ERSTE Group

2014 CEE bond market: Limited impact from Fed tapering, while domestic factors should mitigate yield increases

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Tapering already fairly priced into CEE bonds; fiscal discipline and accelerating GDP growth to help debt sustainability across CEE

Significant pre-financing and bond buyback activity at the end of 2013 gives CEE countries room for manoeuvre in 1HY 2014

A look across the region:

- **Czech Rep – abundant liquidity and lower gross supply to keep yields at low level**
- **Croatia – yields expected to jump to 5.50-5.75%; non-debt one-offs might provide cash injections**
- **Hungary – high external debt and short maturity of government bond portfolio might trigger yield increases**
- **Poland – changes in open pension funds to substantially reduce bond supply next year**
- **Romania – reduction of reserve requirements should boost domestic demand for govies**
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- **Serbia – high financing needs in 2014 due to restructuring of state-owned enterprises and a segment of the financial sector**

The impending reduction of asset purchases by the U.S. Fed is seen as the most relevant event impacting sovereign bond yields next year. Erste Group’s research report “CEE bond market outlook 2014 – Where will Fed tapering and CEE recovery take us?” released today, finds that the tapering has already been fairly priced into CEE bonds and therefore financing conditions for CEE countries should be only marginally impacted. "It looks like the tapering will be very much a controlled process, as the Fed will try to avoid any excessive increases in US yields so as not to threaten the on-going economic recovery. That also limits the upward risk for CEE bond yields and is why we only expect a very moderate increase of yields in the range of 20-70bp next year," explains Juraj Kotian, Head of CEE Macro/FI Research at Erste Group.

’’CEE governments have done a lot of pre-financing and buybacks of securities at the end of 2013, which will give them significant room for manoeuvre in the first two quarters of 2014. Lower fiscal deficits, continuing consolidation efforts - albeit at a slower pace - and improved GDP growth forecasts for 2014 should also help debt sustainability across the CEE countries,’’ Kotian points out. Erste Group analysts expect GDP growth in CEE to accelerate to 2.2% in 2014, versus 1.0% in the Eurozone.

Czech Rep – 2014 gross financing needs at ~9.5% of GDP; abundant liquidity and lower gross supply should keep yields at low level

The Czech Republic’s gross financing needs in 2014 are estimated to be around CZK 370bn, roughly 9.5% of nominal GDP. This includes CZK 270bn in maturing debt (bonds + T-Bills) and CZK 100bn in estimated deficit for 2014. This deficit already includes some additional spending – the economic growth of around 2% next year should provide the government with some room for manoeuvre, without endangering the deficit target of 3%.

In terms of yield levels, domestic factors such as close to zero interest rates environment, abundant liquidity surplus in the Czech banking sector, amplified by recent interventions against the Czech crown, should play against any substantial yield increases. Furthermore, the Czech government is planning to support state financing via better cash management of public institutions.

The fact that the Czech banking sector is awash with liquidity is the consequence of the loan-to-deposit ratio of 73-75%.

Hence the amount of money banks have left to invest has been growing steadily since 2011 and has been the major factor behind the banking sector's ability to buy government debt. This trend is expected to continue in 2014-2015, given the market's expectation that loan growth will remain subdued, as the economy recovers only slowly. The Czech banking sector should generate around CZK 160bn in aggregate liquidity surplus over 2014-15, whereof CZK 65-70bn in 2015.

Croatia – yields expected to jump to 5.50-5.75%; several one-offs might provide cash injections and diminish financing needs

Among the CEE countries, Croatia is the country with the highest risk of a spike in yields, as it runs one of the highest deficits. Additionally, its FX regime requires tight liquidity management, which results in yield increases once the currency is under pressure.

Public debt recently exceeded 60% of GDP (75% if state guaranties are included) and is trending upwards. Roughly 1/5 of public debt will mature throughout 2014, with more than half going to T-bills broadly owned by domestic investors. However, 40% of gross bond issuance for 2014 has been already covered by the recent USD 1.75bn issuance. Erste Group analysts expect the Croat Ministry of Finance to revisit the global markets just sometime in mid-2014. While at present there are limited risks in terms of accessibility, the pricing will depend on the pace of the Fed tapering and materialization of local fiscal consolidation plans.

Hence, HRK yields should be trending up towards the region of 5.50-5.75%. Several potential one-offs, which would provide cash injections, such as the concession of the Croatian motorways operation and the reduction of the state stake in INA to 25%+1, would significantly diminish the financing needs for 2014.

Hungary – high external debt and short maturity of government bond portfolio might trigger yield increases

The total debt of the central state budget is approx. EUR 74bn (74% of GDP), roughly 60% of which is denominated in HUF and 40% in FX. More than 60% of the total debt will mature in the coming five years, while more than 50% of government debt is held by non-residents, making the country rather vulnerable to changes in risk assessment. Apart from foreigners, commercial banks hold a considerable portion (slightly higher than 1/5) of the forint debt.

As for 2014, the total supply of Hungarian government debt is roughly EUR 12bn (12.5% of GDP). The second semester will bring higher FX redemptions, due to the maturity of EUR 2bn EU loan under the 2008 EU-IMF-WB aid package. Thus, it is likely that the debt management agency will continue FX bond issuance (as part of the USD 5bn bond program). However, the currently high government reserves (EUR 3.8bn without USD bond sales) and robust current account surplus (EUR 1.8bn expected) makes it possible to partly refinance the FX redemptions from HUF funds. In terms of HUF issuance, next year's supply will depend on whether the debt agency will replace the maturing FX debt with forint issuance. This could create some upward pressure on forint yields, especially if one takes into consideration the expected less-supportive external market environment due to Fed tapering.

As the most important buyers of Hungarian bonds are foreign institutions, the tapering by the Fed may bring additional risks to foreign bondholding in Hungary. Nonetheless, given their proven commitment toward Hungarian bonds throughout 2012-2013 and the markets' risk appetite for Hungary's speculative rating, Erste Group analyst don't expect a huge decline in foreign bondholding on the Hungarian bond market, while foreseeing a slight decrease of their proportion in the future.

Poland – pension system reform to substantially reduce bond supply next year

Polish public debt has been increasing lately, exceeding the first legislative limit of 50% of GDP and coming dangerously close to the second one of 55% when the economy slowed down. Most of it (70%) is LCY denominated, with the rest issued mostly in EUR and USD. Domestic debt's average rate to maturity is slightly lower, i.e. 4.37 years, while foreign debt maturity is higher at 7.42 years. However, the upcoming changes in the pension system will lower the maturity of domestic debt by around 0.2 years, according to the Ministry of Finance.

Assuming that the reform of the pension system will come into force at the end of January, gross financing needs are anticipated to drop to roughly PLN 132bn (i.e. ~7.7% of GDP) in 2014. Another consequence of the pension system reform will be the change in the structure of the state Treasury debt ownership. The share of foreign investors in Treasury papers is estimated to increase to around 44% (vs. 35% at present) and in total debt to around 62% (vs. 53% at present).

Even though the expected structural changes among Polish bond holders will trigger increased volatility in the market, Poland will maintain stable ratings and a positive perception on international markets, with little reason for sovereign risks to rise substantially. However, being more dependent on global sentiment means that the risks connected with global events, such as the beginning of QE tapering, will have an impact on yields, increasing the current upward pressure.

Romania – reduction of reserve requirements should boost domestic demand for govies

Romania's 2014 gross funding needs are evaluated at RON 65bn or 9.8% of GDP, slightly below the RON 70bn (11.2% of GDP) seen in 2013. Following the MinFin's strategy to extend maturities of LCY bonds issued on the domestic market and to control borrowing costs, there is now a more balanced distribution of government debt over the next couple of years. The investor base has also widened significantly in 2013 and non-residents owned 22% of RON-denominated bonds and bills in the fall of 2013, up from 6% one year ago.

Taking into consideration the still depressed inflation, Erste analysts foresee a flat key rate of 4% throughout 2014 and a reduction of RON minimum reserves to 12% early next year, which should free up RON 4bn into the market. This wil

influence mostly the short end of the yield curve, while the long end will be dominated by external events like the Fed tapering and domestic developments in the political arena. Another 25bp cut in the key rate in January 2014 cannot be excluded, but the chances of seeing the key rate below 3.75% are slim. The Erste analysts forecast for 5Y government bond yields is 4.9% for June 2014 and 5.1% for December 2014. Fed tapering, normalization of inflation and political risks associated with the presidential election scheduled for late 2014 point to a gradual increase in the government's borrowing costs. A rating upgrade and positive spill overs from the precautionary stand-by arrangement with the IMF and EU could lessen the upward pressure on LCY yields, but the general tendency towards higher yields persists.

Going forward, Romania's public debt should remain below 40% of GDP and the budget deficit to decline very slowly towards 2.5% of GDP by 2018.

Slovak Republic – benefits from being part of 'prime grade' club; buybacks should keep issuance low next year.
Slovak government debt has increased significantly following the financial crisis, as the fiscal deficit soared to 8% of GDP and was curbed only gradually. Contributions to European rescue mechanisms have also increased indebtedness. However, fiscal consolidation has been undertaken since 2011 and should bring the deficit to around 3% of GDP for 2013. Moreover, consolidation should continue in the following years, which should limit new issuance and growth of debt.

Apart from lower deficits, the Slovak debt agency remains in a very comfortable position going into 2014 also due to non-debt revenues from the upcoming privatization of the Gov't minority stake in the main telecom operator and extra dividends from state enterprises. All in all, the bond issuance for 2014 could amount to around EUR 6.0bn, which is almost 30% lower than this year. Out of this, EUR 4.1bn will be due to the roll-over of maturing bonds.

Demand from domestic investors is likely to be lower than in the previous years as loans will likely grow faster than deposits and will thus drain bank liquidity. Nonetheless, pension funds might substitute a part of the demand. International investor appetite is likely to remain strong due to the fact that Slovak bonds benefit from being part of shrinking 'prime grade A/A2' debt. The stock of outstanding 'prime' grade debt in the Eurozone fell from almost EUR 7tn to just over EUR 4tn in a relatively short period of time. As a result, Slovakia's share in 'prime' grade Euro Zone outstanding bonds has effectively tripled from 0.3% in 2009 to roughly 0.9%.

Slovak government yields should increase along with the general increase in German bond yields, while the debt agency's strong funding position is seen as a substantial mitigator. Slovak yield spreads to German bonds are expected to remain below 100bp on 10Y bonds.

Serbia – high financing needs in 2014 due to restructuring of state-owned enterprises and a segment of the financial sector
Serbia's public debt stock should be slightly above 50% of GDP by year-end 2013 with the mid-term trend outlook showing deterioration. Financing needs for 2014 will be higher, due to costs related to the restructuring of state-owned enterprises and a segment of the financial sector estimated at 1.7% of GDP, according to the MoF Fiscal Strategy. As for the budget financing plan for 2014, the focus is clearly on the domestic T-bill/bond market and bilateral credit arrangements, with a reported up to EUR 3bn credit arrangement with the United Arab Emirates as the major deal. Additionally, the World Bank is set to play an important role (approx. USD 800mn), especially with respect to supporting the SOEs restructuring and Deposit Insurance Agency recapitalization. Thus the financing plan suggests less reliance on the Eurobond market, with approx. EUR 600mn issuance earmarked and the recent USD 1bn bond issuance attributed as part of the 2014 pre-financing. Erste Group analysts therefore do not exclude the possibility that the MoF might skip further issuance during 2014.

With the funding conditions for 2014 being more reliant on domestic factors, the political stability, fiscal credibility and a potential arrangement with the IMF will play a decisive role. Political tensions have subsided at the moment, while the anticipated EU negations kick-off is seen as a supportive factor for political and macroeconomic stability. Fiscal credibility has been given a short-term lift, following the budget proposal incorporating some consolidation efforts and more a affirmative tone with respect to striking a new deal with the IMF. But that may be short-lived, as the total funding gap in excess of 7% of GDP and more ambitious deficit targets set for 2015-16 provide what we consider to be very limited room for any fiscal slippage. With respect to the relationship with the IMF, the Serbian government will maintain a wait-and-see tactic; as long as financing options remain viable, committing to more fiscal austerity seems unlikely, note Erste Group analysts.

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