Tuesday, October 11,

KBC Banking & Insurance

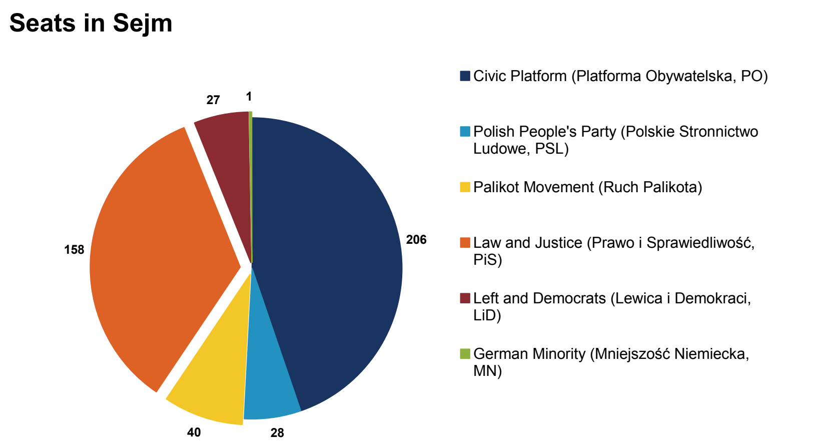
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- The current centre-right coalition will continue to rule in Poland
- The outcome of the Polish parliamentary elections all for CEE currencies' gains
- Performance of the Czech and Hungarian industry worsen
- Hungary's and Poland's inflation data eyed

Chart of the Week: Distribution of Mandates in New Polish Sejm



The current ruling coalition (Civic Platform + People's party) will have a very slim majority in new Sejm..

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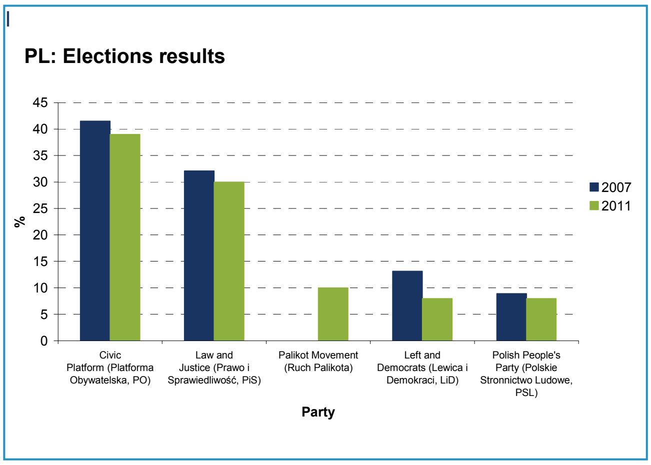
Market's editorial

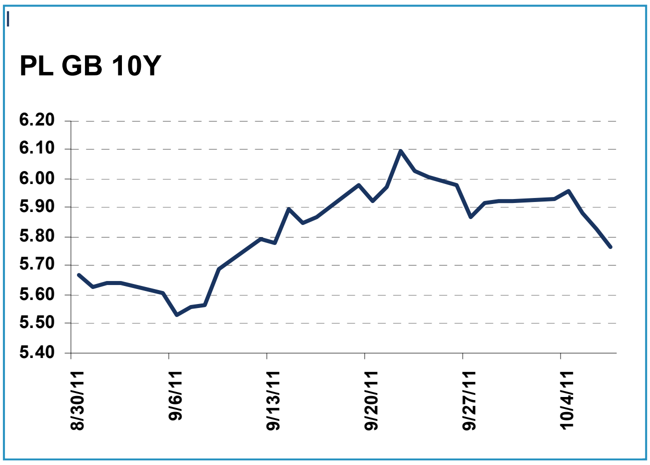
While markets recover, fundamentals deteriorate

The return of the appetite for risk on global markets has come as a huge relief for most Central European markets. Somewhat paradoxically, this relief has come when industrial output figures in the region are deteriorating (see the next page), and with the new orders indicator signalling that the situation will not improve within the next few months either.
The decrease in pessimism was probably most evident on Hungarian and Polish bond markets, where yields went down by tens of basis points over the week. Remarkably, this decline was not at all boosted by central bankers' comments, which, although made, were rather neutral. The fact that the exchange rates of the forint and the zloty have stabilised (also with a contribution by the National Bank of Poland) was much more important for the bonds of the countries concerned.

Polish elections brings political continuity

That said, the beginning of this week may be interesting in Poland in particular, because of the general election held at the weekend. Donald Tusk should be the first prime minister in Poland to be re-elected for the second term. According to the preliminary results of parliamentary elections (after 99% of votes counted) Tusk's Civic platform (PO) has around 39% while current coalition partner (Peasant party, PSL) reached 8.5%. It means that current coalition has the majority of 234 seats in 460 seats Sejm. What is more important that the opposition is not unified and PO can partly rely on support of post-communists or extreme-liberals from Palikot movement. The main opposition party (Law and Justice, PiS) ranked as second (with approximately 30% support) but it has very weak coalition potential anyway. One can hardly imagine post-communists or extreme liberals to be in serious talks with conservative PiS.
From the market point of view the outcome of elections is clearly positive. The PO lead coalition should focus more on fiscal discipline and promises to reduce the debt burden to 48% of DP till 2015 and to introduce permanent rule capping the public spending. Although the measures to reach the fiscal goals are not specified yet, it is worth noting that the PO is not in favour of tax increases and it plans to reduce main VAT tax rate by 1 pp.
All in all in the short term we can see a positive reaction of the Polish zloty and the pair could move to the area near 4.25 EUR/PLN. There can be also certain positive spill-over effects on neighbouring regional currencies.





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.7	-0.76%	↘	↘
EUR/HUF	293	-0.02%	↘	↘
EUR/PLN	4.32	0.02%	↘	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2.26	6.60	↗	↘
10Y PLN	7.06	-6.68	↘	↘
10Y HUF	4.79	-4.58	↘	↘

Review of Economic Figures

Engine of Czech growth slows

The August industrial output figure alone was no surprise. The output was up by 5.9% y/y, i.e., 0.6% less than in July. As usual in recent months, the main contributors to the year-on-year increase in output again included cars, engineering, and metal production. By contrast and in line with expectations, electronics production and the food industry did not perform well. We should also bear in mind that an extra business day in the month contributed to The August figure. However, much more interesting news than the rise in output is the first decline in new industrial contracts (-3.4% y/y) in 21 months, during which they rose steadily. Contracts declined for carmakers (-6.2% y/y), metal producers (-9.9%) and notably for electronics producers (-18.7%). While new foreign contracts were still in the black (+3.3% y/y), they could not counterbalance the declining domestic demand for industrial products this time, no matter whether electronics, electrical engineering, or cars. In addition, it has been increasingly evident that even the existing rising trend of foreign contracts has been waning month by month, and therefore we cannot even rule out that we will soon see a first decline in foreign contracts. By and large, we can say that industry, the strongest sector of the Czech economy, is slowly running out of steam, hand in hand with declining domestic demand and the increasingly obvious signs of decelerating economic growth in Europe. This is why we soon expect much worse GDP figures than we saw in the first half of the year.

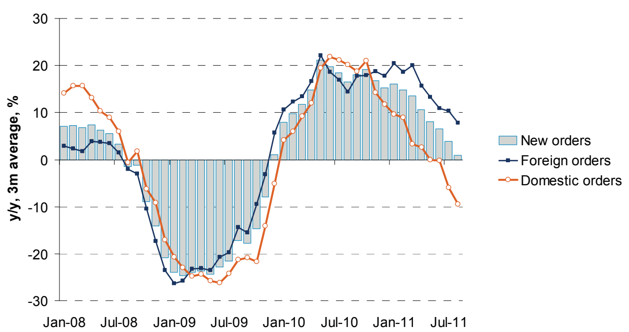
Interestingly, the Czech unemployment, which usually goes down in September; declined faster than usual last month. On the one hand, fewer school-leavers were added to statistics while, on the other hand, a greater number of people were deregistered from public employment offices. No doubt, this was the last wave of early retirements before new conditions take effect.

The unemployment fall is clearly good news, though slightly clouded with the increased number of early retirees. Less positive news is another decline in new jobs. Unemployment may also fall slightly in October, but the end of the year will again see the number of unemployed increase. Thus the unemployment rate may hit 8.5% at the end of the year.

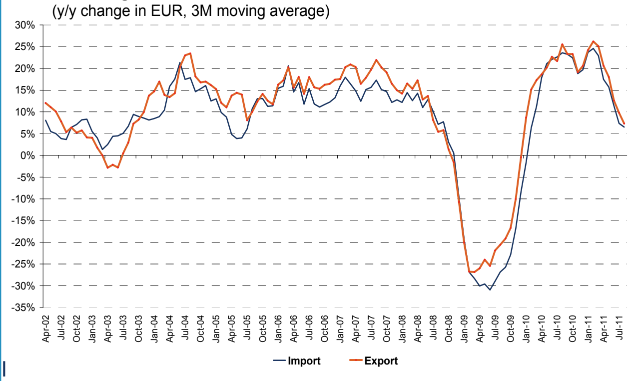
Hungary feels negative spill over effect too

Hungary is also witnessing the consequences of the global slowdown. Industrial output fell 0.4% Y/Y in August, which is pointing for a further slowdown in the growth rate from the second quarter. Foreign trade balance however remained surprisingly strong at €492m surplus as export continued to show a small growth of 3.1% Y/Y. This also means that the slowdown could be manageable for Hungary as long as it coupled with a large external surplus.

CZ: Industrial new orders



HU: Foreign trade
(y/y change in EUR, 3M moving average)



Weekly Preview

TUE 9:00	HU Inflation (change in %)		
	Sep-11	Aug-11	Sep-10
CPI y/y	**3.9**	3.6	3.8

HU: Weaker push inflation higher

The forint, which has been weak in recent weeks, pushed probably the Hungarian headline inflation higher.

THU 10:00	CZ Cur. Account (CZK bn)		
	Aug-11	Jul-11	Aug-10
C/A monthly	**-20.4**	-12.8	-23.5
cummulative (YTD)	**-61.7**	-41.2	-90.8
Trade bal. monthly	**-4.0**	5.7	-1.3
cummulative (YTD)	**60.7**	64.7	46.0

CZ: Dividend season continues

Dividends were likely again responsible for the anticipated current account deficit in August. While the dividend outflow of recent months has been much lower than last year, we do not expect this trend to be maintained in the months to come. In addition, August's current account was also affected by a poor trade balance figure. In any event, we predict that, expressed as a share of GDP, this year's current account deficit will remain at much the same level as last year's, i.e., close to a safe 3% of GDP. Adjusted for reinvestment, the current account deficit may even be close to zero.

THU 14:00	PL Inflation (change in %)		
	Sep-11	Aug-11	Sep-10
CPI y/y	**4.2**	4.3	2.5
Food (ex Alc.) y/y	**3.7**	4.5	4.3
Transport (including fuel)	**8.8**	7.9	3.8

PL: Inflation will fall slightly

The September inflation likely fell slightly to 4.2% y/y. We predict a seasonal increase in food prices for the first time since May (their weight in the consumer basket is 24%), with the increase to be 0.7% m/m. Likewise, the transportation sub-index, which should primarily reflect the weaker Polish currency (the zloty has depreciated by nearly 9.5% m/m against the US dollar), should contribute to inflation which remains well above the target of the National Bank of Poland. We do not expect inflation to fall significantly until December, when the year-on-year price rise might return to less than 4%.

Calendar

Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	10/10/2011	9:00	Trade balance	EUR M	08/2011 *P			450		354.8	
CZ	10/10/2011	9:00	Unemployment rate	%	09/2011	8.1		8.1		8.2	
CZ	10/2011	9:00	CPI	%	09/2011	-0.3	1.7	-0.3	1.7	-0.3	1.7
HU	10/11/2011	9:00	CPI	%	09/2011			0.1	3.7	-0.1	3.6
CZ	10/13/2011	10:00	Current account	CZK B	08/2011	-20.4		-15		-12.8	
PL	10/13/2011	14:00	CPI	%	09/2011		4.2	0.4	4.1	0	4.3
PL	10/13/2011	14:00	Current account	EUR M	08/2011			-1525		-1611	
PL	10/13/2011	14:00	Trade balance	EUR M	08/2011			-1110		-1200	
HU	10/14/2011	9:00	Industrial output	%	08/2011 *F					-1.3	-0.4
PL	10/14/2011	14:00	Money supply M3	%	09/2011					1.9	

Forex Technicals

EUR/CZK Daily Chart:

Currently toying back with Downtrendline off May 2010 high, with rebound off year low having retested April 2010 low (25.0150) and reapproached the broken Uptrenline off low (see graph).
Support at 24.6760/ .6500 (weekly modified Alpha Beta trend bottom + weekly Short Term Moving Average↑/ last week low), with next levels at 24.4640/ .4450 50 Week Moving Average↑/ weekly Medium Term Moving Average↑) and 24.4000/ .3800 (Sept 27/ 16 lows + monthly envelope bottom), where pause favored.
Failure to hold would see next levels at 24.3380 (61.8% 23.9200 to 25.0150), ahead of 24.2700 (Sept 09 low) and 24.1900/ .1630 (break-up daily/ hourly): tough on 1st attempts.

Resistance at 24.8400/ .8600 (weekly Bollinger top/ gap hourly), with next level at 24.9490 (Oct 03 high), where pause favored.
Failure to cap would see next levels at 24.9800 (weekly modified Alpha Beta trend top), ahead of 25.0150/ .0360 (current year high + see above/ 76.4% Dec 2010 high to 23.9200) and 25.1400 (1st target off daily Double Bottom off 24.5900: see graph): tough on 1st attempts.

EUR/HUF Daily Chart:

Pair currently back above the Uprendline off low and 292.10 (neckline long term Double Bottom: see graph).
Support at 292.20 (weekly Short Term Moving Average↑), ahead of 291.88/ 291.50 (reaction low hourly/ 236% 261.90 to 300.65): needs to sustain below to call end of alert for HUF.
Failure to hold would see next levels at 289.40/ 288.41 (reaction lows hourly), ahead of 285.35/ 285.00 (Sept 27 low/ neckline Double Bottom: see graph), where pause favored.

Resistance at 296.67/ 297.36 (weekly Bollinger top/ gap hourly), where pause favored.
Failure to cap would see next levels at 300.65 (current year high), ahead of 301.30/ 301.55 (1st target off 285.00/ weekly Starc top): tough on 1st attempts.

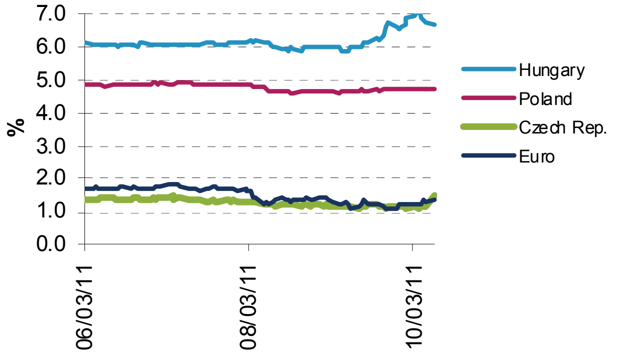
EUR/PLN Daily Chart:

New year high scored on move above the neckline of a long term Head And Shoulders bottom (4.2400: see graph) but currently back below the Uptrendline off low.
Support at 4.3219/ .3205 (weekly envelope bottom/ break-up hourly): must sustain back below to indicate better fortunes for Zloty.
Failure to hold would see next levels at 4.2815 (Sept 16 low) and 4.2665 (38.2% 3.8290 to 45370): tough on 1st attempts.

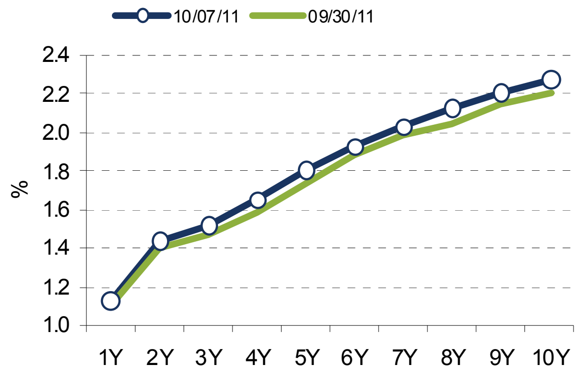
Resistance at 4.3760 (gap hourly), ahead of 4.3895/ .3920 (reaction highs hourly), where pause favored.
Failure to cap would see next levels at 4.4648/ .4659 (weekly Bollinger top/ weekly envelope top): suspect tough to sustain through on 1st attempts.

Fixed-income in Charts

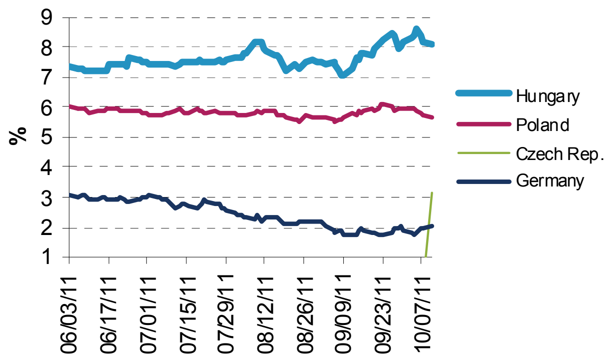
FRA 3x6



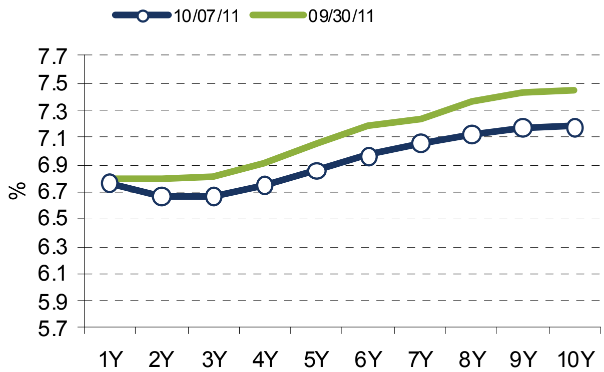
CZ IRS



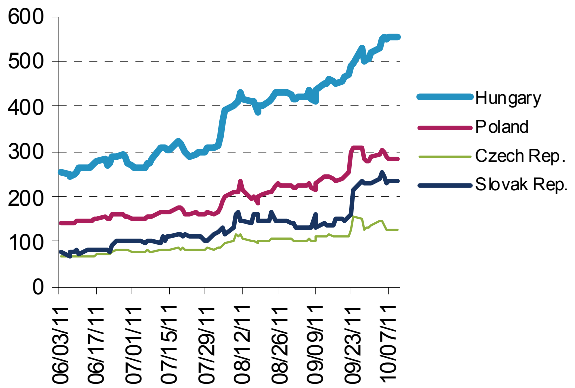
10Y GB Yields



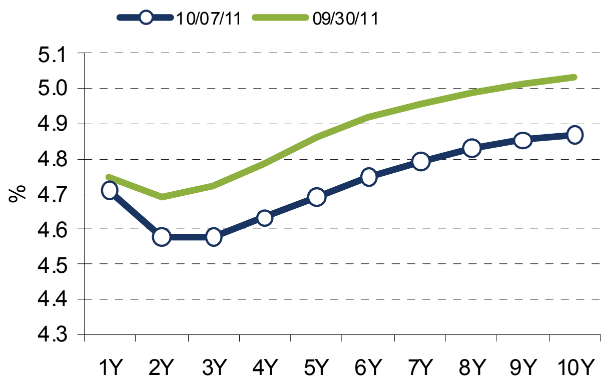
HU IRS



CDS 5Y



PL IRS



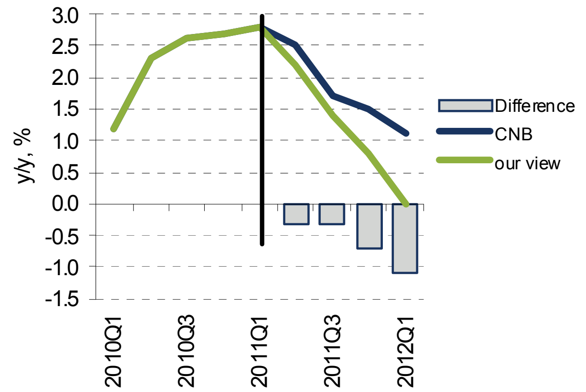
Source: Reuters

Medium-term Views & Issues

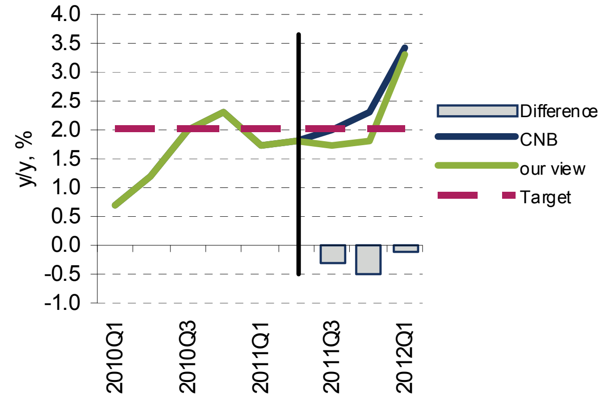
	The Czech Republic	Hungary	Poland
Growth & key issues	Although the situation in the governing coalition after some turmoil has stabilized again, tensions in the government coalition might return during discussions of the 2012 budget. The government intends to change the system of direct taxes radically 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.	We believe that factors that kept the Polish economy growing during the World Financial Crisis will gradually step aside and we estimate that the economy will grow at a slower pace next year. More specifically, a room for relatively loose fiscal policy seems to have diminished as the debt-to-GDP ratio almost reached the constitutional threshold of 55 % in 2010. As regards monetary conditions, higher interest rates should, in our view, contribute to a slowdown in both households' consumption as well as private and public investment during the next year.
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 domestic demand should counter a rise in inflation. We expect the CNB to maintain its wait-and-see policy at least until next autumn. The first rate hike delivered by the Czech central bank is probable in Q3 2012 (in contrast to the current prognosis implying it in 4th 2011).	We highlight the possibility of a surprise rate hike on worsening inflation outlook and deteriorating external environment. The government fiscal consolidation package contains VAT hike and several other tax increases, which deteriorate the inflation outlook, while the Greek tragedy creates a deteriorating external environment for the forint.	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	For the next few months, the Czech koruna should remain under pressure because of the escalating tension surrounding Greece and more dovish stance of CNB. Nevertheless, after the Greek issue is resolved, the koruna has potential to appreciate. 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.	Negative sentiment on global markets continued to weigh on the forint, which slid to as EURHUF reached a new record high 300. The stabilisation in 5y5y forward spread over the euro is a necessary condition for the forex market has become more optimistic about the long-term outlook.	The Polish zloty remains under pressure. The coordinated action of Polish state owned bank BGK and Polish central bank (NBP) provided certain relief to the Polish currency. Nevertheless it is questionable whether the weakness of the Polish zloty is over. It is not very clear whether the NBP or the Ministry of Finance have any strategy how to defend the currency. The markets were used to the fact that Polish authorities were comfortable with the range 3.8-4.25 EUR/PLN, where the pair stayed for nearly two years. Nevertheless this time the authorities did not mind much weaker zloty before stepping in.

CB's Projections vs. Our Forecasts

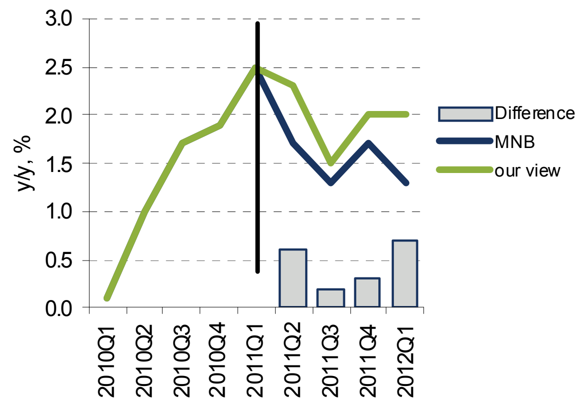
CZ: GDP Outlook



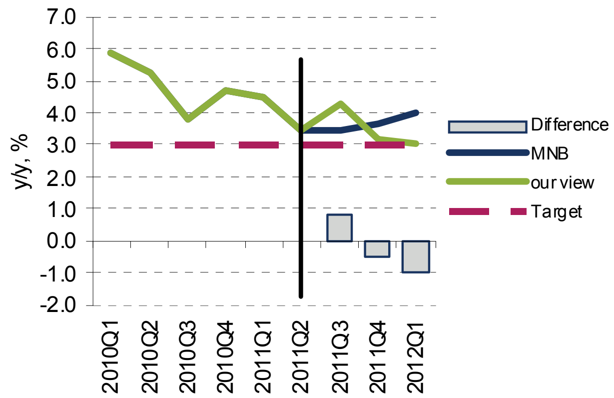
CZ: Inflation outlook



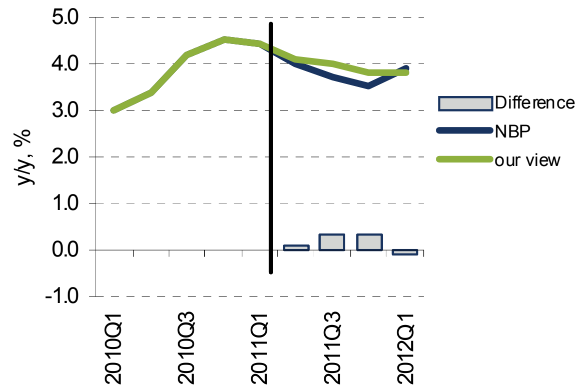
HU: GDP Outlook



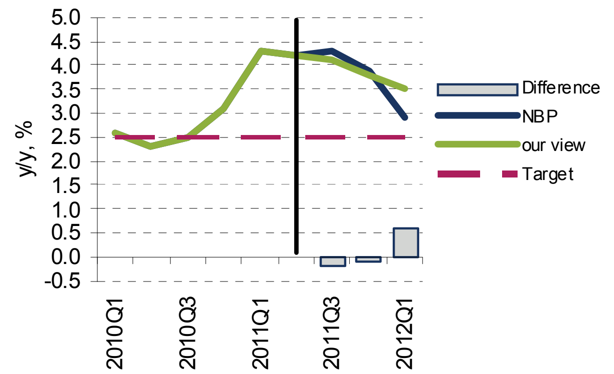
HU: Inflation outlook



PL: GDP Outlook



PL: Inflation outlook



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	*1.18*	1.17	1.19	1.22	1.25	1.42
Hungary	BUBOR	*6.12*	6.00	6.00	6.00	6.00	6.00
Poland	WIBOR	*4.76*	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	*2.26*	2.05	2.10	2.40	2.70	3.05
Hungary	HU10Y	*7.06*	7.50	7.50	7.50	7.25	7.00
Poland	PL10Y	*4.79*	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	*24.7*	25.0	24.4	24.0	23.8	23.8
Hungary	EUR/HUF	*293*	295	280	270	270	268
Poland	EUR/PLN	*4.32*	4.35	4.10	3.95	3.90	3.90

GDP (y/y)

	2011Q1	2011Q2	2011Q3	2011Q3	2012Q1	2012Q2	2012Q3
Czech Rep.	*2.8*	2.2	1.4	1.4	0.0	0.4	1.4
Hungary	*2.5*	1.5	1.5	1.5	2.0	1.8	1.8
Poland	*4.4*	4.3	4.0	4.0	3.8	3.7	3.5

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

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	*1.8*	1.7	1.8	3.3	3.5	3.4	3.2
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

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