Central European Weekly

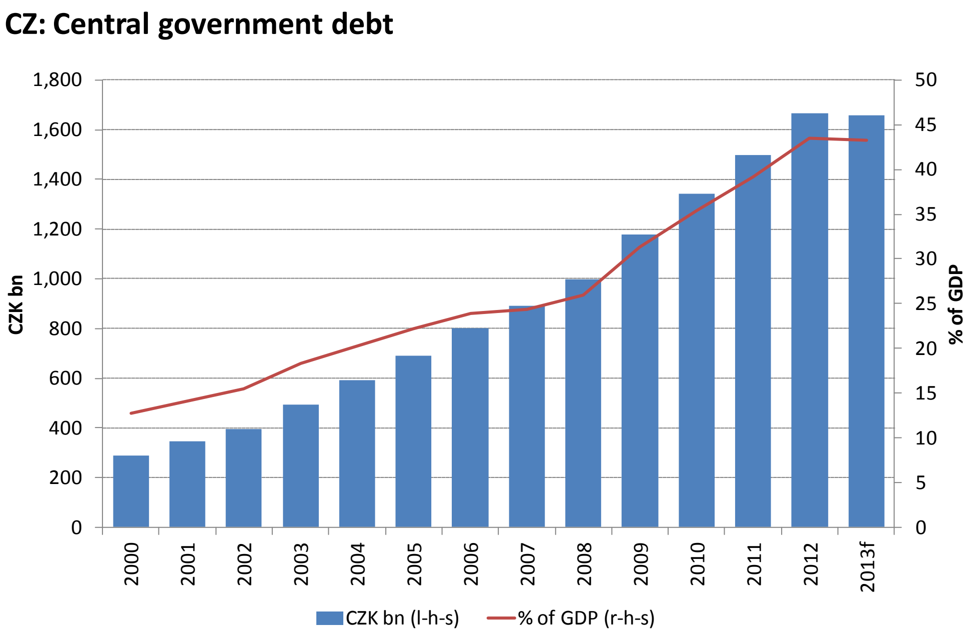
Monday, 15 July 2013

Table of contents

Weekly Highlights:

- CE bonds in a recovery mode
- The Czech MinFin cuts its further financing needs
- While inflation ticks higher in the Czech Republic and Hungary, in Poland drops to all-time lows

Chart of the Week: Czech Debt ready to fall



Market's editorial

Bond recovery driven by foreign central banks

Central European bonds are successfully eliminating the losses generated in late May and early June. This is paradoxically happening despite the fact that, for example, Czech and Hungarian inflation went up; however, inflation is certainly not a factor that should trouble Central European government bond markets, because, among other reasons, the year-on-year rise in consumer prices in the region is still lower than the inflation targets of the respective central banks.

The primary factors to have propelled government bond prices in the region were statements made by central bankers in other countries. Particularly Hungarian and Polish bonds reacted to the first wave of the series of dovish comments coming from the Fed in late June. Another positive signal subsequently came from ECB President Draghi, whose fairly dovish attitude also sprang a surprise. Finally, last week, Fed Chief Bernanke partly negated his surprisingly hawkish statements made after the last FOMC meeting. This led to a global fall in market interest rates, which also hit Central European markets. Thus bond yields in Central Europe dropped radically in the last three weeks, although they still remain well above this year's lows, which will hardly be reached.

Let us add that one specific factor had a positive effect on Czech bonds: the release of the new Government Debt Financing Strategy. The strategy indicates that, if the Czech Ministry of Finance succeeds in completing the Treasury project, then, given the existing budget developments, the Czech Republic's government debt may decline in nominal terms this year.

The Czech MinFin will curb bond supply further

Outgoing Minister of Finance Kalousek unveiled a revision to its Funding and Debt Management Strategy for 2013. In this strategy, the Czech MinFin has further reduced its borrowing needs for this year. The Ministry is going to borrow CZK 110-140 bn less than originally planned (CZK 230.7 bn). Thus the gross borrowing need of the Czech State has fallen to CZK 90.7-120.7 bn, with the Ministry of Finance having obtained more than CZK 71 bn of that updated amount by the end of June alone.

Hence the already healthy position of the Czech State in the financial market may even improve as its issuance needs for this year have been virtually met. At last, the Czech Republic is putting in place the State Treasury System, owing to which all liquidity in the public sector will be available to the State in a single account managed by the central bank. This free liquidity currently amounts to approximately CZK 250 bn, and thus the Ministry of Finance no longer needs to borrow so much to sufficient reserves.

This time, the reduction of issued T-bills in favour of bonds will lead to quite reasonable extensions of debt maturities. Thus the revised Funding and Debt Management Strategy still provides clear bias for more bond issues in the domestic market and, where appropriate, in a foreign market, while envisaging the continuation of the successful practice of issuing government savings bonds for individuals and selected institutions. Consistent with this is the issue schedule for July and August, which envisages bonds for CZK 4-16 bn and CZK 4-14.5 bn respectively.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*26.0*	*0.44%*	→	→
EUR/HUF	*292*	*-0.50%*	↗	↗
EUR/PLN	*4.29*	*-0.90%*	↗	→

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*1.92*	*1.38*	↘	↗
10Y HUF	*5.37*	*-1.65*	↘	↗
10Y PLN	*3.79*	*-2.45*	↘	↗

Review of Economic Figures

Bond recovery driven by foreign central banks

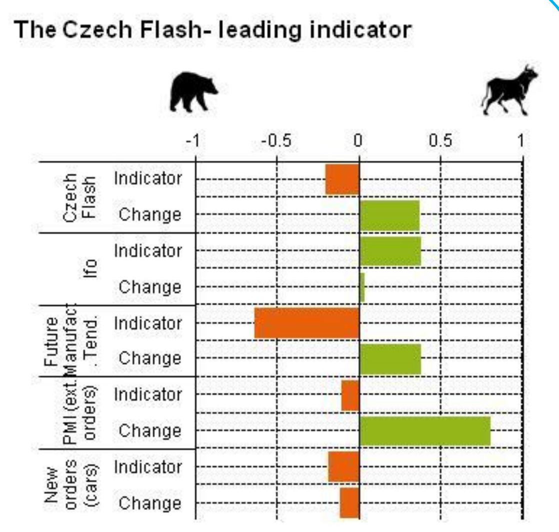
After the negative surprise of May industrial production figure, foreign trade data shows also a slowdown of economic revival in May. Export decreased by 1.9% YoY in May while import was down by 0.9% YoY in May. Export and import expanded by 11.7% YoY and 7.6% YoY respectively in April. As the industrial production increased every month in January and April period on month-on-month basis, market became slightly more optimistic about the economic recovery in Hungary. The latest figures confirm our conservative view that Hungary may be able to avoid recession in 2013, but the dynamic of growth may remain modest and real GDP growth may be around 0.3% YoY in 2013.

Foreign trade figure also confirms our view that domestic demand remained subdued in 1H13, so Hungary's economic performance still depends on the external environment and mainly on the European developments. As a positive effect of the balance adjustment process, the foreign trade balance was EUR653m in May and YTD EUR3.1bn, which is the second highest read in the history. 12m rolling trade balance to GDP figure circulated around 7.5% in the last one year. German IFO index suggest that export may catch up slightly in the following months, so foreign trade surplus may widen further. Poor economic outlook calls for continuation of rate cut cycle, base rate may cut by 25bp to 4% in July.

Another fall of the Czech industrial production and new orders

On the one hand, May's industrial output met expectations, having fallen by 2.2% y/y, with mining and car production responsible for the year-on-year drop this time, which was no great surprise; nevertheless, the attention of the most important Czech sector is focused on new orders, and these are definitely no reason to rejoice. While a month earlier, orders looked fairly promising (+5.8%), now they have fallen by 6.1% y/y. Naturally, this may be due to last year's stronger comparative baseline, because total orders and, in particular, cars, performed very reasonably in May last year, but we need to wait for the months to come to see whether this will be confirmed or disproved. In any event, we do not see the current figure from industry as dramatic or overwhelming, and we do not even consider the outlook for industry – unlike the outlook for construction – to be that gloomy.

The second half of the year should see a more stable rise in production as well as orders, owing not only to a better outlook for European demand, but also to the stabilisation of domestic demand. In addition, industrial firms, which have recently cut their workforce by 1.8%, under recessionary pressure, might stop dismissing their staff over the course of time. After all, KBC/CSOB leading indicator the Flash is also fairly positive in this regard.

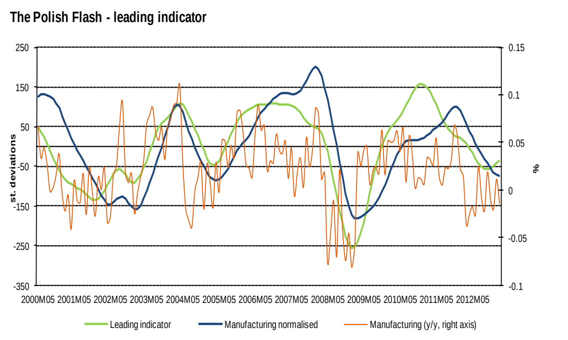


the level of the indicator vis-à-vis historical values
**Change: the change in the indicator vis-à-vis historical values

While inflation ticked higher in the Czech Republic and Hungary, in Poland dropped to all-time lows

Hungary's consumer price index increased by 0.2% MoM in June and inflation was up by 1.9% YoYvs market consensus of 1.8% YoY. Core inflation slowed down from 3.2% YoY in May to 3.0% YoY in June.

The main driver of the low inflation in Hungary is the moderation of households' energy prices (utility cost reduction by the government at the beginning of the year) and the low domestic demand especially for tradable durable goods. The government introduced additional utility cost cut for water and drain fee, rubbish carriage cost by 10% from July, which moderates inflation further, but on the other hand the price of the tobacco may increase from mid-July, because the government widened the maximum spreads of the retail profit margin to 10%.



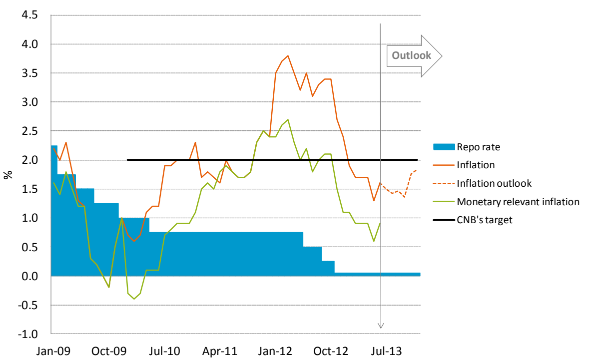
There is an upward pressure on fuel price as well because of increasing brent price and stronger USD compared to June. Additionally food and market services prices are running above 4% YoY and the former has a slightly accelerating tendency.

In the read of monetary council Hungarian inflation is well anchored because of very low domestic demand. Although they see that some measures implemented by the government may have some upward pressure on inflation, the effect of these measures may be very limited because of the strong competition for the consumers. The council see inflation target of 3% YoY achievable on the relevant time horizon (6 to 8 quarters ahead), while economic performance is still vulnerable and subdued, which allows looser monetary policy. We see average inflation at 2.2% YoY in 2013 and around 3% YoY in 2014, but CPI may accelerate close to 3.5% YoY at the end of 2014.

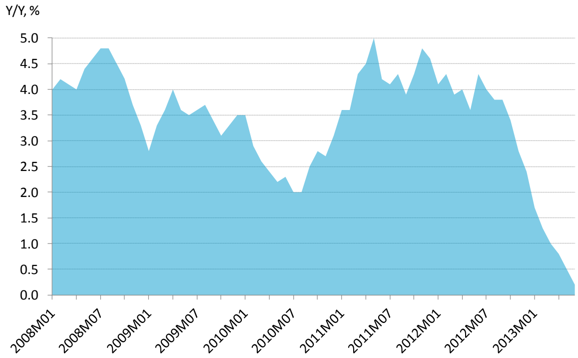
June's consumer prices in the Czech Republic rose more than was expected by the market. The CPI was up by 0.4% m/m, due in particular to an increase in food prices by nearly 3%. What is known as the potato effect occurred, i.e., the switch from ware potatoes to new potatoes. Thus the increase in food prices partly offset the impacts of the falling price plans for mobile calls taking place in the Czech market in recent months. Year-on-year inflation rose from May's 1.3% to 1.6%, thus exceeding the central bank forecast, which envisaged inflation of only 1.4%. While in the past we used to see inflation in the Czech Republic as being primarily generated by regulated housing prices, now it is primarily driven by food prices – i.e., the second largest component of the household consumer basket

Regarding the fresh figures on Polish inflation for June, it came out more or less in line with our expectations. That said, year-on-year inflation further slowed and hit an all-time low at 0.2 percent even as prices stagnated on a month-on-month basis (we expected 0.1 % decrease; the largest surprise was 0.4 % increase in transport prices). Although inflation stays markedly below the level targeted by the central bank (NBP) - which is 2.5 percent with 1 percentage point tolerance band - we do not expect the NBP will react to such developments, and will keep rates at the all-time low of 2.5%. We think that inflation hit its rock bottom in June. Nevertheless, the planned reduction in energy prices for households might curb inflation below 0.5% y/y even during the summer.

CZ: Inflation and interest rates



PL: CPI inflation

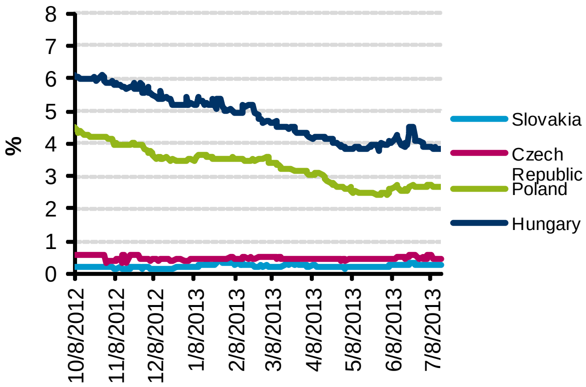


Calendar

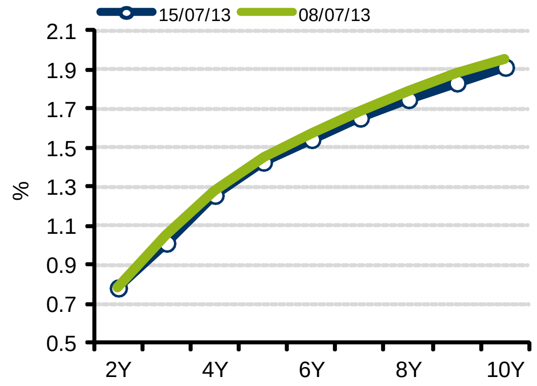
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	07/15/2013	9:00	PPI	%	06/2013	0	0.6	-0.1	0.6	-0.3	0.3
PL	07/15/2013	14:00	CPI	%	06/2013	-0.1	0.2	0.1	0.3	-0.1	0.5
PL	07/15/2013	15:00	Budget balance	PLN M	06/2013					-30943	
PL	07/16/2013	14:00	Wages	%	06/2013			3.4	2.1	-3.4	2.3
PL	07/16/2013	14:00	Core CPI	%	06/2013			0.1	1	-0.1	1
PL	07/17/2013	14:00	Industrial output	%	06/2013			1	1.3	-0.7	-1.8
PL	07/17/2013	14:00	PPI	%	06/2013			0.2	-1.8	0.1	-2.5

Fixed-income in Charts

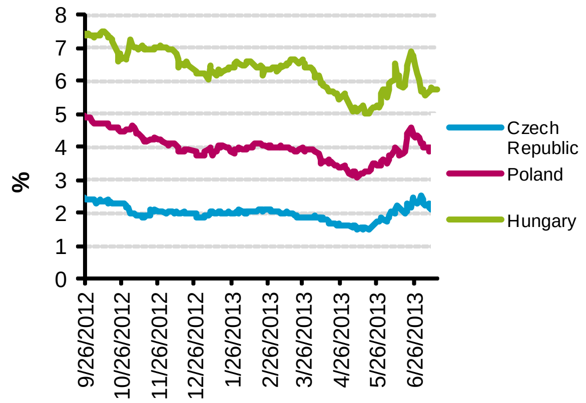
FRA 3x6



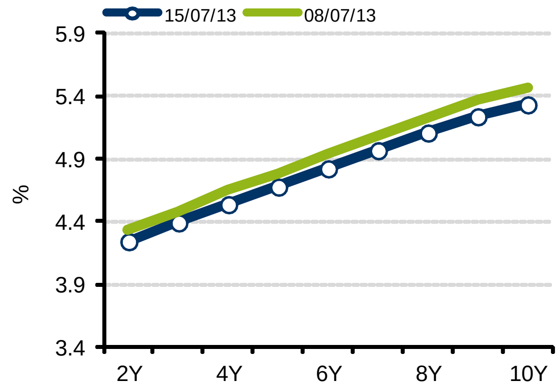
CZ IRS



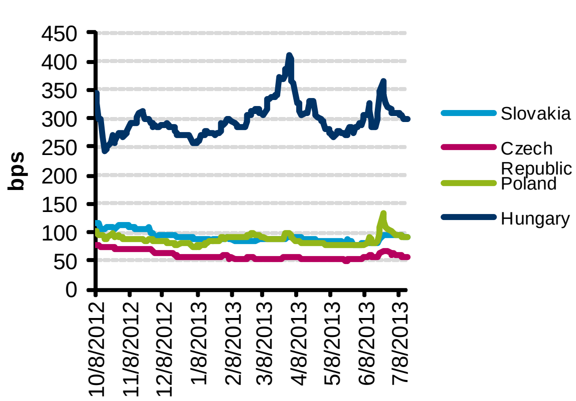
10Y GB Yields



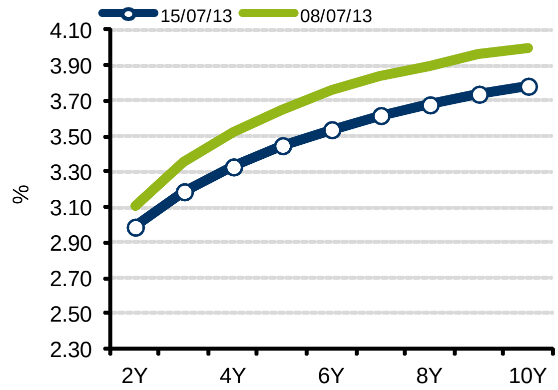
HU IRS



CDS 5Y



PL IRS



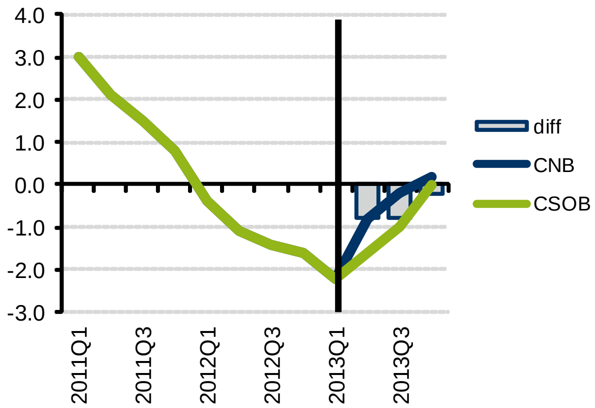
Source: Reuters

Medium-term Views & Issues

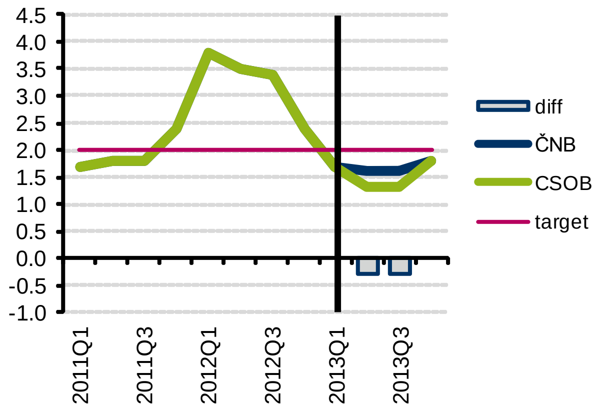
	The Czech Republic	Hungary	Poland
Growth & key issues	Three years after last elections the Prime Minister resigned and his cabined fell. With minor exceptions, the bulk of political scene in the CR refuses to call premature elections a less than year before regular parliamentary elections. Newly formed “independent” caretaker government has to ask the Parliament for confidence and start to prepare the 2014 state budget. Prior to that, the Parliament will vote on its dissolution that is on premature elections.	Negative signs of growth in May about second quarter economic performance. Industrial production decreased by 2.1% YoY. The ongoing fall of electronic devices were standing behind the bad May figure, while car manufacturing companies are still helping industrial production. It looks that in 2Q13 Hungary’s GDP may slow down on QoQ basis from the very impressive 0.7% QoQ growth in 1Q13, but may remain in the positive territory. We expect 0.3% YoY growth from 2013.	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.	The NBH feels comfortable itself with the latest consumer price index development and sees inflation target of 3% achievable on relevant time horizon. In the mean time economic performance is still subdued so they see further room for rate cut. The possible slowdown of FED’s QE policy calls for more cautious monetary policy in the future, so NBH will monitor market development very closely. Until the international sentiment remains favorable monetary council may continue rate cut cycle, so we expect that base rate may be moderated from 4.25% to 4% on 23 July.	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, the central bank decided recently to cut interest rates to a new all-time low at 2.5%. Although inflation is seen markedly below the target (and is expected to stay there in the rest of this year), we expect the NBP to keep rates unchanged.
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 EURHUF remained relatively sensitive on international developments but it was traded mainly in a range of 290 and 300. As a narrower range we can name 292 and 297 which is between the 100 and 200 days moving average. The recent wide range if acceptable for the NBH, and we see that NBH may tolerate around 305 and 310 levels for a couple of weeks as well without any active intervention. We expect that in the positive market sentiment the above mentioned trading range may remain in the following weeks.	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

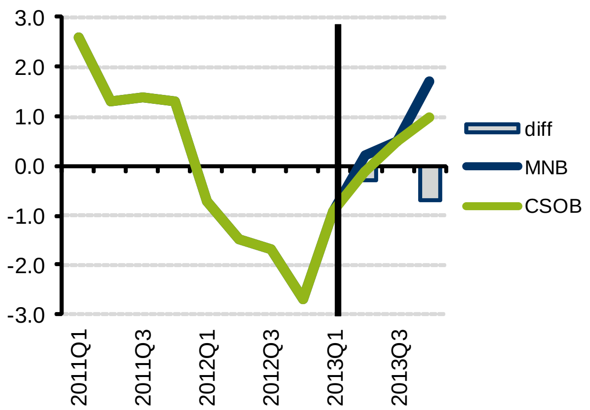
CZ: GDP outlook (Y/Y, %)



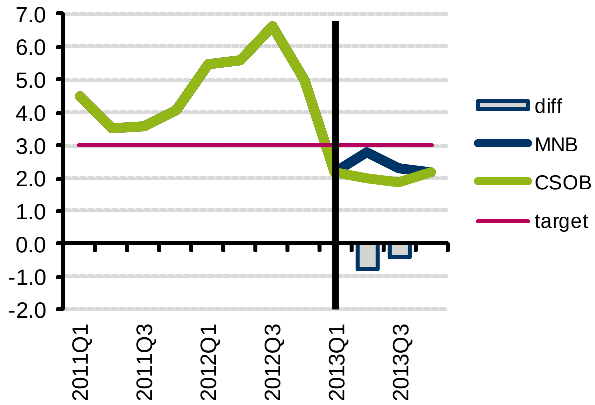
CZ: Inflation outlook (Y/Y, %)



HU: GDP outlook (Y/Y, %)

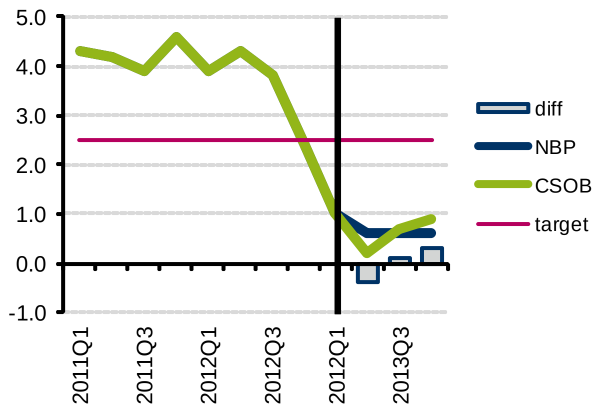


HU: Inflation outlook (Y/Y, %)



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	3.75	3.75	-25 bps	6/25/2013
Poland	2W inter. rate	*2.50*	4.25	3.25	2.75	2.75	2.75	-25 bps	7/3/2013

*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	0.44	0.43	0.43
Hungary	BUBOR	*4.19*	5.75	4.90	4.20	3.80	3.90
Poland	WIBOR	*2.69*	4.11	3.39	2.73	2.60	2.65

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	CZ10Y	*1.916*	1.37	1.31	1.97	1.90	2.00
Hungary	HU10Y	*5.37*	5.49	5.41	5.84	5.80	6.20
Poland	PL10Y	*3.79*	3.60	3.61	4.14	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	26.0	25.9	25.5
Hungary	EUR/HUF	*292*	291	304	295	300	300
Poland	EUR/PLN	*4.29*	4.08	4.18	4.33	4.25	4.20

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	-0.1	0.5	1.0
Poland	2.3	1.3	0.7	0.5	0.6	1.2	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	1.9	2.2
Poland	4.3	3.8	2.4	1.0	0.2	0.7	0.9

Current Account

	2012	2013
Czech Rep.	-1.9	-1.9
Hungary	1.5	2.0
Poland	-4.0	-3.8

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-4.4	-3.0
Hungary	-2.5	-2.7
Poland	-3.9	-4.0

Source: CSOB, Bloomberg

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