Central European Weekly

Monday, 24 June 2013

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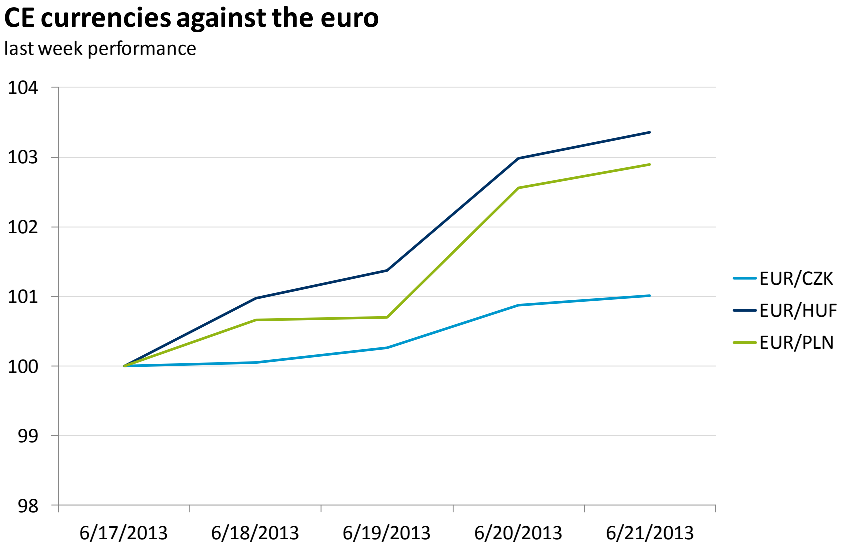
- The CNB Board meeting: downside inflation risks v. moderate economic optimism

Chart of the Week: Regional FX sell-off



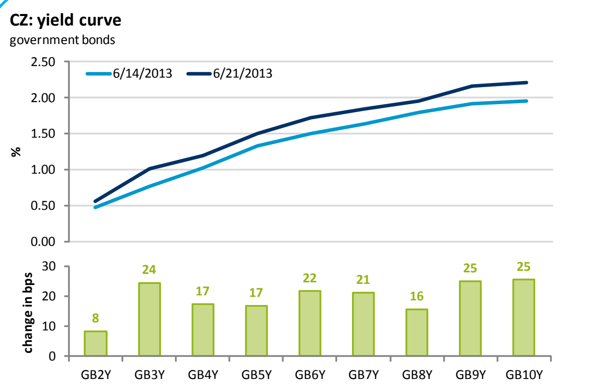
FOMC meeting accelerated sell-off on regional Forex markets. The forint and zloty have been loosing almost three percent against the euro..

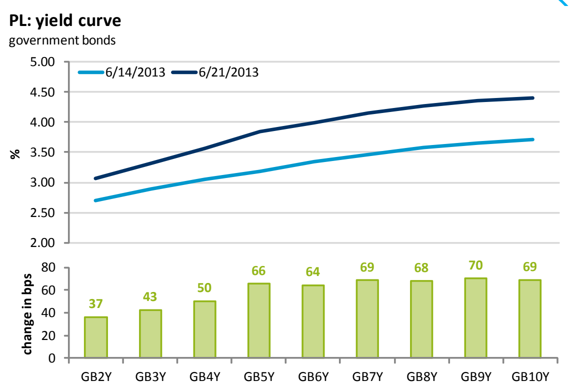
Market's editorial

Sell-off puts question mark above NBH&NBP rate cut bets

While Czech financial markets were practically unaffected by the fall of the Government and the related risk of an early election, neither the koruna nor Czech bonds (not to mention stocks) could resist the global sale of assets, triggered by Fed Chief Bernanke. Nevertheless, investors holding Czech fixed-income may feel comforted by the fact that their losses are fairly moderate compared to those in Polish and Hungarian assets. Since Wednesday's FOMC meeting, yields of Hungarian and Polish government bonds (i.e., swap rates) have surged by 50 and more basis points, while the forint and the zloty have weakened by almost 3%.

We wonder whether the current sell-off will have any substantial impact on regional policy makers – in particular the National Bank of Hungary and the National Bank of Poland. Both institutions are ready to help their respective economies by another rate cut, because inflation hovers at all-time lows there and its outlook is still favourable, given the poor domestic demand. Naturally, the threat of monetary tightening and the related rise in dollar interest rates, i.e., the capital outflows back to the US, does not favour such intentions. The question now is whether the sell-off of regional currencies and government bonds may frighten the NBP and the NBH enough to discourage them from further official rate cuts. For the time being, we believe that currency and bond losses have not reached such scale yet as to make us reconsider our bets regarding another rate cut by the NBH this week and by the NBP next month. However, like in many other areas, also here momentum matters – if asset prices in Poland and Hungary continue to fall at the current rate, we may even be 'surprised' by their central bankers preferring stable interest rates in order to maintain stability of domestic financial markets.





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	25.9	1.04%	→	→
EUR/HUF	300	2.06%	↘	↘
EUR/PLN	4.35	1.93%	↘	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.96	14.62	↗	↗
10Y HUF	6.33	15.30	↗	↗
10Y PLN	4.23	12.65	↗	↗

In Focus: CE Leading Indicators

Central European leading indicators point to a cautious bottoming process in the months ahead. While the Czech and Hungarian improvement in Flashes have already been confirmed by the hard data improvement, in Poland the bottoming process seems to be much less certain.

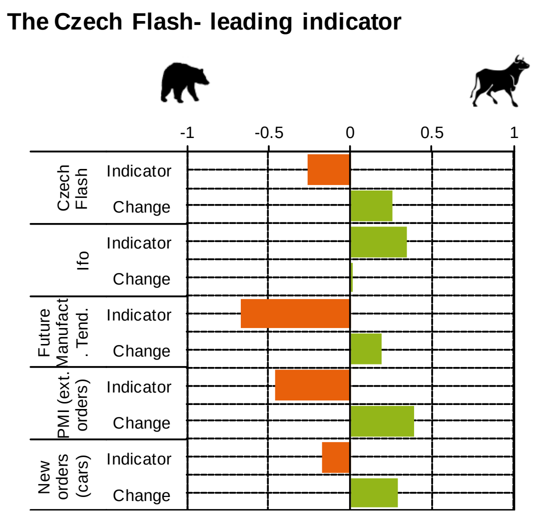
The Czech Flash rose for a seventh consecutive month in May. In addition, after a data revision, Czech industrial output went up for the third consecutive month (normalised in February, March and April).

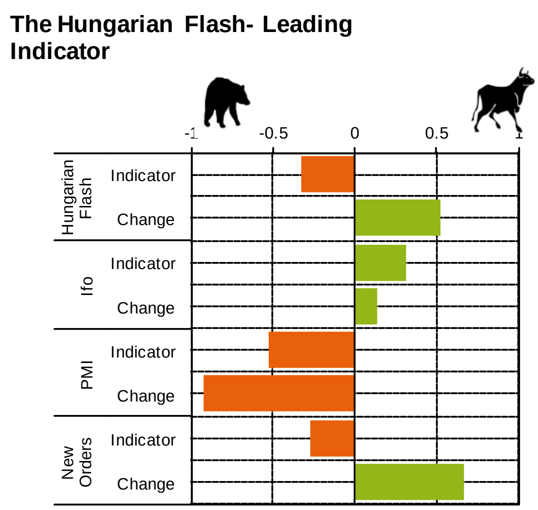
We still remain concerned about the decelerating growth rate of the Czech Flash (falling momentum) – the positive momentum has been easing for the last three months. This is not typical when an economy is bottoming out after a long recession – the signals are usually clearer and leading indicators are improving at an accelerating rate. Nevertheless on the positive side, seven consecutive improvements are a decent series, and last month again saw improvements across all components of the Czech Flash. Moreover, the improvements were bolstered by hard data from industry in the last three months. Thus an industrial recovery in the second quarter of the year seems to be increasingly likely. Of course, there are still doubts as to its strength and sustainability.

The Polish Flash improved slightly in May. However, this is no reason to rejoice after April's surprising decline. The positive accrual is still very small. This, combined with April's decline, is signalling mixed future for the Polish industry (in the 3-4 months horizon).

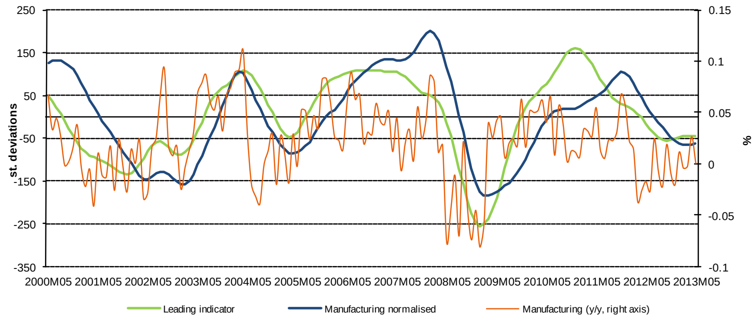
The performance of the Polish Flash is currently worse than that of its Czech counterpart. The Czech Flash, unlike the Polish one, has been rising continuously (though running out of steam). In addition, Polish industry, unlike the Czech one, has not quite hit its bottom yet. Hard data has not yet reacted to the modest improvements in the soft indicators this year.

The Hungarian Flash has been volatile recently. At the moment, the it shows fairly moderate and highly nervous accruals, which indicates moderate recovery in the months ahead. Just like in the Czech case the hard data (industrial output) are already confirming the positive turnaround. Nevertheless, the individual components of the Flash keep sending conflicting signals. While new orders in the industry posted strong gains, Hungarian PMI declined significantly in May. If the recovery is about to continue, that kind of inner divergence should diminish and positive accruals should grow.

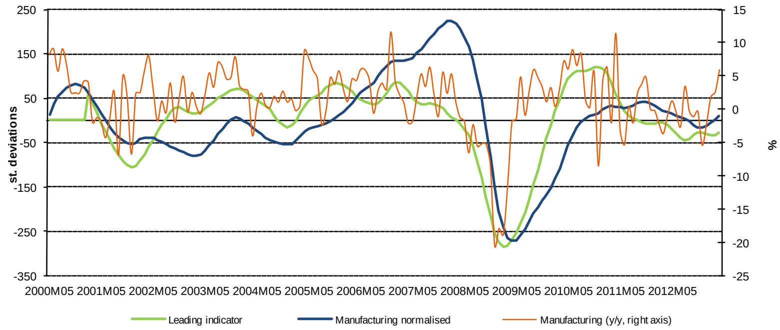




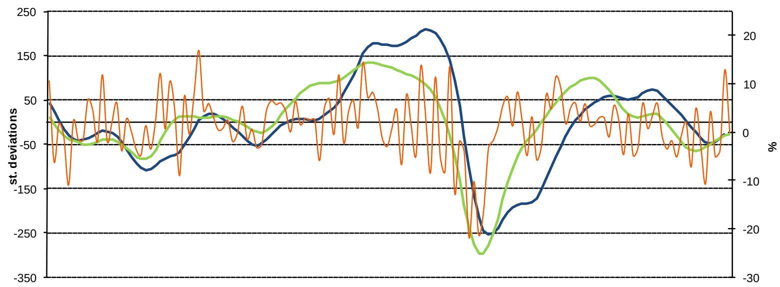
The Polish Flash - leading indicator



The Hungarian Flash - leading indicator



The Czech Flash - leading indicator



Weekly preview

TUE 14:00 NBH base rate

	This meeting	Last change
rate level (in %)	**4.25**	5/2013
change in bps	**-25**	-25

THU 13:00 CNB base rate

	This meeting	Last change
rate level (in %)	**0.05**	11/2012
change in bps	**0**	-20

HU: The NBH might cut again despite the sell-off

Not even the rapid depreciation of the forint and the sale of domestic government bonds should discourage the NBH from cutting its base interest rate again. The main (domestic) macroeconomic arguments for a cut in the base rate are currently very low inflation and its very favourable outlook.

CZ: CNB rates still unchanged

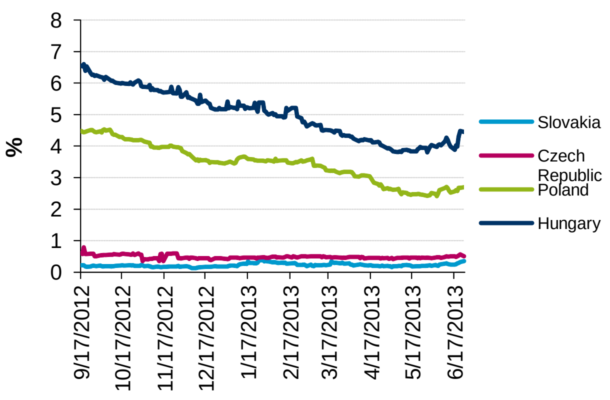
At its fourth meeting of this year, the CNB Board will have to cope with the worse than predicted performance of the Czech economy and with much lower than expected inflation. Although the new forecast will not be available to the Board before August, the graph of inflation risks to the forecast is likely to be slightly favourable for monetary easing. As the CNB announced in the autumn, the only step that might be taken is forex interventions; however, such a step would not be very well founded by the current level of the koruna (EUR/CZK 25.80). Thus we are only likely to see highlighting of the downside inflation risks to the forecast, while we may also see moderate optimism that the economy has hopefully started to bounce off its presumed bottom already.

Calendar

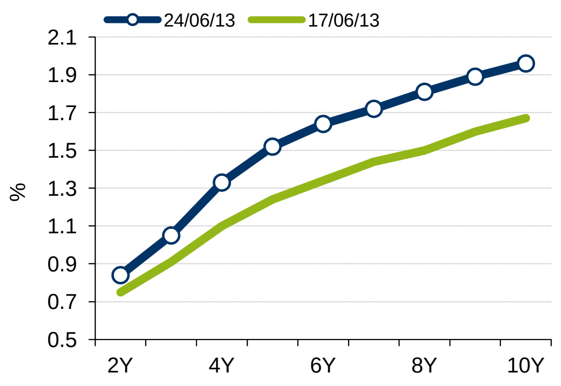
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	06/25/2013	10:00	Retail sales	%	05/2013			0.8	0	-2.7	-0.2
PL	06/25/2013	10:00	Unemployment rate	%	05/2013			13.7		14	
HU	06/25/2013	14:00	NBH meeting	%	06/2013	4.25		4.25		4.5	
HU	06/27/2013	9:00	Unemployment rate	%	05/2013			10.8		11	
CZ	06/27/2013	12:30	CNB meeting	%	06/2013	0.05		0.05		0.05	
HU	06/28/2013	8:30	Current account	HUF B	1Q/2013			120		242	
HU	06/28/2013	9:00	PPI	%	05/2013				-1.1	-1.2	0.7
CZ	06/28/2013	11:00	Money supply M2	%	05/2013						4.3
PL	06/28/2013	14:00	Current account	EUR M	1Q/2013			-2645		-3477	

Fixed-income in Charts

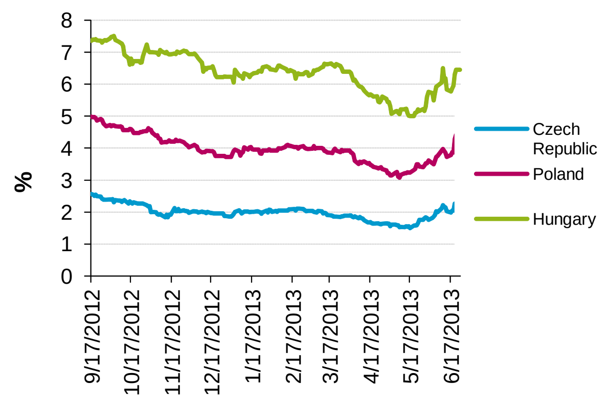
FRA 3x6



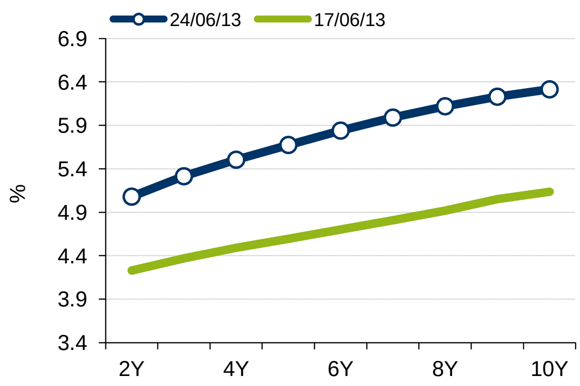
CZ IRS



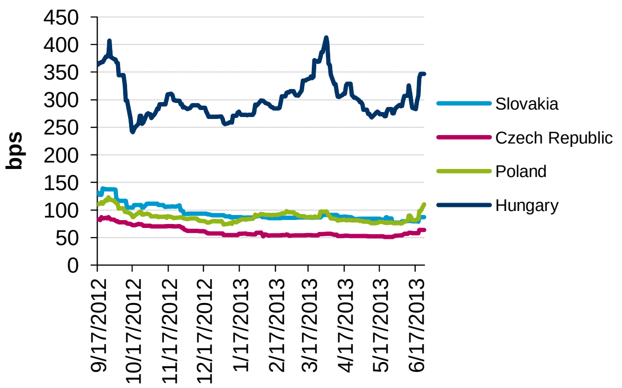
10Y GB Yields



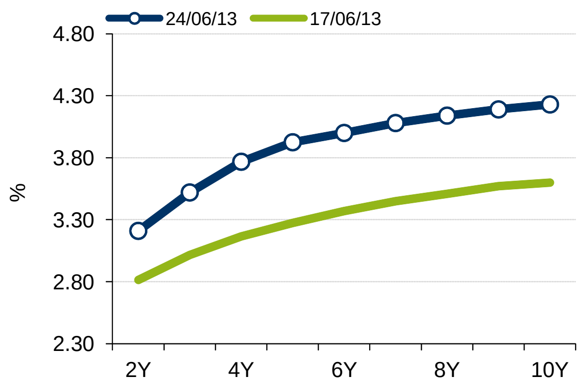
HU IRS



CDS 5Y



PL IRS



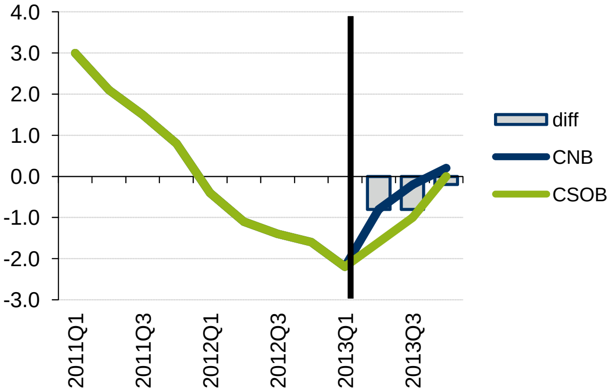
Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	Three years after last elections the Prime Minister resigned and his cabined fell. With minor exceptions, the bulk of political scene in the Czech Republic refuses to call premature elections a less than year before regular parliamentary elections. President's responsibility now is to find a new Prime Minister, who would be tolerated by a majority of the MPs and, at the same time, capable of constituting a new cabinet that would be able to govern transparently as well as to prepare the 2014 state budget.	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 the NBH rate at 4.0%, while the downside risk to our forecast is high.	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 rise in rates and yields in core markets. However, given the improvement in Hungary's balance of payments and global market sentiment, we believe that any significant forint's weakness will be rather temporary than persistent. Moreover, the NBH might opt for a pause in its easing cycle, which will be a supportive factor for the currency.	The zloty has been hit by an outflow of funds related to the rise in US government bond yields. Sharp depreciation of the zloty spurred the NBP to intervene in favor of the Polish currency. We believe that the central bank might decide to step in again if the zloty remained persistently above EUR/PLN 4.30 level (the last intervention occurred at EUR/PLN 4.32).

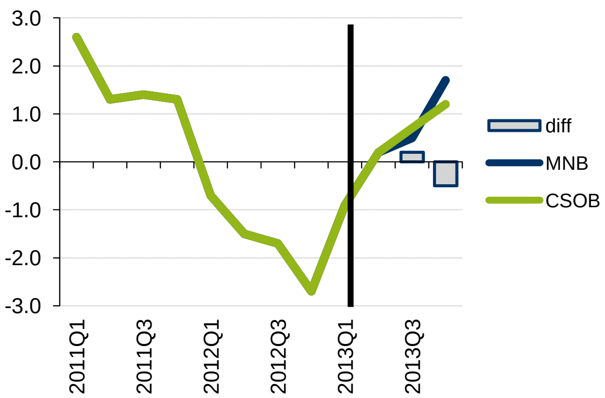
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

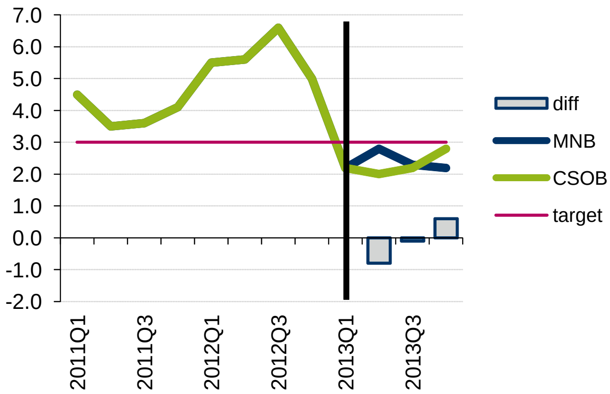


CZ: Inflation outlook (Y/Y, %)

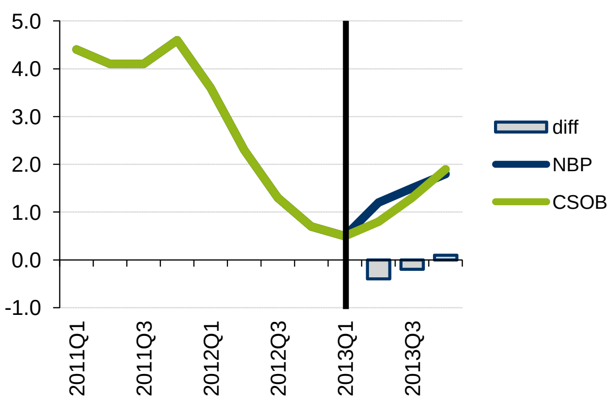
HU: GDP outlook (Y/Y, %)



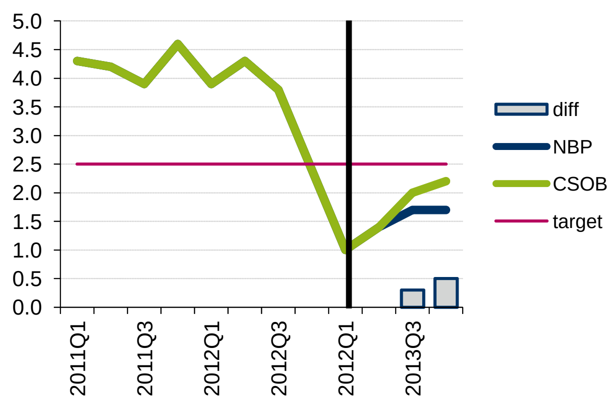
HU: Inflation outlook (Y/Y, %)



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	*4.38*	5.75	4.90	4.50	4.25	4.00
Poland	WIBOR	*2.74*	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	*1.96*	1.37	1.31	1.70	1.70	1.85
Hungary	HU10Y	*6.33*	5.49	5.41	5.70	5.50	5.00
Poland	PL10Y	*4.23*	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	*25.9*	25.1	25.7	25.7	25.5	25.2
Hungary	EUR/HUF	*300*	291	304	290	300	300
Poland	EUR/PLN	*4.35*	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	1.3	1.3	1.8
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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