FLASH NOTE

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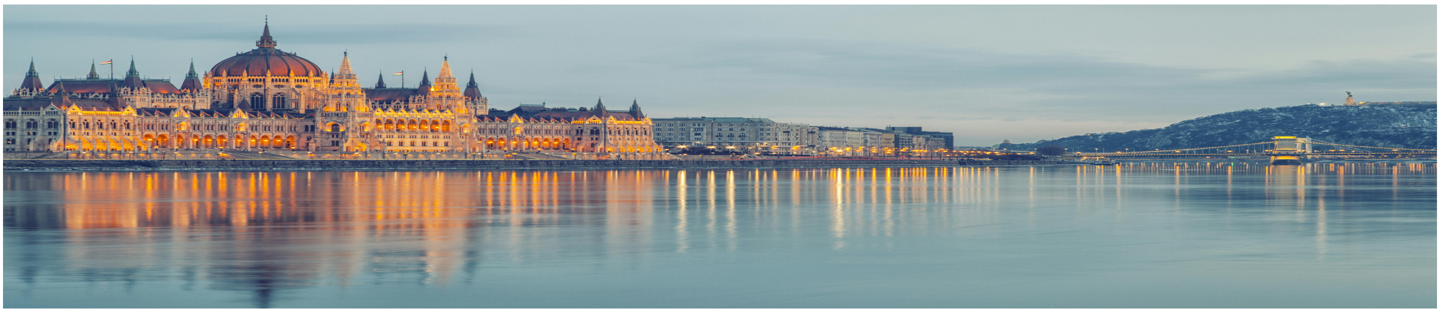

Emerging markets: looking at Eastern Europe

Chapter 3

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Thanks to relatively solid macroeconomic fundamentals, the *nearshoring* phenomenon and attractive interest rates, there is no need to look far to benefit from emerging market potential.

Like Asia and Latin America, **the EMEA region (Europe, Middle East and Africa)** harbours attractive opportunities for investors. The region is home to diversified economies with well-developed agricultural or manufacturing industries and lands rich in raw materials. But it is also marked by wide disparities between the countries.

A close look at the specific characteristics of each country is necessary to identify promising markets and assets, while taking into account the associated risks. **Eastern Europe** lies at the epicentre of the Ukrainian crisis, but its repercussions differ from country to country, and some of these **offer attractive potential returns today, especially for bond investors seeking diversification**.

Eastern Europe: nearby emerging market potential

More than a year after the Russian offensive in Ukraine, the resulting humanitarian, political and economic consequences continue to reverberate across the world and have particularly shaken Eastern European countries. The strains caused by the conflict and sanctions imposed on Russia by Western countries have sparked a major energy crisis, especially in Europe because of its deep dependence on Russian fossil fuels.

This energy crisis, coupled with the after-effects of the Covid-19 pandemic and the resulting monetary policies, have taken the world into a new inflationary environment not seen for decades. That said, by launching their rate-tightening cycles shortly after the pandemic crisis, some Eastern European countries **have been able to contain this widespread price inflation to a certain extent**, despite the sharp deterioration in their business relations with Russia. This has given them greater leeway than developed countries to implement their monetary policies.

After experiencing soaring inflation, some countries, such as Hungary, Poland or the Czech Republic, will likely be among the first to **launch a rate-cutting cycle, starting from today's very attractive levels**.

In parallel, the strains caused by the Ukrainian crisis have prompted some businesses in the European Union to seek alternative solutions to quell uncertainties relating to supply chains, notably **by relocating part of their production facilities in Eastern Europe**, which offers a qualified labour force at a more competitive cost.

In this new geopolitical order, some countries in the region, benefiting from this trend and boasting more solid fundamentals, **offer attractive long-term opportunities, such as within the Hungarian and Romanian bond markets**. In view of this still uncertain backdrop, however, active and flexible management is essential to capitalise on these opportunities while avoiding pitfalls.

The diversity of Romania

Thanks to its diversified economy, varied natural gas supply sources and renewable energy production, Romania is containing the direct economic impact of the war in Ukraine.

Romania is the seventh-biggest economy in the European Union[1] and operates in key sectors such as manufacturing, agriculture, energy, automotive and services. The country has **harnessed its own coal, oil and gas resources, together with its production of renewables, and was able to turn to other suppliers** when the Russia-Ukraine war broke out and sanctions on Russia were tightened.

The deterioration in business relations between Western countries and Russia **has also strengthened the *nearshoring* phenomenon to Romania's benefit**. Uncertainties surrounding the war and higher production costs resulting from the energy crisis have led many border countries to outsource some of their activities to Romania, where costs are competitive and the workforce is qualified.

The global return of inflation has not spared Romania, but the country reacted quickly in a bid to quell rising prices. **The Romanian central bank raised its key interest rate** up to 7% in January 2023[2]. The economy is already showing signs of slowing, calling for a more accommodative policy in the near future.

The country's relative political stability, low public debt relative to its gross domestic product (GDP) and efforts to beef up its response to the environmental aspect of ESG criteria **are all factors contributing to Romania's attractiveness, particularly that of its external sovereign debt**.

Hungary: a promising issuer

Although energy price inflation is slowing globally, it continues to have considerable repercussions on food prices. Hungary has been particularly affected by this phenomenon, having recorded record food price inflation in March of 25.6% year-on-year – more than three times the average rate of 8.3% in the European Union[3]. However, the downward trend in food price inflation should influence the behaviour of Hungarian inflation, as confirmed by lower figures in the past two months.

In its efforts to contain mounting inflation, Hungary began raising interest rates well before most developed countries and **has had a policy rate of 13% since September 2022**

What's more, **the relative solidity of its macroeconomic fundamentals** makes Hungary an attractive long-term issuer. Its rigorous fiscal policy, which was tightened in 2022 to tackle its soaring deficit, has helped to keep a lid on its debt, minimising the risk of a payment default.

Lastly, Hungary **is actively seeking to improve its extra-financial aspects**. The country has pledged to honour Europe's carbon neutrality objective and plans to close its last coal-fired plant in 2025, while investing in renewable energies[4].

In these conditions, Hungary can be a key issuer to diversify portfolios and potentially offer attractive yields:

- **Local sovereign debt** offers very attractive real interest rates for investors, who could also benefit tactically from an appreciation of its currency.
- The prospect of a global economic recession could also benefit **Hungary's external sovereign debt**, which would offer long-term performance potential.

DID YOU KNOW?

We have developed a proprietary ESG rating system for sovereign debt that allows us to assess the objectives and trends of emerging countries on environmental, social and governance aspects. Our model is founded on 12 criteria in line with the principles for responsible investment (UNPRI) and covers more than 70 emerging countries.

Beyond Eastern Europe, some African countries also offer attractive yields in the bond sector, such as Benin or Ivory Coast. These commodity-rich countries are investing in growth and improving their macroeconomic fundamentals.

Through our series of articles dedicated to emerging markets, we have discovered the potential of this universe, whether in Asia, Latin America or the EMEA region, both in equity and bond markets. The emerging world harbours many opportunities but flexibility is required to seize them where they arise, while being highly selective and employing active risk management: this is what characterises Carmignac's approach.

[1] International Monetary Fund, 2021.

[2] Banca Națională a României, https://www.bnr.ro/Monetary-Policy--3318-Mobile.aspx

[3] Eurostat, 19/04/2023.

[4] "Hungary brings coal exit forward by five years to 2025", Euractiv :https://www.euractiv.fr/section/energie/news/hungary-brings-coal-exit-forward-by-five-years-to-2025/

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Read dedicated article

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Carmignac Portfolio EM Debt A EUR Acc

ISIN: LU1623763221

Recommended minimum investment horizon

Lower risk Higher risk

1	2	**3***	4	5	6	7

Main risks of the Fund

EMERGING MARKETS: Operating conditions and supervision in "emerging" markets may deviate from the standards prevailing on the large international exchanges and have an impact on prices of listed instruments in which the Fund may invest.

INTEREST RATE: Interest rate risk results in a decline in the net asset value in the event of changes in interest rates.

CURRENCY: Currency risk is linked to exposure to a currency other than the Fund’s valuation currency, either through direct investment or the use of forward financial instruments.

CREDIT: Credit risk is the risk that the issuer may default.

The Fund presents a risk of loss of capital.

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