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Erste Bank Analysts: The overall situation remains challenging with still good prospects for CEE

- Equity markets expected to move sideward on high volatility in Q3 and potentially beyond
- No direct impact of sub-prime crisis recognizable on CEE markets
- Poland and Austria overweight, SEE neutral, Russia improving

Erste Bank analysts say, that overall, CEE economies have hardly been affected by the global downturn. *“Although a slight slowdown is likely to have taken place in 2Q, this was due to cyclical reasons, in our view. For this economic cycle, the peak already seems to be behind us and growth should moderate further in the coming quarters. The reasons are numerous: the interest rate hikes should start to bite, the tight labor markets form a natural barrier for continued above-potential growth and, finally, the high energy and food prices are dampening the real spending power of consumers. The catch-up process is the fundamental basis for continuing growth rates above those of developed markets”*, says Henning Esskuchen, Co-Head of CEE Equity research at Erste Bank.

The Erste Bank analysts still see the moderating growth in CEE as a result of the economic cycle, rather than a direct impact of the current global turmoil. Inflation remains a topic everywhere. As we have to choose between inflation plagued economies, we not only opt for CEE markets because inflation is accompanied by the corresponding domestic demand and growth. Probably even a stronger argument would be that in this situation, central banks in CEE still have tools available to deal with the situation. While the FED, as well as the ECB has to balance between keeping the economy alive and fighting inflation driven by external factors, it remains a big question mark to what extent interest rate hikes will have an impact on domestic inflation. In CEE, however, there is domestic demand and strong credit growth, which is exactly what interest rate hikes could have an impact on.

ZEW Indicator CEE: Mostly positive assessment of the current economic situation in Central and Eastern Europe; outlook remains cautious for the time being

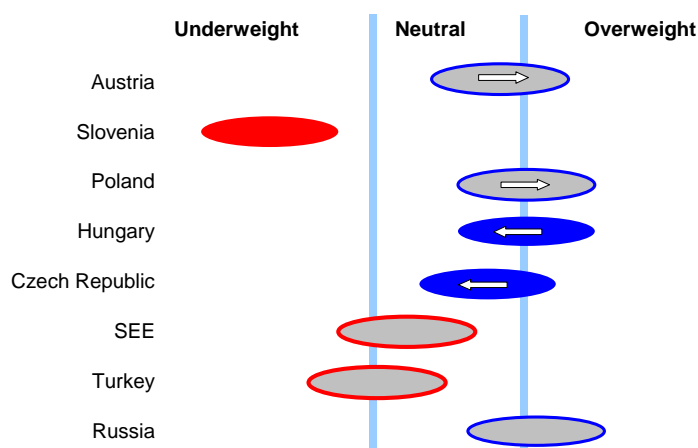
The recent ZEW/Erste Bank sentiment indicator again confirmed the weakening outlook. The current situation was assessed as further deteriorating, both for the Eurozone as well as for CEE. Two thirds of survey participants considered the current situation for CEE as normal (65.5%), while nobody considered the current situation as bad. Still, 35% consider the current situation as good, contrary to the Eurozone, where only 15% view the current situation as good and 82% see it as normal. For economic expectations, the view is balanced between an unchanged situation and a worsening environment for CEE (both 43%). The special question this time was about expectations on commodity prices. Obviously, the majority of survey participants expect further rising commodity prices.

Markets will continue to move sideways, with substantial volatility:

Erste Bank analysts: *“We still see no major recovery for the third quarter - a situation that could prevail for the rest of the year. We continue to stick to liquidity and size, which would favor the usual suspects, such as Austria, Poland and (also driven by other factors) Russia. Commodities should remain driven both by demand expectations as well as by speculation. Hence, energy remains the favourite sector. Austria and Poland remain overweight in our proposed allocation, albeit at a thinner margin than previously.”*

Erste Bank Allocation proposal:

- **Moderate overweight = Poland.** In particular, Poland seems to have further lost support among its domestic investors, with pension funds now decreasing their equity weighting to below 30%. Domestic mutual funds continued to experience cash outflows, a trend that has prevailed since November of last year. Consequently, the previously accepted slightly higher valuation has turned into a negative argument for the market.
- **Moderate overweight = Austria.** For Austria, we had to improve the model outcome to arrive at our overweight rating. However, the market still trades at a forward P/E of 10.5 and earnings revisions actually turned positive again, after previous downward revisions.
- **Moderate overweight = the Czech Republic.** The Czech Republic was moved more towards a moderate overweight by our model. Even though the market remains somewhat unspectacular, it remains a kind of safe haven in the region.
- **Hungary = overweight, but not as strong as model suggests.** Hungary was spotted as an overweight by our model, but, as in previous issues, we opted to soften this result a bit. The overall addressing of macroeconomic troubles has not resulted in immediate results and inflation (driven by wage growth) remains a problem as well. Valuation remains a clear argument for the region and as soon as we see better news flow from the macro side, this could be the basis for improving performance.
- **SEE moved towards a more neutral position.** While we consider the outperformance of the **Serbian** market in the second quarter as a speculative move, we still see quite some potential in the **Romanian** market - for those who dare. The overall macro picture certainly remains somewhat bleak for the market, but recent data suggests that the situation of a high current account is not a one-way street, while the measure implemented are indeed able to spur export growth and limit imports. In particular, the still sound situation in investments appears to be a promising sign. **Croatia** still has its troubles, but at least valuations came down a bit further. Valuation, which has been the main contributor to the previous underweight, actually is not that much of a downside anymore. Hence, we position the region as a moderate neutral.
- **Improving its weighting = Russia.** Russia was the clear winner in terms of our model outcome and we confirm this result by further promoting the market towards an overweight position. Commodity prices and the political will to strengthen the economy should support the market during these turbulent times.
- **Underweight = Turkey.** Our model sees **Turkey** with only very moderate negative expected returns, and we continue to see the market as an option once its political troubles have been solved. This, however, could still last until early next year. Consequently, we acknowledge the low valuation, but still keep the market at underweight/neutral for the time being.



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