Monday, November 14,

Banking & Insurance

Central European Weekly

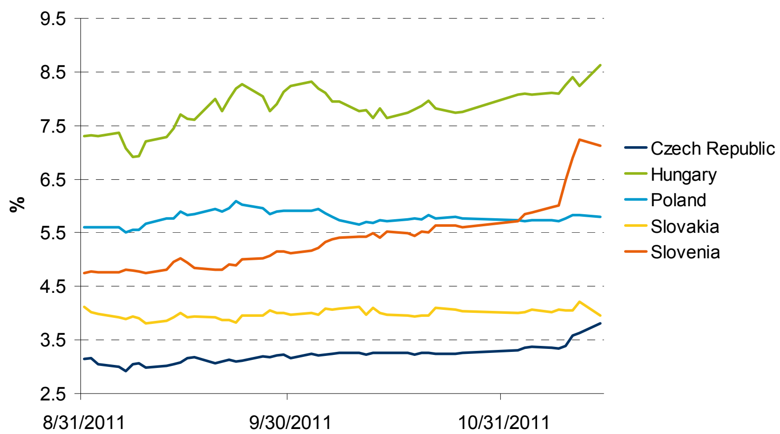
Written by CSOB Prague and K&H Budapest

Weekly Highlights:

- Heavy sell off on CEE bond markets drives Slovenian 10Y yields above 7%
- Hungarian markets are screaming for higher rates
- Food caused accelerated in the Czech Republic
- Domestic demand set to remain weak in both Hungary and Czech

Chart of the Week: Heavy sell off on the CEE bond markets

Yields of 10Y government bonds



Slovenian 10Y yields soared due to a heavy sell-off on CEE bond markets

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Market's editorial

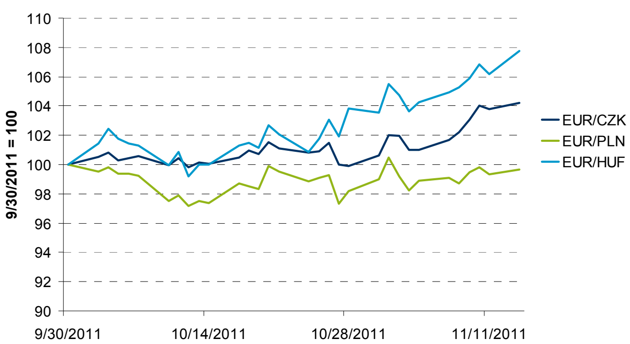
Sell-off in CE bond markets

Last week the nervousness stemming from euro-zone peripheries was visible across Central European bond markets. So far, it has been mainly visible at FX markets of more vulnerable countries (like in Hungary, see next paragraph). The pressure on the fixed income markets is something new for many markets. For instance, the Czech 10Y yield tracked its German counterpart till the beginning of October as Czech bonds were playing a role of safe heaven mirror for a while. Nevertheless the escalation of the crisis in recent weeks led foreign investors to the liquidation of their positions in Czech bonds too. Hence, the spread over the 10Y German bund has widened by more than 80 bps since the mid October.
Meanwhile, negative sentiment prevails also in Hungary while only the Polish market performs slightly better mainly due to higher liquidity and partly probably thanks to interventions of the state owned BGK. On the other hand in Slovenia (the euro member), the deterioration of sentiment has been pretty significant as 10Y yield has spiked over 200 bps up to 7% since the beginning of October. Also in Slovakia the tensions have intensified and Slovaks failed in most recent bond auction to attract solid demand.
For the week ahead the sentiment on the eurozone peripheries should be crucial. Nevertheless it seems that even current calm down may hardly stop sell-offs at some markets after breaking through certain levels (EUR/CZK, 10YHUF, 10Y CZ).

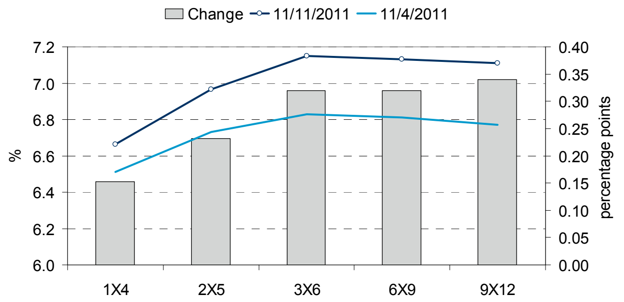
Hungarian markets are screaming for higher rates

The most challenging is the situation on financial markets, where the forint has been underperforming peers for months now as Hungary is often seen the weakest coutnry in the CEE region. The currency has depreciated by around 20% in two months putting additional burden to the already troubled foreign currency borrowers. This means that the central bank may have to weigh in financial stability concerns into its decisions as another wave of defaulting loans would be very negative for the outlook. So far, there has been only a very mild statement published from the central bank after the October meeting, which put emphasis instead on the inflation outlook, which markets rather ignored.
Currently, money markets are pricing in more than 130bps rate hikes for the next months and the government was not able to sell T-Bills a week ago. This is suggesting that the short-term of the yield curve is misplaced and there may be no calm down before a rate hike series begins. Until then, we remain sceptical about the outlook of the currency and bonds.

CE currencies



HU FRA



Source: Reuters

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*25.7*	*1.82%*	↗	→
EUR/HUF	*312*	*1.83%*	↗	→
EUR/PLN	*4.39*	*0.65%*	↗	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*2.26*	*0.40*	↗	↗
10Y PLN	*7.19*	*1.41*	↗	↗
10Y HUF	*5.06*	*1.61*	↗	↗

Review of Economic Figures

Food caused accelerated inflation in the CR

In October the consumer prices increased by 0.3% m/m. The higher inflation is chiefly caused by food. The increase in the prices of goods is a reflection of the increasing prices of seasonal goods and the last traces of the impact of the higher prices of agricultural commodities. An interesting observation came from the CNB, which speculates that retailers may have begun to prepare for the January increase in VAT in advance. Year-on-year inflation – and monetary policy inflation – hit 2.3% and surpassed the goal of the CNB and also the latest prognosis by the central bank, by two-tenths. The rise in consumer prices in the CR is now as rapid as it was at the end of last year.

The higher inflation, together with the weaker crown, may be to the detriment of the latest prognosis by the CNB, which assumes a reduction in rates, and higher inflation must also be assumed during the coming months. The greatest jump in inflation will arrive at the turn of the year, when retailers will raise prices as a result of the increase in the lower VAT rate. Paradoxically, the increased inflation in the CR will approach that of the euro area, which is already contending with a relatively high inflation rate.

Foreign trade surpluses are increasing

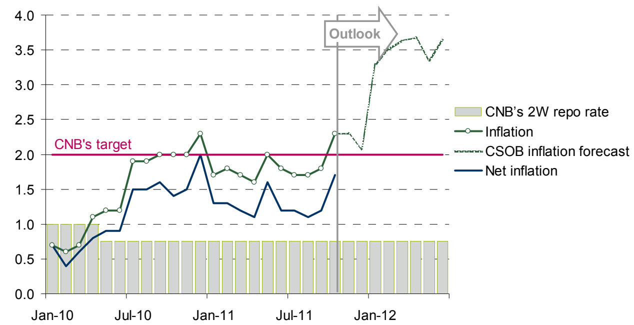
In September, Czech industrial production increased by only 2.5% y/y, which is the weakest result since December 2009. While automotive companies are still doing fairly well and the rate of their production has increased to 22.1%, other strong branches of industry are reporting weaker results, whether this concerns electrical engineering, the food industry, or metal production. While the pace of industry has not been too surprising, new contracts have. After a weaker August, September seems more promising, because contracts increased by 2.6%, and even by 12.7% abroad. And cars are playing first fiddle again. It seems that industry will not crash for the time being, even though domestic demand is weakening. Automotive companies are still faring very well and new contracts are still positive. In the flood of pessimistic reports from Europe, the data from the CR remains positive.

While the dynamic of foreign trade has dropped significantly, the surplus in the trade balance doubled in September to nearly 21 billion crowns. While European demand continues to fall, it is successfully being substituted, at least partially, by exports to Russia and to some Asian countries. The export of cars is the chief cause of the high trade surplus. Exports to the Russian market (+1.9 billion crowns), to the German market (+1.7 billion) and the French market (0.6 billion) reported the greatest rises. With regard to imports, it is clear that weak domestic demand is resulting in smaller volumes of imported goods. Furthermore, imports have slowed significantly (to 3.5%) even though the prices of raw materials remain high. Even though weaker export performance by the Czech Republic can also be assumed in the future, the foreign trade surplus may still grow and surpass the threshold of 160 billion crowns this year.

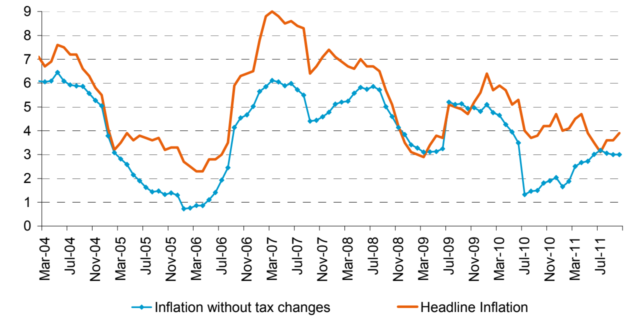
Domestic demand still weak in Hungary

Hungary is getting into a more difficult situation every day as the economy is slowing day, while pressure on financial markets grow. The economy is expected to slow down to 1.0% Y/Y in the third quarter from 1.5% Y/Y in the second due to mainly the slowing demand for its export, which has been the only positive contribute to growth this year. Not surprisingly, depressed domestic demand helped inflation under control and albeit the headline index rose to 3.9% Y/Y in September from 3.6% Y/Y, core inflation remained unchanged at the targeted 3.0% level.

CZ: Inflation and CNB's Target
(%)



Inflation
(y/y change in %)



Weekly Preview

TUE 9:00 **CZ GDP (change in %)**

	Q3-11	Q2-11	Q3-10
GDP (y/y)	**1.4**	2.2	2.6
GDP (q/q)	**0.0**	0.1	0.8

CZ: Growth at the mercy of foreign demand

The first estimate of the development of the Czech economy during the third quarter may not end up too positively. Even though no details will be established, only a lightning quick estimate prepared on the basis of incomplete data, it can be assumed that during the third quarter the economy was driven simply by foreign trade. Domestic demand fell as a result of lower household and government consumption. The economy remains positive, but it is increasingly clear that it is founded on the automotive industry, while other branches and fields are losing this year.

TUE 9:00 **HU GDP (change in %)**

	2011Q3	2011Q2	2010Q3
GDP (y/y)	**1.0**	-0.1	0.8
GDP (q/q)	**0.2**	1.5	1.7

HU: For the time being growth has lost pace slightly

The economy is expected to slow down to 1.0% Y/Y in the third quatrter from 1.5% Y/Y in the second due to mainly the slowing demand for its export, which has been the only positive contribute to growth this year.

TUE 10:00 **CZ Cur. Account (CZK bn)**

	Sep-11	Aug-11	Sep-10
C/A monthly	**-20.0**	-33.7	-27.6
cummulative (YTD)	**-94.9**	-74.9	-118.3
Trade bal. monthly	**12.0**	-4.2	1.9
cummulative (YTD)	**72.5**	60.5	47.9

CZ: Current accounts under the influence of dividends

Surplus foreign trade in goods and services, on the one hand, and the continuous outflow of dividends on the other hand, are responsible for the September result of the current account payment balance. In any case, the current account result continues to reside in safe territory, near three per cent GDP, where it will remain for the rest of this year.

TUE 14:00 **PL Inflation (change in %)**

	Oct-11	Sep-11	Oct-10
CPI y/y	**3.9**	3.9	2.8
Food (ex Alc.) y/y	**2.7**	3.3	4.8
Transport (including fuel)	**8.1**	7.6	4.9

PL: Inflation will remain unchanged

The year-on-year inflation rate probably stagnated in October on the level of 3.9% y/y, a level it reached in the previous month, and should therefore remain high above the inflation goal of the NBP. Our former estimate indicated a fall in year-on-year inflation, but after taking into account the development of the zloty exchange rate and the prices of agricultural products, we adjusted our estimate upwards. After four consecutive month-on-month falls, the chief contributor to growth should again be food prices and prices of non-alcoholic beverages (the key item, the weight of which in the consumer basket is 24%), which, in our estimate, rose by 1% m/m. The rise in prices of clothing and shoes should be reflected in a similar seasonal rise in prices. Apart from this, we also expect that the rise in fuel prices, where the weaker zloty should also play a role, should also con-

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tribute to a month-on-month rise in prices by 0.5% (the same as last year).

Calendar

Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	11/14/2011	14:00	Money supply M3	%	10/2011			0.7		1.6	
CZ	11/15/2011	9:00	GDP	%	3Q/2011 *P	0	1.4	0.2	1.6	0.1	2.2
HU	11/2011	9:00	GDP	%	3Q/2011 *P			0.1	0.8	0	1.5
HU	11/15/2011	9:00	Industrial output	%	09/2011 *F					3.9	3
CZ	11/15/2011	9:00	PPI	%	10/2011	0.1	5.7	0	5.6	0.2	5.6
CZ	11/15/2011	10:00	Current account	CZK B	09/2011	-20		-16.4		-33.65	
PL	11/15/2011	14:00	Trade balance	EUR M	09/2011			-587		-750	
PL	11/15/2011	14:00	Current account	EUR M	09/2011			-1842		-1730	
PL	11/15/2011	14:00	CPI	%	10/2011			0.4	4	0.1	3.9
PL	11/15/2011	15:00	Budget balance	PLN M	10/2011					-21.9	
CZ	11/16/2011	12:00	CZ bond auction 3.85%/2021	CZK B	11/2011			7			
HU	11/17/2011	12:00	GB bond auction/fixed rate	HUF B	11/2011 *A						
HU	11/18/2011	9:00	Wages	%, ytd.	09/2011				5.1		6.5
PL	11/18/2011	14:00	Wages	%	10/2011			1.1	5.2	-0.3	5.2

Forex Technicals

EUR/CZK Daily Chart:

Rebound off puts pair currently above 25.3800 (Dec 2010 high + neckline Double Bottom: see graph).
Support at 25.5230/ .5010 (broken weekly Bollinger top/ break-up daily), with next levels at 25.4280 (weekly envelope bottom), ahead of 25.2550/ .2120 (break-up daily/ weekly Short Term Moving Average↑).
Failure to hold would see next levels at 24.8990 (break-up daily), ahead of 24.7970 (weekly Medium Term Moving Average↑) and 24.6500/ .6300 (Oct 27 low Oct 10 low), where pause favored.

Resistance at 25.7900 (current new year high?), ahead of 25.8250 (weekly Star top) and 25.9210 (weekly envelope top), where pause favored.
Failure to cap would see next levels at 26.1240 (38.2% 29.6900 to 23.9200), ahead of 26.4150 (1st target off 25.3800): tough on 1st attempts.

EUR/HUF Daily Chart:

Pair back above 292.10 (neckline long term Double Bottom: 1st target would be 322.75) and new year high being scored.
Support at 311.95 (weekly modified Alpha Beta trend bottom), with next levels at 308.90/ .40 (reaction low hourly/ break-up daily + weekly envelope bottom), ahead of 306.61/ .30 (weekly Short Term Moving Average↑/ reaction low hourly), where pause favored.
Failure to hold would see next levels at 302.71 (Nov 04 low): needs to sustain back below to signal return of better fortune for HUF.

Resistance at 315.65/ 315.91 (today's + current new year high?/ weekly Bollingertop), where pause favored.
Failure to cap would see next level at 317.45 (historic high + weekly envelope top + weekly Starc top): tough on 1st attempts.

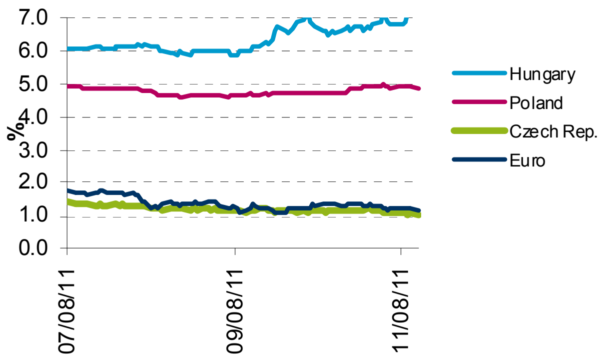
EUR/PLN Daily Chart:

Above 4.2400 (neckline of a long term Head And Shoulders bottom: see graph).
Support at 4.3733/ .3650 (weekly Short Term Moving Average↑/ break-up hourly), with next levels at 4.3555 (weekly modified Alpha Beta trend bottom), ahead of 4.3300/ .3274 (Nov 03 low + weekly Medium Term Moving Average↑/ weekly envelope bottom), where pause favored.
Failure to hold would see next levels at 4.3185 (reaction low hourly), ahead of 4.2995 (break-up hourly) and 4.2815 (Oct 27 low).
4.2665/ .2640 = neckline daily Double Top/ 38.2% 3.8225 to 4.5370: needs to sustain back below to signal return of better fortune for Zloty.

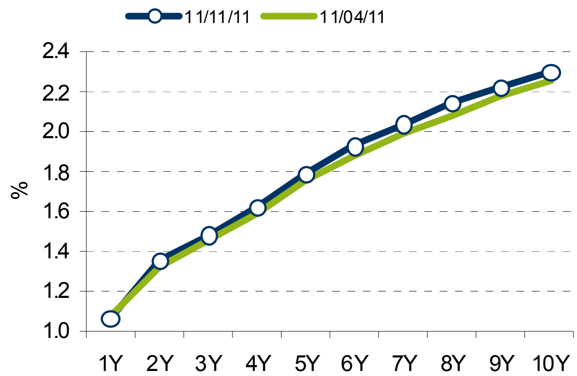
Resistance at 4.4123 (weekly modified Alpha Beta trend top), ahead of 4.4332/ .4370 (reaction highs hourly), and 4.4513 (weekly envelope top), where pause favored.
4.4888 = Nov 01 high: suspect tough to sustain through on 1st attempts.

Fixed-income in Charts

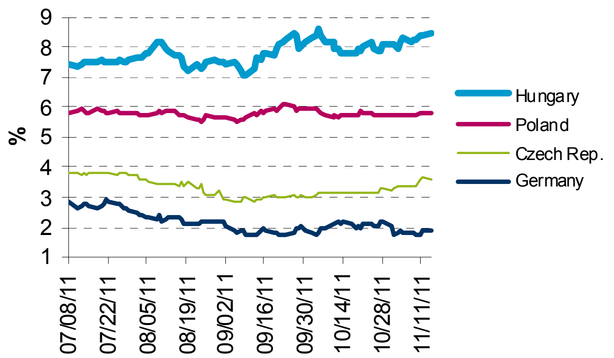
FRA 3x6



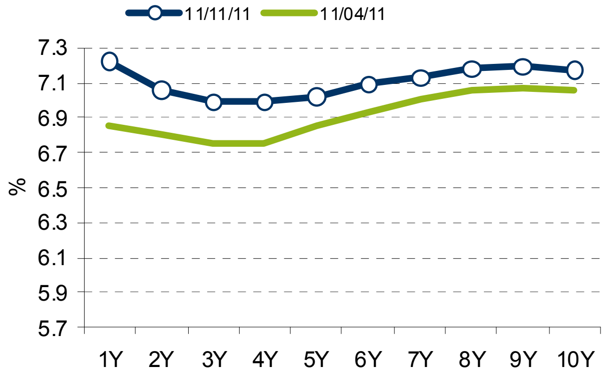
CZ IRS



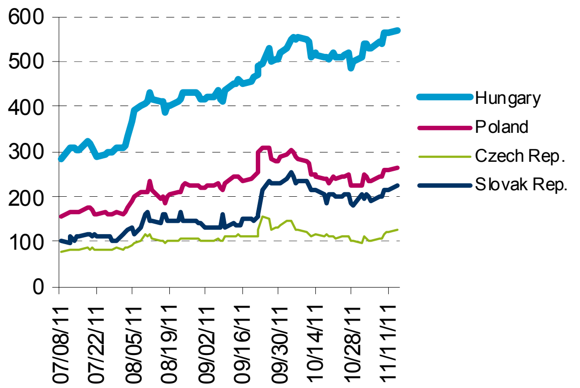
10Y GB Yields



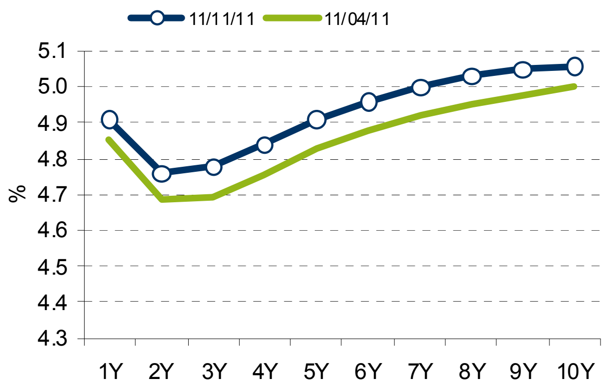
HU IRS



CDS 5Y



PL IRS



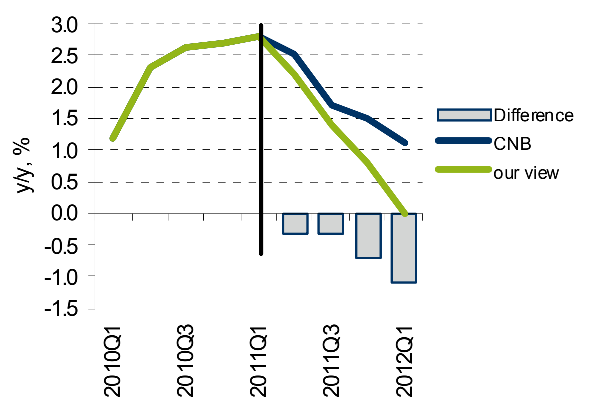
Source: Reuters

Medium-term Views & Issues

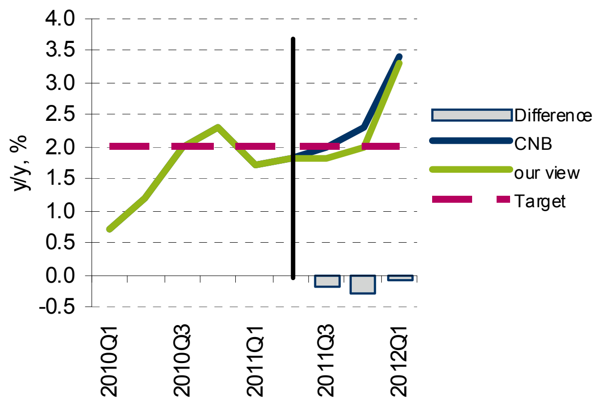
	The Czech Republic	Hungary	Poland
Growth & key issues	Although the situation in the governing coalition after some turmoil has stabilized again, tensions in the government coalition might return during discussions of the 2012 budget. The government intends to change the system of direct taxes radically 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 increased above the central bank's target in October driven by food and fuel prices. Fuel prices as well as prices of agricultural commodities continue to pose a risk for future inflation. In January the inflation will jump above the 3% as a result of V.A.T. increase. 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 the end of the next year. The first rate hike delivered by the Czech central bank is probable in 2013H1.	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

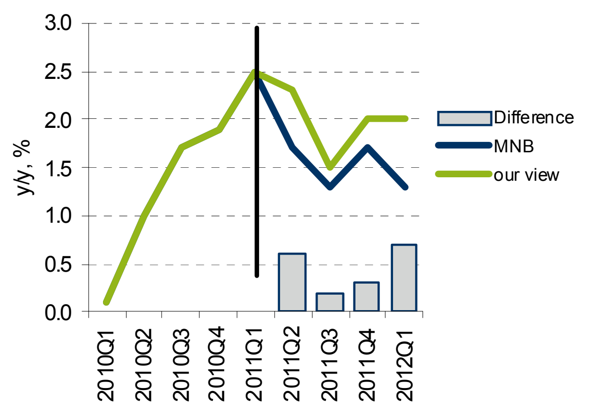
CZ: GDP Outlook



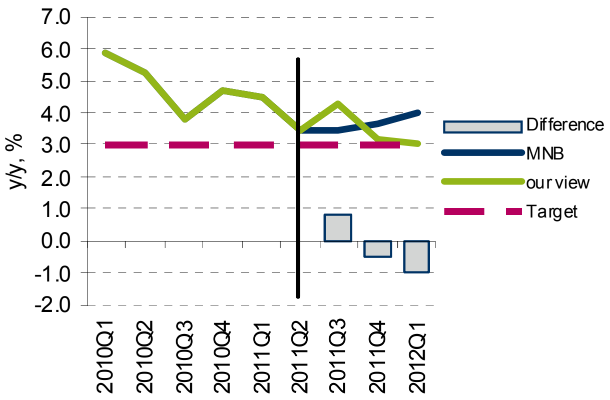
CZ: Inflation outlook



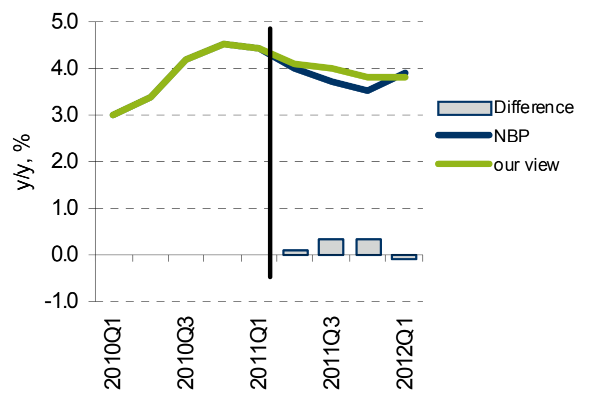
HU: GDP Outlook



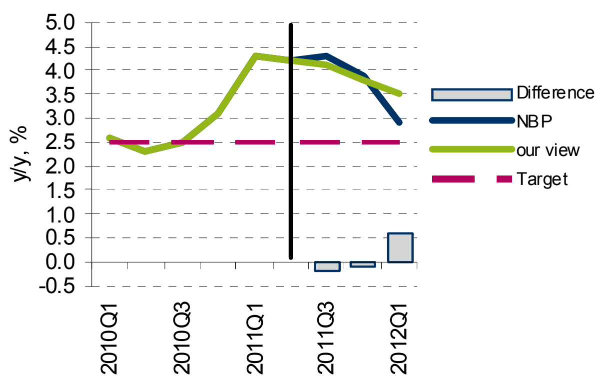
HU: Inflation outlook



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	0.75	-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	*1.14*	1.17	1.17	1.18	1.20	1.21
Hungary	BUBOR	*6.31*	6.00	6.50	7.00	7.00	7.00
Poland	WIBOR	*4.93*	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	2.20	2.30	2.50	2.85
Hungary	HU10Y	*7.19*	7.50	7.00	7.50	7.50	7.50
Poland	PL10Y	*5.06*	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	*25.7*	25.0	26.0	25.3	25.0	24.7
Hungary	EUR/HUF	*312*	295	280	270	270	268
Poland	EUR/PLN	*4.39*	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*	1.8	2.0	3.3	3.3	3.0	3.0
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
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Joke Mertens	+32 2 417 30 59
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