



Central European Weekly

Monday, 02 November 2015

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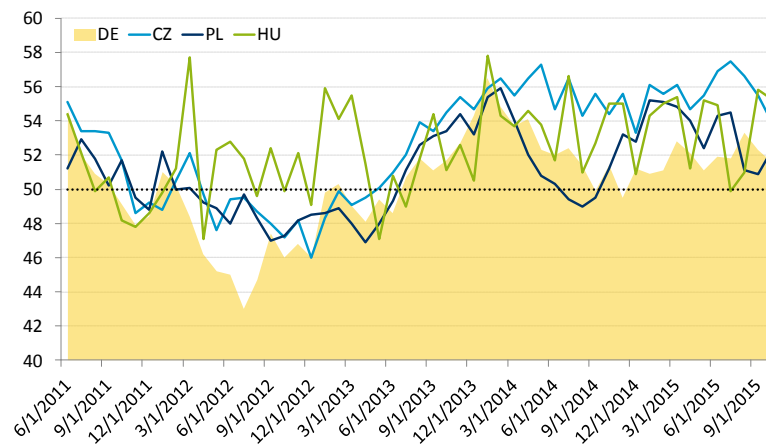
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Weekly Highlights:

- Will the CNB Bank Board extend its intervention regime until the end of 2016?
- The NBP on hold again despite ongoing deflation
- Weekly preview: Czech and Hungarian retail sales figures should remain strong in September

Chart of the Week: Regional PMIs in October

PMI: CE vs Germany



The latest regional PMI figures show a mixed picture. While the Czech PMI with signs of weakening of new export orders fell short of (market) expectations, its Polish counterpart showing a slight improvement in its export orders sub-index surprised to the upside and provides some support for the zloty. At the same time, however, the former still stands well above the latter

Market's editorial

Central banks' meeting in focus

This week, regional markets will pay most attention to the meetings of the NBP (Wednesday) and the CNB (Thursday). Both central banks will have a new forecast at its disposal. We expect no changes in monetary policy setting in either case though the Czech National Bank may discuss extension of the intervention regime beyond the end of 2016.

The NBP on hold, watching the first steps a new government

Regarding The NBP, it will again leave interest rates unchanged. The Monetary Policy Council, whose term of office is drawing to a close with many of its members probably being replaced in early 2016, is still struggling with inflation far below the target on the one hand (recall the October figure, which showed negative inflation at minus 0,8.% year-on-year), and the swiftly growing economy on the other. While the outlook to be outlined by the new November forecast will probably be slightly more pessimistic (notably as concerns inflation), the willingness to continue to cut rates in the remainder of the year will likely remain low, partly due to the more expansive programme of the incoming government as well as a weaker zloty in post-election period. Moreover, the MPC will have to watch the first steps of a new government, especially in term of their fiscal (expenditure) plans.

Will the CNB Bank Board extend its intervention regime?

At its November meeting the CNB Board will discuss this year's last forecast, one which may not necessarily bring any revolutionary changes. The only possible scenarios are a very moderate reduction of the inflation outlook for next year and, at the same time, an increase in this year's expected growth of the Czech economy. As we do not expect a change in the main monetary policy parameters at this meeting either, the primary question will continue to be whether or not the CNB will announce an extension of its

exchange rate commitment until 2017. So far the central bank has kept declaring that it will not abandon this policy before the second half of 2016. Nevertheless, a lower inflation outlook along with the probable extension and expansion of the quantitative easing in the euro area are encouraging the CNB to extend its exchange rate commitment further into the future. After all, central bank representatives have already mentioned this option, and therefore it would not be very radical or new information. Thus the CNB is only waiting for the appropriate moment to announce its intention. As the November meeting is combined with a new forecast, this date seems likely to us. Thus it would provide important information to that part of the business sector which is considering the appropriate timing of its hedging against exchange rate risk exposure; moreover, this would be a slap on the face to the speculators betting on an earlier termination of the existing exchange rate policy. As a matter of fact, this could mitigate the need for forex interventions, during which, we believe, the CNB bought euros worth more than 7 bn in the last three months.

Bond sell-off hits Hungary too, foreign bond holdings lower

Global core bonds have still traded with a downward bias in the wake of the Fed's hawkish FOMC statement, which pushed slightly up the yields along the Hungarian bond curve too. Interestingly, the foreign holding of forint denominated bonds has decreased by roughly HUF50bn in a week time, while by about HUF 150bn in 2-month time, so the decrease of exposure by foreigners has been continuing. It is also interesting that the NBH bought foreign currency denominated Hungarian bonds in the last three months, so it looks like that NBH is intervening on the bond market and probably not only in the case of foreign currency denominated bonds, but also in case of HUF ones, but we will see the October figures only couple of weeks later.

| | Last | Change 1W |
|---------|------|-----------|
| EUR/CZK | 27.1 | -0.01% |
| EUR/HUF | 311 | -0.35% |
| EUR/PLN | 4.25 | -0.60% |

| | Last | Change 1W |
|---------|------|-----------|
| 10Y CZK | 0.85 | 1.19 |
| 10Y HUF | 2.75 | 0.73 |
| 10Y PLN | 2.32 | -3.53 |

Weekly preview

WED 14:00
NBP rate (in %)

| | This | Last change |
|---------------|-------------|-------------|
| rate level | 1.50 | 3/2015 |
| change in bps | 0 | -50 |

PL: Rates again unchanged

The National Bank of Poland will again leave interest rates unchanged. The Monetary Policy Council, whose term of office is drawing to a close with many of its members probably being replaced in early 2016, is still struggling with inflation far below the target on the one hand (recall the October figure, which showed negative inflation at minus 0,8.% year-on-year), and the swiftly growing economy on the other. While the outlook to be outlined by the new November forecast will probably be slightly more pessimistic (notably as concerns inflation), the willingness to continue to cut rates in the remainder of the year will likely remain low, partly due to the more expansive programme of the incoming government as well as a weaker zloty.

THU 9:00
CZ Retail Sales (change in %)

| | Sep-15 | Aug-15 | Sep-14 |
|--------------------|------------|--------|--------|
| Sales | 4.7 | 4.4 | 7.0 |
| cummulative (YTD) | 7.0 | 7.3 | 5.8 |
| Sales (cars excl.) | 3.0 | 2.9 | 3.1 |
| cummulative (YTD) | 5.1 | 5.4 | 2.8 |

CZ: Rise in retail sales driven by cars

We expect that the consumer shopping boom persisted in September, fuelled by attractive prices and growing real household income. Car sales most probably went up significantly again – as already indicated by their registrations. Nevertheless, the retail sector excluding the automotive segment is also likely to grow solidly, riding the wave of demand for electronics encouraged by the expansion of e-commerce. The improvement in consumer demand is still too weak to trigger demand-pull inflation, and therefore it can still be regarded as reasonable.

THU 9:00
HU Retail sales (y/y change in %)

| | Sep-15 | Aug-15 | Sep-14 |
|---------|------------|--------|--------|
| Monthly | 5.0 | 4.6 | 4.6 |

HU: Retail sales

The net real wage growth of about 3.5% and the increasing employment suggest that the retail sales may continue to grow about 5% Y/Y in September as well just like the previous month. The online cashier machines are whitening the economy, which distorts the figure slightly upward.

THU 13:00
CNB base rate

| | This meeting | Last change |
|-------------------|--------------|-------------|
| rate level (in %) | 0.05 | 11/2012 |
| change in bps | 0 | -20 |

CZ: CNB's new forecast

At its November meeting the CNB Board will discuss this year's last forecast, which may not necessarily bring any revolutionary changes. The only possible scenarios are a very moderate reduction of the inflation outlook for next year and, at the same time, an increase in this year's expected growth of the Czech economy. As we do not expect a change in the main monetary policy parameters at this meeting either, the primary question will continue to be whether or not the CNB will announce an extension of its exchange rate commitment until 2017. For the moment it remains true that the central bank will not abandon this policy before the second half of 2016.

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

| | Sep-15 | Aug-15 | Sep-14 |
|-------------------|--------|--------|--------|
| Monthly | 3.5 | 6.3 | 8.8 |
| cummulative (YTD) | 4.9 | 5.1 | 5.6 |

CZ: Industry at a good pace again

After August's lower performance, affected by factory-wide holidays, industry most probably returned to solid growth in September. Although the output rate was curtailed by the one less business day in the month, the figures from industry should be very positive. Carmakers are very likely to keep the role of industry leader again, followed by the plastics and food industries. The energy sector is likely to be in the red. Industry as a whole most probably kept its position as the driver of the entire economy in September, thus largely contributing to persisting strong economic growth.

FRI 9:00 HU Industry (change in %)

| | Sep-15 | Aug-15 | Sep-14 |
|---------|--------|--------|--------|
| Monthly | 5.8 | 6.2 | 5.5 |

HU: Industrial production

The industrial production started to slow down in the previous months due to the smaller external demand, but the last years base is low because of the model change of Suzuki. It means that the industrial production may continue to increase around 6% Y/Y, so the September figure might show 5.8% Y/Y growth.

CZ: Interventions continued in September

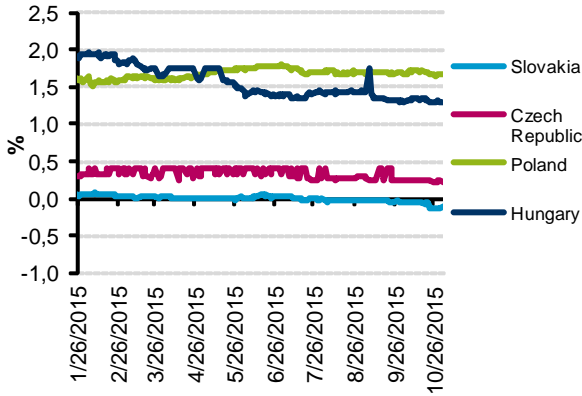
The financial markets will eagerly await not only the new forecast but also other figures from the central bank to be released towards the end of the week. These will include data on forex reserves and the CNB's FX trading statistics, which should bear out the strong activity of the central bank on the forex market, just as in July and August. The development of the exchange rate of the koruna suggests that the CNB intervened against appreciation of the Czech currency beyond the set threshold of CZK 27 per EUR, and thus we can only speculate how large the trading volume actually was. At the moment we can predict that the amount the central bank had to buy and add to its forex reserves might have been around EUR 2.5 bn.

Calendar

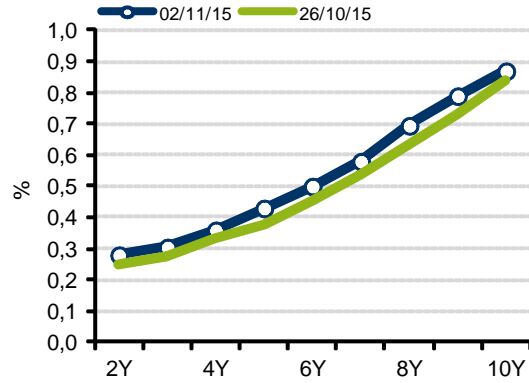
| Country | Date | Time | Indicator | Period | Forecast | | Consensus | | Previous | |
|---------|------------|-------|--------------------------|------------------|----------|------|-----------|------|----------|------|
| | | | | | m/m | y/y | m/m | y/y | m/m | y/y |
| PL | 11/02/2015 | 9:00 | PMI manufacturing | 10/2015 | | | 51.2 | | 50.9 | |
| HU | 11/02/2015 | 9:00 | Trade balance | EUR M 08/2015 *F | | | | | 459 | |
| HU | 11/02/2015 | 9:00 | PMI manufacturing | 10/2015 | | | | | 55.8 | |
| CZ | 11/02/2015 | 9:30 | PMI manufacturing | 10/2015 | | | 55 | | 55.5 | |
| CZ | 11/02/2015 | 14:00 | Budget balance | CZK B 10/2015 | | | | | -2.8 | |
| PL | 11/02/2015 | 14:00 | CPI | % 10/2015 *P | 0.2 | -0.6 | 0.2 | -0.7 | -0.3 | -0.8 |
| PL | 11/04/2015 | 14:00 | NBP meeting | % 11/2015 | 1.5 | | 1.5 | | 1.5 | |
| CZ | 11/05/2015 | 9:00 | Retail sales | % 09/2015 | | 4.7 | | 4 | | 4.4 |
| HU | 11/05/2015 | 9:00 | Retail sales | % 09/2015 | | | 5 | | 5 | 4.7 |
| CZ | 11/05/2015 | 13:00 | CNB meeting | % 11/2015 | 0.05 | | 0.05 | | 0.05 | |
| HU | 11/05/2015 | 16:00 | Budget balance | HUF B 10/2015 | | | | | -954.6 | |
| CZ | 11/06/2015 | 9:00 | Construction output | % 09/2015 | | | | | | 4.7 |
| CZ | 11/06/2015 | 9:00 | Trade balance (national) | CZK B 09/2015 | 11 | | 17 | | -0.1 | |
| CZ | 11/06/2015 | 9:00 | Industrial output | % 09/2015 | | 3.5 | | 3.4 | | 6.3 |
| HU | 11/06/2015 | 9:00 | Industrial output | % 09/2015 | | 5.8 | | 5.7 | -2 | 6.2 |

Fixed-income in Charts

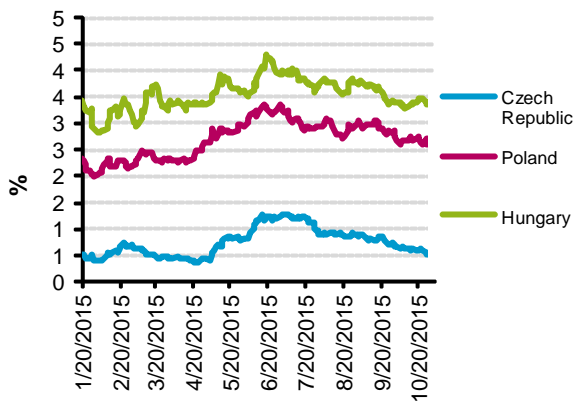
FRA 3x6



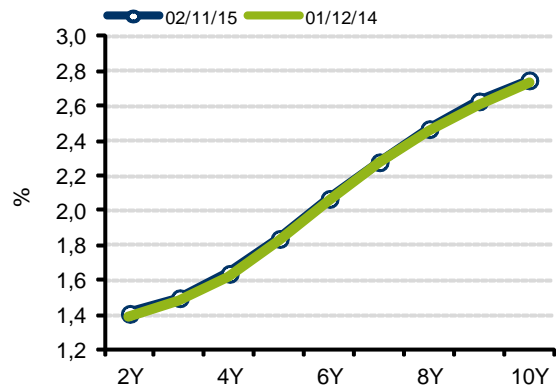
CZ IRS



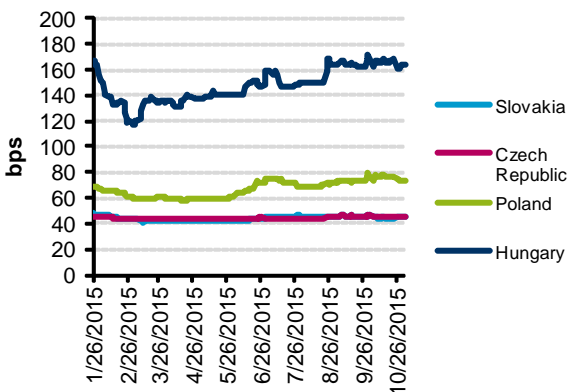
10Y GB Yields



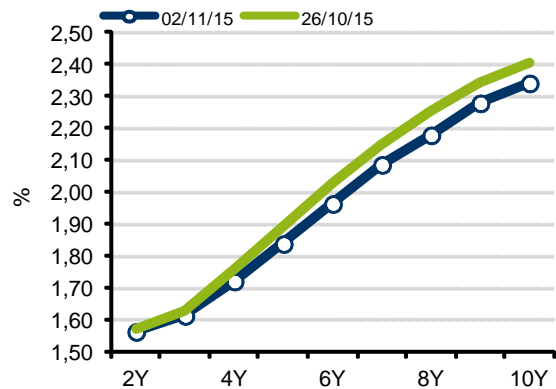
HU IRS



CDS 5Y



PL IRS



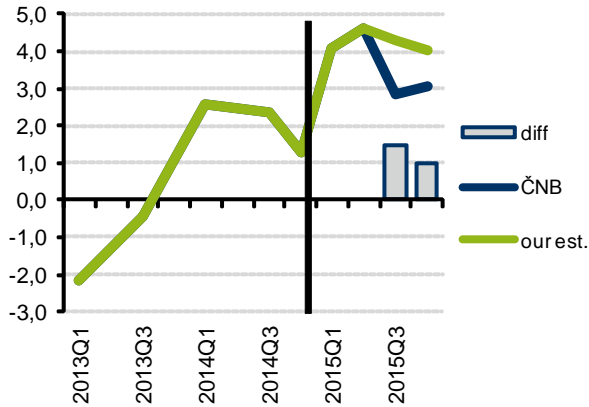
Source: Reuters

Medium-term Views & Issues

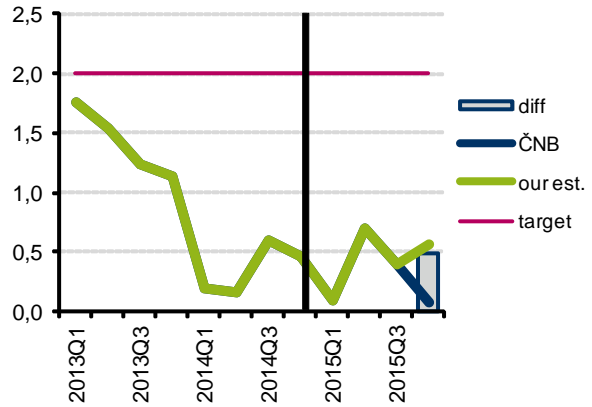
| | The Czech Republic | Hungary | Poland |
|-------------------------------------|---|---|---|
| Growth & key issues | <p>Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – encouraged by growing real wages and employment – becoming a strong stimulus. At the moment, we cannot expect any fundamental economic changes or reforms, except for the abolition of the pension reform and the introduction of the electronic registration of sales. Progress in the country's preparations for joining the euro area is not expected in this electoral term either.</p> | <p>The Hungarian economy has continued to record solid growth this year as the working day adjusted GDP grew by 3.4% Y/Y in the first quarter. Looking ahead the GDP growth might slow down slightly in the coming quarters, but the favourable European conjuncture and the increasing net real wage and employment increase might provide a stable base for the growth so we expect that Hungarian economy may grow by about 3% Y/Y in 2015.</p> | <p>Although the overall positive economic developments in Europe and the long-term eased monetary policy should translate into growth of the Polish economy within the range of 3.5-4% this year as well as the next, we put our outlook on hold unless there is a clear view on the economic policy of the new government. This should be based on an economic program of the opposition party - Law and Justice.</p> |
| Outlook for official & market rates | <p>The CNB's monetary policy continues to be based on record-low interest rates and the weak koruna. The exchange rate policy, not allowing the koruna to strengthen beyond (below) EUR/CZK 27.0, is most likely to remain in place at least until the second half of 2016, and low interest rates probably even longer. The reason is that inflation remains below the 2% target and will most likely remain there next year, and will only slowly approach the target.</p> | <p>The NBH surprised the market as it shifted the interest rate corridor of overnight (O/N) instrument by 25bp downward, so the new interest rate is 0.1% (base rate minus 125bp) for deposit and 2.1% (base rate plus 75bp) for loans. This move means practically a 25bp rate cut and is clear the NBH is fully committed to force out money from NBH so it cannot be excluded that further steps may come in the future. We think the NBH will cut further its base rate, if the ECB loosen further its monetary policy and the EUR/HUF moves closer to 300. In that case the base rate might be cut below 1%, while we think that with the previous speed, namely by 15bp per meetings.</p> | <p>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. This promise will probably be hold, while we should wait how the MPC will be changed in 2016 as new President and Sejm will appoint almost all Board members.</p> |
| Forex Outlook | <p>Relatively strong economic growth, current and capital account surpluses and ongoing QE in the euro zone have been the key factors behind the recent strength of the koruna. We believe the Czech National Bank will meet its "pledge" and won't terminate its intervention regime before the second half of 2016 and can extend the pledge even further. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Possible start of tightening of US monetary policy poses negative risks for the koruna. We however think the fallout should only be limited.</p> | <p>We think that any strengthening of the HUF is rather temporary and the NBH's commitment to the long time low interest rate (just like the gradual push out of foreign holding from Hungarian government bonds) may lead to a HUF weakening in the coming weeks and months. It is also clear that the NBH has no problem with the HUF weakening, so rate hike driven by a temporary HUF devaluation is out of picture.</p> | <p>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 euro-zone. 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. On the other hand, the zloty might be afraid of personal changes in the NBP, which might lead to more dovish policy stance of the MPC.</p> |

CBs' Projections vs. Our Forecasts

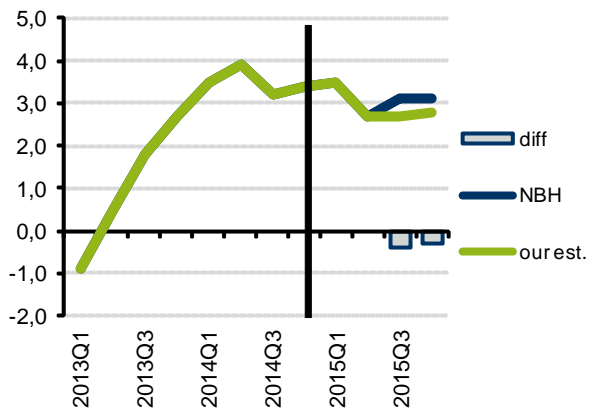
CZ: GDP outlook (Y/Y, %)



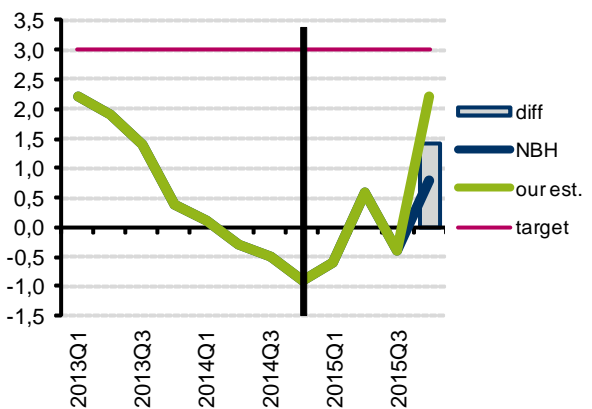
CZ: Inflation outlook (Y/Y, %)



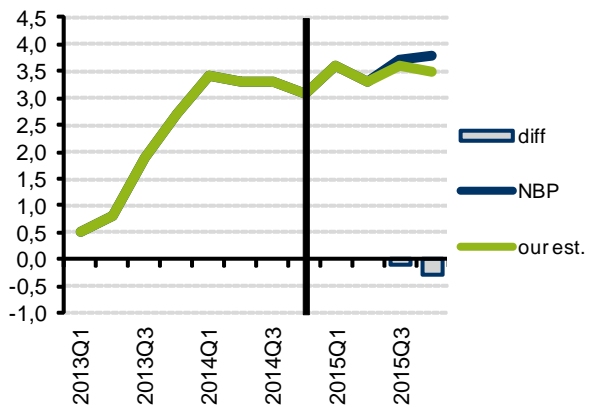
HU: GDP outlook (Y/Y, %)



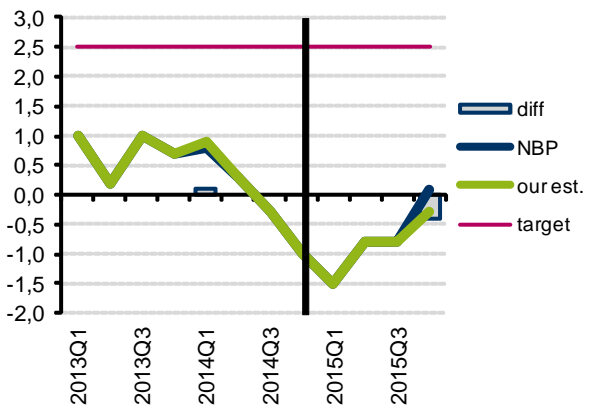
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outlook (Y/Y, %)



Source: CNB, NBP, MNB, KBC

Summary of Our Forecasts

Official interest rates (end of the period)

| | | Current | 2015Q1 | 2015Q2 | 2015Q3 | 2015Q4 | 2016Q1 | 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. | 1.35 | 1.95 | 1.50 | 1.35 | 2.00 | 2.25 | -10 bps | 7/21/2015 |
| Poland | 2W inter. rate | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | -50 bps | 3/4/2015 |

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

| | | Current | 2015Q1 | 2015Q2 | 2015Q3 | 2015Q4 | 2016Q1 |
|------------|--------|---------|--------|--------|--------|--------|--------|
| Czech Rep. | PRIBOR | 0.00 | 0.30 | 0.29 | 0.26 | 0.28 | 0.28 |
| Hungary | BUBOR | 1.35 | 1.89 | 1.41 | 1.35 | 2.10 | 2.40 |
| Poland | WIBOR | 1.73 | 1.65 | 1.72 | 1.73 | 1.65 | 1.67 |

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

| | | Current | 2015Q1 | 2015Q2 | 2015Q3 | 2015Q4 | 2016Q1 |
|------------|-------|---------|--------|--------|--------|--------|--------|
| Czech Rep. | CZ10Y | 0.87 | 0.64 | 1.30 | 0.98 | 1.15 | 1.20 |
| Hungary | HU10Y | 2.75 | 2.71 | 3.45 | 2.93 | 3.60 | 3.80 |
| Poland | PL10Y | 2.34 | 2.12 | 3.01 | 2.50 | 2.40 | 2.80 |

Exchange rates (end of the period)

| | | Current | 2015Q1 | 2015Q2 | 2015Q3 | 2015Q4 | 2016Q1 |
|------------|---------|---------|--------|--------|--------|--------|--------|
| Czech Rep. | EUR/CZK | 27.12 | 27.57 | 27.35 | 27.19 | 27.05 | 27.00 |
| Hungary | EUR/HUF | 311 | 300 | 315 | 314 | 315 | 310 |
| Poland | EUR/PLN | 4.25 | 4.07 | 4.19 | 4.25 | 4.15 | 4.10 |

GDP (y/y)

| | 2014Q3 | 2014Q4 | 2015Q1 | 2015Q2 | 2015Q3 | 2015Q4 | 2016Q1 |
|------------|--------|--------|--------|--------|--------|--------|--------|
| Czech Rep. | 2.4 | 1.3 | 4.1 | 4.6 | 4.3 | 4.1 | 2.3 |
| Hungary | 3.2 | 3.4 | 3.5 | 2.7 | 2.7 | 2.8 | 2.2 |
| Poland | 3.3 | 3.1 | 3.6 | 3.3 | 3.6 | 3.5 | 3.5 |

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

| | 2014Q3 | 2014Q4 | 2015Q1 | 2015Q2 | 2015Q3 | 2015Q4 | 2016Q1 |
|------------|--------|--------|--------|--------|--------|--------|--------|
| Czech Rep. | 0.7 | 0.1 | 0.2 | 0.8 | 0.4 | 0.9 | 1.5 |
| Hungary | -0.5 | -0.9 | -0.6 | 0.6 | -0.4 | 2.2 | 2.7 |
| Poland | -0.3 | -1.0 | -1.5 | -0.8 | -0.8 | -0.3 | 0.2 |

Current Account

| | 2015 | 2016 |
|------------|------|------|
| Czech Rep. | 1.5 | 1.5 |
| Hungary | 6.0 | 4.5 |
| Poland | -1.2 | -2.0 |

Public finance balance as % of GDP

| | 2015 | 2016 |
|------------|------|------|
| Czech Rep. | -1.6 | -1.3 |
| Hungary | -2.3 | -2.1 |
| Poland | -3.0 | -2.5 |

Source: KBC, Bloomberg

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