Central European Weekly

Monday, 25 November 2013

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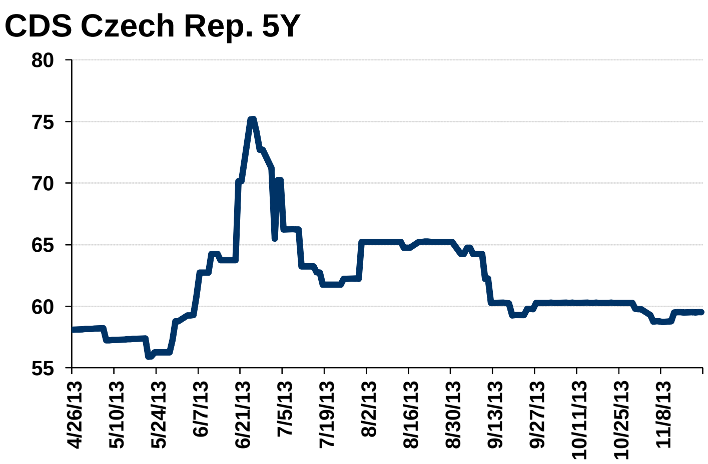
Chart of the Week: Czech Sovereign Risk



The Czech sovereign risk has been quite stable in the post-election period..

Market's editorial

The IMF supports the CNB's involvement in currency wars

We would like to put the CNB-intervention-koruna topic behind us. Unfortunately, we cannot do so, because the topic still sparks surprisingly lively discussions. Last week, key the CNB Board member Lízal admitted, for some people surprisingly, that the exchange rate of CZK 28 per EUR would be no science-fiction for the CNB. Virtually, immediately afterwards, the IMF came out with a statement that in fact supported the CNB's action, to the extent that the IMF sees it as correct, in view of imminent deflationary pressures. The IMF's approval of the CNB's policy is important, because the IMF is the main arbiter as to whether a country is stirring up currency wars and, if a country does launch them, whether such action is justifiable.

What to add? While the CNB surprised us by launching its intervention regime against the koruna in November, its current actions are completely consistent with what central banks in developed countries currently do. We believe that a one-off 5% weakening of the koruna resolves nothing – neither in terms of inflation nor in terms of growth; however, this does not mean that the CNB will abandon its current policy. In effect, just the contrary may be true. Just as the Fed put in place the policy of quantitative easing – at first QE I, and then when there was a risk that its policy would not work, it switched to QE II, and eventually ended up with QE III, which will never end, the CNB may weaken the koruna to specific target levels, on and on. If the weakening of the currency to the EUR/CZK 27 levev does not work, the bank may easily push it to the EUR/CZK 28 level or rather higher. In that event, really no one would argue with the central bank that its policy will have evident impacts.

Thus the above conclusion has its practical implications: since the launch of the interventions, no one has said that the exchange rate of the koruna must be fixed to CZK 27.0 per EUR. If Czech data continues to deliver unpleasant surprises (like the latest GDP figure), the situation may always be evaluated in such a way that the CNB will wish to continue to open up the monetary channel and weaken the koruna in the Czech version of quantitative easing. After all, this is exactly how the U.S. market in government bonds has evaluated incoming information ever since the Fed launched its policy of buying bonds to add them to its balance, financed by printing new dollars.

Promising talks about the new Czech government

While the CNB interventions have grabbed most of attention of the Czech public and financial markets another important issue should be monitored too - forming of a new Czech government coalition after parliamentary elections held on October 26th.

Last week, Bohuslav Sobotka, head of the Czech Social Democratic Party (CSSD), was given a mandate by president Zeman to lead talks about forming a new government. The CSSD nominally won the elections, but the true winner was the ANO 2011, a party founded by billionaire Andrej Babiš a couple of years ago that surprisingly collected nearly 20 % of votes. At present moment, it seems that the future government will most likely consist of the CSSD, the ANO 2011 and the Christian Democrats.

While it is too early now for a definite program of the new cabinet (we can expect it in December at best) some important indications regarding its content have been available. ANO may succeed in its effort to freeze CSSD´s plans for income tax hikes. And prospective coalition parties look ready to boost public investment projects, especially in the infrastructure (highways, railways, etc.). We have to wait definitely for the end of negotiations and also implementation details, but so far it looks that the program to be born can be market-friendly and does not damage the Czech sovereign risk, which has been quite stable in the post-election period.

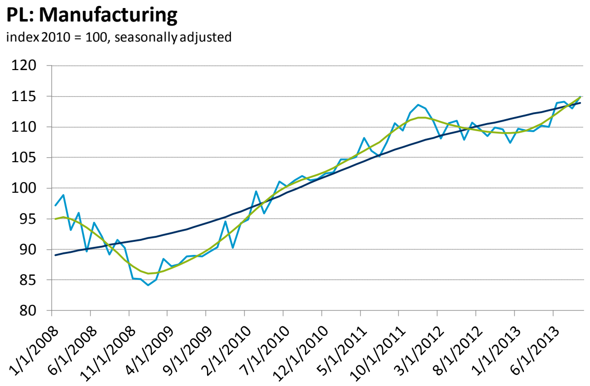
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.3	0.33%	→	→
EUR/HUF	299	0.46%	→	↘
EUR/PLN	4.19	0.38%	→	↘

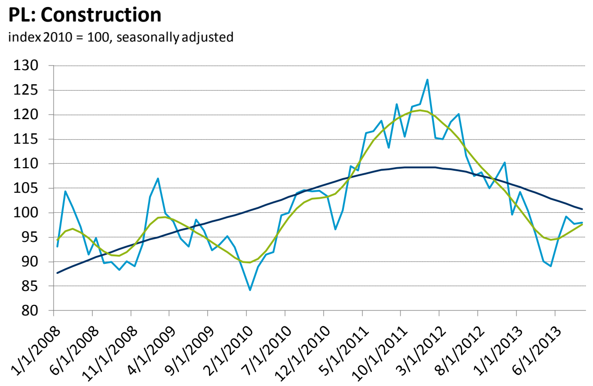
	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	2.06	4.42	↗	↗
10Y HUF	5.31	1.53	↗	↗
10Y PLN	4.18	1.58	↗	↗

Review of Economic Figures

The Polish industry confirms a strong beginning of the last quarter

Industrial output in Poland was up by 4.4% y/y in October (3.8% when seasonally adjusted) and confirmed that Polish industry also opened the last quarter of the year in a quite big way. Output rose in 26 of 34 sectors of industry, and the encouraging fact is that some of them are also those greatly contributing to the total value added, such as the manufacture of rubber and plastic products (+11.5% y/y) or the production of means of transport (+10.2% y/y). From the beginning of the year to October, industrial output rose by 1.7% vis-à-vis the same period of last year. On the month-on-month basis, industrial output went up by 0.2%. October seems to have seen an improvement not only in industry but also in construction, where output rose by 2.3% m/m according to data from the Polish Statistical Office.





Weekly preview

TUE 14:00	NBH base rate	
	This meeting	Last change
rate level (in %)	**3.20**	10/2013
change in bps	**-20**	-20

HU: Another rate cut and dovish statement

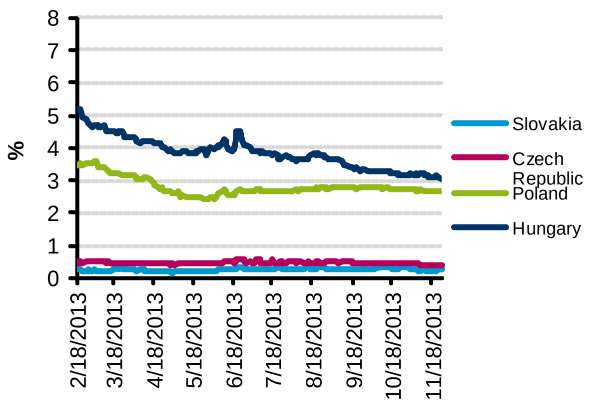
The latest macroeconomic figures delivered some surprise for the market. CPI fell to 0.9% YoY in October from 1.4% in September and based on the already approved public utility cost reductions, inflation may decrease further and may remain below average 2% YoY in 2014. Although core inflation stuck between 3% YoY and 3.5% YoY, the inflation expectations are still modertaing and getting closer to 3% YoY, which is the inflation target of the NBH. GDP accelerated from 0.5% YoY in 2Q13 to 1.7% YoY in 3Q13 mainly driven by agriculture, industrial production and construction (the latter is driven mainly by government's investment). The output gap is still negative, which together with the low inflationary figure gives room for further rate cut for the NBH. The EURHUF was traded mainly in a narrow range of 295 and 299, the international market environment remained positive. With ECB's rate cut, NBH can also loosen its monetary policy, additionally Debt Management Agency was able to issuance USD2bn 10-year Rephun, which moderates the refinancing risk of Hungary in 2014. So we maintain our expectation that NBH my cut base rate by 20bp from 3.4% to 3.2% and the statement may end with dovish stance allowing further cut if international sentiment remains supportive.

Calendar

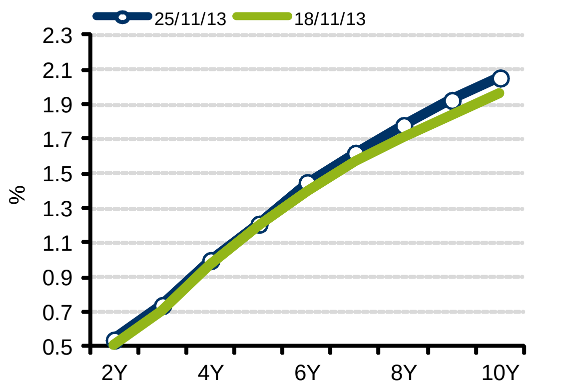
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	11/26/2013	10:00	Unemployment rate	%	10/2013			13		13	
PL	11/26/2013	10:00	Retail sales	%	10/2013			4.8	4.3	-0.9	3.9
HU	11/26/2013	14:00	NBH meeting	%	11/2013	3.2		3.2		3.4	
HU	11/27/2013	9:00	Unemployment rate	%	10/2013			9.8		9.8	
HU	11/29/2013	9:00	PPI	%	10/2013				1.6	0	1.6
PL	11/29/2013	10:00	GDP	%	3Q/2013 *F					0.6	1.9
CZ	11/29/2013	11:00	Money supply M2	%	10/2013						5.1

Fixed-income in Charts

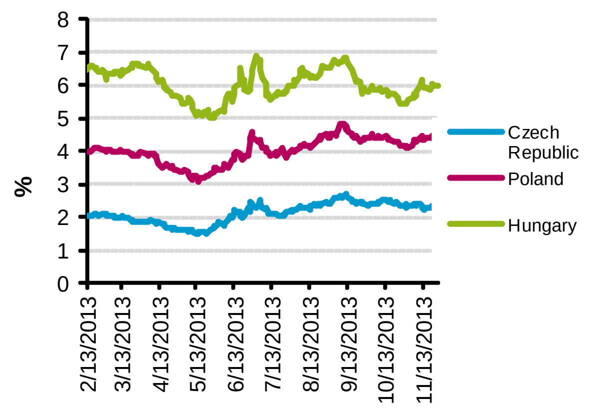
FRA 3x6



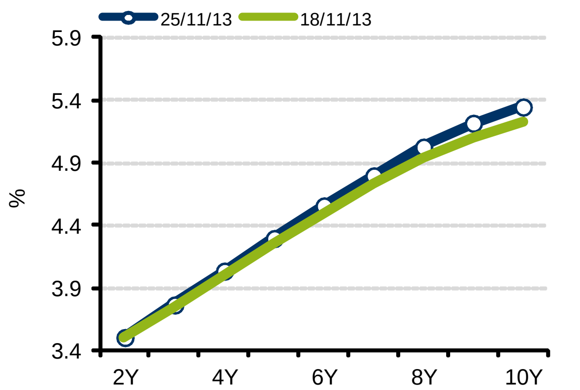
CZ IRS



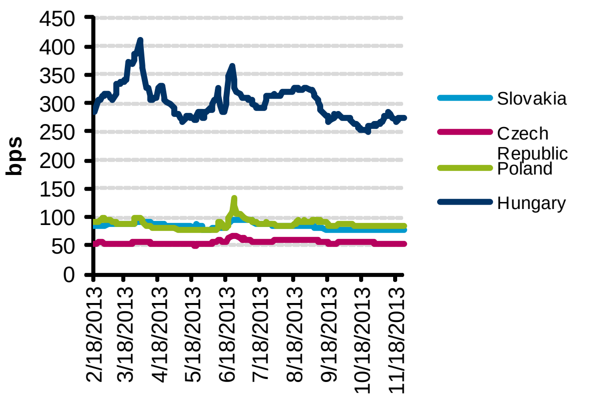
10Y GB Yields



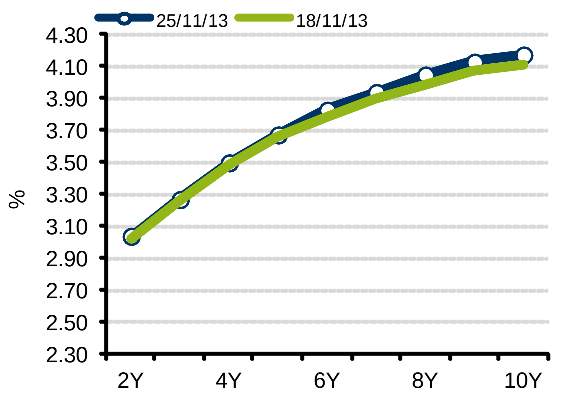
HU IRS



CDS 5Y



PL IRS



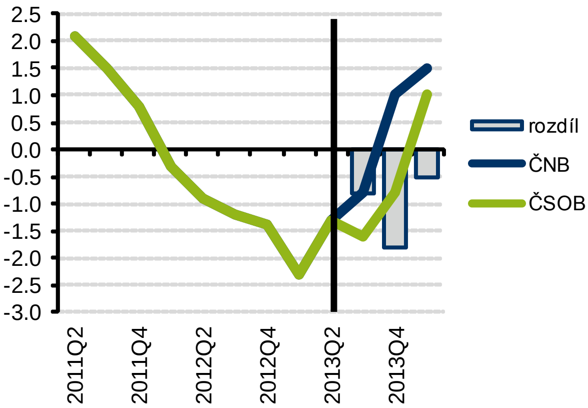
Source: Reuters

Medium-term Views & Issues

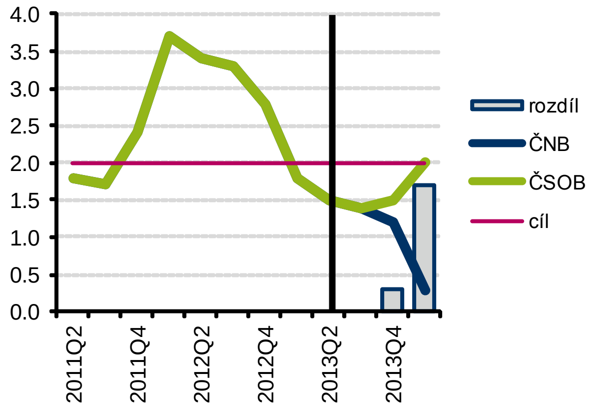
	The Czech Republic	Hungary	Poland
Growth & key issues	The CR is still led by a government that has stepped down, while the negotiations by winners of the early election have begun only recently, hence it is too soon to predict what exactly the economic policy of the future government will look like. The CR is unlikely to avoid an interim budget in early 2014, but this alone should not prevent the economy from growing soon. As confirmed by production statistics, industry continues to drive the economy; however, agriculture, construction and services dragged the economy back into the red in Q3.	As elections are coming in 2014, the government may do everything to maintain the relatively good performance. The NBH's funding for lending program may boost the economy by 0.2-0.4% Y/Y in the following quarters; the net real wage growth may help the domestic consumption, while public investments are likely to continue at least till mid-2014. Additionally there were temporary stop of production in some industrial sectors end of last year, which provides very low base for this year, so we expect around 2.5% Y/Y GDP growth for 4Q13 and around 1% Y/Y average growth for 2013, which may accelerate to around 1.6% Y/Y in 2014.	According to the preliminary estimates, the Polish economy grew by 1.9 % Y/Y and 0.6% Q/Q in the third quarter 2013. Although the figures might be revised along with the release of detailed information on 29th November, it is clear that the economy bottomed-out in the second quarter. Moreover, detailed information should confirm a return to more balanced structure of growth, which should be driven not only by export-oriented industry but also by domestic consumption.
Outlook for official & market rates	The CNB has completely exhausted the possibility of easing its monetary policy through interest rates, and therefore it has decided to weaken the koruna and keep it close to CZK 27 per EUR. Statements from the CNB representatives indicate that the CNB would like to maintain that level for a prolonged period, until strong inflation pressures become evident in the economy. The CNB believes that the depreciation of the koruna should enable the economy to avoid deflationary pressures and boost its growth up to 2.1% next year.	GDP and inflation figures clearly leaves to door open for further cut of base rate especially the ECB and FED also may continue loose monetary policy. So we maintain our expectation that NBH may cut base rate by 20bp from 3.4% to 3.2% on 26 November and most likely to 3% in December, but after it NBH may slow down further the rate cut cycle even if international sentiment remains positive and supportive for Hungary.	Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. On the other hand, improving prospects of the Polish economy were confirmed by preliminary estimates of GDP for the third quarter. Better GDP should persuade members of the Monetary Policy Council to stick to forward guidance given at the November meeting, i.e. promise to keep interest rates unchanged until the end of the first half of 2014.
Forex Outlook	The CNB has started FX interventions and we expect the koruna to stay within the regime at least till the end of 2014. Hence the currency should stay above 27.00 EUR/CZK at least in 12-month horizon. When the FX targeting regime is set to be abandoned, the CNB will have to intervene on the market much more aggressively to stop the spot koruna from appreciation. As a side effect, the forward koruna can appreciate significantly before the regime is abandoned.	While on one hand the forint could be constrained by relaxed NBH's policy, on the other it can profit from loose ECB's and Fed's policies. So, we see the EUR/HUF traded in the range and we expect low volatility. The narrow range at the moment is between 296.5 and 300, the wider range is 292 and 302. We don't expect to break out from this range for the next weeks, we would rather bet on short term on some strengthening.	Low inflation pressures and improving prospects of the economy may support the zloty in months ahead. The Polish currency might perform particularly well in comparison with the koruna as the room for koruna's appreciation remains virtually closed and the economic recovery in Poland is likely to continue. In our view, Fed's QE tapering remains the main risk for the zloty.

CBs' Projections vs. Our Forecasts

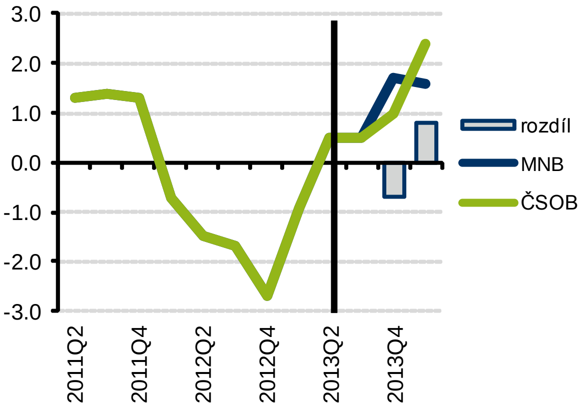
CZ: GDP outlook (Y/Y, %)



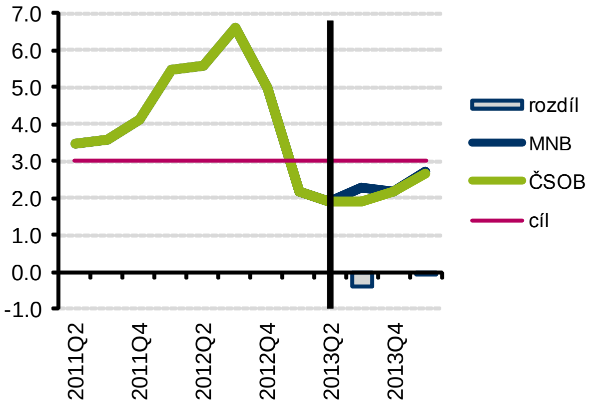
CZ: Inflation outlook (Y/Y, %)



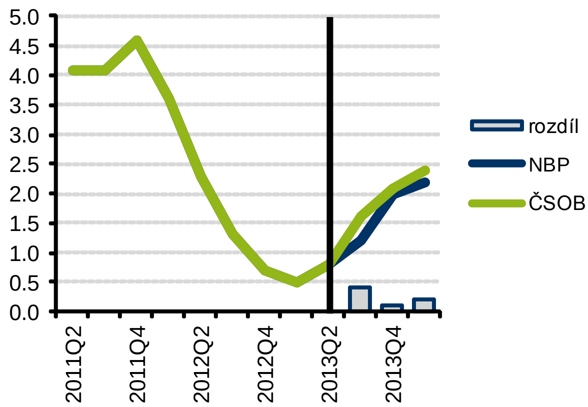
HU: GDP outlook (Y/Y, %)



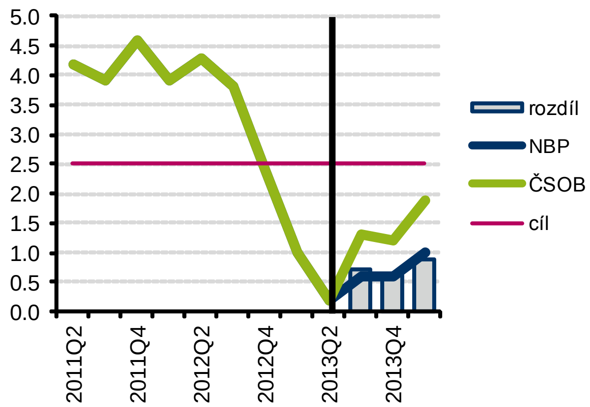
HU: Inflation outlook (Y/Y, %)



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.	*3.40*	5.75	5.00	4.25	3.60	3.75	-20 bps	10/29/2013
Poland	2W inter. rate	*2.50*	4.25	3.25	2.75	2.50	2.50	-25 bps	7/3/2013

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	PRIBOR	*0.38*	0.50	0.47	0.44	0.42	0.43
Hungary	BUBOR	*3.35*	5.75	4.90	4.20	3.56	3.50
Poland	WIBOR	*2.65*	4.11	3.39	2.73	2.67	2.75

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

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	CZ10Y	*2.055*	1.37	1.31	1.97	2.06	2.15
Hungary	HU10Y	*5.31*	5.49	5.41	5.84	5.17	5.90
Poland	PL10Y	*4.18*	3.60	3.61	4.14	4.24	3.95

Exchange rates (end of the period)

		Current	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	EUR/CZK	*27.3*	25.1	25.7	26.0	25.7	27.1
Hungary	EUR/HUF	*299*	291	304	295	297	300
Poland	EUR/PLN	*4.19*	4.08	4.18	4.33	4.22	4.20

GDP (y/y)

	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Czech Rep.	-0.9	-1.2	-1.4	-2.3	-1.3	-1.6	-0.8
Hungary	-1.5	-1.7	-2.7	-0.9	0.5	0.5	1.0
Poland	2.3	1.3	0.7	0.5	0.8	1.6	2.1

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	1.6	1.0	1.4
Hungary	5.6	6.6	5.0	2.2	1.9	1.9	2.2
Poland	4.3	3.8	2.4	1.0	0.2	1.3	1.2

Current Account

	2012	2013
Czech Rep.	-1.9	-1.7
Hungary	1.5	2.0
Poland	-4.0	-3.8

Public finance balance as % of GDP

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

Source: CSOB, Bloomberg

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