

Prospects for Recovery Remain Solid

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Despite concerns about Greece, January’s data were strong, and continue to point toward a sustained economic recovery.

The economic recovery in the EEMEA region continues to advance, in contrast with recent declines in the region’s asset prices, which largely reflect the potential risks to the economic recovery from events in Greece. While this tail risk merits serious attention, it is important to remember that the cyclical recovery in the EEMEA region remains intact and idiosyncratic risks have diminished. Evidence of improved creditworthiness exists in fiscal adjustment, sharply reduced current account deficits, and an orderly de-leveraging of the banking sector.

Recent data suggest that real GDP is likely to surpass our forecast for growth of 4.5% in 2010. This forecast remains above consensus, which has risen steadily to 3.5% currently from 2.2% in July 2009. Preliminary data for the fourth quarter of 2009 show that real GDP grew by more than expected in two large economies that have reported, Russia and Poland, but contracted in two others, Hungary and Czech Republic. Russia’s GDP grew by 5.3% quarter-on-quarter seasonally adjusted (q/q sa), marking the second quarter of strong gains. Poland’s GDP grew by 2.0% q/q sa in the fourth quarter, and had the strongest growth rate of all EU

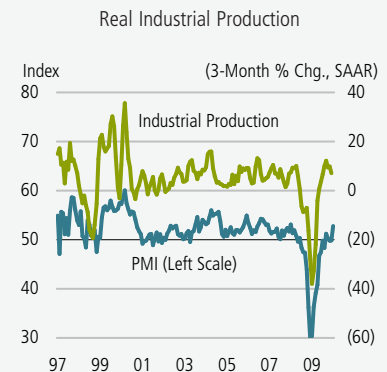
member states in 2009 at 1.7%.

In Hungary, real GDP contracted by -0.4% (q/q sa) in line with expectations, while its contracted by more than expected at -0.6% (q/q sa) in the Czech Republic. In both cases, weak domestic demand overpowered the recovery in industry.

Given that growth indicators for the fourth quarter are particularly strong in Turkey and South Africa, four of the six largest economies look likely to have recorded GDP growth. We will wait for final fourth quarter GDP releases before revising our 2010 calendar year GDP forecasts.

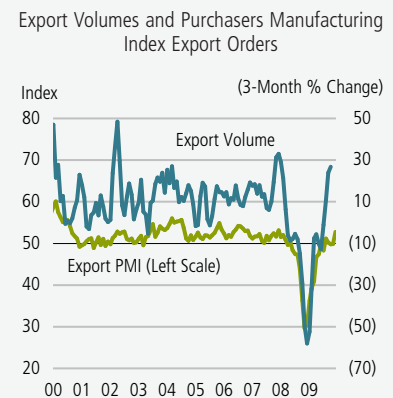
High-frequency, monthly economic data continue to point toward a rebound in growth. The mix of growth is consistent with our expectations. The rebound in production is being driven by exports, restocking following unprecedented inventory liquidation, and loose fiscal and monetary policies. By contrast, final private domestic demand and bank credit remain weak. Our forecast has called for the rebound in domestic demand to lag exports. Early signs of stronger employment and wages in some of the larger economies support this view.

Display 1
Output Has Rebounded



Source: Haver Analytics and AllianceBernstein

Display 2
Export Demand Is Major Driver



Source: Haver Analytics, Netherlands Bureau for Economic Policy Analysis and AllianceBernstein

The rebound in production and exports is well established. The purchasers' manufacturing indices posted strong gains in January, rising to a composite level of 51.8 from an average of 50.3 for the previous four months (**Display 1**). PMI data are now at the highest level since February 2008, and above the expansionary level of 50 in all six major economies. The mix is also favorable, with new orders rising to 53.5 from 51.2. The strong PMI readings are consistent with the rebound in industrial production growth, which exceeded a 10% annualized pace (three-month over three-month) in December for the fourth month in a row, led by Turkey.

A recovery in export demand and the global trade cycle has supported the rebound in production (**Display 2**). Export orders in the PMI rose in January to 52.8, which is the strongest reading since December 2006. This rebound is supported by export volume increases of 20% (3m/3m saar). Asian demand appears to be driving a large part of the external demand. But so is external demand from western and eastern Europe, where the collapse in trade was multiples of the contraction in final demand.

Inventory restocking has also supported the recovery (**Display 3**). In many countries, the inventory liquidation cycle has been unprecedented. In South Africa, for example, inventories have declined by -31.5 billion rand in real terms over the past five quarters, as compared with -27.2 billion in the three years 1989 to 1991. The restocking process is a necessary pre-requisite for an acceleration in final domestic demand, because restocking itself leads to employment and higher wages. This is the reverse of de-stocking, which lead to unemployment and lower wages.

Consistent with the inventory cycle, labor markets have begun to improve. Employment has grown in sequential terms in at least four of the six largest economies—Russia, Turkey, South Africa and

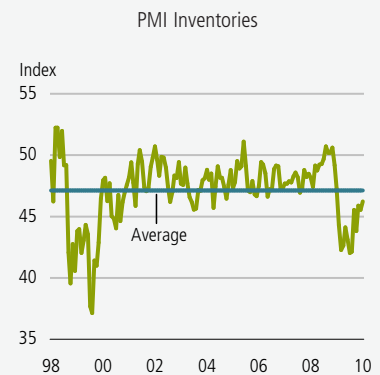
Hungary. In Poland, the decline in employment has stabilized, and in the Czech Republic employment was still declining through the third quarter of 2009, which is consistent with today's weak GDP release.

Government consumption and investment has also been supportive of growth (**Display 4**). Stimulative fiscal policies have centered on tax reductions and increased social transfers. The magnitude of stimulus for the region as a whole has outstripped previous downturns in 1998 and 2001–2002. During those episodes, the Russia crisis and weaker creditworthiness placed greater constraints on countercyclical fiscal policies.

In contrast to the improvement in these indicators, private consumption and investment levels remain soft. Retail sales volumes are now growing in sequential terms in Russia (5.9% 3m/3m saar) and Poland (2.5%). In other countries, retail sales are still contracting—Hungary (-4.8%), Czech Republic (-7.6%) and South Africa (-5.1%)—but have rebounded from the lows in early to mid-2009. Turkey does not report retail sales, but the strength of most other indicators suggests that retail sales would be on the stronger end of the spectrum.

Finally, the contraction in domestic credit growth has started to slow, but loan growth continues to contract overall (**Display 5**). This pattern suggests that banks continue to shrink their balance sheets as growth recovers. A lag in credit growth is consistent with previous emerging market cycles, when absolute credit growth generally recovered after a lag of one or two years. This precedent, together with improvements in the credit impulse—the change in credit growth—suggest that bank lending should resume during 2010 in most economies. This shift is already evident in Turkey, where nominal credit has risen by 14% since April 2009.

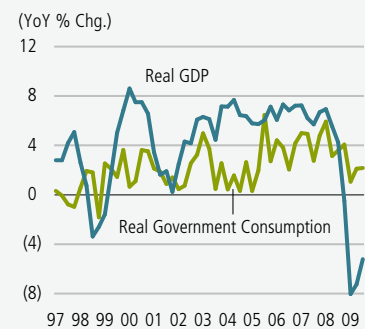
Display 3
The Inventory Cycle Will Support Growth



Source: Haver Analytics and AllianceBernstein

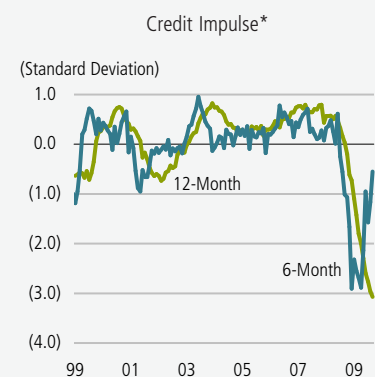
Display 4
Public Consumption Has Supported Growth

Real GDP and Government Consumption Growth



Source: Haver Analytics, National Statistical Office and AllianceBernstein

Display 5
Credit Contraction Has Slowed



*Reflects the change in net new credit as a % of GDP over a 12-month period, adjusted for changes in exchange rates.
Source: EMED, Haver Analytics and AllianceBernstein

Overall, the rebound in economic growth is increasingly apparent and consistent with our four macro themes for 2010 that we identified at the start of the year: above consensus growth, mixed inflation outlook with pockets of supply-side inflation pressures; varying policy outlooks by country; and improvements in sovereign creditworthiness.

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