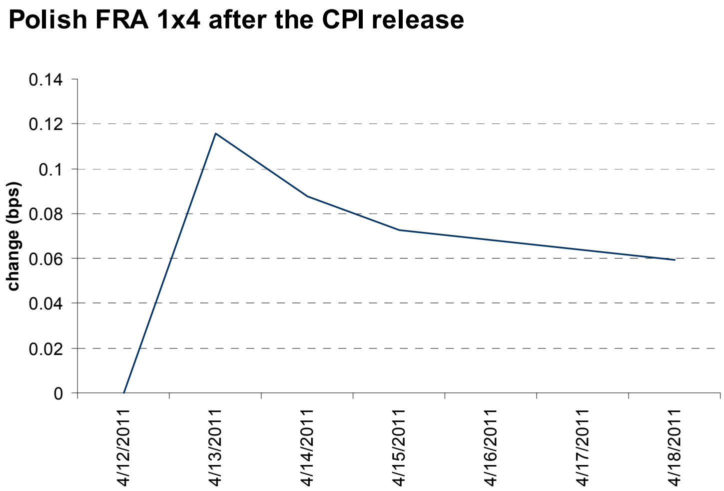
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Next Polish interest rate hike may come earlier after surprisingly high inflation in March
- Polish-Czech interest-rate differential may enhance regional carry trades
- Czech inflation remains low and primarily supply driven
- MNB stays on hold as expected

Chart of the Week: Polish interest-rate expectations



Polish FRA rates jumped right after the release of the March inflation readings. But rate hike bets cooled down a bit thanks to dovish rhetoric coming from the Polish MPC.

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Market's Editorial

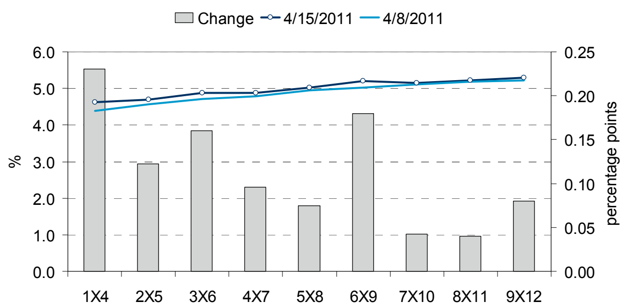
Next interest rate hike may come earlier after surprisingly high Polish inflation

Poland's inflation took everyone's breath away, including ours. It rocketed upwards from February's 3.6% y/y to 4.3% y/y. This is almost 2 p.p. above the central bank target and high above the current forecast. Such a rapid rise in inflation may give numerous Polish central bankers nightmares. Hence we have decided to shift our bets on further rate hike from July to June. At the moment, we do not expect more than the two previously anticipated rate hikes this year (in June and October). We believe that the moderate doves, who primarily view the current inflation as a one-off cost shock from the imported prices of oil and food, will dominate the Monetary Policy Council in the end. That shock should dissipate next year because the labour market situation is not good, and the increased commodity prices should not influence wage negotiations. Governor Belka's recent reaction confirmed our comment: he said that the inflation surprise was "unpleasant" but every "supply shock" will "peter out after some time".

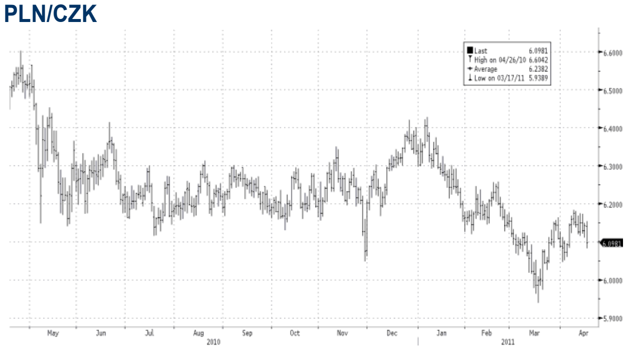
Polish-Czech interest-rate differential may enhance carry trades

Even so, markets may temporarily bet on much more aggressive monetary tightening in Poland, particularly in light of the increased inflation. Inflation is likely to peak in April at around 4.6% and then in August at much the same level. Thus, over the course of time, the rise in Polish short-term yields may contrast, to a greater extent, with the Czech market, where the Czech National Bank need not hasten to raise rates at the moment, given the low inflation. Consequently, the widening interest rate differential may soon encourage investors to launch carry trades – speculative positions in the Polish zloty financed from Czech korunas – to a much greater extent. This is also why we do not currently put much stock in a further strengthening of the Czech koruna; in the wake of Poland's inflation, the currency has dropped below the 55-day average and, being at levels close to CZK 24.00 per EUR, we consider it to be overvalued.

PL FRA



PLN/CZK



Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.24	-0.70%	↘	↗
EUR/PLN	3.948	-0.33%	↘	↗
EUR/HUF	267.1	1.32%	↘	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.98	-0.08	→	↗
10Y PLN	6.13	-0.01	→	↗
10Y HUF	6.94	0.11	→	↗

Review of Economic Figures

The Polish inflation surprises strongly on the upside in March…,

After February's inflation in Poland, which surprised markets on the downside, March's inflation was another surprise, this time on the upside. Last month, the consumer price index went up by 4.3% compared to the same period last year (we as well as the market had anticipated 3.9% y/y). The month-on-month inflation went up at the fastest pace since February 2009 and hit 0.9%. The rise was primarily driven by food prices, which were up by 2.2% m/m and a huge 7.3% y/y. Given the current high inflation level, we believe that inflation may remain above the upper threshold of the central bank's tolerance band until the end of the year. Prices should continue to rise in April, when year-on-year inflation may even exceed the 4.5% mark, thus hitting levels last seen on the eve of the outbreak of the global financial crisis in the summer of 2008.

…while the Czech inflation remains low and primarily supply driven

Unlike inflation in Poland and Hungary, the Czech Republic's inflation remains very low. Year-on-year inflation was down by 0.1% to 1.7%, i.e., 0.3% below the central bank target and forecast. Compared to February, the consumer price index was up by only 0.1%, due in particular to increased fuel prices and the supply of new seasonal clothing to shops. By contrast, holiday package prices went down, as is usual in this period. That said, Czech inflation is pushed only by the increased prices of agricultural and energy commodities on global markets. Demand-pull inflation is not driving prices in the Czech Republic upwards at all. Plenty of consumer goods are even much cheaper on the year-on-year basis, because demand has not recovered yet. In addition, demand is curbed by fiscal austerity measures. No significant price increase is likely to occur on the Czech market in the months to come either. Thus inflation may remain below the Czech National Bank target (2%) until the middle of the year at least. The high price of crude oil is already included in fuel prices, while food prices will start to fall seasonally over the course of time.

MNB stays on hold as expected

The Hungarian central bank kept the base rate unchanged as was widely expected. The relatively strong currency and small uptick in headline inflation (it rose to 4.5 % y/y in March) kept risks probably balanced, while demand driven inflationary pressures are still low in the economy. We do not expect these things to change considerably in coming months, hence the base rate could remain at 6%. The long-term risk is probably for a rate hike if the economy accelerates and core central banks tighten.

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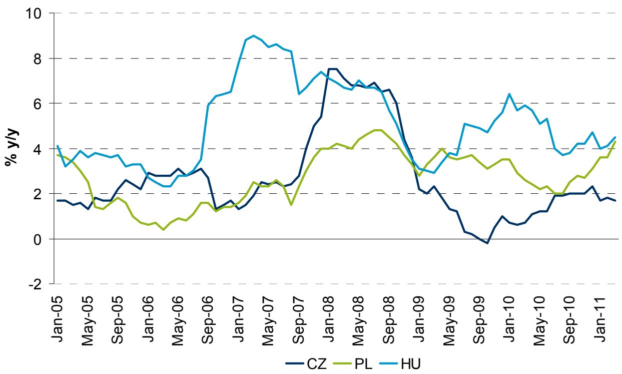
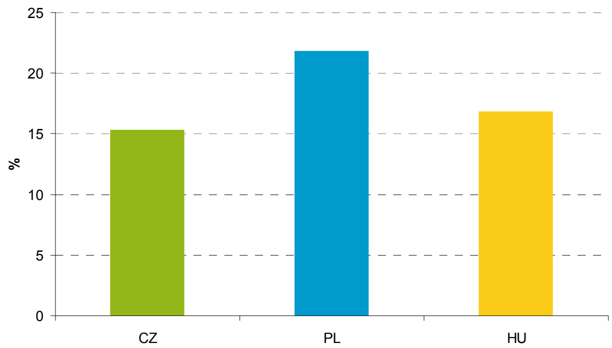
Inflation in Central Europe



Share of food in headline inflation



Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
HU	**18.4.2011**	**14:00**	**NBH meeting (%)**	**04/2011**	**6.00**		**6.00**		**6.00**	
PL	18.4.2011	14:00	Wages (%)	03/2011			6.3	4.2	0.9	4.1
HU	19.4.2011	09:00	Wages (%, ytd.)	02/2011				5.8		1.6
PL	19.4.2011	14:00	PPI (%)	03/2011			0.7	8.3	1.0	7.3
PL	**19.4.2011**	**14:00**	**Industrial output (%)**	**03/2011**			**18**	**9.6**	**3.5**	**10.7**
PL	20.4.2011	14:00	Core CPI (%)	03/2011			0.3	1.8	0.1	1.7
HU	21.4.2011	12:00	GB bond auction/fixed rate (HUF B)	04/2011 *A						
HU	22.4.2011	09:00	Retail sales (%)	02/2011				0.7		0.1

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:

Testing neckline of short term Double Top (24.1800: see graph).
Support at 24.1160 (monthly envelope bottom), ahead of 24.0780/ .0600 (76.4% 23.9200 to 24.5900/ break-up daily Feb 08), where pause favored.
If unable to hold, next levels at 24.0040 (monthly modified Alpha Beta trend bottom), ahead of 23.9200 (year low).
In case of move to new medium term lows, 23.7700/ .7300 = 1st target off 24.1800?/ 1st target of long term daily Double Top off 25.0150: tough on 1st attempts.

Resistance at 24.3400/ .3760 (breakdown daily/ weekly Short Term Moving Average↓): ideal area to stay below to keep current better tone on CZK.
Failure to cap, would see risk towards 24.4650 (April 07 high + weekly modified Alpha Beta trend top).
24.5800/ .5900 = March 31 and 24 highs/ current recovery high off 23.9200), where pause favored.

EUR/HUF Daily Chart:

Rebound off new year low reapproaching 268.40 (March 19 high + see graph: neckline short term Double Bottom).
Support at 265.55 (break-up daily), ahead of 263.01/ 262.91 (new year low/ monthly modified Alpha Beta trend bottom), where pause favored.
If unable to hold, next levels at 261.66 (monthly Bollinger bottom), ahead of 260.93 (2010 low): tough on 1st attempts.

Resistance at 268.40 (see above), ahead of 269.00/ 269.20 (breakdown daily/ weekly Medium Term Moving Average↓), where pause favored.
If unable to cap, next levels at 269.80 (38.2% 280.80 to 263.01), ahead of 271.10/ 271.50 (monthly Short Term Moving Average↓/ breakdown weekly): sustained trade above would indicate end of current love affair with HUF.

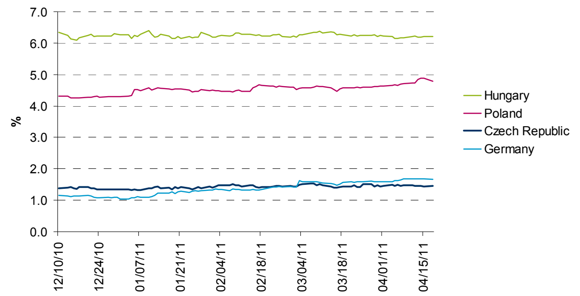
EUR/PLN Daily Chart:

Toying back below Downtrendline off 4.2400 and below 3.9820 (neckline short term Double Top: see graph).
Support at 3.9435 (current reaction low off 4.1225?), ahead of 3.9340/ .9324 (break-up hourly/ monthly envelope bottom), where pause favored.
If unable to hold, next levels at 3.9240 (break-up daily Feb 18), ahead of 3.9176/ .9158 (1st target off 3.9820/ monthly modified Alpha Beta trend bottom) and 3.9117 (50 Month Moving Average↑).
3.8982/ .8970 = 76.4% 3.8290 to 4.1225/ Feb 17 low: tough on 1st attempts.

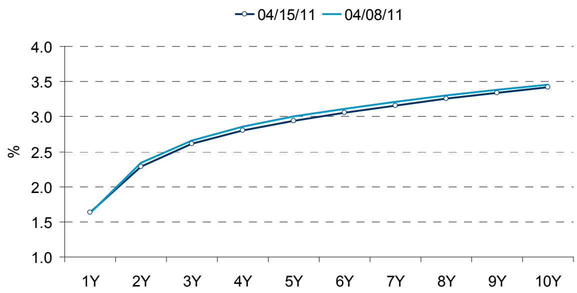
Resistance at 3.9820 (see above): Zloty on better footing while below this area.
If unable to cap, next levels 3.9920 (reaction high hourly + weekly Short Term Moving Average↓), ahead of 4.0060/ .0130 (breakdown hourly/ daily): tough on 1st attempts.

CE Fixed-income in Charts

FRA 3x6

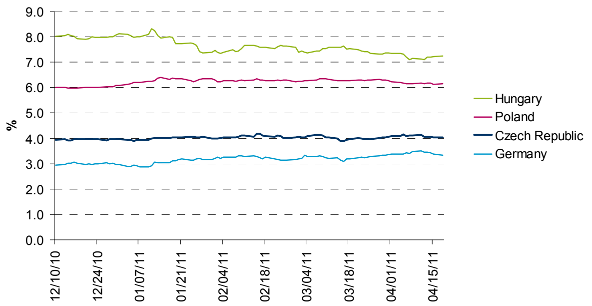


CZ IRS

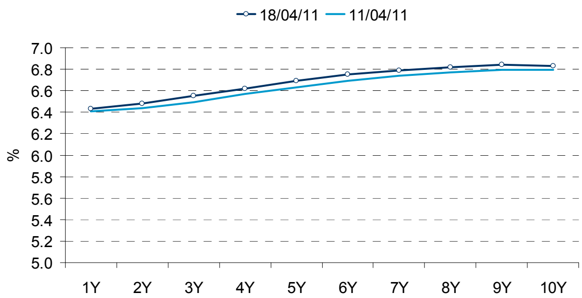


Source: Reuters

10Y GB Yields

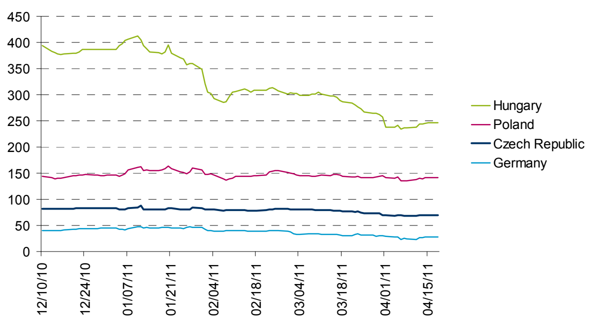


HU IRS

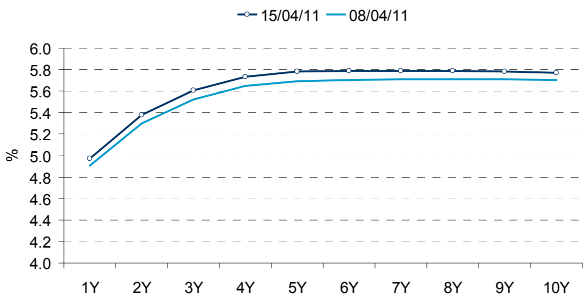


Source: Reuters

CDS 5Y



PL IRS



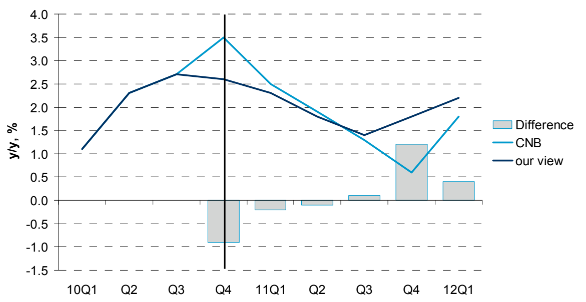
Source: Reuters

Medium-term Views & Issues

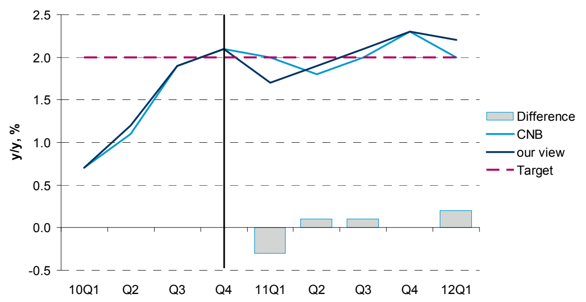
	The Czech Republic	Hungary	Poland
Growth & key issues	The June general election resulted in the victory of the centre-right parties, whose policies are austerity-minded. The new Cabinet has set a realistic target of cutting the deficit to less than 3% by 2013. The reduction by less than a percentage 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.	According to our estimates, the Polish economy grew in Q1/2011 at more or less the same pace as in the last quarter of the previous year. Given the recent set of data, we revise the expected growth up to 4.4% in 2011. Mainly domestic consumption and investment should drive the growth with government and external sector having more or less neutral impact. However, one should bear in mind that there is risk of revisions of previous figures due to due to huge errors and omissions line of the balance of payments (around 4% of GDP).
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.	A sharp increase in inflation expectations led to the further round of monetary tightening in Poland. In line with our expectations, the National Bank of Poland increased the reference rate by 25 bps to 4%. Given the fact that the rate of inflation should stay above the target in the rest of 2011, we expect that interest rates in Poland should rise even further. We think that two more hikes hang in the air. Our scenario bets on the first hike as early as at July's Monetary Policy Council's meeting. The second hike could take place during Q4/2011.
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.	The forint began to correct after touching the level of 263 and weakened to 267 by Wednesday. From a technical perspective it strengthened from 275 to 263, so a 50% correction would allow it to depreciate to 268/€. On a fundamental basis, we do not expect any major shift in the currency for April-May as the upcoming Convergence Program could give us more details about the deficit reduction measures and there is another eurobond issuance in the pipeline. Inflation was higher in March (4.5%), but demand side inflationary pressures look weak in the economy, so the outlook has remained unchanged.	Tighter monetary policy has not helped the zloty very much so far and we believe even further monetary tightening has only limited potential to boost the Polish currency. First of all because market has already priced in our interest rate outlook. The effect of domestic tightening may also be somewhat offset by interest rate hikes in euro zone. Further more we are afraid of negative effect of errors in Polish balance of payments on Polish GDP and especially on highly important debt/GDP ratio. Given that uncertainty ahead of Parliamentary elections, we remain more or less neutral on Polish currency at levels around 4.00 EUR/PLN.

Central Bank's Projections versus Our Macro Forecasts

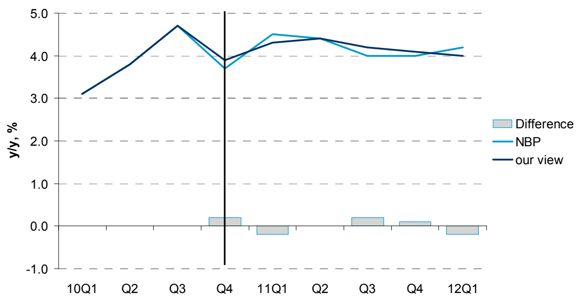
CZ: GDP Outlook



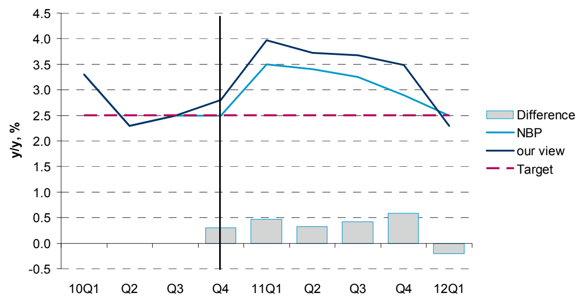
CZ: Inflation outlook



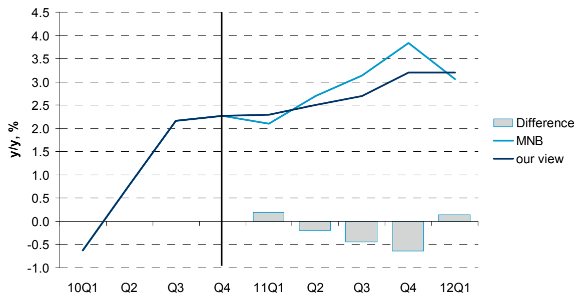
PL: GDP Outlook



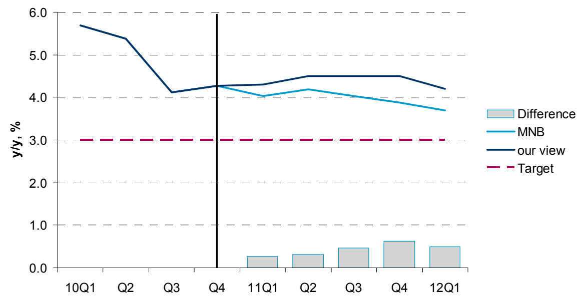
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	Jun-11	Sep-11	Dec-11	Mar-12	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	1.00	1.25	1.25	-25 bps	5/6/2010
Hungary	2W deposite r.	*6.00*	6.00	6.00	6.25	6.25	25 bps	1/24/2011
Poland	2W inter. rate	*4.00*	4.25	4.25	4.50	4.75	25 bps	4/6/2011

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

		Current	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	PRIBOR	*1.21*	1.35	1.45	1.60	1.72
Hungary	BUBOR	*6.10*	6.00	6.00	6.25	6.25
Poland	WIBOR	*4.29*	4.35	4.50	4.55	4.55

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

	Current	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	*3.42*	3.40	3.50	3.60	3.70
Hungary	*6.825*	7.50	7.25	7.00	7.00
Poland	*5.774*	5.95	6.00	6.00	6.00

Exchange rates (end of the period)

		Current	Jun-11	Sep-11	Dec-11	Mar-12
Czech Rep.	EUR/CZK	*24.3*	23.7	24.0	24.6	25.5
Hungary	EUR/HUF	*267*	280	275	270	270
Poland	EUR/PLN	*3.95*	3.90	3.60	3.70	3.60

GDP (y/y)

	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012
Czech Rep.	2.2	1.9	1.3	1.7	2.5
Hungary	2.3	2.5	2.7	3.2	3.2
Poland	4.3	4.4	4.6	4.2	4.0

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

	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Czech Rep.	2.0	2.1	2.2	2.2	2.2
Hungary	4.5	4.5	4.5	4.2	4.0
Poland	4.3	4.5	4.2	3.4	3.5

Current Account as % of GDP

	2010	2011
Czech Rep.	-3.8	-3.6
Hungary	0.5	1.0
Poland	-2.1	-2.9

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

	2010	2011
Czech Rep.	-4.7	-4.3
Hungary	-3.8	-2.9
Poland	7.1	-7.9

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