Monday, May 31, 2010

Central European Weekly

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

Czech Republic

Social Democrats win the elections, but there will be a right-wing government

Hungary

MNB disappoints and leaves its base rate on hold

Poland

Severe winter slows down the Polish GDP growth

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.85	0.56%	↘	↘
EUR/PLN	4.071	-1.16%	↘	↘
EUR/HUF	274.4	-1.52%	→	→
3M PRIBOR	1.24	0.00	→	→
3M WIBOR	3.86	0.01	→	→
3M BUBOR	5.21	-0.02	↘	↗
10Y CZK	4.18	0.13	→	↗
10Y PLN	5.76	-0.02	→	↗
10Y HUF	7.05	-0.06	→	↗
3M EURIBOR	0.70	0.02	↗	↗
10Y EMU	2.67	0.01	↗	↗

Last values from Friday 15:30 CET

Czech elections bring a market-friendly political context

The outcome of the Czech Republic's general election and the meeting of the National Bank of Hungary are the two interesting events that effect Central European markets early this week.

As far as the Czech election is concerned, markets patiently (but little nervously) awaited the election outcome. Regarding the results, although Social Democrats (CSSD) won the popular vote, because the ČSSD has no chance to form a left-wing coalition government, a new right-wing government collation will likely be formed. Such a coalition would have a comfortable majority in the Lower house of the Parliament (118 votes of 200). If the talks are successful, the result will be a coalition that aims to cut the budget deficit (through spending cuts) as soon as possible, crack down on corruption, as well as reform the pension system. In our view, the above outcome of the general elections is very market friendly. Should the fiscal restriction with anti-corruption measures be applied effectively, it would support strongly both the koruna and Czech bonds in the medium term.

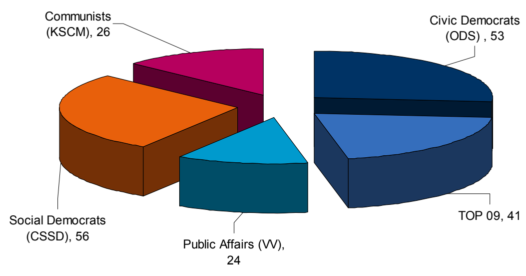
In Hungary, by contrast, the election has been over for some time and, before the new government presents a revised fiscal outlook for Hungary for the years to come, markets on Budapest (particularly the bond market) will have to cope with the fact that the MNB disappointed part of the market as it kept its base rate unchanged (at the 5.25 % level).

Czech Republic

Macro review

The election to the Chamber of Deputies was won by the Social Democrats (CSSD), but they will most likely not be able to form a government. Neither the lead which the Social Democrats have over the runner-up – the Civic Democratic Party (ODS) – nor their electoral gain will probably be enough for them to become the governing party. Overall, it could be said that the results achieved by both of these parties, which have been dominant until now, were weak in these elections (CSSD 22.1%, ODS 20.2%). The post-electoral negotiations thus for the time being indicate that a centre-right coalition could be created here, consisting of the Civic Democrats and two new parties (the conservative TOP09 and Public Affairs - Veci verejne, which is positioned in the centre of the political spectrum), which right off the bat, in their electoral premiere, achieved double-digit results. Unlike coalitions from previous years, the centre-right coalition could have a majority of 114 votes in the 200-member Chamber of Deputies, which would ensure that it could govern comfortably and allow for the possibility of putting through the necessary reforms. The Czech Republic could after many years have again a strong government, which won't be based on a fragile parliamentary majority or so-called political turn-coats. It would thus gain the chance for the necessary reform of public budgets, the pension system, education, and healthcare, which these potential coalition parties endorse. It should be clear in the coming days or even hours who will be given the first chance by the President of the Republic to draw up a government, or rather a coalition consultation about a government. This will also subsequently influence the period over which the current "caretaker" government, which has served more than its time, will still remain at the figurative helm.

Election to the Chamber of Deputies: Seats allocation to parties



Business confidence is continuing to grow in the CR. While business confidence only grew slightly in May, the trend, which confirms the gradual recovery of confidence to the level recorded here just before last year's economic recession, remains positive. Not only industrial enterprises but also businesses active in construction, wholesale/retail, as well as services view the development of the economy more positively. The common denominator is a more favourable view of the current situation. However, businesses view the developments in the next 3-6 months differently. Consumers also remain cautious in their expectations. The expectations for the next 3-6 months have only improved slightly in the industrial sector. This is in line with the positive trend of industrial contracts, which show significant year-on-year increases. While these are increases from very low levels, the fact that almost all industries in the CR have already bottomed out is positive. The evaluation of the current developments has also improved in construction, but, unlike the industrial sector, the expectations for the next 3-6 months are decreasing. A lower volume of contracts, which is primarily troubling building construction, is probably to blame for this. The decline in housing construction is particularly evident, but commercial construction has probably not yet hit bottom either. A similar view of the confidence development also applies to retailers. They view the current situation more positively than a month ago, but they are more cautious with respect to the months to come. A decline in consumer confidence, which is probably due to concern about the development of consumers' financial situations in the upcoming period, is also worth mentioning. If we summarise May's confidence data, **we find that neither businesses nor consumers have succumbed to optimism, although the figures that reflect the development of the economy in the previous months are rather positive. Concern or cautiousness persists as to another deceleration of the improvement in demand in the second half of the year**.

Currency

For most of the week, the Czech koruna moved within the narrow bounds of EUR/CZK 25.44-25.78. With the absence of major domestic stimuli, the currency lacked strong stimuli to greater fluctuations. At the very end of the week, with the increasing nervousness about the outcome of the general election, the koruna weakened somewhat to CZK/EUR 25.94

Surprisingly positive outcome of Czech elections should be positive for the koruna – especially in the midterm. Although the koruna has easily erased its pre-election losses, we remain still cautious as the short term development is more about global fears of euro-financial contagion.

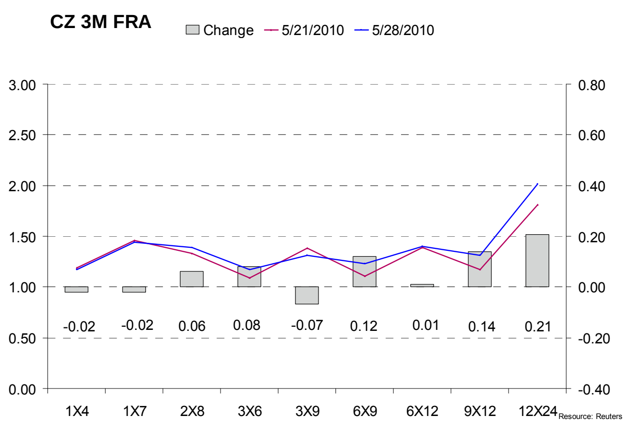
EUR/CZK technical picture

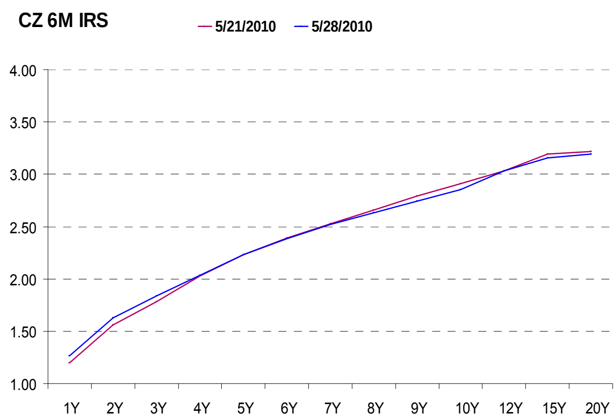
(25.6200) Rebound from 25.0150 failed to regain the broken Uptrendline off low (see graph).
1st support area at 25.4470 (broken falling weekly Moving Average), with next levels at 25.3000 (May 12 low), ahead of 25.2220 (April break-up daily), where pause favored.
If wrong, next levels at 25.0600 (weekly Bollinger bottom), ahead of 25.0150 (current year low) and 24.9750 (Sept 2009 low): tough on 1st attempts.
Resistance area at 25.9750 (May 20 high), ahead of 26.0800 (breakdown hourly), where pause favored.
Failure to cap would see next levels at 26.2200/ .3000 (weekly Bollinger top/ current recovery high off 25.0150) and 26.3330 (Feb 08 high): tough on 1st attempts.

DAILY CHARTS:

Fixed income

Czech bonds did not fare well last week, with the yield curve rising along the full length and flattening somewhat. It went up by almost 20 bps at the short end and more than 17 bps at the long end. Bonds may be affected by the government's proposed increase in the volume of bonds to be issued this year, to cover the flood damage. At its last session before the general election, the Parliament approved a volume increase of CZK 3bn.
Nevertheless, last week's main event on the domestic bond market was the auction of the 5.0%/2019 bond for the planned amount of CZK 6bn. In the end, the Ministry of Finance sold bonds for CZK 7.197bn. However, the demand of CZK 10.5bn only exceeded supply 1.5 times. The average yield was 4.040%. By comparison, the average yield in the previous auction of the same bond, held in early March, was 4.031%.
This week is free of major statistics. However, the results of the general election may influence the market. **Numerous investors might already find the high yields attractive. Nonetheless, the development of the global aversion to risk will also be relevant. A decrease, if any, in this aversion should also lead to improved demand for the Central European region and consequently for Czech bonds**.





Hungary

Macro review

Hungary is expected to reach a cornerstone this week, when the central bank has stopped cutting the base rate and the new government is planning to revise this year's budget deficit significantly higher from the official 3.8% of GDP target.
Recent data confirmed the slow recovery of the economy and PMI indicators suggested that this could continue over the coming months. However, the upswing could be tested shortly due to the deterioration of the market sentiment, which may not just be a reflection of the latest risk aversion swing, but also by the worsening fundamental outlook.
The outgoing government has pledged the deficit at 3.8% of GDP in order to reverse Hungary's rising public debt ratio of 80% of GDP by 2011. This however does not look likely now and the consensus expects the deficit to reach 5% of GDP by December, more than it expected in the previous months. The deterioration of the fiscal outlook has been visible since last autumn, but so far markets did not take this too seriously, but rather ignored it as the IMF program was assumed to limit any fiscal loosening attempt.
Yet, this may also change shortly if the new government sets a new deficit target above the 7% of GDP threshold, way above the consensus estimate, as well.
This would not be unprecedented in the fiscal history of the country as every election year since 1994 saw the deficit exceeding 8% of GDP.
Consequently markets did not take such a big revision easily. The currency had usually a slump of 5-10%, while yields rocketed up 100-200bps.
This time, **Mr Varga, head of the PM office said on Sunday evening that the deficit could be around the 7.0-7.5% of GDP level** that was put forward by a group of economists a year ago. Fears were mounting that time, but have recently abated a bit as the new economic minister pledged the deficit to be lower between 4.5% and 6.5% of GDP.
The announcement thus could be compared to the middle of this range and the date of the announcement is said to be the 6th of June or the end of this week.
Probably in light of these growing concerns, the Monetary Council decided on maintaining the base rate at 5.25%. The consensus and the market were mixed about the decision and roughly 50% probability was attached to another 25bps rate cut.
Fidesz officials highlighted that there will be no austerity irrespective of what the budget revision will mean. This could point out to a weaker political willingness for more tightening measures, despite Mr Varga comment that the government may need to decide on quick changes after the fiscal revision as the Greek crisis changed the sentiment on capital markets.
Overall, the government is sending out mixed signals about the future stance of the fiscal policy, while there is a growing risk of a higher-than-expected budget deficit outcome. This does not paint an attractive outlook over Hungarian assets thus **we recommend to reduce positions in the forint and bonds.**

Currency

The forint has recovered to the key level of 275.00 from the low of 284.00 on the back of improving sentiment on equity markets and risk appetite.
On the one hand, easing fears from risky assets could help the forint to recover for longer, while we think that local fundamentals may come to the limelight in a negative way.
Disappointing fiscal news could however bring back fears to the market and we may quickly see the pair testing recent lows again. Post-election weakening is not unusual and both in 2002 and in 2006, the forint saw massive drop about 7-8% after the announcement of a higher deficit arrived. **On this basis, we would not rule out the possibility of seeing new 1-year record lows of around 290-300/€ over the coming weeks.**

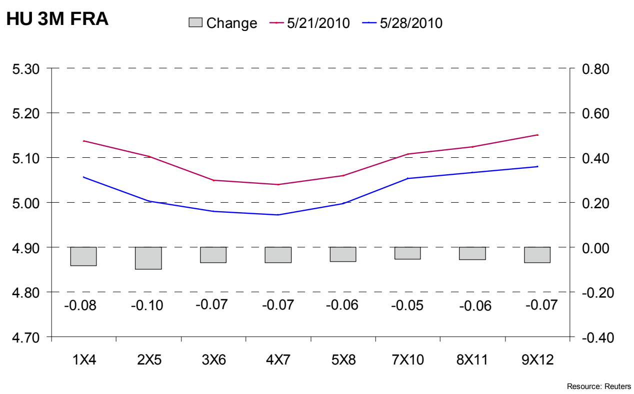
EUR/HUF technical picture

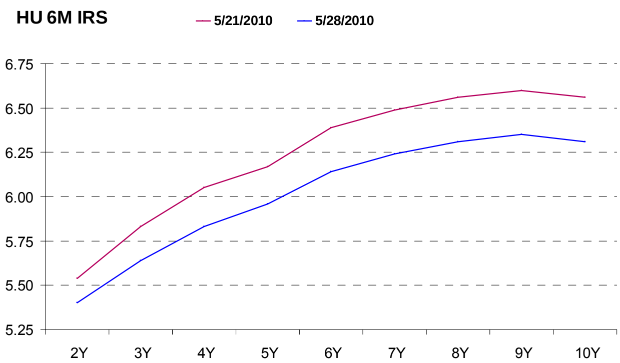
(273.50): Rebound from year low retested 283.60 (see graph).
Resistance at 280.57/ 281.50 (weekly Bollinger top/ May 25 high), where pause favored.
Failure to cap would see next levels at 284.25/ 285.20 (May 20/ 06 highs): tough on 1st attempts.
Support at 272.90 (current reaction low off 284.25?), with next level at 271.15 (May 12 low), where pause favored.
If wrong, next levels at 270.50 (rising weekly Long Term Moving Average), ahead of 270.20/ .00 (61.8% 260.93 to 285.20/ weekly Bollinger midline) and 269.60 (rising weekly Medium Term Moving Average): tough on 1st attempts.

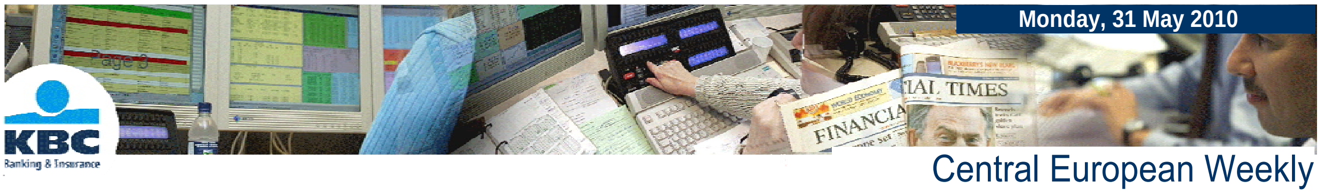
DAILY CHARTS:

Fixed income

The bond market has also seen some recovery with the currency and yields lowered by some 30bps from the highs of 7.50% at the long-end, while short-dated papers remained anchored to the 5.0% level. The outlook is generally similar to the currency and more importantly could be how much the central bank may tolerate a weaker currency. In the current situation, when high headline inflation is paired with lower underlying inflation, the bank could tolerate some currency weakness, but this may be limited as rising energy costs could lead to a deterioration of the outlook, as well. **The FRA curve continues to see the bias towards a rate cut from MNB, but this would also depend on the fiscal outlook**.







Poland

Currency

The Polish zloty came under severe pressure at the beginning of last week. That was primarily due to the heavy sell off on the global equity markets driven by ongoing worries about the European banking sector. The zloty touched 4.18 EUR/PLN

The central bank meeting had hardly any influence on trading. The Polish central bank kept interest rate unchanged as expected and delivered somewhat more dovish comments pointing to easing inflation pressures for the months ahead. Some central bankers also welcomed the recent weakening of the Polish zloty. Nevertheless Polish central bankers and the deputy finance minister denied that the zloty is currently a managed float. The markets started to speculate on range 3.80-4.20 EUR/PLN, where we saw interventions both against and in favour of the Polish currency. **Although central bankers denied a change in FX regime, deputy governor Witlod Kozinski admitted the central bank tries to avoid excessive volatility on the Polish FX markets and he personally likes the range 3.80-4.20 EUR/PLN**.

At the end of the week the zloty was helped by improving global sentiment and the proposal for a new Central bank governor. Acting president Bronislaw Komorowski proposed the respected economist and former Prime Minister Marek Belka. This news helped the zloty to outperform the region and attack 4.00 EUR/PLN by the end of the week.

We believe the zloty trading should remain cautious in the near term as the euro tensions could continue to weigh on the region. Slightly weaker than expected GDP figures are more or less in line with our view and should not have material impact on the markets. The slowdown was driven mostly by fall in construction due to severe winter. This has probably been the main reason for pretty steep decline in investments. Nevertheless, we are happy to see ongoing solid expansion in private consumption and exports. Hence we see the possibility of GDP acceleration in the rest of 2010.

EUR/PLN technical picture

(4.0500): Rebound off 3.8225 sent the pair above the channel top off 4.9300 and retested the neckline of the long term Double Top (4.2250: see graph).

1st support area at 4.0380/ .0166 (reaction low hourly/ break-up hourly), with next levels at 3.9786/ .9700 (weekly Bollinger midline/ break-up daily), where pause favored.

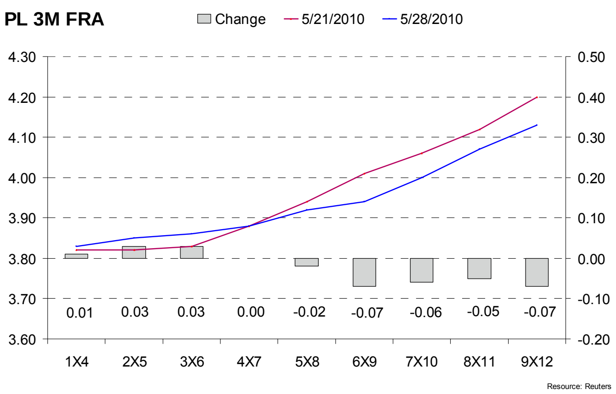
If wrong, next levels at 3.9487/ .9400 (rising weekly Medium Term Moving Average/ May 13 low): tough on 1st attempts.

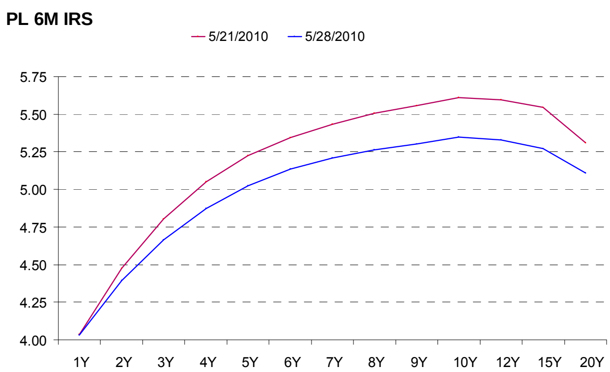
1st Resistance comes in at 4.0895 (breakdown daily), with next level at 4.1479 (weekly Bollinger top), where pause favored.

If wrong, next levels at 4.1799 (May 25 high), ahead of 4.2050 (May 20 high).

4.2400/ .2455 = recovery high off 3.8225/ 38.2% 4.9300 to 3.8225: tough on 1st attempts.

DAILY CHARTS:





Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	31.5.2010	09:00	PPI (%)	04/2010		-3.0		-1.7	-0.2	-3.5
PL	**31.5.2010**	**10:00**	**GDP (%)**	**1Q/2010**				**3.1**		**3.1**
CZ	31.5.2010	11:00	Money supply M2 (%)	04/2010						3.2
HU	**31.5.2010**	**14:00**	**NBH meeting (%)**	**05/2010**	**5.00**		**5.25**		**5.25**	
CZ	1.6.2010	14:00	Budget balance (CZK B)	05/2010					-78.2	
HU	2.6.2010	09:00	Trade balance (EUR M)	03/2010 *F					653.1	
HU	4.6.2010	09:00	Industrial output (%)	04/2010 *P					-0.4	2.8

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

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Our forecast

Official interest rates (end of the period)

		Current	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	0.75	1.00	1.25	-25 bps	5/6/2010
Hungary	2W deposite r.	*5.75*	5.25	5.00	5.00	5.00	5.00	-25 bps	2/23/2010
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	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	PRIBOR	*1.24*	1.20	1.15	1.22	1.35	1.60
Hungary	BUBOR	*5.21*	5.30	5.10	5.00	5.00	5.00
Poland	WIBOR	*3.86*	3.90	3.90	4.10	4.30	4.30

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

	Current	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	*2.87*	3.25	3.45	3.65	3.80	3.95
Hungary	*6.405*	6.00	6.00	6.00	6.00	6.00
Poland	*5.36*	5.00	5.00	5.00	5.20	5.50

Exchange rates (end of the period)

		Current	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	EUR/CZK	*25.9*	25.3	24.8	24.8	23.8	25.5
Hungary	EUR/HUF	*275*	275	270	265	265	260
Poland	EUR/PLN	*4.07*	3.90	3.80	3.60	3.90	3.30

GDP (y/y)

	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011
Czech Rep.	*-3.1*	1.4	1.7	1.5	1.4	1.7
Hungary	*-5.3*	-3.0	-1.5	0.5	1.0	2.0

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

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	*0.7*	1.4	2.1	2.1	2.0	1.9
Hungary	*5.9*	4.7	4.2	3.5	3.5	3.5

Current Account as % of GDP

	2009	2010
Czech Rep.	-1.0	-0.7
Hungary	-1.0	-0.5

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

	2009	2010
Czech Rep.	-5.9	-5.5
Hungary	-3.9	-5.5