Economic and Capital Market Outlook 2011

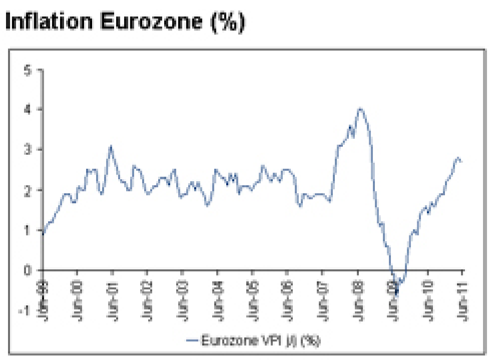
20.06.2011

Euro zone doing well | US stuck in trough | CEE on fast lane

- **Euro zone 2011: GDP growth 2%, inflation 2.6%**
- **ECB: 0.25% interest rate move expected in July**
- **US 2011: First interest rate hike only in 1Q 2012**
- **CEE:Growth 1% higher than in euro zone**

Euro zone is doing well

Three years after the onset of the crisis, “normality” has not yet fully returned to the market. Apart from the after-effects, the situation in the euro zone was made harder by the events in Japan, the high oil price and the sovereign debt crisis in the euro zone periphery. Exports developed very satisfactorily in the first phase of economic recovery. Even countries with traditionally high current account deficits such as Spain profited.



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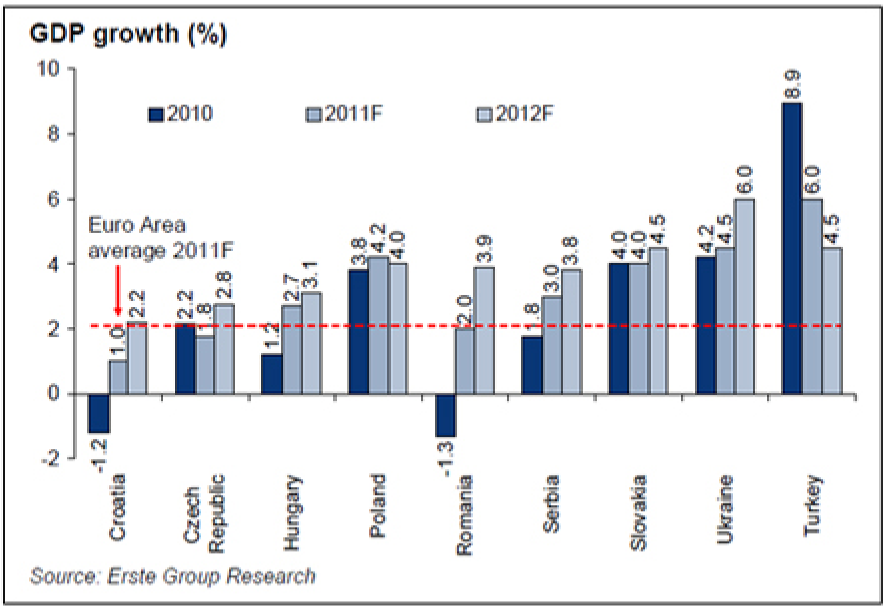
“Even though the export dynamic could slow slightly, we expect further positive contributions from net exports this year of 2%,” said Gudrun Egger, Head of Fixed Income Research at Erste Group. Export growth will be determined by developments in emerging markets such as China, and at the same time, domestic demand is picking up in the core countries of the euro zone. Inflation is expected to remain high over the short term due to higher commodity prices, but in the medium term, it should drop back to around 2% according to the Erste Group experts. To counteract second-round effects like higher wages and prices across a broad basis, the ECB is expected to raise key lending rates in July and November by 25bps respectively according to the Erste Group experts. In the coming year, a longer pause is expected at a key lending rate of around 2% due to the slow economic growth rates and moderate inflation. The bond market will continue to be volatile in the euro zone. By year-end, bond yields at the short end are expected to climb slightly due to the interest rate hikes, while at the long end (10-year maturity) yields should remain more or less stable.

Sluggish growth in the US

The US economic data were much weaker than expected in the second quarter. According to the experts, the sluggish growth is due to the long phase of high oil prices and the disaster in Japan. The economic indicators are expected to improve in the second half of the year, but recovery will progress only slowly. The reason is the oversupply on the real estate market which is expected to normalize only in 2013. "We do not see any inflationary pressure in the US at present. We expect the inflation rate at around 2.6% in 2011, just like in the euro zone," explained Rainer Singer of Fixed Income Research Erste Group. The drivers of inflation up to now had been energy and food prices.

Even though it is still slow, the US economy is recovering and an end to the extremely expansive monetary policy is in now sight. The Fed is expected to carry out the first interest rate hike of 25 basis points in the first quarter of 2012. The bond market is still extremely overvalued in the assessment of Erste Group Research, because the risks of US fiscal policy do not seem to be priced in yet. Unless the political parties in the US reach an agreement to lift the debt ceiling by the end of August, a sovereign default is possible. Therefore, we do not view US Treasuries as particularly attractive investments at present.



CEE countries surpass growth rate of euro zone

The economic recovery in the CEE countries[1] is progressing according to a similar pattern as in the euro area. The economic upswing has been driven by exports up to now. For this reason, open economies like the Czech Republic and Slovakia profited enormously, as they have very close relationships with the German industrial sector. The growth dynamic is not spread evenly across the entire region. Similar to the euro zone, the upswing in the CEE countries, which had high current account deficits before the crisis, set in at a later point in time. The IMF packages of the past two years contributed substantially to the reduction of these deficits. In the first quarter, Romania finally overcame the recession as one of last of these countries. This leaves Croatia in the red; the upswing there is expected to start gradually only as of the second quarter. Economic growth in CEE for 2011 is estimated by Erste Group experts at 3.2%, and if one includes Turkey, then the figure is 3.8%. In only two CEE economies is growth expected to slow in the coming year: Turkey and Poland.

Generally, the region is profiting strongly from the low level of government debt with the exception of Poland (2010: 7.9%). The consolidation measures were postponed there but now need to be addressed, and this will probably have a dampening effect on the economy. Long-term inflationary fears are currently not expected in the CEE, because high commodity prices are the driving force in this case as well. The bond market is developing mostly positively: Despite the turmoil in government bonds, many CEE countries have successfully placed euro bonds on foreign markets. "In our opinion, rating agencies are still hesitating about withdrawing the rating downgrades of these countries until there is further evidence of a sustainable recovery in the region," added Rainer Singer, responsible CEE analyst.

[1] CEE8: Croatia, Serbia, Romania, Slovakia, Czech Republic, Ukraine, Hungary, Poland

Eurovisions June 2011 [pdf; 996.3 KB]