CEE markets and stocks: bottom reached, heading for recovery

Current hype around expected Fed QE exit overdone for CEE yields and equity markets – no impact on real economies beyond short-term market volatility

CEE Macroeconomic picture: Some CEE countries – Hungary and Romania – have been gaining momentum

Economic Sentiment for the CEE Region: ZEW/Erste sentiment suffers blow due to Turkey, ifo Business clock improving

Country allocation: moderately positive on Austria and CEE; carefully favoring SEE (esp. Serbia); short-term allocation for Turkey and Poland

10 Top picks: Polish BZ WBK, Turkish Halkbank and Austrian OMV newly on the list

Henning Esskuchen, Head CEE Equity Research

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News on potentially tighter liquidity has triggered a correction, as markets in emerging Europe also appeared to be driven too much by liquidity as a technical factor. "Since we tend to understand any tightening as a signal that fundamental improvement is on its way, the detoxification process might still be painful for a while, but eventually much needed fundamental support for the market outlook should appear on the scene. Also, we would expect the Fed to act quite carefully, since any recovery for the US appears to be quite fragile. We tend to see immediate market reactions in emerging Europe as overdone, both for yields as well as for equity markets", summarizes Henning Esskuchen, Head of CEE Equity Research at Erste Group in his recent CEE Equity strategy report. "In a positive scenario, we might be on our way to normalization, along with moderate growth, restrained inflation and a somewhat accommodative monetary policy. However, for the time being, markets remain fragile. A reliable fundamental outlook that could lend more stable support to markets is still not visible, but the consensus should finally start to reflect the improving macro indicators."

CEE Macroeconomic picture: Some CEE countries – Hungary and Romania – have been gaining momentum

"Despite the gloomy outlook in the Euro Area, some CEE countries have been gaining momentum. Hungary and Romania, the first two countries that started with tough consolidation in 2009 and the first to successfully exit the excessive deficit procedure this year can catch some breath", foresees Esskuchen. "Besides the short-term impact on volatility, we do not expect the Fed's decision to have an impact on real economies in CEE, as their external financing needs have declined substantially." Hungary remains vulnerable in the event of a stronger sell-off, as it has one of the highest stock of portfolio investment in the region (about 50% of GDP vs. about 23% of GDP for CEE countries on average).

Real GDP growth (y/y, %)	2011	2012f	2013f	2014f
Croatia	0.0	-2.0	-0.8	0.8
Czech Republic	1.9	-1.2	-0.3	0.9
Hungary	1.6	-1.7	0.2	1.2
Poland	4.3	1.9	1.3	2.6
Romania	2.2	0.7	1.8	2.3
Serbia	1.6	-1.9	1.5	2.5
Slovakia	3.2	2.0	0.5	2.0
Turkey	8.8	2.2	3.6	5.0
Austria	2.7	0.8	0.5	1.7
Eurozone	1.5	-0.5	-0.3	1.0
CEE7 average	**2.9**	**0.5**	**0.8**	**2.0**
CEE7+Turkey	**5.1**	**1.1**	**1.9**	**3.1**

Individual forecasts for CEE markets:

Czech GDP should partly benefit from reconstruction work after the May floods, but as this year's damage was only about ¼ of those seen in 2002, the q/q growth rates will not be strong enough to bring the full-year to black numbers in 2013.

1.8% GDP growth in Romania in 2013 with upward potential to 2.2% y/y in the case of a good agricultural harvest (which seems likely).

The Polish economy, which had been the most resilient economy in CEE during the crisis, is still slowing down.

Hungary's another round of extraordinary taxation on the corporate and banking sector may have negative implications for the country's long-term growth prospects.

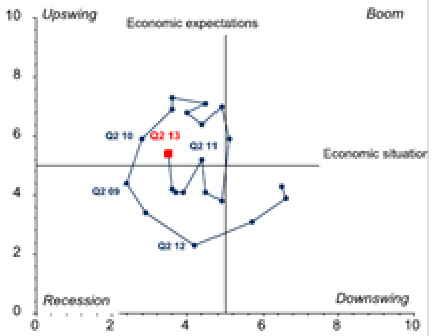
The Croatian economy should recover from 2014 onward, mainly on the back of gradually recovering investments and exports.

Turkey's economy forecast to grow by 3.6% in 2013.

Economic Sentiment for the CEE Region: ZEW/Erste sentiment suffers blow due to Turkey, ifo Business clock improving

The latest ZEW/Erste sentiment indicator for CEE* suffered a blow, mostly because of protests in Turkey. The Eurozone, however, has been showing signs of improvement and, given that exports are currently the most immediate driver for CEE economies, this should allow for a carefully positive reading.

Ifo business clock – CEE CEE...

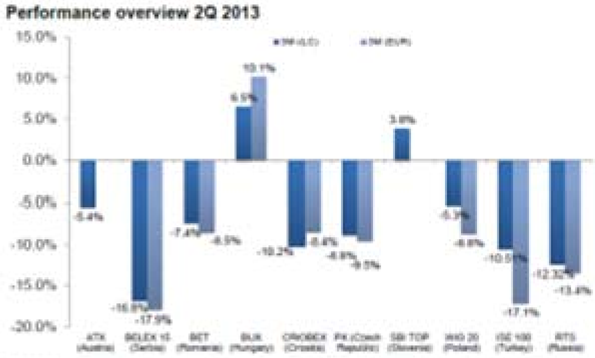


Source: Datastream

The Ifo Business Clock allows for hope that CEE has finally left its state of undecidedly hovering around in the recession area in the last quarters and is finally making a much more direct move into an upswing. "What is good is that CEE, despite its decisive move in the right direction, is well behind other emerging markets globally, which should bode well as a relative outlook for its stock markets", concludes Esskuchen.

Country allocation: moderately positive on Austria and CEE; carefully favoring SEE (especially Serbia); short-term allocation for Turkey and Poland

Performance overview 2Q 2013



2Q 2013 – 3month performance, closing price 28.06.2013; Source: Factset Partners, Erste Group Research

"While any news flow on changes in monetary policy and liquidity obviously will have a substantial impact on any market in the region, we would expect markets to trade a bit without direction. In particular, Turkey should be the most vulnerable market, while Poland has its extra burden stemming from changes in its private pension system. With markets digesting news flow from the Fed and elsewhere, we could well imagine that a longer period of normalization has just begun. Growth will be moderate, but at least there are signs of a recovery in forward-looking indicators. We are a bit undecided on whether we want to already call this a goldilocks economy. In any case, allocation for this quarter will probably require more of a tactical approach, which should be especially true for Turkey," explains Esskuchen.

Austria – sound neutral to overweight

The recently slightly shaky banking sector, which dominates the local index, might have pushed the market down more than it deserves. Hence, we would argue that the Austrian valuation was being pushed down by external factors far too much. Also, its positioning between the developed and emerging market universes might help the market regain its previous strength. We improve the neutral model call and stretch it towards neutral to overweight.

CEE – moderate overweight

The Czech Republic was the only market with a notable rise of equity risk premium, offering the highest discount to historical levels. Hence, we would again consider blue chips interesting and also start to like CEZ and Komercni banka again. We removed Telefónica from our expected underperformers, owing to its hefty dividend yield. Hungary again surprised negatively by adding to sector taxes. However, this time it was probably with the intention of being ready for extra spending after leaving the EDP. Public spending might become visible as early as September in preparation for next year's election. While we acknowledge that this still has the character of a bet, we confirm our model's outcome and rate it moderate overweight.

Poland – neutral (negative bias), but watch closely

As one of the most liquid markets in the region, it should have been most affected by the recent correction driven by liquidity concerns. However, digesting this shock might have triggered some quick upward moves shortly after, but the ongoing discussion on domestic pension funds is quite likely to keep the market down. We expect no final decision earlier than September or even October. Hence, uncertainty will prevail and to remain conservative, we add some underweight bias to our neutral positioning. On a stock picking basis, however, bargain hunters may want to look at BZWBK and keep an eye on Bogdanka and KGHM below PLN 100, as well as Lotos or PKN below PLN 30 and 40.

Romania and Bulgaria – moderate overweight

Romania should be among the strongest growing economies in the region, while the valuation is more than attractive and the growth outlook confirms the sound standing. Currently, pending privatizations might have a reasonable chance to finally help break the liquidity trap. However, for most of the third quarter, liquidity might remain a show-stopper, that's why we still tend to assign a moderate overweight for those who can deal with small sizes.

Russia – neutral

As long as concerns about disinflation and liquidity remain in place, we tend to see little support for the market overall. Fundamentally, growth remains broadly absent. It might still be an argument for the Russian market that it is an alternative to Turkey. Neutral at best, vetoing the model outcome.

SEE – sound neutral

If we take out Croatia, we would still carefully favor SEE, which in this case means Serbia. Serbia could take over the EU accession story from Croatia, with its accession path now being open. Liquidity is even more of an argument for the Serbian market than for the Croatian one and hence our rating is a bit more careful, slightly reducing the rather bullish outcome of our model.

Turkey – sound neutral

The fact that Turkey will be most vulnerable to changes in liquidity should prevent the market from rising too strongly to its previous levels. We could well imagine that the BIST-100 offers attractive trading gains, depending on news flow and continued accession of what the situation will look like. Hence, we preserve the right of acting again more tactically on Turkish market, as we did already in the past. In general, however, we believe that the Turkish economy might weather any yield/liquidity related trouble better than most people think and remain fans of the market on a more long-term perspective. Calling it a neutral we would look for short-term trading gains.

10 Top picks

July 2013 selection

Top 10 picks	Expected underperformers
Alarko Hldg	Lotos Group
BZ WBK (new)	**LPP (new)**
Egis	Wienerberger
Fondul Proprietatea	
Halkbank (new)	
Immofinanz	
Kapsch TraffiCom	
Krka	
Migros	
OMV (new)	

Source: Erste Group Research

"Despite the top down risk for Turkey and Poland we have newly included Halkbank and BZ WBK in our top ten picks, replacing Bank Pekao and PKO BP", explains Esskuchen. "Also OMV finally made it among the top picks (replacing Turk Telecom) after being on overweight already for some time." With a much weaker share price Telefonica was dismissed from expected underperformes, with LPP taking its place. Alarko Hldg, Fondul Proprietatea and Immofinanz remain among the top ten picks, as do Egis and Krka, as well as KTC and Migros. The trio of expected underperformers is completed by Lotos Group and Wienerberger.

* The ZEW-Erste Group Bank Economic Sentiment Indicator for Central and Eastern Europe including Turkey (CEE) is calculated as the balance of positive and negative assessments of the economic development on a six-month time horizon.