Monday, March 14, 2011

Banking & Insurance

Central European Weekly

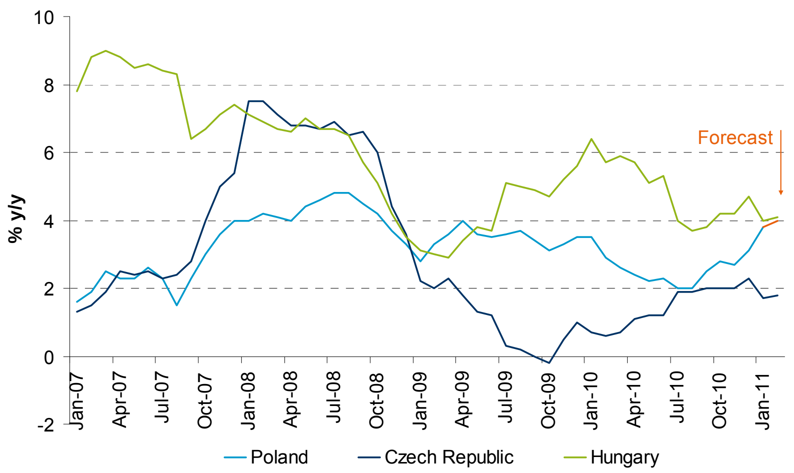
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- CE markets cope with external risk, but domestic factors could be another challenge
- Czech headline inflation surprises on the downside and stays below CNB's target
- In Focus: New Czech Methodology for Balance-of-Payments
- Preview: Polish headline inflation climbs to 4% in February

Chart of the Week: Czech, Hungarian and Polish headline inflation

CPI Inflation in the CE region



While the Czech and Hungarian readings for the headline inflation have already softened, the Polish CPI is expected to move further north.

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Market's Editorial

Although tsunami has not washed CE markets,

This time, the deterioration of the sentiment on global markets, triggered by a coincidence of independently occurring negative events, also affected Central Europe to a certain extent. The deterioration of the market sentiment was primarily evident in the Polish forex market and, to a certain extent, also in the Hungarian bond market, which was gearing up for an auction, and therefore the rise in yields cannot be attributed to external phenomena alone.

Although the markets' fear of the damage in Japan and of the developments in Libya and surely in the periphery of the euro area may wane, cautiousness in respect of Central European markets is still advisable, due also to national reasons. We believe that Polish as well as Hungarian government bonds should be on the alert, and even the Czech koruna, which has been stable thus far, may be at risk.

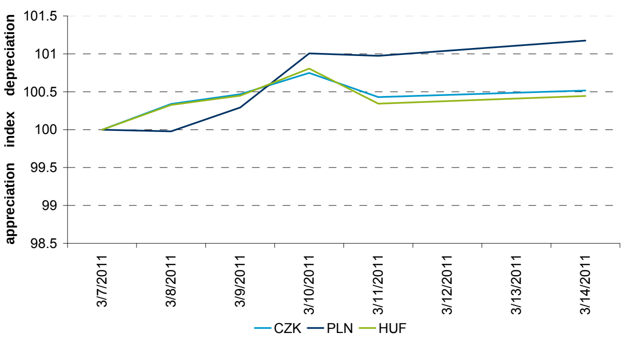
…upcoming domestic factors might do so.

As far as Polish government bonds are concerned, these should very carefully follow the data on February's inflation, which may again deliver an unpleasant surprise, by possibly hitting the psychological level of 4.0% y/y again. Should this really happen, the bond market may even more aggressively step up its bets on the National Bank of Poland raising its rates in early April.

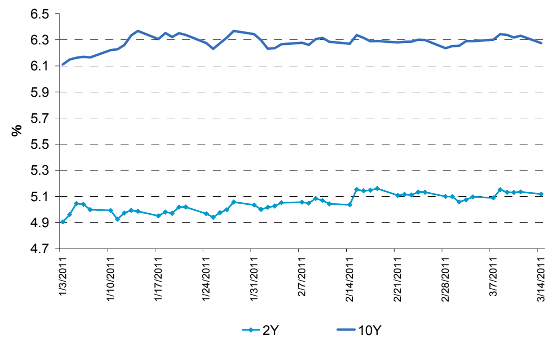
As regards Hungarian bonds, the development of public budgets poses the main risk. These have posted great deterioration in the first two months of 2011, with the government justifying this by the seasonal budget developments. Nevertheless, the deficit seems to be high, even if we take seasonal effects into account. More budget figures of this sort could make the market even more nervous.

Finally, we also remain cautious about the Czech koruna, which we consider to be overvalued in terms of long-term fundamentals. Naturally, this may not apply to the short-term and medium-term horizons, but the widening of the interest rate differential between euro rates and Czech rates, because of the hawkish tenor set by the ECB, might draw attention to the position of the Czech koruna.

CE exchange rates against the euro



Polish bond yields



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.28	0.00%	↗	↗
EUR/PLN	4.030	1.23%	↗	↗
EUR/HUF	272.6	0.48%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.94	-0.06	→	↗
10Y PLN	6.31	0.03	↘	↗
10Y HUF	7.33	0.18	↗	↗

Review of Economic Figures

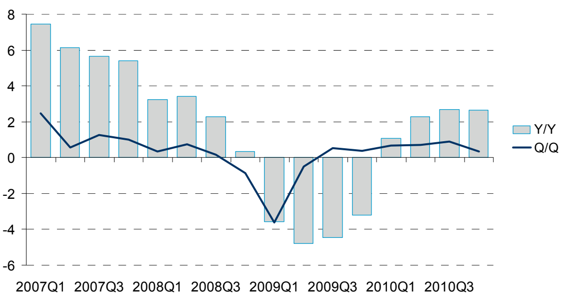
Revision reduced the Czech economic growth

Rapidly expanding industry on the one hand, and a weaker performance of the rest of the economy on the other hand, make up the picture of the Czech economy, according to the latest data for the last quarter of 2010. Industry, notably cars and electronics, still plays the main part, while agriculture, construction, and partly also some services, are not developing very well. Households are again affected by expenditure cuts, triggered by rising unemployment and a drop in real wages. The first expenditure cuts are evident in consumption by the government sector. Investment closed last year with a very poor figure, having dropped by 2.3%, due primarily to the cuts in expenditure on machinery and means of transport. For the CNB, the latest figure means that the economy is faring much worse than the bank predicted in its previous forecast. Thus the GDP, along with wage and inflation developments, is yet another figure encouraging the CNB's moderate approach for the next few months. Hence there is no need to raise rates in a hurry. This year's economic growth is likely to decelerate slightly. The reasons will include government expenditure cuts, with a decline in real wages, and consequently further reductions in household consumption, also being likely. During this year, the economy might approach its pre-crisis level; however, it will not exceed that. The main risks to the future development of the Czech economy continue to lie abroad. For the moment, however, as we can see, for example, from industrial contracts, foreign demand is continuing to improve, thus strongly facilitating the recovery of the upturn in the CR.

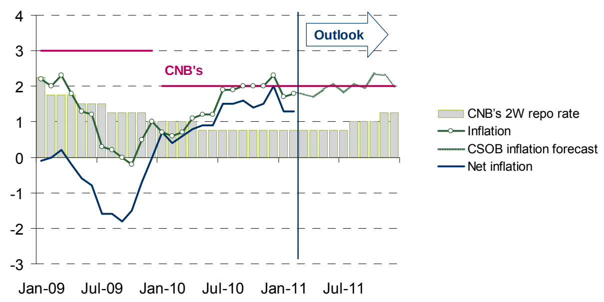
Czech inflation still below the CNB's level

February's inflation was primarily driven by the prices of food, alcohol, and seasonally costlier package tours. By contrast, the prices of clothing, shoes, household equipment, and even fuel went down this time. Nonetheless, the fall in fuel prices was just temporary, as the rapidly rising oil prices in recent weeks could not yet fully affect inflation. Overall, year-on-year inflation went up by 0.1 to 1.8%, and thus remains lower than that of the eurozone, in spite of deregulations. The prices driven by increasing costs are on the rise, but poor demand sufficiently curbs retailers in raising their prices. While March's inflation will reflect the current increase in petrol and diesel prices, inflation should still remain below the target level of the CNB, in spite of record-breaking oil prices and consequent fuel prices on the Czech market. There is definitely no need for the CNB to hasten to raise rates, because demand-pull inflation is still nowhere to be seen, and real wage developments are evidence of this. There is absolutely no stimulus to any improvement of consumer demand now, and therefore inflation only remains at the mercy of the foreign prices of both energy and food commodities. In addition, among the inflation risks within the next twelve months, we can also include the VAT change currently being discussed; after the initial proposal to move most goods and services from the reduced VAT rate to the standard rate, the latest proposal is to raise the reduced rate to 14% in the first stage (2012), and to unify both rates at 17.5% in the second stage (2013). The initial inflation stimulus may be approximately 1.1%. Nonetheless, the central bank should, by its nature, ignore the VAT increase, that is to say its primary impacts.

CZ: GDP Growth
(%)



CZ: Inflation and CNB's Target
(%)



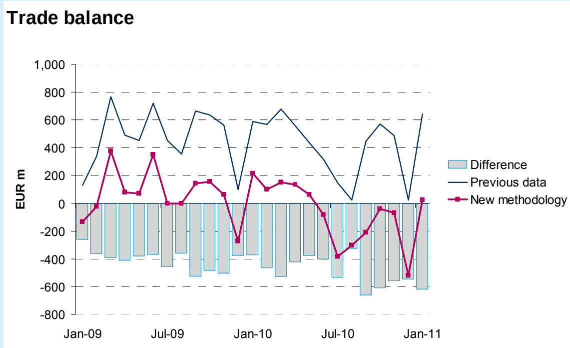
In Focus: New Czech Methodology for Balance-of-Payments

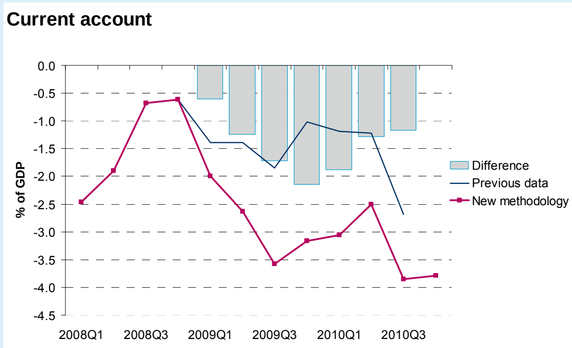
The new Czech methodology for balance-of-payments statistics significantly changes foreign trade balance as well as current account deficits.

This year, the Czech Statistical Office has begun releasing two sets of data on the development of the CR's trade balance, and they differ greatly, as indicated by last year's figures. On the one hand, there is a surplus of CZK 122.8bn, and on the other hand, a deficit of CZK 23.3 bn. Both figures are correct, but their interpretation is somewhat difficult, and some may even find it misleading. That said, the Statistical Office complements the currently applicable data with figures according to the national concept of foreign trade, which involve a reduced effect of re-exports and the profit margins of tax non-residents operating on the Czech market, notably in the electrical and automotive industries.

To date, the values of exports and imports have been based on the prices of goods crossing the national border. This method is currently changing to the concept of national accounts, which consider the ownership change itself, between residents and non-residents, to be foreign trade. The reason for this change is the fact that the rising volume of foreign trade is not consistent with the capital flows on the financial account of the balance of payments. Thus, to date, the amount of exports has been overvalued and the amount of imports undervalued. The problem was temporarily addressed by what is known as branding – the import of 'brand' within the balance of services. Thus the new methodology reduces the amount of the exports of goods, in terms of accounting, while eliminating the above-mentioned brand imports. The difference will be largely offset, but not entirely (due to the actually higher imports of goods and the switch from CIF to FOB), and worsen the current account data and consequently likely also the GDP. However, the new changes will become obvious in the national accounts (GDP) after some time. For the moment, we need to distinguish two sets of foreign trade data and take account of the deterioration of the current account deficit beyond 3% in 2010.

BOX: See the difference between the old and new methodology in real figigures





CE Weekly Preview

TUE 9:00 **CZ PPI (y/y change in %)**

	Feb-11	Jan-11	Feb-10
m/m	**0.2**	1.4	-0.3
y/y	**5.1**	4.6	2.0

CZ: PPI still under pressure from expensive raw materials

The rising prices of agricultural and energy commodities likely continued to affect the producer price index in February. Thus the year-on-year PPI might exceed the 5% mark. The last time that the PPI rose at such a fast rate was just ahead of the onset of the economic recession in 2008.

And this pressure of input costs on producer prices is not waning in March either, as we can see from the current prices of oil and agricultural commodities. This is why the rising PPI will tend to put pressure on the consumer price index, particularly in respect of food and fuel prices. Yet the prices should not trigger any inflation upsurge, because poor domestic demand will continue to curb such a surge perfectly.

TUE 10:00 **PL Inflation (change in %)**

	Feb-11	Jan-11	Feb-10
CPI y/y	**4.0**	3.8	2.9
Food (ex Alc.) y/y	**5.1**	4.8	2.8
Transport (including fuel)	**7.4**	7.2	8.2

PL: Headline inflation climbs to 4% in February

In January, Poland's inflation surprised markets, by hitting 3.8% y/y. Prices went up mainly because of globally high commodity prices and an increase in VAT rates and administrative prices. According to our forecasts, February's inflation likely rose to 4% y/y; in addition, we expect that prices in Poland will continue to rise in March, when inflation should hit this year's high of around 4.2% y/y. This is no pleasant situation for the central bank, because inflation has already exceeded the upper threshold of its tolerance band. Hence we anticipate another rate hike as early as at the April meeting.

WED 9:00 **CZ Retail Sales (change in %)**

	Jan-11	Dec-10	Jan-10
Sales	**3.5**	-1.6	-5.2
cummulative (YTD)	**3.5**	1.0	-5.2

CZ: Recovered car sales encourage the retail sector

We expect that the retail sector fared well in January, due primarily to rising car sales, a low comparative baseline and a greater number of business days; nevertheless, it would be very audacious to speak of any recovery of consumer demand. Above all, it is largely based on the automotive segment, which is driven by the purchases of vehicles by businesses rather than households. Another factor consists of the statistical bases, which will have a great influence on the individual year-on-year figures this year. By and large, however, we do not expect any acceleration of the rise in retail sales. The data will seesaw, but the trend will be close to stagnation.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	14.3.2011	10:00	Current account (CZK B)	01/2011	12.0		10.2		-0.69	
PL	14.3.2011	14:00	Trade balance (EUR M)	01/2011			-610		-1 106	
PL	14.3.2011	14:00	Money supply M3 (%)	02/2011			1.0		-1.8	
PL	14.3.2011	14:00	Current account (EUR M)	01/2011			-1 280		-1 573	
CZ	15.3.2011	09:00	PPI (%)	02/2011	0.2	5.1	0.3	5.2	1.4	4.6
PL	**15.3.2011**	**14:00**	**CPI (%)**	**02/2011**	**0.4**	**4.0**	**0.4**	**3.9**	**1.2**	**3.8**
CZ	16.3.2011	09:00	Retail sales (%)	01/2011		3.5		3.0		-0.2
PL	16.3.2011		Bond auction	10Y						
PL	16.3.2011		Bond auction	20Y						
PL	16.3.2011	14:00	Wages (%)	02/2011			1.9	4.9	-11.9	5.0
PL	16.3.2011	15:00	Budget balance (PLN M)	02/2011					-2 757	
HU	17.3.2011	09:00	Industrial output (%)	01/2011 *F					15.5	10.9
PL	**17.3.2011**	**14:00**	**Industrial output (%)**	**02/2011**			**3.1**	**10.4**	**-6.4**	**10.3**
PL	17.3.2011	14:00	PPI (%)	02/2011			0.3	6.7	0.4	6.2
HU	18.3.2011	09:00	Wages (%, ytd.)	01/2011				2.3		-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

CE Forex Technicals

EUR/CZK Daily Chart:

Below long term Triangle bottom (see graph).
Support at 24.1800/ .1660 (March 03 low/ 61.8% 23.9200 to 24.5650), with next levels at 24.0720/ .0600 (76.4%/ break-up daily Feb 08) and 24.0310 (monthly envelope bottom), where pause favored.
If unable to hold, next levels at 23.9200/ .9000 (current reaction low off 25.3800/ weekly + monthly Bollinger bottoms), where pause favored.

Resistance at 24.4550 (breakdown daily + weekly Medium Term Moving Average↓), where pause favored.
In unable to cap, next levels at 24.5650/ .5770 (current recovery high off 23.9200? + weekly Bollinger midline + see graph: neckline short term Double Bottom/ monthly Short Term Moving Average↓), ahead of 24.6500/ .6650 (50% 25.3800 to 23.9200/ 4th wave off 25.3800 on hourly charts): tough on 1st attempts.

EUR/HUF Daily Chart:

Rebound off low retested the broken Uptrendline off 2010 low (see graph).
Support at 270.70/ .39 (March 08 low/ reaction low hourly), ahead of 269.60/ 269.00 (March 01 low/ Feb 17 low), where pause favored.
If unable to hold, next levels at 268.25 (weekly Bollinger bottom), ahead of 267.90/ .40 (weekly modified Alpha Beta trend bottom/ year low) and 266.10 (monthly envelope bottom): tough on 1st attempts.

Resistance at 274.60 (weekly + monthly Bollinger midlines), ahead of 275.20 (current recovery high off 267.40 + see graph: neckline Double Bottom).
If unable to cap, next levels at 276.24/ 276.55 (monthly envelope top/ Jan 20 high + weekly modified Alpha Beta trend top), ahead of 276.85 (broken 50 Week Moving Average↑) and 278.00/ .20 (breakdown daily/ 61.8% 285.00 to 267.40): tough on 1st tests.

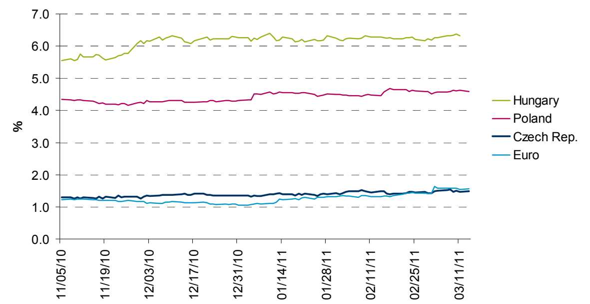
EUR/PLN Daily Chart:

Testing Downtrendline off 4.2400 (see graph) and above 3.9610 (neckline Double Bottom).
Support at 4.0030/ .0000 (previous reaction highs), ahead of 3.9844 (weekly Short Term Moving Average↑): needs to settle back below to indicate return of better fortune for Zloty.
If unable to hold, next levels at 3.9531/ .9488 (broken weekly Long Term Moving Average↓/ March 01 low), ahead of 3.9340/ .9282 (break-up hourly/ weekly modified Alpha Beta trend bottom), where pause favored.

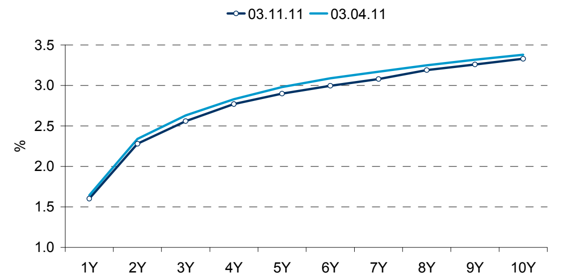
Resistance at 4.0335/ .0436 (monthly Bollinger midline/ 76.4% 4.1100 to 3.8290), ahead of 4.0517 (weekly Bollinger top), where pause favored.
Failure to cap would see next levels at 4.0657 (monthly modified Alpha Beta trend top), ahead of 4.0770 (1st target off 3.9610): tough on 1st attempts.

CE Fixed-income in Charts

FRA 3x6

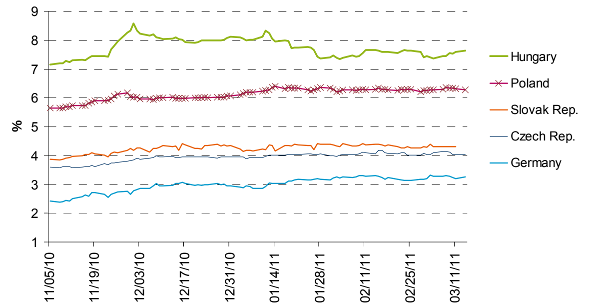


CZ IRS

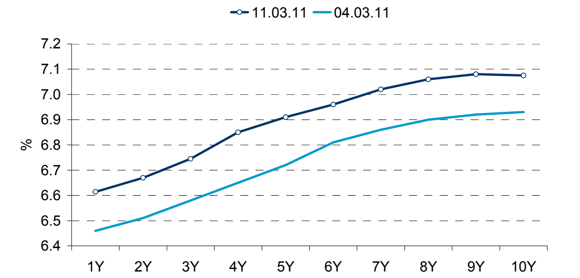


Source: Reuters

10Y GB Yields

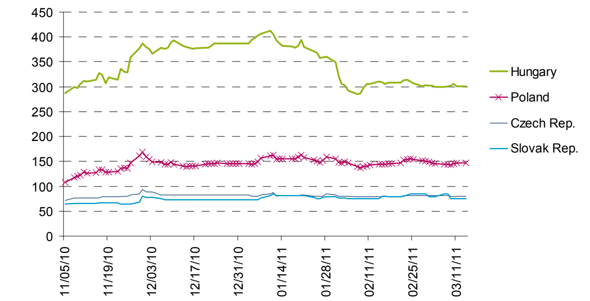


HU IRS

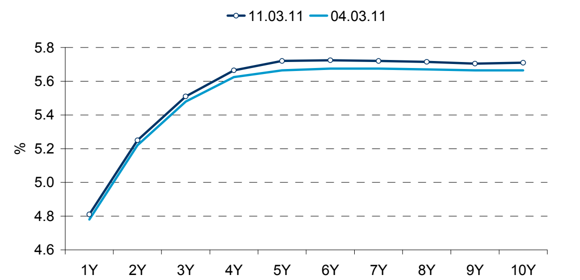


Source: Reuters

CDS 5Y



PL IRS



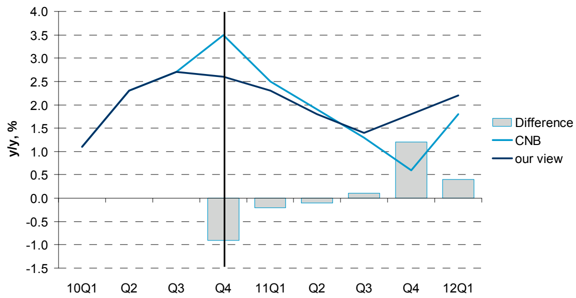
Source: Reuters

Medium-term Views & Issues

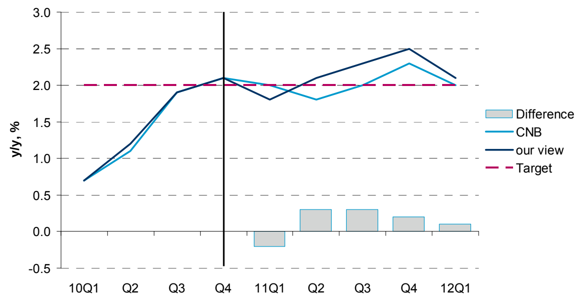
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage point per year is reasonable and doesn't pose a huge risk to the ongoing economic recovery. Already last year's budget ended with a lower than planned deficit. The general government deficit even felt below 5% of GDP in 2010. The fundamental precondition for hitting the budget targets is the launch of reforms, notably of the social security and pension system.	Hungary's government decided to carry out a large-scale fiscal overhaul program over 3-years (2011-2013) in order to boost growth. The impact on the economy will come from higher activity of the working age population and shrinking size of government spending. Lower spending helps to cut the deficit amid tax reductions and the program overall cuts the deficit by 2% of GDP in 2012 and further 1% of GDP in 2013. The long-term outlook mainly depends on the execution. We recommend waiting until the 2010 ESA budget deficit number is released in March before deciding on investments.	The Polish economy slightly slowed down in the fourth quarter judging from a flash estimate of whole year GDP growth. For 2011 we expect growth should be nearly the same as in 2010 (3.7% y/y). Mainly domestic consumption and investment should drive the growth with government and external sector having more or less neutral impact. Despite the fact that demand pulled inflation remains muted, CPI should further rise in January. According to our estimates, the infl. might even breach 1 p.p. point tolerance band, mainly due to one-off adjustments of VAT and commodities prices.
Outlook for official & market rates	Inflation climbed above the central bank's target due to higher fuel and foodstuffs' prices and to administrative measures. Fuel prices continue to pose a risk to inflation. On the other hand, weak demand and the strong koruna should counteract the rise in inflation. We still think that the CNB will hike its rates sooner than its new prognosis announced (2011 Q4). We believe that rates may be raised as early as in the third quarter of this year. The CNB's repo rate should reach 1.25% by the end of 2011.	Since the November meeting – the central bank increased the base rate by 75bps, so it stands at 6.0 %. Economists together with us expect an unchanged rate without any hesitation. So a move would be very surprising for markets. The consensus also expects the base rate to stay here for a considerable period as inflation is expected to return to 3% only in 2012, while second round effects of the recent energy and food price increase look to be moderated. Domestic inflation and rate hike stories look to have ended now.	The Polish central bank started a hiking cycle at the beginning of the year as we expected. On the other hand, we are no fan of aggressive monetary tightening for now .One must take into account that inflation, although it accelerates above the target, is now purely cost/supply driven and the NBP cannot do much about it. On the other hand more aggressive ECB stance should lead the NBP to at least three more hikes during this year (April, Q3, Q4) to 4.50% by December 2011.
Forex Outlook	Although fundamentals behind the Czech currency continue to be strong (the Czech economy should outperform euro-zone and the external balance should remain at reasonable levels), our long term model suggests that recent gains were too aggressive. Nevertheless the Czech koruna may continue to profit from approaching start of interest rate hiking cycle in short term (3-6 month). It may move into the defensive at the end of 2011. The profit taking could be triggered by the Polish elections and the related weakening of the Polish zloty.	Optimism before the government's spending reform package also boosted appetite for Hungarian assets. In this situation, it will be difficult to meet expectations and markets may thus correct in the coming weeks. Relatively mild positioning of foreign investors together with the forint's neutral performance visá- vis its peers make a sharp correction unlikely for now, except if global outlook changes significantly by for example an oil-price triggered slowdown In the longer term positive impact could depend on the productivity boost.	Since calls for the stronger zloty had fallen on deaf ears, the Polish central bankers' rhetoric moved to a more hawkish mode. Tighter monetary conditions should further support the Polish currency. We bet on strong gains especially after the euro crisis is more clearly resolved – 6 month target at 3.55 EUR/PLN. Nevertheless the parliamentary elections in autumn 2011 and the risk o breaching the second prudential level for government debt (55% GDP) may bring temporary volatility of the PLN by the end of the 2011.

Central Bank’s Projections versus Our Macro Forecasts

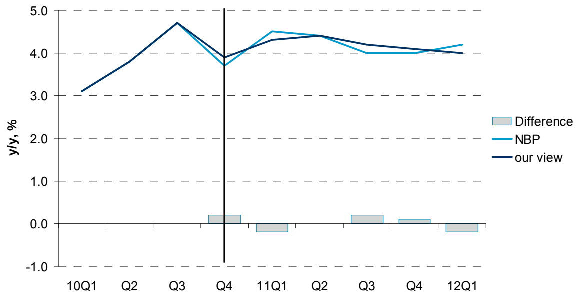
CZ: GDP Outlook



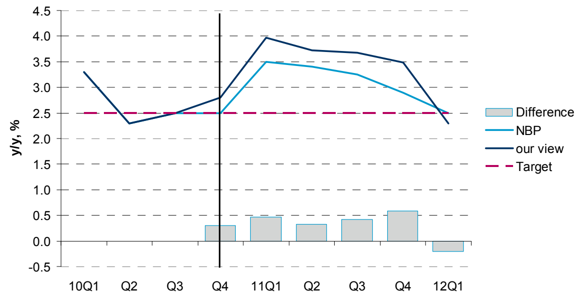
CZ: Inflation outlook



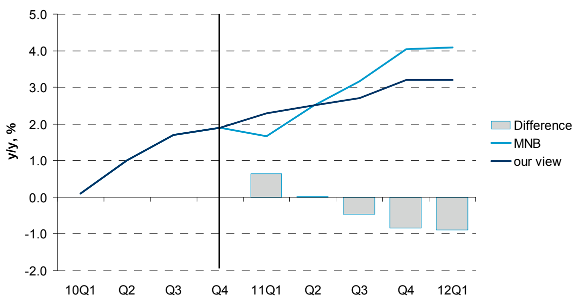
PL: GDP Outlook



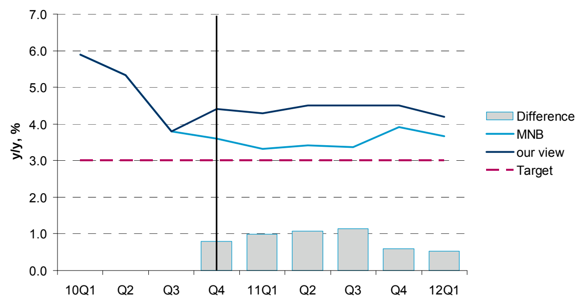
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	1.00	1.25	1.25	-25 bps	06/05/2010
Hungary	2W deposite r.	*6.00*	6.00	6.00	6.00	6.25	6.25	25 bps	24/01/2011
Poland	2W inter. rate	*3.75*	3.75	4.00	4.25	4.50	4.75	25 bps	19/01/2011

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

		Current	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	PRIBOR	*1.21*	1.22	1.35	1.45	1.60	1.72
Hungary	BUBOR	*6.10*	6.10	6.00	6.00	6.25	6.25
Poland	WIBOR	*4.18*	4.15	4.35	4.50	4.55	4.55

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

		Current	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.		*3.33*	3.30	3.40	3.50	3.60	3.70
Hungary		*7.09*	7.50	7.50	7.25	7.00	7.00
Poland		*5.7101*	5.80	5.95	6.00	6.00	6.00

Exchange rates (end of the period)

		Current	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	EUR/CZK	*24.3*	24.7	23.7	24.0	24.6	25.5
Hungary	EUR/HUF	*273*	280	280	275	270	270
Poland	EUR/PLN	*4.03*	4.00	3.90	3.60	3.70	3.60

GDP (y/y)

		Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012
Czech Rep.		2.9	2.4	2.1	1.5	1.5	2.5
Hungary		2.0	2.3	2.5	2.7	3.2	3.2
Poland		*3.9*	4.3	4.4	4.6	4.2	4.0

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

		Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Czech Rep.		2.0	2.4	2.5	2.4	4.5	4.8
Hungary		4.3	4.5	4.5	4.5	4.2	4.0
Poland		3.8	3.5	3.5	3.3	2.5	2.6

Current Account as % of GDP

	2010	2011
Czech Rep.	-1.0	-2.6
Hungary	0.5	1.0

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

	2010	2011
Czech Rep.	-5.9	-5.0
Hungary	-3.8	-2.9

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