Sunday Wrap

Happy Sunday from Covent Garden in the middle of London, where I still sit in shock and sadness after Thursday's election. I'm shocked by the conduct of the election campaign, I'm wondering about the democratic fairness of the UK's first-by-the-poll system, and I'm saddened by the now inevitable conclusion that the UK will indeed be leaving the EU within weeks – for the Brexiteers' illusionary sovereignty. But there you go…

This will be the last Sunday Wrap of the year, a year which has been truly exceptional in terms of asset performance. Equity indices are up year-to-date by more than 20% across most countries (with the noticeable exception of the UK and some EM countries). The STOXX Europe 600 has clocked the best year since 2009.

Of course, we had a broadly similar equity rally in 2017, but that was a more classic risk-on story, fueled by the then synchronized acceleration in global GDP. In contrast, this year's story is better described as a monetary policy (including QE) driven rally, particularly fueled by the Fed following the 2018 Q4 sell-off. As a result, not only equities did well, but bonds also delivered solid returns in 2019 with high single digit numbers for the euro area sovereign periphery, HY and EM hard-currency among others.

As we argued in our Outlook publication in November, we don't think present valuations can hold through 2020, but there is a lot of uncertainty as we move into the new year. Our Outlook is based on the team's collective assessment of the risks, both upside and downside, but the probabilities assigned to the various scenarios by my individual team members naturally differ.

Therefore, for this last Sunday Wrap of the year, I have collected from my team members what they consider the most important issues, hopes or fears, relative to our base case forecast. Here they are (starting with myself):

1. **The upcoming US election could lead Trump seriously astray in foreign policy matters (me – Erik)**
2. **The US might impose sanctions on Chinese companies (Stefan Kolek)**
3. **Brexit could lead to a break-up of the UK (Daniel Vernazza)**
4. **ECB announces that rates are below the reversal rate and hikes (Marco Valli)**
5. **Eurozone inflation (or inflation expectations) drop, and the ECB does nothing, thereby losing credibility (Chiara Cremonesi)**
6. **The European Commission eases fiscal rules and helps re-start investment and hence fiscal expansion (Loredana Federico)**

Erik F. Nielsen
Global Head of CIB Research
Group Chief Economist
(UniCredit Bank, London)
+44 207 826-1765
erik.nielsen@unicredit.eu

Bloomberg: UCGR, UCFR
Internet: www.unicreditresearch.eu

7. **The German governing coalition breaks up, paralyzing not only German, but also European, policy making (Andreas Rees)**
8. **Greece returns towards investment grade with big implications for markets (Tullia Bucco)**
9. **Berlin's famous airport gets completed and Eastern Germany emerges as a new hi-tech European center (Florian Hillenbrand)**
10. **The right country wins the Euro-2020….**

1. US election issues: Could Trump do something really stupid? (by me, Erik)

As you hopefully know, in our base case forecast for 2020 we assume no material change to US trade policies, but more of a "on-again-off-again" attitude of the Trump administration to global trade and other foreign policies.

We recognize a clear two-way risk to this assumption: On the one-hand, with an eye on stock markets, Trump may – during the election year – recognize the wisdom of scaling back tariffs (of course sold as a victory), as indeed seems to be the case with Thursday's announcement on Phase-1 with China (although note that bilateral tariffs will remain much higher than before Trump's madness began.) On the other hand, being a nationalist ruling with no due process as preparation, Trump may also double down and lash out at China or others again, as he did towards part of Latin America just weeks ago. Or he might even go further in search of international tensions, if not even confrontation.

I hope for the former but fear the latter. So long as we don't know who the democratic challenger will be it seems rather meaningless to start guessing on Trump's prospect of re-election. But if we are broadly right that the US economy slows during 2020, and the job market begins to weaken, I wonder if the shine begins to come off Trump. And if the Fed dots (or the forwards) are more correct than we are, namely that there'll be few, if any, rate cuts, it wouldn't be a stretch to see US equities drop significantly - possibly leading an increasingly erratic president to lash out left, right and center.

Could this lead to the threatened auto tariffs on Europe, or further attacks on steel producers? And/or, if Trump faces a left-leaning Democrat in the final stretch up to the election, could one imagine further sable-rattling towards Iran, or other Middle Eastern tensions, in an attempt to hammer home to US voters the importance of a strong US military?

Lots of worries to be sure, but personally, I won't sleep well again until Trump is out of the White House…

2. Financial sanctions could be applied to Chinese banks or firms by the US in 2020 (by Stefan Kolek, our credit strategy research team)

In extension of Erik's worries, I also worry about the broader anti-Chinese sentiment infiltrating US institutions and decision-making.

Specifically, financial sanctions could be applied with the aim of curbing China's economic power. Imposing sanctions on one or a few Chinese banks or firms – such as excluding them from the primary market for USD-denominated equity or credit or even from accessing USD-denominated payment infrastructure – would scare investors away from external Chinese debt and equities.

This would be negative for Chinese assets and for overall EM corporate credit, as, e.g., 25% of the JPM CEMBI Broad index is made up of Chinese mainland corporations (the largest share attributed to one country). Many Chinese issuers in the index are rated IG. This also means that they attract so-called yield tourists, i.e. crossover investors in investment-grade securities who are looking for yield enhancement. Potential credit rating downgrades below IG on the back of such a scenario would trigger "forced sellers" amid IG investors. These investors would quickly exit Chinese credit – similar to what happened with Russian assets in 2014, when the US sanctioned Russian firms during the Ukraine crisis. This led Russian credit risk premiums to surge, also adversely affecting the overall JPM CEMBI and leading to a substantial widening in EM credit risk premiums. At less than 11%, the share of Russian firms in the index was much smaller than the current share of Chinese firms. Consequently, sanctions against Chinese corporations could also pose a risk to EM corporate assets.

This risk is not unfounded. In March, a federal court in Washington, D.C., ordered three Chinese banks to comply with a subpoena issued under the USA Patriot Act in response to allegations that US sanctions on North Korea had been violated. In June, the court found the banks in contempt for refusing to comply and enabled the US treasury secretary and attorney general to impose financial sanctions on the banks. Granted, sanctions have not been imposed so far. But with Chinese corporate credit-risk premiums currently at 220bp, the risk of such financial sanctions being imposed certainly does not seem to be priced in. In this context, I note recent reports regarding discussions in the US about restricting US capital flows to China, e.g., preventing US pension funds from holding stakes in Chinese companies.

3. Brexit and the risk to an emerging UK break-up (by Daniel Vernazza, of our macro economics team)

Our base-case scenario is that now that Boris Johnson has a large parliamentary majority, he will have the flexibility to face down the hardliners in his party, and agree on an extension to the transition period, if in all but in name. But the risk of a hard Brexit at end-2020, when the standstill transition period is due to expire, is real and if it happened it would cause major economic damage, mostly to the UK.

Eleven months (between end-January and end-2020) is a highly unrealistic timeframe to sign a free trade agreement that typically takes years. This is particularly the case as the UK will also be busy negotiating trade deals with several other countries – it's a (unachievable) manifesto pledge to sign trade deals covering 80% of UK trade within three years.

The same issues over the pooling of sovereignty in return for market access, which have dogged Brexit negotiations with the EU for the past three years, will resurface again in negotiations on the future relationship. Talks will be very difficult, complex and lengthy. Both sides will defend their own interests: the EU will want to protect the integrity of its single market, just as the Tories are seeking to deregulate and diverge from EU law. A free trade deal will require the UK to commit to the EU's "fair playing field" rules. Mr. Johnson may ultimately decide that a clean break (WTO rules) is the only way to "take back control".

The very strong performance of the Scottish National Party (SNP) in the election, winning 48 of the total 59 seats in Scotland, will bring the issue of Scottish independence back to the forefront. The SNP campaigned in this election for another independence referendum, and the pressure will only increase following the result. Boris Johnson has so far ruled out another independence referendum, but that could become much harder to do in the near future.

Indeed, when the UK leaves the EU, powers will be returned to the UK, but some of these powers belong to so-called devolved areas, which the Scottish government has power over. When Boris Johnson looks to do a trade deal with the US, it will likely cover devolved areas such as agriculture (e.g., accepting US chlorinated chicken) and environmental standards. The price of Scottish government consent would likely be another Scottish independence referendum, and if the Conservative Westminster government were to impose its will on Scotland, it would likely stoke the independence movement further, and maybe not only in Scotland but also in Northern Ireland, where Thursday's election led to a nationalist (as opposed to a pro-UK unionist) majority for the first time.

4. ECB announces that rates are below the reversal rate and hikes (by Marco Valli, of the macro economics team)

I have been thinking about the possible options for the ECB if they were to come to the conclusion that the "reversal rate" has been passed and, therefore, the level of policy rates has to be raised somewhat – though still in negative territory. (Remember the reversal rate is the unobservable rate at which monetary policy reverses its intended effects and becomes contractionary.) Having passed the reversal rate does not necessarily imply that the ECB miscalculated when it decided to lower the deposit rate to -0.50%, because the level of the reversal rate tends to rise over time.

If this were to be the case, the first practical issue the ECB will face is a communication challenge. Strictly speaking, if they conclude that the deposit rate has fallen below the reversal rate, a rate hike would actually be an easing of policy, which would contradict the current rate guidance. But how would they persuade markets about this? The problem for the ECB is that they would need brand-new guidance to convince markets that they are just moving away from the reversal rate, and not planning to raise rates back to or above zero. But it is not clear what the level of the reversal rate is, how that will evolve in the future and why markets should believe the ECB. Therefore, I suspect that forward guidance might not be of great help this time around.

In terms of transmission, higher short-term rates would: (i) raise the floor for the cost of ECB liquidity provision to banks via TLTROs (although expanding the tiering system would help), (ii) put upward pressure on short, intermediate and longer-term segments of the risk-free yield curve, (iii) lead to wider credit spreads, and (iv) strengthen the euro. The ECB will have to try to counter most of these effects, or ask other players to help with policies that are outside the remit of a central bank.

In this environment, fiscal policy would almost certainly have to provide additional stimulus. However, if countries with little or no fiscal space take part in the fiscal easing – politically, it might be difficult to keep them completely on the sidelines – there is a risk that their sovereign debt might come under pressure, with negative spillover on the cost of funding of the private sector in these jurisdictions. Therefore, the ECB would probably have to step up the pace of asset purchases under the current QE program to cap the repricing of the risk-free curve and, especially, credit spreads.

In turn, this would bring forward the time when the ECB will have to decide which self-imposed constraint they want to relax (we suspect that they will raise concentration limits and stick to the capital keys). For banks, the implications of this scenario would be mixed, as higher short-term (but still negative) rates would presumably accompany flatter curves. If fiscal policy is not able to completely offset the drag on growth, banks might end-up being worse off. If so, the ECB should seriously consider adding (senior) bank bonds to its list of purchasable assets.

5. EMU growth and inflation slow further and ECB needs to act - with what? (by Chiara Cremonesi, of our strategy research team)

I'll address a different ECB-related risk than what Marco discussed above. While the latest eurozone data have improved marginally, as highlighted by Lagarde at Thursday's press conference, the risk of a more pronounced economic slowdown and/or a drop in inflation or inflation expectations in 2020 - compared to our baseline scenario of 0.8% GDP growth and average inflation of 1% - continue to exist. If the ECB is then unable to deliver any meaningful additional stimulus, due to the internal split within the governing council, credibility will then become an issue with potentially serious consequences for markets.

In this scenario, markets would become nervous as doubt arises about the ability of monetary policy to provide support in case of a crisis and, at the same time, they will price in the lack of any alternative stimulus measures. This would trigger a sizeable rally in Bunds, not because of markets pricing in further cuts or further QE, but simply as a result of safe-haven bids. Sovereign spreads would therefore widen sharply, including for those countries deemed "safe" like France, with the widening proportional to their relative ranking in terms of macroeconomic fundamentals.

We estimate that a 20-30bp drop in inflation expectations, associated with a 0.5% negative shock to eurozone growth (compared to our baseline scenario), and a decline of 0.1-0.2% in core inflation – to which the ECB is seen as unresponsive - would lead to a decline of 10Y Bund yields to at least -0.80%. In Italy, the deterioration of fundamentals alone would send the 10Y BTP/Bund spread to a range of 200-220bp, while the higher risk aversion would likely add up to 100bp on top.

An ECB credibility problem would also hit the euro, triggering a potentially heavy selloff. In a scenario as described above, my colleague Roberto Mialich expects EUR/USD to move back below 1.05, and - more critically – EUR/CHF would also drop significantly – say towards 1.05 and below – given the typical role as a safe-haven of the Swiss franc.

We think that such an episode of spread widening would indeed trigger some form of reaction by the ECB down the road. While the ECB intervention would eventually calm markets, this episode would risk undermining the ECB's credibility longer term as skepticism towards a more consensus-driven (therefore slower-acting) ECB leadership could take form, a factor that would likely lead to wider sovereign spreads in the medium term.

6. European Commission eases fiscal rules and restarts investment (by Loredana Federico, of our macro economics team)

In our baseline scenario, the eurozone will not benefit from any measurable expansionary fiscal policy in 2020 as only very few countries are seen to have fiscal room (mainly Germany), and these countries are not prepared to use it.

There is, however, a measurable probability that a more active policy could be triggered in more countries because the new European Commission will likely announce a review of the Stability and Growth Pact (SGP). I think such a review would entail legislative changes, rather than just being a reinterpretation of the existing rules. The new commissioner for Economic and Financial Affairs, Paolo Gentiloni, recently set the second half of 2020 as a potential date for a SGP review. Increasing awareness of the drawbacks of the current framework should override any fears the EU leaders might have about the implicit risk of any change.

I think the recent recommendations made by the European Fiscal Board will be the key guidelines for the Commission's proposal; therefore, the main goal of the SGP review will be to move towards simple, enforceable and anti-cyclical rules. Such changes to the rules would bring numerous benefits. A focus on nominal public spending would clearly mitigate the considerable uncertainty that has surrounded the current method of assessment. The measurement so far has been based on a country's structural budget balance, the estimate of which is based on the output gap, which is an unobservable variable that is itself an estimate.

As a consequence, there are different estimates of the structural budget balances, and, importantly, of the fiscal stance of a country, depending on which statistical source the estimate is based on. Worse still, such estimates might change over time as the output gap is revised later. Besides simplifying the rules, the focus on public spending developments would also lessen the risk of implementing pro-cyclical fiscal policies, which is likely to happen when basing decisions on a value that is never known for certain. At the same time, and for the same reason, it should reduce the recourse to discretionary decisions. A choice to connect the evolution of public spending to the country's revenue, potentially without further limitations, would automatically lead countries that grow more to spend more, which would result in positive spillover to the entire area. Moreover, a new target based on reducing public debt rather than a medium-term objective of adjusting the structural budget balance would help increase the credibility of the rules and foster a wider consensus around them and perhaps the European project as a whole.

The legislative changes could lead to a direct improvement in growth by stimulating growth-enhancing spending. Since the sovereign debt crisis, aggregate public investment has been more severely affected by the need to accelerate compliance with fiscal rules. This suggests that it will be desirable to implement exemptions for investment when determining a country's public spending path. Rather than a blanket exemption for investment, such exemptions would likely be strictly related to the commission's new goals, for instance, making it easier for governments to invest in green priorities.

European financial markets will progressively benefit from this effort to create more deeply embedded and better coordinated fiscal policy throughout the euro area, and we might see some stimulus getting under way already before the end of 2020.

7. Break-up of the grand coalition in Germany and the risks for Europe (by Andreas Rees, of our macro economics team).

Germany has a well-known record of political stability. In the last 70 years, there have only been three snap elections: in 1972 (Willy Brandt, SPD); in 1983 (Helmut Kohl, CDU); and in 2005 when Angela Merkel (CDU) succeeded Gerhard Schröder (SPD). 2020 could become the year in which the fourth snap election takes place, or a minority government is built. While a break-up of the grand coalition is not our baseline scenario, there is a substantial probability of political turmoil next year. This could just come at a time when Germany is taking over the EU Council Presidency in the second half of 2020.

The latest developments in German politics have become messy. In a nutshell, the Social Democrats have made tough demands, including a substantially higher minimum wage and rising government spending for infrastructure and tackling climate change. Although leading politicians of the CDU/CSU signaled their willingness to talk, they outright rejected the surrender of the "black zero" in the public budget. The latter has become the "holy grail" of the conservatives, whose abolition could trigger the break-up of the grand coalition.

The next juncture in the German political drama is already waiting for us: the election in Hamburg in February of next year. Hamburg, a federal city state, has traditionally been a stronghold of the Social Democrats. At the last election in 2015, the SPD got nearly 46%. In the case of substantial losses, the Social Democrats would come under further pressure and call it quits, sooner or later.

What would a break-up of the grand coalition mean for the rest of Europe? No matter how you look at it, German politics would probably be paralyzed and only be concerned with itself, at least for some time. The preparation of snap elections would take two months at a minimum. There is also no guarantee that a new more stable government then takes over. According to the latest opinion polls, a majority for a coalition between the CDU/CSU and the Greens is a close call. A revival of “Jamaica” talks (between the Conservatives, the Liberals and the Greens) seems to be unlikely. A minority government solely consisting of the CDU/CSU would probably also be a lame duck with little authority on the European level.

The list of crucial EU policy issues is long: Brexit; the completion of the banking union by a common deposit insurance; possibly still the struggles for the new EU budget, since the UK as a net contributor is missing; the EU Commission’s ambitious plans for tackling climate change; a EU-China summit at which Germany together with France aims at pursuing a common European policy towards China; the planned abolition of the unanimity principle in foreign-policy decisions; and finally, we have US President Trump as potential troublemaker in his election campaign. In the light of all these issues, let’s hope that German politicians become again aware of their European responsibility…

8. Greece returns towards investment grade with big implications for markets (by Tullia Bucco, of our macro economics team)

Since it took power, the new Greek government, which was elected in July, has swiftly adopted legislation aimed at making it easier to invest in the country, reducing red tape and reviving the country’s stalled privatization agenda. It has also implemented systemic reform aimed at restoring the health of Greece’s banking system, notably via more-forceful reduction of the non-performing loans that sit on Greek banks’ balance sheets. The latter represents a key step towards accelerating recovery in bank lending to firms and reversing a contraction in lending to households. These reform efforts are in a preliminary stage, and the IMF is right to point out that the government’s resolve in confronting vested interests, which have traditionally blocked reforms, has yet to be tested. However, if the government stands firm in the pursuit of its objectives, and if tangible results materialize in the form of growth and FDI, further rating upgrades are likely to be forthcoming.

Greece’s sovereign credit ratings are, at best, three notches below investment grade, and two out of three of the main rating agencies that rate the sovereign at this level have placed their assessments on positive outlook. This means that they may raise their ratings within the next 12 months if the country’s outlook, including its ability to access capital markets, materially improves. If this is the case, a two-notch upgrade of the sovereign would not be unprecedented – it happened this year – although it occurred when Greece’s ratings were much lower. Once the country’s credit ratings close in on the investment-grade level (just one notch below), we think that markets would start pricing in further action from rating agencies, putting pressure on them to act. Eventually, the rating agencies, which are well-known for lagging behind markets, would follow suit and bring Greece’s credit ratings back to investment grade for the first time in nearly a decade.

A return to investment-grade status could have meaningful consequences for Greece. The country would qualify for re-inclusion in major bond indices and become eligible for the ECB's QE. Returning to investment grade would be a game-changer for the country, in that it would allow it to regain market confidence and would put the Greek economy on a sustainable recovery path. Stronger growth will, in turn, spur more job creation and help relieve poverty, which has affected many households as a result of many years of poorly conceived austerity policies.

9. Berlin and Eastern Germany emerge as a new hi-tech European center (by Florian Hillenbrand, of our credit research team)

The history of the construction of Willy Brandt Airport, Berlin Brandenburg (BER), has caused little reason for positivity. After recurrent delays and cost overruns, October 2020 is the current target date for its opening. However, there are reasons to be optimistic: anybody (apart from Erik) who has travelled to Berlin-Tegel Airport in the past few years will agree that whatever the new airport looks like and whatever deficits it may have, it will mark a quantum leap for the transport infrastructure of Brandenburg and Northeastern Germany as a whole. (Erik, who doesn't like to shop, claims he can walk the 20 meters between the taxi and the plane in less than 5 minutes at Tegel, a convenience not matched by any other capital city airport.)

And here come Tesla, BASF and Microvast as first movers. Elon Musk and Martin Brudermüller certainly took the imminent opening of the new airport into consideration when announcing their plans for an aggregate multi-billion euro investment in this region. Tesla and BASF will be accompanied by Microvast, a market leader in the design, development and manufacturing of ultra-fast charging lithium-titanate batteries. Not only did Microvast express its intention to invest an initial EUR 43mn, with plans for a final amount in the triple-digit-million euro area, it also decided to relocate its European headquarters from Frankfurt to Ludwigsfelde outside Berlin – a fact that lends credence to Elon Musk's plans.

Of course, it takes more than just a new airport to attract global investors to a region. The area around Berlin provides comparatively cheap production factors, particularly labor (in Brandenburg labor costs are 78% of the German average) and land at just 52% of the average German price. In addition, investors benefit from supportive governments at all levels (more than EUR 260bn invested since 1992), as well as proximity to political decision makers (Brandenburg surrounds Germany's capital, Berlin) and reliably functioning infrastructure (dense autobahn system, and finally a new airport).

The long-awaited launch of BER Airport could be the ignition for an entire region to take off economically. The three landmark projects of Tesla, BASF and Microvast are the first sparks, with many other companies likely to follow their example. As this storyline unfolds, the benefits are manifold: Brandenburg might move out of its disadvantageous economic, fiscal, and socioeconomic situation and become a flourishing landscape 30 years after Chancellor Kohl's famous prediction.

10. The winner of Euro-2020 will be…. (by anonymous…)

… yes, a surprise here as well! According to the bookmakers, it'll be a battle between England, France, Belgium, the Netherlands, Germany, Spain and Italy (all with odds at 10/1 or lower), but – with all due respect – we all know in our hearts that just like in 1992, Denmark will come off the beach on June 12 and head to Rome for the first match against Finland – and then cruise nicely on to the final at Wembley on July 12. Whether the opponent in the final will be Germany (like in 1992), the youthful French team, or someone else remains to be seen… (okay, full disclosure: I wrote this!)

And on that note, I thank you all for another year of reading the Sunday Wrap, as well as our other research publications, and for your many comments, questions and views during 2019. I hope we'll get plenty of opportunities to further deepen our conversations about policies, economics and markets in 2020.

Till then, I wish you all happy holidays. The Sunday Wrap will be back in early January.

Best

Erik

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UniCredit Research* — Macro Research

Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

EEMEA Economics Research

Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu

Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de

Florin Andrei, Ph.D.
Senior Economist, Romania
+40 21 200-1377
florin.andrei@unicredit.ro

Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr

Dr. Ágnes Halász
Chief Economist, Head of Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu

Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg

Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

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