

Global Evolution

In September 2014 Global Evolution visited Romania to get better insight on whether there is any upside to the current slow growth environment in the coming quarters. With respect to the weak growth and low inflation we were also interested in getting a stronger sense of the subsequent path of monetary policy. Furthermore we wanted to examine if the current IMF program is dead or if there is reason for optimism with respect to reactivating the program after it went off-track during the summer. Finally, our aim was to get a better sense of possible surprises in the presidential elections (1st round scheduled for 2 November), or if incumbent Prime Minister Victor Ponta is a certain winner.

During the trip we met with Central Bank officials, government officials, IMF, World Bank, local banks and local asset managers.

Romania

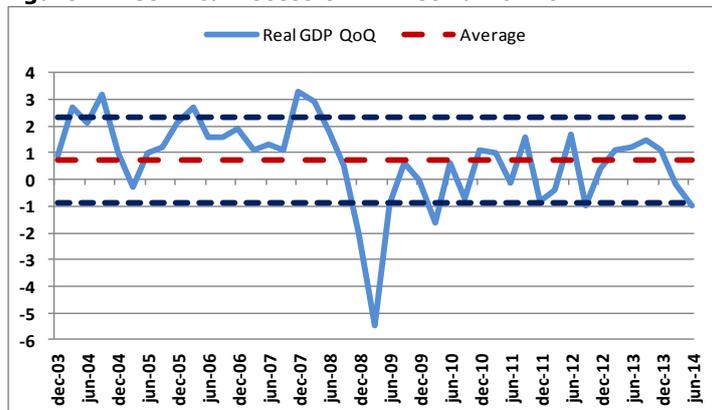
Indicator	2009	2010	2011	2012	2013F	2014F	2015F
GDP (real, yoy%)	-6.6	-1.2	2.4	0.5	3.5	2.0	3.4
Inflation (% yoy)	4.7	8.0	3.1	5.0	1.6	3.5	3.0
Current account (% GDP)	-4.2	-4.4	-4.5	-4.4	-1.1	-2.5	-4.2
Exports (% of GDP)	24.5	30.0	34.4	34.3	34.8	33.6	33.2
Fiscal balance (% GDP)	-7.3	-6.4	-4.3	-2.2	-2.5	-2.3	-2.3
Public debt (% GDP)	29.4	37.1	40.1	41.0	42.5	41.9	40.9

Source: Citi Research & Global Evolution

Recession in H1 2014

After a reasonably strong economic performance in 2013 growth has slowed dramatically in 2014 thereby leaving the country in technical recession in the first half of 2014 with two consecutive quarters of negative growth.

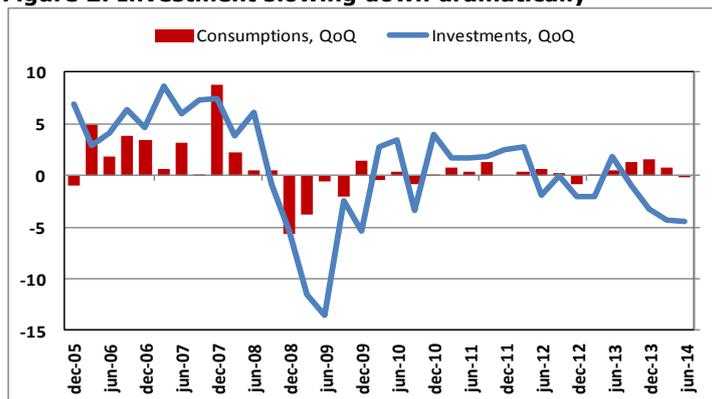
Figure 1: Technical recession in first half of 2014



Source: Bloomberg & Global Evolution

It is primarily investments that have taken a big hit in the last couple of quarters.

Figure 2: Investment slowing down dramatically



Source: Bloomberg & Global Evolution

The slowdown in investment is the result of several factors but most importantly the government decided to levy a tax on "special constructions" which took a heavy toll on private investments. Furthermore public investments have also been slowing due to fiscal adjustment and poor utilization of EU funds. The absorption rate of EU funds has gone up quite a bit but execution of the projects is still very slow.

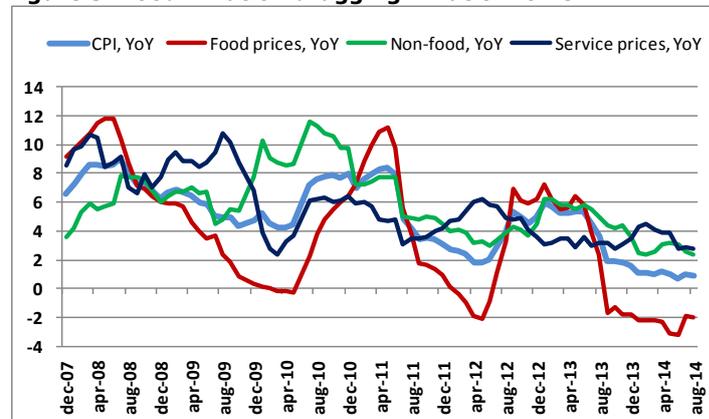
Growth will pick up in second half of 2014

According to the Ministry of Finance we will see stronger public investments in the second half of 2014 as several projects co-financed with the EU will start coming online. Furthermore, the government has already announced that the "special construction" tax will be lowered again which should help private investments as well. Finally private consumption is also expected to pick up on the back of higher disposable incomes, a stronger labor market and some pent-up demand following muted consumption during the last couple of years. All that said it is unlikely that we will see a strong economic rebound and full year 2014 growth is likely to settle in the 1.5-2.0% range. For 2015 most market participants expect growth around 3% which in our opinion would be a reasonable growth rate. However, we are also a bit skeptical since the government will have to tighten its fiscal stance further if it is to comply with the demands from EU.

Inflation running very low

Like most of Eastern Europe inflation is running very low and as for the rest of the region a lot has to do with declining food inflation, weak growth and deflationary pressure from the Euro zone. Food inflation accounts for roughly 35% of the headline inflation in Romania so the volatile food price series is an important driver for overall inflation.

Figure 3: Food inflation dragging inflation lower



Source: Bloomberg & Global Evolution

Several market participants and not least the Central Bank seem very complacent with the current low inflation and - at the same time - didn't see any bigger risk of a stronger pick-up later in the year. However, we are a bit skeptical that food inflation will stay low since we have not to our knowledge seen structural changes that would suggest it to stay permanently low. When asking about this point we got very inconclusive answers. We see some risk of a stronger pick up in food inflation in late 2014 and 2015 which will lift headline inflation as well. That being said it is very difficult to see inflation in the short to medium term moving above the Central Banks target of 2.5% +/- 1%-point.

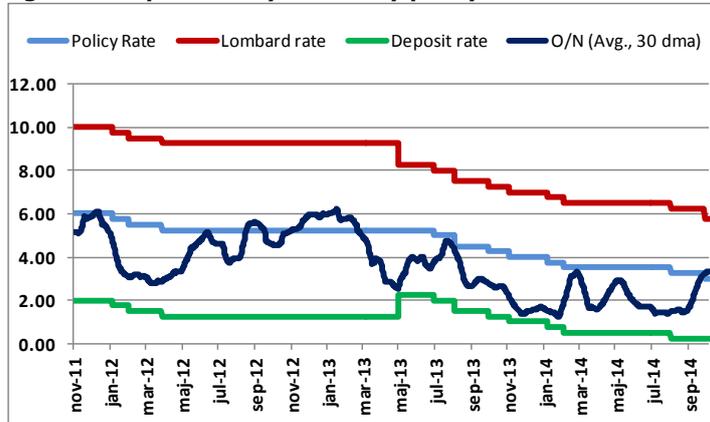
Expansionary monetary policy

The backdrop of weak growth and low inflation has seen the Central Bank pursuing a relatively expansionary stance which has resulted in a 725bps cut in the policy rate since the peak in 2008 of which 200bps have been cut since July 2014. Currently the policy rate stands at just 3%. The real monetary stance has been even more expansionary since the most important monetary policy tool in Romania is the Central Bank's open market



operation allowing it to have full control with short term money market rates. These rates have constantly been lower than the policy rate - a practice that the IMF has complained about since it makes the monetary policy less transparent.

Figure 4: Expansionary monetary policy



Source: Central Bank of Romania & Global Evolution

Monetary policy continues to be dovish but depends on the exchange rate

We believe that the Central Bank will keep a dovish stance and lower its growth and inflation expectations in the next inflation report to be published on 6 November. But we also think that the Central Bank will be very vigilant about the exchange rate and adjust the short term rate accordingly to secure a very stable EURRON in the 4.40 - 4.45 range. This means higher interest rates whenever there is pressure on the currency. The bank's sensitivity towards the exchange rate is due to the high pass-through to inflation and the still relatively high level of FX denominated borrowing by households and companies. That being said we still believe the Central Bank is biased towards pushing rates lower whenever there is room for it.

IMF program off track

The current stand-by program (SBA) went off track in June when the IMF visited the country for the third review under the program. The disagreements are on some structural reforms, privatizations and not least uncertainties on the 2015 budget. The IMF is aware that it is impossible to make adjustments to the budget ahead of presidential elections in November so the fund has agreed to postpone negotiations till after the elections. From a funding perspective the program is not important but it is still a good anchor to have and it would be a negative signal if the program was cancelled. We think the program will come on track again even though the negotiations will be tough. IMF will most likely be flexible not least on the budget and Romania can probably also get some leeway from the EU that is currently requiring an adjustment of the fiscal deficit to 1.4% of GDP from 2.2% in 2014.

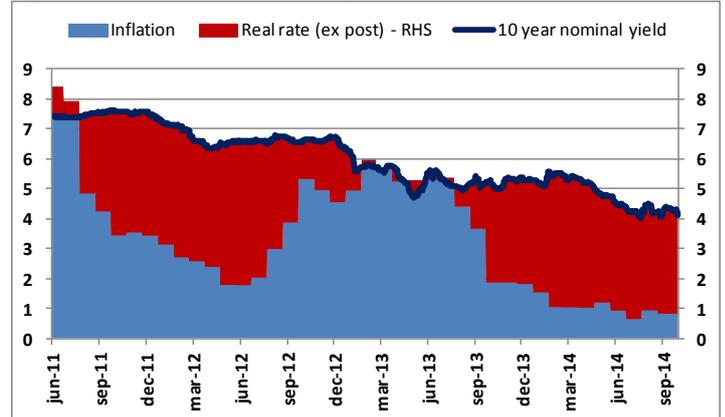
Politics - Victor Ponta most likely the next president

Current Premier Minister Victor Ponta remains favorite to win the presidential elections in November but it is not a given. Apparently the opposition candidate, Klaus Werner Iohannis, from the National Liberal Party is gaining ground and is now seen as a serious contender. Klaus Werner Iohannis has been the mayor of Sibiu since 2000 and is credited for turning Sibiu into one of the most popular tourist destinations in Romania. We don't see the election as a real risk since either we will have more or less the status quo of Victor Ponta, albeit with changes to the government since Ponta can obviously no longer be prime minister, or we will have an even better outcome if Klaus Iohannis wins.

Valuations

Even though nominal yields have been on a long term downward path we still think that valuation is reasonably attractive since real rates have moved higher due to the very low inflation. That being said we are very much aware of a possible uptick in inflation later in the year and will react promptly to higher food inflation numbers.

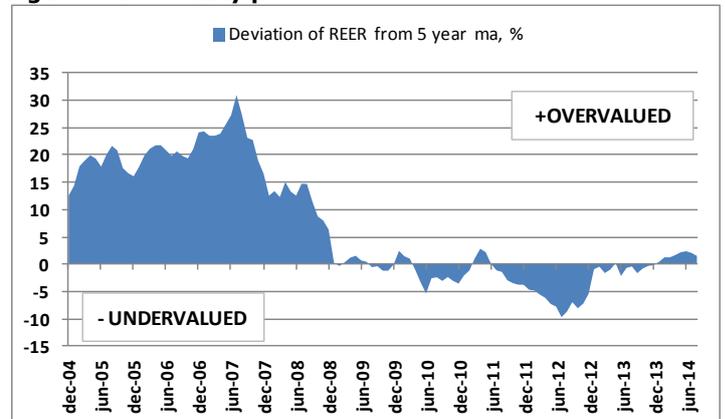
Figure 5: Real rates still very attractive



Source: Bloomberg & Global Evolution

The exchange rate also seems reasonably fairly priced if you look at long term REER trends with the current level very close to the 5 year moving average. Furthermore we believe the Central Bank will hold the currency very stable against the EUR in the 4.40 - 4.45 range for the remainder of 2014.

Figure 6: RON fairly priced



Source: Bloomberg & Global Evolution

Investment strategy

To conclude we are neutral on Romania FX vs. EUR but see further possible gains in the bond market during Q4, 2014. We will be very mindful for a possible uptick in food inflation that can put upward pressure on headline inflation and end the downward trend in nominal yields.

Lars Peter Nielsen, Senior Portfolio Manager



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