

## Equity positions weighted neutral again for the first time since 4Q 2007 – but the crisis is not over yet

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- The equity markets may stabilise in 2Q, therefore Erste Group recommends: Overweight cash, underweight bonds, stocks neutral
- US: Stabilisation possible due to the government's stimulus package, but concerns about control issues exist; no trend reversal in US equities; Asia and Latin America fundamentally more attractive
- Euroland: Concerns over jobs depressing demand; "non-standard" Central Bank measures likely; attractive valuation of European equities
- Japan: Unprecedented decline in exports; Japanese equities slightly overweight; potential in financial and healthcare stocks and in cyclical consumption



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The impacts of the global financial and confidence crisis have wormed their way into the real economy. Economic sectors have been hit that are traditionally among the first to react sensitively to cyclical changes (e.g. automotive and aviation industry, IT and other component suppliers). These are typically industries that feel the negative effects of changes in peoples "attitudes", i.e. their tendency to save more and spend less. In addition, they also bear the brunt of any drops in investment activity and cost-cutting efforts in other industries. The crisis has now touched the real economy and is not over yet. Now one has to wait and see whether the liquidity injections and rate cuts orchestrated by central banks and government aid programmes will produce the desired effects. In any case, the extreme slide of the equity markets over a period of more than 1 ½ years was clearly exaggerated. The rebound recently recorded was more than overdue. Whether this was the end of the rope is yet to be seen. "We believe in any case that the equity markets may at least stabilise in 2Q and therefore set our global equity weighting to neutral. The lows of early March 2009 still might be tested again. Overall, caution continues to be advisable, which is why we are keeping the overweighting in cash positions," said Fritz Mostböck, Head of Research of Erste Group.

Therefore, the recommendation of Erste Group is: **Overweight cash,**

**underweight bonds, stocks neutral.**

### Asset allocation for 2Q 2009

#### Neutral Portfolio

|        |             |
|--------|-------------|
| Cash   | Overweight  |
| Bonds  | Underweight |
| Stocks | Neutral     |

#### Internationales Bond-Portfolio

|                  |             |
|------------------|-------------|
| Europa           | Overweight  |
| USA              | Underweight |
| Japan            | Neutral     |
| Emerging Markets | Neutral     |

#### **International stock portfolio**

|                  |                     |
|------------------|---------------------|
| Europa           | Neutral             |
| USA              | Underweight         |
| Japan            | Slightly overweight |
| Emerging Markets | Slightly overweight |

#### **FX-Allokation**

|              |             |
|--------------|-------------|
| Dollar-Block | Underweight |
|--------------|-------------|



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#### **US: Interest rates, fixed income market and currency – stabilisation is possible thanks to the government's stimulus package, concerns over control issues**

The downturn of the US economy appears to have slowed down in the 1Q 2009. In the second quarter, calmer conditions in the financial sector combined with continuing low gasoline prices and the government's stimulus package should lead to a stabilisation of the economy even if uncertainty will remain high. For the time being, the Erste Group analysts expect only sluggish growth rates for the US economy, driven exclusively by rising debt.

In the fixed income market, the key factor besides the massive increase in public debt will be the monetary policy of of US central bank. The Fed has been pumping massive amounts of liquidity into the economy and buying up securities since the beginning of the year. These measures have meanwhile reached a scale that is giving rise to concerns about whether the effects of these moves will be controllable. The question of how it will be possible to withdraw these funds again at an appropriate pace is being asked more frequently. If this is done too late, the consequence may be inflation; doing it too early might throttle economic recovery. "In stabilising the economy the Fed will prefer to take risks on the side of inflation and therefore start tightening liquidity later rather than sooner. The fixed income markets will react to these risks with selling pressure. Intense public sector issuing activity may, in addition, push up US yields while the risks of inflation lead us to expect a weakening of the dollar," commented Rainer Singer, Co-Head of CEE Macro/Fixed Income Research.

#### **US equity market: No trend reversal in US stocks; Asia and Latin America fundamentally more attractive**

In the US, the economic environment has not improved over the past months. Unemployment is constantly rising and key economic indicators such as industrial production are not showing any signs of a recovery yet. Minor improvements in a number of sentiment indicators are not sufficient to initiate a sustainable trend reversal. Moreover, the financial crisis has not loosened its grip on the US over the past few months. It would be an illusion to assume that the structural problems of the US financial industry might be resolved in a matter of just a few quarters. Moreover, the fundamental valuation of US equities is anything but attractive.

Even if the current market phase seems to signal that the long downtrend has come to a halt, it must be pointed out that what we have seen is probably just a technical rebound. The current rally exhibits many features typical of a bear market rally. Investors are urgently warned against buying US financial stocks as many formerly renowned companies are now in the process of being broken up. All that remains here is the expectation of company dissolutions with all the negative consequences for investors.

It is definitely still too early days for a sustainable trend reversal in US equities. Other equity markets, including in particular a number of Asian countries (China, Taiwan, Hong Kong, Japan) and Latin



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American markets (Brazil, Chile) are not only in better shape fundamentally, but also significantly more attractive from a technical perspective. “Hands off US stocks. We maintain our recommendation to underweight US stocks in favour of Asian and Latin American markets,” said Ronald Stöferle, International Equity Markets analyst.

#### **Euroland: Interest rates and fixed-income market – concerns over jobs depress demand, “non-standard” Central Bank measures likely**

The slump in world trade has hit economic activity in Euroland hard. It has forced capacity utilisation down rapidly, which is why investment activity is not expected to provide any boost to the

economy. Households are benefiting from the massive drop in energy prices, yet worries about jobs have been depressing demand. This leaves only the public sector as a growth driver of the economy this year. The fact that the downturn in Euroland is still continuing unabated raises the downside risks for the forecast.

The ECB will react to these developments by cutting its key interest rate to 1%. Because of the relatively low risk of deflation, it should then leave the rate at this level, even if for a longer period of time. That the Central Bank may take so-called “non-standard” measures appears likely. In a first step, the Central Bank would be expected to extend the maturities of loans backed by securities. In the bond market, short maturities might benefit from further ECB rate cuts. Longer maturities are suffering under rising inflation risks, developments in the US and growing budget deficits. This should push yields up,” says Rainer Singer, Co-Head of CEE Macro/Fixed Income Research.

#### **European equity market – positive signs that rock bottom has been reached, attractive valuation**

In the European equity markets, some signs can be identified that the markets have bottomed out. The first quarter, for example, did not see any broad-based wholesale sell-offs of stocks any more. By now companies are being picked more carefully, as a result of which only slightly less than half of all stocks dropped below their lows of the previous quarter up to now this year. By way of comparison: In the fourth quarter, this was the case with 97% of all stocks. Also, recent months have seen a shift among sectors at the stock exchanges. Traditionally defensive stocks (e.g. pharmaceutical companies, utilities) underperformed the market, while cyclical sectors (e.g. commodities, chemicals) did better and occasionally even recorded absolute gains. Compared with past experience, this may be interpreted as a first sign that the markets have bottomed out.

In terms of price/book value and P/E, European stocks are currently valued attractively and offer higher yield potential than bonds. We expect that this trend will continue in early-cycle sectors this quarter. “We upgrade European stocks to Neutral but still advise caution as market bottoms are still very fragile given continuing high volatility. Locally we do not expect any above-average profits in Europe in the coming quarter,” said Ronald Stöferle, International Equity Markets analyst.

#### **Japan: Economy, interest rates and currency – historic decline in exports**

The steep plunge in international trade is affecting countries with external trade surpluses, which traditionally relied on exports as their key growth driver, harder than countries running deficits. This is particularly obvious in Japan, where the drop in exports in January and February by more than 45% year-on-year led to a massive fall in production. Since 4Q 2008, the trend has accelerated further. The fact that episodes of a similar kind have been unknown since the 1950s makes it even harder to cast the future economic development in numbers.

Like many central banks worldwide, the BoJ has significantly expanded its use of alternative measures, while keeping its key rate at zero. The yen has meanwhile reacted to the gloomy economic outlook and receded from its highs. Nonetheless, some renewed firming before the end of the crisis should not be ruled out.

#### **Japan equity market – slightly overweight, potential in financial and healthcare stocks and in cyclical consumption**

While not all is rosy in the country of the rising sun, we still believe that thanks to its sound financial system and increasing self-confidence, Japan will surprise mostly on the positive side. This assumption is supported by continuing brisk takeover activity. While the international M&A market tumbled dramatically in 2008, acquisitions by Japanese companies abroad were up almost 300%. Japanese tycoons have been trying to benefit from the strength of the yen and low valuations and have thus been acting counter-cyclically. It therefore appears likely that the Nikkei225 will soon test the level of 9,000 and, subsequently, 9,500. In the international country allocation, the analysts reiterate their recommendation to slightly overweight Japanese equities. On an industry basis we see good

potential and appealing opportunity-risk profiles in the financial sector, in health care and, increasingly again, in cyclical consumption.

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