Monday, October 17, 2011

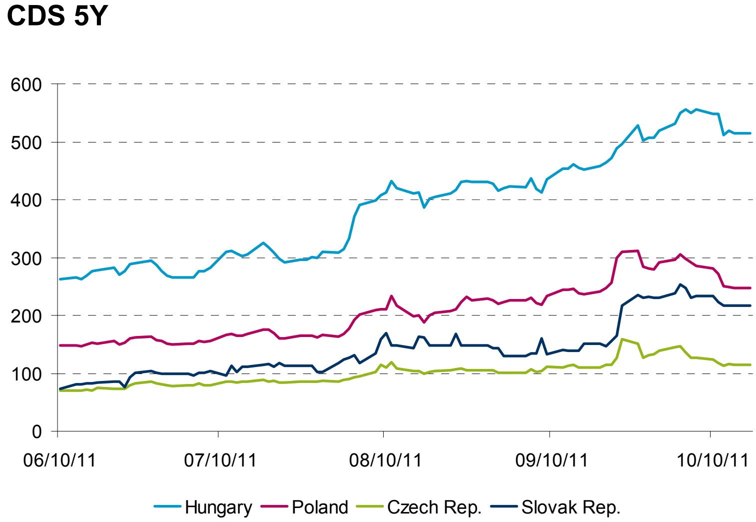
Central European Weekly

Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Polish elections overshadowed by failure of the Slovak government
- Polish inflation readings surprise on the downside
- Czech and Polish C/A balance slip into deep deficits

Chart of the Week: Regional Sovereign Risk (CDS spreads)



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Market's editorial

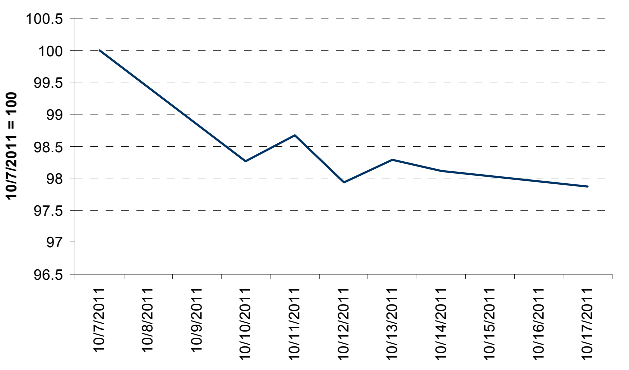
EMU members Slovaks grab regional attention

While Poland's general election has just taken place, a snap election is going to be held in another part of the region. The Slovak drama, surrounding the vote on the EFSF bailout fund, toppled the Slovak government in the end, with the outcome likely to be an early election in Slovakia.
Admittedly, Slovakia, being a euro zone member, is not a country to have a direct impact on the developments in the other Central European countries; yet it may be interesting to see how the temporary political uncertainty will influence the risk premium on the Slovak government debt.

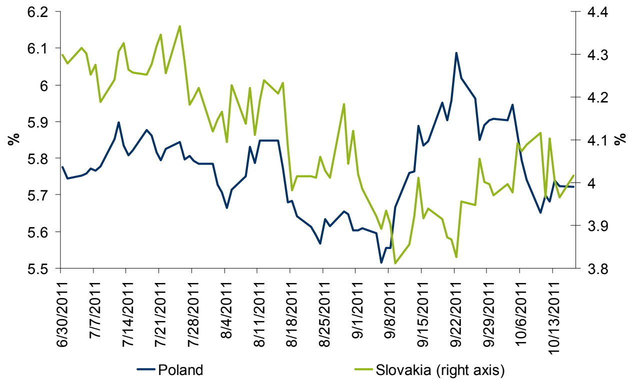
Slovak and Polish CDS spreads might converge

Interestingly, Slovakia currently pays a lower credit premium than Poland; however, markets, and today even rating agencies, are fairly sensitive to whether a country has a unified government with a clear majority in Parliament, a government that is able to enforce an unpopular budget cuts and tax hikes if necessary. Owing to the post-election continuity of Poland's centre-right coalition of the Civic Platform and the People's Party, that country stands a good chance of having such a government. By contrast, Slovakia will be in for feverish talks as to what government the country should actually form until the election is held; in addition, there will be uncertainty about the composition of Parliament after the early election.
Given such political constellations in Poland and Slovakia, we would not be greatly surprised if the risk margins of the Slovak government debt (CDS) were to exceed Poland's CDS.

PL: The zloty after elections



PL, SK: 10 years yields



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*24.7*	*-0.50%*	➔	➚
EUR/HUF	*291*	*-1.52%*	➔	➚
EUR/PLN	*4.27*	*-1.77%*	➔	➚

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*2.38*	*4.85*	➚	➚
10Y PLN	*7.00*	*-0.57*	➚	➚
10Y HUF	*4.95*	*1.33*	➚	➚

Review of Economic Figures

Regional inflation do not follow EMU's example

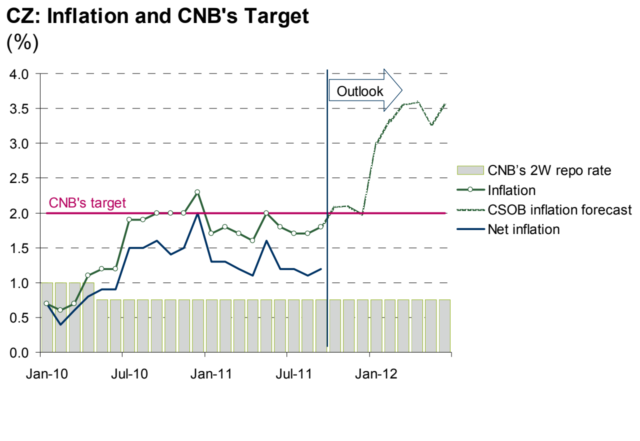
In line with expectations, September's seasonal decline in package tour prices made the consumer price index go down by 0.2% (m/m) in the Czech Republic. By contrast, the retail prices of food, seasonal clothing, and shoes went up. Year-on-year inflation has reached 1.8%, i.e., 0.2% below the Czech National Bank's target and 0.4% below the CNB's latest forecast. As usual, year-on-year inflation was primarily fuelled by food prices, which are 3.9% higher than in the same period last year, and by the rising costs associated with housing (+2.7%). However, the day when the CR's inflation would be lower than the CNB's target is drawing to a close. Inflation will climb to 2% quite soon and, more importantly, exceed 3% at the beginning of next year. End-of-year inflation will also be affected by the increase in natural gas prices for households, as well as by the preparations for a change in the reduced VAT rate. That said, we will again need to get used to a temporarily accelerated price rise, albeit curbed by poor demand, as we do not believe that household consumption will increase in real terms before the end of this year or in 2012. The latest inflation figure is neutral for the central bank. Hence the CNB may stick to its wait-and-see policy and leave its rates unchanged until the second half of next year at least.

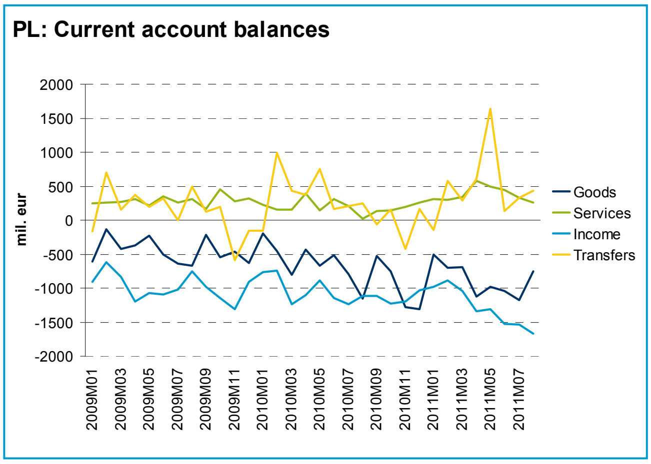
The September inflation in Poland surprised markets, as it fell significantly. Compared to August, the year-on-year price rise decelerated by 0.4 percentage points to 3.9%. The month-on-month price rise was 0.1%. As far as the structure is concerned, we were primarily surprised at the month-on-month decline in food prices, the weight of which in Poland's consumer basket is 24%, and at the decline in transport prices, which have not been significantly affected by the weak zloty thus far (the currency depreciated by 5.1% in September, compared to August). Given the September low inflation, we have revised our forecast, as we now expect end-of-year inflation to fall to closely below the upper threshold of the tolerance band of the National Bank of Poland, i.e., below 3.5%. In addition, for purely technical reasons, inflation is likely to go down again next year, because the price index soared by 1.2% m/m in January this year, due also to the impact of the increased VAT.

High dividends outflows bring C/A into red

The Czech current account figure was much worse than the most pessimistic expectations in August. The deficit hit this year's high (of CZK 33.7 bn), notably because of a high dividend outflow to foreign countries. According to the CNB's data, the dividend outflow in that month alone was CZK 39 bn. In addition to the balance of income, where these dividends are included, the trade balance was also in the red this time, due to the poor performance of foreign trade, which is typical of that month. Although the August current account deficit was the highest over the last four years, the development of the balance of payments is not dramatic to any great extent. Since the beginning of the year, the current account deficit has been lower than in the same period of last year, that is to say close to 3% of GDP, and even less than 1% if adjusted for reinvested profit. The figure for this year as a whole is likely to be similar.

The Polish zloty was affected not only by lower than expected inflation but also by August's balance of payments data last week. The current account deficit was EUR 1.73 bn (as opposed to EUR 2.01 bn in the same month of 2010). The negative figure was primarily affected not only by the trade balance deficit of EUR 0.75 bn, but above all by the high balance of income deficit, which reflected dividend payments from foreign direct investment (EUR 1.2 bn). By contrast, a high share of reinvested profit (EUR 0.89 bn) was somewhat better news for the zloty.
Even so, the development trend of Poland's current account is not at all positive, because the accumulated deficit for the last 12 months stands at EUR 18.2 bn. That said, this year's figure is likely to be very close to 5% of GDP.





Calendar

Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	10/17/2011	9:00	PPI	%	09/2011	0	5.4	-0.1	5.4	-0.1	5.7
HU	10/18/2011	9:00	Wages	%, ytd.	08/2011				4.6		6.2
PL	10/2011	14:00	Wages	%	09/2011			0	5.5	-0.6	5.4
PL	10/19/2011	14:00	Industrial output	%	09/2011			10	5	4.3	8.1
PL	10/19/2011	14:00	PPI	%	09/2011			0.6	7.4	0.4	6.6
HU	10/20/2011	12:00	GB bond auction/fixed rate	HUF B	10/2011 *A						
PL	10/20/2011	14:00	Core CPI	%	09/2011			0.3	2.8	0.2	2.7
HU	10/21/2011	9:00	Retail sales	%	08/2011				-0.8		-1.3

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 the broken Uptrenline off low (see graph).
Support at 24.6300/ .6130 (Oct 10 low/ weekly modified Alpha Beta trend bottom), with next levels at 24.5660/ .5400 (weekly envelope bottom/ reaction low hourly), ahead of 46.4680/ .4660 (weekly Medium Term Moving Average↑/ 50 Week 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 24.8600/ .8660 (gap hourly/ weekly Bollinger top), ahead of 24.9080 (weekly envelope top) and 24.9300/ 24.9490 (Oct 07/ 03 highs), where pause favored.
Failure to cap would see next levels at 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 but back below 292.10 (neckline long term Double Bottom: see graph).
Support at 289.88 (weekly envelope bottom), with next levels at 288.65/ .50 (current reaction low off year high/ monthly envelope bottom) and 288.18 weekly modified Alpha Beta trend bottom), where pause favore.
Failure to hold would see next levels at 285.84/ 285.35 (38.2% 261.90 to 300.65/ Sept 27 low): needs to sustain below to call end of alert for HUF.

Resistance at 292.65 (broken weekly Short Term Moving Average↑), ahead of 294.20 (reaction high hourly) and 296.45 (Oct 12 high), where pause favored.
Failure to cap would see next levels at 297.78 (weekly Bollinger top), ahead of 299.44 (weekly modified Standard Error band top) and 300.65 (current year high + weekly modified Alpha Beta trend top): tough on 1st attempts.

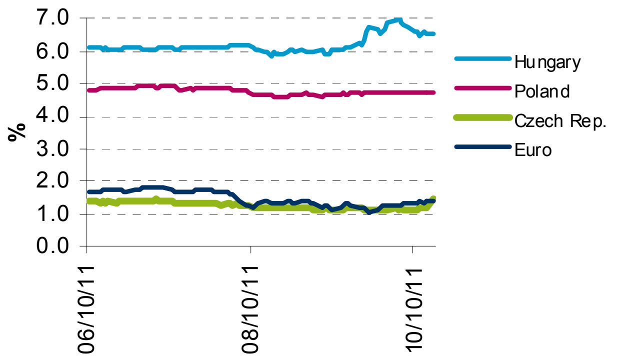
EUR/PLN Daily Chart:

Failed to regain the Uptrendline off low (see graph) but still above 4.2400 (neckline of a long term Head And Shoulders bottom).
Support at 4.2640 (break-up daily + 38.2% 2010 low to 4.5370), ahead of 4.2550 (1st target of daily Double Top off 4.3600) and 4.2369 (weekly envelope bottom + weekly Medium Term Moving Average↑), where pause favored.
Failure to hold would see next levels at 4.2217 (weekly modified Alpha Beta trend top) and 4.2000 (break-up weekly charts): tough on 1st attempts.

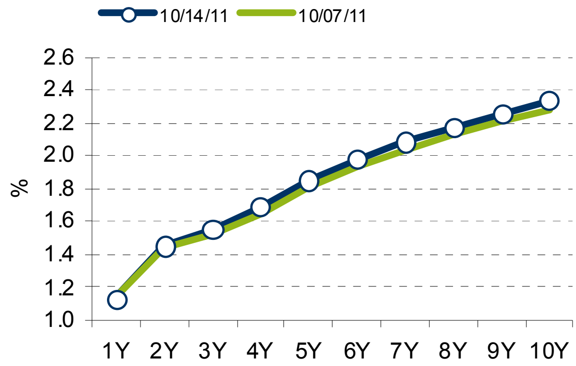
Resistance at 4.3250 (breakdown hourly), ahead of 4.3510 (breakdown daily + weekly Short Term Moving Average↓), where pause favored.
Failure to cap would see next levels at ahead of 4.3651 (weekly envelope top), ahead of 4.3875/ .3895 (reaction highs hourly) and 4.4037 (weekly modified Alpha Beta trend top): suspect tough to sustain through on 1st attempts.

Fixed-income in Charts

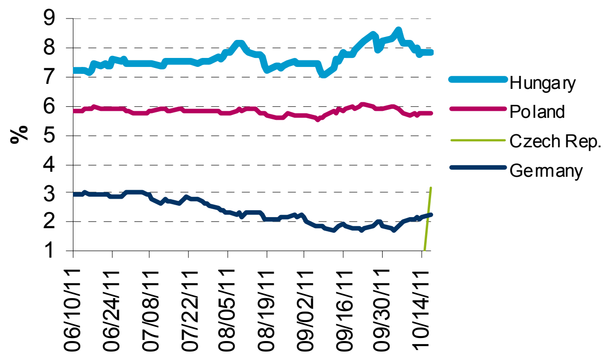
FRA 3x6



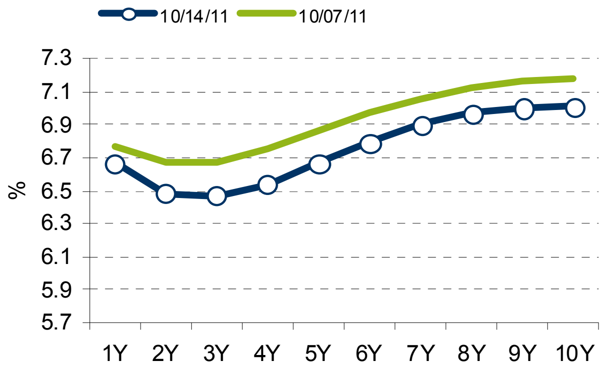
CZ IRS



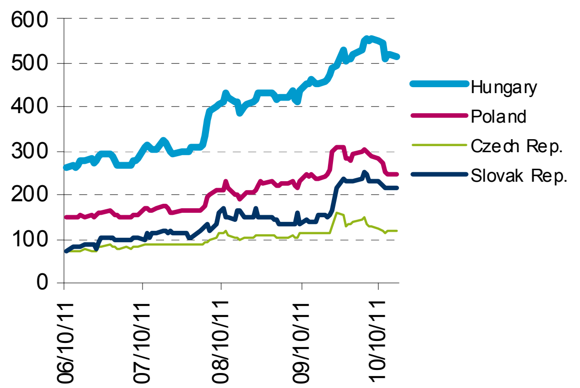
10Y GB Yields



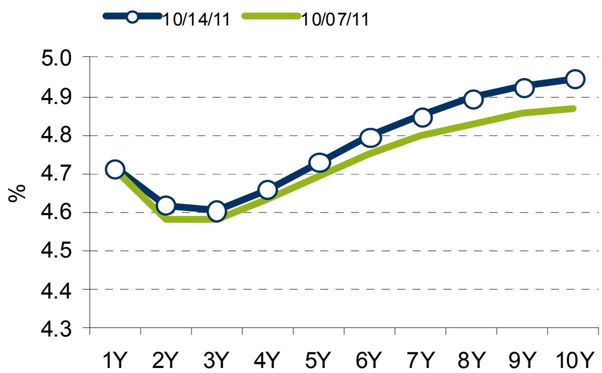
HU IRS



CDS 5Y



PL IRS



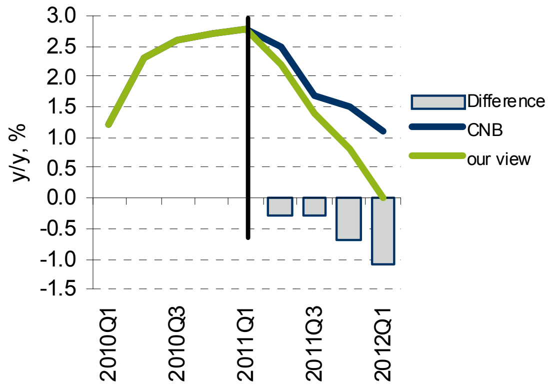
Source: Reuters

Medium-term Views & Issues

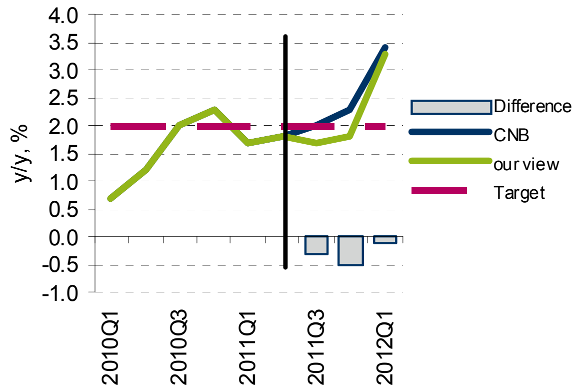
	The Czech Republic	Hungary	Poland
Growth & key issues	Although the situation in the governing coalition after some turmoil has stabilized again, tensions in the government coalition might return during discussions of the 2012 budget. The government intends to change the system of direct taxes radically 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 Q32012 (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

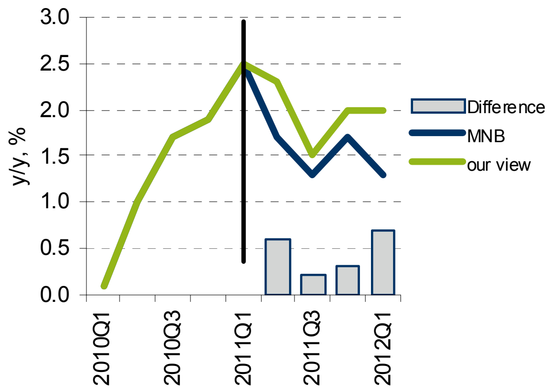
CZ: GDP Outlook



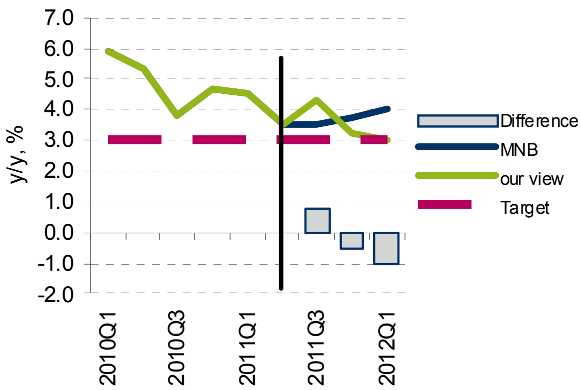
CZ: Inflation outlook



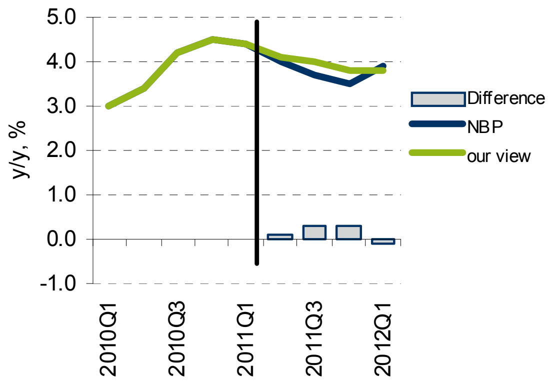
HU: GDP Outlook



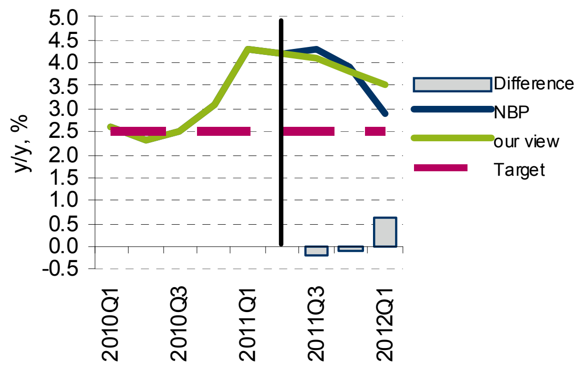
HU: Inflation outlook



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	*1.17*	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	*2.32*	2.05	2.10	2.40	2.70	3.05
Hungary	HU10Y	*7.02*	7.50	7.50	7.50	7.25	7.00
Poland	PL10Y	*4.93*	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	*24.8*	25.0	24.4	24.0	23.8	23.8
Hungary	EUR/HUF	*294*	295	280	270	270	268
Poland	EUR/PLN	*4.29*	4.35	4.10	3.95	3.90	3.90

GDP (y/y)

	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3
Czech Rep.	*2.8*	2.2	1.4	0.8	0.0	0.4	1.4
Hungary	*2.5*	1.5	1.5	2.0	2.0	1.8	1.8
Poland	*4.4*	4.3	4.0	3.8	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	-5.0

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)	
Piet Lammens	+32 2 417 59 41
Peter Wuyts	+32 2 417 32 35
Didier Hanesse	+32 2 417 59 43
Joke Mertens	+32 2 417 30 59
Mathias Van der Jeugt	+32 2 417 51 94
Dublin Research	
Austin Hughes	+353 1 6646892
Prague Research (CSOB)	
Jan Cermak	+420 2 6135 3578
Jan Bures	+420 2 6135 3574
Petr Baca	+420 2 6135 3570
Bratislava Research	
Marek Gabris	+421 2 5966 8809
Warsaw Research	
Budapest Research (K&H)	
Gyorgy Barcza	+36 1 328 99 89

Global Sales Force	
Brussels	
Corporate Desk	+32 2 417 45 82
Commercial Desk	+32 2 417 53 23
Institutional Desk	+32 2 417 46 25
London	+44 207 256 4848
Frankfurt	+49 69 756 19372
Paris	+33 153 89 83 15
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