Weak Eurozone Data Boost Central and Eastern Europe

Lower chance of rate hikes enhances opportunity set.

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The latest purchasing managers' index manufacturing figures from the eurozone were surprisingly weak. Given that they are an amalgamation of survey data, it's difficult to say for certain why they were so disappointing, but it was probably due to a combination of idiosyncratic regional issues such as Brexit and more general concerns over global growth. Whatever the reason, the impact is that the European Central Bank (ECB) will not be hiking rates any time soon.

This is good news for investors in Central and Eastern Europe (CEE), where growth has been stronger than the rest of the Continent. The combination of strong local growth and the continuation of a dovish policy environment in the neighboring eurozone should mean that good opportunities to invest in CEE will continue to arise.

Romania, for example, has had a tumultuous time in recent years. The populist government overstimulated the economy in 2016–2018, leading to a spike in inflation that damaged investor confidence. More recently, though, inflation has peaked, and the government has shown signs that it has shifted to a more responsible fiscal position. Having hiked by 75 basis points last year, the central bank is unlikely to raise rates again in the near future if—as we believe—inflation remains under control. Romanian bond yields have been stable so far this year and could follow eurozone rates lower, which is why we currently hold a long position in Romanian rates.

We began buying Serbian debt when its yields were in the double digits. The 10-year yield is now down to 5.5%, but we think that Serbia's bonds still offer value. Inflation in the country is running at around 2.4% and has been fairly stable for the past few years, while the government has been running a primary fiscal surplus as it negotiates to join the European Union. There's a nice mix of sound macroeconomic fundamentals and sensible policymaking that resemble the Poland of 20 years ago, and we continue to hold this position.

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Talking of Poland, we currently have a short position on Polish rates. Gross domestic product growth in the country has been strong at 5% and unemployment has been low, but wage growth and inflation have been held back, partly due to an influx of workers from Ukraine. I think that has come to an end and that wages are beginning to rise again, which could signal rate rises down the line. I don't necessarily think that Polish rates will rise steeply, but if any central bank is going to be forced into hiking, it will probably be the National Bank of Poland. The market is pricing no changes in the policy rate over the next three years, so a short position on the country's rates therefore makes sense as a hedge against our long positions on Romania and Serbia.

Finally, we have a long position on the Czech koruna versus the euro. The Czech Republic has been capacity-constrained for a number of years, and it was one of the first countries to begin hiking rates in the summer of 2017, which means that short-term rates are high compared with the rest of the region, delivering positive carry versus the euro. The economy still lacks capacity, and inflation is running above target. We believe the currency is undervalued by around 5% and that the rates differential with the ECB is unlikely to diminish as the ECB becomes more concerned about eurozone growth. Indeed, the Czech National Bank might hike a bit more, meaning the koruna may appreciate, hence our long position in the currency.

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