Monday, November 22,

Central European Weekly

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Czech Republic

Bonds' sell-off continues, even as the FinMin sees lower budget deficit in 2010

Hungary

Wage data and employment figures show labour market's recovery is slow

Poland

New set of data won't bring a sufficient support for a rate hike yet

The Week Ahead

Polish central bank will postpone its decision about a rate hike

Overview

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.68	0.30%	↗	↗
EUR/PLN	3.936	0.09%	↗	↗
EUR/HUF	274.0	-0.86%	↗	↗
3M PRIBOR	1.22	0.00	→	→
3M WIBOR	3.85	0.00	→	↗
3M BUBOR	0.00	0.00	↗	↗
10Y CZK	3.47	-0.01	↗	↗
10Y PLN	5.86	0.11	↗	↗
10Y HUF	7.14	0.13	↗	↗
3M EURIBOR	1.14	0.08	→	↗
10Y EMU	2.69	0.13	↘	↗

Last values from Friday 15:30 CET

Central Europe escapes contagion from the Irish crisis

It almost seemed that the financial crisis that hit the global economy in 2009 had dispersed for good, when a new problem, related to the highly vulnerable situation within the Irish banking sector, emerged in the euro area. Thus the risk premiums on government bonds in the periphery of the eurozone have again hit highs, indicating that the aversion to risk in Europe is on the rise.

Remarkably, Central European forex and bond markets have reacted to the Irish crisis very cautiously thus far. As a matter of fact, these markets are thus repeating their reaction to a similar crisis this last spring, when Greece was the affected country and when the initial reaction of Central European markets was also very moderate. Just like in April or May of this year, only Hungarian fixed income instruments, which have priced in obviously higher risk premiums (the yields of Hungarian bonds and CDS have increased by approximately 50 basis points since the beginning of October), have reacted negatively to the problems of Ireland.

The moderate reaction by Central European markets to Ireland's problems is fairly logical. Just like in the case of Greece, there is no risk of direct contagion through financial or trade channels; however, this perception of the Irish crisis in Central Europe might only change if the increase in risk premiums at the periphery of the eurozone threatened the growth of the entire monetary union, or if a (controlled or uncontrolled) bankruptcy of some of the eurozone countries were imminent. Nevertheless, we do not find ourselves at such a stage at the moment, and therefore we still consider any major depreciation of Central European currencies or a major decline in bond prices to be temporary rather than long-term, and consequently we consider this to be an attractive opportunity to take long positions in CZK, PLN and HUF, and in the government bonds of the relevant countries.

Czech Republic

Currency

The Czech koruna significantly underperformed the region last week. It came from a sideways mode at the beginning of the week to a defensive one. Interestingly this defensive mode was triggered by the rising hopes for Irish bailout, which was rather applauded in the rest of the region. The weakness of the Czech currency was probably the effect of the lowest yields in the region that makes it attractive funding currency for regional carry trades, which is even more the case after recent dovish comments from CNB. Also the recent increase in EURIBOR could have boosted the attractiveness of the koruna as regional funding currency. **From the beginning of the month the Czech koruna, in contrast with the rest of the region, started to exhibit negative correlation to the S&P 500 index.** That is not typical for emerging market currency and points to the possibility of carry trade emergence.

Given the fact that week ahead is, regarding domestic releases, not interesting, we expect the global sentiment to be main driver on the Czech markets. We are curious to see whether low yielding koruna is able to appreciate that.

Fixed income

The Czech bond market has been playing a catch up process with core bond markets as it had previously absented from the sell-off experienced in the first half of the November. As a result the Czech bond yield curve steepened in a bearish fashion and for example the 10Y bond yield jumped by more than 10 bps. Moreover, yields have continued to rise even at the beginning of this week, while the market shrugged off the positive comment from Finance Minister Kalousek, who indicated that the public budget gap for this year should be lower than the original target (5.1 % of GDP instead of 5.3% of GDP).

EUR/CZK technical picture

(24.6400) Double Top off 25.0150 (previous year low: see graph), with new reaction low off 29.6900 having been scored.

1st support area at 24.5350 (reaction low hourly), with next levels at 24.4550 (break-up hourly + weekly modified Alpha Beta trend bottom), ahead of 24.3450 (current reaction low off 29.6900), where pause favored.

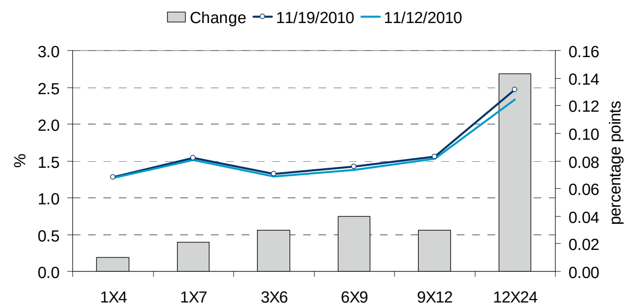
If unable to hold, next levels at 24.2930 (weekly Bollinger bottom), ahead of 24.1960/ .1910 (monthly envelope bottom/ monthly Bollinger bottom) and 24.0240/ .0000 (monthly modified Al-pha Beta trend bottom/ psycho): tough on 1st at-tempts.

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 .

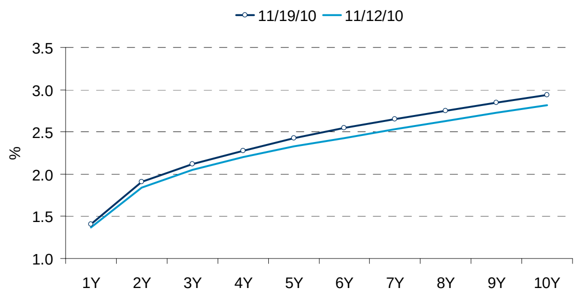
DAILY CHARTS:

CZ FRA



Source: Reuters

CZ IRS

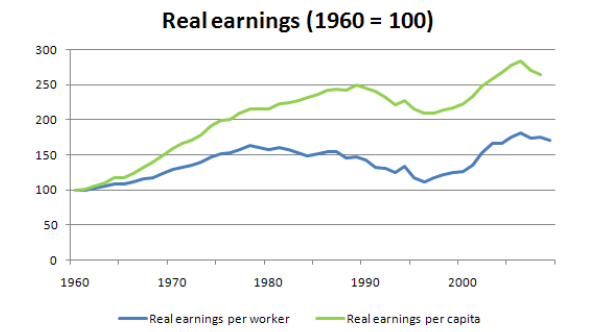


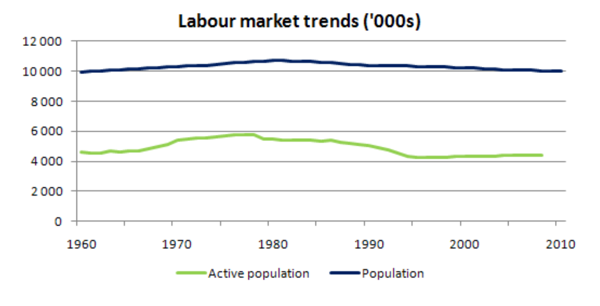
Source: Reuters

Hungary

Macro review

Last week was relatively quiet on the macro data front and debate about Hungary remained centered about the medium-term fiscal outlook as one-off revenue measures will expire in 2013 implying a risk of higher deficit.
Wage data and employment figures showed continuation of the labour market's slow recovery. Unemployment lowered to 10.8% in October, while wage growth remained moderate at 2.3% Y/Y in September underpinning the slack in the economy, which may curtail cost-side pressures in inflation. Retail trade reflects this with a mere 0.2% Y/Y growth, despite households' relatively strong 8% Y/Y net wage increase due to more favourable taxation of the average income since the beginning of the year.
Minutes of the October Monetary Council meeting revealed a more balanced approach to rate changes as there were 1-1 votes for both directions.
We looked into some more details about Hungary's long-term trend and found that wage per employee could play an important role behind population and employment trends.
We found that per worker real income started to decline after the late '70s, while per capita real income kept on growing until 1989. This meant that there had been a widening gap between the two and in favour of non-workers' income, like pensions or capital income.





Unfortunately, working became less attractive vs passive income and this had probably some negative consequences onto the labour market, which began to deteriorate shortly thereafter.

After 1979, number of actively working people started to decrease and a few years later families began to show less willingness for having babies, while resulted in a declining population since then.
By the late '90s, Hungary lost about 1m jobs, which the government is now trying to win back over the next 10-years.

Currency

EUR/HUF technical picture

(274.40): Pair currently back below 276.70 (see graph: neckline Head And Shoulders Top) and above Uptrendline off year low.
Resistance at 277.00 (breakdown hourly), ahead of 278.85/ 278.90 (breakdown daily Sept 23/ Nov 17 high), 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 modified Alpha Beta trend bottom), where pause favored.
If wrong, next levels at 269.08/ 268.70 (weekly Bollinger bottom/ current reaction low off 292.10) and 268.28 (76.4% 260.93 to 292.10): tough on 1st attempts.

DAILY CHARTS:

Since the currency weakened to the key level of 278/€ last week, good news about Ireland helped it to recover sharply to the 272.50 level by the beginning of this week. This is a tad weaker than this month's record high of 269.50/€ and could suggest that the market is in a stabilization mode around the pivotal level of 275.00/€.
The next key event could be the central bank's meeting next week, which could soften the hawkish tone of the August

outlook, but may keep uncertainty about interest rate changes and therefore may not help much to the currency.

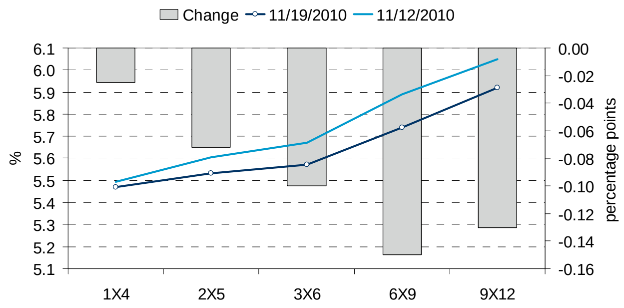
Fixed income

The bond market did not recover much with the currency as yields on high risk eurozone debt markets remained high and Hungary's CDS did not declined much from the level of 330bps. The 10-year bond has been trading around the 7.30% level, just above the key level of 7.25%, but foreign demand remained solid. Foreign investors bought about Ft360bn bonds since the summer.

The short-end softened a bit on its rate hike expectation and the 9x12 FRA tenor kept about 50bps rate hike intact, less than the 75bps it had a week-ago.

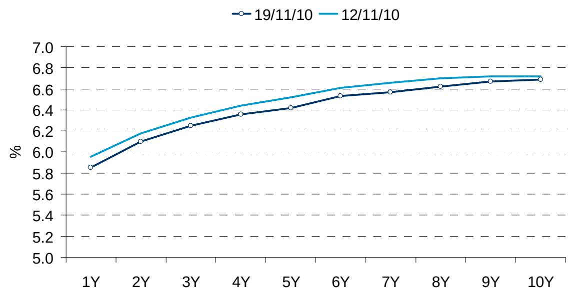
Lack of demand side pressure in inflation however keeps us convinced that rate hikes are probably less likely than implied by markets.

HU FRA



Source: Reuters

HU IRS



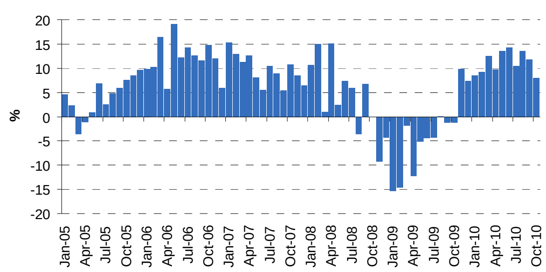
Source: Reuters

Poland

Macro review

Regarding previous week, releases of Polish macroeconomic indicators did not bring any significant surprises and in our opinion supported current rather dovish policy stance.
On Monday, the figure on October's CPI inflation was in line with market expectation (2.8% y/y) and was slightly surprising from the viewpoint of Polish Ministry of Finance, which expected 0.1 percentage point higher growth. As far as month on month dynamics is concerned, inflation rose by 0.5%, mainly due to higher food and clothing prices.
Labor market statistics released on Thursday showed a bit faster than expected growth in October's employment (2.1% y/y), but at the same time slower development in gross wages (3.9% y/y).
Although surprised negatively, the October's result of industrial output (8.0% growth y/y) released on Friday confirmed that the Polish economy is in good shape and producer prices reading was a little lower than market expectations (4% y/y).
Apart from quantitative releases, minutes of the Monetary Policy Council's (MPC) October's meeting were published on Thursday. While some Council members argued that currently observed economic recovery can potentially create inflationary pressures, other MPC members claimed the recent positive development in consumption may slacken unless supported by stronger growth of gross wages.
Thus, in our opinion, MPC should on its meeting held this Tuesday (23.11.) decide to keep interest rates at the current levels.

Polish industrial output, y/y



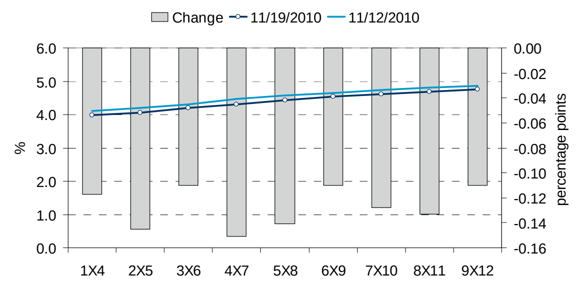
EUR/PLN technical picture

(3.9375): 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 3.8964 (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 level at 3.8680 (weekly Bollinger bottom): tough on 1st attempts.
1st Resistance comes in at 3.9650/ .9700 (break-down daily/ Nov 17 high + weekly modified Alpha Beta trend top): ideal area to stay below to keep current mood on Zloty.
Failure to cap would see next level at 4.0005 (Oct 29 high), where pause favored.

DAILY CHARTS:

Fixed income

PL FRA



Source: Reuters

CE Weekly Preview

TUE 14:00 **NBP rate (in %)**

	This meeting	Last change
rate level	**3.50**	5/2009
change in bps	**0**	-25

PL: The NBP is unlikely to change rates

There is every indication that the National Bank of Poland (NBP) will announce the keeping of its reference interest rate unchanged at its current level of 3.5% at its meeting to be held this Wednesday (November 24). The minutes of the Monetary Policy Council (MPC) meeting indicate that great differences persist in the central bankers' opinions. While some MPC members see the current recovery as sustainable and are afraid of inflationary pressures, the other group argues that, after the one-off effects peter out, consumption will decelerate, evidence of which, according to them, is the slow real wage growth. Recently, the debate has primarily focused on the exchange rate of the Polish zloty. Particularly Governor Belka often reiterates his concerns about the appreciation of the Polish currency, if interest rates were to be raised.
That said, events that were of interest to more than just economists took place at the Monetary Policy Council during November. Firstly, relatively strong signals indicating a rate hike occurred. Two of the six central bankers who had voted for leaving rates unchanged at the August meeting (the last meeting from which we have detailed information as to how the individual bankers voted) turned from doves into hawks 'on the fly' (Winiecki, Zielinska-Glebocka). Last week, however, their colleague Bratkowski changed his mind in exactly the opposite way, while Anna Zielinska-Glebocka likely concluded that the hawkish garb was not appropriate for her and also returned among the doves. In addition, if we take account of the consistently dovish position of Governor Belka and the latest data from the Polish economy, which sprang no significant surprises, we find that the period of record-breaking low interest rates is likely to persist for at least one additional month. Our scenario currently envisages that a 25 bps rate hike will be announced at the December meeting.

Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
PL	22.11.2010	14:00	Core CPI (%)	10/2010			0.2	1.2	0.2	1.2
PL	**23.11.2010**	**14:00**	**NBP meeting (%)**	**11/2010**	**3.50**		**3.50**		**3.50**	
HU	25.11.2010	09:00	Retail sales (%)	09/2010				0.4		0.0
PL	**25.11.2010**	**10:00**	**Retail sales (%)**	**10/2010**			**3.1**	**8.1**	**1.2**	**8.6**
PL	25.11.2010	10:00	Unemployment rate (%)	10/2010			11.6		11.5	
HU	26.11.2010	09:00	Unemployment rate (%)	10/2010			10.8		10.9	

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

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	1.00	1.25	-25 bps	5/6/2010
Hungary	2W deposite r.	*5.25*	5.25	5.25	5.25	5.25	5.25	-25 bps	2/23/2010
Poland	2W inter. rate	*3.50*	3.50	3.75	4.00	4.00	4.00	-25 bps	6/25/2009

*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	1.23	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	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Czech Rep.		*29509*	2.65	2.80	2.90	3.05	3.20
Hungary		*6650*	6.50	6.50	6.25	6.00	6.00
Poland		*53800*	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	*24685.0*	24.8	24.5	24.6	24.6	25.5
Hungary	EUR/HUF	*274350*	280	280	275	275	275
Poland	EUR/PLN	*39375.00*	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)

		Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-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

Current Account as % of GDP

	2009	2010
Czech Rep.	-1.0	-2.2
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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