EAST CAPITAL

Macro Monitor
February 2012

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The real turnaround or another false start?

The first month of the year is not always the most exciting, but this year January turned out to be different, at least from an investment point of view. Stock markets around the world rallied and investors, who were very negative for most of the autumn, suddenly became optimistic and willing to take risks again.
It seems that Santa Claus brought a sack of positive surprises over the holidays. Some may even suggest that Super Mario was Santa.

The main gifts in Santa's sack were European Central Bank, ECB, liquidity and better than expected US macro data. The increasingly ambitious and credible fiscal agenda within the Euro zone and renewed commitments to keeping US interest rates low for longer were also welcome presents to investors. These handouts encouraged investors to take on more risk again and even dip their toes in emerging markets, with global emerging markets funds noting a record inflow of USD 7.7bn during the first four weeks of the year.

Liquidity program – a success

Investors kept expecting more than they got from the European policymakers for most of the autumn. Everyone (almost) wanted the European Central Bank to become a lender of last resort by committing to buy unlimited sovereign bonds on the primary market. The ECB refused, encouraged by the Germans, but initiated a liquidity program called LTRO, Long Term Refinancing Operations, instead. The LTRO allows banks to borrow almost unlimited money from the ECB over 3 years at a 1% interest rate. The program was launched in December and turned out to be a success, as more than 500 banks borrowed almost EUR 500bn. This liquidity helped to bring down bond yields within the Euro zone and most likely also pushed investors back into emerging market assets. The next auction is scheduled for February and is expected to be even larger, possibly surpassing EUR 1,000bn.

ECB's and its Governor's Mario Draghi's liquidity program managed to secure banks' refinancing requirements and boost stock markets around the world.

These liquidity operations were a success because the stigma attached to tapping the ECB for money disappeared, and they are important parts of the financial firewall under construction within the Euro zone. The idea is to build a wall around Greece (and possibly also Portugal), which is increasingly viewed as insolvent, preventing it from bringing down solvent but illiquid economies like Italy and Spain in the event of a default. The ECB liquidity combined with the prospects of increased resources from the IMF and the Euro zone's rescue funds is increasingly being regarded as a potentially credible firewall. If we make an alphabet soup of the acronyms - EFSF, ESM, LTRO, SBA, FCL – that make up the firewall, it could eventually boil down to as much as EUR 3,000bn, which should be large enough to contain an eventual default.

Agreed on the fiscal compact

This optimism is spreading, although the old problems in the Euro zone remain unresolved. The Euro zone still struggles with unsustainable debt levels and poor growth outlooks. The extraordinary Euro zone summit in late January neither solved the lingering Greek problems nor tackled the growth challenge, which was the official focus of the meeting. The leaders did agree on the so called fiscal compact, but it was watered down to such an extent that it will matter little for the short-term economic outlook. It is, however, an important political goal and should help to convince the Germans to agree on more monetary support for the peripheral countries. And there was progress in the discussions with the private bond holders in Greece, which is one of the most sensitive issues, suggesting that a second bailout program could be reached before Greece runs out of money. 20 March has become a firm deadline as Athens has large bond repayments due on that date.

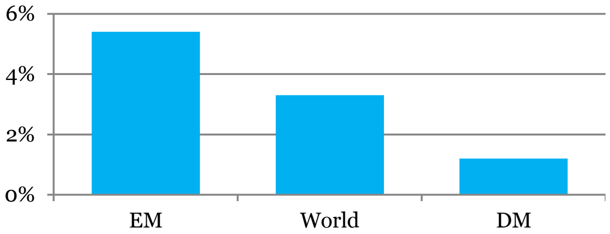
Revised growth but less volatility

That the IMF and the World Bank revised down their global growth forecasts in January was widely expected and did not manage to put a lid on the optimism. The IMF wrote down the expectations for the Euro zone to -0.5% for 2012, as the previous

1.1% growth prediction was unrealistic given all the budget cuts that were announced during the autumn.

They also revised down the growth for other developed economies by 1pp and for emerging markets by 0.7pp. Developed markets are now expected to grow a modest 1.2% in 2012, while emerging markets should grow 5.4%. The world economy is estimated to grow 3.3% on a purchasing power adjusted basis.

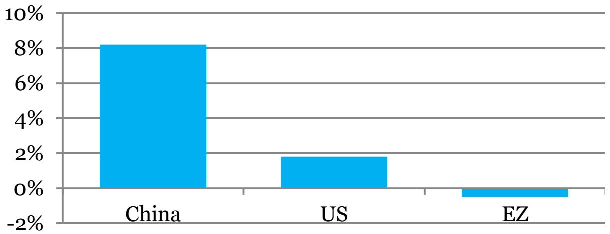
Real GDP growth 2012E



Source: IMF, January 2012

Growth forecasts like these are finally starting to catch up with reality and the revisions are likely to be smaller going forward if the muddling through scenario in the Euro zone plays out. There is an emerging consensus on growth, although everyone is still hedging their bets by mentioning all the downside risks.

Real GDP growth 2012E

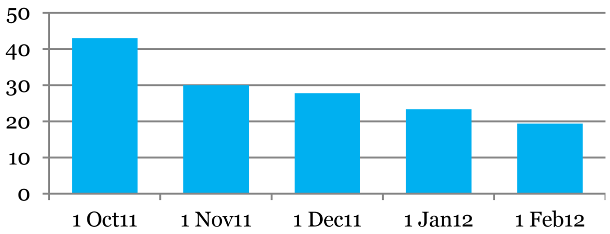


Source: IMF, January 2012

More importantly, the fact that key macro numbers from the US and China, the two largest economies in the world, were better than expected helped to boost the optimism. Investors have been focusing on the fact that US unemployment has fallen, while growth forecasts for 2012 were revised up. And the fact that PMI, Purchasing Managers Index, climbed back over 50, while inflation dropped to 4.1% helped to dismiss the fears of a hard landing in China.

Many analysts are now asking if January was the real turnaround or another false start, like October last year. I personally think it is the beginning of the turnaround but there are enough complicated issues left on the table to expect volatility to return from time to time. But the fact that the VIX index, a measure of volatility (it measures the implied volatility of S&P 500 index options over the next 30 days), has dropped below 20 again is reason to be optimistic – at least for now.

VIX index

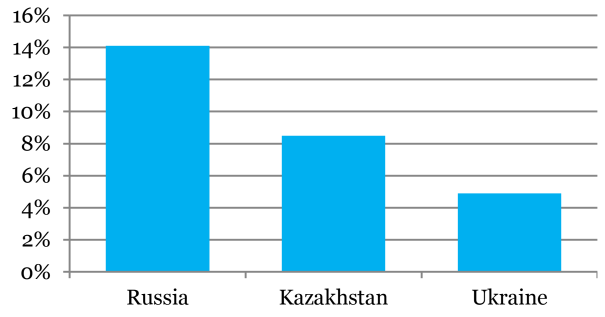


Source: Bloomberg

Marcus Svedberg
Chief Economist

Rebounding markets

January 2012 performance (USD)



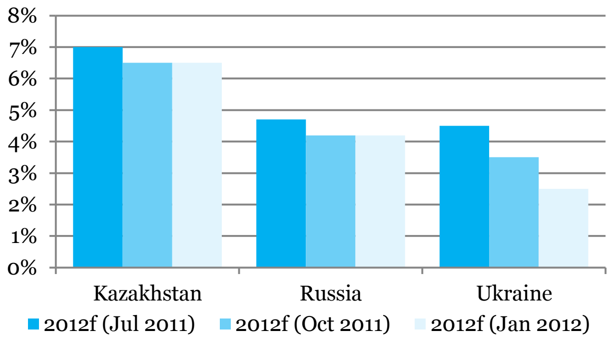
Source: Bloomberg

The Russian market got off to a great start, even though many Russians were on their usual New Year's break in early January. The political uncertainty, which pressed down the market in December, eased as the protests turned out to be larger than expected but also more peaceful than feared. The market gained 14.1% in January and was one of the best markets in Eastern Europe, thus repeating the pattern of strong performance whenever external volatility abates. The market has disconnected from the oil price lately and is more closely correlated with the VIX index.

The frontier markets in the CIS also rose in January, but the gains were more modest. The Kazakh and Ukrainian markets recorded gains of 8.5% and 4.9% respectively.

Resilient growth

Real GDP growth forecasts for 2012



Source: EBRD

While growth is slowing down rapidly and forecasts are being revised sharply in much of Europe, the economies in the CIS have proved to be quite resilient. The Russian economy grew 4.3% in 2011, which was slightly higher than expected, and noteworthy, as the 2010 number was revised up from 4% to 4.3% as well. The EBRD did not revise down the growth prospects for Russia for 2012 in its January outlook and maintains that the economy will grow 4.2%. This is on the bullish side but may turn out to be right as consumption, the main growth driver, remains buoyant, while oil prices are expected to stay high.

The growth outlook for Kazakhstan was also maintained at 6.5%, while it was revised down sharply to 2.5% for Ukraine.

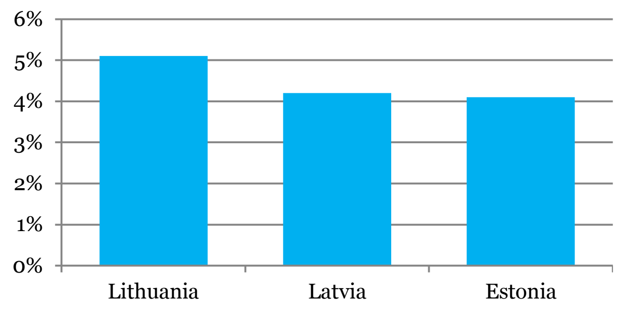
Criticism after Kazakhstan election

80% of the votes in the parliamentary elections in Kazakhstan went to the ruling party, Nur Otan.

The parliamentary election in Kazakhstan on 15 January did not produce any surprises. The ruling Nur Otan party received 80% of the votes and incumbent Prime Minister Karim Massimov was sworn in for another period, with the support of 99 out of 104 deputies in the lower chamber of the Majilis. The fact that two other parties made it into the parliament for the first time since the 1990s was expected and is not likely to change anything. The soft opposition parties, Ak Zhol and the Communists, passed the 7% threshold and will thus be represented in the parliament. The Social Democratic Azat party, which is a more genuine opposition party, only received 1.5%. Leaders from Azat staged protests after the election and were detained for 15 days. The OSCE, an election watchdog, criticised the arrests and stated that the vote "did not meet fundamental principles of democratic elections".

The positive mood reached the Baltics

January 2012 performance (USD)



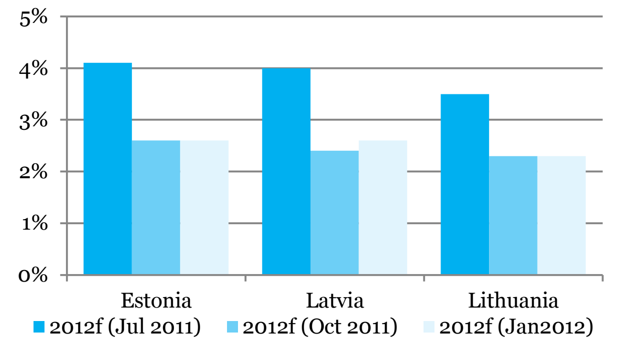
Source: Bloomberg

The positive sentiment arising from ECB liquidity auctions and better-than-expected US and Chinese macro data also helped to push the Baltic stock markets higher in January. The gains were, however, generally smaller in these frontier markets than in the larger index markets in Eastern Europe. The exchanges in Tallinn, Riga and Vilnius gained between 4 and -5%, while the currencies appreciated marginally against the USD.

The regional news flow was rather thin in January, and the markets continued to be driven by external events. It can, however, be noted that Estonia was awarded the Golden Swot award for the second year in a row by the European Voice. It's a light-hearted annual award that correctly pointed out that Andrus Ansip is the second longest-serving PM in the EU and that he presides over the best-performing economy.

Growth will slow down eventually

Real GDP growth forecasts for 2012



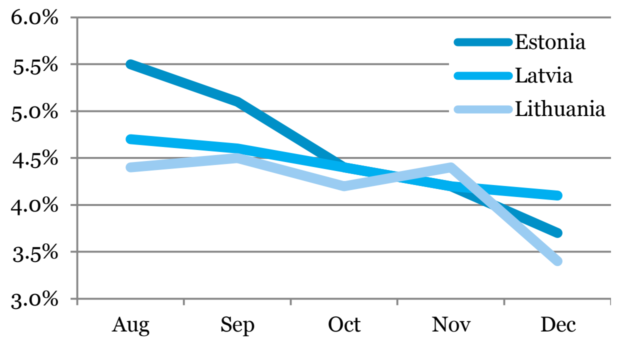
Source: EBRD

The Baltic economies ended 2011 in a strong fashion. Lithuania gained 4.8% in 4Q and 5.8% over the full year. Strong retail sales and industrial production numbers indicate that the other two economies should follow the same path (Estonia and Latvia are expected to have grown around 8% and 5% respectively in 2011). Improved consumer sentiment in the region also indicates that Baltic households remained confident despite gloomy reports from the Euro zone.

The EBRD (European Bank for Reconstruction and Development) did not reduce the growth outlook for the Baltic trio in its January update, as it had already revised down growth to around 2.5% for 2012. The EBRD actually revised up the numbers slightly for Latvia, which may be wise as the latest retail sales figures surprised on the upside, at 9.5% in December.

Inflation is falling

CPI development in 2H 2011 (y-o-y)



Source: MacroBond

Even though domestic demand has been strong lately, inflation in the region has remained at healthy levels. Inflation picked up during 1H 2011, but fell across the region during the second half of the year. CPI dropped to 1 pp to 3.4% in Lithuania, almost 2pp to 3.7% in Estonia and fell from 4.7% to 4.1% in Latvia.

These developments demonstrate how the Baltic economies are now able to sustain high growth without increased price pressure. With GDP in the region now close to pre-crisis levels, this is a good sign of further maturation from the economies' earlier boom-bust structure. A combination of prudent policies and a favourable base effect should help the Baltic economies to keep inflation under control in the near future.

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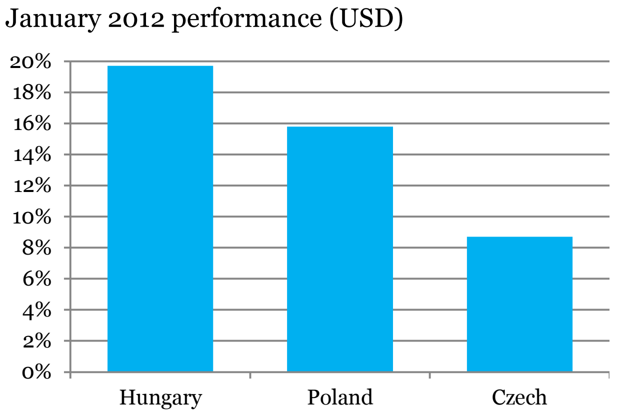
Relief rally in Hungary

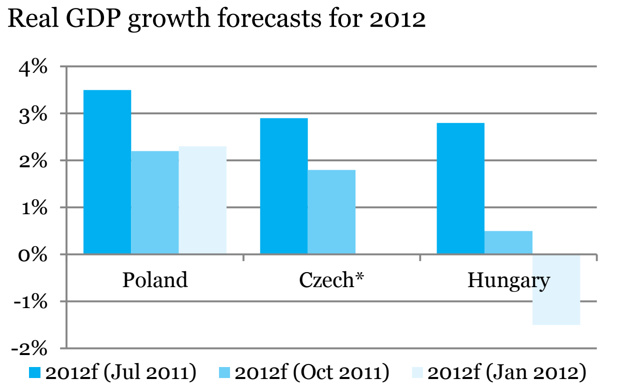


Source: Bloomberg

The Hungarian market was very much in focus in January. The month started on a very bad note after the Hungarian government introduced a set of laws that will limit the independence of the central bank. But the Orban government was forced to reopen negotiations with the IMF in January and promised not only to reverse those laws but also commit to budgetary and structural reforms. The equity market and the currency rose sharply as a result, with the Budapest exchange ending the month as the strongest market in Eastern Europe, noting a 19.7% gain.

The Polish market was also strong, benefitting from the improved sentiment in the Euro zone, and ended the month with a 15.8% gain. The Czech market, which was surprisingly resilient in December, performed in line with the region at large and gained 8.7%.

Uneven growth prospects



Source: EBRD and *IMF

It was perhaps not very surprising but nevertheless symbolic that the EBRD slightly revised up Poland's growth forecast for 2012, while slashing the already meagre growth outlook for Hungary. The former is doing most things right from a governance perspective, while the latter is making a lot of mistakes. But more importantly, the Polish economy is less dependent on the struggling Euro zone than the Hungarian economy. The EBRD now believes Poland will grow 2.3% in 2012 (see next story for details), while Hungary is expected to contract by 1.5%, which would make them the worst performing economy in Eastern Europe.

The EBRD no longer covers the Czech Republic, but the economy is generally regarded to perform somewhere between its neighbours. The latest IMF forecast, which is slightly outdated, forecasts 1.8% growth for 2012. Prague would be satisfied if that turns out to be the case.

Polish pleasures

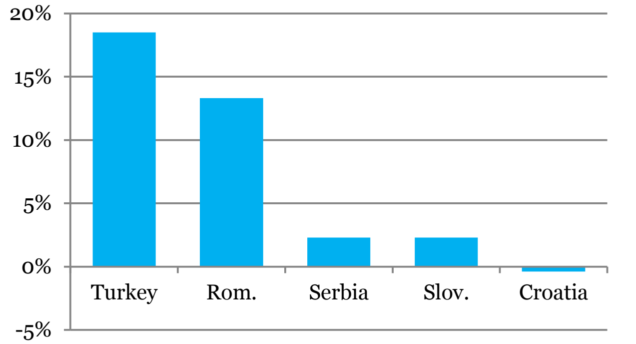
The newly finalised motorway A1, at the junction Sośnica – Maciejów in Poland, built by Polimex Mostostal, is one of East Capital's investments that benefits from the strong domestic demand in the country.

The general impression from data reported in January is that the Polish economy will stay strong, despite the ongoing commotion in Western Europe. After two months below 50, Polish PMI for January, was back into expansionary territory, at 52.1, and the 5.4 point increase m-o-m is the largest since 2009. Industrial production in December was up 9.5% y-o-y, mainly due to strong numbers from the export-orientated industries.

The economy showed resilience all through 2011, with GDP growing at 4.3 % on the back of increased investment activity and strong domestic demand. Even though the economy is likely to slow down in 2012, the upcoming European Football Championship together with increased activity in shale gas exploration projects will support the economy and keep a good momentum going into 2012.

Rally in Turkey and Romania

January 2012 performance (USD)



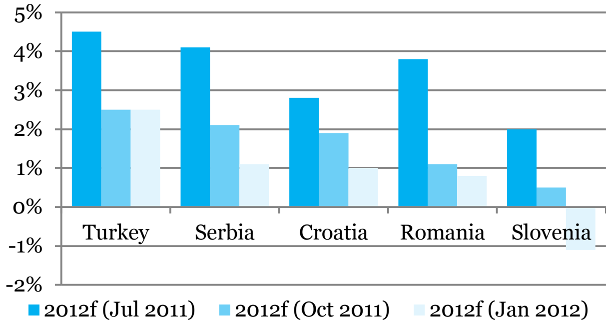
Source: Bloomberg

The Turkish equity market, which underperformed during the end of 2011, started 2012 on a strong note. The market gained 18.5% in January and was the second best market in Eastern Europe. It benefitted from the improved sentiment in Europe and the US as the commitment to low interest rates (US) and enhanced liquidity operations (Euro zone) should make it easier for Turkey to finance its large current account deficit.

The Romanian market was also strong, gaining 13.3%. The other markets in Southeastern Europe developed more modestly. The exchanges in Serbia, Slovenia, Bulgaria and Croatia were actually the four worst in Eastern Europe. The first three noted small gains, while Croatia ended the month with a marginal 0.4% drop.

Growth much below potential in 2012

Real GDP growth forecasts for 2012



Source: EBRD

The growth prospects for the economies in Southeastern Europe have been revised down in line with the Euro zone. This makes sense given the high level of integration through trade, investment and banking linkages. Growth is now expected to be around 1% or lower, which is much below the region's potential, due to low domestic and external demand.

Turkey is an exception as the economy is less dependent on external demand. It is nevertheless expected to slow down sharply from the extreme growth rates witnessed in 2011. There is a risk that the landing will be somewhat harder than generally assumed if the correction of the current account deficit turns out to be bigger than expected.

Romanian riots

Protest against political incompetence and economic austerity held in front of the government headquarters, in Bucharest, Romania, 24 January 2012.

It has been described as the Battle of Bucharest and Romania's winter of discontent, but the labels are secondary to the underlying importance of the riots that took place throughout Romania in January. People are protesting against political incompetence and economic austerity in general. President Basescu and Prime Minister Boc have been targeted and their ruling Democratic Liberal Party has dropped sharply in the opinion polls. Basescu is especially disliked after a public row with a ministry official over health care privatisation plans, an incident that seems to have sparked the protests. The riots have resulted in a number of causalities and are also likely to bring down the government, but it remains unclear whether or not they will last until the general elections in November.

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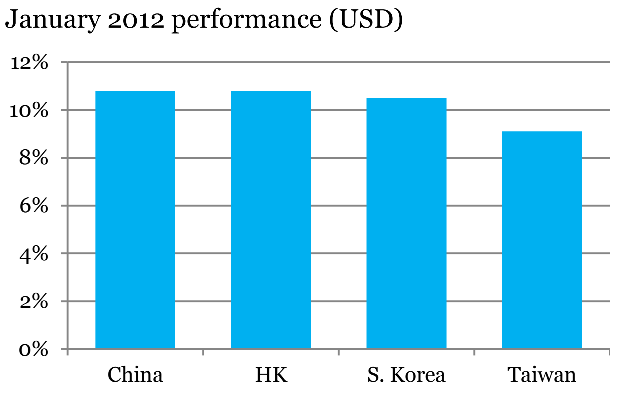
Steady markets in January

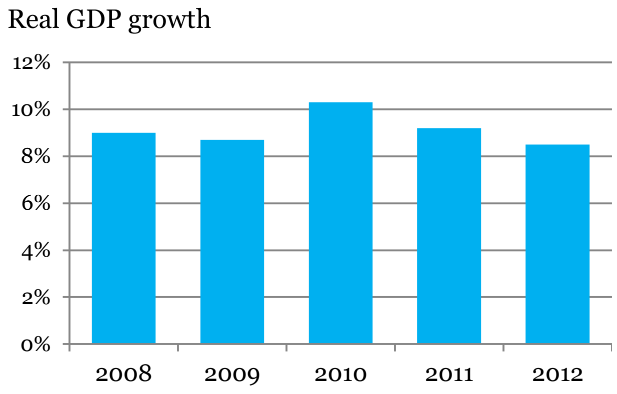


Source: Bloomberg

Stock markets in Asia rose strongly in January thanks to renewed optimism about global growth. In China, bank lending growth had rebounded by the end of last year and auto sales figures for December exceeded expectations. The January PMI index rose to 50.5, indicating that the Chinese manufacturing sector expanded during the month.

The Chinese market rose 10.8% on the back of a strong performance from the banking sector. Taiwan rose 9.1%, with many large technology stocks beating the market. South Korea gained 10.5% thanks to large foreign capital inflows. Elsewhere, Singapore had the best month in over 2 years, rising 13.3%. Bank stocks were the largest contributors to index performance. Thailand gained 7.9%, with strong sectors across the board. Indonesia rose 3.9% with coal exploration companies leading the rise and defensive stocks falling. Malaysia gained 3.5% during the month.

No landing in China



Source: MacroBond

China published GDP growth figures for 4Q11 that were higher than expected, at 8.9%, which helped to push the stock markets higher. For the full year 2011, GDP growth ended at 9.2%, which is lower than the 10.4% in 2010. Urban income rose 8.4%, compared to 7.8% in 2010, and rural income rose 11.4% compared to 10.9% in 2010.

We expect the Chinese economy to slow down to 8-8.5% growth in 2012. The GDP growth rate for 2012 depends on how badly hit China is by declining exports to the Euro zone and how much stimuli the government gives the economy. We expect more cuts in the required reserve ratios at the banks and we noted that bank credits increased to RMB 640bn in December, up from RMB 562bn in November. Inflation fell to 4.1% in December and is no longer a major concern.

Chinese New Year – a festival of spending

According to Chinese horoscopes the economy will be strong during the year of the Water Dragon.

On 23 January we entered the Year of the Water Dragon, according to the Chinese lunar calendar. According to Chinese tradition, the dragon is a celestial, benevolent creature that brings good luck. It originally represented the emperor, and today it represents power. As the dragon is an auspicious animal, a baby boom is expected in China this year.

Chinese New Year is an important festival for the Chinese, and even though property sales fell during the week of festivities, other sectors experienced growth. Total retail sales during this week of gift giving increased with 16.2% at RMB 470bn and 176 million Chinese tourists spent RMB 101.4bn during the week. Chinese public transportation counted 387 million passengers the same week, while an increasing number of middle and upper-middle class Chinese chose to travel abroad.