Monday, August 30, 2010

KBC Banking & Insurance

Central European Weekly

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Czech Republic

Three hawkish strikes from CNB Board members, but little reaction from the market

Hungary

External balance continues to improve

Poland

GDP driven by surprisingly strong domestic demand

The week ahead

The Czech Republic to unveil its issuance calendar for the last quarter of 2010

Overview

Summer season was only affected by bond bulls

	Last	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.77	↗	↗
EUR/PLN	3.980	↗	↗
EUR/HUF	284.6	↗	↗
3M PRIBOR	1.24	→	→
3M WIBOR	3.81	→	→
3M BUBOR	0.00	↗	↗
10Y CZK	3.24	↗	→
10Y PLN	5.39	↗	→
10Y HUF	7.20	↗	↗
3M EURIBOR	0.90	→	→
10Y EMU	2.12	→	→

Last values from Friday 15:30 CET

An investor, who went out for a holiday in early August and, after returning, looked at the displays showing the developments in Central European forex and bond markets, might arrive at interesting conclusions. With the exception of the Czech and partly the Polish bond markets, only negligible changes occurred over the last few weeks. Naturally, the calmer developments are due to lower liquidity on both global and regional markets, which, typically in the summer, reduces the volatility on most financial markets. As already indicated, exceptions to this were the Czech and Polish bond markets, which were very liquid, due also to the capital inflow from foreign investors. This demand drove bond prices upwards.

However, from a **macroeconomic point of view**, Central Europe did not see any significant events. The development of key macroeconomic fundamentals basically met expectations. An exception to this was the news on fiscal austerity under preparation by the new Czech government, which had a favourable reception with the rating agencies. That said, although the actual fiscal deterioration in the Czech Republic may not be as aggressive as it initially seemed it would be (and this may also apply to the intended restriction), this signal was enough for rating agencies to start to consider upgrading the country's rating. The prospects for the rating upgrade may, at least partly, justify the unexpected bullish rally on the Czech bond market during the summer. Polish government bonds did ride on a similar wave. The reason was that beside solid Polish fundamentals these bonds offer very attractive yields.

Czech Republic

Macro review

Three CNB Board members (Zamrazilova, Janacek and Holman) have recently started to talk on the chance of a rate hike in the Czech Republic even as the Czech National Bank, in line with expectations, did not change rates at its August meeting. In addition, it clearly indicated that rates would remain unchanged for quite a long time. The current central bank forecast even indicates that its rates might only be raised for the first time in approximately a year. Recent developments at the major economies also indicated that there is no need to hasten to raise rates anytime soon. U.S. economic growth is decelerating. The German economy, by contrast, is growing at a record-breaking rate but it is unlikely to maintain its current growth pace.

Czech demand remains muted as do potential inflationary pressures. In addition, the restrictive fiscal policy is becoming relevant, as are most probably increased taxes and regulated prices. Inflation will be above the CNB's target level very soon, due in particular to administrative moves and the effect of the comparative baseline. Nevertheless, we expect that the CNB will not yet raise rates this year – as signalled by certain comments from the CNB, mainly because economic growth is not yet accelerating, a credit boom has not even started and demand-driven inflation is just a possible long-term scenario. Low rates do not threaten compliance with the CNB's inflation target in any way and rather only reflect the current condition of the economy and the risks of its further development.

Currency

The **Czech koruna** continues to trade in a very narrow holiday range below 25.00 EUR/CZK. The domestic calendar was more or less empty and the price action of the Czech currency partly reflected the change in sentiment on the global equity markets. Nevertheless it seems much more resilient to external shocks than neighbouring central European currencies.
Hence, even in the case of prevailing bearish sentiment on the global markets, the EUR/CZK should stay below first stronger resistance levels at 24.990 EUR/CZK so far.

EUR/CZK technical picture

(24.7500) Below Uptrendline off low, with broken Downtrendline off 29.6900 having played Support role so far (see graph).
1st support area at 24.6110 (Aug 04 low + current new reaction low off 29.6900), where pause favored.
If wrong, next levels at 24.5210 (76.4% 22.9250 to 29.6900), ahead of 24.4220 (monthly envelope bottom + modified weekly Alpha Beta trend bottom) and 24.2900 (monthly Bollinger bottom): tough on 1st attempts.
Resistance area at 24.9900 (Aug 16 high), ahead of 25.0150/ .0220 (previous year low/ breakdown daily): ideal area to stay below to keep current short term mood on CZK intact.
Failure to cap would see next levels at 25.2400/ .2560 (falling weekly Medium Term Moving Average/ 38.2% 26.3000 to 24.6110?) and 25.3660 (weekly Bollinger midline).
Inability to cap would be indication of something more serious for CZK.

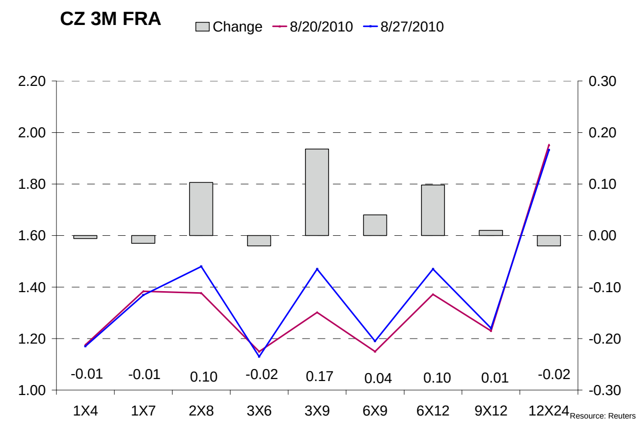
DAILY CHARTS:

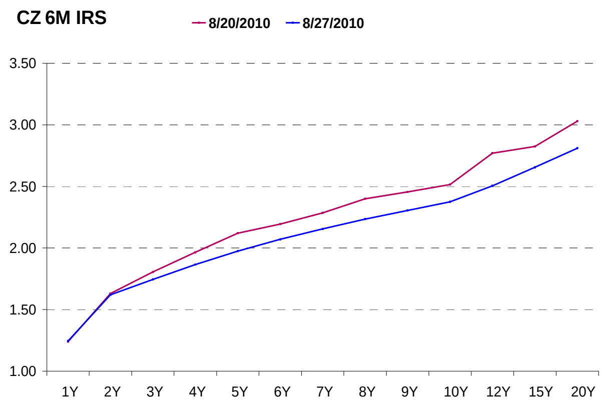
Fixed income

The **Czech bond market** experienced a few interesting sessions last week. Relatively strong demand sent yields down across the curve and the curve flattened. The market was influenced by domestic news that the ministry of finance would prefer short maturity bond issuances till the end of this year and by investors looking for higher yields. Also the development on EMU markets contributed decline in Czech yields of slightly over 1 bps at the short end and over 17 bps for 10-year bonds.

The main event of this week will be Wednesday's auction of the 3.40%/2015 bond. An amount of CZK 7bn is planned.

We expect the entire volume to be subscribed even if the market prefers longer maturities. By comparison, the average yield of the previous tranche of the same securities, of July 14, 2010, was 3.001% with cover ratio 2.55.
Another crucial domestic event will be the release of the issuance calendar, which is planned by the Czech MinFin for Wednesday. The key thing to watch will be whether the calendar will be thinner than that of the third quarter (approximately 50 bln of bonds) and whether the amount of longer bonds will be visibly reduced or not.





Hungary

Macro review

Macro data in August confirmed the consensus view about a gradual recovery amid improving external balance and low inflation.

Industrial output grew 12.6% Y/Y in July, slightly less than the 13.7% Y/Y rate before, but still strong enough to see real growth returning in the coming quarters. The second quarter GDP was tad better at 1.0% Y/Y, but the central bank raised concerns that the economy may rebound at a slower pace in 2011 and cut its growth forecast to 2.7% from 3.2%.

The recovery has been taking place amid a favourable balance. The foreign trade surplus was again strong in June at €557m, which is pointing for a higher trade surplus for the year. This caused the central bank to revise its current account forecast to a small surplus from a deficit and the better external balance could help Hungary to repay external debt faster. Inflation does not seem to be an issue as headline inflation fell to 4.0% Y/Y from 5.3% Y/Y in July due to mainly the disappearance of last year's VAT hike effect. The underlying inflation trend also seems positive as core inflation is just 1.1% Y/Y due to the low consumption of indebted households.

The biggest concern for the central bank was not economic, but financial risks as risk aversion weakened the currency in August. The 7-member Monetary Council decided to keep the base rate unchanged at 5.25%, but added the possibility of a rate hike if a higher inflation outlook and increasing risk premia on forint assets would warrant such a move.

This week's calendar contains producer prices and the purchasing manufacturing index, which could slightly alter the picture, but we do not expect any major shift in the outlook. The next key event could be the 2011 budget proposal due early October, which may show the new directions of fiscal policy.

Currency

The **forint** reacted negatively to the growing risk aversion worldwide and the pair slid to 286.00 from 278.00 last week. The previous recovery from mid-July has thus ended with a new correction, but last week's low is still higher/better than July's top in EUR/HUF of 292.00, suggesting that the appreciating trend could remain valid.

The outlook will be highly dependent on the build up of global risk appetite, which may be a slow process as investors very often like to see a decline in volatility before they return and buy the high-yielding forint. As long as the swings of the forint remain limited between 282.00 and 285.00, we are a bit more positive about the outlook for the coming weeks.

EUR/HUF technical picture

(283.78): Above long term triangle pattern and toying back with 283.60 (see graph: neckline Long Term Double Bottom).

Resistance at 286.60 (July 30 high), ahead of 288.38/ .65 (76.4% 292.10 to 276.35/ July 23 high), where pause favored.

Failure to cap would see next levels at 290.57 (weekly Stop And Reverse), ahead of 292.10 (July 19 high): tough on 1st attempts.

Support at 280.05/ 279.50 (break-up daily/ hourly), with next levels at 278.16/ 277.70 (reaction lows hourly), where pause favored.

If unable to hold, next levels at 276.35 (Aug 18 low), ahead of 275.50 (June 21 low) and 273.75 (June 03 low): tough on 1st attempts.

DAILY CHARTS:

Fixed income

The bond market also reacted negatively to the global growth jitters, but it remained so at the end of the week, when global bond yields started to rise. For them, easing recession fears could thus also become a problem and thus it is hard to imagine a positive scenario for the coming weeks.

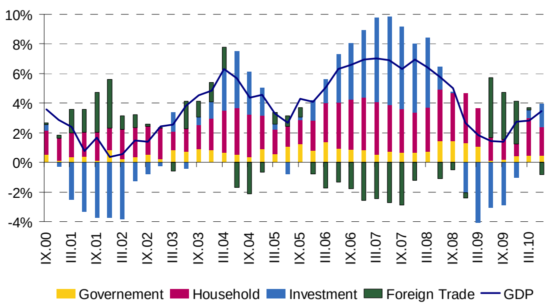
Poland

Macro review

The National Bank of Poland is slowly but certainly, starting to flirt with the idea of a rate hike. Polish central bankers did not hide their concerns about the worsening news from the global economy, notably the U.S., after their last meeting. On the other hand, the domestic economy is continuing to grow at a rate exceeding 3%y/y, benefiting from the recovery of the construction sector and industry, which is tied to the German economy.

Last figures released on Monday only confirmed that GDP growth continues to accelerate on y/y basis (3.5%). More surprisingly, this is not so much the effect of accelerating exports to neighbouring Germany, but it is mostly domestic demand. That partly plays down the concerns on a global slowdown in the second half of 2010.

Polish GDP, y/y



Thanks to solid growth, the domestic labour market is also starting to improve slowly, although this is still largely due to seasonal factors, and the improved employment is not yet evident in wage growth. Current inflation is still fairly low (2%) but this is the result of the favourable comparative baseline. Starting from August, the positive base effects should peter out and due to rapidly rising food prices, inflation may climb significantly above the 2.5% central bank target.

Nonetheless, the medium-term inflationary risk that worries central bankers most is public finance. In spite of decent economic growth, the 2010 deficit will be around 7% of GDP for the second consecutive year, and with the general election drawing near, the government does not feel like cutting expenditure in 2011 either. This could make the central bank proceed to a precautionary rate hike as early as the end of 2010.

EUR/PLN technical picture

(3.9825): Currently back in long term triangle pattern, but near apex (see graph).
1st Support area at 3.9680/ .9525 (reaction lows hourly), where pause favored.
If unable to hold, next levels at 3.9250/ .9210 (Aug 19 low/ 76.4% 3.2022 to 4.2400), ahead of 3.9056 (modified weekly Alpha Beta trend bottom): tough on 1st attempts.
1st Resistance comes in at 4.0270 (Aug 04 high): ideal area to stay below to keep current mood on Zloty.
If unable to cap, next levels at 4.0453 (38.2% 4.2400 to 3.9250), ahead of 4.0560 (breakdown daily + falling weekly Moving Average): 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
PL	**30.8.2010**	**10:00**	**GDP (%)**	**2Q/2010**				**3.2**		**3.0**
HU	31.8.2010	09:00	PPI (%)	07/2010					1.4	6.9
CZ	31.8.2010	11:00	Money supply M2 (%)	07/2010						5.2
HU	1.9.2010	09:00	Trade balance (EUR M)	06/2010 *F					566.9	
CZ	**1.9.2010**	**12:00**	**CZ bond auction 3.40%/2015 (CZK B)**	**09/2010**			**7**			
CZ	1.9.2010	14:00	Budget balance (CZK B)	08/2010					-69.0	
PL	**2.9.2010**	**10:00**	**GDP (%)**	**2Q/2010 *F**				**3.2**		**3.0**
CZ	3.9.2010	09:00	Wages (%)	2Q/2010						1.5

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	Sep-10	Dec-10	Mar-11	Jun-11	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	0.75	0.75	-25 bps	06/05/2010
Hungary	2W deposite r.	*5.25*	5.25	5.25	5.25	5.25	-25 bps	23/02/2010
Poland	2W inter. rate	*3.50*	3.50	3.75	3.75	4.00	-25 bps	25/06/2009

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

		Current	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	PRIBOR	*1.24*	1.20	1.20	1.25	1.40
Hungary	BUBOR	*5.35*	5.25	5.25	5.25	5.25
Poland	WIBOR	*3.81*	3.90	3.90	4.10	4.30

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

	Current	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	*2.44*	2.65	2.85	3.10	3.30
Hungary	*6.625*	6.50	6.50	6.25	6.00
Poland	*4.912*	4.95	5.00	5.60	5.60

Exchange rates (end of the period)

		Current	Sep-10	Dec-10	Mar-11	Jun-11
Czech Rep.	EUR/CZK	*24.8*	24.8	24.5	24.6	24.6
Hungary	EUR/HUF	*285*	280	280	275	275
Poland	EUR/PLN	*3.98*	4.00	3.90	3.60	3.70

GDP (y/y)

	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011
Czech Rep.	1.5	1.4	1.7	2.3	2.6
Hungary	0.5	1.0	1.2	1.4	2.0

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

	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Czech Rep.	2.1	2.1	2.0	1.9	1.9
Hungary	4.2	3.5	3.4	3.2	2.8

Current Account as % of GDP

	2009	2010
Czech Rep.	-1.0	-1.4
Hungary	1.6	1.0

GDP (in ESA95 standards)

	2009	2010
Czech Rep.	-5.9	-5.5
Hungary	-3.9	-3.8

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