Central European Weekly

Monday, 07 January 2013

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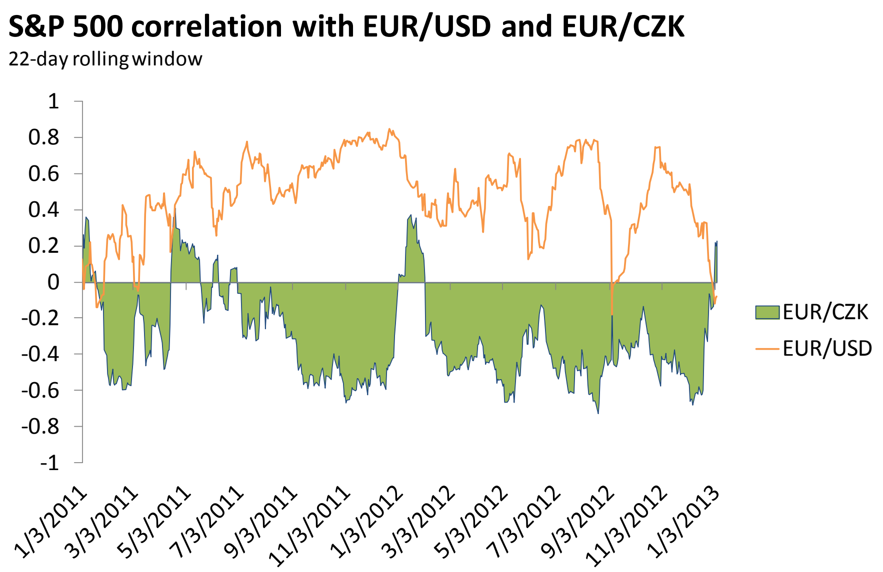
Weekly Highlights:

- Suspicious behaviour of the Czech koruna
- The bets on a significant decline in Polish rates are exaggerated
- Czech industry disappoints
- Uncertainty around new CB governor might harm Hungarian bonds

Chart of the Week



It seems as if the Czech koruna is beginning to drop its usual links to the euro-dollar and stock markets... (Source: CSOB, Bloomberg)

Market's editorial

Suspicious behaviour of the Czech koruna

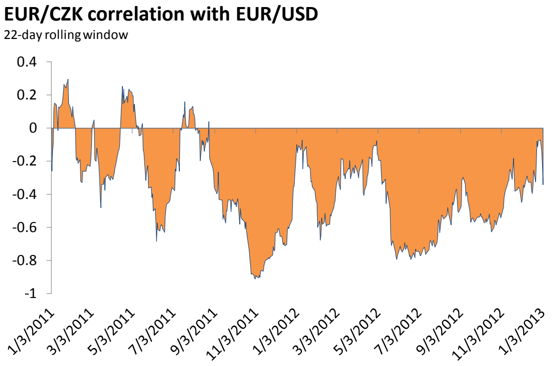
It seems as if the Czech koruna is beginning to drop its usual links to the euro-dollar and stock markets. The negative correlation of the EUR/CZK currency pair with the S&P 500 stock index has been the lowest since the beginning of the year, while the negative correlation with the EUR/USD currency pair is also near the lows seen in 2012. This may be due in part to the efforts to cope with low liquidity during the Christmas holidays. In the period of low Christmas liquidity, the koruna surprisingly strengthened (to the vicinity of CZK 25.00 per EUR) and now, notwithstanding global optimism, remains on the defensive, adjusted for its Christmas appreciation. However, this may be a sign of deeper changes in the links of the koruna to global markets.

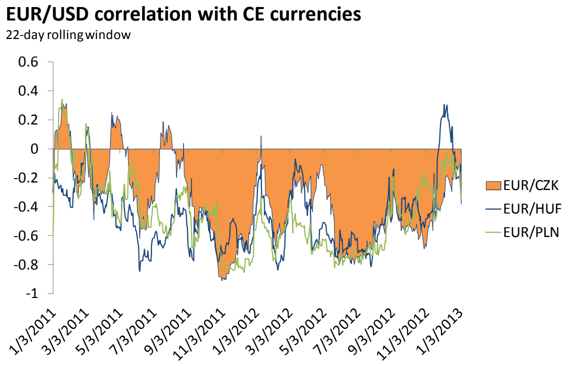
Remarkably, the negative link of the dollar to stock markets is also waning in global markets. The link worked as follows: strong stocks = global optimism = depreciation of the super-safe and low-interest dollar. Why should good U.S. figures suddenly imply a strong dollar? Basically, it is nothing but the return of the traditional link, forgotten during the crisis. Good figures should imply bets on higher nominal as well as real rates and the improvement of the interest rate differential vis-à-vis the euro. Investors currently believe that the Fed will not change rates until 2015, and therefore the dollar has not responded positively to the improved data. But central bankers have also said that if unemployment falls to less than 6.5% (7.8% now), they will begin to tighten monetary policy. Favourable figures from the labour market may revive such bets over the course of time.

In that event, it would also have a greater impact on the behaviour of the Czech koruna. Global optimism and rising stock markets have typically involved the appreciation of the currency vis-à-vis the euro and its double appreciation vis-à-vis the dollar. However, the situation may be reversed. The reality may be a surprising combination of the appreciation of the koruna against the euro and its depreciation against the U.S. dollar. Thus the links between the EUR/USD and the EUR/CZK might consequently obtain a new dimension for the first time in a long while.

Czech industrial production fell short of expectations

Regarding today's fresh figures on Czech industrial production in November, those fell short of market expectations; after working-day adjustment, the output fell by 6.2% Y/Y and 0.8% M/M. After the release, the koruna surged and breached above resistance at EUR/CZK 25.38 and currently is seen even above 25.50.





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.5	1.42%	→	→
EUR/HUF	291	-0.29%	→	→
EUR/PLN	4.12	1.05%	→	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.49	8.04	→	↗
10Y HUF	5.64	2.73	→	→
10Y PLN	3.78	5.56	→	↗

In Focus: Polish interest rates

The bets on a significant decline in Polish rates are exaggerated. While the economy is growing slowly by Polish standards, it is heading for better times.

Although, from the economic point of view, there are not now many reasons for Poland to rejoice (after all, this applies to Europe as a whole), we continue to believe that the bets on a decline in market rates by approximately an additional 90 points within the next nine months are still exaggerated.

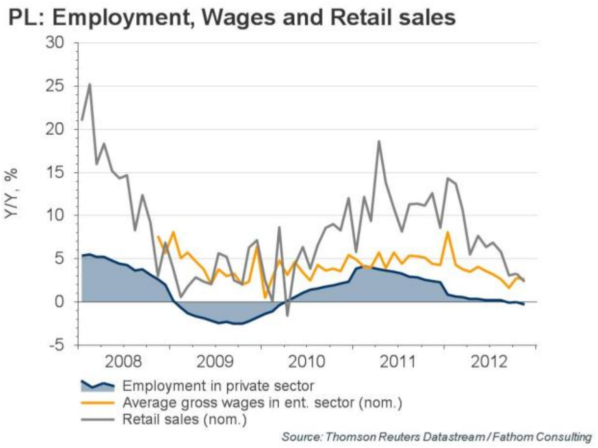
Let us summarise the current situation, first. The Polish economy grew by 1.4% y/y in the third quarter of last year, i.e., at the slowest rate since the second quarter of 2009. Compared to the post-Lehman period, the current deceleration is more attributable to domestic demand, which was an element that kept the Polish economy afloat in the above-mentioned year, 2009. Net exports clearly drove growth in the last two quarters. Nevertheless, we believe that the situation might start to improve as early as in the second quarter, with our leading indicators showing that industry might provide positive stimuli.

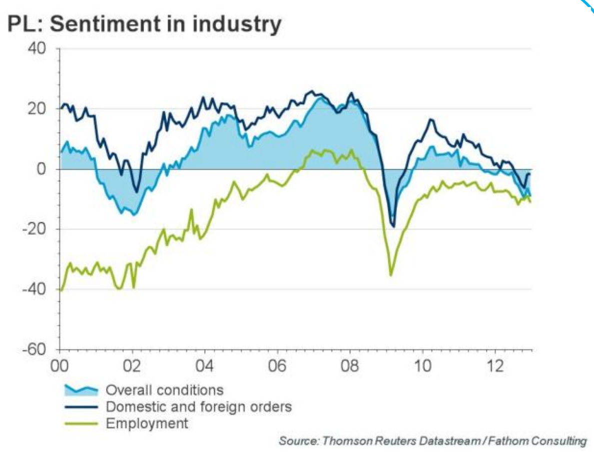
The situation in industry is improving.

While December's business mood index in industry, released last week, remained below the key level of 50 points, thus still signalling a deterioration of conditions, its value improved for a third consecutive month. New orders developed fairly well (the highest since July), as did new export orders (the best since March). Better prospects for Polish industry are also suggested by our leading indicator, one of the components of which is the German business mood index, Ifo. Not even the labour market situation is very critical. Admittedly, retail sales as well as wages are stagnating or even slightly falling in real terms (adjusted for inflation), but the development of employment in the private sector is far from being as adverse as in 2009 (see the graph). By contrast, construction is likely to continue to develop unfavourably on the year-on-year basis.

The composition of NBP members should not favour significant rate cuts either

If we combine the above factors with the central bank's reticent view of further monetary tightening (bear in mind that the National Bank of Poland somewhat surprisingly raised rates as recently as in May of last year), we believe that one or two 25 bps rate cuts (including this week's) are on the agenda at the moment. We will see what mood the Monetary Policy Council will be in at its two-day meeting, which will conclude this Wednesday.





Weekly preview

WED 14:00	NBP rate (in %)	
	This	Last change
rate level	**4.00**	12/2012
change in bps	**-25**	-25

The NBP will again proceed to a rate cut

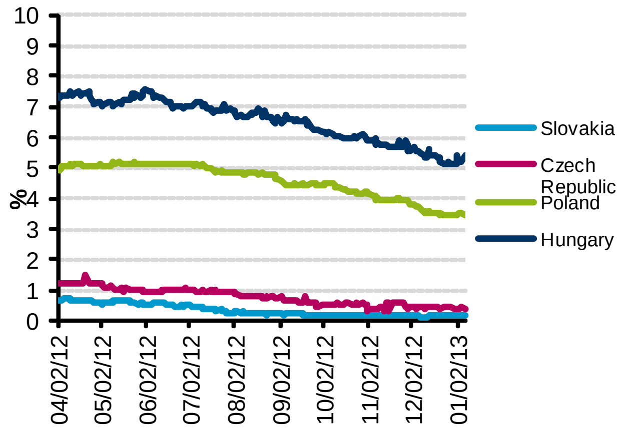
We believe that the National Bank of Poland will again cut its reference interest rate, by 25 bps to 4%, at its meeting to be held this week. In the third quarter of last year, the Polish economy grew at the slowest rate since 2009 and, in spite of the stabilising situation, we should anticipate one or two additional rate cuts; this is even recognised by the advocates of stricter monetary policy at the NBP (such as Jan Winiecki; see the text on page 3 for details).

Calendar

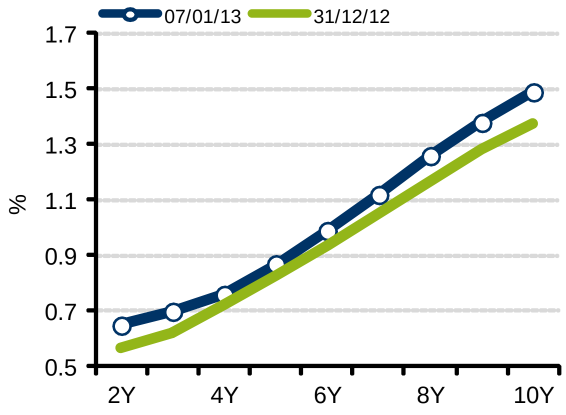
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	01/07/2013	9:00	Construction output	%	11/2012						-4.3
CZ	01/07/2013	9:00	Industrial output	%	11/2012		-2		-1.3		4.1
CZ	01/07/2013	9:00	Trade balance	CZK B	11/2012	20		24		32.97	
HU	01/07/2013	9:00	PPI	%	11/2012				-1.9	-0.4	0.2
HU	01/08/2013	9:00	Industrial output	%	11/2012 *P					-3.8	-3.8
CZ	01/09/2013	9:00	CPI	%	12/2012	-0.1	2.2	0.1	2.4	-0.2	2.7
CZ	01/09/2013	9:00	Unemployment rate	%	12/2012	9.3		9.4		8.7	
HU	01/09/2013	9:00	Trade balance	EUR M	11/2012 *P					646.9	
CZ	01/09/2013	12:00	CZ bond auction 2013-19, x.xx%	CZK B	01/2013						
CZ	01/09/2013	12:00	CZ bond auction 2012-17, floating rate	CZK B	01/2013						
PL	01/09/2013	14:00	NBP meeting	%	01/2013	4		4		4.25	
HU	01/09/2013	17:00	Budget balance	HUF B	12/2012					-691.7	
CZ	01/11/2013	9:00	Retail sales	%	11/2012		-2.8		-0.2		2.2

Fixed-income in Charts

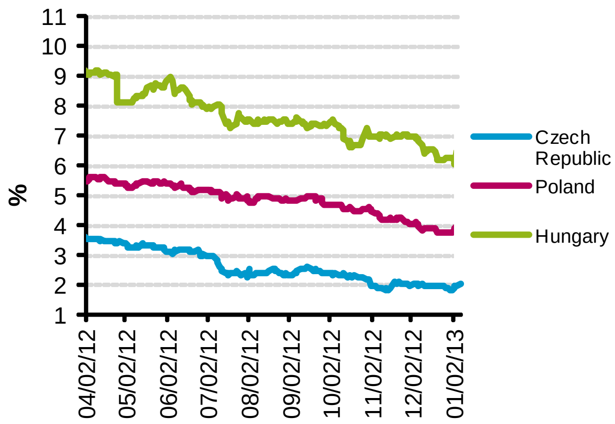
FRA 3x6



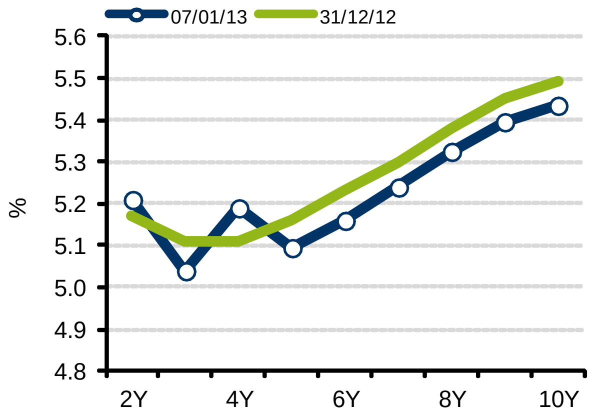
CZ IRS



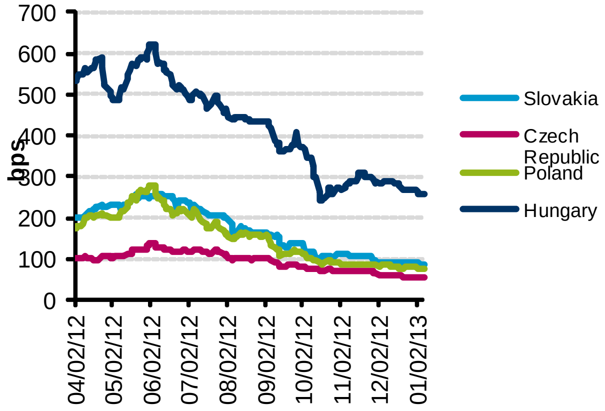
10Y GB Yields



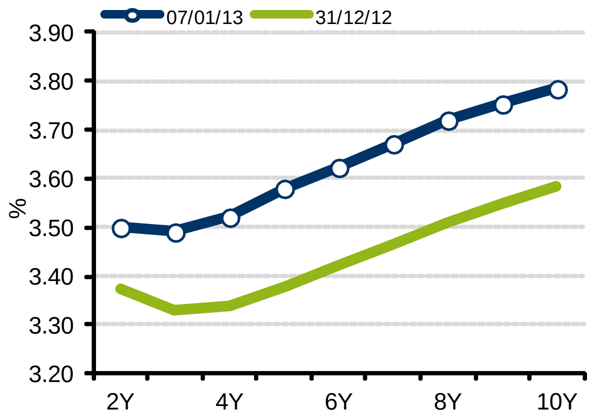
HU IRS



CDS 5Y



PL IRS



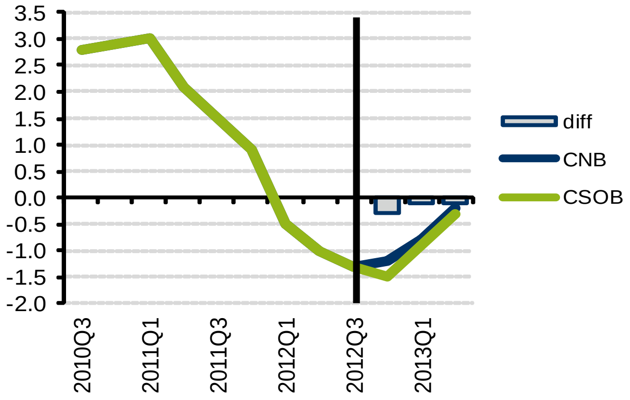
Source: Reuters

Medium-term Views & Issues

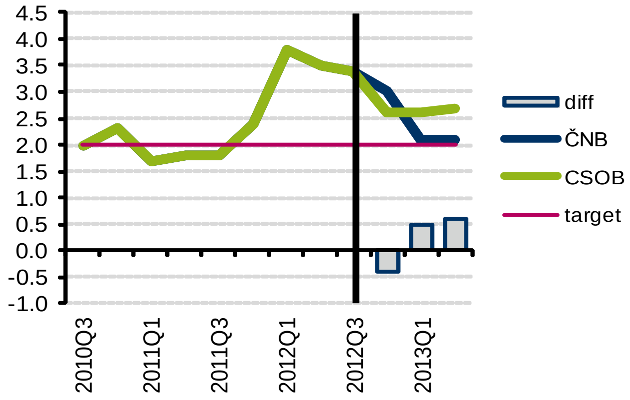
	The Czech Republic	Hungary	Poland
Growth & key issues	September's rapid drop in industrial output (-7.1% y/y) is primarily due to a lower number of business days and to weakening demand. This time, the greatest decline was generated by carmakers (-11.1%), which had been up until now the primary drivers of industry as a whole, exports and also GDP. The figures from industry are not pleasant, even if we look at the statistics of new orders, which fell by 5.2%.	The government announced HUF 764 billion (2.5% of GDP) of fiscal measures. On one side the government's commitment to keep the budget deficit under 3% seems to be firm. On the other hand, it is fairly evident that the government is likely to be able to keep its deficit below the Maastricht level only at the cost of sharply reduced economic growth.	Growth of the Polish economy fell to 1.4% in the third quarter of 2012. Clearly, factors that kept the Polish economy growing during the World Financial Crisis have stepped 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 2.1% in 2012.
Outlook for official & market rates	At its last meeting, the Czech National Bank (CNB) Board again decided to cut its interest rates. Thus the central bank's base rate hit a new all-time low of 0.05% and the CNB made a commitment to keep it there until it sees a significant inflationary pressure. In our view, these will not be visible until the second half of 2014.	The NBH will probably continue to gradually ease its policy. Year-on-year inflation already fell to 5.2 percent and is expected to ease further due to a substantial government subsidies of energy prices. Moreover, the term of central bank governor and his two deputies, who were the only members of the monetary policy council who consistently opposed recent cuts, is coming to an end.	The data confirms the declining performance of the Polish economy, while pointing out a slightly faster inflation fall towards the target than expected. In a response, the National Bank of Poland decreased its interest rates by another 25 basis points in December. We believe that further weakness in the Economy warrants further monetary easing by another 25 or 50 bps at the beginning of 2013.
Forex Outlook	CNB willingness to intervene against the koruna should play against the currency in the near term. Also the Forex Outlook Czech domestic factors do not look very supportive - slow continuation of real convergence That said, the koruna may be more vulnerable to potentially negative news from euro zone at the beginning of new year. Bottoming out of the recession should help the koruna in the second quarter of 2013.	The forint has been able to withstand both NBH's rate cuts and worsened relationship with the IMF. The exchange rate might not be stable forever, especially if the NBH continue to ease its policy, or if the naming of the new governor undermines market confidence.	Zloty's fundamentals should not permit the currency perform well in the short-run as the economy should slow down and the Central bank is about to continue in monetary easing cycle. Nevertheless bottoming out in the first quarter should help the zloty to regain the positive momentum in 2013.

CBs' Projections vs. Our Forecasts

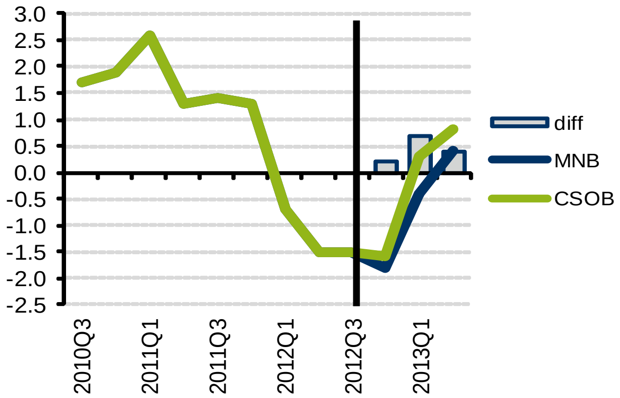
CZ: GDP outlook (Y/Y, %)



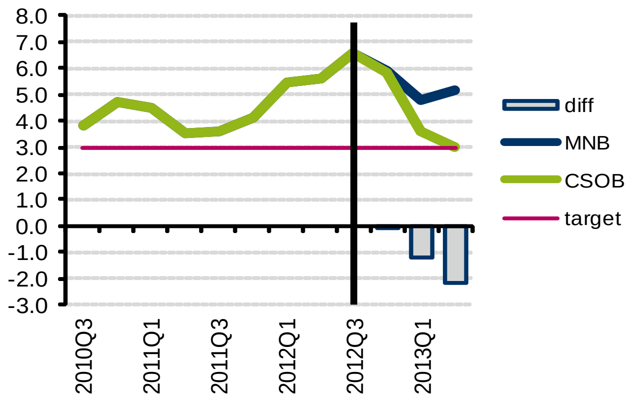
CZ: Inflation outlook (Y/Y, %)



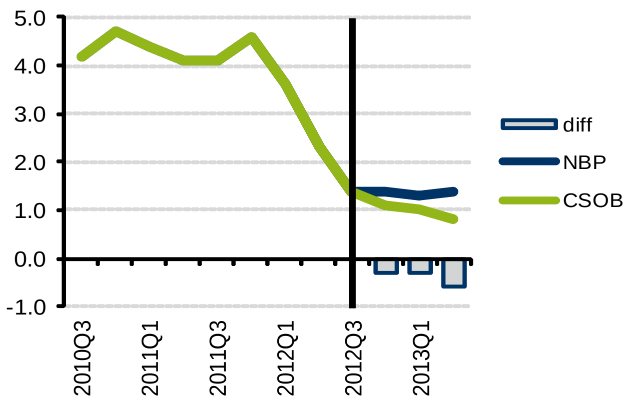
HU: GDP outlook (Y/Y, %)



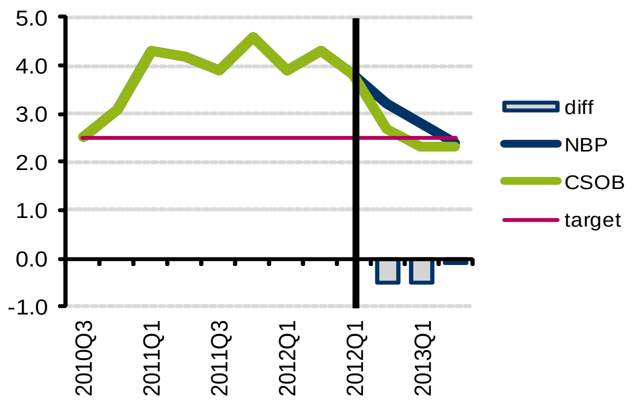
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)



Zdroj: ČNB, NBP, MNB, ČSOB

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	Last change	
Czech Rep.	2W repo rate	*0.05*	0.50	0.50	0.05	0.05	0.05	-20 bps	9/27/2012
Hungary	2W deposit r.	*5.75*	7.00	6.50	5.75	6.50	6.25	-25 bps	12/18/2012
Poland	2W inter. rate	*4.25*	4.75	4.75	4.25	4.00	4.00	-25 bps	12/5/2012

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

		Current	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
Czech Rep.	PRIBOR	*0.50*	1.03	0.80	0.50	0.50	0.45
Hungary	BUBOR	*5.73*	7.20	6.61	5.75	6.40	6.20
Poland	WIBOR	*4.08*	5.13	4.92	4.11	4.90	4.90

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

		Current	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
Czech Rep.	CZ10Y	*1.491*	2.02	1.61	1.37	1.40	1.50
Hungary	HU10Y	*5.64*	6.71	6.56	5.49	7.25	7.00
Poland	PL10Y	*3.78*	4.74	4.39	3.60	5.40	5.40

Exchange rates (end of the period)

		Current	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
Czech Rep.	EUR/CZK	*25.5*	25.5	25.1	25.1	24.7	24.6
Hungary	EUR/HUF	*291*	286	285	291	280	280
Poland	EUR/PLN	*4.12*	4.22	4.11	4.08	4.15	4.00

GDP (y/y)

	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
Czech Rep.	0.9	-0.5	-1.0	-1.3	-1.5	-0.9	-0.3
Hungary	1.3	-0.7	-1.5	-1.5	-1.6	0.3	0.8
Poland	4.6	3.6	2.3	1.4	1.1	1.0	0.8

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

	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2
Czech Rep.	2.4	3.8	3.5	3.4	2.6	2.6	2.7
Hungary	4.1	5.5	5.6	6.6	5.8	3.6	3.0
Poland	4.6	3.9	4.3	3.8	2.7	2.3	2.3

Current Account

	2012	2013
Czech Rep.	-1.7	-1.9
Hungary	1.5	1.0
Poland	-4.0	-3.8

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-5.0	-3.0
Hungary	-2.5	-2.2
Poland	-3.5	-4.0

Source: CSOB, Bloomberg

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