What's up in CEE?

- Global and not local politics will be decisive for CEE in 2017
- Inflation will increase in 1Q17 only but cool thereafter
- EU funds to drive investments up again next year
- Fiscal expansion in Romania and Poland will reach limits

Juraj Kotian
Head of CEE Macro/FI Research
juraj.kotian@erstegroup.com

Zoltan Arokszallasi
Chief Analyst, CEE Macro/FI Research
zoltan.arokszallasi@erstegroup.com

When trying to ascertain what events could be decisive next year for CEE, we can see a relative scarcity of exact events. On the political front, global events - and not local, CEE ones - could be decisive. Elections will come in France, the Netherlands and Germany that could entail risks for CEE, too, while snap elections elsewhere in Europe could also occur. Elections are only scheduled in the Czech Republic, but the country's economy has always been rather immune to political changes. While we see Euroskepticism as high in many parts of CEE as well, the popularity of EU membership is still solid and has been increasing in some CEE countries in the last few months. Still, global political uncertainty will limit the gains of CEE fixed assets.

A key factor in recent years has been the rather low level of inflation for CEE, which is currently changing, mostly due to the changing dynamics in the oil price. Due to this, we see inflation going up strongly in the coming months, but the factor stemming from the oil price should fade later on; for the remainder of 2017, inflation should not accelerate too much further. Although domestic demand is picking up, imported inflation is still rather muted in CEE.

Investments have been a drag in CEE in 2016, mainly due to the major slowdown in EU fund inflows. This should reverse next year. Therefore, in most CEE countries, investments could be a positive driver of GDP growth.

Although Hungary seems to also be aggressively easing its fiscal stance lately, we see Poland and Romania at the limit as far as the 3% of GDP nominal Maastricht threshold is concerned. Their fiscal policies in 2016 are especially to blame. While the deficit in both countries could end below 3% of GDP in 2016, the margin will be very tiny and some counter-measures will definitely need to be adopted to keep the deficit below 3% of GDP in 2017.

A major factor affecting Czech markets has been the FX cap, which has been in place since late 2013 to keep the EURCZK above 27 in an otherwise free-floating regime. We expect that economic and political uncertainties in the EU will lead to postponement of the exit from this regime until the end of 2017, but we also believe that the CNB will prevent the exchange rate from significant appreciation via a small amount of interventions, and thus without there being any need to cut rates to negative territory.

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Country macro outlooks*

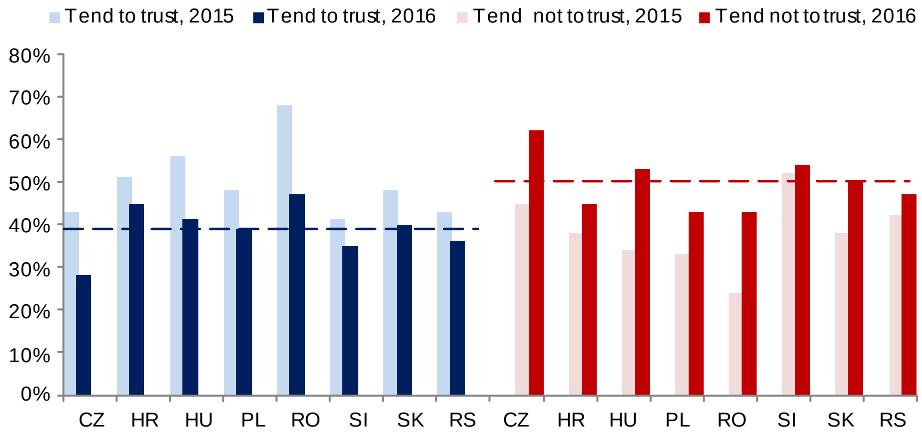
* The updated macro outlook for the Czech Republic will likely be published next week.

Five most important factors affecting CEE in 2017

1) Politics – global, not local

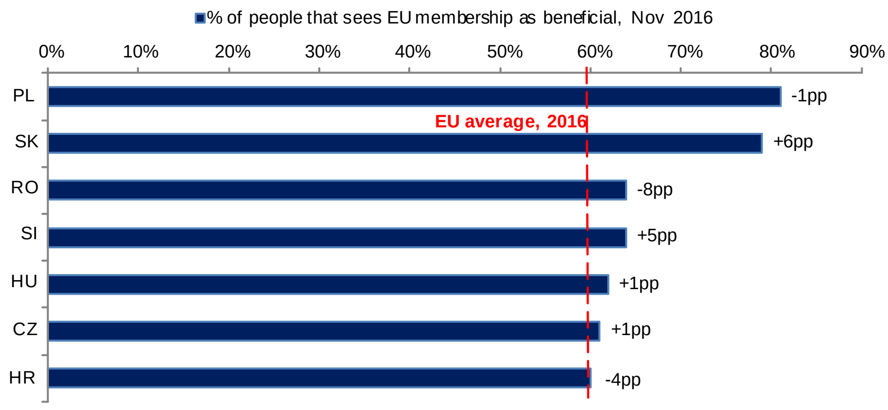
On the political front, international rather than domestic politics will mainly affect CEE countries in 2017. A string of events starting with elections in France, the Netherlands and Germany will keep risk aversion at an elevated level. On top of that, we cannot rule out snap elections in Italy and the UK government is about to trigger Article 50 and thus kick the can down the road. Global political uncertainty and especially the threat of further fragmentation of the EU will limit the gains of CEE fixed assets (bonds, currencies). The Czech economy has always been immune against the domestic political cycle and thus the general elections that will take place in October (the precise date is not known yet) will not be a game changer. As in Western Europe, non-standard or soft Eurosceptic parties have been on a slight upward trend, benefiting from "criticizing Brussels" for a lack of leadership and mismanagement of the migration crisis. On the other hand, the popularity of EU membership itself is still very strong in CEE and hardly any relevant political party (even soft Eurosceptic) questions it.

Trust to EU (leadership) deteriorated significantly over the last year



Source: Erste Group Research, Eurobarometer

People in CEE still see EU membership as beneficial

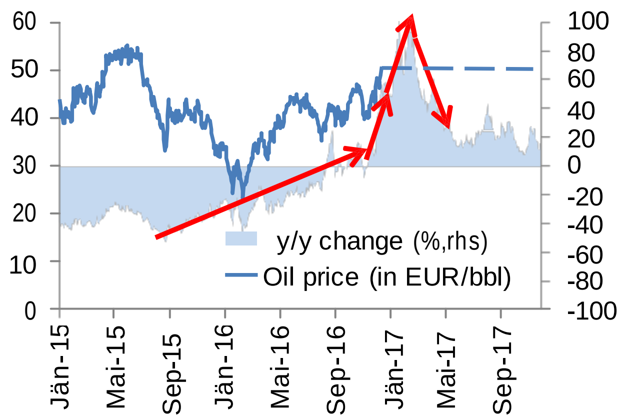


Source: Erste Group Research, Eurobarometer

2) Inflation to rapidly increase in 1Q17 but to cool thereafter

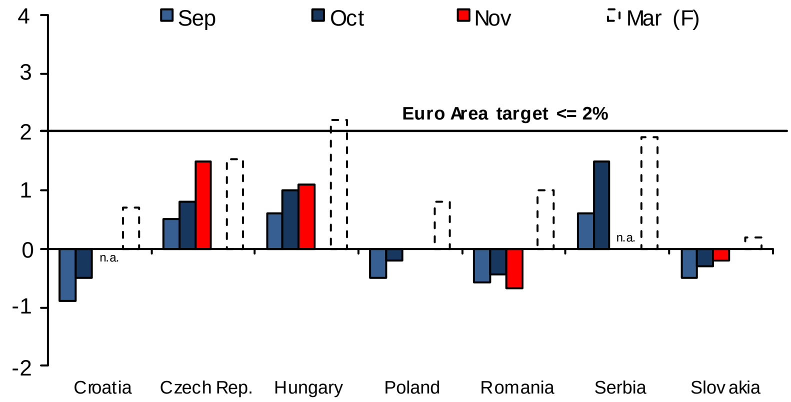
Inflation had already started going up in recent months and we expect it to continue to increase in the early months of 2017, thus completely ending the multi-year period of deflation recently seen in many CEE countries. Until end-1Q17, the oil price is likely to exert increasingly strong upward pressure on y/y inflation – not because of the recent OPEC decision, but because of very low oil prices a year ago. This base effect will cause a spike in inflation in March 2017, but the effect will quickly fade, causing inflation to lose momentum after March. In countries with tightened labor markets (like the Czech Republic and Hungary), we might see some upward pressure on prices stemming from higher wage growth and inflation approaching the inflation target range. In other countries, we see inflation undershooting the inflation target. Overall, we see inflation averaging 1.3% in 2017 for CEE, vs. -0.4% in 2016. We do not expect any central bank in CEE to tighten its monetary policy in 2017.

Oil price will increase inflation strongly only in the beginning of next year



Source: Bloomberg

Forecasted increase of inflation rate in 1Q17



Source: Erste Group Research, Bloomberg

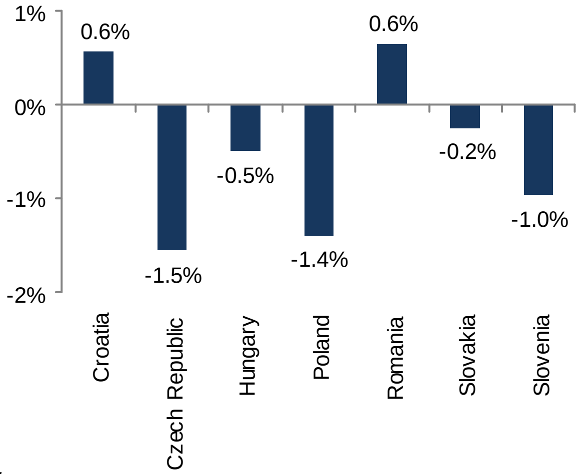
3) Investments up again

A large change in the GDP growth composition in 2017 will come from investments. In 2016, investment growth turned negative as a consequence of the strong base effect caused by record-high net EU funds inflow in 2015. YTD net EU funds inflow went down by 1/3 in 2016 in CEE, but should not deteriorate further in 2017. The base effect will fade in the first months of 2017 (in Slovakia, the effect will be delayed by several months due to its later peak), thus enabling investments to remain neutral or positively contribute to growth. After declines in investment in several countries in 2016, mostly due to the above factors (Croatia, Hungary, Poland, Slovakia, Slovenia), investments are to grow in all countries in our region. Growth of fixed capital formation should hover between 3.4-7.0% next year in CEE.

Growth of gross fixed capital formation, percent, 2015-17

Source: Erste Group Research

Change in YTD net EU funds inflow as %of GDP (Jan-Sep 2016 vs. Jan-Sep 2015)



Source: Eurostat

4) Fiscal expansion in Romania and Poland to reach limits

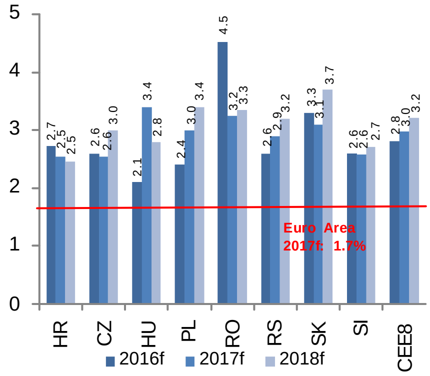
While the fiscal situation has improved a lot for many CEE countries and all CEE countries except for Serbia cut their deficit below 3% of GDP, we see Romania and Poland as having very limited fiscal space to maneuver in 2017. Their fiscal policies in 2016 are especially to blame, as these resulted in unprecedented fiscal loosening (Romania), or an ambitious social spending program insufficiently covered by regular tax revenues (Poland). While the deficit in both countries could end below 3% of GDP in 2016, the margin will be very tiny and some counter measures will definitely need to be adopted in order to keep the deficit below 3% of GDP in 2017. While we do not expect the EC in its May assessment to recommend that the Council put Poland and Romania under the Excessive Deposit Procedure in 2017, there will be an explicit warning of this in 2018 unless corrective measures are taken. On the other hand, Croatia will likely be abrogated from the Excessive Deficit Procedure in June.

5) CNB to exit from currency cap

We think that the CNB will abandon its policy of an FX cap in 2017; this has been in place since 2013 and has helped to contain deflationary pressures resulting from the potential appreciation of the CZK. We expect that economic and political uncertainties in the EU will lead to postponement of the exit until the end of 2017. We believe that the CNB will prevent the exchange rate from significant appreciation via a small amount of interventions and thus without there being any need to cut rates to negative territory. The market is overly long in CZK and short in EUR, which means that many investors might seek an opportunity to close their position right after the initial gain of the CZK, thereby stabilizing the currency. We expect the CNB to allow gradual appreciation of the CZK vs. the EUR (approx. 1.5-2% per annum) over the next few years.

Real economy

Real GDP growth (y/y, percent)



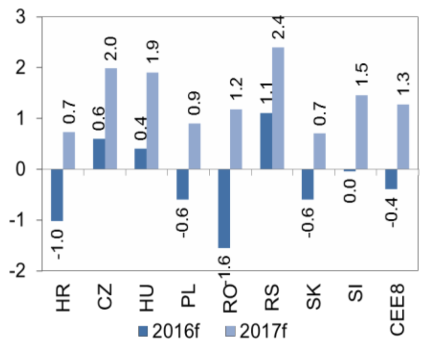
Source: Erste Group Research

Growth in the third quarter showed a slowdown in CEE vs. the second quarter. Industrial production was showing unexpected weakness in several countries, while EU-funded investments have still not picked up after strong growth in 2015. Household consumption continues to be the backbone of overall growth in CEE, as wage growth and increasing employment are still strengthening the purchasing power of households. Compared to actual data, growth surprised to the downside in Poland (at just 2.5%), in the Czech Republic (1.9%) and in Romania (4.4%, but we had expected 5.2% due to fiscal easing). On a positive note, we can see improving economic conditions in Croatia and Serbia. The recently ailing Croatia expanded 2.7% (y/y), while Serbia expanded 2.6%. Due to the downside surprise in Poland, we cut our forecast for average growth to just 2.4% for 2016, and to 3.0% for next year.

In 2017, growth should actually be a shade higher (3.0%) than the level expected in 2016 (2.8%), as EU-funded investments should pick up somewhat, while some countries in CEE continue to pursue fiscal relaxation (especially Romania and Hungary).

Inflation

Average inflation (percent)

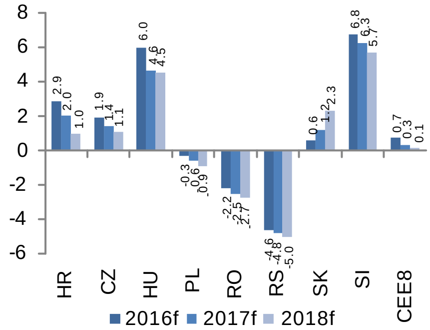


Source: Erste Group Research

Annual inflation numbers have started to go up everywhere in the last few months, as the base effect stemming from oil prices started to exert upward pressures instead of the former, downward pull. Until end-1Q17, the oil price is likely to exert increasingly strong upward pressure on inflation. However, the oil price (unless there is a longer-run upward trend starting) is not very likely to cause a similar effect later next year. As for other factors, the increase in wages and strengthening household consumption are also contributing to an increase in prices – although core inflation is still rather muted everywhere and falls short of central bank targets. Imported disinflation is still a factor for CEE countries. We see inflation averaging 1.3% next year for CEE, vs. -0.4% this year.

External balance

Current account (% of GDP)

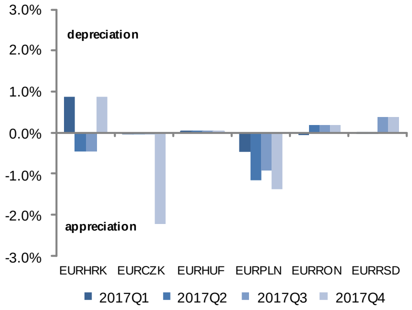


Source: Eurostat, Erste Group Research

External balances show a rather divergent pattern in the region: while Slovenia (6.0% of GDP) and Hungary (4.6% of GDP) are expected to boast significant surpluses in the current account balance, other countries (Croatia, the Czech Republic, Slovakia) are showing a much milder surplus. In addition, Poland is to show a mild deficit, while Romania and Serbia are to show a more pronounced deficit in the current account. Overall in the CEE countries, we expect the current account to show a mild surplus. As household consumption is to grow further, we expect a slight, but general deterioration in current account positions, with Romania having risks due to hefty fiscal relaxation that could contribute to significant deterioration in the current account.

Currency outlook

Expected changes in exchange rates (relative to close on Dec 9th)



Source: Bloomberg, Erste Group Research

CEE currencies have been on a slide after the election of Donald Trump as US president. Looking forward, current exchange rates are not far from our year-end forecasts, while we also do not see any huge trend in exchange rate developments next year. Although our point estimates do not suggest strong swings, we think that the Hungarian forint and Polish zloty could experience bouts of volatility. In Hungary, the Central Bank's actions (trying to push liquidity out of its balance sheet) could contribute to swings, while in Poland, risks tied to policymaking could continue to unnerve investors, albeit the higher carry helps the PLN. In Romania, it remains to be seen what policies the freshly-elected government could pursue, but in the absence of fiscal countermeasures, we could not rule out some volatility on the leu's market. In the Czech Republic, we think that exit from the FX regime will come in 4Q17 at the earliest; the CNB is expected to keep appreciation pressures burdened at around a maximum of 2% after exit.

Monetary assessment

Despite our expectations for increasing inflation, we do not see central banks as being likely to react too quickly with tightening. Negative real rates could also be the normal course of business on major markets (US, euro area), which could make it unnecessary to hike in CEE in the coming months. As a matter of fact, due to the Hungarian Central Bank's actions, there is a risk of a further decrease in short-term interest rates there. Elsewhere, policy rates (which are better anchors for markets than in Hungary) could be kept unchanged.

Bond market outlook

After the victory of Donald Trump, it soon became evident that our former yield forecasts for CEE for year-end 2016 cannot be maintained. We increased our forecasts by roughly 20-50 basis points for the region for end-2016 and for 1Q17 for 10Y bonds. Forecasts for the longer run, however, depend heavily on global market developments. The exact policies of Trump and the outcome of the upcoming political minefield in Europe (with the aftermath of the Italian referendum, and the Dutch, French and German elections in 2017) will be crucial. Spreads over Bunds have also widened too much immediately after the election results in the US, in our view, especially in Hungary and in Poland. On the other hand, we see some upward risks to our forecasts in Croatia.

Capital market forecasts

Government bond yields	current	2017Q1	2017Q2	2017Q3	2017Q4
Croatia 10Y	3.02	3.00	2.90	2.80	2.80
spread (bps)	270	266	250	231	217
Czech Rep. 10Y	0.49	0.67	0.47	0.48	0.49
spread (bps)	16	33	7	-1	-14
Hungary 10Y	3.32	3.21	3.08	3.05	3.05
spread (bps)	300	287	268	256	242
Poland 10Y	3.51	3.40	3.25	3.20	3.35
spread (bps)	318	306	285	271	272
Romania10Y	3.57	3.60	3.65	3.70	3.75
spread (bps)	325	326	325	321	312
Slovakia 10Y	1.02	1.10	1.20	1.25	1.30
spread (bps)	69	76	80	76	67
Slovenia 10Y	0.96	1.10	1.10	1.20	1.30
spread (bps)	63	76	70	71	67
Serbia 7Y	5.68	5.50	5.50	5.50	5.50
DE10Y (BBG)*	***0.32***	***0.34***	***0.40***	***0.49***	***0.63***

3M Money Market Rate	current	2017Q1	2017Q2	2017Q3	2017Q4
Croatia	0.85	0.75	0.70	0.70	0.70
3M forwards		-	-	-	-
Czech Republic	0.29	0.28	0.28	0.27	0.27
3M forwards		0.29	0.27	0.25	0.24
Hungary	0.39	0.50	0.50	0.50	0.50
3M forwards		0.40	0.45	0.51	0.59
Poland	1.73	1.70	1.73	1.73	1.75
3M forwards		1.79	1.81	1.84	1.88
Romania	0.80	0.85	1.00	1.05	1.10
3M forwards		0.99	1.03	1.33	2.04
Serbia	3.45	3.50	3.50	3.50	3.50
3M forwards		-	-	-	-
Eurozone	-0.32	-0.25	-0.25	-0.25	-0.25

FX	current	2017Q1	2017Q2	2017Q3	2017Q4
EURHRK	7.52	7.60	7.50	7.50	7.60
forwards		7.55	7.58	7.61	7.63
EURCZK	27.02	27.02	27.02	27.02	26.43
forwards		26.94	26.87	26.79	26.73
EURHUF	314.8	315.0	315.0	315.0	315.0
forwards		315.6	316.2	316.8	317.5
EURPLN	4.44	4.43	4.40	4.41	4.39
forwards		4.47	4.50	4.52	4.54
EURRON	4.52	4.50	4.51	4.51	4.51
forwards		4.53	4.55	4.57	4.59
EURRSD	123.5	123.5	123.5	124.0	124.0
forwards		-	-	-	-
EURUSD	1.06	1.06	1.08	1.10	1.12

Key Interest Rate	current	2017Q1	2017Q2	2017Q3	2017Q4
Croatia	0.50	0.30	0.30	0.30	0.30
Czech Republic	0.05	0.05	0.05	0.05	0.05
Hungary	0.90	0.90	0.90	0.90	0.90
Poland	1.50	1.50	1.50	1.50	1.50
Romania	1.75	1.75	1.75	1.75	1.75
Serbia	4.00	4.00	4.00	4.00	4.00
Eurozone	0.00	0.00	0.00	0.00	0.00

Real GDP growth (%)	2015	2016f	2017f	2018f
Croatia	1.6	2.7	2.5	2.5
Czech Republic	4.6	2.6	2.6	3.0
Hungary	3.1	2.1	3.4	2.8
Poland	3.9	2.4	3.0	3.4
Romania	3.8	4.5	3.2	3.3
Serbia	0.8	2.7	3.0	3.3
Slovakia	3.8	3.3	3.1	3.7
Slovenia	2.3	2.6	2.6	2.7
CEE8 average	**3.7**	**2.8**	**3.0**	**3.2**

Average inflation (%)	2015	2016f	2017f	2018f
Croatia	-0.5	-1.0	0.7	1.2
Czech Republic	0.3	0.6	2.0	1.9
Hungary	-0.1	0.4	1.9	3.0
Poland	-0.9	-0.6	0.9	1.4
Romania	-0.6	-1.6	1.2	2.0
Serbia	1.7	1.1	2.4	3.1
Slovakia	-0.3	-0.6	0.7	2.0
Slovenia	-0.5	0.0	1.5	1.9
CEE8 average	**-0.4**	**-0.4**	**1.3**	**1.8**

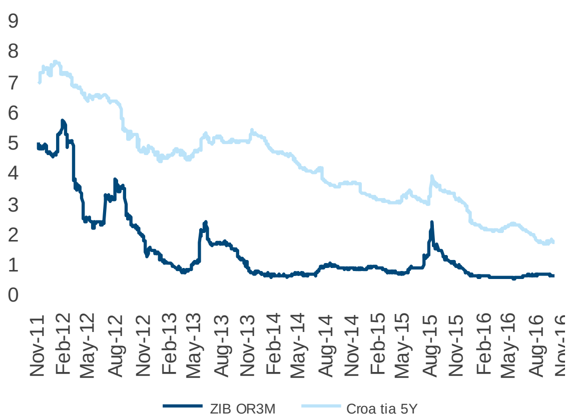
Unemployment (%)	2015	2016f	2017f	2018f
Croatia	16.3	15.3	14.1	13.4
Czech Republic	5.1	4.2	4.3	4.2
Hungary	6.8	5.2	4.5	4.5
Poland	10.6	9.2	8.7	8.5
Romania	6.8	6.7	6.8	6.7
Serbia	17.7	16.0	15.6	15.2
Slovakia	11.5	9.8	9.2	8.3
Slovenia	9.0	8.0	7.5	6.9
CEE8 average	**9.3**	**8.1**	**7.7**	**7.4**

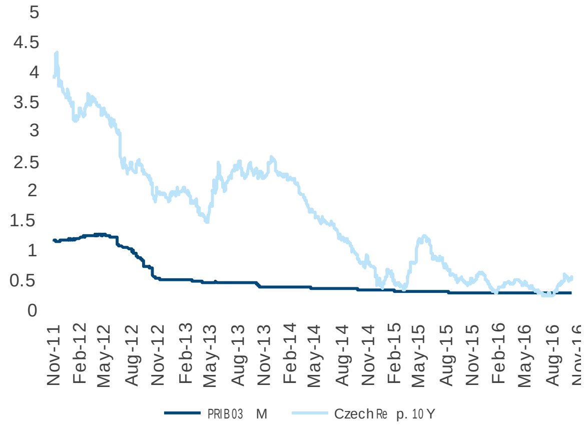
Public debt (% of GDP)	2015	2016f	2017f	2018f
Croatia	86.7	86.0	84.6	83.3
Czech Republic	40.3	37.2	36.0	36.4
Hungary	74.7	74.3	74.0	72.5
Poland	51.5	51.9	52.4	52.1
Romania	38.4	40.4	41.8	42.3
Serbia	74.7	73.8	73.0	72.6
Slovakia	52.7	52.6	52.7	51.8
Slovenia	83.4	80.0	79.1	77.5
CEE8 average	**53.7**	**53.3**	**53.3**	**53.0**

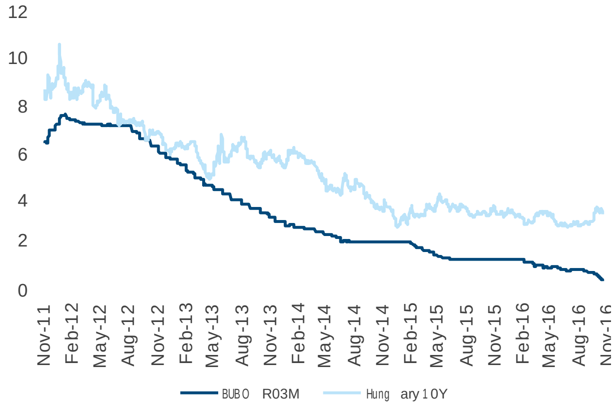
C/A (%GDP)	2015	2016f	2017f	2018f
Croatia	5.1	2.9	2.0	1.0
Czech Republic	0.9	1.9	1.4	1.1
Hungary	3.4	6.0	4.6	4.5
Poland	-0.2	-0.3	-0.6	-0.9
Romania	-1.1	-2.2	-2.5	-2.7
Serbia	-4.8	-4.2	-4.6	-4.8
Slovakia	-1.3	0.6	1.2	2.3
Slovenia	5.2	6.8	6.3	5.7
CEE8 average	**0.4**	**0.7**	**0.3**	**0.1**

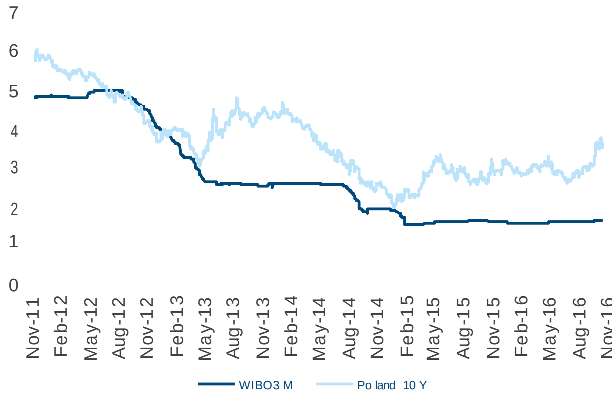
Budget Balance (%GDP	2015	2016f	2017f	2018f
Croatia	-3.2	-1.7	-2.2	-2.0
Czech Republic	-0.4	0.5	0.2	-0.2
Hungary	-2.0	-2.2	-2.7	-2.5
Poland	-2.5	-2.5	-3.0	-2.9
Romania	-0.7	-2.9	-3.0	-3.0
Serbia	-3.8	-2.1	-1.9	-1.7
Slovakia	-2.7	-2.2	-1.5	-1.2
Slovenia	-2.9	-2.5	-2.0	-1.7
CEE8 average	**-2.0**	**-2.0**	**-2.2**	**-2.2**

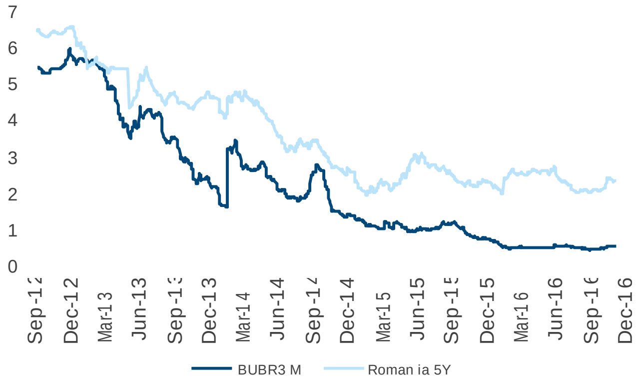
Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

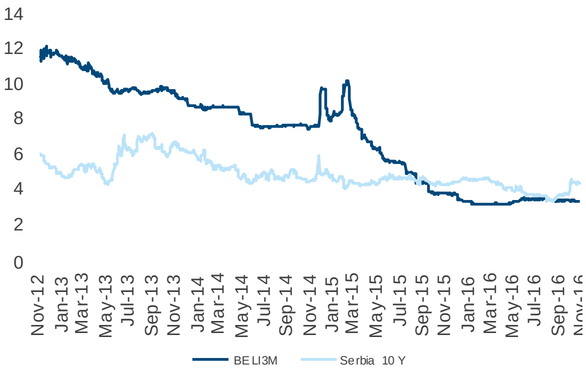


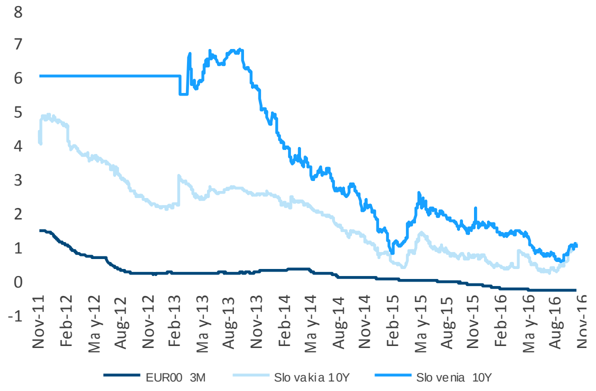












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Contacts Group Research

Head of Group Research	
Friedrich Mostböck, CEFA	+43 (0)5 0100 11902
Major Markets & Credit Research	
Head: Gudrun Egger, CEFA	+43 (0)5 0100 11909
Ralf Burchert, CEFA (Agency Analyst)	+43 (0)5 0100 16314
Hans Engel (Senior Analyst Global Equities)	+43 (0)5 0100 19835
Christian Enger, CFA (Covered Bonds)	+43 (0)5 0100 84052
Margarita Grushanina (Economist AT, CHF)	+43 (0)5 0100 11957
Peter Kaufmann, CFA (Corporate Bonds)	+43 (0)5 0100 11183
Stephan Lingnau (Global Equities)	+43 (0)5 0100 16574
Carmen Riefler-Kowarsch (Covered Bonds)	+43 (0)5 0100 19632
Rainer Singer (Senior Economist Euro, US)	+43 (0)5 0100 17331
Bernadett Povazsai-Römhild (Corporate Bonds)	+43 (0)5 0100 17203
Elena Statelov, CIIA (Corporate Bonds)	+43 (0)5 0100 19641
Gerald Walek, CFA (Economist Euro)	+43 (0)5 0100 16360
Katharina Böhm-Klamt (Quantitative Analyst Euro)	+43 (0)5 0100 19632
Macro/Fixed Income Research CEE	
Head CEE: Juraj Kotian (Macro/FI)	+43 (0)5 0100 17357
Zoltan Arokszallasi, CFA (Fixed income)	+43 (0)5 0100 18781
Katarzyna Rzentarzewska (Fixed income)	+43 (0)5 0100 17356
CEE Equity Research	
Head: Henning Eßkuchen	+43 (0)5 0100 19634
Daniel Lion, CIIA (Technology, Ind. Goods&Services)	+43 (0)5 0100 17420
Christoph Schultes, MBA, CIIA (Real Estate)	+43 (0)5 0100 11523
Vera Sutedja, CFA, MBA (Telecom)	+43 (0)5 0100 11905
Thomas Unger, CFA (Banks, Insurance)	+43 (0)5 0100 17344
Vladimira Urbankova, MBA (Pharma)	+43 (0)5 0100 17343
Martina Valenta, MBA (Real Estate)	+43 (0)5 0100 11913
Editor Research CEE	
Brett Aarons	+420 956 711 014
Research Croatia/Serbia	
Head: Mladen Dodig (Equity)	+381 11 22 09178
Head: Alen Kovac (Fixed income)	+385 72 37 1383
Anto Augustinovic (Equity)	+385 72 37 2833
Milan Deskar-Skrbic (Fixed income)	+385 72 37 1349
Magdalena Dolenec (Equity)	+385 72 37 1407
Ivana Rogic (Fixed income)	+385 72 37 2419
Davor Spoljar, CFA (Equity)	+385 72 37 2825
Research Czech Republic	
Head: David Navratil (Fixed income)	+420 956 765 439
Head: Petr Bartek (Equity)	+420 956 765 227
Jiri Polansky (Fixed income)	+420 956 765 192
Pavel Smolik (Equity)	+420 956 765 434
Jan Sumbera (Equity)	+420 956 765 218
Roman Sedmera (Fixed income)	+420 956 765 391
Jana Urbankova (Fixed income)	+420 956 765 456
Research Hungary	
Head: József Miró (Equity)	+361 235 5131
Gergely Ürmössy (Fixed income)	+361 373 2830
András Nagy (Equity)	+361 235 5132
Orsolya Nyeste (Fixed income)	+361 268 4428
Tamás Pletser, CFA (Oil&Gas)	+361 235 5135
Research Poland	
Head: Magdalena Komaracka, CFA (Equity)	+48 22 330 6256
Marek Czachor (Equity)	+48 22 330 6254
Tomasz Duda (Equity)	+48 22 330 6253
Mateusz Krupa (Equity)	+48 22 330 6251
Karol Brodziński (Equity)	+48 22 330 6252
Research Romania	
Head: Mihai Caruntu (Equity)	+40 3735 10427
Head: Dumitru Dulgheru (Fixed income)	+40 3735 10433
Chief Analyst: Eugen Sinca (Fixed income)	+40 3735 10435
Dorina Ilasco (Fixed Income)	+40 3735 10436
Research Slovakia	
Head: Maria Valachyova, (Fixed income)	+421 2 4862 4185
Katarina Muchova (Fixed income)	+421 2 4862 4762
Research Turkey	
Umut Ozturk (Equity)	+90 212 371 25 30
Oguzhan Evranos (Equity)	+90 212 371 25 42

Treasury - Erste Bank Vienna

Group Markets Retail Sales	
Head: Christian Reiss	+43 (0)5 0100 84012
Markets Retail a. Sparkassen Sales AT	
Head: Markus Kaller	+43 (0)5 0100 84239
Equity a. Fund Retail Sales	
Head: Kurt Gerhold	+43 (0)5 0100 84232
Fixed Income a. Certificate Sales	
Head: Uwe Kolar	+43 (0)5 0100 83214
Markets Corporate Sales AT	
Head: Christian Skopek	+43 (0)5 0100 84146

Fixed Income Institutional Sales

Group Markets Financial Institutions	
Head: Manfred Neuwirth	+43 (0)5 0100 84250
Bank and Institutional Sales	
Head: Jürgen Niemeier	+49 (0)30 8105800 5503
Institutional Sales Western Europe AT, GER, FRA, BENELUX	
Head: Thomas Almen	+43 (0)5 0100 84323
Charles-Henry de Fontenilles	+43 (0)5 0100 84115
Marc Pichler	+43 (0)5 0100 84118
Rene Klasen	+49 (0)30 8105800 5521
Dirk Seefeld	+49 (0)30 8105800 5523
Bernd Bollhof	+49 (0)30 8105800 5525
Bank and Savingsbanks Sales	
Head: Marc Friebertshäuser	+49 (0)711 810400 5540
Sven Kienzle	+49 (0)711 810400 5541
Michael Schmotz	+43 (0)5 0100 85542
Ulrich Inhofner	+43 (0)5 0100 85544
Martina Fux	+43 (0)5 0100 84113
Michael Konczer	+43 (0)5 0100 84121
Klaus Vosseler	+49 (0)711 810400 5560
Andreas Goll	+49 (0)711 810400 5561
Mathias Gindele	+49 (0)711 810400 5562
Institutional Sales CEE and International	
Head: Jaromir Malak	+43 (0)5 0100 84254
Central Bank and International Sales	
Head: Margit Hraschek	+43 (0)5 0100 84117
Christian Kössler	+43 (0)5 0100 84116
Bernd Thaler	+43 (0)5 0100 84119
Institutional Sales PL and CIS	
Pawel Kielek	+48 22 538 6223
Michal Jarmakowicz (Fixed Income)	+43 50100 85611
Institutional Sales Slovakia	
Head: Peter Kniz	+421 2 4862 5624
Monika Smelikova	+421 2 4862 5629
Institutional Sales Czech Republic	
Head: Ondrej Cech	+420 2 2499 5577
Milan Bartos	+420 2 2499 5562
Barbara Suvadova	+420 2 2499 5590
Institutional Asset Management Sales Czech Republic	
Head: Petr Holecek	+420 956 765 453
Martin Perina	+420 956 765 106
Petr Valenta	+420 956 765 140
David Petracek	+420 956 765 809
Institutional Sales Croatia	
Head: Antun Buric	+385 (0)7237 2439
Željko Pavičić	+385 (0)7237 1494
Ivan Jelavic	+385 (0)7237 1638
Institutional Sales Hungary	
Attila Hollo	+36 1 237 8209
Borbala Csizmadia	+36 1 237 8205
Institutional Sales Romania	
Head: Ciprian Mitu	+43 (0)50100 85612
Stefan Racovita	+40 373 516 531
Business Support	
Tamara Fodera	+43 (0)50100 12614
Bettina Mahoric	+43 (0)50100 86441

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