Central European Weekly

Monday, 08 June 2015

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- Zloty, forint and regional bonds under pressure
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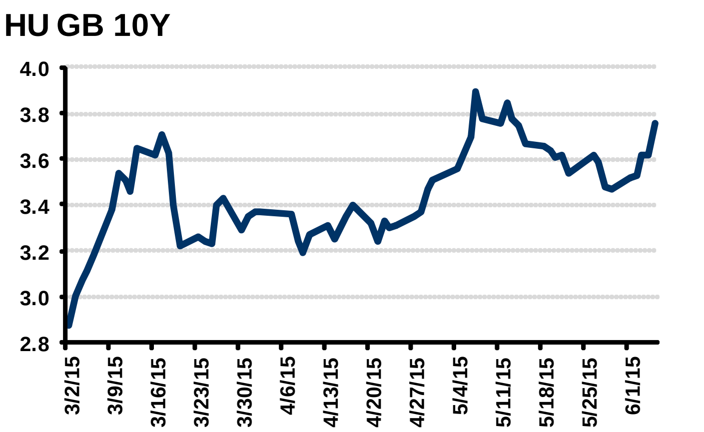
Chart of the Week: Hungarian bonds



HU GB 10Y, last 66 days. Source: Reuters

Hungarian bonds are facing sell-off despite new measures announced by the NBH, which should make government bonds more attractive

Market's editorial

Sell-off: not just an external story

Not only volatility in core bond markets but also domestic factors such as the effects of the aftermath of the presidential election in Poland and new monetary measures taken by the National Bank of Hungary contributed to the fact that the forint and the zloty continued to weaken for another week. Of course, even Czech government bonds could not avoid the global sell-off either (see the chart below).

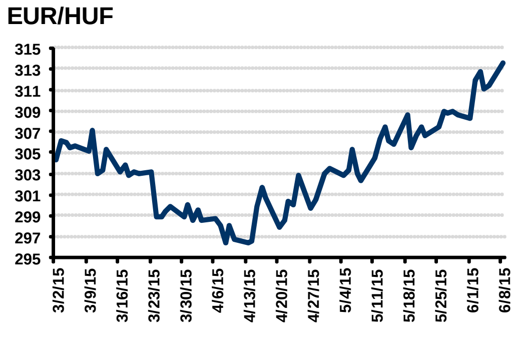
Unless the rise in dollar interest rates ahead of the approaching Fed meeting (June 17) decelerates, the prospects for the Polish and Hungarian currencies may not be good for the coming days either because fear of the Fed's rate hike may have an adverse impact on emerging markets as a whole (while the zloty and the forint are still clearly belong to this category). In this respect, today's troubles of the Turkisk lira, which has hit all-time lows might not be a positive factor for the zloty and forint either. Recall that Turkish President's Erdogan's AKP party has lost its simple majority in parliament, preliminary election results showed yesterday, which will not only complicate Erdogan's hopes of passing constitutional changes, but also to establish a new government.

May's inflation figures interesting, but watch the Fed

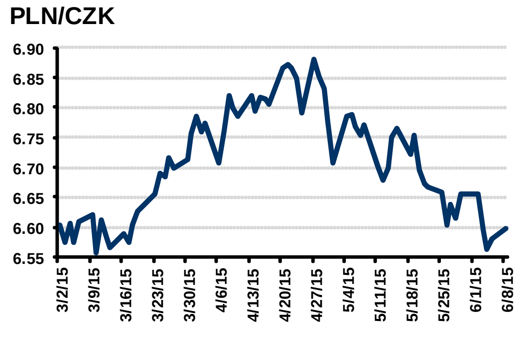
Although inflation data will be released across the region in the days to come, their weight may be completely overshadowed by events on foreign markets. Inflation across the region is expected to have increased in May, which may theoretically be good news for regional currencies. However, it should be taken into account that higher inflation may add fuel to the flames on domestic markets in government bonds, which may face an even more aggressive sell-off fuelled by an outflow of foreign investors.

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
EUR/CZK	27.4	-0.05%	→	→
EUR/HUF	314	1.59%	↗	↗
EUR/PLN	4.16	1.02%	↗	↗

	Last	Change 1W	Outlook 1W ahead	Outlook 1M ahead
10Y CZK	1.28	22.49	↗	↗
10Y HUF	3.41	10.71	↗	↗
10Y PLN	3.01	9.28	↗	↗



EUR/HUF, last 71 days. Source: Reuters



PLN/CZK, last 71 days. Source: Reuters

Review of Economic Figures

Czechs are very eager to shop now...

April's retail sales growth was again very strong. The upbeat consumer mood, encouraged by falling unemployment and moderate real income growth, has improved the population's demand for not only cars but also other consumer goods, fuel and food this year.

Year-on-year retail sales (excluding cars) grew by 6% and retail sales as a whole by a huge 6.4%. The improved consumer appetite has also been encouraged by favourable prices, which are falling by almost 2% in the retail sector.

It is no longer any surprise that consumers are still primarily interested in e-commerce, where sales are growing at a double-digit rate. Besides, people's demand for leisure goods and, of course, electronics and clothing, improved in April.

As concerns the strong growth in car sales, it is still true that distinguishing grey re-exports from sales to actual domestic customers is difficult. Hence we are not overestimating the record-breaking car sales on the Czech market.

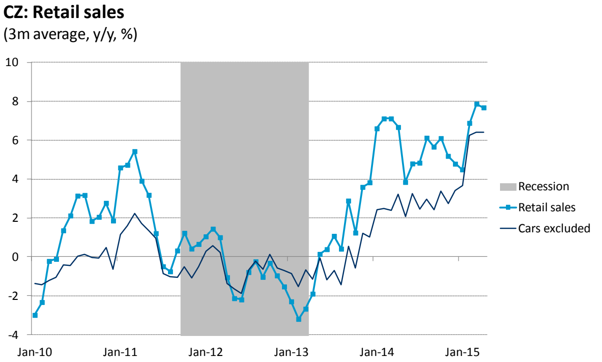
..., while wage growth not impressive despite lower unemployment rate

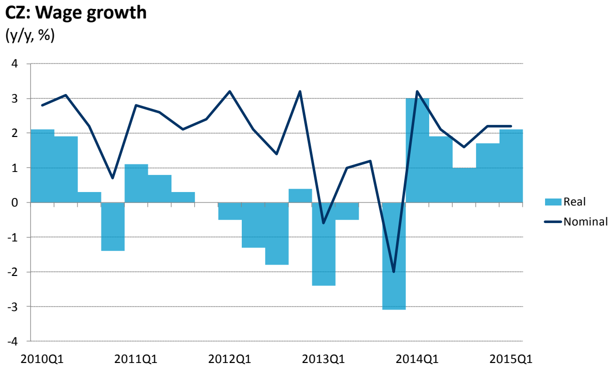
Despite strong economic growth, wage growth remains very moderate in the Czech economy. Thus the average nominal wage grew by only 2.2% and the real wage by 2.1% in the first quarter of this year. Nevertheless, this is no surprise because news from individual sectors (except the public sector) did not suggest any wage boom.

Employers are not eager to raise wages, while employees are not even creating any strong pressure for wage growth. This is a traditional picture, reflecting employees' efforts to keep their jobs and the fairly weak position of trade unions.

Thus wage growth continues to be very moderate. However, with nearly zero inflation, people's real income has improved at least slightly. Naturally, the average wage is still a virtual figure rather than a reflection of reality. A better view of wages is provided by the median wage, which is growing at a slower rate than the average and lags behind the average by more than CZK 4,000.

Meanwhile, there here have been new data releases coming from the Czech Statistical Office on Monday morning, which have showed that the economy has been really in a good shape. While the Czech industry grew by robust 4.3% y/y in April (despite a very strong comparative base), the unemployment rate already dropped to 6.4% in May, which was the lowest figure in three years.





In Focus: NBH new policy meassures

Acces to base rate intrument limited further

The National Bank of Hungary will change its monetary policy tools from 23rd September. The new base rate instrument will be the 3-month depo rate, which will be fixed, while the 2-week depo instrument remains, but the amount the banks can place into it will be maximized (at HUF1000bn) gradually till the end of the year. As the amount will be maximized, the yield will be determined during auctions, but it is likely that the 2-week depo rate will get closer to the O/N depo rate, which is 1%pt below the actual base rate level. Additionally the regulatory minimum liquidity coverage ratio (the ratio of high quality liquid assets to cash outflows in the next 30 days) will be increased from 60% to 100% from 2016, but the exact date was not announced yet. Our expectation is end 1Q16, as it may help for Debt Management Agency to issue more HGBs at the beginning of the year to be able to replace the Rephun redemption.

Highe demand for domestic bonds and lower sterilisation

The goal of these measures are the following: 1) more than HUF5000bn is placed in 2-week depo, which causes huge sterilization cost for NBH, and in case of a rate hike cycle these costs are increasing further, so they would like to decrease the money placed in NBH 2) the domestic ownership of Hungarian government bonds are low in regional comparison and the NBH would like the channel some money from NBH into the government bonds and these measures may force banks and local investment funds to buy more HGS, 3) the FX reserve of the NBH is huge compared to the short-term external redemption, so NBH would like to decrease the FX reserves via paying back external debt.

The HUF weaker, the bond yield curve steeper

We think that the goals are good in long-term, it decreases Hungary's vulnerability, but it may cause some stress on the market in short-term. First of all on the FX market, as some speculative short-term money may leave Hungarian markets, which depreciates the HUF (it was reflected in the sudden weakening after the announcement). As Debt Management Agency announced that it won't change the issuance plane after NBH's decision, the change of the monetary tools, and the increase of the required LCR (liquidity ratio) from the banks may create an over demand on the Hungarian HUF bond market keeping Hungarian bond yields at low level. The Hungarian yield spread above the bund has been already narrowed by roughly 30-40bp and the 12-month T-bill yield fell to new low levels on yesterday's auction. It looks like that the short-end of the curve may be affected more aggressively by NBH's decision, but so far the market reactions were quite moderate.

Weekly preview

TUE 9:00 — CZ Inflation (change in %)

	May-15	Apr-15	May-14
CPI m/m	**0.1**	0.3	0.1
CPI y/y	**0.5**	0.5	0.4
Monetary relevant inflation y/y	**0.4**	0.3	0.3

CZ: Inflation remains low and stable

We believe that the price level in the Czech Republic did not change significantly in May. Thus inflation most likely remained at April's 0.5%, i.e., 0.2% above the Czech National Bank's last forecast. The figure could have been even better but the rise in fuel prices has resulted in price growth of 0.1% compared to April in recent weeks. Inflation is not and is still unlikely to be a problem for the Czech economy. Demand-pull inflation is still nowhere to be seen, and thus we can only rely on the prices of imported goods and on cigarette taxes. In any event, the new inflation figure may be slightly pleasing to the central bank.

TUE 9:00 — HU Inflation (change in %)

	May-15	Apr-15	May-14
CPI m/m	**0.3**	0.4	-0.2
CPI y/y	**0.1**	-0.3	-0.1

HU: Inflation again higher

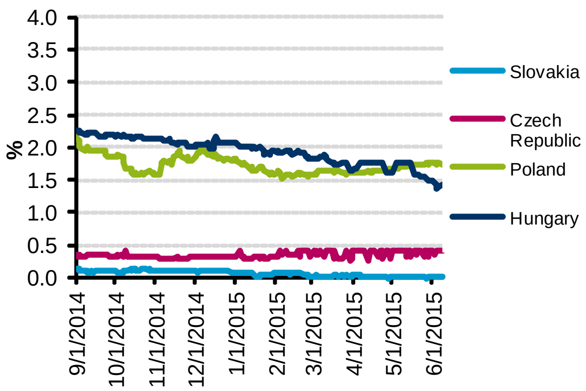
Headline inflation (y/y) probably moved higher in May as higher petrol prices and positive base effect was in play.

Calendar

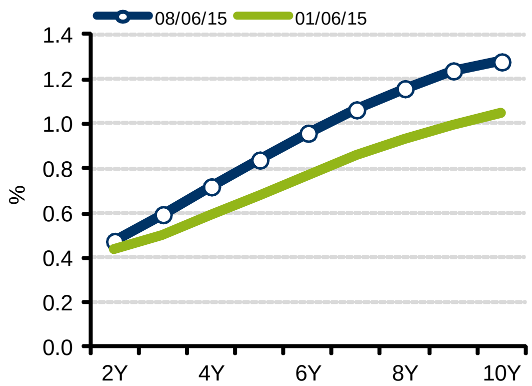
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	06/08/2015	9:00	Construction output	%	04/2015		6.8				8.4
CZ	06/08/2015	9:00	Trade balance	CZK B	04/2015	19		18		19.2	
CZ	06/08/2015	9:00	Industrial output	%	04/2015		4		4		6.2
CZ	06/08/2015	9:00	Unemployment rate	%	05/2015	6.4		6.3		6.7	
HU	06/08/2015	9:00	Trade balance	EUR M	04/2015 *P			730		929	
HU	06/08/2015	16:00	Budget balance	HUF B	05/2015					-609.8	
CZ	06/09/2015	9:00	CPI	%	05/2015	0.1	0.5	0.1	0.6	0.3	0.5
HU	06/09/2015	9:00	CPI	%	05/2015			0.3	0.2	0.4	-0.3
PL	06/12/2015	14:00	Money supply M3	%	05/2015			0.9	7.5	-0.9	7.2

Fixed-income in Charts

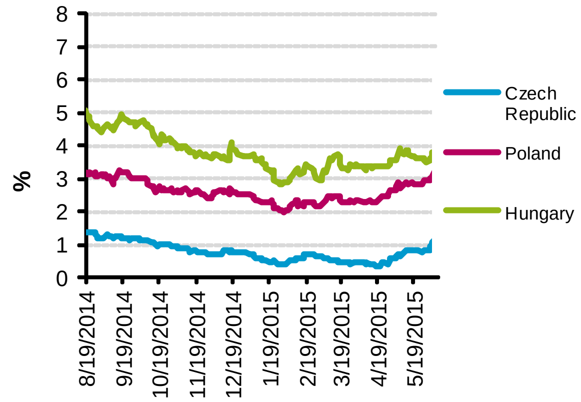
FRA 3x6



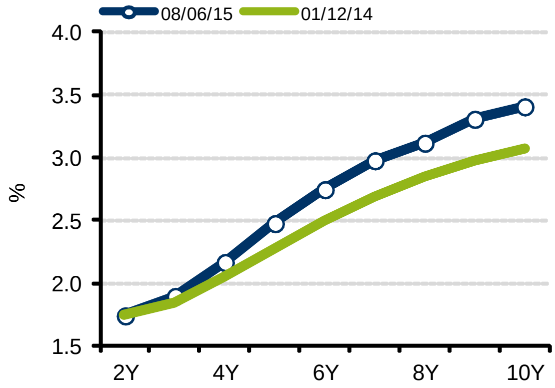
CZ IRS



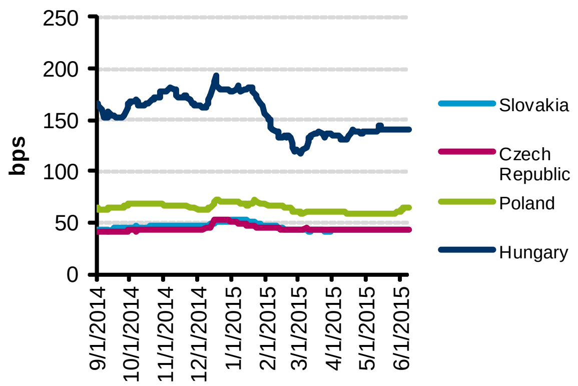
10Y GB Yields



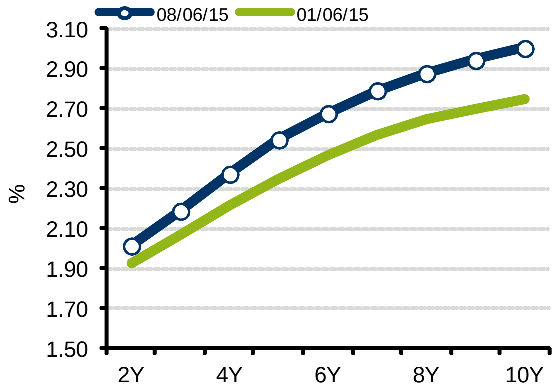
HU IRS



CDS 5Y



PL IRS



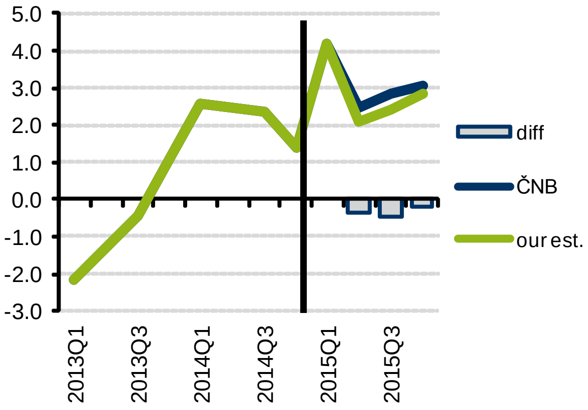
Source: Reuters

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.	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.	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%.
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 longer term outlook for inflation is still below the central bank's official forecasts.	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.	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, the 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.	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.

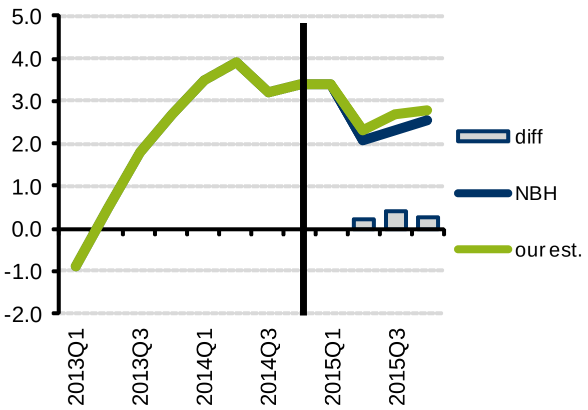
CBs' Projections vs. Our Forecasts

CZ: GDP outlook (Y/Y, %)

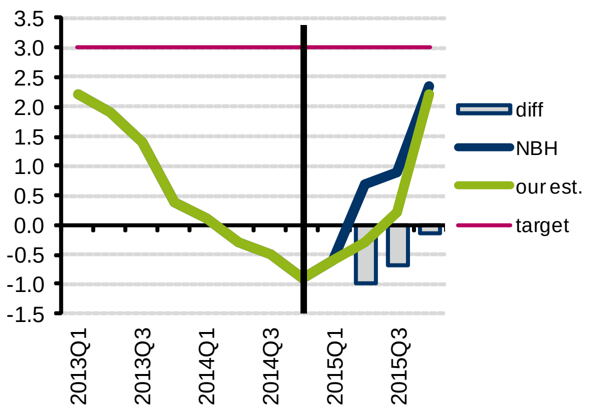


CZ: Inflation outlook (Y/Y, %)

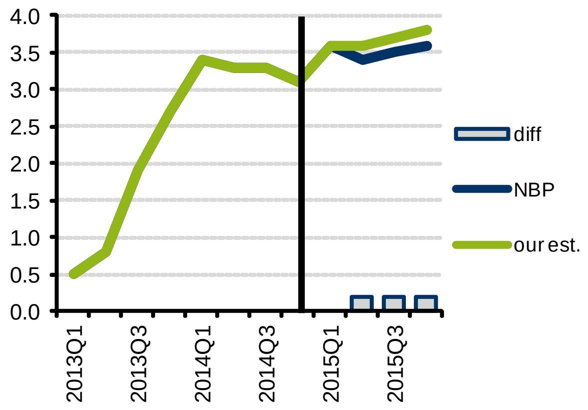
HU: GDP outlook (Y/Y, %)



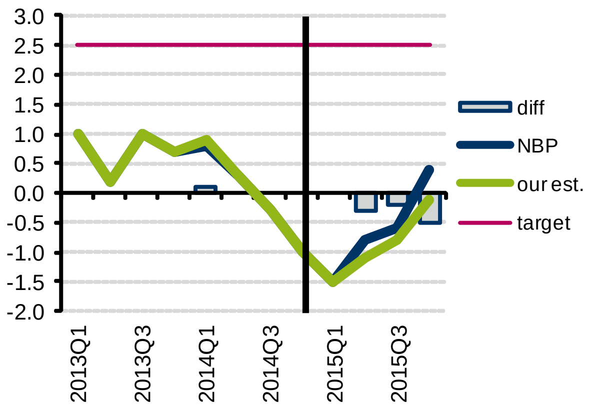
HU: Inflation outlook (Y/Y, %)



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.	*1.65*	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	*1.51*	1.89	1.70	1.70	2.10	2.40
Poland	WIBOR	*1.68*	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	*1.28*	0.64	0.80	0.75	0.80	0.80
Hungary	HU10Y	*3.41*	2.71	3.20	3.40	3.60	3.80
Poland	PL10Y	*3.01*	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	*27.43*	27.57	27.30	27.60	27.30	27.30
Hungary	EUR/HUF	*314*	300	310	317	315	310
Poland	EUR/PLN	*4.16*	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	2.1	2.4	2.8	2.5
Hungary	3.2	3.4	3.4	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	0.6	0.3	0.8	1.5
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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