



Central European Weekly

Monday, 02 May 2016

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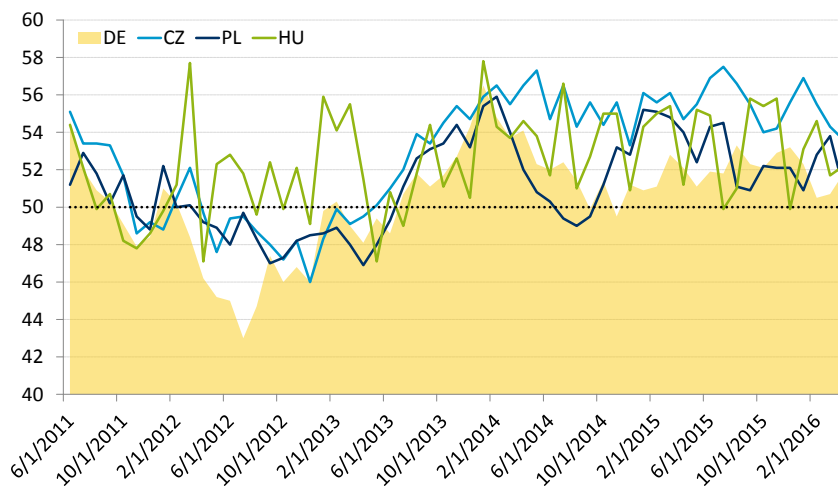
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Weekly Highlights:

- [Czech and Polish business sentiment worsen in April](#)
- [NBH cools rate-cut bets](#)
- [Weekly preview: The CNB and the NBP on hold](#)

Chart of the Week: Business sentiment in CE

PMI: CE vs Germany



The Czech PMI hit a 16-month low in April.

Central Bank & Markets

The NBH corrects aggressive rate-cut bets

It seems that the Hungarian central bank wants to correct market expectation about further easing. Following a rather neutral NBH's policy statement there was another hawkish statement coming from the NBH their time from its vice-governor Mr. Nagy. He said that the rate-cut expectations were excessive and the key question is whether there will be a third rate cut in May or even a fourth in June. Let us remind that the NBH targets its base rate, which could be maintained for two years, so it means that they may cut smaller now, and may keep slightly below the optimal level later. Nagy also adduced on the looser fiscal policy, which requires than less loose monetary policy in the near future. The budget proposal contain 2.4% of GDP deficit for 2017, which means at least 0.4% of GDP looser fiscal policy in a time, when economy may accelerate from 2.4% Y/Y to 3.1% Y/Y growth.

Recall that Hungary will have parliamentary election in 2018, the government tries to increase its popularity, so they increase the spending in education and in healthcare, decrease the VAT of milk, eggs and poultry, gives subsidies for new homes, maintains the employment level in the public sector although it was promised earlier that there will be lay-off in that segment etc., so the government tries to collect votes. At a for glance the budget was planned on a conservative way, so we don't expect substantially higher deficit than the plan for 2017 and it still ensures the moderation of public debt, but it may not help to accelerate the upgrade of Hungarian debt by rating agencies.

In respect of the above news it is worth noting that important changes in the tone of Hungarian National Bank's statements, which brought the interest-rate-setting meeting, held on Tuesday. The statement already started to cool down the market's aggressive rate cut expectation with

the sentence of '...in the Council's assessment, the sustainable achievement of the inflation target points to a further slight reduction in the policy rate' compared to the March statement of '...Interest rate cuts will continue as long as monetary conditions become consistent with the sustainable achievement of the inflation target'.

Hence the case for the stronger forint substantially increased and the market may re-test the EUR/HUF 307 levels soon, which was the bottom this year and NBH was quite unhappy at that times. Nevertheless, our views were confirmed by the new information, and we maintain our opinion that the NBH may cut base rate in May to 0.9% while the cycle may be finished in June..

The CNB and the NBP on hold this week

We expect the CNB Board to come up with no fundamental changes in monetary policy settings or in the timing of the discontinuation of its existing exchange rate system.

At the end of this week regional markets will definitely watch an interest-rate meeting of the Polish central bank. We do not expect the Monetary Policy Council (MPC) to change rates, though, as shown by April's inflation figures, Poland still remains in deflation (the consumer price index fell by 1.1% y/y). The depreciation of the zloty, which may be related to concern about a scheduled revision of Poland's ratings by Moody's (May 13), may weigh against a rate cut. Nevertheless, the market may be still interested in whether the comment will again include a mention that the majority of MPC members did not rule out the possibility of interest rate cuts in the event of an economic slowdown in Poland, a phrase included in the (detailed) minutes of the MPC meeting held in March.

	Last	Change 1W
EUR/CZK	27.1	0.05%
EUR/HUF	312	-0.17%
EUR/PLN	4.38	-0.73%

	Last	Change 1W
10Y CZK	0.71	2.17
10Y HUF	2.28	8.80
10Y PLN	2.41	-0.62

Review of Economic Figures

Czech and Polish business sentiment worsen in April

The Polish industry delivered another disappointing figure as the fresh PMI figures in manufacturing came out below market expectations and hit three-month lows in April. The month-on-month decline in the sentiment was driven by both current business conditions and new orders components of the index. Regarding the employment sub-index, it showed further improvement in conditions but the pace of growth was the slowest since the autumn 2014.

Regarding the Czech PMI, the index hit a sixteen-month low in April. Although conditions in industry remain favourable (the headline index reached 53.6 points), it showed decline in the fourth consecutive month. The most worrying probably was only tepid pace of growth of new orders. On the other hand, demand for new workers remains strong which is a good sign from the perspective of the central bank which expects relatively fast wage growth.

Interestingly, according to official surveys the mood in the Czech economy has actually declined, but good news is coming from industry at least. This primarily applies to new orders, which businesses have for more than eight months, while the utilisation of existing production capacities keeps increasing. Hence the decline in business confidence is rather attributable to the fact that the rate of industrial output has to gradually decelerate and reflect the possibilities of industrial businesses, which are already facing a lack of skilled workforce and slow improvements in

demand. Europe's growth is not expected to accelerate this year, and thus growth in domestic output is unlikely to maintain the same rate as last year. The high willingness of businesses to invest this year is good news, given that the last quarter of last year was not very impressive in terms of investment.

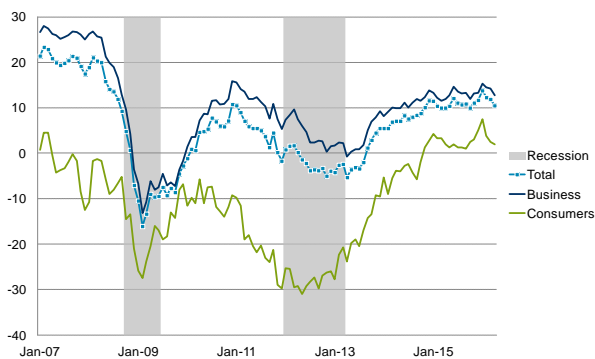
Czech consumer confidence decreases from its record levels

Even consumer sentiment in the Czech Republic has worsened compared to previous months, yet we can say that domestic consumers are from panicking or depressed. More likely, they are starting to ask themselves whether their financial position will continue to improve. It is thus a reflection of healthy scepticism rather than a change in mood. In addition, they are not very afraid of unemployment, and not at all of inflation. Therefore, we can still expect consumption to primarily drive domestic demand and consequently economic growth this year.

The Polish inflation as expected deeply negative in April

A flash estimate of the Polish inflation for April surprised both us and the market negatively. The headline inflation came out at -1.1% Y/Y and deflation has therefore deepened last month. Although in our base scenario we expect the central bank will keep rates unchanged, it may still be interesting to watch the outcome of this week's meeting of the National Bank of Poland (on Friday).

CZ: Business and consumer confidence



PL: Inflation



Source: Thomson Reuters Datastream / Fathom Consulting

Weekly preview

THU 13:00

CNB base rate

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

CZ: The CNB in a stable mode

We expect the CNB Board to come up with no fundamental changes in monetary policy settings or in the timing of the discontinuation of its existing exchange rate system at May's meeting. While a new inflation forecast will be available to the CNB Board, it may not necessarily differ significantly from that of February. The main reason for a reduced inflation outlook is likely to be lower oil prices but, as we have seen in recent days, oil has already offset part of its price fall. In any event, inflation will probably climb above the 2% target slightly later than expected by the CNB to date. However, this alone may not necessarily imply another extension of the exchange rate policy, especially as the CNB Board has already extended the indicative date of the discontinuation twice this year. Moreover, it is still true that 1) exemptions from meeting the inflation target can still be applied to fluctuations of raw material prices and 2) the Czech economy is not as inflation-free as suggested by the headline inflation rate. Numerous sub-indices (whether core inflation or prices of services) indicate that prices in the economy are rising at a moderate and stable rate. As concerns the probability of putting negative interest rates in place, we do not believe that the CNB will want to resort to such a move soon. If the central bank were to use them, it would more likely do so when it discontinues its FX interventions, and the move would only apply to liquidity subsequently flowing into the market. It would be more about using them as a tactical instrument rather than duplicating the experimental policy of the ECB. And the last argument we can cite is that the CNB may not have needed to intervene on the FX market at all (or nearly at all) in the last two months.

FRI 9:00

CZ Retail Sales (change in %)

	Mar-16	Feb-16	Mar-15
Sales	5.6	10.5	8.8
cummulative (YTD)	7.1	7.9	7.9
Sales (cars excl.)	5.0	8.6	5.5
cummulative (YTD)	5.9	6.5	5.9

CZ: Consumers are not lacking appetite to spend

The slightly worse rates of improvement may at first glance suggest a deceleration in the improvement in domestic demand, but we believe that this is actually just a result of two factors: 1) the effect of high comparative baselines (especially in the automotive segment) and 2) the lower number of business days in the month. The retail sector is still growing very rapidly; nonetheless, it is consistent with positive consumer expectations as well as with the improving financial position of domestic households. In real terms, retail sales in nearly all segments were at all-time highs, and thus we cannot talk about any contraction at all. The development of retail sales – as an indication of consumption development – just confirms the expectation that household consumption will be the main driver on the demand side of the Czech economy, i.e., GDP, this year.

FRI 14:00

NBP rate (in %)

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

PL: The NBP still on hold despite deflation

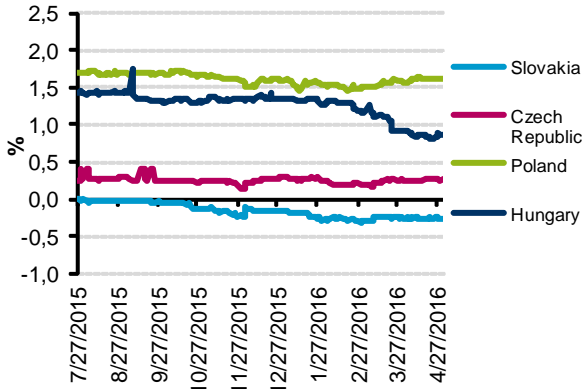
We do not expect the Monetary Policy Council (MPC) to change rates, although, as shown by April's inflation figures, Poland remains in deflation (the consumer price index fell by 1.1% y/y). The depreciation of the zloty, which may be related to concern about a scheduled revision of Poland's ratings by Moody's (May 13), may weigh against a rate cut. Nevertheless, the market may be interested in whether the comment will again include a mention that the majority of Council members did not rule out the possibility of interest rate cuts in the event of an economic slowdown in Poland, a phrase included in the (detailed) minutes of the MPC meeting held in March.

Calendar

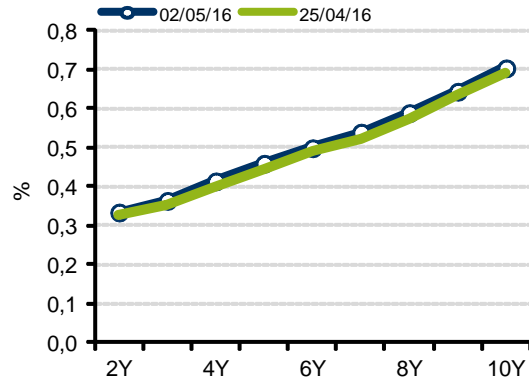
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	05/02/2016	0:00	Earnings Kofola	CZK	1Q/2016						
HU	05/02/2016	9:00	PMI manufacturing		04/2016					51.7	
PL	05/02/2016	9:00	PMI manufacturing		04/2016			53		53.8	
CZ	05/02/2016	9:30	PMI manufacturing		04/2016					54.3	
CZ	05/02/2016	14:00	Budget balance	CZK B	04/2016					43.6	
HU	05/03/2016	0:00	Earnings Magyar Telekom	HUF	1Q/2016						
HU	05/03/2016	9:00	Trade balance	EUR M	02/2016 *F					979	
CZ	05/04/2016	0:00	Earnings Erste Group Bank	CZK	1Q/2016						
CZ	05/04/2016	0:00	Earnings Komerčni banka	CZK	1Q/2016						
HU	05/04/2016	9:00	Retail sales	%	03/2016						6.4
CZ	05/05/2016	0:00	Earnings Fortuna	CZK	1Q/2016						
CZ	05/05/2016	13:00	CNB meeting	%	05/2016	0.05		0.05		0.05	
HU	05/06/2016	0:00	Earnings MOL Group	HUF	1Q/2016						
HU	05/06/2016	9:00	Industrial output	%	03/2016					-0.8	1.8
HU	05/06/2016	9:00	Trade balance	EUR M	03/2016 *P						
CZ	05/06/2016	9:00	Retail sales	%	03/2016		5.6				10.5
PL	05/06/2016	14:00	NBP meeting	%	05/2016	1.5		1.5		1.5	

Fixed-income in Charts

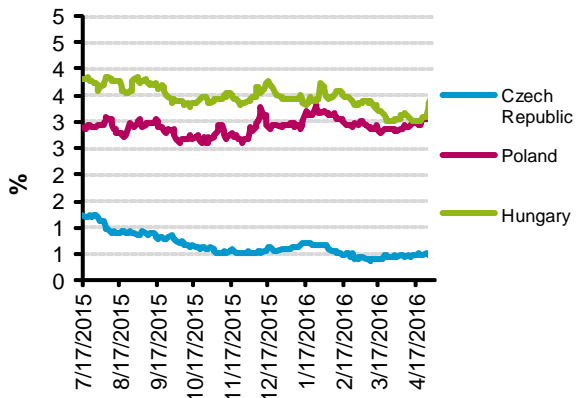
FRA 3x6



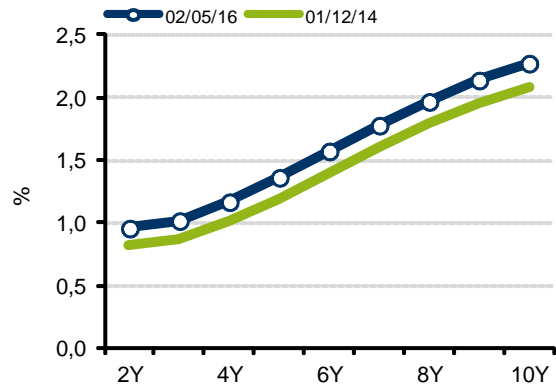
CZ IRS



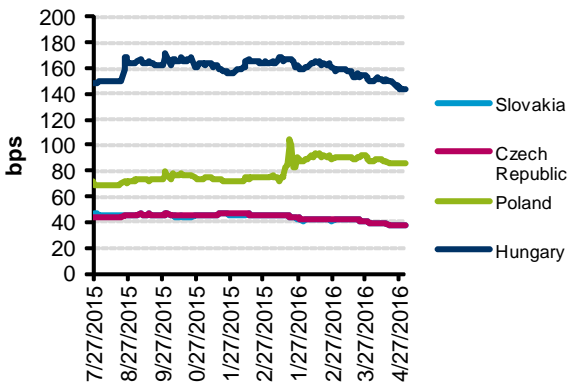
10Y GB Yields



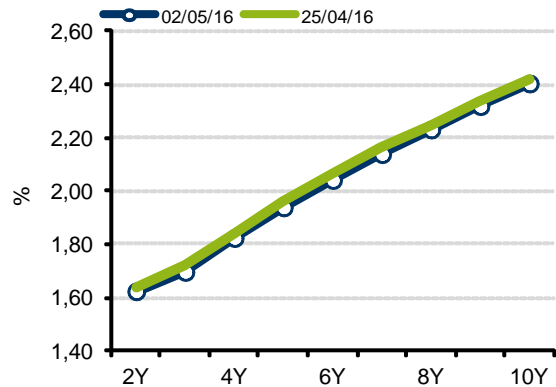
HU IRS



CDS 5Y



PL IRS



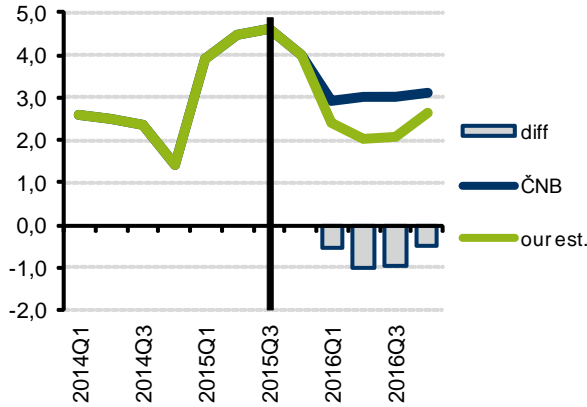
Source: Reuters

Medium-term Views & Issues

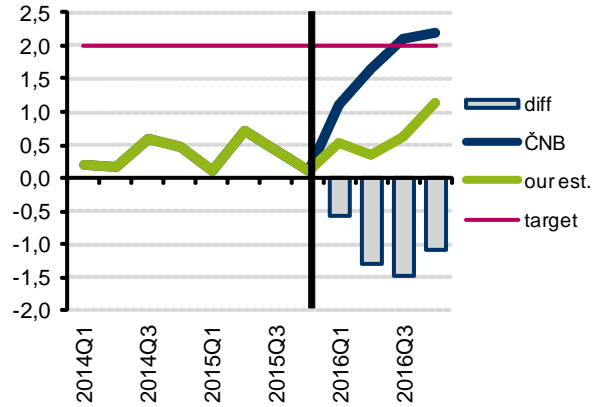
	The Czech Republic	Hungary	Poland
Growth & key issues	<p>Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private 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 4Q15 GDP growth might bounce back closer to 3% Y/Y, as EU funds money use was accelerated, the government increased the spending and the industrial production and domestic consumption might be stronger, so the growth might be around 2.7% Y/Y in 2015. The outlook is less favorable. The investments started to fall, the EU funds money use may substantially lower in this year due to the new budgetary period. The government tries to boost the construction via new government program, which targets new homes for households. The domestic consumption may remain strong thanks to the increasing wage mass. In case there is no substantial slowdown of international growth and the agriculture provides an average harvest, the economic growth might be around 2.3% Y/Y in 2016.</p>	<p>Prospects of the Polish economy remain good in our view. For the whole year 2016 we expect GDP growth may reach 3.5 - 4.0 percent. Apart from low interest rates (further cuts cannot be excluded) and a relatively weak zloty, we expect the economy to draw additional support from policy measures of the new government (stimuli for private consumption). The risks thus stem mainly from a possible deterioration in the external environment, most notably in China, Russia and other emerging markets.</p>
Outlook for official & market rates	<p>The latest forecast does not envisage the return of inflation to the target before early 2017, with inflation not significantly diverging from it afterwards either. The CNB has extended its exchange rate commitment until the first half of 2017. The possibility of introducing negative interest rates has been increasing, in light of the widening of the interest rate differential vis-à-vis the euro area and developments in domestic financial markets. But we still don't expect negative CNB's rates. There are two main preconditions for negative official rates: 1) significant ECB's rate cut, 2) continuing large monthly fx interventions of the CNB.</p>	<p>The Monetary Council continues the rate cut cycle in the following months. We believe that the easing cycle may be continued at least till June, when the next inflationary report will be published. The latest inflation figure (falling from 0.3% Y/Y in February to -0.2% in March) also gives gunpowder for monetary easing, so we expect 15bp cut on 26th April, which might be followed with two more steps in May and June down to 0.75% from the current level of 1.2%.</p>	<p>We expect the NBP to keep official rates stable, but we think that risks for of further rate cuts have increased. The main reason is the combination of the "inflow of cheap euros from the ECB", ongoing deflation and stronger currency (PLN). Hence, should the zloty get strong there could be a window of opportunity for the NBP to ease its policy in the second quarter of this year. Nevertheless this is not our main scenario yet.</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. With regard to the inflation outlook and ECB's policy, we anticipate an exit from the fx regime in the first quarter of 2017. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Current turmoil on the Chinese market poses negative risks for the Central Europe. We however think the impact on the koruna should only be limited.</p>	<p>We think that the NBH's commitment to the long time low interest rate may lead to short-term HUF weakening. Although compared to other emerging markets HUF looks like quite stable, the fears of Chinese hard lending scenario pushed EURHUF trading range between 313 and 318. Although the huge trade and current account balance supports HUF in medium term, the ongoing foreign sell-off of HUF denominated gov. bonds and the uncertain sentiment keeps weakening pressure on HUF, so we see bigger risk on the weak side on short term, which means that EURHUF may be pushed towards 325.</p>	<p>We think that zloty's sell-off related to markets' fears coming from appointment of new members of the Monetary Policy Council (MPC) is over now. Nevertheless, while domestic fundamentals should be relatively supportive for the zloty, the currency should be mostly driven by sentiment in emerging markets and the ECB or the Fed policy actions respectively.</p>

CBs' Projections vs. Our Forecasts

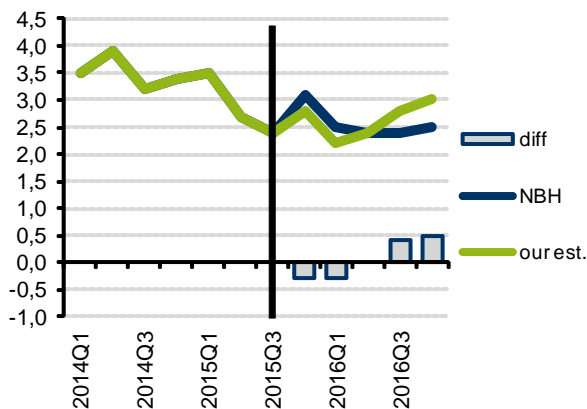
CZ: GDP outlook (Y/Y, %)



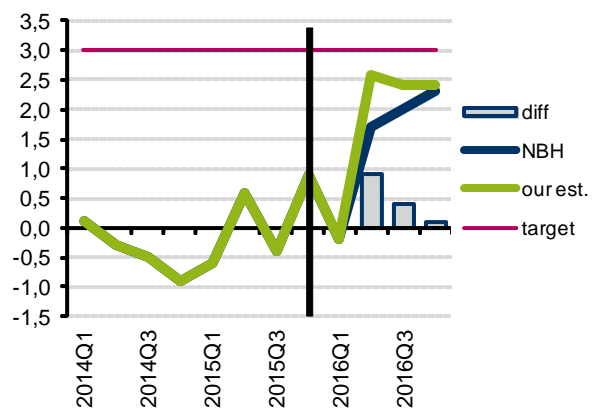
CZ: Inflation outlook (Y/Y, %)



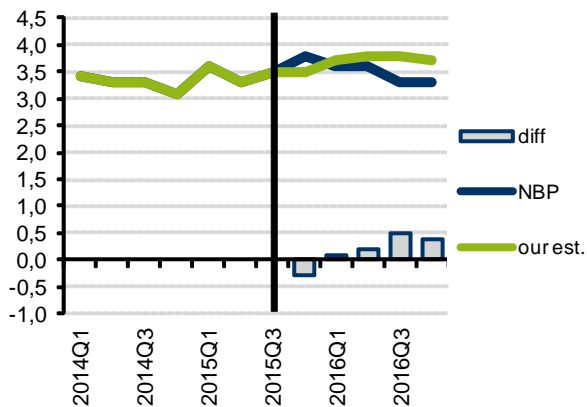
HU: GDP outlook (Y/Y, %)



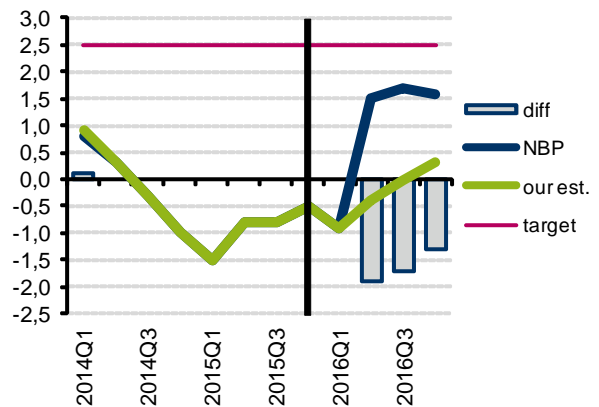
HU: Inflation outlook (Y/Y, %)



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	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	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	1.35	1.20	2.50	2.75	3.00	-10 bps	7/21/2015
Poland	2W inter. rate	1.50	1.50	1.50	1.50	1.50	1.50	-50 bps	3/5/2015

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

		Current	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	PRIBOR	0.00	0.25	0.25	0.24	0.25	0.25
Hungary	BUBOR	1.05	1.35	1.20	2.60	2.90	3.10
Poland	WIBOR	1.67	1.72	1.67	1.65	1.65	1.65

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

		Current	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	CZ10Y	0.71	1.01	0.63	0.73	0.81	0.90
Hungary	HU10Y	2.28	2.91	2.07	4.00	4.20	4.40
Poland	PL10Y	2.41	2.47	2.23	2.50	2.60	2.75

Exchange rates (end of the period)

		Current	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	EUR/CZK	27.07	27.03	27.05	27.02	27.02	27.02
Hungary	EUR/HUF	312	316	314	308	305	300
Poland	EUR/PLN	4.38	4.27	4.25	4.39	4.27	4.25

GDP (y/y)

	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	4.5	4.6	4.0	2.4	2.0	2.1	2.6
Hungary	2.7	2.4	2.8	2.2	2.4	2.8	3.0
Poland	3.3	3.5	3.5	3.7	3.8	3.8	3.7

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

	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Czech Rep.	0.8	0.4	0.1	0.3	0.5	0.7	1.4
Hungary	0.6	-0.4	0.9	-0.2	2.6	2.4	2.4
Poland	-0.8	-0.8	-0.5	-0.9	-0.4	0.0	0.3

Current Account

	2015	2016
Czech Rep.	0.9	0.8
Hungary	6.0	5.1
Poland	-1.2	-1.5

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-0.4	-1.0
Hungary	-2.3	-2.0
Poland	-3.0	-2.9

Source: KBC, Bloomberg

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