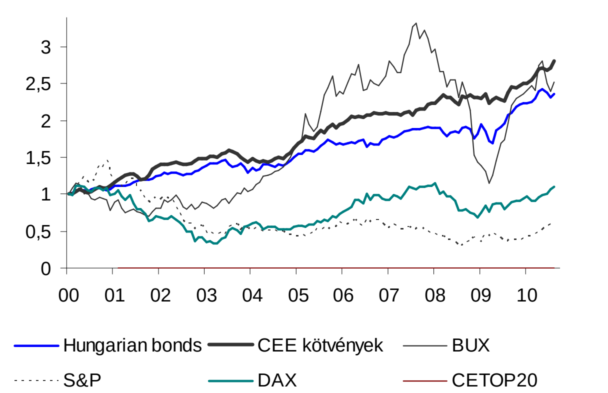
Monthly analysis – September

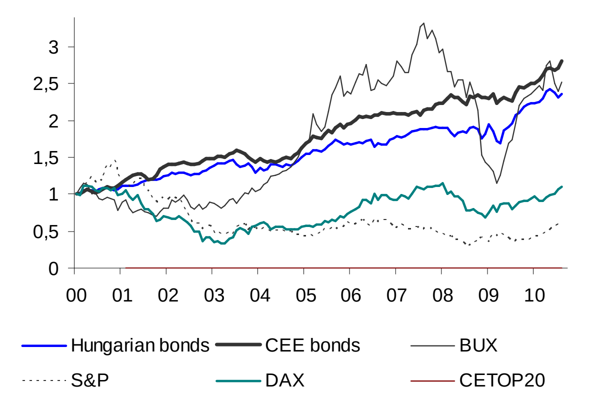
Do markets do more than just punish?

Much has been written, in many places, about the past few months' deterioration in Hungary's fundamentals; however, it's a little known fact that the stark disparity between Hungary's performance and that of its peers is due, in equally large measure, to the macroeconomic success story of our regional competitors, notably the Czech Republic. Of course, the positive Czech example is nothing new: as far back as in the 19th century, unlike their Hungarian counterparts, the Czech elite typically preferred other means of risk assumption to the card table and horse track... The strong vein of thriftiness remains to this day, which is why the Czech Republic is commonly, and for good reason, referred to as the "Singapore of Central and Eastern Europe". This year, however, there is more to it than simply the Czech Republic's excellent general creditworthiness. At the beginning of the year, for example, we noted with concern the country's growing financing requirement as the economy tried to pull itself out of the most severe recession of the past two decades, and found itself faced with falling tax receipts accompanied by rising costs. In July, however, the new government led by Petr Necas, the first in many years to enjoy a legislative majority, introduced measures aimed at substantially reducing the budget deficit, which according to plans will be set on a downward curve in the coming years, to be halved in the space of three years. The entire program is made even more credible by the fact that it promises a substantial improvement as early as next year, as a 10% reduction in government payroll costs, the slashing of maternity and unemployment support and the cancellation of previously announced tax cuts will result in savings totalling CZK 74 billion, or 2% of GDP.

Hungarian bonds underperforming in 2010 and over the longer term



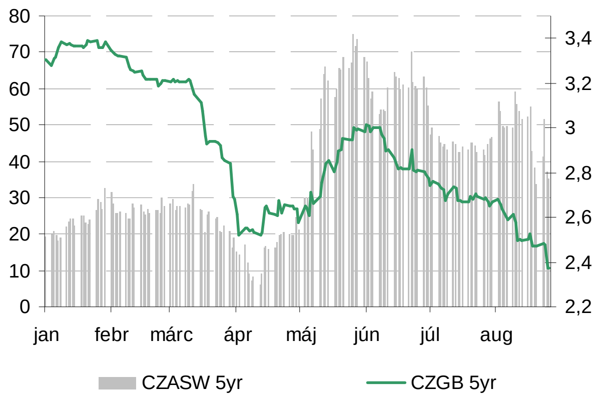
Source: Bloomberg



Source: Aegon Fund Management

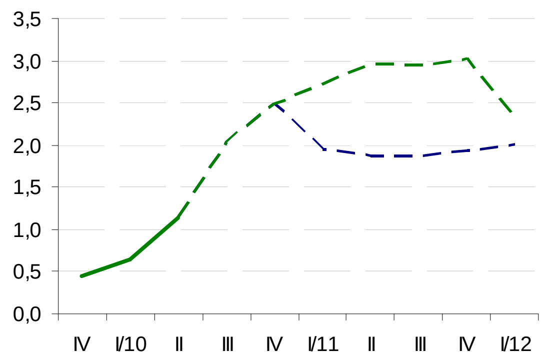
And there was certainly no shortage of positive market feedback: the yield on Czech bonds maturing in 2024 has fallen by 120 basis points to 3.5% since the beginning of the year, while in the Hungarian market similar notes are changing hands at a 7.5% yield, a figure that wasn't much higher in January. This week some EUR 5.3 billion in offers were received in the Czech Eurobond issue, and the risk premium had to be reduced from 115 basis points to 105 basis points almost at the last moment, due to the high level of demand, while the volume of the issue was also increased to EUR 2 billion from EUR 1.5 billion. The 10-year euro government bond sold at 3.7%. The situation is similar in the case of bonds issued in the local currency, with the three-year Czech notes selling at under 2% at Wednesday's auction. The credit rating institutes haven't been stingy with their plaudits either. Fitch, besides the low level of state debt (35%), highlighted the Czech economy's resistance to shocks, its credible monetary policy, strong banking system and external balance. It's no wonder, then, that investors are beginning to treat the Czech Republic as a safe haven in the region, and the bond yields are increasingly reminiscent of the bond market of a stable, mature economy.

Asset swaps tightening - still more to go…?



Source: Bloomberg

Change in the inflation forecast



Source: CNB, Aegon Fund Manager

As a negative side-effect of the strict fiscal policy the economy could slow down, which may be cushioned by a further reduction in the base rate. Instead of an interest rate cut, however, the maintenance of the current 0.75% rate is likely, followed by an increase in the base rate from the second half of 2011. A cut in rates is ruled out by the fact that in the inflation forecast for 2011, with the incorporation of the electricity price increase expected in January, the – until now 1.9% – annual price indices predicted for each quarter could rise to between 2.5% and 3%.

Prepared by AEGON Global Asset Management / AAM CEE
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