Global Strategy 2nd Quarter 2010

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Outlook Bond, Currency and Equity Markets: US and Europe

- Financial crisis overcome
- Risks due to high government deficits
- Real economy partially stabilized
- Selective strategy recommended

Fritz Mostböck, Leiter des Erste Group Researchs

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The global financial and economic crisis seems to have come to an end. The massive monetary and fiscal policy measures taken by central banks and governments have finally managed to contain the crisis. Sentiment on the markets and the investment climate among businesses and market participants has continued to improve. In some segments of the economy (cyclical industries), the trend is again moving moderately upwards, while in others (defensive, consumer sectors), the effects of the crisis are still a burdening factor. Generally, it was, above all, the equity and credit markets that took the lead and anticipated this positive development by recording rising prices over the past few months. “The negative impacts for the financial and currency markets will result largely from the necessity to reduce – in some cases – the very high level of government debt in the future,” said Fritz Mostböck, Head of Erste Group Research. “A clear differentiation will generally be made between countries and asset classes. Only an impartial analysis of the fundamental data and facts rather than superficial generalizations will show the right way out of the crisis,” Mr. Mostböck continued. Analysts recommend investors to continue taking a selective approach on financial markets. The strategy in a nutshell for the second quarter 2010: Slightly underweight cash, slightly overweight bonds, neutral in equities.

Asset Allocation Q2 2010	
Neutral Portfolio	
Cash	Slightly underweight
Bonds	Slightly underweight
Equities	Neutral
International Bond-Portfolio [1)]	
Europa	Neutral
USA	Neutral
Japan	Neutral
Emerging Markets	Overweight

International Equity Portfolio [1]	
Europa (developed)	Slightly underweight
USA	Neutral
Japan	Neutral
Emerging Markets	Slightly overweight
FX-Allokation	
Dollar-Block	Underweight

US: Interest rates, bond market and currency

The economy in first quarter will grow at a much slower pace than in the fourth quarter. However, this will be due only to changes in inventories which had accounted for more than half of the growth rate in 4th quarter and will not contribute at all or even negatively in the first quarter. The second quarter is expected to report similar growth rates as in the first quarter. Due to dampening factors such as asset losses of households and the still high overcapacities in industry, no continuous rise of the growth rate may be expected. Rather, the trend will be one of fluctuations around moderate levels. Over the long term, the consolidation of the government budget will burden the economy. Erste Group macro analyst Rainer Singer on US budget: “Ultimately, there will be no way around a budget consolidation. The later it comes, the more dramatic it will have to be.” The experts expect the Fed to withdraw liquidity in the second half of the year. A first interest rate hike is realistically expected at the earliest for the end of 2010.

Rainer Singer

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As regards US government bonds, further price losses may be expected; probably in the second half-year. As the Greek crisis abates, the high budget deficit of the US will shift into the focus of attention and push the exchange rate euro vs. US dollar further towards the 1.4 mark. A further short-term firming of the USD is possible though.

US equity markets

Most sentiment indicators currently support a cautiously positive outlook for US stocks. The fact that trading volumes are still very sluggish is a slight negative factor for the stock market though. “Only around the end of the medium-term uptrend of the overall market may one expect investors to take their profits on cyclical stocks and shift their preference to the utilities again,” said Hans Engel, market strategist for international stocks. Right now, we are not there yet. At present, the US stock market is technically in a relatively good condition, and for this reason, a neutral weighting of US stocks seems appropriate.

Hans Engel, Marktstratege für internationale Aktien

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Euroland: Interest rate trend and bond market

While the economy was bolstered by temporary effects in third quarter 2009, GDP went up in the euro zone only marginally by +0.1% in the fourth quarter. Net exports were the main positive drivers of this development, but investment activity contributed negatively to GDP. End consumer demand is not yet robust and concentrates on the already available macro data. Therefore, in the first quarter, the development of the economy is expected to be weak – unchanged versus fourth quarter. Changes to inventories were a pleasant surprise and boosted GDP in 1Q and 2Q. Various indicators reflect the expectations of an economic recovery. “We expect a moderate improvement of economic output in the euro area and forecast a GDP growth rate of +0.7% for 2010 and of +1.4% for 2011,” explained Erste Group macro analyst Rainer Singer. Inflation is expected to remain low for some time based on this moderate economic improvement. The ECB is expected to raise the key lending rate (+25 bps) in 1Q 2011. Yields on 10-year German government bonds will remain relatively stable over the coming months. Investors are now concentrating more on the size of government debt. Germany (benchmark for the euro zone) has one of the lowest budget deficits (2010e: -5%) in the euro area.

Equity market Europe
After Erste Group analysts had recommended overweighting equities in global portfolios in the last quarter, the potential perceived for the second quarter 2010 is only slight and for this reason the equity weighting is neutral. For the region of Europe (developed), a slight overweighting is recommended compared to other markets, with the CEE region being expect to perform better. The risk of a major correction is assessed as limited, because valuations are already low, interest rates are also low and the uptrend in leading indicators should support markets.

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