

Fundamentals and valuations make their return to the table in CEE equity markets

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- 2009 rally driven by rising risk appetite and liquidity supply; support for rally is fading, but no new lows expected
- Rising liquidity supportive for all asset classes
- Banks and cyclicals leading sectors in CEE since March 2009, but defensive sectors may be outperformers over next months

CEE CDS spreads* vs. New Europe Blue Chip Index



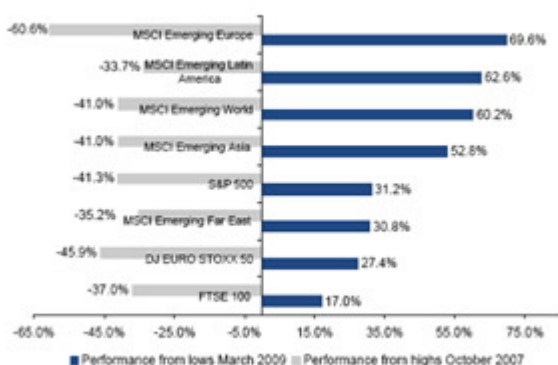
* regional spread calculated as median of A, CZ, HU, HR, PL, RO
Source: Bloomberg, Reuters, Factset

After excessive increases in risk aversion, documented in the increases of CDS spreads, a more reasonable view and consequently falling risk premiums determined markets to recover strongly. Nevertheless, Erste Group analysts say that the equity markets have seen their bottom, while the real economy is still in search of its final low; the data indicate a slowing of the decrease, at best. They point that the argument of decreasing risk premiums lifting equities is losing steam and should have used up most of its potential already.

Corresponding to a less panic-driven view on markets, confidence started to recover across the board. In its latest release, the ZEW indicator for the region even turned positive on economic outlook, allowing equity markets to front-run the expected economic recovery. However, without reliable signs of fundamental improvement, equity markets should hover around a sideways trend - in the best case.

Erste Group analysts point that, since the beginning of the year, cash is leaving low-yielding money market funds, looking for a new home in bond and equity markets. Furthermore, fund flows are to some extent circumventing developed markets and focusing on emerging markets. Within global equity funds, emerging markets have already reached their historical weight again (9.6%).

Equity market performance from March lows 2009 vs. performance from highs Oct. 2007

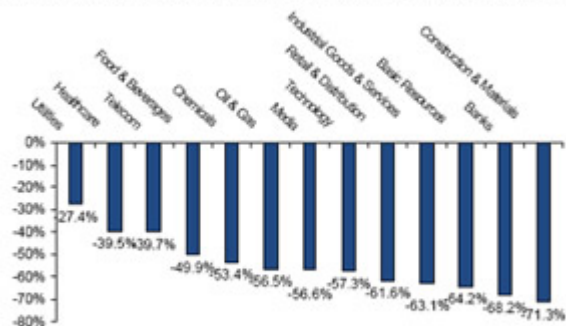


Source: Factset, Emerging Europe, Latin America, Emerging World and Emerging Far East based on MSCI indices performance

Since the cleaning up of an oversold situation has been the main driver, previously strongly sold markets and sectors performed the best in the recent market upswing. Emerging European stocks, which had been oversold (on worries about the heavy debt burden of the entire region), outperformed all other geographic regions by a significant margin. Meanwhile, 'safer havens' like the US, UK and Western European stocks underperformed in this rally.

Correspondingly, cyclical sectors and financials, which suffered the most from the record-high risk aversion and overdone fears of total economic collapse, have outperformed defensive industries, driven by this base effect from lows in March this year.

Sector performances from highs in October 2007



*Sectors based on Erste Group Research coverage –
Source: [Factset](#)

Overall, Erste Group analysts still favour more defensive sectors, such as utilities, telecoms and pharmas, although these sectors have posted the best performances over the entire cycle since October 2007 (losing the least). Apart from purely performance-based considerations, and given the assumption that the argument of decreasing risk premiums is losing steam, it should be worth looking at fundamentals and valuations again, they say: “We expect more defensive industries to now be a bit more in the spotlight again, since they should have weathered the current situation better, meaning with much less spectacular moves in their financials”.

Sector allocation

- Cyclical stocks do not recommend themselves, at least not for 2009; only for 2011 estimates is a trend of improving growth expectations seen.
- Basic resources leads the pack in terms of negative growth expectations in 2009, with a more distant (and uncertain) recovery in 2010 and 2011.
- A pretty strong upswing is seen in financials, even on 2009 expected earnings. Logically, insurance has some part in this development, but (more strongly) banks are more likely to be seen revised in a positive direction, indicating that the situation is not as bad as initially thought. For financials, growth is expected to kick in again at increasing levels in 2011, while insurance is seen as offering strong growth rates for all periods in both regions (Euro Stoxx and CEE).
- Finally, defensive industries are seen as offering pretty stable growth rates already in 2009. Utilities are seen as growing between 3% (2009e) and 9% (2011e) in both regions; telecoms are rather flat, while healthcare is expected to produce improving growth rates of between 6% in 2009 and about 13% in 2011. Interestingly, EPS growth of about 22% is expected in the CEE region for 2010.

Country allocation

Erste Group analysts:

- favour Poland, which they already saw in better terms in the previous report.
- remain somewhat cautious on the Hungarian market, with its strongest argument being that it is the home of interesting pharmaceutical companies.
- are a bit more sceptical in Slovenia.
- recommend cautiousness on Russia and continue to see the market as rather speculative and driven by commodity prices, which can be risk and chance.
- like Turkey rather better. Fundamentally, it certainly shares its burden in terms of weakness, but they think that it still offers a nice alternative also in terms of market size.

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