Monday, November 15,

Central European Weekly

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

Czech Republic

The Czech economy is accelerating, inflation is not

Hungary

Trade balance shows a surplus

Poland

Supportive figures may trigger interest rate expectations in the week ahead

The Week Ahead

Polish labour market may see further improvement

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24,63	0,20%	↗	→
EUR/PLN	3,930	0,73%	→	↘
EUR/HUF	276,2	0,92%	↗	↗
3M PRIBOR	1,22	0,00	→	→
3M WIBOR	3,86	0,01	↗	↗
10Y CZK	3,48	0,05	↗	↗
10Y PLN	5,70	0,04	↗	↗
10Y HUF	7,03	0,14	↗	↗
3M EURIBOR	1,20	0,07	↗	→
10Y EMU	2,51	0,12	→	↗

Last values from Friday 15:30 CET

Irish contagion in Central Europe

The fear of a default of Ireland affected all of the weaker parts of the eurozone last week. Although the epicentre of the tension was clearly in Ireland and Portugal, the Spanish and Italian risk premiums also reached their highest levels since the establishment of the eurozone.

The sentiment in Central Europe on the other hand is still calm and relaxed. At the end of last week, this was supported by better-than-expected GDP data in the Czech Republic and Hungary. The increasing expectations about the start of the tightening cycle in Poland, Central Europe's largest economy, are also supportive for the region. These bets led to a swift increase in yields on the money market last week. All of these factors drove Central European currencies away from the eurozone's problems.

The depreciation of the Polish and Czech currencies was negligible (around 0.5%). The spread against 10Y German Bund widened only slightly in Poland (+5 bps, as opposed to +100 bps in Ireland), and even narrowed in the Czech Republic. As usual, Hungarian markets were most affected by the global tension. The forint weakened by nearly 1% and the spread against the yield of 10Y German bonds went up by 15 bps. However, purely domestic factors might also have been relevant in Hungary. Prime Minister Orbán's government made foreign investors uncertain by his plan to extend the extraordinary taxation of selected sectors beyond 2012.

If the tension surrounding Ireland continues to escalate and the situation heads towards an external bailout, Central European markets may feel somewhat more of the heat. However, this should again primarily affect Hungary's spreads against the Bund.

Czech Republic

Macro review

The first GDP forecast for the third quarter of the year indicates that the economy fared better than expected. The GDP grew by 1.1% against the second quarter, and even 3% y/y. Although details are still unavailable, we expect that exports by industrial firms are primarily driving the economy. Likely, we cannot rely much on domestic demand, yet domestic demand is also most likely improving slightly, primarily fuelled by consumption. We also agree with the Czech National Bank, which cites a significant effect from the boom of solar power plants in its latest forecast. Most probably, inventories also played a major role, but we need to wait for December to get a clearer picture. At the moment, the full-year GDP for 2010 seems likely to exceed the 2% mark. This will eliminate half of last year's loss that the recession inflicted on the economy. Nevertheless, the question is how the economy will develop next year. What will be the performance of the economy in times when expenditure is cut significantly and foreign demand is unlikely to improve as rapidly as it has thus far? Uncertainties persist, yet we will still wait to reconsider our outlooks for 2011. At the moment, we anticipate GDP growth of 1.8% next year. The central bank has already reconsidered its outlook, anticipating a significant growth deceleration to as low as less than 1% in the second half of the next year. According to the CNB, the Czech economy should only grow by 1.2% for the whole of 2011, due primarily to the restrictive fiscal policy, the completion of the inventory replenishment process, and the external slowdown.

While the economy is accelerating, inflation has remained at the CNB's target level for the second consecutive month. Thus year-on-year inflation is 0.2% below the central bank's latest forecast. Monetary policy inflation is continuing to be below the lower threshold of the CNB's tolerance band, and stands at 0.9%, just like in September. October's inflation as a whole was surprisingly low. We believe that the improved developments are primarily based on a decline in food prices, which have not yet fully absorbed this year's rapid increase in agricultural commodity prices. The current development of the other items in the consumer basket is in line with expectations. We believe that inflation will remain very close to the target value in the months to come. However, the impact of what is known as deregulation (of rent in particular) at the beginning of next year is not quite clear. Regulated prices may drive inflation slightly above the target, yet the future inflation developments as a whole can still be viewed as favourable. After all, this is also what the CNB expects in its new forecast, anticipating inflation to be constantly close to or at the target level.

Currency

The better than expected results of the Czech economy served as a shield protecting the Czech koruna against strengthening US dollar during the most of the last week. Nevertheless, the koruna closed slightly weaker at 24.65 EUR/CZK as the market sentiment was not too much in favour of Central European currencies due to the problems in Ireland.

We expect the koruna to remain relatively calm during the week ahead, Czech currency should, compared to the rest of CE currencies, resist sell-off attempts related to the possible worse news from Ireland.

EUR/CZK technical picture

(24.6350) Double Top off 25.0150 (previous year low: see graph), with new reaction low off 29.6900 having been scored.

1st support area at 24.4550 (break-up hourly), with next level at 24.4000 (weekly modified Alpha Beta trend bottom) and 24.3450 (current reaction low off 29.6900), where pause favored.

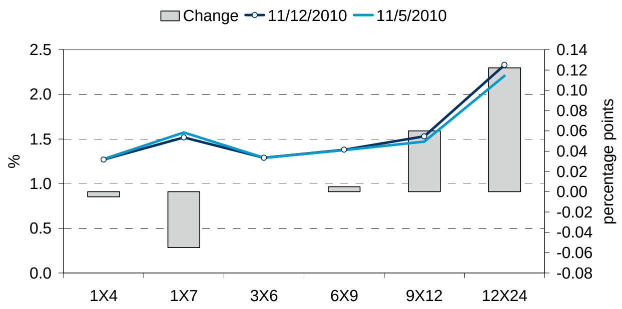
If unable to hold, next levels at 24.1960/ .1910 (monthly envelope bottom + weekly Bollinger bottom/ monthly Bollinger bottom), ahead of 24.0240/ .0000 (monthly modified Alpha Beta trend bottom/ psycho): tough on 1st attempts.

Resistance area at 24.7000/.7100 (Oct 24/ .22 highs) and 24.7500/ .7700 (Sept 16 high + monthly envelope top/ Sept 07 high): ideal area to stay below to keep current short term mood on CZK.

24.9450/ .9900 = Aug 25/ 16 highs: key area to stay below to keep medium term mood on CZK .

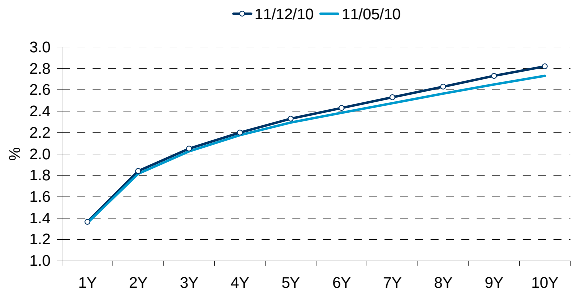
DAILY CHARTS:

CZ FRA



Source: Reuters

CZ IRS



Source: Reuters

Hungary

Macro review

Last week some important macro data were released. First, the trade balance posted an impressive €548m surplus in September, above consensus, which also means a 12-month-rolling-sum of more than €5bn or 5% of GDP. This means that external balance will likely improve this year further as export again grew faster than import. In Hungary's case, this is highly important as previous growth model achieved real convergence at the expense of external balance, but high foreign indebtedness will not allow this to be repeated in the coming years.

This looks possible now as third quarter growth showed quite a sharp acceleration of the economy from 0.8% to 1.6% Y/Y (unadjusted) and to 2.1% Y/Y (adjusted for working days and seasonality). The Q/Q growth rate was 0.8% or 3.2% annualised, underpinning consensus and the government's projection for a 3% growth rate. Details will be available only next month, but we suspect that external demand remained the driving force behind growth, while there were also signs about slowly recovering domestic demand in retail sales data.

The government's program is building on a strong economic recovery, which would generate enough tax revenue to offset the fallout from tax reductions by 2013-2014. We estimate that unchanged real spending and 3% growth on average in this period would be just enough to meet this goal, but of course this is a risky project as the global economy may also become gloomier.

Currency

Overall, higher inflation and faster growth should be positive for the currency and negative for bonds. However, last week the forint weakened as foreign news, especially about Ireland was more important and the market was caught probably bit too long HUF after foreign investors' short-covering had just finished (see the previous weekly on this).

The 278 level stopped the weakening trend on Friday morning, similarly to the correction in October and the market settled down a bit stronger than this. This week's question will be whether this holds on or not and unless we have a new negative shock on global markets, we bet that the weakening trend is probably over.

Fixed income

The bond market also felt the currency's correction and yields rose to 7.00% at the 5-year maturity and little bit higher at longer-dated maturities. Despite the loss, the 5y5y forward spread remained anchored at the 325bps level, so it did not widen last week reflecting broadly unchanged risk of the economy.

The short-end could be an interesting market in the coming weeks as faster growth and higher inflation warrant higher probability of a rate rise, while a stronger currency later could act as a monetary tightening tool, as well. The FRA market expects 50bps rate hike in the next 4-months and total of 75bps rate rise in the next 9-months. We do not expect a rate hike in the foreseeable future as demand driven inflation pressures look to be low, but cost-side pressure could mount to become an issue if the economy gathers momentum and purchasing power of households increase with the tax cut next year.

EUR/HUF technical picture

(275.85): Pair currently still below 276.70 (see graph: neckline Head And Shoulders Top) but back above Uptrendline off year low.

Resistance at 278.40/ 278.85.15 (Oct 20 high + see graph/breakdown daily Sept 23), where pause favored.

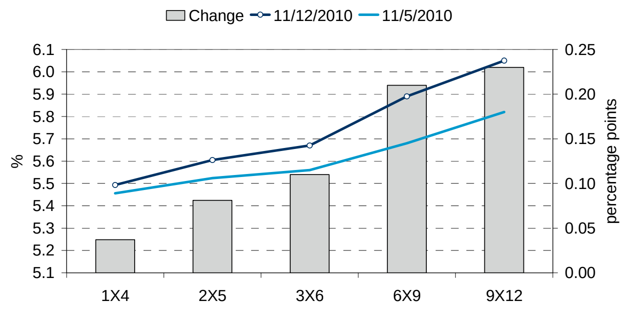
If unable to cap, next levels at 280.40/ .65 (50% 292.10 to 268.70/ breakdown weekly): tough on 1st attempts.

Support at 273.00/ 272.66 (reaction lows hourly), with next levels at 270.00/ 269.80 (Nov 02 low + weekly Bollinger bottom/ break-up hourly), where pause favored.

If wrong, next levels at 268.70 (current reaction low off 292.10) and 268.47/ .28 (weekly modified Alpha Beta trend bottom/ 76.4% 260.93 to 292.10): tough on 1st attempts.

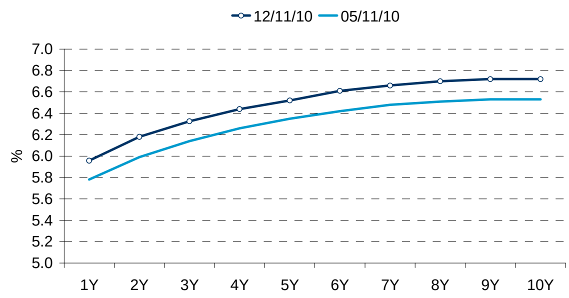
DAILY CHARTS:

HU FRA



Source: Reuters

HU IRS



Source: Reuters

Poland

Macro review

Polish macro-scene was rather empty last week. The zloty managed to stay around 3.90 EUR/PLN till Thursday, supported mainly by mounting interest rate hike expectations: Nevertheless the Irish fears sent the local markets into a defensive mode by the end of the week. The pair moved closed the week around 3.93 EUR/PLN.

The week ahead is stuffed with important macroeconomic figures that can have significant impact on Monetary Policy Council's (MPC) decision next week. CPI is expected to rise to 2.8% y/y, or 0.3 percentage point above inflation target. On Thursday, figures on employment and wages will be published and the release of figures on industrial prices and production is scheduled for Friday.

Apart from global market movers, the results of above mentioned statistics will play an important role in the development of the zloty's exchange rate. **Labour market recovery at faster pace as well as higher inflation could trigger bets that rate hike will take place already at the MPC meeting next week. Hence despite Irish woes we remain positioned bullish on the zloty for short term.**

For longer term we start to be more cautious as worsening fiscal situation may start to have more significant impact on the Polish markets. As we argue in our recent flash we are afraid that Poles may break through the critical prudential level of 55% debt/GDP as early as next year. That should automatically trigger more severe austerity measures by 2013 (see table below)

Budget prudential rules Public debt to GDP	Rule	Law	Lags
> 50% a < 55%	*(Deficit/revenues) must decrease in the following year*	*Public Finance Act*	*2 years*
> 55% a < 60%	*(Debt/GDP) must not increase in the following year*	*Public Finance Act*	*2 years*
> 60%	*Budget must be balance in the following year*	*Constitution*	*2 years*

EUR/PLN technical picture

(3.9385): New reaction low off 4.2400 has met 2nd target of daily Triple Top off 4.0405 (see graph) at 3.8760.

1st Support area at 3.9100 (break-up hourly), with next levels at 3.8967 (weekly modified Alpha Beta trend bottom) and 3.8760/ .8750 (current reaction low off 4.2400 + see above/ 3rd target off 4.0405), where pause favored.

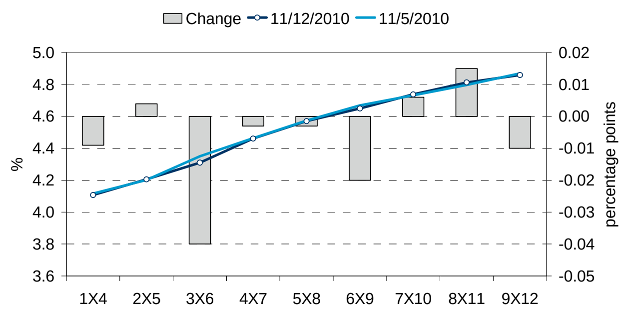
If unable to hold, next levels at 3.8562 (weekly Bollinger bottom): tough on 1st attempts.

1st Resistance comes in at 3.9650 (breakdown daily): ideal area to stay below to keep current mood on Zloty.

Failure to cap would see next levels at 3.9834 (weekly modified Alpha Beta trend top), ahead of 4.0005 (Oct 29 high), where pause favored.

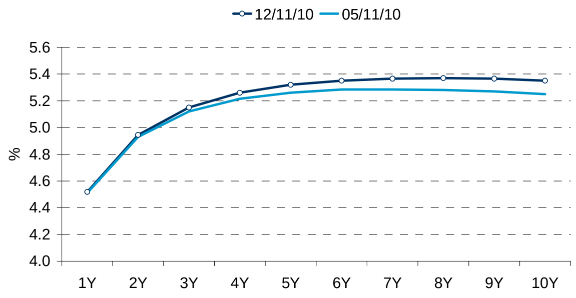
DAILY CHARTS:

PL FRA



Source: Reuters

PL IRS



Source: Reuters

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	15.11.2010	09:00	PPI (%)	10/2010	0.2	2.8	0.2	2.8	0.3	2.4
PL	**15.11.2010**	**14:00**	**CPI (%)**	**10/2010**			**0.4**	**2.8**	**0.6**	**2.5**
PL	16.11.2010	15:00	Budget balance (PLN M)	10/2010					-39 507	
PL	18.11.2010	14:00	Wages (%)	10/2010			1.4	4.0	-0.1	3.7
HU	19.11.2010	09:00	Wages (%, ytd.)	09/2010				1.6		1.9
PL	**19.11.2010**	**14:00**	**Industrial output (%)**	**10/2010**			**-0.2**	**10.0**	**13.2**	**11.8**
PL	19.11.2010	14:00	PPI (%)	10/2010			0.2	4.2	0.1	4.3

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	IX.10	XII.10	III.11	VI.11	IX.11	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	0.75	1.00	1.25	-25 bps	6.5.2010
Hungary	2W deposite r.	*5.25*	5.25	5.25	5.25	5.25	5.25	-25 bps	23.2.2010
Poland	2W inter. rate	*3.50*	3.50	3.75	4.00	4.00	4.00	-25 bps	25.6.2009

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

		Current	IX.10	XII.10	III.11	VI.11	IX.11
Czech Rep.	PRIBOR	*1.22*	1.20	1.23	1.25	1.45	1.65
Hungary	BUBOR	*5.37*	5.25	5.25	5.25	5.25	5.25
Poland	WIBOR	*3.85*	3.90	3.90	4.10	4.30	4.30

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

	Current	IX.10	XII.10	III.11	VI.11	IX.11
Czech Rep.	*2.84*	2.65	2.80	2.90	3.05	3.20
Hungary	*6.73*	6.50	6.50	6.25	6.00	6.00
Poland	*5.35*	4.95	5.00	5.60	5.60	5.80

Exchange rates (end of the period)

		Current	IX.10	XII.10	III.11	VI.11	IX.11
Czech Rep.	EUR/CZK	*24.6*	24.8	24.5	24.6	24.6	25.5
Hungary	EUR/HUF	*276*	280	280	275	275	275
Poland	EUR/PLN	*3.94*	4.00	3.80	3.60	3.70	3.60

GDP (y/y)

	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
Czech Rep.	3.0	2.2	2.0	1.2	1.0	2.5
Hungary	0.5	1.0	1.2	1.4	2.0	2.5

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

	IX.10	XII.10	III.11	VI.11	IX.11	XII.11
Czech Rep.	1.9	2.0	2.2	2.5	2.4	2.4
Hungary	4.2	3.5	3.4	3.2	2.8	3.2

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