Monday, January 25,

KBC
Banking & Insurance

# Central European Weekly

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

## Czech Republic

### CNB Board members threaten the market with more and more hawkish comments

## Hungary

### Real wages continue to fall and undermine domestic demand

## Poland

### Despite the global crisis labour market is developing surprisingly well

## The Week Ahead

### Another 25 bps rate cut by MNB's likely

# Overview

|  | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| EUR/CZK | 26.15 | 0.84% | ↗ | ↗ |
| EUR/PLN | 4.101 | 1.59% | ↗ | ↗ |
| EUR/HUF | 271.9 | 1.85% | ↗ | ↗ |
| 3M PRIBOR | 1.55 | 0.00 | → | ↗ |
| 3M WIBOR | 4.22 | -0.03 | → | ↗ |
| 3M BUBOR | 6.13 | -0.02 | ↗ | ↗ |
| 10Y CZK | 4.39 | 0.06 | ↗ | ↗ |
| 10Y PLN | 6.10 | -0.01 | ↗ | ↗ |
| 10Y HUF | 7.44 | 0.16 | ↗ | ↗ |
| 3M EURIBOR | 0.62 | -0.05 | → | → |
| 10Y EMU | 3.19 | -0.07 | ↘ | ↘ |

Last values from Friday 15:30 CET

## The Greece Contagion Has Not Yet Fully Hit the Region

The case of Greece and its vulnerable fiscal situation has been stirring financial markets for some time. From the Central European point of view, we need to monitor closely whether any negative contagion is spreading to the region.

Fortunately, if we look at the development of sovereign credit spreads, we find a surprisingly positive fact – markets have, thus far, distinguished between Greece, with its budget problems, on the one hand, and the fiscal positions of Central European countries on the other. Everything is clearly evident in the development of credit-default-swaps (CDS), which suggest that, while markets, through these instruments, have viewed the likelihood of Greece, Spain, or Portugal defaulting on their government debts as being much higher in recent weeks, the similar risk premium for Central European countries has remained virtually unchanged.
Of course, this may not necessarily hold true forever. If the crisis surrounding the Greek debt escalates and the Greek CDS hit, for example, the level we saw in Hungarian CDS a year ago (i.e., the risk premium will rise by an additional 200-300 basis points), the negative contagion will hit Central Europe too. What is more, the contagion will not only affect the prices of Hungarian, Polish, or Czech government bonds, it will also trigger downward pressure on regional currencies.
Nonetheless, given that the macroeconomic fundamentals of Central European economies will tend to improve further, the impact of the Greek contagion, if any, should be temporary and therefore rather be a good reason for reopening long positions in Central European currencies or bonds.

# Czech Republic

## Currency

The Czech koruna opened last week at EUR/CZK 25.94. However, after its appreciation to EUR/CZK 25.80, it started to weaken, due to the increase in the global aversion to risk after poorer U.S. statistics, the tightening of China's credit policy, and the problems surrounding Greece and its debt. The Czech currency was not even encouraged by a stronger comment from CNB Board Member Holman, who said that the first rate hike might occur as early as in the second quarter of the year. At the end of the week, the Czech currency was also affected by the declines in global stock markets and the new problems of Portugal's expanded deficit. Thus the currency pair closed the week at around EURR/CZK 26.20.

If the current negative sentiment on the markets prevails, the Czech koruna should remain under pressure. Nevertheless the barrier at 26.30 EUR/CZK may withstand as we consider the low-yielding Czech koruna to be the most resilient in case of a region-wide sell off.

## Fixed income

The Czech yield curve steepened last week, when yields at the short end fell by approximately 2 bps, and those at the long end rose by much the same value. With the lack of new domestic statistics, the market tended to react to central bankers' comments. First, the CNB Governor confirmed that the anticipation of another rate cut was unrealistic. At the end of the week, CNB Board Member Holman noted that rates might go up as early as in the second quarter of the year, and his colleague Zamrazilová confirmed this in her more moderate statement.

During the week, the Ministry of Finance announced that it was considering a bond issue denominated in dollars, for $1-2 bn, this year. In addition, the Czech Republic should gain approximately €1 bn from a similar issue in euros. Nevertheless, neither the amounts nor the foreign-currency issues have been finally determined yet, and are only being discussed at the moment.

The market will also pay attention to comments, if any, from CNB Board members this week, because no interesting figure will be released until Friday's industrial output. However, the main event of the week will be the 3-year government bond auction for CZK 8 bn with a 2.80% coupon. Shorter maturities are usually more in demand and, after the poor auction of the 5.00%/2019 bond in early January, the entire volume should be easily subscribed.

## EUR/CZK technical picture

(26.0500) Drop from 26.4950 tested the Uptrend-line off 24.9750 (see graph) and the broken monthly channel top off 1999 (25.8290).

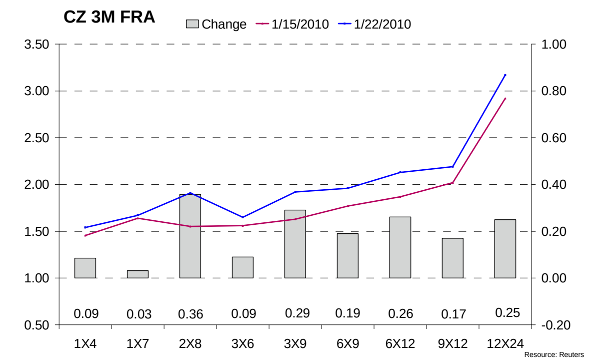
1st support area at 25.92 (break-up daily + weekly Bollinger midline), ahead of 25.7700 (Jan 19 low), where pause favored.

If wrong, next levels at 25.7210 (weekly projection band bottom), ahead of 25.6700 (medium term reaction low hourly) and 25.5800 (Dec 08 low): tough on 1st attempts.

Resistance area at 26.1660 (breakdown daily Jan 12): ideal area to stay below to keep current mood on CZK.

Failure to hold would see next levels at 26.2850 (reaction high hourly), ahead of 26.3900 (Jan 07 high) and 26.4850/ .4950 (Dec 31/ Nov 27 highs), where pause favored.

**DAILY CHARTS:**

# Hungary

## Macro review

During the week, only wage data about November were released. Wages declined 3% Y/Y in nominal terms, more than in October due to steeper (-7.8% Y/Y) fall of public wages.

Negative wage growth was only observed twice before, both were in January in the last two years, when the government brought forward the payment of the annual bonus to December from January. This time however, it is not just earlier payment, but a real cut back on salaries. Negative nominal wage growth also means that real wages are falling by 6% from a year-ago, which account for similar decline of retail sales and consumption.


This week's most important event will be the central bank's rate decision today at 1400CET. Consensus and we expect the central bank to cut the base rate by 25bps to 6.00%, but more important will be to see their logic behind the decision in order to collect some more info about the prospects. The market has been digesting the probability of a longer easing path down to 5.50% for months now, but there is no consensus about this. Some observers even highlighted the possibility of a no change decision today, which would clearly be a surprise and would likely strengthen the currency.

## Currency

The forint joined emerging currencies' losing streak last week and weakened about 2% from 266.50 to 272.50 by Friday. Tighter monetary conditions in China and a stronger dollar have also pushed players towards more cautiousness, which have lead to forint selling.

However, this weakening trend seemed to have run out of steam by this week and the forint recovered to 270.50 on Monday morning. Beside the global sentiment toward high-yielders, the central bank could also have some influence on markets if they dissent from earlier messages in any way.

## EUR/HUF technical picture

(271.00): Currently back above the 1st Down-trendline off high (see graph).

Resistance at 272.80/ .95 (Jan 21 high/ 50% 279.95 to 265.95): ideal area to stay below to keep current mood on HUF.

Failure to hold would see next levels at 273.05 (reaction highs hourly), ahead of 274.60 (61.8%): tough on 1st attempts.

Support at 267.80 (reaction low hourly), ahead of 265.95/ 265.13 (current year low/ weekly Bollinger bottom), where pause favored.

If wrong, risk towards 264.64/ .28 (Nov 16 low/ monthly envelope bottom), ahead of 262.85/ 262.08 (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 also lost ground with the weaker currency. Interest rates at the short-end rose to 5.75%, implicitly forgetting about the probability of a base rate below that level. Yields at the long-end rose close to the key 7.75% level, which could act as a support. Risk is probably for a recovery of bonds over the coming days, but investors are getting increasingly cautious about Hungarian securities before the April elections, which may allow markets to stay unchanged for a longer period.

# Poland

## Macro review

The Polish labour market is developing surprisingly well. Employment fell only slightly at the end of the year, while wage growth surprisingly accelerated (almost 7% y/y). Although industry slowed down in December and the weather started to worsen, Poland still employs more people than it did before the crisis (in early 2008).
The primary reason is the favourable demographic trend, which explains how unemployment in Poland may rise hand in hand with the increasing total number of staff. Poland, unlike most European countries, experienced a baby-boom in the 1980s, and this is a new workforce source now.
Remarkably, job-seekers from this source are able to find jobs during the crisis, and thus unemployment rose at a fairly moderate rate. The number of unemployed in Poland has increased by 40% since the beginning of the crisis (in the Czech Republic, by contrast, the number has almost doubled). The primary reason is the good performance of the construction sector, where almost 200,000 people have found jobs since the start of the crisis. This has counterbalanced the layoffs, to which particularly industrial exporters had to resort. We believe that the success of the construction sector is based on the preparatory work associated with holding the 2012 European Football Championship. In addition, the preparatory work is supported by the reasonable inflow of funds from Brussels.
Even so, we still remain cautious in our outlook for the first half of the year. We are not very nervous about the slightly worsened performance of industry; what makes us more nervous is that a greater percentage of the population is employed in construction. This may lead to a greater cyclicality of the labour market and a greater impact of seasonal layoffs. To our surprise, this probably had not yet had an effect in December. Nevertheless, January's frost across Europe is harder, and construction output is likely to be completely 'frozen' for some time. Also, greater declines in the number of jobs might temporarily curb otherwise strong domestic demand in the first half of the year.

## Currency

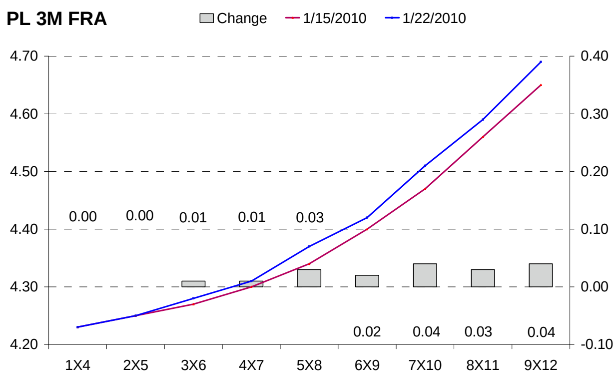
The Polish currency weakened at the end of the last week. The Polish zloty went to the 4.10 EUR/PLN, as it failed to break below 4.00 EUR/PLN during a week. After all, Central Europe still remains somewhat resilient to the growing number of global risks including Greece, financial regulation and Bernanke's reappointment.
Nevertheless if current panic on the global markets prevails we would be pretty cautious for the weeks ahead. The long speculative positions in the zloty are still high and a sudden escape would lead to sharper short term weakening. We do not expect the NBP to change its neutral stance on January meeting. Beside that retail sales figures could come out of near consensus and should not have a great potential to beat global negative sentiment.

### EUR/PLN technical picture

(4.0720): Scored new reaction low off 4.9300.
1st support area 4.0669 (break-up hourly charts), with next levels at 4.0290 (break-up hourly + (weekly Bollinger bottom), ahead of 4.0001/ .0000 (current new reaction low/ psycho), where pause favored.
If wrong, next Support would come in at 3.9795 (5th wave projection on hourly charts: sequence off 4.3300), ahead of 3.9490 (weekly projection band bottom): tough on 1st attempts.
1st Resistance comes in at 4.0950 (current reaction high off 4.0001?), with next levels at 4.1246/ .1261 (falling weekly Medium Term Moving Average/ 38.2% 4.3300 to 4.0001), ahead of 4.1290 (Jan 07 high), where pause favored.

**DAILY CHARTS:**


## Fixed income




Resource: Reuters

# CE Weekly Preview

| MON 14:00 | MNB base rate | |
|---|---|---|
| | **This meeting** | Last change |
| rate level (in %) | **6.00** | 6.25 |
| change in bps | **-25** | -25 |

## HU: Another 25 bps rate cut in MNB's pipeline

Central bank is widely expected to repeat December's 25bps rate easing in January down to 6.00%. The market's question is more about whether February's cut to 5.75% would be the last move or not.

## CZ: The Fall in Industrial Output is Over

| FRI 9:00 | CZ Industry (y/y change in %) | | |
|---|---|---|---|
| | **Dec-09** | Nov-09 | Dec-08 |
| Monthly | **-0.3** | -0.1 | -11.8 |
| cummulative (YTD) | **-13.6** | -13.0 | -1.8 |

One extra business day, the improved development of contracts, and the low comparative baseline were the main factors that influenced industrial output in late 2009. Temporary production shutdowns were probably also relevant in some firms (the automotive industry). Even so, we cannot rule out a pleasant surprise in the form a moderate rise in output, which will make itself felt to a greater extent at the beginning of this year. The reason is that the rate of output will be compared to the extremely low comparative baselines of the previous year, and thus at least the first half of the year will look favorably in the industrial sector at first glance. Yet we cannot expect that the drop stemming from the low demand in 2009 will be offset even during this year as a whole. The development of domestic industry continues to primarily depend on the recovery of foreign demand.

# Calendar

| | Date | Time | Indicator | Period | Forecast | | Consensus | | Previous | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | m/m | y/y | m/m | y/y | m/m | y/y |
| HU | 25.1.2010 | 09:00 | Retail sales (%) | 11/2009 | | -8.0 | | -7.1 | | -7.5 |
| **HU** | **25.1.2010** | **14:00** | **NBH meeting (%)** | **01/2010** | **6.00** | | **6.00** | | **6.25** | |
| HU | 26.1.2010 | 09:00 | Unemployment rate (%) | 12/2009 | 10.6 | | 10.7 | | 10.5 | |
| PL | 26.1.2010 | 10:00 | Unemployment rate (%) | 12/2009 | | | 11.9 | | 11.4 | |
| **PL** | **26.1.2010** | **10:00** | **Retail sales (%)** | **12/2009** | | | **20.9** | **6.1** | **-6.1** | **6.3** |
| **PL** | **26.1.2010** | **14:00** | **NBP meeting (%)** | **01/2010** | **3.50** | | **3.50** | | **3.50** | |
| **PL** | **28.1.2010** | **10:00** | **GDP (%)** | **12/2009 *A** | | | | **1.6** | | **5.0** |
| HU | 29.1.2010 | 09:00 | PPI (%) | 12/2009 | | 2.5 | | 1.3 | 0.5 | 0.3 |
| CZ | 29.1.2010 | 09:00 | Industrial output (%) | 12/2009 *P | | -0.3 | | | | -0.1 |
| CZ | 29.1.2010 | 11:00 | Money supply M2 (%) | 12/2009 | | | | | | 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 | Jun-10 | Sep-10 | Dec-10 | Mar-11 | Last change | |
|---|---|---|---|---|---|---|---|---|
| **Czech Rep.** | 2W repo rate | *1.00* | 1.00 | 1.00 | 1.25 | 1.50 | -25 bps | 16/12/2009 |
| **Hungary** | 2W deposite r. | *6.25* | 5.50 | 6.00 | 6.00 | 6.00 | -25 bps | 21/12/2009 |
| **Poland** | 2W inter. rate | *3.50* | 3.50 | 3.75 | 4.00 | 4.00 | -25 bps | 6/25/2009 |

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

| | | Current | Jun-10 | Sep-10 | Dec-10 | Mar-11 |
|---|---|---|---|---|---|---|
| **Czech Rep.** | PRIBOR | *1.55* | 1.55 | 1.65 | 1.80 | 2.05 |
| **Hungary** | BUBOR | *6.13* | 5.50 | 6.00 | 6.00 | 6.00 |
| **Poland** | WIBOR | *4.22* | 4.60 | 4.70 | 4.80 | 4.80 |

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

| | Current | Jun-10 | Sep-10 | Dec-10 | Mar-11 |
|---|---|---|---|---|---|
| **Czech Rep.** | *3.66* | 3.50 | 3.70 | 3.85 | 4.02 |
| **Hungary** | *7.04* | 7.75 | 8.00 | 7.50 | 7.25 |
| **Poland** | *5.65* | 4.50 | 4.50 | 4.50 | 4.50 |

*Exchange rates (end of the period)*

| | | Current | Jun-10 | Sep-10 | Dec-10 | Mar-11 |
|---|---|---|---|---|---|---|
| **Czech Rep.** | EUR/CZK | *26.2* | 24.8 | 24.8 | 23.8 | 25.5 |
| **Hungary** | EUR/HUF | *272* | 280 | 275 | 270 | 265 |
| **Poland** | EUR/PLN | *4.10* | 4.30 | 3.60 | 3.90 | 3.30 |

*GDP (y/y)*

| | Q3 2009 | Q1 2010 | Q2 2010 | Q3 2010 | Q4 2010 |
|---|---|---|---|---|---|
| **Czech Rep.** | *-4.1* | 1.8 | 1.7 | 0.9 | 1.4 |
| **Hungary** | *-6.0* | -1.5 | 0.5 | 1.0 | 2.0 |

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

| | Dec-09 | Jun-10 | Sep-10 | Dec-10 | Jan-11 |
|---|---|---|---|---|---|
| **Czech Rep.** | *1.0* | 1.6 | 2.1 | 2.2 | 2.0 |
| **Hungary** | *5.5* | 3.5 | 3.5 | 3.5 | 3.5 |

*Current Account as % of GDP*

| | 2009 | 2010 |
|---|---|---|
| **Czech Rep.** | -0.8 | -1.0 |
| **Hungary** | -1.0 | -0.5 |

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

| | 2009 | 2010 |
|---|---|---|
| **Czech Rep.** | -6.5 | -5.5 |
| **Hungary** | -3.9 | -5.5 |



| **Brussels Research (KBC)** | | **Global Sales Force** | |
|---|---|---|---|
| Piet Lammens | +32 2 417 59 41 | | |
| Peter Wuyts | +32 2 417 32 35 | Brussels | |
| Didier Hanesse | +32 2 417 59 43 | Corporate Desk | +32 2 417 45 82 |
| Joke Mertens | +32 2 417 30 59 | Commercial Desk | +32 2 417 53 23 |
| | | Institutional Desk | +32 2 417 46 25 |
| **Dublin Research (KBC Bank Ireland)** | | | |
| Austin Hughes | +353 1 6646892 | London | +44 207 256 4848 |
| **Prague Research (CSOB)** | | Frankfurt | +49 69 756 19372 |
| Jan Cermak | +420 2 6135 3578 | Paris | +33 153 89 83 15 |
| Zdenek Safka | +420 2 6135 3570 | New York | +1 212 541 06 97 |
| Jan Bures | +420 2 6135 3574 | Singapore | +65 533 34 10 |
| **Bratislava Research (CSOB)** | | | |
| Marek Gabris | +421 2 5966 8809 | Prague | +420 2 6135 3535 |
| | | Bratislava | +421 2 5966 8436 |
| **Budapest Research (K&H)** | | Budapest | +36 1 328 99 63 |
| Gyorgy Barcza | +36 1 328 99 89 | Warsaw | +48 22 634 5210 |
| | | Moscow | +7 495 228 69 61 |

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