AEGON Asset Management

Outlook – April 2011

Gábor Orbán: How long will the party last?

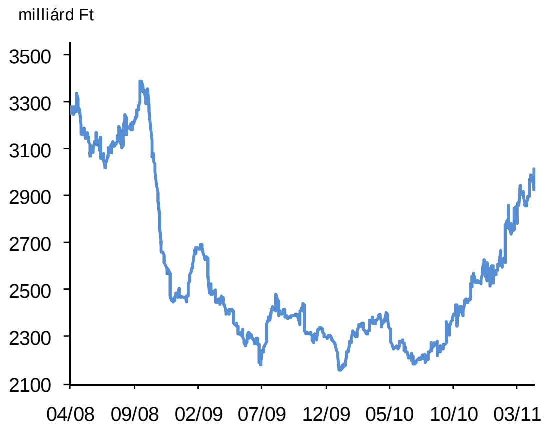
Now that we're approaching mid-2011 the global economic upturn that's lasted two full years appears to have reached maturity. The key signs of this are the robust growth figures, the upward trend in commodity prices and the attendant rise in inflation expectations, as well as the growing danger of a lifting of the strong economic-policy (specifically monetary) measures aimed at stimulating growth. This process of tightening has already begun in the emerging economies, where the emphasis is on quantitative methods (raising reserve ratios), while in the remainder of the year investors will be focusing their attention on decisions to be taken by central banks in major economies. The expected timing, extent and nature of measures to tighten today's extremely loose European and American monetary conditions, therefore, are among the main drivers of capital market trends. The first, 25-basis-point ECB interest rate hike took place in April, marking the start of the process. Statements by the governors of the Fed suggest that the end of quantitative easing in the US is likely to begin in June, and within a matter of months from then mortgage-based (MBS and Freddie/Fannie) notes will no longer be renewed, but will start to be withdrawn from the Fed's balance sheet as they expire, while the Fed funds rate could also begin to rise in 2012.

Strong parallels can be drawn with 2008, when the price of oil shot up to an even higher level than today. At that time, the ECB's initial response to the inflation risk was the same as in April 2011: an interest rate hike of 25 basis points. (In Hungary the interest rate was raised by 100 basis points in 2008 and by 75 basis points in 2011.) Back then the markets were trying to gauge how much banks had lost in the subprime crisis, whereas now close attention is being paid to debt sustainability of the countries on Europe's periphery. In 2008 the outcome was a freezing of the interbank markets, an increase in interest rates, the stalling of refinancing and the resulting decimation of demand, which in turn caused the price of oil to collapse, while expectations of rising inflation gave way to sustained fears of deflation. Following this the ECB's interest hike was quickly reversed, and the benchmark rate fell sharply when both the market and the real economy imploded in the wake of the Lehman crisis.

It's difficult to see what will now bring an end to the upward surge in commodity prices, and whether there can be a "soft landing" from this position. In the United States the dominant view is that the high price of oil acts as an automatic stabiliser, reducing demand, which in turn alleviates inflationary pressure, and so there is no urgent need for monetary intervention. The ECB's latest step, however, is highly likely to trigger a re-pricing of credit for European households, thus dampening consumer demand. The possible lifting of quantitative easing by the ECB, meanwhile, is a far more complicated issue: the banks on the periphery are in such a bad state that withdrawing the current generous availability of funds will remain off the agenda for some time. In the meantime, budgetary tightening has become a matter of increasing urgency everywhere, especially in the US and UK and in countries with a gloomy growth outlook.

Until the end of cheap money becomes a firm reality, appetites for risk will remain high. For the time being, in the short term, there is no reason to doubt either the strength of the upturn, or the sustainability of the current low level of volatility. These circumstances go a long way to explaining the success of the recent Hungarian foreign currency bond issue, since although the news arriving from the domestic market (which was incomparably better than in the previous year) was certainly an important contributing factor, without the printing of money on a global scale this would not in itself be sufficient to generate the total of EUR 4 billion in funds that are planned. Although Hungary's economic policy is on the right track, there has been no permanent change in the traditional perception of the Hungarian market, which is what causes the fluctuations in appetite to have such an exaggerated impact in this market. The local currency is in the process of being revalued, and this is also reflected in the market's decreasing vulnerability – for example, the way it managed to shrug off the bad news arriving from North Africa and Japan. Ultimately, however, Hungary's sensitivity to foreign sentiment stems from its high level of external debt, so in the long term our dependence on foreign investors can only be reduced by the extent to which we work off this foreign debt. This is why the issue of which currency the external debt is denominated in should essentially be determined by the needs and the mandates of investors, as well as by the National Bank of Hungary's FX-reserve policy.

Government securities held by foreign investors



Source: State Debt Management Agency

Republic of Hungary CDS

Source: Bloomberg

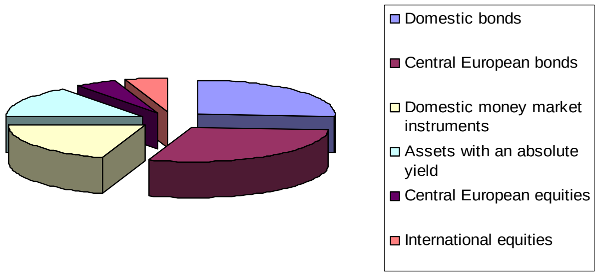
The link between foreign investors and Hungary's debt management efforts warrants close scrutiny, as it is only now that the process of exchanging the loans provided by supranational institutions (IMF, European Commission, World Bank) for market financing is really getting under way. The role of foreign players in the local market deserves special attention also in light of the fact that the portfolio of government securities held by foreign investors topped HUF 3,000 billion again on 13 April. First of all this indicates that following the lengthy period of pessimism, a number of the under-positioned foreign investors topped up their portfolios to a neutral weight of Hungarian bonds. A big question, however, is where the equilibrium in terms of foreign investors' forint government securities portfolio, offloaded with such shocking rapidity at the end of 2008, might be; certainly, the recent two-and-a-half year peak in foreigners' government bond holdings clearly points to an overbought market. It is also unclear whether the circle of investors that previously held this debt will be able to finance the Hungarian state again later on, once the fundamentals have improved and the crisis has run its course, or whether they have simply ceased to exist, in which case the equilibrium point is somewhere below where it was prior to 2008. At the end of 2008 these continental (German and Austrian) investors, who could be described as convergence investors in the traditional sense of the word, fell by the wayside as massive withdrawals were made from funds as a consequence of the general flight from risk. The original convergence funds are shadows of their former selves, and even now that the crisis has passed they have failed to recover, not least because in the meantime the concept of nominal convergence has also lost its meaning. Today, at best, these funds are limited to adopting tactical positions in the Hungarian market for a few months at a time. Added to this, the European banking sector is also stymied by the fact that its books are full of bonds issued by countries on the periphery of the eurozone, whose increasing bankruptcy risk means that the banks have no leeway to take on additional risk, in the Hungarian bond market for example.

The good news is that the past two years, not least due to the indirect effects of money printing, appear to have witnessed a strengthening of those US pension funds and large dedicated emerging-market fund managers (and reportedly even an Asian central bank) which, as strategic investors, are seeking major exposure to emerging markets. One reason for the structure of this year's Hungarian foreign currency bond issues, in which the ratio of dollar to euro bonds is 3:1, is that there is stronger demand for investments of this type among the US funds. Besides, it is certainly no coincidence that the Polish government also announced a dollar bond issue this week. On the forint bond market too, it is the American buyers who have been the main movers over the past few weeks, having virtually single-handedly bought up the quantities put on the market by the government, while domestic investors have essentially taken a back seat. Given the evident growing importance of US end-investors, it appears that for the purpose of assessing potential foreign positions in the local bond market, the earlier high reached in the summer of 2008 could again serve as a useful benchmark.

Recommended portfolio:

In the present market environment AEGON Fund Management considers the following portfolio structure to be ideal, offering balanced performance with a medium risk profile:

Assets	Weight
Domestic bonds	26%
Central European bonds	29%
Domestic money market instruments	20%
Assets with an absolute yield	15%
Central European equities	5%
International equities	5%



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