Monday, September 13, 2010

KBC Banking & Insurance

Central European Weekly

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Czech Republic

While economic growth accelerates, inflation surprises on the downside

Hungary

Inflation fell sharply due to seasonal factors

Poland

NBP governor Marek Belka still on the dovish side

The Week Ahead

Polish regular monthly macro figures in focus

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.68	-0.36%	→	→
EUR/PLN	3.939	-1.04%	→	→
EUR/HUF	284.4	-0.06%	↘	→
3M PRIBOR	1.22	-0.02	→	→
3M WIBOR	3.81	0.00	→	↗
3M BUBOR	5.37	0.04	↘	→
10Y CZK	3.22	-0.02	→	→
10Y PLN	5.46	0.07	→	↗
10Y HUF	6.92	-0.28	↘	→
3M EURIBOR	0.89	-0.01	→	↗
10Y EMU	2.39	0.27	↘	↗

Last values from Friday 15:30 CET

Germany drives Central Europe less than you may expect

The two largest economies of Central Europe sped up their respective growth rates in the second quarter of the year. The Czech Republic grew by 2.4% y/y and Poland by a decent 3.5% y/y. To date, commentary has explained Central Europe's good performance by the reasonable growth of the German economy, in addition to low comparative base.

However, after a closer look into the structure, we find something else. Growth in both countries was primarily driven by the rebuilding of inventories, which had been massively reduced by businesses at the peak of the crisis in the first half of 2009. Such replenishments often involve a necessary increase of imports – notably in the raw-material-intensive engineering industry or electronics. Thus the rebuilding of inventories negated the otherwise decent launch of exports in both countries. In the end, the contribution of foreign trade to GDP growth was very low in both Poland and the Czech Republic, and did not exceed 0.5%. Nevertheless, the effect of the replenishments of inventories should run out of steam within the next few quarters, while the rate of exports will become more relevant, particularly for the Czech economy.

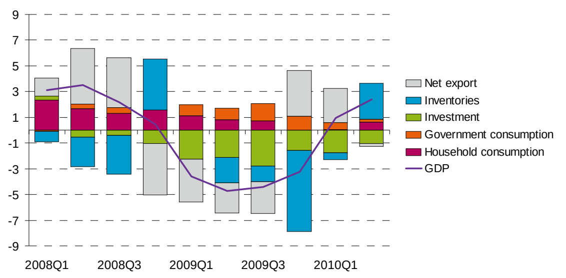
On the other hand, household consumption delivered a pleasant surprise in both countries. Of course, this was partly due to the low comparative baseline; however, especially the Czech Republic saw its consumption go up, notwithstanding the persisting high unemployment rate, which we will likely also have to live with in 2011. Therefore, regardless of households' fairly good financial health, we do not believe that household consumption can continue to drive Central Europe irrespective of the global climate, which may start to deteriorate in late 2010. Germany and its main trading partners (France, Spain, Italy = 25% of Germany's exports) will start to curb their expenditure. And these are no optimistic prospects for us at the moment.

Czech Republic

Macro review

The economy performed slightly better in the second quarter of the year than indicated by the flash forecast by the Statistical Office. Compared to the previous quarter, the GDP grew by 0.9%, the fastest rate over the last two and a half years. Year-on-year economic growth sped up from 1.0% (Q1) to 2.4% (Q2). However, if we take a closer look at the figures, we are not triumphantly. Not only grew GDP much more slowly than that of Germany, our largest trading partner, but the growth structure was not favourable either. The main contributor to the growth was the change in inventories. Modest consolation is that household consumption has resumed rising, but we are sceptical this represents a new trend. Growth was also fuelled by increased government expenditure, which is, however, soon going to be curbed significantly. A drop in investment, which has persisted for nine quarters, was no surprise either. Investment in machinery has been curbed most significantly, followed by investment in buildings, structures, and means of transport, although the latter investment lags well behind the former. The question is whether the economy will maintain its existing growth rate, particularly if the speculations about the deceleration of the Western European and U.S. economies occur increasingly.

GDP Growth Contribution
(percentage points)



While the GDP developments improved slightly in the second quarter, July's data from the economy lagged behind somewhat. Despite the very low comparative baseline, industrial output was up by only 5.3%, construction fell by 4.5%, and retail sales by 1%. The figures were largely affected by the lower number of working days in July, which had two fewer working days, and this primarily affected industrial output, where the deceleration of the rise in the production of means of transport to 2.2% probably had a great impact, given the large weight of means of transport in industry. In addition, contracts for the automotive industry fell by almost 9% after eleven months. This may be due to the expiration of the scrapping bonus programmes in Europe. Even so, contracts as a whole went up by an exact 10%. July's industrial output indicates that the second half of the year will be poorer for this sector. We expect that the rate of industrial output will slow down significantly in that period, with full-year industrial output in that sector to go up by 6.5% (as opposed to 9.1% for the first seven months).

August inflation is 0.1% lower than expected by the market as well as the central bank. Consumer prices were down by 0.3% m/m, while year-on-year inflation went up by 1.9%, just like in July. The month-on-month decline in prices was primarily due to food, fuels and the seasonal sale of clothing and shoes. Package tour prices, by contrast, went up. Thus we will not find any surprise in the inflation structure. Compared to last year, consumers already pay higher prices for food (+3.7%), healthcare (+7.5%) and, as usual, housing (+2.1%). We expect no significant inflation changes by the end of this year, and believe that inflation will be very close to 2%. In addition, we anticipate another rise in food prices, due to poorer crops and the subsequent rise in agricultural commodity prices. However, next year's inflation is a big unknown. The uncertainty stems from the extent of the electricity price increase (speculation ranges from 8% to 30%) and a potential increase of the lower VAT rate to 12%. If we admit the extreme scenario, based on both administrative moves, inflation will reach as high as 3.5%. Yet the outlook does not provide any strong arguments for the CNB to raise its base rate from its current low. Monetary-policy inflation is still moderate (0.8%) and the considered administrative moves are tax-based, and thus will only have a negligible effect on inflation. In addition, the more the State will push inflation higher by its moves, the more restrictive will be the effect of this on demand in the economy, and thus discussions on demand-pull inflation would then again be groundless. Hence we keep our scenario of the central bank rate stability, within at least the next six to nine months, unchanged.

Currency

In spite of the series of interesting statistics released almost every day, **the EUR/CZK pair remained within a narrow range below EUR/CZK 24.8 throughout the week**. The development of the aversion to risk as well as the upwards correction of the Czech Republic's GDP for Q2 2010 and a greater than expected decline in month-on-month inflation only had a minimal impact. The market also ignored statements from **CNB Board Member Janáček**, who toned down his previous statements of late August, when he had not ruled out the need to raise rates soon. This time, he was not that strict, saying that he considered rates to be adequate at the moment, with no need to raise them soon.

The start to the week should be optimistic on better Chinese data. But we are still somewhat sceptical toward ongoing bullish rally. **Hence we continue to see the koruna stabilising above important levels around 24.60 EUR/CZK**.

Fixed income

The Czech yield curve went down along the full length and steepened slightly last week, falling by 10.5 bps at the short end and almost 9 bps at the long end. Unlike the developments in the German market, where yields went up somewhat, the Czech market was influenced by **two new issues** of securities.

At the very beginning of the week, the bond market reacted to the 10Y **bond issue denominated in euros**, the country's first euro issue for more than a year. The country's relatively good position on financial markets made it possible to sell the bonds worth €2bn at the yield of 105 bps above mid-swaps, with demand reaching €5.3bn. Curiously, the yield of similar Italian securities was 114 bps above mid-swaps, although the rating of Italy is better than that of the Czech Republic. According to a statement by the MinFin, the revenue from that subscription should cover the financial needs until the end of this year as well as in the first months of 2011.

Another auction, this time in CZK, was held on Wednesday. The Ministry of Finance supplied the 2.80%/2013 securities for the planned amount of CZK 7bn. The auction was 3.38 times oversubscribed, thus confirming the expectations that the eurobond issue would spark concern about a lower possible supply of koruna bonds and that demand would consequently be very good, even for short-term maturities. At the end of the week, August inflation proved to be lower than expected, and this encouraged the persisting demand for longer maturities, and not only because of the expectations that the 2011 issues will mostly include short-term securities. This was also indicated by Minister of Finance Kalousek, who in his interview spoke of efforts to cut the costs of interest payments on issued bonds from CZK 74bn to no more than CZK 70bn in 2011. He believes that this might be achieved by issuing securities with shorter maturities, or longer maturities with a variable coupon.

The current account and the producer price index data, to be released this week, will hardly have any effect on the bond market. Therefore, the main event of the week will be the last auction of Q3, scheduled for Wednesday. The Ministry of Finance will supply the 5.00%/2019 bond for the planned volume of CZK 8bn. A lower supply of koruna bonds and demand for longer maturities should also attract good demand this time, supporting the long end of the curve.

EUR/CZK technical picture

(24.6800) 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 fa-vored.

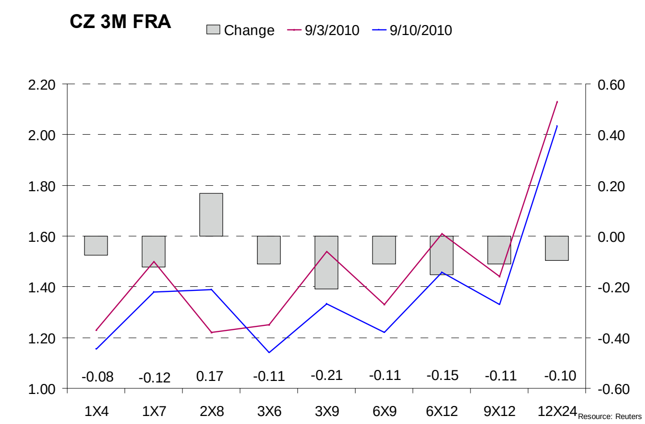
If wrong, next levels at 24.5210 (76.4% 22.9250 to 29.6900), ahead of 24.3700 (weekly Bollinger bot-tom) and 24.3140/ .3050 (weekly modified Alpha Beta trend bottom/ monthly envelope bottom): tough on 1st at-tempts.

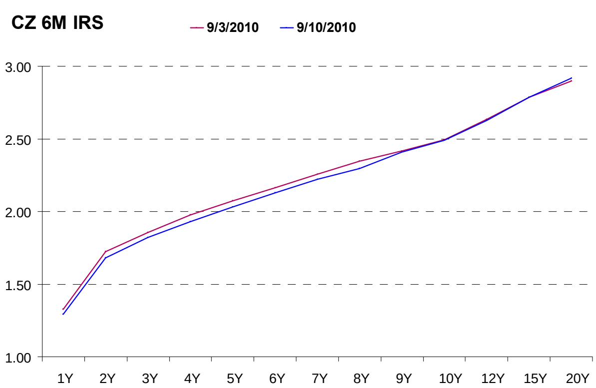
Resistance area at 24.7700 (weekly modified Al-pha Beta trend top), ahead of 24.9450/ .9900 (Aug 25/ 16 highs): ideal area to stay below to keep cur-rent short term mood on CZK intact.

Failure to cap would see next levels at 25.0530 (falling weekly Medium Term Moving Average), ahead of 25.2560/.2800 (38.2% 26.3000 to 24.6110?/ weekly Bollinger midline).

Inability to cap would be indication of something more serious for CZK.

DAILY CHARTS:





Hungary

Macro review

Last week's main event was the government's announcement that it will stick to the below 3% of GDP deficit target for 2011. Markets cheered the news and we are waiting for the details to see how the government plans to achieve this. The budget proposal has to be submitted to the Parliament before the 15th of October.

The 2011 budget deficit target is important because it has to guarantee that Hungary sets a declining public debt-to-GDP ratio, which was one of the goals of the 2008 IMF program in order to put the country on a sustainable growth path.

Macro data was mixed during the week, trade balance surplus narrowed to just €240m from the regular €500m in July as probably exporters cut back production to prepare themselves for a slower eurozone recovery. Accordingly, industrial output declined during the month by 1.1% M/M, but remained at the 11.5% Y/Y pace due to the base effect.

The budget balance widened to 114% of the full-year target in August, showing that there are risks around this year's 3.8% of GDP target, as well. The government has pledged again that it will stick to it via tighter ministry spending and albeit we think that the target will likely be achieved, this is not a done deal, yet.

On the positive side, inflation decelerated to 3.7% Y/Y in August against expectations for acceleration from July's 4.0% Y/Y reading. Food prices declined during the month as locally produced fruits and vegetables reached markets, but close to 1% core inflation also shows that demand driven inflation has disappeared from the economy. Unsurprisingly, wage growth remained very low at 0.9% Y/Y in August, as expected.

Interestingly, **central bank minutes revealed that the Monetary Council has become increasingly divided about the future of interest rate policy**. Two members, including the Governor voted for a hike, while four members decided to keep it unchanged and one thought it would be wise to lower the current level of 5.25% by 25bps. This is a bit surprising after the hawkish Inflation Report in August and suggests that also policy makers are uncertain about the outlook.

Currency

The forint reacted established an appreciating trend after the government announced the 2011 budget deficit target of 3% of GDP.

The pair climbed 2% from the weekly low of 289 to 283.50 by Friday. Foreign investors also became more active after the announcement and easing fears from a 'W' shape recovery in the US could have also helped here.

We think that there are probably more gains for the HUF to reap and the pair could rise to the resistance level at 278 before the trend would exhaust.

EUR/HUF technical picture

(283.50): Toying back with 283.60 (see graph: neckline Long Term Double Bottom).

Resistance at 286.30 (breakdown hourly), ahead of 288.00/ .79 (weekly modified Alpha Beta trend top/ weekly Bollinger top) and 289.55 (Sept 08 high), where pause favored.

Failure to cap would see next level at 292.10 (July 19 high): tough on 1st attempts.

Support at 281.76/ .20 (monthly envelope bottom/ break-up weekly), ahead of 280.05/ 279.50 (break-up daily/ hourly), where pause favored.

If unable to hold, next levels at 278.16/ 277.70 (reaction lows hourly), ahead of 276.35/ 275.50 (Aug 18/ June 21 lows): tough on 1st attempts.

DAILY CHARTS:

Fixed income

The bond market also reacted positively to the better fundamental outlook and yields lowered 50bps in the last two days of the week. Strong demand on the bond auctions triggered the move as investors' bid totalled Ft200bn and therefore the debt management agency was able to raise the issuance amount from Ft50bn to Ft70bn.

Yields at the long-end thus narrowed the key 7.00% level and the 5y5y forward IRS spread compressed to 315bps from 370bps. **There is still a long way to go for bonds to establish a credible convergence path, but there could be some consolidation after the steep run**.

Poland

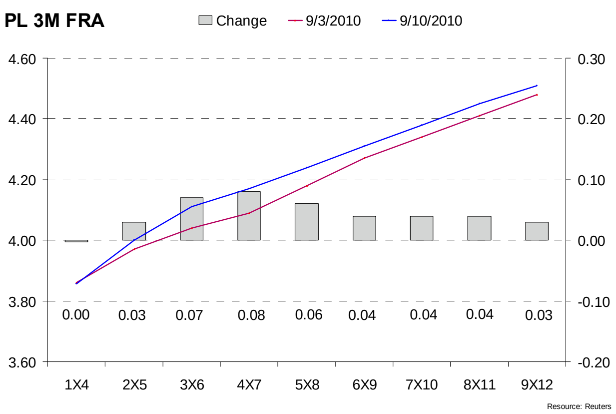
Currency

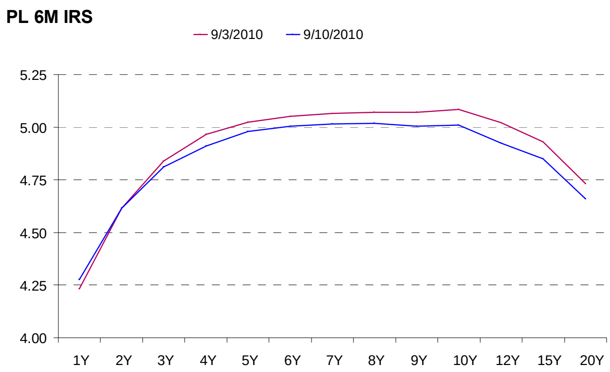
The Polish zloty gained on improving global sentiment and moved to 3.93 EUR/PLN by the end of the week.
The start of the week should be positive too. Series of positive Chinese figures helped to boost overall sentiment on emerging markets. Beside that, the zloty could profit from an upbeat assessment of the Polish economy made by the MPC governor Marek Belka. He believes that after investments started to grow, GDP could accelerate to 4% y/y growth. Nevertheless he currently does not see any inflation pressure in the economy and therefore we put him rather in a dovish camp for now. **We continue to see the first rate hike by the end of the year in case we see investment performance to improve.**
Later during a week there is series of important domestic figures. Accelerating industry and improving labour market conditions should confirm ongoing recovery. Beside that diminishing base effect should continue to push up inflation slowly back to the NBP target. Nevertheless once again global sentiment should be crucial for the zloty. From a technical point of view the pair may also feel little discouraged as moving closer to important technical levels around 3.92 EUR/PLN.

EUR/PLN technical picture

(3.9280): Currently below long term triangle pattern, but near apex (see graph).
1st Support area at 3.9190 (current reaction low off 4.0270?), ahead of 3.9020/ 3.9004 (1st target of daily Triple Tops off 4.0405/ rising 50 Month Moving Average), where pause favored.
If unable to hold, next levels at 3.8760/ .8750 (last targets off 4.0405) and 3.8674 (weekly Bollinger bottom + weekly modified Alpha Beta trend bottom): tough on 1st attempts.
1st Resistance comes in at 3.9600 (breakdown hourly + weekly modified Alpha Beta trend top), with next level at 3.9922 (breakdown daily).
4.0180/ .0270 (Aug 31 high + falling weekly Moving Average/ Aug 04 + 24 highs): ideal area to stay below to keep current mood on Zloty.

DAILY CHARTS:





Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	13.9.2010	10:00	Current account (CZK B)	07/2010	-15.0		-13.0		-15.0	
PL	14.9.2010	14:00	Money supply M3 (%)	08/2010			0.5		0.1	
PL	**14.9.2010**	**14:00**	**CPI (%)**	**08/2010**			**-0.4**	**2.1**	**-0.2**	**2.0**
CZ	15.9.2010	09:00	PPI (%)	08/2010	0.1	2.2	0.1	2.2	0.0	2.3
HU	15.9.2010	09:00	Industrial output (%)	07/2010 *F					-1.1	11.5
CZ	15.9.2010	12:00	CZ bond auction 5.00%/2019 (CZK B)	09/2010			6			
PL	16.9.2010	14:00	Wages (%)	08/2010			-1.1	3.9	0.9	2.1
PL	16.9.2010	15:00	Budget balance (PLN M)	08/2010					1 622.4	
HU	17.9.2010	09:00	Wages (%, ytd.)	07/2010				0.9		0.5
PL	17.9.2010	14:00	PPI (%)	08/2010			-0.1	4.2	0.3	3.9
PL	**17.9.2010**	**14:00**	**Industrial output (%)**	**08/2010**			**-1.6**	**13.3**	**-6.1**	**10.3**

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	Sep-11	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	0.75	0.75	1.00	-25 bps	06/05/2010
Hungary	2W deposite r.	*5.25*	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	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	Sep-11
Czech Rep.	PRIBOR	*1.22*	1.20	1.20	1.25	1.35	1.55
Hungary	BUBOR	*5.37*	5.25	5.25	5.25	5.25	5.25
Poland	WIBOR	*3.81*	3.90	3.90	4.10	4.30	4.30

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

	Current	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Czech Rep.	*2.5809*	2.65	2.75	2.90	3.05	3.15
Hungary	*6.67*	6.50	6.50	6.25	6.00	6.00
Poland	*5.02*	4.95	5.00	5.60	5.60	5.80

Exchange rates (end of the period)

		Current	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Czech Rep.	EUR/CZK	*24.7*	24.8	24.5	24.6	24.6	25.5
Hungary	EUR/HUF	*284*	280	280	275	275	275
Poland	EUR/PLN	*3.94*	4.00	3.90	3.60	3.70	3.60

GDP (y/y)

	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
Czech Rep.	2.0	1.4	1.5	1.1	2.0	3.0
Hungary	0.5	1.0	1.2	1.4	2.0	2.5

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

	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Czech Rep.	1.9	2.0	2.0	2.1	2.4	2.5
Hungary	4.2	3.5	3.4	3.2	2.8	3.2

Current Account as % of GDP

	2009	2010
Czech Rep.	-1.0	-1.5
Hungary	0.5	1.0

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

	2009	2010
Czech Rep.	-5.9	-5.5
Hungary	-3.8	-3.0

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