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KBC Banking & Insurance

Central European Weekly

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Czech Republic

Rate cut likely when the central bank meets this week

Hungary

Profit-taking send the forint to the key EUR/HUF 275 level

Poland

Polish central bank shifts to a neutral mode

The Week Ahead

Another CNB 25 bps Rate Cut on the Horizon, but Nothing More

Overview

Central Banks at the Czech-Polish Crossroads

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	26.45	2.27%	↘	→
EUR/PLN	4.245	1.75%	↘	→
EUR/HUF	273.3	2.34%	→	→
3M PRIBOR	1.84	0.00	→	↘
3M WIBOR	4.18	0.00	→	→
3M BUBOR	6.89	-0.01	→	→
10Y CZK	4.17	0.07	→	→
10Y PLN	6.11	0.03	→	→
10Y HUF	7.21	0.38	→	→
3M EURIBOR	0.73	-0.02	→	→
10Y EMU	3.26	-0.10	→	↗

Last values from Friday 13:30 CET

Every week, Central Europe proves to the investors on Wall Street and London's City that it is not a uniform region, where economies can be easily lumped together. The latest evidence is the divergence of the monetary policies in Poland and the Czech Republic.

Last week, the National Bank of Poland, after the release of a new inflation forecast, sent the clear message that time has come for a re-orientation of monetary policy and that markets should no longer hope for an easier policy stance and rate cuts. Inflation remains high and the Polish economy, as the sole exception in the entire European Union, has actually avoided recession, as delimitated by negative growth rates. Even better, the economy is showing signs of recovering. So, the central bank sees inflation risks. Therefore, we expect stable rates in the final months of 2009 that will at some point in 2010 followed by a gradual tightening of policy in 2010.

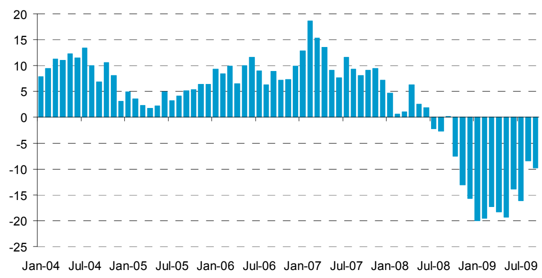
The Czech Republic also sees the first signs of recovery but, given the greater openness of the Czech economy, its economic decline was deeper and its recovery is also likely to be slower. In addition, the Czech Republic is far from being encumbered with increased inflation and is more likely to struggle in keeping inflation in the positive in the next months. The dovish statements by Governor Tůma and Deputy Governor Singer were inspired by fears of an undershooting of inflation compared to the target. Apart from the possibility of another rate cut, on which we definitely count, the central bankers will also discuss alternative options for a further easing of monetary policy, like direct forex interventions against the koruna. However, these should be avoided, because this threat and verbal interventions alone have already weakened the Czech currency significantly over the last month and eased the inappropriately tightened monetary conditions.

Czech Republic

Macro review

According to the first forecast of the Statistical Office, September's industrial output fell by 11.9%. Adjusted for the effect of the different number of working days, industrial output was down by 9.8% y/y. At first glance, the decline is greater than that of August, but it is still a figure than can be viewed positively in the context of today's situation, as August was significantly affected by transfers of employee holidays and large contracts for the automotive industry.
In the months ahead, industry will continue to benefit from the depletion of car inventories, a result of the effect of the German cash for clunkers program. However, the demand for other products of the domestic industry is only recovering very slowly. Nevertheless, year-on-year data from industry will start to approach the very low comparative baselines of the last quarter of 2008, and thus the year-on-year declines will no longer be as significant as in the first half of this year. We cannot even rule out that in December industry may show the first positive figure in the last fifteen months. However, the obstacle and the permanent risk, which will continue to curb the output will be the slow and poor recovery of European demand, which, in addition, will have to be counterbalanced by the fact that the extraordinary government measures of early this year will die down.

Industrial production
(%, y/y, working day adjusted data)



Industrial confidence worsened again slightly in October but in a perspective of about 6 months, confidence lingers at ongoing very low levels, slightly above lows registered in early 2009. While the industry is currently using more of its production capacities, it does not view the development of demand for the next few months optimistically. There are worsened expectations of the overall economic situation for the next three to six months, as well as worsened prospects for domestic and foreign demand and employment. The current decline in confidence is no great surprise, as the growth stimuli in Western Europe are gradually running out of steam and will hardly be substituted with private demand soon.

EUR/CZK technical picture

(26.4600) Rebound from 24.9750 trying to settle back above the neckline of long term Triple Top (26.3250) and puts the pair above the inverted channel off 27.7000 (see graph).
1st support area at 26.0200 (see graph: neckline Head and Shoulders bottom), with next levels at 25.6710 (rising weekly Medium Term Moving Average) and 25.5300 (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 26.6200 (current recovery high off 24.9750), ahead of 26.7770 (38.2% 29.6900 to 24.9750), where pause favored.
Failure to cap would see risk towards 26.8510 (potential of daily channel break off 27.7000) and 27.0570/ .27.0650 (76.4% 27.7000 to 24.9750/ last target off 26.0200: see above): tough on 1st attempts.

DAILY CHARTS:

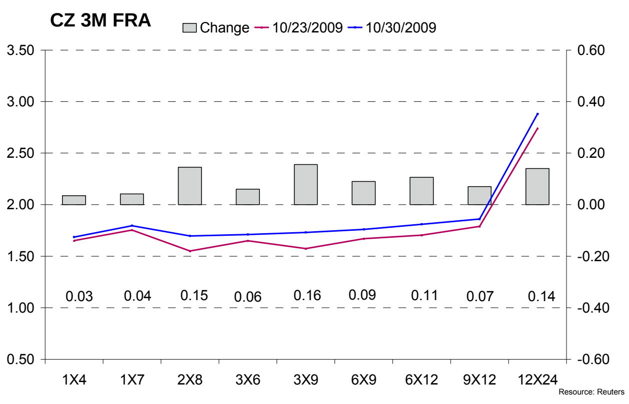
Currency

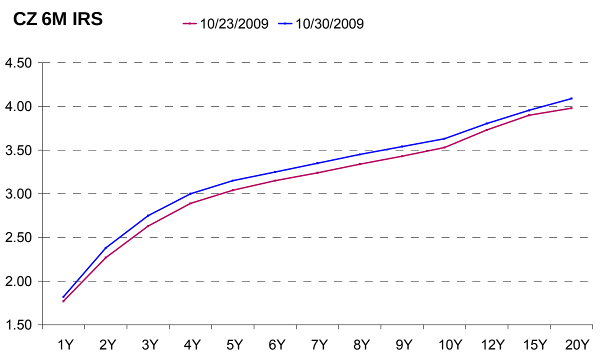
The Czech koruna continued to depreciate against the euro last week. At the very beginning of the week, the currency pair weakened to more than CZK 26.00 per EUR, and closed the week at CZK 26.50 per EUR, although the week was one day shorter, due to a bank holiday. The main reason for the depreciation of the Czech currency was probably the development of the aversion to risky assets, which was increasing in the first half of the week in particular. After all, notwithstanding the fundamental reasons, the other currencies of the region developed much the same.

Fixed income

Czech bonds fell last week; the yield curve went up along the full length and steepened, with short-term yields rising by 8 bps. At the very beginning of the week, the Ministry of Finance announced that an additional CZK 14 bn would be required to cover this year's deficit, likely to be raised by new issuance. Later, the Minister of Finance also unveiled some of the terms of the bond issue to be available to retail investors, which is planned for next year. This will include CZK 20 bn in 10Y securities, with the yield of 5% p.a. now being considered. These electronic format bonds will be available at Czech Post or over the Internet.

The main event of this week will be the Czech National Bank meeting. As the meeting is drawing near, increasing speculation is occurring as to whether the central bankers will cut rates again or support the economy in some other way. However, the depreciating koruna is reducing the conviction in the market that the rate cut is likely. However, we stand behind our call of a 25 basis points rate cut. Otherwise, major central bank meetings will be held abroad this week, namely of the FED, the ECB, and the Bank of England, and their decisions may also influence the Czech market. Until then, however, the currently predominant conviction that the global economy is starting to grow should rather continue to work against bonds.





Hungary

Macro review

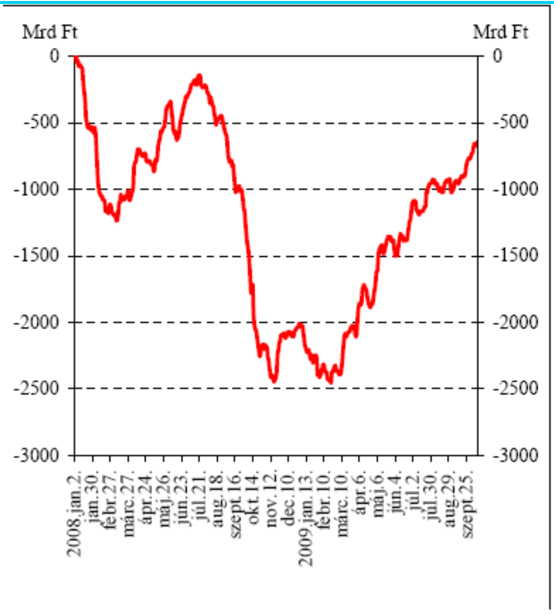
Last week was relatively quiet on the macro front in Hungary. Unemployment rose to double-digit levels between the monitored July-September period and reached 10.3%. This is in line with the consensus expectation for a bottoming out in the third quarter. Low growth below the potential level of 2-3% should push unemployment a bit higher in the coming quarters as the economy is not expected to reach this growth level before Q410.

This week will see new data on trade balance (September), the budget deficit (October) and industrial production (September). These could fine tune the path of the recovery, while the budget figure could be important to see the risks to meet this year's deficit target of 3.9% of GDP.

Currency

The forint had a bad week as the appreciation trend ran out of steam on Monday and the pair weakened throughout the rest of the week. The EUR/HUF rate reached the key 275.00 level by Thursday, which was followed by a quick recovery on Friday, but the market has so far failed to establish a firm ground above this level, hence risk of further weakness is on the cards.

The chart below shows central bank's data about foreign banks' position on the EUR/HUF market. It shows that there was large forint selling last year and earlier this year, which totalled Ft2,500bn or €10bn. It reversed after March and foreign banks have bought back almost all the forint they sold before.



As this type of 'short squeeze' flow runs out on the market, the next key challenge could be to establish long-run support behind the currency. Here, the appropriate interest rate level could be a key issue.

EUR/HUF technical picture

(273.00): New reaction low off high, but strong rebound puts the pair above the Downtrendline off high (see graph).

Resistance at 275.40/ 275.73 (current recovery high off 262.85/ 23.6% 317.45 to 262.85), where pause favored.

If wrong, next levels at 276.67 (50% 290.50 to 262.85), ahead of 278.00 (Sept 01 high + neckline Double Bottom: see graph): tough on 1st attempts.

Support at 270.45 (break-up daily Oct 27), with next levels at 267.80/ 266.40 (reaction lows hourly), where pause favored.

If wrong, next levels at 262.85 (current new reaction low off 317.45), ahead of 262.08 (61.8% 227.87 to 317.45): tough on 1st attempts.

DAILY CHARTS:

Fixed income

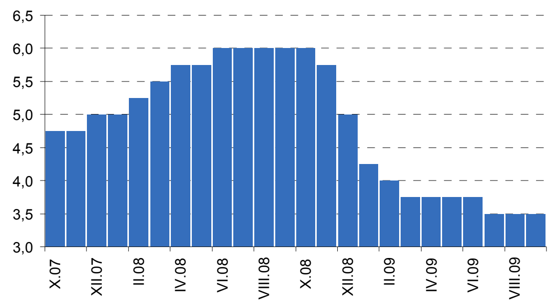
The bond market lost value with the weakening currency and yields rose about 50bps during the week. This means that yield levels are again close to the 7.25% level for bonds, while T-Bill yield levels inched up to around 6.50%. The FRA market forgot levels below the 6.00% figure and now expects the bottom of the rate cycle around 6.20%. This leaves the door open for further rate cuts, albeit at a slower pace from the current 7.00% level.

Poland

The Polish zloty came under pressure last week. The spike in risk aversion and the strengthening US dollar sent the pair as high as 4.29 EUR/PLN. Although the zloty failed to recover during a week, it posted more moderate losses as compared to neighbouring koruna and forint.

There was almost no reaction on the NBP meeting. The Central bankers, as expected, left the interest rates unchanged at the record low level of 3.5%. As the inflation remains elevated and the economy is on recovery track, the NBP used the new inflation projection to change its main policy stance. In the statement, they said that the risks of undershooting and overshooting inflation in the medium term are balanced. Previously the medium term risks were skewed in favour of undershooting. Now the board more officially confirms the neutral stance of monetary policy, which is in line with our view of interest rate stability until the end of the year and moderate tightening in 2010.

NBP rate (%)



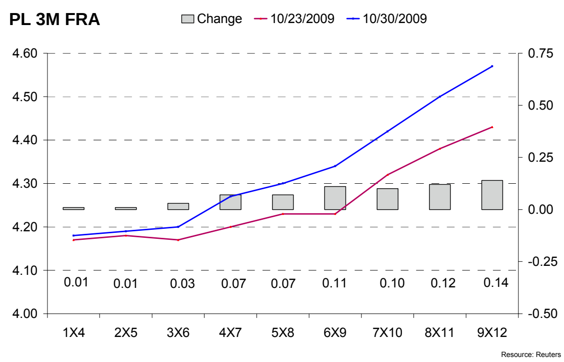
For the upcoming week, the zloty remains a toy in hands of global players. The domestic calendar is empty hence the attention should stick to the busy global one including US ISM and payrolls report, Fed and ECB meeting. Although the sentiment can remain somewhat negative in the near term, we stick to our mid-term bullish view and believe the zloty should continue to trade below its 50-week and 200-day moving average (4.31 EUR/PLN and 4.38 EUR/PLN).

EUR/PLN technical picture

(4.2450): Rebound off 4.0656 sent the pair currently back above 4.2250 (the neckline of a long term Double Top) and above the Falling Wedge top off 4.9300 (see graph).
1st support area at 4.2120 (reaction low on hourly charts), with next levels at 4.1713 (rising weekly Medium Term Moving Average): must sustain back below to signal improvement for Zloty.
Next Support would come in at 4.1450 (Oct 21 low), ahead of 4.1203 (76.4% 4.0656 to 4.2975), where pause favored.
1st Resistance comes in at 4.2897/ .2975 (Oct 12 high/ current recovery high off 4.0656 + see graph: neckline Double Bottom): tough on 1st attempts.
If wrong, risk towards 4.3110 (falling weekly Long Term Moving Average), ahead of 4.3203 (50% 4.5750 to 4.0656), where pause favored.

DAILY CHARTS:

Fixed income



CE Weekly Preview

THU 12:00	CNB base rate	
	This meeting	Last change
rate level (in %)	**1.00**	8/2009
change in bps	**-25**	-25

CNB Rate Cut on the Horizon

The CNB Board will again receive the first new inflation forecast in three months. Monetary policy inflation (which does not reflect changes to indirect taxes) should be, for the next 12 months, lower than that anticipated by the previous forecast. The GDP forecast for next year is also likely to be reduced, because of the risks of the recovery of the EU economies. The koruna also favoured a rate cut, but it has lost some of its strength in recent days and, together with the other currencies in the region, depreciated against the euro. However, it is quite likely that the koruna will recover soon and return to stronger levels. Therefore, we think the CNB board will vote for a rate cut to the new rock-bottom level of 1%.

FRI 9:00	CZ Foreign trade (CZK bn)		
	Sep-09	Aug-09	Sep-08
Balance	**18.0**	10.6	10.5
cummulative (YTD)	**118.0**	100.0	82.6
Exports (y/y in %)	**-10.0**	-8.8	4.8
Imports (y/y in %)	**-14.0**	-14.2	6.8

Trade Balance to show again a Higher Surplus

As indicated by the first forecast of September's industrial output, September's production and exports fared much the same as in August, and hence we expect that the year-on-year trade surplus will rise again. Additional arguments for an improved trade balance figure are the lower oil and natural gas prices, which reduce the value of imported raw materials. Therefore September's trade balance stands a good chance of posting an all-time record-breaking surplus for that month over the entire period when comparable statistics have been available. The trade surplus predicted for the whole of 2010, at CZK 100 bn, should be easily exceeded.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	2.11.2009	14:00	Budget balance (CZK B)	10/2009					-87.3	
HU	5.11.2009	09:00	Industrial output (%)	09/2009 *P		-17.0		-18.3	-0.5	-19.8
CZ	**5.11.2009**	**12:30**	**CNB meeting (%)**	**11/2009**	**1.00**		**1.25**		**1.25**	
HU	5.11.2009	17:00	Budget balance (HUF B)	10/2009	-1 200.0				-1 059.2	
CZ	**6.11.2009**	**09:00**	**Trade balance (CZK B)**	**09/2009**	**18.0**				**10.6**	
HU	6.11.2009	09:00	Trade balance (EUR M)	09/2009 *P	300.0				254.3	

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	3.75	4.00	-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	*1.84*	1.65	1.70	1.70	1.80	1.85
Hungary	BUBOR	*6.89*	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.		*3.69*	3.65	3.70	3.80	3.80	3.90
Hungary		*6.715*	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	*26.5*	25.7	26.0	24.8	24.8	25.5
Hungary	EUR/HUF	*274*	270	270	275	270	270
Poland	EUR/PLN	*4.25*	4.10	4.30	3.60	3.90	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	Dec-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	-6.0

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

	2008	2009
Czech Rep.	-1.6	-5.8
Hungary	-3.9	-4.5
Poland	-6.0	-6.0

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