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Central and Eastern Europe poised for comeback

Gast-AutorIn / Guest Author

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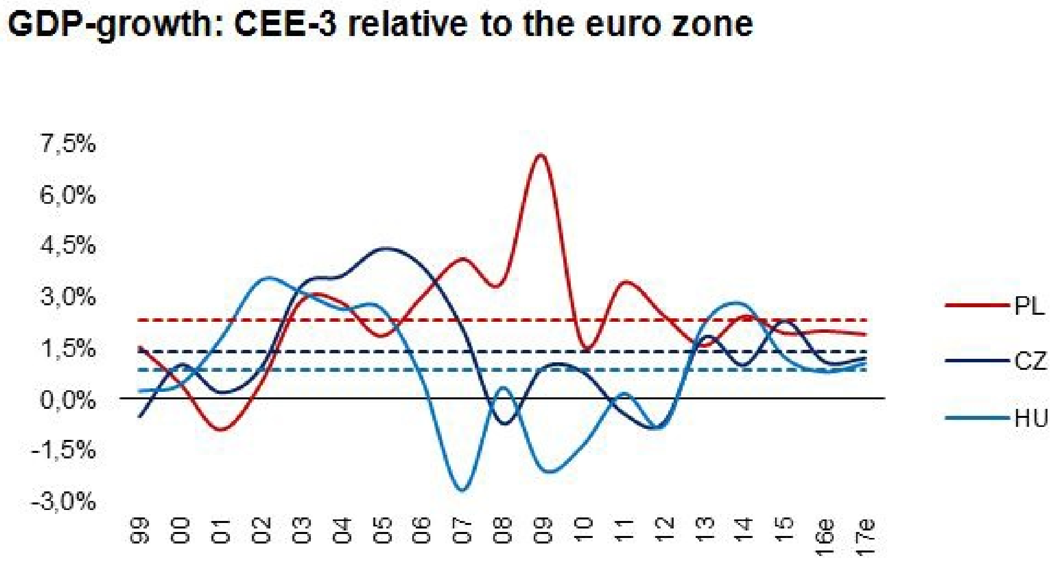
Interest rates are at record lows in the euro area, as a result of which investors can feel a great deal of pressure to achieve acceptable yields. This situation shifts their focus back to the countries of Central and Eastern Europe (CEE). Central and Eastern Europe currently comes with more positive aspects than one might think. There are factors at play that might drive investor attention to this region in the foreseeable future. The risks are largely of a political nature, as the tensions with Western Europe with respect to migration, the Ukraine conflict, and the re-emergence of nationalistic economic policies suggest.

Robust economic outlook: higher growth rates than in Western Europe

We are talking about a market of 400 million people. In the coming years, the gross domestic product in the region is going to experience strong growth at rates significantly above the growth perspectives of the core EU states. For 2016 analysts expect GDP growth of +3% and above for countries such as Poland, Romania, and Turkey. Hungary and the Czech Republic will be growing at more than +2% this year and in 2017 (source: Bloomberg consensus estimates). Even Greece, after years of crisis, is starting to recover and might show a significant sign of life at +1.6% next year.

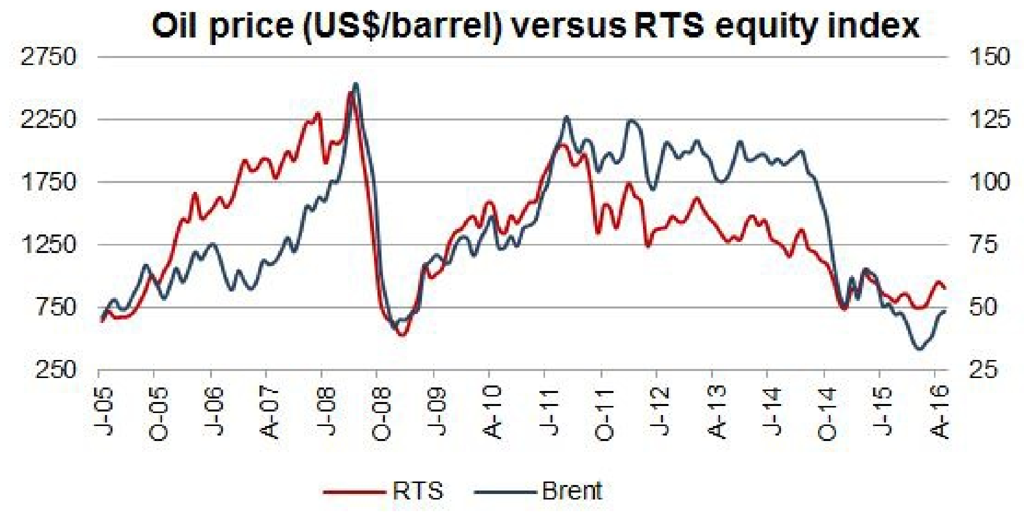
On the bond markets investors can expect a yield of 3.5 to 4.5% against a stable political backdrop, calculates the fixed income fund management Erste Asset Management. With its purchase programme, the ECB contributes to a run on euro government bonds and corporate bonds. The risk is therefore manageable and is largely restricted to the geopolitical level. The low exchange rates of the local currencies support exports. The increase in purchase power acts as driving force for domestic consumption.



*Source: IMF; Erste Asset Management. *) BIP, real, J/J der CEE-Länder-minus Eurozonme*

Low public debt
The level of debt of the East European countries and companies also support the case for the investment region. In contrast to earlier crises, for example in 1998 and 2008, the debt ratios are now not excessive. Current account and budget deficits in the region are low. Competitiveness is up. In the most recent location ranking by the World Bank, 10 out of 20 East European countries had improved, among them Poland, Russia, and Slovenia.

After the CEE equity markets lost more than 40% of their value post-Lehman in the past five years (in euro terms), a trend reversal has recently become more probable. The stock exchanges benefit from the recovery of the commodity prices, especially the oil price, which has almost doubled since its February low.



Source: Bloomberg; Erste Asset Management

Russia: potential in spite of oil and sanctions
Russia was most affected by the falling commodity prices, which came on top of the sanctions imposed by the EU and the USA. The GDP of the, surface-area-wise, largest country decreased by 3.7% last year. Even if the Russian economy will not be able to grow yet in 2016, the first indicators have started suggesting a recovery: inflation has fallen from its high of 16.9% (2015) to most recently 7.3%. We expect the central bank in Moscow, which reduced its key-lending rates to 10.5%, to continue cutting rates in the coming months and thus to support economic growth.

Stock exchanges benefit from the comeback of the convergence story
The stock exchanges in the area command comparatively attractive valuations. At a price/earnings ratio of 11.3x, the CEE equity markets offer a valuation discount of 25% vis-à-vis the stock exchanges of core Europe. And although the estimated

earnings growth in Eastern Europe is still not convincing, the potential is intact for equity investors. While the indices are dominated by the energy and banking sectors, it is the strong influence of commodities that may have positive repercussions on the market if the commodity markets were to stabilise further and gradually recover. Some of the biggest and most profitable energy and commodity producers in the world are based in Russia. They have benefited a great deal from the depreciation of the country's currency, i.e. the rouble.

Turkey: young population, young economy
At a joint total of 74%, Russia and Turkey command the biggest weighting in the East European equity fund ESPA STOCK EUROPE-EMERGING. The Turkish equity market offers access to a rapidly growing, young economy with one of the best demographic developments in the world. The P/E is currently a low 7x (as of June 2016)

Dividend yield clearly above European stock exchanges
The relative attractiveness of the East European stock exchanges is also reflected in the dividend yield. East European companies are currently traded at an average dividend yield of more than 4% p.a., i.e. clearly higher than the yields in Europe (3.8%) or on the global emerging markets (2.8%).

Political risks remain in place – Brexit could trigger volatility
The stock exchanges in Eastern Europe have not managed to de-couple from the global markets. There are still risks with regard to global growth, the interest rate policy from here on in (especially as far as the rate hikes in the USA are concerned), and the development of the local currencies. Investors will be monitoring the political development in Russia and Ukraine closely. At the end of the year, Russia will be holding parliamentary elections. Turkey and its constitutional amendments will draw a lot of attention. Lastly, there is Greece, where the debt crisis has not been fully overcome and no agreement with the IMF and the EU has been ratified yet.

Dedicated funds:

ERSTE BOND DANUBIA: Bond fund with a focus on Central and Eastern Europe

ESPA STOCK EUROPE-EMERGING: Equity fund with a focus on the emerging markets of Central and Eastern Europe

Risk notes according to 2011 Austrian Investment Fund Act

In accordance with the fund provisions approved by the Austrian Financial Market Authority (FMA), ERSTE BOND DANUBIA intends to invest more than 35% of its assets in securities and/or money market instruments of public issuers. A detailed list of these issuers can be found in the prospectus, para. II, point 12.

ESPA STOCK EUROPE-EMERGING may exhibit increased volatility due to the composition of its portfolio: i.e. the unit value can be subject to significant fluctuations both upwards and downwards within short periods of time.

ESPA STOCK EUROPE-EMERGING may make significant investments in demand deposits or time deposits with a maximum maturity of 12 months pursuant to section 72 of the 2011 Austrian Investment Fund Act.

ESPA STOCK EUROPE-EMERGING may make significant investments in derivatives (including swaps and other OTC derivatives) pursuant to section 73 of the 2011 Austrian Investment Fund Act.

Dieter Kerschbaum
Dieter Kerschbaum is active in the field of communication and media ERSTE-SPARINVEST since 2001 and fulfills the function of the spokes person of the company.

As a graduate of political science and journalism at the University of Vienna he was active many years for media and PR-companies before joining ERSTE-SPARINVEST. He supervised listed companies and companies in the financial services sector.

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