CEE

Quarterly

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4Q 2015

"Your Leading Banking Partner in Central and Eastern Europe"

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CEE in the autumn of 2015: The New Safe Haven?

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- The summer of 2015 was a turbulent one. Market volatility spiked in 3Q15 on concerns about Chinese growth and uncertainty regarding the pace and timing of the anticipated Fed rate hikes. Risk appetite slumped, triggering massive outflows from emerging markets (EM) as currencies and asset prices fell.
- In CEE, the difficult global market environment has further amplified the already significant divergence. Once again, the new EU members in Central Europe (EU-CEE)[1] stand out, with their economies buoyed by the fledging recovery in the euro Area (EA) and financial markets safeguarded by strong external positions and prudent policies. Unlike other EMs, EU-CEE currencies and asset prices have barely budged during the recent turbulence, transforming the region into a “safe haven” for investors in EM
- By contrast, Russia and Turkey have been severely affected by the global market volatility, albeit for different reasons. While Russia has been hammered by the renewed drop in oil prices and EU-US sanctions, Turkey’s woes are domestically-rooted and stem from protracted political instability and policy inaction. However, it is long-standing structural rigidities in both countries that make them so vulnerable.
- With the recovery in the EA gaining speed, growth in the EU-CEE will remain above potential in 2015 and 2016, and will be increasingly centered on domestic demand. The latter will be supported by improving labor markets, growing confidence and stimulative policies, as cyclically strong revenues provide scope for more spending or tax cuts. The main policy challenge for the EU-CEE would be the timing of the tightening cycle to balance the risks posed by the Fed hike and the growing probability of inflation remaining low for longer
- Others in the region have less policy flexibility. Firmer foreign demand will pull Croatia and Serbia out of recession, but growth prospects remain dim due to structural rigidities and the need for more fiscal consolidation to correct large fiscal imbalances and high public debt.
- Elsewhere in the region, the outlook has deteriorated. In Turkey, market volatility will remain elevated and confidence subdued at least until yearend, weighing on the TRY and growth. At the same time, the large C/A deficit and heavy dependence on foreign capital leave Turkey particularly vulnerable to the potential fallout on EM from the Fed rate hike, raising major challenges for monetary policy that have been left unaddressed thus far
- Russia, meanwhile, is slipping deeper into recession, with oil prices falling and sanctions restraining market access. A recovery is unlikely until late 2016 and will be slow due to long-standing structural problems. The combination of rising inflation and of shrinking output has posed major policy challenges, with the CBR likely to halt rate cuts until inflation eases early next year. At the same time, fiscal problems will intensify as falling oil revenues and limited financing force the government to choose between growth-negative spending cuts or inflationary depreciation.
- A tenuous truce in the east and the debt restructuring accord with private bondholders have provided a welcome break for Ukraine’s battered economy. However, downside risks will remain elevated as long as the conflict remains frozen and foreign official financing lags. Growth should return next year, but is likely to languish until reforms take hold, with the slow recovery raising worries about debt sustainability once IMF repayments begin.
- The main risk ahead is fallout from a Fed rate hike. While we think this is mostly priced in, the risk for disorderly market reaction remains. Turkey is most vulnerable, but Serbia and Croatia are also at risk, too. Russia, with no market access, is unlikely to be directly affected, but would suffer from the global fallout. The EU-CEE should remain resilient thanks to the lack of economic imbalances and prudent policies.

[1] This group includes some of the countries that joined the EU in 2004 and 2007, namely Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia. Croatia is addressed separately.

The good, the bad and the ugly

Increased market volatility in 3Q15 led to large capital outflows and a drop in EM asset prices

Market volatility spiked in 3Q15, with the uncertainty surrounding the anticipated Fed rate hike amplified by growing worries about a "hard landing" in China. Gloomy news from the world's second-largest economy has been reinforced by growing signs about a marked slowdown in other major emerging markets. Oil and other commodity prices dropped, and capital outflows from EM accelerated towards levels not seen since the taper tantrum more than two years ago. This is in contrast with the continued steady recovery in the EA and solid growth in the US.

This has amplified the growing divergence within CEE…

…with Turkey and Russia hard hit and EU-CEE resilient

Against this backdrop, EM assets have suffered. Currencies have depreciated, bond and equity prices have soared and growth prospects have weakened. In CEE, the difficult external environment has amplified the growing divergence we had noted previously. While the region's two largest economies – Russia and Turkey – have been hammered, the rest has weathered the latest market disturbance largely unscathed. Once again, the EU-CEE stands out, both in terms of economic and well as market performance.

Growth in CEE is set to continue at a brisk pace, with external positions remaining strong

Indeed, growth in the EU-CEE continued at a brisk pace in 2Q15 and short-term indicators suggest that the momentum will be sustained in 3Q15. We now expect real GDP to rise 2-3.5% for the year as a whole, slightly above potential. If initially growth was led by exports spurred by the recovery in the EU, now it has shifted towards domestic demand. Falling unemployment, firmer wage growth and inflation at historical lows have boosted consumption, while stepped-up EU fund absorption has boosted investment. At the same time, external positions are strong. Export growth, although off its impressive 1Q15 pace, has remained solid, with current accounts in surplus or near balance. External financing has been plentiful, supporting currencies and creditworthiness perceptions.

The lack of macroeconomic imbalances has left scope for growth-supportive policies…

…with monetary policy staying lax and room for fiscal easing

The absence of macroeconomic imbalances has opened space for growth-supportive policies. Monetary stances have remained lax, with inflation near zero due to lower food and oil prices and imported inflation, and with ample capital inflows and ultra-low foreign interest rates supporting currencies. At the same time, cyclically strong revenues have cut deficits, providing space for extra spending or tax cuts. The push to maximize the use of EU funds from the 2007-13 EU budget before they expire has also provided a one-off boost to growth.

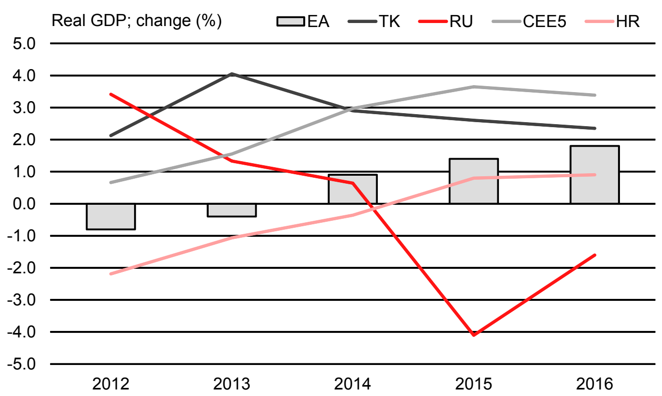
Financial markets have remained resilient…

…transforming the EU-CEE into a safe haven among EM

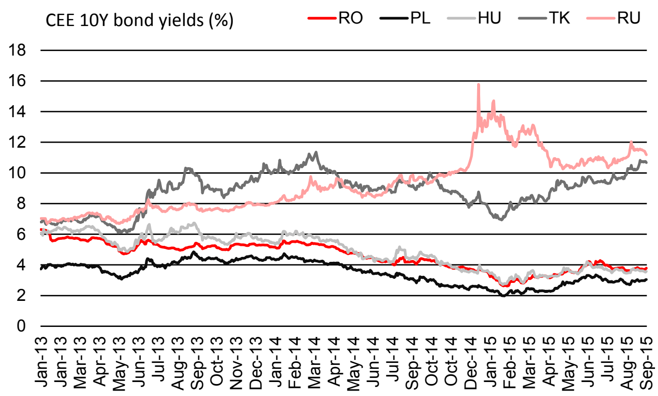
Strong and sustainable growth and the lack of macroeconomic imbalances have been reflected in improved risk perceptions. The EU-CEE market performance has decoupled itself from the general EM trend, demonstrating remarkable resilience to market disturbances with already tight spreads narrowing further. With small direct exposure to China and on the winning side of the commodity price rout, the EU-CEE is increasingly viewed as a safe haven among EM.

STRONGER GROWTH OUTLOOK, LACK OF IMBALANCES HAS TRANSFORMED EU-CEE IN EM SAFE HAVEN

The increasingly divergent growth outlook…



…has been accompanied by diverging risk premia



Source: Bloomberg, Haver, UniCredit Research

Growth has returned also to Croatia and Serbia…

…but will remain lackluster due to structural limitations and weak public finances…

Others in the region were less fortunate. While the recovery in the EA has helped pull Croatia and Serbia out of recession, growth in both will be lackluster this year at less than 1%. This partly reflects the far smaller share of merchandise exports than in the EU-CEE that has limited the positive impact of the rebound in Europe. Unlike the EU-CEE, domestic demand has yet to recover, constrained by significant and growing macroeconomic imbalances that have weighed on confidence and have constrained the policy response.

…that necessitate further fiscal tightening, weighing on growth

Public finances remain weak in both countries, with deficits outsized and government debt at dangerously high levels. This leaves next to no room for growth-supporting measures, with fiscal policy set to remain tight to comply with EU rules in Croatia and the terms of the IMF standby arrangement in Serbia. Scope for monetary policy flexibility is very limited in both, too, due to their high euroization.

The precarious fiscal positions leave both countries at elevated risk in case of a "sudden stop"

The precarious fiscal positions, with growth low and inflation all but absent, do not bode well for debt sustainability. And while the search for yield and strengthened investor confidence as the growth outlook improved has enabled both governments to pre-finance themselves into next year, this has come at a cost. Risk premia, although lower than at the start of the year, remain elevated for both countries and well above that in EU-CEE. Both remain vulnerable to a "sudden stop", with Croatia in somewhat better position with the current account in surplus, while Serbia is running a current account deficit of 4% of GDP.

Political tensions, security concerns and policy inaction have prevented Turkey from benefiting from the rebound in Europe and the low oil prices

Unlike central Europe, Turkey has failed to benefit from the positive developments in the EU, the lower oil prices or the global liquidity glut. Instead, it was among the most affected by the recent market volatility. This failure reflected a combination of protracted political tensions, a sharply deteriorated security situation, heavy exposure to countries affected by geopolitical conflicts and last, but not least, policy inaction. All these woes have been reinforced by the structurally high current account deficit and heavy reliance on portfolio and short-term capital, causing the economic performance to deteriorate markedly.

The upside surprise to growth in 1H14 is unsustainable and came at a cost…

…with inflation on the rise and a deteriorating underlying C/A position

The upside surprise to growth in 1H15, which was due mainly to fiscal expansion ahead of the June election and one-off factors, is unlikely to be sustained and came at a cost. Inflation pressures have intensified and the underlying current account position has deteriorated with exports struggling, mainly due to regional geopolitical tensions. Sentiment and high-frequency indicators point to a significant slowdown, with political uncertainty now extended until yearend, domestic political tensions rising and fighting with the PKK escalating.

TRY weakness has not been helpful to growth in the near term…

…and will continue with the CBRT likely to remain dovish until the November elections

The weak currency failed to help either. Battered by political tensions and growing worries about the sustainability of external financing, the TRY has lost more than 30% vs. the USD since the start of the year. Policy inaction played a role, too, with the CBRT not reacting to the rise in inflation due to political pressure, but also its own convictions. In the near term, the weak currency will be a drag on growth as it erodes real incomes through higher inflation, and affects confidence, while the long-term benefits on exports take time. With early elections set for 1 November, we expect the CBRT to remain dovish and to respond with rate hikes only in tandem with the Fed.

Russia has been the major loser from the oil price rout…

…causing economic contraction to accelerate and the growth outlook to weaken

Russia, meanwhile, has been the major loser from the reversal of the commodity cycle. With 75% of export receipts and nearly half of government revenues coming from oil and natural gas, the renewed dip in oil prices since July has dealt a major blow to the already weakened economy. The oil shock has been amplified by Russia's continued cutoff from global financial markets due to the sanctions. Economic contraction accelerated in 2Q15 and appears to have continued into 3Q15, leading us to revise down our 2015 growth projection to -4.1%.

Given the reliance on oil and the sanctions, policy options are limited….

…prompting the CBR to let the RUB depreciate …

Given the heavy dependence on oil and the lack of market access, policy options remain limited. The CBR responded to the drop in oil prices by letting the RUB depreciate but, unlike last year, this was done in an orderly way, helping avoid drawdowns on FX reserves. The cost of this policy, however, was a renewed bout of inflation that is likely to run its course by yearend, and an even deeper slump in domestic demand.

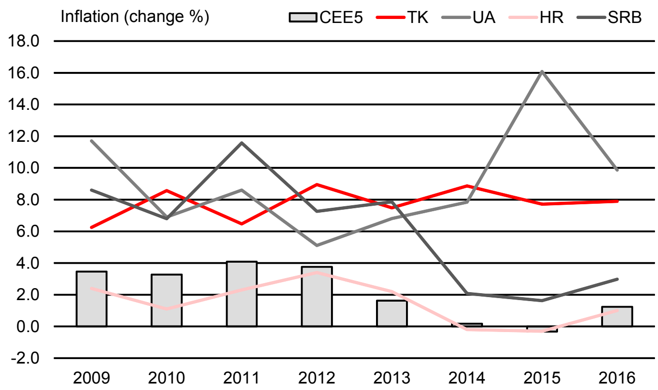
…at the cost of higher inflation

In Ukraine, the economy seems to have bottomed out…

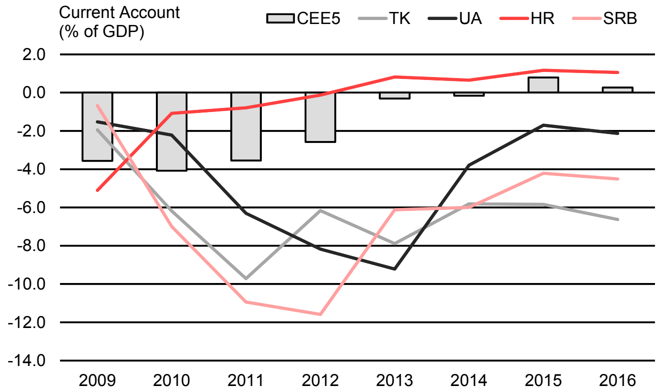
Meanwhile, fiscal policy, which was strongly expansionary early in the year, was tightened recently as the authorities realized that the oil price slump and the sanctions are here to stay. Other than that and some ad-hoc fiscal support to ailing banks and companies, the anti-crisis response has been largely absent.

MACROECONOMIC IMBALANCES SIGNIFICANT IN TURKEY, RUSSIA, UKRAINE, ABSENT IN EU-CEE

Inflation elevated in Russia, Turkey, Ukraine, absent in EU-CEE



C/A deficits remain a problem in Serbia and Turkey



Source: Haver, Bloomberg, UniCredit Research

…with inflation abating and the C/A shifting to a small surplus

However, external financing has remained limited, stifling financial markets…

In Ukraine, by contrast, which has been hit by an unprecedented financial and geopolitical crisis, the economy seems to have bottomed out in 2Q15. Real GDP, industrial output and retail sales all stabilized during the summer or have shown tentative growth, albeit from a very low level. This reflected a tenuous recovery in confidence as the fragile truce in the east has been holding, while the disruptions caused by the loss of major production capacity in the east seem to have largely run their course. Inflation after the jump related to the hike in administered energy prices has abated, and the collapse in imports was large enough to more than offset the drop in exports and shift the current account into a slight surplus.

…and reforms have advanced unevenly due to the resistance of powerful vested interests

The global backdrop for CEE should remain positive assuming gradual Fed normalization…

Elsewhere, however, the news has been less encouraging. As we pointed out in the previous *CEE Quarterly*, the amount of official financing, while enough to prevent an outright collapse, has been insufficient to stabilize domestic financial markets or the banking system. Both remain in limbo, necessitating pervasive FX capital controls and weighing on growth. Progress on reforms has been mixed. Fiscal adjustment and NBU reforms have advanced, as have the initial steps of the energy sector restructuring, but deeper reforms have stalled due to both institutional weaknesses and the control of large financial and industrial groups over large parts of the economy and politics. Finally, the drawn-out conflict in the east has continued to divert precious resources, while the collapse in commodity prices has further hit the economy.

Going in different directions

…but the outlook will be vastly different within CEE…

…with EU-CEE best positioned

Developments to date point to an increasingly divergent outlook for the CEE sub-regions. Our near-term projections are based on assumptions about a further slight acceleration in EA and the U.S. growth, commodity prices stabilizing in 2016 with moderate upward potential, a “soft landing” in China and a gradual path of Fed rate hikes. The ECB is expected to continue with its QE program as initially planned.

EU-CEE growth should remain robust, with external positions solid and external financing ample

Under these assumptions, the global backdrop for CEE should be positive. However, the outlook would be vastly different for the different sub-regions due to their macroeconomic vulnerabilities, integration with the EU, policies and the state of reforms. Judging by these criteria, the EU-CEE is best positioned to benefit from the favorable global environment.

With output gaps closing, price pressure will begin building up…

…but low foreign prices should keep inflation low…

…leaving scope for continued growth-supportive policies

Next year, growth in the EU-CEE should remain robust, again above potential. A slight slowdown can be expected in countries that have relied the most on EU funds for investment, with their absorption set to dip during the transition between the two EU budgets everywhere except for Poland. However, most of the slowdown in EU-funded investment should be offset by firming consumption, as tighter labor markets result in higher wage growth. With growth well balanced, external positions should remain stable. Given the preponderance of FDI-related flows and the strong fundamentals, we see little if any risks for external financing.

Growth will be constrained in Croatia and Serbia, with fiscal policy set to tighten further…

High deficits and debt leave both vulnerable to a "sudden stop"

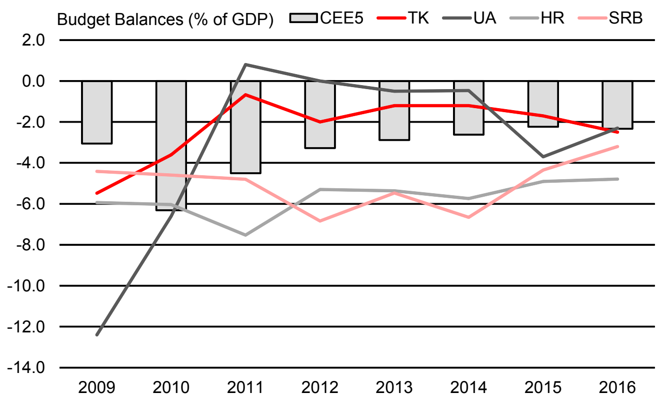
With the output gap closing, price pressure should begin picking up next year. However, still low by recent standards, oil prices, depressed food prices and low imported inflation are likely to suppress domestic inflation well into next year. We now expect inflation to remain below targets for most of 2016, enabling central banks to leave interest rates at record lows, except in Poland, where we expect the tightening cycle to commence late next year. Supported again by cyclically stronger revenues, fiscal policies will remain accommodative, except perhaps in the Czech Republic, with significant easing expected in Romania, Poland and Slovakia. Even so, budget deficits will remain within the 3% of GDP EU-mandated limit everywhere.

The near-term outlook has deteriorated in Turkey…

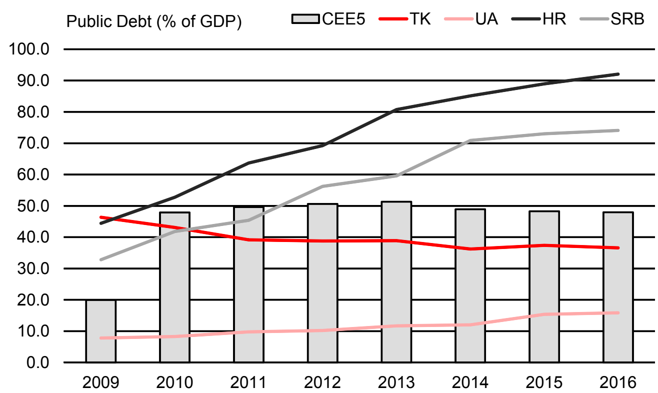
Despite a favorable external environment, the imbalances in Croatia and Serbia remain a drag on growth, with real GDP expected to pick up only slightly next year. Fiscal policies would need to be restrictive again to comply with the EU and IMF mandated targets, respectively. However, despite the further decrease in fiscal deficits, government debt will remain on an upward trend in both countries. This will leave them vulnerable to bouts of risk aversion, but major volatility should be avoided thanks to Serbia's IMF agreement and Croatia's EU anchor.

STRONG PUBLIC FINANCES IN EU-CEE UNDERPIN CONFIDENCE, BUT REMAIN AN ISSUE ELSEWHERE

Large fiscal deficits require further tightening in Croatia, Serbia…



…in order to bring government debt on sustainable footing



Source: Haver, Bloomberg, national MoF, UniCredit Research

…with political uncertainty and security concerns set to weigh on confidence and the TRY

Pre-election considerations will keep policies expansionary in the near term…

In Turkey, by contrast, the near-term outlook has deteriorated, and we see no upside potential until a new government is formed, perhaps early next year. Current polls suggest that the November election will not change the balance of power, resulting in another hung parliament. However, political parties would not risk yet another election and will agree on a coalition. Until then, political uncertainty will weigh on the outlook and the TRY, as will the intensifying fighting with the PKK and the stepped-up prosecution of other political opponents.

…with the CBRT unlikely to tighten monetary policy until the Fed rate hike

In the near term, fiscal policy will remain expansionary, but the windfall gain from the higher-than-budgeted inflation, the weaker TRY and strong imports should largely offset the pre-electoral increase in spending, leaving the deficit at 1.7% of GDP.

Assuming a government is in place early next year, the outlook should improve from 2Q16…

Pre-electoral considerations are likely to prevent the CBRT from tightening until the Fed rate hike, although a decision to simplify the complicated central bank's interest rate structure may see the policy rate – the two-week repo rate – raised from the current 7.5% towards the effective bank funding rate (8.6% at present). This, however, would have no impact on the policy stance.

…but policy uncertainty will remain with personal changes in the economic team likely in 2016

Assuming a government is in place next year, the outlook should improve starting in the second quarter. Growth should pick up, market volatility would ebb, the TRY should stabilize and inflation should moderate. This relatively benign outlook, however, is subject to economic policies remaining broadly unchanged. This might not be the case, however, with the term of the current CBRT governor expiring in March 2016 and the composition of the future economic team highly uncertain. If the AKP remains in control, pressure to ease monetary policy will intensify, while fiscal policy will be eased to accommodate populist pre-election promises. Together with a rise in interest payments due to higher borrowing rates recently, the deficit would widen to 2% of GDP or more next year.

The outlook for Russia looks gloomier, with a recovery unlikely before the middle of 2016

The CBR is likely to halt rate cuts until 2016 due to rising inflation

The outlook for Russia looks gloomier, with oil prices likely to remain low and sanctions in place. The economy looks likely to bottom out only in the second half of 2016. Due to the weak start, however, real GDP would decline again next year as a whole. Assuming oil prices near USD 50/bbl, the RUB should stabilize within the RUB 65-70/USD, which we see as a short-term equilibrium. The CBR, however, looks likely to pause its rate cuts until inflation embarks on a firm downward path early next year.

Looking ahead, fiscal policy is the main challenge…

…with a combination of spending cuts and a weaker RUB likely to offset the drop in oil prices

Looking ahead, fiscal policy will be the key challenge. With oil prices unlikely to rebound soon and financing options limited, the government will be facing a difficult dilemma – to cut real spending by more than 10%, or 2% of GDP, let the RUB depreciate further, or deplete the oil reserve fund. We think that the authorities would probably resort to a combination of all of the above. In any case, we see the current RUB level as unsustainable beyond 2015 at current oil prices without spending cuts, which we consider politically implausible. Therefore, we expect the currency to lose another 10% or so in nominal terms to boost oil revenues.

Ukraine will see a gradually improving outlook, but growth will remain sluggish…

In Ukraine, we see a gradually improving outlook, contingent on a continued truce in the east. Growth could return in qoq terms by 4Q15 and continue next year, but the pace will be slow, leaving full-year real GDP growth at 1.7% after a 12.7% decline this year. Inflation should slow but would still remain in double digits, with the current account in a small deficit.

…with a faster recovery contingent on more external financing and faster reforms

Slow medium-term growth would could put debt sustainability at risk

A faster acceleration in growth would require much larger external financing and a faster pace of reforms. The former is needed to unlock financial markets and enable the NBU to lift capital controls that have strangled economic activity, and the latter to boost potential growth. However, neither looks likely at present, raising concerns about the longer-term outlook. In this respect, weaker medium-term growth raises doubts about the sustainability of the recently agree on debt restructuring agreement, especially once IMF repayments commence in 2018.

Despite the favorable macro-economic outlook, numerous risks remain

Diverging risks and vulnerabilities

Even though risks vary across CEE, the region looks better-positioned than most other EM to cope with them

While the global macroeconomic outlook remains favorable for CEE, the ongoing market volatility entails numerous risks. These vary widely across countries and, while contained in EU-CEE, they could be quite substantial for more vulnerable economies in the region. The *EM Heatmap* we introduce with this issue provides an overview about the vulnerabilities in CEE and other key EM across a broad range of economic, financial and structural indicators (page 12). The key conclusion is that the CEE region, despite its heterogeneity, looks better positioned than most other large EM to cope with potential challenges.

Key among the risks is potential market turbulence triggered by the Fed rate hikes…

…along with a slowdown in China, and the migrants' crisis in Europe

Key among the potential risks is the uncertainty surrounding the timing and pace of U.S. monetary policy normalization and its impact on global risk appetite and capital flows to EM. Recently, concerns have risen also about the possibility of a sharper slowdown in Chinese growth and the impact it could have on global trade and commodity prices.

While the risks of a Grexit, highlighted in our previous *Quarterly Report,* have all but vanished, the unprecedented migrant crisis has raised new, potentially far-reaching challenges for Europe and for CEE.

The deferral of the Fed hike has prolonged uncertainty…

…but appears to have been largely prices-in already…

…making a rally likely once it happens

While the decision by the Fed to defer yet again the start of the tightening cycle has led to a market rally in its aftermath (more in bonds than in FX), the rally has been rather shallow, especially in CEE. In fact, we think that the deferral of the first rate hike has probably done more harm than good going forward because it has extended the period of uncertainty about when and how fast the Fed would move. It has been this uncertainty – now prolonged possibly through December – that has battered EM assets and led to massive capital outflows. As we think that the first rate hike is already priced in at present in asset values, we expect, once it happens, asset prices to rally as investors adjust to the new normal. This assumes, of course, that the first hike will be modest and the pace of subsequent tightening moderate.

Turkey is most vulnerable in CEE

Potential capital outflows would weigh on the TRY and trigger major rate hikes …

…forcing a rapid C/A adjustment, recession and deterioration in bank and corporate balance sheets

Against this background, Turkey undoubtedly remains most vulnerable in the region, both due to its well-known structural problems (a high current account deficit and excessive reliance on portfolio and short-term capital for financing), but also dysfunctional politics, the complicated geopolitical and security situation in and around the country, and policy inaction. There is a non-negligible risk of a surge in global risk aversion or a domestic event triggering large capital outflows. With net FX reserves at less than USD 30bn, the CBRT has little firepower to calm markets, leaving it no choice but to hike interest rates, perhaps as much as 200-300bp. We are less concerned about the immediate outflows, given the liquidity constraints of bond and equity markets, but more about the cessation of the inflows needed to finance the C/A deficit and sustain growth. If these outflows stop for more than a few weeks, the economy would enter recession and corporate and banks' balance sheets would deteriorate markedly.

Croatia and Serbia are also vulnerable to a reversal in capital inflows…

…that could trigger forced fiscal adjustment and recession

Apart from Turkey, Croatia and Serbia are also vulnerable. Both have large public financing needs met mostly via markets (and Serbia also a sizable C/A deficit). A "sudden stop" would trigger major financing pressures, which will be larger in Serbia given the higher share of non-residents on the bond market. Again, given poor market liquidity, outflows would be less of a problem than the loss of funding that would trigger forced fiscal adjustment and recession.

In the rest of CEE, risks are more limited…

…with Russia and Ukraine cut off from financial markets…

…and EU-CEE more likely to attract capital inflows due to its resilience

In the rest of CEE, the potential impact of a spike in global risk aversion due to the Fed is more limited. Russia and Ukraine are already cut off from markets, so that the direct impact would be minimal. Russia, however, would be affected indirectly via global contagion, which would become evident in intensified pressure on the RUB and bond prices and the availability and the costs of funding for Russian companies. The EU-CEE, on the other hand, would be largely immune from such contagion, with the countries potentially most exposed to bond outflows (Hungary and Poland) having substantially reduced their vulnerability. In fact, we might see inflows into this region as investors search for a safe haven with still acceptable returns.

Vulnerability to a Chinese "hard landing" is limited, except for Russia and Ukraine…

In recent months, worries have grown also about the possibility of a sharp slowdown in China, with potential far-reaching consequences for global growth. The effect could be two-fold: a drop in Chinese imports and a renewed slump in commodity prices. On both counts, Russia is by far the most vulnerable in CEE. Not only would direct trade be hit (China is Russia's largest trading partner), but commodity and oil prices would slump and many of the energy supply projects already agreed on with China would be halted. (China already asked for new terms and conditions on the East Siberian pipeline after the drop in natural gas prices). Depending on its magnitude, a "hard landing" in China could shave 2-3% off of Russia's GDP. Ukraine will be hit as well, given its close links to China (which accounts for 8% of exports) and reliance on commodities (one-third of exports).

...with the rest of the region having minimal direct exposure…

The rest of the region is much less exposed to China, at least directly. Exports to China account for less than 3% in EU-CEE and exposure to the rest of Asia is limited. Moreover, these countries are large net energy and commodity importers and would benefit from lower oil prices.

…but indirectly EU-CEE can be hit via trade links if EA exports to China falter

However there might be a larger indirect exposure through EA exports to China, which are significant. In this respect, the countries most integrated in the production chains of EA exporters would be hit the most – Hungary, Czech Republic and Slovakia. In any case, the impact should be manageable and would only slow the recovery but not reverse it.

The migrants' crisis has posed new challenges to parts of CEE…

…both administrative and fiscal…

Finally, in recent months, a new potential risk has arisen related to the unprecedented move to Europe of refugees from Syria and the rest of the Middle East. Scores of migrants have flooded the Balkans and Central Europe, with Serbia, Hungary and Croatia suffering the most, along with Greece and Turkey. These events have greatly strained not just the administrative capacity of these countries to handle the flood of people, but also put a heavy toll on their finances. Turkey, which has nearly 2 million refugees, reported having spent thus far more than 0.8% of GDP on caring for the migrants. Budgets have also come under pressure in Hungary, Serbia and Croatia as all struggle to handle the flow on their way to Western Europe.

…but also potentially threatening to dent intra-EU relations and cooperation

More importantly, however, with potentially larger and more far-reaching consequences is the inability of the EU members to find a practical solution on how to handle the problem and spread the burden. An East-West divide has emerged that can cause long-lasting damage to relations in the EU, with potentially significant economic and financial fallout for CEE.

EM VULNERABILITY HEATMAP

	BG	CZ	HR	HU	PL	RO	RS	RU	SK	TR	UA	MX	BR	CL	SA	ID	IN	CN
External Liquidity																		
Current account (% of GDP)	2.1	0.7	-1.0	4.7	-0.1	0.1	-5.3	5.1	0.4	-5.7	-3.8	-2.0	-4.3	-0.1	-5.4	-2.4	-1.2	2.8
Extended Basic Balance (% of GDP)**	7.9	4.5	3.7	8.8	3.9	4.5	-1.4	3.1	0.7	-3.9	-3.9	-1.0	-2.4	3.2	-5.6	-0.7	0.4	14.4
FX Reserves coverage (months of imports)	6.8	3.8	8.5	4.7	6.0	5.8	7.7	7.5	-	4.7	2.1	4.8	11.8	5.9	4.0	7.7	7.0	21.7
External Debt (excl.ICL, % of GDP)	89.4	67.2	113.8	119.2	72.9	43.6	92.6	43.2	90.4	54.5	154.2	22.9	32.7	58.5	42.4	35.0	23.1	18.5
Short-term debt (% of GDP)	18.5	27.9	8.3	16.7	7.8	7.4	0.6	3.2	20.3	16.5	27.4	2.8	2.6	21.0	29.8	5.2	4.1	11.1
REER (Index, 2010=100)	96.1	86.7	92.6	88.9	92.5	97.9	117.4	88.9	122.2	84.1	75.8	92.7	73.4	92.2	77.4	89.1	102.8	127.0
Domestic Finances																		
Household Debt (% of GDP)	29.6	33.7	41.4	26.0	36.6	22.4	16.5	20.0	35.6	23.2	13.2	15.2	25.7	34.4	34.0	9.9	10.7	36.2
Nonresident holdings of gov.debt (% total)	-	17.0	0	49.0	38.9	18.1	-	20.3	-	19.4	4.7	36.3	20.8	17.0	34.3	39.6	3.3	2.5
Banking System																		
Credit Impulse (% of GDP)	-1.5	1.2	-0.3	-4.1	3.5	-0.2	-2.3	3.8	3.4	2.2	-16.6	3.0	7.0	8.0	6.4	4.2	3.7	21.1
Loans/deposit ratio (%)	87.0	77.7	69.3	84.4	101.9	91.0	107.5	93.4	91.4	124.5	149.8	91.3	119.6	103.0	98.9	114.4	114.4	65.1
NPL (% of total loans)*	16.7	5.6	16.9	11.9	8.5	12.8	22.8	7.4	5.4	2.7	44.3	3.0	3.0	2.9	3.2	2.3	4.2	1.2
Domestic Banks CAR (%)*	21.9	16.9	20.6	17.0	17.0	18.6	21.4	12.9	17.4	15.5	9.0	15.5	15.5	16.7	14.1	19.9	12.8	13.2
Domestic Banks RoE (%)*	7.2	17.6	5.2	-2.4	12.4	8.9	5.4	2.8	11.9	14.6	-86.6	16.6	13.9	13.0	19.8	19.7	10.8	17.6

*Indicators as of 2014; **For HU, SK and RU data is as at 1Q15

Source: Haver, Bloomberg, UniCredit Research

Legend
Not vulnerable
Somewhat vulnerable
Moderately vulnerable
Highly vulnerable

EM VULNERABILITY HEATMAP (CONTINUED)

	BG	CZ	HR	HU	PL	RO	RS	RU	SK	TR	UA	MX	BR	CL	SA	ID	IN	CN
Policy																		
Policy Rate, nominal (%)	0	0.1		1.5	1.5	1.8	5.0	11.0	-0.2	7.5	30.0	3.3	14.3	3.0	5.8	7.5	7.3	4.6
Real policy rate (%)	-0.5	-0.6		1.3	2.4	1.7	3.7	-3.7	-0.1	-0.2	-18.1	0.4	4.8	-1.1	1.2	0.4	2.1	3.1
Real Money market rate (%)	0	-0.4	0.8	1.2	2.5	1.0	3.5	-3.7		2.9	-21.3	0.3	-7.8	-0.6	1.6	-0.1	-4.8	1.8
Headline inflation (yoy %)	0.6	0.7	0	0.2	-0.8	0.1	2.2	15.8	-0.1	7.7	58.8	2.9	8.5	4.2	4.5	7.1	5.1	1.5
Core Inflation (yoy %)	-1.0	0.4	0.5	1.2	0.3	2.0	-	17.1	0.1	7.3	43.8	2.3	6.5	4.4	5.7	5.0	4.6	1.6
GG Fiscal balance (% of GDP)*	-3.7	-1.0	-5.0	-2.6	-3.5	-1.9	-6.3	-1.2	-3.0	-1.5	-4.6	-3.2	-6.2	-1.6	-4.1	-2.2	-7.2	-1.1
GG Primary balance (% of GDP)*	-3.4	0.2	-1.5	1.4	-1.3	-0.4	-3.3	-0.8	-1.4	0.8	-1.2	-1.1	-0.6	-1.0	-1.0	-0.9	-2.6	-0.7
Government Debt (% of GDP)*	26.9	41.6	80.9	76.9	48.8	40.4	72.4	17.9	54.0	33.5	71.2	50.1	65.2	13.9	45.9	25.0	65.0	41.1
Markets																		
External Debt Spread (10Y, bp)	231.4	49.4	339.1	311.6	254.8	341.5	860.7	856.9	56.9	700.7	1,764.4	370.9	1,026.3	223.7	592.7	597.6	550.7	128.7
Local Currency Curve (5Y, %)	1.8	0.4	3.5	3.0	2.7	3.1	7.2	11.3	0.4	9.6	20.8	5.2	15.8	4.2	7.8	8.3	8.1	3.3
Local currency bond spread (2s10s)	222.1	124.7	89.5	177.0	132.4	218.2	156.8	17.4	120.7	-39.0	-3,418.8	193.0	-104.0	117.0	151.6	40.3	6.3	121.0
CDS (5Y, bp)	161.8	47.4	273.6	159.2	75.0	132.4	-	341.9	49.0	225.1	2,676.0	131.2	259.9	86.9	209.4	174.8	-	94.3
FX 3m implied volatility (%)		4.4	4.0	8.0	7.7	5.5	-	21.1	12.1	14.0	-	11.1	15.8	10.5	14.0	10.4	6.7	1.4
Structural*																		
IBRD Doing Business*	36.0	47.0	67.0	58.0	30.0	50.0	77.0	64.0	35.0	51.0	112.0	43.0	123.0	39.0	44.0	117.0	140.0	90.0
WEF Competitiveness Ranking*	54.0	37.0	77.0	60.0	43.0	59.0	94.0	53.0	75.0	45.0	76.0	61.0	57.0	33.0	56.0	34.0	71.0	28.0
Unemployment (%)	9.7	5.1	17.2	6.9	7.4	4.9	18.4	5.6	11.2	10.2	9.7	4.4	6.7	6.6	25.0	3.6	8.6	4.1

*Indicators as of 2014; **For HU, SK and RU data is as at 1Q15

Source: Haver, Bloomberg, UniCredit Research

Legend
Not vulnerable
Somewhat vulnerable
Moderately vulnerable
Highly vulnerable

CEE Strategy: Scope for further rally in CE4

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- We enter 4Q15 having suffered huge outflows from EM bond funds on the back of a sharp drop in oil prices and concerns about global growth. We fear this commodity price and Chinese weakness could be a structural change which could keep bonds in EM LatAm and Asia under pressure for some time. Given the risks, we expect CE4 to outperform the rest of EM on slower reflation, low issuance, comfortable cash reserves and excess liquidity. However, a meaningful EM bond rally is unlikely until outflows stabilize and risk sentiment improves. ECB and Fed concerns over global growth with downside risks to inflation may be a catalyst for further tightening, but any rally is likely to be shallow and volatility will probably stay elevated.
- In local markets, excess liquidity in the case of Romania and Czech Republic should force down front end rates and see investors extend duration, resulting in bull flattening of local curves. In Hungary, local bank demand for bonds via structural NBH support will support 2- 5Y bonds, with the long end of the curve at more risk of widening. We recommend being marketweight in Poland, with reflation slowing and with potential for a limited rally if ECB QE is extended. Idiosyncratic events in Russia and Turkey keep risks elevated and we recommend staying underweight, but we are more constructive beyond November in Russia once inflation has peaked.
- On the whole, we see more value in local bonds than hard currency bonds in CE4, but see value in the REPHUN USD 24s and 41s in Hungary on scarcity value and POLAND USD 24s in Poland on the spread to local bonds. In Romania, we like the ROMANI USD 41s and we think the Bulgaria 24s in EUR offer good value. We prefer USD-denominated bonds over local paper in Turkey and Russia due to country risks, and we see relative value trades as being the least volatile option in 4Q15. We recommend 5s10s flatteners in Romania and 2s5s flatteners in Hungary. We also favor HGB 19s vs. REPHUN EUR 19s.

CEE bonds outperform as EM FX suffers

China and oil prices caused significant deterioration in EM…

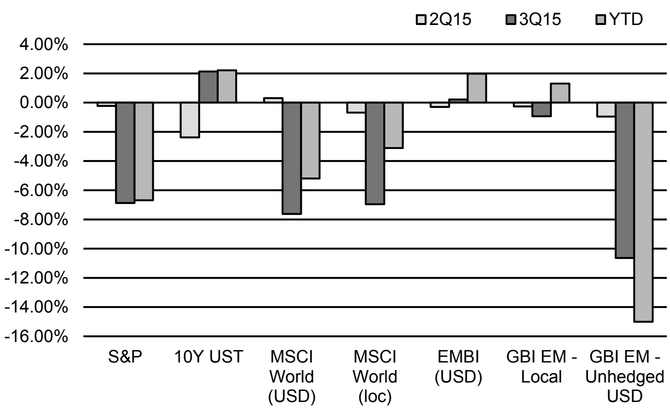
… with LatAm and Asia suffering compared to…

...the CE4 region which outperformed

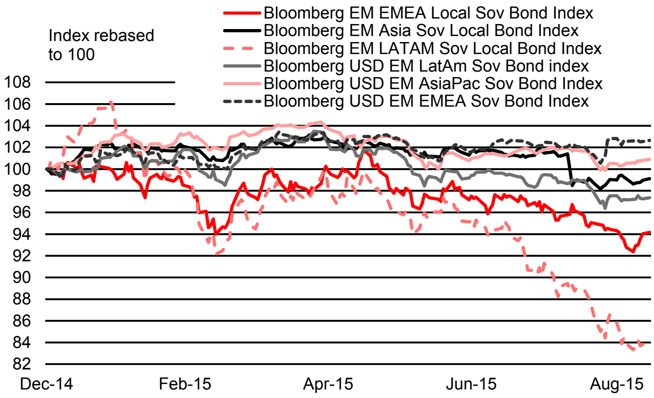
A Greek exit from the eurozone has been avoided, but now EM face issues with China and sharply lower commodity prices. Risk sentiment remains weak and investors hesitant after a significant selloff in EM bonds. Local currency bonds widened significantly across LatAm, EM Asia and among high yielders, leaving most yields at their widest levels YTD. In contrast, the CEE bond performance was strong, with the exception of Russia and Turkey, CE4 10Y yields tightening on average by 25bp over 3Q15. We expect this trend to continue into 4Q15.

EM DEBT MARKET PERFORMANCE IN A GLOBAL CONTEXT

Asset returns YTD



EM regional bond returns



Source: Bloomberg, UniCredit Research

Key themes for 4Q15

1. CE4 region – the best place to be in 4Q15 on a risk-adjusted basis

CE4 region is likely to outperform the rest of EM, on…

Among EM, bonds in Romania, Poland, Hungary and Czech Republic (CE4) should provide the best risk-adjusted returns in 4Q15 for three reasons. First, the pace of reflation is set to slow. Falling oil prices, a better harvest and lower import prices should keep inflation low. A rise is expected before year-end as base effects fade and domestic demand increases, but in the interim central banks will remain dovish, providing support to bonds. Second, with significant lower exposure to commodities and China compared to the rest of EM, CE4 are better placed if the growth slowdown turns out to be a longer structural change.

…slower reflation, low China and commodities exposure, and…

…more fundamental resilience

Third, in contrast to other EM economies, CE4 is more resilient. Macro-economic imbalances have been reduced, while the external financing capacity is positive, reducing reliance on volatile portfolio inflows. Moreover, deficits are being kept in check, reducing the amount of financing needs below 3% of GDP, covered mostly by local investors, and the pressure on currencies and on bond yields is much smaller than in other EM. Finally, real yields are high comparatively and bond issuance in 4Q15 is low, as financing needs in most CE4 are close to being met.

2. Commodity weakness and China rotation may be the start of a structural change

A change in the drivers of China's economy could lower commodity demand, while…

China's move away from investment to a consumption-driven economy will reduce demand for energy imports by de-emphasizing the manufacturing sector. In addition, a slowdown in the pace of urbanization is weakening construction, dampening base metal prices. This combined with potentially slower growth provides little support to commodity prices in the short term.

…demand in EM and Europe could also fall…

Lower demand for commodities is also probable. EM commodity exporters have been traditional drivers of demand, but they will likely reduce consumption as low prices persist. A loss in export revenue will likely prompt an increase in supply, depressing prices further. In addition, the economic benefit of lower commodity prices (denominated in USD) is likely limited by USD strength, while the risk of slower growth in Europe may undermine any expected rise in demand.

...raising risks among EM commodity exporters

These potential changes risk increased financial imbalances in EM economies reliant on commodity exports, in particular EM LatAm and Russia, while a potential Chinese slowdown will likely spill over onto EM Asia. Lower export and fiscal revenues are likely to raise political risks amid deteriorating budget deficits, and keep bond yields and currencies under pressure.

A longer-term rally is unlikely until risk sentiment improves, and…

3. Outflows and negative risk sentiment need to stabilize to facilitate a rally

Until the risk environment improves and outflows start to stabilize, we see little scope for a longer term rally in EM bonds. The short-lived improvement in sentiment after the Greece exit crisis was followed by more worrisome growth issues in China. Significant outflows from EM bond funds followed, which are now reaching 60-70% of the levels seen during the 2013 taper tantrum. A repositioning by foreign investors toward stronger economies, such as Poland and Mexico, may help, but until the pace of outflows slows, EM bond fund redemptions will provide little support for any kind of relief rally.

...outflows stabilize.

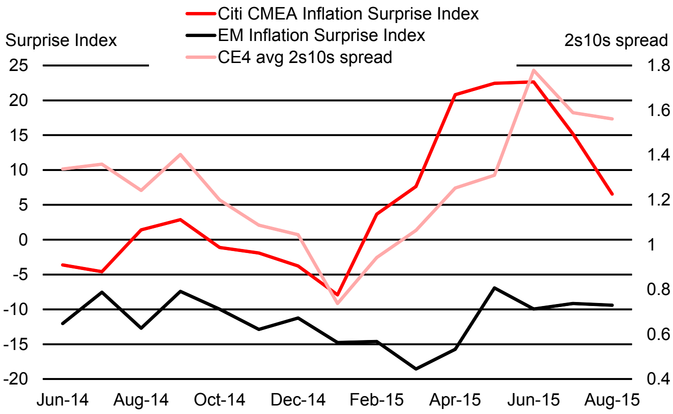
The Fed and ECB may provide support to EM bonds via…

4. ECB and Fed could be short-term white knights to EM rescue

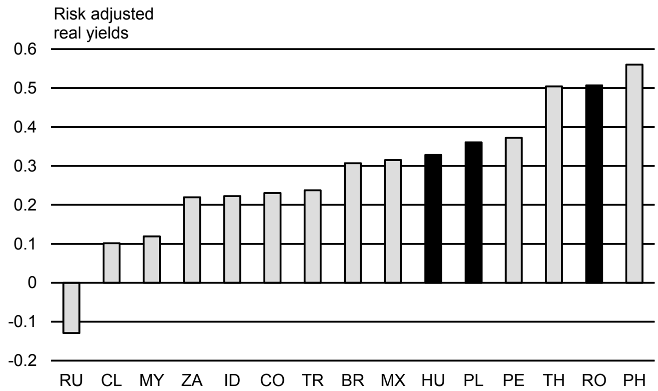
The ECB and US Fed could be the catalyst for a relief rally in EM bonds. Beyond the US Fed rate hike delay, concerns over falling energy prices and global growth were a theme echoed by the ECB, with both central banks highlighting downside risks to inflation. This should see investors switch from equities into bonds, putting downward pressure on Bund and US Treasury yields, prompting a short-term rally in EM bonds via spreads. Additionally, it should alleviate pressure on EM currencies. In CEE, if falling inflation gives way to more ECB QE, then a more significant rally in CE4 bonds is likely. The downside is that volatility will remain elevated, as the market remains obsessed with central bank rhetoric and developments in China.

…concerns about global growth and downside risks to inflation

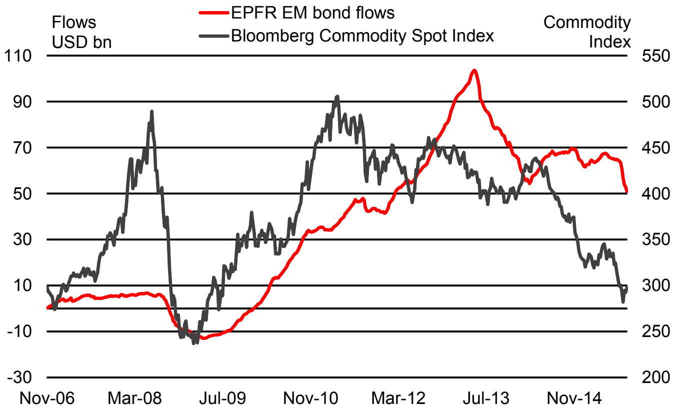
CURVES TO BULL FLATTEN ON SLOWER REFLATION



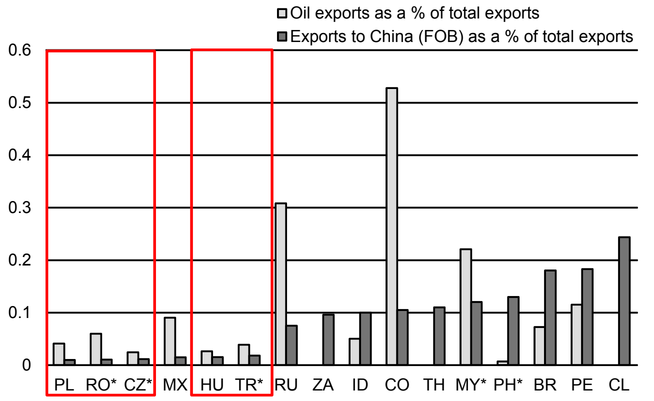
CE3 REGION WITH HIGH RISK ADJUSTED REAL YIELDS



COMMODITIES TO LEAD OUTFLOWS TO EM

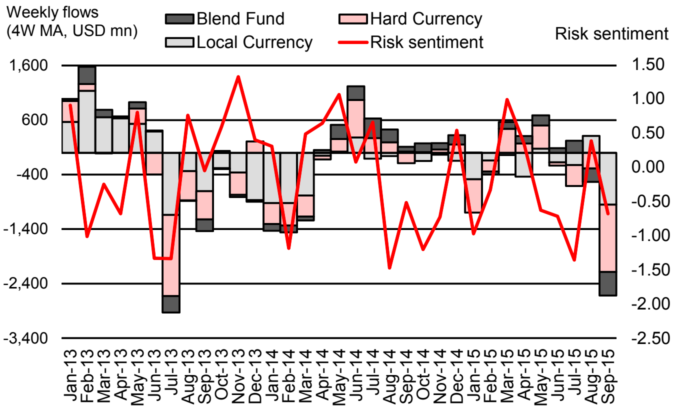


EM EXPORTS OF OIL AND EXPORTS TO CHINA

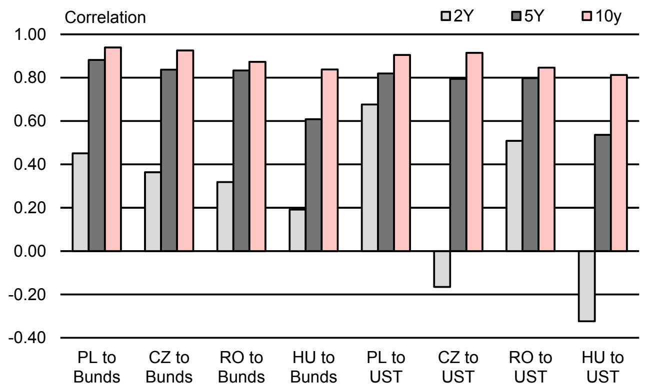


**Includes Mineral fuels, lubricants and related materials*

RISK SENTIMENT VS. FOUR WEEK AVERAGE OUTFLOWS



12M CORRELATION OF CE4 YIELDS TO BUNDS AND UST



Source: Bloomberg, EPFR,Haver, UniCredit Research

Local currency bonds: Better bond environment in CE4

Slowing reflation, low issuance and strong reserves should be positive for CE4 bonds

We favor CE4 bonds on slowing reflation, low issuance, strong reserves and excess liquidity. In Hungary, local banks' compliance with the liquidity coverage ratio and strong support in the 3Y and 5Y discount IRS auctions should support 2-5Y bonds. We recommend HGB 20. However, the HGB curve is at risk of steepening due to weak 10Y IRS demand, which is unlikely to offset foreigners exiting HGBs, 3Q15 switch auctions undersubscribed and reflation toward the end of 2015. We recommend 2s10 steepeners entering 2016.

We recommend 5Y bonds in Hungary and…

…an overweight of ROMGBs on low inflation and excess liquidity

In Romania, we recommend being overweight ROMGBs due to negative inflation, high real yields and 4Q15 government spending, likely to lead to a tightening of front end rates. With Greek, political and mark-to-market issues behind us, we expect duration extension, resulting in a curve bull flattening. We recommend ROMGB 23s and 5s10s flatteners.

We recommend being marketweight in Poland on slowing reflation, and…

In Poland, we recommend being marketweight in POLGBs. The impact of rising domestic demand on inflation is being offset by lower oil and food prices. POLGB support may come from slower reflation, low issuance, a dovish ECB and the possibility that the QE program is extended. However, we also see political and fiscal risks ahead of the election.

…see scope for short-term tightening in Czech yields

Excess bank liquidity, a dovish CNB and stalling inflation in the eurozone should see Czech bonds gain additional support from European investors. While domestic demand and inflation will accelerate in 2016, yields could tighten until December 2015. We recommend being long CZGB 36s against short CZGB 16s short term and paying 10Y swaps into 2016.

We prefer to stay underweight in Russia and Turkey short term, but…

…we see opportunities in the latter half of 4Q15 in both

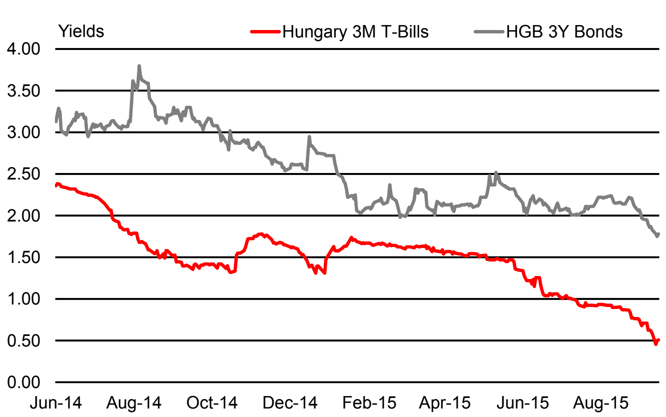
Rising inflation in Russia and in Turkey is creating a difficult backdrop. We recommend being short term underweight Russia due to higher inflation, rising issuance due to missed borrowing targets, and deteriorating fundamentals. However, we would move to marketweight in November as inflation is likely to peak, nominal yields are high and there is a chance the market starts pricing in rate cuts in 2016 if the currency stabilizes. In Turkey, we recommend being underweight and avoiding the front end of the curve. Rising inflation, political risks, and foreign outflows should keep yields elevated. We are more constructive on a six-month time horizon, as we see high potential growth and the political environment stabilizing.

We favor local bonds in Serbia, and yields should tighten provided reforms stay on track, while…

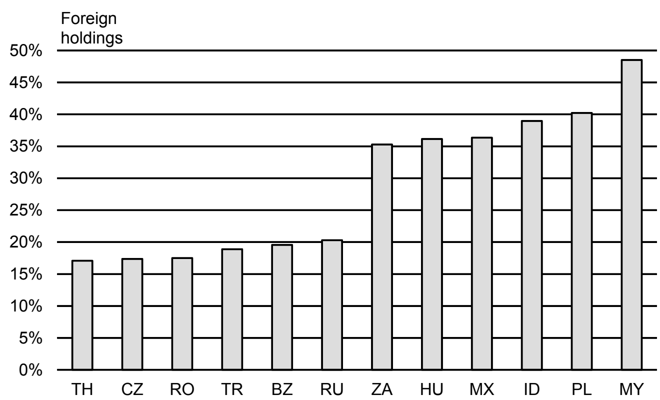
….in Croatia, we see little scope for a rally in local paper

Serbian local bonds should tighten further, but Croatian local bonds need a catalyst. We recommend the local 3Y and 7Y bonds in Serbia. Despite a rise in inflation, the target will not be met and we expect rate cuts of 50bp in 4Q15. Encouraging reform progress has helped, but a positive IMF review and the sale of Telekom Serbija in 4Q15 will be needed for longer-term yield tightening. In Croatia, further fiscal consolidation is needed, with a risk that public debt rises further amid an insufficient reduction in the budget deficit. Inflation remains negative, but with tight bond spreads to Bunds, we see little scope for a rally.

T-BILLS IN HUNGARY ANCHORING THE FRONT END OF HGBS



FOREIGN HOLDINGS IN ROMANIA LOW IN EM



Source: Statistical Offices, Bloomberg, UniCredit Research

Hard currency bonds: Value remains in USD bonds

We prefer local bonds to hard currency bonds in CE4…

… but we think hard currency bonds still hold value

Hard currency bonds in CE4 have value but we expect local bonds to outperform. Despite hard currency bonds outperforming local bonds by 250bp in 3Q15, we expect local currency bonds in CE4 to outperform hard currency bonds into year-end. We favor USD over EUR-denominated bonds due to better yields and Z-spreads, but see scope for further tightening in both.

We prefer the REPHUN 24s and 41s on scarcity value, and…

…recommend Poland USD 24s with a wide spread to POLGBs

CE4 USD-denominated bonds and EUR bonds should rally over 4Q15. High yields and a lack of issuance favor USD-denominated bonds over EUR-denominated bonds in Hungary and Poland. The goal to reduce external debt to less than 30% of total debt and replace Eurobond issues with local bonds in Hungary should create scarcity value for REPHUNs. This, combined with an expected ratings upgrade to investment grade and another upgrade in 1Q16,should be positive for external debt. We recommend the REPHUN USD 41s and REPHUN USD 24s. In Poland, USD-denominated paper is better value than local issues beyond the 6Y tenor. We recommend the POLAND USD 24s.

We favor local bonds over hard currency bonds in Romania, and…

…we favor the BGARIA EUR 24s and 35s in Bulgaria

In Romania, we like local bonds over hard currency bonds but think USD-denominated bonds offer good value. We recommend the ROMANI USD 44s and ROMANI USD 23s, which are trading at wide spreads to US Treasuries. We also recommend the ROMANI EUR 24s. We expect a EUR 1.1bn 10Y Eurobond issue before year-end, but anticipate that the up-weighting of ROMANI EUR paper in the Euro EMBIG Diversified Index in November will offset this supply. Outside of CE4, we recommend the BGARIA EUR 24s and BGARIA EUR 35s in Bulgaria due to robust domestic demand. These bonds have the additional benefit of being off benchmark if risk sentiment deteriorates.

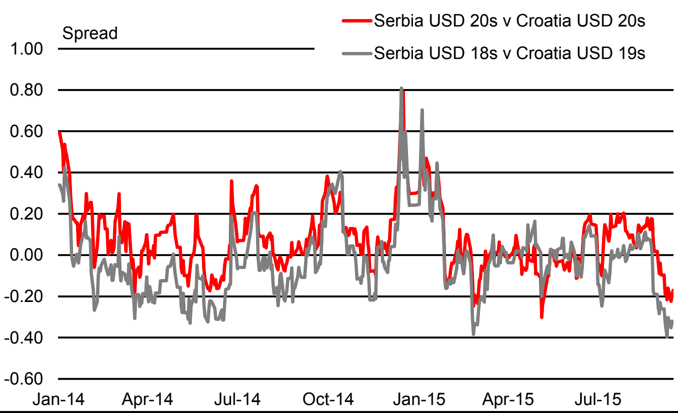
We prefer USD-denominated bonds to local bonds in Russia and Turkey and …

Balancing risks, we prefer USD-denominated bonds to local paper in Russia and Turkey. In Russia, despite sufficient reserves, we see little scope for a rally, given the current backdrop, but we think the RUSSIA USD 42s provide attractive yields. In Turkey, spreads have widened significantly, but with volatility likely due to short-term risks, we think the TURKEY USD 36s are better value than local bonds.

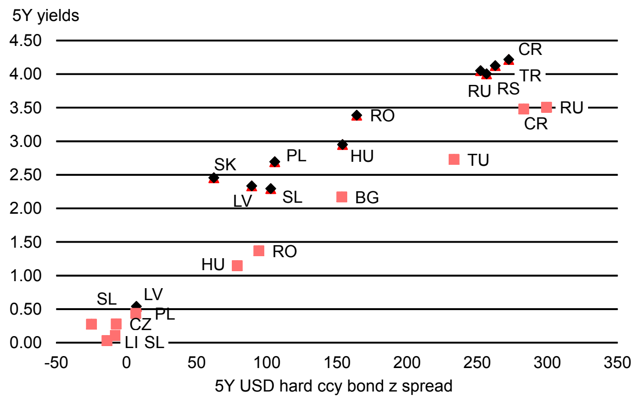
….think that Serbian USD bonds are trading too tight to Croatia

In the Balkans, Serbian USD bonds are expensive to Croatia. Yields in Serbia tightened on the spread to local paper where yields fell due to rate cuts and low inflation. Currently, Serbian USD bonds are trading too rich to Croatia. We recommend going long CROATIA USD 19s against SERBIA USD 18s on a spread of 37bp and also long CROATIA USD 20s against SERBIA USD 20s on a spread of 25bp.

SERBIA USD BONDS TRADING RICH TO CROATIA



USD BONDS BETTER VALUE COIMPARED TO EUR BONDS



Source: EPFR, Bloomberg, UniCredit Research

Relative value: the least risky option

With challenges ahead in EM, we favor potentially less volatile RV trades

4Q15 is likely to present a number of challenges for investors; elections in Poland, Turkey and Croatia (expected in November), falling commodity prices and challenges in China likely to impact inflation and EM sentiment create a potentially volatile backdrop until the end of the year. We expect relative value trades should reduce some of the risks.

Expected duration extension has us favoring 5s10s flatteners in Romania and 2s5s in Hungary…

1. **Flattening yield curves:** In Romania, low inflation until mid-2016 and excess liquidity via government spending should keep front-end yields anchored. We recommend Romania 5s10s flattener as we expect investors to extend duration on the ROMGB curve. In Hungary, T-bills will remain well bid due to the implementation of the liquidity coverage ratio. With front end yields low, we expect some extension in duration and this, combined with strong demand in the 5Y IRS auction, should see 5Y bonds continue to tighten. We recommend a 2s5s flattener.

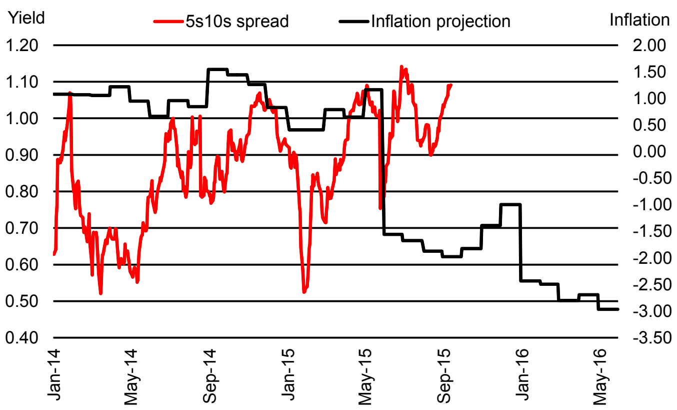
...ASW in the 10Y in Poland are at extended level, and…

2. **Asset swap divergence:** After the recent 'risk off' period, there are a number of asset swap spreads that look attractive. We recommend buying POLGB 25s against paying 10Y swaps. The spread is 42bp, which is an all-time high. We expect the spread to tighten 20bp. We also recommend selling CZGB 22s against receiving 7Y swaps. With a current spread at -47bp, a historic low, we expect some mean reversion over the next six months.

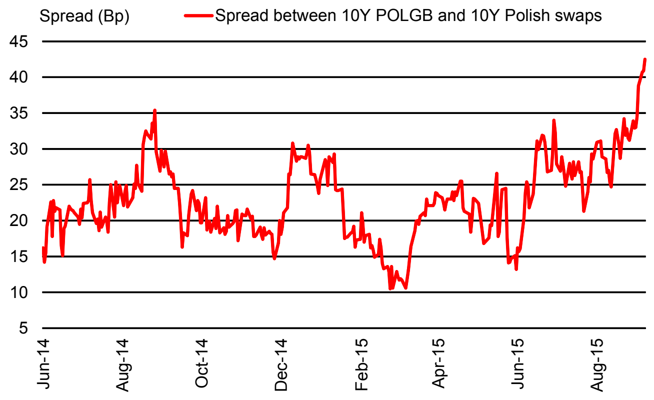
…we see greater support for HGB over EUR REPHUN and expect the spread to tighten

3. **Hard currency vs. local currency bond spreads:** We recommend being long the HGB Jun 2019 against short REPHUN EUR Jan 2019. With greater local support for local bonds via the 5Y IRS program and REPHUN EUR bonds looking rich to peers, we expect local bonds to outperform REPHUN EUR paper.

ROMGB 5S 10S SPREAD SET TO FLATTEN



ASSET SWAP IN 10Y POLAND LOOK ATTRACTIVE



Source: Bloomberg, UniCredit Research

CEE Fixed Income Trade recommendation performance

1Q15 Quarterly P&L: +328bp
2Q15 Quarterly P&L: +436bp
3Q15 Quarterly P&L: +288bp

YTD total P&L: +1,052bp

CLOSED TRADES SINCE THE LAST QUARTERLY 2Q15 – LEVELS IN BASIS POINTS

Date Initiated	Trade	Entry level	Target	Stop loss	P&L	Comment
30 Jan	Long Croatia USD 20s vs. short Serbia USD 20s	-7	27	-20	-13	NBS cut rates 100bp and the spread to USD paper saw yields tighten also
29 Apr	Long ROMGB 25s vs. POLGB 25s	78	35	90	-12	Romania suffered briefly due to a combination of misunderstood Greek risk and political disagreement with the IMF which saw bond selloff hitting our stop loss
18 May	Long ROMGB 25 vs. short ROMGB 20s	87	55	103	-16	
					Total -41bp	

OPEN TRADES – LEVELS IN BASIS POINTS

Date Initiated	Trade	Entry level	Target	Stop loss	Current level	P&L	Comment
28 Apr	Long Romani EUR 24s vs. POLAND EUR 24s	126	100	139	113	13	Romania should benefit via very low inflation compared to Poland, which should see reflation rise via domestic demand. This will likely see local bond spreads widen, causing the POLAND EUR 24s to widen also through the spread.
18 Sept,	Long POLGB 25s vs. pay 10Y swaps	42	20	55	42	0	Spread should tighten through better sentiment, slower reflation and potential for further ECB QE, which should bring some support back to POLGBs.
						Total 13 bp	

Source: Bloomberg, UniCredit Research

TRADE RECOMMENDATION PERFORMANCE FROM THE LAST QUARTERLY 3Q15 (NOT INCLUDED ABOVE) – LEVELS IN BASIS POINTS

Date Initiated	Trade	Entry level	Current level	P&L	Comment
18 June	Pay 10Y swaps	1.25	1.02	-23	Strong domestic demand was expected to bring an early exit from the EUR-CZK floor. However, with the drop in commodity prices, inflation risk is to the downside and yields tightened via excess liquidity in the banking system.
18 June	SERBIA 18s	7.21	6.01	120	The NBS continues to ease rates amid a weak domestic backdrop. GDP growth is improving and a hike in utility prices may raise inflation in the future, but we expect the NBS will have to ease rates another 50bp before year-end.
	SERBIA 22s	8.76	8.29	46	
	Long CROATIA USD 21s v SERBIA USD 21s	0.06	-0.04	-10	
18 June	Long Russia 22s	11.10	11.39	-29	While being slightly more constructive OFZs at the start of last quarter due to expect CBRT rate cuts and lower inflation, we were not expecting a 30% drop in oil prices. This caused significant RUB weakness and will flow through into higher inflation, likely limiting further rate cuts in the very short term.
	Russia USD 20	4.45	4.07	38	
	Russia USD 44	6.15	5.96	19	
	OFZ 2s5s steepener	-0.24	0.06	30	
18 June	5Y swap rec vs short TURKGB 5Y	0.24	-0.15	39	Despite recommending to underweight Turkey, the level of lira depreciation and the lack of response from the CBRT was surprising. We expect further volatility up to the election which will likely keep yields elevated.
	TURKEY USD 21	2.84	2.98	-14	
18 June	Pay 10Y swaps in Romania	3.92	3.54	-38	Greek, local political and market-to-market issues caused some turbulence, but with inflation surprising to the downside (and likely to stay negative until at least mid-2016) due to the VAT cut, we expect yields to continue to tighten over 4Q15.
	ROMGB 23s	4.11	3.56	54	
	ROMGB 5s10s flattener	1.07	1.11	-4	
	ROMANI USD 44s	5.18	4.88	30	
	ROMANI USD 23s	3.92	3.55	37	
18 June	Payer 10Y swaps in Poland	3.03	2.45	-57	Domestic demand continues to pick up but reflation may be slower in the next few months than we originally projected due to the drop in oil prices. Poland benefited last quarter from a tightening in Bund yields and also its 'safe-haven' status among EM economies after a period of declining risk sentiment.
	POLGB 2s10s steepener	1.37	1.11	-26	
	POLAND USD 21	3.04	2.70	34	
	Poland USD 22 vs POLGB 22s	0.12	0.33	-21	
	POLGB 2s5s10s butterfly	0.18	0.06	12	
18 June	Payer 10Y swaps in Hungary	3.51	2.92	-59	We had expected the HGB curve to steepen, as the long end of the curve widened over 3Q15. However, despite foreigners continuing to exit long end HGBs, the curve has been supported by lower Bund yields, a drop in inflation and some support from local banks via 10Y IRS auction. However, we expect reflation will be stronger heading into 2016 and we expect the curve will steepen beyond 4Q15.
	HGB 2s10s steepener	-2.66	-2.74	-8	
	HGB 20s	3.20	2.56	64	
	HGB 22s	3.78	3.11	66	
	Long REPHUN USD 21 vs HGB 20s	0.48	0.84	-35	
	REPHUN USD 23s	4.20	3.89	31	
18 June	BGARIA EUR 24	3.20	2.75	46	Oversold in wake of the Greece crisis. Excess bank liquidity will support yields going forward.
18 June	Basket of CE3 swaps against receive US and EU swaps	0.81	0.55	-26	We expected the long end in Hungary, Czech Rep. and Poland to widen as domestic demand picked up and that flowed through to inflation. However, the drop in oil prices, dovish ECB and delay in the first Fed hike meant CE3 bonds at the long end performed better than expected.
			Total	**316**	
			Overall Total	**288bp**	

Source: Bloomberg, UniCredit Research

CEEMEA FX: Favoring relative value

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Potential trade ideas and rationale:

1. **Look for opportunities to buy HUF, MXN and INR relative to ZAR, IDR and KRW.** The former group could benefit relative to the latter group as Chinese policy makers emphasize fiscal spending in the newer infrastructure sector, while continue to reign in the over-invested construction sector. **Stay long USD-ZAR.**

2. **Look for opportunities to buy on dips in EUR-TRY on a strategic basis:** TRY REER still seems modestly overvalued and one way that could be resolved is via a higher EUR-TRY. We remain skeptical that even an extension of the ECB's QE could sustainably weaken the EUR; we forecast EUR-USD higher from here.

3. **Sell into TRY-RUB upticks on a tactical basis**. Some of the 12% underperformance of RUB vis-à-vis TRY since June could reverse near term. Russian policymakers may favor FX stability if energy prices stabilize. On the other hand, we are not sure that the CBRT is trigger happy to raise rates. From 3Q to 4Q, BoP typically flows turn from positive to negative for TRY, and from negative to neutral for RUB.

4. **Sell EUR-HUF and EUR-PLN into October,** betting on markets attempting to play the ECB QE theme (22 October ECB meeting). **Look to buy EUR-PLN from November onwards,** with BoP seasonality and political uncertainty favoring a weaker PLN.

#1 Winners and Losers from China's stimulus shift

Trade view: Look for opportunities to buy HUF, MXN and INR relative to ZAR, IDR and KRW. Stay long USD-ZAR.

Favor HUF, MXN and INR relative to ZAR, IDR and KRW

We know weaker Chinese growth has softened commodities and commodity dependent FX in Asia and LatAm…

Chinese growth has clearly slowed and had an impact on markets and a number of emerging market currencies. We already know that slowing Chinese growth and slowing investment have hurt a lot of emerging market currencies, particularly the more commodity-dependent currencies in Asia and LatAm. In many ways, this is the reverse of the situation seen after 2009 when authorities conducted a very large fiscal stimulus aimed at the commodity-intensive construction sector (chart 1).

…which on the surface favors CE3 vs. ZAR and RUB…

In CEEMEA, ZAR and RUB are considered the usual candidates for being vulnerable, given that they are net-commodity exporters. On the other hand, CE3 currencies (PLN, HUF and CZK) are net commodity importers and hence one could make the argument that they face a positive supply shock which should help growth, and perhaps add to resilience in currencies.

…but a shift in the focus of Chinese fiscal stimulus from here…

However, focusing on the texture of Chinese growth could be important in terms of differentiating EM FX performance going forward. Recent reports suggest that Chinese authorities are considering sizeable fiscal stimulus. However, unlike in early 2009, such stimulus is expected to be focused on *infrastructure industries* rather than *property and construction.*

…from the old industries of construction to newer infrastructure….

Recent data show that Chinese fixed asset investment in infrastructure is growing decently compared to real estate and manufacturing which continue to slow (chart 2). If authorities continue to de-emphasize construction but now begin to target infrastructure, what implication may it have on currencies?

Chart 1: Commodities closely aligned to Chinese construction investment

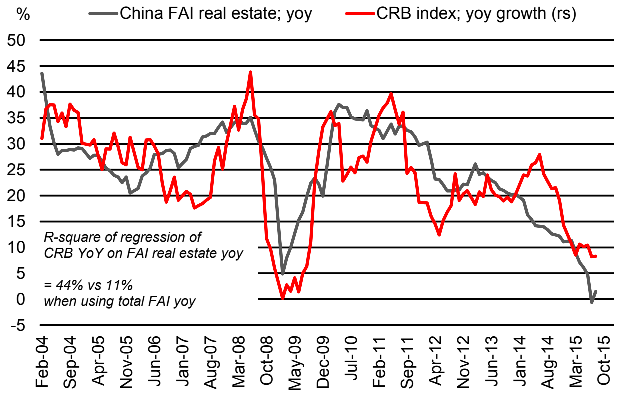
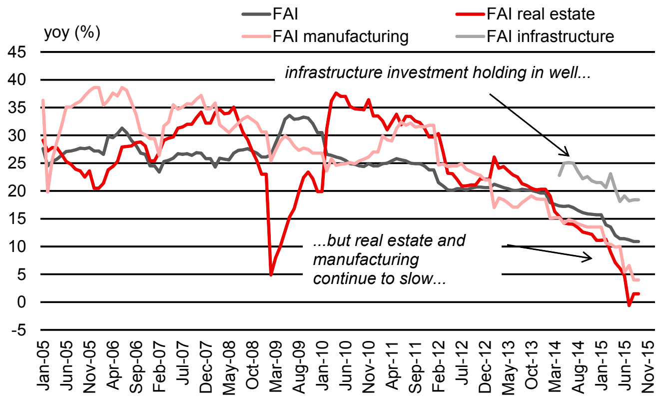


Chart 2: China FAI components: Infrastructure investment strong but construction investment weak



Source: Bloomberg, UniCredit Research

…could favor some EM FX over others…

In order to answer this question, we look at data on Chinese import growth from various emerging market countries from 2010 to present and estimate regressions for each on fixed asset investment growth in **(a)** real estate and **(b)** infrastructure growth.

..Examining Chinese imports from EM vs. these two components of Chinese FAI…

Our strategy would be to favor those currencies whose exports to China appear to feed China's infrastructure investment relative to real estate investment. Charts 3 and 4 (on the following page) present the results.

…suggest that ZAR, CZK, IDR, KRW, MYR and BRL

Our results suggest that PLN and HUF in CEEMEA, TWD in Asia and COP and CLP in LatAm appear relatively immune to a continued slowing in Chinese construction. On the other hand, ZAR appears the most vulnerable in CEEMEA. And interestingly, our findings indicate that CZK could be somewhat at risk via the potential change in structure of imports. While a commodity exporter as well, RUB scores as less vulnerable and appears in a similar position as TRY. In Asia, IDR, KRW and MYR look exposed, while in LatAm BRL continues to stand out as being vulnerable to ongoing slowing in the Chinese construction sector.

…could lose out vs. HUF, INR and MXN

In terms of currencies that could benefit from rising infrastructure investment, HUF stands out, as do INR in Asia and MXN in LatAm.

Chart 3: EMFX less vulnerable to slowing Chinese construction investment

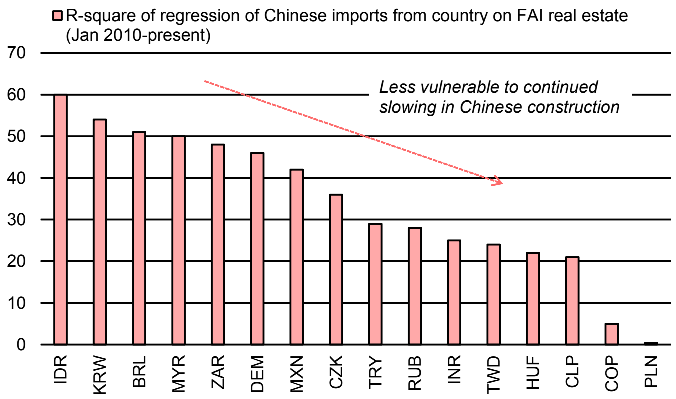
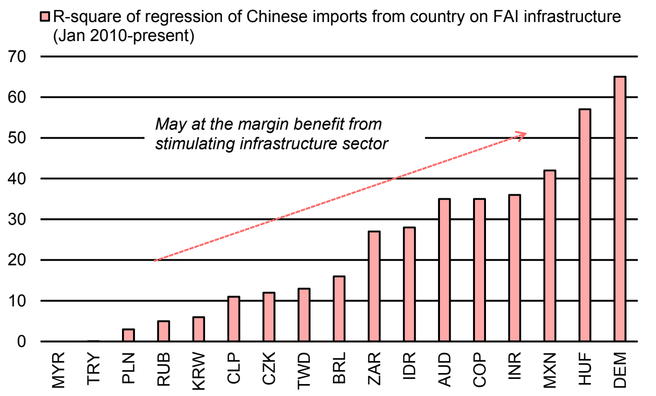


Chart 4: EM FX that may benefit from Chinese infrastructure spending



Source: UniCredit Research

#2 TRY: Still Medium-term bearish, and struggling to find a positive catalyst in the short-term

Buy on dips in EUR-TRY

Trade view: Look for opportunities to buy on dips in EUR-TRY, especially ahead of the 22 October ECB meeting.

Modest TRY REER overvaluation could be resolved via higher EUR-TRY…

TRY is cheaper compared to three months ago and yields are at more attractive levels, but we struggle to see a positive catalyst on the horizon for TRY in the next few months. From a valuation perspective, TRY may have become considerably less overvalued than was the case, but there is still a mild 5-6% REER overvaluation relative to other externally imbalanced currencies when we look at the IMF's external balance assessment (chart 5).

...with CBRT sounding concerned about weak external demand and with the euro area one of the bright spots

One way that could be resolved is via a higher EUR-TRY. Exports to the euro area are one of the few bright spots for the Turkish export sector. In some presentations in 2Q, the CBRT presentations contained charts which showed that the TRY had appreciated against the EUR (though weakening against the USD).

Avoid positioning on the basis of politics

Ahead of the June election, the tactical strategy on TRY seemed a bit clearer: play for a tactical rally on an AKP simple majority (though not a constitutional majority), and for longer term investors, using any such TRY rally to re-position for a medium term bearish TRY view.

TRY: Damned if the AKP get a simple majority, damned if they don't?

But this time around, we struggle to see what constitutes good news on the political front. On the one hand, should the AKP fail to gain a simple majority (as polls are currently suggesting), we may have to go through the drama of the AKP trying to form a coalition once again. This would be negative from the view of continued uncertainty. On the other hand, should the AKP gain a simple majority, we are concerned that political pressure on the CBRT will increase again. Indeed, just as coalition talks failed, the political criticism of the CBRT (which had largely been absent around the election and coalition talks) resurfaced, which hurt the currency. Hence, we would not position on political scenarios this time around.

Chart 5: TRY REER still modestly overvalued according to IMF external balance assessment (TRY vs. the fragile five)

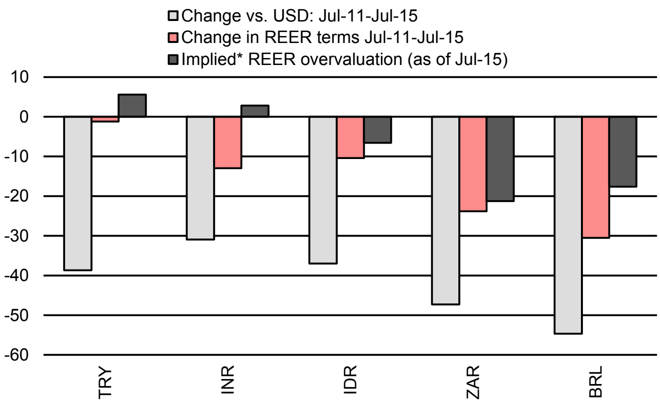
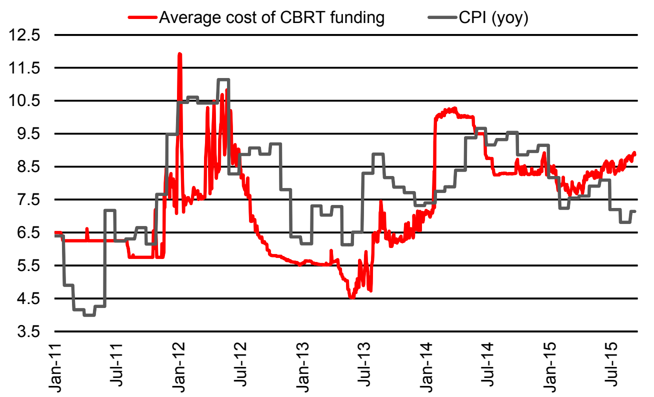


Chart 6: Inflation was trending higher when CBRT aggressively raised the average funding rate in the past – unlike the present.



Source: IMF, Bloomberg, UniCredit Research

We don't think CBRT action will be a barrier to further TRY losses…

From our point of view at present, the most important question when one continues to position with a bearish TRY view from here depends on whether one thinks the CBRT is close to decisively hiking interest rates as was the case in January 2014, or squeezing liquidity and engineering higher rates as had been done with much success in 2011-12 (and with less success in 2013).

While TRY has weakened sharply, we think still that this is less likely at this stage and things may first need to get worse. We cite some reasons below in addition to the general belief that the CBRT's hands are tied by politicians.

…so long as inflation is not trending higher yet…

First, we find that typically the CBRT has tightened policy when inflation has been trending higher with strong momentum (chart 6). Recently, inflation has been weaker due to specific short-term effects (food prices). While such weakness in inflation could well prove temporary, we think one would need to see successively stronger inflation prints to make a strong CBRT response to (indirectly) stabilize the TRY more likely.

…and so long as TRY risk premia are blowing out in line with other EM…

Secondly, we find that the CBRT has tended to tighten policy in a TRY asset sell-off whenever idiosyncratic developments were in the driver's seat and Turkey was selling off more than similar-rated EM. The CBRT often shows charts containing risk premium measures of similarly-rated EM like Indonesia, South Africa and Brazil in their presentations (called "selected economies average[2]". In chart 6 below, we plot the differential of Turkey 5Y sovereign CDS vis-à-vis the above group against **(a)** the benchmark 1W repo rate and **(b)** the CBRT's average funding rate.

…and not beyond that seen in other EM

There is a reasonably good fit and whenever the CBRT tightened liquidity via the rates corridor (in 2011-12) or hiked rates decisively (January 2014), Turkey sovereign CDS were trading considerably wider versus other similarly rated EM. Currently, one could argue that the CDS differential is trading tight because the other EM countries' CDS are very wide, given broader risk-aversion and specific concerns- including the recent downgrade of Brazil. However, that exactly underlines our point: our interpretation is that the odds the CBRT decisively respond to stabilize TRY increase when the central bank can do something about it. Right now, any action may be futile given several EM are being affected, and not just Turkey.

Things may have to get worse still to elicit a CBRT tightening response…

Admittedly, with a much lower level of net FX reserves relative to other emerging markets, there may be little choice but to use higher interest rates to stabilize the TRY. Other EM central bankers may have the leeway of considering strong USD-selling intervention. However, we still think that things may have to get even worse before the CBRT comes in (indirectly) stabilize the TRY via higher interest rates.

Chart 7: No blowout in TRY CDS vis-à-vis other EM which preceded prior CBRT actions

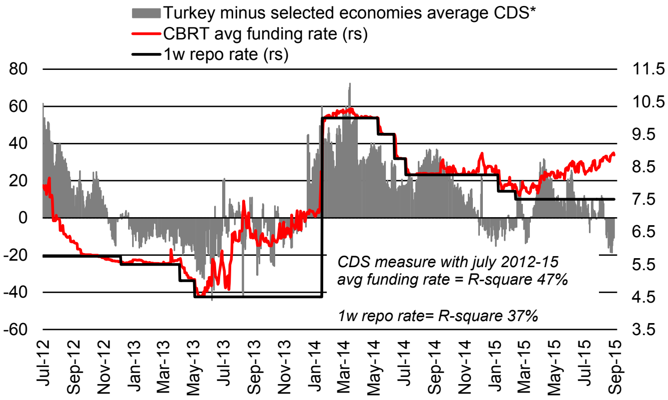
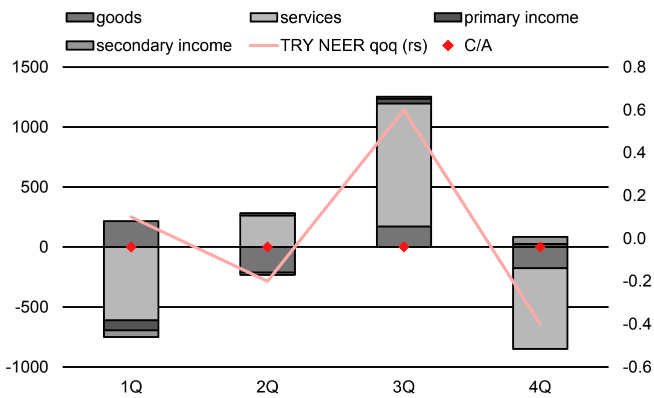


Chart 8: Turkey C/A: seasonal factors



Source: Bloomberg, UniCredit Research

[2] For example, see page 63 of the CBRT's 3Q Inflation report here

Bearish BoP flows could further undermine TRY in 4Q

Finally, seasonality continues to support our view for further underperformance in the TRY for the remainder of the year. Charts 8 shows the quarterly seasonal factors of the current account to 4Q. Indeed, 3Q is usually a good quarter for TRY. Hence. even in the event we somehow get a positive catalyst which sees bonds rally and drives (currently) underweight investor flows back into Turkey, weakness elsewhere in the balance of payments could provide some offset in 4Q.

Chart 9: A weaker RUB to ensure oil revenues (RUB terms) remain adequate

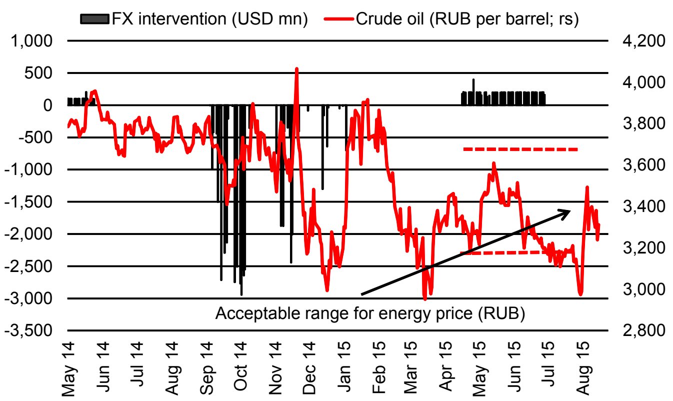
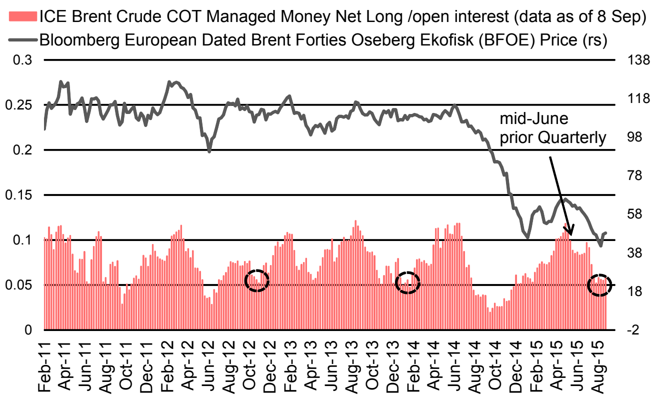


Chart 10: Positioning suggests more two-way risk in energy prices (hence RUB) compared to 3 months earlier



Source: Bloomberg, UniCredit Research

#3 RUB: Medium-term bearish, but tactically constructive

Trade view: Sell into TRY-RUB upticks.

Medium term a lower RUB is inevitable …

We have a bearish fundamental view on the RUB with an annual average USD-RUB forecast at 75 and 85 for 2016 and 2017, respectively. In the absence of a sharp rally in energy and/or de-escalation in financial sanctions, further RUB weakness will be a necessary part of both the external and internal adjustment of the economy. That said, as long as energy prices maintain some stability, our impression is that policy makers would prefer to see some stability in USD-RUB in a 65.00-70.00 range. In the event that USD-RUB moves to a 68.00-70.00 range, our preference would be to be long the RUB against the TRY. TRY-RUB has rallied by almost 12% over the past four months, and there may be decent scope for a reversal. We present a number of reasons below why we have this view on a tactical basis.

But if energy prices stabilize, we like selling TRY against RUB…

Chart 11: Russia C/A: seasonal factors

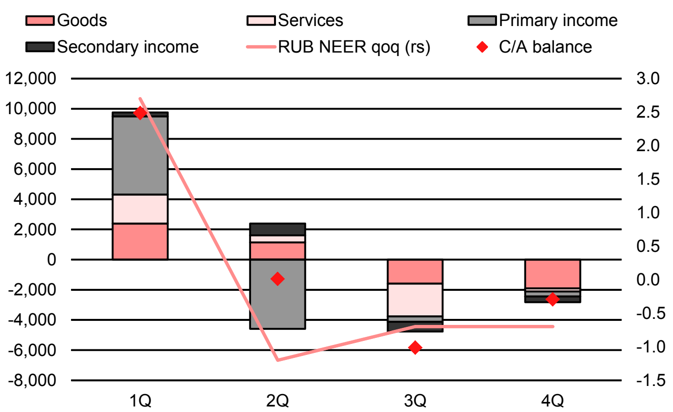
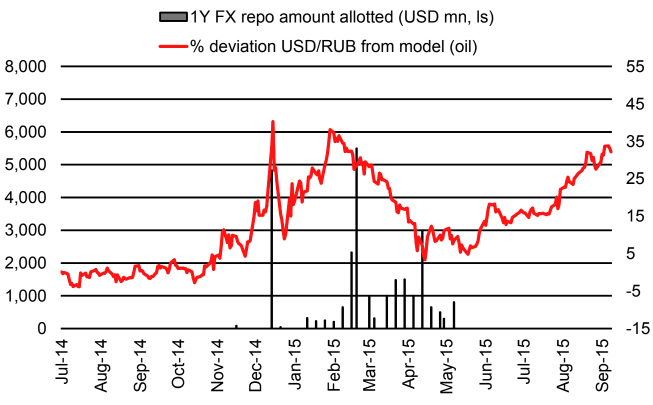


Chart 12: Re-introduction of 1Y FX repo would help RUB relative to energy prices



Source: Bloomberg, Central Bank of Russia, UniCredit Research

Relative to three months ago, positioning argues for more two-way risks in energy prices (and hence RUB) in the near term

First, we remain wary on extrapolating bearish price action in energy prices and think that compared to three months ago, there is much more scope for two-way price action. When writing the last quarterly, we flagged that tactically the risk was for weaker energy prices weighing on the RUB. At the time, we found that some measures of positioning were at stretched levels on the long side that preceded corrections lower in energy prices. We reproduce the positioning series here (chart 10) and it now shows that positioning seems a lot cleaner. Hence, rather than extrapolating weakness in the next 1-3 months, we remain cognizant that there may be scope for more two-way price action in energy prices. All else being equal, that should translate into more range-bound trading in USD-RUB.

…seasonality suggests trade flows could be less negative in 4Q vs. 3Q…

Secondly, the seasonal trough of Russia's current account is behind us (chart 11). Indeed, this was one reason for our bearish view back in July . Hence, there may be less of a negative drag – that was seen in 3Q – carrying over into the final months of the year. Corporate debt payments do pick up from USD 29.3bn in 3Q to USD 36.8bn in 4Q, which would pose a risk if the CBR were to not address any excess FX demand via FX repos.

…and amid signs authorities could be more concerned with recent pace of RUB volatility…

Thirdly, there are signs that authorities- while happy with a weak currency given movements in energy prices- may have become concerned about the pace and volatility of recent movements.. Since late August, the CBR and the government have reportedly been working together with companies on the sale of FX revenues, while the CBR has become more open to increasing FX liquidity via FX repos if needed. We find that the rhetoric is quite different to what was seen as recently as early August when the CBR sounded more sanguine about corporate demand for FX. It also reminds us a bit of the last few weeks of December when authorities were coordinating activities with exporters to sell FX revenue when the RUB was close to a trough.

…increasing FX repos would be RUB positive

Increasing FX repos would be a tactically positive signal for the RUB. Chart 12 reproduces the residual of a regression of USD-RUB on energy prices (or the part that cannot be explained by energy prices) against the provision of liquidity via the 1Y FX repos. As can be seen, the 1Y FX repos helped RUB perform strongly beyond what was explained by oil prices.

#4 CE2 FX: Still range bound vs. EUR. No strong cue for PLN-HUF

Trade view: Sell EUR-HUF and EUR-PLN into October. Look to buy back EUR-PLN from November onwards with BoP seasonality and political uncertainty weakening the PLN. Avoid taking directional bets on PLN-HUF into year-end. A stabilization in energy prices and a more dovish NBH next year (despite faster reflation in Hungary) would help PLN-HUF develop a rally next year.

Expect downward pressure in EUR-HUF and EUR-PLN in October…

From a big picture point of view, we have in recent quarters emphasized the importance of ECB QE expectations (which we capture here by 5Y German real yields) on both EUR-PLN and EUR-HUF. Recent price action suggests that ECB QE has not been a driver and the recent moves lower in both crosses is largely a removal of risk-aversion in broader EM. But over October, we think that: **1.** Expectations of a more dovish message and potential step-up in QE ahead of the 22 October ECB meeting, and **2.** A better demand-supply backdrop for Bunds could drive German real yields and hence EUR-HUF lower in October.

…followed by a rally in EUR-PLN from November on political uncertainty…

However, further through October markets could become more nervous as we approach the 25 October parliamentary elections in Poland and immediately after. Recent polls show that the main opposition party PiS has a strong lead and could well gain control over both houses. If this is the case, then the PiS may be able to select a majority of members in the Monetary Policy Council when current mandates expires in January-February 2016.

…and with BoP seasonality favoring PLN under performance in Q4

Markets could adopt the view that the make-up of the MPC could become more dovish and the prospect for rate hikes in 2016 could be unwound. While not our baseline, another potential source of risk is of fiscal policy slippages under the proposed policies of the PiS which could pose a risk to Poland's EM safe haven status. But besides the political noise , what really makes us nervous and aligns with a more negative scenario for the PLN into year-end is balance of payment seasonality, which tends to work against the zloty as we move from 3Q to 4Q.

Chart 13: EUR-PLN vs. 5Y German real yields

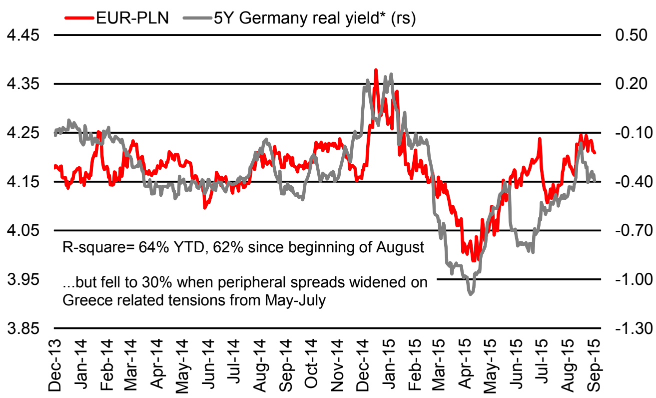
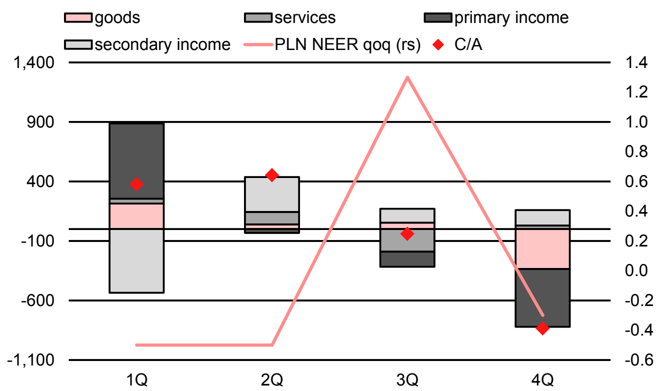


Chart 14: Poland C/A: seasonal factors

(C/A vs. PLN NEER)



*German 5Y Obl yield minus 5Y breakeven

Source: Bloomberg, UniCredit Research

Relative policy divergences should have helped PLN-HUF rally…

In terms of relative value, we have much sympathy with a long PLN-HUF on the monetary policy divergence theme. It seems clear that over the longer haul, there is some evidence that relative monetary policy and interest rate differentials do drive moves in PLN-HUF (chart 15).

… with the NBH remaining dovish and potentially anchoring funding rates lower for longer…

We currently look for two hikes from the NBP in 2016, while Poland could be one the only CE3 country benefitting from larger EU fund flows next year than in 2015. On the other hand, it is our strong view that the NBH will continue to ensure excess liquidity remains in place via various measures – like the recent acceleration of the implementation of the liquidity coverage ratio (LCR). This will ensure that T-bill and 3-5Y T-bond auctions remain well bid while keeping front rates at levels well below the level of the official policy rate. This will ensure HUF remains a low yielding currency attractive for funding purposes.

.. but the sharp decline in energy prices last year and recently…

...may have undermined the policy divergence theme

That said, we think that movements in energy prices may have been responsible for breaking down the relationship between relative rate expectations and PLN-HUF. As a proportion of GDP, the energy trade deficit for Hungary is far larger than that of Poland (energy deficit near 6.5% of GDP for Hungary in 2014 vs. 2.6% for Poland). We think as a consequence that changes in trade flows perhaps tend to help Hungary relative to Poland when energy prices fall by a big margin. This may help explain why there is a longer term relationship between appreciation cycles in PLN-HUF and energy prices (Chart 16).

Chart 15: PLN-HUF and 2Y IRS differential

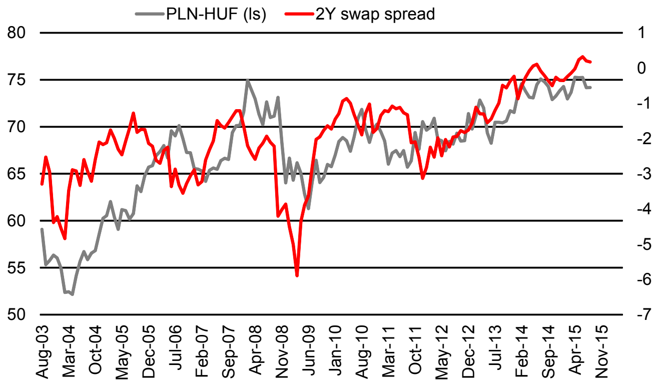
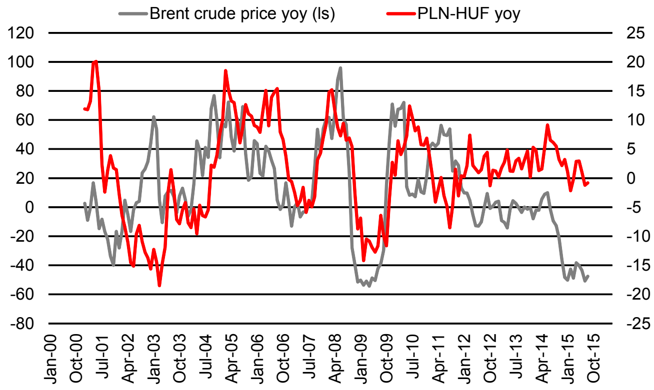


Chart 16: PLN-HUF vs. energy prices (both yoy)



Source: Bloomberg, UniCredit Research

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

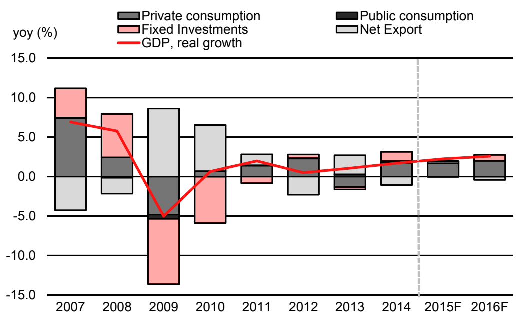
Outlook – We raise our forecast for real GDP growth to 2.3% (from 2.1%) for this year and to 2.6% (from 2.4%) next year to take into account the sharply increased EU funds absorption along with the stronger-than-expected fall in oil prices, which should act like a tax cut and support domestic demand. Rising wages, low inflation, and a further rise in new jobs, mostly for workers with medium-to-high qualifications, will help lift consumer spending. These three factors should more than offset the pronounced deceleration of export growth next year, when normalization of US interest rates is likely to constrain demand in some of Bulgaria's key trading partners in EM. The virtual absence of macroeconomic imbalances leaves Bulgaria among the most resilient to the effect of Fed tightening. The major downside risks could come from negative surprises associated with the upcoming bank stress tests and AQR.

Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)

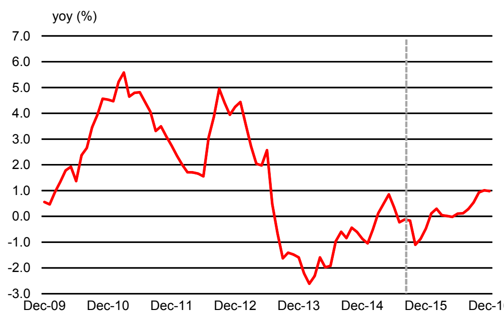
KEY DATES/EVENTS

- 25 Oct: Local elections
- 30 Oct: Budget Act 2016 introduced in Parliament
- 13 Nov: Flash GDP estimates for 3Q15

GDP GROWTH WILL GAIN MORE STRENGTH



INFLATION IS EXPECTED TO RETURN SOON



Source: NSI, BNB, MoF, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	40.9	41.0	42.0	42.9	44.1
Population (mn)	7.3	7.2	7.2	7.2	7.1
GDP per capita (EUR)	5.618	5.665	5.833	5,989	6,199
Real economy yoy (%)					
GDP	0.5	1.1	1.7	2.3	2.6
Private Consumption	3.2	-1.8	2.4	1.1	2.4
Fixed Investment	2.0	-0.1	2.8	3.6	4.4
Public Consumption	0.5	3.6	1.9	0.9	0.6
Exports	0.8	9.2	2.2	7.7	3.5
Imports	4.5	4.9	3.8	6.6	3.6
Monthly wage, nominal (EUR)	374	396	423	452	478
Unemployment rate, avg (%)	12.3	12.9	11.4	9.5	8.3
Fiscal accounts (% of GDP)					
Budget balance	-0.4	-1.8	-3.7	-2.2	-2.5
Primary balance	0.3	-0.9	-3.0	-1.3	-1.5
Public debt	17.6	17.9	26.9	26.4	28.6
External accounts					
Current account balance (EUR bn)	-0.1	0.8	0.4	1.8	1.1
Current account balance/GDP (%)	-0.3	1.9	0.9	4.2	2.4
Basic balance/GDP (%)	2.3	4.9	3.1	7.2	5.6
Net FDI (EUR bn)	1.1	1.2	0.9	1.3	1.4
Net FDI (% of GDP)	2.6	3.0	2.2	3.0	3.2
Gross foreign debt (EUR bn)	37.7	36.9	39.8	39.9	40.2
Gross foreign debt (% of GDP)	92.2	90.0	94.7	93.1	91.2
FX reserves (EUR bn)	15.6	14.4	16.5	20.6	23.6
Inflation/Monetary/FX					
CPI (pavg)	3.0	0.9	-1.4	-0.2	0.4
CPI (eop)	4.2	-1.6	-0.9	-0.5	1.0
Central bank reference rate (eop)	0.04	0.07	0.02	0.02	0.03
USD/BGN (eop)	1.48	1.42	1.61	1.67	1.60
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.52	1.47	1.47	1.72	1.63
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Reseach

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

Bulgaria: rotation of growth drivers

Domestic demand rise in 2Q15 was centered on reserves changes, which increases the odds for more revisions, where abnormally large positive contribution of reserves changes is reduced, while those of individual consumption and investments are increased

We stick to our above-consensus scenario and raise our forecast for real GDP growth from 2.1% to 2.3% for this year and from 2.4% to 2.6% next year. In 2Q15, output expanded 0.5% qoq in seasonally adjusted terms, or 2.4% yoy, in line with our expectations. Positive news came from domestic demand (up 3.9% yoy), while the contribution of net exports fell sharply.

Fundamentally, the economy looks well positioned to continue its export-led recovery, which has been reinforced by the sustained drop in oil prices, the weaker euro and a gradually improving labor market. Recent data releases, especially August's improvement in economic sentiment (which posted its highest headline print in seven years), are consistent with another 0.5% qoq growth in 3Q15. Growth in 2H15 will be mostly supported by EU funds absorption, which was taken to an unprecedentedly high level and ought to help investment gain more traction. The latter should more than offset the negative impact of smaller tourism receipts and the one-off hit that capital controls in Greece are likely to have had on exports in 3Q15.

Despite headwinds from weak global trade, we remain bullish on the Bulgarian economy and its resilience this and next year

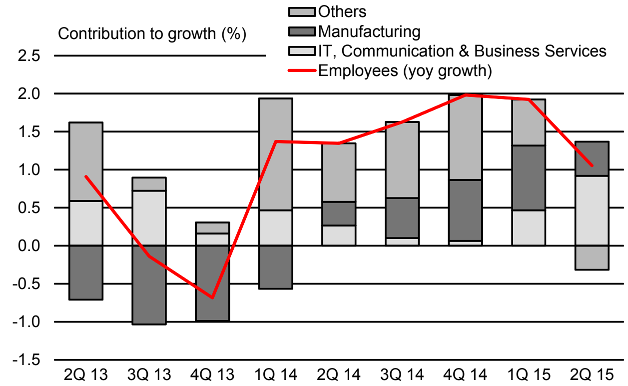
The rotation of growth drivers that started this year will increasingly take shape next year. As a result, GDP growth will pick up and its composition will improve. In particular, we expect exports to buck the trend of disappointing global trade growth and rise by another real 3.5% next year. Still, this will represent a moderate deceleration from the 7.7% growth forecasted for this year. Most of the weakening will reflect the impact of the upcoming normalization of US interest rates, which we expect to negatively affect demand in some of Bulgaria's trading partners that are seen as particularly vulnerable, such as Serbia, Croatia, and especially Turkey. In contrast, a gradually improving labor market, the impressive progress in EU funds absorption, abundant internal and external liquidity as well as the lagging effect from the recent stronger-than-expected fall in energy prices should all help boost private consumption and investments next year.

A further rise in new jobs, increasing wages and still low inflation will lift consumer spending

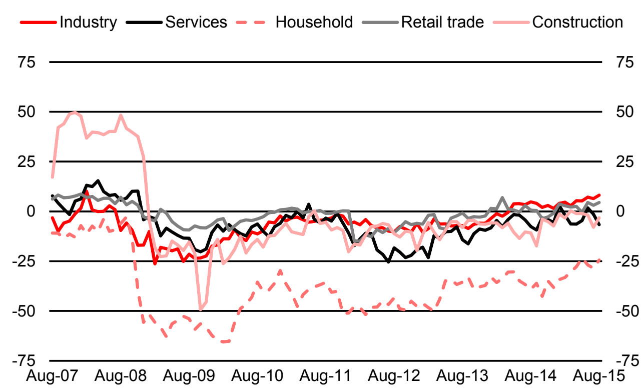
Wage growth increases in 1Q15 were spearheaded by IT services (10.0% yoy), administrative and support service activities (13.1% yoy) as well as professional, scientific and technical activities (12.7% yoy)

The sustained recovery in labor market fundamentals is especially important for the continuation of the upward trend in consumption. The unemployment rate declined to 9.7% in 2Q15 (from 9.9% in 1Q15 and 11.5% a year ago), driven by a 1.1% yoy gain in employment. This was a marked deceleration from the roughly 2% growth reported during the preceding two quarters, perhaps suggesting that jobs' recovery has entered into a more advanced phase after the easy gains last year. It is particularly encouraging that two-thirds of the new hiring comprised well-paid workers in services outsourcing (especially IT, but also many back-office services – see lhs chart). Not surprisingly, real wage growth has picked up, rising an impressive 7.2% yoy in 1Q15. As a result, employment expectations have risen gradually (see rhs chart), particularly in manufacturing and retail trade, pointing to a further improvement in labor market conditions.

Services outsourcing joined manufacturing as employment drivers



Employment expectations have moved higher across the board



Source: Eurostat, NSI, UniCredit Research

Improvement of EU funds absorption rate, to 85% in July 2015 is particularly encouraging, given the very weak start of the process, when in the first four years cumulative absorption was just 15.6% of the total

An impressive improvement in EU funds absorption, to 85% in July, has also helped support growth this year. In addition, all seven operating programs, which will entitle the country to receive another EUR 7.4bn in the next program period (2014-2020), have been agreed on with the EC. Efforts to boost absorption will also benefit from the very strong fiscal position this year, which will allow pre-financing some of the shovel-ready infrastructure projects from the new program period. This means that, while EU transfers are set to peak in 2015 before going markedly lower in 2016, the underlying construction activities will be much more evenly distributed, supporting the GDP growth performance not only this but also next year.

Bulgaria imports around 30mn barrels of crude oil annually for its refinery in Burgas, with half of the output of the latter marked for export. To cover its domestic needs, Bulgaria also imports some 2.7bn m³ of natural gas. Prices of natural gas are linked to a raft of oil-related benchmarks and follow market fluctuations with a considerable lag of between 6 and 9 months

At current consumption levels, a USD 10 fall in the oil price shifts USD 460mn from foreign oil producers to local oil consumers annually. Even assuming only half of this windfall gain is passed on to final consumers, the size of the resulting stimulus could amount to 0.5% of GDP, which would be equivalent to a 1 ppt cut in the 10% flat income tax (to 9%). Given the significant lag needed for the fall in oil price to feed through to the economy, we expect that the corresponding positive impact on GDP growth will materialize at least through 1H16.

The stronger growth, increased EU transfer receipts and stepped-up tax enforcement helped greatly improve the fiscal position

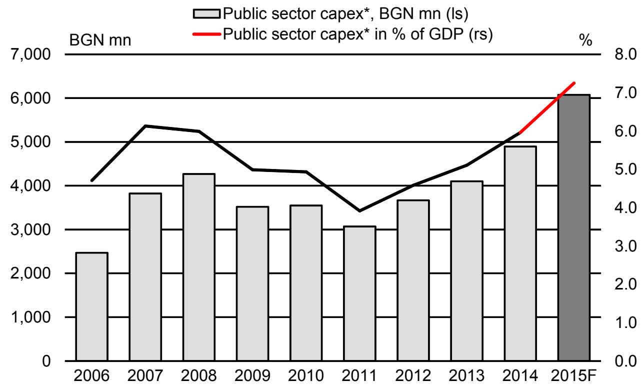
Absence of any macroeconomic imbalances allows consolidation of fiscal position to progress only very gradually from here

The January-August general government budget shifted to a surplus of 0.7% of GDP, from a similar deficit a year ago, which has opened up significant room to boost spending in the remainder of the year. The bulk of this will go to provide co-financing of infrastructure projects, needed to maximize the absorption of EU funds from the planning period that ended in 2013. This would push public capex to its highest level since 2006 (see lhs chart) and would provide a major boost to growth, both in the short term as well as in the long term by removing infrastructure bottlenecks. Meanwhile, the jump in revenues could ease the pressure to cut spending elsewhere, and particularly in wage and maintenance costs in the bloated police sector. More progress on this front seems likely next year, when as part of the 2016 fiscal plan preparation, MinFin is set to reclassify 6K mostly administrative jobs in the police sector, which would produce a decent cut in contribution costs. This is a step in the right direction. However, much more seems necessary if Bulgaria wants to push its public sector wage costs, at 9.7% of GDP in 2014, closer to those of EU star performers Romania, Germany, and particularly the Czech Republic, where these account for 7.7%, 7.7% and 7.1% of GDP.

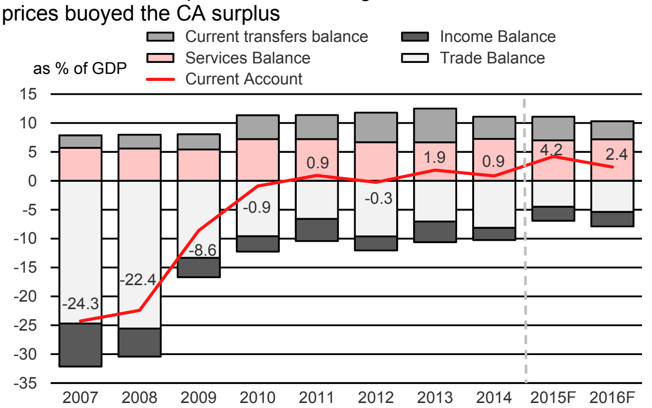
Solid improvement in external position leaves Bulgaria among the most resilient EM to the effect of Fed tightening

Solid increase in export volumes, underpinned by improving competitiveness and pronounced terms of trade gains associated with lower oil prices, helped push the CA surplus to 0.8% of GDP in January-June 2015, from a 0.4% deficit a year ago, which is very positive, as it would provide a safety buffer when the Fed starts hiking interest rates (see rhs chart). Despite the very favorable outlook, several important downside risks remain, key among which involves negative surprises associated with the upcoming bank stress tests and AQR.

Maximized EU funds absorption helped push public sector capex to new highs



Solid increase in export volumes, rising EU transfers and lower oil prices buoyed the CA surplus



*2015 Public sector capex are based on UniCredit Bulbank forecast

Source: BNB, NSI, MoF, UniCredit Research

Strategy: Bulgarian assets still offer opportunities

A major effort to improve tax compliance will help aid gross financing requirements as the MinFin is likely to undershoot the budget deficit target for this year on the back of better-than-expected macro developments.

Negative net issuance on the domestic market is expected to reach BGN 1.265bn up to the end of 2015…

With foreign funding needs for 2015 already covered, the MinFin will return to the domestic government bond market in September following three months of zero issuance – achievable due to fiscal reserves being buoyed by the stronger-than-expected budget performance and frontloading of 2/3 of expected 2015 financing in 1Q. Sovereign bond issuance was planned at BGN 300mn in 3, 5 and 10Y bonds in September, with expectations for 4Q issuance to slow to approximately BGN 300mn. Demand for government bonds should be high as BGN 1.865bn of domestic debt matures over the period. We anticipate that the significant amount of negative supply will keep yields tight and prompt further rotation by local investors from local currency domestic bonds into hard currency Eurobond paper. The average weighted share of external debt held by residents has been on a steady upward trend since January, increasing from 24% to 40% to the end of June. We expect this trend to continue as the ratio is still short of the 2013-1H14 average of 47% and there is a possibility that the ratio overshoots, as excess liquidity in the domestic financial system continues to build up.

…which should support local investors' ongoing rotation into Eurobond paper…

…and push yields lower, particularly at the long end of the yield curve

Given this backdrop, we see room for further yield tightening in Bulgarian external paper, particularly at the long end where local banks have been less active. We recommend buying the BGARIA EUR 27s and BGARIA 35s, which are the best value on the BGARIA EUR curve. After the Greek turbulence during the summer, spreads between BGARIA EUR 35 and comparable Polish paper are 10bp wider than in end-May. We expect the spread to tighten and turn slightly negative, as has been the case in other segments of the yield curve.

Author: Nikola Georgiev, Economist (UniCredit Bulbank)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**2.3**	**4.7**	**1.8**
Budget deficit	1.6	0.9	1.1
Amortization of public debt	0.5	3.6	0.6
Domestic	0.5	1.2	0.6
Bonds	0.4	0.1	0.6
Bills	0.2	1.1	0.0
External	0.0	2.4	0.0
IMF/EU/Other	0.2	0.2	0.2
Financing	**2.3**	**4.7**	**1.8**
Domestic borrowing	1.6	0.5	0.5
Bonds	0.6	0.4	0.5
Bills	1.0	0.1	0
External borrowing	2.5	3.2	1.5
Bonds	1.8	3.1	1.4
IMF/EU/Other	0.7	0.1	0.1
Privatization	0.0	0.0	0.0
Fiscal reserves change (- = increase)	-1.8	1.0	-0.2

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**14.0**	**15.7**	**13.2**
C/A deficit	-0.4	-1.8	-1.1
Amortisation of medium to long term debt	4.8	7.1	4.4
Government/central bank	0.2	2.6	0.2
Banks	0.8	0.8	0.6
Corporates	3.9	3.7	3.6
Short term debt amortization	9.5	10.4	9.9
Financing	**14.0**	**15.7**	**13.2**
FDI	0.9	1.3	1.4
Portfolio flows	1.2	2.2	1.2
Borrowing	7.2	7.3	5.4
Government/central bank	2.5	3.2	1.5
Banks	0.8	0.4	0.3
Corporates	3.9	3.7	3.6
Short-term	10.4	9.9	9.0
EU transfers	1.5	1.7	1.3
Other	-5.0	-2.6	-2.0
Change in FX reserves (- = increase)	-2.1	-4.0	-3.0

Source: BNB, MoF, UniCredit Research

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

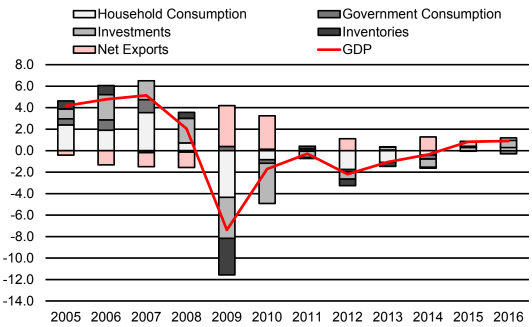
Outlook – Following the encouraging growth performance in 1H, we now see the recovery to continue at about the same pace in 2H and accelerate only slightly in 2016 due to the fiscal drag. Further fiscal adjustment is unavoidable next year and remains a key precondition for complying with the measures recommended in the Country Specific Recommendations from the European Commission. With the general elections approaching, we also see risks for populist measures. The adverse short-term impact of fiscal consolidation is outweighed by the growing financing risks in case market sentiment deteriorates.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

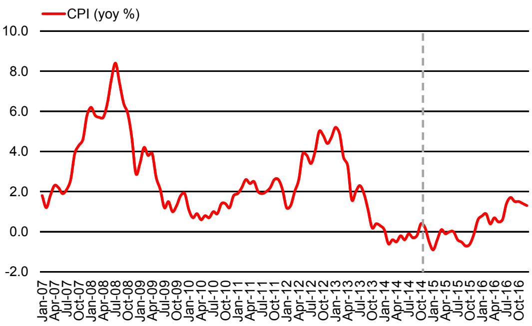
KEY DATES/EVENTS

- 20 Oct: EDP Notification
- 29 Nov: GDP flash estimate 3Q
- 4 Dec: GDP estimate 3Q
- Nov/Dec: General elections
- 30 Dec: Balance of Payments 3Q

GDP GROWTH



INFLATION OUTLOOK



Source: IMF, National ministries of finance, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	44.0	43.5	43.0	43.2	44.1
Population (mn)	4.3	4.3	4.2	4.2	4.2
GDP per capita (EUR)	10,301	10,225	10,161	10,246	10,519
Real economy yoy (%)					
GDP	-2.2	-1.1	-0.4	0.8	0.9
Private Consumption	-3.0	-1.9	-0.7	0.5	0.5
Fixed Investment	-3.3	1.4	-3.6	0.5	3.3
Public Consumption	-1.0	0.3	-1.9	0.1	-1.5
Exports	-0.1	3.1	7.3	6.6	4.2
Imports	-3.0	3.1	4.3	5.8	3.9
Monthly wage, nominal (EUR)	1,048	1,048	1,042	1,072	1,091
Unemployment rate (%)	15.8	17.2	17.3	17.5	17.0
Fiscal accounts (% of GDP)					
Budget balance	-5.3	-5.4	-5.7	-4.9	-4.8
Primary balance	-1.9	-1.9	-2.2	-1.2	-0.8
Public debt	69.2	80.8	85.1	88.9	92.1
External accounts					
Current account balance (EUR bn)	-0.1	0.4	0.3	0.5	0.5
Current account balance/GDP (%)	-0.1	0.8	0.7	1.2	1.1
Basic balance/GDP (%)	2.5	2.8	3.7	4.3	5.1
Net FDI (EUR bn)	1.2	0.9	1.3	1.4	1.8
Net FDI (% of GDP)	2.7	2.0	3.0	3.2	4.0
Gross foreign debt (EUR bn)	45.3	46.0	46.7	48.2	50.1
Gross foreign debt (% of GDP)	103.0	105.6	108.4	111.5	113.5
FX reserves (EUR bn)	11.2	12.9	12.7	13.2	13.8
Inflation/Monetary/FX					
CPI (pavg)	3.4	2.2	-0.2	-0.3	1.0
CPI (eop)	4.7	0.3	-0.5	0.6	1.3
1W money market rate	1.39	0.68	0.58	0.65	0.90
FX/USD (eop)	5.73	5.55	6.30	6.61	6.27
FX/EUR (eop)	7.55	7.64	7.66	7.73	7.65
FX/USD (pavg)	5.85	5.71	5.75	6.69	6.40
FX/EUR (pavg)	7.52	7.57	7.63	7.64	7.62

Source: UniCredit Research

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

Searching for policies to support the ongoing recovery

GDP is now expected to rise 0.8% in 2015, but identified macroeconomic imbalances and some unorthodox policy measures weigh on growth prospects in the medium term

GDP is growing but risks are multiple, as the sizable macroeconomic imbalances weigh on the recovery. Real GDP growth accelerated, to 1.2% yoy in 2Q from 0.5% in 1Q and has become broad-based, with all expenditure items expanding. .All of the expenditure components of GDP performed well. Even fixed investment, after a protracted decline, has begun recovering. The main contribution to growth, however, comes from exports, now accompanied by recoveries in services and industrial production. Short-term indicators, including those related to tourism, suggest that the economic expansion has continued at an annual pace of roughly 1% during 3Q as well. As a result, the risks for the 2015 GDP outlook are now more on the upside, leading us to revise our full year forecast to 0.8% yoy.

Export performance spurs current account surplus, in contrast to imbalances in other segments

The rebound in both merchandise and services exports has helped keep the current account in surplus, offsetting some of the imbalances rooted in public sector finances and the large external debt. Lower oil prices and smaller income outflows have also contributed to the current account surplus. Some softening in merchandise export growth can be expected in the second half of the year following the double-digit yoy expansion in 1H15, but we still see exports as the main driver of the expected C/A surplus over the medium term. In addition, gradually improving EU fund absorption should improve external financing.

Growth in government revenues reduces the risks of additional fiscal consolidation this year, but the drag for 2016 will increase as general elections can provoke some expansionary policy

Recent fiscal developments suggest that the government's target for 2015 is achievable, but only if the policy stance is sustained. However, the looming general elections in November or December have raised the risks of fiscal expansion. Thus far this year, economic growth has helped boost tax revenues, while the government used the global liquidity glut to meet easily most of its funding needs for 2015. These developments have made additional fiscal consolidation measures unnecessary during the remainder of the year. With tax revenues rising by 10% yoy in 1H15, there is even some room for deficit reduction. However, this improvement stems from cyclical developments rather than structural measures. Favorable access to markets and comfortable funding conditions eased pressure on the government to continue the fiscal adjustment. At the same time, the risk for fiscal slippages in 2016 has risen as a result of recent policy steps that had general elections in mind. These include, for example, restoration of annual bonuses for loyal civil servants, increasing wages in healthcare and benefits for poorer households.

The looming elections have increased policy uncertainty. The election campaign will shift again the focus from economic policy to politics in what should be yet again a close race of two major coalitions for a new government mandate. In such an environment, pressure has increased for populist measures such as the recent changes in the Consumer Credit Act with the intention of enabling the restructuring of CHF household loans. The proposed changes, if implemented, would mean significant direct losses for banks on the order of EUR 1bn, according to the central bank, or more than twice the average annual profit for the sector. The largest banks would be hit disproportionately hard, with a negative impact on their credit rating outlook, as it will squeeze their capital. While banks' capital position should remain robust, their lending potential would weaken and funding conditions for the rest of economy would deteriorate. The budget would be hit as well, as CHF loan restructuring would reduce banks' profits and the corporate tax they pay.

Country Specific Recommendations remain the main guideline for a reform agenda rightly addressing existing imbalances

Despite the encouraging developments this year, the backdrop for the economic recovery remains difficult. Whatever government takes over after the election, it will be faced with the same policy challenges. The medium-term risks stemming from the existing macroeconomic imbalances need to be urgently addressed, with further fiscal consolidation being the only option. Consequently, we keep our view of an only moderate acceleration of growth in 2016, to 0.9%.

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

Outlook – Larger EU fund inflows are behind the new upgrade of our 2015 GDP growth forecast to 4.1%. Despite a slowdown, 2016 growth will be broad-based and closer to long-term potential. Fiscal policy and net exports will support growth this year, but will turn neutral in 2016. Inflation remains subdued due to falling commodity prices. The CNB is likely to look through the rapid closing of the negative output gap and focus on reflation, leaving the FX intervention regime unchanged at least until 2H16.

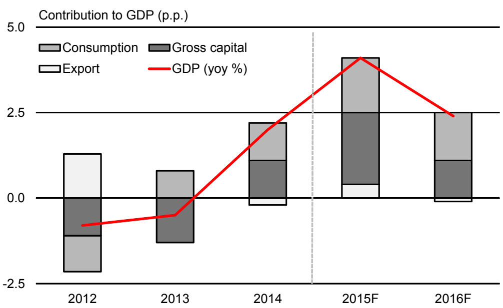
Strategy outlook – Like in the eurozone, the Czech bond market is driven by the non-standard policy of central banks. CZGB yields are set to trace German Bunds, while being less volatile.

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

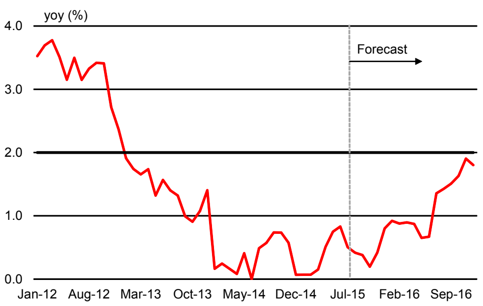
KEY DATES/EVENTS

- 24 Sept, 5 Nov, 16 Dec: CNB policy meetings
- 1 Oct, 2 Nov, 1 Dec: Manufacturing PMI
- 13 Nov, 27 Nov: 3Q15 GDP (flash estimate, structure)

INVESTMENT LIFTING GDP IN 2015, TO SLOW IN 2016



CPI TO STAY BELOW 1% YOY UNTIL MID-2016



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	160.8	157.0	154.8	163.9	172.0
Population (mn)	10.5	10.5	10.5	10.5	10.5
GDP per capita (EUR)	15,297	14,934	14,704	15,552	16,315
Real economy yoy (%)					
GDP	-0.8	-0.5	2.0	4.1	2.4
Private Consumption	-1.4	0.7	1.5	3.1	3.0
Fixed Investment	-3.0	-2.8	2.0	6.0	3.5
Public Consumption	-1.8	2.3	1.8	2.5	2.0
Exports	4.5	0	8.9	6.8	6.4
Imports	2.8	0.1	9.9	7.0	6.9
Monthly wage, nominal (EUR)	997	964	930	970	1,022
Unemployment rate (%)	6.8	7.7	7.7	6.5	6.1
Fiscal accounts (% of GDP)					
Budget balance	-3.9	-1.2	-2.0	-1.6	-1.7
Primary balance	-2.5	0	-0.4	-0.3	-0.5
Public debt	44.6	45.0	42.6	40.9	41.3
External accounts					
Current account balance (EUR bn)	-2.5	-0.8	0.9	1.7	1.1
Current account balance/GDP (%)	-1.6	-0.5	0.6	1.0	0.6
Basic balance/GDP (%)	1.4	-0.7	3.7	2.7	2.7
Net FDI (EUR bn)	4.8	-0.3	4.9	2.8	3.5
Net FDI (% of GDP)	3.0	-0.2	3.1	1.7	2.1
Gross foreign debt (EUR bn)	96.8	99.7	103.0	112.5	122.6
Gross foreign debt (% of GDP)	60.2	63.5	66.6	68.7	71.3
FX reserves (EUR bn)	34.0	40.8	44.9	57.0	62.0
Inflation/Monetary/FX					
CPI (pavg)	3.3	1.4	0.4	0.4	1.2
CPI (eop)	2.4	1.4	0.1	0.8	1.8
Central bank target	2.0	2.0	2.0	2.0	2.0
Central bank reference rate (eop)	0.05	0.05	0.05	0.05	0.05
3M money market rate	1.00	0.46	0.36	0.30	0.30
FX/USD (eop)	19.06	19.96	22.91	23.16	21.72
FX/EUR (eop)	25.14	27.43	27.73	27.10	26.50
FX/USD (pavg)	19.58	19.55	20.72	24.12	22.33
FX/EUR (pavg)	25.14	25.97	27.53	27.25	26.80

Source: UniCredit Research

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

The high tide of economic growth

We are revising GDP growth up for 2015 and down for 2016, both by 0.3 p.p.

Three months after having made a substantial change to our 2015 GDP forecast, we are revising it up further to 4.1%. With the original tailwinds remaining in place, the strong pick-up in EU fund absorption is the main catalyst for our latest upgrade. However, we expect that lower capital transfers will cause growth to dip to 2.4% in 2016. Despite the sharp slowdown, growth is set to remain broad-based and closer to its long-term potential.

This year's revision is due to stronger investment, due mainly to larger EU fund inflows…

The GDP growth rate of 4.4% yoy registered in 2Q15 was broad-based. Among demand components, non-residential construction stood out, jumping 13.2% yoy. Investment in this sector was the highest for a second quarter since 2009 and is largely attributable to road repairs, helped by EU financing. Furthermore, recent inventory accumulation likely captures unfinished similar investment projects, most of which should conclude by the end of 2015. Excluding EU financing fixed capital formation is expected to expand further. Residential construction should react positively to the higher purchasing power of households, while the corporate sector will likely continue to expand its production capacities.

…and to strong exports due to demand from the EU

In 2015, exports could rise by close to 7% yoy in real terms, despite stagnation in global foreign trade. A geographic export breakdown confirms that demand from major EU trading partners is increasing. Product-wise, improvements have been broad, with transport equipment and car parts playing the most important role. That said, we expect net exports to make a smaller positive contribution to GDP growth in 2H15, with growth slowing further next year. For 2016, our baseline scenario has Czech exports rising slightly faster than 6% and net exports broadly neutral with respect to GDP growth.

Private consumption remains firm against the backdrop of rising employment, accelerating nominal wages and persistently low inflation

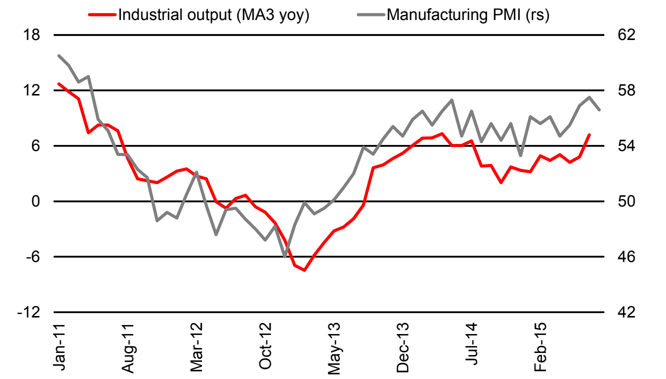
The momentum in private consumption should carry over to 2H15 and 2016. The upbeat outlook for private spending results from three factors: declining unemployment, accelerating nominal wage growth and persistently low inflation. The unemployment rate has recently dropped to a new post-crisis low, while the number of vacancies has hit its highest level since late 2008. Labor market tightness should add pressure on wages. While the pickup in wage growth this year is expected to be driven largely by pay increases in public administration, private sector wages should rise faster next year.

Inflation is set to stay below 1% yoy until mid-2016

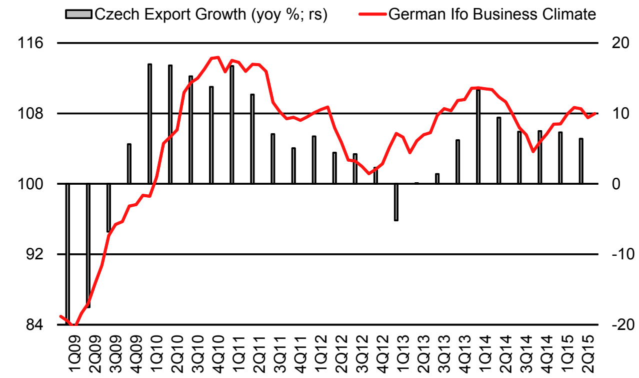
Annual inflation will probably remain below 1% until mid-2016 due to low or even negative inflation imported from the eurozone and further reductions in energy prices for households. Consequently, inflation is expected to return to the 2% target only in 2017. Low inflation will continue to bolster private spending, but will also keep the central bank's dovish bias firmly in place.

INDUSTRIAL OUTPUT IS SET TO GROW AT A SUSTAINED PACE, DRIVEN BY BOTH DOMESTIC AND EXTERNAL DEMAND

The manufacturing PMI implies an acceleration in industrial output growth



German Ifo business confidence suggests that Czech exports still have some potential to accelerate



Sources: CZSO, Markit, IFO, UniCredit Research

The CNB is committed to keeping the EUR-CZK floor until 2H16…

The central bank does not expect an earlier start to monetary policy tightening, despite GDP expanding faster than the CNB had projected. In fact, the latest CNB staff forecast does not show inflation returning to the 2% target before early 2017 because it expects falling commodity prices to reduce imported inflation. Thus, the probability of keeping the EUR-CZK floor at 27.0 until 2H16 has risen.

…intervening since July to defend it…

CNB interventions restarted in July as EUR-CZK tested the 27.0 floor, probably explaining most of the CNB's net foreign assets increase of EUR 4.1bn since June. Foreign investors were probably behind the recent pressure on EUR-CZK, while domestic companies have yet to start hedging their FX positions in anticipation of the CNB giving up the exchange rate floor. If interventions continue, the FX shortage in the market should prevent a sudden and sharp CZK appreciation when the floor is removed. For end-2016, we are comfortable with our EUR-CZK forecast of 26.50, with monetary conditions tightening via FX appreciation after the exit. Rate hikes are expected to follow only in 2017.

… and leading to a widening of the negative EUR-CZK basis…

… that offers limited opportunities for arbitrage

Following interventions, the negative EUR-CZK basis plummeted, leaving room for arbitrage opportunities by using the forward market. However, the scope of using this opportunity until the floor will be removed is limited for several reasons: **1.** The CNB remains committed to the floor. The recent dip in annual inflation caused by lower oil and food prices could keep inflation below target until the end of 2016. Thus, a bet on the removal of the floor would require a minimum horizon of nine months to one year. **2.** Forward markets remain illiquid due to limited FX positions at local banks. **3.** Local banks are close to the full limit with the CNB, as shown by the volume of the deposit facility and of repo operations. The only other option left for CZK buyers is to place liquidity in negative-yielding T-bonds and T-bills.

The fiscal impulse will be positive in 2015 and neutral in 2016

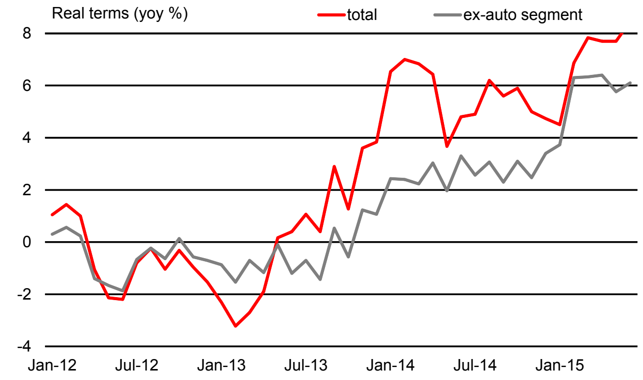
The positive fiscal impulse in 2015 exceeds 0.5% of GDP if EU fund inflows are included. At the same time, we are reducing our forecast for the budget deficit to 1.6% of GDP from 2.0% previously, on the back of lower interest rate costs and higher direct tax revenues. For 2016, the budget draft assumes a CZK 70bn deficit, roughly in line with the shortfall expected for 2015. Hence, we continue to expect a neutral fiscal stance in 2016.

Risks to 2015 are minor. The main risks for 2016 are a delay in monetary normalization and weaker external demand

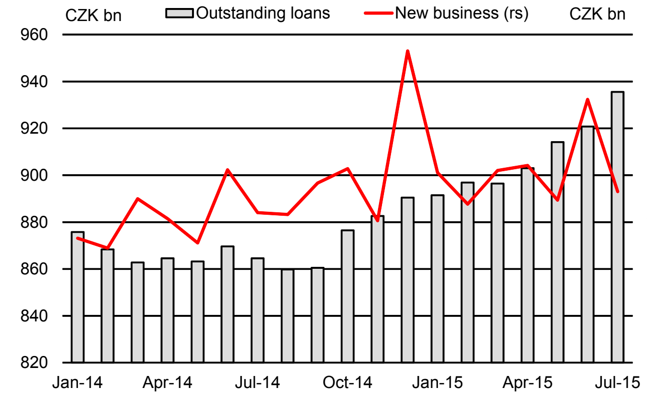
We see only minor risks to our 2015 forecasts, but bigger ones for 2016. In the event of a slowdown in activity abroad, coupled with lower commodity prices and a lower inflation outlook in the eurozone, the CNB could preserve the FX floor beyond the end of 2016 or even push EUR-CZK higher. The biggest risks to growth come from a potential weakening of demand in the eurozone.

BOTH PRIVATE CONSUMPTION AND BUSINESS INVESTMENT CONTRIBUTE TO POSITIVE TRENDS IN THE ECONOMY

Retail sales are soaring; this year's rise driven in a larger scale than last one by the core segment, not just cars



Corporate loan volumes have been accelerating since late 2014



Source: CZSO, CNB, UniCredit Research

Strategy: Excess liquidity to anchor front end yields

Yields for maturities up to 4Y are negative…

… with the short end pushed lower by bets against the EUR-CZK floor

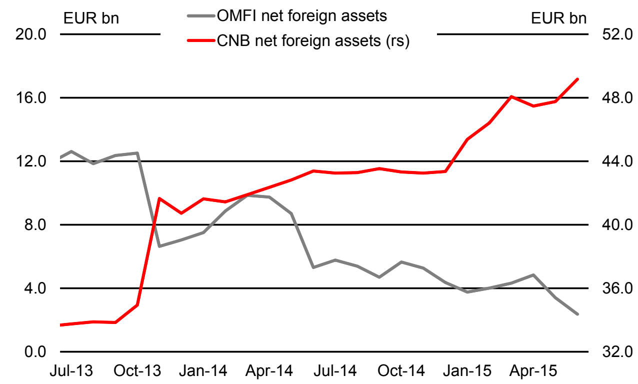
We expect CZGB yields to track Bund yields…

…and we see potential for curve flattening in the short term

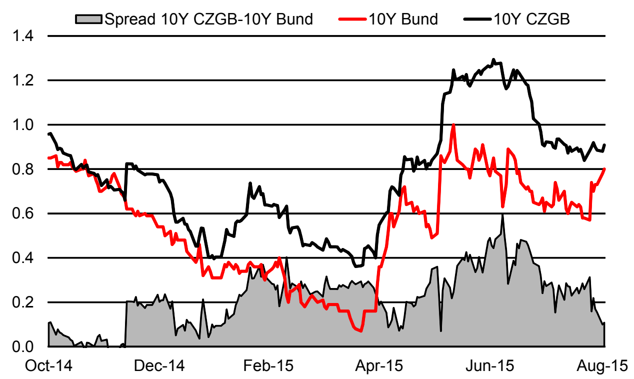
Excess liquidity in the banking system, continued support from eurozone investors and Czech bonds being a natural EM 'safe haven' in times of market turbulence have led to negative yields out to the 4Y tenor. Debt instruments with less than 2Y to maturity have markedly negative yields, which reflects investors' building positions anticipating a CZK appreciation via a CNB exit from interventions. Like in the eurozone, the Czech bond market is largely driven by the non-standard policy of the central bank. We expect this pattern to prevail over fluctuations in the government's financing needs or considerations about a short-term inflation outlook. We expect the CZGB yield curve to track German Bund yields while being less volatile.

While front-end yields should remain anchored, we expect inflation to start to rise slightly beyond October, but to remain benign. This, combined with a dovish outlook from the ECB and continued QE, suggests that being long CZGB 36s against short CZGB 16s provides an attractive carry on the curve.

CNB's net foreign assets are on the rise due to EU fund conversions as well as FX market interventions; other banks' NFA at a record low



German Bund yield fluctuations are mirrored by CZGB with slightly lower volatility



Sources: CZSO, Macrobond, UniCredit Research

EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**47.7**	**50.0**	**50.9**
C/A deficit	-0.6	-1.0	-0.6
Amortisation of MT-LT debt	7.0	8.0	8.0
Banks	0.8	0.9	0.8
Government and central bank	1.6	1.8	2.3
Other sectors	4.6	5.3	5.0
Amortisation of ST debt	41.3	43.0	43.5
Financing	**47.7**	**50.0**	**50.9**
FDI	5.4	4.2	4.9
Borrowing	38.5	39.9	43.6
Banks	17.1	17.0	17.0
Government and central bank	1.0	2.0	2.0
Companies	20.4	20.9	24.6
EU transfers and other	3.8	5.8	2.4

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014E	2015F	2016F
Gross financing requirement	**13.3**	**13.5**	**15.0**
Budget deficit	2.9	2.8	2.6
Amortisation of public debt	10.4	10.8	12.4
Bonds	5.7	5.7	6.8
EIB loans	0.4	0.1	0.1
Bills	4.4	5.0	5.6
Financing	**13.3**	**13.5**	**15.0**
Domestic borrowing	10.2	9.5	12.6
Bonds	5.8	6.6	9.6
Bills	4.4	2.9	3.0
External borrowing	0.1	0.0	2.3
Bonds	0.0	0.0	2.2
EIB/IMF	0.1	0.0	0.1
Change in cash reserve (- = increase)	3.1	4.0	0.1

Sources: CNB, MoF, UniCredit Research

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

Outlook – Private-sector growth is losing steam amid slowing investment and poor HUF lending outside the FGS. As a result, we expect new growth-boosting measures from the NBH in 2016. The fiscal impulse turned negative and will remain so in 2015 and 2016 due to public debt constraints. Strong retail issuance and demand from banks offset outflows from foreign holdings of HGBs. Thus, yields are better cushioned than the currency from episodes of risk aversion. We expect a first upgrade to investment this year, with at least one more in 2016.

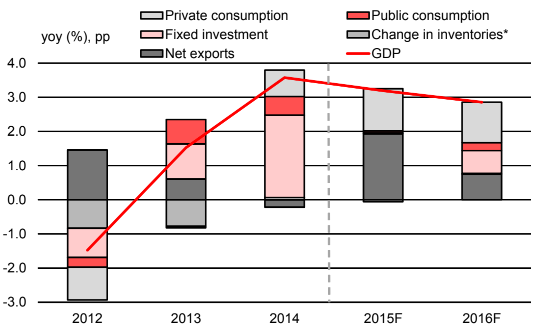
Strategy – Front end yields should continue to tighten via net negative T-bill issuance and the early implementation of the LCR. Combined with strong 3Y and 5Y IRS auctions, this will continue to support 3-5Y HGBs. We recommend the HGB 20s on an attractive roll-down. The long end of the curve is at risk of further steepening as inflation picks up.

Author: Dan Bucşa, Economist (UniCredit Bank London)

KEY DATES/EVENTS

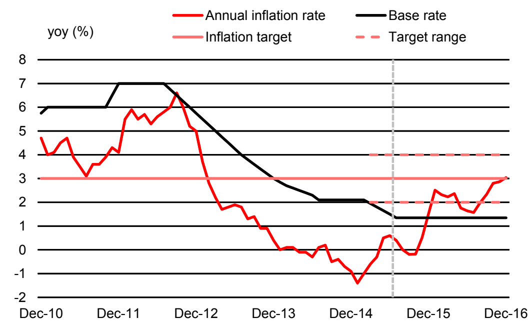
- 13 Nov, 4 Dec: 3Q15 GDP (flash estimate, structure)
- 22 Sept, 20 Oct, 17 Nov, 15 Dec: NBH rate meetings
- 6 Nov, 20 Nov: rating reviews from Moody's and Fitch

GDP DRIVERS



*Adjusted for statistical error

HEADLINE INFLATION VS. TARGET



Source: CSO, NBH, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	97.6	100.5	103.2	107.4	111.5
Population (mn)	9.9	9.9	9.9	9.8	9.8
GDP per capita (EUR)	9,831	10,141	10,452	10,913	11,360
Real economy yoy (%)					
GDP	-1.7	1.5	3.6	3.1	2.8
Private Consumption	-1.9	-0.1	1.6	2.9	2.9
Fixed Investment	-3.8	5.2	11.7	3.1	5.4
Public Consumption	0.0	3.3	2.5	-0.1	0.7
Exports	2.0	5.9	8.7	7.4	5.8
Imports	0.1	5.9	10.0	6.7	6.7
Monthly wage, nominal (EUR)	771	776	768	784	790
Unemployment rate (%)	11.0	10.2	7.7	7.1	7.0
Fiscal accounts (% of GDP)					
Budget balance	-2.3	-2.5	-2.5	-2.4	-2.0
Primary balance	2.3	2.1	1.6	0.7	1.1
Public debt	78.5	77.3	76.9	76.7	75.9
External accounts					
Current account balance (EUR bn)	1.8	4.1	4.1	6.0	5.3
Current account balance/GDP (%)	1.9	4.0	4.0	5.6	4.7
Basic balance/GDP (%)	3.4	5.0	4.6	4.8	5.6
Net FDI (EUR bn)	2.1	0.9	0.6	-0.9	0.9
Net FDI (% of GDP)	1.5	0.9	0.6	-0.8	0.8
Gross foreign debt (EUR bn)	127.5	119.5	118.7	118.4	115.8
Gross foreign debt (% of GDP)	130.6	119.0	115.0	110.2	103.9
FX reserves (EUR bn)	31.8	32.6	33.7	34.4	35.2
Inflation/Monetary/FX					
CPI (pavg)	5.7	1.6	-0.2	0.2	2.4
CPI (eop)	5.0	0.4	-0.9	1.5	3.0
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	5.75	3.00	2.10	1.35	1.35
3M money market rate (avg)	6.99	4.31	2.41	1.35	1.38
HUF/USD (eop)	220.93	215.67	252.46	273.91	271.19
HUF/EUR (eop)	291.29	296.91	314.89	313.00	320.00
HUF/USD (pavg)	225.10	223.70	232.44	264.99	273.80
HUF/EUR (pavg)	289.34	297.01	308.66	309.31	313.58

Source: NBH, CSO, UniCredit Research

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

Growth fatigue and dovish policies

Economic growth is slowing…

Economic growth is slowing in Hungary faster than in other Central European countries and it is not industry's fault. In fact, exports have performed well above expectations in 2015 amid strong car sales in the eurozone. As a result, a record trade surplus is on the cards, despite booming imports. With demand from the eurozone expected to remain healthy in 2016 and scope to further increase production, manufacturing and exports will probably grow faster than potential. The dark spot in an otherwise rosy picture is the increased reliance on eurozone demand, while Hungary's exports outside the EU are rising slower due to geopolitical and economic headwinds. As a result, a potential slowdown in eurozone demand remains the biggest risk to Hungary's growth outlook in 2016.

…despite strong exports and industrial production…

…amid strong demand from the eurozone

Domestic demand is lagging…

In contrast, domestic demand has been lagging in this recovery and continues to do so, despite relentless efforts from the government to boost both consumption and investment. The main reasons for the slowdown in domestic demand are:

…as the labour market's contribution is fading…

1. Its past drivers, public employment schemes and real wage dynamics, will weaken from here. The former is relying on limited public funding. The latter will slow due to reflation;.

…cheap lending is failing to boost consumption and investment…

2. Cheap lending and the conversion of FX loans are not boosting demand. The Funding for Growth Scheme (FGS) has added approximately 0.1% of GDP a month in new lending over the past year, but larger companies continue to delever. As a result, private investment fell in 1H15 once car manufacturers finished expanding production capacities. Capital formation is unlikely to recover this year due to the lack of new large investment projects. Meanwhile, households continue to reduce their debt, despite the positive wealth effect from the FX loan conversion and the discount afforded in the process. The conversion of remaining FX retail loans is unlikely to increase the borrowing appetite of households.

…and the fiscal impulse is turning negative.

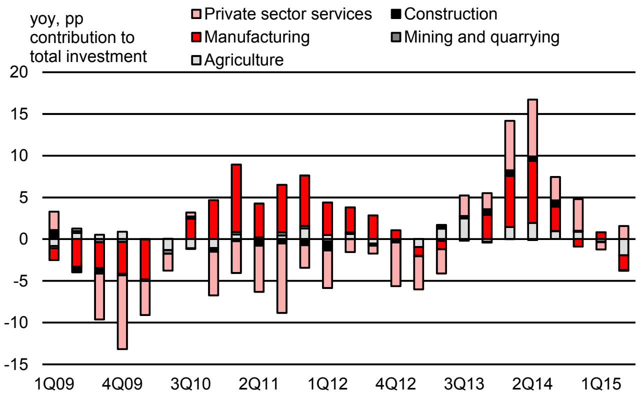
3. The fiscal impulse is turning negative. There is limited additional room for tax and/or regulated price cuts due to the government's struggle to reduce the debt stock. Public investment recovered in 2Q15 after a poor first quarter, but could be crowded out by mounting contingent liabilities from the purchasing of private banks.

Public debt has risen well above last year's level…

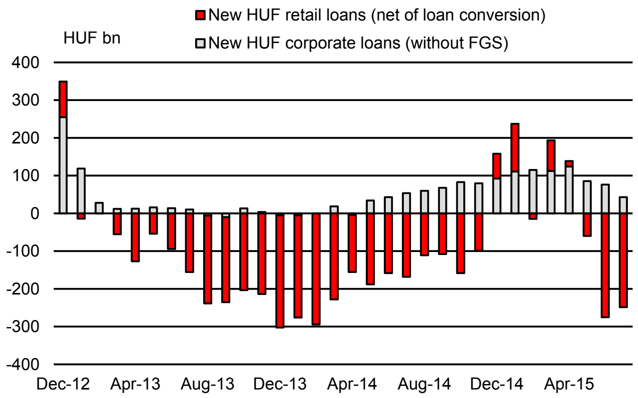
Meanwhile, public spending continues unabated. Public debt rose to 79.7% of GDP at the end of 2Q15. One reason for this is the seasonal pattern in government expenditure, most of the deficit being incurred in the first part of the year. That said, reducing public debt below 76.9% of GDP by year-end[3] will require a significant squeeze on expenditure and issuance.

GROWTH IN THE PRIVATE SECTOR IS LOSING MOMENTUM

Private-sector investment is slowing markedly vs. 2014



Private lending in HUF is not picking up, despite very low rates



Source: NBH, CSO, UniCredit Research

[3] The public debt rule states that public debt needs to fall every year as a percent of GDP. Last year's level was 76.9%.

The debt rule can be met…

…helping Hungary regain its investment grade.

The government can reduce public debt **1.** by spending from its reserves[4]; **2.** by letting the currency appreciate before year-end[5] and/or **3.** by reducing net issuance in 4Q15. As a result, we expect a first upgrade to investment in November and at least another one in 2016.

Large outflows from foreign bond holders have been offset by demand from retail investors…

…and from banks, helped by NBH's Self-financing program.

Faced with large outflows from foreign bond buyers, the Debt Management Agency increased its reliance on domestic investors. The stock of retail bonds and bills increased by HUF 1.06tn in the year ending in July 2015[6] . At the same time, the combined net issuance of HGBs and T-bills has been almost flat, with bond issuance offsetting the gradual reduction in the volume of T-bills. This shift from bills to bonds was helped by the NBH's Self-Funding Program, which offers 3Y, 5Y and 10Y interest rate swaps at a discount from market rates to banks interested in buying HGBs. The 3Y and 5Y swaps proved very successful, with the allocation exceeding HUF 525bn (1.6% of GDP)[7] for an average discount vs. market bond yields of 90bp. Demand for the 10Y swaps has been much lower so far, probably due to the longer tenor.

The short end remains well anchored by T-bill demand related to the higher LCR

Meanwhile, short-term interest rates have been anchored below the base rate by strong demand for T-bills coming from banks that need to comply with a higher liquidity coverage ratio (LCR) by April 2016. Besides a higher LCR, the shift in the policy instrument from two-week to three-month deposits will boost demand for sovereign paper at least until year-end.

EUR-HUF is affected by portfolio outflows…

…and by lax monetary conditions…

…as the NBH is likely to pursue lax monetary policies

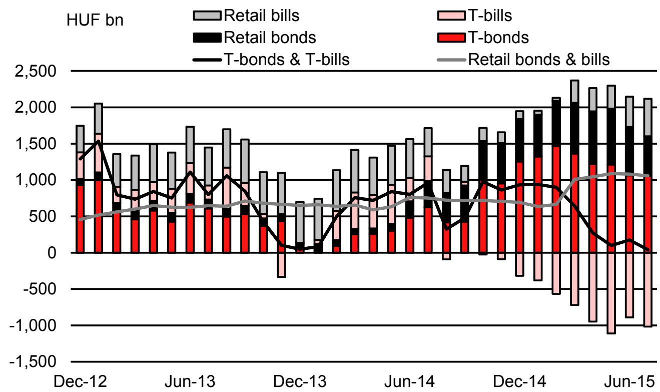
Due to strong demand from local investors, the large decline in foreign bond holdings has had limited impact on yields, but has affected the currency. Regardless of foreign flows in and out of HGBs, EUR-HUF could continue to trade above 310 (i.e., above what fundamentals would imply) for most of 2015 and 2016 due to lax real monetary conditions. The central bank is unlikely to hike before the end of 2016. In fact, more easing measures are in the pipeline. Once the FGS will expire at the end of this year, the NBH could try to stimulate lending via new programs that will pump liquidity into the economy at preferential interest rates. Such measures could be announced before the end of 2015, easing monetary conditions further.

Inflation could reach the 3% target by the end of 2016

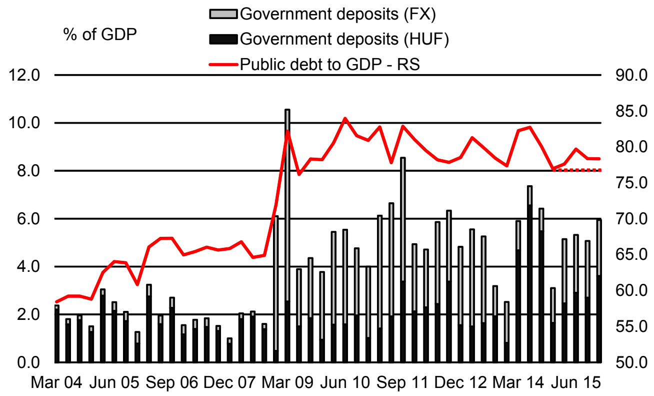
At the same time, inflation is expected to rise starting in 4Q15, reaching 1.5% by year-end. That said, the pace of reflation will be slower than previously expected due to lower oil prices, a better-than-expected harvest and a fall in imported inflation. We expect inflation inside the 2-3% range in 2016, with an overshoot possible only if oil or food prices rise significantly.

ISSUANCE COULD FALL TOWARDS THE END OF THE YEAR IN ORDER TO MEET THE PUBLIC DEBT RULE

Strong reliance on local bond investors, mostly retail



The government has enough reserves to ensure the decline in debt



Source: NBH, DMA, UniCredit Research

[4] Fiscal reserves are sufficient to also accommodate the early repayment of EUR 0.9bn of external debt expiring in 2016.
[5] The debt to GDP ratio would decline by 0.3pp for each percent of nominal appreciation. We assume EUR-HUF at 315, the current issuance plan for 2015 and the early repayment of EUR 0.9bn in external debt maturing in 2016.
[6] This represents almost 3.4% of GDP and 96.3% of the change in outstanding marketable debt in the 12 months to July 2015.
[7] Between the first IRS auction held on 18 June and the last one held before the publishing of the quarterly, on 3 September.

Strategy: Structural changes create demand for front end

Front end rates should fall via negative T-bill issuance and LCR adjustments

The front end and belly should be well supported…

…but we think the long end of the curve is at risk of bear-steepening

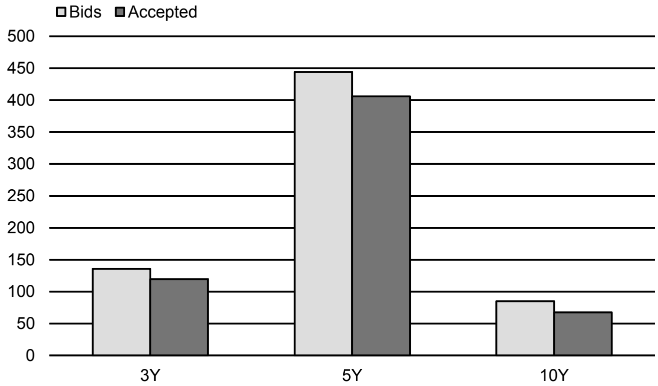
Net negative T-bill issuance in 4Q15 and the decision to accelerate the implementation of tighter LCR will continue to put downward pressure on front-end yields until the end of the year. In addition, the success of the 3Y and 5Y discount IRS auctions has partly offset the significant outflows from foreign holdings of HGB in 2015 (HUF 651.3bn as of 15 September) and local banks continue to keep the front end and belly of the curve well bid. Thus, we see value in HGBs up to the 5Y tenor. We are not expecting the same support for the long end of the curve, as shown by muted demand for the 10Y IRS auction and for switch auctions. With foreigners significant holders of the long end and inflation likely to increase (albeit at a slower pace than originally thought), we expect the curve to steepen further. Thus, we recommend buying the HGB 22s, which offer a 57bp roll-down to the HGB 20s.

We recommend the HGB 20s on an attractive roll-down…

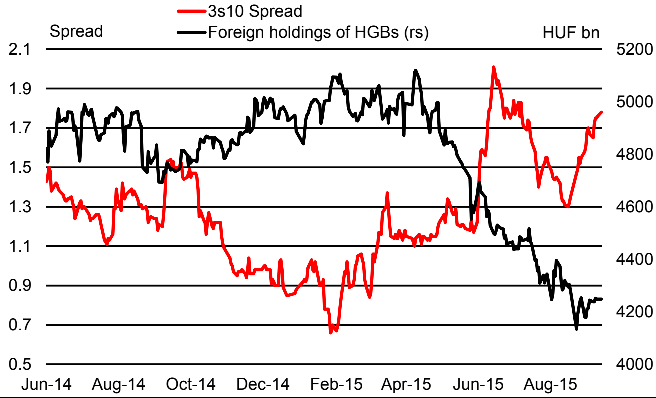
…and still favour REPHUN USD bonds on better yield, Z-spread and scarcity value

We continue to favour REPHUN USD. Higher yields and Z-spreads and small (or no) FX issuance in 2016 (AKK is planning to use funds from selling retail securities and NBH reserves to repay most FX debt) should continue to provide support. We recommend the REPHUN USD 41s and REPHUN USD Nov 23s. Front-end REPHUN EUR paper is better value than longer-dated paper, which is trading rich to ROMANI EUR and MEXICO EUR.

Discount IRS auctions have been well bid for 3Y and 5Y…



… supporting the 3-5Y segment, despite foreign outflows



Source: AKK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**28.2**	**20.0**	**20.1**
Budget deficit	2.6	2.6	2.2
Amortization of public debt	25.6	17.4	17.9
Domestic	19.2	15.1	13.2
Bonds	7.8	4.2	2.5
Bills	6.2	5.3	4.9
Loans and retail securities	5.2	5.6	5.8
External	6.4	2.3	4.7
IMF/EU and other loans	3.4	0.2	2.3
Bonds	2.9	2.0	2.4
Financing	**28.2**	**20.0**	**20.1**
Domestic borrowing	25.7	19.4	19.1
Bonds	13.4	7.4	8.0
Bills	5.1	4.9	4.3
Loans and retail securities	7.1	7.0	6.8
External borrowing	2.3	0.0	1.0
Bonds	2.2	0.0	1.0
Other	0.1	0.0	0.0
Change in govt. reserves (- = increase)	0.0	0.6	0.0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**24.0**	**15.5**	**16.3**
C/A deficit(+)/ surplus(-)	-4.1	-6.0	-5.3
Amortization of medium to long term debt	11.4	5.2	8.5
Government/central bank	6.9	2.1	5.2
Banks	2.2	0.8	1.5
Corporates	2.4	2.3	1.8
Short term debt amortization	16.7	16.3	13.1
Government/central bank	4.2	3.4	2.7
Banks	7.9	8.6	6.0
Corporates	4.6	4.3	4.4
Financing	**24.0**	**15.5**	**16.3**
FDI (net in and out)	0.6	-0.8	0.8
Equity	-2.0	-0.6	-0.3
Medium and long-term borrowing	6.1	0.7	3.9
Government/central bank	1.8	-2.1	1.3
Banks	1.9	0.5	0.7
Corporates	2.3	2.3	1.8
Short-term borrowing	16.3	13.1	9.4
Government/central bank	3.4	2.7	2.2
Banks	8.6	6.0	3.0
Corporates	4.3	4.4	4.2
EU transfers	4.5	3.7	3.4
Change in FX reserves (reduction(+)/increase(-))	-1.4	-0.7	-0.9

Source: AKK, IMF, NBH, UniCredit Research

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

Outlook – We expect growth of 3.7% in 2015 and 3.8% in 2016 amid strong consumption, a positive fiscal impulse in 2015 and larger EU fund inflows next year. Despite growing domestic demand, exports to the EU could prevent a rapid widening of the C/A deficit. The opposition PiS is the frontrunner in October's general elections, but will have to backtrack on some election promises to prevent a re-widening of the budget deficit. We still expect two rate hikes in 2016, but risks of rates on hold until the end of next year are significant.

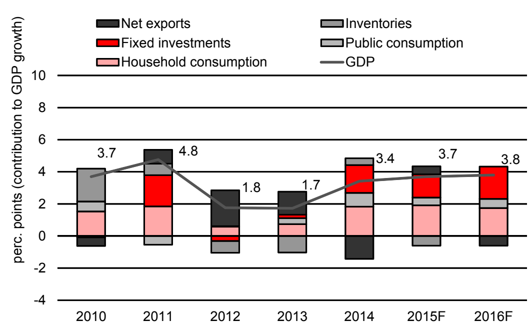
Strategy – Dovish ECB and slower reflation are mildly more positive for bonds short term so that we recommend staying marketweight, favouring the POLGB 21s. Into December, we expect the curve to bear steepen as inflation and global rates rise and we advocate moving to underweight POLGBs and paying 10Y swaps. The zloty may come under pressure before the elections but could provide an attractive entry level against the EUR above the 4.30 level.

Author: Marcin Mrowiec, Chief Economist (Bank Pekao)

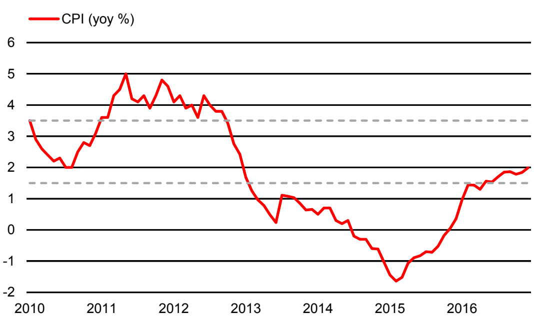
KEY DATES/EVENTS

- 5-6 Oct, 3-4 Nov, 1-2 Dec: MPC decision-making meetings
- 25 Oct: parliamentary elections
- Nov: new government
- 9 Nov: NBP inflation forecast

GDP COMPONENTS



HEADLINE INFLATION VS. TARGET



Source: StatOffice, NBP, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	386.1	395.9	412.6	430.6	461.8
Population (mn)	38.1	38.1	38.0	38.0	38.0
GDP per capita (EUR)	10,143	10,402	10,847	11,326	12,156
Real economy yoy (%)					
GDP	1.8	1.7	3.4	3.8	3.9
Private Consumption	1.0	1.2	3.1	3.2	3.0
Fixed Investment	-1.6	1.1	9.2	7.4	10.0
Public Consumption	0.2	2.1	4.7	2.7	3.2
Exports	4.3	4.8	5.6	9.3	6.9
Imports	-0.6	1.8	9.1	7.7	8.5
Monthly wage, nominal (EUR)	891	911	948	986	1,035
Unemployment rate (%)	12.8	13.5	12.3	10.8	10.2
Fiscal accounts (% of GDP)					
Budget balance	-3.7	-4.0	-3.2	-2.8	-2.5
Primary balance	-1.1	-1.5	-1.2	-1.0	-0.9
Public debt	54.4	55.7	50.1	50.2	49.0
External accounts					
Current account balance (EUR bn)	-13.7	-5.1	-6.0	-1.5	-4.1
Current account balance/GDP (%)	-3.5	-1.3	-1.4	-0.4	-0.9
Basic balance/GDP (%)	-2.1	-1.3	1.1	2.4	1.9
Net FDI (EUR bn)	5.6	0.1	10.5	12.0	13.0
Net FDI (% of GDP)	1.4	0	2.5	2.8	2.8
Gross foreign debt (EUR bn)	279.6	279.0	291.4	301.0	334.4
Gross foreign debt (% of GDP)	70.7	69.6	71.9	70.2	70.5
FX reserves (EUR bn)	82.6	77.1	82.6	96.9	90.7
Inflation/Monetary/FX					
CPI (pavg)	3.7	0.9	0	-0.6	1.8
CPI (eop)	2.4	0.7	-1.0	0.7	2.1
Central bank target	2.5±1pp	2.5±1pp	2.5±1pp	2.5±1pp	2.5±1pp
Central bank reference rate (eop)	4.25	2.50	2.00	1.50	2.00
3M money market rate	4.91	3.02	2.51	1.75	2.00
USD/PLN (eop)	3.10	3.01	3.51	3.89	3.52
EUR/PLN (eop)	4.09	4.15	4.26	4.20	4.08
USD/PLN (pavg)	3.26	3.16	3.15	3.65	3.72
EUR/PLN (pavg)	4.19	4.20	4.19	4.19	4.17

Source: CSO, NBP, MinFin, UniCredit Research

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

Stable growth and potential government change

The economy is on a strong growth path…

…helped in 2015 by lax fiscal policies and investment…

…and consumption

GDP is expected to grow by 3.7% in 2015, with private consumption and investments being the main drivers. After a temporary slowdown to 3.3% yoy in 2Q15, the growth rate could increase again towards 4% yoy in 2H15. The main factors of the expected re-acceleration are fiscal spending and investment. Higher direct tax receipts and non-tax revenues coupled with a temporary fall in co-financing of EU funds has left scope for net spending of 1.1% of GDP before the end of the year – a full 1% of GDP more than in 4Q14. Government consumption and investment will benefit from the positive fiscal impulse, while private consumption will be boosted by the real wage bill growing at more than 5% yoy.

Investment could accelerate in 2016 due to larger EU fund inflows

In 2016, investment could accelerate further, helping the economy to expand by 3.8%. We expect the absorption of EU funds from the 2014-20 disbursement period to pick up strongly next year, helping capital formation grow by approximately 10% yoy. At the same time, the growth rates of the real wage bill and consumption could slow as inflation rebounds.

We expect strong demand from the EU to help exports this year and next

We expect exports to the EU to offset completely weaker demand from the rest of the world[8] in 2015 and 2016. Even though robust domestic demand will boost imports in 2016, the C/A deficit could widen to just 0.5% of GDP in 2016 from 0.1% of GDP estimated for 2015, remaining well inside the -4.1% average for 2004-14. Most soft indicators predict healthy foreign demand ahead and the weak manufacturing PMI reading from September seems to be a one-off, driven more by bottlenecks in energy supply rather than by an actual fall in export orders. That said, a stronger reliance on exports to the EU increases the risk of a potential slowdown in European demand. Even in such a negative scenario, Poland’s solid domestic demand dynamics should cushion growth better than in the rest of Central Europe.

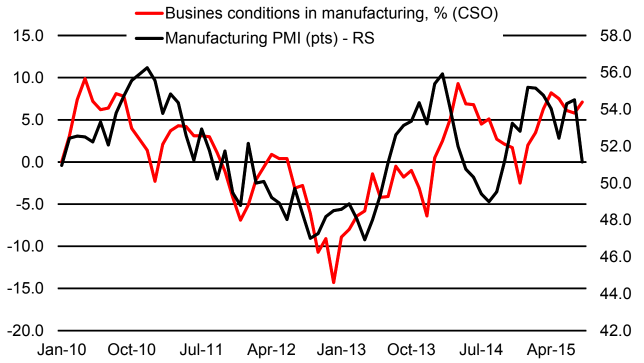
Opposition Law and Justice could win elections in October…

…and form a new government...

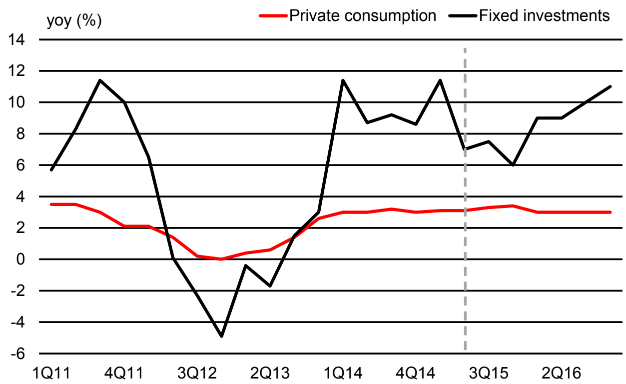
A government change looks more probable following parliamentary elections. Over the summer, the opposition Law and Justice party (PiS) opened up a double-digit lead in opinion polls over the ruling Civic Platform (PO). Pawel Kukiz’ protest movement has fallen to 6-7% in recent polls, with the Popular (Peasant’s) Party (PSL), the liberal NowoczesnaPL and the ultra-liberal KORWiN also close to the 5% threshold needed to enter Parliament. A coalition of left-leaning parties could also enter Parliament, as it currently enjoys approximately 7% of voters’ preference. If PiS’ lead over PO is confirmed on 25 October, the governing coalition could change after eight years of PC – PSL governments. PiS has an outside chance to govern on its own if most of the smaller parties fail to enter Parliament.

ECONOMIC GROWTH SHOULD ACCELERATE FURTHER

Manufacturing should rebound further, despite the recent fall in PMI



Investment is expected to outpace consumption



Source: StatOffice, UniCredit Research

[8] Especially from other EM, with Russia and Ukraine standing out as the biggest drag on Polish exports.

…but will have to ignore some of its election promises…

…in order to prevent a re-widening of the budget deficit…

…and a sell-off in Polish assets

Tax changes included in the PiS' election program would widen the budget deficit in 2016, most likely sending EUR-PLN and bond yields higher. President Andrzej Duda proposed an increase in the tax-free amount of personal income tax[9] and a lowering of the retirement age[10]. PiS' candidate for prime minister, Beata Szydlo, suggested the introduction of a subsidy of PLN 500 per child[11], which could cost up to PLN 20bn. On the financing side, the introduction of banking and supermarket taxes could bring in PLN 5bn and PLN 3bn per year, respectively. Other offsetting measures, such as reducing tax evasion, are not well defined. Thus, the financing gap in the PiS' election program, if implemented, could reverse part of the fiscal adjustment that led to Poland exiting the excessive deficit procedure earlier this year. As a result, any new government would have to backtrack on some of these populist plans in order to avoid losing Poland's status as a safe haven among EM.

Reflation will be gradual, with the headline rate re-entering the target range next year…

Annual inflation is expected to turn positive in December, ending the year close to 0.4% yoy. Reflation will be slower than previously expected[12], but even with additional supply-side shocks, base effects are likely to push consumer prices higher from 4Q15 onwards. First, most of the negative fuel price inflation will leave the base in 4Q15 and 1Q16. Second, food price inflation will rise when excluding the combined effect of last year's Russian imports ban and of the drought in August.

…but reaching the central target only in 2017

As a result, annual inflation could rise close to 1.5% already in 2Q16 and to 2.0% by the end of next year. Lower commodity prices will weigh on imported inflation, but we expect core inflation to offset this effect. The negative output gap could close amid a tightening of the labour market and strong investment. We expect inflation to return to target around mid-2017.

The monetary policy outlook is very uncertain…

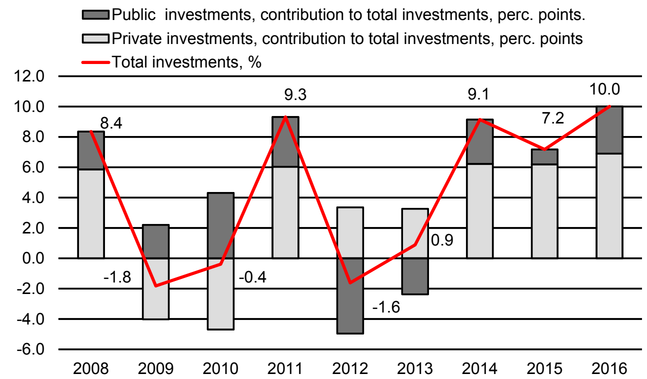
…due to the pace of reflation and the reshuffling of the MPC…

…but we maintain our expectations for two hikes in September and November 2016

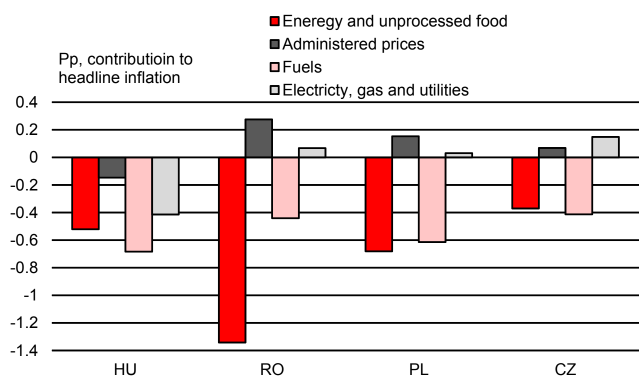
The monetary policy outlook is difficult to predict due to changes in the composition of the Monetary Policy Council. Our baseline scenario is for rates to be kept on hold until September 2016, when we expect a first hike. By that time, our forecast shows inflation safely inside the target range and exceeding the current level of the key rate. A second rate hike could follow in November 2016, when a new inflation forecast will be released. That said, risks of no rate hikes until the end of next year are significant and stem from two sources. First, inflation could undershoot expectations if supply-side shocks – such as low oil, food and/or imported prices – persist. Second, a new parliamentary majority could appoint a more dovish MPC that could choose to increase interest rates only when inflation will threaten to exit the 1.5-3.5% target range.

A RECOVERY IN ACTIVITY AND LARGE BASE EFFECTS SHOULD HELP REFLATION

Investments will be boosted by private sector and EU funds



Reflation will be helped by large base effects



Source: CSO, UniCredit Research

[9] The estimated annual cost is approximately PLN 18bn, or 0.9% of GDP.
[10] The initial cost is estimated at PLN 13bn, but the associated budget spending would increase over time.
[11] For the second and all subsequent children and from the first child for poor families.
[12] The difference between the current inflation forecast for December 2015 and the June one is -0.3pp.

Higher pressure on currency than on yields

We recommend being long zloty this autumn, on election uncertainty…

…if EUR-PLN is close to or above 4.30

Investors are expected to keep the PLN under pressure due to their negative view of domestic politics, which is unlikely to change until autumn. However, we believe that political risk is exaggerated, and we expect the new cabinet to keep spending under control. This, coupled with the strong economic performance, could push the zloty stronger in 2016. Therefore, we recommend being long zloty close to (or above) EUR-PLN 4.30.

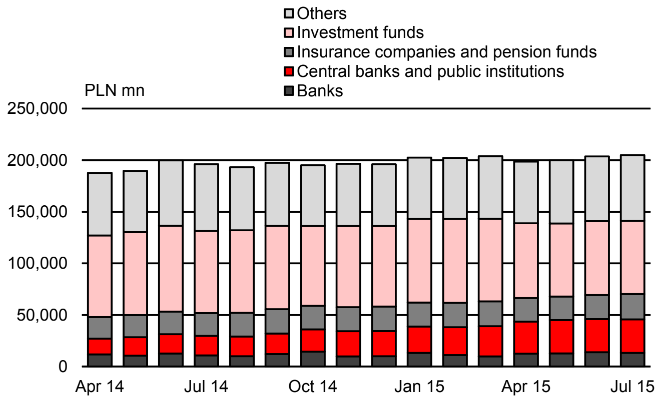
We are slightly more positive regarding POLGBs on a dovish ECB, slower reflation, and EM safe-haven status, however..

POLGBs will likely bear-steepen into year-end on rising global rates and inflation…

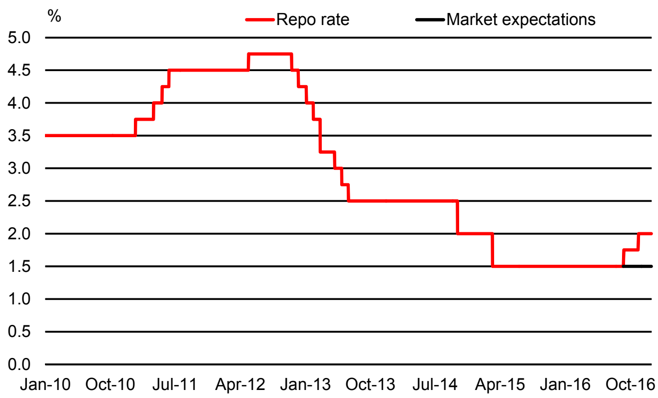
…and we think hard currency USD paper is better value than domestic paper

In the very short term, we are slightly more positive on POLGBs than before due to: **1.** ECB QE supporting CE4 bonds, particularly POLGBs; **2.** No supply pressure on yields; **3.** Slower reflation; **4.** Poland's status as an EM safe haven (an economy with strong fundamentals and low commodity and Chinese exposure). That said, higher inflation towards the end of 4Q15 and potential Fed hikes could lead to a steepening of the POLGB curve. We expect the 2Y benchmark to be below 2.00% and the 10Y benchmark close to 3.25% by at the end of 2015. We recommend being marketweight POLGBs in the next two months, moving to underweight in December and paying 10Y swaps in 2016. We think the belly remains the best value on the POLGB curve, in particular the POLGB 21s. We think that hard currency USD paper offers better value and we recommend the POLAND USD 22s and POLAND USD 24s. We also see scope for the POLAND EUR 21s to tighten short term against Bunds.

Central banks keep increasing their share of POLGBs ,



We still expect two rate hikes in late 2016 (none priced in)



Source: Finance Ministry, NBP, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**28.2**	**30.1**	**41.0**
Budget deficit	8.3	11.5	15.8
Amortisation of public debt	19.9	18.6	25.2
Domestic	17.0	15.1	22.4
Bonds	17.0	15.1	22.4
Bills	0.0	0.0	0.0
External	2.9	3.5	2.8
IMF/EU	0.0	0.0	0.0
Financing	**28.2**	**30.1**	**41.0**
Domestic borrowing	26.1	25.1	40.4
Bonds	27.5	22.8	40.3
Bills	0.0	0.0	1.9
Other	-1.4	2.3	-1.9
External borrowing	2.1	5.0	0.6
Bonds	3.6	3.5	5.0
IMF/EU	0.0	0.0	0
Other	-1.4	1.5	-4.4

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**90.5**	**90.0**	**89.1**
C/A deficit	5.3	0.6	2.3
Amortisation of medium to long term debt	37.9	44.0	42.4
Government/central bank	2.9	3.5	2.8
Banks	5.6	5.1	5.3
Corporates	29.4	35.4	34.3
Short term debt amortisation	47.3	45.5	44.4
Financing	**90.5**	**90.0**	**89.1**
FDI	7.0	2.0	3.5
Equity	0.3	-1.5	0.5
Borrowing	71.5	58.5	53.4
Government/central bank	2.1	5.0	0.6
Banks	16.4	18.0	17.8
Corporates	53.0	35.5	35.0
EU transfers	10.7	31.0	29.6
Other	1.0	0.0	2.1

Source: CSO, NBP, MinFin, UniCredit Research

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

Outlook – Romania's economic outlook is very positive for bonds, with good growth, negative inflation at least until mid-2016, a positive fiscal impulse feeding into market liquidity and a potential IMF agreement. The caveat is an unbalanced growth picture, with consumption outperforming other types of expenditure, but this is unlikely to influence investors in the short term. We expect the NBR to remain on hold this year and next. A potential government change should not affect markets amid a broad political consensus for an IMF agreement.

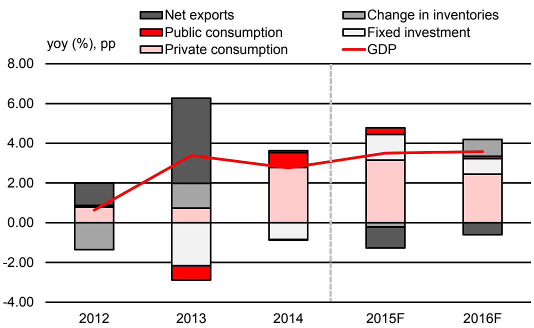
Strategy – We expect the ROMGB curve to bull flatten due to high real yields and inflation remaining negative until at least mid-2016. We recommend being long ROMGB 23s. We like the ROMANI EUR 24s and continue to favor USD-denominated bonds, in particular the ROMANI USD 23 and ROMANI USD 44s.

Authors: Dan Bucşa, Economist (UniCredit Bank London)
Anca Maria Aron, Senior Economist (UniCredit Bank Romania)

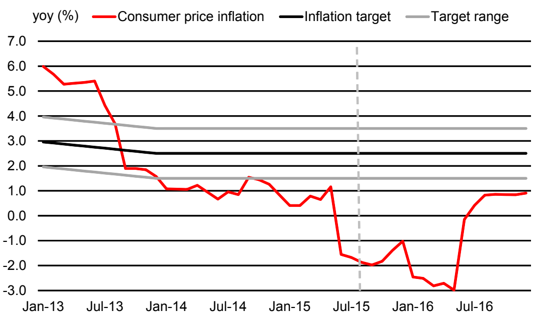
KEY DATES/EVENTS

- 30 Sept, 5 Nov: NBR rate decisions
- 13 Nov, 3 Dec: 3Q15 GDP (flash, structure)
- 27 Sept: official ending of IMF/ EC agreement

GDP COMPONENTS



INFLATION OUTLOOK



Source UniCredit Research, NBR, Statistical Office

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	133.9	144.3	150.0	157.4	167.7
Population (mn)	20.1	20.0	19.9	19.9	19.8
GDP per capita (EUR)	6,663	7,207	7,521	7,918	8,461
Real economy yoy (%)					
GDP	0.6	3.4	2.8	3.5	3.6
Private Consumption	1.2	1.2	4.5	5.0	3.9
Fixed Investment	0.1	-7.9	-3.5	5.9	3.5
Public Consumption	0.4	-4.8	5.3	2.3	0.8
Exports	1.0	16.2	8.1	6.4	6.5
Imports	-1.8	4.2	7.7	9.0	7.8
Monthly wage, nominal (EUR)	479	507	531	562	587
Unemployment rate (%)	6.9	7.1	6.8	6.8	6.7
Fiscal accounts (% of GDP)					
Budget balance	-2.9	-2.2	-1.5	-1.3	-2.7
Primary balance	-1.1	-0.5	0.0	0.2	-1.3
Public debt	37.3	38.0	39.8	38.1	38.2
External accounts					
Current account balance (EUR bn)	-6.1	-1.2	-0.6	-0.6	-0.8
Current account balance/GDP (%)	-4.5	-0.8	-0.4	-0.4	-0.5
Basic balance/GDP (%)	-2.7	1.2	1.2	1.5	1.4
Net FDI (EUR bn)	2.4	2.9	2.5	2.9	3.2
Net FDI (% of GDP)	1.8	2.0	1.7	1.8	1.9
Gross foreign debt (EUR bn)	100.9	97.8	94.3	88.5	88.2
Gross foreign debt (% of GDP)	75.3	67.8	62.9	56.2	52.6
FX reserves (EUR bn)	31.2	32.5	32.2	31.5	34.4
Inflation/Monetary/FX					
CPI (pavg)	3.3	4.0	1.1	-0.7	-0.7
CPI (eop)	5.0	1.6	0.8	-1.0	0.9
Central bank target	3.0	2.5	2.5	2.5	2.5
Central bank reference rate (eop)	5.25	4.00	2.75	1.75	1.75
3M money market rate	5.22	4.05	2.14	1.04	1.11
FX/USD (eop)	3.36	3.26	3.69	3.80	3.63
FX/EUR (eop)	4.43	4.48	4.48	4.45	4.43
FX/USD (pavg)	3.47	3.33	3.35	3.94	3.71
FX/EUR (pavg)	4.46	4.42	4.44	4.45	4.44

Source: UniCredit Research

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

Good short-term outlook dampens long-term worries

Romanian bonds could outperform those of other EM in 2015 and 2016…

Romania is well positioned to weather the EM turmoil: the economy is growing at more than 3% yoy, the budget is running the largest surplus on record, a small current account deficit is covered by FDI and EU funds, while inflation is negative and will remain below target until end-2016. Combining this with foreign investors owning less than 20% of local bonds, the highest real yields among countries included in the GBI-EM index[13] and the expected increase in interbank liquidity, Romanian bonds could outperform those of other EM.

…with risks to the bullish picture being long term and related to potential growth

The caveats to this bullish picture relate more to the coherence of public policies and their impact on potential growth. While this is an important issue to tackle, it is unlikely to be addressed in election year 2016 or to influence investor perception this year and next.

We expect growth above 3% this year and next…

…with consumption being the most important driver…

The economy will continue to grow above potential in 2015 and 2016, expanding more than 3% each year. Private consumption will remain the main driver amid strong real wage growth, tax cuts and a rebound in lending. Real wage growth accelerated above 7% in 2015 from 4% in 2014 due to repeated hikes in the minimum wage and falling inflation. VAT cuts[14] could cap annual inflation at -1.0% in 2015 and 1.3% yoy in 2016, thus ensuring that real wage growth will remain above 5% in 2016. In addition, lower oil prices and a good harvest in 2015 will boost real incomes while allowing the central bank to remain on hold. As a result, lending in local currency is expected to rise in double digits, supporting the rebound in housing, a new cycle of consumer lending and the gradual switch from FX to local currency loans.

…amid a large fiscal impulse…

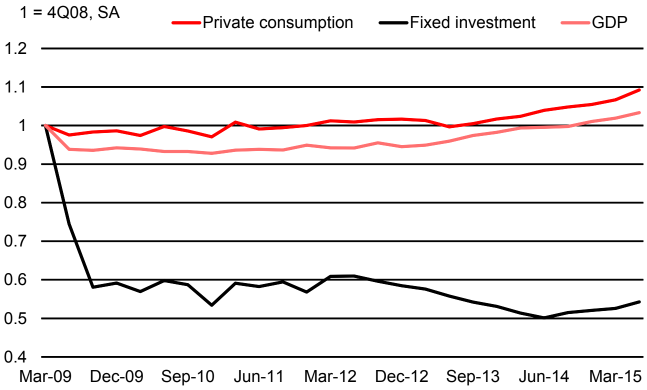
…that is unlikely to push the budget deficit above 3% of GDP…

…but will further affect public investment…

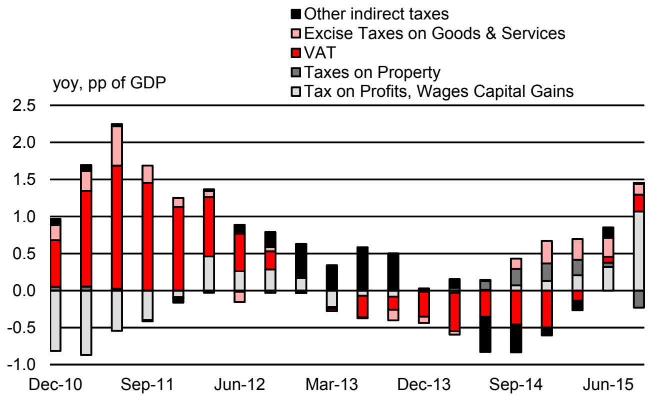
A large fiscal impulse will further boost consumption until mid-2016. The economic recovery and improved tax collection led to larger-than-expected budget revenues, with indirect taxes outperforming. Meanwhile, budget expenditure lagged amid a further squeeze in public investment and co-financing for EU funds. This led to a budget surplus of 1% of GDP at the end of August, leaving room for a whopping 2.5% of GDP deficit in the last four months of the year. Politicians were quick to capitalise on the fiscal room by cutting taxes and increasing wages. Parliament voted for a significant dose of fiscal easing in 2016, even though tax cuts will be phased in over two years to keep the projected budget deficit below 3% of GDP in 2016. The policy mix, however, is unbalanced because politicians favored again consumption over investment. The toxic "pillar tax" on constructions other than buildings will remain in place until 2017[15], while direct taxes and social security contributions will be frozen.

THE FOCUS ON BOOSTING CONSUMPTION VIA VAT CUTS IS UNWARRANTED

Fixed investment is lagging consumption since the crisis



The improvement in VAT receipts follows poor revenues in 2014



Source: NIS, MinFin, UniCredit Research

[13] After Nigeria will be excluded from the index in October.
[14] The government cut the VAT for food from 24% to 9% on 1 June 2015 and will cut the main VAT rate from 24% to 20% on 1 January 2016.
[15] The extra excise duty on fuels and the current level of the dividend tax will also be maintained until 2017.

… as well as investment in production capacities…

… and will lead to a loss of competitiveness

The outcome is a closing of the output gap, driven solely by consumption. Investment in production capacities is lagging, with the only bright note being the rebound in real estate. The loss of competitiveness amid higher unit labour costs comes at a time when exports are lagging the rest of the region due to a lack of significant investment projects and faltering demand from Turkey and the Middle East, Ukraine, and Russia. So far, a wider trade deficit on goods has been offset completely by the growing trade surplus on services. Romania's market share in transportation, IT and support services continues to rise due to low labour costs and advantageous taxation, while remittances exceed profit outflows from investment.

Balance of payments flows offer support to the RON…

… although depreciation pressures could re-emerge beyond 2016.

As a result, the C/A deficit may remain below 1% of GDP this year and next, being covered by foreign direct investment. EU funds inflows will drop below 2% of GDP next year at the start of the new disbursement period. Thus, the external financing capacity could halve in 2016 from approx. 3% of GDP this year, but will be large enough to keep EUR-RON inside the 4.40-4.50 range for most of 2015 and 2016. Beyond next year, falling competitiveness could increase pressure on the RON and on banks to accelerate the conversion of FX loans into RON.

The NBR could remain on hold in 2015 20016…

… reducing minimum reserve requirements if monetary conditions demand.

The NBR will probably stay on hold until the end of 2016. While inflation will remain below target due to tax cuts, lax fiscal policies threaten to overheat consumption and household lending. The central bank might react by toughening prudential regulation, but rate hikes seem off the table because they could deter investment in tradables and the gradual shift to RON lending. Moreover, we expect the NBR to keep interest rates below the policy rate by continuing the gradual reduction in minimum reserve requirements.

A possible government change is unlikely to add to volatility…

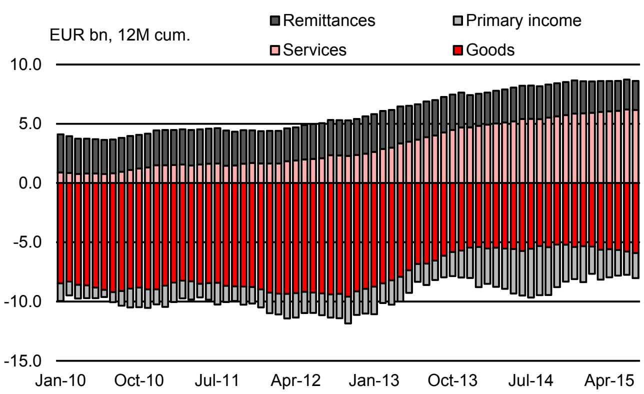
… with all parties now backing a new IMF agreement.

A government change is still on the cards ahead of next year's general elections. However, the governing coalition could remain the same, even if Prime Minister Victor Ponta is replaced. A political agreement among local parties will hopefully reduce the scope for additional populist measures. In fact, the entire political spectrum has expressed its desire for a precautionary IMF agreement to follow the current SBA, which expires in September 2015. According to IMF representatives, a new agreement is conditional on sound fiscal policies.

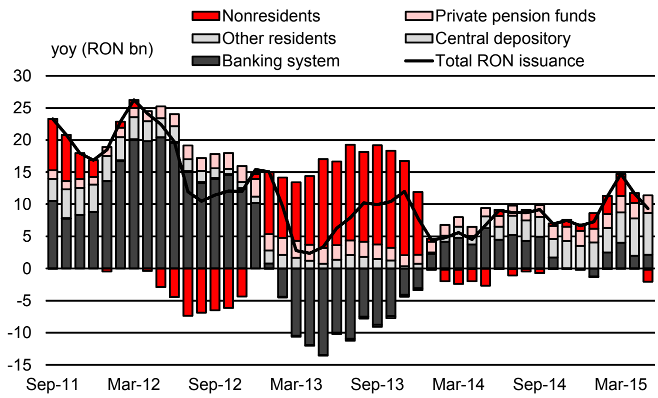
Romanian bonds remain well supported by low inflation, lax monetary policy, low foreign holdings of local bonds and a potential new IMF agreement. In 2Q15, foreign holdings dropped below 20% of outstanding ROMGBs amid large redemptions and low appetite for EM assets. In compensation, local investors increased their holdings by more than EUR 1bn this year. Despite planned tax cuts and wage hikes, we expect the budget deficit to remain below 3% of GDP in 2016 amid a further squeeze in public investment. Higher financing needs could be covered mostly by returning foreign investors and a drop in fiscal reserves.

THE BOP SUPPORT TO THE RON REMAINS INTACT

Strong service exports offset the larger trade deficit on goods



Demand from local investors outweighs bond sales by nonresidents



Source: NBR, MinFin, UniCredit Research

Rally to continue amid negative inflation and high liquidity

ROMGB curve should be well supported by…

…high yields, negative inflation and excess liquidity

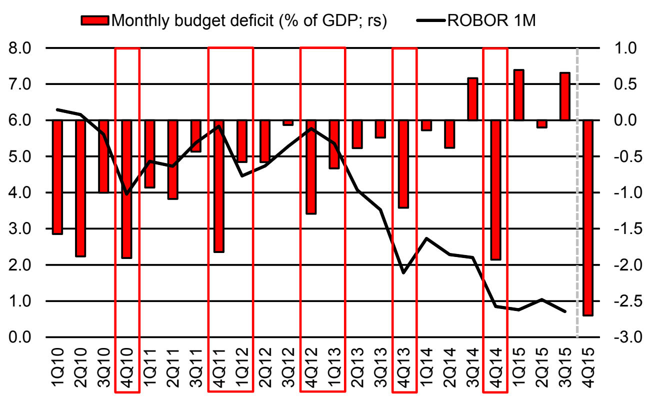
The ROMGB curve should bull flatten and we favour the ROMGB23s.

We favour ROMANI USD 23 and 44s bonds due to better yields and Z-spreads

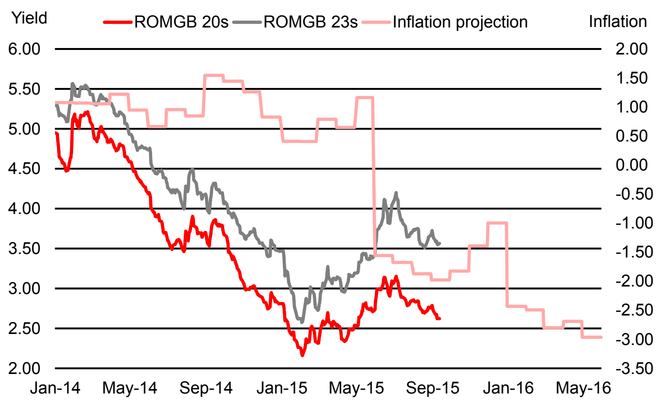
ROMGBs should be well supported in 2015 and 2016 by high real yields, low inflation and abundant liquidity. VAT cuts could keep inflation below 0% at least until mid-2016. In addition, the government's net spending will exceed 2.5% of GDP before year-end and this will fuel excess liquidity in the banking system, dwarfing 4Q15 RON net issuance and causing front-end rates to tighten. This might push local and foreign investors to re-extend duration, after reducing it in 1H15 due to Greek debt woes, and local political and mark-to-market issues. As a result, we expect the curve to bull-flatten, with the 2s10s spread falling below 100bp. We recommend staying overweight ROMGBs, preferring ROMGB 23s. The risks to this call are that EM continue to experience outflows due to rising risk aversion and Fed rate hikes. In addition, local investors could postpone extending duration if the political situation is perceived as volatile amid a potential change of government.

Romania's weight in the Euro EMBIG Diversified index will increase to third largest by the end of November. In anticipation, we prefer the ROMANI EUR 24s vs. ROMANI EUR 20s. We still see better value in the ROMANI USD paper and favour the ROMANI USD 23s and ROMANI USD 44s which are the best value on the curve from a yield and Z-spread perspective.

Yields will benefit from high fiscal spending at the end of the year



… and from low inflation throughout 2016



Source: NBR, MinFin, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**12.7**	**12.3**	**14.6**
Budget deficit	2.8	2.6	4.5
Amortisation of public debt	9.9	9.7	10.1
Domestic	8.9	7.0	8.5
Bonds	6.3	4.2	6.2
Bills	2.2	2.5	2.0
Loans	0.4	0.3	0.3
External	1.0	2.7	1.6
Bonds and loans	0	1.0	1.5
IMF/EU/IFIs	1.0	1.7	0.1
Financing	**12.7**	**12.3**	**14.6**
Domestic borrowing	9.7	8.9	11.3
Bonds	6.9	6.6	9.0
Bills	2.5	2.0	2.0
Loans	0.3	0.3	0.3
External borrowing	4.9	1.6	3.0
Bonds	4.3	1.1	2.0
IMF/EU/WB	0.6	0.5	1.0
Other	0.0	0.0	0.0
Fiscal reserve change (+decline/- increase)	-1.9	1.8	0.3

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**36.2**	**30.9**	**27.4**
C/A deficit	0.6	0.6	0.8
Amortisation of medium to long term debt	23.5	19.3	14.3
Government/central bank	9.8	6.2	3.3
Banks	7.1	6.4	4.6
Corporates	6.6	6.7	6.4
Amortisation of short term debt	11.3	10.1	11.3
Government/central bank	0.3	0.4	0.3
Banks	4.8	3.5	4.1
Corporates	6.2	6.2	6.9
Other	0.8	0.9	1.0
Financing	**36.2**	**30.9**	**27.4**
FDI	2.5	2.9	3.2
Equity	0.3	0.1	0.1
Borrowing	30.7	23.6	25.2
Government/central bank	9.8	2.9	4.8
Banks	9.0	8.4	7.8
Corporates	11.9	12.3	12.6
EU Funds - capital transfers	4.0	3.5	1.8
FX reserve change (+decline/- increase)	-1.3	0.8	-2.9

Source: MinFin, NBR, NSO, UniCredit Research

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

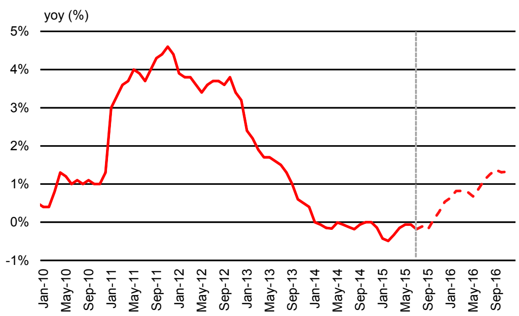
Outlook – Slovakia's economy could grow faster than 3% in 2015 and 2016, driven by domestic demand and exports to Europe. EU funds and elections in early spring 2016 will boost public investment, while household spending will be supported by real wage growth, fiscal spending and subdued inflation as a result of the oil price slump and a VAT cut for basic food. The foreign trade surplus could narrow due to accelerating imports, resulting in a small C/A deficit. The Social Democrats are expected to win general elections scheduled for March 2016, but could be forced to form a governing coalition.

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

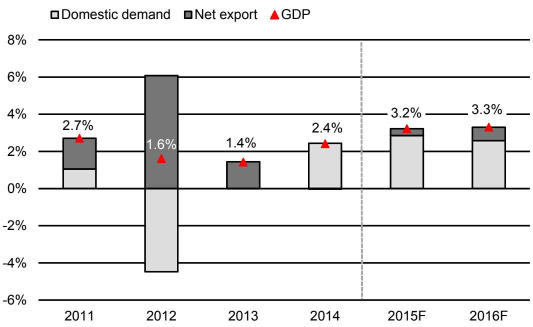
KEY DATES/EVENTS

- 9 Oct, 10 Nov, 10 Dec – Industrial production
- 13 Oct, 12 Nov, 14 Dec – CPI
- 13 Nov – flash 3Q15 GDP
- 4 Dec – 3Q15 GDP structure

INFLATION TO REMAIN SUBDUED



GDP TO ACCELERATE, DRIVEN BOTH BY DOMESTIC AND EXTERNAL DEMAND



Source: Statistical Office SR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	72.2	73.6	75.2	77.5	80.4
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	13,354	13,598	13,883	14,302	14,848
Real economy yoy (%)					
GDP	1.6	1.4	2.4	3.2	3.3
Private Consumption	-0.5	-0.8	2.2	2.6	2.8
Fixed Investment	-9.3	-2.7	5.7	6.1	3.1
Public Consumption	-2.0	2.4	4.4	2.5	1.5
Exports	9.3	5.2	4.6	5.4	5.6
Imports	2.6	3.8	5.0	5.4	5.2
Monthly wage, nominal (EUR)	805	824	858	879	901
Unemployment rate (%)	14.0	14.2	13.2	11.9	10.8
Fiscal accounts (% of GDP)					
Budget balance	-4.2	-2.6	-2.9	-2.6	-2.0
Primary balance	-2.4	-0.7	-0.9	-0.8	-0.3
Public debt	52.1	54.6	53.6	53.6	53.6
External accounts					
Current account balance (EUR bn)	0.7	1.1	0	-0.2	-0.2
Current account balance/GDP (%)	0.9	1.5	0.1	-0.3	-0.3
Basic balance/GDP (%)	4.2	2.6	0.7	2.3	1.6
Net FDI (EUR bn)	2.3	0.8	0.5	2.0	1.5
Net FDI (% of GDP)	3.2	1.0	0.6	2.5	1.9
Gross foreign debt (EUR bn)	54.9	60.4	67.8	71.4	74.9
Gross foreign debt (% of GDP)	76.0	82.1	90.1	92.1	93.1
Inflation/Monetary/FX					
CPI (pavg)	3.6	1.4	-0.1	-0.1	1.0
CPI (eop)	3.2	0.4	-0.1	0.5	1.3
Central bank reference rate (eop)	EUR	EUR	EUR	EUR	EUR
3M money market rate	EUR	EUR	EUR	EUR	EUR
FX/USD (eop)	EUR	EUR	EUR	EUR	EUR
FX/EUR (eop)	EUR	EUR	EUR	EUR	EUR
FX/USD (pavg)	EUR	EUR	EUR	EUR	EUR
FX/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

Election spending and EU funds investment to boost growth

Economic growth is expected to exceed 3% this year and next…

…driven by both domestic demand…

The Slovak economy is expected to continue growing by more than 3% in 2015 and 2016. We expect GDP to be driven by both recovering domestic demand and higher exports. The rebound in investment could continue as optimism is rising among companies and the state is increasing EU fund absorption at the end of the 2007-2013 disbursement period. Moreover, the fiscal impulse will increase further ahead of general elections scheduled for early spring 2016, helping both investment and consumption. The latter will benefit from real wage growth, a tighter labor market and re-leveraging amid low interest rates.

…and exports

Stronger domestic demand is leading to a cyclical recovery in imports, although lower commodity prices are preventing a rapid increase. Meanwhile, exports are benefiting from the recovery in the eurozone and from the weaker euro, but not enough to prevent a narrowing of the trade surplus. As a result, we expect the C/A surplus to turn to deficits in 2015 and 2016. At the same time, FDI inflows should rise, with privatizations reaching 1% of GDP.

The economy's dependence on car manufacturing will rise…

…with a new plant scheduled to open in 2018

Slovakia attracted another big investment in car manufacturing, with Jaguar-Land Rover planning an investment equivalent to 2% of GDP. As a result, fixed investment will increase in 2017-18, temporarily reducing the trade surplus. Production will begin in 2018-22, slower than at other car plants. Thus, Slovakia's exports and industrial production will remain strongly dependent on the automotive sector. That said, product diversification (from smaller city cars to luxury SUVs) increases the resilience of the sector.

Upside risks to growth are coming from lower energy prices…

…and additional fiscal easing

Upside risks to our GDP forecast are coming from lower energy prices and fiscal easing ahead of elections. A third package of measures[16] will bring a VAT cut for selected foodstuffs, an increase in the minimum wage and a cut in the healthcare contribution of low-income employees. All the measures are expected to support household spending, with low-income households benefiting the most. Meanwhile, the cash budget execution suggests that fiscal targets will be met in 2015. The cash deficit was only -2.2% of GDP at the end of August vs. a budgeted shortfall of -3.9% of GDP, mainly due to better-than-expected tax collection. This, in turn, benefited from the economic recovery (automatic stabilizers) and from measures taken in previous years to fight tax evasion. Despite the pre-election splurge, the budget deficit is expected to remain below 3% of GDP. As a result, public debt will fall below the debt brake of 55% GDP, with one-off privatization revenues from telecommunications accelerating the adjustment.

Downside risks to growth are related to external demand weakness…

…especially from China…

…but demand from the eurozone can offset weak sales to EM

Downside risks to the growth forecast are related to external demand weakness. The most important direct impact could come via a worsening of sentiment. Consumer confidence plummeted to a 1.5-year low following Greece's debt woes, recovering incompletely after the new aid package was approved. Another threat is coming from China's slowdown. Although China accounts for less than 2% of Slovak exports, it could have a negative impact on sectors like car manufacturing. China receives 8-9% of Slovakia's car exports (mostly SUVs). However, as long as domestic demand in the eurozone is not affected by external shocks, increasing car registrations in Europe should offset weaker demand from emerging markets like China and Turkey or trade sanctions from Russia.

Inflation will remain low due to low commodity prices, and cuts in administered prices and VAT

A series of supply-side shocks from falling commodity and food prices, and from cuts in administered prices (e.g., lower rail transport prices for students and pensioners) led to negative inflation. Inflation could turn positive again at the end of the year, but the VAT cut for food will prevent it from rising significantly above 1% yoy by the end of next year.

The Social Democrats could form a governing coalition after next spring's elections

Polls are suggesting that the ruling Social Democrats could win next year's elections, but their support is declining. Yet even if opposition parties will have a majority, they are unlikely to form a stable coalition. Therefore, a governing coalition between Social Democrats and one other party seems the most likely scenario.

[16] The first package of measures was announced in June 2014, while most of the measures were implemented gradually in 2H14. The second package was announced in May 2015 and third one is scheduled for the beginning of 2016.

Bosnia and Herzegovina (B3 stable/B stable/not rated)*

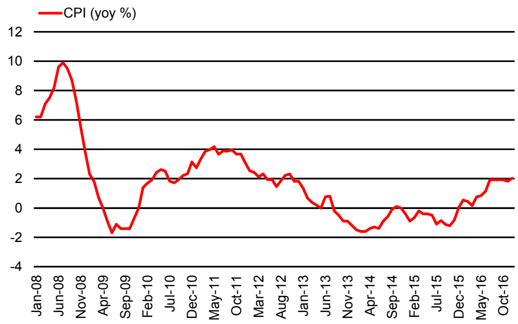
Outlook – BH's economy is recovering, with firmer domestic and foreign demand likely to boost real GDP growth to about 2% this year from 1.1% in 2014. However, significant macroeconomic imbalances remain with a large C/A deficit at 8% of GDP, the fiscal deficit at 3.2% and public debt at 46.5% of GDP. Reforms have continued to lag, hampered in part by ongoing political weakness. The latest IMF SBA expired in June, but the government is likely to seek a new SBA later this year to reduce vulnerability to shifts in market sentiment. To this end, a Reform Agenda has been agreed on by all authorities. It is already being implemented with the approval of a new labour law but so far only in one of two entities, the Federation of B&H.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

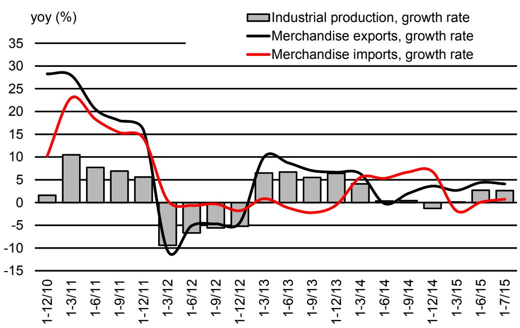
KEY DATES/EVENTS

- 30 Sept – GDP for 2Q15 – first results
- 30 Sept – BoP for 2Q15
- Oct – Labour Force Survey – final report
- Oct – Construction works report
- 4Q: New SBA negotiations

CPI EXPECTED TO SLOW



MERCHANDISE EXPORTS



Source: IMF, National ministries of finance, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	13.4	13.7	13.9	14.1	14.8
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,491	3,569	3,641	3,693	3,878
Real economy yoy (%)					
GDP	-0.9	2.4	1.1	2.0	3.5
Monthly wage, nominal (EUR)	660	661	659	660	674
Unemployment rate (%)	44.1	44.6	43.9	43.5	43.0
Fiscal accounts (% of GDP)					
Budget balance	-1.9	-2.2	-3.0	-3.2	-2.1
Primary balance	-1.9	-2.2	-3.0	-3.2	-2.1
Public debt	39.0	41.7	44.7	46.5	47.5
External accounts					
Current account balance (EUR bn)	-1.2	-0.8	-1.1	-1.1	-1.2
Current account balance/GDP (%)	-8.7	-5.7	-7.6	-8.0	-8.1
Basic balance/GDP (%)	-6.8	-4.0	-4.6	-4.3	-4.3
Net FDI (EUR bn)	0.3	0.2	0.4	0.5	0.6
Net FDI (% of GDP)	1.9	1.6	3.0	3.6	3.8
Gross foreign debt (EUR bn)	6.9	7.0	7.4	7.7	8.1
Gross foreign debt (% of GDP)	51.4	51.0	52.8	54.3	54.4
FX reserves (EUR bn)	3.3	3.6	4.0	4.1	4.1
Inflation/Monetary/FX					
CPI (pavg)	2.1	-0.1	-0.9	-0.7	1.3
CPI (eop)	1.8	-1.2	-0.4	0	2.0
3M money market rate	0.33	0.13	0.13	-0.02	-0.01
FX/USD (eop)	1.48	1.42	1.60	1.67	1.60
FX/EUR (eop)	1.95	1.95	1.95	1.95	1.95
FX/USD (pavg)	1.52	1.47	1.47	1.71	1.64
FX/EUR (pavg)	1.95	1.95	1.95	1.95	1.95

Source: UniCredit Research

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

Stronger growth, rising macroeconomic imbalances

GDP grew by 2.1% in 1Q15 yoy according to preliminary estimates, led primarily by construction and services

The economic recovery is set to continue as activity in construction and manufacturing has accelerated. GDP is reported to have grown by 2.1% yoy in 1Q15, boosted by the rebound in construction, mainly reflecting reconstruction work after last year's floods, and services. In seasonally-adjusted terms, the acceleration in growth has been impressive, from 0.1-0.2% qoq in the first half of 2014 to 0.6% in 4Q14 and 1Q15. Even though construction lost momentum in 2Q15 as civil engineering works slowed, the growth momentum is likely to have been sustained by the strong recovery in manufacturing. The latter has been driven by both foreign and domestic demand, providing a solid basis for growth in 2H15. Therefore, we maintain our GDP growth forecast of 2% yoy for this year. Prospects beyond 2015 depend on the external environment, which we view as broadly favorable, but crucially on progress in reforms, which has been lagging recently.

Current account deficit is expected to widen further in 2015, but at a slower pace as growth of merchandise imports is not as strong as previously expected

The acceleration in growth has been accompanied by a further widening of the C/A deficit, which is expected to rise to around 8.0% of GDP in 2015 from 7.6% in 2014. The deficit remains structurally large mainly due to the heavy import dependence of the economy. However, this is 0.5% of GDP less than what we expected earlier mainly due to lower oil prices that cut nominal import growth to just 0.7% yoy in the first seven months of 2015. The large deficit is financed primarily via borrowing from international financial institutions, but FDI has a significant share (mostly in the energy sector).

The rebound in growth has been accompanied by a marked recovery in employment. Registered employment rose 1.5% yoy in 7M15, extending last year's gain of 2.4%. As a result, unemployment started to decline, but still remains exceptionally high. However, with unemployment assessed at 27.7% of the workforce in April's Labour Force Survey (following ILO methodology) those developments are far from encouraging and call for changes in labour legislation. Even though gross nominal wages were unchanged in 1H15vs. 1H14, they rose slightly in real terms due to deflation, which we expect to persist for most of 2015. Consumer prices continued falling during the first seven months of 2015, with 12M inflation at -0.6% in July, mainly due to falling food and fuel prices and imported deflation via the currency board arrangement. We expect this trend to continue until year-end before inflation returns next year once oil prices stabilize and imported deflation reverses.

Deflation still present, but prices are expected to stabilize in the remainder of the year

Progress on structural reforms has not been impressive. Because BH authorities were unable to implement the agreed on policies, the last four tranches under the IMF SBA totaling EUR 152mn remain undisbursed. As a consequence, financing of the budget deficits of both entities had to rely on domestic bonds issuance. However, we view this situation as unsustainable given heightened market volatility ahead of the first Fed rate hike. We consider a new IMF agreement as crucial to anchor policies and keep public finances under control

Fourth extended SBA expired in June, but a follow-up program is expected to be negotiated during the autumn

***Reform agenda* adopted by all levels of government in B&H is expected to boost needed reforms on which both IMF and European Commission insist**

A follow-up SBA with the IMF is expected to be negotiated during the autumn. The first precondition (new labour law enacted) has already been fulfilled by the Federation of B&H in July, while approval by the other entity, Republic of Srpska, is expected in the coming months. In addition, the approval by all levels of government of the *Reform Agenda* gives hope that broader reforms will accelerate as well. The *Reform Agenda* is a blueprint for reforms that integrates the policies demanded by the IMF and the European Commission. These include measures to boost growth and job creation, further fiscal consolidation needed to put government finances on a sustainable footing, improve the quality of governance, and rein in government spending. Envisaged reforms should also enhance bank oversight and revive bank lending, improve the functioning of the labour market, strengthen tax collection, improve the business environment and attract investment. The reform agenda is dauntingly demanding and will require determination and political resolve.

Russia (Ba1 negative/BB+ negative/BBB- negative)*

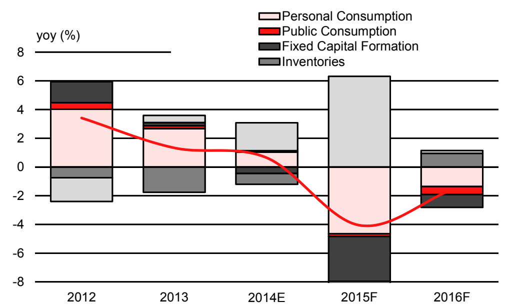
Outlook – The optimism from better-than-expected 1Q15 performance has faded away, as the renewed drop in the oil price, no progress on sanctions relief, and limited policy response have weighed on the ruble and confidence. The outlook has worsened significantly as a result, leading us to downgrade our GDP forecast to -4.1% this year. We still expect the recession to last well into 2016, with a potential turnaround only in 2H16. We also expect the recent RUB depreciation to intensify price pressures, boosting inflation to more than 14% for 2015 from the 11-12% expected earlier, with a decline likely next year, to around 9%.

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

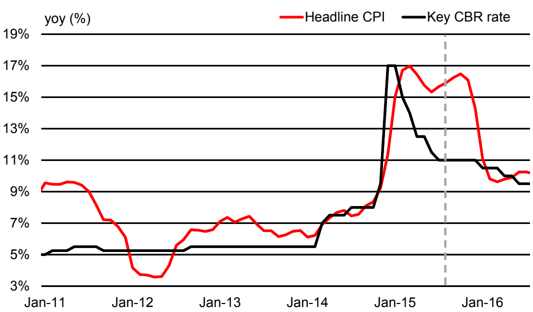
KEY DATES/EVENTS

- 25 October – Budget-2016' submission to the State Duma
- 30 Oct, 11 Dec – MPC meetings
- 18-23 of every month – short-term statistical overview

DOMESTIC DEMAND WEAKENS



INFLATION TO REMAIN ELEVATED



Source: Federal Statistical Service, CBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	1545.6	1560.8	1403.8	967.6	885.3
Population (mn)	143.0	143.3	143.7	143.5	143.4
GDP per capita (EUR)	10,808	10,892	9,769	6,743	6,174
Real economy yoy (%)					
GDP	3.4	1.3	0.6	-4.1	-1.6
Private Consumption	7.8	5.0	1.9	-8.0	-2.5
Fixed Investment	6.6	1.0	-2.0	-15.0	-5.0
Public Consumption	2.6	1.1	0.5	-1.0	-3.0
Exports	1.1	4.6	-0.1	-0.1	1.2
Imports	8.7	3.8	-7.9	-27.7	1.2
Monthly wage, nominal (EUR)	675	696	641	474	406
Unemployment rate (%)	5.3	5.4	5.6	5.9	6.5
Fiscal accounts (% of GDP)					
Budget balance	0.0	-0.5	-0.5	-3.7	-2.3
Primary balance	0.2	-0.1	0.1	-3.1	-1.6
Public debt	10.2	11.7	12.0	15.4	19.1
External accounts					
Current account balance (EUR bn)	63.2	24.8	46.5	57.5	55.8
Current account balance/GDP (%)	4.1	1.6	3.3	5.9	6.3
Basic balance/GDP (%)	4.2	0.8	1.3	4.2	4.3
Net FDI (EUR bn)	1.4	-11.7	-28.5	-17.0	-18.0
Net FDI (% of GDP)	0.1	-0.8	-2.0	-1.8	-2.0
Gross foreign debt (EUR bn)	485.1	546.7	491.0	433.9	391.2
Gross foreign debt (% of GDP)	31.4	35.0	35.0	44.8	44.2
FX reserves (EUR bn)	407.3	377.4	319.3	257.8	238.4
Inflation/Monetary/FX					
CPI (pavg)	5.1	6.8	7.8	16.1	9.9
CPI (eop)	6.6	6.5	11.4	14.4	9.3
Central bank target	5-6	5-6	5.0	-	4.0
Central bank reference rate (eop)	5.50	5.50	17.00	11.00	9.50
3M money market rate	7.45	7.08	18.30	12.25	10.35
FX/USD (eop)	31.07	32.72	54.4	68.40	75.84
FX/EUR (eop)	39.92	44.97	68.34	79.35	92.54
FX/USD (pavg)	30.37	31.84	38.46	62.40	73.03
FX/EUR (pavg)	40.23	42.41	50.87	70.52	86.18

Source: UniCredit Research

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

Slipping deeper into the red

The near-term outlook for Russia has deteriorated markedly…

The near-term outlook for Russia has deteriorated markedly. The renewed decline in oil prices and heightened global market volatility ahead of the first Fed rate hike have dashed hopes for an early recovery. The weak 2Q15 GDP outturn, along with current short-term indicators, suggests that the economy has yet to bottom out. We now expect the contraction in real GDP to exceed 5.5% from peak to trough and that a recovery would come only in the second half of 2016. The outlook for domestic demand has weakened, as private consumption followed, with a lag, the drop in real incomes, and the scope for fiscal accommodation vanished.

…and as a result, we now revised our real GDP projection for 2015 from -3.5% to -4.1%

The supply-side response has been muted. Except for a few niche sectors such as agro-processing, import substitution has not even started, hindered by insufficient and costly funding, and the poor demand outlook. The government, meanwhile, has struggled to come up with a consistent policy response, which has been limited thus far mainly to budget support to troubled entities. Labor market adjustment has been largely absent, with employers responding to the demand slump by cutting wages and work hours rather than employment. As a result, we now revised our real GDP projection for 2015 from -3.5% to -4.1%.

The external environment has deteriorated, too. Growing concerns about the slowdown in emerging markets (especially China) have weighed on commodity prices. Risk aversion to emerging markets has increased, with the sanctions imposed by the U.S. and the EU additionally constraining capital inflows. Demand in Russia's main CIS neighbors has plummeted, and a wave of competitive devaluations has hit exports to the region.

At its current level of RUB 67-71/ USD the currency is in short-term equilibrium…

All these caused the RUB to weaken 35% from its April peak by September. Aware of the nonmonetary factors pushing the currency lower, the CBR chose not to intervene other than suspending the daily purchases begun in May. Another factor leading the authorities to accommodate the RUB weakening was the need to offset the fall in budget oil revenues. With debt repayments low (USD 8bn in 4Q15) and oil prices likely to stabilize, we expect that the currency is in short-term equilibrium at its current level of RUB 67-71/USD.

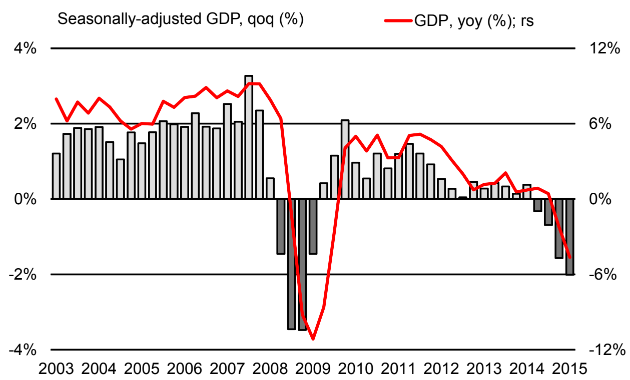
…but an acceleration in inflation (to more than 14% vs. the 11-12% projected earlier) through the rest of the year is likely

Even under these relatively benign assumptions, we anticipate a substantial acceleration in inflation through the rest of the year – to more than 14% vs. the 11-12% projected earlier. The deteriorated inflation outlook and the ongoing RUB volatility prompted the CBR to pause its rate cutting cycle in September and it now looks more likely to take a pause until yearend.

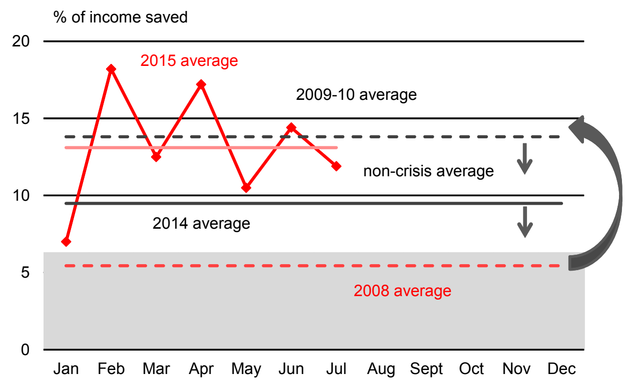
Over the longer term, however, we see substantial downside risk for the RUB. These risks stem from the unfavorable external environment expected next year, the significant policy constraints and the difficult fiscal outlook (see our *Russia: mounting fiscal challenges*).

THE REAL ECONOMY IS STRUGGLING WITH HEADWINDS

The economy is sinking deeply into the red …



...and precautionary savings have risen markedly



Source: Rosstat, Bloomberg, UniCredit Research

The environment is not likely to turn much better for Russia soon…

With the stalemate in Ukraine unlikely to be resolved soon, prospects for the sanctions to be lifted or eased soon are slim. (There is a risk of new sanctions if the separatist-controlled regions hold separate local elections in October). While we assume oil prices to recover modestly (to USD 62/bbl for Urals by yearend) and growth in the EU to firm, these developments are likely to be offset by the slowdown in emerging markets and especially in China.

…and policies will stay generally restrictive…

…helping slow the pace of RUB depreciation

Policies are not likely to be growth-supportive either. While the CBR most likely will resume cutting rates in 2016, the pace will be measured to safeguard against inflation. Despite the September 2016 Duma and local elections, we expect restrictive fiscal policy as the government strives to find a new budget equilibrium. As a result, we expect the pace of RUB depreciation to slow markedly, leaving the currency broadly unchanged in real terms in 2H16.

…as growth embarks on a slow recovery path in 2H16

…and inflation slows towards 9% or less by December 2016

Under these assumptions, we expect growth, after languishing early on, to embark on a slow recovery path in the second half of the year, supported by an inventory buildup and a depreciation-driven shift in demand away from imports. Overall real GDP could contract by a modest 1.5%. After peaking in late 2015, inflation should slow rapidly thereafter, due to base effects in addition to the above-mentioned policy factors, to circa 9% by December 2016. The current account surplus is expected to shrink relative to GDP, but will remain large enough to offset capital outflows, leaving FX reserves little changed.

The forecast is subject to significant risks, both upside and downside, with the oil price and sanctions to be the key factors

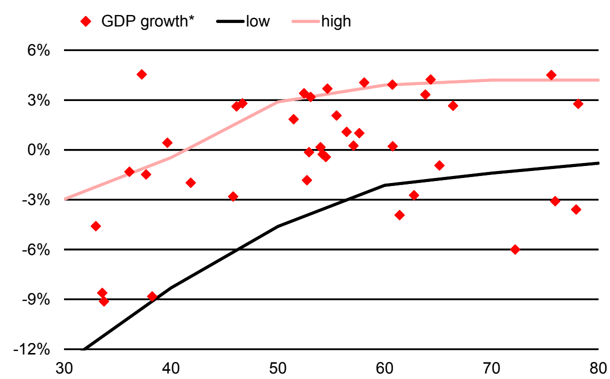
The above forecast is subject to significant uncertainty and risks, both upside and downside, with the oil price and the status of sanctions the key factors. A faster-than-currently-anticipated rebound in oil prices (towards USD 70/bbl for Urals) would help bring forward the recovery. The ruble would stabilize in nominal terms near its current level, disinflation would be stronger and fiscal pressures would ease. A significant easing of the sanctions would have a similar albeit smaller effect. On the other hand, should oil prices fall further (e.g. below USD 40) or if sanctions are tightened, the recession would be deeper and could extend into 2017, with the RUB facing a much larger adjustment. A significant further slowdown in China or other major EMs is another risk, but mostly via commodity prices, with the demand effect likely to be modest initially and more apparent beyond 2017. At the same time, Russia's vulnerability to the anticipated Fed rate hike should be limited given its lack of market access.

Under any scenario, Russia is facing major medium-term challenges

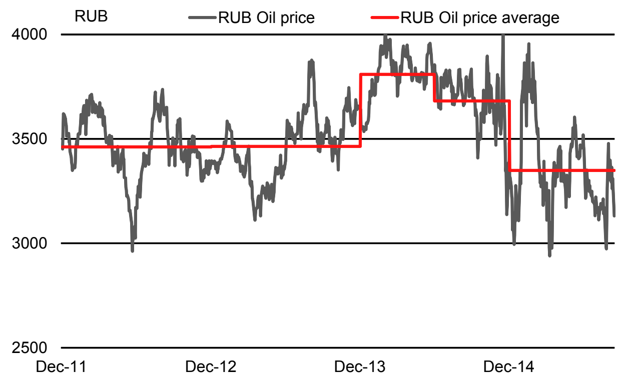
Under any scenario, Russia is facing major medium-term challenges, with the current crisis largely domestically-bred, rooted in long-standing structural rigidities, and a poor business climate until recently masked by the windfall oil revenues, with the sanctions and the fall in oil prices only reinforcing their impact. The crisis created incentives to implement reforms, yet until they advance, the economy will continue to be plagued by slow growth, excessive dependence on oil and capital inflows and, ultimately, diminishing gains in living standards

RUSSIAN GROWTH CANNOT BE FUELED BY OIL REVENUES

Economic growth in 2016 GDP is not ensured at any reasonable oil price without authorities' efforts…



…while oil revenues' contribution to the budget shrinks, reducing the scope for discretionary policies



*Growth rate implied by historical patterns under different oil price dynamics

Source: Bloomberg, UniCredit Research

Strategy: Perfect storm creating bleak short-term outlook

We recommend staying underweight OFZs due to…

…rising inflation, increased supply in 4Q15 and deteriorating growth outlook

We expect the OFZ curve to bear flatten

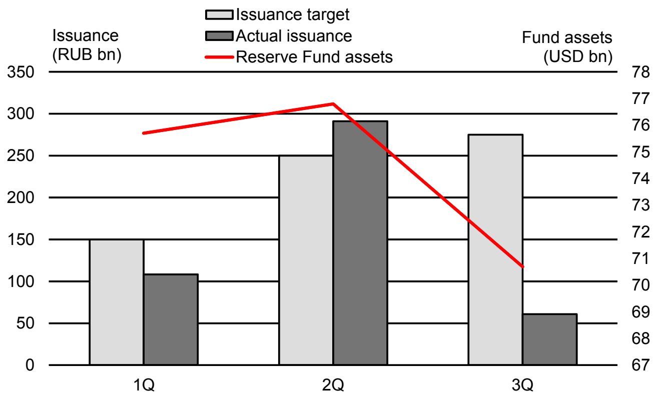
We recommend staying underweight Russian bonds due to rising inflation, supply issues, deteriorating growth outlook, and lack of structural reforms. Inflation will remain high over the next few months due to the drop in oil (- 24% since June) which has triggered an 18.6% depreciation in USD-RUB since June. Global oil supply is likely to outstrip demand at least in the short term, which will weigh on the RUB. Recent bond issuance has been weak and the 3Q15 target is unlikely to be met. Supply may be pushed into 4Q15, which could put yields under further pressure. The growth outlook is poor and GDP has been revised down. Consumer and investment activity has declined, along with revenues from external activities, while the slowdown in China has not helped. Nevertheless, government spending has increased, creating a risk that the RUB will be allowed to continue to depreciate to offset the shortfall. This will prompt further bear flattening of the OFZ curve.

Some support may come via the policy rate being kept on hold, however..

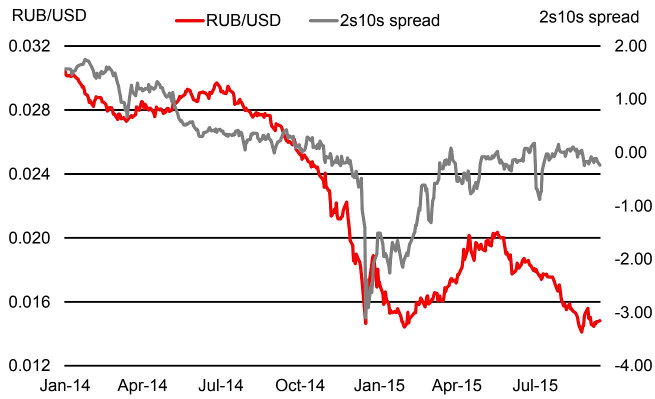
…given the FX risk, we prefer RUSSIA USD bonds

Some support for bonds may come via the CBR. First, planned rate cuts are likely to be kept on hold at least in the short term, and second higher volumes at FX repo auctions should take some pressure off the RUB. However, this is unlikely to be enough to prevent further yield widening. As such, we recommend being underweight OFZs and we favor the less risky long end of the curve. We like RFLB27s. Given the volatility and currency risk, we think that hard currency USD paper offers better value and we favor RUSSIA USD 42s.

Issuance misses target, could move more supply to 4Q15



Depreciation in RUB suggests 2s10s spread should bear flatten



Source: MinFin, Bloomberg; UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**11.7**	**55.4**	**35.1**
Budget deficit	6.6	40.1	21.5
Amortisation of public debt	5.1	15.3	13.6
Domestic	5.1	13.4	12.7
Bonds	5.1	13.4	12.7
Bills	-	-	-
External	-	1.9	0.9
Financing	**11.7**	**55.4**	**35.1**
Domestic borrowing	9.8	11.4	10.0
Bonds	9.8	11.4	10.0
Bills	-	-	-
External borrowing	-	-	-
Bonds	-	-	-
Sovereign Fund	-	41.7	21.9
Other	1.8	2.3	3.2

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**52.1**	**21.3**	**16.7**
C/A deficit	-46.5	-57.5	-55.8
Amortisation	93.0	78.8	72.5
Government/central bank	0	2.0	0
Banks	28.0	21.0	28.5
Corporates	65.0	55.8	44.0
Errors and omissions	5.6	0	0
Financing	**52.1**	**21.3**	**16.7**
FDI	-28.5	-17.0	-18.0
Portfolio equity	-14.6	-1.6	-6.7
Borrowing	51.2	32.5	52.8
Government/central bank	0	0	0
Banks	15.6	11.0	14.6
Corporates	35.6	21.5	38.2
Resident lending abroad	-36.7	-25.3	-18.2
Official reserves change / other	80.7	32.7	6.8

Source: Rosstat, CBR, UniCredit Research

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

Outlook – The Serbian economy has turned the recessionary corner thanks to the low base, stronger fixed investments and the impulse from net exports. We expect the economy to grow by 0.5% this year, to be followed by a broad-based recovery in 2016 as domestic consumption accelerates. Inflation will nonetheless remain subdued, and is expected to reach the lower-end of the NBS target band only from 1Q16. Even so, we believe the scope for additional monetary easing is limited, and expect only a maximum of 50bp in rate cuts in 4Q15. On the fiscal front, budget savings to date have exceeded the target, but this should not open the door for fiscal relaxation in 2016 as this would intensify Serbia's debt troubles and undermine greatly its credibility.

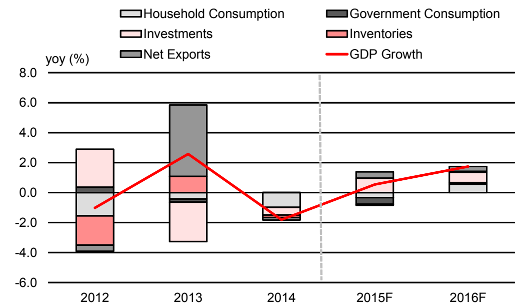
Strategy outlook – We remain constructive 3Y and 7Y SERBGBs until November, when Serbia will have to pass the next IMF review and privatize Telekom Srbija. We like SERBIA USD 21.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

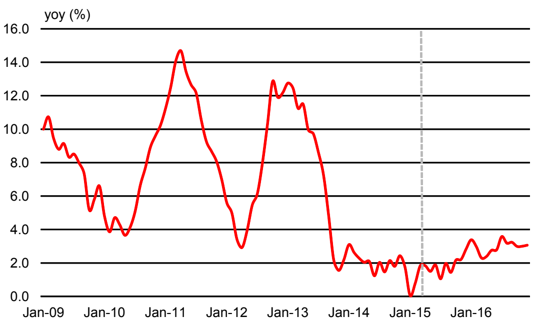
KEY DATES/EVENTS

- 30 Sept, 31 Oct, 31 Nov – Industrial output
- 12 Oct, 12 Nov, 11 Dec – Consumer Price Index
- 15 Oct, 12 Nov, 10 Dec – Policy rate decision
- 20 Oct, 20 Nov, 21 Dec – Current account balance

GDP GROWTH



HEADLINE INFLATION



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	31.7	34.3	33.1	32.7	33.2
Population (mn)	7.2	7.2	7.2	7.2	7.2
GDP per capita (EUR)	4,401	4,785	4,594	4,541	4,605
Real economy yoy (%)					
GDP	-1.0	2.6	-1.8	0.5	1.7
Private Consumption	-2.0	-0.6	-1.3	-0.4	0.8
Fixed Investment	13.2	-12.0	-2.7	5.2	3.5
Public Consumption	1.9	-1.1	0.1	-2.3	0.6
Exports	0.8	21.3	3.9	8.2	7.2
Imports	1.4	5.0	3.3	5.6	5.1
Monthly wage, nominal (EUR)	508	537	524	484	483
Unemployment rate (%)	23.9	22.1	19.8	20.0	19.5
Fiscal accounts (% of GDP)					
Budget balance	-6.8	-5.5	-6.7	-4.3	-3.2
Primary balance	-4.9	-3.0	-3.7	-0.8	0.9
Public debt	56.2	59.6	70.9	73.0	74.1
External accounts					
Current account balance (EUR bn)	-3.7	-2.1	-2.0	-1.4	-1.5
Current account balance/GDP (%)	-11.6	-6.1	-6.0	-4.2	-4.5
Basic balance/GDP (%)	-14.0	-9.9	-9.7	-0.2	-0.2
Net FDI (EUR bn)	-0.8	-1.3	-1.2	1.3	1.4
Net FDI (% of GDP)	-2.4	-3.8	-3.7	4.0	4.2
Gross foreign debt (EUR bn)	25.6	25.7	25.9	25.9	26.4
Gross foreign debt (% of GDP)	80.9	75.1	78.4	79.3	79.6
FX reserves (EUR bn)	12.0	12.1	11.6	10.8	10.5
Inflation/Monetary/FX					
CPI (pavg)	7.3	7.9	2.1	1.6	2.3
CPI (eop)	12.2	2.2	1.8	2.8	3.1
Central bank target	4.0±1.5%	4.0±1.5%	4.0±1.5%	4.0±1.5%	4.0±1.5%
Central bank reference rate (eop)	11.25	9.50	8.00	4.50	5.50
3M money market rate	11.64	10.15	8.26	7.83	6.60
FX/USD (eop)	86.18	83.13	98.73	114.81	110.34
FX/EUR (eop)	113.72	114.64	121.50	122.50	126.00
FX/USD (pavg)	87.96	85.16	88.45	111.69	111.94
FX/EUR (pavg)	113.13	113.09	117.26	121.14	124.26

Source: UniCredit Research

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

Turning the corner

In 2Q15, the economy grew by 1% yoy, driven by fixed investments and strong net external demand

The Serbian economy exited recession in 2Q15 and is set for a faster recovery in 2H15, owing to a combination of low base effects, bellow-target inflation and the larger net exports. Revised GDP data for 2Q15 showed the economy grow by 1% yoy, after contracting for five quarters. GDP expanded by 2.6% qoq sa, with this rise driven primarily by net exports, which added 2.1pp to annual GDP due to decelerating imports. Export growth remained unchanged however (+8.6% yoy), partly because the decline in unit labor costs of tradeables was mitigated by the real appreciation of the effective exchange rate of the dinar. The strongest rise in domestic demand was seen among fixed investments (+8.6% yoy), which benefited from reforms to labor and bankruptcy legislation. The restoration of mining and electricity (output to pre-flood levels also boosted industrial production in 2Q15 and is expected to drive output growth in 2H15 alongside stronger manufacturing and construction activity. In contrast, domestic consumption fell further due to austerity, subtracting 1.6pp from 2Q15 GDP growth.

Despite the recovery, domestic demand will remain weak…

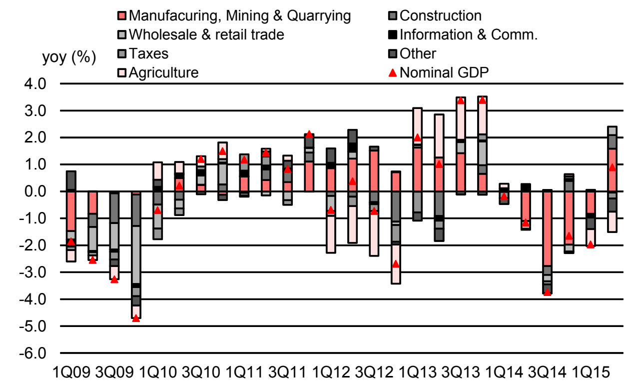
We expect GDP to grow by 0.5% in 2015 and accelerate to 1.7% in 2016, supported by a low base and firmer demand in the EU. Fixed investment could drive the recovery of domestic demand, adding an average of 0.9pp to GDP until end-2016. In part, this is explained by the firms' better financial position and higher volume of investment loans. Meanwhile, fiscal consolidation will continue to weigh on domestic demand due to cuts in public sector wages and pensions introduced in November 2014, and the layoffs in the SOE sector. As a result, private consumption might recover only in 1H16, supported by low inflation and stronger remittances. We expect net exports to contribute positively to GDP throughout the entire forecast horizon (avg. 0.4pp in 2015-16) thanks to stronger EU growth, the expected increase of wheat exports and the restoration of steel production to pre-flood levels at the Zelezara Smederevo steel mill. The Fiat plant is unlikely to contribute to growth this year, but the production of the new SUV LX model could start next year, helping GDP growth.

…and keep inflation below the lower-end of the NBS target until 1Q16

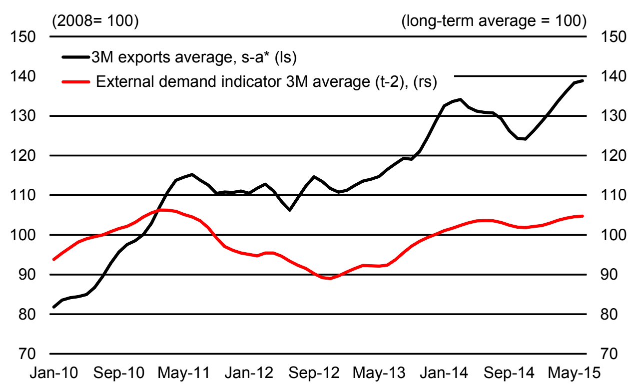
The low inflation environment has encouraged the NBS to cut rates to all-time lows, bringing the easing cycle close to an end. In September, the NBS cut the policy rate by an additional 50bp to 5%, bringing the cumulative rate easing cycle to 300bp. The decision was timely, and responded mainly to the remarkably low inflation environment, since the headline reading remains below the lower limit of the 4±1.5%target range. Inflation could re-enter the target range in December 2015 and remain there for most of 2016. In view of this, and provided the dinar remains stable, we believe there is scope for additional easing in 4Q15, albeit limited to a maximum of 50bp to 4.5%. Further cuts would be on the cards only if inflation fails to rebound towards the central target.

ECONOMIC ACTIVITY IS IMPROVING, BUT REMAINS CONSTRAINED BY WEAK DOMESTIC CONSUMTPION

Mining and electricity output have returned to pre-flood levels…



…while external demand conditions continue to improve



Sources: Haver, SORS, NBS, UniCredit Research

We expect the C/A deficit to narrow to 4.3% of GDP by end-2015, supported by low oil prices and stronger EU demand

External imbalances are correcting, but remain large. In 1H15, the C/A deficit narrowed by 30% yoy, driven by a combination of a rising surplus in the balance of services, an increase in remittance inflows and lower revenue outflows from FDI and the banking system. Financing also narrowed, particularly among portfolio inflows (-7% yoy in 1H15), but FDI rose, covering 72% of the C/A deficit. We expect the C/A deficit to narrow to EUR 1.4bn (4.3% of GDP). This assumes strong demand from the EU and oil prices below USD 55/bbl.

Excess budget savings this year are driven by temporary factors…

The budget performance to date is ahead of plan and set to undershoot this year's deficit target. The general government consolidated budget deficit contracted by 65% yoy to RSD 39.3bn in 7M15, reaching only 17% of the 2015 target. The adjustment was driven by one-off revenues (i.e., SOE dividend payments and sale of 4G licenses) but also by improved VAT (+2.5% yoy) and excise tax (+3.8% yoy) collection. We expect the 12% hike to electricity prices introduced in August to raise excise revenues this year by an additional 0.2% of GDP. In addition, expenditure was also trimmed, with public investment falling alongside pensions (-3.3% yoy) and public sector wages (-10.9% yoy). Consequently, we expect the budget deficit to narrow to 4.3% of GDP this year, well-below the finance ministry's target of 5.9% of GDP.

…. hence the need for the government not to backpedal on its reforms to meet its deficit targets

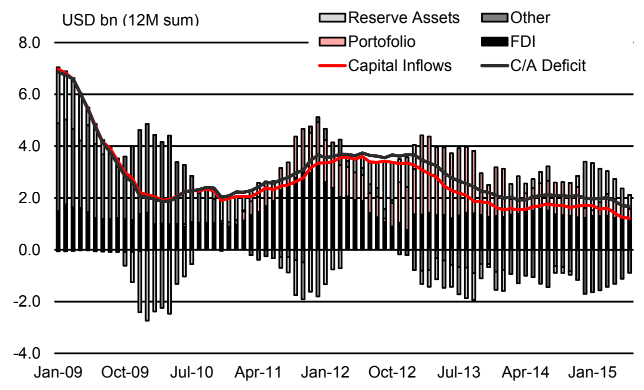
Nevertheless, we see no room for fiscal easing, while there is a need to accelerate public sector reform and the privatization process. Recently, PM Aleksandar Vucic announced the government's intention to renegotiate the terms of the 3-year deal with the IMF to allow the MinFin aims to raise public wages and pensions in order to spur growth. Mr. Vucic is arguing that the cuts introduced in November 2014 have more than exceeded savings plans. The IMF is unlikely to accept the reversal of the fiscal improvement to date, since most of the savings come from these cuts (ca. 1.5pp of GDP). At the same time, public administration layoffs and liquidation of troubled SOEs will intensify in 4Q15, putting further pressure on redundancy spending. Moreover, interest payments will continue to rise, while 2016 revenues will be deprived of this year's one-off gains. Any backtracking on reforms would prevent the deficit from reaching the 3.9% of GDP target set for 2017 and the stabilization of public debt, which has doubled since 2010 while undermining investors' confidence.

Funding needs this year have been lowered to EUR 5.4bn, owing to the lower deficit and reduced borrowing costs in the domestic market

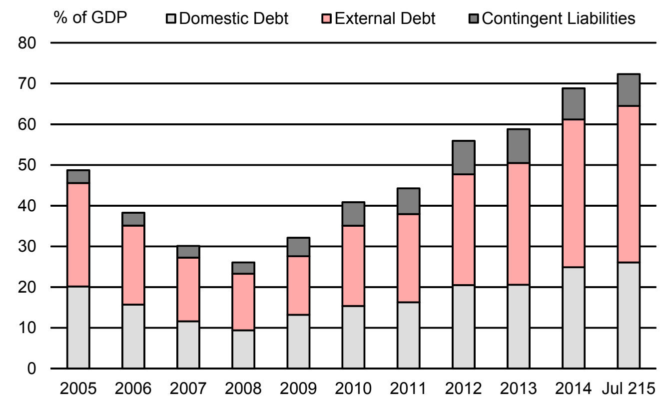
The projected lower deficit has reduced Serbia's funding needs for this year, prompting the government to cancel the planned EUR 1.5bn Eurobond issue in 4Q15. As such, we expect total funding needs of EUR 5.4bn this year (vs. EUR 5.9bn initially), to be financed entirely on the domestic market (EUR 4.4bn) after excluding IFI loans (EUR 0.6bn) and cash reserves (EUR 0.4bn). The Public Debt Administration also announced its intention to start regular buy-backs of dinar securities to replace more expensive old debt.

DESPITE THE CORRECTION, EXTERNAL AND INTERNAL IMBALANCES REMAIN LARGE

CAD financing has shifted from portfolio capital to FDI



Serbia's high public debt burden has not peaked



Source: Haver, Bloomberg, NBS, UniCredit Research

Strategy: Constructive bonds but approaching the crossroads

We recommend the local 3Y and 7Y bonds on…

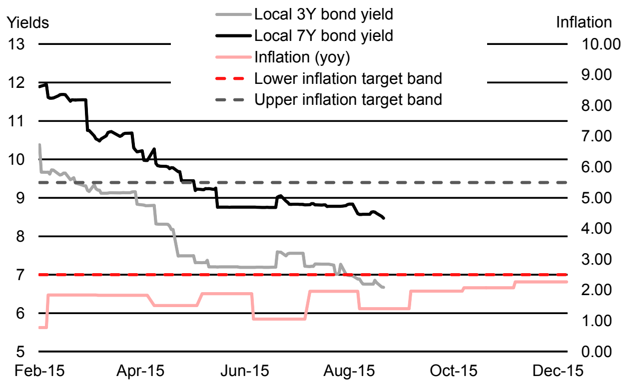
We are optimistic on local 3Y and 7Y bonds due to a positive second IMF review, high real yields and a stable currency. Inflation may start to rise due to higher utility prices but weak domestic demand should see the NBS ease rates by 50bp before year-end. The crossroads come in Nov/Dec. Since the IMF is unlikely to agree to an increase in public sector wages and pensions, a stand-off with the government would be credit negative. Second, the sale of Telekom Srbija is expected before year-end. This will be bellwether event in the reform process. If completed it will be very positive and likely to see bond yields continue to tighten.

… but wage and pension hikes, as well as the Telekom Srbija privation in 4Q15 will give better indication on the reform momentum

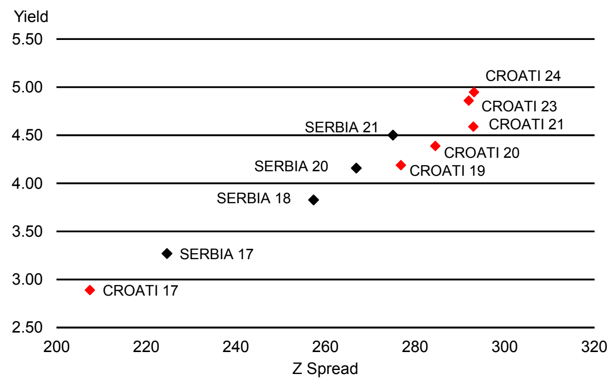
USD bonds look rich to peers

We recommend the 3Y and 7Y benchmark bonds. There is room for further rally and for Serbia to substantially lower borrowing costs but this requires the correct decisions to be made in Nov/Dec. On the external debt, the SERBIA USD 21s are the best value on the curve, trading cheap to the SERBIA USD 17s. However relative to CROATIA USD 20s, the SERBIA USD 20s look expensive trading 22bp inside.

INFLATION SET TO RISE BUT BELOW LOWER END OF BAND



SERBIA USD 20 PAPER IS TRADING RICH TO SERBIA USD



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**5.0**	**4.8**	**5.0**
Budget deficit	2.2	1.4	1.1
Amortization of public debt	2.8	3.4	3.9
Domestic	2.2	2.8	3.3
Bonds	0.3	1.5	1.7
Bills	1.9	1.3	1.6
External	0.6	0.6	0.6
IMF	0.6	0.6	0
Financing	**5.0**	**4.8**	**5.0**
Domestic borrowing	3.9	4.4	4.0
Bonds	2.5	2.9	2.5
Bills	1.3	1.5	1.5
External borrowing	1.2	0.6	1.0
Bonds	0	0	0
IMF/EU	0.1	0.4	0.2
Other	1.1	0.3	0.8
Change in cash reserves (+=decline)	-0.1	-0.2	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**6.4**	**6.0**	**5.6**
C/A deficit	2.0	1.4	1.5
Amortization of medium to long term debt	4.3	4.5	3.9
Government/Central Bank	0.6	0.6	0.6
IMF	0.6	0.6	0
Other	0	0	0.5
Banks	1.0	0.8	0.7
Corporates	2.7	3.2	2.7
Amortization of short term debt	0.2	0.1	0.1
Government/Central Bank	0	0	0
Banks	0.2	0.1	0.1
Corporates	0	0	0.1
Financing	**6.4**	**6.0**	**5.6**
FDI	1.2	1.3	1.4
Equity	0	0	0
Borrowing	4.8	4.5	4.7
Government/Central Bank	1.2	0.6	1.0
IMF	0.1	0.4	0.2
Bonds	0	0	0
Other	1.1	0.3	0.8
Banks	1.1	0.7	0.6
Corporates	2.5	3.2	3.1
Change in FX reserves (+ = decline)	0.4	0.2	-0.5

Source: NBS, MinFin, UniCredt Research

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

Outlook – The near-term outlook has worsened with the risks highlighted in our 3Q release materializing: political uncertainty has intensified following the failure to form a government after the hung June election, geopolitical tensions have spilled over on Turkish territory and global risk appetite has slumped. The TRY has come under intense pressure amid faltering confidence and policy inaction. With political tensions and market volatility likely to persist until yearend at best, growth will slump with the TRY weak and inflation rising. Assuming modest fallout of the Fed hikes, growth should recover next year. However, continued policy inaction would raise odds of financial turmoil, should risk appetite remain weak.

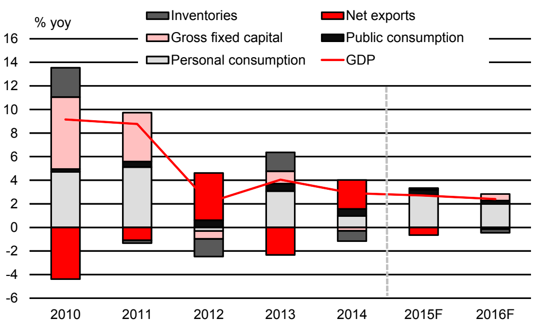
Strategy – We recommend staying underweight TURKGBs due to volatility in upcoming election and rising inflation. We see better value in hard currency USD and EUR bonds.

Author: Lubomir Mitov, Chief CEE Economist (Unicredit Bank London)

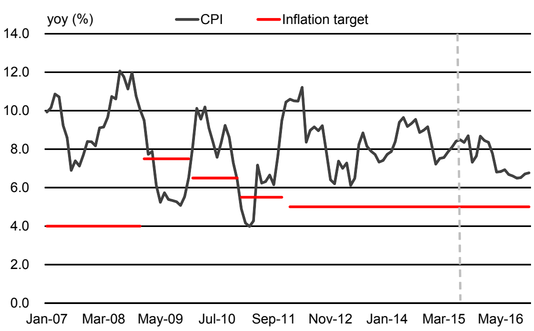
KEY DATES/EVENTS

- 1 Nov – general elections
- 5 Oct, 3 Nov, 3 Dec – Consumer price index
- 14 Oct, 11 Nov, 10 Dec – Current account balance
- 21 Oct, 24 Nov, 22 Dec – Policy rate decision

ECONOMIC GROWTH COULD SLOW FURTHER



INFLATION WILL REMAIN WELL ABOVE TARGET



Source: TurkStat, CBRT, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	608.3	616.8	602.2	609.5	600.5
Population (mn)	75.8	74.7	75.8	76.5	77.3
GDP per capita (EUR)	8,025	8,255	7,944	7,969	7,766
Real economy yoy (%)					
GDP	2.1	4.0	2.9	2.6	2.4
Private Consumption	-0.5	4.6	1.5	4.4	3.0
Fixed Investment	-2.7	4.3	-1.2	0.6	1.6
Public Consumption	6.1	5.9	5.6	5.5	2.0
Exports	16.3	0.1	5.5	0.2	3.6
Imports	-0.4	8.5	-1.1	3.8	4.0
Monthly wage, nominal (EUR)	919	961	968	948	927
Unemployment rate (%)	8.4	9.0	9.9	10.5	10.7
Fiscal accounts (% of GDP)					
Budget balance	-2.0	-1.2	-1.2	-1.7	-2.5
Primary balance	1.4	2.0	1.6	1.3	0.7
Public debt	38.8	38.9	36.2	37.4	36.6
External accounts					
Current account balance (EUR bn)	-37.5	-48.7	-35.0	-35.6	-39.8
Current account balance/GDP (%)	-6.2	-7.9	-5.8	-5.8	-6.6
Basic balance/GDP (%)	-5.5	-7.3	-5.5	-5.5	-6.3
Net FDI (EUR bn)	3.9	3.5	1.9	1.8	1.7
Net FDI (% of GDP)	0.6	0.6	0.3	0.3	0.3
Gross foreign debt (EUR bn)	256.9	282.2	331.5	344.7	362.0
Gross foreign debt (% of GDP)	42.2	45.8	55.1	56.6	60.3
FX reserves (EUR bn)	75.8	79.5	87.1	87.0	87.1
Inflation/Monetary/FX					
CPI (pavg)	9.0	7.5	8.9	7.7	7.9
CPI (eop)	6.2	7.4	8.2	9.5	7.1
Central bank reference rate (eop)	5.50	4.50	8.25	9.25	8.00
3M money market rate (Dec avg)	7.69	9.47	10.17	8.25	8.25
USD/TRY (eop)	1.79	2.07	2.29	3.07	3.12
EUR/TRY (eop)	2.36	2.84	2.78	3.60	3.81
USD/TRY (pavg)	1.80	1.91	2.19	2.89	3.03
EUR/TRY (pavg)	2.33	2.53	2.91	3.26	3.64

Source: UniCredit Research

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

Turkey: Self-Inflicted Troubles

Despite the favorable external environment, economic performance has continued to disappoint

Economic performance has continued to disappoint. Despite lower oil prices, the recovery in the EU and ample global liquidity growth has remained lackluster, inflation firmly on an upward trend and the underlying external position has weakened. Financial markets have been hammered, with the TRY falling to an all-time low in September and bond prices plummeting.

Geopolitical tensions, concerns about China and heightened risk aversion ahead of the Fed rate hike have played a role…

External factors have definitely played a role. Geopolitical tensions in Iraq, Russia and Egypt have shaved off a large chunk of Turkish exports; Growing concerns about China and the uncertainty about the timing and size of the first Fed rate hike have hit risk appetite, triggering an exodus from emerging markets, with Turkey among the hardest hit.

…but domestic politics remain the main culprit…

…with confidence hammered by heightened political tension and policy inaction

However, domestic politics are the main culprit. The failure to form a coalition following the hung June election extended the period of political uncertainty until at least yearend. The caretaker government lacks the mandate and the program to do much on economic policy, extending the period of inaction. At the same time, the CBRT has failed to take action to stem the TRY rout and to reign-in rising inflation, partly under pressure from the president, partly due to the beliefs of its management. All this has taken a heavy toll on confidence.

Confidence has been hit also by the deteriorating security situation

Confidence has been hit additionally by the deteriorating security situation. For reasons not quite clear, fighting has resumed between the government and the Kurdish militant PKK, ending a two-year old truce that was supposed to lead to durable peace. At the same time, Turkey reluctantly launched sporadic airstrikes against ISIS in Syria following attacks on Turkish territory and the government stepped-up the prosecution of the Gülen movement.

Growth held up relatively well in 2Q15, but this was mostly due to one-off factors and major fiscal easing…

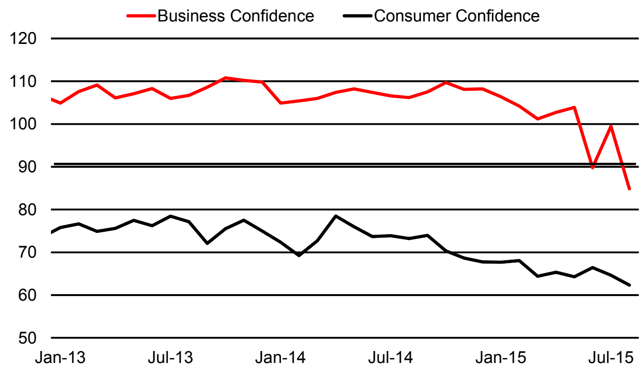
Against this background, GDP growth held up surprisingly well in 2Q15, accelerating to 3.8% yoy from 2.3% in 1Q15. However, about 1.2 pp of this increment reflected a one-time event (the launch of a new refinery capacity at Tupras). Excluding the latter, growth would have been only slightly higher than in 2Q15, with the uptick driven by a pre-election spending spree (a 7.2% rise in government consumption) and robust private consumption. (The latter was supported by a combination of rising government transfers, lower oil prices and recovering credit growth.).

…while the external balance has continued deteriorating amid weak exports

At the same time, the external balance continued worsening, with export volumes falling 2% yoy in 2Q15 as imports rose by a similar magnitude. This trend has continued into 3Q15, largely erasing the terms of trade gains stemming from the oil price and leaving the C/A deficit little changed yoy in USD terms and slightly wider relative to GDP at 6% in January-July.

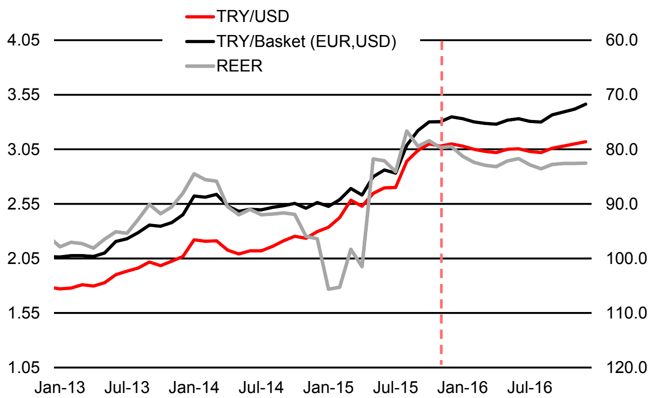
ECONOMIC ACTIVITY IS EXPECTED TO SLOW

Sentiment indicators have deteriorated sharply this year



Index = 100 represents a stable economic outlook; Index > 100 (<100) represents an optimistic (pesimistic)

Real depreciation could come to a halt



Source: Haver, MinFin, CBRT, UniCredit Research

Inflation has accelerated again, driven by nontradables…

…which, along with the weaker external position would justify tighter monetary policy

At the same time, inflation remains stubbornly high, despite lower domestic fuel prices and virtually unchanged administered prices. Core inflation accelerated to 7.7% yoy in August from a recent low of 7% in April, driven largely by services. The shift in inflation to nontradables, along with the deteriorating current account (in volume terms) and unemployment near record lows points to a positive output gap that would argue for tighter monetary policy.

The CBRT, however, has chosen not to hike rates…

…leading to sizable portfolio outflows and a much weaker TRY

The CBRT, however, insists that its stance is tight enough and no rate hike is needed. Markets have remained unconvinced, leading to large portfolio outflows and strong pressure on the TRY. The latter was not helped by statements of key government officials welcoming a weaker TRY. In fact, a weak currency is contractionary in the near term by boosting inflation and reducing real incomes, with the beneficial effect on export taking about half a year to become apparent.

The political turmoil and policy inaction have taken their toll on confidence…

…pointing towards sharply slower growth, further TRY weakness and higher inflation

The political turmoil and policy inaction have taken their toll, with PMI and other confidence indicators deteriorating sharply. With political tensions unlikely to abate until after the November election, confidence is unlikely to improve before 2016 and could be further hit by the fallout of the forthcoming Fed rate hike. Real GDP growth looks set to slow to 2.8% yoy in 3Q and 2% in 4Q, leaving full-year growth at 2.6%, down from 2.9% last year. With the TRY likely to weaken to 3.10-3.15/USD, inflation looks set to accelerate to 9.5% by yearend (partly due base effects).

Lower oil prices should help contain the C/A deficit with financing adequate if the fallout of the Fed hike is modest…

..enabling the CBRT to delay rate hikes until the Fed moves

The deteriorating underlying position notwithstanding, the renewed fall in oil prices should help contain the C/A deficit to just under 6% of GDP. External financing is likely to remain volatile ahead of the Fed rate hike. We expect portfolio outflows to continue, but be more than offset by stepped-up borrowing by banks and corporations as long as global sentiment does not worsen further. In this case, the CBRT is likely to raise its policy rate by 50-100bp just ahead of the Fed hike. In preparation for this, the CBRT has pledged to "simplify" its policy framework, which is likely to involve a shift to a single rate in line with its average cost of funding (currently at 8.6%).

Another hung parliament looks likely after the November election

...leaving the TRY under pressure until a government is formed…

…with growth unlikely to rebound and the TRY to firm until then

Opinion polls do not show major shifts in political preferences. The AKP has gained support on the wave off the nationalism triggered by the clashes with the Kurds, but is still well below the 44-45% needed for a single-party government with the Kurdish HDP highly likely to remain in parliament. With new coalition talks likely, a new government won't be in place before 2016. Until then, markets will remain volatile and the TRY under pressure. We think that, this time, a coalition would be more probable as all the parties try to avoid yet another election that could be disastrous for Turkey's battered economy. In this case, growth should recover next year.

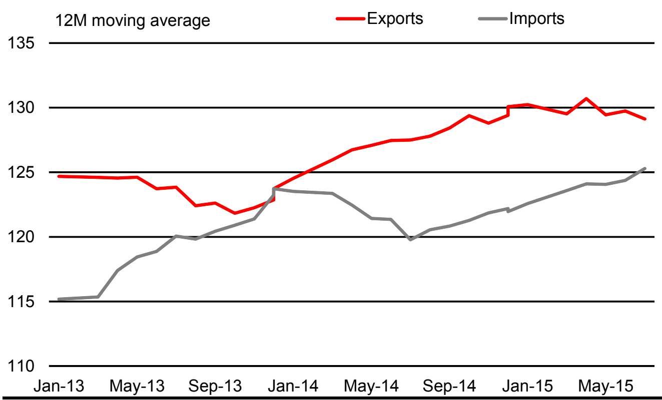
Near-term risks remain on the downside …

…in which case a recession would be hard to avoid

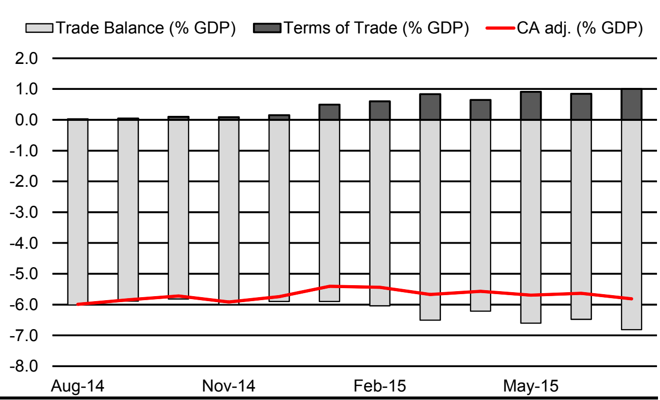
Near-term risks remain on the downside especially those related to the fallout of the Fed hikes and a potential escalation of the fighting in the east. In this case, the CBRT would have to raise interest rates, perhaps sharply, to safeguard financial stability, but with serious adverse impact on growth. A recession might be difficult to avoid in this case.

EXTERNAL IMBALANCES ARE NOT ADJUSTING

Exports stagnate as imports rise again



Large terms of trade gains conceal a deteriorating C/A



CBRT, Turkstat, Unicredit Research

Strategy: Idiosyncratic issues to weigh on yields

Stay underweight TURKGBs due to…

..election volatility, rising inflation and…

…vulnerability to rising US interest rates.

We recommend remaining underweight Turkey amid a breakdown of the PKK peace process and political volatility around November's general elections. In addition, inflation is set to rise. The failure of the CBRT to hike rates with USD-TRY above 3.00 will keep inflation elevated and see it rising into 2016. This will negatively impact the private sector, heavily reliant on foreign funding, through upward pressure on front end yields. Finally, Turkey is vulnerable to declining sentiment and rising US interest rates, particularly the banking sector where external debt and non-performing loans have been rising. In addition, foreigners continue to reduce TURKGB holdings (by USD 4.17bn in the last three months) while bond auction support has been weak amid rising yields.

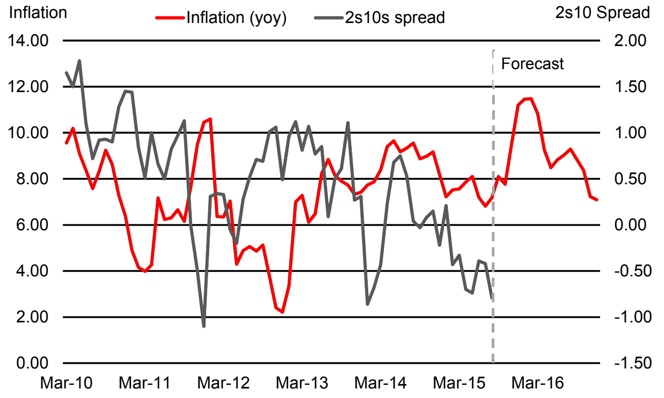
We would move to marketweight if the CBRT raise rates or there was a quick formation of a Government

Hard currency USD paper has better risk adjusted value.

We recommend staying underweight TURKGBs, but favour the longer dated TURKGB 23s. Yields are attractive and we would move to marketweight if the CBRT hiked rates or a government was quickly formed after the election as longer term the environment should improve. We think the hard currency USD paper is better value on a risk-adjusted basis and we like the TURKEY USD 41s. We also see some value in the TURKEY EUR 23s.

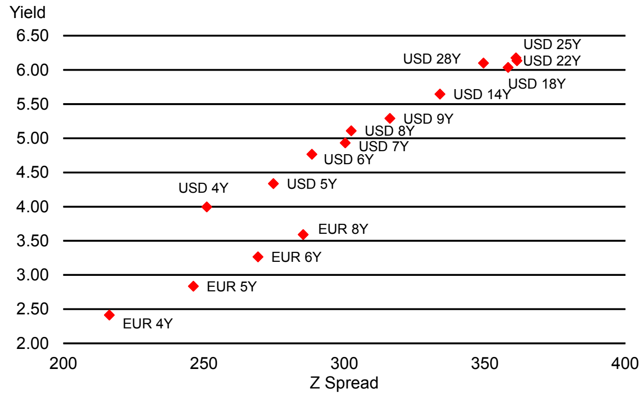
EXPECT FURTHER CURVE INVERSION AS INFLATION RISES

Depreciating lira push up inflation and with it front end rates



USD PAPER BETTER VALUE AGAINST EUR PAPER

With better yields and z spreads we favour TURKEY USD bonds



Source: Haver, Bloomberg, Unicredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**56.4**	**55.2**	**53.7**
Budget deficit	8.4	9.8	11.1
Amortisation of public debt	48.0	45.4	42.6
Domestic	43.3	40.8	38.2
Bonds	43.3	40.8	38.2
Bills	-	-	-
External	4.7	4.6	4.4
Financing	**56.4**	**55.2**	**53.7**
Domestic borrowing	47.4	55.6	48.0
Bonds	47.0	55.6	48.0
Bills	0.4	-	-
External borrowing	5.5	-3.0	5.0
Other	3.5	2.6	0.7

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**166.7**	**174.1**	**182.2**
C/A deficit	35.0	35.6	39.8
Amortisation of medium to long term debt	29.4	25.8	30.0
Government/central bank	4.7	4.6	4.4
Banks	7.2	12.8	13.0
Corporates	17.4	8.4	12.6
Short term debt	102.3	112.7	112.4
Financing	**166.7**	**174.1**	**182.2**
FDI	5.9	5.1	5.0
Portfolio	1.9	-1.2	0.2
Borrowing medium to long term	49.2	57.1	60.3
Government/central bank	5.5	3.0	5.0
Banks	20.8	25.2	27.3
Corporates	23.0	28.9	28.0
Short term borrowing	113.1	110.5	117.5
Errors & omissions/other	-3.8	-1.8	-3.3
Reserve accumulation	0.4	4.4	2.5

Source: CBRT, UniCredit Research

Ukraine (Ca negative/CC negative/C)*

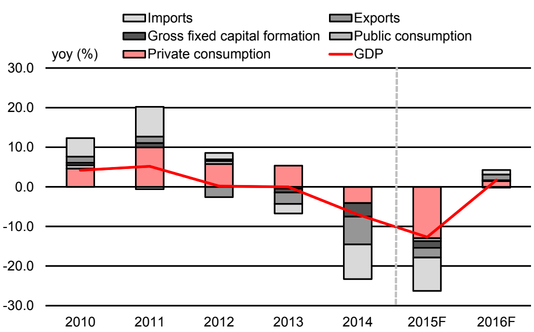
Outlook – A tenuous truce in the east and the debt restructuring agreement with private bondholders have provided a window of opportunity for Ukraine to exit the vicious cycle of a deepening recession and inflation. However, downside risks remain elevated as long as the conflict in the east remains unresolved and foreign official financing continues to lag. Growth should resume next year, but is likely to remain modest at less than 2% until structural reforms take hold Despite encouraging progress recently, challenges remain daunting. Unless growth rebounds, concerns about debt sustainability are likely to re-emerge again once IMF loans begin to be repaid in 2018.

Author: Lubomir Mitov, Chief CEE Economist (UniCredit Bank London)

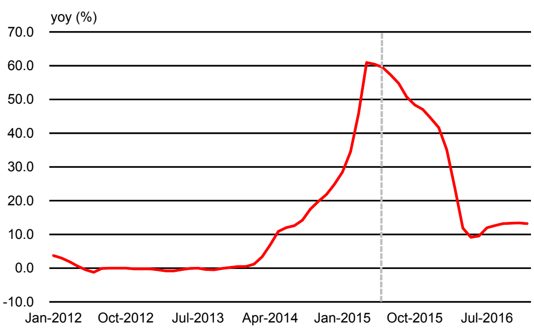
KEY DATES/EVENTS

- End-September: Debt restructuring deal to be finalized
- 25 October: Local elections
- December: Third Review under the IMF EFF agreement

GDP COMPONENTS



INFLATION OUTLOOK



Source UniCredit Research, NBR, Statistical Office

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	174.6	178.3	130.5	93.8	93.8
Population (mn)	45.5	45.4	42.9	41.2	40.8
GDP per capita (EUR)	3,837	3,928	3,041	2,276	2,299
Real economy yoy (%)					
GDP	0.2	0	-6.5	-12.7	1.7
Private Consumption	8.7	7.9	-9.0	-15.0	2.0
Fixed Investment	2.6	-6.7	-22.4	-20.0	2.5
Public Consumption	4.5	-2.7	0.4	-5.0	-1.0
Exports	-6.8	-8.5	-14.1	-19.8	5.3
Imports	3.6	-5.4	-21.3	-24.2	3.6
Monthly wage, nominal (EUR)	292	294	232	175	185
Unemployment rate (%)	7.8	7.9	9.7	10.3	10.4
Fiscal accounts (% of GDP)					
Budget balance	-4.1	-4.6	-4.5	-4.6	-3.7
Primary balance	-2.3	-1.2	-1.2	0.7	1.5
Public debt	36.5	40.2	71.2	68.9	70.7
External accounts					
Current account balance (EUR bn)	-10.8	-12.0	-4.1	-1.4	-1.6
Current account balance/GDP (%)	-8.2	-9.2	-3.8	-1.7	-2.1
Basic balance/GDP (%)	-5.8	-7.3	-4.0	-1.3	-0.7
Net FDI (EUR bn)	4.2	3.5	-0.3	0.4	1.3
Net FDI (% of GDP)	2.4	1.9	-0.2	0.4	1.4
Gross foreign debt (EUR bn)	102.4	97.8	97.1	107.3	111.8
Gross foreign debt (% of GDP)	58.6	54.8	74.5	114.4	119.2
FX reserves (EUR bn)	17.6	14.6	5.0	11.0	13.4
Inflation/Monetary/FX					
CPI (pavg)	0.6	-0.3	12.1	49.6	16.4
CPI (eop)	-0.2	0.5	24.9	44.4	13.2
Central bank target	-	-	-	-	-
Central bank reference rate (eop)	7.50	6.50	14.00	22.00	15.00
3M money market rate	8.40	7.90	9.20	26.50	25.00
FX/USD (eop)	8.09	8.24	15.66	22.21	26.50
FX/EUR (eop)	10.68	11.32	18.95	25.98	32.33
FX/USD (pavg)	8.13	8.16	12.01	22.81	25.29
FX/EUR (pavg)	10.46	10.84	15.96	25.78	30.34

Source: UniCredit Research

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

A window of opportunity not to be missed

Economic activity has shown signs of tenuous stabilization…

After three quarters of steep declines, economic activity appears to have stabilized. Real GDP was little changed in seasonally adjusted terms during 2Q15, even though the yoy decline remains still outsized at nearly 15%. High-frequency indicators point in the same direction: industrial production stabilized in 2Q15 with initial signs of tepid growth at the start of 3Q, and the contraction in retail trade seems to have tapered off.

…thanks in part to the truce in the east and the stabilization in the regions not affected by the war

The economic stabilization appears to stem from several factors: the fragile truce in the east has held, putting a floor under confidence, enabling those parts of the economy that remained unscathed by the war and have started benefitting from the currency depreciation to grow again. Lower energy prices and a modest relaxation of the still pervasive FX market restrictions appear to have helped, too. Finally, the shock from the separation of the eastern regions now held by the separatists appears to have run its course by now.

The economy should return to growth next year, but the recovery will remain sluggish…

…constrained by dysfunctional financial markets and fiscal retrenchment …

The somewhat-earlier-than-anticipated stabilization led us to revise slightly up our projection for the full year, with real GDP now expected to decline 12.7%, rather than 13% as initially thought. Barring renewed intensification of the conflict, we expect the first signs or a broader recovery to become apparent already in 3Q. However, the pace of the recovery will remain sluggish and uneven, constrained by the remaining FX restrictions, dysfunctional banking system and acute lack of liquidity. The need to maintain a strongly restrictive fiscal stance will also continue to weigh on growth, at least next year.

With output below potential and the UAH tightly managed by the NBU, inflation is set to slow

With output way below potential, the UAH kept little changed by the NBU and the initial shock from the sharp hike in domestic energy prices ebbing, monthly inflation has slowed sharply, to virtually zero in June and seasonal deflation in July and August. However, the high base effect will keep yoy inflation elevated at more than 40% until yearend. We expect a further slowdown next year, although the need for further adjustments in administered prices and the likely UAH depreciation once FX controls are lifted will leave inflation in double digits in 2016.

The improvement in the C/A has been impressive…

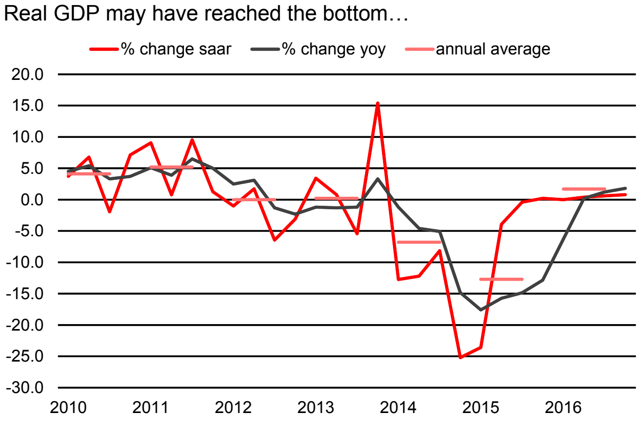
…but only thanks to a collapse in imports…

…with exports falling sharply, too

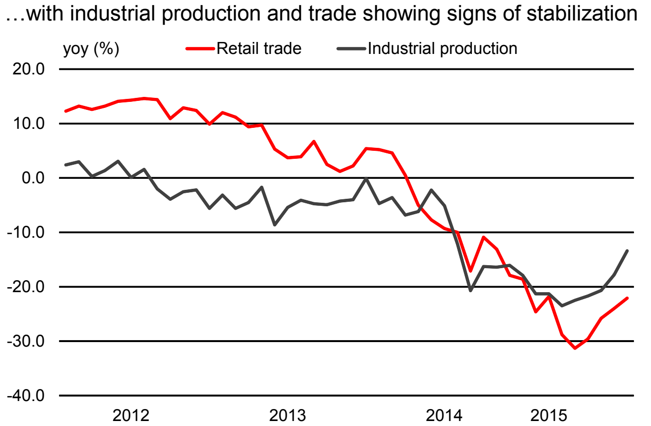
The improvement in the current account has been impressive too, but for the wrong reasons. The shift to a surplus during January-July from a USD 2.7bn deficit a year before was driven by a 35% drop in import volumes. Export volumes fell 20% yoy, reflecting a combination of falling foreign demand and lower prices for key Ukrainian exports such as steel and chemicals, along with the loss of Russian markets and significant capacity located in the separatist-controlled areas. We expect the C/A to return to deficit in 2H15, partly due to seasonality, partly due to some recovery in imports as the economy grows again. As a result, the full-year deficit could remain low at 1.8% of GDP before widening slightly to 2.1% next year.

AFTER THREE QUARTERS OF PRECIPITOUS DECLINE ECNOMIC ACTIVITY HAS STABILIZED

Real GDP may have reached the bottom…



…with industrial production and trade showing signs of stabilization



Source: NIS, NBR, UniCredit Research

External financing remains difficult…

…with private outflows financed by official loans…

…a pattern that cannot be sustained going forward

At the same time, the external financing situation remains difficult. Rollover ratios remain low, resulting in net repayments by banks and corporations of USD 4.5bn. FDI was negative as were trade credits, which in the past were used to channel back flight capital to Ukraine. While heavy borrowing by the government and the NBU from the IMF and other official creditors helped boost reserves by USD 3bn (to a still low 2.5 months of imports), this financing pattern cannot be sustained going forward.

The recent debt restructuring agreement with private creditors could play a pivotal role…

…but the terms raise doubts about its sustainability

In this respect, the recent agreement with private creditors to restructure some USD 18bn in Eurobonds is key, This is an important milestone towards restoring Ukraine's solvency and access to capital markets. However, the short grace period (only two years before payments begin), the high coupon and the modest write-down of just 20% have raised concerns about the sustainability of the deal over the medium term. The lack of agreement with Russia on the USD 3bn bond issued in 2014 and due in December has also added to the uncertainty.

Debt repayment obligations jump after 2017…

…necessitating heavy borrowing on capital markets…

…prospects for which remain uncertain

While much will depend on the pace of the recovery and the vigor of Ukraine's economy over the longer term, liquidity pressures will rise once repayments to the IMF commence and the grace period expires. Meeting these obligations and servicing the restructured debt alone would require borrowing on foreign capital markets of USD 6- 8 bn a year starting in 2018. Securing such amounts on capital markets so soon would be a daunting challenge and would depend, apart from global risk appetite, on restoring peace and on the pace of reforms.

A durable peace in the east looks elusive

Reforms track record has been mixed…

…and the political situation fluid.

Substantial uncertainties remain on both counts. While the truce has held for now, a negotiated solution looks as distant as ever, which undoubtedly will weigh on confidence. As regards reforms, the track record is mixed. While important steps have been taken to tackle corruption and revamp the police, other reforms have largely stalled. The control of powerful financial-industrial groups over large parts of the economy remains intact and institutional capacity is poor. The political situation remains fluid, too, under heavy dominance of vested interests.

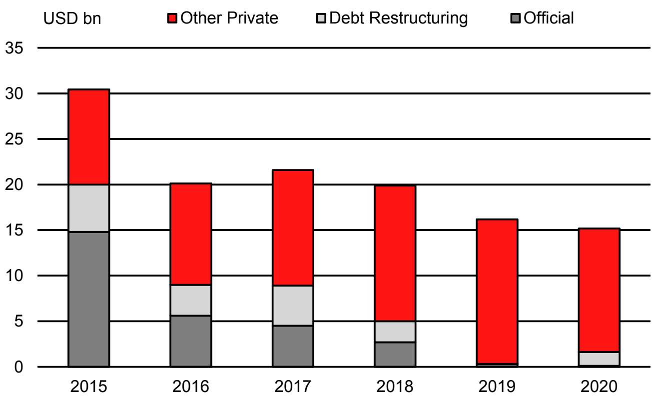
In the near term, the key priorities are bank restructuring and unlocking financial markets…

…while the NBU might need to contend with a weaker UAH to preserve competitiveness gains

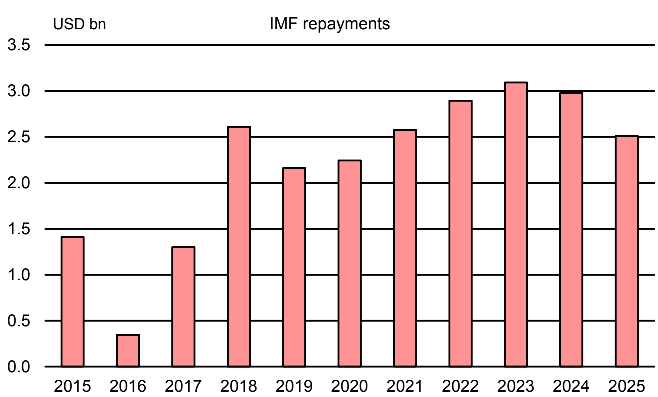
In the near term, the key priorities are unlocking financial markets and restructuring the troubled banking system. In regard to the former, the NBU needs to lift FX market restrictions, but is constrained by low reserves. On bank reforms, the first step based on the (now outdated) 2014 assessment is largely completed, but the second (based on recent economic developments) has been extended through 2018. The delays unlocking financial markets have been detrimental to growth and need to be resolved as soon as possible. Toward this end, the NBU may need to contend with a weaker UAH to balance supply and demand once FX restrictions are lifted, as well as to preserve the competitiveness gains afforded by the depreciation.

LARGE DEBT REPAYMENTS AFTER 2018 LEAVE MEDIUM-TERM DEBT SUSTAINABILITY AT RISK

Borrowing needs form private capital markets rise after 2018…



…once IMF repayments start and official financing ends



Source: NBU, IMF, MinFin, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**11.4**	**12.9**	**6.9**
Budget deficit	4.7	3.2	3.1
Amortisation of public debt	6.7	9.7	3.8
Domestic	2.8	4.8	2.3
Bonds	2.0	4.8	2.3
Bills	0.8	-	-
External	3.9	4.9	1.6
Financing	**11.4**	**12.9**	**6.9**
Domestic borrowing	3.1	4.3	1.6
Bonds	2.7	4.3	1.6
Bills	0.4	-	-
External borrowing	6.3	7.9	2.1
Rescheduled/postponed	-	1.6	1.5
Discounted debt transaction	-	0.4	0.4
Other	2.0	-1.4	1.4

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016FF
Gross financing requirement	**42.6**	**40.7**	**35.9**
C/A deficit	4.1	1.4	1.6
Amortisation of medium to long term debt	14.5	17.0	13.4
Government/central bank	5.5	5.6	2.4
Banks	2.9	2.5	2.1
Corporates	6.1	8.9	8.9
Short term debt	23.9	22.4	20.8
Financing	**42.6**	**40.7**	**35.9**
FDI	0.2	0.5	1.3
Portfolio	-0.5	-0.1	0
Borrowing medium to long term	8.4	20.8	14.3
Government/central bank	4.6	14.9	4.7
Banks	1.4	1.4	2.5
Corporates	2.4	4.5	7.1
Short term borrowing	20.5	19.8	18.0
Postponed/rescheduled	-	1.6	1.5
Discounted debt transaction	-	0.4	0.4
Errors & omissions/other	3.8	3.6	3.2
Reserve accumulation	10.2	-5.8	-2.9

Source: IMF, NBU, MoF, Unicredit Research

Key dates over 4Q15: Rate and rating decisions

September	22-Sep	Turkey rate decision
	22-Sep	Hungary rate decision
	22-Sep	Turkey rate decision
	22-Sep	Czech Rep rate decision
	25-Sep	Lithuania – Fitch rating
	25-Sep	Slovenia – Fitch rating
	25-Sep	Lithuania – S&P rating
	30-Sep	Bulgaria rate decision
	30-Sep	Romania rate decision
October	2-Oct	Bulgaria – Moodys rating
	6-Oct	Poland rate decision
	9-Oct	Latvia – Moodys rating
	9-Oct	Romania – S&P rating
	15-Oct	Serbia rate decision
	16-Oct	Czech Rep – Fitch rating
	16-Oct	Russia – Fitch rating
	16-Oct	Czech Rep – Moodys rating
	16-Oct	Russia – S&P rating
	20-Oct	Hungary rate decision
	21-Oct	Turkey rate decision
	30-Oct	Bulgaria rate decision
	30-Oct	Russia rate decision
November	4-Nov	Poland rate decision
	5-Nov	Czech Rep rate decision
	5-Nov	Romania rate decision
	6-Nov	Latvia – Fitch rating
	6-Nov	Hungary – Moodys rating
	6-Nov	Turkey – S&P rating
	12-Nov	Russia rate decision
	13-Nov	Croatia – Moodys rating
	17-Nov	Hungary rate decision
	20-Nov	Estonia – Fitch rating
	20-Nov	Hungary – Fitch rating
	20-Nov	Estonia – Moodys rating
	24-Nov	Turkey rate decision
	27-Nov	Latvia – S&P rating
	30-Nov	Bulgaria rate decision
December	2-Dec	Poland rate decision
	4-Dec	Bulgaria – Fitch rating
	4-Dec	Turkey – Moodys rating
	10-Dec	Serbia rate decision
	11-Dec	Romania – Moodys rating
	11-Dec	Slovakia – Moodys rating
	11-Dec	Bulgaria – S&P rating
	11-Dec	Estonia – S&P rating
	11-Dec	Ukraine – S&P rating
	11-Dec	Serbia rate decision
	15-Dec	Hungary rate decision
	16-Dec	Czech Rep rate decision
	18-Dec	Serbia – Fitch rating
	18-Dec	Slovenia – S&P rating
	22-Dec	Turkey rate decision

Source: UniCredit Research

Acronyms used in the CEE Quarterly

- BNB – Bulgarian National Bank
- C/A – current account
- CBR – Central Bank of Russia
- CBRT –Central Bank of the Republic of Turkey
- CE – Central Europe
- CEE – Central and Eastern Europe
- CNB – Czech National Bank
- DM – developed markets
- EC – European Commission
- ECB – European Central Bank
- EM – emerging markets
- EU – European Union
- FCL – Flexible Credit Line (from the IMF)
- FDI – foreign direct investment
- IFI – international financial institutions
- IMF – International Monetary Fund
- MinFin – Ministry of finance
- NBH – National Bank of Hungary
- NBP – National Bank of Poland
- NBR – National Bank of Romania
- NBS – National Bank of Serbia
- NBU – National Bank of Ukraine
- PLL – Precautionary and Liquidity Line (from the IMF)
- PM – prime minister
- qoq – quarter on quarter
- sa – seasonally adjusted
- SBA – Stand-by Arrangement (with the IMF)
- SOE – state-owned enterprise
- WB – World Bank
- yoy – year on year

Notes

Notes

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