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Central European Weekly

Monday, 26 May 2014

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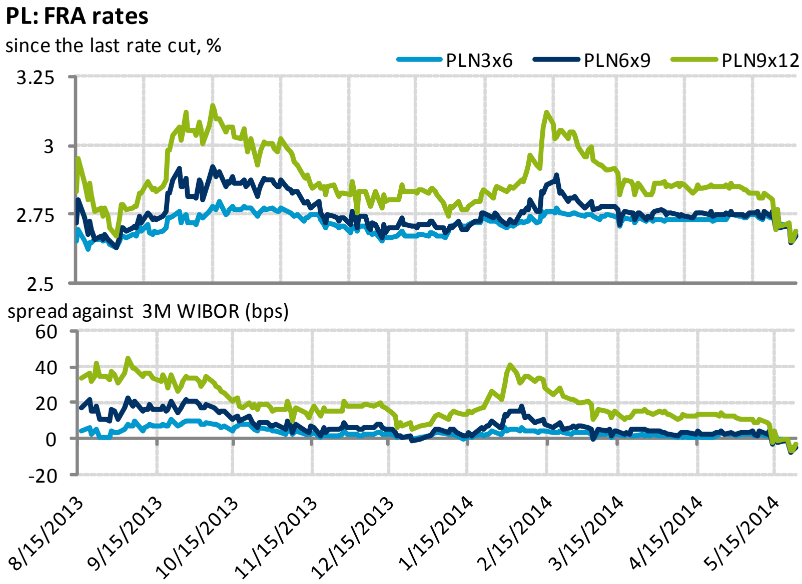
Chart of the Week



Markets have started to price in rate cuts already which could be even more supported if the zloty strengthens further. (Source: Bloomberg, CSOB)

Market's editorial

The NBH financial stability report supports rate cut bets

The National Bank of Hungary released its new stability report last week and we think that the MPC's view about stability concerns might be quite mitigated. The stress test showed that even under severe but plausible negative scenario, the banking sector's capital needs to comply with regulatory requirements would amount to HUF 16-18 billion in the period to the end of 2015, which represents a very low risk compared with the capital injections received by banks in the recent period. Additionally from liquidity perspective, the banking sector has an adequate liquidity buffer to absorb significant shocks (for more see please **In Focus**).

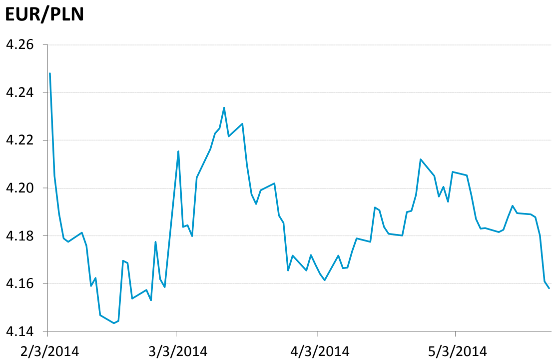
The positive financial stability report together with strong forint, negative inflation and supportive international environment supports the scenario for another 10bp rate cut (from 2.5% to 2.4%) on the upcoming MPC meeting will held this Tuesday. We will closely watch how dovish the statement may be. We expect that it might be slightly more dovish than last time, so they may suggest the continuation of rate cut cycle more directly.

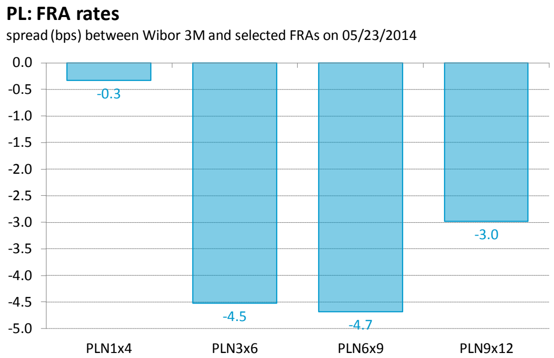
Polish rates to remain stable, with the ECB posing a risk

By contrast, in spite of low inflation in Poland, we still do not expect the NBP to decide to ease its monetary policy again. Bear in mind that Poland's interest rates are at all-time lows and the continuing economic recovery should prevent any rate cut. After all, even dovish NBP President Belka said after the April meeting that a rate cut at the time of a recovering economy is a central banker's 'mortal sin' and any change of the NBP's opinion would likely require a substantial revision of the economic growth outlook. Such a revision does not seem to be likely at the moment.

Still, markets have started to price in rate cuts already which could be even more supported if the zloty strengthens further. On the other hand, we see the room for further gains of the zloty as limited given the fact that the rates will likely remain stable in the rest of the year.

In this regard, actions by the European Central Bank probably pose a greater risk in the end, as the ECB may easily surprise markets at its early June meeting (June 5) by easing its monetary policy more aggressively than expected. The zloty would likely strengthen in that event, and with inflation below the target for a long time, this would not be welcome news for the NBP, which might react to that.





	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	*27.4*	*-0.22%*	→	↘
EUR/HUF	*303*	*-0.69%*	→	↘
EUR/PLN	*4.16*	*-0.79%*	→	↘

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	*1.55*	*1.97*	→	↗
10Y HUF	*4.36*	*-2.24*	↘	↗
10Y PLN	*3.62*	*-2.96*	↘	↗

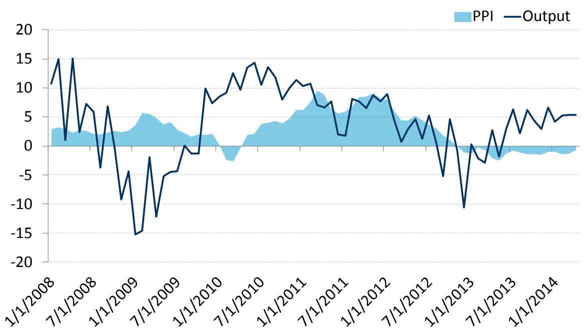
Review of Economic Figures

The Polish economy continues to recover against the backdrop of low inflation

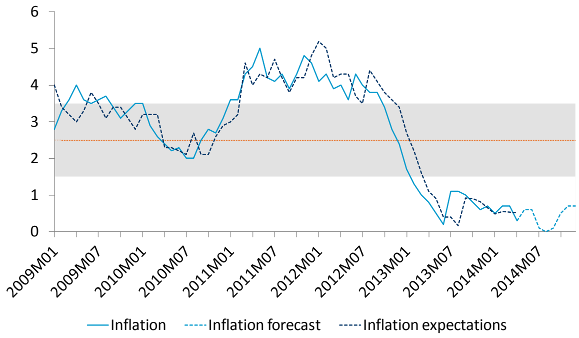
The macroeconomic data released last week nicely illustrated the developments in the Polish economy seen in recent months. Data on April's industrial output pointed out a very reasonable rise in industry and construction on the one hand, while the producer price index for the same month confirmed the lack of inflationary pressures on the other hand.

As concerns data from industry, the encouraging news is that a total of 27 of 34 sectors, including the most important ones, rose on the year-on-year basis in April. By and large, industry rose by 5.4% y/y (5.3% seasonally adjusted). Even better news was the persisting recovery of construction, which rose by 13.3% y/y seasonally adjusted, and this indicates that investment opened the second quarter well. On the other hand, the data from industry again contrasts with the PPI, which was down by 0.7% y/y and 0.1% m/m (the same month-on-month price change as in the manufacturing industry).

PL: Industrial output vs. producers' prices
year-on-year, %



PL: Inflation and inflation expectations
Y/Y in %; NBP tolerance band is grey, inflation target is orange dotted line



In Focus: the NBH financial stability report

The NBH sees stronger domestic financial sector

The National Bank of Hungary released its new stability report on Thursday. The NBH sees the stability of the domestic financial sector strong as the capital adequacy ratio rose to 17.4% by the end of 2013. The stress test showed that even under severe but plausible negative scenario, the banking sector's capital needs to comply with regulatory requirements would amount to HUF 16-18 billion in the period to the end of 2015, which represents a very low risk compared with the capital injections received by banks in the recent period. Additionally from liquidity perspective, the banking sector has an adequate liquidity buffer to absorb significant shocks.

Loan-to-deposit ratio back to 100 %?

The loan-to-deposit ratio moderated to 107% by the end of 2013 and NBH expects that it may stabilize around 100% in the coming years. Parallel to it the sector's reliance on external funding continues to decrease. Although the lending still declined in 2H13, the spread moderated from level of 4-5% to around 1%.

They see the bad portfolio as one of the most important factors behind the subdued lending activity. The NPL ratio in the banking sector was 18% at end-2013.

It is quite likely that the government and the NBH may introduce some measures in the coming months to speed up the write down of the non-performing portfolio, which may require some additional capital injection into local banks. As the profitability of the banking sector is still low and very divided, the NBH expects consolidation on the market.

Financial stabilty no obstacle for rate cuts in Hungary

Based on this stability report the MPC's view about stability concerns might be quite mitigated. Adding to it that HUF strengthened by around 1-2% against EUR, there is no pressure coming from the currency side either. First Mr. Balog (vice-governor), then Mr. Matolcsy (governor) said that they see more room for rate cuts, but none of them signal what may be the end of the cycle. Mr. Matolcsy only mentioned that some eonomists' estimations are too ambitious. Although there is no deflationary pressure in Hungary, the latest inflationary figure (-0.1% Y/Y in April) may modify the NBH's forecast of inflation orbit, which means that CPI may return to around 3% Y/Y (the level of inflation target) only beginning of 2016. Only in bracket, but we have a scenario in which government may increase the excise duties as there is a miss-match on the revenue side of the budget, because of too low inflation level. In that case inflation may accelerate faster.

Weekly preview

TUE 14:00 NBH base rate

	This meeting	Last change
rate level (in %)	**2.40**	4/2014
change in bps	**-10**	-10

NBH base rate to fresh all-time lows

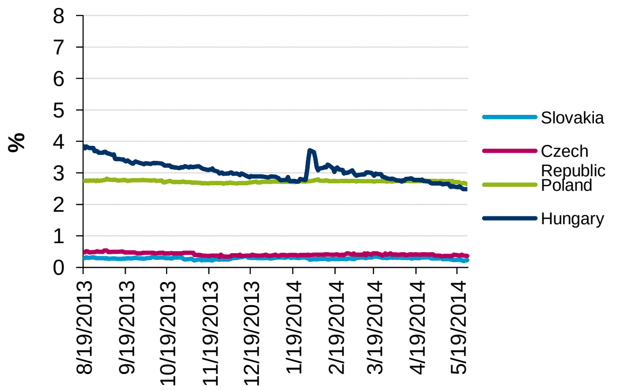
Taking in account that the international sentiment is also quite supportive and risk taker, the most likely scenario is 10bp rate cut (from 2.5% to 2.4%) on next MPC meeting will be held on Tuesday (27 May). More interesting is how dovish the statement may be. We expect that it might be slightly more dovish than last time, so they may suggest the continuation of rate cut cycle more directly.

Calendar

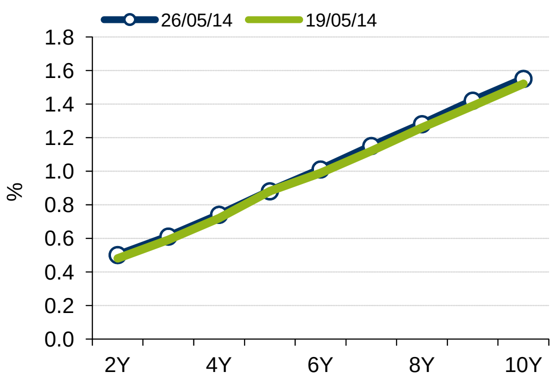
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
PL	05/26/2014	10:00	Unemployment rate	%	04/2014			12.9		13.5	
PL	05/26/2014	10:00	Retail sales	%	04/2014			2.9	9	12.5	3.1
HU	05/27/2014	14:00	NBH meeting	%	05/2014			2.5		2.5	
HU	05/28/2014	9:00	PPI	%	04/2014					-0.6	-1.9
HU	05/29/2014	9:00	Unemployment rate	%	04/2014			8.5		8.3	
PL	05/30/2014	10:00	GDP	%	1Q/2014 *F					1.1	3.3
CZ	05/30/2014	10:00	Money supply M2	%	04/2014						5.1

Fixed-income in Charts

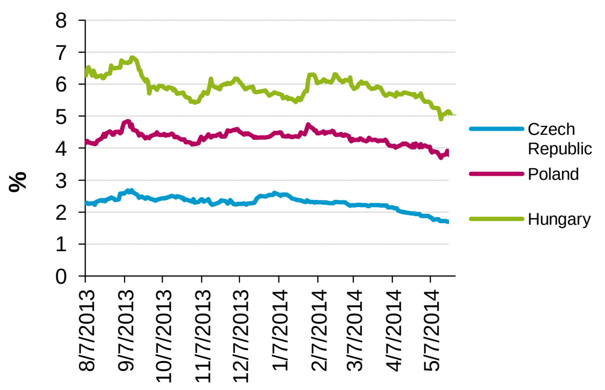
FRA 3x6



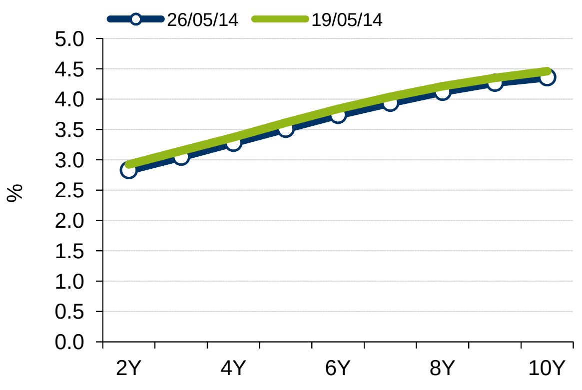
CZ IRS



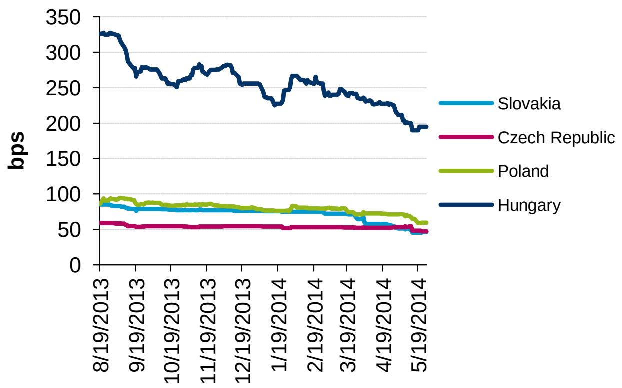
10Y GB Yields



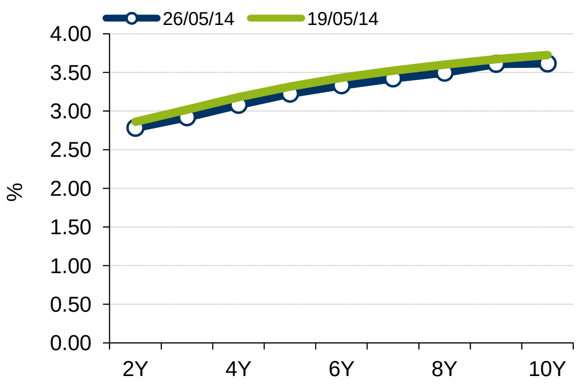
HU IRS



CDS 5Y



PL IRS



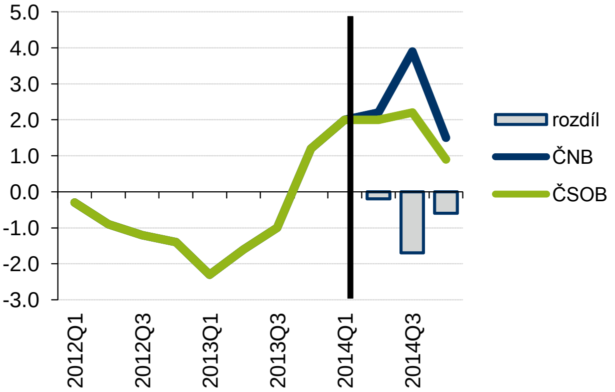
Source: Reuters

Medium-term Views & Issues

	The Czech Republic	Hungary	Poland
Growth & key issues	The president appointed a new coalition government a few months after the election. 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.	Based on the first quarter figure and the recent trends in the economy, Hungary's GDP may grow above 2.5% Y/Y in 2014 and it cannot be excluded that the growth might be close to 3% Y/Y level. The low base supports this economic growth level in short term, but without a substantial rise of investments in the private sector this year, economy may slow down to around 2% Y/Y level in 2015.	According to the GUS estimates the Polish economy grew by 3.3% in 2014Q1. For this year, the growth should significantly exceed 3%. Household consumption should support growth, owing to the improving labor market situation as well as to low inflation. Investment should also develop favorably, owing to the replenishment of inventories as well as to gross capital formation In addition, lower government debt could also give a greater lift to the economy. By contrast, net exports are likely to curb rather than boost growth, especially in view of recent crisis in Ukraine.
Outlook for official & market rates	The CNB has 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 2.6% this year. The CNB is very unlikely to change rates, and just as likely to maintain its intervention regime throughout this year.	As the minutes of last MPC meeting highlighted that the council didn't want to give clear massage of the stop of rate cut cycle, and Minister of National Economy (Mr. Varga) said in an interview yesterday that there is still room for loosen the monetary policy, it is now very likely that NBH may cut base rate again in May and the tone of the statement might remain also quite loose.	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, 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 official interest rates will remain stable in the rest of this year and that the first rate hike could come in the first half of next year.
Forex Outlook	The CNB has started FX interventions and we expect the koruna to stay within the regime at least till the mid 2015. 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.	The NBH ongoing easing cycle might be also a reason, why HUF was hit more aggressive in this sell-off than its regional peers. It has also a massage that Hungary is still more sensitive on international sentiment than its regional PEERs. So we don't expect substantial HUF strengthening from the levels of EUR/HU 305 .	Low inflation pressures and improving prospects of the economy may support the zloty in months ahead. Albeit we expect only gradual strengthening against the euro, the Polish currency might perform well against the koruna as the room for koruna's appreciation remains virtually closed and the economic recovery in Poland is likely to continue at faster pace. In our view, Fed's QE tapering remains the main risk for the zloty. The Zloty is also more vulnerable to the emerging markets sell-offs such as to rising tensions in Ukraine.

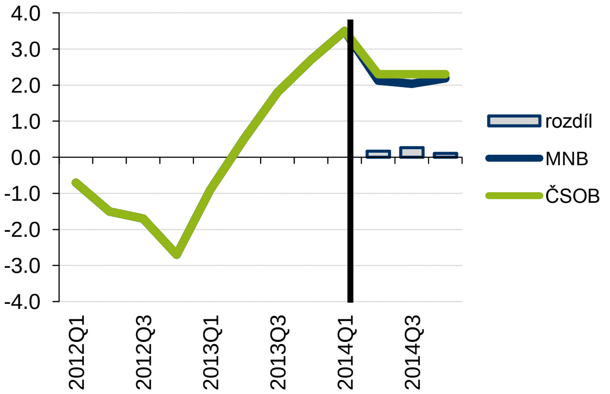
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)



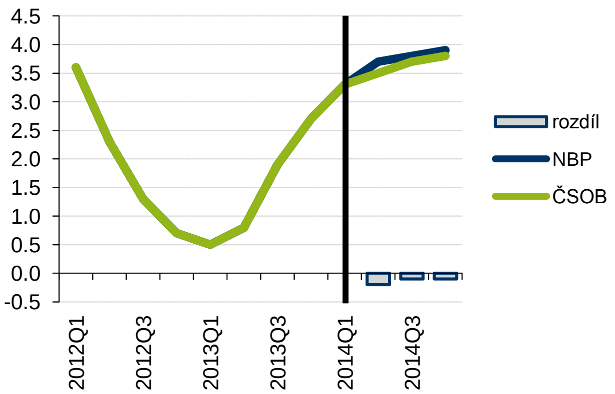
CZ: Inflation outlook (Y/Y, %)

HU: GDP outlook (Y/Y, %)

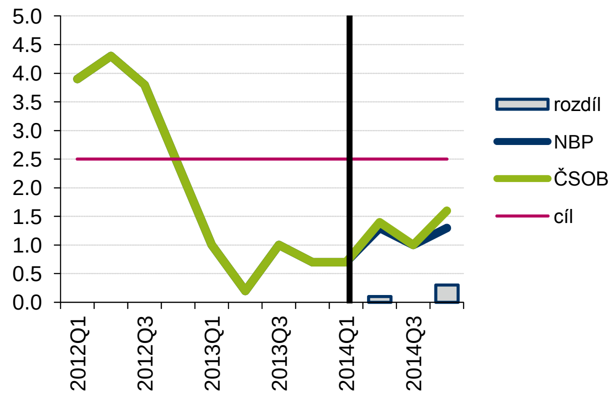


HU: Inflation outlook (Y/Y, %)

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	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4	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.	*2.50*	3.00	2.60	2.50	2.50	2.50	-15 bps	4/29/2014
Poland	2W inter. rate	*2.50*	2.50	2.50	2.50	2.50	2.75	-25 bps	7/3/2013

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

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	PRIBOR	*0.36*	0.38	0.37	0.36	0.36	0.40
Hungary	BUBOR	*2.55*	2.99	2.67	2.50	2.50	2.50
Poland	WIBOR	*2.72*	2.71	2.71	2.75	2.75	3.00

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

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	CZ10Y	*1.55*	2.09	1.84	1.75	1.90	2.00
Hungary	HU10Y	*4.36*	5.25	4.95	5.00	5.30	5.70
Poland	PL10Y	*3.62*	4.25	4.03	4.10	4.45	4.70

Exchange rates (end of the period)

		Current	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	EUR/CZK	*27.4*	27.3	27.4	27.2	27.2	27.2
Hungary	EUR/HUF	*303*	297	307	305	298	295
Poland	EUR/PLN	*4.16*	4.16	4.17	4.16	4.15	4.09

GDP (y/y)

	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	-1.6	-1.0	1.2	2.0	2.0	2.2	0.9
Hungary	0.5	1.8	2.7	3.5	2.3	2.3	2.3
Poland	0.8	1.9	2.7	3.3	3.5	3.7	3.8

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

	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Czech Rep.	1.6	1.0	1.4	0.2	0.3	1.1	1.5
Hungary	1.9	1.4	0.4	0.1	0.6	0.7	0.8
Poland	0.2	1.0	0.7	0.7	1.4	1.0	1.6

Current Account

	2013	2014
Czech Rep.	-1.4	-1.4
Hungary	2.0	2.2
Poland	-1.2	-2.5

Public finance balance as % of GDP

	2013	2014
Czech Rep.	-1.5	-2.5
Hungary	-2.7	-3.0
Poland	-4.4	-3.5

Source: CSOB, Bloomberg

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