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Central European Weekly

Monday, 17 September 2012

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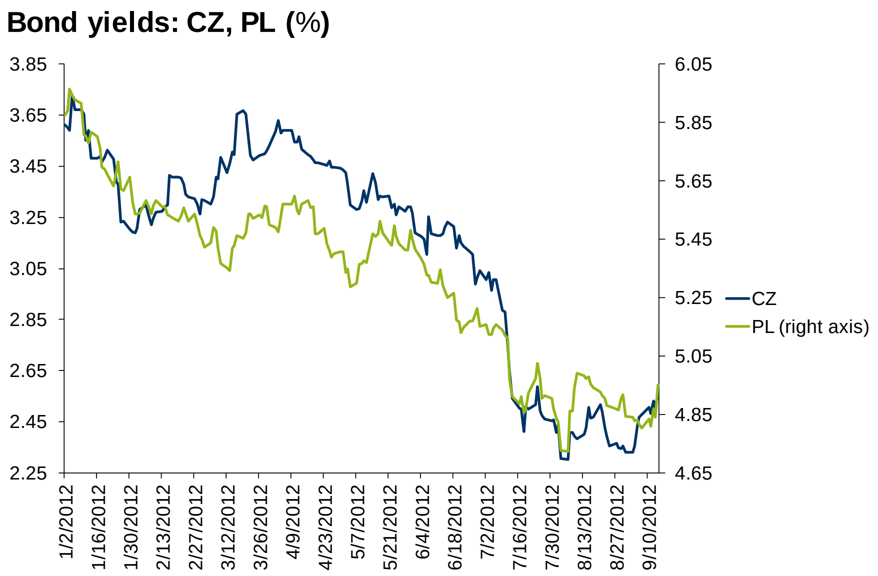
Weekly Highlights:

- CE Markets extended their rally after the Fed meeting
- Strong koruna and zloty make a case for monetary easing even stronger
- The Hungarian inflation moves back to the 6% level

Chart of the Week



Czech and Polish bond yields are seen close to this year's low. (Source: Bloomberg)

Market's editorial

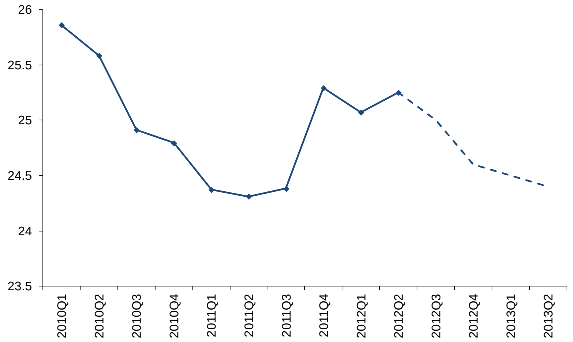
The Fed has brought bullish sentiment even higher

The Fed's decision to begin another round of quantitative easing added yet more strength to the bullish sentiment in Central European financial markets. Not only stocks but also currencies are faring well, with the only exceptions being Czech and Polish government bonds, which had been overbought in recent weeks, as they were an attractive resort for investors fleeing from certain eurozone markets. Paradoxically, the sell-off in Polish and Czech bond markets occurred when it came to light that the August inflation rate favoured early cuts in the official rates by the Czech National Bank and the National Bank of Poland. Moreover, as mentioned above, the Fed (and ECB's) move made Central European currencies very strong, consequently tightening the monetary conditions in those economies, which will improve inflation outlook.

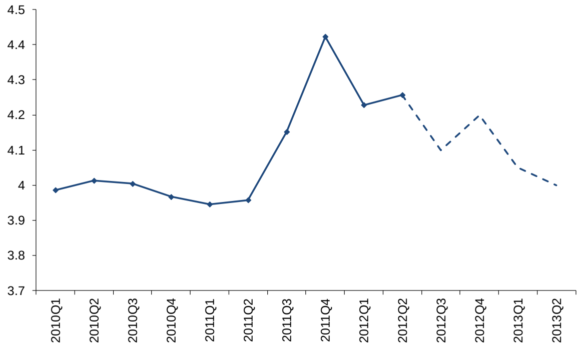
Strong CE currencies tighten monetary conditions

Speaking about the CE currencies, it is worth noting that the Polish zloty has already strengthened by more than 3%, the Czech koruna by 2%, and the Hungarian forint by approximately 1.5%, since the beginning of September. In our view although the global optimism in markets may persist for some time, it may not necessarily result in a significant appreciation of Central European currencies. The relevant central bank easing would likely become very attentive if their local currencies strengthened to around EUR/CZK 24.00 and EUIR/PLN 4.00. In such a case Polish rates might be cut more aggressively, whereas the Czech National Bank would likely intervene against the strong koruna at least verbally. Just bear in mind that currently, the CNB's latest forecast envisages the koruna as being more than EUR/CZK 25.50.

EUR/CZK: CSOB outlook (dotted line)



EUR/PLN: CSOB outlook (dotted line)



	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	24.5	0.54%	↘	↗
EUR/HUF	283	-0.03%	↘	↗
EUR/PLN	4.10	0.53%	↘	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.79	6.55	↗	↗
10Y HUF	6.58	1.39	↗	↗
10Y PLN	4.55	2.83	↗	↗

Review of Economic Figures

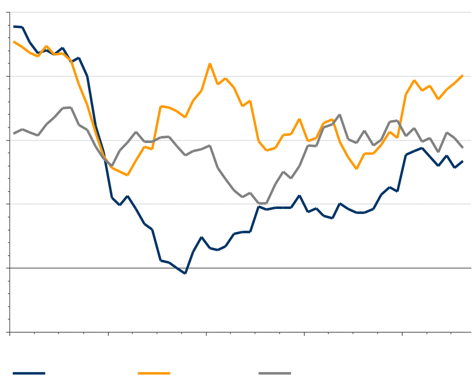
Czech inflation driven by VAT

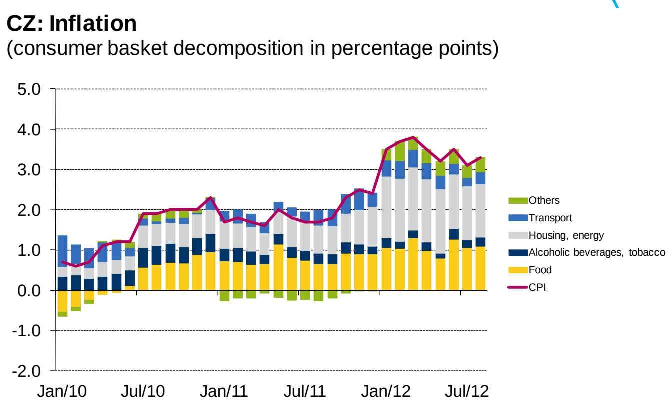
August's decline in **Czech** consumer prices (-0.1% m/m) was primarily caused by lower food prices, followed by those of clothing and mobile phones. Fuel prices went up this time, approaching their recent highs. However, consumer prices are 3.3% higher than in August last year, mainly because of administrative moves, i.e., the increased VAT and regulated prices. Nevertheless, the VAT is in no way to blame for everything, because food prices are also influenced by other factors, such as the rising prices of energy and agricultural commodities. Although headline inflation is above 3%, monetary-policy inflation is exactly at the CNB target (2%) now. This is why the CNB may stick to its policy of record-low rates. As the development of the main economic parameters in the CNB forecast is worsening and favours another easing of the monetary policy, the CNB Board is likely to vote on another repo rate cut, to a new low of 0.25%, as early as at its September meeting. It is also likely that there will be enough votes for such a move this time.

In line with our expectations, **Poland's** inflation again fell to less than 4%, mainly because of clothing prices. Although inflation remains well above the 2.5% target of the National Bank of Poland, the inflation trend is clearly downward. We expect that by the end of the year, inflation will fall below the upper bound of NBP's tolerance band (i.e., 3.5% Y/Y). Hence, if inflation expectations also decrease and industrial output continues to ease, Polish rates will be set to fall as early as at the beginning of October.

Hungary's headline inflation back at the 6% level

Hungary's year-on-year inflation rate has again climbed to 6% y/y. This fairly high figure was no great surprise, albeit the Governor of the National Bank of Hungary Simór reacted to it negatively, stating that the central bank would not be able to meet its inflation target (of 2-4%), neither this year nor the next. The NBH will, indeed, be unable to push inflation to less than 4% this year, but it may succeed in doing so next year, because headline inflation is still being primarily driven by factors that the central bank in a small open economy cannot influence (prices of food and petrol and indirect taxes).





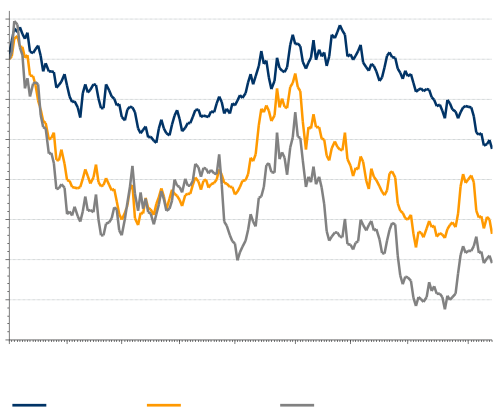
In Focus

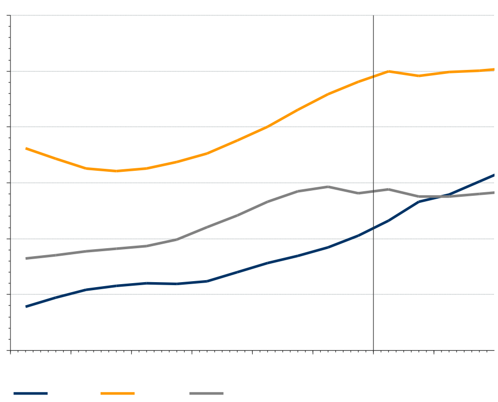
Where will Central European currencies stop appreciating?

Central European currencies opened September in a much more optimistic mood than we had expected. This was primarily due to the ECB's commitment to intervene in peripheral markets and due to a decline in peripheral yields. Afterwards, Central Europe was pleasantly surprised by the U.S. Fed, which, through the QE3, undermined the U.S. dollar and encouraged risky assets. The Polish zloty has strengthened by more than 3%, the Czech koruna by 2%, and the Hungarian forint by approximately 1.5%, since the beginning of September; however, the appreciation of the Czech koruna and the Polish zloty seem to be particularly exorbitant.

The Czech economy remains in a recession while the Polish economy is decelerating significantly, with both central banks set to cut rates soon. Although Poland's economic growth is still greater than that of the eurozone, the real appreciation of the local currency is taking place through increased inflation. This is why the long-term models for the zloty do not currently indicate much latitude for the appreciation of the currency to less than PLN 4.00 per EUR. While Czech inflation does not significantly differ from that of the eurozone, the performance of the Czech economy lags well behind that of the German economy and, in the last few quarters, even behind the eurozone as a whole. Thus real convergence has been practically non-existent since 2009, and in fundamental terms there are not many arguments for a restart of the trend of the long-term appreciation of the koruna.

Thus, although the global optimism in markets may persist for some time, it may not necessarily result in a significant appreciation of Central European currencies. The relevant central banks would likely become very attentive if their local currencies strengthened to around 24.00 EUR/CZK and 4.00 EUR/PLN respectively. Polish rates might be cut more aggressively, whereas the Czech National Bank would likely intervene against the strong koruna at least verbally. At the moment, the CNB's latest forecast envisages the koruna as being more than CZK 1 weaker, at 25.50 EUR/CZK.



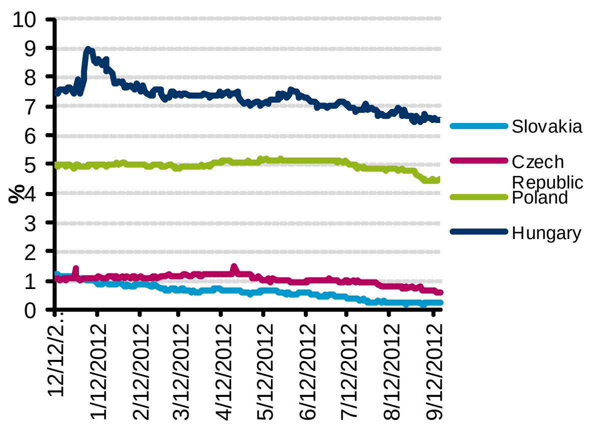


Calendar

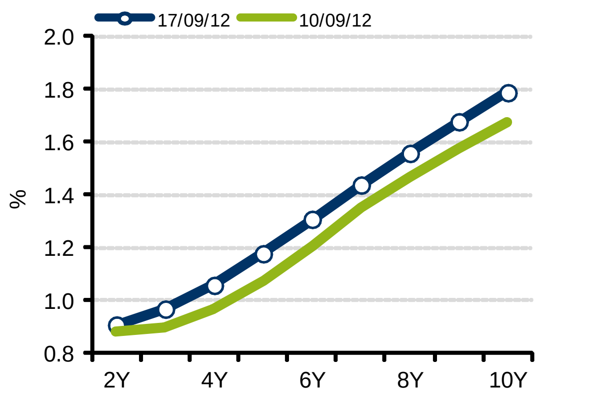
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	09/17/2012	9:00	PPI	%	08/2012	0.2	1.6	0.1	1.6	-0.3	1.3
PL	09/17/2012	15:00	Budget balance	EUR M	08/2012					-24343	
HU	09/18/2012	9:00	Wages	%	07/2012				4.2		4.1
PL	09/18/2012	14:00	Wages	%	08/2012			0.3	3.1	-1.5	2.4
PL	09/19/2012	14:00	PPI	%	08/2012			-0.1	3	-0.2	3.7
PL	09/19/2012	14:00	Industrial output	%	08/2012			0.4	1.8	-2.3	5.2
PL	09/20/2012	14:00	Core CPI	%	08/2012			-0.1	2.1	0.1	2.3

Fixed-income in Charts

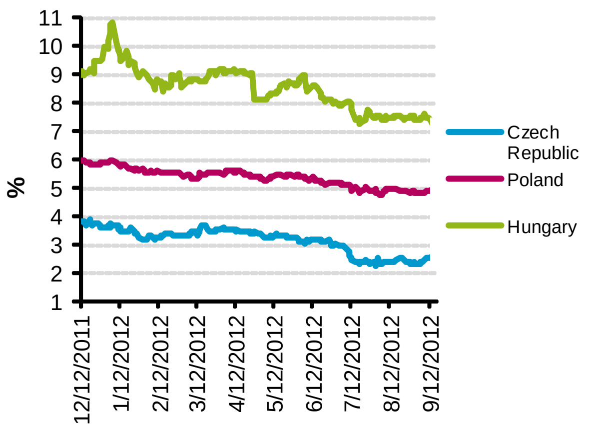
FRA 3x6



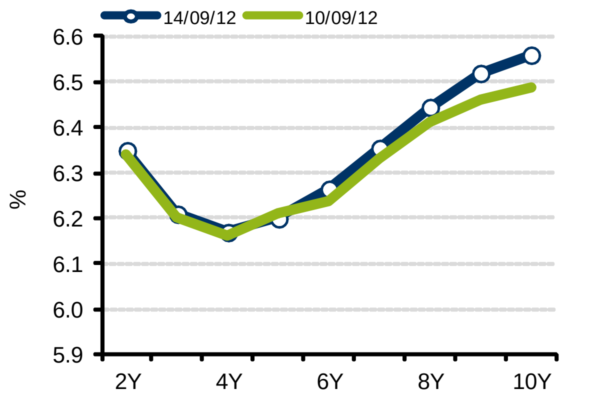
CZ IRS



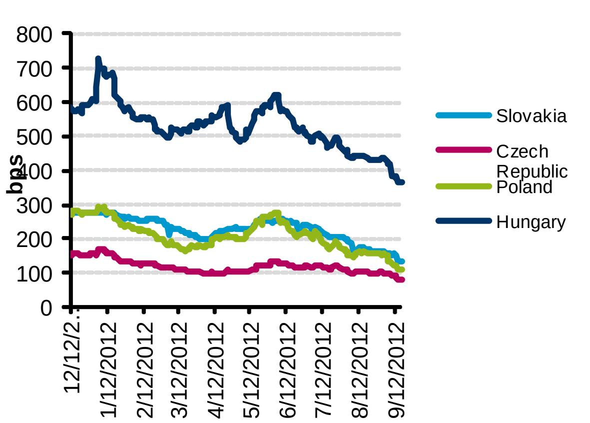
10Y GB Yields



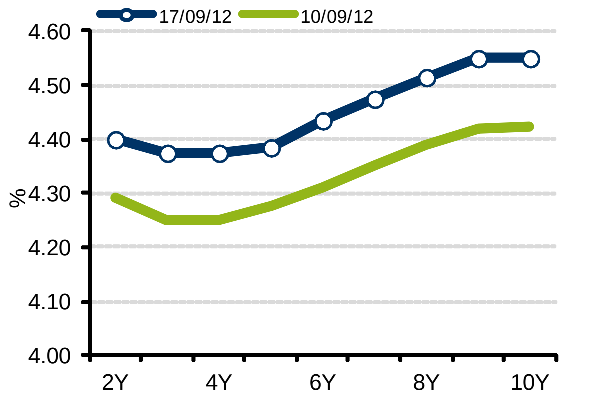
HU IRS



CDS 5Y



PL IRS



Source: Reuters

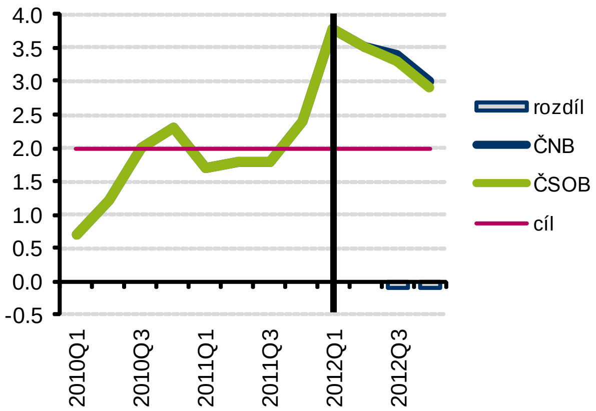
Medium-term Views & Issues

	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 2.4% in the second 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, although at a more moderate pace. 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 about 2.5% in 2012.
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. Another rate cut can be expected in Autumn as the GDP as well as inflation have been falling faster than the CNB expected.	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. For now we continue to see the space for one more 25 bps cut by the end of the year and 50bps more in 2013.	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. For now the deteriorating macro-figures start to argue for a rate cut. However this might not come till November when inflation expectations cool down and new forecast is on the table.
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 euro zone at the beginning of the autumn and may come back above 25.00 EUR/CZK.	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 slows down and the Central bank is about to change its course. At the beginning of the autumn we may see some renewed selling pressure as uncertainties around ECB intervention on the secondary markets and Greek package may weigh on CE currencies.

CBs' Projections vs. Our Forecasts

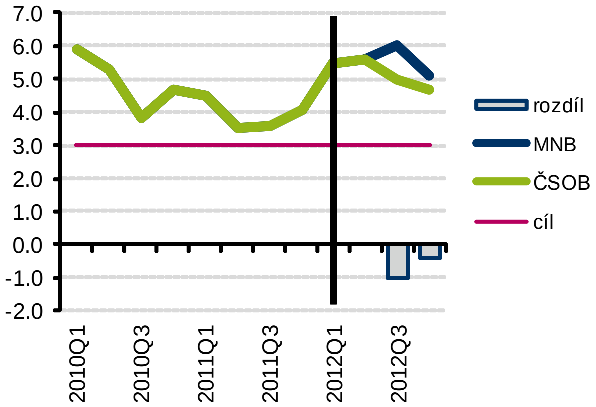
CZ: GDP outlook (Y/Y, %)

CZ: Inflation outlook (Y/Y, %)

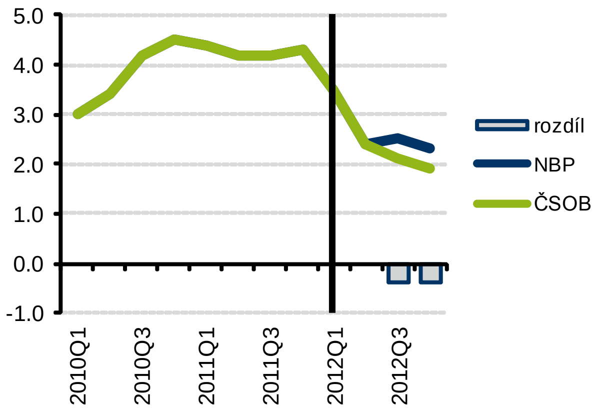


HU: GDP outlook (Y/Y, %)

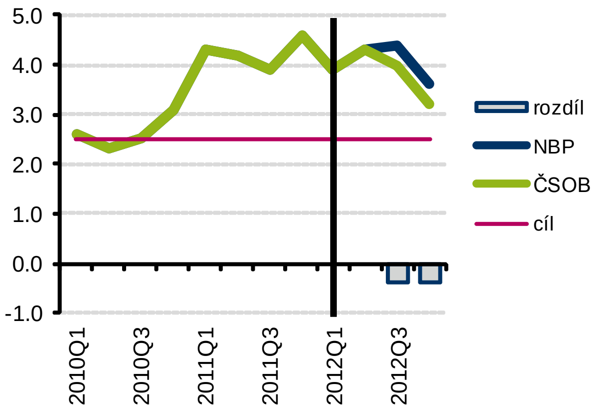
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outlook (Y/Y, %)



Zdroj: ČNB, NBP, MNB, ČSOB

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	0.25	0.25	0.25	-25 bps	6/29/2012
Hungary	2W deposit r.	*6.75*	7.00	7.00	6.75	6.50	6.50	50 bps	8/28/2012
Poland	2W inter. rate	*4.75*	4.50	4.75	4.75	4.50	4.50	25 bps	6/5/2012

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

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	PRIBOR	*0.86*	1.28	1.03	0.70	0.70	0.70
Hungary	BUBOR	*6.88*	7.25	7.20	6.70	6.50	6.40
Poland	WIBOR	*4.95*	4.94	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	*1.79*	2.25	2.02	1.60	1.70	1.80
Hungary	HU10Y	*6.58*	7.36	6.71	6.75	7.50	7.25
Poland	PL10Y	*4.55*	4.95	4.74	5.20	5.30	5.40

Exchange rates (end of the period)

		Current	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1
Czech Rep.	EUR/CZK	*24.5*	24.8	25.5	24.2	24.9	24.5
Hungary	EUR/HUF	*283*	294	286	290	290	280
Poland	EUR/PLN	*4.10*	4.14	4.22	4.10	4.30	4.15

GDP (y/y)

	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4
Czech Rep.	2.1	1.3	0.6	-0.7	-1.2	-1.2	-1.0
Hungary	1.5	1.4	1.4	-0.7	-1.2	-0.7	-0.4
Poland	4.2	4.2	4.3	3.5	2.4	2.1	1.9

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	2.9	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.	-2.2	-1.9
Hungary	1.5	1.0
Poland	-4.0	-3.8

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-3.0	-3.8
Hungary	-2.5	-2.2
Poland	-3.5	-4.0

Source: CSOB, Bloomberg

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