

Press release

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Investor sentiment improved, but a selective strategy on financial markets is still recommendable

- **US: limited upward potential for US stocks in the medium term; emerging markets fundamentally more attractive**
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- **Japan: further recovery, but only moderate growth in the medium term; stock market downgraded to neutral**

The global economic and financial crisis seems to have been halted for now. The monetary and fiscal policy measures taken by the central banks and governments have succeeded in containing the crisis. *“Right now, we cannot really say if the crisis has been completely overcome and cut at the roots,”* pointed out Fritz Mostböck, Head of Erste Group Research. In any case, the sentiment among businesses and market participants has brightened enormously. However, we need to wait and see if the global liquidity measures and interest rate cuts by the various central banks have been successful. In some areas of the economy, the trend is moving moderately upwards again, while in others the crisis has hardly abated. The Erste Group analysts therefore recommend sticking to a selective strategy on financial markets and to overweight cash for now.

Therefore, the recommendation of Erste Group is: **Overweight cash, underweight bonds, stocks neutral.**

Asset allocation for 4Q 2009:

Neutral portfolio	
Cash	Overweight
Bonds	Underweight
Stocks	Neutral
International bond portfolio	
Europe	Neutral
USA	Underweight
Japan	Neutral
Emerging Markets	Overweight
International stock portfolio	
Europe	Overweight
USA	Underweight
Japan	Neutral
Emerging Markets	Slightly overweight
FX allocation	
Dollar block	Underweight

US: Economy, bond and currency market – economy to be supported in H2 2009 by temporary factors and expected to slow down again in 2010

The US economy seems to have bottomed out, and after the slight decrease in Q2 the third quarter will record a considerable increase. Nevertheless, the factors that have played a role in the economic growth seen over the past three months will already subside starting Q4 2009 or in the first half of 2010. For example, the US version of the scrappage premium for cars massively boosted car sales in July and even more in August, but this scheme has come to an end. Thus, the only support expected in Q4 should come from inventory reduction. Overall, Erste Group analysts perceive the US economy to be supported in 2HY 2009 by temporary factors and as such it is expected to slow again next year, although it should not slip back into recession. The economic outlook for 2010 is bleak, with the stimulus package by the US government and the liquidity injections by the Fed already accounted for. Consumer demand should remain subdued, and high overcapacities let us expect the same for investments.

The US central bank will remain in the spotlight. The Fed has been pumping massive amounts of liquidity into the economy in an unprecedented fashion. Therefore, it has a difficult task ahead of it next year: it has to remove liquidity from the economy in the correct dosages. If it withdraws the liquidity too soon, chances are that the economy will be stifled. Delayed action, on the other hand, could result in rising inflation rates down the line. "We think that the Fed will start withdrawing liquidity in the second quarter of next year at the earliest, and we do not expect interest rate hikes before the third quarter," commented Rainer Singer, Co-Head of CEE Macro/Fixed Income Research.

The medium-term risks of the expansive monetary as well as the fiscal policy are expected to cause the USD to depreciate further.

US equity market: limited upward potential for US stocks in the medium term; emerging markets fundamentally more attractive

The medium-term upswing that had started in March continued throughout the past months on the US equity markets. Almost all sector indices posted gains in the past quarter. However, the fact that utilities were extremely weak and closed down on the quarter shows investors' long-term interest in US equities is of a limited nature. Additionally, Erste Group analysts point out that whereas the US share indices have been rising since March, turnover has been sliding. This leads them to conclude that the most recent upswing on the stock exchange in the USA is less stable than on other markets.

"Overall, we do not perceive much potential for US equities over the medium term. On the one hand, the valuations are not low enough so as serve as a reason to buy, and on the other, the growth prospects for the near future are lacking," is the assessment of Hans Engel, International Equity Markets analyst at Erste Group.

There are much more attractive alternatives on emerging markets right now that offer lower risk and probably greater potential. The long-term perspective is clear: US equities will not be the outperformers of the coming years. Therefore, the recommendation of analysts remains to strategically underweight US equities. Overall, in this phase of the global economy a generally neutral equity weighting seems appropriate.

Euroland: Interest rates and bond market – rebound from recession expected in Q3; sustainable consumer demand is still questionable

Industrial production and private consumption already benefited from governmental support measures such as the passenger car scrap premium. Sentiment and leading indicators show that the economies in the euro zone are expected to move out of recession already in 3rd quarter. However, this economic recovery should not be overestimated. The economy is still close to the trough and it remains to be seen if consumer demand will be able to improve sustainably. For the full year 2009, the Erste Group analysts' GDP forecast of -3.6% remains intact. *"The insecurity regarding the precise impact of the recession on the labour market will weigh on the consumption propensity for some time to come,"* explains Rainer Singer. The lower capacity utilization rates and the weak company earnings suggest only weak dynamics for capital expenditures in the corporate sector. The forecast for GDP growth in the euro zone 2010 is still cautious and stands at +0.4%. Accordingly, inflation should remain low in the foreseeable future. It is to be assumed that the ECB will gradually increase key lending rates only in 2HY 2010 again. Erste Group analysts expect the yields on ten-year German government bonds to rise, due to the growing degree of indebtedness.

European equity market: stocks had a strong performance; overweight due to more attractive valuations

The European equity markets continued their strong performance in the past three months. Financials were yet again the top performers at +30% while the industrial sector also recorded strong gains in the past quarter and increased by a remarkable 26%. Commodity producers (+20%) benefited from the market environment as well as from the overweighting of cyclicals in the portfolios of investors amid the improving economic situation. Finally, the underperformance of defensive sectors was prolonged in the third quarter. One of the main reasons for the current recovery of the equity market is the globally low level of government bond yields. The interest rate curve is currently descending as steeply as it was only in 1998 the last time. Steep interest rate curves have had very positive effects on stock exchange gains, historically speaking.

"We upgrade our global weighting of Europe as a region to "overweight" and generally recommend a "neutral" stance towards shares. This means we are cautiously positive about the purchase of shares," states Hans Engel, International Equity Markets analyst at Erste Group. At this point of the economic cycle, equities are fairly valued in the opinion of the Erste Group analysts. The recommended overweight for Europe is mainly based on the fact that the US market is more expensive. The S&P 500 is currently traded at a price/book value ratio of 2.2x, whereas the same ratio is 1.45x for the Euro Stoxx. This is a gap of more than 50%. Even if one compares inverse PERs (earnings yields) and the bond yields on these markets, the picture painted for European equities is much brighter.

Japan: Economy, interest rates and currency – further recovery, but only moderate growth in the medium term

Erste Group Research believes there is further upside potential in Japan after – as expected – a positive second quarter. Based on exports, the overall production in 3Q should also have increased slightly. Exports have benefited from various factors. First, demand from Asia, with China in the lead, has risen sharply in the past few months. On the other hand, global economic stimulus programmes and the end of the inventory adjustments should have a positive effect. These effects are limited in time though, and for this reason, pre-crisis levels will not be reached any time soon and capacity utilization is expected to remain low. This is also why the risk of a renewed deflation is assessed as particularly high. The BoJ is therefore not expected to deviate from its expansive course any time soon.

The yen firmed again. The interest rate spread, growing exports or the change in government might have contributed to boosting the yen. *"The characteristic of the yen as a safe haven seems to no longer have any validity,"* highlights Rainer Singer. *"We believe that strong levels close to USDJPY 90 may be expected in the short to medium term."*

Japanese equity market: lower dynamics; downgraded to neutral

The Japanese equity market continued to recover, increasing by almost 5% in the past quarter. However, it fell slightly short of the dynamics shown by its European and US peers, which was among other things due to the stronger yen.

According to Erste Group analysts, the Japanese equity market is extremely attractive – among other things due to the low valuation. The fact that Japanese stocks are strongly underweighted in institutional and also retail portfolios as well as the massive liquidity in Japan could be the right ingredients for an imminent recovery. On the other hand, the strongly falling real estate prices and the wage developments are giving rise to justified deflationary fears. The appreciating yen constitutes another burdening factor. Analysts recommend a neutral weighting for the Japanese equity market in their international country allocation.

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