Central & Eastern European Strategy

3rd quarter 2014

CEE riding the global liquidity wave

- CE with tailwinds, Russia with headwinds
- Neutral view on most CEE debt markets
- Bonds gaining the momentum again
- Breathing pause for equities

Raiffeisen RESEARCH

Raiffeisen RESEARCH

Central & Eastern European Strategy

Explanation:
e ... estimate
f ... forecast
p ... preliminary figures
n.v. ... no value

Abbreviations
Currencies and Countries

ALL	Albanian lek
BAM	Bosnian marka
BGN	Bulgarian lev
BYR	Belarusian roubel
CZK	Czech koruna
EKK	Estonian kroon
HUF	Hungarian forint
HRK	Croatian kuna
LTL	Lithuanian litas
LVL	Latvian lats
PLN	Polish zloty
RON	Romanian leu
RSD	Serbian dinar
RUB	Russian rouble
SIT	Slovenian tolar
SKK	Slovak koruna
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
FCY	Foreign Currency
FDI	Foreign Direct Investments
FX	Foreign Exchange
FY	Full year
GDP	Gross Domestic Product
LCY	Local Currency
mmav	month moving average
mom	month on month
O/N	overnight rate
pp	percentage points
PPI	Producer Price Index
qoq	quarter on quarter
T/B	Trade Balance
ULC	Unit Labour Costs
yoy	year on year
ytd	year-to-date

Stock Exchange Indices

BELEX15	Serbian stock index
BET	Romanian stock index
BUX	Hungarian stock index
CROBEX10	Croatian stock index
PX	Czech stock index
MICEX	Russian stock index
SASX-10	Bosnian stock index
WIG 20	Polish stock index

Equity related

DY	Dividend yield
EG	Earnings growth
LTG	Long term (earnings) growth
P/B	Price book ratio
P/E	Price earnings ratio
RS	Recommendation suspended
UR	Under Revision
Euro area	*Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, 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*
CIS	*European CIS (Commonwealth of Independent States) countries - Russia, Ukraine, Belarus*
CEE	*Central and Eastern Europe (CE + SEE + CIS)*

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

Good GDP dynamics and low inflation in most CE and SEE countries

- **Upswing gaining ground in Central Europe**
- **Recession in the CIS region**
- **Global monetary policy and higher risk tolerance create benign capital market conditions in CEE as well**

Even though any easing of the tensions in the Ukraine-Russia dispute appears to be a far-off prospect, the conflict is clearly having less and less of an effect on economic and financial market developments as it drags along. Our baseline scenario does not foresee any further escalation or major sanctions, and thus the positive trends in economic activity and capital market prices for the second half of the year are not called into question. As a result, due to the surprisingly strong start to the year, we have upgraded some of our 2014 GDP forecasts for the CEE countries. For Russia and Ukraine, however, the forecasts were lowered. The disappointing first quarter also had a negative impact on the 2014 GDP projections for Austria (1.3% instead of 1.5%).

For the majority of CEE countries, one positive aspect is that domestic demand, both in the form of private consumption and private investment, is increasingly responsible for economic growth. Consequently, looking ahead to the coming 12 months, we see sustained, strong growth dynamics, especially in countries such as Romania, Poland, the Czech Republic and Hungary. Another interesting point is that inflation has dropped to historical lows in most of the countries. In most CEE countries, however, we expect this trend to turn around towards rising inflation rates during H2 2014.

Impact on monetary policy and exchange rates

In the field of monetary policy, the extremely low rates of inflation in several CEE countries have also paved the way for historically low levels of interest rates. In conjunction with the extremely expansive monetary policy being pursued by the European Central Bank (ECB), which will likely continue its generous supply of liquidity for the foreseeable future, no changes in key rates are expected in the CEE region until early 2015. In Hungary, the downward cycle in interest rates which has been seen in recent years may come to an end at 2.2% this summer. By contrast, we do not believe that there will be more rate hikes in Russia, as the central bank has successfully stemmed the tide of rouble depreciation. In terms of currency developments, we tend to expect mixed developments in H2, with mild gains for PLN, CZK and TRY, and generally somewhat weaker rates for HUF, RON and RUB.

Impact on the bond and equity markets

With the higher risk tolerance, yields in most of the CEE countries declined again in the spring. Until the end of the year, we generally expect slightly higher yield levels throughout the region, in line with marginal increases in USD and EUR government bond yields. As a result, yield curves will grow steeper and the sometime high coupons (in particular for Turkey and Russia) will offer attractive spreads as the year progresses.

Without any spectacular moves, the emerging equity markets managed to cancel out their underperformance compared to developed market equities during the second quarter. Following this period of catching up, the uptrend should continue at a slower pace until the fourth quarter. Due to the rather limited earnings prospects and higher valuations, purchases can only really be justified for a longer-term investment horizon. As the third quarter is traditionally vulnerable to setbacks, we tend to lean mostly towards hold recommendations.

Financial analyst: Peter Brezinschek

MARKET STRATEGY*

	Eurobonds		LCY Bonds		FX
	EUR	USD	2y	10y	–
BG	H	–	–	–	–
HR	S	S	–	–	S
CZ	H	H	H (B)	H (B)	H (B)
HU	B	B	H	H	S (H)
PL	B (H)	H	H	H	H (B)
RO	H (B)	H (B)	H	H	H
RU	H (S)	H (S)	S (H)	S (H)	S
RS	–	B (H)	–	–	H
SK	–	–	–	–	–
SI	–	–	–	–	–
TR	B (H)	H	H	H (S)	B (S)
UA	H (S)	S	–	–	H (S)
BY	–	H	–	–	S

**based on absolute expected performance:*
- LCY bond: absolute performance in LCY
- Eurobonds: based on expected spread change
RU, TR, UA FX recomm. against USD, others against EUR
Previous recomm. (as of 14 May 2014) in brackets
horizon: **end 3rd quarter 2014**
B: buy; H: hold; S: sell
Source: Raiffeisen RESEARCH

Recommendations[1] - stock markets

Indices	
Buy	ATX, BET
Hold	MICEX, WIG 20, BUX, PX, BIST Nat. 100
Sell	CROBEX 10

Equities

BZ WBK
Current share price: PLN 376.35[2]
Target price: PLN 464
PKP Cargo
Current share price: PLN 80.05[2]
Target price: PLN 99
OMV
Current share price: EUR 32.44[2]
Target price: EUR 37.00
BRD-GSG
Current share price: RON 9.10[2]
Target price: RON 10.40
Evraz
Current share price: GBp 92.45[2]
Target price: GBp 116

Recommendations[1] – debt markets

Corporate bonds	
Buy	LUKOIL 3.416% due 2018 Sberbank 5.4% due 2017

[1] horizon: **end 3rd quarter 2014**
[2] the indicated price is the last price as available at 6.30 a.m. (CET) on 23 June 2014
[3] unhedged (performance in EUR)
Source: Raiffeisen RESEARCH

Real GDP (% yoy)

Countries	2012	2013	2014e	Consensus	2015f	Consensus
Poland	1.9	1.6	3.3	3.2	3.3	3.6
Hungary	-1.7	1.1	2.7	2.7	2.5	2.3
Czech Rep.	-0.9	-0.9	2.6	2.3	2.4	2.7
Slovakia	1.8	0.9	2.7	2.5	3.0	3.1
Slovenia	-2.5	-1.1	1.0	0.2	1.0	1.0
CE	**0.6**	**0.8**	**2.9**	2.7	**2.9**	3.1
Croatia	-2.2	-0.9	-0.8	-0.3	1.0	0.8
Bulgaria	0.6	0.9	2.0	1.6	3.5	2.4
Romania	0.6	3.5	3.5	3.0	3.5	3.3
Serbia	-1.5	2.5	0.0	1.1	2.0	2.4
Bosnia a. H.	-1.1	1.9	0.0	1.7	3.5	2.8
Albania	1.6	0.4	2.0	1.7	3.0	2.5
Kosovo	2.5	3.0	3.0	n.v.	4.0	n.v.
SEE	**-0.1**	**2.2**	**2.0**	2.0	**2.9**	2.6
Russia	3.4	1.3	-0.3	0.2	1.0	1.6
Ukraine	0.2	0.0	-7.0	-5.2	1.5	0.8
Belarus	1.7	0.9	0.5	1.8	1.5	2.9
CIS	**3.1**	**1.2**	**-0.8**	-0.2	**1.1**	1.6
CEE	**2.1**	**1.2**	**0.5**	0.8	**1.7**	2.1
Turkey	2.1	4.1	3.5	2.7	4.0	3.6
Austria	**0.9**	**0.3**	**1.3**	1.4	**2.1**	1.8
Germany	0.9	0.5	1.8	2.0	2.5	2.0
Euro area	**-0.6**	**-0.4**	**1.2**	1.1	**2.0**	1.5

Source: Thomson Reuters, Bloomberg, Consensus Economics, Bloomberg, Raiffeisen RESEARCH

Consumer prices (avg, % yoy)

Countries	2012	2013	2014e	2015f
Poland	3.7	0.9	0.4	2.3
Hungary	5.7	1.7	0.7	3.0
Czech Rep.	3.3	1.4	0.8	2.2
Slovakia	3.6	1.4	0.1	1.4
Slovenia	2.6	1.8	1.8	2.0
CE	**3.8**	**1.2**	**0.6**	**2.3**
Croatia	3.4	2.2	0.6	2.0
Bulgaria	3.0	0.9	1.1	3.5
Romania	3.3	4.0	1.9	3.0
Serbia	7.8	7.8	5.5	5.5
Bosnia a. H.	2.1	-0.1	-0.3	2.5
Albania	2.0	1.9	2.3	2.5
Kosovo	2.5	1.8	1.0	2.5
SEE	**3.7**	**3.4**	**1.9**	**3.2**
Russia	5.1	6.8	6.7	5.3
Ukraine	0.6	-0.2	11.3	9.0
Belarus	59.2	18.3	21.0	20.0
CIS	**6.4**	**6.6**	**7.5**	**6.0**
CEE	**5.4**	**4.9**	**5.1**	**4.7**
Turkey	8.9	7.5	8.5	7.4
Austria	**2.6**	**2.1**	**1.5**	**1.8**
Germany	2.1	1.6	1.0	2.0
Euro area	**2.5**	**1.4**	**0.8**	**1.3**

Source: Thomson Reuters, Raiffeisen RESEARCH

Current account balance (% of GDP)

Countries	2012	2013	2014e	2015f
Poland	-3.5	-1.3	-1.1	-2.1
Hungary	1.8	3.0	3.4	3.5
Czech Rep.	-1.3	-1.4	0.4	0.3
Slovakia	2.2	2.2	1.7	1.4
Slovenia	3.3	6.5	6.4	5.0
CE	**-1.5**	**0.0**	**0.4**	**-0.3**
Croatia	-0.1	1.3	1.2	0.7
Bulgaria	-0.8	1.9	0.7	-0.5
Romania	-4.4	-1.1	-2.0	-2.5
Serbia	-10.7	-4.9	-5.3	-6.2
Bosnia a. H.	-9.8	-5.9	-8.1	-11.1
Albania	-9.3	-10.4	-10.3	-11.0
Kosovo	-8.0	-7.0	-7.7	-7.8
SEE	**-4.4**	**-1.4**	**-2.2**	**-2.9**
Russia	3.6	1.6	2.3	2.0
Ukraine	-8.5	-9.1	-3.0	-3.1
Belarus	-2.9	-10.2	-5.5	-6.1
CIS	**2.5**	**0.4**	**1.7**	**1.4**
CEE	**0.7**	**0.1**	**0.9**	**0.4**
Turkey	-6.2	-7.8	-6.3	-6.0
Austria	**2.4**	**2.7**	**2.9**	**2.4**
Germany	7.4	7.5	7.0	6.5
Euro area	**1.4**	**2.4**	**2.5**	**2.0**

Source: Thomson Reuters, Raiffeisen RESEARCH

General budget balance (% of GDP)

Countries	2012	2013	2014e	2015f
Poland	-3.9	-4.3	-3.3	-2.9
Hungary	-1.9	-2.3	-2.8	-2.9
Czech Rep.	-4.2	-1.5	-1.5	-2.5
Slovakia	-4.4	-2.8	-2.6	-2.5
Slovenia	-3.8	-7.0	-5.0	-4.0
CE	**-3.7**	**-3.4**	**-2.9**	**-2.8**
Croatia	-5.0	-4.9	-4.8	-4.5
Bulgaria	-0.4	-1.9	-1.8	-1.3
Romania	-3.0	-2.3	-2.5	-2.3
Serbia	-6.4	-4.8	-7.2	-6.3
Bosnia a. H.	-2.0	-1.5	-1.5	-1.8
Albania	-3.4	-6.0	-6.6	-4.5
Kosovo	-2.7	-2.7	-2.0	-2.0
SEE	**-3.3**	**-3.0**	**-3.4**	**-3.0**
Russia	0.4	-1.0	-0.5	-0.4
Ukraine	-5.5	-6.5	-7.0	-4.5
Belarus	0.5	0.2	0.0	0.0
CIS	**0.0**	**-1.4**	**-1.0**	**-0.7**
CEE	**-1.4**	**-2.1**	**-1.7**	**-1.5**
Turkey	-2.4	-2.2	-2.5	-2.5
Austria	**-2.6**	**-1.5**	**-2.6**	**-1.2**
Germany	0.1	0.0	0.0	0.0
Euro area	**-3.7**	**-3.0**	**-2.5**	**-2.3**

Source: Thomson Reuters, Raiffeisen RESEARCH

Public debt (% of GDP)

Countries	2012	2013	2014e	2015f
Poland	55.6	57.0	50.7	50.4
Hungary	80.2	79.2	81.5	81.0
Czech Rep.	46.2	46.0	45.7	46.5
Slovakia	52.2	55.4	55.2	56.2
Slovenia	54.0	73.0	75.0	75.0
CE	**56.5**	**58.3**	**55.3**	**55.4**
Croatia	56.2	67.4	70.8	73.2
Bulgaria	18.5	19.0	22.0	20.0
Romania	38.0	38.4	38.5	38.2
Serbia	59.9	61.0	67.1	69.3
Bosnia a. H.	39.7	41.5	42.5	41.5
Albania	61.5	68.0	72.0	70.0
Kosovo	18.0	20.0	22.0	22.0
SEE	**41.1**	**43.5**	**45.4**	**45.4**
Russia	10.5	11.3	11.5	12.0
Ukraine	36.8	40.3	54.0	54.5
Belarus	31.3	32.5	34.4	36.0
CIS	**13.1**	**14.1**	**15.4**	**15.9**
CEE	**27.5**	**28.9**	**29.1**	**29.4**
Turkey	39.7	39.4	38.5	38.0
Austria	**74.4**	**74.5**	**80.5**	**78.8**
Germany	81.0	78.4	77.3	74.5
Euro area	**90.7**	**92.6**	**93.7**	**93.1**

Source: Thomson Reuters, Raiffeisen RESEARCH

Gross foreign debt (% of GDP)

Countries	2012	2013	2014e	2015f
Poland	72.7	70.8	69.2	68.0
Hungary	131.1	123.5	118.2	112.6
Czech Rep.	50.9	54.2	55.6	53.9
Slovakia	71.5	82.7	84.6	86.7
Slovenia	115.6	113.3	114.0	115.3
CE	**77.7**	**77.6**	**76.5**	**74.8**
Croatia	103.1	105.8	106.6	104.2
Bulgaria	94.3	93.5	89.1	82.4
Romania	75.7	67.5	62.8	61.3
Serbia	86.9	78.9	79.6	78.7
Bosnia a. H.	63.3	62.2	63.5	62.5
Albania	25.8	28.2	28.9	30.8
Kosovo	14.8	14.4	13.9	13.4
SEE	**80.6**	**75.7**	**72.7**	**70.4**
Russia	31.4	34.1	39.0	39.3
Ukraine	74.4	78.9	106.8	98.0
Belarus	51.9	52.7	56.1	54.0
CIS	**35.4**	**38.1**	**43.8**	**43.7**
CEE	**51.3**	**52.4**	**56.2**	**55.5**
Turkey	42.0	45.0	52.5	48.4
Austria	**n.v.**	**n.v.**	**n.v.**	**n.v.**
Germany	n.v.	n.v.	n.v.	n.v.
Euro area	**n.v.**	**n.v.**	**n.v.**	**n.v.**

Source: Thomson Reuters, Raiffeisen RESEARCH

Exchange rate EUR/LCY (avg)

Countries	2012	2013	2014e	2015f
Poland	4.18	4.20	4.16	4.04
Hungary	289	297	308	319
Czech Rep.	25.1	26.0	27.3	27.1
Slovakia	euro	euro	euro	euro
Slovenia	euro	euro	euro	euro
Croatia	7.52	7.58	7.63	7.65
Bulgaria	1.96	1.96	1.96	1.96
Romania	4.46	4.42	4.45	4.44
Serbia	113	113	116	119
Bosnia a. H.	1.96	1.96	1.96	1.96
Albania	139	140	140	140
Kosovo	euro	euro	euro	euro
Russia	39.9	42.3	47.7	48.6
Ukraine	10.4	10.8	14.7	14.8
Belarus	10,748	11,828	14,107	15,899
Turkey	2.31	2.53	2.85	2.70
Austria	**euro**	**euro**	**euro**	**euro**
Germany	euro	euro	euro	euro
USA	**1.29**	**1.33**	**1.34**	**1.29**

Source: Thomson Reuters, Raiffeisen RESEARCH

Ratings[1]

Countries	S&P	Moody's	Fitch
Poland	A-	A2	A-
Hungary	BB	Ba1	BB+
Czech Rep.	AA-	A1	A+
Slovakia	A	A2	A+
Slovenia	A-	Ba1	BBB+
Croatia	BB	Ba1	BB+
Bulgaria	BBB-	Baa2	BBB-
Romania	BBB-	Baa3	BBB-
Serbia	BB-	B1	B+
Bosnia a. H.	B	B3	not rated
Albania	B	B1	not rated
Kosovo	not rated	not rated	not rated
Russia	BBB-	Baa1	BBB
Ukraine	CCC	Caa3	CCC
Belarus	B-	B3	not rated
Turkey	BB+	Baa3	BBB-
Austria	**AA+**	**Aaa**	**AAA**
Germany	AAA	Aaa	AAA

[1] *for FCY, long-term debt*
Source: Bloomberg, Raiffeisen RESEARCH

Exchange rate forecast

Countries	20-Jun[1]	Sep-14	Dec-14	Jun-15
vs EUR				
Poland	4.17	4.15	4.10	4.05
Hungary	305.90	310.0	315.0	320.0
Czech Rep.	27.44	27.3	27.2	27.2
Croatia	7.58	7.64	7.68	7.59
Romania	4.40	4.42	4.45	4.45
Serbia	115.48	115.0	117.0	120.0
Albania	140.22	140.0	139.5	139.5
vs USD				
Russia	34.5	36.3	37.0	38.0
Ukraine	11.91	11.60	11.50	11.20
Belarus	10185	10900	11500	12300
Turkey	2.14	2.10	2.10	2.10
EUR/USD	1.36	1.32	1.30	1.27

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

Key interest rate forecast

Countries	20-Jun[1]	Sep-14	Dec-14	Jun-15
Poland	2.50	2.50	2.50	2.75
Hungary	2.40	2.20	2.20	2.20
Czech R.	0.05	0.05	0.05	0.05
Romania	3.50	3.50	3.50	3.50
Russia	7.50	7.50	7.00	7.00
Turkey	8.75	8.25	7.75	7.75
Euro area	0.15	0.15	0.15	0.15
USA	0.25	0.25	0.25	1.00

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

3m money market rate forecast

Countries	20-Jun[1]	Sep-14	Dec-14	Jun-15
Poland	2.48	2.72	2.72	3.05
Hungary	2.43	2.60	2.65	2.70
Czech R.	0.04	0.10	0.20	0.35
Croatia	0.38	1.00	1.00	1.30
Romania	1.89	2.40	2.65	2.95
Russia	9.49	9.80	9.30	9.10
Turkey	9.34	9.50	9.20	9.00
Euro area	0.21	0.20	0.20	0.30
USA	0.23	0.30	0.45	1.20

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

2y LCY yield forecast

Countries	20-Jun[1]	Sep-14	Dec-14	Jun-15
Poland	2.60	2.6	3.0	3.8
Hungary*	3.10	2.9	2.9	3.2
Czech R.	0.27	0.3	0.3	0.6
Croatia	2.50	3.2	3.5	3.5
Romania	2.73	3.2	3.5	4.2
Russia	7.82	8.3	8.0	8.0
Turkey	8.44	8.6	8.7	8.3
Austria	0.06	0.2	0.2	0.5
Germany	0.03	0.1	0.1	0.4
USA	0.46	0.6	0.8	1.6

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

5y LCY yield forecast

Countries	20-Jun[1]	Sep-14	Dec-14	Jun-15
Poland	3.17	3.2	3.6	4.3
Hungary	3.41	3.3	3.5	4.0
Czech R.	0.56	0.7	0.9	1.3
Croatia	3.78	4.5	4.0	4.0
Romania	3.55	3.9	4.2	5.0
Russia	8.30	8.5	8.2	8.7
Turkey	8.40	8.5	8.6	9.0
Austria	0.54	0.7	0.8	1.3
Germany	0.40	0.5	0.7	1.2
USA	1.68	1.9	2.3	2.8

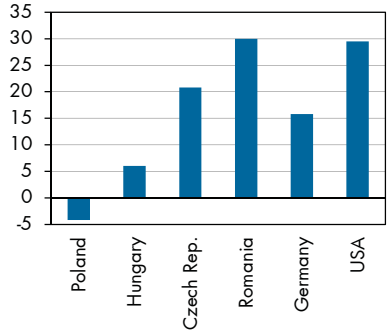
[1] 5:00 p.m. (CET)
Source: Bloomberg, Raiffeisen RESEARCH

10y LCY yield forecast

Countries	20-Jun[1]	Sep-14	Dec-14	Jun-15
Poland	3.64	3.6	3.9	4.5
Hungary	4.44	4.5	4.8	5.2
Czech R.	1.49	1.7	2.0	2.4
Croatia	4.07	4.5	4.5	4.5
Romania	4.35	4.7	5.0	5.6
Russia	8.47	8.9	8.8	9.3
Turkey	8.80	9.0	9.5	9.8
Austria	1.64	1.8	2.0	2.4
Germany	1.34	1.5	1.8	2.2
USA	2.61	2.9	3.3	3.7

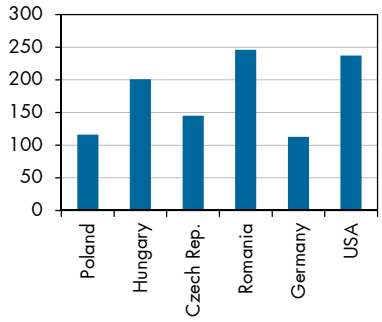
[1] 5:00 p.m. (CET)
Source: Bloomberg, Raiffeisen RESEARCH

Expected yield change



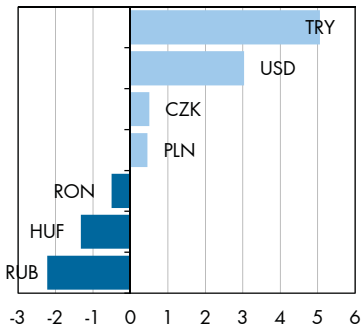
Bp-change of 10y gov. bond yield in next 3 months
Source: Bloomberg, Raiffeisen RESEARCH

Yield structure



Bp-spread between 10y and 3m maturity
Source: Bloomberg, Raiffeisen RESEARCH

LCY changes vs. EUR (% qoq)[1]



[1] forecasts for 30/09/2014 in comparison to 20/06/2014
Source: Bloomberg

Stock market indicators

	Earnings growth		Price/earnings ratio	
	14e	15f	14e	15f
ATX	20.7%	28.5%	14.7	11.4
WIG 20	1.5%	8.7%	14.2	13.0
BUX	-21.8%	20.9%	11.9	9.9
PX[1]	39.1%	15.6%	14.8	12.8
MICEX	8.2%	0.9%	5.5	5.4
BET	25.2%	-0.1%	10.8	10.8
CROBEX10	-20.7%	-5.5%	25.7	27.2
BIST Nat. 100	6.4%	18.5%	11.5	9.7

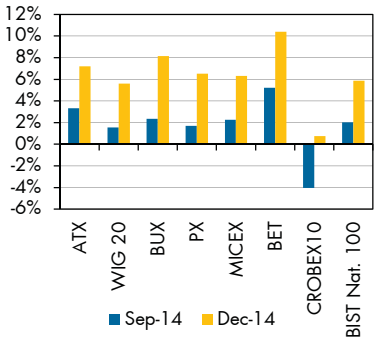
[1] Czech Rep. (PX): excl. Tatry Mountain Resorts, Orco Property Group and Stock Spirits Group
Source: Thomson Reuters, IBES, Bloomberg, Raiffeisen RESEARCH

Stock market forecasts

	Index estimates			
	20-Jun[1]	Sep-14	Dec-14	Jun-15
ATX	2,565	2,650	2,750	2,700
WIG 20	2,462	2,500	2,600	2,630
BUX	18,953	19,400	20,500	20,400
PX	1,033	1,050	1,100	1,110
MICEX	1,486	1,520	1,580	1,620
BET	6,748	7,100	7,450	7,400
CROBEX10	1,042	1,000	1,050	1,060
BIST Nat. 100	78,401	80,000	83,000	84,000

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

Expected index performance



Source: Raiffeisen RESEARCH

Challenging conditions in CEE

- **Exchange rates and CEE stock markets with high volatility**
- **Portfolio somewhat weaker in H1 compared to the benchmark**
- **Promising absolute performance for the portfolio**

Sum of last quarter[1]

RBI portfolio (in EUR)	8.66%
Benchmark (in EUR)	8.87%
RBI outperformance (in EUR)	-0.21%
by weighting of equities vs. bonds	0.00%
regional equity weightings	-0.17%
weighting of EB vs. LCY bonds	0.00%
country weightings of LCY bonds	-0.04%
country weightings of EB EUR	0.00%
country weightings of EB USD	0.00%
joint effects / duration	0.00%

1 19 March 2014 - 20 June 2014
EB...Eurobonds
Source: Thomson Reuters, Raiffeisen RESEARCH

Period 1: 19 Mar 2014 - 8 Apr 2014

RBI portfolio (in EUR)	3.22%
Benchmark (in EUR)	3.28%
RBI outperformance (in EUR)	-0.06%
by weighting of equities vs. bonds	0.00%
regional equity weightings	-0.04%
weighting of EB vs. LCY bonds	0.00%
country weightings of LCY bonds	-0.02%
country weightings of EB EUR	0.00%
country weightings of EB USD	0.00%
joint effects / duration	0.00%

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

Period 2: 8 Apr 2014 - 27 May 2014

RBI portfolio (in EUR)	4.02%
Benchmark (in EUR)	4.11%
RBI outperformance (in EUR)	-0.09%
by weighting of equities vs. bonds	0.00%
regional equity weightings	-0.07%
weighting of EB vs. LCY bonds	0.00%
country weightings of LCY bonds	-0.02%
country weightings of EB EUR	0.00%
country weightings of EB USD	0.00%
joint effects / duration	0.00%

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

Period 3: 27 May 2014 - 20 Jun 2014

RBI portfolio (in EUR)	1.43%
Benchmark (in EUR)	1.48%
RBI outperformance (in EUR)	-0.05%
by weighting of equities vs. bonds	0.00%
regional equity weightings	-0.06%
weighting of EB vs. LCY bonds	0.00%
country weightings of LCY bonds	0.00%
country weightings of EB EUR	0.00%
country weightings of EB USD	0.00%
joint effects / duration	0.00%

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

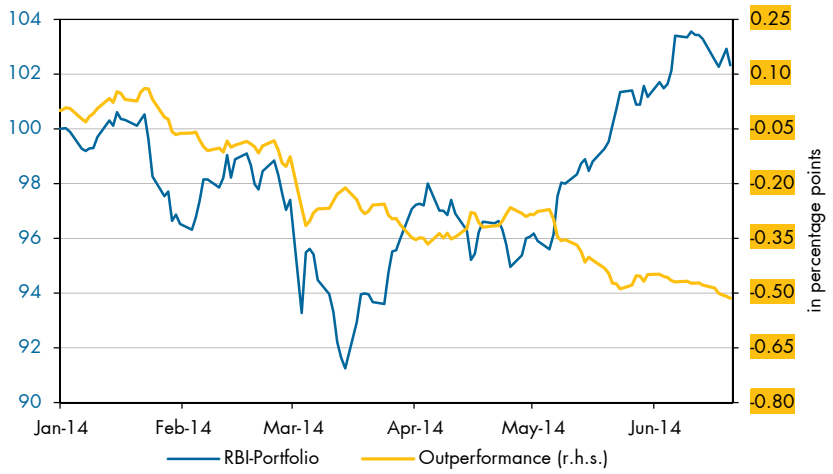
At the level of the portfolio as a whole, the second quarter was better than the first. Due to the persistent volatility in equity investments and exchange rates, in Q2 defensive markets which featured stable currencies tended to be overweighted. Furthermore, the decision was made not to take a position in equities versus bonds. Despite overall positive absolute performance of 2.32% since the beginning of the year, the portfolio currently lags 51bp behind the benchmark.

Within the **equity segment,** the Czech and Romanian stock markets were overweighted in the first two periods. This positioning was financed from Russia and Hungary and resulted in underperformance of -11bp. In the third period, these markets were shifted to neutral in order to reduce the risk of deviating from the benchmark. Due the economic disappointments, the Croatian stock market appeared to be an option. In total, this bet cost us performance of -17bp in the equity segment.

In the **LCY bond segment**, Czech and Romanian bonds were overweighted in the first two periods. The underperformance of about 4bp was mainly driven by the strong appreciation of the forint and the rebound by the rouble. The third period yielded an almost neutral result. All in all, the portfolio of LCY bonds posted underperformance of ca. 4bp in Q2.

Financial analyst: Stefan Theußl

Performance 2014



Source: Thomson Reuters, Raiffeisen RESEARCH

CEE portfolio

	2012	2013	Year to date
Benchmark	21.90%	-2.54%	2.83%
Portfolio	21.07%	-2.41%	2.32%
Relative Performance	-0.83%	0.12%	-0.51%

Source: Thomson Reuters, Raiffeisen RESEARCH

Sentiment turns the corner, risks remain acute

- **Economic dynamics buoying CEE financial markets**
- **Rebounds for CEE equities**
- **Currencies remain in focus**

Accelerating economic dynamics in the core CEE countries (aside from Russia and Ukraine) are providing good conditions for local financial markets. All in all, these markets should be able to profit strongly from the anticipated gradual improvement in economic activity in the euro area. At the same time, the dependence on the recovery in the euro area also represents the biggest risk, along with the simmering conflict between Russia and Ukraine, especially if there are surprises in relation to economic performance in the developed markets or monetary policy in these markets.

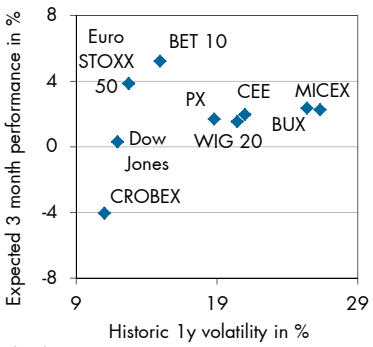
The risk-reward profile of the **CEE equity markets** has improved in the past quarter, but it is still less attractive than in the developed markets. Volatility remains high and the two largest positions in the equity segment do not warrant an overweighting. On the one hand, the Russian equity index represents the biggest risk (due to the ongoing conflict with Ukraine) and on the other hand the return prospects of the Polish equity index are limited (pension reform).

The **bond segment** is dominated by the ECB's monetary policy, which should continue to have a supportive effect on the markets in CEE. On average, the yield premiums on 10-year government bonds are still attractive compared to the developed markets, which should help foster positive price performance. On the other hand, investors' behaviour is mainly being dictated by the risk related to the exchange rates. Presently, the elevated level of risk is a factor against an overweighting of local currency bonds.

As short-term volatility is traditionally higher in the third quarter, **we remain neutral between equities and bonds** at the level of the overall portfolio. Provided that there is no further escalation in geopolitical risks and a sustained economic recovery materialises, we expect to see more balanced performance by both asset classes over the summer.

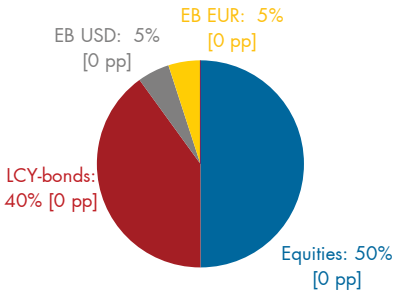
Financial analyst: Stefan Theußl

Risk-return (%)



In local currency
Source: Thomson Reuters, Raiffeisen RESEARCH

CEE portfolio weightings Q3 2014



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

Historical volatility & performance (%)

	Equities[1]						Bonds					
	Volatility[2]		Performance YTD		Performance 5Y yoy[3]		Volatility[2]		Performance YTD		Performance 5Y yoy[3]	
Countries	EUR	LCY	EUR	LCY	EUR	LCY	EUR	LCY	EUR	LCY	EUR	LCY
Czech Republic	11.6	11.6	10.8	11.1	-4.1	-3.2	1.9	1.4	4.5	4.8	6.5	7.5
Hungary	19.0	15.7	-3.7	-0.6	-1.3	0.6	8.0	3.5	3.8	7.1	10.1	12.2
Poland	12.4	10.7	3.8	4.1	8.0	6.5	5.8	2.7	3.9	4.2	9.1	7.5
Romania	15.1	14.9	10.9	9.3	14.5	15.4	2.2	0.6	2.3	0.8	3.9	4.8
Russia	23.8	18.4	-4.9	-2.6	5.0	6.3	13.9	6.2	-3.6	-0.3	8.0	9.7
Turkey	26.1	18.7	18.8	17.0	9.2	16.0	15.4	7.2	11.3	9.6	4.1	10.6
Croatia	11.6	11.7	-4.3	-4.8	-1.2	-0.4	3.4	3.4	6.2	6.2	8.1	8.1
CEE	13.4	-	2.8	-			4.6	-	4.0	-		

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

CEE Bonds: Potential mostly exhausted

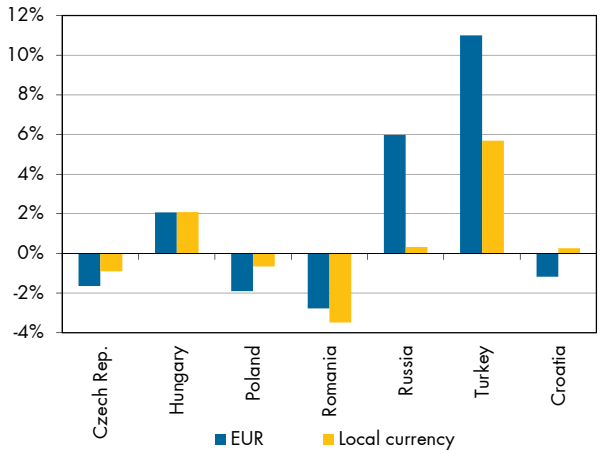
- **Short-term risks due to political turbulence**
- **Romanian bonds: attractive carry**
- **Russia underweighted due to geopolitical tensions**

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	20.0%	20.0%	0.0%
Hungary	20.0%	20.0%	0.0%
Poland	45.0%	45.0%	0.0%
Romania	6.0%	5.0%	1.0%
Russia	4.0%	5.0%	-1.0%
Turkey	5.0%	5.0%	0.0%
Croatia	0.0%	0.0%	0.0%

Source: Raiffeisen RESEARCH

Historical relative performance*



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

Yields on bonds from the CEE region appear relatively attractive, against the backdrop of the current low interest rate levels in the developed markets. Nevertheless, as the rate-cutting cycle has broadly come to an end, the potential for further price gains on investments in fixed-rate paper in CEE has mostly been exhausted.

Although the risk of a geopolitical escalation of the tensions between Russia and Ukraine has already been priced out by the markets, from the current vantage point there is really no way to tell which direction the situation will develop. Uncertainty on the markets will probably also be driven by the upcoming elections in Turkey and political problems in Poland, even if only briefly. As a result, we believe that one should not rule out a rapid increase in exchange rate volatility for CEE currencies, and we thus opt to take a more defensive positioning in the bond segment.

In Romania, we do not expect to see any further reductions in key interest rates despite the recent low inflation figures; moreover, the yields of Romanian bonds are even likely to increase slightly. Nevertheless, we do project that the exchange rate of RON vs. EUR will move on a relatively stable sideways path over the medium term. This, together with the attractive carry on Romanian bonds, prompts us to overweight Romania by 1pp in the bond segment. Any more uncertainty about possible further political tensions between Russia and Ukraine could result in elevated exchange rate risk for investments in Russian bonds and outflows of capital from this region. Furthermore, over the long run the rouble will tend to exhibit structural depreciation trends versus the US dollar and the euro. Based on these risks for Russian bonds, we underweight them by 1pp.

Financial analyst: Stefan Memmer

Expected bond market performance (%)

	3m		6m		9m		12m	
Countries	**EUR**	**LCY**	**EUR**	**LCY**	**EUR**	**LCY**	**EUR**	**LCY**
Czech Republic	-0.1	-0.6	-1.2	-2.0	-1.7	-2.6	-2.3	-3.2
Hungary	-0.5	0.8	-3.3	-0.4	-3.7	-0.8	-5.7	-1.2
Poland	1.1	1.3	1.1	0.0	0.2	-2.0	-0.4	-2.6
Romania	-1.3	-0.6	-2.6	-1.3	-2.9	-2.8	-4.1	-2.8
Russia	-4.4	-0.3	-2.8	1.9	-5.7	0.1	-2.5	2.6
Turkey	6.1	1.3	6.8	0.6	5.7	1.7	12.0	3.4
Croatia	0.3	1.1	0.9	2.2	2.2	3.4	4.3	4.5

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

Balanced risk-reward profile

- **Geopolitical tensions priced out for now**
- **Romania with solid outperformance**
- **High possibility of a setback for Polish stocks**

Given the fact that markets have already mostly priced out the possibility of a major geopolitical escalation of the conflict between Russia and Ukraine, **macro-economic and valuation aspects** should once again come to fore in terms of the development of performance.

While the upward trend in the oil price would suggest good performance on the Russian stock market, Russian stocks historically have a poor risk-return profile. In Croatia and Hungary, we do not see any factors that would lead to outperformance of these two stock markets, due to the relatively modest economic growth and the expensive looking valuations. Accordingly, we do not opt for an overweighting of Russian, Croatian and Hungarian equities. Romanian stocks should be able to post further gains, amidst low interest rate conditions and positive economic performance. **Romanian stocks are also attractive** thanks to the high dividend yields and favourable valuations, in our opinion. Although we take a positive view of the growth outlook for the Polish economy over the medium term, Polish shares look relatively expensive with a projected P/E of 14.2 for 2014. Furthermore, we see the possibility of prices falling as a result of the pension reform impact on the stock market. With this in mind, we underweight Poland in the equity segment by one percentage point and use this to finance an overweighting of one percentage point for Romania.

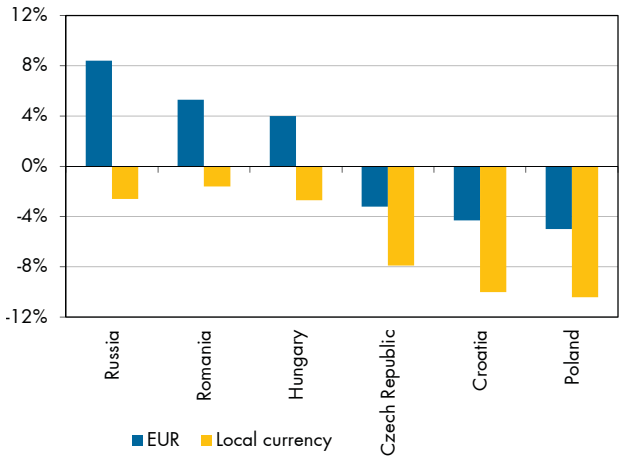
Financial analyst: Stefan Memmer

Portfolio weightings: stocks

	Portfolio	Benchmark	Difference
Czech Republic	15.0%	15.0%	0.0%
Hungary	12.0%	12.0%	0.0%
Poland	24.0%	25.0%	-1.0%
Russia	40.0%	40.0%	0.0%
Croatia	3.0%	3.0%	0.0%
Romania	6.0%	5.0%	1.0%

Source: Raiffeisen RESEARCH

Historical relative performance*



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

Expected stock market performance (%)

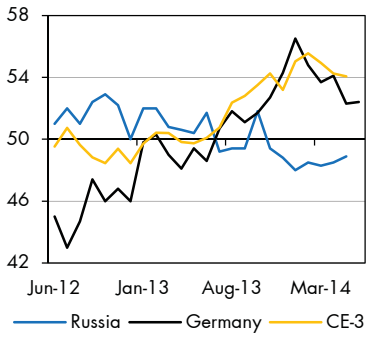
	3m		6m		9m		12m	
Countries	**EUR**	**LCY**	**EUR**	**LCY**	**EUR**	**LCY**	**EUR**	**LCY**
Poland	2.0	1.5	7.4	5.6	12.0	8.8	10.0	6.8
Hungary	1.0	2.4	5.0	8.2	5.5	8.7	2.9	7.6
Czech Republic	2.2	1.7	7.5	6.5	10.4	9.4	8.4	7.5
Russia	0.0	2.3	3.5	6.3	5.5	9.7	5.6	9.0
Romania	4.7	5.2	9.1	10.4	11.8	11.9	8.4	9.7
Croatia	-4.8	-4.0	-0.6	0.8	2.5	3.6	1.6	1.7

Not annualised, LCY...local currency
Source: Raiffeisen RESEARCH

West-East divide: CE robust, Russia stutters

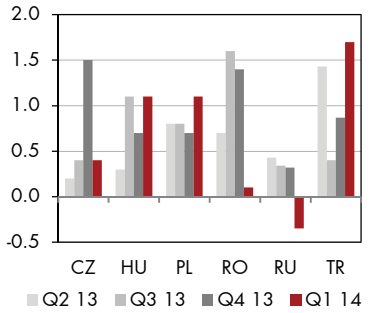
- **Robust economic performance expected in CE – forecasts revised upwards**
- **Russia close to stagnation; deep recession in Ukraine due to turmoil in the east**
- **Romania to excel, while Western Balkans mired in structural weaknesses**
- **CE inflation rates to normalise from low levels; peak reached in Turkey and Russia**

CE-3 vs Russia PMI (points)



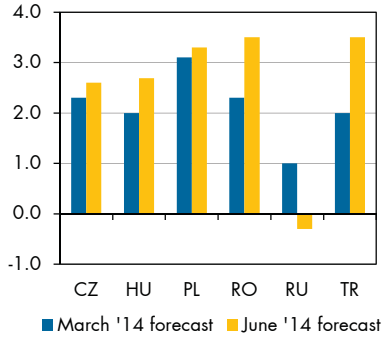
CE-3: equally weighted CZ, HU, PL; for HU 3m moving average
Source: Thomson Reuters, Raiffeisen RESEARCH

CEE GDP growth rates (% qoq)



Source: Bloomberg, Raiffeisen RESEARCH

2014 GDP forecast changes (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

In **Central Europe (CE), growth performance became more robust**. For several countries (i.e. Czech Republic, Hungary, and Romania), we even adjusted our economic forecast for 2014 upwards. Poland continues to be the engine of growth in CE with just over 3% growth. In the meantime, Romania is set to be the favourite in South Eastern Europe (SEE), with expected growth of 3.5% – as much as in 2013. Banking crisis-ridden Slovenia emerged from recession and should be able to achieve a modest growth rate. A major topic for the stronger economies in CEE is the shift from narrow, export-led growth based on recovering euro area demand to a broader, domestically-supported growth pattern. We already see some positive indications of this in the GDP data for Czech Republic, Hungary, Poland, Slovakia and Romania. While spillover from the Ukraine/Russia crisis may have some negative effect on exports, we do not see a strong impact on CE and SEE in our main scenario. The situation in the **Western Balkans is less dynamic**: smaller export sectors, structural weaknesses, and to some extent the recent flooding weigh on the economy. Croatia is in its sixth year of recession, and growth forecasts for Serbia and Bosnia were both cut down to stagnation.

Further to the east, the focus has been on the ongoing **economic deceleration of the Russian economy**, which lacks clear growth drivers, and the **geopolitical tensions with Ukraine/the West** after the annexation of Crimea. It is likely that the second factor has amplified the first one. With the (still existing) risk of tougher economic sanctions on Russia, some investment plans have been put on hold in H1. Moreover, household demand has slowed down. Thus, for **Russia, we expect close-to-stagnant GDP growth** or even a slight decline this year. The imposition of substantial economic ("sectoral") sanctions by the West represents a tail risk to our Russia forecast – while de-escalation would allow for some improvement in H2. Neighbouring **Ukraine faces a multitude of challenges**: an armed revolt in the east of the country and the corresponding collapse of the local economy in these regions (accounting for 15% of GDP and 25% of exports), protracted gas negotiations with Russia, and finally a still shaky political situation. For 2014, we expect Ukraine's GDP to contract by around 7% and to only recover slightly in 2015. Finally, Turkey is developing better than seen three months ago, and even with domestic demand easing, the good export figures allow for high headline growth. Despite some risks due to the situation in Iraq/Syria, we see growth of 3-4% for 2014.

Inflation has come down substantially in the region, reaching record lows. In the coming quarters, we **expect CE inflation to return to more normal levels**, i.e. from levels close to 1% or even below to 2-3% in CE-3 and 3-3.5% in Romania. By contrast, in **Russia and Turkey**, recent inflation rates have been elevated, partly on FX weakness. In Russia, the current level of 7-8% is likely to recede to between 6-7% in H2 and possibly fall towards 5-6% in 2015. We think that the inflation peak in Turkey has been reached and may decline to 7-8% in 2014-15 on average. Finally, Ukraine faces strong inflation of more than 10% this year, given the devaluation of the FX rate by 30%.

Financial analyst: Andreas Schwabe, CFA

Eurobond market may experience a stronger shift towards EUR

- **Eurobond market may experience a stronger shift towards EUR, weaker outlook due to UST**
- **The larger EUR issuance may help remove some smaller mispricing between the EUR and USD segments**
- **The Eurobond market is likely to remain fairly downbeat due to USA monetary policy tightening risks**
- **Presently, we find CE to be the strongest sub-region of CEE**

Monetary policy decisions in Western markets are traditionally very important for the CEE Eurobond market. Ironically, as often was the case, the Eurobond market is likely to take stronger guidance from US monetary policy, while the EU policy anchor will play only a limited role for a smaller number of CEE markets which traditionally have stronger links to euro area (EA). In particular, **the anticipation of rising yields in the UST market is likely to trim the Eurobond market performance in the US dollar segment**. Nevertheless, we do not expect a strong discorrelation to develop between the USD and EUR segments as long-term EUR yields are likely to more or less follow the bearish path of rising UST yields.

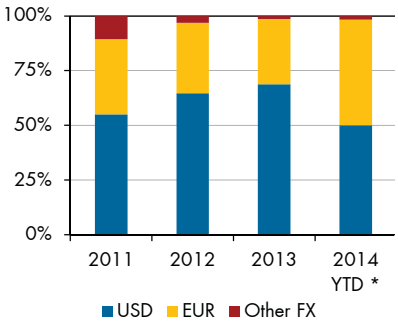
Still, a negative yield differential of 150-160bp means that a lower yielding EUR market is likely to reap more benefits, as the situation may help this segment to attract new issuers who are willing to take advantage of relatively low borrowing costs. During the first five months of 2014 we have seen the volume of sovereign placements in EUR surge to USD 25.6 bn equivalent compared to just USD 15.9 bn for the whole of 2013. In CEE, issuance in EUR reached almost half of all CEE sovereign placements for the first time since 2009. Therefore, **we project issuance in EUR to remain strong this year on the back of higher issuing activity by CEE sovereigns** coupled with the benign interest rate outlook for EA. At the same time, we see a good chance for the larger EUR issuance to help remove some smaller mispricing in the EUR segment compared to the USD market. **The new EUR placements are also likely to help boost the duration in this segment** as the issuers are likely to continue to target a 10-year maturity area.

Still, **the outlook for the Eurobond market is likely to remain fairly downbeat** due to the growing likelihood of monetary tightening in the USA next year and relatively tight valuations of many EM sovereigns. In Q2, many CEE sovereigns saw their spreads tightening in the market rally as Ukraine-Russia conflict remained relatively contained and affected primarily CIS countries. **Current market valuations and sharply negative z-scores of many CEE as measured by the EMBIG spread suggest that** – in the absence of country-specific positive factors – **any further market upside may be limited**. Therefore, we would expect the correlation between CEE Eurobond yields and UST 10-year yield to strengthen in Q3, which could result in another market sell-off to send bond prices down.

The uneven prospects of economic recovery in EA may also impose additional limitations on the economic performance of CEE sovereigns and, implicitly, limit their market upside. **Presently, we find CE to be the strongest sub-region of CEE which should be capable of reaping the full benefits from the EA recovery** while the recovery odds appear slimmer for SEE and CIS this year.

Financial analyst: Gintaras Shlizhyus

CEE sovereign issuance by FX*



** only sovereign Eurobonds, 2014 YTD includes issues for January till mid June 2014*
Source: Bond Radar, Bloomberg, Raiffeisen RESEARCH

CEE ratings direction

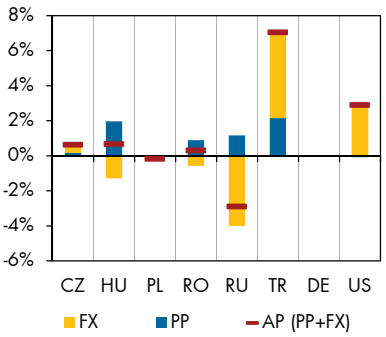
	rating *	RBI view**
CE:		
CZ	AA-/A1/A+	⇔
SK	A/A2/A+	⇔
PL	A-/A2/A-	⇔
SI	A-/Ba1/BBB+	⇔
HU	BB/Ba1/BB+	⇧
SEE:		
RO	BBB-/Baa3/BBB-	⇔
BG	BBB-/Baa2/BBB-	⇔
TR	BB+u/Baa3/BBB-	⇩⇔
HR	BB/Ba1/BB+	⇩
RS	BB-/B1/B+	⇧⇔
AL	B/B1/n.r.	⇔
BH	B/B3/n.r.	⇔
CIS:		
KZ	BBB+/Baa2/BBB+	⇩⇔
RU	BBB-/Baa1/BBB	⇩
BY	B-/B3/n.r.	⇩⇔
UA	CCC/Caa3/CCC	⇔

** rating - S&P/Moody's/Fitch*
*** RBI view - likely direction of rating change in 3-12 months perspective*
⇔ no change
⇧ upgrade possible
⇩ downgrade possible
Source: Rating agencies, Raiffeisen RESEARCH

Bear steepening of LCY yield curves expected until end-Sept 2014

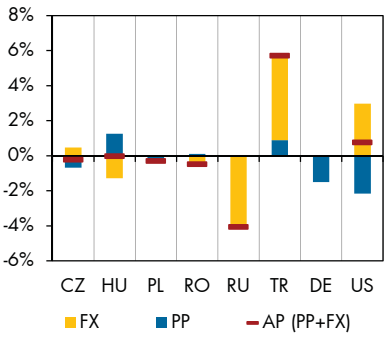
- **FX market gains added to the already benign price developments on CEE LCY debt markets**
- **Continued low-rate environment in both the euro area and CEE should lead to bear steepening, while...**
- **...the attractive carry would justify to HOLD CEE debt market exposure on a 3m horizon**
- **Russian debt market is the exception though, with continued RUB weakening weighing on expected performance**

Expected perf. 2y LCY bond -> Sep-14



FX: Currency performance (chg LCY/EUR)
PP: Bond price performance (price chg + carry)
AP: Absolute performance (PP + FX)
DE: Only price performance (PP)
Source: Bloomberg, Raiffeisen RESEARCH

Expected perf. 10y LCY bond -> Sep-14



FX: Currency performance (chg LCY/EUR)
PP: Bond price performance (price chg + carry)
AP: Absolute performance (PP + FX)
DE: Only price performance (PP)
Source: Bloomberg, Raiffeisen RESEARCH

Market Strategy (horizon: Sep-14)*

	LCY Bonds		FX
	2y	10y	
CZ	Hold	Hold	Hold
HU	Hold	Hold	Sell
PL	Hold	Hold	Hold
RO	Hold	Hold	Hold
RU	Sell	Sell	Sell
TR	Hold	Hold	Buy

** based on expected absolute performance in LCY.*
Source: Raiffeisen RESEARCH

CEE local debt markets have seen strong bids during the past three months. In the CE-4 space (CZ, HU, PL & RO), **local currency (LCY) yield curves (YC) shifted downwards** considerably. Given stable (CZK) or, in most cases, stronger exchange rates versus EUR (between 19 March 2014, the deadline of our previous strategy publication, and 18 June, when writing this report), the **FX component added to the overall favourable price performances** of CEE LCY debt markets. In the 2y segment, Turkey was the top performer, which justifies our earlier BUY recommendations. With regard to the 10y segment of CEE LCY government bonds, Hungary led the pack, posting more than 10% total performance in the period. At the other end of the spectrum, Russia's performance was fairly neutral, thanks to the recent recovery rally on RUB markets. Following de-escalation of the Ukraine conflict and, consequently, the decreasing likelihood of further sanctions against Russia by Western powers, the **recovery of the rouble pulled investors back to the RUB markets**. Additional factors from the external front supporting the favourable bond market performances in CEE included the speculation about and finally the de-facto **easing of monetary policy in the euro area**, which prompted cash-rich investors in search of yields into the high-yielding LCY debt markets.

Phantasies of possibly more ECB easing should remain in the market which should anchor especially the front end of CEE local currency yield curves around current levels on a 3m horizon (i.e. end-Sept 2014, the time horizon to which our recommendations refer). In contrast to our earlier take, the **cyclical rise in core market yields, especially Bund yields, is likely to be postponed** to the last quarter of 2014, so the related upward pressure on CEE yields should also come with a lag. At the same time, the likelihood that the **US rate-hiking cycle will start already in Q1 2105** (our baseline) **received another boost** recently, whilst the most adversely affected markets here should be the Russian OFZ market and the Turkish govie market (in contrast to CE-4 where the monetary conditions in the euro area – we expect record low rates at least until mid-2015 – are more relevant). Summing up, a **bear steepening of CEE LCY YC is our baseline scenario for Q3**.

While the **Turkish debt market is expected to outperform at the end-Sept 2014 horizon** (due to the high carry overcompensating the expected price losses) and strong appreciation of TRY versus EUR is assumed (due to a significantly stronger USD versus EUR over the same forecast horizon), we feel that the geopolitical risks (Iraq) and local political risks (presidential elections in mid-Aug) are too pronounced to upgrade our recommendation for TURKGB to BUY. As mentioned above, TURKGBs have already a huge rally behind them, following the local elections end-March and the market seems to be overbought.

Summing up, based on the expected absolute performance, we would recommend to **HOLD CEE debt market exposure. The big exception is our view of the Russian OFZ market** where we would take profits following the impressive recovery rally of the past few weeks. Our FX strategists' expectations of a continued weakening of the rouble on a 3m, 6m and 9m horizon (our FX performance calculations are versus EUR) would eat away at the attractive performance the high carry still offers.

Financial analysts: Stephan Imre

Foreign exchange expectations – negative on the Russian rouble

- **We are neutral for PLN and CZK, but have a sell recommendation for HUF against EUR for Q3 2014**
- **Russian rouble is susceptible for weakening after the recently seen strong rebound**
- **Turkish lira could show weakness before August elections, but overall Q3 performance indicates buy recommendation**
- **Ukraine hryvnia neutral as uncertainties prevail**

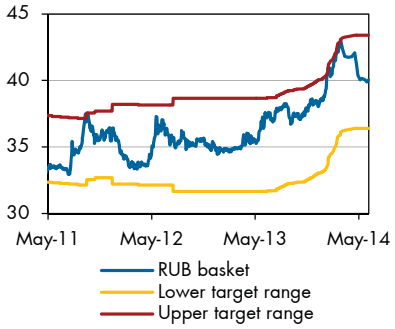
In our last strategy report one quarter ago, we had two buy recommendations: the Polish zloty and the Czech crown. Whereas the **zloty gained against the euro throughout the second quarter**, justifying our buy recommendation, the **crown only showed a sideways movement** without getting nearer to its intervention level of 27.0 against the euro. Turning to the sell recommendations, we had the Hungarian forint, the Russian rouble and the Ukraine hryvnia for the second quarter. Whereas our **hryvnia call proved to be correct with depreciation of some 14% against EUR, the Hungarian forint gained against our projection 1.4%** to the euro. Our **bearish call on the Russian rouble proved wrong,** as it quickly reversed from its depreciation trend in the course of the second quarter. This caught us on the wrong foot as we had expected the Ukraine crisis to continue weighing on the rouble for longer.

For the coming quarter, we expect the **Czech crown** to show only small potential against the euro by **moving a bit closer to the intervention level of EUR/CZK 27.0**, especially if inflation data see an upward tick. Whereas we are positive for the **Polish zloty** in the medium term, our projections for the third quarter only indicate a **minor appreciation**. This is also due to the latest strong appreciation move which was a bit overdone in our view and already saw some reversal. As for the CIS region, we think that the **Russian rouble has already shown a remarkably strong countermovement to the depreciation seen in the first quarter.** This countermove back into the middle of the target band should, however, run out of steam. We expect the **rouble to now return to its depreciation trend seen before the Ukraine crisis**. Given the current strength of the rouble, our EUR/USD projections leaves RUB with a 2.3% depreciation expectation against EUR and a hefty 5% depreciation against USD, making RUB a sell on a quarterly basis. The Ukraine hryvnia has moved in a trading range of 11-12 against USD. Given our projection that this trading range will remain and with the hryvnia currently at the weak end of this trading range, our calculations indicate appreciation potential of almost 3%, but **given the continued uncertainty we would nevertheless not put a buy recommendation out for the hryvnia.** We have a **buy recommendation for the third quarter for the Turkish lira against EUR**. While we would not exclude a weakening trend at first towards the elections in August, we project some strengthening potential for the lira thereafter. All in all this would add up to appreciation potential for the lira against the EUR of 5% for the third quarter.

Taking a more **medium-term outlook** (6-12 months), we would continue to **favour the Polish zloty,** given the benign economic fundamentals. For the Czech crown, we have postponed the expectation for the end of the intervention level towards Q4 2015. Only thereafter do we project **appreciation potential reappearing for the crown**. We remain negative on the Hungarian forint in the medium term, due to the likelihood of political intervention affecting the exchange rate. Here of course, the unpredictability of any political action makes such a forecast extremely difficult. For the **Russian rouble** as well as the Ukraine hryvnia, we also project a **medium-term depreciation trend** based on slower economic growth assumptions.

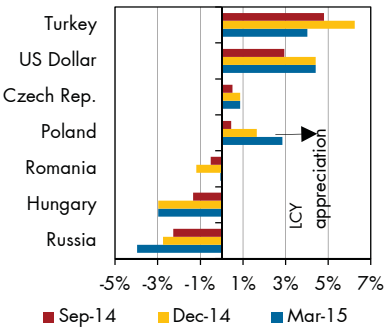
Financial analyst: Wolgang Ernst, CEFA

RUB has already seen appreciation



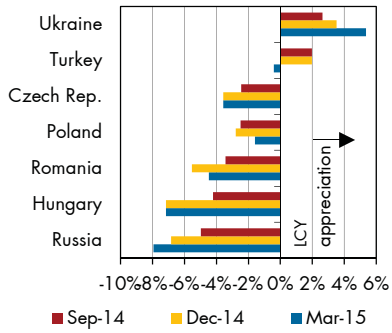
RUB basket: 5y high 43.23 5y low 32.89
Source: Bloomberg, Russian Central Bank, Raiffeisen RESEARCH

Projections LCY vs. EUR



Source: Bloomberg, Raiffeisen RESEARCH

Projections LCY vs. USD

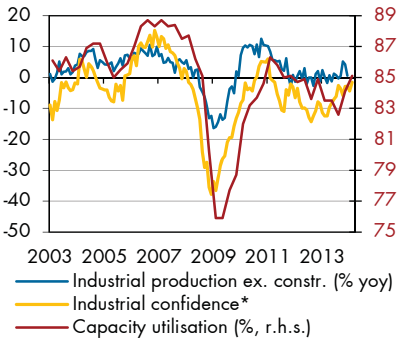


Source: Bloomberg, Raiffeisen RESEARCH

Economic recovery takes a break, but resumption expected

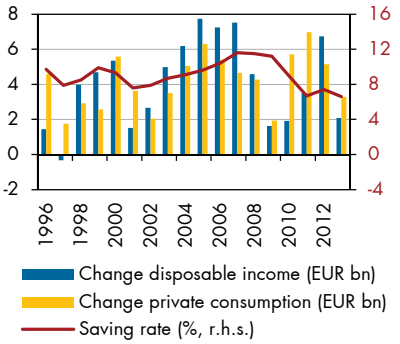
- **Weaker growth in the first quarter, but not a reversal**
- **Weaker pace of economic recovery now appears more likely**
- **Improvement in domestic demand stalls, external trade still the main support for now**
- **Inflation below 2%, but clearly above euro area average**

Capacity utilisation is back to average



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

Saving rate: Low point reached?



Source: Statistics Austria, Raiffeisen RESEARCH

The acceleration of business cycle dynamics seen in the second half of 2013 did not continue in the first three month period of the current year, as real GDP growth decelerated from 0.4% qoq (Q4 2013) to just 0.2% qoq. Private consumption continued to be below-average, in contrast to government consumption. Compared to the previous quarter, investments once again showed a decline, albeit a small one, due equipment investment, whereas another gain was registered in construction investment. Rising exports and slightly weaker import growth resulted in a stronger contribution from net exports to quarterly GDP growth, while domestic demand was a detrimental factor due to the significantly negative contribution of inventories. Consequently, **economic performance** in Austria was **still driven by external trade**, while the recovery in domestic demand faltered.

The development of some key **leading indicators** was rather **disappointing of late**. For instance, the purchasing managers' index for manufacturing fell by 3.2 points to 50.9 between December and May, and the EU Commission's economic sentiment indicator stagnated during the same period. It should be noted, however, that the indicators are still in expansive territory (purchasing managers' index) or are above the long-term average (economic sentiment indicator).

Consequently, both indicators signal a further increase in economic activity in Austria, even though the strength of the economic recovery will be lower than in previous phases of revival. For Q2 and the following quarters, quarterly growth rates are also now expected to be somewhat lower than previously thought. The **more subdued GDP forecasts for this year** and next year reflect this factor and the economic setback during the first quarter. Accordingly, we lowered our real GDP forecasts for this year and 2015 by 0.2 percentage points each to 1.3% and 2.1%, respectively. **Domestic demand is still expected to continue increasing and the contribution of net exports should decline.** For example, start-

Key economic figures and forecasts

	2012	2013	2014e	2015f
Real GDP (% yoy)	0.9	0.3	1.3	2.1
Private consumption (% yoy)	0.5	-0.2	0.6	1.6
Gross fixed capital formation (% yoy)	1.6	-0.7	0.2	3.2
Nominal exports (% yoy)	3.8	4.9	7.2	8.6
Nominal imports (% yoy)	2.3	2.6	5.3	8.9
Trade balance (goods and services, EUR bn)	9.9	14.7	18.9	19.9
Current account balance (EUR bn)	7.3	8.4	9.4	8.0
General budget balance (EUR bn)*	-8.0	-4.7	-8.4	-4.0
General budget balance (% of GDP)*	-2.6	-1.5	-2.6	-1.2
Unemployment rate (avg, %, EU definition)	4.4	4.9	4.8	4.7
Consumer prices (avg, % yoy)	2.6	2.1	1.5	1.8
Real wages (% yoy)	0.7	0.4	1.0	0.9
Unit labour costs (% yoy)	3.0	2.5	1.9	2.1

** state, provinces, municipalities and social security authorities*
Source: Statistics Austria, Thomson Reuters, Raiffeisen RESEARCH

ing from the end of 2014, domestic demand should account for the largest share of quarterly GDP growth. Until then however, net exports will still contribute the lion's share to GDP growth, based on the assumption of solid development of exports and comparatively weaker import growth. This slower growth in imports is due to the weaker-than-expected development of domestic demand. The conflict in Ukraine continues to be a risk to our economic scenario. In the event of economic sanctions between the EU and Russia (which is not what we expect), it is highly likely that there will be negative implications for business cycle dynamics.

The expected recovery in domestic demand should be supported in part by stronger growth in **private consumption.** Even though this may only materialise in the second half of the year, there are several factors pointing to a revival in private consumption. For example, a more pronounced increase in employment is expected over the forecast horizon, but this will hardly have an impact on the unemployment statistics, due to the steady rise in the labour force. To some extent, the below-average consumer confidence can be viewed against this backdrop. Another factor is the positive development of real wages (moderate wage growth coupled with low inflation), which creates favourable conditions for private consumption. At the same time, it can be expected that part of the increase in real income will be used to raise the saving rate, which has fallen significantly in recent years.

Investment activity is also expected to support domestic demand over the forecast horizon. Equipment investment should be supported by the favourable financing conditions, the need for replacement investment and the level of capacity utilisation, which returned to the long-term average. In this regard, one positive aspect is that not only has industrial confidence been higher than the long-term average since the autumn of 2013, it is actually exhibiting positive momentum.

The development of **inflation** (HICP) has been subdued in recent months. Aside from December (2.0% yoy), inflation has always been around 1.5% yoy since October 2013. The strongest contributions to inflation came from services prices, whereas goods prices have only played a subordinated role. In 2014 as a whole, the rate of inflation is expected at 1.5%, followed by 1.8% in 2015.

Financial analyst: *Matthias Reith*

GDP: value added by sector

Change (% yoy, in real terms)	2012	2013	2014e	2015f
Agriculture & forestry	-8.0	-1.4	0.0	0.0
Prod. of goods/mining	1.1	1.3	3.1	4.0
Energy/water supply	9.7	8.7	0.5	2.5
Construction	0.8	0.3	1.5	2.2
Wholesale and retail trade	-1.7	-1.4	0.3	2.0
Transportation	-1.0	-0.6	1.0	2.2
Accom. & restaurant trade	1.6	-2.3	0.5	1.2
Information and communication	-1.5	-2.0	0.7	2.0
Credit and insurance	2.7	-0.1	0.5	1.7
Property & business services	1.7	0.7	1.2	2.2
Other economic services	0.8	0.3	1.5	2.8
Public sector	-0.2	0.3	0.2	0.5
Healthcare, social services	2.0	1.6	1.4	1.5
Other services	1.1	1.5	1.5	2.0
Gross domestic product	0.9	0.3	1.3	2.1

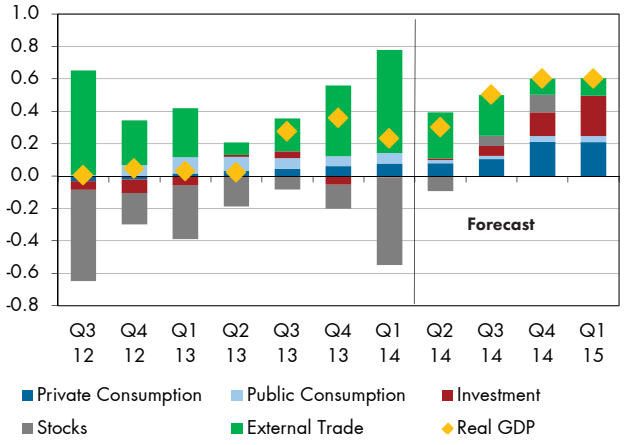
Source: Statistics Austria, Raiffeisen RESEARCH

GDP: expenditure composition

Change (% yoy, in real terms)	2012	2013	2014e	2015f
Private consumption	0.5	-0.2	0.6	1.6
Public consumption	0.2	1.6	1.1	0.7
Gross fixed capital formation	1.6	-0.7	0.2	3.2
Equipment	2.1	-3.4	-1.1	3.0
Construction	2.5	1.2	1.4	3.4
Exports	1.2	2.7	5.6	6.6
Imports	-0.3	0.5	3.7	6.9
Gross domestic product	0.9	0.3	1.3	2.1

Source: Statistics Austria, Thomson Reuters, Raiffeisen RESEARCH

Contributions* to real GDP growth (qoq)

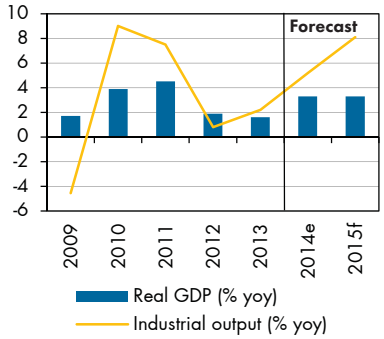


** in percentage points*
Source: Thomson Reuters, Raiffeisen RESEARCH

High resilience of the Polish economy

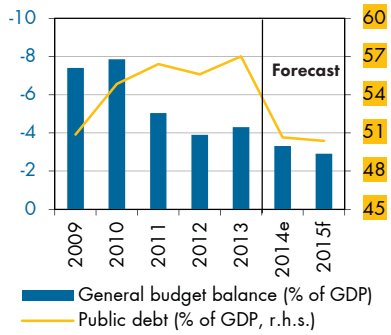
- **Domestic demand drives solid growth in Q1, investment jumps by 10% yoy**
- **Low inflation precludes interest rate hikes in 2014, hikes possible in Q2 2015**
- **Strengthening potential of PLN versus EUR seems to be exhausted, sideways movement expected on a 3m horizon**
- **POLGB bond market not a buy anymore following the recent rally**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

Economic outlook

The Polish economy showed high resilience to adverse external factors during the first quarter. While euro area GDP dynamics disappointed slightly in Q1, **they surprised on the upside yet again in Poland**, as growth accelerated to 3.4% yoy from 2.7% yoy in the previous quarter. It appears that not only the scale of growth was positive, but also its structure, as it was **based mainly on domestic demand** (contribution of 2.9pp) for the first time since Q1 2012. As expected, private consumption continued its gradual upswing with a rate of 2.6% yoy. Slight improvements on the labour market and falling inflation helped to generate rising real wage growth and positively influence consumer confidence. The **biggest surprise came in fixed capital investments** which jumped by 10.7% yoy. This robust growth was generated to a large extent by the construction industry, where production was facilitated by the exceptionally good weather conditions. However, leading indicators such as the PMI index point to stabilisation of economic growth in Q2. Therefore, we stick to the scenario of GDP growth stabilising at above 3% yoy in 2014.

The upswing in economic activity has not yet resulted in any inflationary pressure. The **CPI index surprised on the downside,** dropping to a mere 0.2% yoy in May. This low level of inflation rules out possible interest rate hikes this year and raises speculations about further cuts. Nonetheless, we do **not expect further monetary policy loosening** as the economy is accelerating well, based on the rebound in domestic demand. Consequently, we forecast that **interest rates will remain unchanged at least until Q2 2015** when we expect CPI to edge closer to 2% yoy. The crucial factor for future MPC decisions will be the new inflation report's forecasts. If GDP is projected to accelerate further, it would be unlikely for the Council to decide in favour of a rate cut. However, only in the event of possible growth deceleration combined with a scenario of prolonged disinflation, the Council could decide for additional policy loosening in our opinion.

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	311.1	354.7	370.4	381.5	388.8	408.9	441.4
Real GDP (% yoy)	1.7	3.9	4.5	1.9	1.6	3.3	3.3
Industrial output (% yoy)	-4.5	9.0	7.5	0.8	2.2	5.2	8.1
Unemployment rate (avg, %)	11.0	12.1	12.4	12.8	13.6	13.1	12.7
Nominal industrial wages (% yoy)	4.4	3.3	5.0	3.4	2.9	3.3	5.0
Producer prices (avg, % yoy)	3.4	2.1	7.6	3.3	-1.3	-0.6	1.6
Consumer prices (avg, % yoy)	3.5	2.6	4.3	3.7	0.9	0.4	2.3
Consumer prices (eop, % yoy)	3.5	3.1	4.6	2.4	0.7	0.9	2.5
General budget balance (% of GDP)	-7.4	-7.9	-5.0	-3.9	-4.3	-3.3	-2.9
Public debt (% of GDP)	50.9	54.8	56.4	55.6	57.0	50.7	50.4
Current account balance (% of GDP)	-3.9	-5.1	-4.9	-3.5	-1.3	-1.1	-2.1
Official FX reserves (EUR bn)	55.2	70.0	75.7	82.6	77.1	83.7	89.7
Gross foreign debt (% of GDP)	62.5	66.9	67.5	72.7	70.8	69.2	68.0
EUR/PLN (avg)	4.33	3.99	4.12	4.18	4.20	4.16	4.04
USD/PLN (avg)	3.10	3.01	2.96	3.25	3.16	3.10	3.13

Source: Thomson Reuters, Raiffeisen RESEARCH

Financial market outlook

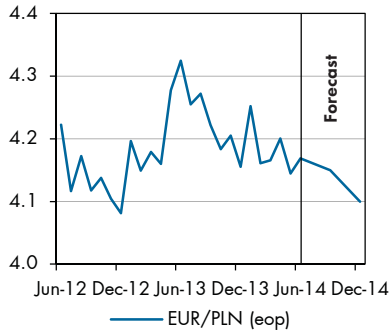
The Polish zloty showed the expected appreciation trend throughout Q2 with an additional strong tone in June heading towards EUR/PLN 4.10 and overshooting our already positive projections. PLN was supported by the benign economic developments, additional monetary easing in the euro area as well as the pricing out of some external risks (Ukraine). The recent political debacle with the "Polish tape gate" only had short-term negative implications for PLN in our view, erasing some of the earlier gains.

The appreciation trend in Q2 was already very strong, making technical corrections in Q3 more likely in our opinion. We believe that a somewhat cautious view for the zloty is supported by speculations about possible interest rate cuts in Q3 in Poland, the benign economic expectations which have already been priced in and the prolonged external risks related to Ukraine. Therefore, we would only expect a sideways movement for the zloty until the end of Q3, putting EUR/PLN at 4.15. Nevertheless, our **medium-term outlook continues to indicate an overall appreciation trend for the zloty** against the euro.

In line with these broadly favourable FX market developments, the **PLN government bond yield curve saw a downward shift for all maturities** in the past three months. The back end of the curve – the 10y benchmark yield moved south by 60bp since 19 March (cut-off date of our previous strategy publication) – outperformed shorter maturities (40bp decrease in the 2y yield). The favourable bond market performance was in line with the regional trend in Hungary, for example, which also witnessed a bull flattening of the yield curve. The main drivers were the same ones which supported the FX market moves. Given the prevailing expectations of more easing in the euro area and the corresponding delay in the cyclical rise in Bund yields, along with speculations about the resumption of the rate-cutting cycle in Poland (not our baseline view) on the back of still-subdued inflationary pressures, **shorter-dated tenors in particular should remain well anchored** over a 3m horizon. With longer-dated yields likely to experience moderate upward pressure in the same time frame, a **bear steepening of the POLGB curve is our call for the short term**. Nevertheless, the stable currency in tandem with the still-attractive carry on POLGB should more or less compensate for the price losses which we anticipate. Therefore, we would not buy-in into this market any longer, but would **recommend holding Polish government bond exposure.** The main upward risk to our scenario is stronger-than-expected ECB easing, whilst any reescalation in the Ukraine-Russia conflict poses the main downside risk.

Financial analysts: Michał Burek, Raiffeisen Polbank, Warsaw
Stephan Imre, RBI Vienna

Exchange rate development



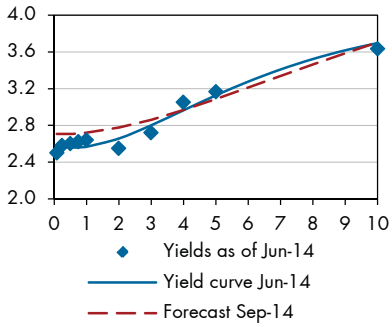
EUR/PLN: 5y high 4.57, 5y low 3.83
Source: Bloomberg, Raiffeisen RESEARCH

Exchange rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
EUR/PLN	4.17	4.15	4.10	4.05	4.05
Cons.		*4.10*	*4.06*	*4.06*	*4.02*
USD/PLN	3.07	3.14	3.15	3.12	3.19
Cons		*3.04*	*3.06*	*3.07*	*3.07*

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

PLN rate and yield curve (%)*



** 1m – 12m interest rates; 2y – 10y LCY gov. bond yields*
Source: Bloomberg, Raiffeisen RESEARCH

Interest rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
Key rate	2.50	2.50	2.50	2.50	2.75
Consensus		*2.50*	*2.50*	*2.63*	*2.75*
1 month[2]	2.40	2.62	2.62	2.63	2.90
3 month[2]	2.48	2.72	2.72	2.77	3.05
Consensus		*2.72*	*2.75*	*2.90*	*3.04*
6 month[2]	2.50	2.74	2.80	2.92	3.20
12 month[2]	2.54	2.82	2.90	3.09	3.37

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

Yield forecasts

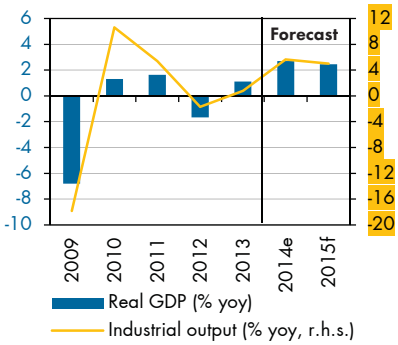
	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
2y T-bond[2]	2.60	2.6	3.0	3.4	3.8
Cons.		*2.9*	*3.0*	*3.2*	*3.4*
5y T-bond[2]	3.17	3.2	3.6	4.0	4.3
10y T-bond[2]	3.64	3.6	3.9	4.3	4.5
Cons.		*4.0*	*4.2*	*4.3*	*4.4*

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

Trend remains positive

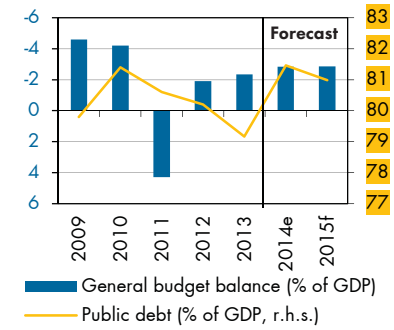
- **Recovery gathering momentum; for 2014 we expect 2.7% GDP growth, while inflation should reaccelerate**
- **Private investments booming, household consumption lags behind**
- **Possibility of deeper-than-expected rate cuts pose the biggest risk for HUF vs. EUR**
- **Holding Hungarian LCY debt would be recommended**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

Economic outlook

In the first quarter of 2014, the Hungarian economy **showed surprisingly robust growth**. GDP was 3.5% higher year-on-year and up 1.1% from the previous quarter, driven by a healthy looking production structure. The **expansion of industrial production** was responsible for almost half of overall economic growth, but the **service industry also added** 0.9 percentage points (pp) and construction contributed 0.5pp. On the demand side, the growth engine is increasingly shifting towards the private economy: household consumption grew 1.5% yoy in the first three months, and private investments saw stunning 26.4% growth – admittedly from a very low base.

As the **recovery in domestic demand** is progressing faster than anticipated, we adjusted our GDP forecasts upwards: we now project 2.7% GDP growth this year and 2.5% in 2015. More importantly, we see the positive trends continuing and the private sector contribution should remain strong. Although household consumption is lagging behind overall economic growth due to the ongoing deleveraging, it is reviving after seven lean years, and gross fixed capital formation is expected to head 8% higher for the year. This is a much needed turn of events, partly boosted by the **cheap loans available** via the central bank's Funding for Growth Scheme. On the other hand, with the external environment gradually improving, the sizeable surplus on the Hungarian trade balance is likely to improve further – we expect it to record a surplus of 8% of GDP (aided by the weakening of the Hungarian forint against the euro).

In April, Fidesz-KDNP won a **two-thirds majority in the parliamentary elections for a second term** in a row. We expect that the third Orbán **Government will have a similar agenda** as the previous one. This entails keeping the budget deficit below 3% of GDP, carrying on with large sector taxes on selected industries, further strengthening the role of the public sector, and promoting the reduction of the FX loan exposure of the state, the corporate sector and the household sector.

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	91.5	96.3	101.3	96.1	98.0	99.0	101.2
Real GDP (% yoy)	-6.8	1.3	1.6	-1.7	1.1	2.7	2.5
Industrial output (% yoy)	-17.8	10.6	5.4	-1.7	0.8	5.7	5.0
Unemployment rate (avg, %)	9.8	11.1	11.0	10.9	10.4	7.4	6.2
Nominal industrial wages (% yoy)	3.8	5.5	6.2	6.2	4.6	5.5	5.8
Producer prices (avg, % yoy)	4.9	4.5	4.3	4.3	0.7	0.9	3.5
Consumer prices (avg, % yoy)	4.2	4.9	3.9	5.7	1.7	0.7	3.0
Consumer prices (eop, % yoy)	5.6	4.7	4.1	5.0	0.4	2.5	3.3
General budget balance (% of GDP)	-4.6	-4.2	4.3	-1.9	-2.3	-2.8	-2.9
Public debt (% of GDP)	79.8	81.4	80.6	80.2	79.2	81.5	81.0
Current account balance (% of GDP)	-0.2	1.1	0.8	1.8	3.0	3.4	3.5
Official FX reserves (EUR bn)	30.0	33.7	37.8	33.9	33.0	33.0	31.0
Gross foreign debt (% of GDP)	149.9	143.5	130.3	131.1	123.5	118.2	112.6
EUR/HUF (avg)	280.3	275.4	279.4	289.2	296.8	308.5	318.8
USD/HUF (avg)	201.1	207.6	200.7	225.0	223.5	230.2	247.1

Source: Thomson Reuters, Raiffeisen RESEARCH

Financial market outlook

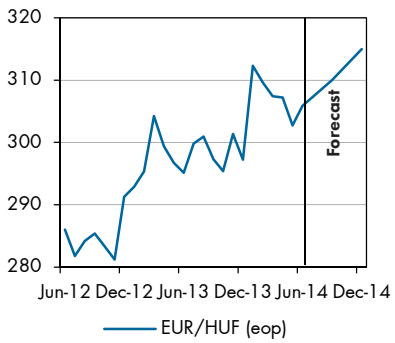
Inflation mostly surprised on the downside in the first five months of 2014, even sinking below zero in April and May (negative inflation for the first time since 1968). While disinflation is attributable to some degree to declines in fuel and food prices, the main contributor was administered household energy price cuts. Since these one-off items will fade out in H2 2014, we forecast a **gradual return of CPI inflation to the central bank's target of 3% by Q2 2015**.

Given our inflation outlook, the **room for additional monetary policy stimulus is limited.** The MNB has lowered the base rate every month since August 2012 with cuts now totalling 460bp. Although there is no clear guidance by the MPC anymore, we see token rate cuts coming in the summer with the base rate probably not sinking below 2%. On the other hand the **central bank is shaping monetary conditions with additional tools** such as the Funding for Growth Scheme (where it provides interest-free funding for commercial banks to stimulate SME lending activity) and a change in its monetary policy toolkit. Replacement of the two-week central bank bill with the two-week deposit facility is essentially a decision that was based on considerations to make the main sterilising instrument less attractive to investors. The intention is to channel liquidity that is currently on the central bank's balance sheet to the market of short-dated Hungarian government bonds. In our view, this will largely work out and therefore HGBs should experience excess demand – especially for intra-year tenors (T-bills). The longer the maturity, the less additional demand we would expect, which, in turn, could contribute to a **moderate steepening of the yield curve**, i.e. short-dated yields should remain more or less stable, whilst longer tenors would benefit less. The spread to Bunds (spread tightening was impressive across most CEE debt markets in the past few months) should remain fairly stable. On a longer horizon, the back end of the HGB curve should outperform the short end, in line with the cyclical rise in core market yields. Overall, on a 3m horizon we **recommend to hold Hungarian government debt papers.**

The combination of excess liquidity in the financial markets and the melt-down of interest rates and yields also increases the risk that **the Hungarian forint might experience pressure in the second half of this year.** According to our forecast, HUF weakening will be smaller than initially expected, but gradual. However, we would not rule out renewed peaks in the EUR/HUF rate. We expect the exchange rate to end the year at 315 against the euro.

Financial analysts: Ádám Keszeg, Raiffeisen Bank Zrt., Budapest
Stephan Imre, RBI Vienna

Exchange rate development



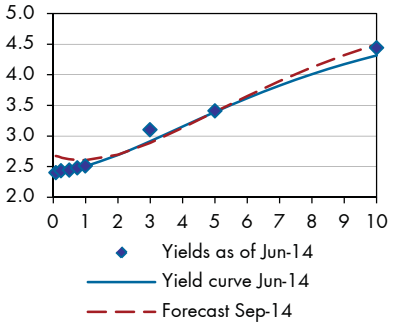
EUR/HUF: 5y high 320.41, 5y low 261.32
Source: Bloomberg, Raiffeisen RESEARCH

Exchange rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
EUR/HUF	305.90	310.0	315.0	315.0	320.0
Cons.		*304.0*	*302.0*	*300.0*	*299.0*
USD/HUF	224.94	234.8	242.3	242.3	252.0
Cons.		*226.0*	*227.0*	*227.0*	*228.0*

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

HUF rate and yield curve (%)*



** 1m – 12m interest rates; 3y – 10y LCY gov. bond yields*
Source: Bloomberg, Raiffeisen RESEARCH

Interest rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
Key rate	2.40	2.20	2.20	2.20	2.20
Consensus		*2.25*	*2.38*	*2.63*	*2.75*
1 month[2]	2.40	2.40	2.40	2.40	2.40
3 month[2]	2.43	2.60	2.65	2.70	2.70
Consensus		*2.64*	*2.56*	*2.63*	*2.76*
6 month[2]	2.44	2.65	2.75	2.85	2.85
12 month[2]	2.51	3.00	0.00	0.00	0.00

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

Yield forecasts

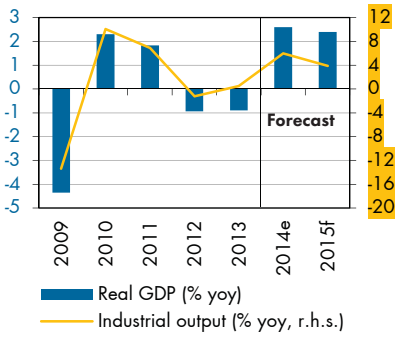
	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
3y T-bond[2]	3.10	2.9	2.9	3.0	3.2
Cons.		*n.v.*	*n.v.*	*n.v.*	*n.v.*
5y T-bond[2]	3.41	3.3	3.5	3.7	4.0
10y T-bond[2]	4.44	4.5	4.8	5.0	5.2
Cons.		*4.9*	*5.2*	*5.2*	*5.0*

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

Back to quick growth

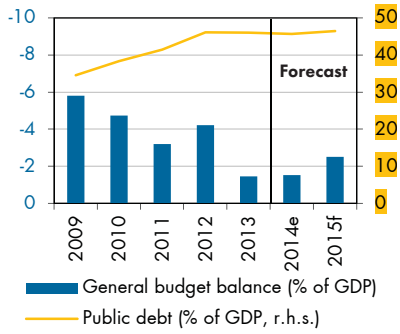
- **Strong recovery without inflation**
- **Monetary policy strongly expansive, fiscal policy mildly expansive**
- **EUR/CZK to remain above 27.0 until Q4 2015**
- **Inflation and bond yields will only increase gradually in line with core and regional peer markets**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

Economic outlook

The Czech economy grew by 0.4% qoq in Q1 after expanding by 1.5% qoq in Q4 2013. Given that GDP growth in Q4 2013 was boosted by one-off factors, the quarterly rate of growth was a positive surprise. Quarterly growth in Q1 was **mostly driven by consumption of government and households** (growth of 1.8% qoq and 1.2% qoq, respectively). Fixed investments grew by better than expected 1.2% qoq. The contribution of net exports was positive. The **structure of GDP growth is favourable**, as growth is no longer driven only by external demand, but also by internal demand. Industrial production and retail sales also continued on an upward trend. The PMI index rose to almost 58 points in May, marking one of the highest values globally and indicating very rapid growth in Q2. Due to the remarkable GDP figures, monthly data and leading indicators, we decided to **raise our GDP growth forecast** for this year by 0.3 percentage points to 2.6%. The forecast of 2.4% for 2015 is left unchanged. Our forecast is also supported by the **expansive monetary policy and mildly expansive fiscal policy**. The new Czech government agreed to raise wages in the public sector by 3.5%, boost infrastructure expenditures, introduce a third, lower VAT rate on selected items, etc. in 2015. Because of fiscal expansion, the fiscal deficit is expected to rise to 2.5% of GDP in 2015 from the current year's forecast 1.5% of GDP.

Unlike GDP, **inflation continued on a downward trend** and reached a cyclical low of +0.1% yoy in April. The main reason for the decline in inflation was lower-than-expected inflation in the euro area. CNB and we believed that the economy would import external inflation through a weak CZK, but there is not much to import in the current environment. Lower-than-expected inflation **postpones the expected exit from the FX intervention regime**. We believe that brisk growth and almost zero inflation are not mutually consistent. Higher internal demand will translate into higher inflation in the future, although the leakage of internal demand to CPI will be slower than we initially expected.

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	142.4	150.0	155.6	153.1	149.5	147.3	154.0
Real GDP (% yoy)	-4.4	2.3	1.8	-0.9	-0.9	2.6	2.4
Industrial output (% yoy)	-13.4	10.1	6.9	-1.2	0.5	6.0	3.9
Unemployment rate (avg, %)	6.2	7.0	6.7	6.8	7.7	7.5	7.4
Nominal industrial wages (% yoy)	3.5	3.8	3.4	3.4	0.9	2.1	3.5
Producer prices (avg, % yoy)	-3.1	1.2	5.6	2.1	0.8	-0.1	1.7
Consumer prices (avg, % yoy)	1.0	1.5	1.9	3.3	1.4	0.8	2.2
Consumer prices (eop, % yoy)	1.0	2.3	2.4	2.4	1.4	1.7	1.8
General budget balance (% of GDP)	-5.8	-4.7	-3.2	-4.2	-1.5	-1.5	-2.5
Public debt (% of GDP)	34.5	38.4	41.4	46.2	46.0	45.7	46.5
Current account balance (% of GDP)	-2.4	-3.9	-2.7	-1.3	-1.4	0.4	0.3
Official FX reserves (EUR bn)	28.9	31.8	31.1	34.0	40.8	42.0	43.4
Gross foreign debt (% of GDP)	43.5	47.6	49.0	50.9	54.2	55.6	53.9
EUR/CZK (avg)	26.44	25.28	24.59	25.14	25.98	27.34	27.11
USD/CZK (avg)	18.97	19.06	17.66	19.55	19.56	20.40	21.02

Source: Thomson Reuters, Raiffeisen RESEARCH

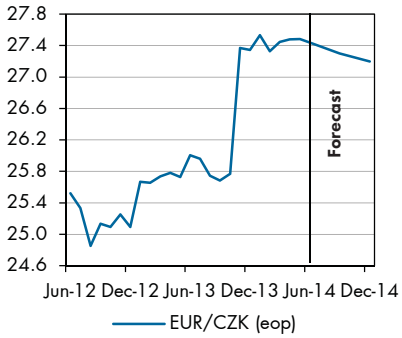
Financial market outlook

Although the economy has been growing faster than expected, inflation has remained subdued. This means that the CNB will very likely postpone exiting its regime of keeping EUR/CZK above 27.0. We believe that **over the next twelve months CPI inflation will gradually rise above the 2% CNB target**, but the CNB will rather hesitate to let the currency appreciate during the summer vacation and low market activity. As the CNB will publish new inflation forecasts in July and then in November, we see the **highest probability of an exit in November 2015**. If there is market speculation about CZK appreciation, the CNB might also decide to abandon the current policy regime if it feels comfortable with the inflation outlook. In our baseline scenario, we expect CZK to appreciate by about 2.5% versus EUR in Q4 2015. However, we maintain our view that the process of abandoning the FX floor will be tricky, as there may be strong pressures either from speculative or hedging activity. The CNB has studied the Swiss National Bank extensively and we might find many similarities, for example in communication. How the CNB will communicate the exit without bringing about a sharp increase of FX reserves remains puzzling. According to our calculations an inflation rate 10bp lower than our forecasts implies a delay in the expected CZK appreciation by one month. However, our baseline assumption is that inflation will reach 2.0% by January 2015.

With inflation close to zero, looser monetary conditions in the euro area and the increasing likelihood that the quasi-zero rate environment locally will last throughout 2015, **Czech government bond yields managed gains in Q2 2014**. Additional support came from the fiscal front, as the government budget figures were surprisingly positive. We expect that the economy will expand further and CPI inflation will gradually pick up, while fiscal policy will be slightly expansionary in the coming years. As Czech debt managers frontloaded issuance in H1 2014, the financing position of the Ministry of Finance remains favourable. In Q3 2014, the MoF plans to auction only CZK 10-20 bn of medium and long-term government bonds. Full-year net CZGB emission is expected to amount to less than CZK 120 bn. **Until the end of 2014 we expect only a gradual increase in Czech government bond yields**, in line with core, but also regional peer markets. Whilst the front-end of the CZGB curve should remain well anchored around the current levels, the back end should rise earlier and be more pronounced as the year progresses, leading to a bear steepening of the yield curve. Nevertheless, this should materialise mainly starting from Q4, so **for Q3 we stick to our neutral recommendation for CZGB**.

Financial analysts: Michal Brozka, Raiffeisenbank a.s., Prague
Stephan Imre, RBI Vienna

Exchange rate development



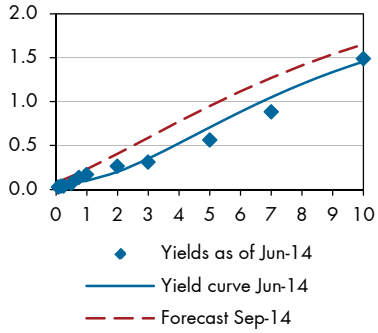
EUR/CZK: 5y high 27.69, 5y low 23.99
Source: Bloomberg, Raiffeisen RESEARCH

Exchange rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
EUR/CZK	27.44	27.30	27.20	27.20	27.20
Cons.		*27.10*	*27.10*	*27.00*	*26.90*
USD/CZK	20.18	20.68	20.92	20.92	21.42
Cons.		*20.20*	*20.50*	*20.40*	*20.50*

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

CZK rate and yield curve (%)*



** 1m – 12m interest rates; 2y – 10y LCY gov. bond yields*
Source: Bloomberg, Raiffeisen RESEARCH

Interest rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
Key rate	0.05	0.05	0.05	0.05	0.05
Consensus		*0.05*	*0.06*	*0.08*	*0.11*
1 month[2]	0.03	0.05	0.05	0.20	0.20
3 month[2]	0.04	0.10	0.20	0.35	0.35
Consensus		*0.34*	*0.36*	*0.40*	*0.48*
6 month[2]	0.07	0.10	0.30	0.50	0.60
12 month[2]	0.17	0.30	0.50	0.70	0.00

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

Yield forecasts

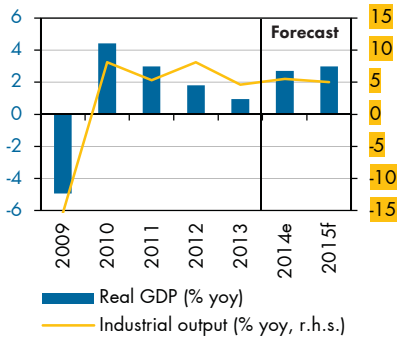
	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
2y T-bond[2]	0.27	0.3	0.3	0.5	0.6
Cons.		*0.6*	*0.7*	*0.7*	*0.9*
5y T-bond[2]	0.56	0.7	0.9	1.0	1.3
10y T-bond[2]	1.49	1.7	2.0	2.2	2.4
Cons.		*2.0*	*2.1*	*2.2*	*2.4*

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

Balanced growth

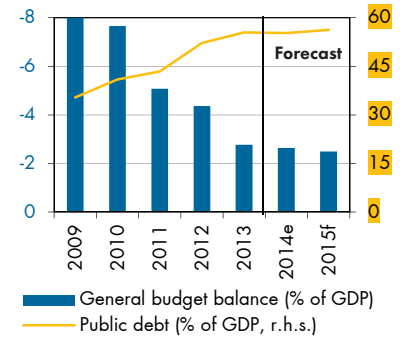
- **Positive surprise of domestic demand**
- **Consumer sector should have an exceptional year**
- **Price development remains very weak**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

The GDP data for Q1 2014 painted a **picture of improvement** in the Slovak economy. After a long period of time, the **structure of growth has visibly changed** more in favour of domestic demand. Household consumption grew by as much as 3.4% yoy, while investment activity is gaining strong momentum and growing at 3.6% yoy. Export activity was in line with the good industrial production numbers (Q1 2014: +9.8% yoy). For the rest of 2014, we expect the quarterly rate of GDP growth to remain at 0.7%, and thus the annual average will be around 2.7% in 2014. Also, we see the broad-based **structure of growth as being sustainable**.

All types of production sectors should benefit from the recovery, especially industry and consumer services. Only construction might stagnate. The recovering economy should help to **decrease the unemployment rate** to 13.7% from 14.2% in 2013.

Consumer price **inflation reached a historical low** in April 2014 at -0.2% yoy. Inflation has been at a "zero" level for several months now, and we only expect a very gradual increase towards 0.6% at the end of 2014. The decrease in energy prices and stagnating food prices are the most important factors behind price developments. Moreover, it seems that the agricultural harvest will also be good this year, limiting possible food price increases next year. Therefore, without visible demand price pressures, **inflation is set to remain at very low levels.** We consider this development as supportive for the real economy without any danger of falling into a deflationary spiral. However, low inflation may potentially create problem for public finances. The low nominal GDP growth makes the ratios for debt and deficit to nominal GDP look slightly worse. MinFin estimates that lower-than-expected nominal growth may increase debt by around 0.5% of GDP in 2014.

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

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	63.1	65.9	69.0	71.1	72.1	73.9	76.6
Real GDP (% yoy)	-4.9	4.4	3.0	1.8	0.9	2.7	3.0
Industrial output (% yoy)	-15.5	8.1	5.3	8.1	4.6	5.5	5.0
Unemployment rate (avg, %)	12.1	14.4	13.4	13.9	14.2	13.7	12.9
Nominal industrial wages (% yoy)	2.6	5.4	3.6	4.0	3.6	4.2	3.5
Producer prices (avg, % yoy)	-2.5	-2.8	2.6	3.9	-0.1	-3.5	1.5
Consumer prices (avg, % yoy)	1.6	1.0	3.9	3.6	1.4	0.1	1.4
Consumer prices (eop, % yoy)	0.5	1.3	4.4	3.2	0.4	0.6	1.5
General budget balance (% of GDP)	-8.0	-7.7	-5.1	-4.4	-2.8	-2.6	-2.5
Public debt (% of GDP)	35.4	41.0	43.4	52.2	55.4	55.2	56.2
Current account balance (% of GDP)	-2.6	-3.7	-2.0	2.2	2.2	1.7	1.4
Gross foreign debt (% of GDP)	72.3	74.5	76.5	71.5	82.7	84.6	86.7
EUR/SKK (avg)[1]	30.13					Euro area membership at EUR/SKK 30.126	

[1] *Euro area entry on 1 January 2009*
Source: Thomson Reuters, Raiffeisen RESEARCH

Not yet out of the woods – but no recession anymore

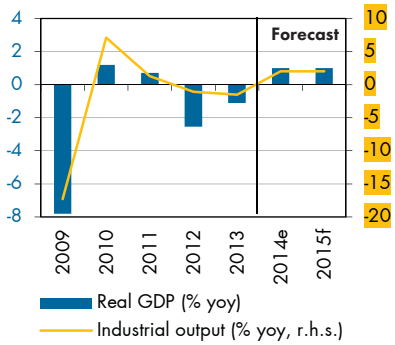
- **Exports and industrial production continue to recover**
- **Q1 GDP disappoints with weak investment and domestic demand**
- **Inflation still low around 1% – to rise moderately in H2**

Towards the end of last year the **growth outlook for Slovenia improved**. As we wrote in our update a quarter ago, the country made **progress in solving the banking crisis** by increasing capital and establishing a bad bank, while thriving export demand finally seemed to kick-start the ailing domestic economy. Also, industrial production growth returned, showing expansion of 3-4% yoy in March and April. Thus, the Q1 GDP data was a slight disappointment: while headline GDP growth remained robust at 1.9% yoy in Q1, the quarter-on-quarter data showed a substantial deceleration to -0.3% (vs. +1.2% in Q4 2013). Consumer demand remained weak at 0.5% yoy growth. The structure has again shifted back to external demand, especially given the steady export dynamics and a bounce-back in inventories. Thus, we would still not expect the Slovenian economy to grow too quickly this year. However, **another year of recession seems unlikely** as well, and we **upgrade our GDP forecast** from -0.5% to 1% this year (above the current consensus of 0.2%), but reduce the forecast for 2015 moderately by 0.5pp to 1%.

As everywhere in the region, inflationary dynamics have been subdued, partly on the weak growth dynamics the past two years. Currently, the HCPI stands at 1% in May and 1.3% for the average of the previous 12 months. **Some acceleration in price developments towards the end of the year seems possible** in the current recovery, and thus inflation for the whole year may amount to slightly below 2%.

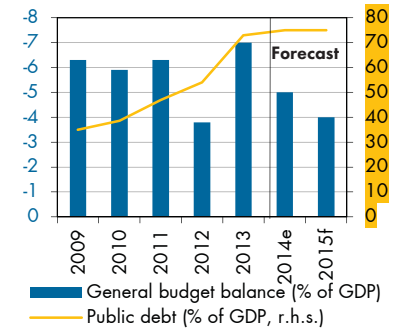
Financial analysts: Andreas Schwabe, CFA

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Public and external debt



Source: Thomson Reuters, Raiffeisen RESEARCH

Key economic figures and forecasts

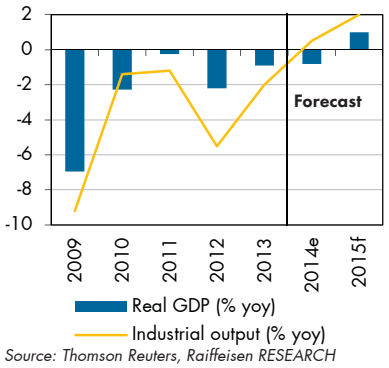
	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	35.4	35.5	36.2	35.3	35.3	36.0	36.8
Real GDP (% yoy)	-7.8	1.2	0.7	-2.5	-1.1	1.0	1.0
Industrial output (% yoy)	-17.3	7.1	1.3	-1.1	-1.5	2.0	2.0
Unemployment rate (avg, %)	5.9	7.3	8.2	8.9	10.5	10.5	10.0
Nominal industrial wages (% yoy)	4.6	3.6	2.7	3.7	4.0	3.5	3.5
Producer prices (avg, % yoy)	-1.3	2.1	4.4	0.8	0.2	1.0	2.0
Consumer prices (avg, % yoy)	0.9	1.8	1.8	2.6	1.8	1.8	2.0
Consumer prices (eop, % yoy)	1.8	1.9	2.0	2.7	1.5	2.0	2.0
General budget balance (% of GDP)	-6.3	-5.9	-6.3	-3.8	-7.0	-5.0	-4.0
Public debt (% of GDP)	35.0	38.6	46.9	54.0	73.0	75.0	75.0
Current account balance (% of GDP)	-0.6	-0.1	0.4	3.3	6.5	6.4	5.0
Official FX reserves (EUR bn)	0.7	0.8	0.8	0.7	0.7	0.7	0.7
Gross foreign debt (% of GDP)	113.9	114.7	110.8	115.6	113.3	114.0	115.3
EUR/USD (avg)[1]	1.39	1.33	1.39	1.29	1.33	1.34	1.29

1 Euro area entry on 1 January 2007
Source: Thomson Reuters, Raiffeisen RESEARCH

The thorny path to economic recovery

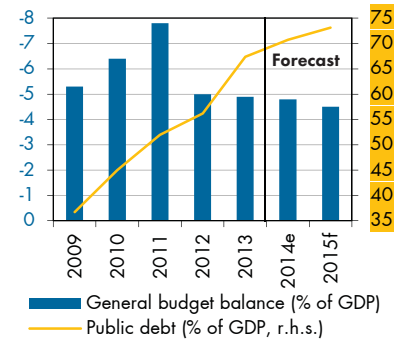
- **Recession continues, long way to recovery**
- **Impetus for reforms coming from abroad**
- **Low interest rate environment supports government borrowing**
- **Negative risks remain, due to lack of fundamental improvements**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

Economic outlook

For the sixth year in a row, Croatia has been struggling with recession and poor prospects of recovery. Although **real GDP expanded in Q1 2014 on a quarterly basis** and largely offset the strong decline that was seen in H2 2013, economic activity remained at a very low level. Consequently, the **annual growth rate remained negative for the 10th consecutive quarter.** Investments – which should be a forerunner of a short-term recovery – will continue to contract for the rest of the year. Private investments are hampered by the unfavourable investment environment, while public investments are largely dependent on foreign capital and the ability to draw on EU funds. In both cases, the readiness of the announced projects is questionable and **administrative capacity, a crucial factor for any project, is relatively low**. Low employment, high pessimism, continued deleveraging and falling disposable income are factors which widely support the expectations that domestic demand will not rise even this year. The old growth model based on consumption financed by foreign capital has worn out and the prolonged structural recession highlights the **need for stronger and faster structural changes**.

While the Excessive Deficit Procedure (EDP) emphasises the need for structural adjustments in the state budget (particularly on the spending side), the **Macroeconomic Imbalance Procedure (MIP) highlights the structural problems of the labour market and the very low competitiveness of industry and exports** as the main stumbling blocks to sustainable growth and recovery. Croatia will therefore certainly continue with the adjustment i.e. a reduction of government spending, reforms in large public systems and restructuring of the manufacturing sector. However, we are sceptical about the speed of adjustment which results in significantly lower potential growth rates and statistically much less favourable indicators for Croatia's current level of development.

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	44.8	44.4	44.2	43.5	43.1	42.7	43.9
Real GDP (% yoy)	-6.9	-2.3	-0.2	-2.2	-0.9	-0.8	1.0
Industrial output (% yoy)	-9.2	-1.4	-1.2	-5.5	-2.0	0.5	2.0
Unemployment rate (avg, %)	9.1	11.8	13.5	15.9	17.2	17.4	17.2
Nominal industrial wages (% yoy)	0.8	0.0	1.3	1.9	-1.0	0.0	2.0
Producer prices (avg, % yoy)	-0.4	4.3	6.4	7.0	0.5	-1.5	2.8
Consumer prices (avg, % yoy)	2.4	1.1	2.3	3.4	2.2	0.6	2.0
Consumer prices (eop, % yoy)	1.9	1.8	2.1	4.7	0.3	1.5	2.0
General budget balance (% of GDP)	-5.3	-6.4	-7.8	-5.0	-4.9	-4.8	-4.5
Public debt (% of GDP)	36.8	45.0	52.0	56.2	67.4	70.8	73.2
Current account balance (% of GDP)	-5.1	-1.1	-0.9	-0.1	1.3	1.2	0.7
Official FX reserves (EUR bn)	10.4	10.7	11.2	11.2	12.9	12.5	12.6
Gross foreign debt (% of GDP)	101.0	104.7	103.8	103.1	105.8	106.6	104.2
EUR/HRK (avg)	7.34	7.29	7.43	7.52	7.58	7.63	7.65
USD/HRK (avg)	5.26	5.49	5.34	5.85	5.71	5.69	5.93

Source: Thomson Reuters, Raiffeisen RESEARCH

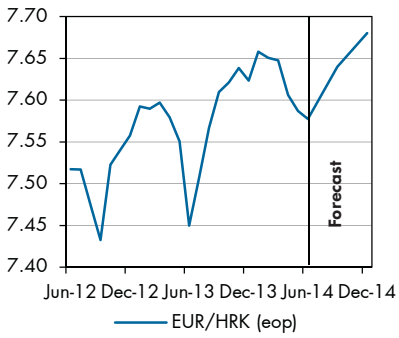
Financial market outlook

The liquidity that has been present on the money market over the years is still successfully keeping interest rates at low levels, while at the same time favouring the rollover of maturing T-bills at very favourable conditions and maintaining the stability of the local currency. With the low interest rate environment and ample HRK liquidity, **interest in EUR-linked T-bills has almost disappeared**, and thus most activity remains on the longer end of the pure HRK short-term curve. For a long time now yields have been stuck at minimum level (1-year at 2%). We do not see any changes on the horizon, not even during the summer when some of the liquidity normally drains from the financial system due to the tourist season. Such developments will be supported by the likely absence of local bond issuance in Q3 as the **government tapped the Eurobond market at the end of May** in the amount of EUR 1.25 bn. Since the ECB has clearly shown its readiness to maintain its ultra-expansive monetary policy, the next maturity, scheduled for early January in the amount of EUR 750 mn, might be settled by **tapping the international market once again, probably during autumn 2014**. Under such circumstances, borrowing for Croatia will be relatively affordable although the great vulnerability and negative risks (in the medium to long-term perspective) remain in place, which is mirrored in the sub-investment rating. The narrowing of the spreads seen in Q2 should be completely attributed to global market conditions, i.e. favourable economic developments in the USA and the ECB's easing, and not to any fundamental improvements in the Croatian economy. Developments in the EM countries have a substantial impact on Croatian Eurobond movements. Therefore, the search for higher yields will continue to create pressure on Croatian issues, but **no significant tightening of spreads until the end of the year should be expected**. They will most likely hover round the current levels (10-year spread - 230 / 260 bp). As 2015 will be even more demanding in the sense of debt repayment, the government might exploit the current risk-on sentiment and abundant domestic liquidity situation to prefund for early 2015. Accordingly, one more domestic bonds issue should not be fully excluded which in that case implies volatility for local yields and at least a little excitement on the sleepy domestic debt market. As regards FX movements, the rate is following the **usual pattern of seasonal HRK appreciation as the tourist season approaches**, but the EUR/HRK exchange rate is not expected to go below 7.52. We expect **depreciation pressures to re-intensify towards the end of the year.**

EUR/HRK is apparently slowly but steadily sliding to higher levels due to the lack of foreign currency inflows. The EUR/HRK downside potential is curbed by the influence of fiscal risks, bank provisioning, the private sector's external de-leveraging and dividend pay-outs to non-residents.

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

Exchange rate development



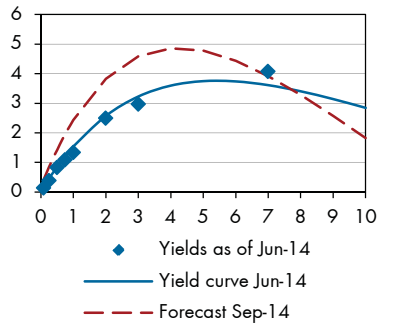
EUR/HRK: 5y high 7.67, 5y low 7.18
Source: Bloomberg, Raiffeisen RESEARCH

Exchange rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
EUR/HRK	7.58	7.64	7.68	7.66	7.59
Cons.		*7.62*	*7.66*	*7.65*	*7.63*
USD/HRK	5.57	5.79	5.91	5.89	5.98
Cons.		*5.66*	*5.78*	*5.78*	*5.82*

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

HRK rate and yield curve (%)*



** 1m – 12m interest rates; 2y – 10y LCY gov. bond yields*
Source: Bloomberg, Raiffeisen RESEARCH

Interest rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
Key rate	7.00	n.v.	n.v.	n.v.	n.v.
Consensus		*7.00*	*6.88*	*6.88*	*6.88*
1 month[2]	0.13	0.75	0.70	0.70	0.70
3 month[2]	0.38	1.00	1.00	1.00	1.30
Consensus		*1.25*	*1.00*	*1.10*	*n.v.*
6 month[2]	0.83	1.30	1.40	1.40	1.50
12 month[2]	1.33	1.85	1.90	1.90	2.20

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

Yield forecasts

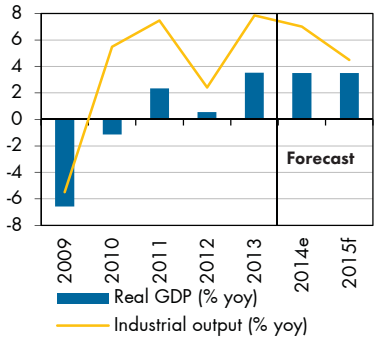
	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
2y T-bond[2]	2.50	3.2	3.5	3.5	3.5
Cons.		*n.v.*	*n.v.*	*n.v.*	*n.v.*
5y T-bond[2]	3.78	4.5	4.0	4.0	4.0
10y T-bond[2]	4.07	4.5	4.5	4.5	4.5
Cons.		*n.v.*	*n.v.*	*n.v.*	*n.v.*

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

The wheels of economy are turning

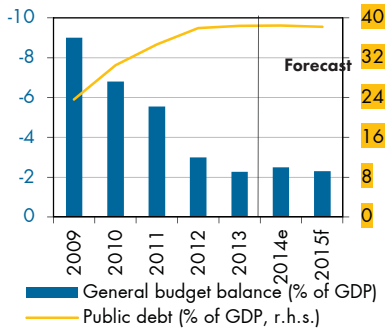
- **Economic activity on an upward trend, while the rebound in private consumption gains speed**
- **Negotiations with the IMF to continue, as risks for missing budget deficit targets rise**
- **Record low inflation creates room for the NBR to preserve accommodative policy for longer**
- **Moderate, but gradual rise in ROMGB yields expected in line with core market moves**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

Economic outlook

Economic activity remained on an upward trend in Q1, as real GDP excluding agriculture advanced by 3.8% yoy and by 0.8% qoq. Growth in private **consumption was the main GDP driver** in Q1 and its dynamics (6.7% yoy, 3.1% qoq) were much faster than expected.

We expect real GDP to advance by 3.5% and real GDP excluding agriculture to expand by 3.8% in 2014. This implies an average GDP quarterly growth rate of around 1.1% during Q2-Q4. We see **domestic demand as the main driver of growth**, as both households and companies have incentives to increase their spending: interest rates are at historically low levels, the exchange rate has appreciated, and depressed level of consumption and investment offer enough room for a rebound, if optimism returns. Lending in RON shows signs of reviving. We also expect the government to increase investments in the coming quarters, after having slashed them in Jan-Apr. **Exports and industry should increase further**, given improving external demand. However, the revival in domestic demand should go hand in hand with higher imports, which may offset the positive contribution of exports to GDP growth.

Public budget execution has resulted in a **low budget deficit so far**, but several red flags have popped up: revenues from taxes and social contributions and from EU funds were below plan and investment spending was sharply reduced. The government decided to exempt from taxation reinvested earnings starting from July and it plans to reduce social security contributions paid by employers by 5pp starting from October. It failed to convince the IMF technical staff that these measures would not threaten the budget deficit targets negotiated for 2014 and 2015. As a result, the **IMF review in June ended without an agreement on a new Letter of Intent** and the assessment will continue until the next review in November. Missing budget deficit targets for 2014 and 2015 seems likely, but major policy slippages will probably be avoided.

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	118.3	124.4	131.5	131.7	142.2	151.3	163.2
Real GDP (% yoy)	-6.6	-1.1	2.3	0.6	3.5	3.5	3.5
Industrial output (% yoy)	-5.5	5.5	7.5	2.4	7.9	7.0	4.5
Unemployment rate (avg, %)	6.9	7.3	7.4	7.0	7.3	7.2	7.1
Nominal industrial wages (% yoy)	10.0	8.3	6.7	4.6	4.6	5.3	5.5
Producer prices (avg, % yoy)	2.5	4.4	7.1	5.4	2.1	2.0	3.8
Consumer prices (avg, % yoy)	5.6	6.1	5.8	3.3	4.0	1.9	3.0
Consumer prices (eop, % yoy)	4.7	8.0	3.1	5.0	1.6	3.0	3.0
General budget balance (% of GDP)	-9.0	-6.8	-5.5	-3.0	-2.3	-2.5	-2.3
Public debt (% of GDP)	23.6	30.5	34.7	38.0	38.4	38.5	38.2
Current account balance (% of GDP)	-4.2	-4.4	-4.5	-4.4	-1.1	-2.0	-2.5
Official FX reserves (EUR bn)	28.3	32.4	33.2	31.2	32.5	31.5	32.5
Gross foreign debt (% of GDP)	68.7	74.3	75.1	75.7	67.5	62.8	61.3
EUR/RON (avg)	4.24	4.21	4.24	4.46	4.42	4.45	4.44
USD/RON (avg)	3.04	3.17	3.05	3.47	3.33	3.32	3.44

Source: Thomson Reuters, Raiffeisen RESEARCH

Financial market outlook

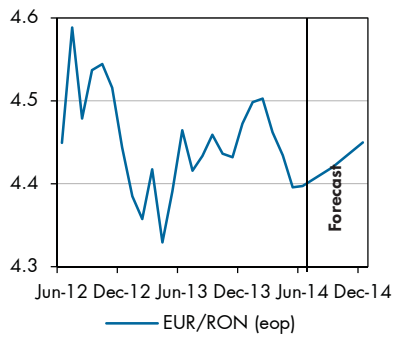
The low inflation environment remains in place, especially in Q3 2014. To a large extent, the subdued level of annual inflation in May (0.9% yoy) is the result of transitory factors, the effects of which will fade in the second half of the year. We hint at the favourable statistical base effect due to a very good agricultural production last year and the decrease in the VAT rate for bread and similar products in September 2013. However, current inflationary pressures are weaker than initially expected, with monthly inflation surprising the market on the downside in the last three months. Based on these developments, we **revised our year-end CPI inflation forecast for 2014 down to 3% yoy, from the previous figure of 3.5% yoy.**

Money market rates started to trade lower than the key rate (3.5%) in March again, with the negative spread widening in May especially. Currently, ROBOR rates are at levels consistent with a monetary policy rate of 3.0% or even lower. Looking ahead, in the context of inflationary pressures building at a slower-than-expected pace, with the additional space provided by the recent measures by the ECB and assuming no episodes of severe depreciation pressures on RON, we see **room for money market rates to remain below the key rate until Q1 2015.**

On the domestic bond market, the ROMGB curve witnessed a more or less parallel downward shift over the past three months with yields decreasing by around 100bp on average. If we add to this image the very good demand indicated by the results of the primary market auctions and the appreciation path of the exchange rate (RON gained more than 2.5% vs EUR during this period), foreign investors' appetite for RON-denominated government securities returned, which translated into increased portfolio inflows. In this context, the decision of **S&P to improve Romania's rating by one notch** had no material impact on RON financial markets, since this was widely anticipated. Going forward, whilst positive macroeconomic developments might continue to fuel expectations for leu appreciation, we believe that economic fundamentals, especially the low level of net foreign capital inflows, are more in favour of a smooth and mild depreciation path towards the end of the year. The **presidential elections to be held by the end of the year might also contribute to some volatility**. As far as the bond market is concerned, the return of inflation rates towards values close to the medium-term level of 3% in the second half of the year will be accompanied by an upward trend in yields. This trend should be intensified by the cyclical rise in Bund yields which we expect to materialise as the year comes closer to an end. However, our **HOLD recommendations for ROMGB remain valid** given our expectations that the carry will compensate for the expected price losses on a 3m horizon.

Financial analysts: Nicolae Covrig, Gabriel Bobeica, Raiffeisen BANK S.A., Bucharest
Stephan Imre, RBI Vienna

Exchange rate development



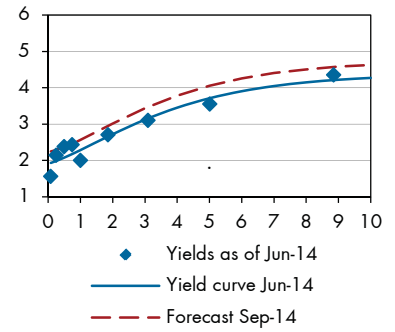
EUR/RON: 5y high 4.64, 5y low 4.06
Source: Bloomberg, Raiffeisen RESEARCH

Exchange rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
EUR/RON	4.40	4.42	4.45	4.40	4.45
Cons.		*4.46*	*4.45*	*4.43*	*4.42*
USD/RON	3.23	3.35	3.42	3.38	3.50
Cons.		*3.31*	*3.35*	*3.34*	*3.37*

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

RON rate and yield curve (%)*



** 1m – 12m interest rates; 2y – 10y LCY gov. bond yields*
Source: Bloomberg, Raiffeisen RESEARCH

Interest rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
Key rate	3.50	3.50	3.50	3.50	3.50
Consensus		*3.50*	*3.50*	*3.50*	*3.75*
1 month[2]	1.31	2.20	2.60	2.80	2.90
3 month[2]	1.89	2.40	2.65	2.85	2.95
Consensus		*2.81*	*2.94*	*3.05*	*3.33*
6 month[2]	2.01	2.40	2.60	2.70	2.90
12 month[2]	2.10	2.45	2.65	2.75	3.00

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

Yield forecasts

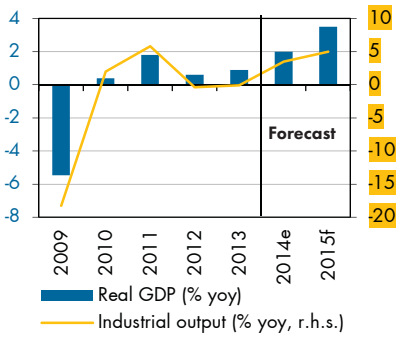
	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
2y T-bond[2]	2.73	**3.2**	**3.5**	**3.9**	**4.2**
Cons.		*n.v.*	*n.v.*	*n.v.*	*n.v.*
5y T-bond[2]	3.55	3.9	4.2	4.7	5.0
10y T-bond[2]	4.35	4.7	5.0	5.4	5.6
Cons.		*n.v.*	*n.v.*	*n.v.*	*n.v.*

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

Economy on promising recovery track

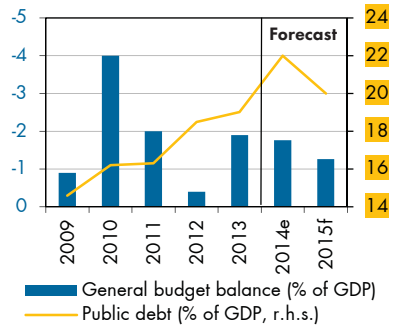
- **GDP growing on the back of stronger domestic demand**
- **Lending growth in the corporate segment finally emerges**
- **Limited export growth due to weak competitiveness**
- **High fiscal stability with potential risks on the horizon**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

In Q1 2014, GDP grew by 1.4% yoy in real terms. In contrast to Q4 2013, growth was clearly pushed forward by domestic demand. Exports, which had been the main growth driver in 2013, contributed marginally to the GDP increase in Q1 (+0.1pp). Accordingly, doubts about the competitiveness of exports might not be groundless. However, acceleration is expected in Q2 and Q3 on the back of the continuing EU recovery. Subdued **household consumption and investments** in 2013, resulting mainly from the unstable political situation, **rose significantly in Q1** (+3.8% yoy and +4.6% yoy, respectively). Moreover, the increase occurred despite the persistent unpredictability in the political environment. Modestly declines in interest rates and stronger lending (despite deflation) supported consumption and investment in Q1. These developments are expected to intensify in the coming quarters. Despite the pressure for more public spending, the fiscal sector continued to be stable, as the **budget deficit in Q1 was below the previous year's level**. Furthermore, public debt rose slightly. The highest fiscal risk in the middle term, however, arises from the alleged deficit of the National Electric Company. It could be either covered by politically very unpopular price increases or simply be covered by the state budget. The latter would raise serious questions about fiscal stability. Inflation kept diminishing in Q1 (-0.8% eop yoy). However, the downward trend is expected to be reversed in the coming months due to stronger domestic demand and higher GDP growth. The currency board remained stable on the basis of the high coverage of the monetary base with FX reserves (170.4%). No threats are identified in the medium term. At the beginning of June **S&P downgraded Bulgaria's long- and short-term sovereign credit ratings to BBB-/A-3 from BBB/A-2** (outlook stable). The agency cited structural impediments facing Bulgaria, which constrain institutional effectiveness and impede economic growth.

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

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	34.9	36.1	38.5	39.9	39.9	42.1	44.5
Real GDP (% yoy)	-5.5	0.4	1.8	0.6	0.9	2.0	3.5
Industrial output (% yoy)	-18.3	2.0	5.8	-0.4	-0.1	3.5	5.0
Unemployment rate (avg, %)	6.8	10.2	11.3	12.3	12.9	12.6	12.1
Nominal industrial wages (% yoy)	13.4	8.6	10.1	11.5	0.9	5.1	6.3
Producer prices (avg, % yoy)	-6.6	8.7	9.4	4.2	-1.4	1.3	4.4
Consumer prices (avg, % yoy)	2.8	2.4	4.2	3.0	0.9	1.1	3.5
Consumer prices (eop, % yoy)	0.6	4.5	2.8	4.2	-1.6	1.6	3.4
General budget balance (% of GDP)	-0.9	-4.0	-2.0	-0.4	-1.9	-1.8	-1.3
Public debt (% of GDP)	14.6	16.2	16.3	18.5	19.0	22.0	20.0
Current account balance (% of GDP)	-8.9	-1.5	0.1	-0.8	1.9	0.7	-0.5
Official FX reserves (EUR bn)	12.9	13.0	13.3	15.6	14.4	17.2	17.9
Gross foreign debt (% of GDP)	108.3	102.7	94.3	94.3	93.5	89.1	82.4
EUR/BGN (avg)	1.96	1.96	1.96	1.96	1.96	1.96	1.96
USD/BGN (avg)	1.40	1.47	1.41	1.52	1.47	1.46	1.52

Source: Thomson Reuters, wiiw, Raiffeisen RESEARCH

Will public sector reforms be halted due to massive floods?

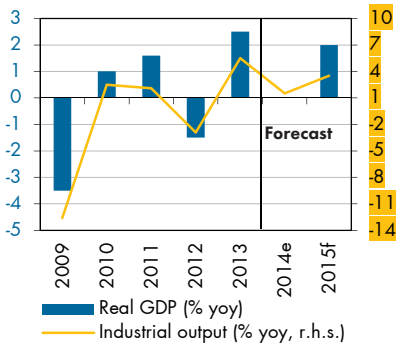
- **Value of the flood damage could top EUR 1 bn**
- **EIB, EBRD and World Bank desire to financially help with flood recovery**
- **EUR/RSD sentiment unmoved, as RSD yields kept falling**
- **Serbia against imposing sanctions on Russia**

Historically **high floods hit the country causing damage** which may amount to more than EUR 1 bn and putting pressure on the economy. The market did not respond to the new environment, i.e. EUR/RSD exhibited a remarkably stable pattern, risk appetite for local debt was maintained, and yields were untouched. All of this was supported by the credibility that the NBS and the government have gained due to their achievements in the previous two years. Nonetheless, sentiment might change as only up to 25% of the value of the damage will be funded from external sources, putting pressure on the economy in 2014. In 2015, reconstruction may emerge as a new economy driver thanks to widespread infrastructure works. **FIAT exports will remain the powerful force but the volumes are a bit restrained** due to full capacity utilisation, while agricultural exports will be cut to compensate the flooded area's needs. Together with the electrical energy imports, this might put the pressure on the C/A gap financing.

The market was overjoyed with the clear victory of the Serbian Progressive Party in the early parliamentary elections, given its open reform commitment. Still, the flood disaster may result in delays to the **implementation of some public sector measures, as structural reforms will be continued**. In this scenario, the internal resources for flood damage financing will tighten while the pressure on the budget financing might be lingering, at least until the country receives the EUR 3 bn from the United Arab Emirates. Debt refinancing needs have been largely secured as risk appetite shifted to the longer end of the yield curve, supported by elevated short-term risks and better pricing. The **IMF negotiations will follow after the final value of the damage and the recovery plan are delivered,** but signing a deal is not likely in 2014. Given the energy relations with Russia (i.e. 80% of Serbia's gas is imported from Russia), the country did not impose sanctions on Russia, but reiterated that the EU is equally important, given the start of the accession negotiations in January 2014.

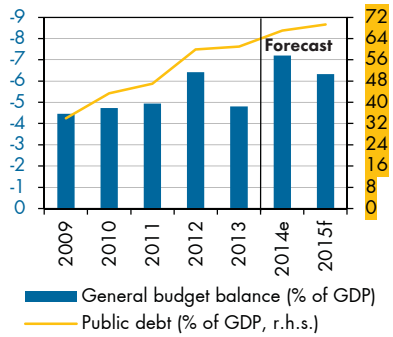
Financial analyst: Ljiljana Grubic, Raiffeisenbank a.d., Belgrade

Real GDP (% yoy)



Source: Bloomberg, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

Key economic figures and forecasts

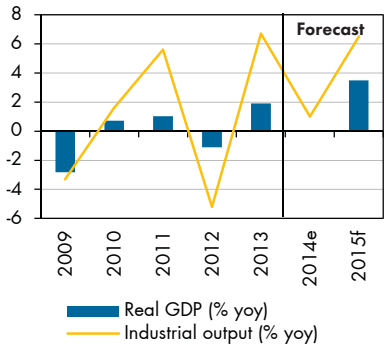
	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	29.0	28.0	31.5	29.6	32.8	33.7	35.4
Real GDP (% yoy)	-3.5	1.0	1.6	-1.5	2.5	0.0	2.0
Industrial output (% yoy)	-12.6	2.5	2.1	-2.9	5.5	1.5	3.5
Unemployment rate (avg, %)	16.1	19.2	23.0	23.9	22.1	24.5	23.0
Nominal industrial wages (% yoy)	5.0	10.0	5.0	1.5	1.5	4.0	5.0
Producer prices (avg, % yoy)	5.6	12.7	14.2	8.5	7.0	6.0	6.0
Consumer prices (avg, % yoy)	8.2	6.3	11.3	7.8	7.8	5.5	5.5
Consumer prices (eop, % yoy)	6.6	10.3	7.0	12.2	2.2	5.0	5.0
General budget balance (% of GDP)	-4.5	-4.7	-4.9	-6.4	-4.8	-7.2	-6.3
Public debt (% of GDP)	34.0	43.4	47.0	59.9	61.0	67.1	69.3
Current account balance (% of GDP)	-6.6	-6.7	-9.1	-10.7	-4.9	-5.3	-6.2
Official FX reserves (EUR bn)	10.6	10.0	12.1	10.9	11.2	11.9	12.3
Gross foreign debt (% of GDP)	77.7	84.9	76.7	86.9	78.9	79.6	78.7
EUR/RSD (avg)	94.0	103.0	102.0	113.0	113.1	115.7	119.4
USD/RSD (avg)	67.4	77.6	73.3	87.9	85.1	86.4	92.5

Source: Thomson Reuters, Raiffeisen RESEARCH

Economy slammed by the worst natural disaster in 120 years

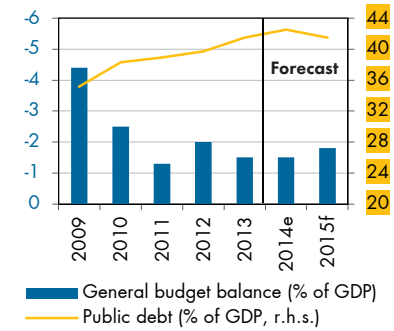
- **Good start by main economic indicators overshadowed by the impacts of the natural disaster**
- **Stagnation in 2014 followed by a reconstruction-driven recovery in 2015**
- **Speed of recovery will highly depend on the mobilisation of financing**
- **Ongoing negotiations over an increase in IMF and World Bank funding**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

The first heavyweight indicators for Q1 2014 which are highly correlated with GDP reflected a strong continuation of the economic recovery in 2014. Exports of goods and industrial production advanced by 6% yoy and 4.6% yoy, respectively, driven by the benign external environment in the euro area (60% of exports goes to these countries). However, the quite **firm start to the year was completely overshadowed by the worst flooding in 120 years** which strongly hit the SEE region in mid-May, affecting Bosnia and Herzegovina and Serbia in particular. Although an official estimate of the damage will only be available after the assessment by the EU team in late June, the first preliminary estimates of BiH institutions points to an amount in the range of EUR 1.3 -1.5 bn which is 10-11% of GDP. Therefore, **we expect substantial downward pressure on GDP** and major drivers of the economy starting from Q2 onwards, namely, agriculture, industrial production, exports and investments as a result of the direct loss of capital (damage) and indirect loss of potential production and exports due to interruption of production and transport. We suppose weak growth in industrial production and exports in 2014, accompanied by a substantial slump in investments. Agriculture – which comprises 6.6% of GDP – will suffer recession again this year. Although we assume to see a continuation of the infrastructure projects planned for 2014 (continuation of the Corridor Vc works and electricity sector investment cycle), the dynamics of these planned works will not be sufficient to pull gross fixed capital formation into positive territory, due to much more dramatic loss of capital resulting from the natural disaster.

BiH officials are currently negotiating an increase in the **financing framework with the IMF and World Bank**, while in the meantime all requirements were successfully fulfilled for the sixth and seventh review and payment of the tranches in early July 2014 within the framework of the current Stand-by Arrangement.

Financial analyst: Ivona Zametica, Raiffeisen BANK d.d., Sarajevo

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	12.4	12.7	13.1	13.1	13.5	13.6	14.4
Real GDP (% yoy)	-2.8	0.7	1.0	-1.1	1.9	0.0	3.5
Industrial output (% yoy)	-3.3	1.6	5.6	-5.2	6.7	1.0	6.5
Unemployment rate (avg, %)	24.1	27.2	27.6	28.0	27.5	27.5	26.0
Nominal industrial wages (% yoy)	9.2	2.4	6.8	2.2	-0.5	0.0	4.0
Producer prices (avg, % yoy)	-3.2	0.9	3.7	1.9	-1.8	0.0	2.4
Consumer prices (avg, % yoy)	-0.4	2.1	3.7	2.1	-0.1	-0.3	2.5
Consumer prices (eop, % yoy)	0.0	3.1	3.1	1.8	-1.2	0.3	2.0
General budget balance (% of GDP)	-4.4	-2.5	-1.3	-2.0	-1.5	-1.5	-1.8
Public debt (% of GDP)	35.1	38.3	38.9	39.7	41.5	42.5	41.5
Current account balance (% of GDP)	-6.6	-5.5	-9.5	-9.8	-5.9	-8.1	-11.1
Official FX reserves (EUR bn)	3.2	3.3	3.3	3.3	3.6	3.8	4.1
Gross foreign debt (% of GDP)	53.8	57.5	67.0	63.3	62.2	63.5	62.5
EUR/BAM (avg)	1.96	1.96	1.96	1.96	1.96	1.96	1.96
USD/BAM (avg)	1.40	1.47	1.41	1.52	1.47	1.46	1.52

Source: Thomson Reuters, Raiffeisen RESEARCH

Finally EU candidate status

- **Modest economic growth of around 2% in 2014**
- **Base interest rate at new historic low**
- **Key territorial and administrative reform already started**
- **EU candidate status granted**

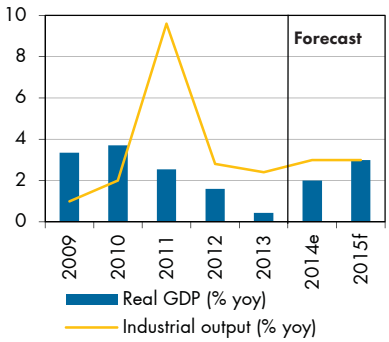
After sub-par growth of just 0.44% in 2013, a modest recovery is expected to unfold with growth of around 2% in 2014. In H1 2014, GDP is estimated (official figures have not been published yet) to have expanded at a moderate rate, due to slack domestic demand, tight fiscal policy and the private sector's reluctance to increase investments. We expect relatively **stronger performance in H2 2014**, however, as the domestic agriculture product will kick in, the start of the touristic season will see moderate improvements in infrastructure and better overall economic sentiment might start to boost domestic demand slightly. Weak inflationary pressures are reflected in the relaxed monetary policy, with the base rate at just 2.5%. We see the **base rate remaining at low levels for the rest of 2014**, in order to stimulate private investments and domestic consumption.

Public debt might remain at high levels for 2014, but will eventually start to contract from 2015 at around 70% of GDP compared to 72% in 2014. Fiscal consolidation has started, as the budget deficit was reduced by 73% year on year by April 2014, and **we expect a prudent policy on public investments** in the future as well. The government seems to have gained the trust of foreign financial institutions as **financial agreements worth over USD 600 mn have already been signed with the IMF and World Bank**. Furthermore, there is also the possibility that another financial agreement may be signed with the World Bank in 2015.

End of June the **EU Council finally granted the candidate status to Albania** as a reward for its efforts in implementing structural reforms. Even though this is a step forward, the EU accession remains still a long-term objective that could take at least 10 years. However, the country is going to profit from EU funds under the Instrument for Pre-Accession Assistance (IPA) in order to carry out comprehensive reforms and strategic investments, and will benefit from the participation in EU programs.

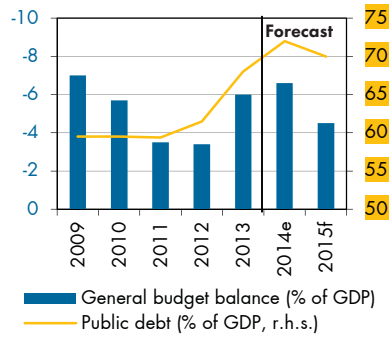
Financial analyst: Joan Canaj, Raiffeisen Bank Sh.a., Tirana

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

Key economic figures and forecasts

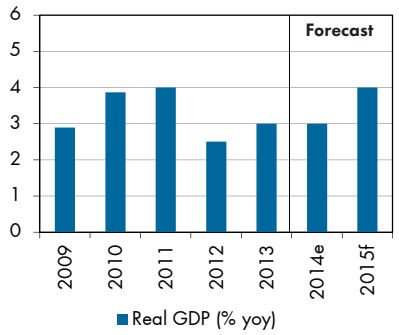
	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	8.3	8.9	9.4	9.7	9.8	10.2	10.5
Real GDP (% yoy)	3.4	3.7	2.6	1.6	0.4	2.0	3.0
Industrial output (% yoy)	1.0	2.0	9.6	2.8	2.4	3.0	3.0
Unemployment rate (avg, %)	13.0	13.5	14.0	13.3	17.0	17.5	17.0
Nominal industrial wages (% yoy)	4.0	8.0	8.0	8.0	8.0	8.0	8.0
Producer prices (avg, % yoy)	0.4	0.2	2.6	1.1	-0.4	4.0	5.0
Consumer prices (avg, % yoy)	5.0	4.0	3.5	2.0	1.9	2.3	2.5
Consumer prices (eop, % yoy)	3.5	3.5	1.7	2.4	1.9	2.4	2.4
General budget balance (% of GDP)	-7.0	-5.7	-3.5	-3.4	-6.0	-6.6	-4.5
Public debt (% of GDP)	59.5	59.5	59.4	61.5	68.0	72.0	70.0
Current account balance (% of GDP)	-16.5	-10.8	-11.8	-9.3	-10.4	-10.3	-11.0
Official FX reserves (EUR bn)	1.6	1.9	1.9	1.9	1.9	1.9	1.9
Gross foreign debt (% of GDP)	23.7	24.7	24.5	25.8	28.2	28.9	30.8
EUR/ALL (avg)	132.1	137.8	140.4	139.0	140.3	140.1	140.2
USD/ALL (avg)	94.8	103.9	100.8	108.2	105.6	104.5	108.7

Source: Thomson Reuters, Raiffeisen RESEARCH

Expectations facing reality

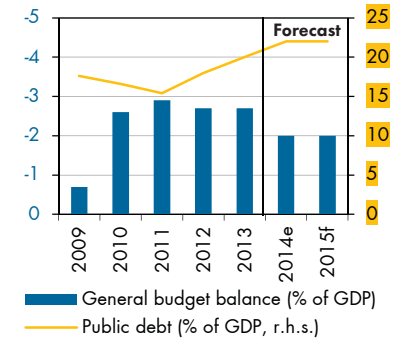
- **Improved loan conditions supporting consumption**
- **Business community needs stronger signals of improving environment**
- **After June elections unstable government to be expected**
- **Discussions on introducing a national currency**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

The **pace of growth in the real sector should remain stable**, although it has not been as strong as expected. In particular, external trade might not deliver the forecasted results, despite stable oil prices and the current rally on metals. The signs of improvement in the export environment have proven to be somewhat optimistic and may be corrected downwards. On the other hand, **domestic demand is developing with increased speed.** The main contributing factor in this regard is consumption, caused by lower interest rates on loans and the subsequent higher borrowing. In addition to this, some 80,000 public sector employees received a 25% increase in salary, strengthening their purchasing power.

After the general elections at the beginning of June, the **political parties are considering possible coalitions**, and two of the combinations are more likely. One likely scenario is that the outgoing incumbent Democratic Party of Kosovo (PDK) of Prime Minister Hashim Thaci, which came out again as largest faction in the latest elections, will find a junior partner to form a parliamentary majority and a new government. The other scenario – which is being pursued by the former opposition, comprised of the Democratic League of Kosovo (LDK), the Alliance for the Future of Kosovo (AAK) and the Initiative for Kosovo (Nisma), – is to join forces and leave PDK in opposition. In both cases, the **next government will be fragile** and new elections cannot be ruled out. Viewed in this light, there is no expectation for significant improvement of the business environment by the government in the short run.

So far, the recent increase in the salaries of public employees has not broken the low inflation trend, and **deflationary risks remain in the next few months**. In light of this, as well as with consideration to meeting criteria for European integration and generally the need to develop monetary policies, the Governor of the Central Bank recently announced that the Bank would review the possibility of introducing a national currency in a broader range. So far Kosovo is a dollarised nation and the euro is used as the official currency.

Financial analyst: Fisnik Latifi, Raiffeisen Bank Kosovo J.S.C., Pristina

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	4.1	4.1	4.6	4.7	4.9	5.0	5.2
Real GDP (% yoy)	2.9	3.9	4.0	2.5	3.0	3.0	4.0
Unemployment rate (avg, %)	45.4	45.1	41.4	44.8	30.5	30.9	31.0
Producer prices (avg, % yoy)	3.8	4.7	5.7	1.7	2.5	2.5	2.5
Consumer prices (avg, % yoy)	-2.4	3.5	7.3	2.5	1.8	1.0	2.5
Consumer prices (eop, % yoy)	0.1	6.6	3.6	3.7	0.5	1.2	2.5
General budget balance (% of GDP)	-0.7	-2.6	-2.9	-2.7	-2.7	-2.0	-2.0
Public debt (% of GDP)	17.6	16.6	15.4	18.0	20.0	22.0	22.0
Current account balance (% of GDP)	-9.1	-12.6	-14.4	-8.0	-7.0	-7.7	-7.8
Official FX reserves (EUR bn)	0.6	0.7	0.6	1.2	1.4	1.4	1.5
Gross foreign debt (% of GDP)	16.8	17.1	15.8	14.8	14.4	13.9	13.4
EUR/USD (avg)*	1.39	1.33	1.39	1.29	1.33	1.34	1.29

** EUR official currency in Kosovo*
Source: Thomson Reuters, Raiffeisen RESEARCH

Exports and industrial output as the weakest points

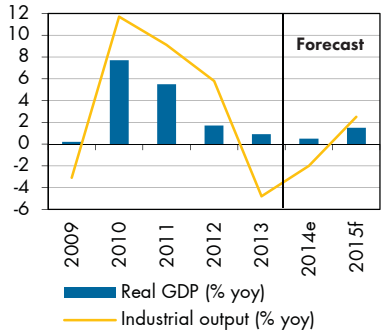
- **Economy returned to growth thanks to an improving external trade balance**
- **Little potential for higher economic growth**
- **Inflation and devaluation pressures remain**
- **Russian financing will support the local currency**

Following GDP contraction in the first two months of 2014 (compared to these months in 2013), the Belarusian **economy returned to** 1.1% yoy **growth** over the period from January to April on the back of still-strong public consumption and a return to a positive external trade balance of USD 0.6 bn amidst lower imports. At the same time, FX revenues from exports in the first four months 2014 declined by about USD 1 bn against the previous year, owing to lower prices on international markets and weaker demand for Belarusian investment goods. It is expected that the situation with exports will remain difficult at least until the end of this year, partly influenced by weak GDP performance in Russia. Activity in the **industrial sector** will continue **to contribute negatively to growth** and internal demand, which is now the key supporting factor for economic performance, will likely diminish. Thus **economic growth** in the coming quarters is only expected **to be moderate**, amounting to around 0.5% yoy in 2014 and to 1.5% yoy in 2015. Inflation rose in the period Jan-May (8.9% YTD growth), due to growth in regulated prices and recent hikes in food prices, and thus the official forecast of 11% will obviously not be achieved and a figure closer to 20-25% can be reached. BYR depreciation continues at a gradual pace amidst a negative current account balance (USD 1.7 bn or 10.9% of GDP in Q1 2014) and stable net FX purchases both by households and the corporate sector (USD 300 mn only in May). FX reserves have already decreased by USD 1.4 bn YTD to USD 5.4 bn, which is the lowest figure since November 2011, when Belarus received USD 2.5 bn from privatisation.

We expect **further depreciation of the Belarusian rouble**, but with the promised Russian loan of USD 2 bn (designated for FX reserves replenishment), a more profound correction of the BYR rate can be avoided. Accordingly, we have revised our forecast for less significant BYR weakening this year.

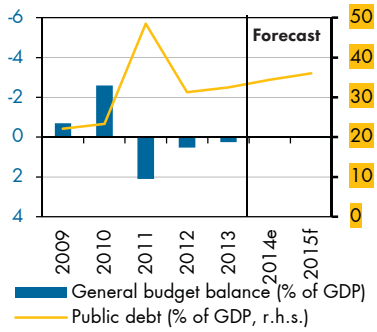
Financial analyst: Mariya Keda, Priorbank Open Joint-Stock Company, Minsk

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

Key economic figures and forecasts

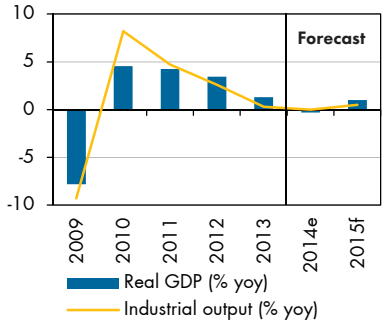
	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	35.3	41.6	43.1	49.3	53.8	54.9	58.4
Real GDP (% yoy)	0.2	7.7	5.5	1.7	0.9	0.5	1.5
Industrial output (% yoy)	-3.1	11.7	9.1	5.8	-4.8	-2.0	2.5
Unemployment rate (avg, %)	0.9	0.7	0.5	0.5	0.5	1.0	1.0
Nominal industrial wages (% yoy)	9.5	25.3	59.2	93.8	35.2	25.0	20.0
Producer prices (avg, % yoy)	13.6	13.6	71.4	76.0	13.6	12.9	12.5
Consumer prices (avg, % yoy)	13.0	7.7	53.2	59.2	18.3	21.0	20.0
Consumer prices (eop, % yoy)	10.1	9.9	108.7	21.8	16.5	25.0	15.0
General budget balance (% of GDP)	-0.7	-2.6	2.1	0.5	0.2	0.0	0.0
Public debt (% of GDP)	22.2	23.3	48.5	31.3	32.5	34.4	36.0
Current account balance (% of GDP)	-12.5	-15.0	-8.5	-2.9	-10.2	-5.5	-6.1
Official FX reserves (EUR bn)	3.4	2.6	4.6	4.4	3.6	3.0	2.6
Gross foreign debt (% of GDP)	43.6	50.9	60.9	51.9	52.7	56.1	54.0
EUR/BYR (avg)	3,892	3,954	7,263	10,748	11,828	14,107	15,899
USD/BYR (avg)	2,792	2,981	5,218	8,360	8,906	10,528	12,325

Source: Thomson Reuters, Raiffeisen RESEARCH

At the crossroads

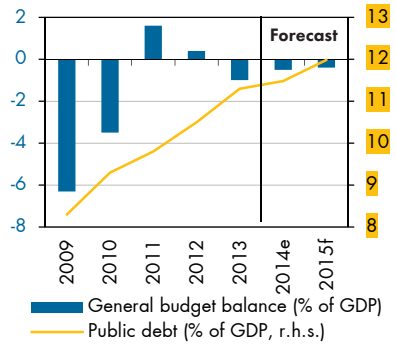
- **Second cut in GDP estimate for 2014 due to the weak economy and recent political turmoil**
- **Russian budget to receive significant additional revenues on the back of RUB depreciation and high oil price**
- **Due to ongoing geopolitical uncertainty, RUB to depreciate moderately by the end of the year**
- **Against this backdrop, underperformance of OFZ market expected**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget balance and public debt



Source: Thomson Reuters, Raiffeisen RESEARCH

Economic outlook

The weak Q1 2014 macro data confirmed our concerns of rising risks for the Russian economy. GDP growth continues to slow down, having decelerated by more than one half in Q1 2014 (to 0.9% yoy vs. 2% yoy in Q4 2013). The most disappointing results are being seen in investments and industrial production. Although some infrastructure projects financed in part by the National Welfare Fund are slated for H2 2014, we do not expect this to be significant enough to change the downward trend in investments this year. The deceleration of **household consumption has become an additional risk**. Economic stagnation and decreasing internal demand should start to affect the labour market. Although unemployment will remain low, we see risks of a slowdown in real wages and retail sales in H2 2014. **Accelerating inflation** (CPI reached 7.6% yoy in May) and higher borrowing cost also affect both consumption and investments. We believe that – in a situation when companies are at a stage of modernising– RUB depreciation is likely to prolong a pause in investments, rather than to support investments. Even if serious sanctions are not implemented, persistent geopolitical uncertainty could lead to CAPEX freezes by the major companies. All of these factors have prompted us to **see Russia in a moderate recession with real GDP expected at -0.3% yoy**. On the positive side, the Russian budget is expected to receive large additional revenues (~RUB 700 bn net in 2014), which may allow for a balanced budget or even a small surplus in 2014 (0.5% of GDP vs. initial -0.5% of GDP as per Minfin estimates). The reason for these positive dynamics is **RUB depreciation**, which – given the features of the Russian budget (major part of revenues is denominated in USD as it comes from duties on exported oil&gas) – translates into higher revenues. However, even with the extra budget revenues, the current unstable situation does not guarantee a surplus. At the same time, barring any additional political tensions and provided the oil price remains stable, Minfin seems to have an opportunity to replenish the Reserve fund in 2014.

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	879.2	1,147.1	1,342.0	1,540.0	1,578.0	1,481.0	1,539.5
Real GDP (% yoy)	-7.8	4.5	4.3	3.4	1.3	-0.3	1.0
Industrial output (% yoy)	-9.3	8.2	4.7	2.6	0.3	0.0	0.5
Unemployment rate (avg, %)	8.4	7.5	6.6	5.7	5.6	5.8	5.8
Average gross wages (% yoy)	7.8	12.4	11.5	13.9	10.0	11.5	8.0
Producer prices (avg, % yoy)	13.9	16.7	12.0	5.1	3.7	3.5	3.5
Consumer prices (avg, % yoy)	11.8	6.9	8.5	5.1	6.8	6.7	5.3
Consumer prices (eop, % yoy)	8.8	8.8	6.1	6.6	6.2	6.0	5.7
General budget balance (% of GDP)	-6.3	-3.5	1.6	0.4	-1.0	-0.5	-0.4
Public debt (% of GDP)	8.3	9.3	9.8	10.5	11.3	11.5	12.0
Current account balance (% of GDP)	4.1	4.4	5.2	3.6	1.6	2.3	2.0
Official FX reserves (EUR bn)	291.0	331.0	349.7	369.1	342.9	337.8	337.8
Gross foreign debt (% of GDP)	37.1	31.8	31.1	31.4	34.1	39.0	39.3
EUR/RUB (avg)	44.2	40.3	40.9	39.9	42.3	47.7	48.6
USD/RUB (avg)	31.7	30.4	29.4	31.1	31.9	35.6	37.7
Basket/RUB (avg)	37.4	34.8	34.6	35.1	36.6	41.0	42.6

Source: Thomson Reuters, Raiffeisen RESEARCH

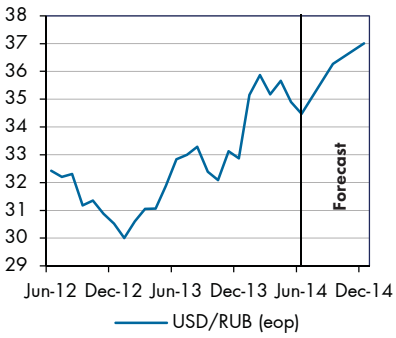
Financial market outlook

Rising tensions in Ukraine and threats of economic sanctions against Russia by Western powers as well as the economic slowdown contributed to RUB weakening in Q1 2014. Hopes of de-escalation in Ukraine as well as quick measures by the Russian Central Bank (CBR), however, helped stabilise RUB in the following quarter. The **CBR reduced depreciation pressure by increasing interest rates and adjusting the movement of the FX band.** Foreign exchange reserves remain large and are adequate to prevent extreme RUB movements even in rough times. After having used considerable volumes for interventions in recent months, the CBR has scaled back the intervention volume considerably. We expect RUB dynamics to remain rather volatile unless the situation in Ukraine de-escalates on a sustainable basis. A cautious stance by the Russian authorities towards referenda in eastern Ukraine was treated by the markets as a move towards de-escalation, which lowered the chances of potential economic sanctions by US/EU against Russia. In particular, **RUB assets reacted positively and outperformed other government bond markets,** but the rebound of the rouble against its basket may already have been overdone in recent weeks. Fundamentally, we anticipate less intensive capital flight and a current account surplus in H2 2014 to limit depreciation pressure on the rouble, but due to weak economic growth and the ongoing geopolitical uncertainty, **in our view equilibrium on FX market may be skewed towards moderate depreciation** in the coming quarters.

Driven mainly by the recent RUB rally, foreign investors re-entered the OFZ market despite relatively high CPI inflation and high CBR REPO rates. The 10y OFZ yield shifted down by approximately 100bp in June, corresponding to a 90bp spread over REPO rates (a historical low: the spread was 240bp before the emergency rate hikes). The main reason for the currently low yields and the considerable yield curve flattening was the **limited supply of new paper.** In addition, in May the RUB borrowing program for 2014 was halved from RUB 825 bn to RUB 435 bn as federal budget revenues were revised upwards. As we doubt that the federal budget will be post a surplus this year, the net borrowing in the amount RUB 119 bn does not look excessive (OFZs maturing this year total RUB 316 bn). Unlike recent years, **in 2014 OFZ market is becoming a source of rouble liquidity** (debt managers to raise RUB 119 bn and to pay out RUB 272 bn in coupons). This is why we think that **OFZ pricing is quite expensive and anticipate that the expected RUB depreciation in H2 2014 will trigger a correction** on the local debt market. In the current market conditions, we would therefore recommend to take profits.

Financial analysts: Maria Pomelnikova, Denis Poryvay, ZAO Raiffeisenbank, Moscow
Stephan Imre, RBI Vienna

Exchange rate development



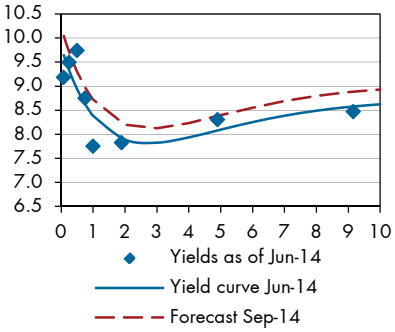
USD/RUB: 5y high 36.63, 5y low 27.28
Source: Bloomberg, Raiffeisen RESEARCH

Exchange rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
EUR/RUB	46.82	47.9	48.1	48.7	48.3
Cons.		*48.7*	*48.5*	*48.5*	*48.1*
USD/RUB	34.47	36.3	37.0	37.4	38.0
Cons.		*36.2*	*36.5*	*36.6*	*36.7*
RUB basket	40.03	41.5	42.0	42.5	42.7

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

RUB rate and yield curve (%)*



** 1m – 6m interest rates; 1y – 10y LCY gov. bond yields*
Source: Bloomberg, Raiffeisen RESEARCH

Interest rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
Key rate	7.50	7.50	7.00	7.00	7.00
Cons.		*7.38*	*7.13*	*6.75*	*6.38*
1 month[2]	9.18	9.70	8.85	8.60	8.70
3 month[2]	9.49	9.80	9.30	9.10	9.10
6 month[2]	9.74	10.00	9.50	9.30	9.30

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

Yield forecasts

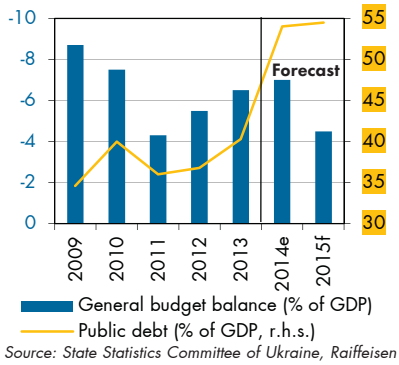
	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
2y T-bond[2]	7.82	8.3	8.0	8.0	8.0
Cons.		*n.v.*	*n.v.*	*n.v.*	*n.v.*
5y T-bond[2]	8.30	8.5	8.2	8.6	8.7
10y T-bond[2]	8.47	8.9	8.8	9.4	9.3
Cons.		*n.v.*	*n.v.*	*n.v.*	*n.v.*

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

In the midst of political turmoil

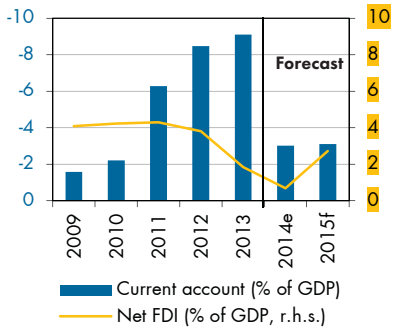
- **Ukraine remains in the midst of a political storm, due to the armed revolt in Donbas**
- **Successful elections increase chances for de-escalation, but Russia-Ukraine negotiations will be the key**
- **Assuming no further political escalation, massive external support helps to restore macroeconomic stability in the short term**
- **Hryvnia closer to fundamentally justified levels, but overshooting should not be ruled out, given the high political risks**

Budget balance and public debt



Source: State Statistics Committee of Ukraine, Raiffeisen RESEARCH

Current account and FDI inflows



Source: State Statistics Committee of Ukraine, Raiffeisen RESEARCH

Economic outlook

The political **situation remains extremely dangerous and unpredictable** with violent conflict in the Eastern Donbas region, where **heavily armed separatists** have occupied large swathes of the **Donetsk and Luhansk regions** and claim independence from Ukraine (albeit, the Crimea-style referendum on independence held in mid-May has been widely deemed illegitimate). The Ukrainian government responded by launching **full-scale military anti-terrorist operations.** Heavy fighting subsequently ensued in the region with hundreds of deaths reported on both sides, but no clear winner emerging so far. At the same time, the attempts to spread protests in other south-eastern parts of the country did not succeed, thanks to much more active position of the local administrations, security forces and population. The **separatist sentiment is apparently heavily supported by Russia**, which is determined to keep Ukraine in its sphere of influence. The **presidential elections,** held on 25 May, proved to be a unanimous success, given the high voter turnout of 60% (albeit it was impossible to organise the voting process in large parts of Donbas), lack of any major disruptions and violations, and an overwhelming **victory by one candidate** – politically seasoned **businessmen Mr. Petro Poroshenko** – in the 1st round. The outcome of elections clearly indicates the consolidation of the Ukrainian nation behind the new President, hoping that he will be able to overcome the mortal threats the country is currently facing. Thus, on the one side, the election success substantially diminishes the risks of further political escalation. On the other side, we do not expect the political conflict in Ukraine to be resolved quickly and political **uncertainty will persist for a few months at least**. The key issues to watch on the political front in the immediate future are the negotiations on Donbas, progress in constitutional reform and the announcement of snap parliamentary elections.

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	81.7	102.7	117.2	135.6	133.2	102.5	110.8
Real GDP (% yoy)	-14.8	4.2	5.2	0.2	0.0	-7.0	1.5
Industrial output (% yoy)	-21.9	10.7	8.1	-0.5	-4.0	-10.0	2.5
Unemployment rate (avg, %)	8.8	8.1	7.9	7.7	7.5	8.5	8.0
Nominal industrial wages (% yoy)	5.0	21.9	20.9	15.0	8.0	-2.0	0.0
Producer prices (avg, % yoy)	6.6	20.9	19.0	3.6	-0.1	13.5	12.0
Consumer prices (avg, % yoy)	15.9	9.4	8.0	0.6	-0.2	11.3	9.0
Consumer prices (eop, % yoy)	12.3	9.1	4.6	-0.2	0.5	19.0	9.0
General budget balance (% of GDP)	-8.7	-7.5	-4.3	-5.5	-6.5	-7.0	-4.5
Public debt (% of GDP)	34.6	40.0	36.0	36.8	40.3	54.0	54.5
Current account balance (% of GDP)	-1.6	-2.2	-6.3	-8.5	-9.1	-3.0	-3.1
Official FX reserves (EUR bn)	17.8	24.8	23.4	17.2	12.5	13.0	13.9
Gross foreign debt (% of GDP)	88.2	85.2	83.0	74.4	78.9	106.8	98.0
EUR/UAH (avg)	11.2	10.5	11.1	10.4	10.8	14.7	14.8
USD/UAH (avg)	8.0	7.9	8.0	8.1	8.2	10.9	11.4

Source: Thomson Reuters, Raiffeisen RESEARCH

The political turmoil weighed heavily on an already **fragile economy**, albeit the GDP decline in Q1 2014 only amounted to a surprisingly small 1.1% yoy, apparently supported by robust agricultural output growth. However, in the coming quarters we **expect a visible deterioration** in growth dynamics, mostly stemming from the halt of production in the turmoil-stricken regions (where 25% of country's industrial output is produced) and deteriorating trade relations with Russia. As a result, Ukraine's GDP is expected to contract by 6-7% yoy in 2014, while we envisage the **end of the recession in 2015** (GDP will grow 1.5% yoy), assuming eventual political stabilisation and some success in implementing structural reforms. Inflation is currently on the rise, fuelled by **large-scale exchange rate adjustment** and administrative tariff hikes. Hence, eop CPI is to increase to 19% yoy in 2014. On the positive side, C/A has already adjusted massively, mostly due to the sharp drop in imports. We expect that the C/A deficit will amount to nearly 3% of GDP in 2014, down from over 9% in 2014.

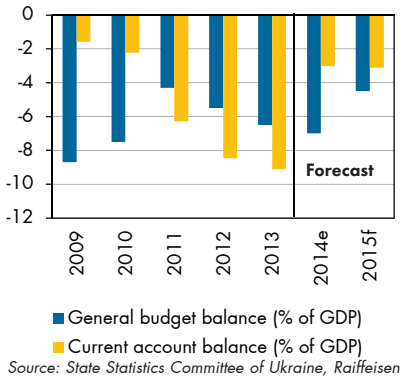
Financial market outlook

After years of basically keeping USD/UAH at 8, the falling FX reserves forced the Ukrainian central bank to abandon the peg and switch to a flexible exchange rate regime in February 2014. Since then, the hryvnia has lost around 30% of its value against the USD due to the economic imbalances as well as the geopolitical tensions. Given the increasing risk of major economic fallout (i.e. currency collapse, government default, full-scale banking crisis), foreign donors came up with an unprecedented **financial help package** with a **total volume of USD 27 bn over the next two years**. The package has been centred around an **IMF stand-by arrangement of USD 17 bn,** which envisaged the implementation of stabilisation measures and full-scale structural and macroeconomic reforms. In May, Ukraine received total assistance of USD 5 bn, which helped to restore macroeconomic stability – i.e. to meet budget spending targets and replenish FX reserves, which slid to the critical level of USD 14.2 bn at end-April.

According to our calculations, assuming no further political escalation, the foreign support package will allow Ukraine to close the external financing gap in 2014-2015. As for the exchange rate outlook, the policy of **changing from a currency peg towards a floating currency has already led to a considerable adjustment**, looking at the relative PPP exchange rate. It becomes obvious that the hryvnia has reversed its overvaluation that it had built up over past years and has returned towards more sustainable exchange rate levels. We believe that **over the short term political developments will most likely determine FX rate movements**. Accordingly, if the political situation does not deteriorate further in the next months, **the exchange rate will most likely fluctuate in the range of USD/UAH 11-12** as the external financial assistance mostly covers public financing needs. Nevertheless, with uncertainty remaining extremely high any forecasts bear a considerable source of risk regarding the further path of UAH until at least the geopolitical situation clears.

Financial analysts: Dmytro Sologub, Raiffeisen Bank Aval Public Joint Stock Company, Kiev;

Budget and current account balance



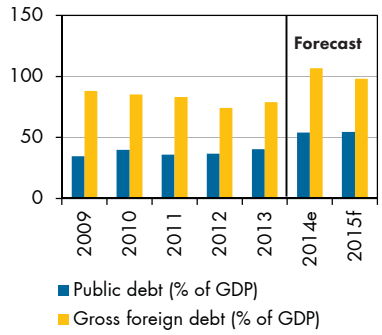
Source: State Statistics Committee of Ukraine, Raiffeisen RESEARCH

Exchange rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
EUR/UAH	16.19	15.3	15.0	14.7	14.2
Cons.		*15.1*	*14.7*	*14.9*	*14.8*
USD/UAH	11.91	11.6	11.5	11.3	11.2
Cons.		*11.2*	*11.1*	*11.2*	*11.3*

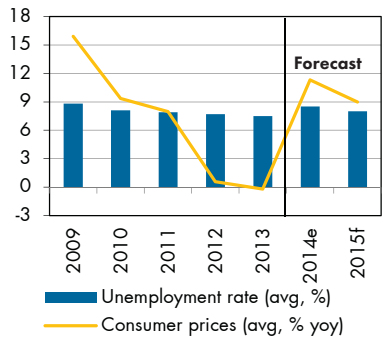
[1] *5:00 p.m. (CET)*
Source: Bloomberg, Raiffeisen RESEARCH

Public and external debt



Source: State Statistics Committee of Ukraine, Raiffeisen RESEARCH

Inflation outlook

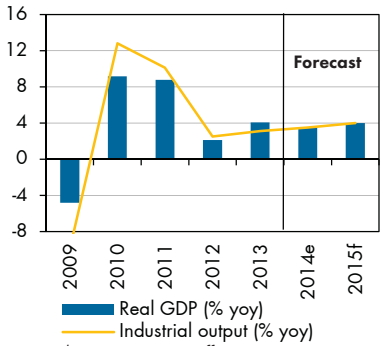


Source: State Statistics Committee of Ukraine, Raiffeisen RESEARCH

Uninterrupted growth masks underlying weakness

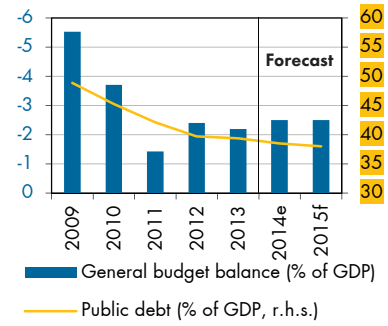
- **Growth structure shows weakening domestic demand as well as strong export growth**
- **High inflation still causing headaches, while the current account deficit declines somewhat**
- **Moderate correction of TURKGBs expected following impressive rally**
- **While not ruling out temporary spikes in USD/TRY ahead of the presidential election, we forecast a stronger lira**

Real GDP (% yoy)



Source: Thomson Reuters, Raiffeisen RESEARCH

Budget and current account balance



Source: Thomson Reuters, Raiffeisen RESEARCH

Economic outlook

As was the case in many CE and SEE countries, **Turkey's economic performance surprised on the positive side** in Q1. GDP growth did not decline at all and came in at 4.4% yoy – similar to the readings in the two previous quarters. In quarter-on-quarter terms, GDP growth even doubled to 1.7%. This was unexpected as **political jitters early this year substantially soured sentiment** on Turkey, prompting us to expect a negative impact on the economy as well. However, at second glance, the high headline GDP growth masks **substantial changes in the composition of growth:** in 2013, Turkey's economy was mainly driven by domestic demand, while net exports were a substantial drag on real growth. This turned around again in Q1. Household demand slowed to 2.1% yoy and fixed investment contracted slightly, both indicating some underlying deceleration in the local economy, but after a good run. On the other hand, real export demand jumped by 11% in comparison to the same quarter one year earlier. This pattern is also supported by the balance of payments, as exports rose 9% yoy in Jan-Apr and imports shrank 4%, resulting in a **one-third decline in the current account deficit.** Leading indicators, such as the PMI, point to deteriorating sentiment in the past few months, shifting from expansionary indications towards lower growth. Thus, in the future GDP dynamics might again decelerate to 0.75%-1% per quarter, adding up to **GDP growth of around 3-4% for the full year**. This would be slightly below the growth registered in 2013 (but much higher than our GDP estimate of 2% yoy from the beginning of the year).

Headline **inflation has shot up since the beginning of the year**, advancing from 7.4% to 9.7% in May, and core inflation is even slightly higher. This is partly a hangover from the 17% depreciation last year and probably excessively loose policy ahead of the tightening early this year. The markets see a **decline in inflation to around 8%** towards the end of the year – which is still a high reading for the region.

Key economic figures and forecasts

	2009	2010	2011	2012	2013	2014e	2015f
Nominal GDP (EUR bn)	439.5	549.5	554.8	612.1	626.1	623.5	738.0
Real GDP (% yoy)	-4.8	9.2	8.8	2.1	4.1	3.5	4.0
Industrial output (% yoy)	-9.9	12.8	10.1	2.5	3.1	3.5	4.0
Unemployment rate (avg, %)	13.7	11.7	9.6	9.0	9.5	9.5	9.0
Nominal industrial wages (% yoy)	8.1	8.0	8.0	6.0	6.0	6.0	6.0
Producer prices (avg, % yoy)	1.2	8.5	11.1	6.1	4.5	7.0	6.0
Consumer prices (avg, % yoy)	6.2	8.6	6.5	8.9	7.5	8.5	7.4
Consumer prices (eop, % yoy)	6.5	6.4	10.5	6.1	7.4	8.8	6.0
General budget balance (% of GDP)	-5.5	-3.7	-1.4	-2.4	-2.2	-2.5	-2.5
Public debt (% of GDP)	48.9	45.2	42.1	39.7	39.4	38.5	38.0
Current account balance (% of GDP)	-2.0	-6.2	-9.7	-6.2	-7.8	-6.3	-6.0
Official FX reserves (EUR bn)	49.4	60.2	60.3	75.8	80.5	80.8	76.9
Gross foreign debt (% of GDP)	42.8	39.7	42.6	42.0	45.0	52.5	48.4
EUR/TRY (avg)	2.17	2.00	2.34	2.31	2.53	2.85	2.70
USD/TRY (avg)	1.55	1.51	1.68	1.80	1.91	2.13	2.09

Source: Thomson Reuters, wiiw, Raiffeisen RESEARCH

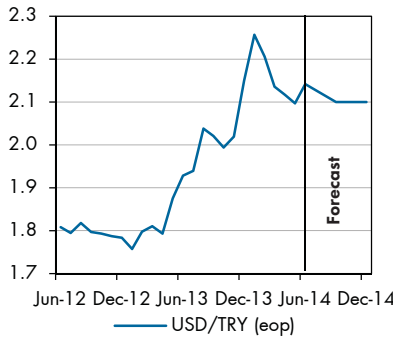
Financial market outlook

Lira markets were one of the top performers in the EM space during the past three months. Following the local elections at the end of March, both **FX and FI markets witnessed an impressive rally – from, nota bene, overshot levels**. In that timeframe, the 2y yield of the TURKGB curve nosedived by around 200bp, whilst the 10y yield fell by more than 150bp. This **impressive bull steepening led to a gradual normalisation of the curve** which had an inverted shape following the emergency rate hikes by the Turkish central bank (TCMB) back in January. On the external front, the de-escalation of the Ukraine conflict and the additional easing measures by the ECB were the main prerequisites for this outperformance, whilst the **overall improving sentiment on Turkey pulled yield-hunting investors back to Turkey**. This improved risk perception – between end-January and 22 May 5y USD CDS were down 100bp and TRY was temporarily 10% stronger vs. USD – allowed the TCMB to partially roll-back the emergency rate hikes from January and to **cut its main interest rate tool by 50bp in May**. The market is currently pricing in much deeper cuts, which has also contributed to the rally of TURKGBs, and this is also reflected in the latest capital flow data reflecting an ongoing increase in foreign bond holdings. The bulk of the inflows is concentrated in the 2015 and 2016 maturity segments which are amongst the most liquid spots on the TURKGB curve.

At the moment, the Turkish debt market seems overbought. According to our baseline assumption, the TCMB will **continue with gradual rate cuts, but in our view the market is factoring in too much of that**. Although Turkish central bankers are making efforts to communicate inflationary developments proactively, CPI inflation is still high (9.7% yoy in May), in sharp contrast to other CEE markets where deflationary fears do not even seem wholly unwarranted. However, MPC members already began to announce in early 2014 that inflation will peak during the summer months. Against this backdrop, CB governor Basci recently confirmed that the MPC will continue with the gradual rate cuts in a measured way. **TRY vs. USD should be fairly unaffected by the likely continuation of the rate-cutting cycle**, as markets are currently pricing too much MP easing. Our call is for a stronger lira vs. USD on a 3m horizon, while **risks to our USD/TRY forecast became skewed to the upside** recently: The conflict in Iraq has become more and more a matter of concern. This could have a negative impact on current account dynamics, the lira and would ultimately hamper the expected disinflation process. Furthermore, local political risks could move back into focus ahead of the presidential elections scheduled for August.

Financial analysts: Andreas Schwabe, CFA
Stephan Imre, RBI Vienna

Exchange rate development



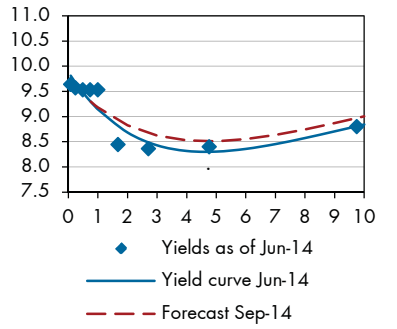
USD/TRY: 5y high 2.34, 5y low 1.4
Source: Bloomberg, Raiffeisen RESEARCH

Exchange rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
EUR/TRY	2.91	2.77	2.73	2.80	2.67
Cons.		*2.93*	*2.90*	*2.92*	*2.88*
USD/TRY	2.14	2.10	2.10	2.15	2.10
Cons.		*2.18*	*2.19*	*2.20*	*2.20*

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

TRY rate and yield curve (%)



** 1m – 12m interest rates; 2y – 10y LCY gov. bond yields*
Source: Bloomberg, Raiffeisen RESEARCH

Interest rate forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
Key rate	8.75	8.25	*7.75*	*7.75*	*7.75*
Consensus		*n.v.*	*n.v.*	*n.v.*	*n.v.*
1 month[2]	9.40	9.30	9.00	8.80	8.60
3 month[2]	9.34	9.50	9.20	9.10	9.00
Consensus		*10.22*	*10.22*	*10.21*	*9.84*
6 month[2]	9.30	9.50	9.30	9.20	9.10
12 month[2]	9.30	9.50	9.30	9.20	9.10

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

Yield forecasts

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
2y T-bond[2]	8.44	8.6	8.7	8.6	8.3
Cons.		*n.v.*	*n.v.*	*n.v.*	*n.v.*
5y T-bond[2]	8.40	8.5	8.6	8.8	9.0
10y T-bond[2]	8.80	9.0	9.5	9.7	9.8
Cons.		*n.v.*	*n.v.*	*n.v.*	*n.v.*

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

Calm after the Ukraine storm

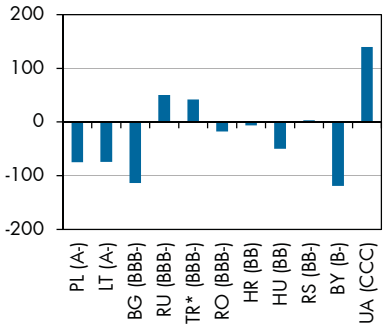
- **CEE Eurobonds managed to return good performance in Q2, amidst decreasing likelihood of sanctions against Russia**
- **Issuing activity is likely to drop in Q3, as CEE has already prefunded nearly 70% of the required amounts**
- **CEE may offer less relative value pick-up for international investors in Q3; within CEE only CE retains a stable outlook**
- **We favour Hungary's Eurobonds, due to strengthening fundamentals and the likelihood of a single-notch upgrade**

EMBIG USD value & spreads*

	20-Jun[1]		Spread values, bp		
	Index	Spread, bp	Q/Q	5y min	5y max
PL (A-)	557	107	-13	90	361
LT (A-)	160	107	-36	91	493
BG (BBB-)	1018	68	0	31	461
RU (BBB-)	927	232	-35	151	456
TR* (BBB-)	654	223	-41	137	411
RO (BBB-)	134	164	-31	151	528
HR (BB)	139	239	-27	145	657
HU (BB)	270	195	-59	149	726
RS (BB-)	207	249	-30	217	724
BY (B-)	143	526	-146	507	1706
UA (CCC)	606	784	25	393	1276
Europe*	1007	233	-34	171	485
Africa	859	269	-18	183	462
Asia	555	186	-17	133	359
Mid East	458	364	-25	280	532
Latam	630	322	-54	285	526
Global	682	268	-40	227	476
Inv.grade	515	182	-22	135	326
BB	610	245	-51	188	533
B	1147	645	-187	406	1099

[1] closing prices 5:00 p.m. (CET)
** TR - Turkey Fitch rating, Europe - CEE, Q/Q - quarter-on-quarter, 5y - 5-year minimum and maximum*
Source: Thomson-Reuters, Raiffeisen RESEARCH

CEE EMBIG rating spread, bp*



** JPM USD EMBI Global index family, TR - Turkey Fitch rating*
Source: Thomson-Reuters

Market trends

The CEE Eurobond market managed to return good performance in Q2, thanks in large part to the successful presidential elections in Ukraine which fostered hopes of a possible de-escalation of the situation and decreased the risk of economic sanctions against Russia. Within the CEE segment, riskier assets demonstrated a strong rebound, with Turkey, Hungary and Belarus scoring above average returns in the range of 5-7%. The other two outperformers were Kazakhstan and Romania. In a related story, **Romania benefited from S&P's rating upgrade to BBB-**, which put it firmly in investment grade territory; **Hungary's rating outlook was also lifted from negative to stable** signalling the end of the downgrade path. The other sovereigns benefiting from rating upgrades were two Baltic countries, Latvia and Lithuania. Nevertheless, as we predicted in our last Strategy East report, the rating situation in CEE was not so straightforward. In April, S&P downgraded Russia's rating one notch to BBB- and the outlook for Kazakhstan was revised from stable to negative on monetary policy concerns and structural issues. Bulgaria also lost one notch, with its rating dropping from BBB to a BBB- ceiling after S&P became concerned about political volatility and lagging growth exerting negative pressure on the pace of reforms.

Primary markets

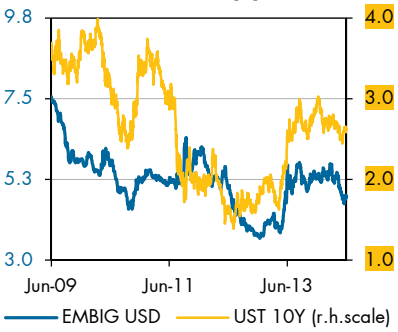
As we anticipated, Q2 was a fairly busy period in the primary Eurobond markets. Cumulative sovereign issuance from CEE reached USD 10.3 bn in Q2 which was almost two times lower than in Q1, but nearly 30% higher compared to Q2 2013. It should be mentioned that lower issuance in Q2 is fairly common for the region, as more CEE sovereigns traditionally target Q1 under normal market conditions, since many of them employ pro-active funding strategies aiming to cover a larger part of the annual funding needs in a pre-loaded manner. **The three largest sovereign issuers from CEE in H1 included Slovenia**, which actively pre-funded its 2014 borrowing plan, **Poland and Turkey**. Hungary also was fairly actively issuing Eurobond debt, although later the government announced a shift in its long-term debt strategy favouring domestic debt and targeting a reduction of Eurobond debt. **Currency-wise, we saw a positive shift, with EUR-denominated placements accounting for up to 50% of all sovereign Eurobonds** issued in H1 compared to just 30% in 2013. Previously, CEE governments had been actively using the USD market and their return to EUR might signal their desire to diversify currency risks to avoid a higher concentration in a single foreign currency. As for the outlook on primary markets, **we expect issuing activity to drop in Q3, as CEE governments have already prefunded nearly 70% of the required amounts** and may not need to rush to the market at any cost. Among potential issuers in Q3, we spot Serbia and Kazakhstan which pre-announced their plans, although no exact timing details were given. In another story, Russia is unlikely to come to the market this year, due to the political situation and worsening risk perception in the markets.

Outlook & Strategy

We believe the market outlook in Q3 will be determined by a few important factors. First of all, the recent market rally erased the relative underperformance of CEE. Now, only CIS appears cheap compared to the rest of the CEE sovereigns and EM peers. The other CEE trade fairly tight spread-wise, which may cap future potential. **As a result, CEE might offer less relative value pick-up** for international investors **in Q3**. The second caveat concerns rating and fundamentals, which are shaping regional risk perception. In our opinion, in CEE only the CE sub-region retains a stable outlook. **We see negative rating pressure persisting in SEE**, with the outlook remaining negative due to the poor fiscal performance of Croatia and possible delays in the implementation of fiscal reforms in Serbia owing to the impact of the natural disaster on state finances. The recent downgrade of Bulgaria also puts a negative cast on the SEE outlook. Despite this, we believe that in SEE only Croatia stands a real chance of another rating downgrade. Meanwhile, **the Ukraine-Russia crisis is becoming a systemic issue which will continue to affect CIS market performance**. Recently, we saw S&P lower its outlook for Kazakhstan, not least due to its stronger links to the stagnant Russian economy. In Ukraine, the economic crisis will continue to impair the market outlook while market pricing shows that investors remain overly optimistic about Ukraine risk. Last but not least, **the tightening of credit conditions associated with the Fed tapering is likely to drive EM spreads up, albeit slowly**. At the same time, the ECB dovish rhetoric is unlikely to bring benefits for EM as the regulator in Europe will probably not take measures going beyond the pre-announced steps. As we anticipate UST yields to start rising more in Q3-Q4, investors are likely to take more critical view of EM, while re-adjusting their risk perceptions. We continue to **favour Hungary's Eurobonds**, due to the reversal in the rating path thanks to strengthening fundamentals which increase the likelihood of a single-notch upgrade. Also, despite relatively tighter pricing, the strong likelihood of fiscal tightening implementation should help to preserve the investment value appeal of Serbia. At the same time, **we see more downside in Ukrainian and Croatian Eurobonds** due to a mix of fundamental and, in the case of Ukraine, also political problems.

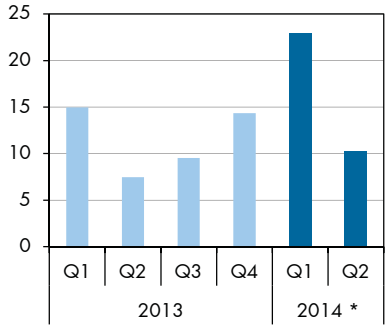
Financial analyst: Gintaras Shlizhyus

CEE EMBIG vs. UST 10y yields (%)*



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

CEE Eurobond issuance timeline *



** USD bn, sovereign government Eurobonds only in all currencies, 2014 - cumulative to-date*
Source: Bloomberg, BondRadar, Raiffeisen RESEARCH

Benchmark Eurobond forecast and performance

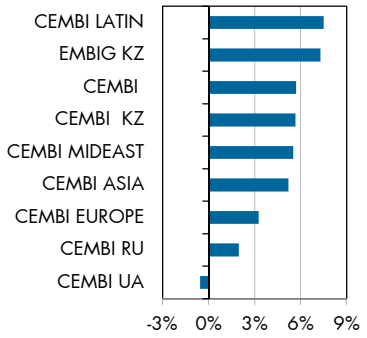
				Spread		Range			Spread	Range			Spread	Range		
		Rating	Dur.	23-Jun	Sep-14	min.	max.	Perf. (%)	Dec-14	min.	max.	Perf. (%)	Mar-15	min.	max.	Perf. (%)
PL 3% due 23	USD	A-	7.7	**90**	**95**	84	100	-2.7	**112**	102	118	-7.1	**103**	93	109	-8.0
PL 4.5% due 22	EUR	A-	6.6	**67**	**70**	64	73	-1.0	**82**	76	85	-3.1	**76**	70	79	-4.0
LT 6.625% due 22	USD	A-	6.1	**80**	**95**	66	110	-2.2	**118**	88	132	-6.1	**103**	73	117	-6.4
LT 4.85% due 18	EUR	A-	3.4	**107**	**125**	89	143	-1.0	**154**	118	172	-2.6	**135**	99	153	-2.7
BG 4.25% due 17	EUR	BBB-	2.8	**138**	**130**	147	122	0.1	**145**	162	136	-1.1	**142**	159	134	-1.5
RU 4.5% due 22	USD	BBB-	6.6	**157**	**180**	134	203	-2.9	**220**	174	243	-8.2	**195**	149	218	-7.9
TR 3.25% due 23	USD*	BBB-	7.6	**192**	**200**	183	208	-2.9	**235**	218	243	-8.5	**218**	201	226	-8.8
TR 5.125% due 20	EUR*	BBB-	5.2	**252**	**260**	243	268	-1.0	**304**	287	312	-4.4	**283**	266	291	-4.3
RO 4.375% due 23	USD	BBB-	7.6	**143**	**150**	137	157	-2.8	**176**	163	183	-7.8	**163**	150	170	-8.3
RO 4.875% due 19	EUR	BBB-	4.7	**183**	**195**	172	207	-1.1	**231**	208	243	-3.8	**212**	189	224	-3.8
HR 5.5% due 23	USD	BB	7.0	**225**	**260**	191	295	-4.5	**319**	250	354	-11.5	**281**	212	316	-10.2
HR 6.5% due 15	EUR	BB	0.5	**104**	**120**	88	136	-0.1	**147**	115	163	-0.3	**130**	98	146	-0.2
HU 5.375% due 23	USD	BB	7.0	**180**	**155**	206	130	-0.3	**157**	207	131	-3.2	**166**	217	141	-5.3
HU 3.875% due 20	EUR	BB	5.1	**204**	**180**	228	156	0.6	**193**	241	169	-1.1	**198**	246	173	-2.3
RS 7.25% due 21	USD	BB-	5.8	**204**	**190**	218	176	-0.4	**210**	239	196	-3.9	**208**	236	194	-4.9
BY 8.95% due 18	USD	B-	3.0	**466**	**500**	432	534	-1.4	**569**	501	602	-4.9	**528**	460	561	-4.3
UA 7.5% due 23	USD	CCC	6.2	**641**	**700**	582	759	-5.0	**657**	539	716	-4.8	**650**	532	709	-5.6

*[1] closing prices 5:00 p.m. (CET); * 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, Raiffeisen RESEARCH

CIS credits: Un-breaking of investors' hearts almost completed

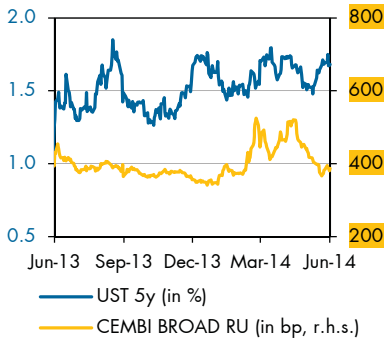
- **Technical factors taking the front seat, event risk receding**
- **Room to rally as repricing still underway**
- **EUR not as esoteric as before**
- **Focus on primary market and selective bets**

Q2 2014 ytd returns*



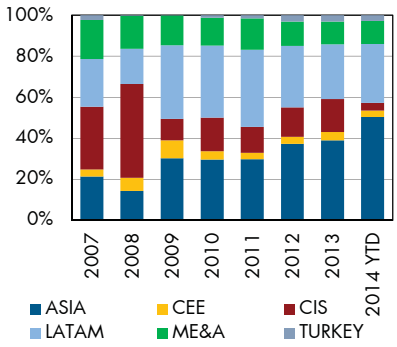
** data are for Broad Series*
5y average annual return in %: CEMBI UA: 16, EMBIG KZ: 13.1, CEMBI EUROPE: 11.8, CEMBI RU: 11.7,CEMBI KZ: 11.3, CEMBI: 9.6, CEMBI MIDEAST: 9.3, CEMBI LATIN: 9.1, CEMBI ASIA: 8.8
Source: JP Morgan, Raiffeisen RESEARCH

UST vs. CEMBI RU Index



UST: 5y high: 2.82 %, 5y low: 0.54 %
CEMBI BROAD RU: 5y high: 702 bp; 5y low: 254 bp
Source: Bloomberg, JP Morgan, Raiffeisen RESEARCH

EM corporate issuance (%)



Source: Bond Radar, Raiffeisen RESEARCH

CIS credits have had a bumpy ride in the year to date, which was clearly a result of Ukrainian-Russian standoff and repricing after Mr Putin's commitment not to proceed with further annexations in Ukraine followed by the signing of the gas accord between Russia and China. Also, the Ukrainian presidential elections on 25 May were a supporting factor for valuations. We stick to our view that the announced set of sanctions does not have a material impact on the fundamental position of Russian corporate credits. However, we may see increased volatility in the coming months, due to the ongoing gas dispute between Ukraine and Russia, and the military conflict in eastern Ukraine.

Even though **the slowdown in the real economy is the factor to watch in CIS**, in particular in Russia and Ukraine, **Emerging Markets (EM) may be supported by technical factors** in the next few months. We argue that quality spread contraction and bottom-fishing in the developed markets (DM) space does not offer many attractive investment opportunities anymore. The tight DM valuations and the search for yield pick-up should translate into more demand in those parts of the EM space which offer the most value.

We expect event risks to diminish further and **external risks to become more prominent in the CIS** remit. In particular, we think that the **future shape of the Fed's monetary policy** will be a key external factor for bond valuations in CIS. A higher UST yield curve is clearly negative for total return investors. However, we think that losses on DM credit products could catalyse more inflows into the CIS space, which offers juicier spreads as a compensation for the rising risk-free rate. We suggest **focusing on selective bets and new primary market issues**. We think that the pent-up supply due to the lack of market access should translate into higher primary market premiums for the new Eurobond offerings. However, despite the current build-up of the new issue pipeline, we think the summer season will not be conducive to overly vigorous primary market activity in the CIS space. Nonetheless, a few deals should come through and primary market premiums could offer interesting pick-up over the issuers' secondary curves.

EUR is a rather exotic currency of issue in the CIS Eurobond space, but it **has been becoming more attractive** since the last ECB meeting due to its more relaxed monetary policy setting. We think that the EUR investor environment will be more accepting for CIS issuers, due to a combination of the following factors. First, compared to the Fed, the ECB's monetary policy is more relaxed which should decrease refinancing costs for issuers and increase investors' risk appetite. Second, the EU has adopted a more reserved position than the USA towards Russia in terms of imposing sanctions which could indicate a less hostile investor environment.

In our last strategy publication, we argued that short durations of Russian credits were oversold and that a return to a steeper credit curve was on the cards due to low refinancing risks. Our argument proved to be well-based as the 10y-3y z-spread premium of BBB-rated Russian credits increased from about 50bp in mid-March to about 90bp now.

Taking a look at the Q2 performance, the global emerging market (EM) corporate credit index returned 3.7% for the quarter-to-date. The main contributors to this performance were Kazakh high yields (+6.4%), Kazakh investment grades (+6.3%), Ukraine (+6.0%), LatAM (+4.9%) and Asia (+3.4%). The Russian segment lagged behind with a 0.7% qtd return. However, the relatively high outperformance of Kazakh high yields was of a technical nature. In the May rebalancing, ALLIBK 10.5% due 2017, the bond of the restructured Alliance Bank, left the index. Taking a look at spreads, Russia trades 7bp wide of its pre-selloff level, while Ukraine and Kazakhstan trade 327bp and 65bp inside. As spread development was quite fragmented in Q2, we think that technically speaking there is still some room to rally in the Russian credit space.

On the primary market, EM issuance continued to flourish despite the missing flows from Russia. The total EM amount of USD 160 bn for the quarter to date (qtd) has already surpassed the total Q2 2013 amount of USD 126 bn. Strong issuance from Asia drove the volumes while the CIS region's USD 3.1 bn accounted for mere 2% vs. 18% during Q2 2013. **The CEE region showed resilience to increased regional geopolitical risks** as investors seemed to redirect Russian flows towards CEE as the hunt for yield continued. The issued USD 10.7 bn qtd is 3.4 times higher than the amount issued in CIS. CEE activity was driven by sovereign issuance which accounted for almost 80% of the total. In the CIS, countries other than Russia and Ukraine seemed little impacted by the crisis. The three issues from Kazakhstan and Azerbaijan totalling USD 1.5 bn were well received by the markets. With the successful Ukrainian presidential election in May, the situation calmed down somewhat and in June we saw the first Russian issuer approach the market, as Alfa-Bank's holding parent placed EUR 350 mn Eurobond. Following the successful Russian deal, the pipeline has been filling up as several regular issuers such as Sberbank, VEB, Gazprombank followed suit. We have noticed the increased use of EUR as a preferred issuance currency. In our view, this is driven by more favourable pricing conditions due to the accommodating monetary effect of the ECB's stance and European investors less stringent approach to Russian risks on the back of softer rhetoric of EU leaders towards Russia. We expect to see **revived activity on the primary markets during Q3 2014, but the market environment will remain fragile** with investor sentiment depending on the emergence of additional regional risks.

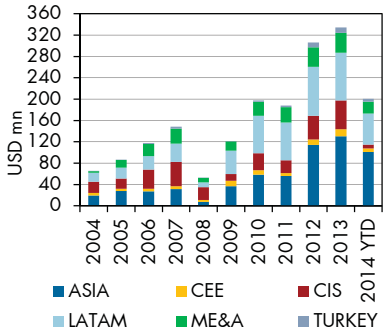
As regards valuation, the Russian oil and gas sector has seen a significant correction reaching pre-crisis levels in the middle of June as fading geopolitical risks made the likelihood of economic sanctions against the sector less probable. However, the increasing violence in eastern Ukraine and the failed gas talks with Gazprom reminded of fragile investor sentiment, with spreads widening another 25bp across the board. In our view, if no additional external shocks materialise, valuations will tighten back to pre-crisis levels. On relative value basis we like LUKOIL 3.416% due 2018 and Novatek 6.604% due 2021, which trade around 60bp wider in asw terms compared to the pre-crisis levels seen in January.

We continue to dislike the transport sector which is faced with railcar overcapacity and the slowdown of Russia's economic growth, both factors which will keep a lid on healthier EBITDA growth. As things stand, we maintain our sell call on FESCO 8.75% due 2020.

In the banking space, we like the EUR-denominated Gazprombank 3.984% due 2018 and the USD-denominated Sberbank 5.4% due 2017.

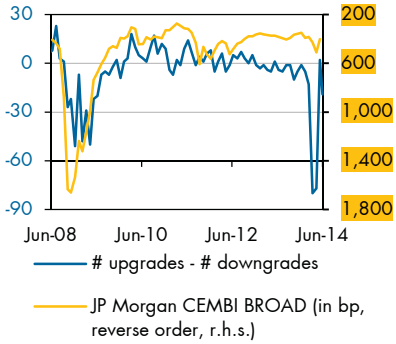
Financial analysts: Martin Kutny, Lubica Sikova, CFA

EM corporate issuance



Source: Bond Radar, Raiffeisen RESEARCH

Rating drift in Russia



CEMBI BROAD: 5y high: 572 bp; 5y low: 265 bp
Source: Bloomberg, JP Morgan, Raiffeisen RESEARCH

Selected CIS Eurobonds

Issuer	ISIN	Maturity	Yield in %
Alfa Bank	XS0544362972	25/09/17	5.7
Alrosa	XS0555493203	03/11/20	6.7
Evraz	XS0618905219	27/04/18	8.8
Gazprom	XS0885733153	06/02/20	5.1
Halyk Bank	XS0298931287	03/05/17	4.8
KazMunay-Gaz	XS0556885753	09/04/21	4.9
VimpelCom	XS0587031096	02/02/21	7.5

Source: Bloomberg, Raiffeisen RESEARCH

Conditions remain good

- **Geopolitical concerns now only play a secondary role**
- **Significant earnings growth thanks to the low basis**
- **ATX expected to develop positively**

Value matrix*

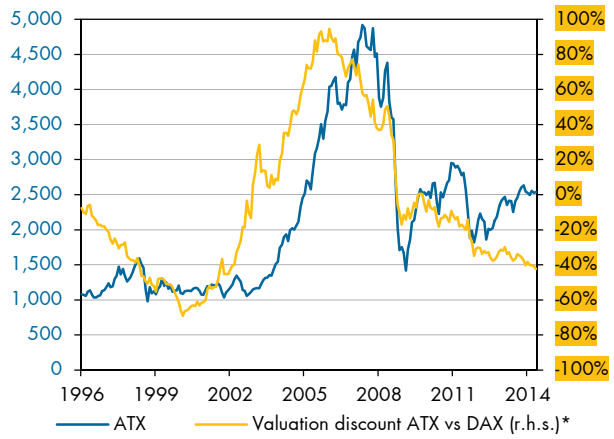
Domestic business activity		3	(2)
Exports	OECD - excl. Eastern Europe	2	(2)
	Eastern Europe	2	(2)
	Asia	2	(2)
Company earnings		2	(2)
Key sectors		2	(2)
Valuation - P/E-ratio		3	(2)
Interest rates / yields		2	(2)
Exchange rates		2	(2)
Foreign equity markets		2	(2)
European liquidity		2	(2)
Technical outlook		2	(3)

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

During the past quarter, the **performance of the Austrian equity market** was **quite bumpy** on the whole. One of the main reasons for this was the conflict in eastern Ukraine, especially since several Austrian companies are involved in Ukraine and Russia. At the same time, following the elections in Ukraine and the declining likelihood of direct Russian military intervention, the stock markets began to ascribe less importance to this factor, while not writing it off completely. In line with this, the ATX was also able to slowly recover again, with the improving sentiment on the international equity markets certainly playing a role in this regard.

During the past quarter, **economic performance in Austria** was **relatively disappointing** as was the case in most of the other euro area countries, especially considering that economic activity had picked up during the second half of 2013. The development of private consumption in particular fell short of the expectations. Basically, we stick with our expectations of economic expansion in 2014. Although the pace of growth will be slower than we originally projected, the Austrian economy should grow at a real rate of 1.3% this year. This is also suggested by the leading indicators which are available for Austria. Looking ahead, we see improving domestic demand as a key growth driver, which should take over from the current growth engine of foreign trade. Looking at Eastern Europe, the economies in the CIS region will probably contract this year. There are **more positive prospects** for countries such as **Romania, Poland and the Czech Republic.** In particular, we expect the first of these countries to record the strongest growth in the region.

ATX shows valuation discount



** Cyclically adjusted price/earnings ratio based on rolling 10 year trailing index earnings*
Source: Thomson Reuters, Raiffeisen RESEARCH

At the corporate level, the **past reporting season** was generally **unspectacular**. All in all, the numbers that were released were unable to impart any significant momentum to the ATX. This was probably also because the **companies' outlooks** could best be described as **subdued**. For instance, Erste Group is not expecting any significant growth in revenue this year, due to the low interest rate environment and restrained credit demand. Following the profit warning by Verbund back in February, it now looks

Sector structure of the ATX

Sector	Company	Weight
Financials	CA Immobilien, conwert, Erste Group, Immofinanz, Raiffeisen Bank International, Uniqa, Vienna Insurance Group	46.4%
Industrials	Andritz, Oesterreichische Post, Wienerberger, Zumtobel	16.9%
Energy	OMV, SBO	14.2%
Basic materials	Mayr-Melnhof, Lenzing, RHI, voestalpine	16.1%
Telecom	Telekom Austria	4.3%
Utilities	EVN, Verbund	2.2%

Source: Raiffeisen RESEARCH, Raiffeisen Centrobank, Vienna Stock Exchange

even more uncertain whether Austria's largest domestic utility can meet its published targets. Andritz, on the other hand, confirmed its corporate outlook, which features only a small increase in turnover but better net profit. Nor was there much of a sense of euphoria at voestalpine. Although the steel division profited from stronger demand during the last quarter, management has some doubts about how stable price conditions will be.

The future course of events in **Ukraine and Russia** will still also play a significant role for some of the companies. Nevertheless, this factor is **relatively negligible for the majority of the companies in the ATX**. Since we do not expect to see any further escalation in the situation in our baseline scenario, the increasing pace of global economic activity this year should also allow for a recovery in earnings. Following the approximately 6% slump in earnings in 2013, which can be explained by certain one-off impacts at some of the index heavyweights, we remain confident about the prospects for this year. Similar to our last publication, we would like to note that while our **projected earnings growth figure of around 21%** may seem high at first glance, it is based on the reduced basis from the previous year.

Although we **no longer consider the absolute valuation** level of the Austrian stock market **to be attractive**, at the moment it appears to make more sense to look at the relative valuation compared to other asset classes. Specifically, viewed against the backdrop of even more expansive monetary policy by the ECB and the resulting increase in asset prices in the government bond and corporate bond segments, we do not see the ATX's 2014 P/E ratio of 14.7 as being that expensive. In contrast to other established equity indices such as the DAX, the ATX also continues to exhibit a massive discount looking at the cyclically-adjusted P/E ratio based on longer-term average earnings.

Summary: In the months to come, we expect to see a fundamentally positive development of the ATX. Although there may be repeated episodes of uncertainty from geopolitical factors, it seems that the current conditions are very benign for equities, with an eye to the prevailing liquidity environment. As a result, there is **still upside potential for the valuation levels.** In our view, the ongoing economic recovery in the euro area and the **relatively solid earnings growth** compared to other markets should pave the way for higher levels for the ATX during the summer and beyond. **"Buy"**.

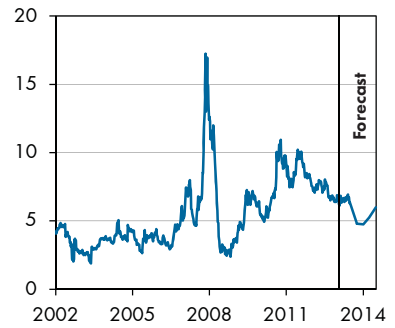
Financial analyst: Johannes Mattner

Fair value of ATX[1] - June 2015

	Bond yields (10y)		
EY-BY[2]	**2.00%**	**2.25%**	**2.50%**
6.25%	2,726	2,646	2,570
6.00%	2,811	2,726	2,646
5.75%	2,902	2,811	2,726
5.50%	2,998	2,902	2,811
5.25%	3,102	2,998	2,902
5.00%	3,213	3,102	2,998
4.75%	3,332	3,213	3,102
4.50%	3,460	3,332	3,213
4.25%	3,598	3,460	3,332
4.00%	3,748	3,598	3,460
3.75%	3,911	3,748	3,598
3.50%	4,089	3,911	3,748
3.25%	4,283	4,089	3,911
3.00%	4,498	4,283	4,089

[1] based on the expected earnings for 2014/2015 (i.e. 224.9 index points)
[2] earnings yield less bond yield
Source: Raiffeisen RESEARCH, Raiffeisen Centrobank

Earnings yield* less bond yield



** earnings yield = E/P; based on 12-month forward earnings*
Source: Thomson Reuters, Raiffeisen RESEARCH, Raiffeisen Centrobank

Valuation and forecasts

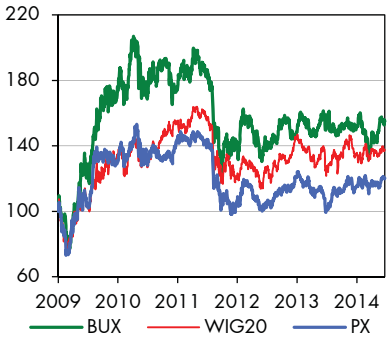
	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15
12-months forward earnings	224.9	187.6	200.2	212.4	224.9
Bond yield forecast	1.65	1.75	2.00	2.15	2.35
Earnings yield less bond yield (EY-BY)	**7.12**	**4.80**	**4.75**	**5.25**	**6.00**
ATX-forecast based on EY-BY		2,864	2,965	2,871	2,693
ATX-forecast	**2,565.0**	**2,650**	**2,750**	**2,660**	**2,700**
Expected price change		3.3%	7.2%	3.7%	5.3%
Range		2,400-2,750	2,500-2,850	2,500-2,850	2,500-2,850
P/E based on 12-month forward earnings	11.4	14.1	13.7	12.5	12.0

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

Breathing pause expected over the summer months

- **Geopolitical conflict in Ukraine continues to be an issue**
- **No further significant escalation expected between East and West**
- **Local and fundamental factors coming back into focus**
- **Valuations of CEE indices generally no longer cheap**

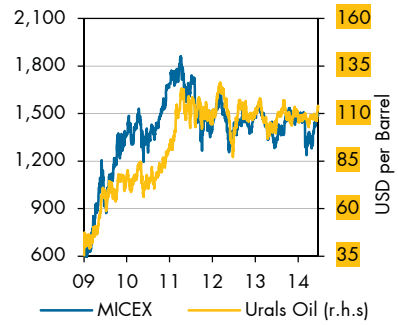
CE core indices



Source: Thomson Reuters, Raiffeisen RESEARCH

During the last three months, the performance of the CEE equity markets has been quite positive, especially as political risk in relation to the conflict in Ukraine was priced out. While this crisis is probably not going to be resolved quickly and the situation will likely remain tense in the coming quarters, we do not believe that there will be any further escalation. Consequently, investors' interest will probably shift more strongly to fundamental factors. In economic terms, a significant recovery is emerging in most countries (with the exception of Russia and Croatia). Key rates should remain at their currently very low levels until Q1 2015 (Fed) and Q3 2015 (ECB) and thus not provide any cause for concern for the time being. For lack of alternative investments, we see an advantage for equities as an asset class. Nevertheless, following the sometimes very strong increases in prices seen recently, we believe that a pause is likely. In terms of valuations, most of the CEE indices are no longer looking cheap, and consequently we only expect to see minor price gains during the traditionally weaker summer period. In light of the solid economic data, the equity markets should subsequently head for a pleasing end to the year.

MICEX vs Oil



Source: Thomson Reuters, Raiffeisen RESEARCH

The **Russian stock market** managed a robust rebound after the situation in Ukraine did not deteriorate any further. It also does not appear to be the case that the sanctions between the West and Russia are intensifying, and consequently we do not expect to see any considerable escalation of the crisis. The political tensions have probably peaked and the stock exchange in Moscow is gradually becoming accustomed to the situation: the crisis is no longer such a hot topic for investors despite the high profile in the political sphere. There are much greater worries about the poor economic performance in Russia (GDP 2014e: -0.3%), with the risks tending to be skewed to the upside in this respect thanks to the strong revenues from oil exports (fostered by the weaker rouble). The economic stagnation is being reflected more and more in the earnings growth estimates for the MICEX companies, which are currently projected at a lean 8% (2014e) and 1% (2015f). The only supportive factor is the valuation of the MICEX, which – despite the massive increases in prices – continues to be extremely attractive, with a P/E ratio of 5.5. All in all, we only expect to see a mildly positive performance in the next three months. **Hold**.

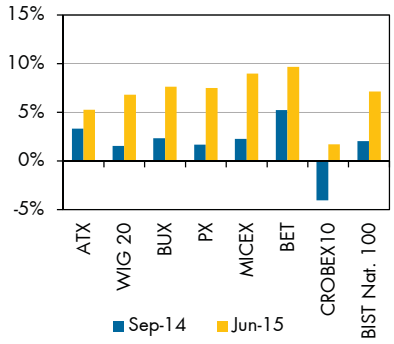
Value matrix stock markets

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

1 (4) denotes highly positive (negative) influence on the market. All factors are weighted equally. Assessment refers to a 3-month period.
Source: Raiffeisen RESEARCH

The **Polish** stock market index **WIG 20** has only registered a mild gain of just about 2.5% since the beginning of the year, but has been able to recoup the decline in prices triggered by the Ukraine crisis. Economic conditions continue to improve, even though this has not yet been reflected in the stock market. The projected aggregate earnings expectations for 2014 continue to look very small, at +1.5%. In terms of valuation, the WIG 20 is already higher than the levels of many Western indices (projected P/E ratio for 2014: 14.2). Furthermore, one must keep in mind the impacts of the pension reform: by the end of July, Poles must actively declare whether they want to continue paying into private pension funds. As of 13 June, only 1.5% of the previous participants of the overall 16.697 mn (status: end-May 2014) had opted to do so. Consequently, there appears to be a high probability of a disappointing result and thus significantly weaker inflows into private pension funds. If less than 10% of participants elect to stay in, the private pension funds may turn into net sellers of Polish stocks. **Hold**.

Expected index performance



Source: Raiffeisen RESEARCH

The **Czech** leading index **PX** has recorded a gain of 4.4% since the beginning of the year. The recently good fundamental data have been especially supportive, with GDP expanding by 2.5% in Q1, the strongest increase in the last three years. Corporate earnings should continue to be fostered by the weak koruna, which is supported by the government and favourable interest rate conditions. Negative headlines were recently seen on the mining company NWR, which presented a plan for debt restructuring, including a haircut. Nevertheless, creditors

Indices in performance comparison

	2005	2006	2007	2008	2009	2010	2011	2012	2013	20-Jun-14[1]
ATX	50.8%	21.7%	1.1%	-61.2%	42.5%	16.4%	-34.9%	26.9%	6.1%	0.7%
BUX	41.0%	19.5%	5.6%	-53.3%	73.4%	0.5%	-20.4%	7.1%	2.2%	2.1%
WIG 20	35.4%	23.7%	5.2%	-48.2%	33.5%	14.9%	-21.9%	20.4%	-7.0%	2.5%
PX	42.7%	7.9%	14.2%	-52.7%	30.2%	9.6%	-25.6%	14.0%	-4.8%	4.4%
MICEX	84.3%	67.5%	11.5%	-67.2%	121.1%	23.2%	-16.9%	5.2%	2.0%	-1.2%
BET	50.9%	22.2%	22.1%	-70.5%	61.7%	12.3%	-17.7%	18.7%	26.1%	3.9%
CROBEX	26.4%	62.2%	63.2%	-67.1%	16.4%	5.3%	-17.6%	0.0%	3.1%	1.3%
BIST Nat. 100	59.3%	-1.7%	42.0%	-51.6%	96.6%	24.9%	-22.3%	52.6%	-13.3%	15.6%
CECE Composite Index	44.7%	14.7%	10.5%	-53.7%	40.5%	15.7%	-29.1%	25.7%	-9.6%	2.0%
DAX	27.1%	22.0%	22.3%	-40.4%	23.8%	16.1%	-14.7%	29.1%	25.5%	4.6%
Euro Stoxx 50	21.3%	15.1%	6.8%	-44.4%	21.1%	-5.8%	-17.1%	13.8%	17.9%	6.2%
S&P 500	3.0%	13.6%	3.5%	-38.5%	23.5%	12.8%	0.0%	13.4%	29.6%	6.2%
MSCI World	13.7%	13.5%	2.8%	-40.1%	22.8%	7.8%	-7.6%	13.1%	26.3%	4.9%

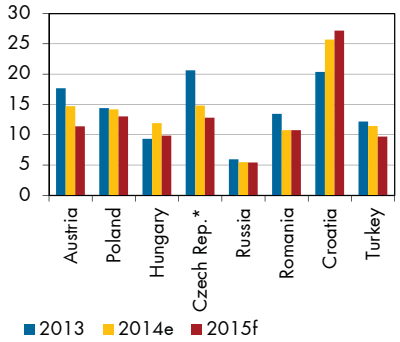
In local currency
[1] 11:59 p.m. (CET)
Source: Bloomberg, Thomson Reuters, Raiffeisen RESEARCH

Stock market indicators

	Long-term growth	Earnings growth			Price/earnings ratio			Dividend yield
		13	14e	15f	13	14e	15f	14e
ATX	5.3%	-5.8%	20.7%	28.5%	17.7	14.7	11.4	3.0%
WIG 20	3.2%	-24.9%	1.5%	8.7%	14.4	14.2	13.0	4.3%
BUX	3.7%	-2.2%	-21.8%	20.9%	9.3	11.9	9.9	3.1%
PX[1]	6.9%	-8.0%	39.1%	15.6%	20.6	14.8	12.8	4.1%
MICEX	3.9%	-8.5%	8.2%	0.9%	5.9	5.5	5.4	4.7%
BET	6.7%	14.8%	25.2%	-0.1%	13.5	10.8	10.8	5.1%
CROBEX10	2.9%	7.9%	-20.7%	-5.5%	20.4	25.7	27.2	2.8%
BIST Nat. 100	7.5%	-7.2%	6.4%	18.5%	12.2	11.5	9.7	2.2%

[1] Czech Rep. (PX): excl. Tatry Mountain Resorts, Orco Property Group and Stock Spirits Group
Source: Thomson Reuters, IBES, Bloomberg, Raiffeisen RESEARCH

P/E ratios in comparison

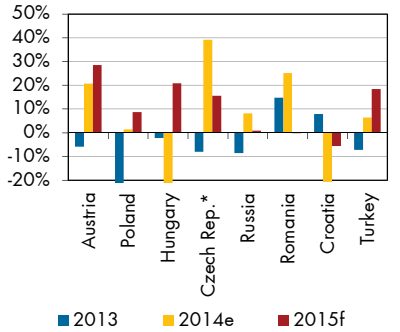


** Czech Rep. (PX): excl. Tatry Mountain Resorts, Orco Property Group and Stock Spirits Group*
Source: Thomson Reuters, IBES, Bloomberg, Raiffeisen RESEARCH

will have to approve this plan, otherwise there is a risk of insolvency. In line with this, S&P cut the rating to CC with a negative outlook. All in all, we continue to expect a positive, but moderate performance from the Czech stock market. **Hold**.

The **Hungarian** stock market index **BUX** was able to recover from some temporary weakness and is just barely back in positive territory since the beginning of the year. Macro-economic conditions continued to improve last quarter, prompting us to once again revise up our forecast for economic growth in 2014 to 2.7%. At the same time, this has had little effect on the development of anticipated earnings for the companies in the index, which was revised lower from -11% to almost -22%. As a result, the anticipated aggregate P/E ratio for 2014 amounts to 11.9, and we would no longer view this as being relatively attractive, but rather as merely moderate. As expected, Viktor Orban emerged as the clear winner from the parliamentary elections held in April, and consequently political uncertainty remains an issue. Despite the improvement in local conditions, we only expect subdued positive performance. **Hold**.

Earnings growth



** Czech Rep. (PX): excl. Tatry Mountain Resorts, Orco Property Group and Stock Spirits Group*
Source: Thomson Reuters, IBES, Bloomberg, Raiffeisen RESEARCH

The **Turkish** leading index **BIST National 100** posted a gain of 20% for the last three months, and thus turned around its performance since the beginning of the year into positive territory (+16%). After the local elections in March, political sentiment initially improved, before reaching another negative high point with protests marking the Gezi anniversary. Political risk will probably remain high, in relation to the presidential elections on 10 August and the increasingly difficult situation in Iraq. Iraq is a key trading partner of Turkey and higher oil prices from the geopolitical tensions also hit Turkey particularly hard, due to its chronically high current account deficit. In any case, we expect to see economic growth of +3.5% in 2014 (after +4.1% in 2013) despite the massive interest rate hike early in the year. Consequently, we see good support for the earnings growth estimate of 6.4% (2014e) for the companies in the BIST index. Furthermore, a slowdown in lending growth and a possible increase in non-performing loans could have a negative impact on the financial sector, which is strongly weighted in the BIST (39%). All in all, we thus take a cautious stance on the coming quarter. **Hold.**

Emerging hopes of some easing of tensions in the Ukraine conflict also triggered rising share prices on the **Romanian stock market.** Consequently, the leading index BET has posted a gain of around 10% since the referendum on the status

Index estimates

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15	Recommendation
ATX	2,565	2,650	2,750	2,770	2,700	**BUY**
Performance		3.3%	7.2%	8.0%	5.3%	
Range		2,400-2,750	2,500-2,850	2,500-2,850	2,500-2,850	
WIG 20	2,462	2,500	2,600	2,680	2,630	**HOLD**
Performance		1.5%	5.6%	8.8%	6.8%	
Range		2250-2700	2,400-2,800	2,450-2,900	2,400-2,900	
BUX	18,953	19,400	20,500	20,600	20,400	**HOLD**
Performance		2.4%	8.2%	8.7%	7.6%	
Range		17,300-20,700	18,000-22,000	18,000-22,500	18,000-22,500	
PX	1,033	1,050	1,100	1,130	1,110	**HOLD**
Performance		1.7%	6.5%	9.4%	7.5%	
Range		900-1,150	950-1,200	1,000-1,250	980-1,250	

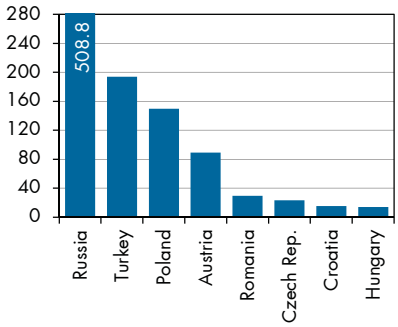
In local currency
[1] 11:59 p.m. (CET)
Source: Thomson Reuters, Raiffeisen RESEARCH

of Crimea (16 March 2014). Since beginning of year, the index has managed an increase of 3.9%. Amongst other things, the ongoing improvement in economic conditions was responsible for this. For example, GDP expanded at a rate of 3.8% in Q1 2014, driven by domestic consumption. This prompted us to revise our full-year GDP forecast up from 2.3% to 3.5% as well. Certain companies stand to benefit from the steadily good fundamental data and the record-low interest rate (3.5%), in addition to the latest tax breaks which were recently announced, and this should also have a positive impact on the Romanian stock exchange index going forward. From June 2014 to December 2016, earnings which are reinvested in the production and/or purchase of technical equipment, machinery and tools will be exempted from tax. The main beneficiaries should be companies from the energy sector, such as Romgaz, Nuclearelectrica and Transelectrica. Above and beyond this, the announced new issues by Electrica and CE Oltenia should ensure additional liquidity on the stock market. With a dividend yield of 5.1% (2014e aggregate for the BET) and a P/E ratio of 10.8 (2014e), Romanian stocks continue to look like an interesting investment opportunity. **Buy**.

Since beginning of year, the **Croatian CROBEX10** index has kept up the pace with its Eastern European peers and managed to book an increase of around 3.9%. In light of the dismal economic conditions, this is somewhat surprising. The EDP (Excessive Deficit Procedure) applied by the European Union since the beginning of the year forces the Croatian government to keep cutting back into order to curb its public debt. Measures include the government's announcement that it will increase network charges for telecom operators. Index heavyweight Hrvatski Telekom projects that this will result in additional costs of up to EUR 18 mn annually. GDP has now been contracting for 10 consecutive quarters and this has also prompted us to lower our forecast for full-year 2014 (GDP 2014e: -0.8%, compared the previous figure of 0%). In light of the situation, we expect a negative development of corporate earnings for the CROBEX10 companies (2014e: -20.7%) and thus a potential increase in the valuation for this already quite expensive looking market (2014e P/E ratio: 25.7). **Sell**.

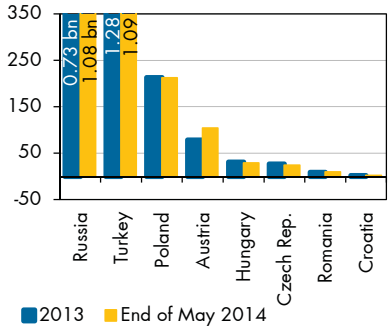
Financial analysts: Aaron Alber, Andreas Schiller, Christioph Vahs

Market capitalisation overview



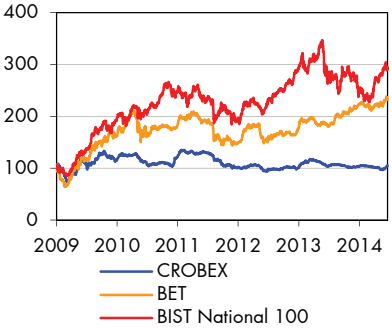
In EUR bn; end of May 2014
Source: FESE, WFE, BSE, ZSE, Raiffeisen RESEARCH

Avg. daily turnover (EUR mn)



Source: FESE, WFE, BSE, ZSE, Raiffeisen RESEARCH

SEE indices in comparison



Source: Bloomberg, Raiffeisen RESEARCH

Index estimates

	20-Jun[1]	Sep-14	Dec-14	Mar-15	Jun-15	Recommendation
MICEX	1,486	1,520	1,580	1,630	1,620	**HOLD**
Performance		2.3%	6.3%	9.7%	9.0%	
Range		1,300-1,650	1,350-1,700	1,450-1,800	1,400-1,800	
BET	6,748	7,100	7,450	7,550	7,400	**BUY**
Performance		5.2%	10.4%	11.9%	9.7%	
Range		6,000-7,500	6,500-8,000	7,000-8,200	6,800-8,200	
CROBEX10	1,042	1,000	1,050	1,080	1,060	**SELL**
Performance		-4.0%	0.8%	3.6%	1.7%	
Range		900-1,100	950-1,150	1,000-1,180	980-1,180	
BIST Nat. 100	78,401	80,000	83,000	86,000	84,000	**HOLD**
Performance		2.0%	5.9%	9.7%	7.1%	
Range		70,000-88,000	73,000-90,000	80,000-95,000	78,000-95,000	

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

Major resistances still in place

ATX

ATX Index, 01:10 p.m., 20 June 2014 CET
5y high: 3,000; 5y low: 1,652
Source: Bloomberg

ATX

Last 2,564
Position: long
Target 2,710

Close to the rising support line the last decrease reversed and a W-pattern has been established as it gets depicted by the arrows. Accordingly, an increase seems to be likely, but for now, it has not crossed the downward resistance at 2,600, therefore, a setback might follow before a breakout would succeed, stop at 2,400.

BIST 100

XU100 Index, 00:40 p.m., 20 June 2014 CET
5y high: 93,178; 5y low: 34,909
Source: Bloomberg

BIST 100

Last 78,690
Position: neutral

The bullish Wedge pattern that was established in the second half of 2013 has led to a rally which is currently hitting resistance. Thus, a bearish Engulfing was completed and the RSI on the lower plot looks strongly extended to the upside. As a consequence, a pullback to 73,240 is not to rule out; instead the buy signal would get triggered at 82,400 -> 87,900 – 92,600.

BUX

BUX Index, 00:20 p.m., 20 June 2014 CET
5y high: 25,322; 5y low: 14,325
Source: Bloomberg

BUX

Last 19,074
Position: neutral

Since the beginning of 2012 the index is bounded within a long-term sideways pattern; hence it fluctuates close to the Moving Average. Consequently, the market is considered to revert back to its mean whenever it departs from it. However, with regard to the last monthly candles we recognize a sharp rally from the low at 15,980 which would indicate an upside breakout to follow, but the strong resistances i.e. the downtrend line and the pattern's upper boundary have not breached. Therefore, a reliable bullish confirmation is missing. Buy 20,200 -> 21,830 or sell 15,600 -> 13,660.

CROBEX 10

Last 1,028
Position: long
Target 1,050 – 1,065

The strong rally since May points to a reversal of the long-term downtrend, but the important resistance at 1,030 has not breached. In addition, the index looks overbought, thus a bounce back close to the resistance is expectable and the stop should be trailed to 980.00.

CROBEX

CRO10 Index, 00:50 p.m., 20.06.2014 CET
5y high: 1,282; 5y low: 879.42
Source: Bloomberg

MICEX

Last 1,491
Position: long
Target 1,593

For the time being, it struggles to cross the downtrend resistances which might result in a pullback to 1,450 or to 1,430. Nonetheless, from a long-term point of view chances for a breakout to succeed are rather strong, thus bullishness would be confirmed at 1,515 -> 1,593.

MICEX

INDEXCF Index, 01:27 p.m., 20 June 2014 CET
5y high: 1,859; 5y low: 871.33
Source: Bloomberg

WIG 20

Last 2,461
Position: long
Target 2,840

The index is coiling within a long-term triangular pattern; hence, it shoud be rated neutral. However, the Bollinger Bands' squeeze resembles a contraction of volatility which often precedes strong breakouts. Therefore, a test of the resistance area between 2,550, respectively, 2,630 seems to be likely.

WIG 20

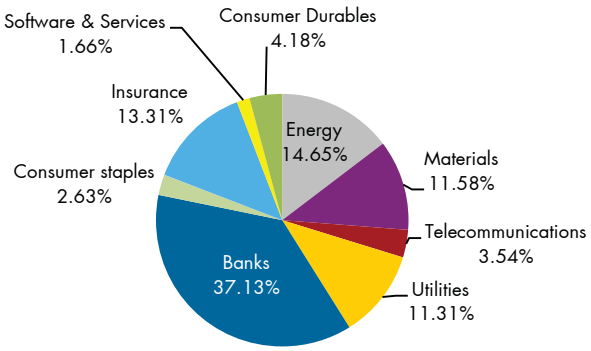
WIG20 Index, 01:10 p.m., 20 June 2014 CET
5y high: 2,932; 5y low: 1,790
Source: Bloomberg

Financial analyst: Stefan Memmer

Sector weightings in comparison

Sector weightings Poland, WIG 20

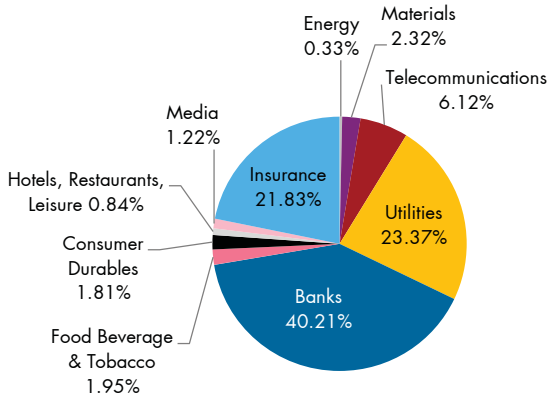
Dom. market cap.: EUR 149.9 bn (Source: FESE; 31-May-14)



Source: Thomson Reuters, Raiffeisen RESEARCH

Sector weightings Czech Republic, PX[1]

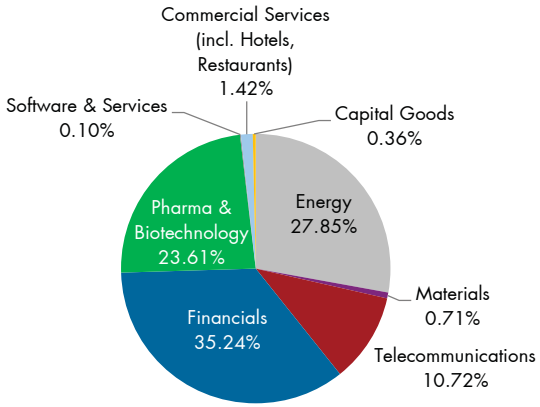
Dom. market cap.: EUR 23.4 bn (Source: FESE; 31-May-14)



[1] excl. Tatry mountain resorts
Source: Thomson Reuters, Raiffeisen RESEARCH

Sector weightings Hungary, BUX

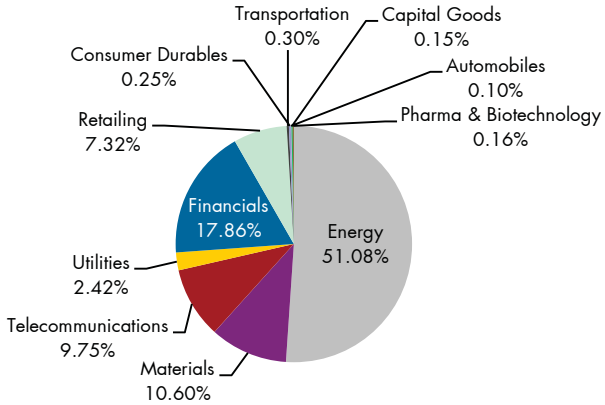
Dom. market cap.: EUR 14.3 bn (Source: FESE; 31-May-14)



Source: Thomson Reuters, Raiffeisen RESEARCH

Sector weightings Russia, MICEX

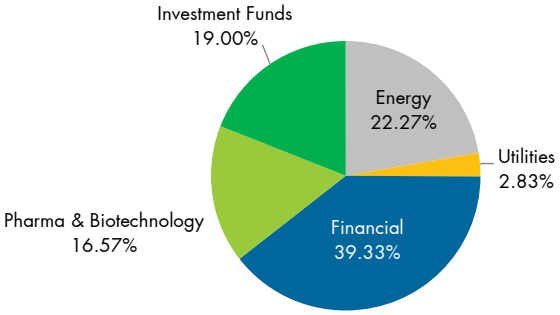
Dom. market cap.: : EUR 508.8 bn (Source: WFE; 31-May-14)



Source: Thomson Reuters, Raiffeisen RESEARCH

Sector weightings Romania, BET

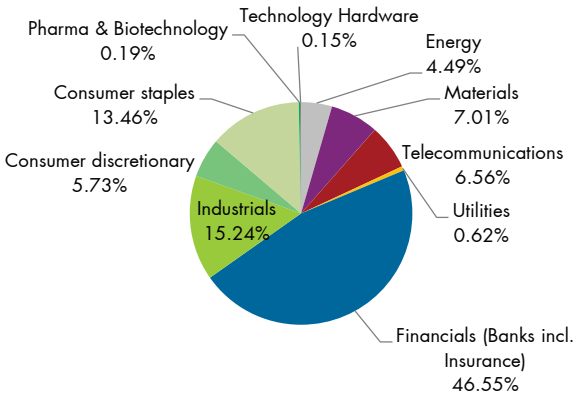
Dom. market cap.: EUR 29.7 bn (Source: BSE; 31-May-14)



Source: Bloomberg, Raiffeisen RESEARCH

Sector weightings Turkey, ISE 100

Dom. market cap.: EUR 193.9 bn (Source: FESE; 31-May-14)



Source: Thomson Reuters, Raiffeisen RESEARCH

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

Financials: Looking at performance laggards

- **Main sector risks: FX mortgage saga in HU, ECB stress-tests, PL rate outlook and SKOKs**
- **The market might be driven by sentiment (recovery) in Russia and GDP growth in CEE**
- **Our short-term picks: BZW (recent weakness), BRD (turnaround) and Komercni (dividend)**

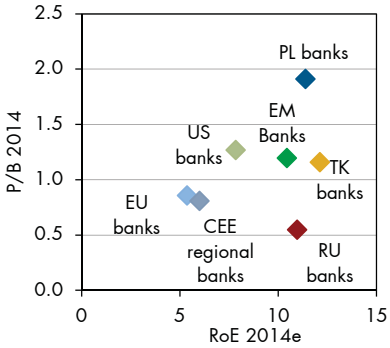
Polish banks: Our view has become a bit more bullish as a result of a combination of an underperformance, lower RFRs and sound aggregate mid-term earnings of +12% CAGR until 2016e. For some names the recent weakness might be utilised as a good entry point (BZW, ALR). As we do not believe in GNB's ambitious financial target for 2015/16, its slightly rich multiples would not speak in favour of advising clients to buy despite a bad run in May. After BHW has reached premium levels following the May/June rally we do not see further upside justified. The only underweight remains MBK due to elevated multiples for 2015e. After conducting EPS cuts, we think that PKO now looks only a notch more attractive vs. PEO, with its ~10% P/E ratio discount to peers. We do not believe in a rapid sell-off in banks from pension funds and assume that shares will be gradually passed on to investment funds. The low interest rate environment is more a sentiment issue, while the pending solution for the undercapitalised SKOKs (credit unions) remains a moderate risk for the sector. The recent bond rally might help some names in Q2 (BHW, MBK).

Erste/OTP/Komercni: Tailwind from Hungary's macro situation and the strong capitalisation of OTP should back an ongoing re-rating towards its tangible BPS 2014e of HUF 5,100. After the Supreme Court ruling has left room for manoeuvre open for the government's decision on FX mortgages, we prefer staying at the sidelines. For the same reason and ahead of the ECB stress test, we tend to be more cautious on Erste. We have reduced our 2014/15e estimates for KB on the cautious guidance, although lower yields and the flagged capital optimisation (special dividend speculation in the mid-term) offer a buying opportunity, in our view.

Romanian banks: We keep our BUY rating for BRD and expect that the bank has just entered an ROE expansion cycle, driven by a drop in CoR. After the recent rally of TLV, spurred probably by MSCI index changes, we downgrade the stock to SELL due to the moderate mid-term EPS growth potential.

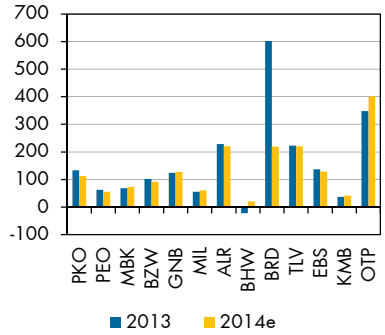
Financial analysts: Jovan Sikimic, Stefan Maxian

P/B - RoE regression



Source: Bloomberg

Cost of Risk (in bp)



Source: Bloomberg

Sector comparison*

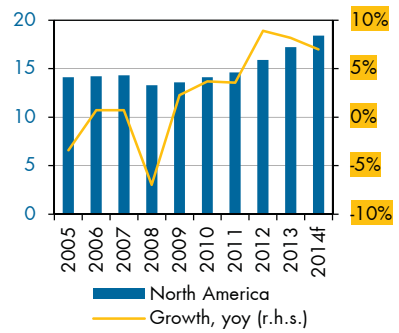
Company	Recommendation	Target price	P/E		P/BV		DY	
			2014e	2015f	2014e	2015f	2014e	2015f
Erste Group	Hold	28.00	15.4	11.7	0.9	0.9	1.6%	2.6%
Komercni Banka	Buy	5,250	14.8	14.0	1.8	1.7	4.8%	5.3%
OTP	Hold	4,900	10.8	7.9	0.8	0.8	3.9%	4.4%
PKO BP	Buy	47.10	14.7	12.4	1.8	1.6	2.4%	2.8%
BZ WBK	Buy	464.00	16.2	14.5	2.3	2.1	3.1%	3.4%
Getin Noble Bank	Hold	3.30	17.7	14.9	1.6	1.4	0.0%	1.9%
Bank Pekao SA	Hold	206.00	16.5	14.7	2.0	1.9	5.2%	5.8%
mBank	Reduce	466.00	16.7	15.5	2.0	1.9	3.6%	3.9%
Bank Millennium	Hold	9.27	15.0	13.4	1.7	1.6	3.3%	3.7%
Alior Bank	Buy	111.00	17.2	12.8	2.3	2.0	0.0%	0.0%
Bank Handlowy	Hold	128.00	17.1	14.9	2.1	2.0	5.0%	5.7%
BRD-GSG	Buy	10.40	13.6	8.4	1.1	1.0	2.3%	4.8%
Banca Transilvania	Sell	1.48	12.0	10.7	1.3	1.2	0.0%	2.3%
RBI**	NC	NC	16.1	8.2	0.7	0.7	3.6%	4.4%
Komercijalna	UR	UR	8.2	7.6	0.5	0.4	0.2%	0.3%
Aik Banka	UR	UR	5.3	4.6	0.3	0.3	0.0%	0.0%

UR = under revision, NC = not covered
** recommendation and target price refer to a 12 month horizon; ** consensus estimates*
Source: Raiffeisen Centrobank estimates

Oil & Gas: Oil price stability to be challenged in the longer term

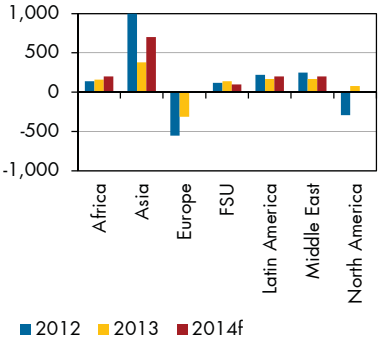
- **Increasing production in the USA to keep oil price stable in the medium term**
- **Rising production costs to drive oil price in the longer term**
- **We favour LUKoil in the CIS and OMV/OMV Petrom in CEE**

Crude oil production, mn boepd



Source: Global 2014 E&P Spending Outlook by Barclays

World Total Oil Demand growth*



**kboepd (1,000 barrels of oil equivalent per day)*
Source: IEA Oil Market Report May 2014

The Brent oil price has never been so stable as currently since the end of the last decade. Once it recovered from the post-financial crisis lows, the Brent price has been hovering around USD 100-110 per barrel, remaining stable in spite of (i) global oil demand surpassing a level of 90 mn boepd in 2012, (ii) gradually increasing oil finding, development and lifting costs, and (iii) depreciation of the US dollar. To a certain extent, the behaviour of the oil price over the last three years could be explained by the shale oil and gas revolution in the USA, as a result of which total crude production in the USA rose by 48% over 2007-13. With the USA expected to further expand its hydrocarbon production in the medium term, we believe that the oil price growth could be capped unless US authorities decide to relax the long-standing ban on exporting crude oil. Although the White House is facing mounting pressure to look into a possible relaxation of the export ban, we believe that the availability of low-end refineries could represent a temporary solution for US oil producers. Those refineries, known as condensate splitters, turn super-light oil called condensate into products such as naphtha, which is used as a petrochemical feedstock. Thus, conversion of unexportable condensate into readily exportable products could ease the impact of the export ban. According to the Financial Times, about 445 kboepd of processing capacity is planned or under construction in new splitters in the Gulf of Mexico region, which is an increase of cc. 5% in the area's refining capacity. The underinvestment of international oil companies (please see our previous CEE Strategy report) could also be supportive for the oil price in the longer term. In conclusion, we believe that the mix of the above-mentioned factors could keep the oil price stable for another few years. Longer-term, however, there are plenty of reasons to believe that the oil price should go up.

We continue to favour upstream players. We believe that OMV and OMV Petrom stand to benefit from an improved production profile and stable output, while LUKoil is attractive due to share buybacks and increasing output.

Financial analyst: Oleg Galbur

Sector comparison*

Company	Recommendation	Target price	P/E		EV/EBITDA		P/CE	
			2014e	2015f	2014e	2015f	2014e	2015f
OMV	Buy	EUR 37.00	11.4	10.4	4.2	3.9	2.9	2.7
OMV Petrom	UR	UR	5.0	5.7	2.8	2.8	3.0	3.1
MOL	Hold	HUF 13,600	9.7	7.5	6.0	5.2	2.9	2.4
PKN	Reduce	PLN 42.50	13.0	10.0	5.8	5.2	4.8	4.6
Lotos	Hold	PLN 41.50	8.6	8.0	6.1	5.7	4.0	2.6
Gazprom	Hold	RUB 142	3.0	3.3	2.0	1.9	1.9	2.1
Novatek	Buy	RUB 499	12.6	12.1	7.3	6.6	9.6	10.7
LUKoil	Buy	RUB 2,499	5.3	6.7	3.1	3.5	3.0	3.5
Rosneft	Hold	UR	9.3	6.3	5.3	3.9	4.8	3.8
Tatneft	Buy	RUB 237	5.6	6.5	3.8	4.0	4.5	5.0

UR = under revision
** recommendation and target price refer to a 12 month horizon*
Source: Raiffeisen Centrobank estimates

Utilities: Falling interest rate curve props up performance

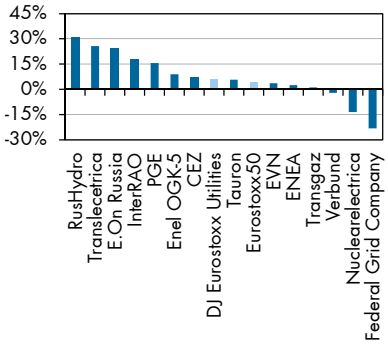
- **Fundamental picture still unchanged; high valuation levels**
- **Russia is catching up**
- **BUY recommendations: Transelectrica, Transgaz, E.ON Russia, Enel OGK-5 and Inter RAO**

Utilities were able to hold up well compared to the overall market development in Q2 and European companies even outperformed the market a bit in the recent past. Russian utilities staged a strong recovery across the board after having been dragged down by a market slump caused by political factors. As regards Polish utilities, PGE and Energa outperformed the rest – the former because of more positive earnings expectations and the latter on account of the inclusion into the MSCI Poland Index. On the political front, there was not much news due to the elections to the EU Parliament: the most important reform areas – the CO_2 market, energy efficiency laws and energy market reform – are still not being taken care of, and it increasingly seems that decisions in this regard will unlikely be taken before Q1 2015. Only Poland was a notable exception in that first steps towards capacity markets had positive effects on electricity prices. We expect a quiet summer on the commodity front (power price drivers: hard coal and CO_2). The reporting season in Central Europe was generally characterised by lower results due to declining prices and weak demand (weather-related), but not all was bad: EVN's measures to compensate for the shortfall in demand worked better than expected, and Tauron required fewer renewable electricity certificates. Still, its EBIT decline just fell short of the 20% mark. The Central European companies' outlooks were unchanged. However, Romanian utilities reported surprisingly positive Q1 results as they managed to cut cost beyond expectations.

We stick to our view that the fundamental picture should not change dramatically, not least because the political decision-making process is still anything but dynamic. The valuation levels of utilities have continued to increase, driven by the declining interest rate curve and persistent downward revisions of earnings expectations. We have BUY recommendations on Transelectrica, Transgaz and the Russian utilities E.ON Russia, Enel OGK-5 and Inter RAO.

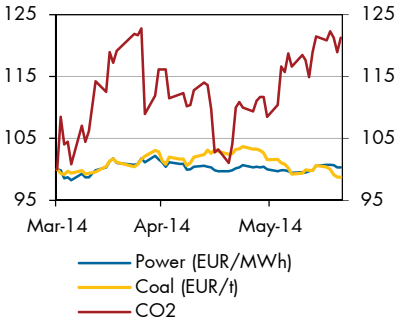
Financial analyst: Teresa Schinwald

Strong rebound in Russian utilities



Source: Bloomberg

CO_2 still volatile at low levels



Source: Bloomberg

Sector comparison*

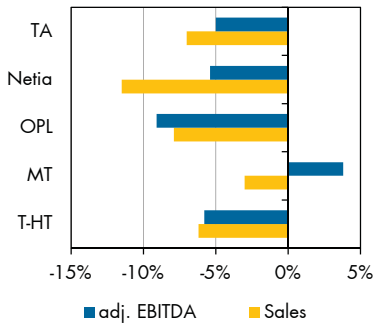
Company	Recommendation	Target price	P/E		EV/EBITDA		DY	
			2014e	2015f	2014e	2015f	2014e	2015f
CEZ	Buy	CZK 670	11.4	12.4	6.2	6.4	6.5%	6.4%
Enea	Hold	PLN 15.30	10.6	11.7	5.3	6.0	2.8%	2.6%
Enel OGK-5	Buy	RUB 1.34	5.0	4.7	3.1	2.9	8.0%	8.4%
E.On Russia	Buy	RUB 3.11	14.2	7.8	7.1	4.3	5.6%	7.7%
EVN	Hold	EUR 11.70	10.6	11.6	3.7	3.4	4.0%	4.0%
Federal Grid Company	Hold	RUB 0.07	2.8	3.2	3.3	3.5	0.6%	0.0%
InterRAO	Buy	RUB 0.014	9.9	5.0	2.5	1.9	2.5%	5.0%
PGE	Hold	UR	12.4	13.2	5.4	5.7	4.0%	3.8%
RusHydro	Hold	RUB 0.62	8.8	6.5	5.0	4.3	2.8%	3.9%
Tauron	Hold	PLN 5.30	10.9	11.0	5.5	5.8	2.6%	3.0%
Transelectrica	Buy	RON 20.50	8.1	8.5	3.9	4.0	10.2%	8.0%
Transgaz	Buy	RON 229	5.3	5.4	2.9	3.2	9.0%	9.6%
Verbund	Hold	EUR 15.20	25.7	19.8	10.0	8.9	2.1%	2.6%

*UR = under revision; * recommendation and target price refer to a 12 month horizon*
Source: Raiffeisen Centrobank estimates

Telecom: A wave of ownership changes

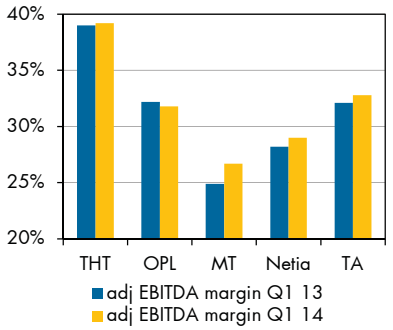
- **Ownership changes are rampant in CEE**
- **The Polish 4G frequency auction saga continues**
- **CEE market to shrink further in H2 14**

Sales and EBITDA growth yoy Q1 14



Source: Companies, Raiffeisen Centrobank

EBITDA margin comparison



Source: Companies, Raiffeisen Centrobank estimates

In contrast to some Western European markets which are showing first signs of bottoming out, we expect the CEE telecommunications market to shrink further in H2 14, delaying a potential re-rating of CEE telecom players until there is more clarity on potential market stabilisation in the mid-term. The Austrian market stands aside, with signs of market repair and pricing picking up from the trough of 2013. Ownership changes are abundant in CEE, with Deutsche Telekom having completed the purchase of GTS, the Slovenian government in the process of selling its stake in Telekom Slovenije (with a number of bidders pursuing the opportunity, including Deutsche Telekom through T-HT) and PPF in the process of conducting a mandatory tender offer for the remaining stake in Telefonica CR. In Poland the investor base in Netia has recently undergone major changes (MCI has taken a stake of over 7% and entities associated with Mr. Jakubas ca. 15%) and we still see a potential upside from M&A fantasy. In Austria, America Movil has made an offer for shares in Telekom Austria valid until July 10.

Poland's price war seems to be going through a more quiet period as operators gear up for the delayed LTE auction that is mired in controversy after a number of consultation rounds. We expect intense competition between the Big Three (Orange Polska, T-Mobile and Cyfrowy Polsat's Polkomtel) and the market disruptor P4. Thus we see potential alliances as the key price drivers. We also expect a continuing sideways trend in Orange Polska shares until completion of the auction. In Hungary, the re-launched 4G tender is on-going with bids for packages of frequencies (800, 900, 1,800 and 2,600 MHz) having been submitted by June 16. In our view, Magyar Telekom's share price does not correspond to the fundamental value, benefitting from parent buy-out speculation which, in our view, is unlikely at this point. It is also uncertain whether energy distribution activities will be continued by Magyar Telekom given adverse regulatory changes. The Croatian market has been affected by local regulatory risk as well: in response to the government's threefold hike of the radiofrequency fee (increase by ca. EUR 18.2 mn) T-HT announced it will increase the prices for prepaid customers by 10%, while prices for post-paid clients will be increased by HRK 8 plus VAT per month effective from July 2014.

Financial analyst: Jakub Krawczyk

Sector comparison*

Company	Recommendation	Target price	P/E		EV/EBITDA		DY	
			2014e	2015f	2014e	2015f	2014e	2015f
Telekom Austria	Hold	EUR 7.20	25.3	18.8	6.5	5.9	0.7%	1.4%
Hrvatski Telekom	Hold	HRK 180.00	11.7	12.8	3.2	3.2	4.4%	4.0%
Magyar Telekom	Sell	HUF 270.00	26.5	26.5	4.5	4.3	0.0%	0.0%
Orange Polska	Hold	PLN 11.00	49.1	99.3	5.3	5.4	4.8%	4.8%
Netia	Buy	PLN 5.90	53.1	29.0	4.0	4.1	8.1%	8.1%
MTS	Hold	USD 18.10	14.3	13.3	5.1	5.2	6.4%	6.7%
VimpelCom Ltd	Hold	USD 10.00	14.5	13.2	4.5	4.3	0.4%	0.4%
MegaFon	Buy	RUB 31.00	11.4	11.3	5.4	5.3	5.7%	6.1%
Rostelecom	Buy	RUB 118.60	7.6	5.3	3.4	2.9	3.1%	4.3%

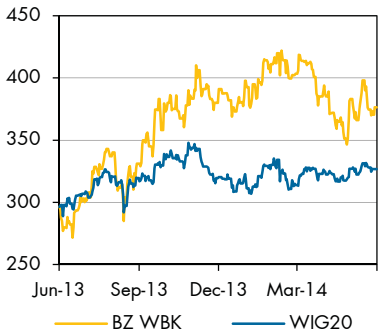
** recommendation and target price refer to a 12 month horizon*
Source: Raiffeisen Centrobank estimates

BZ WBK: Attractive value after recent weakness

- **Current share price: PLN 376.35[1]**
- **Target price: PLN 464**
- **Market capitalisation: EUR 8,464 mn**

Given the underperformance of late, we have recently upgraded the stock to BUY combined with an upward adjustment of DPS and a slight increase of the long-term RoE to 15.4%. As the mid-term outlook, in our view, remains quite healthy we would recommend seizing the YTD weakness of the stock. Our model takes into account the upcoming EPS accretive consolidation of a 60% stake of Santander's Polish retail arm SCB, including a 5.4 mn rights issue and subsequent share swap with Santander. BZ WBK trades at 16x 2014e P/E ratio or at a 3% discount to peers, while after including SCB the discount widens to 5% in 2015e, which we consider another reason for getting more upbeat on the stock. Admittedly, it is not all blue skies over Polish banks in the short term. However, BZW, in our view, looks less sensitive to key rate and pension fund risks than the sector average.

BZ WBK



5y high: PLN 422, 5y low: PLN 85.15
Source: Bloomberg

After the Q1 14 results release the CEO was vocal that adjusted for one-offs the profitability should go up by 3-5% yoy (RCBe adjusted 2014e: PLN 2.2 bn vs. PLN 1.85 bn in 2013). As regards lending growth, the focus remains on SMEs, cash loans and large corporates, while the share of mortgages should decrease going forward. Our slight growth in EPS forecasts stems from the inclusion of AVIVA and from lower CoR after a good performance in Q1 14, including a clearly positive wording from the management that the current guidance of 100 -110bp for FY 2014 can be revised down to 90-95bp. The NPL ratio decline of 40bp qoq to 7.5%, which may continue to decline towards 7.0%, supports this trend. The CEO expects a positive NIM trend, fitting our expected +7bp to 3.3%. On opex, there were no big changes apart from the Aviva impact and slightly hiked integration costs for the Kredyt Bank merger.

Apart from the upcoming SCB consolidation in Q2 14, the next event which could have an impact on EPS is the sale of the 50% stake in the BZ WBK Asset Management subsidiary to Santander.

Financial analyst: Jovan Sikimic

Income statement & balance sheet (IFRS)

in PLN mn	2013	2014e	2015f	2016f
Income statement				
Net interest income	3,276	3,505	3,797	4,043
Risk provisions	-730	-680	-671	-636
Net commission income	1,779	1,787	1,893	2,008
Net trading result	186	149	149	149
Pre-tax profit	2,515	2,708	3,037	3,373
Net profit after minorities	1,983	2,162	2,428	2,700
Balance sheet				
Loans and advances to customers	71,622	76,799	80,199	84,262
Amounts owed to customers	78,543	82,295	84,939	87,676
Shareholders' equity	13,872	15,032	16,379	17,865
Total assets	106,089	110,727	114,126	118,667

Source: BZ WBK, Raiffeisen Centrobank estimates

Key ratios

	2013	2014e	2015f	2016f
EPS adjusted	21.21	23.12	25.96	28.87
P/E	18.28	16.28	14.50	13.03
Book value per share	148.37	160.78	175.18	191.07
Price book ratio	2.61	2.34	2.15	1.97
Price tang. book value	2.71	2.42	2.22	2.03
Dividend per share	10.71	11.56	12.98	14.44
Dividend yield (%)	2.8%	3.1%	3.4%	3.8%
RoE adj.	13.6%	15.0%	15.5%	15.8%
Loans/deposits	91.2%	93.3%	94.4%	96.1%
Tier 1 ratio	12.3%	13.4%	14.2%	15.1%

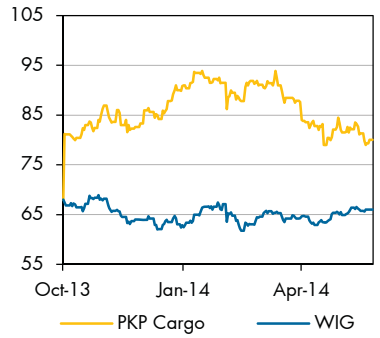
Source: BZ WBK, Raiffeisen Centrobank estimates

[1] *the indicated price is the last price as available at 6.30 a.m. (CET) on 23 June 2014*

PKP Cargo: Attractively valued FCF yield

- **Current share price: PLN 80.05[1]**
- **Target price: PLN 99**
- **Market capitalisation: EUR 862 mn**

PKP Cargo



5y high: PLN 93.89, 5y low: PLN 79
Source: Bloomberg

PKP Cargo is the leading and incumbent rail cargo company in Poland (with a market share amounting to approx. 50% based on tons of cargo transported and approx. 60% on rail freight turnover).

We maintain our view on PKP as one of the most attractively valued plays on the Polish macro economy (GDP is expected to increase by 3.3% yoy this year and 3.3% yoy next year) and predominantly the reviving construction cycle without bearing the risk construction companies have to undertake. We still see some restructuring potential in the company related to employment figures (although almost halved from the peak a few years ago), energy saving or organisational optimisation. We admit, however, that there is competitive pressure resulting in a likely tariff decline (offset by cost cuts, though). Also, weak coal consumption (resulting from the mild winter) and ongoing railway modernisation (and hence lower rolling stock turnover) could result in some short-term performance uncertainty. We nonetheless consider the company to be undervalued vs. also state-controlled utilities in terms of business links (coal), valuation (PKP Cargo trades at EV/EBITDA of 3.9x and 3.3x for 2014e and 2015e, respectively) and free cash flow generation.

PKP Cargo benefits from the fact that the government is responsible for railway infrastructure modernisation and hence is expected to generate a positive FCF yield hovering around 7% in 2014e-2016e vs. utilities burdened with high capex resulting in negative FCF in the years to come.

Financial analyst: Bartlomiej Kubicki

Income statement & balance sheet (IFRS)

in PLN mn	2013	2014e	2015f	2016f
Income Statement				
Consolidated sales	4,553.9	4,690.6	4,879.2	5,028.5
EBITDA	499.0	821.7	927.7	994.0
EBIT	110.2	405.9	495.4	545.0
EBT	88.5	405.5	498.9	551.7
Net profit b.m.	65.4	312.2	389.1	435.9
Net profit a.m.	74.0	307.2	384.0	430.7
Balance sheet				
Total assets	5,743.6	5,799.6	6,044.6	6,328.5
Shareholders' equity	3,446.5	3,616.2	3,844.1	4,080.2
Goodwill	2.7	2.7	2.7	2.7
NIBD	-331.4	-422.9	-521.4	-622.9

Source: PKP Cargo , Raiffeisen Centrobank estimates

Key ratios

	2013	2014e	2015f	2016f
EPS	1.65	6.86	8.57	9.62
P/E	52.0	11.7	9.3	8.3
Operating CF per share	15.63	17.82	18.90	20.23
Price cash flow	5.5	4.5	4.2	4.0
Book value per share	76.95	80.74	85.83	91.10
Price book value	1.1	1.0	0.9	0.9
Dividend yield	3.6%	4.4%	5.4%	6.1%
ROE	2.2%	8.7%	10.3%	10.9%
ROCE	2.4%	8.0%	9.5%	10.0%
EV/EBITDA	7.1	3.9	3.3	3.0

Source: PKP Cargo, Raiffeisen Centrobank estimates

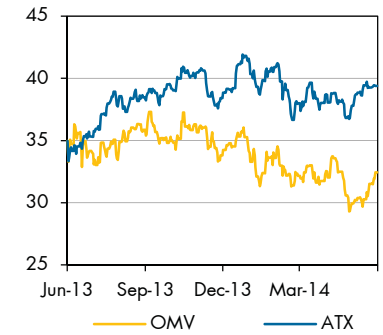
[1] *the indicated price is the last price as available at 6.30 a.m. (CET) on 23 June 2014*

OMV: Investing in future growth should not be punished

- **Current share price: EUR 32.44[1]**
- **Target price: EUR 37.00**
- **Market capitalisation: EUR 10,578 mn**

OMV's strategy goes against the strategies pursued by most of its peers, which are focused on short/medium-term cash generation and efficiency improvements. Refraining from any further expansion and turning into a generous cash cow would of course have been warmly welcomed by the market but, obviously, would only have a short-term effect, since a mature upstream portfolio and sharply falling reserves replacement ratios would have come into investor's focus. Therefore, we strongly believe that OMV's management is doing a good job in developing a sustainable source of earnings growth in its core business (i.e. upstream) as well as improving the performance of businesses which currently face challenging environments (i.e. refining, gas&power).

OMV



5y high: EUR 39.69, 5y low: EUR 21.24
Source: Bloomberg

We believe that the management's confidence in funding future capex needs from internally generated cash (after dividends) should somewhat ease the market's concerns regarding OMV's cash generation potential. Moreover, OMV still has a comfortable gearing, but also valuable non-core assets that could be disposed of if needed (i.e. Borealis's stake in Borouge). In nutshell, we believe that with its robust cash generation in Romania and strong growth potential in the upstream segment OMV could be an attractive investment for long-term investors. Therefore, we maintain our BUY recommendation for the stock.

We expect a stable upstream environment. Refining margins are expected moderately higher than last year, which together with the fully modernised Petrobrazi refinery and after the divestment of Bayernoil should lead to healthier earnings in H2. The gas market is expected to be severely burdened by depressed gas consumption. Therefore, successful renegotiation of the Gazprom gas supply contract and any progress on the approval and implementation of the South Stream gas pipeline should be supportive for OMV.

Financial analyst: Oleg Galbur

Income statement & balance sheet (IFRS)

in EUR mn	2013	2014e	2015f	2016f
Income Statement				
Consolidated sales	42,414	37,655	42,213	43,855
EBITDA	4,563	4,722	5,128	6,314
EBIT	2,602	2,369	2,622	3,686
EBT	2,291	2,118	2,368	3,442
Net profit b.m.	1,729	1,483	1,539	2,134
Net profit a.m.	1,162	927	1,018	1,603
Balance sheet				
Total assets	31,786	31,941	33,795	35,261
Shareholders' equity	11,614	12,133	12,760	13,955
Goodwill	1,086	1,086	1,086	1,086
NIBD	4,190	4,946	5,415	5,285

Source: OMV , Raiffeisen Centrobank estimates

Key ratios

	2013	2014e	2015f	2016f
EPS	3.56	2.84	3.12	4.91
P/E	9.8	11.4	10.4	6.6
Operating CF per share	12.60	11.34	12.09	14.54
Price cash flow	2.8	2.9	2.7	2.2
Book value per share	35.61	37.20	39.12	42.79
Price book value	1.0	0.9	0.8	0.8
Dividend yield	3.6%	3.7%	3.9%	4.5%
ROE	9.9%	7.8%	8.2%	12.0%
ROCE	10.1%	8.5%	8.3%	10.4%
EV/EBITDA	4.7	4.2	3.9	3.2

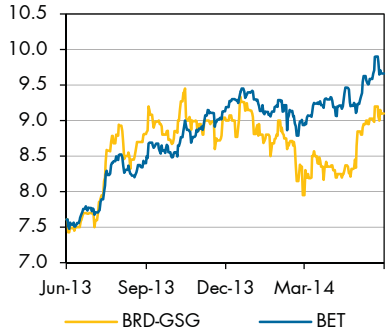
Source: OMV , Raiffeisen Centrobank estimates

[1] *the indicated price is the last price as available at 6.30 a.m. (CET) on 23 June 2014*

BRD-GSG: An upward trend in ROE fanned by macro tailwinds

- **Current share price: RON 9.10**[1]
- **Target price: RON 10.40**
- **Market capitalisation: EUR 1,443 mn**

BRD-GSG



5y high: RON 15.9, 5y low: RON 7.125
Source: Bloomberg

We reckon that BRD-GSG is just at the beginning of a ROE expansion cycle, after two painful years which have also shaken the confidence of investors in the prospects of the stock. The rebound in profitability should be mainly driven by the drop in CoR, as the coverage ratio has improved significantly over the past years and Romania's economic recovery strengthens. This should more than compensate for the short-term pressure on the top line. The improvement in ROE should also be supported, in our view, by resuming dividend payments. We have a 12m TP of RON 10.4 which would imply a 2015e P/BV of 1.13x, when we see the ROE well above COE. We confirmed our BUY call and consider BRD-GSG the best option on the local exchange to play the macro recovery story in Romania. We see the stock recovering some of the huge underperformance relative to Banca Transilvania.

Following the management guidance, we have recently lowered our 2014e net profit estimate by around 30% to RON 467 mn, on the back of an increase in CoR for the year, which would still mark a major turnaround. We see only a modest increase in NPLs and coverage ratio and a CoR of 220bp. We believe that NIM bottomed out in Q1 14, given lower reserves requirements and reduced rates paid for deposits, especially for EUR, but we have slightly downgraded our NIM estimate for the whole year and our implicit NII projection. The rationale is the weaker performance of its subsidiaries in 2013, which is revealed only once a year, combined with depressed NIM in Q1 14. Together with lower trading income yoy, the top line should shrink almost 6% yoy, which should drive the C/I ratio toward 52%. We expect top line growth to resume in 2015, which, together with a further decrease in CoR, should strengthen the bottom line in the coming years.

We expect BRD-GSG to resume dividend payments starting this year. First of all, the bank is well capitalised, with a capital adequacy ratio according to Basel III of 15.8% in Q1 14. Moreover, SocGen's targets for its Romanian operations envisage a ROE of 13% -14% by 2016e – figures which are difficult to achieve without dividend payments. We see a DY of 2% for 2014e and just below 5% for 2015e.

Income statement & balance sheet (IFRS)

in RON mn	2013	2014e	2015f	2016f
Income statement				
Net interest income	1,728	1,599	1,717	1,834
Risk provisions	-2,131	-770	-521	-483
Net commission income	768	789	825	860
Net trading result	387	326	312	314
Pre-tax profit	-640	560	905	1,052
Net profit after minorities	-558	467	756	878
Balance sheet				
Loans and advances to customers	34,422	35,669	37,879	40,656
Amounts owed to customers	36,065	36,087	38,367	40,988
Shareholders' equity	5,346	5,793	6,405	6,980
Total assets	47,991	46,751	48,195	51,021

Source: BRD-GSG, Raiffeisen Centrobank estimates

Key ratios

	2013	2014e	2015f	2016f
EPS adjusted	-0.80	0.67	1.09	1.26
P/E	-11.17	13.61	8.40	7.24
Book value per share	7.67	8.31	9.19	10.02
Price book ratio	1.17	1.10	0.99	0.91
Price tang. book value	1.17	1.11	1.00	0.92
Dividend per share	0.00	0.21	0.43	0.50
Dividend yield (%)	0.0%	2.3%	4.8%	5.5%
RoE adj.	-10.1%	8.4%	12.4%	13.1%
Loans/deposits	95.4%	98.8%	98.7%	99.2%
Tier 1 ratio	12.3%	13.1%	13.9%	14.2%

Source: BRD-GSG, Raiffeisen Centrobank estimates

[1] *the indicated price is the last price as available at 6.30 a.m. (CET) on 23 June 2014*

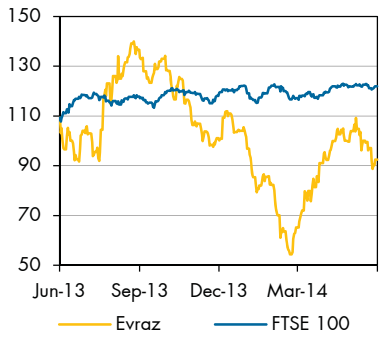
Financial analyst: Alexandru Combei

Evraz: A play on growing efficiency and margin improvement

- **Current share price: GBp 92.45[1]**
- **Target price: GBp 116**
- **Market capitalisation: EUR 1,745 mn**

Ahead of a seasonal revival in demand for construction steel, we reckon with temporary positive momentum in steel prices in autumn. We believe that Evraz's large exposure to the Russian construction sector should provide support to the company's share price. In addition, we anticipate that Evraz may deliver visible improvements in its operational performance in H1 14e (the company plans to report its H1 14e financials on August 27). Evraz's management sounded confident to achieve cost savings of USD 350-400 mn in FY 14e which should be a result of growing economies of scale at Evraz's steel making and mining assets. We believe that via optimisation of its operational assets Evraz should be able to reduce its G&A expenses by USD 50 mn in FY 14e.

Evraz



5y high: GBp 460.50, 5y low: GBp 54.4*
** since 07/11/2011 (listing of Evraz Common Shares)*
Source: Bloomberg

In the coming month Evraz should raise a syndicated loan. As soon as this is completed we anticipate that Evraz should be able to refinance its existing debt and replace it with longer maturities and lower interest rates. We also like the company's focus on cash generation and dedication to a reduction of the financial leverage. Taking into account that some of Evraz's assets (e.g. the rail mill at ZSMK) started to operate this year, we reckon that Evraz should be able to increase sales of high-margin steel products and this should have a positive effect on Evraz's operating margin already in H1 14e.

Since January Evraz's share price has dropped by 15% ytd and underperformed its global peers. In our view, the underperformance was driven by high geopolitical risks and pressure coming from the slowdown in China. Taking into account operational improvements, we believe that Evraz was overlooked by investors. Given the recent share price weakness, we reckon with a higher potential for an upswing of Evraz's share price at the end of the summer.

Financial analyst: Iryna Trygub-Kainz

Income statement & balance sheet (IFRS)

in USD mn	2013	2014e	2015f	2016f
Income Statement				
Consolidated sales	14,411	14,800	15,418	16,112
EBITDA	1,821	1,890	2,012	2,142
EBIT	19	710	821	963
EBT	-613	11	93	202
Net profit b.m.	-572	15	56	121
Net profit a.m.	-572	15	56	121
Balance sheet				
Total assets	17,704	17,642	17,528	17,609
Shareholders' equity	5,007	4,925	4,981	5,102
Goodwill	1,988	1,988	1,988	1,988
NIBD	6,279	6,235	6,076	5,922

Source: Evraz OGK-5, Raiffeisen Centrobank estimates

Key ratios

	2013	2014e	2015f	2016f
EPS	-0.39	0.01	0.04	0.08
P/E	-4.8	153.3	42.4	19.6
Operating CF per share	1.29	0.69	0.70	0.76
Price cash flow	1.4	2.3	2.2	2.1
Book value per share	3.40	3.27	3.31	3.39
Price book value	0.5	0.5	0.5	0.5
Dividend yield	3.3%	0.0%	0.0%	2.3%
ROE	-11.2%	0.3%	1.1%	2.4%
ROCE	0.6%	7.8%	3.9%	4.6%
EV/EBITDA	5.1	4.7	4.3	4.0

Source: Evraz OGK-5, Raiffeisen Centrobank estimates

[1] *the indicated price is the last price as available at 6.30 a.m. (CET) on 23 June 2014*

RBI Risk Indicator

Performance since 2009*

	Mean return. annualized	Max drawdown	Sharpe ratio**	Volatility
RBI Risk Indicator strategy	12.7%	-10.1%	1.136	11.3%
Benchmark***	7.8%	-17.5%	0.829	9.2%

Yearly performance*

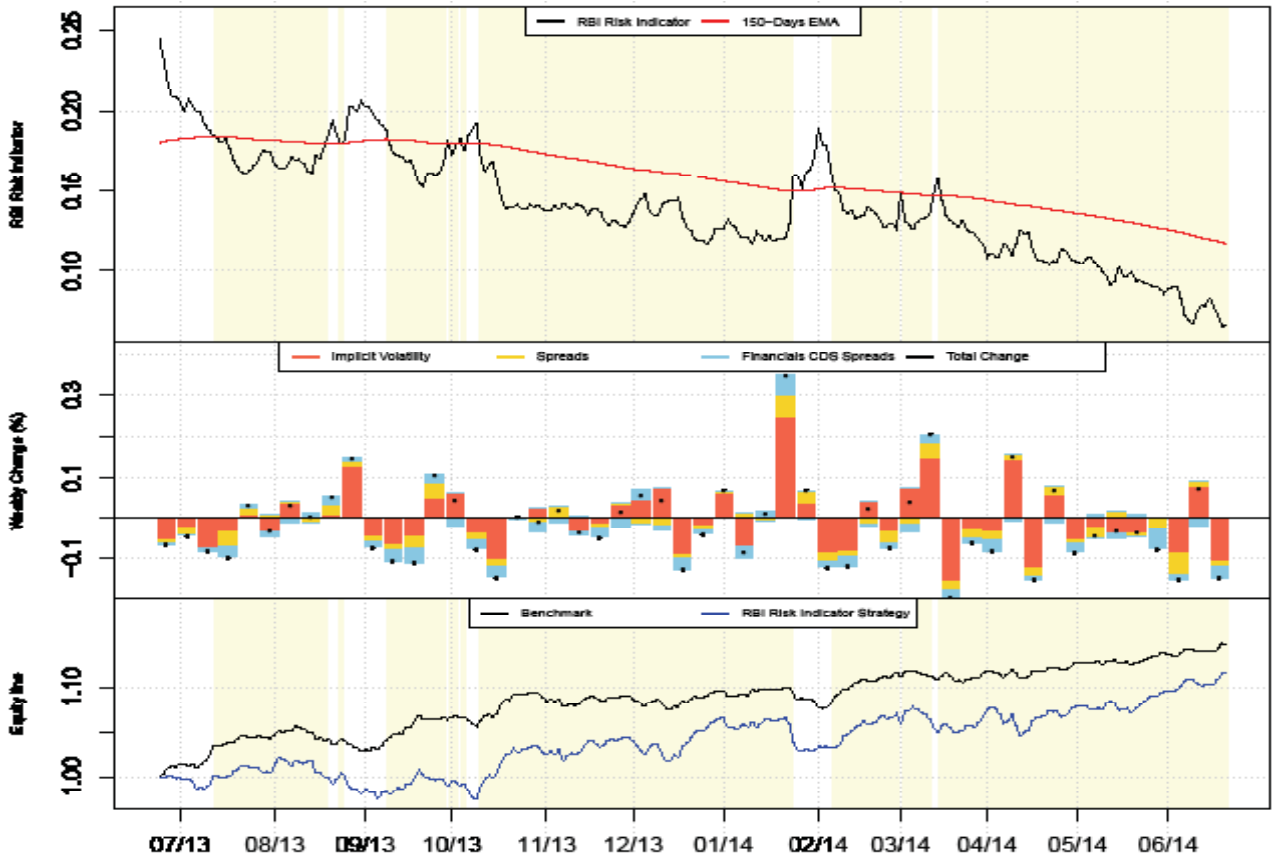
	2009	2010	2011	2012	2013	2014 ytd
RBI Risk Indicator strategy	27.3%	13.5%	-0.6%	13.9%	15.7%	4.8%
Benchmark***	14.6%	8.4%	0.0%	7.1%	9.0%	4.6%

** All performance measures based on signals generated using end of week closing prices and restructuring on the following Monday. **risk free rate = 0 %; ***composed from MSCI World and JPM Global Bonds*
Source: Thomson Reuters. Raiffeisen RESEARCH

Description

*The **RBI Risk Indicator** is a quantitative indicator that serves primarily as a short-term decision support instrument for high-risk investments.*
The timing-rule goes as follows: An index sinking below the 150-day moving average (i.e. in the case of a falling level of risk aversion) equals a buy-signal for shares. The opposite case should be interpreted as a sell-signal. Generally speaking, high RBI Risk Indicator values imply a very low risk appetite and high risk premiums.
Please refer to the special publication ‚New Edition of the RBI Risk Indicator', published on 8 April 2013, for a detailed description.

RBI Risk Indicator



Source: Thomson Reuters, Raiffeisen RESEARCH

Beta to MSCI World and MSCI EM

Beta: Measures the sensitivity of an equity index to changes of a factor (MSCI World and MSCI EM)
Beta > 1: The equity index shows larger swings then the factor.

Up-Beta: Up-beta > 1: The equtiy index rises more then the factor in positive periods.

Down-Beta: Down-beta > 1: The equtiy index decreases more then the factor in negative periods.

Beta to MSCI World

	Beta	Up-Beta	Down-Beta	Up-Down
EM Europe	0.91	0.81	0.84	-0.03
Czech Republic	0.52	0.36	1.42	-1.05
Poland	0.74	0.49	0.51	-0.03
Russia	0.98	1.05	1.14	-0.09
Hungary	0.52	0.50	0.95	-0.45

Betas to MSCI World; weekly returns of the last 2 years
Source: Thomson Reuters, Raiffeisen RESEARCH

Beta to MSCI EM

	Beta	Up-Beta	Down-Beta	Up-Down
EM Europe	0.97	0.92	0.70	0.22
Czech Republic	0.61	0.11	1.04	-0.93
Poland	0.86	0.81	1.12	-0.31
Russia	1.01	1.02	0.14	0.88
Hungary	0.79	1.22	0.52	0.70

Betas to MSCI EM; weekly returns of the last 2 years
Source: Thomson Reuters, Raiffeisen RESEARCH

Risk notifications and explanations

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Warnings

- Figures on performance refer to the past. Past performance is not a reliable indicator of the future results and 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 is reduced by commissions, fees and other charges, which depend on the individual circumstances of the investor.
- The return on an investment 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 the future results and development of a financial instrument, a financial index or a securities service.

A description of the concepts and methods which are used in the preparation of financial analyses can be found at: www.raiffeisenresearch.at/conceptsandmethods

Detailed information on sensitivity analyses (procedure for checking the stability of potential assumptions made in the context of financial analysis) can be found at: www.raiffeisenresearch.at/sensitivityanalysis

The distribution of all recommendations relating to the calendar quarter prior to the publications date, and distribution of recommendations, in the context of which investmentbanking services within the meaning of § 48f (6) Z 6 Stock Exchange Act (BörseG) have been provided in the last 12 months, is available under: www.raiffeisenresearch.at/distributionofrecommendations

Bonds

Recommendations history: Local currency government bonds (B: buy; H: hold; S: sell; I: no change)*

	CZ				HU				PL				RO				RU				TR			
Date of change	2y	5y	10y	CZK	2y	5y	10y	HUF	2y	5y	10y	PLN	2y	5y	10y	RON	2y	5y	10y	RUB	2y	5y	10y	TRY
19/03/2014	Hold	Hold	Hold	Buy	Hold	Hold	Sell	Sell	Hold	Hold	Sell	Buy	Hold	Hold	Hold	Hold	Buy	Buy	Hold	Sell	Buy	Hold	Buy	Hold
02/05/2014	I	I	I	I	I	I	Hold	Hold	Buy	Buy	Buy	I	I	I	I	I	Hold	Hold	I	I	Hold	I	Sell	Sell
14/05/2014	Buy	Buy	Buy	I	I	I	I	I	I	I	I	I	I	I	I	I	I	I	I	I	I	I	I	I
20/06/2014	Hold	Hold	Hold	Hold	I	I	I	Sell	Hold	Hold	Hold	Hold	I	I	I	I	Sell	Sell	Sell	I	I	I	Hold	Buy

** recommendations based on absolute expected performance in LCY-*
TRY vs. USD; RUB vs. Basket; other FX vs. EUR
Source: Raiffeisen RESEARCH

Recommendations history: Sovereign Eurobonds (B: buy; H: hold; S: sell; I: no change)*

	BG		HR		CZ		HU		PL		RO		RU	
Date of change	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD
19/03/2014	Hold	–	Sell	Sell	Hold	Hold	Buy	Hold	Hold	Hold	Hold	Hold	–	Buy
29/04/2014	I	–	I	I	I	I	I	Buy	I	I	Buy	Buy	Sell	Sell
20/06/2014	I	–	I	I	I	I	I	I	Buy	I	Hold	Hold	Hold	Hold

** recommendations based on absolute expected performance, i.e. expected spread change*
Source: Raiffeisen RESEARCH

Recommendations history: Sovereign Eurobonds (B: buy; H: hold; S: sell; I: no change)*

	RS		SK		SI		TR		UA		BY	
Date of change	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD	EUR	USD
19/03/2014	–	Hold	–	–	–	–	Buy	Hold	Sell	Sell	–	Hold
29/04/2014	–	I	–	–	–	–	Hold	I	I	I	–	I
20/06/2014	–	Buy	–	–	–	–	Buy	I	Hold	I	–	I

** recommendations based on absolute expected performance, i.e. expected spread change*
Source: Raiffeisen RESEARCH

Corporate Credits

Recommendations history (12M)

Fesco	Start of coverage	10/03/2014
	Date of recommendation	Recommendation
FESHRU 8.75% due 2020	10/03/2014	Sell
GAZPROMBANK	Start of coverage	16/04/2013
	Date of recommendation	Recommendation
GPBRU 6.25% due 2014	10/07/2013	Buy
LUKOIL	Start of coverage	17/04/2008
	Date of recommendation	Recommendation
LUKOIL 6.356% due 2017	04/06/2014	Buy
LUKOIL 6.125% due 2020	06/05/2014	Buy
LUKOIL 4.563% due 2023	10/07/2013	Hold

Novatek	Start of coverage	26/01/2011
	Date of recommendation	Recommendation
NVTKRM 6.604% due 2021	06/05/2014	Buy
NVTKRM 5.326% due 2016	10/07/2013	Hold
NVTKRM 5.326% due 2016	27/08/2013	Buy
SBERBANK	Start of coverage	06/05/2009
	Date of recommendation	Recommendation
SBERRU 5.4% due in 2017	31/03/2014	Buy

Equities, asset allocation

Recommendations history

Date	MICEX	WIG 20	PX	BUX	BET	CROBEX 10	BIST 100	ATX
20/06/2013	Sell	Sell	Sell	Sell	Sell	Sell	Buy	Hold
13/08/2013	I	I	I	I	I	I	I	Sell
17/09/2013	Buy	Buy	Buy	Buy	Buy	Buy	Buy	Buy
19/12/2013	Hold	Buy	Buy	Buy	Buy	Sell	Hold	Buy
19/03/2014	Hold	Buy	Buy	Hold	Buy	Sell	Buy	Buy

Equities

Financial instruments/ Company	Date of the first publication
MICEX	21/12/2009
WIG 20	01/06/1994
PX	01/06/1994
BUX	01/06/1994
BET	19/12/2006
CROBEX 10	31/07/2009
BIST 100	25/06/2012
ATX	01/04/1993

Equities

BZ WBK

Start of Coverage: 07/03/2005

Recommendation history

Date	Rating	Target Price	Prev. day's close	Upside
10/06/2014	Buy	464.00	389.90	19.0%
24/03/2014	Hold	428.00	403.30	6.1%
22/01/2014	Hold	398.00	384.00	3.6%
09/12/2013	Hold	397.00	391.00	1.5%
23/10/2013	Hold	383.00	374.20	2.4%
21/08/2013	Hold	340.00	337.00	0.9%
10/06/2013	Hold	310.00	292.00	6.2%
18/01/2013	Hold	278.00	269.00	3.3%
16/08/2012	Hold	234.00	228.00	2.6%
25/06/2012	Hold	234.00	229.90	1.8%

Source: Raiffeisen Centrobank

PKP Cargo

Start of Coverage: 17/01/2014

Recommendation history

Date	Rating	Target Price	Prev. day's close	Upside
19/05/2014	Buy	99.00	79.00	25.3%
17/01/2014	Buy	103.00	86.20	19.5%

Source: Raiffeisen Centrobank

OMV

Start of Coverage: 01/02/2002

Recommendation history

Date	Rating	Target Price	Prev. day's close	Upside
16/05/2014	Buy	37.00	31.09	19.0%
12/02/2014	Buy	39.50	33.06	19.5%
26/11/2013	Hold	40.00	36.10	10.8%
13/11/2013	Buy	42.80	36.00	18.9%
22/08/2013	Buy	42.40	33.45	26.8%
27/05/2013	Hold	39.20	37.48	4.6%
13/03/2013	Hold	35.90	34.40	4.4%
23/11/2012	Buy	31.60	27.32	15.7%
07/08/2012	Buy	33.50	26.20	27.9%

Source: Raiffeisen Centrobank

BRD-GSG

Start of Coverage: 06/11/2003

Recommendation history

Date	Rating	Target Price	Prev. day's close	Upside
10/06/2014	Buy	10.40	9.03	15.2%
20/02/2014	Buy	10.80	8.80	22.7%
09/12/2013	Hold	10.10	8.98	12.5%
30/10/2013	Buy	10.35	9.00	15.0%
10/06/2013	Hold	8.24	7.92	4.0%
17/04/2013	Reduce	7.89	8.03	-1.7%
03/12/2012	Reduce	7.09	7.30	-2.9%
06/09/2012	Reduce	7.79	8.25	-5.6%
25/06/2012	Hold	9.67	8.80	9.9%

Source: Raiffeisen Centrobank

Evraz

Start of Coverage: 02/11/2009

Recommendation history

Date	Rating	Target Price	Prev. day's close	Upside
15/04/2014	Buy	116.00	85.85	35.1%
31/01/2014	Hold	100.00	86.00	16.3%
11/10/2013	Hold	141.00	130.90	7.7%
17/07/2013	Hold	102.00	96.85	5.3%
21/02/2013	Hold	327.00	280.70	16.5%
01/10/2012	Buy	344.00	246.60	39.5%
17/09/2012	Hold	344.00	293.70	17.1%

Source: Raiffeisen Centrobank

Coverage universe recommendation overview

Empty	buy	hold	reduce	sell	suspended	UR
Universe	51	56	10	5	11	6
Universe %	37%	40%	7%	4%	8%	4%
Investment banking services	10	13	1	0	2	3
Investment banking services %	34%	45%	3%	0%	7%	10%

Source: Raiffeisen Centrobank

Technical analysis

Technical analysis: Historical recommendations

Date	ATX	BELEX 15	BUX	BIST 100	CROBEX 10	MICEX	PX	WIG 20
13/11/2013	NEUTRAL	BEARISH	BULLISH	I	BULLISH	NEUTRAL	BEARISH	I
29/11/2013	I	BULLISH	I	I	I	I	BEARISH	I
06/12/2013	I	I	BULLISH	I	I	I	I	I
18/12/2013	I	I	NEUTRAL	I	I	I	I	I
30/01/2014	BEARISH	BEARISH	BEARISH	I	I	BEARISH	BEARISH	I
12/02/2014	BULLISH	BULLISH	I	I	I	BULLISH	NEUTRAL	BULLISH
20/02/2014	NEUTRAL	NEUTRAL	I	I	BEARISH	NEUTRAL	I	I
27/02/2014	BEARISH	I	I	I	NEUTRAL	I	I	BEARISH
06/03/2014	I	I	I	I	BULLISH	I	I	BULLISH
12/03/2014	BEARISH	I	NEUTRAL	I	NEUTRAL	BEARISH	BEARISH	BEARISH
23/06/2014	BULLISH	I	I	NEUTRAL	BULLISH	BULLISH		BULLISH

Technical analysis

Financial instruments/ Company	Date of the first publication
ATX	15/04/1995
BELEX 15	01/10/1996
BUX	01/10/1996
CROBEX	18/11/2009
MICEX	02/09/2013
PX	15/03/2002
WIG 20	01/10/1996

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BZ WBK	-
PKP Cargo	4,5,21
OMV	4,5,6,21,22
BRD-GSG	-
Evraz	-

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