Central European Weekly

Monday, 01 July 2013

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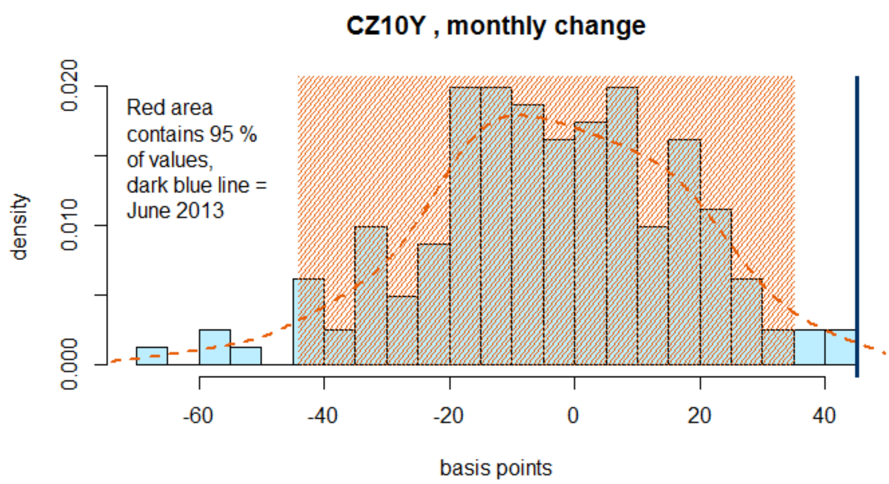
- Regional business sentiment improved in June
- The NBH did not fear to cut rates to fresh lows
- The Czech yield curve steepens sharply
- The NPB ready to cut rates to cyclical lows

Chart of the Week: June's hike in CZK swaps



Czech swap rates showed an unprecedented growth in June ***See the blue vertical line*** *in the chart above, which represents the increase of the 10Y CZK swap rate and it lies outside 95% confidence interval (Source: Bloomberg, CSOB).*

Market's editorial

The NBH did not fear to cut rates. Will the NBP follow suit?

The central banks in Central Europe evidently continue to be troubled by the fact that the actual inflation is below their inflation targets.

Last Tuesday, the National Bank of Hungary was unafraid of a dramatic sale of domestic bonds and a weaker forint and, with a view to highly favourable inflation developments, cut its base interest rate to a new all-time low. In addition, the NBH Monetary Council made it clear that this would not be its last rate cut; however, a limiting factor for its further decisions will be the behaviour of core markets, notably the developments in dollar and euro interest rates.

After Tuesday's rate cut in Hungary to an all-time low, the Czech National Bank also came out with a strongly dovish signal. Through the press conference by Governor Singer, it warned that the risks to its macroeconomic forecast were tilted on the downside and that the probability of launching interventions (against the 'strong' koruna) was consequently increasing. Singer indicated that there was not yet a majority of votes on the CNB Board in favour of an intervention against the koruna. This may change over time, depending on the development of external factors and, in particular, of domestic macroeconomic data.

We interpret Singer's comments approximately as follows: if the koruna again strengthened significantly towards the levels around which it hovered in mid-June, the launch of actual interventions in order to boost the economy would be very likely this time. Bear in mind that the EUR/CZK currency pair even strengthened below the EUR/CZK level for a short time before the release of May's surprisingly low inflation. Afterwards, however, the koruna began weakening and therefore did not provoke the CNB Board enough to intervene. In this regard, let us add that the question of CNB interventions will become clearer with a new forecast (with an implied prediction of the EUR/CZK exchange rate), which will be available to the CNB Board at its next meeting in early August.

It is the NBP's turn this week. The Polish MPC, just like the National Bank of Hungary, is likely to prefer domestic factors (low inflation and growth) over global ones (sell-off domestic bonds and a weaker zloty) and will cut its repo rate by an additional 25 basis points. Nevertheless, we believe that this will be the last expansive move in this cycle, and we would not be surprised if it affected the zloty, at least temporarily, as the Polish currency did not at all like the rising interest rates in the leading markets in the past few weeks.

The Czech yield curve steepens at an unprecedented rate

The rise in long-term market interest rates, i.e., the steepening of the yield curve in the last few weeks, is unprecedented. The phenomenon, triggered by fixed income dollar markets, has also hit the Czech market, and thus, for example, the 10Y koruna swap rate went up by 67 basis points during June. The rise is nearly pecentage point from the lows of late April and early May. This is absolutely unique in terms of probability – something like Taleb's Black Swan. Clearly, the rise in Czech market interest rates is not driven by domestic factors; it is solely a foreign affair, stemming from the concern of the U.S. bond market about the possible impacts of the fact that the Fed will no longer buy (such a large quantity of) those instruments, to add to its balance sheet. Nonetheless, compared to the development of the yields/rates of similar dollar or euro rates, their rise was not that extreme.

June's rise in the 10Y dollar and euro swap rates was only 38 and 46 basis points respectively. These increases (or even jumps) in rates still easily fit in the 95% probability interval, while nothing like that can be said of the jump in CZK swap (10 Y) rates.

Naturally, the question is how far market interest rates may climb. This is hard to predict at the moment, even though all of these events are evidently at the mercy of the U.S. yield curve. Purely on the basis of probability, the rates are unlikely to continue to rise so rapidly for another month. A black swan would not be a black swan if it occurred in pairs or even in flocks.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	26.0	0.56%	→	→
EUR/HUF	294	-0.86%	↗	→
EUR/PLN	4.32	-0.28%	↗	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2.00	-2.44	↗	↗
10Y HUF	5.75	-15.81	↗	↗
10Y PLN	4.14	-3.16	↗	↗

Review of Economic Figures

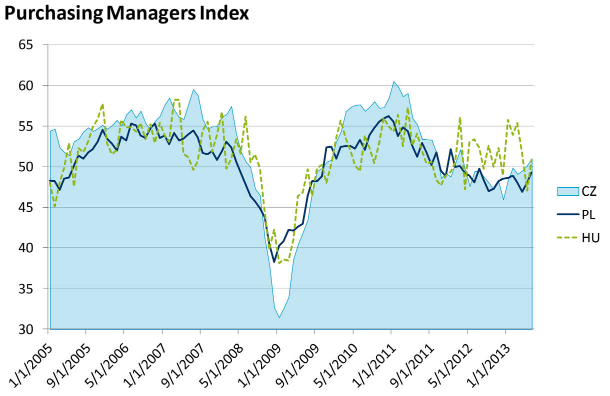
Regional bussines sentiment impreved in June

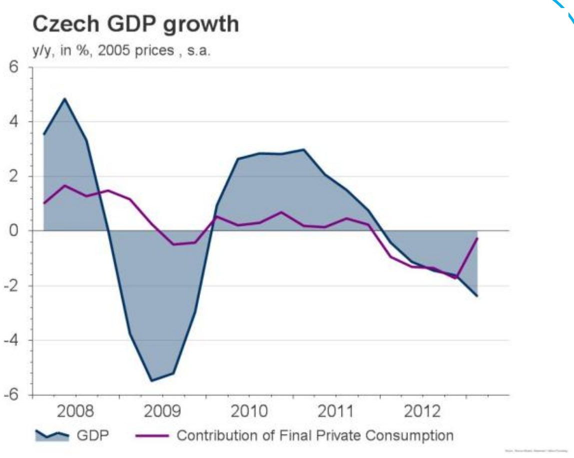
All regional PMI's for June showed an improvement of the bussiness sentiment in all three Central European economies. Maybe the most importantly, the Polish manufacturing sector surprised on the upside and improved substantially in June. Although still staying below the key 50 points level, the overall index increased to 49.3 points mainly thanks to the increase in new orders. Significant improvement in Polish PMI thus supports our bets on stabilization of the economy in the second half of this year (as it is a part of our Polish Flash leading indicator). The Czech PMI meanwhile pointed to an expansion of the industry in the second consecutive month. Crucially, new export orders picked up as well in June and supported broad-based improvement of conditions in industry. Hungarian PMI also returned back above 50 points level after a sharp decline last month.

The Czech economy: worse and even yet worse

The revision of the Czech GDP figure for the first quarter of the year included additional less favourable data. The preliminary forecast, according to which the GDP fell by -0.8% q/q (-1.9% y/y), was followed by the first forecast of 1.1% (-2.2% respectively), and now the data has been again revised downwards to -1.3% (-2.4%). The reason is an update of the data with figures on excise duties and VAT, which also influenced foreign trade figures. Thus the drop in the economy is slightly greater than previously expected, albeit still primarily attributable to a reduction of inventories, associated with extraordinary effects, such as the stockpiling of cigarette revenue stamps in late 2012. Apart from the GDP deterioration, the Central Statistical Office also published other interesting data from national accounts. A noticeable item is the record-breaking drop in the disposable income of households, which reached 1.8% in the first quarter. Another interesting fact is that the amount of household spending was much the same as last year in nominal terms; however, due to higher inflation, that amount bought a lower volume of goods and services.

The latest data has not changed our view on the development of the Czech economy, which is experiencing its longest recession ever. The economy is still at its bottom, and even though the first signs of its recovery are evident, they are still uncertain. Higher industrial orders and an improved bussiness sentiment (see the June PMIs outcome above) contrast with the falling performance of construction and certain services; not to mention a positive turnaround of consumption, which was slightly stronger than in late 2012. However, given the extraordinary and temporary factor of inventories in the first quarter, the second quarter stands a chance of being more successful, let us say stabilising, for the Czech economy. The second half of the year might already see a moderate recovery, which will strongly depend on the performance of export industries, however. The latest data from Germany makes such expectations fairly realistic.





Weekly preview

WED 14:00 NBP rate (in %)

	This	Last change
rate level	**2.50**	6/2013
change in bps	**-25**	-25

PL: the NBP to cut rates for the last time

The National Bank of Poland evidently continues to be troubled by the rapid inflation fall below the target, as well as by the adverse structure of GDP growth, which was again driven only by net exports. Although these factors had been evident for a longer time, the NBP hesitated to take aggressive steps. Nevertheless, this has changed and, given the poor start of the second quarter (and the prospects for inflation staying below the target because of the regulation of energy prices), we believe that with the release of a new forecast, the NBP will decide to cut rates by 25 bps, thus completing its current monetary easing cycle.

THU 9:00 CZ Retail sales (y/y change in %)

	May-13	Apr-13	May-12
Monhtly	**-1.5**	1.5	-1.6
cummulative (YTD)	**-1.8**	-1.9	-0.7

CZ: Poor demand drives the retail sector down

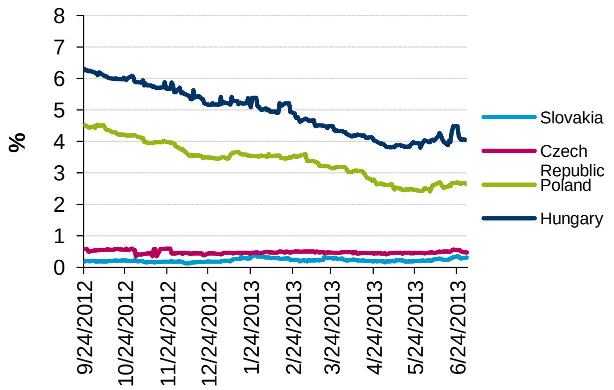
We do not expect any sign of an improvement in consumer demand from May's retail sales data either. The trend also remains negative in new car sales as well as in consumer goods. The fall in real household income, along with poor consumer confidence, does not currently hold out any hope of any quick change of the negative spending trend in the retail sector. Of course, we are aware of the positive result for the previous month, but it was attributable to an additional business day in that month.

Calendar

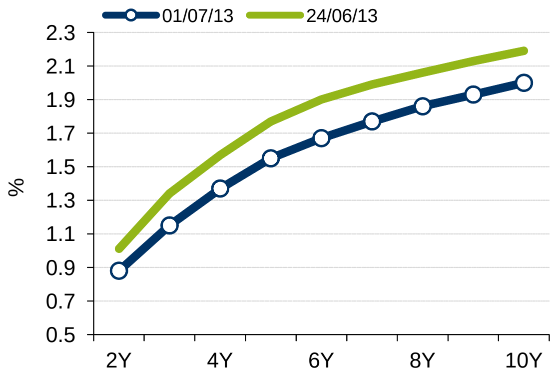
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	07/01/2013	9:00	PMI manufacturing		06/2013					47.1	
PL	07/01/2013	9:00	PMI manufacturing		06/2013					48	
CZ	07/01/2013	9:30	PMI manufacturing		06/2013					50.1	
CZ	07/01/2013	14:00	Budget balance	CZK B	06/2013					-39.8	
HU	07/02/2013	9:00	Trade balance	EUR M	04/2013 *F					700.5	
PL	07/03/2013	14:00	NBP meeting	%	07/2013	2.5		2.5		2.75	
CZ	07/04/2013	9:00	Retail sales	%	05/2013		-1.5				1.5
HU	07/04/2013	9:00	Retail sales	%	05/2013						3.4
HU	07/05/2013	9:00	Industrial output	%	05/2013 *P					1.2	2.9

Fixed-income in Charts

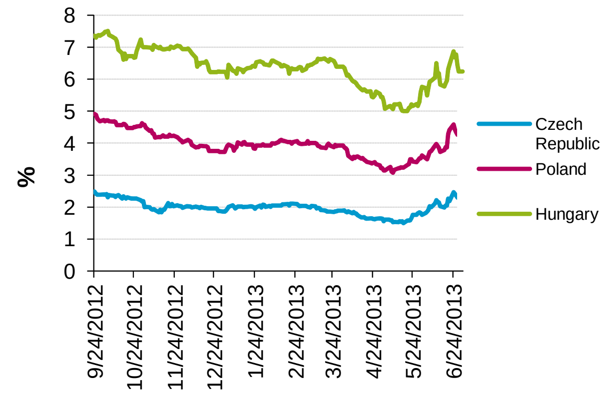
FRA 3x6



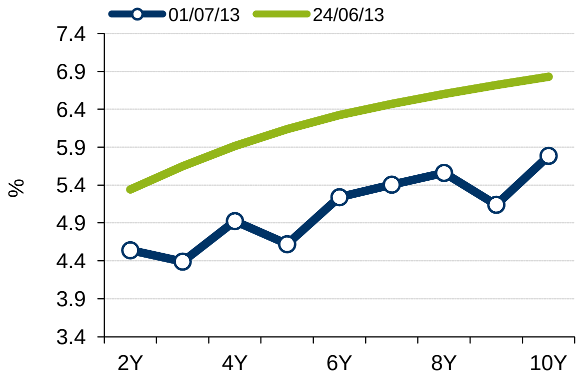
CZ IRS



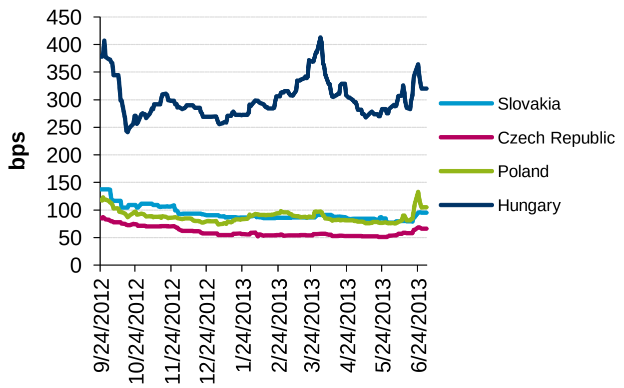
10Y GB Yields



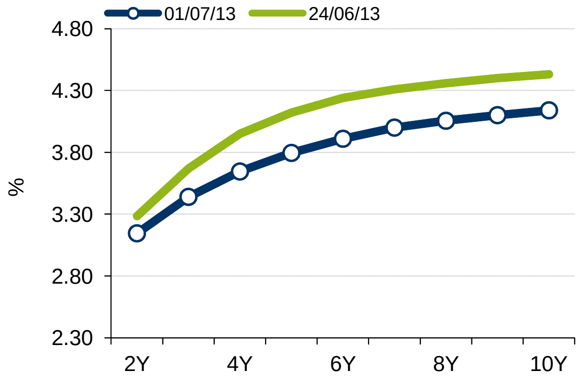
HU IRS



CDS 5Y



PL IRS



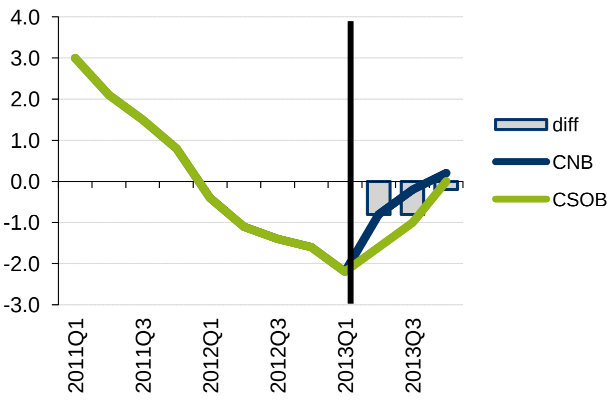
Source: Reuters

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).

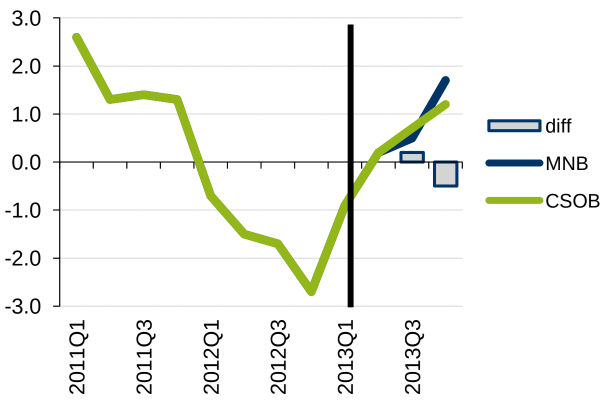
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

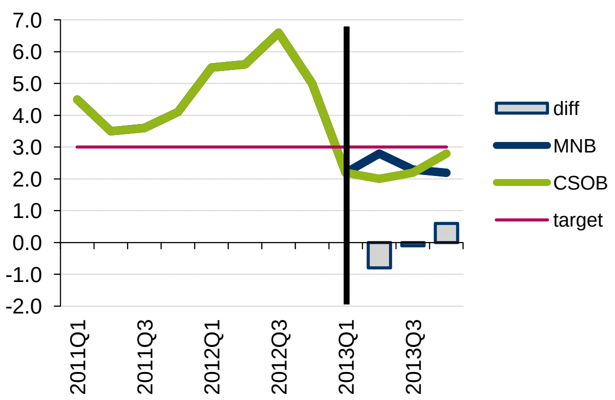


CZ: Inflation outlook (Y/Y, %)

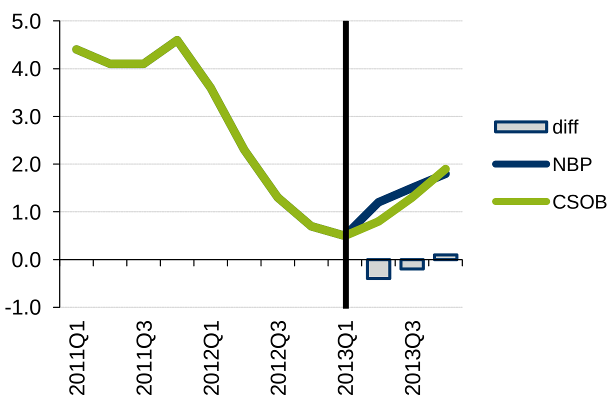
HU: GDP outlook (Y/Y, %)



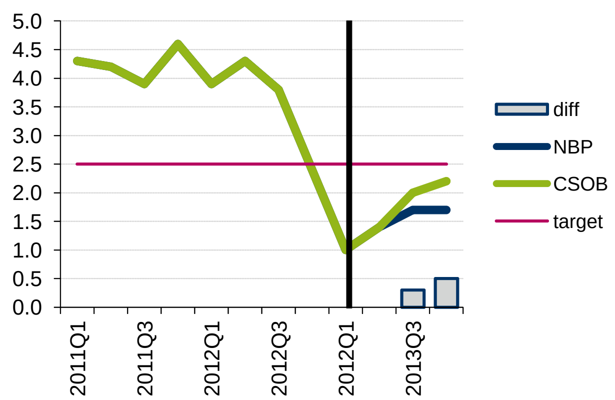
HU: Inflation outlook (Y/Y, %)



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.	*4.25*	5.75	5.00	4.25	4.00	3.75	-25 bps	6/25/2013
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	*4.20*	5.75	4.90	4.50	4.25	4.00
Poland	WIBOR	*2.73*	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	*2*	1.37	1.31	1.90	1.90	2.00
Hungary	HU10Y	*5.75*	5.49	5.41	5.70	5.50	5.00
Poland	PL10Y	*4.14*	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	*26.0*	25.1	25.7	25.7	25.9	25.5
Hungary	EUR/HUF	*294*	291	304	290	300	300
Poland	EUR/PLN	*4.32*	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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