Europe's financial fringe

BY MORENO ZANI

The EU countries on the periphery of the eurozone might be as rewarding as they are risky. With their economies adapting to required standards, they can benefit from both access to the world's biggest market and independent monetary policy.

Financial markets are navigating perilous waters as all-time high equity indices are threatening imminent reversals and a new banking crisis may well unfold.

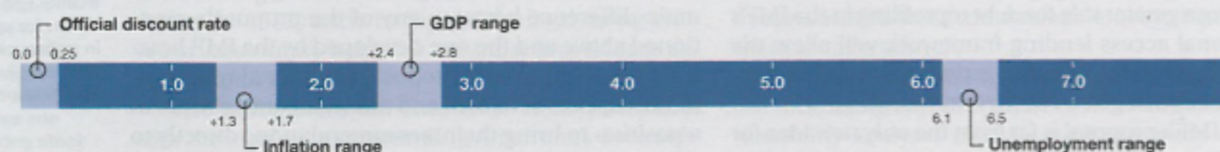
The fixed income markets have prospered immensely from the expansionary monetary policies implemented by the US Federal Reserve and the European Central Bank over the last few years, and their massive liquidity injections have pushed interest rates to extraordinarily low levels. Investors' perception of risk has radically changed. Issuers that were once considered high-risk have managed to secure tight risk premiums in this environment.

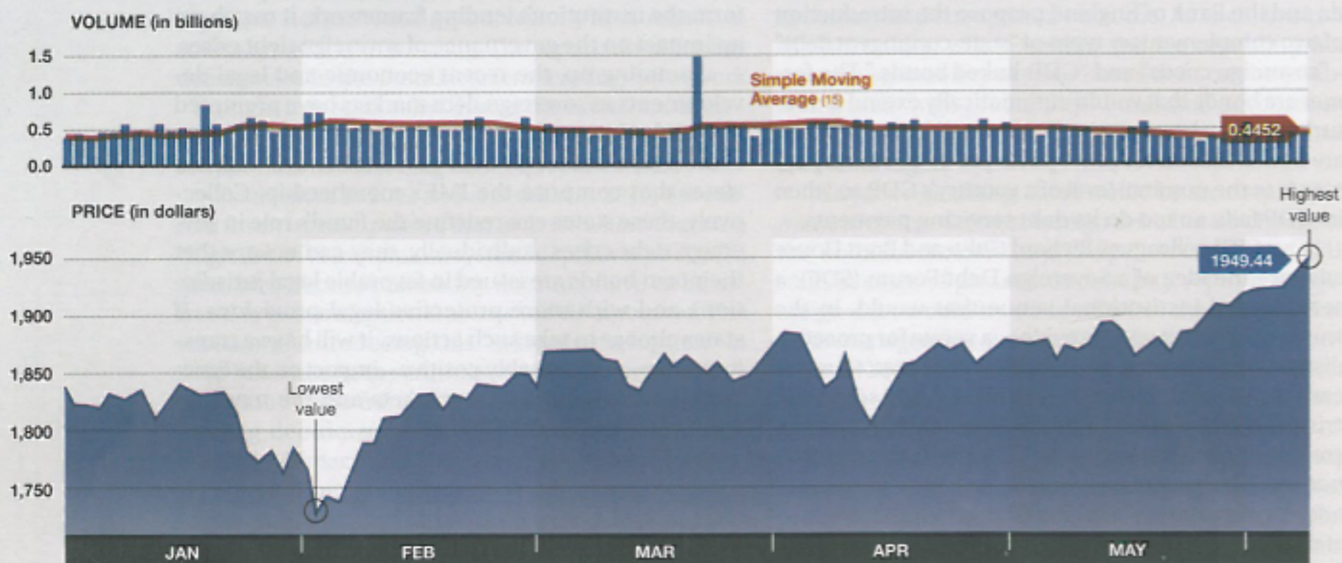
A strong mismatch has been established between the intrinsic risk metrics of fixed income issues and the markets' perception of risk, with investors now seemingly ready to do anything in order to generate returns.

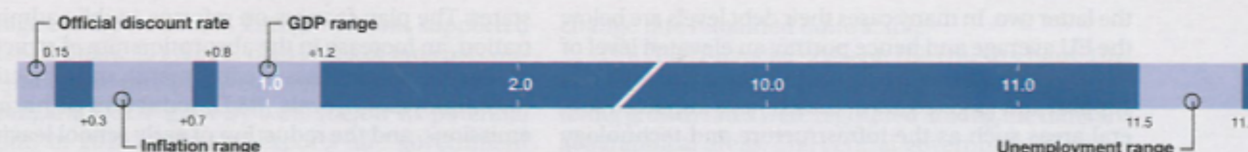
In this scenario, it would be useful to analyze the markets from another angle in order to determine the possibility of generating returns in conditions of acceptable risk.

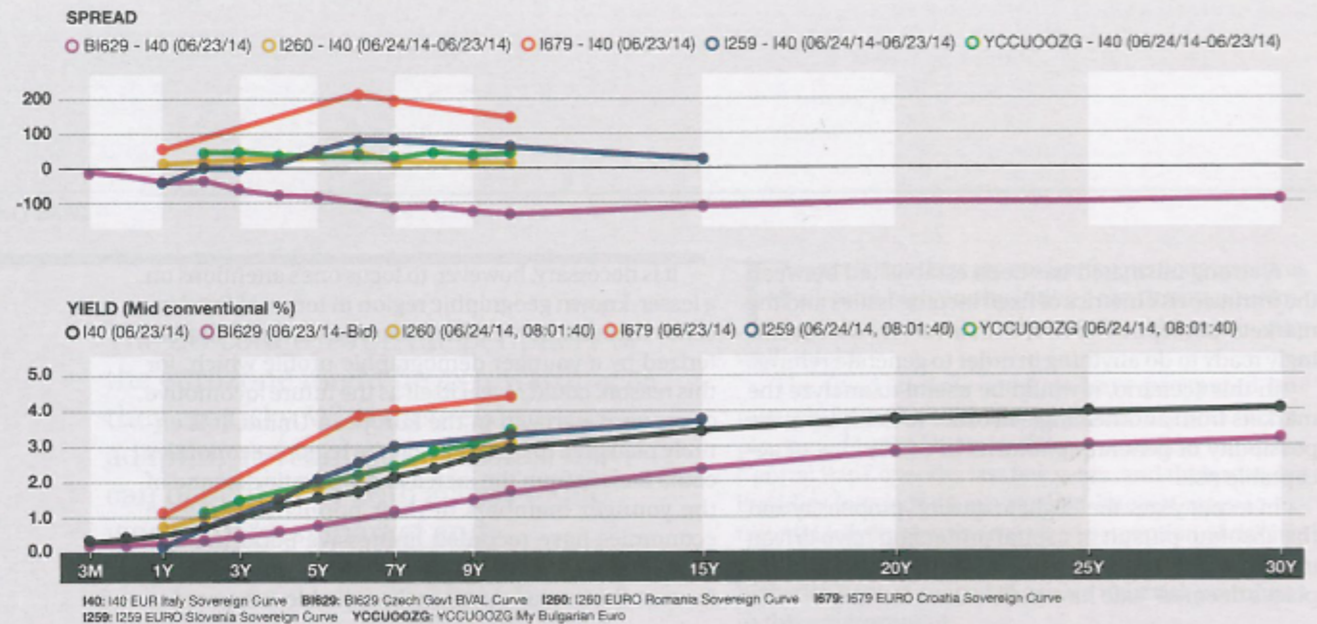
In recent years, the "flight to quality" propensity and the absolute pursuit of capital protection have driven investors towards the eurozone's core nations, the only places deemed "safe havens."

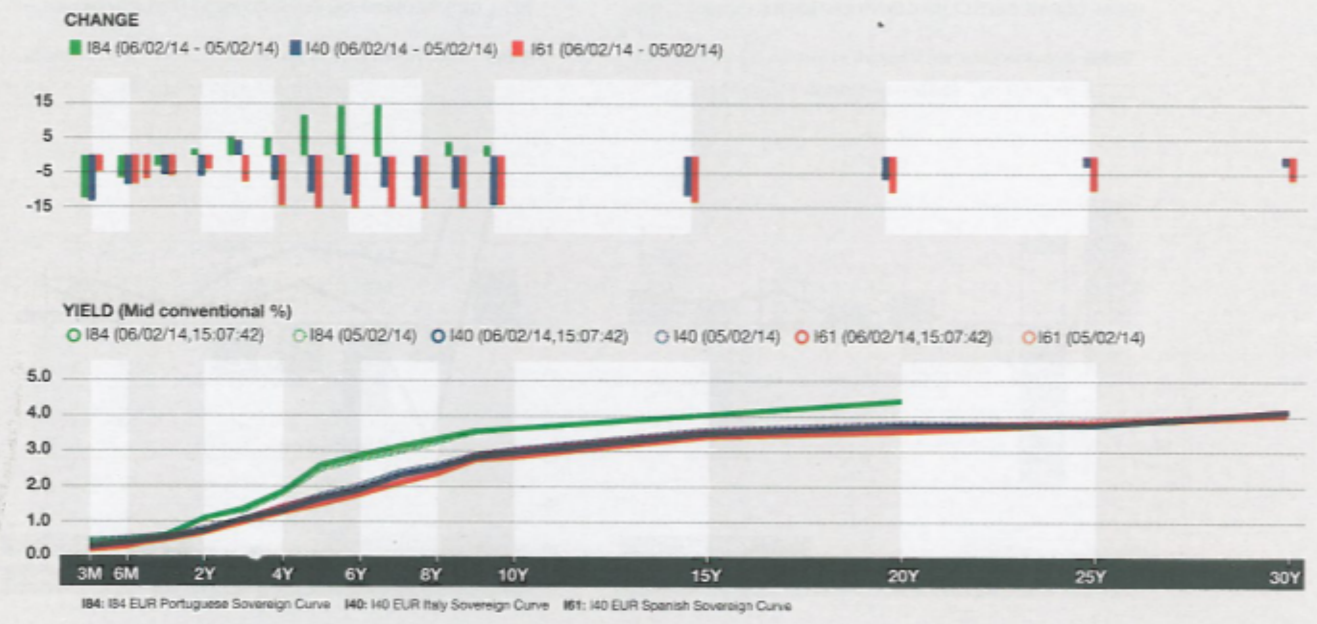
It is necessary, however, to focus one's attentions on a lesser-known geographic region in terms of fixed income investments, Eastern Europe, an area characterized by a younger demographic profile which, for this reason, could reveal itself as the future locomotive of economic growth in the European Union. It is entirely plausible to imagine that the region's economies could benefit from the increasing domestic demand of the younger members of their populations. These economies have recorded impressive performances when compared to Italy and France, with growth rates in most circumstances more than double compared to











the latter two. In many cases their debt levels are below the EU average and hence portray an elevated level of sustainability. Recent reforms implemented with the support and targeted aid of the EU have impacted several areas such as the infrastructure and technology sectors, and market liberalization. Smart decisions which, when combined all together, may have laid the foundations for a sustainable and lasting growth cycle.

The characteristics described above denote, at first sight, a higher quality credit profile than the other European countries. However, as too often happens, there are both positive and negative elements that the markets are unable to correctly price.

Let us look at Romania, Bulgaria, Croatia, and the Czech Republic, which continue to offer interesting risk/reward profiles in their government and corporate fixed income securities.

Analyzing the yield curves of the aforementioned countries, we can observe that there is essentially no direct relationship between the yields to maturity and the quality of the macroeconomic fundamentals.

In more detail:

Romania, after leaving the Soviet orbit of influence in 1989 with a highly obsolete industrial system, and joining the EU in 2007, generated a middle class and reduced a widespread level of poverty through the modernization of its economy. Romania, along with all the other members of the EU, adhered to the "Europe 2020" project, in which the European Commission outlines the growth strategy for all its member states. The plan focuses on reforms (public administration, an increase in the absorption rate of structural funds, and business environment) and objectives (unemployment levels, R&D, reduction of harmful emissions, and the reduction of early school leaving).

The 2008-2009 crisis did not overly impact the country, contrary to most other European member states, which was able to maintain a positive GDP growth rate and contain unemployment levels, due to prudent macroeconomic measures. The crisis was also an opportunity to undertake long-awaited reforms in the economic-financial, social security, public finances, and national healthcare sectors.

The strong performance of the Romanian economy during 2013 was led by the industrial sector (mainly focused on the automotive, construction, and IT industries).

The European Commission estimates that GDP growth will remain above potential up until 2015 not only due to the favorable international context (aid package from the EU) but also due to the implementation of macroeconomic reforms in the labor and goods & services markets. It is also predicted that the key drivers of growth will shift from the export sector (which benefits from relatively lower labor costs) to internal demand, which will grow on the back of increased standards of living and middle class expansion.

Bulgaria, formerly belonging to the Soviet bloc, joined the EU in 2007. During the four-year period 2004-2008, it registered considerable growth rates, an average of 6% per annum. This growth was supported by a solid financial system, high levels of internal consumption, and foreign investment flows.

Bulgarian GDP grew by 0.6% (below its potential output) in 2013, driven by exports and government spending, coupled with a contraction in household spending.

The economic recovery will be more diversified than in the past, with internal demand that will gather steam and assist the already strong export sector on the back of a favorable corporate tax regime that will strongly incentivize the industrial sector.

The budget deficit will remain stable at about 1.9% in 2014, and will decline further in 2015. This is an important factor as it leaves ample room for maneuver allowing the Bulgarian government to implement expansionary economic reforms.

Croatia joined the EU on July 1, 2013. The country remains one of the richest of the Slavic countries. The nation was heavily impacted, even in economic terms, by the 1991-1995 War, during which output fell dramatically. But more importantly, it missed out on the first investment flows going into Central and Eastern Europe after the fall of the Berlin Wall.

Between 2000 and 2007, the Croatian economy performed rather well. GDP growth rates of between 4% and 6% were registered, driven primarily by the tourism sector and by internal consumption, which was spurred by an extensive use of consumer credit, while the inflation levels and the kuna's foreign exchange rate remained quite stable.

The 2008 financial crisis hit the country hard. Unemployment reached historic highs, and hugely differing growth rates were registered among the different geographical areas. The central government reduced public spending and increased taxes, hiking up the value added tax as well.

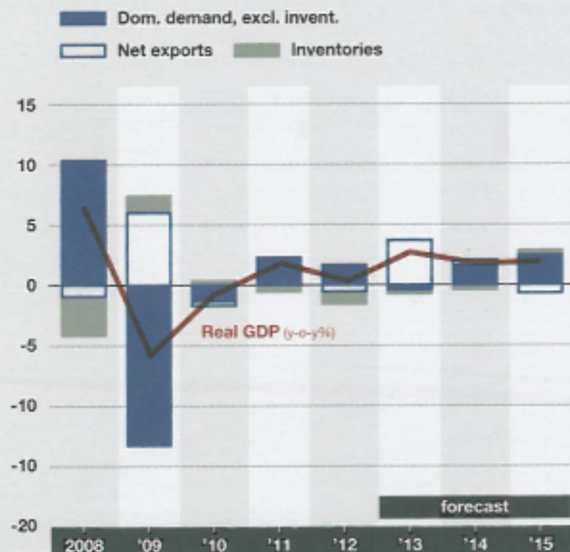
GDP contracted by 1.03% in 2013. Factors that contributed to this negative growth in 2013 included internal demand and the export sector. With the current economic policies, it is estimated that GDP will grow by 0.5% in 2014, with major contributions coming from the exports of goods & services, from tourism, and from structural investments.

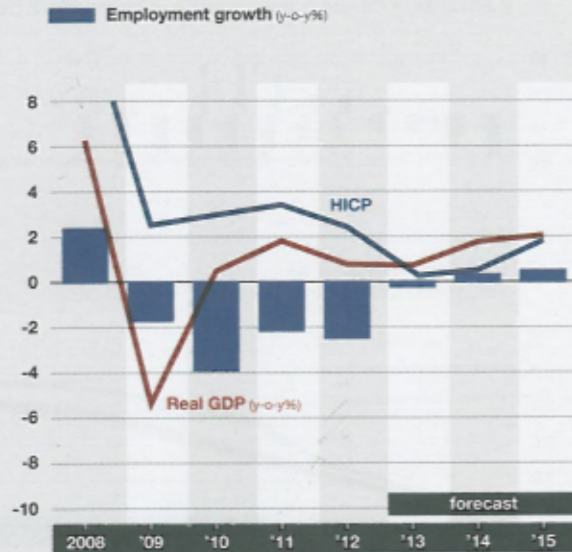
The latter will mainly come from the public sector, which will benefit from funds received from the EU. Exports will be driven by stronger demand from EU member states. Croatia's foreign demand for its goods will be weaker than others' as its main trading partners are Italy and Slovenia.

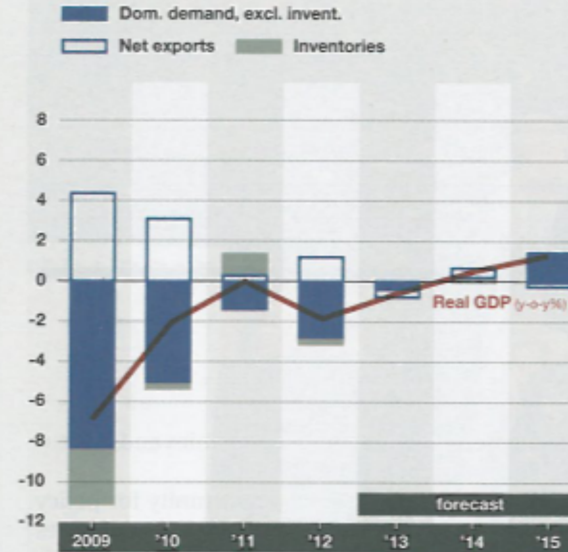
Internal demand (private consumption) will fall further in 2014 as households continue their "deleveraging" process. There should be a modest increase in internal demand in 2015.

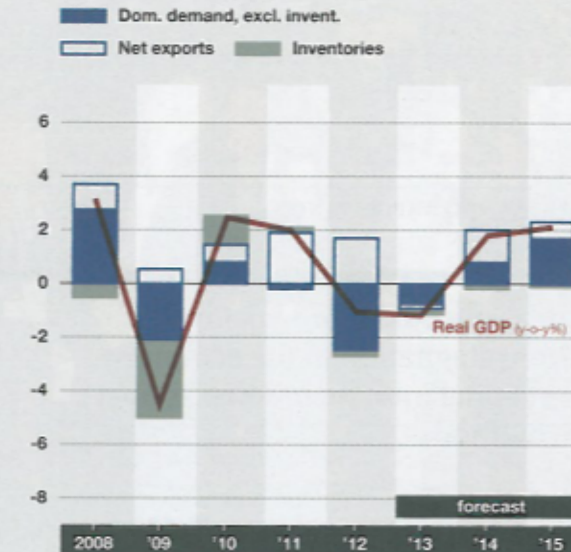
The budget deficit, which stood at 6% in 2013, is expected to fall to 5.4% in 2014 and to 4.8% in 2015 on the back of reforms to the national pension system, approved in January.

The **Czech Republic** is characterized by a stable and flourishing economy, highly integrated into the other









European markets. On the one hand, we find an established financial system, relatively conservative and focused on domestic dynamics, and hence substantially in good health. On the other, the economy is mainly geared towards the export sector, extremely dependent on the European economy, Germany in particular.

The country's main industry is the automotive sector which, together with the industrial sector, constitutes 25% of the manufacturing sector in the Czech Republic. For the first time, automotive production hit 1 million units in 2010, 80% of which went to export markets.

For the foreseeable future, the Czech Republic's economy is expected to improve its performance, driven primarily by the export sector which will benefit from the recovery of the eurozone. Very positive signals are also expected from the manufacturing and industrial sectors which will benefit from increased new orders and higher profit margins. In this context, the downside risks for the Czech Republic are essentially external, deriving from the euro area.

The budget deficit stood at 2.7% of GDP in 2013, and is forecast to remain substantially stable at 2.8% in 2014. The main reforms aimed at reducing this deficit consist of the reduction of the indexation of pensions, the increase in excise duties, and new revenues from the concession of radio and TV frequencies.

Summing up, the positive elements: The aforementioned countries have debt/GDP ratios well below the European average. Only Slovenia and Croatia have estimated 2014 GDP growth rates below the EU average. And with the sole exception of Croatia and Slovenia, unemployment levels are below the European average.

Following ECB President Mario Draghi's announcement of ordinary and extraordinary monetary policy measures on June 5, the effects of these policies are expected to be quite significant on their economies. Ultra-low interest rates and targeted loans tied directly to business lending will boost the eurozone economies. Not only will the core European countries benefit from these, but the frontier nations of the EU periphery, such as Bulgaria and Romania, will also reap the rewards. These economies are, in fact, heavily geared toward manufacturing, which will be positively impacted. In reference to the fixed income markets, the monetary policies of the ECB have contributed to the further yield tightening of the traditional peripheral countries, rendering more attractive Eastern European debt instruments.

On the other hand, however, significant political risks remain, with widespread corruption and a banking system that is not yet on par with European standards, despite enjoying the ECB's financial safety net after joining the EU. This has recently been demonstrated by the European Commission's $2 billion credit line (partially guaranteed by the EU) in support of Bulgaria's banking system following bank runs on two of the main Bulgarian credit institutions not owned by European banking groups.

This case demonstrates how, even in the presence of a solid financial system, panic can insinuate itself and wreak considerable damage.

These are the risks and opportunities of investing in the frontier countries of the outer periphery of the EU. Unfortunately, despite the last few years dedicated to creating and fostering solidity in the European financial systems, the eurozone is still facing cases, such as Bulgaria, that provide systematic risk and contagion to nearby countries. At the same time, Portugal (which is neither Bulgaria nor Romania) is currently facing a national crisis through the troubled Banco Espirito Santo.

This highlights the important work that the EU and the ECB are still required to undertake in order to restore stability and confidence to the eurozone and provide a "safe haven" status to investors.

Do not forget that other European financial institutions (such as BNP and UBS) are struggling due to different problems, but of a size and gravity of far bigger dimensions that risk throwing the EU back into the throes of the recent crisis, a reminder that even the core EU countries are not without risks. For both peripheral and core EU countries, it is a case of risk/return, bearing in mind that markets are "globalized" and problems are transmitted quickly throughout the global system.

Clearly, within the banking system, a quicker adoption and implementation of the EU banking regulatory and supervisory framework outlined by Draghi would help in stabilizing the situation.

So the perceived macroeconomic risks are under- and over-estimated by the markets, according to the prevailing "state of grace" of the markets. Personally, I would evaluate the risks not on an individual level but in a more general context, within a European framework, to which each risk is linked by a two-way street. Let us not forget that the aforementioned countries are members of NATO, have access to the EU's structural funds, and, for a certain number of years, still maintain their own central banks and currencies, allowing them to be very competitive from an industrial point of view.

Considering that investors are faced with investment decisions, the government and corporate debt instruments of these countries, expressed in euros, offer interesting economic returns throughout the entire maturity spectrum when compared to the current yields offered by Italian, Spanish, and Irish instruments, and at absolutely favorable risk/return conditions.

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