INTEREST RATE OUTLOOK| EUROZONE, USA

ECB and US Fed not yet at finish line

Analysts:
Maurice Jiszda
maurice.jiszda@erstegroup.com

Gerald Walek
gerald.walek@erstegroup.com

Markets are watching US trade policy

Capital market participants are expecting a series of interest rate cuts this year in both the Eurozone and the US, with two interest rate cuts of 25 basis points each by the US Federal Reserve and four by the European Central Bank (ECB). In the US, the still strong labor market weakened somewhat over the course of last year, while the Eurozone economy could certainly do better with a further easing of monetary policy. What both central banks have in common is that an annual inflation rate of two percent is the target, or one of them. However, the latest inflation data on both sides of the Atlantic showed sideways or even upward trends. Rising energy prices and a broad-based trade conflict could put additional upward pressure on inflation. However, we assume that both central banks will cut interest rates further, although there is uncertainty about the extent.

Donald Trump's new presidency undoubtedly poses a number of risks. The announcement to set US tariffs at 10% worldwide, 25% for Canada and Mexico from February 1, 2025, and, in particular, to impose 10-60% tariffs on Chinese imports would lead to trade conflicts and thus to uncertainty for both companies and consumers. Further potential risks lie not only in the geopolitical problem areas, but also in the fact that the US could lose trustworthiness in the course of a possible reorganization of global trade. For example, in the run-up to his presidency, Trump openly torpedoed the USMCA agreement, the successor to NAFTA, which he himself had negotiated during his first term of office, and suddenly linked trade policy with immigration and drug policy.

As always, in this interest rate outlook, we present our expectations for both central banks, the ECB and the US Fed, as well as for the respective government bond markets in compact form. In addition, we focus on the economic policy issue of trade conflicts, which very quickly returned to the spotlight in the wake of Donald Trump's inauguration on January 20, 2025.

Major Markets & Credit Research
Rainer Singer (Head)

Maurice Jiszda, CEFA®, CFDS®
(Economist USA)
Gerald Walek, CFA® (Economist EZ)
Maximilian Möstl (Economist AT)

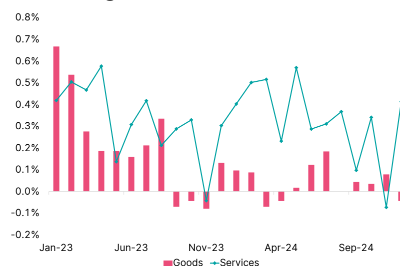
Note: Information on past performance is not a reliable indicator of future performance.

Eurozone - Economic data weaker than expected

The ECB is very likely to make the next interest rate cut of 25 basis points (bp) at the end of January. The slow progress in underlying inflation in 4Q24 was in line with the central bank's expectations. In contrast, downside risks to the economic outlook have increased in 4Q. France is struggling with a politically unstable situation combined with a public budget that threatens to spiral out of control. Germany's economy shrank by a further 0.2% in 2024. Due to the self-imposed debt brake, no noticeable fiscal support is to be expected here in the short term either. In addition, the Eurozone faces the threat of a trade conflict in the Trump 2.0 era, which poses further downside risks to the growth outlook.

The ECB economists have taken the slower economic recovery into account in their updated growth forecasts, particularly the weaker momentum of consumption. The growth forecast for 2025 has therefore been lowered to 1.1% (previously 1.4%) and for 2026 to 1.4% (previously 1.5%). Nevertheless, economists expect investment momentum to improve in 2025, thanks in part to the less restrictive monetary policy. Following the interest rate cuts since mid-2024 and based on market expectations regarding the future development of interest rates, the negative effects of the monetary tightening to date on economic growth are expected to subside in 2025.

Inflation goods and services, M/M in

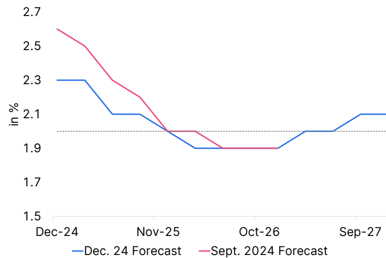


Source: ECB, Erste Group Research

The latest inflation data was mixed. The increase in headline inflation in 4Q24, resulting from base effects in energy prices, was expected by the ECB and the market. Little progress was made in underlying inflation, measured by the development of services inflation, among other things. However, this had also been forecast by the ECB. Indicators leading underlying inflation, such as wage growth, cooled further in 3Q24, as expected. In addition, service provider inflation should automatically fall slightly from January, due to the expiry of a base effect in Germany (normalization of VAT in Germany in 2024). We are therefore confident that underlying inflation will steadily lose momentum as early as the first half of 2025.

Specifically, wage growth of 4.4% y/y in 3Q24 was slightly below the ECB's expectations of 4.5%. For 4Q24 and 1Q25, the ECB is forecasting a further slowdown in momentum to 4.2% and 3.7%, respectively. Based on current developments, this expected path appears to be realistic or rather conservative.

ECB economists' inflation forecasts

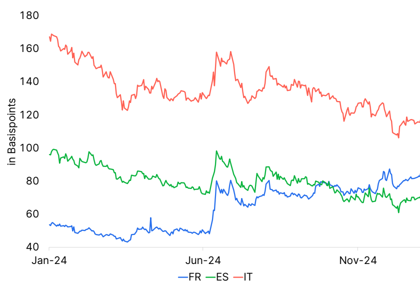


Source: ECB, Erste Group Research

We expect four rate cuts of 25bp each in 2025, in January, March, June and September. We think that the ECB Governing Council will have come to a temporary end to interest rate cuts at a deposit rate of 2%. With the economy recovering more slowly than expected and political factors increasing the uncertainty surrounding the outlook, we believe it makes sense to keep the interest rate close to a neutral level in 2025. At the last ECB meeting in December, President Lagarde noted that the ECB had already come a long way towards achieving its target of a sustainable inflation rate of 2%. Furthermore, the ECB now sees risks to the inflation outlook on both the upside and the downside.

Since the beginning of December last year, yields on German government bonds have risen massively and have approached the last highs of summer 2024. The yield curve has steepened significantly, which means that yields on longer-dated German government bonds have risen more than those on shorter-dated bonds. As downside risks such as political uncertainties in the Eurozone and the possibility of EU deficit proceedings still exist, we believe that the guidelines from the US are the main driver, due to the increased and priced-in inflation expectations. In addition, the ECB's balance sheet reduction, coupled with weaker liquidity at the end of the year, favored the strong and rapid upward movement in yields. We believe that the rise in yields has gone too far and expect German yields to fall by the end of the year.

Spreads to Germany, 10-year term
in basis points



Source: refinitiv, Erste Group Research

Spreads on the Eurozone government bond markets developed differently in 4Q2024. Risk aversion towards France increased further and risk premiums for French government bonds with a 10-year term exceeded the level of Spanish bonds for the first time. This was triggered by the worsening imbalance in the French government budget in connection with the end of the government under Prime Minister Barnier, who failed to vote on a consolidation budget for 2025.

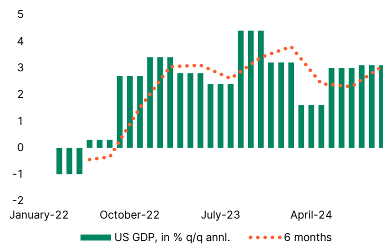
For the time being, France has succeeded in transferring the 2024 budget to 2025 by means of a special law. However, this draft will not lead to the consolidation of the deficit in 2025 that the European Commission is hoping for. In this case, France's deficit would probably stabilize at a level of 6% or even slightly higher, at best. It is now the top priority of the newly appointed Prime Minister Francois Bayrou to pass a budget for 2025 in parliament as quickly as possible that takes into account the changes suggested by the European Commission (tax increases and spending cuts). International rating agencies have already reacted to the worsening situation in France by downgrading the credit rating or lowering the outlook. A noticeable improvement in the situation in France remains to be seen, which is why we do not want to rule out a further increase in risk premiums for French bonds in 2025.

In contrast, the situation of public budgets in Spain and Italy improved. Rating agencies rewarded this development by upgrading the outlook and raising the credit rating. Spain in particular has recently been able to rapidly reduce its debt and current deficits thanks to dynamic growth. The financial market rewarded this positive development by narrowing the risk premiums for Spanish and Italian bonds.

US - Solid economy, stubborn inflation and problems with national budget

At the meeting of the FOMC, the committee of the US Federal Reserve that decides on interest rates, which ended in mid-December, key interest rates were lowered by 25 basis points. Since then, the range of the federal funds target rate has been 4.25-4.5%. The economic trend is solid and the growth rate for the third quarter of 2024 was revised upwards from 2.8% to 3.1%, while the unemployment rate remained low at 4.1% for December. The FOMC noted that the inflation target of 2% had been approached, although the inflation rate was still seen as somewhat elevated. Fed Chairman Powell emphasized that monetary policy had now moved significantly closer to the neutral position. The members of the FOMC now expect a median of just two interest rate cuts (50bp in total) and no further four until the end of 2025.

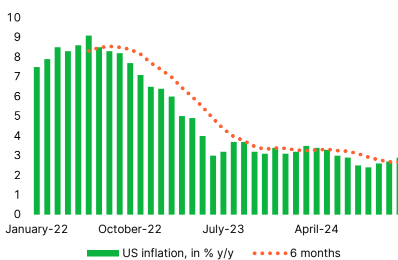
US GDP, q/q in % annualized



Source: U.S. Bureau of Economic Analysis, Erste Group Research

In addition to the economy, sentiment and the labor market in the US are also positive. Consumer confidence has been rising for months and the survey of purchasing managers shows strong results for the economically dominant service sector, while the manufacturing sector is still in recession. 1Q2025 could bring a special boom due to front-loaded consumption and investment, but we ultimately see a noticeable slowdown in the US economy for full-year 2025, as we expect dampening effects from Trump's economic policy plans from 2Q2025, above all the planned tariff regime. On an aggregate basis, headline inflation rose slightly to 2.9% at the end of the year and has left the downward trend that was already underway to form a sideways trend. Core inflation has remained virtually unchanged at a persistently high level for several months, with price pressure from highly-weighted housing costs easing only slightly. In December, the US Federal Reserve surprised everyone with its new forecasts for inflation in 2025, which it expects to be 0.4% higher at the end of 2025 than estimated last September. Prices could be boosted by higher US tariffs, although this could be mitigated by a strong USD, as well as by a sustained rise in energy prices in the US, although this is not our base scenario.

US inflation, y/y in %



Source: U.S. Bureau of Labor Statistics, Erste Group Research

Yields on US government bonds rose noticeably in the final weeks of last year and at the beginning of this year. The yield curve has steepened, with yields on long maturities rising significantly more than those with short maturities. The rise was driven by Trump's trade policy plans and the Fed's latest inflation expectations for this year. In our opinion, the markedly priced-in inflation expectations are too high. We therefore expect yields to fall over the course of 2025.

US reaches debt limit in January of this year

The public budget situation in the US can be characterized as clearly tense, and the expected long-term debt level in relation to economic output is already considered problematic. US Treasury Secretary Janet Yellen, who left office on January 20 and will be replaced by Scott Bessent, warned that the US would reach its debt limit between the middle and end of January. Extraordinary measures would have to be taken to prevent the US from being unable to meet its payment obligations. Extraordinary measures in conjunction with current tax revenues usually give Congress several months to pass a new extension or increase of the debt ceiling. So far, the possible extraordinary measures have included canceling some investments related to public service

pension funds and forgoing certain investments in these and other funds, and salaries may no longer be paid on time. We assume that the Treasury Department will have no more room for maneuvering during the summer months. If Congress does not act by then, no new debt could be incurred and payments would have to be at least partially stopped, including possibly debt service. The general abolition of this concept to rein in government spending is currently once again the subject of intense political debate, due to a lack of resounding success, and could also become a majority option. We believe that the US will find one solution or another out of self-protection, as a payment delay or even a default would shake the capital markets and be detrimental to the US.

Based on data from the Congressional Budget Office (CBO), the US public deficit for 2024 will amount to around 6.4% of gross domestic product (GDP), while the debt ratio will rise to the same level as GDP. If debt to government agencies and funds were added, which would make the figure roughly comparable with European debt figures, the debt-to-GDP ratio would be 125%. These figures are already high on their own - even by international standards. Projections by the CBO show that, despite a large number of expiring tax breaks, an annual deficit of more than 6% of GDP must be assumed over the next 10 years, which would increase the debt level for 2034 by a further 20 percentage points (in relation to GDP). Donald Trump's election campaign plan would even see the debt level soar to 142% of GDP in 2035. Trump's agenda includes the income-independent extension of all existing tax breaks beyond 2025 and cap-free deductibility of a portion of the local tax burden in the calculation of federal taxes. In addition, there are to be tax exemptions for tips and overtime and tax relief for first-time homebuyers. The corporate tax rate is to be reduced from 21% to 15%, while at the same time softening regulatory requirements. Trump is also planning significantly tighter border controls and deportation procedures, as well as 25% tariffs on all imports from Canada and Mexico, 10-60% tariffs on imports from China and a global tariff quota. However, the proposed tariffs will generate far too little revenue to plug the gaping hole in the US budget. The government's inability to finance its own spending, coupled with the potentially enormous increase in national debt, could lead to a long-term loss of confidence in both US government bonds and the US dollar.

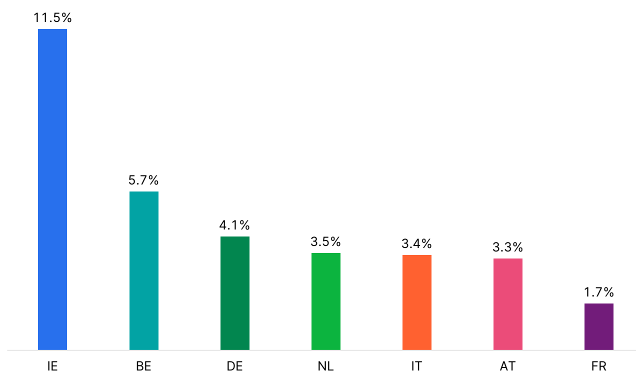
Focus - Trade conflict will preoccupy markets in 2025

With Trump taking office for his second term as US president, global trade is facing troubled times. Trump has already announced far-reaching punitive tariffs for China, Canada and Mexico. The EU will probably not escape unscathed in 2025 either. However, we assume that the Trump administration will use tariff threats to strengthen its own negotiating position, among other things. Although the impact is difficult to assess, we expect trade barriers to have a dampening effect on global economic growth and global trade in the medium term. Against this backdrop, we have already slightly lowered our GDP forecasts for the US and the Eurozone until 2026.

Trade dispute from EU perspective

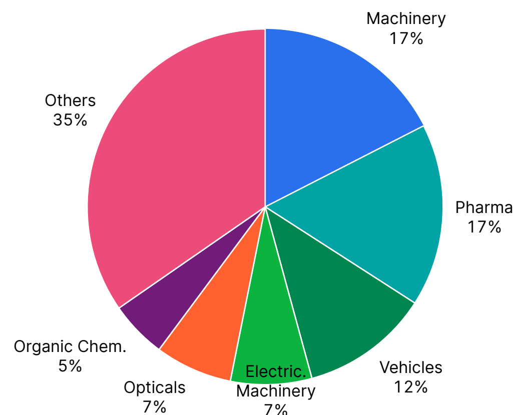
At the country level, countries such as Ireland, the Netherlands, Belgium, Germany, Italy and Austria would be particularly affected by stricter trade barriers with the US. However, due to the interconnectedness of supply chains within the EU and at the global level, it is possible that a country that has only a small direct export quota to the US could be more affected indirectly by US tariffs than it appears at first glance. In terms of sectors, Ireland, Belgium and the Netherlands are particularly closely intertwined with the US via the pharmaceutical industry, while for Germany, Italy and Austria, mechanical engineering plays a major role in trade with the US.

Ireland and Netherlands particularly dependent
Exports to US as % of GDP, 2023



Source: trademap, Erste Group Research

Industries at risk
EU exports to US by sector share, 2023



Source: trademap, Erste Group Research

In the medium term, we assume that EU companies will increasingly consider relocating production capacities to the comparatively dynamic US market. Less regulation and the risk of greater isolation of the US markets are key arguments for this. The decision will certainly be difficult for small and medium-sized companies, for whom it is likely to be much more difficult to take the step across the Atlantic. However, they risk losing sales markets in the EU in the coming years if capacities of corporate customers migrate to the US.

The question of how severely a country will be affected by possible import duties also depends on the composition of exports by sector. Studies show that exports of machinery, for example, are less sensitive to tariffs, while exports of automobiles are much more sensitive.

Based on the combination of the importance of the US as a sales market and the composition of the industry, Germany is likely to be the country most affected by a trade conflict. The situation in Ireland is somewhat more complex, as Ireland is a popular location for US companies in the EU, due to its tax advantages. Due to Ireland's tax attractiveness, it is therefore possible that a not insignificant proportion of exports from Ireland to the US "pass

through" Ireland, while a large part of the value added was generated in other EU countries. It is therefore possible that the negative effect on GDP growth in Ireland is less than it appears at first glance. In general, however, it can be said that chemical products, which account for a high proportion of exports from Ireland to the US, react very sensitively to import duties. In Germany, the problem lies in the high importance of automotive exports to the US, which are likely to suffer just as noticeably from import duties.

The US also plays an important role as a sales market for Italy, although Italy's industry composition is more favorable compared to Germany. Machinery clearly dominates Italy's exports, while exports of automobiles to the US play a comparatively minor role. We expect a trade conflict with the US to have the least dampening effect on growth in France and Spain. The main reason for this is both the minor importance of the US as a sales market and the favorable sector composition.

Trade dispute from US perspective

The new US President Trump attracted attention months ago with his statement that tariffs are the most beautiful word in the dictionary, and he never tires of repeating it. He wants to use this strategy to protect key sectors of US industry, bring back jobs and generate revenue for the national budget.

Tariffs drive up prices and create inefficiencies

However, tariffs increase the cost of imported goods. Many US companies are also part of global supply chains. Tariffs make production more expensive, as imported primary products become more expensive. This weakens the competitiveness of the US on international markets. Companies that rely on these products often pass on the higher prices to consumers. As a result, the cost of living rises and the purchasing power of households falls, as does demand. Tariffs protect inefficient domestic industries from competition. However, instead of using resources efficiently, they are diverted to unproductive sectors, which inhibits growth. Countries affected by US tariffs often respond with retaliatory tariffs on US exports. This hurts US companies that rely on exports. While tariffs can save jobs in protected industries in the short term, companies in export-oriented sectors lose jobs due to retaliatory tariffs. Studies show that the jobs created by tariffs are significantly lower than the jobs lost and that tariffs have an inflationary effect. The latter makes it more difficult for the central bank to control inflation.

Transportation, energy, chemicals, electronics, agriculture, metal and machinery are export-oriented

According to the USITC, the US International Trade Commission, based on data from 2023, the sectors with the highest share of imports are electronics (19%), transportation (19%), chemicals (14%), machinery (9%), energy (9%), metals (8%) and agriculture (7%). The largest import partners are Mexico, China, Canada, Germany, Japan, South Korea and Vietnam. Very export-heavy sectors are transportation (18%), energy (17%), chemicals (16%), electronics (15%), agriculture (9%), metal (9%) and machinery (8%). More than half of all exports go to Canada (18%), Mexico (16%), China (7%), the Netherlands (4%), Germany (4%) and Japan (4%). US states that could be very sensitive to counter-tariffs from international trading partners are Iowa, Nebraska, Kansas, Washington and California (agriculture), Michigan, Ohio, Indiana and Texas (transportation, metals, machinery), Texas and Louisiana (energy), Oregon (electronics) and Texas (chemicals). As the US would lose a

USA could lose massive share of global trade

significant share of global trade, due to fewer imports and counter-tariffs on the products it exports, the major ports in California, New York and New Jersey would also be unable to escape the feared downturn.

So, while tariffs can protect some industries in the short term, the disadvantages outweigh the benefits, especially if US imports are subject to more or less high tariffs on a global basis and trading partners take comparable countermeasures. We currently expect Trump to take a more cautious approach compared to the election campaign, as indicated by initial statements since his inauguration. However, the potential for both economically and politically far-reaching global consequences of US trade policy exists.

Forecasts[1]

GDP	2023	2024	2025	2026
Eurozone	0.4	0.7	1.0	1.0
US	2.9	2.8	2.0	1.8

Inflation	2023	2024	2025	2026
Eurozone	5.5	2.4	1.9	2.0
US	4.1	3.0	2.5	2.4

Interest rates	current	Mar.25	Jun.25	Sep.25	Dec.25
ECB MRR	3.15	2.65	2.40	2.15	2.15
ECB Deposit Rate	3.00	2.50	2.25	2.00	2.00
3M Euribor	2.64	2.46	2.22	1.98	1.99
Germany Govt. 2Y	2.29	2.10	2.00	2.00	2.00
Germany Govt. 5Y	2.39	2.20	2.10	2.10	2.00
Germany Govt. 10Y	2.58	2.40	2.30	2.30	2.20
Swap 10Y	2.52	2.40	2.50	2.55	2.50

Interest rates	current	Mar.25	Jun.25	Sep.25	Dec.25
Fed Funds Target Rate*	4.33	4.38	4.13	3.88	3.63
3M SOFR	4.30	4.33	4.08	3.83	3.58
US Govt. 2Y	4.27	4.20	4.00	3.80	3.60
US Govt. 5Y	4.44	4.42	4.21	4.06	3.92
US Govt. 10Y	4.63	4.60	4.40	4.30	4.20
EURUSD	1.05	1.03	1.03	1.05	1.06

*Mid of target range

Prices from January 24, 2025
Source: Market data provider, Erste Group Research

[1] Regulatory requirements oblige us to point out the following: Forecasts are not a reliable indicator of future performance.

Contacts

Group Research

Head of Group Research
Friedrich Mostböck, CEFA®, CESGA® +43 (0)5 0100 11902

CEE Macro/Fixed Income Research
Head: Juraj Kotian (Macro/FI) +43 (0)5 0100 17357
Katarzyna Rzentarzewska (Fixed income) +43 (0)5 0100 17356
Jakub Cery (Fixed income) +43 (0)5 0100 17384

Croatia/Serbia
Alen Kovac (Head) +385 72 37 1383
Mate Jelić +385 72 37 1443
Ivana Rogic +385 72 37 2419

Czech Republic
David Navratil (Head) +420 956 765 439
Jiri Polansky +420 956 765 192
Michal Skorepa +420 956 765 172

Hungary
Orsolya Nyeste +361 268 4428
János Nagy +361 272 5115

Romania
Ciprian Dascalu (Head) +40 3735 10108
Eugen Sinca +40 3735 10435
Dorina Ilasco +40 3735 10436
Vlad Nicolae Ionita +40 7867 15618

Slovakia
Maria Valachyova (Head) +421 2 4862 4185
Matej Hornak +421 902 213 591
Marian Kocis +421 904 677 274

Major Markets & Credit Research
Head: Rainer Singer +43 (0)5 0100 17331
Ralf Burchert, CEFA®, CESGA® (Sub-Sovereigns & Agencies) +43 (0)5 0100 16314
Hans Engel (Global Equities) +43 (0)5 0100 19835
Maurice Jiszda, CEFA®, CFDS® (USA, CHF) +43 (0)5 0100 19630
Peter Kaufmann, CFA® (Corporate Bonds) +43 (0)5 0100 11183
Heiko Langer (Financials & Covered Bonds) +43 (0)5 0100 85509
Stephan Lingnau (Global Equities) +43 (0)5 0100 16574
Maximilian Möstl (Credit Analyst Austria) +43 (0)5 0100 17211
Carmen Riefler-Kowarsch (Financials & Covered Bonds) +43 (0)5 0100 19632
Bernadett Povazsai-Römhild, CEFA®, CESGA® (Corporate Bonds) +43 (0)5 0100 17203
Elena Statelov, CIIA® (Corporate Bonds) +43 (0)5 0100 19641
Gerald Walek, CFA® (Eurozone) +43 (0)5 0100 16360

CEE Equity Research
Head: Henning Eßkuchen, CESGA® +43 (0)5 0100 19634
Daniel Lion, CIIA® (Technology, Ind. Goods&Services) +43 (0)5 0100 17420
Michael Marschallinger, CFA® +43 (0)5 0100 17906
Nora Nagy (Telecom) +43 (0)5 0100 17416
Christoph Schultes, MBA, CIIA® (Real Estate) +43 (0)5 0100 11523
Thomas Unger, CFA® (Banks, Insurance) +43 (0)5 0100 17344
Vladimira Urbankova, MBA (Pharma) +43 (0)5 0100 17343
Martina Valenta, MBA +43 (0)5 0100 11913

Croatia/Serbia
Mladen Dodig (Head) +381 11 22 09178
Boris Pevalek, CFA® +385 99 237 2201
Marko Plastic +385 99 237 5191
Matej Pretkovic +385 99 237 7519
Bruno Barbic +385 99 237 1041
Davor Spoljar, CFA® +385 72 37 2825
Magdalena Basic +385 99 237 1407

Czech Republic
Petr Bartek (Head, Utilities) +420 956 765 227
Jan Bystřický +420 956 765 218

Hungary
József Miró (Head) +361 235 5131
András Nagy +361 235 5132
Tamás Pletser, CFA® (Oil & Gas) +361 235 5135

Poland
Cezary Bernatek (Head) +48 22 257 5751
Piotr Bogusz +48 22 257 5755
Łukasz Jańczak +48 22 257 5754
Krzysztof Kawa, CIIA® +48 22 257 5752
Jakub Szkopek +48 22 257 5753

Romania
Caius Rapanu +40 3735 10441

Group Markets

Head of Group Markets
Oswald Huber +43 (0)5 0100 84901

Group Markets Retail and Agency Business
Head: Christian Reiss +43 (0)5 0100 84012

Markets Retail Sales AT
Head: Markus Kaller +43 (0)5 0100 84239

Group Markets Execution
Head: Kurt Gerhold +43 (0)5 0100 84232

Retail & Sparkassen Sales
Head: Uwe Kolar +43 (0)5 0100 83214

Markets Retail Sales CZ
Head: Roman Choc +420 956 765 374

Markets Retail Sales HUN
Head: Peter Kishazi +36 1 23 55 853

GM Retail Products &Business Development
Head: Martin Langer +43 (0)50100 11313

Corporate Treasury Product Distribution AT
Head: Martina Kranzl-Carvell +43 (0)5 0100 84147

Group Securities Markets
Head: Thomas Einramhof +43 (0)50100 84432

Institutional Distribution Core
Head: Jürgen Niemeier +49 (0)30 8105800 5503

Institutional Distribution DACH+
Head: Marc Friebertshäuser +49 (0)711 810400 5540
Bernd Bollhof +49 (0)30 8105800 5525
Andreas Goll +49 (0)711 810400 5561
Mathias Gindele +49 (0)711 810400 5562
Ulrich Inhofner +43 (0)5 0100 85544
Sven Kienzle +49 (0)711 810400 5541
Rene Klasen +49 (0)30 8105800 5521
Christopher Lampe-Traupe +49 (0)30 8105800 5523
Danijel Popovic +49 1704144713
Michael Schmotz +43 (0)5 0100 85542
Christoph Ungerböck +43 (0)5 0100 85558
Klaus Vosseler +49 (0)711 810400 5560
Slovakia
Šarlota Šipulová +421 2 4862 5619
Monika Směliková +421 2 4862 5629

Institutional Distribution CEE & Insti AM CZ
Head: Antun Burić +385 (0)7237 2439
Jaromir Malak +43 (0)5 0100 84254

Czech Republic
Head: Ondrej Čech +420 2 2499 5577
Milan Bartoš +420 2 2499 5562
Jan Porvich +420 2 2499 5566
Pavel Zdichynec +420 2 2499 5590

Institutional Asset Management Czech Republic
Head: Petr Holeček +420 956 765 453
Petra Maděrová +420 956 765 178
Martin Peřina +420 956 765 106
David Petráček +420 956 765 809
Blanka Weinerová +420 956 765 317
Petr Valenta +420 956 765 140
Croatia
Head: Antun Burić +385 (0)7237 2439
Zvonimir Tukač +385 (0)7237 1787
Ana Tunjić +385 (0)7237 2225
Natalija Zujic +385 (0)7237 1638
Hungary
Head: Peter Csizmadia +36 1 237 8211
Gábor Bálint +36 1 237 8205
Balazs Papay +36 1 237 8213
Gergő Szabo +36 1 237 8209
Romania
Head: Cristian Vasile Pascu +40 373 511 695

Group Institutional Equity Sales
Head: Michal Řízek +420 224 995 537
Werner Fürst +43 (0)50100 83121
Viktoria Kubalcova +43 (0)5 0100 83124
Thomas Schneidhofer +43 (0)5 0100 83120
Oliver Schuster +43 (0)5 0100 83119
Czech Republic
Head: Michal Řízek +420 224 995 537
Jiří Fereš +420 224 995 554
Martin Havlan +420 224 995 551
Pavel Krabička +420 224 995 411
Poland
Head: Jacek Jakub Langer +48 22 257 5711
Tomasz Galanciak +48 22 257 5715
Wojciech Wysocki +48 22 257 5714
Przemyslaw Nowosad +48 22 257 5712
Maciej Senderek +48 22 257 5713
Croatia
Matija Tkalicanac +385 72 37 21 14
Hungary
Nandori Levente + 36 1 23 55 141
Krisztian Kandik + 36 1 23 55 162
Balasz Zankay + 36 1 23 55 156
Romania
Valerian Ionescu +40 3735 16541

Group Fixed Income Securities Markets
Head: Goran Hoblaj +43 (0)50100 84403

Fixed Income Flow Sales
Head: Gorjan Hoblaj +43 (0)5 0100 84403
Margit Hraschek +43 (0)5 0100 84117
Christian Kienesberger +43 (0)5 0100 84323
Ciprian Mitu +43 (0)5 0100 85612
Bernd Thaler +43 (0)5 0100 84119
Zsuzsanna Toth +36 1 237 8209
Poland
Pawel Kielek +48 22 538 6223
Michal Jarmakowicz +43 50100 85611

Fixed Income Flow Trading
Head: Gorjan Hoblaj +43 (0)5 0100 84403

Group Fixed Income Securities Trading
Head: Goran Hoblaj +43 (0)50100 84403

Group Equity Trading & Structuring
Head: Ronald Nemec +43 (0)50100 83011

Business Support
Bettina Mahoric +43 (0)50100 86441

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