Written by ČSOB Prague and K&H Budapest

Central European Weekly

Monday, 01 September 2014

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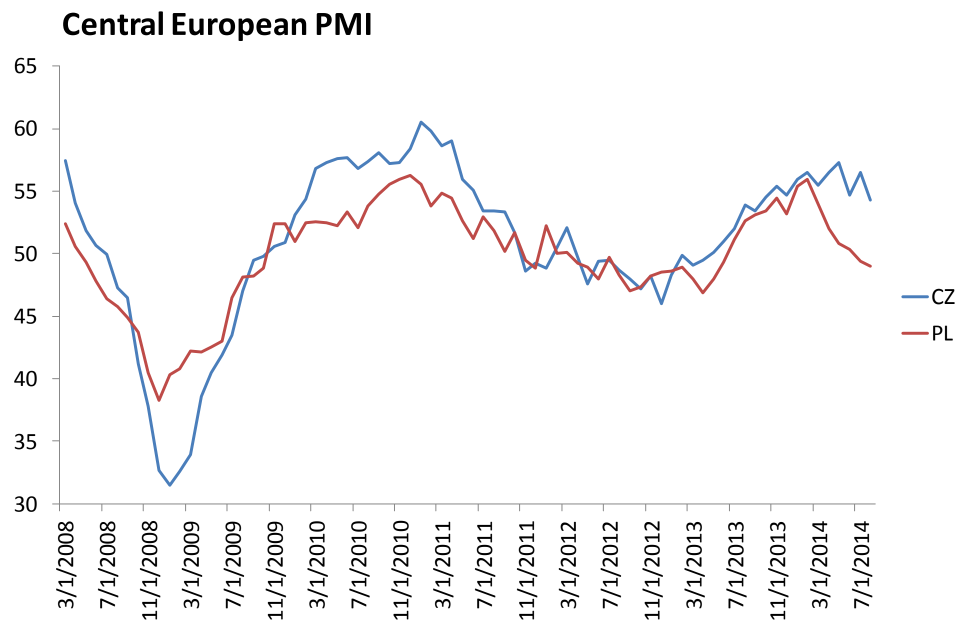
Chart of the Week. Regional PMIs in sync fall



While Polish PMI remains below 50 point threshold for the second consecutive month, the Czech headline figure stays in expansion territory.

Market's editorial

The Russian-Ukraine conflict back on the agenda

The crisis between Ukraine and Russia is still not over and we should consider how the conflict might develop. While rebels in the eastern part of Ukraine, supported by the Russian 'voluntary' military assistance, are making further progress, the European Union is going to arm itself in Brussels against Russia at least in terms of human resources. The already approved candidate for the new EU President is Poland's Prime Minister Tusk, which would not make happy Moscow as Poland has held a hawkish stance (against Russian) among EU states. On the other hand, while Russia would not be pleased at such personnel developments in the top of the EU, but the question is whether this will scare Russia enough to stop supporting the separatists in Ukraine. This is unlikely, and therefore the EU will have to step up its sanctions to ensure that the conflict will really hurt Russia economically. In any event, it needs to be anticipated that an escalated diplomatic and trade conflict between Russia and the EU would hurt not only the Russian economy but also the economies in Central Europe. After all, new details of Poland's economic performance (GDP and PMIs), in certain aspects, that the conflict already took its toll.

The Polish economy feels the heat from the East

In this context, it is not that surprising that regional currencies quite sensitively (negatively) reacted to the escalation in the eastern part of Ukraine. By contrast, prices of government bonds in the region are much less susceptible to the Ukrainian-Russian conflict, because they are influenced by other factors, which have firmly fixed the bullish trend in this asset class thus far. These factors include disinflation pressures, which are omnipresent in Europe and which make central banks push their official interest rates lower and lower. This might be the case for the Polish central bank too, but no already this week. We believe that details of the Polish GDP (with strong demand-led growth) do not provide sufficient reasons to cut the official interest rates already at September's meeting. On the other hand, the likelihood of a rate cut in the months to come is increasing, in view of decelerating quarter-on-quarter growth (as recently as in the early second quarter, we anticipated approximately 0.2-0.3% faster quarter-on-quarter growth than the reality) and visible negative risks to economic growth (the Ukrainian crisis) as well as risks to the return of inflation to its target (sanctions imposed on Russia, ECB policy). At its September meeting, we believe, the NBP will set the stage for a rate cut. We see November's NBP meeting as the most appropriate for this move. At that time, the GDP growth data for the third quarter will already be available; moreover, the Monetary Policy Council will have a new inflation forecast at hand. Nevertheless, the chance that the NBP will set the stage this week for an October rate cut cannot be ruled out either.

Election of Tusk as next EC President makes some nervous

Moreover, some investors are taking into account other domestic risks for Poland. For instance, they are afraid that Tusk´s party, the Civic Platform (PO), need not be able to find an equipollent helmsman after PM escape to Brussels. Recalls that the market-friendly PO is trailing behind the Law and Justice party in opinion polls and Tusk´s appointment hardly improves its chances to maintain power after the next elections in autumn 2015. We expect markets to become increasingly sensitive to opinion poll results in the coming months.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.7	-0.43%	➔	➔
EUR/HUF	315	0.22%	↘	↘
EUR/PLN	4.21	0.53%	↘	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.12	-6.67	↗	↗
10Y HUF	3.72	-6.30	↗	↗
10Y PLN	2.91	-2.52	↗	↗

Review of Economic Figures

The Polish GDP fuelled by strong domestic demand in Q2

According to revised data, the Polish economy grew by 3.3% y/y and 0.6% q/q in the second quarter of the year. Compared to the preliminary data released in early August, this is a moderate improvement of the year-on-year forecast by 0.1%.

Although the data unveils a rapid decline in the contribution of net exports to GDP growth – the main growth driver of the last two years has become a curb – the contribution of domestic demand has increased all the more. From its point of view, probably the greatest surprise was the fairly large contribution of the change in inventories to GDP growth, which slightly tainted the pleasure from the otherwise very good growth structure, as it has given rise to doubts about future developments. However, both household consumption (2.8%) and investment maintained their strong growth rates. Although investment rose at a slightly slower year-on-year rate in the second quarter than in the first, the increase was still 8.4% y/y. The rise in investment was consistent with another good construction output (7.7% y/y) on the supply side. The added value in industry increased below the average, if compared to the recent history, but still quite decently (3.2% y/y).

Regional PMIs in sync decline in August

Sentiment in regional manufacture sector deteriorated further, which sugests that the conflict is already taking its toll. Recall that the Polish manufacturing PMI declined further to 49.0 in August – the lowest level since May 2013. Within the PMI, for the first time since June 2013, not only New orders but also Output has fallen. The Czech PMI figures confirmed some cooling in August, too. Nevertheless, the value at 54.3 stays well above the long-term average. The biggets dropp recorded, however, the Hungarian PMI. The index declined to 51.7 points, while the July reading was at the 56.7 level. The bad news is that the new orders sub-index showed a large drop in August and was the 6th lowest value for the month since 1995.

The NBH confirms its happiness with the current set-up

The NBH left base rate unchanged at 2.1% in line with market expectations. The Monetary Council emphasized in the statement that they don't see inflationary pressure in the economy and CPI may achieve the 3% inflation target at the end of the forecasted horizon. The low CPI is because of the unused capacity utilization, the low wage dynamic and the public utility cost reduction. Also the low imported inflation and the decreasing inflationary expectations of the households keep CPI at a low level.

According to the Council, the Hungarian economy stepped on the way of growth in 2013 and the conjuncture will be more equalized in the future thanks to the funding for lending program, the use of EU funds money, the loosening lending conditions and the increasing domestic demand. Also the labour market is improving, the employment is slowly increasing. The savings ratio may remain above its pre-crisis level. The Monetary Council highlighted the international sentiment slightly deteriorated last month because of the geopolitical risks and the change of expectations regarding FED's monetary policy. The international market environment requires cautious monetary policy.

The statement concludes with the following sentences: "The Council judges that, based on available information the current level of the central bank base rate is consistent with the medium-term achievement of price stability and a corresponding degree of support for the economy. If the assumptions underlying the Bank's projection hold, achieving the medium-term inflation target points in the direction of maintaining current loose monetary conditions for an extended period." It confirms that the NBH is happy with the recent market development and has a comfortable manoeuvring room, so no rate change is expected in the near future. Definitely the main short-term risk is international sentiment. Nevertheless, we have seen quite strong buying interest recently which has also been supported by rising government bonds yields. The official rates may thus remain stable provided that the sentiment does not deteriorate markedly.

Weekly preview

WED 14:00	NBP rate (in %)	
	This	Last change
rate level	2.50	7/2013
change in bps	0	-25

PL: the NBP sets the stage for an autumn rate cut

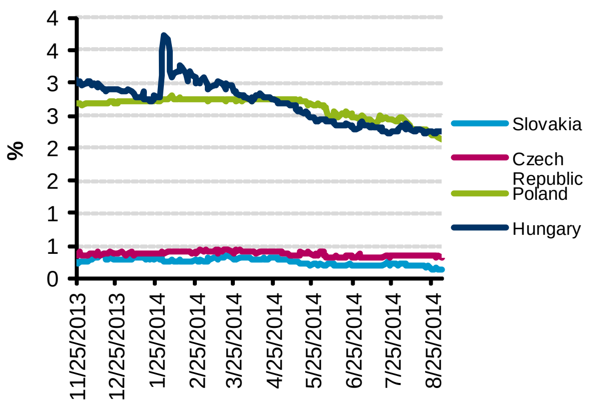
We believe that Poland's GDP data for the second quarter of the year does not provide sufficient reasons to cut the official interest rates at September's meeting of the National Bank of Poland. On the other hand, the likelihood of a rate cut in the months to come is increasing, in view of decelerating quarter-on-quarter growth and visible negative risks to economic growth (the Ukrainian crisis) as well as risks to the return of inflation to its target (sanctions imposed on Russia, ECB policy). At its September meeting, we believe, the NBP will set the stage for a rate cut. We see November's NBP meeting as the most appropriate for this move. At that time, the GDP growth data for the third quarter will already be available; moreover, the Monetary Policy Council will have a new inflation forecast at hand. Nevertheless, the chance that the NBP will set the stage for an October rate cut this week cannot be ruled out either.

Calendar

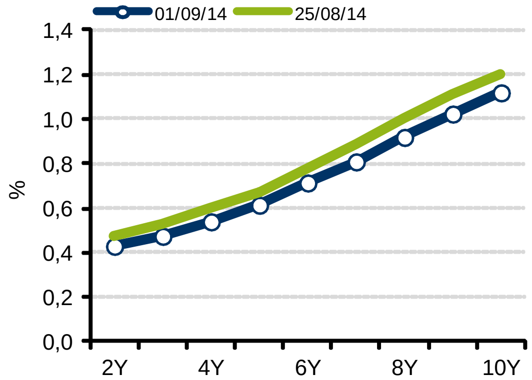
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	09/01/2014	9:00	PMI manufacturing		08/2014					56.7	
PL	09/01/2014	9:00	PMI manufacturing		08/2014			49		49.4	
CZ	09/01/2014	9:30	PMI manufacturing		08/2014			55.5		56.5	
CZ	09/01/2014	14:00	Budget balance	CZK B	08/2014					4.5	
HU	09/02/2014	9:00	Trade balance	EUR M	06/2014 *F					609.7	
HU	09/03/2014	9:00	Retail sales	%	07/2014						3.8
HU	09/03/2014	9:00	GDP	%	2Q/2014 *F					0.8	3.9
PL	09/03/2014	14:00	NBP meeting	%	09/2014	2.5		2.5		2.5	
CZ	09/04/2014	9:00	Retail sales	%	07/2014		7		4.3		8.2
CZ	09/05/2014	9:00	Real wages	%	2Q/2014				2.1		3.1
HU	09/05/2014	9:00	Industrial output	%	07/2014 *P					1.8	11.3

Fixed-income in Charts

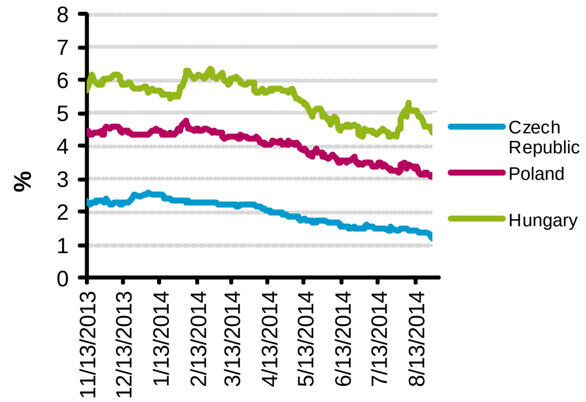
FRA 3x6



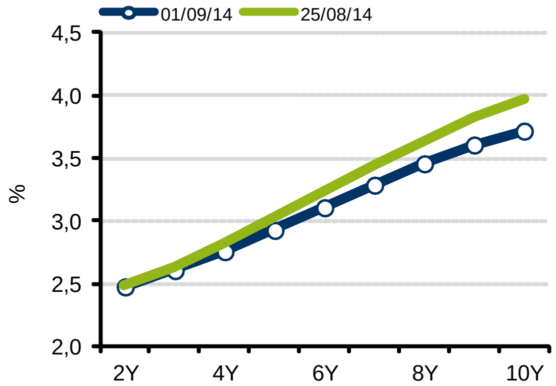
CZ IRS



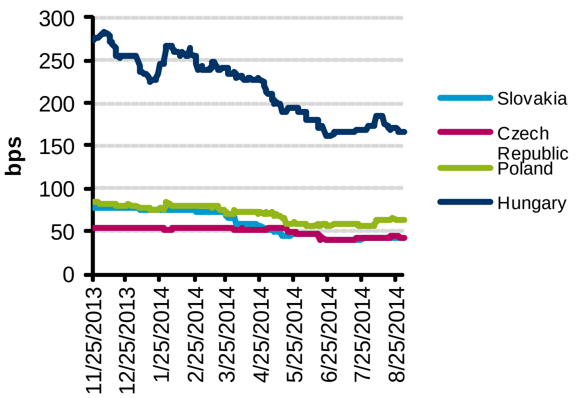
10Y GB Yields



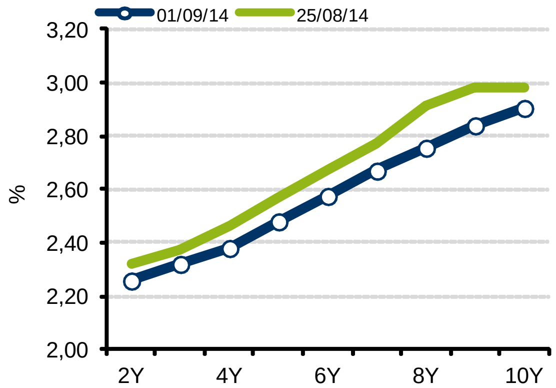
HU IRS



CDS 5Y



PL IRS



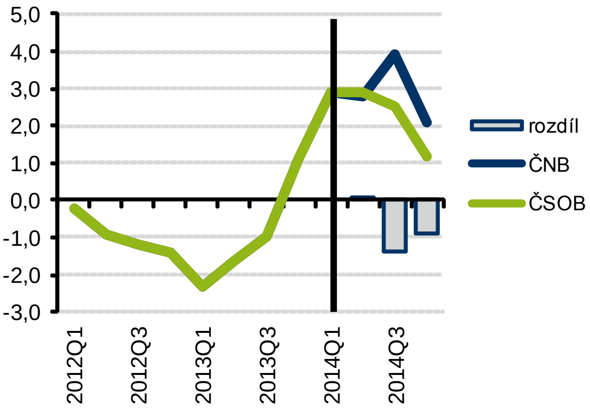
Source: Reuters

Medium-term Views & Issues

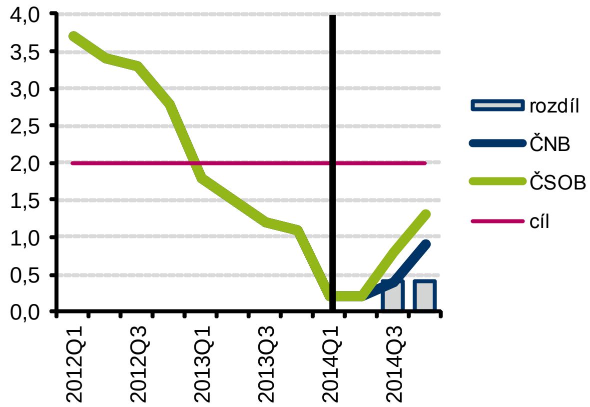
	The Czech Republic	Hungary	Poland
Growth & key issues	The economy is in a period of upswing. The key economic fundamentals remain very strong, with many of them even improving over the course of time. The new government, formed after the autumn 2013 election, is just gradually starting to carry out its 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.	Based on the first quarter figure and the recent trends in the economy, Hungary's GDP may grow above 2.5% Y/Y in 2014 and it cannot be excluded that the growth might be close to 3% Y/Y level. The low base supports this economic growth level in short term, but without a substantial rise of investments in the private sector this year, economy may slow down to around 2% Y/Y level in 2015. On the other hand, in spite of growing domestic demand, inflation appears well anchored and inflationary expectations stick close to 3 %. Moreover, as this year's harvest may be good, food processing industry hardly escalates price pressures in the economy.	According to the GUS estimates the Polish economy grew by 3.4% in 2014Q1. For this year, the growth should significantly exceed 3%. Household consumption should support growth, owing to the improving labor market situation as well as to low inflation. Investment should also develop favorably, owing to the replenishment of inventories as well as to gross capital formation In addition, lower government debt could also give a greater lift to the economy. By contrast, net exports are likely to curb rather than boost growth, especially in view of recent crisis in Ukraine.
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 CZK 27 per EUR. 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 (not before the second half of 2015), 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. Although the recent development has supported our bets on faster economic recovery in Poland, outlook for persistently low inflation should play in favor of stable official interest rates in the rest of this year. Although we cannot exclude possible rate cut as we forecast inflation to fall significantly below zero over the summer , the monthly data released thus far indicates similar growth for the second quarter as that for the first (3.4% y/y). And this should not be enough to cut rates.
Forex Outlook	The CNB has started FX interventions and we expect the koruna to stay within the regime at least till the mid 2015. Hence the currency should stay above 27.00 EUR/CZK at least in 12-month horizon. When the FX targeting regime is set to be abandoned, the CNB will have to intervene on the market much more aggressively to stop the spot koruna from appreciation. As a side effect, the forward koruna can appreciate significantly before the regime is abandoned.	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.	Low inflation pressures and improving prospects of the economy may support the zloty in months ahead. Albeit we expect only gradual strengthening against the euro, the Polish currency might perform well against the koruna as the room for koruna's appreciation remains virtually closed and the economic recovery in Poland is likely to continue at faster pace. The main risk as regards the zloty is the ECB decision to ease MP which could further support the currency.

CBs' Projections vs. Our Forecasts

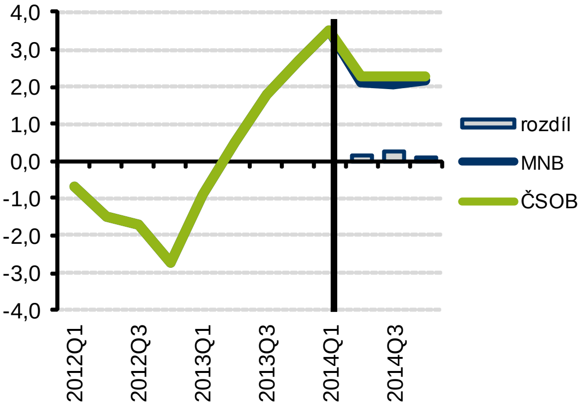
CZ: GDP outlook (Y/Y, %)



CZ: Inflation outlook (Y/Y, %)

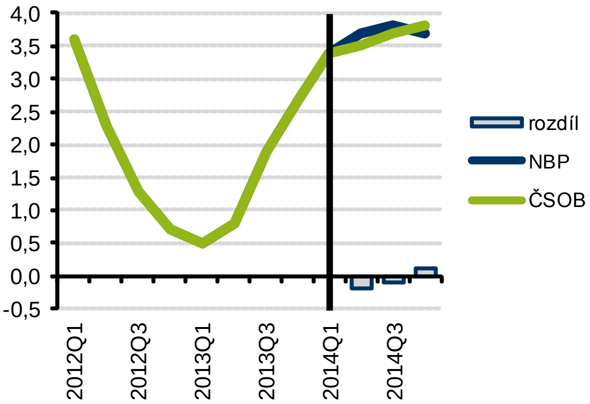


HU: GDP outlook (Y/Y, %)



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	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	Last change	
Czech Rep.	2W repo rate	*0.05*	0.05	0.05	0.05	0.05	0.05	-20 bps	27/09/2012
Hungary	2W deposit r.	*2.10*	3.00	2.60	2.30	2.50	2.50	-10 bps	22/07/2014
Poland	2W inter. rate	*2.50*	2.50	2.50	2.50	2.50	2.75	-25 bps	03/07/2013

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

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	PRIBOR	*0.35*	0.38	0.37	0.35	0.35	0.35
Hungary	BUBOR	*2.14*	2.99	2.67	2.34	2.50	2.50
Poland	WIBOR	*2.58*	2.71	2.71	2.68	2.75	3.00

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

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	CZ10Y	*1.12*	2.09	1.84	1.34	1.40	1.50
Hungary	HU10Y	*3.72*	5.25	4.95	3.77	5.30	5.70
Poland	PL10Y	*2.91*	4.25	4.03	3.39	4.45	4.70

Exchange rates (end of the period)

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	EUR/CZK	*27.7*	27.3	27.4	27.4	27.9	27.7
Hungary	EUR/HUF	*315*	297	307	310	298	295
Poland	EUR/PLN	*4.21*	4.16	4.17	4.16	4.15	4.09

GDP (y/y)

	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	-1.6	-1.0	1.1	2.9	2.9	2.5	1.2
Hungary	0.5	1.8	2.7	3.5	2.3	2.3	2.3
Poland	0.8	1.9	2.7	3.4	3.5	3.7	3.8

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

	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	1.6	1.0	1.4	0.2	0.0	1.0	1.4
Hungary	1.9	1.4	0.4	0.1	0.6	0.7	0.8
Poland	0.2	1.0	0.7	0.7	0.2	-0.4	0.2

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.	-1.5	-2.5
Hungary	-2.7	-3.0
Poland	-4.4	-3.5

Source: CSOB, Bloomberg

Contacts

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41	**Brussels**	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Institutional Desk	+32 2 417 46 25
Mathias van der Jeugt	+32 2 417 51 94	France	+32 2 417 32 65
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Frankfurt	+49 69 756 19372
Shawn Britton	+353 1 664 6892	Singapore	+65 533 34 10
Prague Research (CSOB)			
Jan Cermak	+420 2 6135 3578	**Prague**	+420 2 6135 3535
Jan Bures	+420 2 6135 3574		
Petr Baca	+420 2 6135 3570		
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	**Bratislava**	+421 2 5966 8820
Budapest Research			
David Nemeth	+36 1 328 9989	**Budapest**	+36 1 328 99 85

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