Tuesday, September 21,

KBC Banking & Insurance

Central European Weekly

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

Czech Republic

The inflow of money from EU Funds is slowly starting to increase. CNB remains calm

Hungary

Encouraging signs in the labour market

Poland

Polish industrial output accelerates on export oriented manufacturing

The Week Ahead

CNB should stay on hold

Overview

Both the Czech Republic and Poland issue eurobonds at the right time

As could be expected, the favourable conditions for financing government debt encouraged Central European countries (among others) to take advantage of these conditions, not only on domestic but also on international markets, to fund their respective financing needs. First, the Czech Republic very successfully issued government eurobonds denominated in euros followed by Poland (though the volume of its issue was lower). The risk premiums that both countries had to pay were very low and even below those paid by a number of the more developed countries of the euro area.

While the Czech Republic or Poland may have been able to issue government debt bonds on their domestic markets and in local currencies with the same ease (or even under better conditions), the timing of the eurobond issues of both countries was very good chosen. On the one hand, markets as well as rating agencies still view the macroeconomic or fiscal situations of the Czech Republic and Poland very positively; and on the other hand, the tension on the European bond market has been within acceptable limits thus far. However, none of the above favourable factors for Central European eurobond issuance need necessarily continue to apply in the weeks to come.

Czech Republic

Macro review

The Czech Republic is entitled to apply for CZK 768.9bn (approximately 18% of GDP) from the Structural and the Cohesion Fund in 2007-2013. Applications for subsidies from Structural Funds already amount to CZK 914bn, with projects for more than CZK 300bn already approved.
The reason is that there is a significant delay between project implementation and the actual inflow of money from Brussels. During the implementation of projects, the required money is pre-financed from the state budget. After the project is completed, the money is refunded to the individual state budget headings and paid to the Ministry of Finance by the European Commission (certification).
The Ministry of Finance will need to exchange all the euros received from the EU for korunas at the Czech National Bank; however, the central bank will most likely not be able to keep so many euros in its forex reserves. It already has a problem with its increasing reserves, because of losses (though only accounting losses) and criticism from the ECB. In addition, a further accumulation of reserves may lead to an inadequate easing of the monetary policy. Therefore we believe that in the end the CNB will not prevent the Brussels euros from having a positive impact on the koruna.

Currency

Last week, the koruna stayed below CZK 24.70 per EUR. Nevertheless, this does not mean that it experienced a calm and trouble-free week. After opening at CZK 24.666 per EUR, the koruna started to appreciate, with the decrease in the aversion to risk in the wake of a few favourable U.S. and particularly Chinese statistics. During that appreciation, it ignored the surprising fall in the current account, which was, however, due to a high outflow of dividends. It also disregarded opinions by CNB's Robert Holman, who predicted that the koruna would no longer strengthen so rapidly in the future. The Czech currency maintained this trend the next day, when it closed at CZK 24.55 per EUR, i.e., at a level that it last saw approximately 22 months ago. The moderate increase in the global aversion to risk stopped the appreciation of the koruna in the second half of the week and pushed the currency back to the vicinity of its opening level.
The main domestic event of this week will be the CNB Board meeting. Although some rate hike considerations have been voiced from the CNB in recent weeks, **we do not anticipate a rate change at this meeting and believe that its impact on the money market will also be negligible**. The meeting of the FOMC in the United States on Tuesday, by contrast, will be more important for the fluctuations of the EUR/CZK currency pair. At that meeting, the bankers should also decide whether to continue their bond buying policy. We expect that the subsequent appreciation of the dollar, if any, would have a negative effect on Central European currencies, including the koruna.

EUR/CZK technical picture

(24.6900) Below Uptrendline off low, with broken Downtrendline off 29.6900 having played Support role so far (see graph).
1st support area at 24.4800 (current new reaction low off 29.6900), where pause favored.
If wrong, next levels at 24.3180/ .3050 (weekly modified Alpha Beta trend bottom/ weekly Bollinger bottom + monthly envelope bottom): tough on 1st attempts.
Resistance area at 24.7700 (Sept 07 high), with next levels at 24.8110/ .8330 (breakdown hourly/ weekly modified Alpha Beta trend top), ahead of 24.8600 (Aug 31 high).
24.9450/ .9900 (Aug 25/ 16 highs): ideal area to stay below to keep current short term mood on CZK intact.

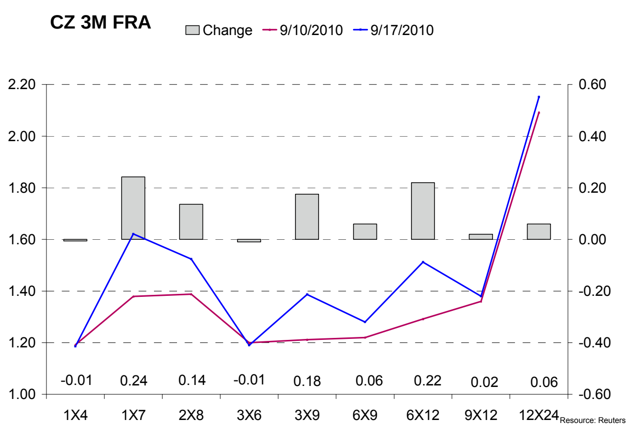
DAILY CHARTS:

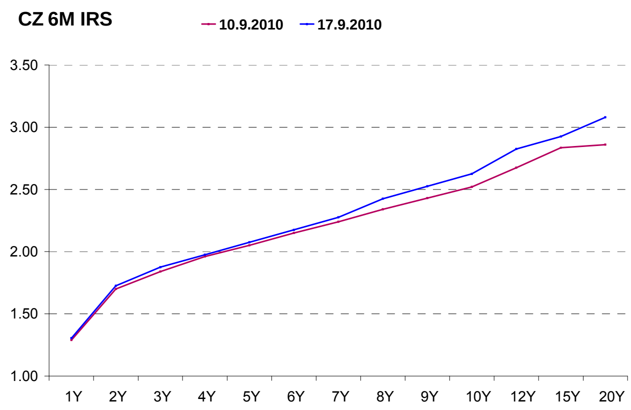
Fixed income

The Czech yield curve went up along the full length and flattened last week, with yields rising by 5 bps at the short end and more than 11 bps in the 10Y segment. That said, the beginning of the week was marked by below-average trading volumes, and bonds were not even stirred by comments from CNB Board Member Řežábek. In his opinion, the existing rates correspond to a crisis situation, but there is no such situation at the moment. In addition, the low official rates have not led to an adequate decline in market rates; nonetheless, Mr Řežábek declined to comment as to how he would vote at the upcoming CNB Board meeting, scheduled for September 23.
However, the main event of last week was the auction of the 5.00%/2019 government bond, where the Ministry of Finance supplied securities for CZK 6bn. Demand was moderate this time, and only exceeded supply 1.35 times. Bonds

were sold for a total of CZK 5bn, at the average yield of 3.143%. By comparison, demand in the previous tranche of the same bonds on July 21, 2010 exceeded supply 2.71 times, at the average attained yield of 3.818%. Lower than expected demand is attributed to the fact that planned for the last quarter of this year is a new bond issue, due in 2021, which, as a new 10Y benchmark, may be more attractive to investors.

The spotlight will be on the CNB meeting this week. However, with no rate change anticipated, its impact on the bond market will not be significant. Things would certainly become more interesting **if Moody's, in line with its comments, upgraded the ratings of the Czech Republic and Poland.** Nevertheless, this week is likely too soon for such consideration, and therefore the market will be subject to the development of the global aversion to risk. This aversion may be influenced by a comment from the U.S. Fed as well as by U.S. statistics at the end of the week. In addition, the existing higher yields, and **comments from the Ministry of Finance that next year's debt financing needs may be at the lower threshold of the plan, could also help maintain demand for domestic bonds and modify the impacts, if any, of global market developments**.





Hungary

Macro review

Last week was relatively quiet on the macro front in Hungary. Revised industrial output data confirmed the preliminary result of 11.5% Y/Y output growth in July as export manufacturing's recovery has moderated somewhat during the summer.
High unemployment and slow growth helps companies to keep wage costs low and wage growth remained very low at 0.9% Y/Y in July. There are some encouraging signs in the labour market pointing to some recovery, but it may take a while for the labour market to improve significantly, hence wage growth is expected to remain moderate for longer.
Last week's main news was the threat from rating agencies about a possible downgrade to non-investment status if the government deviates from fiscal tightening in the coming years. The government announced that it will stick to a below 3% of GDP target in 2011 two weeks ago, but rating agencies said that they want to see the details behind it.
The government has to submit the 2011 budget proposal to the Parliament by October 15.

Currency

The forint was trading within a trading narrow range of 281 and 283 last week. Despite the aforementioned concerns about the US or Hungary's budget, investors have so far remained uninterested to take risks in either direction, which allowing the forint to stay broadly unchanged.

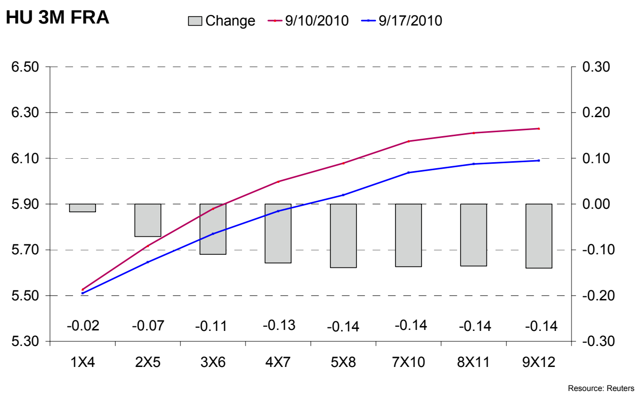
Fixed income

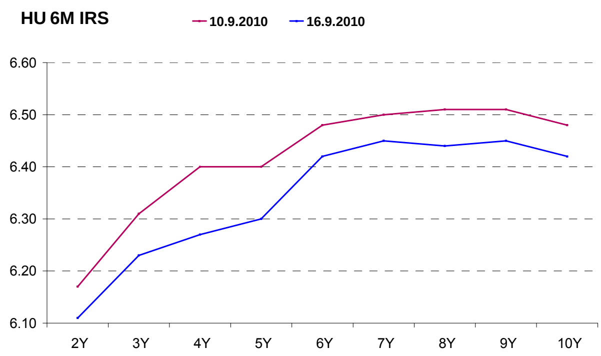
The bond market rallied a bit further last week and yields dipped to the 6.90% level at the long-end. Long-term forward spreads also narrowed to 290bps as the market is probably getting more optimistic about the outlook for nominal convergence.
The short-end has also consolidated during the week and rate hike expectations faded quickly. Only the 9x12 FRA rate remained high at the 6.00% level, while shorter maturities got close to the central bank's benchmark rate of 5.25%.

EUR/HUF technical picture

(282.50): Failed to regain the broken Uptrendline off 262.05 (see graph).
Resistance at 284.40/ .70 (reaction highs hourly), ahead of 286.30/ .70 (breakdown hourly + weekly modified Alpha Beta trend top/ breakdown daily), where pause favored.
Failure to cap would see next levels at 288.24 (weekly Bollinger top), ahead of 289.55 (Sept 08 high): tough on 1st attempts.
Support at 280.65/ .05 (current reaction low off 289.55/ break-up daily), were pause favored.
If unable to hold, next levels at 279.46/ .13 (76.4% 276.35 to 289.55/ weekly modified Alpha Beta trend bottom) and 276.35 (Aug 18 low): tough on 1st attempts.

DAILY CHARTS:


HU 3M FRA
Change
9/10/2010
9/17/2010
-0.02
-0.07
-0.11
-0.13
-0.14
-0.14
-0.14
-0.14
1X4
2X5
3X6
4X7
5X8
7X10
8X11
9X12
Resource: Reuters


HU 6M IRS
10.9.2010
16.9.2010
2Y
3Y
4Y
5Y
6Y
7Y
8Y
9Y
10Y

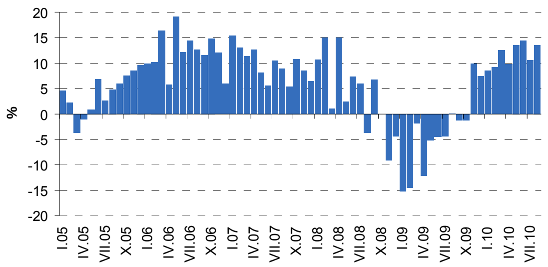
Poland

Currency

The zloty stayed nearly unchanged around 3.95 EUR/PLN over the week despite further gains on global equity markets and solid domestic figures. The industrial production accelerated to 13.5% y/y mainly thanks to export oriented manufacturing and maybe more important we see some bottoming in the wage dynamics. On the other hand the inflation still stays pretty low. The inflation stabilised at 2% y/y in August, which points to a slower comeback to the central banks target in the upcoming months. Together with mixed comments from MPC members this puts our base scenario of a first interest rate hike by the year end at risk. For that to happen we would have to see clear growth in investment and a further improvement in the labour market (seasonally adjusted) in upcoming months.

For the week ahead we wait for retail sales and unemployment. The unemployment should decline further and we believe not only thanks to seasonal factors, but also more and more due to ongoing strong performance of the Polish economy. On the other hand the nominal growth in the retail sales should continue to be only moderate as inflation stays at low levels. From a trading point of view**, we continue to be somewhat suspicious to bet on further gains of Polish currency for now. We believe that 3.9177 EUR/PLN could hold**.

Polish industrial output, y/y



EUR/PLN technical picture

(3.9525): Currently below long term triangle pattern, but near apex (see graph).

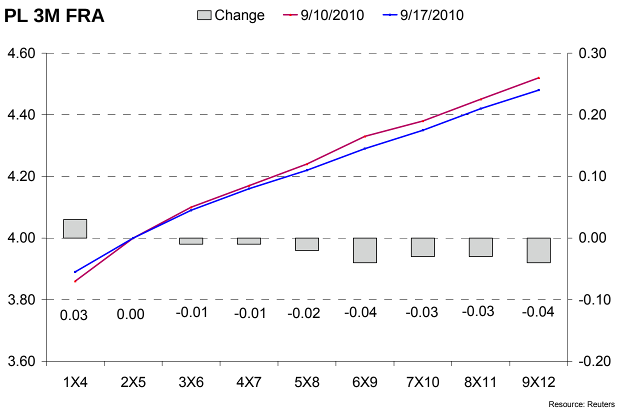
1st Support area at 3.9177 (current reaction low off 4.2400), ahead of 3.9020/ 3.9004 (1st target of daily Triple Tops off 4.0405 + weekly Bollinger bottom/ rising 50 Month Moving Average), where pause favored.

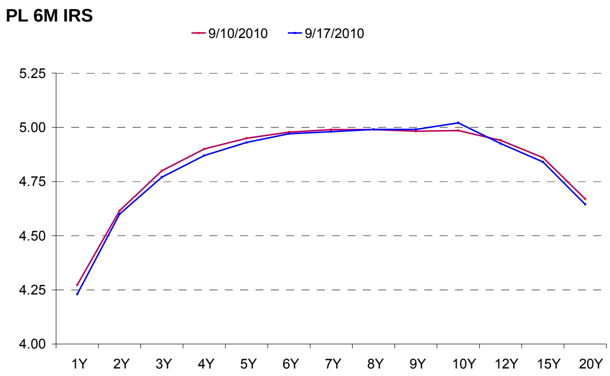
If unable to hold, next levels at 3.8760/ .8750 (last targets off 4.0405) and 3.8630 (weekly modified Alpha Beta trend bottom): tough on 1st attempts.

1st Resistance comes in at 3.9600/ .9808 (Sept 08 high/ 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:


PL 3M FRA
Change
9/10/2010
9/17/2010
4.60
4.40
4.20
4.00
3.80
3.60
0.30
0.20
0.10
0.00
-0.10
-0.20
0.03
0.00
-0.01
-0.01
-0.02
-0.04
-0.03
-0.03
-0.04
1X4
2X5
3X6
4X7
5X8
6X9
7X10
8X11
9X12
Resource: Reuters


PL 6M IRS
9/10/2010
9/17/2010
5.25
5.00
4.75
4.50
4.25
4.00
1Y
2Y
3Y
4Y
5Y
6Y
7Y
8Y
9Y
10Y
12Y
15Y
20Y

CE Weekly Preview

THU 13:00 **CNB base rate**

	This meeting	Last change
rate level (in %)	**0.75**	5/2010
change in bps	**0**	-25

CZ: CNB rates unchanged

Although in recent weeks four CNB Board Members have made comments in favour of an early rate hike, we do not believe that the CNB Board will actually hike rates at its September meeting. Although Q2 economic growth was higher than the central bank had expected, this has not at all improved the economic outlook for next year. Both headline inflation and monetary policy inflation remain below the forecast as well as below the target level of the central bank. The inflation outlook for next year is uncertain, though mainly because of the unknown development of regulated electricity prices and a possible change in the lower VAT rate. There is no need to change rates at the moment. **Hence we expect that they will continue to be stable in the months to come and still believe that the CNB should not start a tightening cycle until approximately the middle of 2011**.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
PL	21.9.2010	14:00	Core CPI (%)	08/2010			0.0	1.2	0.1	1.2
HU	22.9.2010	09:00	Retail sales (%)	07/2010						-4.6
CZ	**23.9.2010**	**12:30**	**CNB meeting (%)**	**09/2010**	**0.75**		**0.75**		**0.75**	
PL	24.9.2010	10:00	Unemployment rate (%)	08/2010			11.3		11.4	
PL	**24.9.2010**	**10:00**	**Retail sales (%)**	**08/2010**			**-2.8**	**5.3**	**3.2**	**3.9**

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

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

Our reports are also available on: www.kbc.be/dealingroom