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Central European Weekly

Monday, 08 December 2014

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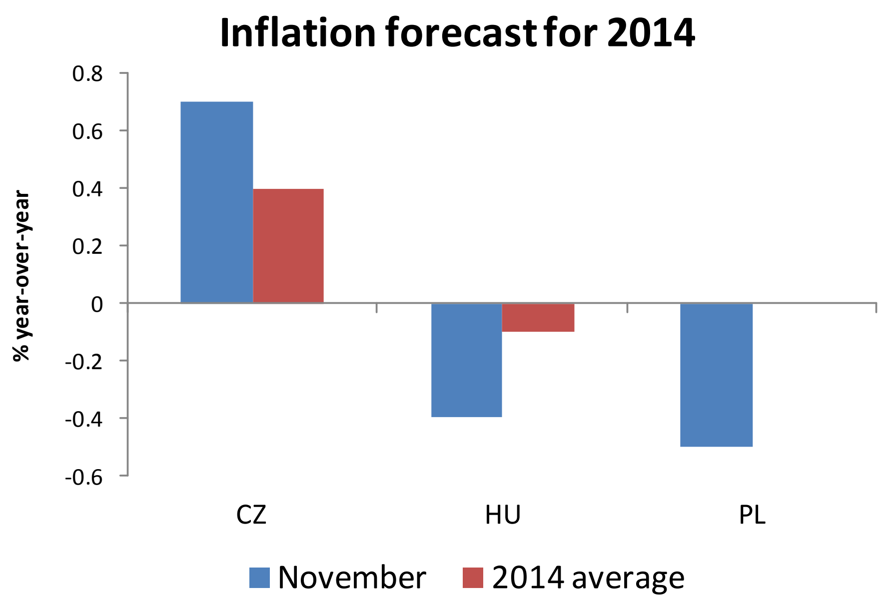
- The zloty finishes the year in a bullish mode
- Czech macro figures confirms ongoing recovery
- Czech and Hungarian inflation influenced by failing fuel prices in November

Chart of the Week: Inflation in Central Europe



Thanks to the 6% delvaluationof the Czech koruna in November 2013, the Czech Republic is the only country (among its PEER's) with positive inflation figures in 2014.

Market's editorial

The bullish year-end for the Polish zloty

The Polish zloty is closing the year in a positive way, with the central bank having slightly contributed to this. Not only because the bank has not taken any further step in 2014 after its surprising rate cut of 50 basis points in October, but it also adopted a fairly neutral attitude at its last meeting. This drove the Polish currency to four-month highs, but it also means that the zloty may close the year at the level at which it opened the year. Polish economic policymakers may be very satisfied with this in the end (as the public debt reporting statistics for the year will look better as a whole). On the other hand, it is also true that cyclical data – which gradually improved in the most recent quarter of the year, thus making the currency more attractive in fundamental terms – may also favour a stronger zloty.

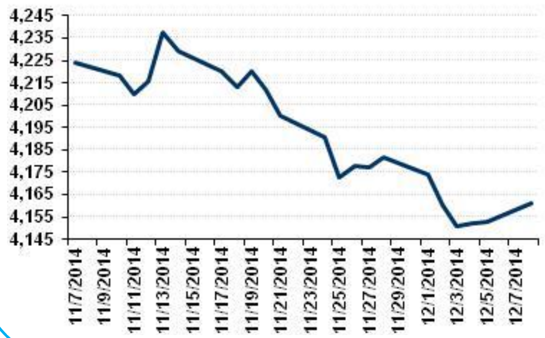
Falling oil and November's inflation figures in focus

This week, which will be actually the last but one business week of this year for global as well as regional financial markets, will be primarily dominated by November's inflation data, which may be interesting for Central European government bonds and partly in the end also for the regional currencies. We will see how much inflation in the last month will be influenced by lower oil, i.e., fuel prices. If these had not fallen dramatically in recent weeks, inflation would have certainly gone up across the region. Now it can stagnate at very low (deflationary) levels, just as in Germany. Naturally, this is likely to be one of the last bullish messages for Central European government bonds this year, one in which they performed so well.

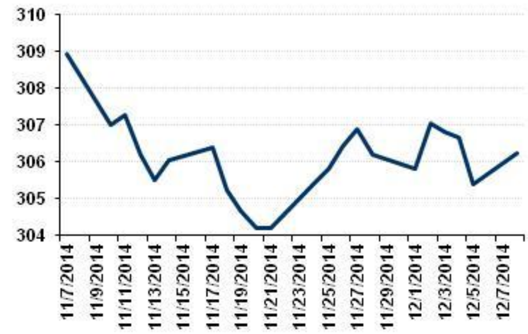
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*27.6*	*0.04%*	→	→
EUR/HUF	*307*	*0.02%*	↗	↗
EUR/PLN	*4.16*	*-0.37%*	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*1.04*	*7.81*	↗	↗
10Y HUF	*3.19*	*7.05*	↗	↗
10Y PLN	*2.55*	*12.38*	↗	↗

EUR/PLN



EUR/HUF



Review of Economic Figures

Czech labour market continues to improve

November's data from the Czech labour market surpassed expectations. Although the unemployment rate was expected to increase, it actually stagnated at October's 7.1%. This is a very good figure, primarily attributable to economic growth and clearly also to seasonal jobs in the retail sector, which is gearing up for the Christmas holidays. Thanks to solid growth, new jobs are also emerging in the economy quite rapidly. With nearly 60,000 jobs available, there are currently nine applicants per job on average. A year ago the ratio was 15:1. The number of new jobs stands at a six-year high and is still rising. While December will see a moderate unemployment increase hand in hand with the termination of fixed-term employment contracts, unemployment will continue to be well below 8%.

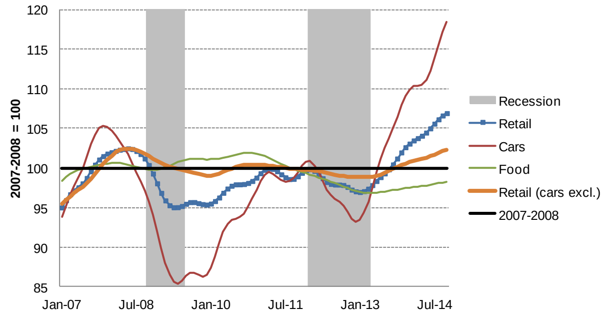
...but wage growth remains below CNB's projection

Growth of Czech wages for the third quarter of the year fell short of expectations. The average and median wages in the economy grew by only 1.8% and 1.5% respectively. While this means moderate real wage growth in the economy thanks to low inflation, the growth is not at all impressive, as wages essentially stagnated on a quarter-on-quarter basis. The average wage is still a sort of imaginary figure that two-thirds of employees fail to reach; however, there is no acceleration in the median wage either. Thus the real increase in these wages is largely attributable to low inflation, which is well below the CNB's target. Although wage growth is not impressive at all, it is positive that wages are starting to recover at least, after two years of falling in real terms. Thus, in addition to falling unemployment, people's purchasing power is slightly improving and this, combined with the upbeat consumer mood, is leading to higher household consumption.

Cars still driving Czech retail sales up

Cars were again responsible for the high increase in retail sales in October. The car market boom is not over, and has maintained a very strong rate for twelve consecutive months. The very good consumer mood, along with the improving financial position of households, is restoring consumers' appetite for buying durable goods, which certainly include cars as well. A more accurate picture of the willingness to shop is provided by the retail sales data excluding the automotive segment. These sales grew by almost 5% in October while retail sales as a whole grew by 7.5%, with cars even growing by nearly 14%. The performance of the retail sector will continue to be solid in the remainder of the year. However, sales growth is unlikely to continue to be that impressive, given the high comparative baselines of late last year, when purchases started to grow rapidly for the first time in the wake of the devaluation.

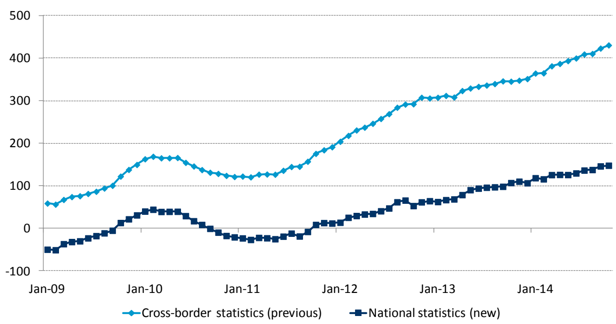
CZ: Retail sales
(trend)



Trade balance surplus grows

The improving trade balance figures are attributable to car exports on the one hand and falling prices of imported raw materials on the other. The trade balance closed October with a double-digit surplus (CZK 10.2bn in national statistics and CZK 39.5bn in cross-border statistics), although exports did not grow as fast as we had expected. Given last year's devaluation of the koruna, the year-on-year rate of 10% actually means an increase of just around 3%. If we exaggerate, we can say that exports are under the control or at the mercy of cars, yet we can see two divergent trends in imports. Firstly, the decline in the prices of imported raw materials is starting to become evident, thus reducing the value of imports; on the other hand, the improved domestic investment demand also means an increased need for technology imports. The overall foreign trade trend remains positive and the Czech Republic stands a great chance of hitting a new record-breaking trade balance surplus of approximately CZK 450 bn in cross-border statistics, i.e., CZK 160 bn in national statistics.

CZ: Annual Trade Balance Surplus
(CZK bn)



Solid industrial output again at the mercy of cars

Czech industry grew at a slower rate in October (3.2% y/y). Carmakers, with their new model offensive, again played the key role. New orders are also rising decently. New employees are still being recruited while wages are growing at a very moderate rate. October's industrial output is again primarily attributable to the rising car production, followed by the energy sector and chemical industry. Engineering, one of the largest industries, declined this time, despite its recent favourable developments. Although the latest industrial output figure slightly fell short of expectations, new orders promise continued growth in the months to come. The primary contributors are again carmakers, followed by electronics and metal product manufacturing. Owing to their decent results and new orders, industrial businesses may continue to recruit new staff and thus contribute to this year's improvement in the labour market. By contrast, there is still only moderate wage growth despite the positive developments.

Weekly preview

TUE 9:00 **CZ Inflation (change in %)**

	Nov-14	Oct-14	Nov-13
CPI m/m	**-0.1**	0.2	-0.1
CPI y/y	**0.7**	0.7	1.1
Monetary relevant inflation y/y	**0.5**	0.5	0.3

CZ: Stable inflation story

Year-on-year inflation most likely remained at October's 0.7% in November. Month-on-month prices most probably declined slightly by 0.1%, mainly because of cheaper fuel and seasonally lower recreational prices. The current slump in oil prices on global markets is still far from evident in domestic fuel prices, and therefore we can expect inflation to continue to develop positively in the months to come. We still do not believe that inflation will hit the CNB's target level next year.

THU 9:00 **HU Inflation (change in %)**

	Nov-14	Oct-14	Nov-13
CPI y/y	**-0.4**	-0.4	0.9

HU: Inflation still in negative territory

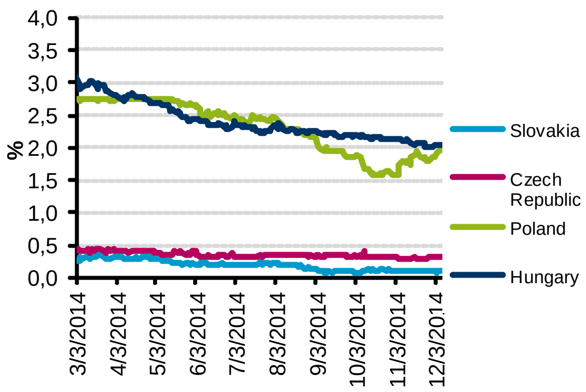
Consumer price index was -0.5% Y/Y in September and -0.4% Y/Y in October. We expect that CPI may remain at -0.4% Y/Y in November. Based on our estimation the food prices (good harvest in this year) and energy prices (oil price drop) may keep the inflation in negative territory, while we see no substantial change in the orbit of tradable and services prices (the former stuck around 0% Y/Y while the latter around 2.5% Y/Y). As the main drivers of the deflation are food and energy, we expect that core inflation may remain around 1.5% Y/Y in November. It seems that CPI may move only to 0.1% Y/Y in December and we see the average inflation at -0.1% Y/Y in 2014.

Calendar

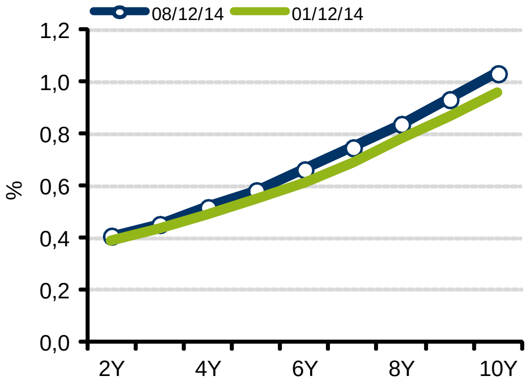
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	12/08/2014	9:00	Unemployment rate 15-64	%	11/2014	7.2		7.1		7.1	
CZ	12/08/2014	9:00	Trade balance (national)	CZK B	10/2014	13.5		16.5		19.3	
CZ	12/08/2014	9:00	Industrial output	%	10/2014		4.2		4		8.3
CZ	12/08/2014	9:00	Construction output	%	10/2014						9.5
CZ	12/09/2014	9:00	CPI	%	11/2014	-0.1	0.7	-0.2	0.7	0.2	0.7
HU	12/09/2014	9:00	Trade balance	EUR M	10/2014 *P					938.7	
HU	12/09/2014	17:00	Budget balance	HUF B	11/2014					-809.6	
HU	12/11/2014	9:00	CPI	%	11/2014		-0.4		-0.5	-0.3	-0.4
HU	12/12/2014	9:00	Industrial output	%	10/2014 *F					-2.6	1.7
CZ	12/12/2014	10:00	Current account	CZK B	3Q/2014					-1241.3	
PL	12/12/2014	14:00	Money supply M3	%	11/2014			-0.2	8	0.7	7.7

Fixed-income in Charts

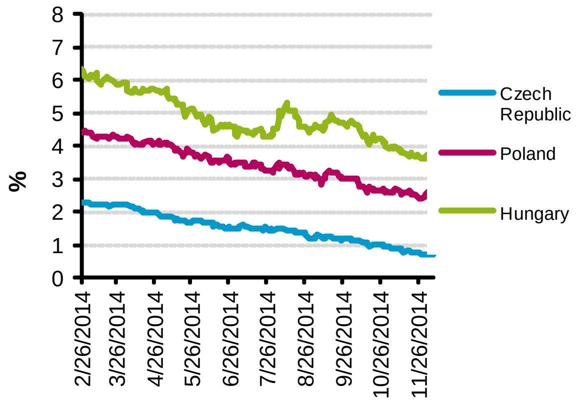
FRA 3x6



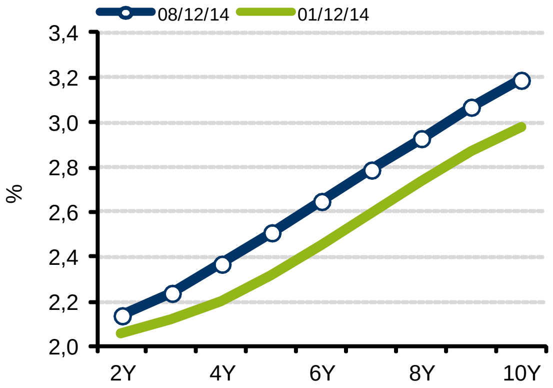
CZ IRS



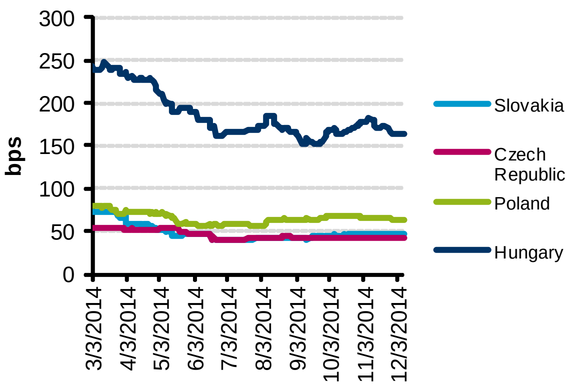
10Y GB Yields



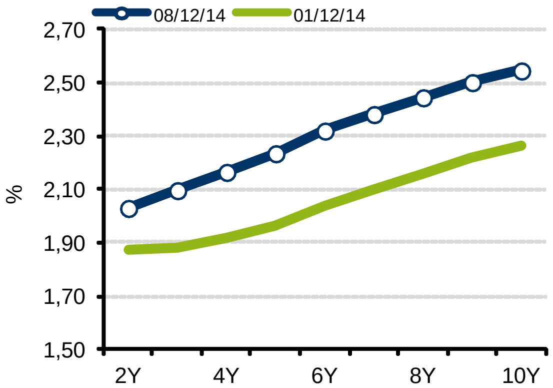
HU IRS



CDS 5Y



PL IRS



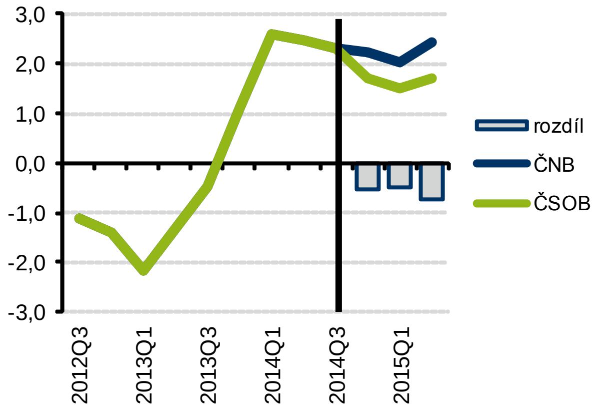
Source: Reuters

Medium-term Views & Issues

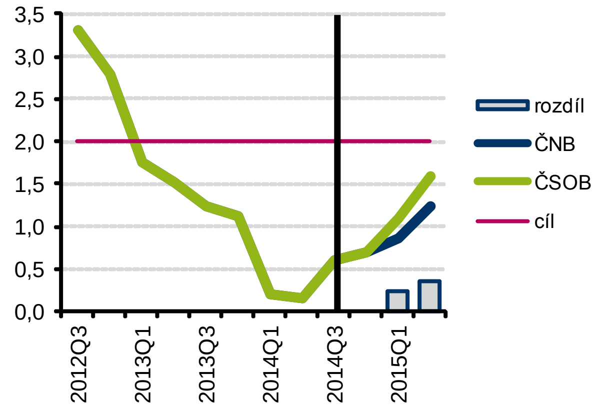
	The Czech Republic	Hungary	Poland
Growth & key issues	The economy is in a period of upswing. The key economic fundamentals remain very strong, with many of them even improving over the course of time. The new government, formed after the autumn 2013 election, is just gradually starting to carry out its programme. It should include not only savings but also greater tax relief for parents with children, a new VAT rate, and likely also the termination of the new funded pension system (called the 2nd pillar), set up in the last two years.	We expect that the economy may slow further in 4Q14 in the range of 2% Y/Y and 2.5% Y/Y, because the new orders in the construction sector is falling, there external demand is deteriorating, so the net external component of the growth is getting smaller. The average GDP growth may be at 3.3% Y/Y in 2014, while it may slow to around 2.2% Y/Y in 2015.	According to the GUS estimates, the Polish economy grew by 3.3% in 2014Q3. Moreover, the structure of growth was robust – it was driven by strong households' consumption and investment. Expectations of a slowdown of growth rates in the second half of the year may therefore not materialize. The recent figures suggest this year's economic growth will therefore almost certainly remain well above 3%.
Outlook for official & market rates	The CNB has exhausted the possibility of easing its monetary policy through interest rates, and therefore it has decided to weaken the koruna and keep it close to EUR/CZK 27. Statements from the CNB representatives indicate that the CNB would like to maintain that level for a prolonged period, until strong inflation pressures become evident in the economy. We believe that the exchange rate targeting will be abandoned much later (during the second half of 2016), and that the move will certainly not be accompanied by a rise in interest rates, as suggested by the official forecast.	The NBH has finished its easing cycle in Hungary by cutting the base rate to the 2.1%. The NBH emphasized that the inflation may return to the inflation target (3% Y/Y level with the tolerance channel of +/-1%pt) at end-2015, but if the Monetary Council sees that the inflationary outlook is changing, they will adjust the monetary policy. Our base case is that first hike may come in summer 2015, but the cycle might be gradual a slow, so we expect that base rate might remain below 3% at end-2015.	Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. After surprising markets by cutting interest rates by 50 basis points in October, the NBP surprised in November as well, this time by leaving rates unchanged. The overall tone of the meeting was, however, dovish and we therefore not exclude additional rate cut in the beginning of the next year.
Forex Outlook	We anticipate clearly lower growth and inflation in the euro area, and therefore we also predict, on the whole, a slower rate of Czech inflation. In 2015, inflation will again be below the CNB's 2% target, and the question is how the CNB Board will react to this. The recollection of the negative response from the Czech public to the last devaluation of the currency and the fact that inflation will remain in positive territory should be the main arguments against a further targeted weakening of the currency. Yet we see an approximately 40% likelihood of this scenario, which might happen in 2015.	In a longer term perspective, HUF is still in a weakening channel implying a 2-3% depreciation of the currency against EUR on a yearly basis. Taking into account the government's and NBH's statements, such a gradual depreciation of the currency is welcomed as it definitely not endangers the stability of the country. Additionally the government still wants to solve the problems of the foreign currency denominated loans in the households sector in autumn, which may give the National Bank of Hungary an even bigger room of maneuvering room.	Less optimistic economic outlook and renewed monetary policy easing should cap room for prospective strengthening of the zloty in months to come. For the rest of the year, we therefore expect a stagnation of the zloty against the euro and consider risks as skewed slightly towards possible depreciation, even though Polish assets could draw support from further easing of monetary policy conditions in the euro zone.

CBs' Projections vs. Our Forecasts

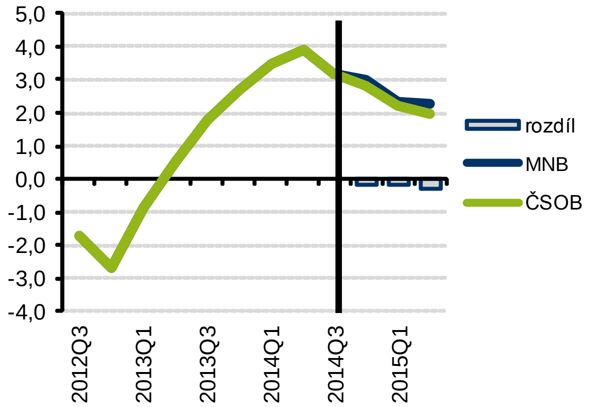
CZ: GDP outlook (Y/Y, %)



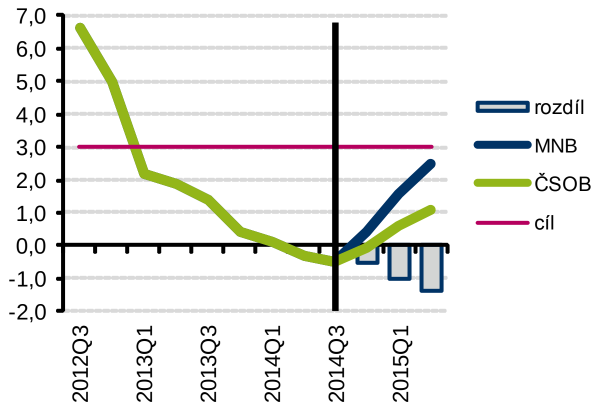
CZ: Inflation outlook (Y/Y, %)



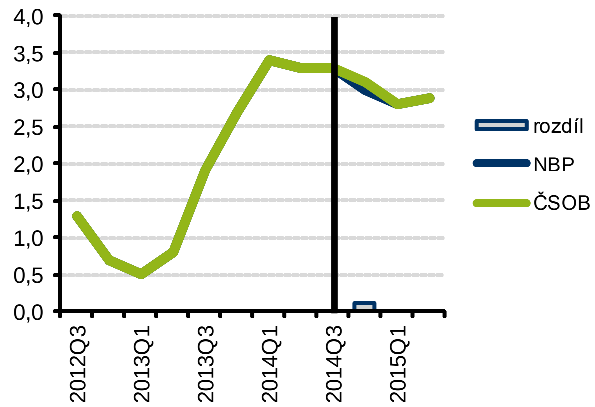
HU: GDP outlook (Y/Y, %)



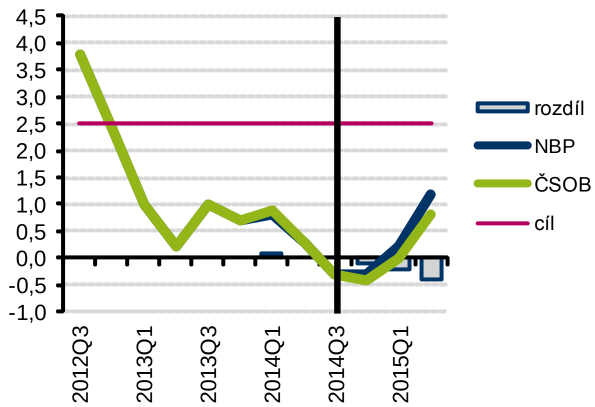
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)



Source: CNB, NBP, MNB, CSOB

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	Last change	
Czech Rep.	2W repo rate	*0.05*	0.05	0.05	0.05	0.05	0.05	-20 bps	9/27/2012
Hungary	2W deposit r.	*2.10*	2.60	2.30	2.10	2.10	2.10	-10 bps	7/22/2014
Poland	2W inter. rate	*2.00*	2.50	2.50	2.50	2.00	2.00	-50 bps	10/8/2014

*Short-term interest rates 3M *IBOR (end of the period)*

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	PRIBOR	*0.34*	0.37	0.35	0.34	0.35	0.35
Hungary	BUBOR	*2.10*	2.67	2.34	2.09	2.15	2.15
Poland	WIBOR	*2.06*	2.71	2.68	2.28	2.00	2.00

Long-term interest rates 10Y IRS (end of the period)

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	CZ10Y	*1.035*	1.84	1.34	1.22	1.15	1.20
Hungary	HU10Y	*3.19*	4.95	3.77	3.92	3.50	3.50
Poland	PL10Y	*2.55*	4.03	3.39	2.87	2.60	2.20

Exchange rates (end of the period)

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	EUR/CZK	*27.6*	27.4	27.4	27.5	27.5	27.8
Hungary	EUR/HUF	*307*	307	310	311	310	309
Poland	EUR/PLN	*4.16*	4.17	4.16	4.18	4.20	4.20

GDP (y/y)

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	-0.4591015	1.1	2.6	2.5	2.3	1.7	1.5
Hungary	1.8	2.7	3.5	3.9	3.2	2.8	2.2
Poland	1.9	2.7	3.4	3.3	3.3	3.1	2.8

Inflation (CPI y/y, end of the period)

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	1	1.4	0.2	0.0	0.7	0.8	1.2
Hungary	1.4	0.4	0.1	-0.3	-0.5	-0.1	0.6
Poland	1	0.7	0.9	0.3	-0.3	-0.4	0.0

Current Account

	2013	2014
Czech Rep.	-1.4	-1.4
Hungary	2.0	2.2
Poland	-1.2	-2.5

Public finance balance as % of GDP

	2013	2014
Czech Rep.	-1.3	-2.0
Hungary	-2.7	-3.0
Poland	-4.4	-3.5

Source: CSOB, Bloomberg

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