Metzler Payden

Research

Emerging Europe Q&A

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1 Is Emerging Europe still attractive?

We believe it is. The structural growth and convergence story of Emerging Europe remains unchanged. The stock market correction was a result of exogenous shocks (for example, the Lehman bankruptcy) rather than the result of an endogenous problem with the Emerging Europe story. The notable exceptions to this are the Baltics, where overinvestment and rigid monetary policy created a bubble, and Hungary, which, due to its fiscal imbalance going into the crisis, was prone to suffer the most once economic conditions worsened.

Short-term, we also believe we are at the beginning of a new economic cycle, which has benefitted emerging market stocks significantly in the past.

Even though stocks in the region are up significantly this year, we still need another +90% rally to reach the 2008 highs. It has to be noted, however, that gains of this magnitude could require years of solid economic growth.

2 What countries & sectors do you currently favor?

We currently prefer Russia and Poland, although the portfolio is relatively well-balanced between the commodity (inflation) "play" in Russia and the convergence "play" in Emerging Europe. On the sector side, we like exposure to the industrial and construction sectors in the entire region, as well as real estate (but mainly in Russia), and after a correction, banks as well as energy and commodity-related companies. From a style perspective, we see substantially more upside in mid- and small caps than in the blue-chips of the region in the medium term (2-3 years).

3 How do you feel about Russia's political situation?

We see the political situation in Russia as stable at this time. Putin's and Medvedev's domestic agendas are well-known: they declared their willingness to a) further open up the economy, b) diversify away from the strong dependence on oil and gas, which is a very difficult task, and c) fight corruption because they understand that this is the biggest barrier to completing sorely needed projects. Corruption is indeed a significant problem. However, it is not limited to Russia but also an issue in many other Emerging European economies as well as in Asia and Latin America. This, however, is not news and we believe it is largely accounted for (i.e. stocks are already trading at a discount to reflect this).

On the foreign policy side, relations with the U.S. have improved under the new administration. Russia also has a lot more say in international affairs as a G8 member and a recognized nuclear power compared to other major emerging markets.

4 Are Central & Eastern Europe's banks healthy?

Third-quarter earnings confirmed our view that the Eastern European banking system was never at risk of total collapse. Even though non-performing loan (NPL) ratios have moved up (OTP Bank (Hungary) NPL was 7.4%; Erste Bank (Austria): 6.3%; Polish banking sector: 6.6%), this is an expected development in a major recession and we expect NPLs to peak in Q4 of this year. It is important to note, however, that funding for loan growth will remain a challenge for banks with a Western Europe-based parent, as well as for banks with a limited branch network. Growth may be depressed in the short term as a result.

5 Is this region attractive vs. Latin America and Asia?

Emerging Europe as a single region has three strategic investment themes: 1) **Energy/commodities** (due to Russia's energy and metals dominance), 2) **Convergence** (due to the support of the European Union), and 3) **Outsourcing** (due to cheap Emerging Europe wages and low taxes). Even though Asia and Latin America have some of the aforementioned themes, Emerging Europe is the only region where investors can be exposed to all three.

The importance of the European Union should not be underestimated. Together with providing significant financial resources to its newly-acceded members (in Poland, for example, EU assistance will amount to about 3.2% of GDP for the next five years), the EU has mandated the creation of a unique political and legal framework across the entire (enlarged) region, thus providing better protection for foreign investment than in other emerging regions.

Last, but not least, if a wave of protectionism results from the global economic crisis, and there is some evidence for that, global emerging markets could be affected negatively. However, Emerging Europe would be relatively well-protected as its access to the largest market in the world, the EU, would be guaranteed.

6 Is Emerging Europe a hedge against Inflation?

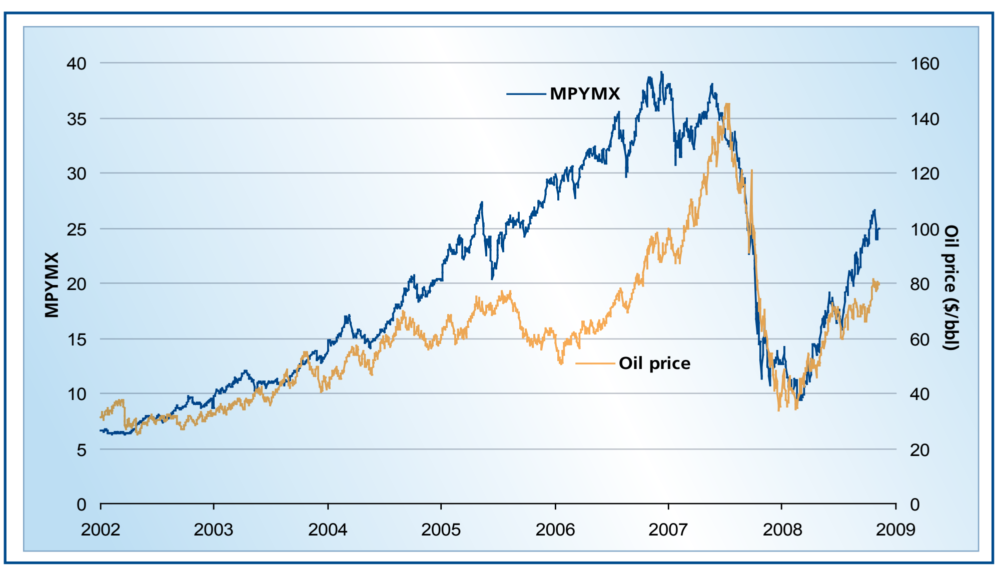
This will depend to an extent on the source of inflation and the individual market.

If the limited availability of commodities is the main source of a substantial pick up of inflation, Russia stands to benefit significantly due to its role as a major commodity exporter. On the other hand, Emerging Asia, as a net commodity importer, will likely be hurt by higher oil and metals prices (same goes for Central and Eastern Europe ex Russia).

If, however, developed countries' central banks allowed inflation to go higher in order to help alleviate the debt burden, consumers in those countries would eventually be hurt. Emerging market consumers should be more resilient as rising structural productivity and the ongoing convergence should drive real wages higher, providing support for consumer spending and a relative inflation hedge vis-à-vis the developed world. It is important to note, though, the inflation would likely hurt both markets, and the "emerging" advantage here is more relative than absolute.

7 What is the fund's correlation with oil/commodities?

Emerging Europe's performance is not just a function of the oil price, even though there are periods where correlation is high, especially when Russia is the leading market and our exposure to energy stocks is high. Those periods are sometimes followed by periods of time when the market is driven by other factors (such as the period between mid-2004 until 2006). In the chart below, the blue line represents fund performance (left axis), while the orange line shows the oil price (right axis):



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