Monday, February 08,

Central European Weekly

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

Czech Republic

CNB on hold as expected, as it adaopts a wait-and-see stance

Hungary

The bond market faced a sharp sell-off

Poland

The zloty only slightly affected by negative contagion

The Week Ahead

Czech GDP should record growth for the third quarter in row

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	26.19	0.01%	↗	↗
EUR/PLN	4.103	1.42%	↗	↗
EUR/HUF	274.1	1.06%	↗	↗
3M PRIBOR	1.53	-0.02	→	→
3M WIBOR	4.20	0.01	→	→
3M BUBOR	5.99	-0.01	→	↗
10Y CZK	4.46	0.11	↗	↗
10Y PLN	6.11	0.01	↗	↗
10Y HUF	7.67	0.26	↗	↗
3M EURIBOR	0.61	0.00	→	→
10Y EMU	3.10	-0.11	→	↗

Last values from Friday 15:30 CET

Is Central Europe Set for a Negative Correction?

Finally, Central Europe after all felt the negative impact of the increases in the risk premiums on government debts in the euro area. Even so, the depreciation – of both currencies and bonds – was only limited and temporary. Above all, the Polish zloty, which was able to hit this year's new highs and traded under the psychological level of EUR/PLN 4.0, demonstrated its strength and resistance to the increasing aversion to risk. We would like to add that the excellent fundamentals of the Polish economy really predestine the zloty to continue to appreciate. Any negative correction needs be viewed as a temporarily and, we believe, should be used for the reactivation of zloty long positions.

Perhaps, such an opportunity is arising right at the moment. The market concern about the fiscal development of the vulnerable members of the euro area has not yet receded, and this, in combination with some of the mixed statistics from the global economy, may lead to a stronger correction on emerging markets as well as in Central Europe. For example, Polish and Hungarian bonds, which still bear fairly high yields, have been in the black since the beginning of the year. We could hardly imagine that the Hungarian or Polish bond markets could maintain this year's gains if the sales of the government bonds of the peripheral countries of the eurozone persist.

Czech Republic

Macro review

The CNB Board's decision to leave interest rates unchanged was broadly anticipated. Yet the last CNB Board meeting necessarily drew attention, because a new inflation forecast was discussed there, and this, for the first time in three months, presents the CNB's updated 18-month view of the development of the Czech economy.
By and large, the central bank has not significantly changed its economic outlook since November. It still anticipates economic growth of around 1.4%, with the GDP to grow by 2% in the first quarter of the year and to ease afterwards. The central bank anticipates end-of-year inflation slightly above the target, although due in particular to tax measures. Monetary-policy inflation will only approach the inflation target slowly and will not hit it until the second quarter of 2011. The bank anticipates market interest rates to be slightly lower than expected in the previous forecast, while the exchange rate of the koruna against the euro should be slightly stronger, according to the new forecast. Overall, the forecast favours the stability of market interest rates in the first half of the year and their gradual rise in the second half. We only add that the risks of the new forecast are balanced, according to the CNB. See the table below for the comparison of the latest and previous forecast for the last quarter of this year and the second quarter of 2011.
The forecast indicates that the CNB, just like the ECB, is not in a hurry to tighten its monetary policy. Hence a rate hike is unlikely to occur before the second half of the year or, more probably, the end of the year, when the development of domestic and foreign demand may be securer and more stable. Naturally, the current development of inflation, which has ended up above the CNB forecast in recent months, will continue to be highly relevant. Nevertheless, we expect that the overall economic development, which is still affected by a great deal of uncertainty, will continue to be of greater relevance for the CNB's decisions than a short-term inflation divergence. While some statistics occasionally encourage us to be more optimistic, there is still time enough to tighten monetary policy. A strong and stable recovery is still well out of the question. And, given the anticipated continuation of curbed domestic demand (both consumer and investment demand), there is no need to be afraid of demand-pull inflationary pressures; more the other way round.

Currency

The koruna hovered near the EUR/CZK 26.00 last week. The currency opened as well as closed the week above that level, although it temporarily succeeded in appreciating slightly. The domestic scene provided few signals for the fluctuation of the Czech currency, with neither the CNB Board meeting nor the subsequent comments containing-surprises. Thus the main stimuli came from the EUR/PLN currency pair and from concerns that the problems of Greece might also spread to other countries, and this kept the EUR/CZK currency pair above the EUR/CZK 26.00.
The global picture does not look very encouraging. Hence we see some short term losses on the Czech FX market. Although domestic figures including GDP should continue to support the ongoing recovery and our short term pessimistic view is purely tactical, we would not by surprised to see the Czech koruna at 26.60 EUR/CZK level soon.

EUR/CZK technical picture

(26.2300) Drop from 26.4950 tested the Uptrend-line off 24.9750 (see graph).
Now reapproaching the neckline of long term Multiple Tops (26.3250).
1st support area at 25.9500 (break-up hourly charts), with next levels at 25.8700 (Feb 03 low), ahead of 25.7700 (Jan 19 low), where pause favored.
If wrong, next levels at 25.6700 (medium term reaction low hourly) and 25.5800 (Dec 08 low): tough on 1st attempts.
Resistance area at 26.3900 (Jan 07 high), where pause favored.
Failure to hold would see next levels at 26.4850/ .4950 (Dec 31/ Nov 27 highs), ahead of 26.6200 (Oct high): tough on 1st attempts.

DAILY CHARTS:

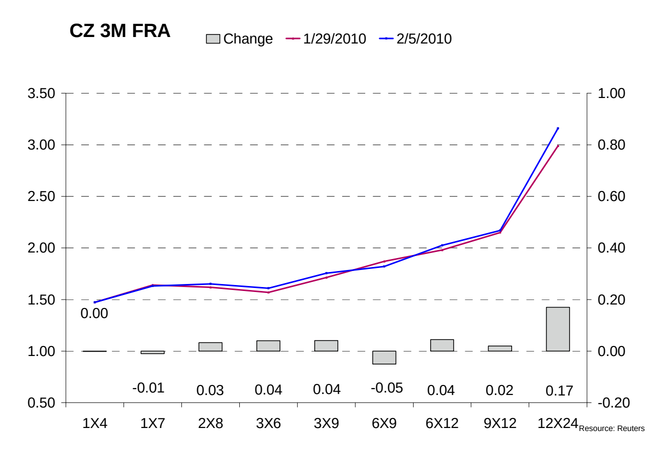
Fixed income

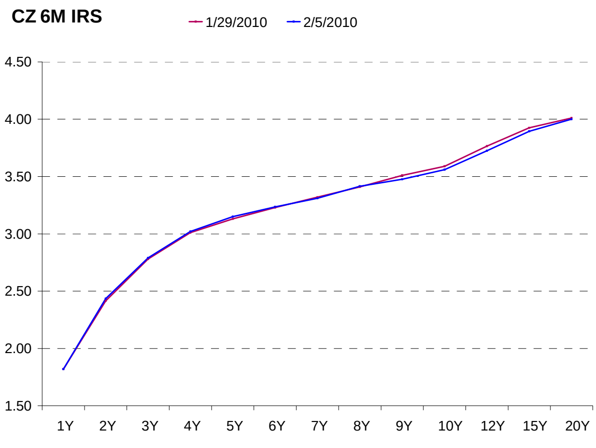
The Czech yield curve steepened last week, as yields fell by almost 9 bps at the short end and rose by nearly 3 bps at the long end. The domestic scene was free of major statistics, and the market ignored the surprisingly favourable January budget data. However, the decline in stock markets played a role, as did the concern about Greece and the spreading of its financial problems to other countries.

Nonetheless, the most important event of the week was Thursday's CNB Board meeting. A rate change had not been anticipated, and thus the market awaited the accompanying comment and a new inflation forecast. According to the comment, a rate hike is unlikely to occur until the second half of the year, and tax changes will temporarily increase inflation above the CNB's target.

Also, the Minister of Finance noted during the week that he was considering a foreign currency bond issue for €1-2bn in 2010. Previously, however, the Ministry had expected that up to a half of all new issues of the entire volume of CZK 280 bn might be denominated in foreign currencies. On Friday, the Lower House of the Czech Parliament approved the issuance of government bonds for CZK 153 bn to cover this year's state budget deficit, the approved deficit of which is CZK 10 bn higher.

This week, apart from the trade balance figure, which will hardly have any effect on markets, the data to be released at the very end of the week, such as the GDP for the last quarter, will be relevant. Thus the spotlight will be taken by Wednesday's auction of the 5.70%/2024 bonds for CZK 6 bn. Longer maturities are less in demand now, and therefore the Ministry will probably have to accept higher yields if he wants to sell the entire volume.

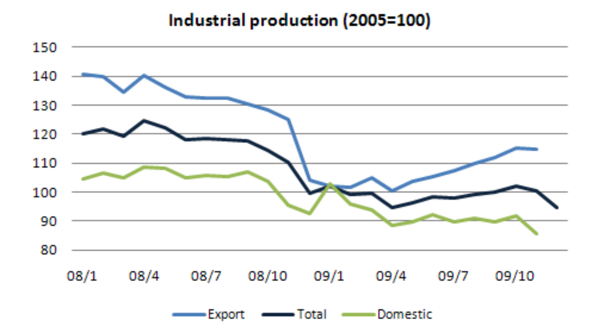




Hungary

Macro review

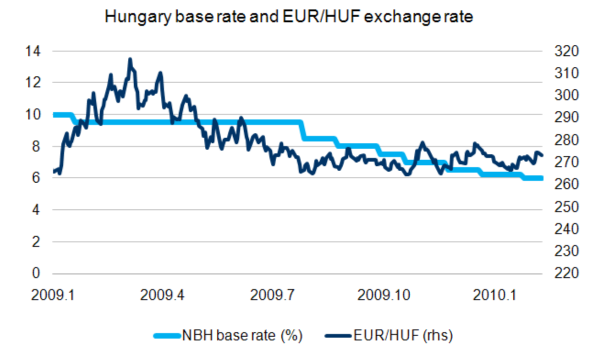
Last week's eco data shed some less favourable light onto the Hungarian economy as economic activity seems to have slowed down considerably in December.
The December industrial output fell 5.7% M/M and annual change remained negative (-1.4% Y/Y) against expectations for a small increase. January business indices were however promising, so we have to wait for at least one more data set to judge whether the probability of a 'W'-shaped recession has increased.



January budget balance came in at Ft31bn, down from last year's Ft37bn surplus. The election year makes the fiscal outlook ugly and the largest opposition party, Fidesz already said that the deficit will likely increase to 7-8% of GDP as state owned companies have large amount of debt to be taken over by the government. The main risk stems from social security funds', which have accumulated 30% of the planned full-year deficit already in January.
Good trade balance performance had also a setback in December to €271m from €400-450m in previous months. Weaker activity data suggests that export could have performed weaker in the month and thus the revival of export will be very important in January-February.

Currency

The forint's three-week long decline pushed the pair into a new low in 2010 around the level of 275.00. Rising fears from public debt in Europe triggered another wave of risk aversion that led to a major selloff in emerging market currencies. Trading range for the forint has probably shifted down to 272-275 for this week, while the longer-term outlook has remained dim and cloudy in our view.
This week's key data will be the January inflation on Friday, which is expected to rise only marginally to 5.7% Y/Y from 5.6% Y/Y. We however see greater chance for a higher reading probably at 6.0% Y/Y as regulated and fuel prices went up at the beginning of the year.



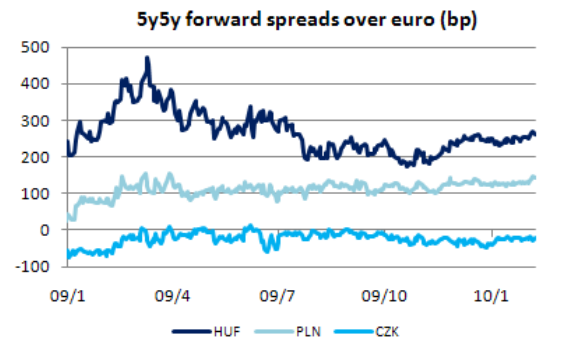
EUR/HUF technical picture

(274.50): Downtrendline off high under threat (see graph).
Resistance at 276.64 (76.4% 279.95 to 265.95), where pause favored.
Failure to hold would see next levels at 277.15 (weekly Bollinger top), ahead of 277.98 (monthly envelope top) and 279.95 (Dec 17 high): tough on 1st attempts.
Support at 271.60 (break-up hourly + daily), with next levels at 268.90 (Feb 03 low), ahead of 268.70/ .30 (break-up hourly/ daily), where pause favored.
If wrong, next levels at 265.95/ 265.61 (current year low/ monthly envelope bottom): tough on 1st attempts.

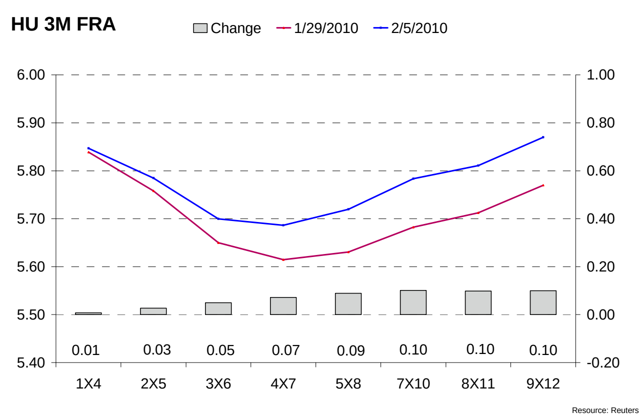
DAILY CHARTS:

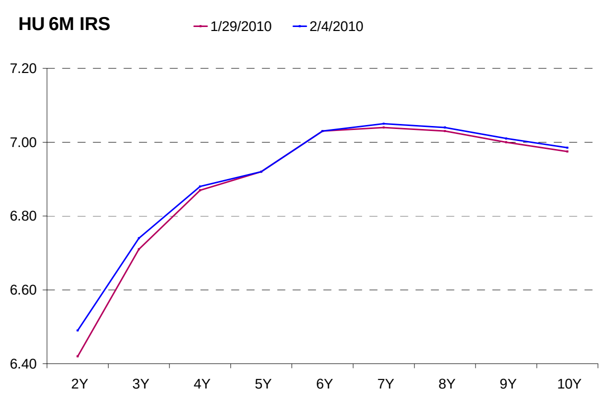
Fixed income

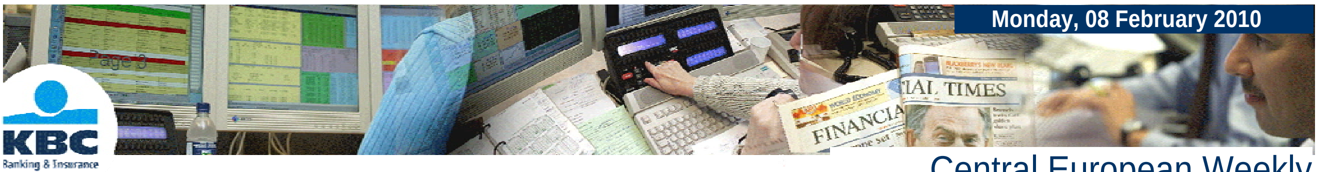
The bond market fell sharply throughout the week as the forint's selloff triggered similar moves for government securities. The popular 5y5y forward swap spread widened to the level of 270bps, which we have not seen since last July. This deterioration of the long-term outlook could be the result of mounting political risk due to elections in April, which could see modification of the fiscal path for the years ahead.



Widening long-term spreads are usually not a good sign for the outlook as it makes the market more vulnerable towards incoming news. It may also insist the central bank to halt with rate cuts and keep the base rate unchanged at 6.00% at this month's meeting due in two weeks time. Friday's inflation number may also influence the short-term outlook and the risk is one the negative side, in our view.







Poland

Currency

The Polish zloty failed to stay below the crucial 4.00 EUR/PLN level. Although it closed below that barrier on Monday and Tuesday, it surprised us how easily it came back in the defensive. As the currency came under pressure, the pair got as high as 4.14 EUR/PLN. The sell off at the end of the week was primarily driven by the weakness on both global and local equity market. Warsaw´s blue chip index fell almost 4% to its lowest since November.

The domestic calendar is empty for this week and we are pretty sceptical concerning the global emerging markets sentiment. Hence we see the risk of further short term losses on the Polish fx market in the sessions ahead. The Polish currency could also underperform the rest of the region, especially the Czech koruna, as several market participants are still long mainly in higher yielding Polish zloty.

EUR/PLN technical picture

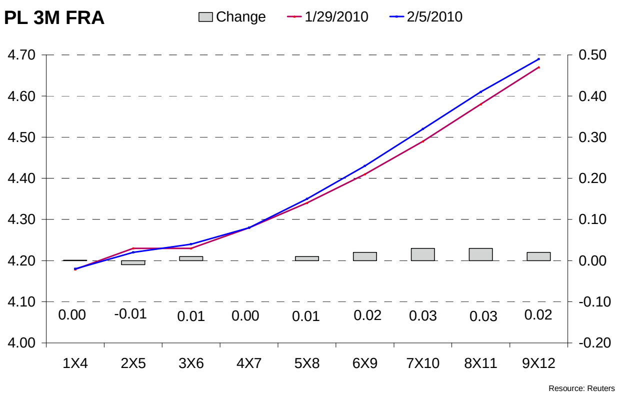
(4.0955): Scored new reaction low off 4.9300, in falling wedge pattern (see graph: top being approached).

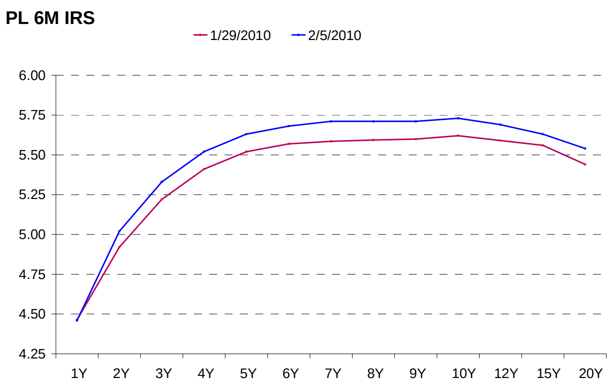
1st support area 4.0465 (break-up hourly charts), with next levels at 4.0110 (break-up daily), ahead of 3.9550 (current new reaction low), where pause favored.

If wrong, next Support would come in at 3.9206 (5th wave projection on hourly charts off 4.0770 in sequence from 4.3300): tough on 1st attempts.

1st Resistance comes in at 4.0988 (breakdown hourly + falling weekly Medium Term Moving Average), with next levels at 4.1135/ .1290 (Jan 27 high/ Jan 07 high) and 4.1425 (50% 4.3300 to 3.9550), where pause favored.

DAILY CHARTS:





CE Weekly Preview

TUE 9:00 **CZ Inflation (change in %)**

	Jan-10	Dec-09	Jan-09
CPI m/m	**1.6**	0.2	1.5
Food m/m	**2.0**	1.6	1.6
Housing, energy	**3.0**	0.0	4.7

CZ: Inflation is being driven by administrative moves

January's inflation was substantially affected by the increase in regulated rents, followed by the impact of the increased VAT and excise duties. As usual, seasonal food prices also went up. However, the forecast of the moderate reduction in energy prices is uncertain, as it could be partly offset by the increase in the fees for related services. The increase in month-on-month inflation was also boosted by fuel prices, which went up due to the increased excise duty. Notwithstanding these significant administrative moves, Czech inflation should not expand to any great extent. It is unlikely to hit the CNB's target until the second half of the year.

FRI 9:00 **CZ GDP (change in %)**

	Q4-09	Q3-09	Q4-08
GDP (y/y)	**-3.0**	-4.1	0.5
GDP (q/q)	**0.7**	0.8	-0.7

CZ: GDP in the red for the last time

The preliminary GDP forecast for the last quarter of 2009 should confirm the moderate economic recovery. Compared to the third quarter, the GDP might have grown by approximately 0.7%, but the economy will still show a year-on-year decline – for the last quarter probably. However, just like the CNB, we expect that the reasonable start of this year will be followed by a major slowdown of economic growth, which will persist until the end of the year. Nevertheless, GDP data is still subject to regular revisions and updates, and thus we are likely to see changes to previously released figures.

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

	2009Q4	2009Q3	2008Q4
GDP	**-5.0**	-7.10	0.7
Fixed Investment	**-5.0**	-6.8	4.3
Consumption	**-7.0**	-7.9	-0.4
Exports	**-3.0**	-6.9	12.7
Imports	**-2.0**	-14.6	10.5

HU: GDP still deeply the red

GDP fall could have softened during the last quarter of 2009 due to base effects, but preliminary data could disappoint markets expecting 4.8% Y/Y reading.

HU: Inflation bounces stihtly up

TUE 9:00 **HU Inflation (change in %)**

	Jan-10	Dec-09	Jan-09
CPI y/y	**6.0**	5.6	3.1
core CPI y/y	**5.2**	4.8	3.4
Food y/y	**3.5**	2.9	4.6

Inflation is expected to rise only marginally by the consensus to 5.7% Y/Y, while we see a more marked upturn to 6.0% Y/Y.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	**8.2.2010**	**09:00**	**Trade balance (CZK B)**	**12/2009**	**3.5**		**3.5**		**14.5**	
CZ	**9.2.2010**	**09:00**	**CPI (%)**	**01/2010**	**1.6**	**1.1**	**1.5**	**1.0**	**0.2**	**1.0**
HU	9.2.2010	09:00	Trade balance (EUR M)	12/2009 *P			266.5		409.5	
CZ	9.2.2010	09:00	Unemployment rate (%)	01/2010	9.8		9.7		9.2	
CZ	11.2.2010	09:00	Industrial output (%)	12/2009 *F		1.3				2.1
CZ	11.2.2010	09:00	Construction output (%)	12/2009						7.8
HU	**12.2.2010**	**09:00**	**GDP (%)**	**4Q/2009 *P**				**-4.1**		**-7.1**
HU	**12.2.2010**	**09:00**	**CPI (%)**	**01/2010**			**0.7**	**5.7**	**0.0**	**5.6**
CZ	**12.2.2010**	**09:00**	**GDP (%)**	**4Q/2009 *P**		**-3.0**		**-2.7**		**-4.1**
CZ	12.2.2010	10:00	Current account (CZK B)	12/2009	-4.0		-9.0		-1.6	
PL	12.2.2010	14:00	Current account (EUR M)	12/2009			-862		-1 272	
PL	12.2.2010	14:00	Money supply M3 (%)	01/2010			0.4		2.9	
PL	12.2.2010	14:00	Trade balance (EUR M)	12/2009			-804		-292	
PL	12.2.2010	15:00	Budget balance (PLN M)	01/2010					552.1	

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 = suppl

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.	*6.00*	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	*1.53*	1.55	1.65	1.80	2.05
Hungary	BUBOR	*5.99*	5.50	6.00	6.00	6.00
Poland	WIBOR	*4.19*	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.	*3.59*	3.50	3.70	3.85	4.02
Hungary	*7.1*	7.75	8.00	7.50	7.25
Poland	*5.74*	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	*274*	280	275	270	265
Poland	EUR/PLN	*4.11*	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

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