Monday, October 25,

KBC Banking & Insurance

Central European Weekly

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Czech Republic

Opposition gains a majority in the upper house – no impact on markets

Hungary

Details of new government's tax package unveiled

Poland

Zloty eyes the NBP meeting

The Week Ahead

The NBP will leave its base rate unchanged but it might bring a hawkish signal

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.57	0.14%	→	↗
EUR/PLN	3.967	1.54%	→	↗
EUR/HUF	274.6	0.03%	→	↗
3M PRIBOR	1.20	0.00	→	↗
3M WIBOR	3.84	0.02	→	↗
3M BUBOR	5.35	0.00	↗	↗
10Y CZK	3.46	0.14	→	↗
10Y PLN	5.59	0.08	→	↗
10Y HUF	6.88	0.08	→	↗
3M EURIBOR	1.09	0.00	↗	→
10Y EMU	2.47	0.12	→	→

Last values from Friday 15:30 CET

QE2 seems to be mostly priced in CE government bonds

Speculation on the (second) quantitative easing in the United States has also stirred Central European markets in recent weeks. While the reaction of currencies to the decrease in the aversion to risk and the inflow of funds into the region was not that positive, government bond markets fared well. Since the beginning of the month, the spread against the German 10Y Bund has dropped by almost 20 basis points in the Czech Republic and nearly 15 basis points in Hungary and Poland. By contrast, Central European currencies remained slightly defensive throughout the period, having lost just less than 1% over the same period.

Central European markets were not only influenced by the global mood but also by domestic factors (notably in Hungary). Nevertheless, speculation on the further massive printing of dollars played an important role. We would not be surprised that, after the Fed announcing specific steps at its November 2-3 meeting, the positive effect of the QE2 story will peter out. Today, the bulls on the global markets may interpret even bad figures from the U.S. positively, as they could be seen as an argument for a stronger launch of quantitative monetary easing. After the Fed meeting, the uncertainty on the amount of the new monetary expansion will disappear. Thus worse figures from the U.S., if any, will again tend to drive risky assets into the defensive.

In light of the developments in recent weeks, Central European bonds, the prices of which are currently fairly high, are much more liable to switch to a defensive mode. Central European currencies, which tended to stagnate over the last two weeks could be more susceptible to a deterioration of the global sentiment. On the other hand, if further domestic figures in Poland are supportive to a tightening of the domestic monetary conditions in Central Europe's largest economy, this may still keep the zloty at fairly high levels and also indirectly encourage other currencies in the region.

Czech Republic

Macro & policy review

The Social Democrats (CSSD) won in a by-election held on Friday and Saturday for the Senate. Thus, the opposition CSSD gained a majority in the upper chamber of parliament and can directly influence the process of adopting reform laws. The government coalition, however, still has a majority in the Lower house of parliament and therefore the coalition can always outvote the upper house of parliament. But given the time-consuming legislative process, there may be delays of some laws needed to comply with the state budget.

Currency

The **Czech koruna** remained more or less unchanged for the most of last week, having reacted neither to global news nor to a series of rather hawkish comments from the CNB. It was not upset to any great extent until later last week, when the market saw one-off purchases of the euro and sales of the koruna by one large client. This made the Czech currency weaken to EURCZK 24.70. However, a strong Ifo index and a weaker USD following the G20 meeting subsequently enabled the koruna to eliminate at least some of its losses.
This week, the koruna will watch in particular the zloty and its reaction to the NBP decision on Wednesday. Should the zloty firm after the meeting, the koruna will follow suit and the EUR/CZK cross rate could test the 24.39 support level.

Fixed income

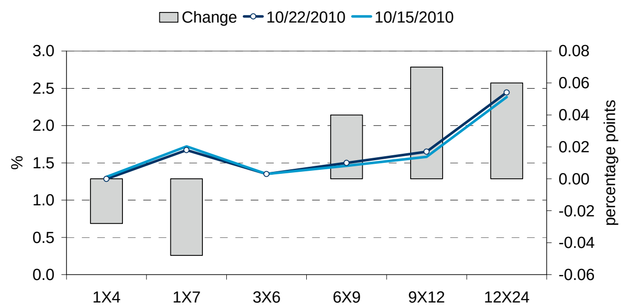
The Czech fixed income market faced another slightly hawkish comment from a CNB Board member – this time form vice governor Hampl, who said that present low rates were not sustainable. As a result, bets on a rate hike in the first half of the next year increased. We can hear even more comments from the CNB Board this week as central bankers have the last chance to express their opinion ahead of the meeting next Thursday.

EUR/CZK technical picture

(24.65) Double Top off 25.0150 (previous year low: see graph), with new reaction low off 29.6900 having been scored.
1st support area at 24.5510 (break-up hourly), with next levels at 24.3900/ .3650 (Oct 14 low/ current new reaction low off 29.6900), ahead of 24.2240/ .2020 (monthly Bollinger bottom/ weekly modified Alpha Beta trend bottom), where pause favored.
If wrong, next levels at 24.1040/ .0760 (weekly Bollinger bottom/ monthly envelope bottom), ahead of 24.0000 (psycho + monthly modified Alpha Beta trend bottom): tough on 1st attempts.
Resistance area at 24.7100 (current recovery high off 24.3650?), ahead of 24.7500/ .7700 (Sept 16/ 07 highs): sustained trade above would see risk towards 24.8600 (Aug 31 high), ahead of 24.9450/ .9900 (Aug 25/ 16 highs): key area to stay below to keep current medium term mood on CZK.

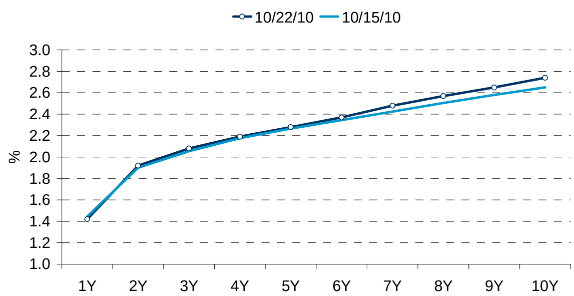
DAILY CHARTS:

CZ FRA



Source: Reuters

CZ IRS



Source: Reuters

Hungary

Macro review

The main macroeconomic theme is the impact of the government's package over the longer-term. Its main principle to finance a tax cut on labour from temporary revenues has many questions. So far only the Fiscal Council published a research document about the package and it estimated that it would slow down growth in 2011 by 0.1% and have no impact on that later.
The newly introduced special taxes are:

- energy companies: 1.05% tax on net revenue (revenue without VAT)
- retail sector: 0% below Ft500m net revenue; 0.1% between Ft500m and Ft30bn;0.4% between Ft30bn and Ft100bn and 2.5% above Ft100bn net revenue
- telecommunication sector: 2% below Ft500m; 4% between Ft500m and Ft5bn; 6.5% above Ft5bn

The fear is that these special taxes will worsen the investment climate and therefore would have a negative effect on growth. Studies however revealed that Hungary's growth model relied too much on capital investment and that a lack of employment growth was the key problem behind the low potential growth rate. The flat personal income tax of 16% aims at improving labour participation, which is the second lowest in Hungary in the EU27 after Malta.
The indirect impact on inflation and on the external balance may also be important, though it is difficult to estimate. For example, the special tax is just 0.3% of the retail turnover, thus it may have a minor effect on prices, especially if the tax is passed on to profit and to suppliers, as well.
There could also be legal hurdles for the introduction as the European legislation allows special taxes in the telecom sector only if the revenue is used to offset market distortions of the sector. Secondly, the Constitutional Court may rule against these, although this does not seem likely since special taxes on banks and energy companies were introduced years ago, albeit amounts were smaller.
Beside the government's new measures, we had wage data (wages were 1.9% Y/Y) and retail sales (0.0% Y/Y) from August, both showing lack of demand pull inflationary pressures in the economy.
On the good side, business confidence expectations soared to a 4-years high level in October according to the GKI index. Consumer confidence expectations also improved to the pre-crisis level of 2008 underpinning households optimistic view about the future.
Last, but not least, the central bank is expected to maintain the base rate at 5.25% today. They adopted a hawkish tone in August, but since the currency rallied from 285/€ to 275/€ and inflationary pressures have basically disappeared, they may continue to soften their tone. A rate cut would be premature to talk about, but the financial markets are depending less on external factors than before, which could give some more room for the bank to set its own policy path.

Currency

EUR/HUF technical picture

(275.55): Pair currently still below 276.70 (see graph: neckline Head And Shoulders Top) but back above Uptrendline off year low.
Resistance at 278.40/ 278.85 (Oct 20 high + falling weekly Medium Term Moving Average/ breakdown daily Sept 23), where pause favored.
If unable to cap, next levels at 280.40/ .65 (50% 292.10 to 268.70/ breakdown weekly): tough on 1st attempts.
Support at 272.25/ 271.89 (break-up hourly/ weekly Bollinger bottom), with next levels at 270.40/ .17 (Oct 14 low/ weekly modified Alpha Beta trend bottom), where pause favored.
If unable to hold, next level at 269.80 (break-up hourly), ahead of 268.70/ .28 (current reaction low off 292.10/ 76.4% 260.93 to 292.10): tough on 1st attempts.

DAILY CHARTS:

The forint had a correction last week after the currency reached a 6-months high of 269.50/€. This move sent the pair back to 278/€ - close to the 50-day moving average of 279.10 – where it found support and the market settled down in the 273-275 range.

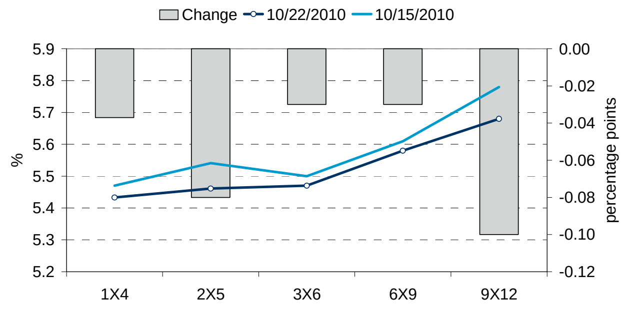
The market flow looks to be determined by real investors as the short-term carry is not that rewarding at a base rate of 5.25%, while bond buyers need to convert their foreign currencies into the forint in order to cover their bond position.
This looks to be a more or less healthy market, which may last for the time being.

Fixed income

The bond market followed the currency and yields rose back to the key 7.00% level, but good demand on Thursday's bond auctions showed that demand had not vanished completely. The bid-cover ratio of two at the auctions thus kept the week's losses limited and this week we may see the recovery phase after this.

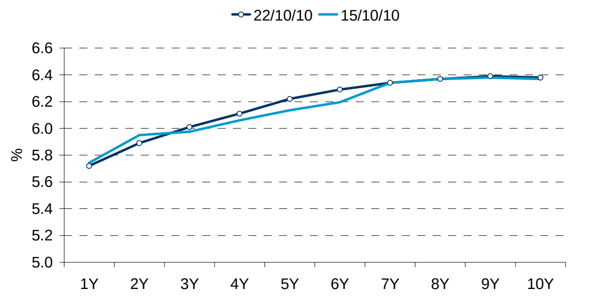
The short-end remained convinced that a 25bps rate hike is the next step, but this could be challenged now, especially if the central bank softens its hawkish rhetoric today.

HU FRA



Source: Reuters

HU IRS



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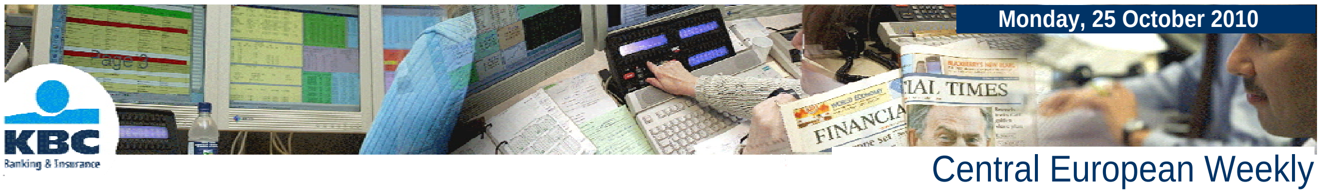


Poland

Macro review & Currency

The Polish zloty was slightly in the defensive last week. After its unsuccessful attempt to remain below EUR/PLN 3.92, it changed direction and started to offset its previous appreciation. The slowing of the decline of the U.S. dollar was an unfavourable factor for the zloty. Domestic macro-economic figures more or less met expectations. Industrial output decelerated slightly and employment is continuing to improve.

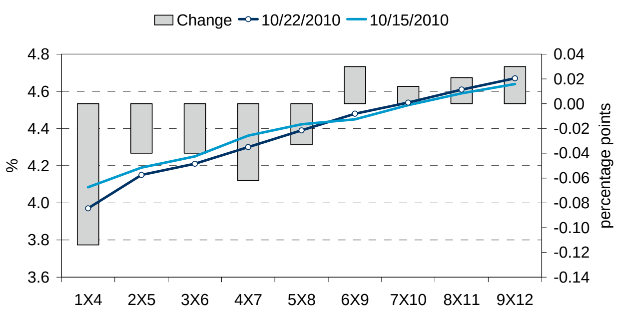
The NBP minutes of the last meeting sprang a moderate surprise, as it showed that the fiscal policy is not viewed as a major medium-term inflation risk. However, it seems that Poland's central bankers are troubled by investments rather than by high structural government deficits. We assume that if investment adjusted for inventories goes up (in upcoming GDP report), the hawks on the Monetary Policy Council will take the upper hand. This might support the case for a 25 bps rate hike before the end of this year.

EUR/PLN technical picture

(3.9700): New reaction low off 4.2400 has met 1st target of daily Triple Top off 4.0405 (see graph).
1st Support area at 3.9320 (break-up hourly), with next levels at 3.9055 (reaction low hourly) and 3.8900 (current new reaction lo off 4.2400), where pause favored.
If unable to hold, next levels at 3.8760/ .8750 (last targets off 4.0405): tough on 1st attempts.
1st Resistance comes in at 3.9980 (Sept high + neckline short term Double Bottom): ideal area to stay below to keep current mood on Zloty.
Failure to cap would see renewed risk towards 4.0143/ .0270 (weekly modified Alpha Beta trend top/ Aug high), where pause favored.

DAILY CHARTS:

PL FRA



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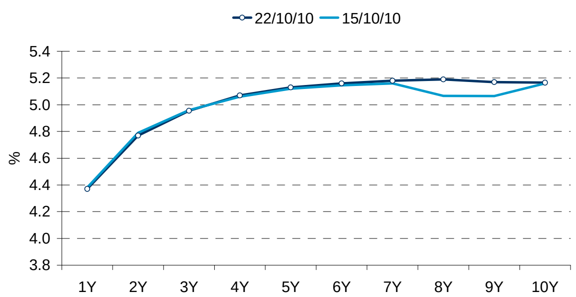
PL IRS



Source: Reuters

CE Weekly Preview

MON 14:00 **MNB base rate**

	This meeting	Last change
rate level (in %)	**5.25**	4/2010
change in bps	**0**	-25

MNB stays on hold and continue to watch markets

The MNB is expected to maintain the base rate at 5.25% today. They adopted a hawkish tone in August, but as the currency rallied from 285/€ to 275/€ and inflationary pressures have basically disappeared, they may continue to soften their tone. A rate cut would be pre-mature to talk about, but the financial markets are depending less on external factors than before, which could give the bank some more room to set its own policy path.

WEN 14:00 **NBP base rate**

	This meeting	Last change
rate level (in %)	**3.50**	6/2009
change in bps	**0**	-25

NBP will leave its rate unchaged, but speak hawkish

Although there are strong bets on a monetary tightening in Poland, we think it will not materialize before the MPC will know the outcome of the GDP report for the third quarter (released on November 30th). However, the MPC might deliver visibly more hawkish comment to its decision this time.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	**25.10.2010**	**14:00**	**NBH meeting (%)**	**10/2010**	**5.25**		**5.25**		**5.25**	
PL	**26.10.2010**	**10:00**	**Retail sales (%)**	**09/2010**			**-0.6**	**6.6**	**-1.6**	**6.6**
PL	26.10.2010	10:00	Unemployment rate (%)	09/2010			11.4		11.3	
PL	**27.10.2010**	**14:00**	**NBP meeting (%)**	**10/2010**	**3.50**		**3.50**		**3.50**	
HU	28.10.2010	09:00	Unemployment rate (%)	09/2010			11.1		11.0	
HU	29.10.2010	09:00	PPI (%)	09/2010					-0.2	9.0
CZ	29.10.2010	11:00	Money supply M2 (%)	09/2010						4.6

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

		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	*1.20*	1.20	1.20	1.25	1.35	1.55
Hungary	BUBOR	*5.35*	5.25	5.25	5.25	5.25	5.25
Poland	WIBOR	*3.84*	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.	*2.735*	2.65	2.75	2.90	3.05	3.15
Hungary	*6.37*	6.50	6.50	6.25	6.00	6.00
Poland	*5.14*	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	*24.6*	24.8	24.5	24.6	24.6	25.5
Hungary	EUR/HUF	*275*	280	280	275	275	275
Poland	EUR/PLN	*3.97*	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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