European Emerging Markets:
2008 - The Most Trying Year on Record for Equities in Eastern Europe

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The last quarter of 2008 proved to be the hardest one for investors in Eastern Europe. Precipitated by the bankruptcy of Lehman Brothers in mid-September, market performance in October and November was nothing short of dismal, hitting risky assets globally. Emerging Europe was no exception as companies sold off to valuation levels unseen in more than a decade. At the same time, tumbling commodity prices put additional strain on countries like Russia, where both the state budget and company financials came under pressure. As elsewhere, credit concerns, albeit still present, started giving way to worries over economic growth and company earnings. In addition, the market failed to stage a meaningful rally even from its extreme low valuations.

At the beginning of the New Year, expectations for risky investments are once again muted as the global economy continues to show no signs of a meaningful recovery and investors remain on the sidelines. Even though 2008 GDP growth was positive in a majority of the region's countries, the slump in the global economy has now reached the Central and Eastern European (CEE) region. Drastic deterioration of EU export prospects is turning into the major channel of contagion. As consumers also retreat, thanks to a combination of slower real income growth, less credit availability, and significant uncertainty, the average GDP growth forecast for the CEE region is 1.5%. This will impact earnings negatively in the first half of 2009; consensus earnings estimates have come down dramatically in the last quarter of 2008.

One positive side-effect of the drop-off in economic activity and commodity prices is the dramatic reduction in inflation. Substantial leeway to reduce interest rates in almost all of the CEE countries is foiled by a fragile development of exchange rates and persistently high levels of risk aversion.

Russia: The precipitous fall in commodities (especially oil) was a huge negative for the market. The oil price lost 75% compared to its peak and so did the stock market. A combination of 70% of index earnings coming from the commodity sector and investor de-risking and de-leveraging has hurt the equity market strongly. Oligarchs received margin calls on their equity stakes using them as credit collateral as they were forced to sell shares into a free-falling market thereby exaggerating the downward move.

On the positive side, Russia has one of the largest foreign currency reserves in the emerging market (EM) world with $426 billion. Fiscal reserves are at $250 billion, providing a good cushion for authorities. Russia has a very low external debt-to-GDP ratio with net debt being at almost zero. Consumption is more resilient than expected, productivity growth in manufacturing is still impressive and the economic returns on investments are higher than in other BRIC (Brazil, Russia, India and China) countries. Most importantly, the price/earnings ratio of the market is below three for this year - the cheapest valuation of all emerging markets (dividend yields of some large caps are above 10%).

Poland: There is mounting evidence that Poland is unlikely to escape the full brunt of the economic slowdown currently engulfing Western Europe due to the severity of the collapse in export markets. Even though the economy grew 4.8% in 2008, it is likely to contract going forward, as the Polish economy recorded its first year-over-year drop of exports in recent history. Corporate profits are also under pressure, especially in the banking sector. Sectors with high sensitivity to exports will likely contract the most.

On the other hand, private consumption is more resilient here than in the rest of the region and substantial monetary easing is expected ahead. Stock market valuations are undemanding historically, at 10 times forward earnings, which represents a 35% discount to their historic median. It has to be noted, however, that this stock market still trades at a premium to its peers.

Czech Republic: A combination of slowing growth and lower inflation has allowed the Central Bank to cut interest rates aggressively, while the country's fiscal position is less strained than in most other CEE countries, allowing more flexibility for fiscal stimulus packages. Plus, there are also no imbalances in the banking system as seen elsewhere in the region.

However, the country's economy is highly exposed to foreign trade, especially with Western Europe, which is having a few growth problems of its own. Domestically, things are not much better. The manufacturing industry (automotive sector) is already seriously hit with the latest data pointing towards weaker-than-expected car sales as a major driver of negative retail sales.

Hungary: The country was one of the more vulnerable major CEE countries going into 2008. The year proved to be one of economic imbalances with account and fiscal deficits, inflation, and household debt coming onto the agenda. The International Monetary Fund (IMF), EU and World Bank came to the rescue with a $25 billion package, partially restoring confidence.

With little room for fiscal and monetary policy support after years of tolerating large imbalances in the economy, all of the sectors of the Hungarian economy are expected to contract in 2009, although the current account balance will likely improve. Growth will also suffer as rampant foreign currency lending to the retail sector in the past as well as currency turmoil will lead to a sharp decrease in lending activities.

Turkey: Recently the outlook for the Turkish economy worsened sharply forcing the Central Bank into action. Two major interest rate cuts of 1.25% and 2.00%, supported by falling inflation, were meant to stop the free-falling economy. If global financial stresses continue, however, Turkey's external funding situation is likely to remain challenging in 2009. An IMF package will be key for the country's economy. Negotiations are at an advanced stage and are expected to be concluded before local elections in March.

The balance of economic risk is likely to improve this year as a result of lower oil prices and fewer domestic imports. The Central Bank's power to cut interest rates might be limited due to the funding situation.

The political situation remains relatively stable after the constitutional court decided against banning the governing ultra-conservative AK Party in July last year.

Outlook

With emerging Europe's equity markets making very pessimistic earnings assumptions, market valuations in the low single digits, and global fiscal and monetary stimulus aimed at re-flating the world economy, it is easy to see a large upside for stocks in the coming years. It is just as likely, however, to see yet another leg of the sell-off, this time driven by concerns over the ailing health of the global economy or (for a change) local news. The convergence "story," while having suffered a set-back, remains pivotal for investors in Eastern Europe, and recent episodes have shown the financial importance of the European Union in the region. Attention, however, should also be paid to signs of market recovery in the US and China, as conditions there are likely to lead the global rebound.

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