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Central European Weekly

Monday, 18 January 2016

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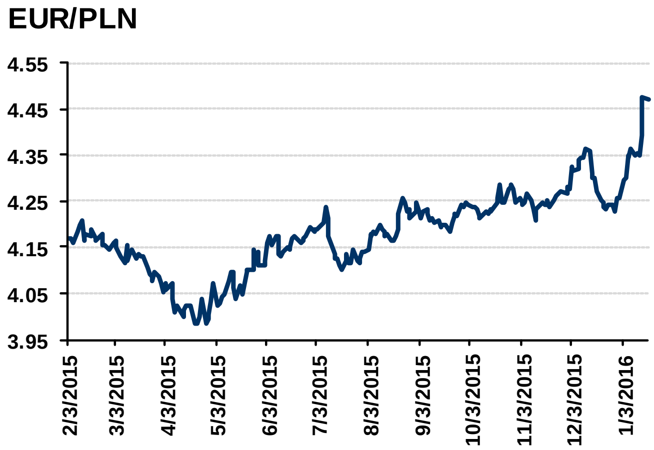
Weekly Highlights:

- S&P punishes new Polish government by sovereign rating downgrade, Moody's and Fitch stay on hold
- The zloty at five-year lows
- In focus: NBH's new measures motivate banks to buy more government bonds
- The Czech inflation returns to zero

Chart of the Week: Zloty's sell-off



The EUR/PLN pair shot up to five-year highs after S&P sovereign rating downgrade

Market's editorial

The Polish zloty under fire

The global sale of risky assets, triggered by China, has also - fairly logically - hit emerging markets. While the spreading financial contagion also affected Central Europe, the impact was surprisingly limited. Apart from regional stock markets, the Polish zloty remains the main and essentially the most visble victim of contagion. The oveall poor sentiment was exagerated by two more blows: conversion proposal for CHF mortgages and a sovereign rating downgrade.

Polish mortgages in CHF – following the Hungarian way

Regarding a draft bill that envisaging assistance to FX mortgage borrowers domestic banks would be forced to return the difference between total repayment cost in the PLN and in foreign currency (like the CHF) to the borrowers by reducing principle repayments. The borrowers should be entitled to convert their FX mortgages into zloty denominated mortgages at an individual rate that should reflect the corresponding PLN calculated has remained open. Nevertheless, rough estimates indicate losses for domestic banks amounting up to PLN 50 high or more than 2 % of GDP. In our view, though, such a bad scenario need not materialize.

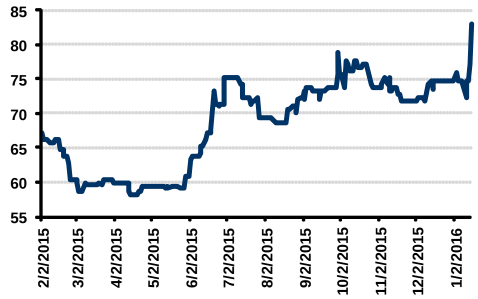
S&P sovereign downgrade of Poland – too much

Even more importantly, the S&P downgraded Poland´s long to BBB+ from A independence losses some key institutions (the Constitutional Court, the NBP) suffered due to various legislative measures passed since the parliamentary election in October 2015. Interestingly, the Fitch confirmed their A class while Moody`s, rating Poland one notch above Fitch, have also confirmed stable outlook for its A2 rating tool. All in all, we tend to see the latest S&P and probably stained with political bias. We evaluate Polish macro fundamentals more favourably; hence consider the latest EUR/PLN shift as overshooting and see long PLN positions worth accumulating.

	Last	Change 1W
EUR/CZK	27.0	0.02%
EUR/HUF	315	-0.82%
EUR/PLN	4.48	3.03%

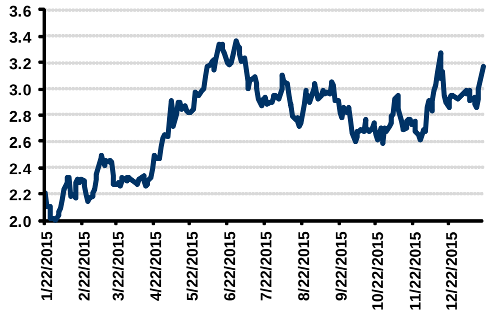
	Last	Change 1W
10Y CZK	0.93	-3.12
10Y HUF	2.74	-0.54
10Y PLN	2.61	5.76

CDS Poland 5Y



CDS Poland 5Y, last 250 days. Source: Reuters

PL GB 10Y



PL GB 10Y, last 250 days. Source: Reuters

Review of Economic Figures

Low petrol prices keeps the Czech inflation close to zero

Inflation still does not seem to be returning to the Czech economy. Thus consumer prices quite unsurprisingly fell in December – this time by 0.1% – mainly because of cheaper food and fuel. Fuel prices are falling deeper and deeper below CZK 30 due to falling oil prices, thus keeping inflation just closely above zero. Year-on-year inflation, monitored by the central bank, reached 0.1%, just as in November. Thus the gap between actual inflation and the central bank's latest (November) forecast continued to widen. While the gap was 0.5% in November, it even increased to 0.7% in December. Moreover, the decline in diesel and petrol prices on the Czech market is far from over.

We see low inflation as something positive because it is primarily attributable to the above-mentioned fuel. Cheap oil meant that domestic businesses and households could save more than CZK 30 bn last year and spend or invest the money elsewhere. And unless the situation on the oil market changes dramatically, this year's 'savings' may exceed approximately CZK 25 bn. Inflation is not even emerging on the consumer goods market. Although prices of some electronics grew in December, this tended to be a Christmas effect, which will be negated by subsequent price reductions in January and February. In addition, at a time of a surplus in foreign production capacities for consumer goods and even for cars, prices cannot be raised to any great extent, particularly if the fight for customers is being moved to e-commerce, which eliminates borders between individual countries.

No high inflation is likely to occur in 2016 either. Inflation will most probably remain below 1% for most of the year and will reach the Czech National Bank's tolerance band at least only towards the end of the year. Although increased wages may start to generate demand-pull inflation for the first time in a few years, this will not be any very visible process. Prices in such a small economy as the Czech one are still largely influenced by inflation developments in Europe. Yet the central bank may not be necessarily disappointed at the development of consumer prices. Low inflation is and will continue to be primarily attributable to cheap fuel, which is completely out of monetary policy control; moreover, fuel can be exempted from inflation targeting. Therefore we expect neither the introduction of negative interest rates nor any further devaluation of the koruna. A postponement of the departure from the intervention policy by a few months until 2017 appears to be the most likely scenario to us.

The Hungarian inflation up as expected

The Hungarian consumer price index increased from 0.5% YoY in November to 0.9% YoY in December fully in line with our expectation. The core inflation remained at 1.4% YoY in December. The average inflation was -0.1% YoY in 2015 up from -0.2% YoY in 2014, so Hungary had practically two consecutive years with zero inflation.

The CPI went up from -0.4% YoY in September 2015 to 0.9% YoY in December 2015. There were two main reasons behind the jump of inflation: 1) base effect (regulated price cut of gas, electricity etc. and the sharp fuel price drop in 2014), 2) the worse harvest in 2015 pushed up food price.

A little surprise that despite of the relatively strong domestic consumption, the tradable and market services price increase stopped in the last two months of 2015.

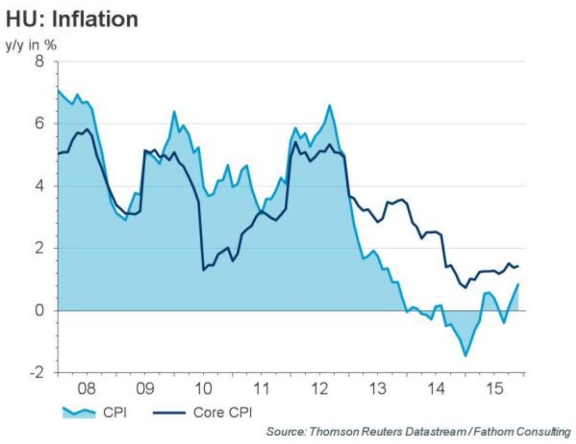
Looking ahead the again falling oil price may push down inflation in 2016. Our inflation orbit forecast shows an increase for January, but it may be followed by a gradual moderation of CPI down to around 0.5% YoY in the middle of the year. Then the 2H16 may show an inflation increase again and we see now CPI around 2.5% YoY at the end of the year, while average inflation might be around 1.5% YoY in 2016.

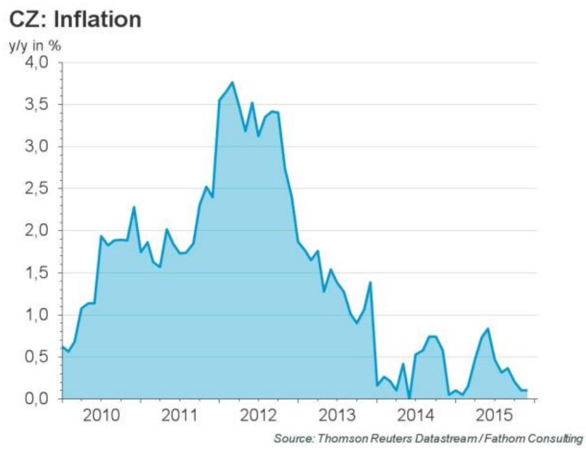
As a consequence, the NBH is in a comfortable situation, as inflation may return close to its inflation target of 3% YoY gradually till end of 2017, so it can keep base rate unchanged at 1.35% in 2016. We expect rate cut in case of EURHUF moves below 305 permanently. In the other hand, if HUF weakens substantially we think that NBH might remain calm, as the sensitivity on exchange rate is relatively small after the conversion of FC denominated loans. For the government only the end of year exchange rate is important because of the public debt level. So we expect no base rate change for 2016.

Czech are not lacking a shopping appetite at all

The upbeat consumer mood and, in the end, also the continuously improving financial position again led to a significant increase in retail sales in November. Thus retail sales (excluding cars) were up by 6.8% y/y in real terms. Taking into account the larger number of business days in the month, the increase was slightly lower (5.6%), though still very strong. Probably nobody is surprised by the e-commerce boom any more, with e-commerce sales rising at a double-digit rate. Likewise, it is nothing new that Czech consumers are buying more and more home electronics and mobile phones, and are also starting to spend more money on entertainment. Moreover, compared to the previous year, Czech consumers may still save a significant amount of money in fuel and spend it elsewhere.

Retail sales still clearly indicate that household consumption remains one of the main pillars of the Czech Republic's economic growth. Czech consumers are spending more and more money – most likely to be borne out by December's probably record-breaking data – thus catching up with what they missed out on during the last two recessions. Therefore, we do not consider the current shopping boom to be problematic or even potentially harmful at all. The Czech economy is still very far from starting to overheat. This year, we expect a slightly weaker rise in retail sales, including in the automotive segment. Although this segment is influenced by re-exports and by non-residents' purchases, its growth could ease after last year's record. In addition, a high comparative baseline will contribute to a lower rise in retail sales. Yet the result should be very solid, bring economic growth and perhaps, at last, also some demand-pull inflation, impatiently watched for by the central bank.





In Focus:

New NBH measure encouraging banks to buy more bonds

The National Bank of Hungary will abolish gradually the 2-week depo instrument from in April. Technically it means that the NBH will decrease the approved amount tin the tender by HUF250bn every week in April, so till April the maximum amount can be placed in 2-week depo in NBH is HUF1000bn like today and it will be reduced to 0 in April. The NBH would like to channel this money first into SME lending then into government bonds, so the NBH increases the offers IRS amount by 20% and the pricing will be also more attractive. NBH said that it is the final step of the restructuring of monetary policy tools, so they not planning to change it until the current environment remains.

Since the NBH started this program in mid-April, the sterilization stock decreased substantially (by roughly HUF800-1000bn), while without the self-financing program and without the conversion of the foreign currency denominated loans into HUF ones the sterilization stock amount would be HUF3000bn higher.

The required liquidity ratio rule will be stricter from 1st of April, which may put pressure on the banks to place their unused free liquidity into government bonds.

The NBH expects HUF400-800bn new inflow into government bonds in the next 5 months, while there was HUF1300bn new inflow from banks into government bonds between June and December in 2015. This amount was enough to counterbalance the decrease of foreign sell-off of Hungarian bonds (Templeton was the main seller). Looking on this year's net HUF financing need (HUF800bn because of budget deficit, HUF450bn because of the redemption of EU loan and roughly HUF1100bn because of redemption of FC bonds) and taking into account that the overwhelming part of this financing is needed in the first 5 months, the original plan that Hungary can refinance the FC debt redemption without FC bond issuance in not likely. The Debt Management Agency announced that there will be roadshow these weeks to measure the demand of a renminbi bond issuance, but also a euro issuance is likely in 1Q16.

What to really expect on Hungarian markets?

So our expectation due to the program is that the bond market might be forced in a relatively tight range in the next months. On the demand side there is the locals, who get nice IRS pricing from NBH making bond attractive, but on the sell side there might be the foreigners, who may sell bond at around historic low levels. It suggests a 40-50bp range trading for the coming months. Additionally we think that the government doesn’t want to see higher yields than last year, so if there is not enough demand for HUF bond than they may rather issue slightly more FC denominated bonds.

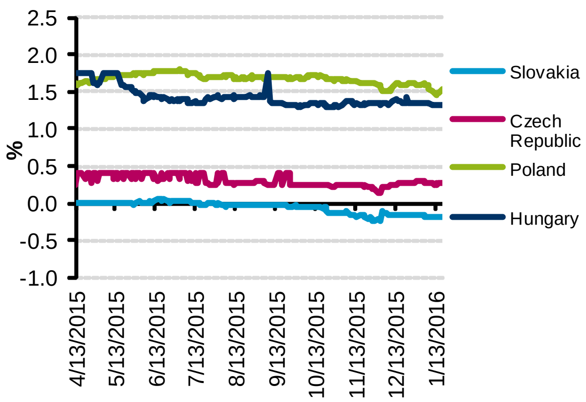
This program helps to achieve the goal, that he HUF part of the debt and the domestic ownership of the debt is increasing in 1H16, additionally the 2017 budget proposal might be also approved by the government (the deficit target might be around 1.7% of GDP), so a rating upgrade of Hungarian debt is likely in May and June by Fitch and Moody’s.

Calendar

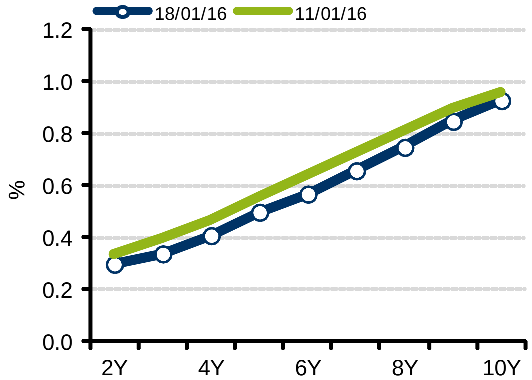
Country	Date	Time	Indicator		Period	Forecast		Consensus		Previous	
						m/m	y/y	m/m	y/y	m/m	y/y
CZ	01/18/2016	9:00	PPI	%	12/2015			-0.4	-2.9	-0.4	-3.7
PL	01/18/2016	14:00	Core CPI	%	12/2015			0	0.2	-0.1	0.2
CZ	01/20/2016	12:00	CZ bond auction 2016-18, 0.00%	CZK B	01/2016						
CZ	01/20/2016	12:00	CZ bond auction 2015-2023, x.xx%	CZK B	01/2016						
CZ	01/20/2016	12:00	CZ bond auction 2013-2028, 2.50%	CZK B	01/2016						
PL	01/20/2016	14:00	Wages	%	12/2015			8.9	3.5	1.3	4
PL	01/21/2016	14:00	Industrial output	%	12/2015			4.8	5.5	-2.6	7.8
PL	01/21/2016	14:00	PPI	%	12/2015			-0.2	-0.9	0	-1.8
PL	01/21/2016	14:00	Retail sales	%	12/2015			19.5	3.2	-5.9	3.3

Fixed-income in Charts

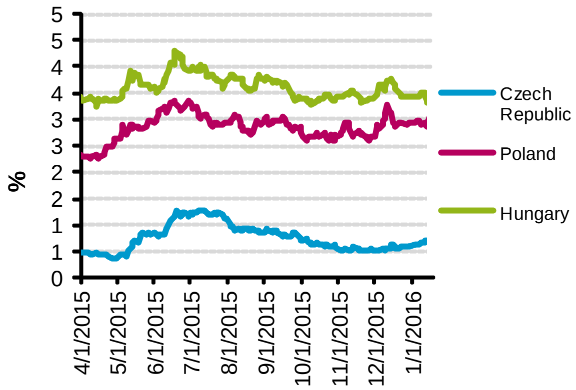
FRA 3x6



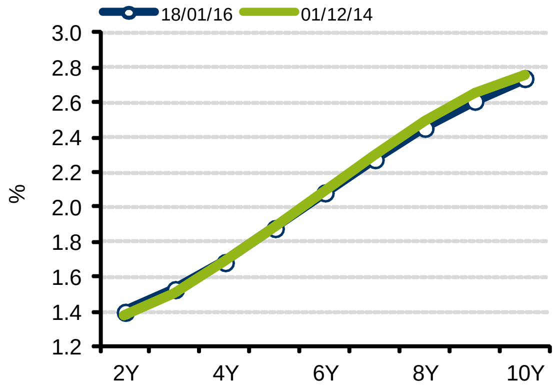
CZ IRS



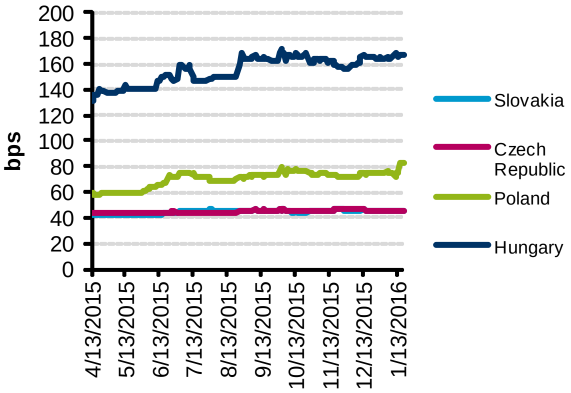
10Y GB Yields



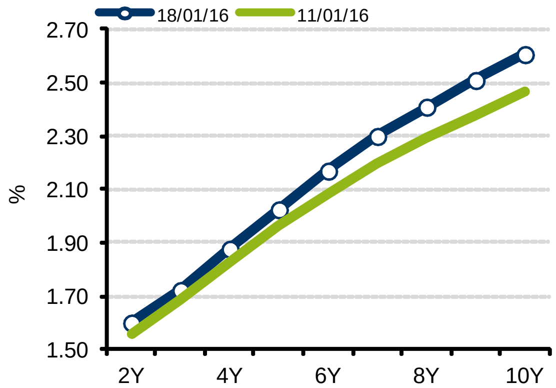
HU IRS



CDS 5Y



PL IRS



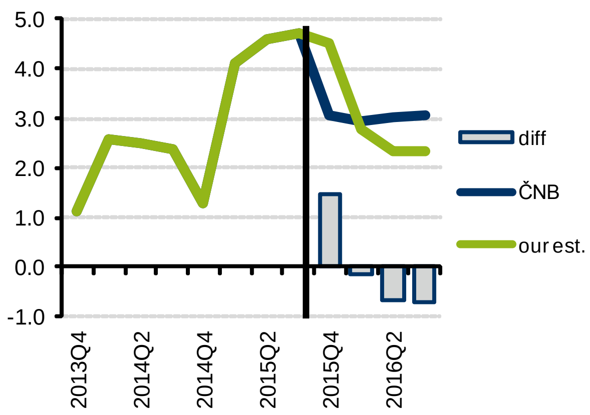
Source: Reuters

Medium-term Views & Issues

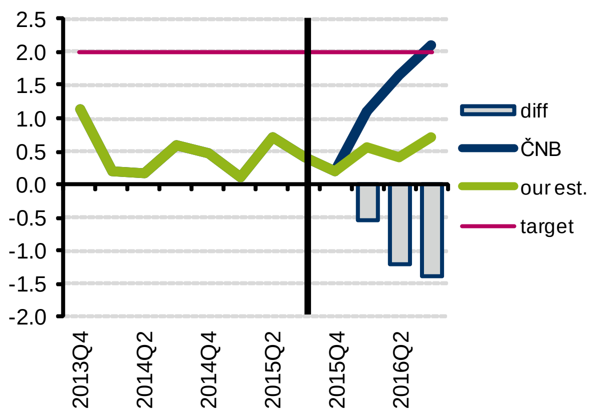
	The Czech Republic	Hungary	Poland
Growth & key issues	Growth significantly accelerated, primarily driven by the manufacturing industry, albeit most sectors of the economy are showing a positive trend. On the demand side, we can see an investment boom by the private and public sectors, with private consumption – 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 4Q15 GDP growth might bounce back closer to 3% Y/Y, as EU funds money use was accelerated, the government increased the spending and the industrial production and domestic consumption might be stronger, so the growth might be around 2.7% Y/Y in 2015. The outlook is less favorable. The investments started to fall, the EU funds money use may substantially lower in this year due to the new budgetary period. The government tries to boost the construction via new government program, which targets new homes for households. The domestic consumption may remain strong thanks to the increasing wage mass. In case there is no substantial slowdown of international growth and the agriculture provides an average harvest, the economic growth might be around 2.3% Y/Y in 2016.	Prospects of the Polish economy remain good in our view. For the whole year 2016 we expect GDP growth may reach 3.5 - 4.0 percent. Apart from low interest rates (further cuts cannot be excluded) and a relatively weak zloty, we expect the economy to draw additional support from policy measures of the new government (stimuli for private consumption). The risks thus stem mainly from a possible deterioration in the external environment, most notably in China.
Outlook for official & market rates	The CNB has implicitly postponed the deadline for discontinuing its intervention policy until late 2016 but, unlike its previous practice, it does not want to commit itself to any clearer deadline this time. As we don't expect exit from the fx regime before Q1 2017, the first rate hike can occur in the H2 2017 or even latter. A scenario of negative rates is not on the agenda. Given the market developments, the CNB itself is even considering it to a lesser extent than it has done recently.	The NBH plans to keep base rate unchanged at 1.35% till the end of its forecasting period, which is 4Q17. It is more or less in synchrony with the ECB's monetary policy forward guidance. The main attention of NBH is decreasing FX reserve and the amount of money placed at the NBH. So the Council may change rather the monetary tools first, but in case HUF strengthens to around 300 base rate cut cannot be excluded either, although this is not our base case. We expect first rate hike only for 2017, as with the conversion of households' FC loans to HUF ones, the tolerance level of a weaker HUF jumped substantially. So EURHUF around 320 and 325 won't force NBH to hike rate.	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. This promise will probably be hold, while we should wait how the MPC will be changed in 2016 as new President and Sejm will appoint almost all Board members.
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. With regard to the inflation outlook and ECB's policy, we anticipate an exit from the fx regime in the first quarter of 2017. The above mentioned factors should however keep the koruna close to EURCZK 27.0 in the months ahead. Current turmoil on the Chinese market poses negative risks for the Central Europe. We however think the impact on the koruna should only be limited.	We think that the NBH's commitment to the long time low interest rate may lead to short-term HUF weakening. Although compared to other emerging markets HUF looks like quite stable, the fears of Chinese hard lending scenario pushed EURHUF trading range between 313 and 318. Although the huge trade and current account balance supports HUF in medium term, the ongoing foreign sell-off of HUF denominated gov. bonds and the uncertain sentiment keeps weakening pressure on HUF, so we see bigger risk on the weak side on short term, which means that EURHUF may be pushed towards 325.	Although the new government may eventually turn out to be more market-friendly than had been expected, we think that pressures on zloty´s depreciation may intensify again at the beginning of 2016 when most members of the Monetary Policy Council (MPC) will be replaced and probability of further monetary easing will rises. Although Fed hikes and weaker zloty could prevent the altered MPC from cutting rates again we target the EUR/PLN peak at 4.40.

CBs' Projections vs. Our Forecasts

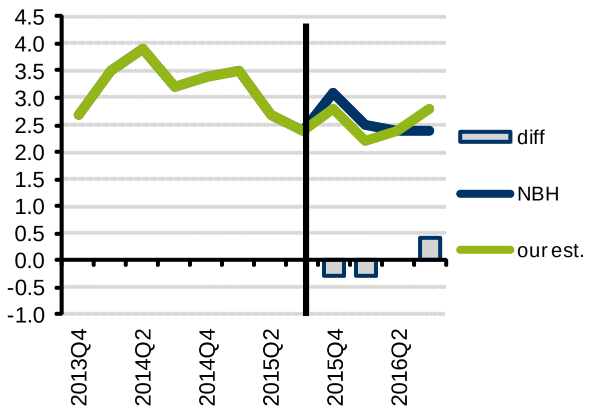
CZ: GDP outlook (Y/Y, %)



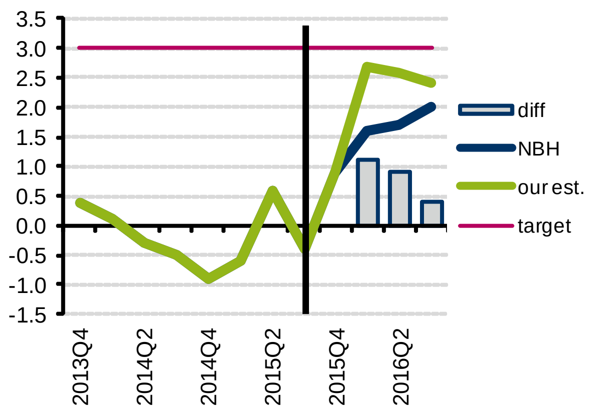
CZ: Inflation outlook (Y/Y, %)



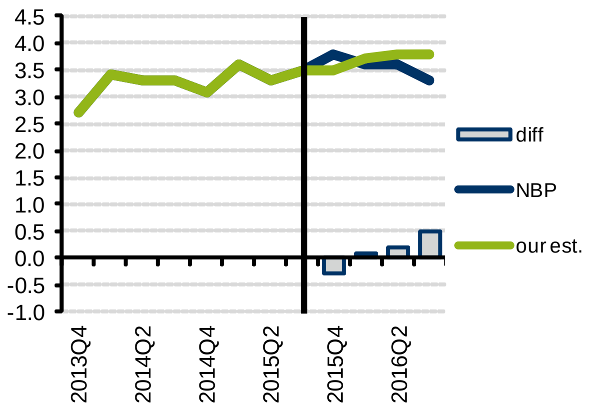
HU: GDP outlook (Y/Y, %)



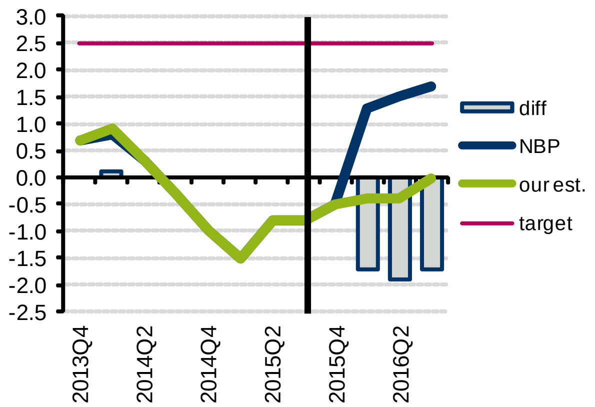
HU: Inflation outlook (Y/Y, %)



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	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	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*	1.35	1.35	2.25	2.50	2.75	-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	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
Czech Rep.	PRIBOR	*0.00*	0.26	0.25	0.24	0.25	0.25
Hungary	BUBOR	*1.35*	1.35	1.35	2.40	2.60	2.90
Poland	WIBOR	*1.7*	1.73	1.72	1.65	1.65	1.65

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

		Current	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
Czech Rep.	CZ10Y	*0.93*	0.98	1.01	1.08	1.15	1.23
Hungary	HU10Y	*2.74*	2.93	2.91	3.80	4.00	4.20
Poland	PL10Y	*2.61*	2.50	2.47	2.50	2.50	2.60

Exchange rates (end of the period)

		Current	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
Czech Rep.	EUR/CZK	*27.04*	27.19	27.03	27.02	27.02	27.02
Hungary	EUR/HUF	*315*	314	316	310	308	305
Poland	EUR/PLN	*4.48*	4.25	4.27	4.40	4.30	4.26

GDP (y/y)

	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
Czech Rep.	4.1	4.6	4.7	4.5	2.8	2.3	2.3
Hungary	3.5	2.7	2.4	2.8	2.2	2.4	2.8
Poland	3.6	3.3	3.5	3.5	3.7	3.8	3.8

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

	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
Czech Rep.	0.2	0.8	0.4	0.1	0.6	0.5	0.7
Hungary	-0.6	0.6	-0.4	0.9	2.7	2.6	2.4
Poland	-1.5	-0.8	-0.8	-0.5	-0.4	-0.4	0.0

Current Account

	2015	2016
Czech Rep.	1.5	1.5
Hungary	6.0	5.1
Poland	-1.2	-1.5

Public finance balance as % of GDP

	2015	2016
Czech Rep.	-1.4	-1.3
Hungary	-2.3	-2.0
Poland	-3.0	-2.9

Source: KBC, Bloomberg

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