20. July 2015

https://blog.en.erste-am.com/turning-more-positive-on-cee-equities/

Turning more positive on CEE equities

Peter Szopo

© Photo: iStock

In searching for a perfect example of a sideways market one does not need to look further than at Central and Eastern European (CEE) equity markets. The CECE Composite, a Euro-based index of 23 Polish, Czech and Hungarian blue-chips (Bloomberg: CECEEUR), has been range bound for nearly four years, rarely trading outside a narrow range of ±8% from its mean over the period. A recent spike by 23% that started in January and lifted the index beyond this trading range was halted by the escalation of Greece-related risks. The only market in the region that has participated in the broader equity rally in Europe and the US in recent years has been the Romanian market.

Source: Bloomberg; Erste Asset Management.

Source: Bloomberg; Erste Asset Management.

Outlook is brightening

Looking into the second half of the year, there are reasons for turning more sanguine on CEE equity markets:

1. Growth has been robust: Industrial production in the region continues growing twice as fast as in the Eurozone. Also manufacturing PMIs, which were 1.5-3 percentage points higher in CEE than in Western Europe in recent months, confirm that CEE economies are outgrowing their western European peers. The consensus outlook for the Eurozone suggests that economic growth will reaccelerate in the course of the year, thus providing support for CEE.
2. Positive earnings outlook: After four years of decline, earnings growth is turning highly positive. According to consensus forecasts net profits will approximately double in 2015 and moderately grow in 2016.
3. Improving profitability: The strong earnings momentum is mainly the result of better operating margins. The average EBIT margin in the market, which nearly halved since 2010 is expected to reach 13% in the current year, and ROE is projected to climb from 4.8% last year to 9%.
4. Undemanding valuation: The market is trading on 12.9 times estimated 2015 earnings. Despite the pedestrian price performance in recent years, trailing multiples stayed stubbornly high due to the mediocre earnings performance. Now, as earnings are gaining momentum, forward multiples have dropped from above 15x in the fourth quarter 2014 to their current level of below 13. The discount to core Europe is higher than anytime in the past three years.
5. Less challenging risk backdrop: After the avoidance of Grexit, most risk indicators are signaling falling uncertainty, which suggests that markets can expect a bit of tranquility following the turbulence in the second quarter. Greek issues will most likely stage a comeback, but for now Grexit is off the agenda.
6. ECB is here to support: Monetary policy in Europe will remain highly accommodative in the foreseeable future. Quantitative easing is finally showing up in the data, and following the Greek spectacle, the ECB will even see less reason to switch to a more restrictive policy stance.

*Source: Bloomberg; Erste Asset Management. *) 3-month rolling averages; CEE: GDP-weighted annual percentage changes of PL, CZ, HU, RO, SK.*

Risks remain (as always)

While a number of factors signal a better economic and risk backdrop for CEE equities in the near term, both global and homegrown risks remain (in addition to any renewed deterioration of the Greek situation).

The most formidable risks are Chinese growth and financial market risks, which seem contained for the time being, and the rate of rising US rates. In contrast to their peers in the Eurozone, Japan and China the US Fed and the Bank of England have indicated that their policy rates will be lifted in the near future – with the Fed's move being the much more important move, of course. While the rate liftoff in the US is probably the most widely advertised policy move in financial history, there seems to be still a gap between market expectations (assigning a probability of about 50% to a rate hike this year) and the Fed, which recently has sent stronger signals than before that the economic backdrop is set for a liftoff. While the longer-term fallout from a (moderate) hike should not be overestimated, the immediate response for risky assets such as CEE stocks will be negative.

Finally, also on the domestic front risks are looming, mostly in Poland. The political change in the course of the recent presidential elections are signaling a move towards a less market friendly and more nationalistic policy stance, as exemplified in the recent debate over the 'repolonization of the financial industry'. Political uncertainty will likely increase in the run-up to the parliamentary elections this October, as investors fear an 'Orbanization' of Polish economic polic.

Bottom line: Yes, the backdrop for CEE stock market is brightening, but at the same time there are also good reasons for not getting carried away.

Peter Szopo

Peter Szopo has worked as chief equity strategist at the Erste Asset Management since March 2015. Before he already worked as a consultant for equity fund management at Erste Asset Management for Central and Eastern European equity markets. From November 2009 to April 2013, he was head of the research department at Alfa Bank in Moscow.

After his research work at WIFO (Austrian Institute of Economic Research) from 1978 to 1990, he worked as a securities specialist in various management functions at internationally renowned investment banks. During this time he held the position of Head of Research at such institutions as Creditanstalt Investmentbank, UniCredit Bank Austria, Robert Fleming Securities, and at Bank Sal. Oppenheim.

Along with his analysis activities, he worked from 1997 to 2000 at Eastfund Management as the fund manager for Central and Eastern European equity.