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# Central European Weekly

Monday, 27 April 2015

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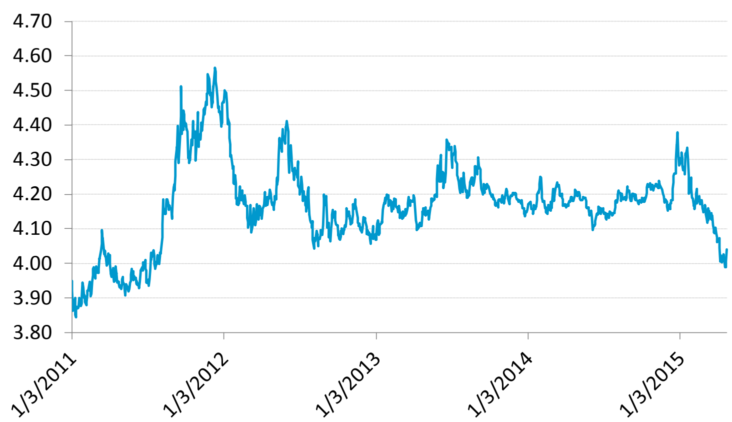
## Weekly Highlights:

- NBH rates at all-time lows, more cuts to come
- Polish data suggest strong growth continues
- The confidence in the Czech economy remains unchanged at high levels

## Chart of the Week: Strong Polish zloty




*Last week, the Polish zloty hit the strongest level since June 2011 (Source: Bloomberg, CSOB)*

# Market's editorial

## NBH's base rate at all-time lows, more cuts to come

Last week, the National Bank of Hungary delivered an expected rate cut. The base rate has thus been reduced by 15bps from 1.95% to 1.8%. The Monetary Council highlighted in the statement that year-on-year inflation is expected to approach 3% inflation target towards the end of the forecasted period. The council is optimistic about the economic growth outlook, which is supported both domestically and externally.

Regarding the market environment, the Council again emphasized that cautious monetary policy is required as the geopolitical risks are increasing. The statement however concluded with the same sentence as last month: 'Cautious easing of the policy rate may continue as long as it supports the achievement of the medium-term inflation target.'

Although CPI was -0.6% Y/Y in March, it started to accelerate in the last two months and is likely to return into the positive territory during the summer. Main drivers of the increase are to be the rising fuel and unprocessed food prices, but the continuously strong domestic demand should start to push up the prices of market services and tradable goods up as well. We expect that inflation may accelerate to about 2.5% by the end of the year, which is already within the NBH's tolerance band (3% +/-1ppt).

So, we maintain our view that there is no need for further rate cut from fundamental perspective. At the same time, the NBH seems to act in line with the market expectations. The rate cut cycle may thus continue as long as the external environment remains supportive. It is also quite clear that the NBH is relatively sensitive on the strong HUF and - although it has no exchange rate target - NBH would like to see EURHUF rather in the range of 305 and 310.

We therefore expect the NBH may extend the gradual rate cut cycle, which was resumed after 7 months pause in March, in the coming months. Keeping current pace of cuts, the NBH may reach the Polish base rate level (1.5%) at the end of June. At the same time, in case there are no external geopolitical shocks (like Greece or Ukraine insolvency problems), the 1.5% base rate might mark the bottom of the cycle.

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| EUR/CZK | *27.5* | *0.11%* | ➔ | ➔ |
| EUR/HUF | *303* | *1.71%* | ➔ | ➔ |
| EUR/PLN | *4.04* | *1.14%* | ➔ | ➔ |

| | Last | Change 1W | Outlook 1W ahead | Outlook 1M ahead |
|---|---|---|---|---|
| 10Y CZK | *0.59* | *14.56* | ➘ | ➚ |
| 10Y HUF | *2.80* | *4.48* | ➘ | ➚ |
| 10Y PLN | *2.24* | *6.43* | ➘ | ➚ |

# Review of Economic Figures

## Polish data suggest strong growth continues

In Poland, March industrial production growth (8.8% y/y) marked the strongest year-on-year expansion in four years, beating all forecasts. Moreover, the nominal retail sales growth of 3.3% and corresponding 6.6% real growth (let us recall that Polish economy has experienced a price decline over the past nine months) confirmed excellent prospects of the Polish economy.

On Friday, the Polish labour market came out in line with market expectations: the March unemployment rate fell to its six-year low. While the recent strong growth of wages in the corporate sector (+4.9 % in March) was boosted by a shift in bonus payment period in the mining sector, Friday's data unequivocally confirmed firm footing of the Polish economic growth.

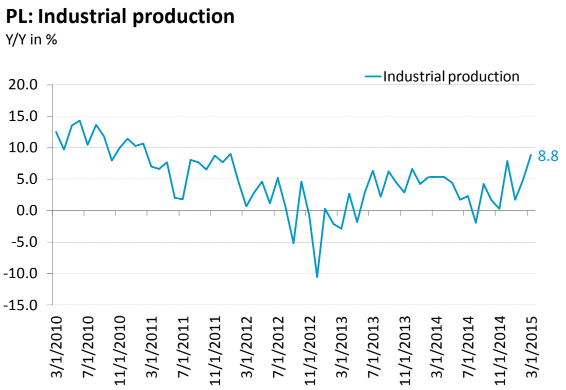
All in all, data provided an additional support for NBP´s commitment to keep rates unchanged and thereby supported the zloty which on Tuesday hit nearly a four-year high against the euro.

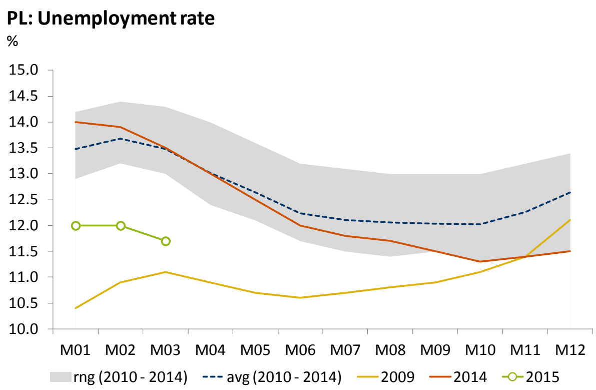
## The mood in the Czech economy remains unchanged

April's figures from the Statistical Office confirmed reasonably high confidence in the Czech economy. The upbeat mood is primarily growing in construction, which is returning to an upswing for the first time in some years thanks to new orders. The situation in industry did not change significantly compared to the previous month. A very decent stock of orders, positive expectations for the months to come and high utilisation of its existing capacities are still evident. Businesses were able to utilise up to 90% of these capacities in their best years; hence the current 85.1% suggests that certain industries have not yet returned to their pre-recession levels, while others have already built new capacities. Those which are still subdued include the mining industry in particular. The good news about the latest figures is the high willingness of businesses to invest in expanding and renovating their production facilities. This clearly applies to the expanding automotive industry, which, owing to its excellent performance in recent years, sees room for further increases in its market share on the European market.

The mood is improving not only in construction but also in trade. This reflects improving consumer demand, financially boosted by growing employment, growing income and clearly also the almost zero inflation. The stimulus of cheaper fuel is also clearly playing a positive role. Although consumer confidence decreased last month, it is still very high. Concern about a possible deterioration in the economic situation within a year has grown but this is more about prudence rather than a reaction to any real threat on the horizon.

By and large, we consider the data on the mood in the economy to be very positive. They signal a high appetite for spending money as well as investing. Thus mood is no barrier threatening this year's economic growth. It remains true that the Czech Republic's upswing is primarily determined abroad, where outlooks have been revised upwards so far.



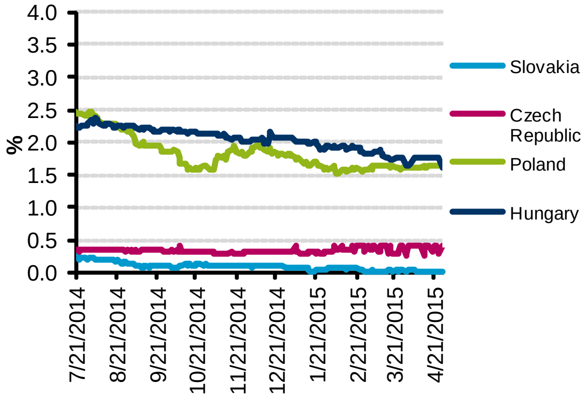



# Calendar

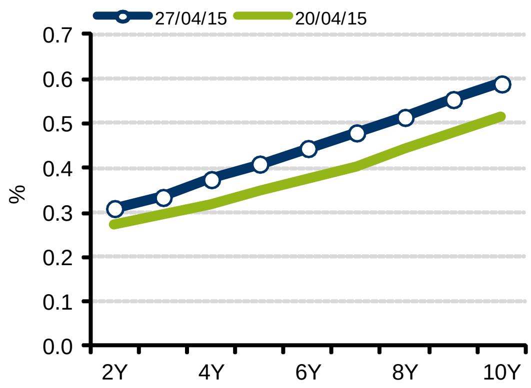
| Country | Date | Time | Indicator | | Period | Forecast | | Consensus | | Previous | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | m/m | y/y | m/m | y/y | m/m | y/y |
| HU | 04/29/2015 | 9:00 | Unemployment rate | % | 03/2015 | | | 7.7 | | 7.7 | |
| HU | 04/30/2015 | 9:00 | PPI | % | 03/2015 | | | | | -1.5 | -3.2 |
| CZ | 04/30/2015 | 10:00 | Money supply M2 | % | 03/2015 | | | | | | 5.1 |

# Fixed-income in Charts

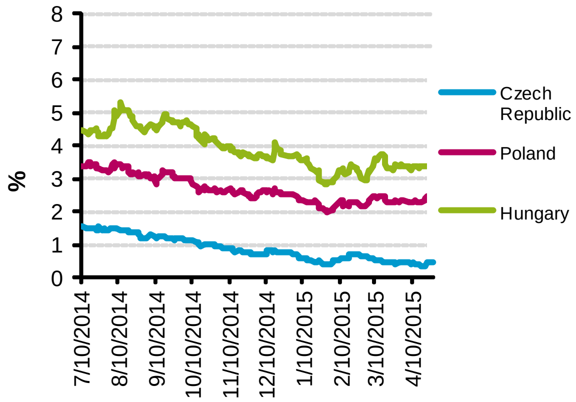
## FRA 3x6



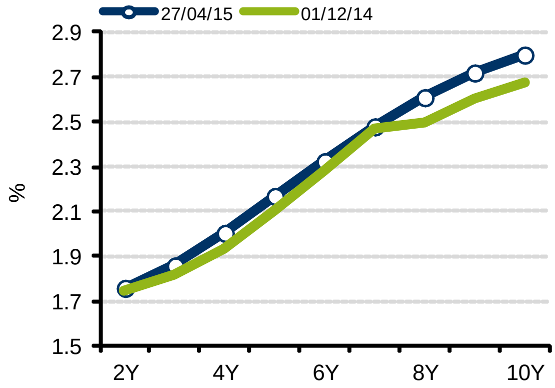

## CZ IRS



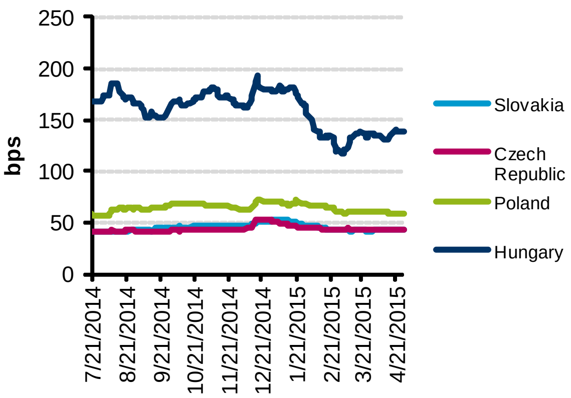

## 10Y GB Yields



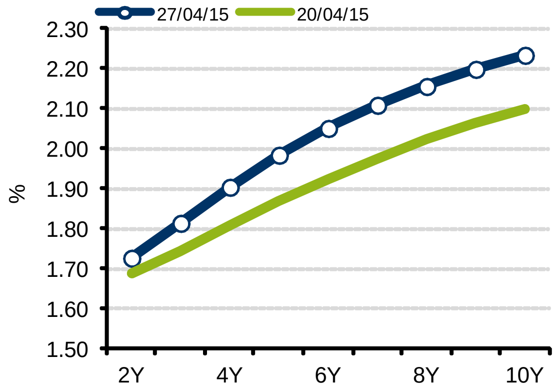

## HU IRS




## CDS 5Y




## PL IRS



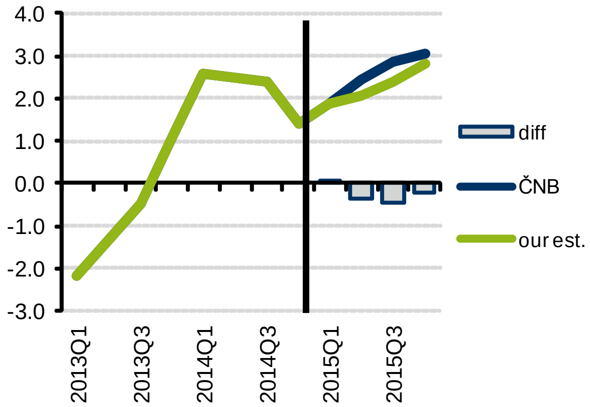

Source: Reuters

# Medium-term Views & Issues

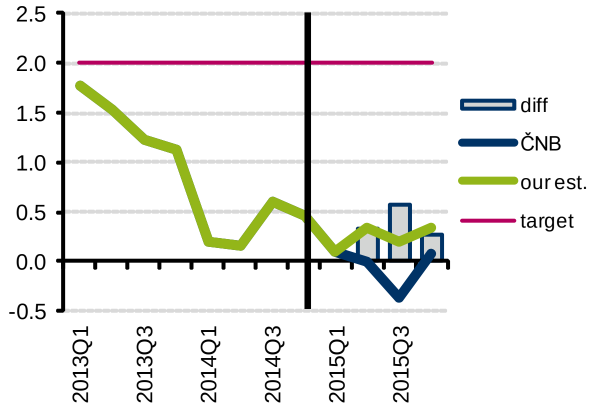
| | The Czech Republic | Hungary | Poland |
|---|---|---|---|
| Growth & key issues | The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged 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. | Hungary's economy may slow down, but probably less than previously expected thanks to the improving international environment and the stable and strong domestic demand. So economy may grow around 2.5% y/y in 2015 and now we see rather positive risk in this forecast.<br>We recognized in the last couple of months that exchange rate has very low effect on the inflation, so the NBH cannot easily accelerate the CPI with the depreciation of the currency.<br>We see this year's inflation around 0% Y/Y, but CPI may be around 2% Y/Y in December. | According to the GUS estimates, the Polish economy grew by 3.1% in 2014Q4 and by 3.3% in whole year. As in previous quarters, economic growth was driven mainly by strong domestic demand. Particularly encouraging was a high contribution of investment to economic growth. As for this year, we expect economic growth to slow down slightly below 3%. |
| Outlook for official & market rates | 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 outlook for inflation as well as short-term interest rates is still below the central bank's official forecasts. | The march rate cut form the NBH (by 15 bps) confirms our view that mainly the international environment may lead the next months' decisions, and the council may move with 10bp steps in the following months. We see relatively high chance for cuts in April and May, so the base rate might be moderated to 1.75% at the end of May. | 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 | 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. | In a longer term perspective, HUF is still in a weakening channel implying a 2-3% depreciation of the currency against EUR on a yearly basis. Taking into account the government's and NBH's statements, such a gradual depreciation of the currency is welcomed as it definitely not endangers the stability of the country. Additionally the government still wants to solve the problems of the foreign currency denominated loans in the households sector in autumn, which may give the National Bank of Hungary an even bigger room of maneuvering room. | 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. |

# CBs' Projections vs. Our Forecasts

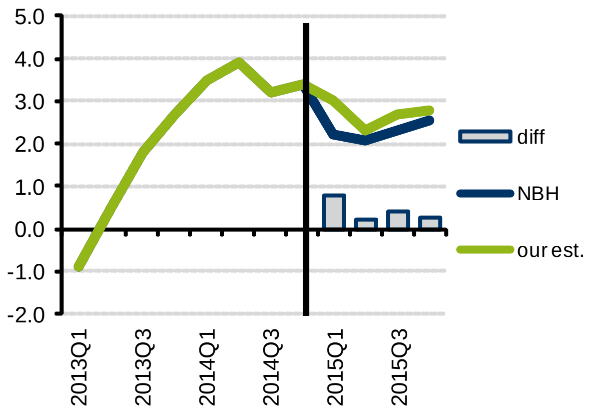
**CZ: GDP outlook** (Y/Y, %)



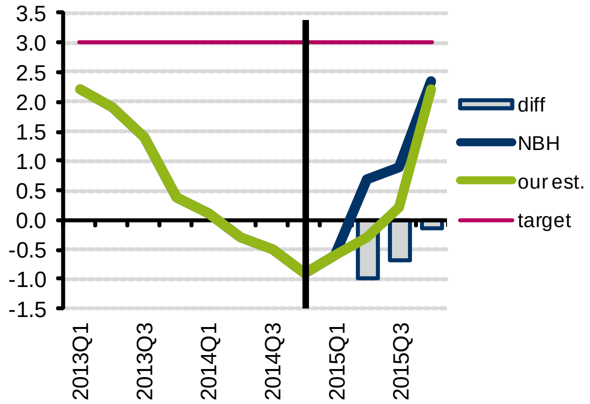

**CZ: Inflation outlook** (Y/Y, %)



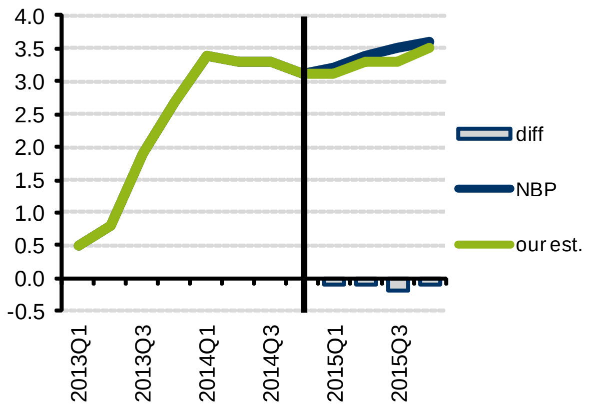

**HU: GDP outlook** (Y/Y, %)




**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. | *1.80* | 1.95 | 1.70 | 1.70 | 2.00 | 2.25 | -10 bps | 4/21/2015 |
| **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 | *0.31* | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 |
| **Hungary** | BUBOR | *1.71* | 1.89 | 1.70 | 1.70 | 2.10 | 2.40 |
| **Poland** | WIBOR | *1.65* | 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 | *0.59* | 0.64 | 0.50 | 0.50 | 0.65 | 0.70 |
| **Hungary** | HU10Y | *2.80* | 2.71 | 3.20 | 3.40 | 3.60 | 3.80 |
| **Poland** | PL10Y | *2.24* | 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 | *27.46* | 27.57 | 27.30 | 27.60 | 27.30 | 27.30 |
| **Hungary** | EUR/HUF | *303* | 300 | 310 | 317 | 315 | 310 |
| **Poland** | EUR/PLN | *4.04* | 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 | 1.9 | 2.1 | 2.4 | 2.8 | 2.5 |
| **Hungary** | 3.2 | 3.4 | 3.0 | 2.3 | 2.7 | 2.8 | 2.2 |
| **Poland** | 3.3 | 3.1 | 3.1 | 3.3 | 3.3 | 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 | 0.5 | 0.1 | 0.6 | 1.4 |
| **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.** | 1.6 | 1.5 |
| **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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