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3Q 2015

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CEE: A resilience test

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- 2015 saw a good start for the CEE region. Buoyed by the rebound in demand in the euro area (EA) and ample liquidity thanks to the ECB's QE, growth surprised to the upside – but not everywhere. While it firmed in Central Europe, growth remains lackluster in Turkey and elusive in the Western Balkans. Russia and Ukraine, meanwhile, sank deeper into recession as the fallout of the drop in commodity prices has been exacerbated by the geopolitical tensions between them and the related sanctions on Russia.
- The new EU members in Central Europe (EU-CEE) benefitted the most thanks to their deeper integration with the EA. Moreover, unlike the recent past, this time the rebound in growth has been broad based, with fixed investment picking up on the improved growth outlook and private consumption finally taking off in response to improving labor markets, rising real incomes and the winding down of the multi-year deleveraging process.
- Going forward, the pace of economic expansion will remain solid in EU-CEE, increasingly boosted by domestic demand. The latter will be supported by stimulative policies. With budget revenues likely to outperform expectations thanks to robust growth, governments in the EU-CEE can afford to spend more or cut taxes. At the same time, low inflation should help keep monetary policy accommodative through the rest of the year.
- In contrast, fiscal policies will remain a drag on growth in both Serbia and Croatia under programs agreed with the IMF and the EU, respectively. Both countries stand to benefit less from the rebound in the EA given lesser integration and less enabling investment climates, but the pickup in foreign demand should still help pull them out of recession. Plagued by political uncertainty, heightened market volatility and sluggish exports due to geopolitical tensions and flagging competitiveness, growth in Turkey will languish in 2015.
- While in Russia the stabilization of oil prices and the tenuous truce in eastern Ukraine have cushioned slightly the drop in output, the bottom has not been reached yet. The recession is likely to be shallower, but also longer than previously expected, with prospects for recovery muted by long-standing structural weaknesses and the consequences of sanctions.
- Ukraine, on the other hand, is fighting for survival, with the economy in free-fall, financial markets frozen and odds for a disorderly external debt default rising with the debt restructuring talks stalled. While in both countries policies remain largely crisis-driven and therefore counter-cyclical, Russian authorities enjoy more room for maneuver thanks to significant fiscal and FX buffers and a moderation in inflation. The latter, along with fragile ruble stabilization, has opened scope for more aggressive rate cuts.
- In the rest of the region, the easing cycle is about to come to an end. With output in EU-CEE approaching potential, labor markets firming and the impact of the drop in oil and food prices fading later this year, inflation could surprise on the upside. However, rate hikes may well be delayed as long as the ECB's QE keeps interest rates in the EA low and liquidity ample. Rate hikes seem imminent in Turkey, in contrast, where inflation pressures have intensified, market volatility is high and political uncertainty is rising.
- Despite the generally favorable outlook, numerous risks remain, key among which is the potential effect of the upcoming Fed rate hikes. Everybody would be affected, but countries with better fundamentals are likely to be more resilient – especially the EU-CEE, where macroeconomic imbalances are minimal. On the other hand, countries with weaker fiscal or current account positions and heavy reliance on foreign funding look more vulnerable – especially Turkey, but also Serbia and Croatia.
- Among the other risks, a possible intensification of fighting in Ukraine or a disorderly Grexit is worth mentioning. Both, however, are likely to have relatively limited contagion effects beyond the countries directly involved. The outcome of renewed hostilities in Ukraine would mostly hurt Russia and Ukraine themselves barring sustained natural gas supply interruptions. A Grexit would hit trade in the neighboring countries, but a broader dislocation should be averted with local subsidiaries of Greek banks well ring-fenced.

Increasingly divergent growth outlook

Despite the generally favorable global backdrop, growth performance in the CEE sub-regions has become increasingly divergent. The 1Q15 outcome surprised on the upside among EU-CEE, but has been largely disappointing elsewhere. This divergence is rooted in the varying degrees of integration of the individual countries within the EU, the quality of economic policies, political stability, and ultimately on the state of structural reforms.

On all the above factors, the new EU-CEE score much better than the rest of the region. Their integration within the supply chains of major EA corporations is particularly deep, with exports to the EA ranging from 40% to 75% of GDP. This has allowed the EU-CEE to benefit the most from the rebound in EA demand – but also to secure a larger share of the gain in EA exports to third countries afforded by the weaker euro.

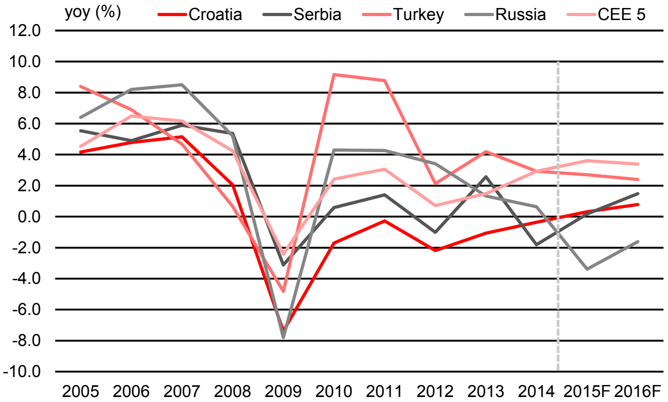
The EU-CEE region also benefits from the virtual absence of macroeconomic imbalances. Inflation is all but nonexistent, current accounts are in balance or in surplus, fiscal deficits well anchored below 3% of GDP and banking systems, which are to a large extent foreign-owned, well capitalized and liquid. This macroeconomic resilience has had multiple benefits: markets' risk perceptions are low, hence risk premia and borrowing costs low and funding readily available; policy flexibility is much larger than elsewhere with little or no need for further fiscal adjustment, and ample scope to keep interest rates at record low levels.

As a result, EU-CEE has a greater scope for growth-supportive policies. With no need for further fiscal adjustment, the extra revenues produced by the cyclical upturn are likely to be used, at least in part, to boost government spending. Low interest rates thanks to monetary accommodation have helped encourage the resumption in bank lending. Finally, EU-CEE has access to substantial resources in the form of EU transfers (on the order of 2-3% of GDP a year, depending on the utilization rate), that provide a powerful stimulus to public investment. Croatia is entitled to similar amounts, but the utilization rate there is much lower given still the insufficiently developed institutional framework.

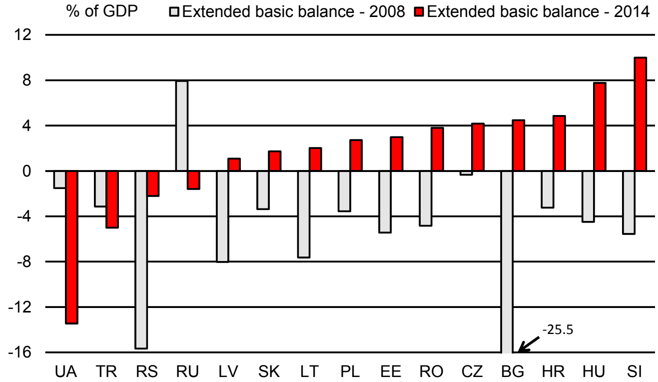
These advantages have not only resulted in a stronger rebound in exports among EU-CEE, but have also spilled over to the domestic economy. Improving labor market conditions and stronger real wage growth – afforded in part by the drop in inflation but also by tighter labour market conditions – have boosted consumption, as has the winding down of the multi-year deleveraging begun in the aftermath of the 2008 global financial crisis. The improved growth outlook, along with the availability of cheap funding and substantial EU transfers, has helped boost fixed investment. As a result, growth is likely to firm above 3% on average and become more sustainable and less dependent on foreign demand.

GROWTH IS EXPECTED TO EXCEED 3% IN EU-CEE, WHILE EXTERNAL IMBALANCES HAVE BEEN REVERSED

GDP growth in CEE



External imbalances have been eliminated in EU-CEE



Source: national statistical offices, UniCredit Research

The picture is different in the rest of the region. Croatia and Serbia, with smaller manufacturing sectors, lower trade integration with the EU and much smaller FDI – partly due to cyclical reasons, but also less inviting investment environments – have benefitted less. True, exports have rebounded there, too, but domestic demand remains more constrained partly because of the need to advance fiscal consolidation. Both countries will have deficits on the order of 5% of GDP and government debt at 80% of GDP or more. Growth has stagnated early in the year and, even though we expect eventually both countries to exit recession this year, the pace of economic expansion will remain modest at less than 1%

The growth performance has been particularly disappointing in Turkey. This was the country that was expected to benefit the most from the combination of stronger foreign demand, lower oil prices and abundant global liquidity, providing it with the opportunity to boost growth while reducing macroeconomic imbalances. In fact, growth has remained anemic, its composition has worsened and imbalances have increased. The 1Q15 growth rate of 2.3% yoy was not only lower than in EU-CEE, but also entirely driven by fiscal expansion and private consumption. Export volumes contracted due to regional geopolitical tensions, but also due to the loss of competitiveness vis-à-vis Europe, and investment has languished. Price pressures have intensified and the underlying external balance has weakened.

Much of the deterioration is rooted in domestic politics. Political tensions were running high well ahead of the 7 June parliamentary election and were reinforced by intensified political pressure on the central bank to cut rates. Confidence has plummeted – and with it investment as financial market pressures have intensified, sending the TRY nearly 20% down vis-à-vis the USD since the start of the year. Political uncertainty has only increased after the election ended in a hung parliament, necessitating prolonged and complicated coalition talks.

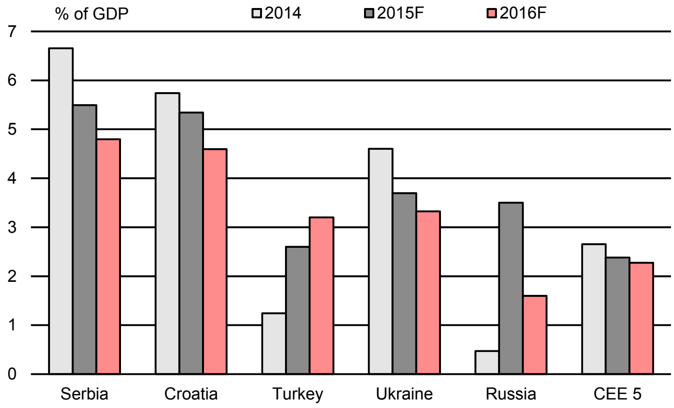
These tensions have precluded any counter-cyclical policies. In fact, the odds for a rate hike have increased and look almost certain once the Fed begins raising US rates. Therefore, we now see real GDP in Turkey expanding only 2.7% this year, with potential downside risks if Fed rate hikes trigger a stronger wave of global risk aversion. Inflation would remain high this year and, even though the headline C/A deficit would narrow thanks to lower oil prices, the underlying stance will continue weakening.

Russia and Ukraine will remain in recession this year as a result of the combination of terms of trade losses due to falling commodity prices, long-standing structural rigidities and the fallout of the war in eastern Ukraine. However, the magnitude and the outlook are quite different in each country. In Ukraine, real GDP now looks likely to drop by as much as 12-13% – partly reflecting the loss of capacities in the war-torn East, and any recovery is contingent on securing additional official funding and reaching a durable negotiated solution of the conflict.

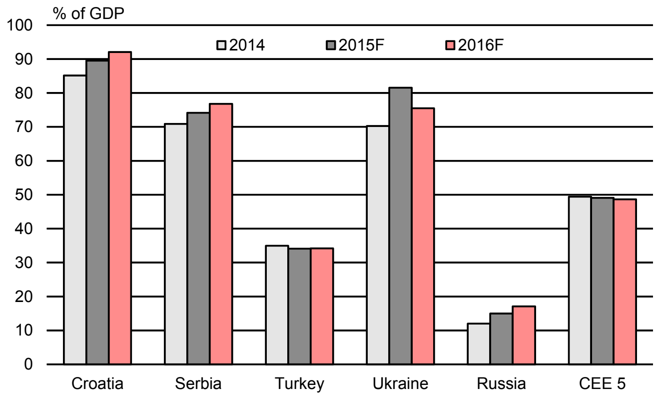
In Russia, the recession is likely to be shallower, but also more protracted. This would reflect the stabilization of oil prices and the ruble, as well as the delayed response of economic agents to the drop in demand. At the same time, the return to growth will be delayed because of pervasive structural rigidities that remain unaddressed, the lack of investment and the impact of the technological sanctions on the already unimpressive potential growth.

LIMITED FISCAL RISKS IN EU-CEE, BUTA STRONG ADJUSTMENT NEEDED IN SERBIA AND CROATIA

Budget balances benefit from a cyclical rise in revenues in EU-CEE



…while debt to GDP ratios remain below 60% in most countries



Source: MinFins, statistical offices, UniCredit Research

The era of low inflation winding down…

The divergent growth trends across the CEE have resulted in a divergent inflation outlook. Inflation developments have been diverging for quite some time already, with inflation in Turkey and Russia much higher than in EU-CEE, suggesting a significant structural element. In Ukraine, inflation has mainly reflected the sharp depreciation of the currency and steep hikes in administered energy prices, and therefore is likely to be largely transitory.

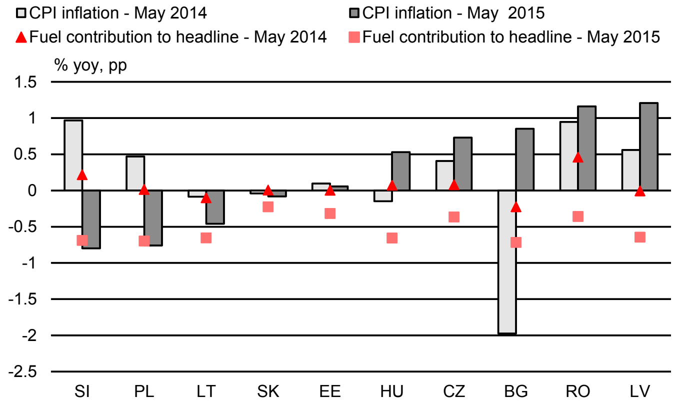
In EU-CEE, inflation has remained low both due to the sizable economic slack and one-off factors. Below-potential output has kept unemployment high and wage demands subdued, containing core inflation. At the same time, the drop in food prices last summer following the Russian countersanctions and that of oil prices last fall have pushed headline inflation into negative territory. Now both factors look set to exit the base. The rebound in output has largely erased the output slack as demonstrated by the drop in unemployment and accelerated real wage growth. The impact of last year's drop in oil and food prices will largely disappear later this year, and imported inflation is likely to rise in line with the weaker euro. As a result, both core and headline inflation will rebound later in the year, approaching central banks' targets next year.

In contrast, after spiking to as high as 17%, inflation look set to slow rapidly in Russia, thanks to the tenuous ruble stabilization and the fall in inflation triggered by the collapse in domestic demand. We expect the ruble to remain broadly stable through the rest of the year, assuming oil prices of around USD 65/bbl and no intensification of the fighting in Ukraine. Disinflation will be also supported by indirect government control on key food prices and deferral of administered price adjustments. Even so, at 11% by yearend and 6.8% by the end of 2016, inflation in Russia will remain well above that in the EU-CEE or the Western Balkans.

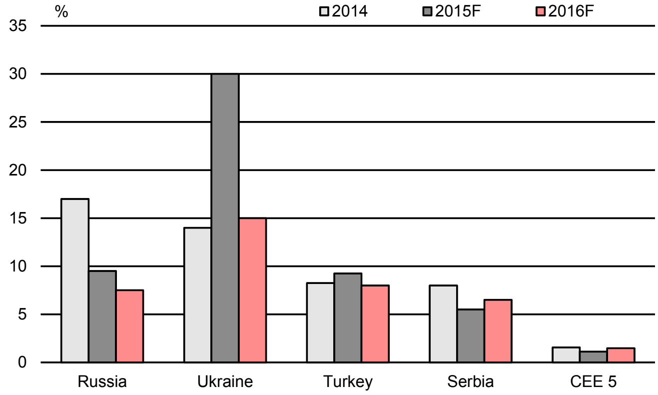
In Turkey, inflation has already accelerated markedly. This reflected both sustained high food prices and the pass-through of the weaker lira, but also significant acceleration of demand-driven inflation as evident in the rise of all nine core inflation indicators and in services prices. Despite a temporary reduction in the late summer because of base effects, inflation is likely to remain elevated at near 9% through yearend and then abate only slowly to 6.8% by the end of 2016, again well above the CBRT's own target and much higher than in EU-CEE.

REFLATION HAS STARTED IN EU-CEE, WITH DISINFLATION EXPECTED IN RUSSIA AND UKRAINE

Reflation has started in Central Europe, despite the drag from fuel prices in place until 4Q15



Hikes expected in EU-CEE and Turkey, cuts in Russia



Source: national statistical offices, central banks, UniCredit Research

…and with it the era of monetary accommodation

The prospects of rising inflation would post a challenge to central banks in EU-CEE, but not before next year. In the meantime, the policy response will vary. The easing cycle appears to have been already competed in Poland, where growth has been the strongest, wage pressures more profound, and the monetary policy council more conservative. Policies look likely to remain accommodative for a while in the rest of the region, however, with further rate cuts likely this year in Hungary, Serbia and Russia, albeit for different reasons.

In Serbia, the real rate is still too high relative to its peers because of perceived weaker creditworthiness. In Hungary any further easing would reflect the preference of the central bank for boosting growth despite the prospect of rapid reflation. Rate hikes would come on the agenda in all inflation-targeting EU-CEE countries next year, but their timing would depend largely on the degree to which global monetary conditions would be tightened by then and might be delayed by the ECB's QE.

Rate cuts will be on the agenda in Russia as well this year given the drop in inflation and the prospect of broad ruble stability. Even so, mindful of the potential downside risks, the CBR is likely to be cautious, cutting its policy rate by a total of 300bp through yearend to 9%. (At this level, the policy rate would still be slightly positive on a 12-month ex-ante basis). These cuts would mostly benefit domestic banks by lowering their funding costs, but are unlikely to do much to boost growth.

In Turkey, by contrast, the combination of strong credit growth, surging consumption, rising core and headline inflation, and the deteriorating underlying external position all point to a positive output gap and would argue for monetary tightening. The sustained pressure on the lira would also suggest the need for higher interest rates. The CBRT, in fact, has tightened policy slightly, using macro-prudential measures and shifts within its interest rate corridor, but has refrained thus far from policy rate hikes.

This might change soon, however, with financial markets unimpressed by these palliative measures and heightened political uncertainty weighing on the lira until a new coalition government is formed. Rate hikes will become a virtual certainty once the Fed raises its own policy rate or even earlier if a failure of the coalition talks sends the lira sharply lower.

Numerous Potential Risks Looming

Despite the generally favorable near-term outlook, downside risks remain plentiful. Some of these would affect the whole CEE region, and some would have a more limited impact. Among the global risks, key for the region are potential renewed slowdown in Europe and the impact of the upcoming Fed rate hikes. A potential renewal of the fighting in Ukraine and a disorderly Grexit are two risk events with a more limited impact.

We judge the likelihood of a slowdown in Europe as low, but feel that markets tend to underestimate the potential impact of the Fed rate hikes on global risk appetite and capital flows to emerging markets. While a potential slowdown in Europe would affect everybody, especially EU-CEE given their deep integration with the EA, the effect of the Fed hikes will be more nuanced and would vary depending on the macroeconomic vulnerability of each country. The attached “Heat Map” attempts to summarize this vulnerability across a range of indicators and countries, both in Europe and outside.

To an extent, the potential impact of the Fed rate hikes would affect the whole CEE region by raising borrowing costs and making access to funding more difficult. The extent to which different countries would be affected would depend both on the magnitude and the duration of the likely market disturbance as well as the macroeconomic soundness of each individual country.

Under these circumstances, EU-CEE looks more resilient. This reflects the absence of macroeconomic imbalances, ample buffers in the form of FX and fiscal reserves, limited borrowing requirements and rollover needs (other than FDI-related) and sound and liquid banking systems not reliant on wholesale funding. (Most EU-CEE banking systems have loans to deposit ratios below 1). Therefore, these countries should be able to cope with any disturbance in global capital flows relatively easily.

This said, among EU-CEE, some countries look relatively more exposed. These include first and foremost Hungary, where nonresidents hold 40% of local currency bonds and where government debt is the highest at near 80% of GDP. In the near term, the liquidity risk should be contained by insufficient market liquidity that would prevent an exit. However, yields on the longer end would spike, and, if sustained, would over time result in significantly higher debt servicing costs that would complicate fiscal policy. Poland would be relatively exposed as well again due to the high concentration of foreign investors in the long end of the curve.

Among the rest of the region, Ukraine and Russia are already without market access, so any impact of the Fed hikes should be minimal. Croatia and Serbia are heavily exposed, however, given sizable fiscal deficits, high government debt and already high borrowing costs. While the risks in Croatia should be somewhat mitigated by the substantial share of local investors, Serbia looks particularly at risk.

Among all CEE countries, Turkey looks most exposed to a potential Fed-related market upheaval. This reflects the combination of a high C/A deficit that is mostly structural and reliance on volatile portfolio flows for financing. The structural essence of the C/A deficit makes it virtually impossible to reduce without cutting imports which would result in a recession if capital inflows decline for more than a couple of months, with the CBRT’s net reserves limited to USD 35bn. Although this is not to be excluded, this is not our baseline scenario. Under the latter, we assume capital inflows would recover after a couple of months – but growth would suffer nonetheless as the CBRT hikes interest rates, perhaps 150 to 200bp. There will be a slowdown, but recession should be avoided.

A flare-up of fighting in Ukraine would have a much more limited impact. With trade with Russia and Ukraine already down 30-60%, and their share limited across the CEE, and with financial linkages minimal, the direct fallout would be modest – assuming natural gas supplies are not interrupted. We consider the likelihood of such a disruption minimal given the crucial importance of these revenues for Russia's starved economy. There will be an indirect impact – if the additional US/EU sanctions are met again with Russian counter-sanctions – but it should be fairly limited. Relatively more affected would be Bulgaria, Croatia and especially Turkey, all of which rely heavily on Russian tourists.

The direct impact of a disorderly Grexit seems to be exaggerated by markets. There will be some direct impact – mostly on the neighboring countries via the trade channel, but Greece's share in exports does not exceed 2% in any country of the region with the exception of Bulgaria – e.g., less than that of Russia – so it should be manageable. The indirect consequences in the form of a spike in euro periphery bond yields and with them CEE bond yields – could be more significant, but the ECB with its QE program has established sufficient safeguards, we think.

Additional concerns have been raised by the strong presence of Greek-owned banks in parts of the region – especially Bulgaria, Serbia and Romania. However, these banks have become financially independent from their parent banks. Both the ECB and the national central banks have implemented programs that have reduced their exposure to Greek risk to a minimum. This has been recognized by rating agencies that rate some of the lager subsidiaries several notches above the patent bank – and that long ago before the current crisis. The only potential risk is that of a bank run "by association", but even so, national central banks have sufficient buffers to handle such an unlikely event.

CEE Strategy: A time for decisive action

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- Curve steepening in EM Central Europe should continue in 3Q15 as rising domestic demand facilitating higher inflation combines with higher global rates via a more hawkish Fed. High foreign holdings in long-dated tenors and idiosyncratic political instability are unlikely to provide support, although some reprieve may arrive short term if bund yields stabilize in July and in 4Q15 via a lack of supply.
- In local markets, more discerning investment is called for. Short-term opportunities are available in Romania as inflation is set to plummet. Meanwhile, higher inflation in Poland and Hungary along with stronger correlation to core rates makes positioning more challenging. We see better opportunities in high yielding, non-correlated bonds in Russia and Serbia where easing cycles look set to continue.
- Hard currency bonds in CEE are better value than other EM regions on comparative credits. On a cross asset basis, USD bonds look better value than EUR in most countries and we see value in 6Y Poland, 10Y Hungary and longer tenors in Romania and Russia. EUR bonds are close to fair value, with the exception of Croatia and Bulgaria where overestimated potential spillover from Greece may provide an opportunity.
- With large gyrations in global bond markets ahead and changing growth and inflation projections in CEE, relative value opportunities could offer better value and lower volatility than directional trades. On long end vulnerabilities in CE4, we look to pay a basket of swaps against core rates, and initiate curve trades in Poland and Russia as yield curves are expected to normalize. We also see benefit in playing the bond vs. swap convergences as risk aversion eases.

EM flounders as equities outpace bonds

Local CEE bonds continue to underperform equities…

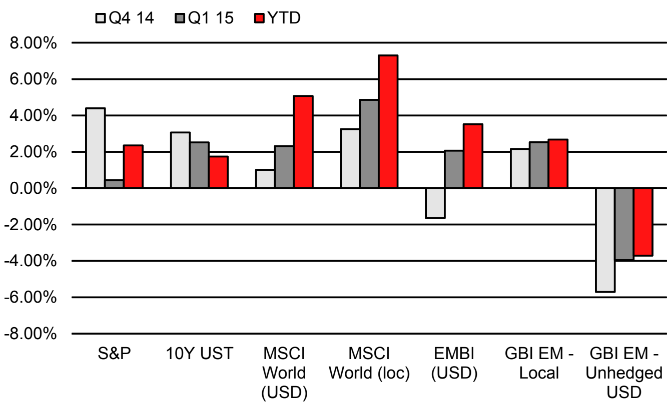
…as global bonds weaken,

...but outperformed EM LatAm and underperformed EM Asia

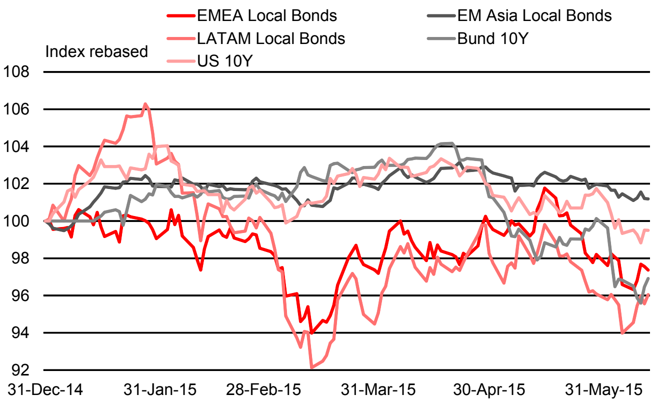
A pickup in growth in the US and early signs of a rebound in Europe continued to spur another strong quarter in equities. 1Q15 tightening in bond markets has given way to aggressive selloffs in 2Q15 as rising risks in the eurozone via Greece and gradual steps toward the anticipated US Fed rate hike turned the market increasingly defensive. Rising global rates dragged EM bonds with them at a time when EM FX had only just started to recover. EM bond performance has been mixed, with EM Asia continuing to outperform EMEA and LatAm, benefiting from low inflation, accommodative monetary policy and lower correlation to US and European rates.

EM DEBT MARKET PERFORMANCE IN A GLOBAL CONTEXT

Asset returns YTD



EM regional bond returns



Source: Bloomberg, UniCredit Research

Key themes for 3Q15

1. Curves in CE3 to steepen further

Curves are likely to steepen in C3 due to higher inflation…

We expect curves to steepen in Poland, Hungary and Czech Republic (CE3) for three reasons. First, domestic demand continues to pick up, with growth and inflation surprising to the upside. Inflation should continue to rise as growth accelerates and the impact of lower oil prices falls out of the base.

…foreigners exiting and…

Second, long end CE3 curves are highly correlated to core rates. Foreign investors dominate the long end in Hungary and Poland and are already reducing their positions. Rising rates in the US and/or Europe could accelerate their exit.

…idiosyncratic country reasons

Third, idiosyncratic factors will play a bigger role than before. In Hungary, the easing cycle may conclude in 3Q15 on rebounding inflation. The FRA curve is pricing in a total of 25bp in cuts in the next three months, while we expect 15-45 bp in additional cuts. Furthermore, moving the policy rate from two week to three-month deposits should anchor front end rates, while the introduction of the Mortgage Funding Adequacy Ratio and the issuance of mortgage bonds will increase supply pressure on the long end. In Poland, election uncertainty is likely to weigh on sentiment, while in the Czech Republic, stellar GDP growth could end central bank dovishness sooner than the market is currently expecting. In a first step, the CNB could start hinting at the removal of the CZK floor. This would be the first step in monetary tightening and should steepen the curve.

2. Short-term bund stabilization followed by rising volatility

We expect bunds to stabilize short term…

We expect bund yields to stabilize in July on the back of reduced short positioning and rising demand pressure. Eurozone inflation should rise at a much slower pace in August and the 5y5y inflation swaps are plateauing. This combined with a reduction in bund futures short positions in June should provide support to yields. In addition, an increase in demand-side pressure via reinvestment of bund redemptions and coupons in June/July and the ECB QE front-loading purchases should also help.

…on the ECB front loading purchases, and reinvestment

Risks to bonds beyond July are to the downside

After July yield risks are to the upside. Better US data should keep front end rates elevated as the US curve bear flattens, while in Europe risks are more two way. Rising inflation is likely to be partially offset by QE but US yields may well set a floor and pull bund yields higher. Implications for CEE are that duration should be reduced in highly correlated markets like CE3, while less correlated curves like Russia and those out of benchmark like Serbia and Slovenia may provide some protection.

3. Political and Greek debt uncertainties may provide good entry levels

Political noise should increase in CEE, with…

…coalition resolution in Turkey, elections in Poland and corruption allegations in Romania

Expect political noise to increase in CEE in 2H15, which will keep markets volatile but may provide opportunities. In Turkey, the coalition resolution path is vulnerable to political wrangling with a severe TRY depreciation likely raising the probability of rate hikes. In Poland, the surprise win of Andrzej Duda in presidential elections made the outcome of parliamentary elections (expected in the autumn) more unpredictable. We think that fears of a U-turn in macroeconomic policies are overdone given solid economic fundamentals, strong institutions and checks and balances in Poland. We would look to buy into an associated selloff. In Romania, corruption allegations could increase short-term volatility in the lead-up to parliamentary elections (scheduled for 2016, but potentially sooner), however longer term a decline in perceived corruption is likely to reduce the EM risk premium in the bond market, as is a successful conclusion of the IMF agreement.

Misunderstood Greek contagion issues in CEE…

…could present a buying opportunity

Greek debt issues have continued to weigh on markets but we think the risk to EM is misunderstood. Bulgaria, Romania and Serbia stand out as the most exposed countries[1] but Greek bank subsidiaries in this region are well capitalized, liquid and the reliance on parent-bank financing has been all but eliminated. In addition, the central banks of Bulgaria and Romania stand ready to support banks in case of stress and have experience in dealing with runs on deposits. If there is contagion from the Greek crisis, it could be create an attractive entry level into bonds in the region.

4. A lack of supply may provide some bond support in 2H15

Most countries are ahead of issuance targets,…

…which may support local bonds in 2H15, but…

Most countries are ahead of issuance targets, which should be supportive of bond markets in 2H15 along with the trend to issue floaters. Poland and Hungary have completed over 70% of their 2015 borrowing requirements, with the former having large reserves and expected to limit auctions to favorable market conditions, while the latter should benefit from further rate cuts and demand from local banks for short-term paper. The Czech Republic, Turkey and Serbia have completed over 50% of domestic issuance, while Romania is slightly behind but auction support remains strong and high fiscal reserves could be used instead. In Russia, 2Q15 issuance is on target after the 1Q15 target was missed, but high reserves make year-end targets less critical to meet.

…expect some hard currency EUR bond issues

In hard currency bonds, there is unlikely to be any supply of USD hard currency bonds but expect some supply of EUR hard currency bonds. We are expecting a EUR 1.5-2.0bn issue of a tenor 10Y or greater from Romania and a EUR 1.5bn issue from Serbia. Given auction support, both should see strong uptake.

5. Liquidity decline to continue as long as risk aversion remains elevated

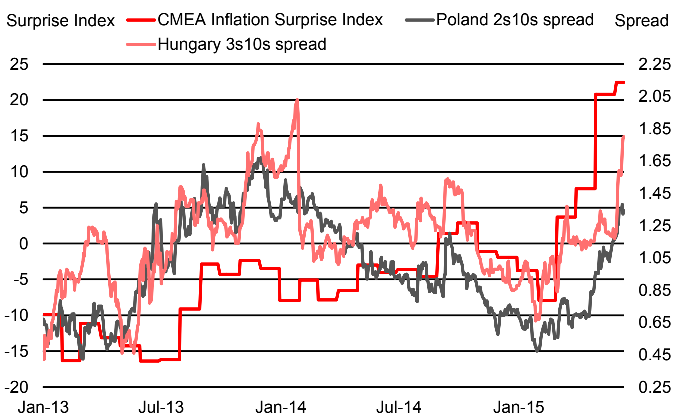
Liquidity has declined with risk aversion remaining elevated...

…and may not change until…

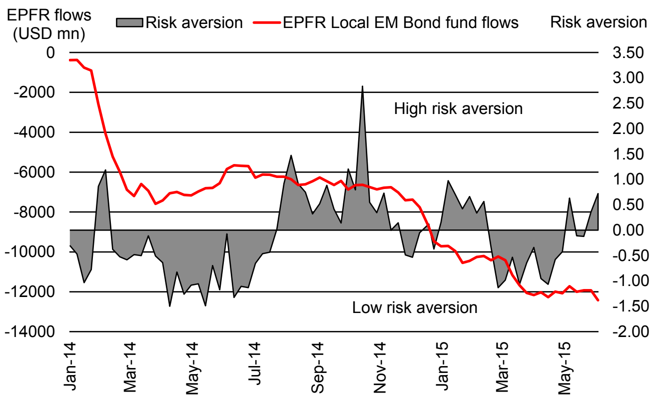
…the Greek issue and/or the Fed rate hike has been resolved

Liquidity has declined amid a deterioration in risk sentiment and significant outflows from EM bond funds. Moreover, reduced bank balance sheets and lower risk limits have limited the banks' ability to provide liquidity at a time when it has been needed the most. As such, most investors have likely been forced to sell EM FX, use more liquid swaps and/or bund futures to hedge bond positions – hence, higher FX volatility and wider swap-bond spreads. Sentiment is unlikely to improve significantly until there is some resolution of the Greek- troika standoff and the market can look beyond the first Fed rate hike. Once this occurs, risk appetite should improve and greater liquidity should return to the market. The worst-case scenario would be a delay to the resolution of the Greek crisis, pushing uncertainty in Europe over a US rate hike in September.

INFLATION SURPRISING TO THE UPSIDE



RISING RISK AVERSION AMID EM BOND FUND OUTFLOWS



Source: Bloomberg, EPFR, UniCredit Research

[1] For details, please *see The Country Note CEE exposure to Greece is limited but not negligible* from 20 February 2015.

Local currency bonds: Tricky quarter ahead

Reflation and rising global yields likely in 2H15 may make for a challenging period for EM bonds

We recommend reducing duration in Poland, and…

…steepeners in CE3, while…

With ongoing reflation amid external bond headwinds, 3Q15 could be a difficult quarter for local EM bond markets. In Poland, we recommend being underweight and reducing duration as the long end remains subject to multiple risks, notably ownership structure, rising core rates and parliamentary elections. We recommend 2s10s steepeners and paying 10Y swaps. In Hungary, the easing cycle is approaching an end but we recommend staying market weight into July as bunds stabilize. We favor the HGB 20s and HGB 22s, where the rolldown remains attractive. Beyond July, risks are to the downside and we recommend reducing duration as curve steepening seem inevitable with the policy rate moving from two week to three month deposits and supply of long-dated mortgage bonds in 2016 puts pressure on the long end. We favor 2s10s steepeners and paying 10Y swaps.

…ROMGBs should be supported by lower inflation

The Czech curve should remain well supported by excess liquidity in the banking system, but a less dovish central bank amid the rebound in growth and inflation should prompt steepening. We recommend paying 10Y swaps. We recommend staying overweight Romania, as the VAT cut for food should keep inflation well below the target range until May 2016, which should be positive for longer end ROMGB. We favor ROMGB 23s and 5s10s flattener. We would reduce duration in July and initiate a pay 10Y swap position into 4Q15 as inflation starts to rebound.

We recommend being market-weight in Russia,…

….on lower core rate correlation, falling inflation and rate cuts, and…

…underweight Turkey until yields reach more attractive levels

The non-correlated nature of Russia may provide protection, but political uncertainty in Turkey requires a higher yield for entry. We recommend being marketweight in Russia. While structural imbalances and political risks remain, we expect the downward inflation trajectory and stable oil prices to give the CBR room to cut rates into the end of the year, resulting in curve bull steepening. Moreover, demand from local banks will probably remain healthy. We recommend being long RFLB 22s and a steepening trade of long RFLB 17s against short RFLB 20s. In Turkey, the ongoing negotiations regarding a coalition government are unlikely to reduce market volatility. We recommend being underweight TURKGBs given the uncertainty, but would look to go long TURKGB Sep22s FX unhedged if the yield reaches 10%. At a 10% yield, it is likely that USD-TRY is above 2.80 and raises the chances that the CBRT would need to raise rates.

We favor local bonds in Serbia, but…

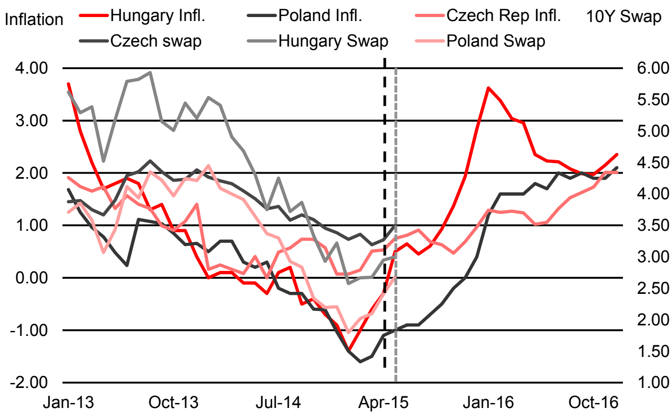
…are less inspired by Croatia at current levels

High-yielding Serbian local bonds remain attractive compared to similar Croatian bonds. Weak domestic demand in Serbia combined with low inflation and with high real yields should see further easing from the NBS. Adding the encouraging reform progress, we continue to favor 3Y and 7Y local benchmark bonds. The higher fixed rate coupons on these bonds should also technically lower interest rate risk, but further yield tightening will be driven by reform progress. In Croatia, fiscal imbalances and lack of reform progress and low yields compared to a better credit like Hungary make local bonds uninspiring.

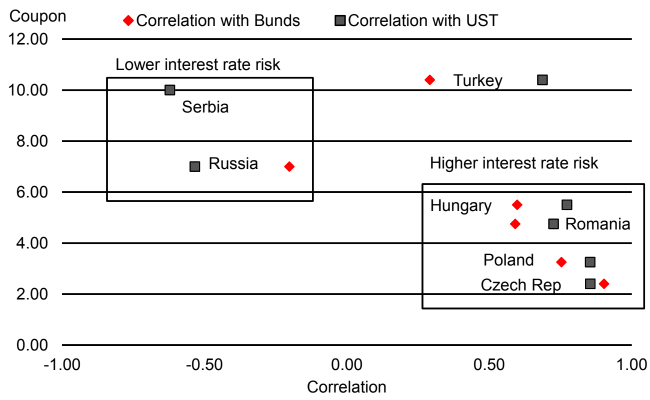
Bund yield stabilization may see yields in the Baltic area tighten

In the CEE's eurozone members, the expected tightening via ECB QE has failed to materialize as government bond purchases remain well behind target. The widening in yields highlights the two-way risks to ECB QE, and correlation to core yields. If bund yields stabilize, Slovenian local bonds could rally. However, very tight yields, relatively low coupons and external bond headwinds into year-end mean the risk/reward is unattractive.

CE3 INFLATION PATH VS 10Y SWAPS



CEE 10Y CORRELATIONS WITH BUNDS AND USTS



Source: Bloomberg, UniCredit Research

Hard currency bonds: USD still providing better value

Inflows into hard currency bonds are starting to wane….

Despite strong inflows into hard currency bond funds this year (USD 2.30bn until 10 June 2015, as measured by EPFR) compared to local currency bond funds (outflows of USD 3.25bn over the same period), support is starting to wane as the whole EM bond asset class comes under pressure. Greater concern over rising global yields is causing some bond contagion to EM economies. Liquidity fears amid relatively concentrated foreign investor holdings and EM firms potentially facing refinancing risks amid currency depreciation could increase vulnerabilities for countries that are dependent on foreign capital flows. In CEE, Turkey is the most vulnerable from this point of view.

…on rising EM and global bond yields

CEE USD hard currency bonds are generally better value than other EM regions…

On an EM cross asset basis, we think that USD bonds in CEE offer better value than in other regions. Within the low credit risk category, Poland stands out, still having value on a relative basis, as does Romania compared to LatAm and Asian equivalents, while Russia looks attractive given the high yields and Z-spread in the absence of currency risk. EUR hard currency paper across CEE looks less compelling as Z-spreads and yields are very tight and exposed to two-way risks to bund yields.

…and in CE USD hard currency bonds are more attractive than local bonds

In Central Europe, we recommend POLAND USD 21s, which have an equivalent Z-spread to longer-dated USD bonds, a spread of 24bp to the closest local tenor and attractive rolldown. EUR bonds in Poland and Czech Republic are trading too tight to eurozone members from CEE in yield and spread given that the latter benefit from the ECB's QE directly. In Hungary, a lack of issuance will continue to provide support to hard currency bonds, and a combination of an anticipated rating upgrade and currency risk into a Fed hike should provide further support. We recommend REPHUN USD Feb 23s. At current yields, compared to other EMs, REPHUN EUR paper is overvalued even when considering a rating upgrade back to investment grade. In Romania, USD paper remains attractive and we favor ROMANI USD 44s. The EUR paper is fair value and, given market liquidity, we would wait for the new EUR issue rather than initiating a position at these levels.

We recommend POLAND USD 21s, in Hungary REPHUN USD 23s and…

….in Romania the ROMANI USD 44s

We favor RUSSIA USD 42s, on declining inflation, rate cuts and rising reserves

In Russia, we are more constructive due to very good debt metrics and (still) sizeable reserves. Moreover, a likely rally in local currency bonds amid expected rate cuts benefits hard currency bonds. We recommend RUSSIA USD 42s. Turkey remains very vulnerable to political noise and external factors both of which could have a dramatic impact on the lira and corporate sector. We recommend to be underweight, and overall we prefer hard currency USD bonds to local bonds.

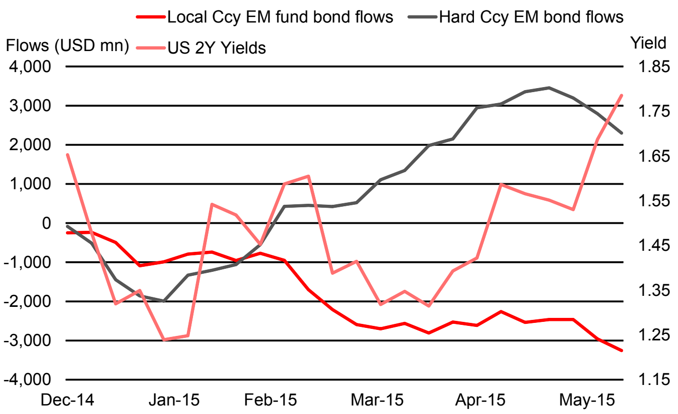
We favor BGARIA EUR 24s at the right level, after…

…widening on misunderstood Greek risks, and…

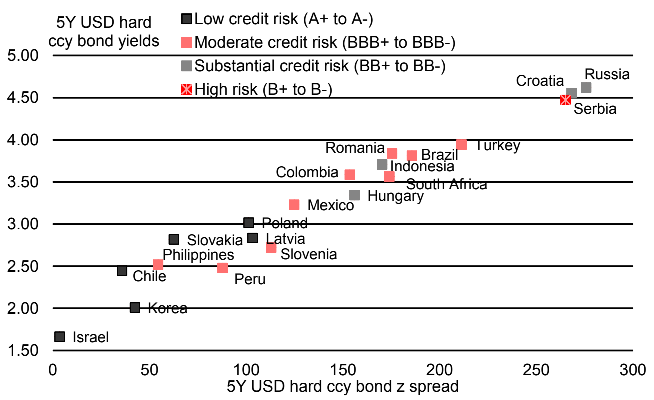
...recommend being long CROATIA USD 21s against SERBIA USD21

In the Balkans, there are opportunities at the right levels. Yield widening in Bulgaria via the core rate selloff and overestimated potential impact from Greece's standoff with the troika left EUR bonds looking more attractive compared to equivalent EM credits. This happened despite steady demand form local banks and an improvement in macro and fiscal metrics. We recommend a long position in BGARIA EUR 24s if the yield reaches 3.15%. In Serbia, hard currency SERBIA USD 21s bonds are trading at yields lower than CROATIA USD 21s. We believe that this is a cyclical trade that would favor Croatia going forward and we recommend being long CROATIA USD 21s against short SERBIA USD 21s.

SUPPORT FOR EM HARD CURRENCY BOND WANING…



…BUT BETTER VALUE IN CEE THAN ELSEWHERE



Source: EPFR, Bloomberg, UniCredit Research

Relative value: the volatility safety blanket

RV trades should limit excessive volatility in 3Q15, and…

With a number of significant 'bond sensitive' events due to occur in the next six months, notably rising inflation in CEE, the end of easing cycles, rising political noise and potentially higher global rates, we see more palatable opportunities in curve and relative value trades. These should provide protection against excessive bond market swings. We identify a few opportunities to take advantage of:

…we are looking to take advantage of…

…curve steepening in CE3, via a beta play of a basket of CE4 10Y swaps against US/EU 10Y swaps

1. **Long end vulnerabilities:** improving growth, rising inflation, less dovish central banks and dominance of foreign investors in CE3 (Hungary, Czech Rep, Poland) bonds mean risks to yields are to the upside. We recommend buying an equally- weighted basket of payer swaps in CE3 against an equal weight basket of receiver EU and US swaps. The CE3 basket has a beta of 1.20 against US 10Y swap and 1.44 against EU 10Y swap.

Normalizing yield curve is an opportunity for a butterfly in Poland and steepener in Russia

2. **Normalizing curve shapes:** In Poland, the FRA curve is starting to price in 25bp in hikes 12 months ahead. We are currently expecting 50bp in hikes in 2H16 and the 5Y widening at a similar pace to the 10Y with the 2Y barely moving. As a result, we recommend buying the belly and selling the wings in a 2s5s10s butterfly in the POLGB curve. In Russia, we recommend 2s5s steepeners as front end rates decline.

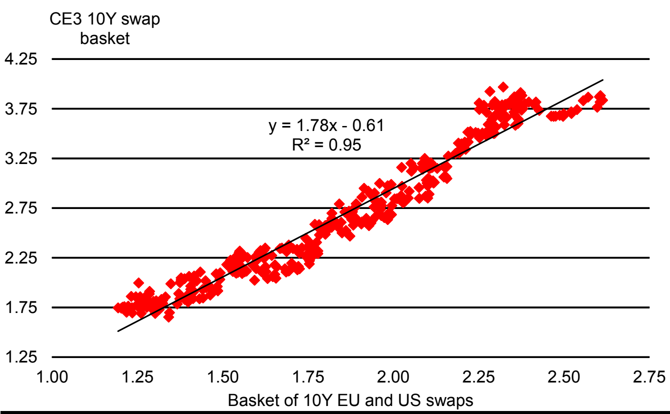
…while bond and swap spreads are too wide in Turkey, and…

3. **Bond vs. swap divergence:** In Turkey, the 5Y swap is trading 50bp outside the 5Y bond, probably because investors use the more liquid swap to hedge bond risk. As election uncertainty abates, we expect to see opportunities for a TURKGB rally and this will likely see swaps trade inside bonds. We recommend selling TURKGB 5Y, FX hedged to cover the FX and carry risk, against a received 5Y swap position.

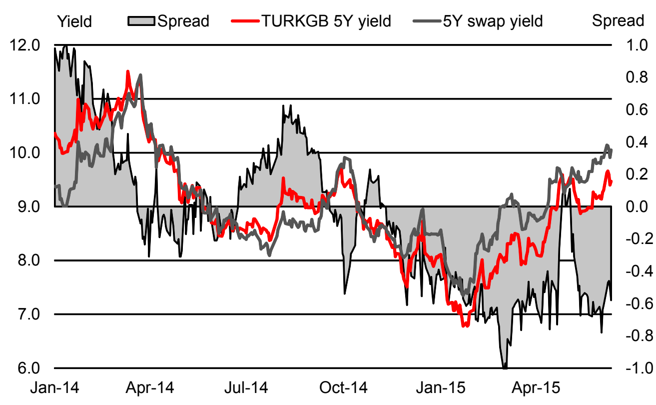
…we continue to favor a convergence in yield between hard and local bonds

4. **Hard currency vs. local currency bond spreads:** In Poland and Hungary, USD-denominated bonds continue to look better value compared to local bonds due to lower currency risk, higher yield and Z-spreads. Curves could bear steepen amid rising inflation and more rate hikes being priced in. We recommend a long position in POLAND USD Mar 22s against POLGB 22s and being long REPHUN USD Feb 21s against short HGB Nov 21s.

CE3 10Y PAYER SWAPS VS US/EU RECEIVERS



5Y TURKGB SPREAD TO SWAPS



Source: Bloomberg, UniCredit Research

CEE Fixed Income Trade recommendation performance

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

CLOSED TRADES SINCE THE LAST QUARTERLY 2Q 2015 – LEVELS IN BASIS POINTS

Date initiated	Trade	Entry level	Target	Stop loss		P&L	Comment
09 Oct	Receive 10Y Poland v Pay 10Y Hungary	103	175	50		-53	Monetary cycle reversal as Poland stopped easing with domestic demand increasing, while Hungary restarted an easing cycle after the economy failed to rebound. We are expecting further easing in the short term.
22 Jan	Long POLGB 23s v short HGB 23s	-78	-120	-65		1	
02 Feb	Long POLGB 17s v short 2Y Bunds	173	138	192		-19	
20 Feb	Long LITHUAN EUR 26s vs. 10Y Bunds	43	17	57		-14	The higher beta of Lithuania EUR bonds caused a larger widening in the Bund selloff.
31-Mar	Long Romani EUR 20s vs. REPHUN EUR 20s	16.8	-15	25		-8	The Romania curve steepened sharply as core rates widened and REPHUN EUR likely had better European support.
					Total	**-93bp**	

Source: Bloomberg, UniCredit Research

OPEN TRADES – LEVELS IN BASIS POINTS

Date initiated	Trade	Entry level	Target	Stop loss	Current level	P&L	Comment
30 Jan	Long Croatia USD 20s vs. short Serbia USD 20s	-7	27	-20	-7	0	Croatia is a better credit than Serbia and Croatian bond yields should trade inside Serbia.
27 Feb	Long Serbia 3Y local bonds	967			720	247	Weak domestic demand, low inflation and high real yields should continue to give the NBS ample room to cut rates.
27 Feb	Long Serbia 10Y local bonds	1190			876	314	
28 Apr	Long Romani EUR 24s vs. POLAND EUR 24s	126	100	139	124	2	A relative inflation play as inflation is set to drop in Romania after the VAT cut, while rising growth in Poland is likely to see inflation pick up over the rest of 2015.
29 Apr	Long ROMGB 25s vs POLGB 25s	78	35	90	85	-7	
18 May	Long ROMGB 25 vs. short ROMGB 20s	87	55	103	102	-15	Declining inflation should see ROMGB curve bull flatten.
					Total	**541 bp**	

Source: Bloomberg, UniCredit Research

TRADE RECOMMENDATION PERFORMANCE FROM THE LAST QUARTERLY 2Q15 (NOT INCLUDED ABOVE) – LEVELS IN BASIS POINTS

Date initiated	Trade	Entry level	Current level	P&L	Comment
18 Mar	SLOREP 26s	1.07	2.80	-173	A lack of buying via ECB QE, and correlation with the bund yield widening failed to provide any support to the bond or to any curve flattening.
	SLOVEN USD 23s	3.42	3.89	-47	
	SLOVEN 24s v 18s	1.12	1.54	-42	
18 Mar	Long Russia 22s v TURKGB22s	5.38	1.61	377	Trading the relative FX reserve vulnerability, with Turkey being less insulated from market risk and having deteriorating fundamentals compared to Russia which still has substantial reserves.
	Long Russia EUR 20s v TURKGB EUR 20s	2.71	1.37	134	
	Long Russia 2Y v 2Y TURKGB	4.48	0.90	359	
18 Mar	TURKGB 20s	8.31	9.35	-104	Significant curve widening in the run-up to the election, on the back of vulnerabilities relating to rising inflation, a deteriorating currency, election risk and fears of a US Fed rate hike. Hard currency bonds continue to provide better protection against idiosyncratic volatility.
	TURKEY USD 22	4.24	4.54	-30	
	TURKEY USD 36	5.16	5.62	-47	
	TURKEY EUR 21	2.49	3.07	-58	
18 Mar	ROMGB 23s	3.27	4.04	-79	Bonds widened on the back of core rates and misunderstood risks of Greek bank contagion and the IMF dispute with Romanian authorities. We expect bonds to perform better once the impact of the VAT cut to food starts to come through via significantly lower inflation prints..
	ROMANI USD 44s	4.51	5.31	-80	
	ROMANI EUR 24s	1.85	2.95	-110	
18 Mar	POLGB 21s	2.17	2.97	-79	Outright long POLGBs remain vulnerable to rising growth and inflation. Given the additional foreign holder risks at the long end of the curve and increased political noise in the run-up to the election expect POLGB to underperform as the curve continues to steepen short term. This may eventually be followed by bear flattening as the market starts to price in 2016 rate hikes, lifting yields in the front end.
	POLGB 22s	2.27	3.11	-84	
	POLAND USD 22s	2.77	3.21	-44	
	POLAND EUR 25ss	0.68	1.79	-111	
	Pay 10Y swaps	2.29	3.07	78	
	2s10s steepener	0.78	1.38	60	
	Long POLAND USD 24s v POLGB 24	2.27	3.11	41	
18 Mar	HGB 20s	2.89	3.25	-37	Some widening on the associated selloff in bunds but the curve remains well supported from expected further easing by the NBH and the shift of the policy rate from two weeks to three months. However, the curve is likely to steepen further from here due to correlation of the long end with US rates, high concentration of foreigners in the long end and mortgage loan bonds, expected in 2016, which will likely but pressure on long end yields.
	REPHUN EUR 20s	1.23	1.61	-38	
	REPHUN USD 41s	4.85	5.39	-54	
	REPHUN USD 23s	3.97	4.33	-35	
	Long HGB 3Y vs. POLGB 3Y	0.46	-0.09	54	
	3s10s steepener	1.29	1.98	69	
	Pay 10Y swaps	2.99	3.57	58	
18 Mar	Lithun USD 17s vs. Latvia USD 17s	0.24	0.16	8	Balancing differing levels of bond support via ECB QE and geopolitical risks, we favor Lithuania over Latvia.
			Total	**-14**	
			Overall total	**436bp**	

Source: Bloomberg, UniCredit Research

CEEMEA FX: Our views for 3Q

Main points and potential trade ideas

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EUR-PLN and EUR-HUF: Still a buy on dips for now, initially on Greek concerns, but later on risk of continued volatility in bunds. July could see some tactical downside in both pairs. This may present opportunities to go long spot and volatility via options.

TRY: Maintain a negative view on the Turkish lira on weak macro fundamentals. Buy EUR-TRY on dips, as the CBRT remains concerned about weak external demand. With a SARB hike in July largely priced in, look to go tactically long TRY-ZAR into July if there are stronger signs of a Turkish coalition government being formed. Positioning is supportive.

RUB: USD-RUB should trade in a 50 – 60 range, but initially at the weaker end of the range with the biggest risk coming from potential weakness in energy prices and position reduction. Budget performance and FX intervention dynamics will be important.

CZK: Should the CNB keep its characterization of risks to inflation unchanged on 25 June, expect some modest CZK weakness in July helped by some stability in core yields and seasonal weakness in the current account. But expect a stronger CZK from August on should the CNB debate over an exit from the floor intensify.

EUR-PLN & EUR-HUF: A bumpy ride with an eye on Greece and Bunds

Our working assumption for the next three months: Tactical downside in July but a buy on dips

We still look for a wide 4.05-4.25 and 302-320 range for EUR-PLN and EUR-HUF respectively in the months ahead. We would think of the coming quarter in terms of three sub-parts. First, the remaining weeks of June will see both pairs biased higher via EUR short-covering risk as we approach the 30 June expiration of Greece's aid package. Second, the month of July could see both pairs come under some pressure again, assuming that (a) Greece uncertainty recedes and (b) we see a slightly stronger tone on EGBs. Third, from August onwards the move higher in both pairs resumes, driven by (a) a return to the core-yield normalization theme (as the Fed hike comes into greater focus) and (b) greater political noise in Poland after the president-elect assumes office in August.

Greece noise isn't resulting in a bad selloff in CE4 like in 2011…

The uncertainty surrounding Greece doesn't appear at first glance to be impacting CE4 currencies to the same degree as seen back in 2H 2011 (chart 1) when contagion in the EGB market affected the banking system and resulted in a sharp tightening of liquidity in EUR money markets. Over this period, the latter explained the bulk of variation for a cross like EUR-PLN. Many things have changed since then, most of all the ECB's liquidity backstop/QE, limited Greek debt in the hands of the private sector, also not forgetting stronger external balances (Poland was running a C/A deficit back in 2011).

…but is weakening both currencies via EUR short-covering risk…

…which can continue till the end of June

That said, we think that uncertainty over Greece has affected both EUR-PLN and EUR-HUF to the extent that it has prevented investors from building up short EUR exposure. Recent reduction in short EUR positions since March has not only come with higher bund yields, but with a modest widening in peripheral spreads. Both pairs have becoming increasingly negatively correlated with the evolution of CFTC gross short positions this year in contrast to the past[2] (chart 2). Accordingly, we will be monitoring the evolution of peripheral spreads as well in gauging these pairs. A further widening is likely to push both pairs higher as we move towards the end-June deadline for the Greek aid program.

Chart 1: Tighter EUR liquidity drove EUR-PLN rally during sovereign debt crisis. But not now

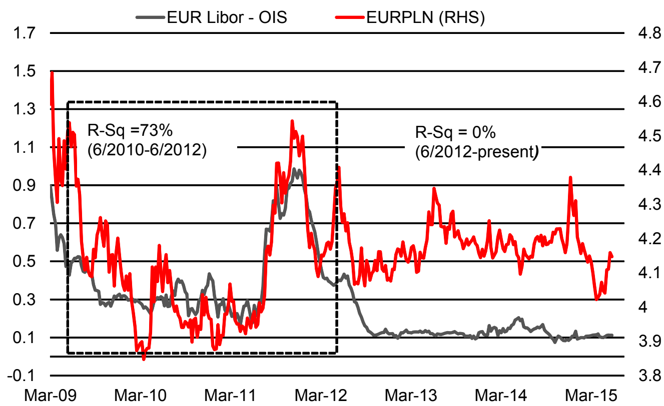
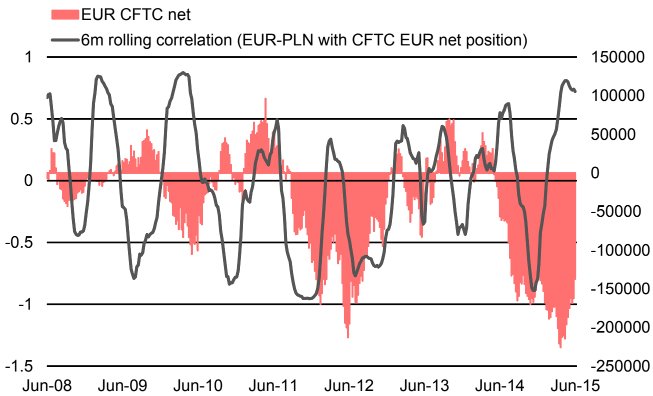


Chart 2: Instead, EUR-PLN is now highly sensitive to EUR short-covering



Source: Bloomberg, UniCredit Research

Expect a heavier tone in both pairs in July...

...which should once again reverse as we move to August

Beyond Greece, broader developments in the EGB market will determine the path of both crosses. Our fixed income strategy team expects a bit more stability in July on better seasonals and negative net supply[3]. All else being equal, we think that this will translate into some downward pressure on both crosses in July. However, we are not sure this move will last and we think the risk remains for a return of volatility in bund yields as well as increasing negative political noise in Poland from August onwards.

[2] YTD correlation of EUR-PLN with weekly CFTC net non-commercial EUR positioning is +0.65% vs. -0.43 from 2010-2013 and -0.21 from 2000-2015.
[3] See Curves & Crosses Rates: Seasonal patterns in EMU bond markets, 22 May 2015.

Wary of technical factors resulting in increasing bund volatility

Beyond the macro fundamentals, we are mindful of so-called "technical" factors related to the distortions created in demand and supply by central bank actions. We think this could continue to exacerbate volatility of moves. The experience of the JGB market in 2003 suggests that strong central bank unconventional easing, signs of a cyclical rebound as well as forced selling by Japanese banks can create a vicious cycle of higher yields resulting in actions that beget even higher yields. We have noticed some similarities in price action of bunds today with JGBs back then (chart 3). There may be many differences between the euro area now and Japan back then, but putting our strategist caps on, we think beyond an initial period of calm in July, higher volatility will remain with us.

…which should see both spot and especially implied volatility better bid further out

This matters a great deal to both EUR-PLN and EUR-HUF: of all EUR-CEEMEA FX crosses, a sizeable part of the volatility in both pairs seen over the past year can be explained by EUR rate volatility[4]. More specifically, EUR rate volatility has explained an even greater proportion on a longer 5-year view, hence we doubt FX volatility will stay lower than bund volatility may dictate in the months ahead (chart 4).

Chart 3: Volatility in EUR rates: A known unknown (Bund yields now vs. 2003 JGB VaR shock)

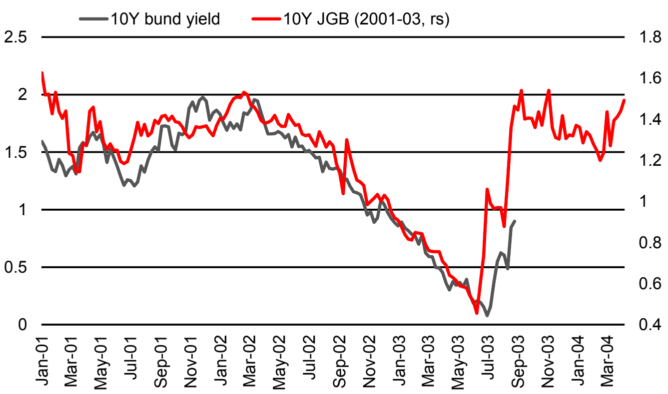
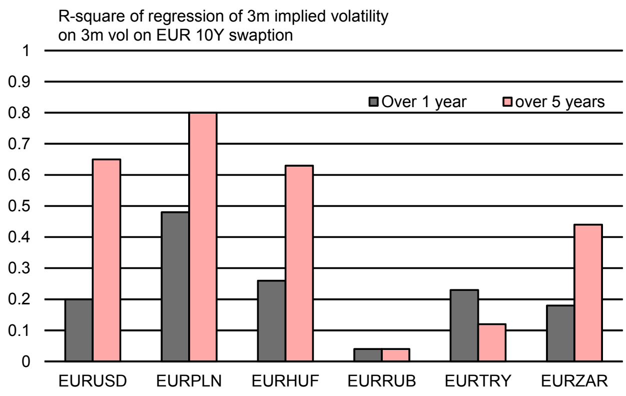


Chart 4: EUR-HUF and EUR-PLN implied volatility to be increasingly driven by volatility in EUR 10Y yields



Source: Bloomberg, UniCredit Research

In addition, political noise could increase in Poland from August on…

Increased pricing of NBP rate hikes could temper PLN losses

At the same time, while markets so far have paid little heed to the ruling PO party slipping behind in polls ahead of the October parliamentary election in Poland, we think there may be an increase in political noise from August onwards when President-elect Andrzej Duda assumes office. This will likely weaken the PLN from a tactical perspective, even though the broader macroeconomic fundamentals remain solid. A factor that could limit losses on the Zloty during this period (relative to the Forint) would be if markets start pricing in higher rates as a rebound in inflation adds to a solid domestic growth trajectory. Currently inflation is still negative and markets are pricing in modestly higher rates; 25bps and 50bps in 12 and 18 months respectively. Once inflation starts to rebound, its plausible markets could price in some further tightening. That said, in the next three months, we think the external environment and political noises could dominate.

Look to accumulate call options in both EUR-PLN and EUR-HUF awaiting a July "dip"

Taken together, we think both pairs remain a buy on dips for now. In July, there may be scope for tactically selling both pairs. But on a three-month view, the better strategy may be to accumulate long positions in **both EUR-PLN and EUR-HUF in July via call options, betting on a move higher in both spot as well as implied volatility.**

[4] We use the implied volatility on a 3M10Y EUR IRS swaption in this example (Bloomberg ticker is EUSN0C10 Curncy).

TRY: Medium-term bearish but opportunities for a relief rally on a coalition

Look to build long positions in EUR-TRY

As far as the Turkish lira is concerned, on a longer-term view it remains one of the weakest currencies in the region for reasons we have discussed many times: still wide external imbalances, a highly leveraged domestic sector and a lack of competitiveness. **We like being strategically long EUR-TRY on any dips.** Our impression is also that with external demand weaker, the CBRT would welcome weakness in TRY against the EUR and we have noticed the central bank subtly placing increasing emphasis on the lira being strong against the euro rather than the lira being at its weakest levels against the USD.

Political uncertainty will last longer...

In the near term, political uncertainty will keep markets in limbo: the time line is such that the 45-day deadline for a coalition to be formed applies from around the beginning of July (rather than the 7 June election result), roughly from when the speaker of Parliament will be elected. This means uncertainty can remain with us for a while. That said, **if we do get more signs of a coalition being formed- especially with the MHP** which has a strong economic team, we think that there may be scope to position for a decent relief rally in the lira. A first hint could be political parties agreeing on the election of the speaker of parliament. That said, any TRY recovery should not last too long as any such coalition could prove unstable and its possible the AKP finds some of the demands made by any coalition hard to swallow.

…but greater signs of a coalition being formed in July…

…could result in a rally in TRY-ZAR

On 29 June , the South Africa energy regulator (NERSA) meets to assess Eskom's request for a hike in the electricity tariff over FY 2015-16 (from the 12.7% previously requested and already approved up to 25.3%). Should the request be approved, the SARB projects that it will result in inflation breaching its target for four quarters and adding 0.6ppt to the CPI peak seen at 7.4% in 1Q16. Such a development will almost certainly ensure a hike by the SARB at its meeting on 23 July. However, the risk has been well flagged and markets have already begun pricing in a series of rate hikes; the ZAR 9X12 forward rate agreement now trades 95bp over the 3-month money market rate compared with flat back in February. Moreover, we do not think such a development of high inflation (on a supply shock) amid weak growth will be taken well by the market and the ZAR could come under increasing pressure.

Relative positioning suggests scope for some tactical TRY outperformance

Furthermore, our analysis suggests that TRY may have priced in a fair amount of political risk and uncertainty relative to other countries facing some similar external imbalances (chart 5) whereas positioning – which we gauge here by estimated ETF flows (chart 6) has been increasingly short from March onwards compared to neutral (in the case of South Africa) or slightly long (in the case of Indonesia). The latter two are also at risk of higher US rates, and in a relative value position we would be removing the negative beta to rising US rates.

Chart 5:
TRY vs. ZAR & IDR (spot and 3M implied volatility)

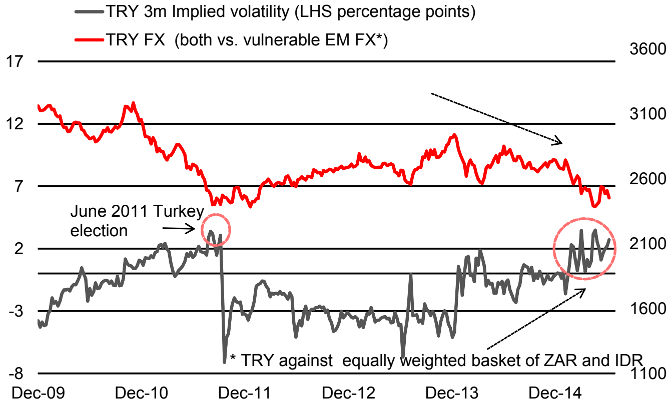
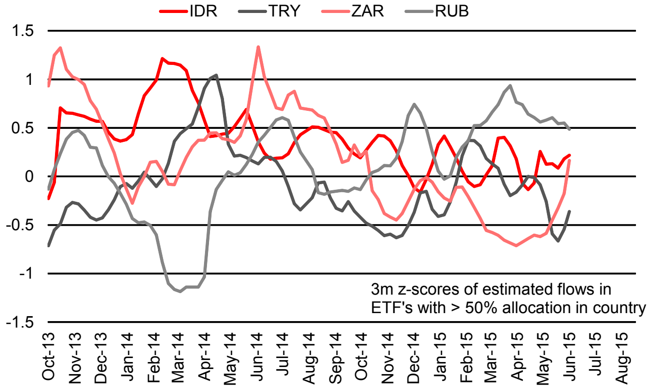


Chart 6:
ETF Z-scores show investors short TRY, neutral ZAR and long RUB



Source: Bloomberg, UniCredit Research

RUB: In a 50-60 range on USD-RUB, but initially at the weaker end

In a 50-60 range on USD-RUB…

We think the ruble will continue to remain in a range of about 50-60 on USD-RUB, pivoting around the 55.00 level which the CBR appears to be comfortable with. As before, the main drivers for the currency will remain the outlook for energy prices as well as whether there is a meaningful escalation or de-escalation in sanctions. The recent G7 meeting suggested that any de-escalation of sanctions remains a remote prospect for now.

…but RUB biased weaker first on elevated positioning in brent crude futures as well as RUB…

In the very near term, we think the greater risk may be for weaker energy prices weighing on the RUB. We find that positioning in Brent crude is quite stretched on some measures and we are coming off of levels that resulted in a correction lower (chart 7). Similarly, ETF positioning (see chart 6 above) reflects that some investors have built up positions in RUB via unhedged equity inflows and the positioning remains elevated. Both of the above suggest that the risk is for position reduction at this stage.

Budget performance and daily FX intervention dynamics will be important

Further out, the two other things to monitor in gauging the authorities' preferable level for the RUB will be **1.** Budget performance and **2.** Dynamics around FX intervention.

The budget deficit has been widening at the fastest pace since the aftermath of the 2008 financial crisis and authorities will likely want to keep the crude oil price (in RUB terms) at a level that brings them closer to achieving their fiscal targets (chart 8). Additionally, the dynamics surrounding daily interventions will be an important signaling tool: Indeed, recently the CBR abstained from its daily USD 100-200mn intervention when USD-RUB was testing above 57.00. The central bank apparently remains concerned that too volatile movements in the RUB could see households (that have in recent months reversed their demand for hard currency) lose faith once again.

Sterilization of FX intervention suggests the CBR not actively trying to devalue RUB…

It's not clear to us that FX intervention in itself is part and parcel of a process to engineer a weaker RUB. In a number of speeches, the CBR has tried to communicate that intervention is more a means to build up FX reserves buffer gradually over a 5-7 year period, rather than an outright measure to weaken the currency. Indeed, the CBR Governor stated recently that any intervention will be sterilized. Had the CBR chosen to leave proceeds unsterilized while also cutting interest rates, it would have been a red flag that the central bank is indeed actively pursuing a RUB devaluation. That is not the case at present.

Chart 7:
Crude energy prices at a risk of another correction?

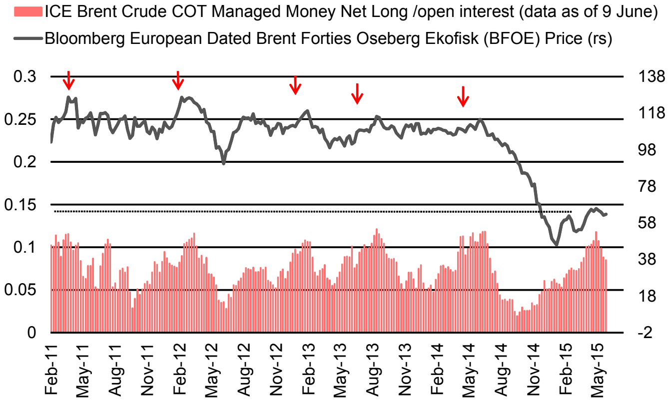
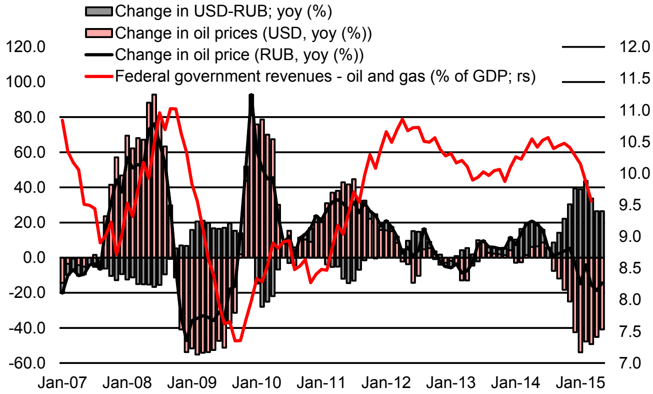


Chart 8: Budget performance will be important for gauging the authorities' preferences for the RUB



Source: Bloomberg, UniCredit Research

CZK: Stronger from August on as the debate over floor exit heats up

CZK could weaken modestly in July on stabilization of bund yields and seasonal weakness in C/A

Consistent with the potential for some stability in bund yields through July, we think there could be some moderate underperformance in CZK. At current levels, CZK stands at the top of the range against a basket of PLN and HUF (chart 9). Seasonally, increased repatriation of profits by multi-national companies in the Czech Republic tends to weaken the current account surplus from Q2 onwards. This was not evident in the April data, but if seasonals repeat themselves, there could be some modest weakness initially in CZK (chart 10).

But increasing signs of CNB debating an exit from the EUR-CZK floor could see CZK better supported

However, much will depend on the evolution of the CNB's communication given the stronger signs of a cyclical rebound taking hold. Our economists believe that the CNB could increase the debate surrounding an exit from the EUR-CZK floor from August onwards, when the next inflation report is released. The next event in this regard will be the CNB meeting on 25 June. Should the central bank change its characterization of risks to inflation from "downside" to "balanced", markets could bid CZK higher.

Next event risk is the CNB meeting on 25 June

In the absence of a strong change in the characterization of risks to inflation (from downside risk to balanced), we think there could initially be some modest weakness in CZK over July. But the situation from August on will likely reverse as we approach the inflation report or if volatility in core yields resurfaces. From that point onwards, we expect a decisive break of support and we see the CZK strengthening against both HUF and PLN as markets look towards the impending rate hike from the Federal Reserve. Historically, CZK has had a lower beta to US yields compared to either the PLN or the HUF.

Chart 9:
50:50 basket of PLN & HUF vs. CZK: At lower end of recent ranges

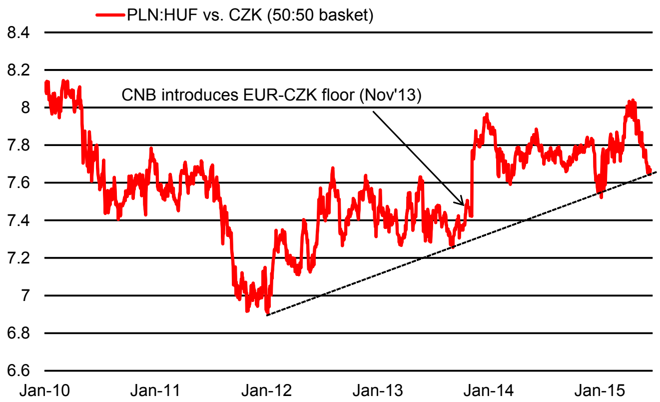
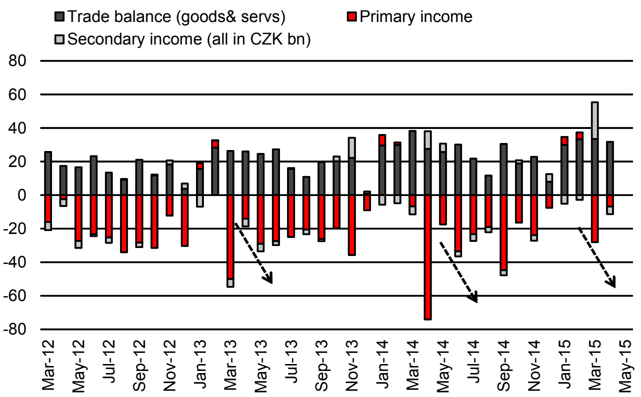


Chart 10: CZK:
Primary income deficits could weigh on C/A in the next few months



Source: Bloomberg, UniCredit Research

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

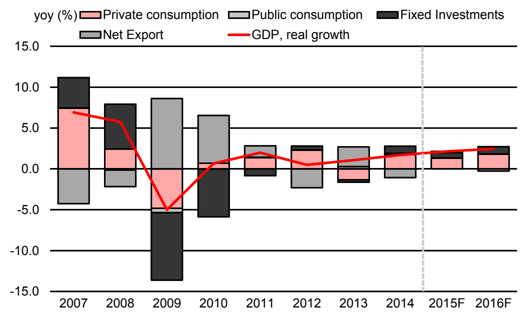
Outlook – We revised upward our projection for real GDP growth from 1.9% to 2.1% for this year and to 2.4% (from 2.3%) next year. This revision reflects the marked export-led acceleration of economic activity in 1Q15 as well as the much stronger and faster than initially anticipated impact that lower energy prices and the weaker euro have had on the growth and jobs recovery. In a low-capital flow environment and with room for fiscal policy accommodation limited, we expect stronger exports, gradually rising employment and improved absorption of EU funds to be the main growth drivers both this year and next. The main risk to our baseline scenario remains the non-negligible probability for a Greek sovereign default that could trigger a messy exit of the country from the euro area.

Author: Kristofor Pavlov, Chief Economist (UniCredit Bulbank)

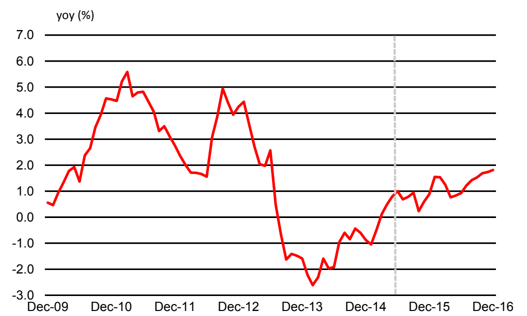
KEY DATES/EVENTS

- 3Q: Appointment of new BNB governor
- 14 Aug: GDP flash estimate 2Q15
- 14 Aug: Number of employees 2Q15

GDP GROWTH WILL SLOWLY GAIN STRENGTH



DEFLATION RISK EASED MARKEDLY



Source: NSI, BNB, MoF, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	40.9	41.0	42.0	43.1	44.7
Population (mn)	7.3	7.2	7.2	7.2	7.1
GDP per capita (EUR)	5 618	5 665	5 833	6 010	6 274
Real economy yoy (%)					
GDP	0.5	1.1	1.7	2.1	2.4
Private Consumption	3.2	-1.8	2.4	1.9	2.5
Fixed Investment	2.0	-0.1	2.8	2.7	3.9
Public Consumption	0.5	3.6	1.9	0.2	0.3
Exports	0.8	9.2	2.2	8.2	4.1
Imports	4.5	4.9	3.8	7.6	4.3
Monthly wage, nominal (EUR)	374	396	423	453	482
Unemployment rate, avg (%)	12.3	12.9	11.4	10.2	9.4
Fiscal accounts (% of GDP)					
Budget balance	-0.4	-1.8	-3.7	-2.6	-2.5
Primary balance	0.3	-0.9	-3.0	-1.7	-1.5
Public debt	17.6	17.9	26.9	28.9	30.2
External accounts					
Current account balance (EUR bn)	-0.1	0.8	0.4	1.4	0.8
Current account balance/GDP (%)	-0.3	1.9	0.9	3.2	1.9
Basic balance/GDP (%)	2.3	4.9	3.1	5.6	4.5
Net FDI (EUR bn)	1.1	1.2	0.9	1.0	1.2
Net FDI (% of GDP)	2.6	3.0	2.2	2.4	2.6
Gross foreign debt (EUR bn)	37.7	36.9	39.8	40.2	40.4
Gross foreign debt (% of GDP)	92.2	90.0	94.7	93.4	90.3
FX reserves (EUR bn)	15.6	14.4	16.5	19.6	21.7
Inflation/Monetary/FX					
CPI (pavg)	3.0	0.9	-1.4	0.4	1.4
CPI (eop)	4.2	-1.6	-0.9	0.9	1.8
Central bank reference rate (eop)	0.04	0.07	0.02	0.02	0.03
USD/BGN (eop)	1.48	1.42	1.61	1.81	1.69
EUR/BGN (eop)	1.96	1.96	1.96	1.96	1.96
USD/BGN (pavg)	1.52	1.47	1.47	1.81	1.75
EUR/BGN (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

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

Bulgarian recovery is taking a stronger hold

Some of the upside risks to our near-term growth forecast have materialized in 1Q15

The favorable external environment helped real GDP growth to accelerate to 3.5% qoq in 1Q15 saar. This is not only the strongest reading in more than four years, but is also more than double the average quarterly growth posted in the preceding two years. This solid performance was once again powered by exports, while domestic demand stabilized near the levels reached at the end of 2014. Exports, which rose at an impressive 20.6% saar qoq 1Q15, surprised on the positive side, coming on the back of a significant 37.5% saar jump in the previous quarter.

Lower prices of energy should continue to support households' disposable income and corporate profitability, and therefore private consumption and investment

The sharp acceleration in Bulgarian exports (which now exceed the pre-crisis level by as much as 40%) rests on sound foundations. This impressive performance is above all attributable to the new production capacities in manufacturing including pharmaceuticals, cosmetics, furniture and household appliances, but also, increasingly, automotive components and spare parts. Rising investment in transportation and services outsourcing also helped push export volumes up. In addition, it seems that Bulgarian exports have benefited more from the current extraordinarily favorable external environment than those of most of its peers. Lower energy prices have been more supportive to Bulgarian exports, with the economy far more energy intensive than the rest of the CEE with which it competes mostly in the same markets. Finally, deeper deflationary pressure over the past year translated into stronger cost competitiveness gains vis-a-vis the countries that are members of the euro area or had pegged their currencies to the euro.

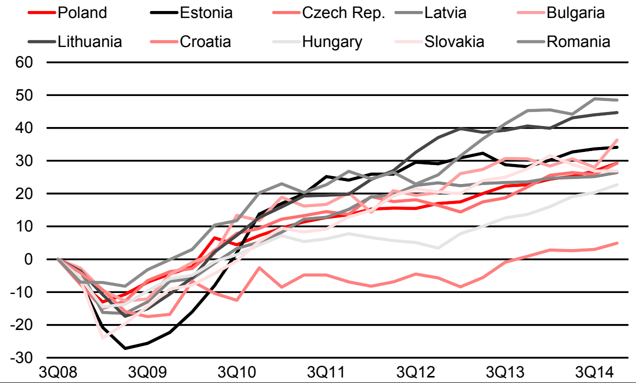
53k jobs were added in 1Q15 from a year before, which helped push unemployment down to 10.6% in 1Q15, from 13.0% over the same period in 2014

These developments bode well for the economy in the medium term for at least two reasons. First, they imply that the acceleration of exports is sustainable, suggesting that the outlook for exports has improved. And second, the latter should also support the jobs and incomes recovery, as many export-oriented companies seem to have reached the point where expanding output would require adding more workers and perhaps even start raising wages more rapidly. Stronger employment, in turn, would be crucial for boosting private consumption and household sector recovery further, both of which have lagged thus far.

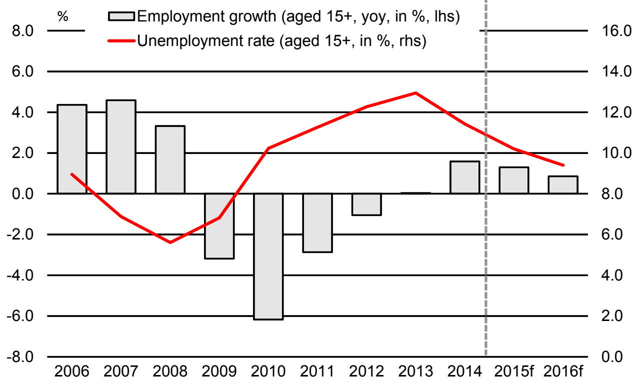
We revised upwards our growth projection for this year and next as some important reforms appear to have gained momentum

Given all of the above, we revised upward our projection for real GDP growth for 2015 from 1.9% to 2.1% and for 2016 to 2.4% from 2.3%. We expect, given the low-capital flows environment and limited scope for further fiscal accommodation, that stronger exports, along with gradually rising employment and improved absorption of EU funds, will be the main growth drivers in the near term. More importantly, the government has finally taken some of the painful measures needed to stabilize the ailing energy sector, and is likely to bring its overreliance on Russia as the only supplier of natural gas to more manageable levels by the end of the decade. Another positive development is the success of the tax and customs authorities to reduce smuggling that shifted the general government balance to a large surplus during January-April.

Cumulative change in exports in CEE countries since 3Q08 (3Q08 = 100)



Employment growth and unemployment rate forecast



Source: Eurostat, NSI, UniCredit Research

However, much more remains to be done on combatting corruption and investing in human resources

However, the medium-term growth outlook will continue to be dampened by the sluggish pace of important structural and institutional reforms. Key among these is the fundamental reform of the judicial system which is needed to reduce corruption and red tape, along with the restructuring of the underfinanced healthcare and education sectors. Some initial steps have been taken on all of these, but much more remains to be done. The need for further balance sheet adjustments in some sectors, where debt remains elevated, is likely to hamper growth as well.

We expect fiscal policy to remain growth neutral this year….

With the government intent to cut the fiscal deficit to 3% of GDP from the 3.7% in 2014

Min Fin's preliminary estimates show that the budget had a hefty surplus during January May, equal to BGN1.3bn, or 1.5% of GDP of annual GDP. This reflects a combination of overly conservative macro assumptions underpinning the budget and solid progress in boosting tax collection. If the government's estimates prove correct, tax revenue may exceed the budget by 1.8% of GDP for the full year. This should open additional room for boosting non-interest spending, which should be growth positive, but would also allow saving some of the extra revenue to reduce the deficit by more than targeted. We doubt the government would use the whole available fiscal space to boost spending and support demand, even though GDP growth remains uneven and the labor market recovery seems still at an early stage. We think that policy makers will use some two-thirds of the windfall to boost spending, including co-financing for the shovel-ready EU funded projects from the new planning period, while the remaining one-third will go to cut the deficit to perhaps some 2.6% of GDP in 2015 compared with the 3.0% of GDP target.

The risks associated with a Grexit seem exaggerated…

…with Greek-owned banks in much better shape now

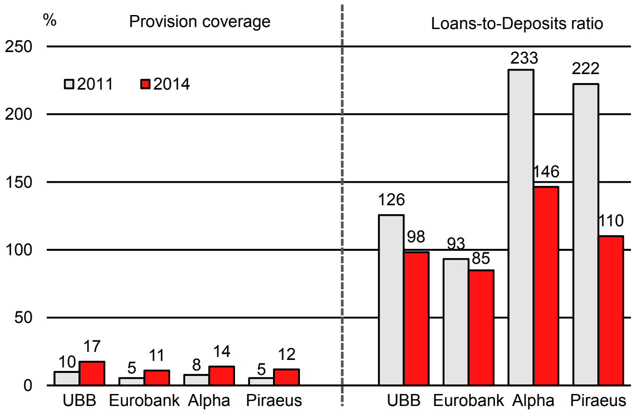
Resilience should be boosted also by the generally good health of the banking system…

…a solid external position…

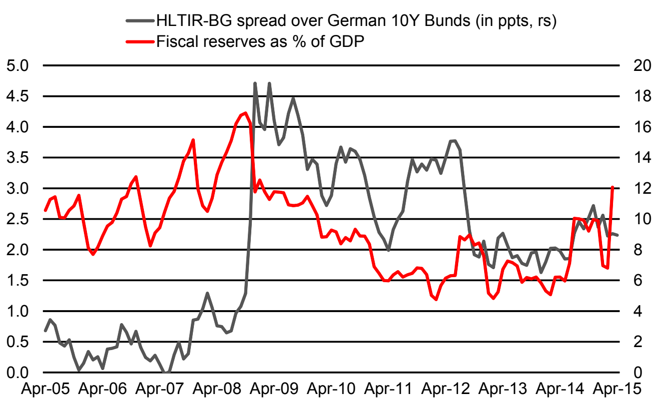
…and abundant liquidity

The potential fallout of a "Grexit" remains the key near-term risk. However, the risk for capital flows is smaller than in 2012 and appears greatly exaggerated. The subsidiaries of Greek banks in Bulgaria are in much better shape now, which helped them to greatly increase their capacity to absorb shocks. Loan-to-deposit ratios are much lower and provisions have doubled relative to 2012 (see lhs chart). This suggests that good progress has been made over the past few years in absorbing most of the remaining losses stemming from the bursting of the real estate bubble and subsequent recession. True, there has been some leakage of deposits triggered by intensified concerns over Greece, but its size seems manageable given the overall strength of the banking system. On a consolidated level, the sector is flush with liquidity, with a loan-to-deposit ratio down to 83.6% in April, the second lowest in CEE. The external position is solid, too, with both 12M CA and extended basic surpluses widening (to 1.6% and 6.4% of GDP) in March 2015, from already very robust levels in the year before. The fiscal reserves stood at 12% of GDP in March, prompting the government to scrap two domestic bond issues in March and April on top of all auctions scheduled for June.

Greek banks' KPIs



Strengthening of funding costs and fiscal buffers



Source: ECB, BNB, MoF, UniCredit Research

Strategy: Recent selloff of Bulgarian assets presents a buying opportunity

Negative spillover to Bulgarian assets from Greek debt troubles intensified, despite a sustained reduction in vulnerability on almost every possible contagion front

We continue to see vulnerability to developments of the Greek debt situation as significantly reduced from before, due to sizable improvement on all possible contagion fronts. What's more, the successful debt management efforts of the MinFin have already addressed all of the sovereign's foreign funding needs for 2015. On the domestic front, issuance remains more limited and only 37% of the FY target has been achieved, but with expected fiscal outperformance the gross issuance target is likely to be revised down significantly. The successful return to the Eurobond market in March not only led to a material improvement in the maturity profile and funding costs for the sovereign, but also resulted in a rebuilding of fiscal buffers (to 12.1% of GDP) which allow for smooth coverage of remaining 2015 redemptions (2.5% of GDP), concentrated in 2H 2015. On a more fundamental level, abundant liquidity in the domestic financial system, particularly the banking sector, should keep yields at bay in an environment of continued deposit expansion, negative credit growth and limited GB supply.

We see room for closing of the recent widening in spreads vs. benchmarks

Investors' disregard for these fundamental support factors has resulted in an unfair, in our view, punishment of Bulgarian assets for trouble in Greece. The recent selloff on the external market has been followed, with a short lag, by the domestic front as the entire yield curve has undergone an upward shift. The biggest move was concentrated in the 10Y (domestic market) and 12Y (external) where local banks are less active and yields moved north by 58 and 69bp, respectively since the end of May. This compares unfavorably to increases in comparable Polish (65bp) and Croatian (59bp) paper, with residual maturity of 10Y highlighting the widening spread with regional and similar credit rating benchmarks. Against the background of healthy fundamentals, we view this as a good buying opportunity in light of the UCG's baseline scenario that the Greek sovereign does not default on its payments to official creditors.

Author: Nikola Georgiev, Economist (UniCredit Bulbank)

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**2.3**	**3.9**	**2.0**
Budget deficit	1.6	1.1	1.1
Amortization of public debt	0.5	2.6	0.7
Domestic	0.5	1.1	0.7
Bonds	0.4	0.1	0.6
Bills	0.2	1.1	0.2
External	0	1.5	0
IMF/EU/Other	0.2	0.2	0.2
Financing	**2.3**	**3.9**	**2.0**
Domestic borrowing	1.6	0.6	0.6
Bonds	0.6	0.4	0.4
Bills	1.0	0.2	0.2
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
Fiscal reserves change (- = increase)	-1.8	0.1	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**14.0**	**15.3**	**13.7**
C/A deficit	-0.4	-1.4	-0.8
Amortisation of medium to long term debt	4.8	6.2	4.6
Government/central bank	0.2	1.7	0.2
Banks	0.8	0.8	0.6
Corporates	3.9	3.7	3.8
Short term debt amortization	9.5	10.5	9.9
Financing	**14.0**	**15.3**	**13.7**
FDI	0.9	1.0	1.2
Portfolio flows	0	-0.1	0
Borrowing	7.2	7.4	5.6
Government/central bank	2.5	3.2	1.5
Banks	0.8	0.4	0.3
Corporates	3.9	3.7	3.8
Short-term	10.5	9.9	9.0
EU transfers	1.5	1.4	1.3
Other	-3.9	-1.2	-1.3
Change in FX reserves (- = increase)	2.1	3.1	2.1

Source: BNB, MoF, UniCredit Research

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

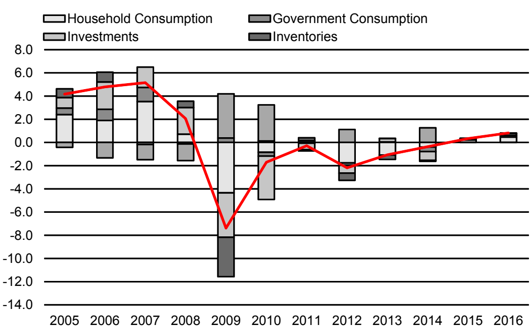
Outlook – The recovery of private consumption and continued growth in external demand in 1Q15 open the door to exit recession this year with modest growth of 0.3%. However, investments are expected to remain contained by both the uncertain investment environment and the unconvincing investment pipeline, while public consumption will have to remain subdued to meet EDP targets. The economy is faced with macroeconomic imbalances, which require a number of reforms and measures recommended in the latest Country Specific Recommendations from the European Commission. A general government deficit above 5% does not allow fiscal stimulus to the economy, as further public debt growth towards 90% of GDP is becoming a heavy burden for the economy.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

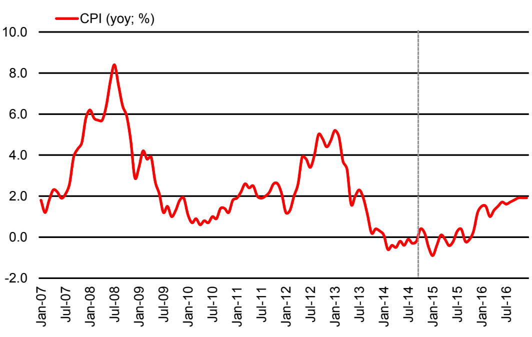
KEY DATES/EVENTS

- July: Local market bond issuance
- 17 July: Labor Market Survey 1Q
- 31 July: Disposable income survey 2010-2013
- 28 Aug: GDP flash estimate 2Q
- 4 Sept: GDP estimate 2Q
- 30 Sept: BoP 2Q

GDP GROWTH



INFLATION OUTLOOK



Source: IMF, MinFin, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	44.0	43.5	43.0	43.1	44.3
Population (mn)	4.268	4.256	4.236	4.216	4.196
GDP per capita (EUR)	10,301	10,225	10,161	10,214	10,550
Real economy yoy (%)					
GDP	-2.2	-1.1	-0.4	0.3	0.8
Private Consumption	-3.0	-1.9	-0.7	0.3	0.5
Fixed Investment	-3.3	1.4	-3.6	0.4	3.3
Public Consumption	-1.0	0.3	-1.9	-0.3	-1.5
Exports	-0.1	3.1	7.3	4.2	3.7
Imports	-3.0	3.1	4.3	3.9	3.6
Monthly wage, nominal (EUR)	1,048	1,048	1,042	1,048	1,072
Unemployment rate (%)	15.8	17.2	17.3	17.5	17.0
Fiscal accounts (% of GDP)					
Budget balance	-5.3	-5.4	-5.7	-5.3	-4.6
Primary balance	-1.9	-1.9	-2.2	-1.7	-0.6
Public debt	69.2	80.8	85.1	89.5	92.0
External accounts					
Current account balance (EUR bn)	-0.1	0.4	0.3	0.5	0.4
Current account balance/GDP (%)	-0.1	0.8	0.7	1.1	0.8
Basic balance/GDP (%)	2.5	2.8	3.4	4.2	4.7
Net FDI (EUR bn)	1.2	0.9	1.2	1.3	1.7
Net FDI (% of GDP)	2.7	2.0	2.7	3.1	3.9
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	111.8	113.1
FX reserves (EUR bn)	11.2	12.9	12.7	13.0	13.8
Inflation/Monetary/FX					
CPI (pavg)	3.4	2.2	-0.2	0	1.6
CPI (eop)	4.7	0.3	-0.5	1.2	1.9
1W money market rate	1.4	0.7	0.6	0.7	0.9
USD/HRK (eop)	5.73	5.55	6.30	6.61	6.27
EUR/HRK (eop)	7.55	7.64	7.66	7.73	7.65
USD/HRK (pavg)	5.85	5.71	5.75	6.70	6.40
EUR/HRK (pavg)	7.52	7.57	7.63	7.65	7.62

Source: UniCredit Research

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

Exiting from recession but facing many challenges

GDP is now expected to rise 0.3% in 2015, but identified macroeconomic imbalances weigh on growth prospects

GDP growth is on a modest recovery path, but risks stemming from macroeconomic imbalances still remain a drag on Croatia's recovery. Recent data releases for 1Q15 provide an encouraging start, but prospects of stronger growth this year remain constrained by weak competitiveness levels, high external liabilities, and both private and public debt levels. On the real economy front, recent consumer confidence and retail sales data point to a potential recovery in private consumption, reinforced by the income tax-driven increase in net wages. However, we doubt that this will translate into an immediate strong rebound of private consumption, since deleveraging tendencies in the private sector, namely by households, remain strong. Investment activity also remains weak and is likely to remain so due to poor project preparation and the austerity-driven cuts to public investment. The financial envelope from EU budget is becoming a big opportunity for Croatia to initiate new investment cycle. Envelope is very generous, at 2.6% of GDP per annum. However, implementation of investment activities defined in planning documents for EU financial perspective 2014-2020 is slow. Accelerated use of this source of funding, provided the authorities also properly tackle the structural reforms included in the new set of Country Specific Recommendations prepared by the European Commission, could give an impetus to investment and GDP growth.

Investment recovery is recognized as important driver of growth, but still out of sight

European Commission urged reforms in a new set of Country Specific Recommendations

The European Commission accepts the recent proposal of policy measures, but continues to emphasize the risks of excessive macroeconomic imbalances. Announcing it a few months ago, the European Commission was considering an option to activate the Excessive Imbalance Procedure while waiting for submission of documents envisaged in the European Semester cycle. In those documents, the government presented its reform agenda and fiscal plans in the medium-term. Finally, an option to taper the requirements was not exercised, but the need for reforms was emphasized once again. Recommendations were presented in the following six areas with further policy measures to follow: fiscal and tax policy, pension and health care reforms, labor market and social welfare, governance in public sector/SOEs and territorial and administrative organization of local units, institutional and legal framework for doing business, private debt restructuring and privatization.

Headline deficit targets have widened, putting public debt dynamics further at risk

Corrective fiscal measures are considered a necessary precondition to create an environment for other reforms. Final budget deficit data for 2014 showed a gap of 5.7% in 2014, which also translated into public debt amounting to 85% of GDP, although it is important to note that it is also a consequence of more comprehensive coverage of general government then ever before. However, the very first recommendation from the list above is linked to fiscal consolidation, as the recent government agenda envisaged a delayed correction in the headline fiscal deficit figure, cutting it to below 3% only in 2017, while "structural effort" targets (1% in both 2015 and 2016) are set to be achieved. Structural efforts are not followed by a decline in the headline deficit figure as cuts on the expenditure side do not follow revenue dynamics. Recent projections from the MoF envisage a headline deficit target of 5.0% of GDP in 2015, including the new set of measures, triggered by the initial request from the European Commission. We still see some weaknesses in revenue collection and expenditure plans and the risk of a higher deficit of 5.3% of GDP. Such a fiscal gap should push debt towards 90% in 2015, increasing the burden for further consolidation as interest payments are already now at 3.7% of GDP.

Inflation is to remain low due to falling food prices and weak domestic demand

Weak domestic demand and contained food and energy prices will keep inflation subdued this year. Consumer prices have stagnated lately, following divergent developments in food, clothing and energy prices, as they still declined mildly, and the remainder of the consumer basket, where particularly the prices of services rose. Prices ex food and energy (core inflation) increased recently at between 0.8%-1% yoy. We entered the year with headline inflation still in negative territory, but towards the end of the year we expect a mild rise in energy prices and a recovery in domestic demand. This should result in a gradual rise in inflation, but the annual average of price changes should remain around 0% in 2015.

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

Outlook – The GDP quantum leap in 2015 (3.8%) stems from a rare combination of external and domestic factors such as strong car demand in the eurozone, robust investment and increased consumer spending. With higher-than-expected inflation, the CNB may consider exiting its FX intervention regime before mid-2016 and may start communicating this from August 2015 on. Fiscal policy will be growth conducive in 2015 and neutral in 2016.

Strategy outlook – CZGBs remain well supported by low financing needs, good primary market demand, lax monetary policy and excess liquidity. Yet an expected rise in UST and Bund yields could result in a steeper yield curve later this year, and we recommend paying 10Y swaps. Short-term rates could start moving higher once the CNB signals the end of FX interventions.

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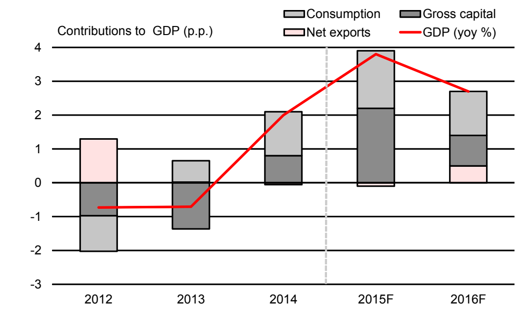
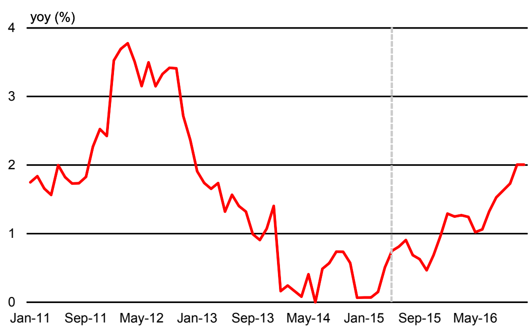
KEY DATES/EVENTS

- 25 Jun, 6 Aug, 14 Sept: CNB policy meetings
- 1 Jul, 3 Aug, 1 Sept: Manufacturing PMI
- 14 Aug, 28 Aug: 2Q15 GDP (flash estimate, structure)

DOMESTIC DEMAND WILL BE THE MAIN GROWTH DRIVER IN 2015 AND 2016



INFLATION TO ACCELERATE FROM EARLY 2016



Source: CZSO, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	161.0	157.3	155.0	162.1	171.5
Population (mn)	10.5	10.5	10.5	10.5	10.5
GDP per capita (EUR)	15,321	14,968	14,726	15,399	16,296
Real economy yoy (%)					
GDP	-0.7	-0.7	2.0	3.8	2.7
Private Consumption	-1.7	0.4	1.7	2.8	2.4
Fixed Investment	-2.8	-4.4	4.5	5.5	4.0
Public Consumption	-1.0	2.3	2.3	1.4	1.0
Exports	4.3	0.3	8.8	8.0	7.5
Imports	2.6	0.3	9.6	8.8	7.5
Monthly wage, nominal (EUR)	997	964	930	955	1,005
Unemployment rate (%)	6.8	7.7	7.7	6.6	6.2
Fiscal accounts (% of GDP)					
Budget balance	-3.9	-1.2	-2.0	-2.0	-2.0
Primary balance	-2.5	0	-0.4	-0.6	-0.6
Public debt	44.6	45.0	42.6	41.8	42.2
External accounts					
Current account balance (EUR bn)	-2.5	-0.8	0.9	0.2	0.1
Current account balance/GDP (%)	-1.6	-0.5	0.6	0.1	0
Basic balance/GDP (%)	1.4	-0.7	3.7	2.7	2.8
Net FDI (EUR bn)	4.8	-0.3	4.9	4.2	4.8
Net FDI (% of GDP)	3.0	-0.2	3.1	2.6	2.8
Gross foreign debt (EUR bn)	96.8	99.7	103.0	111.3	121.3
Gross foreign debt (% of GDP)	60.1	63.3	66.5	68.7	70.7
FX reserves (EUR bn)	34.0	40.8	44.9	50.0	50.0
Inflation/Monetary/FX					
CPI (pavg)	3.3	1.4	0.4	0.5	1.4
CPI (eop)	2.4	1.4	0.1	1.0	2.0
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
USD/CZK (eop)	19.06	19.89	22.8	23.4	22.0
EUR/CZK (eop)	25.14	27.43	27.73	27.40	26.80
USD/CZK (pavg)	19.58	19.57	20.7	25.3	24.2
EUR/CZK (pavg)	25.14	25.97	27.53	27.60	27.10

Source: UniCredit Research

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

The growth quantum leap

Rare concentration of tailwinds for the economy justifies our upward GDP forecast revision

We are revising substantially upwards our full 2015 forecast to 3.8% amid a rare combination of tailwinds for the economy, both from the external and the domestic demand side. Policies are set to contribute positively as well, with a moderate fiscal impulse underway and an accommodating monetary stance. As a result, we believe that the 1Q15 growth surprise is not a one-off. Nevertheless, this year's growth rate will exceed potential and we expect growth to slow next year, as some drivers will lose steam.

The 20-month streak of WE yoy growth in new car registrations is seen as one of the most important drivers of Czech GDP

Improving growth prospects for the eurozone are set to act as the key tailwind via trade links. In particular, the 20-month streak of annual growth in new car registrations in Western Europe pushed the estimated share of car manufacturing in total Czech GVA for 2014 to 5%, the highest in the EU. All three passenger car manufacturers will continue to expand production throughout 2015, benefiting from past investment and changes in production lines.

Construction activity starts to play a more prominent role in fixed capital formation

Despite exports growing at a fast pace, the contribution of net exports to GDP growth will be neutral at best due to strong import demand related to both investment and consumption. As to the former, capital spending on machinery and transport equipment has been on the rise since 3Q13 and a survey among manufacturers suggests that their capex growth may reach 9% this year. Confidence has improved among construction companies as the private sector started to releverage. As a result, tenders opened in 1Q15 were 60% yoy higher. Big projects are underway in real estate and logistics, while residential construction has yet to witness a takeoff despite residential prices bottoming out in 4Q13.

Private consumption is set to continue expanding, driven by low inflation and increasing employment

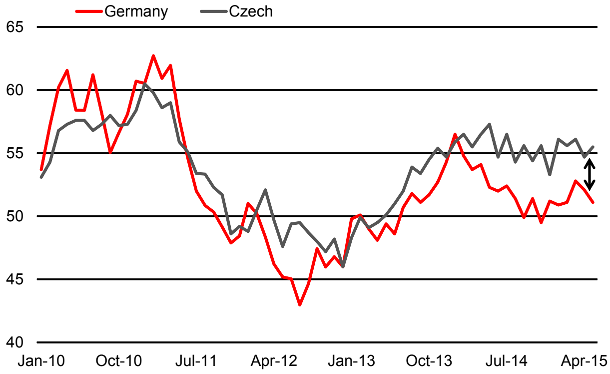
Private consumption is boosted by households' real income growth as well as pent-up demand for durables. Consumer confidence hit a seven-year high in January, before inflation bottomed out, and its current level is consistent with private consumption growth of 2-3%. In 2015, low inflation will compensate for weak nominal wage growth in supporting private spending. With most of new hiring targeting low-qualified job seekers, wage gains will remain modest. In 2016, we expect an acceleration in nominal wage growth to play a bigger role in driving private consumption, despite higher inflation. Government consumption will also expand in 2015, at least via healthcare spending. Loose regulation will generate additional demand for health services in the short term but poses a medium-term risk for public spending.

GDP dynamic is projected to outpace GVA in 2015

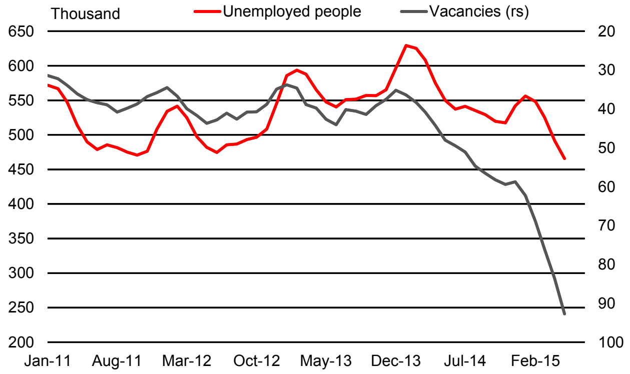
Last but not least, the role of uneven collection of excise taxes should be mentioned as a one-off influencing GDP growth. The factor understated the genuine GDP momentum in 4Q14, as suggested by the comparison of gross value added (GVA,3.0% yoy) and GDP (1.4% yoy). In 1H15, there is room for a pay-back of a similar magnitude.

INDUSTRIAL OUTPUT IS SET TO GROW AT A STABLE PACE, UNEMPLOYMENT TO SHRINK

The Czech PMI points to better momentum in manufacturing compared to Germany



The multi-year high in job vacancies highlights tighter labour market conditions



Sources: CZSO, UniCredit Research

Fiscal policy could be growth-conducive in 2015, turning neutral by 2016

The positive fiscal impulse is estimated at 0.5% of GDP in 2015, despite an expected fall in the share of government revenues and current expenditures in GDP. In contrast, capital spending could rise amid a stronger focus on public infrastructure projects financed from government and/or EU funds. The fiscal policy stance in 2016 is difficult to gauge at the moment. The central government budget deficit proposed by Finance Minister Andrej Babiš for next year stands at CZK 70bn, CZK 30bn less than the planned deficit for 2015. Coalition partners failed to agree on the budget draft and the budget law may be changed substantially before being adopted. We would rather count on a neutral stance for fiscal policy in 2016.

The pace of reflation could surprise further

Inflation is expected to end 2015 at 1.0% yoy and return to target by late 2016. Upward surprises pushed inflation 0.4pp above the CNB forecast by May 2015. The pace of reflation could surprise further, both due to stronger domestic demand – evident in non-food prices – and a reversal in supply-side shocks – evident in higher oil prices.

The CNB might consider ending sooner its FX intervention policy…

…due to a faster closing of the output gap…

…and higher inflation.

The CNB is expected to react already in June to the GDP quantum leap and stronger reflation. The central bank could move from downside to balanced risks to its inflation forecast, abandoning the idea of an upward shift of its EUR-CZK floor at the same time. Better GDP growth could lead to a faster closing of the output gap, now expected by the CNB in 2H16. As a result, the CNB may consider exiting its FX intervention regime before mid-2016 and could start discussing this option at the August MPC meeting. Whatever the outcome, we are convinced that the CNB will communicate in a timely manner any shift in its policy stance in order to prevent market volatility and to maintain its reputation for transparency and accountability. As a result, EUR-CZK is projected to trade trendless and range-bound over the next few months. The market could start positioning itself for a stronger CZK from late 2015 or early 2016 onwards if the exchange rate floor is abandoned in 1H16.

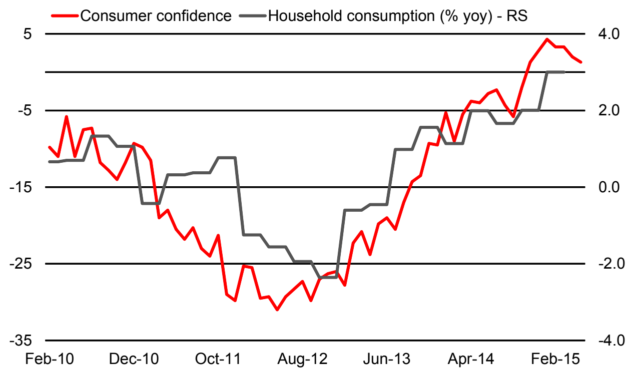
The GDP forecast comes with downside risks…

…but macroeconomic imbalances will be contained

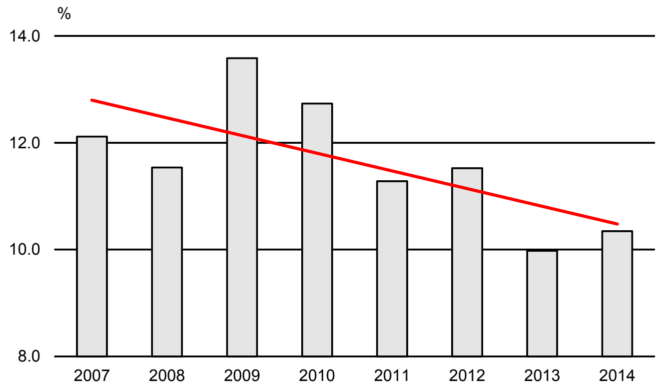
The sharp rise in our 2015 GDP forecast comes with greater downside risks. The growth momentum may be vulnerable to a premature end to any of the numerous supporting factors. Among external drivers, weaker car sales in the eurozone would affect Czech exports significantly. On the domestic side, the labour market is expected to tighten by 2016, resulting in labour shortages for new projects in some regions. Having said that, risks are related to GDP momentum, with macroeconomic imbalances contained or eliminated. The C/A is set to remain close to equilibrium this year and next, while a widening of the general government deficit will become an issue beyond 2016 if an economic slowdown is coupled with a lack of structural reforms.

IN 2015, PRIVATE SPENDING SHOULD BENEFIT FROM SOLID CONSUMER SENTIMENT AND A LOWER HOUSEHOLD SAVING RATIO

Consumer confidence near its 8-year high looks consistent with private consumption growth at 2% to 3%



The uptick in the households' saving ratio in 2014 is expected to reverse in 2015



Source: CZSO, Labor Ministry, UniCredit Research

Strategy: curve steepening is inevitable in 2016

Government financing needs are projected to be stable and may be partially covered by increasing the state treasury cash reserves…

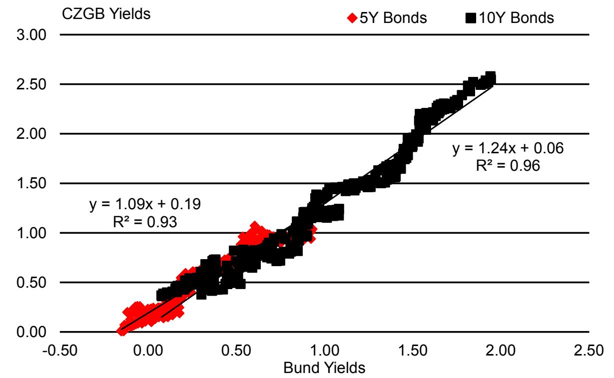
…but the CZGB curve could steepen in 4Q15 and 2016…

…due to higher UST and Bund yields…

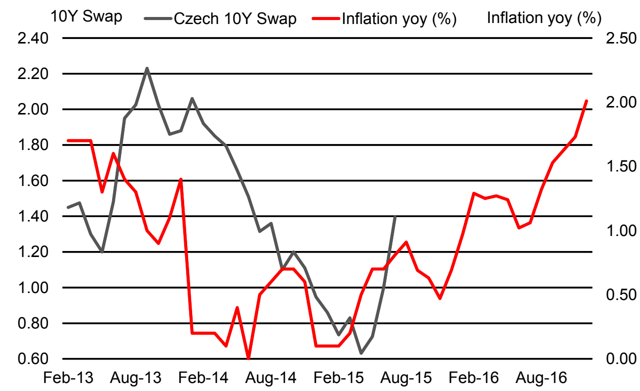
…with all yields moving higher once the CNB starts normalising monetary policy

We expect no supply pressure on bonds in 2015 as financing needs remain low, issuance has already covered over 50% of target and auction support remains strong. In addition, the MinFin intends to broaden the range of quasi-government institutions obliged to hold their accounts with the central bank. Although not our base-case scenario, the measure would increase the state treasury's cash reserve and could reduce bond financing by 1.0-1.5% of GDP. Nevertheless, the curve remains well anchored due to excess liquidity in the banking sector and strong support from European investors. Yields remain highly correlated with Bunds, and spreads to CZGB should be stable. In the short term, Bund redemptions and reinvestment in June/July combined with the ECB front loading QE purchases should stabilise Bunds yields and support CZGBs. Beyond July, however, upward pressure on UST and Bund yields could lead to a bear steepening of the CZGB curve. Some reprieve may come in September - October when Czech inflation is expected to dip. The potential abandoning of the CZK floor in 2016 will be seen as a first monetary tightening measure. This should see CZK strengthen but, with rate hikes likely to follow, the CZGB curve could come under further pressure. We recommend building a 10Y Czech payer swap position into the end of 2015 since the curve will start to steepen more aggressively into 1Q16 as inflation picks up.

Bund yields continue to be the short term driver of the CZGB



Rising inflation in 2016 will likely see the curve steepen



Source: Bloomberg, UniCredit Research

M-T AND L-T EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**46.9**	**47.1**	**50.0**
C/A deficit	-0.9	-0.2	-0.1
Amortisation of MT-LT debt	7.0	6.3	9.1
Banks	0.8	0.5	1.0
Government and central bank	1.6	1.3	2.8
Other sectors	4.6	4.6	5.4
Amortisation of ST debt	40.7	41.0	41.0
Financing	**46.9**	**47.1**	**50.0**
FDI	5.4	5.4	5.9
Borrowing	40.0	39.9	42.1
Banks	17.1	18.5	18.5
Government and central bank	2.5	2.3	3.8
Companies	20.4	19.1	19.8
EU transfers and other	1.5	1.8	2.1

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**13.3**	**13.3**	**14.9**
Budget deficit	2.9	3.6	3.7
Amortisation of public debt	10.4	9.7	11.2
Bonds	5.7	5.6	6.7
EIB loans	0.4	0.1	0.1
Bills	4.4	3.9	4.0
Financing	**13.3**	**13.3**	**14.9**
Domestic borrowing	10.2	10.5	11.7
Bonds	5.8	6.5	7.3
Bills	4.4	4.0	4.4
External borrowing	0	0.1	2.3
Bonds	0	0	2.2
EIB/IMF	0.1	0.1	0.1
Change in cash reserve	-3.1	-2.7	-0.8

Sources: CNB, MoF, UniCredit Research

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

Outlook – Growth will probably exceed 3% in 2015, but a slowdown in fixed investment is clouding the outlook for 2016. Exports will outperform as long as European demand remains strong. Steady consumption growth is accelerating inflation, which could return to target in 1Q16. Even so, the central bank is unlikely to reverse easing if inflation remains below 4%. Tight fiscal policies, the reduction of external debt and the central bank's self-funding plan could help Hungary return to investment grade in November.

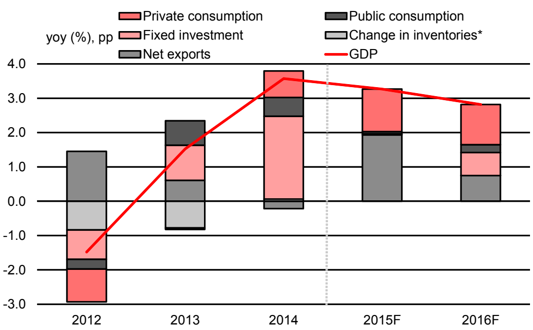
Strategy – Despite strong support from BoP flows and external deleveraging, the HUF is unlikely to appreciate strongly due to accommodative monetary policy. Stabilization in Bund yields may provide short-term support to HGBs, but ultimately we expect the curve to steepen toward year end and we recommend 3s10s steepeners and paying 10Y swaps.

Author: Dan Bucşa, Economist (UniCredit Bank London)

KEY DATES/EVENTS

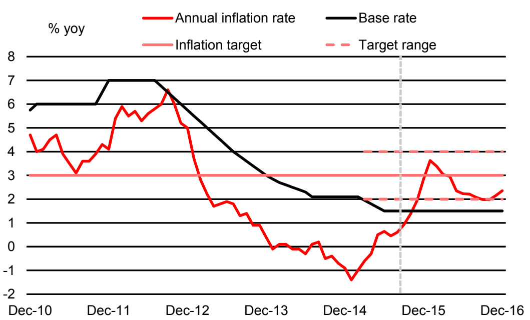
- 14 Aug, 4 Sept: 2Q15 GDP (flash estimate, structure)
- 23 June, 21 July, 25 Aug, 22 Sept: NBH rate meetings
- 20 Nov: rating review from Fitch
- 10 July, 6 Nov: rating reviews from S&P

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	107.6	111.6
Population (mn)	9.9	9.9	9.9	9.8	9.8
GDP per capita (EUR)	9,832	10,141	10,450	10,926	11,367
Real economy yoy (%)					
GDP	-1.7	1.5	3.6	3.2	2.9
Private Consumption	-1.9	-0.1	1.6	2.6	2.5
Fixed Investment	-3.8	5.2	11.7	0.1	3.1
Public Consumption	0	3.3	2.5	0.3	1.1
Exports	2.0	5.9	8.7	9.0	6.8
Imports	0.1	5.9	10.0	8.0	6.8
Monthly wage, nominal (EUR)	771	776	768	785	791
Unemployment rate (%)	11.0	10.2	7.7	7.3	7.1
Fiscal accounts (% of GDP)					
Budget balance	-2.3	-2.5	-2.6	-2.4	-2.5
Primary balance	2.3	2.1	1.5	1.6	1.5
Public debt	78.5	77.3	76.9	76.5	77.1
External accounts					
Current account balance (EUR bn)	1.8	4.1	4.3	4.9	5.7
Current account balance/GDP (%)	1.9	4.0	4.1	4.5	5.1
Basic balance/GDP (%)	3.4	5.0	4.6	4.2	5.9
Net FDI (EUR bn)	2.1	0.9	0.5	-0.4	0.9
Net FDI (% of GDP)	1.5	0.9	0.5	-0.4	0.8
Gross foreign debt (EUR bn)	127.5	119.5	118.4	117.5	117.3
Gross foreign debt (% of GDP)	130.6	119.0	114.7	109.2	105.1
FX reserves (EUR bn)	33.9	33.8	34.6	35.4	37.7
Inflation/Monetary/FX					
CPI (pavg)	5.7	1.6	-0.2	0.7	2.6
CPI (eop)	5.0	0.4	-0.9	2.8	2.4
Central bank target	3.0	3.0	3.0	3.0	3.0
Central bank reference rate (eop)	5.8	3.00	2.10	1.50	1.50
3M money market rate (avg)	5.8	3.11	2.10	1.54	1.65
HUF/USD (eop)	220.93	215.67	252.46	273.91	271.19
HUF/EUR (eop)	291.29	296.91	314.89	315.00	320.00
HUF/USD (pavg)	225.10	223.70	232.44	264.99	273.80
HUF/EUR (pavg)	289.34	297.01	308.66	309.01	313.58

Source: UniCredit Research

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

The central bank's tour de force

Economic growth is slowing, but remains broad based…

…with exports and industry performing the best

Hungary's economic growth is losing steam and needs new drivers to remain above 3% yoy. Quarterly growth rates are expected to slow below Central European averages this year and next, despite broad-based growth driven by exports and private consumption on the demand side and industry, construction and retail trade on the supply side. Hungarian exports are faring better in 2015 than in any other CEE country amid solid external demand and new production capacities, mainly at car, chemical and rubber manufacturers. The weak euro is helping, but it is European demand that is providing the strongest boost.

Private consumption is helped by wage growth, FX mortgage haircuts and a recovery in lending…

The picture is more mixed for domestic demand. Private consumption will enjoy the combination of robust wage growth and low inflation until the end of 3Q15. At the same time, the haircut to FX mortgage debt (20% on average) and low interest rates are helping households to borrow which, in turn, helped mortgage prices bottom out. However, the fiscal impulse to private consumption will decline in 2016, with major tax breaks postponed due to tight fiscal targets.

…but fixed investment growth is slowing for both infrastructure…

…and private investment

Fixed investment, which provided the largest contribution to GDP growth in 2014, will have a mixed evolution at best, even if their annual contraction in 1Q15 will prove temporary. The scope for infrastructure spending remains low as the government is still looking to acquire private companies. The recent brokerage scandal could wipe out the extra budget revenues that came with the improvement in domestic demand and tax collection, while banks could fund up to 94% of the losses covered by the financial sector. More worrying, private investment is struggling amid little new foreign investment and the slower EU fund uptake. Despite HUF interest rates falling to all-time lows, new corporate lending is relying mostly on the Funding for Growth Scheme, with the FGS and the FGS+ combining for HUF 37.5bn in net new lending in 4M15, enough to ensure that new lending remained positive in the year ending April 2015.

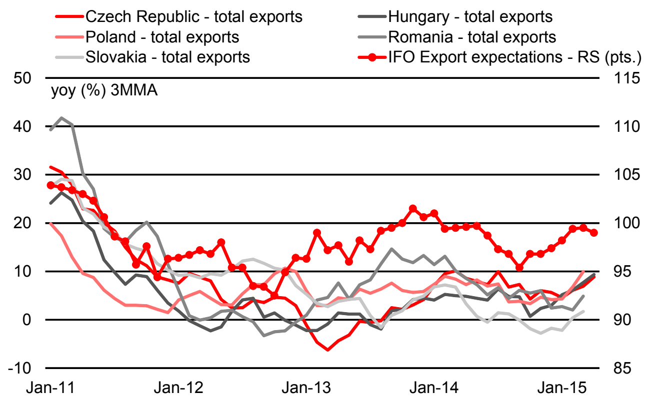
The central bank will continue to ease liquidity via rate cuts…

…the FGS and, if needed, subsidized IRS

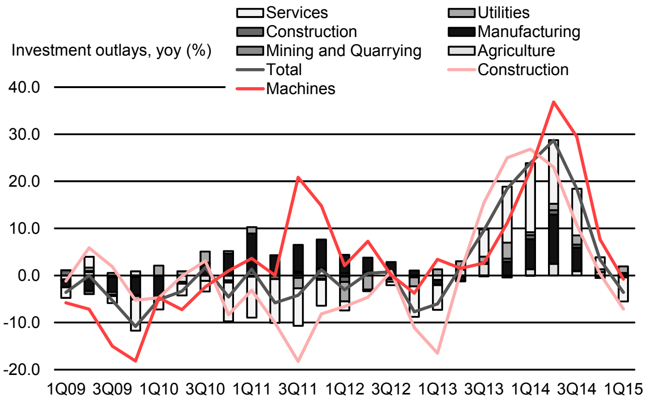
Sustainable growth needs a degree of predictability currently unavailable in Hungary. The central bank is holding the carrot: its lax liquidity policies are expected to target lower interest rates in the short term via rate cuts to 1.50% by the end of June and potentially to 1.20% by the end of 3Q15. Lower long-term rates could be achieved through the FGS and the change in monetary policy instruments. In order to boost the banks' demand for HGBs, the NBH will increase the liquidity coverage ratio to 100% from 2Q16 and will reopen the discount IRS facility to help banks extend duration[5]. The expected revival of the mortgage bond market is unlikely to support long-term yields[6] as limited demand could cap bond maturities at 3-5Y.

EXPORTS ARE DRIVING GROWTH, BUT FIXED INVESTMENT TURN INTO A DRAG

European demand and new capacities are driving Hungarian exports



Fixed investment is slowing sharply



Source: NBH, commercial bank reports, UniCredit Research

5 For details, please see the *EEMEA Macro Flash - Hungary: the summer easing season begins* from 3 June 2015.
6 For details, please see the *EEMEA Macro Flash - Hungary: introducing the Mortgage Funding Adequacy Ratio - not another easing tool* from 10 June 2015.

Inflation will continue to surprise on the upside…

…probably touching the 3% target in 1Q16…

…without triggering a reversal in rate cuts

The protracted easing cycle relied so far on falling inflation, but we believe that the pace of reflation will surprise the NBH. Last year's price cuts and falling fuel prices will exit the base and inflation could climb above 2.5% by year-end, unless food prices fall significantly this summer. Even though we expect inflation to reach the 3% target in 1Q16, we do not think that the NBH will reverse rate cuts next year. The central bank made monetary policy more flexible earlier this year by focusing on a 2-4% range instead of the 3% point target. Annual inflation will probably remain inside this range in the absence of significant shocks[7].

Government policies remain unpredictable…

…with banks likely to cover part of the brokerage losses

Meanwhile, the government is holding the stick, its unpredictable policies including ad-hoc taxation, interventions that weaken competition and backtracking on announced policies. Following the recent brokerage scandal, authorities could force banks to cover part of the losses via contributions to the Investor Protection Fund (BEVA), offsetting part of the HUF 60bn reduction in the bank tax scheduled for 2016. Frequent changes to taxation (most recently on advertisement and banks) might continue as the government is trying to comply with ambitious spending targets and the pledge to reduce public debt at the same time.

The tight budget execution in 4M15 bodes well for the 2015 deficit…

…but the Russian loan could threaten the reduction in public debt in 2016

The government changed the debt rule in order to avoid squeezing expenditures at a time when the negative output gap has almost closed. Even so, we still expect a small decline in the public debt to GDP ratio in 2015 as the budget deficit will remain well below nominal GDP growth. The 12M-rolling budget deficit narrowed to 1.5% of GDP in April 2015 and the 2.4% annual target remains within reach. Yet the deficit might have to fall towards 2% of GDP next year to allow for a lower debt to GDP ratio if Russia will disburse the first EUR 1bn loan tranche to build the Paks nuclear power plant.

A larger C/A, strong FDI and EU funds will finance external deleveraging…

…that is unlikely to lead to strong HUF appreciation…

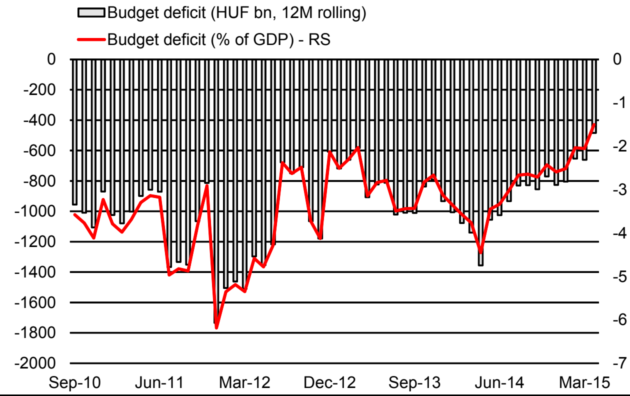
The C/A surplus could increase further this year if strong European demand for Hungarian goods and services offsets higher imports. Adding FDI and EU fund inflows, the extended basic balance will continue to cover all types of capital outflows, allowing for a further reduction in external debt. The conversion of FX mortgage loans into HUF and the potential conversion of HUF 300bn in FX (mostly car) loans will accelerate external deleveraging. Despite the external rebalancing, the HUF is unlikely to appreciate strongly due to additional monetary easing and the reduction in the EM exposure of USD-based investors.

…but will increase the chances of one (maybe two) rating upgrades to investment grade in November 2015

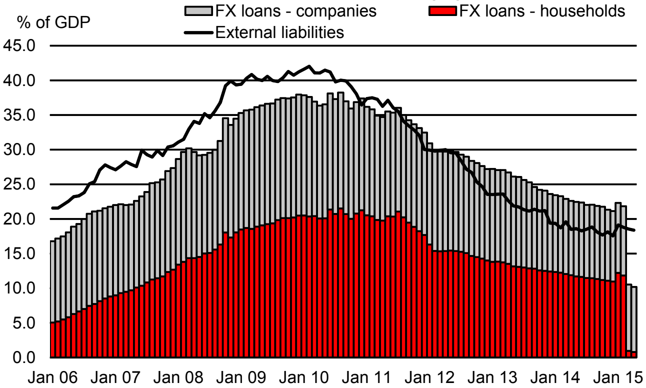
A combination of lower public and external debt could finally bring the first upgrade back to investment grade when Fitch will update Hungary's rating on 20 November. There is an outside chance that Moody's will upgrade Hungary on 6 November if the country sticks to reducing bank levies without threatening its goal of reducing public debt.

TIGHTER FISCAL POLICY AND LOAN CONVERSION WILL HELP REDUCE HUNGARY'S STOCK IMBALANCES

The fiscal adjustment is helped by the economic rebound



Banks' external debt will fall after the FX mortgage loan conversion



Source: CSO, NBH, UniCredit Research

[7] The most significant ones would be higher oil prices, a poor harvest in 2016 and strong HUF depreciation.

Strategy: Short-term support for belly as curve steepens

We recommend marketweight HGBs on a mixed outlook

The belly of the curve is better value…

…due to the roll-down in the curve…

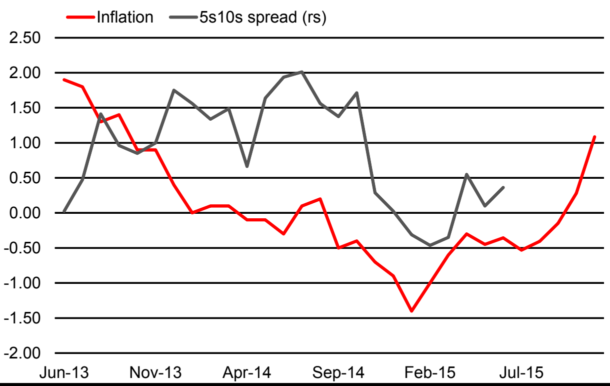
…while the long end should steepen as inflation rises

We recommend being marketweight in HGBs and avoiding the long end of the curve. Initially, we expect the local curve to bull steepen as Bund yields stabilise, the NBH cuts rates to 1.50% or below (the curve is pricing 20bp in cuts) and movement from two week deposits into T-bills will anchor the front end of the curve. HGBs up to the 5Y tenor continue to be held mostly by locals, helped partly by last year's discount IRS. This has provided an attractive roll-down in the belly of the curve and we recommend the HGB 22s with a spread of 58bp to the HGB 20s, and also the HGB Jun 20s with a spread of 36bp to the HGB 19s. Longer term, with inflation set to pick up combined with the issuance of mortgage bonds in 2016 (to reduce the banking sector asset-liability mismatch), long-dated HGBs remain vulnerable. In addition, foreigners still own most of the longer tenors despite reducing their holdings by HUF 373bn (7.7%) between 31 March and 15 June. As a result, long-end HGB yields have a stronger correlation with core rates and we recommend 5s10s steepeners and paying 10Y swaps.

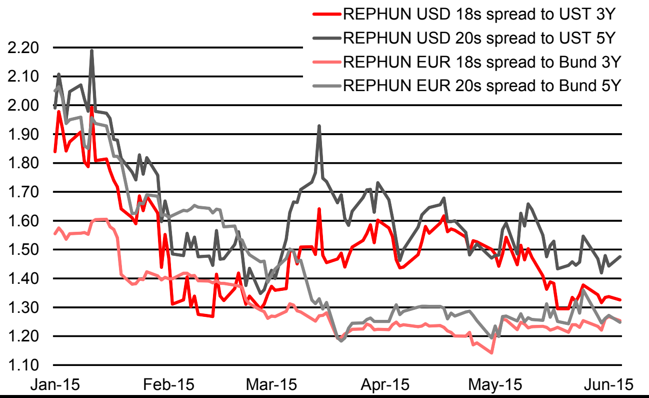
REPHUN USD bond still offer better value but REPHUN EUR bonds look fully priced

On a balance of risks, the REPHUN USD bonds continue to offer better value due to their lower core rate risk, higher yield and scarcity value since the AKK is unlikely to issue in USD. We recommend the REPHUN USD 23s. The REPHUN EUR bonds may offer an opportunity if Bund yields tighten, but with the REPHUN EUR 19s and 20s trading within a 5bp spread to Bunds, we see little value currently.

HGB curve should start to steepen toward year end



REPHUN USD bonds offer better value than REPHUN EUR bonds



Source: AKK, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**28.3**	**19.1**	**22.0**
Budget deficit	2.7	2.6	2.8
Amortization of public debt	25.6	16.5	19.3
Domestic	19.2	15.1	13.9
Bonds	7.8	4.2	3.2
Bills	6.2	5.3	4.9
Loans and retail securities	5.2	5.6	5.8
External	6.4	1.4	5.3
IMF/EU and other loans	3.5	0.3	2.1
Bonds	2.9	1.1	3.2
Financing	**28.3**	**19.1**	**22.0**
Domestic borrowing	25.6	19.4	19.5
Bonds	13.4	7.4	8.3
Bills	5.1	4.9	4.5
Loans and retail securities	7.1	7.1	6.7
External borrowing	2.3	0	2.5
Bonds	2.2	0	2.5
Other	0.1	0	0
Pension funds	0	0	0
Government reserves (decrease(+)/increase(-))	0.2	-0.3	0

Source: AKK, IMF, NBH, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**23.8**	**16.5**	**16.3**
C/A deficit(+)/ surplus(-)	-4.3	-4.9	-5.7
Amortisation of medium to long term debt	11.4	5.1	8.9
Government/central bank	6.9	2.1	5.2
Banks	2.1	0.7	1.5
Corporates	2.4	2.3	2.1
Amortisation of short term debt	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	**23.8**	**16.5**	**16.3**
FDI	0.5	-0.4	0.8
Equity	-2.0	-1.0	-0.8
Long-term borrowing	6.0	2.8	5.9
Government/central bank	1.8	0	3.0
Banks	1.9	0.5	0.8
Corporates	2.3	2.3	2.2
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	2.8	3.3
Change in FX reserves (reduction(+)/increase(-))	-1.5	-0.8	-2.3

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

Outlook – We increased our GDP growth forecast to 3.8% in 2015 and 3.9% in 2016 amid strong consumption and fixed investment growth, as well as better foreign demand. Inflation could climb to 0.7% yoy in December 2015 and towards 2.0% yoy by the end of 2016. We expect the NBP to hike rates by 50bp in 2H16. The private sector is releveraging, borrowing mostly long term and in PLN. The outcome of autumn parliamentary elections remains unclear, but we do not expect a U-turn in policies. Fiscal consolidation is set to continue in 2015 after the European Commission recommended lifting the EDP in May.

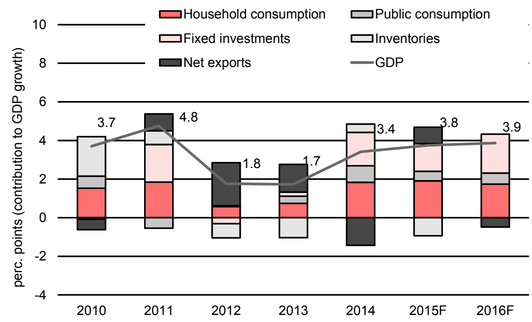
Strategy – Rising domestic demand and external factors are likely to cause the POLGB curve to steepen. We recommend being underweight POLGBs and initiating 2s10s steepeners and paying 10Y swaps. The zloty may remain under pressure due to political noise but could provide an attractive entry level against the EUR above the 4.20 level.

Author: Marcin Mrowiec, Chief Economist (Bank Pekao)

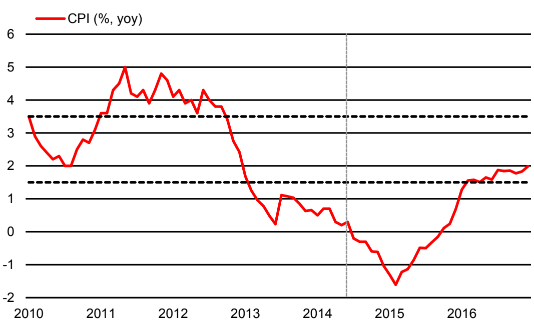
KEY DATES/EVENTS

- 7-8 July, 1-2 Sept, 5-6 Oct: MPC decision-making meetings
- Parliamentary elections – October 2015
- 31 July, 7 Aug, 11 Sept – rating reviews from Fitch, S&P, Moody's

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)	278.0	278.0	289.7	301.5	332.7
Gross foreign debt (% of GDP)	70.3	69.3	71.4	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	4.26	2.67	2.06	1.79	2.30
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: UniCredit Research

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

Political noise unlikely to affect broad-based growth

We revised our 2015 GDP growth forecast from 3.4% to 3.8%, and for 2016 from 3.4% to 3.9%...

...amid strong consumption growth...

Further improvements in the labor market, better foreign demand and larger fixed investment prompt us to revise our GDP forecast to 3.8% in 2015 and 3.9% in 2016, from 3.4% previously for both years. The risk of inflation expectations falling amid negative inflation did not influence wage setting at the beginning of 2015. Better corporate profitability permitted the inflation-adjusted growth rate of the wage bill to accelerate above 6% yoy. Higher inflation could slow real wage growth before the end of the year, but this is expected to be offset by additional household borrowing. Finally, social security spending will probably increase in the run-up to general elections, expected in October 2015. As a result, private consumption could contribute strongly to economic growth this year and next.

...better foreign demand...

Higher consumer spending will boost imports, but exports might outpace them in 2015 if demand from the eurozone improves further. Outside the EU, the weaker PLN vs. the USD is offset by falling demand from Russia, Ukraine and the Middle East. The larger trade surplus and lower profit repatriation are expected to help narrow the C/A deficit this year below 0.5% of GDP. As a result, the extended basic balance could record a surplus of 4.8% of GDP.

...and fixed investment

Strong external demand could further reduce spare capacity, supporting fixed investment. The latter rose by 9.8% qoq saar for the past seven quarters, accelerating again in the nine months ending March 2015 due to a combination of private investment and infrastructure projects supported by EU fund inflows. Even if the pace slows from here, this year's growth rate could be close to 7.4% yoy. Risks to robust, broad-based growth come mostly from the eurozone's resolution of the Greek debt problem and the stand-off with Russia.

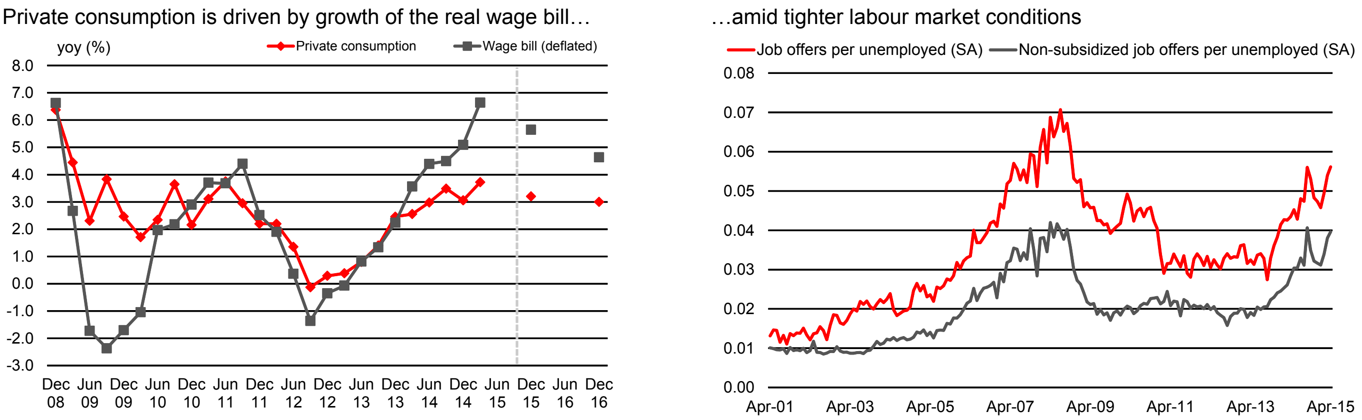
The outcome of autumn's parliamentary elections remains wide open...

A noisy election campaign will probably overshadow economic developments until autumn. After Andrzej Duda of the opposition Law and Justice Party (PiS) won May's presidential elections, PiS opened up a lead in opinion polls over the ruling Civic Platform (PO). However, the election outcome remains wide open, as three to six parties could enter parliament[8].

...but we do not expect a U-turn in policies

Even if the government majority changes, we believe that fears of a U-turn in policies are overblown. On the domestic front, PiS' time in power between 2005 and 2007 brought a reduction in budget deficits from 5.2% of GDP in 2004 to 1.9% of GDP in 2007 combined with cuts to personal income tax thresholds and social security contributions. On foreign policy, NATO and the EU remain Poland's natural allies, even though PiS is a euroskeptical party. Its anti-Russian stance is even tougher than that of the ruling PO.

TIGHTER LABOUR MARKET CONDITIONS SUPPORT WAGES AND PRIVATE CONSUMPTION



Source: StatOffice, UniCredit Research

[8] For details, please see the *EEMEA Macro Flash - Poland: higher political risk but no U-turn in public policies* from 29 May 2015.

Inflation is expected to climb to 0.7% yoy in December 2015…

…and towards 2.0% yoy by the end of 2016…

We expect CPI inflation to rise to 0.7% yoy by the end of the year after bottoming out in February at -1.6% yoy. As last year's food and fuel price shocks will exit the base gradually, headline inflation will return inside the 1.5-3.5% target range in 1Q16 unless food prices decline again amid another bumper harvest[9]. With the expected closing of the negative output gap, demand-side pressure on prices should push core and headline inflation higher, the latter being expected to end 2016 above 2.0% yoy. Inflation could exceed the 2.5% central target if oil or food prices rise faster than expected in 2016.

…and we expect 50bp in rate hikes in 2H16, but not sooner…

…due to gradual reflation…

With the threat of deflation declining significantly, the easing cycle is most likely over. This is in line with the Monetary Policy Council's statement after the 50bp cut from March 2015. However, the reversal of the easing cycle will probably have to wait until 2H16 for two reasons: the speed of reflation and changes in MPC membership. While volatile prices will contribute strongly to reflation from 3Q15 on, core inflation will probably remain low this year. Stronger consumption demand is expected to accelerate non-food inflation in 2016 without pushing headline inflation outside the target range. As a result, the MPC could fine-tune policy by hiking twice in September and November 2016 by a cumulative 50bp to 2%.

…and changes to the MPC in January-February 2016

We believe that rate hikes are not on the cards in 1H16 also due to elections to the MPC. The mandates of eight of ten current members will expire before the end of February 2016. Incoming MPC members will probably take some time to assess the need for policy changes before acting.

The private sector is releveraging

Lax monetary conditions pushed PLN lending rates to their lowest levels on record. As a result, private sector re-leveraging accelerated in 2015, driven by local currency loans. Longer-term borrowing for mortgages and investment is outpacing short-term loans for consumption and working capital, boding well for the resilience of the recovery.

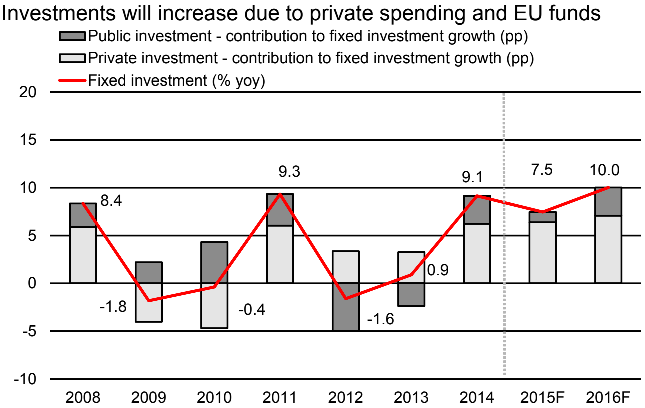
Poland exited from the EDP in May…

…with fiscal consolidation set to continue this year

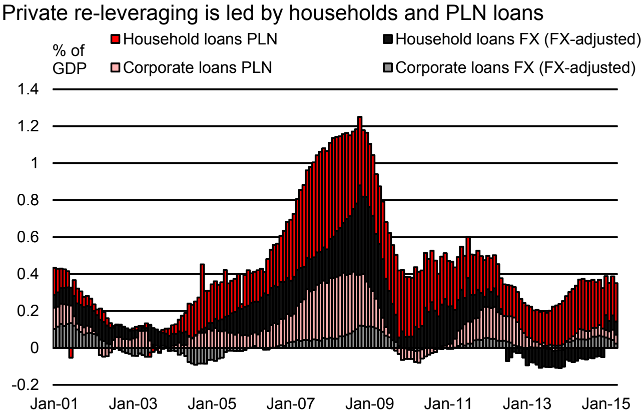
On 12 May, the European Commission recommended lifting the excessive deficit procedure (EDP), which was in place since 2009. According to official data, Poland's general government deficit narrowed to 3.2% of GDP in 2014. The reasons for a faster-than-expected lifting of the EDP were the sustainable reduction of the headline deficit close to the reference value from the Stability and Growth Pact (3% of GDP) and public debt below 60% of GDP. We expect the general government deficit to moderate to 2.8% of GDP this year. Proposals put forward by newly-elected President Andrzej Duda to raise the tax-free allowance and reverse the reform extending retirement age to 67 years are unlikely to be approved ahead of general elections in the PO-dominated parliament.

FIXED INVESTMENT AND PRIVATE SECTOR RE-LEVERAGING ADD TO GROWTH RESILIENCE

Investments will increase due to private spending and EU funds



Private re-leveraging is led by households and PLN loans



Source: StatOffice, UniCredit Research

9 In May, the European Commission forecasted crops to remain above the 5-year trend in 2015, factoring in a slight decline vs. 2014.

Accelerating growth to keep POLGBs under pressure

External factors and domestic demand will likely see the POLGB curve steepen in the coming months…

…and we recommend 2s10s steepeners and paying 10Y swaps…

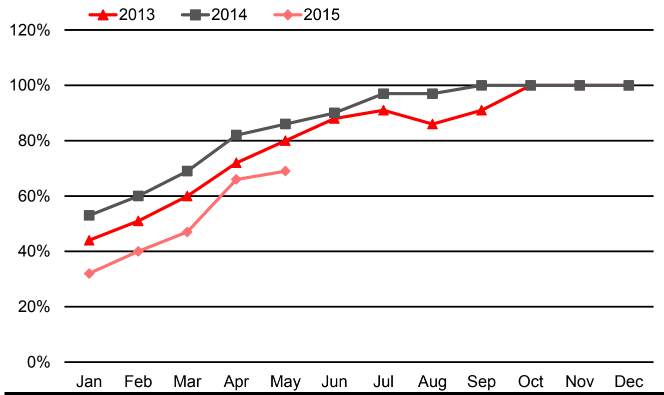
…but the curve should bear flatten into 2016 as rate hikes begin to be priced in

Although the NBP is likely to keep rates stable until mid-2016, rising inflation combined with risks of Fed hikes and higher volatility on Greek debt concerns are likely to keep the POLGB curve under pressure, leading to further steepening. In addition, if investors overestimate the political risk related to parliamentary elections, appetite for POLGBs could deteriorate, especially with foreigners predominately active in the long end of the curve, prompting further steepening. We expect the 2Y benchmark to breach 2.00% and the 10Y to be close to 3.50% in late 2015. As a result, we recommend being underweight in POLGBs, paying 10Y swaps and initiating 2s10s steepeners. In early 2016, a faster domestic recovery and higher inflation should see the market start to price in rate hikes, which may cause the curve to bear flatten. We see better value in USD bonds and favour the POLAND USD 22s longs against short POLGB 22s. Hard currency EUR bonds are generally trading very tight against Bunds.

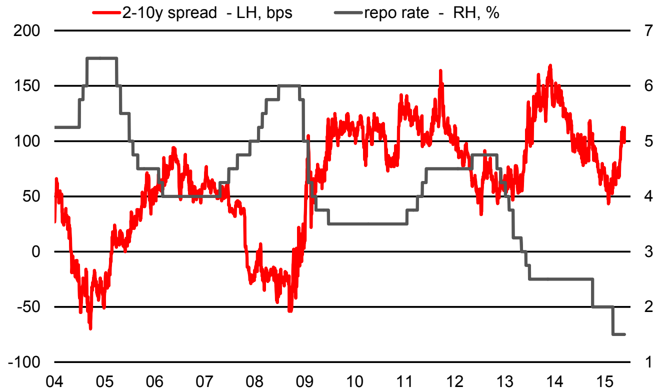
Election noise may provide an attractive entry to be long PLN vs. EUR

The zloty is likely to remain under pressure from domestic politics in the short term. We do not see the political risk as significant. A strong economic performance is likely to support the zloty in 4Q15 and we would look to go long zloty amid political noise in the run-up to parliamentary elections, looking for an entry level above EUR-PLN 4.20.

The coverage of borrowing needs is slightly below last years' level, but still well advanced



Yield curve may steepen further



Source: Finance Ministry, NBP, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**28.2**	**31.9**	**34.2**
Budget deficit	8.3	10.1	10.8
Amortization of public debt	19.9	21.8	23.4
Domestic	17.0	18.8	20.3
Bonds	17.0	18.8	20.3
Bills	0	0	0
External	2.9	3.0	3.1
IMF/EU/IFIs	0	0	0
Financing	**28.2**	**31.9**	**34.2**
Domestic borrowing	26.1	26.3	29.9
Bonds	27.5	27.1	31.1
Bills	0	0	0
Other	-1.4	-0.8	-1.2
External borrowing	2.1	5.6	4.3
Bonds	3.6	4.0	4.3
IMF/EU/WB	0	0.2	0
Other	-1.4	1.4	0

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**91.2**	**90.5**	**91.3**
C/A deficit	6.0	1.5	4.1
Amortization of medium to long term debt	37.9	43.5	42.8
Government/central bank	2.9	3.0	3.1
Banks	5.6	5.1	5.3
Corporates	29.4	35.4	34.3
Amortization of short term debt	47.3	45.5	44.4
Financing	**91.2**	**90.5**	**91.3**
FDI	6.0	7.5	8.0
Equity	0.6	2.0	2.0
Borrowing	71.5	59.0	57.1
Government/central bank	2.1	5.6	4.3
Banks	16.4	18.0	17.8
Corporates	53.0	35.5	35.0
EU transfers	10.7	31.0	29.6
Other	2.4	-9.0	-5.4

Source: CSOP, NBP, Ministry of Finance, IMF, UniCredit Research

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

Outlook – Private consumption remains the biggest growth driver, helped by VAT cuts, higher minimum wages and a rebound in household borrowing. Meanwhile, infrastructure spending is limited, weighing on exports and potential growth. Corruption accusations brought against PM Victor Ponta will contribute to political volatility, while the stand-off between Greece and the troika represents another risk. In case of protracted political uncertainty or if Greece leaves the eurozone, we expect the RON to be harder hit than bonds. This year's monetary easing will probably be reversed next year, when the NBR could hike the base rate by 25-75bp.

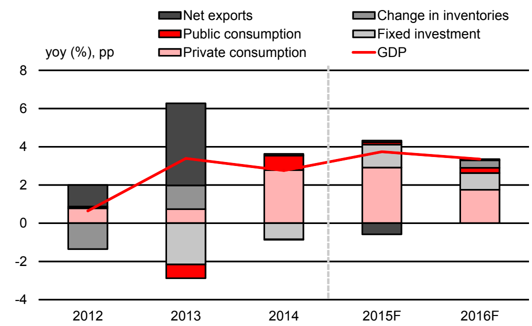
Strategy – We expect the local bond curve to bull flatten short term as inflation drops. As such, we recommend being long ROMGB 23s and 5s10s flatteners. We continue to favour USD-denominated bonds and recommend the ROMANI USD 23 and ROMANI USD 44s.

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

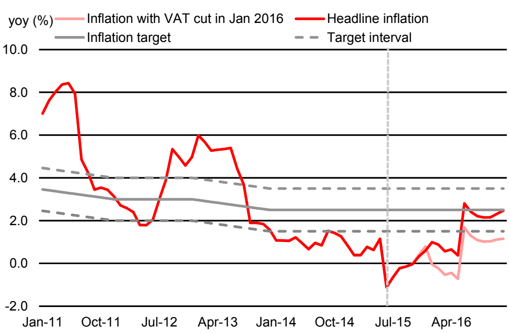
KEY DATES/EVENTS

- 1 July, 4 August, 30 September: NBR rate decisions
- 14 August, 4 September: 2Q15 GDP (flash, structure)
- 16-30 June: EC review, 16 July: beginning of IMF review
- 27 September: 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	158.7	168.8
Population (mn)	20.1	20.0	19.9	19.9	19.8
GDP per capita (EUR)	6,663	7,207	7,521	7,982	8,517
Real economy yoy (%)					
GDP	0.6	3.4	2.8	3.7	3.4
Private Consumption	1.2	1.2	4.5	4.6	2.8
Fixed Investment	0.1	-7.9	-3.5	5.5	3.9
Public Consumption	0.4	-4.8	5.3	0.9	2.0
Exports	1.0	16.2	8.1	7.1	6.0
Imports	-1.8	4.2	7.7	8.5	5.8
Monthly wage, nominal (EUR)	479	507	531	559	584
Unemployment rate (%)	6.9	7.0	6.8	6.7	6.3
Fiscal accounts (% of GDP)					
Budget balance	-2.9	-2.2	-1.5	-1.5	-1.9
Primary balance	-1.1	-0.5	0.0	0.0	-0.5
Public debt	37.3	38.0	39.8	38.4	37.8
External accounts					
Current account balance (EUR bn)	-6.1	-1.2	-0.6	-0.8	-0.5
Current account balance/GDP (%)	-4.5	-0.8	-0.4	-0.5	-0.3
Basic balance/GDP (%)	-2.7	1.2	1.2	1.3	1.6
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	89.4	88.4
Gross foreign debt (% of GDP)	75.3	67.8	62.9	56.3	52.3
FX reserves (EUR bn)	31.2	32.5	32.2	32.6	35.4
Inflation/Monetary/FX					
CPI (pavg)	3.3	4.0	1.1	0.2	1.7
CPI (eop)	5.0	1.6	0.8	0.6	2.5
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	2.50
3M money market rate	6.04	2.58	1.69	1.50	2.00
USD/RON (eop)	3.36	3.26	3.69	4.12	3.82
EUR /RON (eop)	4.43	4.48	4.48	4.45	4.43
USD/RON (pavg)	3.47	3.33	3.35	4.08	3.95
EUR/RON (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

The consumer is battling political and regional headwinds

Growth in excess of 3% will depend on consumption-enhancing policies…

Romania's jigsaw growth is set to last. After the upward surprise from 1Q15, when GDP rose by 4.3% yoy, growth probably slowed in 2Q15 amid tight fiscal policies, but could accelerate again in 3Q15 due to a VAT cut[10] and remain high in 4Q15 due to seasonally higher public spending. As a result, GDP growth could reach 3.7% this year. Inconsistent fiscal policies will continue to shape growth in election year 2016. The government proposed cutting the general VAT rate from 24% to 20% in January 2016, but this measure might be postponed amid opposition from the European Commission (EC) and the IMF. In this case, the government could favour consumption and wages over investment to keep growth above 3% in 2016.

…weighing on investment, exports and potential growth…

Cutting indirect taxes and neglecting infrastructure is affecting foreign direct investment and potential growth. As a result, export growth could lag that of regional peers in 2015 and 2016 as car exports are declining this year. Electronics producers provide some impetus for exports, but falling demand from Turkey and Ukraine is offsetting their positive impact.

…and on corporate re-leveraging

The chronic lack of investment extends to the private sector, where firms are wary of expanding production facilities despite consumption growing at a healthy pace and borrowing costs being at all-time lows. New lending to companies remains weak, as more than 60% of firms report no borrowing needs, some due to a good cash position, and some due to pessimistic expectations. On a bright note, building output rebounded as prices bottomed out.

Consumers will benefit from lower VAT, higher wages and a controversial insolvency law

While firms are yet to capitalise on the public policy mix, the consumer stands to benefit the most from it. A wealth effect from lower VAT for food and minimum wage hikes lifted consumer sentiment to 7-year highs. As a result, demand for new RON retail loans increased, as did loan maturity. A controversial personal insolvency law will help distressed borrowers.

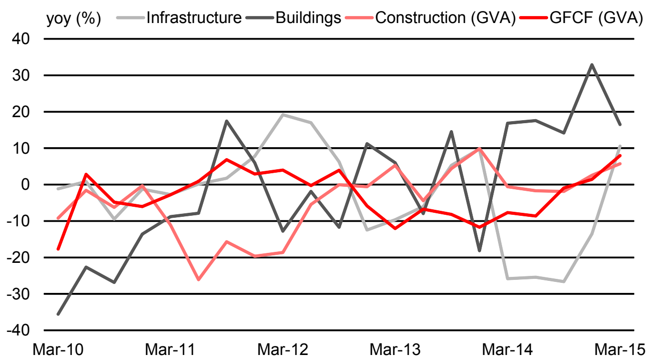
Rate cuts could end amid RON weakness, but the easing cycle will continue with MRR cuts…

…but rate hikes are on the cards in 2016

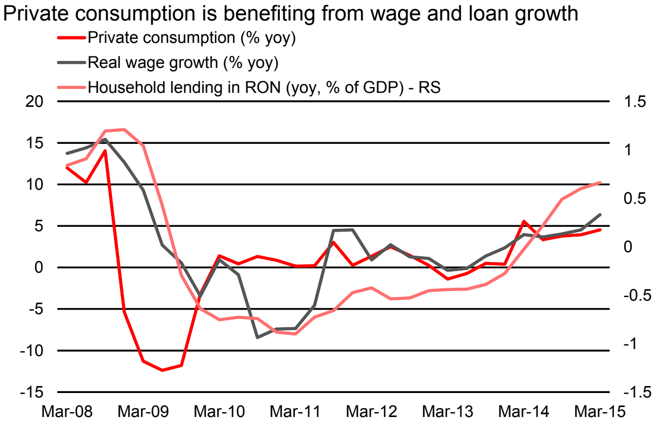
The NBR surprised markets by cutting rates because inflation will turn negative after the June VAT cut. Further rate cuts could be off the cards if the RON remains under pressure, but the NBR will fuel excess liquidity by reducing minimum reserve requirements. However, the NBR could be forced to hike next year by up to 75bp after the VAT cut for food will exit the base, pushing inflation close to the 2.5% target. Rate hikes could be capped at 25bp and inflation might remain below 2% next year if the government cuts the main VAT rate in January. Reflation could be slower than expected if European grain crops are indeed the third-largest ever[11]. Higher oil prices and a bad harvest in 2016 would push inflation above the forecast.

PRODUCTIVE INVESTMENT IS THE LAST WEAK LINK IN THE RECOVERY STORY

Fixed investment is supported by construction, not machinery



Private consumption is benefiting from wage and loan growth



Source: NIS, NBR, UniCredit Research

[10] The main VAT rate for food was cut from 24% to 9% on 1 June 2015.
[11] This is the EC's forecast. In anticipation, Romania's wheat exports are approximately 24% yoy cheaper, although 20pp is explained by USD strength.

Corruption charges against PM Victor Ponta could lead to political volatility…

On 5 June, the National Anticorruption Directorate (DNA) brought several corruption charges against PM Victor Ponta. Mr. Ponta refused to resign, despite President Klaus Iohannis urging him to do so. The Chamber of Deputies vetoed the PM's prosecution, since the governing coalition led by Mr. Ponta's Social Democratic Party (PSD) is enjoying a comfortable majority. From here on, the main scenarios are: **1.** PSD will continue to govern until general elections (expected in October 2016), with Mr. Ponta or one of his allies heading a more vulnerable coalition. **2.** The opposition led by the National Liberal Party (PNL) will manage to get a parliamentary majority by splitting PSD's coalition and will call early elections. **3.** A PNL-led coalition will govern until general elections. Whatever the outcome, a period of market volatility could follow, but in the long term, the anticorruption campaign will be positive for the country.

…with the stand-off between Greece and the troika being another risk…

In addition to political noise, the stand-off between Greece and the troika could affect Romania, but we believe that the impact might be limited. Romania's exports to Greece were just 1.4% of total exports in 2014. While Greek subsidiaries had 13.6% of the banking system's assets in 2014, they are well capitalized and very liquid. In addition, the NBR stands ready to support them in case of stress (e.g., a short-term bank run if Greece exits the eurozone). Hence, we believe that the Romanian economy and financial assets should withstand a Grexit if the eurozone avoids a contagion to asset (especially bond) prices.

…weighing mostly on the RON…

… but support from the basic balance, low debt repayments and large reserves could prevent a selloff

Due to political and external volatility, EUR-RON is in danger of exiting temporarily the 4.40-4.50 range, unless the NBR will offer support. In addition, balance of payments flows, small debt repayments and high reserves could prevent a sharp selloff. On 12M cumulated data, the positive extended basic balance could remain close to 4% of GDP in 2015, covering all bank outflows. Public sector external debt repayments represent just 2.6% of GDP in 2015 and 2016[12]. In addition, FX reserves are almost three times higher than short-term external debt, while MinFin reserves cover net financing needs and all bond redemptions for 2015.

The government is yet to agree with all IMF/EC requirements…

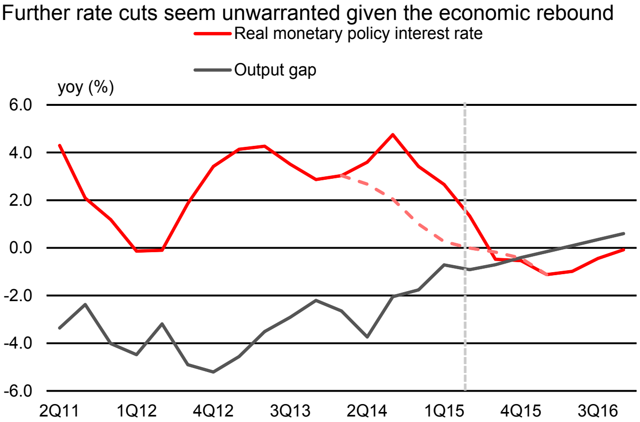
…but authorities could backtrack on some fiscal easing…

…paving the way of continuing the SBA with a PLL

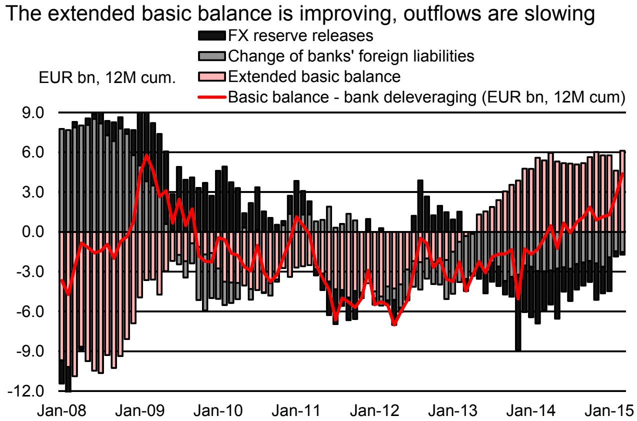
A positive end to the third stand-by arrangement (SBA) with the IMF could boost confidence in Romanian assets, especially if it is followed by a precautionary and liquidity line (PLL). The SBA should end on 27 September and time is running out for the Romanian government to comply with IMF/EC requirements. On a positive note, the parties agreed to a new calendar of gas price liberalisation. On a negative note, the IMF believes that cutting the general VAT rate next year would widen the budget deficit to 3% of GDP. If EM assets come under pressure, the government could make concessions to secure a PLL, such as postponing major tax cuts. However, the restructuring of two loss-making energy companies (Oltenia and Hunedoara) will probably have to wait for next year's general elections since it would trigger significant layoffs.

STRONGER BOP SUPPORT FOR THE RON WILL OUTWEIGH THE LAXER MONETARY POLICY

Further rate cuts seem unwarranted given the economic rebound



The extended basic balance is improving, outflows are slowing



Source: NBR, NIS, UniCredit Research

[12] IFI repayments are nearing the end. The NBR will repay to the IMF EUR 0.6bn this year and EUR 0.1bn in 2016, while the MinFin will reimburse a EUR 0.2bn in 2015 and 2016 to IFIs. The MinFin repaid EUR 1.5bn to the EC in March 2015 with the next tranche due in 2017. The MinFin ended IMF repayments this year.

Short-term bull flattening as inflation is set to drop

ROMGB curve set to bull flatten as inflation falls…

…and accommodative backdrop leads us to favour ROMGB 23s

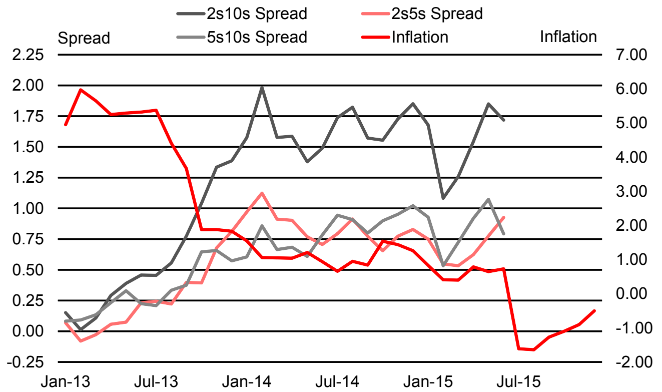
Political noise is likely to increase short-term volatility

The steep ROMGB curve, caused in part by the rise in core rates and an overreaction to the Greece debt and IMF issues, should start to bull flatten. Inflation should drop sharply after the June VAT cut, while the dovish NBR has left the door open to further accommodation, giving the local curve additional support. Bond auctions remain well supported and, while issuance is behind target, the high fiscal reserves mean issuance will not put pressure on yields. As such, we recommend staying overweight ROMGBs and favour the longer-dated ROMGB 23s and 5s10s flattener in the anticipation of low inflation. However, volatility is likely to increase due to political noise related to the anticorruption campaign. While this may have a greater impact on the currency and potentially be a short-term negative, ultimately it should improve investor confidence and raise the chances of a rating upgrade further down the line.

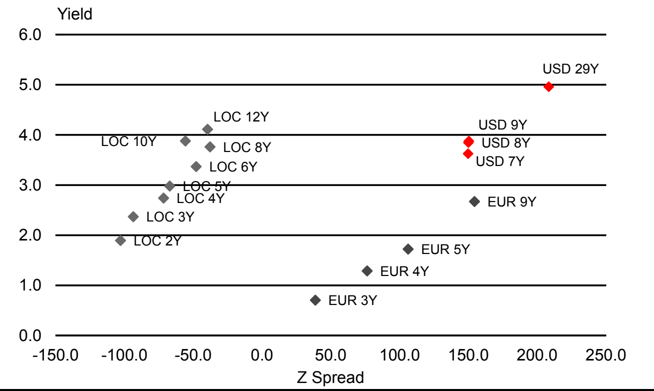
We favour ROMANI USD bonds on the back of better yields and lower currency risk

In regard to external debt, we expect EUR 1.0-1.5bn in a new Eurobond issued when yields begin to stabilise. This may see some rotation out of current EUR paper tenors into the 'on the run' issue. Given the equivalent Z-spreads, higher yields and lower currency risk, we prefer USD-denominated bonds and recommend the ROMANI USD 24s and ROMANI USD 44s.

The steep ROMGB curve is likely to flatten as inflation drops



USD paper remains lower risk and better value than local and EUR



Source: NBR, MinFin, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**12.7**	**12.6**	**13.5**
Budget deficit	2.8	2.9	3.1
Amortisation of public debt	9.9	9.7	10.4
Domestic	8.9	7.0	8.9
Bonds	6.3	4.2	6.6
Bills	2.2	2.5	2.0
Loans	0.4	0.3	0.3
External	1.0	2.7	1.5
Bonds and loans	0	1.0	1.5
IMF/EU/IFIs	1.0	1.7	0
Financing	**12.7**	**12.6**	**13.5**
Domestic borrowing	9.7	8.9	10.8
Bonds	6.9	6.6	8.5
Bills	2.5	2.0	2.0
Loans	0.3	0.3	0.3
External borrowing	4.9	2.5	2.5
Bonds	4.3	2.0	2.5
IMF/EU/WB	0.6	0.5	0
Other	0	0	0
Fiscal reserves (reduction(+))	-1.9	1.2	0.2

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**36.2**	**31.1**	**27.4**
C/A deficit	0.6	0.8	0.5
Amortisation of medium to long term debt	23.5	19.3	15.6
Government/central bank	9.8	6.2	3.6
Banks	7.1	6.4	5.4
Corporates	6.6	6.7	6.6
Amortisation of short term debt	11.3	10.1	10.3
Government/central bank	0.3	0.4	0
Banks	4.8	3.5	3.8
Corporates	6.2	6.2	6.5
Other	0.8	0.9	1.0
Financing	**36.2**	**31.1**	**27.4**
FDI	2.5	2.9	3.2
Equity	0.3	0.1	0.1
Borrowing	30.7	24.5	24.9
Government/central bank	9.8	3.8	4.2
Banks	9.0	8.4	8.3
Corporates	11.9	12.3	12.4
EU Funds - capital transfers	4.0	4.0	2.0
Change in FX reserves (reduction(+)/increase(-))	-1.3	-0.4	-2.8

Source: NBR, MinFin, Bloomberg, UniCredit Research

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

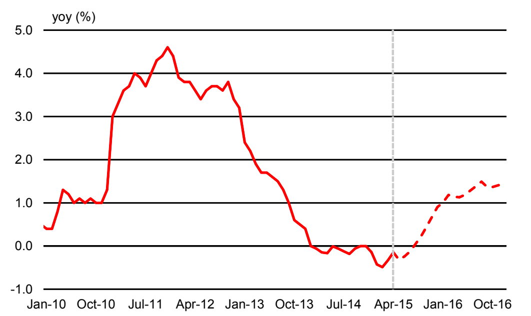
Outlook – GDP growth is expected to accelerate to 3.2% in 2015 and 3.3% in 2016, boosted by stronger domestic demand and recovering demand from Europe. Private consumption will benefit from fiscal spending ahead of elections, real wage growth and a rebound in lending. Fixed investment will be boosted by infrastructure spending. While past shocks from lower fuel and food prices, as well as administered price cuts, will exit the base, reflation will be slowed by a cut in VAT for food and pharmaceuticals scheduled for 1Q16. The foreign trade surplus should narrow due to accelerating imports, probably balancing the C/A. 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)

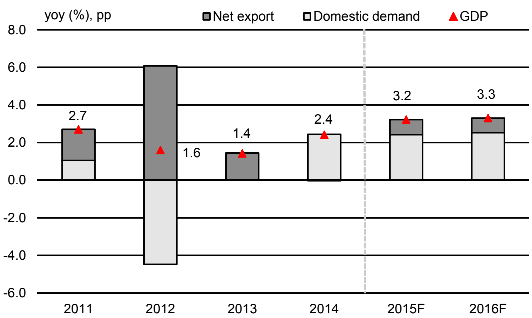
KEY DATES/EVENTS

- 10 July, 10 Aug, 10 Sept – Industrial production
- 13 July, 12 Aug, 14 Sept – CPI
- 14 Aug – flash 2Q15 GDP
- 4 Sept – 2Q15 GDP structure

INFLATION TO REMAIN SUBDUED



GDP TO ACCELERATE DRIVEN BOTH BY DOMESTIC AND EXTERNAL DEMAND



MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	72.2	73.6	75.2	77.4	80.3
Population (mn)	5.4	5.4	5.4	5.4	5.4
GDP per capita (EUR)	13,349	13,594	13,894	14,304	14,841
Real economy yoy (%)					
GDP	1.6	1.4	2.4	3.2	3.3
Private Consumption	-0.5	-0.8	2.2	2.4	2.2
Fixed Investment	-9.3	-2.7	5.7	4.1	3.8
Public Consumption	-2.0	2.4	4.4	2.5	1.5
Exports	9.3	5.2	4.6	5.7	6.0
Imports	2.6	3.8	5.0	5.3	5.6
Monthly wage, nominal (EUR)	805	824	858	879	901
Unemployment rate (%)	14.0	14.2	13.2	11.8	10.7
Fiscal accounts (% of GDP)					
Budget balance	-4.2	-2.6	-2.9	-2.6	-2.0
Primary balance	-2.4	-0.7	-1.0	-0.8	-0.3
Public debt	52.1	54.6	53.6	53.6	53.7
External accounts					
Current account balance (EUR bn)	0.7	1.1	0	-0.1	0
Current account balance/GDP (%)	0.9	1.5	0.1	-0.1	0
Basic balance/GDP (%)	2.9	3.0	1.0	0.9	0.9
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	71.3	74.8
Gross foreign debt (% of GDP)	76.0	82.1	90.1	92.1	93.2
FX reserves (EUR bn)	EUR	EUR	EUR	EUR	EUR
Inflation/Monetary/FX					
CPI (pavg)	3.6	1.4	-0.1	0	1.3
CPI (eop)	3.2	0.4	-0.1	0.9	1.4
Central bank reference rate (eop)	EUR	EUR	EUR	EUR	EUR
3M money market rate	EUR	EUR	EUR	EUR	EUR
EUR/USD (eop)	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR

Source: UniCredit Reseach

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

Growth lifted by external demand and pre-election spending

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

Economic growth is expected to exceed 3% and become broader based in 2015 and 2016, with both domestic and external demand contributing. Risks to fast growth are mostly external, the most important being EU-Russia tension amid the conflict in Ukraine, a slowdown in large EM and the impact on the eurozone of Greece's financial problems.

…driven by both domestic demand…

On the domestic side, household spending is expected to be the main growth driver, driven by high real wage growth, releveraging amid low interest rates, a tighter labour market and government spending. Better consumer and external demand provide support to private investment, while public spending for building highways is picking up. This is boosting the battered construction sector, where top players are still struggling amid financial troubles.

…and exports…

Better demand from the eurozone is offsetting the drag from emerging markets. Car registrations in the eurozone continue to accelerate, boosting Slovak exports, especially to large markets like Germany, France and Great Britain. This should be enough to offset the negative impact of broken trade links to Russia and weaker demand from Ukraine, China and Turkey.

…although higher imports could balance the C/A

Stronger domestic demand led to a cyclical recovery in imports, but so far this has been slowed by declining commodity prices and gas imports[13], as well as rebounding exports. However, import growth could accelerate later this year. As a result, we expect the foreign trade surplus to shrink in 2015, leading to a balanced C/A. At the same time, FDI inflows should rise, with the privatization of Slovak Telecom expected to generate 1% of GDP.

Economic growth will receive support from fiscal policy…

…with both deficit and debt thresholds expected to be met

With general elections scheduled for March 2016, public spending is expected to target voters, undermining previous efforts towards fiscal consolidation. Better-than-expected economic growth than the government forecasted in the 2015 budget resulted in higher tax revenues and created room to cut the budget deficit. Instead, the government decided to increase spending. The ruling Social Democrats implemented a second package[14] of mostly populist social measures and a third one, the largest yet, is scheduled for the beginning of 2016, just before general elections. It will include, among other things, a VAT cut from 20% to 10% for basic food products and pharmaceuticals, an increase in the minimum wage from EUR 380 to EUR 400, higher maternity benefits and childcare allowances. All measures will benefit consumers, especially low-income ones, and should keep private consumption growth high this year and next. At the same time, the budget deficit will fail to decline significantly below 3% of GDP this year, while public debt is expected to fall due to privatization revenues, remaining below the debt brake of 55% of GDP.

Reflation will be slowed by a VAT cut scheduled for 1Q16

Fiscal policy will affect inflation as well. A series of supply-side shocks from falling oil and food prices and 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, when oil-price shocks will exit the base, but the VAT cut for food and pharmaceuticals will prevent inflation from rising significantly above 1% yoy at the end of next year.

The Social Democrats remain favored to retain power…

…but could be forced to enter a two-party coalition after elections

Polls are suggesting that the ruling Social Democrats could win next year's elections, but their support is declining. The opposition remains fragmented, with several parties close to the 5% threshold needed to enter parliament. Yet even if opposition parties will have a majority, a stable coalition is unlikely. Therefore, a coalition between Social Democrats and one other party seems the most likely scenario. The main candidates to become junior coalition partners are the Christian Democrats and the Nationalists, the latter governing with the Social Democrats in 2006-2010.

[13] Gas imports fell by approximately 1.5% of GDP in 2014.
[14] The first package was announced in June 2014, with most of the measures implemented in 2H14.

Slovenia (Baa3 stable/A- stable/BBB+ stable)*

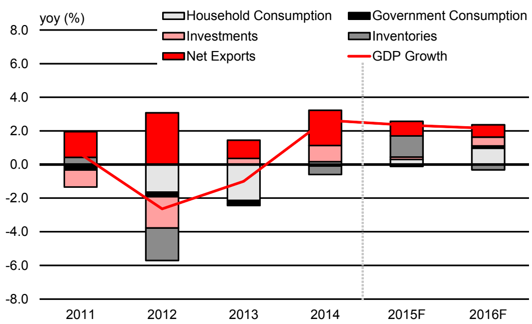
Outlook –Slovenian economic growth is expected to decelerate mildly to 2.3% in 2015 but the composition of growth will be broad based. Net exports will weaken due to stronger domestic demand, but this will not prevent Slovenia from running C/A surpluses in excess of 6% of GDP throughout the forecast horizon. Inflation is expected to rise in 2016, but will still remain below the EU average. On the fiscal front, the budget deficit is set to meet the EDP targets and narrow to 3% of GDP this year, driven by expenditure savings. That said, there is an imperative need to speed-up and complete the privatization programme initiated in mid-2013 as otherwise this would greatly undermine the government's credibility and put at risk the sustainability of Slovenia's soaring public debt trend.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

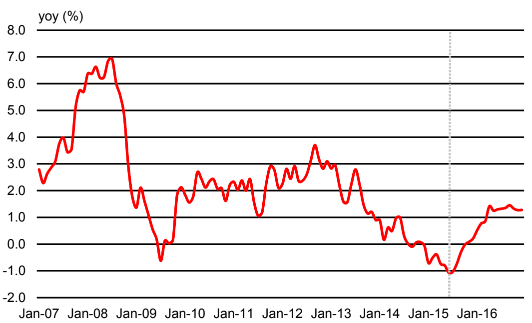
KEY DATES/EVENTS

- 30 June, 31 July, 31 Aug – Consumer Price Index
- 30 June, 30 Sept, 31 Aug – Retail Sales
- 10 July, 10 Aug, 10 Sept – Industrial Production
- 10 July, 10 Aug, 10 Sept – Trade balance
- 31 Aug – 2Q15 GDP

GDP GROWTH TO EASE IN 2015



INFLATION TO ACCELERATE IN 2H15



Source: NBS, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	36.0	36.1	37.2	38.2	39.4
Population (mn)	2.1	2.1	2.1	2.1	2.1
GDP per capita (EUR)	17,506	17,549	18,065	18,522	19,034
Real economy yoy (%)					
GDP	-2.6	-1.0	2.6	2.3	2.2
Private Consumption	-2.9	-4.0	0.3	0.6	1.9
Fixed Investment	-8.9	1.9	4.8	0.7	2.6
Public Consumption	-1.5	-1.1	-0.5	-0.6	0.8
Exports	0.3	2.6	6.3	5.8	6.2
Imports	-3.9	1.4	4.1	5.4	6.1
Monthly wage, nominal (EUR)	1,526	1,523	1,540	1,556	1,584
Unemployment rate (%)	8.9	10.1	9.7	9.3	8.8
Fiscal accounts (% of GDP)					
Budget balance	-4.0	-14.9	-4.9	-3.0	-2.8
Primary balance	-2.0	-12.3	-1.7	0.6	0.8
Public debt	53.7	70.4	80.9	82.6	82.1
External accounts					
Current account balance (EUR bn)	1.0	2.0	2.2	2.3	2.5
Current account balance/GDP (%)	2.7	5.6	5.8	5.9	6.3
Basic balance/GDP (%)	3.9	5.8	9.0	10.2	9.3
Net FDI (EUR bn)	0.5	0.1	1.2	1.6	1.2
Net FDI (% of GDP)	1.3	0.2	3.2	4.3	3.0
Gross foreign debt (EUR bn)	41.5	40.2	46.2	47.7	48.7
Gross foreign debt (% of GDP)	115.3	111.2	124.1	124.8	123.8
Inflation/Monetary/FX					
HICP (pavg)	2.8	1.9	0	-0.5	1.2
HICP (eop)	3.1	1.1	-0.1	0.2	1.3
Central bank reference rate (eop)	EUR	EUR	EUR	EUR	EUR
EURIBOR 3M	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR
EUR/USD (pavg)	EUR	EUR	EUR	EUR	EUR

Source: UniCredit Research

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

A broad-based recovery, but in need of privatization

GDP growth accelerated by 2.9% yoy in 1Q15, due to rising inventories and the rebound of private consumption

Domestic demand accelerated strongly in 1Q15, and is set to drive GDP growth this year. Final 1Q15 GDP data showed the Slovenian economy accelerating by 0.8% qoq sa, and by 2.9% yoy (from 2.1% in 4Q14). The acceleration was driven predominantly by domestic demand, namely inventories, which added a whopping 2.5pp to GDP growth. As expected, fixed investments (-0.8% yoy) and government expenditures (-0.5% yoy) remained depressed, but these were fully offset by the rebound in private consumption (+0.4% yoy; +0.2pp to GDP). This is partly explained by the deflation-driven increase in real wages (up 1.9% in March), and partly by the strong improvement in consumer confidence levels. This was also reflected in strong retail sales data in 1Q15 (+5.1% yoy). Net exports were also up (+6% yoy), although their positive impact was smaller than in the previous two quarters due to rising imports.

Private consumption and investment will drive GDP growth this year…

…but it is expected to decelerate to 2.2% in 2016 due to falling public investment and weaker impulse from net exports

We expect GDP growth to be broad based throughout the forecast horizon, but weaker than in 2014. In particular, we see GDP growth this year decelerating to 2.3% yoy, and to 2.2% yoy in 2016. Private investment will make the biggest contribution to GDP growth this year (ca. 1.4pp), as indicated by improving business confidence indicators and the strong inventory build-up in 1Q15. These are likely to flow into new machinery and equipment in the tradable sectors, driven by accelerating external demand. Similarly, we expect private consumption to strengthen further and add an average of 0.7pp to GDP until 2016. Low oil prices and higher real wages will help on this front, provided labor market conditions continue to improve. A recovery in public consumption is expected only in 2016, but this will be accompanied by a sharp decrease in public investment due to the end of the drawdown from the 2007-13 EU fund programs. Exports will remain strong due to stronger EU growth, but the contribution from net exports will weaken on the back of stronger domestic demand and resulting import growth. Even so, this will not prevent the C/A surplus from exceeding 6% of GDP in 2016, provided the deleveraging of the corporate sector continues.

Inflation is expected to resume only in 2016, but will still remain below the EU average

Low oil prices will keep average inflation negative this year, although it is expected to resume in 2016 due to rising energy prices and the gradual recovery of domestic demand. In May, HICP inflation decreased by 0.8% yoy, constituting the sixth consecutive month where inflation remains in negative territory. This brings the year-to-date reading down 0.5% yoy, with most of this drop attributed to the decline in fuel prices. By year-end, we expect inflation to flatten and recover slowly in 2016 due to rising oil prices and stronger domestic demand.

We expect the deficit to remain within the EDP limits in the forecast horizon…

The general government budget deficit is expected to reach the EDP target of 3% of GDP this year, driven by stronger revenues and expenditure savings. In April, the state budget deficit had a surplus of EUR 0.1bn, bringing the Jan-Apr deficit down 22.3% yoy to EUR 0.5bn (or 1.5% of GDP). The decline was driven largely by rising state revenues (+5.2% yoy), namely from higher income and VAT proceeds, but expenditures also fell moderately (-0.6% yoy). This year, we expect the general government deficit to fall to 3% of GDP, down from 4.9% of GDP in 2014. The adjustment will be driven primarily by expenditure savings, namely subsidy reforms and the prolongation of measures to reduce the public sector wage bill. Looking ahead, the deficit is set to contract further (2016F: -2.8% of GDP), albeit at a slower pace, favored by the contraction in fixed investment caused by the end of the drawdown period from the 2007-13 EU funds programs.

…but speeding up the privatization process is crucial to limit contingent liabilities and curb public debt

The privatization process has slowed down due to mounting political pressure. The latest episode of political strife revolves around the long-awaited sale of Telekom Slovenia (TS), the largest company included in the mid-2013 privatization list. Private equity firm Cinven submitted the sole bid (EUR 130/share) for the 72.75% government stake in TS but was rejected on 15 June by the Holding Company (SSH) after the offer was made conditional on the approval by Macedonian authorities of a merger between the Macedonian subsidiaries of Telekom Slovenia and Telekom Austria. While the deal is not yet off the table, we fear a compromise will be difficult to reach and take longer than planned. This is highly unwelcomed, as it risks undermining investors' confidence in the government and its privatization agenda.

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

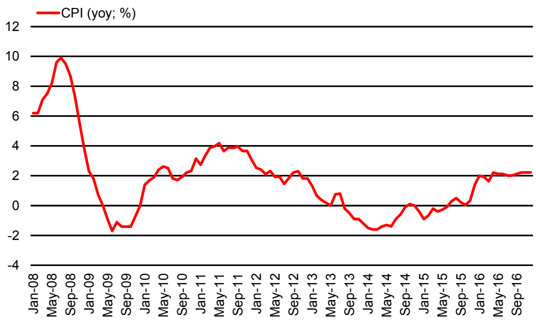
Outlook – The BH economy proved to be more resilient to the damage caused by the natural disaster in spring of last year. Consequently, GDP growth likely reached 1% in 2014, instead of the expected stagnation. However, available 1Q15 high frequency data indicate that GDP growth is not keeping up the pace from 2H14. Nevertheless, we maintain our GDP growth forecast of 2% this year, as export growth and construction activity are expected to gather speed in 2H15. BH's EU accession path has been recently unblocked as EU foreign ministers agreed on the Stabilization and Association Agreement (SAA) to come into force on 1 June. On the other hand, the pending Stand-By Arrangement (SBA) is expected to be renewed in the autumn.

Author: Hrvoje Dolenec, Chief Economist (Zagrebačka banka)

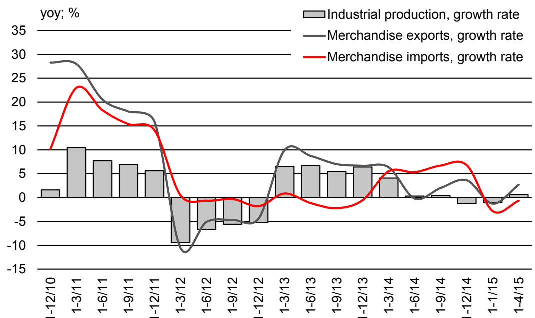
KEY DATES/EVENTS

- 30 June - 1Q15 BoP
- 30 June, 30 Sept – 1Q15 GDP (P), 2Q15 GDP (P)
- 30 June – GFS central government 4Q14-1Q15
- 10 July – Labour Force Survey

CPI EXPECTED TO SLOW



MERCHANDISE EXPORTS



Source: IMF, MinFin, Eurostat, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	13.2	13.4	13.8	14.1	14.9
Population (mn)	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3,430	3,507	3,605	3,680	3,892
Real economy yoy (%)					
GDP	-1.2	2.1	1.0	2.0	3.5
Monthly wage, nominal (EUR)	660	661	659	665	686
Unemployment rate (%)	44.1	44.6	43.9	43.6	43.1
Fiscal accounts (% of GDP)					
Budget balance	-1.9	-2.3	-3.0	-3.3	-2.1
Primary balance	-1.2	-1.4	-2.0	-2.4	-1.1
Public debt	39.7	42.5	45.1	47.3	48.3
External accounts					
Current account balance (EUR bn)	-1.2	-0.8	-1.1	-1.2	-1.3
Current account balance/GDP (%)	-8.9	-5.7	-7.7	-8.5	-8.6
Basic balance/GDP (%)	-6.9	-4.1	-4.6	-4.9	-4.9
Net FDI (EUR bn)	0.3	0.2	0.4	0.5	0.6
Net FDI (% of GDP)	2.0	1.7	3.1	3.6	3.8
Gross foreign debt (EUR bn)	6.9	7.0	7.4	7.7	8.1
Gross foreign debt (% of GDP)	52.3	51.9	53.3	54.5	54.1
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	2.1
CPI (eop)	1.8	-1.2	-0.4	1.4	2.2
1M EURIBOR	0.33	0.13	0.13	-0.02	-0.01
BAM/USD (eop)	1.48	1.42	1.60	1.67	1.60
BAM/EUR (eop)	1.96	1.96	1.96	1.96	1.96
BAM/USD (pavg)	1.52	1.47	1.47	1.71	1.64
BAM/EUR (pavg)	1.96	1.96	1.96	1.96	1.96

Source: UniCredit Research

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

External demand and construction expected to drive growth

GDP growth lost momentum in 1Q15, but construction and external demand should strengthen again

The recovery momentum from 2H14 lost steam in 1Q15, but growth is expected to gather speed in 2H15. GDP yoy growth in 3Q14 and 4Q14 stood at 0.5% and 2.4%, respectively, lifting 2014 annual GDP growth to 1% yoy The acceleration responded in part to increased reconstruction activity in the flood-hit areas, up 3.4% yoy in 2H14. Growth in construction was accompanied by transportation and storage, wholesale and retail trade and support services. However, available high-frequency data suggest construction activity slowed down in 1Q15 (0.3% qoq sa), while industrial production saw a decline in March and April. Even so, we maintain our GDP growth forecast of 2% yoy this year, since construction activity and external demand are expected to accelerate in 2H15. Beyond 2015, we expect economic growth to accelerate further, provided structural reforms are implemented.

Current account deficit rose in 2014 due to the slowdown in merchandise exports and persistent import growth. We expect a further widening in 2015

Current account gap is expected to widen further in 2015 due to the higher merchandise deficit. C/A deficit is expected to rise further in 2015 to around 8.5% of GDP, reflecting the import dependent structure of the economy. Historical data suggest periods of significant GDP growth always have been accompanied by a widening C/A deficit driven by faster growth of merchandise imports versus exports, exceeding in some years 9% of GDP. A similar pattern was noted during last year, especially after the floods.

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

Inflation declined in 2014, but should stabilize in 2015. Consumer prices in BH decreased for the second consecutive year. Until April, average inflation stood at -0.4% yoy, mainly due to falling clothing and footwear inflation and lower oil and gas prices. However, with energy prices recovering by the end of the year and with the acceleration of prices of imported goods, we might see inflation accelerate by year-end, bringing the average to positive territory.

Current extended SBA expires in June, but a follow-up program is expected to be negotiated with newly-formed government

Stand-By Arrangement with IMF expires by the end of June, and the newly-formed government is expected to negotiate a follow-up program. The budget deficit, according to existing estimates, widened last year, but much less than had been initially expected following the huge cost of floods and landslides. Thus, we also cut our estimate following the latest view of the IMF at 3.0% of GDP, which is 1 percentage point less than our previous forecast. We consider the SBA to be a crucial anchor to keep public finances under control. The extended SBA with the IMF, which expires on 30 June, set total financing of SDR 558.03mn or EUR 620mn. So far, disbursements reached SDR 422.75mn (or EUR 475mn). Remaining tranches have not been disbursed yet as the IMF further postponed its 8th review due to a lack of progress in the implementation of agreed on policies. After almost six months since the October elections, a new government has been formed, so the talks over the disbursement of the pending tranches and a follow-up program are expected to resume in June. A new agreement is expected by year-end and will provide a much-needed fiscal anchor. Projected payment to the IMF in December 2015 is set at SDR 18.26mn, so we expect that a new arrangement will be concluded by then. The IMF insists on ambitious structural reforms to boost growth and jobs, make government finances sustainable and improve governance, closely coordinating the program with the EU, EBRD and WB.

BH's EU accession path unblocked as EU foreign ministers agreed for SAA to come into force on 1 June

Stabilization and Association Agreement (SAA) with EU comes into force on 1 June. Political parties from both entities, Federation of Bosnia&Herzegovina and Republic of Srpska, representing all three main ethnic groups (Bosniaks, Croats and Serbs), signed the declaration on European commitment and indispensable reforms on the path to EU integration on 23 February, led by the German and UK initiative. As EU foreign ministers agreed for SAA to come into force on 1 June, unblocking the talks on accession, it created room for additional EU financial assistance. However, progress towards accession remains dependent on resolving obstacles emerging from disagreements between and within entities and main ethnic groups in approaching centralization/decentralization of the country/entities, all of which occur in a very complex political framework. Provided those obstacles are overcome, reforms could gain momentum in an effort to achieve EU candidate status. In the meantime, it seems likely that BH will become a WTO member by year-end.

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

Outlook – Russia has slipped into recession that will likely last into next year, but will be shallower than initially thought. Firmer oil prices, a tenuous stabilization in Ukraine and a mild decline of 2.2% in 1Q15 led us to revise down the magnitude of the expected decline in real GDP, to 3.1% from 4.5% previously. The inflation outlook has improved, too, thanks to RUB stabilization and a drop in domestic demand due to sharply lower real incomes. These factors should enable the CBR to cut interest rates to 9.0-9.5% by yearend. Even though fundamentals suggest that the RUB is near equilibrium now, the balance of risks is on the downside.

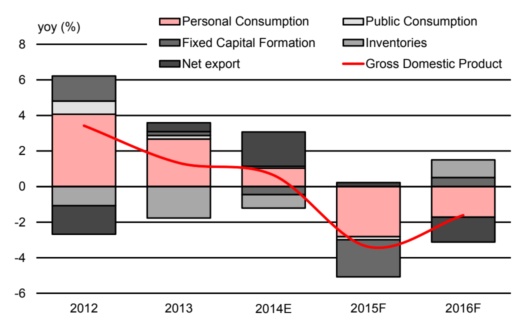
Strategy: We recommend being long Russian bonds on lower inflation, stable oil prices, rising reserves and a relatively stable ruble allowing the CBRT to cut rates further in 2H15.

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

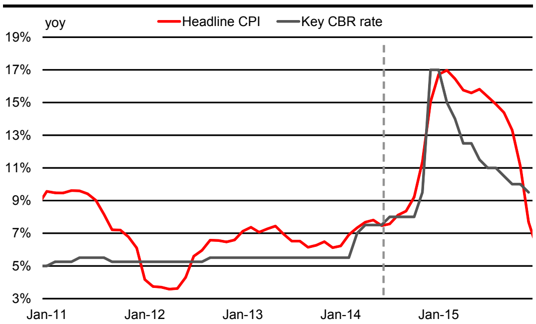
KEY DATES/EVENTS

- 31 July, 11 September – MPC meetings
- August – Import sanctions revisited
- 18-23 of every month – short-term statistical overview

DOMESTIC DEMAND WEAKENS



INFLATION ABOVE TARGET FOR NOW



Source: Federal Statistical Service, CBR, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	1546	1561	1404	1216	1223
Population (mn)	143.0	143.3	143.7	143.7	143.7
GDP per capita (EUR)	10,808	10,892	9,769	8,463	8,512
Real economy yoy (%)					
GDP	3.4	1.3	0.6	-3.4	-1.6
Private Consumption	7.8	5.0	1.9	-5.0	-3.1
Fixed Investment	6.6	1.0	-2.0	-9.5	2.5
Public Consumption	2.6	1.1	0.5	-1.0	0
Exports	1.1	4.6	-0.1	-10.0	-2.0
Imports	8.7	3.8	-7.9	-15.0	4.0
Monthly wage, nominal (EUR)	675	696	641	512	505
Unemployment rate (%)	5.3	5.4	5.6	6.6	6.9
Fiscal accounts (% of GDP)					
Budget balance	0	-0.5	-0.5	-3.5	-1.6
Primary balance	0.2	-0.1	0.1	-3.0	-1.1
Public debt	10.2	11.7	12.0	15.0	17.1
External accounts					
Current account balance (EUR bn)	63.2	24.8	46.5	38.3	18.2
Current account balance/GDP (%)	4.1	1.6	3.3	3.2	1.5
Basic balance/GDP (%)	3.5	1.6	0.8	2.4	0.9
Net FDI (EUR bn)	1.4	-11.7	-28.5	-13.2	10.5
Net FDI (% of GDP)	0.1	-0.8	-2.0	-1.1	0.9
Gross foreign debt (EUR bn)	485.1	546.7	491.0	475.6	421.2
Gross foreign debt (% of GDP)	31.4	35.0	35.0	39.1	34.,4
FX reserves (EUR bn)	407.3	377.4	319.3	320.1	307.0
Inflation/Monetary/FX					
CPI (pavg)	5.1	6.8	7.8	15.1	6.8
CPI (eop)	6.6	6.5	11.,4	11.1	6.8
Central bank target	5-6	5-6	5.00	-	-
Central bank reference rate (eop)	5.50	5.50	17.00	9.50	7.50
3M money market rate	7.45	7.,08	18.30	10.75	8.50
USD/RUB (eop)	31.07	32.73	54.40	58.09	56.11
EUR/RUB (eop)	39.92	44.97	68.34	67.96	68.46
USD/RUB (pavg)	30.37	31.85	38.46	57.37	56.24
EUR/RUB (pavg)	40.23	42.41	50.87	65.31	68.55

Source: UniCredit Research

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

Shallower but prolonged recession

Russian economy has entered recession, but it was buffered in part by temporary factors…

Russian economy's decline in 1Q15 reached 2.2% in yoy terms. Compared with the preceding quarter, the decrease was still significant at 9% saar. The relatively mild recession reflected mainly one-off or temporary factors. Fiscal policy added 1.3% of GDP to demand as the federal government brought forward spending (especially on defense and security). A boost in confidence thanks in part to the ruble's impressive recovery early in the year (largely engineered by the CBR) appears to have put a floor under private consumption and investment. Despite the recession, employment held up largely unchanged as companies – partly under government pressure – chose to cut wages and resort to part-time work rather than cut staff.

…few if any of these would be present during the remainder of the year...

Few if any of these factors will be present during the remainder of the year. Fiscal policy would need to be tightened significantly going forward if the fiscal targets are to be reached. Scope for further RUB appreciation seems to have been exhausted with the currency near its equilibrium at current oil prices, and both the CBR and the Cabinet intend to prevent further strengthening. Finally, with real incomes plummeting, consumption is likely to weaken further.

The improvement in the net foreign balance made a major positive contribution, on the order of 7% of GDP in 1Q15, but the adjustment was entirely via imports, which fell by more than one-third in volume terms yoy. Exports will be restrained by oil and gas supply constraints and a drop in demand among CIS countries that have been hit hard by Russia's own recession.

The economy has not yet bottomed out, and real GDP is likely to shrink further in the second half of the year, before leveling off in early 2016

All this suggests that the economy has not yet bottomed out. Real GDP is likely to have shrunk again in 2Q15, perhaps at a similar if not stronger rate than in 1Q, and at a slower pace through the second half of the year, before leveling off in early 2016. This would leave real GDP 3.4% lower for the year as a whole, with another decline of 1.6% or so likely next year. These projections assume the tentative truce in eastern Ukraine holds, current sanctions remain in place but no new ones are introduced, and oil prices at USD 65/bbl.

While the recession would be shallower, it might well prove more extended that many believe

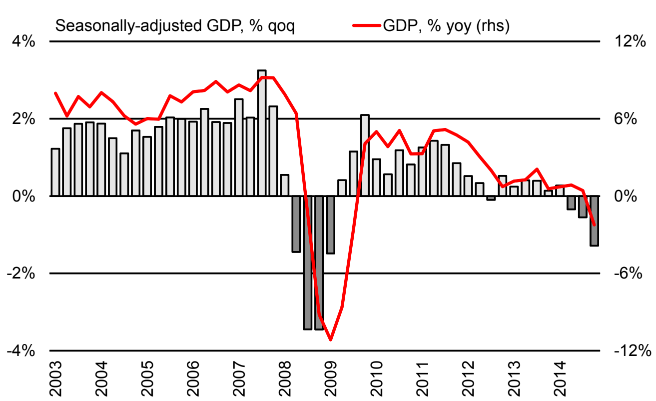
While the recession would be shallower, it might well prove more extended that many believe due to the slow adjustment in consumers' behavior and investment inefficiency. Supply-side factors such as lagging investment, a declining labor force and cut-off access to state of the art technology (especially in oil and gas) are likely to constrain medium-term growth, too.

Inflation has started abating sharply towards 5-6% a month in annualized terms

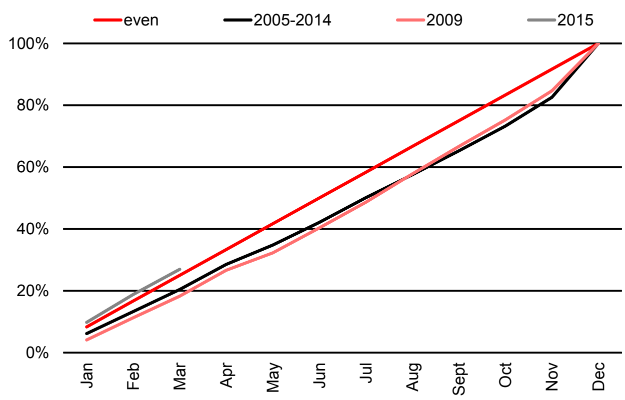
With domestic demand sharply lower and the ruble stabilizing, inflation pressures have eased. After peaking at near 17% in March, 12-month inflation has started abating with monthly inflation slowing sharply towards 5-6% a month in annualized terms. Barring a renewed sizable depreciation, we now expect 12-month inflation to slow to around 11% by yearend (compared with more than 12% projected previously) and into single digits in early 2016.

REAL ECONOMY IS STRUGGLING WITH HEADWINDS

Economy entered recession…



...despite the government's efforts



Source: Rosstat, Bloomberg, UniCredit Research

The inflation outlook is supported by a broadly stable currency

The inflation outlook should be supported by a broadly stable currency. Measured by the sustainability of the current account and the federal budget, the ruble appears to be near its equilibrium at present oil prices and market conditions. On the external side, lower principal repayments through the rest of the year and smaller resident capital outflows (reflecting mainly plummeting export earnings) should broadly mirror a smaller current account surplus, leaving FX reserves largely unchanged through yearend. On the fiscal side, RUB/USD at 55 should be sufficient to meet the deficit target of 3.8% of GDP without additional cuts.

These developments should enable the CBR to continue cutting interest rates to 9.5% through yearend

These developments should enable the CBR to continue cutting interest rates. We expect the policy rate to be cut by as much as 200bp to 9.5% through yearend. At this level, the real policy rate would still remain slightly positive in ex-ante terms. However, well aware of the risks of premature and too large cuts, the CBR is likely to remain cautious and proceed at a measured pace. In any case, the prospective rate cuts would provide little immediate boost to growth given the significant capital and liquidity pressures among most domestic banks, but would benefit the latter by gradually alleviating these pressures.

The balance of risks for the RUB is skewed towards the downside

This said, the balance of risks for the RUB is skewed towards the downside. The recent rally aside, Russian borrowers remain cut off from foreign markets: in 1Q15, net repayments to foreign creditors amounted to USD 37bn out of USD 38bn due. These repayments were mainly refinanced via cheap FX repos by the CBR, which helped prop up the ruble, but at the expense of the loss of USD 40bn on FX reserves. Repayments due are smaller going forward, but the CBR has all but stopped providing FX liquidity and has started buying FX with the view to boost FX reserves by USD 140bn within a few years. Finally, the outlook for oil prices remains uncertain, along with prospects for the evolution of the situation in Ukraine.

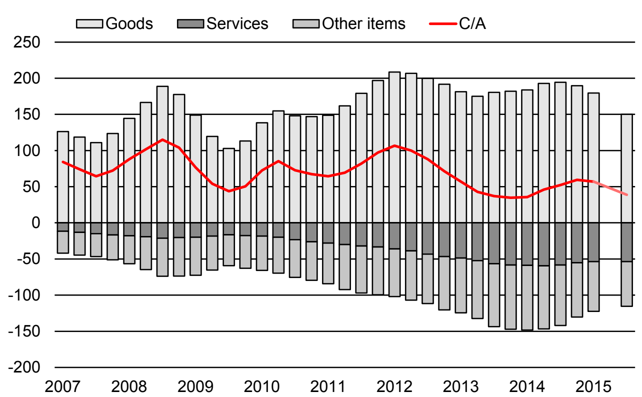
Even if the current situation seems sustainable in the near term, medium-term risks are rising

Even if the current situation seems sustainable in the near term, medium-term risks are rising. In order to achieve fiscal balance at the projected oil price, the ruble would need to depreciate to RUB/USD 65-67, and remain in that range in real terms in 2016 and beyond. Such a depreciation would add an additional 4pp to inflation over the next six months, resulting in an injurious depreciation-inflation cycle with potentially serious impact on financial stability.

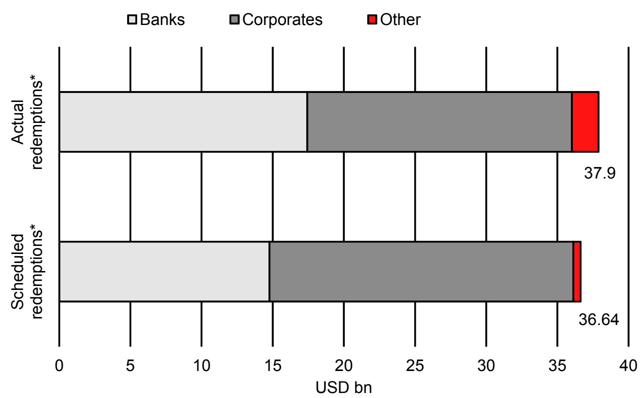
Fiscal risks will be rising as a result, especially beyond 2016, when, with current policies, the oil reserve fund would be largely exhausted. With output growth unlikely to pick up under the current external and political circumstances, the government would face the unenviable choice by 2017 of either resorting to central bank financing or to cut the currently largely-protected social and military spending. The latter, however, would be extremely difficult politically ahead of the March 2018 presidential election.

THE BALANCE OF RISKS FOR THE RUB IS SKEWED TOPWARDS THE DOWNSIDE

Current account is to shrink…



...while refinancing is highly constrained.



*As of 1 January 2015

Source: CBR, Bloomberg, UniCredit Research

Strategy: Optimistic on bonds but political risk remains

Despite the risk, we are more constructive on Russian bonds due to…

…falling inflation, stable oil prices and ruble, allowing room for further rate cuts

We recommend being market-weight local bonds…

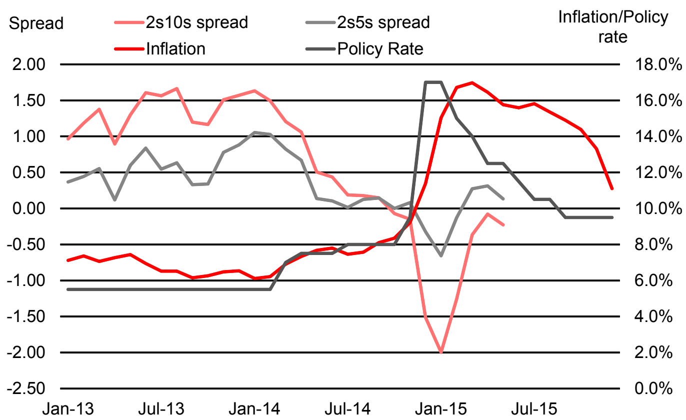
…and expect the curve to bull steepen

We see lower risk in USD bonds, especially in the 5Y tenor

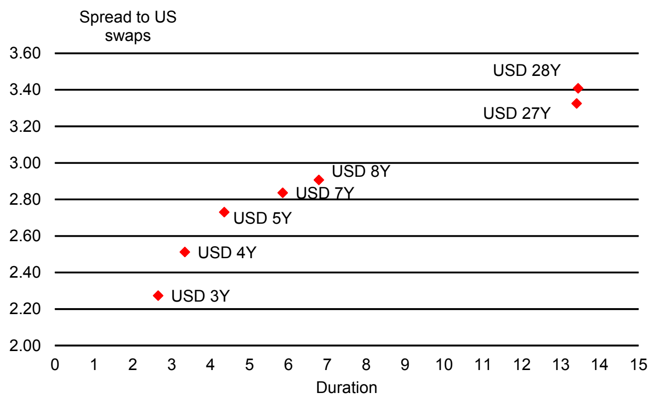
The recent tension in Ukraine highlights the fragile nature of the conflict and possible sanction extensions remain a threat – but looking beyond this, not unsubstantial risk, we are more constructive on local bonds for a number of reasons. First, oil prices have stabilized after rising 18% since the end of 1Q15; this has seen the RUB appreciate but it has now returned to the 53-56 range, which we think the CBR was targeting, in part by the decision to accumulate FX reserves. Second, the economy is in recession and inflation will likely continue to fall – we expect to 12% by year-end, and with rates still high this gives the CBR ample room to cut rates. After the 100bp cut in June, we expect the CBR will cut rates by another 200bp down to 9.50% by year-end. Third, FX reserves have been increasing and remain substantial, a backstop for any significant RUB depreciation. The OFZ curve remains very flat, but with the downward path of inflation and policy rates, the curve should start to bull steepen. As such, we recommend being marketweight local OFZ bonds, but see lower risk in the belly and long end. We favor long positions in RFLB 22s and a steepening trade of long RFLB 17s against short RFLB 20s.

Hard currency USD bonds remain lower risk due to the more attractive Z-spreads and absence of currency volatility. Balancing yields with duration risk, we favor RUSSIA USD 20s which have an attractive rolldown profile, with 45bp between them and RUSSIA USD19s. The lower correlation of Russian bonds with core rates is also attractive.

Rates and inflation dropping likely to cause bull steepening



Steep rolldown in hard currency USD curve from the 5Y tenor



Source: Rosstat, CBR, Bloomberg; UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**11.7**	**13.3**	**11.4**
Budget deficit	6.6	42.6	19.6
Amortization of public debt	5.1	13.4	12.7
Domestic	5.1	13.4	12.7
Bonds	5.1	13.4	12.7
Bills	-	-	-
External	-	-	-
Sovereign Fund	-	-42.7	-21.9
Financing	**11.6**	**13.3**	**12.8**
Domestic borrowing	9.8	12.7	9.9
Bonds	9.8	12.7	9.9
Bills	-	-	-
External borrowing	-	-	-
Bonds	-	-	-
Other	1.8	0.6	1.9

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**52.1**	**45.7**	**61.9**
C/A deficit	-46.5	-38.3	-18.2
Amortization of debt	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	5.3	7.6
Financing	**52.1**	**45.7**	**61.9**
FDI	-28.5	-13.2	10.5
Equity	0	0	0
Borrowing	51.2	27.0	38.0
Government/central bank	0	0	0
Banks	15.6	11.0	14.6
Corporates	35.6	16.0	23.4
Domestic investments abroad	87.5	31.0	26.5
Official reserves change / other	-58.1	0.8	-13.1

Source: Rosstat, CBR, UniCredit Research

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

Outlook – The Serbian economy remains in recession but is set to recover in 2H15 thanks to stronger fixed investments and external demand. We have raised our GDP growth forecasts this year by 0.5pp to 0.2% yoy, although the rebound could be stronger. We expect inflation to stabilize within the target in 2H15 which, alongside a stable dinar, should encourage an additional 100bp in rate cuts this year. Banks' large NPLs remain a growing concern, namely among state-owned banks, but contagion risks from Greece are limited. On a more positive note, the budget deficit remains below plan, and is likely to undershoot this year's target provided there is a sizeable downsizing of Serbia's SOE sector.

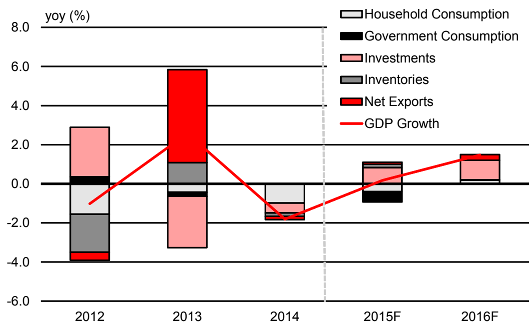
Strategy – We continue to recommend the 3Y and 7Y local benchmark bonds as weak domestic demand and low inflation should allow the NBS to cut rates further. With the bonds having a high real yield, being off benchmark and non-correlated to core rates, support for further issues should remain strong.

Author: Carlos Ortiz, Economist (UniCredit Bank London)

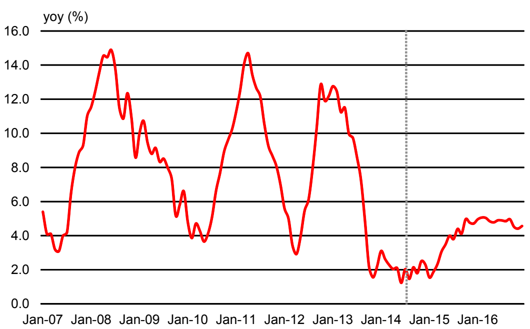
KEY DATES/EVENTS

- 22 June, 20 Jul, 20 Aug – Current account balance
- 30 June, 31 July, 31 Aug – Industrial output
- 09 July, 13 Aug, 10 Sep – Policy rate decision
- 13 July, 12 Aug, 11 Sep – Consumer Price Index

GDP GROWTH TO STAGNATE IN 2015



INFLATION TO STABILIZE AND REACH TARGET IN 2H15



Source: NBS, MinFin, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	31.7	34.3	33.1	32.9	34.1
Population (mn)	7.2	7.2	7.2	7.2	7.2
GDP per capita (EUR)	4,401	4,785	4,594	4,574	4,736
Real economy yoy (%)					
GDP	-1.0	2.6	-1.8	0.2	1.5
Private Consumption	-2.0	-0.6	-1.3	-0.5	0.3
Fixed Investment	13.2	-12.0	-2.7	4.5	5.1
Public Consumption	1.9	-1.1	0.1	-2.8	0
Exports	0.8	21.3	3.9	8.0	6.4
Imports	1.4	5.0	3.3	6.0	4.6
Monthly wage, nominal (EUR)	508	537	524	489	500
Unemployment rate (%)	23.9	22.1	19.8	20.0	19.5
Fiscal accounts (% of GDP)					
Budget balance	-6.8	-5.5	-6.7	-5.5	-4.8
Primary balance	-4.9	-3.0	-3.7	-1.9	-0.6
Public debt	56.2	59.6	70.9	74.1	76.8
External accounts					
Current account balance (EUR bn)	-3.7	-2.1	-2.0	-1.5	-1.6
Current account balance/GDP (%)	-11.6	-6.1	-6.0	-4.5	-4.6
Basic balance/GDP (%)	-9.2	-2.3	-2.3	-0.4	-0.5
Net FDI (EUR bn)	0.8	1.3	1.2	1.4	1.4
Net FDI (% of GDP)	2.4	3.8	3.7	4.1	4.1
Gross foreign debt (EUR bn)	25.6	25.7	25.9	27.4	27.8
Gross foreign debt (% of GDP)	80.9	75.1	78.4	83.1	81.6
FX reserves (EUR bn)	12.0	12.1	11.6	11.8	11.6
Inflation/Monetary/FX					
CPI (pavg)	7.3	7.9	2.1	2.9	4.4
CPI (eop)	12.2	2.2	1.8	4.8	3.9
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	5.50	6.50
3M money market rate (Dec avg)	11.75	8.88	9.85	5.8	7.4
USD/RSD (eop)	86.18	83.13	98.73	114.81	110.34
EUR/RSD (eop)	113.72	114.64	121.50	122.00	125.00
USD/RSD (pavg)	87.96	85.16	88.45	111.69	111.94
EUR/RSD (pavg)	113.13	113.09	117.26	121.29	123.86

Source: UniCredit Research

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

An encouraging start

Domestic demand returned to positive territory in 1Q15, helped by investments and a softer fall of private consumption…

The Serbian economy is set to exit recession in 2H15, supported by stronger private investments and net external demand. Final 1Q15 GDP data showed the economy contracted by 1.8% yoy, equaling the drop in 4Q14. In seasonally adjusted terms, GDP contracted by 0.4% qoq, but the decline was less than originally anticipated. This is partly due to the plunge in the price of oil, which has helped limit the contraction in private consumption (-0.6% yoy) resulting from the cuts to public sector wages and pensions in 4Q14. Effectively, this has also translated into a more modest contraction in retail sales (-0.7% yoy SA), and higher cash flows for companies. Fixed investments and inventories also benefited from an impressive rebound in 1Q15, fully offsetting the negative contribution from domestic consumption (-1.2pp). On the net external demand front, exports accelerated strongly (+9.7% yoy) thanks to a weaker dinar, but failed to overcome the (oil-driven) surge in imports (+11% yoy). Even so, we expect net exports to regain ground this year, reinforced by stronger EU growth and a low base.

…leading us to revise upward our GDP growth estimates to 0.2% yoy in 2015 and 1.5% yoy in 2016

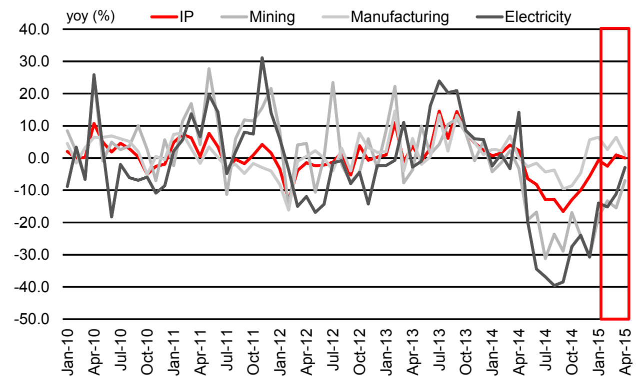
We expect the economy to stagnate this year, but there is significant potential for a stronger rebound. We have raised our GDP growth estimates this year by 0.5pp to 0.2% yoy, and by 0.2pp to 1.5% yoy in 2016. The revision captures more resilient private consumption and a stronger impulse from private fixed investments and net exports. However, we see potential for a stronger recovery over the forecast horizon, particularly if the Zelezara Smedrevo's steel production plans increase as planned (1.2mn tons in 2015; 1.5mn tons in 2016). According to official estimates, this could add an additional 0.5-0.6pp to GDP this year and as much as 0.8pp in 2016. Mining and electricity output is also recovering following last year's floods, thanks to the clearing of water from a number of mines in the Kolubara river basin. We expect a return to pre-flood coal production levels by end-2H15 (90,000 tons/day), which should provide a stronger carryover into 2016 GDP. In contrast, we do not expect a strong impact of Fiat's recently-signed car export agreement with Russia, due to Fiat's small share of the Russian market and the weak state of its domestic demand.

We expect the NBS to cut the policy rate in 3Q15 by an additional 50bp to 5.5%

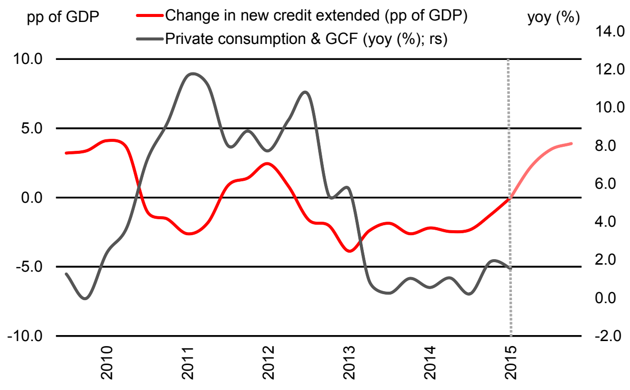
Inflation remains below target, opening the door for additional rate cuts in 3Q15. Inflation eased further in May (1.5% yoy) remaining below the lower-end of the NBS 4±1.5% target band for the 15 consecutive month, hindered by decelerating food and low oil prices. Looking at 3Q15, we expect the low base for food and fuel prices to fade which, combined with the agreed electricity price hike of 15% effective 1 August, should help accelerate inflation towards the target. Even so, we still asses the current monetary stance as tight, and expect the NBS to cut the policy rate by an additional 50bp to 5.5%. Assuming no change to the deposit rate, this would bring the policy rate closer to the average reverse repo rate.

THE ECONOMY IS SET TO RECOVER IN 2H15 DRIVEN BY PRIVATE FIXED INVESTMENTS AND EXPORTS

IP is catching up as the mining and electricity sectors recover



Domestic demand will benefit from a credit impulse in 2015-16



Source: Haver, SORS, NBS, UniCredit Research

Banking sector NPLs stand at 21.8% of gross loans, centered in the corporate and SOE sectors

Banking sector NPLs remain high, but contagion risks from Greece are limited. In February, system-wide NPLs rose to 21.8% of gross loans, partly as a result of a dip in lending at the start of the year. The bulk of these NPLs remain in the corporate (24.9%) and SOE (36.2%) sectors, but we fear these will remain on the upside as the economy continues to adjust. On a positive note, the system-wide capital adequacy ratio remains high (20%) while impairment provisions stand at a conservative 59.2% of NPLs. Even so, we see an imperative need for domestic banks to undergo a thorough cleanup of their balance sheets, which is likely to be enforced once it is confirmed by the Asset Quality Review due end-September. On a positive note, the exposure of Serbian banks to Greece is manageable, as Greek-controlled banks account just for 14.1% of banking sector asses (RSD 417.8bn at end-2014).

We expect the budget deficit to drop below target and public debt to stabilize only from 2017…

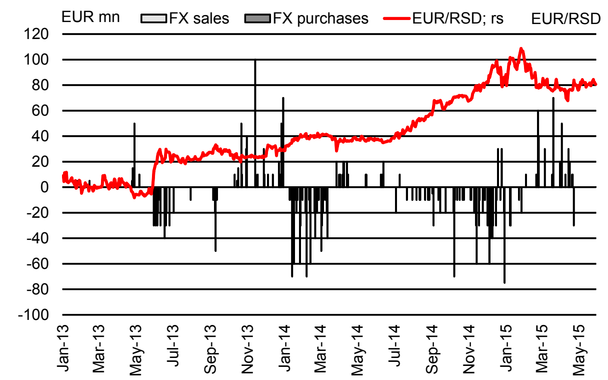
Budget performance to date is ahead of plan, boding well for the government to meet this year's deficit target. Between Jan-Apr, the general government's augmented budget deficit fell by a whopping 74% yoy to RSD 22bn, undershooting also the MinFin's target (RSD 71bn). Predominantly, the adjustment was facilitated by a windfall of one-off revenues (i.e. SOE dividend payments and sale of 4G licenses) but also from improved VAT and excise tax collection. However, efforts were also made to reduce pensions (-3.3% yoy) and the public sector wage bill (-12% yoy). The pace and scope of this early adjustment were welcomed by the IMF in its first Quarterly Review last May, while providing the government with comfortable room to meet its full-year target of 5.9% of GDP. Provided the measures to fight the grey economy remain effective and the government does not backpedal by softening its cuts to public sector entitlements, we expect the deficit (incl. contingent liabilities) to drop to 5.5% of GDP this year (from 6.7% of GDP in 2014). This upfront adjustment should help the government meet its deficit target of 3.8% of GDP by 2017 and put the public debt trend back on a sustainable path after having doubled in the past five years (2016F: 76.8% of GDP).

…provided the SOE restructuring process advances as planned

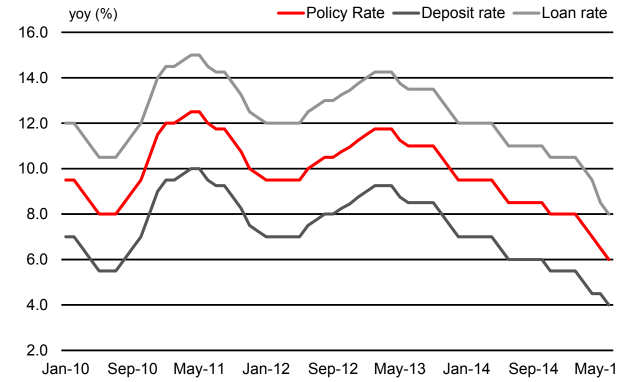
An efficient and timely restructuring of the SOE sector remains essential to validate the IMF program and consolidate public finances. This is one of the three main pillars set out in the government's Fiscal Strategy, as SOE contingent payments have cost the State an average of 2% of GDP per annum since 2011. A total of 512 companies have been slated for sale by year-end, of which more than 200 have already been put into bankruptcy procedure. Even so, we see the government's objective ambitious given the lack of investors' buying interest to date and large restructuring of the labour force it involves. In view of this, the government adopted a bill in mid-May extending the deadline to end-2016 for 17 of its largest and most strategic SOEs[15]. On a positive note, USD 400mn in support loans have been agreed on with the World Bank and another USD 200mn with the EBRD. This is welcomed, as it should help build credibility and provide an anchor for an efficient downsizing of Serbia's oversized SOE sector.

LOW INFLATION AND STABLE DINAR POINT TO LOOSER MONETARY POLICY IN 2H15

FX purchases by the NBS have helped stabilize the dinar in 2Q15…



...which, alongside low inflation, supports additional rate cuts



Source: Haver, Bloomberg, NBS, UniCredit Research

15 Among the 17 strategic companies are truck maker FAP, petrochemicals producer Petrohemija, food maker PKB, Resavica mines, and drug maker Galenika.

Strategy: Cautiously optimistic on easing and reforms

The domestic economy remains accommodative for bonds…

…with further reforms the key to deficit reduction and lower yields

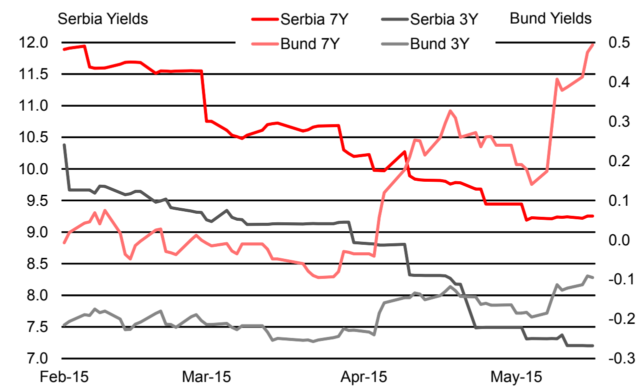
We continue to recommend the 3Y and 7Y domestic bonds but…

…the USD paper looks fully priced

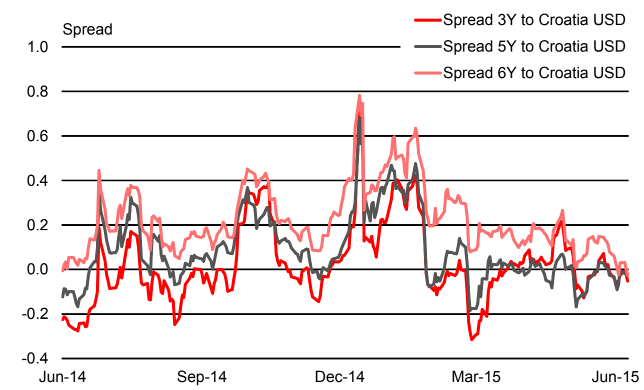
Despite better external demand, rising GDP growth projections and inflation which may rise due to electricity price rises and base effects, we think the bond backdrop remains encouraging with domestic demand remaining benign and the high real rates likely to force the NBS into further easing. An encouraging first IMF review with 1Q15 fiscal performance in line with targets and reduced budget deficit further improvement may arrive with the successful sale of SOEs such as Telekom Srbija expected in October. Provided the reform milestones continue to be met we expect to see the budget deficit reduced which will support lower yields. We continue to favor the local 3Y and 7Y benchmark bonds, while we are not expecting the same compression in yields as 2Q15 but the very high real yield remains attractive in addition the yields have not been correlated with the widening in bund yields one downside risk is that despite auction support has been very strong, issuance is behind target so there may be some supply side pressure. In external USD debt, spreads remain tight against US yields and with the SERBIA USD 18s looking the best value but against spreads to USD paper in Croatia, the Serbia USD bond curve looks fair value.

LOCAL BONDS CONTINUE TO HAVE ATTRACTIVE CARRY WHILE SERBIA USD CURVE LOOKS FAIR VALUE

Local Serbia bonds unaffected by Bund yield widening



Serbia USD curve looks fair value trading flat to Croatia USD bonds



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**5.0**	**5.9**	**4.9**
Budget deficit	2.2	1.8	1.6
Amortization of public debt	2.8	3.4	3.3
Domestic	2.2	2.8	2.7
Bonds	0.3	1.7	1.7
Bills	1.9	1.1	1.0
External	0.6	0.6	0.6
IMF	0.6	0.6	0
Financing	**5.0**	**5.9**	**4.9**
Domestic borrowing	3.9	3.6	3.8
Bonds	2.5	2.4	2.4
Bills	1.3	1.2	1.4
External borrowing	1.2	2.0	1.0
Bonds	0	1.5	0
IMF/EU	0.1	0.4	0.2
Other	1.1	0.2	0.8
Change in cash reserves (+=decline)	-0.1	0.3	0.1

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**7.0**	**6.7**	**6.6**
C/A deficit	2.0	1.5	1.6
Amortization of medium to long term debt	4.8	5.1	4.9
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	3.2
Amortization of short term debt	0.2	0.1	0
Government/Central Bank	0	0	0
Banks	0.2	0.1	0
Corporates	0	0	0
Financing	**7.0**	**6.7**	**6.6**
FDI	1.2	1.4	1.4
Equity	0	0	0
Borrowing	4.8	5.9	4.8
Government/Central Bank	1.2	2.0	1.0
IMF	0.1	0.4	0.2
Bonds	0	1.5	0
Other	1.1	0.2	0.8
Banks	1.1	0.7	0.6
Corporates	2.5	3.2	3.2
Change in FX reserves (+ = decline)	1.0	-0.5	0.4

Source: NBS, Bloomberg, MinFin, UniCredit Research

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

Outlook – 2015 will be a lost year for Turkey, with growth sagging, inflation rising, the underlying external position worsening, and the TRY under pressure. While geopolitics has played a role, sustained political tensions are the main culprit. With the June election resulting in a hung parliament, political uncertainty is likely to linger until a coalition is formed. Even so, with sentiment likely to be hit again as Fed rate hikes approach, the CBRT would have no choice but to hike rates. Assuming muted fallout of the Fed hikes, growth should recover next year. Downside risks are plentiful; however, if political tensions persist, the fallout from the Fed hikes is stronger, or policy actions delayed.

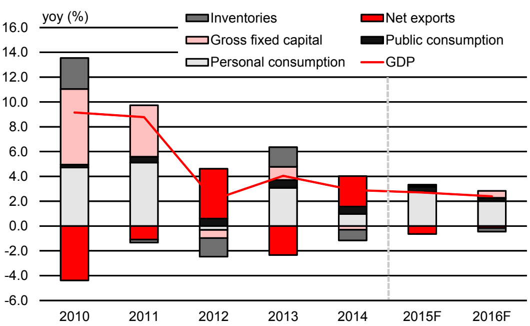
Strategy – We recommend staying underweight TURKGB amid coalition uncertainty. There may be an opportunity in TURKGBs if 5Y yields rise above 10% but currently the risk/return profile is not compelling. There is less risk in the hard currency USD bonds.

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

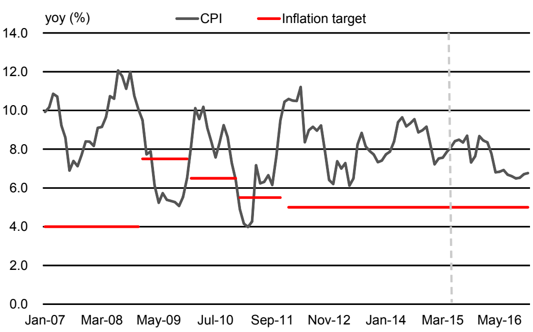
KEY DATES/EVENTS

- 01 July, 03 Aug, 01 Sept – Manufacturing PMI
- 03 July, 03 August, 03 Sept – Consumer price index
- 08 July, 07 Aug, 08 Sept – Industrial production
- 10 July, 11 August, 10 Sept – Current account balance
- 23 June, 23 July, 18 August – Policy rate decision

GDP GROWTH TO SLOWDOWN IN 2015-16



INFLATION TO REMAIN ABOVE TARGET



Source: TurkStat, CBRT, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	614.9	620.0	602.1	648.8	659.6
Population (mn)	75.2	76.1	77.3	78.2	79.0
GDP per capita (EUR)	8,179	8,153	7,787	8,302	8,353
Real economy yoy (%)					
GDP	2.1	4.2	2.9	2.7	2.4
Private Consumption	-0.5	5.1	1.3	4.2	3.0
Fixed Investment	-2.7	4.4	-1.3	0.5	2.4
Public Consumption	6.1	6.5	4.6	3.6	2.5
Exports	16.3	-0.2	6.8	1.9	3.6
Imports	-0.4	9.0	-0.2	4.2	4.0
Monthly wage, nominal (EUR)	919	961	968	994	1,016
Unemployment rate (%)	8.4	9.0	9.9	10.5	10.7
Fiscal accounts (% of GDP)					
Budget balance	-2.0	-1.2	-1.2	-2.6	-3.2
Primary balance	1.4	2.0	1.6	0.4	0.1
Public debt	37.6	37.4	35.0	34.1	34.2
External accounts					
Current account balance (EUR bn)	-37.8	-48.7	-35.0	-31.9	-36.2
Current account balance/GDP (%)	-6.1	-7.9	-5.8	-4.9	-5.5
Basic balance/GDP (%)	-5.0	-6.8	-5.1	-4.1	-4.7
Net FDI (EUR bn)	7.1	6.6	4.1	5.0	5.1
Net FDI (% of GDP)	1.2	1.1	0.7	0.8	0.8
Gross foreign debt (EUR bn)	256.9	282.2	331.5	338.8	369.7
Gross foreign debt (% of GDP)	41.8	45.5	55.0	52.2	56.1
FX reserves (EUR bn)	75.7	80.4	88.1	83.2	86.2
Inflation/Monetary/FX					
CPI (pavg)	8.9	7.5	8.9	8.00	7.10
CPI (eop)	6.2	7.4	8.2	8.70	6.80
Central bank reference rate (eop)	5.50	4.50	8.25	9.25	8.00
3M money market rate (Dec avg)	5.75	8.42	9.6	11.3	9.5
USD/TRY (eop)	1.79	2.07	2.30	2.90	2.85
EUR/TRY (eop)	2.35	2.83	2.83	3.36	3.40
USD/TRY (pavg)	1.80	1.91	2.19	2.68	2.81
EUR/TRY (pavg)	2.32	2.53	2.91	3.09	3.32

Source: UniCredit Research

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

A Golden Opportunity Missed

Turkey's economic performance has disappointed thus far this year…

2015 ought to have been Turkey's year, with the mix of lower oil prices, firmer demand in the EU and strong global risk appetite providing a rare opportunity to boost growth while reducing macroeconomic imbalances. However, none of this came true: growth remains lackluster, exports have stalled and disinflation has reversed. Market pressures have intensified, causing the TRY to lose one-fifth of its value against the USD since the start of the year.

…partly due to external factors, but mainly because of political tension….

…and growing concerns about central bank independence

This poor performance reflects a variety of factors. Geopolitical tensions played an important role, with exports to key markets like Iraq, Russia and Egypt plummeting 30-40% yoy. Exports to the EU have stalled as TRY appreciation against the weakening EUR has hit competiveness. However, political tensions remain the main culprit. Concerns about the AKP potentially gaining a constitutional majority in the June elections rattled markets during most of the first half of 2015. These tensions have been reinforced by President Erdogan's persistent attempts to force the CBRT to cut interest rates that have raised serious doubts about the independence of the CBRT, causing business confidence and consumer sentiment to nosedive.

Growth held up relatively well in 1Q15, but its composition deteriorated with the underlying C/A deficit widening…

While growth in 1Q15 held up relatively well against this background thanks to fiscal expansion and robust consumption (the latter spurred by lower oil prices and recovering credit growth), its composition has worsened. Private investment fell again and the external position continued deteriorating. The underlying C/A deficit widened by 1.2% of GDP yoy in January-April even though the nominal deficit narrowed by 0.6% of GDP thanks to lower oil prices.

…as both headline and core inflation accelerated, along with inflation expectations

Lackluster growth notwithstanding, disinflation has reversed. At 1% a month on average during January-May, inflation was little changed from a year before, but in yoy terms it accelerated to 8.1%. More importantly, as of late price pressures have shifted from food to non-tradables. This suggests rising inflation expectations, driven in part by the weaker TRY. This trend if sustained, would be a major departure from the last 10-12 years, during which the CBRT was able to de-link short-term exchange rate fluctuations from inflation expectations.

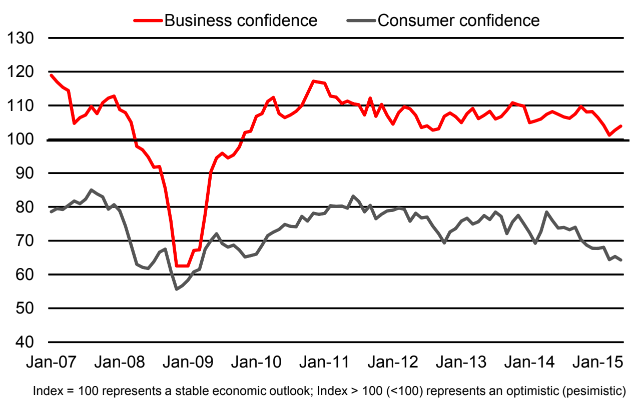
All these developments argue for a tighter monetary stance…

…which the CBRT has implemented only in part, shying away from outright rate cuts because of political pressure

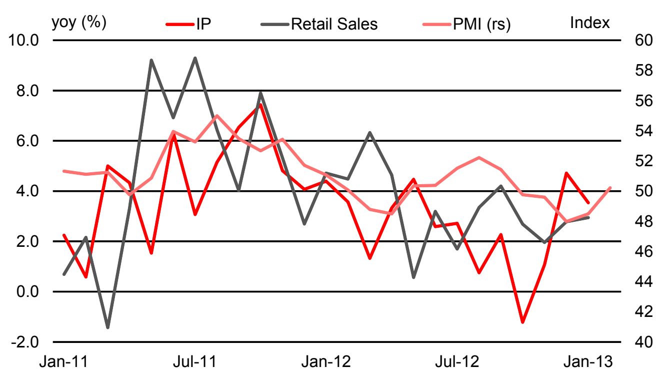
The combination of rising core and headline inflation, booming consumption and the deteriorating underlying external balance point to a still positive output gap and would argue for monetary tightening (as would the persistent pressures on the TRY). The CBRT indeed has tightened its monetary stance by using macro prudential measures and the room for maneuver within its interest rate corridor, but has stopped short of hiking rates, apparently due to the political pressure. Markets have remained unconvinced, however, which resulted in sustained outflows of portfolio capital and persistent pressure on the lira.

ECONOMIC PERFORMANCE HAS DISSAPOINTED IN 1Q15

Consumer and business confidence levels have deteriorated…



…weighing negatively on the real economy



Source: Haver, MinFin, CBRT, UniCredit Research

Hopes for a rebound in growth could well be dashed by the inconclusive election outcome, with forming a coalition likely to be a challenge

While recent PMI readings and other high-frequency data point to a certain firming of activity in 2Q15, hopes for a rebound could well be dashed given the inconclusive outcome of the June polls. The AKP's failure to gain a majority and the Kurdish HDP entering parliament have revamped the political setup. For the first time in 13 years, Turkey will be run by a coalition. This will be a challenge given the diverging views of the parties represented in parliament

We still expect an AKP-MHP coalition to be formed…

…which should be market-positive…

Under our baseline scenario, we assume that a coalition will be formed within the next 45-60 days. A coalition between AKP and the nationalist MHP looks most likely given their common electoral base. It remains to be seen how economic management will be conducted, but with AKP's team well known and that of the MHP led by a respected former central bank governor, an AKP-MHP coalition appears to be the most market-friendly and more fiscally responsible.

..enabling growth to pick up and market tensions to ebb..

…but only briefly as the Fed rate hikes approach, to which Turkey is highly vulnerable

Under these assumptions, growth should pick up in 3Q15 and market tensions should ebb. However, the respite would be brief with the Fed rate hikes coming to the forefront. With its large C/A deficit and reliance on volatile portfolio inflows, Turkey remains as vulnerable as ever to shifts in global sentiment. How hard the economy would be hit would depend on the size and the duration of the Fed-induced market disturbance, and on the policy response.

Assuming a modest and transitory disturbance, the fallout should be manageable…

..rate hikes still look unavoidable, but recession should be averted and the TRY would stabilize…

…but inflation pressures would persist

Assuming a modest and transitory Fed-related disturbance, the impact on the economy would be manageable. The CBRT would still need to raise rates, perhaps 100-150bp, to prop up the TRY and safeguard capital inflows. Economic activity would slow down, but a recession should be avoided and growth should recover towards 3.5% by the second half of 2016. The TRY, after temporarily weakening, should stabilize near its current level early next year and then gradually weaken in line with the inflation differential. Partly due to base effects, but also because of the weaker TRY, 12-month inflation would peak at 8.7% by yearend before easing to 6.8% by late 2016. Both readings will remain well above the CBRT's target as a larger reduction in inflation would require tighter monetary policy than the CBRT is likely to pursue, supported by broader structural reforms, which the coalition government is unlikely to be able to advance.

There are numerous downside risks….

…with failure to form a coalition triggering a market upheaval…

…a deeper Fed-induced disturbance probably leading to a recession…

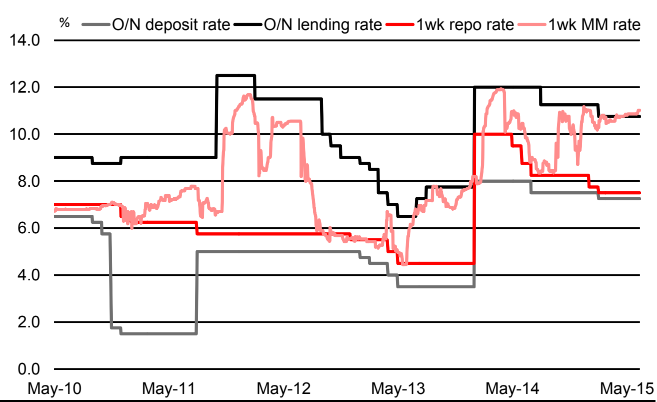
...or belated policy action denting confidence

There are numerous downside risks. A failure to form a coalition would keep political tensions high, resulting in sustained TRY weakness and earlier and larger rate hikes. We think the CBRT would act if the TRY would stay above 2.80-2.85/USD for a sustained period, both to stem inflation expectations, but also because of concerns about the impact the weak TRY would have on banking and corporate balance sheets. Other potential risks comprise a deeper and longer-lasting Fed-induced market disturbance that would reverse capital inflows for long enough to force a major depreciation and attendant rate hikes. In this case, a recession becomes a real possibility. Finally, belated or hesitant policy action by the CBRT may result in a further loss in confidence, larger capital outflows and deeper financial dislocation.

TRY PRESSURES AND RISING INFLATION CALL FOR A TIGHTER MONETARY STANCE

Exports constrained by external factors and loss in competitiveness

Rising core and headline inflation argue for monetary tightening



Source: Haver, Bloomberg, CBRT, TurkStat, UniCredit Research

Strategy: Underweight with opportunities

Stay underweight TURKGBs at current yields, but…

We recommend staying underweight TURKGBs at current yields. Coalition talks are likely to keep volatility high as the political horizon remains uncertain. TRY continues to drive the rates market, inflation remains elevated, driven domestically, although rate hikes are unlikely at current TRY levels. However if USDTRY stabilizes above 2.80 the probability of a rate hike greatly increases - resulting in a rally in the lira and TURKGBs. At 2.80, yields in the belly would be close to 10%, a level where local auction support has returned and we would look to move to market weight in 5Y bonds and initiate 2s10s steepeners in expectation of rate hikes.

...in significant TRY depreciation, the chance of hikes increases…

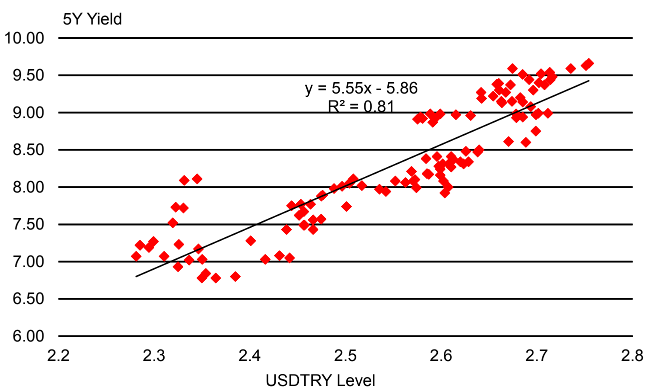
…providing an opportunity at higher yields

Hard currency USD bonds will be less volatile

In hard currency, the USD denominated bonds with currency protection, more attractive z spreads and lower correlation to US yields look better value. We see less risk in the front end of the curve and favour the TURKEY USD 18s. The EUR bonds may see some support if bund yields stabilise but risk to the upside beyond 3Q15. We favour moving duration to the front of the curve.

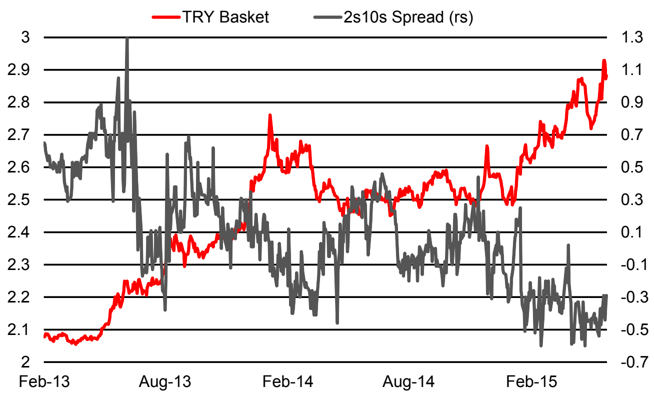
IF USDTRY REACHES 2.80, 5Y YIELDS SHOULD BE CLOSE TO 10%

Correlation of USDTRY with TURKGB 5Y



… AND THE CURVE SHOULD FLATTEN

TRY basket inverse relationship with 2s10s spread



Source: Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**56.8**	**59.9**	**58.3**
Budget deficit	8.9	14.4	16.3
Amortization of public debt	47.9	45.5	42.0
Domestic	43.3	40.3	36.6
Bonds	13.7	35.1	31.2
Bills	0	0	0
External	4.6	5.2	5.4
Financing	**56.8**	**59.9**	**58.3**
Domestic borrowing	47.0	52.0	48.5
Bonds	47.0	52.0	48.5
Bills	0	0	0
External borrowing	6.5	2.8	5.0
Other	3.7	3.5	3.8
Change in cash reserves (+ = decline)	-0.4	1.6	1.0

Source: CBRT, Turkstat, MinFin, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**167.0**	**177.1**	**174.3**
C/A deficit	35.0	32.3	35.6
Amortization of medium to long term debt	29.3	26.5	28.3
Government/Central Bank	4.7	4.6	4.5
Banks	7.2	13.0	11.5
Corporates	17.5	8.9	12.3
Short term debt	99.9	118.4	110.4
Government/central bank	0.6	0.3	0.2
Banks	71.2	85.8	76.8
Corporates	28.1	32.3	33.4
Errors & omissions	2.8	0	0
Financing	**167.0**	**177.1**	**174.3**
FDI	4.1	5.0	5.1
Portfolio	1.9	-1.2	0.2
Borrowing medium to long term	51.2	44.6	40.9
Government/central bank	8.9	2.5	4.2
Banks	23.6	28.1	21.7
Corporates	18.7	14.0	15.0
Short term borrowing	101.5	116.0	121.5
Government/central bank	0.2	0.2	0.4
Banks	73.7	80.7	83.5
Corporates	27.6	35.1	37.6
Other	7.9	10.6	9.2
Reserve accumulation	0.4	2.2	-2.5

Source: CBRT, UniCredit Research

Ukraine (Ca negative/CC negative/CC negative)*

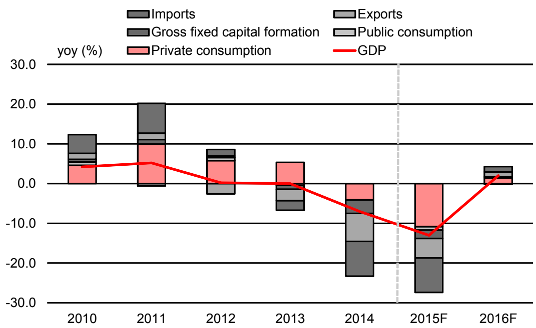
Outlook – Collapsing demand, stalled financial markets and war-related loss of capacity have left the economy in a free-fall, with the C/A still in deficit and inflation surging. These developments have opened a financing gap of 2-3% of GDP in the already underfinanced IMF program. Meeting these additional needs will be difficult given the slow pace of reforms and the official creditors' reluctance to issue "blank checks". The situation is further complicated by the stalled debt restructuring negotiations, a key element of the financial package. Time is running out with substantial payments already due in July for which the authorities have no funding, raising the odds for debt service interruption. A moratorium would not fully deprive Ukraine of funding, but would further complicate the daunting task or stabilizing the struggling economy. This would remain elusive until a lasting solution is found to the conflict – something which looks highly unlikely at present.

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

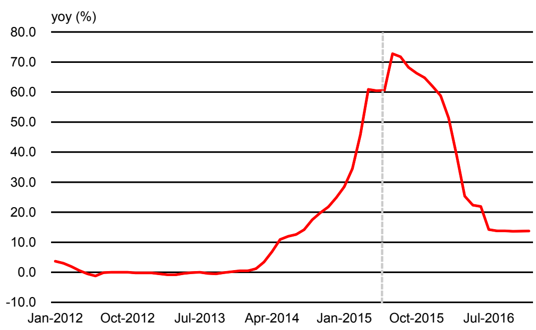
KEY DATES/EVENTS

- 1 July, 4 August, 30 September: NBR rate decisions
- 14 August, 4 September: 2Q15 GDP (flash, structure)
- 19-30 June, 27 September: final review and official ending of IMF/EC agreement

GDP GROWTH TO RESUME ONLY IN 2016



INFLATION TO DECELERATE IN 2H15



Source: State Statistics Service of Ukraine, UniCredit Research

MACROECONOMIC DATA AND FORECASTS

	2012	2013	2014	2015F	2016F
GDP (EUR bn)	135.6	132.0	106.5	79.8	76.1
Population (mn)	45.5	45.4	42.9	42.5	42.7
GDP per capita (EUR)	2,979.0	2,907.0	2,483.6	1,878.7	1,782.1
Real economy yoy (%)					
GDP	0.2	0	-6.8	-13.0	2.0
Private Consumption	11.7	1.0	-9.5	-15.0	2.0
Fixed Investment	0.9	0	-23.0	-20.0	2.5
Public Consumption	2.2	0	0.6	-5.0	-1.0
Exports	-7.7	-5.0	-14.5	-19.8	5.3
Imports	1.9	-6.0	-22.1	-24.8	4.3
Monthly wage, nominal (EUR)	292.0	294.0	232.4	156.5	138.5
Unemployment rate (%)	7.8	7.9	9.3	10.8	10.6
Fiscal accounts (% of GDP)					
Budget balance	-4.8	-4.6	-4.6	-3.7	-3.3
Primary balance	-2.3	-1.2	-1.2	0.8	1.9
Public debt	37.4	40.6	70.3	81.6	75.5
External accounts					
Current account balance (EUR bn)	-11.0	-12.4	-4.0	-1.4	-1.7
Current account balance/GDP (%)	-8.2	-9.2	-3.7	-1.7	-2.2
Basic balance/GDP (%)	-4.7	-2.6	-4.0	-1.4	-0.9
Net FDI (EUR bn)	4.2	3.5	-0.3	0.4	1.4
Net FDI (% of GDP)	3.1	2.6	-0.3	0.5	1.8
Gross foreign debt (EUR bn)	102.3	103.7	105.8	123.3	124.4
Gross foreign debt (% of GDP)	75.5	78.5	99.3	154.4	163.4
FX reserves (EUR bn)	17.2	14.6	5.2	11.7	14.2
Inflation/Monetary/FX					
CPI (pavg)	0.6	-0.3	12.1	58.7	23.0
CPI (eop)	-0.2	0.5	24.9	61.9	13.7
Central bank reference rate (eop)	7.5	6.5	14.0	30.0	15
3M money market rate (Dec, avg)	24.4	12.0	21.00	32.00	18.00
USD/UAH (eop)	8.1	8.2	15.7	32.0	30.8
EUR/UAH (eop)	10.6	11.1	19.0	37.4	36.3
USD/UAH (pavg)	8.1	8.1	12.0	24.2	30.2
EUR/UAH (pavg)	10.4	10.8	15.0	27.8	35.6

Source: UniCredit Research

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

Time is running out…

Ukraine's economy is imploding, with real GDP set to drop as much as 13% this year…

Ukraine's economy is imploding. Real GDP dropped 18% yoy in 1Q15, extending a similar decline in 4Q14. High-frequency data suggest that the contraction in 2Q15 is likely to have been as strong if not stronger. Even if the economy stabilizes at the new lower level later in the year (only likely if hostilities do not re-escalate), real GDP would drop 13% this year. This compares with a decline of 5.5% assumed in the original IMF program recently revised to 9%.

…partly because of the loss of capacity due to the war…

…which constrained exports, resulting in a sizable C/A deficit despite the collapse in demand

All components of demand dropped steeply, with private consumption hit by collapsing real incomes, investment hurt by weak confidence (due in part to the war), and export volumes slumping 20%. The latter has kept the C/A at a sizable deficit of 4.4% of GDP during January-April, much larger than assumed under the program, despite an even sharper drop in imports. Much of the collapse in output and exports reflects the loss of capacity due to the war in the eastern part of the country. Separatist-controlled areas account for 8% of the territory, 10-12% of GDP and roughly 15% of exports. However, most of the war-related contraction occurred in the second half of 2014 and early 2015, with recent data implying that activity may have leveled off by now.

Policies played a role, too, with fiscal adjustment and price hikes weighing on demand…

…and financial markets frozen due to FX restrictions and dysfunctional banks

Policy actions have played a major role as well. Fiscal policy had necessarily to be tightened sharply further to cope with the large deficit. Steep hikes in administered energy price to curb quasi-fiscal losses have pushed inflation to 60%, weighing heavily on demand. Delays in implementing the recapitalization of domestic banks have hit confidence, triggering major deposit outflows. Finally, pervasive exchange market restrictions imposed by the central bank to conserve reserves have all but cut off access to FX. Financial markets have stalled as a result, constraining the activities even of those parts of the economy that remain viable.

The adverse developments rendered the IMF framework implausible…

…opening an additional large financing gap

These adverse economic trends have rendered the framework of the initial IMF program implausible. The much steeper decline in activity and the larger C/A deficit have opened additional financing gaps that could be offset only in part by higher inflation. Assuming no intensification of fighting, we think that additional financing needs would amount to USD 2-3bn this year, or 2.5-3.5% of GDP. This amount is in addition to another USD 12-15bn needed to complete the bank recapitalization (estimated at USD 9bn by the authorities, the bulk of which would have to come from the government) and to boost FX reserves to USD 15bn – the level we think is the minimum needed to be able to phase out FX market restrictions.

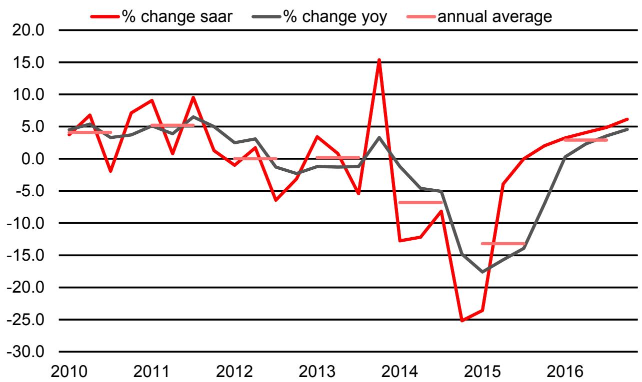
Disbursements need to be frontloaded to avert a collapse…,

…but doing so will be difficult due to sluggish pace of reforms

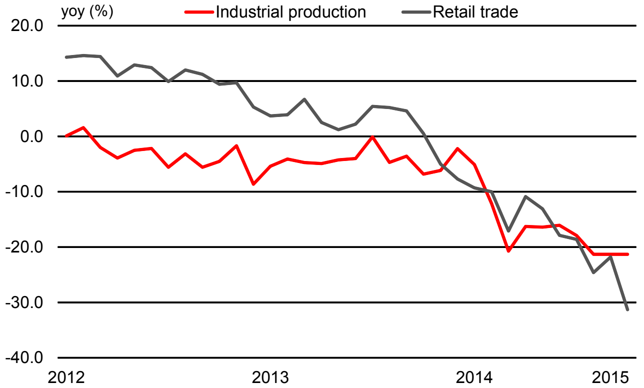
Augmenting the already large official financing package will be very difficult – mainly because the slow pace of reforms has made official creditors increasingly wary of providing "blank checks". At the same time, disbursements need to be heavily frontloaded to deal with the imminent danger of an economic and financial meltdown. And all this is against the backdrop of the lingering conflict in the East.

ECONOMIC ACTIVITY HAS COLLAPSED AMID FALLING CONFIDENCE AND WAR DAMAGE

GDP to drop much more than assumed by IMF



As IP and domestic demand implode



Source: NBU, national statistics office, UniCredit Research

Authorities are committed to reforms at the top…

…but implementation has lagged due to lack of capacity

One cannot claim that Ukrainian authorities have not pushed reforms. Much has been done – especially on the legal framework for fighting corruption, disclosing true bank owners, the first steps of energy reforms That said, implementation has lagged – at times because of the opposition by powerful vested interest groups, in other cases because of poor institutional capacity.

Financing pressures are reinforced by the lack of progress on debt restructuring…

Financing issues will be further reinforced by the lack of progress in talks to restructure Ukraine's roughly USD 19bn privately-held foreign government debt. This is essential because it is a key element of the program's financing plan. Talks have stalled on two issues: how to deal with the USD 3bn in bonds purchased by Russia in late 2013 and the disagreement between authorities and creditors on whether a principal haircut is needed.

…with the fate of the Russian bonds undecided…

…potentially threatening default by late December

Russia insists that this bond purchase is an official loan and made it clear that it won't participate in any restructuring. Ukraine considers them bonds like any other and subject to the same treatment. Because the problem is essentially political, we do not expect that it will be resolved outside a broader deal on the conflict. This looks improbable for now, at least until December, when the Russian bonds are due. Because of the same political sensitivity and the lack of money, we do not think Ukraine will repay the bonds when they become due, essentially triggering a default.

Suspension of debt servicing could come earlier if both parties do not agree on the restructuring

Suspension of debt servicing could occur earlier, however, if authorities and bondholders do not come to terms soon. While both sides are haggling, time is running out: a government guaranteed bond is due by late July, and more in September. Because a complete debt restructuring is a key condition for the second tranche disbursement, Ukraine would not be able to receive more financing, risking running out of money and defaulting in a few months.

Bondholders insist that no principal haircut is needed…

… with the government adopting the opposite position…

…implicitly supported by the IMF

Based on the initial program, creditors insist that cash-flow relief via a maturity extension and some coupon reduction would suffice to meet the terms set by the IMF. The government insists that given the sharply deteriorated economy, a haircut is imminent. The passage of a law threatening a moratorium if agreement is not reached, and a statement by the IMF that it would continue financing even in case of default have upped the stakes recently. We think that, given the latest developments and the uncertain future, a 35-40% haircut would be needed, along with more substantial coupon reductions to meet IMF targets.

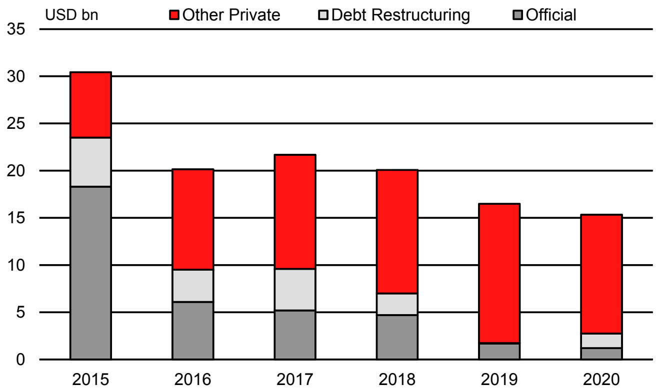
A default or hard restructuring would have no impact in the short run…

…but could seriously damage Ukraine's access to markets over the long run

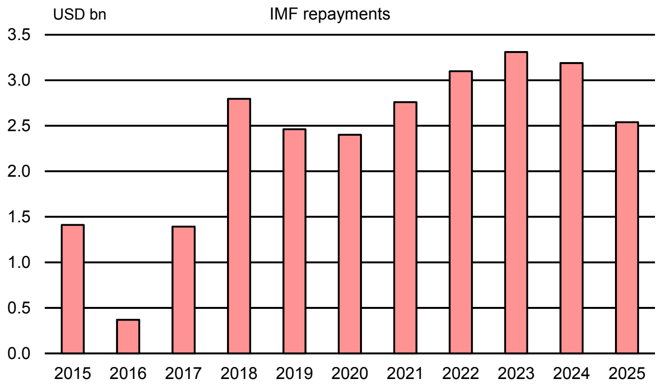
While a default or a "hard restructuring" would have few implications this year, when potential savings are high and markets are off-limits, they might seriously damage Ukraine's long-term access to financial markets. Currently, the program assumes restoration of market access by 2017, with especially heavy borrowing needs from 2019 to 2023 when the bulk of IMF loans are due. A hard restructuring could seriously damage Ukraine's standing with its creditors, barring market access for long and eventually forcing the IMF to embark on a follow-up program to repay itself.

MEDIUM-TERM EXTERNAL FINANCING PROFILE REMAINS CHALLENGING

Dependence on private capital markets rising



As repayments to the IMF soar



Source: NBU, Bloomberg, UniCredit Research

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**11.4**	**9.9**	**7.3**
Budget deficit	4.7	3.7	3.4
Amortization of public debt	6.7	6.2	3.9
Domestic	2.8	0.4	0.9
Bonds	2.0	0.8	0.9
Bills	0.8	0	0
External	3.9	5.8	3.0
Financing	**11.4**	**9.9**	**7.3**
Domestic borrowing	3.1	1.7	3.0
Bonds	2.7	1.7	3.0
Bills	0.4	0	0
External borrowing	6.3	9.4	3.2
Other	0.7	0	0
Change in cash reserves (+ = decline)	1.3	-1.2	1.1

Source: National Bank of Ukraine, MinFin, UniCredit Research

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2014	2015F	2016F
Gross financing requirement	**43.1**	**31.6**	**24.2**
C/A deficit	4.2	-1.4	-1.7
Amortisation of medium to long term debt	14.5	15.7	13.4
Government/central bank	5.5	4.7	2.9
Banks	2.9	2.2	2.1
Corporates	6.1	8.9	8.4
Short term debt	23.9	17.2	12.5
Government/central bank	0	0	0
Banks	4.4	4.2	2.5
Corporates	19.5	13.0	10.0
Errors & omissions	0.5	0	0
Financing	**43.1**	**31.6**	**24.2**
FDI	0.5	0.5	1.3
Portfolio	-0.3	-0.1	0
Borrowing medium to long term	13.1	22.7	15.1
Government/central bank	9.1	14.7	5.1
Banks	1.4	1.8	2.0
Corporates	2.6	6.2	8.0
Short term borrowing	17.2	12.5	13.5
Government/central bank	0	0	0
Banks	4.2	2.5	1.3
Corporates	13.0	10.0	12.2
Other	12.6	-4.0	-5.7
Reserve accumulation	10.0	-5.8	-3.0

Source: CBRT, Turkstat, UniCredit Research

Key dates over 3Q15: Rate and rating decisions

June	19-Jun	Bulgaria - Fitch rating
	19-Jun	Czech Rep - Moodys rating
	19-Jun	Slovenia - S&P rating
	23-Jun	Turkey rate decision
	23-Jun	Hungary rate decision
	25-Jun	Czech Rep rate decision
	30-Jun	Bulgaria rate decision
July	03-Jul	Russia - Fitch rating
	03-Jul	Serbia - Fitch rating
	08-Jul	Poland rate decision
	09-Jul	Serbia rate decision
	10-Jul	Hungary - Moodys rating
	17-Jul	Croatia - Moodys rating
	17-Jul	Croatia - S&P rating
	17-Jul	Serbia - S&P rating
	21-Jul	Hungary rate decision
	23-Jul	Turkey rate decision
	24-Jul	Estonia - Moodys rating
	24-Jul	Czech Rep - S&P rating
	31-Jul	Croatia - Fitch rating
	31-Jul	Poland - Fitch rating
	31-Jul	Slovakia - Moodys rating
	31-Jul	Slovakia - S&P rating
	31-Jul	Russia rate decision
	31-Jul	Bulgaria rate decision
August	06-Aug	Czech Rep rate decision
	07-Aug	Ukraine - Fitch rating
	07-Aug	Turkey - Moodys rating
	07-Aug	Poland - S&P rating
	13-Aug	Serbia rate decision
	14-Aug	Slovakia - Fitch rating
	18-Aug	Turkey rate decision
	21-Aug	Romania - Fitch rating
	21-Aug	Romania - Moodys rating
	25-Aug	Hungary rate decision
	28-Aug	Ukraine - S&P rating
	31-Aug	Bulgaria rate decision
September	02-Sep	Poland rate decision
	04-Sep	Lithuania - Moodys rating
	10-Sep	Serbia rate decision
	11-Sep	Poland - Moodys rating
	11-Sep	Russia rate decision
	18-Sep	Turkey - Fitch rating
	18-Sep	Slovenia - Moodys rating
	18-Sep	Hungary - S&P rating
	22-Sep	Turkey rate decision
	22-Sep	Hungary rate decision
	24-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

Source: UniCredit Research

Notes

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