



Central European Weekly

Monday, 15 June 2015

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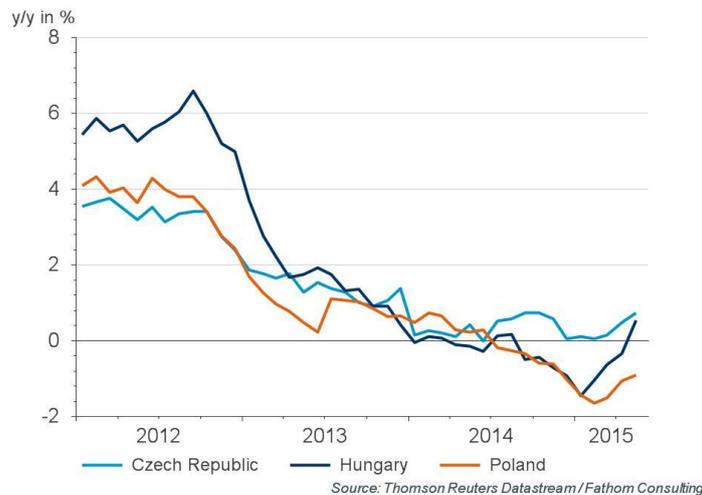
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Weekly Highlights:

- Surprise jump of Hungarian inflation might give good reason to stop NBH's easing cycle
- Koruna at three-month highs thanks to higher inflation and positive news from the economy
- Polish inflation surprises on the downside in May

Chart of the Week: Headline inflation

Inflation



May figures showed that headline inflation in the region on the rise.

Market's editorial

Higher-than-expected inflation helps the CZK and the HUF

Higher-than-expected inflation in the Czech Republic and Hungary helped both the koruna and the forint strengthen slightly last week, based on the consideration that nothing will now make the Czech National Bank and the National Bank of Hungary ease their respective monetary policies, as the fear of deflation has gone. For the CNB, this can therefore mean that CNB Board members will no longer consider introducing negative interest rates as one of their options. In case of the NBH we think that the inflation orbit the NBH forecasted in March inflationary report is not tenable, so the Central bank may have to revise it in the June inflationary report upward, which might give a good opportunity for the Monetary Council to stop the easing cycle at 1.5%, which implies another 15bps rate cut in June.

The May inflation not so good news for the Polish zloty

Polish markets have been also awaiting May's figures, but we do not expect that the zloty could actually profit these inflation readings. The data came actually in below market expectations (-0.7% y/y) as the headline inflation actually

reached -0.9% y/y. Hence, inflation in Poland remains well below zero and therefore far from the target of the central bank (2.5%), we do not think that May figures will have any impact on its policy. NBP has already said it is likely to keep interest rates unchanged in the remainder of this year which is in line with our expectations. On the other hand, lower inflation may make some market participants revise their expectations of interest rate hike early next year which have started to build recently.

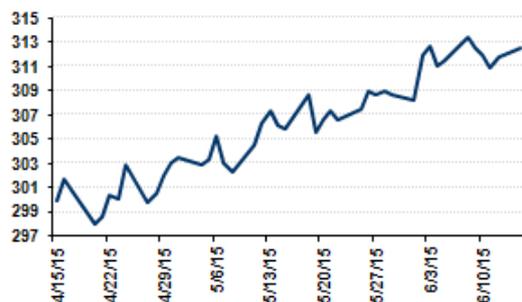
Regional markets should watch Greece and the Fed

Nevertheless, key events for the regional currencies as well as bonds (and stocks) will clearly take place abroad this time – especially in Greece and Brussels. Negotiations between Greece and its creditors again failed this weekend. This is weighing on global markets as sentiment turns risk-off. While markets will also be counting down to the Fed policy decision on Wednesday, we assume that they will keep a low profile due to the developments surrounding Greece with the Euro group meeting on Thursday.

	Last	Change 1W
EUR/CZK	27,3	-0,47%
EUR/HUF	313	-0,40%
EUR/PLN	4,15	-0,65%

	Last	Change 1W
10Y CZK	1,36	3,82
10Y HUF	3,62	5,54
10Y PLN	3,11	2,47

EUR/HUF



EUR/HUF, last 44 days. Source: Reuters

EUR/CZK



EUR/CZK, last 118 days. Source: Reuters

Review of Economic Figures

Inflation in the region on the rise

May's consumer price index grew by 0.3% m/m and a huge 0.7% y/y **in the Czech Republic**. Thus inflation surpassed the expectations of markets as well as of the central bank. The main contributors to May's price increases included fuels, reflecting the development of oil prices on global markets, seasonally costlier food, cigarettes and alcohol. Alcohol and tobacco have after all helped inflation in the Czech Republic grow for a number of months. The latest figures have confirmed that deflation has been warded off.

Apart from cigarettes and alcohol, only footwear and clothing are significantly costlier than last year. By contrast, food and numerous consumer goods – notably electronics – have become cheaper and cheaper. The new inflation figures surpassed the central bank forecast and should actually please the CNB. Inflation should remain below 1% in the months to come. The CNB's target level is still fairly far away, with inflation not to climb there before late 2016.

The Hungarian consumer price index was 0.5% Y/Y in May up from -0.3% Y/Y in April and well above the consensus forecast of 0.1% Y/Y. The core inflation increased from 1.2% Y/Y in April to 1.3% Y/Y in May.

The main driver of the jump of the inflation was fuel (up by 3.9% M/M adding 0.3%pt to inflation), unprocessed food (up by 4.1% M/M adding 0.2%pt to CPI). The base effect also pushed CPI higher as last year the gas, the marker priced energy and food prices were shrinking.

Looking ahead it looks like that inflation returns much faster than NBH forecasted it in its March inflationary report and CPI may already get close to inflation target at the end of this year, while and the average inflation might be around 3% Y/Y in 2016, while NBH forecasted that inflation may reach the inflation target of 3% Y/Y only at the end of 2017.

It is true at the moment that core inflation is increasing only slowly, but we expect that the jumping unprocessed food price may spill over into the processed one, which may push up core inflation. Market services inflation is already running at around 3% Y/Y, so the main open question: is the stable relatively strong demand able to boost the tradable goods prices as well? Our answer is yes; especially that EURHUF is weakening, which is likely to push up the price of the new collections and new cars in the coming months.

Unlike the Czech Republic and Hungary, inflation rate in Poland surprised slightly to the downside of market expectations in May as it reached -0.9% Y/Y and 0.0% m/m (vs. expected -0.7% y/y and 0.2% m/m). As regards the month-on-month structure, the most significant surprise

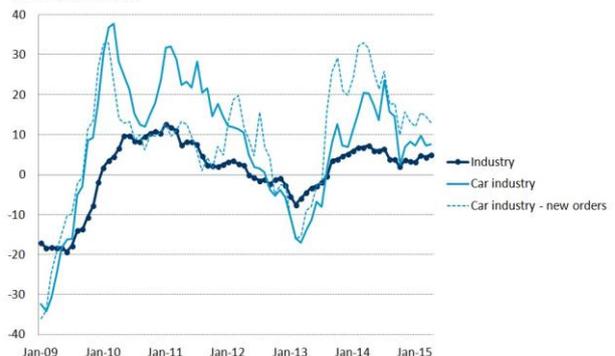
was slower than expected growth in transport prices. Moreover, prices of communication services fell as well last month and food and non alcoholic beverages prices fell slightly as well.

Although **inflation in Poland** remains well below zero and therefore far from the target of the central bank (2.5%), we do not think that May figures will have any impact on its policy. NBP has already said it is likely to keep interest rates unchanged in the remainder of this year which is in line with our expectations. On the other hand, lower inflation may make some market participants revise their expectations of interest rate hike early next year which have started to build recently.

The Czech industry maintains a very decent rate...

Czech industry met expectations and continued to grow very decently in April. Industrial output was 4.3%, which was a very promising figure in view of the high comparative baseline of last year. Thus the driver of the economy is maintaining a very solid rate, continuing to drive the economy upwards.

CZ: Industrial Production
(3m average, y/y, %)



Growth – of industry, exports and GDP – is primarily attributable to carmakers, whose output grew by more than 8%. Moreover, the months to come also look promising, as new orders for the automotive industry grew by almost 6% this time. We anticipate a rate similar to April's in the months to come. The positive outlook for industry is not only based on cars; the production of electric equipment, metal products and plastics will also boast very decent performances. By contrast, the downturn in the mining industry is probably not yet over.

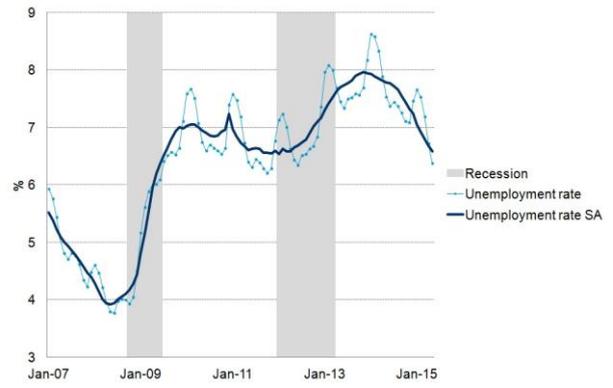
... while unemployment fell in May again

In line with expectations, the unemployment rate in the Czech Republic fell from 6.7% to 6.4% in May, thanks to seasonal jobs and persisting strong economic growth in particular. Thus the unemployment rate has fallen to a level

last seen in May three years ago. This has completely eliminated the negative effect of the last recession, which affected the economy in 2012-2013.

The number of unemployed fell by 84,000 people y/y, with 45,000 additional vacancies being available now. This is a very positive change, primarily attributable to economic growth, which is generating jobs in the manufacturing industry in particular. We believe that unemployment will continue to fall until the autumn, when seasonal jobs slowly draw to an end, and will most likely close this year below 7%.

CZ: Unemployment rate

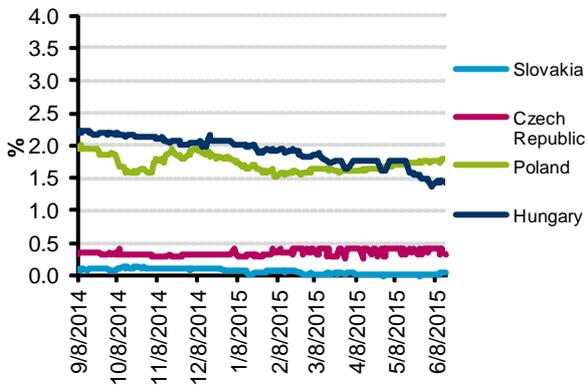


Calendar

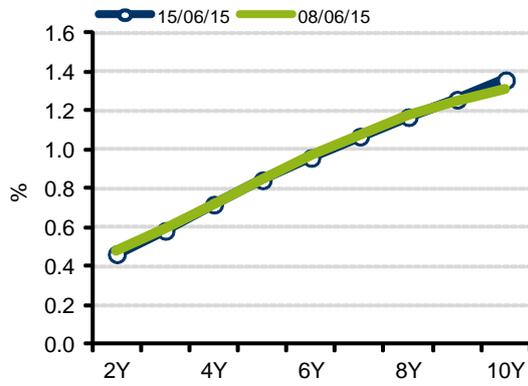
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	06/15/2015	10:00	Current account		CZK B 04/2015	0		-3		26,65	
PL	06/15/2015	14:00	Current account		EUR M 04/2015			1155		1938	
PL	06/15/2015	14:00	Trade balance		EUR M 04/2015			631		674	
PL	06/15/2015	14:00	CPI	%	05/2015	0,1	-0,8	0,2	-0,7	0,4	-1,1
PL	06/15/2015	15:00	Budget balance		PLN M 05/2015					-16700	
CZ	06/16/2015	9:00	PPI	%	05/2015	0,3	-2,3	0,2	-2,4	0,4	-2,6
PL	06/16/2015	14:00	Core CPI	%	05/2015			0	0,5	0,4	0,4
PL	06/17/2015	14:00	Wages	%	05/2015			-2,5	3,7	-2,2	3,7
PL	06/18/2015	14:00	Industrial output	%	05/2015			-0,5	3,3	-8,1	2,3
PL	06/18/2015	14:00	PPI	%	05/2015			0,2	-2,2	-0,3	-2,6
PL	06/18/2015	14:00	Retail sales	%	05/2015			0,5	1,6	-2,1	-1,5

Fixed-income in Charts

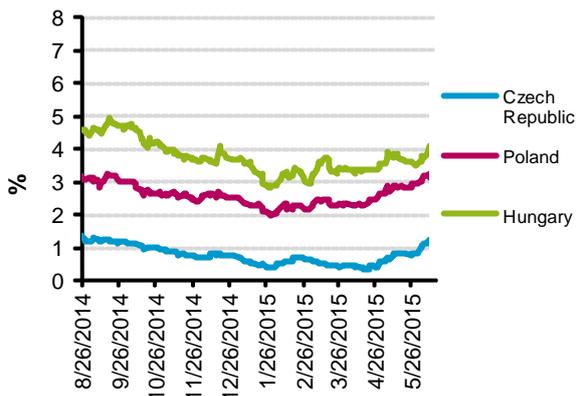
FRA 3x6



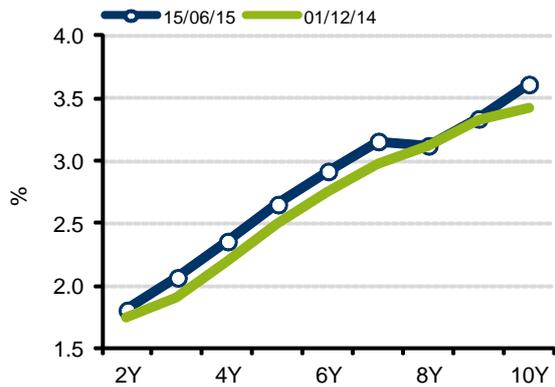
CZ IRS



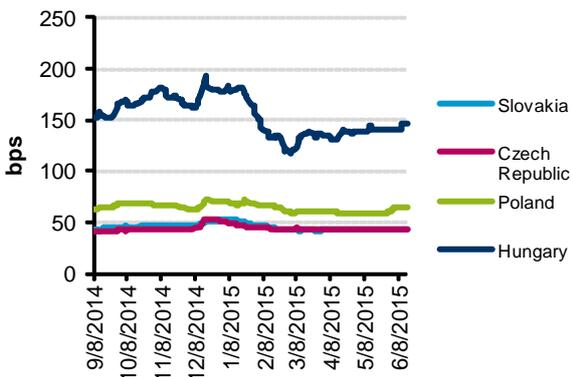
10Y GB Yields



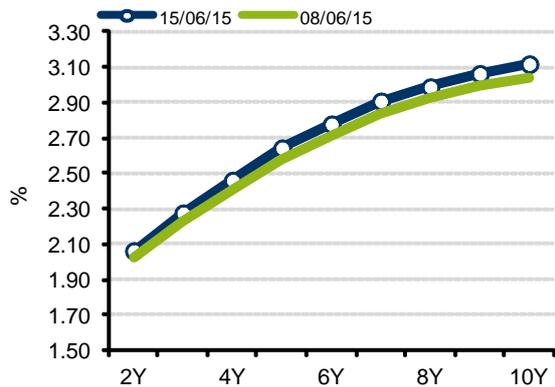
HU IRS



CDS 5Y



PL IRS



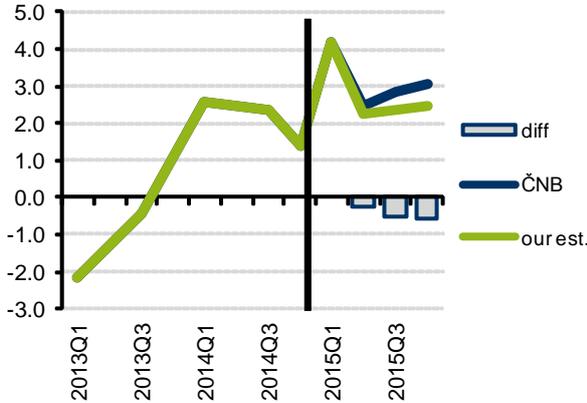
Source: Reuters

Medium-term Views & Issues

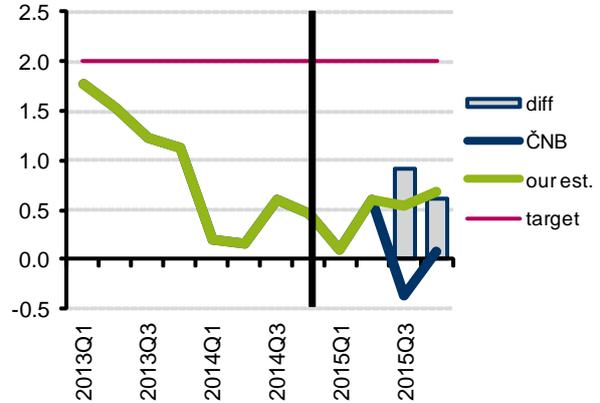
	The Czech Republic	Hungary	Poland
Growth & key issues	<p>The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing of the public sector, which is, however, generating no pressures on the capital market thanks to fairly low debt and reserves. The government policy has not delivered any fundamental economic changes so far, perhaps except for the planned abolition of the pension reform and partial modifications of certain taxes and social security benefits. The issue of euro adoption is still on ice in the CR.</p>	<p>The Hungarian economy has continued to record solid growth this year as the working day adjusted GDP grew by 3.4% Y/Y in the first quarter. Looking ahead the GDP growth might slow down slightly in the coming quarters, but the favourable European conjuncture and the increasing net real wage and employment increase might provide a stable base for the growth so we expect that Hungarian economy may grow by about 3% Y/Y in 2015.</p>	<p>According to the GUS, the Polish economy grew by 3.6% in 2015Q1. As in previous quarters, economic growth was driven mainly by strong domestic demand. We suspect households consumption was again the key driver of economic growth in Poland. As for this year, we expect economic growth may be 3.5-4%.</p>
Outlook for official & market rates	<p>Interest rates remain at all-time lows and, given the positive inflation outlook, the CNB is unlikely to raise its base rate before 2017. In addition, the central bank will not proceed to such a move before it abandons its current exchange rate policy, which is based on maintaining the exchange rate above the EUR/CZK floor. Moreover, the decreasing inflationary expectations may even delay these two steps. This possibility is reflected by money market rates and, in particular, by IRS and government bond yields. Our longer term outlook for inflation is still below the central bank's official forecasts.</p>	<p>The National Bank of Hungary cut base rate by 15bp from 1.8% to 1.65%. Although the statement mentioned these changes, it doesn't give main importance to it. In our view the last sentence: 'Cautious easing of the policy rate may continue as long as it supports the achievement of the medium-term inflation target' confirms that the NBH is determined to moderate the base rate to the Polish level of 1.5%, which is likely to be achieved already in June. We expect that it might be the end of the rate cut cycle as fundamentally we see less and less reasons to continue the cycle, while the stability risk aspect is increasing.</p>	<p>We expect the NBP to keep rates at new lows (1.50%) this year, but we cannot completely rule out the likelihood of further rate cuts. The main reason is the combination of the "inflow of cheap euros from the ECB" to markets and the unusually open commitment by the NBP not to continue to cut rates. In addition, if we take account of this year's inflation rate, which is likely to be negative for the year as a whole, such a climate will probably attract investments in Polish assets. In that event, additional pressure for the appreciation of the zloty and consequently for an inflation fall can be expected.</p>
Forex Outlook	<p>We believe a hike of EUR/CZK floor is still unlikely. This would require deterioration of currently positive economic outlook. On the other hand the, the more aggressive verbal interventions may keep the Czech koruna on the defensive for a while. Hence it is probable that the pair forgets about testing the 27 EUR/CZK for now. Fundamentally, the Czech currency should be more sensitive to readings of major Czech macroeconomic indicators – inflation, wages, industry and, of course, GDP. The koruna may get more nervous ahead of May's CNB Board meeting, where a new inflation forecast will be submitted.</p>	<p>In a longer term perspective, the HUF is still in a weakening channel implying a 2-3% depreciation of the currency against EUR on a yearly basis. In a short-run, however, if the NBH says in June that they stop now the rate cut cycle than it is rather bullish for the forint as some key market players bet that the NBH may cut the base rate to even 1.2%.</p>	<p>We expect the zloty to gain on growing capital inflows exploiting the positive interest rate differential at the time short term yields are mostly negative in the eurozone. Given the NBP pledge to end the rate cutting cycle, the market may feel temptation to test the willingness of the central bankers to tolerate further gains of the Polish currency.</p>

CBs' Projections vs. Our Forecasts

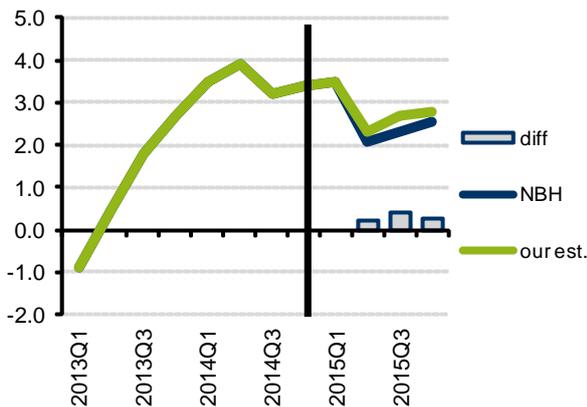
CZ: GDP outlook (Y/Y, %)



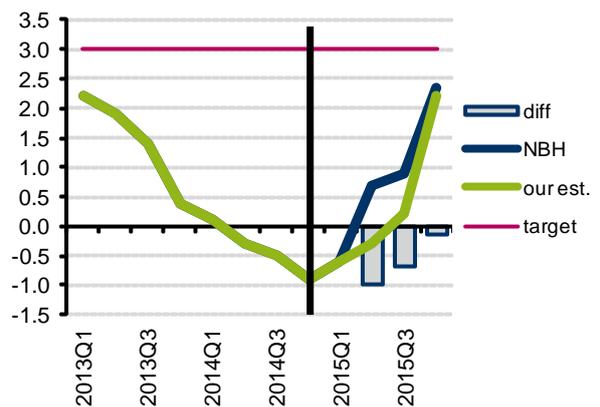
CZ: Inflation outlook (Y/Y, %)



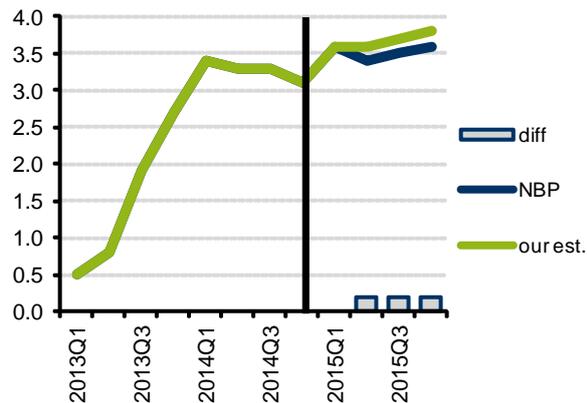
HU: GDP outlook (Y/Y, %)



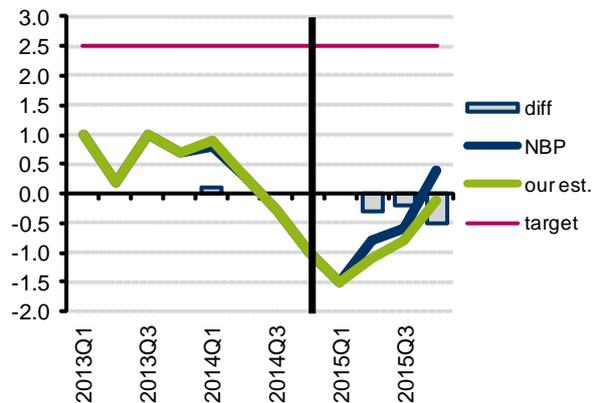
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outlook (Y/Y, %)



Source: CNB, NBP, MNB, KBC

Summary of Our Forecasts

Official interest rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	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.	1,65	1,95	1,70	1,70	2,00	2,25	-10 bps	5/26/2015
Poland	2W inter. rate	1,50	1,50	1,50	1,50	1,50	1,50	-50 bps	3/4/2015

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	PRIBOR	0,31	0,30	0,30	0,30	0,30	0,30
Hungary	BUBOR	1,50	1,89	1,70	1,70	2,10	2,40
Poland	WIBOR	1,71	1,65	1,55	1,60	1,65	1,67

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	CZ10Y	1,36	0,64	1,35	1,45	1,55	1,50
Hungary	HU10Y	3,62	2,71	3,20	3,40	3,60	3,80
Poland	PL10Y	3,12	2,12	2,10	2,20	2,40	2,80

Exchange rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	EUR/CZK	27,32	27,57	27,30	27,60	27,30	27,30
Hungary	EUR/HUF	313	300	310	317	315	310
Poland	EUR/PLN	4,15	4,07	4,05	4,00	4,10	4,05

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2,4	1,4	4,2	2,2	2,3	2,5	2,5
Hungary	3,2	3,4	3,5	2,3	2,7	2,8	2,2
Poland	3,3	3,1	3,6	3,6	3,7	3,8	3,8

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

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	0,7	0,1	0,2	0,8	0,5	1,0	1,7
Hungary	-0,5	-0,9	-0,6	-0,3	0,2	2,2	2,7
Poland	-0,3	-1,0	-1,5	-1,1	-0,8	-0,1	0,4

Current Account

	2015	2016
Czech Rep.	2,0	1,8
Hungary	4,0	3,8
Poland	-1,2	-2,0

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-2,4	-1,9
Hungary	-2,2	-2,0
Poland	-3,0	-2,5

Source: KBC, Bloomberg

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