Monday, November 09,

KBC Banking & Insurance

Central European Weekly

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Czech Republic

The Czech trade balance continues to show huge surpluses

Hungary

Industrial production back in positive territory in the third quarter

Poland

Polish inflation in the focus this week

The Week Ahead

Will Czech and Hungarian GDP readings mark the bottom of the business cycle?

Overview

CNB stays on hold and paves the way for a strong koruna

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.72	-2.74%	↘	↘
EUR/PLN	4.247	0.06%	↘	→
EUR/HUF	274.4	0.41%	↘	→
3M PRIBOR	1.83	-0.01	↗	↘
3M WIBOR	4.19	0.01	→	→
3M BUBOR	6.89	0.00	→	→
10Y CZK	4.22	0.05	↗	→
10Y PLN	6.13	0.03	→	→
10Y HUF	7.20	-0.01	→	→
3M EURIBOR	0.71	-0.02	→	→
10Y EMU	3.35	0.09	→	↗

Last values from Friday 16:30 CET

The Czech National Bank has never before seen its Governor and Deputy Governor be outvoted in the CNB Board twice in consecutive meetings; While we do not yet know the exact voting results of Thursday's CNB Board meeting (the exact result will be available in a week), it is quite likely that the four votes (out of seven) that decided to leave the CNB's repo rate unchanged included neither the vote of Governor Tůma nor that of the influential Deputy Governor Singer. The group that preferred rate stability outvoted the Governor, even though the CNB's new inflation forecast actually envisaged a repo rate cut, because its assumptions included a fall in the three-month Pribor, from today's 1.8% to 1.1% (or to 1.2%) in this quarter of the year, according to the central bank's projection.

Thus the CNB rates will continue to be above the rates of the ECB as well as the Fed after yesterday's meeting, and this will increase the attractiveness of the koruna against both the euro and the dollar. Therefore we believe that there is a great risk that the koruna may again hit the levels where it had settled before the verbal interventions by CNB Governor Tůma and Deputy Governor Singer. Hence the unpredictable exchange rate of the Czech currency will be the primary factor that will, just like last Thursday, again determine, in the middle of December, whether the bottom of the CNB's repo rate will be 1.25% or 1.0%. Obviously, however, with a strengthening global recovery the window of opportunity for a final cut slowly closes.

Czech Republic

Macro review

Last week, the CNB Bank Board decided to keep interest rates on hold by a narrow 4:3 majority. This was out of step with expectations following the release of the last vote outcome, where both the Governor and Vice-Governor had been in favour of cutting the key rate to 1%. Nevertheless, the close result of the vote shows that efforts were clearly being made in certain quarters to reduce the rates. One of the likely factors persuading the Board to leave rates unchanged was the latest central bank forecast discussed by the Board. Not only did the central bank raise the inflation outlook for the end of next year to 2.4% (up from 1.9%), but also stated that the koruna's exchange rate meant that there were upside risks to the forecast. This is somewhat surprising given that the crown's depreciation, which saw it deviate from the forecast level, was a short-lived episode influenced by interest-rate expectations and the shifting risk aversion among foreign investors.

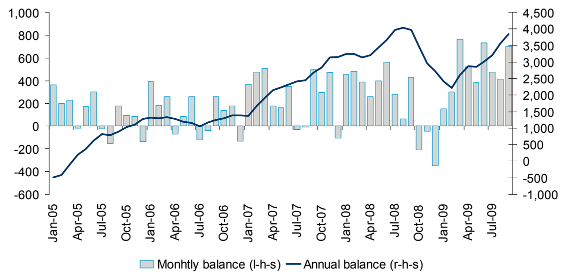
CNB stays on hold despite the new forecast envisages a W-shaped recovery. The CNB's latest prognosis also reveals that it expects the economy to fare better than it had been anticipating three months ago. GDP momentum is now forecast to grow at 1.4% in 2010, double the original figure of 0.7%. The CNB also projects that the economy will run out of steam over the next year as demand for Czech output wanes.

		New forecast	Comparison	Previous forecast
Inflation	2009Q4	0.1	⬇	0.7
	2010Q4	2.4	⬆	1.9
Monetary-policy relevant inflation	2009Q4	0.1	⬇	1.1
	2010Q4	1.6	⬇	1.9
PRIBOR 3M	2009Q4	1.1	⬇	1.6
	2010Q4	2.1	⬆	1.9
CZK/EUR	2009Q4	25.6	⬇	25.9
	2010Q4	25.7	⬆	25.6
GDP	2009	-4.4	⬇	-3.8
	2010	1.4	⬆	0.7

Even more interesting is the premise that year-end 3M PRIBOR market interest rates will stand at just 1.1%, leading to the only possible interpretation that the forecast clearly anticipated a reduction in the CNB's interest rates. The three-month market rate should not return to current levels until the second half of next year. This conclusion is not particularly consistent with the actual decision taken by the Bank Board and is open to various interpretations. The momentarily weaker koruna and the fact that some Board members are not keen on tweaking the rates any further may have played a role. All we can infer is that we may be in for another rate cut, depending on fresh economic figures and the ex-change rate in the coming weeks and months. Incidentally, the central bank is keeping to form by approaching its exchange-rate predictions very cautiously, and now envisages an effectively stable rate of EUR/CZK 25.70 throughout the next year.

In line with expectations, the foreign trade posted a surplus of CZK 17.8 bn in September. The year-on-year trade surplus is more than CZK 7 bn higher than in September last year, due in particular to cheaper raw materials, and partly also because of higher exports of machinery and means of transport. September's export results are still evidently influenced by Germany's bonus for scrapping cars, which propelled car makers, and enabled them to overcome the drop in output they had experienced in the first half of the year. The impact of the scrapping bonus will also be evident in October's exports, but its effect will subsequently peter out. On the other hand, we will see the positive effects of cheaper raw materials, which reduce the value of imports for a few more months. Cheaper oil and natural gas are shrinking imports by tens of billions of crowns, but are not the only reason why the trade balance has been steadily improving this year. The other, even more important, reason is poor domestic demand. The current trade balance figure should not be overvalued. Although the trade surplus is high, exports are continuing to fall at a double-digit rate (currently by almost 14%), with no sign of a turnaround at the moment. By the end of this year, the trade balance surplus will climb to CZK 110 bn. This will have been the highest year-on-year surplus ever, and we expect that this will definitely not be the last record-breaking figure.

Trade balance
(EUR million)



Currency

Last week, the Czech koruna fared the best of all of the Central European currencies. While it opened the week at CZK 26.58 per EUR, it took advantage of the favourable sentiment towards risky assets, and was probably also encouraged, although this is hard to explain logically, by the developments on the domestic political scene, where the Czech President enabled the ratification of the Treaty of Lisbon after lingering difficulties. And lastly, the Czech National Bank encouraged the koruna by leaving rates unchanged. The currency subsequently continued to appreciate, and closed the week at around CZK 25.70 per EUR.

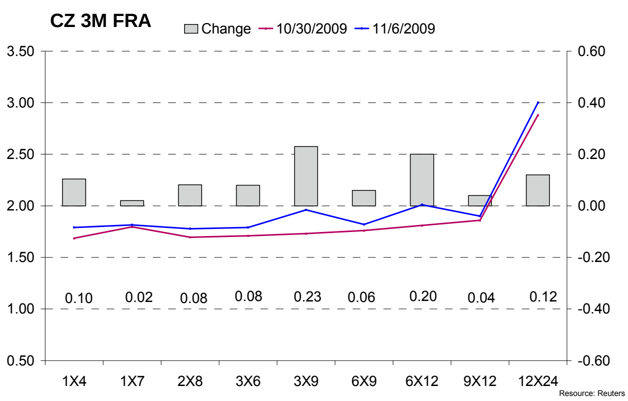
EUR/CZK technical picture

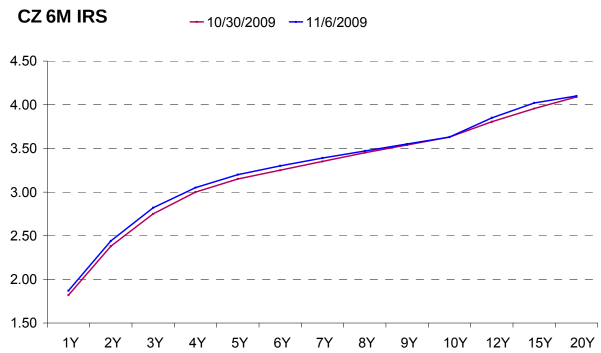
(25.7200) Rebound from 24.9750 failed to settle back above the neckline of long term Triple Top (26.3250), with drop from 26.6200 reapproaching the broken inverted channel top off 27.7000 (see graph).
1st support area at 25.6820 (Sept 19 low), with next levels at 25.6030 (61.8% 24.9750 to 26.6200), ahead of 25.5300 (break-up daily) and 25.3630 (76.4%), where pause favored.
If wrong, next level would come in at 25.1200 (Sept 29 low) and 24.9750 (reaction low off 29.6900): tough on 1st attempts.
Resistance area at 26.3350 (breakdown daily Nov 02), ahead of 26.6200 (current recovery high off 24.9750) and 26.7770 (38.2% 29.6900 to 24.9750), where pause favored.

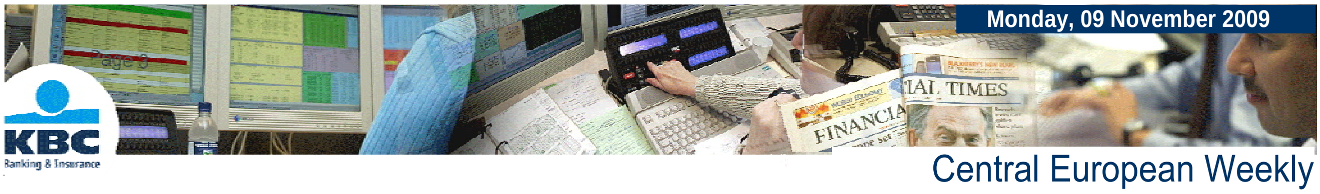
DAILY CHARTS:

Fixed income

Bonds fared well last week, but the yield curve in the end fell by no more than just 3.5 bps and steepened. The demand for bonds, particularly short-term ones, was maintained by the strengthening koruna and, at the end of the week, also by the CNB keeping its monetary policy stable after its meeting. Another stimulus to bonds was the announcement by the Ministry of Finance that it was planning just a single auction of the 5.70%/2024 bonds for CZK 6 bn, and a single treasuries auction for CZK 5 bn, for December. Thus the Ministry wishes to comply with this year's volume of securities (including treasuries) issued for CZK 280 bn. Later, however, the Minister of Finance admitted that he would have to ask the Lower House of Parliament for an additional issue this year worth CZK 14 bn, to cover social security expenditure in particular.
This week will be opened by the release of the consumer price index data. Another anticipated price fall will only confirm that there are still no risks of inflationary pressures, and this may maintain demand for bonds. Also, November's only issue – the 5.00%/2019 government bonds for CZK 5 bn – is under preparation for Wednesday. The previous tranche of the same securities, issued in early September, initiated reasonable demand; owing to the small volumes to be issued by the end of the year, we also expect robust demand this time.



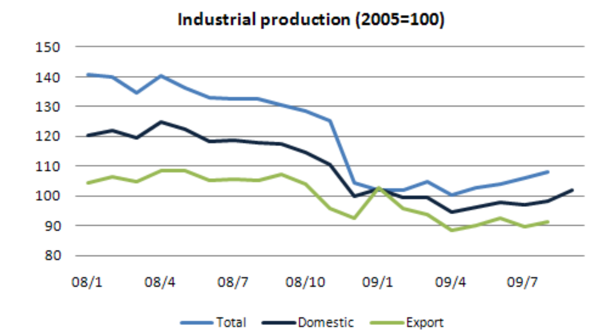


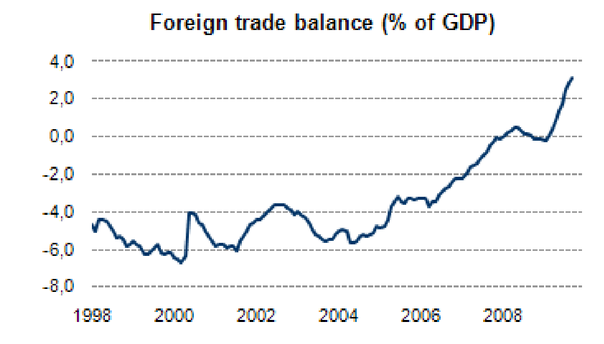


Hungary

Macro review

Recent macro data have been supportive for the recovery path of the Hungarian economy as economic activity seems to have been gaining momentum, while the external balance has remained on an improving track. Preliminary data showed 3.7% M/M increase of the industry in September, which surprised us on the positive side. With this data the third quarter expanded on a Q/Q basis, for the first time since the crisis began mid-2007. Better industrial production figures give a positive tone to this week's GDP release, although sharply contracting household consumption could counterbalance this.
In line with the slow recovery of activity, September foreign trade data showed another big surplus of €486m in the month. Export decline softened to 17.1% Y/Y, while import fell 23.0% Y/Y. The 12-month cumulative trade balance reached a surplus of 3.2% of GDP, pointing for a quicker recovery of the external balance this year than envisaged by the IMF program.





Last, but not least the government was happy to announce a budget surplus for October of Ft11bn. This brought down the year-to-date deficit to Ft1048bn, closer to the full-year target at Ft1000bn of 3.9% of GDP. It seems that the government is successfully managing the cash-flow figures to meet the target this year, which could keep the optimistic sentiment alive until the elections early next year. However, accrual based figures tend to differ significantly from the cash-flow based ones, so we would not rule out another round of revision of this year's figure to a higher level next year.

Currency

The forint reached a 4-months low at 282.00 at the beginning of the week, which acted as a turning point for the currency. Improving sentiment on global markets helped the revival of carry-trades, which lifted the forint, as well. The pair recovered to 273.00 by the end of the week and depending on the global conditions, the appreciation could continue for now.

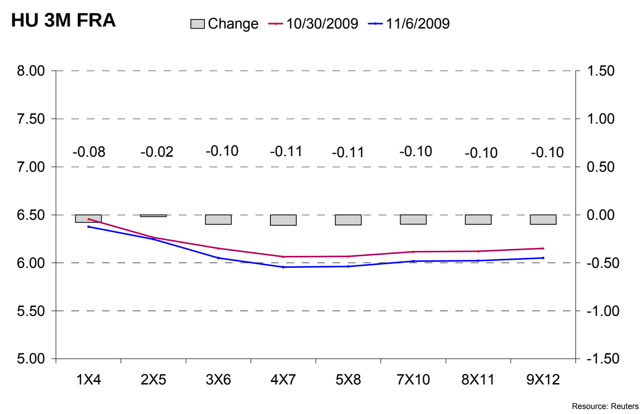
EUR/HUF technical picture

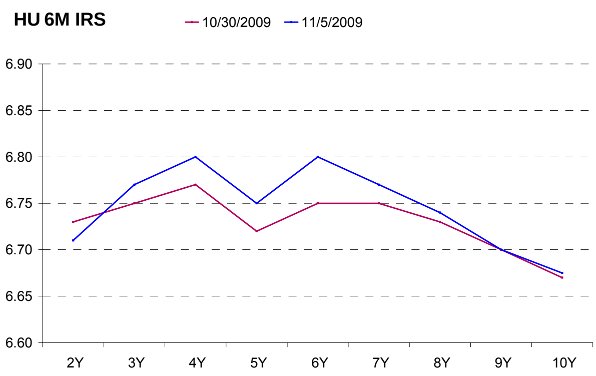
(274.00): Strong rebound off 262.85 puts the pair above the Downtrendline off high and tried to extend above 278.00 (see graph).
Resistance at 280.10 (reaction high hourly), with next levels at 283.60/ .70 (current recovery high off 262.85/ 38.2% 317.45 to 262.85), where pause favored.
If wrong, next levels at 284.56 (June 18 high), ahead of 284.93 (Irregular C off 262.85): tough on 1st attempts.
Support at 271.10 (reaction low hourly), with next levels at 270.77/ 270.45 (61.8% 262.85 to 283.60/ break-up daily Oct 27), where pause favored.
If wrong, next levels at 267.80/ 266.40 (reaction lows hourly).
262.85/ .08 = current new reaction low off 317.45/ 61.8% 227.87 to 317.45: tough on 1st attempts.

DAILY CHARTS:

Fixed income

The bond market lost about 25bps in yield terms with the weakening currency and has fully recovered this in the latter part of the week. The short-end is digesting the bottom of the easing cycle and the recovery brought back the long-standing view of a 6.00% bottom of the base rate in 3-months time. The long-end has remained anchored to an ASW spread of 70bps and a 5y5y forward spread of 200bps. Unless fundamentals surprise, current levels could remain with us for a prolonged period and range trading could follow the currency around these levels.



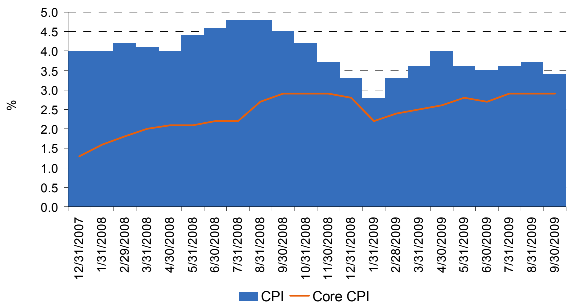


Poland

The calendar of domestic events was empty last week. The initial weakness of the zloty was driven by closing speculative positions in USD/PLN. The pair shot as high as 4.315 EUR/PLN, but failed to break above 50-week moving average. Furthermore later during the week the sentiment on the global equity markets turned positive and helped the zloty to come back to the 4.20 EUR/PLN area. Successful sale of Samurai bond and positive outcome of the largest European IPO of the year (PGE) have helped the Polish markets as well.

This week is just the opposite of the past one. The global scene is rather boring, but the domestic one slowly becomes more interesting. The major issue is October inflation, scheduled for the end of the week. It should show that the administrative and cost driven pressures are slowly waning out. That is not going to be a big surprise for the NBP, which should be comfortable with its neutral bias till spring 2010. In the short term the zloty should keep eye on the Wall Street sentiment.

Polish inflation, y/y (%)

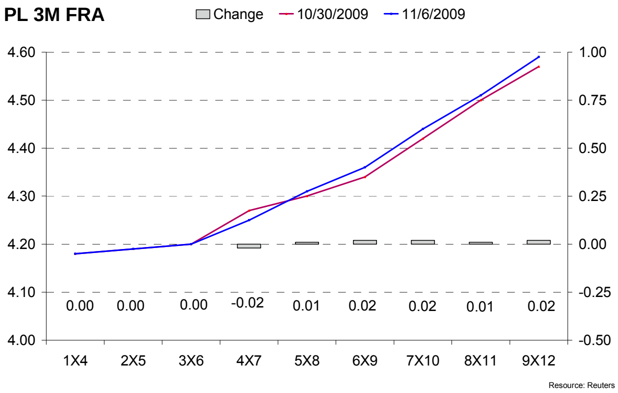


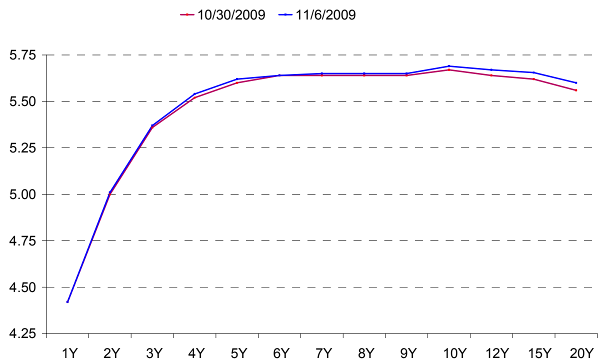
EUR/PLN technical picture

(4.2400): In Flag off 4.0656, with pair reapproaching the broken Downtrendline off 4.9300 (see graph).
1st support area at 4.2120 (reaction low on hourly charts), with next levels at 4.1978 (50% 4.0656 to 4.3300): must sustain back below to signal improvement for Zloty.
Next Support would come in at 4.1666 (61.8%), ahead of 4.1450 (Oct 21 low) and 4.1279 (76.4% 4.0656 to 4.3300), where pause favored.
1st Resistance comes in at 4.2951 (reaction high hourly), with next level at 4.3300 (current new recovery high off 4.0656): tough on 1st attempts.
If wrong, risk towards 4.3700 (breakdown July on daily charts), where pause favored.

DAILY CHARTS:

PL 3M FRA





CE Weekly Preview

WED 9:00 — **HU Inflation (change in %)**

	Oct-09	Sep-09	Oct-08
CPI y/y	**4.9**	4.9	5.1
core CPI y/y	**5.0**	5.1	4.6
Food y/y	**2.8**	3.0	6.3

HU: Headline Inflation Stays below 5 %

October inflation could have remained unchanged at 4.9% Y/Y as higher fuel prices counterbalanced the disinflationary effect of the recession. Core inflation may edge lower though.

WED 10:00 — **CZ Cur. Account (CZK bn)**

	Sep-09	Aug-09	Sep-08
C/A monthly	**-3.2**	-8.5	-11.1
cummulative (YTD)	**-20.5**	-17.3	-55.7
Trade bal. monthly	**20.0**	12.5	13.6
cummulative (YTD)	**138.3**	118.4	110.0

CZ: The Current Account Posts Only a Negligible Deficit

As we could see from September's foreign trade data (a surplus of CZK 18 bn), the current account is also very likely to show a fairly good figure. Although the outflow of yields including dividends will probably continue to be close to CZK 20 bn, the surpluses of the balance of services and notably the balance of goods should ensure that this year's current account will continue to develop much better than last year's.

FRI 9:00 — **CZ GDP (change in %)**

	Q3-09	Q2-09	Q3-08
GDP (y/y)	**-4.8**	-5.5	2.9
GDP (q/q)	**1.2**	0.1	0.5

CZ: GDP Flash Estimate Piont to Q/Q growth

While the preliminary GDP forecast, to be released by the Statistical Office on Friday, will not yet indicate any details on the structure of economic growth/downturn, we expect that the relatively good quarter-on-quarter figure will be primarily due to the improved development of foreign trade, inventories, and government expenditure. On the other hand, household consumption, and particularly investment, probably continued to be curbed. The year-on-year figure will still signify strongly depressed performance, but it should already bear out the expectations that the worst is over for the economy.

FRI 9:00 — **HU GDP (y/y change in %)**

	2009Q3	2009Q2	2008Q3
GDP	**-7.0**	-7.50	0.8
Fixed Investment	**-4.0**	-3.3	-1.0
Consumption	**-6.0**	-4.0	-0.6
Exports	**-17.0**	-14.0	17.6
Imports	**-28.0**	-22.6	15.0

HU: IP figures Show GDP May Surprise on the Upside

Third quarter GDP could surprise on the upside after industrial production expanded during the quarter from Q2 and net export's contribution to GDP could counterbalance the shrinking domestic demand.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	9.11.2009	09:00	Unemployment rate (%)	10/2009	8.6		8.6		8.6	
CZ	**9.11.2009**	**09:00**	**CPI (%)**	**10/2009**		**-0.1**	**-0.1**	**-0.1**	**-0.4**	**0.0**
PL	10.11.2009	14:00	Current account (EUR M)	09/2009					-69	
PL	10.11.2009	14:00	Trade balance (EUR M)	09/2009					-481	
CZ	11.11.2009	09:00	Industrial output (%)	09/2009 *F		-12.0		-12.0		-11.9
CZ	11.11.2009	09:00	Construction output (%)	09/2009						0.6
HU	**11.11.2009**	**09:00**	**CPI (%)**	**10/2009**		**4.9**			**-0.1**	**4.9**
CZ	11.11.2009	10:00	Current account (CZK B)	09/2009	-3.2		-5.5		-8.5	
CZ	13.11.2009	09:00	Retail sales (%)	09/2009		-6.0		-6.0		-3.5
CZ	**13.11.2009**	**09:00**	**GDP (%)**	**3Q/2009 *P**		**-4.8**				**-5.5**
HU	13.11.2009	09:00	Industrial output (%)	09/2009 *F		-17.0				-15.0
HU	**13.11.2009**	**09:00**	**GDP (%)**	**3Q/2009 *P**		**-7.0**				**-7.5**
PL	13.11.2009	14:00	Money supply M3 (%)	10/2009					0.9	
PL	**13.11.2009**	**14:00**	**CPI (%)**	**10/2009**					**0.0**	**3.4**

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*	1.25	1.25	1.25	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	*1.83*	1.80	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.		*3.67*	3.70	3.70	3.80	3.80	3.90
Hungary		*6.73*	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	*25.7*	25.7	26.0	24.8	24.8	25.5
Hungary	EUR/HUF	*275*	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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