

Going Long Hungarian Bonds? You Betcha

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Business Monitor’s Emerging Europe team has been cautious regional financial markets over the past several weeks, holding a neutral position across asset classes in the company’s in-house market portfolio since June 12. The long equity positions the team had held through the end of March to early June continue to look shaky amid technical signs of consolidation or further sideways trading. With the equity market looking less convincing, the team has sought out opportunities in the fixed income market, where local debt securities, especially in central Europe (Hungary, Czech, Poland) have suddenly made major gains. As a result, the CEE team has jumped back into the market, initiating a long Hungarian 3-year treasury bond view when the yield was at 9.51%. Since then, the yield has fallen 26bps to 9.25%.



Hungary 3-year treasury bond, yield (%)

From a fundamental perspective, this call sounds counterintuitive. BMI has long cautioned that Hungary would be a regional underperformer while simultaneously stressing that expansionary fiscal policy would make government fixed income a particularly uninspiring investment. After all wasn't it in Hungary that a government bond auction failed in Q408 sparking the financial crisis there?

To be sure, I'll admit that the call didn't seem to gel with some of the core macroeconomic views that had been presented for some time by the team, but the justifications for short-term gains are compelling. First, the technicals simply cannot be ignored. The 3-year treasury (and its 5-year counterpart) have smashed through 18-month trendline resistance at the end of June, pushing back into the single digits for the first time since December.

Second, the stabilisation of the financial markets globally over the past three months has significantly altered the short-term risk profile for Hungarian local debt. Namely, we have seen a marked stabilisation in the Hungarian forint which will be crucial for opening rate cuts by the National Bank of Hungary (NBH). Having to defend the currency after the October financial crisis has meant that Hungary is the only major economy in CEE to have not engaged in sharp monetary easing H109. Since the beginning of the year, Hungary has only cut by 25bps to bring its base rate to 9.50%, whereas Turkey has cut by 625bps (to 8.75%) and Poland by 75bps (to 3.75%). With the forint having appreciated by 15.5% since its record low in 2008, there are now increasingly dovish signals from the Hungarian monetary council, especially as aggregate demand remains in a sharp contractionary phase.

To be sure, the opportunity in Hungarian fixed income reflects the greater potential in the market as investors price out the crisis risks they had originally priced in during the fourth quarter. Of course, big caveats remain and I do not intend on ignoring the core macroeconomic view for the country, which remains very weak. Fiscal concerns remain prominent and ultimately, I cannot see the NBH being able to cut aggressively as risks of another forint sell-off continue into 2010. While I see solid scope for yield compression towards 8.0%, I don't see a break lower than that.