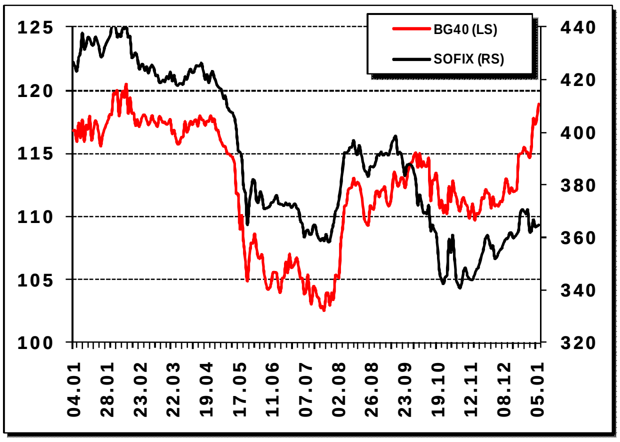
Positive start after a year on the red

The year was negative for the Bulgarian stock market despite the mostly positive trend of world indices. The market cap weighted index SOFIX was deeply negative with 15.19% decline, whereas the price-weighted BG40 fell only 2.10%. This was in contrast to the previous year when SOFIX outperformed BG40 and jumped 19%. However, the changes in SOFIX could be understating the decline but the broader indices outperformed and we consider the market as not in this bad shape.



The main reason for the better performance of small-caps was the absence of foreign investors. Data from the Central bank showed two periods of large changes of foreign inflows to stocks – decline in March and similar increase in August. The second period coincided with the largest gains of 2010 and foreign capitals could be the main contributors as demand in August spread out to large stocks like Chimimport and banks. But only temporarily.

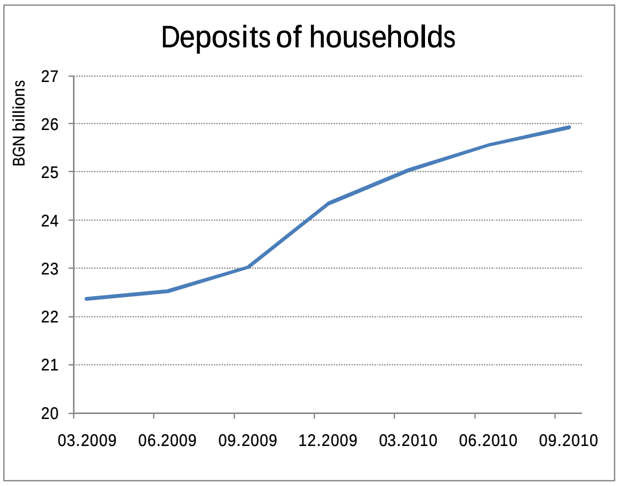
The black swan of BSE

Probably, the main reason not to have bottom of the market in early summer was the government decision to de facto nationalize the accounts of professional pension funds. The market expected solid supply of stocks when the decision was finally announced but soon afterwards became clear that stocks will not be for immediate sell. This news could not support the prices of largest companies to levels of the previous month.

The uncertainty is powerful factor for the market. But there is a possibility that market participants are feeling generally disappointed as none of the expected privatization deals took place in 2010. Domestic investors relied on the forthcoming privatizations of tobacco companies and shares of utilities for improvement of the capital flows from abroad. However, this looks unrealistic at the moment due to the low liquidity and we doubt that stocks will attract demand unless at extremely low valuation. On the contrary, the fresh supply will likely put additional pressure on stock prices and thus will contribute to the slide of share prices. And further avoidance from domestic investors.

Macro picture

The stock market will depend mostly on domestic investors for its initial boost of prices and liquidity. Their tendency to investments will depend on the economic and income growth during the year as main factors for the confidence and risk appetite.



For the moment, deposits of households are rising steadily due to the high interest rates and the low level of capital expenditures of individuals, including real estates. The capital inflows to banks will put additional pressure on the interest rates this year and we will witness some interest to investments in stocks.

We expect that GDP growth will be around 2% this year. At the same time, inflation pressure will be more persistent and broad-based as compared to 2010. This will have only moderate negative effect on the investors' confidence but will probably support the risk appetite.

Sectors and stocks for 2011

The better investments in 2011 will be small caps with sound fundamentals. Those stocks are in limited number as the majority of smaller companies are experiencing serious difficulties or their valuation is too high at the moment. Banks will attract the market attention, mainly from international investors but domestic speculators will also put money in the financial sector. The reasons are few but strong – the very good valuation for three of the four banks. They have profits and low price-to-earnings ratios, whereas NPLs are not rising or are contained. The economy is approaching the point when the credit activity will start to accelerate. Banks don't have many high yield alternatives and will be forced to slash rates on deposits.

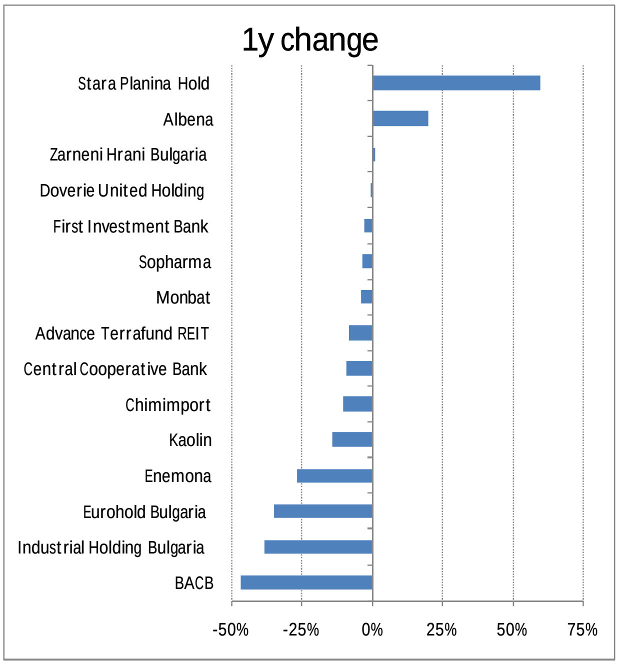
In the previous market comments we emphasized on the change of return on equity ratios during the last year. The three companies with higher RoE are Monbat, Sopharma and Chimimport. Their ratios had little change since the beginning of the year. The market would like to see some improvement along with higher cash flows from operations before to reconsider their attractiveness. The three companies have large investments programs, either almost completed or in early stages. The perspectives of growth will start to dominate in investors' decisions when risks of double recession fade and all eyes turn to rising revenues. This is unlikely to happen during the first half of the year.

Political issues

The year began with serious political tensions. Medias released the calls between the customs chief and several high-profile officials that discussed corruption and political support for private companies. This has huge impact on the confidence of the government but it is unlikely that will result to parliamentary crisis as the cabinet have solid support. However, this is an election year and it is probable that some changes in the current cabinet will take place before the late-autumn votes for president and mayors. The market is ignoring the political issues and we consider the risks as low.

Stocks in focus

The year began with modest increase of SOFIX. However, the index is down 13.40% for the last 12 months and only one third of its components underperformed.



We can see some ***bottom-fishing*** from speculators in the stocks with huge losses. Eurohold Bulgaria and Industrial Holding Bulgaria are planning to increase their capital, which will have negative impact on the stock prices for the months to come due to the large supply. Enemona was under pressure for the same reason in January 2010. Among stocks that don't bear the burthen of huge losses in 2010 are Monbat, Sopharma and First Investment Bank. They are good candidates to attract funds from institutional investors during the first half of the year.

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BUY	More than 5% higher as compared to SOFIX and BG40 performance
HOLD	Market performance, +/-5% as compared to SOFIX and BG40
SELL	More than 5% lower as compared to SOFIX and BG40 performance

Frequency of Recommendations: No schedule of recommendations is available. The frequency of recommendations depends on specific factors to individual companies and the opinion of the analyst(s) for the necessity of minor or major changes.

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