ERSTE GROUP

Global Strategy

Outlook International Financial Markets – 4th Quarter 2009

Sentiment improved

USA - Stocks: Valuations up - perspectives down
Economy: Temporary factors leaving a mark

Europe - Stocks: Overweight because of more attractive valuations
Economy: Growth rates should come down in Q4

Japan - Stocks: lower dynamics - downgraded to neutral
Economy: further recovery, but only moderate growth in the medium term

USA

Equity market

Another bear market rally in the third quarter

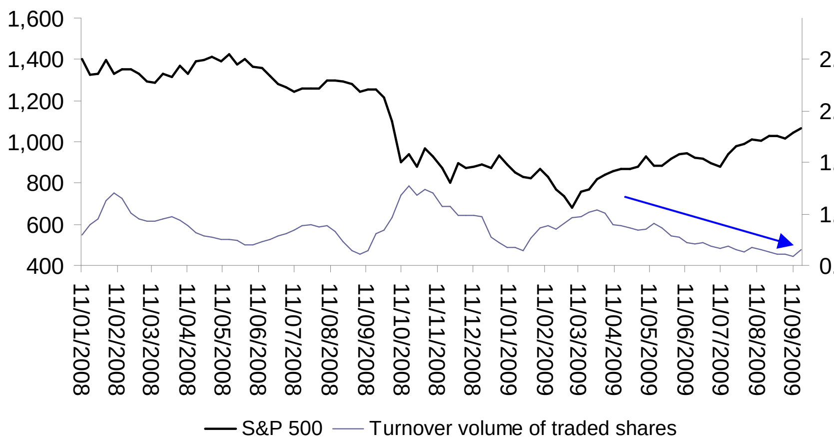
The medium-term upswing that had started in March continued throughout the past months on the US equity markets. Almost all sector indices posted gains in the past quarter. Only utilities were extremely weak and closed down on the quarter. This represented a remarkable divergence to the overall market, highlighting the fact that the most recent upswing was not supported by the kind of market width that would usually accompany sustainable trend reversals on the equity market. Relative weakness of this important sector is not unheard of in a rising market, but a negative performance in absolute terms shows that the investors' long-term interest in US equities is of a limited nature and that they mainly want to exploit the cyclical trend reversal to reap short-term profits.

Very low turnover

Aggregate turnover of American equities has been weak for a while for the most important indices such as S&P 500, Dow Jones, or Nasdaq. This fact sets the American equity market clearly apart from almost all other equity markets. Investors – including those from the USA – seem to be finding numerous more attractive alternatives and increasingly prefer to invest their capital in growth markets. This also led to a situation where the S&P 500 and the Dow Jones index embarked on their trend reversal only months after the most important indices from Asia, Latin America, or Eastern Europe, and they ended up reaching their equilibrium only in the middle of July.

The following chart shows the aggregate share turnover of the S&P 500 index, as compared to the period of 2000 to 2007. Whereas the US share indices have been rising since March, turnover has been sliding. It is a fact that upward movements that are carried by low turnover are less sustainable than those with high turnover. Therefore the most recent upswing on the stock exchange in the USA is less stable than on other markets. The most recent equity turnover has only come to 70% of the long-standing average, after adjustments for the different levels of the S&P 500.

S&P 500 and turnover



Sources: Erste Group Research, Reuters, Datastream

Paradigm shift on the stock exchanges

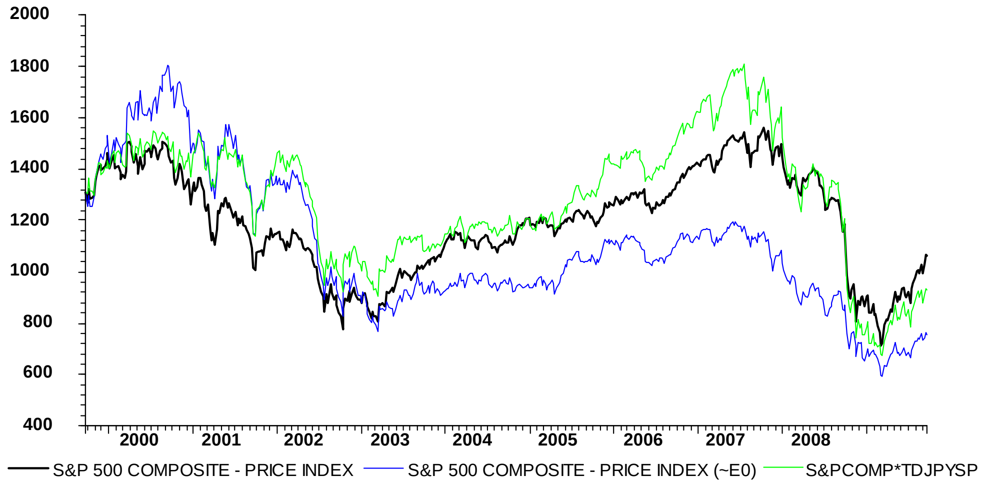
The S&P 500 shares were not the only ones to record a considerable fall in investor interest (as manifested primarily by declining volumes). Dow Jones and Nasdaq 100 showed the same picture.

S&P on a long-term downward trend

The inherent weakness of the US indices becomes apparent when we compare the current upswing to the one from 2003 to 2004. Again, even after adjustments for the different index values, the current increase in the US indices is supported by substantially lower turnover than the previous one that started in 2003. The shortfall amounts to about 15%. This is currently one major distinguishing aspect between US shares and most other markets, where trading volumes have mostly been up recently. On top of that it is remarkable to see that for the first time in many years the trend reversal on the global stock exchanges was not triggered by the USA but by the emerging markets (Brazil, China etc).

These are signs of a paradigm shift highlighting the fact that investors have broadened their horizon and do not just stubbornly focus on the development in the USA anymore. For growth investors, the American equity market holds little interest anyway, given that the long-term trends are headed downwards in this market.

The following graph shows the past ten years of the S&P 500 in USD, EUR, and JPY.

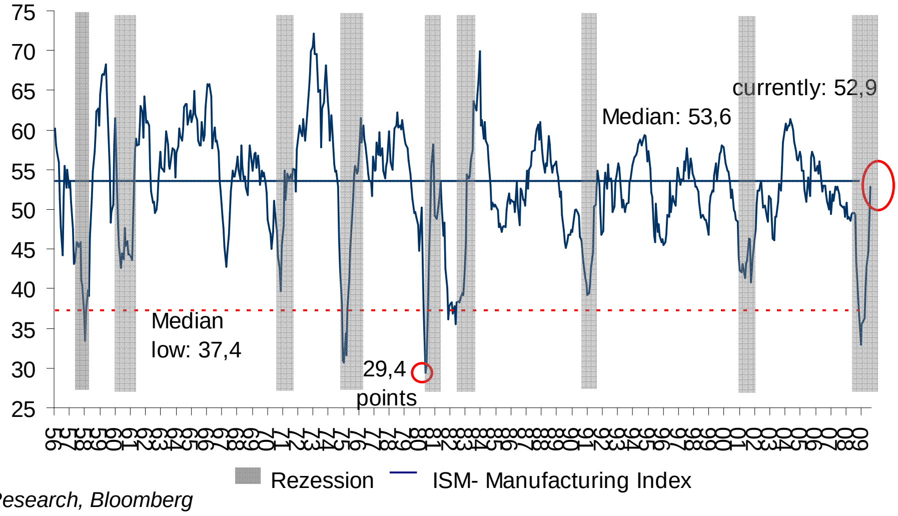


Source: Datastream

The sentiment shows first short-term signs of a recovery with regard to the future economic development. The ISM Purchase Manager index has increased to neutral (currently 52.9) in the past months and thus even suggests a minor expansion. However, this has to be seen in connection with the numerous government programmes: especially the “cash for clunkers” scheme lifted the car market enough for inventories to be almost fully drawn down now, which means that the current demand has led to an increase in industrial production.

ISM Index in neutral area

ISM Manufacturing and US recessions 1956-2009

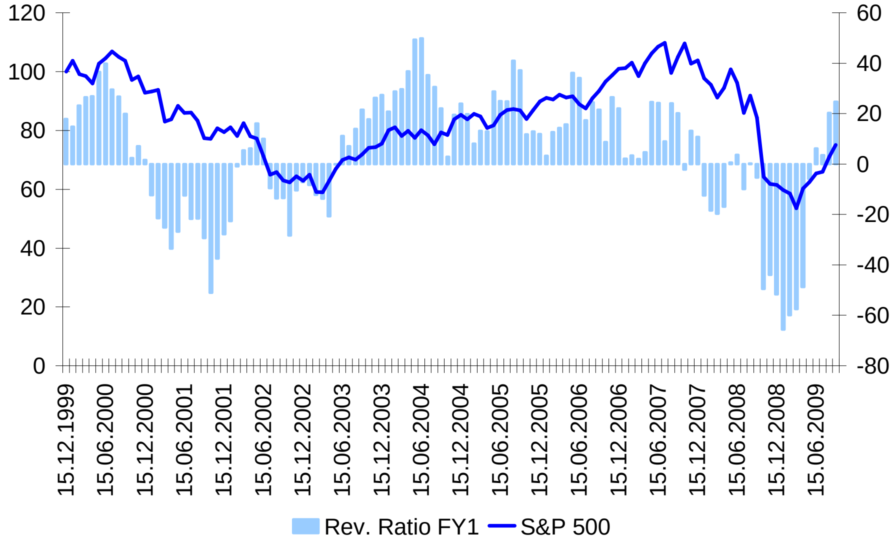


Sources: Erste Group Research, Bloomberg

The earnings ratio is also back on positive territory: since the beginning of this quarter it has indicated a surplus of positive earnings revisions. This was not only triggered by the most recent surge on the equity markets. The now slightly more optimistic outlook for future earnings is also a result of radical restructuring that entailed substantial job cuts in most of the companies.

The following graph shows the development of the revision ratio for the S&P 500 index. By the way, the companies in the Nasdaq Composite index have gone through the same positive development.

Revision ratio S&P 500



Sources: Factset, Erste Group Research

Currently earnings revisions are therefore clearly improving. That said, here are – in our opinion – the risk factors for the future development of the EPS revision trend:

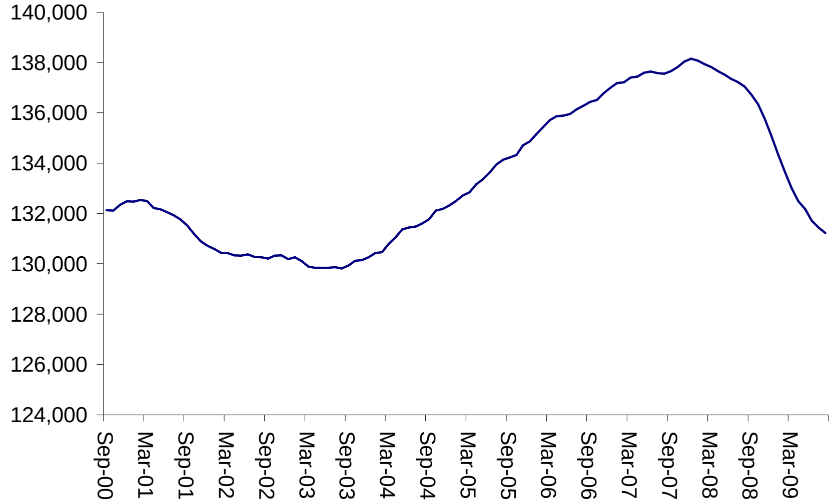
- a temporary appreciation of the US dollar, which would dampen the sales revenues of the international companies

- a continued high or even increasing level of energy and commodity prices, which would eat into the purchase power of US consumers

- a sustained unemployment rate on the current high level, as this would further harm the propensity to consume

As far as the labour situation is concerned, it is an interesting detail that fewer people had a job in 2009 than in 2000. The chart underneath shows the development in the non-agricultural sector.

Number of jobs in the USA in the non-agricultural sector (in thousands)



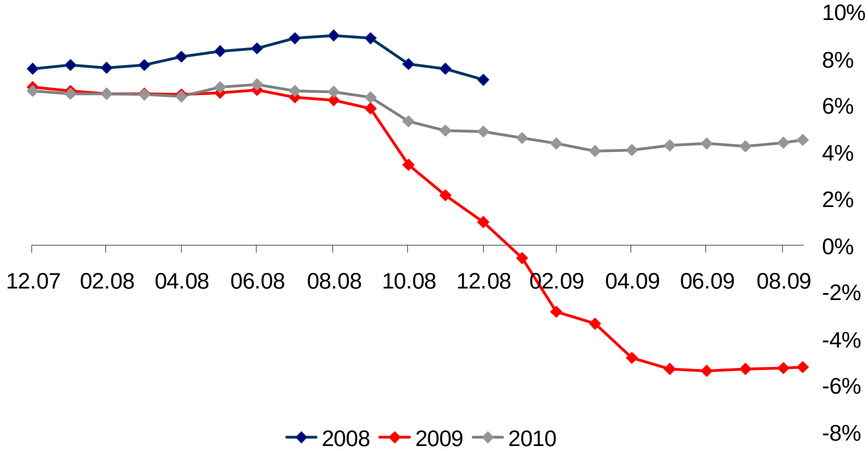
Source: Bloomberg

The long-standing trend is still positive during this period. But if it had not been for the boom in the housing market that was triggered by the central bank and the commercial banks, the trend would probably be headed downwards. This shows how unsustainable the support of the most recent bubble of the property market was for the labour market, and it confirms the fact that trend reversals take a lot of time. It will probably not be any different this time either. Therefore we do not really expect the employment situation to change before the end of 2010. One has to bear in mind that more than 30% (!) of the production capacity in the US industrial sector is still unutilised.

Experience shows that the US equity market will only reliably rise if the unemployment rate is at the very least not higher than a year before. This is not the case yet, which is also why we do not rate this market positively.

Only when the companies start not only recording higher profits, but also higher sales growth rates can we see an improvement of the situation. The estimated growth rates for the S&P 500 companies are positive for 2010. After the slump of 2009, US investors should hope for no unexpected appreciation of the US dollar to endanger these estimates. The following chart shows the sales forecast for the S&P 500 companies over the years.

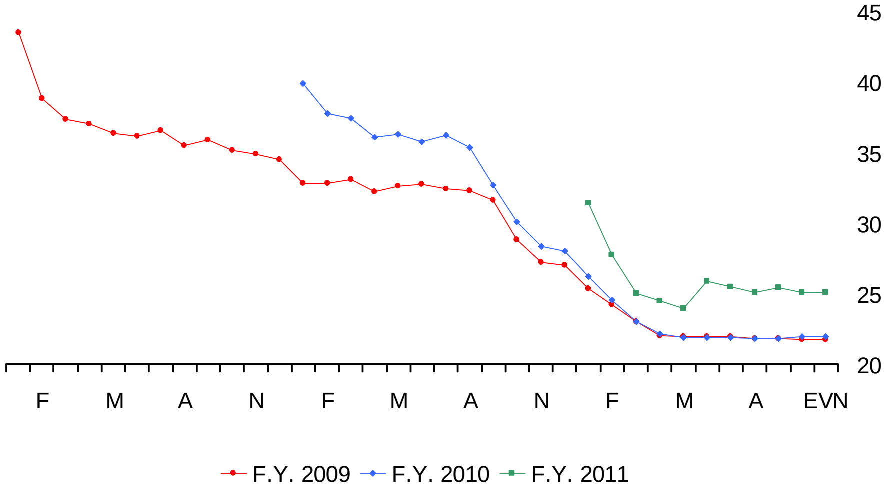
Sales forecast S&P 500



Source: Factset

Whereas the sales forecasts signal a positive development, the dividend forecasts for the S&P 500 index look rather less promising: dividends are likely to stagnate in 2010. This outlook seems realistic especially because of the weakness of the labour market.

Dividend forecast S&P 500



Source: Factset

Valuation:

The current dividend yield of the S&P 500 is 2.01%, i.e. 1.4 percentage points, and thus clearly, below the 10Y yield of government bonds. Earnings have experienced such a bad slump recently that the PE of 135x (source: Datastream) is of little explanatory value.

However, the fact that the dividend yield is currently substantially lower than the bond yields in spite of the low earnings shows that the positive aspects of a future recovery are already priced in. The missing earnings and dividend dynamics are responsible for the rather limited upward potential of the US shares at the moment. Under these circumstances, a value investor would simply wait for a better valuation, or s/he would go and look for a better valuation in other markets (and find it as well).

Outlook:

Steer clear of US financial shares in the long run

We expect the US property market to remain weak in the coming quarters. As long as the situation on the labour market does not improve, the housing market will remain lacklustre, which will in turn constitute a crucial burdening factor for US financial shares. Therefore we expect this sector to underperform the market for a number of quarters.

Due to a rising savings ratio, consumer cyclicals will presumably not outperform the market either in the medium term. This means that non-cyclicals appear much more attractive in the long run. This includes shares from the healthcare sector as well as biotechnology and food, particularly if the companies operate on the basis of an international business model. The energy sector contains a number of attractive companies, too.

Overall we see only little upward potential for American shares in the medium term. On the one hand, valuations are not low enough to serve as buying argument. And on the other hand, there is a lack of growth perspectives in the foreseeable future.

Low potential – underweight US shares

Investors can find simply more attractive alternatives with lower risk and probably considerably higher potential on many equity markets these days. It makes sense that in a period of paradigm shift the emerging markets were the first ones to embark on the upward trend in their most recent trend reversal. It took the leading US indices as well as numerous European peers months to follow suit. Now on the other hand we expect the developed markets, maybe even the USA, to trigger the next decline, whereas we believe that most emerging markets will not immediately go down the same road and take a while before heading south.

The long-term perspective is clear: US shares will not be the outperformers in the coming years. We therefore stick to our recommendation to strategically underweight American shares.

Global Strategy

We have no problem finding much more interesting opportunities in most emerging markets, which we would currently overweight. Overall, and given the current situation of the global economy, we would recommend a neutral equity portion.

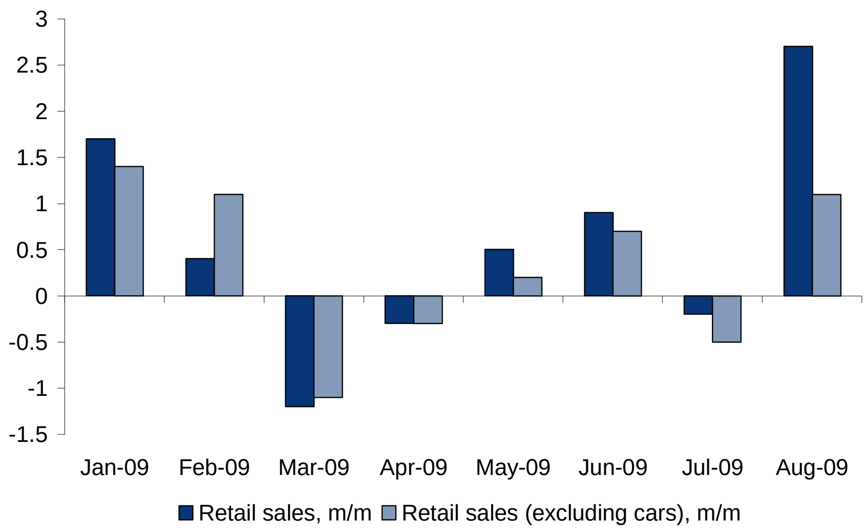
USA

Economy, bond, and currency markets

Temporary factors supporting GDP growth

The US economy seems to have bottomed out, and after the slight decrease in Q2 the third quarter will record a considerable increase. However, the economic outlook for the periods afterwards should not take the third quarter as yardstick: the economic growth in the past three months was crucially supported by two factors that will have become ineffective or at least subside already in the fourth quarter of 2009 or in the first half of 2010. The US version of the scrappage premium for cars ("cash for clunkers") massively boosted car sales in July and even more so in August. The scheme has come to an end now, and we expect a sharp decline in sales in September because previous figures were undoubtedly inflated by advance purchases. These negative effects will probably continue to make themselves felt in October. We expect aggregate car sales in the fourth quarter to decline from their Q3 figures. The second factor to support GDP growth is the inventory cycle. It is likely to bolster economic growth in the fourth quarter and possibly even beyond that. The economic slump that started in the last months of 2008 has caused a massive clearance of inventories. Said clearance seems to have slowed down considerably in the third quarter, and in the fourth quarter, inventory levels should remain stable or even grow. Given that in this case the GDP calculations are based on the comparison of the rates of change, we expect a positive contribution to GDP from changes in inventories for both quarters.

Retail sales, m/m in %



Source: Bloomberg

Demand should remain subdued in 2010

The economic outlook for 2010 is bleak, with the stimulus package by the US government and the liquidity injections by the Fed already accounted for. This is due to the fact that US consumers should remain cautious. The losses they suffered to their housing assets many of which were funded by debt are so high that they will continue to dampen consumers' willingness to spend. A further increase in the unemployment rate is an additional negative factor for private consumption. Subdued consumer demand together with a massive amount of unutilised capacity in the industrial sector make any decisive growth stimuli on the investment front unlikely.

No inflation pressure in the foreseeable future

This weak economic environment should provide no fertile soil to pressure on prices at all, and inflation should thus remain low. At the same time, we do not regard fears of deflation as justified either. For deflation to strike, expectations of falling prices would have to manifest themselves, which in turn requires a long period of economic weakness first. We do not expect the USA to be facing a similar scenario as Japan in the 1990s (and afterwards), because structural adjustments are much faster implemented in the USA than in Japan.

Global Strategy

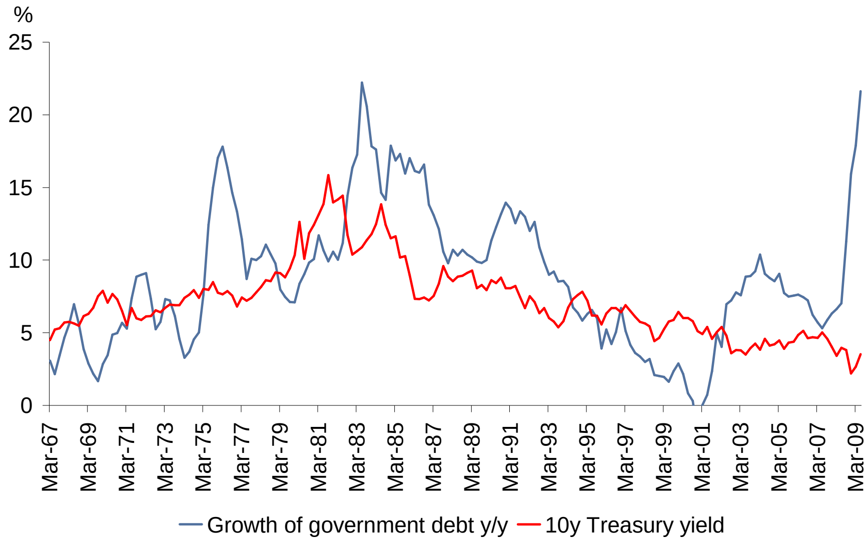
Out with the old crisis, in with new challenges

When announcing the end of the purchase programme for securities for the end of October (government bonds) and the end of March 2010 (mortgage bonds), the mai8n message actually was that an extension of the programme was not planed. These are first careful steps towards a normal monetary policy. But the road ahead is still far, because the central bank has inflated its balance sheet since the insolvency of Lehman Brothers in an unprecedented fashion. Those were crisis interventions that will have to be taken out of the system again sooner or later – which will be the challenging task for the Fed in the coming year. If it withdraws the liquidity too soon, chances are that the economy will be stifled. Delayed action, on the other hand, could result in rising inflation rates down the line. We think that the Fed will start withdrawing liquidity in the second quarter of next year at the earliest, and we do not expect interest rate hikes before the third quarter.

Support for government bonds by the central bank is expiring

Current yields reflect mainly the weak US economy. Other factors such as the massive increase in financing requirements in the public sector as well as the inflation risk, which goes hand in hand with the aggressive policy of the US central bank in the long run, do not seem to be priced in from our point of view. This can be partially explained by the fact that the two factors, both of which are negative for the bond market, do not amplify each other, but cancel each other out in parts. The purchase of securities by the US central bank, together with the liquidity measures taken, boosted demand for US government bonds. But this supporting factor for government bonds will subside and ultimately disappear. At the same time however, supply will remain high, given that the new debt incurred by the public sector in the current fiscal year will amount again to about 10% of GDP. This is our central argument in favour of an imminent increase of the medium and long-term yields, and it may be helped by a further improvement of the market environment, which could make investors diversify into riskier assets again.

Growth of government debt and 10Y yield, in %



Source: Fed Reserve of Bank St. Louis, Bloomberg

Dollar remains under pressure

The US dollar will probably remain under pressure. In contrast to the bond market, the risk factors are not offsetting each other (monetary policy vs. government debt), which has been crucial for the depreciation of the dollar so far. These risk factors will not change for the time being, and neither will therefore the pressure on the dollar. Only the already low levels in a historic context could lend the dollar support at some point. Also, too strong a euro relative to the dollar would be detrimental to the outlook for the export-oriented economy of Euroland and thus bolster the US dollar from that angle. The risks associated with our forecast are not symmetrically distributed, but skewed towards a stronger depreciation of the dollar.

Global Strategy

Europe

Stock market

Low valuations, steep interest rate curve

The European equity markets continued their strong performance in the past three months. The broadly based DJ Stoxx 600 increased by 18%. (Historically) low share valuations, improved consensus estimates, the steepest interest rate curve since 1996, and of course a further rise in the economic leading indicators (EMIs, commodity prices) pushed share prices to new year-highs.

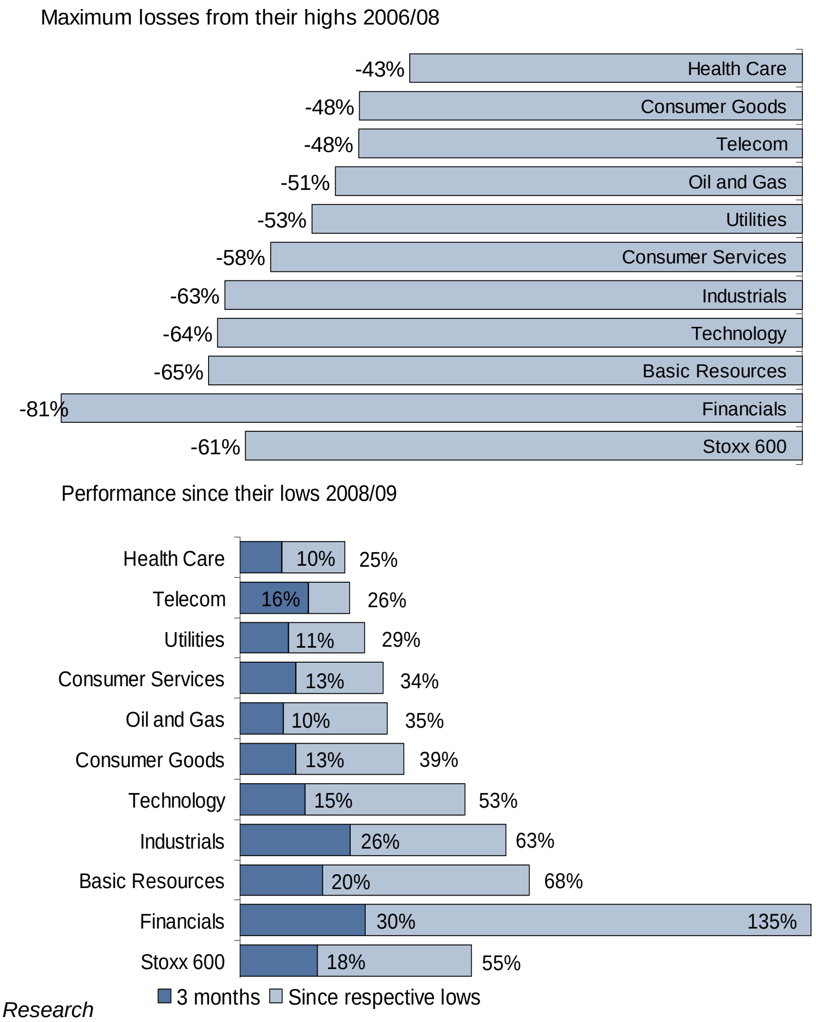
Financials outperformed in Q3

As far as the development of the sectors over the past three months is concerned, financials were yet again the top performers at +30%. The rise is due to the banks' increased earnings in the second quarter. The financial sector mainly benefited from the level of the key lending rates, which remained at their historic low, and from the rather more relaxed situation on the interbank market.

Industrials and commodities benefited from the cyclical trend

The industrial sector also recorded strong gains in the past quarter and increased by a remarkable 26%. Commodity producers (+20%) benefited from the market environment as well as from the overweighting of cyclicals in the portfolios of investors amid the improving economic situation. On top of that we saw the tendency of those sectors outperforming the overall market that had incurred the most substantial falls from their respective highs, which they had reached in the bear market at different points in time. This situation is exemplified in the chart underneath. If the sentiment remains positive, this trend is very likely to continue in the fourth quarter.

Stoxx 600 sectors:



Source: Datastream, Erste Group Research

Telecoms with steep rise after good results

The underperformance of defensive sectors was prolonged in the third quarter. The pharmaceutical and energy sectors gained “only” 10%. In the case of the oil and gas sector, the stagnating oil price was the main culprit causing the underperformance, hovering around USD 65-70 per barrel since the beginning of June. Clear winners among the defensive sectors were the telecommunication companies, closing up 16% on the quarter. The better than expected Q2 results of leading companies such as France Telekom and Telefónica had triggered substantial price increases. However, we think that this is it for the relative strength vis-à-vis other defensive sectors, since the revision ratio for the 2010 earnings is still negative and the fundamental valuations of the companies in this sector are now around market average.

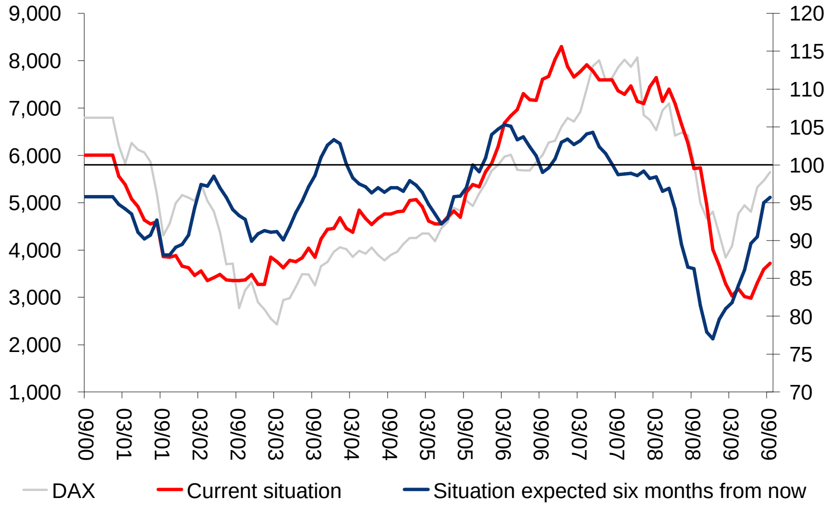
Ifo, ZEW, and Sentix index continue to rise

One of the factors responsible for the rising share prices is the continued improvement in the sentiment among companies. The important Ifo business climate index posted a strong increase in the past months. The upswing was for the first time supported by the improved current assessment component. In September the Ifo index rose for the sixth consecutive time, by 0.8 to 91.3, thus setting its highest value since September 2008. The values of the ZEW and the Sentix index for the Eurozone confirm the currently positive outlook of the business managers in Europe. The expectation component of the ZEW index for example has meanwhile risen to its highest level since 2005.

EMI Eurozone at a 16-month high

The EMI index continues to exhibit positive tendencies for the Eurozone. It increased in September to the 16-month high of 50.8 points after 40.4 in August. The EMI index for the service industry rose to 50.6 points and was thus in the positive area for the first time in 16 months. The production index increased as well. At 49.0 points it had reached a new 15-month high, highlighting the positive sentiment of the purchase managers in the Eurozone.

Ifo index Germany and DAX, 2000-2009



Source: Bloomberg

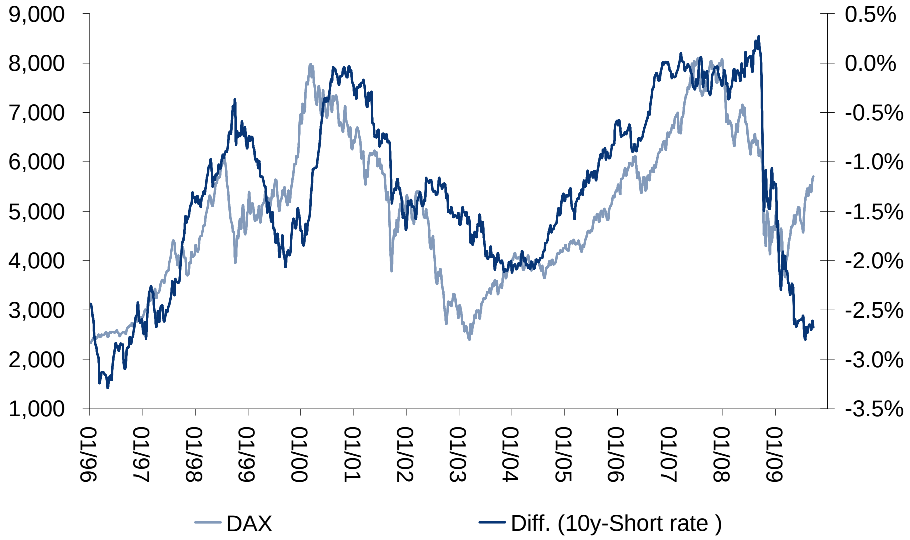
Ifo index history: a “W” formation in the past recessions

However, taking into account the long-term development of the Ifo index, we advise to exercise a certain degree of caution. In the past four “big” recessions in Europe (74/75, 80/82, 92/93, and 2001/03), the index followed a W-shaped path, and in two cases the second decline was deeper than the first one. This means that in the long run the current improvements should be carefully considered on the basis of historic examples. A declining Ifo index would usually tend to exert pressure on the equity markets. The correlation coefficient of the semi-annual changes of the Ifo and the DAX since 2000 has been a high 0.69. In the coming months we might see a decline in the Ifo index as a result of the weakening inventory cycle.

VDax below 25 points

The VDax painted a positive picture last quarter. The measure of implicit volatility of DAX options decreased from about 29 points at the beginning of July to below 24 points. This is still significantly above the long-term median of 18 points, but the downward trend was prolonged in Q3, after the index had reached a high of around 73 points during the financial crisis. The falling volatility makes it now possible again for investors to hedge their share positions as the costs of options are declining.

Inverted interest rate curve and DAX since 1995

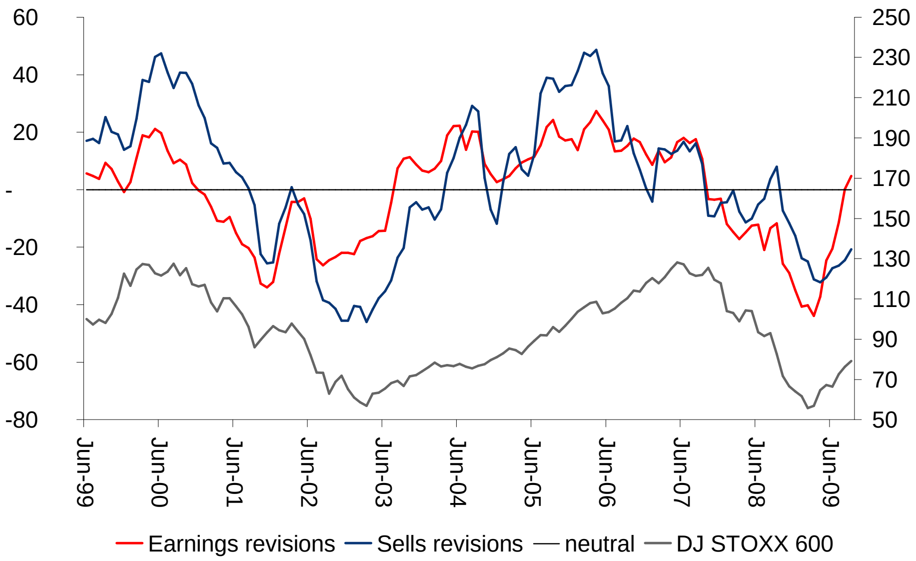


Source: Bloomberg, Erste Group Research

Low Bund futures (2Y: 1.18%; 10Y: 3.36%) support shares

One of the main reasons for the current recovery of the equity market is the globally low level of government bond yields. The interest rate curve is currently descending as steeply as it was only in 1998 the last time. Steep interest rate curves have had very positive effects on stock exchange gains, historically speaking. Although the yield curve lags behind during bull and bear markets, it is currently very supportive to the equity market given that the alternative, i.e. government bonds, offers very low yields. German government bonds at the short and long end remained more or less constant, or declined slightly, in the third quarter. 2Y bonds are traded at an implicit yield of 1.18% (-0.24bps), and 10Y bonds at 3.36% (-0.13bps).

Earnings and sales revisions Stoxx 600



Sources: Factset, Bloomberg, Erste Group Research

Stoxx 600, excluding financials: +21% earnings q/q in Q2

The fundamentals of the Stoxx 600 companies continued to improve in the second quarter. On top of the positive quarterly figures in the financial sector (64% of companies exceeded their earnings estimates) most other sectors reported better-than-expected earnings as well. The aggregate net earnings of the Stoxx 600 index without financials increased to EUR 37bn (+21%). That was the second consecutive increase (q/q) after the aggregate loss of EUR 2bn in the fourth quarter of 2008.

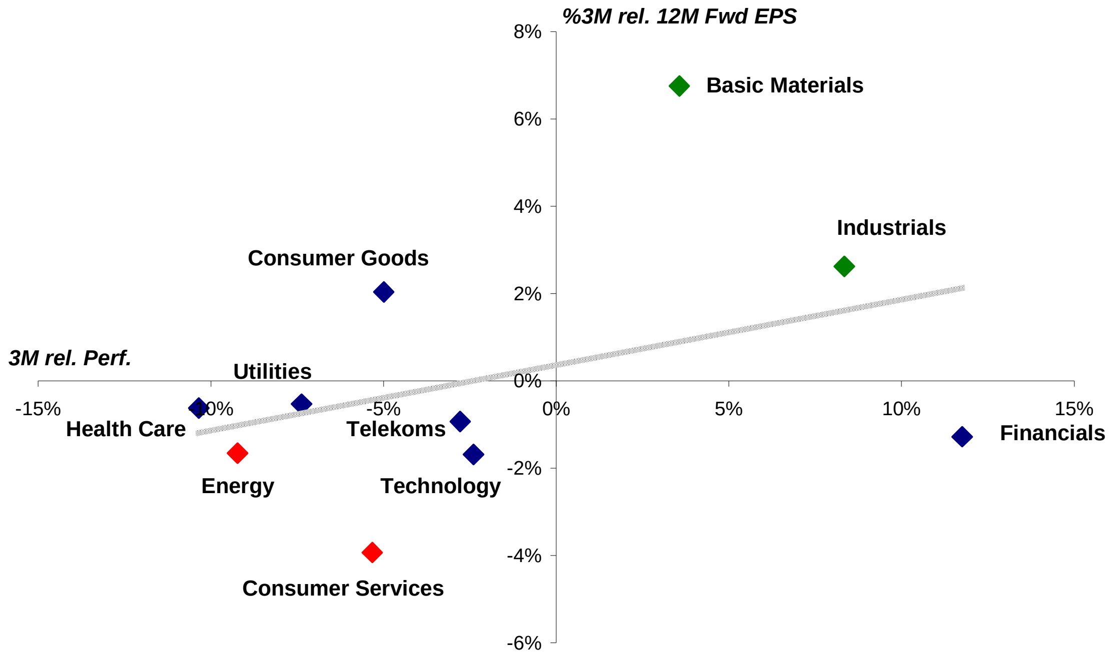
Revision ratio positive for the first time since 2007

The EPS revision ratio, in the positive area this month for the first time since September 2007, was another positive signal of the recovering corporate sector. The tendency of this ratio is stable, since it remained positive throughout the bull market of 2003 to 2007 after turning from negative to positive in 2003. That said, the EPS momentum remains slightly negative.

Further downward revisions for sales

The sales revision ratio is still negative, but the trend is pointing up. Only two out of three estimates are revised downwards anymore. Estimates put aggregate Stoxx 600 sales growth for 2009 at 0.8%, whereas next year sales are supposed to grow by 3.5%. Generally speaking the current development of EPS and sales estimates is somewhat similar to the situation of the last economic trough in 2003. Back then, EPS forecasts reached their low before the sales forecasts as well.

Relative performance against 12M forward EPS, MSCI Europe:



Sources: Datastream, Erste Group Research

Fundamentals taking to centre stage

The comparison of the relative performance of the sectors with their respective earnings revisions shows a positive correlation (as exemplified above). This positive correlation is a good sign, given that it used to be indirectly proportional over a long period of time. Commodities and industrials, in particular, confirmed their outperformance by the above-average improvement in the estimates of the primary analysts.