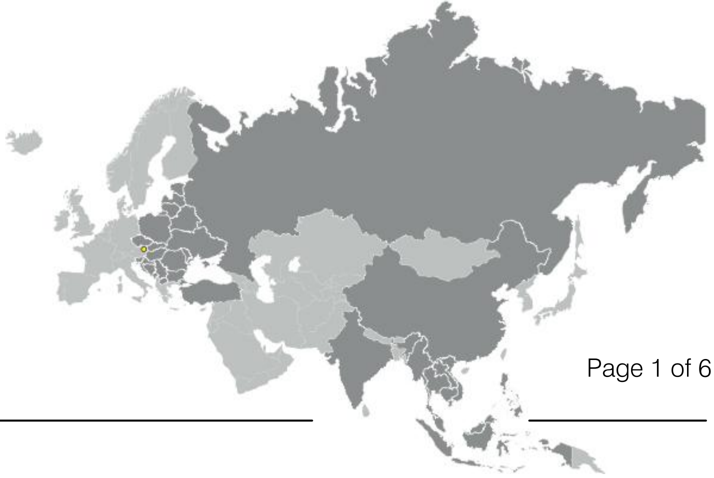
February 2011

Current capital market report on the Emerging Markets

emreport



Regional overview

Rising inflationary pressure especially in the Emerging Markets as a result of increases in commodities prices and booming economies

Political unrest in North Africa could spread to other countries and regions

The financial markets were influenced by a range of issues in January. The debt woes in the Eurozone essentially remain unsolved, the financial problems among states and municipalities in the US are intensifying and the ever growing increases in commodities prices are leading to rising inflationary pressure, especially in the Emerging Markets (EM). The latter also plays a major role in the unrest that has recently flared up in North Africa, where widespread protests are threatening to topple regimes that have been firmly established for decades. Although the flight of the Tunisian dictator hardly had any effect on financial markets outside of Africa, the spread of the protests to Egypt, which until now was considered to be quite stable, could have a much greater impact over the medium to long term. On one hand, this threatens to drastically change the already very fragile balance of power in the Middle East, and on the other, countries that are much more important from a global standpoint – such as Saudi Arabia – could get caught up in the protests. The potential effects on oil prices and the world economy would be enormous. However, it remains to be seen whether this type of domino effect will actually come to fruition. In any case, the potential political turbulence in Asia should not be underestimated either, especially if rice prices continue to increase dramatically.

Developed equity markets largely unimpressed by unrest, inflation worries and interest rate hike

Emerging Markets weaker than established markets for the fourth month in a row

With the exception of the regional African markets and, to some extent, the Southeastern European markets, the global equity markets have hardly reacted to the developments in North Africa so far. On one hand, the risks are apparently still considered to be low at the moment, and on the other, the liquidity that is being pumped into the financial system on a massive scale primarily by the US Federal Reserve is driving stock prices up even further. These price gains are also being attributed to the relatively strong US purchasing managers indices. Naturally, the question is how much longer the extremely high profit margins currently being enjoyed by companies will be able to stand up against rising commodities prices – and against the inevitable strong dampening effects of the discontinued government stimulus programmes that will set in sooner or later. So far, the equity markets have been equally unimpressed by the continued increases in long-term interest rates, which in turn largely reflect the rising long-term inflation worries of many market participants. Fed chairman Bernanke clearly still does not see any danger of inflation – and is blatantly ignoring food and energy prices along with the potential global distortions triggered by his increasingly aggressive policy of printing money.

Recovery for government bonds from euro peripheral countries

The unrest in North Africa has pushed the problems in the euro peripheral countries into the background for the time being. Although the underlying problems of excess public debt in the Southern European peripheral countries and Ireland as well as the massive economic imbalances within the euro area still remain, risk premia for the PIIGS countries fell considerably in January. It remains to be seen whether this will last.

CEE economies, in particular Poland and the Czech Republic, continue to show signs of robust recovery, and Hungary delivered surprisingly positive economic data as well. On the other hand, the economic situation in Turkey has turned somewhat gloomier of late, especially because the country is relatively close to the region being affected by the unrest in North Africa.

CEE bond and equity markets produce differing results in January

The CEE equity and bond markets exhibited very different developments in January. The improved risk sentiment among investors benefited the Czech koruna in particular, but the zloty, forint and ruble posted gains as well. In contrast, the Turkish lira experienced negative development after the central bank once again cut the key rate while at the same time raising the minimum reserve rates in order to curtail lending. Yield premia for Eurobonds in the region largely trended sideways before climbing somewhat at the end of the month.

Country focus

China

China grew by 9.8% in real terms in the fourth quarter of 2010, which was much higher than the market's expectations. Both foreign trade and domestic demand contributed to this growth. Since the first quarter is traditionally the strongest quarter in China, any potential economic downturn will not materialise for a few months. Therefore, the debate surrounding whether China is overheating remains acute. Both the money supply (+19.7% in December) and the volume of lending beg the question of whether the central bank's monetary policy measures are having any effect at all – and whether the bank is really pursuing a more restrictive monetary policy. The inflation rates eased slightly December. As a result of lower vegetable prices, the consumer price index "only" rose to 4.6% (November: 5.1%), while core inflation (excluding food and energy) climbed to 2.1%. This must be qualified by pointing out that anecdotal reports indicate much stronger price increases and that the weighting of the food components in the consumer price index was reduced in December. The drastic increases in minimum wages (by roughly 20% within a few quarters) also suggest that the cost of living is increasing much more than is being admitted officially and in practice will lead to correspondingly high second-round effects among wages. On the whole, this is probably positive for the domestic economy, but it does not bode well for the majority of exporters.

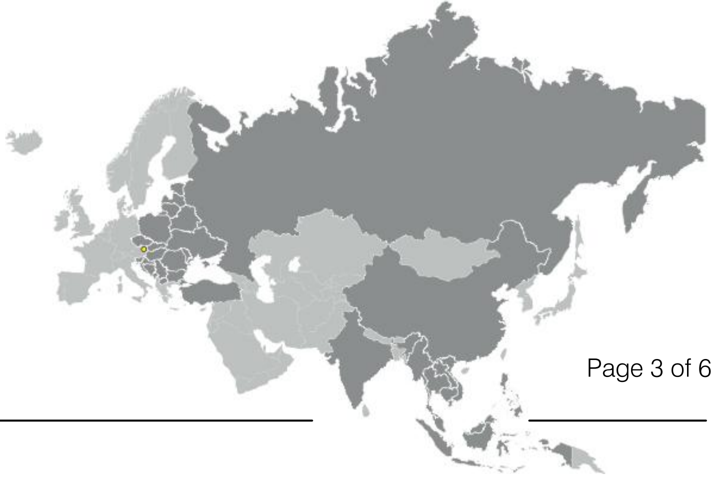
Persistently high economic growth

Money supply and lending also show considerable increases – inflation worries remain

China's equity market is still not keeping pace with the price gains on the established markets. Despite the relatively favourable valuations compared to the other Emerging Markets in the region, Chinese shares are still unable to gather any upward momentum. The tensions on the Chinese equity market will likely remain, and the below-average performance will continue in the coming months as a result.

India

Economic growth in India continues to develop well. After a mild easing in the autumn, the inflation situation is already starting to intensify again. This prompted the central bank to hike interest rates for the seventh time in a row – this time to 5.50%. The inflation worries are being



triggered by the increase in prices for agricultural commodities and food, which are naturally strongly weighted in the basket of consumer goods in the Emerging Markets. The rising oil prices are also very negative for India's economy. It seems clear that the central bank will not be able to solve these supply-side inflation problems with its interest rate hikes. Instead, the interest rate hiking cycle should be viewed in light of the fact that the Indian economy is growing above potential. Strained capacities are leading to second-round effects and a general rise in the price level. Therefore, interest rate hikes should also lead to a stabilisation of inflation expectations. Additional interest rate hikes are a certainty, and will come at the latest at the next central bank meeting in April. The market is currently pricing in an additional 2.0% in interest rate hikes on a one-year horizon. As a result, the monetary environment will likely remain negative for the bond segment for the foreseeable future.

Inflationary pressure on the rise again – another interest rate hike from the central bank

Hefty correction on the Indian equity market

The Indian equity market has been in the midst of a hefty correction since the beginning of the year. It lost nearly 11% in January, and both large caps and small caps were hit equally hard by this trend. After spending 2010 as the darling of foreign investors and attracting large sums of foreign capital, India is now experiencing profit-taking and a portion of this capital is being withdrawn. As is to be expected, several financials and real estate names came under especially strong pressure. The best long-term opportunities are still probably to be found amongst small and medium-sized companies, many of which are trading at fairly attractive levels again and still offer very good earnings growth. Nevertheless, the correction on the Indian equity market may continue over the coming weeks.

Brazil

Interest-sensitive stocks under pressure – the threat of additional interest rate hikes and weaker economic data are putting a damper on things

In terms of economic developments, inflation worries and the fear of interest rate hikes remain the key issues. To make matters worse, the most recent economic data came in surprisingly low (even indicating shrinking industrial production!), while the inflationary pressure persists. As expected, the central bank increased interest rates by 0.50% to 11.25%. During 2011, the key rate could rise to around 12.5%.

The equity market closed January with a loss of roughly 4%. As a result, names sensitive to interest rates (banks and real estate companies) as well as providers of consumer goods (which are often purchased on credit) were the worst performers. Commodities stocks, on the other hand, performed well for the most part. Most Brazilian stocks are still looking very overvalued. Without Petrobras and Vale, whose valuations are relatively low, the price-earnings ratio for the overall market would be much higher. Accordingly, the equity market has already priced in a good deal of positive expectations, and the remaining upside potential appears quite limited, at least over the short term.

Russia

Inflationary pressure continues to rise in Russia – consumer prices increased at an annual rate of 8.8% in December (November: 8.1%). Although the central bank once again left the key rate unchanged at the end of January, rate hikes are expected before too long – the increase in bond yields clearly reflects these expectations of rising interest rates.

Russia is profiting from rising oil prices, but inflationary pressure is mounting

On the back of rising oil prices, the Russian equity market posted strong gains at a relatively high level of turnover. Oil and gas stocks were in particularly high demand, especially because an agreement between the Ministry of Energy and the Ministry of Finance regarding the taxation of these stocks appears to be imminent. Integrated steel stocks and coking coal manufacturers, which benefited from a temporary shortfall in the Australian supply due to the floods, also posted handsome price gains. Gold mines, food retailers and telecommunications stocks were among the losers.

Turkey

Robust growth continues, but the unrest in North Africa and capital outflows are dragging the Turkish financial markets down

According to the central bank's estimates, the Turkish economy grew by over 8% in real terms in 2010. The budget deficit is expected to come in lower than the government's mid-year estimate. However, the central bank's inflation outlook was revised upward, primarily due to a change in the assumptions about the development of food and oil prices. Although the central bank once again lowered the key rates in January, it raised the minimum reserve rates for banks at the same time. With this measure, the central bank aims to lower the amount of short-term investment capital in the financial system and mitigate foreign trade imbalances through a weaker currency. The Turkish lira was once again the weakest currency in the region in January. At the same time, drastically rising yields (falling bond prices) were observed for Turkish LCY bonds.

Stock prices on the Istanbul Stock Exchange fell in January, and financials in particular came under pressure. The escalating situation in Tunisia and Egypt accelerated the decline in prices. As in December, foreign investors were on the sell side.

Poland

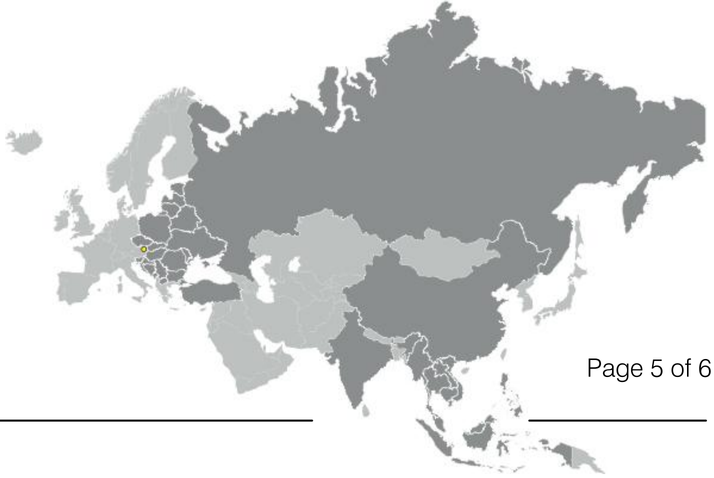
Poland's economy is still in good shape

First interest rate hike since the global economic crisis

Additional interest rate hikes expected in 2011

Poland's economy is still proving to be very robust – growth is expected to come in at 3.8% in real terms for 2010. Industrial production grew at a pace of around 11.5% yoy in December. This growth is still being powered by higher domestic and foreign demand, but it failed to match the market expectations of around 11.9%. Inflation recently rose to 3.1% yoy, moving even higher above the central bank's target. As expected, this led the central bank to raise the key rate from 3.5% to the current level of 3.75% – the first interest rate change since mid-2009. During 2011, however, the bank's monetary policy will likely become even more restrictive and interest rates will be raised. Prices for Polish government bonds came under pressure in January, while the zloty profited from the prospects of higher interest rates.

The Polish stock index WIG lost around 1.4% in January. At the end of January, the Polish government raised the upper limits for equity investments by pension funds. This will likely soften the negative effects of reduced pension contributions. However, the potential for a market



overhang caused by additional privatisations on the part of the government is also putting pressure on the market.

Czech Republic

The Czech economy is still rebounding strongly, supported mainly by robust foreign demand, especially from Germany. Imports and exports still show high growth rates compared to the previous year. Industrial production showed a surprisingly strong increase in November – much like in Hungary. Inflation rose slightly again to 2.3% annualised in December. However, the "core rate" (excluding food and energy prices) came to just 0.3%. In January, yields on Czech bonds once again tracked the underlying developments in EUR benchmark bonds (Germany) and trended higher over the month. The Czech koruna was the strongest currency in the region in January.

Following a period of strong gains, the Czech equity market took a breather in January, rising by around 1%.

Hungary

Surprisingly strong economic data

Central bank raises interest rates for the third time in a row

Hungary surprised the market with unexpectedly strong industrial production data for November, which led all market observers to revise their growth forecasts for 2010, 2011 and 2012 upward. The forint posted gains against the euro, and even stronger gains versus the Swiss franc – the first good news for foreign currency borrowers in quite some time. Over the long term, the level of Hungarian yields still looks attractive. Nevertheless, prices will remain volatile, particularly in light of the persistent lack of clarity about future reform plans and the tensions between the government and the central bank. The latter once again hiked interest rates by 0.25% to 6% – an understandable move in the face of rapidly rising inflation. Inflation increased by 4.7% yoy in December; the "core rate" (excluding food and energy) advanced by 2% (July 2010: 1.3%).

The Hungarian equity market was the strongest in the region in January, posting a gain of 6.5% as stock prices were ignited by the surprisingly positive economic data.

CEE peripheral markets

The political situation in Romania has eased over the past few months; the reforms ordered by the IMF are being implemented, so there is nothing standing in the way of the next tranche. The Romanian government published its refinancing plans and is looking to tap the Eurobond market as a source of financing more often in the coming years.

Yield premia on Eastern European Eurobonds trended sideways for most part during the month. They increased somewhat towards the end of the month as a result of the protests in North Africa and the Middle East. From a long-term perspective, the current levels still look attractive. Nevertheless, volatility will likely remain high, thanks to the nagging uncertainty about debt in the peripheral Eurozone countries.

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