Global overview

Almost all EM equity markets posted more steep price declines in September

Problems include the global slowdown in economic activity, fears of recession in the USA and Europe, and the Eurozone debt crisis

Prices on the Emerging Market (EM) and the developed country stock exchanges continued to fall in September. It appears that the global economy is experiencing a broadly synchronised slowdown in activity, and many international financial institutions and analysts have lowered their global growth forecasts for 2011 and 2012. The likelihood of a recession in the USA, the EU and Japan has increased sharply. By contrast, economic growth in most of the Emerging Markets should remain in positive territory, but will also weaken tangibly. In relation to China, there are more and more observers who are worried about a “hard landing” for the world’s second largest economy. So far, however, the economic data from China are not showing any signs of this. Nevertheless, if there is a steep decline in Chinese economic growth, many of the other Emerging Markets would be threatened with significantly lower economic growth as well. The commodity markets held up relatively well in the summer months, but the deterioration in the global growth prospects in September then led to some sharp price declines, in particular for industrial metals. This may lead to tangible easing in inflation in the EM in the coming months and could also allow the central banks and governments in the EM to take stronger economic stimulus measures if necessary. Consequently, we still believe that most of the Emerging Markets are well prepared for a global economic slowdown, thanks to their improved financial resources and their strongly growing domestic markets.

European banking system under increasing pressure; still no sign of credible solutions on the horizon

The persistent uncertainties in relation to the Eurozone debt crisis are having a stronger and stronger impact on economic performance in the Eurozone and the global economy. The European banking system is exhibiting increasing signs of stress, and some of the indicators in this regard are already at or higher than the levels seen around the Lehman Brothers collapse at the end of 2008. In contrast to autumn 2008, there is very little support from the state now, and indeed this is actually part of the problem in many respects. The conflicting interests within the Eurozone are obviously strongly limiting the ability of the governments to take action. As a result, there is still no credible plan to effectively put an end to the crisis. Instead, policymakers seem to be hoping that the ECB will be able to stabilise the situation for the time being and prevent any further escalation. Italian and British banks were downgraded by the rating agency Moody’s, either because the relevant country rating had been previously lowered (Italy) or because the agency postulated less willingness to provide public sector aid to the banks in the event that such became necessary (Great Britain). The EU stress tests for banks carried out in the summer are turning out to be more and more of a farce. The major Belgian-French bank Dexia, which allegedly passed the stress test without any problems, is now on the verge of collapse and will be rescued by the Belgian (and French) governments. Considering that the bank’s balance sheet total amounts to well more than one and a half times Belgium’s economic output, a bail-out on this order of magnitude may result in some deterioration of Belgium’s sovereign rating. At present, it is unclear how the governments in the Eurozone wish to stop this vicious spiral. In any case, the US finance minister felt compelled to propose that the Europeans significantly expand the EFSF stability fund and, if necessary, take on considerably more debt. This proposal, of course, comes as no surprise, as the USA – the world's biggest debtor – has "solved" its debt problems again and again by simply racking up new debts. But since this approach ultimately leads to cranking up the money printing presses and thus entails significant long-term inflationary risks, there is currently still strong resistance to this "solution", especially in Germany. On the other hand, an EFSF of several thousand billion euros refinanced by the ECB may look like the "cheapest" solution and be seen by politicians as an attractively simple "solution", which may at least save them the headache of some very unpopular measures for a while. Accordingly, if the situation deteriorates even further it is certainly conceivable that policymakers may resort to this option. Of course, this "solution" does not actually solve anything, but then neither does constantly raising the US "debt ceiling" which actually has no real meaning left at all.

Will the Euro stability fund be increased massively?

Country focus

China

As the risks threatening economic activity increase at the international level, the risks in China are also mounting, although this is not visible in the data developments right now. In terms of inflation, the high point has probably been passed. At the same time, the last consumer price inflation reading of 6.2% yoy was well higher than the central bank's target, which is set at 4.0% (but is only taken as a guideline). More progress continues to be made in internationalising the yuan. The latest plan of the Chinese government authorities is to create a CNY-denominated fund which undertakes investments abroad but also extends loans. This is yet another attempt to raise the yuan's profile as an international currency. The range of fluctuations on the Chinese equity market is enormous. Ups and downs of 4% to 6% on a daily basis are not unusual. The close correlation with the established markets is clear to see. The Chinese equity market will only be able to embark on a positive trend again when the situation and developments on the international markets calm down and support a soft landing for the Chinese economy. The fluctuations in prices are mainly driven by banks and real estate companies. The former are suffering from pressure due to worries about higher defaults on loans, while the later are under pressure due to falling sales and fears about financing bottlenecks in the future. In general, the real estate sector is one of the areas where some market observers are expecting a significant decline in prices in China, and this in turn could act as a brake on the economy. It remains to be seen whether this will actually happen.

Chinese central bank facing increasingly difficult decisions between fighting inflation and the threat of a major economic slowdown

India

Volatility is also very intense on the Indian equity market. The acute risk aversion on the international markets has clearly led to outflows of capital from India (as well as other markets), and this has also resulted in pressure on the Indian rupee. Speculations about restrictions on capital flows, however, were immediately denied. Along with the international worries, inflation also continues to be a problem in India. No easing in the situation is expected in the immediate future. India continues to struggle with high food and fuel prices. Moreover, wage growth is running at 12%-15%, which is the highest in the Asian region, and the latest depreciation of the rupee also means that imported inflation is on the rise. The latest rate hike to 8.25% was nevertheless probably the last one, as the risks to the economy have also increased substantially. Accordingly, by the end of the year it is quite likely that the wholesale price index will slip to below the 8% mark and the next rate cut will be priced in. This could generate some material support for the equity market.

Inflation continues to be the main problem for the Indian economy

Brazil

Growth expectations for 2011 and the following year have been lowered further, and most analysts are now expecting the real increase in Brazilian GDP to fall well short of 4% in both years. The Brazilian currency has also lost ground massively against the US dollar again and this finally prompted the central bank to intervene and sell USD to support the Brazilian currency. This stands in sharp contrast to the situation in the spring and summer of this year, when the central bank was constantly looking for new ways to foil further appreciation of the Brazilian real. In the midst of this, share prices of exporters have been able to buck the general trend on the stock market and bounce back slightly, after having suffered from the strong national currency in the past months. Nevertheless, most Brazilian shares slid substantially lower in line with the international trend. Commodity sector stocks lost ground in particular, as commodity prices tanked, along with consumer sector companies and real estate stocks.

Brazil's central bank intervenes to support the real

Russia

Russia's economic recovery continues to lose momentum as the economy only grew at a rate of 3.4% yoy in Q2 2011, versus 4.1% in Q1. Industrial production held up better than expected recently, but further weakening is anticipated here too in the months to come. There were two major developments on the political scene in Russia: first, it appears that the Putin-Medvedev merry-go-round is functioning. Ex-President and Prime Minister Putin will be campaigning for the office of President in 2012 and incumbent President Medvedev will be switching back to his old job as Prime Minister. Second, Finance Minister Kudrin surprisingly lost his job, after explaining that he did not want to work under Medvedev as PM and criticised the planned increase in military spending. This triggered some pressure on Russian bonds and equities. Russia's strongman, Vladimir Putin, is thus losing a very experienced Finance Minister and one of his close confidantes as well, who always stood up for a relatively conservative budget policy. Time will show what direction the budget developments take in Russia. In this regard, the other major uncertainty factor for Russia is the development of oil prices, of course. If oil prices fall even more sharply, Russia's budget deficit will turn out to be much higher than

Putin to run for president, surprising resignation of Finance Minister Kudrin

planned. Due to the current market turmoil, it is also possible that the targeted privatisation efforts will be strongly hindered or at least delayed. The rouble weakened substantially against the euro-US dollar currency basket in month-on-month terms; the resignation of Finance Minister Kudrin was a negative factor, along with falling oil prices. In this environment, prices of Russian bonds also fell, while yields increased strongly in September. Russia's equity market, measured in terms of the MICEX, lost another 12%. With this, the market has lost nearly 20% since the beginning of the year. Once again, banks and mining stocks were very weak in September. Precious metal producers held up relatively better again, although they also suffered from the falling prices of gold and silver. Oil&gas stocks also did mildly better than the market as a whole, even though the planned tax reform in the oil&gas sector was less than the market was anticipating.

Falling oil prices could lead to a significant rise in the Russian budget deficit; tax reforms in the oil&gas sector turns out to be disappointing for the sector

Turkey

In Q2 2011, the preliminary Turkish economic growth rate amounted to 8.8%, which was far higher than the anticipated level of 6.3%. In September, the rating agency S&P raised the rating on Turkish LCY bonds to investment grade level for the first time ever, but Turkish bonds denominated in foreign currencies were not affected by this. Turkish bonds temporarily profited, but then lost ground sharply on the whole for the month, as a result of the steep rise in risk aversion triggered by the escalating Eurozone debt crisis. The biggest challenge for the country continues to be the very high current account deficit. Recently, however, some improvement has been seen in this regard, and the relatively intense depreciation of TRY this year should also be beneficial. Inflation was surprisingly unpleasant again, mainly due to higher import prices following the intense weakening of the lira in recent months. If economic dynamics in Turkey's key trading partners deteriorate tangibly in the months to come, the central bank has some leeway for further rate cuts even if inflation remains slightly higher.

Turkish economic growth was stronger than expected

The ISE-100 stock index for the Istanbul exchange was one of the only stock indices in the world to post a gain in September, with an increase of around 8%. But as the Turkish lira continued to slip at the same time, non-resident investors had little left to enjoy from this gain.

Turkish equities post gains in September, bucking the global trend

Poland

Poland was the only country in the region to maintain positive economic growth during the economic crisis in 2008/09. One of the main factors behind this was the relatively strong fiscal countermeasures taken by the Government. In light of the current debt situation in the country, however, the leeway for a higher budget deficit looks considerably narrower in the future. Accordingly, it does not look like Poland will be able to once again avoid the developments affecting the region. And the outlook for the region itself has clouded over even more. Industrial production and retail sales in Poland were once again surprisingly strong however. In the months to come though, economic activity will taper off and the leading indicators are clearly pointing to a slowdown. During the previous month, the year-on-year rate of inflation rose slightly more

PLN under pressure; central bank intervenes on the FX market strongly, but inflation is currently not one of the main worries for market participants. As investors' risk aversion shot higher, Polish bonds and the zloty lost ground massively. The central bank intervened to arrest the decline of the currency. If this downward trend continues, one can expect to see further measures to strengthen PLN, because if the exchange rate versus the euro weakens too much, the FX debts will rise to very unpleasant levels for the Government. According to the Polish constitution, if debt exceeds 55% of GDP (and it is currently just barely lower than this level), budget consolidation is required, and given the current conditions, the Government is naturally not interested in this.

Poland's WIG20 index dropped by around 11% in September. Weak performance was registered for miners and construction firms, whereas most of the utilities and telecoms performed better than the market average. Bank stocks moved roughly in line with the market as a whole in September, after putting in a relatively strong performance in the previous month.

Czech Republic

The Czech Republic is still a kind of anchor of stability in the region. Exports and imports remain robust right now, but leading indicators are pointing to a mild slowdown, and thus economic dynamics are expected to fade in the coming months. At the same time, compared to Poland the Czech Republic would be much more severely affected by a slump in demand from Western Europe, in particular since Czech domestic demand still shows no signs of recovery. In early September, parliament passed an increase in VAT and significant cuts in social spending to reduce the budget deficit, and these are measures which are hardly likely to boost the domestic economy. Inflation developments have been surprisingly benign, with the annual rate recently falling to +1.7%. With this, inflation is back within the tolerance band of the central bank, and thus there is no pressure on the monetary authorities to take measures in this regard. Accordingly, the central bank can concentrate on economic conditions and in the event of a more pronounced slump in the growth prospects, a rate cut would even be possible. Right now, the key rate is still at the record low level of 0.75%. The Czech koruna was weaker in September and Czech bond prices also slid lower.

In line with the negative global trend, the Czech stock market also lost ground, posting a decline of another 11%, similar to what was seen in August. Telecoms performed better than the market average, whereas some financials saw prices plunge lower.

Hungary's Government takes controversial measures to relieve pressure on FX borrowers

Hungary

Economic activity in Hungary has weakened significantly in recent months. During the second quarter, growth merely stagnated, dragging down the rate for the year as a whole to just 1.5%. Clearly, there has been a sharp decline in the robust external demand, which was a major factor behind Hungarian GDP growth early in the year. The manufacturing sector purchasing managers' index, however, rose in a surprising move, edging up to 50.8 points, with readings above 50 pointing to expansion. On the other hand, the developments in business sentiment and

consumer confidence hardly provide any grounds for optimism. Inflation was recently surprisingly high, coming in slightly stronger-than-expected at an annual rate of 3.6%. If inflation trends lower in the second half of the year, as projected by the central bank, there would be some leeway for lowering interest rates. Due to the intense turbulence on the market and the weakening forint, however, this would be a difficult path to follow. Amidst the current negative market conditions, the announcement and parliamentary approval of the Government's plans to pass some of the burdens from FX loans from private households to the banking sector, affecting foreign banks in particular, was also not helpful. This once again triggered intense criticism from abroad, and legal and political disputes at the European level look certain to follow. The forint was one of the weakest currencies in the region in September. Prices of Hungarian bonds dropped sharply as investors' risk sentiment plunged lower. Over the long term, the level of Hungarian yields still looks attractive, but over the short term more strong volatility can be expected.

The Hungarian equity market was one of the weakest in the region, with a loss of around 15% in September. Particularly painful losses were registered for the index heavyweight OTP, which had already lost almost a quarter of its market value in August and slipped another 22% in September. The bank suffered from the government's plans in relation to FX loans and possible stricter regulations which could weigh on equity capital and the interest margin.