

CNB TIGHTENING: ANOTHER MISGUIDED MONETARY POLICY.

MARTIN LOBOTKA, (+420) 777 027 165, MLobotka@42fs.com, Research@42fs.com

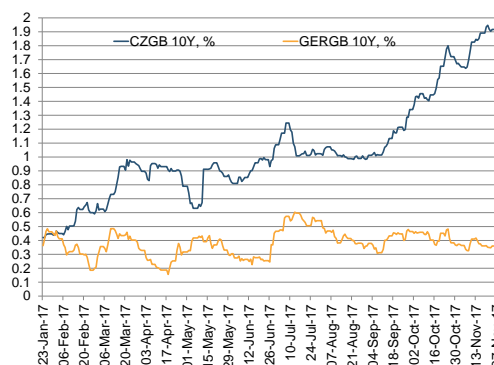
After FX interventions that brought very little, CNB's policy is again misguided,...

...seeing and responding to the demand threat where there really is very little of it.

Czech bond and FX markets are in for a correction.

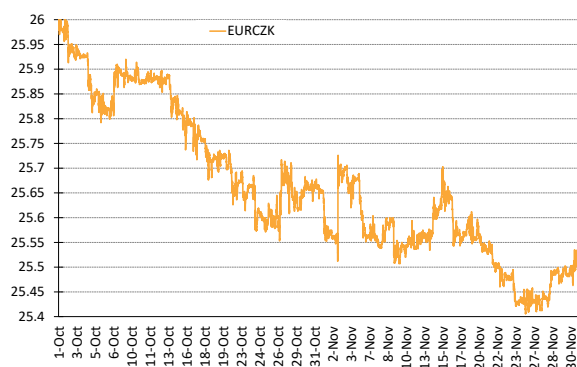
CNB hiked the key 2-week repo rate twice this year, in a stark contrast to what I originally expected when interventions ended in April. And although CNB's latest (November) forecast sees only a little over 1 hike until the end of 2018, (at least) some Board members are itching to do more and analysts are falling over themselves who will forecast swifter tightening for 2018. Not that this is not understandable at the first glance – economy grew at 5% y/y in the last quarter, the unemployment is the lowest in the European Union (under 3% according to Eurostat, with Malta second and Germany third) and confidence indicators are at or close to all-time highs. One could be forgiven for thinking that Czech Republic is about to become an inflation hellhole.

The expectation of the tighter monetary policy is reflected in the EURCZK and the bond markets. The outlook for higher interest rates triggered massive sell-off in the domestic bond market, pushing 10-year yields to almost 2% and thereby widening the risk premium to German equal-maturity Bunds to over 150 bps. Considering that when the sell-off began at the end of summer almost half of the bonds were held by non-residents, it is certain that most of these bonds were sold by non-residents.



SOURCE: 42 FINANCIAL SERVICES

The non-residents, however, didn't leave the CZK. This is clear from the evolution of the EURCZK exchange rate which over the same period fell to as low as 25.40. In the forward market, the widening of the interest rate differential between Czech Republic and Eurozone produced only small improvement of the points¹ so the theory is that most of the foreign investors betting on CZK appreciation just shifted from bond market into FX forward market.



SOURCE: 42 FINANCIAL SERVICES

¹ Before the end-of-the-effect of the Resolution fund threw any relationship between interest rates in Eurozone and Czech Republic as a determinant of the forward points out of the window.

12 December | 2017

In other words, the outlook for CNB and the exchange rate are closely linked. And both are determined by the outlook for inflation. Let us therefore examine it.

On the surface, inflation picture is clear. The strong growth of the economy, driven by domestic demand, led to the increase of the demand pressures and hence overall inflation and therefore the tighter monetary policy of the CNB was necessary, possible even overdue – remember, after all, that as recently as in 1Q17, CNB was buying tens of billions of euros worth of foreign exchange to *ease* the monetary policy, and that, for instance, the current uber-hawk Mojmir Hampl² was advocating ending the interventions later than in the middle of the 2017 (!). One could thus be forgiven for thinking that CNB realized, belatedly, that it overdid it, and started chasing the rising inflation. Hence the 2017 hikes coming shortly after monetary policy easing...

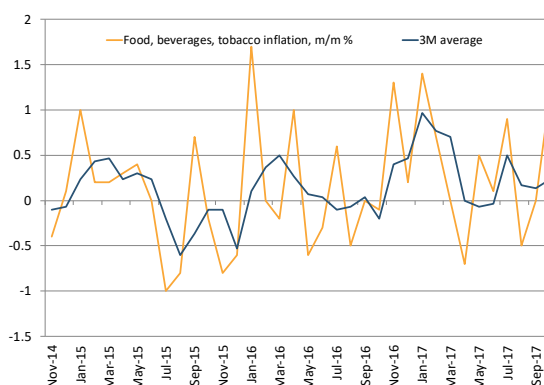
The deeper look at the inflation, however, isn't supportive of this demand-drives-the-inflation narrative. See,

the current monetary-policy relevant inflation (MPRI) is only half due to the demand (≡core³) inflation, i.e., due to the rise of headline inflation without (primary effect of) indirect taxes, without regulated prices, fuel and food prices. This core inflation is only responsible for about 1.4 pp of the October's MPRI of 3%; and

another 1.4 pp was contributed by the food, alcohol and tobacco prices. In other words, had the food prices stagnated y/y instead of growing at 5.1% y/y, the fastest rate since May 2011, the MPRI

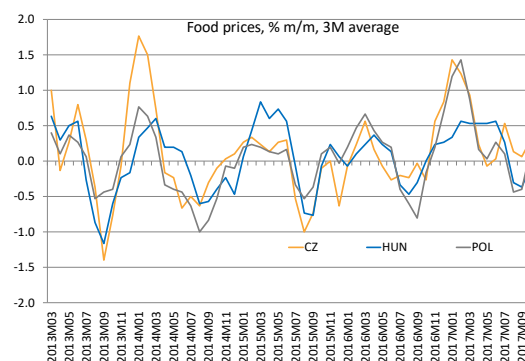
would be approximately half of what it is now.

The non-demand character of the food price increases is by itself the sufficient illustration of how "large" the inflation threat really is in the Czech Republic. But it doesn't stop here. Most of the food price increase in the Czech Republic that we see in the y/y inflation figures occurred in the four months between November 2016 and February 2017, over which time the food prices rose almost 4%.



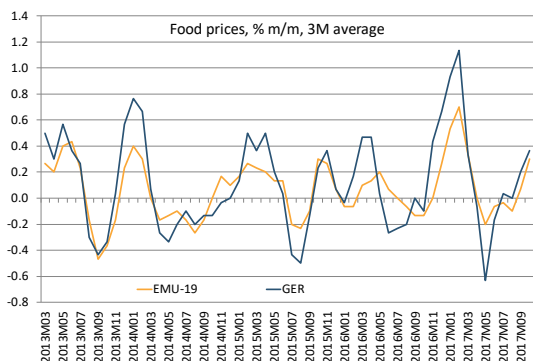
SOURCE: CZECH STATISTICAL OFFICE (FOR OFFICIAL CPI COMPUTATION)

Moreover, this was not only Czech phenomenon: it occurred in neighboring countries and in Eurozone, as the following pictures illustrate.



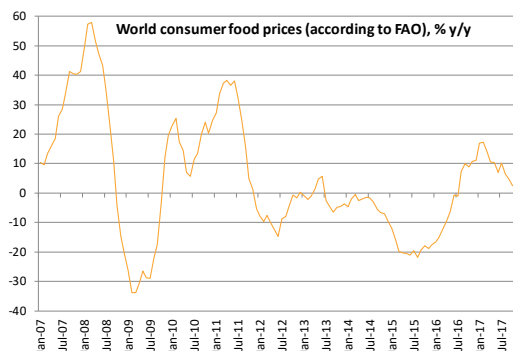
² Hampl said a week after the most recent – and dovish – forecast of the CNB was released in early November that he's ready to *hike* again in December. That is what I call volte-face.

³ CNB began calling the demand inflation the core inflation in May. I shall henceforth use the 'core' inflation where previously 'demand' inflation would have been used.

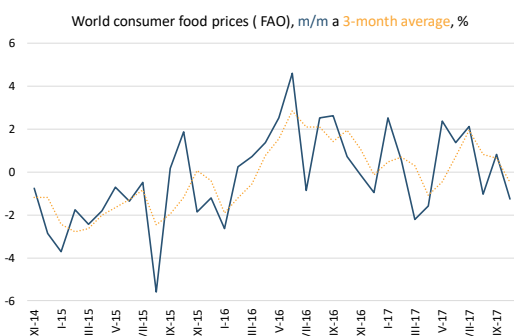


SOURCE: EUROSTAT

What this really means is that unless we see the repeat this year of what happened in those four months of 2016 and 2017, the base effect will quickly bring the food price inflation down over November 2017 – February 2018 – and the headline inflation with it. That this is likely is seen in global food prices as well, the growth dynamics of which is much weaker than last year.



SOURCE: FAO



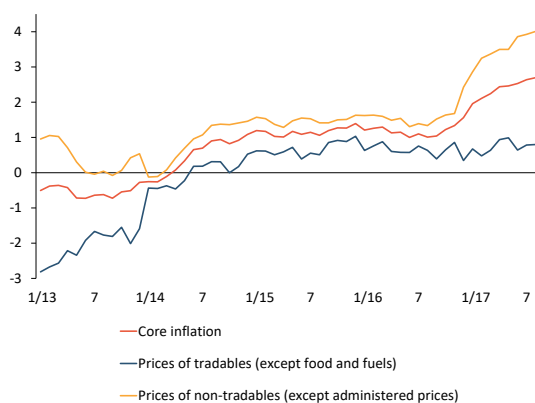
SOURCE: FAO

Looking at the second major component of the monetary policy relevant inflation, the core inflation, there are no reasons to think that its

increase reflects the true demand pressures of households. Instead, **the rise of core inflation mostly reflects two non-demand factors:** the electronic registration of sales (known as ‘EET’ in the Czech Republic) and the change of the computation of the imputed rents as a component of the service sub-index of the core inflation. The following picture shows clearly that the rise of core inflation

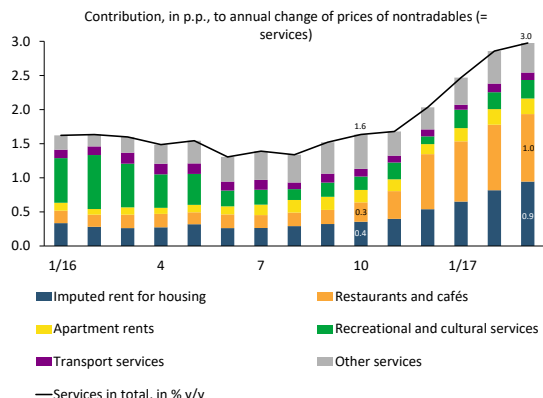
■ began abruptly in November 2016 and,

■ was driven exclusively by rise of non-tradable component thereof, i.e. by services.



SOURCE: CNB, INFLATION REPORT IV/2017 (III.1 HERE ↗)
NOTE: ALL NUMBERS IN PERCENT Y/Y.

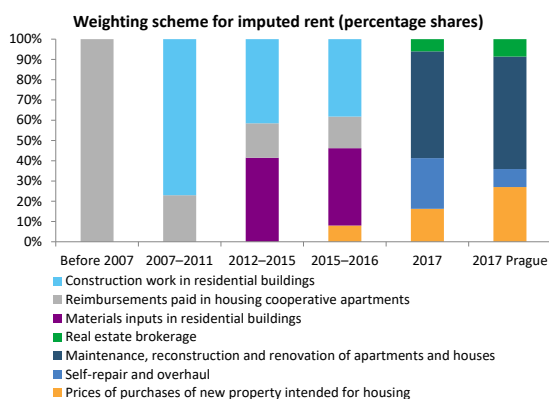
But which services? Well, pretty much only **restaurants and imputed rents!** Out of the increase of service inflation between October 2016 (1.6%) and March 2017 (3%) – which is when service prices took off – of 1.4 pp, the imputed rent and restaurants were together responsible for 1.2 pp thereof, i.e. for 85% (!). The further quickening of service inflation to 4% at the end of 3Q17 was then due almost exclusively to imputed rent.



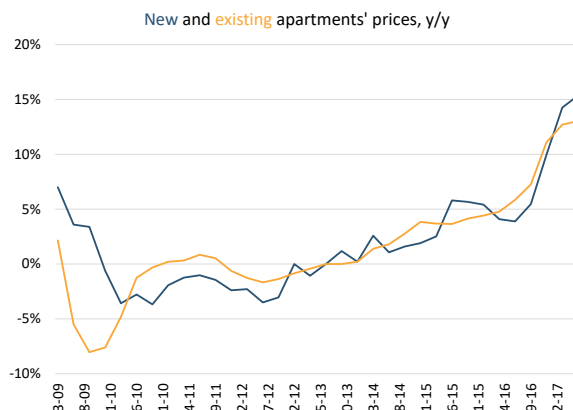
SOURCE: CNB, INFLATION REPORT II/2017 (BOX 3 HERE ↗)
NOTE: ALL NUMBERS IN PERCENT Y/Y.

As we noted in our other materials before, the implementation of EET led to the massive one-off increase in restaurant prices, with some compounding effect of higher food price growth that occurred at the same time.

As regards the imputed rent, its rise is due to the increase in weight of new property prices in the computation of imputed rent. This change occurred at the end of 2016 and meant that the weight of new apartments' prices in the imputed rent jumped from 8% to 16.3% in regions outside Prague, and to 27% in Prague. This has the effect of injecting the real estate price component more heavily into the consumer price index (itself a questionable move...) and – in light of this change happening just as house price growth was at its strongest - of making CNB's monetary policy more responsive to house prices.



SOURCE: IBID.



SOURCE: CNB ARAD DATABASE.

And responded it did – with two hikes coming few months after the end of interventions (and another one debated for December), both of them justified by alleged 'demand' pressures. When, in fact, all there really was was 'just' a housing bubble for which interest rates are a very blunt tool, and electronic record of sales.

Anyway. Looking forward, the strong disinflation is what lies ahead, disinflation that will bring Czech inflation below 2% soon, and possibly lower (depending on house prices, mainly). First, food prices are unlikely to rise as strongly in the coming months as they did at the end of 2016 and the beginning of 2017, thereby producing a visible and strong base effect in the food inflation. Second, the effect that the implementation of EET had on restaurant prices will fall out of the base, also producing the strong base effect. House prices continue to rise, but there are signs of slowdown in the quarterly growth dynamics, not only because of the rise in mortgage rates but also because of the measures CNB took in 2017 to rein in the hot real estate market. This will thus translate into weaker y/y growth of imputed rent and thus much weaker service inflation. Finally, the Eurozone demand inflation is low and will not quicken much (the labor market still has a lot of slack and the wage growth is weak) so it is unlikely that we will import inflation to make up for these domestic effects.

For monetary policy, bond markets and for EURCZK, the implications of this forecast are clear. As the market realizes that there are much weaker demand pressures that would threaten the price

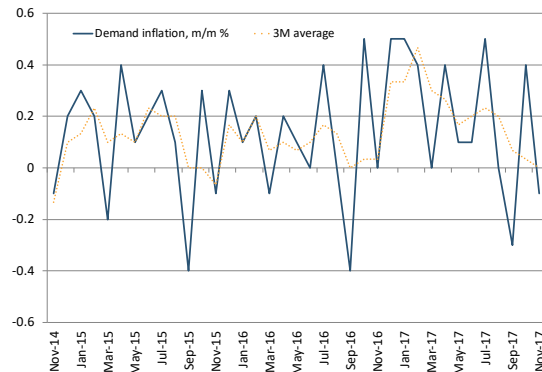
stability in Czech Republic than what casual look at headline inflation suggests, there will be

- repricing of the bonds, with yields coming down notably, especially on the long end of the curve, and
- weakening of the CZK, very likely above 26 and towards 27, as investors, currently in the forward market, take profit.

Both bond and EURCZK markets got where they are on the idea that CNB's monetary policy will diverge massively from that of ECB. But it will not.

POST SCRIPTUM: According to the data released yesterday (Monday, December 11), Czech November annual monetary-policy relevant inflation fell 0.3 pp to 2.7%, mainly due to food price inflation slowdown. More importantly, the trend monthly dynamics of the

core (demand) inflation slowed further and is now lower than in November 2016. So much demand inflation threat...



SOURCE: CNB

12 December | 2017

DISCLAIMER

This publication has been prepared by 42 Financial Services Czech Republic (further referred to as '42 Financial Services' only). This report is for information purposes only.

Publications in the United Kingdom are available only to investment professionals, not private customers, as defined by the rules of the Financial Services Authority. Individuals who do not have professional experience in matters relating to investments should not rely on it.

The information contained herein has been obtained from public sources believed by 42 Financial Services to be reliable, but which may not have been independently justified. No guarantees, representations or warranties are made as to its accuracy, completeness or suitability for any purpose.

This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument or any other action and will not form the basis or a part of any contract.

Neither 42 Financial Services nor any of its affiliates, its respective directors, officers or employers accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith. Any opinion, estimate or projection expressed in this publication reflects the current judgment of the author(s) on the date of this report. They do not necessarily reflect the opinions of 42 Financial Services and are subject to change without notice. 42 Financial Services has no obligation to update, modify or amend this report or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate.

The past performance of financial instruments is not indicative of future results. No assurance can be given that any financial instrument or issuer described herein would yield favorable investment results.

42 Financial Services, its affiliates, principals or employees may have a long or short position or may transact in the financial instrument(s) referred to herein or may trade in such financial instruments with other customers on a principal basis. 42 Financial Services may act as a market maker in the financial instruments or companies discussed herein and may also perform or seek to perform investment banking services for those companies. 42 Financial Services may act upon or use the information or conclusion contained in this report before it is distributed to other persons.

This report is subject to the copyright of 42 Financial Services. No part of this publication may be copied or redistributed to persons or firms other than the authorized recipient without the prior written consent of 42 Financial Services.

By accepting this report, a recipient hereof agrees to be bound by the foregoing limitations.

Copyright: 42 Financial Services Czech Republic, 2017.

All rights reserved.