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Central European Weekly

Monday, 29 June 2015

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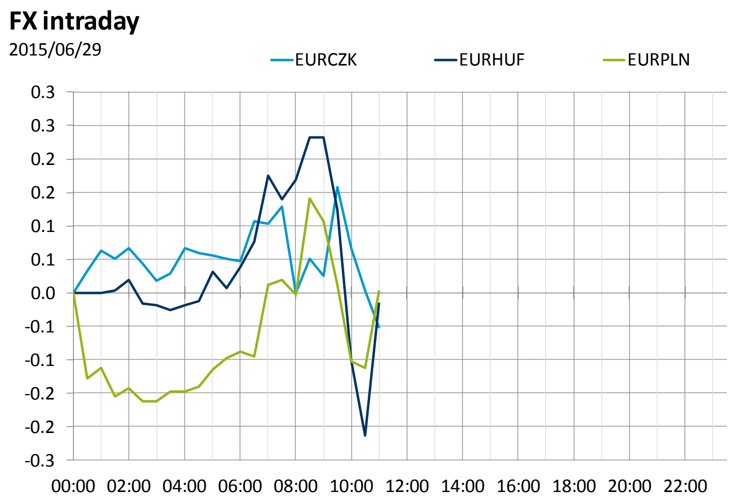
Weekly Highlights:

- Contagion from Greece evolves as expected – Polish and Hungarian assets down, Czech bonds up
- NBH cuts as expected, but surprisingly its easing cycle might not be over yet
- CNB upgrades its outlook as it sees risks to inflation forecast at monetary-policy horizon as balanced now

Chart of the Week: Regional FX v. referendum



The CE currencies have so far been relatively immune to the Greek debt woes...
(Source: Bloomberg, CSOB)

Market's editorial

Greeks activated risk-ff sentiment in Hungary and Poland

After Greek PM Tsipras unexpectedly called for referendum (5th July) on Friday, the Eurogroup convened and refused Greek FM Varoufakis request for a one month extensions of the talks on Saturday. Though the probability of Grexit increased, door for solution is not yet closed, mainly thanks to the ECB that kept the ELA active.

Towards this backdrop, risk-off sentiment should dominate markets today and in the next few days. While investors might be cautious before trading on a Grexit and wait for further signals from the players involved, we expect that Polish and Hungarian assets could be under pressure in days ahead. This view has also been confirmed by today's early trading as both the currencies (i.e. the zloty and the forint) and government bonds (10Y) have been under pressure. Hungarian assets may be the most vulnerable. Although the government "solved" the long-standing issue of FX mortgages earlier this year, the fact that Hungarian public debt is still the highest among CE countries (77% of GDP in 2014) along with the central bank's policy could contribute to relative underperformance of the forint government bonds. On the other hand, Czech assets seem to weather the fallout from unfortunate turn of events in Greece quite well as expected as the koruna is only little changed and government bonds (10Y) are even seen a little bit stronger as they follow German Bunds.

To sum up, we expect the risk-off sentiment to be the most visible in case of Polish and Hungarian government bonds along with weaker forint and zloty. At the same time, we expect the losses to remain relatively contained.

NBH cuts as expeceted, but easing cycle does not end

The National Bank of Hungary cut base rate by 15bp from 1.65% to 1.5% - fully in line with market expectations. The main focus was, however, on the comment as with the latest cut Hungary's base rate reached the Polish level and it was based on the new inflationary report, which will be published on Thursday.

The Council said that the inflation may remain below the inflation target of 3% Y/Y in 2015 and 2016, and it may reach the inflation target only at the end of the forecasted period, so in late 2017. We see substantially faster acceleration of consumer price index and we think that Hungary may have already around 3% Y/Y inflation at the end of this year, beginning of next year.

So the main surprise in the comment was that the Council suggested that the rate cut cycle may continue with small steps. The 'small' may refer to the slowdown of rate cut from the current 15bp steps to 10bp.

The other reason why further monetary easing may come is the global loose monetary environment (ECB's and BOJ's program and the postponement of FED rate hike). It suggests that the NBH may continue rate cut till there is not a clear date, when the FED starts the rate hike. It means that in case FED delivers the first hike in September, NBH may cut the base rate to 1.2% in three steps.

The option for further rate cut may suggest also that the NBH doesn't care if the EUR/HUF pair moves well above 320, especially if we take in account the still existing geopolitical risks.

So based on the statement, the Council's clear intention to maintain the illusion of continuing of rate cut cycle (which became more and more an expected scenario on the markets) and main message of the statement that the next step might be 10bp rate cut in July.

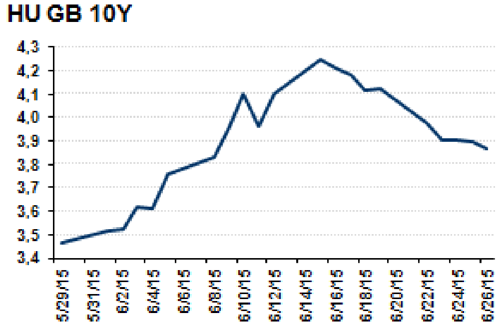
CNB: inflation riska are balanced now

As expected CNB's repo rate (as well as the deposit rate) remains at 0.05% and the exchange rate commitment to defend the EUR/CZK floor at 27.0 will remain in place without any changes. The Czech National Bank is still prepared to prevent the koruna from strengthening below this threshold; nevertheless, apart from the first few days after the devaluation in 2013, the CNB has not been compelled to do so again at all.

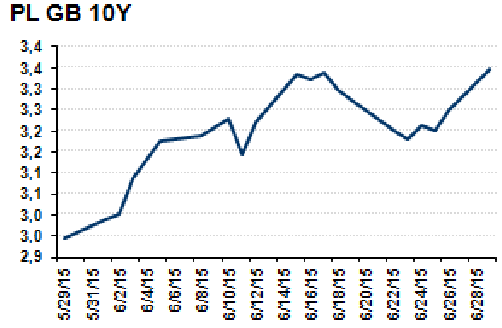
While Thursday's CNB Board meeting was no revolution, we can still infer a few interesting or useful observations from its conclusions. Hence, the exchange rate commitment remains unchanged and the current exchange rate policy will remain in place until the second half of next year at least. Moreover, any further possible devaluation is increasingly unlikely. The CNB is also not in favour of considerations of an earlier termination of this policy. The interest rate outlook remains unchanged. Thus, the CNB expects the market rates at the short end of the curve to be constantly low until the end of 2016 at least. The negative repo rate option is technically (in terms of interest on mandatory minimum reserves) and administratively prepared but this is just a reaction to the European authorities' requirement within the meaning of 'being prepared'. Therefore we do not even envisage a negative repo rate anymore. The CNB is definitely not ultra-optimistic about inflation. It expects that, within the monetary policy horizon (up to 18 months), inflation will only approach the defined 2% target. This is consistent with our considerations. By and large, the CNB Board sees the risks to the forecast as balanced, interestingly - last time they were on the downside. Unlike the last time the bank is no longer talking on low wage growth that might curb inflation and consequently boost deflationary expectations soon. Thus the tenor of the forecast as a whole has slightly changed in terms of risks but things have otherwise remained more or less unchanged. We still anticipate neither negative interest rates nor a repo rate hike this year or the next. The nearest possible date of terminating this exchange rate (intervention) policy is the late 2016.

	Last	Change 1W
EUR/CZK	27.2	0.06%
EUR/HUF	315	1.16%
EUR/PLN	4.20	0.65%

	Last	Change 1W
10Y CZK	1.29	-4.80
10Y HUF	3.55	2.31
10Y PLN	3.08	3.54



HU GB 10Y, last 21 days. Source: Reuters



PL GB 10Y, last 21 days. Source: Reuters

Weekly preview

FRI 9:00 CZ Foreign trade (CZK bn)

	May-15	Apr-15	May-14
Balance (national)	**16.0**	19.9	12.6
cummulative (YTD)	**94.2**	78.2	83.8
Balance	42.5	44.1	33.5
cummulative (YTD)	**209.0**	166.5	198.9

CZ: Trade balance surplus continues to balloon

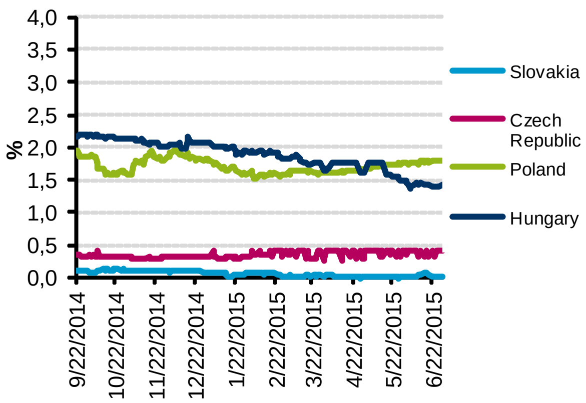
We expect May's foreign trade data to spring no surprises. The existing favourable export trend, primarily fuelled by the success of domestic carmakers on the European market and cheaper raw material imports, most probably contributed to another increase in the trade surplus. Thus the annual cumulative surplus might hit another all-time high, whether in the national statistics or in the previously more preferred cross-border statistics. The balance of the latter statistics might even climb to CZK 500 bn, i.e., surpass 11% of GDP, this year. As a result, the Czech Republic will again boost its orientation on exports and thus also on industry.

Calendar

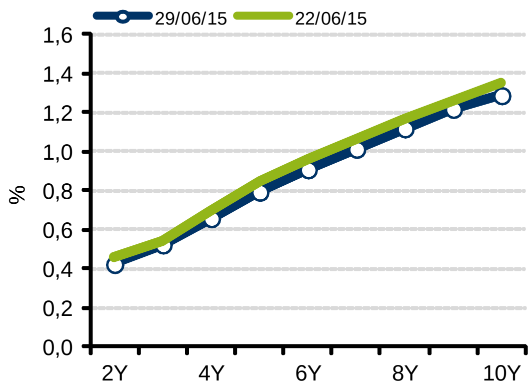
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	06/30/2015	9:00	GDP	%	1Q/2015 *F					3.1	4.2
HU	06/30/2015	9:00	PPI	%	05/2015					-0.1	-1.7
CZ	06/30/2015	10:00	Money supply M2	%	05/2015						5.1
PL	06/30/2015	14:00	Current account	EUR M	1Q/2015			2200		-1971	
PL	07/01/2015	9:00	PMI manufacturing		06/2015			52.2		52.4	
HU	07/01/2015	9:00	PMI manufacturing		06/2015					55.1	
CZ	07/01/2015	9:30	PMI manufacturing		06/2015			56		55.5	
CZ	07/01/2015	14:00	Budget balance	CZK B	06/2015					-22.1	
CZ	07/03/2015	9:00	Trade balance (national)	CZK B	05/2015	16		15.4		19.9	
HU	07/03/2015	9:00	Trade balance	EUR M	04/2015 *F					534	

Fixed-income in Charts

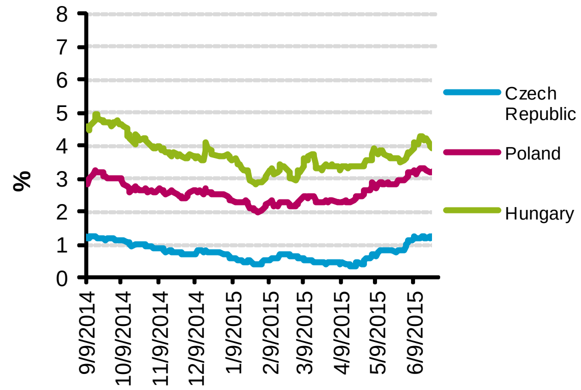
FRA 3x6



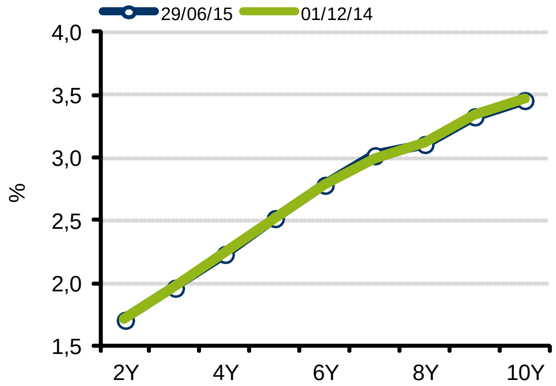
CZ IRS



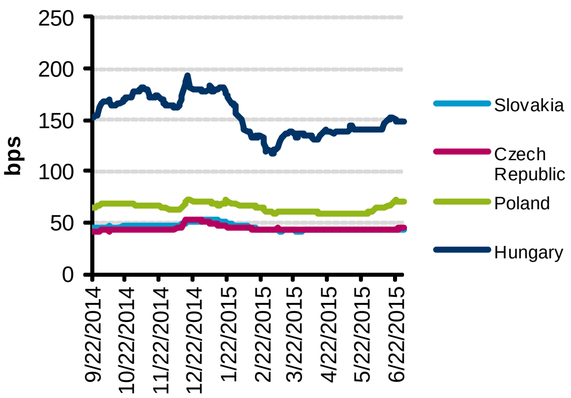
10Y GB Yields



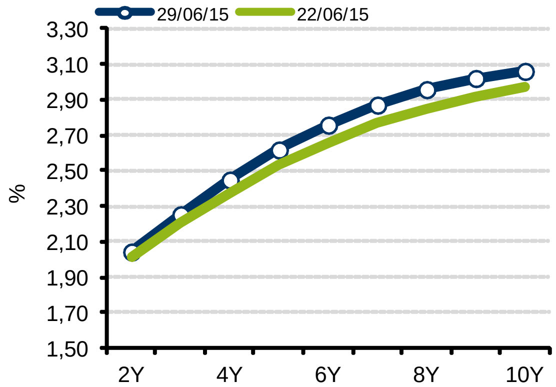
HU IRS



CDS 5Y



PL IRS



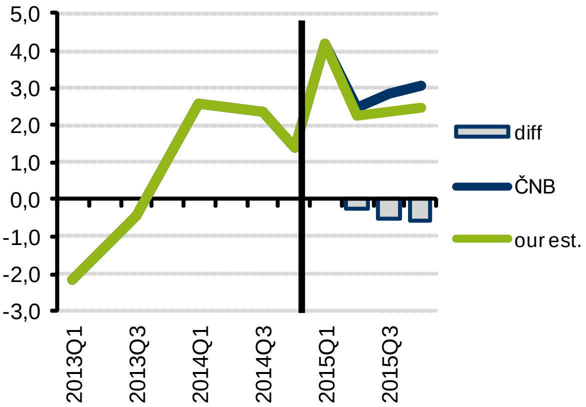
Source: Reuters

Medium-term Views & Issues

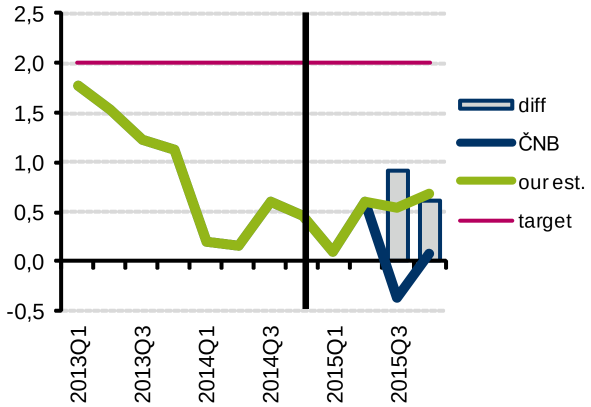
	The Czech Republic	Hungary	Poland
Growth & key issues	The current economic recovery is primarily based on the outstanding performance of the automotive industry on the one hand and restored investment and consumption growth on the other. Economic growth has also been encouraged by the deficit financing 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 1.65% to 1.5% in June. The Council said that the inflation may remain below the inflation target of 3% Y/Y in 2015 and 2016, and it may reach the inflation target only at the end of the forecasted period, so in late 2017. So based on the lasts statement, the Council's clear intention to maintain the illusion of continuing of rate cut cycle (which became more and more an expected scenario on the markets) and main message of the statement that the next step might be 10bp rate cut in July.	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. 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%.	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

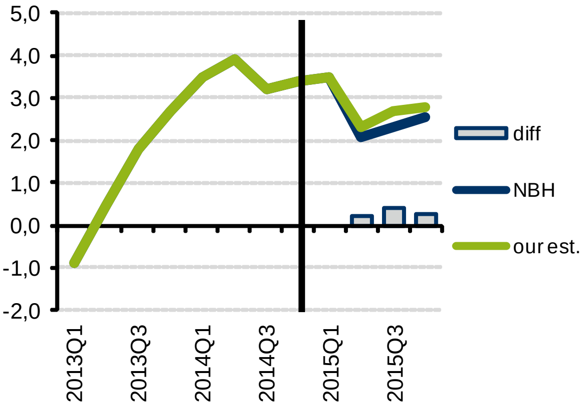
CZ: GDP outlook (Y/Y, %)



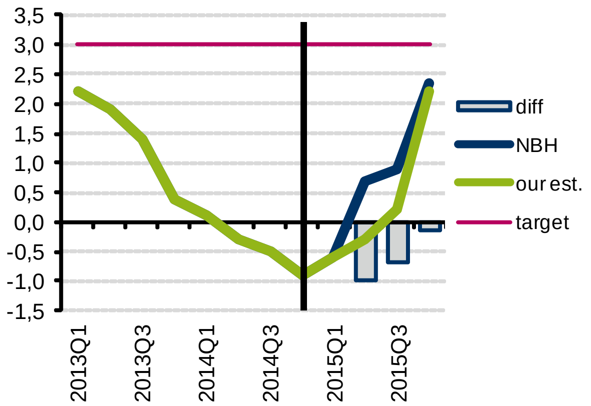
CZ: Inflation outlook (Y/Y, %)



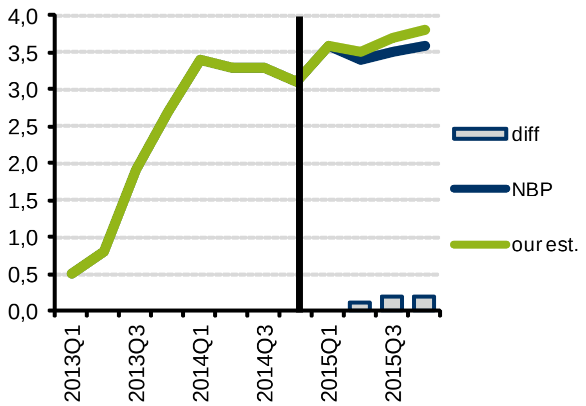
HU: GDP outlook (Y/Y, %)



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.	*1.50*	1.95	1.70	1.70	2.00	2.25	-10 bps	6/23/2015
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	*1.42*	1.89	1.70	1.70	2.10	2.40
Poland	WIBOR	*1.72*	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	*1.29*	0.64	1.35	1.45	1.55	1.50
Hungary	HU10Y	*3.55*	2.71	3.20	3.40	3.60	3.80
Poland	PL10Y	*3.06*	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	*27.24*	27.57	27.30	27.60	27.30	27.30
Hungary	EUR/HUF	*315*	300	310	317	315	310
Poland	EUR/PLN	*4.20*	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	3.5	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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