

Fixed Income Weekly

FOR PROFESSIONAL INVESTORS

Investing in the EU Frontier

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Key takeaways

- Our recent trip to the sunny Balkans investigated a range of countries that, whilst in geographic proximity, stand each in their own individual realities and in some cases on opposing fundamental trajectories.
- Serbia has seen positive momentum after implementing successful structural reforms while Croatia's macro picture has improved but is still heavily dependent on tourism. And then there is Romania, which has experienced strong growth but appears to be a good story about to go bad.
- At present, we see stronger bond investment opportunities in the western Balkans.

Full commentary

Our recent trip to the sunny Balkans investigated a range of countries that, whilst in geographic proximity, stand each in their own individual realities and in some cases on opposing fundamental trajectories. We take Serbia, Croatia and Romania each in turn, examining both their investment opportunities and their risks. In short, we see stronger bond investment opportunities in the western Balkans at present.

Looking first at Serbia, the macro situation has surpassed even the most optimistic expectations and overall remains on a positive course. Successful structural reforms, linked to the International Monetary Fund's (IMF) engagement, as well as a rebound in economic activity as a spillover from core Europe, have resulted in the headline fiscal deficit falling from 7% of GDP in 2014 to 1.4% last year. The government is keen to maintain positive momentum aided by a follow-up IMF deal.

Perhaps counterintuitively, the structural adjustment has not prevented growth from recovering. Higher output is accompanied by stronger performance of the labor market where the private sector is not only absorbing reductions in the public sector but also creating additional new jobs. In 2017, an expected pick up in imports will reduce the contribution of trade to GDP but other sectors will be supportive.

In terms of meeting the country's financing needs, Serbia has mainly funded itself by issuing local securities in euros. Nonetheless they also continue to develop a local dinar-denominated yield curve and are looking for inclusion in the JPMorgan Government Bond Index-Emerging Markets (EMBI) as soon as next year.

Similarly, Croatia is a country whose macro picture has improved. Growth here has rebounded but, led by tourism, it is of a very different composition than in Serbia. With a current account surplus and a reduced fiscal deficit, increasingly in focus is the subject of whether Croatia will be able to join the Eurozone and adopt the euro. While it seems clear that both the central bank and the public would generally be in favor, it is far less obvious whether the political community would be supportive. For those in favor of accession, the main motivation is largely driven by the potential elimination of currency risk for both external debt and indexed domestic debt.

Although there is some uncertainty cast by political infighting, there are more significant challenges that currently present themselves to the country's economy. Having finally pulled out of a six-year recession, a dark cloud has been cast over the positive momentum by Agrokor, the country's largest retailer. Through mismanagement of debt, the company is facing a systemic crisis that will significantly impact a range of sectors in Croatia, including the banking sector. Although at this stage it remains unclear as to the extent to which specific institutions will be affected, the impact of the Agrokor crisis is estimated by the central bank to come to 0.4% of GDP.

Tourism has been boon to the country in part due to the misfortune of other tourist locales, such as Turkey or Egypt. Additionally, there has been a structural change in the nature of tourism with better quality hotels attracting wealthier visitors and foreign direct investment (FDI) strong in this sector. A caveat to this, however, is that the country needs to build its industrial base rather than growing into a Caribbean-style economy which is wholly reliant on tourism.

Romania, at first glance, appears like its western cousins. The country has strong growth and is offered sizable structural funds from EU succession, boasting a competitive economy after years of adjustment post-crisis. However, the current policy mix is negative from a credit perspective and the country currently appears to be a good story going bad.



This week's market developments

Monday, July 3

- Markit UK Manufacturing PMI decreased to 54.3 for June
- Markit US Manufacturing PMI decreased to 52.0 for June
- Eurozone unemployment rate remained at 9.3% in May
- US ISM manufacturing increased to 57.8 for June
- US construction spending growth increased to 0.0% m.o.m. (s.a.a.r) in May

Tuesday, July 4

- Markit/CIPS UK Construction PMI decreased to 54.8 in June

Wednesday, July 5

- Markit Eurozone Services PMI (final estimate) decreased to 55.4 in June
- Markit/CIPS UK Services PMI decreased to 53.4 in June
- US factory orders growth decreased to -0.8% m.o.m. (s.a.) in May
- US durable goods growth increased to -0.8% m.o.m. (s.a.) in May

Thursday, July 6

- Germany factory orders growth increased to 1.0% m.o.m. (s.a.) in May
- US ADP employment change decreased to 158,000 for June
- US ISM Non-manufacturing Composite increased to 57.4 in June

Friday, July 7

- Germany industrial production growth increased to 1.2% m.o.m. (s.a.) in May
- UK industrial production growth decreased to -0.1% m.o.m. (s.a.) in May
- UK manufacturing production growth decreased to -0.2% m.o.m. (s.a.) in May
- US change in nonfarm payrolls increased to 222,000 for June
- US unemployment rate increased to 4.4% in June

Source: Bloomberg, as of July 10, 2017



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In theory, the EU's institutional framework should act as a backstop to limit the pace of fiscal damage and eventually correct the direction of policy change. However, this will prove toothless in ex ante prevention of poor policy until deficit numbers are posted and EU safeguards kick in, if at all, and remains open to political considerations. In the meantime, Romania appears set to push ahead with pro-cyclical fiscal stimulus, which will manifest itself as well in a deteriorating external balance.

Alongside this, poor absorption of EU structural funds stemming from an unstable political situation may put additional pressure on the credit as well as the issue of investment being curtailed to allow for higher current expenditure.

Ultimately, we fear we know how this story ends. Crowding out of the private sector lifts interest rates, which further chokes off productive investment and scares away bond investors. The currency which could fundamentally underperform on account of higher inflation may also suffer from a portfolio outflow wave. Romania's saving grace is its low public debt levels and we can only hope this remains the case after its current fiscal extravagance is unwound.

 **Map of the Week**
EU Frontiers



Next week's market developments

Monday, July 10

- Japan PPI growth is expected to decrease to 2.0% y.o.y. in June

Tuesday, July 11

- Japan Tertiary Industry Index growth is expected to decrease to 0.5% m.o.m. in May
- UK ILO unemployment rate is expected to remain at 4.6% in May
- Eurozone industrial production growth is expected to increase to 1.0% m.o.m. in May

Wednesday, July 12

- US PPI final demand growth is expected to remain at 0.0% m.o.m. in May

Thursday, July 13

- US CPI growth is expected to increase to 0.1% m.o.m. in June

Friday, July 14

- US retail sales advance growth is expected to increase to 0.1% m.o.m. in June
- US industrial production growth is expected to increase to 0.3% m.o.m. in June

Source: Bloomberg, as of July 10, 2017

 **Central Bank Watch**

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on September 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	June 14, 2017	1.00% - 1.25%	1.17%	July 26
ECB	-5 basis points	March 10, 2016	0.00%	-0.18%	July 20
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.03%	July 20
BoE	-25 basis points	August 4, 2016	0.25%	0.37%	August 3

Source: Bloomberg, July 10, 2017

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