

Eastern European Equities Update, June 30, 2009



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Market Comment

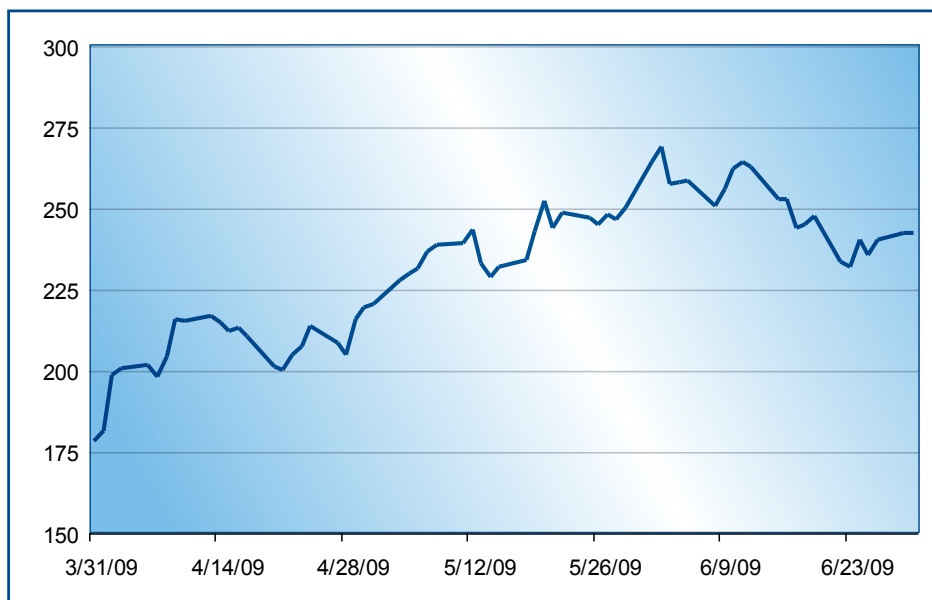
The stock markets in Eastern Europe recovered from their lows and showed strong performance during the second quarter, as signs of stabilization emerged in the financial system and the real economy. The broad Nomura Central and Eastern Europe Index posted double-digit gains over the course of the quarter but consolidated from its interim peak in early June.

The **Russian Equity market** (+35.5%) was the best performing market in our universe until the beginning of June, but sold off before the quarter ended. The second wave of the recovery was driven by domestic stocks as domestic demand remained more resilient than initially expected, thanks to the step-by-step ruble devaluation and the substitution of imports. Much of the recovery in Russian asset prices, however, has been driven by the realization that the risk to the Russian economy was overstated by the market or the market's (mis)perception that the oil price was going to fall much further. In the real economy, most industrial sectors are starting to show signs of growth (although from a very low base.) Seasonally-adjusted data shows that industry is growing, while retail sales are in the process of bottoming out.

It is quite likely that GDP will soon show positive quarter-over-quarter growth in seasonally adjusted terms, although we believe this will be due to the exceptional inventory adjustment. Nevertheless, Russia will be back on a sustainable growth path in the third quarter and Russian stocks offer good value after the recent consolidation.

The **Polish Equity market** (+28.4%) mirrored other Central and Eastern European stock markets and recovered strongly in the second quarter. Among the main reasons for the rally were improving global sentiment and leading indicators as well as the stabilizing Polish zloty. GDP for the first quarter stood at +0.8%, a good number for the expected worst quarter of the year. Economists still expect economic growth of +1% for the full year as Poland's industrial base is well-diversified and less dependent on exports to Western Europe than its neighboring economies. The flipside of the recession is the much faster-than-anticipated adjustment of the current account deficit as imports contract at a

faster pace than exports. The current Polish account surplus for the first quarter is overall supportive to the currency, and has already contributed to a strengthening zloty. The central bank further cut interest rates as



inflation continued to decline, providing further stimulus.

The **Czech stock market** ended the quarter up +26.4%. President Klaus appointed Jan Fischer as the interim Prime Minister (replacing Mirek Topolanek) after Topolanek's minority government lost the no-confidence vote. During the first quarter, GDP declined -3.4%, which should mark the bottom for the Czech economy. It should benefit from stabilization in Western Europe going forward, as more than half of its exports go to the euro zone.

The **Hungarian Equity market** was the best performing equity market within our investment universe and ended the quarter up +56.5%. Some of this strong performance came from the currency, as the Hungarian forint appreciated by 13% after it had been selling off since the beginning of the financial crisis. Gordon Bajnai was appointed as the new prime minister after the resignation of Ferenc Gyurcsany. The new government released a detailed action plan for the next twelve months identifying five priority areas: short-term crisis management, stabilization, economic growth stimulus, restoring confidence and the country's euro zone entry.

The **Turkish Equity market** continued its strong performance and finished the quarter up +46.4%. First quarter GDP fell a sharp -13.8%, much worse than expected due to sharp declines in household spending and investments, which were only partially offset by a 5.7% rise in government spending and a better external balance. The deeply negative GDP print raised doubts about the potential of an inventory restocking impulse to help the economy. The Turkish central bank continued to lower its benchmark rate, which now stands at 8.75%. This has been of great help to commercial banks, as it has led to a significant expansion in their net interest margins.

Investment Review

A consolidation of stock markets was expected and necessary after the strong rebound since March. We expect choppy stock markets over the next few weeks until real economic evidence underpins an economic recovery in the second half of the year. Further "green shoots" will not be enough to drive stock markets higher from current levels. We will stick to a larger cash position in the next weeks to be ready to pick up some shares which offer good value and should re-rate as soon as the operational fog dissipates.

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