at the end of October 2011 and the annual figure will be below the deficit target of 4.4% of GDP. The better-than-expected performance owes to higher revenues from indirect taxes (+18.7% yoy) and lower wage and social security spending (-5.7% yoy). At the same time, it was probably forced by insufficient financing: redemptions have exceeded new issuance on the local market by RON 2.4bn (0.4% of GDP) in October and November 2011, while the planned MTN issuance was postponed because of lack of sufficient demand. In this context, the deficit target of 1.9% of GDP for 2012 looks ambitious, but also difficult to finance at reasonable costs, since Romania will compete with the financing needs of larger, better rated European countries. We believe that the deficit could fall to 2.5% of GDP in 2012 and 2013 (when the deficit target is 0% of GDP), financed by drawing EUR 1.5bn from the IMF and EUR 1bn from the WB. Our view on budget financing is based on partial rollovers of public debt by foreign investors and local banks and on the expectation that foreign markets will not be tapped in 1H12, when the equivalent of EUR 4.9bn in locally-issued RON debt will mature.

Difficult current account financing, despite sub-4.5% of GDP forecasted levels

Since September, we have downgraded our FDI expectations to just EUR 1bn in 2011 from EUR 1.9bn. In 2012 and 2013, the expected rebound to EUR 1.5bn and EUR 2bn could be driven by foreign investment projects prioritised by authorities, but also by re-invested profits and inter-company loans that will supplement the scarcer and more expensive banking financing. The current account deficit has been covered in 2011 mainly by portfolio investment (EUR 2.8bn in 9M2011), RON yields – highest among new EU members – compensating for increased risk aversion. Volatile financing and reduced risk appetite will probably cap the current account deficit together with higher exports and lower imports of foodstuffs in 1H2012. Throughout the forecast horizon, the weak RON will prove C/A supportive, although the impact of foreign demand on exports is twice as strong. The forecasted C/A deficits are 4.3% of GDP in 2011 and 2012 and 3.6% of GDP in 2013.

The inflation target for 2012 could be missed because of negative base effect from food prices

The Romanian National Bank cut the monetary policy rate to 6% in November 2011 and we expect two further cuts in 1H2012, helped by the benign inflation outlook. The inflation rate was 3.6% in October and is expected to finish 2011 around this level. Annual CPI inflation could fall below 3% in April 2012, only to rebound in H2012 on a very strong base effect (the food price-driven cumulative deflation between June and September 2011 was 1.2%). The 2012 year-end forecast is 4.5%, above the 2%-4% target interval. The forecast doesn't assume major changes to the consumer basket, although this would be the right time for Romania to switch to a structure based on national accounts (with a lower weight for food), rather than 2-year old surveys.

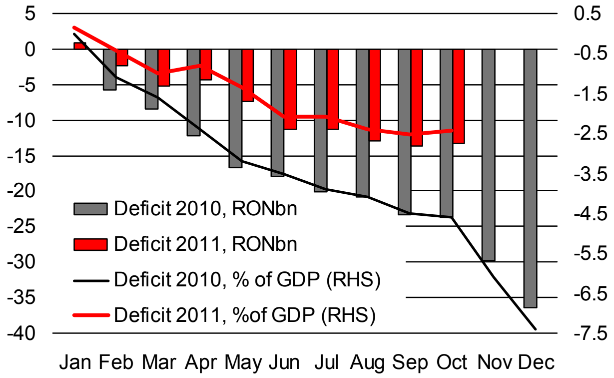
More pessimistic view on interest and exchange rates

We still believe that the financing of the public deficit will drive both RON and market rates in 2012. The MinFin could tap directly the private sector for funding, adding pressure on RON deposit rates and further depleting the banking sector of liquidity. Alternatively, the NBR could provide liquidity to local banks willing to increase their exposure to ROGBs. Absent drastic quantitative easing measures (unlikely since it would weaken the RON), we expect real monetary conditions to tighten, despite the monetary policy easing. The RON has been hit recently by investor worries regarding possible contagion from euro area debt problems, but the NBR has capped the currency below 4.38 RON/EUR. While denying any ceiling for the pair, the NBR is unlikely to let the RON depreciate above 4.4 RON/EUR for more than a few days, since the central bank fears that the FX loan portfolio (especially consumer loans and loans to SMEs) will deteriorate further. Hence, we see the EUR/RON pair moving inside the 4.3-4.4 RON/EUR interval for most of 2012, with higher levels tested in case of extreme risk aversion and lower levels possible if the FX supply improves on the local market.

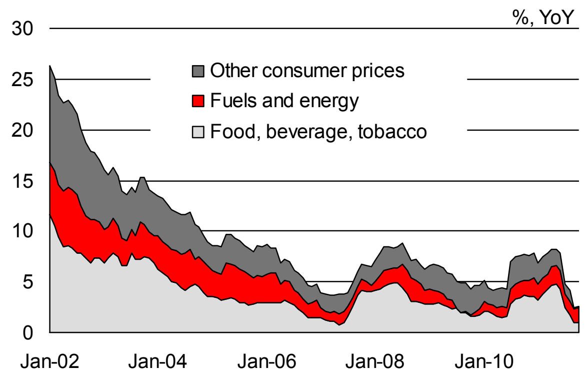
Risks coming from contagion through the financial system are manageable

The current macroeconomic outlook could worsen if the situation in the Euro Zone deteriorates. In the adverse scenario of deleveraging by some of the local banks, the NBR will probably intervene through the Deposit Guarantee Fund and substitute missing funding out of its FX reserves. At EUR 32.2bn, the FX reserves cover 133.6% of the foreign liabilities of the banking system (EUR 24.1bn in September 2011). Romanian banks are well capitalized (the solvency ratio was 13.4% at the end of 3Q2011), but reported losses of RON 774mn (EUR 177.8mn) for the first nine months of 2011 on the back of falling net non-interest income (-38.5% yoy). The perceived weaknesses coming from overexposure to Greece and Austria are actually limited. According to the NBR, the direct exposure of Greek banks to Romania amounted to around EUR 4bn mid-year, i.e 1/8 of the FX reserves of the NBR. The National Bank of Austria has imposed recently a cap of 1.1 on the loan-to-depo ratio for new lending by the subsidiaries of Austrian banks. Concerns regarding the potential deleveraging of local subsidiaries of Austrian banks are not warranted, since lending by the three main Austrian-owned players (Erste's BCR, Raiffeisen Bank and UniCredit Ţiriac Bank, ranked first, third and sixth respectively by market share) increased by 6.9% yoy in September 2011, the system-wide growth rate for non-government lending being 6.7% yoy. The three banks overperformed while achieving a loan-to-depo ratio below 1.

Impressive budget performance YTD



Food price deflation explains sharp disinflation



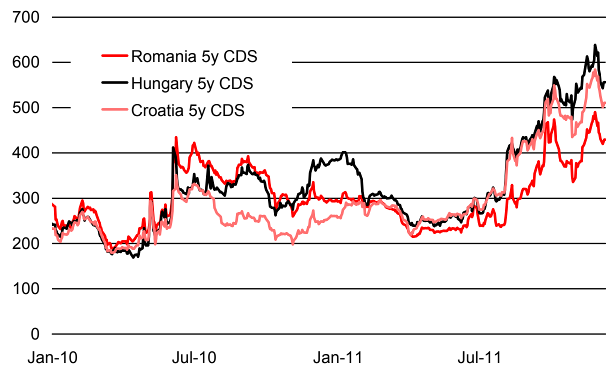
Source: UniCredit Research

Strategy: add position via the new Eurobond

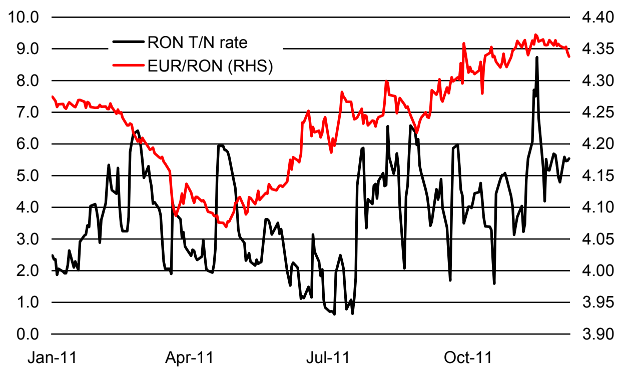
Among all asset classes we see Romanian credit the most attractive. We think the NBR will continue controlling EUR/RON rate with money market liquidity and hence see no particular reason to see the FX significantly diverging from current rates. In local currency debt the lack of significant non-resident positioning provides an important cushion but we think the yield cap introduced by the MinFin makes it a relatively unattractive asset class compared to credit.

Regarding Romanian external credit we currently see the Romani EUR 18 the cheapest but we prefer to wait for the new Eurobond and add to our position via that paper. We believe impressive YTD budget performance coupled with a strong IMF anchor should continue to see Romanian credit outperforming. We currently estimate that Romania will issue about EUR 1.5bn Eurobond while the rest of the external borrowing will be financed from IMF/WB.

Romania credit outperformed regional peers



EUR/RON is stabilized via higher money market rates



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011F	2012F	2013F
Gross financing requirement	**16.7**	**12.8**	**12.7**
Budget deficit	5.7	2.7	2.8
Amortisation of public debt	11.0	10.1	9.2
Domestic	11.0	9.4	9.2
Bonds	2.0	2.3	3.5
Bills	9.0	7.1	5.7
External	0	0.7	0
IMF/EU	0	0	0.7
Financing	**17.3**	**12.8**	**12.7**
Domestic borrowing	13.2	8.8	10.2
Bonds	4.7	1.9	4.0
Bills	8.5	6.9	6.2
External borrowing	4.1	4.0	2.5
Bonds	1.5	1.5	1.5
IMF/EU/WB	2.6	2.5	1.0
Other	0	0	0

Source: Ministry of Finance, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011F	2012F	2013F
Gross financing requirement	**43.7**	**39.2**	**38.9**
C/A deficit	4.5	4.6	4.4
Amortisation of medium to long term debt	14.2	13.6	16.0
Government/central bank	2.5	3.1	5.5
Banks	2.2	1.5	1.5
Corporates	9.5	9.0	9.0
Amortisation of short term debt	25.0	21.0	18.5
Financing	**43.7**	**39.2**	**38.9**
FDI	1.0	1.5	2.0
Equity	-0.1	0.0	0.7
Borrowing	41.0	35.4	33.3
Government/central bank	4.1	4.0	2.5
Banks	6.6	5.3	5.8
Corporates	30.3	26.1	25.0
EU Funds	1.8	2.3	2.9

Source: NBR, UniCredit Research

Slovakia (A1 stable/A+ negative/A+ stable)*

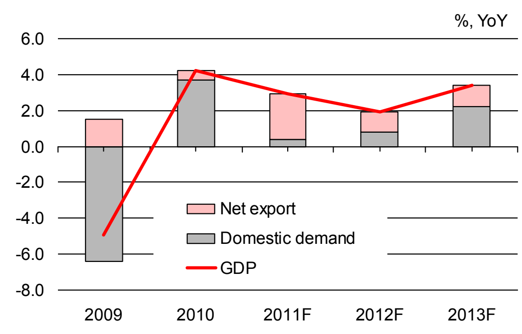
Outlook – PM Radicova's government collapsed amidst EFSF voting – early elections will take place on 10th March next year. Our base-line scenario assumes that a mixed left-right coalition government will come to power which will avoid dramatic policy shifts. The economy has been decelerating slightly in 3Q11; a more pronounced slowdown is forecast for 4Q11-1Q12 as lower demand from the euro zone will take a toll on Slovak manufacturing exports. Given the continued weak FDI inflow, further reforms and measures to give boost to the country attractiveness as an FDI destination gain urgency.

Author: Vladimír Zlacký, Chief Economist (UniCredit Bank)

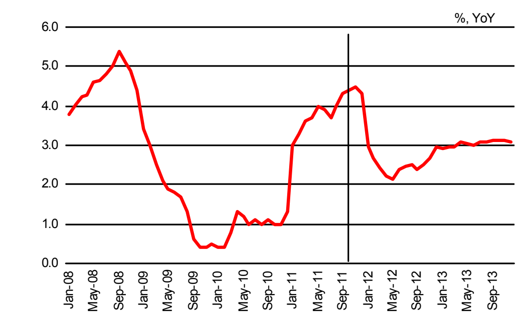
KEY DATES/EVENTS

- 10 Jan, 8 Feb, 8 Mar – Industrial production
- 13 Jan, 13 Feb, 12 Mar – CPI
- 15 Feb – flash GDP
- 6 Mar – GDP and its structure

NET EXPORT AS A MAIN GROWTH DRIVER OF SLOVAK ECONOMY IN 2011-2012



INFLATION IS EXPECTED TO DECELERATE



Source: Statistical Office SR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011F	2012F	2013F
GDP (EUR bn)	62.9	65.9	69.0	71.2	74.8
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	11,608	12,132	12,703	13,102	13,776
Real economy yoy (%)					
GDP	-4.9	4.2	2.9	1.9	3.4
Private Consumption	0.1	-0.8	-0.7	0.6	1.6
Fixed Investment	-30.2	22.1	6.6	1.9	5.1
Public Consumption	6.2	1.5	-5.0	-0.5	0
Exports	-15.9	16.5	9.7	5.5	7.1
Imports	-18.1	16.3	7.5	4.6	6.3
Monthly wage, nominal (EUR)	745	769	792	819	855
Unemployment rate (%)	12.1	14.4	13.3	13.4	13.2
Fiscal accounts (% of GDP)					
Budget balance	-8.0	-7.9	-5.1	-4.7	-2.9
Primary balance	-6.5	-6.6	-3.6	-2.7	-0.7
Public debt	35.4	41.0	44.2	47.6	48.2
External accounts					
Current account balance (EUR bn)	-2.3	-2.3	-0.6	-0.3	-0.3
Current account balance/GDP (%)	-3.6	-3.5	-0.9	-0.4	-0.4
Basic balance/GDP (%)	-2.9	-1.9	0.6	1.0	1.0
Net FDI (EUR bn)	0	0.4	0.9	1.4	1.7
Net FDI (% of GDP)	-0.1	0.6	1.3	2.0	2.2
Gross foreign debt (EUR bn)	45.2	49.7	53.3	57.0	60.6
Gross foreign debt (% of GDP)	71.9	75.4	77.3	80.0	81.0
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Inflation/Monetary/FX					
CPI (pavg)	1.6	1.0	3.9	2.5	3.0
CPI (eop)	0.5	1.3	4.3	3.0	3.1
Central bank target	2.0	EUR	EUR	EUR	EUR
Central bank reference rate (eop)	2.5	EUR	EUR	EUR	EUR
3M money market rate	4.2	EUR	EUR	EUR	EUR
EUR/USD (eop)	22.7	EUR	EUR	EUR	EUR
EUR /EUR (eop)	30.2	EUR	EUR	EUR	EUR
EUR /USD (pavg)	21.4	EUR	EUR	EUR	EUR
EUR /EUR (pavg)	31.3	EUR	EUR	EUR	EUR

Source: UniCredit Research

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

Government falls, economy decelerates

Government collapsed amidst EFSF voting, early elections in March next year

PM Radicova's coalition government collapsed in October after a junior coalition partner, liberal SaS, refused to back the vote for an EFSF upgrade which was combined with a confidence motion. The EFSF changes were approved in the second round of voting but the opposition SMER party extracted a drastic concession from the ruling coalition for its support – early elections in March next year. Inspection of the current polls suggests that SMER with more than 40% current support will clearly win the elections and – under some extreme scenarios – might even be able to form a one party government. Nevertheless, our baseline scenario assumes a mixed left-right coalition government after the March election which would likely avoid radical policy turnarounds. While a weaker push for structural reforms is to be expected, fully reneging on commitment to fiscal consolidation is rather unlikely. All major parties, including SMER, have voiced their support for fiscal consolidation even if means will surely differ. Furthermore, a new constitutional law on fiscal responsibility – likely to be adopted by the year-end - should circumscribe the room for future fiscal excesses.

The interim government plans to adopt 2012 budget with a less ambitious target

The most crucial fiscal target is set by the excessive deficit procedure – Slovakia is required to reduce its public finance deficit below 3% in 2013. Our base-line scenario assumes that the next government will attempt to meet this target. Political considerations clearly play a role in the run-up to the March elections. The current coalition government, governing for the interim period, has opted for a less ambitious 2012 deficit target of 4.6% GDP (originally 3.8%). While this means a slowdown in fiscal, the laxer (than originally planned) fiscal policy will lend some support to the decelerating economy in 2012. The announced 3Q11 GDP figures (+0.8% qoq sa, 3.0% yoy) suggest that the Slovak economy slowed somewhat (on the annual basis) vis-à-vis 2Q11, in line with our expectations. The structure of growth indicates that net exports continued to be the main driver alongside with investments (+5,9% yoy). However, overall gross capital formation declined by 12.1% due to a much lower addition to inventories than in 3Q10 – household consumption (-0.9% yoy) and government consumption (-3.3% yoy) were also a drag on growth. Overall, the growth was highly imbalanced in 3Q11 with the net exports' contribution to growth 9ppt while that of the domestic demand negative 6ppt. Some improvement was registered on the labour market as the number of employed people grew by 1.7% yoy in 3Q11. The CPI inflation, which has climbed to 4.4% in October, is likely to peak at 4.5%-4.6% in November before falling down in the following months. In 2012 we expect average inflation to decline to 2.5% which should give a boost to real household incomes generating a moderate recovery in household consumption. In an environment of lower demand from the ailing euro zone economies for Slovak exports, this will lend some domestic support. We now forecast 1.9% yoy economic growth in 2012 (previously 2.8%).

The economy decelerating, strong disinflation ahead

FDI has not recovered since the crisis

The most recent FDI data for the first seven months of the year suggest that inflows have still not accelerated, registering a meager 0.9% of GDP. Further reforms and measures to boost the country's attractiveness as a destination for FDI thus gain urgency. A high profile attempt of a large existing electronics producer to relocate further east – which was reconsidered only after the government offered generous tax breaks – is just the tip of the iceberg. The coming slowdown might further accentuate the process of eastward re-allocation of several firms with a negative impact on growth and employment.

The banking sector stable and profitable

The banking sector remains stable, well capitalized and profitable (double-digit ROE). Corporate credit has been growing by 7%-8% yoy in the last few months, while core corporate deposits were stagnant. Retail deposits have been increasing by strong 7% yoy and accelerating reflecting increasing households' savings rate as well as ashift from riskier assets into cash. Retail loans were slightly decelerating recently (to ca 11% yoy growth) due to slowdown in the growth of mortgages (still +17% yoy). The banking sector will be negatively affected by the bank levy which will be introduced in 2012 and will bring about EUR 100 mil. into state coffers. During the turbulent times post EFSF voting S&P stated that the current A+ rating could be endangered if the political situation worsens the consolidation of public finances and delays ongoing reforms. Moody's commented that the government's downfall is credit negative as it increases uncertainty and jeopardizes the fiscal targets of the Radicova government.

Rating agencies warn about the possibility of lower rating

Slovenia (Aa3 negative/AA- negative /AA- negative)*

Outlook – Headwinds for the economy are building as we move into 2012 where we forecast a contraction of GDP of 0.5% yoy. Although elections on 4 December produced a surprising result regardless of the make up of the new government, financing pressures within the core as well as the periphery of EMU are ever increasing, with any shortfalls in policy being rapidly punished. With this in mind, the newly elected government will have to act quickly to protect Slovenia against excessive pressures.

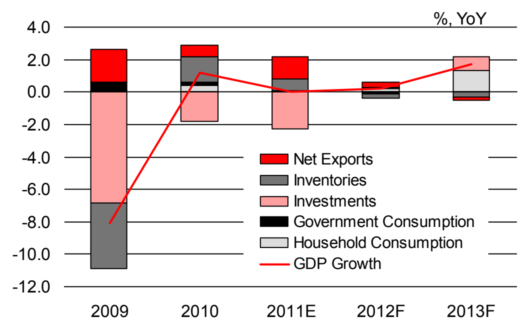
Strategy outlook – We believe Slovenian bonds are cheap but liquidity is a problem with bid ask widening to a few big figures. We would cautiously add to positions via Slorep 21 papers.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)

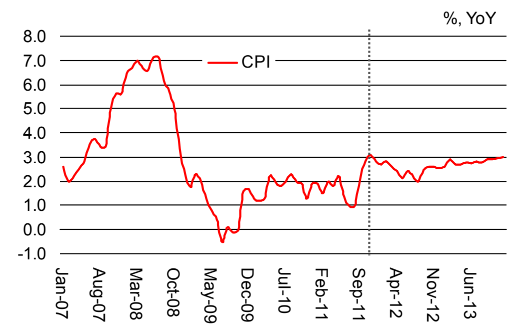
KEY DATES/EVENTS

- Dec/January: formation of government talks
- January 12th: ECB governing council meeting
- February 9th: ECB governing council meeting
- Late February: 4Q11 GDP release

GROWTH TO BE BALANCED AND MODERATE



INFLATION IS OFF THE PEAK



Source: Slovenian Statistical Office, Bank of Slovenia, Ministry of Finance, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	35.3	35.4	36.3	37.0	38.3
Population (mn)	2.0	2.0	2.1	2.1	2.1
GDP per capita (EUR)	17,309	17,293	17,665	17,939	18,558
Real economy yoy (%)					
GDP	-8.0	1.4	0.5	-0.6	1.1
Private Consumption	-0.1	-0.6	0.2	0	1.0
Fixed Investment	-23.3	-8.3	-10.4	0.6	3.0
Public Consumption	2.9	1.5	0.1	-1.0	-1.0
Exports	-17.2	9.5	7.5	4.2	5.0
Imports	-19.6	7.2	5.6	3.0	4.6
Monthly wage, nominal (EUR)	1,439	1,495	1,520	1,565	1,615
Unemployment rate (%)	5.9	7.3	8.2	7.8	7.4
Fiscal accounts (% of GDP)					
Budget balance	-6.0	-5.6	-5.8	-4.5	-3.5
Primary balance	-4.7	-4.1	-3.7	-2.6	-2.1
Public debt	35.9	40.7	48.2	51.9	53.5
External accounts					
Current account balance (EUR bn)	-0.5	-0.3	-0.1	-0.3	-0.4
Current account balance/GDP (%)	-1.3	-0.8	-0.2	-0.8	-1.0
Basic balance/GDP (%)	-3.1	0.1	1.7	1.9	2.3
Net FDI (EUR bn)	-0.6	0.3	0.7	1.0	1.3
Net FDI (% of GDP)	-1.8	0.9	1.9	2.7	3.3
Gross foreign debt (EUR bn)	40.3	40.9	43.0	44.8	48.0
Gross foreign debt (% of GDP)	114.1	115.5	118.5	121.1	125.3
FX reserves (EUR bn)	0.7	0.8	0.8	0.7	0.7
Inflation/Monetary/FX					
CPI (pavg)	0.9	1.8	2.0	2.4	2.6
CPI (eop)	1.8	1.9	2.8	2.3	3.0
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	1.0	1.0	1.3	1.0	1.8
3M money market rate	1.2	0.8	1.4	1.7	2.6
EUR/USD (eop)	EUR	EUR	EUR	EUR	EUR
EUR /EUR (eop)	EUR	EUR	EUR	EUR	EUR
EUR /USD (pavg)	EUR	EUR	EUR	EUR	EUR
EUR /EUR (pavg)	EUR	EUR	EUR	EUR	EUR

Source: UniCredit Research

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

Focus shifts to reform requirements

GDP contracts 0.5% yoy in 3Q as gross fixed capital formation stays very weak

In 3Q11 the economy contracted 0.5% yoy and 0.2% qoq seasonally adjusted on chronically weak investment activity. For 2011 we now expect growth of only 0.5% yoy. Moreover the downside risks to 2012 are on the increase. As well as the need for a great fiscal effort, we note exports of goods and services amount to approximately 70% of GDP. The deteriorating outlook for EMU growth, especially in 1H12, has the potential via the trade channel to impact on growth rather significantly. In addition, domestic credit to non-financial enterprises is contracting this year – we do not have a breakdown of lending data by sectors in 2011 but data for 2010 from the central bank's Financial Stability Review shows the financial and insurance activities, professional services, real estate and wholesale and retail trade sectors all saw reductions in bank loans while manufacturing saw a sharp slowdown in growth (to only EUR 22mn). It is unlikely that the banking sector will be able to support the economy very rapidly. We forecast a contraction in GDP of 0.5% yoy in 2012.

Slovenia is not like a traditional 'periphery economy'

Though a member of EMU and located on the periphery, it is important to point out that Slovenia does not share many of the characteristics of a traditional 'periphery economy'. Slovenia has already undergone a sharp C/A adjustment – from a deficit of 6.7% of GDP in 2008, we forecast this year's C/A deficit at 0.2% of GDP. At a negative 37% of GDP last year, Slovenia's net international investment position is much more favorable than many other small economies within EMU. The banking sector appears relatively stable considering its borrowings from the ECB at the end of September amounted to EUR 423mn compared to EUR 602mn at the end of 2010. At 48% of GDP public debt is still low, though more than double end-08 ratios.

Nonetheless, fiscal consolidation must be addressed

That said fiscal consolidation must be addressed. Public debt should be roughly 48% of GDP at the end of 2011, well inside the Maastricht criterion, but in an environment of slow growth that ratio will rise towards 60% of GDP in the near to medium term without a change in policy settings. Our estimates suggest that following Croatia, Slovenia has the most work to do within CEE to stabilise public debt to GDP. We expect the Euro zone countries to be under even greater pressure heading into 2012 to consolidate their fiscal positions. Although we are waiting for a new government to be formed and to outline its economic policy, we therefore forecast a deficit of 4.5% of GDP in 2012 and 3.5% in 2013.

Relatively high public sector borrowing requirement in 2012 of EUR 4bn

We estimate that the government will need to borrow slightly more than EUR 3bn to cover the budget deficit and maturing debt obligations in 2012. In addition, we note that there are EUR 2bn in banking sector loans under government guarantee maturing next year – in a worst case scenario the government would have to borrow in excess of EUR 5bn next year. We also note the Ministry of Finance announced on 22 November said it may issue as much as EUR 4bn in debt, including in non-euro markets if needed.

Solid current account and international investment position, but risks remain

Though Slovenia's C/A and IIP position looks solid, the economy may struggle to rollover existing borrowings. A glance at the breakdown of its net international investment position suggests that while the headline shortfall is not excessive, Slovenian entities have borrowed significant amounts offshore over recent years, in part to finance domestic expansion but also to increase their investments offshore. The majority of foreign capital inflows have been debt creating in nature.

Election outcome a bit of a surprise, but economic policy moves will be influenced by market conditions

The elections on 4 December threw up a surprise with the center-left Positive Slovenia party gaining the most votes. Negotiations over the new government may prove drawn out given most likely 4 parties will be needed to form a comfortable majority in parliament. Regardless of the make up of the new government, financing pressures within the core as well as the periphery of EMU are ever increasing, with any shortfalls in policy being rapidly punished. With this in mind, the newly elected government will have to act quickly to protect Slovenia against excessive pressures.

Bosnia Herzegovina (B2 negative/B negative/Not rated)*

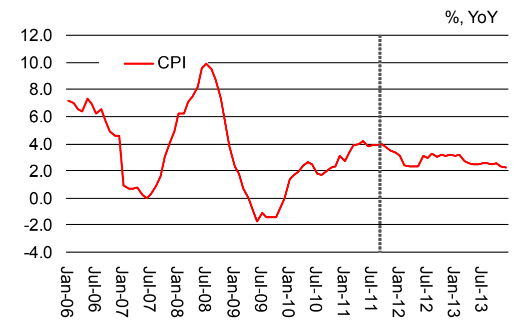
Outlook – Although export growth has been solid in 2011 the worsening external environment is having an impact and we have accordingly revised our 2012 forecast from 1.5% to 0.5% in 2012. We expect the fiscal deficit to widen in 2012 and would expect the formation of a national level government in 2012 to enable a re-engagement with international financial institutions which would provide a much needed boost in sentiment toward Bosnia Herzegovina.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)

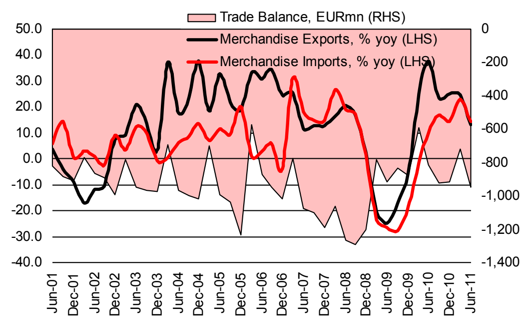
KEY DATES/EVENTS

- 25 January CPI and Industrial production
- 25 February CPI and Industrial production
- March/April balance of payments 2011

CPI EXPECTED TO MODERATE



MERCHANDISE EXPORTS UNDER PRESSURE



Source: Statistical Agency of BiH, Central bank of BiH, IMF, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	12.3	12.5	13.2	13.6	14.3
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,194	3,258	3,437	3,550	3,731
Real economy yoy (%)					
GDP	-2.9	0.7	1.8	0.5	2.5
Monthly wage, nominal (EUR)	616	622	650	672	693
Unemployment rate (%)	41.5	42.9	43.3	43.5	43.0
Fiscal accounts (% of GDP)					
Budget balance	-5.7	-4.5	-4.0	-4.5	-3.5
Primary balance	-5.1	-3.7	-3.1	-2.8	-2.2
Public debt	35.4	39.2	41.2	44.3	45.7
External accounts					
Current account balance (EUR bn)	-0.8	-0.7	-1.0	-1.0	-1.2
Current account balance/GDP (%)	-6.2	-5.6	-7.9	-7.2	-8.4
Basic balance/GDP (%)	-4.7	-4.2	-6.4	-6.1	-6.3
Net FDI (EUR bn)	0.2	0.2	0.2	0.2	0.3
Net FDI (% of GDP)	1.5	1.4	1.5	1.1	2.1
Gross foreign debt (EUR bn)	0	0	0	0	0
Gross foreign debt (% of GDP)	0	0	0	0	0
FX reserves (EUR bn)	3.2	3.3	3.2	3.3	3.3
Inflation/Monetary/FX					
CPI (pavg)	-0.4	2.2	3.7	2.8	2.6
CPI (eop)	0	3.1	3.3	3.2	2.4
3M money market rate	0.9	0.6	1.2	1.5	2.5
BAM/USD (eop)	1.37	1.47	1.47	1.43	1.40
BAM/EUR (eop)	1.96	1.96	1.96	1.96	1.96
BAM/USD (pavg)	1.41	1.48	1.41	1.49	1.42
BAM/EUR (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 slow in 2012 on weaker external environment

GDP growth forecast unchanged for 2011 but lowered to 0.5% in 2012 on weaker external environment

GDP growth forecast is unchanged for 2011 at 1.8%, mostly due to solid exports of goods and the related trend of industrial production in the first three quarters of this year. Thus, merchandise exports in this period rose 17.4% yoy, and industrial production 6.9% yoy over this period. Nevertheless, the deteriorating external environment is adversely impacting on economic activity in Bosnia and Herzegovina. There is already a deceleration in October's industrial production with growth of only 0.6% yoy. While headline merchandise trade figures to October still suggest solid export performance, key export sectors such as basic metals, metal products, mining and wood and wood products are all exhibiting signs of deceleration. In addition, we expect weak private consumption on minimal wage and loan dynamics. Therefore, our forecast of real GDP growth is revised from 1.5% yoy to 0.5% yoy in 2012.

Weaker growth and high expenditure levels lead to higher fiscal deficit in 2012

Insufficient efforts of entity governments to cut public expenditures and our expectations of slower growth underpin our moderate revision of the fiscal deficit to 4.5% of GDP in 2012. At same time we expect a slight reduction of the estimated deficit for this year to 4.0% of GDP, predominantly as a result of rising indirect tax revenues in the first 3Q of this year. The fiscal position in Republika Srpska, which in recent years has been stronger than the Federation, is also deteriorating. This is mainly due to increased expenditures for health and pensions, to a lesser extent because of investment in energy and infrastructure projects. This deterioration in the RS fiscal position may, however, improve the chances of a deal on the formation of a national level government. Meanwhile, the existing arrangement with the IMF expires in July 2012, with only one-third of available funds drawn down – a new deal is contingent upon a national government being formed.

Higher yields likely as governments turn to local t-bill issuance to finance deficits

Stronger dynamics on the domestic financial market: Both the Federation and Republika Srpska governments began issuing t-bills and t-bonds in 2011 as the IMF program was effectively suspended. In 4Q11 yields have risen. We expect accelerated issuance of t-bills and t-bonds in 2012 but with yields rising given the recent sovereign downgrade by S&P. The national level government, once formed, will also likely show interest in financing its activities locally, especially given the need to repay previously disbursed funds to the IMF at the end of 3Q and during 4Q12.

Lower current account deficit in 2012, but financing pressures remain as first repayments to IMF occur in 2H12

Slow down in foreign trade will provide slightly narrower current account deficit in 2012. Considering the trends in the current account items and in the value of foreign trade, we have increased our current account deficit forecast for 2011 (from 7.2% to 7.9%), while the combination of substantially lower exports and imports through weak private consumption and less imports of raw materials will lead to a lower current account deficit of 7.2% in 2012 (previous forecast 8.3%). Portfolio inflows and reductions in external assets are increasingly important sources of financing BiH's current account deficit. While we expect minimal FDI inflows in 2012, the banking sector's access to external financing will remain in place even though net inflows will be lower compared to previous years.

Pressure grows for formation of national level government

Efforts to formulate a national level government continue. With domestic and international pressure to form a government rising, we expect a government to be formed in 2012. The formation of a national level government and the negotiation of a new deal with the IMF would be important factors in improving sentiment toward BiH in 2012.

Sovereign rating remains under pressure

Sovereign rating. On 30 November 2011, Standard and Poor's lowered the long term credit rating by a notch from B+ to B with negative outlook citing the inability to form a national level government and its implications for the 2011 and 2012 budgets (the national level budget is only 9% of public spending) as the main rationale for the move. Given the ongoing political uncertainty in the country the sovereign rating remains exposed to downside risk.

Croatia (Baa3 stable/BBB- negative/BBB - negative)*

Outlook – The weaker global outlook in 1H12 combined with the expected fiscal tightening post-elections is likely to push the economy back into recession in 2012. The main focus in the near-term will be the economic policy initiatives the new government announces given Croatia's sovereign credit rating is on the bottom investment grade rung with two of three agencies maintaining a negative outlook

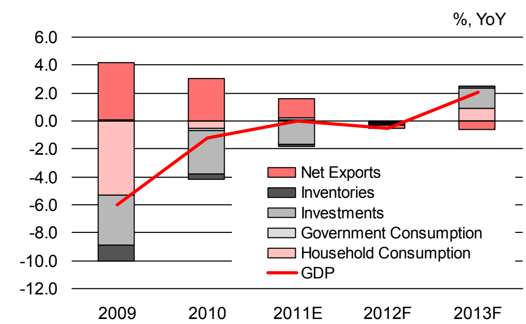
Strategy outlook – Croatian Eurobonds are cheap compared to the region and current credit rating. The reason is uncertainty regarding an IMF cooperation following the election. Liquidity is an issue but on balance we recommend buying Croatia USD 21 papers on dips.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)

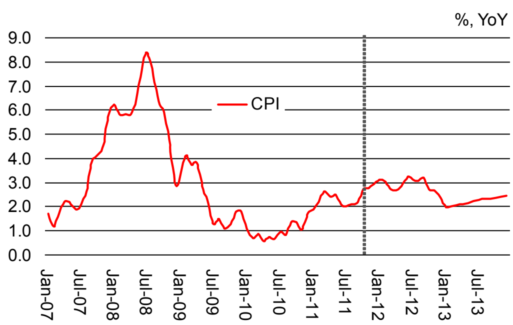
KEY DATES/EVENTS

- Early January: constitution of the new parliament and confirmation of the new government
- January/February: referendum on joining the EU
- 24 February: Flash estimate for 4Q GDP

GDP GROWTH DRIVERS



INFLATION OUTLOOK



Source: Central Bureau of Statistics, Croatian National Bank, Ministry of Finance, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	45.7	45.9	46.0	47.0	49.4
Population (mn)	4.4	4.4	4.4	4.4	4.4
GDP per capita (EUR)	10,310	10,388	10,423	10,645	11,182
Real economy yoy (%)					
GDP	-6.0	-1.2	0	-0.5	2.0
Private Consumption	-8.5	-0.9	0.2	-0.1	2.0
Fixed Investment	-11.8	-11.3	-7.0	-0.3	6.5
Public Consumption	0.2	-0.8	0.5	-0.4	0
Exports	-17.3	6.0	-3.5	1.3	4.5
Imports	-20.4	-1.3	-5.8	1.7	5.2
Monthly wage, nominal (EUR)	1,051	1,053	1,048	1,072	1,125
Unemployment rate (%)	9.1	11.8	13.3	13.1	12.5
Fiscal accounts (% of GDP)					
Budget balance	-3.9	-4.8	-6.0	-5.0	-4.0
Primary balance	-2.4	-2.9	-2.9	-2.4	-1.8
Public debt	35.2	41.2	49.6	53.4	55.3
External accounts					
Current account balance (EUR bn)	-2.4	-0.5	-0.2	0	-0.6
Current account balance/GDP (%)	-5.2	-1.1	-0.4	0	-1.1
Basic balance/GDP (%)	-2.6	-0.4	1.3	2.5	2.4
Net FDI (EUR bn)	1.2	0.3	0.8	1.2	1.8
Net FDI (% of GDP)	2.6	0.7	1.6	2.6	3.5
Gross foreign debt (EUR bn)	45.2	46.5	46.8	47.3	50.0
Gross foreign debt (% of GDP)	99.0	101.2	101.5	100.6	101.2
FX reserves (EUR bn)	10.4	10.7	11.0	11.5	12.0
Inflation/Monetary/FX					
CPI (pavg)	2.4	1.1	2.4	2.9	2.2
CPI (eop)	1.9	1.8	2.9	2.4	2.4
Central bank reference rate (eop)	6.0	6.0	6.0	6.0	6.0
3M money market rate	8.6	1.2	1.3	2.0	2.1
HRK/USD (eop)	5.11	5.55	5.64	5.47	5.27
HRK /EUR (eop)	7.31	7.38	7.50	7.50	7.38
HRK /USD (pavg)	5.28	5.52	5.35	5.67	5.37
HRK /EUR (pavg)	7.34	7.29	7.44	7.46	7.40

Source: UniCredit Research

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

Focus shifts to economic policy after elections

Positive 3Q, but outlook for 2012 has deteriorated

Economy expands in 3Q by 0.6% yoy. In seasonally adjusted terms the economy grew 0.3% qoq according to our estimates. Industrial production remains weak at -1.3% yoy over Jan-Oct while headline merchandise exports rose only 0.8% yoy in the same period. More positively, the 3M seasonally adjusted MA of underlying export growth (ex ships and oil) in October grew 3.9% yoy. We expect the economy to flat line in 2011 (down from 0.2% previously) but we mark our 2012 GDP forecast down from 1.0% yoy to -0.5% yoy. A combination of expected fiscal tightening, weak external environment in 1H12, no scope for a loosening of monetary policy and relatively weak domestic credit activity drive this forecast. The main risk on the domestic scene we see for 2012 is the public sector borrowing requirement – in an environment where access to external financing is limited, the risk of crowding out the private sector is greater the larger the public sector's borrowing needs.

GDP forecasts lowered as external environment sours and expectations for 2012 are scaled back

Current account – a surplus is not out of the question. A solid tourist season and declining merchandise imports lead us to forecast a current account deficit of only 0.4% of GDP in 2011. In 2012 we forecast a balanced current account, but this could easily turn to a surplus should import growth contract more than we forecast. With a pick up in FDI to EUR 1.2bn the basic balance would move to a surplus of 2.5% of GDP in 2012. Nonetheless, with an estimated EUR 18bn in foreign debt to service in next year the issue of external financing looms large. So far the rollover ratio of foreign debt has been in excess of 100% each year since 2008. While we expect corporates to moderately reduce exposure to external debt in 2012, the banking sector will generate inflows, although to a lesser extent than in previous years.

We see a slightly higher budget deficit in 2011 and minimal scope for a looser monetary policy stance

Fiscal and monetary policy outlook. In 2012 we expect the new government to embark on a fiscal consolidation and maintain our 5.0% of GDP fiscal deficit forecast to reflect this expectation, even though the details of the government's economic policy are yet to be revealed. Together with the refinancing needs of the general government this implies a total borrowing requirement of EUR 3bn in 2012. The one distinct advantage the new government has is that it has no external bonds to refinance until April 2014. A scenario with an IMF program in place is likely. The EUR/HRK remains exposed to the risk of upward pressure despite a balanced external account given the ongoing euro zone crisis and high external debt service obligations. We therefore see no scope for a loosening of monetary policy settings, noting that the central bank increased mandatory reserve requirements from 13% to 14% effective 12 October.

Elections expected 4 December amid uncertainty over economic policy in 2012

New government in place. Elections on 4 December saw the center-left Social Democrat-led Kukuriku coalition sweep to power with 81 seats in the 151 member parliament. This implies a stable majority of 6 in the new parliament, which is more solid than it might seem at first given Croatian governments have traditionally enjoyed the support of ethnic minority members of parliament (the outgoing government relied on the 8 ethnic minority votes for their majority). With a clear majority there is no need for negotiations over the formation of a new government which means that once the leader of the coalition gets a mandate from the president, he should be in a position to form a government well within the 30 day limit set out in the constitution. The bottom line is that a new government should be up and running by mid-January 2012 at the latest.

No change to credit rating, for now

Sovereign credit rating outlook. Now that the election is out of the way and a new government is expected to be formed relatively soon, the focus shifts to concrete economic policy measures. As we have said in the previous reports, a credible plan to generate a fiscal surplus over the life of the next parliament, accelerated structural reforms and more openness toward private sector investments are key to maintaining the sovereign investment grade credit rating.

Kazakhstan (Baa2 stable/BBB+ stable/BBB positive)*

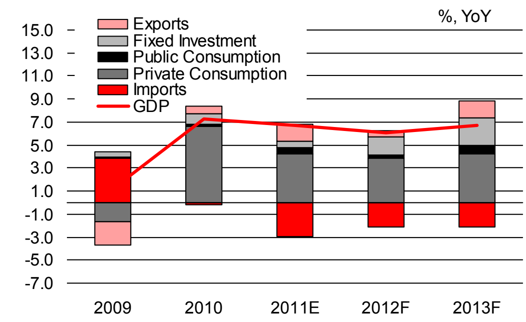
Outlook – Real GDP growth remained at strong 7% yoy in 1Q-3Q11. We hope that the current investment fatigue in oil and gas is transitory and growth can remain above 6% also long-term. The weak spot continues to be banking. In terms of sovereign risk this is however outweighed by solid government finances, prompting S&P and Fitch to upgrade Kazakhstan's ratings recently. For 2012 we forecast economic growth to hold up at 6.0% despite somewhat lower export growth as terms of trade stay relatively favorable and allow further increases in incomes and consumption while investment regains momentum. We drop however our appreciation expectations and see the KZT broadly unchanged vs. the USD in 2012, because a moderately lower C/A surplus and continued high portfolio outflows combine with weaker RUB prospects.

Author: Hans Holzhacker, Chief Economist (ATF Bank)

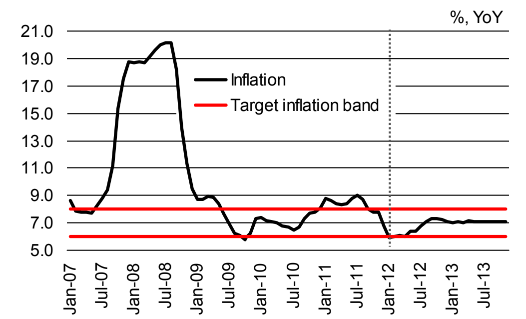
KEY DATES/EVENTS

- Parliamentary elections on 15-16 January
- New government in January or February
- Final concepts for distressed asset fund, BTA, peoples IPO to be published in 1H2011

2011 GROWTH CONSUMPTION-DRIVEN; WE HOPE INVESTMENT REGAINS SOME MOMENTUM



INFLATION BACK WITHIN TARGET



Source: ASRK, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	77.3	111.5	134.0	157.9	171.9
Population (mn)	16.2	16.4	16.6	16.7	16.9
GDP per capita (EUR)	4,772	6,781	8,078	9,432	10,178
Real economy yoy (%)					
GDP	1.2	7.3	6.8	6.0	6.7
Private Consumption	-2.8	10.9	7.0	6.4	6.9
Fixed Investment	1.9	3.8	2.2	6.6	9.5
Public Consumption	1.1	2.7	7.5	3.1	10.6
Exports	-6.2	1.9	4.5	1.7	4.8
Imports	-15.9	0.9	11.9	8.6	8.6
Monthly wage, nominal (EUR)	329	397	437	521	556
Unemployment rate (%)	6.6	5.8	5.4	5.2	5.0
Fiscal accounts (% of GDP)					
Budget balance	-4.3	3.0	5.5	5.0	5.2
Primary balance	-3.9	3.5	6.3	5.8	6.0
Public debt	13.9	14.8	12.6	13.8	14.6
External accounts					
Current account balance (EUR bn)	-2.4	3.3	6.3	5.4	3.2
Current account balance/GDP (%)	-3.2	2.9	4.7	3.4	1.9
Basic balance/GDP (%)	8.5	9.5	11.2	7.6	6.1
Net FDI (EUR bn)	9.0	7.4	8.8	6.6	7.2
Net FDI (% of GDP)	11.7	6.6	6.6	4.2	4.2
Gross foreign debt (EUR bn)	75.5	86.9	84.2	84.8	87.0
Gross foreign debt (% of GDP)	97.7	77.9	62.8	53.7	50.6
FX reserves (EUR bn)	15.9	20.8	23.6	24.2	25.4
Inflation/Monetary/FX					
CPI (pavg)	7.3	7.1	8.5	6.6	7.1
CPI (eop)	6.2	7.8	7.8	7.2	7.1
Central bank target	7.0	7.0	7.0	7.0	7.0
Central bank reference rate (eop)	7.0	7.0	7.5	7.5	7.5
3M money market rate	9.6	2.0	1.8	3.8	4.0
KZT/USD (eop)	148.4	147.4	147.5	147.5	147.5
KZT /EUR (eop)	212.2	196.0	196.2	202.1	206.5
KZT /USD (pavg)	147.5	147.4	146.6	147.5	147.5
KZT /EUR (pavg)	205.0	194.5	203.7	194.0	203.4

Source: UniCredit Research

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

A rare country to see its ratings upgraded

S&P and Fitch upgrade

Fitch Ratings on 21 November 2011 upgraded Kazakhstan's long-term foreign issuer default ratings to 'BBB' from 'BBB-', Standard & Poor's on 11 November 2011 to BBB+ from BBB. We agree that Kazakhstani sovereign risk is low, given combined reserves of the central bank and the National Oil Fund of USD 75bn (44% of GDP, 85% of net assets of the banking system). We regard the political situation as rather stable and view the likelihood of severe rifts in the society due to the succession of the President as rather limited. In view of the currently low investment, we are a bit more concerned than S&P on whether indeed the "oil output will almost double over the next decade". We believe, as the rating agencies do, that bank "debt and risks remain significant, particularly regarding BTA Bank", but see only a moderate impact on the government's creditworthiness.

Real GDP growth strong but primarily consumption-driven; some signs of a slowdown

Real GDP grew 7.0% yoy in Jan-Sep 2011. We estimate that this translates into 6.9% yoy growth in 3Q, somewhat weaker than the 7.3% yoy in 2Q. Growth continues to be consumption-driven: constant price retail sales were up 12.7% yoy in Jan-Oct. One reason is cars: the number of imported passenger cars increased by 37.7% yoy in Jan-Sep to 27,164. The housing market has bottomed out: In Jan-October, 13.7% more sale-purchase contracts were concluded than in the year before; prices (in KZT) increased 9.4% yoy on the secondary market to KZT 112.9K (USD 763/m2) in October. Wages were 7.3% higher in Sep than the year before in real terms, average per capita incomes grew 5.9% (to EUR 228). Thanks to the consumption-driven nature of growth, we expect only a moderate impact from global turbulences. However, with industrial output stagnating and exports past peak in 3Q, we reduce our full year 2011 GDP forecast slightly from 7.0% to 6.8%.

Investment sluggish, industry grew a mere 1.5% yoy in October, mining particularly weak

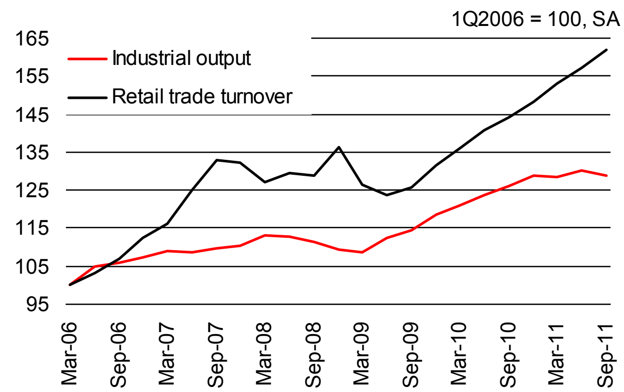
Investment and growth in industry need to be stronger to keep growth prospects intact long-term (we hope for above 6% growth). Investment outlays rose a mere 0.8% yoy in Jan-October, investment in mining fell 6.8% yoy. Industrial output was up a rather weak 4.0% yoy in Jan-Oct and a mere 1.5% yoy in October alone. Mining was down 2.1% yoy in October and up only 1.9% yoy in Jan-October. Manufacturing did better at 6.9% yoy in Jan-October. However, while chemicals continue to grow fast, such important branches as metallurgy and food show weakness now as well.

Current account positive, but in 3Q2011 substantial overall BoP outflows.

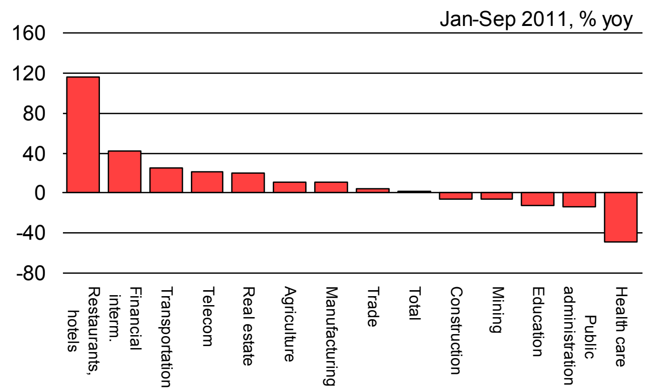
The current account was USD 113.5mn in surplus in 3Q according to preliminary NBK data, bringing the 9M2011 surplus to USD 9.3bn or roughly 7% of 9M GDP. Export growth slowed to 21% yoy in USD terms in 3Q from 62% yoy in 2Q, import growth from 43% to 24% yoy. We expect a further deceleration in export growth in 4Q. Reserves were up USD 3.6bn over the 9M but fell by USD 1.6bn in 3Q2011 with portfolio investment outflows totaling USD 3.2bn (1.3bn in resident investment abroad, 1.9bn in reflows of non-resident investment) and short-term capital outflows of USD 0.8bn. Net inward FDI at USD 2.5bn in 3Q was rather on the weak side (in 4Q2010 it was 3.4bn and in 3Q2010 3.0bn) and fits in the picture of current investment fatigue in oil and gas. FDI figures by industries (for 1H2011) show an USD 0.4bn outflow from the oil-gas industry in 2Q.

GROWTH IS CONSUMPTION-DRIVEN

Industrial output and retail sales, constant prices



Investment outlays



Source: ASRK, NBRK, UniCredit Research

We expect an overall fiscal surplus (oil+nonoil) of 5.0% in 2012 of GDP vs. 5.5% in 2011

Fiscal policy is set to remain prudent. The budget law for 2012-2014 foresees a Republican (central government) budget deficit of 2.6% of GDP in 2012, narrowing to 1.5% of GDP in 2013 and 1.3% of GDP in 2014 - down from planned 2.8% of GDP in 2011 (we believe the actual outcome will be 2.5% of GDP this year). Transfers from the Oil Fund are fixed at KZT1.2trn (USD 8bn) per year. Budget revenue in 2012 is forecast at 16.0% of GDP, an increase of 7.1% over the 2011 budget. Budget expenditures for 2012 are planned at 18.6% of GDP, an increase of 6.6%. We expect for 2012 an overall fiscal (oil + non-oil) surplus of 5.0% of GDP vs. 5.5% in 2011.

Inflation eases as money growth slows. In contrast to Russia, no liquidity crunch in Kazakhstan

Growth in 3M slowed to 13.4% yoy in October from 16.8% yoy in September. Growth in M1 fell to 14.7% yoy from 20.2% yoy with money supply contributing little to inflation pressures. At the same time, the 12.2% mom increase in banks' reserve holdings with the NBRK in October shows that liquidity is not scarce in Kazakhstan. The NBRK is unlikely to take either tightening measures or measures in support of liquidity. Inflation eased to 7.8% in Nov, within the central bank's implicit target of 6%-8%. We expect a further decline due to the statistical base effect to as low as 6% in Feb-March 2012 and a return to marginally above 7.0% by Dec 2012 with little change in the underlying monthly inflation rate as easing food price pressures are outweighed by faster tariff hikes.

Some credit growth, but concentrated at banks with aggressive policies while sector problems are largely unresolved

Credit grew 12.7% yoy in October, 11.2% YTD, compared with -2.0% YTD in Oct 2010. Though perhaps 3pp of this was due to accounting (writing back of loans), there actually has been moderate credit growth in 2011. However, NPLs are still on the rise. The MinFin drafted a new law separating rehabilitation and bankruptcy processes and introducing creditor councils. Amendments to the tax law have been adopted, which should ease the writing off of bad loans, but all this, along with the planned distressed asset fund, still needs to be put into practice. The road to banking system health will remain lengthy and bumpy, given the magnitude of the accumulated problems. BTA is currently drawing up a new business plan. After reviewing the plan the state-holding SK will decide to what extent BTA will be re-capitalized and what other measures are to be taken.

We believe the KZT to remain in a 145-150 corridor to the USD over the forecast period

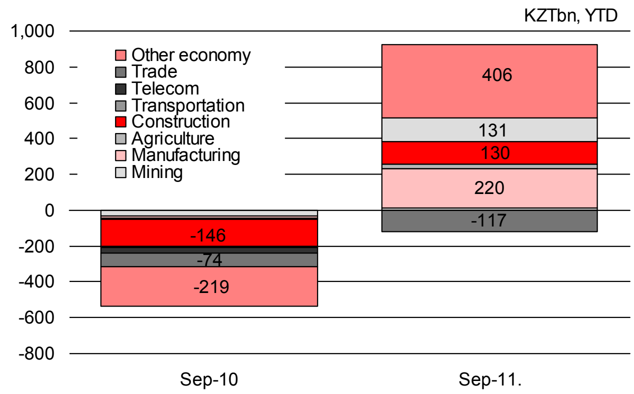
After intervening against the KZT until May, the NBRK sold foreign exchange in the amount of roughly USD 4.7bn in June-Oct. However, purchases and sales of FX began to match in November. We believe that the NBRK has sufficient reserves to hold the KZTUSD below 150 unless the international situation worsens sharply. At the same time, we do not believe the NBRK – considering the turbulent global environment – has any appetite to allow appreciation below 145 any soon.

Elections, brought forward from Aug to Jan 2012, rather stabilize the current political system; substantial policy changes are unlikely

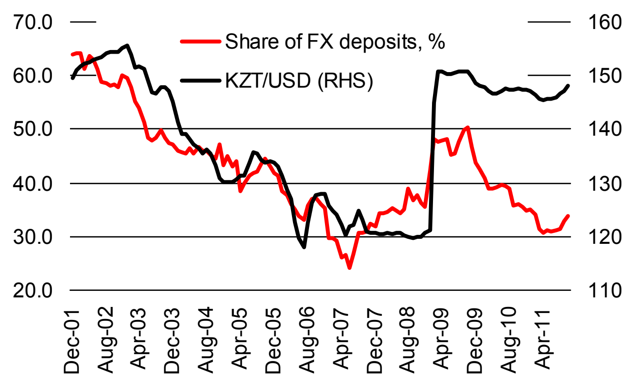
Elections to the lower house of parliament, the Majilis, are scheduled for 15 January 2012. At least one party beside the ruling Nur Otan will have to be represented according to new legislation. Though some government reshuffling will take place after the elections, we do not expect any dramatic policy changes, with Nur Otan being highly likely to win the overwhelming majority of seats.

LOAN GROWTH IN MOST INDUSTRIES EXCEPT TRADE

Loans by industry, change in stocks



Share of foreign exchange in overall deposits vs. the FX-rate



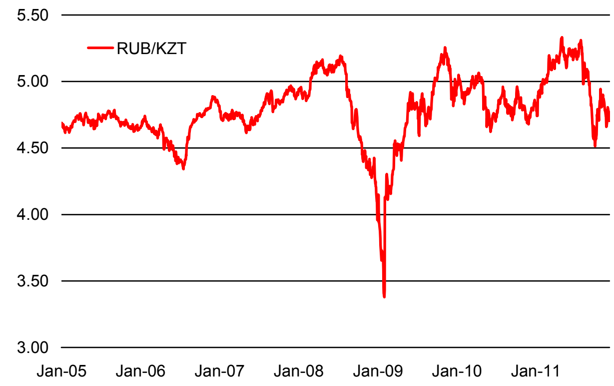
Source: NBRK, UniCredit Research

Strategy: we do not see particular value in KZT

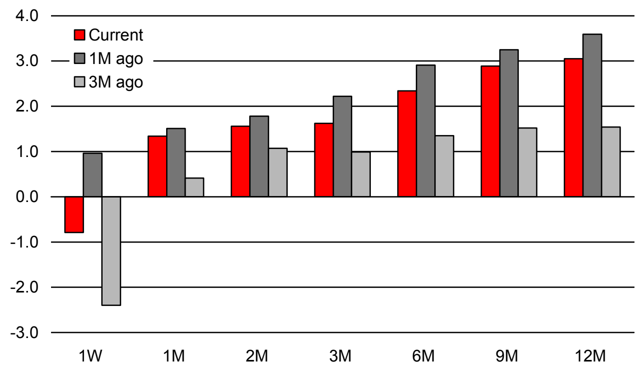
As opposed to one year ago when the strong RUB some upside pressure on RUB raised the chance of the potential KZT revaluation this time around we think the outlook for the KZT is fairly stable. We note that the RUB/KZT cross is roughly in line with long term average and hence we see no particular pressure on the NBK to move in either side. We think the RUB would need to move 20/25% in either direction before this option is seriously considered.

Meanwhile we note that implied yields in KZT NDF market are also fairly low and ranging around 2%-4%. We think this is not enough risk premium to bet even on the stable KZT outlook. Accordingly we remain neutral on KZT for the time being and would look to add position in case the RUB/KZT meaningfully moves or NDF implied yields increase significantly.

RUB/KZT is in the middle of the range



NDF implied yield higher but not enough



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
Gross financing requirement	3.7	4.4	2.5
Budget deficit*	3.3	3.9	2.2
Amortisation of public debt	0.4	0.5	0.3
Financing	3.7	4.4	2.5
Borrowing	3.3	3.9	2.5
Other	0.4	0.5	0.0

*Republican budget

Source: Ministry of Finance, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
Gross financing requirement	2.3	0.2	0.8
C/A surplus	-6.2	-5.4	-3.2
Amortisation (loans)	8.5	5.6	4.0
Government/central bank	0.2	0.4	0.1
Banks	1.6	1.4	1.2
Corporates	6.7	3.9	2.6
Financing	2.3	0.2	0.8
FDI (inward net)	8.8	6.6	7.2
Equity	0.0	0.4	0.5
Borrowing (loans)	7.9	6.2	6.4
Government/central bank	0.3	0.4	0.5
Banks	1.4	1.9	2.0
Corporates	6.2	4.0	3.9
Other (outward FDI, portfolio, lending)	-14.4	-13.0	-13.3

Source: NBRK, UniCredit Research

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

Outlook – Russia is in the hottest point of the political cycle, so all the indicators are showing short term improvements. The economy is accelerating on the real side in manufacturing, agriculture and services. The Central Bank of Russia's consumer inflation target is also likely to be achieved, although the capital outflow for the year is large despite increased money market interest rates. Hence we do not expect rate actions by the CBR in the medium term. At the same time, the situation in during 2012 and further is not that obvious: the trade balance is likely to deteriorate, fiscal discipline is also under question.

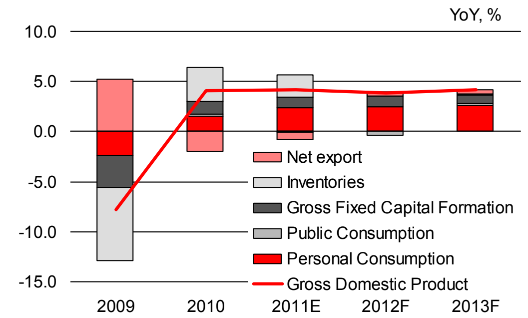
Strategy – We expect risk reward to improve toward long RUB positions only after the election cycle. We see buying OFZ 18 papers as a very attractive trade just ahead of a potential change in Euroclearability of Russian bonds. We would use Russia credit as a hedge and recommend buying 5y Russia CDS vs. 5y Turkey CDS.

Author: Artem Arkhipov , Head of Macroeconomic Analysis and Research (UniCredit Bank Russia)

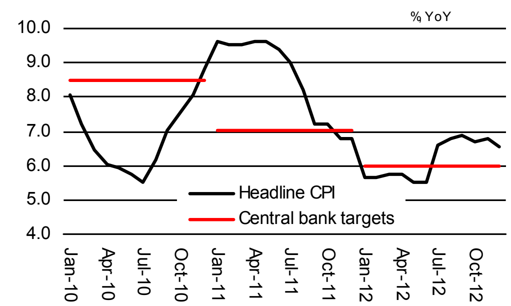
KEY DATES/EVENTS

- 18-22 of each month – Monthly indicators
- Last Fri of each month – CBR rate decision

DOMESTIC AND INVESTMENT DEMAND SHOULD OVERTAKE EXPORTS AS KEY GROWTH DRIVER



INFLATION IS LIKELY TO REMAIN BELOW REFINANCE YEAR RATE



Source: Federal Statistical Service, CBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	871	1,102	1,242	1,376	1,480
Population (mn)	141	141	140	140	140
GDP per capita (EUR)	6,165	7,817	8,873	9,827	10,573
Real economy yoy (%)					
GDP	-7.8	4.0	4.2	3.9	4.2
Private Consumption	-4.8	2.7	4.8	5.0	5.2
Fixed Investment	-16.2	6.0	5.0	4.8	4.3
Public Consumption	-0.5	0.7	-0.1	-2.2	0.8
Exports	-4.7	11.1	2.2	4.8	4.7
Imports	-30.4	25.4	7.5	5.9	5.1
Monthly wage, nominal (EUR)	422	518	566	617	667
Unemployment rate (%)	8.3	7.5	7.0	6.5	6.4
Fiscal accounts (% of GDP)					
Budget balance	-12.4	-6.6	2.0	-1.5	-1.5
Primary balance	-11.6	-5.8	1.5	-3.0	-3.0
Public debt	7.8	8.3	8.6	10.0	11.2
External accounts					
Current account balance (EUR bn)	35.7	55.9	99.2	54.2	36.8
Current account balance/GDP (%)	4.1	5.1	8.0	3.9	2.5
Basic balance/GDP (%)	3.5	4.2	6.4	3.2	2.0
Net FDI (EUR bn)	-5.5	-9.8	-14.2	-1.9	8.3
Net FDI (% of GDP)	-0.6	-0.9	-1.1	-0.1	0.6
Gross foreign debt (EUR bn)	329.8	356.3	314.7	308.8	313
Gross foreign debt (% of GDP)	34.7	34.7	25.3	22.4	21.1
FX reserves (EUR bn)	307.3	358.7	388.7	397.8	402.9
Inflation/Monetary/FX					
CPI (pavg)	11.7	6.9	8.6	6.2	5.8
CPI (eop)	8.8	8.8	6.8	6.5	5.6
Central bank target		8.5	8.25	7.5	7.0
Central bank reference rate (eop)	6.0	5.0	5.25	5.50	5.50
3M money market rate	7.5	4.0	6.6	6.0	5.8
RUB/USD (eop)	30.2	30.5	31.2	30.7	31.0
RUB /EUR (eop)	43.1	40.6	41.5	42.0	43.3
RUB /USD (pavg)	31.8	30.3	29.4	30.9	30.9
RUB /EUR (pavg)	44.2	40.0	40.9	40.6	42.5

Source: UniCredit Research

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

Economics: challenges of post election year

Russian economy is set to expansion in 2012 on strong fundamentals and high energy prices

During the next several months the most important topic for the Russian economy is the policy and agenda after Parliamentary and Presidential elections. Although the winners in both cases seem to be quite predictable, efforts of the authorities are directed to ensure that both economic backgrounds, political and social consensus are solid. At the December Duma elections United Russia's influence is decreased to 238 seats, which implies loss of the supermajority. The leading party is still able to support all "regular" initiatives of the acting Government. However, passing the so-called federal constitutional laws – requires 2/3 of the Parliament to vote "for" – now becomes a larger problem.

Indeed, current economic situation in Russia provides support to that: all the key macroeconomic indicators are demonstrating optimism. First, the inflation (as measured by the CPI) which started the year with levels at about 10% yoy now is falling to less than the CBR's target (5.6% for 11 months YTD). Chances are that low levels are sustainable in the short term – due to non-growing foods prices, non-expansionary monetary policy and delay in tariffs increase till July 2012. Above mentioned factors made us to lower our inflation forecast to 6.8% for 2011 eop. Second, the economic activity in Russian manufacturing sector is improving: the recent reading of the Manufacturing PMI demonstrated a solid optimism at 52.6 (indicating highest expansion since March), and so does the Services PMI (54.8). Driven by manufacturing and agriculture, the GDP accelerated to 4.8% yoy in 3Q11. A portion of this improvement comes from investment demand which continues to recover from the 1Q11 pitfall, and the fixed investment growth rate reached 5.3% yoy in October. What is also important is that risks for the economy (e.g. a sharp decline of oil prices) have not materialized, or their influence is minor at the moment. It seems that observed positive trends and also upward revisions of the beginning-of-the-year indicators (e.g. retail trade dynamics) increase chances that our forecasts for full year's real economy growth (2011FY GDP growth at 4.2%) would be achieved and possibly somewhat exceeded.

Russia has finalized an agreement on joining the World Trade Organization

Moreover, there are some important international improvements have just happened: Russia is on the final stage of joining the WTO. The process took about 18 years and is expected to be finished in the first half of 2012. Entry will lower import tariffs on goods and open up Russia's market for goods and some services (e.g. insurance sector). The impact of lowering trade barriers is likely to be mixed – depending on the particular industry. According to the World Bank study, the overall welfare gains from WTO entry could mount to a total of 3.3% of the country's GDP within 5 years, and 11% in the long run, mainly because of increased competition in service industries. Russia's financial sector should become more multinational, with the insurance sector, in particular, likely to attract an influx of global players. WTO entry is as well about investment as it is about trade. It would send a signal that Russia, perceived to have high business and environment risks, is committed to a rules-based system of business conduct.

Budget stability in 2012 will depend on implementation of social and defense spending and export income of energy commodities

At the same time, this nice picture is accompanied with a more neutral outlook on the fiscal side. Resignation of the Minister of Finance poses questions about the degree of the budget stability in the medium term – both social spending and defense programs are announced to be massive. On the one hand, this spending should become a driver for the economy. A headline budget surplus number for 10m11 is RUB 1.4 trln (3.2% of GDP), and the state debt burden (less than 8.4% of GDP) also allows that. On the other hand, the sustainability of the fiscal revenues is clearly a function of volatile oil prices, so the budget balance could easily return into the negative territory. Also, the propensity to import is very high, and a significant portion of this government stimulus would be irrelevant to the local economy.

Coming year would see a reverse in capital outflows in the absence of negative external shocks

Another trend that makes us cautious about the medium term outlook is the growing outflow of capital. On the one hand, the reasons for outflow are obvious: the timing for investment in Russia is not perfect due to [unlikely but possible] political changes, and the situation in the rest of the world now is not suggesting bulk of foreign investments as well. On the other hand, available projects (especially large-scale and state-related) allow many opportunities.

Authorities are quite conservative, expecting an outflow of USD 10-20bn outflow in 2012. However, we think that in case of world economic relief and absence of negative surprises during elections, the trend could reverse much faster.

Partially, one of the reasons for that is that Russia is much less dependent on foreign inflows than before: after huge growth of portfolio investment inflows in 2006 (602% yoy) and a substantial increase in 2007 (32% yoy), now it is much more modest. Thus, contraction caused by risk aversion would not have significant impact.

CBR stands firm providing liquidity for the banking system just like they did during 2008-2009 crisis

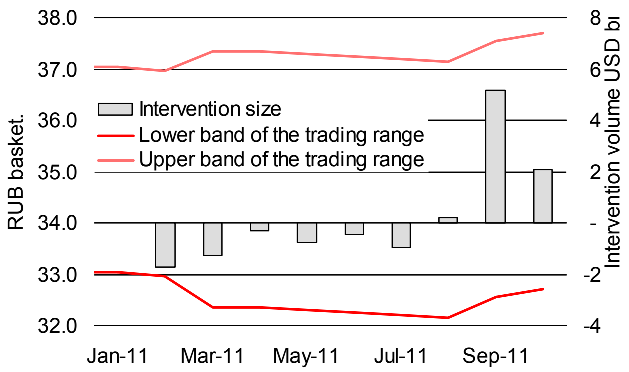
Moreover, we note that – just like in 2007-2008 – the Central Bank of Russia is very proactive in providing liquidity: as soon as risks for the sector were recognized it significantly widened refinancing options for banks. In fact, now the minimum requirements for bonds to serve as collateral in operations with the CBR are as low as B- or similar (as opposed to previous level of B+), the haircut for the state securities is 0% (1.25%), and limits of repo operations are now RUB 600bn (RUB 300bn).

The CBR also demonstrates positive shifts in terms of flexibility of its forex operations. First, since March the boundaries for the RUB bi-currency basket – operating indicator for the CBR – had been widened by 1 RUB. Then, although the CBR intervenes (sold hard currency volumes in Sept-Oct accounted for USD 7.2bn), it changes targeted maximum and minimum values quite often (see the chart below). Moreover, its attitude to short-term volatility of particular currencies became less nervous.

Given all that, we expect the CBR would follow its policy of inflation targeting, and this in fact implies that current levels of key interest rates (including reference rate, banking sector operations rates, etc.) would be mainly unchanged. In particular, we see 8.25% refinancing rate for several months. What concerns the local currency, the RUB basket is likely to follow the oil play – as long as the oil revenues are high but capital outflow persists, the basket is to stay at 35.75-36.50 with exchange rates to USD and EUR be dependent on their relative valuation in the FX markets. The potential for a significant RUB depreciation in the medium term is unlikely, although the long-term outlook is to be neutral-to-negative due to fundamentals, e.g. the dynamics of the trade balance and overall economy strength.

CBR IS READY TO PROTECT LOCAL CURRENCY, DOWNSIDE RISK FROM PORTFOLIO OUTFLOW IS LIMITED

We expect CBR to be on the protective side of the market which should stabilize RUB in the middle of the corridor



Portfolio inflows to Russia shows lackluster recovery after 2008-2009 crisis

IMF countries refer to the aggregate of inflows to Hungary, Latvia, Romania and Ukraine.

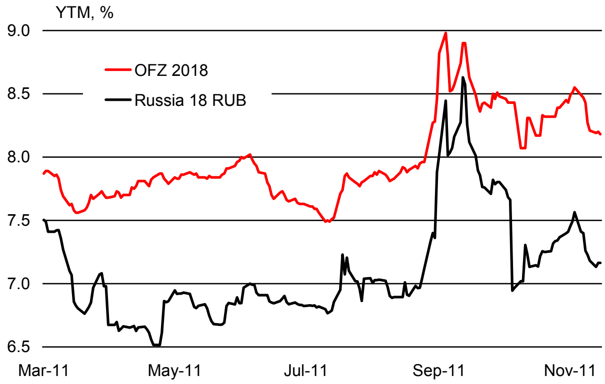
Source: CBR, Federal Statistical Service, UniCredit Research

Strategy: LC bonds attractive, scale up FX in 1Q-2Q, use CDS as a hedge

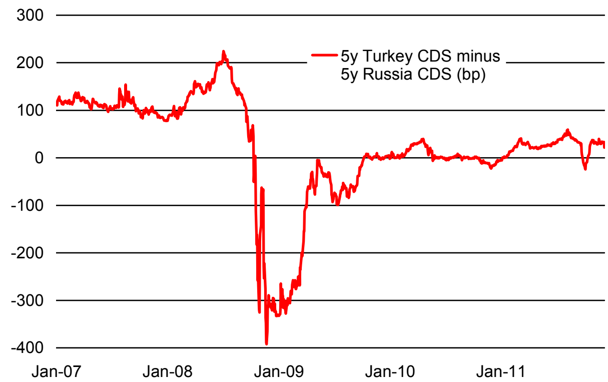
We think the best risk reward trade is Russia is buying local currency government bonds (OFZs) as they might become eligible for Euroclear settlement during 2012. As of January 2012 they will be allowed to trade outside MICEX which is the first step toward Euroclear in our view. As the local currency locally traded bonds are trading about 100bp wider in yields then the Russia RUB 18 paper we think they offer good value. Moreover as CPI is expected to move toward the 5% yoy level they also offer attractive real return as well.

In terms of FX we prefer to wait till 1Q-2Q before we scale up exposure: uncertainty about capital flows (although the bulk of it is probably behind us) and forthcoming election-related noise and potentially some fiscal loosening coupled with significant CBR liquidity injection mean to expect better levels to add to this trade. **We consider Russia CDS as an attractive hege tool** as recommend buying Russia 5y CDS versus Turkey 5y CDS at around 20bp. We target at least 100bp underperformance.

OFZ is cheap vs. Russia RUB 18



Russia 5y CDS vs. Turkey 5y CDS



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
Gross financing requirement	**-14.9**	**32.0**	**33.7**
Budget deficit	-24.8	20.6	22.2
Amortisation of public debt	9.9	11.4	11.5
Domestic	9.9	11.4	11.5
Bonds	9.9	11.4	11.5
Financing	**36.7**	**35.8**	**35.0**
Domestic borrowing	34.6	29.2	27.9
Bonds	34.6	29.2	27.9
Bills			
External borrowing	2.1	6.7	5.1
Bonds	2.1	6.7	5.1

Source: Ministry o f Finance, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2011E	2012F	2013F
Gross financing requirement	**-38.70**	**2.59**	3.76
C/A deficit	-99.20	-54.20	-36.80
Amortisation of debt	60.50	56.79	40.56
Government/central bank	3.00	3.54	2.53
Banks	21.80	18.10	12.93
Corporates	35.70	35.14	25.10
Financing	**98.1**	**95.1**	**97.1**
FDI	20.8	24.7	29.5
Equity	-	-	-
Borrowing	70.5	81.8	89.3
Government/central bank	2.1	6.7	5.1
Banks	25.2	27.7	30.5
Corporates	43.1	47.4	52.2

Source: CBR, UniCredit Research

Serbia (BB stable/BB- stable)*

Outlook – We expect GDP growth to slow to 1% in 2012 as the international environment impacts export growth and domestic demand remains weak. 1H12 should see continued monetary easing as inflation moderates. The delay in Serbia's bid for EU candidate country status to March 2012 is also a blow for the government ahead of elections by May 2012. While we see banks increasing long-term exposure to Serbia, heading into 2012 the outlook for the financing of the current account deficit has deteriorated.

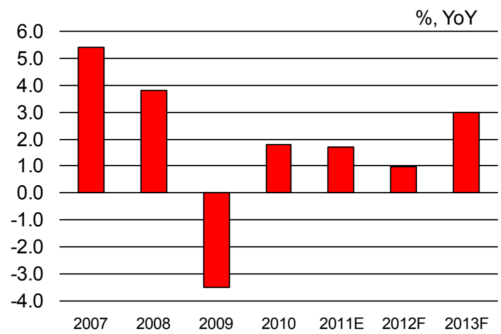
Strategy outlook – We see the IMF cooperation as an important support factor for Serbian markets and see new Serbia USD 21 as an attractive long term investment opportunity following the recent sell-off. We would also consider adding to local t-bills.

Author: Goran Šaravanja, Chief Economist (Zagrebačka banka)

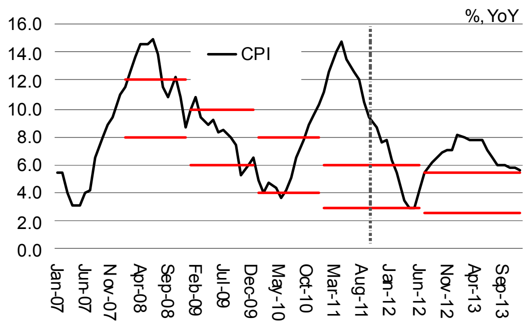
KEY DATES/EVENTS

- 19 January: NBS executive board meeting
- 9 February: NBS executive board meeting
- March 2012:
  Decision on EU candidate country status for Serbia

GDP FORECAST



MONETARY POLICY



Source: Serbian Statistical Office, National Bank of Serbia, Ministry of Finance, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	28.9	28.6	32.5	34.3	37.2
Population (mn)	7.3	7.3	7.3	7.2	7.2
GDP per capita (EUR)	3,943	3,917	4,471	4,741	5,141
Real economy yoy (%)					
GDP	-3.5	1.8	1.7	1.0	3.0
Monthly wage, nominal (EUR)	470	462	518	555	588
Unemployment rate (%)	16.1	20.0	23.0	22.5	21.5
Fiscal accounts (% of GDP)					
Budget balance	-4.5	-4.7	-4.6	-4.5	-4.3
Primary balance	-3.6	-3.5	-3.1	-3.0	-3.0
Public debt	34.1	42.6	42.3	44.8	46.1
External accounts					
Current account balance (EUR bn)	-2.1	-2.1	-2.3	-2.6	-3.0
Current account balance/GDP (%)	-7.2	-7.3	-7.2	-7.6	-7.9
Basic balance/GDP (%)	-2.5	-4.3	-2.5	-4.7	-3.9
Net FDI (EUR bn)	1.4	0.9	1.5	1.0	1.5
Net FDI (% of GDP)	4.8	3.0	4.6	2.9	4.0
Gross foreign debt (EUR bn)	22.8	23.8	24.5	25.5	28.0
Gross foreign debt (% of GDP)	78.9	83.3	75.5	74.3	75.3
FX reserves (EUR bn)	10.6	10.0	11.0	11.0	11.5
Inflation/Monetary/FX					
CPI (pavg)	8.4	6.3	11.2	5.4	6.8
CPI (eop)	6.6	10.5	7.8	7.0	5.6
Central bank target	8.0±2.0%	6.0±2.0%	4.5±1.5%	4.0±1.5%	4.0±1.5%
Central bank reference rate (eop)	9.5	11.5	9.5	9.0	8.5
3M money market rate	14.5	10.0	12.3	10.1	9.5
RSD/USD (eop)	67.1	79.3	78.2	75.2	75.0
RSD /EUR (eop)	96.0	106	104	103	105
RSD /USD (pavg)	67.6	77.8	73.4	78.1	75.4
RSD /EUR (pavg)	94.0	103	102	103	104

Source: UniCredit Research

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

EU accession delay muddies outlook as elections approach

Industrial production and export dynamics slow as international environment deteriorates

Growth slows as international environment deteriorates. The flash estimate for 3Q11 GDP was 0.7% yoy reflecting a slowing of the economy foreshadowed by moderating industrial production and merchandise export data. Seasonally adjusted mom data have shown slowing manufacturing and overall industrial production since July. Merchandise trade growth is also slowing quickly with September and October showing growth of only 3.9% and 6.3% yoy respectively (Jan-Oct '11 export growth is 17.5% yoy). We expect further moderation in the coming months noting that Serbia's largest exporter at the moment – US Steel – is considering whether to continue production as part of a review of its global operations. We GDP growth of 1.7% in 2011 and lower our 2012 forecast to only 1% as a result of these trends and continued weak domestic demand.

More cuts in the policy rate in the near-term, but hikes likely in 2H12

Monetary policy – easing cycle continues: On 8 December the National Bank of Serbia lowered its policy rate by 25bps to 9.75% on the back of improving inflation dynamics driven by weak domestic demand, delays in hiking administered prices and favorable agricultural price trends. In 2012 we expect headline inflation to bottom out near 3% yoy in March/April in part as base effects also help the disinflation process. Nonetheless, the post-election environment is likely to see administered price rises which leads us to expect year-end inflation at 7.0% yoy in 2012. As a result we see rate hikes in 2H12 which lead us to forecast a net 75bps drop in the policy rate to 9% at the end of the year. We expect the EUR/RSD to remain broadly stable in 2012 on account of the new IMF program despite our view policy rates will bottom out below 8% in 1H12 and an, on balance, riskier outlook for financing.

Current account deficit financing prospects look riskier heading into 2012

Current account financing: In 2012 we see the current account deficit widening slightly to 7.6% from 7.1% of GDP in 2011 as export growth slows. On the financing side FDI inflows are at risk after a solid 2011 because of the international environment. This should see the basic balance widen from a deficit of 2.5% of GDP to 4.6% in 2012. The main risk however is that portfolio inflows which exceeded EUR 1.5bn in the first 3Q of 2011 as non-residents soaked up t-bills earlier in the year reverse as 53-week t-bills begin to mature in March 2012 and 18-month t-bills redemptions accelerate in August 2012. The private sector continues to lower its external debt (we expect this to continue in 2012) and banks to 3Q11 have also lowered their short-term external exposure – long term net loan inflows remain positive and we expect that to remain the case in 2012. In addition, approximately EUR 170mn in repayments to the IMF (mainly August and November) fall due next year.

Minimal progress on fiscal deficit reduction likely in 2012

Fiscal policy – elections are a risk. On 8 December the Treasury surprised the market by cancelling all T-Bill auctions from that day to the end of 2011 without offering an explanation – more than likely this represents an effort to ensure public debt does not exceed the 45% of GDP threshold by end 2011 set out in fiscal responsibility legislation. In 2012 we see little movement on reducing the fiscal deficit in part because of the elections, but also because slower growth will impact revenue dynamics.

EU accession process on hold as decision on candidate country status is delayed

EU delays accession process. The European Council did not grant Serbia EU candidate country status on December 9th, but rather put back the decision to March 2012 noting European governments will "examine and confirm that Serbia has continued to show credible commitment and achieved further progress in moving forward" in relations with Kosovo.

Risks to sovereign credit rating on the downside

Sovereign rating. With elections due in May 2012, the EU accession process on hold for now and the unsupportive global background we see no scope for a ratings upgrade. The main risk we see is the general election – the delay in EU accession opens up possibilities for anti EU integration political parties. While we do not expect an anti-EU government post-May, any domestic political constraints between now and May 2012 leading to no progress on EU accession would be a negative for the sovereign.

Turkey (Ba2 positive/ BB positive/BB+ stable)*

Outlook – Turkey's GDP growth is set to slow from 7.5% this year to between 2.0%-3.0% for 2012. From a deficit in excess of 10% of GDP in 2011, the C/A should narrow to circa 8% of GDP by year end. In 2012, Turkish banks and especially non-bank corporates are to slow their pace of borrowing from abroad due to the rising cost of borrowing and/or less availability to funding. The base year factors will play a major role in keeping the yoy headline CPI inflation elevated in double digits during the first half of 2012. Assuming a better global backdrop in 2H12, Turkey's GDP performance will be tangibly better by 4Q next year compared to the first three quarters of next year. Rating agencies are unlikely to upgrade Turkey to the investment grade next year.

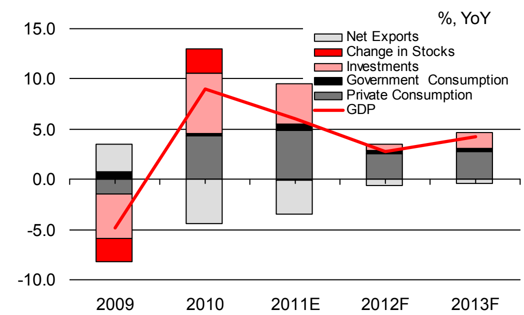
Strategy – We expect Turkey to outperform both in FX, rates and credit asset classes. We recommend selling EUR/TRY, buying mid long end TURKGB and sell Turkey 5y CDS vs. 5y Russia CDS.

Author: Guldem Atabay, Economist (UniCredit Menkul Değerler A.Ş.)

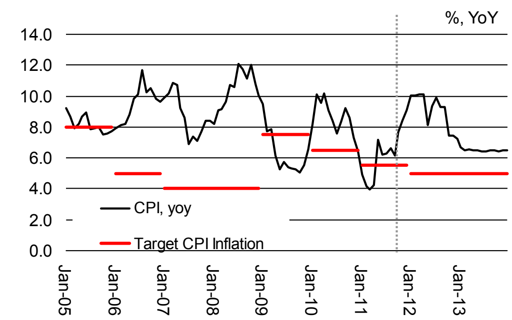
KEY DATES/EVENTS –

- 22 Dec. / Jan-Feb-Mar range of 19-25: MPC meetings
- 1Q12: New income tax code to be drafted
- 1H12: Drafting of the new Constitution begins

INVESTMENT GROWTH OUT OF THE PICTURE NEXT YEAR



HEADLINE INFLATION TO FLOAT IN DOUBLE-DIGITS DURING MOST OF 1H12



Source: TurkStat, CBT, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	441.0	551.9	548.0	577.3	625.3
Population (mn)	71.6	72.7	74.6	75.7	76.7
GDP per capita (EUR)	6,158	7,581	7,337	7,619	8,143
Real economy yoy (%)					
GDP	-4.7	9.0	7.5	2.8	4.2
Private Consumption	-2.3	6.7	7.1	3.6	3.9
Fixed Investment	-19.1	29.9	16.4	2.4	6.2
Public Consumption	7.8	2.0	6.4	2.5	2.5
Exports	-5.0	3.4	7.4	10.0	10.0
Imports	-14.3	20.7	18.5	9.8	9.0
Monthly wage, nominal (EUR)	248.5	295.0	275.9	288.1	309.3
Unemployment rate (%)	14.0	11.9	10.5	10.8	11.0
Fiscal accounts (% of GDP)					
Budget balance	-5.5	-3.6	-1.7	-1.8	-1.5
Primary balance	0.1	0.9	1.5	1.1	0.9
Public debt	45.5	41.6	39.5	39.0	38.5
External accounts					
Current account balance (EUR bn)	-9.7	-35.7	-58.3	-44.0	-45.8
Current account balance/GDP (%)	-2.3	-6.5	-10.4	-7.8	-7.7
Basic balance/GDP (%)	-3.2	-5.8	-7.7	-5.7	-
Net FDI (EUR bn)		6.8	8.9	8.0	10.7
Net FDI (% of GDP)	1.37	1.24	1.56	1.42	1.80
Gross foreign debt (EUR bn)	124.2	144.7	136.7	136.7	143.3
Gross foreign debt (% of GDP)	43.7	39.4	41.6	43.9	43.7
FX reserves (EUR bn)	49.0	60.3	70.4	67.2	70.7
Inflation/Monetary/FX					
CPI (pavg)	6.3	8.6	6.3	9.0	6.5
CPI (eop)	6.5	6.4	9.1	7.2	6.5
Central bank target	7.5	6.5	5.5	5.0	5.0
Central bank reference rate (eop)	6.5	6.5	5.8	5.8	6.0
3M money market rate	11.7	7.4	7.9	8.1	8.5
TRY/USD (eop)	1.49	1.54	1.84	1.85	1.83
TRY /EUR (eop)	2.13	2.05	2.45	2.53	2.56
TRY /USD (pavg)	1.55	1.51	1.67	1.88	1.84
TRY /EUR (pavg)	2.15	1.99	2.32	2.47	2.54

Source: UniCredit Research

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

A challenging 1H12 to partially ease external vulnerabilities

Over 2H-11 Turkey has surprised us on the upside on growth but 2012 will be noticeable slower

Relative to our September call, Turkey again surprised on the upside with its strong growth performance over recent months. This is based mostly on domestic demand, though at this stage the economy is finally showing signs of slowdown**.** 2012 will see more rebalancing as the composition of demand shifts more towards partly to external demand while we expect full year growth to slow to around 2.0%-3.0%. Assuming a better global backdrop in 2H12, Turkey's GDP performance will be tangibly better in 2H12 than 1H. On a more positive note the government has space to support the economy in the event of a sharped global slowdown. The budget deficit/GDP is set to narrow to 1.7% in 2011 from last year's 3.6% while public debt remains on a downward path.

Turkey's CAD/GDP to slow to circa 8.0% by YE 2012 which is better; but still high.

The flipside of the coin for Turkey is its rising external vulnerabilities, with this year's C/A deficit likely to be in double digits and the economy's gross external financing requirement nearing USD 200bn. The pressuring EU credit problems and Turkey's high external funding requirement, combined the rising cost of borrowing and/or less available funding translates into a more challenging year ahead. Portfolio flows to Turkey have already stalled. Turkish banks and especially non-bank corporates are likely to slow their pace of borrowing from abroad. Less capital inflows means less C/A deficit financing – we expect Turkey's C/A to narrow to a still wide 8.0% of GDP by end next year

CBT draws off a variety of policy tools

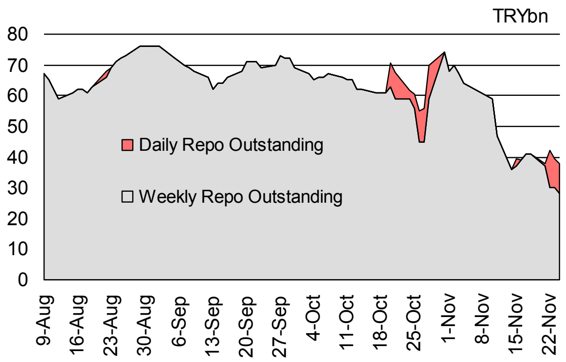
Against this backdrop, the CBT's policy seems pretty clear, namely prevention of further significant TRY losses. To achieve its aim of stabilizing TRY, the CBT has the following tools to hand: **1.** the weekly repo rate or official policy rate, currently at 5.75%, **2.** open market operations accompanied by the the overnight interest rate corridor of 5.0-12.5% **3.** reserve requirement ratios and **4.** FX intervention. The Bank's most active tools at this stage are open market operations and the overnight interest rate corridor. Changes in reserve requirement ratios and FX intervention are playing a role but at least for now are secondary relative to the overnight interest corridor. Recent central bank actions suggest that the CBT has reached a stage where it wishes to use its FX reserves more sparingly.

CBT is reluctant to contract its balance sheet…

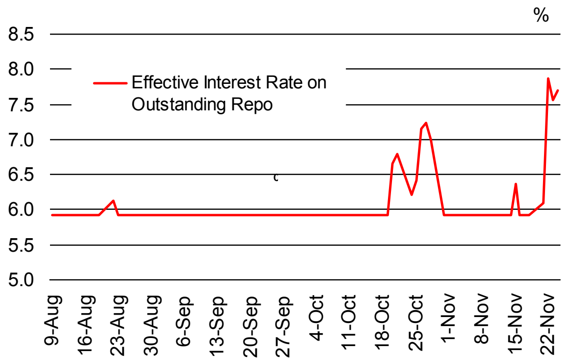
The CBT's actions throughout this year suggest that it remains convinced of a slowdown in economic activity, making it reluctant to contract its own balance sheet in a significant way. Earlier this year the CBT forced the banking system to post more TRY at the central bank via higher TRY reserve requirements but offset this for the most part by increasing its provision of funding to the banking system via open market operations. More recently the CBT has allowed the banking system to cover TRY reserve requirements with FX deposits while at the same time contracting the amount of liquidity it provides the banking system via open market operations. The size of its balance sheet is on the increase once again.

CBT NOW GEARING BACK TO TIGHTENING FROM ITS SUPRISING EASING IN AUGUST

Higher CPI inflation and much weaker TRY urged the CBT to an active employment of its "interest rate corridor.



As the O/N funding rate is set higher at 12.5% more funding from the O/N market eventually escalates cost of funding



Source: CBT, UniCredit Research

…but providing funding to the banking sector over a much shorter time horizon

While the CBT's balance sheet has not contracted, changes in the maturity profile of its open market operations increases its control over TRY. Upon the introduction of its unorthodox monetary policies, the CBT switched from 3 month to 7 day liquidity provision. This has been central to the speed with which it has been able to contract the amount of funding it is providing to the banking sector via open market operations. From TRY 74.0bn at end-October, the volume of open market operations stood at TRY41bn by end-November. More recently the CBT has begun to limit the availability of 7 day liquidity, forcing some banks to draw off more expensive overnight liquidity. In short the CBT is in a position to force the domestic banking system to pay much more for liquidity access.

Weaker domestic confidence means that the CBT has a lot at stake

Taking all of the above into account, a forced increase in the amount of TRY deposits at the CBT may prove the most viable option available for the Bank to stabilize TRY in the event of an increase in market pressures. While the CBT has impacted the cost of TRY to date, it has not impacted its overall provision due to its decision to allow banks to cover TRY reserve requirements with FX. In short the CBT remains convinced that the macro slowdown is sufficient to ease inflation pressures and does not want to add any further downward pressure on the banking sector and economic activity. Should TRY pressures build further, a hike to TRY reserve requirements which is not compensated for by an increase in the volume of open market operations could do the trick.

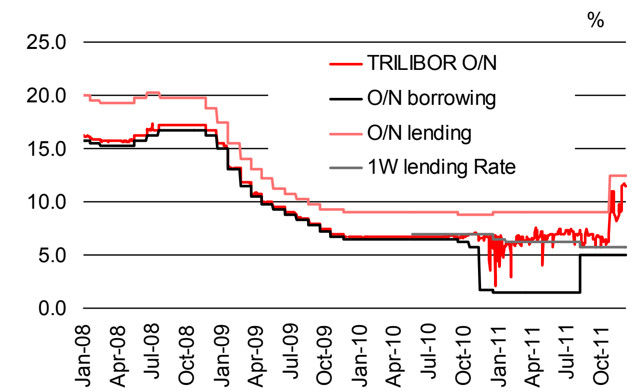
Further FX intervention is also an option but the CBT's scope to do so is far from unlimited. The CBT's policy of covering part of the TRY RRR obligations with FX is helping to reverse the decline in total FX reserves. Yet, gross FX reserves (excluding gold) stand at USD 85.2bn compared to USD 93bn back in July 2011 when FX sale auctions began. During this time the net FX reserves eased to USD 47bn (18 November) from USD 55bn back in July. A decline in domestic confidence in TRY means that the CBT has a lot at stake in terms of achieving its objective of stabilising TRY but a rapid reversal of TRY losses appears unlikely given the uncertain external environment and the CBT's preference to maintain a low policy rate. In the event of a sharp improvement in market sentiment, the CBT could welcome a 5-10% appreciation in TRY but thereafter would like revert to a policy of FX reserve accumulation.

Nonetheless, rating agencies unlikely to upgrade Turkey finally to investment grade next year

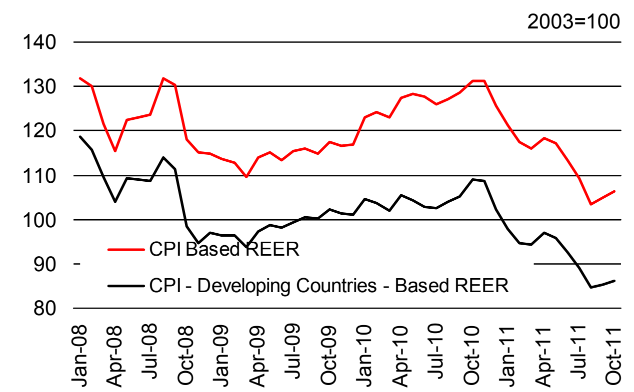
Rating agencies unlikely to upgrade Turkey to the investment grade next year. The C/A deficit will narrow but remain wide. Meanwhile inflation will remain high until 2H and risks the investor community questioning the CBT's credibility once again. Apart from economy related risks, political risks related to a possible referendum on a new constitution could also shy the rating agencies away from delivering a rating upgrade next year.

SAERCH FOR YIELD KEEP INVESTOR ATTENTION IN TURKEY'S BOND MARKET DESPITE THE CURRENCY WEAKNESS

The CBT's "interest rate corridor"



Turkish Currency-CPI based REER



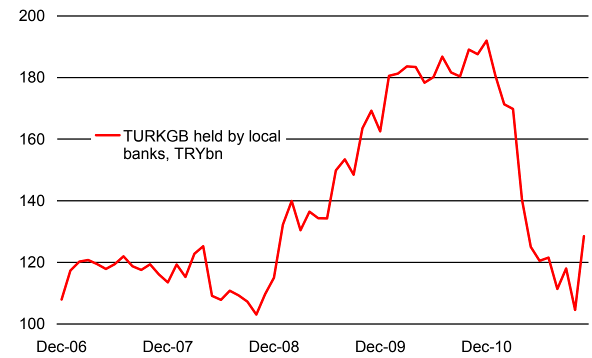
Source: CBT, UniCredit Research

Strategy: sell EUR/TRY and add long TURKGB

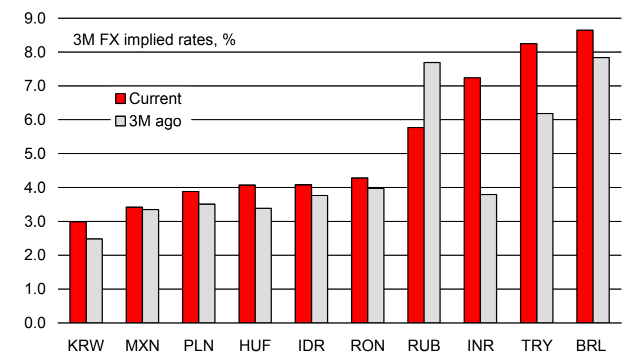
In CEEMEA FX our top pick is short EUR/TRY: As the CBT started using its balance sheet more actively to control the TRY we believe the risk outlook for the TRY changed significantly compared to one year ago. In a recent analysis of the available tools at hand we concluded the CBT has a reasonable chance for success while it looks convinced that the economic slowdown will largely contribute to the rebalancing of the Turkish economy. The price of the active balance sheet usage (via FX interventions, TRY liquidity control) is obviously a sharp rise of short term rates. This in turn has pushed the TRY implied rates higher during 4Q11 and it is now the second highest among all EM countries. In volatility adjusted basis the TRY offer the attractive ratio as well. Although we do believe that the CBT might start rebuilding its FX reserves in case of strong appreciation (5/10%) this is still decent risk reward in our view. Moreover as we express our view against the EUR while the CBT prefers to focus on the 50/50% EUR and USD basket our trade should perform in case EUR/USD moves lower. We target 2.30 (about 6.3% gain). The trade also provides about 70bp positive carry per month.

We are constructive in rates and credit as well. For similar arguments we expect local rates to perform well and recommend buying mid to long end TURKGB while as a hedge opportunity we see value in buying Russian 5y CDS versus selling 5y Turkey CDS.

Banks TURKGB holdings declined significantly in 2011



Carry on TRY longs in restored



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010	2011F	2012F	2013F
Gross financing requirement	117.2	74.8	74.9	77.6
Budget deficit	19.8	9.4	9.7	8.6
Amortisation of public debt	97.4	65.4	65.2	69.0
Domestic	89.05	57.8	58.4	61.5
Bonds	77.5	51.4	52.0	54.8
Bills	11.6	6.4	6.4	6.8
External	8.35	7.6	6.8	7.5
Financing	97.4	65.4	65.2	69.0
Domestic borrowing	79.5	55.7	54.4	57.0
Bonds	70.0	51.2	48.4	50.7
Bills	9.6	4.5	6.0	6.3
External borrowing	7.45	5.4	5.6	5.5
Bonds	4.9	3.2	3.2	3.1
IMF/WB	0.0	0.0	0.0	0.0
Other	2.6	2.1	2.4	2.4

Source: CBT, Ministry of Finance, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010	2011F	2012F	2013F
Gross financing requirement*	67.2	72.7	71.4	75.6
C/A deficit	36.0	56.3	45.7	46.5
Amortisation of medium to long term debt	34.6	27.1	25.7	29.1
Government/central bank	6.0	5.7	5.7	4.1
Banks	5.1	4.7	4.9	4.7
Corporates	23.6	16.8	15.1	20.3
Errors and omissions	3.5	10.7	0.0	0.0
Financing	67.2	72.7	71.4	75.6
FDI	5.9	7.9	8.3	10.9
Equity (private, net)	2.6	0.8	1.9	3.6
Borrowing Medium to Long term	29.0	33.3	35.6	34.4
Government/central bank	5.1	4.7	4.5	4.0
Banks	5.8	8.6	8.3	8.7
Corporates	18.2	20.0	22.7	21.8
Other (incl. reserve accumulation)	29.7	30.8	25.6	26.7

* Short term debt (the stock from the previous period) is mostly trade related and we assume it will be rolled over

Source: UniCredit Research

Ukraine (B2 stable/B+ stable/B stable)*

Outlook – 2011 was a year of missed opportunity for Ukraine. As a result Ukraine must secure either a gas price deal with Russia or financing from the IMF if it is to avoid a large currency devaluation and collapse in economic activity in 2012. Sovereign and gross external financing requirements are on the increase while a loss of domestic confidence in the currency has translated into a trend of FX reserve loss at the NBU defends UAH. Low rollover ratios and tight domestic liquidity means that the banking system is not in a position to support economic activity.

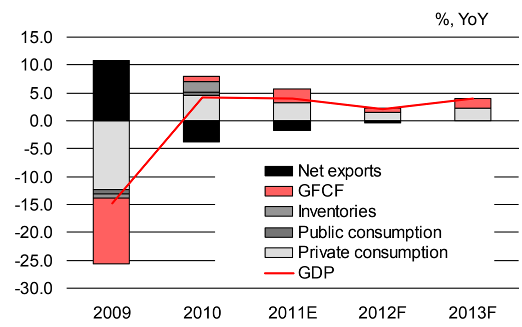
Strategy outlook – We recommend buying short dated Ukrainian Eurobonds which do not reflect the credit risk properly and offer attractive carry in our view.

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

KEY DATES/EVENTS

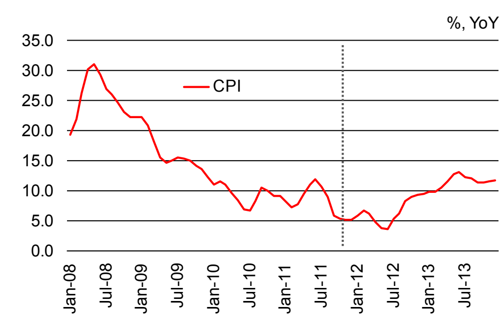
- 17 Dec: EU summit, end-Dec: potential for gas price deal with Russia
- 5-10 of each month: FX reserve data
- End-Jan: 4Q-11 GDP data

WITNESSING DOMESTIC DEMAND LED GROWTH



Source: Ukraine State Committee Statistics, UniCredit Research

NOT ONLY FOOD RISING IN PRICE



Source: Ukraine State Committee Statistics; UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2009	2010	2011E	2012F	2013F
GDP (EUR bn)	84.2	86.6	98.0	112.5	109.4
Population (mn)	46	45.8	45.5	45.3	44.8
GDP per capita (EUR)	1,831	1,891	2,153	2,482	2,442
Real economy yoy (%)					
GDP	-14.8	4.2	4.0	2.0	3.9
Private Consumption	-14.9	7	5	2.5	3.5
Fixed Investment	-50.5	4.9	12.5	4.5	8.5
Public Consumption	-2.4	2.7	0.7	0	0.3
Exports	-22	4.5	10.7	8	10
Imports	-38.9	11.1	13.3	8.2	9.5
Monthly wage, nominal (EUR)	170	213	228	268	322
Unemployment rate (%)	9	8.4	7.5	6.9	6.5
Fiscal accounts (% of GDP)					
Budget balance	-6.2	-5.7	-4.5	-3.7	-3.2
Primary balance	-5.1	-4.2	-2.6	-1.7	-1.2
Public debt	35	42.2	41.5	41.6	38.9
External accounts					
Current account balance (EUR bn)	-1.2	-2.3	-5.4	-4.4	-4.4
Current account balance/GDP (%)	-1.5	-2.6	-5.5	-3.9	-4.0
Basic balance/GDP (%)	2.3	2.6	0.6	0.5	0.1
Net FDI (EUR bn)	3.2	4.5	6.0	5.0	4.5
Net FDI (% of GDP)	3.8	5.2	6.1	4.4	4.1
Gross foreign debt (EUR bn)	72.6	87.7	91.2	86.4	85.4
Gross foreign debt (% of GDP)	86.2	101.3	93.1	76.8	78.1
FX reserves (EUR bn)	17.7	25.1	22.6	20.4	20.7
Inflation/Monetary/FX					
CPI (pavg)	16	9.4	8.0	6.6	11.5
CPI (eop)	12.3	9.1	5.1	9.5	11.8
Central bank target	tentative target of 5% by 2014				
Central bank reference rate (eop)	10.25	7.75	7.75	7.75	7.75
UAH/USD (eop)	8	7.97	8	8.4	9.2
UAH /EUR (eop)	11.5	10.6	10.6	11.5	12.9
UAH /USD (pavg)	8.1	8.0	8.0	8.2	8.82
UAH /EUR (pavg)	11.3	10.5	11.2	10.9	12.2

Source: UniCredit Research

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

The honeymoon period has firmly come to an end

Revising down our growth forecast further

The growth outlook in Ukraine is deteriorating for a number of reasons and the government's assumption of 4% GDP growth (up until recently 5.0%), written into next year's budget, is overly optimistic. From the 3% we had forecast in mid-September, we are marking down our estimate to 2.0% for 2012, though we highlight considerable uncertainty surrounding this. Steel prices have shifted downwards while in terms of volume output, it will be difficult to generate any postive contribution next year given such a bumper harvest this year, though there should be a terms of trade gain to the extent that the export ban on agriculture has been lifted. Metals account for 40% of total exports.

Banking sector also to drive growth lower

Banking sector pressures are also significant and closely linked to UAH pressure. As part of its effort to control UAH, the central bank is absorbing domestic liquidity which has translated into a significant tightening of lending standards and pushed up both deposit and lending rates. Meanwhile Ukraine has posted the lowest external bank rollover ratios in the region for some time but September saw these plummet. Over 2010, the average external bank rollover ratio on medium to long term debt stood at 0.65, representing USD 2.1bn of outflows from the sector. Over the first 9 months of this year, there was no improvement, with the sector showing a further USD 2.9bn in outflows. This translates into an average rollover ratio of 0.54. However in September the rollover ratio plummeted to 0.03, translating into outflows of USD 1.1bn in just one month. In October the banking sector saw net outflows of USD 0.4bn. This is a situation which leaves any new lending reliant on deposit growth next year. According to our estimates it is very unlikely that credit supports economic activity next year. The chart above shows the impact of a halt (but not a contraction) in new credit extension on real domestic demand growth, pushing it into negative territory for much of next year.

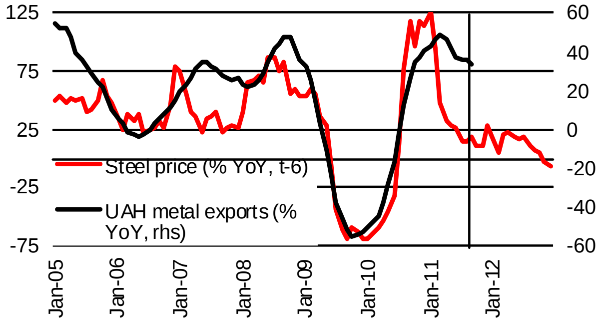
Government financing is problematic

Central bank efforts to control UAH impact not only banking sector liquidity but also government's financingle issuance of USD-denominated debt is a struggle. The Eurobond market is shut, at least for now. Of course reversion to central bank financing of the deficit is an option, as was already the case over 3Q, but this compromises the central bank's ability to defend UAH. The NBU has returned to being the largest holder of domestic government debt.

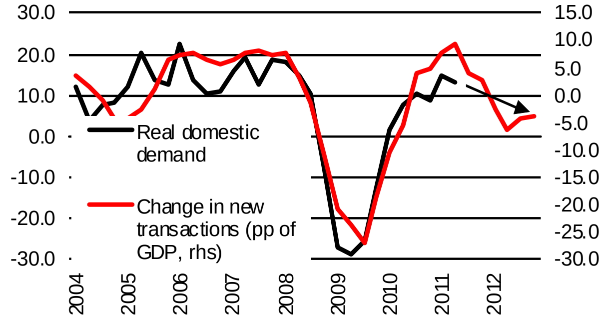
FX devaluation is an undesirable option, for now

Given the link between currency defence, the banking system's ability to support the economy and government financing, maintenance of the current status quo may be manageable for a short period of time but in reality has a very shelf life not longer than a couple of months. That said the domestic authorities' enthusiasm to defend UAH has a number of motivations. Probably the primary motivation is political – more so than the alternatives (an IMF-forced gas price hike, sale of the GTS), currency devaluation ahead of next October's parliamentary election is viewed as politically costly.

Steel export growth limited, assuming steel prices unchanged from Oct



Credit & domestic demand growth (assuming new lending collapses to zero)



Source: National statistics agency, NBU, State Committee Statistics, UniCredit Research

From an economic perspective, the near term consequences are also significant. In the event of either a one step devaluation or the introduction of a currency band rather than a peg, there is a strong likelihood that the NBU would in any case be forced to draw down a significant portion of FX reserves to defend a new level. We doubt the authorities would opt for 'shock therapy' in the form of an instantaneous move from a peg to a free float overnight. Moreover any currency devaluation would bring with it balance sheet impacts for an economy which at Ukraine's stage of development is already relatively heavily indebted.

Gas deal is critical in near term

Near term focus in on a gas price deal with Russia. If agreed upon, a gas price deal has the potential to provide BoP relief into the New Year but as ever the devil is in the detail. Ukraine is paying USD 400 per 1000cbm in 4Q, up from USD 264pcm in 1Q, with an average 2011 price (not weighted) of USD 322pcm. Latest press reports suggest a deal whereby Ukraine secures gas at USD 220-230pcm. According to our estimates this would reduce the trade balance next year (assuming unchanged gas import volumes) by less than USD 4.0bn. Crucial to any deal will be financing provided in return for partial ownership/control of power of the gas pipeline, either in the form of an upfront loan or trade finance.

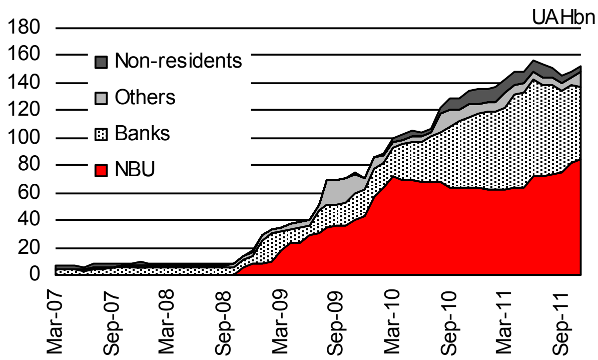
In the absence of a deal, pressure will build quickly

If by year end Ukraine is not in a position to announce a deal, pressure on UAH, government financing and the banking sector is likely to build rapidly. The NBU lost USD 4.6bn in FX reserves over Sep-Nov. The NBU has limited ammunition to smooth external pressures. At USD 31bn, FX reserves are USD 3.8bn below where they were mid-08. FX reserves are sufficient to cover 6 months of imports, broadly in line with end-07 ratios. FX reserve coverage of short term external debt stands at 1.26 times as of 2Q, below where we were at any stage since 2007/08. In this scenario the domestic authorities must choose between an agreement with the IMF or currency devaluation (which in any case will have to be followed either with an IMF agreement or a gas price deal). To the extent that hiking gas prices seems to be considered less politically costly domestically, we see an IMF agreement as most likely.

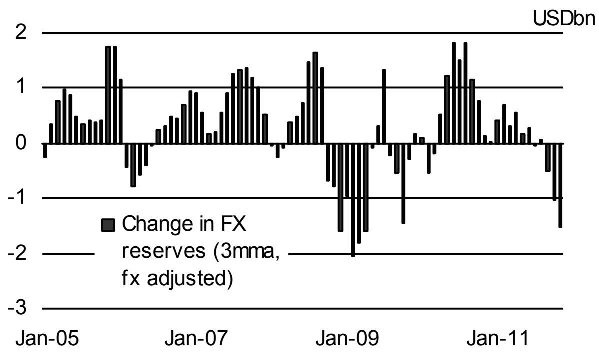
IMF conditionality: Not just about gas prices

Following a two week visit, the IMF mission left Kiev on 4 November as the Ukrainian authorities hold out for a deal with Russia. In the event that this is not available, the domestic authorities will have to fulfill conditionality on a number of fronts. A 30% gas hike is likely to prove unavoidable. Assuming it is approved by parliament, it takes 30 days to come into effect. A 2012 budget that brings the deficit in line with target will be required. The government will have to compensate on two fronts, namely for this year's overshoot and an excessively high growth projection for next year. This year's overshoot is made up in part by Naftogaz. Relative to an original IMF assumption of 0.4% of GDP this year, the deficit will likely exceed 1.5% of GDP. There is also the risk that arrears have accumulated once again, flattering what appears to be an impressive central government budget deficit YTD. Assuming all of the above is agreed upon, there remains the risk that former PM Tymoschenko's improvement may slow or even prevent approval of any disbursement by the IMF.

NBU once again biggest holder of domestic government debt



Back to a world of FX reserve loss

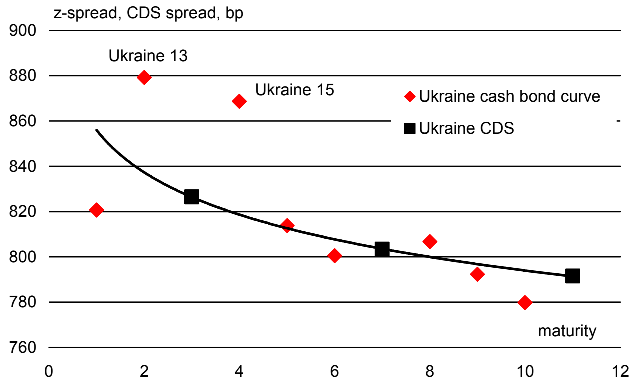


Source: MinFin, NBU, State Treasury, UniCredit Research

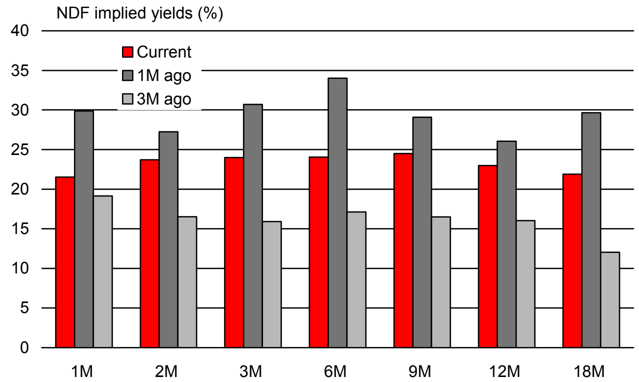
Strategy: buy short dated Ukraine Eurobonds

Ukrainian credit markets have underperformed in 2011 (5y Ukraine vs. 5y SovxCE widened to around 500bp from 300bp) due to uncertain IMF outlook, high beta, and depreciation pressure on the currency with associated clear difficulty of government funding in the UAH market. The biggest casualty of the EMU bank deleveraging and cut in jump to default limits (limit of total notional exposure) has been the Ukrainian short end with Ukraine 12 and Ukraine 13 trading around 10% yields. We believe the near term outlook for Ukrainian credit is not as bad. First and most importantly the state does not have too much debt coming due in 2012: USD 1bn Euorobond maturity and USD 2.5bn IMF repayment, assuming that the VTB loan will be rolled over. In case the bond market remains completely shut and no other official financing arrives we think worst case FX reserve could cover at least partly those maturities. On the other hand the NBU has limited ability to smooth external pressure on a longer term in case the Eurobond market remains closed while no deal is reached with Russia and/or IMF. Moreover the extreme poor domestic public funding (evidenced in continuous auction cancellations) puts some additional pressure on the government. Exactly because of these reasons we think Ukraine will need to secure some form of official funding (either IMF or Russia). The preferred solution at this moment appears to be a deal with Russia. We think FX devaluation is the less preferred option. Against this backdrop we think the inverted credit curve does not reflect properly the Ukrainian credit risk and recommend buying Ukraine 13 papers for about 9% yield.

Ukraine short end credit is cheap



NDF curve is pricing a significant devaluation



Source: Bloomberg, NBU, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	**9.1**	**15.5**	**13.0**
Budget deficit (excl Nafto)	2.0	2.2	2.2
Amortisation of public debt	6.3	8.9	5.9
Domestic	5.4	4.6	1.0
Short term	1.6	0.4	1
Medium to long term	3.8	4.2	
External	0.9	4.3	4.9
of which IMF	0	2.5	4.1
Financing	9.0	15.5	13.0
Domestic borrowing	6.9	9.6	7.4
of which NBU	1.9	0	0
Short term	0.4	1.0	1.0
Medium to long term	6.5	8.6	6.4
External borrowing	2.1	5.9	5.6
Bonds	2.1	1.4	1.5
IMF	0	1.3	2.1
Other	0	3.3	2.1

External debt amortisation	0.9	4.3	4.9
Eurobonds coming due	0.9	0.4	0.8
Russia VTB loan		1.4	0
IMF	0	2.5	4.1

Source: Ministry of Finance of Ukraine, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2010E	2011F	2012F
Gross financing requirement	47.7	44.6	39.4
C/A deficit	5.4	4.4	4.4
Medium to long term amortisation	15.9	17.1	13.7
Banks	6.0	6.5	5.2
Corporates	7.4	7.5	6.0
Government/central bank	2.4	3.2	2.5
Short term debt amortisation	18.3	21.6	19.8
Banks	3.2	3.6	1.8
Corporates	13.6	16.5	16.5
Government/central bank	1.5	1.5	1.5
Other (incl. intercompany lending, capital flight	8.1	1.5	1.5
Financing	40.7	42.4	37.9
FDI	4.0	4.0	4.0
Portfolio flows	-0.2	0	0
Medium to long term borrowing	16.0	15.4	12.6
Banks	3.1	3.3	2.6
Corporates	9.1	7.5	6.0
Government/central bank	3.8	4.7	4.0
Short term borrowing	18.5	21.6	19.8
Banks	3.3	3.6	1.8
Corporates	13.7	16.5	16.5
Government/central bank	1.5	1.5	1.5
Other	7.0	2.3	1.6
Change in reserves	2.5	1.5	1.5

Source: NBU, UniCredit Research

Notes

Notes

Notes

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