

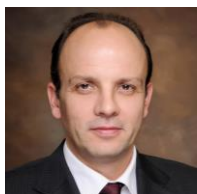


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Global Fixed Income **CENTRAL AND EASTERN EUROPE GROWTH CREATES RELATIVE VALUE OPPORTUNITIES**



Peter Botoucharov
*Fixed Income
Sovereign Analyst*



Ivan Morozov
*Fixed Income
Sovereign Analyst*

KEY POINTS

- Strong economic growth in central and Eastern Europe has been synchronized across countries but has been accompanied by a divergence in inflation dynamics.
 - We are finding that this environment presents a number of attractive relative value opportunities.
 - However, despite these opportunities, investors also need to be aware of certain idiosyncratic political risks facing the region.
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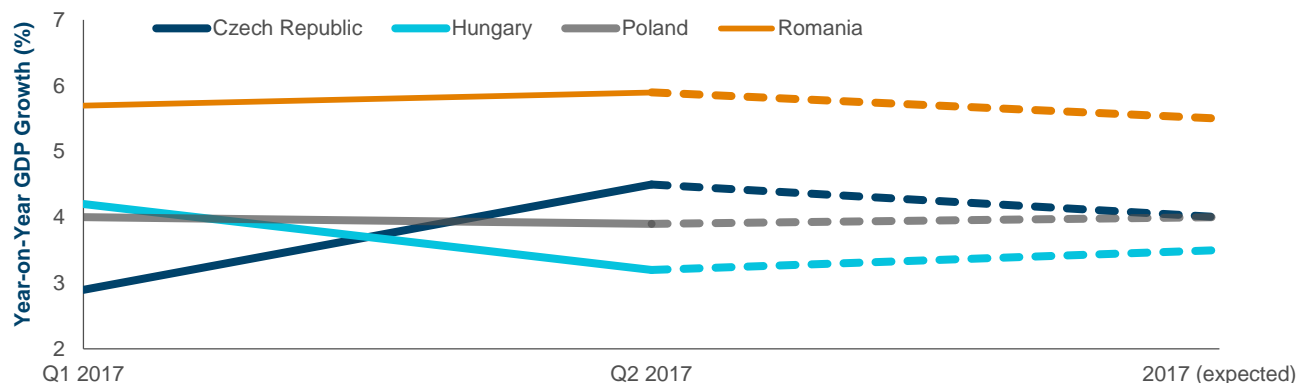
Central and Eastern Europe (CEE) have recently benefited from strong, broad-based economic growth that has exceeded market expectations, driven, in part, by robust levels of private consumption and investments. This growth has been synchronized across a number of countries in the region and has opened a number of attractive opportunities for fixed income investors.

The Romanian, Czech, Polish, and Hungarian economies have all generated bumper growth so far in 2017, with full-year gross domestic product (GDP) expected to rise by 5.5%, 4%, 4%, and 3.5%, respectively (see Figure 1, page 2). Buoyant external demand has been a contributing factor as central European nations, particularly those that are European Union (EU) member states, have benefited from economic expansion across the bloc, which is the biggest recipient of CEE exports.

Serbia, while not an EU member, has benefited from its Stabilisation and Association Agreement with the EU, through which it can export industrial goods to the European Single Market. Indeed, strong export growth has stimulated increased investment and employment across the whole of CEE, which in turn has led to healthy domestic demand growth in the region.

Figure 1: Year-on-Year GDP Growth in the Czech Republic, Hungary, Poland, and Romania

As of September 25, 2017



Source: FactSet; data analysis by T. Rowe Price.

EU STRUCTURAL FUNDS

The disbursement of EU structural funds has also buoyed the region. Poland is set to be the biggest beneficiary of planned support funds from the 2014–2020 EU budget, receiving around €115 billion over the period, with annual receipts equivalent to around 3% of GDP. Romania, the Czech Republic, and Hungary also rank in the top 10 of EU member states by budget receipts. Fiscal stimulus measures, including tax cuts and increases in pension payouts, have further contributed to growth, in particular to that of Romania, Hungary, and Poland.

Elsewhere, Russia and Turkey have both seen second-quarter GDP come in well ahead of market expectations. Turkey in particular has benefited from a slightly more stable political outlook following a coup attempt in 2016, and the government has provided fiscal support to its economy, extending its fiscal deficit, although a recent dispute with the U.S. could weigh on confidence.

This rapid growth has tightened the labor markets of many of these economies. Unemployment in some CEE countries, such as the Czech Republic, Hungary, and Poland, has declined to historically low levels, and labor shortages are growing. Wage growth has been exceptionally strong, reaching double digits in several CEE economies in the past year. Despite this, however, labor costs in the region remain low relative to Western Europe, attracting considerable foreign direct investment flows. Meanwhile, in Russia, unemployment has fallen to its lowest level since 2014.

DIVERGING INFLATION

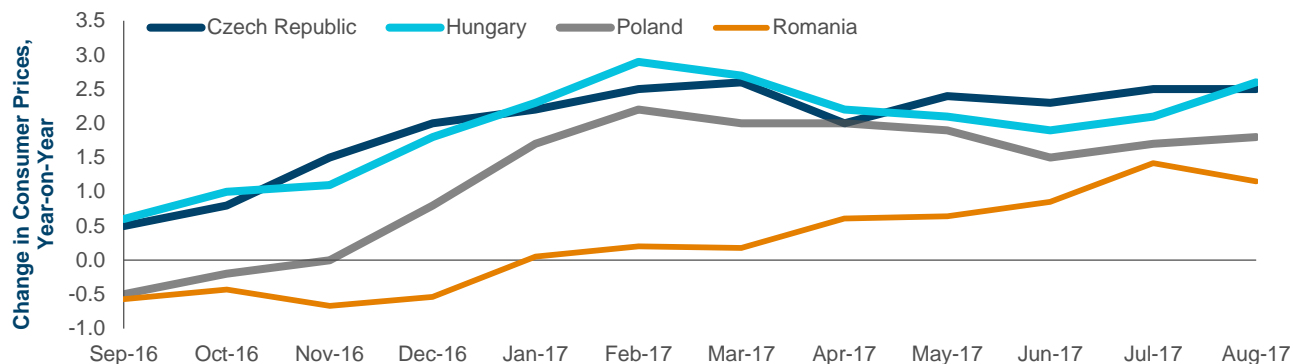
However, in spite of this broadly coordinated growth, the expansion of CEE has been accompanied by a divergence in inflation dynamics. On the one hand, a number of CEE countries have started to exhibit gradually rising inflation, driven by improving growth and tightening labor markets (see Figure 2, page 3). Hungary, for instance, is among the most exposed countries to reflation, in part because its economic growth has been driven by highly labor-intensive industries, and it has suffered acute labor shortages. Headline inflation in Hungary rose more rapidly in the year to August than in any other country in CEE, although inflation remains below the Hungarian central bank's target.

Poland, the Czech Republic, Romania, and Serbia are also facing the prospect of rising prices. In these economies, where interest rates are comparatively low for emerging markets, central banks are beginning to take steps to tighten their monetary policy accordingly, albeit with varying degrees of urgency.

On the other hand, countries such as Russia and Turkey have high but declining inflation, and benchmark interest rates are typically higher than in the rest of the CEE region—Turkey's late liquidity window rate stood at 12.25% in September, while Russia's benchmark interest rate was 8.5%. Here, there is the opportunity to cut interest rates.

**Figure 2: Core Inflation in the Czech Republic, Hungary, Poland, and Romania
September 2016 to August 2017, Year-on-Year**

As of August 31, 2017



Source: FactSet.

VARIED MONETARY POLICY

Beyond the clear demarcation between the economies with rising inflation and those with high but declining inflation, there are additional nuances in the reactions of central banks to growth. Among the countries where inflation is on the up, central banks have shown varied appetites for tightening monetary policy, and the diversity of monetary approaches across CEE can be seen as a microcosm of the broader emerging debt markets universe. Following the financial crisis of 2007–2008, many central banks in CEE implemented accommodative monetary policies and slashed interest rates to record lows in an effort to stimulate economic recovery. And despite the recent uptick in growth, monetary policy across much of the region has remained relatively accommodative, as policymakers are still cautious about prematurely tightening following years of stalling growth.

For example, the Hungarian National Bank has maintained an ultra-dovish tack despite rising inflation. At its September meeting, the bank implemented additional monetary accommodation measures, stressing the importance of keeping interest rates low in order for inflation to reach its target on a sustainable basis. Poland's central bank has also erred on the side of dovishness, with the market pricing in the first interest rate hike in late 2018.

Other policymakers, however, have been more aggressive. The Czech National Bank (ČNB) stands out as one of the most hawkish in the region. The ČNB was one of the first central banks in Europe to begin to move away from ultralow rates, hiking its benchmark policy rate from 0.05% to 0.25% in August, and is projected to further hike rates throughout 2017 and into 2018. Prior to this, the bank had eliminated its cap on the strength of the Czech koruna in April in response to strong growth and rising inflationary pressures in the country.

The National Bank of Romania, which—like the central banks of the Czech Republic and Hungary—is having to contend with mounting inflationary pressures, is expected to start gradually tightening monetary policy later this year, although much less aggressively than the ČNB. The National Bank of Serbia is also on the cautious side, although it maintains the highest interest rate in the region, currently at 3.75%, in view of its somewhat higher inflation compared with CEE peers. Russia, by contrast, embarked on a cycle of interest rate cuts at the beginning of 2015, after it had hiked its benchmark rate 650 basis points to 17% in late 2014 following a precipitous depreciation of the ruble. Turkey, meanwhile, maintains a relatively tight policy stance, but we expect it to begin loosening next year.

MEDIUM-TERM POLITICAL RISK

In this environment of varied monetary policy responses, political risk in CEE is a potential medium-term threat to the region, although with limited shorter-term implications. Poland, Hungary, and, to a lesser extent, Romania, all

face political insurgency movements focused on deglobalization and national interests that could harm their economic prospects. In Poland, the political situation has deteriorated as the incumbent Law and Justice party government has tightened its grip on all branches of power in the country, while in Hungary, Prime Minister Viktor Orbán's plans to make the country an "illiberal democracy" and his rejection of the EU's proposed refugee quotas have heightened investors' concerns over the country's political risk.

These political headwinds have potentially material longer-term implications for these markets. While the EU has no mechanism in place for penalizing countries that violate the bloc's principles of democracy, it could bring about measures to limit the disbursement of EU structural funds at the start of the next budgetary cycle in 2020. Given the importance of structural funds to CEE countries, the impact on growth on these countries could be significant and could lead to credit rating downgrades.

These risks need to be monitored. However, in the nearer term, the buoyant, broad-based growth in CEE does create a promising investment environment in spite of the political challenges.

It is essential to combine active management with in-depth fundamental research and a risk-aware approach to mitigate market inefficiencies and exploit these opportunities.

INVESTMENT OPPORTUNITIES CONTINUE

The divergent inflation dynamics and varied monetary policy approaches in CEE offer attractive relative value opportunities in particular. We favor holding overweight duration positions in countries where interest rates are high and are expected to decline, or where monetary policy is exceptionally dovish and central banks have the flexibility to maintain an easy monetary stance, versus underweights in countries with low rates and hawkish central banks. Specifically, we favor long rate positions in Russia and Turkey. We also like holding overweight duration positions in Serbia—where T. Rowe Price was one of the earliest international investors—which offers higher yields than peers and has a steep yield curve, as well as in Poland, versus short rate positions in the Czech Republic.

There are also opportunities in currencies. We favor long positions in the Czech koruna against the euro—despite the koruna's strong appreciation this year—and long positions in the Serbian dinar.

Notwithstanding the opportunities created by the region's strong economic growth, these positions need to be monitored closely and are subject to revision should the underlying inflation and growth dynamics change. It is essential to combine active management with in-depth fundamental research and a risk-aware approach to mitigate market inefficiencies and exploit these opportunities.

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