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Quarterly

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1Q 2017

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

Outlook – Given the country's very strong position – with a solid growth momentum, twin surpluses and abundant fiscal and FX reserves – the immediate impact of the GERB's government resignation on growth and policy making more generally would be rather small. Growth is likely to remain strong in early 2017, and if the general elections don't produce a pronounced shift toward more dysfunctional policies, the economy is likely to reach its cyclical peak in end of 2017 or in early 2018 – roughly two years after the rest of CEE-EU. Downside risks have risen, in the meantime, as odds for a populist-nationalist coalition winning the general elections have increased. If such a scenario materializes, the hard-won stabilization of the energy sector would be most at risk, in our view.

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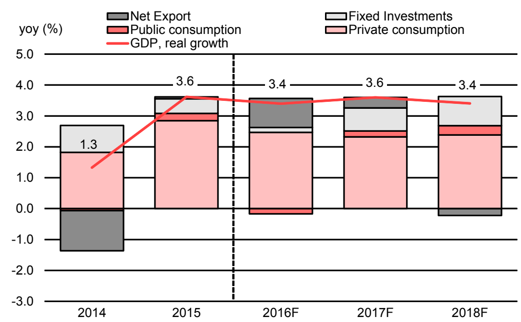
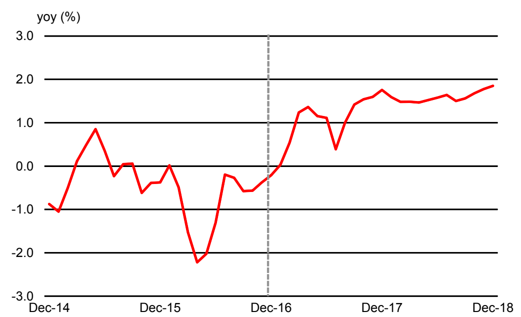
KEY DATES/EVENTS

- Mid-Feb: GDP flash estimates for 4Q16
- Mid-Feb: Labor force survey data for 4Q16
- End-Mar/early Apr: General government elections

GDP GROWTH TO STABILIZE AT ROBUST LEVELS



CPI INFLATION WILL CONTINUE TO ACCELERATE



Source: NSI, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2014	2015	2016F	2017F	2018F
GDP (EUR bn)	42.8	45.3	46.5	48.6	51.1
Population (mn)	7.2	7.2	7.1	7.1	7.0
GDP per capita (EUR)	5,937	6,330	6,528	6,871	7,252
Real economy, yoy change (%)					
GDP	1.3	3.6	3.4	3.6	3.4
Private Consumption	2.5	3.9	3.4	3.2	3.3
Fixed Investment	3.4	2.7	0.2	3.5	4.5
Public Consumption	-0.8	2.9	-2.1	2.5	4.0
Exports	3.1	5.7	5.4	4.8	4.9
Imports	5.2	5.4	3.8	4.2	5.2
Monthly wage, nominal (EUR)	420	458	493	533	577
Real wage, change (%)	7.4	9.0	8.6	6.9	6.7
Unemployment rate (%)	11.4	9.1	7.7	6.8	6.0
Fiscal accounts (% of GDP)					
Budget balance	-3.6	-2.9	1.7	-1.7	-2.3
Primary balance	-3.0	-2.0	2.5	-0.9	-1.5
Public debt	26.4	25.6	28.7	25.2	25.3
External accounts					
Current account balance (EUR bn)	0.0	0.2	1.7	1.2	0.4
Current account balance/GDP (%)	0.1	0.4	3.7	2.4	0.8
Extended basic balance/GDP (%)	4.4	6.8	8.0	7.0	5.6
Net FDI (% of GDP)	2.1	3.5	3.0	3.3	3.5
Gross foreign debt (% of GDP)	92.0	75.3	72.8	67.9	63.8
FX reserves (EUR bn)	16.5	20.3	22.7	24.3	26.2
Months of imports, goods & services	6.5	8.0	9.2	9.2	9.2
Inflation/Monetary/FX					
CPI (pavg)	-1.4	-0.1	-0.8	1.1	1.6
CPI (eop)	-0.9	-0.4	-0.2	1.8	1.9
Central bank reference rate (eop)	0.02	0.01	0	0	0
USD/BGN (eop)	1.79	1.76	1.77	1.81	1.71
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.47	1.76	1.83	1.78	1.69
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96
Real effective exchange rate, 2000=100	139.8	136.9	136.0	135.4	136.1
Change (%)	-1.1	-2.1	-0.6	-0.5	0.6

Source: Eurostat, NSI, BNB, MoF, UniCredit Research

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

Outlook remains favorable, but downside risks are rising

The sizeable fiscal boost, which the public sector was set to provide in the remainder of the year, failed to materialize

The acceleration in GDP growth in 2H16 (pushing full-year GDP growth to 3.7% from 3.5% in 1H16), which we anticipated in September, failed to materialize. Real GDP increased by 3.4% yoy in 3Q16, somewhat weaker than both the 3.6% 2Q16 outturn and our 3.7% forecast. While we were right to expect that the record-breaking increase in tourist arrivals and wheat harvest would boost output in 3Q16 and further in 4Q16, it was the jump in fiscal spending that we foresaw three months ago where our forecast missed the mark. We were expecting that the drag from investment was about to ease, as the budget balance was set to shift from a 3.7% of GDP surplus in July to a 1.6% deficit in December, but the unexpected loss of the presidential election forced the GERB government to resign and altered its fiscal plan for the remainder of the year. We now expect a 1.7% of GDP budget surplus in December which, if correct, would produce considerable fiscal tightening equivalent to 4.6% of GDP in 2016.

Survey results point to continued solid growth momentum in 4Q16

Meanwhile, business and consumer sentiment proved very resilient in the period between the first and the second round of the presidential election, which suggests that, apart from the shift to growth-negative fiscal policy in 2H16, the short-term outlook for the economy is likely to remain little changed. Indeed, the headline business sentiment indicator in November rose to its highest level in seven years (see lhs chart), with the employment expectation component being particularly buoyant across the board. Consequently, we decided to revise our full-year GDP growth projection for 2016 downward to 3.4% yoy from 3.7%.

Consumption-driven growth will remain strong in 2017 and 2018…

…but will slow down thereafter, in the absence of growth-enhancing reforms

So far, the negative impact from Brexit proved smaller than expected…

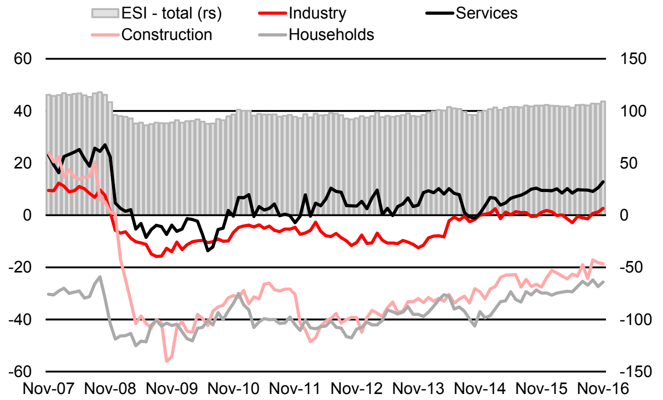
…but will keep long-term arrangements in relations between UK and EU uncertain for a protracted period of time

We expect a slight acceleration in growth in 2017 to 3.6% – just a notch higher vis-à-vis our previous forecast. As before, domestic demand and individual consumption in particular will be in the driver's seat. The latter will mostly draw support from the solid rise in wages, while the pace of job creation is forecasted to shift to a lower gear, as labor shortages constrain the pace of economic expansion in some sectors. At the same time, there are indications of a somewhat stronger global recovery. This is mostly attributable to the upward revision of our GDP growth projection for the EA (to 1.5% from 1%), which reflects a shift in our perception of the impact of Brexit, which we now see as an unfolding event with only a limited negative impact in the short run, while keeping uncertainty elevated over the longer term. With the trade shock from Brexit now less than feared, we expect real export volumes to rise close to 5% in 2017, much stronger than our previous projection in September for a 3.5% rise.

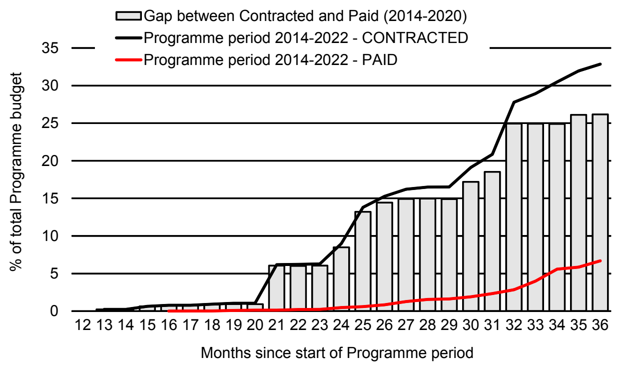
The upward revision of GDP growth in 2017 also reflects stronger investment

Meanwhile, the gap between EU funds absorption on a contractual and cash basis rose to a whopping 27% (see the rhs chart), pointing to a large volume of infrastructure projects which are about to enter the construction phase. Thus, after a slow start of EU projects from the new planning period in 2016, public investments are likely to receive a significant boost in 2017 and thereafter.

Sentiment recovery to new post-crisis highs continues



EU funds absorption is set to shift into higher gear



Source: Eurostat, EU funds-single information web portal, UniCredit Research

FDI stabilizing close to 3% of GDP, as stronger EU inflows and higher lending, all point to more investment…

…boosting further both productivity and exports

Solid corporate profits and improving productivity, coupled with signs that production capacity is falling short to meet expected demand in a number of sectors, also bode well for investment. Lending conditions are likewise improving, helped by a favorable combination of abundant liquidity, the falling cost of borrowing and stronger provisions of credit from multinational institutions such as the EIB, which have focused on the SME segment where local players have been less eager to expand. With households more confident about the stability of their income and job and banks willing to lend more, the outlook for the residential construction sector has also improved (see lhs chart), which points to both more construction activity and moderately higher house prices in both 2017 and 2018.

The drop in the number of employed in 3Q16 looks like a technical correction…

. ..as it comes against the backdrop of exceptionally solid job growth in the preceding two quarters

The number of employed in 3Q16 posted a decline yoy (-1%) for the first time since 4Q14, but the big picture looks reassuring. This reflects a drop in the number of self-employed in agriculture, which has been under way for years since jobs are migrating to sectors with higher productivity, as well as job losses in construction, due to the slow start of EU projects under the new planning period. As these trends are not entirely new, the drop seems also driven by weaker job creation in the rest of the economy, including a limited number of sectors facing labor shortages. We are not particularly worried, however, because job losses in construction should be over soon, as more EU projects are started, and especially because the fall comes against the backdrop of two consecutive quarters of an outstandingly strong pace of job creation (1.2% on average in 1H16 yoy vis-à-vis 0.4% in both 2014 and 2015), which makes the 3Q16 result look like a technical correction. Wage growth has been strong, at the same time, while risks for price competitiveness appear well contained, given a record-breaking C/A surplus which is estimated to come close to 3.7% of GDP at the end of 2016.

The outcome of early parliamentary elections is highly uncertain…

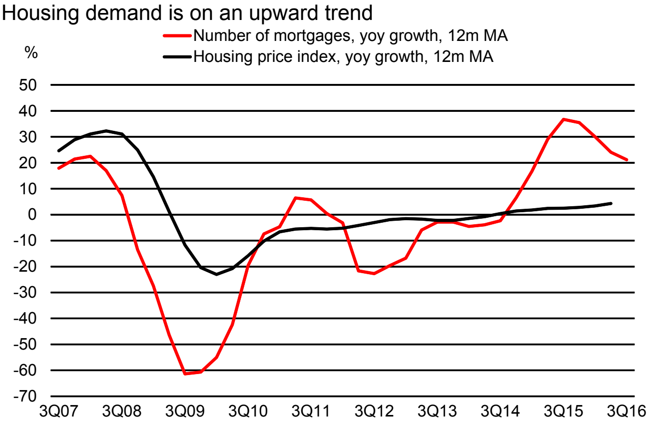
…with odds for the emergence of a populist-nationalist coalition being significant

A potential shift towards populist policies (similar to the ones in 2013 – 14) could have a far-reaching adverse impact

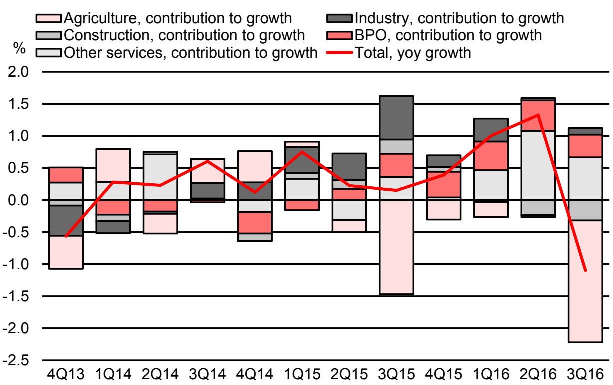
Hard-won stabilization of the energy sector may prove only short-lived if populists return to power

Deceleration of growth-enhancing reforms following snap elections is the key downside risk to our benign baseline scenario. This will amount to a major setback, given that the long-term outlook is already dark as a result of sharply deteriorating demographics. Efforts to cut corruption and overhaul sclerotic prosecution remain the key concerns, while there has been only limited progress thus far in identifying the policy changes needed to make growth not only stronger but also more inclusive. Given the country's very strong position – with solid growth momentum, twin surpluses and abundant fiscal and FX reserves – the risk for a sharp immediate deceleration of growth is small. We think that any incoming government will keep the budget deficit below the 3% threshold to avoid a standoff with European Commission that may put access to EU funding at risk. If the past has any clue to offer, budget implementation risks are likely to increase if socialists win, given their poor track record in boosting tax collection. Previous socialist-led governments have also favored social spending over investment, reducing infrastructure spending and co-financing for EU funds. In case of an excessive reversal of regulations enacted by the outgoing administration, risks for the stability of the energy sector may resurface. The past proclivity of socialist-led governments to committing to large-scale energy infrastructure projects with huge corruption potential, which at the same time make little sense on purely economic grounds, is also a risk worth watching.

Housing demand is on an upward trend



Drop in 3Q16's hours worked seems driven by technical factors



Source: NSI, Registry agency, UniCredit Research

Strategy: Value in scarcity

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Bulgarian bonds will continue to have scarcity value in 2017 with a light redemption calendar, the budget balance turning to a large surplus in 2016 and little additional issuance until 2019. Local banks continue to be awash with liquidity and will continue to be strong bid.

In 2015 and 2016, the Sovereign tapped the 7, 12 and 20-years' maturity in international markets on several occasions, issuing EUR 3.1bn in 2015 and EUR 2bn in 2016. The redemption calendar for 2017 is very light with EUR 1bn maturing in July, which was prefunded in early 2016, and the following scheduled maturity is for 2022. Hence, the USD curve will remain empty going forward, and the EUR curve relatively light.

Bulgarian EUR bonds have issue sizes slightly below other bonds in the region and the lack of USD-assets will continue to limit international portfolio investment, particularly from the US. US investors own approximately 8% of all the stock of foreign investment, which is about 1/3 of the ownership in Hungary and Slovenia or half of the ownership in Romanian bonds. Eurobond issues are mostly owned by local banks which are currently awash with liquidity; they hold the largest positions in short-term maturities, while owning relatively less of longer-term bonds.

Bond scarcity has created value and rewarded foreign investors with a better performance in 2016 compared to rated peers Hungary and Romania, with the 2023 and 2028 bonds issued in 1Q16 performing particularly well. We continue to like BGARIA bonds for their scarcity value and fiscal metrics and we prefer the belly of the curve, which currently has a lower ownership rate by local banks.

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2016F	2017F	2018F
Gross financing requirement	**-0.1**	**2.4**	**2.0**
Budget deficit	-0.8	0.8	1.2
Amortization of public debt	0.7	1.5	0.8
Domestic	0.5	0.4	0.6
Bonds	0.5	0.4	0.6
Bills	0	0	0
Loans	0	0	0
External	0.2	1.1	0.2
Bonds and loans	0	1.0	0
IMF/EU/Other IFIs	0.2	0.2	0.2
Financing	**-0.1**	**2.4**	**2.0**
Domestic borrowing	0.3	0.3	1.3
Bonds	0.3	0.3	1.3
Bills	0	0	0
Loans	0	0	0
External borrowing	2.1	0.1	0.1
Bonds	2.0	0	0
IMF/EU/Other IFIs	0.1	0.1	0.1
Privatization/Other	0	0	0
Fiscal reserves change (- =increase)	-2.4	1.9	0.6

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2016F	2017F	2018F
Gross financing requirement	**10.1**	**11.1**	**10.7**
C/A deficit	-1.7	-1.2	-0.4
Amortization of medium and long term debt	3.9	4.7	3.7
Government/central bank	0.2	1.1	0.2
Banks	0.5	0.4	0.4
Corporates/Other	3.2	3.1	3.0
Amortization of short-term debt	7.9	7.7	7.4
Financing	**10.1**	**11.1**	**10.7**
FDI (net)	1.4	1.6	1.8
Portfolio equity, net	0.9	-0.7	-0.2
Medium and long-term borrowing	5.4	3.3	2.8
Government/central bank	2.1	0.1	0.1
Banks	0.3	0.4	0.5
Corporates/Other	3.0	2.7	2.2
Short-term borrowing	7.7	7.4	7.2
EU structural and cohesion funds	1.4	1.5	1.6
Other	-4.3	-0.4	-0.6
Change in FX reserves (-= increase)	2.4	1.6	1.9
Memoranda:			
Nonresident purchases of LC govt bonds	0	0	0
International bond issuance, net	2.0	-1.0	0.0

Source: BNB, MoF, UniCredit Research

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