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Central European Weekly

Monday, 09 March 2015

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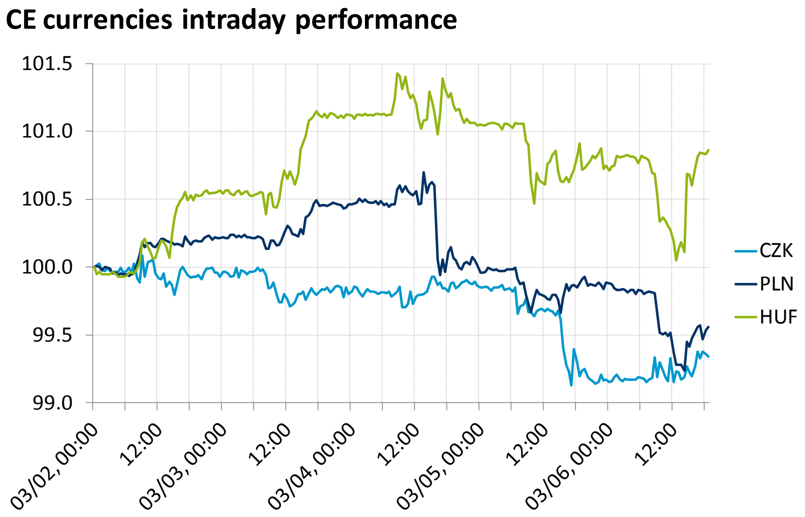
Chart of the Week



The Czech koruna outperformed its peers on President Zeman´s verbal intervention. (Source: Bloomberg, CSOB)

Market’s editorial

Central European currencies fared very well last week.

Let’s start with Czech President Zeman who again opposed the CNB Board intervention policy. As a result the koruna reacted with its greatest appreciation over the last two weeks, approaching EUR/CZK 27.25. Although the president’s position on the monetary policy is well known, his criticism was probably even slightly stronger this time. Moreover, the president made his statements at a time when the Czech koruna, along with the other Central European currencies, is rather in the limelight. The incipient quantitative easing in the euro area and negative yields on numerous Western European markets are attracting investors into the few locations with positive rates and yields. Hence last week the Polish zloty also clearly reacted positively to the news that the local Monetary Policy Council decided not to allow rates to fall anymore.

Another alternative available to investors finding themselves face to face with the massive printing of new euros is the artificially undervalued currencies such as the Czech or Danish koruna. Investors do not usually get (much) better yields from them but they can bet on future appreciation of the currency – the end of the respective intervention policies. We do not currently consider such a scenario to be realistic in the Czech Republic. Notwithstanding the president’s verbal attacks, the CNB Board’s commitment is clear; members of the CNB Board will only be replaced gradually; and Jiří Rusnok, the likely candidate for new governor, essentially supported the launch of the interventions. Nevertheless, in light of the president’s statements and the incipient QE in the euro area, foreign players will be eager to test whether the Czech National Bank is really willing to defend the EUR/ CZK floor at the 27.00 level. If such testing does take place, we do not expect the Czech koruna to remain at those levels for too long.

NBP aggressive rate cut calls for NBH’s action

The Hungarian forint, which had touched its 8 months high at the end of February, failed to extend its gains at the beginning of March. Not only the HUF strengthened in the last two weeks, but there also was a strong demand for the Hungarian government bonds, resulting in a 40-50bp fall of the yields. The main reasons were as follows:

1) improving international sentiment (less hawkish FED stance, launch of the new ECB bond purchasing program),

2) relief from geopolitical risks (Greece and Ukraine),

3) strong economic growth in Hungary and positive assessment released by rating agencies (thanks to the planned banking tax cut).

The Hungarian market prices a 20bp rate cut within 2 months and a 40bp cut within 6 months. NBH’s official statement following the last rate decision at the end of February, however, was less dovish than markets had expected. Since the Monetary Council didn’t declare strong commitment to easing, we believe that it has been divided regarding urgency of a rate cut reduction. In such a situation, an agressive monetary decision in neighboring Poland (a 50bps rate cut) may provides an important message to act agressively in Hungary too.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.3	-0.93%	↘	↗
EUR/HUF	305	-0.03%	↘	→
EUR/PLN	4.13	-0.73%	↘	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	0.94	8.05	→	→
10Y HUF	3.07	13.28	→	→
10Y PLN	2.34	14.81	→	→

Review of Economic Figures

The Czech inflation remains in positive territory

The Czech inflation in January surprised on the upside; headline inflation came out at 0.1% Y/Y (market consensus was -0.1% Y/Y), mainly thanks to rising prices of cigarettes.

In fact, the February inflation matched our estimate, so we can hold our assumtion that average inflation remains near 0.3% this year.

The Czech Statistiscal Office also released foreign trade for January and (un)employment) figures for February. They show that the general economic situation has been still improving.

Hungary's GDP details: strong investmenst and consuption

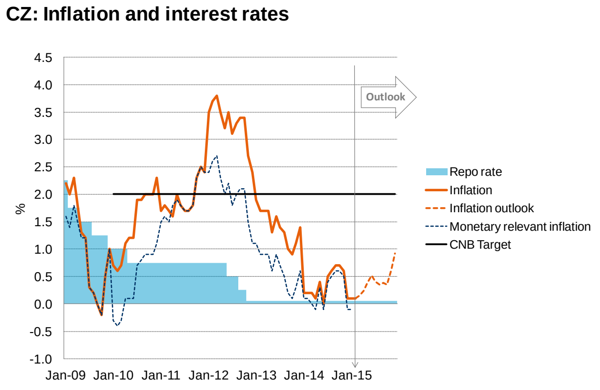
The Hungarian economy grew by 3.4% during last quarter of 2014 – according to the second (detail) reading of GDP data published by the Hungarian Statistical Office. In 2014 as a whole the value added of the economy was up by 3.6% compared to the previous year (the data slightly improved as its first reading was 3.5%).

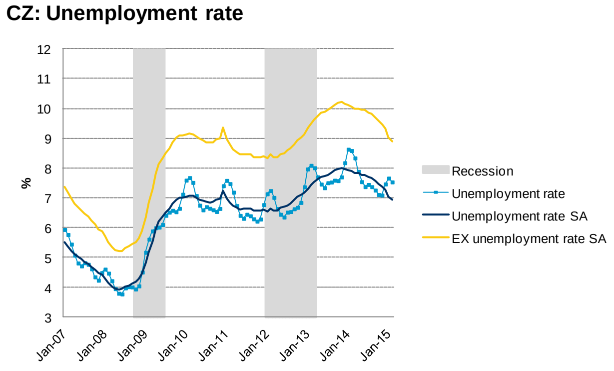
Mainly the industrial sector fuelled growth, representing 1.2 percentage points within the whole figure, while services sector contributed 1.1 percentage points to the increase. Within the services sector trade activity (wholesale and retail trade) and professional, scientific, technical and administrative activities are worth highlighting. Agriculture and construction were significant as well, both adding 0.5 points to the growth.

From the aspect of demand, 2.3 percentage points were attributed to investments while household consumption added 1 percentage points to the figure. Compared to the previous years, increase in household consumption is quite remarkable, considering that this sector could contribute to the growth more than this year only in 2006. The increase was also indicated by last year's improving retail sales data.

Investments slowed down heavily in the last quarter, so their contribution for the growth may be much less. That might be counterbalanced by household consumption, which can improve further this year. Regarding the production aspect, a change in the structure is possible where services may dominate, pushing back industrial sector to the second place.

All in all we expect a somewhat slower growth for this year, around 2.5%.





In Focus: Polish official rates at all-time lows

The NBP cut base rate by 50 bps to 1.50%...

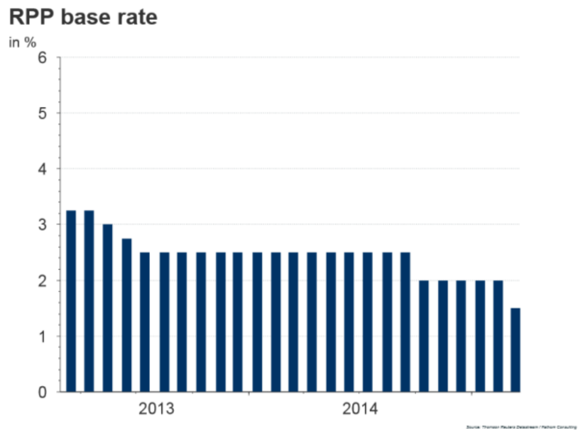
The regional event that probably attracted the greatest attention last week was a meeting of the National Bank of Poland (NBP). The bank decided to cut rates by 50 bps. The majority of the market had not anticipated this. However, judging by the market reaction, the official press statement that this marked the end of the rate cut cycle was an even greater surprise.

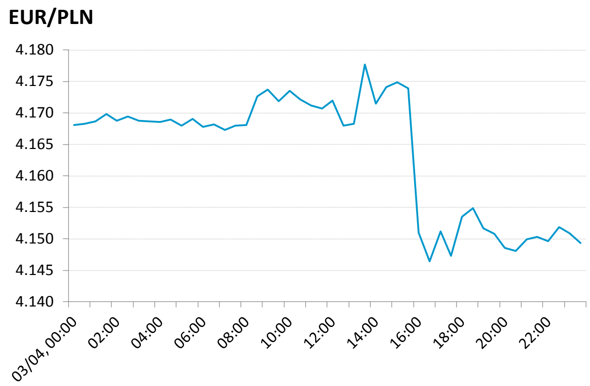
... and stated that its rate cut cycle was over.

Even the comments made by NBP president Belka after the meeting were unusually strong regarding further rate cuts. The NBP president stated, inter alia, that the latitude for a rate cut he had mentioned in previous weeks and months had been exhausted with the last decision by the NBP. He added that he could not imagine a realistic scenario that would make the bank cut rates again, with the decision by the NBP already taking account of the anticipated impacts of the launch of QE in the euro area. According to Mr Belka this was one of the factors that made the NBP proceed to a more aggressive move; moreover, a solid majority of MPC members are said to have agreed on that move.

However, a combination of European QE and strong commitment by the NBP attracts investors...

Given the foregoing, we expect the central bank to keep rates at new lows (1.50%) this year, but we cannot completely rule out the possibility of further rate cuts. The main reason is the combination of the “inflow of cheap euros from the ECB” to markets and the unusually open commitment by the NBP not to continue to cut rates. In addition, if we take account of this year’s inflation rate, which is likely to be negative for the year as a whole, such a climate will probably attract investments in Polish assets. In that event, additional pressure for the appreciation of the zloty and consequently for an inflation fall can be expected, all of this in a climate that, according to the NBP, is characteristic of “very low inflation expectations from businesses as well as households”...





Weekly preview

FRI 9:00 **CZ Retail Sales (change in %)**

	Jan-15	Dec-14	Jan-14
Sales	**4.2**	5.9	7.5

CZ: Trade on a wave of cars

As signalled by registrations of new vehicles, January continued to see strong sales growth in the automotive retail segment. Combined with the positive mood among consumers, enjoying abundant purchases of new home electronics (the prices of which are falling in spite of deflation), trade is also likely to be in positive territory in the first months of this year. Nevertheless, demand growth is not yet strong enough to trigger a wave of demand-pull inflation because wage growth will certainly not be impressive this year either.

FRI 9:00 **CZ Industry (y/y change in %)**

	Jan-15	Dec-14	Jan-14
Monhtly	**3.3**	7.3	5.6

CZ: Poor start of the year for industry

At first glance, industrial output will probably be slightly lower than we have been used to in the past months. However, this will be the purely statistical effect of the one less business day in January this year. By and large, we anticipate a very solid rate of output, particularly in the traditionally strong sectors, such as cars, production of electric equipment and computers. Orders will be even more interesting than output growth this time. However, we expect that they will continue to grow by at least a single-digit rate early this year, unlike orders in Germany. Thus industry will maintain its position as the driver of the Czech economy this year, although it will not be that easy to repeat last year's outstanding performance.

FRI 14:00 **PL Inflation (change in %)**

	Feb-15	Jan-15	Feb-14
CPI y/y	**-1.4**	-1.3	0.7

PL: Polish economy remains in deep deflation

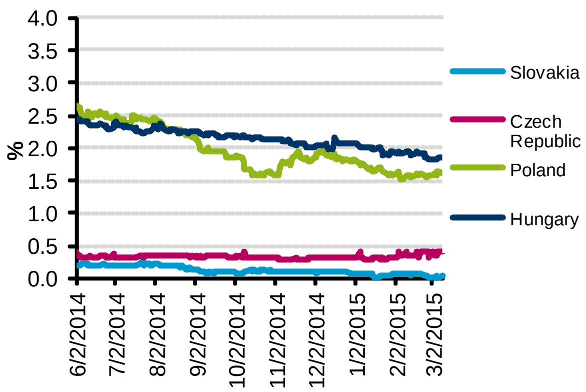
After a greater than expected slump in January's inflation we believe that prices also continued to fall in February. According to our forecasts, prices in Poland were down by 1.4% y/y and remained unchanged on a month-on-month basis. Although the price of oil rose slightly in February compared to January, it still remains close to all-time lows and continues to influence falls in prices, in transport in particular. Bear in mind that January's greatest surprise was the more than 4% year-on-year decline in the price of this item of the consumer basket. Another factor that will probably contribute to deflation is food prices, although these might contribute to an inflation turnaround during the year, hand in hand with the disappearance of the effect of the high comparative baseline in the wake of last year's good harvest and the period when sanctions were imposed on Russian food imports.

Calendar

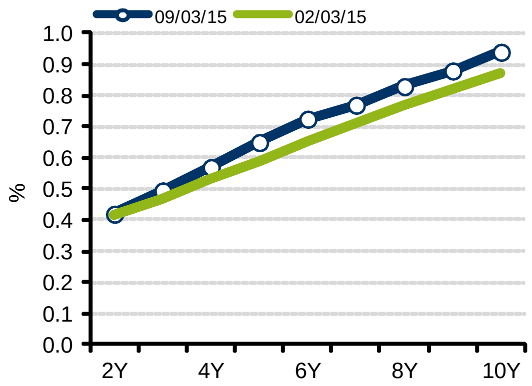
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	03/09/2015	9:00	CPI	%	02/2015	0.2	0.2	0	-0.1	0.1	0.1
CZ	03/09/2015	9:00	Trade balance (national)	CZK B	01/2015	27		16.8		-3	
CZ	03/09/2015	9:00	Unemployment rate 15-64	%	02/2015	7.6		7.6		7.7	
HU	03/10/2015	9:00	CPI	%	02/2015			0.4	-1.1	-0.2	-1.4
CZ	03/11/2015	9:00	Real wages	%	4Q/2014		2.8		2.5		1.2
HU	03/11/2015	9:00	Trade balance	EUR M	01/2015 *P			449.5		344.7	
CZ	03/11/2015	12:00	CZ bond auction 2013-2019, 1.50%	CZK B	03/2015						
CZ	03/11/2015	12:00	CZ bond auction 2014-2027, floating rate	CZK B	03/2015						
CZ	03/13/2015	9:00	Construction output	%	01/2015						-6.6
CZ	03/13/2015	9:00	Industrial output	%	01/2015		3.3		2.5		7.3
CZ	03/13/2015	9:00	Retail sales	%	01/2015		4.2		3.2		5.9
PL	03/13/2015	14:00	Money supply M3	%	02/2015			0.7	8.6	-1.4	8.5
PL	03/13/2015	14:00	CPI	%	02/2015	-0.2	-1.4	0.1	-1.3	-0.2	-1.3

Fixed-income in Charts

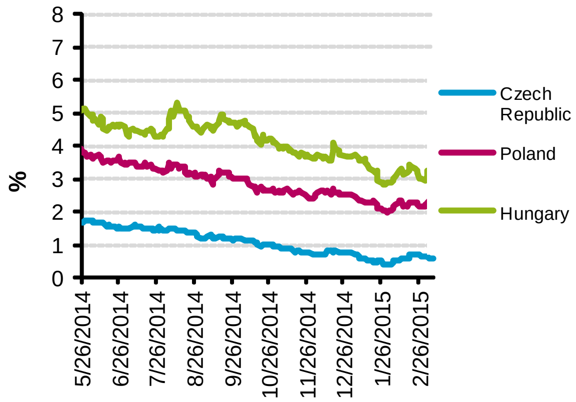
FRA 3x6



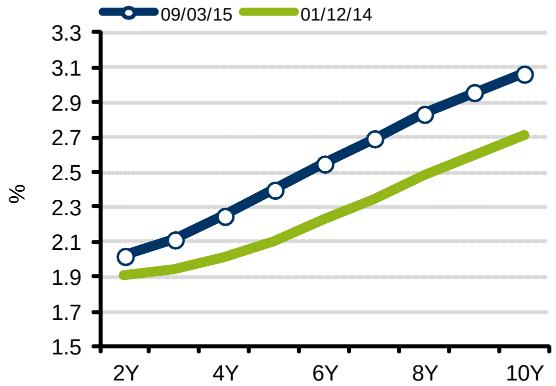
CZ IRS



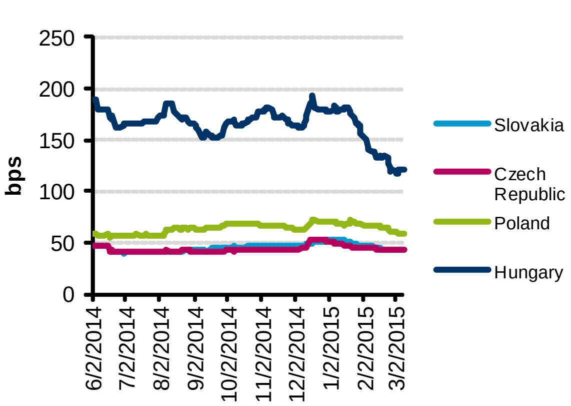
10Y GB Yields



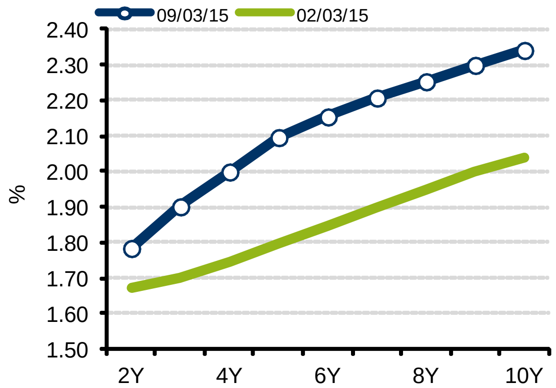
HU IRS



CDS 5Y



PL IRS



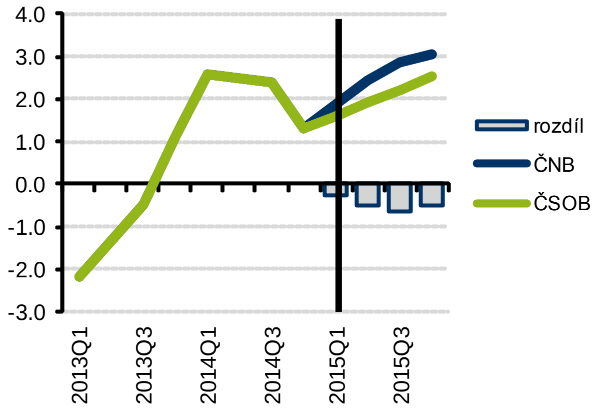
Source: Reuters

Medium-term Views & Issues

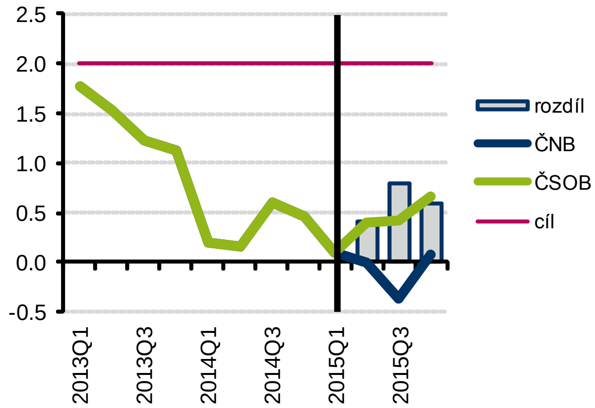
	The Czech Republic	Hungary	Poland
Growth & key issues	The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing of the public sector, which is, however, generating no pressures on the capital market thanks to fairly low debt and reserves. The government policy has not delivered any fundamental economic changes so far, perhaps except for the planned abolition of the pension reform and partial modifications of certain taxes and social security benefits. The issue of euro adoption is still on ice in the CR.	Hungary's economy may slow down, but probably less than previously expected thanks to the improving international environment and the stable and strong domestic demand. So economy may grow around 2.5% y/y in 2015 and now we see rather positive risk in this forecast. We recognized in the last couple of months that exchange rate has very low effect on the inflation, so the NBH cannot easily accelerate the CPI with the depreciation of the currency. We see this year's inflation around 0% Y/Y, but CPI may be around 2% Y/Y in December.	According to the GUS estimates, the Polish economy grew by 3.1% in 2014Q4 and by 3.3% in whole year. As in previous quarters, economic growth was driven mainly by strong domestic demand. Particularly encouraging was a high contribution of investment to economic growth. As for this year, we expect economic growth to slow down slightly below 3%.
Outlook for official & market rates	Interest rates remain at all-time lows and, given the positive inflation outlook, the CNB is unlikely to raise its base rate before 2017. In addition, the central bank will not proceed to such a move before it abandons its current exchange rate policy, which is based on maintaining the exchange rate above the EUR/CZK floor. Moreover, the decreasing inflationary expectations may even delay these two steps. This possibility is reflected by money market rates and, in particular, by IRS and government bond yields. Our outlook for inflation as well as short-term interest rates is still below the central bank's official forecasts.	A deep rate cut in Poland might be actually a trigger for NBH easing too. While the plan of extending the NBH's funding for lending program on big corporates rather works against a rate cut, the strong forint together with deflation and rate cuts elsewhere go the other way. Hence, the earliest rate cut in Hungary may come on 24th March as the NBH will publish the next inflationary report at that time. Based on the NBH's minutes from the last rate setting meeting – the Council agreed that the Council should decide on the possibility of changing the base rate after a comprehensive assessment of the outlook for inflation and the real economy and in view of the March issue of the Inflation Report.	We expect the NBP to keep rates at new lows (1.50%) this year, but we cannot completely rule out the likelihood of further rate cuts. The main reason is the combination of the "inflow of cheap euros from the ECB" to markets and the unusually open commitment by the NBP not to continue to cut rates. In addition, if we take account of this year's inflation rate, which is likely to be negative for the year as a whole, such a climate will probably attract investments in Polish assets. In that event, additional pressure for the appreciation of the zloty and consequently for an inflation fall can be expected.
Forex Outlook	We expect that the Czech central bank will not come up with any revolutionary changes at its eagerly expected February meeting. Nonetheless, the koruna will likely be weakening before the meeting. How far can the pair EUR/CZK weaken in the upcoming weeks? Markets remember that the November 2013 intervention pushed the EUR/CZK pair higher by about 5-6 %. It would not be surprising then, if we see the short-term peak in the EUR/CZK 28.7-29 territory (i.e. a roughly 5% devaluation against the 2014 average). After the February (5th) meeting, the crown should start trimming the loss.	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.	We expect the zloty to gain on growing capital inflows exploiting the positive interest rate differential at the time short term yields are mostly negative in the eurozone. Given the NBP pledge to end the rate cutting cycle, the market may feel temptation to test the willingness of the central bankers to tolerate further gains of the Polish currency.

CBs' Projections vs. Our Forecasts

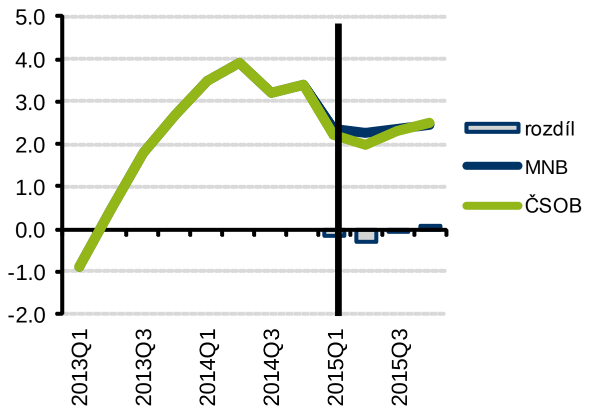
CZ: GDP outlook (Y/Y, %)



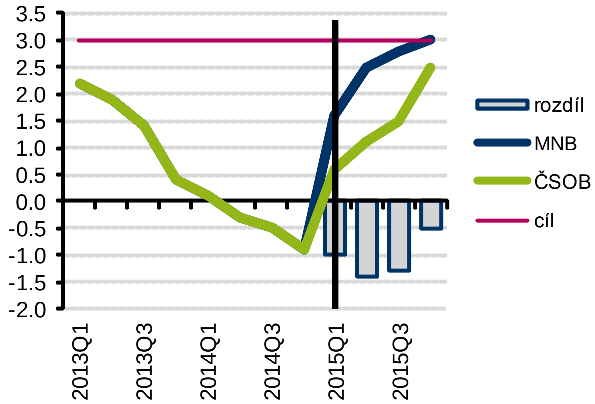
CZ: Inflation outlook (Y/Y, %)



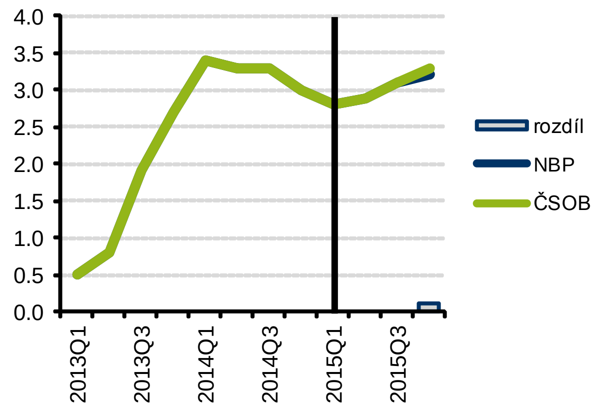
HU: GDP outlook (Y/Y, %)



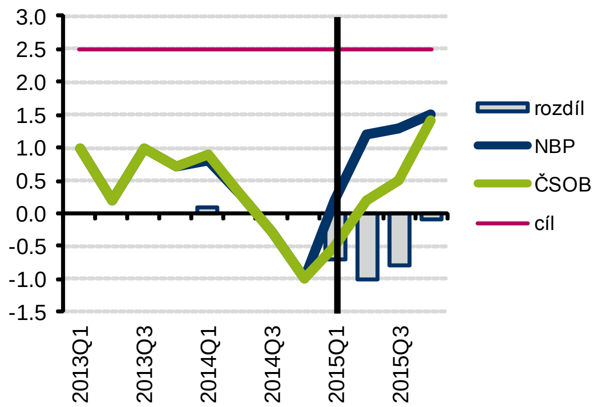
HU: Inflation outlook (Y/Y, %)



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	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	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*	2.10	2.10	2.10	2.10	2.10	-10 bps	7/22/2014
Poland	2W inter. rate	*1.50*	2.50	2.00	1.50	1.50	1.50	-50 bps	3/4/2015

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

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	PRIBOR	*0.33*	0.34	0.33	0.33	0.32	0.33
Hungary	BUBOR	*2.08*	2.09	2.10	2.10	2.10	2.10
Poland	WIBOR	*1.65*	2.28	2.06	2.00	2.00	2.00

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

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	CZ10Y	*0.94*	1.22	0.88	0.75	0.78	0.93
Hungary	HU10Y	*3.07*	3.92	3.25	3.50	3.50	3.65
Poland	PL10Y	*2.34*	2.87	2.23	2.20	2.10	2.20

Exchange rates (end of the period)

		Current	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	EUR/CZK	*27.3*	27.5	27.7	27.2	27.5	27.8
Hungary	EUR/HUF	*305*	311	316	315	315	318
Poland	EUR/PLN	*4.13*	4.18	4.28	4.25	4.22	4.20

GDP (y/y)

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	2.6	2.5	2.4	1.3	1.6	1.9	2.2
Hungary	3.5	3.9	3.2	3.4	2.2	2.0	2.3
Poland	3.4	3.3	3.3	3.0	2.8	2.9	3.1

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

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3
Czech Rep.	0.2	0.0	0.7	0.1	0.2	0.5	0.4
Hungary	0.1	-0.3	-0.5	-0.9	0.6	1.1	1.5
Poland	0.9	0.3	-0.3	-1.0	-0.5	0.2	0.5

Current Account

	2014	2015
Czech Rep.	0.0	1.8
Hungary	2.2	2.5
Poland	-2.5	-2.5

Public finance balance as % of GDP

	2014	2015
Czech Rep.	-2.0	-2.4
Hungary	-3.0	-3.0
Poland	-3.5	-3.0

Source: CSOB, Bloomberg

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