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Central European Weekly

Monday, 27 January 2014

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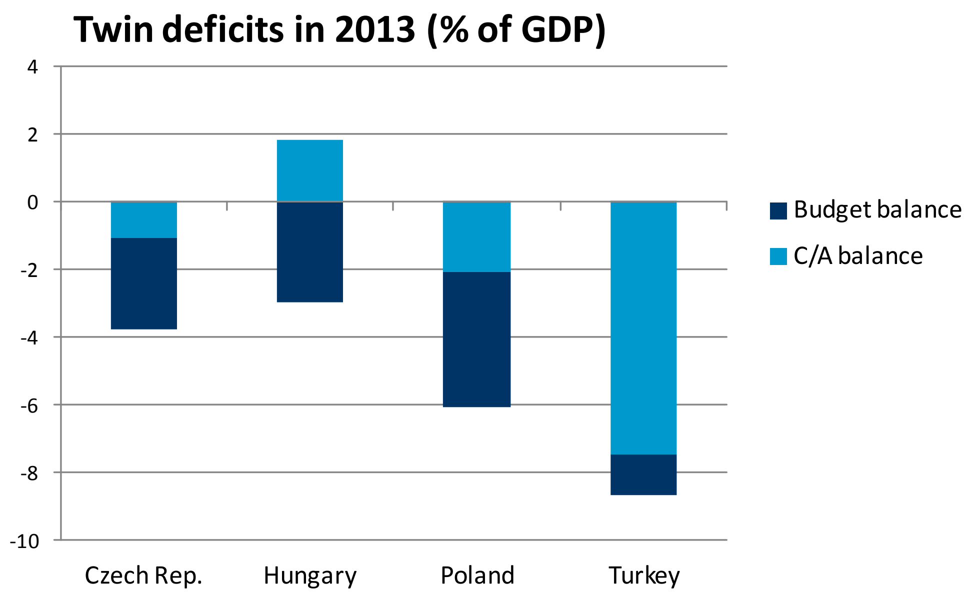


Monday, 27 January 2014

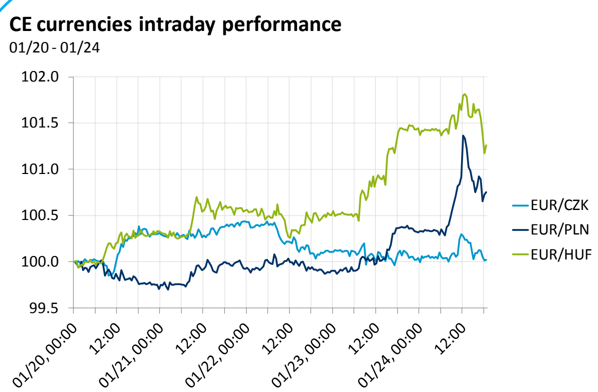
Market's editorial

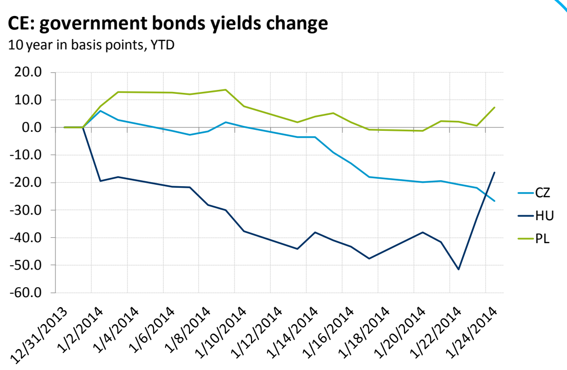
Regional markets caught by contagion from Turkey

Last week, Central European markets appeared finally under pressure that stemmed from an ongoing sell-off in emerging markets. The Polish zloty weakened around 2% last week, while Hungarian bond yields went up by approximately 25 bps.

While the koruna's intraday losses were negligible, the forint and the zloty in particular fell quite sharply. Although both currencies took back some losses by the end of the session (the forint even settled a bit stronger than on Thursday), they closed the week weaker by 1.3% and 0.9% respectively and last week's trading action thus confirmed relative vulnerability of the Central European currencies to external shocks. More or less the same applied to government bonds - while the yield of the Czech government bond (10 year) followed its German counterpart and fell slightly on Friday, Polish and Hungarian 10 year bonds were under pressure and their yields rose by 7 bps and 17 bps respectively. While in the case of zloty generally worse than expected domestic macroeconomic figures might have also been in play (weak retail sales) - in our view, the regional sell-off is mostly related to the recent bearish development in emerging markets – especially to contagion from Turkey.

That's a fairly obvious reaction. Still, if the sell-off in Turkey, Ukraine, Argentina or South Africa continue, Central European currencies should remain under pressure but sooner or later they should at least partly decouple from this bearish trend. Recalls that Central Europe is much better off in fundamental terms – the balances of its current accounts have improved in recent years and the incipient recovery in the euro zone should speed up the whole region this year. Thus the main risk continues to come from the domestic political scene. It means generally, policy-makers might deliver some unexpected mistakes (like the NBH rate cut on last Tuesday) or specifically some fear might generate April's election in Hungary and possible reaction to pension reform in Poland.





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.5	-0.14%	↗	↘
EUR/HUF	307	1.42%	↗	↘
EUR/PLN	4.23	1.66%	↗	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.93	-3.50	→	→
10Y HUF	5.36	6.14	↗	↗
10Y PLN	4.26	2.65	↗	↗

Review of Economic Figures

The NBH cuts bravely by 15bps, making troubles for the HUF

The NBH cut base rate by 15bp from 3% to 2.85%, which was more than the market expected (10bps). Interestingly (given the current development), the members of the NBH council saw the global market sentiment supportive despite of the start of the tapering. Moreover Hungary's required risk premium moderated decreased which was reflected in the CDS and bond yields. They highlighted that the decline in external debt reduces the country's vulnerability.

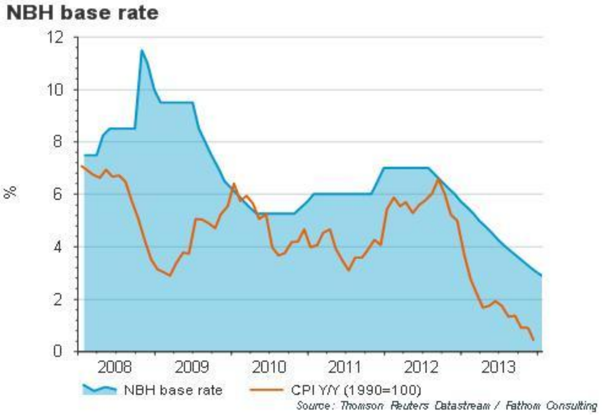
The statement was ended with the sentence: "Considering the outlook for inflation and taking into account perceptions of the risks associated with the economy as well as the improvement in the pace of economic growth, further cautious easing of monetary policy may follow, but a reduction in the increment has become warranted."

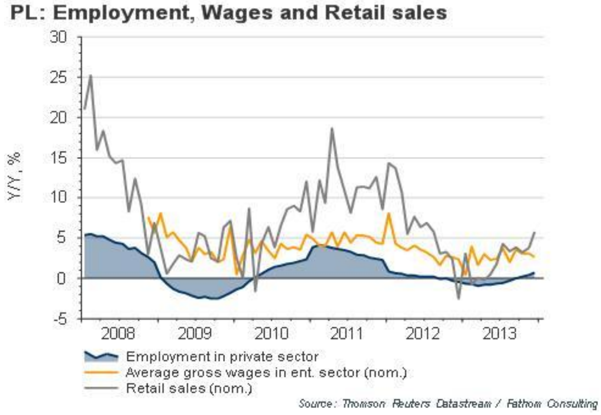
The statement also suggests that the rate cut cycle may continue in the following months. The speed of the cut is highly depends on the global environment as we don't see any substantial change in the domestic developments for the next months. It is also likely that the three options in the decision making may be the 15bp and 10bp cut and the end of the rate cut cycle. As some members highlighted earlier that a gradual weakening of the currency to around 305 won't change the monetary policy we expect that 10bp cut may be delivered in February and also in March. This view could, however, be challenged, if the EUR/HUF stays at current levels (305+) for a longer period.

Polish figures weaker-than-expected in December

December's statistics for the Polish economy, released last week, mostly fell short of market expectations. The greatest positive exception was the labour market data, where unemployment rose by 0.1% less than expected, but the employment indicator, which is more emphasized by the central bank, was slightly worse. The greatest negative surprise was likely the figure from industry, which rose by 'only' 6.6% y/y, rather than in excess of 10%. Retail sales data also unveiled a slower than expected year-on-year rate of increase on Friday – the sales were up by 5.8% y/y (rather than the expected 7%).

As concerns the structure, the worsened figures from industry (seasonally adjusted industrial output went up by 5.2%) were primarily attributable to the decline in the sector comprising the production and distribution of electricity, gas, heat, and conditioned air (-9.8% y/y), which might be due to the extra warm weather, we have seen so far this winter. Regarding the other sectors, their positive trend has persisted in recent months, with a production increase in 30 of 34 sectors. For 2013 as a whole, industrial output was up by 2.2%, due in particular to the second half of the year. We believe that December's worse industrial output was a one-off divergence rather than a trend, and we expect that the Polish economy will continue to recover this year, when it is likely to grow by more than 3%, probably also fuelled by increased domestic consumption (the trend seen in recent months has also been positive for retail sales). Especially the improving labour market situation should contribute to this.



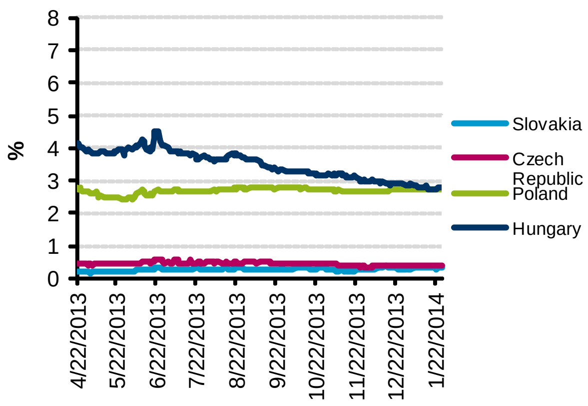


Calendar

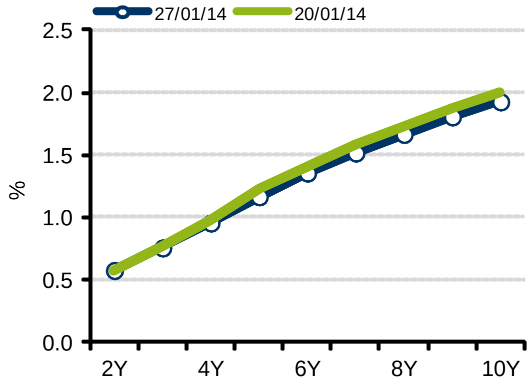
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	01/29/2014	9:00	Unemployment rate	%	12/2013			9.4		9.3	
CZ	01/29/2014	12:00	CZ Bond auction 4,20 %/2036	CZK B	01/2014						
CZ	01/29/2014	12:00	CZ bond auction 3.85%/2021	CZK B	01/2014						
PL	01/30/2014	10:00	GDP	%	12/2013 *A				1.5		1.9
HU	01/31/2014	9:00	Trade balance	EUR M	11/2013 *F					803.5	
HU	01/31/2014	9:00	PPI	%	12/2013				0.7	-0.3	0.6
CZ	01/31/2014	11:00	Money supply M2	%	12/2013						5.3

Fixed-income in Charts

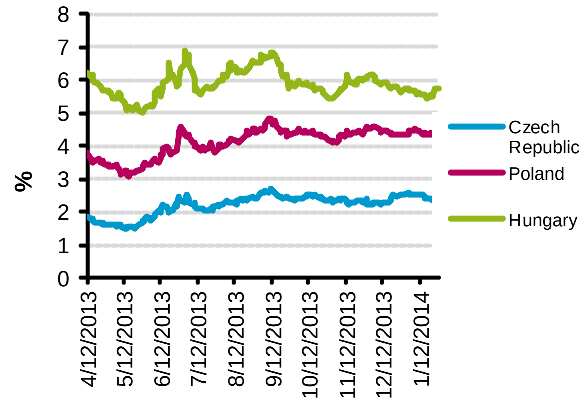
FRA 3x6



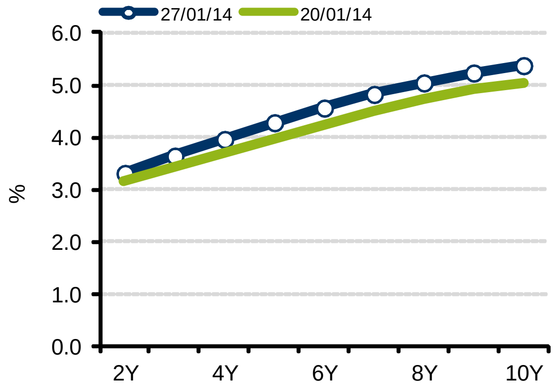
CZ IRS



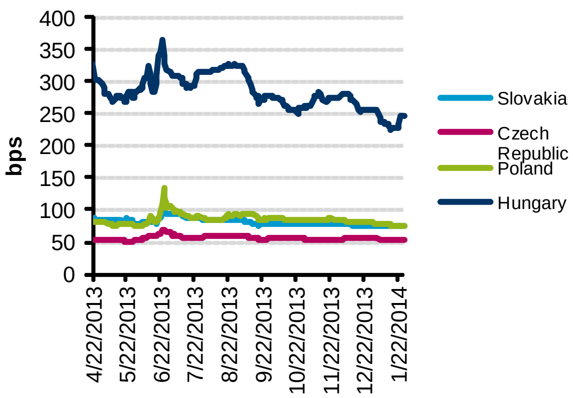
10Y GB Yields



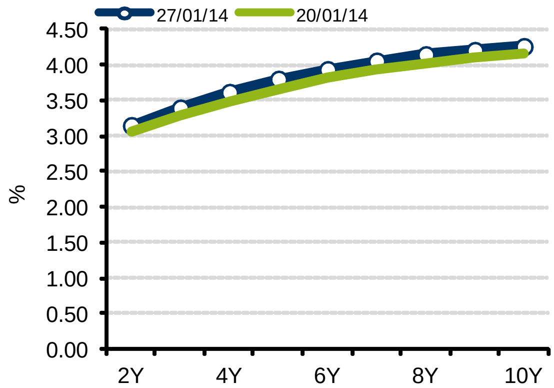
HU IRS



CDS 5Y



PL IRS



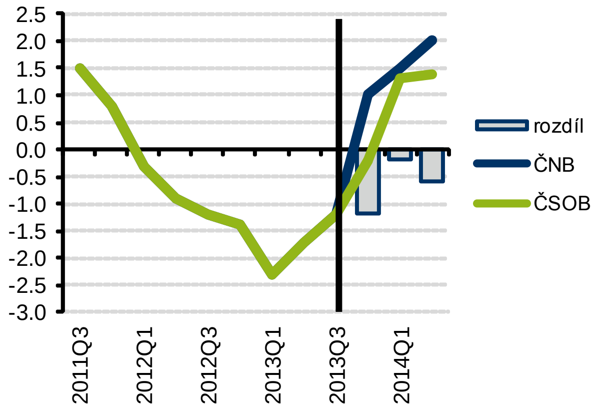
Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	The talks on a new government, which should reflect the outcome of October's early election, are probably coming to an end. The programme of the future government is likely to be consistent with the concluded coalition agreement, which envisages keeping the government deficit below 3% of GDP throughout the government's electoral term. Statistics for the last six months confirm that the worst is over for the economy. The economy is being driven by the manufacturing industry, notably passenger car production, while construction, as well as many of services, are struggling to bottom out.	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.	The Polish economy grew by 1.9% Y/Y and 0.6% Q/Q in 2013Q3. While the growth was again mainly driven by net exports, household consumption contributed 0.6 percentage point (pp) and, maybe even more importantly, data unveiled a negligibly positive contribution of investment (+0.1pp). Figures have confirmed that growth of the Polish economy is starting to be based on more robust foundations. For this year as a whole, the Polish economy should grow by approximately 1.4%, despite its poor performance at the beginning of the year.
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. The CNB is very unlikely to change rates, and just as likely to maintain its intervention regime throughout this year.	The NBH rate cut cycle may continue in the following months. The speed of the cut is highly depends on the global environment as we don't see any substantial change in the domestic developments for the next months. It is also likely that the three options in the decision making may be the 15bp and 10bp cut and the end of the rate cut cycle. As some members highlighted earlier that a gradual weakening of the currency to around 305 won't change the monetary policy we expect that 10bp cut may be delivered in February and also in March. This view could, however, be challenged, if the EUR/HUF stays at current levels (305+) for a longer period.	Inflation pressures in Poland remain subdued and year-on-year prices growth is seen well below the lower tolerance band of the inflation target. Although the recent development has supported our bets on faster economic recovery in Poland (in 2014, the central bank expects 2.9% growth while we estimate 3.1% with upside risks), outlook for persistently low inflation and NBP's strong emphasis on forward guidance along with the fact that all members of the Monetary Policy Council agreed upon it, made us review our scenario and we newly expect that the first rate hike (25 bps) may come rather at the end 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

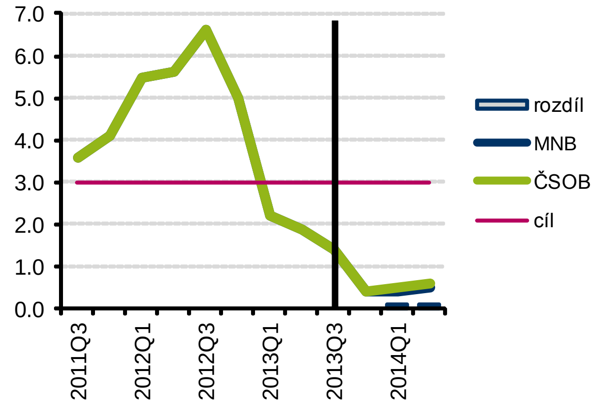
CZ: GDP outlook (Y/Y, %)



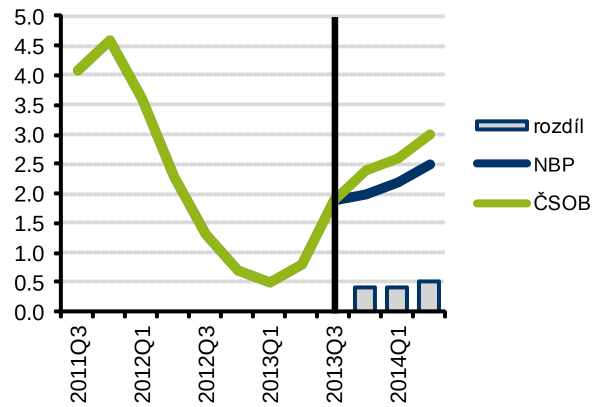
CZ: Inflation outlook (Y/Y, %)

HU: GDP outlook (Y/Y, %)

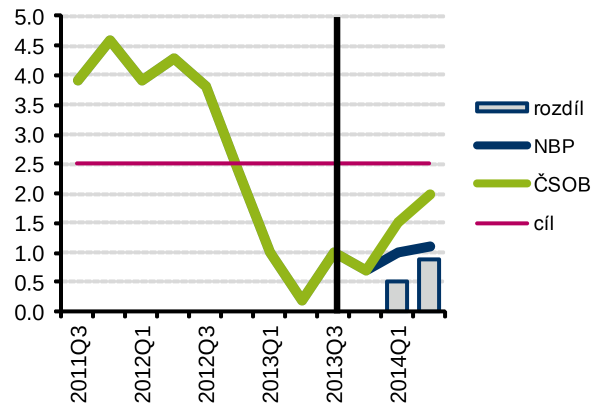
HU: Inflation outlook (Y/Y, %)



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	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	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.	*2.85*	4.25	3.60	3.00	4.00	4.50	-20 bps	1/21/2014
Poland	2W inter. rate	*2.50*	2.75	2.50	2.50	2.50	2.75	-25 bps	7/3/2013

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

		Current	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	PRIBOR	*0.37*	0.44	0.42	0.38	0.37	0.36
Hungary	BUBOR	*2.81*	4.20	3.56	2.99	3.50	3.70
Poland	WIBOR	*2.7*	2.73	2.67	2.71	2.75	3.00

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

		Current	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	CZ10Y	*1.93*	1.97	2.06	2.09	2.17	2.27
Hungary	HU10Y	*5.36*	5.84	5.17	5.25	6.10	6.20
Poland	PL10Y	*4.26*	4.14	4.24	4.25	4.05	4.35

Exchange rates (end of the period)

		Current	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	EUR/CZK	*27.5*	26.0	25.7	27.3	27.3	27.2
Hungary	EUR/HUF	*307*	295	297	297	300	300
Poland	EUR/PLN	*4.23*	4.33	4.22	4.16	4.20	4.10

GDP (y/y)

	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	-1.4	-2.3	-1.7	-1.2	-0.2	1.3	1.4
Hungary	-2.7	-0.9	0.5	1.8	1.9	2.2	2.3
Poland	0.7	0.5	0.8	1.9	2.4	2.6	3.0

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

	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2
Czech Rep.	2.4	1.7	1.6	1.0	1.4	0.5	0.7
Hungary	5	2.2	1.9	1.4	0.4	0.5	0.6
Poland	2.4	1.0	0.2	1.0	0.7	1.5	2.0

Current Account

	2012	2013
Czech Rep.	-1.9	-1.1
Hungary	1.5	2.0
Poland	-3.5	-1.7

Public finance balance as % of GDP

	2012	2013
Czech Rep.	-4.4	-2.5
Hungary	-2.5	-2.7
Poland	-3.9	-4.6

Source: CSOB, Bloomberg

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