

15 April 2008

Erste Bank Analysts: Stock markets to remain volatile – Insecurity not yet over

*“The effects of the US housing crisis have spread to further areas in 1Q 2008,” said Fritz Mostböck, Chief Analyst of Erste Bank, at a press conference on the development of bond, currency and stock markets in the past few months. “This contagion led to some very painful and hefty write-offs, also at prominent financial institutions some of which were even at risk of collapsing (e.g. Bear Stearns). This as of yet unseen extreme situation understandably gave way to a worldwide rise in risk aversion. The insecurity prevailing on the markets and the resultant higher risk premiums will therefore continue to weigh on financial sentiment in the second quarter of 2008,” stated Fritz Mostböck. “For this reason, we recommend the following asset allocation for 2Q 2008: **Overweight cash, neutral in bonds, underweight stocks.**”*

Neutral portfolio

Cash	Overweight
Bonds	Neutral
Stocks	Underweight

International bond portfolio

Europe	Overweight
US	Neutral
Japan	Underweight
High Yield/Emerging Markets	Neutral

International stock portfolio

Europe	Slightly overweight
US	Underweight
Japan	Neutral
Emerging Markets (CEE, SOA, Latin America)	Overweight

FX Allocation

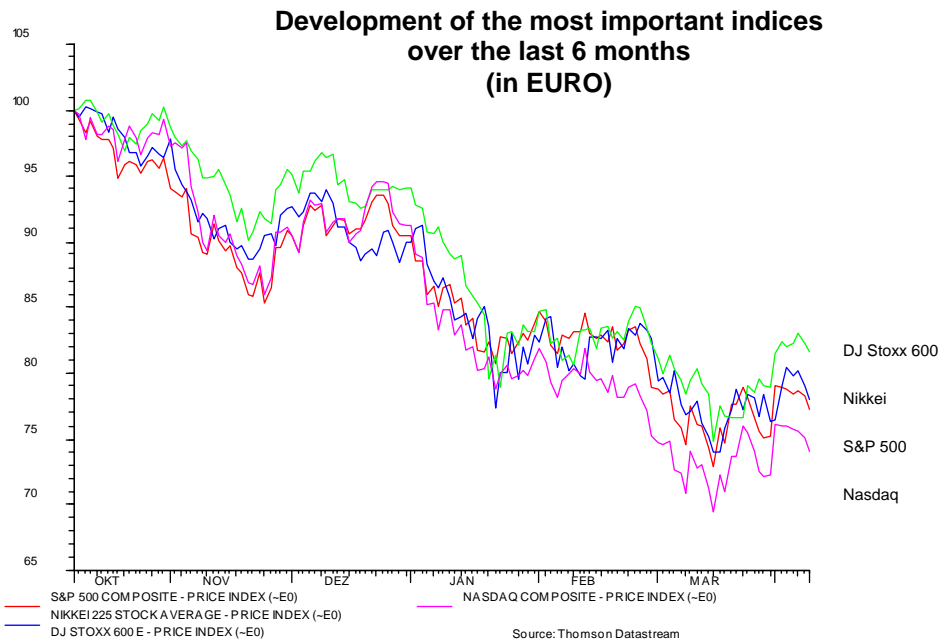
US dollar block	Neutral
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US: The economy is expected to bottom out after another interest rate cut by 50 bps in 2Q

“The decline in overall demand in the economy has tended to be driven by sentiment up to now. However, there is a risk that this could create a downwards spiral in which lower consumption and higher unemployment would feed on each other,” stated Rainer Singer, Head of CEE Macro-/Fixed Income Research. Nonetheless, Erste Bank expects the economy to bottom out soon and to see a subsequent gradual recovery in the second half of the year. The arguments backing these expectations include the assured factor of the tax refunds that will amount to 0.6% of GDP as of May and the uncertain assumption that financial markets will calm. The analysts of Erste Bank expect the US Fed to cut interest rates again by 50 bps at the end of April. By the time of the next meeting at the end of June, the situation should have calmed to allow the key lending rate of 1.75% to be left unchanged. In an environment of recovering markets, the bond market will shed only a minor portion of the price gains made in the past few months. “We expect a slight recovery for the USD,” said Rainer Singer.

US stock market: Risks outweigh opportunities

“On the horizon of the next few weeks, a recovery of US stocks at the start of 2Q seems probable. However, we expect estimated earnings per share for the S&P 500 to be much too high due to the sluggish economy in the US. There will be room for further downwards revisions of earnings expectations in the months to come and this will consequently weigh on the stock market,” said Hans Engel, Market Strategist for International Equities about the US stock market.



The analysts at Erste Bank assess growth stocks as still attractive, especially the stocks of companies with international activities. Thus, investors should give preference to stocks with low levels of indebtedness and stable cash flows. *“In the current environment, it is probably a good idea to underweight US stocks, considering that the ratio of risk-to-expected return renders stocks from other regions more attractive,”* is Hans Engel’s recommendation.

Euroland: Economy to cool off moderately

Euroland’s economy has managed to hold up quite well, with Germany and France posting satisfactory growth rates, and Spain and Italy leaning towards weakness. At the same time, inflation is on the rise and the ECB is still in a tight spot between a slowing economy and a financial market crisis, on the one hand, and high inflation on the other. Ultimately, the scales should tilt towards lower interest rates, because decreasing commodity prices will ease inflationary pressure and thus give the ECB the leeway it needs to give more support to the economic recovery. In the second quarter, government bonds are expected to continue to benefit from prevailing insecurity and the just gradual recovery of trading in the asset-backed markets. Over the long term, the analysts of Erste Bank assess government bonds as overvalued, and therefore recommend short maturities to long-term investors. Versus US bonds, EUR government bonds should perform better though.

The Stock Market in Europe: Sideways movement in 2Q, but relatively stable development compared to other regions

Overall, the positive and negative factors in Europe are in balance and for this reason, Erste Bank expects to see European stock markets trend sideways in the coming quarter. Earnings growth for the current financial year 2008 has already been revised downwards for the companies in the DJ EuroStoxx from 11.8% to only 7.6%.

Most companies succeeded in keeping order intake and industrial output at a high level despite the firming euro and the higher commodity prices. From a fundamental perspective, Europe is better positioned than the US, but it will still not be able to decouple completely due to the overall market risk should the bad newsflows from the US persist. However, even in the case of possible price setbacks, Erste Bank expects stock markets in Europe to develop relatively more stably than in other regions. *“Therefore, we recommend overweighting European securities in the asset class of stocks,”* said Hans Engel.

Japan: Economy expected to be able to survive short US crisis; firmer yen vs. euro over medium term

“The downswing in the US poses a considerable risk in the coming months, even more so considering that the Japanese economy has proven in the past how susceptible it is. However, the core message of our forecast for Japan is that the situation in the US is expected to stabilise in 2Q, and thus, the crisis will be relatively short-lived. We believe the Japanese economy has enough momentum to survive this phase,” said Rainer Singer confidently. It will not pass completely without effect on economic growth though, but the Japanese economy should nonetheless stay on an expansion course. The most important determinant in the coming months for the yen exchange rate will be the subdued risk tolerance in the markets. Carry trades are expected to be reduced further in this environment. The much narrower interest rate spread to the US and the upcoming interest rate cuts by the ECB are also indications of this trend. *“We believe that the yen will continue to firm versus the euro over the medium term,”* stated Singer.

The Stock Market in Japan: Attractive market with potential

“We assess the Japanese stock market as still attractive. In our opinion, there is no need for any exaggerated pessimism, but the market is currently pricing in the worst-case scenario. The valuation level is at an all-time low compared to its own history, and the PERs have meanwhile reached the same level as that of European and US competitors,” according to Hans Engel. As it seems unlikely at present that Japan will decouple from other major stock markets, Erste Bank analysts assess the Japanese stock market as neutral in the current international allocation.

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