Monday, August 29, 2011

KBC Banking & Insurance

Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- S&P upgrades Czech sovereign rating by two notches to AA-
- Koruna strongest in two weeks towards euro near all time highs towards Zloty
- In Focus: Moderate recession in EMU could hit mainly Hungarian economy
- Polish GDP data should point to solid, but slower growth in 2nd quarter

Chart of the Week: TOP 5 of Sovereign Ratings in Central Europe

	Moody's	S&P	Fitch
Slovenia	Aa2	AA-	AA
Czech Rep.	A1	AA-	A+
Estonia	A1	AA-	A+
Slovakia	A1	A+	A+
Poland	A2	A-	A-

After S&P upgrade the Czech Republic almost lead sovereign rating league in Eastern Europe.

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Market's Editorial

S&P's upgrade boosts Czech koruna

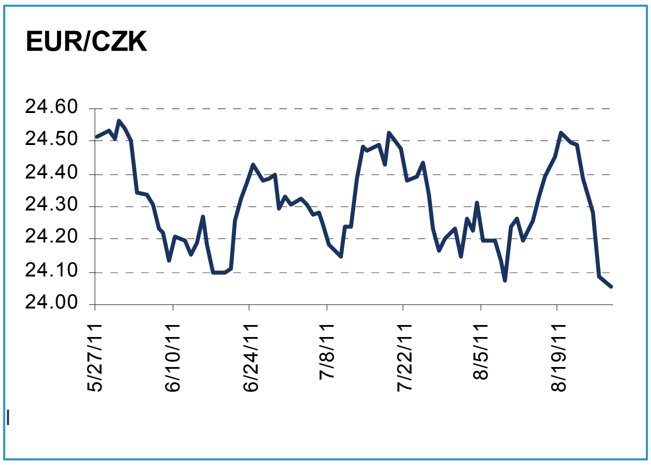
Czech financial markets received a strong positive signal yesterday as Standard & Poor's raised sovereign credit rating of the Czech Republic by two notches to AA- level. Hence, the Czech rating is placed at the same level as Estonia's, while it is one notch higher than that of Italy or Slovakia.

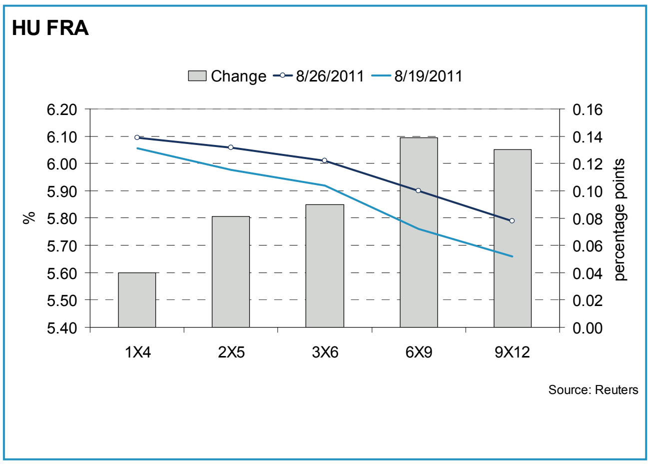
While the S&P gave positive assessment to the country's fundamentals it also mentioned that the change was triggered by a change in the criteria putting stronger emphasis on the political and economic profile of a given country. Regarding the fundamentals the agency appreciated low levels of foreign indebtedness, a deposit-funded banking sector with minimal lending in foreign currencies and largely independent central bank. According to the S&P the upgrade also incorporates expectations that the currently proposed pension system reform will be approved and implemented. We think that while this can be the case the question remains whether the final reform will be as profound as was that originally planned.

As concerns market reaction the most visible one was koruna's appreciation. The EUR/CZK pair has touched two-week low near 24.05 and the PLN/CZK cross is below 5.80 and slowly approaches all time lows (5.71). Although the very short term sentiment can remain positive and EUR/CZK may test 24.00/23.92, we foresee a pause at these levels.

MNB keeps its inflation target at 3.0% level

The Hungarian central bank kept the base rate unchanged at 6% . The Governor's press conference revealed that only one option was on the table, thus the voting was unanimous. The Governor also said that recent inflation data was in line with the June projection and that risks attached to the euro-zone crisis may affect the financial environment in Hungary. He also mentioned that the bank will keep its current 3% inflation target for longer run, suggesting that there was a proposal to lower it. This could mean that the bank sees the inflation outlook rather dovish. It is interesting to see that the market has started to price in rate cuts and the 6x9 FRA now implies a 25bp rate reduction. This looks warranted from an inflation point of view, but such a step may also become risky if the euro-zone crisis worsens. We think that if the government submits a tight 2012 budget and inflation remains low in the coming months, there could be some room for a 25bp rate reduction till the year-end





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*24.1*	*-1.11%*	↗	↗
EUR/HUF	*273*	*0.18%*	↗	↗
EUR/PLN	*4.16*	*0.15%*	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*2.52*	*1.20%*	→	↗
10Y PLN	*6.63*	*1.38%*	↗	↗
10Y HUF	*4.86*	*0.90%*	↗	↗

In focus: What impact would a moderate eurozone recession have on Central Europe?

The worsening business sentiment across the developed world (Germany, United Kingdom, France, the United States) are increasing the likelihood of a recession within the next three to six months. Hence we have decided to explore how a moderate recession in the eurozone would impact on the Central European economies.

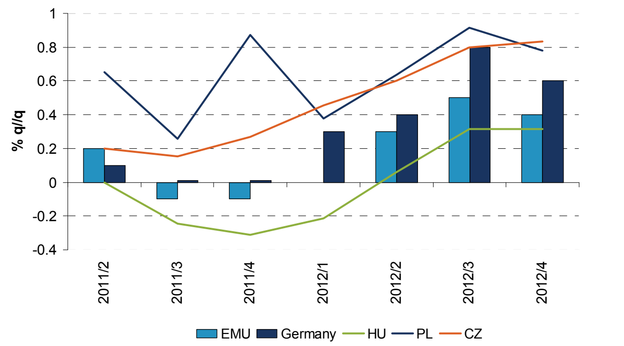
Purely on the basis of our condensed historical experience, the Hungarian economy should be affected the most. Nevertheless in terms of its macroeconomic imbalances, the Hungarian economy is faring much better than before the crisis and, concurrently, a moderate recession in the eurozone (without any financial crisis) may have a shade different impact on all Central European economies than the recent devastating experience associated with the fall of the investment bank Lehman Brothers.

Our forecasts assume a moderate recession in the eurozone (-0.1% q/q for two consecutive quarters). We approximated the impacts on Central Europe with simple ARIMA models including few additional explanatory variables (GDP growth in the eurozone and Germany) estimated for the years 1995-2011, using quarter-on-quarter seasonally adjusted data. The figures, which are not at all surprising, indicate (see the graph below) that, on a cumulative basis, the moderate recession should have the greatest impact on the Hungarian economy and the least impact on the fairly closed Polish economy.

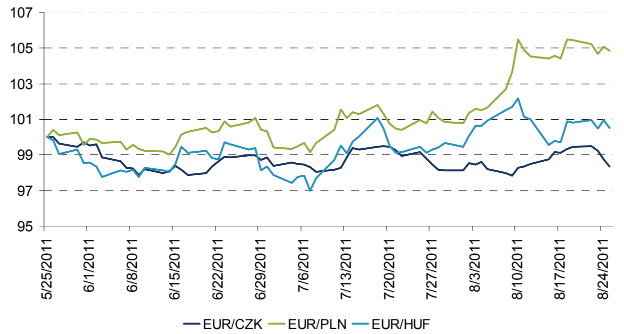
Nevertheless, our model forecast may be biased due to tough experience of the recent crisis, when the correlation of the individual economies with the rest of the world, particularly those that are very open, increased significantly. This may not necessarily reoccur if a milder crisis occurs. Therefore, if the eurozone goes through a conventional recession without a financial crisis, the negative impact on all economies may be smaller. For example, inventories may not be eliminated that dramatically (businesses no longer keep such large inventories) and layoffs will not be that huge (numerous businesses, notably in the Czech Republic and Hungary, already cut their HR costs to the bone during the recent crisis). Also, the availability of funds is unlikely to worsen to such a great extent, because the shock from foreign countries will mostly be purely real (a decline in contracts) rather than taking the form of financial contagion. In addition, Hungary, as a country, has become much less vulnerable to financial contagion, as its government has succeeded in turning significant current account deficits into surpluses.

In recent weeks/months, the Polish zloty (see the graph below) has been the Central European currency most affected by global risks. Nonetheless, given the significant likelihood of interventions by the Ministry of Finance (from abundant EU funding), the latitude for a further depreciation of this currency is limited. Both the Hungarian forint and the Czech koruna may still come under pressure and weaken, should the scenario of a 'moderate recession' in the eurozone happen. As we anticipate just a moderate recession in the eurozone, rather than hitting post Lehman-lows, the depreciation of all Central European currencies should be rather limited.

Impact of EMU recession on growth in CEE



CEE currencies



Weekly Preview

TUE 14:00 — PL GDP (y/y change in %)

	2011Q02	2011Q1	2010Q2
GDP	**4.1**	4.4	3.4

PL: The economy is still doing well

Tuesday's release of GDP data for the second quarter of this year should confirm the persisting very good condition of the Polish economy. According to our forecasts, the economy grew by 4.1% y/y. While industrial output decelerated slightly during the second quarter, it still went up by 5.4% y/y on average. As concerns demand, reasonable household consumption, which sped up compared to the first quarter of the year, on the year-on-year basis, should be highly relevant. The fall in unemployment, which also made itself felt in accelerated wage growth, clearly contributed to this. The impact of foreign trade on the GDP will again be negative, and the increase in the comparative baseline should also have a negative impact on year-on-year growth.

FRI 9:00 — CZ Retail Sales (change in %)

	Jul-11	Jun-11	Jul-10
Sales	**1.7**	-3.5	-1.3
cummulative (YTD)	**2.5**	2.6	0.7

CZ: Retail sales seesaw

Retail sales likely recovered and went up slightly after having declined in June; however, this marks no change in the situation or even in the trend, as this was only due to the effect of different comparative baselines. While June's baseline was very high, July 2010 was weaker in terms of sales. Car sales likely had a favourable impact on the anticipated positive figure, while food sales likely stagnated, in the best case scenario. Domestic consumer demand continues to be modest, which means lower consumption within the GDP, but, on the other hand, also minimal demand-pull inflationary pressures in the economy.

Calendar

Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	08/29/2011	9:00	Unemployment rate	%	07/2011			10.7		10.8	
PL	08/30/2011	10:00	GDP	%	2Q/2011		4.1		4.2	1	4.4
CZ	08/2011	11:00	Money supply M2	%	07/2011						2.2
HU	09/01/2011	12:00	GB bond auction/floating rate	HUF B	09/2011						
SK	09/01/2011	14:00	Budget balance	EUR B	08/2011					-1675	
CZ	09/01/2011	14:00	Budget balance	CZK B	08/2011					-61.1	
HU	09/02/2011	9:00	Trade balance	EUR M	06/2011 *F					615	
CZ	09/02/2011	9:00	Retail sales	%	07/2011						-3.5

Forex Technicals

EUR/CZK Daily Chart:

Reapproached 24.0400 (Aug 10 low) and currently below the Uptrendline off year low after having failed at Downtrendline off May 2010 high (see graph).
Support at 24.0700/ .0400 (see graph: neckline Head And Shoulders Top/ Aug 10 low), ahead of 23.9740 (weekly Bollinger bottom), where pause favored.
Failure to hold would see next levels at 23.9280/ 23.9200 (weekly modified Alpha Beta trend bottom/ current year low), ahead of 23.8900 (weekly envelope bottom): tough on 1st attempts.
Resistance at 24.1750 (breakdown daily), ahead of 24.2350 (weekly envelope top) and 23.3300 (breakdown daily):ideal area to stay below to keep current mood on CZK.
If unable to cap, next levels at 24.5100 (Aug 22 high) and 24.5450 (July 19 high).
24.6650 = May 26 high: tough on 1st attempts.

EUR/HUF Daily Chart:

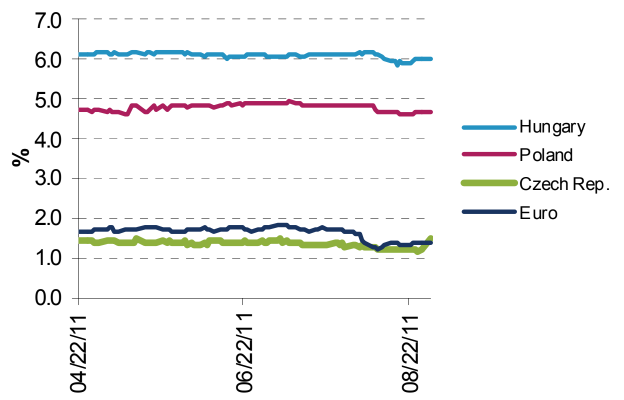
Rebound from new year low puts pair above channel top off 292.10 and tested widening pattern top (see graph).
Support at 270.75/ 270.45 (weekly modified Alpha Beta trend bottom/ Aug 23 low), with next levels at 268.47/ 268.14 (current reaction low off 278.25/ % 261.90 to 278.25): pair must sustain back below to signal better fortune for HUF.
Failure to hold would see next levels at 266.00/ 265.75 (July 22 low/ 76.4%), ahead of 264.75 (break-up daily): tough on 1st attempts.
Resistance at 274.85/ 275.11 (Aug 19 high + weekly envelope top/ weekly Bollinger top), where pause favored.
If unable to cap, next level at 278.25 (current reaction high off year low): tough on 1st attempts.

EUR/PLN Daily Chart:

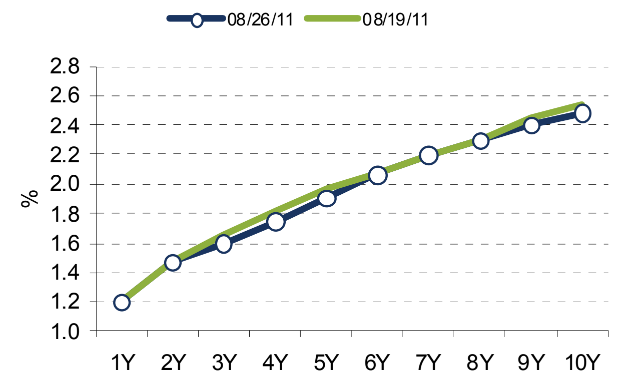
Summer spike reapproached May 2010 high (4.2400) and currently above the neckline of a long term Head And Shoulders bottom (4.1100: see graph).
Support at 4.1362/ 4.1216 (Aug 23 low/ Aug 17 low + neckline short term daily Double Top), ahead of 4.0996 (38.2% May low to 4.2300): pair must sustain back below to signal return of better fortune for Zloty.
Failure to hold would see next levels at 4.0594/ .0525 (50%/ break-up daily), ahead of 4.0191/ 4.0055 (61.8%/ weekly Bollinger midline): tough on 1st attempts.
Resistance at 4.1756 (weekly Bollinger top), ahead of 4.1900/ .1988 (reaction highs hourly), where pause favored.
Failure to cap would see next levels at 4.2250 (Aug 18 high), ahead of 4.2291/ .2300 (weekly channel top off year low/ Aug 10 high) and 4.2400/ .2455 (May 2010 high/ 38.2% 4.9300 to 3.8225): suspect tough to sustain through on 1st attempts.

Fixed-income in Charts

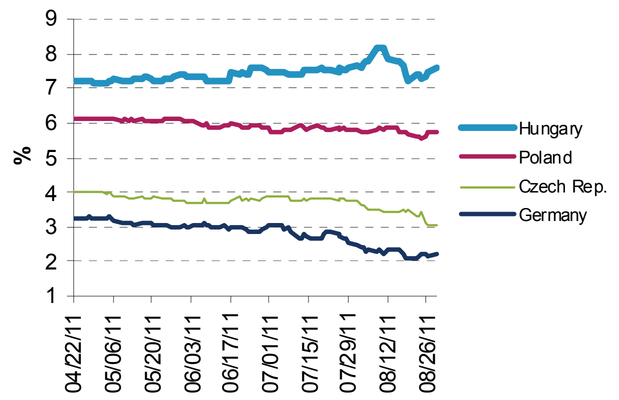
FRA 3x6



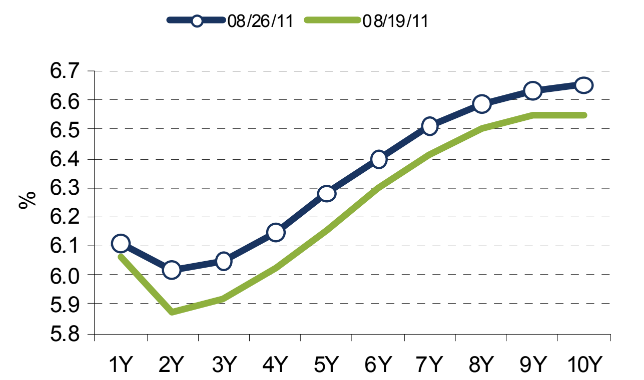
CZ IRS



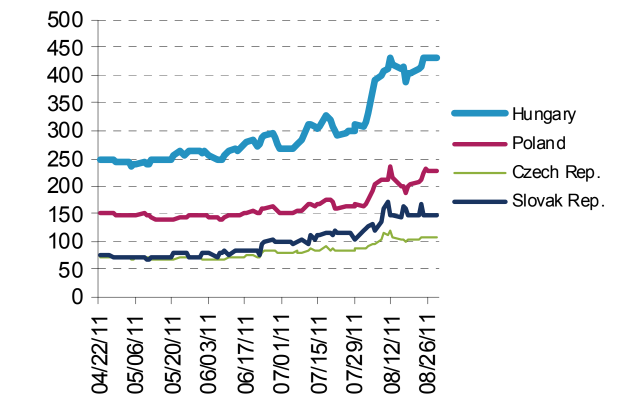
10Y GB Yields



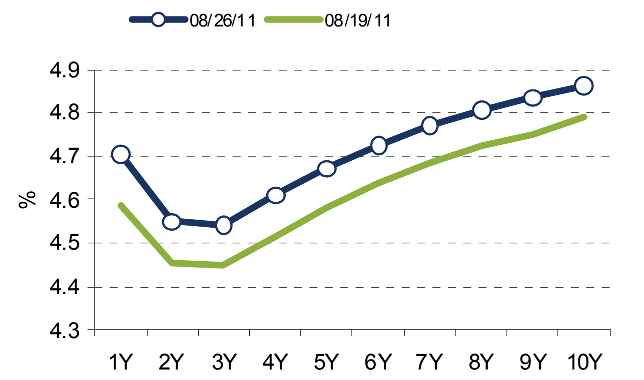
HU IRS



CDS 5Y



PL IRS

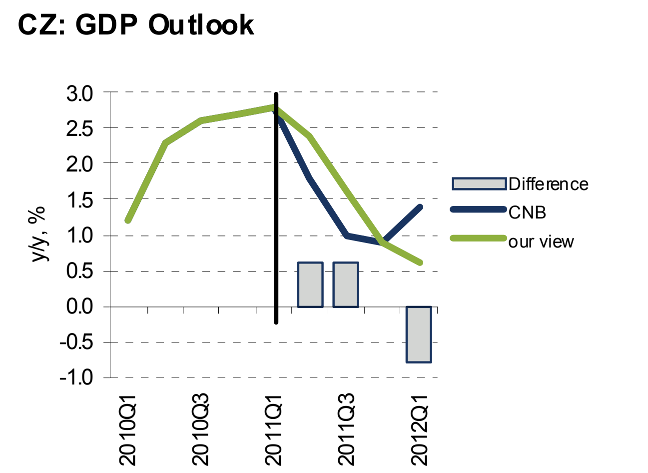


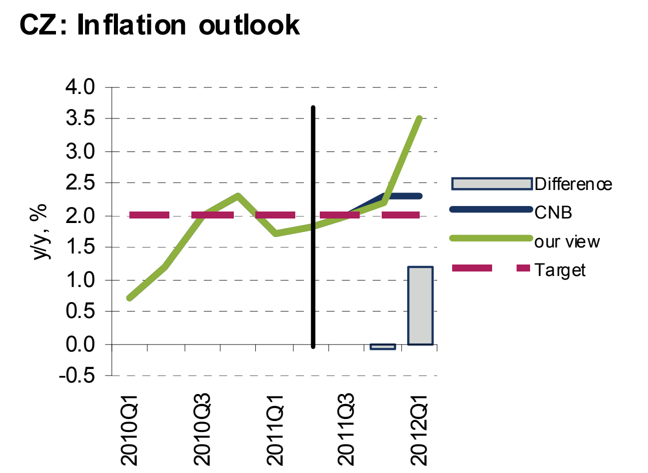
Source: Reuters

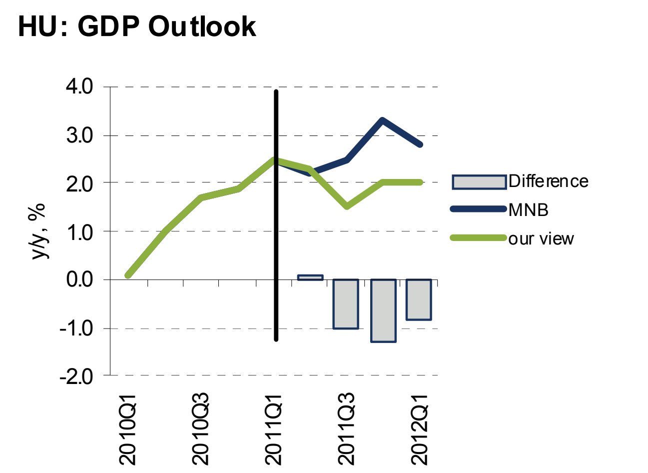
Medium-term Views & Issues

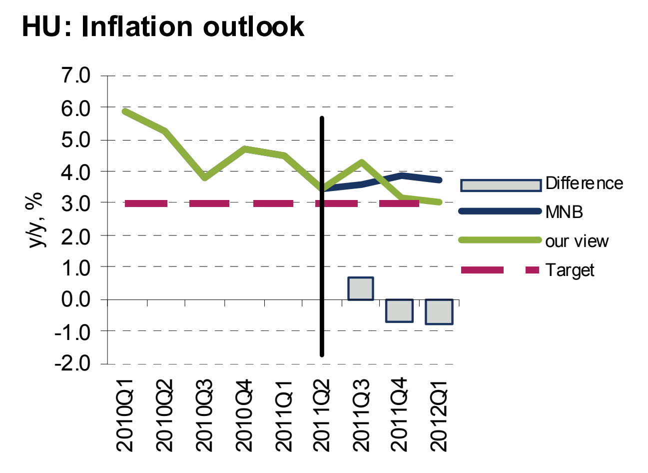
	The Czech Republic	Hungary	Poland
Growth & key issues	Although the situation in the governing coalition after some turmoil has stabilized again, tensions in the government coalition might return during discussions of the 2012 budget. The government intends to change the system of direct taxes radically and to unify gradually the VAT rate in order to push the deficit below 3 percent of GDP by 2013. Despite the positive outlook of the public budgets, the government does not intend to set a target date for the euro adoption in the Czech Republic.	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.	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 inflation boosting administrative measures. Fuel prices as well as prices of agricultural commodities continue to pose a risk for future inflation. On the other hand, weak demand and strong koruna should counter a rise in inflation. We expect the CNB to maintain its wait-and-see policy at least until next spring. The first rate hike delivered by the Czech central bank is probable in Q2/Q3 2012 (in contrast to the current prognosis implying it in 4th 2011).	Inflation rose temporary 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 stabilized and employment growth remains sluggish. Furthermore global risk has somewhat intensified recently. Hence we believe the NBP should stay on hold for some time, at least through 1st quarter 2012.
Forex Outlook	We expect the koruna to weaken moderately after recent rally, triggered by rating upgrade. The main reasons include a later start of the monetary tightening in the Czech Republic and the ongoing debt crisis at the peripheries of the eurozone as well as slow-down in eurozone economies, which should weigh on export-oriented Czech economy. Nevertheless, the accelerating inflow of money from EU Funds, in addition to the slow continuation of real convergence, should remain a positive long-term factor for the Czech currency. We continue to see the koruna stronger in 12-month horizon at 23.40 EUR/CZK.	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. 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 given our outlook the near term potential is not very encouraging. Further more we are afraid that nervousness on the eurozone peripheries combined with the risk of recession both in US and eurozone 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. Hence we believe the pair should not get significantly above 4.25 EUR/PLN.

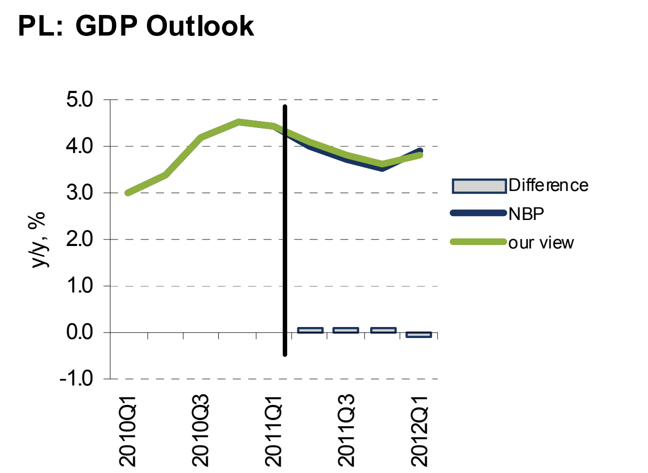
CBs' Projections vs. Our Forecasts

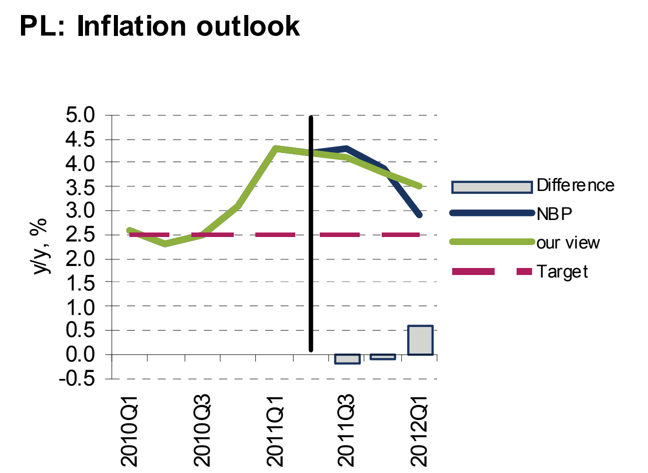












Source: CNB, NBP, MNB, CSOB

Summary of Our Forecast

Official interest rates (end of the period)

		Current	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	Last change	
Czech Rep.	2W repo rate	*0.75*	0.75	0.75	0.75	0.75	1.00	-25 bps	5/7/2010
Hungary	2W deposit r.	*6.00*	6.00	6.00	6.00	6.00	6.00	25 bps	1/24/2011
Poland	2W inter. rate	*4.50*	4.50	4.50	4.50	4.75	4.75	25 bps	6/9/2011

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

		Current	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	PRIBOR	*1.20*	1.20	1.22	1.25	1.35	1.55
Hungary	BUBOR	*6.09*	6.00	6.00	6.00	6.00	6.00
Poland	WIBOR	*4.72*	4.60	4.60	4.60	4.75	4.80

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

		Current	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	CZ10Y	*2.52*	2.50	2.70	2.75	3.10	3.25
Hungary	HU10Y	*6.63*	7.50	7.50	7.50	7.25	7.00
Poland	PL10Y	*4.86*	4.80	5.00	5.00	5.10	5.20

Exchange rates (end of the period)

		Current	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	EUR/CZK	*24.1*	25.0	24.4	23.7	23.5	23.4
Hungary	EUR/HUF	*273*	270	270	268	265	265
Poland	EUR/PLN	*4.16*	4.20	3.90	3.80	3.70	3.70

GDP (y/y)

	2011Q1	2011Q2	2011Q3	2011Q3	2012Q1	2012Q2	2012Q3
Czech Rep.	*2.8*	2.4	1.6	1.6	0.6	1.0	1.8
Hungary	*2.5*	2.3	1.5	1.5	2.0	1.8	1.8
Poland	*4.4*	4.1	3.8	3.8	3.8	4.0	3.9

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

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	*1.8*	2.0	2.2	3.5	3.7	3.3	3.3
Hungary	*3.5*	4.3	3.2	3.0	2.8	2.8	2.8
Poland	*4.2*	*4.1*	3.8	3.5	3.0	2.8	2.5

Current Account

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

Public finance balance as % of GDP

	2010	2011
Czech Rep.	-4.7	-4.3
Hungary	-3.8	-2.9
Poland	-7.1	-6.9

Source: CSOB, Bloomberg

Brussels Research (KBC)		**Global Sales Force**	
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