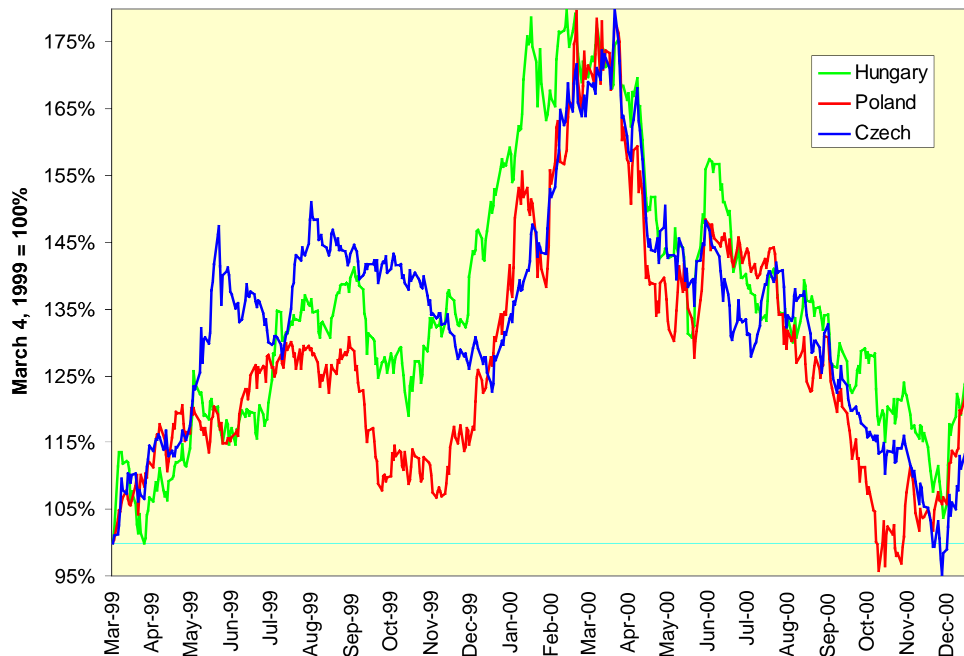
Eastern Europe: Better Than Expected

While hindsight is not 20/20 as often as alleged, we're unlikely to provoke a violent argument by asserting the year 2000 is one most investors would like to forget, and forget soon. In this aspect, it's always interesting to scan the globe and see who managed to dodge assorted bullets.

Early into 2000, few regions looked as vulnerable as Eastern Europe did. Not only were these markets definitely Old Economy, but they had quite logically tied their currency to that of their major trading partners, the euro. This exposed these more fragile economies to an automatic hike in the cost of their non-euro denominated imports each time the euro fell, and of course the euro spent most of the year falling far further and faster than almost anyone thought it would. Moreover, the region is dependent on imports for its petroleum supplies, and petroleum is denominated in U.S. dollars. Finally, the region's reliance on external credits exposed it to both the higher interest rate policies of both the Federal Reserve and the European Central Bank and to wider credit spreads should global lending standards shift away from lower-rated borrowers.

The situation appeared sufficiently precarious to suggest that the end of the Fed's inflation fighting cycle might be forced by an Eastern European debacle much in the same way the Asian crisis of 1997-1998 forced the Fed to remain looser than it would have liked. So, what happened? By Christmas time, the Polish WIG-20 index was up 0.84% on the year in USD terms, while the Czech PX-50 index declined 10.53%, and the Hungarian Traded index fell 25.3%. Some smaller and less liquid Eastern European markets fared even better: The Slovakian Sax index was up 6.62% in USD terms, the Estonian Main index rose 1.59%, and the Ukrainian PFTS index was up a lusty 34.37%.

Selected Eastern European Performance, USD Basis



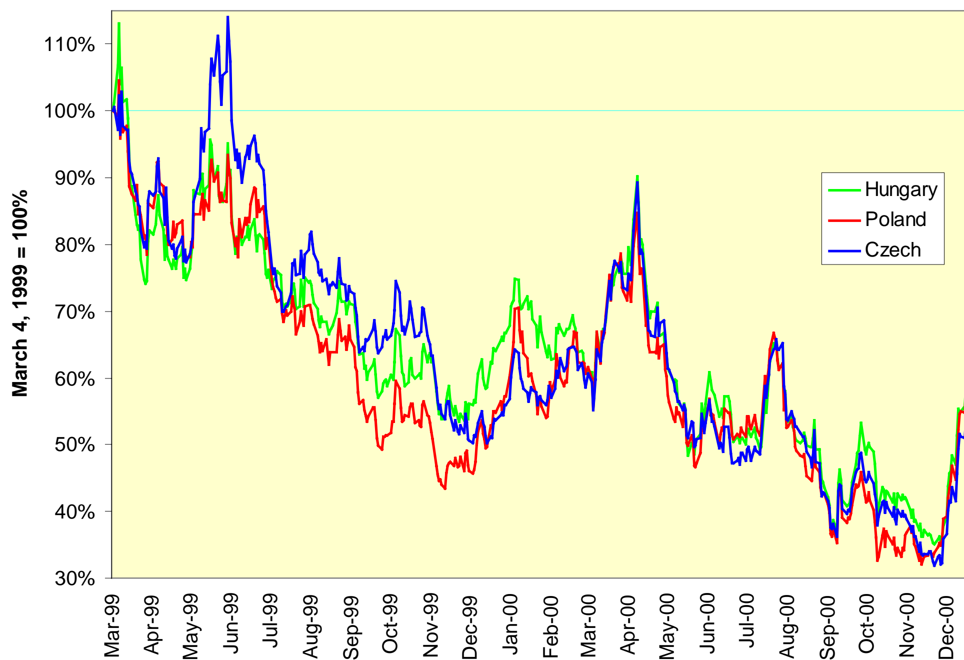
The general path of these indices over the course of 2000 mimics that of the U.S. and other major markets up until December. All three national markets, led by the Polish WIG-20, bottomed by early December and started on an upward course while the U.S. was driving toward its lows of the year. To rub it in, WIG-20 market leaders included Computerland Poland and Optimus, a computer equipment and services

provider. PX-50 leaders included far more mundane entries such as Biocel Paskov, a maker of pulp products, and ZVVZ, a producer of air handling products such as fans and cloth filters, and the leading performer on the Hungarian market was the consumer goods maker FOTEX, up nearly 200% in forint terms. Needless to say, U.S. tech, forest product, and consumer goods stocks didn't lead much in 2000.

Curiously, one of the worst performers on the PX-50 was natural gas distributor Jihoceska Plynarenska, which lost over 58% of its value, and demonstrated one more time that the time-tested rule "if you can't pronounce it, don't buy it" is a good one.

The Oil Effect

While the chart above suggests, correctly, that the October bottoming of the euro set the stage for the Eastern European rally, the picture is not complete without incorporating the effects of crude oil prices into the picture. The reference export crude oil to the region is Russian Urals Blend. If we normalize the USD index values to changes in crude oil prices, a starker picture of commodity price dependence emerges.



Since the euro bottomed on October 25, 2000 at .8272, it has rebounded 11.25% in two months, a respectable gain, yet nothing spectacular as currencies go. The price of Urals Blend, however, has fallen a precipitous 36.5% over the same period. Given the notable disruptions in U.S. energy markets at the moment, the advantages conferred by such a drop in oil prices and a still-cheap but stabilizing euro are considerable for Eastern European manufacturers. And did we mention that their health, safety, and environmental regulations are not as restrictive as American regulations?

A Hedged Approach

While the three indices appear closely correlated, they have rather different risk levels. The WIG-20 has a P/E of 20.3, cheap by American standards, while the Hungarian market has a P/E of 14.9, and the PX-50 has a negative P/E. Let's buy strength and focus then on the WIG-20, either as a cash basket or as the futures that trade on the Warsaw Stock Exchange with a multiplier of 10 zloty (PLN, pronounced "zloty") times the index.

Since March 1999, the elasticity between daily returns on the WIG-20 and the euro has been 1.01%, while the elasticity to Urals Blend has been -0.09% per day. This suggests a simple hedging strategy of flooring the euro and capping Urals Blend (Brent crude oil futures on the International Petroleum Exchange are a very good substitute for Urals) in equal currency amounts.

This trade will give you exposure to these rapidly transforming economies and their cost advantages. And, chances are, it will be non-correlated with the rest of your portfolio.