Tuesday, July 19, 2011

Central European Weekly

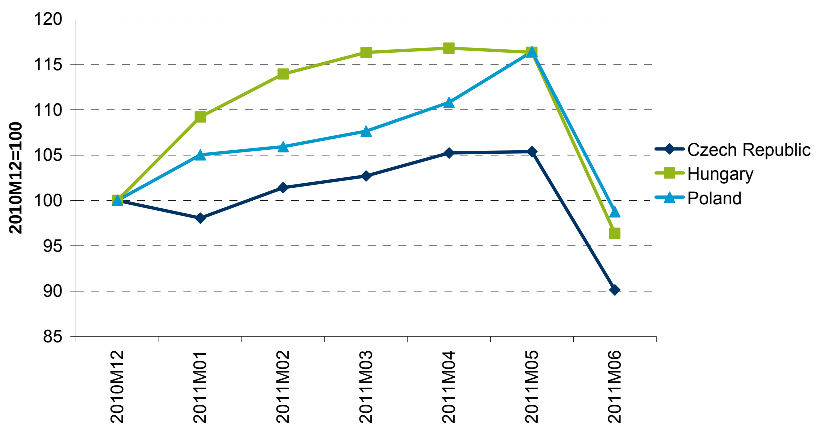
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Drop in vegetable prices pushes inflation lower in Central Europe
- Lower headline inflation will postpone rate hikes in Czech R. and Poland,…
- … which could mean that koruna and zloty will be more vulnerable

Chart of the Week: E-coli effect brings vegetable prices much lower in CE

Vegetables prices in 2011



Vegetable price had been rising till May of this year, but e-coli effect brought the prices significantly lower in June.

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Market's Editorial

The E.coli bacterium had a surprisingly strong impact on vegetable prices in Central Europe in June, and this resulted in an unexpected drop in inflation across the region. Somewhat paradoxically, the fluctuation of the prices of cucumbers and other vegetables may have a longer impact on the functioning of the Czech and Polish economies. Indeed, the improved inflation situation will most likely influence the meetings of the Czech and Polish central banks.

Czech and Polish inflation fall unexpectedly

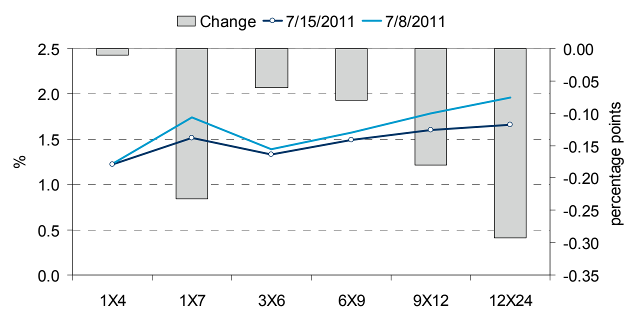
Above all, not only did the Czech Republic's inflation in June return to the near vicinity of the forecast, it even fell below the central bank's target value (2.0%), and this raises expectations the Czech National Bank's might postpone a rate hikes. Although economic growth accelerated more than the CNB had expected, it continues to be primarily driven by foreign demand, as domestic demand is still recovering in the wake of the recent recession. The inflation outlook remains unchanged, i.e., has improved very slightly (if we disregard the discussed and still unclear VAT change), while market expectations of the rise in foreign rates (in the EMU) have also been adjusted downwards. Thus inflation risks are balanced on both the upside and the downside. Therefore the CNB Board may stick to its wait-and-see policy and leave its rates unchanged in August.

As far as Poland is concerned, lower inflation support our scenario of a summer break in monetary tightening. Even if the cucumber prices rise again, June's low prices may contribute to a stabilisation of inflation expectations and thus extend the period of unchanged rates. Therefore, we believe that rates will not be raised again until the November meeting.

Later hikes = more vulnerable currencies

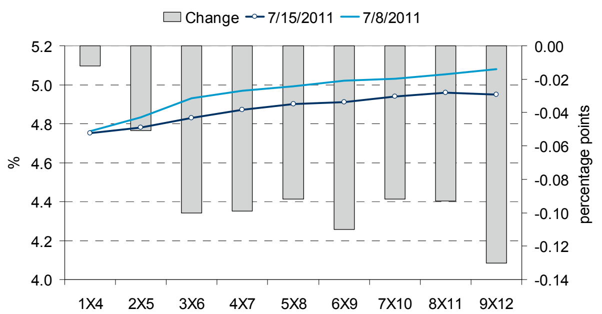
The reduced need for anti-inflationary policy in the Czech Republic as well as Poland logically leads to reduced market interest rate expectations, which implies lower support for the koruna and the zloty. Thus our downward revision of further rate hikes by the CNB and NBP leads to a revision of our forecasts for the exchange rates of the koruna and the zloty. We believe that both currencies will be much more vulnerable to depreciation, which may prove to be fairly significant in the end, given the eurozone developments.

CZ FRA



Source: Reuters

PL 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

Headline inflation fall across the CE region

Food prices strongly influenced the Czech headline inflation. The CPI index went down by 0.2% m/m, while year-on-year inflation fell to 1.8%. Net inflation (adjusted for the effect of deregulations and tax changes) dropped to 1.2%. The main contributors to this include cheaper food, i.e., vegetables, the sales of which were affected by concern about the spreading of the dangerous bacterium. In addition, the potato effect (based on the switch from “old” potatoes to new ones) did not occur this year either, and consequently food prices went down by 1.5% compared to May. On the other hand, we consider the current reduction of certain food prices to constitute a shift in time, rather than any permanent phenomenon. That said, the decline in these prices has only accelerated, and therefore will not occur in the months to come.

By contrast, the prices of natural gas for households, rent, and seasonal package tours went up in June, in line with expectations. Headline inflation was much better than the market expected, and thus approached the central bank forecast. Unlike May, the inflation divergence from the CNB’s forecast has thus narrowed from the original 0.3% to 0.1%.

Poland’s inflation saw a surprisingly rapid drop (-0.4% m/m, -1.8% y/y) for much the same reasons as in the nearby Central European economies. The fear of the German E.coli bacterium pushed cucumber and vegetable prices down, and thus food prices fell by 1.8% m/m, the deepest drop in food prices in the month of June since 1999. Concurrently, fuel prices have started to go down at last, after a three-month continuous rise. Even though the effect of the E.coli bacterium will disappear from inflation figures in the months to come, inflation is likely to finally start to head downwards in August. While June’s lower inflation is based on extraordinary circumstances, it favours our scenario of a longer monetary tightening break in Poland. The increasing external risks, the unconvincing performance of the labour market, and the stabilisation of inflation expectations are our main arguments for a postponement of another rate hike till November this year.

Also the Hungarian inflation is running bit below the Inflation forecast. June’s inflation figure was just 3.5%, well below expectations for a reading of 3.8% Y/Y due to lower food prices.
Beside energy, higher price of food has been a major contributor to the acceleration of inflation in the last months. Surprisingly, it looks to have had a sharp reversal at the beginning of the summer. Inflation of food was 10% Y/Y in May and dropped to 7.6% in June as prices lowered by more than 1% during the month. Fruits and vegetables played a leading role in the process, but other unprocessed food products, like wheat also became cheaper.
For the year as a whole, modest rise of regulated prices help the most as the government refrained from hefty price increases that was used the plug in the budget gap of many local governments.
More stable fuel prices also help the index as inflation of fuel came down from April’s peak of 16% Y/Y to 13% Y/Y in June.
Overall, inflation now looks to be on track to come down to the 3% target level, which goal has not been met for more than a couple of months since the introduction of the inflation targeting regime in 2001. Now, Hungary has a good chance to do this, which may help the bond market to narrow its yield gap with the eurozone.
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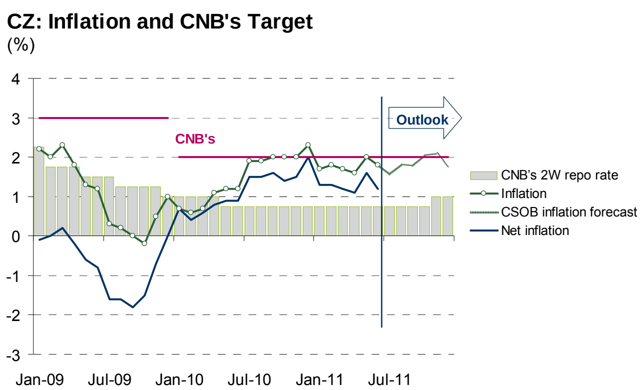
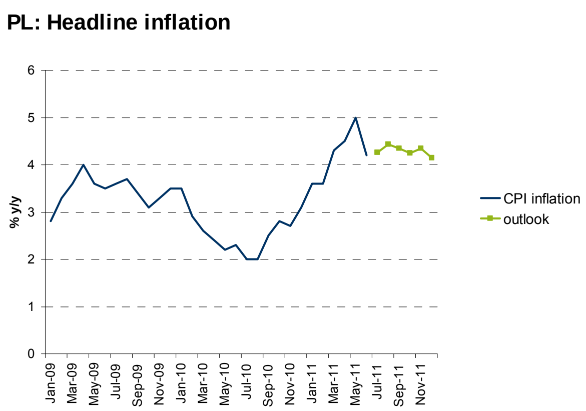
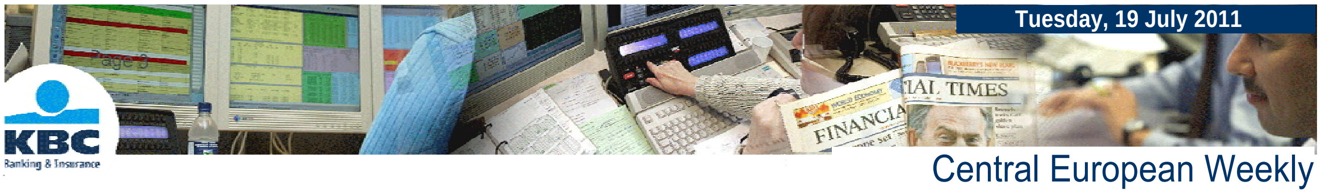




Weekly Calendar

	Date	Time	Indicator	Period	Forecast		Consensus		Previous	
					m/m	y/y	m/m	y/y	m/m	y/y
PL	18.7.2011	14:00	Wages (%)	06/2011			3.2	5.4	-3.2	4.1
HU	19.7.2011	09:00	Wages (%, ytd.)	05/2011				4.2		5.9
PL	19.7.2011	14:00	PPI (%)	06/2011			0.1	5.4	-0.2	6.5
PL	**19.7.2011**	**14:00**	**Industrial output (%)**	**06/2011**			**4.8**	**5.7**	**2.6**	**7.7**
ČR	20.7.2011	12:00	CZ bond auction floating rate/2023 (CZK B)	07/2011			8			
PL	20.7.2011	14:00	Core CPI (%)	06/2011			0.2	2.5	0.4	2.4

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) but approaching Downtrendline off May 2010 high.
Support at 24.2800/ .2600 (break-up daily/ hourly): pair must sustain back below to signal better standing for CZK.
Failure to hold would see next levels at 24.1000/ .0950 (July 11 low/ monthly envelope bottom), ahead of 24.0700 (June 14 low) and 24.0550/ .0450 (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 24.5450/ .5720 (July 15 high/ monthly Medium Term Moving Average↓), ahead of 24.6170/ .6260 (weekly Bollinger top/ monthly envelope top), where pause favored.
If unable to cap, next levels at 24.6650 (May 26 high), ahead of 24.7340 (monthly channel top off March 2009) and 24.8230 (61.8% 25.3800 to 23.9200): tough on 1st attempts.

EUR/HUF Daily Chart:

Rebound from new year low testing 271.15 (see graph: neckline Double Bottom) and Downtrendline off 292.10.
Support at 267.00/ 266.27 (weekly Medium Term Moving Average↑ + reaction low hourly/ weekly envelope bottom), ahead of 265.53/ 264.75 (weekly modified Alpha Beta trend bottom/ break-up daily): pair must sustain back below to signal better fortune for HUF.

Failure to hold would see next levels at 261.90 (new year low), ahead of 261.75/ .70 (monthly envelope bottom/ weekly Bollinger bottom): tough on 1st attempts.

Resistance at 272.60 50 Week Moving Average↓ + current reaction high off 261.90?), ahead of 273.45 (50% 285.00 to 261.90) and 274.80/ 275.20 (March 17/ 24 highs): tough on 1st attempts.

EUR/PLN Daily Chart:

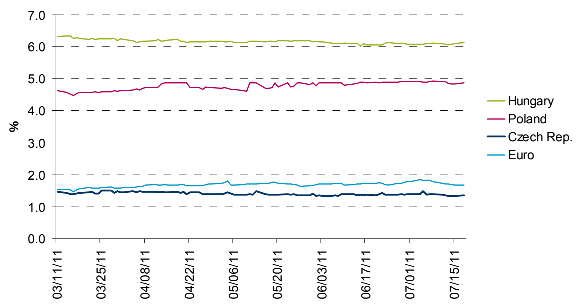
. Tested redrawn Downtrendline off 4.2400 (see graph).

Support at 4.0080/ .0060 (reaction lows hourly), with next levels at 3.9733/ .9618 (weekly Bollinger midline/ break-up daily): pair must sustain back below to signal return of better fortune for Zloty.
Failure to hold would see next levels at 3.9261/ .9235 (July 08 low/ June 14 low), ahead of 3.9125 (May 18 low) and 3.9016 (monthly envelope bottom): tough on 1st attempts.

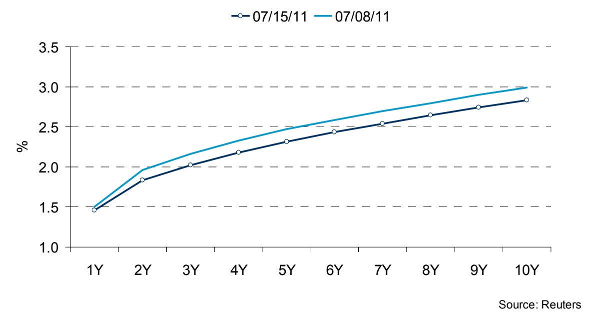
Resistance at 4.0509 (weekly Bollinger top), ahead of 4.0600/ .0673 (July 12 high/ 76.4% 4.1225 to 3.8888), where pause favored.
If unable to cap, next levels at 4.0701 (5th wave projection on hourly charts off 3.8888), ahead of 4.0912 (2nd target off 3.9900: neckline Double Bottom): tough on 1st attempts.

CE Fixed-income in Charts

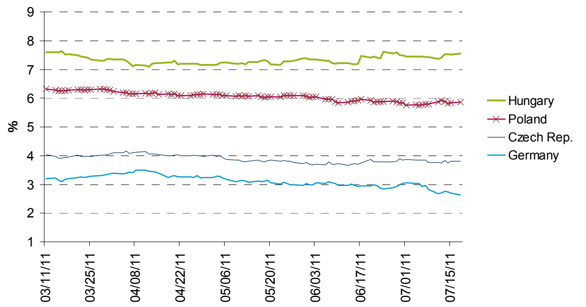
FRA 3x6



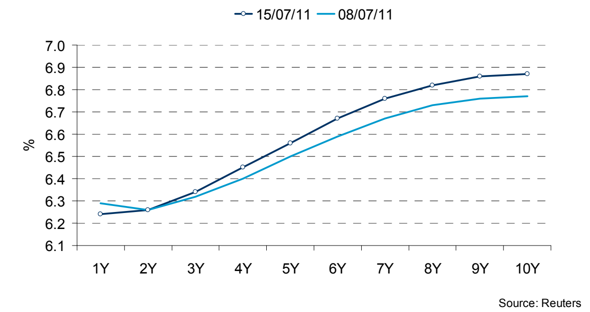
CZ IRS



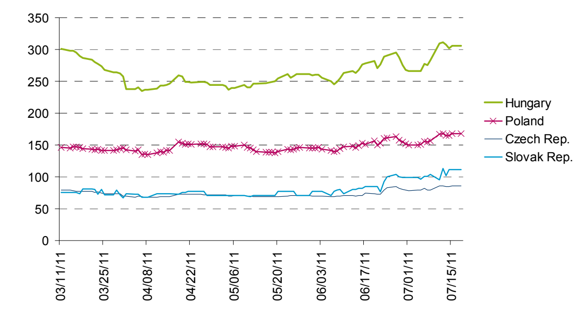
10Y GB Yields



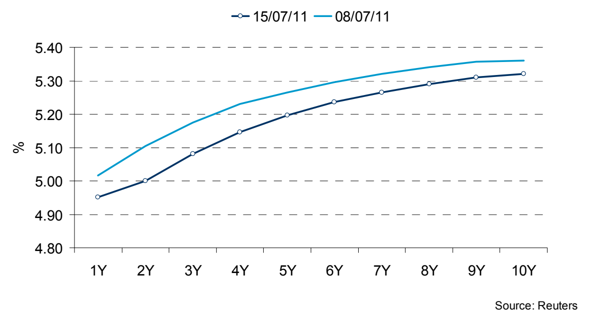
HU IRS



CDS 5Y



PL IRS

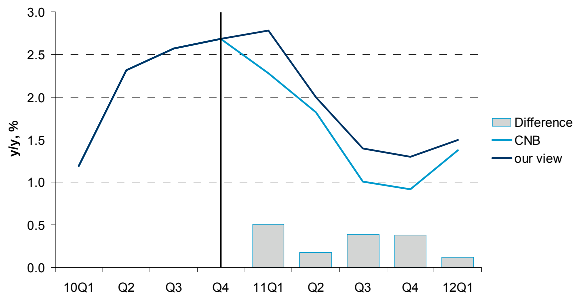


Medium-term Views & Issues

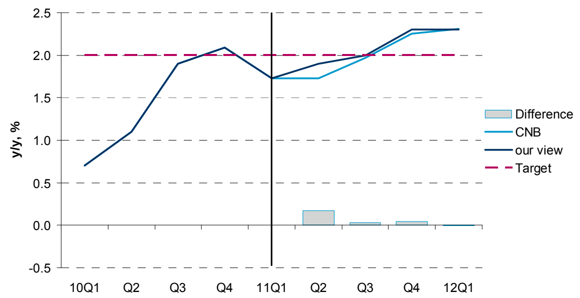
	The Czech Republic	Hungary	Poland
Growth & key issues	The situation in the governing coalition after some turmoil again stabilized. The government can continue to prepare the reforms needed to reduce the deficit of public finances. The general government deficit even felt to 4.7% of GDP in 2010. The 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 actually declined below the central bank's target in spite of higher fuel and foodstuffs' prices and to administrative measures. Fuel prices as well as prices of agricultural commodities continue to pose a risk to inflation. On the other hand, weak demand and the strong koruna should counteract the rise in inflation. We think the CNB can maintain its wait-and-see policy and again leave interest rates unchanged at its August meeting. The first rate hike is probable in November as the present prognosis announced (2011 Q4).	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 third time this year by 25 bps to 4.50%. Although the rate of inflation should stay above the target in the rest of 2011, the inflation expectations have stabilised and employment growth remains sluggish. Hence we believe the NBP should stay on hold for some time, at least during the summer. We expect next interest rate hike in November, but only if the situation on the euro zone peripheries calms down.
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 that nervousness on the eurozone peripheries may weigh on the whole region in the near term. 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

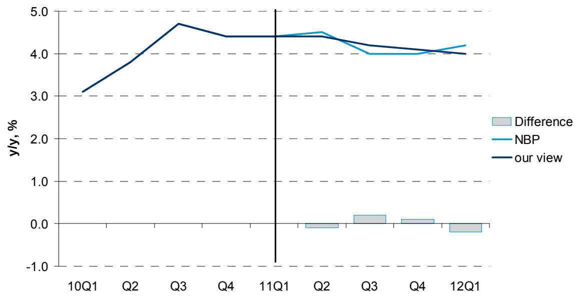
CZ: GDP Outlook



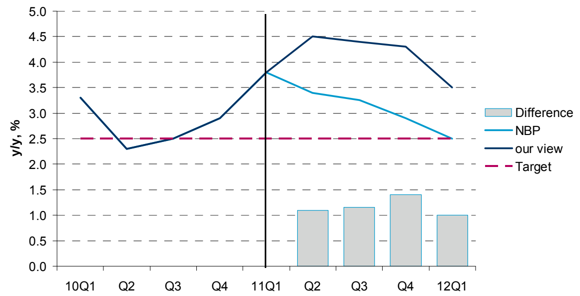
CZ: Inflation outlook



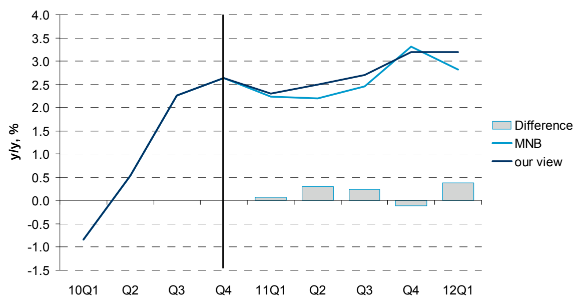
PL: GDP Outlook



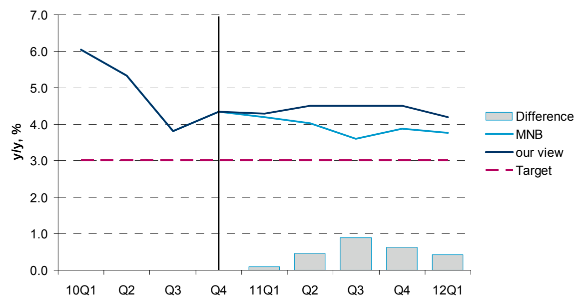
PL: Inflation outlook



HU: GDP Outlook



HU: Inflation outlook



Summary of Our Forecast

Official interest rates (end of the period)

		Current	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	1.00	1.25	1.50	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	*4.50*	4.50	4.75	4.75	4.75	5.00	25 bps	5/11/2011

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

		Current	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12
Czech Rep.	PRIBOR	*1.19*	1.25	1.48	1.65	1.85	1.88
Hungary	BUBOR	*6.09*	6.00	6.25	6.25	6.30	6.30
Poland	WIBOR	*4.69*	4.60	5.00	5.10	5.15	5.15

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

	Current	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12
Czech Rep.	*2.8*	3.30	3.45	3.55	3.65	3.90
Hungary	*6.95*	7.25	7.00	7.00	6.90	6.90
Poland	*5.36*	5.95	6.00	6.10	6.15	6.20

Exchange rates (end of the period)

		Current	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12
Czech Rep.	EUR/CZK	*24.4*	25.0	24.4	23.7	23.5	23.4
Hungary	EUR/HUF	*273*	275	270	267	265	265
Poland	EUR/PLN	*4.04*	4.20	3.90	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.	1.9	2.1	2.5	2.4	2.3	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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