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Central European Weekly

Monday, 10 June 2013

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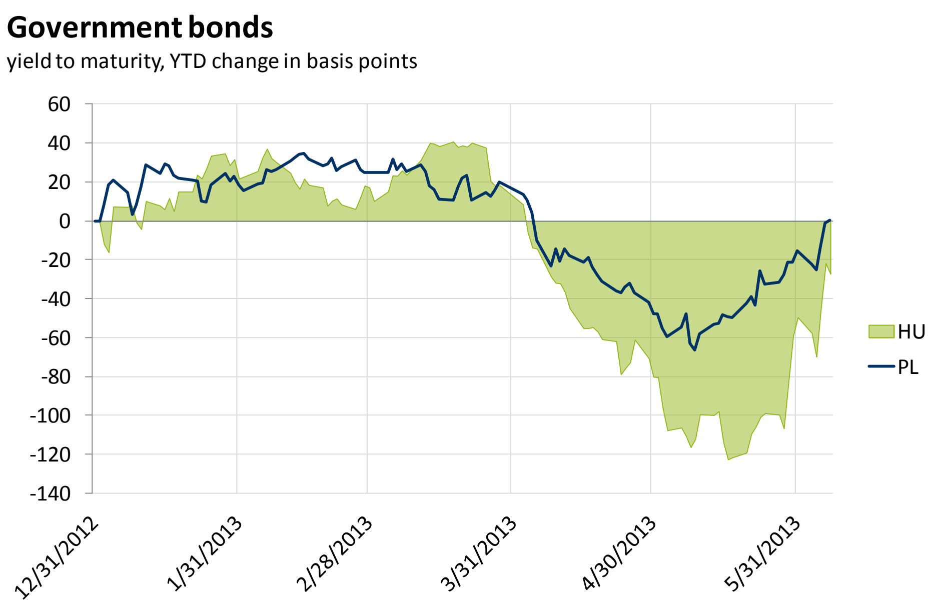
Chart of the Week



- *Regional government bond markets catch up the recent sell-off in core bond markets... (Source: Bloomberg, CSOB)*

Market's editorial

Regional bonds markets catch up sell-off in core markets

While a devastating flood wave rushed over Central European riverbeds, the regional financial markets were 'washed out' by a sale of government bonds. Moreover, this was spiced up by a sale of the zloty and the forint. By contrast, the koruna, notwithstanding the consequences of the devastating flood, somewhat paradoxically acted as a safe harbour, which is based on its status as a super-low-interest currency. In the end, it all resulted in the Polish central bank losing its nerve and intervening in favour of their respective national currencies.

If we focus more closely on the sale in bond markets, we find that it was truly impressive. For instance, Czech and Polish yields went up by 15-30 basis points in a week, even though the National Bank of Poland cut rates and the koruna strengthened by almost 2%. Two factors might have played a negative role in the Central European region. Firstly, the regional bond markets reacted with a delay to the sale in leading markets, now trying to catch up with the latter, and thus their yields are rising faster than, for example, in the eurozone. Secondly, also contributing to the sale might have been the large presence of foreign investors (this applies to the Hungarian and Polish markets), which proved to be a great disadvantage when investors fled from emerging markets. In addition, this was augmented by the civil unrest in Turkey and the related sell-off of local assets.

Thus the sell-off in regional markets is primarily driven by external factors, with domestic macroeconomic data as well as actions by central banks (including interventions) being secondary. Moreover, the question is whether this scenario may change in any way now that U.S. market rates are on the rise and portfolio capital is increasingly heading (back) for the United States.

The NBP should cut deeper, but a weak zloty is a challenge

Regarding the NBP decision cut rates by an additional 25 bps – it just matched market expectations, so it was the information from the subsequent press conference, which moved the markets. This primarily applied to comments from NBP President Belka concerning the exchange rate of the zloty, which has weakened by 3.5% since the beginning of May. Belka stated that neither the depreciation of the zloty nor the huge sales in bond markets (the yield of 10Y bonds went up by 65 bps in the last four weeks) troubled the NBP significantly (i.e., that these issues had not been discussed) and added that the conclusions of the official press statement should not be interpreted in such a way as to indicate that the rate cut cycle was over. In this regard, Belka laid exceptional emphasis on the new forecast, to be available to the NBP at its next meeting in early July. The forecast will almost certainly revise inflation and growth downwards – April's data suggests that the launch of the second quarter of the year was also poor. The deterioration of the forecast alone indicates another cut, likely by 25bps.

Nevertheless the NBP has proved several times in recent months that one ought to be very careful about trusting its statements, and this has also been the case in recent days. Only two days after the bank, through its President Belka, played down the importance of the significant depreciation of the zloty, the NBP, in the wake of the release of good figures from the U.S. labour market, started to intervene in favour of the Polish currency! According to Mr. Belka's words, the NBP's intentions are not to fight against the trend but rather lower the zloty's volatility. In any case, this has made the monetary policy of the NBP slightly schizophrenic – with monetary easing through interest rates on the one hand, and monetary tightening through the currency exchange rate on the other.

In any event, the behaviour of the NBP bears out our hypothesis that the key risk to the scenario of another rate cut is the continuation of the sale in bond markets and consequently a further depreciation of the zloty. Adam Glapinski, a member of the Monetary Policy Council, has supported the hypothesis on Saturday as he said that rather than supporting the economy the prospective rate cut could increase risks of capital outflows. However, these are factors that the NBP can influence by its decisions to a very limited extent, as they are primarily based on external effects, and the central bank itself acknowledges that. In any event, additional rate cuts by the NBP may further harm the zloty, because the market, assuming from FRA and WIBOR rates, only envisages something like that to a limited extent. Hence investors are likely to remain dubious in anticipating further steps by the NBP.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.7	-0.55%	➔	➚
EUR/HUF	298	1.33%	➚	➘
EUR/PLN	4.26	0.47%	➚	➘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.70	9.68	➚	➚
10Y HUF	5.51	10.64	➚	➚
10Y PLN	3.74	11.48	➚	➚

Review of Economic Figures

The Czech economy falls significantly in the first quarter

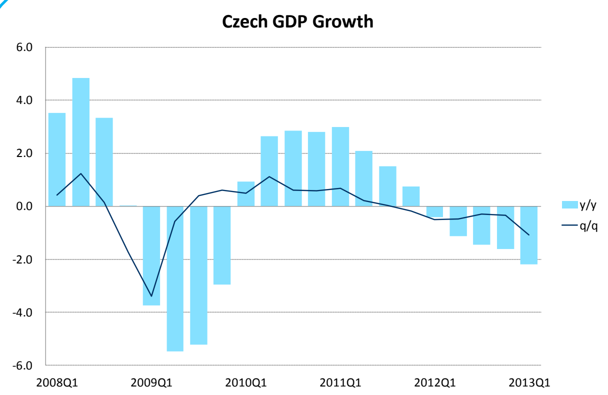
The performance of the Czech economy is much worse than indicated by the first forecasts, released approximately a month ago. The GDP for the first quarter of the year dropped by 1.1% q/q and a huge 2.2% y/y. At first glance, the figures are very poor, but we need to look at the exact reasons. Household and government consumption went up vis-à-vis late 2012, investment rose slightly, and exports improved slightly, while imports stagnated. Thus the poor (quarter-on-quarter) figure can only be explained by inventories. Some of the reasons for the change, i.e., a decline in inventories, included last year's stockpiling of cigarette revenue stamps, and lower stocks in the energy sector as well as in the retail and wholesale sectors. The Q1 performance of the economy was also affected by the automotive industry, which faced poor foreign demand in that quarter of the year; moreover, the largest carmaker had scheduled a temporary technological shutdown for that period. Although the figures for the first quarter are truly adverse, we do not see them, with a view to the causes, as being dramatic or devastating. The economy is approaching its stabilisation phase, which might be followed by the first signs of recovery later this year. However, the overall 2013 figure will remain in the red (we predict -0.7% for the moment); nevertheless, the longest recession of the economy to date should end at approximately the middle of the year.

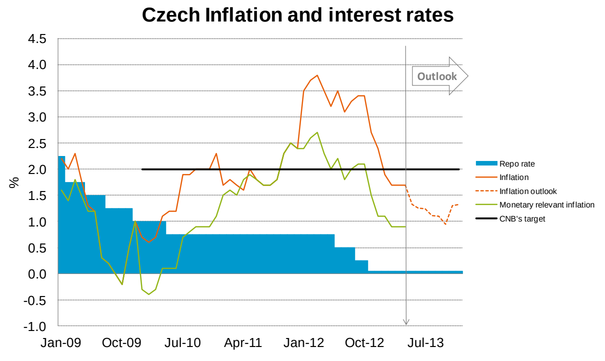
Industry neither surprises nor disappoints

Industry grew by 0.5% in April. Adjusted for a different number of business days in the month, industrial output fell by 3.4%, but new orders suggest that the worst is likely nearly over for the largest Czech sector. New orders look promising, having increased by 5.8%, due in particular to foreign demand and demand for new cars. Thus, after opening this year less successfully, the automotive industry holds hopes of returning to the black. Although the situation in industry as a whole is starting to stabilise, the number of employees is still falling, this time by 1.3% y/y. The outlook for industry remains slightly optimistic, i.e., the poor first half of the year might be followed by the resumption of a very moderate rise, owing to foreign demand. Floods are likely to affect June's and July's figures, but their full-year impact should not be dramatic.

Czech CPI fell sharply in May, inflation rate down to 1.3%

The May consumer prices fell by 0.2% m/m. This price fall was due to competition in telecommunications and utilities. People could thus save money owing to cheaper mobile calls and reduced natural gas prices. By contrast, consumers had to pay more for food, but food prices will stabilise somewhat in the months to come. With the upcoming crop, the current seasonal increase in vegetable prices will wane. Year-on-year inflation, monitored by the central bank, continued to approach the lower threshold of its tolerance band, having fallen from April's 1.7% to May's 1.3%. Poor demand is curbing the latitude for raising the prices of consumer goods and making retailers as well as manufacturers curb their prices. Low inflation also bears out our opinion that low interest rates will persist for longer than was expected, say, half a year ago. Until the economy recovers and consumers start spending their money, inflation will be just a marginal topic in this country.





In Focus: Czech floods – version 2013

The length of the Czech Republic's economic downturn breaks records, but the economy is likely hitting bottom and the floods will not change that in any way

The Czech economy has been in its longest recession ever (a sixth quarter of decline). However, a number of indicators show that the bottom is very near. Not even the current floods should change that in any way.

Since late 2011, the economy has been driven down by the record-breaking drop in private consumption, which is now stabilising, as is investment. In addition, private consumption may be encouraged by the improvements in terms of trade (import prices rising faster than export prices). Numerous export-oriented enterprises are also reporting a decent utilisation of their production capacities (over 90% in the automotive industry). This could help investment continue to stabilise. By and large, the Czech economy is sending a lot of signals that indicate a chance of its bottoming out soon.

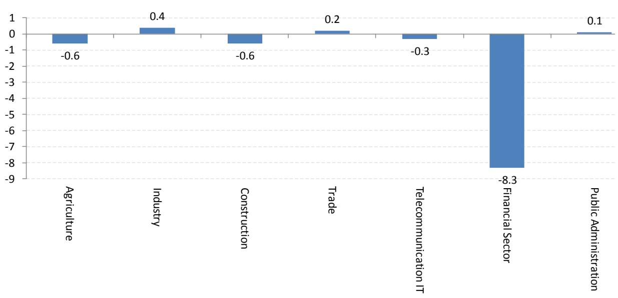
As in 2002, floods will have a small impact on the growth

The current floods should not change much about that. Based on the analogy with 2002 (when the floods were much more devastating, according to the existing forecasts), the impact of the floods on the growth rate was negligible (-0.05% of annual GDP). The annual performance of farmers and builders worsened as a result of the floods. By contrast, industry – the backbone of the Czech economy – proved to remain unaffected a year after the floods and, owing to increased government consumption, it slightly counterbalanced the reduced performance of builders and farmers. Thus the economy as a whole broke even.

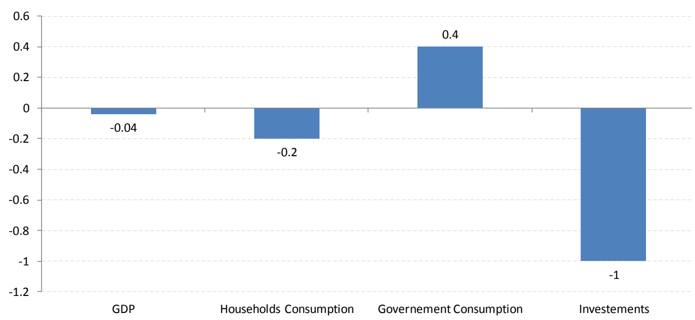
In 2013, the overall damage will be less and has come at the bottom of the economic cycle, after a recession of record-breaking length. Less damage to infrastructure and very poor construction orders are likely to lead to much smaller interruptions of work than in 2002. However, new investment triggered by the floods will be fairly low. It will tend to amount to single billions of korunas, with no chance of influencing the GDP to any great extent. Whether the Czech economy will bottom out sooner or later will depend much more on the willingness of exporters to accelerate investment and to recruit new staff.

The harm done to public budgets should be in single billions rather than tens of billions of korunas. Even it proves to be greater in the end, the Government currently has decent reserves (we estimate them at more than CZK 10 bn in debt service) and will not have a problem borrowing money in the market if it needs more funds.

Impact of the 2002 Floods to the GDP
(Deviation of GDP components from X12-ARIMA trend/cycle in period 2002/Q3 - 2003/Q3, in %)



Impact of the 2002 Floods to the GDP
(Deviation of GDP components from X12-ARIMA trend/cycle in period 2002/Q3 - 2003/Q3, in %)



Weekly preview

PL: Inflation hovers at low levels

THU 14:00	PL Inflation (change in %)		
	May-13	Apr-13	May-12
CPI y/y	**0.8**	0.8	3.6
Food (ex Alc.) y/y	**1.7**	2.1	2.7
Transport y/y	**-2.2**	-2.2	8.1

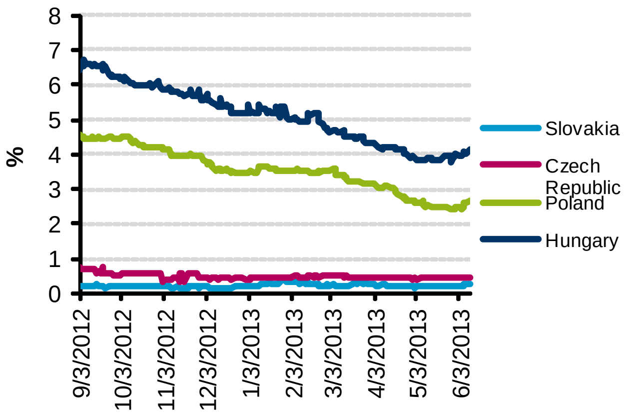
The May inflation rate in Poland stagnated at 0.8% y/y, according to our forecasts. Prices likely went up by 0.2% vis-à-vis April, primarily fuelled by the seasonally rising food prices, as usual. By contrast, another volatile component of inflation – fuel prices – likely went down, primarily encouraged by their decline in global markets, because the average exchange rate of the zloty against the dollar weakened by 1.4%. May's year-on-year inflation rate probably approached its bottom, which we expect to be hit in June (0.6%).

Calendar

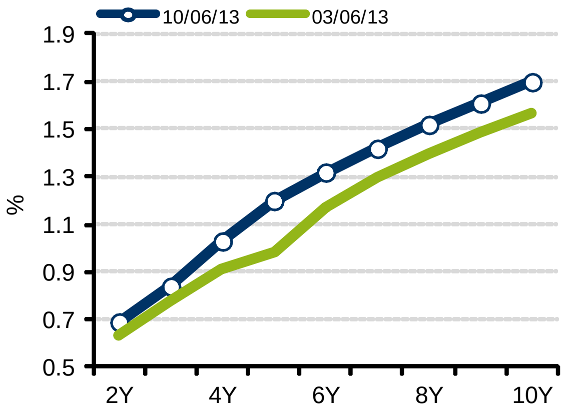
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	06/11/2013	9:00	CPI	%	05/2013					0.3	1.7
CZ	06/12/2013	12:00	CZ bond auction 2013-2019, 1.50%	CZK B	06/2013						
CZ	06/12/2013	12:00	CZ bond auction 2013-2028, 2.50 %	CZK B	06/2013						
PL	06/13/2013	14:00	CPI	%	05/2013					0.4	0.8
HU	06/14/2013	9:00	Industrial output	%	04/2013 *F						
PL	06/14/2013	14:00	Core CPI	%	05/2013					0.6	1.1
PL	06/14/2013	14:00	Money supply M3	%	05/2013					0.1	
CZ	06/17/2013	9:00	PPI	%	05/2013	-0.1	0.4			-0.5	0.5
CZ	06/17/2013	10:00	Current account	CZK B	04/2013	-3.2				-35.8	
PL	06/17/2013	14:00	Current account	EUR M	04/2013					-200	
PL	06/17/2013	14:00	Trade balance	EUR M	04/2013					-273	
PL	06/17/2013	15:00	Budget balance	PLN M	05/2013					-31746	
HU	06/18/2013	9:00	Wages	%, ytd.	04/2013						3.2
PL	06/18/2013	14:00	Wages	%	05/2013					-0.1	3
PL	06/19/2013	14:00	Industrial output	%	05/2013					-2.3	2.7
PL	06/19/2013	14:00	PPI	%	05/2013					-0.6	-2

Fixed-income in Charts

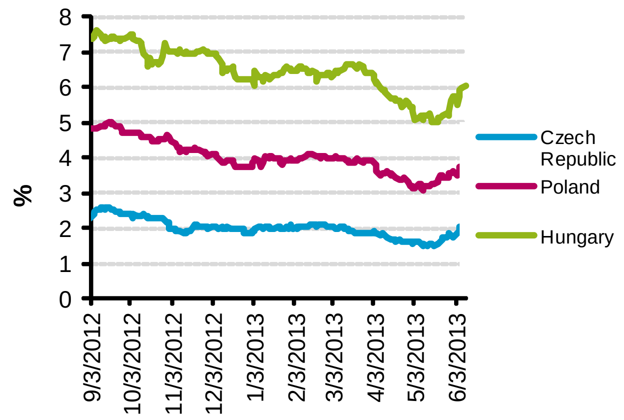
FRA 3x6



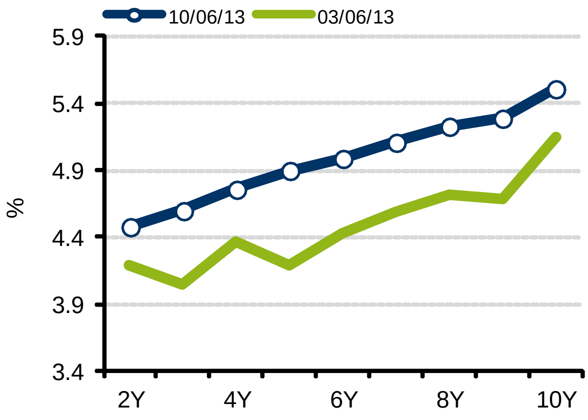
CZ IRS



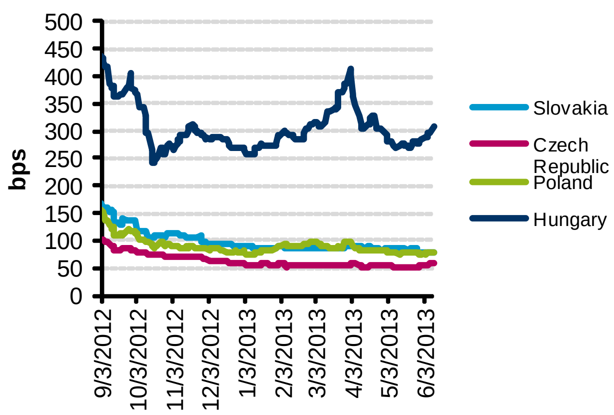
10Y GB Yields



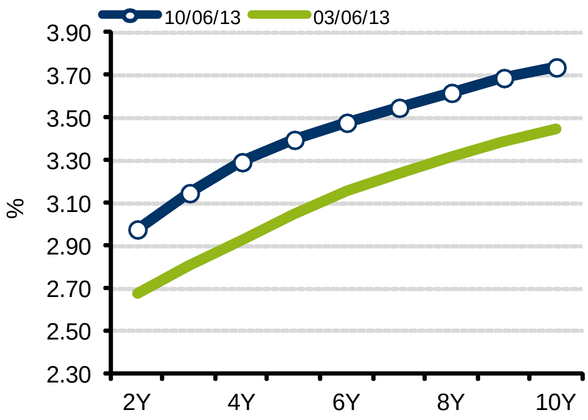
HU IRS



CDS 5Y



PL IRS



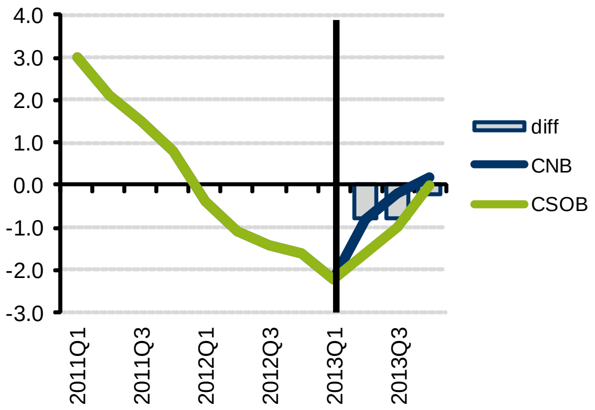
Source: Reuters

Medium-term Views & Issues

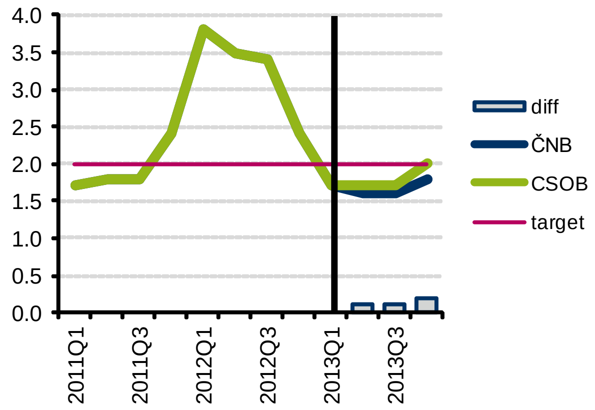
	The Czech Republic	Hungary	Poland
Growth & key issues	The Czech economy remains in a recession, which is shallower but longer than the previous one. The latest data from industry – production as well as orders – still tend to be negative. The drop in domestic demand was followed by a decline in foreign 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.	The behaviour of the NBP bears out our hypothesis that the key risk to the scenario of another rate cut is the continuation of the sale in bond markets and consequently a further depreciation of the zloty. However, these are factors that the NBP can influence by its decisions to a very limited extent, as they are primarily based on external effects, and the central bank itself acknowledges that. In any event, further rate cuts by the NBP are unlikely to benefit the zloty now, because the market, assuming from FRA and WIBOR rates, only envisages something like that to a limited extent.
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.	Two days after the bank, through its President Belka, played down the importance of the significant depreciation of the zloty, the NBP, in the wake of the release of good figures from the U.S. labour market, started to intervene in favor of the Polish currency. The interventions could limit the room for further losses of the zloty, possibly around EUR/PLN 4.32 level.

CBs' Projections vs. Our Forecasts

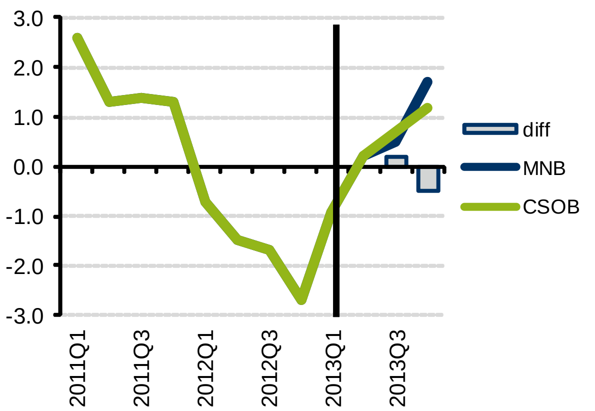
CZ: GDP outlook (Y/Y, %)



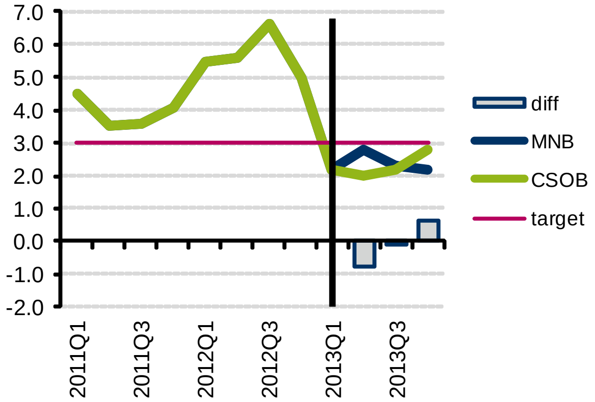
CZ: Inflation outlook (Y/Y, %)



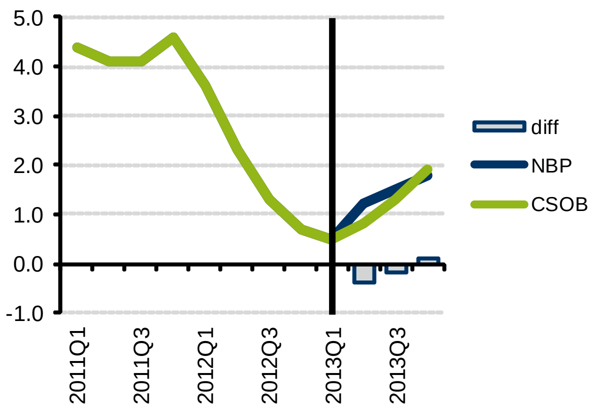
HU: GDP outlook (Y/Y, %)



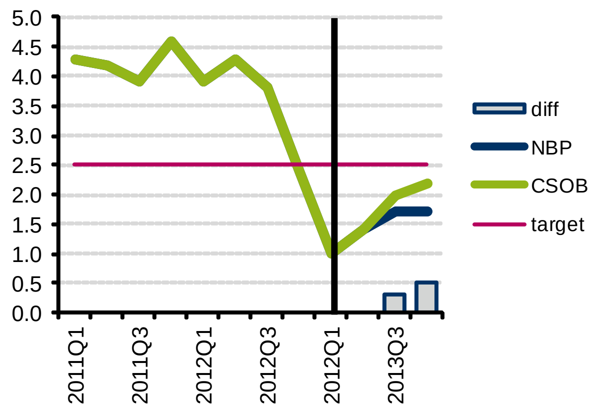
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)



Source: CNB, NBP, MNB, CSOB

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	Last change	
Czech Rep.	2W repo rate	*0.05*	0.05	0.05	0.05	0.05	0.05	-20 bps	9/27/2012
Hungary	2W deposit r.	*4.50*	5.75	5.00	4.25	4.00	3.75	-25 bps	5/28/2013
Poland	2W inter. rate	*2.75*	4.25	3.25	2.75	2.75	2.75	-25 bps	6/5/2013

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	PRIBOR	*0.46*	0.50	0.47	0.45	0.43	0.43
Hungary	BUBOR	*4.39*	5.75	4.90	4.50	4.25	4.00
Poland	WIBOR	*2.76*	4.11	3.39	2.60	2.60	2.65

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	CZ10Y	*1.7*	1.37	1.31	1.40	1.50	1.70
Hungary	HU10Y	*5.51*	5.49	5.41	5.70	5.50	5.00
Poland	PL10Y	*3.74*	3.60	3.61	3.55	3.55	3.65

Exchange rates (end of the period)

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	EUR/CZK	*25.7*	25.1	25.7	25.7	25.5	25.2
Hungary	EUR/HUF	*298*	291	304	290	300	300
Poland	EUR/PLN	*4.26*	4.08	4.18	4.00	4.00	3.90

GDP (y/y)

	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	-1.1	-1.4	-1.6	-2.2	-1.6	-1.0	0.0
Hungary	-1.5	-1.7	-2.7	-0.9	0.2	0.7	1.2
Poland	2.3	1.3	0.7	0.5	0.8	1.3	1.9

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

	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	3.5	3.4	2.4	1.7	1.7	1.7	2.0
Hungary	5.6	6.6	5.0	2.2	2.0	2.2	2.8
Poland	4.3	3.8	2.4	1.0	1.4	2.0	2.2

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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