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Central European Weekly

Tuesday, 10 June 2014

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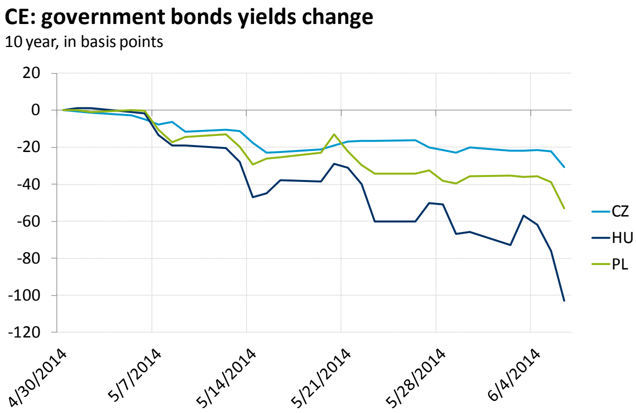
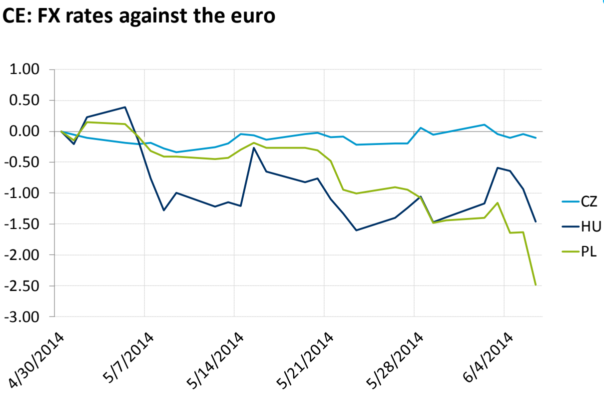
Weekly Highlights:

- ECB sends its steroids to regional FX and fixed-income markets
- The NBP President Belka hints at a possible rate cut
- Hard data like industrial production and retail sales signal that recovery gaining momentum
- Preview for Hungarian and Polish inflation in May

Chart of the Week: CE markets after ECB action





CE government bonds have strongly benefitted from the ECB decision to ease monetary policy... (Source: Bloomberg, CSOB)

Market's editorial

Will ECB's moves bolster Central Europe?

For Central European markets, we tend to expect a slightly positive response to the ECB's move. Higher-yield economies may theoretically see an inflow of speculative capital, which will strive to escape the trap of very low rates in the euro area. Notably higher Polish and Hungarian yields may be attractive, yet the capital may theoretically flow even to the Czech Republic, thus helping the Czech koruna. However, the appreciation of Central European currencies will be limited by the policies of their respective local central banks. The Czech National Bank will not allow the koruna to slip below the EUR/CZK, and further appreciation of the forint as well as the zloty would open the door to a cut in Hungarian and Polish interest rates. Last week, Polish Governor Marek Belka admitted not only the possibility of a rate cut but also that of an intervention against the zloty. Moreover, the Polish currency, along with its Hungarian counterpart, has strengthened by nearly 2.5% since the beginning of May, and therefore Warsaw and Budapest may be quite nervous about further appreciation of their respective currencies. Recal that the first verbal interventions against the Polish currency appeared quite soon – from representatives of the Ministry of Finance on Friday.

Watch the zloty, Polish inflation and the NBP reaction

In this respect it will bevery interesting to digest the upcoming inflation figures. According to our forecast Poland's year-on-year inflation rate rose slightly to 0.4% in May. Let us add that the low inflation rate, which will very likely remain well below the NBP's target throughout this year, should hit bottom during the summer. Given the latest dovish comments from the NBP, markets may be more susceptible to inflation data in the months to come, and especially if the zloty remains very strong. This susceptibility may already become evident after next week's meeting.

The Hungarian inflation still below zero, the NBH easing cycle will continue

The Hungarian statistical office releases data on the May CPI tomorrow. We estimate the May CPI at -0.2% y/y. As recent data show only limited sensitivity of inflation to exchange rate changes in Hungary, HUF´s strengthening in May likely did not push inflation down significantly. On the other hand, in spite of growing domestic demand, inflation appears well anchored and inflationary expectations stick close to 3 %. Moreover, as this year's harvest may be good, food processing industry hardly escalates price pressures in the economy.

The above-mentioned figures suggest that the NBH may continue its monetary policy and the rate-cutting cycle. This, in turn, may be a reason why HUF is underperforming compared to other regional currencies especially the zloty. Moreover, the recent Fitch report on Hungary was less positive than expected, suggesting rating upgrade to be delivered later than many had hoped. The 200-day moving average has been a fairly resilient resistance level, which has already been four times tested, but we still see little chance to get it broken through in near future.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.5	-0.16%	➘	➔
EUR/HUF	303	-0.46%	➘	➔
EUR/PLN	4.10	-1.11%	➘	➔

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.51	0.00	➔	➔
10Y HUF	4.12	-5.94	➔	➔
10Y PLN	3.47	-5.45	➔	➔

Review of Economic Figures

The Czech annual inflation still just above zero

The Czech May consumer price index rose by 0.1% vis-à-vis April, primarily fuelled by alcohol and pharmaceuticals. Year-on-year inflation has climbed to this year's highest level of 0.4%.

Inflation monitored by the central bank continues to be well below its target but this is still mainly a result of January's reduction in energy prices and the long-term decline in mobile telecommunication prices. Nevertheless, it is already evident that the effect of last year's price 'revolution' in mobile services on inflation is starting to wane over the course of time.

Although the Czech National Bank's forecast envisaged an inflation rise to 0.6%, we regard the current figure as very positive given Europe's disinflation trend, which suggested the possibility of a greater fall in food prices. The central bank might still be satisfied with the price developments and the speculations of a further weakening of the koruna might not necessarily begin to occur.

The curbed inflation trend will not change significantly in the coming months either. Inflation may gradually climb to more than 1% by the autumn; firstly, there will be the effect of the low comparative baseline and secondly, prices should also be affected by the increased excise duties on cigarettes.

Recovery of the Czech economy well in place

The stream of good news from the Czech economy was initiated by Wednesday's GDP data for the first quarter of the year. The update to the flash GDP forecast for the Czech Republic for the first quarter of this year was a very nice surprise. While the originally predicted economic growth was only 2% with quarter-on-quarter stagnation, the new figures indicate 2.5% growth, with 0.4% growth on a quarter-on-quarter basis. This is a very good figure, primarily attributable to the manufacturing industry on the supply side and to domestic consumption, investment and exports on the demand side. In line with expectations, the primary driver is the automotive industry, which is benefiting from record-high orders abroad in particular. Low inflation, which enabled consumers to do more shopping, was also relevant.

Evidence of the fact that the good Q1 figures were followed by additional favourable data is the sets of April's data released on Thursday and Friday. Even the latest figures from the retail sector confirm that retail sales are still rising rapidly, this time by 4.9% y/y, with the automotive segment again playing a significant role. The sales of cars and parts were up by more than 10%, while retail sales excluding cars rose by only 2.6%, with the effect of Easter excluded. Thus car sales remain very strong and are set to reach a record-breaking level this year. The question is how many cars are being bought by domestic consumers and how many by businesses, non-residents, and actual re-exports. We expect that the months to come will see a deceleration of the rise in car sales as well as in overall retail sales, hand in hand with the waning effect of last year's low baselines. Even so, their trend will continue to be positive.

In accordance with expectations, industry continued to perform well in April. Industrial output was up by 7.7% y/y and rose very decently even in comparison to March (+1.1%). Carmakers are again playing first fiddle, raising their output by 16.5%, followed by the production of electric equipment (+11.6%). Thus the trend of the previous months remains unchanged. Owing to innovation, large export-oriented businesses are taking advantage of the improving foreign demand for their strong expansion. The outlook for orders, which were up by almost 15% this time, is also good. Their double-digit rise is a promise of the good performance of industry even in the months to come. Carmakers are again dominant, and thus will continue to contribute significantly to growth of the Czech economy in the second quarter. The good performance of industrial enterprises also makes businesses recruit new staff. Thus industry is creating new jobs and consequently improving the labour market situation.

The NBP is still scared of low inflation

The National Bank of Poland (NBP) met expectations and left interest rates unchanged at its June meeting; however, the overall tenor of the meeting was even more dovish vis-à-vis previous months. In spite of the acceleration of quarter-on-quarter economic growth in the first quarter of this year as well as its robust structure, Poland's inflation remains well below the central bank's target, and may even slip into negative values during the summer, notably in August. This time the growing dissatisfaction with a slow price rise was also evident in the official press statement, which no longer included the sentence that the monetary easing cycle concluded last year would help inflation gradually return to its target. Nevertheless, the NBP reiterated in its statement that interest rates should also remain unchanged in the third quarter.

At the press conference following the meeting, the NBP President Marek Belka admitted that, in light of the events of recent months, he did not rule out another rate cut, but he said the NBP certainly did not perceive this as its main scenario. As concerns the timing of the potential rate cut, Belka did not elaborate to any great extent and only stated that it might happen in a "longer time frame". He also added that he was currently unable to say whether, in the event of a change in the official rates in the fourth quarter (for which the 'commitment' of the NBP to keep rates unchanged no longer applies), a rate hike or a rate cut was more likely. And as regards the above-mentioned possible decline in the inflation rate below zero during the summer, Belka added that it was important to make distinctions between a temporary inflation fall into negative territory and long-term deflation.

Markets nee to watch monthly statistics and the zloty

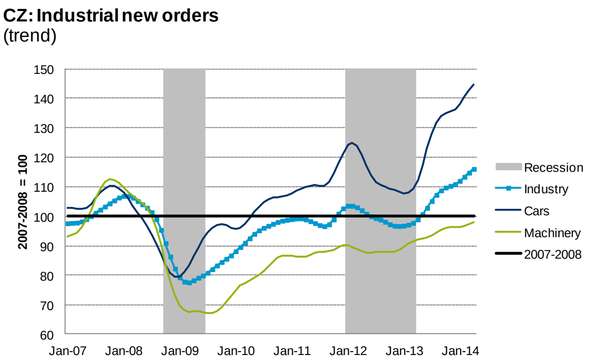
The fact that a possible rate cut is again cited by the NBP means that, for the first time in a longer while, markets will again pay attention to monthly macroeconomic indicators in the months to come. The inflation fall to zero or slightly below zero is alone unlikely to be a good reason for the NBP to cut its official rates again. We believe that the NBP would also need to see a more significant economic growth deceleration, which is initially usually signalled by monthly figures such as industrial output, retail sales or, ahead of time (and with a degree of uncertainty), by 'soft' indicators such as purchasing managers' index (PMI).

The PMI deterioration, which is primarily due to the Ukrainian crisis and which we have seen in recent months, has already been signalling slightly worse prospects for Poland's industry for the months to come. Although the importance of net exports for Poland's economic growth has decreased recently and another question continues to be how the events in Ukraine will influence 'hard' statistics in the end, the combination of slower economic growth and low inflation would clearly increase the risk of policy response by the NBP. From the point of view of assessing the eventual impacts of Ukrainian crisis , GDP growth figures for the second quarter - that will be released in the end of August - could be of particular importance.

A similar risk is posed by the ECB's monetary easing, with this being the primary factor responsible for the appreciation of the zloty by more than 2% since the start of May. The first verbal interventions against the Polish currency appeared quite soon – from representatives of the Ministry of Finance on Friday. On the other hand, NBP officials remain cautious and few of them reiterated that rate would probably stay unchanged in the following months. Quite interestingly, although Mr. Belka admitted a possible negative impact of strengthening zloty on the Polish economy, he said the ECB's decisions was expected and would not complicate NBP's life. As far as a longer-term behavior of the NBP is concerned, the recent comments suggest rather diverse views of Monetary Policy Council's members ranging from Zielinska-Glebocka's words that the NBP is unlikely to extend its forward guidance beyond September (signaling possible rate cuts) to her colleague Glapinski's comments that rates should stay unchanged this year and additional rate cut may be considered in the beginning of the next year.

The Hungarian industry is doing well too

Industrial production growth in April (10.1 % YoY preliminary) was well above expected 7 % YoY and confirmed ongoing acceleration of the sector. Details will be reported on June 12, but it seems likely already now that vehicle production and public orders were the principle growth engines; in addition to the them we guess that also electronic devices will start playing an remarkable role.



Weekly preview

WED 9:00 **HU Inflation (change in %)**

	V.14	IV.14	V.13
CPI y/y	**-0.2**	-0.1	1.8

HU: Headline inflation still below zero

The Hungarian statistical office releases data on the May CPI on Wednesday. Will the headline inflation fall further below -0.1 % YoY in April, or was the bottom of the inflation orbit already reached? Will disinflation process observed at the core inflation last month continue and will the inflation drop again or not (it had decreased from 3.6 % YoY in January to 2.3 % YoY in April)?

We estimate the May CPI at -0.2% y/y. As recent data show only limited sensitivity of inflation to exchange rate changes in Hungary, HUF´s strengthening in May likely did not push inflation down significantly. On the other hand, in spite of growing domestic demand, inflation appears well anchored and inflationary expectations stick close to 3 %. Moreover, as this year's harvest may be good, food processing industry hardly escalates price pressures in the economy.

FRI 10:00 **CZ Cur. Account (CZK bn)**

	Apr-14	Mar-14	Apr-13
C/A monthly	**11.7**	7.4	7.4
cummulative (YTD)	**67.1**	55.4	17.3
Trade bal. monthly	**25.0**	31.2	21.8
cummulative (YTD)	**99.9**	74.9	74.8

CZ: Current account still in a surplus

Owing to very good foreign trade figures, a decent surplus in the balance of services, and the fact that the dividend season has not yet begun, the current account should remain in the black. We even anticipate its best April figure ever. In the months to come, as a result of dividend outflow, the Czech Republic's external balance will gradually slip into a deficit, which will most likely be lower than last year's.

FRI 14:00 **PL Inflation (change in %)**

	May-14	Apr-14	May-13
CPI y/y	**0.4**	0.3	0.5
Food (ex Alc.) y/y	**-0.5**	0.3	1.6
Transport (including fuel)	**0.3**	-2.1	-4.2

PL: The May inflation rises slightly

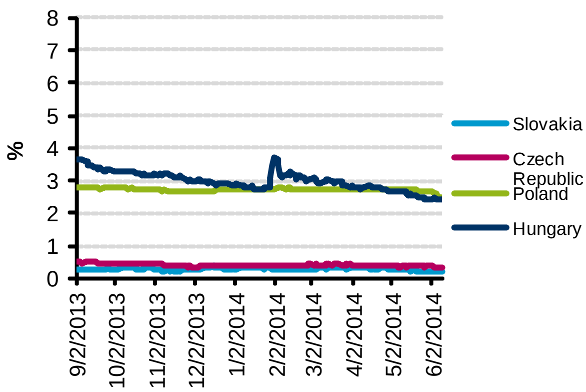
Poland's year-on-year inflation rate rose slightly to 0.4% in May, according to our forecasts. Month-on-month prices likely stagnated. Just as in previous months, the primary determinants of low inflation included only the slightly rising food prices, which were up by 0.7% m/m in the same period of last year. The low inflation rate, which will very likely remain well below the NBP's target throughout this year, should hit bottom during the summer. Given the latest dovish comments from the NBP, markets may be more susceptible to inflation data in the months to come, and this susceptibility may already become evident after next week's meeting.

Calendar

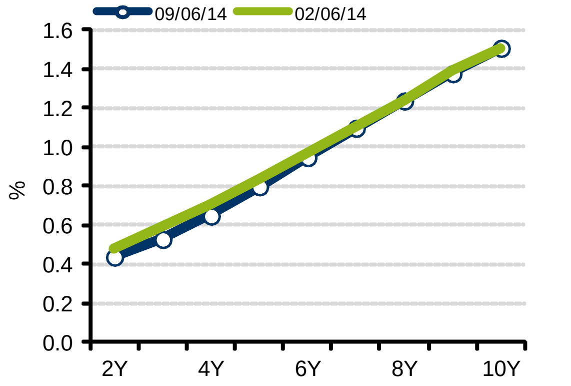
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	06/09/2014	9:00	CPI	%	05/2014	0	0.3	0.1	0.4	0	0.1
CZ	06/09/2014	9:00	Unemployment rate 15-64	%	05/2014	7.7		7.6		7.9	
HU	06/11/2014	9:00	CPI	%	05/2014		-0.2	-0.1	-0.1	0.1	-0.1
HU	06/12/2014	9:00	Industrial output	%	04/2014 *F					2.4	10.1
CZ	06/13/2014	10:00	Current account	CZK B	04/2014	11.2		11.6		23.13	
PL	06/13/2014	14:00	Current account	EUR M	04/2014			510		517	
PL	06/13/2014	14:00	Trade balance	EUR M	04/2014			572		475	
PL	06/13/2014	14:00	Money supply M3	%	05/2014			0.9	5.6	0.6	5.4
PL	06/13/2014	14:00	CPI	%	05/2014		0.4	0	0.5	0	0.3

Fixed-income in Charts

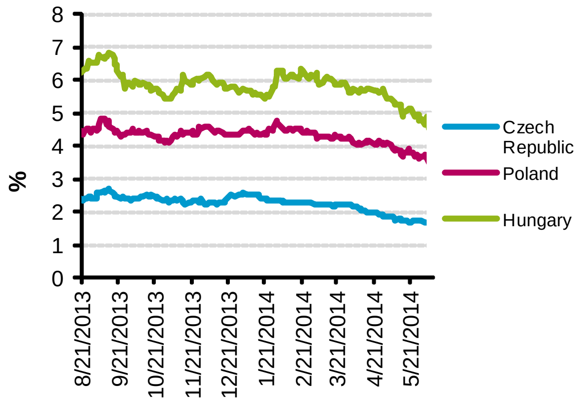
FRA 3x6



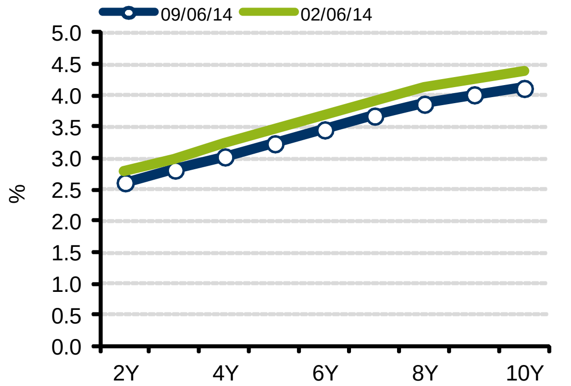
CZ IRS



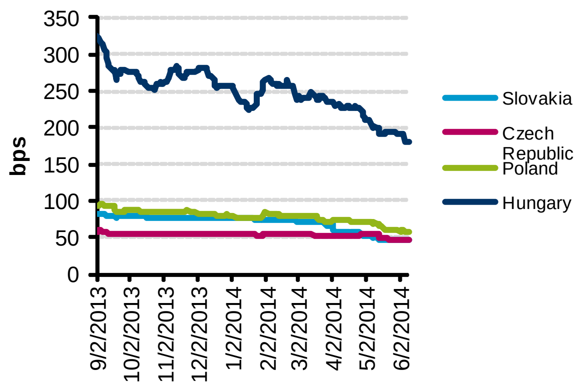
10Y GB Yields



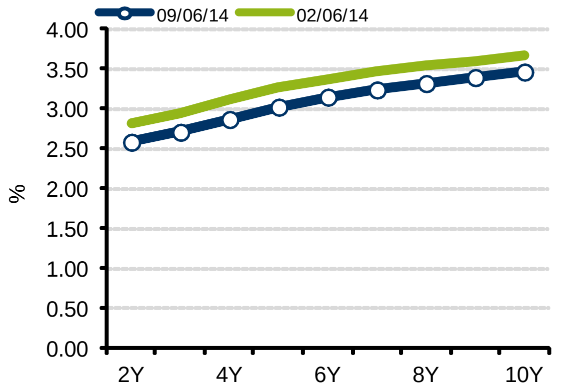
HU IRS



CDS 5Y



PL IRS



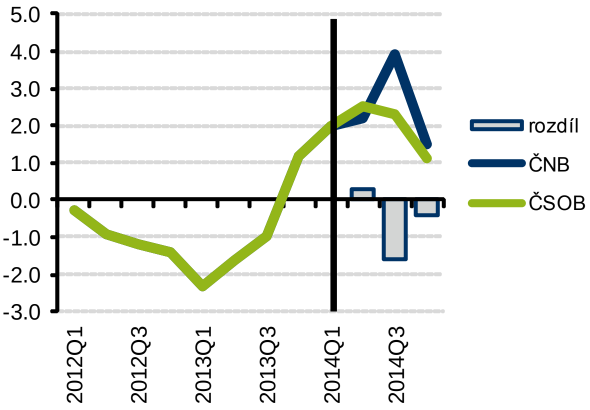
Source: Reuters

Medium-term Views & Issues

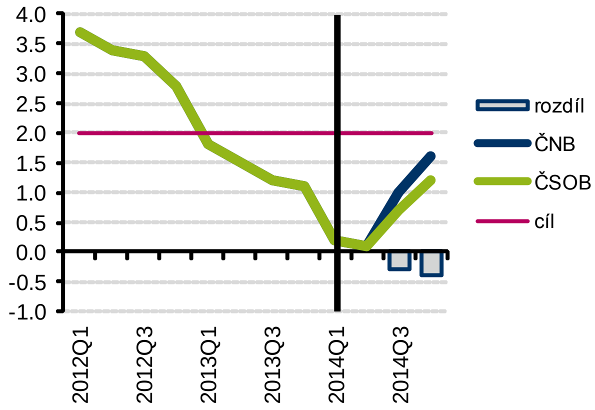
	The Czech Republic	Hungary	Poland
Growth & key issues	The president appointed a new coalition government a few months after the election. The programme of the future government is likely to be consistent with the concluded coalition agreement, which envisages keeping the government deficit below 3% of 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 3.4% 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 should play in favor of stable official interest rates in the rest of this year. The main risk in this regard stems from the ECB meeting and its possible impact on the zloty exchange rate. If the zloty continued to strengthen, it would not be welcome news for the NBP, especially with inflation hovering well-below the target and risk of slower growth due to Ukraine.
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. The main risk as regards the zloty is the ECB decision to ease MP which could further support the currency.

CBs' Projections vs. Our Forecasts

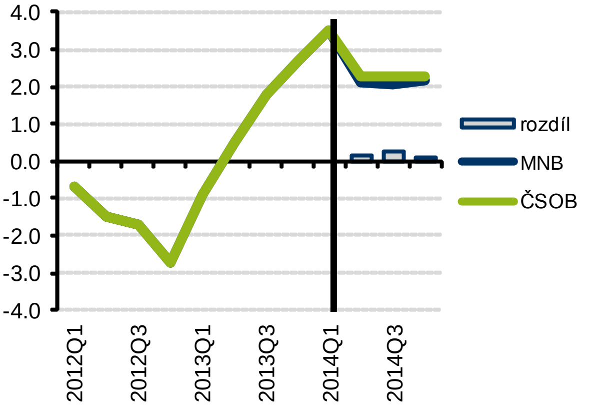
CZ: GDP outlook (Y/Y, %)



CZ: Inflation outlook (Y/Y, %)

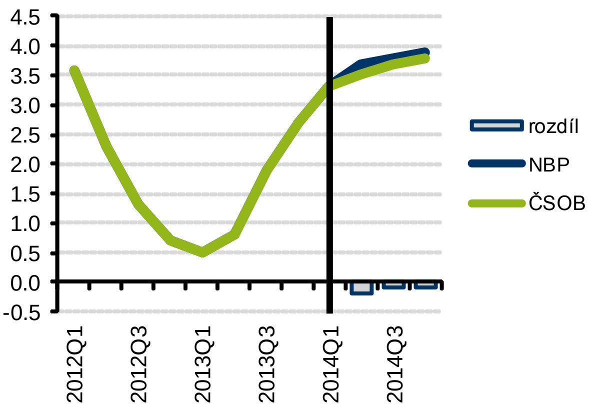


HU: GDP outlook (Y/Y, %)

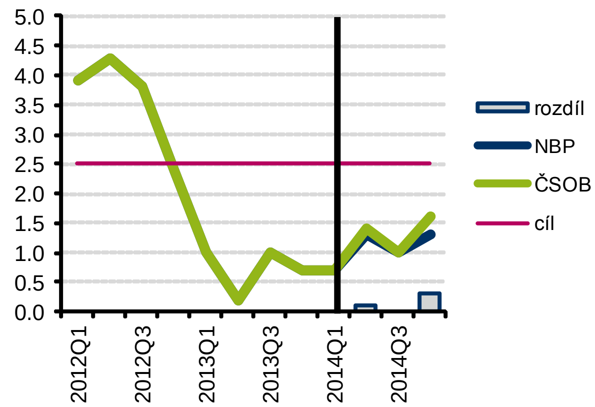


HU: Inflation outlook (Y/Y, %)

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.	*2.40*	3.00	2.60	2.50	2.50	2.50	-15 bps	5/27/2014
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	*2.45*	2.99	2.67	2.50	2.50	2.50
Poland	WIBOR	*2.69*	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	*1.51*	2.09	1.84	1.75	1.90	2.00
Hungary	HU10Y	*4.12*	5.25	4.95	5.00	5.30	5.70
Poland	PL10Y	*3.47*	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	*27.5*	27.3	27.4	27.2	27.2	27.2
Hungary	EUR/HUF	*303*	297	307	305	298	295
Poland	EUR/PLN	*4.10*	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	2.5	2.3	1.1
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	0.2	0.9	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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