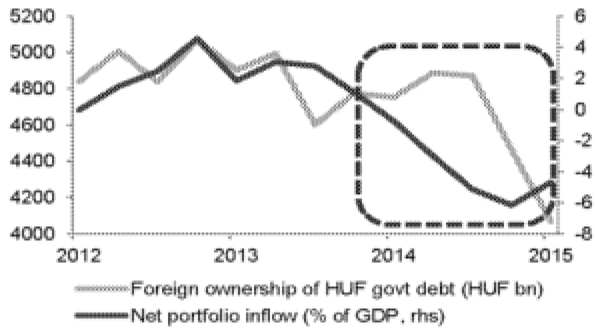
Growth: We expect divergent growth trajectories for Poland and Hungary in the coming year. Hungarian growth should decelerate to 2.4% in 2016, primarily on the back of a decrease in public investment driven by reduced EU funds inflows. This is because the overlap from the old EU budgeting period has ended, and this is normally associated with a sharp drop in EU funds. EU funds inflows in Hungary are normally back-loaded towards the end of the budgeting envelope – for example, just EUR 1.6bn of EU funds were absorbed in each of the first three years of the previous budgeting period (on average), while in the first three quarters of 2015 the absorption was already nearly EUR 5bn. On the other hand, Poland has a much better record of EU funds absorption that is more evenly-distributed over the budgeting period. This is partly the reason we expect Polish growth to remain robust at 3.5% in 2016. Other Polish fundamentals are also sound: valuations are attractive (PLN is the most undervalued currency across our long-term metrics) and macro vulnerabilities have been sharply reduced in recent years.

BoP dynamics: The sharp drop in Hungary's EU funds inflows this year will also lead to a contraction in the capital account. This will come on top of sizable portfolio outflows, as EUR 5.5bn in external debt redemption is planned to be financed by the local banking sector via domestic issuance (part of the NBH's Self-Financing Plan). Non-domestic holdings of Hungarian government debt have come down sharply to 26% from 35% a year ago – the increase in local demand for this debt encouraged as part of the Self-Financing Plan has lowered yields and squeezed out non-domestic investors. This process could continue into next year with the implementation of further local bank QE-type measures mentioned earlier, putting further pressure on the portfolio component. All in all, deteriorating BoP dynamics will weigh on HUF in 2016.

Recent trend of portfolio outflows is likely to continue

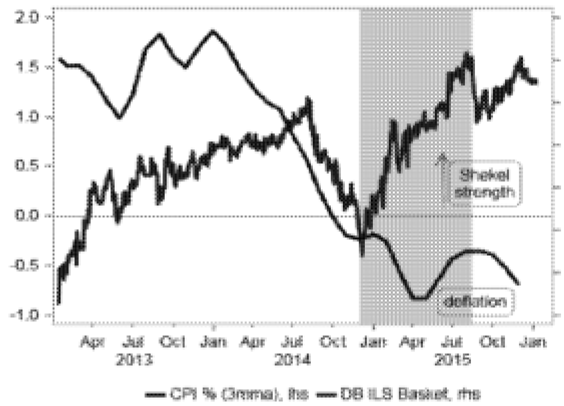


Source: Deutsche Bank, Haver Analytics

ILS the weak one among the other EMEA low yielders

ILS remains a good funding currency, with a near-zero funding cost. The shekel's negative beta to broad dollar strength is high, and therefore the continued USD strength expected this year should lead to some ILS weakness. Barring this, continued FX interventions by the BoI will likely prevent further shekel strength. ILS TWI is near 5-year highs due to substantial appreciation in 2015, as the BoI has not taken steps to substantially weaken the currency like other central banks with similar deflation concerns. But this shekel strength has weighed on exports, growth and inflation, and the BoI's sensitivity to any major shekel appreciation is now likely high. There are particular concerns about the current deflation, present since mid-2014 and deepening in recent months, becoming further entrenched. Discretionary FX interventions were ramped up somewhat in December, but we believe there is more space and likelihood of more intervention acceleration, given the relatively low level of FX reserves (30% of GDP) and recent leg lower in crude.

Shekel strength has contributed to recent deflation



Source: Deutsche Bank, Macrobond

The BoI again sharply downgraded both growth and inflation forecasts in December, providing forward guidance of low rates for long. For 2016, it forecasts only one 15bps hike around year-end, which is even more hawkish than our forecast for the first hike in Q1 2017. Real rate spreads vs the US are already close to 5-year lows, and further widening of rate differentials this year should add upward pressure on USDILS.

Elsewhere in CEE, CZK is the most elevated net long on our CORAX positioning indicator across G10 and EM FX, mainly due to buying by leveraged funds. However, the CNB's EURCZK 27 floor does not look in danger: FX reserves levels are relatively low (30% of GDP); potential CNB losses from eventual CZK appreciation is not a political issue (as was the case in Switzerland); on a relative scale, intervention through the life of the floor has been small – CNB intervened for the first time since the start of the floor (Nov 2013) only in July 2015; inflation is expected to remain below target until well into next year. We believe the CNB will let go of the floor only around end-2016, in line with guidance.

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