Central European Weekly

Monday, 05 October 2015

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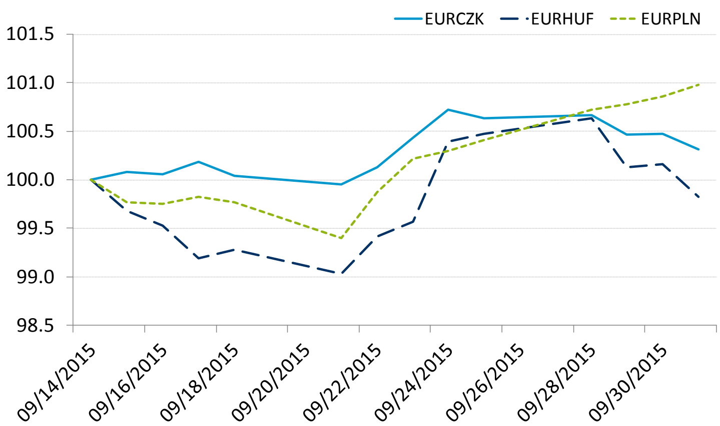
Weekly Highlights:

- Deeper deflation and upcoming elections as bearish sign for the zloty
- The Czech economy in even better shape in 2015Q2
- The Czech industry should still post strong figures for August as VW's affair might be visible later on
- The Czech and Hungarian inflation again very low in September due to low fuel prices

Chart of the Week

CE currencies against the euro



The Polish zloty has underperformed its peers recently

Market's editorial

The Polish zloty weakens as elections looms

Not only the Polish zloty but also Polish shares have under-performed their regional PEERs in recent days. One reason is that the macroeconomic data of recent days and weeks have tended to be weaker (September's PMI drop almost below the 50 level) while another reason is domestic politics. Parliamentary elections will be held in this country in three weeks, and this is an event to which Polish markets are not generally immune.

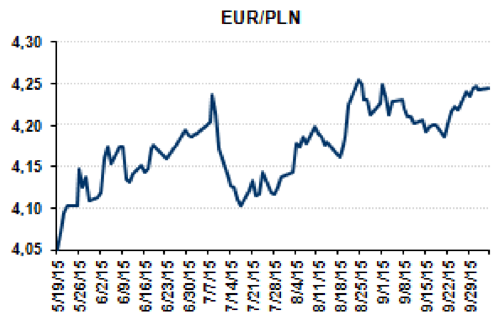
Just as during the spring presidential election, the question is how the market-friendly ruling liberal Civic Platform (OP) will perform and how much the Christian conservatives represented by the Law and Justice (PiS) party will succeed. Opinion polls ahead of the elections indicate that the PiS will win, but now it will be important whether the party will achieve an absolute majority in Parliament, which would probably require gaining more than 40% of the votes. In that event the PiS could fully implement its economic programme, several sections of which are based on tax increases and structural reforms that are not exactly 'pro-market'. Therefore, Polish markets may be more nervous in the next three weeks, and it is clear that the global developments in equity markets and emerging markets will not significantly help Polish assets either.

Thanks to deflation government bonds in a better position

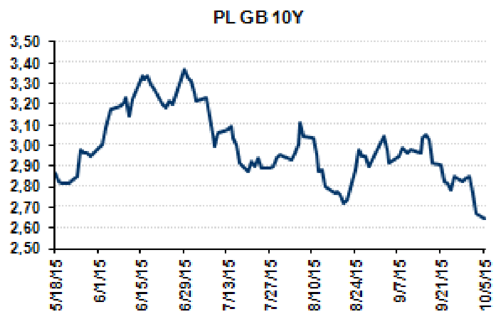
On the other hand Polish government bonds can feel fairly safe, currently being encouraged by two important bullish factors: firstly, Polish inflation fell even more into the red and thus the NBP will tend to welcome easing of monetary conditions; secondly, the very positive developments on global markets in government bonds are also an advantage. Nevertheless, here we should warn again that if the zloty were to weaken really significantly ahead of the elections, it may also adversely affect the market in Polish government bonds. Still, in that bearish scenario for the zloty either the Ministry of Finance or the NBP would probably take advantage of the situation and stabilise the forex market by selling euros, thus getting rid of their huge FX reserves accumulated in recent past.

	Last	Change 1W
EUR/CZK	27.1	-0.44%
EUR/HUF	311	-1.38%
EUR/PLN	4.24	-0.12%

	Last	Change 1W
10Y CZK	0.92	-11.54
10Y HUF	2.77	-5.46
10Y PLN	2.33	-5.82



EUR/PLN, last 100 days. Source: Reuters



PL GB 10Y, last 100 days. Source: Reuters

Review of Economic Figures

Teh Polish deflation deepened in September

According to preliminary estimates, Polish deflation deepened in September - the statistical office said prices fell by 0.8% Y/Y and 0.2% M/M. All in all, the decline means that deflation period in Poland is now likely to extend until the end of this year. Risks of below-zero reading next January increased as well. Regarding the possible impact on monetary policy, we keep our base case and expect interest rates to remain unchanged in the months and quarters to come. In this respect, worse than expected US labour markets figures pose a greater risk (via its prospective influence on ECB and NBP policy).

The Czech economy in even better shape in the 2nd quarter

After the last revision from the Statistical Office, it is clear that economic growth in the second quarter of this year did not only reach the previously presented 4.4% (by the way, the second-best figure in the EU so far), but actually hit 4.6%. What has changed in the data presented to date, i.e., where did this even faster rate of the Czech economy come from? The answer is provided by the Statistical Office itself – updated tax collection data.

If we look at other individual GDP components, we find that the current revision has not changed anything in the rate of household consumption but it has slightly reduced the solidly growing government consumption (to 2.3%) and, in particular, it has significantly increased investment. Thus this year's investment boom has actually been even greater than it has looked so far (+7.3% as opposed to 5.9%). The investments are primarily attributable to activities in buildings and structures, which were responsible for a full half of the investment increase for the whole economy in the second quarter of the year. It will probably not be far from the truth if we also attribute the revision to the public sector, striving to take advantage of EU Funds through rapid infrastructure construction and reconstruction.

It is very nice to see that investment is also being made in machinery and equipment, and this indicates that the private sector is not at all avoiding investments either. Business sector profitability, which is still very strong and has been growing rapidly for two years – while reaching record-breaking levels – is also good news.

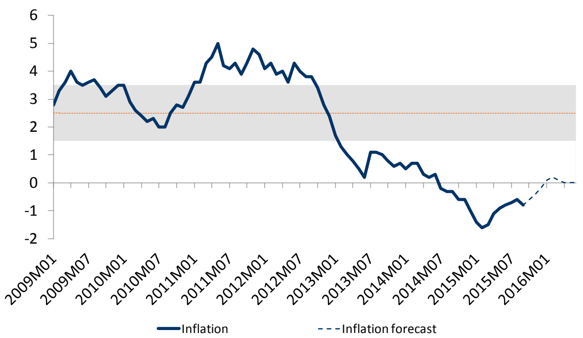
If we look at GDP creation, we find that nothing except taxes is changing significantly. The main driver of the economy continues to be the manufacturing industry, followed by trade and transport, administrative activities, including scientific activities, the financial sector, and public administration. As expected, no sector was in the red.

This listing of good news cannot ignore the improving financial position of households, represented by disposable income, which grew by 3.7% in nominal terms and 3% in real terms. The last time that the financial position of households improved so rapidly was in 2007. Of course, this is primarily attributable to growing employment, low inflation, and restored wage growth in the Czech Republic.

The current updated figures about the development of the Czech economy in the second quarter are confirmed by positive trends in both the supply and demand sides. The economy has also good prospects for the remainder of the year, although it will clearly be increasingly harder to maintain such a high growth rate. Therefore, we expect the rate of growth of the Czech economy to return below 3% next year.

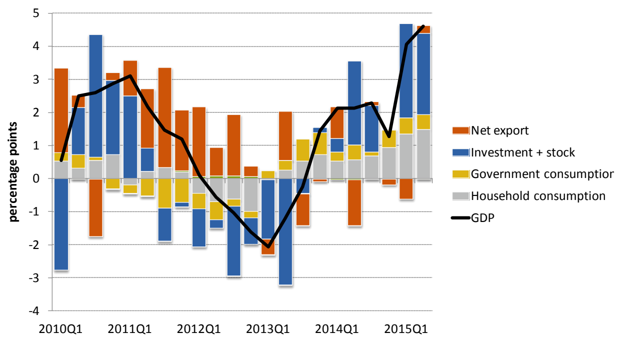
PL: Inflation

Y/Y in %; NBP tolerance band is grey, inflation target is orange dotted line



CZ: Contributions to variation in GDP

(SA)



Weekly preview

TUE 9:00 **CZ Foreign trade (CZK bn)**

	Aug-15	Jul-15	Aug-14
Balance (national)	**0.0**	6.8	1.1
cummulative (YTD)	**109.4**	109.4	110.1
Balance	28.6	31.1	19.6
cummulative (YTD)	**296.4**	267.8	286.0

CZ: Czech demand drives imports

The expected balanced foreign trade figure is not very far from that for August 2014. On the one hand, foreign trade is benefiting from improving European demand for cars and engineering products; on the other hand, strong growth in domestic demand is generating additional pressure for growing imports of consumer as well as industrial goods. Moreover, cheaper oil, reducing the koruna value of the imports of this strategic raw material, and thus partly also improving the trade balance, may also have a positive effect on imports.

TUE 14:00 **NBP rate (in %)**

	This	Last change
rate level	**1.50**	3/2015
change in bps	**0**	-50

PL: Central bank firmly on hold

The National Bank of Poland will again leave rates unchanged. Although the economy has produced less favourable figures recently (inflation, PMI), members of the Monetary Policy Council (MPC) are not very willing to continue to cut rates. We also anticipate rate stability until the end of the year. This scenario is favoured not only by the economic situation but also by the fact that many MPC members will be replaced early next year.

WED 9:00 **CZ Industry (y/y change in %)**

	Aug-15	Jul-15	Aug-14
Monhtly	**6.0**	4.6	-5.7
cummulative (YTD)	**5.1**	5.0	5.2

CZ: Industry driven cars ahead of VW's affair

A strong year-on-year increase on the one hand and a drop vis-à-vis the previous month on the other. This is probably how the performance of Czech industry for August, affected by holidays at carmakers, might look. Aside from this effect, all the other strong industry sectors are likely to post very good figures. Nevertheless, orders, which – we believe – continued to grow at a decent rate in that month, will again be more important in the end. After all, confidence indicators and purchasing manager indicators had also suggested that there were enough new orders.

WED 9:00 **CZ Retail Sales (change in %)**

	Aug-15	Jul-15	Aug-14
Sales	**8.6**	5.7	3.4
cummulative (YTD)	**7.8**	7.7	5.6
Sales (cars excl.)	**5.8**	5.7	2.0
cummulative (YTD)	**5.9**	5.7	2.8

CZ: Cars and electronics dominate the retail

The anticipated very high retail sales figure is again attributable to the current strong sales of passenger cars as well as growing sales by other retailers, notably in e-commerce. Consumer demand is still primarily focused on electronics with their falling prices, household equipment, food and fuel. With the improving financial position of Czech households and the consumer mood remaining positive, sales and household consumption will also grow. Nevertheless, not even such high real sales growth is generating sufficiently large latitude for demand-pull inflation, and consequently a return to standard monetary policy.

Weekly preview

WED 9:00 — **HU Industry (change in %)**

	Aug-15	Jul-15	Aug-14
Monthly	**3.5**	3.4	3.0

HU: Industry slowed down in summer

Industrial production is usually volatile in the summer time because of the high portion on car manufacturer companies, so we expect that the August figure might be below this year's average level of 6.6% Y/Y and might be close to the previous month's read of 3.4% Y/Y.

THU 9:00 — **CZ Unemployment Rate (in %)**

	Sep-15	Aug-15	Sep-14
Rate	**6.1**	6.2	7.3

CZ: Number of vacancies on the rise

We believe that the positive trend on the domestic labour market did not end in September either, and thus the unemployment rate probably fell again. The unemployment rate is therefore heading towards the levels where it stood the last time in 2011, when the economy recovered slightly and only temporarily. Favourable developments can also be expected in the creation of new jobs, the number of which has exceeded the 100,000 mark. Thus the ratio of the unemployed to vacancies will only be 4:1 (on average).

THU 9:00 — **HU Inflation (change in %)**

	Sep-15	Aug-15	Sep-14
CPI y/y	**-0.1**	0.0	-0.5

HU: Fuel price will push inflation below zero

Inflation is expected to remain extremely low because of fuel price drop. After the 0% CPI in August, it may move slightly into negative territory, so we expect -0.1% Y/Y figure for September, but we think that CPI may jump above 0.5% Y/Y already in October because of the base effect of last year's regulated price cut.

FRI 9:00 — **CZ Inflation (change in %)**

	Sep-15	Aug-15	Sep-14
CPI m/m	**-0.3**	-0.2	-0.2
CPI y/y	**0.2**	0.3	0.7
Monetary relevant inflation y/y	**0.0**	0.1	0.6

CZ: Another inflation fall on the horizon

We believe that the consumer price index probably fell again in September. The main contributors to this included fuel and a significant seasonal reduction in package tour prices. Year-on-year inflation likely dropped to 0.2% this time, thus again moving away from the target as well as the forecast of the central bank. Nonetheless, the primary contributors included cheaper fuel and food. We expect that inflation will not begin to rise again before late this year, as the effect of the comparative baseline will start to play an increasing role. Even so, inflation is unlikely to return to the CNB’s target before 2017.

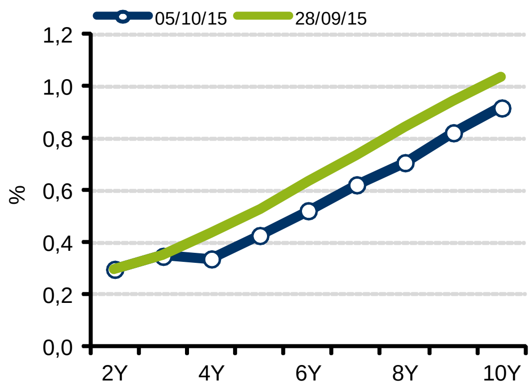
Calendar

Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
HU	10/05/2015	9:00	Retail sales	%	08/2015						7
CZ	10/06/2015	9:00	Trade balance (national)	CZK B	08/2015	0		2.1		6.8	
PL	10/06/2015	14:00	NBP meeting	%	10/2015	1.5		1.5		1.5	
HU	10/06/2015	16:00	Budget balance	HUF B	09/2015					-914.9	
CZ	10/07/2015	9:00	Construction output	%	08/2015						12.3
CZ	10/07/2015	9:00	Industrial output	%	08/2015		6		8.4		4.6
CZ	10/07/2015	9:00	Retail sales	%	08/2015		8.6		7.4		5.7
HU	10/07/2015	9:00	Industrial output	%	08/2015		3.5			-0.7	3.4
CZ	10/08/2015	9:00	Unemployment rate 15-64	%	09/2015	6.1		6.1		6.2	
HU	10/08/2015	9:00	CPI	%	09/2015		-0.1	-0.2	0	-0.6	0
CZ	10/09/2015	9:00	CPI	%	09/2015	-0.3	0.2	-0.3	0.3	-0.2	0.3
HU	10/09/2015	9:00	Trade balance	EUR M	08/2015 *P					646	

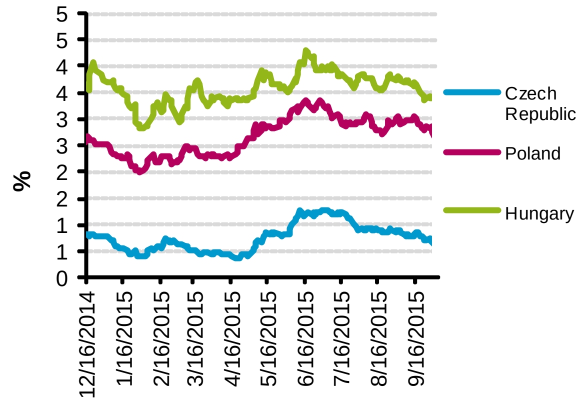
Fixed-income in Charts

FRA 3x6

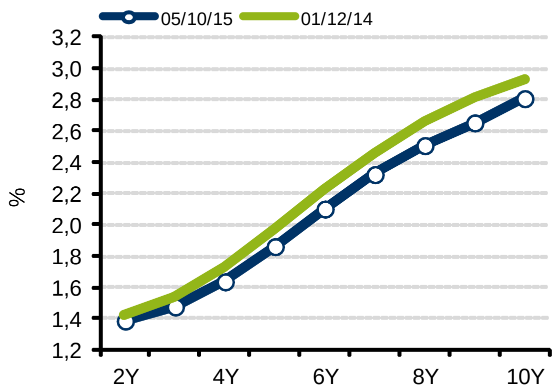
CZ IRS



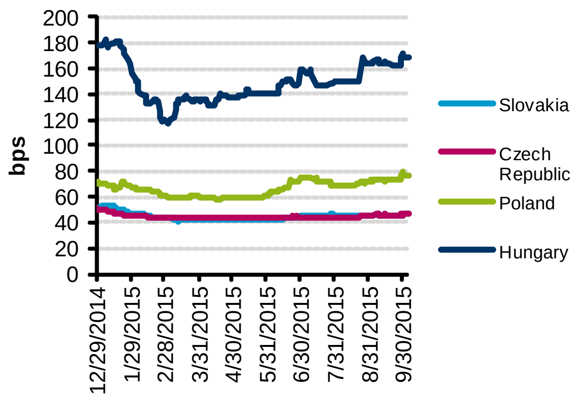
10Y GB Yields



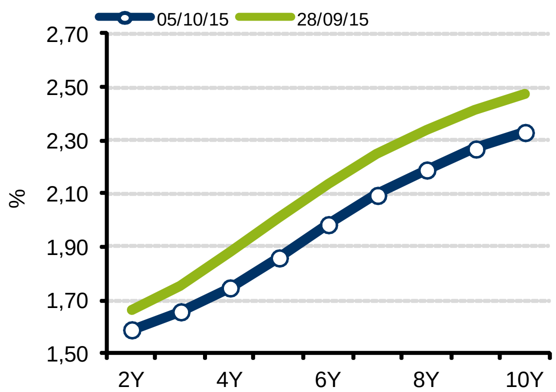
HU IRS



CDS 5Y



PL IRS



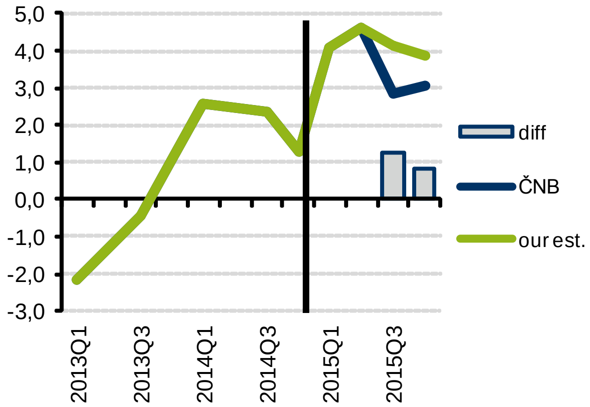
Source: Reuters

Medium-term Views & Issues

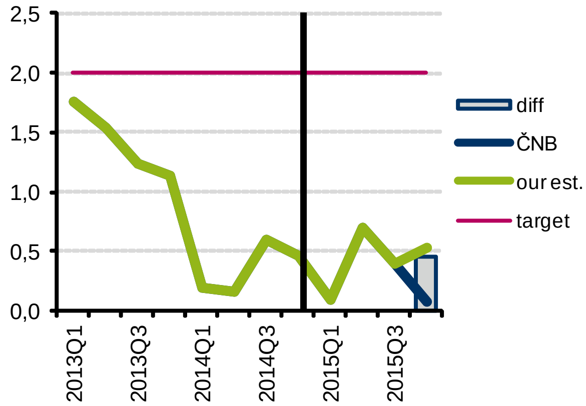
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – encouraged by growing real wages and employment – becoming a strong stimulus. At the moment, we cannot expect any fundamental economic changes or reforms, except for the abolition of the pension reform and the introduction of the electronic registration of sales. Progress in the country's preparations for joining the euro area is not expected in this electoral term either.	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.	The Polish Statistical Office kept its flash GDP forecasts for the second quarter of the year unchanged – this means growth of 3.3% y/y and 0.9% q/q. Thus the data for the second quarter fell short of expectations, but only slightly. Perhaps only the deceleration of the rate of investment may pose some issues; nevertheless, we are not overestimating this at the moment either. The overall positive economic developments in Europe and the long-term eased monetary policy should translate into growth of the Polish economy within the range of 3.5-4% this year as well as the next.
Outlook for official & market rates	The CNB's monetary policy continues to be based on record-low interest rates and the weak koruna. The exchange rate policy, not allowing the koruna to strengthen beyond (below) EUR/CZK 27.0, is most likely to remain in place at least until the second half of 2016, and low interest rates probably even longer. The reason is that inflation remains below the 2% target and will most likely remain there next year, and will only slowly approach the target.	The NBH surprised the market as it shifted the interest rate corridor of overnight (O/N) instrument by 25bp downward, so the new interest rate is 0.1% (base rate minus 125bp) for deposit and 2.1% (base rate plus 75bp) for loans. This move means practically a 25bp rate cut and is clear the NBH is fully committed to force out money from NBH so it cannot be excluded that further steps may come in the future. We think the NBH will cut further its base rate, if the ECB loosen further its monetary policy and the EUR/HUF moves closer to 300. In that case the base rate might be cut below 1%, while we think that with the previous speed, namely by 15bp per meetings.	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.
Forex Outlook	Relatively strong economic growth, current and capital account surpluses and ongoing QE in the euro zone have been the key factors behind the recent strength of the koruna. We believe the Czech National Bank will meet its "pledge" and won't terminate its intervention regime before the second half of 2016. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Possible start of tightening of US monetary policy poses negative risks for the koruna. We however think the fallout should only be limited.	We think that any strengthening of the HUF is rather temporary and the NBH's commitment to the long time low interest rate (just like the gradual push out of foreign holding from Hungarian government bonds) may lead to a HUF weakening in the coming weeks and months. It is also clear that the NBH has no problem with the HUF weakening, so rate hike driven by a temporary HUF devaluation is out of picture.	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. Polish general elections in autumn however pose a negative risk for the zloty.

CBs' Projections vs. Our Forecasts

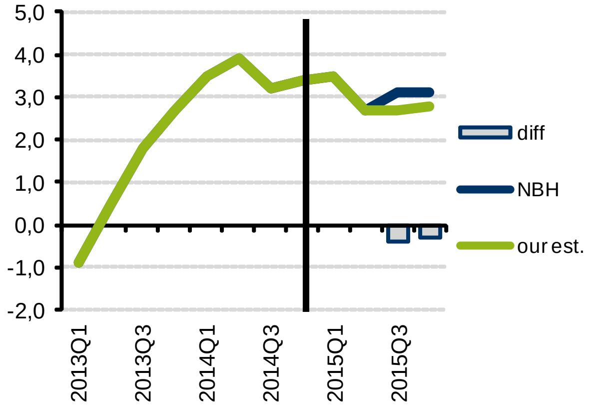
CZ: GDP outlook (Y/Y, %)



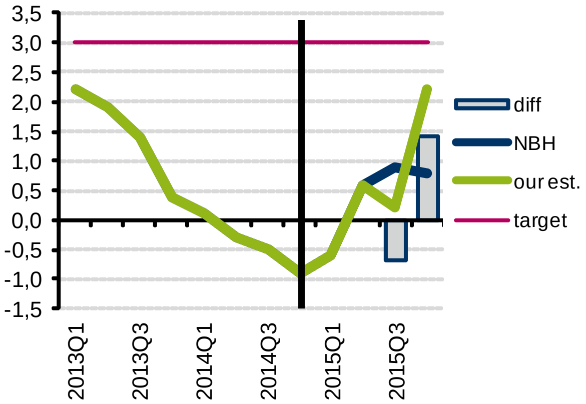
CZ: Inflation outlook (Y/Y, %)



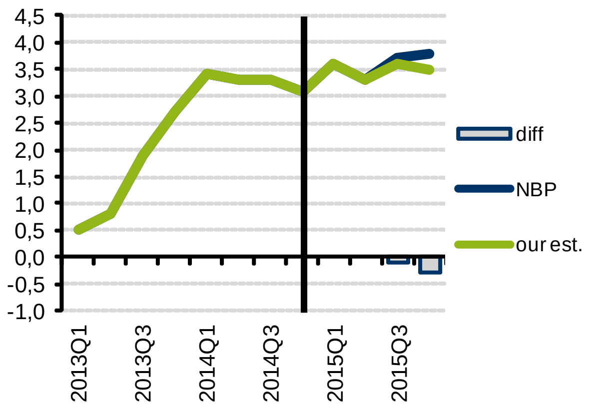
HU: GDP outlook (Y/Y, %)



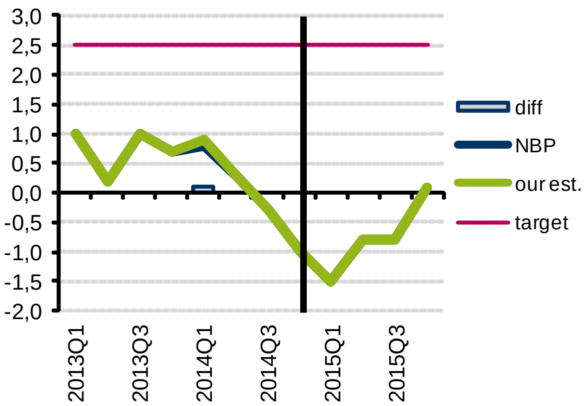
HU: Inflation outlook (Y/Y, %)



PL: GDP outlook (Y/Y, %)



PL: Inflation outllok (Y/Y, %)



Source: CNB, NBP, MNB, 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.	*1.35*	1.95	1.50	1.35	2.00	2.25	-10 bps	7/21/2015
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	*0.00*	0.30	0.29	0.26	0.30	0.30
Hungary	BUBOR	*1.35*	1.89	1.41	1.35	2.10	2.40
Poland	WIBOR	*1.73*	1.65	1.72	1.73	1.65	1.67

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

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	CZ10Y	*0.92*	0.64	1.30	0.98	1.30	1.40
Hungary	HU10Y	*2.77*	2.71	3.45	2.93	3.60	3.80
Poland	PL10Y	*2.33*	2.12	3.01	2.50	2.40	2.80

Exchange rates (end of the period)

		Current	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	EUR/CZK	*27.15*	27.57	27.35	27.19	27.05	27.00
Hungary	EUR/HUF	*311*	300	315	314	315	310
Poland	EUR/PLN	*4.24*	4.07	4.19	4.25	4.15	4.10

GDP (y/y)

	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1
Czech Rep.	2.4	1.3	4.1	4.6	4.1	3.9	2.2
Hungary	3.2	3.4	3.5	2.7	2.7	2.8	2.2
Poland	3.3	3.1	3.6	3.3	3.6	3.5	3.5

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	0.3	0.8	1.4
Hungary	-0.5	-0.9	-0.6	0.6	0.2	2.2	2.7
Poland	-0.3	-1.0	-1.5	-0.8	-0.8	0.1	0.4

Current Account

	2015	2016
Czech Rep.	1.5	1.5
Hungary	6.0	4.5
Poland	-1.2	-2.0

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-1.6	-1.3
Hungary	-2.3	-2.1
Poland	-3.0	-2.5

Source: KBC, Bloomberg

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