The Search For New Emerging Markets

Europe : Crises define Poland, Turkey appeal

Two countries poised for growth, but threatened by euro-zone crisis

Two of the nations that fought hardest for closer ties to Western Europe in recent years may now be glad they didn't get everything they wanted. With the European Union's traditional powerhouses stumbling, solid growth in both Poland and Turkey may offer the best opportunities in the region.

Emerging Europe is the cheapest region in the world, trading at three to four times earnings. It's cheap relative to anything else in the world.

Turkey and Poland wowed observers with their economic performance following a global financial crisis that left regional peers hobbled. Both relied on youthful populations, relatively low debt levels and expanding middle classes to position themselves as the "New Tigers," poised to help drive future global growth. But high unemployment, volatile currencies and reliance on foreign investment could come back to haunt them, especially if the euro-zone debt crisis spins out of control.

Poland was the only European country to avoid recession in the global financial crisis that followed the 2008 collapse of Lehman Brothers. Since the start of the crisis, Poland's economy has grown by 15%, according to the International Monetary Fund, easily topping its next closest EU rival, Slovakia, at 8%.

Turkey didn't escape a post-Lehman contraction, but it more than bounced back from the downturn. After shrinking 4.8% in 2009, Turkey roared back to life and saw gross domestic product expand by 9% in 2010 and 8.5% in 2011, the IMF estimated. By the middle of last year, the economy was 9% larger than it was before the crisis.

Poland's WIG 20 stock index is down 0.9% year-to-date, and has dropped roughly 23% in the past year. Turkey fared better, with the Istanbul Stock Exchange's top index rising 12.6% since Jan. 1 to trim its one-year loss to 8.8%.

Low-hanging fruit

Merely being cheap doesn't necessarily make for a good buy, strategists say, but investors can find plenty to cheer in both economies.

What makes the pair stand out? They share some traits.

Each still has a significant rural underclass. Both have substantial room to improve basic infrastructure by upgrading outdated factories, building and improving roads and so forth. These represent some of the low-hanging fruit that give emerging-market economies their growth potential.

For instance, the completion of a decent road between Berlin and Warsaw can substantially boost productivity in Poland. Another road between Hamburg and Berlin does little for German productivity.

In Poland, about 13% of the population is employed in agriculture, which accounts for just 4% of gross domestic product, according to World Bank data. In Turkey, nearly a quarter of the population remains on the farm, with agriculture accounting for 9% of GDP.

The two countries' youthful populations and growing middle classes are driving consumption and healthy economic growth. Thanks to these factors, Poland and Turkey stand out from western Europe and will offer attractive, if higher risk, investment opportunities in the years ahead.

Both have witnessed monumental economic transformations

"Shock therapy" made for often chaotic transitions across much of the former Eastern bloc after the fall of communism. Poland's more deliberate approach, which saw the country's new leaders move to gradually put in place a series of reforms aimed at building a banking sector and instituting a commercial code, made for a smoother transformation, economists said.

Poland attracted waves of foreign-direct investment as firms sought to tap into central Europe's largest domestic economy.

Poland, which had served as a hub of heavy industry for the Eastern bloc under Soviet domination, managed to capitalize on its large if inefficient industrial base. Poland has become a hub for German and other European firms, often exporting parts back to factories in Bavaria or elsewhere for final assembly. That's left Poland with a relatively balanced economy, with about 40% of GDP tied to exports, and healthy domestic demand.

Fundamentally, Poland is far more structurally sound than most countries in Western Europe. It's got a hard-working labor force.

Turkey, seen as recently as the 1990s as an economic basket case, also saw a rapid transition after emerging from a financial crisis in 2001. Turkey's finance minister at the time, Kemal Dervis, oversaw an overhaul that brought sweeping changes to the country's banking regulations and installed an independent central bank.

While Poland stands as the biggest economy among emerging Central and Eastern European countries, Turkey dominates its corner of Southeast Europe and the Middle East.

Both countries have won praise for stable banking systems. Institutions in neither country were saddled with subprime debt or other toxic assets.

Both have also suffered from rising inflation driven by higher energy and other commodity costs.

There are also big differences

Turkey is much bigger — and poorer — than Poland. There are about 75 million Turks to 38 million Poles. Turkey's per capita gross national income stood at $9,890 in 2010, according to World Bank data, versus $12,440 for Poland.

Turkey carries a larger current account deficit at nearly 10% of gross domestic product, leaving it more vulnerable to sudden shifts in investor sentiment. Turkey is less of an exporter, with the sector equivalent to around a fifth of GDP.

Turkey only has to concentrate on the external deficit fronts. And by concentrate I mean keep it under control, because that's a problem that Turkey has to live with for probably another 10 or 15 years. The current-account deficit is ultimately a savings problem and the savings problem will start to go away as Turkey country gets older and richer, he said. "Right now, we have an environment that's very conducive to high growth and investment-based growth."

There is also the matter of EU membership. Poland has benefited handsomely from aid from Brussels since joining the club in 2004. After numerous delays and acrimonious setbacks, Turkey is trying to reinvigorate its bid for EU membership.

For now, both countries are aiming to slow things down.

Poland has vowed to bring its budget deficit down to 3% of gross domestic product by next year. Turkey is taking steps to rein in its current-account deficit.

Neither is expected to deliver gangbuster growth in the immediate future. The IMF forecasts Poland to grow by 2.6% this year and 3.2% in 2013. Turkey's expected to grow 2.3% in 2012 and 3.2% next year.

And economists say it's unlikely either would manage to escape a downturn if the situation in the euro zone turns chaotic, creating another Lehman-type financial panic or worse.

That said, it's certainly not all rosy among the so-called BRICs, either. Fears of a potential Chinese hard landing periodically roil global markets. Brazil, Russia and India also provide cause for concern.

Poland, on growth trajectory, revels in role as regional proxy

If Poland is a proxy for emerging European economies, it's no wonder the Warsaw Stock Exchange sees itself as a symbol of the country's economic transformation since the fall of Communism more than two decades ago.

Founded in 1991 and originally housed in the former Communist Party headquarters, the exchange today sits in a modern, eight-story, custom-built office block just off Warsaw's again-fashionable Nowy Swiat.

Poland is now widely viewed as a proxy for the wider Central and Eastern European region, something that wasn't the case before the collapse of Lehman Brothers.

Poland's reputation was greatly enhanced by its ability to weather the post-Lehman crisis without falling into recession — the only European economy that can make that boast. That's paid dividends for the exchange and the Polish economy. Coupled with an aggressive approach to attracting listings, the Warsaw exchange has grown rapidly, surpassing Vienna to become the region's largest exchange by market cap.

Nevertheless, Poland faces substantial headwinds. Unemployment remains high and energy costs have kept inflation above the central bank's target. Massive uncertainty surrounding a potential Greek exit from the euro zone prompted heavy selling of the zloty currency last week, which could eventually force the central bank to intervene, strategists said.

Poland's reputation as a rapidly emerging economy that is insulated from risks that dog much of Europe — a characterization that is no longer entirely accurate — has enhanced the attraction of the exchange as global investors search for yield.

Total domestic market capitalization at the Warsaw exchange stood at 122 billion euros at the end of March, topping Vienna at €73 billion and Prague at €30 billion.

Eleven initial public offerings debuted in Warsaw in the first quarter, leaving it fifth in the world behind Shenzhen Stock Exchange, the New York Stock Exchange, Hong Kong Stock Exchange and the Nasdaq.

Before Lehman, the country was overshadowed by the likes of Hungary and the Czech Republic, while investors saw Poland as more of an "emerging-market basket case". Now Poland is viewed as an emerging economy that's less vulnerable to shocks.

But is Poland truly a "tiger" economy?

Annual economic growth of about 3% won't warm the hearts of those looking for breakneck China or India-style expansion.

But compared with the rest of developed Europe, the answer is clearly yes. It's able to adapt much quicker to changes in the external environment and competitiveness.

A large number of underemployed agricultural workers are capable of providing a still-substantial pool of potential industrial labor. Factories still have plenty of room to upgrade equipment and infrastructure — roads and other projects — offer plenty of "low-hanging fruit" that can be harvested to quickly ramp up Polish productivity.

While the euro-zone crisis continues to hang over the Polish economic outlook, there's no reason to think Poland couldn't manage growth of 5% to 6% annually if the debt crisis were resolved.

Poland wowed many observers by managing to avoid recession in the wake of the global financial crisis in 2008-2009, but in some ways Poland's performance shows that it's better to be lucky than good.

In other ways, Poland's relative backwardness also proved to be a boon. The nation's banking system, dominated by foreign lenders, carries a low loan-to-deposit ratio of about 110%. Polish banks held no subprime real-estate debt or sophisticated-but-toxic instruments. Also, Poland's financial regulator successfully pressed foreign bank chiefs not to repatriate Polish banking profits.

Credit still contracted. But Polish companies, which were starved of capital after the fall of Communism, were ready for it, she said. Polish companies are still reluctant to load up on debt, preferring to fund about 80% of new investments out of profits, she said.

Currency matters

Then there's the matter of the currency. Exports and domestic consumption have been the twin pillars of Poland's economic performance.

The financial crisis saw investors fleeing risky assets, including the zloty. The currency's sharp depreciation made already price-competitive Polish exports more attractive, while rising import prices forced Polish firms and consumers to seek out homegrown or homemade goods.

So far, so good

But Poland was spared in part because Germany's economy never fell apart. About 25% of Poland's exports go to its western neighbor. Poland has become a hub for German auto makers and other manufacturers, producing relatively sophisticated parts for final assembly in the form of an Audi sports car or other high-value German exports.

Ask Polish economists what they fear most, and all point to the euro-zone debt crisis. While opinions vary on prospects for a Greek exit or breakup, most agree that Poland is unlikely to escape unscathed from another Lehman-style global crisis.

Indeed, the Polish zloty came under heavy pressure recently as worries mounted over a Greek exit and investors dumped risky assets.

Unemployment, meanwhile, remains elevated at 10.1%, though far off the 20%-plus levels seen in the early 2000s. Poland's central bank earlier in May delivered a widely criticized rate increase in an effort to bring down stubbornly above-target inflation driven largely by higher energy prices.

While the economy faces headwinds, economists see promising signs the Polish economy is ready to climb the value chain. Lewiatan surveys have found that Polish businesses, which previously emphasized price competition, are increasingly focused on competing on quality.

Meanwhile, some economists ponder whether the perception of Poland as an emerging-market economy remains accurate. The economy might no longer fit the mold of a true emerging economy but hasn't fully graduated to the ranks of a developed economy either.

It may be the perception that matters to investors, however. Yield-hungry investors still see Poland as less advanced than it really is, he said.

The perception of Poland is worse than it is. And that's what we benefit from.

Investments

More than 50% of Poland's banking system by assets is owned by Western Europe banks, with Italy at the forefront. Capital flight is a warning sign that has largely been ignored," he said, adding that $15 billion was pulled from Poland in 2011.

As for Turkey, the country risks losing its biggest export market — western Europe — as it tries to further develop its economy and look inward or east, he said. But demand from the Middle East and other emerging markets will act as a cushion and domestic demand is robust.

One positive for both markets is that foreign direct investment may increase, leading to a recovery in the medium term, as investors write off western Europe markets as a lost cause.

ETFs and other mutual funds

One of the easiest and least risky ways of getting exposure to Poland and Turkey is with an exchange-traded-fund, but if investors want a pure play there aren't many choices.

IShares MSCI Poland , Market Vectors Poland or iShares MSCI Turkey are three on offer. Of the two Polish ETFs, we prefer iShares MSCI Poland as it is larger and more liquid. There is also the iShares MSCI Emerging Markets Eastern Europe index ESR, which has 16% exposure to Poland.

There are other emerging market funds that follow a non-cap weighing methodology that have a less than 8% exposure to Poland or Turkey, but tend to be small and not very liquid.

Generally speaking, we think investing in such small markets as Poland and Turkey is best suited for those who have some understanding of those markets. Single-country funds, especially ones in countries with small capital markets, tend to be very volatile, and investors are probably better off investing in a more geographically diverse fund.

There is also a Turkish closed end fund, Turkish Investment Fund, which concentrates on the country's main sectors, which include financials and oil. The fund is managed by Morgan Stanley Investment Management Inc.

Other investment avenues

Investing straight in the stock markets is how big investment banks do it, and it's not impossible for the retail investor, but a broker is required. The Warsaw Stock Exchange provides a list of brokers and a spokeswoman for the exchange said any investor, including European and American, who opens an investment account with any broker on the list can invest in stocks directly on the WSE.

Poland's Central European Distribution Corp. lists on both the Warsaw Stock Exchange and the Nasdaq. One of the world's biggest vodka producers, and an exporter of Sutter Home wines, Cointreau, and Remy Martin cognac, the company is actually based in New Jersey. Investors can also get access to Polish companies listed on the London Stock Exchange.

As for Turkey, investors have to use a broker to directly access the market. The Association of Capital Market Intermediary Institutions of Turkey lists brokers who will give access to non-Turkish investors who open an account with them. See the list of brokers

Options for investing in Turkey are fewer. There is one U.S.-listed company, Turkcell, the country's voice and data provider, which allows U.S. investors direct access.

A back door option into Turkey is via Spanish bank BBVA SA which owns a roughly 25% stake in Turkiye Garanti Bankasi AS, the second-biggest private bank in the country. Of course, BBVA has also been shunned by many investors owing to Spain's part in the euro-zone sovereign-debt crisis.