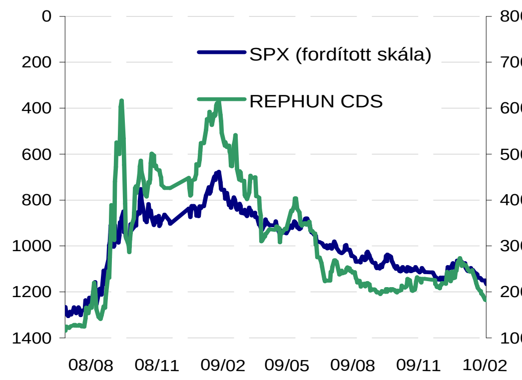
Monthly analysis – March

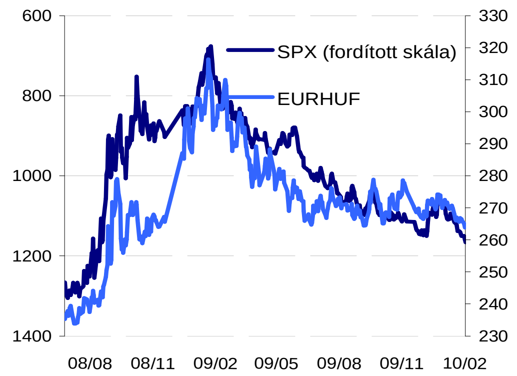
The elections through investors' eyes

With only a few weeks to go before the general elections, many are justifiably asking what they can expect from the financial investments market around the time of the elections, and how it is that the current "growing uncertainty" is not being reflected in the forint exchange rate or in bond yields. The forint has broken through the 265 barrier and is strong as a bull; the CDS (credit default swap) premium, which reflects country risk, is back in pre-Lehman territory, and yields on our government bonds are at levels (on average across all maturities) not seen since well before the crisis. The main reason for the strength in the domestic market is, as has now often been mentioned, positive international sentiment. Investors are once more swimming in liquidity, and for the moment, at least, it appears they do not need to face the true cost of this – the government sector's global debt problem. Both the Hungarian CDS price and the forint exchange rate have been moving in tandem with the US stock exchange index since the outbreak of the crisis, and they still are, with the forint having strengthened in response to the recent stock-market rally.

The S&P 500 index and the Hungarian CDS premium



The S&P 500 index and the EUR/HUF exchange rate



Source: Bloomberg

As far as prevailing circumstances in Hungary are concerned, it is indeed justified to talk of uncertainty – partly in relation to the outcome of the elections, and partly in relation to the intentions of the new government. As regards the election results, the extent of the recent success of radical nationalist party Jobbik is indeed a serious risk factor, though this is mainly because, as a major opposition force, it could throw a spanner in the works and push the government into making a mistake. The main uncertainty stems from the fact that we don't know enough about the intentions of the new government – or rather of Fidesz, the main opposition party currently leading in the polls, as the latter is clearly trying to maintain, and in some regards even increase, its room for manoeuvre in the run-up to the elections. Politically, this is rational behaviour for several reasons. Firstly, the outcome of the elections – whether a two-thirds majority can be achieved, how strongly Jobbik and the MSZP (Hungarian Socialist Party) will be represented in the new parliament – is not known. Secondly, the opposition parties are worried about a possible nasty surprise awaiting them with regard to the state coffers, although such concerns are hopefully exaggerated. Thirdly, knowing the current state of domestic public discourse, it can be assumed that new ideas will all too readily be shouted down: this is what happened, among others, to the idea of introducing the Swedish pension model, which, although it would not have resulted in any budget savings (and consequently any reduction in the level of pensions either) it could perhaps have finally freed the pension system from the scourge of political cycles. What we can surmise in spite of all the secrecy is that the new government's objective will be to release internal economic resources through job creation, giving a boost to forint lending, improving the general business climate and directly supporting small and mid-sized enterprises. A two-thirds majority could even open the way for a reform of the municipal system. This kind of "economic development" approach is very promising, because it could raise the potential growth rate in a way that would not necessarily result in increased budget spending, and is also in line with the currently shifting economics/economic-policy paradigm, wherein the role of government in the economy has grown in stature globally in the wake of the crisis.

The other obvious attempt at increasing room for manoeuvre is reflected in statements suggesting a raising of the deficit target – a suggestion that has not, however, been well received either by international institutions or investors. If this had an objective external cause, such as the collapse of the tax base, as certain observers expect to see, that would be a different matter. But if it is simply the result of a political decision ("pre-election promises"), then that is judged differently. The European Union will not tolerate another collapse of the convergence programme, or a non-observance of the latest, now many-times revised deadline for cutting the deficit, especially not after the Greek fiasco. The IMF, though many regard it as a soft touch on the matter, is focusing on the lowering of government debt as a percentage of GDP, which cannot be achieved alongside a substantial deterioration in the deficit. It is a popular, but false, argument in favour of a higher deficit that we have no reason to be ashamed of our debt ratio of around 80% since this is the average level among developed countries. We must remember, though, that the average debt level of the emerging economies – those that Hungary should be compared with – is exactly half of ours. The National Bank of Hungary's cutting of the base rate is already founded to a considerable extent on fiscal discipline, and the government's reduced borrowing requirement has contributed greatly to the recent positive performance of the bond market. These are essential to the creation of an environment of long-term low interest rates, a precondition for domestic forint lending and the financing of small and mid-sized enterprises.

At the moment, the market primarily sees opportunity in the potential appearance on the scene of a government with a strong mandate and thus the ability to act decisively. For the time being, let us hope that the new government will not fall captive to lobby interests and will stick to a policy of fiscal discipline. Whether this will turn out to be the case will not become clear immediately after the elections, but only in the summer. Until then, we'd all do well to fasten our seatbelts...

Prepared by AEGON Global Asset Management / AAM CEE
Gábor Orbán – Macroeconomic analyst and Head of CEE Fixed Income