INTEREST RATE OUTLOOK | EUROZONE, USA

Time to cut interest rates

Analyst:
Rainer Singer
rainer.singer@erstegroup.com

ECB and US Fed get to work

Both the eurozone and the USA are set for a series of interest rate cuts in the fall. Although the latest inflation data has not yet given the all-clear, overall it points in the right direction. Other economic data also supports expectations for interest rate cuts. In the eurozone, the economy is recovering slowly, while in the USA there are increasing signs of a noticeable slowdown in the labor market. As a result, the decision-making guidelines for the two central banks have become clearer. We expect both the ECB and the US Fed to cut interest rates by a total of 75 basis points by the end of the year. Further rate cuts should then follow in 2025.

A new Donald Trump presidency poses risks. The announcement to raise US tariffs would lead to trade conflicts and thus to uncertainty globally. In the US it would increase inflation risks. The extent of this will probably also depend on the majorities that emerge in both chambers of the US Congress after the elections. There are many possible variations in the distribution of power after the US elections and therefore the consequences. So far, the markets have been calm, but the potential for reactions is certainly there.

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 the eurozone and the US in compact form. We also focus on two economic policy issues that could come under the spotlight in the wake of the US elections: The future trade policy under Donald Trump and the US federal budget.

Contents

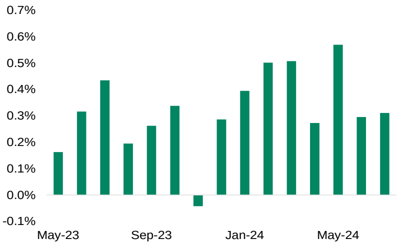
Major Markets & Credit Research
Rainer Singer (Head)

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

Eurozone - Economic data on course for ECB?

The ECB will almost certainly make its next interest rate cut of 25 basis points (bp) in September. The latest data should have been largely in line with the Governing Council's expectations and thus confirm the forecasted achievement of the inflation target in the second half of 2025. This clears the way for the next interest rate cut. The ECB economists' new forecasts for the coming years will also be available in September. Changes compared to the forecasts in June should be minor, but should support further interest rate cuts after September. In particular, we see potential for downward revisions to GDP growth for this year and next. The reason for this is that the latest key economic data has shown only slight improvements at best, meaning that the economy is only getting off to a sluggish start and ECB economists' expectations for a recovery should therefore be pushed back further.

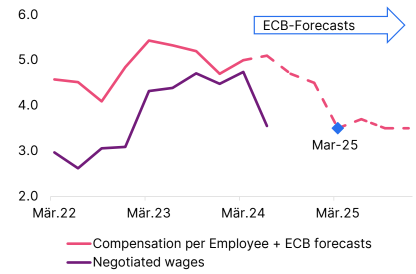
Inflation services, M/M in %



Source: ECB, Erste Group Research

The latest inflation data was mixed and led to little change in the inflation rate over the last few months. This was also expected by the ECB, which does not anticipate the start of a sustained decline in the inflation rate until the end of this year or the beginning of next year. This means that these data did not contradict upcoming interest rate cuts. On the contrary, there were slight improvements in the structure of the inflation rate. The monthly momentum in service prices has slowed in recent months compared to the high levels seen at the beginning of the year. If the monthly rates of increase remain roughly the same, annual inflation will start to fall from the beginning of next year. This means that the overall inflation rate will also fall. The ECB is aware of this and can therefore live with little change in annual inflation for the time being.

Wages, y/y, in %

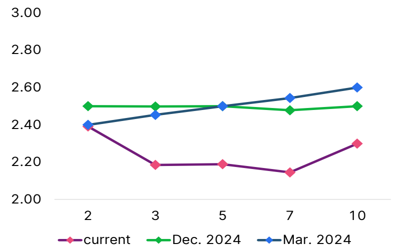


Source: ECB, Erste Group Research

The growth rate of wages will be important for the ECB's assessment of inflation. The increase in the first quarter of this year is likely to have been due to delayed adjustments to inflation in multi-year wage agreements. The growth rate of negotiated wages in the second quarter, which is already available, has fallen significantly and indicates that the increase in the first quarter may indeed have been temporary. The "compensation per employee" indicator will provide clarification, although this will not be published until September 6. The ECB does not expect a noticeably lower growth rate in compensation of employees until the first quarter of 2025. Expectations for the decline in wage pressure until then are modest and the actual figure reported for the second quarter could thus fall even short of the ECB's expectations.

We therefore expect three interest rate cuts totaling 75 bp by the end of the year. The ECB Governing Council will still not commit to an interest rate path in advance, but will make any decision dependent on incoming data. We see the greatest risk to our forecast for the October meeting. The Governing Council could opt for a more cautious, quarterly rhythm. New forecasts from ECB economists are available at the meeting at the end of each quarter and interest rate changes could be implicitly linked to this. In our view, however, the slow economic recovery and relatively rapid interest rate cuts in the US suggest that the ECB Governing Council will move relatively quickly and cut interest rates in October as well as September and December.

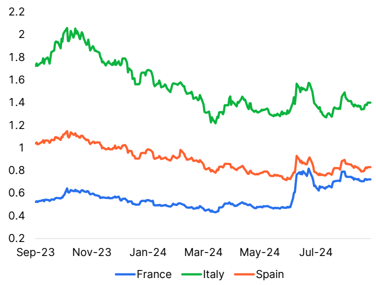
German yield curve forecast, in %



Source: Market data provider, Erste Group Research

We expect yields on German government bonds to continue to move sideways over the coming months, and later longer and medium-term maturities to increase slowly. The biggest uncertainty factor for us is the US elections. If Donald Trump wins the election, the prospect of higher US tariffs and a trade conflict with the US would mean downside risks for the economy in the eurozone and thus downward pressure on German yields. On the other hand, the US market could point in the opposite direction due to the inflation risks for the US posed by higher tariffs. A Trump presidency would therefore increase volatility on the European bond markets. We do not take these possible effects of the US elections into account in our point forecasts. In an extreme case, we roughly estimate the impact to be a decline in German yields of 10 - 20 bp.

10y Yield spreads to Germany, in percentage points



Source: Market data provider, Erste Group Research

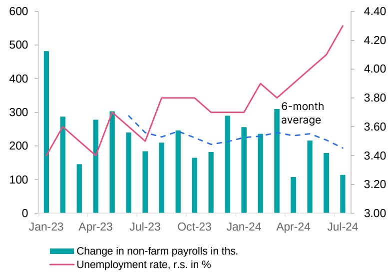
Spreads on the eurozone sovereign bond markets moved sideways after falling since the beginning of the year. The early elections in France and the market turbulence at the beginning of August triggered upward spikes, but these were generally short-lived. The exception among the major countries was France, where spreads remained at a relatively high level. The combination of a difficult government formation - none of the major blocs has an absolute majority of seats in parliament - and the need to reduce the budget deficit, as the EU has initiated an excessive deficit procedure, is unsettling the markets. The current government of experts has presented a budget for 2025 that freezes spending at the level of 2024 and can therefore certainly be seen as an austerity budget (no inflation adjustment of spending). However, this budget still has to be passed by the French parliament by October 1. If a government is formed in time, a new government could still adopt its own budget. There is certainly a need for action. In May, before the recent political turmoil, the European Commission had forecast a deficit of 5% of GDP in France next year.

Italy is the second major country in the eurozone to be subject to excessive deficit proceedings. Although the deficit here is expected to be slightly lower than in France at 4.7% of GDP in 2025, it is expected to increase compared to 2024. Unlike France, however, Italy has a stable government. In our view, Spain is in the best position of the three major spread markets. The deficit should fall to just under 3% in 2025 and the Commission has not initiated proceedings against Spain. The decisive factor for the outlook for all countries will be the budgets that the eurozone countries have to submit to the European Commission by October 15. We see the greatest risk of spreads widening in France.

USA - How quickly will the US Fed cut rates?

The US Federal Reserve is also very likely to cut interest rates in September. Both the economic data and statements by high-ranking representatives, including Fed Chairman Powell, suggest that such a move is likely. We expect a rate cut of 25 basis points (bp), but do not want to rule out 50 bp. In our view, this will be determined by the data published before the meeting of the decisive FOMC committee on September 17-18.

US labor market



Source: Bureau of Labor Statistics, Erste Group Research

The US labor market data for July showed a further slowdown. In conjunction with the previous months' data, some of which were revised, this showed a relatively clear trend of rising unemployment and lower employment growth. The unemployment rate has risen by 0.5 percentage points within four months, following only very slight movements previously. If this recent trend continues, the unemployment rate would soon reach levels that no longer meet the Fed's monetary policy goal of full employment. The members of the FOMC currently see the long-term average unemployment rate at 4.2%, which is an indication of the target value. The recent development of the labor market is not entirely unexpected for the FOMC. Concerns about the labor market were already evident at the meeting at the end of July, i.e. before the publication of the latest labor market data. Powell said that a further significant weakening of the labor market would be unwelcomed. But that is exactly what is now on the cards.

At the same time, the latest inflation data was encouraging. Not only did the monthly price pressure ease, but the movement also came from the right source. Similar to the eurozone, inflation in services in the USA had been stubbornly persistent for a long time. Recently, there were signs of easing from precisely this source. This means that the economic data allows for a rate cut. We expect 25 bp in September. If the inflation data and the labor market data for August are weak again, the door would also be open for a rate cut of 50 bp. In line with our expectations of a further slowdown in the labor market and inflation after September, we expect two further rate cuts of 25 bp each by the end of the year, which should be followed by further rate cuts next year.

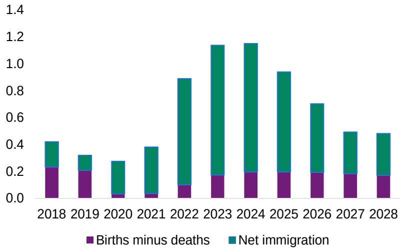
Savings rate as % of disposable income

Source: Bureau of Economic Analysis, Erste Group Research

The pace of US interest rate cuts will also be determined by the US economy, which has proved relatively robust to date. We see a slowdown in the economy as likely, as we consider consumption to be too strong based on the low savings rate. US households have been spending an unusually high proportion of their income since the end of the COVID pandemic. The assumption is that savings accumulated during the pandemic are being spent and thus supporting consumption. The low savings rate is an indication of this. However, these savings should be used up and the momentum of spending should therefore slow down.

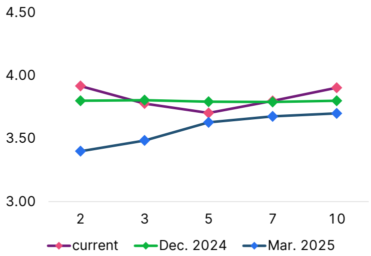
Another explanation for the persistently robust US economy, despite the sharp rise in interest rates since 2022, is the sharp increase in migration to the USA. According to estimates by the Congressional Budget Office, population growth is expected to peak in 2024 and then slowly subside. This means that the support provided by immigration for overall economic demand

US population growth, y/y in %



Source: Congressional Budget Office, Erste Group Research

US yield curve forecast, in %



Source: Market data provider, Erste Group Research

will decline but not cease, as population growth is still expected to remain robust in 2025.

Overall, a moderate slowdown in the US economy therefore seems the most likely scenario for us. We do not expect a recession. Overall economic demand in the US has been surprisingly resilient for decades. Since 2000, shocks have been needed to trigger a recession. These were the bursting of the dotcom bubble in 2001, the financial market crisis in 2008 and the COVID pandemic in 2020. No such event is currently on the horizon.

The bond market has already priced in a considerable amount of interest rate cuts. We therefore expect a volatile sideways trend for medium and longer maturities in the coming months. Short maturities, on the other hand, should benefit from the fact that future interest rate cuts will be taken into account to an increasing extent and yields will therefore fall sustainably. The shape of the yield curve should therefore slowly normalize.

The US elections and Donald Trump's victory are a major source of uncertainty. The US president has far-reaching powers when it comes to trade policy, as Trump proved in his first term of office, but also the current president. Donald Trump is propagating new tariffs on a scale that could lead to a noticeable rise in inflation in the US. An increase of around 1 percentage point seems realistic. However, these estimates are based on assumptions about the extent to which the tariffs will be passed on to consumers and are therefore very uncertain. Whether these would be one-off effects, which would be important for the US Fed's reaction, or not would depend on whether tax cuts are introduced alongside the tariff increases. However, this would require majorities in both chambers of the US Congress. The market reaction to the US elections will therefore also depend on how the majorities in the House of Representatives and the Senate are distributed. If the Republicans win across the board, this would increase inflation risks. We would expect a rise in yields, which we roughly estimate at 20 - 30 bp. However, this scenario is not the basis of our point estimate, where we assume no impact from the US elections, as the outcome of the elections is too uncertain to serve as a basis.

The situation of the public budget in the US and the possible effects of the elections are discussed in the next chapter. In summary, there is an acute need for restructuring, as debt will otherwise continue to rise over the next 10 years and beyond. At the same time, the developments of recent years make it unlikely that the political will to do so will be mustered. The markets accept this outlook for US debt and we do not expect anything to change. However, the USA's dependence on foreign capital harbors risks in the medium and long term.

Focus - What will US elections bring?

With only two months to go until the US elections, the potential impact is coming to the fore. In our view, the two issues that could have the greatest impact on the markets are future US trade policy and the development of the public budget.

During the election campaign so far, Donald Trump has repeatedly called for tariffs of 10% on all imports and 60% on imports from China. Trade conflicts are therefore on the cards. The highest proportion of EU exports to the USA is accounted for by machinery and components of all kinds, closely followed by pharmaceutical products and vehicles. Conversely, with the exception of fossil fuels, pharmaceutical products, aircraft industry products and machinery also account for the highest share of US exports to the EU.

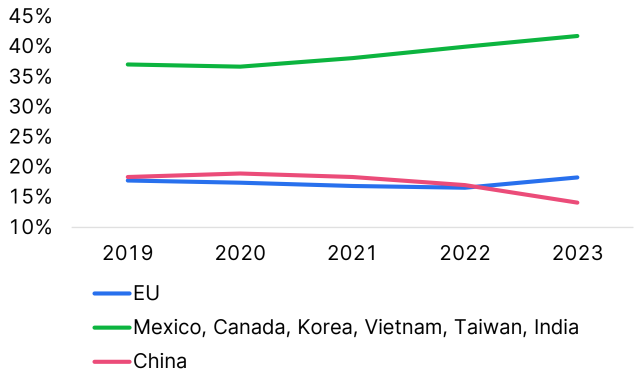
Effects of higher tariffs are difficult to assess

It is difficult to estimate what losses EU companies will suffer as a result of the higher US tariffs. How the costs will be distributed among exporters, importers and US consumers and therefore how high the losses for EU companies will be will depend on the competitive position in the respective sector. The EU's exports to the USA correspond to just under 3% of the EU's GDP. Since all other importers, with the exception of China, would be affected by the same tariff, the competitive disadvantage of EU producers would only be compared to US producers. In our view, the orders of magnitude in question suggest that the overall direct impact on the EU economy would be small. Furthermore, it is very likely that countermeasures by the EU will have to be taken into account, from which EU suppliers would benefit. EU imports from the US are equivalent to 2% of EU GDP. The distribution of the burdens and reliefs of a trade conflict across industries and sectors would vary.

However, a trade conflict would also lead to great uncertainty among companies, which would result in a delay in investments. This would affect more sectors than those that export to the US. This indirect impact would probably be stronger than through trade flows and US tariffs could therefore have a noticeable negative impact on the eurozone economy via this route.

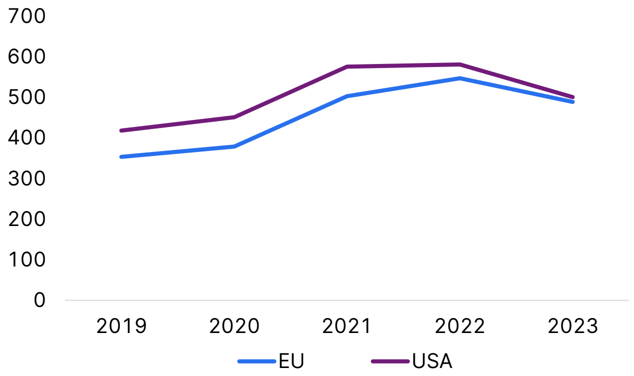
The situation is different for China, as US tariffs would increase much more than for other countries. The impact would probably be significant. The comparatively more moderate measures taken by the last two US presidents have already led to a significant drop in the proportion of Chinese imports to the US. This was also due to Chinese companies relocating their production facilities in order to avoid US tariffs. China has lost many shares of US trade to Taiwan, for example. One example is telephones, where 57% of US imports came from China in 2019, compared to 47% in 2023. Taiwan's share rose by almost three percentage points to 6.4% in the same period. If tariffs actually rise to 60% for China, this would likely prolong and accelerate existing trends. We assume that the main beneficiaries of higher US tariffs on Chinese products would be other countries outside the US. Either Chinese companies will continue to relocate their production or companies based there will export more to the US. India, Southeast Asian countries, Taiwan and Mexico should therefore benefit from higher US tariffs on China.

Share of US imports
in %



Source: International Trade Center, Erste Group Research

Imports from China
in USD bn.



Source: International Trade Center , Erste Group Research

By contrast, the EU should hardly benefit from the higher US tariffs on Chinese goods, as the EU and China hardly compete with each other in the US. This is indicated by the fact that the EU was unable to benefit from China's loss of share of US imports. We have also looked at the most important product categories and compared the shares of China and the EU in US imports. In many product categories, the shares differ so greatly that it cannot be assumed that there is strong competition. Where there are similar market shares, we have looked at whether there have been shifts and whether the losses of one and gains of the other or vice versa have occurred simultaneously. Such developments were only seen in a few product categories. We therefore do not see any pronounced competition between the EU and China in the US market, either in general or in the largest product categories.

For the EU, the focus will be much more on competition from China on the home market and increasing dependency (batteries and semiconductors). The EU will have to think about how to deal with China's increasingly strong position. While China has lost share in the US import market, it has gained share globally and in imports to the EU. In the EU, the share of Chinese imports rose from 8.4% in 2019 to 9.1% in 2023. As a result, the EU now imports almost as much from China as the USA.

US budget: no consolidation in sight

Regardless of who wins the next presidential election, there will hardly be any consolidation of the public budget. This is because the issue has hardly been addressed in the election campaign so far. In addition, US budgets must pass both chambers of the US Congress, with a de facto majority of 60% required in the Senate. This means that the majorities in the US Congress after the elections will also be of decisive importance. There is a high probability that they will remain thin. This suggests that the very cumbersome decision-making process will continue. So far, agreement on annual budgets without a significant reduction in the deficit has regularly only been reached after protracted political negotiations and usually with considerable delay. An increase in the debt limit has regularly taken place literally at the last second. Based on this experience, an agreement on higher revenues and/or lower expenditure over several years seems very unlikely, even though budget consolidation is undoubtedly necessary. This is because, according to estimates by the Congressional Budget Office, the debt will continue to rise with the current legislative situation.

Although the Congressional Budget Office is forecasting a fall in the central government deficit from 7% this year to 5.5% of GDP in 2027, the underlying assumption is that tax cuts expiring at the end of 2025 will not be extended. Even then, total debt will still rise from 99% of GDP this year to 110.5% over the next five years and to 122.4% of GDP over the next 10 years. Here, government provisions for future social spending have already been deducted. Without these deductions and therefore comparable with international data, the IMF forecasts that debt will rise from 123.2 to 133.9 of GDP over the next five years. The IMF does not expect a similar increase for any other G7 country. An increase of just under six percentage points is forecast for the next-ranked country, the United Kingdom.

However, these estimates are still optimistic. This is because it is likely that the tax cuts expiring at the end of 2026 will be at least partially extended and both candidates have further costly proposals in their program, with unclear financing. A sharper increase in deficits and therefore debt than the above forecasts is therefore a realistic possibility.

Finally, one long-term factor that a future government will have to address is the US pension system. This currently still benefits from reserves, but these will be exhausted around the middle of the next decade. Without countermeasures, an additional gap will open up here, which will then further increase the government deficit.

For the markets, the steady rise in US debt over the coming years has hardly been an issue so far. It remains to be seen how long the debt can rise before the markets demand a higher premium. On the one hand, the US is in a unique position as a global hegemonic power with the dollar as the dominant reserve and trading currency. On the other hand, the USA has become accustomed to the constant influx of foreign capital and has thus become dependent. Experience shows that foreign capital reacts more sensitively to rising risks than domestic capital, all the more so if competition among global reserve and trading currencies becomes tougher. There are therefore risks for the USA in the medium and long term.

Forecasts[1]

BIP	2022	2023	2024	2025
Eurozone	3.5	0.5	0.7	1.1
USA	1.9	2.5	2.4	1.4

Inflation	2022	2023	2024	2025
Eurozone	8.4	5.5	2.4	2.1
USA	8.0	4.1	2.8	2.2

Interest rates	current	Dec.24	Mar.25	Jun.25	Sep.25
ECB MRR	4.25	3.15	2.90	2.65	2.40
ECB Deposit Rate	3.75	3.00	2.75	2.50	2.25
3M Euribor	3.49	3.09	2.86	2.64	2.40
Germany Govt. 2Y	2.39	2.50	2.40	2.40	2.40
Germany Govt. 5Y	2.19	2.50	2.50	2.50	2.50
Germany Govt. 10Y	2.30	2.50	2.60	2.60	2.60
Swap 10Y	2.54	2.80	2.90	2.90	2.90

Interest rates	current	Dec.24	Mar.25	Jun.25	Sep.25
Fed Funds Target Rate*	5.33	4.63	4.13	3.63	3.38
3M Libor	5.28	4.71	4.30	3.88	3.63
US Govt. 2Y	3.92	3.80	3.40	3.30	3.20
US Govt. 5Y	3.70	3.79	3.63	3.57	3.46
US Govt. 10Y	3.90	3.80	3.70	3.70	3.60
EURUSD	1.11	1.13	1.14	1.14	1.15

*Mid of target range

Prices as of September 2, 2024
Source: Market data providers, Erste Group Research

[1] By regulations we are obliged to issue the following statement: Forecasts are no 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: Gudrun Egger, CEFA®	+43 (0)5 0100 11909
Ralf Burchert, CEFA®, CESGA® (Sub-Sovereigns & Agencies)	+43 (0)5 0100 16314
Hans Engel (Global Equities)	+43 (0)5 0100 19835
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
Rainer Singer (Euro, US)	+43 (0)5 0100 17331
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® (Euro, CHF)	+43 (0)5 0100 16360
CEE Equity Research	
Head: Henning Eßkuchen	+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
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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