Monday, October 26,

KBC Banking & Insurance

Central European Weekly

Written by CSOB Prague, Kredyt Bank Warsaw and K&H Budapest

Czech Republic

Parliament passes the state budget for 2010 in its first reading.

Hungary

Very weak retail sales point to slow recovery

Poland

Surprisingly strong industrial output helps the zloty

The Week Ahead

Polish central bank is returning to a neutral mode

Overview

Bullish market sentiment contrasts with the bleak real economy

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.86	0.09%	→	→
EUR/PLN	4.172	-0.94%	→	→
EUR/HUF	267.1	-0.13%	→	→
3M PRIBOR	1.84	-0.02	↘	↓
3M WIBOR	4.18	-0.01	→	→
3M BUBOR	6.89	-0.38	→	↘
10Y CZK	4.09	-0.22	→	↘
10Y PLN	6.08	-0.02	→	↘
10Y HUF	6.83	-0.26	→	↘
3M EURIBOR	0.75	0.00	→	→
10Y EMU	3.36	0.09	→	→

Last values from Friday 13:30 CET

Last week, the trend on Central European bond and forex markets in place since the beginning of this month continued. With the exception of the Czech koruna, Central European currencies are still faring well and government bonds are performing even better, with prices sharply higher. The governments of all of the Central European countries used this favourable constellation to patch their budget deficits and quickly subscribe quite significant amounts of government bonds in both domestic and foreign currencies.

The bullish sentiment in most Central European markets contrasts with the macroeconomic developments in the region. While the industrial output in Central Europe has improved slightly over the last two months, it is far from the recovery witnessed in regions like South-East Asia or Latin America. We see two possible explanations for this phenomenon. First, Central Europe, unlike the above-mentioned emerging markets, neither benefits from the growth generated by the Chinese 'engine', nor profits from the restored improvement in commodity demand. Secondly, numerous Eastern European economies (including Central European ones) have experienced a rapid credit boom in recent years, which fuelled private consumption. However, the rise in loans across the region has dramatically decelerated (in some cases, it is even negative), and this continues to affect the development of private consumption and consequently of economic growth.

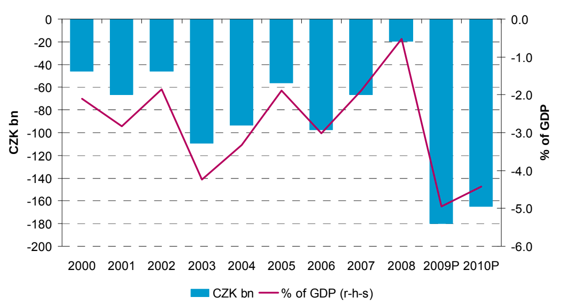
Hence, if Central Europe were to approach its previous growth rate, in the short term, it would only be foreign (i.e., Western European) demand that would again set the engine of Central European economies in motion.

Czech Republic

Macro review

In its first reading, the Lower House of Czech Parliament passed the state budget for 2010, with a deficit of CZK 163bn, or slightly below 5% of GDP. The draft budget has thus passed another round in the approval process, after which the amount of the deficit can no longer be changed, but it a shift of funds between the individual items of the budget is still possible. The budget approval process will be concluded by December's final vote, which will decide on the revenue and expenditure changes proposed.
Unlike this year's budget, the new budget is based on conservative economic forecasts. While this year's budget anticipated economic growth of 4.8%, the Czech economy is likely to actually decline by approximately 4.5%. For next year, the Ministry of Finance expects that the GDP will fall by 0.4%, due primarily to the restrictive package adopted. Unemployment should be around 8.5%, which means a rise by almost 2% compared to the figure expected for this year. For the sake of completeness, we add this is an unemployment rate according to the Labour Force Survey, which is lower than the rate calculated on the basis of Employment Offices' data.

State budget deficit



Compared to the original draft (before the adoption of the restrictive package), the anticipated government deficit went down by approximately CZK 70bn, mostly due to increased taxes and, to a lesser extent, due to a reduction in social security expenditure. The good news is that the deficit might be tens of billions of crowns lower than this year's; even so, its level is hardly sustainable in the long term. Although the Czech Republic is still one of the EU countries with the lowest government debts, the rate at which its debt (and consequently the interest pertaining to it) rises is enormous. For this and next year alone, the State needs to borrow some CZK 350bn and, in addition, needs to repay bonds for CZK 176bn. Hence public finances need to be profoundly reformed, be it on the expenditure or income side, or both, whether because of the need to comply with the Maastricht criteria or because of the ever rising costs of financing the debt. And the newly presented proposals – particularly for increasing social security benefits – will not help the budget at all.

Currency

EUR/CZK technical picture

(25.9500): Drop from 29.6900 highlights Triple Top off 26.3250 (2nd target at 24.9500 has been approached), with rebound off 24.9750 putting the pair currently above the inverted channel off 27.7000 (see graph)
1st support area at 25.6820 (Oct 19 low), with next levels at 25.5650/ .5300 (broken flat weekly Medium Term Moving Average/ break-up daily): needs to sustain back below to signal better standing of CZK.
Next levels would come in at 25.3150 (break-up hourly) and 25.1200 (Sept 29 low), where pause favored.
Resistance area at 26.0160/ .0200 (38.2% 27.7000 to 24.9750/ Aug 05 high + neckline Double Bottom: see graph), where pause favored.
Failure to cap would see risk towards 26.0880 (23.6% 29.6900 to 24.9750), ahead of 26.1400/ .1740 (July 08 high/ reinstalled monthly channel top off 1999 high): tough on 1st attempts.

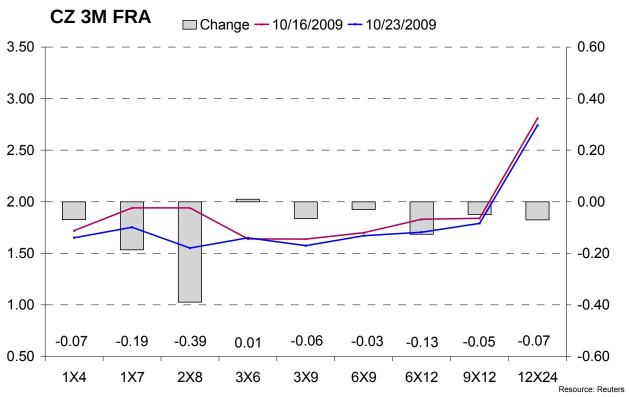
DAILY CHARTS:

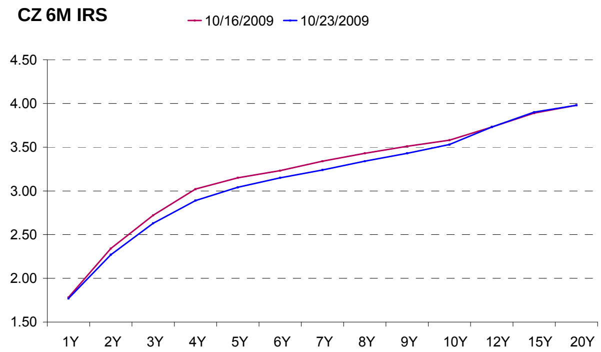
The **koruna**, as we could expect in the wake of the aggressively dovish statements from the Czech National Bank, continues to lag behind the performance of the other currencies in Central Europe and, notwithstanding the appreciation of the forint and the zloty, it weakened and even temporarily tested the psychological resistance at EUR/CZK 26.0 .
We don't expect a strong performance of the koruna in the next few days, as the currency may actually be in for an aggressive easing of the domestic monetary policy (Novem-

ber 5). In addition to a rate cut, which we expect, the CNB may extend its arsenal with direct forex interventions against the koruna. The fear of those threats may increase this week, should other members of the CNB Board deliver their (dovish) comments. They may do it until this Thursday, when the unofficially determined week of silence ahead of the CNB Board's monetary policy meeting starts.

Fixed income

Last week, Czech bonds had another breathtaking run, as the yield curve fell along its full length and flattened slightly. The demand for bonds was maintained by comments from central bankers, who reiterated their warnings of the slow disappearance of the recession, and even did not rule out a double dip recession with a relapse of growth in mid 2010.
Nevertheless, the main event on the market was the auction of another tranche of the 3Y bonds with a variable rate, which, in accordance with expectations, again attracted reasonable investor demand. Demand exceeded supply 3.04 times, as opposed to 2.29 times for the previous tranche, and this enabled the Ministry to increase the volume sold, from the originally considered CZK 5bn to CZK 5.13bn, at the average price of 102.53.
Also, the Ministry of Finance surprisingly announced that it had offered the 2.875%/2016 bonds for CHF 500m to foreign investors, i.e., a greater volume than the Ministry had anticipated a week earlier. The issue was only bought by asset managers and financial institutions. However, no other foreign-currency issue has been planned for this year, according to the Ministry.
The existing high yields and the continuing verbal interventions by the Czech National Bank should maintain the demand for bonds. In addition, the unexpected issue denominated in Swiss francs will reduce the need to issue Czech securities, and this will contribute to maintaining the demand. For next month, the Ministry is only planning one auction at the anticipated volume of CZK 5bn, and this should continue to drive yields down.

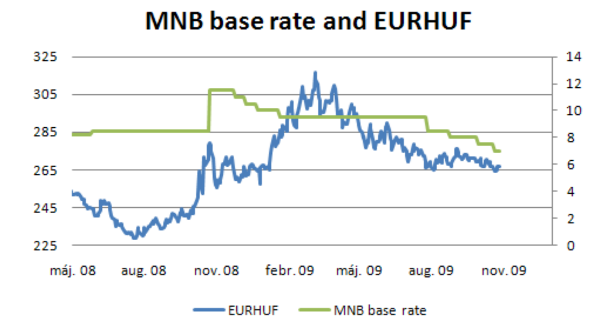




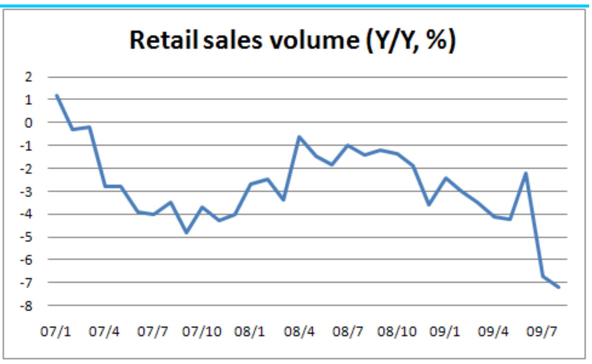
Hungary

Macro review

Central bank's meeting was the eye-catcher last week. The Council did not disappoint markets and delivered another 50bps rate cut to 7.00%.
A negative output gap, lack of demand pressures in inflation and below-target inflation projections for 2010 were mentioned as the main reasons behind the move, while the statement was more cautious on investors' risk appetite for Hungarian assets. Probably, the central bank is also surprised by the sharp rally in recent months on global markets and it may have concerns about the sustainability of the current level of risk appetite.



August retail sales data posted another sharp fall of 7.2% Y/Y after July's -6.7% Y/Y. Fiscal consolidation measures together with tighter retail credit have hurt the purchasing power of households, which are now forced to spend less and save more.



This could signal a weakening of domestic demand in the second half of the year, which would help the country to maintain the healthy external balance improvement visible in the second quarter. On the other hand, it could also undermine the recovery process, although the consensus has already been expecting the bottom for the third quarter, thus some deterioration of activity figures could be tolerated by markets.

This week's focus will be the unemployment data that could post the first double-digit unemployment rate since the mid-'90s. Producer prices may reassure markets about the lack of inflationary pressures, while final trade data from August may fine-tune the preliminary result of €229.4m surplus.

Currency

The currency get close to January highs by trading at 263.00 after the rate cut, but the appreciation did not last long and the pair corrected back to the 265.00 and 267.00 range.

EUR/HUF technical picture

(264.85): New reaction low off high, with pair toying with the Downtrendline off high (see graph).
Resistance at 266.78 (breakdown daily Oct 16), ahead of 269.35/ 270.00 (weekly flat Moving Average→/ breakdown daily Oct 09 + weekly Bollinger midline): ideal area to stay below to keep current mood on HUF.
Failure to cap would see next levels at 272.00/ 273.00 (Oct 08 high/ Sept 21 high), where pause favored.
Support at 262.85 (current new reaction low off 317.45), ahead of 262.08 (61.8% 227.87 to 317.45), where pause favored.
Failure to hold would see risk towards 261.06 (1st Irregular B off 278.00), ahead of 259.60/ 259.06 (3rd target of daily Triple Top off 275.05/ 2nd Irregular B): tough on 1st attempts.

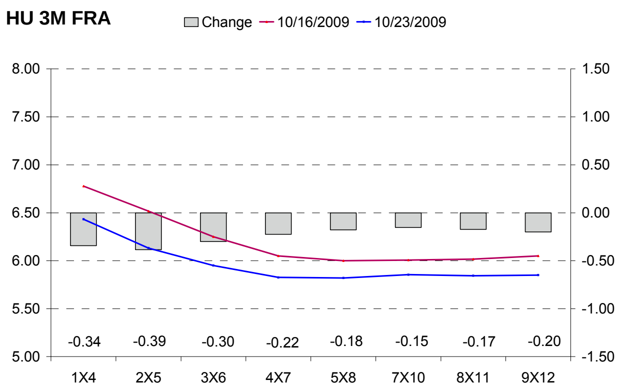
DAILY CHARTS:

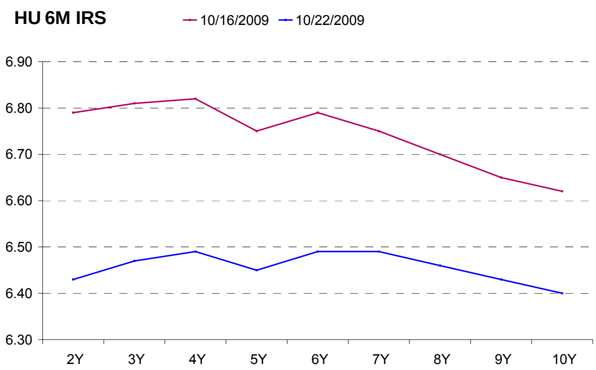
A less optimistic tone on global equity markets together with lower yields in Hungary made the forint carry trade less attractive in the second half of the week and even a weakening trend could now be formulated.

Central bank's data about transactions between domestic and foreign banks show that foreign investors sold about Ft2.5trn on the currency market and bought the equivalent of €10bn last autumn. This forint negative positioning however reversed after March and in the last 6-months almost all of this money has returned to Hungary. This information could signal that the recent appreciation was not been caused by new inflow, but rather by a short squeeze. The forint could thus become a really free-floating currency once the current support disappears.

Fixed income

The bond market rallied further last week and long-term yields approached the key 7.00% level towards the week's end. Currently, short-terms rates below 1-year are trading around 6.30-6.50% levels, while longer-term bonds of 10-year and 15-year maturities trade at 7.00%. The bull run could be partially attributed to narrower asset-swap spreads, which have narrowed at the long-end further to around 60bps last week. ASW spreads are tight zero at the short-end, thus players could find the long-end more appealing now. Sustainability of this spread game is however doubtful as a currency weakening could overwrite the sentiment quickly, but as long as the currency remains above the 270.00 level, the market may not react much.





Resource: Reuters

Poland

Currency

The **Polish zloty** strengthened last week, and closed the week below EUR/PLN 4.2. The Polish currency primarily appreciated at the very beginning of the week, when the strong rise in September's industrial output was announced. The strengthening forint and the weakened dollar also favoured the zloty. Nonetheless, the Polish currency only saw negligible changes on the following days, and slightly weakened at the very end of the week, after less favourable retail sales.

This week is free of more statistics; however, a central bank meeting has been scheduled for Wednesday. Rates are expected to remain unchanged, but the EUR/PLN currency pair may be influenced by the accompanying comments. Until then, the zloty should hover around its current levels; unless the central bankers suggest a rate cut, Poland's good fundamentals may again make the zloty strengthen.

EUR/PLN technical picture

(4.1780): Rebound off 4.0656 sent the pair toying back with 4.2250 (the neckline of a long term Double Top) and currently toying with Falling Wedge top off 4.9300 (see graph).

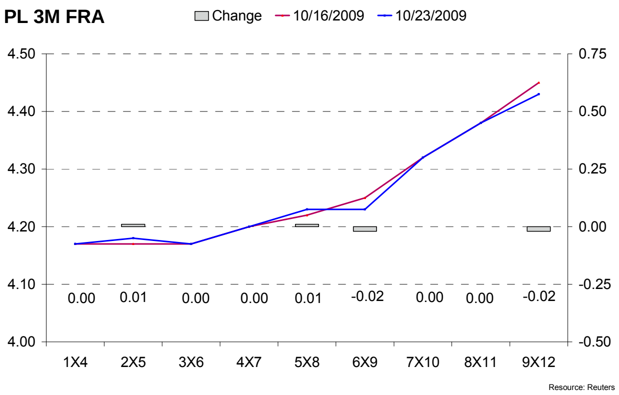
1st support area at 4.1584/ .1450 (broken flat weekly Medium Term Moving Average/ Oct 21 low): must sustain back below to signal improvement for Zloty.

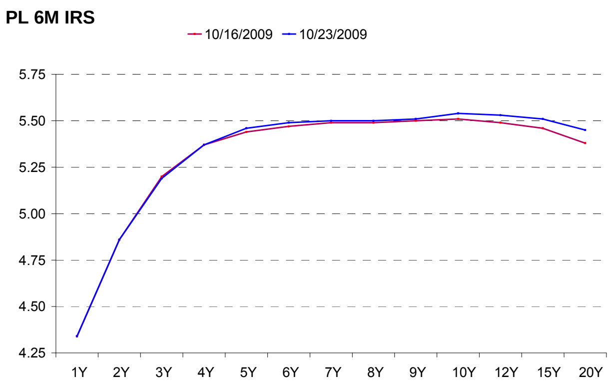
Next Support would come in at 4.1203/ .1111 (76.4% 4.0656 to 4.2975/ reaction lows hourly), where pause favored.

1st Resistance comes in at 4.2230 (weekly Bollinger midline), ahead of 4.2460 (breakdown hourly), where pause favored.

If wrong, next levels at 4.2897/ .2975 (Oct 12 high/ current recovery high off 4.0656): tough on 1st attempts.

DAILY CHARTS:





CE Weekly Preview

Wed 14:00	NBP rate (in %)	
	This meeting	Last change
rate level	**3.50**	6/2009
change in bps	**0 bps**	-25 bps

NBP is returning to a neutral mode

The Polish central bank should stay on hold and deliver more neutral comments suggesting that it slowly leaves its easing bias. The data flow and comments continue to support our view of interest rate stability till the end of the year and slow tightening during the next one

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	26.10.2009	09:00	Industrial output (%)	09/2009 *P		-13.5				-8.4
PL	**28.10.2009**	**14:00**	**NBP meeting (%)**	**10/2009**	**3.50**		**3.50**		**3.50**	
HU	29.10.2009	09:00	Unemployment rate (%)	09/2009			10.1		9.9	
HU	30.10.2009	09:00	Trade balance (EUR M)	08/2009 *F					229.4	
HU	30.10.2009	09:00	PPI (%)	09/2009					-0.5	4.6
CZ	30.10.2009	11:00	Money supply M2 (%)	09/2009						4.0

m/m - monthly change; y/y - yearly change; s.a. - seasonally adjusted; n.s.a. - non-seasonally adjusted; P - preliminary; F - final
EMU, USA, UK, JPY - figures seasonally adjusted, if not stated otherwise; Central Europe - figures seasonally non-adjusted, if not stated otherwise
Government Bond Auction: period = auction settlement date; m/m = total bids; y/y = supply

Our forecast

Official interest rates (end of the period)

		Current	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Last change	
Czech Rep.	2W repo rate	*1.25*	1.00	1.00	1.00	1.25	1.25	-25 bps	8/6/2009
Hungary	2W deposite r.	*7.00*	6.50	6.00	6.00	6.00	6.00	-50 bps	20/10/200
Poland	2W inter. rate	*3.50*	3.50	3.50	3.50	3.50	3.50	-25 bps	6/25/2009

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

		Current	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Czech Rep.	PRIBOR	*1.86*	1.65	1.70	1.70	1.80	1.85
Hungary	BUBOR	*6.90*	6.50	6.00	6.00	6.00	6.00

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

		Current	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Czech Rep.		*3.55*	3.65	3.70	3.80	3.80	3.90
Hungary		*6.51*	7.25	7.00	7.00	6.75	6.75

Exchange rates (end of the period)

		Current	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Czech Rep.	EUR/CZK	*25.9*	0.0	0.0	0.0	0.0	25.5
Hungary	EUR/HUF	*267*	270	270	275	270	270
Poland	EUR/PLN	*4.17*	4.20	3.70	3.60	3.60	3.30

GDP (y/y)

		Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010
Czech Rep.		*-4.8*	-3.1	1.5	1.4	0.5	0.7
Hungary		*-7.3*	-6.1	-2.4	-1.6	0.9	0.0

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

		Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Mar-10
Czech Rep.		*0.0*	0.8	0.9	1.1	2.0	1.9
Hungary		*3.7*	5.0	4.5	3.8	3.8	3.5

Current Account as % of GDP

	2008	2009
Czech Rep.	-3.1	-2.5
Hungary	-6.0	-3.0
Poland	-5.4	-4.5

Public finance balance as % of GDP (in ESA95 standards)

	2008	2009
Czech Rep.	-1.6	-5.8
Hungary	-3.9	-4.5
Poland	-2.7	-3.0

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