Central European Weekly

Tuesday, 17 July 2012

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Weekly Highlights:

- Czech and Polish bond market enjoy strong rally
- Polish inflation surprisingly high again
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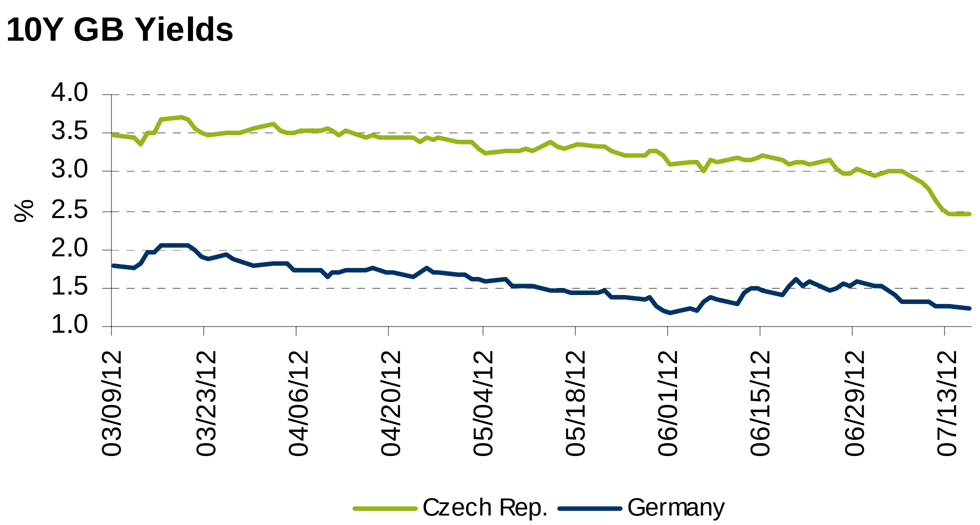
Chart of the Week



The yield of the 10Y Czech government bond benchmark hit fresh all-time lows below the 2.50% level .

Market's editorial

Czech and Polish government bonds rally

Czech and Polish government bonds are in demand. In recent days and weeks their prices have been rising almost without interruption. Czech bond yields thus easily dropped to all-time lows that we could hardly have imagined some time ago. What is responsible for this?

Foreign investors could be behind strong demand

Although there is no evidence in data to confirm foreign investors' improving demand (figures on non-residents holdings are delayed) the foreign buying seems to be the most logical explanation of the rally on the Czech and Polish bond markets. The re-allocation of assets, when portfolio investors who are withdrawing from the Spanish and Italian bond markets are moving some of their assets elsewhere, not only had a positive impact on countries such as Denmark and Sweden but also influenced Central Europe. In addition, after the ECB's rate cut, yields from the bonds issued by the 'safe' countries of the eurozone have virtually fallen to zero, and this naturally made Czech and Polish government bonds even more attractive.

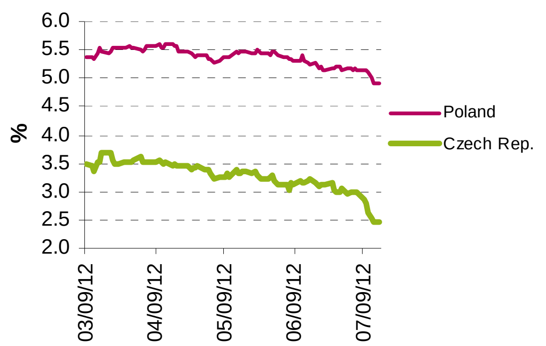
Rate cut bets from the CNB and NBP help too

Another strong factor to improve demand for Czech and Polish government bonds recently is related to the (anticipated) development of official interest rates in those economies. After the recent move by the Czech National Bank, Czech official rates hit all-time lows, while the bets that the National Bank of Poland will soon (within the next six months) cut rates fairly aggressively have also increased recently. Although we do not believe that the CNB may cut its repo rate even lower (to 0.25%) and do see the current bets on an official rate cut in Poland to be exaggerated, we recognise the market arguments that the above scenarios are possible.

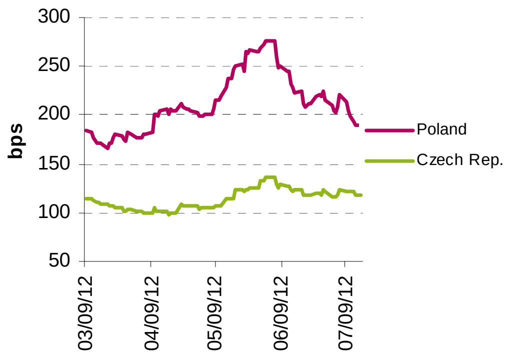
Budget Pre-financing another supporting factor

Finally, reflecting on why Czech and Polish government bonds are faring so well, we also need to view the supply side of the markets. There a clear advantage appears to be the fact that, under their fairly strict budget policies, the Czech Republic and Poland succeeded in significantly 'pre-funding' their (state budget) financing needs for 2012 in the first half of the year.

10Y GB Yields



CDS 5Y



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.4	-0.01%	↗	↗
EUR/HUF	288	-0.26%	↗	↗
EUR/PLN	4.18	-0.15%	↗	↗

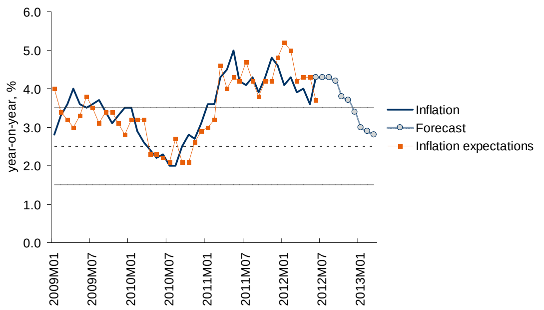
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.76	-3.30	↗	↗
10Y PLN	6.71	-2.26	↗	↗
10Y HUF	4.52	-3.32	↗	↗

Review of Economic Figures

June inflation in Poland indicates stable interest rates

Meanwhile, a figure on the Polish inflation for June surprised slightly on the upside of expectations (i.e., similarly to the Czech Republic and Hungary). As the structure suggests, the main surprise was counter-seasonal increase in food and non-alcoholic beverages prices (+ 0.5% M/M). Despite the European Football Championship, prices of restaurants and hotels rose more modestly than we have expected. The figure might have had an impact on the zloty. Recall that the market had started to bet on cuts in interest rates in months ahead. However, after the release of inflation figure, FRA 3x6 rose by about 7 basis points and the spread between WIBOR 3M and FRA 3x6 was thus seen at 6 basis points. We think that such expectations are premature. We expect that inflation will remain at heightened level in months ahead. According to our estimates, prices growth might return to the upper threshold of the central bank's tolerance band in the end of this year.

PL: Inflation



In Focus

Czech assets still far from safe heaven….

Demand for Czech bonds and the koruna is very good, given that the euro-crisis is still keeping major stock indices in check and the dollar is easily continuing to appreciate against the euro. In recent weeks, the EUR/CZK currency pair has partly lost its usual negative link with the EUR/USD pair and with the S&P 500 stock index, while Czech 10Y bond yields fell to new all-time lows. Yet **there are numerous reasons why we believe that it is too soon to consider those tendencies as evidence of Czech assets becoming something of a safe haven.**

Firstly, while Czech yields have dropped to new lows, the Czech credit risk rating in the CDS market has not changed significantly in recent months, and is ranging between 130 and 140 bps.

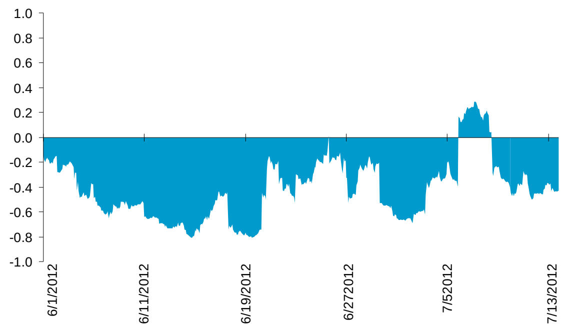
Secondly, a fall in bond yields is not a purely Czech phenomenon at the moment. The fear of poor growth in the global economy as a whole has led to a decline in yields in most safe locations (U.S., German, Swiss markets) as well as in numerous peripheral economies (Ireland, Italy). While it is true that the yield spread between Czech and German bonds has also been improving, it has not even hit the 2012 lows thus far, albeit the absolute level of Czech yields is at an all-time low now.

While the Czech bond market likely saw a single inflow of foreign orders last week, we can scarcely conclude that investors are starting to view Czech government debt as a safe harbour. A similar inflow of foreign funds into the Czech bond market has taken place in the past, and thus it is nothing unusual. If we look at the share of foreign investors in the total holding of the domestic (koruna) debt, it has been ranging between 12% and 14% since the beginning of 2011, having fallen towards the lower threshold of that range in the spring. If the demand of recent days were to mean a return of the share of non-residents in the holding of government debt to 12%, it would involve additional bond purchases by foreign investors for approximately CZK 25 bn. Although this is not a negligible amount, it is not huge either, given the overall variations within the Czech balance of payments.

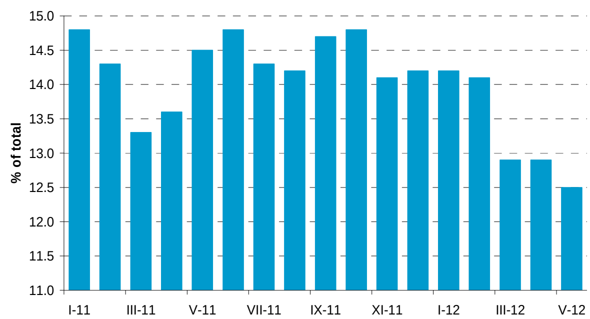
Thus the cash inflows into Czech bonds might temporarily be positively influenced by the exchange rate of the koruna and also strip the Czech currency of its usually negative link with the (safe) dollar. However, such changes in the behaviour of the koruna were always very short in the past and, as we can also see from the current development of the correlations between the EUR/CZK and EUR/USD currency pairs, this also seems to be the case now. The koruna lost its negative link with the dollar for a very short period in the middle of last week.

Rolling correlation of EUR/CZK and EUR/USD

(30 min changes, rolling correlation - 18 hours window)



Non-resident holdings of the Czech domestic government debt

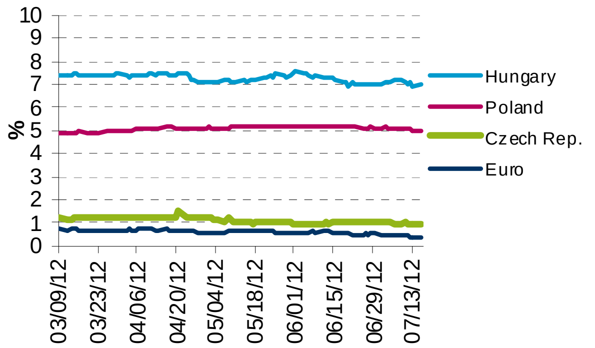


Calendar

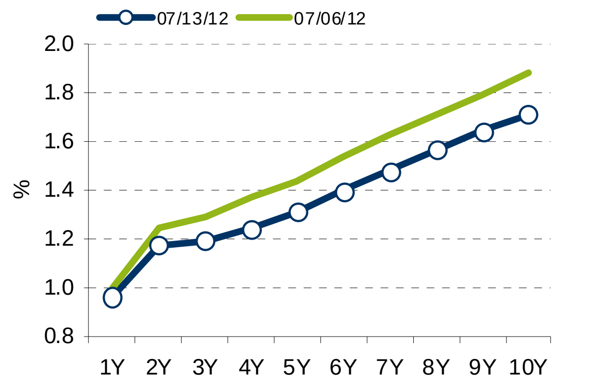
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	07/16/2012	15:00	Budget balance	PLN M	06/2012					-27029	
PL	07/17/2012	14:00	Wages	%	06/2012			3.1	3.6	-2.7	3.8
CZ	07/18/2012	9:00	PPI	%	06/2012	-0.1	1.7	-0.2	1.7	0	1.7
PL	07/18/2012	14:00	PPI	%	06/2012			0.1	4.7	0.2	5
PL	07/18/2012	14:00	Industrial output	%	06/2012			0.9	4.1	4.5	4.6
HU	07/19/2012	9:00	Wages	%, ytd.	05/2012				3.2		2.5
PL	07/20/2012	14:00	Core CPI	%	06/2012			0.3	2.4	0	2.3

Fixed-income in Charts

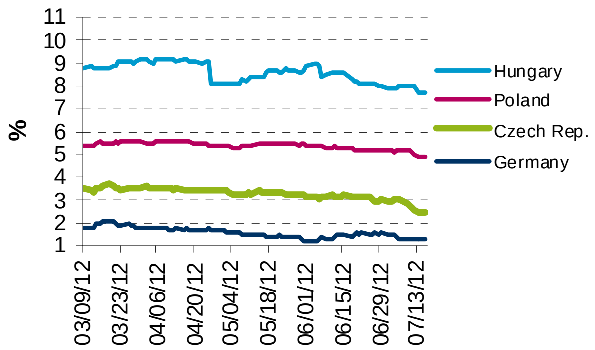
FRA 3x6



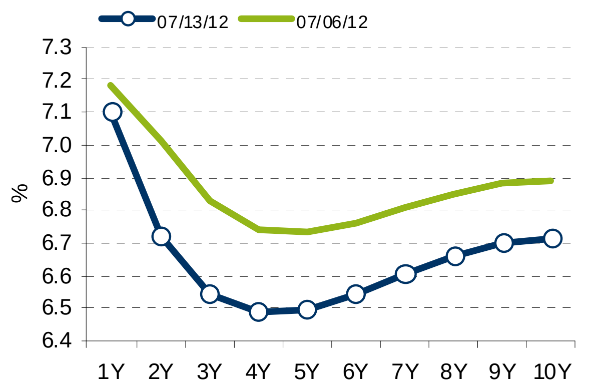
CZ IRS



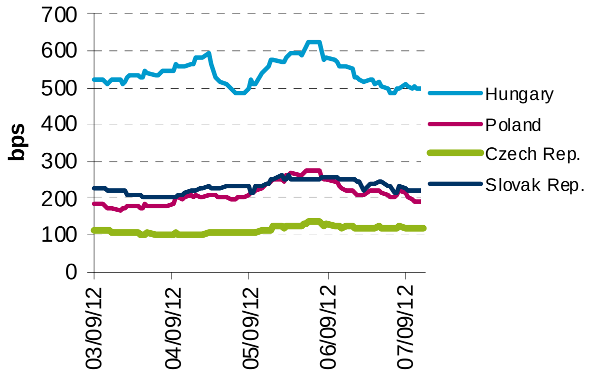
10Y GB Yields



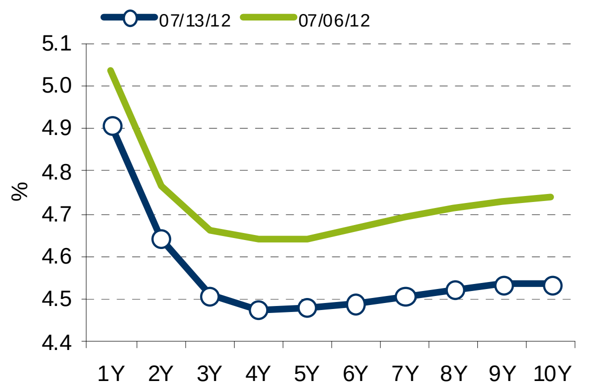
HU IRS



CDS 5Y



PL IRS



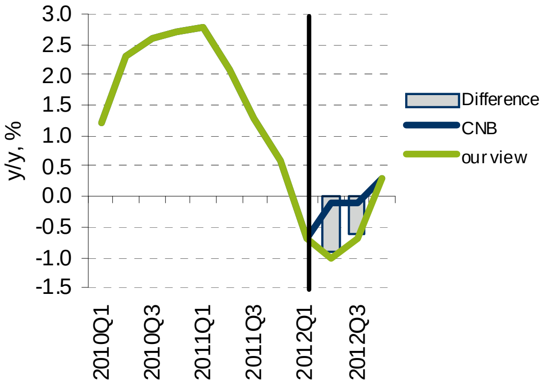
Source: Reuters

Medium-term Views & Issues

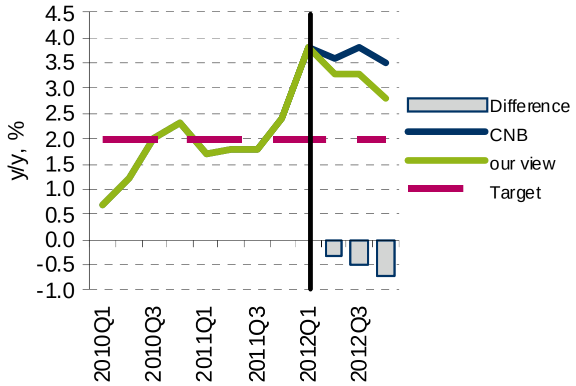
	The Czech Republic	Hungary	Poland
Growth & key issues	The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition to saving, a further discussion of tax increases may be considered. It can not therefore exclude the growing tensions in the government coalition. The government does not intend to set a target date for the euro adoption in the Czech Republic.	The IMF accepted the most recent modification to the central bank law. This means that negotiations may start soon, according to the government around mid-July. The government said that the end date could be between mid-September and end-October. The government announced new tax cuts worth Ft300bn funded 1/3rd from budgetary reserves and 2/3rd from extending the transaction tax onto the central bank and state treasury. In case of the latter, it is only a temporary funding because the state owns both institutions. Although it has not yet been communicated, it may mean that revenue side will be used in 2013 and expenditure side in 2014.	Growth of the Polish economy fell to less than 4% in the first quarter of 2012. We expect that factors that kept the Polish economy growing during the World Financial Crisis will gradually step aside and we estimate that the economy will continue to slow down in following quarters. More specifically, a room for relatively loose fiscal policy seems to have diminished and higher interest rates should, in our view, contribute to a slowdown in both households' consumption as well as private and public investment. Therefore, we expect that the Polish economy might grow by slightly less than 3%.
Outlook for official & market rates	Inflation increased above the central bank's target caused by high fuel and food prices and also by V.A.T. increase. On the other hand, weak domestic demand should counter a rise in demand-pull inflation. In spite of higher inflation the CNB still maintains its waitandsee policy. In fact there are some voices for another rate cut as two board members (incl. governor) voted for cut. So the probability of another monetary policy easening has been increasing. The first rate hike delivered by the Czech central bank is probable in 2013H2.	Shrinking domestic demand may keep inflationary pressures low and from this side rate cuts could come in Hungary. On the other hand foreign demand for Hungarian bonds is still important and this may go against this. We think the MNB could cut around 75-100bps in aggregate, also depending on external conditions.	While the rate hike did not surprise us, owing to the well-managed communication by the NBP, we believe that it was not quite appropriate and we expect rate stability for the rest of this year. What primarily makes us believe so is the more modest rhetoric by the NBP and the expectations of the future development of the Polish economy. Its growth should decelerate significantly in the second half of the year, and this should also lead to a gradual inflation fall towards the inflation target (2.5%).
Forex Outlook	Stronger US dollar may keep further gains limited for the koruna. Also the Czech domestic factors do not look very supportive - slow continuation of real convergence and dovish CNB do not argue for dramatic gains of the Czech currency over 2012. That said, the koruna may be more vulnerable to potentially negative news from eurozone as well as to the domestic political tensions.	Leaving aside the Greek (euro) crisis, the improved relationship with the IMF/EU should be beneficial for the forint in the medium-term.	Zloty's fundamentals should not permit the currency perform well in the short-run as the economy should slow down in second half and the rates should remain flat after the one off hike in May. During the summer we may see some renewed selling pressure after the European championship in football might takes place. The motivation by official authorities to defend the zloty may be weaker this time due to changed methodology of debt/GDP calculation and lower sensitivity to FX volatility...

Cent. Banks' Projections vs. Our Forecasts

CZ: GDP Outlook

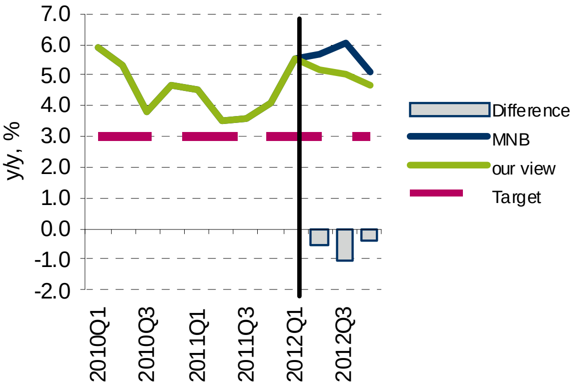


CZ: Inflation outlook

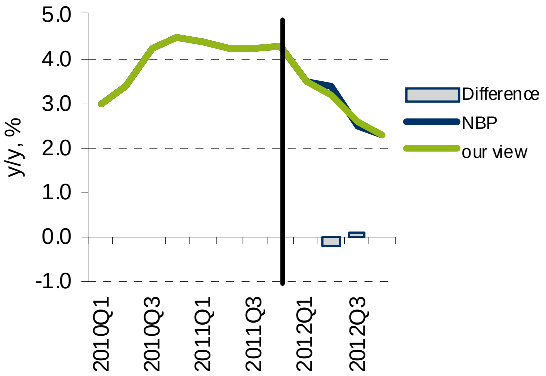


HU: GDP Outlook

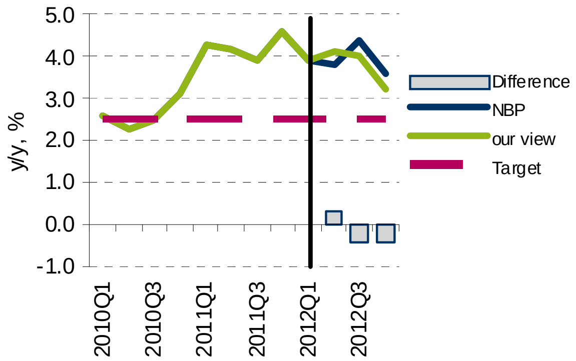
HU: Inflation outlook



PL: GDP Outlook



PL: Inflation outlook



Source: CNB, NBP, MNB, CSOB

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	Last change	
Czech Rep.	2W repo rate	*0.50*	0.75	0.50	0.50	0.50	0.50	-25 bps	6/29/2012
Hungary	2W deposit r.	*7.00*	7.00	7.00	7.00	6.50	6.25	50 bps	12/20/2011
Poland	2W inter. rate	*4.75*	4.50	4.75	4.50	4.50	4.75	25 bps	6/5/2012

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	PRIBOR	*1.06*	1.24	1.03	1.03	1.00	1.00
Hungary	BUBOR	*7.20*	7.00	7.20	7.00	6.50	6.25
Poland	WIBOR	*5.12*	4.60	5.13	4.80	4.80	4.90

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	CZ10Y	*1.76*	2.28	2.02	1.80	2.10	2.25
Hungary	HU10Y	*6.71*	7.10	6.71	7.75	7.50	7.25
Poland	PL10Y	*4.52*	5.00	4.74	5.20	5.30	5.40

Exchange rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	EUR/CZK	*25.4*	24.8	25.5	25.2	25.0	24.5
Hungary	EUR/HUF	*288*	290	286	290	290	280
Poland	EUR/PLN	*4.18*	4.10	4.22	4.25	4.20	4.15

GDP (y/y)

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	2.1	1.3	0.6	-0.7	-1.0	-0.7	0.3
Hungary	1.5	1.4	1.4	-0.7	-0.5	-0.7	-0.4
Poland	4.2	4.2	4.3	3.5	3.2	2.6	2.3

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

	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	1.8	2.4	3.8	3.5	3.3	2.8	3.0
Hungary	3.6	4.1	5.5	5.6	5.0	4.7	3.7
Poland	3.9	4.6	3.9	4.3	4.0	3.2	2.7

Current Account

	2012	2013
Czech Rep.	-2.3	-2.6
Hungary	1.5	1.0
Poland	-4.3	-3.7

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-3.3	-2.8
Hungary	-2.5	-2.2
Poland	-3.0	

Source: CSOB, Bloomberg

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