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CEE Equity Strategy

1Q 2011

Happy New Year!

Environment positive for equity –
CEE is place to be

Stable growth development –
priced in more positively

Domestic consumption becoming factor to watch

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Outlook

We assume further worries spilling over from EU periphery markets and concerns about EUR stability/public debt from time to time. In our outlook for 2010, we warned about troubles stemming from public debt and, unfortunately, we have not been proven wrong. At the same time, we expect central banks to keep rates at the low end, accepting some inflation risk rather than spoiling growth. Hence, liquidity should remain abundant and, with debt levels in the private sector also starting to rise again, we expect asset prices to remain inflated. This should also be good news for commodities and overall for cyclical stocks. Cyclicals have been doing better and should continue to do so for a while - at least in 1H11.

Growth in general should slow down, but not at worrisome levels – just getting back to reasonable levels after strong recovery effects. As we outline in our macro section, more vital signs from domestic consumption are needed, with export-driven growth seeing some question marks. With risk aversion decreasing further and low interest rates now increasingly turning into a positive environment for riskier assets (rather than just expressing pure avoidance of them), we see 2011 in general as a positive year for equity investments.

Sentiment remains healthy - partially increasing, partially maintaining sound levels. While growth should slow down a bit, markets appear to have started to price in even this more moderate growth outlook more generously, indicating that risk aversion is being pushed back further. Consensus earnings growth for the CEE region is seen at some 20% for 2011, with earnings revisions biting a bit into that positive outlook. Fundamentally-based upside potential for equity markets in the region remains sound, even adjusting for current premia for risk (aversion).

Stock picking should be a main theme again, while we would search for sound combinations of balance sheet health, profitability, growth and valuation (unsurprisingly). After a period in which markets were driven mostly by crisis related themes, we imagine that some normality will kick in again, making this approach a viable option. Applying such a filter, we find mostly cyclical stuff, aside from some telcos. The filter also appears to pick more small- to mid-caps, as larger cyclicals have performed quite nicely already.

Our recently published chart book suggests that most markets might see some initial weakness in January, offering opportunities to step in a moment later. Russia and Turkey come out as rather undisputed Overweight calls. Russia is gaining on oil price and valuation. Turkey might see a bit of a prolongation of its recent weakness, but potential positive news flow on rating upgrades could provide a substantial trigger. We would position Austria as a sound neutral, since it might need some time to digest its sound performance in 4Q, ahead of some additional tax burdens imposed. Hungary remains a wait-and-see case, with its final presentation of consolidation measures in early 2011 providing room for a move in either direction. Poland might have an uncertain trend towards an Overweight, since changes in the pension system should weigh on the market, but final outcomes remain a bit uncertain. The Czech Republic is seen as not moving much of anywhere, since we do not see any substantial triggers for the market. For SEE, it will be crucial to see to what extent further progress in big picture changes (economic recovery, EU accession, etc.) will help to lift the rather low valuations.

Our Cassandra observes some positive trends on the monetary front, with not only low rates, but also private lending finally picking up again. The only question marks swing over the Chinese economy. It remains to be seen if China will be able to slow down its lending-driven economy without stepping too much on the brakes. A bit more of a long-term view is our consideration of including developments of working age population into public debt calculations (pension payment obligations). Pension systems are quite a topic these days – Hello, Hungary! Our outcome would be that markets in our region will feel the impact of shrinking populations and increasing pension obligations, but have some buffer from overall much lower public debt levels otherwise. Positioned best in this view is Turkey, along with India and Brazil. Growing working age populations and GDP growth and rather low public debt make these markets an interesting long-term option.

Outlook

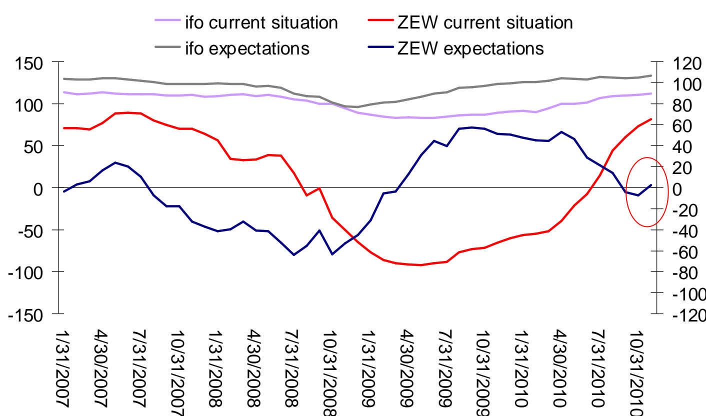
2011 should be good year for equities

In our top-down base case scenario, we assume further worries spilling over from EU periphery markets from time to time. In our outlook for 2010, we warned about troubles stemming from public debt and, unfortunately, we have not been proven wrong. At the same time, we expect central banks to keep rates at the low end, accepting some inflation risk rather than spoiling growth. Hence, liquidity should remain abundant and, with debt levels in the private sector also starting to rise again, we expect asset prices to remain inflated. This should also be good news for commodities and overall for cyclical stocks. Cyclicals have been doing better and should continue to do so for a while. Growth in general should slow down, but not at worrisome levels – just getting back to reasonable levels after strong recovery effects. As we outline in our macro section, more vital signs from domestic consumption are needed, with export-driven growth seeing some question marks. With risk aversion decreasing further and low interest rates now increasingly turning into a positive environment for riskier assets (rather than just expressing pure avoidance of them), we see 2011 in general as a positive year for equity investments.

Stock market expectations stabilizing at high levels

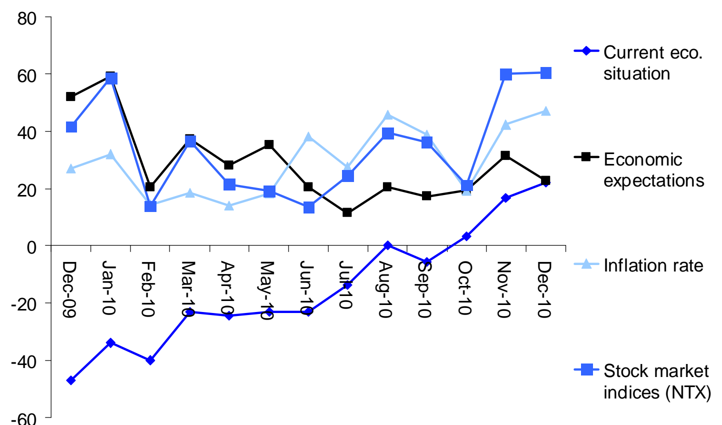
Sentiment seems to have recovered again. In particular, the German ZEW survey on expectations showed some weakness in between, widening the spread to Ifo expectations. The latest survey, however, saw improving numbers on expectations again. With the outlook for Germany (as the engine for CEE growth as well) still at low levels, domestic consumption is becoming increasingly important in CEE markets, offsetting potential weakening demand from Germany's export-driven economy. Our ZEW/Erste sentiment indicator received quite a boost in November, with all indicators heading north – including inflation. However, in the latest survey, carried out in December 2010, the view on the current situation continued to rise, while the outlook came down a bit again. Also, expectations for stock market performance started to move sideways – at very high levels, though.

ZEW and Ifo index Germany



Source: Bloomberg, ZEW

ZEW/Erste sentinment indicator CEE



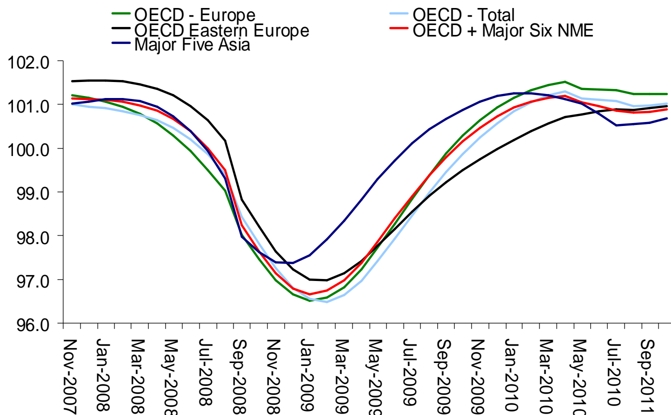
CLI provide stable picture

Along with sound sentiment developments and an apparently diminishing avoidance of riskier assets, it seems that the fundamental outlook has begun to drive market performance again. Basically, a scenario of slowing down growth seems to remain, with base effects finally having faded out. Composite Leading Indicators (CLI, as calculated by the OECD) provide a fairly stable picture, with Eastern Europe (in particular) moving sideways. We would view it as positive that most regions have found their way into a sideways channel at reasonable levels after the strong gains shown in the past.

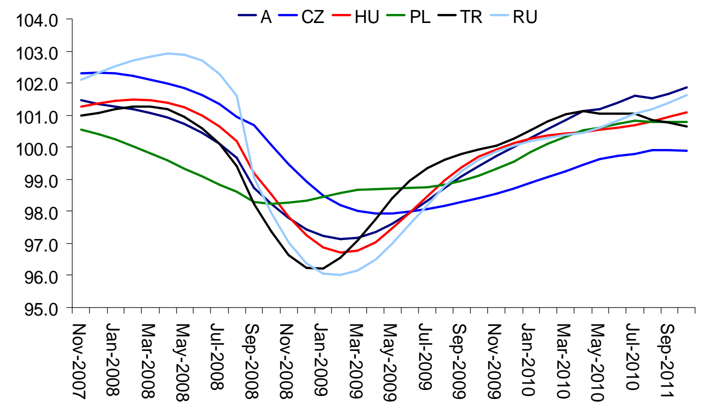
Outlook

Composite Leading Indicators

Global regions



CEE



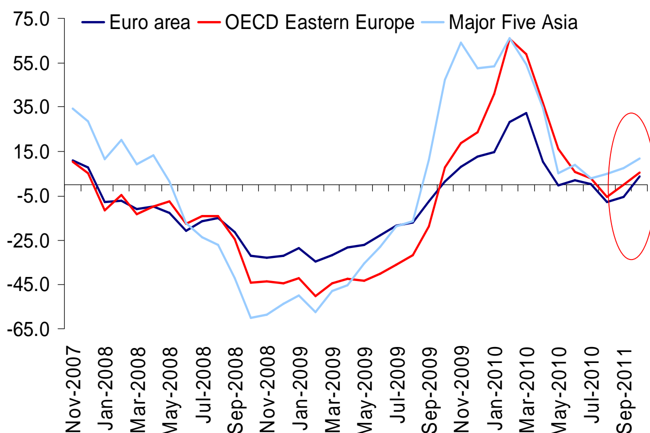
Source: OECD, own calculations (OECD stopped providing data for OECD Eastern Europe. OECD Eastern Europe shown in the chart is based on an average of individual CEE countries, calculated by Erste Group Research)

Even more moderate growth outlook priced in more positive now

The positive picture combining sentiment and fundamentals (as expressed by CLI) becomes visible when looking at spreads between 12-month rates of changes for CLI growth and the corresponding rate for stock markets. While spreads indicated very sour sentiment after the initial euphoria, it seems now that even lower growth is being priced in more positively. We take this as an indication that the low yield environment could finally become supportive for equities, instead of expressing just pure denial of equity investments. On an individual country level, Turkey started to price in growth developments the earliest and strongest, consequently making the market vulnerable to corrections, as we have seen in November and December of 2010 (which were also triggered by central bank actions).

Spread CLI growth 12M rate of change (trend restored) to local index 12M rate of change

Global regions



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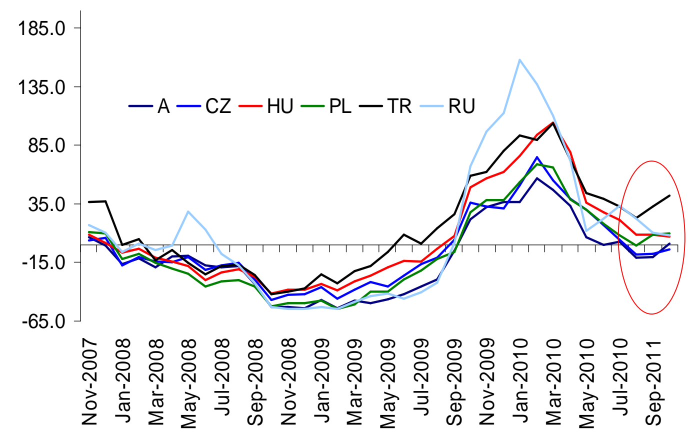


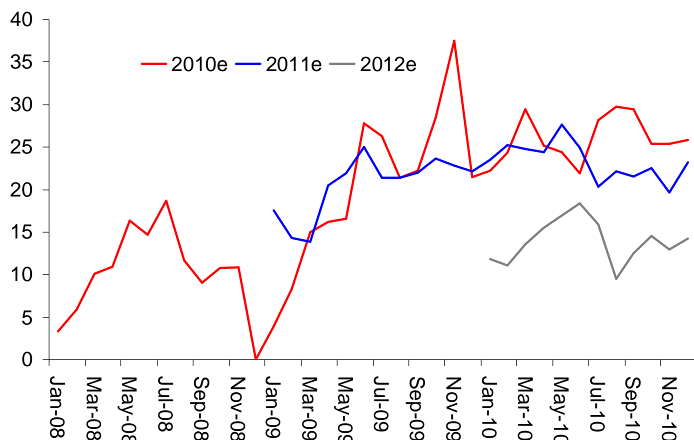
Source: OECD, own calculations (OECD stopped providing data for OECD Eastern Europe. OECD Eastern Europe shown in the chart is based on an average of individual CEE countries, calculated by Erste Group Research)

Growth fine, earnings revisions are step on brakes

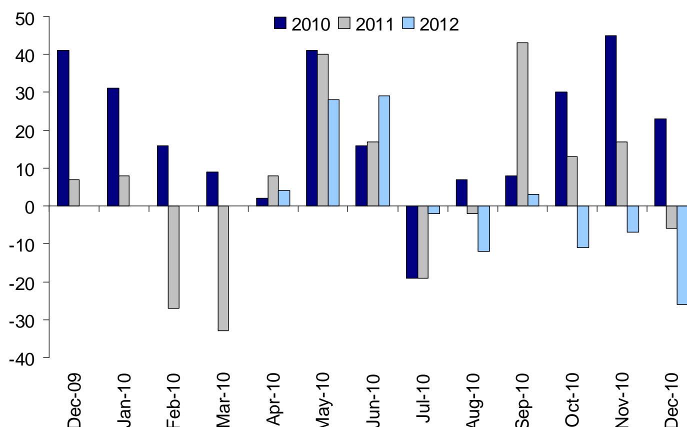
Consequently, corporate earnings growth does not provide an alarming picture. The EPS trend, as expected by the consensus, shows a similar picture, with a stable sideways moving development. Hungary is the only market with a more volatile EPS trend - unsurprisingly, given the creativity of the current government in dealing with consolidation needs. The consensus still expects some 23% EPS growth for 2011 for the CEE region, while growth expectations for 2012 are fading out a bit, with a regional average of some 14% at present. Earnings revisions put this

outlook a bit more on a relative scale, though. While 2010 earnings continued to be revised upwards, balances for the years 2011 and 2012 started to head south. However, as long as we interpret this as unrealistically strong growth rates projected into the future, now being corrected to more reasonable levels, we would not be concerned. Turkey should be a good example for this case, proving that it is not the sky that is the limit. Russia, in turn, enjoys continuously improving revision balances, driven by the positive outlook for commodities.

Consensus EPS growth CEE



Earnings revisions CEE



Source: Facset

Upside indication based on regressing fundamentals

In order to come up with index targets, we revisit a model that we presented earlier. In an attempt to identify further upside (or downside) potential, we again looked at a kind of implied valuation and applied the results to current index levels. As usual, we do not force anyone to rely on our own estimates, but we have based all our calculations on consensus data as provided by Factset. First, we looked at historical 12-month forward estimates for P/BV and ROE on monthly bases (with history as long as available, which means back to 1997 in most cases, but sometimes also with significantly shorter histories, admittedly). In a next step, we looked at the relationship between ROE and P/BV by calculating regressions. Finally, we applied 2012 consensus estimates for ROE as the independent variable and calculated resulting values for P/BV as the dependent variable with the regression formula. The resulting P/BV was finally applied to consensus estimates for the book value in 2012, which gave us implied target values for the respective aggregate. By comparing the target value with the current price level for the respective aggregate, we came up with the shown upside potential that could be reached in early 2012. As usual with these calculations, we would be careful with interpretation and would not stick to an absolute reading, but would rather refer to a relative view, comparing the theoretical upside potentials for the respective aggregates with each other.

Regression based upside potential

Market	Formula	R2	x = (ROE11e)	y = (P/BV11e)	Upside
BET	y = 7.9964x + 0.5571	40%	11.7%	1.5	**84%**
ATX	y = 15.051x - 0.2933	77%	12.0%	1.5	**29%**
PX	y = 11.195x + 0.2041	57%	13.6%	1.7	**28%**
WIG 20	y = 13.753x - 0.0871	61%	13.7%	1.8	**25%**
CROBEX	y = 17.474x - 0.8275	55%	16.7%	2.1	**24%**
RTS	y = 12.772x - 0.5941	62%	13.6%	1.1	**19%**
BUX	y = 16.083x - 0.9363	76%	13.2%	1.2	**14%**
ISE 30	y = 12.66x - 0.3515	69%	16.3%	1.7	**11%**
SBI	y = 23.815x - 0.8354	52%	7.3%	0.9	**3%**

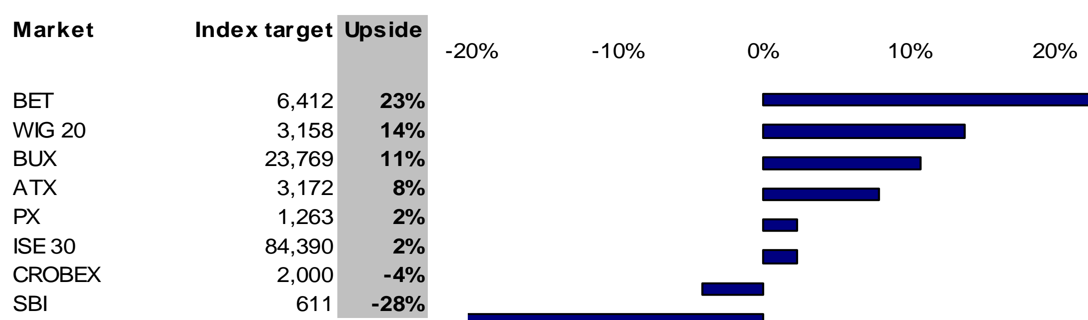
Source: Factset, own calculations

Outlook

Applying current risk premia to adjust index targets

In a next step, we question the theoretical upside and try to come up with some adjusted index targets. As a note of caution, we again would use the resulting numbers rather as an indication, but with this approach we might be getting a bit closer to an index target in absolute terms. We use risk premia as calculated by our model, which compares consensus earnings yields and government benchmark yields. Within this model, we calculate implied fair P/Es based on the historical spread between earnings and benchmark yields plus the current benchmark yield. The comparison between the implied fair P/E and the current P/E tells us the theoretical upside of the market. We use the potential upside as an indication for the risk premium currently applied to the respective market. By doing so, we assume that markets' current risk premia would remain the same throughout the entire year 2011 and that performance simply reflects changes in underlying fundamentals. Obviously, benchmark yields have a strong impact on this way of adjustment. Hence, markets such as Hungary and Romania, where rate cuts can be expected throughout 2011, should see a positive impact, as well as the other way round – e.g. Poland.

Regression based upside potential – risk adjusted



Market	Index target	Upside
BET	6,412	**23%**
WIG 20	3,158	**14%**
BUX	23,769	**11%**
ATX	3,172	**8%**
PX	1,263	**2%**
ISE 30	84,390	**2%**
CROBEX	2,000	**-4%**
SBI	611	**-28%**

Source: Factset, own calculations

Target for Romania down on substantial risk premium

Based on this rough approach, Romania gets the toughest haircut, while its lagging economic recovery and political tensions make it certainly worth a substantial risk premium. However, with growth finally coming back to the market and events such as the listing of the Property Fund, Romania might be worth a look throughout 2011. We consider the upside for Hungary a risky call, since much depends on further progress in economic restructuring and the patience of rating agencies. However, in the case of positive feedback on the presented budget consolidation measures, we might be proven conservative. For Austria, we see two sources of upside. The first is what we calculated as an index target based on risk adjustments. Secondly, we do not think that the undervaluation of currently 20% relative to implied P/E is justified. Turkey might be seen as a special case, with limited upside to its index target. While interest rates should remain supportive for the market overall, it seems that the balanced approach between rates and other measures such as reserve requirements are not too positive for Turkish banks, which as a heavyweight sector had outperformed previously anyway. However, expectations on a rating upgrade, bringing investment grade into reach around election time or shortly thereafter, could make our target null and void in a positive sense. The weak picture of Croatia is certainly due to its current economic situation and the threat of negative changes in ratings. Slovenia, in turn, should be doing well economically. However, despite the fact that its previously lofty valuations came down substantially, it is still relatively expensive compared to its regional peers (12M forward P/E of 13).

Cyclicals to perform further – stock picking becoming more important

Regarding sector allocations, we do not see a straightforward scenario. In general, we assume that cyclicals will continue to do well (in particular in 1H 11), since it seems that now a rather positive growth outlook globally is being priced in. However, most prominent stocks have been performing already quite strongly and no longer recommend themselves as clear buys, unless we see markets allowing for multiple expansions. Commodities should do fine, since we would assume that liquidity will keep prices inflated. However, it remains to be seen if prices will rise further. Again, we see interesting opportunities, such as OMV. Financials should remain impacted by valuation, which is already rather at the higher end in most cases (Poland) and still

undergoing changes in terms of asset quality and regulations. Selectively, however, interesting picks are seen, such as Raiffeisen Bank International. Also, the insurance sector seems appealing to us. Defensives should not be in focus in general, but if Hungary reaches a positive deal with its budget, domestic pharmas will certainly be good picks. Utilities do not seem to be too sexy these days, but Romania might offer some interesting ideas.

We offer a simple filter for stock selection

All told, we would focus on stock picking, rather than sector allocations. For selecting interesting ideas, we use a filter that combines valuation and growth, balance sheet quality and a defensive attribute via dividend yield. After a period in which markets were driven mostly by crisis related themes, we imagine that some normality will kick in again, making this approach a viable option. Technically, we rank our coverage universe by criteria on valuation, profitability, risk and growth separately (all criteria-weighted equally). In a next step, we add up the scores and rank them according to the total score (the lower the better). We have split our view into a dataset for industrials and a separate one for financials. Finally, we show the top 30 industrial stocks from our regional coverage universe and all financials that we have under coverage. This method should yield those companies that offer the best combination of all mentioned criteria. Flaws in this approach are obviously that we look only at a standardized set of fundamentals, without discussing corporate events, such as sudden jumps in earnings (base effects), etc. Also, this approach ignores size and liquidity, although we have added market capitalization and turnover to each stock for better orientation.

All data 2011e	P/E	P/CE	P/BV	Dividend yield	EV/EBITDA	ROE	ROCE	Gearing ratio	EPS growth (LC)	Mcap (EUR mn)	Average turnover (EUR)*
Allami Nyomda	8.20	4.86	1.58	4.8%	4.09	20.5%	20.8%	-15.3%	64.8%	37.0	40,318
austriamicrosystems	9.77	6.22	1.51	2.6%	5.43	17.0%	17.6%	-16.7%	61.6%	363.2	762,739
OMV	7.00	3.22	0.94	3.2%	3.82	14.1%	10.4%	33.9%	13.4%	9,415.3	15,764,894
Action SA	8.52	6.24	1.38	7.0%	6.09	16.9%	13.4%	31.9%	31.5%	71.4	55,837
Petrom	7.36	3.42	0.95	6.8%	4.00	13.3%	9.8%	29.1%	4.3%	4,411.2	197,914
Sojaprotein AD	6.01	4.99	0.64	6.6%	6.34	10.9%	9.7%	62.3%	48.6%	82.0	26,946
ACE	10.47	4.38	1.07	0.0%	3.70	10.8%	10.3%	-4.6%	92.0%	46.8	29,325
Ford Otosan	10.24	6.52	2.44	8.8%	6.48	24.4%	20.6%	0.6%	11.5%	2,229.3	3,632,532
Turk Telekomunikasyon AS	9.16	6.00	3.55	10.0%	5.82	40.5%	23.3%	64.9%	16.3%	11,415.5	5,878,856
Ericsson Nikola Tesla	10.85	8.53	1.34	6.0%	5.91	12.7%	20.0%	-45.8%	12.7%	240.8	76,476
New World Resources	8.73	5.96	2.96	5.7%	4.83	36.4%	26.0%	21.3%	-0.6%	2,869.7	5,192,076
T-Hrvatski Telekom	12.72	7.36	2.13	7.9%	5.64	16.8%	22.6%	-28.9%	5.3%	3,208.5	737,627
Egis	8.76	5.70	0.94	0.6%	4.48	11.3%	12.5%	-25.0%	5.7%	555.8	1,009,656
Tofas	9.70	5.84	2.08	4.1%	6.59	23.0%	14.5%	23.2%	10.0%	1,952.1	4,736,458
Trakcja Polska	12.17	9.00	1.60	5.8%	6.74	13.6%	16.9%	-37.1%	19.8%	165.1	61,400
KGHM	10.00	8.19	2.10	6.0%	6.33	22.2%	23.8%	-19.2%	-20.7%	8,370.8	28,806,470
Telefónica O2 CR	12.24	5.90	1.75	9.1%	5.07	14.0%	14.2%	-5.5%	-18.8%	4,895.4	11,056,583
Berling	10.41	9.70	1.71	7.7%	7.47	17.5%	21.2%	-18.4%	6.5%	27.8	8,528
Transelectrica	10.30	3.29	0.71	3.9%	5.53	7.0%	5.6%	68.0%	586.9%	328.9	35,983
CNG	12.61	5.51	0.85	7.9%	5.84	6.9%	5.2%	22.0%	91.2%	45.3	54,118
Turkcell Iletisim Hizmetleri AS	12.04	7.51	2.19	4.2%	6.66	19.1%	19.8%	-16.8%	8.7%	11,459.3	15,749,192
Neuca	7.50	5.00	1.28	4.0%	7.47	18.4%	9.0%	152.2%	40.8%	85.2	43,318
Farmacol	10.00	8.77	1.09	8.0%	7.72	11.5%	9.7%	-0.7%	15.4%	234.7	76,151
Asseco Poland	9.82	7.73	0.88	2.8%	5.12	9.3%	11.2%	-15.3%	1.8%	1,000.8	2,307,677
MOL	11.55	4.45	1.36	2.6%	5.42	12.2%	7.0%	38.9%	90.9%	7,700.6	11,261,989
Kapsch TrafficCom	12.38	12.6	3.46	2.7%	7.51	31.5%	35.2%	-23.2%	77.2%	866.2	1,135,365
Lotos Group	8.99	3.66	0.65	3.2%	6.98	7.5%	5.3%	72.3%	345.1%	1,215.8	1,835,314
PKN Orlen	10.73	4.63	0.88	2.8%	5.96	8.9%	6.2%	26.7%	39.1%	5,208.6	14,633,907
Tupras	10.81	8.52	2.35	7.4%	7.48	22.3%	19.6%	8.8%	5.5%	4,790.9	14,050,143
TPSA	18.53	4.57	1.63	8.8%	4.78	8.5%	7.0%	33.7%	634.6%	5,723.1	11,785,265

*Source: Erste Group Research; * Average turnover is based on 3M daily average volume multipled with 3M average share price in EUR*

Interestingly, we find quite a few telco stocks among the top 30, mostly gaining from a combination of attractive dividend yields and sound balance sheet structure. However, apart from **Sojaprotein** and **Egis**, we find hardly any other defensive stock among the top 30, while our scoring model clearly favors more cyclical corporates. IT scores quite nicely, driven by

strong earnings growth, at least in the case of Austrian proponents, such as **austriamicrosystems** and **Kapsch TrafficCom.**

All data 2011e	P/E	P/BV	Dividend yield	ROE	Equity ratio	EPS growth (LC)	Mcap (EUR mn)	Average turnover (EUR)*
Aik Banka AD	5.41	0.65	1.0%	12.9%	36.3%	17.1%	308.6	321,466
Bank Asya	7.63	1.17	3.3%	16.4%	13.4%	27.7%	1,270.6	21,657,137
Raiffeisen Bank International	7.08	1.12	2.8%	16.9%	8.1%	73.8%	8,152.6	12,507,860
OTP	7.80	0.91	0.0%	12.4%	14.4%	45.4%	5,127.3	35,861,762
PZU	11.55	2.15	3.6%	19.8%	26.1%	14.2%	7,772.7	24,568,107
Albaraka Turk	9.13	1.53	3.8%	17.9%	10.2%	18.9%	705.8	997,058
BRD-Group SG	7.04	1.26	2.4%	19.3%	13.6%	10.7%	1,994.3	698,136
Halkbank	8.88	2.05	3.9%	25.1%	9.4%	12.3%	8,001.8	30,520,388
Vakifbank	7.38	1.10	3.4%	15.7%	10.1%	10.8%	4,807.2	54,978,670
Akbank	10.55	1.90	2.4%	19.3%	13.8%	14.3%	17,057.6	35,177,518
Vienna Insurance Group	11.33	1.14	3.0%	10.4%	13.8%	14.7%	5,043.2	3,435,804
BZ WBK	13.35	2.35	3.7%	18.4%	10.4%	28.9%	3,936.7	4,874,055
Komercni banka	12.68	2.45	4.7%	20.1%	9.7%	16.7%	6,795.9	13,763,799
Isbank	8.91	1.51	2.8%	18.1%	10.6%	11.4%	12,136.0	100,915,371
PKO BP	14.67	2.25	2.7%	16.1%	15.1%	32.7%	13,832.6	26,072,400
Banca Transilvania	8.80	0.74	1.7%	8.7%	9.1%	23.8%	346.3	222,417
Turkiye Sinai Kalkinma Bankasi	8.93	1.42	1.7%	17.1%	14.7%	11.5%	930.3	2,747,349
Bank Pekao	15.34	2.58	4.6%	17.2%	13.4%	23.1%	12,332.2	18,509,707
Garanti Bank	10.14	1.96	2.5%	20.9%	11.6%	11.0%	16,356.6	160,830,880
Anadolu Hayat	13.80	2.72	5.0%	20.6%	7.4%	17.3%	640.1	886,282
Sekerbank	7.94	0.87	1.9%	11.5%	12.7%	6.9%	653.5	4,940,639
Komercijalna Banka	13.58	0.84	0.0%	6.4%	16.7%	4.5%	354.9	11,445
BRE Bank	15.04	2.14	2.7%	14.9%	5.2%	69.0%	2,298.2	2,447,680
Tekstilbank	26.77	0.92	0.0%	3.5%	18.7%	12.7%	222.9	1,794,401
Turk Ekonomi Bank	10.76	1.19	0.0%	11.7%	9.6%	12.3%	1,199.5	4,923,122
Uniqa	15.86	1.22	1.8%	8.1%	7.8%	30.8%	2,085.6	164,822
Yapi Kredi Bank	12.97	1.89	0.0%	15.7%	12.6%	10.3%	10,453.8	36,653,413
FHB	15.71	1.12	0.0%	7.4%	6.7%	7.9%	228.0	171,593

*Source: Erste Group Research; * Average turnover is based on 3M daily average volume multipled with 3M average share price in EUR*

While in general we are not too upbeat on Turkish banks, in a regional comparison, they still score pretty strongly. Valuations came down quite a bit in the market’s recent correction and strong profitability numbers still make Turkish banking titles worth a look. Raiffeisen Bank International has been a clear pick for us already for a while and we are pleased that Vienna Insurance Group is still scoring quite nicely.

Country outlook – politics, events and issues we would look at

Austria

Overall, we are quite optimistic for the Austrian market, despite several uncertainties stemming from austerity measures and new burdens imposed. However, attractive valuations are bolstered by the sound earnings outlook. We would look for industrials with still reasonable valuations relative to profitability and growth on a stock picking basis. Also, corporates still benefiting from CEE convergence remain on the screen (**Raiffeisen Bank International**, **Vienna Insurance Group)**. Special situations such as in the IT industry should remain attractive for a while. From our scoring model, we read **OMV** as being in a top position, while other picks such as **voestalpine**, **RHI** and **Semperit** did not make it into the top 30, but missed top scores only marginally.

Croatia

Croatia should have parliamentary elections in 2011, with the new government facing tough decisions. Privatization of shipyards will most likely remain one of the key issues in the next year, with the government as the middleman between employee unions and EU requirements. Possible restructurings in the industry could push unemployment up to record heights. This could to some extent hurt the banking sector through higher NPLs. However, it is unlikely that their peak will be reached during the year.

Outlook

INA has an additional issue that the government has to handle. The takeover of INA's gas business (HRK 2bn estimated price) represents a hot potato and should have already been executed by the government. On the other side, it should be interesting to see if there are any new bids for the remaining shares in INA as a counteroffer to MOL. If minority shareholders sell their stakes to MOL, some part of this liquidity could come to the market in the form of additional demand and consequently push other stocks up. **Atlantic Grupa** should also be watched, to see if there are synergies and effects from its Droga Kolinska acquisition. Worth a closer look are **Ingra**, **Magma** and **HG Spot,** which had problems with their debt repayment in 2010 and were on the brink of bankruptcy. HG Spot got a green light from its creditors to postpone its debt maturity, while Magma and Ingra kicked off their capital increase procedures. The failure of any of these companies could cause some turbulence. The construction sector will most likely continue to be in the background, without major infrastructure work ahead. Elections could provide some impulse, but this will depend on the government's debt capacity, for which we do not see much space in 2011. Our top picks remain stocks with exposure to foreign markets and strong exports.

Czech Republic

The Czech market will remain impacted by global, regional and domestic issues as much as any other market in the region. Pension reform in the Czech Republic, which could provide quite an impetus for the Hungarian and (potentially) Polish markets, is planned for 2013. So, this should not drive the market in 2011. As a pretty open economy, risk factors for the Czech market stem from the wide choice of German/Asian growth (China) over again surging risk premia and other turbulence in the EU periphery, as well as further big political issues in Hungary (having an impact on the entire region). Also, commodity prices are decisive for NWR and Pegas. For **CEZ,** the newly added taxes are a topic, while unemployment developments are an important underlying for potentially further increasing the support from domestic demand. We would keep an eye on **NWR** and, given the potential of surprisingly well developing retail, we might see some positive news for **TO2 CR** or **CME**.

Hungary

Apart from the obvious impact of global factors, Hungary will remain among the most prominent reform cases, with a significant impact on the market. The criticism so far has been that government measures are a) creating unpredictability for the market and b) focus too much on one-off effects, with a more lasting impact most likely no earlier than in 2013. By February/March 2011, the government committed itself to announcing a savings plan that would reach its full cost saving impact between 2013 and 2015. Rating cuts already demonstrated that rating agencies expect a comprehensive and serious package. An otherwise resulting further cut in ratings could catapult Hungary into junk status, which would cause a massive sell-off. This could at least theoretically build the biggest risk scenario for Hungary in 2011, but could also emerge as a substantial trigger.

While the mentioned uncertainties make any investment in Hungarian equities a bit of an adventure, those who dare might look at **Richter**, where the developments around the PregLem and Grünenthal acquisitions and the original drug development of cariprazine could drive the stock. For **MOL,** the expected tripled production in Syria (INA, from 6-7kboe per day to 18-20k boe per day, mainly natural gas) and the further development of the Kurdistan exploration might boost the fair value during the year. **PannErgy** should see its improving plastics business supported by initial cash flows from geothermal business. Cash flows should increase over the year, allowing for intensified further drillings. **RFV** should set its own record in investments in 2011 (HUF 12bn, vs. HUF 2.5bn in 2010). The new installations will boost profit in the coming years significantly, while the company expects to have new contracts in the value of HUF 15-20bn in 2011 to provide high dynamic growth later on.

Poland

A main issue for the Polish market will be the pension fund reform and potential impacts on demand for domestic equities. The question will be how (and if) the cash inflow will be reduced and whether the aggressive sub-funds for younger employees will be introduced (with high equity allocation). Currently, flows into Polish mutual funds still have a strong focus on money market products. If and when this changes, the increasing demand for equity should also help to bring small-caps back to the stage. The latest information would call for a substantial cut in transfers into the system. Overall transfers would be cut by some 68% from PLN 21-22bn pa to PLN 6.6-6.9bn. With current limitations for equity allocations this would reduce inflows for the

equity market to about PLN 0.22bn compared to currently PLN 0.68bn on a monthly basis. Announced changes of the maximum allocation of 40% for equity investments and the introduction of more aggressive sub-funds for younger employees could help to offset the negative impact. For more details see Fund Flow section of this report.

The majority of Polish companies are currently sitting on significant cash positions. This should bolster the expectation of strong increases in investments in 2011. Apart from being a supportive factor for GDP growth, this might also lend some momentum to corporate loan growth, which should be positive for banks. Aside from a potential increase in corporate lending, further growing consumption should give some impetus for Polish banks. A continued sound development of the Polish economy overall will remain beneficial for the domestic equity market.

The consolidation of some rather fragmented sectors could be another topic worth looking at. To some extent, banks might be concerned, with food as well. Construction materials and distribution might be other areas that could see some activity. The situation on commodity markets remains a topic to be monitored. **KGMH** will certainly depend on the answer to the question of whether copper prices are inflated by abundant liquidity or supported by improving fundamentals. For the time being, we continue to like KGHM, with its combination of valuation and metal prices. Non-operating assets should provide liquidity, if needed, such as for copper and gold deposits in Canada.

Companies we would look at include **ACE**, a producer of disk brake components. With its production, it has the most important vehicle production hubs in Europe within reach. Our expected sustainable earnings potential vs. its valuation makes it an interesting pick, in our view. With exposure to a potential stronger rebound of the IT distribution market, we also like **Action** and **AB**. Both are showing attractive valuations and react positively to any appreciation move of the zloty. We like Action's strong control of operating costs, as well as its concentration on private label sales, which should result in better margins. AB is already a market leader in Poland and the Czech Republic (~20%). Expected double-digit sales growth in both markets should see further support from realizing final synergies between Polish and Czech subsidiaries.

In food, we favor **CEDC**. After disposing of its distribution, it focuses again on its core business. The recovery in demand in Poland and Russia will support figures in the mid term, the new brand Zubrowka Biala will help regain market share in Poland, and the consolidation of the Russian market will fuel long-term growth. Among construction and materials, **Cersanit**, **Polimex** and **Mostostal Warszawa** would be our picks. Cersanit's top line is driven by the recovery in the region and still significant unutilized capacities. It might be one of the companies starting a new investment spree in 2011. As a diversified leader in the Polish construction market, Polimex should record early cycle gains with its major steel construction segment. While infrastructure was supportive in the downturn, it has good prospects in industrial construction and strong capacities in power engineering. Mostostal might see some positive surprises from its exposure to commercial construction and its net cash position might find some profitable use in 2011. In any case, based on steel construction and power engineering, it should perform as well. Its backlog is already improving and might see double-digit growth in 2011.

Finally, we would keep an eye on **Synthos,** as one of the largest producers of synthetic rubber and expandable polystyrene products in Europe. It has been focusing on maintaining its dominant position for years. Synthos benefits from the upswing in basic materials, while the record natural rubber prices are just brilliant for the firm. Its valuation appears to be fine and its balance sheet is certainly unsuspicious as far as debt goes.

Romania

Cornerstones of the Romanian equity market in 2011 could be seen in two major events – the planned listing of **Fondul Proprietatea** (finally) and the announced plans of utilizing the domestic stock exchange for launching SPOs for still state-owned stakes. The listing of the Property Fund will help deal with the typical emerging market trouble, liquidity and size. Given the average daily turnover on the gray market (~EUR 2.8mn), the listing could almost double the current average daily turnover on the Bucharest market (~EUR 3.9mn). Apart from the liquidity impact on the market, we would expect the Property Fund to trade with quite some discounts to NAV, since it still carries Romania's country risk, has about 50% of its portfolio in illiquid unlisted

equity and the management of the fund is still facing some political interference. Along with the fund's listing, the SPOs of Petrom (a 9.84% stake), Transelectrica and Transgaz (both 15% stakes) should raise interest in the Romanian market. The IPO for Romgaz might cause some further negative attention, since the company has been asked to 'support' budget consolidation needs. This could result in some bigger negative news flow in 2011.

We became a bit less optimistic for utilities, since the impact of regulated tariffs is leaving its mark on corporate earnings. **Transgaz** should post weaker results at least in 1H11, with a substantial dividend yield still an argument for the stock. **Transelectrica** has very strong arguments for a positive tariff development finally, which results in a fine outlook for 2011 and 2012. **SIFs** in general remain attractive, given their large discounts (particularly measured against the market value of core holdings such as BRD). However, negative news flow is still around related to ownership limitations, and the listing of the Property Fund might overshadow the SIFs. All other stocks worth looking at are mainly in defensive areas. This might be seen as appropriate for a market such as Romania. However, the flipside certainly is that defensives might not be that much in focus in general and, secondly, most stocks are still small caps (**Antibiotice, Biofarm, Albalact**). **Teraplast** might be something to look at, with a view on utility infrastructure projects, although these carry the risk of being publicly financed.

Serbia

The main political driver for the Serbian market should be the progress in its membership application for the European Union. After approving and forwarding Serbia's candidacy application, a confirmation of candidate status could follow by the end of 2011. The political side remains rather calm, despite parliamentary elections coming in the next 18 months. The current pro-European government is seen as stable and lasting. Also, a new law on the securities market (drafted with the support of USAID) should pass the Parliament in 1H11. Apart from raising transparency and reporting requirements, the new law should make it easier for IPOs, while legal obstacles and costly procedures were said to have been the main hurdle for new listings in the past. The state's share distribution program should also continue to provide some fresh material to the market. Among the main negative aspects for the Serbian equity market are inflation developments, which might further propel interest rate hikes, spoiling relative equity valuations.

With agriculture accounting for 15% of Serbian GDP, the sector remains among the engines for Serbian exports. We continue to keep an eye on **Sojaprotein**, as the only European soybean producer holding a non-GMO certificate. Corporate restructuring allows the company to focus on value added soy products for human consumption. After severe decreases in construction, the demand for low-cost houses along with several major public projects (incl. infrastructure) should help the Serbian construction market to recover. We would watch **Energoprojekt** within this environment. The firm is active in residential, infrastructure and energy projects not only in Serbia, but in 24 other countries as well. Given that the Serbian state still holds a 33.5% stake, chances to win major domestic projects should not be too bad. Among banks, **AIK Banka** stands out in particular, due to its low valuation, which probably represents more of a discount to its peers than necessary.

Turkey

Politics will again be a major topic for the Turkish market. With 2011, we will enter a three-year-long election period: general elections in 2011, presidential elections in 2012 and municipal elections in 2013. General elections, scheduled for June 2011, will be of cardinal importance, since a discontinuation of the single-party government should be negative news for the economy and the market. A continuation, on the other side, would be a strongly positive trigger, since the elections would most likely be followed by rating upgrades, even up to investment grade.

On the macro front, one major risk could emerge, but only in the case that global major markets experience another major glitch, halting capital flows into Turkey. In this case, the expected C/A deficit of 5.9% of GDP might present a financing problem for the country.

2011 will be a transition year for Turkish banks. They will have to adapt to low interest rates. Operational efficiency will become a major concern (cost management). We expect earnings to be flat or to slightly contract. NIM should contract by some 40-50bp y/y, despite strong loan growth of 25%. Low rates present a structural downside and competition will weigh on NIMs.

Outlook

Contributions from provision reversals and/or strong NPL collections will not continue in 2011. Although we expect NPL formation to remain favorable in 2011, we do not foresee a major positive contribution. Net fee income growth is to recover in 2011 to a rate of some 15% y/y (our Turkish universe), parallel to volume growth. OPEX growth should be at a high single-digit pace in 2011. Declining interest rates and good NPL collection, as two major earnings drivers, will fade out. Hence, cost efficiency will be crucial.

With weaker profitability and slowing earnings growth, we would expect Turkish banking stocks to remain under pressure, after strong outperformance. We prefer participation banks. **Bank Asya** (currently significantly oversold) and **Albaraka Turk** (gaining further market share with less damage to asset quality) should perform better than other Turkish banks. However, Albaraka Turk is among the banks suffering more than others from the recent increase of reserve requirements on short-term deposits. We also like **Akbank,** backed by strong capitalization (the highest free capital to asset ratio). We also expect a change in asset mix towards loans, which have better yields than government bonds. Bond issues will further enhance Akbank's funding ability (on top of low loans/deposits), making the bank suffer less from NIM contraction.

In the short term, we expect sound profitability for both the life insurance and private pension segments. For the mid/long term, however, we see private pensions dominating the revenue base, thanks to strong growth in private pension fund size, while we project diminishing technical profitability from 2012 onwards in life insurance. Growth dynamics for private pension business should stem from:

- Untapped potential – still good opportunities to attract wage earners
- Transfers from employee pension funds – tax advantage of transfers ends June 2012
- 'Vesting' is supported – law amendments regulate 'vesting' issue
- Favorable demographic structure – potential, young age limits cash outflows
- Higher per capita income and more fair income distribution

Anadolu Hayat ve Emeklilik (AHE) is the single life insurance & private pension plan stock listed. Backed by a strong distribution network (an affiliate of Isbank), we expect it to maintain its leading position. We like AHE on the back of (i) its steady cash flow, (ii) strong earnings momentum, (iii) solid financial strength and, (iv) potential for a generous dividend payout.

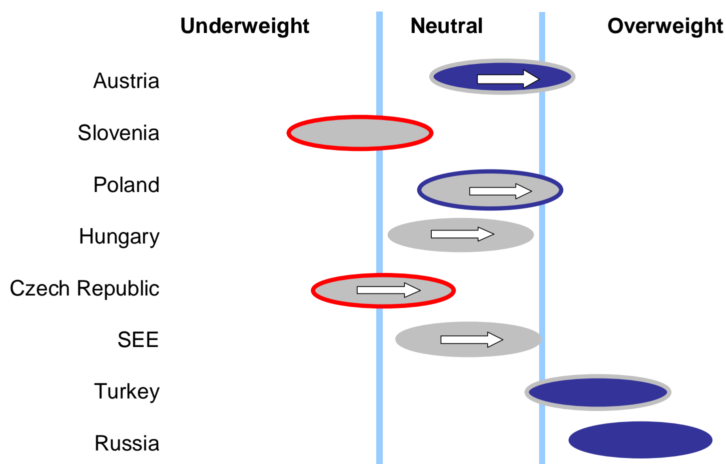
Electricity demand in Turkey was historically higher than GDP growth by 2% on average, while consumption growth was second in the world after China in the past five years. The Energy Markets Regulatory Board (EMRB) estimates that capacity demand will reach over 60,000 MW by 2017, with an average yearly growth of 6.8%. Privatization of generation assets will continue in 2011 after the sale of 59 hydroelectric power plants in 2010. The government will also push forward with two nuclear power plant projects in 2011. Many investors are also eyeing the renewable energy law to be enacted in 2011, which foresees incentives for renewable energy investments, including price guarantees. Electricity prices are also expected to be raised in 2011 after the general elections, which will be beneficial for companies with natural gas-powered plants. Despite the fact that we do not cover these stocks yet, we would look at **Zorlu Energy**. It has an installed capacity of 592 MW in Turkey, with a planned increase of 374 MW, comprised of wind and hydro power plants. A new investment in Moscow with a capacity of 340 MW is expected to be operational in 2011. The Dorad project in Israel is to be Israel's largest private power plant, with a capacity of 800 MW, which is to account for 10% of the electricity generated. The Dorad plant is planned to be operational in 2013. The company has been successful in closing bilateral electricity sales contracts and thus benefits from higher electricity prices.

For 2011, we expect the real estate sector to outgrow GDP. Within the sector, housing should especially be the growth area, due to pent-up demand. Since 2008, housing demand has shrunk remarkably and has not really picked up yet. With the economy recovering, the first sector that reacted positively was automotive, mainly due to sizable incentives. Hence, consumers allocated their budget to this sector. Nevertheless, current rate levels are perfect for the real estate sector to grow. There is no structural reason for the sector to contract, given Turkey's favorable demographic structure and the low quality of the existing housing stock. **Sinpas REIT**

and **Emlak REIT** should definitely be looked at, given their exposure to the housing sector. Also, **Is REIT** could initiate housing projects in 2011.
The automotive sector enjoyed massive growth rates in 2009 and 2010, triggered by tax breaks and low interest rates, along with the strong local currency. Although penetration rates are relatively low, we believe it will be difficult to sustain unit sales in 2011. While we clearly do not make a negative call for the sector, we believe 2011 will be rather challenging. **Tofas** could have its story in the deal with Opel. It will be a more challenging year for **Dogus Otomotiv,** given its exclusively domestic exposure. **Ford Otosan** will continue to compete with Tofas with its Transit and Transit Connect models, which are 9-10 years old. It will not be over the next couple of years that Ford Otosan launches new LCV models.

1Q country allocation proposal
Our recently published chart book suggests that most markets might see some initial weakness in January, offering opportunities to step in a moment later. Russia and Turkey come out as rather undisputed Overweight calls. Russia is gaining on oil price and valuation. Turkey might see a bit of a prolongation of its recent weakness, but potential positive news flow on rating upgrades could provide a substantial trigger. We would position Austria as a sound neutral, since it might need some time to digest its sound performance in 4Q, ahead of some additional tax burdens imposed. Hungary remains a wait-and-see case, with its final presentation of consolidation measures in early 2011 providing room for a move in either direction. Poland might have an uncertain trend towards an Overweight, since changes in the pension system should weigh on the market, but final outcomes remain a bit uncertain. The Czech Republic is seen as not moving much of anywhere, since we do not see any substantial triggers for the market. For SEE, it will be crucial to see to what extent further progress in big picture changes (economic recovery, EU accession, etc.) will help to lift the rather low valuations.

1Q country allocation proposal



Source: Erste Group Research

Outlook

Cassandra's Column

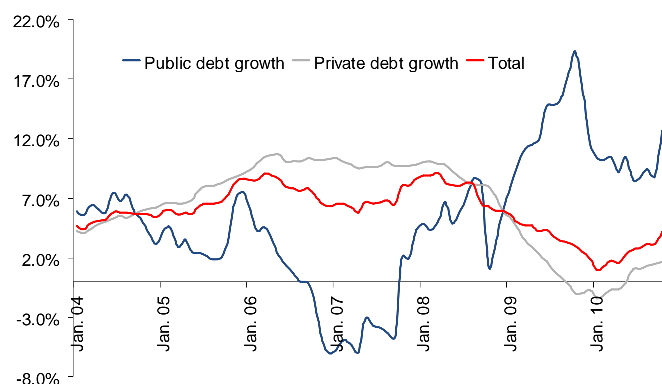
Mixed picture in lending trends

The monetary trends we track show a mixed picture. On one hand, we observe an accelerating trend of debt growth in the euro area and the US. This is clearly supportive for asset prices. On the other hand, we observe that debt growth in China continues to decelerate, from nearly 34% y/y in 2009 to around 18-19% in 2010. Due to accelerating inflation rates, China will quite likely continue to tighten the credit supply further in 2011. The currently rumored loan quota for 2011 would imply a loan growth pace of 12-13% for 2011 - thus a further deceleration. We know from past examples that, after 12-18 months of monetary tightening, economies start to struggle (e.g. Dubai in November 2009). On this time scale, it could be that China starts to struggle sometime during 1H11. Based on this mixed picture, we would say that the rally in asset prices will continue in 1Q11, mainly driven by accelerating loan growth in developed countries. However, we would recommend that investors be alert with regards to probable bumps in the road when it comes to China. The question really is how well the Chinese economy is able to handle the pressure from slowing loan growth.

Lending trends

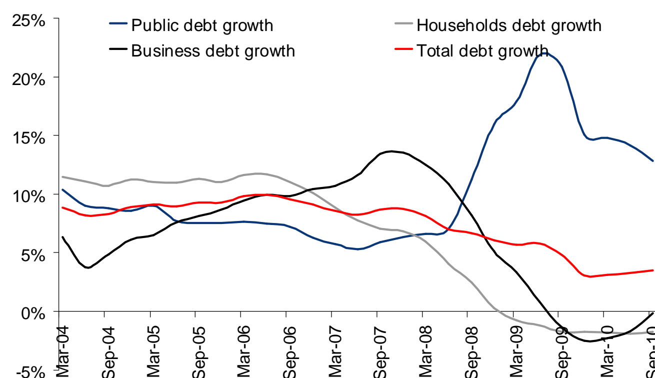
Loan growth shows a mixed picture YTD. In the US and the euro area, we observe a slight pick-up in lending activity, with total loan growth of around 4.2% y/y in October (after 3.1% in September) in the euro area and 3.5% y/y in 3Q10 (after 3.3% in 2Q10) for US debt. Thus, both currency areas' loan and debt development is further supportive for asset prices.

Euro area MFI loan growth Jan-04 – Oct-10



Source: ECB

US debt growth Mar-04 – Sep-10



Source: US Fed

Encouraging private debt development in euro area and US

It is furthermore encouraging to see that private lending activity is picking up in both currency areas. However, we have to admit that debt growth of households in the US is still contracting, by 1.8% y/y (after a contraction of 1.9% y/y in 2Q10) in 3Q10. Business debt growth, on the other hand, developed quite favorably and contracted by just 0.2% y/y in 3Q10 (after contraction of 1.7% in 2Q10). So, the trend is clearly positive. The question mark is the development of public debt growth. October proved once again the importance of public debt growth for the overall debt development of the euro area.

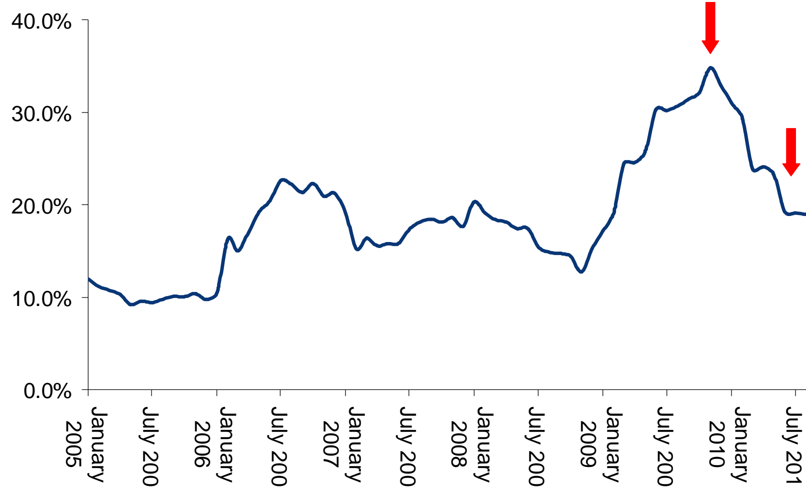
China – soft or hard landing in 2011?

Rising inflation rate triggers tighter monetary stance

So far, China seems to be able to digest the lending spree of 2009 pretty well. However, as of October, unexpectedly high consumer inflation rates (+10% for major food supplies) made the situation a bit more complicated. It now seems as if the massive money supply can no longer be camouflaged in rising asset prices alone. As of January 2010, the Peoples Bank of China took several steps (hiking banks' reserve requirements, as well as raising reference rates) to slow credit growth. The graph below shows that these measures indeed served to decelerate Chinese loan growth from the peak level of 35% witnessed in December 2009 to a mere 18% as of October 2010. Current market rumors indicate that the PBoC is about to leave the loan quota stable for 2011 at around RMB 7,500bn (after more than RMB 7,500bn in 2010).

Outlook

Chinese loan growth Jan-05 – Oct-10



Source: PBoC

Chinese economy in dangerous state in 2011

It is the deceleration of loan growth that is worrisome and will probably put boom time activities under pressure sometime in 2011. However, in light of the quickly rising prices for groceries, China will have to sacrifice its property boom. It seems as if, via its aggressive monetary policy, China has painted itself into a corner. The rumored loan target for 2011 would imply that annual loan growth would further decelerate to 12.8% (after 35% in 2009 and 18% in 2010). History has proven time and again that it is very difficult to engineer a ‘soft landing’ after an economic boom ignited by uncovered credit money.

Debt, working age population and asset prices

Public debt levels in focus for markets

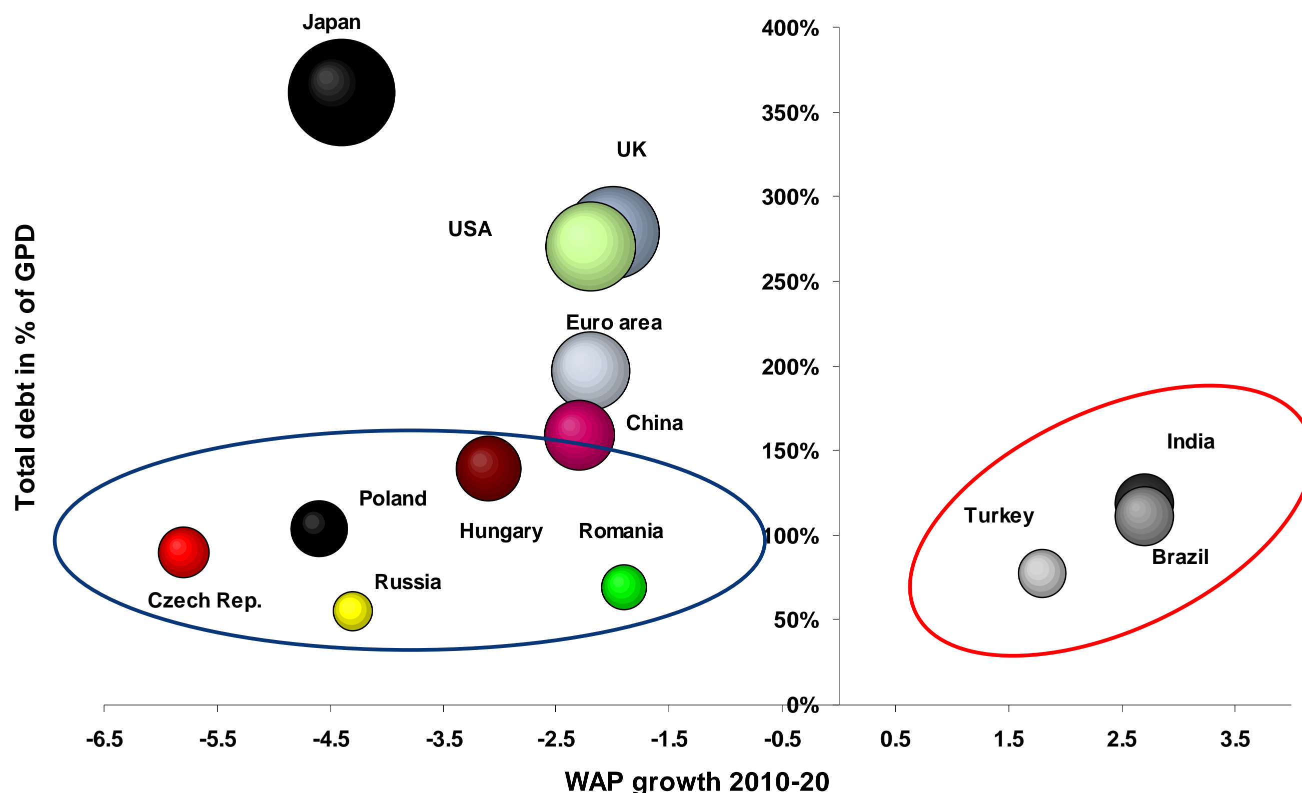
In our outlook for 2010, we warned investors of the risks attached to rising public debt levels that might be a burden for equity markets. Via some sort of on-off switch, the public debt issues have hit equity markets every 2-3 months in 2010. In spring, Greece stumbled upon an unsustainable public debt level and had to be saved by the IMF and the other EU member states. In November, Ireland threw in the towel, slipping as well under the ‘EU safety umbrella’. The consequence of rising public debt levels is first and foremost a rising tax level, which usually lowers asset price levels. Hungary is currently a good example of a government gradually devaluing assets via extra taxes.

Avoiding countries with high debt levels

We would like to take this consideration a step further and broaden our focus. We recommend that investors focus on the total debt level of an economy, not just the public debt level. Additionally, investors should take the intangible debt (shrinking working age population) into consideration. Thus, investors should generally focus on countries with low total debt levels relative to GDP, as well as a favorable demographic profile (growing working age population). An unfavorable demographic profile is an additional hidden financial burden that is not yet visible. Or to put it another way, if countries would have to calculate their uncovered pension obligations in the way that companies do, public debt levels in developed countries would probably explode. Hungary is a good example of what countries do as soon as they are held accountable for their promises . From this perspective, wealth is better protected in countries with a low debt level and a favorable demographic profile.

Outlook

Debt levels 2009 vs. working age population growth 2010-20



Source: Erste Group estimates, U.S. Fed, ECB, PBoC, Global Finance

Turkey is far and away most appealing market in our region

The graph above shows that Japan is more or less a dead man walking, burdened by the highest relative debt level to GDP, in combination with a very quickly shrinking workforce. It also shows that the UK and US are next in line, both burdened with a substantial mountain of debt, in combination with an invisible burden, due to a shrinking working age population in the next decade. Interestingly, the euro area is in a similar position like China. When it comes to debt burden and demographics, China is not an interesting market at all. The most interesting markets in this respect are Turkey, Brazil and India. All three will have a growing working age population in the next decade and their debt burden in relation to GDP is quite low. No doubt these are the markets to go for. We have to admit that main markets in our region like Poland, the Czech Republic and Romania will suffer from a shrinking working age population within the next decade. However, their big advantage is the comparatively low explicit current debt burden. Clearly, Hungary is not a market to be enthusiastic about either.

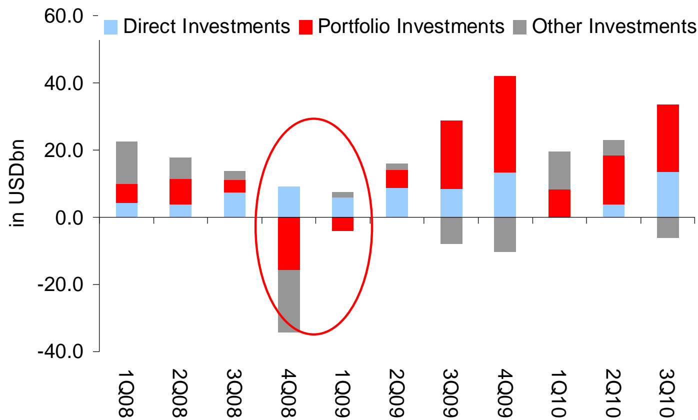
Hot money flows – 2010 still positive

Hot money flow trend still positive

In our outlook for 2010, we have also warned of the risks attached to hot money flows as potential destabilizing sources for emerging markets. It is hard to assess, but it seems to be quite likely that, lured by a nice interest rate spread, in combination with potential currency gains, substantial amounts of short-term-oriented money flew in 2010 into Emerging Market economies. These flows are potentially destabilizing forces. Recently, India has been mentioned several times in this context as well. The current account deficit of some 4% of GDP is increasingly financed by short-term-oriented money flows like borrowings, portfolio investments and bank capital (see right-hand graph below). Nevertheless, it seems as if especially portfolio investments are triggered by a secular shift of capital into Emerging Markets, which lure investors with potential for higher growth compared to the expected lackluster performance of developed countries, which are burdened by significant amounts of debt and an unfavorably ageing population structure.

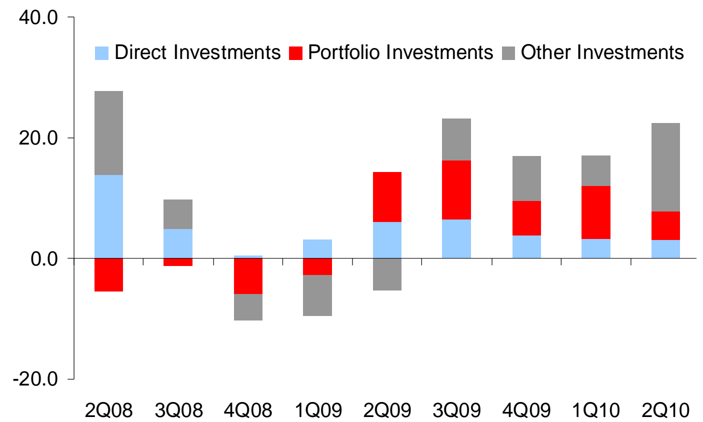
Outlook

Brazilian Capital Account 1Q08 – 3Q10



Source: Central Bank of Brazil

Indian Capital Account 1Q08 – 2Q10



Source: Reserve Bank of India

The comparison above shows that India's capital account behaves in a somewhat more stable manner compared to that of Brazil. Nevertheless, similar to Brazil, India also suffered from capital outflows in 4Q08 as well as 1Q09. These capital inflows are now financing growth and will be dearly missed by India and Brazil when or if investors turn their back on these regions.

CEE Macro Economy

Private consumption needs to pick up

Looking into 2011, the region as a whole should gather some steam, although this will depend on the development of private consumption. It is pretty obvious that foreign trade will not be able to keep the pace of this year, which was partly due to the rebound after the severe slump in 2009. So, will private consumption be able to compensate for lower contributions from foreign trade?

Consumer confidence set to recover

The stage seems to be set for consumers to return. Unemployment rates, while not showing any clear downturn, have remained stable for some time now, which has reduced the uncertainties for households and should improve consumer sentiment. Additionally, unemployment should actually come down in the course of next year. Another factor to consider is the long phase of constraint by households, which the financial crisis triggered. In some countries, this was a necessary adjustment process after previous exaggerations; in other countries, it was a result of uncertainty, as export markets collapsed. These differences are mirrored in the pace of recovery. Countries with imbalances are recovering the slowest from the crisis, but 2011 should be the year when these countries post positive GDP growth. For the other countries, we expect the pace of the economy to be roughly maintained.

Even for laggards the worst is over

Coming back to the countries that were hit hardest by the crisis, we think that the worst of the painful adjustment process is over. Take Romania, where growth after this year's plunge will only be low next year, but the imbalances have been reduced substantially. The current account will be 5-6% of GDP this year and the fiscal deficit will be of a similar magnitude without further austerity measures required. Adjusting for the cycle, Romania is currently on a path to a sustainable deficit. Croatia has also achieved huge progress in reducing the current account balance. But here the efforts on the fiscal side are unlikely to suffice. 2011 is an election year and the government is obviously aiming for significant budget consolidation only after the election. Market-imposed fiscal austerity would definitely reduce the expected slow pace of recovery further.

Hungary's recovery remains shaky

In Hungary, the outlook for private demand is favorable, not least due to the tax cuts already implemented. However, a significant part of the counter-measures that financed the tax cuts are only temporary, which poses some risks. Overall, Hungary has reduced its imbalances to a point during the last few years that allows for a significant economic upswing in the coming year. In the Czech Republic, private consumption already picked up in the second and third quarters of 2010, somewhat earlier than expected. The swift recovery of export-dependent industries obviously lifted the propensity to consume. In the Czech Republic, the recovery is already in a more advanced phase (household demand already reached pre-crisis levels). Together with the fiscal austerity measures kicking in and the traditionally rather cautious Czech consumers, we expect household consumption to grow at the same level as this year. Looking at Slovakia, consumption demand has so far hardly reacted to the strong rebound of the economy after the slump in 2009. We think that there is even enough potential to compensate for the severe fiscal austerity ahead. The economy as a whole should roughly grow at the same level as this year, but the contribution form private consumption should be higher.

Poland's growth comes at a cost

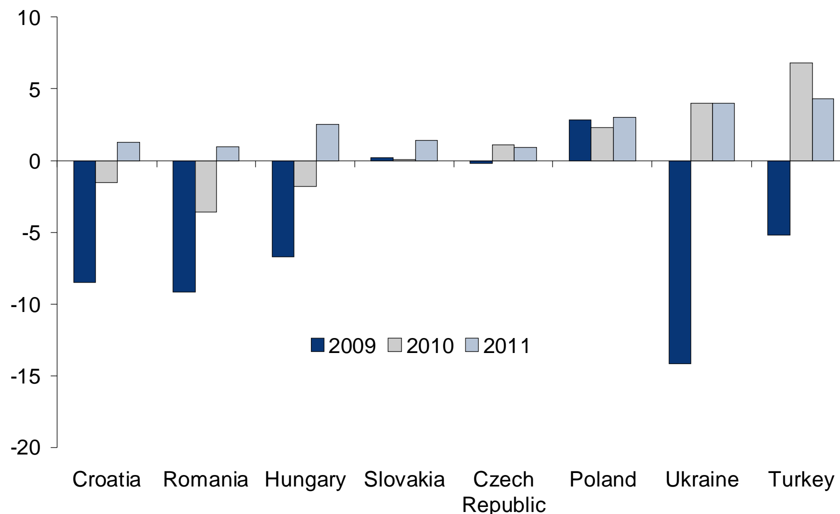
Poland's economy will likely proceed at the same pace as this year. However, continuous growth even in the global slump year of 2009 comes at a cost. Poland's structural deficit will remain one of the highest in the region next year. As in the case of Croatia, the government is trying to push back any serious budget consolidation until after the general elections scheduled for fall of next year. Earlier steps due to market pressure are the main risk for our growth outlook. For Ukraine, we expect growth to proceed at the same pace as this year and private consumption in line with the overall economy. The potential for a rebound is highest in Ukraine - even after solid 2011 growth, the pre-crisis economic output will still not have been achieved.

Turkey to slow down on high levels

Finally, Turkey, which is the only country where we expect growth to slow down. However, this will start from the very high level of 2010, which is clearly unsustainable. The central bank is also in favor of a slower pace and has started to increase minimum reserve requirements and measures will be stepped up in the second half of the year, when we expect interest rates to rise.

CEE Macro Economy

Real household consumption, y/y in %



Source: Local Stastical Offices, Erste Group Research

Main issues remain on the fiscal side

The main topics for the third quarter already known about mainly concern fiscal issues. The Hungarian government is scheduled to announce measures for a sustainable budget consolidation in February. If these measures are credible, Hungarian assets should get a boost. However, some cautiousness will remain on the side of investors, given that political statements have sent markets on a rollercoaster ride in 2010. Another issue is a possible upgrade for Turkey. We still think that the most likely timing is after the elections in summer. But markets might anticipate such a move earlier, especially if they see budget figures not deteriorating in the run-up to the elections.

Poland, Croatia have unambitious targets

The risks for Poland and Croatia, on the other hand, are on the downside. Both countries have unambitious fiscal targets for 2011. Poland will have one of the highest structural deficits in the region, while Croatia will likely overshoot the target set by the government. Pushing the consolidation back until after the election by itself is not the problem, as both countries have debt levels below the 60% of GDP threshold. The question is: To what extent will markets remain patient? On a global scale, we see a slight weakening of Eurozone growth in 1Q as a topic that could have some effect on CEE markets, as well as uncertainties about the US Fed's Treasury purchases (QE2). An improving labor market (on one side) and high yields and a QE-skeptical (Republican) House of Representatives (on the other side) will add uncertainty to the course of monetary policy and, accordingly, volatility to capital markets.

CEE Macro Economy

Macro economic overview

Real GDP growth (%)	2009	2010f	2011f	2012f
Croatia	-5.8	-1.6	1.0	2.2
Czech Republic	-4.0	2.2	2.0	2.8
Hungary	-6.7	1.2	2.8	3.5
Poland	1.8	3.3	3.7	4.4
Romania	-7.1	-2.1	1.2	2.3
Serbia	-3.1	1.6	3.0	3.8
Slovakia	-4.8	4.1	4.0	4.5
Turkey	-4.7	7.6	4.7	5.3
Ukraine	-15.1	4.3	4.5	6.0
CEE8 average	**-3.8**	**2.0**	**2.9**	**3.8**
CEE8+Turkey	**-4.2**	**4.3**	**3.7**	**4.4**

CPI (%), eoy	2009	2010f	2011f	2012f
Croatia	1.9	2.4	2.6	3.5
Czech Republic	1.0	2.0	2.2	2.3
Hungary	5.6	4.0	3.5	2.9
Poland	3.5	2.6	2.7	3.0
Romania	4.7	8.0	4.3	3.1
Serbia	6.6	9.8	6.2	5.0
Slovakia	0.5	1.6	3.8	4.0
Turkey	6.5	6.9	6.9	6.4
Ukraine	13.0	9.2	10.0	8.0
CEE8 average	**4.2**	**4.1**	**3.8**	**3.5**
CEE8+Turkey	**5.1**	**5.3**	**5.1**	**4.7**

Unemployment (%)	2009	2010f	2011f	2012f
Croatia	9.1	11.7	11.7	11.3
Czech Republic	8.1	9.1	8.8	8.5
Hungary	10.0	11.1	10.5	9.6
Poland	11.0	11.9	10.9	9.9
Romania	6.9	7.6	7.4	6.7
Serbia	16.1	19.6	19.0	18.5
Slovakia	12.1	14.3	13.6	12.7
Turkey	14.0	12.3	11.5	10.4
Ukraine	8.8	8.6	8.3	7.8
CEE8 average	**9.9**	**10.9**	**10.4**	**9.6**
CEE8+Turkey	**11.6**	**11.5**	**10.8**	**9.9**

3M rates (average, %)	2009	2010f	2011f	2012f
Croatia	8.9	2.4	3.8	5.0
Czech Republic	2.2	1.3	1.4	2.2
Hungary	8.6	5.5	5.8	5.6
Poland	4.3	4.1	4.7	5.4
Romania	11.7	6.9	6.6	5.8
Serbia	14.4	10.7	12.8	10.5
Slovakia	1.2	0.8	1.2	2.0
Turkey	9.9	7.5	8.2	9.3
Ukraine	18.0	4.4	4.4	6.1
CEE8 average	**7.0**	**4.1**	**4.5**	**5.0**
CEE8+Turkey	**8.2**	**5.5**	**6.0**	**6.7**

C/A (%GDP)	2009	2010f	2011f	2012f
Croatia	-5.5	-3.3	-3.9	-4.8
Czech Republic	-1.0	-2.1	-2.3	-2.1
Hungary	-0.5	1.0	-0.2	-1.4
Poland	-1.6	-2.1	-4.3	-4.9
Romania	-4.5	-5.8	-5.6	-5.0
Serbia	-6.8	-8.6	-9.8	-11.3
Slovakia	-3.2	-2.8	-2.3	-2.7
Turkey	-2.3	-5.9	-5.8	-6.2
Ukraine	-1.7	-1.3	-1.5	-2.0
CEE8 average	**-2.3**	**-2.5**	**-3.5**	**-3.9**
CEE8+Turkey	**-2.3**	**-3.9**	**-4.5**	**-4.8**

Budget Balance (%GDP)	2009	2010f	2011f	2012f
Croatia	-4.3	-4.7	-5.2	-4.8
Czech Republic	-5.9	-5.3	-4.4	-3.6
Hungary	-4.4	-3.8	-2.8	-2.9
Poland	-7.1	-7.8	-6.5	-4.5
Romania	-8.6	-7.6	-5.6	-4.3
Serbia	-4.0	-4.8	-4.1	-3.5
Slovakia	-7.9	-7.5	-5.0	-4.0
Turkey	-5.5	-3.5	-2.7	-2.3
Ukraine	-6.3	-5.5	-3.5	-2.5
CEE8 average	**-6.6**	**-6.5**	**-5.1**	**-3.9**
CEE8+Turkey	**-6.1**	**-5.2**	**-4.1**	**-3.3**

Source: Focus Economics, Erste Group Research

Global Markets

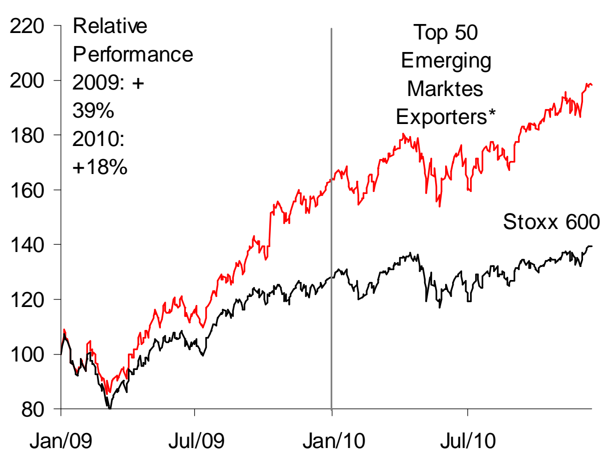
Europe

Equity market

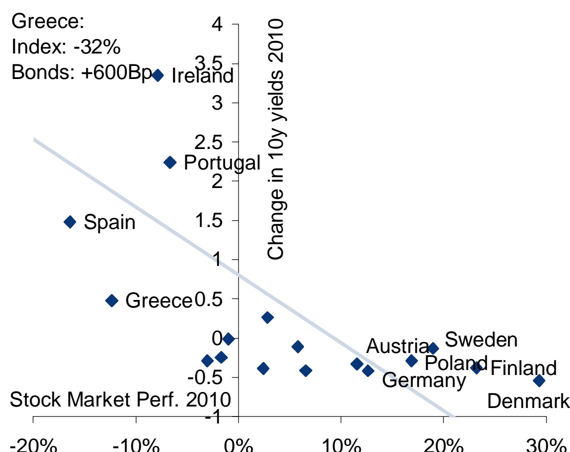
Overweight for European equities confirmed

The increase of almost 7% of the European equity market in the fourth quarter confirmed our earlier “overweight” recommendation. Due to the positive company results, the attractive valuations, and the low bond yields we expect this upward trend to continue in the first quarter of 2011. We prefer companies in cyclical sectors with dynamic sales development in the emerging markets and which will thus benefit from the economic growth in those regions. In addition, as a result of a high degree of seasonality cyclicals tend to fare significantly better in the first half of the year than in the second one. We also expect companies from the oil & gas sector to show a good performance in the first quarter. Shares in this sector were among the under-performers in 2010, but command relatively attractive valuations. On top of that, earnings expectations and the oil price show a positive trend. We recommend underweighting defensives such as telecoms and utilities in view of their clearly declining earnings expectations. The imminent austerity measures by the various governments are very likely to come as a burden to pharmaceutical companies, and earnings growth should underperform average growth rates as a result. In regional terms, the divergence between national indices in Europe should persist in line with the different rates of GDP growth expected for the first quarter of 2011.

Index performances 2009 & 2010



Equities vs. changes in bond yields 2010



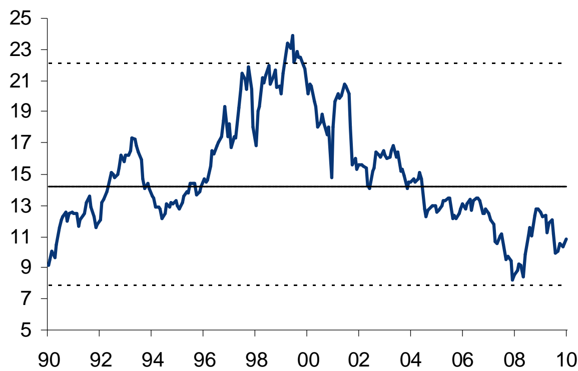
*Source: Bloomberg, Erste Group Research, *The 50 shares in Stoxx 600 with the highest sales in the emerging markets.*

Earnings surprises quite common

When looking at the fundamental results of the Stoxx 600 companies in the third quarter, we find that more than 66% of companies provided positive earnings surprises. Stoxx 600 company earnings were up a total of 47% y/y (+42% in Q2). The valuations based on PE and price/book recorded a slight decline in 2010 in the wake of the positive company results and thus are lending solid support to the equity market. The trend of sales and earnings estimates, reflected by the revision ratio, is also persistently positive.

Global Markets

MSCI Europe: Expected PE



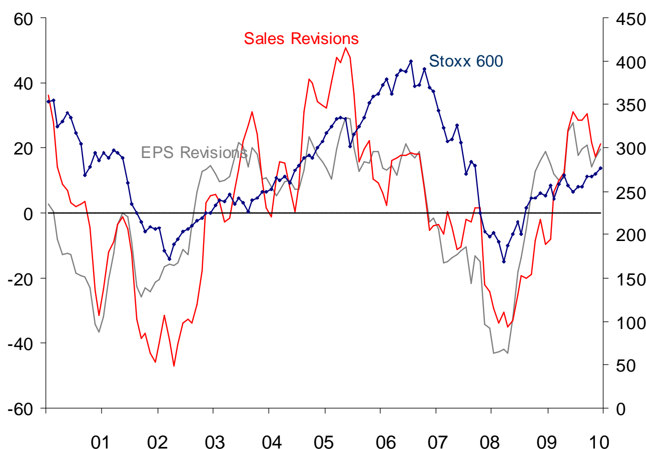
Price/book value

Source: Datastream, Erste Group Research

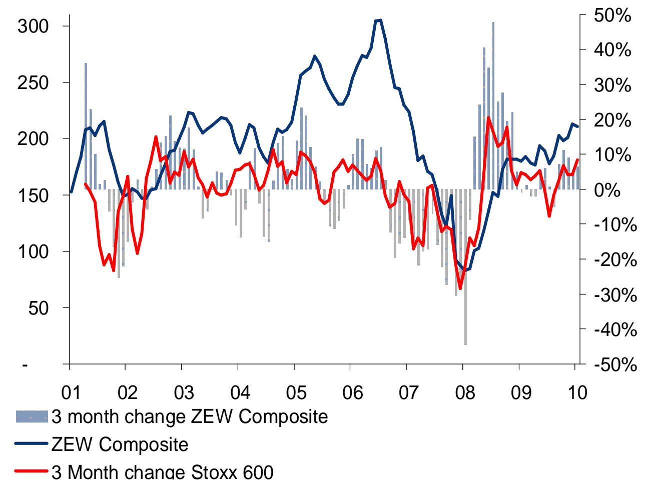
Earnings revisions clearly positive

The positive earnings outlook manifests among other things in the fact that the estimate revisions of sales and earnings per share are still clearly positive for the Stoxx 600 companies. In the past this ratio has often proven itself as good leading indicator for the future development of the equity market. When taking into account the development of the earnings estimates of the ten sectors we also find that the changes in estimates and the relative sector performance have a slightly positive correlation. This shows that investors are looking for shares with a good fundamental outlook and prefer sectors with positive earnings growth, which also reflects a healthy overall situation, because the aforementioned ratios have zero correlation in times of crises.

Earnings and sales revisions



ZEW Composite index* and Stoxx 600



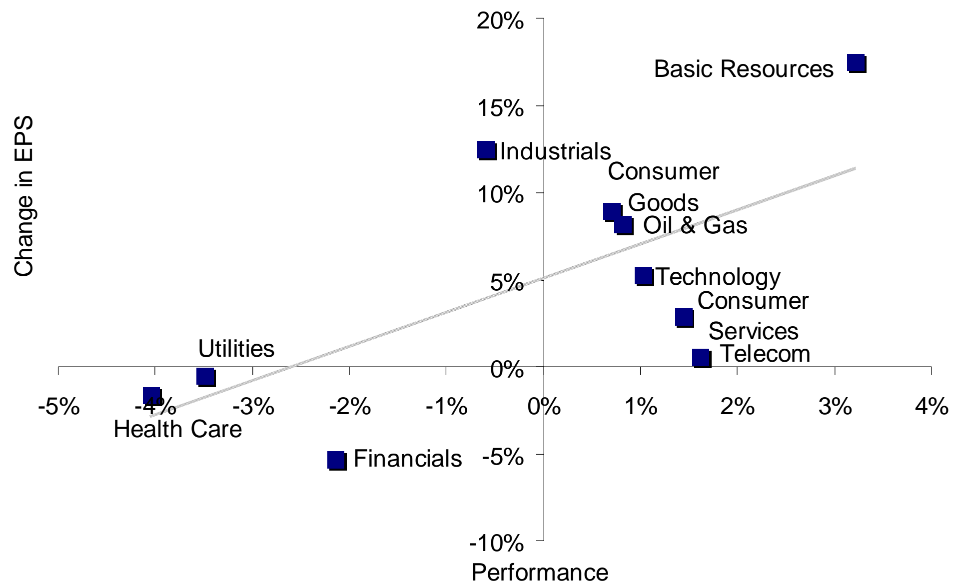
Source: Bloomberg, Datastream; Erste Group Research, *ZEW index expectations + ZEW index current situation +200

Dividend yield equal to government bond yields

The dividend yield in Europe currently amounts to 3.1% and thus equals the yield of 10Y German government bonds. The interest rate curve, a crucial indicator for the equity market, is still very steep. The ECB will not increase the key lending rate before the fourth quarter of 2011. Another supporting factor for the equity markets is the persistent optimism of the economic participants that can be read into the above-cited positive trend of the ZEW index.

In spite of all the positive indicators, one has to keep in mind the fact that risks do remain in the market. The two biggest ones are probably the future development of the debt crisis in Southern Europe and a possible overheating of the economy in the emerging markets (especially China). However, we would rate the chances of price increases in the first quarter as higher than the probability of said risks affecting the equity market. One indicator that would lead us to expect a higher probability of corrections would be the underperformance of cyclical sectors. However, this trend has not emerged yet, as the chart below illustrates. Should our analyses yield a different picture, we would publish the results in a special report in due course. But other than that, we still recommend an overweight of equities in the portfolio.

Sectors in Europe: performances vs. changes in earnings estimates in Q4 2010



Source: Datastream, Erste Group Research

Global Markets

USA/CANADA

Equity market

Taking more risk lifted US market

The recent weeks of rising share prices on the US equity market have been based on the consistently good shape the companies and on the persistent willingness of investors to assume risks. The S&P 500 index gained 9% last quarter, while the Nasdaq Composite index was up almost 11%. A substantial part of the return was only coming through towards the end of the year. Cyclicals were up across the board, whereas utilities remained noticeably weak.

Canada - commodities

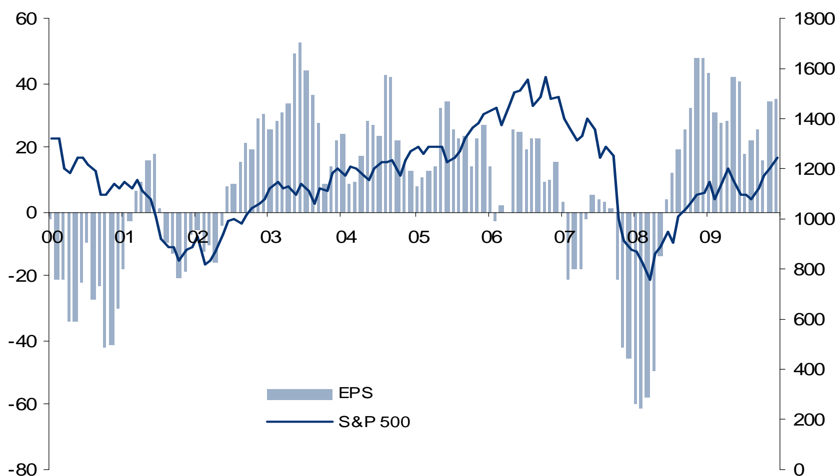
The Canadian equity market also benefited from rising commodity prices. The broadly diversified S&P/TSX Composite index increased by almost 8% on the quarter, while the much more volatile S&P/TSX Venture index, reflecting the performance of the most risky shares in Canada, was up almost 25%. This shows that many investors continued to demand shares with higher risk. Both in the USA and in Canada volatilities have been down for the most important equity indices, laying an essential foundation for further price increases among the North American indices. The following chart illustrates the decline of the VIX index, which reflects the volatility of US shares.

VIX index

Source: Bloomberg, Erste Group Research

Currently there is an overhang of positive vs. negative earnings revisions in the market, much like in previous quarters. The following chart illustrates this fact on the basis of the revisions of the estimated company earnings for the S&P 500 index.

EPS revision ratio S&P500



Source: Erste Group Research, Bloomberg

Said overhang is an important condition for the continuation of the upward trend on the US equity market. The situation of the Nasdaq Composite index is currently similar to the one of the S&P 500. Both S&P 500 and Nasdaq Composite are also running a surplus of positive vs. negative sales revisions. As a result, the equity markets should remain positive in the coming months.

Volumes stable

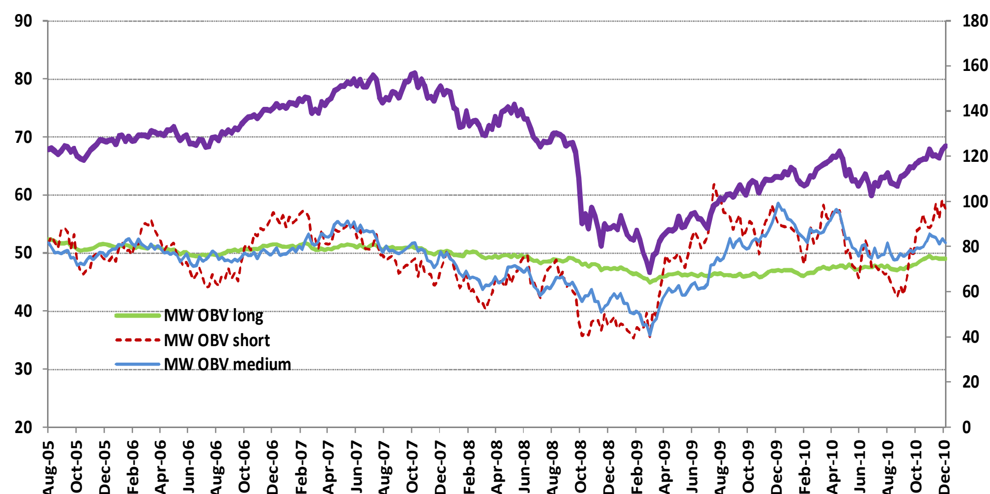
The analysis of the volume flows reveals that the North American main indices are currently stable. The following table illustrates the short-, medium-, and long-term on-balance volume indicators (OBV 20, 40, and 120 weeks) as well as the volatility trend of the shares. Volume indicators above 50 suggest a positive flow of capital for an index within the period of time specified.

Volume and volatility trends

Index	OBV Short 20 Weeks	OBV Medium 40 Weeks	OBV long 120 Weeks	Equity Volatility Trends
Canada S&P/TSX	54.8	50.2	48.5	Decrease
USA - S&P 500	57.6	51.8	49.0	Decrease
USA - Nasdaq 100	61.3	55.6	50.8	Decrease
USA - Dow Jones	60.7	53.6	50.6	Decrease

Source: Erste Group Research, Reuters

OBV trends S&P 500



Source: Erste Group Research, Reuters

For the S&P 500 index, the above chart shows that the indicators of the short- and medium-term OBV are on positive terrain, which confirms the current upward trend. The same situation applies to the other US main indices (Dow Jones, Nasdaq 100) and for the Canadian S&P/TSX index.

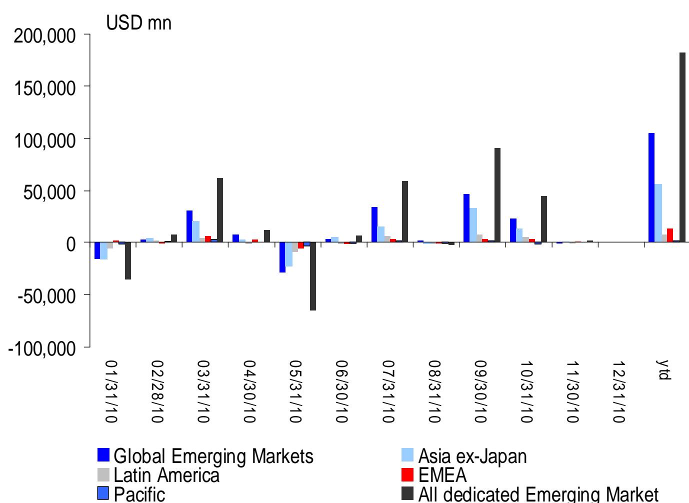
Valuation vs outlook not too attractive

At a PE of 17.2x and a dividend yield of 1.9%, the valuation of the S&P 500 is currently not exactly attractive, given the moderate growth perspectives. The comparable ratios of the Canadian main index SPTSX are 19.3x and 2.6%. The upward potential is therefore limited. We thus recommend a neutral weighting of the US and Canadian equity markets in international portfolios. However, American equities are still by far more attractive than US Treasuries. We can see more potential in some emerging markets, especially in the CEE region.

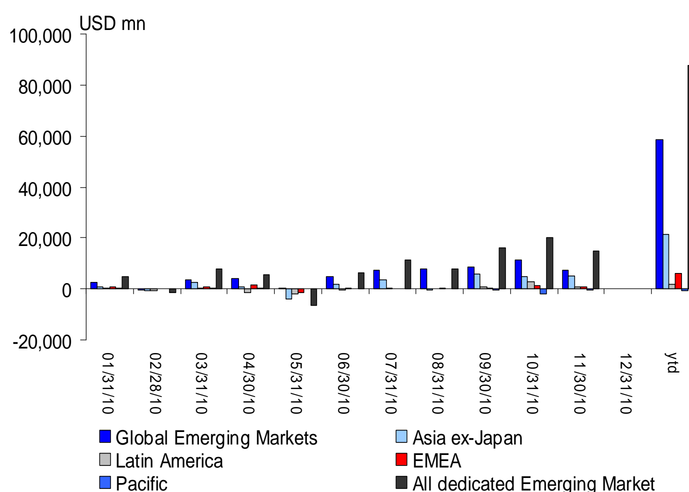
Fund Flow

The latest data reported for December (not yet reflected in the monthly data shown below) indicates that emerging market equity funds will close 2010 with another record for inflows. With only one week to close the year, accumulated flows into emerging market equity funds reached USD 92.5bn, leaving last year's USD 82bn well behind. Hence, emerging markets caught a good portion of money market outflows, which lost another USD 50bn in 2010. However, lately emerging market funds have lost a bit in favor of developed market funds, posting their first weekly outflow since May 2010. In particular, Latin America and Asia ex-Japan dedicated funds saw redemptions. EMEA and GEM funds were moving against this trend, but not strongly enough to switch overall flows for emerging markets into positive territory. In any case, EMEA funds in particular appear ready for a solid start to 2011, with Russia and Africa regional funds set to be the strongest. It seems that the data available so far for December has not verified some concerns on liquidity momentum that came up in our special view on liquidity (more on this below).

Monthly net change



Monthly flows



Source: Emerging Portfolio Research; ***Monthly net change:*** *change in assets minus forex change = portfolio change + monthly flows /* ***Monthly flows****: change in assets minus portfolio change, minus forex change = contribution/redemption to funds*

Fund flows into all emerging market funds as reported for the end of November have summed up to almost USD 88bn, with global emerging market funds taking the bulk of it (USD 58.5bn). Monthly flows for GEM funds were certainly lower in November (USD 7.5bn) compared to the month before (USD 11bn, the peak in 2010), but still quite respectable and, as such, among the highest monthly flows during 2010. Asia ex-Japan placed second with USD 5.3bn (USD 21.2bn accumulated). Latin America and EMEA were at the same levels for November flows (both about USD 1bn), but, on the accumulated level, EMEA is well ahead with USD 6bn, compared to almost USD 2bn for Latin America. The Pacific region has even seen accumulated outflows so far (USD 0.6bn), with tiny but still negative flows in November.

Within emerging Europe, regional funds did reasonably well, with inflows of 1.7% of NAV. The top scorer in the region was Poland (in relative terms), attracting inflows of about 8% of NAV for dedicated Poland equity funds. Russia had inflows of almost 2% in November, while Ukraine was strong with more than 4%, albeit relative to a rather thin asset base. Finally, the Czech Republic and Romania were flat to slightly negative, while Turkey lost flows of some 2% of its NAV.

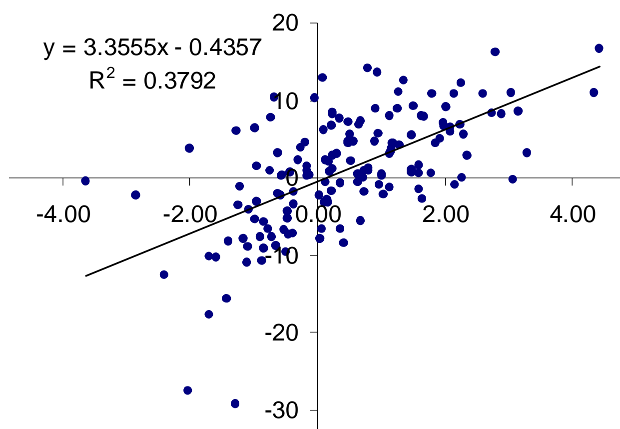
Apart from our usual view on liquidity data, we had a look at fund flow data. We are using data as reported by Emerging Portfolio Research, provided on a monthly basis. The frequency for which we have data available already constitutes the first weakness of any outcome, since data with a higher reporting frequency would certainly yield better insights. In a first step, we followed the idea of using fund flows as a prediction for market performance. Some related positive news is that autocorrelation is rather high; hence, with quite some statistical significance, positive

Fund Flow

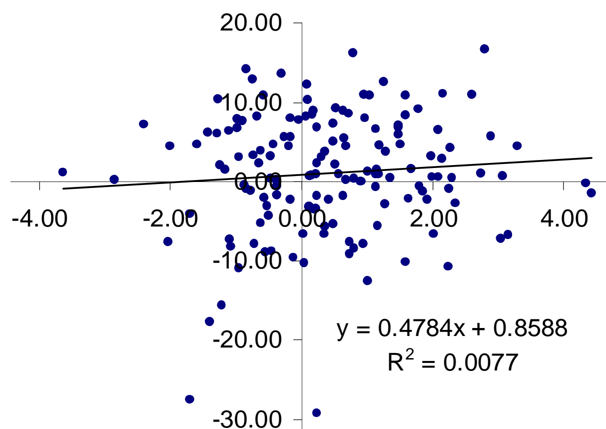
inflows in one month will be followed by positive inflows in the following month. In order to find out if there is a predictive relationship between flows and performance, we simply created regressions between both time series. We found quite a strong relationship, with explanatory power quite high for flows with respect to market performance within the same month. The flaw in this approach, however, is that fund flow data is not available at the beginning of the period; consequently, the explanatory power remains rather a statistical exercise. When comparing flows of a month with the market performance for the following month, the explanatory power drops significantly. We present this relationship with the example of flows for all emerging markets and the performance of the MSCI Emerging World index.

Regression flows and performance – All emerging markets and MSCI Emerging World

Same month



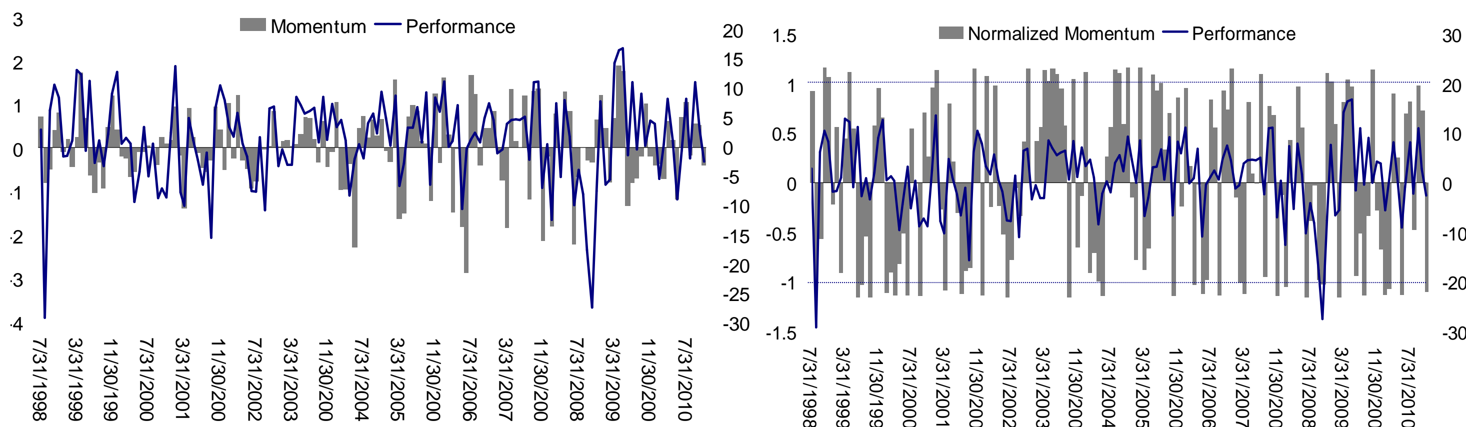
One month time lag



Source: EPFR, Factset, own calculations

Since fund flows are apparently not the right thing to predict performance, something should be in it. Assuming that fund flows could at least be useful for identifying directional moves, we calculated momentums of flows. In addition to the simple momentum, we calculated a smoothed normalized momentum by dividing with a 3-month standard deviation, since flows appear to be quite volatile sometimes (monthly frequency, emerging markets, shaky environment). The simple momentum potentially shows the absolute dimension of the move a bit better, while putting it relative to the 3-month standard deviation might lose a bit in terms of that information, but this instead includes some information about a somewhat more long-term trend. Also, it seems that, in some cases, the normalized momentum has indicated stronger breaks in direction when getting stronger than a standard deviation of 1. We again present the view on momentum for the category All Emerging Markets.

Liquidity momentum - All emerging markets and MSCI World



Source: EPFR, Factset, own calculations

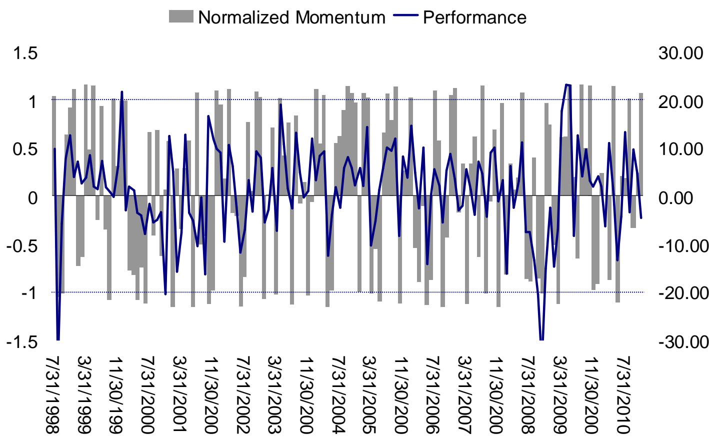
Fund Flow

The data as of the end of November 2010 indicates weaker flows, consequently posting negative momentum. In absolute terms, the momentum did not oscillate that much – falling from 2.35% to 1.64% of NAV - but the normalized momentum smoothed by the standard deviation has indicated a significant drop beyond the critical hurdle of 1, which has often been a contradicting indication in the past. Hence, we might see a swing into positive territory, which is also confirmed by the positive index performance (MSCI Emerging World) in December so far. For EMEA markets, the picture is similar, such that the momentum has turned negative, but very moderately. However, a contraindicating peak was visible already in the month before.

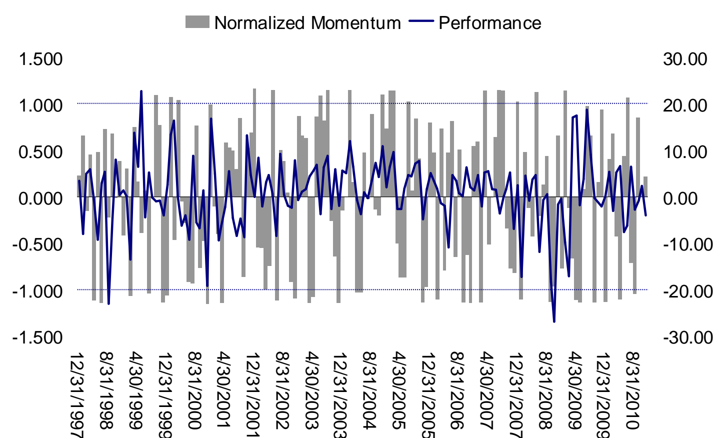
We also applied the same methodology to sub-segments of EMEA markets, i.e. Emerging Europe and individual markets, as available from Emerging Portfolio Research. In some cases, we found no consistent time series (namely Poland and Romania). Hence, we included only substantially shorter periods, which should not spoil the meaningfulness of the analysis, however.

Liquidity momentum

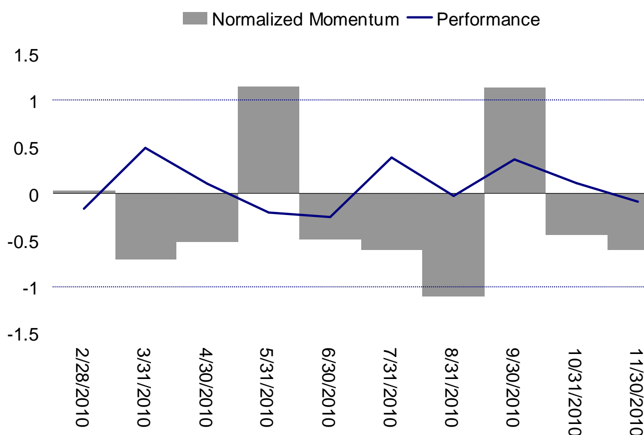
Emerging Europe



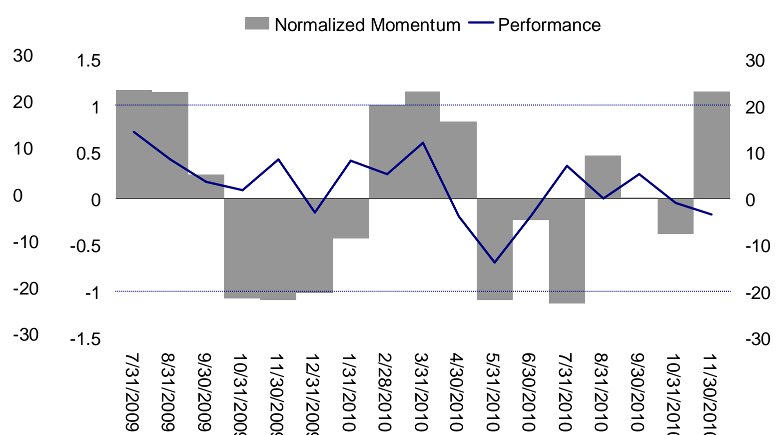
Czech Republic



Poland

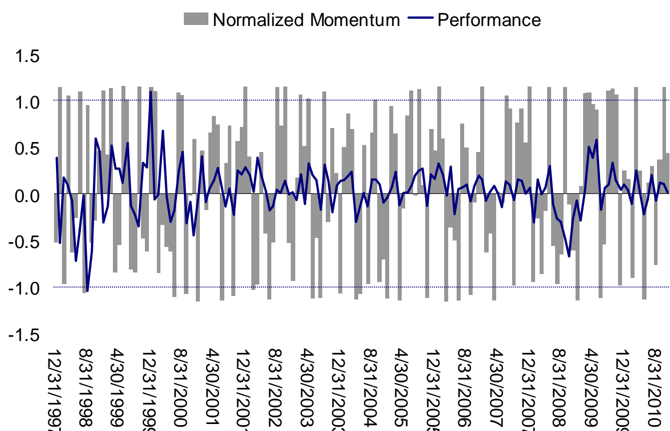


Romania

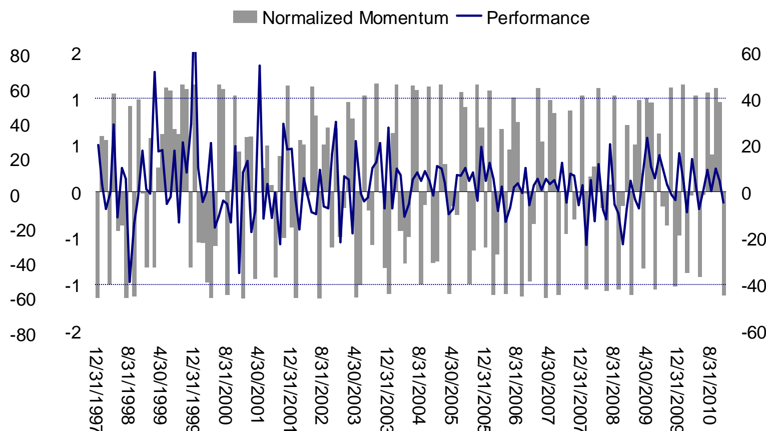


Fund Flow

Russia



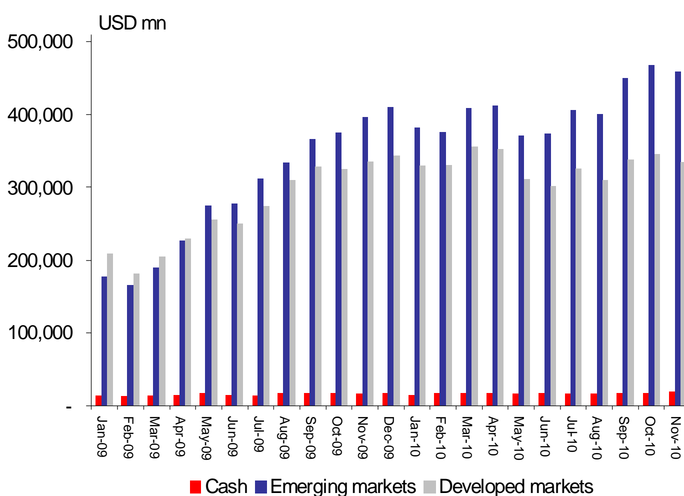
Turkey



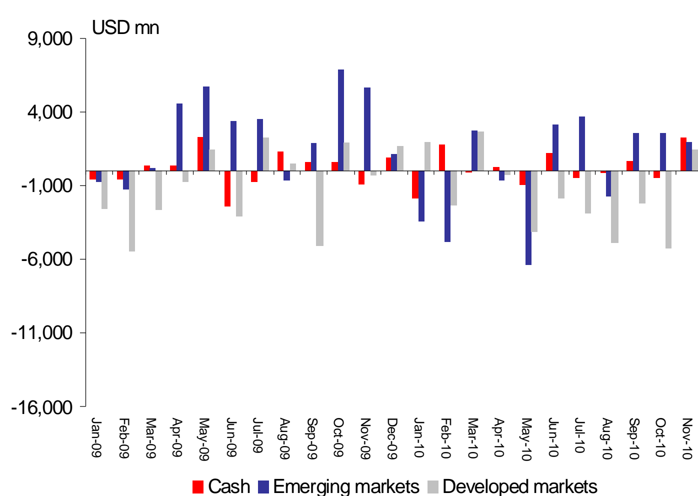
Source: EPFR, Factset, own calculations

For the two biggest markets in the region, we get somewhat different signals. While Turkey is posting a normalized momentum beyond the hurdle of 1, we might see a swing back into positive territory. Russia showed a contraindicating signal already in October and momentum was indeed significantly weaker in November. Emerging Europe funds in total also delivered a strong signal in November, potentially indicating a swing back. Among other individual markets, Romania and the Czech Republic are posting moderately positive momentum, while for Poland the same is true on the negative side. However, when looking at flows in terms of percentage of NAV, we have to state that the Czech Republic, Romania and Turkey were all posting negative numbers.

Total holdings, eop...



...net purchases/sales



Source: Emerging Portfolio Research; ***Total holdings:*** *market value of all holdings for all funds covered;* ***Net purchases/sales:*** *change in market value of holdings - increase (decrease) of market value of holdings*

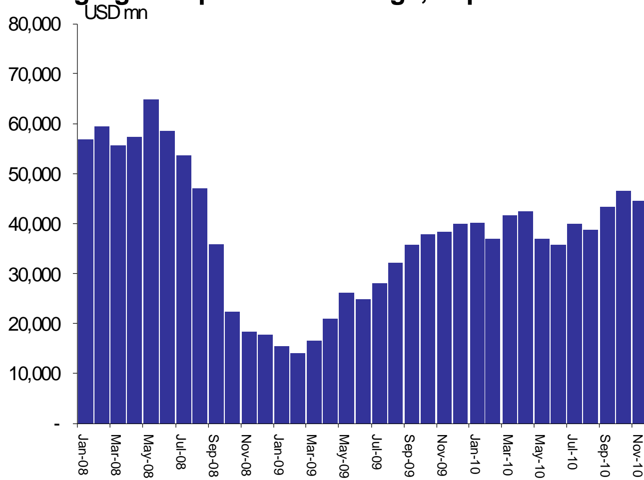
Measured by net buying or selling, emerging markets were still slightly ahead of developed markets, despite already moderating the pace (0.4% of NAV). Relative to NAV, developed markets posted a similar move. More importantly, developed markets turned net selling in October into net buying in November. Finally, cash increased, probably reflecting market tensions in November, as well as the closing of books towards the end of the year.

Emerging Europe continued in its three-month run of consecutive buying, although the pace became lower. While September and October still saw net buying of 2.3% and 2.0% of assets, respectively, the ratio came down to 0.9% in November. Within emerging Europe, the strongest

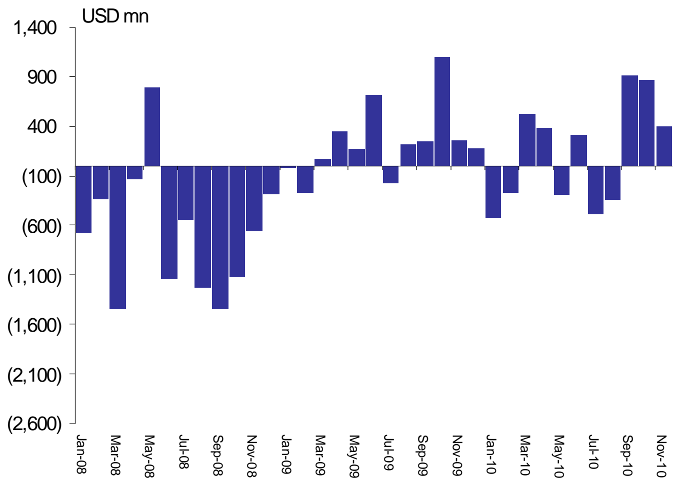
Fund Flow

relative buying was reported for the Baltics and Russia, while within the EU periphery, speculative money was also continuing to buy into Greek assets. Our core region - PL, CZ and HU combined - attracted some moderate interest, while in particular Turkey was actively sold.

Emerging Europe: total holdings, eop...



...net purchases/sales

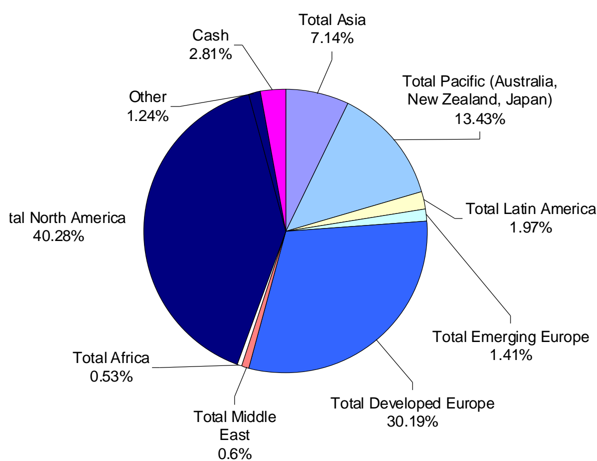


Source: Emerging Portfolio Research; ***Total holdings:*** *market value of all holdings for all Emerging Europe funds covered;* ***Net purchases/sales:*** *change in market value of holdings - increase (decrease) of market value of holdings for all Emerging Europe funds covered*

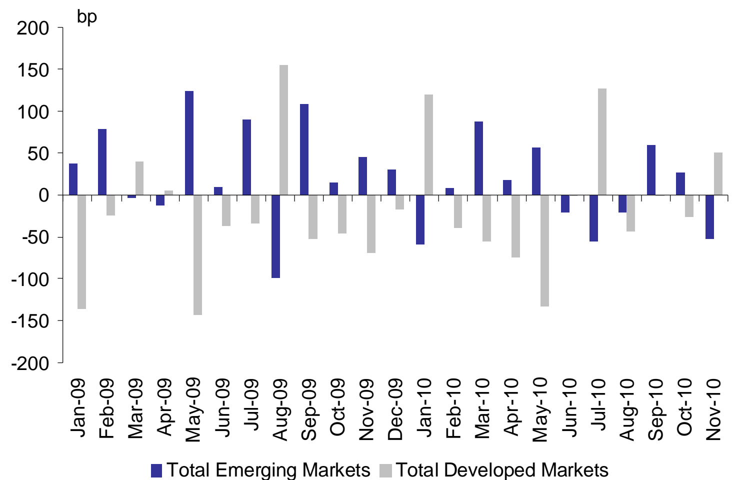
Already indicating what the numbers for December eventually confirmed, weightings for developed markets within global equity funds increased at the expense of emerging markets (both half a percentage point in opposing directions). After losing in weight for quite some time, Pacific markets (AUS, NZ, JP) were swinging back. Cash decreased only moderately in weight.

Emerging markets - weight in Global Equity Funds

Current...



...over time



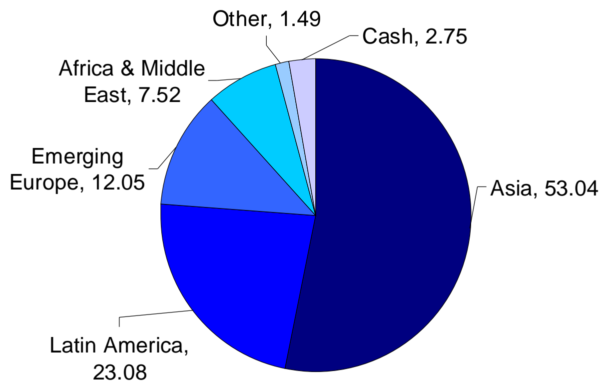
Source: Emerging Portfolio Research

Fund Flow

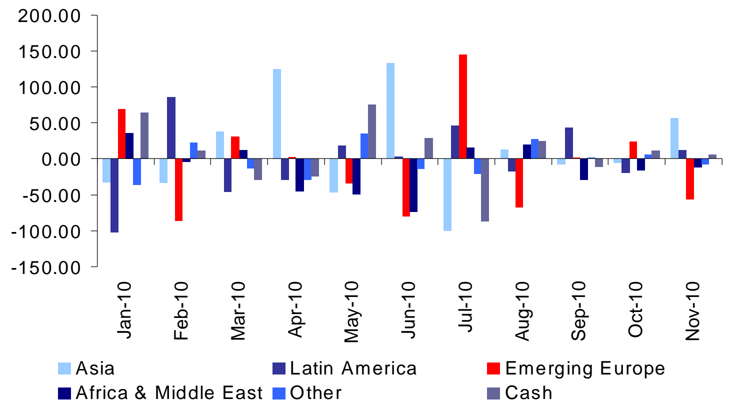
Among global emerging market equity funds, Asia was still the biggest gainer in weight in November (half a percentage point), while emerging Europe lost weight by the same dimension. Cash continued in its slow increase in weight, which started already in August.

Emerging Europe - weight in Global Emerging Market Funds

Current...

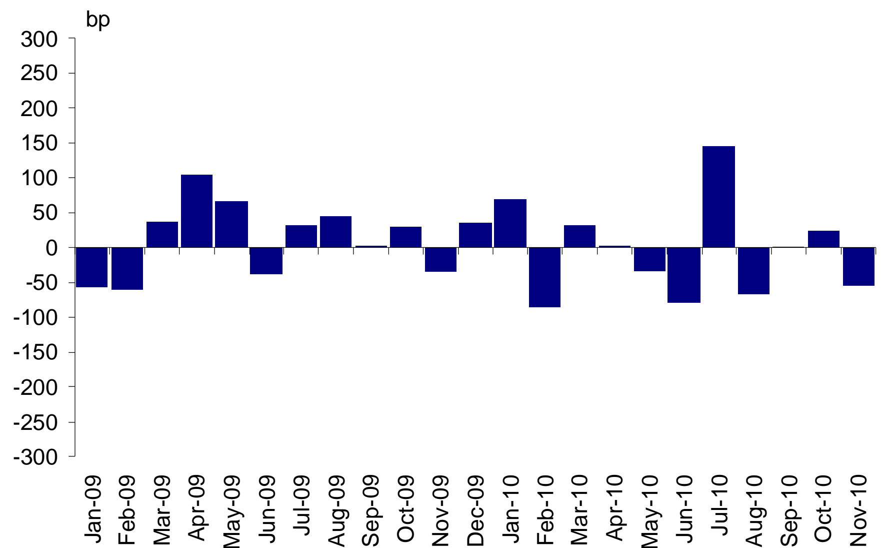


...over time (change in bps)



Source: Emerging Portfolio Research

Change in weighting - Emerging Europe within Global Emerging Market Funds

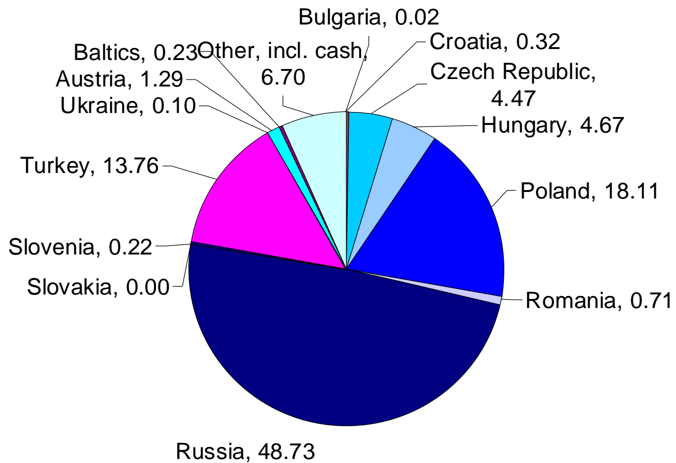


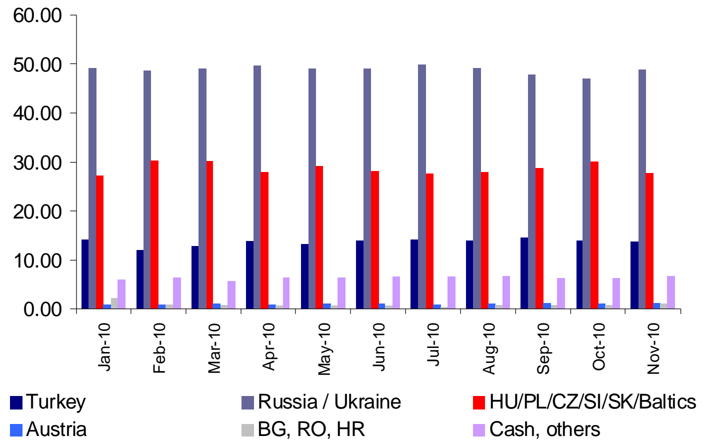
Source: Emerging Portfolio Research

Fund Flow

Among emerging Europe equity funds, Russia was able to gain a bit in weight, more or less at the expense of our core region – Hungary was the biggest loser in weight, unsurprisingly. Turkey lost moderately in weight, while cash gained lightly.

Emerging Europe - country weighting in Emerging Europe Funds

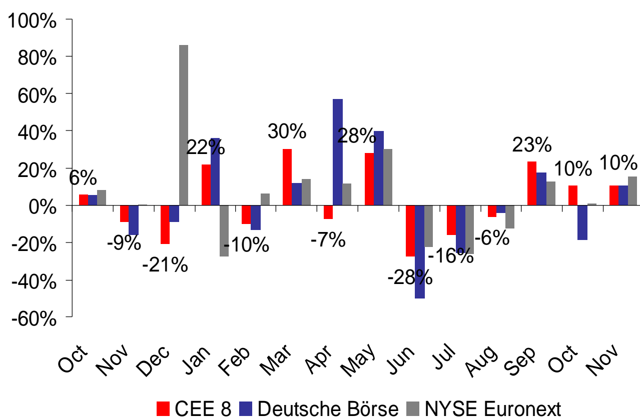




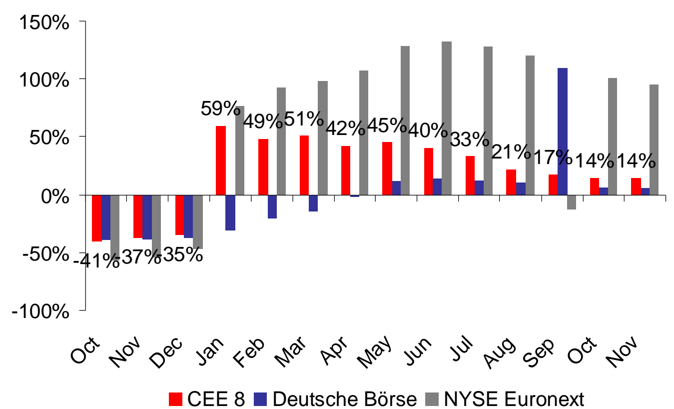
Source: Emerging Portfolio Research

CEE markets were able to keep their moderate pace of increases m/m in turnover, while Deutsche Börse and NYSE Euronext were picking up speed again in November. The Vienna Stock Exchange had the biggest gains m/m, after a strong October, closely followed by the Warsaw market. Other sound gainers were Bucharest and Sofia, after m/m decreases in October. Prague posted a moderate 5% gain in turnover. The Slovenian market was even shrinking, while Budapest remained flat m/m.

Stock exchange turnover m/m



Stock exchange turnover accumulated y/y

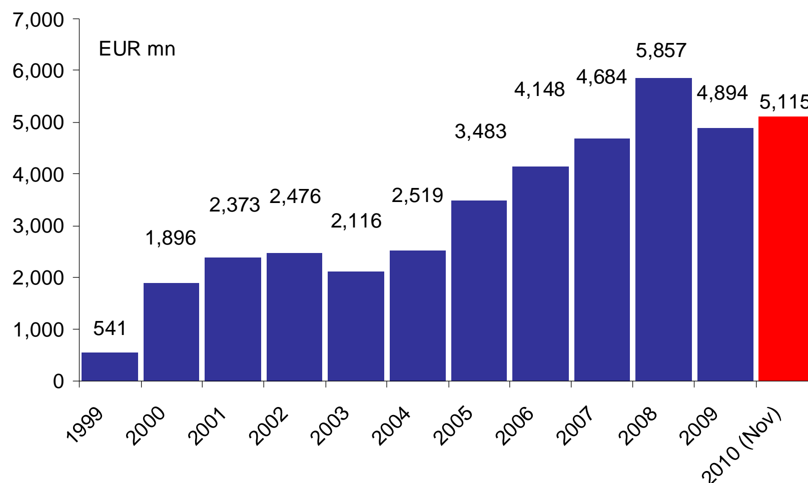


CEE 8 = A, BG, CZ, HU, PL, RO, SLO,SK; Source: FESE

Fund Flow

November transfers into the Polish pension system were some 40% weaker in a y/y comparison. Having already reached 93% of the level of contributions seen for 2009, we are rather confident that the Polish pension system will close 2010 with the same level of transfers as in 2009.

Transfers into Polish pension system



Source: ZUS

Investments into equities by Polish pension funds have reached a new record in absolute terms. As a percentage of NAV, we also witnessed a continued recovery, reaching a pretty high level of 36%. Similar levels were only seen previously in 2007. Consequently, allocations into equity also developed in fine fashion in a monthly comparison

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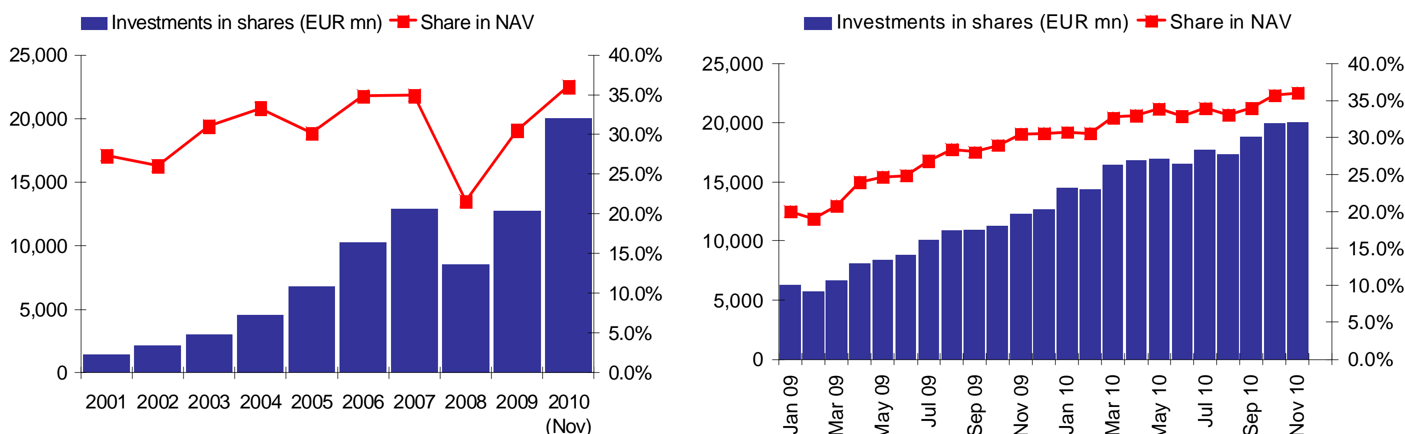
Polish pension funds - development in share investments



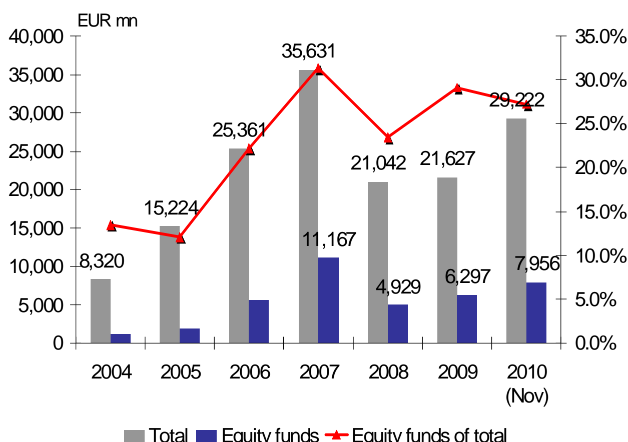
Source: Financial Supervision Authority of Poland

Fund Flow

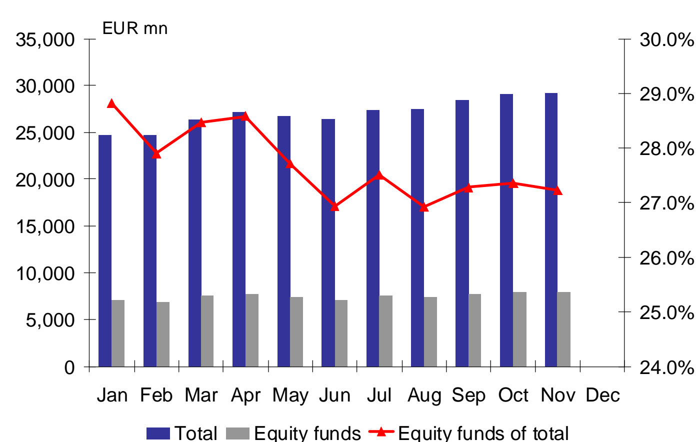
Mutual funds in Poland enjoyed the third-highest monthly cash inflows for the year in November 2010. Consequently, equity allocations remained at quite high levels of slightly above 27%, but still below the level of 29% seen last in 2009

Mutual funds - development of equity portion*...

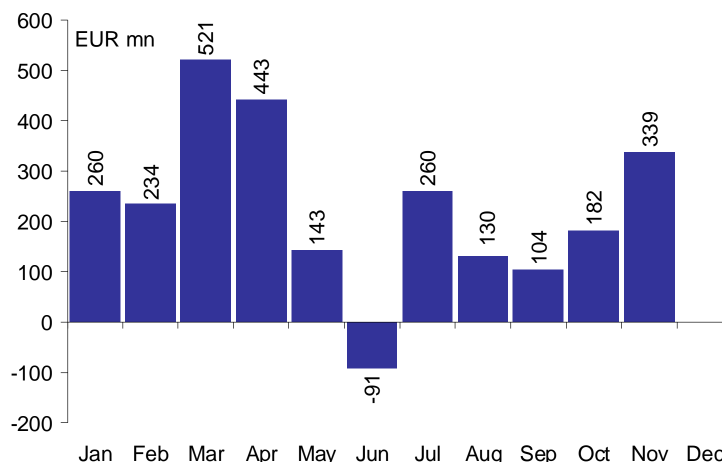
...annually...



...and on a monthly basis



Net cash inflows (2010)



**Equity portion approximated based on equity funds, not including equity exposure in balanced funds, etc. Source: Analyze Online*

Changes to Polish private pension fund scheme

In a move to relieve the pressure on public budgets and avoid harsher spending cuts that otherwise would have been mandatory (according to the Constitution), the Polish government has announced changes to the private pension system. The move is nowhere near as dramatic as the Hungarian case, but it will lower the support of pension funds for both debt and equity markets and should increase volatility. The reform is said to reduce the annual budget deficit by over PLN 15bn (about 1.1% of GDP from 2012 on; in 2011, by about 0.8%) and decelerate the growth of public debt – which has been the main aim of the government. The change is expected to take effect as of April 2011.

So far, Poles have been paying 12.2% of their salaries into the state-run pension scheme and an additional 7.3% into accounts with one of 14 private pension funds. Those funds in total hold assets of some PLN 214bn. With the change announced, transfers to private pension funds will be reduced to 2.3% of monthly salaries, from the current 7.3%. 5% will be held in accounts managed by state social insurance company ZUS. In 2017, there will be a system readjustment

and private pension funds will receive 3.5% (up from 2.3%). Tax incentives were said to provide further motivation to make voluntary contributions to private pension funds.

Pension funds have been receiving PLN 21-22bn per annum in transfers. After the cut, this will drop to PLN 6.6-6.9bn, a reduction of a massive 68%. If the current equity allocation limit is maintained (max. 40% of assets), inflows to the stock market will be limited to PLN 2.5-2.7bn a year (PLN 0.21-0.22bn per month, compared to the current approx. PLN 0.68bn), significantly reducing the capacity of pension funds to buy privatized companies or participate in IPOs. A top aide to Poland's PM said that the pension funds' limit on equity investment will be raised from the current 40%, but no decision has been made on how much.

The prime minister also said that the project to introduce sub-funds (aggressive and money market) will also be implemented and that total equity allocation (across all sub-funds) will probably go up from the current 40%, so that pensions will invest more on the stock market. The cut of transfers alone is obviously negative for equity market prospects (lower available inflows and hence lower aggregate demand). However, coupled with the sub-fund system, its outcome is less clear (it might even be positive for the equity market in the case that there is a short adjustment period and a high mixed equity limit) and it is hard to judge, given the currently known details. Additionally, the role of pension funds as natural market stabilizers will be diminished; hence, volatility might increase.

The key is the mixed equity limit and the mechanism of choice (or distribution) of members between different sub-funds. This will determine the real inflows to the equity market via pension funds. However, according to the press, the members of the funds will have a choice over the sub-funds, which makes the target mixed equity allocation uncertain. This will trigger speculation with retirement savings unless there is some mechanism to limit frequent shifts.

ZEW Indicator CEE

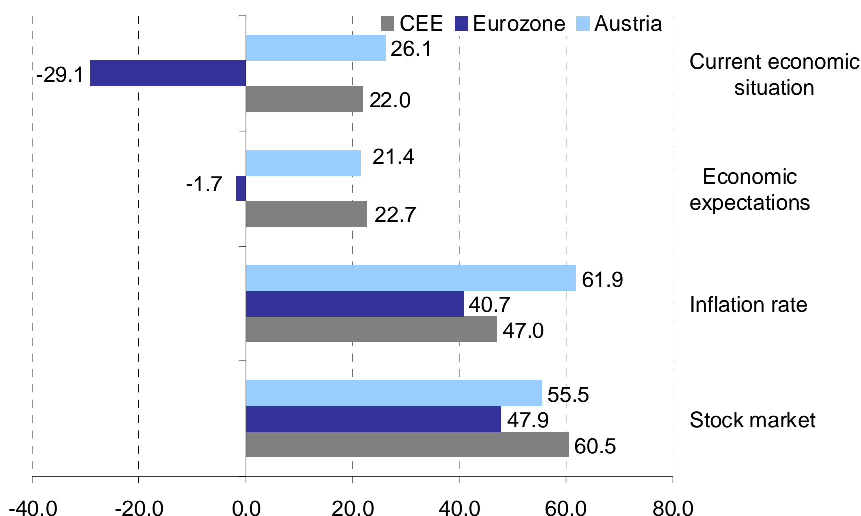
Reduced economic expectations for Central and Eastern Europe

The ZEW-Erste Group Bank Indicator for CEE drops in December 2010 by 8.7 points to a level of 22.7 points. This reflects more cautious economic expectations on a six-month time horizon for Central and Eastern Europe, including Turkey (CEE) compared to the previous month. The assessment of the current economic situation in the CEE region improves in December once again. The respective indicator climbs by 5.3 points to 22.0 points. The economic expectations for the Eurozone decrease by 7.2 points to minus 1.7 points. This is the sole negative indicator in this category. The experts' view on the current situation in the Eurozone deteriorates as well. The respective indicator drops by 7.6 points to minus 29.1 points. The economic sentiment indicator for Austria increases slightly by 1.3 points and reaches a value of 21.4 points. A similar development shows the evaluation of the current business conditions in Austria which improves to 26.1 points.

Economic Outlook for the CEE Region, Austria and the Eurozone

The ZEW-Erste Group Bank Economic Sentiment Indicator for Central and Eastern Europe including Turkey (CEE), which is calculated as the balance of positive and negative expectations for the economic development on a six-month time horizon, decreases by 8.7 points to 22.7 points in December. However, the decline in the expectations of the financial market experts should be considered in the context that 58.5 percent of them do not expect the economic sentiment in the CEE region to deteriorate or to rise within the next six months. This assessment of a widely stable economic situation is not included in the calculation of the indicator. The economic expectations for the Eurozone drop in the current survey by 7.2 points to a value of minus 1.7 points. In contrast the predictions for the economic development in Austria improve by 1.3 points to 21.4 points. While the evaluation of the current economic conditions in the CEE region and Austria improves in December, the respective indicator for the Eurozone drops this month. The balance representing the assessment of the current economic situation in the CEE region climbs by 5.3 points to 22.0 points and the respective indicator for Austria rises by 3.9 points to 26.1 points. The balance for the Eurozone deteriorates by 7.6 points to minus 29.1 points. After the strong increase in November, the expectations regarding the inflation rate in the CEE region within the next six months do rise by 4.8 points to 47.0 points. Almost all survey participants predict an increasing or unchanged inflation rate in the CEE region. For Austria and the Eurozone the inflation indicators increase stronger by 11.9 points to 61.9 points and by 14.1 points to 40.7 points, respectively. While the forecasts for the development of the CEE stock market index (NTX) improve slightly the expectations for the Austrian ATX and the Eurostoxx 50 worsen in December.

ZEW indicator



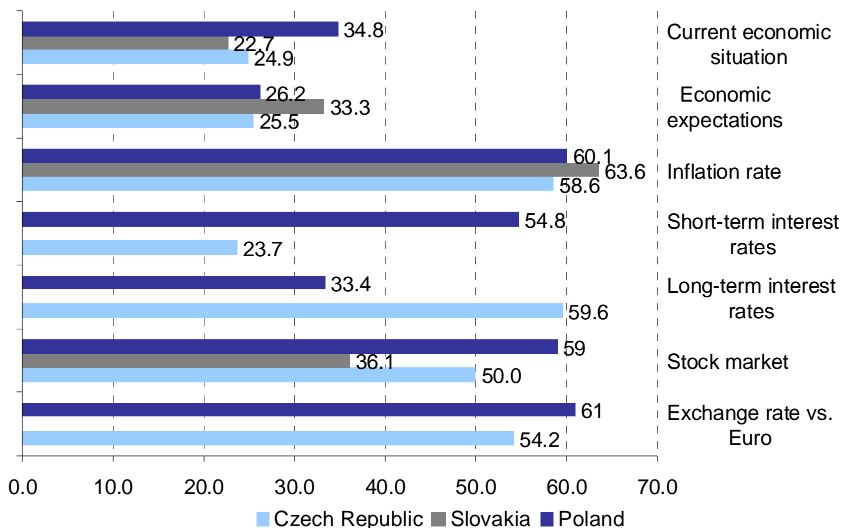
Balance of positive and negative assessment category chosen by respondents of the Financial Market Survey CEE; Source: ZEW

ZEW Indicator CEE

Czech Republic, Poland, and Slovakia: Brighter Outlook for Slovakia

The expected economic development in Slovakia exhibits fairly positive results in December compared to the Czech Republic and Poland. The economic sentiment indicator for Slovakia increases by 8.3 points to 33.3 points while Poland's and the Czech Republic's indicators decrease by 6.3 points to 26.2 points and by 5.4 points to 25.5 points, respectively. This indicates that the financial market experts are confident that the newly planned austerity measures by the Slovak government will not significantly affect the economy negatively. The Slovak indicator achieves the second highest value in country comparison in this category. The indicator reflecting the assessment of the current business cycle in Slovakia gains 12.7 points reaching 22.7 points in December. It depicts the highest increase among all the analysed CEE economies. The assessment of the current business situation in Poland and the Czech Republic changes only marginally. The respective indicator for Poland decreases slightly by 0.2 points to 34.8 points. However, the evaluation of the current economic situation in Poland still remains the best in country comparison apart from Turkey. The respective indicator for the Czech Republic increases by 1.6 points to 24.9 points. Expectations of higher inflationary pressure for Poland are reflected in the double digit increase of the inflation indicator by 12.6 points to 60.1 points. The Polish National Bank also expressed worries about higher core inflation due to the impact of global factors such as the rise in commodity prices in the world markets. More than 60 percent of the survey participants agree with the forecast of higher inflation rates. The inflation indicators of Slovakia and the Czech Republic also continue to depict high values at 63.6 points and 58.6 points. More than 60 percent of the analysts expect an appreciation of the Czech Koruna against the Euro. The respective indicator rises significantly by 30.4 points to 54.2 points. The exchange rate indicator for the Polish Zloty achieves with 61.0 points the highest value in country comparison.

ZEW indicator on country levels



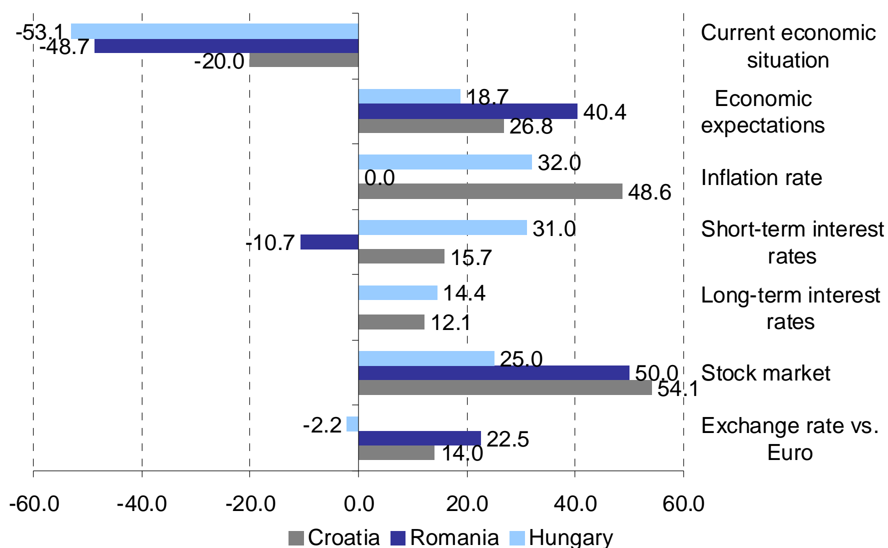
Balance of positive and negative assessment category chosen by respondents of the Financial Market Survey CEE; Source: ZEW

ZEW Indicator CEE

Croatia, Hungary and Romania: Higher Interest Rates in Hungary

The indicators reflecting the expected economic development and the assessment of the current economic situation in Hungary decrease significantly in December by 12.1 points to minus 53.1 points and by 17.7 points to 18.7 points. Thus, Hungary exhibits the lowest indicators among all the analysed CEE economies in these two categories. Romania's economic sentiment indicator wins the first place in country comparison after a rise by 8.8 points to 40.4 points. In contrast the evaluation of the current business cycle shows a more cautious picture. Still more than 50 percent of the survey participants regard the current business conditions in Romania as bad and the respective indicator stands at a level of minus 48.7 points. The economic expectations for Croatia recover marginally by 0.4 points to 26.8 points and the assessment of Croatia's current economic situation improves by 7.0 points to minus 20.0 points. The inflation indicator for Hungary increases significantly by 27.5 points which is the highest increase in country comparison. In line with this result, the indicator reflecting the expected development of the short-term interest rates shows a strong increase as well. The forecasts of the majority of experts for an interest rate increase were confirmed by the recent decision of Hungary's Central Bank to increase the central bank base rate by 25 basis points to 5.75. The inflation indicators for Croatia and Romania decrease by 6.7 points and 16.3 points to 48.6 points and 0.0 points. The balance of Romania's inflation indicator exhibits the strongest decline among all the other CEE economies. More than 60 percent of the polled participants also anticipate an increase in Polish short term interest rates within the next six months. The indicators reflecting the developments of the stock market index and the exchange rate in Hungary on a six month horizon exhibit the strongest declines by 11.9 points and 24.7 points and achieve the lowest values in country comparison of 25.0 points and minus 2.2 points.

ZEW indicator on country levels



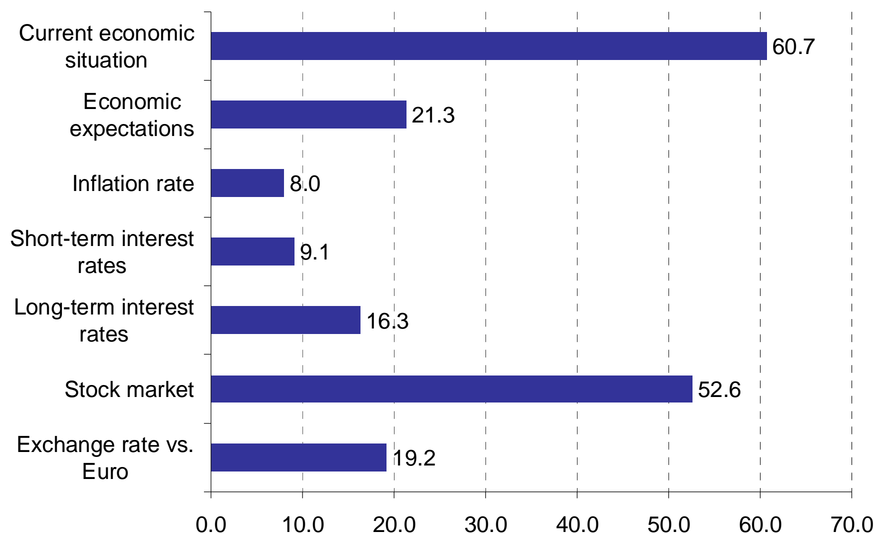
Balance of positive and negative assessment category chosen by respondents of the Financial Market Survey CEE; Source: ZEW

ZEW Indicator CEE

Turkey: Positive Development of Indicators Abates

The positive evaluation of the Turkish economy diminishes slightly in this month's survey. The economic sentiment indicator which reflects the expected development of the Turkish economy on a six-month horizon declines by 5.4 points to 21.3 points in December. More than half of the financial market experts do not anticipate any significant changes of the Turkish economy within the next six months. However, the current business situation in the country seems to outperform the other analysed CEE economies as its respective indicator exhibits the highest value at 60.7 points. More than 60 percent of the survey participants regard Turkey's current economic situation as good. The inflationary pressure in Turkey seems to be fairly small as its inflation indicator decreases by 14.1 points to 8.0 points. The short-term interest rate indicator also decreases by 19.7 points to 9.1 points. The exchange rate expectations of the polled participants rise by 6.1 points to 19.2 points in December.

ZEW indicator Turkey



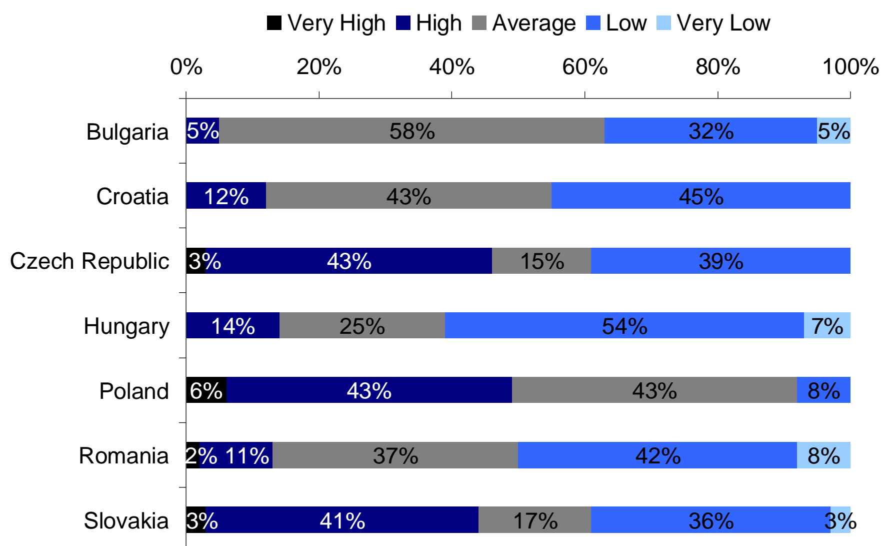
Balance of positive and negative assessment category chosen by respondents of the Financial Market Survey CEE; Source: ZEW

ZEW Indicator CEE

Special Question: Recovery/Growth Prospects of the CEE Economies in 2011

According to the growth expectations of the financial market experts published in the April issue of the Financial Market Report CEE in 2009, Poland and the Czech Republic had the best medium-term prospects in 2009. These positive expectations for Poland and the Czech Republic have not ceased after more than one and a half year. The polled participants still evaluate these two countries to have the best chances for growth even after the dynamic phase of the economic recovery in the CEE region is decelerating. 43 percent of the survey participants foresee high recovery prospects for both countries. 6 percent of the financial analysts even perceive the growth prospects for Poland to be very high. Slovakia also seems to have a promising future economic development as 44 percent of the financial market analysts describe the growth prospects in Slovakia as either very high or high. The business prospects in Hungary and Romania remain critical as more than half of the polled participants evaluate their expected growth to be low or very low.

Assessment of the recovery/growth prospects in 2011



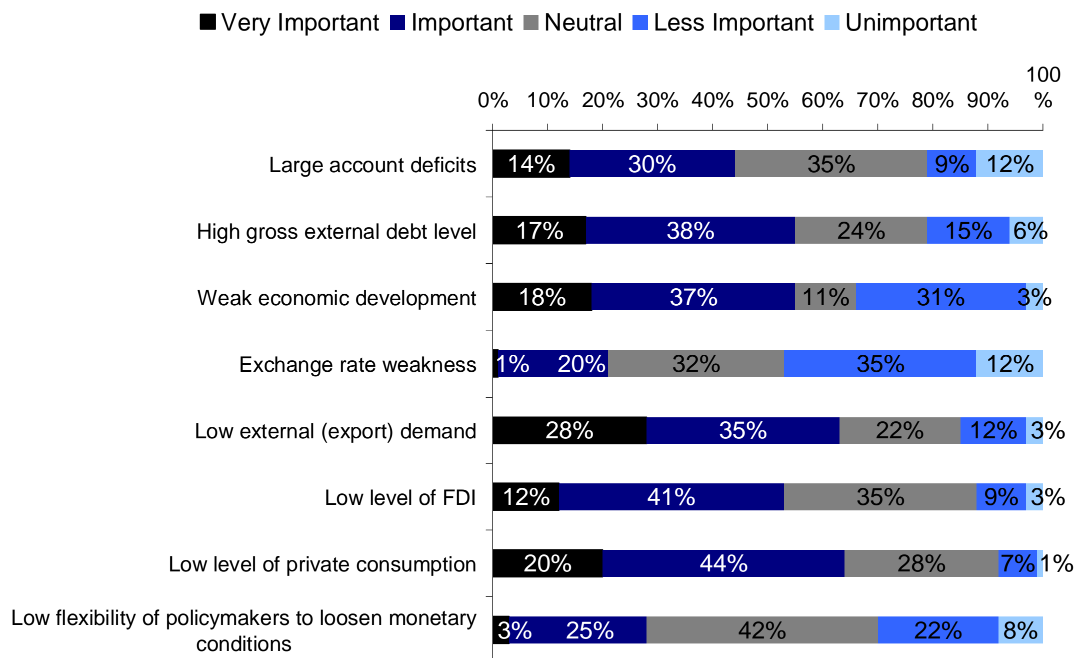
Source: ZEW

The results for Croatia and Bulgaria prognosticate a subdued growth for the next year. In 2010 the CEE region was mostly challenged by low consumption demand, high debt level and the consequences of austerity measures. Following the financial market experts, the challenges for economic growth do not change significantly in 2011. More than 60 percent of the participants fear that the low level of private consumption and the low demand for exports from the CEE region will be a major challenge in 2011. Additionally, more than 40 percent of the analysts regard the large account deficit, the gross external debt level and the weak economic development as either most important or between most important and neutral.

The importance of the exchange rate weakness decreased immensely since the survey in 2009 as it was described as the second most important challenge for recovery prospects while in this month's survey the participants described it as the least important challenge for 2011. The surveyed analysts still regard the low flexibility of policymakers to loosen monetary conditions as a secondary problem for the prospects of growth. Some financial market experts warned of other challenges for 2011 such as inflation, political instability, fiscal consolidation and postponing new financial regulations.

ZEW Indicator CEE

Most important challenges for the CEE region as a whole in 2011



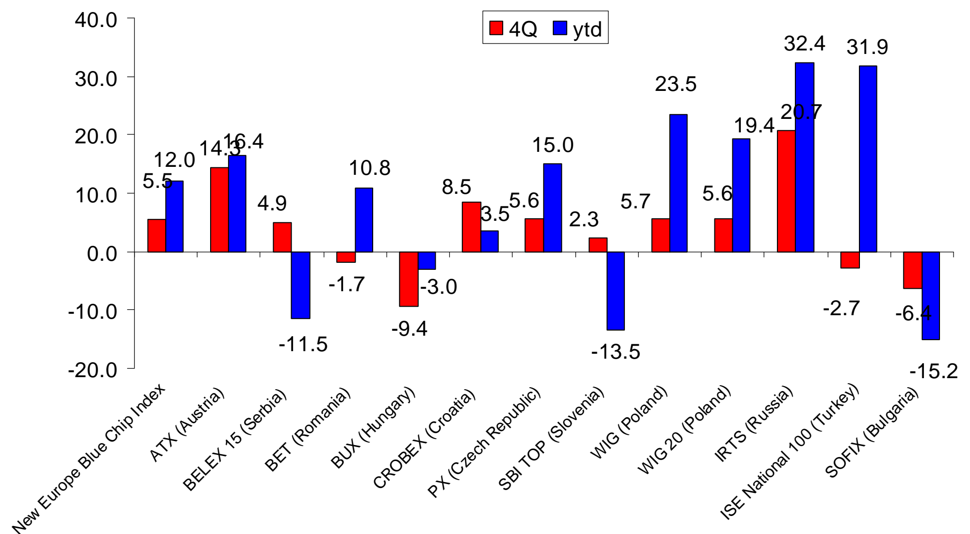
Source: ZEW

Entire text and charts – Source ZEW

CEE Country Allocation

Our model has known it better all along and we have been too greedy with our call for the Turkish market. Its strong performance and uncertainties (mainly) around the banking sector have kicked off a correction, proving our overweight to be wrong. The overweight on Russia, however, has been just right and its top regional performance in 4Q helped the Russian market close at par with Turkey on annual performance. SEE posted a mixed result, with Serbia and Croatia delivering rather good recovery moves, while Romania and - in particular - Bulgaria were in red territory. Reducing our model's overweight call for Hungary has been just right and we could have been even harsher in our final weighting, since government measures have pulled the market deeply into negative performance. Also overruling the model's negative call for Austria has helped us to run off with the region's second best quarterly performance after Russia. Seeing the Czech Republic better than our quant model has brought in some 5.6% in quarterly performance, confirming our relative neutral call. Poland also did better than our quant procedure would have suggested, but our tendency towards an overweight was maybe a notch too strong.

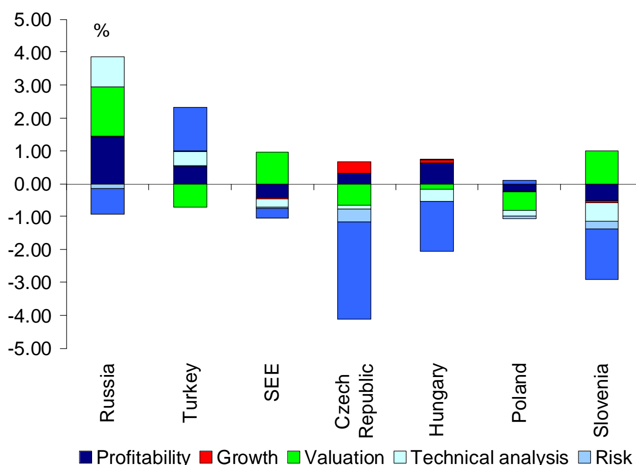
Performance overview (in EUR)



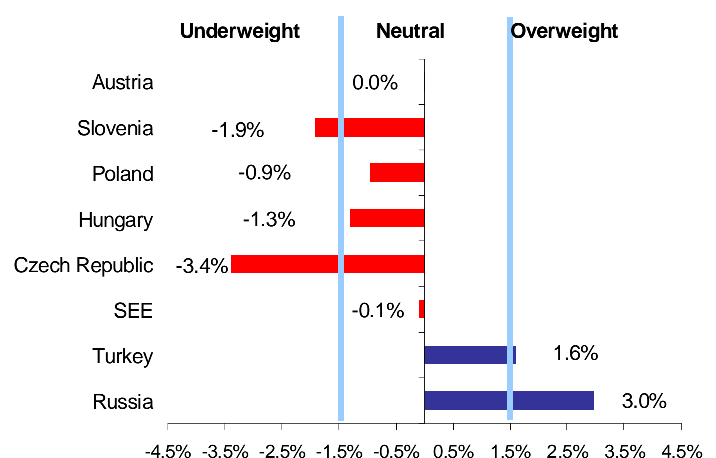
**3Q 2010 = 3month performance, closing price 24.09.2010; Source: Factset Partners, Erste Group Research*

Generally, the quantitative allocation model paints a largely black and white picture for the region, with Turkey and Russia seen as good performers. The rest of the region is seen as performing rather weakly. Main themes are again size and valuation. Our recently published chart book suggests that most markets might see some initial weakness in January, offering opportunities to step in a moment later.

Summary of return components



Allocation based on expected returns



Source: Erste Group Research

CEE Country Allocation

Russia – Overweight

Confirming our model's overweight call for Russia is straightforward. The current oil price and a stable growth outlook, with enough liquidity in the system, should continue to deliver support. Valuation speaks clearly in favor of the market, with the consensus seeing P/E of 8 and 7 for 2011 and 2012, respectively. Also, earnings revisions are painting a clearly positive picture.

Turkey – Overweight

We also accept the overweight decision for Turkey, which is weaker than the Russian call, however. The market might still need more time to digest its recent weakness and we would not expect fireworks already in January. Valuation is certainly an argument against the market for the time being, with forward P/Es slightly ahead of historical averages. Also, the consensus has delivered a substantial weakening in corporate earnings growth outlook for 2011, with a recovery seen in 2012. This goes along with negative earnings revision balances, which have bothered the market already for quite some time. On the positive side, certainly the argument of liquidity remains intact and our chart book offers a quite positive technical reading for the market. Finally, news flow on elections and consequently getting closer to a rating upgrade could provide a substantial trigger.

Austria – Sound Neutral to Overweight

We tend to be a touch more positive for the Austrian market than our model for the first quarter of 2011. However, its sound performance – potentially also triggered by flows ahead of new tax burdens coming with 2011, might put the market a bit on hold for the early days of 2011. However, valuation remains a strong argument for Austria, as it is not only still well below its historical averages, but also posting some 20% undervaluation based on our comparison between earnings and bond yields. Also, on corporate risk, the market should be in fine form. Our chart book publication would see a correction in January, with a support line for the ATX at 2,800, leaving room for a move towards our index target of 3,100 for the full year afterwards.

Hungary – Neutral (wait and see)

A clear call for the Hungarian market remains difficult. Growth remains an argument with some delayed recovery, posting consensus earnings growth rates above 20% for both 2011 and 2012. Valuation as a comparison to historical averages is okay, but earnings yields compared to high bond yields indicate quite little upside for the market. For the first quarter, rate cuts appear rather unlikely. Finally, the market will depend on the package of consolidation measures to be delivered by the government in early 2011. So far, the public authority's creativity has turned out to be quite a burden for the market, but if the policy package is well received by rating agencies, this could turn into a nice trigger for the market – or the other way around.

SEE – Sound Neutral

Valuation is certainly a positive for SEE markets, since overall risk considerations for markets as such have pushed price levels well below a fair level. Romania demonstrates this dramatically, with the comparison of earnings and bond yields posting an implied undervaluation of about 40%. Croatia is not as dramatic, but still offers an impressive theoretical undervaluation of 27% (all based on consensus data). Removing political and economic concerns should remain the biggest hurdle (trigger) for these markets to perform. While Croatia is still considered quite unambitious with its consolidation efforts, Romania is on a good track. Serbia should continue to improve its efforts to join the European Union. Positive news flow on this, along with events such as the listing of the Property Fund in Romania, should provide a trigger for these markets and help remove one of the still biggest obstacles, liquidity.

Poland – Neutral with an uncertain trend toward Overweight

Poland remains a difficult case. Valuation relative to other regional markets is certainly not cheap, while compared to its own historical averages there is still upside. Consequently, the implied upside based on earnings to bond yields comes in at only 10% for the WIG 20. On the other hand, EPS growth rates for the broad market are among the highest in the region for 2011 at least, reflecting Poland's unparalleled growth development during the entire crisis. However, this economic growth comes at the cost of structural deficits and dealing with this has led to unpopular measures such as the reduction of contributions to pension schemes. While this has been expected already for a while, getting more precise should weigh a bit on the market. Finally, it remains to be seen to what extent other measures, such as widening maximum weights of equity in NAV and the establishment of more aggressive sub-funds will help to offset the negative impact. Consequently, 1Q could be a bit undecided for the market.

CEE Country Allocation

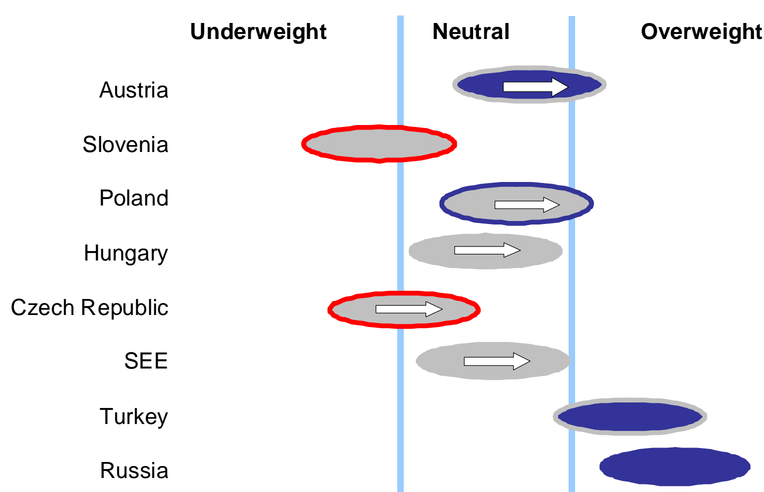
Czech Republic – Neutral to Underweight

Our model suggests a strong underweight for the Czech market. Admittedly, the market has not had much to offer in terms of appealing stories. Consensus earnings growth confirms this view, with some 10% seen for both 2011 and 2012. Also, earnings revisions have tapped negative territory. Telecom might be nice and boring, CEZ is a bit down on new taxes and electricity prices do not provide much of a strong outlook, at least for the first quarter. The bank is doing okay, but also missing a substantial trigger. Hence, we remain looking at commodity stories such as Pegas and NWR. This overall picture might prevent the market from eating up its implied undervaluation of 18%. A forward P/E of about 10 might well remain below its historical average of 13, as long as a substantial trigger for the market remains missing.

Slovenia – Neutral to Underweight

We remain cautious on the Slovenian market, in line with what our quant model suggests. Growth remains stable but moderate and valuations have come down compared to their own historical benchmark, but remain on the expensive side in a regional comparison. Hence, in our view, Slovenia remains a place for selective choices, namely Krka and Gorenje.

Allocation proposal



Source: Erste Group Research

Appendix

Factor model description

In our approach to establishing a regional allocation, we employ a multi-factor model. The model screens a universe of the following countries:

- Austria
- Bulgaria (SEE)
- Croatia (SEE)
- Czech Republic
- Hungary
- Poland
- Romania (SEE)
- Russia
- Serbia (SEE)
- Slovenia
- Turkey

Due to data availability, we pooled Bulgaria, Croatia, Romania and Serbia into one region, which we called Southern and Eastern Europe (SEE). This was done because of the small number of available stocks in the data for this region.

The model refines its results by using a range of factors that are seen as significant in any asset allocation decision. Factors cover the topics of:

- Valuation
- Size/Liquidity
- Profitability
- Growth
- Corporate risk
- Technical analysis

In total, the model relies on 13 single factors.

We start our model view with the year 2005. Via a multiple-regression, we try to identify a relationship between our chosen factors at the end of a period and the observed return for the next period (in our case, we look at quarters). We run this multiple-regression for the first year of chosen history and summarize the results of the regression by calculating an average regression coefficient (b) for the first year for each factor.

As the next step, we use the average b from the past year (not including the current quarter) and the stock's current state for each factor to forecast an expected return for the next period. However, regression coefficients are estimated further on for all following periods. For each period, new forecasts are computed by calculating the past year's average of the regression coefficients for each factor.

To cut it short, the model yields expected returns for each stock in our universe, which we finally aggregate to country levels.

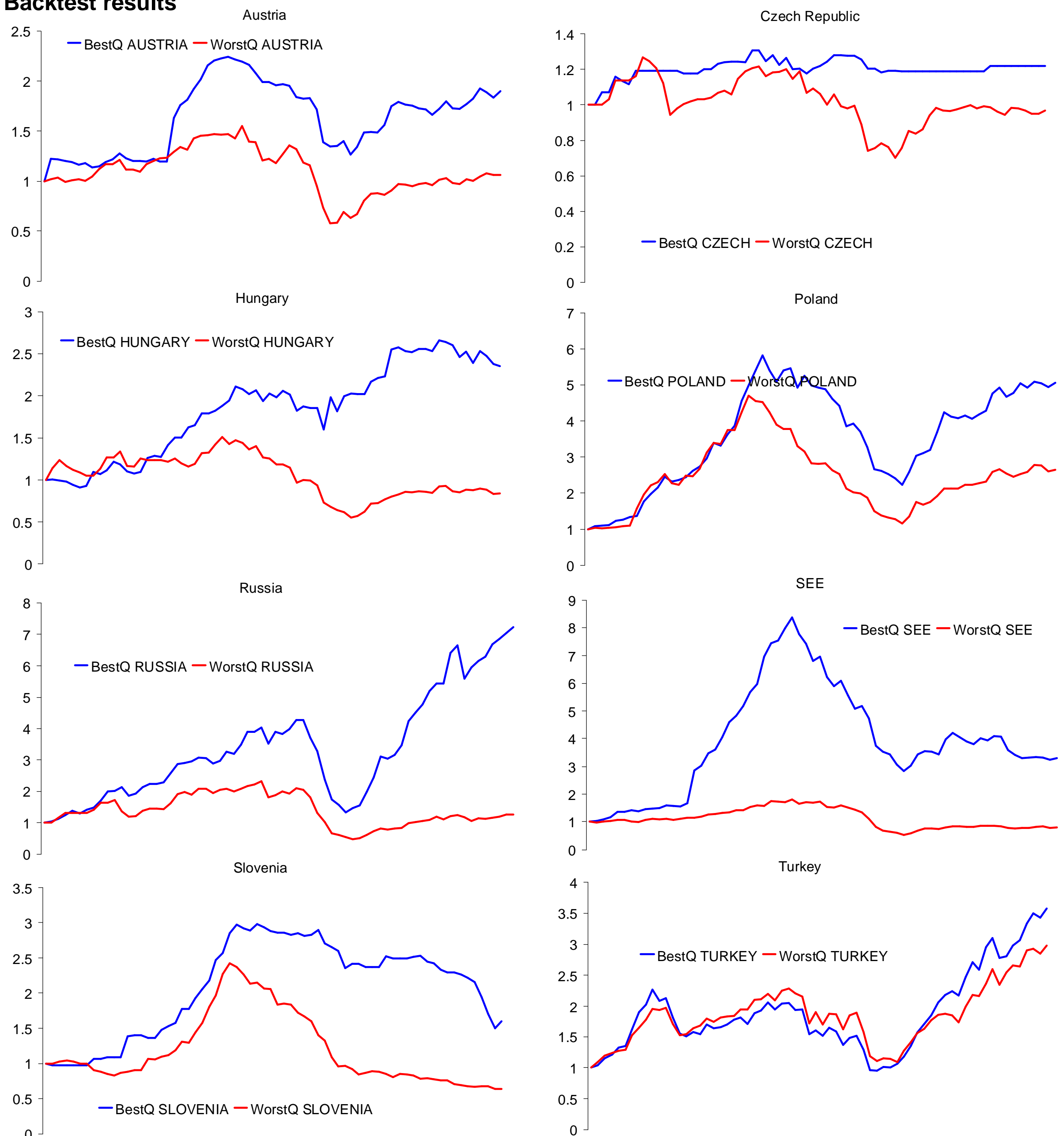
In order to check the outcome of our model, we run a forward looking back test, e.g. how much any portfolio based on the model outcome would have made in terms of return. We differentiate between quartiles and would expect the top quartile to have outperformed the bottom quartile. The outcome indeed indicates that the model works, at least for markets with rather good data quality and - even more importantly - a higher number of stocks being traded. Hence, this already demonstrates the downside of our approach, given the fact that some markets simply offer a limited amount of stocks, which are frequently traded and for which reliable data is available. However, based on this, we would not question the entire approach, but would clearly stress the functionality of our tool: It is an allocation indication, NOT a tradable mechanism. Hence, we allow ourselves to put the pure outcome of the model on a relative scale and use our own judgment to formulate a final view.

Appendix

Finally, for interpretation of the outcome of our model, we use the overall expected return by country, as well as the spread between the high and low (top - last quartile) expected return stocks. The expected return by countries is the forecast, which is the actual state of the factors for each stock in the universe multiplied by the average of the coefficients (b) for each factor from last year's regressions. Since the expected return of each stock is composed of the sum of the expected return components for each factor, we can extract the information regarding from which factor the largest contribution to the expected return comes. Knowing this for each stock and each factor and aggregating on a country level gives us the average contribution of the factor to the total expected return for a country.

We have run a backtest, checking what our allocation model would have yielded. The following charts show the expected returns both for the best and the worth quartile.

Backtest results



Source: Erste Group Research

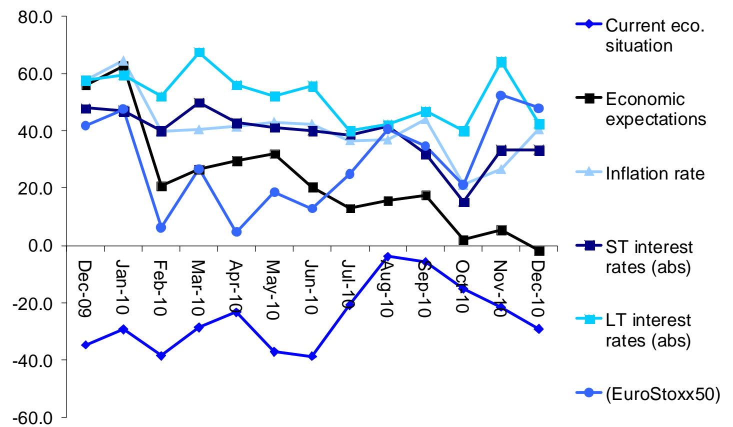
Appendix

ZEW sentiment indicator

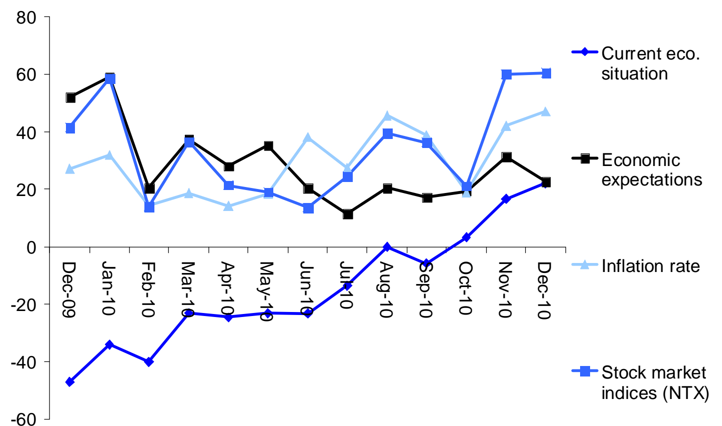
ZEW (Centre for European Economic Research, Mannheim, Germany) and Erste Bank jointly established a sentiment indicator. Each month financial experts in the region are asked to give their assesment on various indicator for the CEE region. Here we show the development of the ZEW indicator over time, aggregated by region as well as on individual country levels. Since the first report was published in June 2007, history is just about to be built over time.

ZEW indicator development

EUROZONE	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Current eco. situation	-34.7	-29.3	-38.5	-28.5	-23.3	-37.0	-38.6	-20.8	-3.9	-5.8	-15.1	-21.5	-29.1
Economic expectations	56.0	62.7	20.8	26.6	29.6	32.0	20.4	13.1	15.7	17.7	2.1	5.5	-1.7
Inflation rate	57.7	64.6	39.7	40.5	41.4	43.1	42.3	36.5	37.0	44.0	21.3	26.6	40.7
ST interest rates (abs)	47.9	47.0	40.0	49.9	42.9	41.2	40.0	38.6	41.6	32.0	15.3	33.3	33.3
LT interest rates (abs)	57.7	59.5	52.1	67.5	56.1	52.2	55.7	40.0	42.2	46.9	40.0	64.2	42.5
(EuroStoxx50)	41.8	47.6	6.3	26.7	4.7	18.6	12.8	24.9	40.6	34.7	21.1	52.4	47.9
Exchange rates (vs. Euro)	-	-	-	-	-	-	-	-	-	-	-	-	-

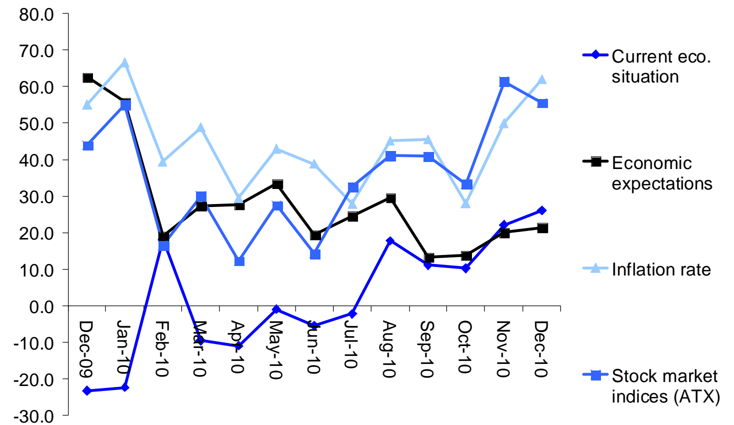


CEE	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Current eco. situation	-47.1	-34.0	-40.0	-23.0	-24.5	-23.1	-23.2	-13.6	0.0	-5.7	3.2	16.7	22.0
Economic expectations	52.0	59.1	20.5	37.3	28.0	35.2	20.4	11.4	20.5	17.3	19.3	31.4	22.7
Inflation rate	27.1	32.0	14.3	18.7	14.2	18.4	38.1	27.5	45.6	38.8	19.0	42.2	47.0
ST interest rates (abs)	-	-	-	-	-	-	-	-	-	-	-	-	-
LT interest rates (abs)	-	-	-	-	-	-	-	-	-	-	-	-	-
Stock market indices (NTX)	41.5	58.6	13.9	36.5	21.4	19	13.6	24.4	39.5	36.3	21.2	60	60.5
Exchange rates (vs. Euro)	-	-	-	-	-	-	-	-	-	-	-	-	-

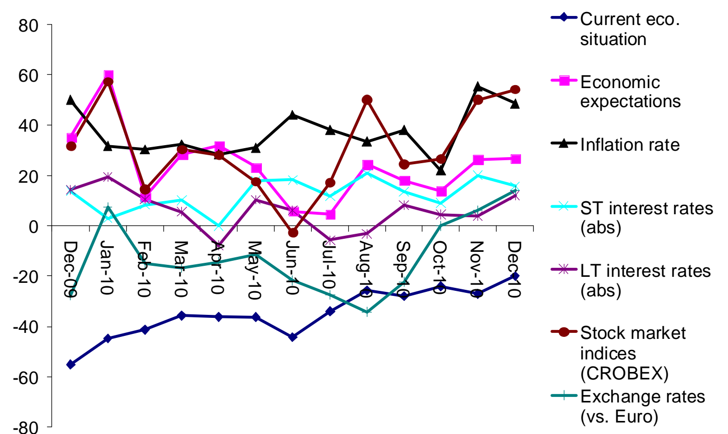


Appendix

AUSTRIA	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Current eco. situation	-23.2	-22.2	18.1	-9.4	-10.9	-0.9	-5.4	-2.2	17.8	11.1	10.3	22.2	26.1
Economic expectations	62.5	55.7	19.1	27.3	27.6	33.4	19.4	24.5	29.5	13.3	13.8	20.1	21.4
Inflation rate	55.0	66.6	39.5	48.8	29.5	42.9	38.8	27.9	45.2	45.5	28.0	50.0	61.9
ST interest rates (abs)	-	-	-	-	-	-	-	-	-	-	-	-	-
LT interest rates (abs)	-	-	-	-	-	-	-	-	-	-	-	-	-
Stock market indices (ATX)	44.0	55.0	16.6	30	12.3	27.5	14.3	32.5	41.1	40.9	33.3	61.3	55.5
Exchange rates (vs. Euro)	-	-	-	-	-	-	-	-	-	-	-	-	-

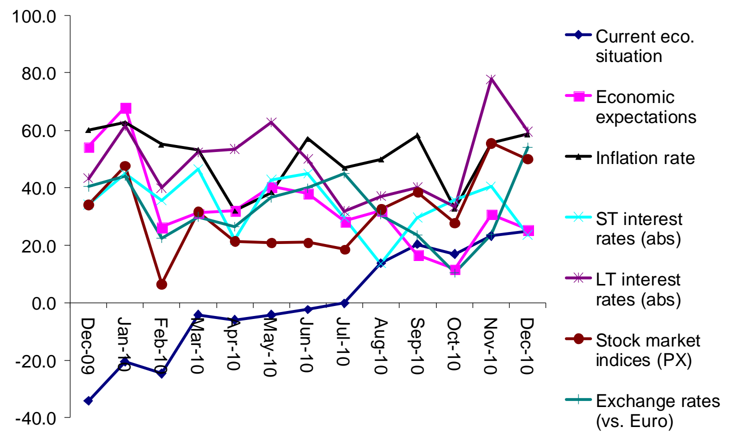


CROATIA	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Current eco. situation	-55	-44.7	-41.3	-35.5	-36.1	-36.3	-44.2	-34	-25.6	-27.9	-24	-27	-20
Economic expectations	35.2	60.1	11.4	28.3	31.8	23.3	5.8	4.6	24.4	18.1	13.8	26.4	26.8
Inflation rate	50.0	31.7	30.3	32.5	28.3	31.0	44.1	38.1	33.4	38.0	22.0	55.3	48.6
ST interest rates (abs)	13.8	2.9	8.4	10.2	0.0	18.0	18.2	11.8	20.7	13.5	8.9	20.1	15.7
LT interest rates (abs)	14.3	19.4	10.5	5.5	-7.8	10.3	6.1	-5.7	-3.1	8.2	4.4	3.8	12.1
Stock market indices (CROBEX)	31.6	57.2	14.4	30.2	28.0	17.4	-2.8	17.1	50.0	24.4	26.5	49.9	54.1
Exchange rates (vs. Euro)	-27.7	7.5	-15	-16.6	-14.3	-11.4	-21.6	-27.5	-34.2	-22.3	0	6.1	14

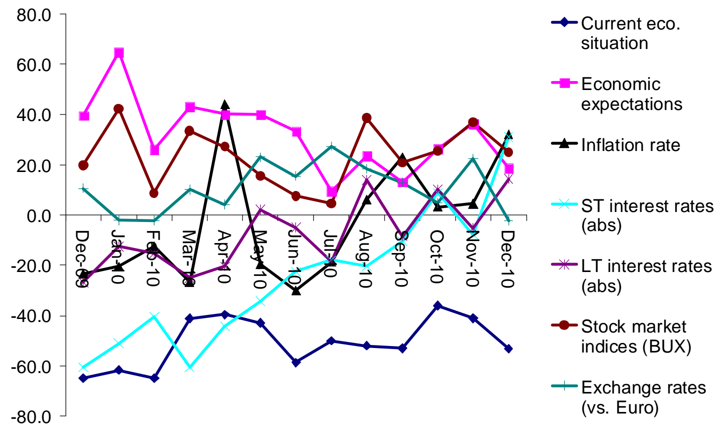


CZECH REPUBLIC	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Current eco. situation	-34.1	-20.4	-24.5	-4.2	-6.0	-4.2	-2.3	-0.1	13.8	20.4	16.9	23.3	24.9
Economic expectations	54.4	68.0	26.5	31.3	32.1	40.4	38.1	28.5	32.0	16.7	11.8	30.9	25.5
Inflation rate	60.1	62.6	55.1	53.2	32	38.3	57.1	46.9	49.9	58.3	32.7	55.8	58.6
ST interest rates (abs)	34.2	45.0	35.6	46.4	22.0	42.8	45.0	29.6	13.7	29.6	35.7	40.5	23.7
LT interest rates (abs)	43.3	61.6	40.0	52.4	53.5	62.7	50.0	31.9	37.1	40.1	33.3	77.8	59.6
Stock market indices (PX)	34.2	47.7	6.6	31.6	21.4	20.9	21.0	18.6	32.6	38.5	27.8	55.6	50.0
Exchange rates (vs. Euro)	40.4	44.0	22.5	29.9	26.5	36.7	40.0	45.0	30.6	23.5	10.4	23.8	54.2

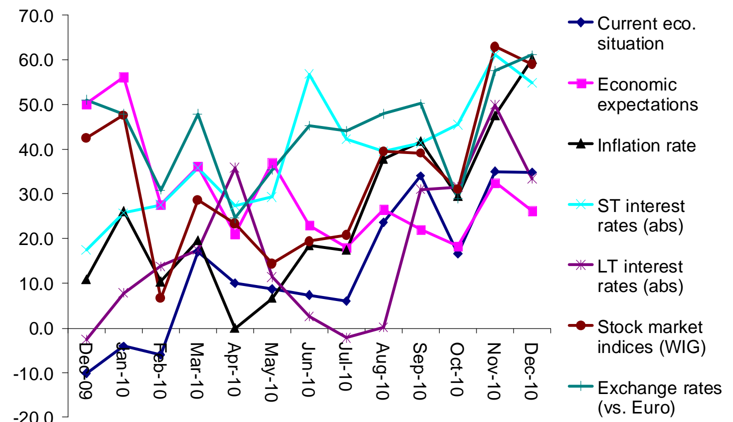
Appendix



HUNGARY	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Current eco. situation	-64.8	-61.6	-64.8	-41.1	-39.6	-42.8	-58.6	-50.0	-51.9	-52.9	-36.0	-41.0	-53.1
Economic expectations	39.6	64.8	26	43.1	40.1	40	33.3	9.6	23.5	13.1	26.3	36.4	18.7
Inflation rate	-23.4	-20.4	-12.5	-26.6	44.0	-19.5	-30.0	-18.7	6.1	23.1	3.3	4.5	32.0
ST interest rates (abs)	-60.5	-51.1	-40.4	-60.5	-44.2	-34.2	-22.5	-17.9	-20.4	-10.4	8.8	-7.9	31.0
LT interest rates (abs)	-26.7	-12.5	-15.2	-25.0	-20.4	2.2	-5.0	-18.5	13.9	-8.4	10.3	-5.2	14.4
Stock market indices (BUX)	19.9	42.3	8.8	33.4	27.2	15.6	7.6	4.6	38.6	20.8	25.4	36.9	25.0
Exchange rates (vs. Euro)	10.7	-2.0	-2.1	10.2	4.1	23.0	15.5	27.4	18.4	13.0	4.9	22.5	-2.2

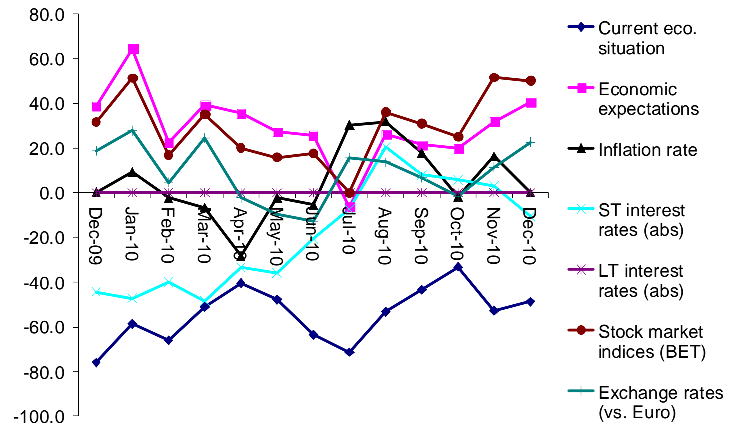


POLAND	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Current eco. situation	-10.1	-4.1	-6.0	17.1	10.0	8.7	7.3	6.0	23.6	34.0	16.6	35.0	34.8
Economic expectations	50.1	56.1	27.6	36.1	21.1	37.0	23.0	18.0	26.5	22.0	18.3	32.5	26.2
Inflation rate	10.9	26.1	10.4	19.6	0.0	6.7	18.5	17.4	37.8	41.7	29.4	47.5	60.1
ST interest rates (abs)	17.5	25.7	27.5	35.8	27.3	29.3	56.8	42.2	39.5	41.4	45.5	61.1	54.8
LT interest rates (abs)	-2.6	7.8	13.8	17.5	35.8	11.4	2.6	-2.2	0.1	31.0	31.5	49.9	33.4
Stock market indices (WIG)	42.5	47.6	6.7	28.6	23.3	14.4	19.4	20.8	39.5	39.1	31.0	62.9	59.0
Exchange rates (vs. Euro)	51.0	47.8	30.8	47.8	24.5	35.3	45.2	44.0	47.9	50.1	28.9	57.5	61.0

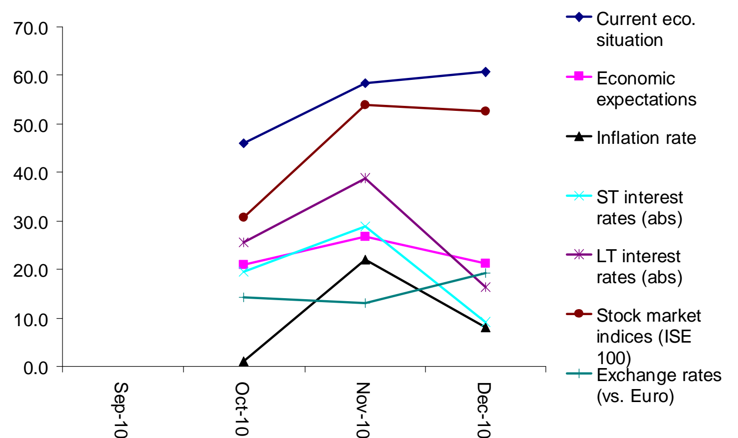


Appendix

ROMANIA	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Current eco. situation	-76.0	-58.6	-66.0	-51.1	-40.5	-47.8	-63.4	-71.4	-53.2	-43.4	-33.2	-52.7	-48.7
Economic expectations	38.7	64.4	22.3	39.2	35.4	27.2	25.7	-6.3	26.1	21.3	19.8	31.8	40.4
Inflation rate	0.1	9.3	-2.3	-6.7	-28.2	-2.4	-5.6	30.2	31.8	17.8	-1.8	16.3	0.0
ST interest rates (abs)	-44.4	-47.3	-40.0	-48.6	-33.4	-36.0	-20.5	-7.5	20.5	7.9	5.7	3.0	-10.7
LT interest rates (abs)	-	-	-	-	-	-	-	-	-	-	-	-	-
Stock market indices (BET)	31.6	51.2	16.7	35.0	20.0	15.7	17.6	-0.1	35.9	30.9	25.0	51.5	50
Exchange rates (vs. Euro)	18.6	27.8	4.6	24.4	-2.3	-9.5	-12.8	15.6	13.7	6.8	-1.7	11.3	22.5



Turkey	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10
Current eco. situation											45.9	58.4	60.7
Economic expectations											20.9	26.7	21.3
Inflation rate											1.1	22.1	8.0
ST interest rates (abs)											19.5	28.8	9.1
LT interest rates (abs)											25.6	38.8	16.3
Stock market indices (ISE 100)											30.8	53.8	52.6
Exchange rates (vs. Euro)											14.3	13.1	19.2



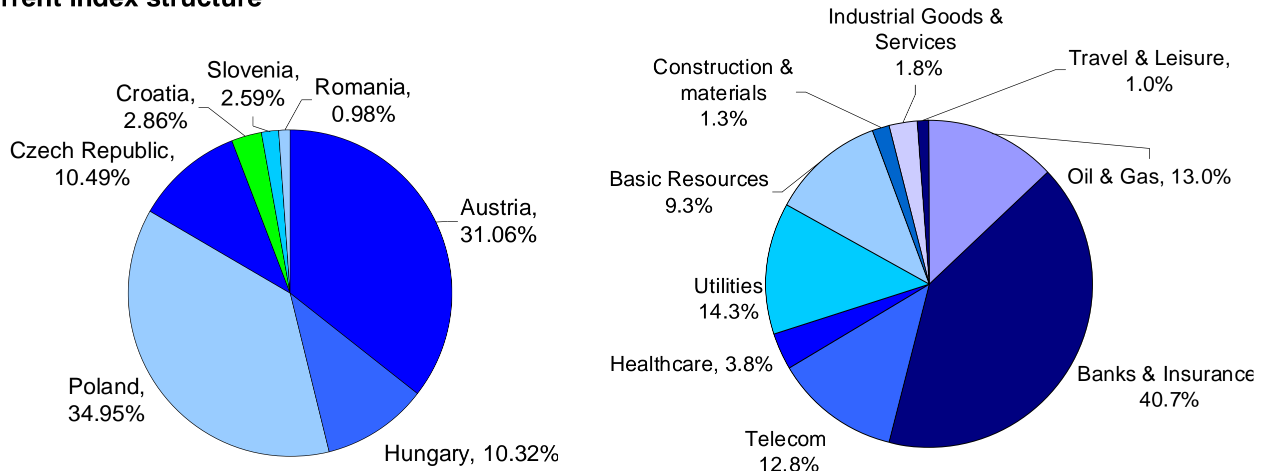
Note: Financial experts were asked about their expectations for the next 6 months. Balances refer to the differences between positive and negative assessments. Source: ZEW

Appendix

New Europe Blue Chip Index (NTX)

In September 2005 Erste Bank together with the Vienna Stock Exchange launched the New Europe Blue Chip Index (NTX). The NTX was designed to summarize the regional convergence theme in Central and Eastern Europe by also offering an investable universe. The index includes the top 30 regional stocks ranked by free float. The NTX is calculated by the Vienna Stock Exchange, quoted real-time and in EUR (.NTX; NTX index <GO>).

Current index structure



Rank	Company	Country	Sector	Free float EUR	Weight
1	Erste Group	Austria	BANKS	9,344,746,776	9.47%
2	PKO BP	Poland	BANKS	7,146,033,791	7.24%
3	CEZ	Czech Republic	UTILITIES	6,598,107,201	6.69%
4	Bank Pekao	Poland	BANKS	5,984,002,743	6.06%
5	KGHM	Poland	BASIC RESOURCES	5,723,050,857	5.80%
6	OMV	Austria	OIL & GAS	4,651,500,000	4.71%
7	PGE	Poland	UTILITIES	4,350,830,016	4.41%
8	Voestalpine	Austria	BASIC RESOURCES	4,300,272,608	4.36%
9	OTP Bank	Hungary	BANKS	4,159,024,854	4.22%
10	PZU	Poland	INSURANCE	3,846,544,340	3.90%
11	Telekom Austria	Austria	TELECOMMUNICATIONS	3,708,796,000	3.76%
12	PKN Orlen	Poland	OIL & GAS	3,559,141,250	3.61%
13	MOL	Hungary	OIL & GAS	3,055,241,532	3.10%
14	T-Hrvatski Telekom	Croatia	TELECOMMUNICATIONS	2,958,580,270	3.00%
15	Andritz	Austria	INDUSTRIAL GOODS & SERVICES	2,850,432,000	2.89%
16	TP SA	Poland	TELECOMMUNICATIONS	2,812,012,486	2.85%
17	Komercni banka	Czech Republic	BANKS	2,618,477,680	2.65%
18	Vienna Insurance Group	Austria	INSURANCE	2,522,240,000	2.56%
19	Raiffeisen International	Austria	BANKS	2,400,314,160	2.43%
20	Richter Gedeon	Hungary	HEALTH CARE	2,018,977,158	2.05%
21	Telefonica O2 CR	Czech Republic	TELECOMMUNICATIONS	1,941,819,713	1.97%
22	Verbund	Austria	UTILITIES	1,892,998,588	1.92%
23	Krka	Slovenia	HEALTH CARE	1,763,653,958	1.79%
24	Wienerberger	Austria	CONSTRUCTION & MATERIAL	1,656,539,739	1.68%
25	PGNiG	Poland	OIL & GAS	1,579,300,620	1.60%
26	BZ WBK	Poland	BANKS	1,175,859,632	1.19%
27	NWR	Czech Republic	BASIC RESOURCES	1,135,569,113	1.15%
28	BRD-Group SG	Romania	BANKS	997,668,050	1.01%
29	bwin	Austria	TRAVEL & LEISURE	964,045,276	0.98%
30	Magyar Telekom	Hungary	TELECOMMUNICATIONS	954,399,681	0.97%
	Total			**98,670,180,093**	**100.00%**

Source: Vienna Stock Exchange, Erste Group Research

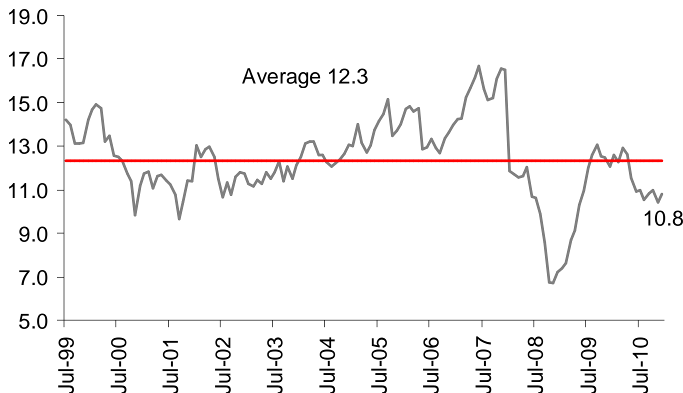
Appendix

Regional valuation and sentiment

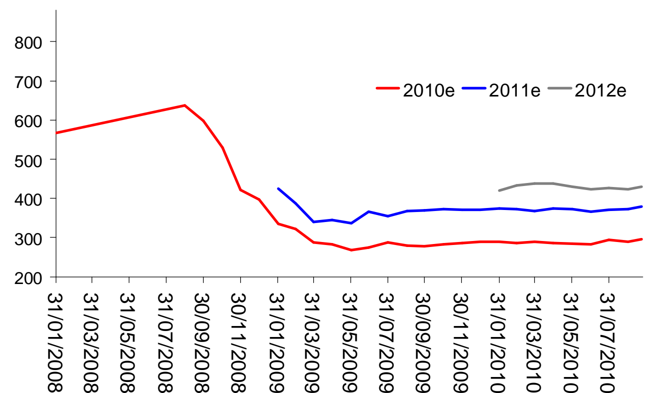
In order to get an overview on valuation, growth and risk premiums, we have summarized the region via the markets of Poland (WIG 20), the Czech Republic (PX), Hungary (BUX), Austria (ATX), Romania, Croatia and Slovenia (BET, CROBEX, SBI not included in risk premium calculation). Additionally, we show data for Turkey and Russia. Admittedly, the overview is also somehow dictated by the availability of reliable consensus data.

CEE Region

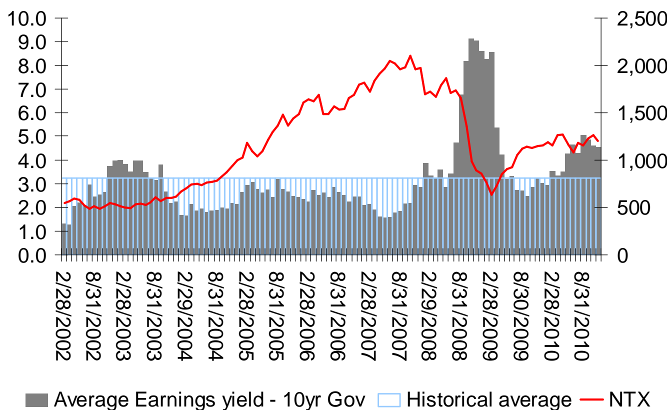
Regional forward PER vs historical average



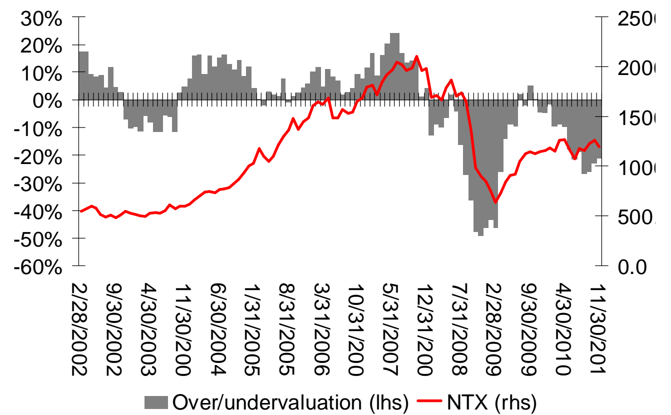
Consensus estimates EPS trend for region in EUR



Development of risk premium CEE Region



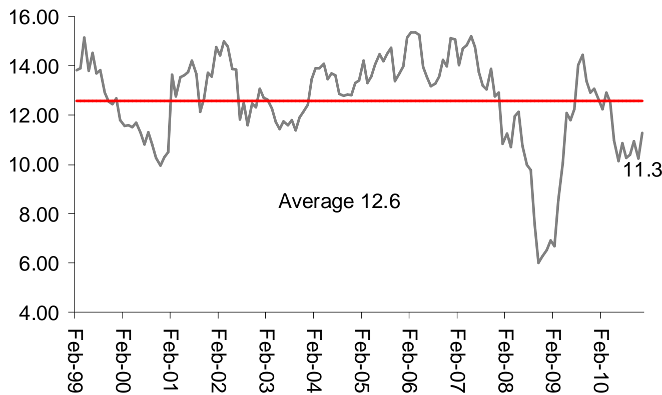
Implied valuation CEE Region



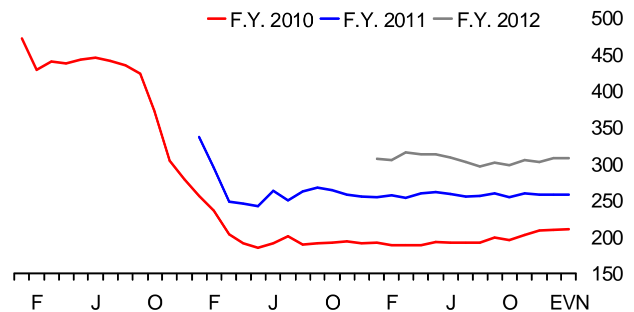
Source: Factset, Erste Group Research

Appendix

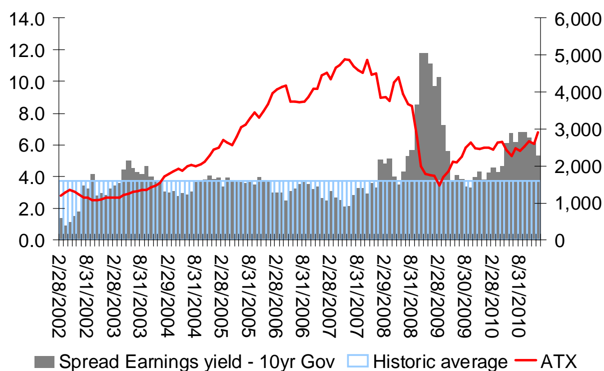
Forward PER vs historical average – ATX



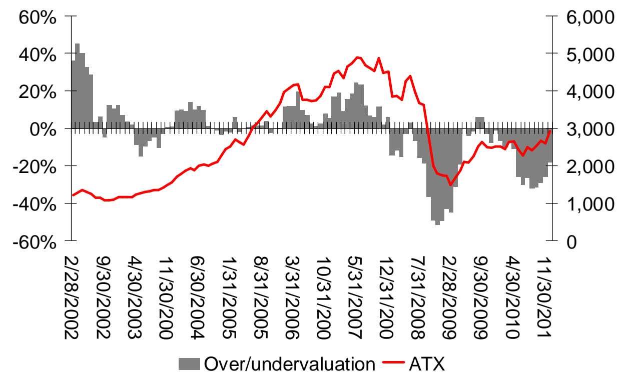
Consensus estimates EPS trend for ATX in EUR



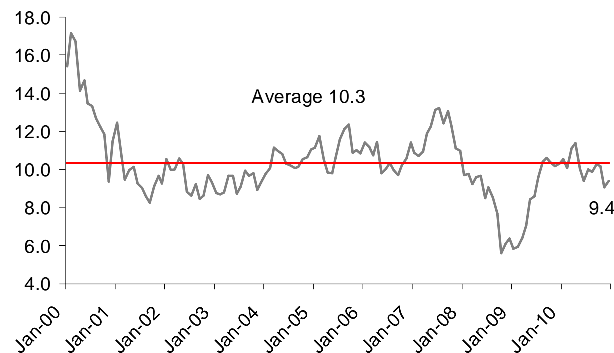
Development of risk premium – ATX



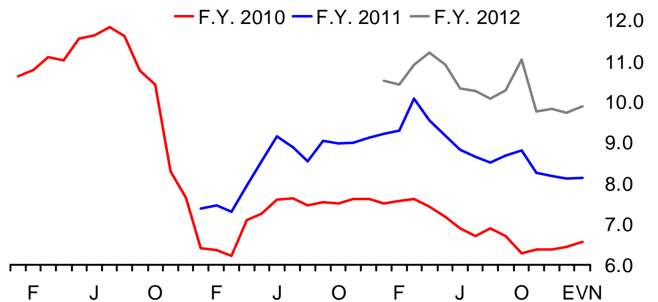
Implied valuation – ATX



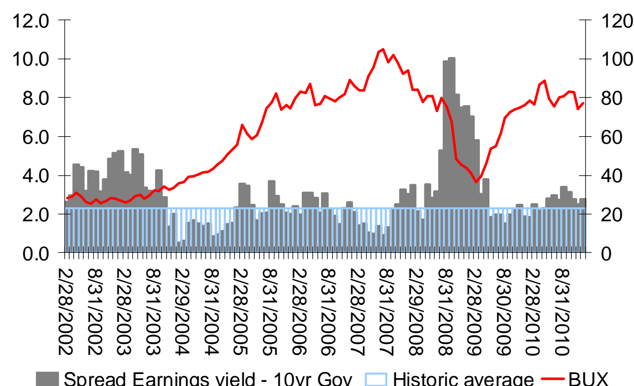
Forward PER vs historical average – BUX



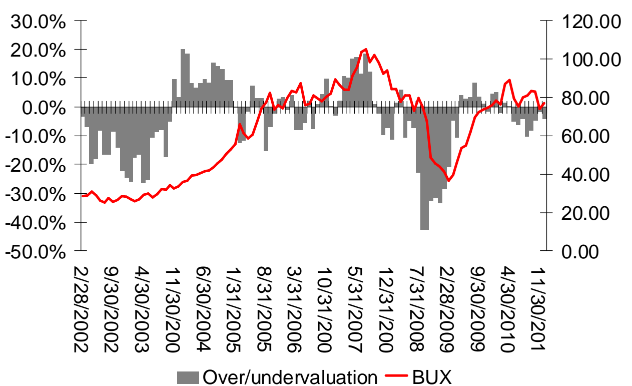
Consensus estimates EPS trend BUX in EUR



Development of risk premium – BUX

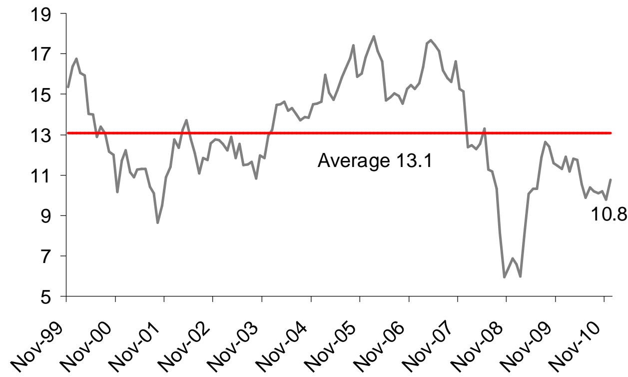


Implied valuation – BUX

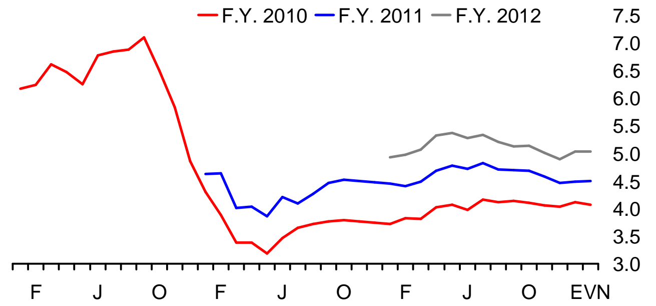


Appendix

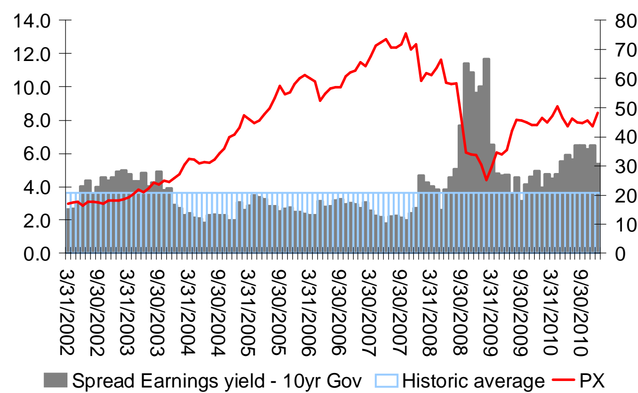
Forward PER vs historical average – PX



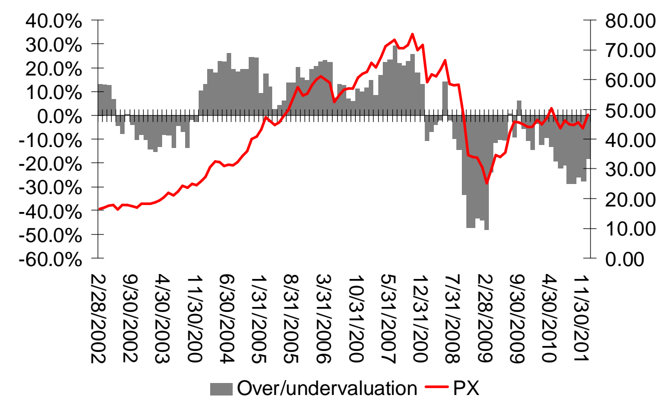
Consensus estimates EPS trend for PX 50 in EUR



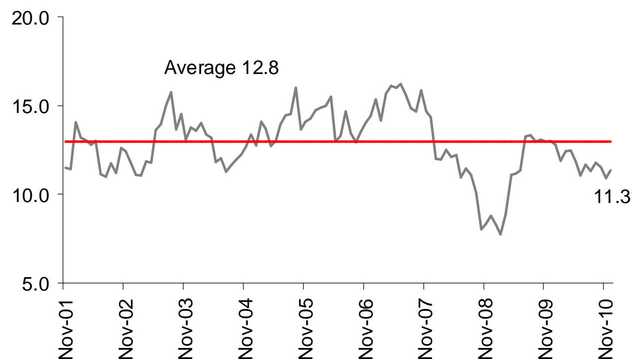
Development of risk premium – PX



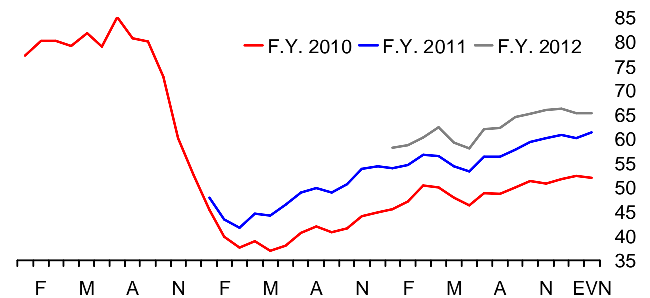
Implied valuation – PX



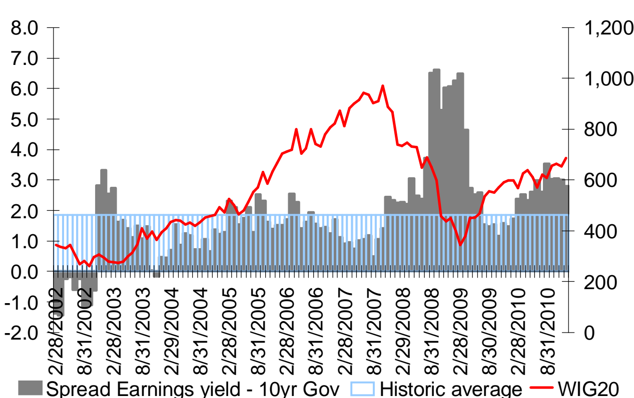
Forward PER vs historical average – WIG20



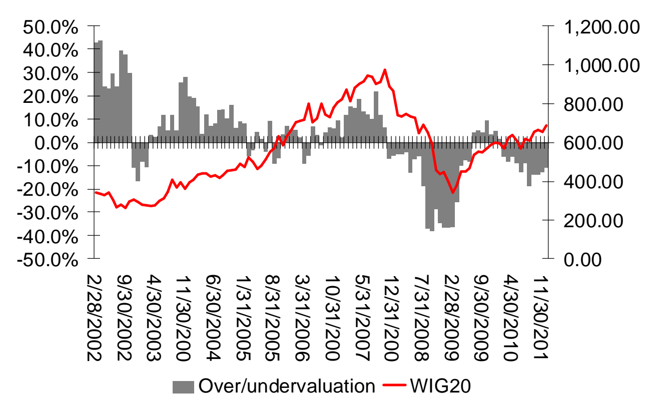
Consensus estimates EPS trend for WIG 20 in EUR



Development of risk premium – WIG20

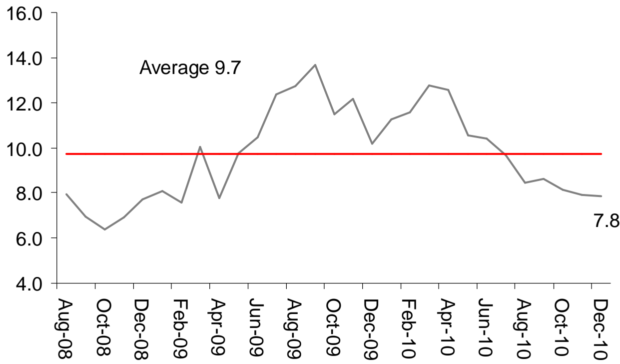


Implied valuation – WIG20

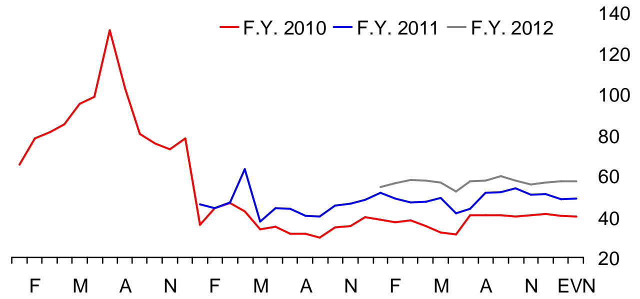


Appendix

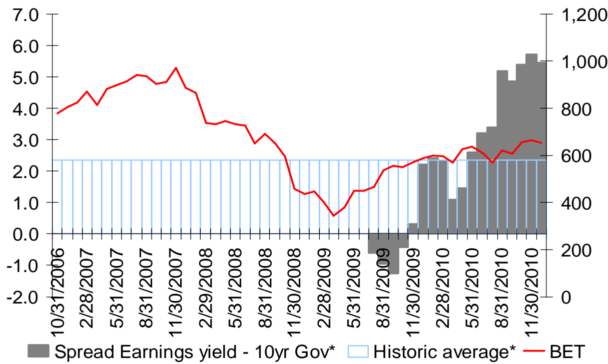
Forward PER vs historical average – Romania



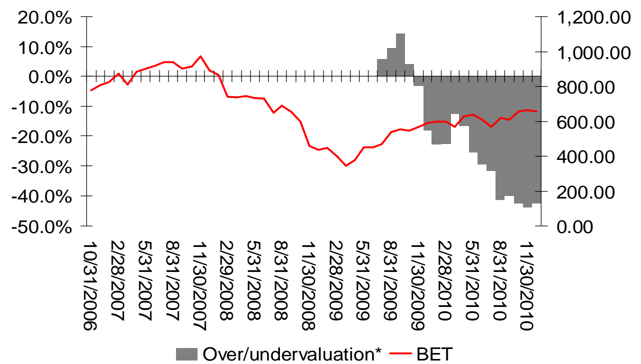
Consensus estimates EPS trend for RO in EUR



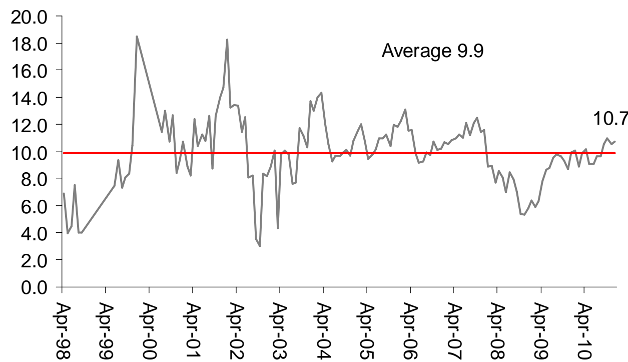
Development of risk premium – Romania



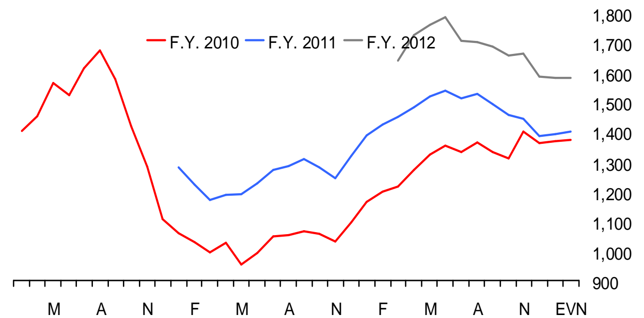
Implied valuation – Romania



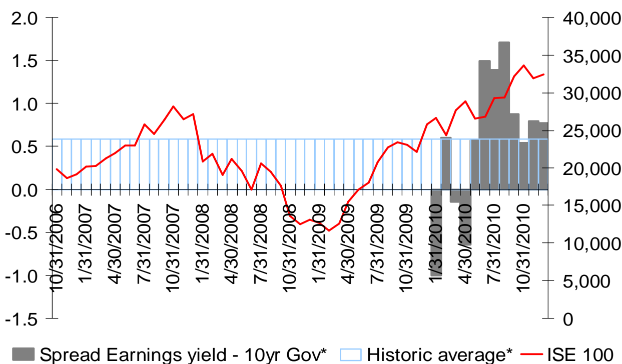
Forward PER vs historical average – Turkey



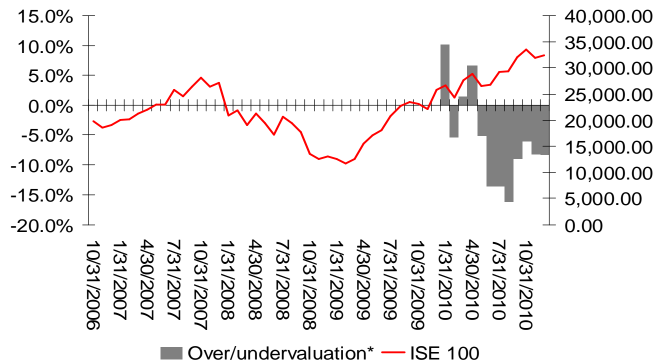
Consensus estimates EPS trend for Turkey in EUR



Development of risk premium – Turkey

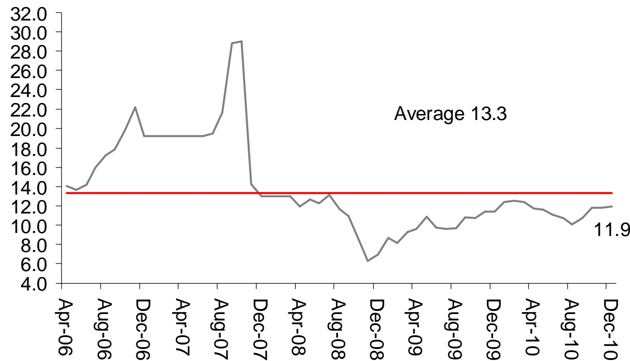


Implied valuation – Turkey

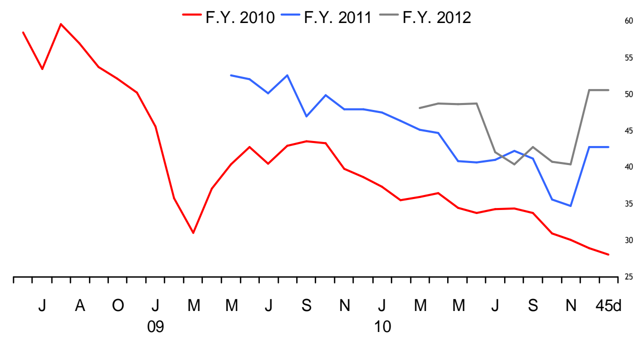


Appendix

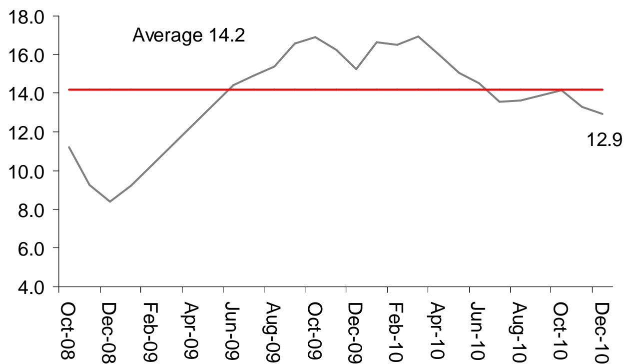
Forward PER vs historical average – Croatia



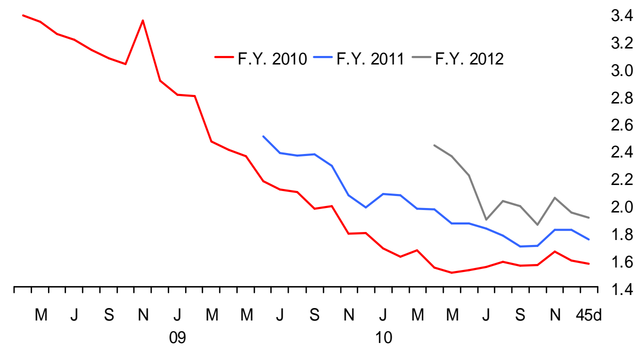
Consensus estimates EPS trend for Croatia in EUR



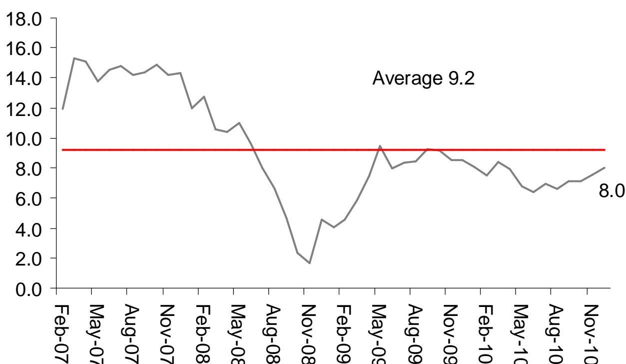
Forward PER vs historical average – Slovenia



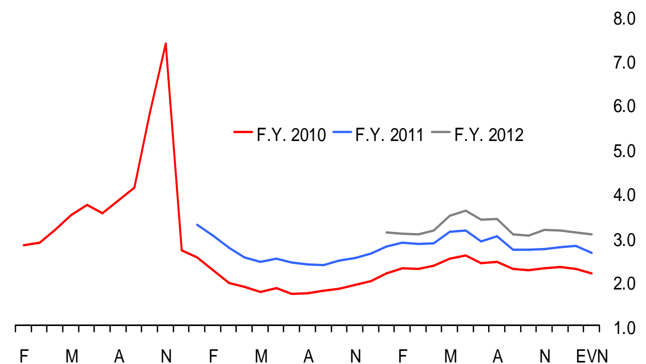
Consensus estimates EPS trend Slovenia in EUR



Forward PER vs historical average – Russia



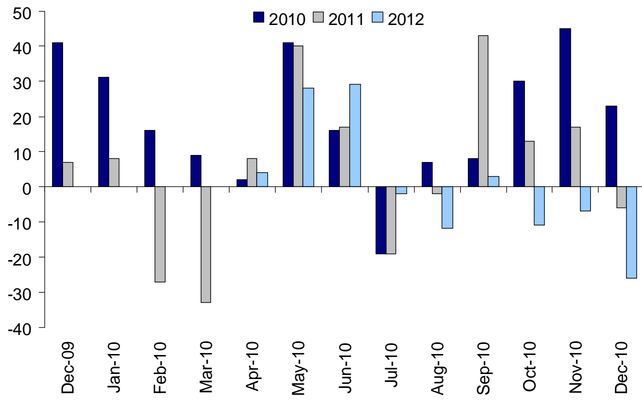
Consensus estimates EPS trend for Russia in EUR



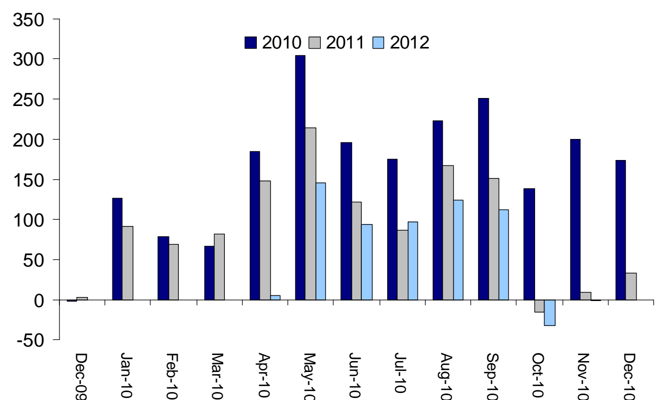
Source: Factset, Erste Group Research

Appendix

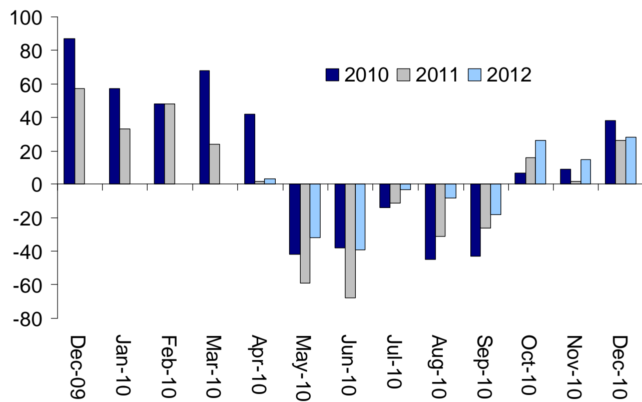
EPS revision rate CEE



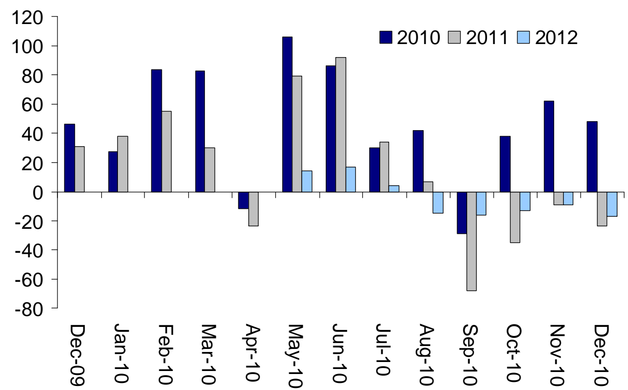
EPS revision rate EuroStoxx 50



EPS revision rate Russia



EPS revision rate Turkey



Source: Factset, Erste Group Research

Appendix

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