ERSTE Group

Euro area 2012: first steps on path to recovery

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Bond, currency and equity outlook for the second quarter

- **Economy: USA ahead of euro zone**
- **Equity markets: Uptrend intact**
- **Bond yields to remain low in 2012**
- **Liquidity from ECB: Tension eased in the euro zone**

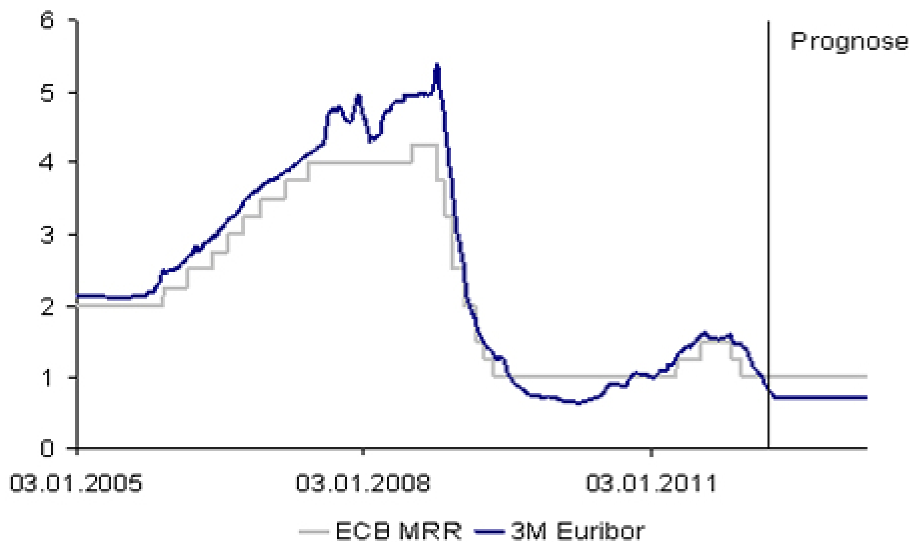
The major leading indicators and consumer confidence have brightened significantly again. Although global growth is expected to slowdown and downside risks still exist due to sovereign debt crisis, a deeper recession is not in sight. Similar picture in the emerging markets, with a growth slowdown.

“The risk environment improved significantly in 1Q 2012. Although signs of economic stabilization in the euro zone have started to appear, we are not calling off the warning yet. The debt crisis remains an issue. Before the backdrop of the debt crisis, yields on benchmark bonds remain low and global equities and gold are still attractive,” said Fritz Mostböck, Head of Research at Erste Group. “Selective investing remains our recommended strategy. Overall, there are opportunities in some stock markets (US, CEE, partly BRICs) and in certain sector and asset classes such as gold,” added Mr. Mostböck.

Fritz Mostböck, Head of Research at Erste Group

Euro zone to enter into “mild recession” in 2012

While the economy continues to pick up in the US, there are tentative signs of stabilization in the euro zone. Consumer confidence rose again and leading indicators remain mixed. The core countries of the euro zone should soon be able to make the first steps on the path to recovery. In Spain and Italy this will take longer because unemployment is still on the rise there. It is above all the debt crisis that will continue to weigh on Europe for a long time. Following a mild recession in the euro zone, growth should turn positive again in 2013. Inflation did not decrease as much as expected. In 2012, inflation will reach 2.4% on average. By generously supplying liquidity, the European Central Bank may have achieved more than by cutting interest rates, and the tension on the financial markets – also regarding the debt crisis – has eased somewhat. However, there are no signs yet that this easing will last longer. As regards interest rates in the euro zone, the main refinancing rate will remain at 1% and there are no further changes planned at present. The US will also stick to its zero-interest rate policy.



Bond markets
The liquidity supplied by the ECB was the determining factor in the first quarter: money market rates dropped showing an effect similar to an interest rate cut. The ECB is expected to continue to provide support through liquidity and keep interest rates low for a long time. German yields are therefore expected to rise only very moderately over the course of the year. As regards Treasuries the improved economic development contrasts with the still low interest rates of the Federal Reserve. The debt crisis remains topical and is counteracting any tendency of a rise in yields on benchmark government bonds.

Euro and US dollar – Which one is stronger?
The liquidity from the ECB has in our opinion had a surprisingly strong easing effect with respect to the debt crisis. The euro also profited from this. However, the fair value remains EUR/USD 1.27. "The brighter growth prospects in the US too point to a stronger US dollar in the course of the year," explainedMildred Hager, Fixed Income Analyst at Erste Group. The key risk in this context remains the resurgence of the sovereign debt crisis in the euro zone.

Mildred Hager,
Fixed Income Analyst at Erste Group

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Gold still shining brightly
The precious metal showed clearly a positive trend in 1Q 2012 and appreciated by 7%. We believe that the correction that started in the autumn of 2011 is largely over. Nothing has changed in the key factors that point to a continued long-term uptrend. A central argument in our opinion is the effective interest rate that will remain negative both in the US and in the euro area for some time to come.

Equity markets – Rising trend
"Most global stocks attained solid double-digit performances in the current year," said Hans Engel, Strategist for International Equities at Erste Group. Albeit investor sentiment has improved, Mr. Engel does not see any confirmation of a sustained uptrend yet: "In the first quarter, trading volumes were thin. Until mid-year, we expect a slightly positive market, but no pronounced bullish streak.

Hans Engel,
Strategist for International Equities at Erste Group

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The MSCI World Index is currently showing a dividend yield of almost 2.8% and is appropriately valued at a PER of 14. Equities are still more attractive than bonds, especially the stocks of international companies that benefit from globally diversified income. Government bonds of the developed markets have returns that are usually far below the dividend yields of stocks. Therefore, equities are also relatively well secured against downside risks. This assessment is especially true for US equities due to the lower weighting of financials compared to the European equities. Most markets are currently on an uptrend, albeit to different extents. For example, the S&P 500 chart presents a much brighter trend than the European DJ Stoxx Index. After the above average increases in the first quarter, stock markets should now rise at a slower pace. US stocks will continue to advance, while European indices will suffer from the heavy weightings of financial stocks, and for this reason, probably post a slightly negative performance for the quarter. Brazil and Russia are our favourite BRIC countries. On the whole we expect a moderate rise of the MSCI global stock index by approximately 5%.

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