Week ahead

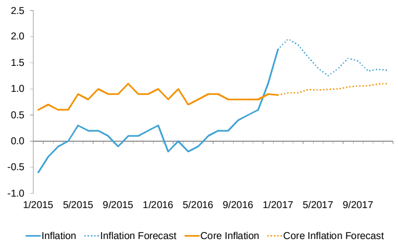
Eurozone – Inflation in February expected at around +2.0% y/y
Eurozone – Bond market volatility increases
Emerging Markets – Industry sentiment expected to ascend in February

Analysts:

Gerald Walek
gerald.walek@erstegroup.com

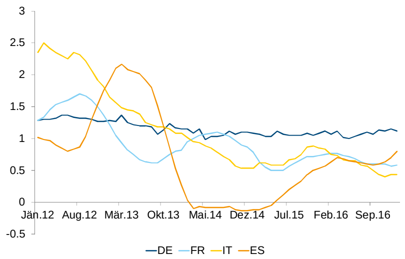
Rainer Singer
rainer.singer@erstegroup.com

EZ – inflation vs. core inflation



Source: Eurostat, Erste Group Research

Core inflation 6-month averages: DE, FR, IT, ES



Source: Eurostat, Erste Group Research

Eurozone – energy component should lead to further increase in inflation in February

Next week (February 28), flash estimates for Eurozone inflation in February will be released. Inflation rose in January to +1.8% y/y – above market expectations. The main driver for the strong increase of inflation in January was the energy component (+8.1 y/y), which is in turn strongly dependent on the development of oil prices. In addition, soft commodity prices rose significantly (+3.5% y/y). Core inflation in comparison remained stable, at +0.9% y/y in January. On a regional level, diverging developments are visible. In Germany, the level of core inflation has been stable for many years at around 1.0 to 1.2%. French and Italian core inflation based on semiannual averages, seem to have bottomed out on different levels (FR: +0.6% y/y; IT: +0.4% y/y). By contrast, Spain's core inflation has confirmed an ongoing upswing since mid-2016 (recently at +1.2% y/y).

Due to the persistent base effects from energy prices, we expect the energy component to continue to contribute substantially to inflation dynamics in the Eurozone in February. ***We expect a further slight increase in headline inflation in February to approx. 2.0%.*** *For the upcoming months, we forecast inflation rates declining somewhat, based on the slightly lower pressure from energy prices. Considering the stronger than expected pricing pressure (energy & food) YTD, we up our inflation forecast for 2017 from +1.3% to +1.5%.*

ECB's further monetary policy decisions will depend on the development of core inflation in the various member states. Accompanied by the ongoing recovery of the Eurozone economy, we expect a steady gradual increase of core inflation until the end of the year, to approx. +1.1% to +1.2% y/y.

German yields fall, despite good economic data

In the course of the week, yields declined severely on the Euro sovereign bond market, which was in clear contrast to the published macro data. The PMI data for the Eurozone published this week showed even further momentum when compared to the already strong January data, thus exceeding market expectations. This confirms the sustained positive economic development within the Eurozone. The decline of German yields started already in January from a high level. The surprise was how far the movement continued this week, especially at the short end. The yield on 2-year German bonds reached historic lows of -0.95%. Basically, we see two causes for the most recent movement. On the one side, the market seems to be experiencing a shortage, driven by two different factors, and on the other side the market is reacting to rising political risks

Major Markets & Credit Research

Gudrun Egger, CEFA
(Head)

Rainer Singer
(Senior Economist Eurozone, US)

Gerald Walek, CFA
(Economist Eurozone)

Margarita Grushanina
(Economist Austria, Quant Analyst EZ)

that stem from the approaching parliamentary elections in the Netherlands (March 15) and the presidential election in France (April 23 and run-off May 7). In addition, the risk of new elections in Italy is looming as well.

The shortage seems to result from the high demand for German bonds as collateral (e.g. short sales, derivatives), alongside high stocks of German bonds held by the central bank. As of January, bonds with a yield below -0.40% are – if necessary – eligible under the terms of the ECB's asset purchase program, which in turn might caused additional downward pressure on shorter-term yields. We assume that this shortage was behind the movements this week, since spreads for French or Dutch over German bonds did not rise further. Nevertheless, the fact remains that political developments exert pressure, which is evident in the substantial widening of spreads since the end of January.

From our perspective, the reaction of markets to political risks is exaggerated. Obviously, the market's wrong assessment of political risks in 2016 (Brexit, US elections) seems to still be deeply embedded, which has now turned into high levels of nervousness. The presidential election in France will take place in two months' time and the poll data sees Le Pen as the clear loser. The wrong predictions of poll data ahead of the Brexit vote and the US presidential election do not make the current French poll data invalid. In 2016, polls indicated a difference between the two political camps at just a few percentage points and was thus quite slim. Le Pen, however, trails her likely opponents substantially. In the run-off election, 40-44% of interviewees would vote for her, while the most likely counter candidates (Fillon or Macron) would reach 56-60%. Nevertheless, the nervousness of the markets could prevail. In the short term, the election results in the Netherlands could dampen or amplify the worries. In the end, we do not expect either of the two countries to leave the Eurozone.

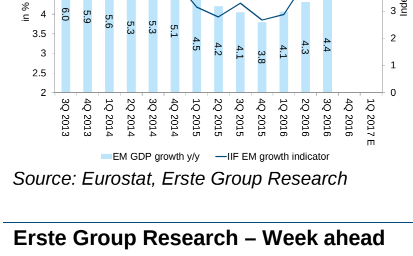
The other factor that likely contributed to the recent yield declines, the scarcity of German government bonds, is more difficult to gauge. Should the obvious distortions, especially at the short end of the curve, persist, the ECB could alter the settings of it security lending program to increase supply. However, there is a risk that the tensions in the repo market could increase further, as the ECB's purchasing program takes more bonds off the market. In total, the situation on the bond market remains highly uncertain. For the time being, we leave our yield forecasts unchanged and remain confident that, after the French election, the macro data will again be the main determinant for the bond market, which points to higher yields. However, in the short term, we expect volatility to remain high.

Emerging Markets – upswing continues; industry sentiment expected to rise in February

Over the course of the next week, industry sentiment data on important Emerging Markets will be released. In January, the data has turned out differently depending on the country. In Russia, sentiment reached – spurred on by rising oil prices – a multiannual high. In India and China, the data is located in slightly expansive territory and in Brazil sentiment remained subdued.

The IIF Emerging Markets growth indicator improved markedly and reached a 5½-year high in January, indicating a growth acceleration of Emerging Markets in 1Q17. In our view, the strengthening of Emerging Market currencies compared to the dollar, as well as the continued increase in commodity prices are additional supportive elements for

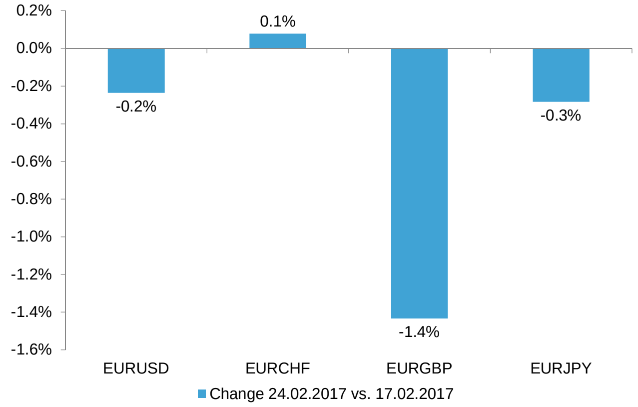
IIF EM leading indicator vs. EM GDP-growth



Source: Eurostat, Erste Group Research *growth in the Emerging Markets. We thus expect industry sentiment to rise in February in most Emerging Markets. This is also good news for the Eurozone's export dynamics and therefore – due to the importance of exports for investment activity – for overall economic dynamics in the Eurozone in 2017.*

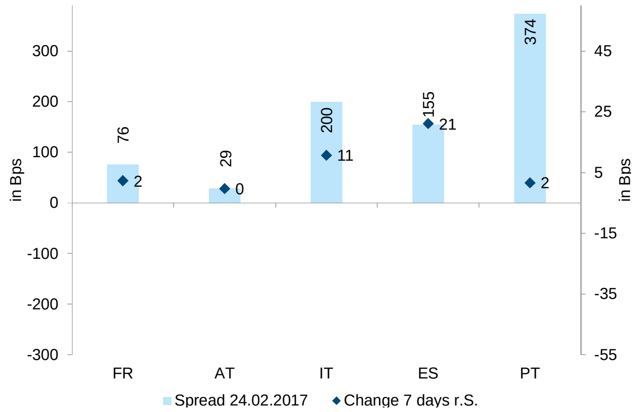
Forex and government bond markets

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



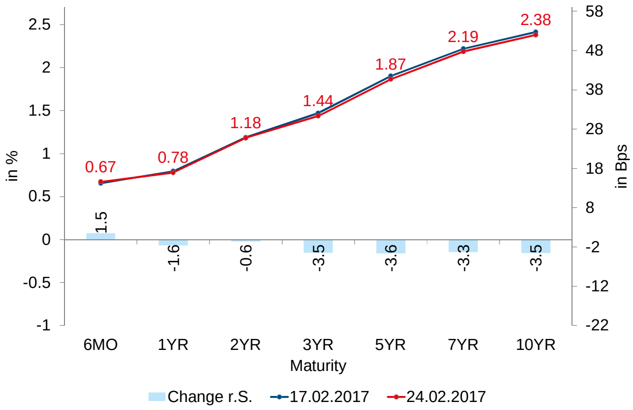
Source: Bloomberg, Erste Group Research

Eurozone – spreads vs. Germany
10Y government bonds



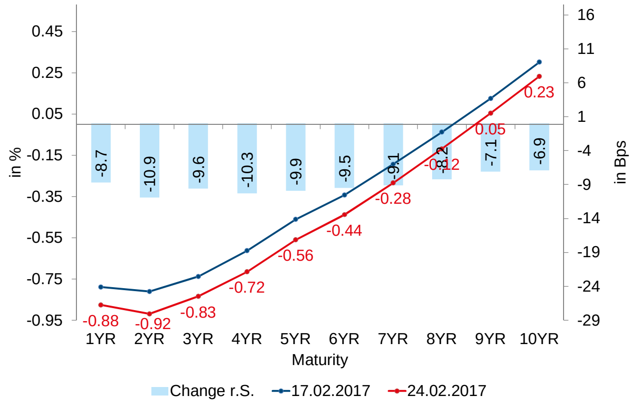
Source: Bloomberg, Erste Group Research

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
24-Feb	9:00	AT	Ind. Prod. y/y	Dec		2.3%
	16:00	US	Univ. Michigan Index	Feb F	96.0 index	95.7 index
		US	New Home Sales	Jan	573.0 thd	536.0 thd
27-Feb	n.a.	FR	Consumer Conf.	Feb		-8.6 index
		DE	Consumer Conf.	Feb		0.2 index
		IT	Consumer Conf.	Feb		-12.9 index
		AT	Consumer Conf.	Feb		-2.6 index
		DE	Retail Sales y/y	Jan		-1.1%
	10:00	AT	PMI Manufacturing	Feb		57.3 index
	11:00	EA	Consumer Conf.	Feb F	-6.2 index	-6.2 index
		EA	Business Conf.	Feb	107.8 index	107.9 index
	14:30	US	Durable Goods Orders	Jan P	1.6%	-0.5%
28-Feb	8:45	FR	CPI m/m	Feb P		-0.3%
		FR	PPI y/y	Jan		1.7%
		FR	GDP y/y	4Q P		1.1%
		FR	Inflation y/y	Feb P		1.6%
		FR	GDP q/q	4Q P		0.4%
	9:00	AT	GDP q/q	4Q F		0.6%
		AT	GDP y/y	4Q F		1.8%
	11:00	IT	Inflation y/y	Feb P	1.3%	1.0%
		IT	CPI m/m	Feb P	-0.2%	-1.7%
	14:30	US	GDP q/q	4Q S	2.1%	1.9%
	16:00	US	Consumer Conf.	Feb	111.1 index	111.8 index
1-Mar	3:45	CN	PMI Manufacturing	Feb	50.7 index	51.0 index
	9:500	FR	PMI Manufacturing	Feb F		52.3 index
	9:45	IT	PMI Manufacturing	Feb F		53.0 index
	9:55	DE	PMI Manufacturing	Feb F	57.0 index	57.0 index
	10:00	EA	PMI Manufacturing	Feb F	55.5 index	55.5 index
	14:00	DE	Inflation y/y	Feb P	2.1%	1.9%
		DE	CPI m/m	Feb P	0.6%	-0.8%
	14:30	US	PCE Deflator	Jan	2.0%	1.6%
	16:00	US	PMI Manufacturing	Feb	56.0 index	56.0 index
2-Mar	9:00	AT	PPI y/y	Jan		0.8%
	11:00	EA	Unempl. Rate	Jan	9.6%	9.6%
		EA	PPI y/y	Jan	3.0%	1.6%
	14:30	US	Jobless Claims	-	240.8 thd	244.0 thd
3-Mar	10:00	IT	GDP y/y	4Q F		1.1%
	10:00	IT	GDP q/q	4Q F	1.1%	0.2%
	11:00	EA	Retail Sales y/y	Jan	1.2%	1.1%

Source: Bloomberg, Erste Group Research

FORECASTS[1])

GDP	2014	2015	2016	2017	2018
Eurozone	1.2	2.0	1.7	1.9	1.7
US	2.4	2.4	1.6	2.1	2.2

Inflation	2014	2015	2016	2017	2018
Eurozone	0.5	0.1	0.2	1.5	1.5
US	1.6	0.1	1.2	2.0	2.3

Interest rates	current	Mar.17	Jun.17	Sep.17	Dec.17
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.33	-0.30	-0.30	-0.30	-0.30
Germany Govt. 10Y	0.20	0.50	0.80	0.80	1.00
Swap 10Y	0.69	0.80	1.10	1.10	1.30

Interest rates	current	Mar.17	Jun.17	Sep.17	Dec.17
Fed Funds Target Rate*	0.66	0.60	0.90	1.10	1.40
3M Libor	1.05	1.00	1.30	1.50	1.80
US Govt. 10Y	2.37	2.40	2.60	2.70	2.80
EURUSD	1.06	1.05	1.08	1.10	1.12

*Mid of target range

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
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

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

Disclaimer

Published by:

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

Erste Group Homepage: www.erstegroup.com