

## EURO-VISIONS: Economic and Capital Market Outlook Euroland, U.S., CEE

[Back](#)

01.06.2010

- Signs of economic upswing, but aftereffects of crisis still a burden
- CEE benefits from backlog
- Government bonds are epicentre of future downside risks
- Inflation remains low, no interest rate hikes yet (FED: 4Q 2010 – ECB: 2Q 2011)
- Bond markets: Demand still exists for high-quality liquid government and corporate bonds

**“Since the start of the financial and economic crisis, the economic differences between the US and the euro zone have become even clearer,”** said Gudrun Egger from Fixed Income Research of Erste Group. While export-oriented countries such as Germany suffered more from the crisis than the large international consumer US, in the CEE region, the countries with high consumer growth and high current account deficits were the hit most harshly. **“Moreover, you can’t lump all euro countries together; you have to differentiate very precisely between the economies,”** said Egger. With the help of economic stimulus schemes, the decline in economic output was slowed down it for a short time, but in many countries this created a situation in which the government took over responsibility for both demand and part of the debt. **“The steep increase in government debt is now the epicentre of the economy’s future downside risks,”** according to Gudrun Egger. **“The manoeuvring room for further economic stimulation measures is therefore limited, while the consolidation efforts will probably put a damper on growth in the future,”** the analyst continued to explain.



Gudrun Egger, Head of Major Markets & Credit Research

[Download \[jpg; 772.3 KB\]](#)

### **Interest hikes only at the end of 2010**

Should the downside risks become more concrete for the economy and consolidation measures increasingly difficult, this would have an impact on interest rate expectations and possible additional monetary policy aid measures. **“From today’s perspective, we expect the US central bank to start raising interest rates already at the end of 2010,”** said Rainer Singer of Fixed Income Research at Erste Group. For the ECB, a first interest rate hike is expected for the second quarter 2011. **“The economy in the US will pick up faster. Moreover, key lending rates there are even lower there than in the euro zone,”** Rainer Singer said as he explained the reasons for the earlier interest rate hikes by the Federal Reserve Bank in the US.



Rainer Singer, Co-Head of CEE Macro/Fixed Income Research

[Download \[jpg; 369.2 KB\]](#)

### **Government debt will be a problem in the years to come**

The dramatic yield increases in South European countries can be explained by the doubts regarding their capacity to service their debts, although speculation has exacerbated developments. In many countries, the roots of the severe deficits go back

to the time before the crisis. In this situation, the fundamental analysis of the country-specific debt indicators has become more significant for the individual assessment of the quality of the government debt.

Starting out from a detailed analysis of the structure of the government revenues and expenditures, Erste Group experts attempt to evaluate the probability and effectiveness of the various consolidation measures. Within respect to the debt dynamic, it should be noted that in some cases consolidation efforts will become necessary over the medium term, while at the same time, economic growth needs to be stimulated.

The task of coping with both aspects will be very difficult for some countries," said Rainer Singer of Erste Fixed Income Research.

One way out of debt would be to encourage inflation, but it is "difficult to implement and implies side-effects such as higher financing costs. Therefore, in our view this is not a feasible option for solving the debt problem," added the Erste analyst.

It is a fact that no country that will be able to avoid a budget consolidation, but the difference is to be found in the respective magnitude of the savings. Greece clearly has the biggest ahead of it. Spain and Portugal have some similarities with Greece, but these countries must be viewed separately. "The reaction of the market with respect to these countries was certainly exaggerated, but understandable," said Singer. If and how fast these countries will be able to return to a sustainable course cannot yet be stated.

As regards the budget deficit, the US and France are in centerfield. Although, thanks to higher growth, the chances seem to be good that their debt will return to sustainable levels, a consolidation will certainly be necessary. This should be initiated as soon as possible, before the markets raise the pressure.

Germany by contrast, will be live up to its reputation of having the most robust government finances. In the CEE countries, government debt (with the exception of Hungary) is relatively low, and in most countries, measures have already been taken to lower the deficit. A low level of indebtedness as well as prospects of economic growth are factors that support the assessment that the debt dynamic will soon be checked in the CEE.

#### Forecast – Exchange Rates

End of month	Current	Sep.10	Dec.10	Mar.11	Jun.11
EUR/USD	1,241	1,30	1,38	1,33	1,30
EUR/JPY	113,3	120	131	126	126
EUR/CHF	1,426	1,39	1,40	1,40	1,40

#### Uptrend in government bonds

Creditworthiness has started to deteriorate in some countries. Therefore, it may be expected that investors will continue to demand high-quality bonds even if the yields of very liquid benchmark bonds (e.g. US, Germany) are already at an extremely low level. As soon as the insecurity on the financial markets eases off, yield curves should start to shift upwards again. The experts of Erste Bank have a preference for German government bonds versus US Treasuries. In the CEE region, Hungarian and Polish bonds seem to be the most appealing, as these have an attractive risk-return ratio.

The current low-interest environment and the improved fundamental data of the companies do not point to any widening tendency of spreads. "Decisive for developments on credit markets will be both the pace of the economic recovery as well as the monetary exit strategy," said Elena Statelov, Credit Analyst at Erste Group. "Investors should focus on the defensive sectors and companies with solid credit ratios," added Statelov. Therefore, fundamental credit analysis will become even more important.



Elena Statelov, Credit Research

[Download \[jpg; 465.2 KB\]](#)

[Präsentation: Konjunktur-/Kapitalmarktausblick "Euro-Visionen" \[pdf; 292.1 KB\]](#)

[Report: "Euro-Visionen" \[pdf; 844.7 KB\]](#)

[Back](#)

