ERSTE Eurovisionen – Outlook

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The **economic indicators for Euroland** point to a continuation of extraordinarily robust growth. At present, economic expansion is being driven by investment activity, which is expected to be sustained by the high degree of capacity utilization and a solid level of order intake. Private consumption decreased slightly in 1Q, because the VAT hike by 3% led to a downturn in Germany. However, this negative effect is expected to dissipate already in 2Q. The outlook for private consumption is bright for the rest of the year bolstered by the strong rise in employment, In an environment of a flourishing global economy exports are also expected to sustain their contribution to growth.

In the light of the massive expansion of money supply, the ECB Council will raise **key lending rates** further to 4.25%. With this hike, a slightly restrictive level will be reached according to our valuation models, which should be enough to keep inflation low. However, if the money supply continues to expand strongly there is also a risk of a further interest rate hike to 4.5%. The bond market posted losses in the first half of the year. Although the correction underway since November is largely over, longer term bonds remain at risk. By contrast, short to medium-term bonds currently offer a much better risk-return ratio.

The **sluggish growth of the US economy** is expected to continue. The equity extraction potential for financing consumer spending will be exhausted and the labour market will lose dynamic. The two factors will lead to weaker growth of private consumption. The core inflation rate is expected to decline, because the consolidation of home prices is starting to show in the basket of goods. We expect lower core inflation rates already in the coming months. In this environment, the US Fed will start adjusting interest rates already in 3Q towards a neutral level. This is expected to benefit the bond market across all maturity segments. A significant burden on the US dollar will only result if the US central bank is forced to cut interest rates drastically, but this is not our core scenario.

Robust economic growth in the CEE region continues in 2007 as well. Hungary is an exception in this context, but the economy is expected to develop better in 2007than the fiscal package would have led one to expect. It is hard to find a uniform line as regards interest rate developments, because **inflation** is not following any common trend. Generally, interest rate spreads between the countries will

tend to narrow. A differentiated view should be taken of bond markets, with Poland and Hungary still being the most attractive markets in our opinion. The outlook for Serbia and the Ukraine, which have been covered for the first time in this issue of Euro-Visions, is definitely promising. The development of local currencies is expected to be positive to stable vs. the euro. Slovakia is on the path to accession to the monetary union in 2009.

We generally expect **spreads to widen** in the coming months on the **EUR corporate bond market**. The current spreads of 64 bps (average of BBB bonds in the JP Morgan Index) seem to be very low even if one assumes that the default probability is below the historic default rate. Another supportive factor for bonds is the ratio of supply to demand as well as the economic situation in Euroland. A possible stock market correction could have some very negative effects on yield premiums. We expect risk premiums to increase until year-end 2007 and consider a widening of 10 to 20 bps as realistic. Nonetheless, should the supply-demand ratio worsen and thus the technical support for corporate bonds disappear, this would make a widening of yield spreads to government bonds by over 20 bps feasible.