Weekly | 2018 | Week 05

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CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	5-Feb	9:00	CZ	Trade balance, Dec'17, CZK bn.	-6.7	-9.0
	5-Feb	10:00	EMU	(Final) Services PMI, Jan'18	57.6	N/A
	5-Feb	11:00	EMU	Retail Sales, Dec'17, y/y	1.9%	N/A
Tuesday	6-Feb	8:00	GER	Factory orders, Dec'17, y/y	2.9%	N/A
	6-Feb	9:00	CZ	Retail Sales, Dec'17, y/y	3.1%	3.5%
	6-Feb	9:00	CZ	Industrial output, Dec'17, y/y	3.7%	4.8%
Wednesday	7-Feb	8:00	GER	Industrial output, Dec'17, y/y	6.8%	N/A
Thursday	8-Feb	9:00	CZ	Unemployment, Jan'18	3.9%	3.9%
	8-Feb	9:00	SPA	Industrial output, Dec'17, y/y	4.0%	N/A
	8-Feb	8:45	FRA	Industrial output, Dec'17, y/y	3.5%	N/A
Friday	9-Feb	10:00	ITA	Industrial output, Dec'17, y/y	1.9%	N/A

* LOCAL TIME IS CET
** (REUTERS/ BLOOMBERG) POLL

FEBRUARY 2018 AUCTIONS

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
SPP 780	1-Feb	2-Feb	4-May-18	CZK 0-5 bn.	N/A
CZGB 2007-2022**	7-Feb	9-Feb	12-Sep-22	CZK 3 bn. max	4,70%
CZGB 2017-2027**	7-Feb	9-Feb	10-Feb-27	CZK 4 bn. max	0,25%
CZGB 2015-2030**	7-Feb	9-Feb	15-May-30	CZK 4 bn. max	0.95%
SPP 781	8-Feb	9-Feb	11-May-18	CZK 0-5 bn.	N/A
SPP 781	15-Feb	16-Feb	18-May-18	CZK 0-5 bn.	N/A
CZGB 2018-2021**	21-Feb	23-Feb	23-Feb-21	CZK 4 bn. max	N/A
CZGB 2015-2026**	21-Feb	23-Feb	26-Jun-26	CZK 4 bn. max	1,00%
CZGB 2018-2029**	21-Feb	23-Feb	23-Jul-29	CZK 4 bn. max	N/A

* FOR T-BILLS, THIS IS MAXIMUM AMOUNT PER PRIMARY DEALER.
** MINFIN CAN CHANGE THE ISSUE AT THE LATEST AT THE DAY OF THE AUCTION ANNOUNCEMENT.

THOUGHT OF THE WEEK

"STRANGE HOW RETURN OF 5-YEAR GERMAN BOND YIELD ABOVE ZERO FEELS LIKE A MASSIVE TIGHTENING…"

WEEK AHEAD

In the Czech Republic, December retail sales and industrial production will be released.

Both will be affected by the lower number of working days in December 2017 (19) compared with December 2016 (21) but adjusting for this we'll see strong numbers. Though likely – in either case – not as strong as soft indicators, i.e. consumer confidence and PMI, suggest.

In Eurozone, **industrial data for December** for all big economies will be released. It will be interesting to see, especially in Germany, whether the sky-high PMI translated into actual industrial production figures – despite November strong figures ↗, PMI is still far higher than the actual production.

Finally, **retail sales** for December will be released but these are unlikely to surprise on the upside as 4Q17 GDP data show (any substantial increase in retail sales would have had to push the growth above 0.6% q/q).

WEEK BEHIND

CNB hikes for the third time in last half a year, sees CZK at 24.6 in 4Q18

Czech January manufacturing PMI at joint-highest in 7 years

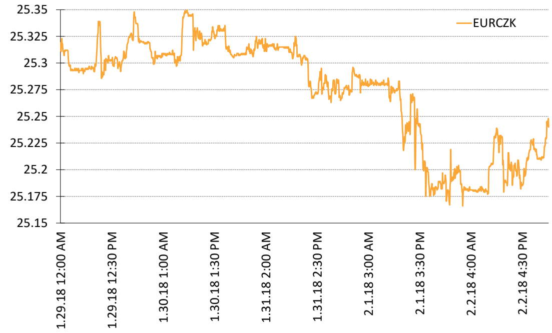
Czech budget precariousness still masked by strong economy

Eurozone economy grew the same in 4Q17 as in 3Q17, rise of leading indicators nonetheless

Eurozone inflation falls on German disappointment

| FX

EURCZK FALLS BELOW 25.20 ON CNB FORECAST



EURCZK strengthened further on CNB's new forecast.

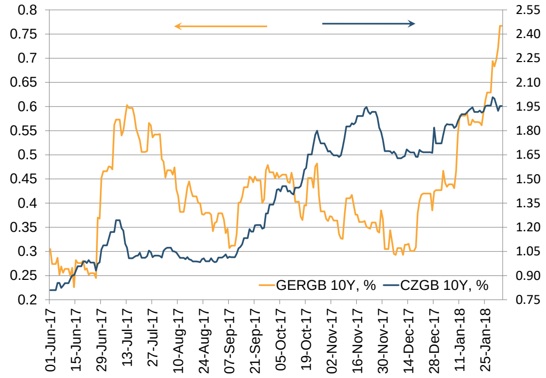
New CNB forecast sees EURCZK at 24.6 in 4Q18, apparently a green light for the market to speculate CZK will firm further.

That said, with CZK this strong at the end of this year, CNB forecast also says '*no more hikes'* this year: in this case, it is the exchange rate which will do most of the (supposedly required) monetary tightening. But, what seems to be propelling the EURCZK lower now is exactly that expectation, i.e. the expectation that CNB will continue to diverge from ECB (i.e., same story which propelled EURUSD to well below 1.10 few quarters back). Hence, this is inconsistent: if CZK strengthens, CNB won't hike. Expecting many hikes and thus selling EURCZK, and strong CZK just isn't the way Czech monetary policy works. It is either – or here. Market should realize this.

| FI

German yields continued to rise as market continued to brush the dovish news aside.

GERMAN LONG YIELDS ROSE TO HIGHEST IN OVER 2 YEARS AS MARKET GETS OPTIMISTIC ON INFLATION

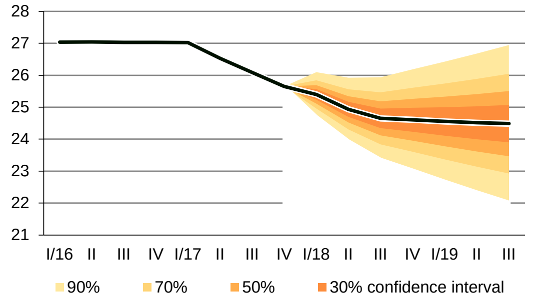


Just a like the week before when market chose to ignore the dovish ECB meeting and focused on strong soft indicators instead (which, by the way, failed to translate into faster growth in 4Q17 ▶), it conveniently ignored persistently low inflation and 'just' 0.6% GDP growth in 4Q17 to focus on Dutch central banker Klaas Knot statement ↗ and FOMC meeting (where Fed funds target was left unchanged). The former is a hawk on ECB governing council who happened to say last week that "QE must stop ASAP" 'cause it's already done what it reasonably could, while FOMC statement ↗ was seen as showing FOMC confidence that inflation will rise, justifying the tightening in US. Both were interpreted as sell-off signals by the market. That the former has been saying this, together with another uber-hawk on Governing Council (Weidmann from Bundesbank), for years, and that the latter only contained (the expression of) belief we'd seen in every FOMC statement in last three years clearly escaped the markets' attention…

Market now wants to see inflation ahead, and thus trades on it – German 5Y rose to positive territory for the first time in 25 months, US 10Y sold off to highest (yield) since April 2014. The fact, however, remains that neither in US nor in Eurozone do we see much in the way of inflation, or signs of inflationary pressures' build-up.

Czech yields ignored all this and fell.

CNB CONTINUES TO BELIEVE TIGHTER POLICY IS NEEDED AND THAT TIGHTENING WILL HAPPEN VIA APPRECIATING CURRENCY



| CZECH ECONOMY

CNB unanimously tightened the policy last week and released new inflation forecast. But it didn't get any more hawkish compared with last forecast from November 2017.

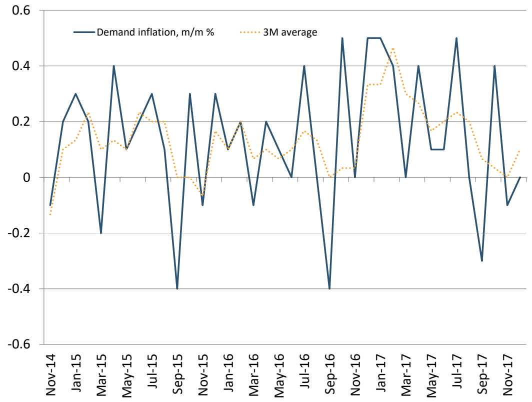
Just like the November forecast the February one calls for just 1 ½ hike(s) in 2018, i.e. nowhere close to three or four hikes some analysts continue to expect. Last Thursday, in my view, CNB decided to frontload the tightening while it still can, i.e. while actual inflation data (last release being from December) still support the myth of demand pressures that need to be contained - because in next three months, we will see CPI falling notably below 2%.

Forecast for 2018 remained essentially unchanged since November iteration thereof: growth forecast for 2018 is 3.6% (vs. 3.4% in November forecast), the average inflation is 1.9% (vs. 2%), EURCZK is 24.9 (vs. 24.9 in previous forecast).

This last thing is important. CNB reverted to the pre-interventions (=pre-November 2013) practice of disclosing the EURCZK forecast implicit in the macroeconomic forecast. This is *not* the CNB expectation of the exchange rate or any commitment, but the trajectory that is, in the model, consistent with trajectories of inflation, repo rate etc. In the current forecast, it thus tells you that expectation that, after the February hike, the repo rate remains essentially flat for the remainder of this year is consistent with EURCZK being 25.4 in 1Q18, 24.9 in 2Q18, 24.7 in 3Q18 and 24.6 in 4Q18 (these four quarterly averages give yearly average of 24.9). In other words, should EURCZK be weaker than this, for whatever reason, it would imply that, cet.par., the repo rate (as another component of monetary conditions) should be higher, i.e. it would imply more hikes.

The forecast thus shows that 1] CNB believes in demand pressures and that it 2] expects them to be contained primarily via appreciating currency. This belief is there despite the fact that

THIS BELIEF IS THERE EVEN THOUGH DEMAND INFLATION DYNAMICS IS WEAK

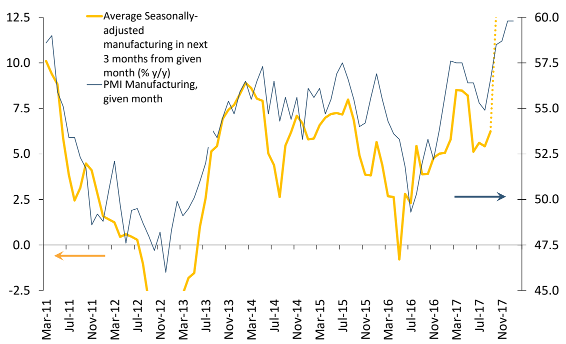


December and November inflation data show no such thing as demand inflation, the dynamics of demand inflation being just like in mid-2016 when CNB was busy fighting *deflation,* and despite the fact that

strengthening of the CZK is historically fairly weak factor in dampening the demand pressures.

Let us thus wait for the January inflation on 14th: CNB will get another proof of demand pressures being nowhere as strong as CNB believes. Will it finally force EURCZK market to find the bottom? Not sure, with market seeing CNB forecast of 24.6 at the year-end. But at some point, huge speculative money still in EURCZK must flow out. Will CNB hike when CZK weakens? Not necessarily - it will very likely happen in a situation with lower inflation that now. But if growth is strong at that time, it might provide CNB with another excuse to normalize the policy further – just like EET and imputed rents provided it with the excuse to end interventions and hike last year**. This cycle is clearly purely political…**

MANUFACTURING PMI AT JOINT-HIGHEST IN 7 YEARS

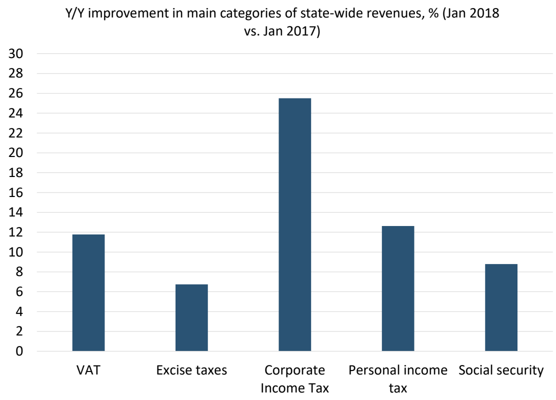


Manufacturing PMI remained at the December's level of 59.8, i.e. at the level consistent with double-digit growth of industry in the coming months.

This is the joint-strongest reading in 7 years, with (expectedly) strong readings in all sub-indices. One interesting piece of news was that pre-production inventories rose at the fastest level since August 2007, the response of manufacturers to supply delays. This may have an effect on 1Q18 GDP growth (on inventories component of aggregate demand).
The industry thus seems to be in for a very strong 1Q18, with possibly double-digit growth. Though I will believe when I see it.

Strong growth is still making Czech budget look much better than it really is.

CZECH BUDGET IMPROVING ON STRONG ECONOMY

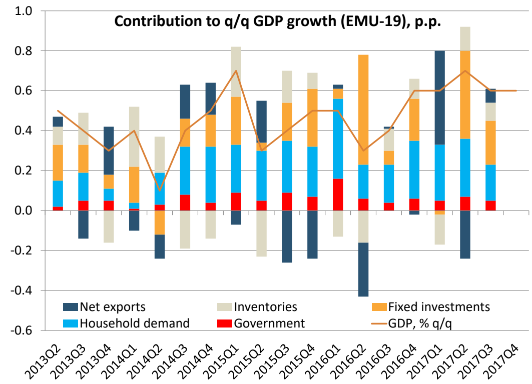


January surplus (adjusted for effects of EU money) was CZK 5 bn. (January 2017: CZK 2.9 bn.), mainly because of growth of revenues. These reflect higher tax revenues due to strong household demand (VAT), usual January 1 rise of taxes on tobacco (excise taxes) and strong labor market (personal income tax + social security).

Growth of expenditures, as is usual with governments of all kinds – this one, with MinFin from party averring to run the country as business being no exception – keeps up with that of revenues. In January, expenditures increased by almost 9% due to by-now-usual combination of higher salaries (school teachers +15% as of November, non-teachers in school +10% from November, + another 9.4% since July etc.) higher pensions, higher contributions to State Agricultural Fund…You name it – "let us squander whatever the strong economy throws our way!"

| EUROZONE ECONOMY

EUROZONE 4Q17 GROWTH IDENTICAL WITH 3Q17 DESPITE STRONGER LEADING INDICATORS

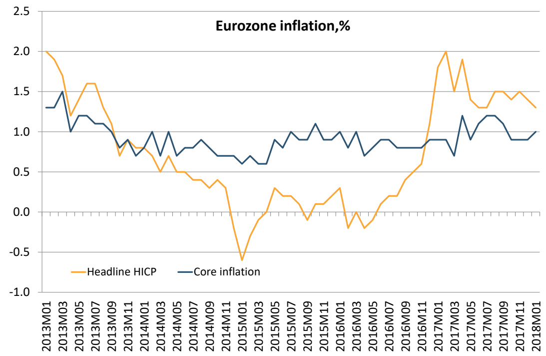


Eurozone 4Q17 growth didn't surprise: not weak, but nowhere near the levels suggested by leading indicators either.

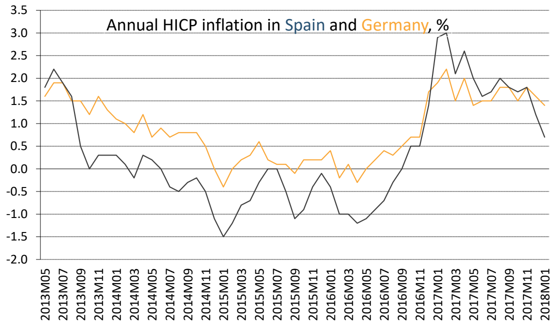
France, Spain reported the 4Q17 results in line with the expectations: 0.6% q/q (1.9% y/y) and 0.7% q/q (3.1% y/y), respectively, were 0.1 pp faster and slower, respectively, than quarterly growth in 3Q17. The Eurozone 1st estimate was also in line with the expectation, at 0.6% q/q, suggesting that Germany and Italy didn't do much better than in 3Q17 either.

While Spain didn't release any structural data, France did. French 4Q17 growth was driven by net exports and domestic demand. While contribution of net exports changed dramatically as against 3Q17 (+0.6 pp. contribution against -0.5 pp in 3Q17), the contribution of domestic demand remained essentially unchanged: contribution of 0.5 pp to 4Q17 q/q growth was just 0.1 pp lower than in the previous quarter. While fixed investments quickened their growth to 1.1% q/q (from 0.9% in 3Q17), growth of household demand slowed (0.3%

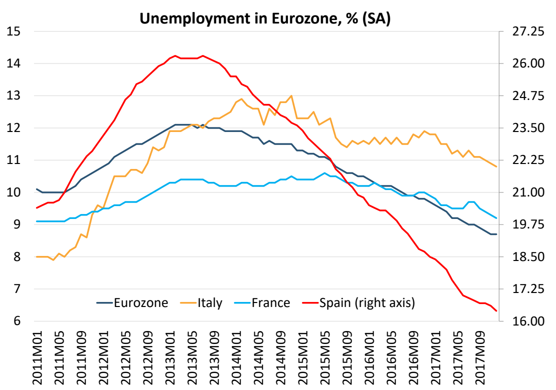
EUROZONE INFLATION REMAINED LOW IN JANUARY….



…AS GERMAN / SPANISH HICP FELL.



EUROZONE UNEMPLOYMENT STAGNATED AT 8.7% IN DECEMBER



q/q vs. 0.6% q/q). In essence, this is how German quarterly growth looked like in *3Q17.*

The GDP data change nothing for the ECB: the monetary policy will remain very loose for a long time. For me, 4Q17 is a slight disappointment: the notable improvement of the leading indicators at the end of 2017 left me hopeful the growth was 0.7%, possibly 0.8% q/q.

Eurozone headline inflation fell slightly because of Germany. Core inflation rose, after three months at 0.9%, to 1%.

The German inflation data release last Tuesday was a big disappointment: headline inflation came in at 1.4%, not only below December (1.6%) but also substantially below expectation. **This in an economy with no unemployment whatsoever** and **one where year ago some German politicians were panicking at the "horror" inflation** ↗ endangering the savings?

The monthly decline was 1%, which could theoretically be blamed on stronger euro…

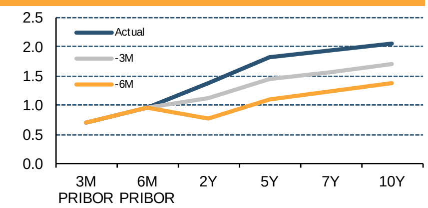
….but then one should explain why French inflation didn't show the same effect. **French HICP inflation rose 1.5% y/y in January** (from 1.1% in December), the monthly decline having been far smaller (-0.1%) than forecast (-0.5%). Statistical office said this was due to 1) energy prices having risen because of rise of crude prices and of taxation, and 2) services' prices.

Finally, Spanish inflation was also slightly below the expectations, with monthly decline of 1.5% translating into annual growth of HICP of just 0.7%.

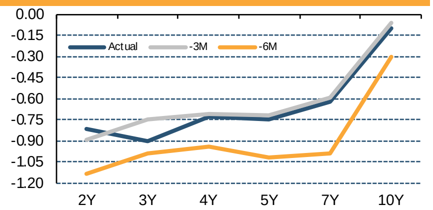
Put together, Eurozone headline inflation slowed to 1.3% while, as mentioned, core inflation edged up to 1%. Taking all this into account the message to ECB and to euro hawks is clear: **monetary policy will remain very loose going forward**, so those betting on closing of the gap between ECB and FED and the implications thereof for euro should think about it one more time. And the fact that unemployment remained at 8.7% in December supports this.

| MARKETS ‡

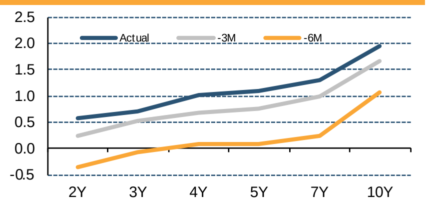
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	0.709	0.969	1.390	1.835	1.930	2.050
	-1M	0.709	0.969	1.335	1.655	1.745	1.870
	-3M	0.709	0.969	1.130	1.460	1.577	1.710
	-6M	0.709	0.969	0.785	1.103	1.231	1.373



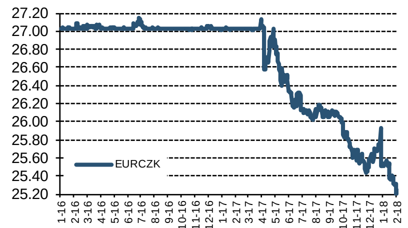
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-0.820	-0.904	-0.731	-0.749	-0.623	-0.097
	-1M	-0.784	-0.834	-0.713	-0.800	-0.605	-0.044
	-3M	-0.893	-0.749	-0.710	-0.717	-0.598	-0.063
	-6M	-1.141	-0.988	-0.942	-1.020	-0.995	-0.306



CZGB**		2Y	3Y	4Y	5Y	7Y	10Y
%	Actual	0.570	0.696	1.019	1.086	1.307	1.953
	-1M	0.551	0.647	0.872	0.855	1.140	1.826
	-3M	0.237	0.527	0.670	0.743	0.979	1.647
	-6M	-0.356	-0.065	0.083	0.083	0.236	1.067



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25.237	4.171	309.91	4.647	4.697	1.246
	-1M	1.750	1.562	1.38	1.681	1.790	1.821
	-3M	1.750	1.562	1.38	1.681	1.790	1.821
	-6M	1.750	1.562	1.38	1.681	1.790	1.821



‡ As of Sunday night
* Spreads to generic bonds
** Generic bond

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