CEE sovereign bonds among best investments in Europe this year - high returns and low volatility increase investor appeal

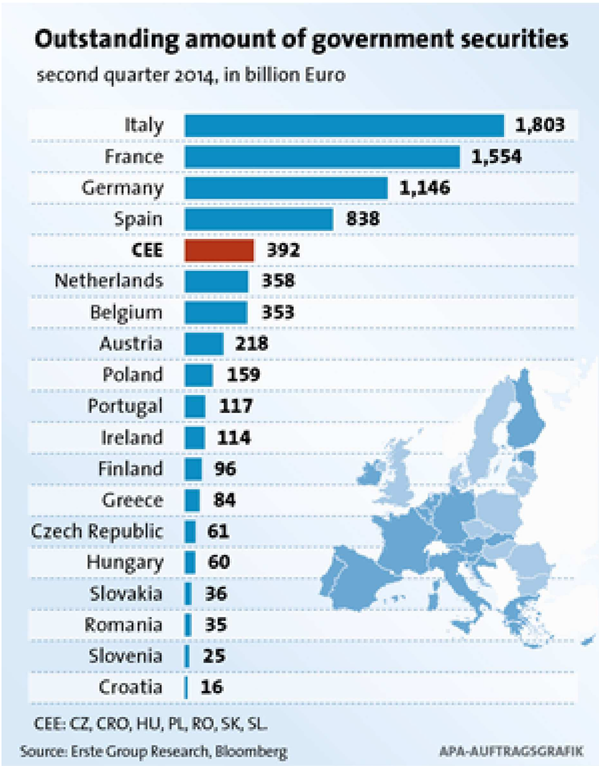
CEE sovereign bond market is 5th largest in continental Europe (approx. EUR 400bn total market cap); CEE sovereign bonds outperform 5Y German and French counterparts

Romania emerges as CEE regional champion among local currency bonds (9.8% total return on 5Y bond); Hungary best regional performer among Eurobonds (10% return) - also beating Italy and Spain

Increasing investor interest in CEE bonds due to more balanced distribution of upward/downward risks and attractive yields vs most Eurozone bonds

Cash position of CEE governments generally comfortable:
- Czech Republic, Hungary, Poland, Slovakia and Slovenia will most likely forgo international issuances in 4Q14
- Croatia, Serbia, Romania and Turkey may take advantage of favourable market sentiment and do some pre-financing in 4Q14
- Poland and Slovakia prefer to tap international markets 1Q15 only

The CEE government bond market has become more significant over the past few years as these countries' relative rating has improved vs. the Eurozone (several CEE countries got upgrades, while many Eurozone countries' rating headed south) and CDS spreads have compressed. This year in particular CEE sovereign bonds stood out as some of the best performing assets in Europe due to the decent yield relative to their fundamentals/ratings, as well as the historically low market volatility, according to the most recent Erste Group Research report "CEE Eurobonds – the 'Sweet Spot'".



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"One of the hottest investment topics at the moment is the low interest rate environment, so we have seen more institutional investors looking to diversify their portfolios and thus eyeing CEE sovereign bonds. With CEE bond markets' capitalization substantially increasing, we have decided to introduce two Erste CEE Bond Indices that help to track the performance of government bonds in the region. Our main finding is that CEE sovereign bonds are some of the best performing assets in Europe, and investing in a basket of such assets could actually significantly reduce volatility without compromising too much on returns," says Juraj Kotian, Head of CEE Macro/Fixed Income Research at Erste Group.

Investments into basket of Eurobonds of CEE countries as measured by the Erste CEE Eurobond Index were generating higher returns for investors this year (6.9%) than investments into CEE local currency bonds measured in EUR (5.3%) by Erste CEE Local currency Bond Index. Both indices show that CEE bonds were outperforming 5Y German and French counterparts, which yielded in the same time period just 3.8% and 4.6% (YTD, including capital gains), respectively. The CEE countries included in these indices are Croatia, the Czech Republic, Hungary, Poland, Romania, Slovenia and Slovakia (the last two are omitted from the Erste CEE Local Currency Bond Index, given that they are both euro area members).

"Among local currency bonds, Romanian 5Y bonds, with a 9.8% total return, outperformed the whole region by far. This is mainly because its currency has not weakened (as it has been well anchored by the central bank) and the liquidity surplus brought yields downs. While HUF-denominated bonds were underperforming our Erste CEE Local Currency Bond Index, Hungarian Eurobonds were the best performers in broader terms, with their 10% annual return beating even Italian, Spanish and Slovenian bonds. Hungarian Eurobonds have benefited most from the further spread compression of sovereign bonds in Europe," explains Juraj Kotian.

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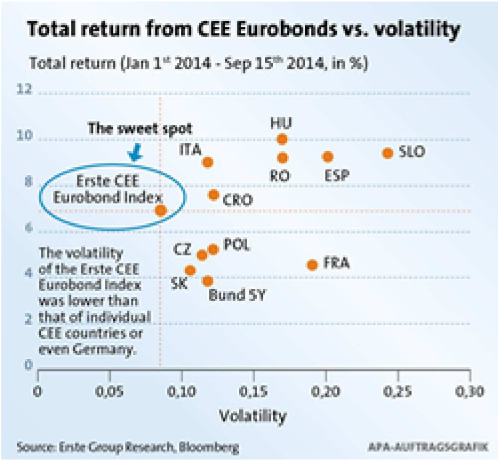
CEE Eurobonds have also been performing very well in risk adjusted terms. The volatility of the Erste CEE Eurobond Index, as measured by standard deviations of daily changes, was lower than that of individual CEE countries or even Germany.



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Over the past few years, the compression of credit default spreads across CEE countries has been notable. To some extent, it has been associated with the fact that the global index of risk (VIX) has been steadily dropping and the premium for risky assets has been going down. Despite the common downward trend in all CEE countries, Erste analysts believe the differences in credit default spread levels are not negligible. *"Although the region tends to be seen as a homogenous area and its markets are prone to co-move in response to changes in global sentiment, the differences in fundamentals seem to explain why the level of credit default spreads vary across the region. Moreover, it appears to affect the magnitude of responses to increases in risk aversion," says Kotian.*

In particular, a country's reaction to change in the global risk aversion is closely related to relative rating. In other words, countries with strong fundamentals (better relative rating) remain more resilient to global turmoil.

Erste research shows that, given the current level of global risk aversion, an improvement in the relative rating by 1 notch should be associated with a 30bp average drop in CDS levels. The changes in the current account deficit are expected to have similar effects on CDS levels, although to a lower extent (reducing the current account deficit by 1pp should be on average related with a 6bp drop in CDS).

When it comes to the outlook and performance of CEE bonds in 4Q14, developments in the external environment will play a crucial role. Across Europe, the potential for any further drops in yields is nearly exhausted for many countries, while the current yield level (in many countries below 1% on 5Y bonds) does not adequately price in any upward risk. From this perspective, many CEE bonds still offer a more balanced distribution of upward/downward risks and associated reward in terms of yield. Furthermore, Erste analysts see some opportunistic potential for short-term currency gains in Hungary and Poland ahead of year-end, which could boost the performance of the Erste CEE Local Currency Bond Index.

Cash position of CEE governments generally comfortable

In what regards the redemption situation and cash buffers in CEE countries and Turkey, several countries should not be in a particular rush to increase supply. Some countries are actually expected to reduce the amount of public debt in 4Q either via buybacks or a lower amount of primary issuance, in order to comply with their debt-brake rules (Slovakia, Hungary). Other countries have a very high level of cash buffers (the Czech Republic, Slovenia), which allows them to have a zero net issuance in 4Q14 and even beyond. For other countries, however, pre-financing 2015 redemptions could be a viable option (e.g. Poland); yet others need to still carry out substantial financing this year, as they are not able to complete the financing plan, or they have low cash buffers (the most notable example of the latter situation is Romania).

As for foreign issuance, Erste analysts expect the Croatian, Serbian, Romanian and Turkish governments to tap foreign markets in 4Q 2014 in order to do some pre-financing for 2015, while Poland and Slovakia may tap foreign markets in early 2015.

Foreign investors' ownership of CEE debt is expected to remain stable or even increase, helped by the ECB additional steps. As for banks, their appetite should also remain pronounced, given the high liquidity in the banking systems in CEE overall. One exception could be Hungary, where the conversion of FX loans into HUF loans could increase the demand for HUF liquidity, and thus decrease banks' appetite for government securities.

Central banks in the region should continue to pin down the short end of the yield curve, keeping policy rates low (or even cutting them further in Poland). Inflation figures are expected to remain rather muted in CEE, with an average of below 2% in 2015, after the muted 0.4% predicted for 2014.

"Overall, moderate supply, the expected support from ECB measures, low inflation and a generally accommodative monetary policy should help keep sovereign bond yields relatively low in CEE. An exception in the short run is Romania, where political risk could increase spreads temporarily in the fourth quarter, while the relatively low levels of cash reserves and a demanding rollover structure could lift yields. On the other side of the spectrum, the Czech Republic should see yield levels pinned down at current rates, and (given the favourable cash position, no plans for net issuance and solid fundamentals) the spread vs. Bund yields could even become negative in 2015," says Zoltan Arokszallasi, Chief Analyst for CEE at Erste Group.

Outlook for 4Q 2014 & 2015:

Croatia: We expect MoF to go for some pre-financing in 4Q14, given the Eurobond (EUR 750mn) maturing early in 1Q15 and a favourable moment to close a proportion of funding needs for 2015. Moving on into 2015, gross financing needs remain elevated and close to 22% of GDP.

Czech Republic: MoF aims to stabilize the total amount of the central government debt at the current levels (CZK 1.68trn; regardless of the development of the business cycle) at least until the end of 2015, hence no new debt issuance in both 2014 and 2015.

Hungary: This year, Hungary has to cover a total of EUR 5.4bn in FX redemptions. Next year, FX redemptions will only amount to EUR 2.4bn. Although the government plans no Eurobond issues for the whole year, and the demand for local EUR-denominated bonds will drop significantly (as only retail investors will be eligible for them), the most recent signals from the government point to a Eurobond issue (possibly in the form of a private placement), which may materialize if it can secure favourable terms.

Poland: Poland has already finished financing this year's borrowing needs and in 4Q14 it should start to pre-finance next year's financing needs. The Ministry of Finance plans an increase of next year's gross borrowing needs to PLN 154.8bn, i.e. around 9% of GDP (from PLN 127bn this year).

Romania: As of end-September, the MoF had covered around 82% of its total funding needs for this year, so the country still needs to carry out financing this year. True to its strategy, it has managed to lengthen maturities, which is why gross funding needs for 2015 have dropped to around RON 50bn; around 22-23% thereof could be tapped from abroad, while the balance will be sourced domestically.

Serbia: The YE indication is that we may see the MoF tapping the Eurobond market, most likely going for a volume of about EUR 750mn. The timing, in our view, remains determined by the progress in the upcoming IMF talks. Looking to 2015, we expect the financing needs to move to above 20% of GDP.

Slovak Republic: In 2015, the debt agency will face roll-over needs of about EUR 4bn, but it is likely that it will buy back part of this volume already in 2014, using its cash reserve and debt issuance. Besides interest savings, the state has an additional motivation to repay bonds early, due to constraints on the public debt imposed by the local debt brake rule.

Slovenia: Following a more demanding funding profile in 2014 (gross financing needs at approx. 14.5% of GDP), 2015 looks more comfortable, with the figure around the 10% of GDP mark. As far as yield expectations are concerned, we see room for further yield compression towards 2.5-2.6% and a subsequent gradual move upwards, owing to expected Bund trajectory.

Turkey: The global interest rate outlook, the inflation trend in Turkey and the monetary policy will be the main factors impacting yields in the next few quarters. We expect the two-year bond yield to remain elevated at 9% at the end of the year and yields to go up to 9.4% by 2Q15. They should hover back towards 9% for the remainder of the year, with the decline in inflation preventing nominal yields from rising, despite the higher real interest rate pressure globally. However, we believe that the CBT should rely on liquidity tightening and lift the funding cost above the policy rate during 2015.

Presentation [pdf; 183.6 KB]