Eastern Europe: Reemerging as a Viable Competitor in Europe

May 2017

Robert Szeles, CFA
Analyst
International Equity

Martin C. Schulz, J.D.
Managing Director
International Equity

A generation has passed since Eastern Europe began its transition from communism to democracy and capitalism. Since then, the region has become increasingly integrated into the global economy and the more successful nations are playing important roles in the supply chain of developed economies. Competitive advantages such as lower production costs and lower wages and tax rates are attracting European Union (EU) and other developed-country manufacturers to outsource to Eastern Europe. Local governments have taken important steps in implementing market reforms to support growth and trade. As a result, per capita incomes in Eastern Europe have been steadily converging to the EU average.

Looking forward, the region stands to further benefit from increased business activity due to an improving economic environment in Western Europe after a difficult post-sovereign crisis period. These countries have demographic advantages over aging Western Europe. However, it is essential that workforce opportunities continue to increase and living standards continue to rise, ensuring that the best and brightest skilled workers not just remain – instead of emigrating – but also return home. If Eastern Europe drives further structural reforms, it will increase its competitive edge over Western Europe, which is finally fully recovered from the aftereffects of the sovereign debt crisis but is still grappling with rising populism across the continent (think Brexit and more), elevated debt levels, and an aging population.

As our international equity team's investment universe further expands to include more developing countries, our top-down analysis – which emphasizes market valuations, risk, growth, and momentum – highlights Eastern Europe as a region that has the potential to outperform. We recently visited Poland, Hungary, Romania, Turkey, and the Czech Republic. We've had a chance to meet with corporate leaders, government officials, academics, and journalists to understand the mindset of the people and the potential of these countries and the region. We sensed that the mindset is constructive as they view the increase in real income, private investments, and consumerism as positive trends for the region. The trips confirmed our belief that the demographics are ripe for supporting sustained growth and governments are slowly making structural changes to allow these emerging countries to compete with their more developed EU counterparts. While there are challenges ahead

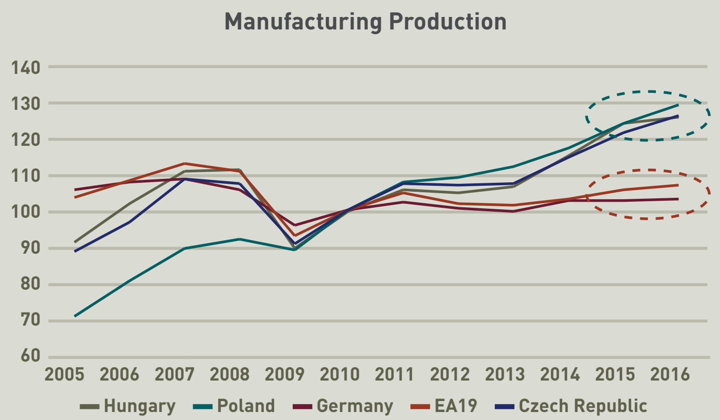
PNC CAPITAL ADVISORS

in passing further meaningful reforms and the potential for increased populism, the region offers significant investment opportunities. Because of shared backgrounds and common themes, we will focus first on the post-communist countries in Eastern Europe, excluding Russia, Belarus, and Ukraine (which requires a separate treatment all its own).

THE FALL OF THE USSR AND THE RISE OF THE FREE MARKET IN EASTERN EUROPE

The task of building market economies after the fall of the Soviet Union has been long and demanding. Several Eastern European countries took immediate steps to liberalize markets, but it was difficult for reformers to overcome vested interests and the status quo. Gains in the years immediately following the collapse of the Berlin Wall were uneven and economies were plagued with recessions and high levels of inflation. Eastern Europe began to produce stronger and more uniform growth after the turn of the century, as large capital inflows helped many countries modernize production and raise income levels. This was especially the case for those countries that joined the EU.

The entry of Eastern European countries into the EU in 2004 accelerated the integration of the region into the heart of Europe and mainly into the German industrial production chain. Similar to the role Mexico has played to the U.S., Eastern Europe provided the rest of Europe with lower labor costs and a dependable manufacturing base. Poland, Czech Republic, and Hungary are all countries that have observed stronger manufacturing production since joining the EU in 2004. Even Sweden and the UK, countries with flexible currencies, underperformed what is now Europe's manufacturing hub. The flood of investments drove new technology, jobs, and capital investments and in turn increased productivity. The countries that fared the best initially were those that were located closest to Western European markets and already possessed a solid manufacturing base – the Czech Republic, Hungary, Slovakia, and Poland. Manufacturing leaders in the region developed and implemented policies that underpinned low-skilled, export-oriented production, including programs focused on infrastructure investment, creation of industrial parks, and cash subsidies or tax breaks. Over time, Eastern Europe became the second-largest car-making area in Europe. Growth in other production sectors from processed foods to consumer electronics, appliances, and pharmaceuticals thrived and provided a more competitive alternative to emerging Asia.

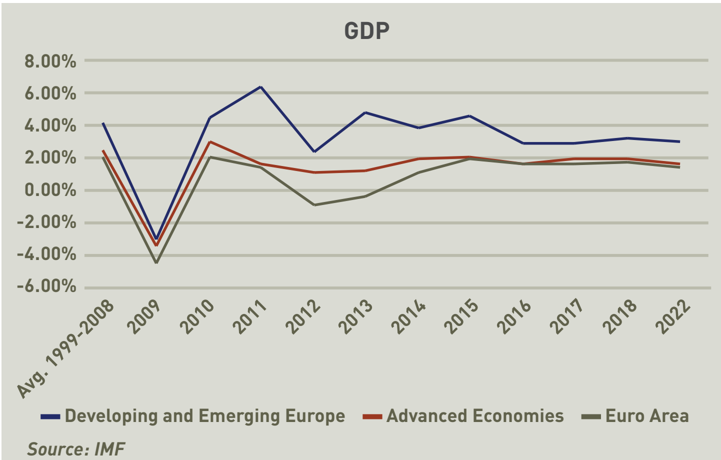


Source: Organization for Economic Cooperation and Development

After the collapse of communism, these formerly, centrally planned economies embraced the free markets and then continued to implement structural reforms throughout the 2000s under the lure of EU membership. The reforms accelerated development and productivity growth, leading to convergence with the bloc's biggest trading partner, Germany. The bottom line is that the integration into the German supply chain has been one of the most significant features of the development of these Eastern European countries in a generation. The shift in manufacturing came at a cost for other Western European markets, including Greece, Italy, Portugal, and Spain. Low wages, relatively high skill levels, and supportive demographics strengthened the manufacturing profile of these countries and attracted foreign investors into Eastern Europe. However, these structural changes and capital inflows were not permanent enough to survive the global financial and European sovereign debt crisis that ensued.

REEMERGING AS A VIABLE COMPETITOR

In 2008, it was Eastern Europe that put the International Monetary Fund (IMF) to work. Ukraine, Hungary, and then Latvia all needed to tap the fund in the aftermath of Lehman Brothers' bankruptcy. Prior to these crises when the economy was strong, massive capital inflows from foreign investments resulted in overvalued currencies and oversized current-account deficits. It was not a period in which we found Eastern Europe attractive. Consequently, the global financial and economic crisis drove down currency values and current-account deficits swelled as investments exited the region, delivering an economic shock – Poland was the only exception. Conversely, supporting the rapid growth of manufacturing in Eastern Europe was the stable inflow of foreign direct investment. Many countries in Eastern Europe ran wide current-account deficits like their Western partners from 2000 to 2008, but these deficits were funded by direct investments, not short-term capital flows, allowing the eastern part of the region to emerge more quickly from the financial crisis. While the region struggled along with most of Europe during this period, the rapid devaluation in its currencies versus its peers allowed its economies to regain their competitiveness as a cheap production location versus major competitors in emerging Asia. With this came higher real labor productivity as technology filled the new production facilities in Eastern Europe.



Eastern Europe's prospects today are much more favorable. For the region as whole, growth is projected to clock in at 3.0% in 2017 and strengthen to 3.3% in 2018, as rising wages in several countries support strong domestic consumption growth. Actual and projected GDP growth rates for developing and emerging European nations – composed of Eastern European countries not in the euro area – are expected to surpass those of advanced countries and the Eurozone group.

DEMOGRAPHICS AND MIGRATION: TWO SIDES OF THE SAME COIN

While the opening up of Eastern Europe's borders brought about tremendous benefits to the region, it also resulted in a sizable outflow of its most productive people. The IMF estimates that close to 20 million, mostly young and skilled Eastern Europeans, left their countries over the past 25 years to seek better opportunities abroad. Even with this outflow, Eastern Europe enjoys certain demographic advantages over the rest of Europe. The proportion of the population that is of working age (15 to 64) is frequently higher in Eastern European countries than in advanced economies to the west. For example, Poland (69.5%), Hungary (67.6%), and the Czech Republic (67.0%) each have a larger share of their population in this group than economic powerhouse Germany (65.8%). Germany (21.0%) has a far greater portion of its citizens who are 65 and over compared with Poland (15.4%), Hungary (17.9%), and the Czech Republic (17.8%), allowing these younger countries to focus on productivity and growth over financing the aging population.

Eastern European countries belonging to the EU have seen rising standards of living and progress on human rights. According to an index that measures social progress, Eastern European nations are now among some of the richest in the world. The non-profit organization that compiles the annual Social Progress Index said the results suggest there could be a drop in the number of Eastern European migrants seeking jobs and better lives in the longer term as conditions improve at home. A similar pattern emerged in Southern Europe when poor people migrated to work in the region's richer countries in the 1960s, these flows of migrants eased once economic conditions improved at home.

Labor shortages in Eastern Europe will put increased pressure on wages, which will not only help keep citizens from emigrating, but perhaps lure back those who left. In addition, rising anti-immigrant sentiment in Western Europe is an increasing source of concern for expatriates and those contemplating emigration. Eastern European governments are also fighting to encourage former residents to return. For example, Poland's Powroty (Returns) program is aimed at persuading back the well-educated and skilled workers who flocked to the United Kingdom when Poland joined the EU. The program supports

Per Capita Income as % of EU Average		
Country	**2005**	**2015**
Bulgaria	37	47
Croatia	56	59
Czech Republic	79	87
Estonia	60	75
Hungary	62	68
Latvia	50	64
Lithuania	53	75
Poland	50	69
Romania	35	57
Slovakia	60	77
Slovenia	67	83

Source: Eurostat

returning Poles with jobs, housing, and health care. In addition, income convergence is a driving force for skilled workers to return home to their roots. Eastern Europe has made great strides in per capita income gains, especially in nations that joined the EU. For example, Poland's per capita income in 2005 was only 50% of the EU average. The latest data available shows it's almost 70%.

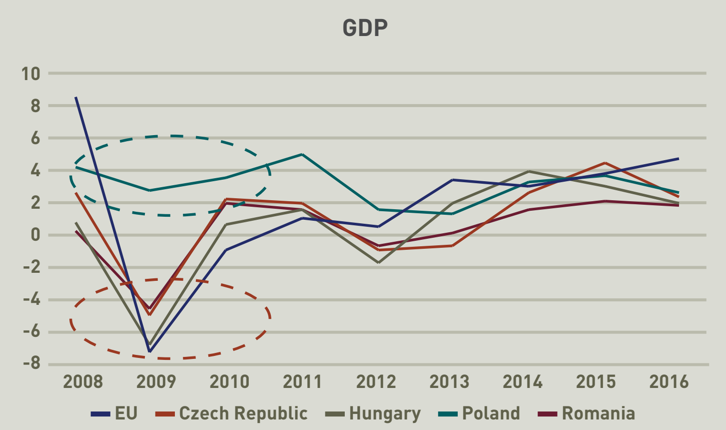
COUNTRY SYNOPSIS

The following takes a closer look at markets that PNC Capital Advisors' International Equity team views as attractive from our unique top-down analysis perspective. As previously mentioned, the team recently visited countries in the region to meet with corporate leaders and potential companies for investment, as well as government officials, academics, and journalists to reaffirm the relative strength of these countries. The framework also includes team members visiting and analyzing specific growth companies from a fundamental bottom-up perspective. Consequently, this dual framework results in investing in what the team believes are the best international growth companies within global markets that have compelling relative valuations with the least amount of risk.

Poland

Poland has pursued a policy of economic liberalization since 1990, and its economy was the only EU country to avoid a recession during the 2008 to 2009 economic downturn. The government of Prime Minister Donald Tusk steered the Polish economy through the Great Recession by expertly managing public finances and adopting pension and tax reforms to shore up public finances. EU membership and access to EU structural funds have provided a major boost to Poland's economy since it joined in 2004.

The Polish economy slowed in 2013, but picked back up in subsequent years. The IMF projects that Poland's GDP will grow 3.4% in 2017 and 3.2% in 2018, well above the average advanced-economy growth rate of 2% in each of those years. Gains in employment and wages, higher social transfers, and low energy prices are supporting private consumption and housing construction. Falling excess capacity and stable financing conditions are expected to stimulate business investment, while public investment financed by EU funds will regain momentum toward the end of 2017. Strong cost-competitiveness and a recovery in external demand should support export growth, allowing the small current-account deficit to remain stable. Poland's unemployment rate of approximately 6% is now well below the EU average, and it's expected to fall to the mid-5% range over the next two years.



Source: Eurostat

Poland faces challenges, including deficiencies in infrastructure, a rigid labor code, and a cumbrous legal, tax, and government framework. For example, Poland still maintains a land bank, which adds red tape to development projects. Stemming the outflow of young, talented Poles is an issue, and the labor market would be strengthened if the government took steps to enhance worker mobility and create incentives for women to join the workforce.

Populism is fairly strong across the region. Poland's ruling Law and Justice (PiS) party is socially conservative, eurosceptic, and nationalist. It plans to introduce expansionary economic policies and increase social spending, resulting in an expected public deficit of approximately 3% of GDP in 2017 and 2018. PiS has been accused by the West of dismantling democratic institutions with policies designed to limit civil liberties, control the media, politicize the civil service, and curtail judicial independence. Poland needs to stay on track to continue to make needed reforms and keep making progress.

Hungary

Hungary made the transition from a centrally planned economy to a market economy, and it now has a per capita income more than two-thirds that of the EU average. The global economic downturn, declining exports, and low domestic consumption and investment, dampened by government austerity measures, resulted in a severe economic contraction during the Great Recession. As a result, Hungary was forced to obtain IMF/EU/World Bank-arranged financial assistance in 2009. In 2010, the government implemented a number of changes, including cutting business and personal income taxes, although it imposed crisis taxes on financial institutions, energy and telecom companies, and retailers.

The IMF projects Hungary will expand 2.9% in 2017 and 3.0% in 2018. Hungary has made progress in reducing its public deficit to under 3% of GDP, and the government appears to be committed to keeping its finances in check. Private consumption should remain the main growth driver, given projected employment gains and faster wage growth, and business investment should to strengthen with favorable credit conditions. New infrastructure projects are being launched with EU structural funding, and housing investments will pick up with higher subsidies and a recovery in housing loans. Hungary's unemployment rate is an impressive 4.5%.

Like Poland, Hungarian politicians use the EU as leverage. Viktor Orban's ruling Fidesz party has clashed several times with EU authorities, including changes affecting the judiciary and the media. A nationalist, conservative, and populist party, Fidesz has been a thumb in the eye of Angela Merkel, especially on the topic of openness to migrants and refugees. In April 2017, Hungary passed a law that could close the Central European University, which was founded by George Soros in 1991 and intended to promote progressive thinking within an open society. As is the case with Poland, it is our belief that Hungary would benefit from a renewed commitment to pursue market reforms.

Romania

Romania is a country of 20 million people, but has yet to obtain emerging-market status. Therein lies the opportunity. Like many of its Eastern European counterparts, Romania is a country that has seen a steady level of capital expenditures over the past decade. Romanian exports continue to move up the value chain. The country is exporting ever more machinery, mechanical devices, and transport equipment in place of low value-added goods such as textiles, metal articles, and mineral fuels. In turn, exporting ever more higher-value goods is boosting Romania's terms of trade meaningfully. Romania's current-account deficit is 1.6% of GDP and the country posted economic growth of 6% in 2016, the largest among European Union member states.

The IMF projects that Romania's economy will expand 4.2% in 2017 and 3.4% in 2018. The ongoing growth spurt is driven by fiscally sponsored consumption, which includes, changes in policy such as public sector wages being lifted 10% and a reduction in the value-added tax on food to 9% from 24%. This may be limited as the county is reaching its 3% of GDP fiscal deficit limit set by the EU. These policies have become the center of political debate. Like many other parts of the world, Romania is struggling with populism and this remains a headwind for the country. Rising productivity and improving competitiveness amid very low debt levels provide a solid footing for future growth.

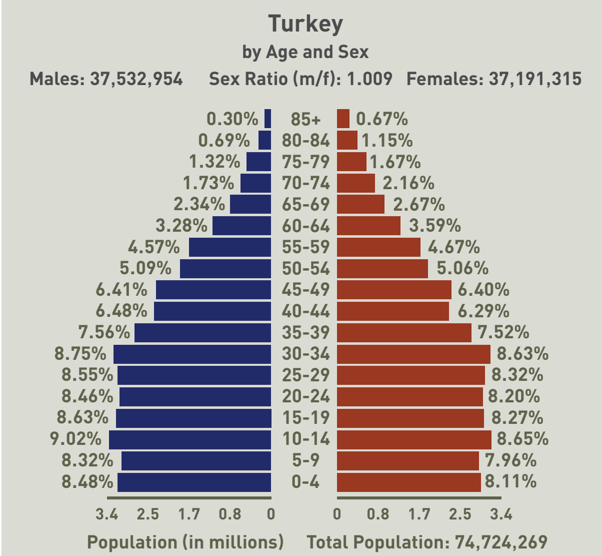
The country is still classified as a frontier market by MSCI, but is optimistically awaiting reclassification to emerging-market status this year. We will continue to monitor Romania as potential long-term opportunity.

Turkey

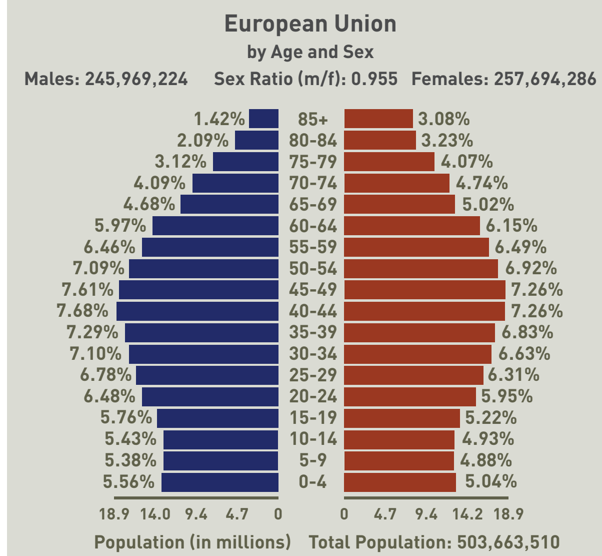
While Turkey is not technically part of Eastern Europe, it comes into the lens when we look at the region. Turkey straddles the continents and is the sole Eastern European/Asian country on our investment team's radar screen that does not have a communist past. The portion of Turkey's land in Europe may be small, but the country's largest city is there. With 14.8 million people, Istanbul is one of the largest and most advanced metropolitan areas in Europe and as one of the EU'S largest trading partners, Turkey has strong economic ties to the continent.

The Turkish economy continues to face geopolitical headwinds and unsettled political conditions. In February, the IMF warned that Turkey's economy will continue to struggle in the near term and called on its government to rein in its fiscal policy. While it projected that Turkey's GDP would grow at 2.5% in 2017 and 3.3% in 2018, the IMF highlighted that the projection is subject to significant risks. Military activity has increased across its southeastern border, as the country is actively engaged in operations in Syria. Turkey was shaken by the failed coup attempt in July 2016, and political unrest continues to be high. In April of this year, a controversial constitutional referendum awarding President Recep Tayyip Erdogan more power passed, but by the slimmest margins. This shows the country is divided about how power should be held within its government.

Turkey has supportive demographics for growth. Half of its population is under the age of 31, and only 8.0% of its citizens are 65 or over, compared to 18.9% in the EU. However, Turkey has one of the highest youth unemployment rates among Organization for Economic Cooperation and Development (OECD) countries. Nearly 30% of young people in Turkey aged 15 to 29 are not employed or in education or training, well above the OECD average of nearly 15%.



Source: Eurostat, 2013



Source: Eurostat, 2013

The Turkish economy is projected to run a sizeable current account deficit in 2017 (4.7%) and 2018 (4.6%), while the unemployment rate is expected to remain at well over 10% over the next two years. The EU's fourth-largest export market and fifth-largest provider of imports, Turkey clearly has significant long-term potential. However, we intend to monitor the short-term risk.

EMERGING MARKET RESILIENCE AND RESURGENCE? EASTERN EUROPE WILL BE A PLAYER.

Overall, we are becoming more constructive on the emerging markets in general. After several years of underperformance and failing to deliver due to weak commodity prices, U.S. Federal Reserve interest-rate hike concerns, weaker economic growth, compressed corporate margins, and a stronger U.S. dollar, emerging markets are starting to stabilize and selectively may be poised to outperform their developed-market peers. We believe that 2016 was likely an inflection point for emerging markets. Subject to a potential risk-off growth scare or inflation-fueled correction later this year, the developing-markets rally looks to be self-sustaining. We also believe that we are closer to a U.S. dollar peak, if we haven't already seen its top. And inflation does not pose the threat it once did.

We believe that developing-market equities may be in an early stage of a multi-year rally. It used to be that political risk emanated primarily from emerging markets. Now, we are seeing a reversal. While we continue to like Europe based on compelling valuations and its cyclical growth prospects, emerging markets don't carry the relative, outsized political risk we are witnessing in the developed markets. In addition, emerging markets have generally accumulated sizeable foreign currency reserves as a buffer against debt default and their currencies are no longer overvalued. Many emerging-market economies can take advantage of the current synchronized global recovery, especially firms with high operating leverage.

Current valuations remain attractive, increasing potential returns and earnings-per-share growth is stabilizing and is expected to rise much faster than in the developed world. The long-term potential of developing-market consumers is well known. Finally investment flows have returned. Our PNC Capital Advisors International Equity team has taken notice, and we are further expanding our product offering and investment footprint in emerging markets. Our disciplined approach of purchasing what we believe are great growth companies and investing in markets with compelling valuations and the least amount of risk will likely mean that Eastern Europe will be a destination for us for the next several years. We will be looking to add to this consumer and manufacturing-driven, growth market going forward. Eastern Europe has some of the highest expected GDP growth in the world.

OPPORTUNITIES AND RISKS

The Eastern European region certainly has more work to do in terms of bringing about more free-market reforms and resisting autocratic and nationalist impulses. Financial markets in these countries are not well developed, putting constraints on investment choices. However, the region greatly benefits from significant tailwinds. The young had been leaving, but may now be returning. There are good reasons to believe that Eastern Europe will be able to attract expatriates back and keep potential emigrants at home. Policies to bring women into the job market and improve mobility could help provide opportunities and address labor shortages. Low debt levels, strong growth, and manageable trade balances make the region extraordinarily interesting. Some of the countries are still classified as frontier markets, and graduation to emerging-market status would be a huge boost to their underdeveloped equity and capital markets. In addition, Eastern European countries are expanding exports and gaining market share and increasing wealth as they catch up to the rest of Western Europe. The region is also poised to directly benefit from the economic recovery in Western Europe. While challenges remain, Eastern Europe is one area that our investment team believes has great potential. Time will tell.

Eastern Europe: Reemerging as a Viable Competitor in Europe

You should consider the investment objectives, risks, charges, and expenses of the PNC Funds carefully before investing. A prospectus or summary prospectus with this and other information may be obtained at 800-622-FUND (3863) or pncfunds.com. Please read it carefully before investing.

PNC Funds are distributed by PNC Funds Distributor, LLC, which is not affiliated with the adviser and is not a bank.

International investments are subject to special risks not ordinarily associated with domestic investments, including currency fluctuations, economic and political change and differing accounting standards that may adversely affect portfolio securities. These risks may be heightened in emerging markets. Because frontier markets are among the smallest, least mature and least liquid of the emerging markets, investments in frontier markets generally are subject to a greater risk of loss than investments in developed markets or traditional emerging markets. To the extent that the Fund invests directly in foreign currencies or in securities that trade in, and pay revenues in, foreign currencies, or derivatives that provide exposure to foreign currencies, the Fund will be exposed to the risk that the currencies will decline in value relative to the U.S. dollar, or, in the case of hedging positions, that the U.S. dollar will decline in value relative to the hedged currency. Investments in growth companies can be more sensitive to the company's earnings and more volatile than the stock market in general. The Fund may invest a portion of its assets in derivatives. Derivative instruments include options, futures and options on futures. A small investment in derivatives could have a potentially large impact on the Fund's performance. The Fund may be unable to terminate or sell a derivatives position. Derivative counterparties may suffer financial difficulties and may not fulfill their contractual obligations. The Fund's investments in securities that are or become illiquid may reduce the returns of the Fund because it may be unable to sell the illiquid securities at an advantageous time or price.

PNC CAPITAL ADVISORS