ERSTE Group

3Q19 CEE bond market report

- **Plummeting yields on core markets dragged yields down across CEE region**
- **No change in key rates in CEE for remainder of year, except for Serbia (-25bp)**
- **Croatia, with strong ambition to join ERM II next year, outperformed other CEE peers**

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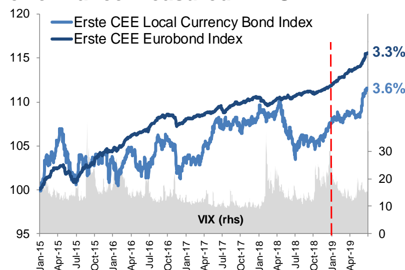
Performance measured in EUR:

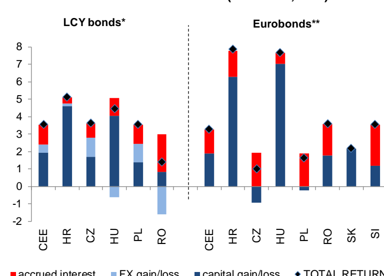


Source: Erste Group Research

Government bond yields	current	2019Q3	2019Q4	2020Q1	2020Q2
Croatia 10Y	1.10	1.10	1.00	1.00	1.00
spread (bps)	133	140	110	90	90
Czech Rep. 10Y	1.41	1.51	1.71	1.87	1.99
spread (bps)	165	181	181	177	189
Hungary 10Y	2.41	2.59	2.68	2.81	2.90
spread (bps)	264	289	278	271	280
Poland 10Y	2.26	2.40	2.50	2.55	2.65
spread (bps)	249	270	260	245	255
Romania10Y	4.57	4.70	4.90	5.10	5.20
spread (bps)	480	500	500	500	510
Slovakia 10Y	0.13	0.35	0.45	0.60	0.60
spread (bps)	36	65	55	50	50
Slovenia 10Y	0.24	0.15	0.20	0.20	0.20
spread (bps)	48	45	30	10	10
Serbia 5Y	3.19	2.80	3.00	2.90	2.70

*Source: Erste Group Research, Bloomberg (spot prices as of **11th July**)**

Performance of 5Y bonds (YTD* in %, EUR)



accrued interest · FX gain/loss · capital gain/loss · TOTAL RETURN

Source: Erste Group Bank, Bloomberg
** estimated from 5Y generic bond yields, YTD as of end of 2Q19*
*** benchmarks with maturity about 5Y*

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

Gathering clouds over global economic growth have turned both the ECB and Fed more dovish. The ECB is preparing for more stimulus to the euro area economy unless the outlook improves, while Fed Chairman Powell hinted at preparedness for an early rate cut. Tensions surrounding the trade tariffs between the US and China have reduced the predictability of global trade and weighed on the global economy. Inflation expectations have fallen in the euro area, sending 10Y yields on German Bunds deeply into negative territory at the pair of O/N (-0.40%) at the beginning of July.

Plummeting yields on core markets due to gloomier growth prospects, and increasing expectations for rate cuts by major central banks, dragged yields down across the CEE region. CEE bond market performance has been strong since the beginning of the year. Our LCY CEE Bond Index increased by 3.6% YTD, while the CEE Eurobond Index went up by 3.3% YTD.

The strongest yield compression has been observed in Croatia, thanks to rating upgrades by S&P and Fitch, with EUR adoption being perceived as a baseline and loose monetary policy. On the other side of the spectrum is Romania, where the diverging fiscal situation limited room for yields decreases. Overall, 10Y yields have collapsed by about 600bp on average in CEE since the beginning of year. We see only little space for higher yields this year in CEE (flat or 20-30bp up).

CEE currencies displayed mixed performance in 1H19. The CZK, HRK and PLN benefited from increased dovish sentiment on core markets and appreciated by roughly 0.5% YTD against the EUR. In the Czech Republic further tightening of monetary policy resulted in visible appreciation of the CZK in 2Q19. The Polish zloty remains under the influence of global rather than local factors. Depreciation of the US dollar at the end of 2Q19 dragged the EURPLN to its highest level for a year. On the contrary, the ultra-dovish monetary policy in Hungary did not prevent the HUF from weakening. The RON benefited from the weakening of the US dollar in 2Q19, but did not manage to recover from the losses gained at the begging of the year.

While inflation increased quite considerably in the first five months of this year (about 80-100bp in the Czech Republic, Hungary and Romania), the latest numbers for June showed some reversal. The high base of oil prices from a year ago should work as a disinflationary factor in the next three months unless oil prices increase considerably. Also, increases in food and vegetable prices should moderate in the upcoming months. This will provide some relief to central banks, which have been facing a dilemma when it comes to tackling high inflation figures at a time when global central banks have turned more dovish.

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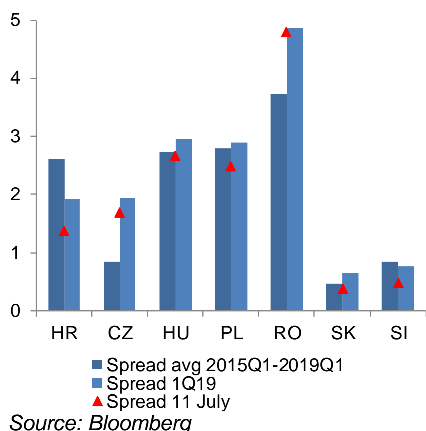
10Y yields spreads above Bunds compressed in all CEE countries but in Romania, %

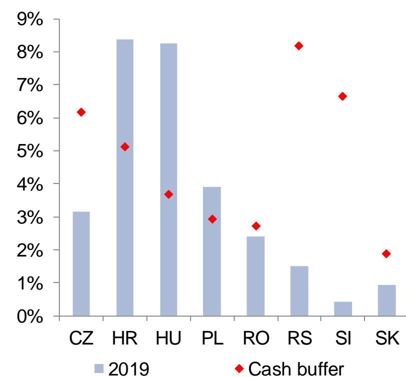


Source: Bloomberg

The greatest pressure on the tightening of monetary policy was obviously in Romania, where inflation has been above the upper band of the inflation target for a long time. However, the governor has ruled out any rate hike, given that the central bank is afraid of any potential worsening of the current account deficit if the RON gets stronger than fundamentally justified due to a widened interest rate differential. The Hungarian central bank has already announced that it will slow down the reduction of FX swaps, which were supposed to be the prerequisite for the normalization of monetary policy. The Czech national bank is also likely done with rate hikes, while the Serbian central bank is the first central bank in CEE to opt for a rate cut (-25bp at July's meeting). At this time, we do not expect any change in key rates in CEE for the remainder of this year, except of Serbia where central bank can deliver another 25bp rate cut.

Local bond issuance has shifted to lower gear in CEE in 2Q19 after seasonally very strong issuance in 1Q19. The focus was more on extension of maturity. Croatia and Serbia made use of the very favorable situation on the international market and placed 10Y Eurobonds worth EUR 1.5bn and EUR 1bn, respectively. For Serbia, it was the first euro-denominated Eurobond issued for the last six years. The Romanian government tapped foreign markets in early July with two issuances (12Y and 30Y) through which it borrowed EUR 2bn. Foreign borrowing will help the Romanian government ease pressure on domestic yields and increase the buffer for the redemption of a Eurobond worth EUR 1.5bn maturing in November. The Romanian and Hungarian government also issued retail bonds worth RON 600mn and HUF 1,000bn in 2Q19. The latter was pretty sizable and for a short time affected liquidity on the market. Given that it was supposed to roll over a HUF 500bn redemption, net issuance was HUF 500bn in single month, i.e. more than half of the full-year net issuance plan for 2019.

Gross financing needs left for 2019 and cash buffers, in pct of GDP



Source: Central Banks, MinFins, Debt Management Agencies, Erste Group Research
Notes: for Romania, cash reserve only includes FX reserves; for Croatia and Serbia, loan redemptions in the 2019 figure are included as estimates

On the fiscal side, we have seen some deterioration, particularly in countries heading for parliamentary elections (Poland this autumn, Romania and Slovakia in 2020) and economic growth does not provide as strong windfall revenues as in the past. Hungary and Romania have been confirmed to stay under the EU's Significant Deviation Procedure (SDP) for breaching the preventive arm of the Stability and Growth Pact, which is applied to countries which do not converge to their Medium-Term Objective target. A recently adopted generous social package in Romania that increases public pensions in 2019-21 will result in a budget deficit increase to 4% of GDP, in our view. That would certainly move Romania into the Excessive Deficit Procedure for breaching Maastricht criteria. EDP has much more power to enforce fiscal discipline than the current SDP, which is completely toothless for countries that are not members of the Eurozone. Romania will feel also more peer pressure from countries like Croatia and Bulgaria, which have already started formal steps towards membership in the euro area.

Croatia's strong ambition to enter the ERM II mechanism in 2020 and join the euro area in 2023 could be rewarded with another rating upgrade this year. Croatia's rating from Moody's, currently at Ba2, is the only one below investment grade and is two notches below the rating from S&P. Given the improved fiscal situation in Croatia (budget in surplus in 2018) and explicit commitment of Croatia's government to implementing further reforms before entering ERM II, a rating upgrade seems very likely.

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Alen Kovac
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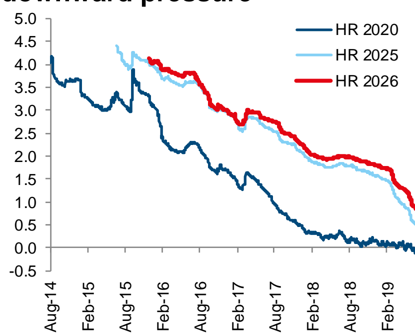
Croatia

Supply and demand factors

Issuance shifted into lower gear in 2Q19, but nevertheless wrapped up quite impressively in 1H19, as the MoF aimed to make use of favorable market conditions and secure the vast majority of its 2019 funding needs. The key event in 2Q19 has been the EUR 1.5bn Eurobond issuance, marked by record-low pricing (YTM 1.32% for the 10Y tenor) amid strong investor demand (3.7 bid-to-cover ratio). Thus, after meeting approx. 2/3 of its local bond issuance target in 1Q, the MoF met its FY19 Eurobond issuance in 2Q19. The T-bill stock also increased in 2Q19, with HRK 3.4bn being issued and HRK 2.7bn maturing. 2H19 brings HRK 8.2bn in T-bill maturities (mostly in 4Q19), implying issuance of similar size. Additionally, the MoF will roll over a maturing FX-linked EUR 1.0bn bond on the local market in November, while the Eurobond issuance acted as pre-financing for a maturing USD 1.5bn (also in November).

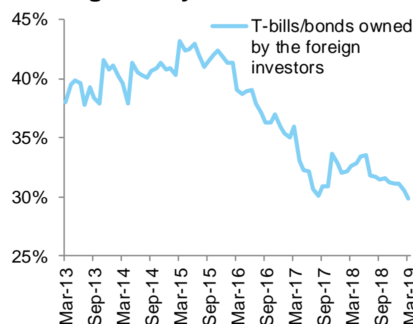
Yields under additional downward pressure



Source: Bloomberg, Erste Group Research

As far as the supply side goes, external demand is anticipated to maintain solid traction, as sentiment remains backed by the S&P and Fitch upgrade to IG region and with increasingly dovish rhetoric from the Fed and ECB additionally supporting risk appetite. There was nothing new on the domestic front, as ample LCY liquidity on top of the above-mentioned factors continued to fuel strong demand from banks, pension funds and asset managers. With the baseline story remaining intact, a similar trend should continue going forward, thus, taking into account the 5.1% of GDP cash buffer, we conclude that the funding profile in 2019/20 remains very comfortable.

Foreign investor presence looking steady

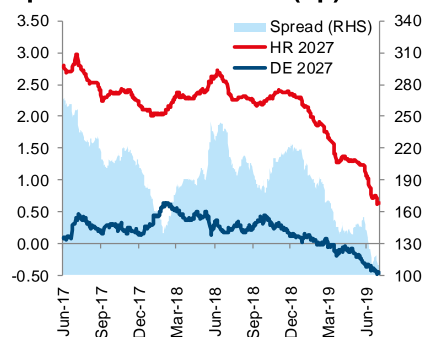


Source: CNB, Erste Group Research

Other factors

The fundamental story remains supportive, as the GDP profile, at least in the short term, remains resilient to global jitters, the fiscal outlook remains sound and anchored by targeted ERM II entry in 2020 and external imbalances continue to shrink. Rating agencies largely met our expectations of an IG rating in 2019 and, apart from Moody's (now two notches below S&P and Fitch), we expect them to remain on hold for the remainder of 2019. The reform package enclosed with the letter of intent to join ERM II envisages the sale of 90 enterprises with a government stake below 25%, so the privatization story is likely to gain some traction going forward.

Spreads down further (bp)



Source: Bloomberg, Erste Group Research

Following a strong beginning to the year, yield performance maintained its robust trend going into 2Q19, being a combination of global (dovish monetary policy tones) and local factors ('BBB-' with positive outlook from Fitch, euro adoption being increasingly perceived as a policy anchor and the ongoing lax monetary policy stance). The long end of the LCY curve (HRK 2029 @1.15%) moved an additional 70bp down q/q and almost 130bp YTD. Its EUR counterpart performed even better, with the long end (EUR 2030) going below 1% (75bp and 175bp down q/q and YTD, respectively) and trading 40bp tighter vs. the benchmark q/q. With regard to the outlook, the above-mentioned factors in our view support further compression in the LCY curve, as we see the long end approaching the 1% mark and see mostly positive risks at the moment.

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Macro analyst
Ceska sporitelna

Czech Republic

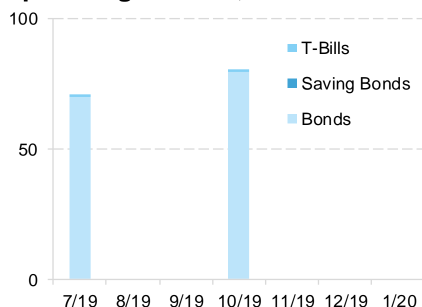
Supply factors

The development of the Czech economy has remained favorable and thus implies sufficient tax income for increased government spending on the one hand and low expenditures on the social security system on the other. However, as the fiscal policy has shifted to a more expansionary stance, we expect the government to need higher financing in the coming quarters. In fact, the deficit of the central government budget arrived at approx. CZK 21bn in May, from the CZK 9bn deficit reached in May 2018.

For the rest of this year, the gross financial needs of the central government should arrive at approx. CZK 180bn. Out of this, the central government budget should reach a deficit at CZK 20-30bn and the government will also have to roll over maturing bonds amounting to CZK 150bn. However, bonds amounting to CZK 70bn will mature in the second half of July and the government has already issued new bonds to finance this amount, which in our view, in turn implies total financial needs at approx. CZK 110bn.

Since the beginning of this year, the MoF has focused on issuing bonds as issued T-bills amounted to only CZK 2.3bn. Compared to previous years, the MoF has changed its strategy towards much lower issuance of T-bills and higher issuance of bonds with longer maturities. This is obviously a consequence of the favorable slope of the curve from the MoF's point of view, which is affected mainly by high demand for papers with longer maturities and relatively low financial needs. We expect that this strategy could continue to be used for the remainder of this year and also next year.

Bonds maturing in the upcoming months, bn

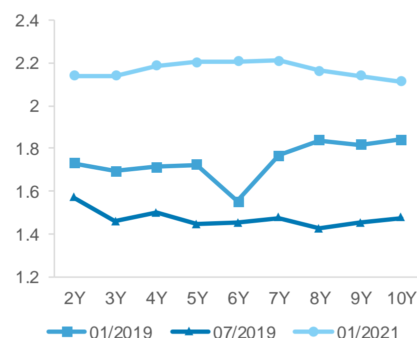


Source: Ministry of Finance; CZK

Demand factors

After five hikes of CNB rates in 2018, the CNB added one 25bp interest rate increase in May, bringing a main 2W repo rate to 2.00%. Due to risks stemming from external factors, we expect the CNB to keep rates stable for the rest of this year and to increase rates again in 2Q20. However, this scenario is conditional upon no no-deal Brexit and no significant increase of US trade tariffs on European cars.

Yield curve to move upwards in 2019 (percent)

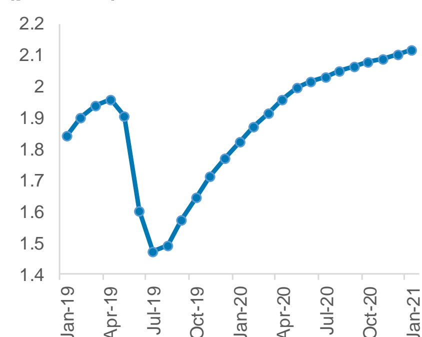


Source: Bloomberg, Ceska sporitelna

The yield curve is now slightly inverse. The short end of the curve is affected by relatively high CNB rates, whereas the long end of the curve is influenced by low German yields, the relatively low issuance policy of the MoF in several previous quarters and also by high demand for Czech government bonds with longer maturities from both residents and non-residents.

We expect the yield curve to also remain slightly inverse for the rest of this year and in 2020. The factors affecting the slope of the curve should not change much, in our view. The short end of the curve will be positively affected by the expected hike of CNB rates, which could occur in 2Q20, in our view. However, the longer end will remain relatively low, due to ongoing loose monetary conditions in the Eurozone and high demand for Czech bonds. A higher issuance policy on the part of the MoF will slightly improve the slope; however, the effects of this factor will be limited compared to other factors.

Expected 10Y bond yields (percent)



Source: Bloomberg, Ceska sporitelna

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Macro Analyst

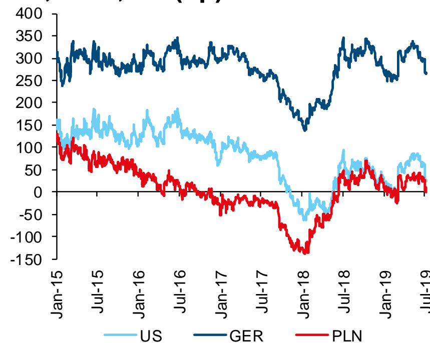
Hungary

Supply and demand factors

In the second quarter, the Debt Management Agency (ÁKK) met its full-year financing targets and focused rather on extending the duration, issuing mainly longer-term government bonds above initially announced amounts. All FX bonds maturing this year were already repaid from forint sources, while FX bond issuance is not planned, thus the share of FX debt within total government debt would decrease to a lower level than the planned (17% by end-2019). Instead, the economic policy has continued to rely on internal financing. In June, a new 5Y retail bond called MÁP 'Plusz', with attractive and continuously rising coupons, was introduced, and this 'generous paper' attracted more than HUF 1,000bn in a single month. The net effect could, however, have been lower, as around half of the new purchases were financed by redemptions of earlier purchased other types of retail bonds.

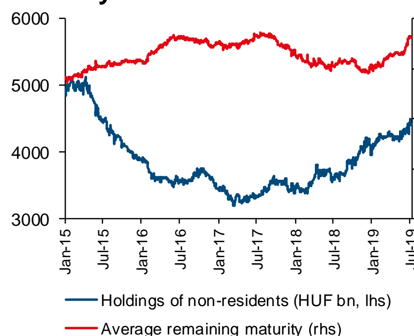
As for demand, HGB exposure of the domestic banking sector remained stable at high levels, amounting to 21.6% of total banking assets in May. The ownership share of the banking sector within LCY government papers was 36.8% in April, according to the latest available statistics, while the foreign investor share stood at 18.5%, more or less unchanged compared to previous months. Sales of retail papers reached 40% of the FY19 gross issuance plan in January-May, but net issuance for the sector was slightly negative in this period. However, given the above-mentioned success of the new retail bond introduced in June, the planned HUF 800bn net issuance of retail papers for this year could, in our view, easily be met. As a result, the share of households in LCY government debt might already have increased from the 25.5% seen at the end of April.

Spread of 10Y HGB yield over US, GER, PL (bp)



Source: Bloomberg, Erste Group Research

Holdings of non-residents and maturity



Source: Bloomberg, Erste Group Research

Other factors

With regard to the short end of the yield curve, the monetary policy of the central bank (MNB) will remain one of the main anchors. At the latest June rate-setting event, the MNB tightened only marginally, leaving rates flat – the policy rate at 0.9% and the O/N deposit rate at -0.05% – and announcing only a small planned decrease in the liquidity to be crowded out on the interbank market. As stated by Vice Governor Nagy, the short-term impact should be rather negligible, with interbank rates to increase by little, as they should remain very close to current levels. Changed global rate expectations, coupled with slightly mitigating inflation rates, could leave room for the MNB to maintain its dovish stance, in our view. The 3M interbank market rate (BUBOR) is unlikely to increase considerably above its current level of 0.25% by year-end. All in all, normalization of loose monetary conditions seems to have paused for the year and reaching the level of the policy rate (0.9%) could even be slower than earlier expected.

On the long end of the yield curve, movements of major bond yield levels may preserve their decisive effects on yields. The latest declines in HGB yields upon the decrease of the German Bund to a historical low value were greater than Hungary's regional peers, which could be a result of the possible reduction of the bond supply in 2H19. Given Hungary's economic fundamentals, especially its relatively high level of inflation rates, long-term bonds currently seem overbought, although substantial upward correction is unlikely while major bond yields remain so depressed.

Yield curve steepness, 10Y-3Y HGB yields (bp)

Source: Bloomberg, Erste Group Research

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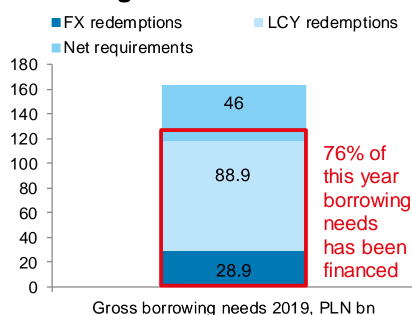
Poland

Supply and demand factors

Poland has 76% of this year's gross financing needs covered as of the end of 2Q19, while pre-financing of 2020 borrowing needs via switch auctions may already exceed 30%, according to the Ministry of Finance statement. As the financing situation is comfortable, the MinFin sold papers worth only PLN 6bn during regular auctions in 2Q19, which is well below the planned PLN 25bn. Due to the high level of financing of borrowing needs and good liquidity situation, the MinFin set the maximum supply of bonds at PLN 13bn in 3Q19. Moreover, Eurobond issuance seems quite likely, along with the USD-denominated bond, as flagged in the MinFin statement. We might expect higher bond issuance in 4Q19 compared to 3Q19, due to heavier pre-financing of next year's needs.

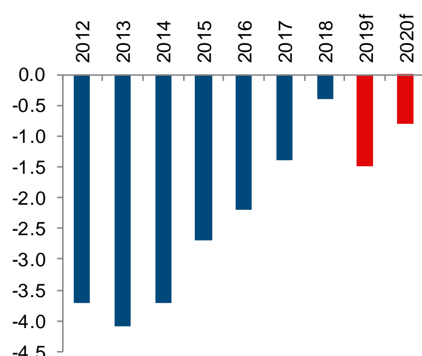
Borrowing needs in 2019



Source: MinFin, Erste Group Research

The budget situation looks less favorable this year than it did in 2018. While last year a budget surplus of PLN 9.5bn was observed after May, this year's budget deficit plummeted to PLN 1.9bn in May from PLN 0.01bn in April. The main reason behind the visible worsening of the budget situation was a much higher transfer to the pension fund system, due to the payment of the 13th pension in May (up by PLN 8.3bn). Tax collection continues to improve, albeit at a slower pace than in 2017-18. Financing of the generous social package announced in February 2019 by the ruling Law and Justice party without breaching the Maastricht limit seems to be secured by planned changes in the pension system that should be accepted by the parliament over summer. The planned reforms assume that funds that are located in Open Pension Funds (OFE) will be, subject to the decision of each individual, transferred to an individual pension account (IKE) or to a virtual account in the social security system. Transfer to IKE is to be burdened with a 15% fee but will be a tax-free amount after retirement, unlike the pension paid from the security system, to which income tax applies. Hence, the government expects PLN 19.3bn inflow from transfer fees paid in two equal tranches worth in total 0.8% of GDP in 2020 and 2021. Having said that, we think that this year increased social spending (500+ program for each child) will most likely be financed with a higher deficit, while next year's budget performance should be supported by one-off inflows related to the pension system overhaul.

Historically low budget deficit, % of GDP



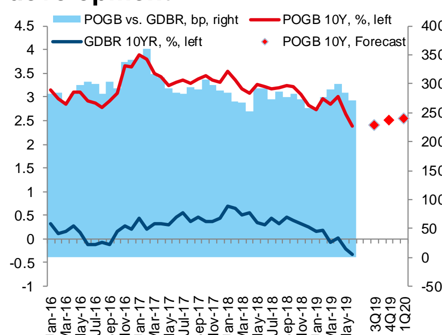
Source: MinFin, Erste Group Research

Demand for Polish papers should remain healthy, mostly due to local investors. Since the beginning of the year, the local banking sector increased its holdings by PLN 36.4bn, while foreign investor holdings decreased by PLN 18bn to the lowest level since 2012.

Other factors

As an aftermath to increased tensions between US and China, Brexit uncertainty and dropping global sentiment, yields on the core market, especially in Germany, went visibly down. The long end of the Polish curve followed core market developments and decreased by roughly 50bp over 2Q19. Furthermore, the recent shift to more dovish rhetoric by major central banks limits the upward potential of yields and supports a stability of rates scenario in Poland. On the other hand, inflation accelerated in Poland and is expected to peak in 1Q20 above the upper bound of the inflation target. All in all, we see limited potential for the Polish curve to go up due to global uncertainty and the low bond supply in the coming months. We see the cap for the 10Y yield at 2.5% this year.

Yield and spread vs. Bunds development



Source: Bloomberg, Erste Group Research

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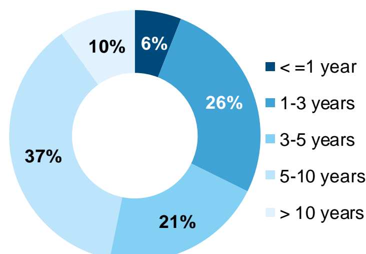
Eugen Sinca
Senior Analyst

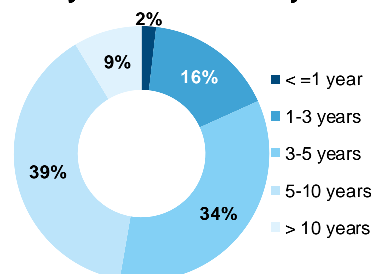
Romania

Government bond issuance in 1Q19 by residual maturity



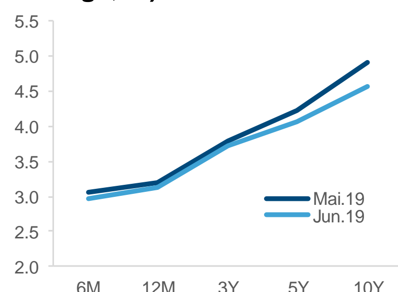
Source: NBR, BCR Research

Government bond issuance in 2Q19 by residual maturity



Source: Ministry of Finance, BCR Research

RON yield curve (mid, monthly average, %)



Source: Ministry of Finance, BCR Research

Non-residents holdings of RON bonds

Source: Ministry of Finance, BCR Research

RON government bonds joined the positive momentum from developed and emerging markets in June after dovish signals sent by the ECB and the FED. Local developments were also supportive, as provisions with a negative impact on banks and private pension funds from GEO 114/2018 were watered down by the government. Besides that, investors welcomed the appointment of a new Board of Directors of the NBR by the Parliament which reinforced their confidence in central bank's independence. On a less positive note for the bond market, the Parliament voted at the end of June the new Pensions Law, with very generous increases in public pensions in 2019-2021 that will add a heavy burden on the state budget. Consequently, we revised our budget deficit forecast for 2020 to 4% of GDP.

Yields fell by 20-40bps throughout June, with the strongest move being seen at the long end of the curve, but part of this trend was reversed during the last trading days of June as investors seemed to pay more attention to the fiscal risks. Budget deficit was 1.4% of GDP in January-May and investors will monitor the budget rectification from August for additional clues about government's determination to keep this year's deficit within Maastricht criteria.

Supply and demand factors

The Ministry of Finance borrowed RON 15.1bn and EUR 423mn from the local market in 2Q19. Auctions went good in May and June when external context was favourable and the Ministry of Finance attracted significantly more volumes from the market than initially planned (117% in May and 160% in June versus indicative volumes published at the beginning of each month).The structure of the residual maturity of RON bonds issued by the Ministry of Finance in 2Q19 changed compared with 1Q19, with a lower share of short-term debt and more medium- and long-term bonds. This reflected both more expensive short-term funding in RON due to the NBR's strict control of market liquidity (1W market rates were close to Lombard rate in April) and high interest from non-residents towards medium- and long-term bonds.

The Ministry of Finance continued to issue retail bonds in 2Q19 and borrowed almost RON 600mn from the population in April and May, with maturities ranging from 1y to 5y and coupon rates between 3.5% and 5%. At beginning of July, Romania issued Eurobonds maturing in 2031 worth EUR 1.4bn and in 2049 worth EUR 600mn.

Going further, positive investor mood towards emerging markets debt is paramount for a swift financing of Romania's gross funding needs. Short-term rates will remain elevated because the NBR will continue to absorb the liquidity surplus through weekly deposit-taking operations. Monthly maturities of government bonds will be very low until February 2020, which means that the Ministry of Finance will drain liquidity from the market through net issuance. At the same time, budget deficit will be more linear distributed throughout the year compared with the pre-2018 situation when deficit ballooned in December alone, pointing towards limited liquidity injections by the government in the remainder of 2019. Demand for short-term bonds is unlikely to strengthen under current circumstances, but medium- and long-term bonds will benefit from dovish large central banks and attractive LCY yields versus CEE peers.

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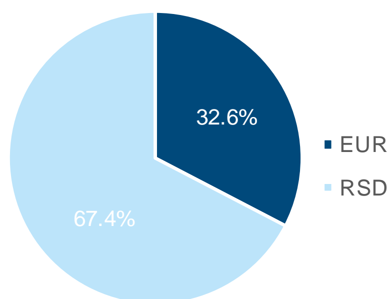
Serbia

Supply and demand factors

Currency structure of public debt



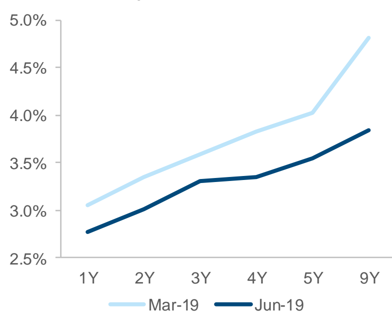
Source: Bloomberg, MoF

After a busy first quarter of the year, the MoF continued at a similar tempo, issuing RSD 88.4bn and EUR 218.6mn worth of T-bills in the second quarter, while also tapping international markets with a 10Y EUR 1bn bond issuance. These operations put the MoF in a comfortable position, as the remaining total gross financing needs stand at just RSD 80bn (1.5% of GDP), while the cash buffer is 8.2% of GDP. The 3Q calendar reveals the MoF commitment towards further dinarization, as only dinar auctions are planned, notwithstanding maturity of EUR 86.5mn (RSD 10.2bn) in euro T-bills alongside RSD 9.1bn maturity in dinar papers. Foreign investor flows to RSD-denominated papers has been very strong recently, boosted by dovish rhetoric from the ECB and Fed, stable local inflation and a still appealing real interest rate premium.

After six years, Serbia returned to international markets, successfully launching a 10Y EUR 1bn bond at just 1.619% YTM, with strong investor interest (bid-to-cover at 6.4x). Proceeds from the issuance were used to buy back USD 700mn of 2020 and USD 400m of 2021 bonds, thus saving roughly EUR 32mn on interest payments. The government will not return to international markets this year, but could tap them again next year, contingent on favorable financing conditions.

Other factors

RSD bond yields



Source: Bloomberg

Acknowledging strong dinar appreciation pressures, the NBS decided to cut its key rate by 0.25% to 2.75% at its July meeting. We have revised our forecast and now expect to see another quarter-cut of the rate by year-end. While there is still a relatively high dose of uncertainty in external environment, dovish global central banks stance, low inflation expectations and disinflationary pressures stemming from strong dinar go in favor of further relaxation. The NBS has bought net EUR 1.39bn so far YTD, with hefty EUR 1.17bn worth of interventions in June and July alone to tame dinar strength. Things are also heating up on the privatization front, with six valid bids received for the controlling share in Komercijalna banka. The government is currently the largest single shareholder and early estimates indicate it could get anywhere between EUR 200-250mn for its 41.7% share. Positive fiscal performance has continued this year so far, with the consolidated budget recording an RSD 4.9bn surplus in May vs. a planned deficit. The difference mostly stems from stronger than expected tax intake, given robust household consumption trend. Notwithstanding the over performance YTD, we still expect a 0.5% of GDP budget deficit, given the announced increase of the minimum wage in September, public sector wage and pensions hike later this year, lowering of the labor-related tax burden, CHF loan conversion cost and ongoing infrastructure investment cycle.

While we were rightfully bullish on the long end of Serbia's LCY, the extent to which yields plummeted exceeded our expectations. The yield on the longest RSD2028 fell by 1% compared to the end of March and is currently trading around 3.8%. Additionally, the short end and the belly of the curve also performed positively, with yields falling 30-50bp compared to the previous quarter. Notwithstanding strong performance in the second quarter, the real interest premium still looks relatively appealing; we expect yields to head further south and see the benchmark 9Y RSD yield around 3.3% in the upcoming period.

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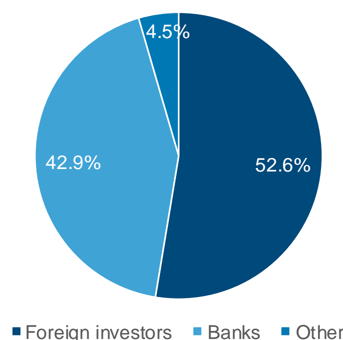
Katarína Muchová
Macro Analyst

Slovakia

Supply and demand factors

The Slovak debt agency ARDAL conducted six standard bond auctions and one syndicated auction in 2Q19. Altogether, EUR 1.7bn was raised between April and June, via bonds with longer maturities (9Y-28Y). This year's issuance totals EUR 2.4bn thus far (52% of the expected amount). Yields further decreased in the course of the quarter, with the 28Y accepted bond yield down to 1.43% (from 1.88% in 1Q19). Demand for Slovak government paper remains high, suggesting smooth outcomes also in the months ahead. The debt agency sees this year's gross funding needs at EUR 4.3bn. Our estimate for gross funding needs is closer to EUR 4.6bn as we view the expected fiscal situation more conservatively. Altogether EUR 3.5bn worth of bonds and T-bills are maturing in 2019 (slightly more than the EUR 3.3bn worth of maturities last year) with the next batch worth EUR 0.4bn due in October.

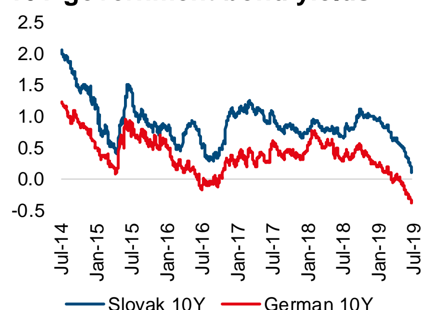
Ownership structure of Slovak government bonds (June 2019)



Source: ARDAL, SLSP

This year's central government cash deficit is expected to be higher than in 2018, even though the accrual public sector budget is planned to be balanced as a ratio of GDP (compared to last year's accrual deficit of 0.7% of GDP). Favourable labour market development and good tax collection still help with the revenues. Yet, the budget relies rather heavily on the revenue side, especially as it anticipates a sizable surplus of municipalities and other non-central government bodies. Special levy on retail chains (introduced this year) was scrapped, thus decreasing the potential revenues this year. On the expenditure side, new social measures and public sector wage hikes were introduced. Given all this, we are more conservative in our projections, especially in light of the headwinds for this year's GDP growth which means no extra revenues courtesy of the economic cycle are likely to materialise this year. We foresee the 2019 fiscal deficit at 0.7% of GDP. Nonetheless, both fiscal deficit and sovereign debt remain comfortably below the Maastricht criteria.

10Y government bond yields



Source: Refinitiv (Thomson Reuters), SLSP

Yield outlook

Slovak 10Y government bond yields recently moved noticeably lower and touched new record lows (0.1% in early July). The 10Y Slovak yield is close to 0.13% these days. Yields are reflecting a more dovish ECB stance, cautious Fed and higher uncertainty. Net inflows of QE stopped in December 2018 but reinvestment of maturing amounts will continue for a substantial amount of time beyond the first rate hike. The recently announced TLTRO3 and changed forward guidance that sees rates at their current level at least until mid-2020 constitute more easing on the part of ECB and markets are even speculating about a deposit rate cut. Domestically, fiscal deficit fell to 0.7% of GDP in 2018 and we expect it to remain around that level also in 2019. Government debt, comfortably under the Maastricht's 60% of GDP, fell below 50% of GDP already in 2018.

Overall, as the outlook brightens, yields on government bonds could increase somewhat reflecting domestic inflation and stable stock of QE. However, more uncertain path of monetary policy in the US and the first ECB hike being postponed towards the end of 2020 (together with further easing in the Euro Area via TLTRO3) have led us to revise our forecast downward. We expect the 10-year Slovak government bond yield at 0.28% in 3Q19 before rising to 0.4% towards the end of the year.

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Alen Kovac
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Erste Bank Croatia

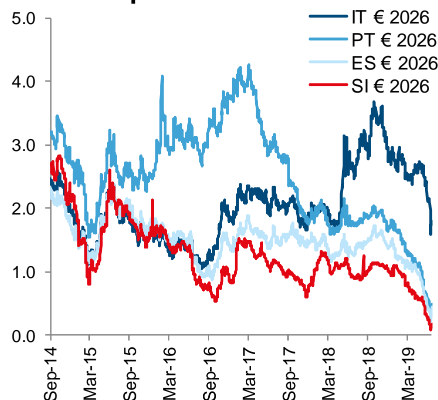
Slovenia

Supply and demand factors

Given that Slovenia covered a significant portion of its total needs for 2019 early in the year, the issuance pace, as expected, slowed down during the second quarter, with the MoF mainly focusing on the short-term debt market, i.e. on regular T-bill placements. The remainder of the year should bring a similar pattern, as all bond maturities were already due in 1Q19, which now leaves only a small amount of T-bill volumes maturing by year-end, where, given the current smooth rollover track record, we expect no surprises. Thus, the largely empty maturity profile in 2H19 and current comfortable funding position mitigates any timing pressures regarding new placements, with Slovenia being in a good position if it opts to do some pre-financing for 2020 (where the focus would likely remain on the longer end of the curve). The high cash buffer of 6.6% of GDP (as of April 2019) also supports such a relaxed position, i.e. suggesting no timing concerns.

We saw no major changes on the demand side. Foreign investors continue to dominate the structure profile, with a steady approx. 60% of total government papers. The improving global fundamental picture and dovish monetary policy tone should continue to drive interest, so we see limited risks concerning foreign demand going forward. On the local side, banks remain the strongest players, though the gradual revival of credit activity and low yield environment to some extent limits appetite for new government debt absorption. Current exposure on their books stands at EUR 3.7bn, or around 13% of overall public debt (as of 1Q19). Bottom line: we expect a similar pattern going into 3Q18.

Gradual decoupling from southern peers

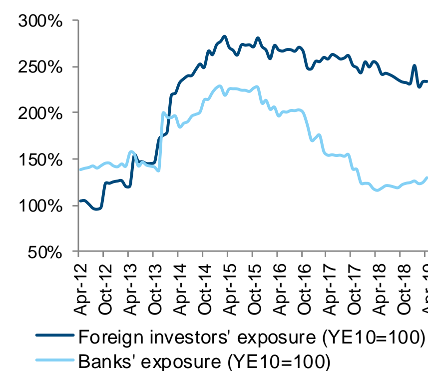


Source: Bloomberg

Other factors

After completing the first phase of the NLB (largest state-owned bank) sale at the end of 2018, Slovenia recently completed the NLB privatization process by selling a 10%-1 share. The Republic of Slovenia remains the biggest shareholder, with a 25+1% stake. In addition to that, Slovenia also kick started Abanka's sale (country's third-largest bank), where, in accordance with the EC deal, Slovenia's government needed to privatize Abanka by the middle of 2019. Late in June, Slovenian Sovereign Holding announced that Abanka would be completely sold to NKBM bank, owned by US fund Apollo, with more detailed information to be disclosed once the deal is finalized. Keeping the privatization process on the right track also favored recent rating developments, with Moody's upgrading Slovenia's outlook from stable to positive, while affirming its Baa1 rating – structural improvements, improving fiscal and public debt metrics were key reasons behind the outlook upgrade. There was also positive news from the fiscal side, as the MoF reported that it expects the budget surplus to rise towards 0.8% of GDP in 2019, amid favorable economic growth and a limited spending pattern, followed by 0.8% and 1.2% of GDP in 2020 and 2021, respectively.

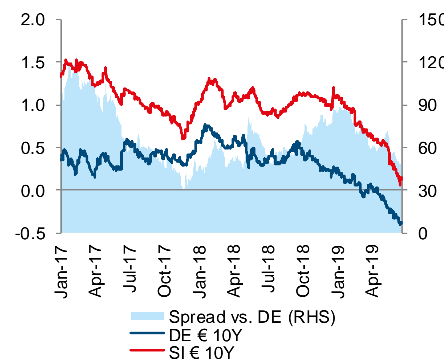
Risk appetite holds steady



Source: Bank of Slovenia

On the yields side, the pattern of decline seen since the beginning of the year extended into 2Q19, though at a more pronounced pace, as yields moved further below the 0.5% mark – the 10Y tenor is currently quoting around the 0.15% level, i.e. down 50bp vs. end-1Q19. Such a pattern largely reflected the recent bund decline, although we also saw some spread tightening vs. DE to around 50bp. With a steady economic outlook and favorable fiscal position supporting the yield profile, the current lower yield level should persist in the upcoming quarters, aligning with expected Bund developments.

Spread falling again



Source: Bloomberg

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Forecasts (spot prices as of July 11th)

Government bond yields

	current	2019Q3	2019Q4	2020Q1	2020Q2
Croatia 10Y	1.10	1.10	1.00	1.00	1.00
spread (bps)	133	140	110	90	90
Czech Rep. 10Y	1.41	1.51	1.71	1.87	1.99
spread (bps)	165	181	181	177	189
Hungary 10Y	2.41	2.59	2.68	2.81	2.90
spread (bps)	264	289	278	271	280
Poland 10Y	2.26	2.40	2.50	2.55	2.65
spread (bps)	249	270	260	245	255
Romania10Y	4.57	4.70	4.90	5.10	5.20
spread (bps)	480	500	500	500	510
Slovakia 10Y	0.13	0.35	0.45	0.60	0.60
spread (bps)	36	65	55	50	50
Slovenia 10Y	0.24	0.15	0.20	0.20	0.20
spread (bps)	48	45	30	10	10
Serbia 5Y	3.19	2.80	3.00	2.90	2.70
DE10Y*	***-0.23***	***-0.30***	***-0.10***	***0.10***	***0.10***

FX

	current	2019Q3	2019Q4	2020Q1	2020Q2
EURHRK	7.39	7.40	7.42	7.42	7.38
forwards		7.40	7.40	7.40	7.40
EURCZK	25.61	25.55	25.30	25.14	24.88
forwards		25.74	25.86	26.00	26.15
EURHUF	325.9	325.0	325.0	325.0	325.0
forwards		326.4	327.1	327.7	328.4
EURPLN	4.27	4.28	4.30	4.31	4.30
forwards		4.29	4.31	4.34	4.36
EURRON	4.73	4.75	4.77	4.79	4.82
forwards		4.77	4.81	4.86	4.91
EURRSD	117.8	117.7	118.0	118.0	117.8
forwards		-	-	-	-
EURUSD	1.13	1.10	1.13	1.15	1.18

3M Money Market Rate

	current	2019Q3	2019Q4	2020Q1	2020Q2
Croatia	0.46	0.50	0.50	0.50	0.50
Czech Republic	2.17	2.16	2.16	2.22	2.36
Hungary	0.25	0.25	0.25	0.35	0.45
Poland	1.72	1.72	1.72	1.72	1.72
Romania	3.17	3.40	3.40	3.30	3.30
Serbia	2.85	2.45	2.48	2.47	2.48
Eurozone	-0.36	-0.30	-0.30	-0.30	-0.30

Key Interest Rate

	current	2019Q3	2019Q4	2020Q1	2020Q2
Croatia	0.30	0.30	0.30	0.30	0.30
Czech Republic	2.00	2.00	2.00	2.00	2.25
Hungary	0.90	0.90	0.90	0.90	0.90
Poland	1.50	1.50	1.50	1.50	1.50
Romania	2.50	2.50	2.50	2.50	2.50
Serbia	2.75	2.50	2.50	2.50	2.50
Eurozone	0.00	0.00	0.00	0.00	0.00

Real GDP growth (%)	2017	2018	2019f	2020f
Croatia	2.9	2.6	3.2	2.5
Czech Republic	4.5	2.9	2.6	2.8
Hungary	4.1	4.9	4.5	3.3
Poland	4.8	5.1	4.8	4.0
Romania	7.0	4.1	4.5	3.8
Serbia	2.0	4.3	3.3	3.5
Slovakia	3.2	4.1	3.4	3.3
Slovenia	4.9	4.5	3.2	3.1
CEE8 average	**4.7**	**4.4**	**4.1**	**3.5**

Average inflation (%)	2017	2018	2019f	2020f
Croatia	1.1	1.5	1.0	1.3
Czech Republic	2.5	2.1	2.6	2.2
Hungary	2.4	2.8	3.3	3.3
Poland	2.0	1.6	2.4	2.7
Romania	1.3	4.6	4.0	3.3
Serbia	3.2	2.0	2.5	1.8
Slovakia	1.3	2.5	2.5	2.5
Slovenia	1.4	1.7	1.5	1.9
CEE8 average	**1.9**	**2.4**	**2.7**	**2.7**

Unemployment (%)	2017	2018	2019f	2020f
Croatia	11.3	8.4	7.4	6.4
Czech Republic	2.9	2.3	3.0	3.3
Hungary	4.2	3.7	3.6	3.5
Poland	7.3	6.1	6.0	6.4
Romania	4.9	4.2	3.8	4.0
Serbia	13.5	12.7	10.6	9.8
Slovakia	8.1	6.5	5.8	5.7
Slovenia	6.6	5.1	4.2	3.7
CEE8 average	**6.3**	**5.2**	**5.1**	**5.2**

C/A (%GDP)	2017	2018	2019f	2020f
Croatia	3.7	2.6	1.4	-0.1
Czech Republic	1.7	0.3	0.4	0.5
Hungary	2.8	0.5	-0.1	0.7
Poland	0.2	-0.7	-0.5	-0.7
Romania	-3.2	-4.5	-4.8	-5.2
Serbia	-5.2	-5.2	-6.3	-6.0
Slovakia	-2.0	-2.5	-2.2	-1.5
Slovenia	7.2	7.0	6.4	5.7
CEE8 average	**0.2**	**-0.9**	**-1.0**	**-1.1**

Public debt (% of GDP)	2017	2018	2019f	2020f
Croatia	77.8	74.6	71.2	68.9
Czech Republic	34.6	32.7	31.0	30.1
Hungary	73.4	70.8	68.2	66.4
Poland	50.6	48.9	48.0	46.5
Romania	35.2	35.0	34.5	36.0
Serbia	59.3	53.6	51.1	49.0
Slovakia	50.9	48.9	47.7	46.2
Slovenia	74.1	70.1	66.5	63.0
CEE8 average	**50.3**	**48.4**	**46.9**	**45.7**

Budget Balance (%GDP)	2017	2018	2019f	2020f
Croatia	0.8	0.2	0.0	-0.5
Czech Republic	1.6	0.9	0.6	0.3
Hungary	-2.2	-2.2	-1.8	-1.5
Poland	-1.5	-0.4	-1.5	-0.8
Romania	-2.7	-3.0	-3.0	-4.0
Serbia	1.1	0.6	-0.5	-0.5
Slovakia	-0.8	-0.7	-0.7	-0.4
Slovenia	0.0	0.0	0.70	0.8
CEE8 average	**-1.0**	**-0.7**	**-1.2**	**-1.1**

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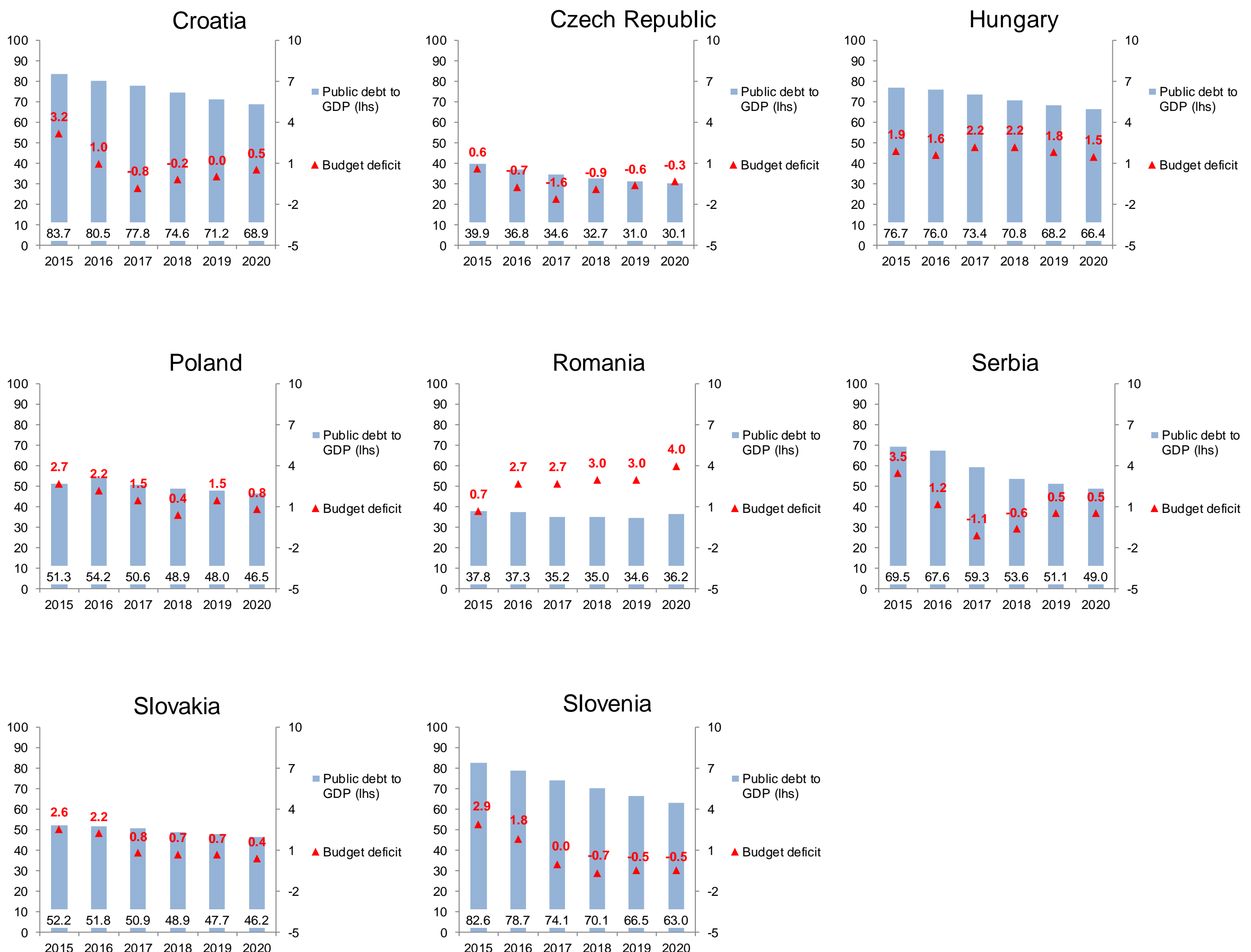
Statistical Appendix

Debt, deficit and growth figures (percent of GDP)



Source: Erste Group Research

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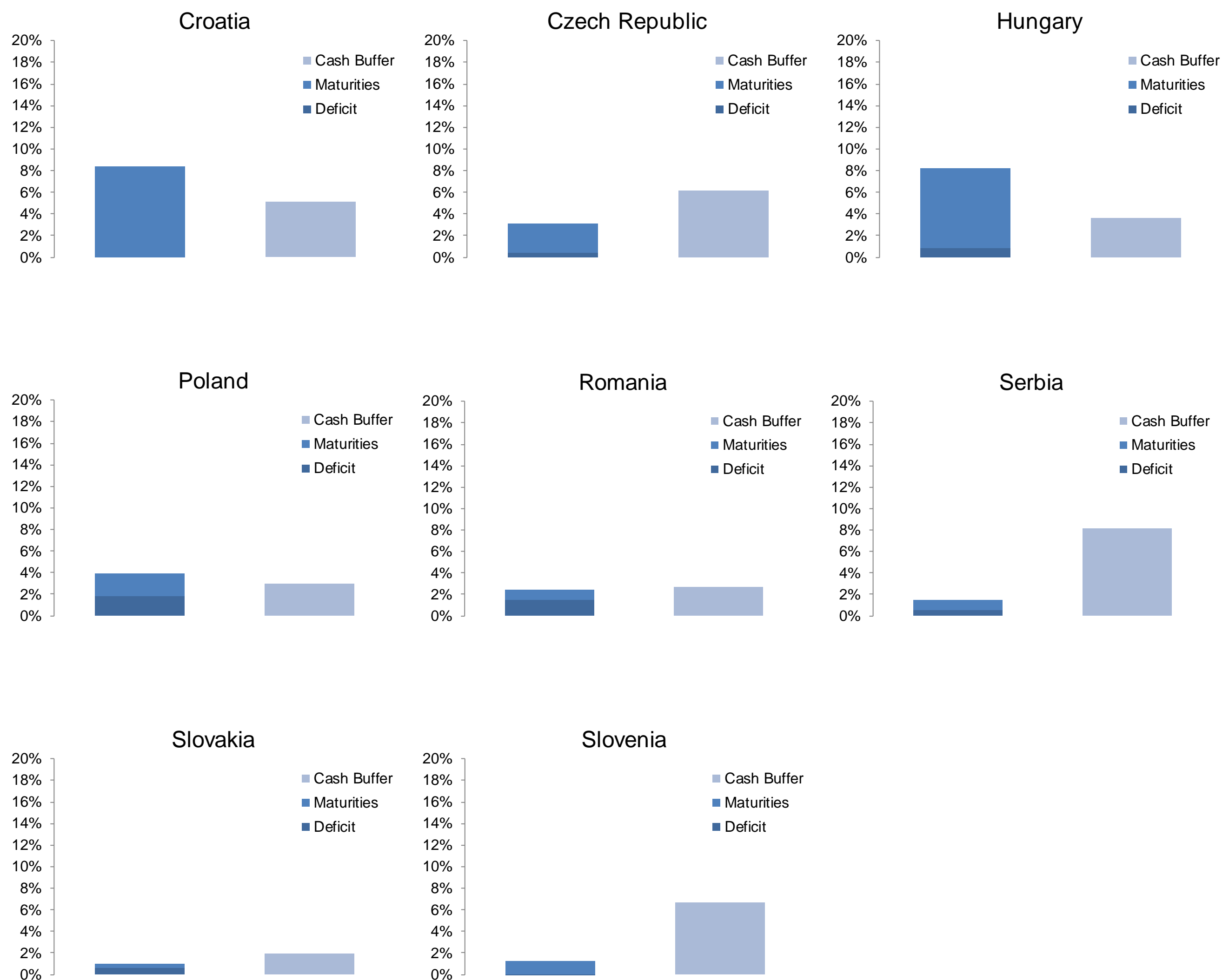
Financing needs in the remainder of 2019 and cash buffers



Note: Percent of forecasted 2019 GDP
Source: Erste Group Research

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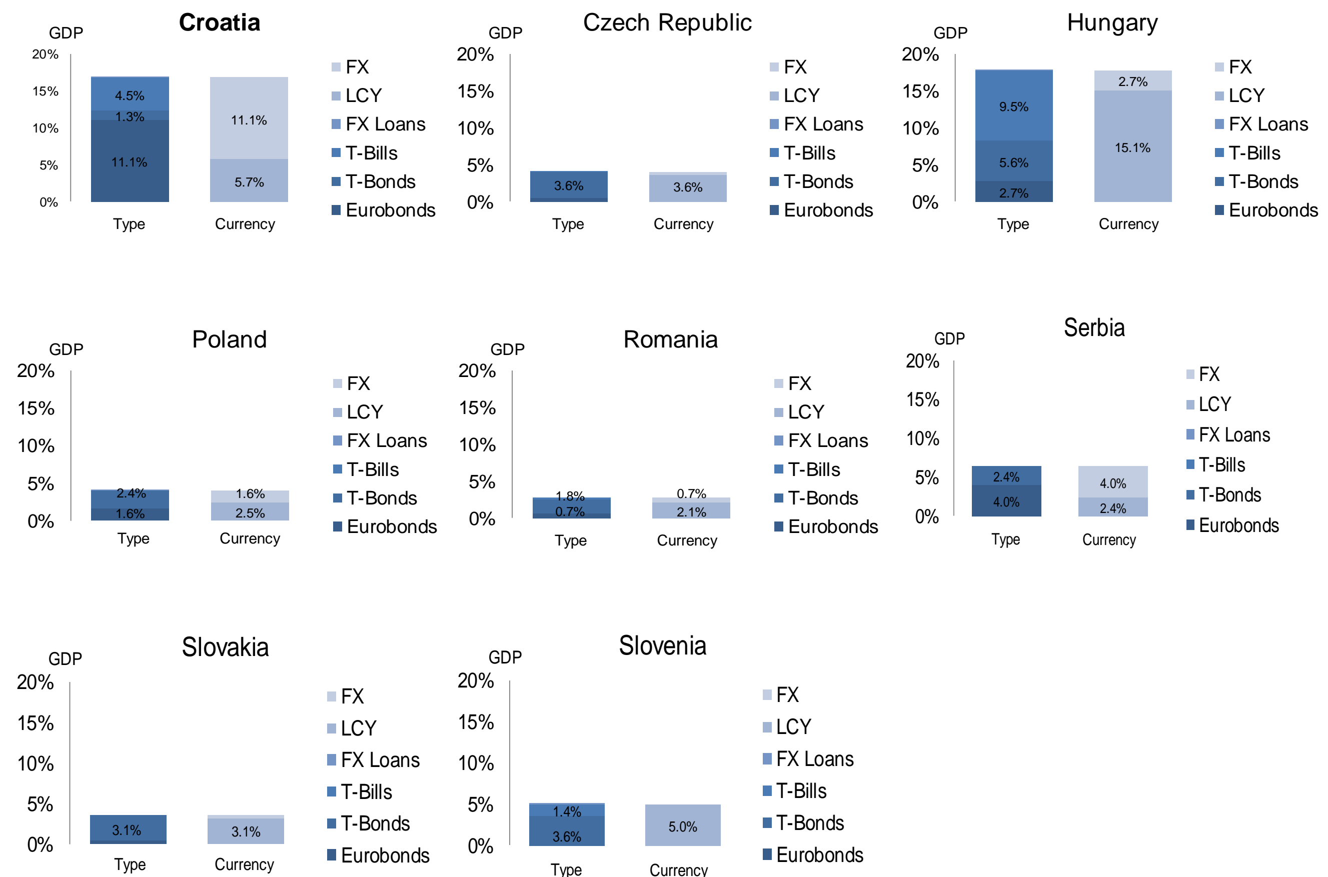
Redemptions in *next 12 months* by type and currency of issue



Source: Bloomberg, Erste Group Research

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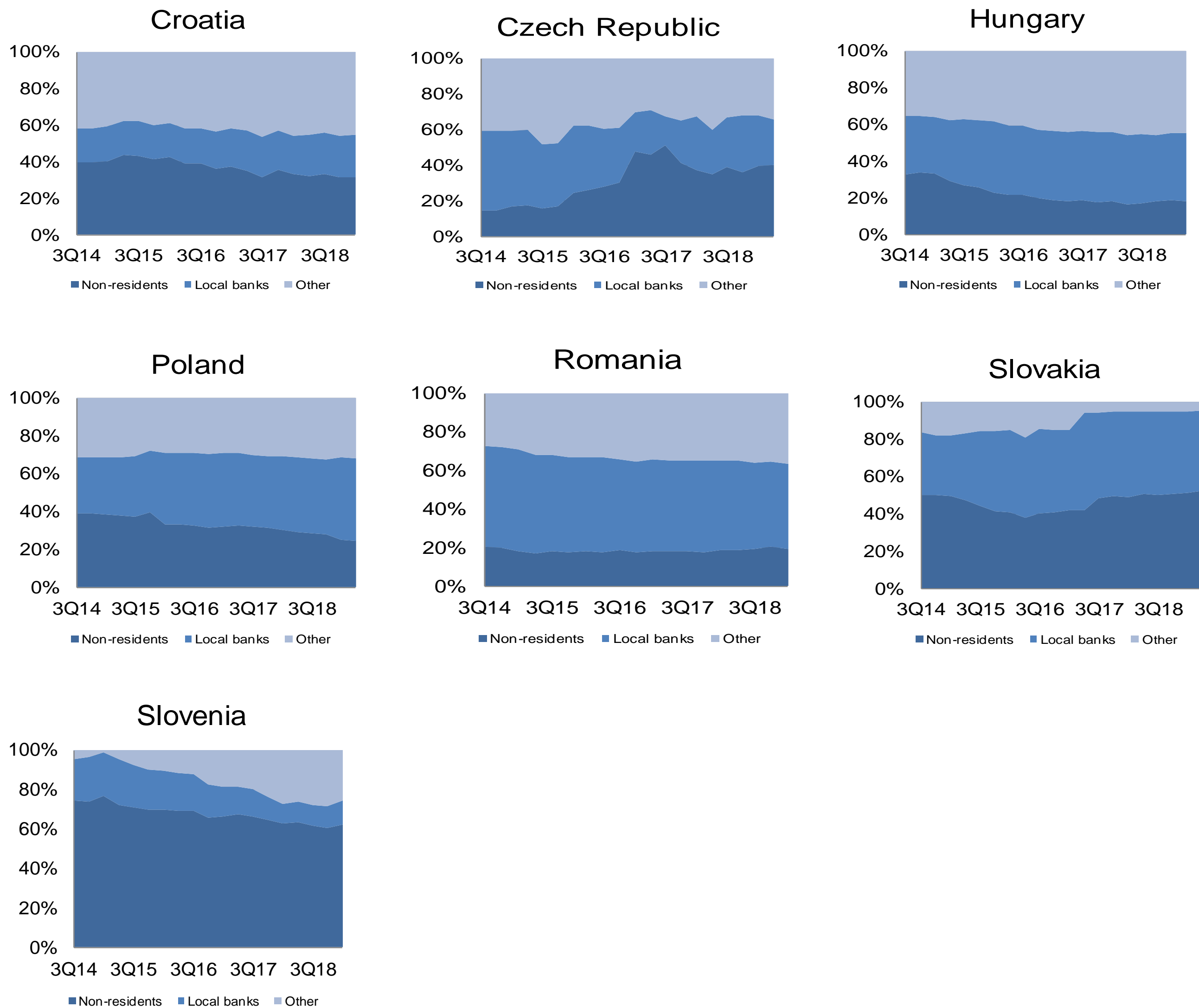
Holding structure of local currency debt securities



Source: Country MinFins, Debt Management Agencies, Erste Group Research
Note: April data for Hungary and Poland

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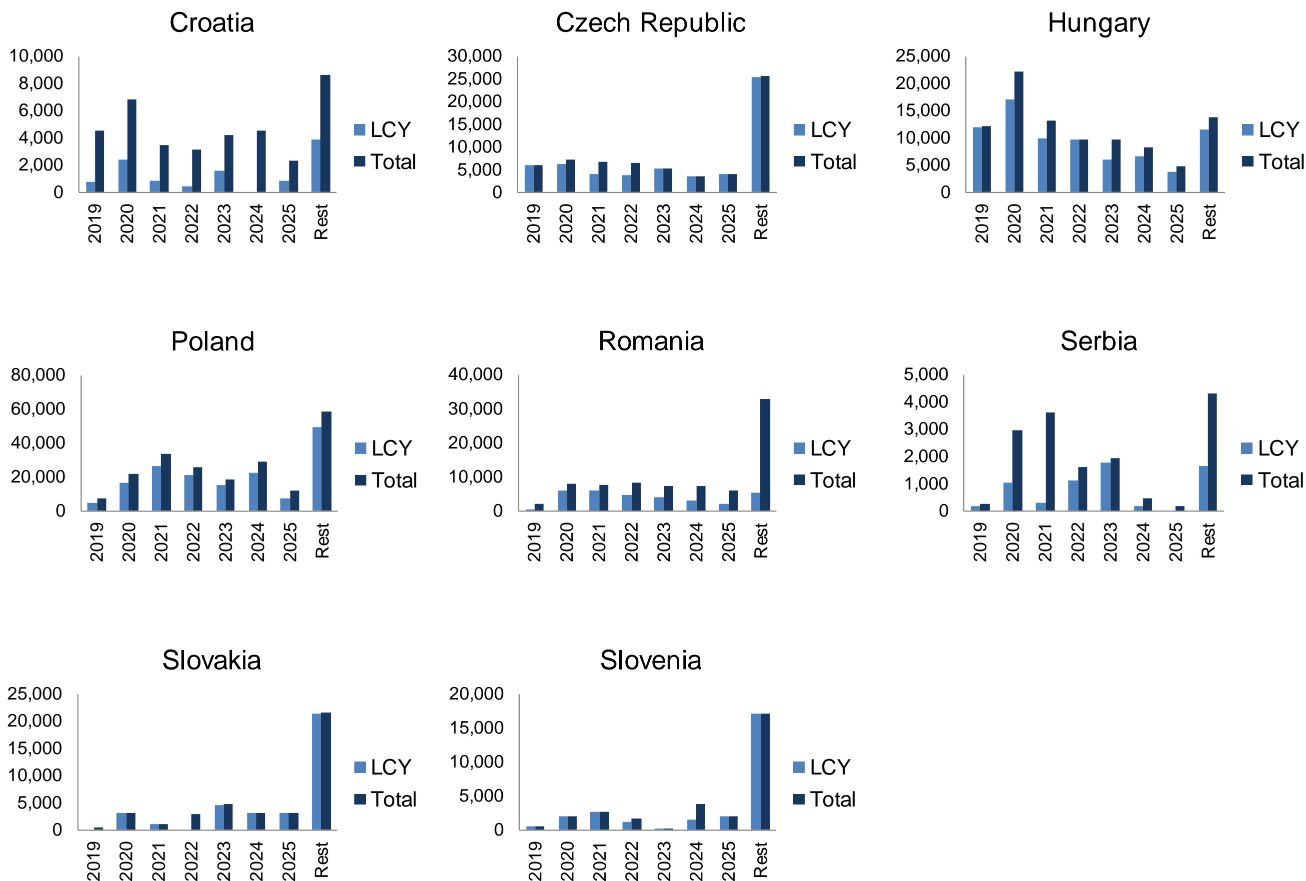
Annual redemptions in LCY and FX



Note: EURmn
Source: Bloomberg, Erste Group Research

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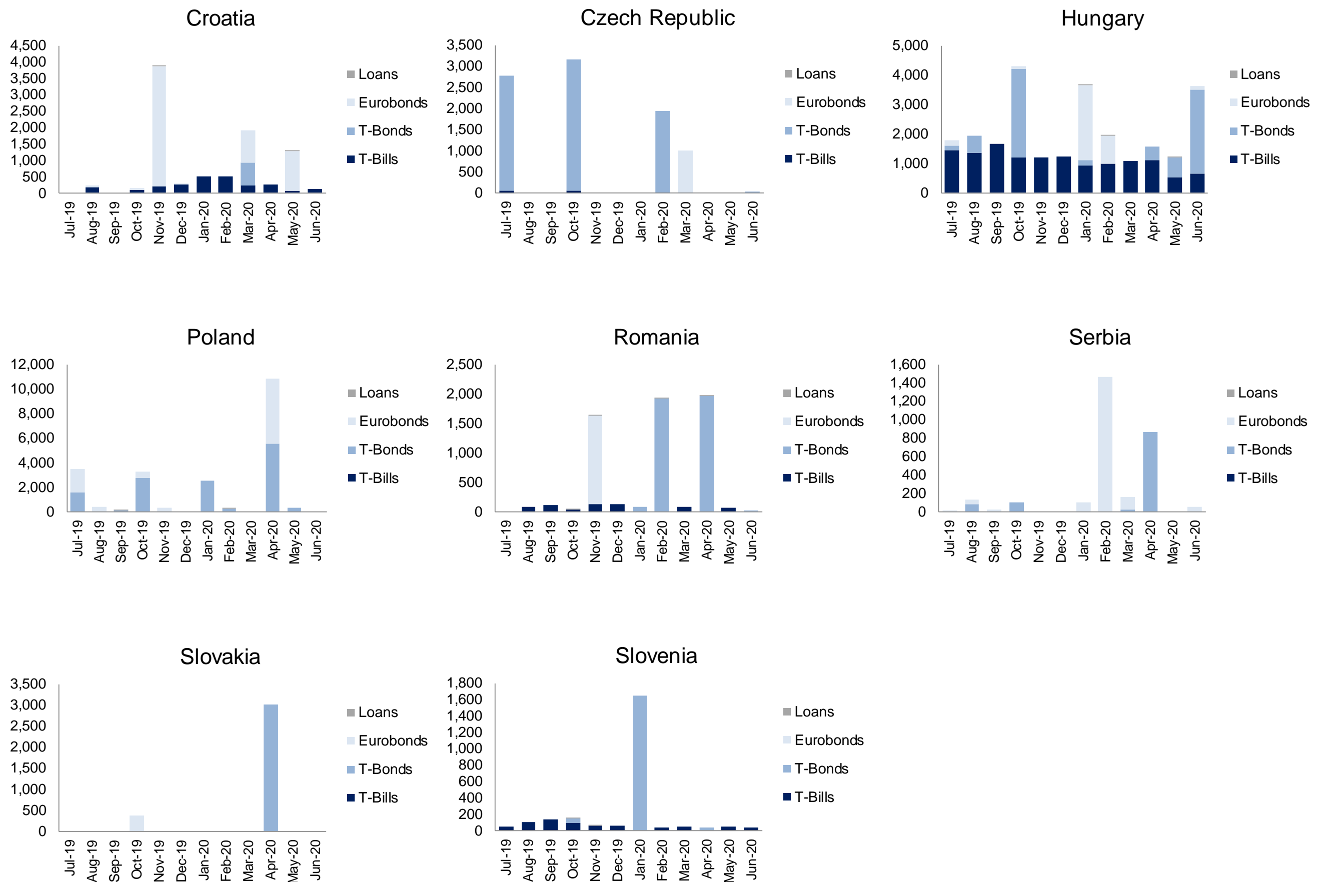
Redemptions in upcoming 12 months (monthly break-down)



Note: EURmn
Source: Bloomberg, Erste Group Research

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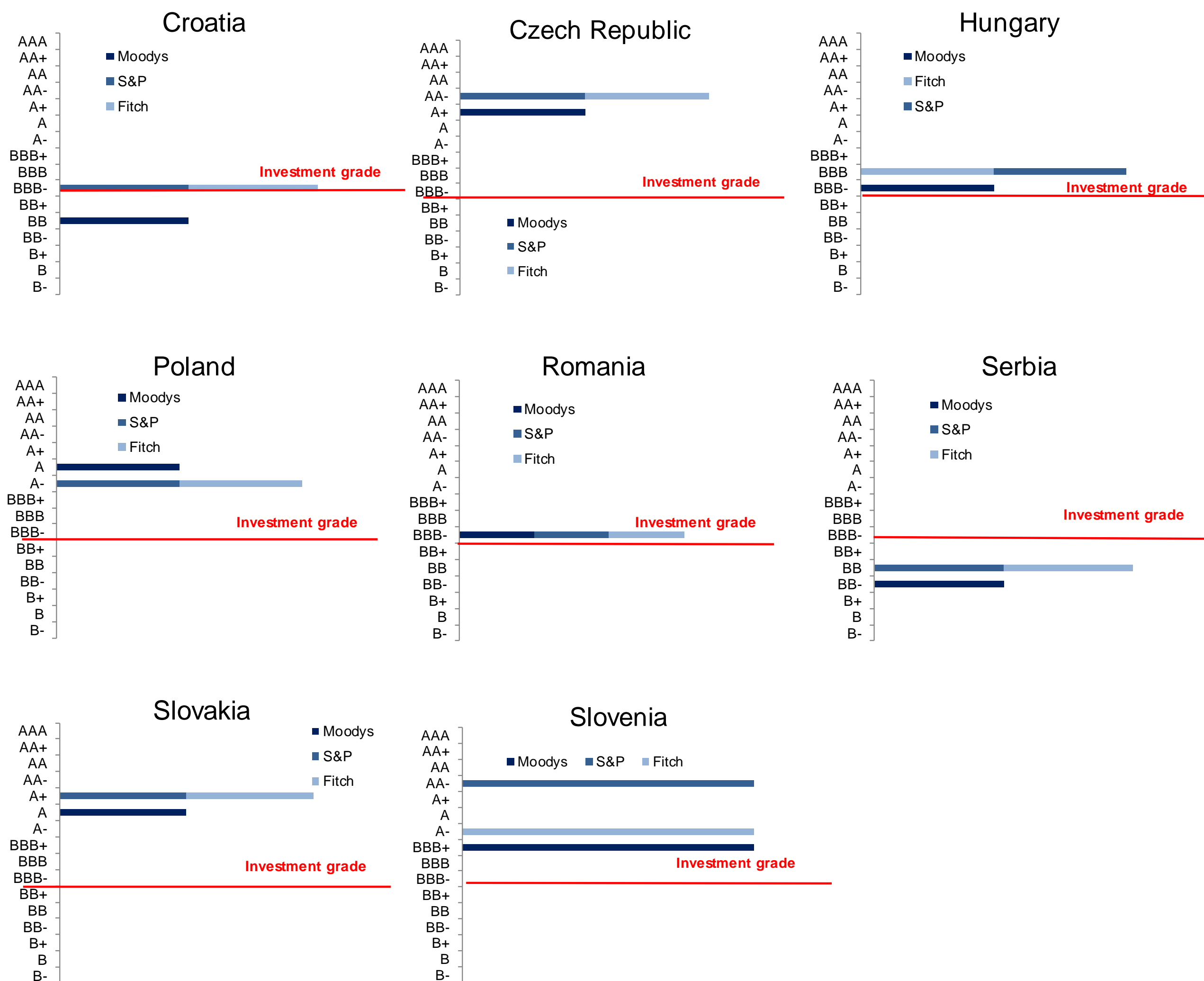
Credit ratings of sovereigns



Source: Bloomberg, Erste Group Research

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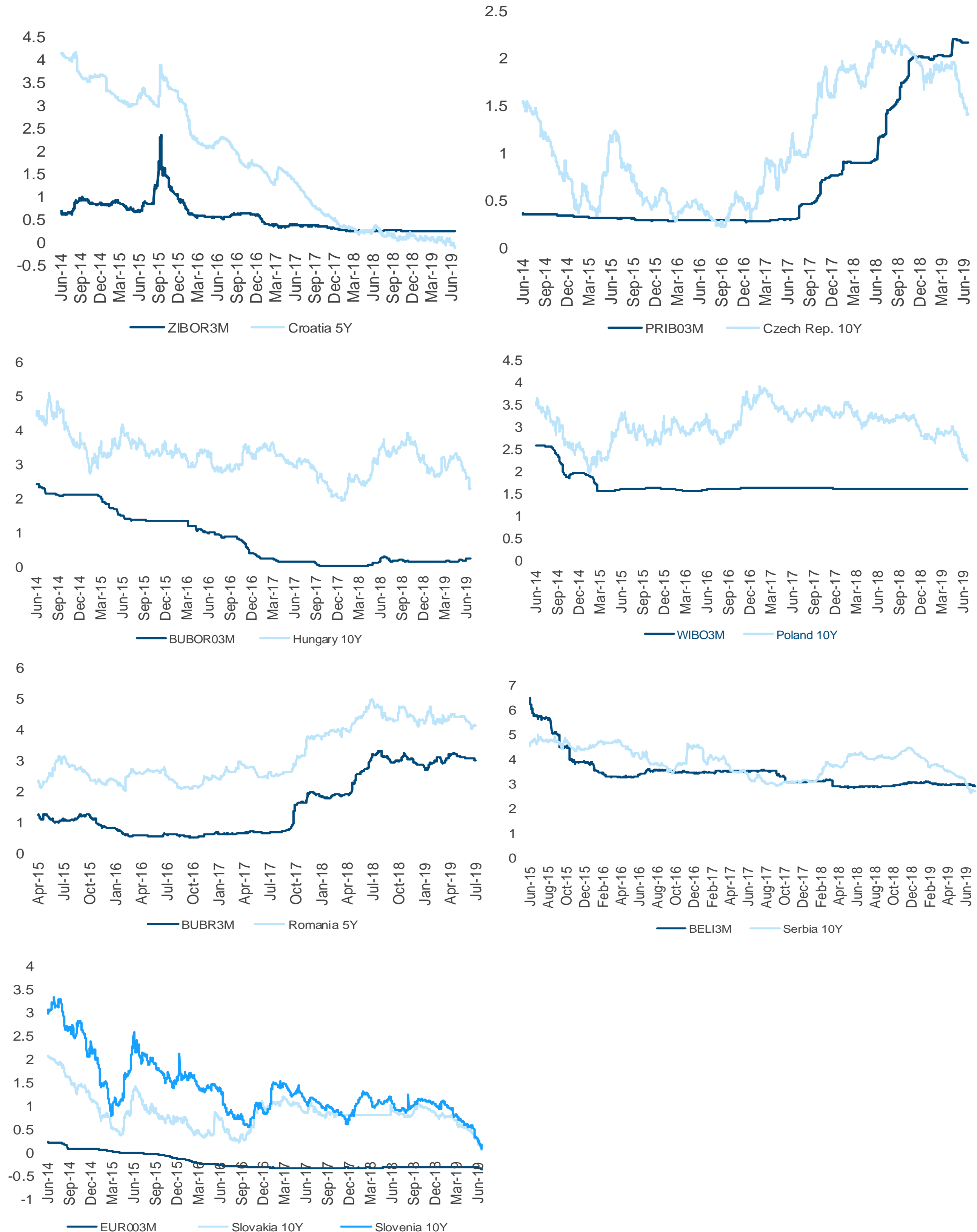
Appendix



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

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