CEE Insights

Fixed Income and Foreign Exchange

Looking ahead this week…

Monday	Tuesday	Wednesday	Thursday	Friday
RO: Unempl. rate **HU**: Trade balance	**RO**: MPC meeting **CZ**: Final GDP data	**PL**: MPC meeting **RO, HU, SK**: Retail sales		**CZ**: Trade balance, Retail sales **HU**: Industrial output

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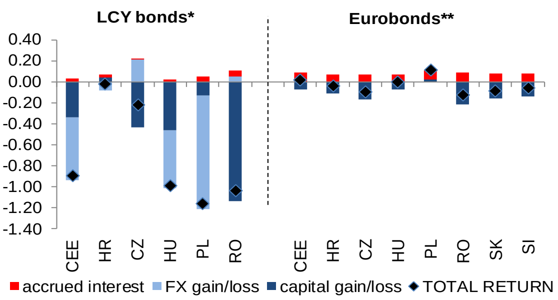
Further divergence of monetary policy direction will be the main topic in CEE this week. On Tuesday, Romania's MPC will discuss whether there is any need to hike the ON deposit rate. Since the beginning of September, short-term rates have increased almost 50bp and bond yields recently went up 20bp. While we see some upward risks for the inflation trajectory (due to the announced hike in administrated prices and excise taxes), the recent market rate increase is rather driven by technical factors, i.e. the side effect of (unconfirmed) FX interventions, which drained RON liquidity from the market. This is why we do not expect the Romanian central bank to act prematurely. We see higher chances for a hike of the deposit rate (to 0.5%) only at the November meeting. In Poland, we expect the MPC to remain neutral on Wednesday and keep rates unchanged. The Hungarian central bank will issue its minutes from the last MPC meeting, which should confirm its extremely strong dovish bias, which should be supportive for Hungarian bonds. We now see the 10Y HU yield at 2% at the year-end.

In case you missed it last week…

- Czech National Bank left rates unchanged, rate hike will be delivered only in November
- Hungarian bonds rallied last week, as market expects central bank to keep dovish bias, even after rate cut
- Zloty depreciated vs. euro after President Duda proposed his project of judicial reform
- Weakening pressure on RON intensified, but EURRON remained below 4.60 threshold



For other events last week, please check respective countries: HR, CZ, HU, PL, RO, TR, SI, SK, SR

On Radar

After poor readings in 2016, investments are overall back in play in CEE, and fortunately, not just because of EU funds. This is apparent in Croatia and Serbia, which did not experience the dip last year that was mainly due to the bump in EU-funded investments. We would especially look at private investments this time. One may mainly associate public investments with EU funds, but this is not fully true, making it hard to see what capital formation in the private sector would be without them. Still, we can see that, generally speaking, there is still significant room for private investments in quite a few countries. In Slovakia, Poland and Romania, private investment growth is quite meager, while the Czech Republic also saw some pickup only recently. In Hungary, the growth is huge, but strongly driven by EU funds; while car manufacturing also shows good investment data that is non-EU fund related, after these projects are finished, non-EU funded private investments could roll back again. Overall, we expect EU funded investments to gain further speed (apart from Hungary, where it is already at full speed), and while private investment is also expected to mostly improve (due to favorable sentiment and supportive financial conditions), keeping up with regulatory reforms and maintaining policy predictability would help private investors, too. (For further details, see the next page.)

EU funds also help private investments greatly; without this, policy or economic uncertainties could potentially hold off investments, even if economic sentiment is supportive

Private investment growth could accelerate in CEE

'How are private investments developing so far this year? What is your outlook for subsequent quarters?'

Croatia: The investment rebound since 2015 is expected to remain in place in the mid run, despite the outlook being to some extent impaired by the Agrokor related uncertainties. Although no distinction is available between public and private investments, we see both of them playing supportive roles, though the above-mentioned rebound was mainly driven by private investments. However, an acceleration of EU funds will clearly back up public investment projects going forward, while the private sector should also find support coming from stable economic conditions, improving sentiment and a lower profit tax burden. Hopefully, working on structural reforms to further relieve red tape constraints and a gradual recovery of corporate loans should also add to the outlook ahead.

Czech Republic: In 1H17, gross capital formation arrived at 3.4% q/q and 0% y/y. In the rest of this year, investment expenditures will significantly accelerate, due to the economic recovery in the Eurozone and tight conditions in the Czech labor market, which have been forcing firms to increase productivity because of the lack of new available employees. In 2017 and 2018, investment growth will reach 3% and 3.5%, respectively. This favorable development will, however, refer mainly to private investment expenditures. Public investment is still relatively low, mainly due to the bureaucratic burden. We expect this situation to improve only gradually in the coming years.

Hungary: From a bird's eye view, investment activity has been quite hefty this year, as the headline annual rate reached 25.4% in 1H17. Even with the substantial pick-up in private investment activity in 1H17, the ratio of private investments to GDP was only 15.8% in 2Q17, on a four-quarter-rolling basis. The rebound in investment activity was mostly related to the revved up rate of EU funds absorption in both the private (+31% y/y) and public sectors (+46.2% y/y), according to the StatOffice. Investment activity in the manufacturing sector, which is of great importance in terms of productive capacities, strengthened by 16.6% y/y in 1H17, led mostly by car manufacturing and electronic device manufacturing companies that are unlikely to receive significant amounts of EU funds. Once the current investments of manufacturing companies are finished, non-EU fund related private investments might visibly decelerate.

Poland: In Poland, private investments in 1H17 decreased 0.3% y/y, although a rebound was expected by the market. As overall investment went up 0.3% y/y in the first half of the year, the growth must have been driven by public investments. Looking at sectors, we observed a strong decrease in mining and the energy sector and a rebound in information and communication, real estate services and trade. Since the beginning of 2017, the general business climate indictor for the industry and construction sectors has been improving. We expect public investments to rebound further in 2H17, as a result of the increase of EU funding. However, a high level of uncertainty will likely hold off private investors.

Romania: Investments in Romania have been in a soft patch in recent years, as mirrored by the ever-falling investment rate (gross fixed capital investments/GDP) to 22.3% in 1Q17 and further on to 22.1% in 2Q17, from the post-crisis peak of 27.3% in 2012. The latest data available for 1Q17 shows a notable pullback in investment rates for both the private and public sectors, to 18.9% and 3.4%, respectively. What is more, the investment prospects are not encouraging for either of the two sectors. On the private side, manufacturing managers are pretty doubtful about investments this year, as indicated by the European Commission's semi-annual survey, while the huge bill from wage and pension rises will likely continue to stifle capital expenditures in the public sector. However, gross fixed capital formation made a shy comeback in April-June for the first time since 2Q16 and with a bit of help from the low base last year, it could end this year in positive territory. It remains to be seen, however, whether the actual growth rate supported by the private sector will be strong enough to prevent the overall investment rate from slipping below 22% this year.

Serbia: Investment dynamics in Serbia are currently driven by two major factors: (i) the gradually improving business climate and legislation regarding bankruptcy and employment laws; (ii) government stimulus in infrastructure projects after disappointing GDP figures in 1H17. In addition, we can see some fresh FDI inflows and reconstruction of some capacities after strikes at Fiat. Bottom line, we expect a stronger contribution from investment demand in Serbia.

Slovenia: Following the 2016 investment halt due to the end of the programming period of EU funding, we saw a strong rebound in investment activity, with the 1H17 performance recording a double-digit increase of 10% y/y. Looking at the more detailed split, on the private investment side, we saw growth gaining traction in previous years, in line with the improving economic outlook and overall improving business climate. On the other hand, the public component was the main culprit behind the 2016 negative investment performance, with an almost 30% y/y decline. However, with accelerating EU fund momentum, public investments are also seen exhibiting a vivid pace. Bottom line, with Slovenia's investment profile remaining mostly influenced by EU fund related projects, realized through both public and public-private partnership deals, we see the investment growth outlook staying strong in the quarters ahead.

Slovakia: Private investments have been lukewarm thus far in 2017. Even though 1Q17 saw 4.3% y/y growth in non-financial corporations' investment activity, the 2Q17 rate was just 0.5% y/y. A fall in investment activity was seen in 2Q17 among financial corporations (-13.4% y/y) and households (-2.1% y/y). Public investment fell 36.1% y/y, extending the fall from 1Q17 (-29.4% y/y), as EU fund utilization remains inadequate. Overall, a positive gross investment change in 2Q17 was due to increased stocks and inventories, rather than due to gross fixed capital formation (which fell 6.7% y/y). Given the favorable growth and labor market development, as well as good financing conditions still supported by an accommodative monetary policy and the availability of EU funds, investment should pick up again. Overall, we expect gross fixed capital formation to rise by 1.5% this year (public and private combined), following last year's correction linked to the high EU fund-driven 2015 base.

Looking ahead

Date	Time	Country	Indicator	Period	Survey	Erste Est.	Prev.	Pre Comment
02. Oct		**RO**	**Unemployment Rate**	Aug			5.2%	
	9:00	**HU**	**Trade Balance**	Jul F			322	
03. Oct		**RO**	**Target Rate**	Oct 3		***1.75%***	1.75%	*Strong reasons to hike depo rate as early as this week, but would fuel market expectations for additional increases in rates in near future, opening door for even higher market rates.*
	8:00	**RO**	**PPI (y/y)**	Aug			3.0%	
	9:00	**CZ**	**GDP (q/q)**	2Q F		***2.5%***	2.5%	*Household consumption and private investment were most important drivers behind strong q/q growth in 2Q.*
	9:00	**CZ**	**GDP (y/y)**	2Q F	*4.7%*	***4.7%***	4.7%	*Favorable y/y figure supported by both domestic and foreign demand.*
04. Oct		**PL**	**Target Rate**	Oct 4	*1.5%*	***1.5%***	1.5%	*Policy rate to remain flat as result of still low inflationary pressure.*
	8:00	**RO**	**Retail Sales (y/y)**	Aug		***8.6%***	8.2%	*Retail sales currently being driven by non-food segment.*
	9:00	**HU**	**Retail Sales (y/y)**	Aug		***4.1%***	4.2%	*Strong net real wage growth and improving consumer confidence imply continuing retail sales growth momentum.*
	9:00	**SK**	**Retail Sales (y/y)**	Aug			4.9%	
5. Oct			**No releases scheduled**					
06. Oct		**CZ**	**Trade Balance**	Aug	*5.0*	***5.0***	-2.1	*Surplus in trade with goods and services mitigated by seasonal factors and higher oil prices.*
	9:00	**CZ**	**Retail Sales (y/y)**	Aug	*4.4%*	***5.0%***	2.5%	*Favorable development in labor market and positive sentiment of households are main factors behind high retail sales growth.*
	9:00	**HU**	**Industrial Production (y/y)**	Aug		***1.5%***	0.2%	*After July slump, August may deliver better annual growth figure.*
	12:00	**RS**	**PPI (y/y)**	Sep			1.8%	

Sources: Bloomberg, Reuters

Major markets

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- The release of some key points of President Trump's tax plans caused a significant market reaction – at least on the bond market. The scheme schedules three levels of progression (currently seven) for income tax, namely 12%, 25% and 35%. However, there was no information disclosed on what level of income these tax rates would apply to. The corporate tax rate is intended to be cut from 35% to 20%. Added to this, there is a series of further measures, including the elevation of deductibles and the abolition of the so-called estate tax, a tax on real estate holdings valued at more than USD 5.49mn or USD 10.98mn for couples.
- This week, manufacturing PMI poll data for major countries among Emerging Markets will be released. In August, sentiment rose in China, India and Brazil; only in Russia was there a slight decline. In China, industry sentiment rose due to strong foreign demand in August. In India, sentiment improved markedly, since uncertainty about the changes in the tax system have disappeared.

Croatia

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- August short-term data slightly exceeded our expectations and extended the favorable tone set thus far in 3Q17. On the industrial production side, we saw growth accelerating to 3.2% y/y (from 2.5% y/y in July), driven by every sector of production on the annual level. Retail trade aligned with the positive trends, as consumption recorded 6.4% y/y (vs. 5.9% y/y in July).
- We saw no major changes on the markets – the exchange rate continued with gradual weakening towards the upper part of the 7.45-7.50 band, amid a reversal of the seasonal support, while bond yields also kept a steady pattern across the board (11Y local curve still below the 2.8% mark).

Czech Republic

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- Overall confidence in the Czech economy slightly increased in September, as confidence of households arrived at 109.2 points, up from the 107.9 reached in August, and confidence of entrepreneurs came in at 97 points (an increase of 0.2 points). The figures confirm that the favorable economic development continued in 2H17.
- The CNB Bank Board decided at its meeting last week to keep interest rates unchanged. The two-week repo rate (2W repo rate) was maintained at 0.25%. In our view, the decision was a slight surprise, as the pro-inflationary risk has increased significantly in the Czech economy. Due to the risk of the economy overheating, we expect the CNB to increase interest rates at the November meeting.

Hungary

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- As growth of revenues (+9.9% y/y) outpaced the rate of expenditure rise (+7.5% y/y) in 1H17, the budget ended up in a surplus of HUF 270.5bn (1.5% of GDP) in 1H17, according to the ESA methodology. However, from a cash flow point of view, the budget ran up a deficit of HUF 697.9bn (approx. 3.8% of GDP) in 1H17.

Poland

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- President Duda presented his project of judicial reform regarding the Supreme Court and National Council of the Judiciary. According to that project, members of the National Council of the Judiciary will be appointed by the Parliament with a 3/5 majority within two months; otherwise, each MP will vote for a member only once. However, the way of appointing members is still not clear.
- The zloty strongly depreciated vs. the euro (1.5% wtd) after President Duda presented his project of judicial reform on Monday. The EURPLN hit 4.3305, the highest level since March this year.
- The budget draft for 2018 has been approved by the Polish government, with 3.9% GDP growth, inflation at 2.3% and the budget deficit no higher than 2.8% of GDP.
- Flash CPI for September arrived at XXX% y/y (TBA @2pm).

Romania

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- The MPC meeting scheduled for Tuesday will be watched closely by investors, due to recent changes in market conditions. We think there will be a hot debate in the MPC on whether to hike the deposit rate in October or November. The reasons to hike the depo rate as early as this week are strong, but such a step would fuel market expectations for additional increases in rates in the near future, opening the door for even higher market rates.
- Weakening pressure on the RON intensified, but the EURRON remained below the 4.60 threshold, making it an outlier in the CEE region in terms of cumulative depreciation over the past month. LCY bonds sold off last week and yields increased by 20-30bp w/w across the curve, amid tight liquidity conditions in the market. Part of the decline in market liquidity is explained by developments in the FX market. At the same time, arguments are building up in favor of a stronger increase in inflation in the coming quarters after recently announced hikes in energy prices and excise taxes on car fuels, creating another risk for RON bonds.
- The Economic Sentiment Indicator (ESI) released by the EC for the Romanian economy was unchanged in September at 104.9 points. Managers in retail trade, industry and construction were more optimistic, while those in services were less upbeat about the economic situation in this sector. Confidence of consumers declined slightly in September, but we do not see this as a structural worsening of the situation in the consumer segment. ESI averaged 104.9 points in 3Q17, below the level from 2Q17 (-0.6pp q/q) and on par with 1Q17. ESI suggests that economic growth could lose some speed in 3Q17 unless agriculture delivers outstanding results.

Serbia

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- Monthly frequency data revealed favorable trends in August, with retail trade growth accelerating from 4.1% y/y in July to 4.4% y/y, while industrial production showed even stronger momentum by expanding 7.3% y/y (vs. 4.2% y/y in July), supported by a vivid performance in the manufacturing sector. The August data fits well with our expectations of a gradual pick-up in 2H17, following the somewhat disappointing 1H17 growth output.
- Following strong appreciation pressures on the dinar in the recent period, the exchange rate maintained a stable footprint last week, staying slightly below the EURRSD 120 mark. On the bond market, we saw the benchmark RSD 2023 yield further compressing, currently moving around the 5.1% level.

Slovakia

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- Unemployment, as measured by the labor bureaus, fell by 0.16pp to 6.54% in August, once again reaching a new record low for Slovakia. Job vacancies are still high, especially in the western part of the country, suggesting that we may expect the favorable development of the falling unemployment rate to continue in the coming months. However, the issues of tightening on the labor market and lack of a qualified labor force in some sectors continue.
- The Slovak debt management agency conducted two auctions of government bonds in September. Slovakia sold EUR 222.3mn worth of government bonds due in March 2037 at an average yield of 1.692%. Another auction saw EUR 88.6mn of bonds maturing in November 2024 being sold at an average yield of 0.439%. The bid-cover ratio was high, reaching 3.16 and 4.18 in the two competitive rounds, respectively. We do not expect a strong reaction on the bond market, especially as yield increases are limited by the still loose ECB monetary policy and Slovakia's good fiscal stance. We expect the 10-year government bond yield to be around 1.1% in 4Q17.
- The coalition parties presented a brief outline for the 2018 state budget and the social package it will include. Next year’s fiscal deficit should fall to 0.8% of GDP, less markedly than the 0.4% planned in last year’s budget outline for 2018. Minimum wage should increase to EUR 480 (up by 10%) and voluntary 13th and 14th wages will be introduced for workers staying for minimum 2-4 years with the same company. In 2019, these extra wages should be exempt from income tax and levies. The government will also increase the wages of state employees that currently earn below the minimum wage (and the difference is balanced by ad hoc measures). Higher pay for night, weekend and public holiday work is set to increase. The details of these measures will be announced later.

Slovenia

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- September CPI closely matched our expectations (EBC: 1.3% y/y), with the headline figure slightly accelerating to 1.4% y/y vs. 1.2% y/y from August, i.e. still moving in a tight band. On the monthly level, inflation picked up by 0.2%, with higher clothing and footwear prices (amid new arrivals) creating the most pronounced upside pressures.
- Yields on bonds showed no major changes throughout the week, with the benchmark EUR 2027 curve still remaining below the 1% mark.

Capital market forecasts

Government bond yields	current	2017Q4	2018Q1	2018Q2	2018Q3
Croatia 10Y	2.70	2.60	2.75	2.90	3.00
spread (bps)	225	201	208	212	211
Czech Rep. 10Y	1.28	1.11	1.20	1.27	1.41
spread (bps)	83	52	53	49	52
Hungary 10Y	2.57	2.00	2.00	2.00	2.00
spread (bps)	212	141	133	122	111
Poland 10Y	3.35	3.38	3.55	3.67	3.91
spread (bps)	290	279	288	289	302
Romania10Y	4.31	4.10	4.30	4.30	4.40
spread (bps)	386	351	363	352	351
Slovakia 10Y	0.86	1.10	1.20	1.25	1.30
spread (bps)	41	51	53	47	41
Slovenia 10Y	0.97	1.00	1.10	1.20	1.30
spread (bps)	52	41	43	42	41
Serbia 7Y	5.18	5.40	5.60	5.60	5.80
DE10Y (BBG)*	***0.45***	***0.59***	***0.67***	***0.78***	***0.89***

FX	current	2017Q4	2018Q1	2018Q2	2018Q3
EURHRK	7.50	7.55	7.55	7.35	7.45
forwards		7.50	7.52	7.53	7.54
EURCZK	25.98	26.00	25.80	25.70	25.60
forwards		25.94	25.95	25.96	25.99
EURHUF	310.7	312.0	315.0	315.0	315.0
forwards		310.8	311.0	311.1	311.2
EURPLN	4.30	4.22	4.23	4.21	4.19
forwards		4.32	4.34	4.36	4.39
EURRON	4.60	4.62	4.60	4.61	4.65
forwards		4.63	4.65	4.68	4.71
EURRSD	119.1	120.0	121.0	121.0	122.0
forwards		-	-	-	-
EURUSD	1.18	1.15	1.13	1.14	1.16

3M Money Market Rate	current	2017Q4	2018Q1	2018Q2	2018Q3
Croatia	0.59	0.45	0.45	0.45	0.45
Czech Republic	0.47	0.67	0.68	0.89	0.89
Hungary	0.04	-0.10	-0.10	-0.10	-0.10
Poland	1.73	1.75	1.79	1.79	1.83
Romania	1.58	0.95	1.15	1.18	1.40
Serbia	3.30	3.60	3.80	3.80	4.00
Eurozone	-0.33	-0.30	-0.30	-0.30	-0.30

Key Interest Rate	current	2017Q4	2018Q1	2018Q2	2018Q3
Croatia	0.50	0.30	0.30	0.30	0.30
Czech Republic	0.25	0.50	0.50	0.75	0.75
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	3.75	3.75	3.75	3.75	4.00
Eurozone	0.00	0.00	0.00	0.00	0.00

Macro forecasts

Real GDP growth (%)	2016	2017f	2018f	2019f
Croatia	3.0	3.0	2.8	2.9
Czech Republic	2.5	3.9	3.2	3.0
Hungary	2.0	3.7	3.4	3.3
Poland	2.8	4.1	3.4	3.0
Romania	4.8	5.5	4.1	2.4
Serbia	2.8	2.1	3.0	3.2
Slovakia	3.3	3.3	3.9	4.2
Slovenia	3.1	4.0	3.3	3.0
CEE8 average	**3.0**	**4.1**	**3.5**	**3.0**

Average inflation (%)	2016	2017f	2018f	2019f
Croatia	-1.1	1.1	1.2	1.5
Czech Republic	0.7	2.5	2.2	2.0
Hungary	0.4	2.4	3.4	3.5
Poland	-0.6	1.8	1.9	2.1
Romania	-1.5	1.0	3.3	2.8
Serbia	1.6	3.3	3.7	4.3
Slovakia	-0.5	1.2	2.0	2.3
Slovenia	-0.1	1.4	1.5	1.8
CEE8 average	**-0.4**	**1.8**	**2.3**	**2.4**

Unemployment (%)	2016	2017f	2018f	2019f
Croatia	13.1	10.9	10.0	9.2
Czech Republic	4.1	3.1	3.1	3.4
Hungary	5.1	4.2	4.0	3.9
Poland	8.9	7.9	7.6	7.4
Romania	6.0	5.4	5.5	5.5
Serbia	15.3	12.7	11.6	11.1
Slovakia	9.7	8.2	7.5	6.8
Slovenia	8.0	7.0	6.3	5.6
CEE8 average	**7.7**	**6.6**	**6.3**	**6.1**

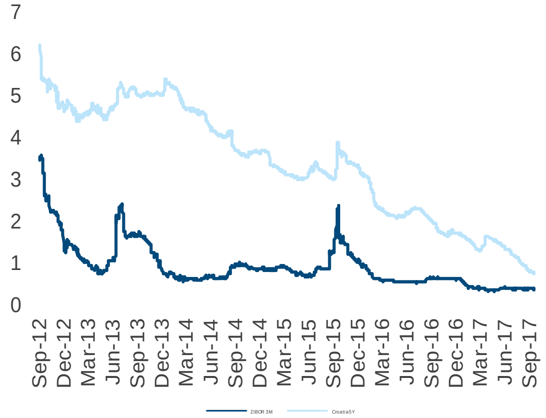
Public debt (% of GDP)	2016	2017f	2018f	2019f
Croatia	83.7	80.7	77.9	74.8
Czech Republic	36.8	32.8	30.2	29.8
Hungary	74.1	72.0	70.7	69.7
Poland	54.4	54.9	54.1	53.2
Romania	37.6	36.9	37.0	37.7
Serbia	72.9	68.0	64.1	60.3
Slovakia	51.9	51.6	50.3	47.8
Slovenia	78.3	75.4	74.1	71.7
CEE8 average	**53.6**	**52.2**	**50.9**	**49.9**

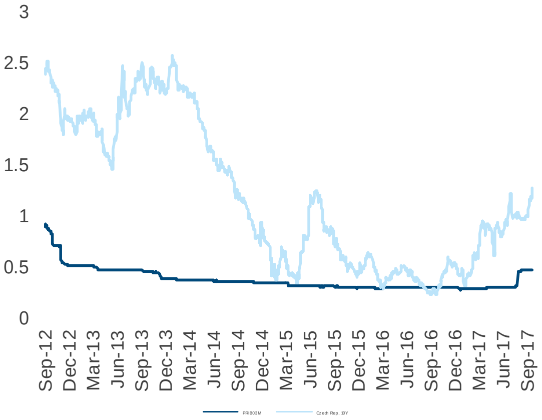
C/A (%GDP)	2016	2017f	2018f	2019f
Croatia	2.6	4.2	2.9	2.3
Czech Republic	3.5	2.6	2.2	1.8
Hungary	5.5	4.1	3.8	3.3
Poland	-0.3	-0.6	-0.9	-1.2
Romania	-2.3	-3.1	-3.7	-3.6
Serbia	-4.2	-4.8	-5.4	-6.7
Slovakia	-0.7	0.4	1.1	1.8
Slovenia	5.2	5.5	5.2	4.9
CEE8 average	**0.8**	**0.4**	**0.0**	**-0.2**

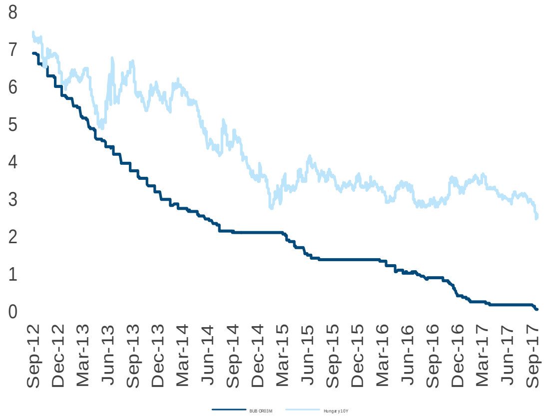
Budget Balance (%GDP	2016	2017f	2018f	2019f
Croatia	-0.8	-0.8	-0.6	-0.5
Czech Republic	0.5	0.2	0.1	-0.1
Hungary	-1.8	-2.7	-2.5	-2.5
Poland	-2.4	-2.6	-2.9	-2.8
Romania	-3.0	-3.0	-3.4	-2.9
Serbia	-1.3	-0.5	-0.6	-0.8
Slovakia	-1.7	-1.5	-0.8	-0.6
Slovenia	-1.8	-1.2	-1.0	-0.8
CEE8 average	**-1.8**	**-1.9**	**-2.1**	**-1.9**

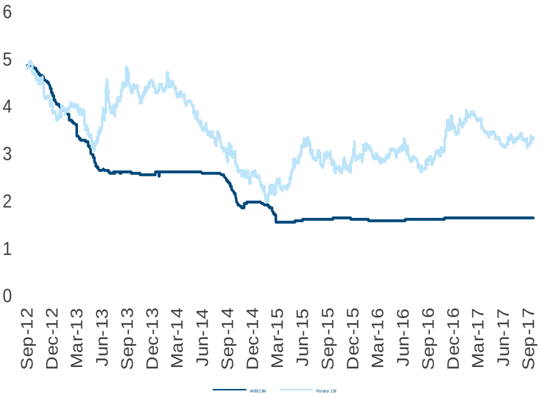
Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

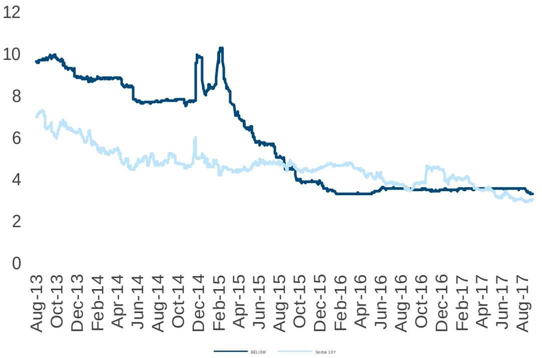
Appendix

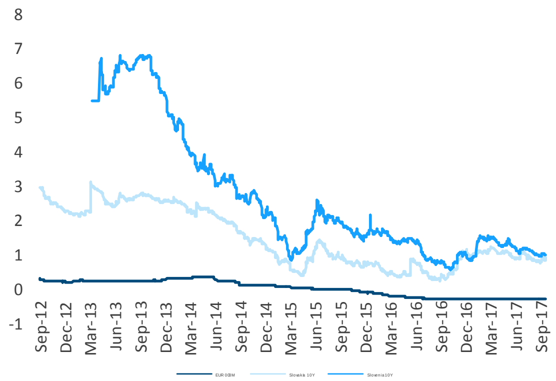












Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

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