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Serbian Sovereign Bond Market

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Chris Bojanovic
Managing Director

Cbonds comes back to London!
V Cbonds Emerging Markets Bond Conference | April 14-15 2016

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Serbia, like most sovereigns in the region, issues bonds in a number of denominations:

- The U$D denominated bonds are traded OTC and settled via Euroclear.
- Most liquid of the three and have the tightest bid/ask spreads.
- They are also the most volatile.

- The €uro denominated bonds are traded and cleared locally via the central Securities depositary and Clearing house in Belgrade (CRHoV).
- They are less liquid and more costly to trade actively but much less volatile

- The RSD denominated bonds are traded and cleared locally via central Securities depositary and Clearing house in Belgrade (CRHoV).
- They are fairly liquid due to high percent of local participants (banks and insurance companies) and recently uptick with foreign interest.
- FX risk but can be offset via FX swaps

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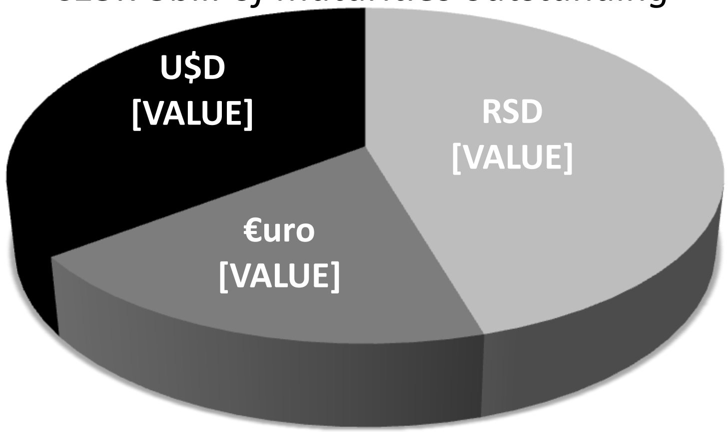
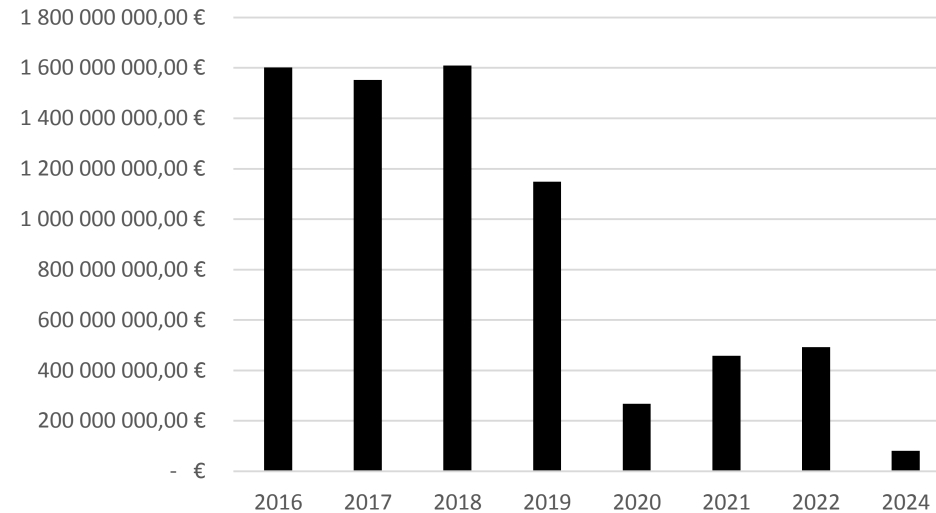
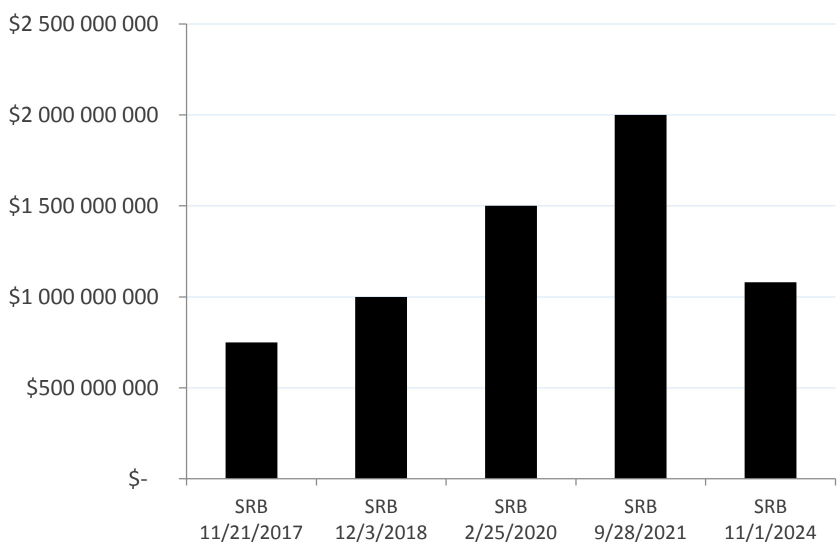
€15.73bil. of maturities outstanding



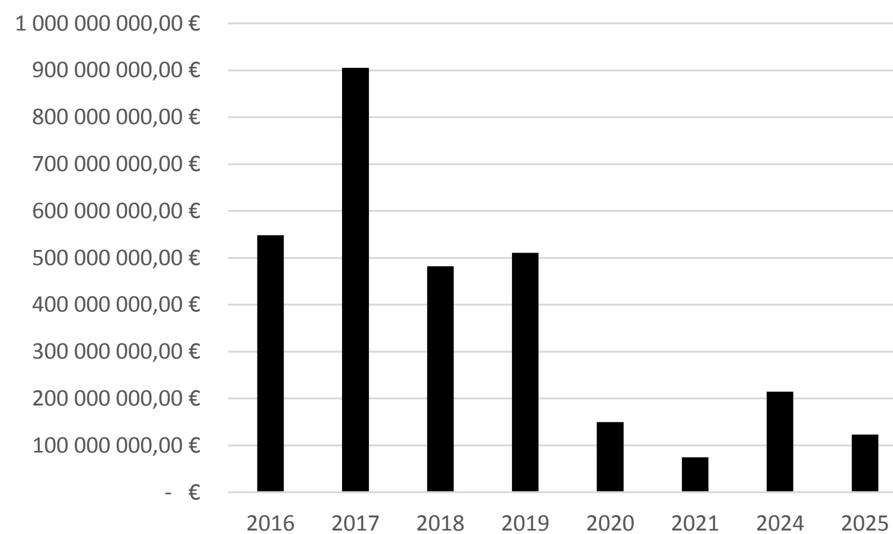
Outstanding Maturities - RSD Bonds in (€uro) €7.2Bil.



Outstanding Maturities U$D Bonds $6.33 Bil. (€5.57)

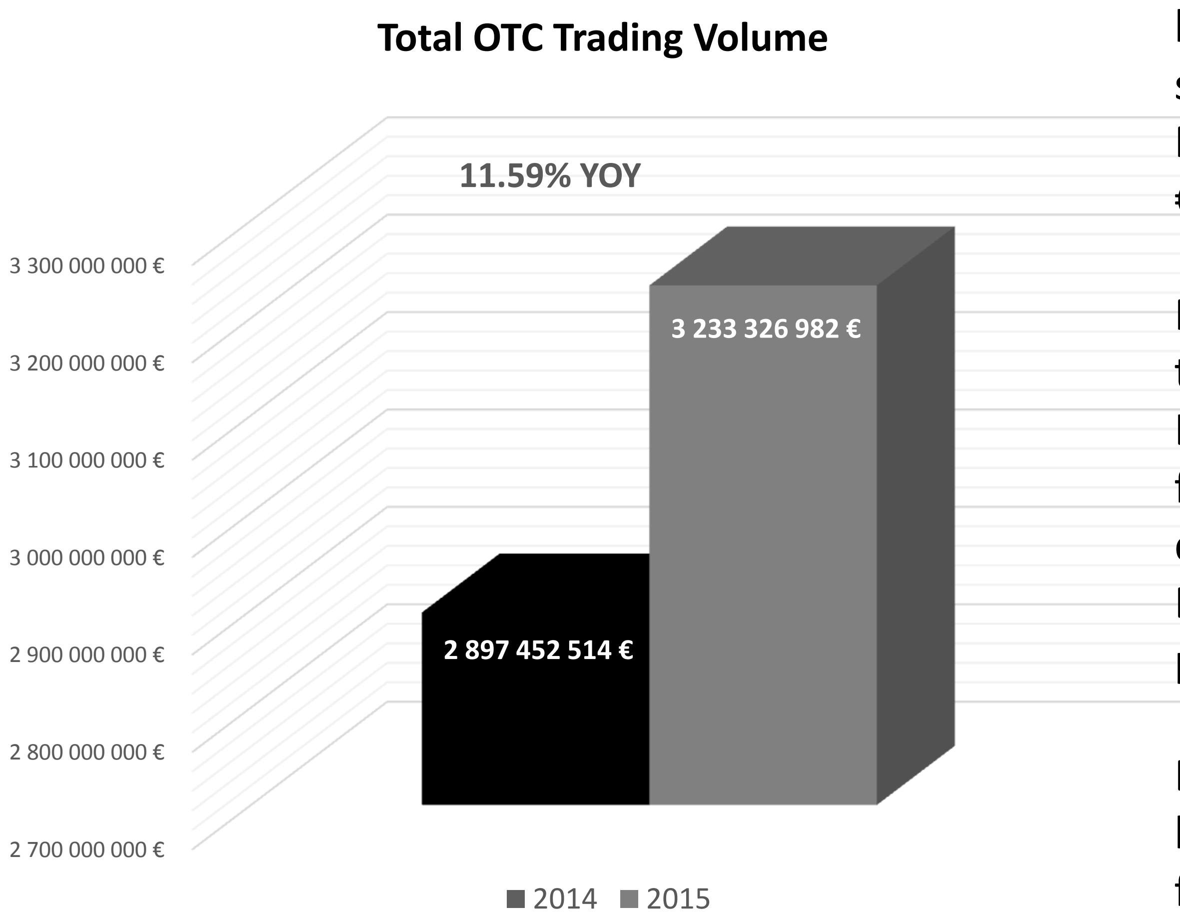


Outstanding Maturities - €uro Bonds €3Bil.



Issued SRB RSD Bonds in € and SRB € Bonds

Issued in 1Q16 compared to 1Q15



OTC trading volumes on local market increased a substantial 11.59% over FY15/FY14 to almost €3.3bil.

Part of this can attributed to the fact that some London banks, brokers and funds, started actively quoting local issuances and Bloomberg launch of ***E-OND*** platform for Serbian bonds.

But also driven by local banks lack of alternatives for deployment of cash.

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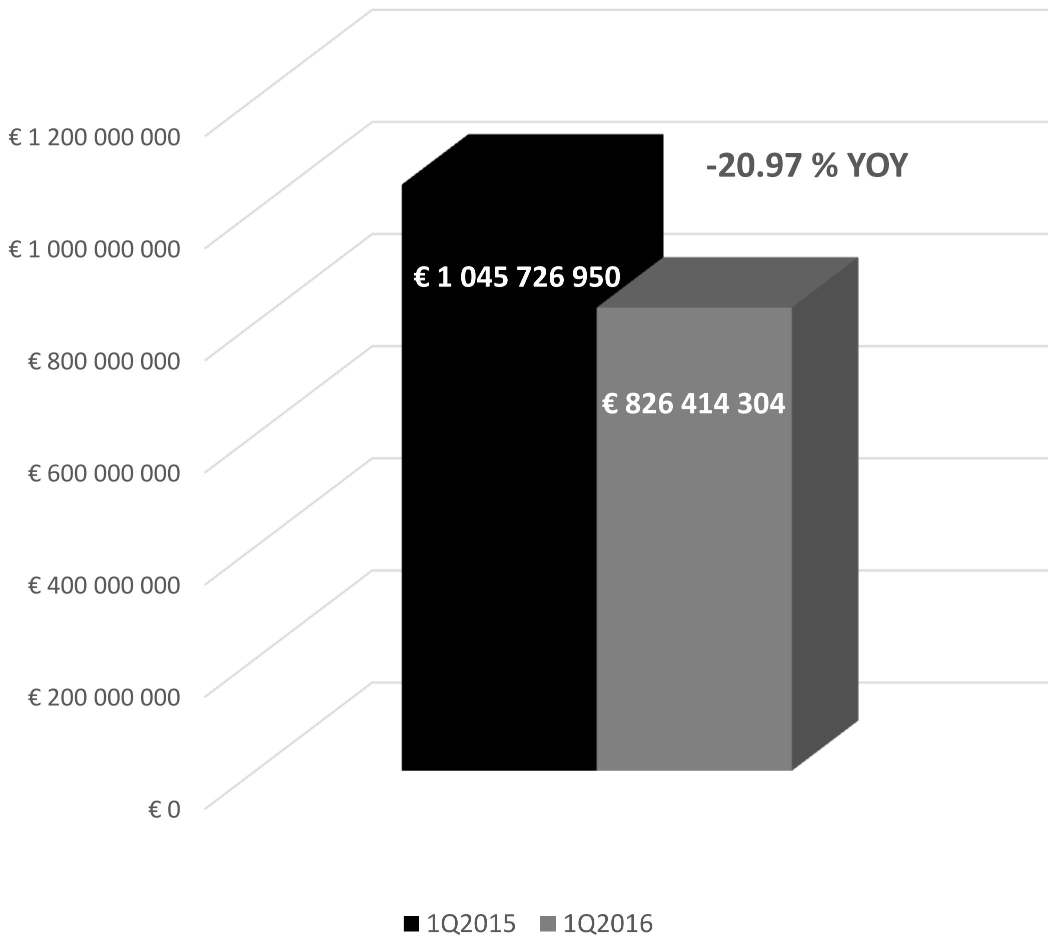
Total OTC Trading volume in €

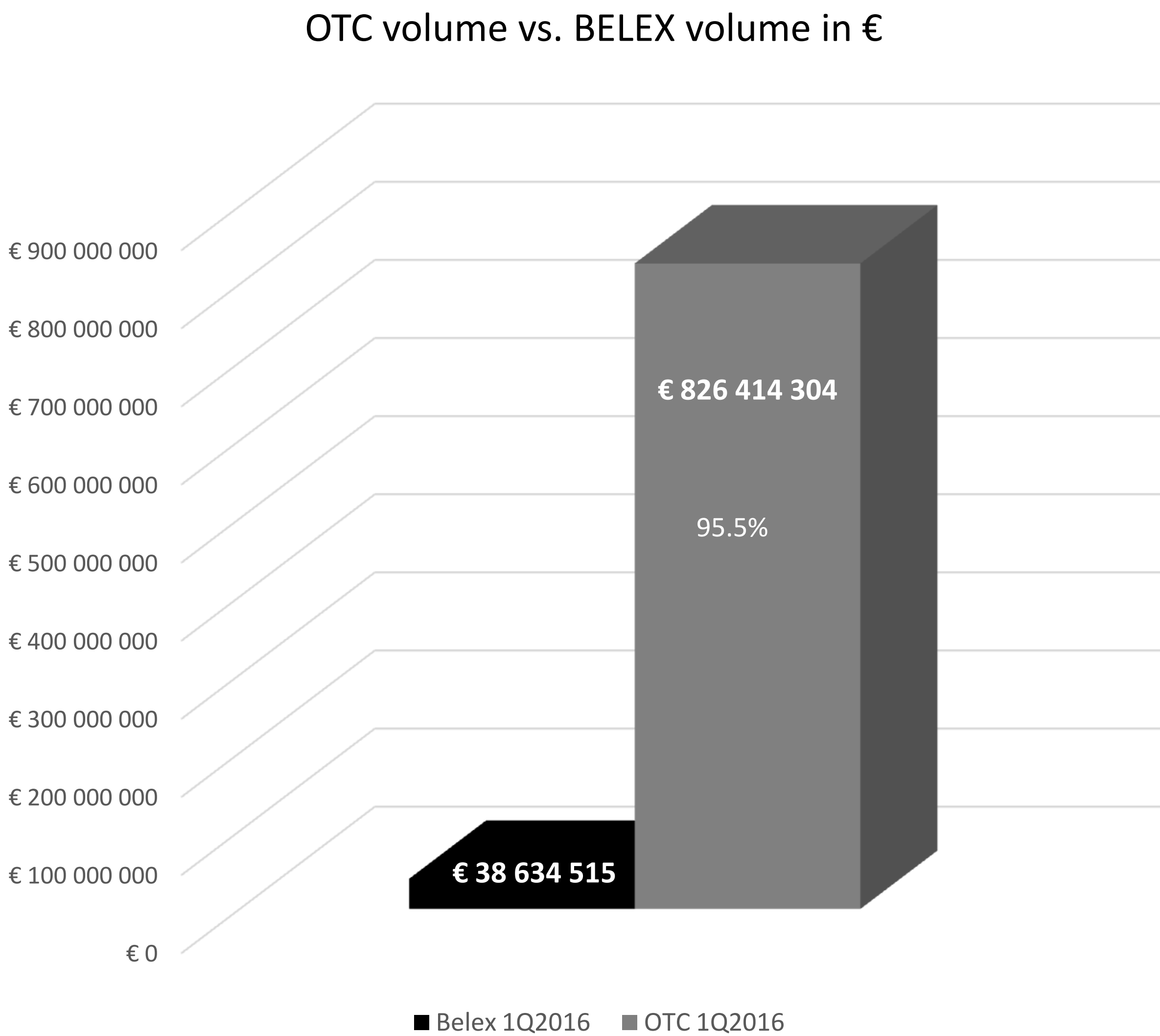


However, Q1-16 has been marked by the 20% drop in the trading volume partly due to:

Sharp decline of yields on the Primary market

Wider bid/ask spreads on the OTC

Fewer scheduled auctions in Q2-16 due to elections (part of the governments election strategy).



As of November 12th 2015, 64 sovereign bond issues with the residual maturities of 1 to 15 years, denominated in RSD and €uro, were listed and started trading on the prime listing of the Belgrade Stock Exchange.

Even though the volume is relatively low it is proved to be a lifeline for Belgrade Stock Exchange and a positive step, allowing smaller investors to participate and contribute to overall secondary market development.

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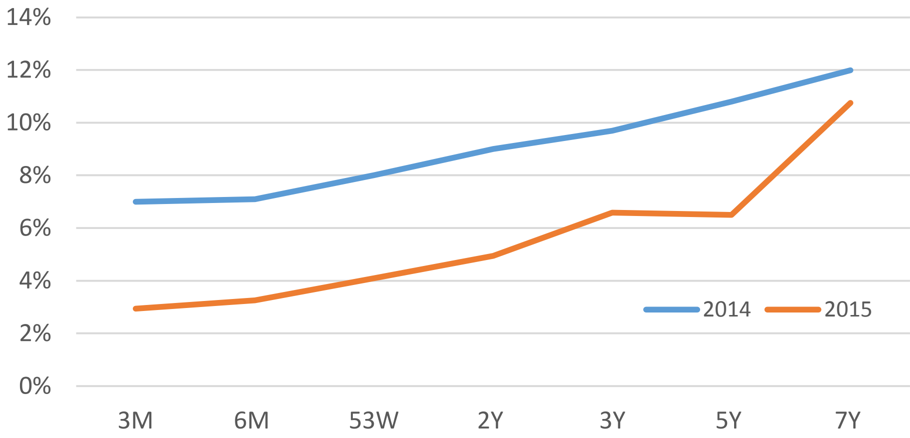
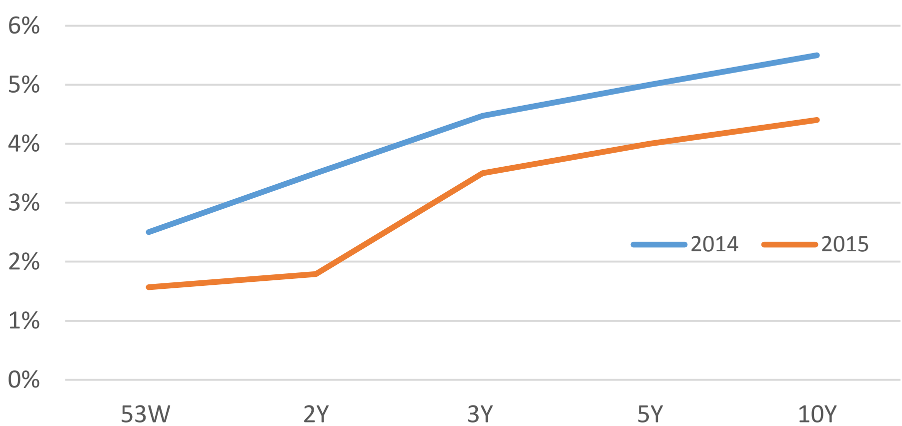
Yield Curve SRB RSD Bonds progression



Yield Curve SRB €UR Bonds progression



Since mid 2015, when ruling coalition turmoil made early elections prospects realistic, Public Debt Agency along with the MinFin has been, in our view, artificially depressing yields on the Primary auctions in order to lower public debt costs especially on the front end of the curve and to a certain extent promote commercial lending by local banks (not much traction thus far).

For example at the latest RSD auctions which had low success rates of 46% and 62% for 3yr. and 2yr. tenors respectively and the March 15th auction hit a low of 16% for the 1yr. Tenor however the yields still managed to decrease.

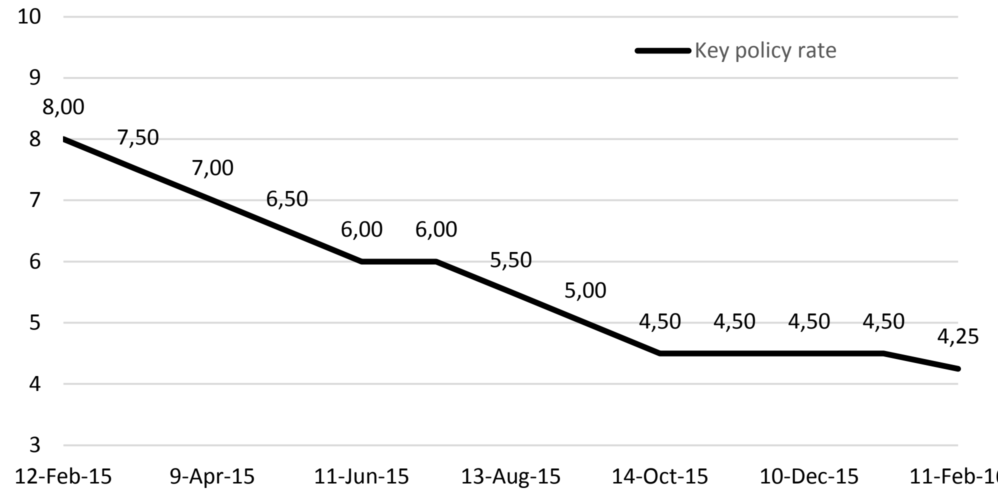
Since the beginning of 2015 the NBS aggressively lowered the key policy rate by 375bps from 8% to to 4.25% .

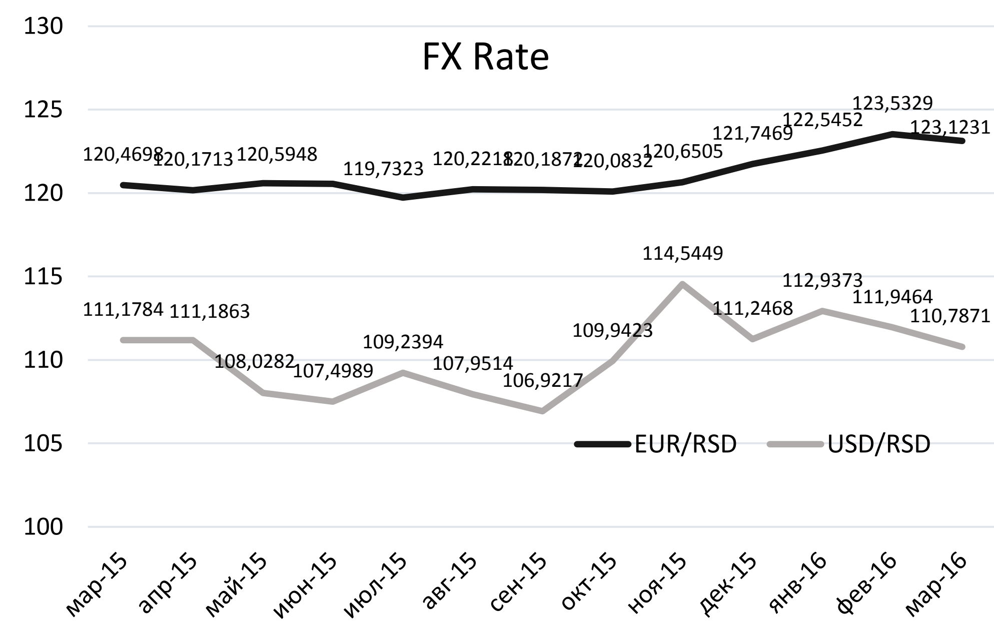
But has in Q1 is has put on the breaks with a comparatively small rate cut of 25bps. Further reductions are on hold until elections.

Reduction of mandatory reserves requirements for RSD and FX released RSD and Euro Liquidity into the system which has, instead of boosting economic activity, placed this liquidity in T-Bills, further compressing the yield curve.

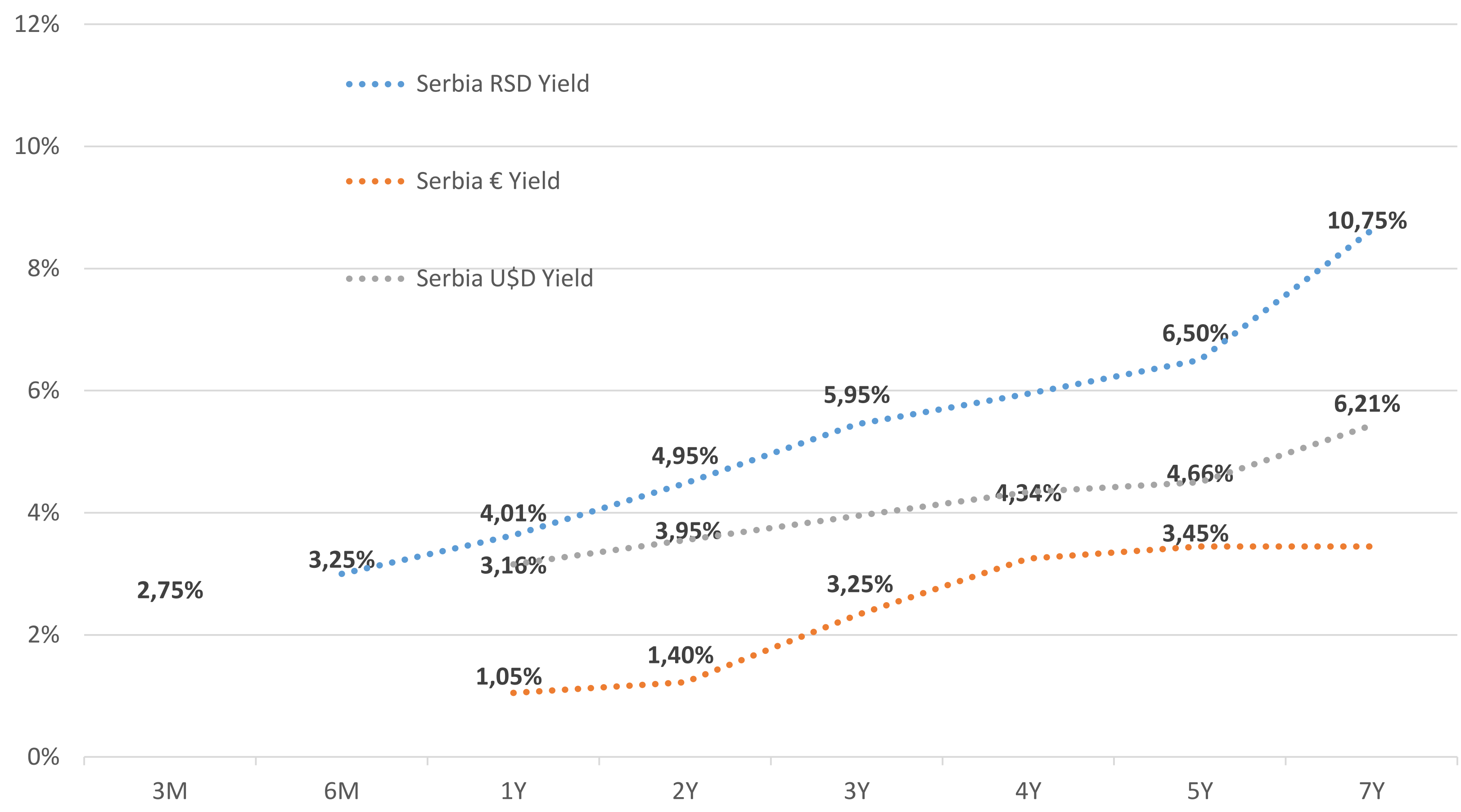
During Q1 the NBS intervened more than 30 times on the FX market with €585 million in order to prevent further decline of RSD FX rate created by investor outflows caused by artificially low yields of primary auction and broad based EM outflows.

In Feb FX reserves hit €10.1bn with 261% coverage of M1 and more than six months' worth of imports of goods and services which implies the NBS has more than enough fire power to keep RSD in check in the near term.





SRB RSD, SRB€ and SRB$ Bonds Yield Curves



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What's the Story?

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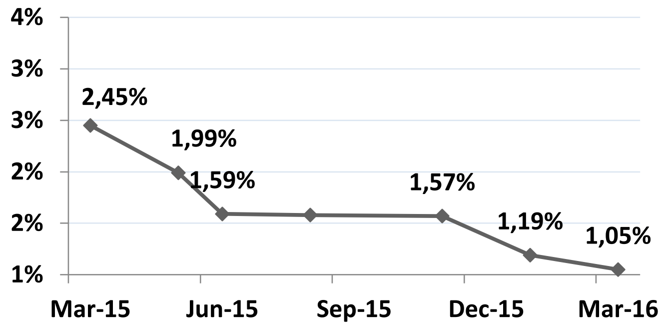
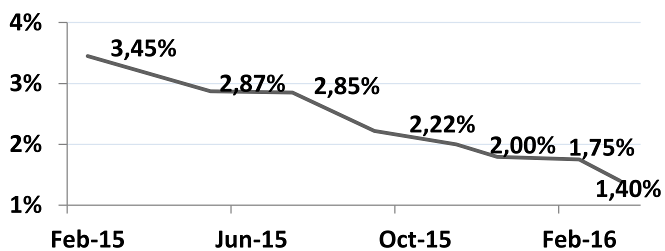
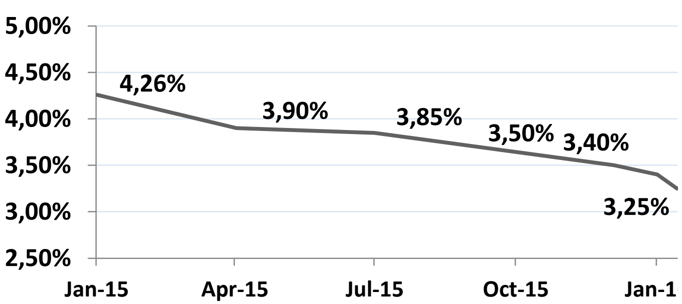
SRB€ 53W



SRB€ 2Y



SRB€ 3Y



The Serbian Government bond market, over the last few years has arguably been the best performing sector of the Serbian capital markets with total returns outperforming equities.

Yields have been steadily declining over the last few years with a strong acceleration 2015 in both local currency RSD and €uro denominated issues.

For example the core 1yr, 2yr, 3yr and 5yr €T-bonds all have double digit yoy contractions.

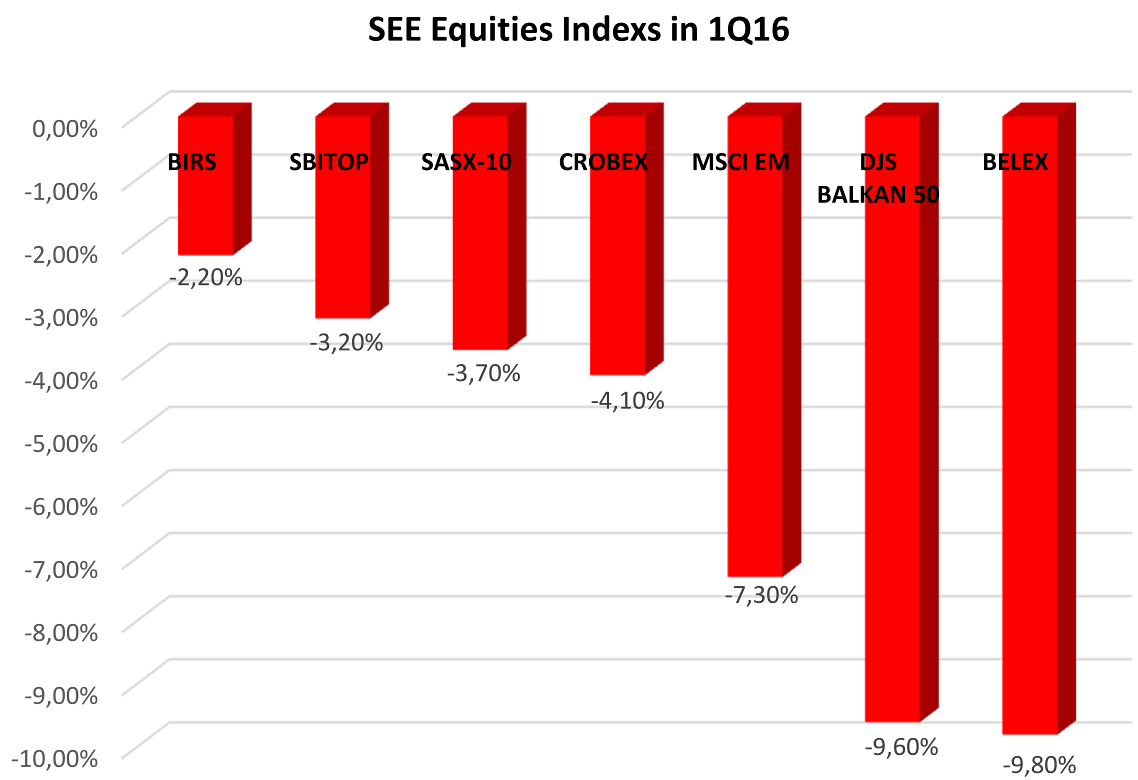
Q1-16 Yields are still declining but at slower rate.

Yields	Yr. 2016	Yr. 2015	Bps	YoY chng%
1Yr.€	1,05	2,45	1,40	-57,1%
2Yr.€	1,40	3,45	2,05	-59,4%
3Yr.€	3,25	4,26	1,01	-23,7%
5Yr.€	3,45	4,79	1,34	-28%

Compared to negative performance of SEE equities in which not a single index was positive in Q1-16

Belex was one of the worst performers in Q1 with -9.8%.

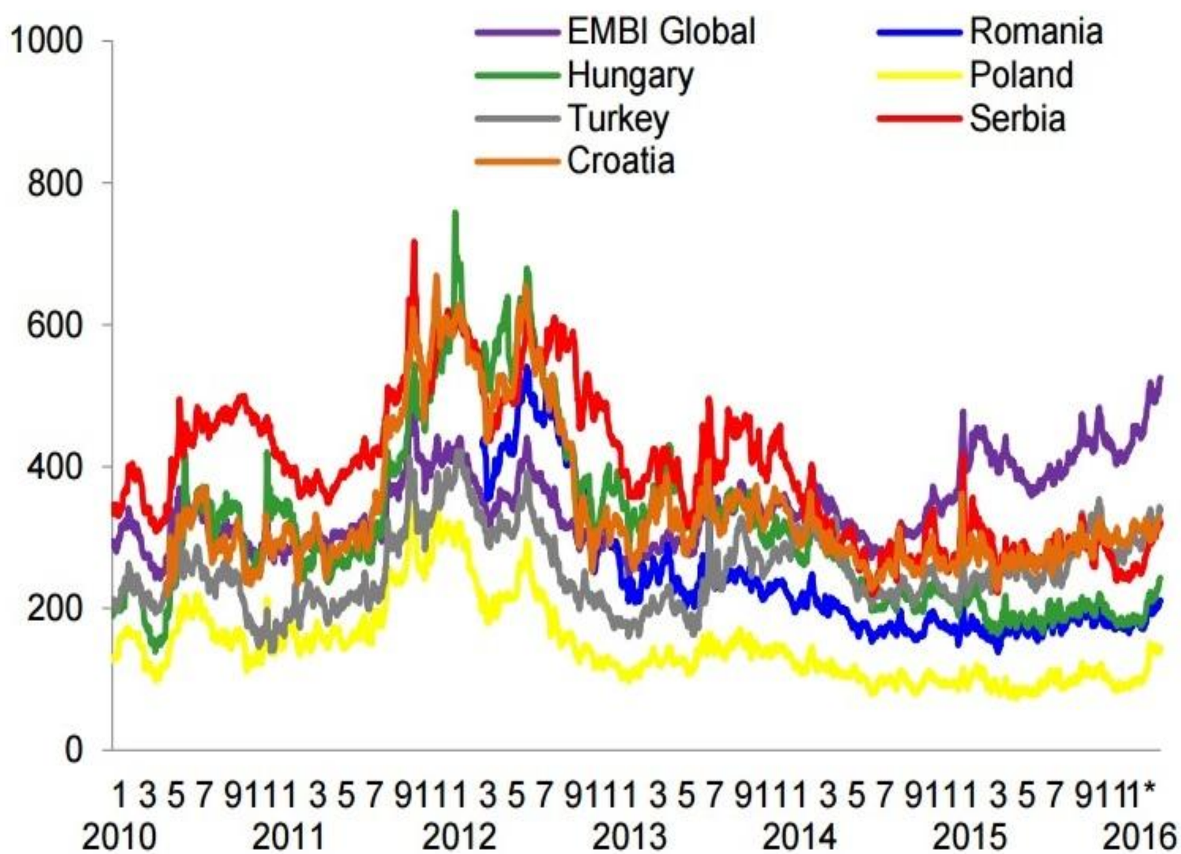
Clearly the Serbia FI market is a better investment alternative to any of the SEE equity indexes.



All SRB issues offer substantially higher yields relative to other sovereigns in the region. However, with marginally incremental risk.

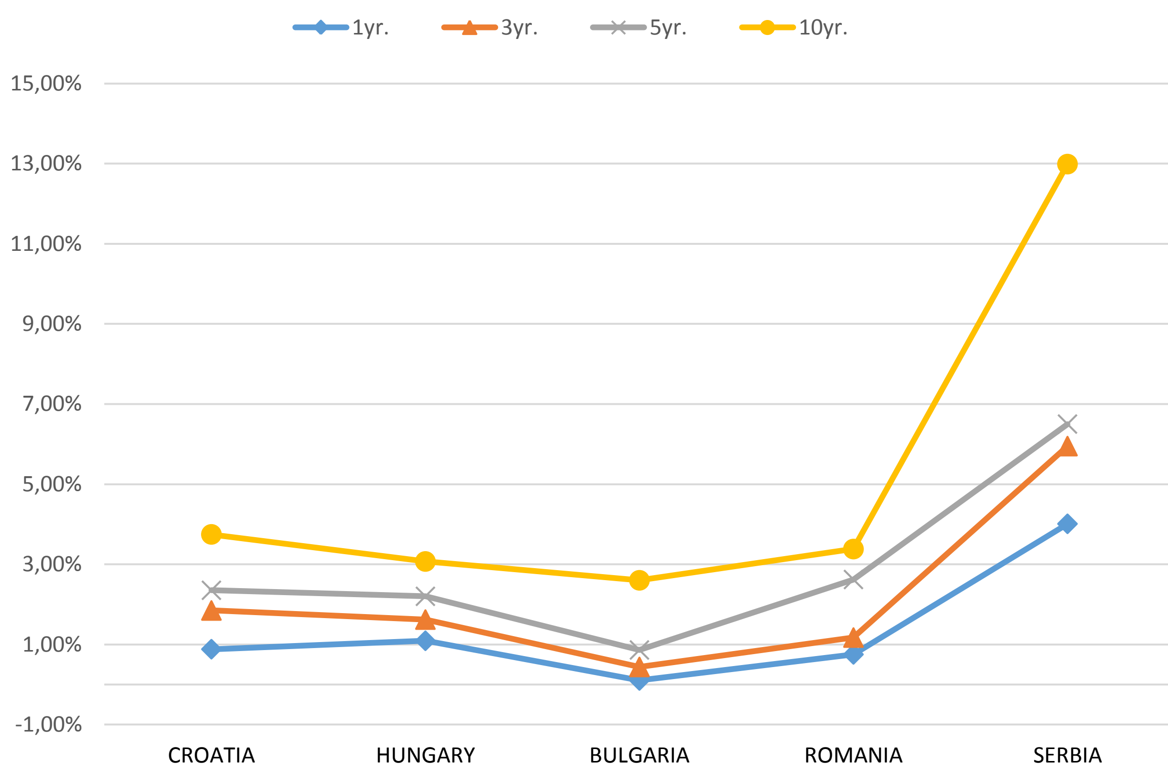
	Foreign Currency Long Term			Local Currency Long Term		
Country	S&P	Moody's	Fitch	S&P	Moody's	Fitch
Bulgaria	BB+	Baa2	BBB-	BB+	Baa2	BBB
Croatia	BB-	Ba2	BB	BB	Ba2	BB+
Hungary	BB+	Ba1	BB+	BB+	Ba1	BBB-
Romania	BBB-	Baa3	BBB-	BBB-	Baa3	BBB
Serbia	BB-	B1	B+	BB-	B1	B+
Slovakia	A+	A2	A+	A+	A2	A+
Slovenia	A+	Baa3	BBB+	A-	Baa3	BBB+

Our view is that the perceived risk of Serbian sovereign debt is out of alignment with the actual risk…



...and that the differentials, especially on the local currency issues, are too wide.

Local currency Yield Curves



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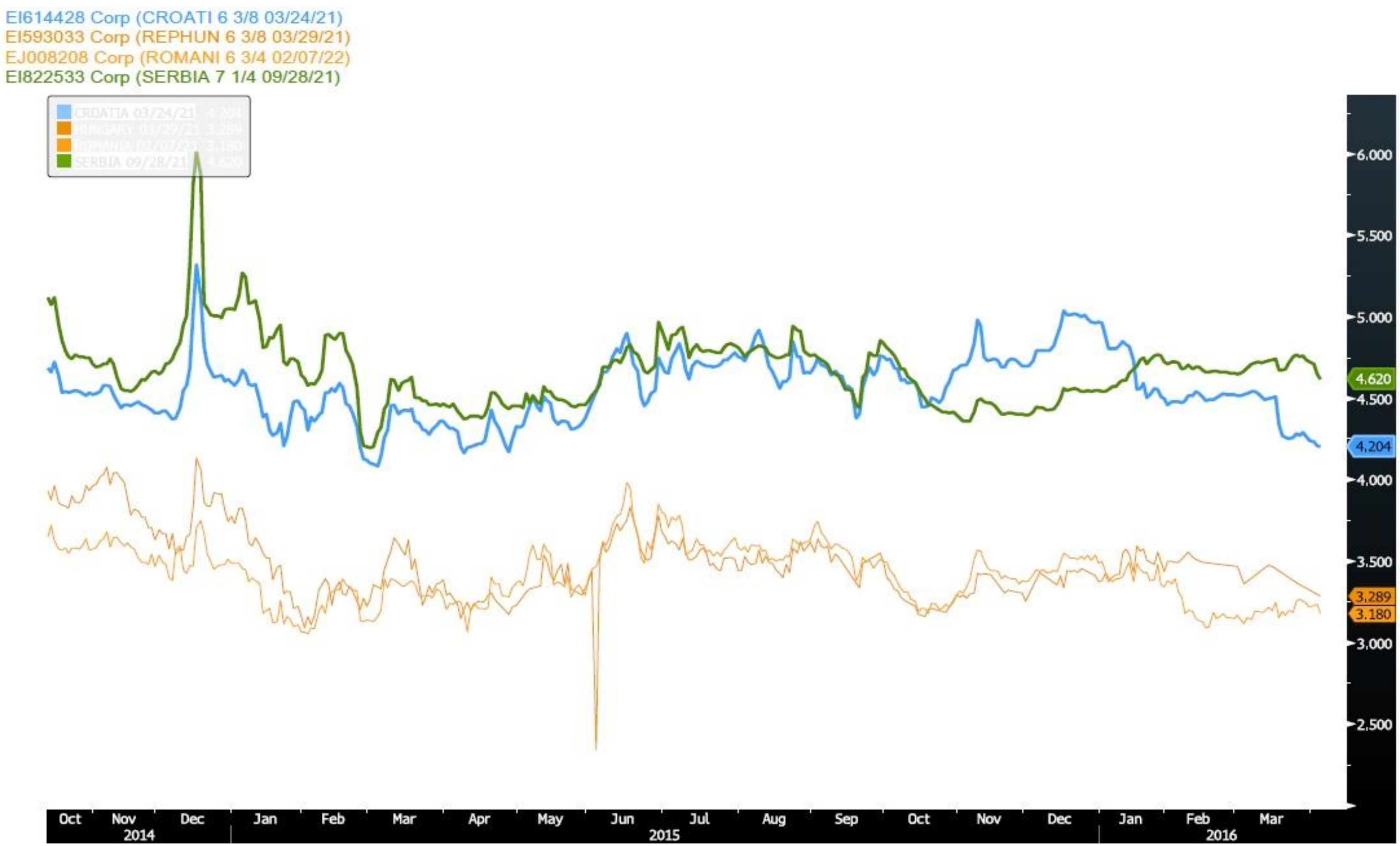
Comparative U$D 2Yr. Eurobond Yields



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Serbia has a Positive outlook with good upside potential for growth.

To reach GDP per capita of Croatia SRB has GDP +100% upside. Half of that in the next five year is a very realistic scenario.

Serbia exited recession last year, real GDP rose 0.7% from -1.8% in 2014 with *GDP forecast for 2016 at 1.5% and 2017 at 1.8%.*

Improved outlook by Fitch (B1) and Moody's (B+) from stable to positive end of 2015 year.

Ind. Output up 14%
Trade deficit down 18.2%
Budget deficit down 2.9%
Unemployment rate down 1.5%
C/A fully covered by FDI
FDI up 50% yoy.

SELECTED ECONOMIC FORECASTS

		2013	2014	2015	2016F	2017F
SLOVENIA	Nominal GDP (EURbn, current prices)	35,9	37,3	38,5	39,1	40,3
	Nominal GDP (USDbn)	47,7	49,6	42,7	41,6	39,1
	GDP per capita (EUR)	17.431	18.091	18.665	18.892	19.439
CROATIA	Nominal GDP (HRKbn, current prices)	329,6	328,4	329,8	334,1	341,8
	Nominal GDP (EURbn)	43,5	43	43,3	43,6	44,4
	GDP per capita (EUR)	10.225	10.114	10.186	10.280	10.468
SERBIA	Nominal GDP (RSDbn, current prices)	3876	3908	3983	4121	4340
	Nominal GDP (EURbn)	34,3	33,3	33,0	33,3	34,5
	GDP per capita (EUR)	4,783	4666	4615	4666	4840

SELECTED ECONOMIC FORECASTS

		Real GDP (yoy, %)	Unemploymen t rate (ILO, %)	CPI Inflation (avg, yoy, %)	Budget balance (%/GDP)	Public debt (%/GDP)	Export of goods & services	Import of goods & services (EURbn)	C/A (%/GDP)	External debt (%/GDP)	EUR/local currency (avg)
SLOVENIA	2014	3,0	9,7	0,2	-4,9	80,9	28,5	-25,6	7,0	124,2	1,33
	2015	2,9	9,1	-0,5	-2,9	83,5	30,0	-26,3	7,3	116,1	1,11
	2016F	1,8	8,8	-0,5	-2,7	79,8	31,4	-27,4	7,5	116,6	1,07
	2017F	2,3	8,4	1,2	-2,2	79,3	33,0	-29,0	7,2	116,5	0,97
CROATIA	2014	-0,4	17,3	-0,2	-5,7	85,0	20,0	-19,1	0,7	108,4	7,63
	2015	1,0	16,7	-0,3	-5,5	90,2	21,3	-19,8	2,9	109,9	7,62
	2016F	0,5	16,8	1,1	-5,7	94,4	22,0	-20,5	2,7	112,6	7,67
	2017F	1,3	16,0	1,4	-4,6	99,1	22,7	-21,3	2,4	115,0	7,70
SERBIA	2014	-1,8	19,3	2,1	-6,6	68,3	14,5	-18,1	-6,0	77,2	117,20
	2015	0,7	17,9	1,4	-3,7	76,5	15,6	-18,9	-4,8	79,6	120,80
	2016F	1,5	18,2	1,8	-4,2	80,9	16,3	-19,4	-4,4	78,1	123,60
	2017F	1,8	17,6	3,1	-3,5	83,3	16,9	-19,9	-4,0	75,4	125,90

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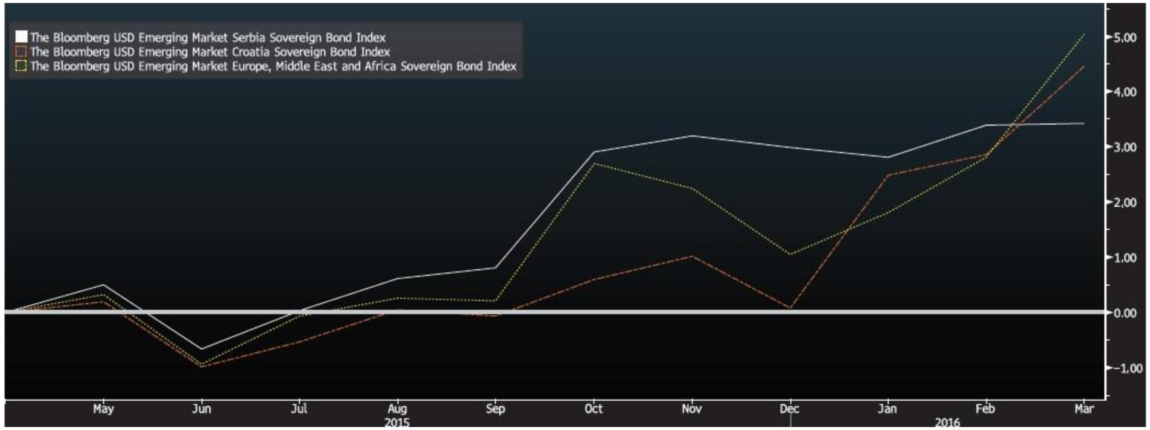
Comparative return as per Bloomberg Emerging Market Sovereign Index.

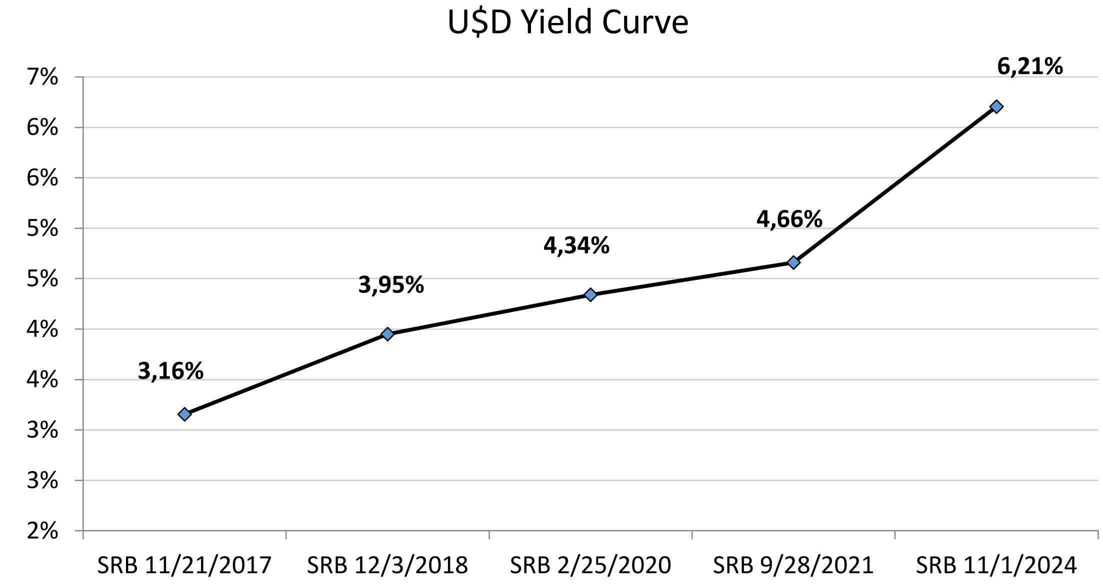
Charts are showing total return of Serbia and Croatia gov't bonds respectively compared to EMEA composite Index over 1, 3 and 5 year period.

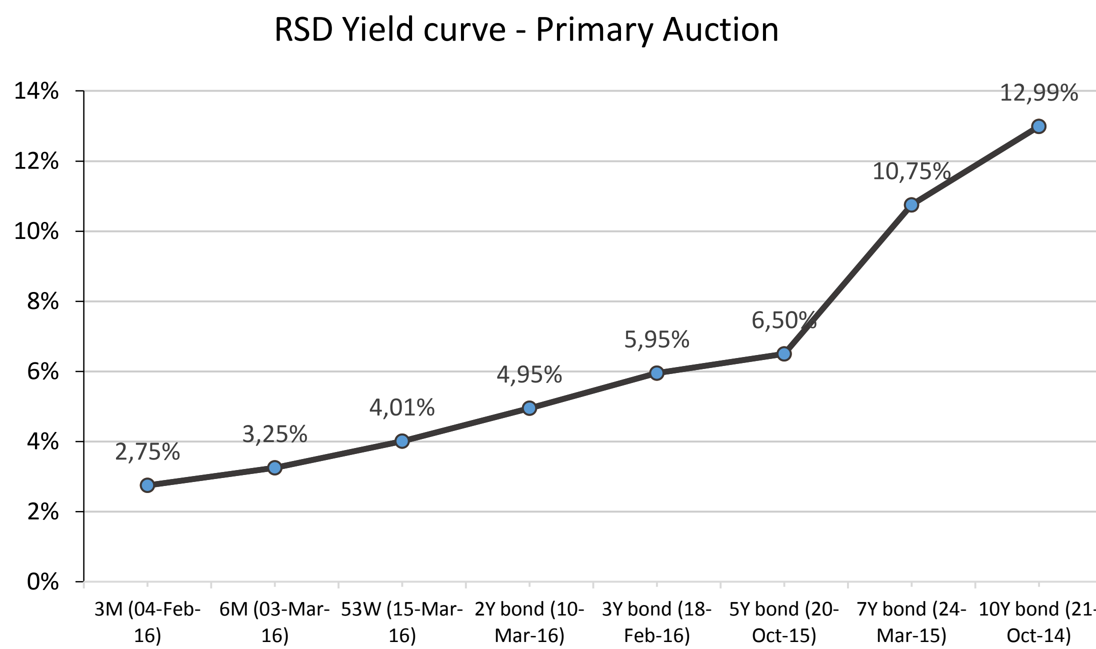


Currently the most compelling opportunities are in the U$D and RSD issues. However, Eurobonds offer several advantages:

1. *Higher liquidity*
2. *Lower transaction costs*
3. *Better bid/ask transparency*
4. *Clearing issues (Euroclear vs local system)*
5. *Coupon size and frequency (S/A vs Annual)*

Description	Maturity date	Coupon
SERBIA17$	21/11/2017	5.250
SERBIA18$	03/12/2018	5.875
SERBIA20$	25/02/2020	4.875
SERBIA21$	28/09/2021	7.250
SERBIA24$	01/11/2024	6.750





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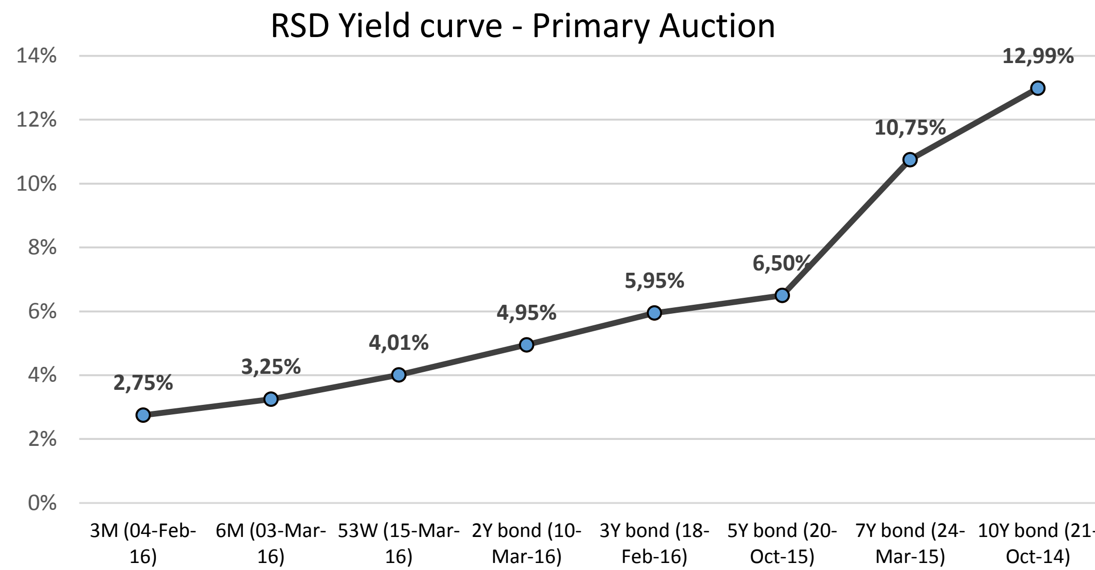
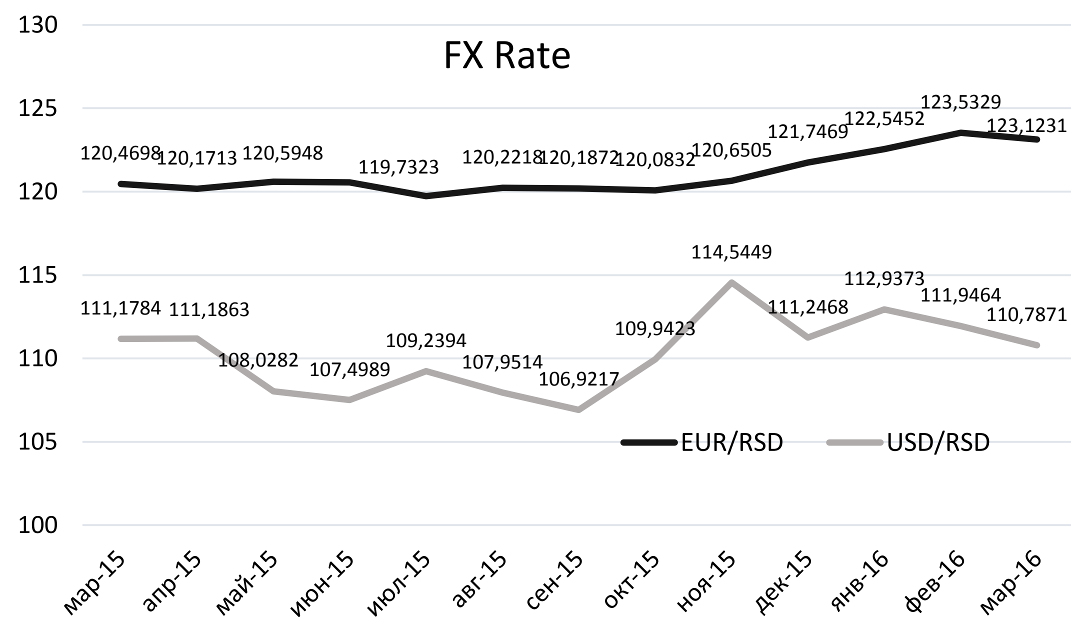
The other opportunity is in the mid and long end of the RSD curve.

The dinar continues to be stable trading with a 120-123 band.

NBS will continue its active management of the Key policy rate and with interventions on the FX market as required to keep the RSD within its trading band and volatility in check.

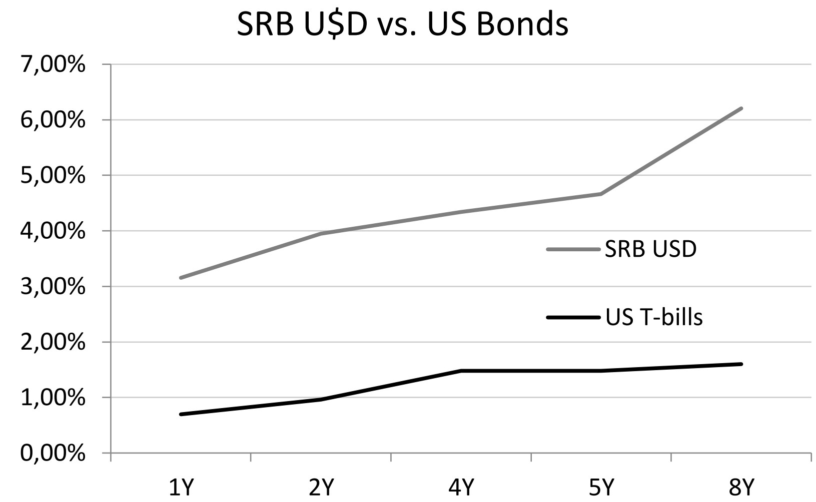
Swaps can be used to hedge FX risk as well.

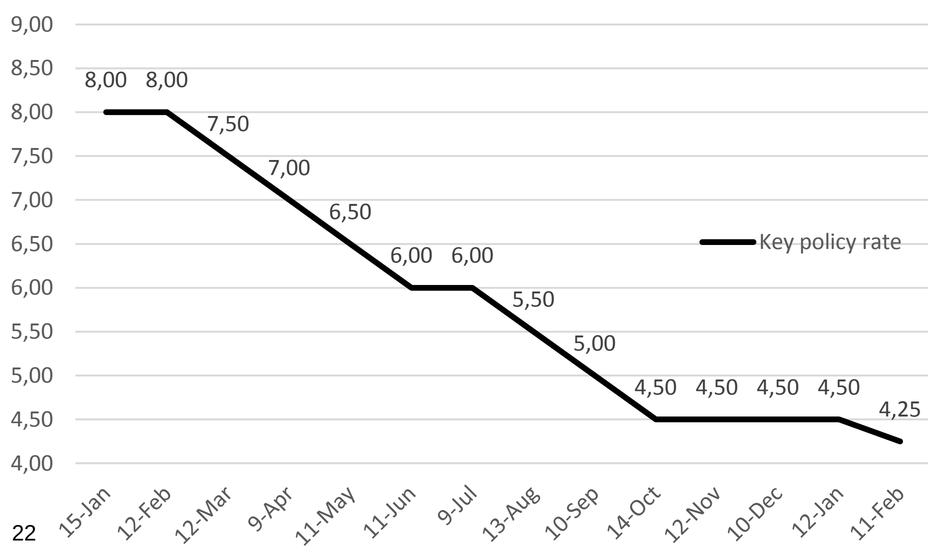


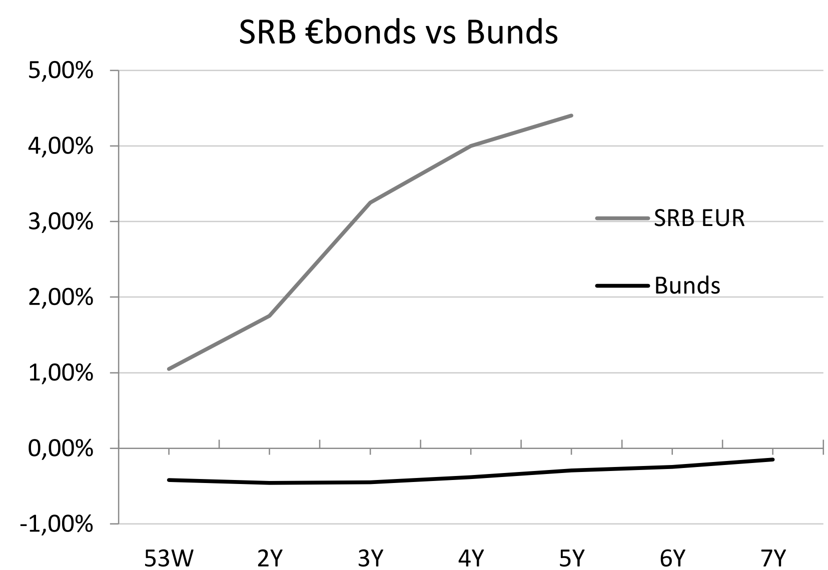


The interest on the $ and € are at or near historical lows. And we do not see this changing in a significant way in near term.

- ECB continues its QE program
- The Fed has stepped back from its initial schedule of hike rates.
- The NBS is on a holding patter until elections and new government is in place and its a bit stuck between the Fed and ECB.



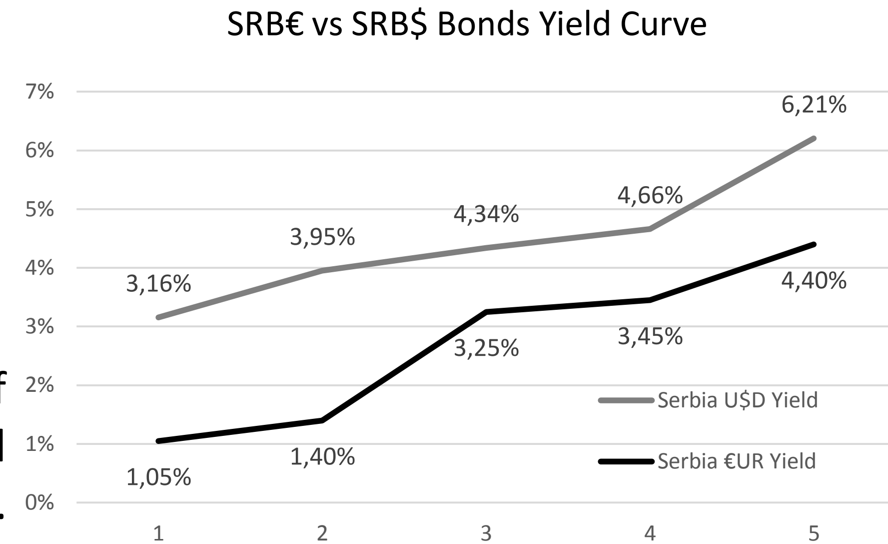


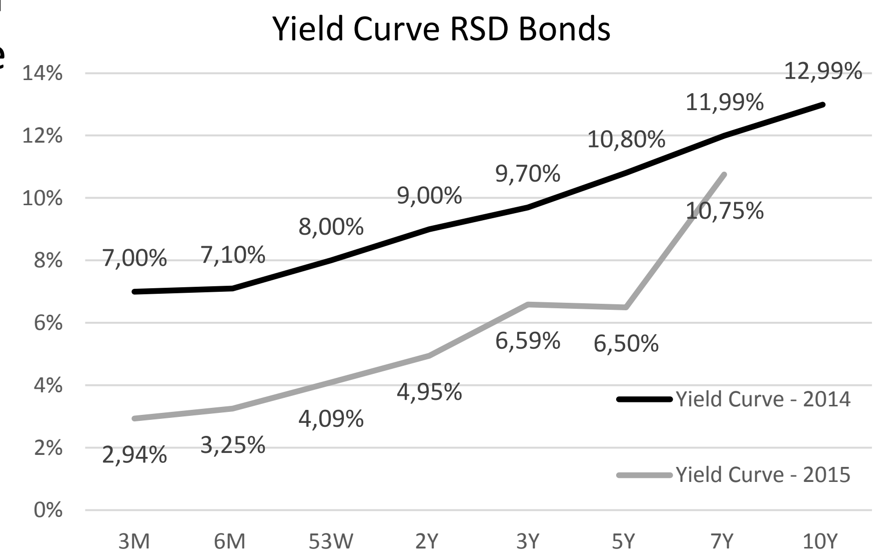


Despite the recent contraction in Yields we feel there is still ample opportunity to take advantage of the yield differentials and interest rates.

"**Perceived risk vs actual risk"** often yields, of emerging market sovereigns, are weighted more by their "perceived" risk than real risk. These "perceived" risks, formed by various remote market participants, are often out of correlation with the real or actual risk of the underlying Sovereign. Sometimes substantially.

Local currency Yield Curves	1yr.	3yr.	5yr.	10yr.
CROATIA	0,88%	1,85%	2,35%	3,75%
HUNGARY	1,09%	1,62%	2,20%	3,07%
BULGARIA	0,10%	0,44%	0,86%	2,60%
ROMANIA	0,75%	1,17%	2,62%	3,38%
SERBIA	4,01%	5,95%	6,50%	12,99%





Capitalizing on the opportunity

Most investors have a buy and hold strategy which produces a solid return for very conservative pension funds or insurance companies.

The buy and hold model allows investors to benefit from a single variable - Price.

But this is not sufficient for active investors looking to maximize their ROIC at acceptable risk levels.

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In order to take advantage of all the variables previously mentioned we have developed a proven model (three years running) allowing investors to achieve substantially higher ROIC (in the double digits) without substantially increasing the risk profile of the investment.

The model involves capturing benefits from the combination of arbitrage of yield/interest rate spreads, capital appreciation by riding certain parts of the yield curve and swapping denominations.

And all investments in SRB bonds are free from capital gains tax

Takeaways:

Serbian Sovereign bonds have had a strong bull market over the last few years with significant yield contractions as they converge to comparable rates of neighboring markets.

Despite this, the yield spreads are still substantial and still provide ample investment opportunities.

Our view is that this is the result of the perceived risk of Serbian sovereign debt is out of alignment with the actual risk. But this is slowly changing as rating agencies are improving their view of Serbian risk.

Currently he most compelling opportunities are in the U$D and RSD yield curves.

Serbian (and Croatian) sovereigns offer the opportunity of compounding the yield/interest rate differentials and capital gains to achieve compelling ROIC at acceptable risk profiles.

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