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KBC

Central European Weekly

Monday, 27 August 2012

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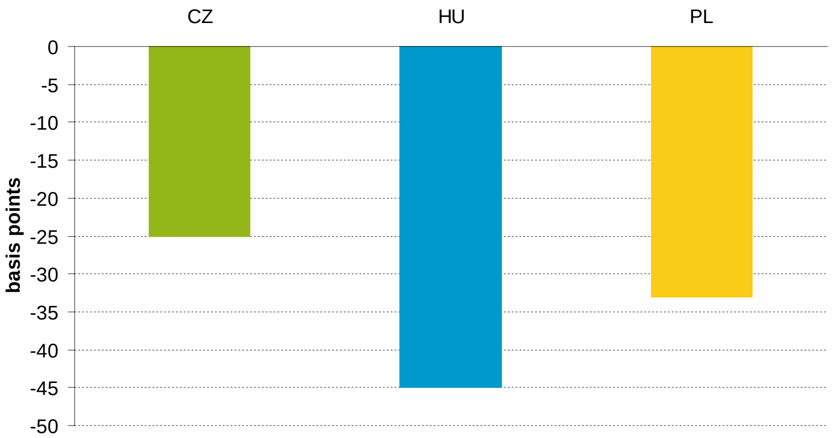
Weekly Highlights:

- CE currencies had a great summer…
- ….as well as the local bond markets, with the yields near historical lows
- Polish macro-figures confirm slowing economic growth
- Despite the strong forint the MNB will stay on hold

Chart of the Week

Spread between FRA 3x6 and related 3M money market rate



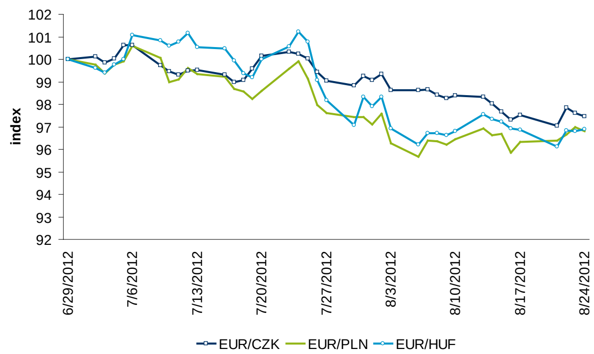
Deceleration in economic growth has spurred bets on further easing in CE countries… (Source: Reuters).

Market's editorial

Central European currencies and assets in general saw a genuine 'summer harvest' in the last two weeks. Since the beginning of July, the Czech koruna has strengthened by 2.5%, while the appreciation of the zloty and the forint has been even 1% greater. In addition, Polish and Czech yields hit new all-time lows. The Polish 10Y yield fell to the vicinity of 4.7% and the Czech yield to less than 2.4% for the first time.

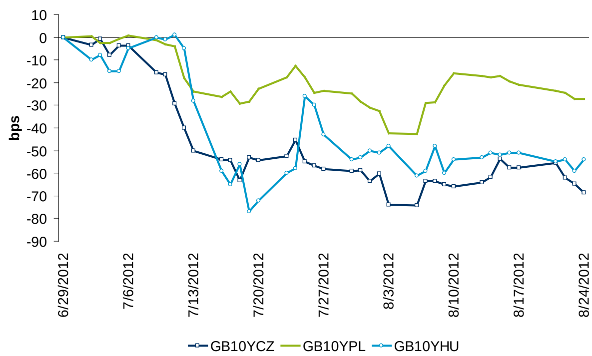
The success of Central European assets is less attributable to local factors than to the declining global aversion to risk, primarily stemming from the bets on greater activity by global central banks. The prospects for cheaper money are driving numerous global investors into 'riskier' assets in their chase of yield. Evidence of the growing importance of common factors for the summer fluctuations is the increasing correlation between the koruna and notably the Hungarian forint, on the one hand, and the Polish zloty on the other. The correlation between the forint and the Czech koruna is the highest since the autumn of 2011, when tension at the peripheries of the euro zone increased significantly. Just as the weakness of both currencies was due to the tension at the peripheries at that time, the common strength of Central European assets is due to the peripheral relief now. We will see how long it will persist in early September.

CE: FX over the summer



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*24.9*	*0.04%*	↘	↗
EUR/HUF	*278*	*0.32%*	↘	↗
EUR/PLN	*4.08*	*-0.16%*	↘	↗

CE: GB yields over the summer



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*1.58*	*-8.67*	→	↗
10Y PLN	*6.57*	*0.61*	→	↗
10Y HUF	*4.48*	*-0.88*	→	↗

Review of Economic Figures

Industry and retail sales confirm the deceleration of the Polish economy

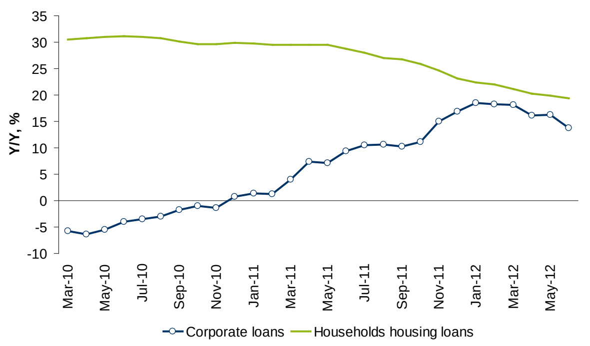
The macroeconomic data released last week confirmed that the growth rate of the Polish economy has been decelerating. Although July's retail sales basically met expectations and industrial output for the same month was even slightly better than expected, it is evident that economic growth will not exceed 3% this year.

As concerns industry, the major industrial sectors that were most significantly affected by the deceleration included the manufacture of non-metal products, while the decline in the activities of the automotive industry and in the manufacture of machinery and equipment was also significant. Metallurgical plants, foundries, and manufacturers of other means of transport have likely fared best in recent months; however, these are smaller sectors of the manufacturing industry. Retail sales, which are still rising in real terms, are beginning to be affected by stagnation or even a moderate decline in real wages.

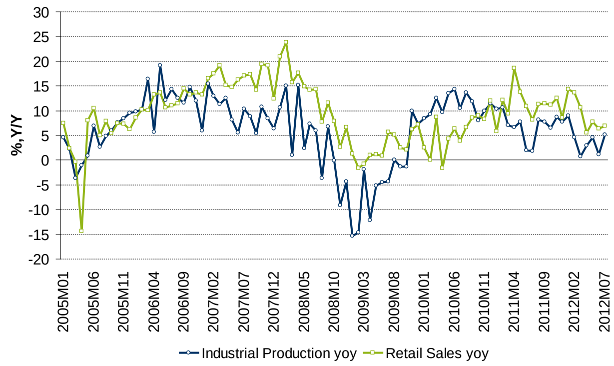
The NBP is not going to take action at the moment

According to the new minutes of its latest meeting, the National Bank of Poland (NBP) is also aware of these trends; at its July meeting, however, the central bank rejected the proposals to cut rates by 50 and 25 basis points by a great majority of votes (9 out of 10 and 8 out of 10 respectively). Yet the market foresees a rate cut, even in excess of 75 basis points within the next nine months. Although higher interest rates are starting to affect the economy – for example, the rate of increase in mortgages is decelerating – we still stick to our opinion that rates will remain unchanged throughout the rest of the year.

PL: Loans
(zloty's portion)



PL: Indicators



Weekly preview

TUE 14:00 MNB base rate

	This meeting	Last change
rate level (in %)	7,00	11/2011
change in bps	0	50

HU: MNB will leave rates unchanged

The National Bank of Hungary (MNB) will probably leave interest rates unchanged at its meeting on Tuesday. We expect, however, rather a narrow vote. On the one hand, recent appreciation of the forint, deeper recession and market bets on a decrease in interest rates speak in favour of the cut; on the other hand, uncertainty related to the IMF talks will probably convince the board to keep official rates at current level. Therefore, we expect the MNB will leave rates unchanged at about 70% probability.

THU 10:00 PL GDP (y/y change in %)

	2012Q2	2012Q1	2011Q2
GDP	3.0	3.5	4.2

PL: GDP growth of around 3%

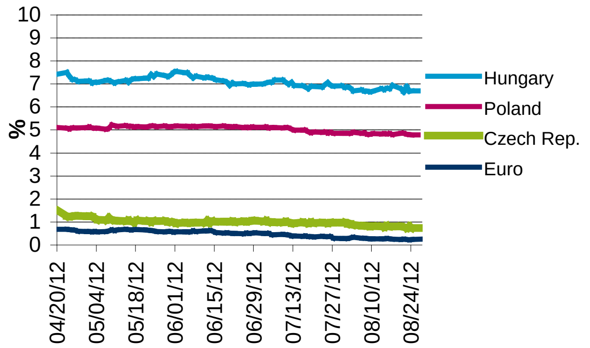
After the year-on-year growth of the Polish economy decelerated to 3.5% in early 2012, the gross domestic product grew by approximately 3% in the second quarter of the year. Another decline in economic activity was evident in industry (its output rose by less than 3% y/y on average in the second quarter) and the rise in retail sales also decelerated significantly. Construction, which ‘only’ went up by a single-digit rate on the eve of the European Football Championship, is unlikely to encourage the GDP to any great extent either. The contribution of foreign trade to growth should be positive again, in spite of the problems of the European economy.

Calendar

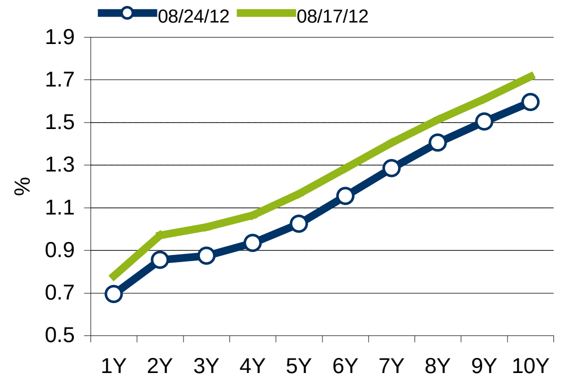
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	08/28/2012	9:00	Unemployment rate	%	07/2012			10.9		10.9	
HU	08/28/2012	14:00	NBH meeting	%	08/2012			7		7	
CZ	08/29/2012	12:00	CZ bond auction 3.85%/2021	CZK B	08/2012						
CZ	08/29/2012	12:00	CZ bond auction floating rate/2017	CZK B	08/2012						
PL	08/30/2012	10:00	GDP	%	2Q/2012		3	0.5	2.9	0.8	3.5
HU	08/31/2012	9:00	Trade balance	EUR M	06/2012 *F					761.7	
HU	08/31/2012	9:00	PPI	%	07/2012				6.7	-1.6	6.9
CZ	08/31/2012	11:00	Money supply M2	%	07/2012						6.5

Fixed-income in Charts

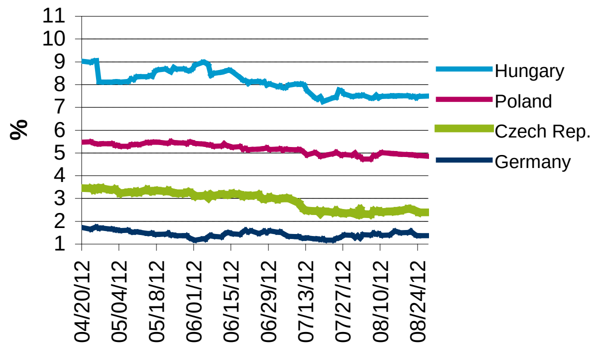
FRA 3x6



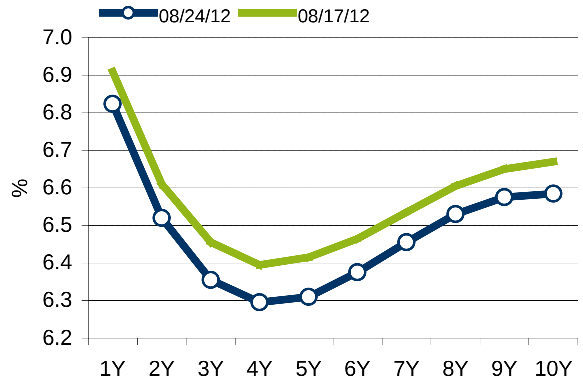
CZ IRS



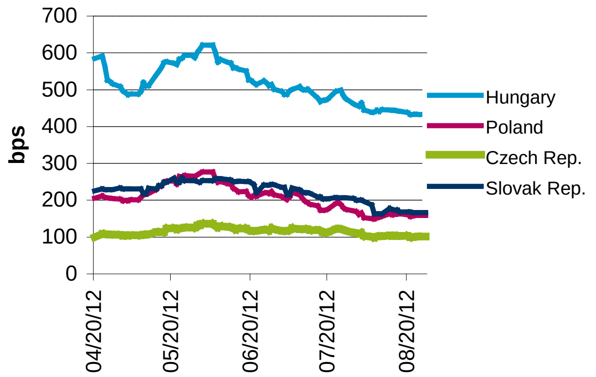
10Y GB Yields



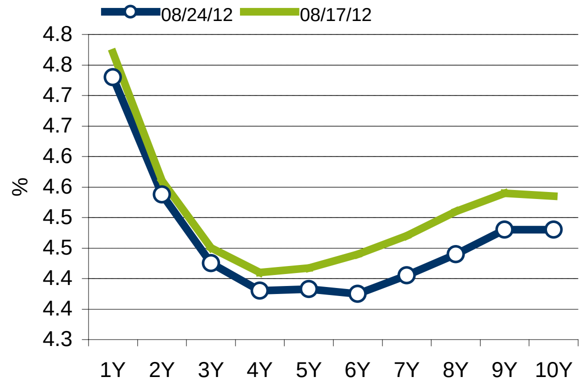
HU IRS



CDS 5Y



PL IRS



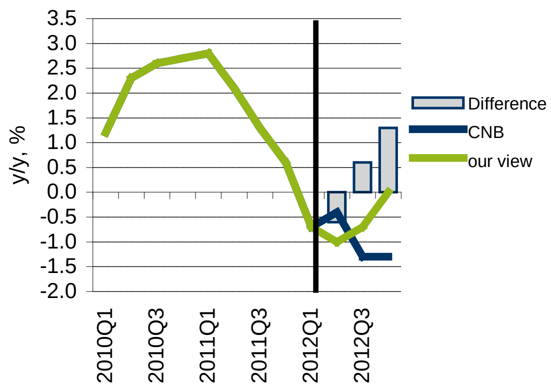
Source: Reuters

Medium-term Views & Issues

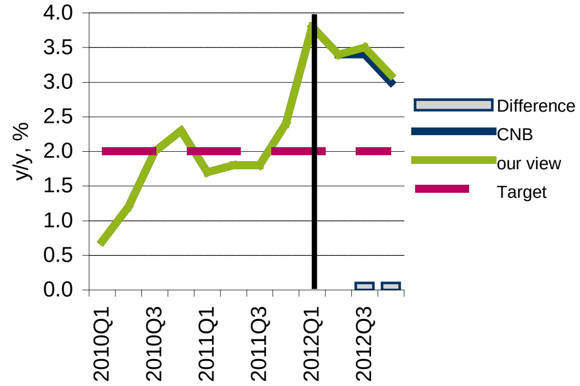
	The Czech Republic	Hungary	Poland
Growth & key issues	The state budget for 2012 is based on the unrealistic assumption of economic growth by 2.5%. Achieving the deficit target of 105 billion remains very uncertain. It will require further austerity measures. In addition to saving, a further discussion 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 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 cut its base rate to 0.5% in June. 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 the 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 as Spanish bank bailout and Greek package uncertainties may weigh on CE currencies . 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

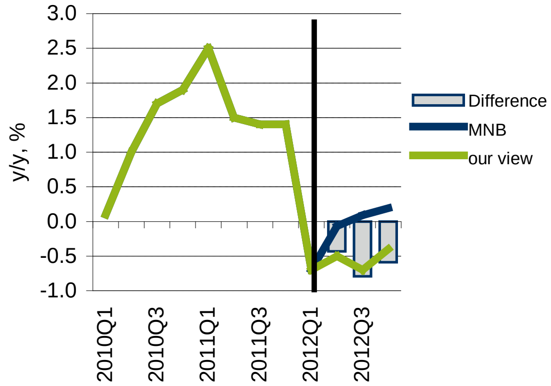
CZ: GDP Outlook



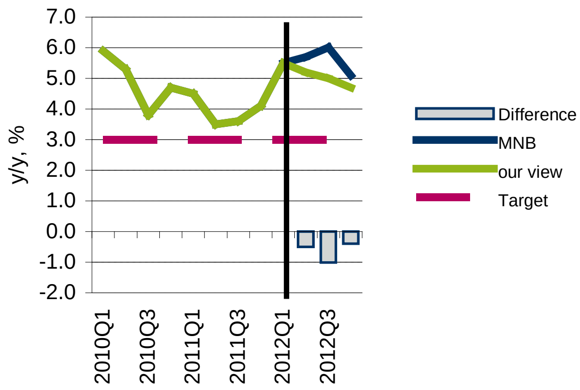
CZ: Inflation outlook



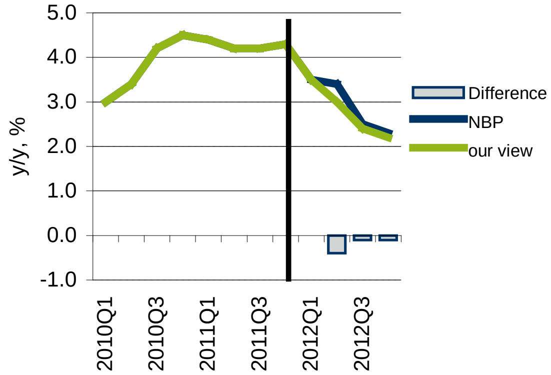
HU: GDP Outlook



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	*0.98*	1.24	1.03	1.00	1.00	1.00
Hungary	BUBOR	*7.15*	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	*1.58*	2.28	2.02	1.80	2.15	2.10
Hungary	HU10Y	*6.57*	7.10	6.71	6.75	7.50	7.25
Poland	PL10Y	*4.48*	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	*24.9*	24.8	25.5	25.2	25.0	24.5
Hungary	EUR/HUF	*278*	290	286	290	290	280
Poland	EUR/PLN	*4.08*	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	0.0
Hungary	1.5	1.4	1.4	-0.7	-0.5	-0.7	-0.4
Poland	4.2	4.2	4.3	3.5	3.0	2.4	2.2

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	3.5	3.1	2.9
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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