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Investing for a
world of change

Notes from the road: Central and Eastern Europe is ripe for relative-value investing

Roger Mark shares insights gained from his recent trip to Central and Eastern Europe, where an increasingly diverse outlook for monetary policy, coupled with country-specific dynamics, creates a rich hunting ground for active investors.

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- Recovering growth, normalising inflation, and high real interest rates paint a positive picture for the region.
- Central banks in Hungary and Czechia should have room to keep cutting interest rates, but rates are likely to remain on hold in Poland well into 2025.
- Political risks to navigate include Hungary's EU dispute, and geopolitical uncertainty in the event of a second term for Trump.

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Modest growth recovery underway

After a shallow recession across much of Eastern Europe in 2023, economic activity is picking up. Sharp disinflation coupled with still-high nominal wage growth has driven a positive shift in real incomes, allowing consumers to rebuild their balance sheets and start spending again. Signs of rising demand and strengthening retail sales were clear across the region's capital cities.

Beyond the consumer sector, various signs point to a more uneven recovery, with industrial production remaining sluggish and locals highlighting still lacklustre corporate sector investment. Structural challenges also remain: Czechia's economy has stagnated since the COVID pandemic and Russian invasion of Ukraine, and its economic ties to the faltering German growth engine mean it is likely to only recover gradually this year. While Hungary and Poland should see more meaningful growth this year, people I met in both countries voiced their concerns over economic challenges: labour/energy intensive firms leaving Poland or prompting a switch to automation; and potentially excess battery manufacturing capacity in Hungary challenging the country's EV growth focused model.

Inflation largely supportive of cautious rate cutting

Both Hungary and Czechia's central banks appear to be on track in keeping inflation around the upper bound of their target range over the next 12 months. Near-term risks mean monetary policymakers remain cautious, and the likelihood of positive surprises has faded, but inflation in both countries should remain largely contained.

> The reason for their cautious stance is that both the Czech National Bank and National Bank of Hungary are concerned that services inflation will remain sticky; the battle against inflation is not yet over and risks could emanate from high wage growth and rising domestic demand. This is most obvious in Hungary, where backward-looking price increases in service contracts (e.g., broadband and insurance services) has led to a meaningful rise in core inflation momentum. Czechia also had to contend with a food price shock in April, although officials I spoke to viewed this as a one-off lagged effect of tax changes – seemingly corroborated with intra-month data in May.

More broadly, there is a clear concern around the policy pathway of the Federal Reserve – not just the European Central Bank; this manifests itself most concretely in concerns around currency weakness, with the National Bank of Hungary notably seeing a relatively stable forint as crucial in its fight against inflation. That said, ultimately there is room to cut interest rates in both markets: although the pace may slow, both central banks seem poised to cut by at least 25bps in June and neither pushed back against market pricing of around 100bps of cuts in Czechia and 75bps in Hungary to year-end (at the time of my meetings).

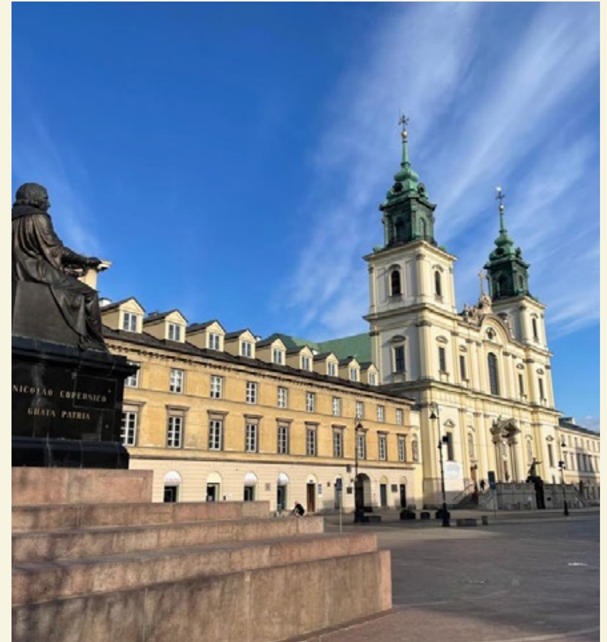
The picture is less benign in Poland, where the liberalisation of energy prices could add 2% to headline inflation in July, with local economists forecasting a rise in headline inflation to as much as 6-7% by year-end/early 2025 (it's currently less than 3%). These worsening inflation dynamics are likely to mean rate cuts are off the table until at least Q2 next year.

Sizeable EU fund flows for Poland

Although looser monetary policy seems a rather distant prospect for Poland, there was considerably more positivity regarding the new government's relationship with the EU. My trip to the country left me with the strong impression that Poland should receive significant EU fund flows in the coming months. Recovery and Resilience Plan amendments will contain few controversial measures and much of the reforms will be backloaded. As a result, Poland could receive around EUR24 billion in recovery funds (in addition to the regular cohesion funds) over the next 12 months – amounting to over 3% of GDP.

The situation is more complicated for Hungary. A partial unfreezing of EU fund flows in recent months is in jeopardy from European Commission proceedings related to procurement rules and a new 'foreign influence' type law introduced at the start of the year. Post European parliamentary elections, the backdrop may prove more conducive for negotiations and concessions from Budapest, although with Hungary due to take over the presidency of the European Council this may complicate the situation as both sides look for leverage. The outlook is uncertain, but we could see a return to politics driving a degree of market volatility in Hungarian assets.

Warsaw, Poland



Source: Ninety One.

Trump looms large

The US elections came up time and again in my discussions, particularly in the context of security and the war in Ukraine. Sitting in Warsaw, I was acutely aware of the city's proximity to both the war and Russia (Kaliningrad is just 150 miles to the north) as well as the impact on Poland's economy (defence spending is to reach 5% GDP; there are now two million Ukrainian refugees in the country). US security guarantees are pivotal to NATO's eastern flank and Poland in particular feels vulnerable. A Ukraine defeat, or Trump-enforced concessions could lead to wider insecurity on the Polish border with perhaps further trade disruptions and a fresh influx of refugees. Even in Hungary, whose prime minister (Viktor Orbán) is seen as close to Trump, there were concerns around the impact of US trade policy on the country's burgeoning relationship with Chinese auto manufacturers.

Budapest, Hungary

Source: Ninety One.

Investment implications

The overall picture of modest growth recovery, inflation within target range, and still-high real rates is supportive for the regional bond market outlook. The prospect of diverging monetary policy is also creating some compelling relative-value trade opportunities across the region's bond and FX markets. We remain cognisant of political risks, whether emanating from Hungary's EU dispute or a Trump second term, but believe that politically induced volatility may create further opportunities for alpha generation.

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