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Central European Weekly

Monday, 27 May 2013

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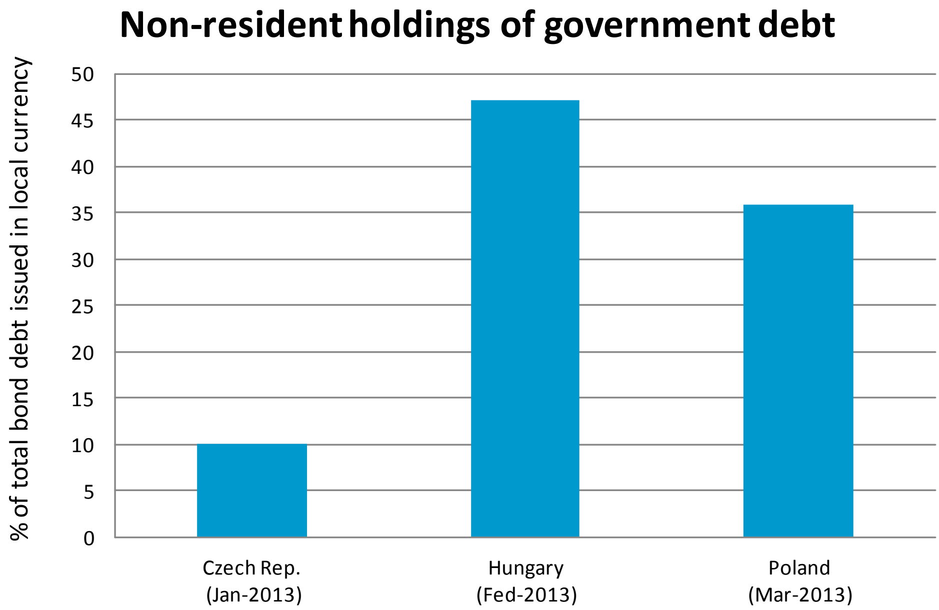
Weekly Highlights:

- Central European bond markets finally hit by sell-off
- In Focus: The Polish leading indicator deteriorates, while Czech looses momentum
- Week ahead: the NBH continues in its gradual easing

Chart of the Week: Bonds v. Foreigners



Year-on-year inflation rates diverge in Central Europe as Poland leads in the region, while the Czech inflation remain at the lowest levels.

Market's editorial

Central European bond markets hit by sell-off

The sale of government bonds faced by key markets for several days has also hit Central Europe. Yields and market rates rose markedly across the entire region, with Hungarian and Polish markets having seen a reduction of the expectations of more rate cuts by their respective central banks.

The Polish bond market most vulnerable

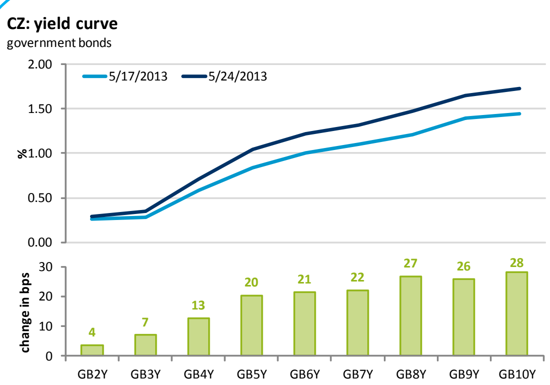
The sale of government bonds was clearly strongest in Poland, where yields went up the most, despite the fact that the Polish data were very poor. Although industry, retail sales and, after all, the labour market disappointed, market rates in Poland rose. This was all due to the fact that the participation of foreign investors in the Polish government bond market has hit an all-time high this year (non-residents hold 36% of Polish government bonds issued in PLN), with this having led to an unsustainable price rise and a corresponding drop in yields. Thus the sell-off in core markets obviously became a good reason to take profits, and this led not only to the price fall but also to a depreciation of the zloty. Nevertheless, Polish bonds may again become attractive if the market has reduced its rate cut expectations to 'only' 25 basis points, while the detailed GDP report shows that the Polish economy is truly suffering from poor demand.

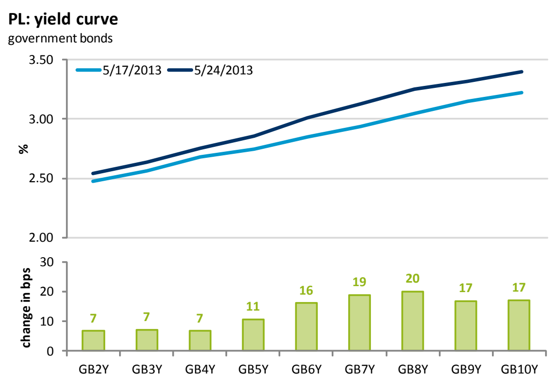
Low non-residents holdings and supply make the Czech bond market more immune, but not completely

Naturally, the sale also affected the Czech and Hungarian bond markets, albeit the situation in these countries seems to be slightly calmer. Two key facts are responsible for this in the Czech Republic – firstly, the presence of non-residents in the Czech market is fairly low (they hold less than 10% of the debt issued); secondly, the supply of new debt is and will be relatively low because of the successful subscription of retail bonds.

Hungarian bonds supported by better fundamentals

As concern Hungarian bonds – they are being supported not only by rate-cut expectations (see weekly preview), but also by the stability of the forint and by good news from the domestic economy. Just recently, it was a better GDP figure and the speculations that the EU will no longer apply the excessive deficit procedure against Hungary (the EU-s decision will come to light already this Wednesday).





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*26.0*	*-0.19%*	↘	↘
EUR/HUF	*289*	*-0.16%*	→	→
EUR/PLN	*4.20*	*0.31%*	↘	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*1.44*	*3.23*	↗	↗
10Y HUF	*4.74*	*2.93*	→	→
10Y PLN	*3.26*	*2.52*	↗	↗

In Focus: Czech and Polish leading indicators

Czech Flash (leading indicator for the Czech Economy) rose for the sixth consecutive time, but the rate of improvement again decelerated (for the third time in a row). This is certainly not a good sign for the strength of recovery in industry. After all, this was confirmed by the industrial output data for March (normalised seasonally adjusted figures indicate a persisting moderate decline).

With the advent of a more stable recovery, the Flash usually rises every month and, in addition, boosts its momentum across all of its components. Unfortunately, the momentum started to deteriorate in February, and worse still, certain components of the Flash began to fall. New orders in the automotive industry continue to develop poorly. Hopefully , this may be attributable to the high comparative baseline of last year, strong winter, and production interruptions at ŠKODA AUTO.

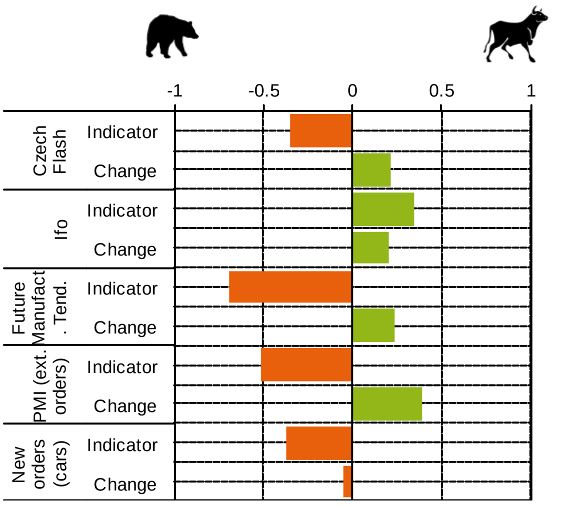
Anyway, April's data indicates that Czech industry is very unsure of hitting its bottom in the first half of 2013. Therefore the prospects for its growth within the next three months cannot be overly optimistic.

The Polish Flash (leading indicator for the Polish Economy) deteriorated in April, while revised figures also indicated a decline in March. Thus four months of rising were followed by two months of falling, and this is no sign of a positive future for the Polish industry (at least not for the next 3-4 months).

The Polish Flash currently looks worse than its Czech counterpart, which, unlike the Polish Flash, is still rising (albeit running out of steam). The current Polish Flash is alarming due to its deterioration across all of its sub-categories (only German Ifo component is rising).

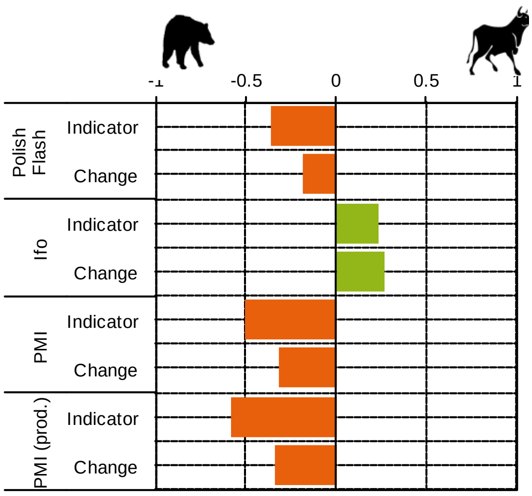
Moreover, Polish industry has just finished stabilising – normalised industry continued to fall slightly in March. All of that is consistent with the overall unflattering picture of the Polish economy, where we, along with markets, are slowly coming to terms with its very poor performance in 2013 (1.4% growth). This enables the National Bank of Poland to ease its monetary policy again as early as at its June meeting.

The Czech Flash- leading indicator



*Indicator: the level of the indicator vis-à-vis historical values
**Change: the change in the indicator vis-à-vis historical values
(1 = the current value is the maximum historical value; -1 = the current value is the minimum historical valu

The Polish Flash- leading indicator



Weekly preview

TUE 14:00 NBH base rate

	This meeting	Last change
rate level (in %)	**4.50**	4/2013
change in bps	**-25**	-25

HU: A gradual rate cut cycle will continue

We believe that the National Bank of Hungary (NBH) will stick to its gradualist easing approach at its Tuesday meeting. We expect that the central bankers will cut rates for the tenth consecutive time to a new all-time low of 4.5%. The main arguments for rate cuts continue to be inflation. It is well below inflation target (of 3% for year-on-year) inflation, partly thanks to the weak domestic demand in the last years, partly to the government's measures. Moreover, inflation is likely to remain below the inflation target for some time as the Government is planning another round of administrative price cuts (this time in water rates, waste disposal and other services). Another argument for easing might a stronger forint too. The currency has been recently encouraged by the news of a better-than-expected GDP figure, so it has widened the central bank's room for easing.

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

	2013Q1	2012Q4	2012Q1
GDP	**0.5**	0.7	3.5

PL: The slowest GDP growth in the last four years

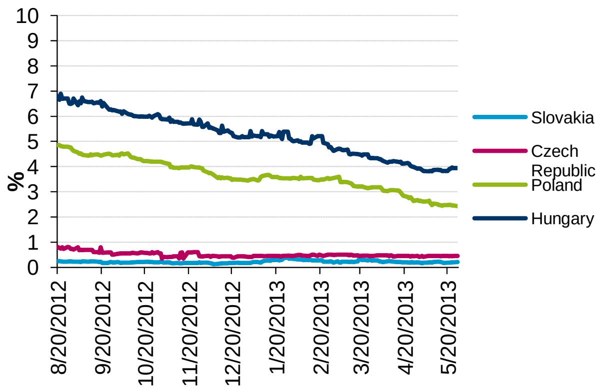
We believe that Poland's Central Statistical Office might revise its first ever flash estimate of economic growth for the first quarter of the year (+0.4% y/y) slightly upwards to 0.5%. While this is still an outstanding figure in the Central European context, it was Poland's slowest growth in the last four years. Just as in previous quarters, net exports likely continued to be the primary driver of growth in early 2013, as also suggested by a significant Q1 surplus in the positive balance of goods and services, registered in the balance of payments statistics of the National Bank of Poland. By contrast, a rapid drop in imports suggests persisting poor domestic demand, in addition to falling commodity prices (the case of Czech GDP); after all, poor domestic demand is also signaled by the moderate fall in retail sales in real terms for the first three months of this year.

Calendar

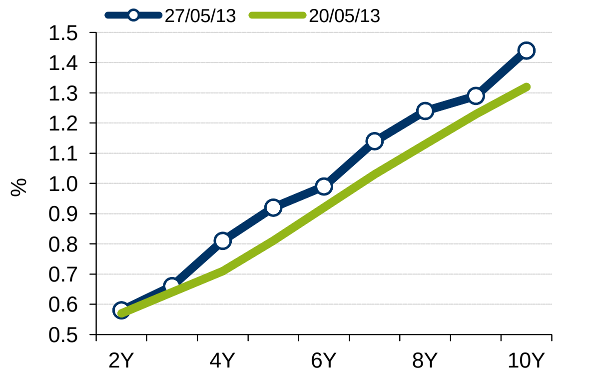
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	05/28/2013	14:00	NBH meeting	%	05/2013	4.5		4.5		4.75	
HU	05/29/2013	9:00	Unemployment rate	%	04/2013			11.7		11.8	
PL	05/29/2013	10:00	GDP	%	1Q/2013		0.5	0.1	0.7	0.1	0.7
CZ	05/29/2013	12:00	CZ bond auction 2013-2019, 1.50%	CZK B	05/2013						
CZ	05/29/2013	12:00	CZ bond auction floating rate/2023	CZK B	05/2013						
HU	05/31/2013	9:00	PPI	%	04/2013				1.2	1.6	2.2
CZ	05/31/2013	11:00	Money supply M2	%	04/2013						4.4

Fixed-income in Charts

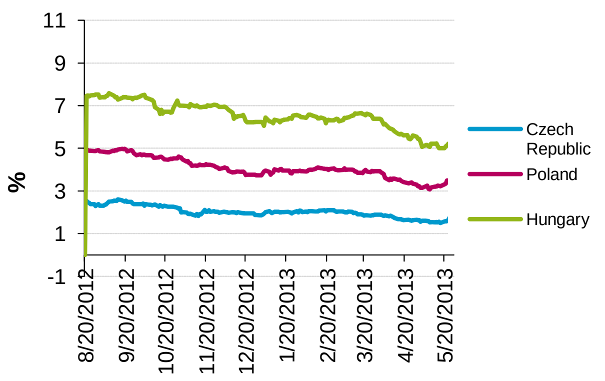
FRA 3x6



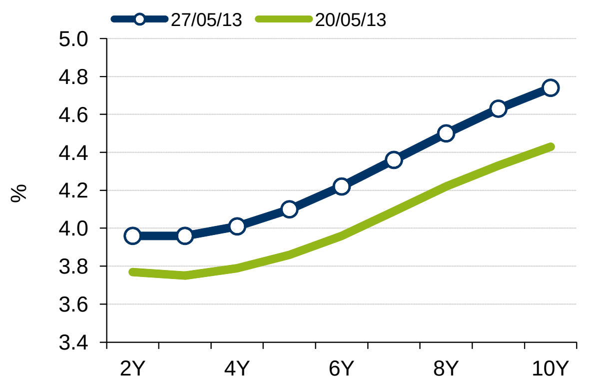
CZ IRS



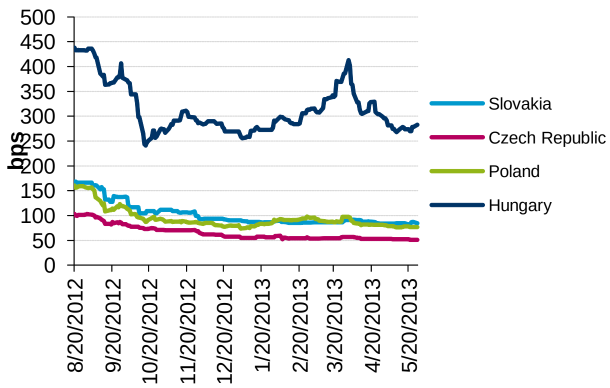
10Y GB Yields



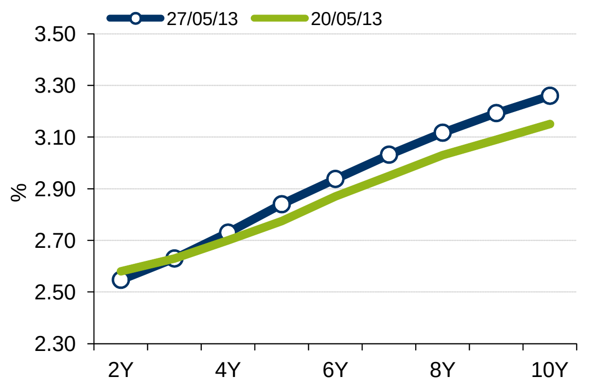
HU IRS



CDS 5Y



PL IRS



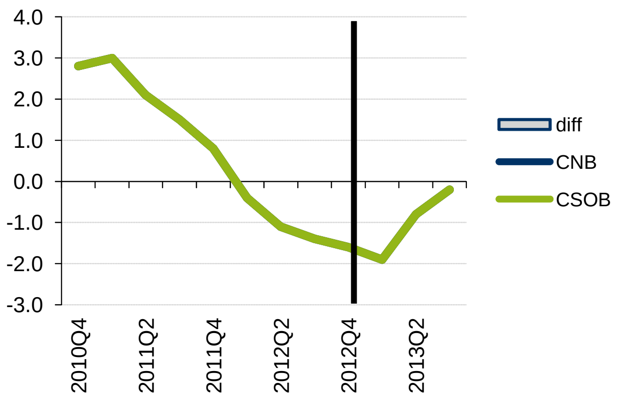
Source: Reuters

Medium-term Views & Issues

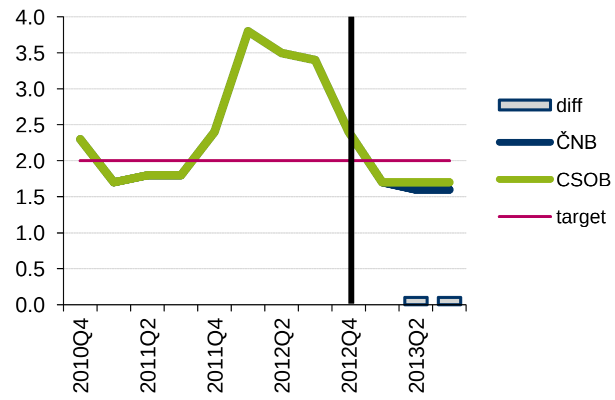
	The Czech Republic	Hungary	Poland
Growth & key issues	The Czech economy remains in a recession, which is shallower but longer than the previous one. The latest data from industry – production as well as orders – still tend to be negative. The drop in domestic demand was followed by a decline in foreign demand. Domestic growth stimuli are still absent. Another VAT increase again has curbed household consumption, while concern about the negative outlook for the European economy curbs the investment activity of domestic firms. Nevertheless, taxes should remain unchanged in the next two years.	Like the Czech economy, the Hungarian has been facing a double dip. The persistent weakness of the domestic demand cannot be compensated by improvement in (net) exports. Real recovery of the economy could be rather visible in 2015.	Growth of the Polish economy fell to 0.7% in the fourth quarter of 2012 (after revision). Figures from the Statistical Office confirmed that the economy was only driven by net exports, which improved owing to falling imports as well as rising exports. Household consumption was down by 1% y/y, while investment also dropped on a year-on-year basis (though much less than in the third quarter). However, we expect that the recent rate cuts should help the economy to bottom out in the second half of 2013.
Outlook for official & market rates	The CNB met expectations and left its rates unchanged, while it downgraded its economic outlook for this year. The CNB expects that the economy will continue to fall this year (-0.5%). The central bank also mitigated concern about forex interventions as an instrument to ease monetary conditions in the economy. Only much worse than expected economic development or rapidly firming koruna could make the central bank 'diverge' from its wait-and-see attitude.	With newly appointed governor of the NBH György Matolcsy and his deputies, the doves have overwhelming majority in the central bank. The tendency for further monetary easing will be mainly supported by the inflation, which decelerated below the central bank target and the domestic demand which stays very low. On the other hand monetary easing is limited by the forint, which is very vulnerable and its weaker levels would hurt FX debtors. We thus believe that NBH will cut rates gradually further. We see the lowest levels of NBH rate at 4.5%, while the downside risk to our forecast is high due to current low transparency of the NBH.	Clearly, the NBP is concerned with a sharp decline in inflation rate and unfavourable structure of GDP growth, which has lately been almost exclusively driven by net exports; traditionally strong domestic consumption and investment even contributed negatively to the 2012Q4 growth. Although signs of relative underperformance of the Polish economy (in comparison with the previous decade) have been present for some time, we thought the MPC would be reluctant to undertake more aggressive easing policies. Recent decisions of the Council, however, have undermined this view. Therefore, we have revised our outlook and newly expect the reference rate to stay unchanged in June and to be lowered by additional 25 bps in July along with the release of a new Inflation report.
Forex Outlook	The koruna does not have much space to weaken further above 26.00 EUR/CZK. We believe in near term stability and lower volatility in a range 25.40-26.00 EUR/CZK. We believe that rather than risks of outright interventions (against CZK), the CNB policy sets a threshold for eventual (fast) strengthening of the koruna. Therefore, we think that the koruna is heading for the period of lower volatility and relative decoupling from global and regional markets.	The forint has experienced some volatility, which has been attached to the recent appointment of a new NBH President (see the text above). However, given the improvement in Hungary's balance of payments and global market sentiment, we believe that forint's weakness will be rather temporary than persistent.	While the surprise by Poland's Monetary Policy Council triggered an immediate negative reaction from the zloty, we believe this should not last for long time. The money market currently anticipates one more rate cut, which, we believe, will not occur; moreover, the market opinion on the NBP may completely turn about. Naturally, this might be grist to the mill of the zloty, which may benefit from fairly high interest rates even today.

CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

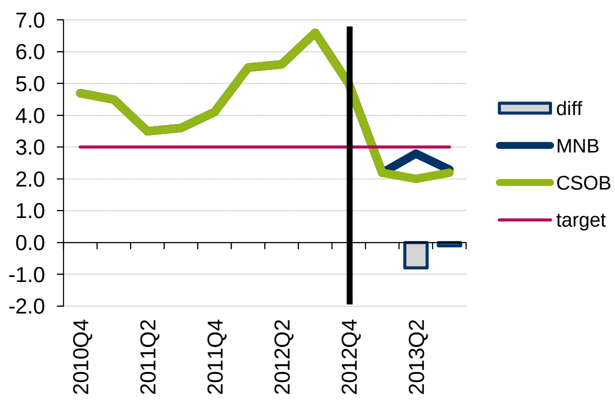


CZ: Inflation outlook (Y/Y, %)

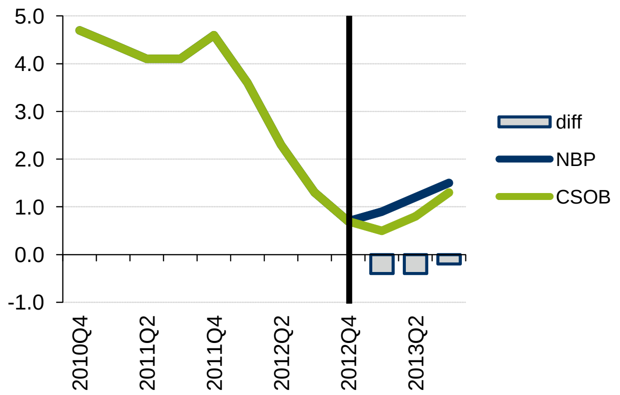


HU: GDP outlook (Y/Y, %)

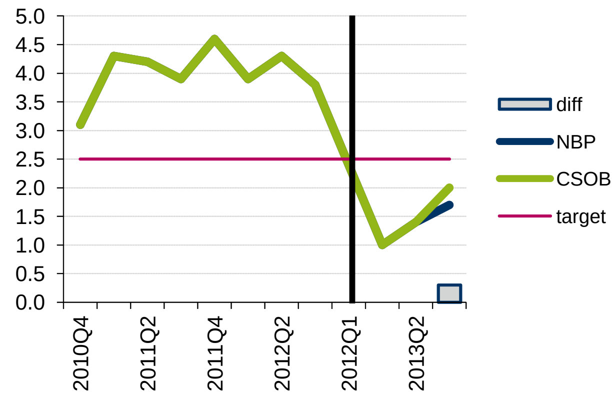
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outlook (Y/Y, %)



Source: CNB, NBP, MNB, CSOB

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	Last change	
Czech Rep.	2W repo rate	*0.05*	0.50	0.05	0.05	0.05	0.05	-20 bps	9/27/2012
Hungary	2W deposit r.	*4.75*	6.50	5.75	5.00	4.75	4.00	-25 bps	4/23/2013
Poland	2W inter. rate	*3.00*	4.75	4.25	3.25	3.25	3.25	-25 bps	5/8/2013

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

		Current	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	PRIBOR	*0.46*	0.80	0.50	0.47	0.45	0.43
Hungary	BUBOR	*4.54*	6.61	5.75	4.90	4.70	4.50
Poland	WIBOR	*2.76*	4.92	4.11	3.39	4.90	4.90

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

		Current	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	CZ10Y	*1.44*	1.61	1.37	1.31	1.40	1.50
Hungary	HU10Y	*4.74*	6.56	5.49	5.41	5.20	4.80
Poland	PL10Y	*3.26*	4.39	3.60	3.61	5.40	5.40

Exchange rates (end of the period)

		Current	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	EUR/CZK	*26.0*	25.1	25.1	25.7	25.7	25.5
Hungary	EUR/HUF	*289*	285	291	304	290	300
Poland	EUR/PLN	*4.20*	4.11	4.08	4.18	4.00	4.00

GDP (y/y)

	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	-0.4	-1.1	-1.4	-1.6	-1.9	-0.8	-0.2
Hungary	-0.7	-1.5	-1.7	-2.7	-0.9	0.2	0.7
Poland	3.6	2.3	1.3	0.7	0.5	0.8	1.3

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

	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3
Czech Rep.	3.8	3.5	3.4	2.4	1.7	1.7	1.7
Hungary	5.5	5.6	6.6	5.0	2.2	2.0	2.2
Poland	3.9	4.3	3.8	2.4	1.0	1.4	2.0

Current Account

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

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-4.4	-3.0
Hungary	-2.5	-2.2
Poland	-3.9	-4.0

Source: CSOB, Bloomberg

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