Bloomberg Adria

Regional analysis Bonds & Equity

2022 Market Wrap-up &

2023 Market Outlook

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Highlights - Equities

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Entering the late hours of the year highlighted by risk aversion amid geopolitical crisis and fight against a multi-decade inflation spike, and since December is traditionally not the month of big market moves, we are making a wrap-up of the 2022 market performance for Adria region.

While global equity markets were broadly plagued by risk aversion arising from the geopolitical concerns and monetary tightening biting into economic and investment outlook, the **equity market in Adria region displayed a mixed performance**. Among the worst performers, we see Slovenian, Croatian and North Macedonian indexes underperforming equity gauges in broader Europe market, however this comes with a material lag as both markets have outperformed the named European peers just up until recent weeks. On the stronger end, Belex 15 ends flat against end of 2021, while both B&H indexes are displaying increases on ytd basis. We still blame **quite low trading volumes** for relatively poorer correlation with global index moves, with regional trading volumes at least 5x lower than e.g. those in Poland and Hungary. The **key reasons for relatively smaller liquidity** of Adria region market are:

- too small capitalization figures to attract bigger global investors;
- the market's perception of return potential (both in terms of value and time to collect) from investing in the local companies;
- a small number of investors' concentration in the regional blue chips.

All these elements still suggest there is an upside potential for the local markets as part of the general convergence towards bigger markets.

On **P/E ratios**, Adria region saw **compression** in multiples more or less in the vicinity as on the benchmark markets, with the biggest reduction in P/Es in Serbia and Croatia, while the best performance (albeit with poor trading volumes) was marked in B&H market. We see the Adria region's drop in PE ratios largely reflecting compression in stock prices as a result of general risk aversion amid:

- geopolitical concerns;
- downbeat economic expectations biting into the companies' profitability potential.

Equity indexes - performance		**Trading volumes (% of free float market cap)**		
	ytd % change	**2022 average**	**7-year average**	**pp Δ (2022 vs 7Y avg)**
SBI TOP	-15.7%	0.03%	0.04%	-0.002
Crobex 10 Index	-11.2%	0.02%	0.03%	-0.011
Belex 15	-0.6%	0.02%	0.07%	-0.054
SASE Free Market 10 Index	7.6%	0.05%	0.05%	-0.007
BIRS Index	23.0%	0.02%	0.04%	-0.026
MBI 10 Index	-9.7%	0.01%	0.01%*	-0.003
		*since mid-2016		
WIG Index	-19.1%	0.16%	0.14%	0.029
BUX Index	-9.3%	0.28%	0.25%	0.033
BET Index	-10.2%	0.06%	0.10%	-0.039
SOFIX Index	-5.1%	0.03%	0.04%	-0.010
MSCI EM Index	-21.1%	0.83%	0.62%	0.208
EURO STOXX 50 Price EUR	-7.8%	0.28%	0.35%	-0.070

P/E ratios	**latest value**	**31.12.2021**	**ytd points change**
SBI TOP	5.98	7.62	-1.64
Crobex 10 Index	12.44	17.09	-4.65
Belex 15	7.58	12.33	-4.75
SASE Free Market 10 Index	19.70	19.00	0.70
BIRS Index	12.78	13.36	-0.58
MBI 10 Index	12.07	15.69	-3.62
WIG Index	6.42	13.21	-6.80
BUX Index	4.92	8.01	-3.09
BET Index	6.18	11.81	-5.63
SOFIX Index	5.71	19.61	-13.90
MSCI EM Index	10.89	13.36	-2.46
EURO STOXX 50 Price EUR	14.12	16.85	-2.73

Source: Bloomberg

Highlights - Bonds

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Aside from high inflation pushing global yields upwards, this year's **risk aversion has also seen widening in bond spreads** globally, as well as in Adria region.

Croatia is the key outlier in this respect, having outperformed the rest of the CESEE universe with the 5Y bond spreads practically at the same levels as at the end of 2021. The key reason for that is investors pricing in benefits from the Eurozone entry from 2023. **Slovenia** has benefited from its stable credit quality, defying fears that the economic weakening at its main trading partners (i.e. Germany etc.) will create negative influences on the economic activity and lead to deteriorated public finance profile in Slovenia as well. **Serbia** was on the weaker end, with investors quoting wider spreads against deteriorating fiscal gap prospects and the influences of economic ties with Russia onto the local economic during periods of heightened geopolitical issues. We see relatively contained spread movements at **B&H** and **North Macedonia** mostly reflecting lack of liquidity of the government bonds and would assume further deterioration in spreads profile given their respective credit ratings and economic structures.

The most recent weeks have shown that investors are still willing to take the risk at attractive prices, with lower priced issuers such as Serbia, B&H and North Macedonia, alongside peers from wider region such as Hungary and Romania, benefiting from a short-lasting global risk recovery. Spreads of the named issuers have indeed tightened, with Serbia likely receiving some impetus from the agreed IMF arrangement, covering part of its near term public refinancing needs. North Macedonia should be on a similar train as Serbia, with the IMF arrangement in place there as well.

The announced budget plans or even indications for the next year's public finance profile are not showing that the governments would use the weakening economic activity to restructure the fiscal structure, but rather opt for widening in the budget gaps led by slowing increase of tax intake and the government support programmes against increased costs of living. Investors are in any way seeing similar signals in broader region at least throughout most of CESEE, which also explains the bond spread movements.

5Y government bond EUR yield	current (%)	Δ year-to-date (pp)
Slovenia	2.427	2.639
Croatia	2.815	2.386
Serbia	6.042	4.320
B&H	6.443	3.039
Poland	3.069	2.991
Romania	4.607	3.455
Hungary	4.372	4.218
N. Macedonia	5.646	3.532

5Y government bond EUR spreads	Current (bps)	Δ year-to-date (bps)
Slovenia	53.2	28.1
Croatia	92.0	2.8
Serbia	414.7	196.2
B&H	451.4	59.6
Poland	108.5	37.5
Romania	271.2	109.7
Hungary	249.3	190.0
N. Macedonia	370.1	105.3

Source: Bloomberg

Outlook For 2023

We see most of 2023 highlighted by volatility, with weaker economic growth the main topic, while inflation gets the tag of being persistently high, but not pushing upwards any more. In such environment where credit risk will gain more focus, we see investors preferring high quality exposures, notably investment grade, which means low support for most Adria region in 2023. That said, **we expect issuers from non-cyclical sectors and those with regulatory frameworks enabling the stability** (e.g. financial sector, telcos) **to benefit** from the overall economic environment and investment shifts. **Cyclical manufacturers and consumer discretionary are to be under pressure**. Also, on food and beverage sector, we think that prolonged period of high inflation will push consumers towards lower margin alternative food products, which is a negative factor for valuations.

On **equity valuations**, we acknowledge that P/E ratios have indeed compressed this year along with moves in a similar magnitude at the broader Europe peers. More importantly this time around is that European equities are running at much lower P/E ratios than the US peers, reflecting investors' views on mid-to-long term business return perspectives, being obviously much better in US than on the „old continent". Furthermore, we see **potential overvaluation in Croatia, B&H and North Macedonia stocks**, as P/E ratios are there much higher than in rest of CESEE, albeit the sectoral structure of the respective indexes must be noted. Still, as long as there is no material upgrade in trading volumes, we do not expect major price moves to reflect more fair pricing. **Slovenian blue chips** could be **positioned for an upside potential** during boats of risk appetite recovery, with the average P/E ratio among the lowest in CESEE and even rest of Europe.

On **bonds**, we do not expect very much corporate issuance activity during challenging times, and investors' focus will be on the government debt. Having embarked on arrangements with the IMF, Serbia and North Macedonia have certainly improved their positions to cover the public financing needs entering into 2023. As global economic slowdown will see **deterioration in credit quality worldwide**, we see **long term rates** for Adria region issuers under **more upside pressure**. Better rated issuers will come out better off in this respect i.e. we see less spread widening for Slovenia and Croatia than for the rest of Adria region.

Country	2023 gross public financing needs (% of GDP)	Current government cash buffer (% of GDP)
Slovenia	7.8%	11.8%
Croatia	11.9%	4.2%
B&H	3.7%	2.1%
Serbia	10.3%	7.3%
North Macedonia	8.8%	5.7%

Source: central banks' data, BBG Adria calculations

We **compared the gross public financing needs** (maturing government debt plus a single-year fiscal gap, for 2023) vs. the current **government cash buffers**. Slovenia seems the best positioned, with the cash buffer covering for more than the public financing needs in 2023. This supports our view that Slovenian bonds will continue to outperform in the next year. All other countries have some flexibility in negotiating the timing and pricing of new borrowing. However, Croatia carries the widest gap between the overall refinancing needs and the current cash buffer. We see this as the Croatia government counts on the local investors to cover for the domestic debt maturity (6% of GDP in 2023), with local pension funds and banks traditionally delivering strong interest for domestic debt issuance. The rest of Croatia financing needs we see coverable by foreign bond issuance, but potentially at higher price than in case of bigger cash buffer. Finally, while North Macedonia will receive the support to cover the remaining financing needs via market or bilateral borrowing from the IMF-approved deal worth 530 mEUR, we expect the B&H to cover the rest of its funding need via mix of market and off-market borrowing at higher price than before.

In all, all elements support our view that the interest rates for private sector loans will rise further, not only due to rising benchmark interest rates (e.g. Euribor), but also reflecting deteriorating credit quality and overall increase in borrowing costs.

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