CEE Insights

Fixed Income and Foreign Exchange

Looking ahead this week…

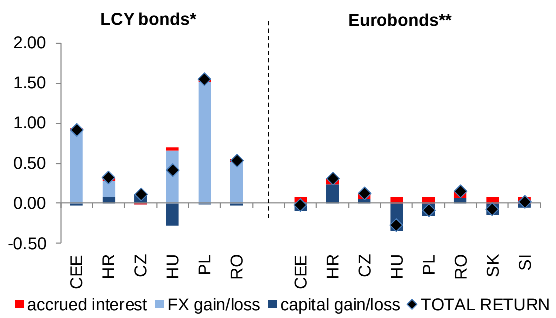
Monday	Tuesday	Wednesday	Thursday	Friday
PL: Unemployment **RS**: Wages	**HU**: Target Rate **SK**: Current Account		**SK**: PPI **HU**: Unemployment	**SI, PL**: CPI **SI, RS**: Retail Sales **HR, RS**: Industry **RS:** Trade Balance

Click for: this week's detailed releases/events, market forecasts, macro forecasts

The Hungarian central bank will hold its MPC meeting on Tuesday. We do not expect any change in the key rate. From September, the central bank should start to limit the amount that banks can deposit in its 3M deposit facility. We expect details to be unveiled only in August, but most likely the limit will be linked to the size of the balance sheet, forcing banks with a liquidity surplus to shift liquidity into either government securities or the money market. On the macro side, there will be mainly unemployment data published across the region, as well as confidence indicators. The next set of important indicators, which should already reflect the post-Brexit vote, July PMIs, will be published for CEE countries at the beginning of next week.

In case you missed it last week…

- Fitch Ratings downgraded Romania's and Poland's long-term LCY rating by notch due to worsened fiscal outlook
- Polish industrial output and retail sales posted robust growth, suggesting strong economic performance in 2Q16
- CEE fixed income market performed well, despite turmoil in Turkey
- For other events last week, please check respective countries: HR, CZ, HU, PL, RO, TR, SI, SK, SR



On Radar

The turmoil in Turkey, which started with a failed military coup ten days ago and now continues with a state of emergency declared by President Erdogan, has raised eyebrows among European politicians and global investors. The Turkish lira lost almost 7% in one week, while 10Y yields went above 10%. CEE markets have not been affected at all. CEE currencies even gained last week and CDS and yields went slightly down. Economically, CEE countries have very little in common with Turkey. Economic linkages are still very weak - the share of exports to Turkey is only around 2% for most CEE countries, although in some countries this has been on an upward trend. There has been increased economic cooperation in recent years between Turkey and SEE countries like Croatia, Slovenia, Serbia and Romania, but relative to the size of these economies, it has not been very significant. Overall, we think that the attempted coup will have its largest effect in the political arena, straining relations between Turkey and the EU on numerous fronts. Turkey is currently the main partner for the EU in its interim solution for the migration crisis. The instability in Turkey may increase pressure on EU member states to find a more durable solution to the migration crisis. (For further details, see the next page.)

Markets in CEE have not reacted to the escalation of the situation in Turkey; economic linkages between CEE and Turkey are quite small.

CEE unaffected by turmoil in Turkey

'How does the turmoil in Turkey affect CEE?'

Croatia: Although Turkey is one of the smallest trade partners for Croatia (around 1% of total exports), exports to that country increased by around 30% y/y, so this could spill over into trade relations and slow this robust growth. In addition, Turkish FDI inflows in banking (KentBank) and tourism (Dogus group) have increased in the last couple of years. In a recent interview, the Turkish ambassador stated that Croatia is one of the most interesting EU countries and that investors are monitoring the energy and wood manufacturing sectors, as well as keeping an eye on the portfolio of State Property Management Administration (DUUDI). Bottom line, although the effects of a potential economic slowdown in Turkey would not be strong, it could disrupt the ascendant financial-economic relations.

Czech Republic: We do not expect that recent political developments in Turkey will have any significant effects on the Czech economy. The Czech economy is mainly linked to Germany and the Eurozone. Thus, real economic activity and price development in the Czech Republic would be affected only indirectly in the event that the situation in Turkey were to negatively spill over into the Eurozone. Moreover, as Czech exporters have a high volume of new orders, we see only minor risks for the coming months, even if the situation in Europe slightly worsens. The same also holds true for the exchange rate and bond yields.

Hungary: So far, we have not seen any spillover from the Turkish turmoil into the domestic Hungarian market, as both LCY and FCY bond yields remained stable. In addition, thanks to the improving international market sentiment, the forint started to appreciate against the euro. Furthermore, there were no visible movements in the CDS either since the Brexit fallout. Hungary's direct economic and trade relations with Turkey are marginal. We therefore see no impact of the events on Hungarian economic dynamics.

Poland: Trade links between Poland and Turkey are rather small (the share of exports and imports stands at 1.5%). Thus, the direct economic impact from the turmoil in Turkey is likely to be limited and would post a downside risk for the outlook only in the case that the Eurozone and Germany are affected. Events in Turkey have not affected the FX and bond market, either. Quite to the contrary, the zloty strengthened, backed by the Fitch decision to affirm the rating and outlook, alongside strong economic data, while 10Y yields have remained stable. Our forecasts thus remain unaffected at this point.

Romania: We maintain our economic forecasts, but see direct risks for the Romanian economy stemming from the political crisis in Turkey. In 2015, Turkey ranked sixth among Romania's export destinations, with delivery of Romanian goods of EUR 2.2bn (1.3% of GDP). The stock of Turkish FDI was EUR 508mn in 2014, but business relations are stronger than those implied by this number because some Turkish companies are incorporated in EU countries. The market turmoil has not been felt on the local markets, and we think that investors will continue to differentiate among countries in the future.

Slovakia: The recent coup attempt in Turkey and the resulting uncertainty present negative risks for Slovakia, but mostly from a geopolitical perspective, rather than a direct economic one. The euro has strengthened against the Turkish lira, presenting positive news for imports from Turkey and negative news for our exports there. However, foreign trade with Turkey is relatively small, as only 1.3% of total Slovak exports and 0.8% of all imports are traded with the country (2016 data). Slovak government bond yields remain low, predominantly due to the continuing QE, but also partly acting as a safe haven in riskier environments (though less so than Bunds). Overall, the attempted coup will have its largest effect in the political arena, straining relations between Turkey and the EU on numerous fronts. Slovakia will have to deal with such questions as well, given its current presidency of the EU.

Slovenia: After signing a strategic partnership with Turkey in 2012, Slovenian-Turkish economic relations are getting firmer and Turkish investors are present and/or interested in various sectors such as tourism, telecommunications, food and the chemical industry; while the share of total exports is at a relatively low 1-1.5%, it is steadily increasing. Thus, a potential economic crisis in Turkey could lead to a decline in both export and investment potential, but given the relatively small share in trade and FDI, Slovenia would not be strongly affected.

Serbia: As one of the emerging European markets, Serbia could profit form the turmoil in Turkey, as investors (especially US-based) could shift their portfolios toward the Serbian bond market. We have already seen compression of the USD 2021 Eurobond by approx. 20bp in the last 10 days. On the other hand, Turkish investors are present in the agriculture, transport and energy sectors in Serbia. Although exports to Turkey are at a relatively modest 2%, it is important to note that Serbia and Turkey signed a free-trade agreement, so the goods trade share is steadily increasing. While Serbian markets could benefit from this situation, trade relations could take a hit.

Looking ahead

Date	Time	Ctry	Release	Period	Erste	Survey	Prior	Pre Comment
25. Jul.	10:00	**PL**	**Unempl. Rate**	Jun	***8.8%***	*8.8%*	9.1%	*We expect further improvement of labor market - not only due to seasonal factors.*
	12:00	**RS**	**Wages y/y**	Jun			-0.6%	
26. Jul.	14:00	**HU**	**Target Rate**	Jul 26	***0.9%***	*0.9%*	0.9%	*3M policy rate expected to remain unchanged. MPC focus should shift to fine-tuning of latest unconventional measures for remainder of this year.*
	14:30	**SK**	**CA Balance (m)**	May			-5.4 m	
28. Jul.	9:00	**SK**	**PPI y/y**	Jun	***-4.8%***		-5.7%	*We expect producer prices to have fallen by 4.8% y/y in June.*
	9:00	**HU**	**Unempl. Rate**	Jun	***5.3%***	*5.4%*	5.5%	*Unemployment rate continues to decline as labor market has been tightening - seasonal factors should assist decline.*
29. Jul.	08:00	**RO**	**Unempl. Rate**	Jun			6.6%	
	10:30	**SI**	**CPI y/y**	Jul	***0.3%***		0.6%	*After prolonged period of deflationary tone, CPI seen as remaining in positive area, although lower clothing prices seen as limiting stronger rebound in July*
	10:30	**SI**	**CPI m/m**	Jul			0.3%	
	10:30	**SI**	**Retail Sales y/y**	Jun	***0.5%***		0.4%	*Consumption performance seen as maintaining positive footprint, with June figure landing slightly stronger vs. May output.*
	11:00	**HR**	**Wages y/y**	May			2.6%	
	11:00	**HR**	**Ind. Prod. y/y**	Jun	***3.3%***		1.6%	*Following slightly weaker May output, June industrial production seen as picking up pace again, thus wrapping up average 2Q performance in excess of 3%.*
	12:00	**RS**	**Trade Balance**	Jun	***-284 m***		-355.3 m	*Continuous improvement of trade balance.*
	12:00	**RS**	**Ind. Prod. y/y**	Jun	***0.8%***		0.9%	*Although we expect rise on monthly basis, strong base effect to keep figure relatively low.*
	12:00	**RS**	**Retail Sales y/y**	Jun	***3.9%***		4.0%	*Seasonal pattern suggesting figure to land at around 4% y/y.*
29 Jul - 1. Aug.	14:00	**PL**	**CPI y/y**	Jul P	***-0.6%***	*-0.5%*	-0.8%	*Deflation to ease further, as commodity prices keep rising.*

Sources: Bloomberg, Reuters

Major markets

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- Concerns regarding the future development of the Turkish economy have risen after the military attempted a coup and President Erdogan declared a ‘state of emergency’. The trade ties between Turkey and major countries of the Eurozone are, however, quite limited. For example, just 1.8% of German exports are destined for Turkey. The ties between the Eurozone and Turkish banks are also quite limited, based on data from the BIS. Thus, for the time being, we do not foresee any negative implications for the Eurozone economy from the recent developments in Turkey.
- The outcome of the FOMC meeting will be announced on Wednesday. This time there will be neither press conference nor any new forecasts from participants on the most important macro variables. Therefore, markets will have to be content with the statement for any clues. As the impact of the Brexit is yet unknown committee members will want to wait for some post-referendum macro indicators before assessing the situation and making any change in monetary policy. Especially, the US labor market has reached full employment and the US economy has accelerated strongly in the second quarter. Currently, We think December is the most likely date for the next interest rate hike.
- On Friday, the first 2Q16 flash GDP growth data for the Eurozone will be released. Based on leading indicators, we forecast that the Eurozone economy will have grown by around 1.6-1.7% y/y in 2Q16. On a component basis, consumption and investments are quite likely to remain the key drivers for growth in the Eurozone. In 3Q16, however, we expect slower GDP growth from the Eurozone due to the Brexit vote.

Croatia

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- The unemployment rate fully matched our expectations, with the June release showing a further decline of 0.8pp m/m, with the figure landing below the 14% mark at 13.6%. Seasonal support continues to drive the better performance on the labor market side, while also anchoring more positive trends on the consumption side.
- There were no major developments on the market side, as the exchange rate remained below 7.50, still reflecting the influence of the seasonal pattern, while the benchmark bond yield remained virtually unchanged on the w/w basis.

Czech Republic

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- PPI inflation arrived at 0.3% m/m and -4.4% y/y. In m/m terms, the increase was influenced by higher oil prices, which were partly offset by decreases in the prices of food products.

Hungary

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- Gross wages rose by 6.6% y/y, while net wages grew by 8.3% y/y in May. If we take into consideration the CPI inflation rate, net real wages increased by 8.5% y/y.
- The budget deficit stood at HUF 312.2bn in June, thus the YTD cash deficit reached HUF 402.1bn (vs. last year's HUF 823.3bn), or 52.8% of this year's CF-based target.

Poland

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- Industry expanded 6.0% y/y in June and retail sales went up 4.6% y/y, well above market expectations. Growing employment and wages as well as fiscal loosening (500+ program) supports private consumption. Overall, the strong monthly data suggests that 2Q16 should remain solid and land above 3% y/y. This argues for stability of rates and we thus expect the MPC to keep the policy rate at 1.5%
- The government supported the presidential project of lowering the retirement age to 60 for women and 65 for men without any further conditions. However, the government wants to have it introduced no sooner than fall next year and is considering limiting freedom to work when receiving a pension. We see the lowering of the retirement age as a costly change, negative for the budget deficit in the short run and threatening public finances in the long run.
- Minister of Finance Szalamacha claims that the budget deficit will be within the fiscal limit of 3% of GDP next year, even if the retirement age is lowered. YTD budget performance shows that tax revenues have been growing, which translates into a lower than expected deficit after half a year. However, as the planned expenses are high, any slowdown in the economy is likely to put pressure on revenue flow and thus the deficit. We continue to considerable fiscal risks and expect the spread vs. Bunds to remain wide.
- Fitch Ratings downgraded Poland and moved Long-Term Local Currency to 'A-' from 'A' and kept the outlook stable. Change of the rating was driven by the change in criteria and Fitch explains it would be inappropriate to wait until the next scheduled review date to update the rating or Outlook. The next scheduled review date for Fitch's sovereign rating on Poland is 1H17. Revision of rating makes agency less likely to act during next review.

Romania

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- Fitch has downgraded Romania's long-term LCY rating to 'BBB-' from 'BBB', while affirming the long-term FC rating at 'BBB-'. The outlooks are stable. Fitch foresees the budget deficit at 3% of GDP in 2016 and 2.9% in 2017 and warns that significantly higher fiscal shortfalls and worsening of government debt dynamics could trigger negative rating action in the future. We think that Romania's ratings are at risk in the next quarters unless the new government that takes office after elections takes decisive measures to keep budget deficit under control.
- The Romanian leu shrugged off worries related to the tense political situation in Turkey and appreciated to 4.455 last Thursday, its strongest

level in almost three months. The MinFin bond auction enjoyed strong demand and yields fell against a backdrop of investor optimism. Stability of the local political landscape ahead of the November parliamentary elections played a role in this respect. We foresee the EURRON at 4.51 in December 2016 and 4.50 in December 2017, with risks coming from the current deterioration of the C/A balance.

Serbia

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- The current account deficit in Jan-May 2016 almost halved, supported by the robust net export performance (exports +11% y/y vs. 4.2% y/y in imports) and increasing surplus on income accounts. On the financing side, net FDI inflows stayed relatively flat at EUR 700mn. Looking forward, we expect similar developments to continue to push the C/A deficit figure to around 4% of GDP.
- On the bond market, we saw some volatility after the issuance of the new tranche of the RSD 7Y benchmark bond, with the yield compressing by around 20bp w/w, now standing at 5.57%. On the FX market, appreciation pressures continued, prompting the NBS to intervene on the market by buying a total of EUR 95mn.

Slovakia

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- Unemployment, as measured by the labor bureaus, remained at 9.5% in June, as new university graduates have finished their studies and usually take a few months off before taking up work in the autumn. The first half of the year saw a substantial fall in the rate of unemployment, largely due to employment growth. We expect this favorable development to continue in the coming months.
- Slovak government bond yields remain low, supported by the ongoing QE. As the ECB's decision to leave monetary policy unchanged in July was expected, SK11 yields hardly moved following the Governing Council meeting and are still at around 0.5%.

Slovenia

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- The May unemployment rate landed one notch below our expectation, with the headline figure further declining to 11.1%, i.e. down 0.4pp on the monthly basis, while also trending 1.1pp lower on the annual level. The ongoing labor market improvement continues to be supportive for the consumption pattern, where we see room for a stronger performance ahead, additionally backed up by the improved consumer sentiment and low inflation trajectory.
- We saw no major moves on the bond side, as yields remained broadly flat throughout the week, with the EUR 2025 curve settling further below the 1% mark.

Capital market forecasts

Government bond yields	current	2016Q3	2016Q4	2017Q1	2017Q2
Croatia 10Y	3.80	3.80	3.80	3.90	3.90
Czech Rep. 10Y	0.36	0.49	0.63	0.62	0.53
Hungary 10Y	2.94	3.05	2.98	2.90	2.82
Poland 10Y	2.88	2.78	2.90	3.00	3.20
Romania10Y	3.23	3.10	2.85	2.85	2.85
Slovakia 10Y	0.48	0.65	0.65	0.70	0.75
Slovenia 10Y	0.82	0.90	0.90	1.00	1.50
Serbia 7Y	5.56	5.50	5.25	5.25	5.25

3M Money Market Rate	current	2016Q3	2016Q4	2017Q1	2017Q2
Croatia	0.80	0.80	0.80	0.80	0.80
3M forwards		-	-	-	-
Czech Republic	0.29	0.29	0.28	0.28	0.27
3M forwards		0.32	0.28	0.25	0.24
Hungary	0.94	1.00	1.00	1.00	1.00
3M forwards		0.88	0.79	0.75	0.74
Poland	1.71	1.68	1.68	1.68	1.68
3M forwards		1.73	1.66	1.63	1.61
Romania	0.80	0.65	0.65	0.65	0.65
3M forwards		0.56	0.71	0.85	1.04
Serbia	3.53	3.50	3.50	3.50	3.50
3M forwards		-	-	-	-
Eurozone	-0.30	-0.25	-0.25	-0.25	-0.25

FX	current	2016Q3	2016Q4	2017Q1	2017Q2
EURHRK	7.49	7.60	7.65	7.65	7.55
forwards			7.52	7.53	7.56
EURCZK	27.02	27.10	27.10	27.03	27.02
forwards			27.01	26.99	26.98
EURHUF	313.4	317.0	318.0	318.0	318.0
forwards			315.3	316.2	317.2
EURPLN	4.35	4.41	4.36	4.33	4.29
forwards			4.40	4.42	4.44
EURRON	4.46	4.50	4.51	4.50	4.50
forwards			4.48	4.49	4.50
EURRSD	123.5	123.0	123.5	123.5	124.0
forwards		-	-	-	-
EURUSD	1.10	1.12	1.10	1.12	1.14

Key Interest Rate	current	2016Q3	2016Q4	2017Q1	2017Q2
Croatia	0.50	0.50	0.50	0.50	0.50
Czech Republic	0.05	0.05	0.05	0.05	0.05
Hungary	0.90	0.90	0.90	0.90	0.90
Poland	1.50	1.50	1.50	1.50	1.50
Romania	1.75	1.75	1.75	1.75	1.75
Serbia	4.00	4.00	3.75	3.75	3.75
Eurozone	0.00	0.00	0.00	0.00	0.00

Macro forecasts (under review due to Brexit)

Real GDP growth (%)	2014	2015	2016f	2017f
Croatia	-0.4	1.6	1.8	2.0
Czech Republic	2.0	4.3	2.2	2.5
Hungary	3.7	2.9	2.0	2.8
Poland	3.3	3.6	3.1	3.3
Romania	3.0	3.8	4.1	3.6
Serbia	-1.8	0.7	2.3	2.6
Slovakia	2.5	3.6	3.1	3.1
Slovenia	3.0	2.9	1.8	2.1
CEE8 average	**2.7**	**3.5**	**2.9**	**3.0**

Average inflation (%)	2014	2015	2016f	2017f
Croatia	-0.2	-0.5	-0.9	1.0
Czech Republic	0.4	0.4	0.6	1.3
Hungary	-0.2	-0.1	0.6	2.0
Poland	0.0	-0.9	-0.6	0.9
Romania	1.1	-0.6	-1.4	1.4
Serbia	2.1	1.7	1.8	2.5
Slovakia	-0.1	-0.3	-0.3	1.2
Slovenia	0.2	-0.5	-0.1	1.5
CEE8 average	**0.3**	**-0.4**	**-0.3**	**1.3**

Unemployment (%)	2014	2015	2016f	2017f
Croatia	17.3	16.3	15.8	15.3
Czech Republic	5.9	4.5	4.1	4.2
Hungary	7.7	6.8	5.5	5.2
Poland	12.4	10.6	9.3	8.7
Romania	6.8	6.8	6.7	6.7
Serbia	19.2	17.7	17.3	17.0
Slovakia	13.2	11.5	10.0	9.3
Slovenia	9.7	9.0	8.5	8.1
CEE8 average	**10.5**	**9.2**	**8.2**	**7.9**

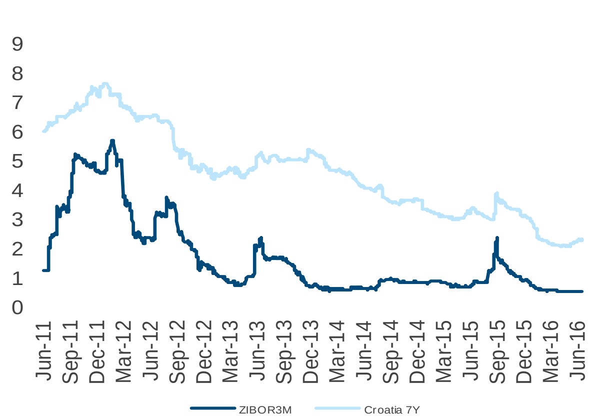
Public debt (% of GDP)	2014	2015	2016f	2017f
Croatia	86.5	86.7	87.3	86.3
Czech Republic	42.7	41.1	40.0	39.1
Hungary	76.2	75.3	75.1	74.3
Poland	50.2	51.5	51.9	52.4
Romania	39.8	38.4	40.6	42.3
Serbia	70.4	75.6	75.8	75.0
Slovakia	53.9	52.9	53.0	53.2
Slovenia	80.8	83.4	81.2	79.8
CEE8 average	**53.8**	**54.0**	**54.1**	**54.1**

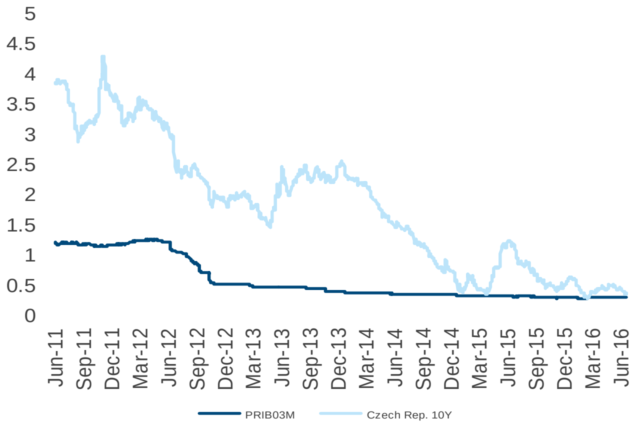
C/A (%GDP)	2014	2015	2016f	2017f
Croatia	0.9	5.2	3.3	2.9
Czech Republic	0.2	0.9	0.9	0.9
Hungary	2.3	4.4	4.9	4.7
Poland	-1.3	-0.2	-0.7	-1.4
Romania	-0.5	-1.1	-2.2	-2.5
Serbia	-6.0	-4.8	-4.3	-4.6
Slovakia	0.1	-1.3	0.0	0.7
Slovenia	7.0	7.3	7.9	7.7
CEE8 average	**-0.2**	**0.6**	**0.3**	**0.0**

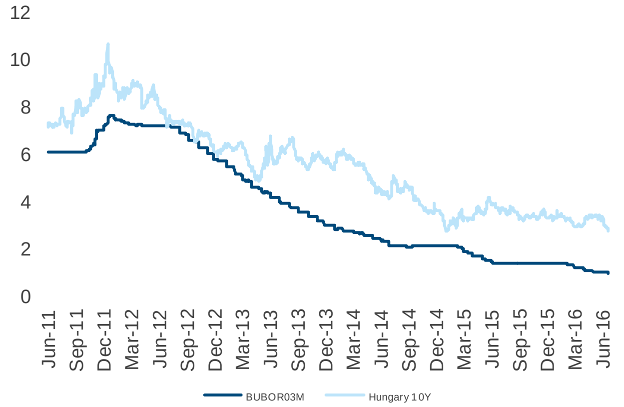
Budget Balance (%GDP	2014	2015	2016f	2017f
Croatia	-5.5	-3.2	-2.8	-2.4
Czech Republic	-1.8	-1.4	-1.1	-1.0
Hungary	-2.3	-2.0	-2.2	-2.7
Poland	-3.2	-2.5	-2.9	-3.1
Romania	-0.9	-0.7	-2.9	-3.5
Serbia	-6.6	-3.8	-3.2	-3.0
Slovakia	-2.7	-3.0	-2.5	-2.0
Slovenia	-5.5	-2.9	-2.6	-2.2
CEE8 average	**-2.8**	**-2.1**	**-2.5**	**-2.6**

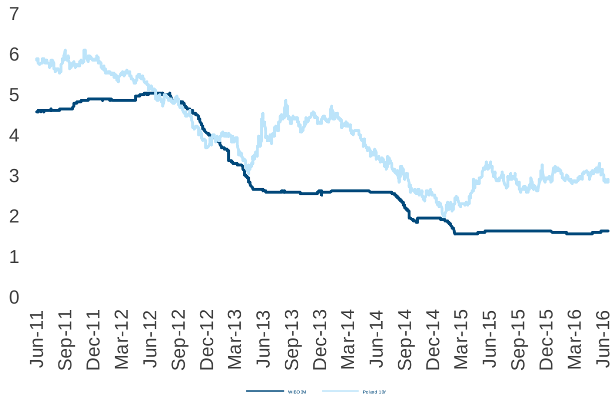
Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

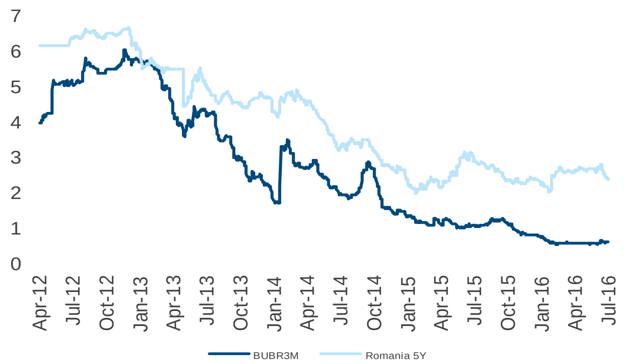
Appendix

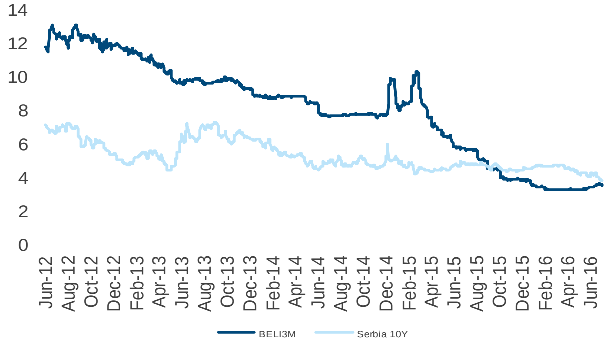


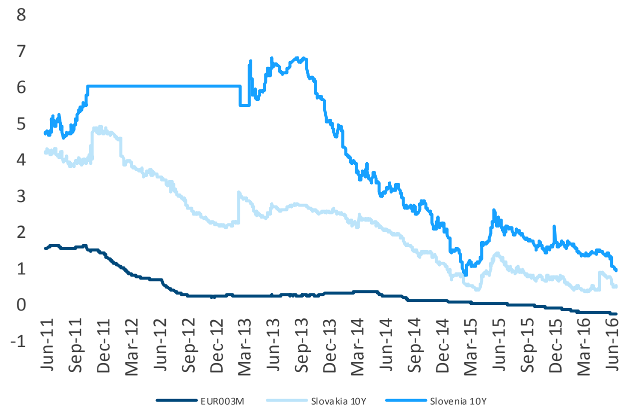












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