Financial Markets under the Influence of Government Debt

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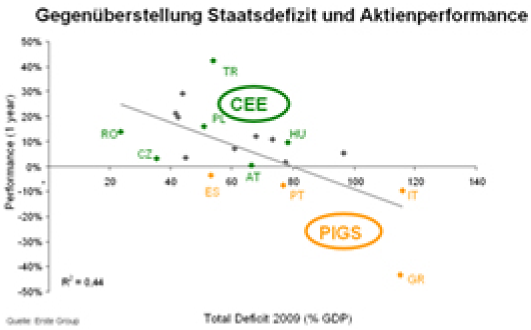
Government indebtedness reflected in local stock indices
The focus will stay on overcoming the high levels of government debt. Countries with relatively low levels of government indebtedness and deficits have performed better this year that those with high levels. A look at the development of yields year-to-date (YTD) and stock market performance in 2010 clearly shows the correlation between higher volumes of government indebtedness and the performance of local benchmark indices. At the global and at the regional level, investors are now taking a more differentiated approach and are including the various overall rates of indebtedness as well as new debt and economic conditions of each country into their decisions (see Chart).

In some cases the extremely high levels of government indebtedness will occupy many countries for some time to come. This is a complex situation that cannot be solved in the short term. “The burden on financial and currency markets will continue to originate mainly from efforts to cope with extremely large government debt,” explained Fritz Mostboeck, Head of Research at Erste Group. “An even stronger differentiation will be made between countries and asset classes in this case. The regional and global sector approaches will temporarily no longer be used,” stated Mostboeck.

Low government debt in Central and Eastern Europe
The CEE countries have much lower levels of government debt than the EU or eurozone average. Except for Hungary, all CEE countries have managed to keep their overall indebtedness below 60% of GDP (though Hungary is still below the euro zone average). By way of comparison: Altogether the government debt of Hungary, Czech Rep., Slovakia, Romania and Croatia (CEE5) is around EUR 200bn, and therefore, some EUR 80bn lower than government debt in Greece (EUR 300bn). If one adds Poland (CEE6), then it is around EUR 414bn and is in total lower than the government debt of Spain (EUR 661bn) or Italy (EUR 1,835bn).

Zentral- und Osteuropa mit geringen Staatsschulen
Die CEE-Staaten weisen deutlich geringere Staatsverschuldungsraten, als der Durchschnitt der EU bzw. Eurozone auf. Außer Ungarn haben alle CEE-Länder ihre gesamtstaatliche Verschuldung unter 60% des BIP gehalten (wobei Ungarn immer noch unter dem Eurozonen Durchschnitt liegt.) Zum Vergleich: Die Staatsverschuldung Ungarns, der Tschechischen Republik, der Slowakei, Rumäniens und Kroatiens (CEE5) macht zusammen etwa EUR 220 Mrd. aus und beträgt damit rund EUR 80 Mrd. weniger als die Staatsschuld Griechenlands (EUR 300 Mrd.). Rechnet man Polen noch mit ein (CEE6), so liegt sie bei etwa EUR 414 Mrd. und ist in Summe niedriger als die Staatsschuld Spaniens (EUR 661 Mrd.) oder Italiens (EUR 1.835 Mrd.).

As revealed by the chart, the so-called PIGS states with high levels of government debt are also those in which local stock markets performed poorly. By contrast, many CEE countries that have low government deficits, have performed well year-to-date - also on the stock markets.



The CEE5 countries with a population of 52 million have the equivalent of only around 70% of the debt Greece which has a population of 11 million. The CEE6 region with some 90 million inhabitants only has some 60% of the debt of Spain (population: 47 million) and less than one-quarter of Italian debt (population 60 million).

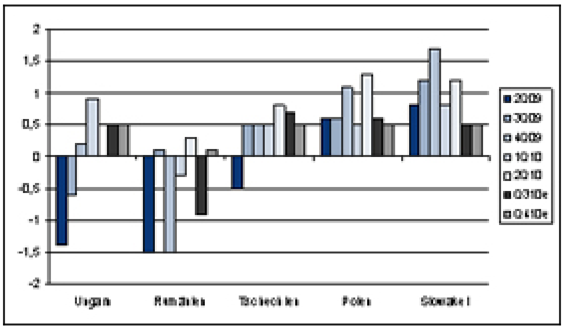
Hungary with its total debt of 79% of GDP is the only CEE country that comes close to the overall average of the euro zone. The remaining countries (Bulgaria, Croatia, Poland, Romania, Serbia, Slovakia, Slovenia, Czech Rep. and the Ukraine) are below the average indebtedness of the euro zone as well as below the Maastricht limit of 60%.

A further important indicator with respect to government debt is the share of government bonds held outside the country. When the ratio is high, the probability of investor pressure and fast selling rises. This is the case in Greece where some 2/3 of government debt (90% of GDP) are held outside the country. By comparison, the corresponding share in CEE6 is around 2% to 23% of GDP.

Investment strategy: CEE is the rising star
Emerging markets should be overweighted long term. The investment climate among financial market participants has improved recently, but trading volumes have continued to be subdued. Fritz Mostboeck recommends following a selective approach, which for 4Q 2010 is summarized below: Underweight cash, neutral in bonds, slightly overweight equities and gold. Europe and the emerging markets such as Central and Eastern Europe should be overweighted in international stock portfolios.

GDP growth indicates that the recovery in CEE is fully underway, even though Hungary and Romania are still lagging somewhat behind. “The divergent trends in GDP show once again how differentiated any assessment of markets in the Eastern region of the EU has to be,” explained Mostboeck.

NTX- The CEE benchmark as an investment opportunity
Investors that want to enter CEE markets will find lots of opportunities for investment in the different markets and sectors. The Vienna Stock Exchange alone calculates 33 country and sector indices for CEE and Russia in the various currencies. Therefore, at the beginning of 2005 Erste Group started cooperating with the Vienna Stock Exchange to create a multi-country CEE benchmark index, the so-called NTX Index. The NTX index is a capitalization-weighted price index calculated in EUR. It contains the 30 largest blue chips based on the criterion of capitalized free float from the countries of Austria, Bulgaria, Croatia, Czech Rep., Hungary, Poland, Romania, Slovakia and Slovenia. “The NTX Index is a very broad multi-country benchmark for the CEE region and is ideal as a basic investment guide,” said Thomas Schaufler, Head of Retail & Sparkassen Austria. The two products, the NTX Index-Zertifikat (AT0000A034M6) and the NTX Exchange Traded Fonds (AT0000A00EH2) track the development of this NTX benchmark index exactly. Both products are quoted on the Vienna Stock Exchange and traded daily.



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