Central & Eastern European Strategy

1st quarter 2017

Return of inflation in CE/SEE

- Domestic demand as growth driver in 2017
- Bond market consolidation in Q1 2017
- RUB potential largely exhausted
- Upbeat conditions on equity market

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Central & Eastern European Strategy

Explanation:
e … estimate (current year)
f … forecast
p … preliminary figures
n.v. … no value

Abbreviations
Currencies and Countries

ALL	Albanian lek
BAM	Bosnian marka
BGN	Bulgarian lev
BYN	Belarusian roubel
CZK	Czech koruna
HUF	Hungarian forint
HRK	Croatian kuna
PLN	Polish zloty
RON	Romanian leu
RSD	Serbian dinar
RUB	Russian rouble
TRY	Turkish lira
UAH	Ukrainian hryvnia

Economic abbreviations

%-chg	Percentage change (not in percentage points)
avg	average
bp	basis points
C/A	Current Account
CPI	Consumer Price Index
ECB	European Central Bank
FCY	Foreign Currency
FDI	Foreign Direct Investments
FX	Foreign Exchange
FY	Full year
GB	Government bond
GDP	Gross Domestic Product
HCPI	Harmonized Consumer Price Index
LCY	Local Currency
mmav	month moving average
mom	month on month
MP	Monetary policy
MPC	Monetary policy council
O/N	overnight rate
pp	percentage points
PMI	Purchasing Manager Index
PPI	Producer Price Index
QE	Quantitativ easing
qoq	quarter on quarter
qtd	quarter to date
REPO	Repurchase agreement
T/B	Trade Balance
ULC	Unit Labour Costs
UST	US Treasury bond
YC	yield curve
yoy	year on year
ytd	year-to-date

Sovereign Bond markets

CZGB	Czech local currency government bonds
HGB	Hungarian local currency government bonds
OFZ	Russian local currency government bonds
POLGB	Polish local currency government bonds
ROMGB	Romanian local currency government bonds
TURKGB	Turkish local currency government bonds

Stock Exchange Indices

ATX	Austrian stock index
BET	Romanian stock index
BIST National 100	Turkish stock index
BUX	Hungarian stock index
PX	Czech stock index
MICEX	Russian stock index
WIG 20	Polish stock index

Fixed income indices

EMBIG	JP Morgan Emerging Markets Bond Index Global
CEMBI	JP Morgan Corporate Emerging Markets Bond Index

Equity related

DY	Dividend yield
EBIT	Earnings before interest and taxes
EBITDA	earnings before interest, taxes, depreciation, and amortization
EBT	earnings before taxes
EPS	earnings per share
EG	Earnings growth
LTG	Long term (earnings) growth
NIBD	Net interest bearing debt
P/B	Price book ratio
P/E ratio	Price earnings ratio
RoE	Return on equity
ROCE	Return on capital employed
RS	Recommendation suspended
UR	Under Revision

Euro area (EA)	*Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovenia, Slovakia, Spain*
CE	*Central European countries – Poland, Hungary, Czech Republic, Slovakia, Slovenia*
SEE	*South East European countries – Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Romania, Serbia*
EE	*Eastern Europe (Russia, Ukraine, Belarus)*
CEE	*Central and Eastern Europe (CE + SEE + EE)*

Please note the risk notifications and explanations at the end of this document

Growth path at risk due to political developments?

- **Real GDP growth of roughly 3% in CE/SEE again in 2017, return to positive inflation rates**
- **Political developments not supportive for investment climate**
- **Monetary policy to remain expansive due to ECB liquidity flood**

Unfortunately, the tendency to give preference to national interests over market economy solutions is becoming noticeable in Eastern Europe as well. Over the short term, this will not jeopardise the robust growth momentum, but the significant benefits associated with the flexibility and deregulation of these markets may diminish over the long term.

In 2017, the strong domestic demand will continue to dominate in the individual regions. We expect average GDP growth rates of just over 3% in CE and SEE, marking the climax of the economic development in Central Europe and the Balkans since 2014. In Russia, we anticipate a return to modest growth, and the same can be said of Ukraine. Investment activity will likely come in slightly below the expectations in the CE/SEE region. While the absorption of EU funds will continue to be a decisive factor in the short term, foreign direct investment will be influenced by the political landscape from a long-term perspective. The positive trend on the labour market and the relatively high wage growth will continue to support private consumption as a key driver of growth.

After two and a half years of deflationary consumer prices, positive inflation rates are expected for CE and SEE already in the first quarter. In Austria, consumer price inflation will likely approach the 2% mark over the course of the year and thus settle well above the euro area average.

The reversal of inflation rates will not yet be reflected in the monetary policy of the CE/SEE countries in 2017. The ultra-expansive monetary policy of the ECB was only recently confirmed. The expansion of liquidity in the euro area until at least the end of 2017 will also support the loose monetary policy in Poland, Hungary, and the Czech Republic. Therefore, we do not expect any interest rate changes for the majority of 2017. It will be interesting to see how the Romanian central bank reacts to the expansive economic plans of the new government. By contrast, the downward trend in inflation is likely to continue in Russia and thus provide justification for further interest rate cuts.

Impact on currencies

Based on the political developments and no tendency towards more restrictive monetary policy in the second half of 2017, we have taken a much more cautious stance in our forecast for EUR/PLN. We do not anticipate much movement for HUF and CZK, even though the peg to the EUR will likely be lifted in the second half of the year. The stronger oil price and the interest differential are supporting RUB.

Impact on the bond and equity markets

Much like on the established equity markets, we expect conditions to be upbeat in the first half of 2017. Along with monetary policy, both the growth expectations and earnings development will likely drive prices up. We see upside potential ranging from 5% to 10% for the majority of the equity indices up until the middle of the year. The ATX is among the front runners. On the bond markets, we expect a certain amount of consolidation in the first few months of the year following the corrections at the end of 2016. In general, however, a moderate upward trend in yields should emerge in the second half of the year at the latest.

Financial analyst: Peter Brezinschek, RBI Vienna

CEE: Market strategy[1]

	Eurobonds		LCY Bonds		FX
	EUR	USD	2y	10y	–
BG	H	–	–	–	–
HR	H	H	–	–	H
CZ	H	–	H	H	H
HU	H	H	H [2)]	B	H
PL	H	H	H	B	H
RO	H	H	H	H	H
RU	H	S	B	H	H
RS	–	B	–	–	H
MK	H	–	–	–	–
KZ	–	B			
TR	H	H	S	S	H
UA	–	S	–	–	S
BY	–	S	–	–	S

[1] **LCY bonds:** *based on absolute performance in LCY*
Eurobonds: *based on expected spread change*
FX *vs. EUR*
Recommendation horizon: **end 1st quarter 2017**
For recommendation history please see page 56
B: Buy; H: Hold; S: Sell
2) HU: 3y, not 2y tenor
Source: RBI/Raiffeisen RESEARCH

Recommendations[1] – stock markets

Indices	
Buy	ATX, MICEX, BUX, PX, WIG 30
Hold	-
Sell	BIST Nat. 100

Recommendations[1] – debt markets

Corporate bonds		curr.[2]
Buy	Gazprom 6.51% due 2022	230bp

[1] *horizon:* **end 1st quarter 2017**
[2] *z-spreads (bp)*
Source: RBI/Raiffeisen RESEARCH

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Real GDP (% yoy)

Countries	2015	2016e	Consensus	2017f	Consensus	2018f	Consensus
Poland	3.9	2.5	2.8	3.0	3.2	2.5	3.4
Hungary	2.9	2.3	2.1	3.2	2.6	3.4	2.7
Czech Rep.	4.6	2.5	2.5	2.7	2.6	2.5	2.6
Slovakia	3.8	3.3	3.3	3.3	3.1	4.0	3.0
Slovenia	2.3	2.6	2.1	2.7	2.2	2.2	2.4
CE	**3.8**	**2.6**	**2.7**	**3.0**	2.9	**2.7**	3.1
Croatia	1.6	2.7	2.5	2.8	2.5	2.8	2.5
Bulgaria	3.6	3.3	2.9	3.0	2.8	3.3	2.6
Romania	3.8	4.7	4.7	3.6	3.5	3.0	3.2
Serbia	0.7	2.7	2.5	3.0	2.8	3.0	3.2
Bosnia a. H.	3.0	2.5	2.9	3.0	3.0	3.5	3.3
Albania	2.6	3.5	3.2	4.0	3.6	4.0	4.0
Kosovo	4.1	3.5	3.6	3.5	3.8	3.5	3.9
SEE	**3.0**	**3.8**	**3.7**	**3.3**	3.2	**3.1**	3.1
Russia	-3.7	-0.5	-0.6	1.0	1.2	1.5	1.5
Ukraine	-9.9	1.0	1.0	2.0	2.2	3.0	3.0
Belarus	-3.9	-3.0	-2.1	0.0	0.6	1.5	1.2
EE	**-4.1**	**-0.5**	**-0.6**	**1.0**	1.2	**1.6**	1.6
Turkey	4.0	2.0	3.0	2.0	3.1	3.5	3.5
Austria	**1.0**	**1.4**	**1.5**	**1.3**	1.3	**1.5**	1.5
Germany	1.5	1.8	1.8	1.7	1.4	1.5	1.4
Euro area	**2.0**	**1.6**	**1.6**	**1.5**	1.4	**1.7**	1.5
USA	**2.6**	**1.6**	**1.6**	**2.4**	2.2	**2.2**	2.3

Source: national sources, RBI/Raiffeisen RESEARCH

Consumer prices (avg, % yoy)

Countries	2015	2016e	2017f	2018f
Poland	-0.9	-0.6	1.1	2.0
Hungary	0.0	0.3	2.5	3.0
Czech Rep.	0.3	0.7	2.0	2.0
Slovakia	-0.3	-0.5	1.1	2.0
Slovenia	-0.8	-0.2	1.3	1.5
CE	**-0.5**	**-0.2**	**1.5**	**2.1**
Croatia	-0.5	-1.2	1.3	2.2
Bulgaria	-0.1	-0.6	1.6	2.0
Romania	-0.6	-1.6	1.2	2.4
Serbia	1.4	1.1	2.5	2.9
Bosnia a. H.	-1.0	-0.9	2.0	2.0
Albania	1.8	1.3	2.2	2.7
Kosovo	-0.5	0.2	1.0	2.0
SEE	**-0.2**	**-1.0**	**1.5**	**2.4**
Russia	15.6	7.2	5.4	5.2
Ukraine	48.7	13.3	10.7	7.5
Belarus	13.5	14.0	12.0	11.0
EE	**17.6**	**7.8**	**6.0**	**5.6**
Turkey	7.7	7.6	8.0	7.5
Austria	**0.8**	**1.0**	**2.0**	**2.1**
Germany	0.1	0.7	1.9	2.2
Euro area	**0.0**	**0.2**	**1.5**	**1.5**
USA	**0.1**	**1.4**	**2.2**	**2.5**

Source: national sources, RBI/Raiffeisen RESEARCH

Current account balance (% of GDP)

Countries	2015	2016e	2017f	2018f
Poland	-0.2	-0.5	-0.8	-1.1
Hungary	4.4	3.5	3.2	2.9
Czech Rep.	0.9	2.4	1.5	1.2
Slovakia	-1.3	-0.7	-0.7	0.2
Slovenia	5.2	7.0	6.8	6.4
CE	**0.5**	**0.6**	**0.3**	**0.1**
Croatia	5.0	3.1	2.5	2.2
Bulgaria	1.1	2.1	0.4	1.0
Romania	-1.2	-2.6	-3.3	-3.5
Serbia	-4.6	-3.7	-3.7	-3.5
Bosnia a. H.	-5.6	-5.4	-7.0	-7.7
Albania	-13.6	-13.6	-14.5	-12.9
Kosovo	-8.8	-9.5	-7.9	-7.5
SEE	**-1.1**	**-1.9**	**-2.7**	**-2.7**
Russia	5.0	2.1	5.2	5.7
Ukraine	-0.1	-3.3	-4.7	-3.9
Belarus	-3.8	-4.3	-3.9	-3.5
EE	**4.3**	**1.5**	**4.3**	**4.9**
Turkey	-4.5	-5.2	-5.8	-4.5
Austria	**1.8**	**1.9**	**1.5**	**1.7**
Germany	8.3	9.0	8.5	8.0
Euro area	**3.1**	**3.3**	**3.3**	**3.1**
USA	**-2.6**	**-3.2**	**-3.5**	**-3.5**

Source: national sources, RBI/Raiffeisen RESEARCH

General budget balance (% of GDP)

Countries	2015	2016e	2017f	2018f
Poland	-2.6	-2.5	-3.1	-3.4
Hungary	-2.0	-1.5	-2.5	-3.0
Czech Rep.	-0.6	0.0	-0.2	0.0
Slovakia	-2.7	-2.5	-2.0	-2.0
Slovenia	-2.7	-2.5	-2.1	-1.9
CE	**-2.1**	**-1.9**	**-2.3**	**-2.5**
Croatia	-3.3	-2.4	-2.9	-2.8
Bulgaria	-2.8	0.3	-1.5	-2.0
Romania	-0.8	-2.5	-3.2	-3.0
Serbia	-3.7	-2.1	-1.8	-1.8
Bosnia a. H.	0.7	-1.5	-1.0	-1.0
Albania	-4.0	-2.5	-2.0	-1.0
Kosovo	-2.2	-2.3	-2.5	-2.3
SEE	**-1.8**	**-2.0**	**-2.6**	**-2.5**
Russia	-3.6	-4.4	-3.3	-2.4
Ukraine	-2.3	-3.5	-4.0	-3.0
Belarus	1.8	0.5	0.0	0.0
EE	**-3.3**	**-4.2**	**-3.2**	**-2.3**
Turkey	-1.2	-2.0	-2.5	-1.8
Austria	**-1.2**	**-1.3**	**-1.2**	**-1.1**
Germany	0.7	0.2	0.1	0.0
Euro area	**-2.1**	**-1.8**	**-1.5**	**-1.5**
USA	**-2.4**	**-3.2**	**-3.5**	**-2.6**

Source: national sources, RBI/Raiffeisen RESEARCH

Public debt (% of GDP)

Countries	2015	2016e	2017f	2018f
Poland	51.3	52.2	53.3	54.9
Hungary	75.5	74.1	73.4	72.6
Czech Rep.	40.3	39.2	38.2	37.0
Slovakia	52.5	52.6	52.5	52.2
Slovenia	83.1	81.3	79.5	78.2
CE	**53.9**	**54.0**	**54.2**	**54.6**
Croatia	86.7	85.3	84.5	82.9
Bulgaria	25.6	29.0	29.0	31.0
Romania	37.9	38.2	39.3	40.2
Serbia	74.7	72.8	70.5	66.4
Bosnia a. H.	42.8	42.5	42.8	42.5
Albania	72.2	70.5	69.0	65.0
Kosovo	13.0	13.5	13.8	14.0
SEE	**47.7**	**48.0**	**48.1**	**48.0**
Russia	12.7	13.5	14.0	14.5
Ukraine	72.6	77.5	78.4	73.0
Belarus	33.0	39.0	38.7	36.5
EE	**17.2**	**18.4**	**18.9**	**18.9**
Turkey	34.0	32.0	33.0	32.0
Austria	**86.2**	**83.4**	**81.1**	**79.5**
Germany	71.2	68.6	66.3	64.0
Euro area	**90.4**	**89.4**	**88.5**	**87.4**
USA	**101.9**	**105.5**	**105.6**	**104.9**

Source: national sources, RBI/Raiffeisen RESEARCH

Gross foreign debt (% of GDP)

Countries	2015	2016e	2017f	2018f
Poland	70.1	74.2	77.2	77.5
Hungary	107.1	98.0	89.0	83.2
Czech Rep.	69.4	73.0	77.1	73.9
Slovakia	85.4	86.1	85.1	83.5
Slovenia	116.6	110.0	104.1	103.0
CE	**64.9**	**66.5**	**67.7**	**66.5**
Croatia	103.8	96.5	94.0	91.5
Bulgaria	75.3	73.7	73.4	71.5
Romania	56.4	54.4	53.1	53.6
Serbia	81.6	74.3	70.6	66.6
Bosnia a. H.	53.4	54.7	54.9	54.2
Albania	72.6	71.8	69.1	67.0
Kosovo	32.7	33.1	34.8	37.5
SEE	**68.4**	**65.2**	**63.7**	**62.8**
Russia	39.1	40.6	32.6	27.0
Ukraine	131.5	133.5	126.6	119.6
Belarus	70.2	77.6	77.3	73.3
EE	**45.9**	**48.0**	**39.8**	**34.1**
Turkey	55.4	57.2	60.9	57.8
Austria	**n.v.**	**n.v.**	**n.v.**	**n.v.**
Germany	n.v.	n.v.	n.v.	n.v.
Euro area	**124.4**	**125.2**	**n.v.**	**n.v.**
USA	**n.v.**	**n.v.**	**n.v.**	**n.v.**

Source: national sources, RBI/Raiffeisen RESEARCH

Exchange rate EUR/LCY (avg)

Countries	2015	2016e	2017f	2018f
Poland	4.18	4.36	4.42	4.33
Hungary	310	312	312	317
Czech Rep.	27.3	27.0	26.9	25.5
Slovakia	euro	euro	euro	euro
Slovenia	euro	euro	euro	euro
Croatia	7.61	7.53	7.52	7.51
Bulgaria	1.96	1.96	1.96	1.96
Romania	4.45	4.48	4.47	4.50
Serbia	121	123	124	125
Bosnia a. H.	1.96	1.96	1.96	1.96
Albania	140	137	137	139
Kosovo	euro	euro	euro	euro
Russia	68.0	74.3	63.7	66.8
Ukraine	24.3	28.4	28.1	30.7
Belarus	1.77	2.21	2.29	2.61
Turkey	3.02	3.34	3.53	3.63
Austria	**euro**	**euro**	**euro**	**euro**
Germany	euro	euro	euro	euro
Euro area	**euro**	**euro**	**euro**	**euro**
USA	**1.11**	**1.11**	**1.03**	**1.09**

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Ratings[1]

Countries	S&P	Moody's	Fitch
Poland	BBB+	A2	A-
Hungary	BBB-	Baa3	BBB-
Czech Rep.	AA-	A1	A+
Slovakia	A+	A2	A+
Slovenia	A	Baa3	A-
Croatia	BB	Ba2	BB
Bulgaria	BB+	Baa2	BBB-
Romania	BBB-	Baa3	BBB-
Serbia	BB-	B1	BB-
Bosnia a. H.	B	B3	NR
Albania	B+	B1	NR
Kosovo	NR	NR	NR
Russia	BB+	Ba1	BBB-
Ukraine	B-	Caa3	B-
Belarus	B-	Caa1	B-
Turkey	BB	Ba1	BBB-
Austria	**AA+**	**Aa1**	**AA+**
Germany	AAA	Aaa	AAA
USA	AA+	Aaa	AAA

[1] *for FCY, long-term debt; NR ... not rated*

Source: Bloomberg, RBI/Raiffeisen RESEARCH

Please note the risk notifications and explanations at the end of this document

Exchange rate forecast

Countries	15-Dec[1]	Mar-17	Jun-17	Dec-17
vs EUR				
Poland	4.43	4.40	4.45	4.35
Hungary	312.95	310.0	315.0	315.0
Czech R.	27.02	27.0	27.0	25.9
Croatia	7.54	7.55	7.47	7.55
Romania	4.53	4.45	4.50	4.45
Serbia	123.55	123.0	123.0	125.0
Albania	135.30	137.0	137.5	139.0
vs USD				
Russia	61.9	63.0	62.0	62.0
Ukraine	26.35	28.00	27.00	28.00
Belarus	1.98	2.15	2.25	2.35
Turkey	3.52	3.40	3.50	3.35
EUR/USD	1.04	1.04	1.02	1.05

[1] 5:00 p.m. (CET)
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Key interest rate forecast

Countries	15-Dec[1]	Mar-17	Jun-17	Dec-17
Poland	1.50	1.50	1.50	1.50
Hungary	0.90	0.90	0.90	0.90
Czech R.	0.05	0.05	0.05	0.05
Romania	1.75	1.75	1.75	2.00
Russia	10.50	9.50	9.00	8.50
Turkey	8.00	8.50	8.50	8.50
Euro area	0.00	0.00	0.00	0.00
USA	0.75	0.75	1.00	1.25

[1] 5:00 p.m. (CET)
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

3m money market rate forecast

Countries	15-Dec[1]	Mar-17	Jun-17	Dec-17
Poland	1.73	1.73	1.73	1.73
Hungary	0.39	0.30	0.30	0.50
Czech R.	0.29	0.30	0.30	0.35
Croatia	0.85	0.90	0.90	0.90
Romania	0.80	0.85	1.00	1.55
Russia	10.64	10.10	9.60	9.10
Turkey	10.17	10.30	10.50	9.50
Euro area	-0.32	-0.30	-0.30	-0.30
USA	0.97	1.15	1.40	1.65

[1] 5:00 p.m. (CET)
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

2y LCY yield forecast

Countries	15-Dec[1]	Mar-17	Jun-17	Dec-17
Poland	2.03	2.1	2.2	2.3
Hungary*	1.10	1.4	1.5	1.7
Czech R.	-0.81	-0.6	-0.7	0.1
Croatia	1.29	1.3	1.3	1.5
Romania*	1.68	1.7	1.8	2.1
Russia	8.37	8.7	8.7	8.2
Turkey	10.82	11.0	11.5	10.5
Austria	-0.63	-0.7	-0.7	-0.5
Germany	-0.78	-0.7	-0.7	-0.6
USA	1.27	1.3	1.4	1.5

[1] 5:00 p.m. (CET); * 3y LCY yields
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

10y LCY yield forecast

Countries	15-Dec[1]	Mar-17	Jun-17	Dec-17
Poland	3.53	3.5	3.6	3.8
Hungary	3.47	3.2	3.2	3.4
Czech R.	0.54	0.6	0.6	1.1
Croatia	3.14	3.1	3.1	3.3
Romania	3.70	3.3	3.4	3.5
Russia	8.58	8.9	8.8	8.6
Turkey	11.26	11.6	11.8	11.5
Austria	0.64	0.7	0.7	1.0
Germany	0.26	0.5	0.5	0.7
USA	2.58	2.7	2.5	2.9

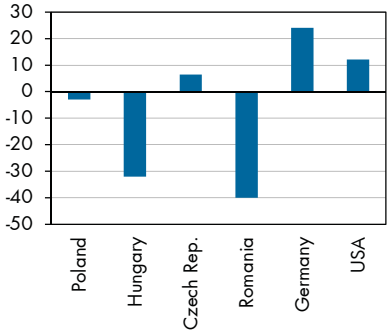
[1] 5:00 p.m. (CET)
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Spreads 10y LCY bonds over Bund

Countries	15-Dec[1]	Mar-17	Jun-17	Dec-17
Poland	327	300	310	310
Hungary	321	265	270	270
Czech R.	28	10	10	40
Croatia	288	256	256	256
Romania	344	280	290	280
Russia	832	840	830	790
Turkey	1,100	1,110	1,130	1,080
Austria	38	20	20	30
USA	232	220	200	220

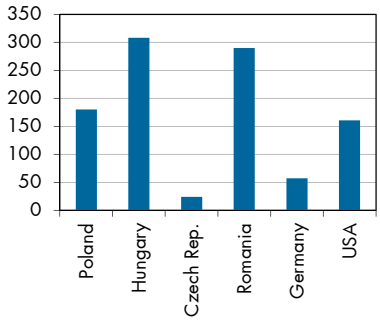
[1] 5:00 p.m. (CET); all values in bp
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Expected 10y LCY yield change



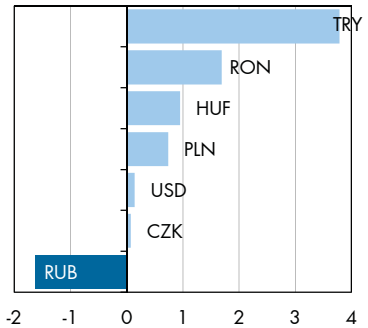
bp-change of 10y gov. bond yield in next 3 months
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Yield curve slope



bp-spread between 10y and 3m maturity
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

LCY changes vs EUR (% qoq)[1]



[1] forecasts for 31 Mar-2017 in comparison to 15 Dec-2016
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Stock market indicators

	Earnings growth		Price/earnings ratio	
	16e	17f	16e	17f
ATX	23.5%	3.3%	13.9	12.2
WIG 30	268.5%	11.9%	13.5	12.0
BUX	n.v.	5.1%	12.1	11.5
PX	5.7%	5.9%	12.6	11.9
MICEX	8.4%	6.4%	7.3	6.8
BIST Nat. 100	4.9%	20.9%	9.9	8.2

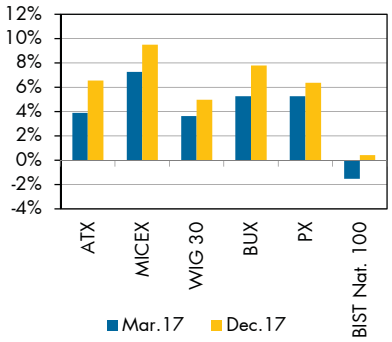
* Romania (BET) excl. Fondul Proprietatea
Source: Thomson Reuters, IBES, Bloomberg, RBI/Raiffeisen RESEARCH

Stock market forecasts

	Index estimates			
	15-Dec[1]	Mar-17	Jun-17	Dec-17
ATX	2,627	2,730	2,650	2,800
MICEX	2,237	2,400	2,280	2,450
WIG 30	2,210	2,290	2,250	2,320
BUX	31,636	33,300	32,400	34,100
PX	912	960	930	970
BIST Nat. 100	77,679	76,500	76,000	78,000

[1] 11:59 p.m. (CET)
in local currency
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Expected index performance



Source: RBI/Raiffeisen RESEARCH

CEE portfolio significantly outperforms benchmark in Q4

- **Strong performance contribution from country weighting in equity segment**
- **Russia was overweighted versus Turkey in equity and bond segment**
- **Total outperformance of 90 basis points generated versus benchmark**

Sum of last quarter[1]

RBI portfolio (in EUR)	4.02%
Benchmark (in EUR)	3.05%
RBI outperformance (in EUR)	0.96 pp
by weighting of equities vs bonds	0.00 pp
regional equity weightings	0.56 pp
weighting of EB vs LCY bonds	-0.02 pp
country weightings of LCY bonds	0.39 pp
country weightings of EB EUR	0.00 pp
country weightings of EB USD	0.00 pp
joint effects / duration	0.01 pp

1 21 Sept 2016 - 15 Dec 2016
EB...Eurobonds
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Period 1: 21 Sep 2016 - 31 Oct 2016

RBI portfolio (in EUR)	1.26%
Benchmark (in EUR)	1.02%
RBI outperformance (in EUR)	0.25 pp
by weighting of equities vs bonds	0.00 pp
regional equity weightings	0.10 pp
weighting of EB vs LCY bonds	-0.02 pp
country weightings of LCY bonds	0.15 pp
country weightings of EB EUR	0.00 pp
country weightings of EB USD	0.00 pp
joint effects / duration	0.01 pp

EB...Eurobonds
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Period 2: 31 Oct 2016 - 25 Nov 2016

RBI portfolio (in EUR)	-1.66%
Benchmark (in EUR)	-1.95%
RBI outperformance (in EUR)	0.29 pp
by weighting of equities vs bonds	0.00 pp
regional equity weightings	0.23 pp
weighting of EB vs LCY bonds	0.00 pp
country weightings of LCY bonds	0.07 pp
country weightings of EB EUR	0.00 pp
country weightings of EB USD	0.00 pp
joint effects / duration	0.00 pp

EB...Eurobonds
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Period 3: 25 Nov 2016 - 15 Dez 2016

RBI portfolio (in EUR)	4.45%
Benchmark (in EUR)	4.04%
RBI outperformance (in EUR)	0.41 pp
by weighting of equities vs bonds	0.00 pp
regional equity weightings	0.23 pp
weighting of EB vs LCY bonds	0.00 pp
country weightings of LCY bonds	0.17 pp
country weightings of EB EUR	0.00 pp
country weightings of EB USD	0.00 pp
joint effects / duration	0.00 pp

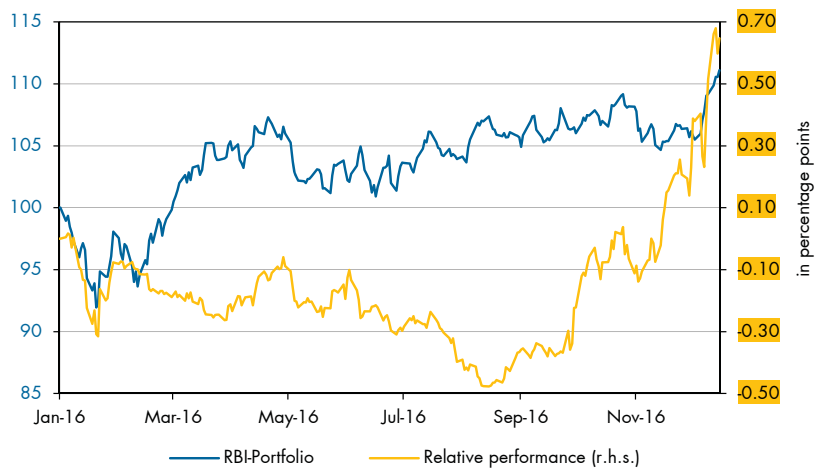
EB...Eurobonds
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Last quarter (21/09/2016 to 15/12/2016), the **CEE portfolio** beat out the benchmark by a total of 96 basis points (bp), with an absolute performance of 3.1%. The majority of the outperformance came from the country weighting within the equity segment (56bp), and the weighting of the individual government bond markets also made a positive impact, with a contribution of 39bp. Our **positive assessment of Russia** based on the rising oil price and the moderate improvement in the economic outlook proved to be particularly profitable in nearly every period. We were overweighted in both the equity portfolio and the bond portfolio, which made a strong contribution to the outperformance, especially in the equity segment. The counterpart to this position was the **underweighting of Turkey** (equity market and government bonds), which also made a positive contribution on the whole, as the political uncertainty dragged down Turkish assets. In the first period, we overweighted the Czech equity market by two percentage points within the **equity segment**, which resulted in a positive contribution. By contrast, we underweighted this market by one percentage point in the second half of the third period, which also contributed to the outperformance versus the benchmark.

In the **bond segment**, the bulk of the outperformance resulted from the overweighting of Russia and the underweighting of Turkish government bonds. The underweighting of Czech government bonds, which was oriented towards a long-term horizon, did not make a positive contribution until the second half of the final period, but this was not enough to offset the losses sustained in the previous periods.

Financial analyst: Nina Neubauer-Kukic, CIIA, RBI Vienna

Performance 2016



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

CEE portfolio

	2013	2014	2015	YTD
Benchmark	-2.54%	-8.11%	2.42%	9.97%
Portfolio	-2.41%	-8.23%	1.78%	10.57%
Relative performance	0.12 pp	-0.12 pp	-0.64 pp	0.60 pp

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Both equities and bonds attractive in CEE

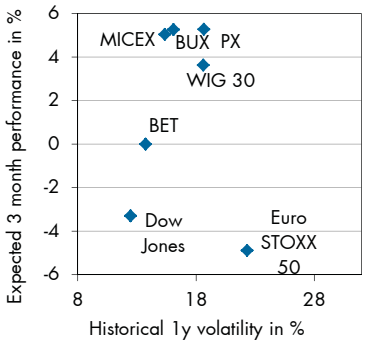
- **Risk appetite likely to remain high in Q1 2017**
- **Positive development expected for CEE equity markets**
- **Bond segment profiting from high carry and stable currencies**

While the emerging markets outside of CEE reacted to Donald Trump's election victory with losses across all asset classes, the Eastern European bond, currency, and equity markets were left relatively unscathed and **benefited from the optimistic sentiment** on the established equity markets. The ECB's decision to extend its bond purchasing programme until December 2017 (at a reduced volume from March 2017) also provided support. We expect the positive sentiment prevailing on the equity markets towards the end of 2016 to carry over into the first quarter and also provide a boost for the Eastern European equity markets. However, the momentum will likely decline somewhat, as performance was outstanding in the final weeks of 2016. At this point, we believe it would be a mistake to assume that this means **Eastern European** equities will outperform bonds. Despite the optimistic outlook for the majority of equities, we expect Poland, which is weighted heavily in the portfolio, and Turkey to continue lagging behind markets such as Russia and Hungary. At the same time, **CEE government bonds** offer **an attractive alternative** for international investors **due to the higher carry**, as the volatility is somewhat lower here than in the case of the emerging markets excluding CEE. The prospect of stable currency developments in the first quarter of 2017 helps to make the bond segment more attractive.

On the whole, we would recommend a **neutral weighting of equities versus bonds** in the CEE portfolio.

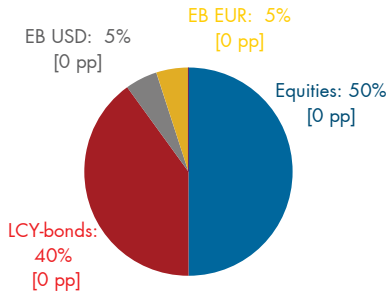
Financial analyst: Nina Neubauer-Kukic, CIIA, RBI Vienna

Risk-return (%)



Local currency
1 MSCI EM Eastern Europe in euro
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

CEE portfolio weightings Q4 2016



LCY…local currency, EB … Eurobonds
[-] , [+] = Over-/underweight versus benchmark
[0] = No over/-underweight versus benchmark
Source: RBI/Raiffeisen RESEARCH

Historical volatility & performance (%)

	Equities[1]						Bonds					
	Volatility[2]		Performance ytd		Performance 5y[3]		Volatility[2]		Performance ytd		Performance 5y[3]	
Countries	EUR	LCY	EUR	LCY	EUR	LCY	EUR	LCY	EUR	LCY	EUR	LCY
Czech Republic	15.2	15.2	-9.0	-9.0	-7.6	-6.5	1.4	1.4	1.1	1.1	4.2	5.4
Hungary	15.5	14.2	33.4	32.1	9.1	9.9	5.7	2.5	6.7	5.6	9.2	10.1
Poland	19.4	17.4	-1.6	1.7	-1.4	-1.8	7.6	3.3	-1.1	2.2	6.5	6.1
Romania	9.6	9.9	5.5	5.6	13.2	14.1	2.9	0.1	0.0	0.1	1.3	2.1
Russia	22.3	13.6	53.6	29.0	0.1	6.6	16.8	3.8	40.2	13.9	-0.9	8.3
Turkey	26.5	17.3	-6.8	7.8	-0.4	8.1	16.6	5.8	-6.7	8.0	-0.9	7.5
Croatia	9.0	8.9	22.7	21.1	-1.4	-1.3	4.8	4.8	9.8	8.4	8.2	8.3
CEE	14.1	-	10.5	-			4.4	-	1.4	-		

[1] MSCI indices
[2] Three months volatility annualised
[3] Five-year annual return
LCY…local currency
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Correction following US election broadens investment spectrum

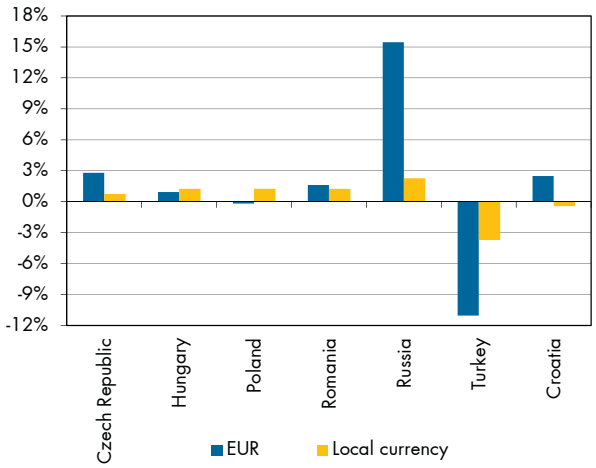
- **We still see potential in RUB yields despite excellent performance in 2016**
- **Polish bonds attractive again after massive correction**
- **We are avoiding Turkey despite tempting yield levels**

Portfolio weightings: bonds*

	Portfolio	Benchmark	Difference
EB USD	10.0%	10.0%	0.0%
EB EUR	10.0%	10.0%	0.0%
LCY	80.0%	80.0%	0.0%
Czech Republic	14.0%	20.0%	-6.0%
Hungary	22.0%	20.0%	2.0%
Poland	47.0%	45.0%	2.0%
Romania	3.0%	5.0%	-2.0%
Russia	11.0%	5.0%	6.0%
Turkey	3.0%	5.0%	-2.0%
Croatia	0.0%	0.0%	0.0%

** share in percentage points*
Source: RBI/Raiffeisen RESEARCH

Historical relative performance*



** since 3 months, local currency bonds versus portfolio bond benchmark*
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Following the ECB's announcement that it will extend its bond purchasing programme until end-2017, we do not expect the exit from the CZK intervention regime in the immediate future. At the same time, the reflation trend in the Czech Republic will not likely be sustainable enough in mid-2017 to be able to burden the economy with a tightening of monetary policy via a stronger exchange rate. This provides further support for our assumption that the "CZKexit" will occur in Q4 2017. On a one-quarter horizon, hence, we are increasing our **underweighting of the low-yielding CZK bond market** by two percentage points (yields on CZGBs are negative for maturities up to six years). In reaction to the massive repricing of the US Treasury market, remaining political risks caused yields on longer-dated Polish and Romanian government bonds to increase more substantially than in Hungary, for example. However, due to the generally more benign risk assessment of Poland (S&P rating outlook was recently upgraded from negative to stable) and the attractive yield levels following the correction, **Polish bonds have become somewhat more attractive** again. Therefore, we are switching from a neutral weighting to a slight overweighting. While we are still maintaining a similar overweight position for Hungary, we **are increasing the underweighting of Romania** somewhat in light of the still dormant fiscal risks. Despite the country's excellent performance in 2016, **Russia remains our favourite in high-yielders.** Therefore, we are once again increasing the overweighting, as the continuation of the interest rate cuts in Q1 and the improved outlook for RUB provide solid arguments. However, we are much less drawn to Turkey despite the fact that yields are trading at dizzying heights, as the fragility of the exchange rate gives cause for concern regarding financial market stability.

Financial analyst: Stepahn Imre; RBI Vienna

Expected bond market performance (%)

	3m		6m		9m		12m	
Countries	**EUR**	**LCY**	**EUR**	**LCY**	**EUR**	**LCY**	**EUR**	**LCY**
Czech Republic	-0.4	-0.5	-0.2	-0.2	1.0	0.9	-0.3	-4.3
Hungary	3.7	2.9	2.4	3.2	3.9	3.1	2.1	3.0
Poland	1.6	1.0	0.3	0.9	1.3	0.7	2.3	0.6
Romania	5.4	3.8	4.7	4.2	6.7	5.0	7.5	5.8
Russia	-1.6	0.2	4.7	2.9	10.8	5.6	7.1	8.3
Turkey	4.7	1.2	5.4	2.9	12.3	6.7	14.3	10.0

Not annualised; 10y treasury bond, LCY…local currency
Source: RBI/Raiffeisen RESEARCH

Interference from politics

- **Poland and Turkey underweighted due to political uncertainty**
- **Russia overweighted based on expected economic recovery and rising oil prices in 2017**
- **Macroeconomic conditions and moderate valuation cause for slight overweighting of Hungary and Czech Republic**
- **Czech Republic offering upside potential**

Turkey is our **strongest underweight** position at 4 percentage points (pp) due to a number of negative factors. President Erdogan is increasingly turning Turkey into an authoritarian regime according to his vision after the failed coup attempt, and the country's tone with the EU is becoming more and more adversarial. It therefore comes as no surprise that the reluctance to invest combined with contracting tourism because of the increase in terror attacks is depressing economic growth. The gradually rising US interest rates and a further appreciation of the USD will also have a negative effect because of the relatively high share of USD debt. We have left **Poland** unchanged at an underweighting of 2 pp because the political uncertainty (internal and with the EU) is continuing and because the financial sector will likely still be impacted by the uncertainty about the plan to convert CHF loans.

Russia remains the **strongest overweight** position, though we have scaled this back somewhat from 5 pp to 3 pp because of the very strong price development. Although we do not expect the sanctions to be lifted in the near future despite the "Trump factor", the gradual economic recovery, a further rise in the oil price over the course of 2017, and the interest rate cuts that we are expecting will likely provide support for Russian equities. We are also optimistic about the **Hungarian** (2 pp) and **Czech** (1 pp) **equity markets** because of the support from the macroeconomic conditions and the moderate valuations. Czech equities also have upside potential relative to their CE counterparts.

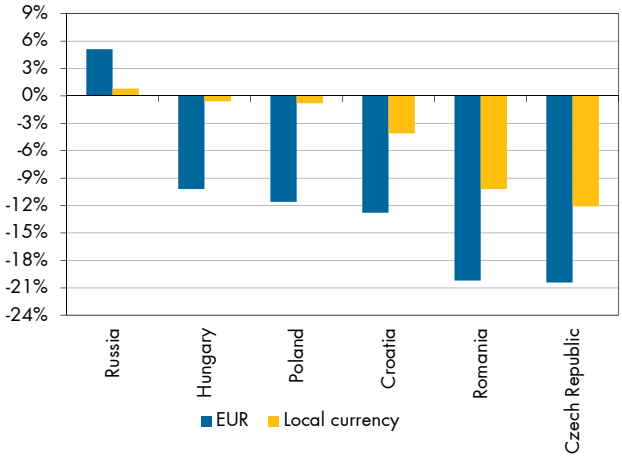
Financial analyst: Andreas Schiller, CFA, RBI Vienna

Portfolio weightings: stocks*

	Portfolio	Benchmark	Difference
Czech Republic	9.0%	8.0%	1.0%
Hungary	9.0%	7.0%	2.0%
Poland	23.0%	25.0%	-2.0%
Russia	38.0%	35.0%	3.0%
Turkey	21.0%	25.0%	-4.0%
Croatia	0.0%	0.0%	0.0%
Romania	0.0%	0.0%	0.0%

** share in percentage points*
Source: RBI/Raiffeisen RESEARCH

Historical relative performance*



** to MSCI CEE, since 3 months*
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Expected stock market performance (%)

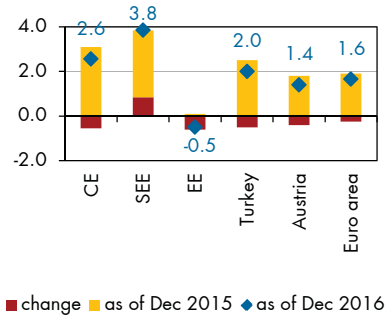
	3m		6m		9m		12m	
Countries	**EUR**	**LCY**	**EUR**	**LCY**	**EUR**	**LCY**	**EUR**	**LCY**
Czech Republic	5.3	5.3	8.6	8.6	2.1	2.0	11.0	6.4
Hungary	6.3	5.3	7.7	8.4	3.4	2.4	7.1	7.8
Poland	4.4	3.6	5.0	5.4	2.6	1.8	7.0	5.0
Russia	5.5	7.3	11.6	9.5	7.3	1.9	8.4	9.5
Turkey	2.6	-1.5	7.7	4.3	4.0	-2.2	5.2	0.4

Not annualised, LCY…local currency
Source: RBI/Raiffeisen RESEARCH

Regional economic outlook for 2017

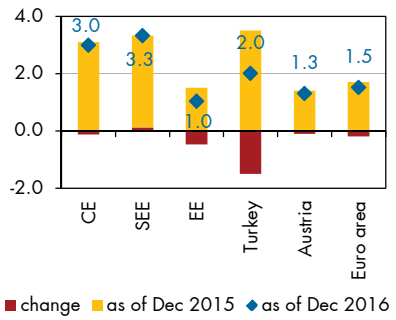
- **Regional growth disparities reduced, given a (sluggish) recovery in Russia and somewhat milder growth in CE**
- **CE GDP growth to hover around 3% in 2017, SEE growth slightly above 3% and EE growth between 1% and 2%**
- **Moderate reflation driven by rising energy prices, but also pressure on core inflation from tight labour markets**
- **Monetary policy to remain expansionary in CE/SEE, moderate tightening in Russia due to falling inflation rates**

GDP forecasts for 2016*



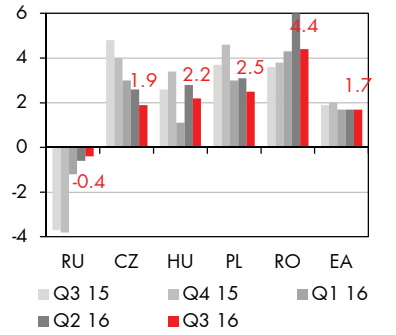
** latest GDP growth estimates in comparison to projection one year ago*
Source: RBI/Raiffeisen RESEARCH

GDP forecasts for 2017*



** latest GDP growth estimates in comparison to projection one year ago*
Source: RBI/Raiffeisen RESEARCH

CEE GDP growth (% yoy)



Russia from Q4 2015: RBI estimates
Source: Bloomberg, RBI/Raiffeisen RESEARCH

In 2016, the divergence in regional growth dynamics diminished and we expect this trend of regional convergence to continue in 2017 and 2018. Russia's recession is flattening out and we expect a return to (rather shallow) growth in 2017. Thus, Eastern Europe (EE) is expected to show growth of between 1% and 2% in the next two years. In Central Europe (CE), some economies such as Poland are showing slower growth than initially expected, but average growth in CE will remain at around 3% for the foreseeable future. Meanwhile, Western Balkan countries, like Croatia or Serbia, were the biggest positive surprises in 2016, posting much faster growth than anticipated and also improving their outlook. Together with a surging Romania, this lifts average SEE growth rates to almost 4% in 2016, and we project rates of above 3% in 2017 and 2018.

Going forward, CEE growth will still largely be driven by household demand, but after a weak 2016 investment should pick up significantly in 2017. In 2016, (public) investment demand in CE/SEE European Union member states suffered from a temporary slump in EU transfers, which resulted in weaker investment figures. As we expect a higher rate of EU fund absorption in 2017, this negative factor should no longer be in place in 2017. This will result in higher investment growth in addition to household demand in 2017 (and 2018) in many countries. In addition, we currently do not see any strong indications that household demand will weaken in our base case scenario in the forthcoming period.

Political developments – external and domestic – remain an important (risk) factor for growth in CEE economies. While the effects of the "Brexit" vote seem to be less disruptive for CEE than many expected and the direct economic impact of the Trump administration on CEE is likely to be minor due to rather weak economic trade and financial ties between CEE and the US, political events in and outside the region continue to have substantial consequences for CEE.

- First, the attempted **military coup in Turkey** and the subsequent reactions by the government and President Erdogan pushed Turkey's GDP down by almost 2% in Q3. We are revising our growth outlook further downward, as we expect uncertainty to prevail in the coming quarters and countercyclical measures by the government will be insufficient to sustain or restart growth.
- In **Poland**, we see a more shallow recovery in investment over the next two years than previously anticipated, as we see **some weakening in the business climate** under the new administration. On the other hand, the more expansionary fiscal policy will bolster household demand – at least in 2017. Overall growth will likely be capped at around 3% in 2017 and might be even more disappointing in 2018.
- In **Russia**, the **economic sanctions** are still weighing on the economy indirectly, as they foster external deleveraging and weaken the investment environment. The EU already decided to prolong the sanctions for the first half of 2017 and it is quite possible that the sanctions stay in place for longer. There is speculation that improved US-Russia relations under the **Trump administration** could lead to a quick end of the sanctions and thus a substantially more

positive economic outlook for Russia. We do not fully reject the idea, but remain cautious on both counts – a fast lifting of the sanctions and a strong positive impact on the Russian economy from better political ties between the US and Russia. The oil price is still much more important for Russia. We are rather optimistic in this respect, projecting an average of USD 58 for Brent in 2017, which is supportive for Russia's return to GDP growth of around 1% in 2017.

- For **Ukraine**, the slow progress in fighting corruption is endangering the flow of IMF funds to the country. The latest payout in autumn came with a one-year delay, and we expect more delays in the future. Both US and European (political and financial) backing may become more sluggish. Moreover, domestic political developments are – as usual in Ukraine – hard to predict. However, our baseline scenario does not foresee any new external or internal shocks, resulting in slight growth and a broadly stable local currency.

In 2017, inflation dynamics will reverse and rise more visibly. With the oil price having reached higher levels again and the base effect of the decline in energy prices of recent years fading, we will see significant reflation in CE/SEE in 2017. The last time a similar effect has been seen was in late 2009/early 2010, when oil prices recovered after the financial crisis. As back then, headline inflation rates will react positively, and we are already seeing this in the latest data in late 2016. Especially in the first quarter, the energy price component will be strongly positive, pushing headline inflation upwards by up to one percentage point in 2017.

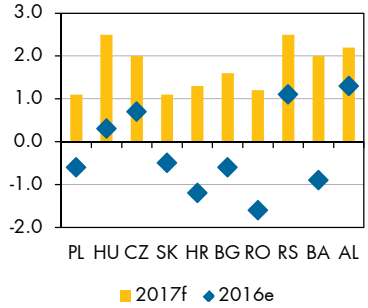
Upward pressure on core rates in CE/SEE: A second factor for rising headline inflation is that core rates may also see some upward pressure, given the tight labour market conditions in certain CE/SEE countries. With unemployment having fallen over the past three years, wage pressure is emerging, which ultimately could also push up inflation. While the trend of reflation is pretty clear, the extent of the effect is less certain.

From a historical perspective, however, inflation rates are still low, allowing monetary policy to remain expansionary in CE/SEE. For most CE/SEE countries, we expect an annual inflation rate of close to 2% at the end of 2017 and an average inflation rate of only above 1% in 2017. Hungary will be at the upper end, reaching 3% yoy at the end of 2017, while Slovenia and Poland will still be at the lower end at between 1% and 2%. Looking back, these rates are still low. Therefore, we do not expect much monetary tightening in the CE/SEE region in 2017, at least not in the form of interest rate hikes. With ECB rates still at zero, monetary authorities will likely abstain from any quick monetary tightening steps. Across CE/SEE, we only expect to see interest rate moves in Romania, with one key rate hike of 25bp to 1.75% in 2017. In Poland, we are changing our view from predicting a hike in H2 2017 to a flat key rate of 1.5% in 2017.

In Russia and Ukraine, inflation dynamics point to a continued reduction in the inflation rate and allow for monetary easing, while in Turkey further disinflation is much more uncertain, given the depreciation pressure on the lira. In Russia, we now expect the inflation rate to fall to at least 5% by the end of 2017, getting close to the central bank target of 4%. Thus, we expect further key rate cuts of at least 150bp from March 2017 until the end of the year. In Ukraine, we may again return to single-digit inflation rates, and – if there is no renewed destabilisation of the economy – a few key rate cuts (along with a continuation of the FX restriction).

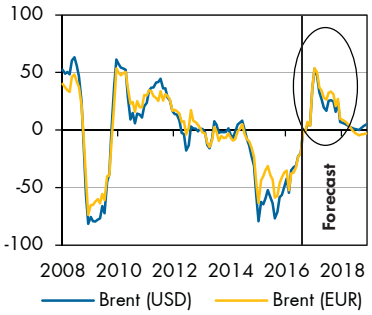
Financial analyst: Andreas Schwabe, CFA, RBI Vienna

CPI projection 2017 vs 2016*



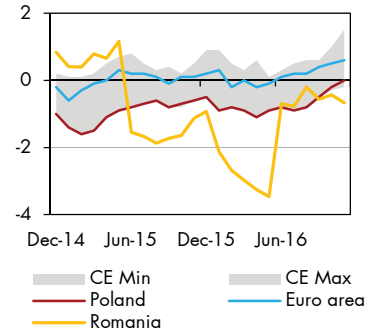
** % yoy, avg*
Source: RBI/Raiffeisen RESEARCH

Positive oil price impact*



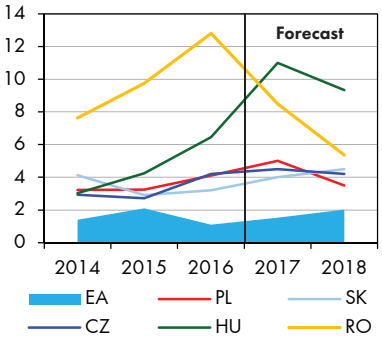
** yearly logarithmic changes of oil price*
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Inflaton trend (% yoy)



Source: Bloomberg, RBI/Raiffeisen RESEARCH

Nominal wage growth expectation*

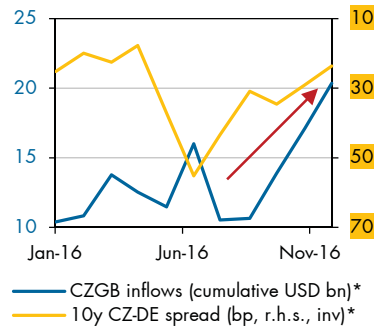


** % yoy*
Source: National sources, RBI/Raiffeisen RESEARCH

New opportunities after the Fed/US Treasury repricing

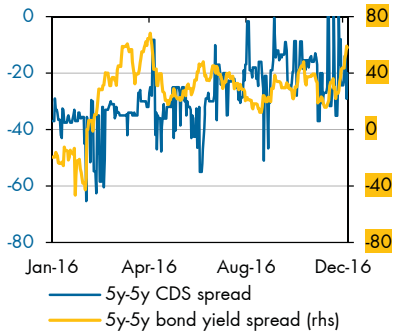
- **We buy Hungary as well as Poland outright on dips amidst non-negligible Fed tail risks**
- **We continue to prefer HGBs over ROMGBs, but also over POLGBs due to divergent credit stories**
- **OFZs a tactical Buy despite doubling supply in 2017 and exhausted RUB potential; longer-term view more constructive**
- **Despite huge yield advantage, we remain hands-off in Turkey due to fragility of TRY market**

Foreign inflows doubled in H2-16



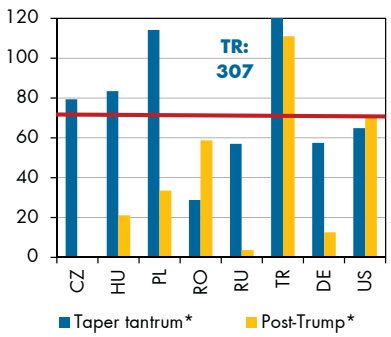
** blue line (lhs): non-resident inflows to CZK local debt market according to IIF "Portfolio Flows Tracker"; orange line (rhs): 10y-10y LCY yield spread vs. Germany*
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Declining credit risk in HU vs. RO*



** left axis: difference between RO 5y USD CDS and HU equivalent (in bp); 5y high: 5, 5y low: -265;*
** right axis: difference between RO 5y LCY yield and HU equivalent (in bp); 5y high: 96, 5y low: -352*
Source: Bloomberg, RBI/Raiffeisen RESEARCH

USTs set in motion rise in CEE yields*



** bp change of 10y LCY yields between taper tantrum (22 May 2013) and announcement of taper delay (18 Sep. 2013); post-Trump is period from 8 Nov 2016 (pre-US election levels) to-date (16 Dec. 2016)*
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Czech Republic: Hold as there is time left for CZK exit positioning

Speculative positioning in CZK assets is the major driver for the unnaturally low yield levels. Foreign capital portfolio inflows surged in H2 2016, doubling non-resident holdings in total outstanding CZGBs during 2016. The 10y-10y spread over DE hovered around 20bp as of mid-December and CZGBs shrugged off the hefty UST repricing. As we are sticking to our view that the CZK re-floating will not likely come before H2 2017 (we target Q4), there is time to position for the expected CZK appreciation. The latter should, however, be contained by preventive actions by the CNB. After the "CZK exit", we expect yields to skyrocket on the back of massive profit-taking. The latter implies a certain risk of an interruption of short-term market functionality, however.

Hungary: Mildly bullish, especially relative to ROMGBs and POLGBs

Long-dated HGBs recouped most of the initial losses suffered in post-Trump trading, but considerably ate into the year-to-date (ytd) performance (of all CE/SEE markets). This is in line with DE and compares favourably with PL and RO. HU's outperformance was also helped by ultra-loose monetary conditions on the local front – including unconventional bond market support by the MNB. The recent government-driven boost to the economic outlook (including potential growth) also plays into our mildly bullish HGB view. For the short term, we therefore recommend buying mid- and long-maturity HGBs on dips. Risks of a significant bearish steepening may be on the cards, though, should local inflation expectations derail or EUR/USD overshoot (EUR/USD strength to peak at 1.02 in Q2). As we believe that there is still idiosyncratic value to be captured, HU will likely outperform not only RO, but also PL on a relative scale (although we have become more constructive on POLGBs). As illustrated, the major reason is the narrowing credit spread of HU vs. RO, which we expect to continue.

Poland: Post-Trump pricing renews POLGB appeal

During the Trumpflation adjustment, PL extended its YTD losses (mainly via the FX component), as unfavourable local politics continued weighing additionally on POLGBs. However, due to the increasing yield pick-up, the attractiveness of PLN instruments has been restored somewhat. Looking ahead, potential FX losses should be limited, with PLN currently trading on the weaker side. Furthermore, we eliminated our rate hike expectations for 2017, which should support market stability. As the repricing of US markets may be concluded for the most part, potential spillover risks from USTs are set to remain contained. Similar to HU, though, the longer-term bear steepening trend (beyond our end-March horizon) will likely materialise gradually, but with the still attractive carry counterbalancing potential price losses. We are therefore upgrading our Hold recommendation for longer-duration POLGBs to a tactical Buy, with risks mainly located on the external front in the form of an overshooting of USD vs. EUR, i.e. when risk sells off more.

Romania: Hold, although decreasing conviction

ROMGBs felt additional pressure from the local political front on top of the global bond market repricing. With election risks in RO increasingly raising investors' concerns during Q4, 10y ROMGBs mirrored the increase in UST yields almost 1:1 in line with PL, but in contrast to HU (and not to mention CZ; see chart 3 on page 12). With the post-communists regaining power in parliament, the pre-election pledges of further tax cuts and wage increases entail significant risks of jeopardising next year's budget performance. With a stable RON outlook, however, we are maintaining our Hold recommendation for ROMGBs for the short term. Apart from Fed tail risks, intensifying rate hike speculations on the local scene are set to exert upward pressure on RON yields in the longer run. This should not only materialise at the back end of the ROMGB curve, as the BNR could start tightening liquidity later in 2017 and prepare for a moderate rate hiking cycle.

Russia: Add exposure on dips, especially for a longer investment horizon

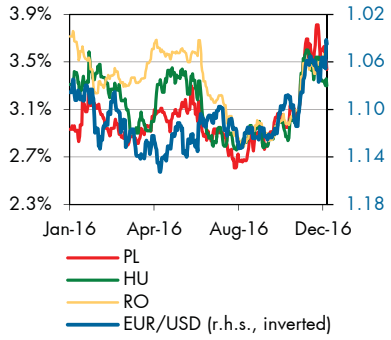
Moderate selling by foreigners in post-Trump trading unsettled the OFZ market, but recent gains in oil and RUB helped to recoup the initial losses. Should foreign demand continue decreasing, however, bearish pressure on OFZs could emerge as local banks will likely find it hard to find appeal in fixed-coupon OFZs. Apart from lively non-resident demand in 2016, the main driver for the considerable price gains was the relatively low supply, but 2017 will be different, as the MinFin aims to print over RUB 1 tn net of OFZs (2x higher than in 2016). In addition, we believe that there will not be much RUB appreciation from the current levels. Based on these factors, we expect moderate yield increases in the near term amidst a more or less stable FX rate. However, with a still attractive carry in place – likely compensating for potential price losses – we would buy RUB bonds especially on dips given the current tight valuations. In particular, we prefer floating OFZs for the short-term investment horizon, as they have relatively low volatility and an implied yield advantage of around 20–40bp over fixed-rate standard OFZs (however, there is some appeal left at the belly of the OFZ curve). Finally, since we expect the resumption of rate cuts – our call is for a cumulative 150bp in cuts in 2017 – OFZs remain our top pick in CEE for the longer-term investment horizon.

Turkey: Despite huge yield pick-up, we refuse to re-enter TURKGBs yet

The repricing on US bond markets hit Turkey at a time when TRY assets were already facing considerable bear pressure. The unreasonable response to the failed coup attempt was the straw that broke the camel's back, triggering the downgrade by Moody's to sub-investment grade back in September. In addition, support from the fundamental front also seems to be deteriorating, with CPI and current account dynamics passing their inflexion points. Against this backdrop, the TCMB tightened monetary conditions and we see elevated risks that it will be forced into putting more coal on the fire to stabilise the lira markets in a more sustainable manner. At the same time, (geo)political risks are becoming more acute, so we continue to sell Turkey.

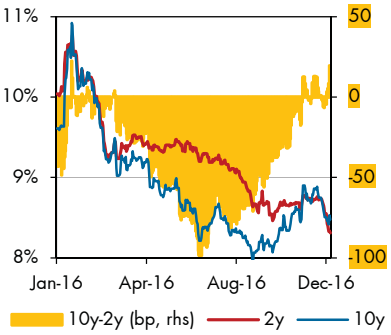
Financial analyst: Stephan Imre, RBI Vienna

10y LCY yields and USD



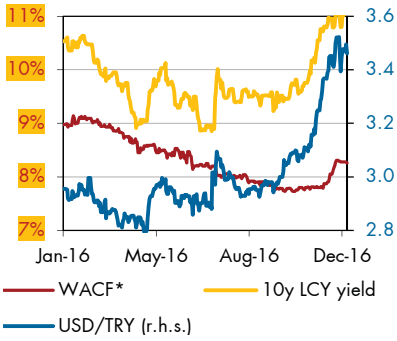
PL: 5y high: 6.4; 5y low: 2.0
HU: 5y high: 10.7; 5y low: 2.7
RO: 5y high: 7.6; 5y low: 2.6
DE: 5y high: 2.1; 5y low: -0.2
EUR/USD: 5y high: 1.39; 5y low: 1.04
Source: Bloomberg, RBI/Raiffeisen RESEARCH

RU: OFZ curve still flat



10y-2y spread: 5y high 195; 5y low - 452
2y: 5y high 17.5; 5y low 5.7
10y: 5y high 16.1; 5y low 6.5
Source: Bloomberg, RBI/Raiffeisen RESEARCH

USD/TRY and 10y TURKGB yield

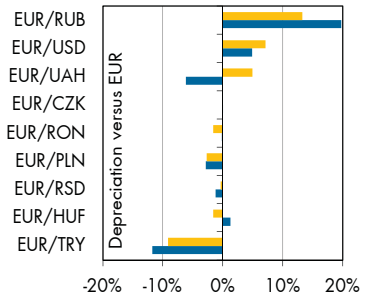


** weighted average costs of funding*
10y LCY yield: 5y high: 11.2; 5y low: 6.0
USD/TRY: 5y high: 3.52; 5y low: 1.74
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Stability expected for RUB, CZK FX regime exit the hot topic

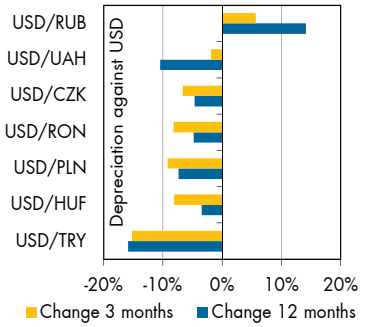
- **CE/SEE currencies expected to show continued stability in Q1**
- **CZK FX regime exit topic to heat up over coming months**
- **RUB potential exhausted after oil price recovery**
- **Turkish lira at oversold levels, but expectation for recovery limited**

Change of LCY value to EUR (%)



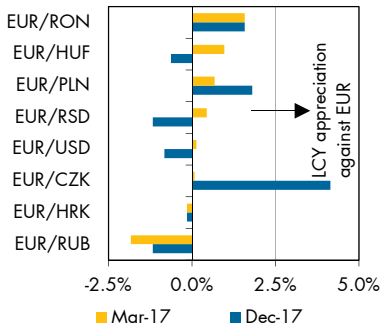
Data as of 07 October 2015
EUR/RUB 5y high: 90.9 5y low: 38.4
EUR/USD 5y high: 1.39 5y low: 1.04
EUR/UAH 5y high: 37.8 5y low: 9.7
EUR/CZK 5y high: 28.4 5y low: 24.3
EUR/RON 5y high: 4.64 5y low: 4.29
EUR/PLN 5y high: 4.5 5y low: 3.99
EUR/RSD 5y high: 123.9 5y low: 102.6
EUR/HUF 5y high: 322.6 5y low: 275.5
EUR/TRY 5y high: 3.79 5y low: 2.19
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Change of LCY value to USD (%)



USD/RUB 5y high: 82.3 5y low: 29
USD/UAH 5y high: 33.8 5y low: 8
USD/CZK 5y high: 26.11 5y low: 18.37
USD/RON 5y high: 4.36 5y low: 3.17
USD/PLN 5y high: 4.28 5y low: 2.99
USD/HUF 5y high: 302.2 5y low: 210.3
USD/TRY 5y high: 3.5 5y low: 1.7
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Projections LCY vs EUR



Source: Bloomberg, RBI/Raiffeisen RESEARCH

Whereas most **CE and SEE currencies saw rather calm development in 2016** (with a partial exception of the Polish zloty), the year again proved to be **volatile for the Russian rouble**. Following a severe depreciation in early 2016, the rouble managed to stabilise and end the year as a whole with a strong outperformance against both EUR and USD. This mostly hinged on the favourable oil price development. The Belarusian rouble and the Ukrainian hryvnia experienced the expected depreciation, albeit with considerably less pressure than in 2015. An extreme outlier over the course of 2016 proved to be the Turkish lira, as political developments led to continuous depreciation, which accelerated in Q4.

Looking at our predictions for the fourth quarter of 2016, the projection for CE and SEE FX stability with low volatility against the euro proved to be correct. In addition, our take that the Polish zloty would be somewhat of an outlier also worked out, while we remained neutral overall for all CE and SEE currencies. We had a sell recommendation against USD for all CE and SEE currencies, which also proved correct given the strong EUR/USD movement.
For EE currencies, we expected stable USD/RUB development, which worked out for most of the fourth quarter. With announcements of cuts in OPEC (and non-OPEC) oil production, the rouble then witnessed additional support towards the end of Q4 that we had not anticipated at that magnitude. Additionally, the strong EUR/USD movement even led to an unexpected appreciation of both UAH and BYN against the euro, while the ongoing depreciation of the Ukrainian hryvnia and the Belarusian rouble against the USD worked out.
The **biggest surprise in Q4 2016 occurred in the Turkish lira**. Even though we had correctly predicted a depreciation trend for the lira, the actual depreciation proved to be significantly more severe than we had estimated. Among other issues, political turmoil, a stronger USD, and geopolitical conflicts contributed to the significant sell-off in the lira.

Outlook for Q1 2017

For the **first quarter of 2017, we once again do not expect too strong of a deviation from the current levels for CE and SEE currencies.** The overall low volatility will likely prevail, while the Polish zloty could once again be an outlier in this regard. This leaves us with a hold recommendation for CE and SEE currencies against both EUR and USD for the first quarter of 2017 (given our neutral stance on EUR/USD).

For the Russian rouble, we have a hold recommendation against both EUR and USD for Q1 2017. This hinges on the additional RUB appreciation we already witnessed in late 2016 on the back of the oil price increase resulting from the announced cuts in OPEC (and non-OPEC) production. We expect this positive oil stimulus to diminish somewhat in early 2017, additionally being counterbalanced by projected interest rate cuts in Russia, higher capital outflow, possible

FX reserve replenishing and effects stemming from the ongoing sanctions. Overall, however, the rouble is expected to continue following the oil price movement at an elevated correlation. The Ukrainian hryvnia and the Belarusian rouble are expected to see ongoing depreciation against both EUR and USD during the first quarter of 2017.

For the Turkish lira, we believe that we have already seen the bulk of the depreciation trend in Q4 2016 that drove TRY well into oversold territory in our view. Additionally, the Turkish central bank is finally expected to respond more clearly to TRY pressure. Nevertheless, lira volatility is projected to remain elevated in Q1 2017, leaving the lira with a hold recommendation against both EUR and USD.

Outlook until year-end 2017

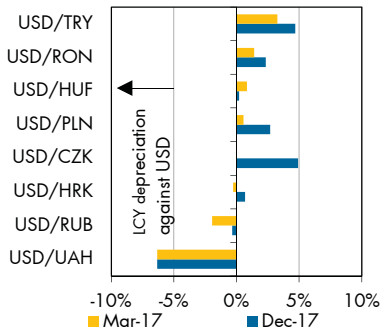
Over the course of 2017, we expect subdued currency volatility overall in CE and SEE. Moderate EUR/PLN appreciation seems possible in our view, albeit at a somewhat lower potential level for the zloty than previously estimated. This hinges on the assumption that the Polish central bank could (like the Hungarian central bank) turn out to be less willing to hike interest rates during the course of the year. Then again, the somewhat oversold PLN position and the expected stronger resistance of the Hungarian central bank towards a normalisation of monetary policy will likely cause PLN to moderately outperform HUF over the course of 2017.

However, the **most watched topic in CE during 2017** will likely be the exit from the Czech FX regime. With the latest extension of the ECB bond buying programme until the end of 2017, our assumption of a later exit from the FX regime in the Czech Republic has gained additional support. Then again, the Czech central bank will continue to put strong emphasis on inflation moving back towards its target range of 2% yoy for an exit from the FX regime. While we expect to see inflation close in on this target during 2017, we do not believe that the target will be exceeded on a lasting basis, thus leaving the central bank with room for interpretation. Recall that the Czech central bank started to talk about mid-2017 as a possible date for an exit from the FX regime. We reiterate our view of a likely extension of the regime well into the second half of 2017 (we have targeted it for Q4 in our scenario). The potential for CZK appreciation after the exit is equally difficult to estimate, as an initial strong CZK appreciation could quickly be counterbalanced by a sell-off of large speculative positions that could then lead to short-term depreciation pressure for CZK. Additionally, the Czech central bank is likely to continue intervening to prevent excessive volatility at that stage. We have a buy recommendation for CZK until year-end 2017.

Whereas BYN and UAH are bound to witness ongoing depreciation against both USD and EUR over the course of 2017, the **Russian rouble is expected to show less volatility compared to 2016 and a basic sideways movement throughout 2017** against EUR and USD. For the Turkish lira, we expect to see phases of strong volatility especially during H1 2017 with potential for stabilisation in H2. Even though this would theoretically leave us with a buy recommendation for TRY against both EUR and USD until year-end 2017, we would emphasise the associated risks given the unpredictable political situation.

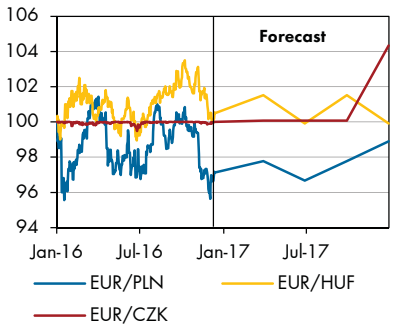
Financial analyst: Wolfgang Ernst, CEFA, RBI Vienna

Projections LCY vs USD



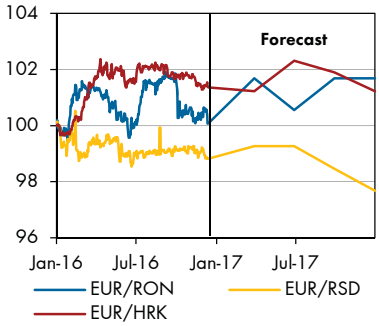
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Outlook 2017 CE currencies vs EUR*



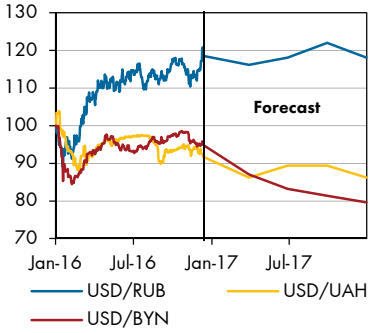
** indexed chart: Jan-16 = 100 (values above 100 denote appreciation vs EUR; below 100 depreciation vs EUR)*
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Outlook 2017 SEE currencies vs EUR*



** indexed chart: Jan-16 = 100 (values above 100 denote appreciation vs EUR; below 100 depreciation vs EUR)*
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Outlook 2017 EE currencies vs USD*



** indexed chart: Jan-16 = 100 (values above 100 denote appreciation vs USD; below 100 depreciation vs USD)*
Source: Bloomberg, RBI/Raiffeisen RESEARCH

A glimpse of hope in rough times

- **Rising UST yields mainly responsible for CEE Eurobond market losses**
- **CEE sovereign Eurobond issuance likely to grow in Q1 2017 after dismal Q4 result**
- **CE likely to demonstrate more resilience to US Fed due to closer proximity to EUR and ECB**
- **We prefer Kazakhstan to Russia in USD and Bulgaria and Croatia to Romania in EUR**

EMBIG USD index & spreads*

	15-Dec		Spread value, bp		
	Index	Spread, bp	qoq*	5y min	5y max
LT (A-)	173	90	21	68	472
PL (BBB+)	602	107	11	71	328
RO (BBB-)	149	176	19	141	528
HU (BBB-)	306	166	0	146	726
KZ (BBB-)	193	254	-32	195	544
TR* (BBB-)	672	364	36	170	411
RU (BB+)	1069	180	-49	155	702
HR (BB)	157	227	8	214	651
RS (BB-)	231	255	24	217	624
BY (B-)	172	355	-19	314	1747
UA (B-)	662	690	-35	556	4281
Europe*	1103	277	-6	-8	456
Africa	942	405	-37	239	714
Asia	621	197	-6	153	309
Mid East	498	420	-74	343	602
Latam	645	470	16	297	719
Global	**730**	**361**	**-1**	**244**	**532**
Inv.grade	**544**	**219**	**-18**	**146**	**337**
BB	**714**	**306**	**24**	**188**	**457**
B	**1,155**	**503**	**24**	**377**	**1,007**

** S&P ratings, TR - Turkey Fitch rating, Europe - CEE, Q/Q - quarter-on-quarter (latest = cut-off date), 5y - 5-year minimum and maximum*
Source: Thomson-Reuters, RBI/Raiffeisen RESEARCH

CEE ratings direction

	rating *	Direction **
CE:		
CZ	AA-/A1/A+	⇔
SK	A+/A2/A+	⇔
PL	BBB+/A2/A-	⇔
LT	A-/A3/A-	⇔
LV	A-/A3/A-	⇔
SI	A/Baa3/A-	⇔⇧
HU	BBB-/Baa3/BBB-	⇔
SEE:		
RO	BBB-/Baa3/BBB-	⇔
BG	BB+/Baa2/BBB-	⇔
TR*	BBu/Ba1/BBB-	⇔⇩
HR	BB/Ba2/BB	⇔
RS	BB-/B1/BB-	⇔⇧
AL	B+/B1	⇔
BH	B/B3	⇔
EE:		
KZ	BBB-/Baa3/BBB	⇔
RU	BB+/Ba1/BBB-	⇔
BY	B-/Caa1/B-	⇔
UA	B-/Caa3/B-	⇔

*⇔ no change, ⇧ upgrade possible, ⇩ downgrade possible; * rating - S&P/Moody's/Fitch, Turkey S&P unsolicited rating; ** the likelihood of rating change in 3 to 12 months; Source: Rating agencies, RBI/ Raiffeisen RESEARCH*

Market trends and ratings

The victory of Donald Trump – who has often expressed his doubts about the validity of extremely low interest rates – in the US presidential elections along with stronger US economic data drove EM debt market yields higher. UST futures started to price in six hikes for 2017–18. Ironically, CEE Eurobond price losses were largely prompted by rising UST yields. To illustrate, the aggregate EMBIG USD spread for CEE added only 2bp compared with an 83bp yield jump for CEE EMBIG, while the yield on a ten-year UST increased by 87bp in the same period. **As we predicted, the CEE EMBIG price lost less in comparison to Latin America and Asia,** while the higher beta EE surprisingly declined less than some SEE or CE countries. Romania turned into the worst performer, with a 7.8% price loss in the run-up to the December elections, while overweighting Croatia's EUR-denominated Eurobonds vs. its USD issues proved to be a good idea. In addition, CEE EUR paper turned into a more stable investment compared with the EU periphery during Q4, as the duration-adjusted yield spread for CEE Eurobonds vs. a five-year Italy + Spain aggregate tightened by 11bp, while at the same time Italy's and Spain's yields surged by 50bp and 26bp, respectively.

On the rating front, the most important events in Q4 were S&P's decision to move the outlook on Poland's rating from negative to stable and Moody's upgrade of Hungary to a Baa3 investment rating with a stable outlook. Also, in line with our expectations, Fitch upgraded Slovenia from BBB+ to A-/stable. At the same time, Moody's downgraded Turkey from Baa3 to Ba1/stable and maintained the positive outlook for Serbia without an upgrade. Last but not least, in a surprising move, Fitch lifted Ukraine's rating from CCC to B-/stable. Going forward, we expect a one-notch upgrade for Serbia from Moody's, while Romania may lose its positive outlook from Moody's on a six-month horizon. Kazakhstan's outlook is expected to stabilise, while Slovenia is likely to see Moody's finally upgrade its rating in 2017 due to strengthened public finances.

Primary markets

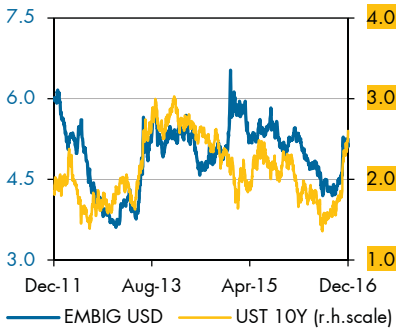
The ensuing "bearishness" on the CEE Eurobond market in Q4 led to a significant reduction of the issuance activity on the primary markets, with sovereign placements reaching only EUR 4.4 bn, or 73% of the Q3 volumes. The largest issuer so far has been Poland with EUR 2 bn, followed by Turkey (EUR 1.4 bn) and Slovenia (EUR 1 bn). As we predicted, issues in EUR accounted for 63% of all CEE sovereign placements in 2016. This trend is likely to persist, as record-low EUR interest rates will continue to attract CEE sovereign issuers to this segment. **We expect a fairly active primary market in Q1 2017, with Turkey, Romania, Poland, Croatia, and the Baltic states very likely to offer sovereign paper.** Also, we project that CEE sovereign placement will reach EUR 31–34 bn in 2017 vs. EUR 28.4 bn in 2016 based on prefunding strategies also trying to cover higher refinancing needs for 2018.

Outlook and strategy

Although the prospects for the CEE Eurobond market may not look so bright because of the prevailing UST tail risk we believe that, paradoxically, more clarity about Fed actions and directionality commitments in 2017 may be positive for the debt markets and could lead to more stability for the long-end bonds. The one-month rolling correlation between EMBIG USD and UST yields surged to 1.0 recently, with just two minor dips at 0.5, which likely makes a stronger case for higher UST yields going forward. On the one hand, the resurging probability of a Fed rate hike triggered a sharp rise in UST yields, which will likely push EM spreads upward. On the other hand, a correction in the market expectations for US Fed directionality helped to trim the negative volatility associated with the uncertainty regarding the timing. As a result, **the impact of the surge in UST yields on EM may be partly contained due to decreasing uncertainty regarding the outlook**. Furthermore, CEE sovereigns may continue to show stronger resilience in this situation. In particular, this may benefit the CEE outlook for the following reasons: a) the ECB's QE has been extended until the end of 2017 and b) clearer US Fed policy rate guidance will reduce negative volatility for EM in the near term. Thus, **higher rated, fundamentally strong CE sovereigns may be likely to demonstrate better resilience to market jitters** as opposed to the more volatile EE. On the other hand, we may see more interest in EE for Kazakhstan and Russia as oil prices are rising. In SEE, spread widening on Romanian issues may be slightly exaggerated, but the fiscal risks associated with the new government may lead to longer market depression. So far, we prefer the similarly rated Hungary at -20bp to Romania. In EE, the tactical sell recommendation for Russia remains in place due to extremely tight valuations, while we like Kazakhstan based on the rating per basis point relationship. Our buy recommendation for Serbia also remains intact in anticipation of the rating improvement. Meanwhile, we are upgrading Croatia USD from sell to hold based on expected policy improvements under the new government potentially leading to a stabilisation of the rating outlook. In the EUR segment, we prefer Bulgaria and Croatia vs. Romania, as the latter may experience negative risk repricing.

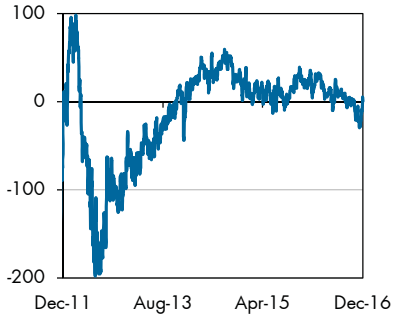
Financial analyst: Gintaras Shlizhyus, RBI Vienna

CEE EMBIG vs. UST 10y yields, %*



** JPM EMBI Global index family*
Source: Thomson Reuters, Bloomberg, RBI/Raiffeisen RESEARCH

CE/SEE vs. EUP spread (bp)*



** spread in basis points between CE/SEE yield (duration adjusted) and 5y EU Peripheral (EUP) average yield, CE/SEE - Czech, Hungary, Latvia, Lithuania, Poland, Romania EUR Eurobonds, EUP - Italy + Spain average 5y yields*
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Benchmark Eurobond forecast and performance

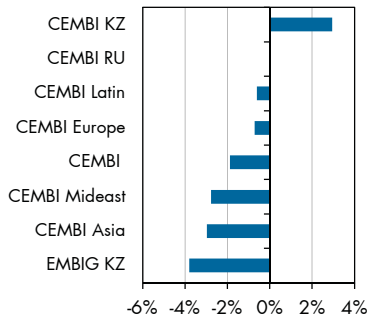
				Spread		Range			Spread	Range			Spread	Range		
Issue		Rating	Dur.	15-Dec	Mar-17	min.	max.	Perf. (%)	Jun-17	min.	max.	Perf. (%)	Sep-17	min.	max.	Perf. (%)
LT 6.625% due 22	USD	A-	4.4	**108**	**115**	105	126	-0.4	**121**	110	132	-0.2	**127**	116	138	-1.4
LT 4.85% due 18	EUR	A-	1.1	**64**	**62**	58	67	-0.1	**64**	60	69	-0.1	**68**	63	72	-0.1
PL 3% due 23	USD	BBB+	5.7	**83**	**93**	87	98	-1.2	**95**	90	100	-0.2	**100**	95	105	-1.6
PL 4.5% due 22	EUR	BBB+	4.6	**71**	**73**	67	78	-0.8	**75**	70	81	-0.7	**79**	74	85	-0.8
RO 4.375% due 23	USD	BBB-	5.8	**148**	**164**	156	173	-1.6	**169**	160	177	-0.7	**177**	168	186	-2.4
RO 4.875% due 19	EUR	BBB-	2.8	**94**	**112**	108	117	-0.9	**114**	110	119	-1.0	**120**	116	125	-1.4
HU 5.375% due 23	USD	BBB-	5.3	**135**	**143**	137	148	-0.5	**146**	140	151	-0.2	**153**	147	158	-1.6
HU 3.875% due 20	EUR	BBB-	3.0	**80**	**71**	69	74	-0.2	**73**	70	75	-0.2	**76**	74	79	-0.6
BG 2% due 22	EUR	BB+	5.0	**141**	**149**	141	156	-1.1	**153**	145	160	-1.0	**160**	153	168	-1.4
TR 3.25% due 23	USD*	BBB-	5.5	**301**	**323**	297	349	-1.9	**336**	310	362	-1.5	**353**	327	379	-3.5
TR 5.125% due 20	EUR*	BBB-	3.1	**341**	**366**	354	379	-1.2	**372**	360	385	-1.4	**391**	379	403	-2.3
RU 4.5% due 22	USD	BB+	4.7	**160**	**187**	173	201	-1.3	**194**	180	207	-1.2	**203**	190	217	-2.6
HR 5.5% due 23	USD	BB	5.3	**202**	**211**	199	222	-0.5	**216**	205	227	-0.3	**227**	216	238	-2.0
HR 3.875% due 22	EUR	BB	4.9	**278**	**273**	267	278	-0.5	**276**	270	281	-0.3	**289**	284	295	-1.0
RS 7.25% due 21	USD	BB-	4.1	**252**	**262**	250	275	-0.5	**269**	256	282	-0.3	**282**	269	295	-1.3
BY 8.95% due 18	USD	B-	1.0	**370**	**449**	431	467	-0.8	**458**	440	476	-1.0	**481**	463	499	-1.3
UA 7.75% due 27	USD	B-	6.9	**653**	**709**	691	726	-4.6	**717**	700	735	-3.9	**753**	736	770	-7.7

** USD bond spreads to UST notes, EUR bond spreads to German Bunds, Perf. as cumulative return of gross prices up to forecast horizon, countries sorted by S&P rating, Turkey - Fitch rating*
Source: Bloomberg, S&P, Fitch, RBI/Raiffeisen RESEARCH

Tug of war – higher UST rates vs benign oil price outlook

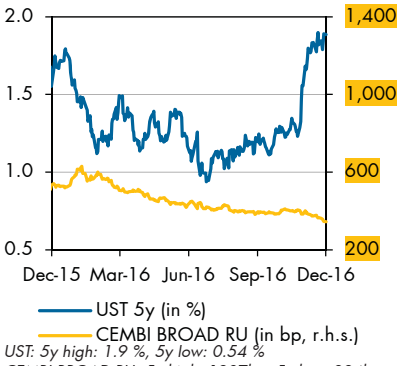
- **Fed's rate hiking cycle – major drag on valuations, spreads' resilience proved strong in Q4 2016**
- **Supportive oil price environment and still benign technical backdrop**
- **Watch for more clarity on Trump's international trade policy**
- **Buy into shorter durations and solid fundamentals**

Q4 2016 qtd returns*



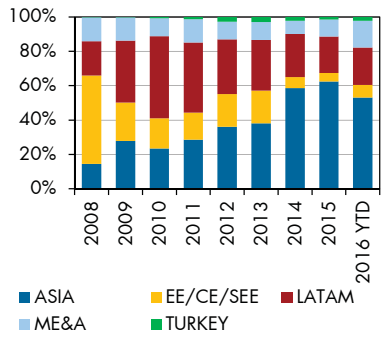
**data are for Broad Series*
5y average annual return in %:
EMBIG KZ: 6.3, CEMBI Asia: 6.4, CEMBI Mideast: 5.7, CEMBI: 5.7, CEMBI Europe: 7.8, CEMBI Latin: 4.2, CEMBI RU: 8.6, CEMBI KZ: 7.3
Source: JP Morgan, RBI/Raiffeisen RESEARCH

UST vs. CEMBI RU Index



UST: 5y high: 1.9 %, 5y low: 0.54 %
CEMBI BROAD RU: 5y high: 1207bp; 5y low: 334bp
Source: Bloomberg, JP Morgan, RBI/Raiffeisen RESEARCH

EM corporate issuance (%)*



** issuance until 12/12/2016*
Source: Bond Radar, Bloomberg, RBI/Raiffeisen RESEARCH

EE credits will remain torn between two contradictory trends in Q1 2017 – a supportive oil price environment, a still benign technical backdrop, and a solid carry on the one hand, and rising risk-free rates and the delivery of President Trump's anti-trade rhetoric on the other. We believe that there will still be potential for spread tightening going forward, as has been proven in the current quarter's tighter spreads despite negative total returns linked to increasing UST rates. The quarter-to-date average monthly rolling correlations between Russian spreads and five-year UST rates remained negative at -0.4, which underscored the relative resilience of Russian spreads to rising risk-free rates. Moreover, we expect a measured consolidation of the oversold market amid stabilising UST rates in Q1–Q2 2017. As a reminder, our economists forecast a ten-year UST rate at 2.7% in Q1 2017 and two additional Fed rate hikes in the course of 2017. Additionally, our oil analyst predicts continued oil price growth momentum in 2017, supported by the outcome of the most recent OPEC meeting. As proven on a number of previous occasions, the correlation between Russian spreads and oil price increases in response to major trend-changing events on the oil market. To recap, the one-month rolling correlation of the two time series has now sunk to -0.90 (month-to-date average: -0.85) in the direct aftermath of the OPEC meeting. We expect the correlation to stay negative, subject to the continued oil price growth momentum in Q1 2017, as the oil sector remains the flagship of the Russian export industry. Furthermore, we think that the EM story can draw investors' interest even in the face of higher growth/inflation expectations in the US. The expectedly higher pace of US economic growth assumed by the markets could spur more global growth, with positive repercussions for the growth trajectory of EM economies, which remains a benign trend in general. Therefore, we think EM markets can become beneficiaries of the additional growth stimulus in the US following the planned policy measures aimed at higher infrastructure and defence spending. However, we are cautious to sound overly optimistic as the US administration's anti-trade campaign will keep markets vigilant, which will support our call for higher volatility in Q1 2017.

Looking at our recommendations, our focus in Russia is still on solid fundamental stories supported by strengthening operating environments. We continue to like Russian oil and gas majors amid the continued oil price momentum supported by the outcome of the last OPEC meeting. We are maintaining our buy call on Gazprom 6.51% due 2022. We reiterate our negative view on the Russian transport sector, as its high exposure to the sluggish economic growth is exerting significant negative pressure on companies' credit metrics. We think that Global Ports' deleveraging focus will be tested again in the next six months and that the challenging operating environment will put renewed upward pressure on leverage. We are maintaining our sell recommendation on GLPRLI 6.872% due 2022. Looking at our covered universe in Kazakhstan, we remain buyers of Halyk Bank's 7.25% due 2021. Halyk benefits from its access to government state programmes, its superior credit rating compared to other local banks helps it to

acquire new trade finance clients, and the bank is able to approach state-related companies with financing. It also remains the most solid credit in the Kazakh banking system in terms of fundamentals and benefits from ties to the country's ruling political elite. We feel that the new supply risk for Eurobond holders remains negligible given the excess liquidity and very hesitant lending.

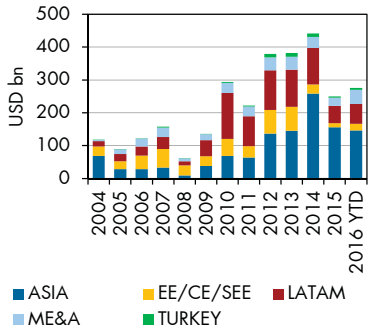
We reiterate that the technical situation remains supportive despite a modest revival of issuance in H2 2016. Although the spike in the global central banks' stimulus is no longer a prevalent trend amid the start of the Fed's rate hiking cycle, the dearth of Russian corporate debt remains a positive factor, as risk-free rates remain at low levels globally. Additionally, the sanction-induced low issuance activity (despite more vibrant H2 2016) has been constraining more flows into the Russian credit market. Therefore, we feel that the asset class can still benefit from scarcity value owing to shrinking supply. To recap, the total market capitalisation of the Russian sub-segment of the EM benchmark index plummeted by 30% compared to three years ago.

Despite the slightly higher share of CEE credits in the overall EM issuance, the revival on the primary market remains modest compared with the pre-crisis 2014 levels. Looking back at 2016, primary market activity in the EM remit picked up by 11% yoy to an equivalent of USD 276 bn, but remained 37% below the equivalent of USD 441 bn reached in 2014. The share of CEE credits in the total EM issuance rose to 7% from 5% in the previous year, but stayed well below the 19% reached in 2013. Turning to the regional distribution of the broader CEE region, EE credits surged by a hefty 214% to an equivalent of USD 14 bn from their 2015 lows of an equivalent of USD 5 bn. However, their issuance was below the equivalent of USD 15 bn reached in 2014 and well below the equivalent of USD 60 bn reached in 2012. CE/SE credits saw a 23% drop to an equivalent of USD 6 bn in 2016, down from the local high of an equivalent of USD 15 bn reached in 2013. Looking at the big picture, the total EM issuance surged to an equivalent of USD 58 bn (+42% yoy) in quarter-to-date terms.

EE credits' returns have been stuck between two major opposing trends: positive oil price momentum following the last OPEC meeting and rising US Treasury rates. Turning to performance, EM credits were hit by the steepening and upward-shifting US Treasury curve, as the shift in sentiment after the surprising outcome of the US presidential election translated into higher growth and inflation expectations. However, rising yields were accompanied by tightening spreads, which supported the argument of the UST-induced sell-off of EM debt. The EM benchmark index has returned -1.9% QTD, while EE credits have held up quite well. Kazakh non-quasi-sovereigns and Russia returned 2.9% and 0.0%, respectively. In contrast, LatAm, MidEast, Asia, and Kazakh quasi-sovereigns lost 0.7%, 2.8%, 3.0% and 3.8%, respectively. Looking at spreads, Kazakh non-quasi-sovereigns tightened by 120bp, followed by Russia (-57bp) and Kazakh quasi-sovereigns (-22bp). On the other hand, 3y, 5y and 10y US Treasury yields have surged by 0.7%, 0.9%, and 1.0% QTD, respectively. The outcome of the OPEC meeting and the oil club's decision to reduce production by 1.2 mn barrels per day (bpd) to 32.5 bpd and the alleged participation of non-OPEC countries increased the likelihood of continued oil price growth momentum. Our oil analyst projects average quarterly oil prices of 54, 58, 61, and 60 USD/barrel of Brent, respectively, in the four quarters of 2017. As a result, the continued strong oil price impetus should provide some leeway for modestly tighter spreads of Russian credits in Q1 2017.

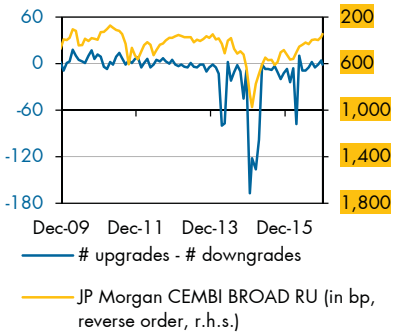
Financial analyst: Martin Kutny, CFA; RBI Vienna

EM corporate issuance*



** issuance until 12/12/2016*
Source: Bond Radar, Bloomberg, RBI/Raiffeisen RESEARCH

Rating drift in Russia



CEMBI BROAD: 5y high: 533bp; 5y low: 296bp
Source: Bloomberg, JP Morgan, RBI/Raiffeisen RESEARCH

Selected EE Eurobonds

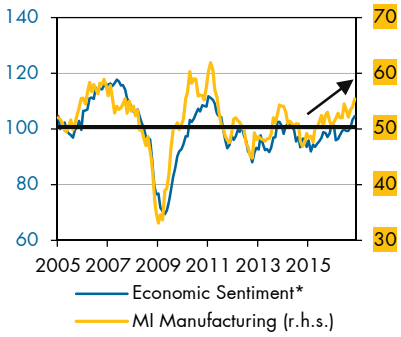
Issuer	ISIN	Maturity	Yield in %
Evraz	XS0618905219	27/04/2018	3.7
Gazprom	XS0708813810	23/01/2021	3.9
Sberbank	XS0799357354	28/06/2019	3.2
Vimpel-Com	XS0587031096	02/02/2021	4.4

Source: Bloomberg, RBI/Raiffeisen RESEARCH

Leading indicators provide reason for optimism

- **Moderate economic upswing in the first three quarters of 2016**
- **Leading indicators give hope for more robust growth**
- **Investments in plant and equipment developing positively, while construction is struggling to gain momentum**
- **Domestic economy still primary driver**

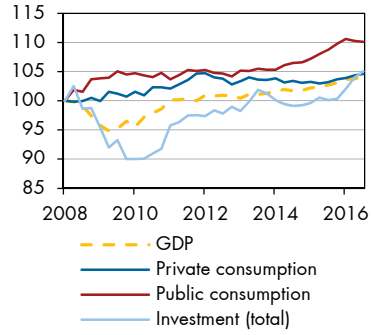
Leading indicators: Upward trend



*European Commission
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

The economy continued its **moderate upward trend** in the third quarter of 2016. Real GDP expanded by just under 0.4% qoq between July and September, putting the growth rate slightly higher than in the first two quarters of 2016 (average of +0.3% qoq). The development of the demand-side components of real GDP growth in the third quarter was also largely similar to that seen in the previous quarters. All in all, the economic upswing in the first three quarters of 2016 was **driven by domestic demand**. Nevertheless, the development of private consumption has fallen somewhat short of the expectations in light of the income tax reduction that went into effect at the beginning of 2016 and other stimulus measures. By contrast, **investments in plant and equipment** have delivered **robust growth**, more than compensating for the muted development of construction investments. Net exports, on the other hand, made no contribution to real GDP growth in the first three quarters of 2016 due to the combination of the sluggish development of real exports (goods and services) and a somewhat more dynamic expansion of real imports.

GDP: looking below the surface*



*real, indexed, Q1 2008 = 100
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

A look at the relevant leading indicators provides reason for optimism. For example, the **purchasing managers' index (PMI) for the manufacturing industry** reached 55.4 points in November, the **highest level since May 2011**. The Economic Sentiment Indicator (ESI) compiled by the European Commission posted a reading of 104.6 in the same month, which is the highest level since June 2011. Construction and industrial sentiment have also shown positive development, while consumer confidence remains firmly below the long-term average. Although the development of the leading indicators described here poses upside risks to our assumptions regarding GDP growth, we still expect an expansion of real GDP in the amount of 1.3% yoy in 2017 (2016e: 1.4% yoy), followed by 1.5% yoy in 2018.

The scenario outlined above of a economic upswing driven by domestic demand will likely remain valid in 2017 and 2018. Although the growth of real disposable household income is expected to weaken in 2017, **private consumption** will

Key economic figures and forecasts

	2015	2016e	2017f	2018f
Real GDP (% yoy)	1.0	1.4	1.3	1.5
Trade balance (goods and services, EUR bn)	13.6	13.9	13.3	14.4
Current account balance (% of GDP)	1.8	2.5	2.2	2.3
General budget balance (% of GDP)	-1.0	-1.3	-1.2	-1.1
Public debt (% of GDP)	85.5	83.4	81.1	79.5
Unemployment rate (avg, %, EU definition)	5.7	6.0	6.3	6.4
Employment (% yoy)	0.9	1.5	1.1	1.2
Consumer prices (avg, % yoy)	0.8	1.0	2.0	2.1
Real wages (% yoy)	1.3	0.5	-0.3	-0.2
Unit labour costs (% yoy)	1.6	1.6	1.5	1.6

Source: Statistics Austria, Thomson Reuters, RBI/Raiffeisen RESEARCH

likely remain a **key driver of economic development** in 2017. The same applies to gross fixed capital formation, although the growth rate is expected to fall short of that seen in 2016. This is due to the sharp increase in investments in plant and equipment, which we expect to slow down again in 2017 and 2018. In contrast, real (residential) construction investment will likely see somewhat higher expansion in 2017 and 2018. Although 2016 will mark the first time since 2012 that growth in this segment has not been negative, the momentum has remained rather subdued in light of rising property prices and population figures. However, the **marked rise in building permits in the first half of 2016 provides hope for an upswing in residential construction investment**. The growth scenario for the domestic economy outlined above will also require solid import growth in 2017 and 2018. However, the development of exports will likely remain subdued in 2017 in light of the external economic environment. We believe that we will have to wait until 2018 to see slightly higher export growth and a positive growth contribution by **net exports.**

Employment has enjoyed **positive development** in recent months. The increase in employed persons is projected at 1.5% yoy for 2016, the highest it has been since 2011. The **unemployment rate** (Eurostat method) **fell below the 6% mark** in autumn (October: 5.9%) and thus retreated slightly from the high seen in the period from July to August (6.2%). This is likely **only a short breather, however**, because the growth in the number of jobs is not expected to be sufficient to absorb the increase in the potential workforce for a number of different reasons (migration from new EU member states, labour market access for asylum seekers, a higher participation rate among women and older persons).

Compared with the prior year, **inflation (HICP)** stagnated between March and August 2016 before picking up markedly in line with the expectations (November 2016: +1.5% yoy), as energy prices in yoy terms were no longer negative. As a result, the inflation differential to the euro area also increased slightly again. This was primarily due to the categories of restaurants/hotels and housing, which are the "usual suspects". Average inflation is expected to come in at 1.0% yoy for 2016, with higher inflation rates projected for 2017 and 2018 (2.0% yoy and 2.1% yoy, respectively).

Financial analyst: Matthias Reith, CIIA, RBI Vienna

GDP: Value added by sector

Change (% yoy, in real terms)	2015	2016e	2017f	2018f
Agriculture & forestry	0.4	3.0	0.0	0.0
Prod. of goods/mining	1.5	2.0	2.1	2.2
Energy/water supply	1.2	-3.0	1.0	1.3
Construction	-1.1	1.7	1.7	2.0
Wholesale and retail trade	0.6	2.0	2.0	2.3
Transportation	0.3	0.0	1.3	1.4
Accom. & restaurant trade	1.0	1.8	1.6	1.8
Information and communication	1.5	0.5	0.8	0.8
Credit and insurance	0.7	0.8	0.5	0.6
Property & business services	1.1	2.1	1.9	2.0
Other economic services	0.9	1.2	0.8	1.0
Public sector	1.1	1.0	1.0	1.0
Healthcare, social services	0.7	1.5	1.4	1.5
Other services	-0.5	1.0	1.1	1.2
Gross domestic product	1.0	1.4	1.3	1.5

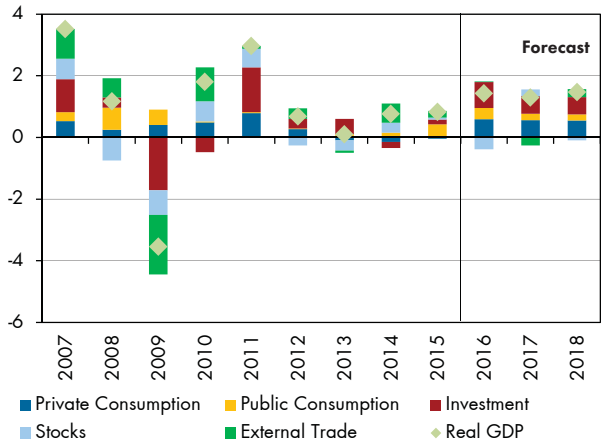
Source: Statistics Austria, RBI/Raiffeisen RESEARCH

GDP: Expenditure composition

Change (% yoy, in real terms)	2015	2016e	2017f	2018f
Private consumption	0.0	1.2	1.1	1.1
Public consumption	2.1	1.8	1.0	1.0
Gross fixed capital formation	0.7	3.7	2.5	2.4
Equipment	3.6	7.1	3.0	2.6
Construction	-1.2	1.7	1.7	2.0
Exports	3.6	2.6	1.8	3.4
Imports	3.4	2.8	2.5	3.2
Gross domestic product	1.0	1.4	1.3	1.5

Source: Statistics Austria, Thomson Reuters, RBI/Raiffeisen RESEARCH

Contributions* to real GDP growth (yoy)

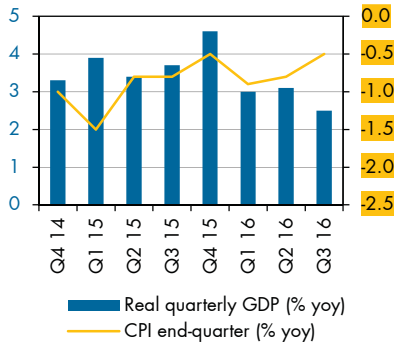


** in percentage points*
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Waiting for the rebound

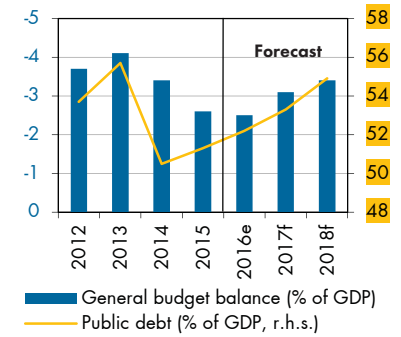
- **Stronger private consumption is not enough to spur GDP growth**
- **High political uncertainty remains the key long-term risk**
- **MPC's hesitancy to hike rates means flat rates for 2017**
- **PLN with only moderate recovery potential in 2017**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget balance and public debt



Source: National sources, RBI/Raiffeisen RESEARCH

Economic outlook

Looking at GDP results, 2016 (so far) might be described as a year of disappointments. The third quarter once again fell short of the expectations and pointed to a further economic slowdown to 2.5%, which is the weakest growth in over two years. The main source of the weakness remains the same – gross fixed capital formation staying in a strong downward trend due to the delayed absorption of new EU funds, lower outlays on the part of local governments and government-owned companies, and much lower investment appetite among private companies. On the positive side, private consumption strengthened in Q3, showing the first positive results of the fiscal stimulus in the form of transfers for families. Taking into account further improvement on the labour market and intensifying signs of stronger wage pressure, this trend will likely continue into 2017. In Q4, this will definitely not be enough to stop the unfavourable trend in GDP, however, especially due to the negative base effect (4.6% growth in Q4 2015). Thus, **a further decline in GDP growth (in our view to 1.7% in Q4) is highly likely, which could cut the result for 2016 as a whole to 2.5%** – the weakest result since 2013. Despite disappointing results in 2016, we still expect significant improvement in 2017 on the back of two supportive trends – further spillovers from fiscal transfers (which means stronger private consumption) and a rebound on the investment side due to a slight acceleration of EU funds absorption and a very low base from this year. The key question, however, is how long might this improvement last and what will be the main growth driver after these two effects vanish? Economic surveys indicate that the perception of uncertainty among enterprises will remain at an elevated level for almost a year. With higher incomes, households have more ability to save, while their plans for big purchases have hardly improved. Long-lasting uncertainty regarding not only the real economy but also taxation and the regulatory environment remains the key long-term risk, which might significantly

Key economic figures and forecasts

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	389.4	394.8	410.7	429.9	425.7	440.3	470.9
Real GDP (% yoy)	1.6	1.4	3.3	3.9	2.5	3.0	2.5
Industrial output (% yoy)	0.5	1.8	4.1	4.9	3.0	4.5	3.5
Unemployment rate (avg, %)	12.8	13.5	12.3	10.5	9.0	8.3	8.2
Nominal industrial wages (% yoy)	3.4	2.9	3.7	3.5	4.3	4.8	3.5
Producer prices (avg, % yoy)	3.3	-1.3	-1.5	-1.7	-0.4	2.0	2.0
Consumer prices (avg, % yoy)	3.7	0.9	0.0	-0.9	-0.6	1.1	2.0
Consumer prices (eop, % yoy)	2.4	0.7	-1.0	-0.5	0.3	1.6	2.5
General budget balance (% of GDP)	-3.7	-4.1	-3.4	-2.6	-2.5	-3.1	-3.4
Public debt (% of GDP)	53.7	55.7	50.5	51.3	52.2	53.3	54.9
Current account balance (% of GDP)	-3.7	-1.3	-2.0	-0.2	-0.5	-0.8	-1.1
Official FX reserves (EUR bn)	82.6	77.1	83.0	87.4	92.0	98.0	100.0
Gross foreign debt (% of GDP)	71.4	70.4	71.1	70.1	74.2	77.2	77.5
EUR/PLN (avg)	4.18	4.20	4.19	4.18	4.36	4.42	4.33
USD/PLN (avg)	3.26	3.16	3.16	3.77	3.93	4.29	3.97

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

reduce consumption via a rise in precautionary savings and limit investment activity. Taking into account the impending additional high budget expenses (such as costs of lower retirement age at the turn of 2017/2018) over a mid-term horizon, the government might be forced to reverse its fiscal policy into a more restrictive approach, which might be the next challenge for growth. This **risk of the economic rebound in 2017 being only a temporary phenomenon** prompted us to significantly revise our view on monetary policy. The recent comments by the MPC indicate that even if the NBP's rather optimistic forecasts for GDP and inflation materialise next year, the council would not consider interest rate hikes. As a result, the market consensus regarding the first rate hikes shifted to early 2018, which in our view might still be an overly optimistic scenario. Taking into account the above-mentioned **risks of further economic slowdown in 2018, rate hikes might not return to the agenda for much longer than just the next year.**

Financial analysts: Marta Petka-Zagajewska, Raiffeisen Polbank, Warsaw

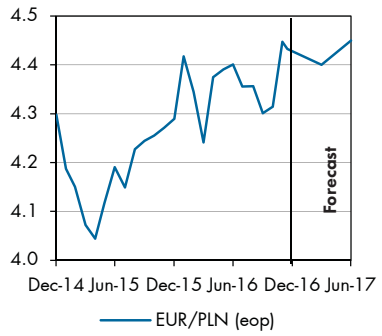
Financial market outlook

The political changes in particular have put additional pressure on the Polish zloty, and this pressure remains at somewhat elevated levels. Whereas we would expect large parts of the political and economic uncertainty to be priced in already, the recovery potential for the zloty will likely only be moderate throughout 2017. Additionally, the past months once again showed that the zloty can still be regarded as a risk proxy for the CEE region, thus making it susceptible to setbacks due to global events, which also translates into higher PLN volatility compared with its peers. Overall, **we project a basic sideways movement in EUR/PLN** for the coming quarter with the most potential for a moderate recovery in H2 2017.

During 2016, POLGBs underperformed the CE/SEE peer markets. Local political risks added to global monetary policy uncertainty, which weighed on POLGBs due to Poland's above-average sensitivity to moves on the US Treasury market. Although it has decreased in recent quarters, the still high share of USD investors in POLGBs backfired all the more after the Trump victory in November. The subsequent hefty repricing on the US debt market spilled over forcefully to the POLGB market, with the ten-year nominal yield increasing to a similar extent that the US equivalent did (see page 12-13). Given the relatively high ten-year POLGB yields following this correction and our expectations of a slightly stronger zloty on the end-March 2017 horizon, **longer-duration zloty bonds have become more attractive again in our view.**

Financial analysts: Wolfgang Ernst, CEFA, Stephan Imre, RBI Vienna

Exchange rate development



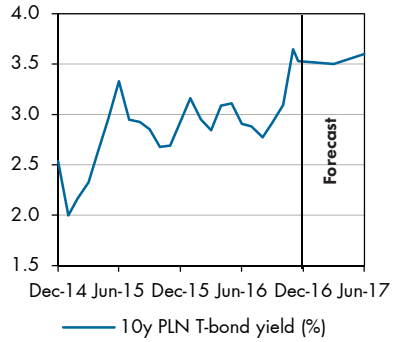
EUR/PLN: 5y high 4.51, 5y low 3.99
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Exchange rate forecasts

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
EUR/PLN	4.43	4.40	4.45	4.40	4.35
Cons.		*4.40*	*4.37*	*4.35*	*4.34*
USD/PLN	4.26	4.23	4.36	4.31	4.14
Cons.		*4.23*	*4.18*	*4.15*	*4.12*

[1] 5:00 p.m. (CET)
Source: Bloomberg, RBI/Raiffeisen RESEARCH

PLN yield development (%)



10y PLN T-bond yield: 5y high 5.97, 5y low 2
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Interest rate forecasts (%)

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
Key rate	1.50	1.50	1.50	1.50	1.50
Consensus		*1.50*	*1.50*	*1.50*	*1.55*
3 month[2]	1.73	1.73	1.73	1.73	1.73
Consensus		*1.73*	*1.73*	*1.76*	*1.82*

[1] 5:00 p.m. (CET) [2] Offered rate
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Yield forecasts (%)

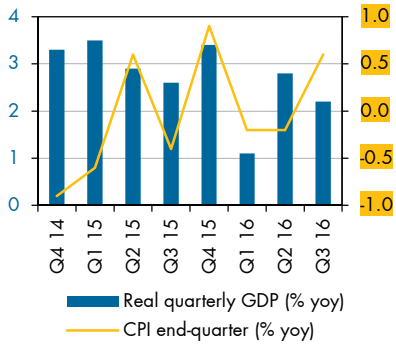
	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
2y T-bond[2]	2.03	2.1	2.2	2.2	2.3
Consensus		*1.8*	*1.9*	*2.0*	*2.1*
10y T-bond[2]	3.53	3.5	3.6	3.7	3.8
Consensus		*3.3*	*3.3*	*3.4*	*3.5*

[1] 5:00 p.m. (CET) [2] Bid yield
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Fiscal stimulus accelerates growth

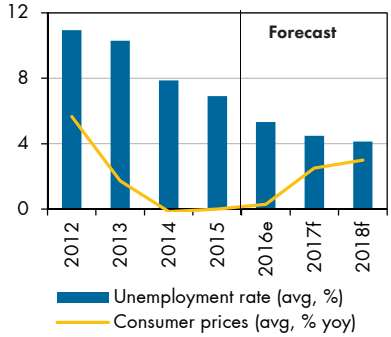
- **One-off factors hinder economic growth in 2016**
- **Wage growth to accelerate in 2017**
- **Inflationary pressures are mounting – 3% target within reach**
- **Unconventional monetary easing – stable key rate**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Inflation and unemployment



Source: National sources, RBI/Raiffeisen RESEARCH

Economic outlook

The Hungarian economy experienced a slowdown of GDP growth in 2016 mainly because of the temporary decline in EU fund utilisation. In 2016, the amount of EU funds dropped to less than half of that in 2015 – from close to 6% of GDP to well below 3%. As EU funds play a major role in public sector investment activity, there was a massive contraction in gross fixed capital formation in 2016. However, EU fund utilisation is expected to accelerate in 2017, so investments will likely grow robustly once again. The other weak spot of the Hungarian economy was the automotive industry: In the previous years, there was a continuous dynamic expansion of capacities in the automotive industry, which stopped by 2016. As new capacities will open in 2017, the automotive industry's output is expected to rise.

By contrast, the expansion of household consumption accelerated in the course of 2016 and was the main source of economic growth. Consumption growth is supported by rising employment and growing wages. The unemployment rate dropped below 5%, employment increased by 3%, and real wages grew by 8% in 2016. At the moment, the scarcity of labour is the main problem for the corporate sector, which translates into further wage increases.

In order to tackle this issue, an agreement was reached between the government, employers, and the trade unions. Accordingly, **there will be a 15% minimum wage increase in 2017** (and a 25% increase in the so-called guaranteed minimum wage for skilled workers). A 5 percentage point cut of the social security contribution paid by employers (from 27% to 22%) and a reduction of corporate income tax (from current 10% and 19% to 9%) are intended to partially counterbalance the growing labour costs at the micro level. Given the already existing wage pressures in various areas of the economy and the already announced wage increases in the public sector, we will experience accelerating wage growth in 2017.

Key economic figures and forecasts

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	99.0	101.3	104.2	108.8	112.7	119.7	125.7
Real GDP (% yoy)	-1.7	1.9	3.7	2.9	2.3	3.2	3.4
Industrial output (% yoy)	-1.7	-3.5	5.3	6.3	1.9	2.6	4.5
Unemployment rate (avg, %)	10.9	10.3	7.9	6.9	5.3	4.5	4.1
Nominal industrial wages (% yoy)	-0.7	4.4	4.0	5.3	7.5	12.0	10.3
Producer prices (avg, % yoy)	4.3	0.7	-0.4	-0.7	-1.0	3.0	2.2
Consumer prices (avg, % yoy)	5.7	1.7	-0.2	0.0	0.3	2.5	3.0
Consumer prices (eop, % yoy)	5.0	0.4	-0.9	0.9	1.1	3.0	3.0
General budget balance (% of GDP)	-2.1	-2.3	-2.5	-2.0	-1.5	-2.5	-3.0
Public debt (% of GDP)	78.3	76.8	76.2	75.5	74.1	73.4	72.6
Current account balance (% of GDP)	1.9	4.1	3.9	4.4	3.5	3.2	2.9
Official FX reserves (EUR bn)	33.9	33.8	34.7	30.5	26.0	24.0	22.0
Gross foreign debt (% of GDP)	129.0	118.4	114.8	107.1	98.0	89.0	83.2
EUR/HUF (avg)	289.2	296.8	308.7	309.9	312.1	312.5	316.9
USD/HUF (avg)	225.1	223.6	232.8	279.4	281.2	303.4	290.7

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Therefore, in 2017 we will see a turnaround in those factors (investments, car industry) that hindered economic growth in 2016, and the major driving force (i.e. household consumption) will further accelerate. Consequently, GDP growth is expected to be more robust than previously assumed – **we have increased our GDP forecast for 2017 from 2.7% to 3.2%.**

These developments, coupled with the expected gradual increase in oil prices, would certainly result in increased inflationary pressures. Therefore, we project that inflation will pick up from the zero level seen over the past three years, and **expect the 3% inflation target to be met by the end of 2017**.

All the main rating agencies upgraded Hungary's rating to investment grade in the course of 2016 due to the improving risk profile.

Monetary easing has resumed in recent months. The National Bank of Hungary (MNB) is implementing it without cutting the key rate (which is at 0.9%), but by increasing HUF liquidity through various measures: 1. capping the volume of three-month deposits, its main policy instrument, at HUF 900 bn until the end of 2016 – harsher limitations of the deposit facility are expected in 2017; 2. introducing ad hoc FX swap tenders (so far, the MNB has added HUF 350 bn of extra liquidity over the past months); 3. lowering banks' mandatory reserve ratio from 2% to 1% (this adds another HUF 170 bn of extra liquidity from December 2016); 4. cutting the overnight lending and one-week collateralised lending facilities to 0.9%. A cut in the base rate is only likely if the current toolkit proves to be ineffective in achieving a sufficient easing of monetary conditions - for the time being, we attach a high likelihood to the success of monetary easing with the existing measures. Rising HUF liquidity can be utilised by banks to increase their lending activity, buy more HUF government bonds (thus reducing HGB yields), and increase supply on the interbank market (successfully pushing BUBOR rates lower while contributing to HUF weakness). Since these measures went into effect, **interbank interest rates have dropped quite sharply and are now trading well below the base rate** – with the three-month BUBOR at 0.4% at the time this report is being written.

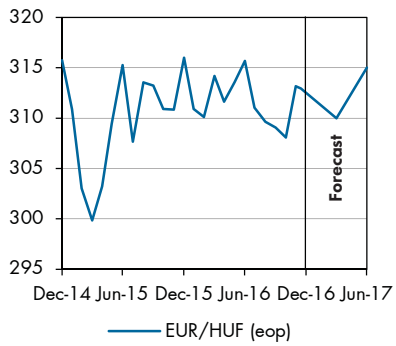
Financial analyst: Zoltán Török, Raiffeisen Bank Zrt., Budapest

Financial market outlook

The reaction of the HGB market to the monetary policy measures was mixed. The shorter maturities have reached all-time lows but longer-term rates could not follow suit, as the post-Trump sell-off came into the picture, leading to some bear-steepening of the yield curve in November. At the same time, Hungary's spread is constantly declining. On the whole, we believe that **longer-term HGBs will also remain attractive in the long run** as yield-hunting investors return to the market. The ten-year maturity is expected to return to a level close to 3% in the coming months. For now, EUR/HUF has returned to the top of its previous 310-315 trading range, as expected. At the moment, there is no reason for us to change our forecast that EUR/HUF will likely remain around these levels over the coming months as well, while the MNB's liquidity-boosting policy will keep supporting it.

Financial analyst: Gergely Pálffy, Raiffeisen Bank Zrt., Budapest

Exchange rate development



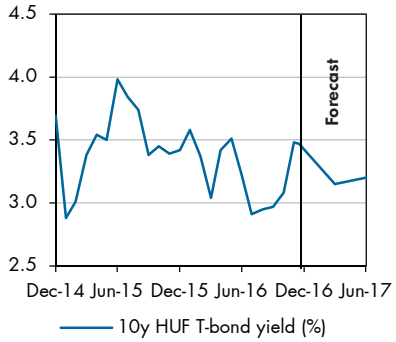
EUR/HUF: 5y high 321.02, 5y low 275.45
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Exchange rate forecasts

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
EUR/HUF	312.95	310	315	310	315
Cons.		*312*	*313*	*310*	*310*
USD/HUF	300.48	298	309	304	300
Cons.		*298*	*296*	*293*	*291*

[1] 5:00 p.m. (CET)
Source: Bloomberg, RBI/Raiffeisen RESEARCH

HUF yield development (%)



10y HUF T-bond yield: 5y high 10.83, 5y low 2.82
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Interest rate forecasts (%)

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
Key rate	0.90	0.90	0.90	0.90	0.90
Consensus		*0.90*	*0.90*	*0.90*	*0.95*
3 month[2]	0.39	0.30	0.30	0.40	0.50
Consensus		*0.74*	*0.71*	*0.70*	*0.69*

[1] 5:00 p.m. (CET) [2] Offered rate
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Yield forecasts (%)

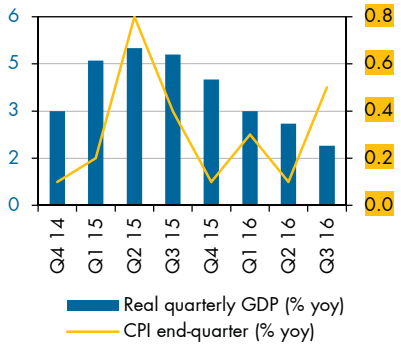
	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
3y T-bond[2]	1.10	1.4	1.5	1.6	1.7
Consensus		*n.v.*	*n.v.*	*n.v.*	*n.v.*
10y T-bond[2]	3.47	3.2	3.2	3.3	3.4
Consensus		*3.30*	*3.30*	*3.35*	*3.41*

[1] 5:00 p.m. (CET) [2] Bid yield
Source: Bloomberg, RBI/Raiffeisen RESEARCH

All eyes on inflation

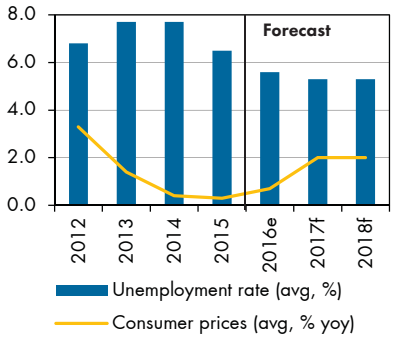
- **2017 wage growth to accelerate to eight-year high, unemployment to reach eight-year low**
- **Inflation to reach CNB's 2% inflation target already in Q1 2017**
- **End of FX commitment getting closer**
- **Government bond yields to rise after exit**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Inflation and unemployment



Source: National sources, RBI/Raiffeisen RESEARCH

Economic outlook

In the Czech Republic, public and private investments are strongly dependent on inflows of EU funds and thus the transition to a new programming period affects the whole investment cycle in the country. In 2016, a drop in public investments, which significantly weakened production in the construction sector, suppressed the overall investment activity. Investment activity is expected to pick up again in 2017.

Persistently solid growth of household consumption at a rate of 2% yoy together with higher investment activity and a strong performance by foreign trade should help overall **economic activity accelerate slightly from 2.5% yoy this year to 2.7% yoy in 2017**. Industrial production, which generates one-third of the Czech GDP and is heavily dependent on car production, will accelerate towards 3.5% yoy. As about one-half of the country's industrial output is exported (mainly to EU countries), we expect export growth to accelerate to above 5.5% yoy and thus slightly exceed import growth.

Faster growth in industrial production is being held back by a lack of qualified technical and blue-collar workers. The current record-high employment and very low unemployment, which is expected to decline to a eight-year low in 2017, are allowing employees to demand higher wages. Furthermore, firms are also pressed to increase wages due to the government's decision to raise the minimum wage by 11%. The ratio of minimum wage to average nominal wage is expected to reach nearly 40% in 2017. Despite the significant wage growth, which reached an seven-year high in 2016, about 60% of all employees still earn a monthly salary below the average wage.

Along with the increases in minimum and public wages, the parliamentary elections coming in autumn will also weigh on the government budget in 2017. Despite the fact that the government will very likely achieve a balanced budget in 2016, the government agreed on a budget deficit of CZK 60 bn for 2017. We

Key economic figures and forecasts

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	160.8	156.9	156.6	167.0	174.5	183.2	200.8
Real GDP (% yoy)	-0.8	-0.5	2.7	4.6	2.5	2.7	2.5
Industrial output (% yoy)	-0.8	-0.1	5.0	4.6	3.3	3.5	3.5
Unemployment rate (avg, %)	6.8	7.7	7.7	6.5	5.6	5.3	5.3
Nominal industrial wages (% yoy)	3.2	1.0	2.9	3.0	4.1	4.0	3.9
Producer prices (avg, % yoy)	2.1	0.8	-0.8	-3.2	-3.3	2.2	2.1
Consumer prices (avg, % yoy)	3.3	1.4	0.4	0.3	0.7	2.0	2.0
Consumer prices (eop, % yoy)	2.4	1.4	0.1	0.1	1.8	1.9	1.9
General budget balance (% of GDP)	-3.9	-1.3	-1.9	-0.6	0.0	-0.2	0.0
Public debt (% of GDP)	44.5	44.9	42.2	40.3	39.2	38.2	37.0
Current account balance (% of GDP)	-1.6	-0.5	0.2	0.9	2.4	1.5	1.2
Official FX reserves (EUR bn)	34.0	40.8	45.0	59.4	80.5	101.0	103.0
Gross foreign debt (% of GDP)	60.2	63.5	67.8	69.4	73.0	77.1	73.9
EUR/CZK (avg)	25.1	26.0	27.5	27.3	27.0	26.9	25.5
USD/CZK (avg)	19.6	19.6	20.8	24.6	24.4	26.1	23.4

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

expect the budget deficit to be very close to zero and reach positive zero the following year. In order to increase revenues and combat the shadow economy, the government decided to introduce electronic sales registration (EET) in four phases, with the first phase starting in December 2016. In reaction to this new law, some firms already increased prices for services, especially for restaurants and hotels, in November 2016.

Inflation accelerated from 0.8% to 1.5% in November, mainly due to the base effect and higher food prices. November inflation was 50bp above the Czech National Bank's (CNB) forecast and 20bp above the market expectations. The effect of EET is expected to contribute to higher prices in December 2016 and especially in January 2017, when many firms will change their price lists. Therefore, we expect CPI inflation to reach the CNB's 2% inflation target at the beginning of 2017. For the **remainder of 2017, we expect inflation to stay close to 2% even without monetary policy tightening.**

Financial analysts: Daniela Milučka, Raiffeisenbank a.s., Prague

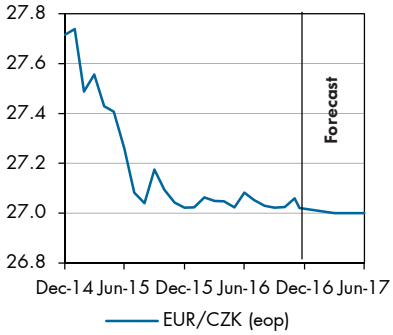
Financial market outlook

We are sticking to our expectation that the CNB will abandon the EUR/CZK 27.0 FX commitment in the second half of 2017. As we correctly anticipated, the amount of FX reserves has already increased to EUR 80 bn, i.e. over 45% of GDP. However, the key variable for the timing of the exit will be the inflation development and outlook. We expect the 2% inflation target to be reached as early as Q1 2017. However, we can hardly rule out a surprise in either direction. In the event of faster inflation, the CNB may decide to end the commitment as soon as possible. Since the CNB promised that it will not cancel the commitment before Q2 2017, the earliest realistic possible date is 1 April. Nevertheless, as mentioned above, in the event that the inflation target is reached quickly it does not necessarily imply that inflation will spiral out of the CNB's tolerance band. The CNB might wait for confirmation that there is no doubt that inflation has reached the target on a lasting basis.

The speculation about future CZK appreciation has translated into the derivative market. These market expectations have translated into high demand for CZK-denominated assets. Czech government bond yields have dropped to below 0% for maturities of up to six years. Excluding the potential CZK appreciation, Czech government bond yields should increase. For the period surrounding the exit from the CNB's EUR/CZK FX commitment, we expect increased volatility for Czech government bonds as well. As a result, **we will likely see higher bond yields all along the yield curve.** While domestic institutions will not change their appetite for CZK-denominated bonds much, foreign ownership will probably decrease. Since the start of the intervention measures, foreign ownership of CZK-denominated bonds has increased by CZK 230 bn to CZK 397 bn, and there is a considerable risk that some investors will want to take a quick profit after the exit.

Financial analysts: Michal Brozka, Raiffeisenbank a.s., Prague

Exchange rate development



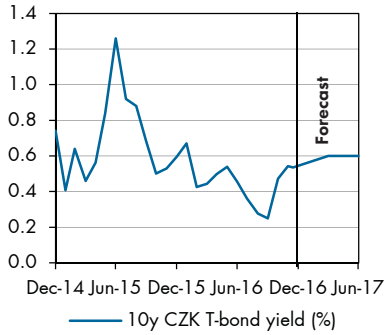
EUR/CZK: 5y high 28.35, 5y low 24.36
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Exchange rate forecasts

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
EUR/CZK	27.02	27.00	27.00	27.00	25.90
Cons.		*27.00*	*27.00*	*26.90*	*26.50*
USD/CZK	25.94	25.96	26.47	26.47	24.67
Cons.		*25.67*	*25.36*	*24.94*	*24.32*

[1] 5:00 p.m. (CET)
Source: Bloomberg, RBI/Raiffeisen RESEARCH

CZK yield development (%)



10y CZK T-bond yield: 5y high 3.87, 5y low 0.24
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Interest rate forecasts (%)

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
Key rate	0.05	0.05	0.05	0.05	0.05
Consensus		*0.05*	*0.05*	*0.05*	*0.10*
3 month[2]	0.29	0.30	0.30	0.30	0.35
Consensus		*0.28*	*0.28*	*0.31*	*0.36*

[1] 5:00 p.m. (CET) [2] Offered rate
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Yield forecasts (%)

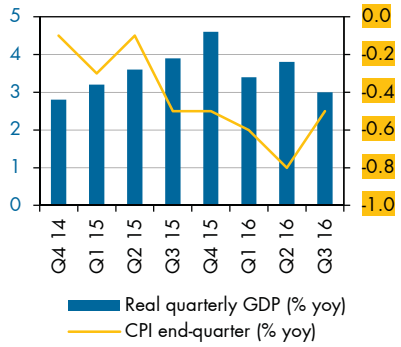
	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
2y T-bond	-0.81	-0.6	-0.7	-0.6	0.1
Consensus		*-0.7*	*-0.3*	*-0.2*	*0.0*
10y T-bond	0.54	0.6	0.6	0.5	1.1
Consensus		*0.7*	*0.7*	*0.8*	*0.9*

[1] 5:00 p.m. (CET)
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Slovakia – Sailing with the wind in its sails at its back

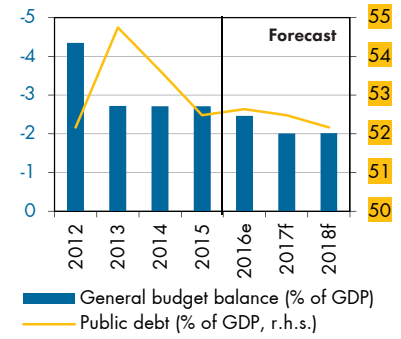
- **The economy continues its steady growth**
- **Reflation on the horizon as wages and employment march on**
- **Consolidation of public finance limited to the minimum necessary**
- **Slovakia as the highest yielding core government bonds**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget balance and public debt



Source: National sources, RBI/Raiffeisen RESEARCH

Economic outlook

Economic growth in Slovakia slowed down to 3.0% yoy in Q3 2016, mainly due to lower gross fixed capital formation (-17.0% yoy). The growth rate was the slowest seen since the beginning of 2015. The fall in investment was anticipated after the strong performance in H2 2015 due to government infrastructure spending driven by EU funds. This year, EU funds absorption is expected to be less than half that seen in 2015. Private investment is not developing as well as expected thus unable to compensate for the lack of government investments. Household consumption continues its steady climb, growing by 2.4% yoy in Q3 2016, and is expected to continue growing in 2017. Due to a slight decrease in Q3 growth, we **are revising our 2016 GDP forecast to 3.3% yoy, with similar growth in 2017**. This year Slovakia expects strong growth of investments in in the automotive sector notably with a new automobile plant (Jaguar Land Rover). Domestic demand decreased by 1.0% yoy in Q3 2016. Due to a slump in investment imports, net exports increased by 4.2% yoy. Imports are expected to rise again in 2017 compared with 2016, making GDP growth more dependent on domestic demand.

Financial analyst: Tibor Lörincz, Tatra banka, a.s. Bratislava

Labour market and inflation

The labour market was booming in 2016, and is expected to continue improving in 2017. The unemployment rate decreased from 10% in Q4 2015 to 9.5% in Q3 2016, and we **expect unemployment to fall to 8.4% in 2017**. In Q3 2016, the employment rate beat the 70% mark for the first time since 2008. The government introduced new legislation to help indebted persons and could ease conditions for importing labour from abroad which should translate to an uptick in employment in 2017

Key economic figures and forecasts*

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	72.7	74.2	75.9	78.7	80.9	84.1	89.1
Real GDP (% yoy)	1.7	1.5	2.6	3.8	3.3	3.3	4.0
Industrial output (% yoy)	8.1	4.6	3.7	5.9	4.0	4.0	8.0
Unemployment rate (avg, %)	13.9	14.2	13.2	11.5	9.7	8.6	7.2
Nominal industrial wages (% yoy)	4.0	3.6	5.4	3.2	3.2	4.0	4.5
Producer prices (avg, % yoy)	3.9	-0.1	-3.5	-4.2	-4.3	0.0	2.0
Consumer prices (avg, % yoy)	3.6	1.4	-0.1	-0.3	-0.5	1.1	2.0
Consumer prices (eop, % yoy)	3.2	0.4	-0.1	-0.5	0.1	1.4	2.2
General budget balance (% of GDP)	-4.3	-2.7	-2.7	-2.7	-2.5	-2.0	-2.0
Public debt (% of GDP)	52.2	54.7	53.6	52.5	52.6	52.5	52.2
Current account balance (% of GDP)	0.9	2.0	0.1	-1.3	-0.7	-0.7	0.2
Gross foreign debt (% of GDP)	75.5	81.5	89.2	85.4	86.1	85.1	83.5

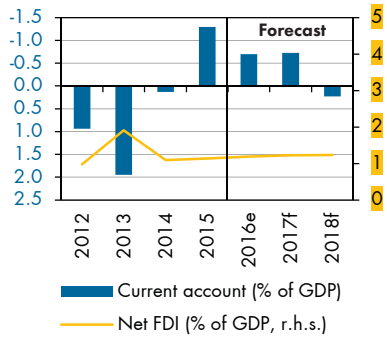
** euro area entry on 1 January 2009*
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

The positive situation on the labour market is underlined by wage growth, which nominally rose to 3.3% yoy in Q3 2016, compared with 2.9% yoy in Q3 2015. In 2017 wages should remain dynamic thanks to an increase of the minimum wage from EUR 405 to EUR 435.

In the second half of 2016, consumer prices quickly went from the historical low of -0.9% yoy to almost zero. The prospects are positive for this trend to continue. Despite a projected decrease in regulated energy prices, we expect inflation to increase to above zero after almost three years. The main drivers will likely be prices of fuel and services. We suppose that the pace of **reflation will be quite dynamic and expect the year-end inflation to be around 1.3% yoy in 2017**.

Financial analyst: Boris Fojtík, Tatra banka, a.s. Bratislava

Current account and FDI inflows



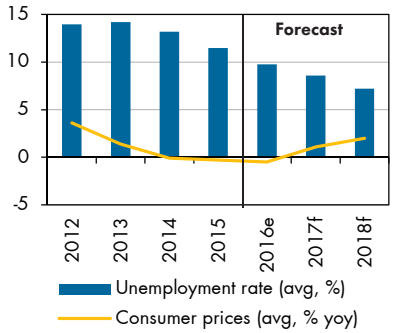
Source: National sources, RBI/Raiffeisen RESEARCH

Public finance

The European Commission (EC) expects the public deficit to come in at 2.0% of GDP in 2016 and 1.5% of GDP in 2017. However, we are a bit more pessimistic with regards to government discipline expecting a deficit of 2.0% GDP in 2017. According to the EC, gross public debt is likely to increase to 53% of GDP in 2016 (from 52.5% of GDP in 2015), mainly due to the cash deficit and the creation of liquidity reserves.

Financial analyst: Juraj Valachy, Tatra banka, a.s. Bratislava

Inflation outlook



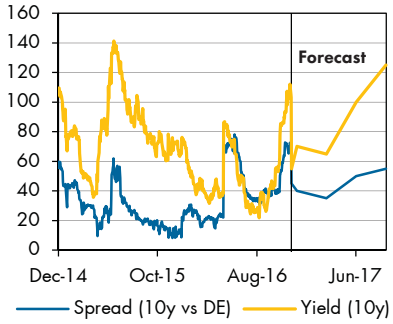
Source: National sources, RBI/Raiffeisen RESEARCH

Bond market

The **spread** on Slovak government bonds (ten-year vs. Germany) has widened significantly recently and currently stands at around 70bp. We consider the spread overstretched at this level, as this is not supported by the development of **economic** and **fiscal fundamentals**. In addition, Slovakia's spread – in contrast to most other euro area countries – did not narrow much after the Italian referendum. Pressure from the primary market may have played a role here. However, this effect should be temporary, as Slovak government bonds are otherwise **benefiting** from the ECB's bond purchases to a particularly **high degree**. The monthly purchase target based on the ECB capital key is disproportionately high in relation to the size of the government bond market. This situation has already led to a noticeable **shortage** of Slovak government bonds, as the Eurosystem already holds 23% of the outstanding volume. As a result, the monthly purchases are now well below the targeted amount of EUR 700 mn. In light of this shortage, we see potential for the Slovak spread to narrow to a level of around 60bp on a short-term horizon (1-4 months). Afterwards it should start to stabilise in line with the development in the euro area. This would once again place Slovak government bonds clearly in the **core segment** of the euro government bond market. This is supported by our quantitative analyses, which indicate that the yields of Slovak government bonds show statistical patterns very similar to those of the core countries even in the case of volatility shocks. Therefore, we now classify Slovakia as the **core country with the highest yield**.

Financial analyst: Patrick Krizan, RBI Vienna

Yield and spread*

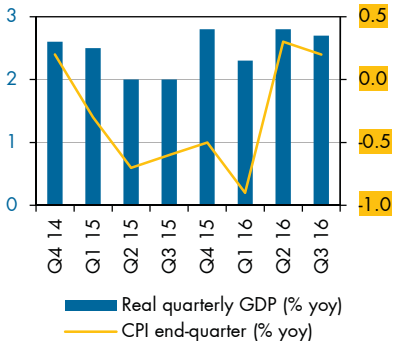


**in basis points*
Yield (10y): 5y high: 488; 5y low: 22
Spread: 5y high: 302; 5y low: 8
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Economic activity shifts up a gear

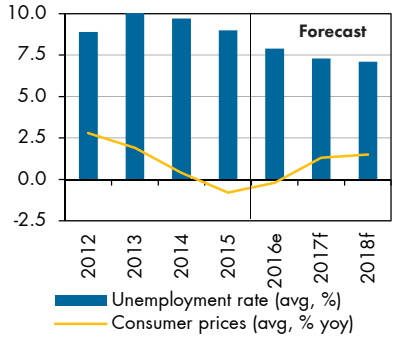
- **Economy benefits from exports in third quarter**
- **Leading indicators improve further, economic activity to be driven by domestic demand to higher extent in 2017 and 2018**
- **Inflation rises above zero mark, expected to continue increasing**
- **Bond market: spread increase expected over the year**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Inflation and unemployment



Source: National sources, RBI/Raiffeisen RESEARCH

At 1.0% qoq, the expansion of real GDP was significantly higher in the third quarter of 2016 than in the two previous quarters (Q1: +0.6% qoq; Q2: +0.7% qoq). Foreign trade proved to be the main driver of economic activity in Q3. The GDP growth achieved in the third quarter and the upward revisions of the growth rates for Q1 and Q2 prompted us to lift our GDP forecast for 2016 as a whole to 2.6% yoy. At the same time, **the outlook for future economic development also appears favourable.** Economic sentiment, for example, has improved further in recent months. Consequently, we now expect higher GDP growth of 2.7% yoy in 2017, as well. However, **economic growth** will likely be **driven by domestic demand to a higher extent in 2017 and 2018.** Private consumption is expected to benefit from the continued positive development of real disposable household income, while investment activity will likely make a positive contribution to GDP growth in the next two years after declining in 2016. Foreign trade is also expected to support economic activity in 2017 and 2018, albeit to a somewhat lesser degree due to the anticipated momentum of the domestic economy and the resulting increase in imports. Due to the development of energy prices, which are now only having a marginally dampening effect, **inflation** (HICP) rose significantly above the zero mark (October: +0.7% yoy). This upward trend in inflation is expected to continue, resulting in considerably higher average inflation rates in 2017 and 2018.

The **spread** on Slovenian bonds (ten-year vs. Germany) has narrowed significantly in recent months. While it was at a similar level to Italy or Spain at roughly 120bp at mid-year, it has now moved into the same territory as the core countries at around 60bp. We consider this level to be the lower limit. This decline is primarily a reflection of the tense supply situation due to the ECB's bond purchases. As their influence on spreads diminishes, we also expect Slovenia's spread to widen noticeably again towards the end of the year.

Financial analysts: Matthias Reith, CIIA; Patrick Krizan, RBI Vienna

Key economic figures and forecasts*

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	36.0	35.9	37.3	38.6	39.3	40.6	42.1
Real GDP (% yoy)	-2.7	-1.1	3.1	2.3	2.6	2.7	2.2
Industrial output (% yoy)	-1.1	-0.9	2.2	5.6	6.1	4.0	4.5
Unemployment rate (avg, %)	8.9	10.1	9.7	9.0	7.9	7.3	7.1
Nominal industrial wages (% yoy)	2.6	2.8	3.3	2.1	2.0	2.5	2.7
Producer prices (avg, % yoy)	1.0	0.3	-1.1	-0.5	-1.4	0.8	1.0
Consumer prices (avg, % yoy)	2.8	1.9	0.4	-0.8	-0.2	1.3	1.5
Consumer prices (eop, % yoy)	3.1	0.9	-0.1	-0.6	0.8	1.9	1.2
General budget balance (% of GDP)	-4.1	-15.0	-5.0	-2.7	-2.5	-2.1	-1.9
Public debt (% of GDP)	53.9	71.0	80.9	83.1	81.3	79.5	78.2
Current account balance (% of GDP)	2.6	4.8	6.2	5.2	7.0	6.8	6.4
Gross foreign debt (% of GDP)	119.1	116.6	124.6	116.6	110.0	104.1	103.0

** euro area entry on 1 January 2007*
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

In line with the growth trend in CEE

- **Robust GDP growth accompanied by low deflation**
- **More effective absorption of EU funds needed**
- **Banking sector prepared for upcoming growth cycle**
- **Political instability may hinder investments and growth in 2017**

In addition to the tense external environment (Syria, Turkey), the domestic political situation also deteriorated. Presidential elections were held in November. As the candidate of the ruling party lost, the prime minister resigned from the government, which means **that early parliamentary elections are on the horizon**. Moreover, it is still not clear what system will be used for the early elections, as voters were in favour of the new majority system in the referendum held in the first round of the election. The president is expected to nominate a caretaker government to hold the elections after taking office on 22 January 2017.

Despite the precarious political environment, **real GDP grew faster than anticipated** (3.4% in Q3 2016) amidst a low deflationary environment, benefiting from the better economic conditions (weaker euro, low oil prices and cheaper money). As expected, the main drivers were net exports and moderately increasing household consumption on the back of declining deposit interest rates and rising salaries. On the other hand, the expanding gross budget surplus (EUR 3.4 bn as of October) is evidence of sound fiscal policy.

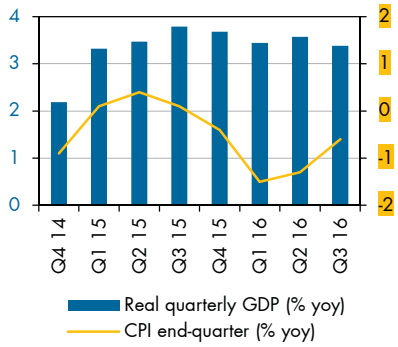
The continuing effects of the ECB's quantitative easing policy will continue to support GDP growth in 2017 (forecasted real growth of 3.0%) amidst a moderate inflation environment. Otherwise, **investments will remain sluggish due to the domestic political situation**, not least because of expected weak administrative capacity to absorb EU funds and programmes. Absorption is projected to remain under the EU average for 2017.

After successful performance in the asset quality revue and stress tests in 2016, the banking sector is expected to grow in 2017, supported by the expected moderate inflation.

The rating agencies Fitch and S&P confirmed the long-term credit rating of the country. However, they point out the instable political prospects and the associated potential implications for the Bulgarian economy.

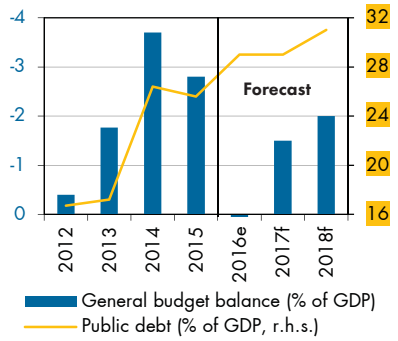
Financial analyst: Emil S. Kalchev, Raiffeisenbank (Bulgaria) EAD, Sofia

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget balance and public debt



Source: National sources, RBI/Raiffeisen RESEARCH

Key economic figures and forecasts

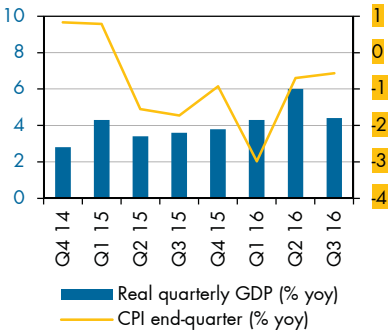
	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	41.9	42.0	42.8	45.3	46.8	49.1	51.7
Real GDP (% yoy)	0.0	0.9	1.3	3.6	3.3	3.0	3.3
Industrial output (% yoy)	-0.4	-0.1	1.9	2.8	2.4	4.2	5.0
Unemployment rate (avg, %)	12.3	12.9	11.4	9.2	7.8	7.4	7.4
Nominal industrial wages (% yoy)	12.7	0.7	1.5	8.7	10.6	8.2	6.7
Producer prices (avg, % yoy)	4.2	-1.4	-1.2	-1.9	-3.0	1.0	1.6
Consumer prices (avg, % yoy)	3.0	0.9	-1.4	-0.1	-0.6	1.6	2.0
Consumer prices (eop, % yoy)	4.2	-1.6	-0.9	-0.4	-0.3	2.0	3.0
General budget balance (% of GDP)	-0.4	-1.8	-3.7	-2.8	0.3	-1.5	-2.0
Public debt (% of GDP)	16.7	17.2	26.4	25.6	29.0	29.0	31.0
Current account balance (% of GDP)	-0.2	1.9	1.2	1.1	2.1	0.4	1.0
Official FX reserves (EUR bn)	15.6	14.4	16.6	20.4	23.5	21.2	22.4
Gross foreign debt (% of GDP)	89.9	87.9	93.1	75.3	73.7	73.4	71.5
EUR/BGN (avg)	1.96	1.96	1.96	1.96	1.96	1.96	1.96
USD/BGN (avg)	1.52	1.47	1.47	1.76	1.76	1.90	1.79

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Diminishing fiscal stimulus to slow down GDP growth

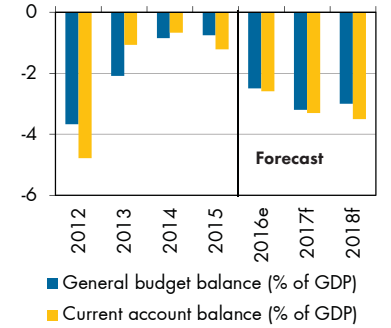
- **PSD won elections by large margin, new parliamentary majority easy to form**
- **GDP advance expected to remain robust, while domestic demand will remain primary driver**
- **Upward trend for inflation rate in 2017, as significant favourable statistical base effect will fade away**
- **First key rate hike expected for end of 2017, ROBOR rates may increase earlier**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget and current account balance



Source: National sources, RBI/Raiffeisen RESEARCH

Economic outlook

After beating expectations in both Q1 and Q2, real GDP growth slowed down more than expected in Q3, coming in at 0.6% qoq and 4.4% yoy. Moreover, both private consumption and gross fixed capital formation unexpectedly fell in Q3 (by 1.6% qoq and 6.5% qoq, respectively). None of the alternative macroeconomic indicators (retail sales, wages, consumer confidence) signalled a contraction of private consumption in Q3, so we see this trend as being temporary. While not expected, the contraction of gross fixed investment is less puzzling, as this GDP component was quite volatile over the past quarters. We have revised the GDP growth forecast for 2016 from 5.2% to 4.7%. **Economic growth will likely slow down in 2017 (to 3.6% in our baseline scenario), as the volume of fiscal stimulus is expected to diminish** as compared with 2016. In 2017, private consumption will likely benefit from the increase in disposable income (as wages in the public sector and minimum wage will be raised again), the low level of interest rates, and the improved confidence among individuals.

In the parliamentary elections held on 11 December, the **Social Democratic Party (PSD) won 45.6% of the votes**, which was a strong result, beating pollsters' expectations and outpacing the tally in the local elections from the summer. As a result, it has become easy for the PSD to form a majority with its ally, the Alliance of Democrats and Liberals (ALDE), which received around 5.8% of the votes. The parliamentary majority comprising the PSD and the ALDE should be fairly stable. The PSD should be able to take the position of prime minister and most of the ministers in the new cabinet. The economic programme for the period from 2017 to 2020 announced by the PSD before the elections envisages a broadly based reduction of taxes for all social categories (e.g. reduction of personal income tax, social contributions, VAT rate, etc.), with the majority of the cuts planned to be enforced in 2018. For the four years, the programme proposed a substantial increase of wages in the public sector and of the minimum wage in the economy. In

Key economic figures and forecasts

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	133.5	144.3	150.3	160.3	169.3	180.7	190.4
Real GDP (% yoy)	0.6	3.5	3.1	3.8	4.7	3.6	3.0
Industrial output (% yoy)	2.4	7.9	6.1	2.8	1.5	5.0	4.0
Unemployment rate (avg, %)	6.8	7.1	6.8	6.8	6.1	5.8	5.7
Nominal industrial wages (% yoy)	4.6	4.2	7.4	6.6	8.0	7.0	5.4
Producer prices (avg, % yoy)	5.4	2.1	-0.1	-2.2	-2.0	2.3	2.8
Consumer prices (avg, % yoy)	3.3	4.0	1.1	-0.6	-1.6	1.2	2.4
Consumer prices (eop, % yoy)	5.0	1.6	0.8	-0.9	-0.5	2.0	2.8
General budget balance (% of GDP)	-3.7	-2.1	-0.8	-0.8	-2.5	-3.2	-3.0
Public debt (% of GDP)	37.3	37.8	39.4	37.9	38.2	39.3	40.2
Current account balance (% of GDP)	-4.8	-1.1	-0.7	-1.2	-2.6	-3.3	-3.5
Official FX reserves (EUR bn)	35.4	35.4	35.7	35.6	37.3	38.4	39.1
Gross foreign debt (% of GDP)	75.5	68.0	63.0	56.4	54.4	53.1	53.6
EUR/RON (avg)	4.46	4.42	4.44	4.45	4.48	4.47	4.50
USD/RON (avg)	3.47	3.33	3.35	4.01	4.04	4.34	4.13

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

addition, an ample investment programme is planned. Overall, economic growth during 2017–2020 is expected to come in at 5.5% on average per year. The head of the PSD recently asked the government to cancel the reduction of taxes planned for 2017 (cut of the standard VAT rate from 20% to 19%, reduction of excises, and removal of tax on special construction), which would create room for the public budget deficit to remain close to 3.0% of GDP.

Both the current account deficit and the foreign trade deficit increased in 2016 from the levels seen in 2015, as the advance of exports of goods and services came in below that of imports. However, the deterioration was not abrupt and FDI inflows and capital transfers from the EU more than covered the current account deficit. We expect the **external imbalances to continue increasing in 2017 and in 2018**, but to remain at **manageable levels**.

The annual inflation rate has remained in negative territory (-0.7% yoy in November), benefiting from the cut of the standard VAT rate from 24% to 20% at the beginning of 2016. Still, despite a rapid increase in consumption and disposable income, the underlying inflationary pressures have not strengthened. For instance, the annual growth rate of the CORE 3 inflation measure (CPI excluding administered prices, volatile prices of food and fuels, and prices of tobacco and alcohol) remained close to 0.5% yoy during June–November. The annual inflation rate is expected to return to positive territory in Q1 2017, as the favourable statistical base effect related to the VAT rate cut in January 2016 will fade away. A strengthening of underlying inflationary pressures due to rapid economic growth and the disappearance of the favourable statistical base effect resulting from the decrease in energy prices in 2016 should keep the **annual inflation rate on an upward trend in 2017, likely putting it at 2.0% at the end of the year.**

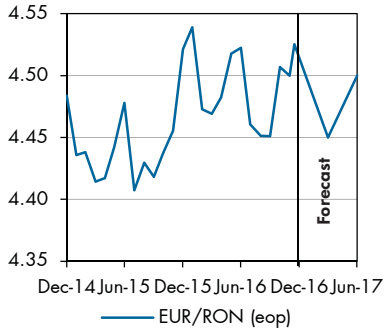
Financial analyst: Nicolae Covrig, CFA, Raiffeisen BANK S.A., Bucharest

Financial market outlook

Although it is decreasing, the liquidity surplus from the money market has remained elevated enough so as not to result in upside pressures on money market rates, which continued to trade at levels significantly below the monetary policy rate (1.75%) in Q4 2016. The anticipated spike in public spending in December is expected to boost the liquidity surplus again at the turn of the year. The liquidity surplus will likely start to decline again in Q1 2017, mainly as a result of the net positive issuance of RON government securities by the Ministry of Finance. The decreasing liquidity surplus may eventually result in some upward pressures on ROBOR rates in Q2 2017. However, such upward pressures are likely to become more evident in H2 2017, when the central bank may also tighten its monetary policy stance. **We expect the first key rate hike to be delivered in November** at the last monetary policy meeting in 2017. In anticipation of the key rate hike, an increase of the interest rate for the permanent deposit facility cannot be ruled out. EUR/RON is expected to remain stable over the course of 2017.

Financial analyst: Nicolae Covrig, CFA, Raiffeisen BANK S.A., Bucharest

Exchange rate development



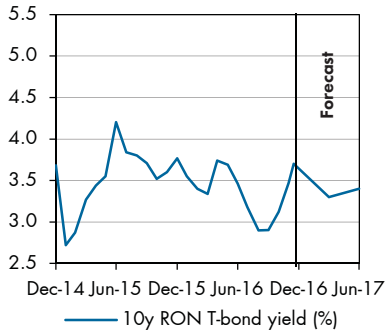
EUR/RON: 5y high 4.64, 5y low 4.29
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Exchange rate forecasts

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
EUR/RON	4.53	4.45	4.50	4.45	4.45
Cons.		*4.50*	*4.51*	*4.51*	*4.50*
USD/RON	4.34	4.28	4.41	4.36	4.24
Cons.		*4.28*	*4.31*	*4.25*	*4.20*

[1] 5:00 p.m. (CET)
Source: Bloomberg, RBI/Raiffeisen RESEARCH

RON yield development (%)



10y RON T-bond yield: 5y high 7.73, 5y low 2.66
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Interest rate forecasts (%)

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
Key rate	1.75	1.75	1.75	1.75	2.00
Consensus		*1.75*	*1.85*	*1.85*	*2.05*
3 month[2]	0.80	0.85	1.00	1.15	1.55
Consensus		*0.97*	*1.14*	*1.31*	*1.59*

[1] 5:00 p.m. (CET) [2] Offered rate
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Yield forecasts (%)

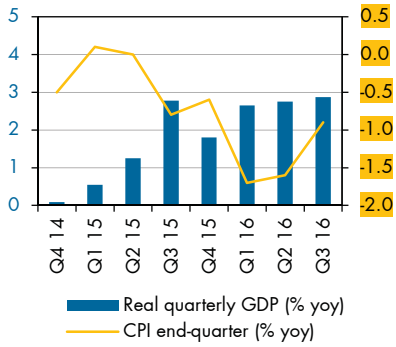
	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
3y T-bond[2]	1.68	1.7	1.8	1.9	2.1
Consensus		*n.v.*	*n.v.*	*n.v.*	*n.v.*
10y T-bond[2]	3.70	3.3	3.4	3.5	3.5
Consensus		*n.v.*	*n.v.*	*n.v.*	*n.v.*

[1] 5:00 p.m. (CET) [2] Bid yield
Source: Bloomberg, RBI/Raiffeisen RESEARCH

2017 – Chance to deliver reforms and make growth sustainable

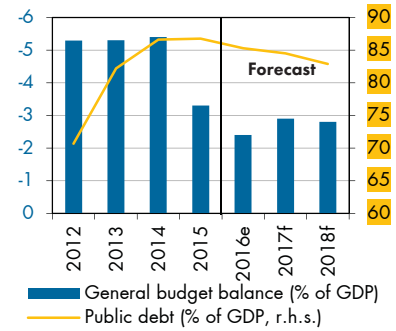
- **Growth driven by domestic demand**
- **Focus on the comprehensive tax reform**
- **Sustainability still to be created**
- **FX stability to be maintained**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget balance and public debt



Source: National sources, RBI/Raiffeisen RESEARCH

Economic and monetary policy outlook

Economic growth in 2016 will exceed even the most optimistic expectations. Croatia finally caught up with the recovery dynamics of its CEE peers, and these positive developments are expected to continue over 2017. The biggest **positive impact will come from domestic demand, primarily from household consumption** as well as both public and private investment. These GDP components will be positively influenced by the new comprehensive tax reform that passed through the parliamentary procedure in Q4 2016.

The aim was to create a stable, simple, and sustainable tax system in order to reduce the tax burden on entrepreneurs and households (estimated at around 1pp or below 37% of GDP). At the same time, the tax reform increases the potential GDP growth by an additional 0.6pp. The short-run cost of the tax reform in terms of lower budget revenues is estimated at HRK 3.3 bn. However, it is likely that part of the amount will be compensated through higher consumption and investment. Despite the elimination of certain exemptions, the income tax reduction is leading to rising consumer optimism.

Based on subdued inflation and the expectation that the year **2017 could bring another excellent tourist season**, we project that household consumption will continue with the growth trend seen in 2016. The importance of tourism is reflected in the structure of accommodation, where the share of private household accommodation is significant (50% apartments/rooms and 25% camping in the peak tourist season). Furthermore, tourism will continue to generate investments, which are widely supported by improved utilisation of EU funds. The latter pertains to both private and public investments. The expected strengthening of domestic demand and the relatively strong growth in exports of services (primarily tourism) entails stronger growth of imports of goods. Therefore, we expect a slightly negative effect of net foreign demand. In this context, the **low competitiveness of the Croatian real** sector (industry) and the consequently high import dependence

Key economic figures and forecasts

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	44.0	43.5	43.0	43.9	45.3	47.3	49.6
Real GDP (% yoy)	-2.2	-1.1	-0.5	1.6	2.7	2.8	2.8
Industrial output (% yoy)	-5.5	-1.8	1.2	2.6	3.7	4.2	3.8
Unemployment rate (avg, %)	15.9	17.4	17.3	16.3	13.6	12.5	11.2
Nominal industrial wages (% yoy)	1.9	1.7	1.5	-4.1	2.0	1.5	2.2
Producer prices (avg, % yoy)	7.0	0.5	-2.7	-3.9	-4.4	0.5	2.4
Consumer prices (avg, % yoy)	3.4	2.2	-0.2	-0.5	-1.2	1.3	2.2
Consumer prices (eop, % yoy)	4.7	0.3	-0.5	-0.6	-0.2	1.5	2.5
General budget balance (% of GDP)	-5.3	-5.3	-5.4	-3.3	-2.4	-2.9	-2.8
Public debt (% of GDP)	70.7	82.2	86.6	86.7	85.3	84.5	82.9
Current account balance (% of GDP)	0.0	1.0	2.1	5.0	3.1	2.5	2.2
Official FX reserves (EUR bn)	11.2	12.9	12.7	13.8	13.2	13.5	13.6
Gross foreign debt (% of GDP)	103.0	105.7	108.6	103.8	96.5	94.0	91.5
EUR/HRK (avg)	7.52	7.58	7.63	7.61	7.53	7.52	7.51
USD/HRK (avg)	5.85	5.71	5.76	6.86	6.78	7.30	6.89

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

are key factors. Actually, despite the positive changes and the fact that Croatian companies (especially SMEs) turned to foreign markets, it is clear that exports of goods and their importance in Croatia remain too minor and weak to be a serious growth driver. Moreover, it clearly emphasises the problems of the local market. The problems are mainly well known and structural, and, among others, include a costly and inefficient public administration and frequent changes in regulations. In addition to strengthening the rule of law, the problem of the large public systems (health, education, and social affairs) should be the key issues that the government has to tackle in the first year of their mandate. Improved fiscal indicators represent a good starting point to make economic growth and development more stable and sustainable.

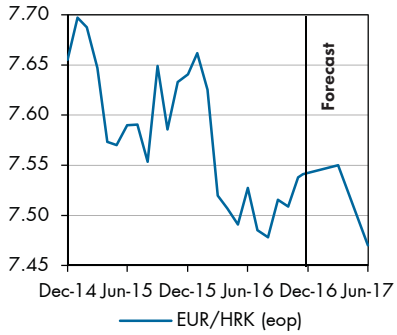
Despite the realistic appearance of the revenue side of the budget for the three-year period from 2017 to 2019, the chance to reduce and structurally change the expenditures was squandered. Moreover, the significant pressures of different budget users increase the risk of expenditures growth. Therefore, our assessment remains conservative compared with the government's forecasts. Still, the estimated deficit below 3% of GDP is sufficient to achieve a primary surplus. As a consequence, public debt will continue to decrease at a modest pace.

Financial market outlook

Political stability, better than expected economic growth, and more favourable fiscal metrics support our expectations that the **sovereign credit rating will become stable**, at least in the short run. An upgrade of the credit rating would require much more, however. First, it would require that the government deliver comprehensive reforms. It would be accurate to say that 2017 is the year of big maturities, as HRK 18.4 bn in liabilities arising from issued bonds and HRK 8.9 bn from loans will come due. As a result, **we expect the government to take on a more active role on the primary market**, at both the local and European level. Q1 2017 seems more demanding in terms of maturities. Huge local market players (primarily mandatory investment funds) might finally satisfy their hunger from pure HRK bond issuance, while a Eurobond is expected to follow soon after that. This will be the first sovereign Eurobond issuance in nearly two years. During H1 2017, prices on the secondary market will likely remain relatively high and yields low, receiving an additional boost from the ample liquidity in the system. The accommodative monetary policy is expected to remain in place, putting pressure on money market rates and yields. As a recovery in economic activity in Croatia is usually accompanied by a strengthening of the local currency, we see a lower EUR/HRK on average. After slight depreciation pressure in Q1 (due to dividend payouts and stronger EUR demand), we expect **HRK to find support in a solid 2017 tourist season**, improved fiscal metrics, a positive net foreign position of banks, and an FCY inflow from investment activity. Of course, the CNB will remain fully committed to maintaining HRK stability, so no major volatility is expected.

Financial analyst: Z. Živković Matijević, Raiffeisenbank Austria d.d., Zagreb

Exchange rate development



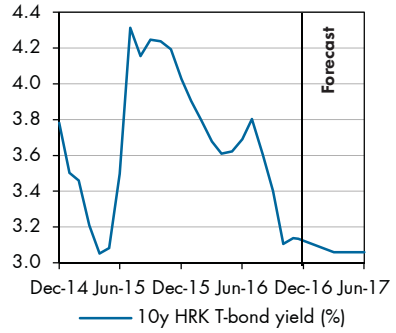
EUR/HRK: 5y high 7.72, 5y low 7.39
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Exchange rate forecasts

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
EUR/HRK	7.54	7.55	7.47	7.50	7.55
Cons.		*7.61*	*7.61*	*7.62*	*7.63*
USD/HRK	7.24	7.26	7.32	7.35	7.19
Cons.		*6.97*	*6.96*	*6.94*	*6.95*

[1] 5:00 p.m. (CET)
Source: Bloomberg, RBI/Raiffeisen RESEARCH

HRK yield development (%)



10y HRK T-bond yield: 5y high 7.42, 5y low 3.01
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Interest rate forecast (%)

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
3 month[2]	0.85	0.90	0.90	0.95	0.90

[1] 5:00 p.m. (CET) [2] Offered rate
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Yield forecasts (%)

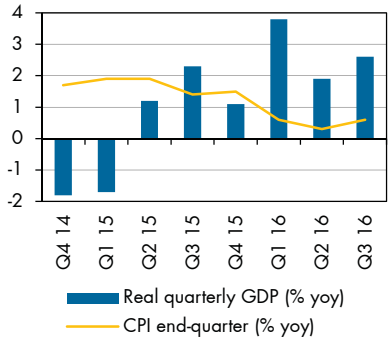
	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
2y T-bond	1.29	1.3	1.3	1.4	1.5
Consensus		n.v.	n.v.	n.v.	n.v.
10y T-bond	3.14	3.1	3.1	3.2	3.3
Consensus		*n.v.*	*n.v.*	*n.v.*	*n.v.*

[1] 5:00 p.m. (CET)
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Public sector reforms ahead

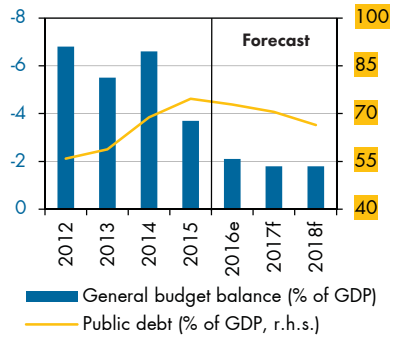
- **Advancing economic growth to continue in 2017**
- **CPI to enter the targeted range in early 2017**
- **Budget deficit to fall below 2% of GDP in 2017**
- **Abundant MinFin T-bills supply, yields at a standstill**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Economic growth in 2017 (3%) is expected to be supported by exports, infrastructure investments and a mild recovery of private spending. In anticipation of a resurgence in inflation, the NBS cut the key rate only twice during 2016 (cumulative cut of 50bp), while making greater use of FX interventions (EUR 1.58 bn) and repo auctions. Stable and low inflation and macroeconomic developments prompted the NBS to cut the inflation target range by 100bp to 3% +/- 1.5pp from early 2017, making it more realistic that inflation will return to within the range at the beginning of 2017. Consequently, the **NBS is likely to leave the key rate unchanged at 4% throughout the year.** Traditionally more sensitive EUR/RSD movements in Q1 amidst a seasonally weaker economic cycle and the preparations for May's presidential elections will be offset through FX interventions.

The government plans to trim down the budget deficit to around 1.7% of GDP (2016e: 2.1%). Although the deficit will widen in absolute terms, its level is still low – close to the 2008 level – and the broadening is predominately fuelled by capital expenditure growth. Smaller adjustments in wages and procurement expenses growth will add to the deficit growth to some extent, although this will also be supportive for private spending. In relative terms, the public debt/GDP ratio will fall (2017e: 70.5%), although the absolute amount will be boosted due to increased refinancing needs for foreign borrowings. The sustainability of the decline in the fiscal ratio is still a function of the success of the privatisation/restructuring of state-owned companies (EPS, Railway, RTB Bor) that will be on the agenda in 2017/2018. According to the Budget Law for 2017, the **Finance Ministry plans to increase the MinFin T-bills issuance by EUR 1 bn to EUR 4.7 bn**, of which EUR 3 bn is earmarked for local debt refinancing. It is not quite clear where the remaining EUR 1.7 bn will be channelled (SOEs, increased refinancing of foreign borrowings in 2017). Similar to the previous year's budget, the government is planning a new Eurobond placement of roughly EUR 1 bn.

Financial analyst: Ljiljana Grubic, Raiffeisenbank a.d., Belgrade

Key economic figures and forecasts

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	31.7	34.3	33.1	33.3	35.0	37.5	39.8
Real GDP (% yoy)	-1.0	2.6	-1.8	0.7	2.7	3.0	3.0
Industrial output (% yoy)	-2.9	5.5	-6.5	7.8	4.8	6.5	6.0
Unemployment rate (avg, %)	23.9	22.1	20.1	17.9	18.0	16.0	14.0
Nominal industrial wages (% yoy)	1.5	1.5	4.0	2.9	4.0	4.0	4.0
Producer prices (avg, % yoy)	5.6	3.6	0.7	0.2	-0.5	1.5	2.5
Consumer prices (avg, % yoy)	7.3	7.9	2.1	1.4	1.1	2.5	2.9
Consumer prices (eop, % yoy)	12.2	2.2	1.7	1.5	1.8	2.8	3.0
General budget balance (% of GDP)	-6.8	-5.5	-6.6	-3.7	-2.1	-1.8	-1.8
Public debt (% of GDP)	55.9	58.8	68.8	74.7	72.8	70.5	66.4
Current account balance (% of GDP)	-11.5	-6.1	-6.0	-4.6	-3.7	-3.7	-3.5
Official FX reserves (EUR bn)	10.9	11.2	10.0	10.4	10.0	10.8	11.5
Gross foreign debt (% of GDP)	81.1	75.4	78.6	81.6	74.3	70.6	66.6
EUR/RSD (avg)	113.0	113.1	117.3	120.7	123.2	123.6	124.9
USD/RSD (avg)	88.0	85.2	88.5	108.8	111.0	120.0	114.6

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Bosnia and Herzegovina is back on the EU path again

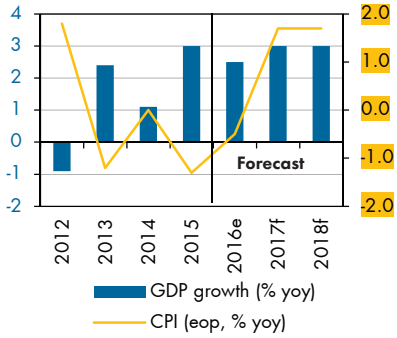
- **Downward revision of estimated GDP to 2.5% yoy in 2016 due to delayed start of investment cycle**
- **Acceleration of economic growth in mid-term period still expected**
- **B&H authorities continue with the EU accession processes**
- **Arrangement with IMF through Extended Fund Facility is our baseline scenario for 2017**

Bosnia and Herzegovina continued with its **moderate recovery pace in 2016**, reporting real economic growth slightly below our expectations, which triggered a downward revision of real GDP growth to 2.5% yoy. The primary reasons for the revision were the underperformance of gross investments and the delay in the continuation of the infrastructure work on Corridor Vc and the start of the work on TPP Tuzla announced for H2 2016.

Coming to the mid-term outlook in the forecasted period, we are still optimistic regarding the acceleration of economic activity, although we have also revised our projections for GDP growth rates downward slightly by 50bp (to 3% yoy in 2017 and 3.5% in 2018) by calculating in the effect of the delays in investment measures planned for 2016. An expected acceleration of economic growth will likely be driven by a **resumption of the blocked public investment work on Corridor Vc and TTP Tuzla**, accompanied by a continuation of the smaller investments in hydroelectric power plants (HP Vranduk) and wind power plants (WP Podvelezje and Mesihovina). Gross investments are projected to expand by 9.3% in 2017–2018, followed by more robust real growth of exports of goods and services by 5.9% yoy thanks to a more favourable external environment for exports of goods from the country (higher forecasted prices of industrial metals and electricity on global markets in 2017) accompanied by a stable recovery of external demand in EA and SEE. In 2017, we expect a **continuation of the EU accession processes in the country**, which were unblocked in 2016 after a positive answer by the EC on Bosnia and Herzegovina's membership application. There are potential downside risks to our mid-term outlook related to potential latent political disagreements and delays in public investments or disruptions related to the Extended Fund Facility Agreement with the IMF, which will likely remain the major driver of the reform processes in the country.

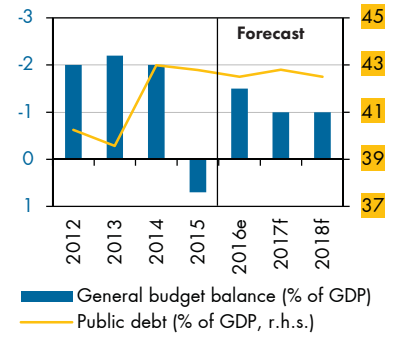
Financial analyst: Ivona Zametica (+387(33) 287 784), Raiffeisen BANK d.d., Sarajevo

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget balance and public debt



Source: National sources, RBI/Raiffeisen RESEARCH

Key economic figures and forecasts

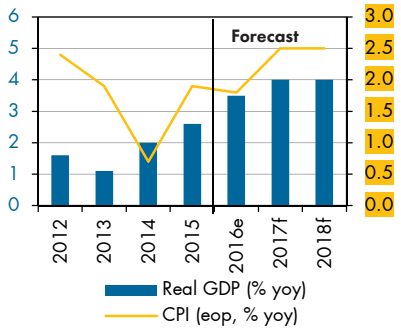
	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	13.4	13.7	14.0	14.6	15.2	16.0	17.1
Real GDP (% yoy)	-0.9	2.4	1.1	3.0	2.5	3.0	3.5
Industrial output (% yoy)	-5.2	6.7	0.1	2.6	4.1	5.5	7.0
Unemployment rate (avg, %)	28.0	27.5	27.5	27.7	25.4	24.3	23.0
Nominal industrial wages (% yoy)	2.2	-0.5	0.3	0.0	3.0	5.0	5.5
Producer prices (avg, % yoy)	1.3	-2.2	-0.2	0.6	1.5	2.0	2.2
Consumer prices (avg, % yoy)	2.1	-0.1	-0.9	-1.0	-0.9	2.0	2.0
Consumer prices (eop, % yoy)	1.8	-1.2	0.0	-1.3	-0.5	1.7	2.1
General budget balance (% of GDP)	-2.0	-2.2	-2.0	0.7	-1.5	-1.0	-1.0
Public debt (% of GDP)	40.3	39.6	43.0	42.8	42.5	42.8	42.5
Current account balance (% of GDP)	-9.1	-5.3	-7.5	-5.6	-5.4	-7.0	-7.7
Official FX reserves (EUR bn)	3.3	3.6	4.0	4.4	4.6	4.8	5.0
Gross foreign debt (% of GDP)	52.2	52.2	51.8	53.4	54.7	54.9	54.2
EUR/BAM (avg)	1.96	1.96	1.96	1.96	1.96	1.96	1.96
USD/BAM (avg)	1.52	1.47	1.47	1.76	1.76	1.90	1.79

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Public debt on decline

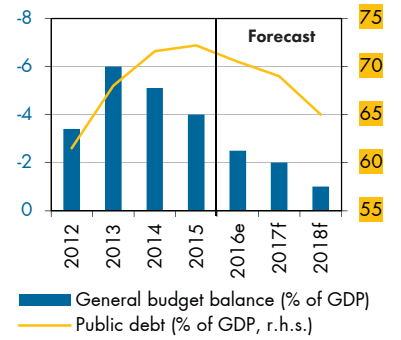
- **Public debt on decline for first time in last five years**
- **Economy to continue growth trend at around 4% in 2017**
- **General elections to be held in mid-2017**
- **Opening of negotiation phase for EU accession likely to start in mid-2017**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget balance and public debt



Source: National sources, RBI/Raiffeisen RESEARCH

The Albanian economy remains on the recovery path, with growth of 3.2% in Q2 2016. The expectations for GDP growth for 2016 as a whole are still at about 3.5%, supported mostly by investments in large projects in energy and a pickup in private consumption. Growth is expected to come in stronger at around 4.0% in 2017, as the **implementation of reforms will improve the business climate**, increase investments in the energy and tourism sectors in particular, and raise employment. Despite the positive economic performance, growth is still below the potential and overall inflationary pressures are subdued. The annual inflation rate rose to 1.9% in November, but it remains well below the target of 3.0% set by the Bank of Albania. The monetary stimulus will not be reduced until the second part of 2017. We would expect a gradual increase in the CPI, with inflation averaging 2.2% in 2017. Public debt has started to decline for the first time in five years, falling from 72.2% of GDP in December 2015 to 69.8% of GDP by September 2016. The increase in revenues, the decrease in capital expenditures, and structural reforms are the main reasons behind the decline. Despite the fact that public investments are expected to rise in 2017, the IMF has certified next year's budget, and the goal is for public debt to decrease to around 69% of GDP. The fiscal consolidation will continue in 2017, with the government aiming for a budget deficit of 2% of GDP.

Albania got a positive **recommendation from the European Commission to open the negotiation process**. The Council of Europe will make a decision by mid-December, which probably will suggest the opening of the negotiation process, conditioned by the implementation of the judiciary system reform. However, the negotiation process is unlikely to start until after the first half of 2017.

It is still unclear whether the current coalition will run together in the next elections. If the governing coalition keeps the current alignment, they are more likely to win as they would be able to capitalise on the successes of the implementation of the structural reforms and the progress made toward the EU integration process.

Financial analyst: Valbona Gjeka, Raiffeisen Bank Sh.a., Tirana

Key economic figures and forecasts

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	9.6	9.7	10.0	10.3	11.0	11.7	12.4
Real GDP (% yoy)	1.6	1.1	2.0	2.6	3.5	4.0	4.0
Industrial output (% yoy)	2.8	2.4	3.0	3.0	1.0	2.5	3.0
Unemployment rate (avg, %)	13.3	17.0	18.0	17.7	16.5	15.0	14.0
Nominal industrial wages (% yoy)	8.0	8.0	8.0	8.0	3.0	1.9	3.7
Producer prices (avg, % yoy)	1.1	-0.4	-0.5	1.0	-2.5	1.0	2.0
Consumer prices (avg, % yoy)	2.0	1.9	1.6	1.8	1.3	2.2	2.7
Consumer prices (eop, % yoy)	2.4	1.9	0.7	1.9	1.8	2.5	3.0
General budget balance (% of GDP)	-3.4	-6.0	-5.1	-4.0	-2.5	-2.0	-1.0
Public debt (% of GDP)	61.5	68.0	71.6	72.2	70.5	69.0	65.0
Current account balance (% of GDP)	-9.4	-10.5	-12.9	-13.6	-13.6	-14.5	-12.9
Official FX reserves (EUR bn)	2.0	2.0	2.2	2.9	2.8	2.8	2.8
Gross foreign debt (% of GDP)	57.4	65.5	69.2	72.6	71.8	69.1	67.0
EUR/ALL (avg)	139.0	140.3	140.0	139.7	137.5	137.5	139.4
USD/ALL (avg)	108.2	105.7	105.5	126.0	123.8	133.5	127.9

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

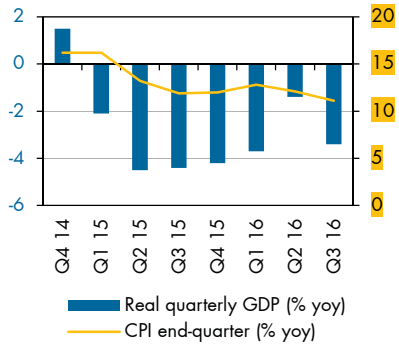
Structural weaknesses limit growth prospects

- **Second recessionary year in a row amidst slow recovery in Russia**
- **Unfavourable potash prices, and crude undersupplies by Russia**
- **BYN is on a long-term depreciation path**
- **Inflation has slowed down and is developing in line with official forecasts**

The estimated 3% drop in GDP in 2016 is linked to the slow recovery in the Russian economy, interruptions in crude supplies by Russia due to the gas price dispute, and lower demand for potash fertilisers. Industrial output registered a 1.5% contraction, and investment fell by 19.5%. We **project GDP stagnation in 2017, followed by a return to 1.5% growth in 2018.** The economic growth prospects are limited by the structural weaknesses, mainly related to inefficient state-owned enterprises. The government has started a number of structural reforms, but is still taking a very cautious approach. Meanwhile, Belarus' growth will be largely dependent on the rollover of the foreign financing and continuation of possibly shrinking energy subsidies. **Inflation came down to a cumulated 10.1% for the first 11 months of 2016 and is expected to gradually decline to single-digit levels by 2018.** The local currency depreciated by 14% in 2016, with especially strong depreciation at the beginning of the year. The stability on the FX market through the end of 2016 was ensured primarily by the ongoing sale of foreign currency by households. Domestic FX bond issuance and EFSD loan tranches were also supportive. Going forward, **we project a further gradual weakening of the BYN**, stemming from persistently high external debt repayments, fragility in foreign trade, and limited options for external financing. We expect the country's current account to remain in deficit, but to contract amidst a slight recovery in commodity prices, the likely resolution of the energy spat with Russia, and the recovery of crude supplies by Russia. Investment and consumer imports are expected to remain weak. On the contrary, in the event that tax measures materialise in the Russian oil industry, income from oil export duties will decrease. In 2017, the inflows from EFSD loan tranches of up to USD 1 bn, domestic FX bond issuance, potential Russian inter-budget gas subsidies, and the privatisation of two state-owned banks (Belinvestbank and Moscow-Minsk) may still leave an FX liquidity gap, which could be covered by a Eurobond or – less likely – an IMF loan.

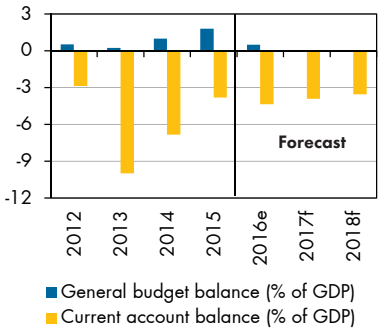
Financial analyst: Natalya Chernogorova, Priorbank Open Joint-Stock Company, Minsk

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget and current account balance



Source: National sources, RBI/Raiffeisen RESEARCH

Key economic figures and forecasts

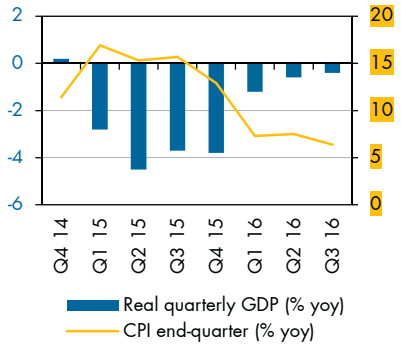
	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	49.4	54.9	57.2	49.1	43.5	47.1	46.6
Real GDP (% yoy)	1.7	1.0	1.7	-3.9	-3.0	0.0	1.5
Industrial output (% yoy)	5.8	-4.9	2.0	-6.6	-1.5	0.5	2.0
Unemployment rate (avg, %)	0.5	0.5	0.5	1.0	1.5	2.0	2.0
Nominal industrial wages (% yoy)	93.8	35.2	20.1	7.6	8.0	10.0	10.0
Producer prices (avg, % yoy)	76.0	13.6	12.8	16.8	14.5	12.5	11.0
Consumer prices (avg, % yoy)	59.2	18.3	18.1	13.5	14.0	12.0	11.0
Consumer prices (eop, % yoy)	21.8	16.5	16.2	12.0	12.0	11.0	9.0
General budget balance (% of GDP)	0.5	0.2	1.0	1.8	0.5	0.0	0.0
Public debt (% of GDP)	31.3	32.5	34.1	33.0	39.0	38.7	36.5
Current account balance (% of GDP)	-2.9	-10.0	-6.8	-3.8	-4.3	-3.9	-3.5
Official FX reserves (EUR bn)	6.1	4.8	4.2	3.8	4.6	4.2	3.9
Gross foreign debt (% of GDP)	51.9	51.8	52.6	70.2	77.6	77.3	73.3
EUR/BYN (avg)	1.07	1.18	1.36	1.77	2.21	2.29	2.61
USD/BYN (avg)	0.84	0.89	1.02	1.60	1.99	2.22	2.39

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

First year after recession

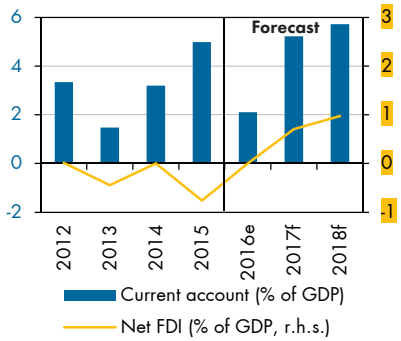
- **GDP growth to be supported by rising oil prices**
- **CBR cautious with key rate cuts to achieve the 4% inflation target**
- **Larger capital outflows could counterbalance oil support for RUB**
- **Fixed-coupon OFZs no longer very attractive**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Current account and FDI inflows



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Economic outlook

In 2017, **we expect the Russian economy to shift to positive growth rates (1% yoy)** amidst a projected rise in average oil prices to above USD 58/bbl. The recovery of domestic demand will be the main driver of growth in 2017 on the back of a pick-up in private consumption (+2.5% yoy) and fixed asset investment (+3% yoy). The inventory cycle may be supportive for a recovery of GDP, although its contribution will be less visible than in 2016. The contribution of net exports to GDP growth will remain around zero against the backdrop of relatively weak export dynamics and a rather pronounced recovery of imports. In 2017, we also expect an improvement **on the supply side, which could translate into 1% yoy growth for industrial production**. While the support from the rouble depreciation of 2014–2015 will virtually disappear and no further pronounced weakening is expected, the main driver of industrial output growth will be domestic demand, while exporters may lose some of their competitive advantages. Meanwhile, we expect **inflation to continue its downward trend in the direction of the CBR's target of 4% by year-end 2017**. However, our base case scenario puts CPI inflation at 5% yoy in 2017, which reflects some material risks for the announced target level. Although we believe that most of the necessary conditions are likely to be met in order to facilitate a continuation of the disinflation (modest regulated tariff indexation, relatively slow recovery of consumption, rouble appreciation), there are risks connected with the indexation of social expenditures that may make the path to the 4% target rather bumpy. Even if the target is reached, we do not believe that this level is quite sustainable, given the large share of non-monetary factors in the CPI. Thus, the CBR's policy is most likely to remain rather cautious and data-dependent. We now expect the first 50bp key rate cut to come no earlier than in March 2017, with a **total of three cuts (150bp) throughout the year**.

Financial analysts: Stanislav Murashov, AO Raiffeisenbank, Moscow

Key economic figures and forecasts

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	1,677.1	1,678.8	1,527.1	1,188.1	1,110.8	1,374.8	1,411.2
Real GDP (% yoy)	3.5	1.3	0.7	-3.7	-0.5	1.0	1.5
Industrial output (% yoy)	2.6	0.4	1.7	-3.4	0.5	1.0	2.0
Unemployment rate (avg, %)	5.5	5.5	5.1	5.6	6.0	6.0	6.0
Average gross wages (% yoy)	13.9	11.9	9.1	4.4	4.0	6.0	6.0
Producer prices (avg, % yoy)	5.1	3.7	5.9	13.0	9.0	7.5	6.5
Consumer prices (avg, % yoy)	5.1	6.8	7.8	15.6	7.2	5.4	5.2
Consumer prices (eop, % yoy)	6.6	6.5	11.4	12.9	6.0	5.0	5.0
General budget balance (% of GDP)	0.4	-1.0	-1.0	-3.6	-4.4	-3.3	-2.4
Public debt (% of GDP)	10.5	11.3	11.5	12.7	13.5	14.0	14.5
Current account balance (% of GDP)	3.3	1.5	3.2	5.0	2.1	5.2	5.7
Official FX reserves (EUR bn)	407.8	369.8	318.5	339.1	366.7	385.7	373.9
Gross foreign debt (% of GDP)	29.5	32.7	29.5	39.1	40.6	32.6	27.0
EUR/RUB (avg)	39.9	42.3	51.0	68.0	74.3	63.7	66.8
USD/RUB (avg)	31.1	31.9	38.6	61.3	67.0	61.8	61.3

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

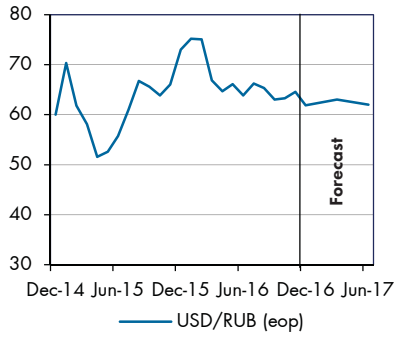
Financial market outlook

In Q4 2016, the surge in yields on US T-bonds did not result in a significant weakening of RUB, as the currency gained support from the oil-exporting countries' agreement to cut production. We note that the oil rebound has caused RUB to appreciate against USD by just 4 RUB (the rouble oil price increased from below RUB 3,000 to above RUB 3,400). We believe that the performance of RUB in comparison to oil can be attributed to higher capital outflows driven by residents' demand for foreign assets (due to higher yields on dollar assets) and the peak in external debt redemption in December 2016 (USD 13.4 bn). Russian banks have already spent a significant portion of their FX liquid assets, which have decreased by USD 25 bn to USD 47 bn YTD. Compared to FX-denominated balances on banks' current accounts (USD 42 bn), there is very little room for a further reduction of FX liquid assets to compensate for outflows from corporate accounts, which are to remain high. For example, **Rosneft alone needs to repay roughly USD 13 bn of its debt (mostly external) in 2017**. Based on these factors, we revised our projection for total non-debt capital outflows upward by USD 10 bn for 2017, which offset the upward change in our oil forecast. As a result, **we made only a modest adjustment to our USD/RUB exchange rate forecast.** Over the long term (forecast for 2019), a recovery of imports backed by economic growth will increase depreciation pressure on RUB, with all other factors being equal.

Yields on OFZs turned out to be very volatile in Q4: A moderate sell-off by foreign investors triggered a significant jump in yields (+100bp up to a YTM of 9% for ten-year papers). This is evidence of the fragility of the local market without foreign demand, as local banks fundamentally do not consider the current yields on fixed-coupon OFZs as attractive to buy and hold. So far, the main driver of the decline of OFZ yields has been the rather low volume of placements: Only a net amount of RUB 253 bn of fixed-coupon OFZs was placed in the first 11 months of 2016, whereas foreigners bought RUB 400 bn. In 2017, the situation may be different as 1) the Minfin aims to print a net amount of over RUB 1 tn of OFZs (twice as high as in 2016); 2) RUB yields are not as high as they were a year ago (while there is no expectation that USD rates will remain low for an extended period of time); and 3) there is not much potential for RUB appreciation from the current level. Based on these factors, we revised our forecast for fixed-yield OFZs upward (by 100bp for ten-year maturities). However, we do not rule out that the Minfin will prefer to mostly place floaters, thus limiting the supply of fixed-coupon papers, which could drive their yields to artificially low levels (this is not our base case). Therefore, local banks will be happy buying floaters to get extra margin over RUONIA and foreigners will be happy holding fixed-coupon papers to get additional gains on re-pricing. We recommend buying floating OFZs, as they have low volatility and their implied fixed yields have a premium of 20–40bp over the standard OFZ yield curve. Within the fixed-coupon OFZ segment, we prefer papers on the belly of the curve.

Financial analysts: Denis Poryvay, AO Raiffeisenbank, Moscow

Exchange rate development



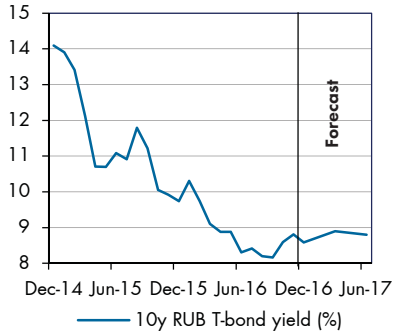
USD/RUB: 5y high 84.24, 5y low 29
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Exchange rate forecasts

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
EUR/RUB	64.46	65.5	63.2	61.2	65.1
Cons.		*69.0*	*68.5*	*68.8*	*69.7*
USD/RUB	61.89	63.0	62.0	60.0	62.0
Cons.		*64.5*	*64.5*	*64.4*	*64.2*

[1] 5:00 p.m. (CET)
Source: Bloomberg, RBI/Raiffeisen RESEARCH

RUB yield development (%)



10y RUB T-bond yield: 5y high 16.24, 5y low 6.44
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Interest rate forecasts (%)

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
Key rate	10.50	9.50	9.00	8.50	8.50
Consensus		*9.6*	*9.0*	*8.6*	*8.3*
3 month[2]	10.64	10.10	9.60	9.10	9.10
Consensus		n.v.	n.v.	n.v.	n.v.

[1] 5:00 p.m. (CET) [2] Offered rate
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Yield forecasts (%)

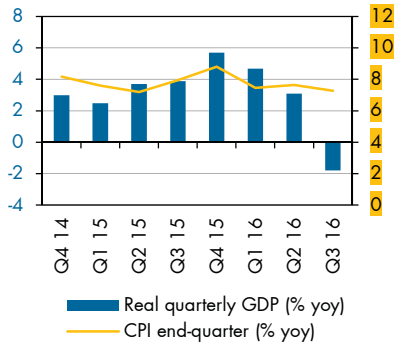
	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
2y T-bond[2]	8.37	8.70	8.70	8.50	8.20
Consensus		*n.v.*	*n.v.*	*n.v.*	*n.v.*
10y T-bond[2]	8.58	8.90	8.80	8.70	8.60
Consensus		*n.v.*	*n.v.*	*n.v.*	*n.v.*

[1] 5:00 p.m. (CET) [2] Bid yield
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Tough times for Turkey

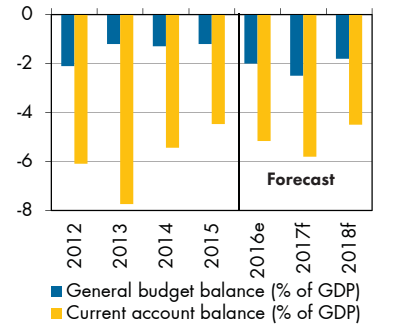
- **GDP contraction in Q3 - substantial downward revison of GDP for 2016/17**
- **Corporate balance sheets and financial stability at risk**
- **Prolongation of lira weakness expected**
- **Against this backdrop, we would not re-enter TURKGBs yet**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget and current account balance



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Economic outlook

In Q3, the GDP growth rate contracted strongly by 1.8% yoy, the first negative rate since Q3 2009. The expenditure breakdown of the data confirmed what was widely expected: July's coup attempt took a heavy toll on the economy, as private consumption contracted by 3.2 % yoy and fixed investment by 0.6% yoy. Exports of goods and services also dragged on growth, falling by 7.0% yoy in Q3 and reflecting the shortfall of tourist arrivals. By contrast, public consumption expanded at a double-digit rate, at 24% yoy. Driven in part by the change in methodology (the Turkish statistical office released major revisions to its national accounts data), the sharp contraction in Q3 led us to revise our full-year growth estimates for both 2016 and 2017 down to around 2%, which also reflects the intensified external headwinds. The leading economic indicators do not hint at a v-shaped rebound, either: Although it recovered from September's disappointing level, industrial production for October still proved to be a negative signal for GDP growth going into the end of the year. In addition, November's PMI survey data signalled a further deterioration of business conditions in the Turkish manufacturing sector. The PMI remained below the critical 50-point threshold for the eighth month in a row in November, indicating that the sub-par growth momentum continues as we move towards the end of the year. The same can be said of the latest figures for consumer confidence. As a result, Prime Minister Binali Yildirim has revealed genuine measures to revive the Turkish economy in 2017. However, he delivered contradictory messages as he wants 2017 to be a "year of austerity" for the public sector while introducing massive support to accelerate the credit volume, creating 600,000 new jobs, and providing further incentives for investments.

The slowing economy and the weaker lira have increased the likelihood of a marked deterioration in bank asset quality next year. Any additional lira depre-

Key economic figures and forecasts*

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	612.2	618.8	602.5	647.1	645.3	669.3	714.9
Real GDP (% yoy)	2.1	4.2	2.9	4.0	2.0	2.0	3.5
Industrial output (% yoy)	2.5	3.1	3.6	3.2	2.0	2.5	3.5
Unemployment rate (avg, %)	8.4	9.0	9.9	10.3	10.0	10.3	10.0
Nominal industrial wages (% yoy)	6.0	6.0	n.v.	n.v.	n.v.	n.v.	n.v.
Producer prices (avg, % yoy)	6.1	4.5	10.2	6.0	5.0	6.0	5.0
Consumer prices (avg, % yoy)	8.9	7.5	8.9	7.7	7.6	8.0	7.5
Consumer prices (eop, % yoy)	6.1	7.4	8.2	8.8	7.0	8.2	7.0
General budget balance (% of GDP)	-2.1	-1.2	-1.3	-1.2	-2.0	-2.5	-1.8
Public debt (% of GDP)	36.2	36.2	35.0	34.0	32.0	33.0	32.0
Current account balance (% of GDP)	-6.1	-7.7	-5.4	-4.5	-5.2	-5.8	-4.5
Official FX reserves (EUR bn)	90.4	95.1	105.2	101.7	104.8	104.8	91.3
Gross foreign debt (% of GDP)	43.1	47.3	50.3	55.4	57.2	60.9	57.8
EUR/TRY (avg)	2.31	2.53	2.90	3.02	3.34	3.53	3.63
USD/TRY (avg)	1.80	1.91	2.19	2.73	3.01	3.43	3.33

** new revisions to national accounts data not included*
Source: Thomson Reuters, wiiw, RBI/Raiffeisen RESEARCH

ciation would further weaken corporate balance sheets and jeopardise financial stability, given corporates' large open FX positions. Given the central bank's limited FX reserves, any intensification of risk aversion against Turkish assets would make it very difficult for the Turkish central bank to avoid substantial interest rate hikes. As the lira has lost nearly one-fifth of its value against the dollar this year, the cumulative depreciation effect could add up to 2 percentage points to headline inflation over the next 12 months, curbing the monetary scope even further.

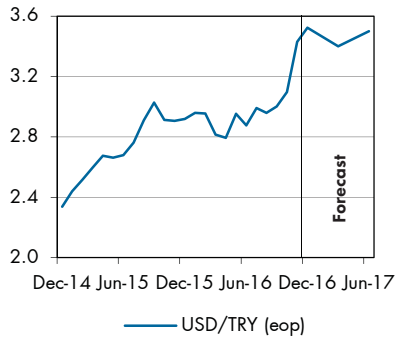
Financial market outlook

The mixture of negative newsflow for TRY in recent months – the political changes in Turkey during 2016 and the aftermath of the failed military coup in particular, the USD strength, and the geopolitical conflicts – was widespread, and led to a historic weakening of the lira. While in our view this phase of depreciation has already reached stages of fundamental overshooting at the end of Q4 with USD/TRY at 3.50, the basic components of TRY weakness and volatility are bound to remain throughout Q1 and 2017 as a whole. As a result, we see **very limited scope for any sustainable lira strengthening** in the coming months. Then again, unless we see further escalation, we would not expect significant additional lira weakening from the current very elevated levels, either. Some very moderate appreciation potential could be seen in the second half of 2017, but risk is currently clearly tilted towards a rather prolonged phase of TRY weakness. In any case, volatility is expected to remain elevated.

The repricing on the US bond markets based on higher inflation expectations hit Turkey at a time when TRY assets were already facing considerable bear pressure. The unreasonable response to the failed coup attempt was the straw that broke the camel's back, triggering the downgrade by Moody's to sub-investment grade back in September. This led to index-related outflows from the local Turkish financial markets. In addition, support from economic fundamentals also seems to be deteriorating, with CPI and current account dynamics passing their inflexion points. Against this backdrop and in an attempt to demonstrate its independence, the TCMB tightened monetary conditions, and we see elevated risks that it will be forced into putting more coal on the fire to stabilise the lira markets in a more sustainable manner. However, there is still a risk of a vicious cycle between the pass-through from the TRY weakening to inflation, which is likely not finished yet. At the same time, (geo)political risks are becoming more acute, so we continue to sell Turkey. **Once the Turkish lira stabilises, however, re-entering the TURKGB market could be worth considering** as a speculative trade.

Financial analysts: Lydia Kranner, Stephan Imre, RBI Vienna

Exchange rate development



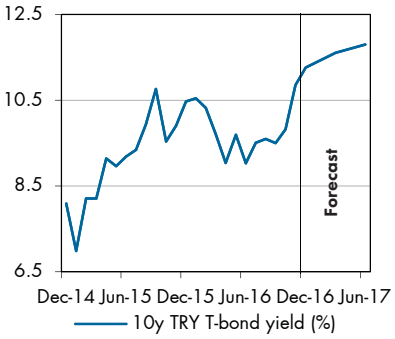
USD/TRY: 5y high 3.55, 5y low 1.74
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Exchange rate forecasts

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
EUR/TRY	3.67	3.54	3.57	3.47	3.52
Cons.		*3.54*	*3.53*	*3.57*	*3.68*
USD/TRY	3.52	3.40	3.50	3.40	3.35
Cons.		*3.40*	*3.46*	*3.50*	*3.50*

[1] 5:00 p.m. (CET)
Source: Bloomberg, RBI/Raiffeisen RESEARCH

TRY yield development (%)



10y TRY T-bond yield: 5y high 11.26, 5y low 6.02
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Interest rate forecasts (%)

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
Key rate	8.00	8.50	8.50	8.50	8.50
Consensus		*8.15*	*8.15*	*8.15*	*8.10*
3 month[2]	10.17	10.30	10.40	10.00	9.50
Consensus		*9.49*	*9.07*	*9.76*	*9.69*

[1] 5:00 p.m. (CET) [2] Offered rate
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Yield forecasts (%)

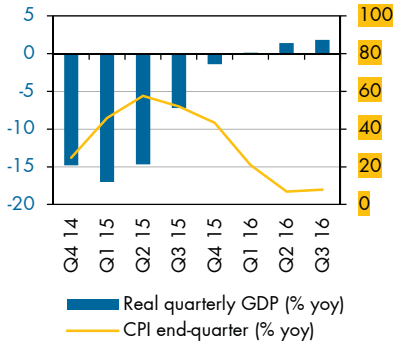
	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17
2y T-bond	10.82	11.0	11.5	11.0	10.5
Consensus		*9.8*	*9.8*	*10.1*	*9.4*
10y T-bond	11.26	11.6	11.8	11.6	11.5
Consensus		*10.7*	*10.6*	*10.5*	*10.0*

[1] 5:00 p.m. (CET) [2] Bid yield
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Is there growth after stabilisation?

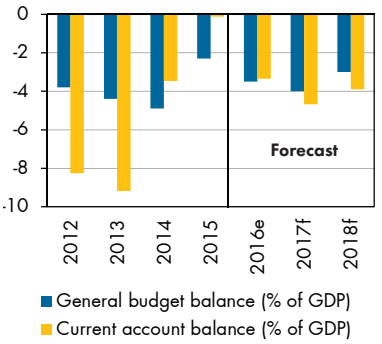
- **Second year of weak recovery expected in 2017**
- **Inflation to drop further towards single-digit rates, allowing for rate cuts**
- **IMF financing delayed further**
- **UAH to remain shaky, but major devaluations likely over**

GDP growth and CPI inflation



Source: Bloomberg, Raiffeisen RESEARCH

Budget and current account balance



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

After a deep decline in 2015, Ukraine's economy has stabilised and resumed growing in 2016. Despite the fact that the inflation rate returned to double-digit figures in late 2016 (due to the hike in tariffs and the strong base effect), the central bank's target of 12% +/- 3pp will most likely be achieved in 2016. In 2017, we expect a decline in the inflation rate to 9% yoy at year-end, whereas most of the year it will be above 10%. Due to the growth of business activity and the frozen conflict in Donbass, industrial production expanded by 1.9% yoy in the period from January to October, and it will finish 2016 around the +2% level. Meanwhile, imports of goods are recovering much faster than exports, and the current account increased in the first ten months of 2016. We see the current account deficit coming in at over 3% of GDP in 2016 and almost 5% in 2017. The **strict administrative controls helped to stabilise the FX in 2016**. Given the decline of inflation and overall economic recovery, the regulator started to ease its monetary policy (by cutting the key rate to 14%, for example). In September, after a year-long delay, Ukraine completed the second EFF programme review, and received the third IMF tranche of USD 1 bn (cut from USD 1.7 bn), as well as associated US financing of another USD 1 bn. As a result, the country's gross international reserves reached the level of USD 15.3 bn as of end-November (which is far below the level expected by the central bank due to lower external financing). At the same time, reforms are proceeding slowly, which implies a further delay in the IMF financing and economic growth below the potential level. Thus, we **expect modest GDP growth of 1% yoy in 2016 and an acceleration to 2% yoy in 2017**. Nevertheless, the risks of an escalation of the conflict in the east and mounting political turmoil still exist, although they are less likely than previously.

Financial analysts: Sergii Drobot, Raiffeisen Bank Aval Public Joint Stock Company, Kiev

Key economic figures and forecasts

	2012	2013	2014	2015	2016e	2017f	2018f
Nominal GDP (EUR bn)	135.2	135.3	99.9	81.4	81.0	93.5	94.4
Real GDP (% yoy)	0.2	0.0	-6.6	-9.9	1.0	2.0	3.0
Industrial output (% yoy)	-0.7	-4.3	-10.1	-13.0	2.0	4.0	4.0
Unemployment rate (avg, %)	8.2	7.8	9.7	9.5	9.0	9.0	8.5
Nominal industrial wages (% yoy)	14.8	7.9	6.0	20.5	14.6	15.0	10.0
Producer prices (avg, % yoy)	3.6	-0.1	17.1	36.0	20.2	20.0	6.9
Consumer prices (avg, % yoy)	0.6	-0.2	12.1	48.7	13.3	10.7	7.5
Consumer prices (eop, % yoy)	-0.2	0.5	24.9	43.3	11.0	9.0	6.0
General budget balance (% of GDP)	-3.8	-4.4	-4.9	-2.3	-3.5	-4.0	-3.0
Public debt (% of GDP)	37.1	40.7	52.9	72.6	77.5	78.4	73.0
Current account balance (% of GDP)	-8.2	-9.2	-3.5	-0.1	-3.3	-4.7	-3.9
Official FX reserves (EUR bn)	18.6	14.8	6.2	12.2	15.2	17.1	16.5
Gross foreign debt (% of GDP)	76.5	79.3	95.2	131.5	133.5	126.6	119.6
EUR/UAH (avg)	10.4	10.8	15.9	24.3	28.4	28.1	30.7
USD/UAH (avg)	8.1	8.2	12.0	22.0	25.6	27.3	28.2

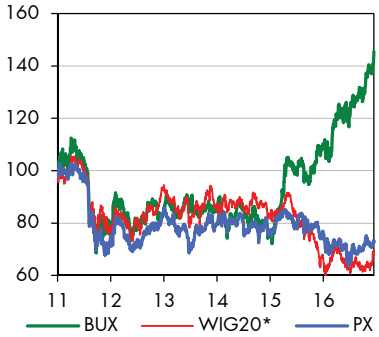
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

CEE equity markets still offer upside potential

- **Continued support from expansive monetary policy**
- **Moderate valuation of many CEE indices**
- **Political uncertainty causing bouts of increased volatility, but no lasting impact**
- **Still no normalisation of political relations with Russia**

Most of the CEE equity markets posted clear growth in the fourth quarter of 2016. In the CE3 region, the Czech PX was somewhat weaker than Poland and Hungary, while only the Turkish leading index was nearly flat due to internal problems. This largely positive performance was due too the solid economic conditions, and the ECB's decision to extend its bond purchases at least to December 2017 (at a lower level starting in April 2017) supported the European equity markets. The double-digit earnings expectations and the moderate valuations were also a positive factor. In the USA, it is still to early to tell what the changes in fiscal, economic, and foreign policy will bring when Donald Trump takes office. In any case, the expansive fiscal policy that he has indicated and the repatriation of profits would provide a substantial additional boost to the already double-digit earnings projections for the US market at large in 2017. In terms of politics, the numerous upcoming elections (Netherlands, France, possibly in Italy, etc.) could cause short-term interference, but our base-case scenario includes no major "accidents". Therefore, the persistently high liquidity as well as our forecast of solid economic development provide a supportive environment for European equities, which also includes the CEE region due to the close economic ties.

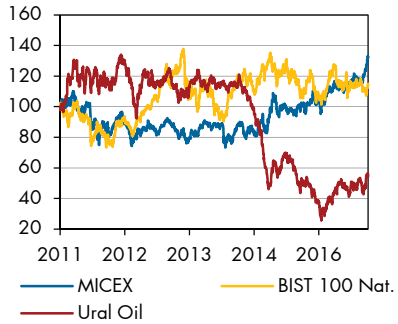
CE core equity indices



In local currency
** due to the short data history of the WIG 30 index we still use the WIG 20*
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

The **MICEX** was again strong in the fourth quarter of 2016 and even reached a new record high. The leading Russian index was one of the best performers overall with a gain of 27% since the start of the year. The USD-denominated RTS index also profited from the appreciation gains of the rouble and was listed over 50% higher than a year before at the date of this publication (mid-December). The latest rally was caused by the further increase in the oil price following the agreement that was reached between OPEC and the most important oil producing countries on output cuts. "Black gold" should rise further in 2017 as a result of the expected reduction in supply and an increase in global demand. The Russian economy should climb out of recession in 2017, which should in turn be good for the equity market. At the same time, the central bank will carefully lower interest rates as inflation declines. Support may come from the election of Donald Trump as US president and the expected appointment of Putin-acquaintance and ExxonMobil CEO Rex Tillerson as Secretary of State, as this may fuel speculations about a thawing of relations between the USA and Russia. Should there actually be progress here (also in terms of lifting the sanctions), the risk premiums

MICEX & BIST 100 Nat. vs oil price



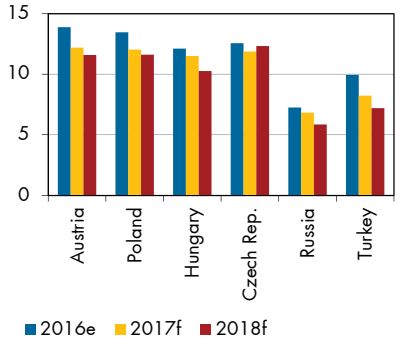
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Value matrix stock markets

	PL		HU		CZ		RU		TR	
Politics	3	(3)	2	(2)	2	(2)	3	(3)	4	(4)
Interest rate trends	2	(2)	2	(2)	2	(2)	1	(2)	3	(3)
Earnings outlook	2	(3)	2	(2)	2	(2)	2	(3)	2	(2)
Key sectors	3	(3)	2	(2)	2	(2)	2	(2)	3	(2)
Valuation (P/E)	2	(2)	2	(2)	2	(2)	1	(1)	2	(2)
Liquidity	2	(2)	3	(3)	3	(3)	2	(2)	1	(1)
Technicals	1	(1)	1	(1)	2	(2)	1	(1)	3	(1)

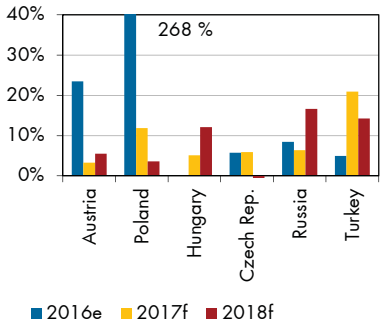
1 (4) denotes highly positive (negative) influence on the market. All factors are weighted equally. Assessment refers to a 3-month period. Figures in brackets reflect our former assessment.
Source: RBI/Raiffeisen RESEARCHSource: RBI/Raiffeisen RESEARCH

P/E ratios in comparison



Source: Thomson Reuters, IBES, Bloomberg, RBI/Raiffeisen RESEARCH

Earnings growth



Source: Thomson Reuters, IBES, Bloomberg, RBI/Raiffeisen RESEARCH

for Russian equities would likely fall substantially. In valuation terms, the MICEX is still cheap despite the strong performance (e.g.: PER 2017e 6.8). The analyst consensus for the projected earnings growth in 2017 and 2018 is also very compelling. In light of the mostly positive factors, we expect the MICEX to deliver above-average performance again in 2017. **Buy**.

The **Polish** equity index **WIG 30** developed very well in the fourth quarter of 2016, bringing the performance since the start of the year to the same level as the established exchanges. This was caused above all by the strong increase in the prices of oil and industrial metals, which in turn proved to be beneficial for the materials and energy sectors. The economic conditions worsened somewhat recently due to the sustained political uncertainty. Aside from the continued troubles with the EU, the political climate in the country itself seems to be hampering private investment activity, a development that will likely not be offset by the high level of private consumption due to the increased social transfers. In light of this, we are lowering our GDP growth projection for 2016 to 2.5% and for 2017 to 3.0%. In addition, even though the pressure on the banking sector in connection with the CHF loans seems to have abated somewhat, the issue will still be a source of uncertainty because no final decision has yet been made. In fundamental terms, earnings should grow by around 11.9% in aggregate terms in 2017, though the resulting valuation (PER 2017e: 12.0) is moderate in any case. Because of the slowing economic growth and the persistent political uncertainty, we are cautious for the short term and out to a 12-month horizon and expect no local outperformance. **Buy**.

The **Czech** equity index **PX** also posted a solid gain in Q4 2016, but is the only leading CE3 index to still be clearly in negative territory since the beginning of the year. The main driver of the uptrend was the heavily weighted financial sector with an index weighting of around 60%. In light of the robust economic growth to date, we have raised our GDP growth estimate for 2016 from 2.3% to 2.5%, but are leaving our projection for 2017 unchanged at 2.7%. Because of the market speculations about the possible end of the FX regime, we already saw a significant increase in the need for interventions by the Czech National Bank. Even if this is still a ways off (we assume Q4 2017), the current increase in speculation pressure represents additional value potential for foreign investors (in an initial overreaction, up to 10% is likely possible, quickly falling to a more sustainable level of 3% to 5%). The expected aggregate earnings increase for the index in 2017 is currently 5.9%, which results in a moderate valuation at an expected PER of 11.9 for 2017. **Buy**.

The **Hungarian** equity index **BUX** again rose significantly in the fourth quarter, putting it at the head of our CEE universe with a gain of 32% since the beginning of 2016. After Fitch and S&P had both already raised their rating for Hungary to investment grade, Moody's followed suit after its review on 4 November 2016

Stock market indicators

	Earnings growth			Price/earnings ratio			Dividend yield
	16e	17f	18f	16e	17f	18f	16e
ATX	23.5%	3.3%	5.5%	13.9%	12.2%	11.6%	3.0%
WIG 30	268.5%	11.9%	3.6%	13.5%	12.0%	11.6%	3.0%
BUX	n.v.	5.1%	12.1%	12.1%	11.5%	10.3%	2.4%
PX	5.7%	5.9%	-3.6%	12.6%	11.9%	12.3%	5.4%
MICEX	8.4%	6.4%	16.7%	7.3%	6.8%	5.9%	4.2%
BIST Nat. 100	4.9%	20.9%	14.3%	9.9%	8.2%	7.2%	2.9%

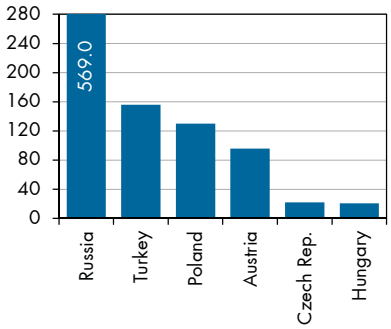
Source: Thomson Reuters, IBES, Bloomberg, RBI/Raiffeisen RESEARCH

and upgraded the country from Ba1 to Baa3. A number of fiscal policy measures (lowering the social security contributions and corporate income tax and an increase in the minimum income) are planned for 2017 that should provide an additional boost to the economy ahead of the elections in 2018. The sentiment indicators are also pointing to continued friendly economic conditions, so we have increased our GDP growth projection for 2017e to 3.2%. The consensus expectation for earnings growth on an aggregate index basis for 2017e is only 5.1%, but the corresponding PER 2017e of 11.5 is still also moderate. We therefore remain optimistic about the further development of the Hungarian equity market, though the pace of growth will likely slow somewhat. **Buy**.

The **BIST 100 Index** has been caught in a band between 75,000 and 80,000 since May 2016 with just a few exceptions (such as the attempted coup). Turkish equities gained ground again during the last positive push on the international equity markets, but we see no reason that the index will break out of this range in 2017. Given the foreign debt of a little over 50% of GDP (not quite half of it in USD) and other macroeconomic disparities (such as the twin deficit), worries about a further rise in US interest rates and the further appreciation of the USD will likely be bad for Turkish equities. The economy is also still being heavily impacted by the consequences of the attempted coup in July and the various terror attacks. The economy contracted by 1.8% p.a. in Q3, falling far short of the consensus expectation. Under the current conditions, we think that the expected earnings growth rate of 20% is too optimistic. The political uncertainty in connection with President Erdogan is a third problem area in our view. There were recent attempts to impair the independence of the central bank and to prevent it from hiking interest rates (in part to stabilise the currency). Relations with the EU have also cooled substantially due to potential plans to reintroduce the death penalty. Given the globally favourable conditions for equities, the attractive valuation in historical comparison (PER 2017e: 8.2) should prevent the index from slipping below 75,000 points for any length of time. Accordingly, our recommendation is **Sell**.

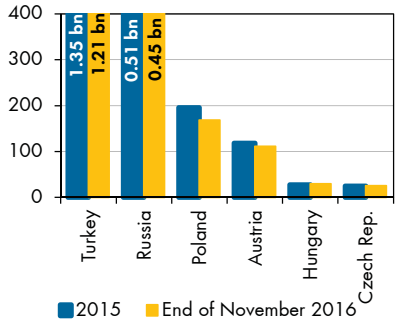
Financial analysts: Andreas Schiller, CFA, Christian Hinterwallner, CEFA, Judith Galter, CIIA, RBI Vienna

Market capitalisation overview



In EUR bn; cut off for data : 12/15/2016
Source: Bloomberg, RBI/Raiffeisen RESEARCH

Avg. daily turnover (EUR mn)



Source: FESE, WFE, RBI/Raiffeisen RESEARCH

Index estimates

	15-Dec[1]	Mar-17	Jun-17	Sep-17	Dec-17	Recommendation
ATX	2,627	2,730	2,820	2,650	2,800	**BUY**
Performance		3.9%	7.3%	0.9%	6.6%	
Range		2,400 - 3,000	2,500 - 3,100	2,400 - 3,100	2,400 - 3,000	
MICEX	2,237	2,400	2,450	2,280	2,450	**BUY**
Performance		7.3%	9.5%	1.9%	9.5%	
Range		2,000 - 2,600	2,200 - 2,700	2,100 - 2,700	2,100 - 2,700	
WIG 30	2,210	2,290	2,330	2,250	2,320	**BUY**
Performance		3.6%	5.4%	1.8%	5.0%	
Range		2,000 - 2,500	2,100 - 2,500	2,000 - 2,500	2,000 - 2,500	
BUX	31,636	33,300	34,300	32,400	34,100	**BUY**
Performance		5.3%	8.4%	2.4%	7.8%	
Range		28,500 - 35,700	30,000 - 36,800	29,200 - 36,800	29,200 - 36,500	
PX	912	960	990	930	970	**BUY**
Performance		5.3%	8.6%	2.0%	6.4%	
Range		800 - 1,100	900 - 1,100	800 - 1,100	800 - 1,100	
BIST Nat. 100	77,679	76,500	81,000	76,000	78,000	**SELL**
Performance		-1.5%	4.3%	-2.2%	0.4%	
Range		68,900 - 83,200	68,900 - 86,700	68,400 - 86,700	68,400 - 83,500	

In local currency
[1] 11:59 p.m. (CET)
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Still room for upward trend to continue

- **Economic outlook solid**
- **Very expansionary monetary policy supportive**
- **Valuations moderate from a historical perspective**

Value matrix*

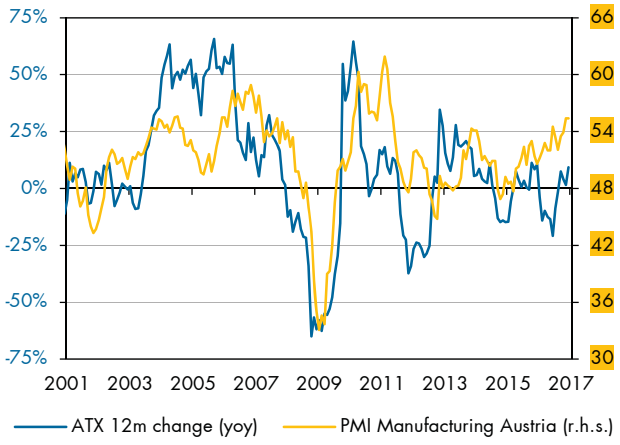
Domestic business activity		2	(2)
Exports	OECD excl. Eastern Europe	2	(2)
	Eastern Europe	2	(2)
	Asia	3	(3)
Corporate profits		2	(2)
Key sectors		2	(2)
Valuation		2	(2)
Interest rates / yields		1	(1)
Exchange rates		1	(1)
Foreign equity markets		2	(2)
European liquidity		1	(1)
Technical outlook		2	(1)

1 (4) denotes highly positive (negative) influence on the market. All factors are weighted equally.
** expected trend for the next 3 to 6 months*
Previous assessment in parentheses
Source: RBI/Raiffeisen RESEARCH, Raiffeisen Centrobank

Following a mixed start to the year, the **Austrian equity market** enjoyed strong development in the fourth quarter of 2016, allowing the ATX to achieve a respectable annual performance of roughly 8% up until the forecast deadline. Support came from the solid overall economic development and a positive earnings season, in which the majority of the companies listed in the benchmark index exceeded the consensus earnings projections. In addition, OPEC's agreement to cut production and the resulting continued recovery of oil prices benefited Austrian energy companies. Finally, the ECB's extension of the asset purchase programme led to additional gains.

We expect further gains in 2017 based on our **projection of persistently solid economic development**. Key leading economic indicators have signalled an upswing recently. In November 2016, for example, the purchasing manager index for the manufacturing sector reached the highest level seen since 2011. There are also many signs of a favourable economic environment in the Eurozone and in Eastern European economies. Based on these developments, it appears that the crisis-plagued Russia may emerge from recession in 2017. In terms of numbers, we expect real GDP growth of 1.3% for Austria in 2017, driven by private consumption and investment activity. Growth is then expected to improve further in 2018.

Economic leading indicator recently strong



Source: Thomson Reuters, Markit, RBI/Raiffeisen RESEARCH

The ECB's **monetary policy** continues to be an important factor for the ATX. The central bank recently announced an extension of the asset purchase programme until at least the end of 2017, although the volume of bond purchases will be reduced from EUR 80 bn to EUR 60 bn from March 2017 onwards. As a result, the debate regarding the "entry into the exit" from the programme has been pushed back significantly. Thus, the continued very expansionary monetary policy should continue to lend support to the Vienna Stock Exchange in 2017, as the excess liquidity circulating in the system will likely flow indirectly into the asset class of equities, as well. In addition,

Sector structure of the ATX

Sector	Company	Weight
Financials	Erste Group, Raiffeisen Bank International, Uniqa, Vienna Insurance Group	29.3%
Industrials	Andritz, Österreichische Post, Wienerberger, Zumtobel	18.2%
Real Estate	BUWOG, CA Immobilien, conwert, Immofinanz	16.6%
Energy	OMV, SBO	16.1%
Materials	Lenzing, RHI, voestalpine	14.5%
Telecommunication	Telekom Austria	1.9%
Utilities	Verbund	2.5%
Consumer Discretionary	Do & Co	1.0%

Source: RBI/Raiffeisen RESEARCH, Raiffeisen Centrobank, Vienna Stock Exchange

the interest rate level will remain low, which will keep refinancing costs down and emphasises the relative attractiveness of the equity market compared to the bond segment. This is illustrated by the difference between the expected earnings yield for 2017 and our projected yield for ten-year Austrian government bonds, which is still substantial at over 700 basis points.

Although the **valuation** of the ATX has increased in absolute terms recently, the market is still moderately valued compared to its historical average. According to our estimates, the Austrian benchmark index is trading at a price/earnings ratio of 12.2 for 2017. Thus, Austria's benchmark index continues to notes at a discount compared with its Western European peers.

We also expect support to come from the anticipated **development of corporate earnings**. Our aggregated adjusted estimates point to corporate earnings growth of 23.5 % in 2016 and 3.3% for 2017 for the ATX.

Summary: The fact that the ECB will continue to take a very expansionary stance for the near future, the resulting prolonged low interest rate environment, and an intermittently weaker EUR will likely provide support for the ATX next year. In addition, a sound economic outlook and solid earnings prospects in combination with moderate valuations suggest that the recent uptrend on the ATX still has room to continue. Therefore, we are upholding our **buy recommendation**.

Financial analyst: Christian Hinterwallner, CEFA, RBI Vienna

Valuation and forecasts

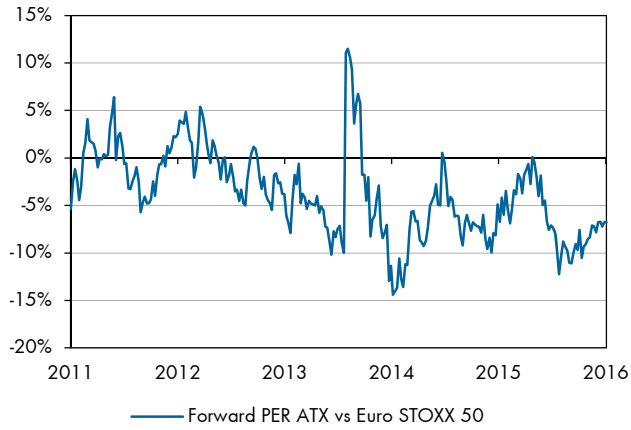
		Mar-17	Jun-17	Sep-17	Dec-17
ATX forecast	2,627	2,730	2,730	2,650	2,800
Expected performance		3.9%	7.3%	0.9%	6.6%
Range		2400 - 3000	2500 - 3100	2400 - 3100	2400 - 3000

[1] *11:59 p.m. (CET)*
Source: RBI/Raiffeisen RESEARCH, Raiffeisen Centrobank

Equity risk premium still attractive

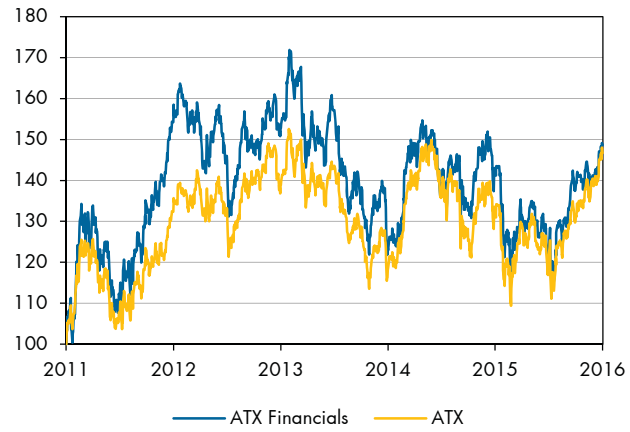
Source: Thomson Reuters, IBES, Raiffeisen RESEARCH

ATX trading at a discount vs euro area stock market



Source: Thomson Reuters, IBES, Raiffeisen RESEARCH

ATX vs ATX Financials



Source: Thomson Reuters, Raiffeisen RESEARCH

Stock Markets: Bullish outlook

ATX

.ATX, 14/12/2016, 06:00 p.m. (CET), 5y high: 2,729, 5y low: 1,752
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

ATX

Last: 2,596 **~BULLISH**

The next main target should be 2,730, the central Fibonacci-Retracement. This one should get crossed and subsequently also 2,800 on the way towards the major resistance 3,013. In spite of the converging volume a close stop at 2,550 (-> 2,480) should be recommendable.

Position:

Long -> 2,730 – 3,010
Stop 2,550

BIST National 100

.XU100, 14/12/2016 06:15 p.m. CET, 5y high: 93,179, 5y-low: 49,837
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

BIST National 100

Last: 76,880 **NEUTRAL**

Since quite a time the rising-resistance line is being tested. For a major bullish signal a topside breakout of the Symmetrical Triangle that is being formed currently would be required, e.g. crossing of 90,230 would signal headroom towards 113,020. As long as a first bullish signal at 85,000 is lacking a sell-signal at 70,000 cannot be fully excluded.

Position:

Buy 80,000 -> 85,000 – 90,230
Sell 70,000 -> 67,730 – 60,110

BUX

.BUX, 14/12/2016, 06:40 p.m. (CET), 5y high 30,629, 5y low 15,687
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

BUX

Last: 31,374 **BULLISH**

The upward-trend which is in effect since 16/01/2015 has just been confirmed again at 26,600 and should thus stretch towards the three rising-resistance lines, e.g., 32,743, 33,705, 35,000. When next to these lines minor oscillations might set in, why stops should not get trailed to close. For example, once 32,743 is being neared a stop at around 31,767 (-> 30,950 – 30,000) might be recommendable.

Position:

Long -> 32,743 – 33,705
Stop 30,250

BET

Last: 7,009 **BULLISH**

The congestion (as of range 6,650 – 7,761) has just been re-entered from the downside. i.e. following the bullish reversal at the rising-support line (in effect since 21/08/2011) at 5,899. In regard of this and in addition the recent bottoming-up from 6,650 an advance towards 7,761 should be downright expectable. Stop 6,645 (-> 6,145).

Position:

Long -> 7,354 – 7,761
Stop 6,645

BET

.BETI, 14/12/2016 07:00 p.m. CET, 5y high: 7,639, 5y-low: 4,256
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

MICEX

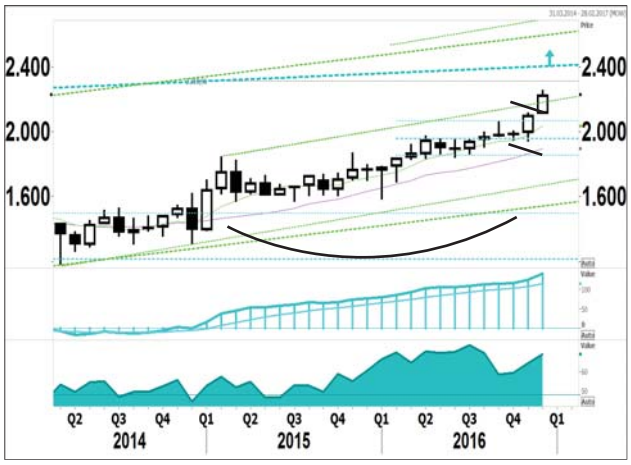
Last: 2,229 **~BULLISH**

As our stop 1,940 has withstood the upward-trend which is in effect since October 2008 still is underway. In accordance with the above markets hitting of the rising-resistance lines is expectable, i.e. in this case of 2,380 andd 2,593. Temporary retracements towards the moving averages (6, 16 weeks) at 2,150 – 2,065 cannot be excluded and would still be in line with bullishness.

Position:

Long -> 2,380 – 2,593
Stop 2,150

MICEX



xx

WIG 30

Last: 2,237 **~BULLISH**

2,100 -> 2,222 has been completed, but now that the Rectangular Triangle (red dotted) has been hit, momentum has diminished. In case this resistance cannot get crossed on this this time it might retrace towards 2,060. The stop has been placed at 2,170 accordingly. Once beyond 2,250 the path would be paved towards 2,319 – 2,427.

Position:

Buy 2,250 -> 2,319 – 2,427
Stop 2,170

Financial analyst: Robert Schittler, CEFA, RBI Vienna

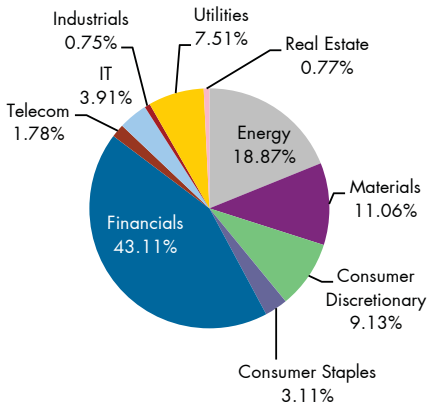
WIG 30

.WIG30, 14/12/2016 08:30 p.m. CET, 5y high: 2,775, 5y-low: 1,879
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Sector weightings in comparison

Sector weightings Poland, WIG 30

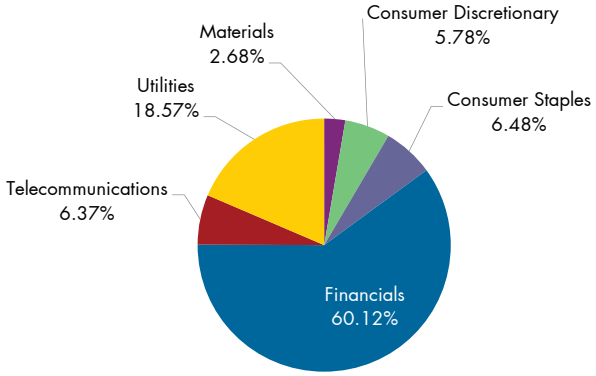
Dom. market cap.: EUR 130,1 bn (Source: Bloomberg; 12/15/2016)



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Sector weightings Czech Republic, PX

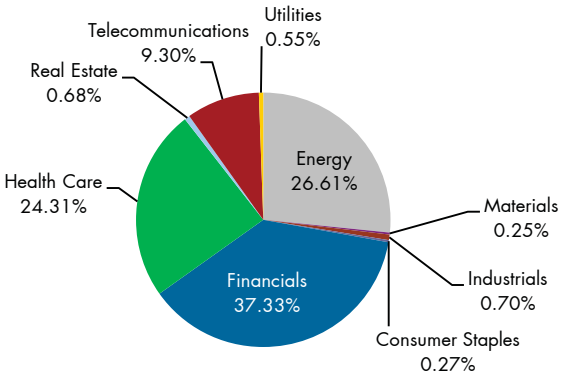
Dom. market cap.: EUR 22,28 bn (Source: Bloomberg; 12/15/2016)



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Sector weightings Hungary, BUX

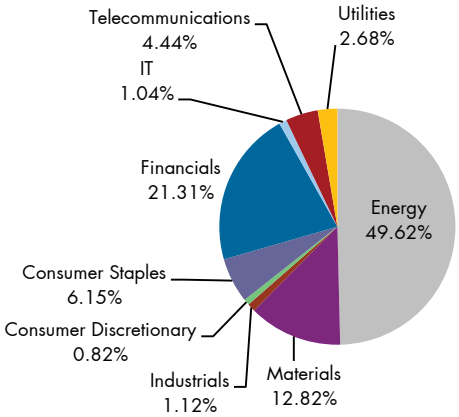
Dom. market cap.: EUR 20,73 bn (Source: Bloomberg; 12/15/2016)



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Sector weightings Russia, MICEX

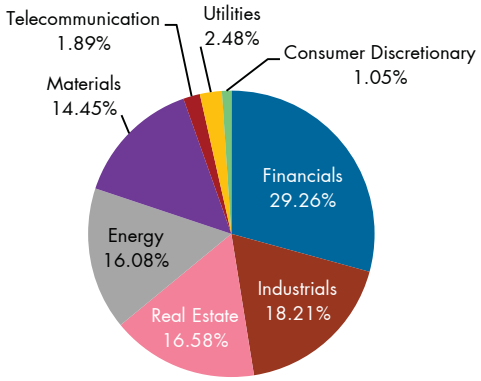
Dom. market cap.: EUR 569 bn (Source: Bloomberg; 12/15/2016)



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Sector weightings Austria, ATX

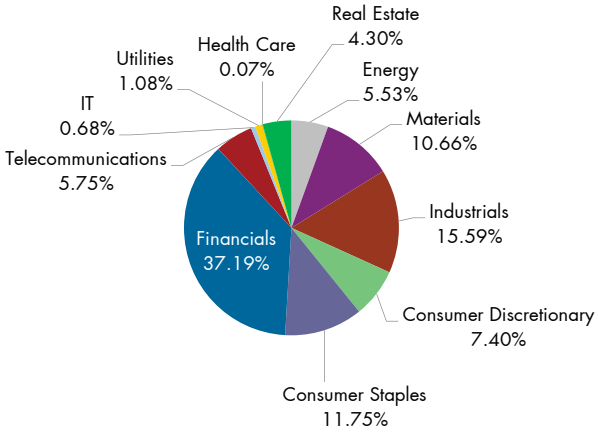
Dom. market cap.: EUR 95,66 bn (Source: Bloomberg; 12/15/2016)



Source: Bloomberg, RBI/Raiffeisen RESEARCH

Sector weightings Turkey, BIST National 100

Dom. market cap.: EUR 155,8 bn (Source: Bloomberg; 12/15/2016)



Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

Banks: Year-end adjustments towards fair multiples

- **Polish banks are fairly valued given no positive catalyst on horizon**
- **Among Polish names we see upside in Alior Bank and favour now PEKAO over PKO**
- **While OTP should show strongest earnings growth in 2017e, we prefer Erste Group given the ytd underperformance**

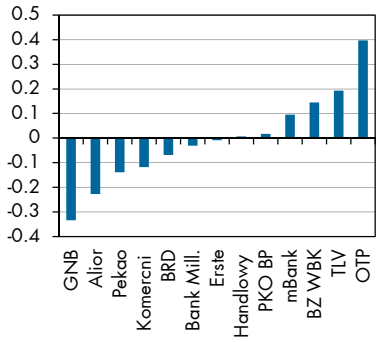
Polish banks delivered a mixed performance so far in the Q4 that ended with a small rally following the sharp November correction on disappointing GDP and PLN depreciation due to the US elections triggering also an EM sell-off. Solid Q3 results could hardly counterbalance the muted sentiment but represent solid fundaments ahead of 2017. Our sample of banks' P/BV 2017e headed to 1.0x at 8.2% median RoE which looks fair given no catalysts (rather risks from bank tax change, return of monetary easing). PL banks trade on 13.5x 2y forward P/E a notch above the 5y average of 13x. We have recently raised 2017 sector earnings by 4% to PLN 10.3 bn (lfl +19% yoy, reported -3% yoy) mainly due to moderate NII revision after good 3Q, implying +13 bps NIM growth yoy.

In the current environment with limited upsides in the sector we prefer ALIOR (pricing out capital increase speculation; discounted P/B on long-term RoE accretive BPH effect). As a result of the notable premium erosion since Q2 16 but still deserving a certain doze of "award", our preference goes to PEKAO over PKO, among other due to vanishing share overhang risks from UniCredit at the former and lower dividend potential at the latter. The latest KNF guidance incl. FX share criteria has narrowed the scope for dividend pay-out ratios. There was no concrete progress on CHF solution. In the wave of PLN depreciation after US elections, we selected some "soft" comments from politicians about the need for action. We continue to incorporate the impact from a mild conversion" (PLN 20 bn) and FX spreads (PLN 6 bn) into our 12m TPs. The increase of risk weights for FX mortgages might round up the capital interventions (after revision of FX and introduction of systemic risk buffers).

Czech banks still rank well in terms of dividend yields and fears that the Central Bank would increase the capital requirement via raising the countercyclical buffer have not materialised. Still NIM pressure and pricing competition do not allow higher core earnings despite strong loan growth. Erste Group should be among the beneficiaries of a yield curve steepening given the low loan/deposit ratio in AT, CZ and SK and the high share of current account funding (>60% overnight deposits). Still, we expect the rise in LT yields to translate into NIM relief not until 2018 as the amortising bond book and unwinding effects should generate NII headwind. Hungary's OTP should post the most dynamic profit growth in 2017e fuelled by M&A activity, a significant reduction of the corporate income tax and the turn-around in loan growth, but the strong stock performance (+40% ytd) has already discounted this development, thus we regard Erste Group (-2% ytd) as our preferred stock.

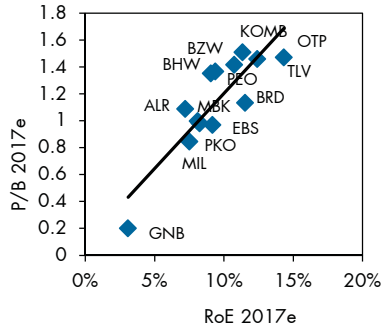
Financial analysts: Jovan Sikimic, Stefan Maxian, CFA

YTD stocks performance (in %)



ytd, incl. Dec 15th
Source: Bloomberg, Raiffeisen Centrobank

P/B - RoE 2017e regression

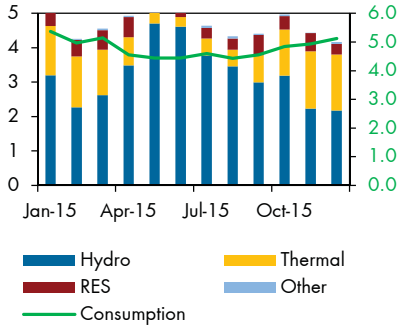


Source: Raiffeisen Centrobank estimates

Utilities: Separation of Austrian and German power markets looming?

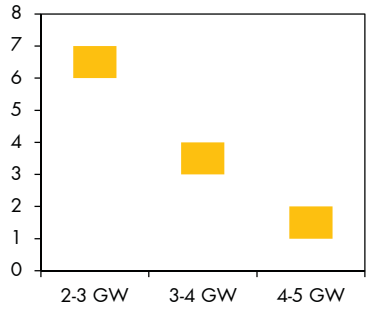
- **Germany asks for a separation of the common market, unified since 2002**
- **Austrian power prices likely to increase, but by how much?**
- **BUY recommendations: EVN, CEZ, Russian generators**

Seasonality of Austrian*



** power production and consumption , 2015, in TWh*
Source: e-Control

Potential price impact of import limits*



** in Austria (in EUR/MWh)*
Source: Verbund, Aurora Energy Research, BNEF

In the past quarter, utilities have underperformed the market following a more hawkish rate outlook and despite a new, but short-lived peak in Central European power prices at the end of October. Russian utilities have been particularly strong, also thanks to RUB appreciation.

The single-price zone created in Germany and Austria in 2002 came under scrutiny in 2015, when Polish and Czech transmission system operators (TSO) called for a separation to remedy unscheduled loop flows to their grids due to wind generation flooding the Polish and Czech systems. Germany backed the plea and is pushing for the break-up despite Polish and Czech TSOs having secured their grids in the meantime, to the extent that the initial case for a market separation was eliminated. Still, with re-dispatch and grid stabilisation costs exceeding the EUR 1 bn mark, imbalances within Germany come at enormous cost. Austria has been a net importer of electricity since about the year 2000, mostly from Germany and the Czech Republic, but imports are also driven by the seasonal nature of hydro power generation. If import restrictions were harsh, prices could increase by up to EUR 7/MWh, according to industry experts, while the base case could mark a EUR 3-4/MWh increase. Verbund could benefit the most from a limitation, in our view, though pump-spreads and flexibility product sales might suffer. Czech power generator CEZ could also sell more power to Austria if there was a significant premium. However, there are still some obstacles to overcome in terms of trade and market organisation – foremost ENTSOe's decision on the limit – before markets could be separated in mid-2018e. Also, as EVN's CEO Layr pointed out, Austria still hopes to negotiate a deal, but chances might be low.

Given strengthening long-term yields, we are more optimistic on regulated returns in the mid-term, however, as regulatory regimes are not to change in Austria and the Czech Republic until 2019e, Polish utilities stand a rather good chance to be the first to benefit from higher yields in 2018e. However, with Polish mining not yet out of the woods, political risks remain high for Polish generators and distributors. In contrast, we see some interesting dividend plays among Russian utilities.

Financial analyst: Teresa Schinwald, Raiffeisen Centrobank

Risk notifications and explanations

Warnings

- Figures on performance refer to the past. Past performance is not a reliable indicator for future results and the development of a financial instrument, a financial index or a securities service. This is particularly true in cases when the financial instrument, financial index or securities service has been offered for less than 12 months. In particular, this very short comparison period is not a reliable indicator for future results.
- Performance of a financial instrument, a financial index or a securities service is reduced by commissions, fees and other charges, which depend on the individual circumstances of the investor.
- The return on an investment in a financial instrument, a financial or securities service can rise or fall due to exchange rate fluctuations.
- Forecasts of future performance are based purely on estimates and assumptions. Actual future performance may deviate from the forecast. Consequently, forecasts are not a reliable indicator for future results and the development of a financial instrument, a financial index or a securities service.

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Detailed information on sensitivity analyses (procedure for checking the stability of potential assumptions made in the context of financial analyses) is available under: www.raiffeisenresearch.com/sensitivity_analysis

Disclosure of circumstances and interests which may jeopardise the objectivity of RBI: www.raiffeisenresearch.com/disclosuresobjectivity

The distribution of all recommendations relating to the 12 months prior to the publications date (column A), as well as the distribution of recommendations in the context of which services of investment firms set out in Sections A (investment services and activities) and B (ancillary services) of Annex I of Directive 2014/65/EU of the European Parliament and of the Council ("special services") have been provided in the past 12 months (column B).

Investment recommendation	Column A Basis: All recommendations for all financial instruments (last 12 months)	Column B Basis: Recommendations for financial instruments of all issuers, for which special services were rendered in the last 12 months
Buy recommendations	46.6%	61.5%
Hold recommendations	35.9%	38.5%
Sell recommendations	17.5%	0.0%

Detailed information on recommendations concerning financial instruments or issuers disseminated during a period of 12 month prior to this publication (acc. to Art. 4 (1) i) Commission Delegated Regulation (EU) 2016/958 of 9.3.2016) is available under: https://raiffeisenresearch.com/web/rbi-research-portal/recommendation_history

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Recommendations history for 12 months

GAZPROM	**Start of coverage**	**17.04.2008**
	Date of recommendation	**Recommendation**
GAZPRU 8.265% due 2034	10/02/2016	Buy
GAZPRU 8.265% due 2034	28/04/2016	Buy
GAZPRU 6.51% due 2022	14/07/2016	Buy
GAZPRU 6.51% due 2022	04/11/2016	Buy
HALYK SAVINGS BANK-KAZAK	**Start of coverage**	**17.04.2008**
	Date of recommendation	**Recommendation**
HSBKKZ 7.25% due 2021	28/04/2016	Buy
HSBKKZ 7.25% due 2021	14/07/2016	Buy
HSBKKZ 7.25% due 2022	04/11/2016	Buy
Global Ports	**Start of coverage**	**14.07.2016**
	Date of recommendation	**Recommendation**
GLPRLI 6.872% due 2022	14/07/2016	Buy
GLPRLI 6.872% due 2022	04/11/2016	Sell

Bonds

Local currency government bonds: Recommendations concerning financial instruments or issuers (disseminated during a period of 12 month prior to this publication), which differ from recommendations made in this publication*

	CZ			CZK	HU			HUF	PL			PLN	RO			RON	RU**			RUB	TR**			TRY
Date	2J	5J	10J		2J	5J	10J		2J	5J	10J		2J	5J	10J		2J	5J	10J		2J	5J	10J	
17/12/2015	H	H	H	H	H	S	S	B	B	B	S	H	B	B	B	B	B	B	H	B	S	S	S	B
25/01/2016	I	–	B	I	H	–	I	H	I	–	I	I	H	–	H	I	–	–	–	–	I	–	I	I
11/02/2016	I	I	I	I	I	I	I	I	I	I	I	I	I	I	I	I	H	–	H	H	I	I	I	I
23/02/2016	I	–	I	I	I	–	I	I	H	–	I	I	I	–	I	H	I	–	I	I	I	–	I	B
24/03/2016	I	–	H	I	I	–	I	I	I	–	I	S	I	–	I	I	I	–	I	S	S	–	S	S
26/04/2016	I	–	I	I	I	–	I	I	I	–	I	H	I	–	I	I	I	–	I	I	H	–	H	I
31/05/2016	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	I	B	–	B	H	B	–	B	H
21/07/2016	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	I	S	–	S	S
27/07/2016	I	–	I	I	B	–	I	I	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	I
25/08/2016	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	I
23/09/2016	I	–	I	I	H	–	H	I	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	H
21/10/2016	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	S	I	–	I	I
24/11/2016	I	–	I	I	I	–	I	I	I	–	I	I	I	–	I	I	H	–	H	H	I	–	I	I
15/12/2016	I	–	I	I	I	–	B	I	I	–	B	I	I	–	I	I	B	–	I	I	I	–	I	I

** recommendations based on absolute expected performance in LCY; ** TRY vs. USD; RUB vs. Basket; other FX vs EUR; B: Buy, H: Hold, S: Sell, I: no change, - no coverage*

Sovereign Eurobonds: Recommendations concerning financial instruments or issuers (disseminated during a period of 12 month prior to this publication), which differ from recommendations made in this publication*

	BG		HR		CZ		HU		KZ		LT		PL		RO	
Date	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD
17/12/2015	H	–	B	B	H	H	B	B	–	B	H	H	B	H	B	B
18/01/2016	I	–	I	I	I	I	I	I	–	I	I	I	H	H	I	I
25/01/2016	I	–	H	H	I	I	H	H	–	H	I	I	I	I	H	H
23/02/2016	I	–	I	I	I	I	B	B	–	B	I	I	I	I	I	I
17/03/2016	I	–	I	I	I	I	I	I	–	I	I	I	I	I	I	I
24/03/2016	I	–	I	I	I	I	H	H	–	I	I	I	I	I	I	I
29/03/2016	B	–	I	I	I	I	I	I	–	I	B	I	I	H	I	I
20/04/2016	I	–	I	I	I	I	I	I	–	I	I	I	I	I	I	I
26/04/2016	H	–	I	I	I	I	I	I	–	H	H	I	S	S	I	I
13/05/2016	I	–	I	I	I	I	I	I	–	I	I	I	I	I	I	I
20/06/2016	B	–	S	S	I	I	B	B	–	I	I	I	I	I	S	S
21/07/2016	I	–	I	I	I	–	I	I	–	I	I	I	I	I	I	I
27/07/2016	H	–	I	I	I	–	H	H	–	B	I	I	I	I	H	H
25/08/2016	I	–	I	I	I	–	I	I	–	I	I	I	H	H	I	I
26/08/2016	I	–	I	I	I	–	I	I	–	H	I	I	I	I	I	I
26/09/2016	B	–	B	S	I	–	I	I	–	I	I	I	B	I	I	I
21/10/2016	I	–	I	I	I	–	I	I	–	I	I	I	I	I	I	I
28/11/2016	H	–	H	I	I	–	I	I	–	B	I	I	H	I	B	I
15/12/2016	I	–	I	H	I	–	I	I	–	I	H	B	I	I	H	I

** recommendations based on absolute expected performance, i.e. expected spread change; B: Buy, H: Hold, S: Sell, I: no change, - no coverage*

Sovereign Eurobonds: Recommendations concerning financial instruments or issuers (disseminated during a period of 12 month prior to this publication), which differ from recommendations made in this publication*

	RU		RS		SK		SI		TR		UA		BY		MK	
Date	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD
17/12/2015	H	H	–	S	H	–	H	–	B	S	H	H	–	S	H	–
25/01/2016	B	B	–	I	I	–	B	–	I	B	–	I	–	I	B	–
23/02/2016	I	I	–	H	I	–	I	–	I	I	–	I	–	I	I	–
17/03/2016	H	H	–	I	I	–	I	–	I	I	–	I	–	I	I	–
24/03/2016	I	I	–	I	I	–	I	–	I	I	–	I	–	I	I	–
29/03/2016	I	I	–	I	I	–	I	–	I	I	–	H	–	I	I	–
20/04/2016	I	I	–	I	I		I		I	I	–	I	–	I	H	–
26/04/2016	I	I	–	B	I	–	I	–	I	I	–	I	–	I	I	–
13/05/2016	I	I	–	I	I	–	I	B	H	H	–	I	–	I	I	–
20/06/2016	I	I	–	I	I	–	I	–	B	I	–	I	–	I	I	–
21/07/2016	I	I	–	I	I	–	I	I	S	S	–	I	–	I	I	–
27/07/2016	B	B	–	I	S	–	I	I	I	I	–	I	–	I	B	–
25/08/2016	I	I	–	I	I	–	I	I	I	I	–	I	–	I	I	–
26/08/2016	H	H	–	H	H	–	H	I	I	I	–	I	–	I	I	–
26/09/2016	I	I	–	B	I	–	I	I	H	H	–	I	–	I	I	–
21/10/2016	I	I	–	I	I	–	I	I	B	B	–	B	-	S	I	–
28/11/2016	S	S	–	I	I	–	I	H	H	H	–	H	-	I	I	–
15/12/2016	H	I	–	I	I	–	I	I	I	I	–	S	-	I	H	–

** recommendations based on absolute expected performance, i.e. expected spread change; B: Buy, H: Hold, S: Sell, I: no change, - no coverage*

Equities

EVN: 5y high: EUR 12.66 5y low: EUR 9.169

Recommendation history

01/02/2002*	Rating	Target Price	Prev. day's close	Upside
02/12/2016	Buy	12.80	10.70	19.6%
26/08/2016	Buy	12.80	10.43	22.7%
31/03/2016	Buy	12.80	10.04	27.5%
01/12/2015	Buy	12.40	10.05	23.4%
30/03/2015	Buy	12.40	10.42	19.0%

** Initiation date*

Alior Bank: 5y high: PLN 99.8, 5y low: PLN 42.03

Recommendation history

23/10/2013*	Rating	Target Price	Prev. day's close	Upside
07/12/2016	Buy	61.00	47.44	28.6%
14/10/2016	Buy	68.00	47.80	42.3%
06/07/2016	Buy	68.10	51.65	31.8%
07/04/2016	Buy	86.00	69.60	23.6%
25/02/2016	Buy	76.00	61.26	24.1%
04/12/2015	Buy	77.00	65.80	17.0%
17/06/2015	Hold	92.80	87.20	6.4%
27/04/2015	Buy	103.00	89.00	15.7%
31/03/2015	Buy	99.00	84.95	16.5%
08/01/2015	Buy	95.00	76.30	24.5%

** Initiation date*

Bank Pekao SA: 5y high: PLN 201.5, 5y low: PLN 115.75

Recommendation history

10/06/2008*	Rating	Target Price	Prev. day's close	Upside
09/12/2016	Buy	136.00	120.20	13.1%
07/12/2016	Hold	136.00	122.50	11.0%
14/10/2016	Hold	137.00	121.00	13.2%
06/07/2016	Hold	142.00	128.20	10.8%
07/04/2016	Hold	161.00	154.50	4.2%
04/12/2015	Buy	161.00	134.55	19.7%
17/06/2015	Hold	185.40	182.00	1.9%
27/04/2015	Hold	196.00	191.75	2.2%
08/01/2015	Hold	191.00	175.40	8.9%

** Initiation date*

OTP: 5y high: HUF 8197, 5y low: HUF 2960

Recommendation history

01/06/2008*	Rating	Target Price	Prev. day's close	Upside
07/12/2016	Hold	8,500.00	8,012.00	6.1%
12/08/2016	Hold	7,600.00	6,979.00	8.9%
06/07/2016	Hold	7,000.00	6,319.00	10.8%
19/05/2016	Hold	7,000.00	6,800.00	2.9%
07/04/2016	Hold	7,000.00	6,890.00	1.6%
23/02/2016	Hold	6,700.00	6,115.00	9.6%
17/06/2015	Hold	5,900.00	5,421.00	8.8%
24/02/2015	Buy	5,000.00	4,330.00	15.5%

** Initiation date*

Verbund: 5y high: EUR 23, 5y low: EUR 10.035

Recommendation history

01/02/2002*	Rating	Target Price	Prev. day's close	Upside
02/12/2016	Hold	15.00	13.65	9.9%
24/08/2016	Hold	15.00	13.59	10.4%
28/07/2016	Hold	15.00	14.00	7.2%
01/12/2015	Hold	15.00	13.11	14.5%
31/07/2015	Hold	15.00	13.99	7.2%
16/07/2015	Hold	15.00	13.78	8.9%
27/03/2015	Hold	16.50	15.78	4.6%

** Initiation date*

CEZ: 5y high: CZK 840, 5y low: CZK 364.1

Recommendation history

01/02/2002*	Rating	Target Price	Prev. day's close	Upside
02/12/2016	Buy	480	415	15.7%
07/04/2016	Buy	470	401	17.2%
30/12/2015	Buy	580	437	32.8%
19/06/2015	Buy	670	547	22.5%
25/03/2015	Buy	740	640	15.6%
26/02/2015	Buy	720	620	16.1%

** Initiation date*

PKO BP: 5y high: PLN 44.15, 5y low: PLN 22.35

Recommendation history

10/01/2005*	Rating	Target Price	Prev. day's close	Upside
07/12/2016	Reduce	25.90	27.20	-4.8%
14/10/2016	Hold	26.10	25.21	3.5%
06/07/2016	Hold	25.20	22.79	10.6%
07/04/2016	Hold	26.60	26.36	0.9%
22/02/2016	Hold	26.20	25.11	4.3%
04/12/2015	Hold	26.60	25.52	4.2%
17/06/2015	Hold	33.60	31.90	5.3%
27/04/2015	Hold	39.10	35.93	8.8%
08/01/2015	Buy	41.70	35.20	18.5%

** Initiation date*

Erste Group: 5y high: EUR 29.71, 5y low: EUR 11.265

Recommendation history

01/02/2002 *	Rating	Target Price	Prev. day's close	Upside
28/11/2016	Buy	30.50	26.60	14.7%
08/08/2016	Buy	28.00	24.07	16.4%
06/07/2016	Buy	25.00	19.07	31.1%
12/05/2016	Buy	28.00	23.45	19.4%
05/04/2016	Buy	29.00	24.66	17.6%
18/02/2016	Buy	30.00	25.59	17.2%
07/10/2015	Buy	30.00	25.97	15.5%
17/08/2015	Hold	30.00	28.42	5.6%
17/06/2015	Hold	27.00	25.20	7.1%
17/02/2015	Hold	24.00	23.09	3.9%

** Initiation date*

Coverage universe recommendation overview

	buy	hold	reduce	sell	suspended	UR
Universe	48	67	4	3	7	3
Universe %	36%	51%	3%	2%	5%	2%
Investment banking services	20	29	0	0	0	1
Investment banking services %	40%	58%	0%	0%	0%	2%

Source: Raiffeisen Centrobank, rounding differences may occur

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Statement pursuant to the Austrian Media Act

Publisher and editorial office of this publication: Raiffeisen Bank International AG, Am Stadtpark 9, A-1030 Vienna

Media Owner of this publication: Raiffeisen RESEARCH – Verein zur Verbreitung von volkswirtschaftlichen Analysen und Finanzmarktanalysen, Am Stadtpark 9, A-1030 Vienna

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Producer of this publication: Holzer Druck, 1100 Vienna, Buchengasse 79

Cut-off for data: 15 December 2016 / **Cover photo:** Peter Brezinschek / **Design:** Kathrin Kořinek, Birgit Bachhofner

Completed: 20 December 2016, 08:00 AM CET; **First dissemination:** 21 December 2016, 9:00 AM CET

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