

EMERGING MARKETS

Emerging Market Monitor - Inflation in Central & Eastern Europe

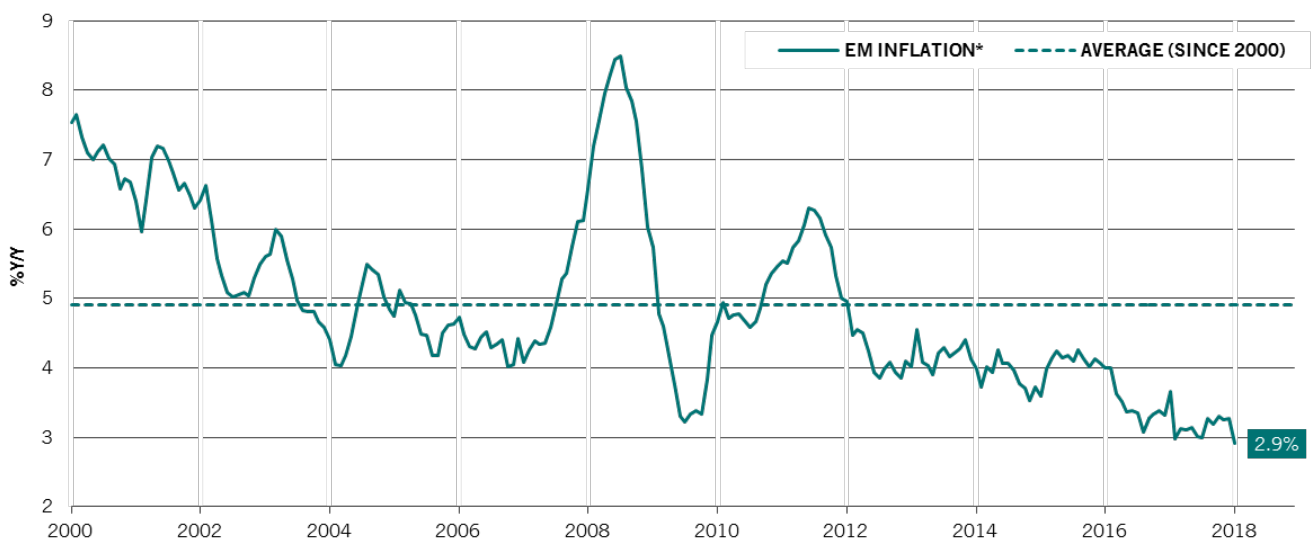
March 2018

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Inflation across emerging markets is at multi-decade lows. But one region is bucking the overall trend: Central & Eastern Europe. What does it mean for investors?

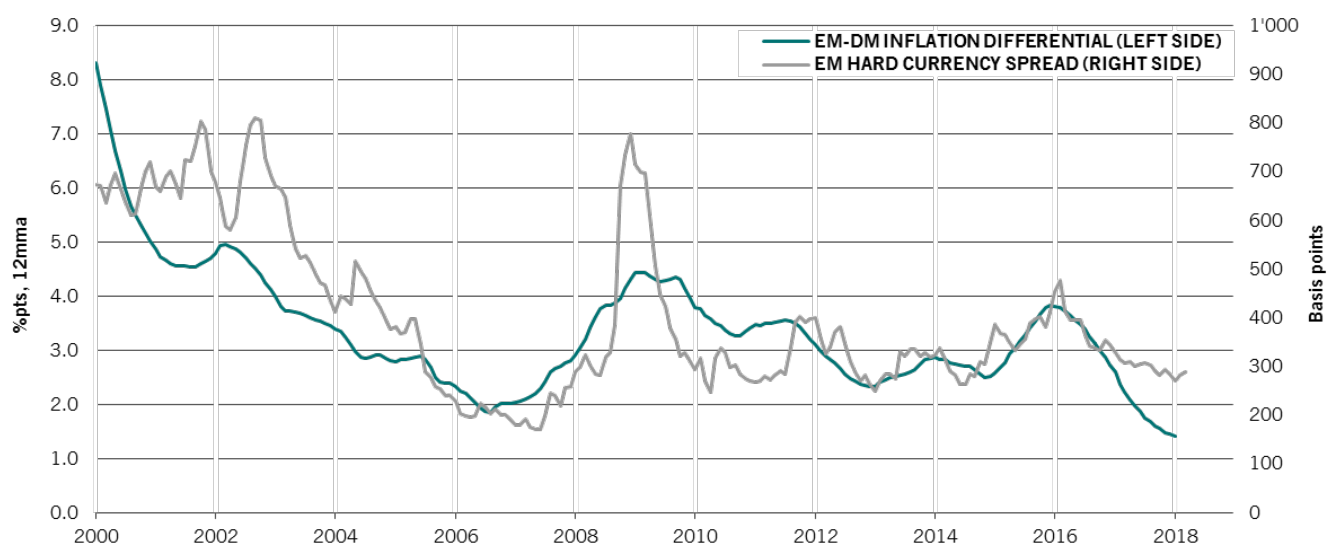
First, some global observations about inflation. Average inflation across emerging markets has fallen to 2.9%, a level not seen since the 1970s, and this is good news for holders of hard currency debt.

FIG. 1 INFLATION IN EMERGING MARKETS



As Fig. 2 below shows, the inflation differential between developed and emerging markets and EM hard currency yield spreads appear closely linked. Even if inflation is expected to pick up modestly in emerging markets, we believe it will rise less than in developed markets, and this supports a further narrowing in emerging hard currency debt spreads.

FIG. 2 - INFLATION DIFFERENTIAL

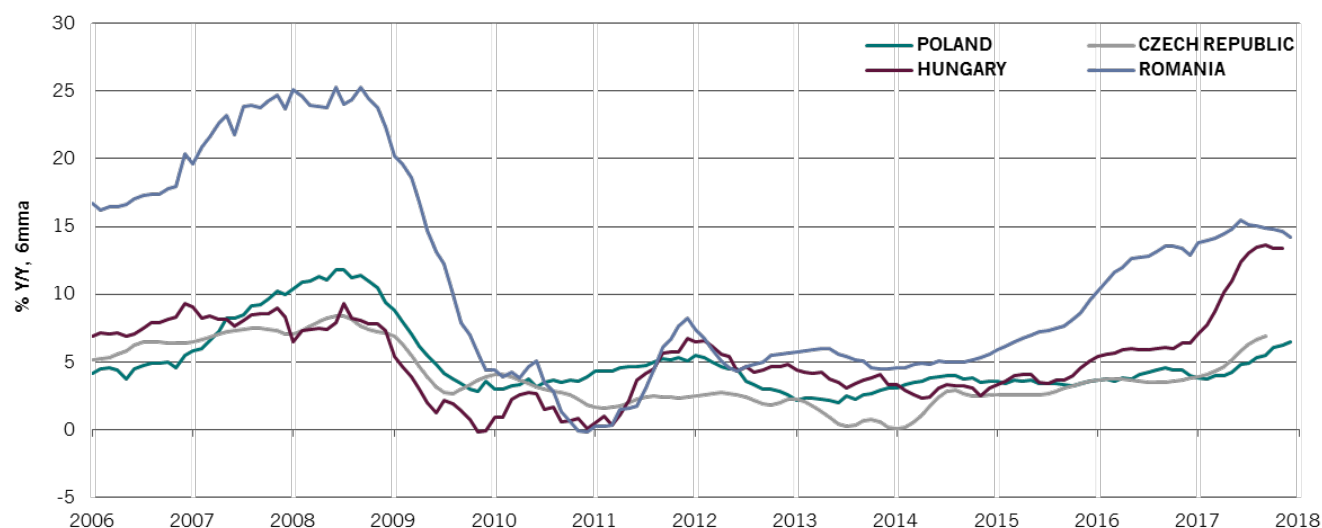


Source: Pictet Asset Management, CEIC, Datastream, January 2018

The exception to the rule...

As mentioned, one cluster of countries bucking the falling inflation trend is the **Central and Eastern Europe (CEE)** markets of the Czech Republic, Hungary, Poland and Romania. This is mainly because of wage growth, which has ticked up in all four countries.

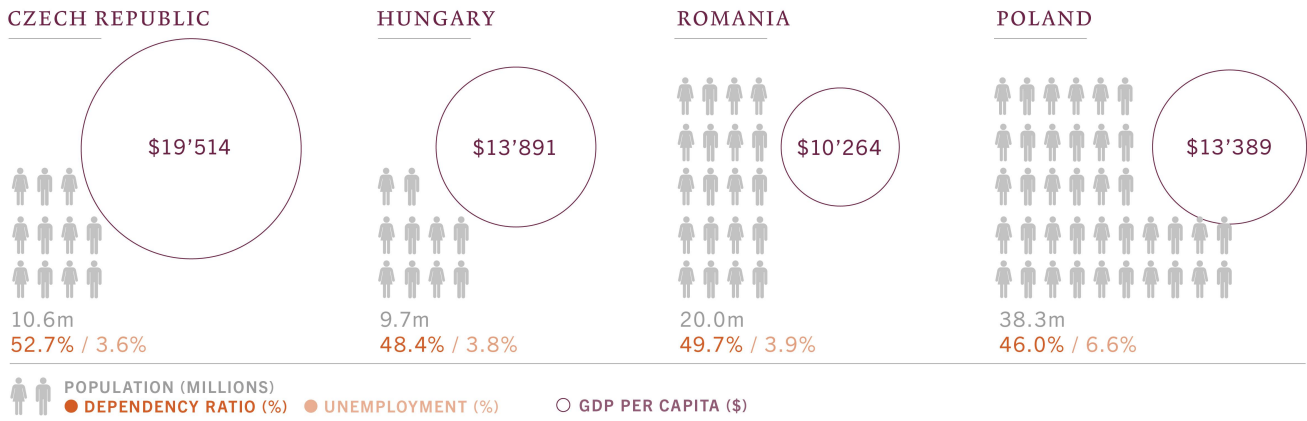
FIG. 3 - NOMINAL WAGE GROWTH IN THE CEE REGION



Source: Pictet Asset Management, CEIC, Datastream, February 2018

The four markets in the CEE region account for over a trillion dollars of GDP and around 80 million people. **Poland** is the region's powerhouse accounting for half of GDP and half of the population. The richest market in terms of GDP per capita is the **Czech Republic**.

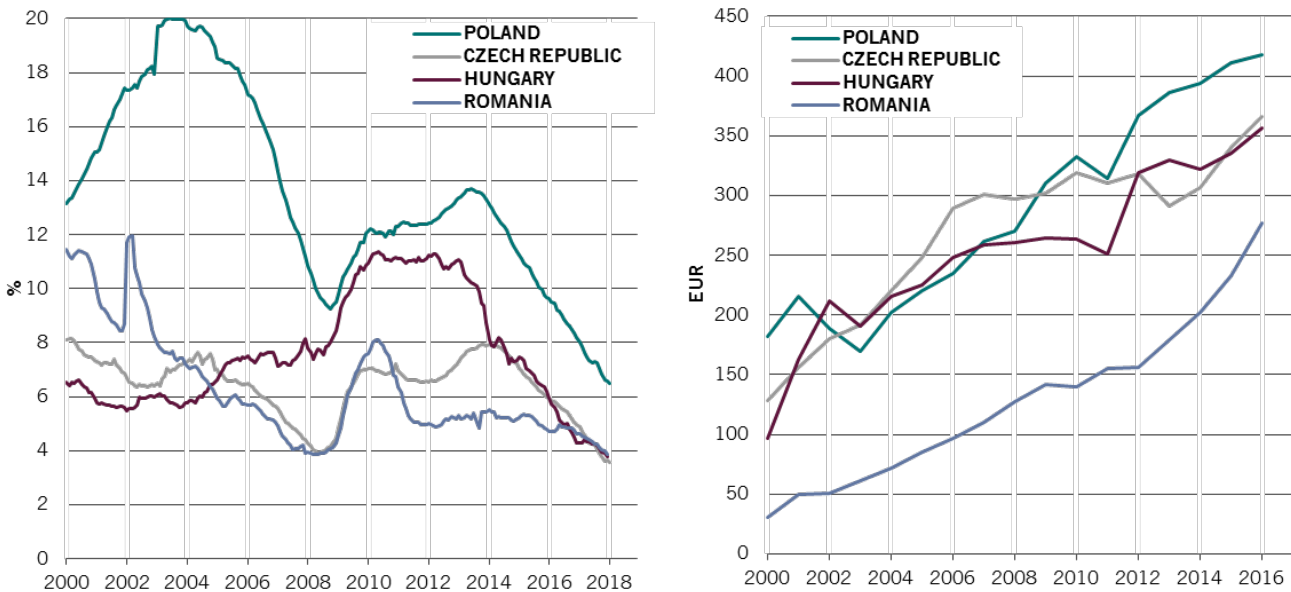
FIG. 4 -THE CEE REGION AT A GLANCE
Population, dependency ratios, unemployment and GDP per capita



Source: Pictet Asset Management, CEIC, Datastream

The charts below show two key drivers of wage increases in these four economies: record-low unemployment and increasing minimum wages.

FIGS. 5A & 5B -
Left chart - Central Eastern Europe unemployment rates (%)
Right chart - Central Eastern Europe minimum nominal monthly wages (EUR)



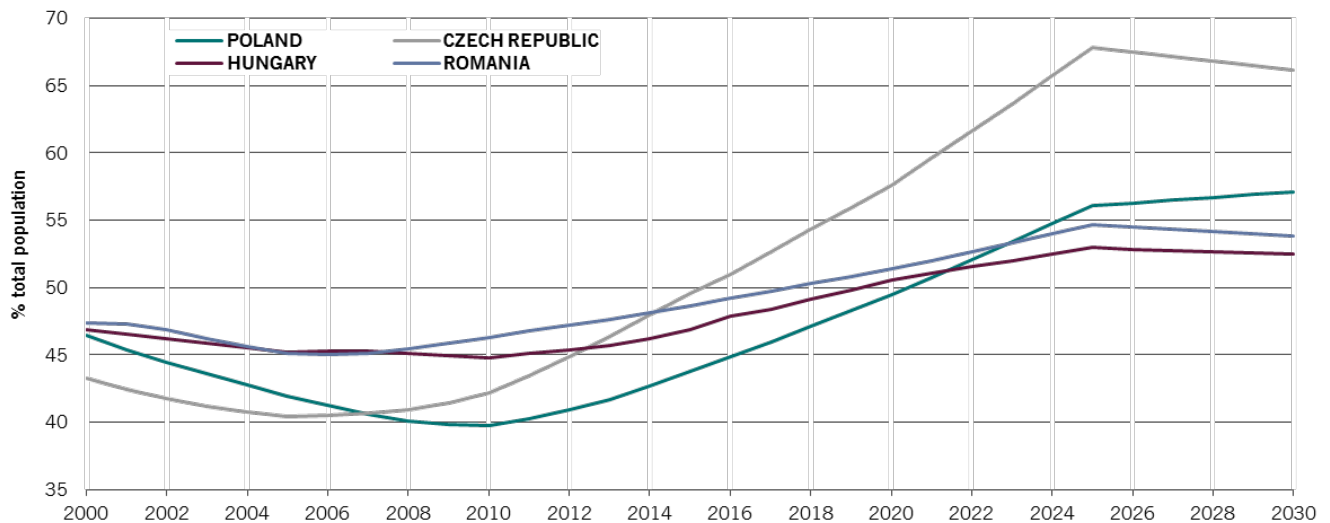
Source: Pictet Asset Management, CEIC, Datastream, February 2018

You can depend on us...

Wage pressure could continue to build in the CEE region as ageing populations and rising life expectancy cause the dependency ratio of non-working to working people to rise across all markets. As Fig. 6 shows this is especially the case for the Czech Republic.

FIG. 6 - RISING DEPENDENCY RATIOS

Dependency ratio is the percentage of population outside of working age: 0-14 year, 65 years +



Source: Pictet Asset Management, CEIC, Datastream, January 2018

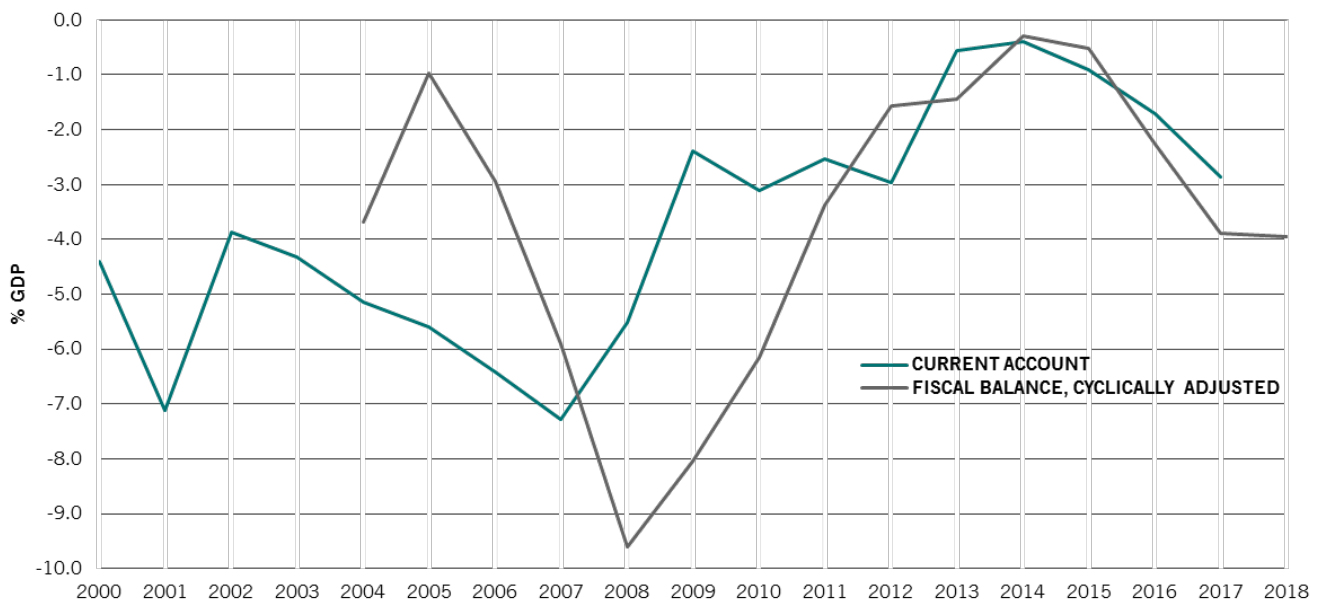
Central banks behind the curve

What does this mean for debt investors? Although rising wage growth in the CEE is a sign of strong economic conditions, the risk of central banks falling behind the curve is a threat for the region’s local currency debt.

Overall CEE central banks have been slow to react to inflation. Poland and Hungary in particular have not started the tightening yet. The Czech National Bank was first to hike rates after the removal of the EUR/CZK floor in April 2017.

FIG. 7 - TWIN PEAKS - ROMANIA MOST AT RISK

Romania's current account and fiscal balance (% GDP)



Source: Pictet Asset Management, CEIC, Datastream. Current account January 2017, fiscal balance January 2018.

Although the Bank of Romania began hiking rates in February 2018, we believe the country is the most at risk. As Fig 7 shows it is the only market in the region with a ‘twin deficit’ – trade and current account - which is deteriorating. We believe this increases the pressure on CPI inflation through an expected depreciation of the currency, in addition to the rising domestic inflationary pressures. We expect a more rapid pace of rate increases in the year ahead.

THE VIEW FROM OUR EMERGING MARKET EQUITY TEAM

By Christopher Bannon, Senior Investment Manager

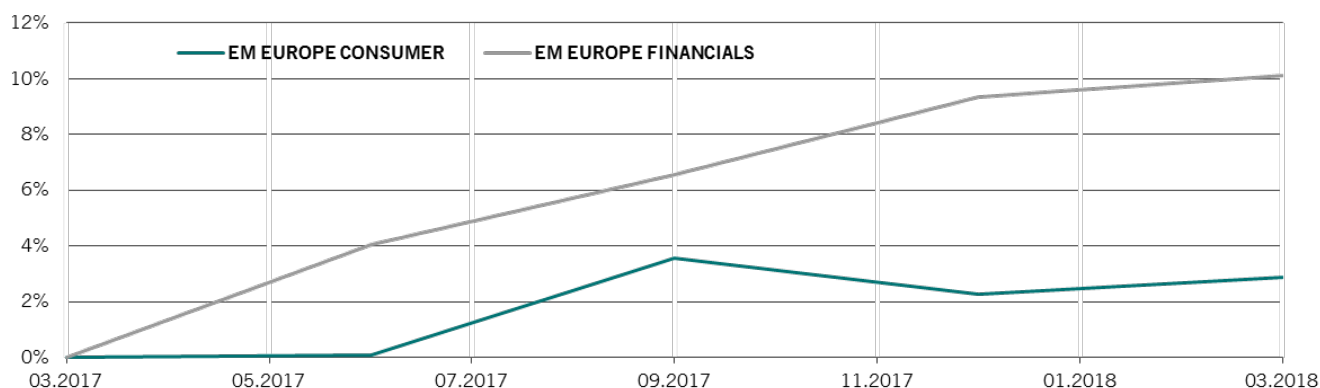


Christmas decorations in Vaci Street, Budapest, Hungary

Backing the consumer boom

The CEE region is booming. In our view this is best captured through stocks exposed to consumption and credit, such as banks and consumer companies backed up by strong fundamentals. Valuations here look reasonable, trading at a slight discount to western European markets. In addition, we believe that forward expectations do reflect strong macro growth dynamics.

FIG 8. UPSIDE IN CONSUMER AND FINANCIALS
Change to 2019 net income expectations

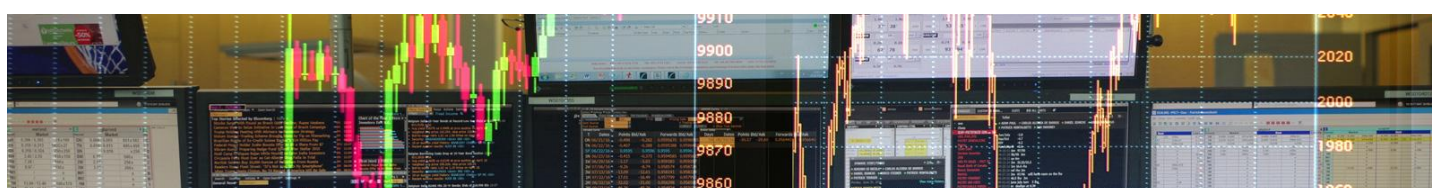


Source: Bloomberg, March 2018

As Fig. 8 shows, both financial services and consumer sectors have seen their earnings forecasts upgraded quite consistently over the past year.

Despite the overall positive trend, the market has been paying greater attention to company fundamentals and rewarding those with the strongest growth prospects. In our view, the increasing dispersion of returns between the market's winners and losers is creating a fertile ground for stock pickers.

MARKET WATCH



MARKET WATCH DATA
28.02.2018

EQUITIES	1 mth (%)	YTD (%)	1 yr (%)	3 yrs ann. (%)	5 yrs ann. (%)	10 yrs ann. (%)
MSCI EM	-4.61	3.34	30.51	8.97	5.02	2.65
MSCI EM Value	-4.67	3.65	22.50	6.53	2.58	1.77
MSCI EM growth	-4.55	3.03	38.69	11.31	7.35	3.43
MSCI AC Asia ex Japan	-4.98	2.21	31.93	9.92	8.09	5.01
MSCI Brazil	-2.01	14.48	22.95	12.91	-0.08	-2.10
MSCI China	-6.40	5.28	46.71	12.63	11.03	4.97
MSCI India	-6.70	-3.49	21.17	4.06	8.69	1.94
MSCI Russia	0.93	13.62	27.99	16.54	0.80	-3.89
MSCI EM Europe	-2.74	7.14	29.52	9.35	-1.37	-3.76
MSCI World	-4.14	0.92	17.36	8.19	10.70	6.03

BONDS	1 mth (%)	YTD (%)	1 yr (%)	3 yrs ann. (%)	5 yrs ann. (%)	10 yrs ann. (%)
JPM EMBI Global Diversified	-1.99	-2.03	4.39	5.75	4.49	7.00
JPM GBI-EM Global Diversified	-1.04	3.39	14.43	4.02	-0.97	3.59
JPM ELMI+	-1.05	1.81	9.69	3.43	-0.25	1.02
JPM CEMBI Broad Diversified Composite	-1.01	-0.94	4.19	5.27	4.20	6.48
JPM Jade Broad Asia Diversified	-2.07	-0.64	7.40	2.52	1.29	-
Chinabond composite	0.14	4.03	10.35	2.74	3.58	-
JPM GBI-EM Global Latin America	-1.29	4.59	10.65	3.88	-1.15	3.80
JPM EMBI Global Diversified Europe	-1.64	-1.55	5.13	7.05	4.57	7.01
JPM Global All Mats	-0.69	0.62	6.07	2.40	0.96	2.42


COMMODITIES	1 mth (%)	YTD (%)	1 yr (%)	3 yrs ann. (%)	5 yrs ann. (%)	10 yrs ann. (%)
S&P GSCI TR	-3.3	0.0	7.0	-7.1	-12.1	-
S&P GSCI WTI TR	-4.3	2.8	9.1	-11.4	-17.3	-
S&P GSCI Brent Crude TR	-5.5	-1.8	15.8	-8.6	-15.5	-
LBMA Gold pm	1.7	2.1	5.0	2.8	-3.7	-

CURRENCIES	1 mth (%)	YTD (%)	1 yr (%)	3 yrs ann. (%)	5 yrs ann. (%)	10 yrs ann. (%)
USD/BRL	-2.52	2.10	-4.24	-4.17	-9.46	-6.35
EUR/BRL	-0.43	0.53	-16.57	-6.80	-8.19	-4.28
USD/RUB	-1.89	1.42	2.20	2.58	-11.62	-8.19
EUR/RUB	0.21	-0.14	-10.96	-0.25	-10.39	-6.16
USD/INR	-2.37	-2.02	2.41	-1.74	-3.54	-4.76
EUR/INR	-0.28	-3.53	-10.77	-4.44	-2.19	-2.65
USD/CNY	-0.64	2.84	8.48	-0.33	-0.35	1.17
EUR/CNY	1.48	1.26	-5.49	-3.07	1.04	3.41
USD/ZAR	0.59	4.88	10.81	-0.43	-5.34	-4.10
EUR/ZAR	2.75	3.27	-3.45	-3.17	-4.01	-1.98

 Top performer among the EM indices or currencies shown in this table, for the corresponding period.

 Worst performer among the EM indices or currencies shown in this table, for the corresponding period.

 Developed markets.

 Source: Datastream, Bloomberg, data as at 28.02.2018 and in USD. Equity indices are quoted on a net dividend reinvested basis; bond and commodity indices are quoted on a total return basis. The currency rates evolution is treated as a performance calculation based on FX rates.

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