

# Eastern & Central Europe:

## *Investment Opportunities Beyond the Political Headlines*

Malcolm Dorson, Portfolio Manager  
June 2017



In the last two years, political developments in Eastern and Central Europe have generated volatile headlines on everything from international sanctions to coup d'états. Looking beyond the headlines, though, select countries and sectors within the region offer considerable growth opportunities at attractive valuations.

# Eastern & Central Europe:

## *Investment Opportunities Beyond the Political Headlines*

### Russia

#### *Politics*

Political risk is a recurring story for the Russian market. Looking back to 2014, assets have digested the Ukraine Crisis, military intervention in Syria, economic sanctions from the European Union (EU) and United States, and accusations regarding intervention in the U.S. election. As such, low valuations (the P/E multiple for the Russian equity market is roughly 50% and 70% lower than the MSCI Emerging Markets Index and S&P 500 Index, respectively<sup>1</sup>) reflect investors' apprehension about investing in Russia. The combination of the mentioned headlines, falling oil prices, and a sharp depreciation of the ruble, sent the country into a two year recession. We are now seeing a turnaround.

**Russia's economy appears to be moving into a period of monetary easing and a return to growth.**

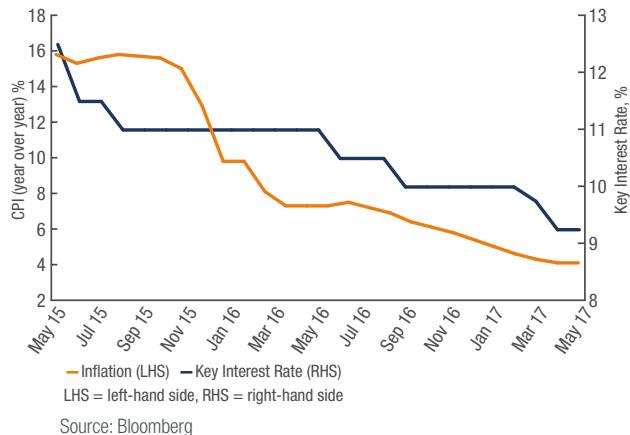
#### *Investment Opportunities*

Recent trends have shifted investors' sentiment on Russia from untouchable to opportunistic. Oil prices have rebounded by roughly 50% from 2016 lows,<sup>2</sup> which, in combination with prudent central bank maneuvers, has translated into a stronger ruble and lower-than-expected inflation levels. Lower inflation has provided room for further monetary easing. The Russian central bank has recently reduced the key interest rate four times down to 9.25% from 11%, which should help spur borrowing, capex, and GDP growth.

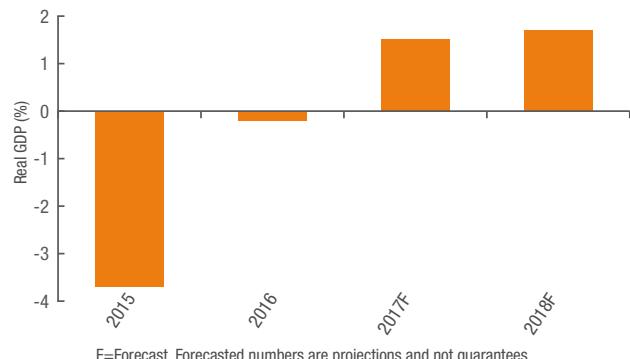
Now, after two years of contraction, Russia's economy is expected to expand in 2017, with a forecast GDP growth rate of 1.5%. Consumer demand, once a main driver of growth in Russia, was severely impacted by the recession and high inflation. As the recovery evens out across regions, an increase in real wages and continued low unemployment should boost consumer activity. These positive trends provide a strong investment case for Russia.

Although geopolitical risks and sanctions remain, there is a long term possibility of an improvement in Russian relations with the West. Any signals implying an easing or removing of sanctions would be another positive catalyst for Russia. Russia's economy appears to be moving into a period of monetary easing and a return to growth. More importantly, company fundamentals are coming from a low base and are well positioned to benefit from an economic turnaround. We continue to invest in domestic stories with structural growth drivers.

#### **Russia's Declining Inflation Allows for Further Monetary Easing**



#### **Russia Rebounds in 2017**



<sup>1</sup>Bloomberg, data as of 6/9/17. The p/e multiple is 6.1x for the MSCI Russia Index, 12.9x for the MSCI EM Index, and 18.8x for the S&P 500 Index.

<sup>2</sup>Source: Bloomberg

## Turkey

### *Politics*

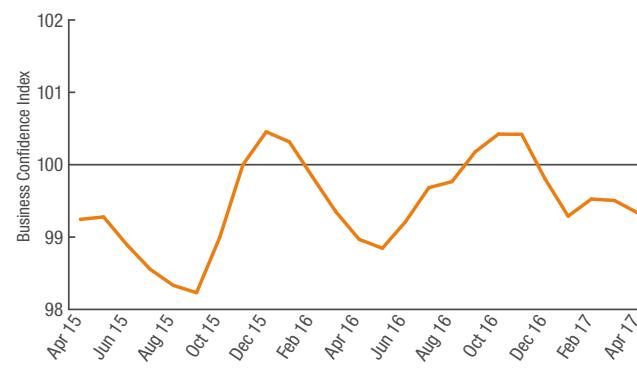
Politics remain center stage in Turkey. The country has been under a state of emergency since the July 2016 failed coup and President Erdogan has managed to expand his powers via a presidential referendum. Erdogan's authoritarian actions, such as imprisoning political opponents and journalists, will continue to generate negative headlines but the shift to an executive presidency will likely keep him in office for at least another two terms. For investors, this could provide continuity, but the economic implications remain uncertain. In terms of growth, this uncertainty will probably put downward pressure on an already weak Turkish lira, accelerate inflation (already high at 11.9%<sup>3</sup>), and potentially lead to a more hawkish monetary policy.

### *Investment Opportunities*

Though Turkey boasts attractive demographics and attractive potential long term growth rates, we believe that its large current account deficit (CAD) make it a less desirable investment opportunity. The country's CAD, despite significantly decreasing from \$74 billion (9% of GDP) in 2011 to \$33 billion (4% of GDP) by the end of 2016,<sup>4</sup> is rising again due to a recovery in oil prices and a slump in tourism following a surge of terror attacks. Over the past few months, business confidence has dipped, an indication that companies are less optimistic on the economy. Adding to this is the negative impact of a stronger U.S. dollar and rising U.S. interest rates, which could hinder Turkey's ability to attract foreign inflows to offset the deficit.

Our portfolios maintain an underweight position in Turkey; however, lower valuations may offer an entry point to high-quality, well-managed companies with earnings growth.

### **Business Confidence in Turkey Declines**



Source: OECD (2017), Long-term average=100

**Consumer sentiment is robust in Hungary, with the consumer confidence index rising to a 10-year high.**

## Central European Three (CE3)

### *Politics*

Hungary, Poland, and the Czech Republic are collectively known as the Central European Three (CE3). These three countries have also experienced their share of political volatility. Poland's PiS party, elected in October 2015, is known for its nationalist rhetoric and desire for wealth redistribution across the economy. In Hungary, Viktor Orbán is on his third term as president and is a good example of the European populist movement. Recently, the Hungarian government passed a bill to toughen restrictions on foreign universities with the aim of closing the Central European University. In the Czech Republic, the recent resignation of the Prime Minister is likely to add to the political turmoil as the country heads into October elections.

### *Investment Opportunities*

Hungary's economy is gaining steam under the strong-arm leadership Viktor Orbán, despite his controversial policies. The government recently presented a bill to Parliament to reduce payroll and corporate tax rates, increase government spending, and increase the minimum wage. In addition, the country's labor market remains strong, with employment expanding by more than 2.5% to 66.5% from 2015 to 2016, and the unemployment rate declining to a record low of 4.6%.<sup>5</sup> Consumer sentiment is also robust, with the consumer confidence index rising to 102,<sup>6</sup> a 10-year high. These positive trends should help drive economic growth.

<sup>3</sup>Turkish Statistical Institute, CPI as of April 2017.

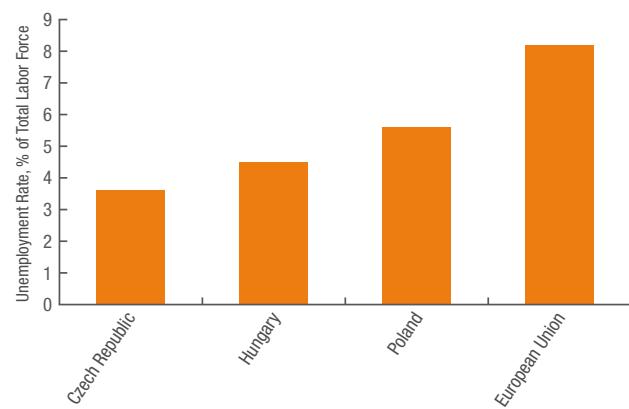
<sup>4</sup>Central Bank of the Republic of Turkey, OECD, May 2017.

<sup>5</sup>OECD

<sup>6</sup>OECD, Consumer confidence index, long-term average=100. Data as of March 2017.

The Czech Republic boasts a highly-skilled workforce and a welcoming business environment. The country is also a beneficiary of the European Structural and Investment Funds (ESIF), the EU's main funding program that invests in job growth across Europe. Rising wages and a 3.6% unemployment rate (one of the world's lowest) supports strong household consumption, where spending has grown from 1.6% in 2014 to 3.0% in 2015.<sup>7</sup> In April, the Czech central bank lifted the cap on its currency, the koruna, which could lead to currency fluctuations. Broadly, we believe that the Czech economy would continue to benefit from a recovery in Europe.

### The CE3 has Some of the Lowest Unemployment Rates in Europe



Source: OECD, as of 4Q2016.

<sup>7</sup>World Bank.

<sup>8</sup>IMF World Economic Outlook, April 2017.

**As active managers, we are able to analyze political implications, filter out noise, and invest in companies with attractive valuations and growth potential.**

Poland is one of the fastest growing economies in the region with GDP growth expected to reach 3.4% this year, well above the growth rate of 2.0% for the EU.<sup>8</sup> The country's large domestic market, wage increases and low unemployment support economic growth. Poland is also the top recipient of ESIF which could provide new investment opportunities. However, growth may be constrained by the PiS party's economic policies, which seem focused on wealth redistribution.

### Compelling Investment Opportunities

At Mirae Asset, we believe that the economies of Eastern and Central Europe offer compelling investment opportunities for long-term investors. As active managers, we are able to analyze political implications, filter out noise, and invest in companies with attractive valuations and growth potential. We are seeing signs of growth returning to Russia and positive momentum in Hungary and Czech Republic. We are cautious on Turkey and Poland, but may take advantage of attractive valuations to invest in high-quality companies with superior management teams and proven operations.

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**Capital Expenditures (capex)** is the money spent to acquire or upgrade physical assets such as buildings and machinery.

**Current Account Deficit (CAD)** is a measurement of a country's trade in which the value of goods and services it imports exceeds the value of goods and services it exports.

**Consumer Price Index (CPI)** measures changes in the price level of a market basket of consumer goods and services purchased by households.

**MSCI Emerging Markets Index** is a free float –adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

**Price-to-Earnings Ratio (P/E)** is the valuation ratio of a company's current share price compared to its per-share earnings.

**Organization of the Petroleum Exporting Countries (OPEC)** is a permanent, intergovernmental Organization. Its objective is to co-ordinate and unify petroleum policies among Member Countries.

**S&P 500 Index** is a leading indicator of US equities, reflecting the risk and return characteristics of the broader large cap universe.

*Past performance is no guarantee of future results.*

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