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ROMANIA'S ROAD TO EUROPE CONTINUES TO MUDDLE THROUGH

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Romania, the fastest growing EU economy, is the largest country exposure in the European element of our Frontier Markets Equity strategy. Romanian stocks have performed strongly in recent months, buoyed by continued economic expansion in the country.

However, with negative noise surrounding the politics, members of our Frontier Markets and Emerging European Equity teams, as well as our fixed income analysts, visited Romania in April to reassess the country's progress.

KEY TAKEAWAYS

- Growth remains strong, with GDP expansion of 5% likely this year, following the 6.9% recorded in 2017. However, we expect a gradual slowing to a more sustainable level over the coming years.
- Rising wages and relatively controlled inflation are still supporting the consumer.
- The banking sector remains in an attractive part of the cycle. Banks are cleaning up loan books and credit is improving post the 2008 crisis. Our largest portfolio exposure in Romania is within the sector.
- In line with trends in Poland and Hungary, Romania's domestic political environment is deteriorating. We are seeing a slow erosion of democratic institutions.

A CLOSER LOOK

Economic data continues to be strong in Romania, which has stood out as the fastest-growing EU country over recent years. Although we are likely to see a slowdown in GDP after an exceptional 2017, growth will still run above potential. This is supported by a solid consumer backdrop of low unemployment and healthy retail sales, as well as recovering industrial production and growing exports.

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Romania is a few years behind countries such as Poland – with a cheap, in-demand, highly-educated and largely English-speaking labour force. Public wages were cut by 25% during the global financial crisis to keep fiscal accounts in line, but recently we have witnessed fast increases in public wages – which have now surpassed 2008 levels. This is applying pressure on the fiscal deficit, while bringing some constraints on other public investments.

Private sector wages have also been increasing. We are keeping an eye on the delicate balance between what is a healthy backdrop for the consumer and the increased inflation and cost risks for companies. Despite this, Romanian wages remain low – with an hourly labour cost half of Poland and Hungary – meaning the country remains an attractive Foreign Direct Investment (FDI) destination. FDI, together with EU structural funds, are likely to remain medium-term growth drivers.

What is the issue with politics, and does it matter? Politically, Romania has taken a negative turn – following the regional trend of Hungary and Poland – towards a slow erosion of democratic institutions. The leading PSD party has been using its parliamentary majority to change legislation, allowing it greater control over the country’s institutions – such as the independence of the judiciary and central bank. It is slowly removing checks and balances from the system.

In addition, public wage increases are constraining the fiscal accounts and public investments are being reduced. To fund the fiscal deficit, an amendment to the pension system to discourage Pillar 2 savings is currently being discussed – similar to Polish reforms. While it would reduce current government expenditures, it could potentially lead to longer term problems. Although Romania often tends to muddle-through political noise, these are all important issues for us to continue monitoring.

In terms of our Frontier Markets Equity portfolio, the macro backdrop is supportive and financial stocks remain the focus. Our holdings include the second and third largest banks in the country, BRD – Groupe Société Générale and Banca Transilvania, both of which have strong domestic franchises. These banks continue to have the highest near-term return on equity (ROE) in the region, with continued recoveries of non-performing loans (NPLs) generated during the previous crisis and limited new NPL generation. We expect both banks to pay high dividends this and next year.

Malik Sarmad Asif, our financials analyst, believes valuations are attractive, given the steady earnings and dividend growth, as well as strong returns and capital positions. Post our trip, Banca Transilvania reported a 49% increase in earnings for the first quarter of 2018, which was off an already-high base.

We also find Med Life to be an exciting structural growth story. Romania's largest private healthcare provider, Med Life is well positioned to benefit from underlying sector trends. Investment analyst Johannes Loefstrand spent time visiting its hospitals and discovered sharp differences between its offering and the legacy state healthcare system. The latter is clearly struggling after decades of underinvestment.

At Med Life, its entrepreneurial management team is proving to be good operators and shrewd capital allocators. Meetings with the company, as well as its key competitor in the space, underlined the continued growth potential and attractive business model of Med Life.

Key Risks - The following risks are materially relevant to the strategy highlighted in this material:

Transactions in securities denominated in foreign currencies are subject to fluctuations in exchange rates which may affect the value of an investment. Returns can be more volatile than other, more developed, markets due to changes in market, political and economic conditions. Investments are less liquid than those which trade on more established markets.

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