KBC Banking & Insurance

Central European Weekly

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Czech Republic

Fall in industrial output slows sharply in October

Hungary

Household sector is able to repay about 10% of its debt a year

Poland

Polish economy on the way to weaker consumption growth

The Week Ahead

Czech fixed income market is waiting for the last bond auction this year

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	26.23	1.34%	↘	↘
EUR/PLN	4.178	0.50%	↘	↘
EUR/HUF	273.8	1.44%	↘	↘
3M PRIBOR	1.76	-0.05	→	→
3M WIBOR	4.19	0.00	→	→
3M BUBOR	6.43	-0.40	↘	↘
10Y CZK	4.08	-0.06	→	→
10Y PLN	6.18	0.01	→	→
10Y HUF	7.34	0.29	↘	↘
3M EURIBOR	0.71	0.02	↗	↗
10Y EMU	3.16	-0.10	↗	↗

Last values from Friday 13:30 CET

Contagion from Dubai seen mainly in currency markets

The news from Dubai frightened markets not only in Asia but also in other parts of the world and the fear of a default by a rich emirate was also evident in Central Europe. Paradoxically, the increase in the aversion to risk was primarily felt on the forex markets and, to a lesser extent, reflected on debt markets. The main victim of the Dubai debt affair was surprisingly the Czech koruna, while pressure for an increase in the government debt risk premium was only evident for Hungarian government bonds.

Central Europe's trade and financial relations with the Persian Gulf emirates are negligible and thus the spreading of a negative infection from that region into Central Europe truly does not make a great deal of sense. Even Hungary's high foreign debts doesn't include any real parallel to the excessively indebted Dubai, as there is a great difference between being a country that is Member State of the EU and being one of the autonomous emirates of the UAE. Thus we primarily view the depreciation of Central European currencies, and partly also the decline in bond prices, as a temporary negative correction, without any major fundamental basis.
However, it will be much more interesting to see how Central European currencies will close this week rather than last week, as this week will be replete with very important events. The ECB will discuss an exit strategy from its current eased policy, major business sentiment indices (including the PMI and ISM) will be published across the globe, and everything will culminate with U.S. labour market statistics. Over the next five days, we will thus see additional strong stimuli to increased volatility and even CE markets may have long ago forgotten Dubai by that time.

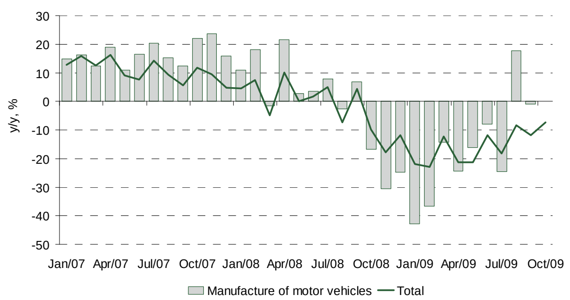
Czech Republic

Macro review

The freefall in industrial output is becoming a thing of the past and the situation in the most important sector of the Czech economy is beginning to stabilise. According to an initial estimate by the Statistical Office, the fall in industrial output in October had slowed 7.3% Y/Y and this figure even comes out at 5% after adjustment for a different number of working days.

This is a relatively good result in comparison to the previous months. On the other hand, the Czech industry will no longer be able to count on the stimulus from the German automobile scrap bonus. In addition, the year-on-year tempo has been calculated using the weak results from the end of last year as a base.
There is no doubt that the situation is stabilising but it is still not the right time for greater optimism yet. Orders are still falling at a double-digit rate and the ending of the scrapping bonus is forcing us to consider shut-downs in the automobile industry. The drop in industrial output for this year will probably exceed 12%.
The coming months should bring another slowdown in the fall in industrial output. This means that the most important sector could return to year-on-year growth as early as the start of next year. But even tin that scenario, companies won't stop reducing head counts and real wages won't post a visible rise. It is still too early for such a reversal. On the contrary, at the turn of the year we can still expect further reductions in employment in the industry. New jobs will start to reappear in larger numbers only after a more significant recovery in domestic and foreign demand.

Industrial production



Currency

The **Czech koruna** weakened against the euro last week. After a few days of testing the level of EUR/CZK 26.00 and given the lack of domestic events, the Dubai problems boosted concern about risky assets and this also weakened Central European currencies including the Czech koruna. The EUR/CZK currency pair closed the week at around EUR/CZK 26.360.
The Czech koruna may stabilise a bit after the huge Dubai sell-off at the beginning of the week. Nevertheless, global investors will stay cautious in a busy week and we do not expect the pair to go easily below 26.00 EUR/CZK.

EUR/CZK technical picture

(26.3700) toying back with the neckline of long term Triple Top (26.3250: see graph).
1st support area at 26.0360 (flat weekly Long Term Moving Average), with next levels at 25.8130/ .7800 (rising weekly Medium Term Moving Average/ reaction low hourly), ahead of 25.5850/ .4900 (break-up hourly/ daily), where pause favoured.
If wrong, next level would come in at 25.4100 (Nov 18 low), ahead of 25.3250 (Nov 11 low): tough on 1st attempts.
Resistance area at 26.4950 (current reaction high off 25.3250?), with next levels at 26.5580 (potential of channel break off 27.7000: see graph), ahead of 26.6200 (reaction high off 24.9750), where pause favoured.
If wrong, next Resistance at 26.8980 (June 15 high), ahead of 27.1050 (June 05 high): tough on 1st attempts.

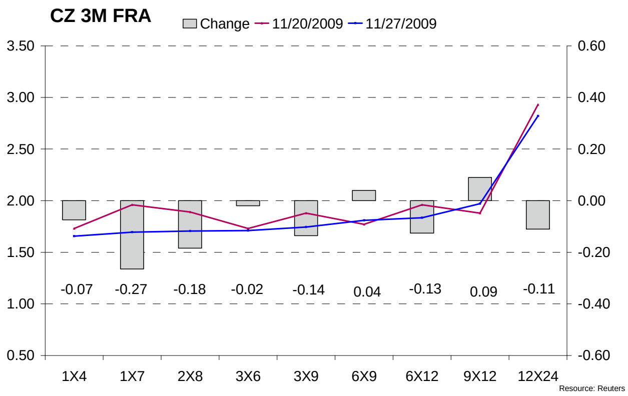
DAILY CHARTS:

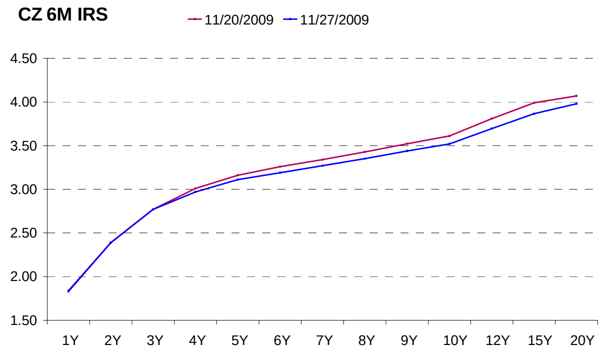
Fixed income

Czech yields went down along the full length of the curve and steepened last week, falling by 7 bps at the short end and 3 bps at the long end. However, the hallmark of most of last week's trading was small volumes and minimal changes, although pressure for the short end of the curve probably persisted after dovish comments by the Czech National Bank Governor and the Deputy Governor. However, the depreciating koruna curbed such stimuli. The Dubai problems boosted trading volumes, but the yield changes were again much lower than those of EMU bonds. The current yields are unlikely to provide much more latitude for a further fall this week and bonds should rather offset their price rises generated last week.

The main event of this week will be the last government bond auction of the year. The Ministry of Finance will supply the 5.70%/2024 bond at the planned volume of CZK 6 bn. We expect that the entire volume of the issue will be subscribed but demand is unlikely to exceed supply significantly.

The Ministry of Finance only has the short time remaining before the end of the year to decide how to finance the additional increase in this year's deficit by CZK 14 bn, approved by Parliament and mostly used for the payments of social security benefits.

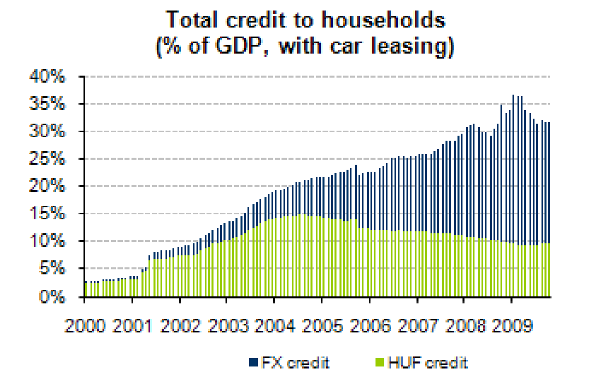




Hungary

Macro review

Last week was quiet on the domestic macro front as only unemployment data was released. It showed a further increase of the unemployment rate in October to 10.4% from 10.3%. The unemployment rate is expected to peak around 11.0%-11.5% in the next quarters.
Meanwhile, the central bank released data on bank credit. The October data showed a further decline of household loans, while corporate loans started to grow after 8-months of de-leveraging. It seems that the household sector is able to repay about 10% of its debt a year. This pace could warrant a faster decline of the country's external debt than was envisaged in the IMF program last year.



The central bank's new Inflation Report did not contain any surprise as it kept the old forecast of a deep recession (-6.7% Y/Y in 2009) intact, while the sub-target inflation path for 2011 was maintained. The short-term inflation outlook was improved marginally after lower inflation readings in recent months, but longer-tem prospects were kept unchanged. There are some dark clouds gathering over the medium-term on the fiscal side, again. The central bank raised its 2010 deficit projection to 4.5% of GDP from 4.2% of GDP due to revenue fallout. It also added that the government could take over maximum 2.7% of GDP debt from state-owned companies and institutions, which would boost the deficit to 7.2% of GDP. That could endanger markets next year, but until the current budget targets are met, like the one for the year-end, markets may ignore these prospects.

Currency

The forint spiked to the level of 275.00 on Friday amid the deteriorating global sentiment, triggered by the Dubai-case, but the market recovered 1% to the 272.00-272.50 levels.
Risk aversion is thus driving the market these days and if the recovery would continue, the forint may try to regain more ground. However, the recent sharp sell-off could also indicate how much the currency's vulnerability has increased over the past months with the central bank rate cuts as the lower interest rate environment is giving less protection to the forint.

EUR/HUF technical picture

(272.50): Strong rebound off 262.85 puts the pair above the Downtrend line off high but failed to sustain above 278.00 (see graph).
Resistance at 276.35/ 277.33 (61.8% 283.60 to 264.64/ 2nd target of hourly Double Bottom off 271.00), with next levels at 278.00 (see graph), ahead of 279.12 (76.4%), where pause favoured.
If wrong, risk would reopen towards 283.60/ .70 (reaction high off 262.85/ 38.2% 317.45 to 262.85): tough on 1st attempts.
Support at 271.00/ 270.50 (see above/ break-up hourly), with next levels at 268.80 (break-up daily), ahead of 266.66/ 265.40 (reaction lows hourly), where pause favoured.
If wrong, next levels at 264.64 (Nov 16 low + weekly Bollinger bottom), ahead of 262.85/ 262.08 (current new reaction low off 317.45/ 61.8% 227.87 to 317.45), where pause favoured.

DAILY CHARTS:

Fixed income

The bond market lost about 20-30bps in yield terms during the week. Long-term 10-year and 15-year yields rose to the key level of 7.50% where they may find support if the market would stabilise. The short-end remained close to the 6.00% level as the market is still looking for further rate cuts probably to below the 6.00% level.

Poland

Macro review

Poland has been viewed as the most resilient economy of the entire Central European region thus far and rightly so, as it remains the only economy in the European Union to maintain a positive growth rate throughout the crisis. In addition to the rapid fall in imports, Poland's GDP has been fuelled by private household consumption in particular, which has a much greater share of GDP in Poland than in its Central European neighbours (notably the Czech Republic). Polish household spending held up much better compared to the Major Western European economies in the first half of the year. This is primarily due to the surprisingly good development of the labour market as unemployment has virtually stagnated over the last few months.

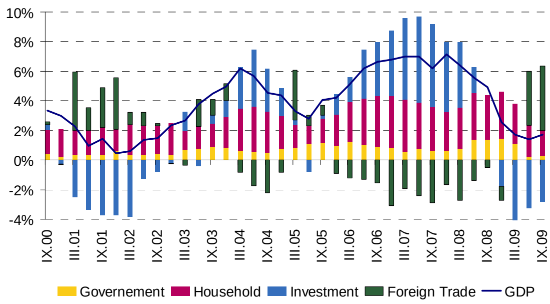
Nevertheless, the labour market situation may worsen with the end of the year drawing near. We believe that two facts have helped to achieve the existing results. A large proportion of Poles are employed in agriculture, which is not as dependent on the swings of the global economy as, for example, the industrial sector. Above all, however, Poles benefited from the above-average performance of its construction sector, which maintained a reasonable demand for seasonal workers. While EU construction output has fallen by 10% y/y on average, Poland's construction output has been rising by 5-10% in recent months. This is probably due to projects financed from Structural Funds and the preparations for the European Football Championship. While Poland's manufacturing industry has lost more than 200,000 workers since the beginning of the crisis, by contrast, about 200,000 jobs were created in the construction sector. Nevertheless, employment in construction is largely affected by seasonal factors, and the increased share of people employed in this sector should lead to a greater increase in unemployment in winter. This may curb consumption towards the end of the year, particularly in the important pre-Christmas months. Hence we expect that, at the end of 2009 and in the first half of 2010, the Polish economy will need to rely much more on the recovering exports, investment, and the replenishments of corporate inventories. This trend is partly visible in the fresh GDP figures for the third quarter (see the graph).

EUR/PLN technical picture

(4.1800): Drop from 4.3300 retested the broken Downtrend line off 4.9300 (see graph).
1st support area at 4.1300 (break-up on hourly charts), with next levels at 4.0955 (Nov 25 low), ahead of 4.0770/ .4.0656 (Nov 17 low/ reaction low off 4.9300), where pause favoured.
If wrong, next Support would come in at 4.0600 (weekly Bollinger bottom): tough on 1st attempts.
1st Resistance comes in at 4.2035 (50% 4.3300 to 4.0770), where pause favoured.
If wrong, next level at 4.2333 (61.8%): tough on 1st attempts.

DAILY CHARTS:

Polish GDP, y/y



Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	30.11.2009	09:00	PPI (%)	10/2009				-0.2	0.1	3.4
CZ	30.11.2009	09:00	Industrial output (%)	10/2009 *P				-8.0		-11.9
PL	**30.11.2009**	**10:00**	**GDP (%)**	**3Q/2009**				**1.5**		**1.1**
CZ	30.11.2009	11:00	Money supply M2 (%)	10/2009					4.3	
CZ	1.12.2009	12:00	Gov. bond auction (CZK 6B)	15Y						
CZ	1.12.2009	14:00	Budget balance (CZK B)	11/2009					-138.1	
HU	2.12.2009	09:00	Trade balance (EUR M)	09/2009 *F					485.6	
CZ	4.12.2009	09:00	Wages (%)	3Q/2009						1.4

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	*1.76*	1.80	1.70	1.70	1.80	1.85
Hungary	BUBOR	*6.43*	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.		*3.56*	3.70	3.70	3.80	3.80	3.90
Hungary		*6.885*	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	*26.3*	25.3	26.0	24.8	24.8	25.5
Hungary	EUR/HUF	*274*	270	270	275	270	270
Poland	EUR/PLN	*4.18*	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

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

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

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