Monday, 11 July 2011

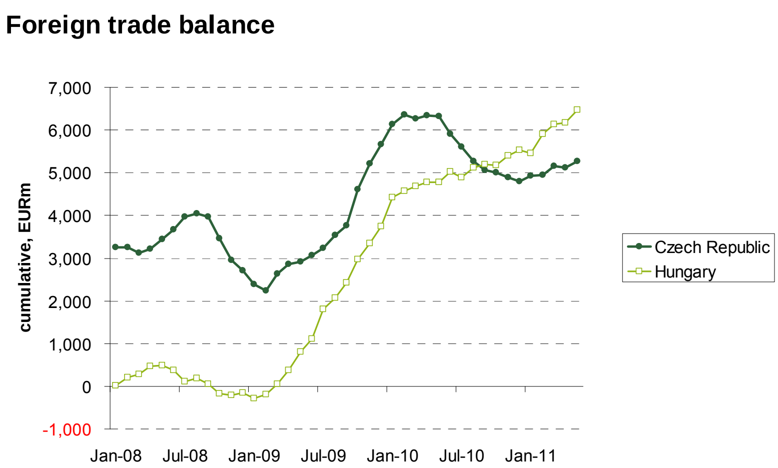
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Rates in Central Europe remain unchanged in these uncertain times
- Czech and Hungarian exports are faring well
- Industry in the CR gains momentum
- Preview: Polish inflation should stabilize at high level in June

Chart of the Week: Czech and Hungarian trade balance in huge surpluses



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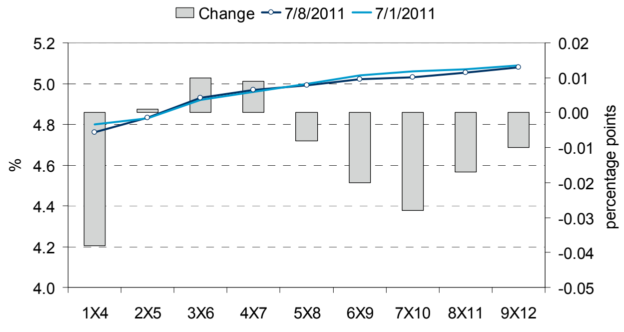
Market's Editorial

Rates in Central Europe remain unchanged in these uncertain times

After three rate hikes, the National Bank of Poland left interest rates unchanged this time. The NBP Governor believes that time is needed to evaluate the existing measures and that we need to wait for these measures to make themselves felt in the economy. Unlike the Czech Republic, the industry in Poland failed to accelerate over the last month and the PMI has been falling for several consecutive months. Although inflation hit ten-year highs, the central bank's restrictive policy helped somewhat to stabilise inflationary expectations, which stopped rising over the last month. If we combine this with the lower growth prediction in the central bank's new forecast and the risk of financial contagion from the periphery of the euro area, it is no wonder that the NBP decided to wait. We believe that another rate hike will not occur until September/October, provided that today's tension in the eurozone stabilises.

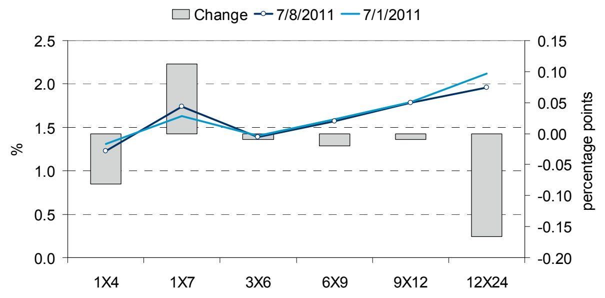
In the end, the **Czech National Ba**nk also doesn't need to be in a hurry. That said, our basic scenario, which envisages the first rate hike at the August meeting, is increasingly ripe for a revision. This also holds true after the latest series of excellent foreign trade and industry figures, indicating a good performance by export-oriented firms in the automotive and engineering industries. On the other hand, domestic demand remains weak and unemployment unpleasantly high. In the end, all of this could make the CNB postpone a first rate hike until the autumn.

PL FRA



Source: Reuters

CZ FRA



Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.17	-0.76%	➚	➔
EUR/PLN	3.951	-0.97%	➚	➔
EUR/HUF	263.8	-1.98%	➚	➔

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	3.65	-0.05	➔	➔
10Y PLN	5.76	-0.09	➔	➔
10Y HUF	7.06	-0.19	➚	➚

Review of Economic Figures

Czech and Hungarian exports are faring well

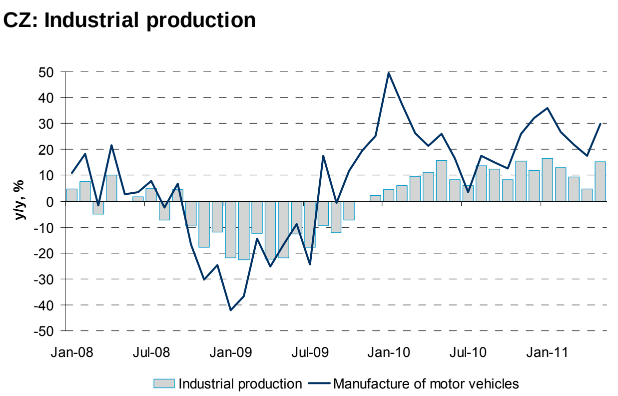
The market anticipated that the **CR's trade balance surplus** would be CZK 11bn. The reality was even better, by CZK 3.4bn. Exporters continued to fare very well in May as their performance improved by more than 18%. Machinery and transport equipment were again the greatest contributors to the rise in exports. More specifically, cars again played the primary role; car exports went up by nearly 14%, and generated a surplus in excess of CZK 25.1bn in May alone. In addition, given further launches of manufacturing facilities in the automotive industry, we believe that the positive trend of road vehicle exports may persist in the months to come. As expected, imports were affected by increased oil prices. Yet the strength of May's exports counterbalanced the effect of costly raw materials. In addition, imports are curbed by poor domestic demand and thus the trend of trade balance improvements may also persist for that reason.

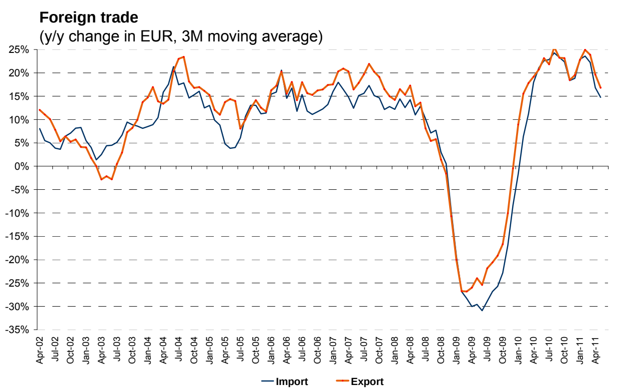
Hungary's foreign trade fared much the same or even better than that of the Czech Republic in May. Hungary again posted a significant surplus (of EUR 719m), fuelled, just like the Czech Republic's foreign trade, by exports, which (expressed in euros) were up by almost 19% y/y and significantly outpaced the rise of imports (14.2%). The drivers of exports, which are tied to the German economy, just like the Czech Republic's exports, also include cars and the electrical industry. Thus Hungary's overall trade balance for the first five months of the year posted a record-breaking surplus of EUR 3.3bn, indicating that the full-year figure will be even much better than that of 2010. According to our forecast, the 2011 trade balance may show a surplus of EUR 7bn, and this may lead to a significant current account surplus of EUR 3bn, i.e., 2.9% of GDP.

Industry in the CR again gains momentum

While data in the previous months signalled that growth in the industry was slowly decelerating, May's data showed just the contrary. Industrial output was up by 2.7% compared to April and by a huge 15.2% y/y, the second best figure since the beginning of the year. The surprising figure from the industry is primarily due to carmakers, followed by firms from the engineering industry and electrical equipment manufacturers. We should also bear in mind that there was one extra business day, which made up approximately 2.5% of the year-on-year figure. That said, just like in previous months, the positive figures from industry are due to car production, which is benefiting from improving foreign demand. It is very likely that this year will surpass last year's car production record (1.072 million units) and set a new record. After all, contracts also indicate a favourable outlook for the months to come, with automotive contracts currently rising by 9%. Unlike carmakers, overall industrial contracts showed a deceleration over the last few months. No doubt this is partly due to the high comparative baseline of last year. Nevertheless, the latest data indicate that demand might ease in the second half of the year. Poor domestic contracts are also evident, reflecting the persisting subdued domestic demand on the Czech market.

The Data from the industry currently are in contrast with leading indicators. Confidence in industry has been declining since February and is approximately at the level of the middle of last year. The purchasing managers index (PMI) indicates similar developments, albeit this indicator is still above the level of 50. In spite of the surprisingly outstanding figure for May, we still expect that growth in industrial output will decelerate in the months to come, although likely to a lesser extent than originally anticipated, because further manufacturing facilities will be launched in the automotive industry.





In Focus: MNB new inflation report

The central bank's latest inflation report from June had a dovish tone about the inflation outlook. It saw inflation above the target in 2011 and for most of 2012, but it predicted that the target could be met after the end of 2012.

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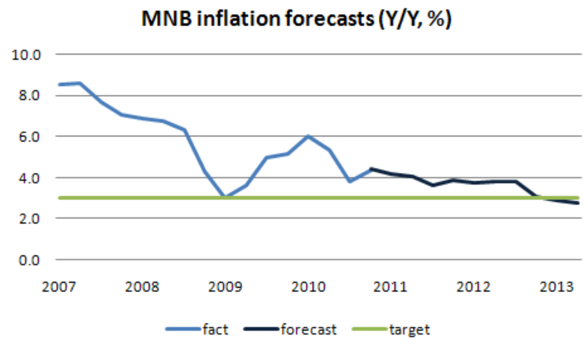
This would be a major achievement for Hungary as the inflation target was achieved only twice. In early 2006, when the government lowered the VAT rate and at the beginning of 2009. Apart from these two episodes, inflation has been above the target since the central bank has been targeting inflation in 2001.

The current elevated level can be traced back to basically two factors. One is the steep rise of energy prices, the other is higher food prices. The better-than-expected inflation data in May pointed out that these factors could slowly fade away if prices remain broadly stable. The 3.9% Y/Y reading in that month helps the quarterly average to come close to the central bank's 4.2% Y/Y forecast after April's high figure of 4.7% Y/Y as inflation is expected to come in around 3.8% Y/Y in June. This means that the central bank successfully predicted a gradual lowering of inflation from the first quarter, This process will have to continue in the coming quarters before we reach the targeted 3% level.



Inflation of services, tradable goods and regulated items has been running between 2% and 3% or below the targeted rate. This suggests that the central bank has a good chance to reach the target if supply-side shocks fade. Demand-side inflationary pressures have been low since domestic demand has been stagnating close to the bottom since 2009 as many households have become the victim of the crisis due to mortgages linked to the CHF/HUF exchange rate.

This means that the positive inflation outlook is the consequence of the country's external indebtedness, which makes the financial system vulnerable to exchange rate shocks.

CE Weekly Preview

WED 14:00	PL Inflation (change in %)		
	Jun-11	May-11	Jun-10
CPI y/y	**4.8**	5.0	2.3
Food (ex Alc.) y/y	**7.5**	8.8	2.9
Transport (including fuel)	**5.9**	6.8	4.8

PL: Inflation decelerated slightly in June

June's inflation likely saw a moderate deceleration to 4.8% y/y, according to our forecasts. Even so, it remains far above the 2.5% inflation target of the National Bank of Poland. Unlike the first five months of this year, June's data should only reveal a negligible month-on-month rise in food and soft drink prices (their weight in the consumer basket is 24%) and even the first month-on-month decline in fuel prices since February of this year. By contrast, seasonal package tour prices likely went up significantly. We believe that inflation will continue to fall slightly in July and expect that it will peak in August for the second time this year.

Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
CZ	**12.7.2011**	**09:00**	**CPI (%)**	**06/2011**	**0.3**	**2.3**	**0.1**	**2.1**	**0.5**	**2.0**
CZ	12.7.2011	09:00	Unemployment rate (%)	06/2011	8.1		8.1		8.2	
HU	**12.7.2011**	**09:00**	**CPI (%)**	**06/2011**			**0.2**	**3.8**	**0.2**	**3.9**
PL	**13.7.2011**	**14:00**	**CPI (%)**	**06/2011**		**4.8**	**0.3**	**4.8**	**0.6**	**5.0**
HU	14.7.2011	09:00	Industrial output (%)	05/2011 *F					-0.8	2.6
HU	14.7.2011	12:00	GB bond auction/fixed rate (HUF B)	07/2011						
PL	14.7.2011	14:00	Money supply M3 (%)	06/2011			1.1		0.8	
CZ	15.7.2011	09:00	PPI (%)	06/2011	0.3	6.0	0.3	6.0	0.5	6.2
CZ	15.7.2011	10:00	Current account (CZK B)	05/2011	-29.00		-20.00		-6.74	
PL	15.7.2011	14:00	Current account (EUR M)	05/2011			-755		-959	
PL	15.7.2011	14:00	Trade balance (EUR M)	05/2011			-800		-719	
PL	15.7.2011	15:00	Budget balance (PLN M)	06/2011					-23.7	

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:

Back below 24.5900/ .5650 (March high/ see graph: neckline medium term Double Bottom).

Support at 24.1730/ .1520 (monthly modified Alpha Beta trend bottom/ break-up daily), where pause favored.

If unable to hold, next levels at 24.0950 (monthly envelope bottom), ahead of 24.0700/ 0450 (June 14 low + weekly Bollinger bottom/ April 27 low).

23.9200/ .9090 = current year low/ broken monthly channel top off 1999 (synthetic charts): tough on 1st attempts.

Resistance at 24.3450 (July 05 high), with next levels at 24.4530/ 4830 (weekly Long Term Moving Average↓/ monthly modified Alpha Beta trend top) and 24.5000 (June 27 high), where pause favored.

If unable to cap, next levels at 24.5790 (weekly Bollinger top), ahead of 24.6220 (monthly envelope top).

24.6650/ .7340 = May 26 high/ monthly channel top off March 2009: tough on 1st attempts.

EUR/HUF Daily Chart:

Failure at Downtrendline off 289.55 sent the pair to a new year low, trying to extend below 263.10/ .01 area (see graph: neckline Double Top).

Support at 261.90/ .75 (current new year low/ monthly envelope bottom)), where pause favored.

If unable to hold, next levels at 261.08/ 260.93 (1st Irregular B off 271.15/ 2010 low + neckline long term Double Top) and 260.56 (monthly modified Alpha Beta trend bottom) and 259.90 (2nd Irregular B): tough on 1st attempts.

Resistance at 264.25 (breakdown daily): ideal area to stay below to keep current short term mood on HUF.

If unable to cap, next levels at 265.55 (July 06 high), ahead of 266.23 (weekly Medium Term Moving Average→) and 268.10 (breakdown daily).

269.47/ .90 = monthly channel top off historic high/ June 28 high: tough on 1st attempts.

EUR/PLN Daily Chart:

Trying to extend below Triangle pattern (see graph), with 3.9235 as neckline of a short term Double top.

Support at 3.9235/ .9203 (June 14 low + see above/ monthly modified Alpha Beta trend bottom), ahead of 3.9125 (May 18 low), where pause favored.

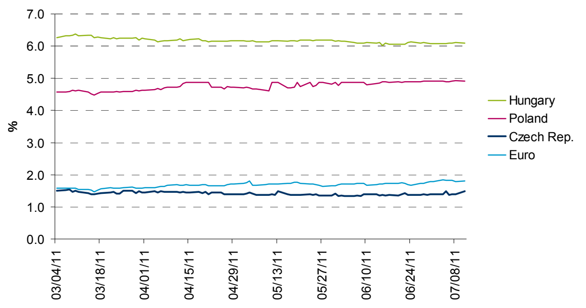
Failure to hold would see next levels at 3.9016/ .9010 (monthly envelope bottom/ weekly Bollinger bottom), ahead of 3.8888 (current reaction low off year high): tough on 1st attempts.

Resistance at 3.9475 (breakdown hourly + weekly Medium Term Moving Average↓), ahead of 3.9553/.9625 (weekly modified Alpha Beta trend top/ July 06 high), where pause favored.

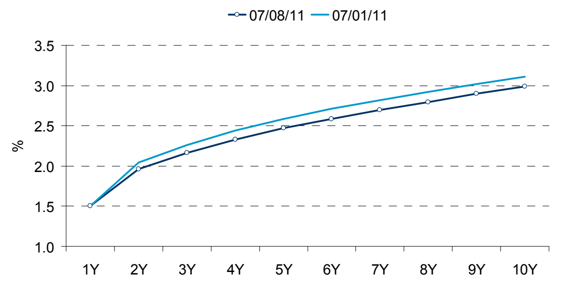
If unable to cap, next levels at 3.9901/ .9942 (monthly modified Alpha Beta trend top/ breakdown hourly), ahead of 4.0180/ 4.0190 (June 26--23 highs): tough on 1st attempts.

CE Fixed-income in Charts

FRA 3x6

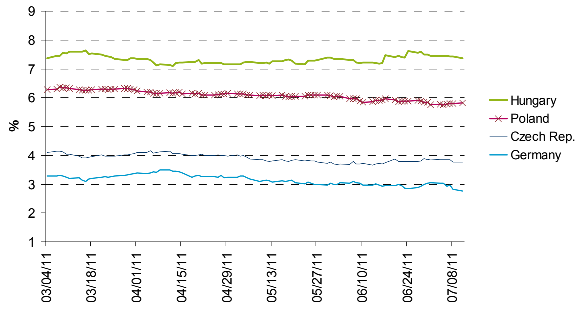


CZ IRS

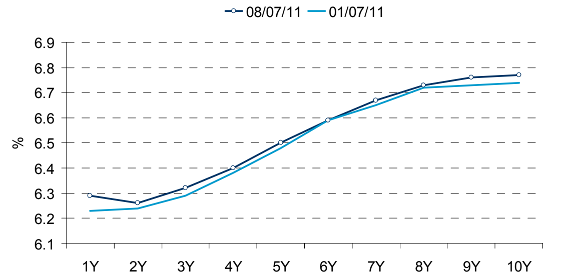


Source: Reuters

10Y GB Yields

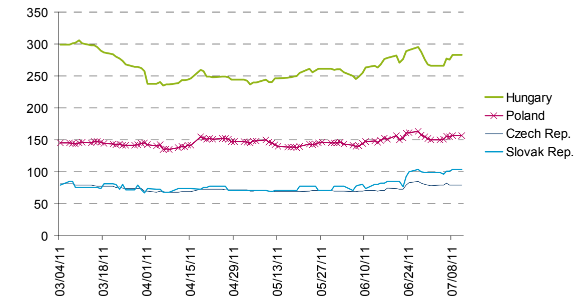


HU IRS

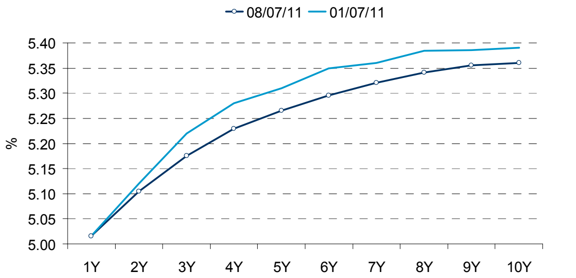


Source: Reuters

CDS 5Y



PL IRS



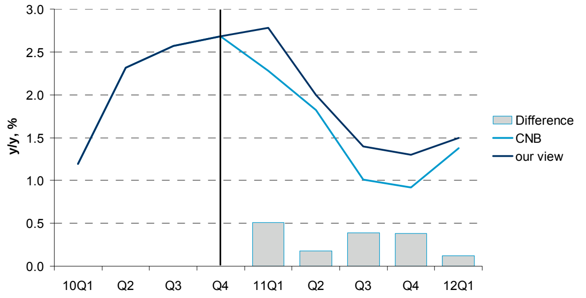
Source: Reuters

Medium-term Views & Issues

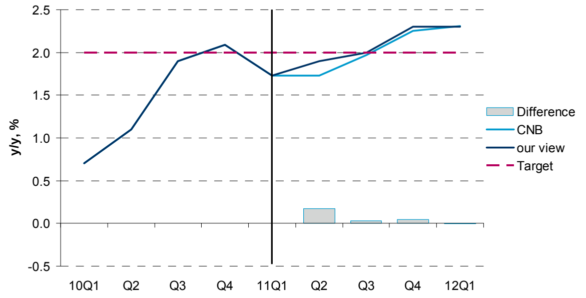
	The Czech Republic	Hungary	Poland
Growth & key issues	The situation in the governing coalition after some turmoil again stabilized. The government can continue to prepare the reforms needed to reduce the deficit of public finances. The general government deficit even felt to 4.7% of GDP in 2010. The government intends to cut the deficit below 3% by 2013. The fundamental precondition for hitting the budget targets is the launch of reforms, notably of the social security and pension system. Despite the positive outlook of the public budgets, the government still does not intend to set date for euro adoption in the country.	Hungary's government decided on an ambitious fiscal consolidation program (Szell Kalman Plan) that sees 3% of GDP deficit reduction measures by 2013. The Convergence Program detailed this further and most importantly targeted the 2012 budget deficit below 3% of GDP without one-off revenues. This is an important step as previous plans saw some 1% of GDP revenues from the asset sale of second pillar pension funds, which were cancelled. Accelerating growth and fiscal policy constitute a positive outlook for Hungary.	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 declined below the central bank's target in spite of 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.	Inflation rose to well above the central bank's 3% target on higher food and fuel prices, but underlying inflation trend remained favourable. Demand side inflationary pressures are low in the economy and hence the central bank expects inflation to return to the target level by end-2012. We generally agree with this view, while acceleration of the economy may challenge this if domestic demand also revives. Currently it is depressed by the strong Swiss franc rate that costs much to foreign currency debtors (though it may change after the new proposal).	Fears of inflation remaining above the target in medium term led to the further round of monetary tightening in Poland. The National Bank of Poland increased the reference rate already for the fourth time this year by 25 bps to 4.50%. 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 believe that the NBP might deliver this year's last hike as soon as at its September monetary policy meeting.
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 gains from the beginning of the year were too aggressive and calls for certain correction. On the other hand probably not substantial as the Czech koruna may start to feel support from the approaching start of interest rate hiking cycle (August 2011).	The forint has outperformed peers in 2011 Spring as fiscal consolidation plans allowed the government to refinance its large, €4bn redemption of bonds and loans, including the first tranche of the IMF loan. Commodity correction and renewed fears about Greece caused the forint to dip. Overall, in a short run risks for the forint seem balanced. In a longer run, should investors' confidence strengthen in the government policies, inflows into the domestic bond market may appreciate the currency further.	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 despite higher than expected inflation we believe that market has already priced in our interest rate outlook. 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. On the other hand in case of more severe selling pressure the Ministry of finance can sell the euros from structural funds and NBP would probably consider more aggressive monetary policy.

Central Bank's Projections versus Our Macro Forecasts

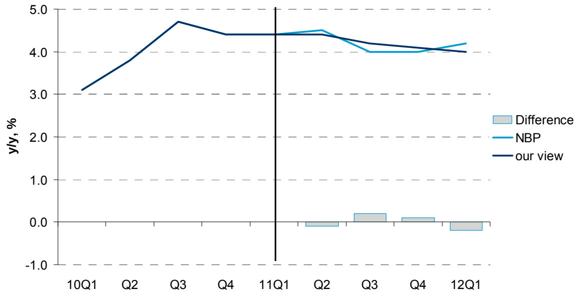
CZ: GDP Outlook



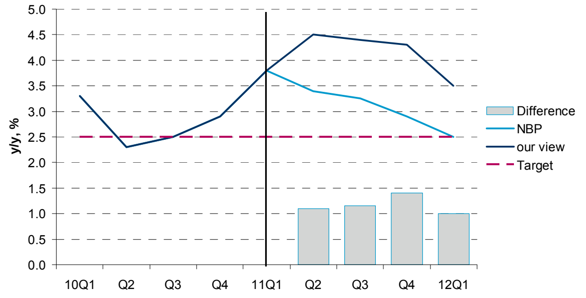
CZ: Inflation outlook



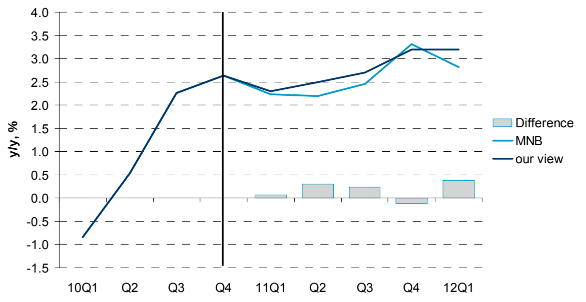
PL: GDP Outlook



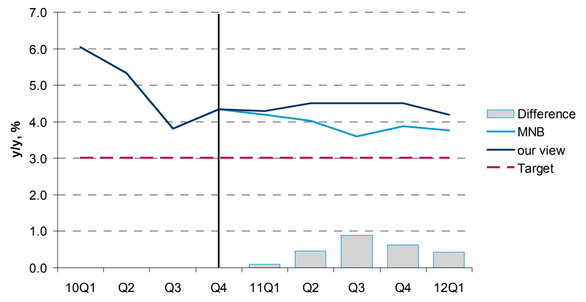
PL: Inflation outlook



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	Jun-12	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	1.00	1.25	1.25	1.50	-25 bps	5/6/2010
Hungary	2W deposite r.	*6.00*	6.00	6.00	6.25	6.25	6.25	25 bps	1/24/2011
Poland	2W inter. rate	*4.25*	4.50	4.75	4.75	4.75	4.75	25 bps	5/11/2011

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

		Current	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Czech Rep.	PRIBOR	*1.18*	1.20	1.45	1.60	1.65	1.85
Hungary	BUBOR	*6.10*	6.00	6.00	6.25	6.25	6.30
Poland	WIBOR	*4.7*	4.60	5.00	5.10	5.15	5.15

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

		Current	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Czech Rep.		*2.7809*	3.10	3.30	3.45	3.55	3.65
Hungary		*6.96*	7.50	7.25	7.00	7.00	6.90
Poland		*5.53*	5.95	6.00	6.10	6.15	6.20

Exchange rates (end of the period)

		Current	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Czech Rep.	EUR/CZK	*24.3*	24.5	24.6	24.4	24.0	23.7
Hungary	EUR/HUF	*269*	280	275	270	267	265
Poland	EUR/PLN	*4.05*	4.00	4.00	3.70	3.70	3.60

GDP (y/y)

		Q2 2011	Q3 2011	Q4 2011	Q1 2012	Q2 2012	Q3 2012
Czech Rep.		2.2	1.4	1.1	1.3	2.6	3.5
Hungary		2.5	2.7	3.2	3.2	3.2	3.2
Poland		*4.4*	4.6	4.2	4.6	4.9	4.7

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

		Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
Czech Rep.		2.2	2.3	2.5	2.4	2.2	2.1
Hungary		4.5	4.5	4.2	4.0	3.5	3.0
Poland		4.4	4.2	3.3	3.5	3.3	3.0

Current Account as % of GDP

	2010	2011
Czech Rep.	-3.8	-3.6
Hungary	0.5	2.9
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	-6.9

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