42 Financial Services

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# Czech Republic Market Outlook | 1H18

## WILL CZK EVER WEAKEN AGAIN?

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**Last year, economy had one of the best years in modern Czech history.** Mainly owing to the strength of domestic demand, the growth came only shy of 5%, with 2nd quarter having been the strongest quarter ever.

**Private demand shall remain the growth driver in 2018 and 2018, but it will not grow as strongly as in 2017.** Household demand will lead the slowdown as unemployment and savings rates have nowhere to fall anymore, as monetary conditions gets tighter and fiscal policy less expansionary.

**Defying my expectations for weaker CZK, EURCZK exchange rate embarked on relentless slide to 25.50 in 2H17,** driven by resurgence of real convergence narrative, hawkishness of the central bank and additional demand from exporters. These three factors will be far less potent a support in 2018 than in 2017, with potential to trigger long-overdue weakening of CZK.

**Czech bonds diverged substantially from their German counterparts in 2H17.** Since this was caused by shift in market expectations regarding the CNB monetary policy, I foresee substantial correction and narrowing of the spread in 1H18 as market realizes CNB will proceed very slowly.

**Key macroeconomic indicators – outlook (42FS)**

| Average, in % unless noted otherwise | 2015 | 2016 | 2017 | Δ | 2018f | Δ | 2019f |
|---|---|---|---|---|---|---|---|
| Real GDP growth | 5.4 | 2.5 | 4.4 | *1.3* | 3 | *0.3* | 2.8 |
| CPI | 0.3 | 0.7 | 2.5 | *0.5* | 1.8 | *0* | 2 |
| EURCZK, absolute level | 27.3 | 27 | 26.33 | *-0.17* | 25.9 | *-0.4* | 25.5 |
| 10Y IRS | 0.9 | 0.67 | 1.37 | *0.17* | 1.75 | *-0.05* | 2 |
| 10Y CZGB | 0.75 | 0.44 | 1.05 | *0.05* | 1.35 | *-0.15* | 1.8 |
| 2W Repo | 0.05 | 0.05 | 0.17 | *0.12* | 0.75 | *0.6* | 1.15 |

Note: Δ = change against previous forecast (in percentage points or, in case of EURCZK, in absolute numbers). 2015/16 are actual numbers .

DATA CUT-OFF: JAN/18/2018

# REAL ECONOMY

**After a strong 2017 driven primarily by domestic demand, this year and next will see slowdown in both of its components, hence slower growth as well.**

**Strong growth in 2017 was due…**

In 2017 – and even without the 4Q17 data being available – it is safe to say that the economy had one of strongest years in modern history. Owing to the two strong quarters of the first half (with growth of 1.5% and 2.5% q/q, the latter being the quickest one in modern Czech history), the economy grew estimate 4.5% y/y in 2017.

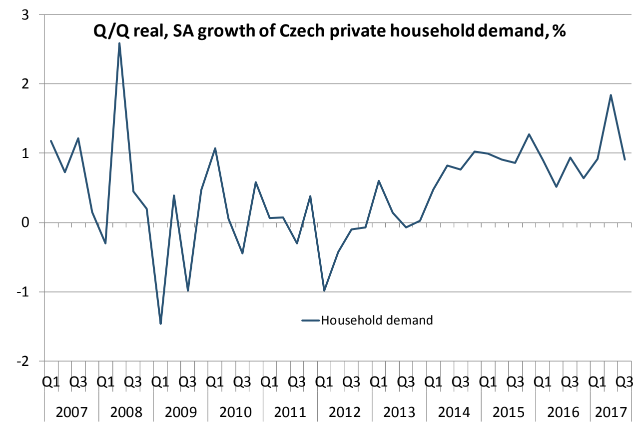
**… to demand of households…**

**The growth was mainly driven by domestic demand, both of companies and of households.** The demand of households was supported by the combination of five factors:

- extremely low **unemployment rate**, which, according to Eurostat, was – and is – the lowest among all of the EU countries;
- strong growth of **real wages** (averaging almost 5% y/y in the 2Q17 and 3Q17 despite the rise of inflation),
- highly optimistic **mood** evidenced by the consumer confidence (which rose to all-time high in 4Q17)
- still very loose **monetary conditions**, and
- **fiscal expansion** of the government in the election year of 2017.

**No wonder, then, that the household demand grew almost 4% cumulatively over the first three quarters of 2017.** Recall that in last outlook from summer 2017, I expressed disappointment at the 'slow' growth (0.7% q/q) of household demand in the 1Q17 (which was the only 2017 number that was available at the time of the writing) and expected quickening from 2Q17 onwards. This indeed happened, with 1.8% q/q in 2Q17 and 0.9% in both 1Q17 (after revision) and 3Q17.

***Household demand grew strongly in 2017***

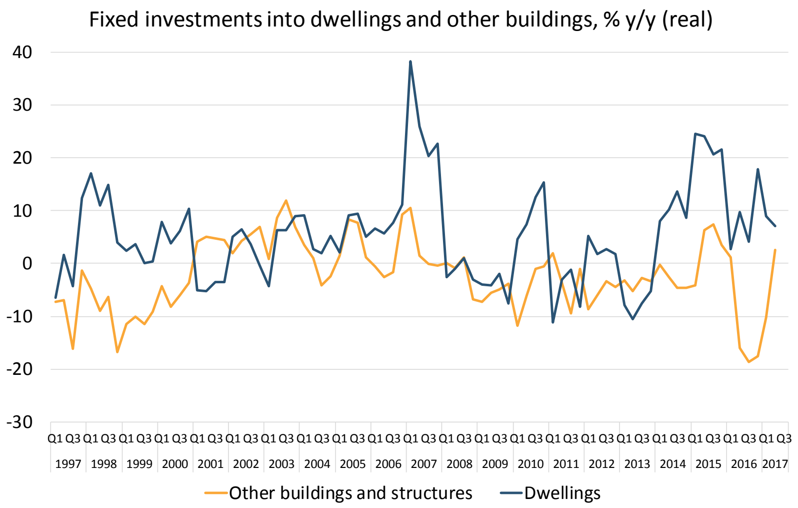


**…and demand of firms, but…**

**Second, equally important contribution, came from fixed investments which grew by 7% over 1Q17-3Q17**. This was seen in

- **improved business confidence,** in turn primarily seen in PMI index and, albeit less so, in business confidence measured by the Czech statistical office. This sanguinity found its expression in strong growth of investment in machinery;
- rebound in **construction**, predominantly in civil engineering (and in continuing strong growth of residential real estate).

***Rebound of civil engineering lifted the growth of fixed investments***




Source: Czech Statistical Office, 42 Financial Services

**…net exports contributed too, and so did…**

**Surprisingly, 2017 saw positive contribution to annual growth also from net exports**. The imports obviously rose, subtracting, as one would expect in an open economy undergoing demand surge, 5 p.p. off the annual growth in both 2Q17 and 3Q17. But exports rose even quicker, with 6.2 pp and 5.6 pp. having been added to the y/y growth in those same quarters. The resulting contribution of net exports to overall growth thus was 1.4 and 0.6 pp.

**…government, if only indirectly.**

**Government demand** did not rise much in 2017, adding on average just 0.3 pp to annual growth in each of the first 3 quarters of 2017. That, however, doesn't mean government was being all that prudent, only that it wasn't squandering the money directly. The fiscal imprudence is seen in the cash budget for 2017: although the economic growth was, as was mentioned above, strong, budget ended up in a (small) deficit. Moreover, not only did the government squander the windfall gains of quick economic growth, it squandered them in the worst possible way: most of the increase in spending went to higher current expenditures which are mostly mandatory. In other words, government increased the long-term inflexibility of the budget by raising salaries in the public sector, pensions, social allowances etc. while undermining the growth potential of the economy by actually decreasing capital expenditures.

**2018 and 2019 growth will be slower as both household demand and…**

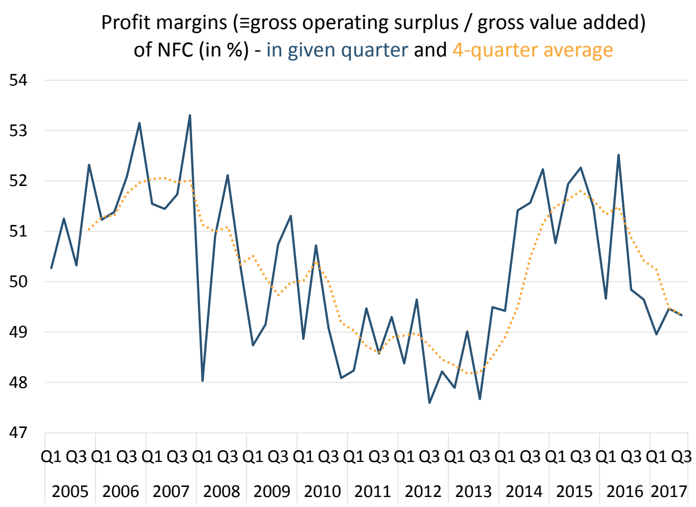
**Looking towards this year and 2019, it is highly unlikely that the growth will be as strong as in 2017, the major reason for this expectation being the expectation of slower growth of household demand.** As mentioned above, household demand had a very strong year, but most of the factors that caused it will not be as supportive in 2018 and 2019 as was the case in 2017.

- The **unemployment rate** now has nowhere to fall. Czech labor market is now in the state of full employment and thus impossible to support the growth of the aggregate household demand the way it'd done it in recent years (i.e. via increase # of workers). The same is true of **savings rate** which is now at all-time low of 10% and thus unlikely to fall much further (hence unlikely to provide additional boost to demand);

- The tightness of the labor market should theoretically result in faster **growth of nominal wages** and, since my expectation (see below) is that inflation will not be faster in 2018 as against 2017 and that it may well be slower (depending, really, only on non-demand factors such as oil), consequently of **real wages**. This is true but there is a limiting factor in that

  - the profitability of the non-financial companies has been decreasing for some time, thereby lowering their willingness to increase wages further, and in that
  - the employers are motivated to increase the import of workers from abroad and to substitute labor with capital.

***Profit margins of non-financial corporations continue to fall***

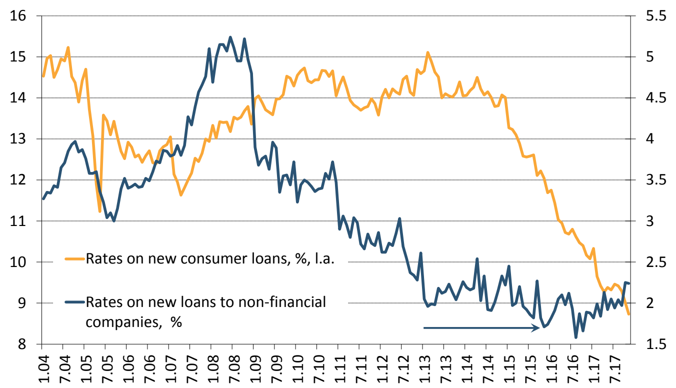



Source: Czech Statistical Office, 42 Financial Services

- The **confidence of the consumers** is at all-time high and unlikely to increase tangibly further, in good part also because of what was written above.

The **monetary conditions**, while still very loose, became less so in the 2nd half of 2017, with CNB hiking twice. As will be explained below, CNB is highly unlikely to retrace those steps this year, and possible to tighten the policy further. The consumer credit has not begun reflecting this yet, with average rate on the new consumer loans falling to all-time low at the end of December, but this trend is unlikely to continue and likely to partially reverse, if only marginally so.

***With CNB tightening policy, the rates on consumer credit will not continue to fall***




Source: Czech Statistical Office, 42 Financial Services

**…demand of firms slow.**

**Fiscal policy of the government should be less** expansionary in next two years than it was in previous two, with election campaign over (even though there is a risk of early elections, it will be hard for the government with no confidence to push through spending).

**Fixed investments will also slow their growth, though to a lesser degree than household demand.** The boom in the residential real estate sector should slow amid higher mortgage rates. Although the investments in the manufacturing sector will continue at the strong rate (it being one way to deal with the shortage of skilled labor), there are two reasons why this should be less than in 2017: 1) Eurozone economy being at its cyclical peak, slowdown in growth dynamics of Eurozone (hence Czech) manufacturing and hence investments is likely 2) industrial capacity utilization oscillates around 84%, only slightly above the long-term average, and consistent with about 3% annual expansion of fixed investments.

**After a very strong growth of domestic demand in 2017, there will be a slowdown in both of its main components in 2018 and 2019. With government not expected to provide additional boost and Eurozone economy expected to lose some steam in 2H18, the GDP growth in Czech Republic will slow in both these years.**

# EURCZK EXCHANGE RATE

**I admit without torture: CZK strengthening in '17 caught me by surprise. This year, it will not be repeated – just the contrary.**

**CZK strengthened massively last year, defying my expectations.**

This time last year, the most debated topic (not only) among the analysts and commentators was when will CNB let CNB float again and what happens once it does so. The expectation regarding the timing was less contentious: the consensus gravitated towards exit 'sometime' in the first half of the year. What happens once the CZK is let go was subject of much fiercer debate.

On the on hand, the fact that Czech economy's real convergence restarted and the fact that 3+ years of interventions kept CZK from its fundamental level were argued to cause EURCZK to relentlessly fall as soon the pair is allowed to.

On the other hand, the fact that the end of 2016 and beginning of 2017 saw massive speculative inflows into CZK caused some, incl. me, to expect that CZK will have a hard time strengthening post-exit. The logic went that as soon as CZK strengthens, speculators will try to exit the positions and will discover that there is no counterparty to take the opposite side of the transaction, the sheer volume of the speculative inflows dwarfing the current account surplus of the economy.

As it turned out, the first group was right. **CZK began strengthening almost immediately after the interventions stopped and continued to do so almost without a correction until today.**

***CZK strengthened below 25.50 in 9 months after the interventions' end***


Source: 42 Financial Services (EURCZK)

## ALL OF THE REASONS WHY CZK GOT STRONGER LAST YEAR…

This had three causes (hindsight is always twenty-twenty…).

**The resurgence of the real convergence,..**

- **The resurgence of the real convergence story.** Before the crisis, the Czech economy (or, to be more precise, the entire regional economy) was converging to the economy of the Eurozone. The real convergence, caused by and reflected in the faster growth of productivity here than in Eurozone, was accompanied by nominal convergence which, in case of Czech republic and because of the nature of the Czech economy, was happening via strengthening of the currency (and not via higher inflation here than in the Eurozone). The process had stalled since 2008, and had restarted in earnest only in 2016. This brought back the memories of pre-crisis years when CZK was strengthening tangibly, and attracted belated speculators.

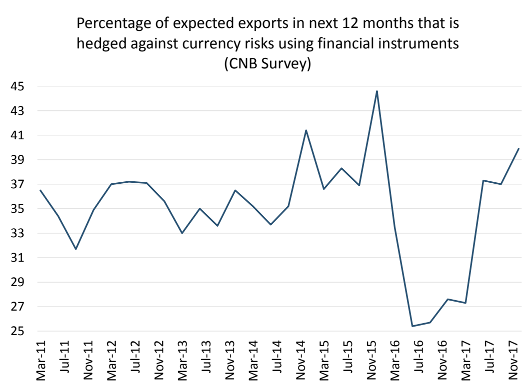
**…the myth of demand inflation …**

**The hawkishness of the CNB.** Czech National Bank must have broken the record in going from fighting deflation via FX interventions to fearing inflation and fighting it via increases of the repo rate. Whereas it took 14 months for FED to go from halting asset purchases under QE to deliver the first hike and then another year to deliver second hike, CNB accomplished the same thing in under 6 months. Illustrative of how quickly it changed its mind is Mojmir Hampl's stance: he was, in mid-March 2017, calling for the postponement of the exit to 2H17, only to vote for the *hike* at the end of September (and at every meeting since)…This hawkishness of the CNB, caused by exaggerated inflation threat, contributed to the market expectation that CNB will diverge from ECB. Even now, some analysts expect CNB to deliver 4 hikes in 2018, expectation that is now, in light of inflation outlook (, more of a wishful thinking than anything else.

**…and the under-hedged exporters caused this.**

**The demand for CZK from exporters.** While previous two factors primarily caused investors to stay put and not take profit (and only some additional demand), the fact that exporters, astonishingly, went into April (the months when interventions ended) under-hedged caused additional demand for CZK. Nominal Czech exports are little under CZK 4000 bn. and so the rise of share of hedged expected exports in the total exports from 27% in 1Q17 to 40% now translates into sizeable (≈ 0.13*4000 bn.) increase of demand for CZK.

***Exporters were seriously under-hedged prior to interventions' end***




Source: CNB

Now, in light of these factors that have just been hypothesized to have caused the CZK strengthening, the question is this: will the same factors support the CZK going forward with the same vigor?

## …WILL NOT BE REPEATED THIS YEAR.

Let us look at each of these in turn.

**Real convergence will continue, but will exert smaller pressure on EURCZK**

- **The real convergence will continue, but it will not exert such an influence on the exchange rate.** This is for two reasons: first, because the actual exchange rate is now close to the fundamental level of the exchange rate (estimated between 25 and 25.50) and, second, because the productivity growth differential will not be as large as in previous two years. Not only did the Eurozone growth quicken towards the end of 2017, but Czech one will be slower in 2018 than it was before. In 2018 and 2019, there should be smaller pressure on the EURCZK from the fundamental perspective.

**Disinflation in 1Q18 will lead market to reevaluate the CNB-ECB divergence story,…**

- **CNB will be much less hawkish this year,** causing the market to eventually reevaluate the expectation of monetary policy divergence vis-à-vis ECB embedded in current exchange rate. This will happen **because inflation will turn out to be notably less of a threat than CNB led market to believe**.
The main thing that last year caused CNB to change its monetary-policy stance so rapidly was inflation threat – or, to be more precise, myth thereof. Just like in November 2013 when CNB saw deflation threat where there really was none, and used it to justify FX interventions that ultimately brought very little in benefits, CNB succumbed to yet another myth last August, this time one of inflation, when it began tightening the policy.
As was elucidated in detail in our December 12, 2017 Special report ↗, the increase of the monetary policy-relevant inflation (or MPRI for short) **in 2017 as against 2016** was (approximately) one half due to increase of food prices and one half due to increase of demand inflation. While food prices undoubtedly reflect forces beyond CNB's reach and not domestic inflation pressures, demand inflation is by definition caused by demand and so should yield to CNB rate hikes. In theory, this is true, but the reality of 2017 in CZ was different: the increase in demand inflation last year was not caused by excessive demand, but **90% of it was caused by just two factors,** factors, which, on the surface, look like of demand nature but which, under the surface, are not such. These two factors are:

**…it being based on misguided reading of inflation increase in 2017.**

  - **implementation of the electronic-record-of-sales** system in late 2016, and
  - **the rise of real estate prices**.

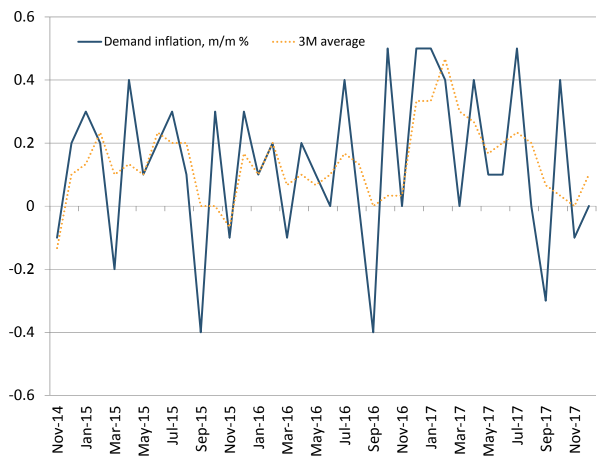
The former translated into rise of prices in restaurants in December 2016 and January 2017 while the latter, coupled with the increase of weight of so-called imputed rents in the consumer price index, effective from January 2017, increased the demand inflation further by increasing service component thereof (imputed rent is an estimate of the rent a house owner would be willing to pay to live in his or her own house). Admittedly, bubbly real estate prices do reflect (also though not only) loose monetary policy and so are amenable to monetary policy tightening. But trying to rein them in via increase in general repo rate is like using cannon to go after rabbits: these imbalances are best tackled via macro-prudential measures, not tightening of the policy.

**Going forward**, as explained in more detail in the above-mentioned Special report ↗ and as, after all, already foreshadowed by November and December inflation releases (which brought fall of demand, or core, inflation to lowest since February 2017), **there will be disinflation in early 2018 that will bring MPRI below the target.** The food price dynamics slowed and so did the dynamics of real estate prices, both of which is causing - and will in 1Q18 continue to cause - fairly strong base effect. And so will the disappearance from the base of EET-induced increase of hospitality (restaurants) prices. Not unimportantly, Eurozone remains stuck in a low inflation, with core one persistently below 1%, and with no trend.

**In other words, there are good reasons to expect inflation will be much lower this year than in 2017. And this will be something CNB will react to.**

**That demand pressures were chimera** is, after all, unambiguously clear from the monthly dynamics of demand inflation.

***An inflation chimera of CNB and the market: monthly demand inflation dynamics back to mid-2016 levels***



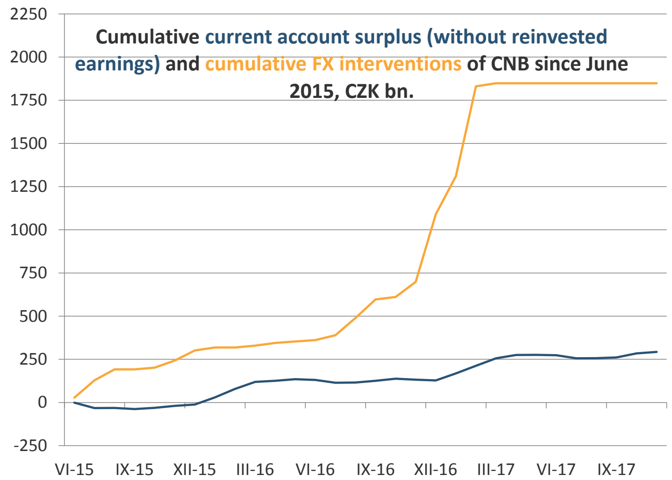

Source: CNB

The demand from exporters for hedging should not support CZK any more: currently, the exporters are hedged in line with historical standards.

## EURCZK WILL GET WEAKER BEFORE IT GETS STRONGER.

**In short, although the long-term tendency for currency to strengthen remains, the case for further strengthening of the currency in 2018 is weak.** Both the convergence story and the demand of exporters will not support CZK as much this year as they did in 2017 while disinflation in 1Q18 will disabuse the market of the notion of increasing CNB-ECB divergence, triggering profit-taking among speculators. And since CZK remains heavily overbought, this is one possible trigger to potentially substantial weakening: once it starts, there is no telling where this can stop. Of course, fundamental convergence and CNB limit the upside of EURCZK, but still: 27 is not unrealistic in such a case. **Were sufficient number of the investors to suddenly rush for exits, we would easily see levels like this time last year. Hence, my expectation that that CZK will see levels above 26 this year, and will not get sustainably below 25 before 2020 (though it can get there short-term).**

***CZK remains fundamentally dramatically overbought***




Source: CNB

**CZK remains heavily overbought and nothing has happened that would have reduced this since the exit – possibly quite the contrary. The factors that caused the CZK to strengthen strongly last year will be far weaker support in 2018. The over-boughtness of the CZK makes CZK vulnerable to changes investors' sentiment, of which the lower-than-anticipated domestic inflation can be one. I expect weakening of CZK before it returns on the strengthening path.**

# Rates and Yields

## Czech bond premium over Germany to narrow

**CZ-GER bond spread widened to largest in 5 years as…**

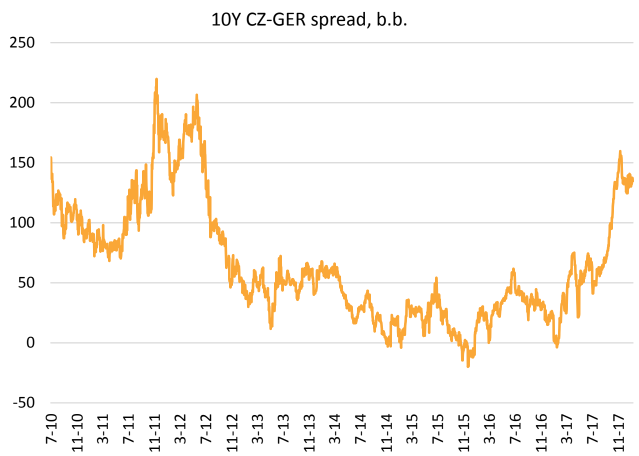
In 2nd half of last year, Czech government bonds began to tangibly diverge from their German counterparts. While German long yields are now only about 25 bps. above their levels from the beginning of 2nd half of 2017 (0.3% vs 0.55%), Czech 10Y rose from over 80 bps. to almost 2% over the same time period. Hence, the spread between CZ yields and German yields widened to highest since debt crisis of 2011-2012. Although that Czech yields will rise somewhat was something I foresaw, I

- didn't think it was going to be this dramatic, and
- thought it was going to be driven by rise of yield in the Eurozone.

**…market began expecting massive CNB-ECB divergence.**

These developments reflected the same market expectation shift as was the one that drove the CZK: expectation of the significant tightening of the monetary policy of the CNB and the subsequent divergence of the CNB policy from that of the ECB. The sell-off was led by foreign investors. The low supply of bonds caused by budget that – because of the strong economic growth last year, and one contributed to significantly by demand of households at that – did nothing to counteract this.

***The CZ-GER bond spread widened to largest since debt crisis***




Source: 42 Financial Services data (generic yields)

**Since Eurozone yields will remain low due to lack of inflation,…**

**From the previous text, a careful reader should now be able to infer that the key determinants of the yields for the coming quarters will be local.**

Although Eurozone yields will remain the key *general* factor in determining the Czech yields, I don't foresee them to be the *specific* driver for 2018. Eurozone remains a low-inflationary environment and considering the rate at which labor market is improving (the unemployment rate is falling at about 1 pp per year) we are still at least couple of years away from the moment when labor market can be viewed as at or close to full employment. Since history of US of last few years shows that even with tight labor market the inflationary rise of wages (i.e., wage growth in excess of productivity growth) is not guaranteed, I think we will not see any tightening of the policy of ECB at least until 2020, and even then it will be slow. There should thus be no abrupt increases in the Eurozone yields this year or next – all I think we will see is a slow upward drift.

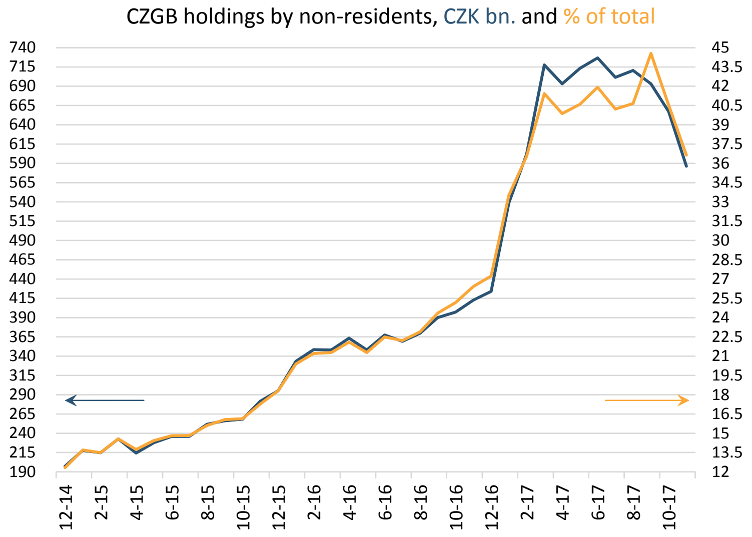
**…as soon as the market realizes CNB will tighten policy only very slowly, the risk premium narrows.**

**Locally a fundamentally, though, situation is ripe for correction, and for narrowing of the CZ-GER spread.** As was explained above, the widening was caused by expectation of CNB-ECB monetary policy divergence.  Since my expectation is that, because of the inflation outlook described above, the tightening of CNB will be very slow (I expect at most one hike this year, and quite likely there will be none), I expect the market to reassess the divergence story over 1H18. And once it does and once dust settles (see following paragraph), the premium over German bunds should narrow to 75 bps. at most, i.e. half of what it is now. Just like it was the shift in market expectation in 2nd half of 2017 that drove yields higher, the correction of the overly hawkish expectations should cause the opposite movement in the first half of 2018. And although wider expected 2018 deficit should theoretically support higher yields, based on how negligibly small impact the budgetary financing needs historically have had on yields, I don't expect this to be much of a factor.

**Overbought CZK can cause volatility, though.**

**There is one big risk: the still-massive speculative presence of foreign investors in Czech government bonds.** See, although they divested of the Czech bonds in 2nd half of 2017 (and switched to IRS market for CZK exposure), foreigners still hold about 36% of all Czech government debt, far more than 12% at the end of 2014 or even 25% at the end of 2016. Hence, CZGB market is still very sensitive to foreigners' decisions. Were they to decide to leave – as I believe at least part of them will this year once it becomes clear CNB is not that different from ECB - spike in local yields shall ensue. However, this will only be a short-term one: local banks' holdings of CZGBs are at historically low levels and banks will readily take the leaving foreigners' positions once it become clear CZK won't strengthen much more because CNB won't hike fast enough.

***The share of non-residents in CZGBs fell in 2H17, but remains very high nonetheless***




Source: www.mfcr.cz

**The Czech-German government bond spread will narrow to about half of what it is now, with most of it coming from lower Czech yields as a consequence of market's reassessment of the CNB interest rate trajectory. The correction will be accompanied by volatility caused by departing foreign investors, though.**

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