Central European Weekly

Monday, 08 September 2014

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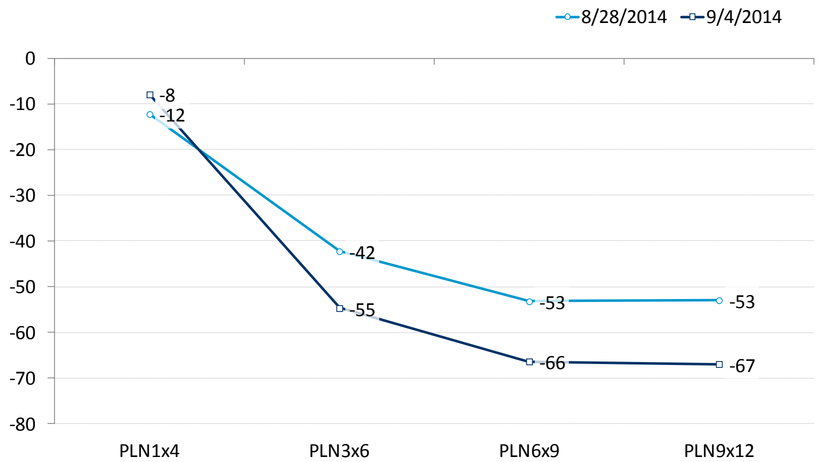
Weekly Highlights:

- Aggressive ECB easing means even more steroids for regional bulls
- The NBP hints at a rate cut in October, another one might be expected in November
- Hard data from Czech and Hungarian industries remain very solid
- Hungary's annual inflation rate figures should be back firmly into positive territory in August

Chart of the Week: Polish rate cut bets

PL: FRA against 3M interbank offered rate (bps)
before and after the NBP meeting



Markets started to price-in even more rate cuts in Poland (Source: Bloomberg, CSOB).

Market's editorial

Another ECB easing means more steriods for regional bulls

The surprisingly aggressive, expansive steps presented by the ECB on Thursday could not go unnoticed in Central European markets. From the purely macroeconomic perspective, the ECB's efforts to stimulate demand to a greater extent certainly should be good news for Central European economies. Central bankers in the region would also likely appreciate it if the ECB succeeded (for example, through a weaker exchange rate against the dollar) in generating higher inflation, which could be 'imported'.

However, from the purely market perspective, the ECB's decision to start private quantitative easing (by buying ABS) is, above all, a clear bullish signal for virtually all Central European markets. Speculators, banks, as well as long-term institutional investors in the euro area, will have even more free euro liquidity in their balances and will, even more aggressively, seek practically any (higher) yield, even outside the euro area. This may result in a rise in the asset prices in the region, which may lead, inter alia, to an even greater compression of interest rates and appreciation of Central European currencies. This may trigger self-fulfilling speculations, and the strengthened zloty or forint may drive not only the National Bank of Poland but even the National Bank of Hungary and the Czech National Bank into a corner, in an effort to ease their monetary policy further. The first in this row is, however, the Polish Central Bank.

The NBP already hinted at a rate cut in October

A meeting of the National Bank of Poland (NBP) was the regional economic event of last week. The NBP left interest rates unchanged at 2.50%, in line with the expectations of the majority of the market; however, the official press statement after the meeting fairly clearly indicates that the opinions of members of the Monetary Policy Council (MPC) are becoming increasingly dovish.

The tenor of the press statement was further underlined by NBP President Belka. He said that the worsened economic outlook would very likely lead to a rate cut. Mr Belka, just like the statement, conditioned a rate cut at the October meeting (October 8) upon the confirmation of waning growth by the economic statistics to be released this month. We believe that such a confirmation is likely. The cooling of economic growth has been recently evident across the monthly data releases, such as retail sales or construction figures. In addition, Mr Belka added that it was his impression from the discussion with the other MPC members that waiting for a new forecast until early November – which was our preferred scenario – was not necessary.

Another rate cut in Poland is also likely in November

Thus the primary question continues to be the amount of the rate cut. We believe that, given the fairly great uncertainty, another rate cut is in the cards in November, again by 25 bps, in addition to that of October. Moreover, another monetary easing in November will also be encouraged by a similar move by the ECB, which surprised markets by the aggressiveness of its steps on Thursday.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.6	-0.37%	➔	➔
EUR/HUF	314	-0.10%	➘	➘
EUR/PLN	4.18	-0.51%	➘	➘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.17	4.00	➘	➘
10Y HUF	3.63	-3.33	➘	➘
10Y PLN	2.76	-5.40	➘	➘

Review of Economic Figures

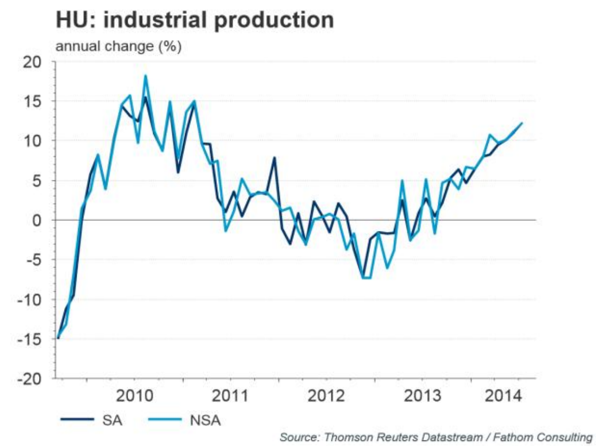
The Czech industrial output growth still surprises on upside

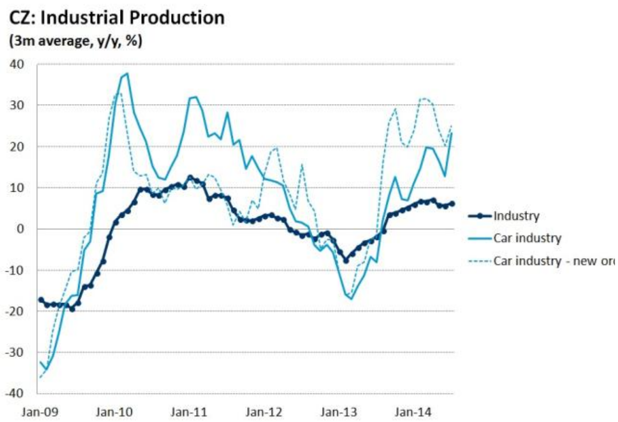
Hungarian macro figures have showed that the industrial production accelerated from 11.3% Y/Y in June to 12.3% Y/Y in July. The figure is well above the consensus expectation of 9.7% Y/Y increase. The figure is strong especially that the base in last year was also relatively high. The working day adjusted industrial growth was also 12.3% Y/Y, while the seasonally and working day adjusted one reflected only marginal slowdown of increase from 1.8% MoM in June to 1.6% M/M in July.

The expectations for a slowdown were not only because of the high base, but more because of the European slowdown. The Hungarian industrial production has quite high correlation with German IFO index, which started to decrease already in April, but this deterioration has been not reflected in Hungarian industrial figure yet. The main reason behind it is that the domestic sales within industrial production started to accelerate in April. Although Statistical Office will published detailed figure of July industrial production next Friday, most likely the domestic sales may accelerated further, but also the new capacities of vehicles production and the low base of electronic devices productions might boost the growth. The further drop of IFO index and the slowing European conjuncture may pull back Hungarian as well, and Industrial production may slow during autumn, the full year average growth can be close to 10% Y/Y in 2014.

The Czech industrial output growth still surprises on upside

The Czech statistical office has published data on July industrial growth. The figures reveal that alike in Hungary also in the Czech Republic industry rose more than markets had expected. Industrial output increased by 8.6 % year-on-year. Unsurprisingly, the robust growth was supported mainly by car industry, which rose by 46.6 % owing to this year´s shift of factory holidays from July to August. The automotive industry will play its leading role in the Czech economy also in coming months, as its accepted orders are still rising at a double-digit pace. Moreover, a double-digit growth of orders did not remain reserved for the most successful industrial branch in July, but it applied for industry as a whole. The Czech industry appears to be in a good shape in spite of economic slowdown in the euro area and sanctions between EU and Russia. Neither PMIs nor new orders indicate that a trend reversal should occur soon.





Weekly preview

CZ: No change of inflation rate

TUE 9:00	CZ Inflation (change in %)		
	Aug-14	Jul-14	Aug-13
CPI m/m	**-0.2**	0.2	-0.2
CPI y/y	**0.5**	0.5	1.3
Monetary relevant inflation y/y	**0.3**	0.3	0.5

In our opinion the annual inflation remained at 0.5% in August, i.e. near the forecast of the central bank and deeply below its target. Low energy and telecom prices dampen inflation pressures this year and enable the CNB maintain its relaxed monetary policy. Only slight increase of inflation (to app. 1.2%) can be expected at the end of this year.

HU: Inflation in positive teritory

THU 9:00	HU Inflation (change in %)		
	Aug-14	Jul-14	Aug-13
CPI m/m	**0.3**	0.1	1.3

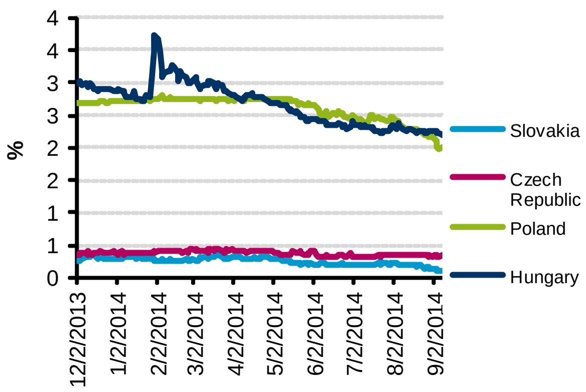
Consumer price index reached its bottom level in June at -0.3% YoY level and jumped to 0.1% YoY in July. The base dropped in last August because of public utility cost reduction, which falls out in this year. Although domestic consumption started to accelerate, the consumption is still moderate and the exchange rate transmission channel is still weak. The harvest was quite good in this year, so no price pressure may come even from food side. we expect that CPI may be 0.3% YoY in August.

Calendar

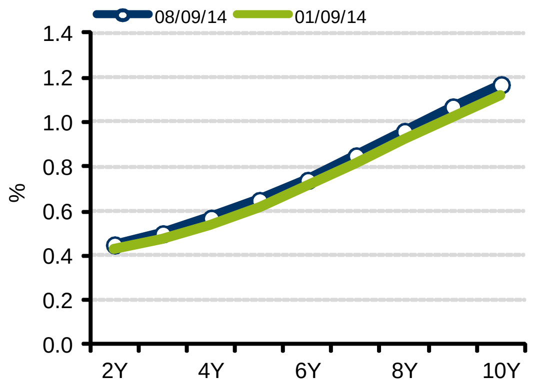
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	09/08/2014	9:00	Unemployment rate 15-64	%	08/2014	7.4		7.4		7.4	
HU	09/08/2014	9:00	Trade balance	EUR M	07/2014 *P					584.1	
CZ	09/08/2014	9:00	Trade balance (national)	CZK B	07/2014	12		10		19.1	
CZ	09/08/2014	9:00	Industrial output	%	07/2014		6		6.6		8.3
CZ	09/08/2014	9:00	Construction output	%	07/2014						5.1
CZ	09/09/2014	9:00	CPI	%	08/2014	-0.2	0.5	-0.2	0.5	0.2	0.5
CZ	09/09/2014	10:00	Current account	CZK B	2Q/2014			-2708		2633.6	
HU	09/09/2014	17:00	Budget balance	HUF B	08/2014					-851.4	
HU	09/11/2014	9:00	CPI	%	08/2014					0.2	0.1
HU	09/12/2014	9:00	Industrial output	%	07/2014 *F						
PL	09/12/2014	14:00	Money supply M3	%	08/2014					0.7	6.2

Fixed-income in Charts

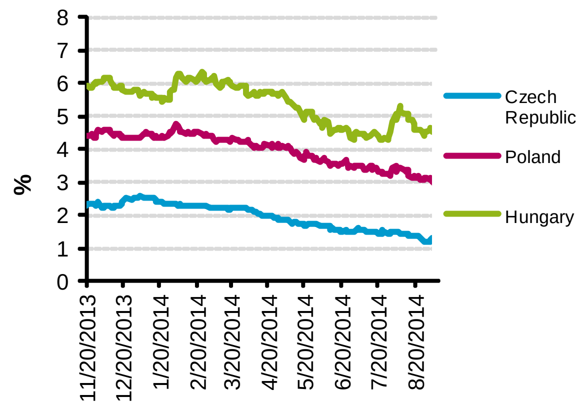
FRA 3x6



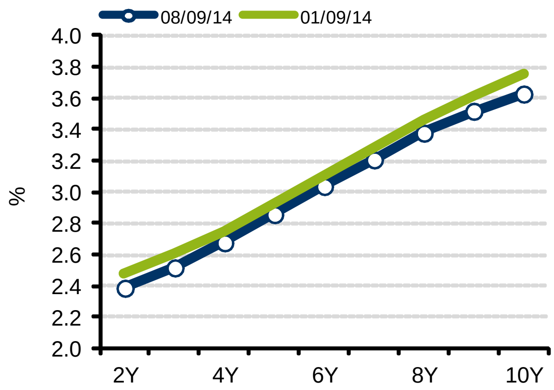
CZ IRS



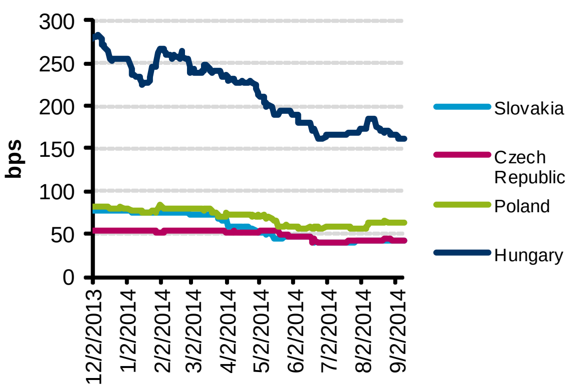
10Y GB Yields



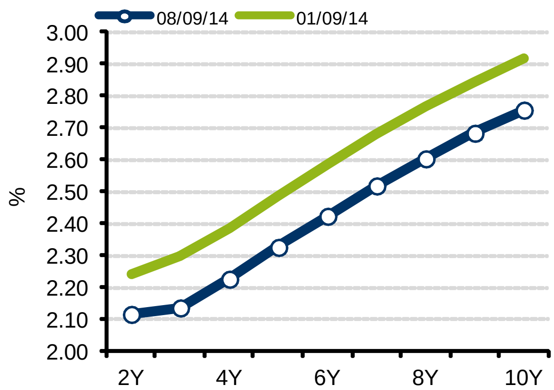
HU IRS



CDS 5Y



PL IRS



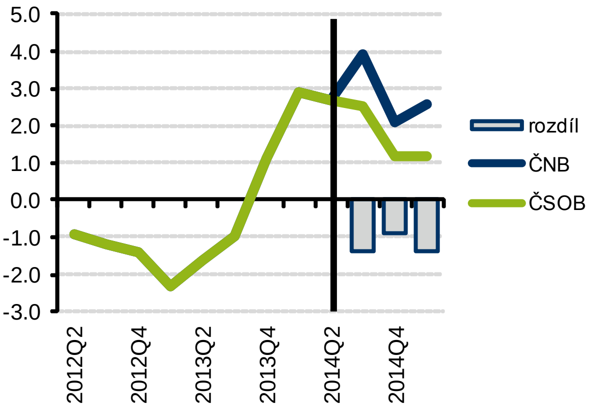
Source: Reuters

Medium-term Views & Issues

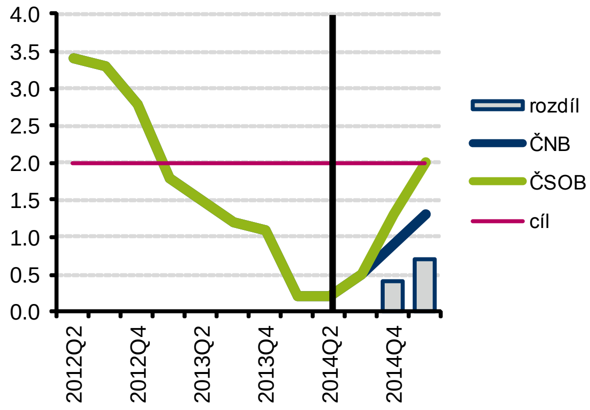
	The Czech Republic	Hungary	Poland
Growth & key issues	The economy is in a period of upswing. The key economic fundamentals remain very strong, with many of them even improving over the course of time. The new government, formed after the autumn 2013 election, is just gradually starting to carry out its 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 3.3% in 2014Q2. The data unveiled a strong contribution of domestic demand but also a high contribution of in inventories which somehow blurred overall good message. On the other hand, ongoing crisis in eastern Ukraine poses clear risks for the economic growth, especially in comparison with our expectations in the beginning of the year. Still, we expect the economy to expand by more than 3% in 2014.
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. At the same time, anti-inflationary risks stemming from Ukraine crisis and ECB recent policy easing are mounting. We therefore expect NBP to cut interest rates by 25 bps in both October and November and risks are skewed towards even more pronounced policy easing in months to come.
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.	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

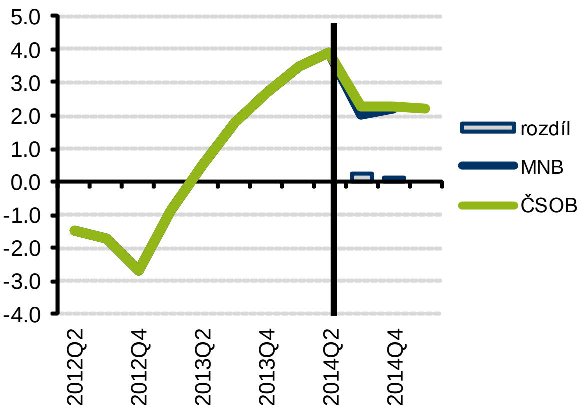
CZ: GDP outlook (Y/Y, %)



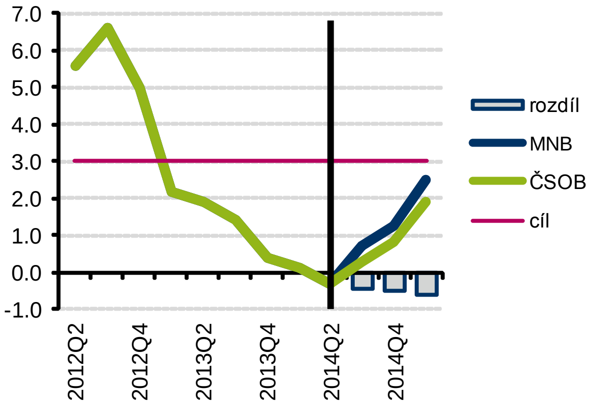
CZ: Inflation outlook (Y/Y, %)



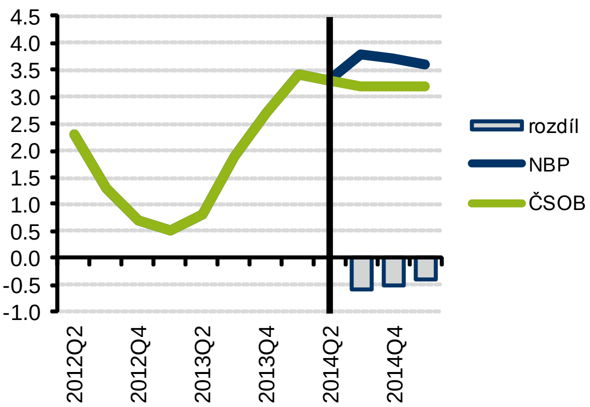
HU: GDP outlook (Y/Y, %)



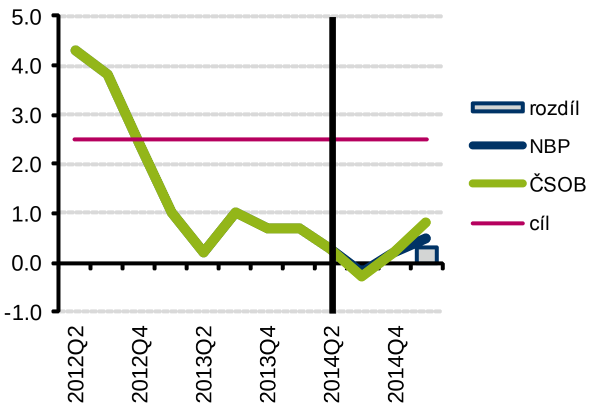
HU: Inflation outlook (Y/Y, %)



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	*2.50*	2.50	2.50	2.50	2.00	2.00	-25 bps	7/3/2013

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

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	PRIBOR	*0.35*	0.37	0.35	0.35	0.35	0.35
Hungary	BUBOR	*2.12*	2.67	2.34	2.15	2.15	2.15
Poland	WIBOR	*2.53*	2.71	2.68	2.45	2.20	2.20

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

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	CZ10Y	*1.17*	1.84	1.34	1.40	1.50	1.75
Hungary	HU10Y	*3.63*	4.95	3.77	3.50	3.50	3.65
Poland	PL10Y	*2.76*	4.03	3.39	2.75	2.60	2.60

Exchange rates (end of the period)

		Current	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	EUR/CZK	*27.6*	27.4	27.4	27.9	27.7	27.4
Hungary	EUR/HUF	*314*	307	310	310	310	310
Poland	EUR/PLN	*4.18*	4.17	4.16	4.19	4.17	4.17

GDP (y/y)

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	-1	1.1	2.9	2.7	2.5	1.2	1.2
Hungary	1.8	2.7	3.5	3.9	2.3	2.3	2.2
Poland	1.9	2.7	3.4	3.3	3.2	3.2	3.2

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

	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1
Czech Rep.	1	1.4	0.2	0.0	1.0	1.4	2.0
Hungary	1.4	0.4	0.1	-0.3	0.3	0.8	1.9
Poland	1	0.7	0.7	0.3	-0.3	0.2	0.8

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

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