Week ahead

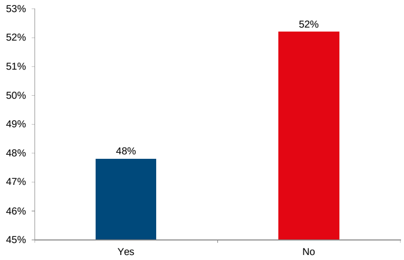
Italy – Constitutional referendum to take place on December 4
US – Labor market strong overall in November
China – Further decline of FX reserves in November to be expected

Analysts:

Rainer Singer
rainer.singer@erstegroup.com

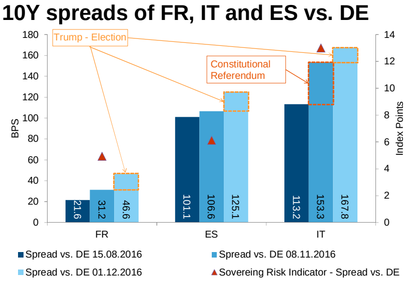
Gerald Walek
gerald.walek@erstegroup.com

IT referendum poll data



Source: Index Research

10Y spreads of FR, IT and ES vs. DE



Source: Eurostat, Erste Group Research

Major Markets & Credit Research

Gudrun Egger, CEFA
(Head)

Rainer Singer
(Senior Economist Eurozone, US)

Gerald Walek, CFA
(Economist Eurozone)

Katharina Böhm-Klamt
(Quantitative Analyst Eurozone)

Margarita Grushanina
(Economist Österreich)

Rejection of constitutional reform to be expected, based on latest poll data

Whether PM Renzi will step down in case of 'no' vote is unclear
Italy is going to decide about a substantial constitutional reform on December 4. The reform intends to bring the current political system based on two chambers to an end by substantially curtailing the rights of the Senate. Due to the differing composition of the Senate and the Parliament, changes of law have sometimes been a complex and time-consuming affair. In addition, the reform intends to transfer several competences from the regions to the central government in Rome. The ongoing weakness of Italy's economy shows how important further reform steps are for the country. In the case of a 'yes' vote in the referendum, the government of Renzi could step up its reform efforts in order to lower the bureaucracy and improve competition on product markets. A 'no' vote would mean the opposite and Renzi's political future would be in doubt. In addition, Italy's already weak growth prospects would weaken further (the EC estimates Italy's potential growth at 0.3% for 2017/18), since the probability for further reforms would decline as well.

The increase of the spreads for Italian vs. German government bonds since summer (the lowest level was seen on August 15) indicates that financial markets have started to price in the increased risks stemming from the poll data, with a tendency towards a 'no' vote. In addition, the election of Trump as US president has increased general political risks, which has led to a further rise of Italian credit risk spreads. This development, however, also resulted in increased risk premiums for French and Spanish government bonds.

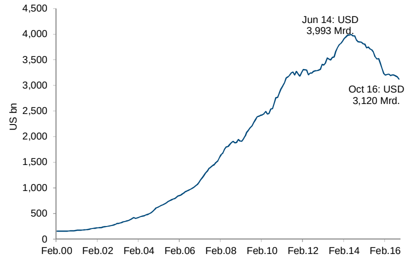
How markets react to a 'no' vote (poll data attach a high probability to a 'no' vote) depends largely on whether Renzi would step down or not. If the government would step down and new elections would be held next year in spring or summer, this would of course increase the political risk for Italy. The toughest opponent in this election would be the 5-star movement, which seeks a referendum on Italy's membership in the Euro Area. We consider Italy exiting the Euro Area a tail risk. The main reasons are that, legally, this would only be possible if a country exits the EU, which, for the time being, no political party in Italy supports. On top of that, substantial economic disruption could be expected, because a looming exit from the Euro Area would probably trigger capital controls and banks would be under pressure. We therefore believe that, in the case of a 'no' vote, the credit spreads for Italian government bonds would rise, due to the rising political and economic risks; however, we do not expect a sell-off. Several reasons speak against this. For example, the market has already prepared itself for such an outcome to a certain extent, the purchase program of the ECB will support the Italian bond market for the foreseeable time, and, in this low interest rate environment, investors are *always searching for higher-yielding assets.*

Strong decline of unemployment rate shows tightening US labor market

The US labor market report for November signaled the ongoing strength of the labor market. Gains in non-farm payrolls were reported at 178,000, marginally below market expectations. This constitutes a considerable improvement compared to the previous month's revised increase of 142,000. Wages disappointed. Average hourly earnings fell by 0.1% m/m, whereas the market had expected an increase of 0.2% m/m. However, the strong decline in unemployment from 4.9% to 4.6% in our view more than compensated for the shortfall in wages. The development of the unemployment rate, together with the slight decline in the participation rate, shows that the labor market is becoming tighter, which is a prerequisite for higher wages. Accordingly, we see the soft wage data as a fluctuation and not meaningful. Overall, we see the data as pointing to an ongoing cyclical upswing of the US labor market.

Further decline of China's FX reserves expected in November

China FX reserves



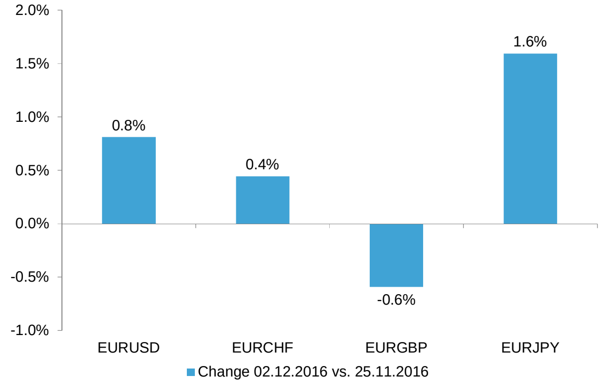
Source: Bloomberg, Erste Group Research

China is going to release the November value of its FX reserves on December 7. The short-term development of China's FX reserves is closely tied to the US dollar. Already in October, the strong rise of the US dollar index (+3% m/m) led to an acceleration of the decline of China's FX reserves to USD 3,120bn. The strength of the US dollar puts pressure on China's FX reserves for two reasons. On one hand, the US dollar rises due to expected interest rate hikes by the Fed, which in turn lowers the relative attractiveness of investments in other currencies, such as the Chinese renminbi. In addition, the valuation of assets of China's FX reserves that are not denominated in USD suffers as well.

Given the prolonged relative strength of the US dollar in November (US dollar index up another 3.1% m/m), we expect another sharp decline of China's FX reserves in November in the magnitude of USD 40-60bn. *Over the longer term, the gradual liberalization of China's capital account supports the continuous decline of China's FX reserves because it allows Chinese investors to diversify their capital abroad. China finds itself in the classic dilemma that a country cannot sustain an independent monetary policy, a fixed exchange rate and open capital borders. Thus far, China has opted for a controlled weakening of the renminbi in order to keep control over its monetary policy. As long as this process runs in an orderly manner, capital markets should not be too worried about it. China's economy stabilized in 2016 and leading indicators point towards GDP growth of 7% in 4Q16. China's positive economic development is also supportive for the exports of the Eurozone.*

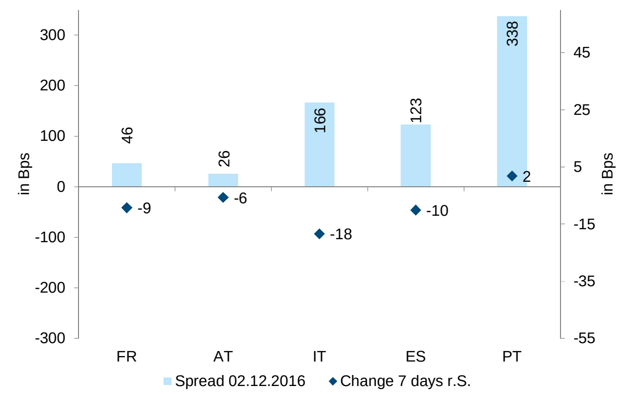
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
change last week
(+ stronger euro / - weaker euro)



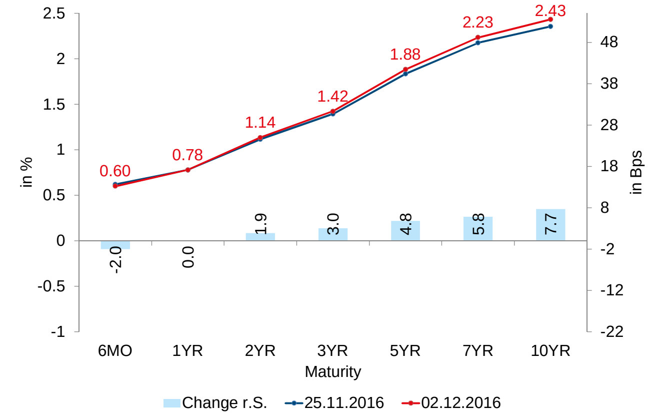
Source: Bloomberg, Erste Group Research

Eurozone – spreads vs. Germany
10Y government bonds



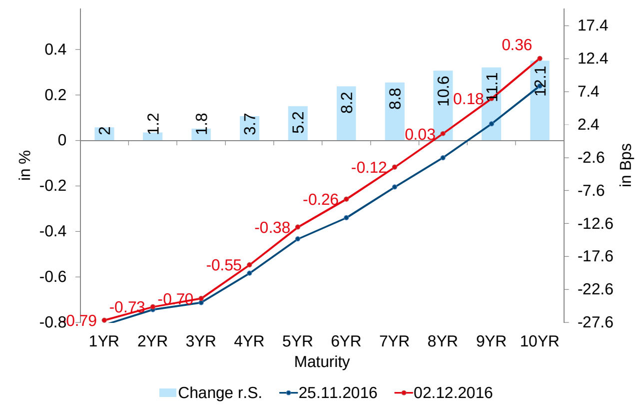
Source: Bloomberg, Erste Group Research

US Treasuries yield curve
change last week



Source: Bloomberg, Erste Group Research

DE Bund yield curve
change last week



Source: Bloomberg, Erste Group Research

Economic calendar

Date	Time	Ctry	Release	Period	Consens	Prior
2-Dec	11:00	EA	PPI y/y	Oct	-0.9%	-1.5%
	14:30	US	Wages y/y	Nov	2.8%	2.8%
		US	Unempl. Rate	Nov	4.9%	4.9%
		US	Chg. Non-Farm Payrolls	Nov	183.5 thd	161.0 thd
5-Dec	11:00	EA	Retail Sales y/y	Oct	1.5%	1.1%
	16:00	US	ISM Non-Manufacturing	Nov	55.3 index	54.8 index
6-Dec	11:00	EA	GDP q/q	3Q F	0.3%	0.3%
		EA	GDP y/y	3Q F	1.5%	1.6%
	14:30	US	Trade Balance	Oct	-41m	-36m
	16:00	US	Durable Goods Orders	Oct F	0.2%	4.8%
7-Dec	n.a.	CN	Forex Reserves	Nov	3071bn	3121bn
	8:00	DE	Ind. Prod. y/y	Oct	1.0%	-1.8%
	8:45	FR	Trade Balance	Oct		-4769m
		FR	CA Balance (m)	Oct		-3413 m
8-Dec	n.a.	FR	Cap Util.	Nov		77.6%
	13:45	EA	Target Rate (lending)	-	-0.40%	-0.40%
		EA	Target Rate	-		0.00%
	14:30	US	Jobless Claims	Dec 3	253.3 thd	268.0 thd
9-Dec	3:30	CN	Inflation y/y	Nov	2.2%	2.1%
		CN	PPI y/y	Nov	2.1%	1.2%
	8:00	DE	CA Balance (m)	Oct		24 m
		DE	Trade Balance	Oct	22m	24m
	8:45	FR	Ind. Prod. y/y	Oct	-0.8%	-1.1%
	16:00	US	Univ. Michigan Index	Dec P	94.5 index	93.8 index

Source: Bloomberg, Erste Group Research

FORECASTS[1])

GDP	2013	2014	2015	2016	2017
Eurozone	-0.3	1.2	2.0	1.5	1.7
US	1.9	2.4	2.4	1.6	2.1

Inflation	2013	2014	2015	2016	2017
Eurozone	1.3	0.5	0.1	0.2	1.3
US	1.5	1.6	0.1	1.2	2.1

	current	Dec.16	Mar.17	Jun.17	Sep.17
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.31	-0.30	-0.30	-0.30	-0.30
Germany Govt. 10Y	0.33	0.30	0.50	0.80	0.80
Swap 10Y	0.73	0.60	0.80	1.10	1.10

	current	Dec.16	Mar.17	Jun.17	Sep.17
Fed Funds Target Rate*	0.31	0.63	0.88	1.13	1.38
3M Libor	0.93	0.94	1.19	1.44	1.70
US Govt. 10Y	2.43	2.20	2.30	2.60	2.70
EURUSD	1.06	1.05	1.06	1.08	1.10

*Mid of target range

	current	Dec.16	Mar.17	Jun.17	Sep.17
Austria 10Y	0.58	0.50	0.70	1.00	1.00
Spread AT - DE	0.24	0.20	0.20	0.20	0.20

Source: Bloomberg, Erste Group Research

1 By regulations we are obliged to issue the following statement: Forecasts are no reliable indicator for future performance

Contacts

Group Research

Head of Group Research	
Friedrich Mostböck, CEFA	+43 (0)5 0100 11902
Major Markets & Credit Research	
Head: Gudrun Egger, CEFA	+43 (0)5 0100 11909
Ralf Burchert, CEFA (Agency Analyst)	+43 (0)5 0100 16314
Hans Engel (Senior Analyst Global Equities)	+43 (0)5 0100 19835
Christian Enger, CFA (Covered Bonds)	+43 (0)5 0100 84052
Margarita Grushanina (Economist AT, CHF)	+43 (0)5 0100 11957
Peter Kaufmann, CFA (Corporate Bonds)	+43 (0)5 0100 11183
Stephan Lingnau (Global Equities)	+43 (0)5 0100 16574
Carmen Riefler-Kowarsch (Covered Bonds)	+43 (0)5 0100 19632
Rainer Singer (Senior Economist Euro, US)	+43 (0)5 0100 17331
Bernadett Povazsai-Römhild (Corporate Bonds)	+43 (0)5 0100 17203
Elena Statelov, CIIA (Corporate Bonds)	+43 (0)5 0100 19641
Gerald Walek, CFA (Economist Euro)	+43 (0)5 0100 16360
Katharina Böhm-Klamt (Quantitative Analyst Euro)	+43 (0)5 0100 19632
Macro/Fixed Income Research CEE	
Head CEE: Juraj Kotian (Macro/FI)	+43 (0)5 0100 17357
Zoltan Arokszallasi, CFA (Fixed income)	+43 (0)5 0100 18781
Katarzyna Rzentarzewska (Fixed income)	+43 (0)5 0100 17356
CEE Equity Research	
Head: Henning Eßkuchen	+43 (0)5 0100 19634
Daniel Lion, CIIA (Technology, Ind. Goods&Services)	+43 (0)5 0100 17420
Christoph Schultes, MBA, CIIA (Real Estate)	+43 (0)5 0100 11523
Vera Sutedja, CFA, MBA (Telecom)	+43 (0)5 0100 11905
Thomas Unger, CFA (Banks, Insurance)	+43 (0)5 0100 17344
Vladimira Urbankova, MBA (Pharma)	+43 (0)5 0100 17343
Martina Valenta, MBA (Real Estate)	+43 (0)5 0100 11913
Editor Research CEE	
Brett Aarons	+420 956 711 014
Research Croatia/Serbia	
Head: Mladen Dodig (Equity)	+381 11 22 09178
Head: Alen Kovac (Fixed income)	+385 72 37 1383
Anto Augustinovic (Equity)	+385 72 37 2833
Milan Deskar-Skrbic (Fixed income)	+385 72 37 1349
Magdalena Dolenec (Equity)	+385 72 37 1407
Ivana Rogic (Fixed income)	+385 72 37 2419
Davor Spoljar, CFA (Equity)	+385 72 37 2825
Research Czech Republic	
Head: David Navratil (Fixed income)	+420 956 765 439
Head: Petr Bartek (Equity)	+420 956 765 227
Jiri Polansky (Fixed income)	+420 956 765 192
Pavel Smolik (Equity)	+420 956 765 434
Jan Sumbera (Equity)	+420 956 765 218
Roman Sedmera (Fixed income)	+420 956 765 391
Jana Urbankova (Fixed income)	+420 956 765 456
Research Hungary	
Head: József Miró (Equity)	+361 235 5131
Gergely Ürmössy (Fixed income)	+361 373 2830
András Nagy (Equity)	+361 235 5132
Orsolya Nyeste (Fixed income)	+361 268 4428
Tamás Pletser, CFA (Oil&Gas)	+361 235 5135
Research Poland	
Head: Magdalena Komaracka, CFA (Equity)	+48 22 330 6256
Marek Czachor (Equity)	+48 22 330 6254
Tomasz Duda (Equity)	+48 22 330 6253
Mateusz Krupa (Equity)	+48 22 330 6251
Karol Brodziński (Equity)	+48 22 330 6252
Research Romania	
Head: Mihai Caruntu (Equity)	+40 3735 10427
Head: Dumitru Dulgheru (Fixed income)	+40 3735 10433
Chief Analyst: Eugen Sinca (Fixed income)	+40 3735 10435
Dorina Ilasco (Fixed Income)	+40 3735 10436
Research Slovakia	
Head: Maria Valachyova, (Fixed income)	+421 2 4862 4185
Katarina Muchova (Fixed income)	+421 2 4862 4762
Research Turkey	
Umut Ozturk (Equity)	+90 212 371 25 30
Oguzhan Evranos (Equity)	+90 212 371 25 42

Treasury - Erste Bank Vienna

Group Markets Retail Sales	
Head: Christian Reiss	+43 (0)5 0100 84012
Markets Retail a. Sparkassen Sales AT	
Head: Markus Kaller	+43 (0)5 0100 84239
Equity a. Fund Retail Sales	
Head: Kurt Gerhold	+43 (0)5 0100 84232
Fixed Income a. Certificate Sales	
Head: Uwe Kolar	+43 (0)5 0100 83214
Markets Corporate Sales AT	
Head: Christian Skopek	+43 (0)5 0100 84146

Fixed Income Institutional Sales

Group Markets Financial Institutions	
Head: Manfred Neuwirth	+43 (0)5 0100 84250
Bank and Institutional Sales	
Head: Jürgen Niemeier	+49 (0)30 8105800 5503
Institutional Sales Western Europe AT, GER, FRA, BENELUX	
Head: Thomas Almen	+43 (0)5 0100 84323
Charles-Henry de Fontenilles	+43 (0)5 0100 84115
Marc Pichler	+43 (0)5 0100 84118
Rene Klasen	+49 (0)30 8105800 5521
Dirk Seefeld	+49 (0)30 8105800 5523
Bernd Bollhof	+49 (0)30 8105800 5525
Bank and Savingsbanks Sales	
Head: Marc Friebertshäuser	+49 (0)711 810400 5540
Sven Kienzle	+49 (0)711 810400 5541
Michael Schmotz	+43 (0)5 0100 85542
Ulrich Inhofner	+43 (0)5 0100 85544
Martina Fux	+43 (0)5 0100 84113
Michael Konczer	+43 (0)5 0100 84121
Klaus Vosseler	+49 (0)711 810400 5560
Andreas Goll	+49 (0)711 810400 5561
Mathias Gindele	+49 (0)711 810400 5562
Institutional Sales CEE and International	
Head: Jaromir Malak	+43 (0)5 0100 84254
Central Bank and International Sales	
Head: Margit Hraschek	+43 (0)5 0100 84117
Christian Kössler	+43 (0)5 0100 84116
Bernd Thaler	+43 (0)5 0100 84119
Institutional Sales PL and CIS	
Pawel Kielek	+48 22 538 6223
Michal Jarmakowicz (Fixed Income)	+43 50100 85611
Institutional Sales Slovakia	
Head: Peter Kniz	+421 2 4862 5624
Monika Smelikova	+421 2 4862 5629
Institutional Sales Czech Republic	
Head: Ondrej Cech	+420 2 2499 5577
Milan Bartos	+420 2 2499 5562
Barbara Suvadova	+420 2 2499 5590
Institutional Asset Management Sales Czech Republic	
Head: Petr Holecek	+420 956 765 453
Martin Perina	+420 956 765 106
Petr Valenta	+420 956 765 140
David Petracek	+420 956 765 809
Institutional Sales Croatia	
Head: Antun Buric	+385 (0)7237 2439
Željko Pavičić	+385 (0)7237 1494
Ivan Jelavic	+385 (0)7237 1638
Institutional Sales Hungary	
Attila Hollo	+36 1 237 8209
Borbala Csizmadia	+36 1 237 8205
Institutional Sales Romania	
Head: Ciprian Mitu	+43 (0)50100 85612
Stefan Racovita	+40 373 516 531
Business Support	
Tamara Fodera	+43 (0)50100 12614
Bettina Mahoric	+43 (0)50100 86441

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Erste Group Bank AG
Group Research
1100 Vienna, Austria, Am Belvedere 1
Head Office: Wien
Commercial Register No: FN 33209m
Commercial Court of Vienna

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