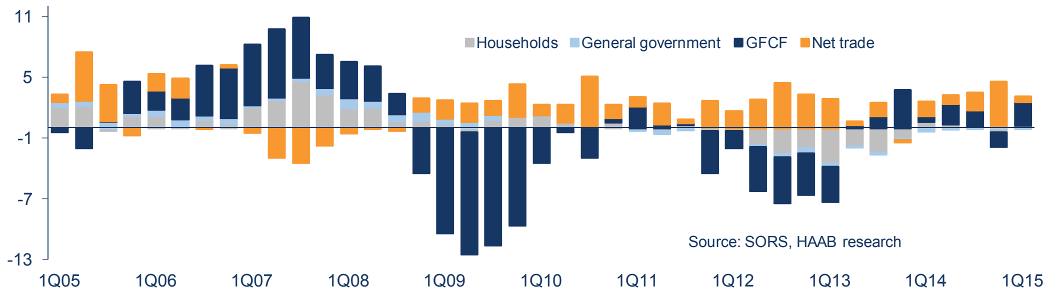
Outperformance and Policy Commitment

We hold our above-consensus 2015 GDP forecast with more balanced risks than in March. Our 2016 GDP growth forecast was tweaked to 2.0% on the back of public EU-funded capex slump and stalled euro-zone's recovery. The budget gap will be likely lower than the MinFin-eyed 2.9% of GDP. Frontloaded ECB QE purchases, sovereign's structural position and fiscal dynamics suggest spread compression in 2H15.

A sturdy start to 2015

The stronger-than-expected 1Q15 GDP (+0.8% qoq, 3.0% yoy seasonally adjusted, prev. 2.0% yoy) owes largely to a whooping (+2.5pp) inventory contribution, followed by net trade and private consumption. While re-stocking in manufacturing is truly a sign of confidence, household spending also surprised on the upside as in addition to a solid recovery of the labour market citizens benefitted from the drop in the oil price that adds to real incomes. Meanwhile, net exports influenced positively if at a slower pace as exports paid-back to a remarkable Q4 and imports rebounded on domestic demand. The first hard data for 2Q15 suggest GDP growth will moderate on fading inventory surge, industrial output slowing to ~4% yoy pace and more subtle net exports' showing. At the same time, sentiment gauges show a further improvement in local/import demand, accompanied by less buoyant external demand as the positive impact from the euro's depreciation is hindered by a weaker-than-expected global demand.

Slovenia: contributions to quarterly changes in real GDP (in pps)



Broad-based recovery shrugs off slowdown in exports

Following a strong Q1 print, we hold our GDP forecast for 2015 (+2.3%), with (i) the recovery broad-based enough to shrug off a slowdown in exports, but even then (ii) competitiveness gains helping Slovenia to latch onto an external demand more than most of CESEE peers. That said, the main driver of growth, in our view, is private equipment investment (in tradable sectors such as ICT and electrical equipment) amid high capacity utilization, better funding conditions, stronger firms' profitability and EU funds. While the recent bounce in oil prices suggests the nature of this stimulus may prove transitory, we think households may finally reduce their saving effort in a zero interest rate environment, as firmer hiring prospects also reduce uncertainty. While risks to our forecasts are more balanced than in March, (geo) political risks (notably around Greek debt talks), weak global growth and foreign demand remain the main swing factors on the downside. Upside risks to our outlook could come from a stronger impact of policy measures and from greater fiscal/investment stimulus from euro area governments. Lastly, we tweak our 2016 GDP growth forecast to 2.0% on the back of public EU-funded capex slump and stalled euro-zone's recovery, as the twin tailwinds (for external demand) of a weak euro and the fall in oil prices fade out.

Low-flation here to stay

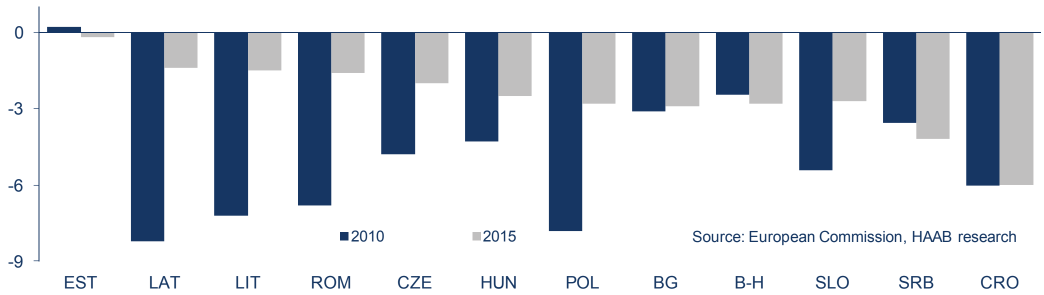
As expected, CPI inflation remained in negative territory, under pressure mainly from energy and clothing prices, and the strong euro. Notwithstanding the expected normalization in unprocessed food and oil prices, inflation is likely to stay in the red through 2015 before bouncing back to 1% in the spring next year. However, given the core inflation in downward trajectory, ongoing slack in the labour market and signs the EU recovery has been softening, the threat of deflation has not evaporated. That being said, we see our 2015 average CPI forecast at -0.25%, before inflation resumes at an average 1% in 2016 amid gradual recovery in domestic demand and higher energy prices. Although first signs of stabilizing inflation in the euro zone offer some relief to the ECB, we expect that with underlying price pressures still very subdued strong monetary policy support will be required for the foreseeable future.

C/A surplus underpinned by export growth

A further increase in C/A surplus this year owes to improved both services and goods trade balances. On the other hand, income deficit swelled on portfolio outflows (higher dividends and interest costs) and worsening of the general government position. Such trends support further increases in C/A surplus this year and next, but with stronger domestic demand and the high import content of production, Slovenia needs further competitiveness gains through wage restraint and non-price factors (eg customization and quality of goods) to sustain these external surpluses.

With easing private de-leveraging and a pick-up in FDI (5% of GDP), the external position is much less dependent on fickle portfolio inflow, though the MinFin may exploit the benefits of ECB QE and issue up to EUR3bn this year to fully cover 2016's redemption. Adding to flexibility is the EC's proposal to lower fiscal reserve via milder issuance (a prudent move ahead of ECB QE tapering in 2016) alongside yet unknown privatization revenue. Despite the recent sale of NKBM bank and plans to enhance privatization with the asset management strategy by October this year, the biggest cases (Telekom Slovenije, NLB) are on hold due to mixed political signals. While the TS sale is not yet off the table, we can't see the cabinet's intention to keep 25%+ share in the largest state-run bank and prevent a single investor to own more than the state as a way to avoid the old problems from recurring in the future.

Slovenia: fiscal deficits (% of GDP)



Fiscal consolidation heads into right direction...

A 3% yoy lower budget deficit (EUR676m) in the year to May is largely driven by tax revenue performance amid stronger corporate profits, generally stronger-than-expected economic recovery and VAT intake. But expenditures also fell slightly due to subsidy cuts accompanied by prolonged public wage freeze and transfers rationalization. Although wage savings sealed with syndicates are lower than initially planned, this shortfall will be offset by intermediate consumption cuts. While fiscal consolidation heads into the right direction, and the budget gap will be likely lower than the MinFin-eyed 2.9% of GDP, the cabinet must show more credibility in order to hit a balanced budget by 2020 by cutting the gap by at least 0.5pp/GDP per annum. This notably concerns the 2016 budget as the planned 0.8pp/GDP spending hike could be merely offset by more efficient E-tax collection, raising fears of even deeper capex cuts if other consolidation measures are not introduced. By end-2015, Slovenia must present pension, health system and labour reforms, start cutting the number of state agencies, and revamp the tax system (lower taxation of labour, higher real estate taxes) to ensure that consolidation is sustainable. To be sure, the government's awareness of the need for supply-side reforms has increased significantly, compared to when it came to power about a year ago, campaigning on an end to austerity as well as higher taxation.

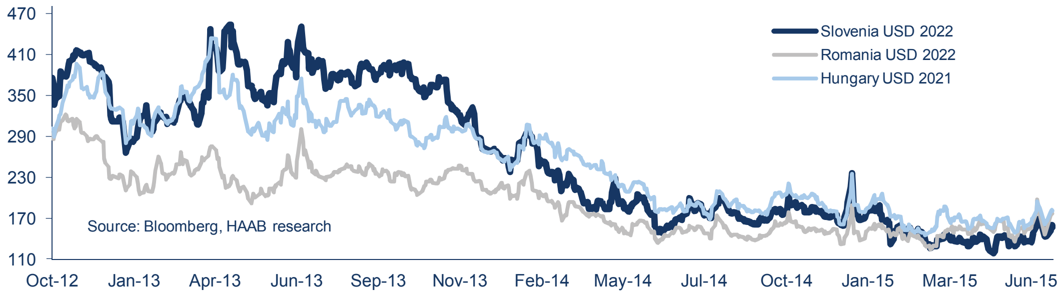
... public debt stabilization in the making

After a surge to 81% of GDP in 2014 on hefty pre-funding, we see public debt gradually higher in the next years in the absence of significant (re)financing operations. However, with privatization receipts (EUR1-1.25bn assumed for 2015-2016) and a similar (EUR1bn+) reduction in the MinFin's cash reserve, it is possible that debt actually drops to about 78% of GDP in 2016 (vs. HAAB's 82%). While the remaining still relatively large cash cushion (EUR3.5bn, 9.5%/GDP) lowers net debt to 68.5% of GDP, this figure can go even lower upon BAMC EUR1bn (2.7% of GDP) bonds redemption as the bad bank sells off the assets it took over in the asset transfer (as part of the banks' capital hike process). There is finally a potential for windfall receipts used to cover redemptions if recoveries by the BAMC exceed those reflected in the haircuts (68% on average) applied in the NPL transfer, as well as from faster sale of equity held in three state-owned banks. Last but not least, public debt stabilization will to a large extent rest on structural reforms (tackling pressures from population aging), ongoing commitment to privatization as well as a credible mechanism to reach medium-term objectives (ie zero-budget deficit rule). Further bank and firms restructuring, with overall ambitious NPL reduction targets, are equally important to reduce the likelihood of a renewed financial stress and the medium-term risk of fiscal support.

Greek contagion introduces volatility in yields

As negotiations between Greece and Troika have taken a turn for the worse, contagion has spread to the EMU bond markets, with Slovenian EUR spreads peaking up 80bp on average from Q2 lows only to stabilize recently. The sell-off in core yields since mid-April as the market also focused more on positive surprises in EMU data and the perceived ECB QE-induced end of the 'deflation fear' has only strengthened the long-term yields' upward tendency. Meanwhile, Slovenian USDs have completely pared their total returns to date and underperformed CESEE peers. While external events will continue to dictate yields development, a full scale contagion from Greece anything similar to 2011/2012 is unlikely (in our view), as we also expect better internal fundamentals to alleviate volatility going forth.

Slovenian spreads in tandem with peers

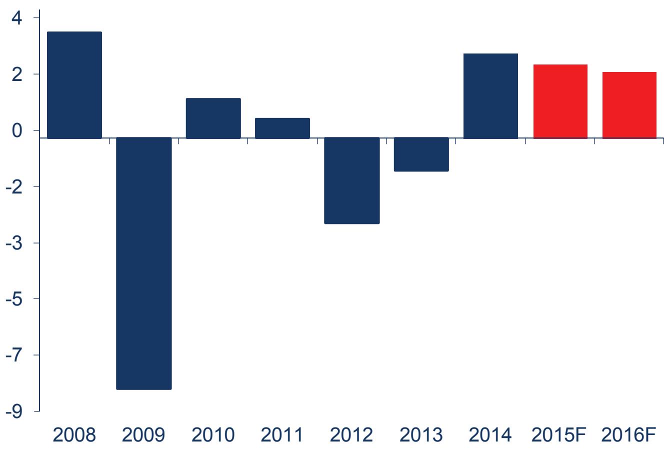


The only certainty is uncertainty

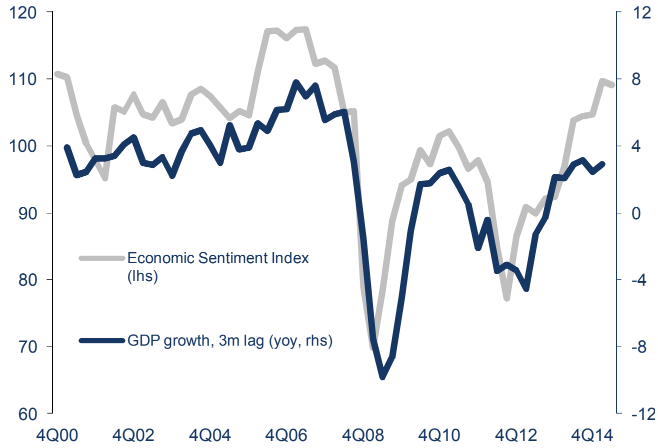
Looking ahead, investors should be reassured by frontloaded ECB QE purchases ahead of the expected negative net debt issuance this summer, supportive local economy's dynamics and fiscal reserve cut considerations, all of which suggests Slovenian spread compression in 2H15. Also, S&P's upgrade of Slovenian outlook on reduced policy uncertainty and improved growth prospects adds to a positive tone. This baseline scenario is everything but smooth, however, in that the government embarks on the main structural reforms only half-heartedly, hoping that higher GDP growth can do the fiscal consolidation trick. Positive external drivers accompanied by concrete key privatizations' results and timely presentation of reforms (before the 2016 budget) together form a bull case where Slovenian bonds outperform Italian and Spanish peers given the renewed fiscal woes and election-related risks, respectively. On the other hand, short-term adverse scenario for Greece, ie the sovereign's default, and potential spillovers from the US rate markets pose the key upside risks for core-periphery spread widening by 100-125bp at the longer end of the curve. In a Grexit scenario, the markets would be dominated by even greater uncertainty, sending periphery spreads up by 200-225bp. Negative external factors alongside political uncertainty when it comes to the government's capacity to launch reforms, strengthen the banking system, stabilize fiscal picture, and boost potential growth would certainly lead us to a pessimistic scenario.

Slovenia's data trends

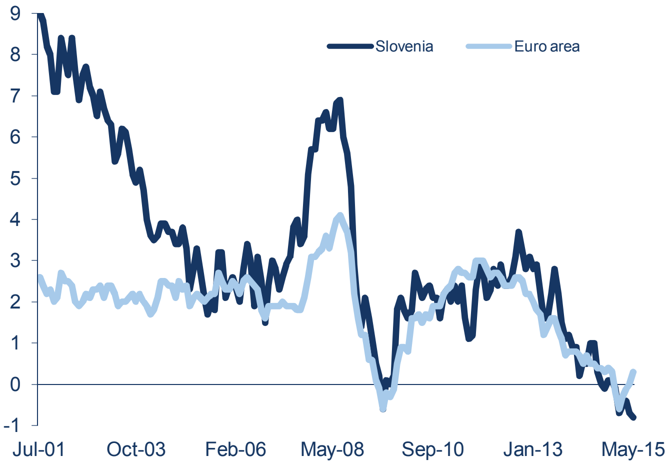
Real GDP growth (% YoY)



Economic confidence vs. GDP growth

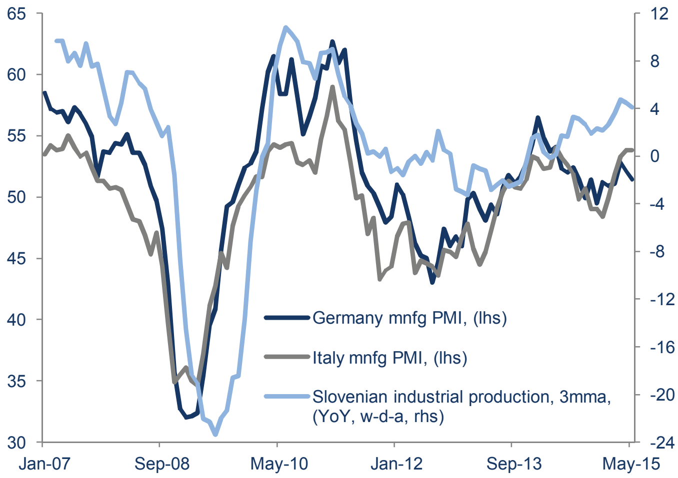


CPI inflation dynamics (% YoY)

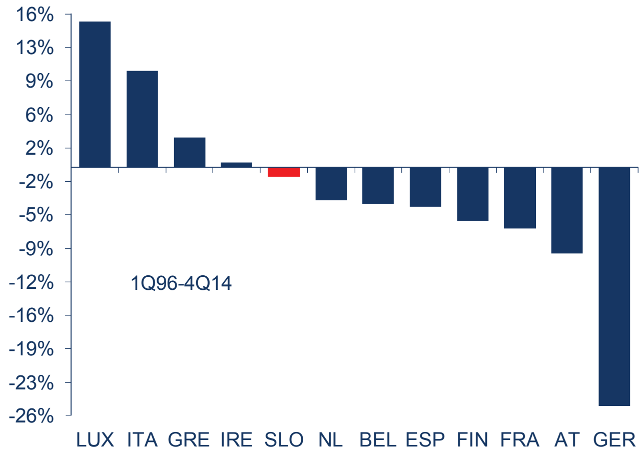


Business sentiment in manufacturing

PMI vs Industrial production - Slovenia



Unit labour cost for the total economy



Source: Slovenian National Bank, Statistical office of the Republic of Slovenia, Ministry of Finance, ECB, European Commission, Bloomberg, HAAB research

SELECTED ECONOMIC FORECASTS

	2008	2009	2010	2011	2012	2013	2014	2015F	2016F
Activity									
Nominal GDP (EURbn, current prices)	35.2	38.0	36.2	36.2	36.9	36.0	36.1	36.7	37.6
Nominal GDP (USDbn)	51.7	52.9	48.0	50.4	47.4	47.8	48.0	39.2	37.6
GDP per capita (EUR)	17,487	18,673	17,668	17,666	17,936	17,489	17,556	17,813	18,264
GDP per capita (USD)	25,726	26,046	23,439	24,602	23,066	23,240	23,338	19,065	18,269
Real GDP (constant prices YoY, %)	3.3	-7.8	1.2	0.6	-2.6	-1.0	2.6	2.3	2.0
Private consumption (YoY, %)	2.6	0.9	1.0	0.0	-2.9	-4.0	0.3	0.8	1.0
Fixed investment (YoY, %)	7.0	-22.0	-13.7	-4.6	-8.9	1.9	4.8	3.5	0.8
Industrial production (YoY, %)	2.5	-17.3	7.1	1.3	-1.1	-0.7	3.9	3.8	3.2
Unemployment rate (ILO, average %)	4.4	5.9	7.3	8.2	8.9	10.1	9.8	9.4	9.0
Prices									
CPI inflation (average % YoY)	5.7	0.9	1.8	1.8	2.6	1.8	0.2	-0.3	1.0
CPI inflation (end-year % YoY)	3.1	1.6	1.4	2.7	2.7	0.7	0.2	0.4	1.2
PPI inflation (average % YoY)	3.9	-1.3	2.1	4.5	0.9	0.3	-0.6	-0.6	1.6
Net wage rates (% YoY, nominal)	7.9	3.4	3.9	2.1	0.4	0.6	1.1	1.0	1.5
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-2.2	-6.3	-5.4	-6.6	-4.0	-14.9	-4.9	-2.7	-2.5
Public debt	26.0	35.5	36.2	46.5	53.7	70.3	80.9	82.0	82.2
Gross public funding needs	n/a	n/a	7.0	10.7	8.0	19.4	15.1	9.4	14.2
External balance									
Export of goods and services (EURbn)	25.090	20.686	23.285	25.948	26.363	27.000	28.643	29.751	30.804
Import of goods and services (EURbn)	25.794	19.999	22.792	25.478	24.889	24.482	25.629	26.534	27.346
Merchandise trade balance (EURbn)	-2.114	-0.425	-0.717	-0.936	-0.036	0.763	1.307	1.497	1.739
Merchandise trade balance (% of GDP)	-6.0	-1.1	-2.0	-2.6	-0.1	2.1	3.6	4.1	4.6
Tourism receipts (EURbn)	1.827	1.804	1.925	1.975	2.008	2.040	2.047	2.088	2.129
Current account balance (EURbn)	-2.059	-0.220	-0.029	0.083	0.955	2.027	2.150	2.347	2.482
Current account balance (% of GDP)	-5.9	-0.6	-0.1	0.2	2.6	5.6	5.9	6.4	6.6
Net FDI (EURbn)	-0.1	-0.5	0.1	0.6	0.5	0.1	1.2	1.8	1.4
FDI (% of GDP)	-0.4	-1.3	0.3	1.8	1.3	0.2	3.3	4.9	3.7
FDI cover (%)	-6.3	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	0.687	0.749	0.803	0.767	0.722	0.669	0.837	0.750	0.750
Import cover (months of imports)	-0.3	-0.4	-0.4	-0.4	-0.3	-0.3	-0.4	-0.3	-0.3
Debt indicators									
Gross external debt (EURbn)	39.306	40.416	40.838	40.292	41.503	40.205	46.218	47.718	48.948
Government (EURbn)	3.736	6.573	8.190	8.748	11.092	15.459	22.159	23.659	24.409
Private (EURbn)	31.939	30.248	30.273	28.534	25.709	23.451	21.976	22.459	23.139
Gross external debt (% of GDP)	111.8	106.5	112.9	111.2	112.6	111.7	127.9	130.1	130.2
Gross external debt (% of exports)	156.7	195.4	175.4	155.3	157.4	148.9	161.4	160.4	158.9
Exchange rates and money									
EUR/USD (end-year)	1.40	1.43	1.34	1.30	1.32	1.37	1.21	1.00	0.95
EUR/USD (average)	1.47	1.39	1.33	1.39	1.29	1.33	1.33	1.07	1.00
Money supply M1 (% YoY)*	-3.7	7.7	13.5	1.5	4.4	0.1	18.5	10.0	7.0
Broad money M3 (% YoY)*	8.9	2.6	2.4	3.5	-1.4	-1.3	6.1	5.0	3.0
Domestic credit (% YoY)	n/a	1.1	1.6	-4.6	-5.8	-21.4	-11.4	1.4	3.7
ECB reference rate (end-year %)	2.50	1.00	1.00	1.00	0.75	0.25	0.05	0.05	0.05
EURIBOR 3M interest rate (average %)	4.64	1.22	0.81	1.39	0.58	0.22	0.21	-0.01	0.05
SLO 5Y yield (average %)	-	-	3.03	3.96	4.55	4.35	1.95	0.80	1.35
SLO 10Y yield (average %)	4.49	4.35	3.84	4.98	6.01	5.87	3.25	1.70	2.50

* Since 2007 ECB data

Source: Slovenian National Bank, Statistical office of the Republic of Slovenia, Ministry of Finance, IMF, HAAB research

SELECTED BANKING SECTOR DATA

	2008	2009	2010	2011	2012	2013	2014	2015F	2016F
Balance sheet									
Assets (EURm)	47,628	51,612	50,319	48,748	46,125	40,344	38,754	39,142	39,924
Assets (%, YoY)	n/a	8.4	-2.5	-3.1	-5.4	-12.5	-3.9	1.0	2.0
Assets (% of GDP)	135.5	136.0	139.1	134.6	125.1	112.0	107.2	107.0	106.0
Net loans (EURm)	33,530	33,910	34,450	32,875	30,964	24,338	21,573	21,878	22,689
Net loans (%, YoY)	n/a	1.1	1.6	-4.6	-5.8	-21.4	-11.4	1.4	3.7
Net loans (% of GDP)	95.4	89.4	95.3	90.8	84.0	67.6	59.7	59.8	60.2
Deposits (EURm)	20,612	23,570	23,507	24,170	23,856	22,550	24,426	24,437	24,450
Deposits (%, YoY)	n/a	14.4	-0.3	2.8	-1.3	-5.5	8.3	0.0	0.1
Deposits (% of GDP)	58.6	62.1	65.0	66.7	64.7	62.6	67.6	66.8	64.9
Loan-to-deposit ratio (%)	162.7	143.9	146.6	136.0	129.8	107.9	88.3	89.5	92.8
Capital adequacy ratio (%)	11.7	11.6	11.3	11.6	11.9	14.0	16.7	16.0	15.3
Performance									
Net interest income (EURm)	945	932	1,038	1,018	886	708	832	771	806
Net interest income (%, YoY)	15.7	-1.3	11.3	-2.0	-12.9	-20.1	17.5	-7.3	4.6
Total operating income (EURm)	1,360	1,425	1,474	1,447	1,566	1,091	1,233	1,180	1,237
Total operating income (%, YoY)	-5.1	4.8	3.4	-1.9	8.2	-30.3	13.0	-4.3	4.9
Pre-provision profit (EURm)	584	660	709	670	823	370	547	515	585
Pre-provision profit (%, YoY)	-13.7	13.0	7.3	-5.4	22.8	-55.0	47.7	-5.9	13.7
Provision charges (EURm)	278	500	810	1,207	1,599	3,809	614	389	316
Profitability and efficiency									
Net interest margin (%)	2.0	1.9	2.0	2.1	1.9	1.6	2.1	2.0	2.0
Pre-tax ROAA (%)	n/a	0.3	-0.2	-1.1	-1.6	-8.0	-0.2	0.3	0.7
Pre-tax ROAE (%)	n/a	3.9	-2.4	-13.3	-20.3	-92.9	-1.7	2.9	6.0
Cost-to-income ratio (%)	57.1	53.7	51.9	53.7	47.4	66.1	55.7	56.4	52.7
Operating expense (% of assets)	n/a	1.5	1.5	1.6	1.6	1.7	1.7	1.7	1.6
Credit quality and provisioning									
NPA ratio (%)	n/a	n/a	7.3	11.4	15.0	13.7	11.5	10.6	10.9
NPA coverage (%)	n/a	n/a	65.7	58.6	60.4	91.6	80.0	83.2	84.1
Provision charges (% of loans)	0.6	1.0	1.6	2.4	3.4	8.8	1.6	1.0	0.8
Provision charges (% of PPP)	47.6	75.7	114.3	180.1	194.3	1,029.2	112.3	75.7	54.0

Source: BSI, HAAB research

Lending activity to pick up in 2015

Loans declined 0.5% ytd on the back of lower other (-3.3% ytd) and public sector loans (-2.6% ytd). Corporate loans also dropped (0.4% ytd) given high indebtness of corporates and banks' reluctancy to lend. The sole positive contributor was retail loans (+0.7% ytd) thanks to improved consumer confidence, but also artificially inflated by the CHF strength which already boosted the stock of loans in 1M15. Looking ahead, we think that loan stock will grow (+1.4% yoy) this year, on the back of stronger retail loans as recovered consumer confidence bodes well for households' consumption and investments. Also, interest rates (on new business) are at multi-year lows which supports retail loan demand. Corporate sector lending is expected to rise (+0.5% yoy) for the first time since pre-crisis years, as fims start with new investment cycle amid improved economic environment. Rise will nevertheless stay low given still high indebtness of firms, as well due to their slow process of restructuring. In 2016, corporate sector loan growth will gain traction (+4.5% yoy), which alongside retail loan growth (+3.8%) implies that loan stock will grow 3.7% yoy.

Pre-tax profit entering positive territory for the first time since 2009

Deposits dropped 0.3% ytd amid 11.3% ytd lower public sector deposits (very volatile category), followed by corporate deposits. Retail deposits grew 4.7% ytd despite the fact that interest rates (new business) continued to fall. As for the latter, we expect retail deposits growth to slow down to 2.1% yoy in 2015 (vs 5.1% yoy) as we think households would rather shift into higher yielding assets. We keep our view that firms would continue to use previously accumulated deposits for investments amid weak cash flows. As for profitability, we see net interest income falling in 2015 given amid lower interest income due to low rates, which offset ongoing decline in interest expenses. Also, we see provision charges stabilizing this year given already high coverage of non-performing assets. Overall, we expect pre-tax profit to enter positive territory in 2015, for the first time since 2009.