Focus of financial markets stays on sovereign debt

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Strategy 4Q 2011 | Economy | Bonds | Equity Markets

- A slowing global economy and sovereign debt concerns are driving up risk aversion
- Earnings outlook on capital markets to remain moderate
- Prices of US/CEE stocks and gold expected to rise

Major leading indicators and consumer confidence have both deteriorated considerably. Therefore, global growth is expected to slow further. An additional source of downside risk is the sovereign debt crisis, which is increasingly impacting the real economy. Growth rates in the euro zone and the US will therefore remain moderate and a recession cannot be ruled out. Growth has slowed in the emerging markets as well. High inflation rates are still a problem there and limiting the potential for cutting interest rates.

"The environment on international financial markets will remain fragile in 4Q of this year as well," explained **Fritz Mostböck**, Head of Research at Erste Group. "The lack of a credible and sustainable global strategy that can solve the government debt problem soon will continue to pose a challenge for capital markets. We therefore continue to recommend a very selective stance. Overall, there are opportunities in selected equity markets – US or CEE – as well as in other asset classes such as gold," added Fritz Mostböck.

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Economic outlook darkens further
GDP in the euro zone is still below its level of before the crisis. Major leading indicators (e.g. OECD, ZEW) and consumer confidence have dropped significantly. Economic performance is expected to stagnate in the euro zone in the second half of the year.
The experts of Erste Group estimate a growth rate of 1.6% for 2011 and forecast the rate for the following year at 0.9%. The sovereign debt crisis in the euro zone constitutes an additional downside risk, which could have an increasingly negative impact on the real economy. Therefore, the economy should grow only moderately in the euro zone as well as in the US.

Erste Group analysts expect an inflation rate in the euro zone of 1.8% in the coming year. Interest rates in the US and the euro zone are expected to remain very low for a longer period of time (until mid-2013). "An interest rate cut in the euro zone seems increasingly likely, especially as the economic outlook is plagued by downside risks," stated **Gudrun Egger**, Head of Major Markets & Credit Research of Erste Group. The potential for higher yields on German Bunds and also on US Treasuries is limited at present. As no clear, credible and swift solution is in sight right now for the euro zone's debt problems, investors are still showing a preference for "safe havens".

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Equities: Downswing already priced in
Following the steep losses of the MSCI World Stock Index in 3Q, investor sentiment plummeted to lows last seen in 1Q 2009. Stock prices have probably already priced in most of the anticipated economic contraction. Although corporate earnings expectations were revised downwards just recently, their absolute level remains high. In some markets, there are clear signs that the trend is bottoming out. Equities from the US and CEE are more attractive than those of other regions. The leading indices of the BRICS countries are being negatively affected by high inflation and high key lending rates. “We believe there is potential for a slight upturn in 4Q due to the very negative attitude toward equities seen recently,” explained **Hans Engel**, Erste Group Strategist for International Equity Markets.

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The investment strategy for 4Q 2011 in detail:

Investment strategy 4Q 2011		
Government bond yields		**Dec. 2011**
Germany (10y)	→	2.00
USA (10y)	→	2.00
Corporate bond yields Euro zone		
Investment grade	→	
High yield	↗	
Currencies		**Dec. 2011**
USD	↗	1.35
YEN	↗	101.3
CHF	→	1.20
Gold (USD)	↗	1,834
Equities		**Dec. 2011**
Global	→	-3% / +3%
Euro zone	→	-10% / -3%
US	↗	+3% / +10%
Japan	↘	-10% / -3%
CEE	↗	+3% / +10%
BRICs	→	-3% / +3%

Notes:
The forecasts are assessments of changes in asset classes in absolute terms and not in relation to each other. Bond yields and stock performance are in local currency.