Weekly | 2018 | Week 05

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| CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**
Wednesday	13-Feb-19	9:00	CZ	CPI, Jan'19, y/y	2.1%
	13-Feb-19	10:00	CZ	Current Account, Dec'18, CZK bn.	-4.1
	13-Feb-19	11:00	EMU	Industrial production, Dec'18, y/y WDA	-3.3%
Thursday	14-Feb-19	8:00	GER	(Preliminary) 4Q18 GDP , q/q	0.2%
	14-Feb-19	11:00	EMU	(2nd estimate) 4Q18 GDP , q/q	0.2%
	14-Feb-19	9:00	CZ	(Preliminary) 4Q18 GDP , q/q	0.7%
Friday	15-Feb-19	11:00	EMU	Trade Balance, Dec'18, EUR bn. (SA)	15.7

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

| FEBRUARY 2019 AUCTIONS

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
CZGB 2014-2025**	6-Feb-19	8-Feb-19	17-Sep-25	CZK 5 bn. max	2.40%
CZGB 2017-2027**	6-Feb-19	8-Feb-19	10-Feb-27	CZK 5 bn. max	0.25%
SPP 808*	14-Feb-19	15-Feb-19	16-Aug-19	CZK 5 bn. max	N/A
CZGB 2019-XXXX EURO***	20-Feb-19	22-Feb-19	22.2.21/22.2.22	EUR 100 mn. max	0.00%
CZGB 2018-2029**	27-Feb-19	1-Mar-19	23-Jul-29	CZK 5 bn. max	2.75%
CZGB 2015-2030**	27-Feb-19	1-Mar-19	15-May-30	CZK 5 bn. max	0.95%
CZGB 2006-2036**	27-Feb-19	1-Mar-19	15-May-36	CZK 2 bn. max	4.20%
SPP 809*	28-Feb-19	1-Mar-19	29-Nov-19	CZK 0-5 bn.	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 FOR ONE WITH SIMILAR MATURITY.
*** TO BE DETERMINED ACCORDING TO THE ACTUAL MARKET SITUATION.

| THOUGHT OF THE WEEK

" IF YOU THINK YOUR GOVERNMENT SUCKS, LOOK AT UK'S ONE."

WEEK AHEAD

Preliminary 4Q18 GDP and January 2019 inflation are of interest this week here.

Inflation is forecast at 2.1% in January, although I have a feeling a base effect from housing prices could cause there to be a surprise on the downside. Last January, the weight of the new property prices was increased in the CPI's imputed rent sub-index (which has weight of 10% in the consumer basket) and it was quite a noticeable increase, from 27% to 39% in Prague, for instance. As far as I can tell ↗, there wasn't any change of weighting this January. At any rate, I expect most of the inflation to still be due to housing segment.

Flash 4Q18 GDP will probably come in strong: monthly data, especially for retail sales, were very good in 4Q18, and while industry slowed, it was nowhere near (yet) as dramatic as in Germany.

In Eurozone, Germany will release the 4Q18 GDP estimate. Here, weak December industry data that came out last week may cause undershooting of the expectations set at 0.2% q/q.

WEEK BEHIND

Czech industry barely grew in 4Q18,…

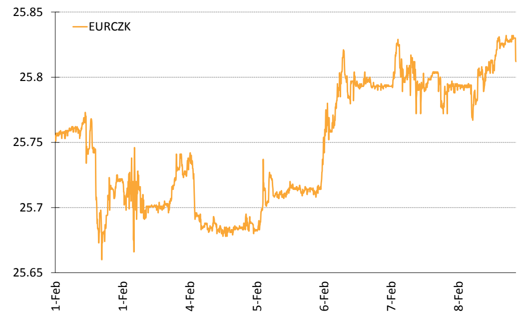
…but retail sales were strong, apart from cars and fuel

Someone switched the Bloomberg off at CNB, it appears

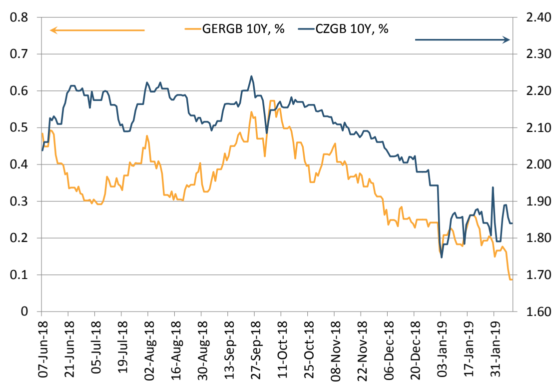
German industry weakness deepens in Dec'18

Eurozone retail still far from inflation-threatening growth rates

EURCZK RISES ABOVE 25.80 AND…



…GERMAN 10YS FALLS BELOW 10 BPS., AFTER WEAK GERMAN DATA.



| FX

EURCZK rose further above 25.80,…

…after weak German industrial data. CNB's rather hawkish meeting didn't do anything to move CZK to stronger levels.

| FI

German bonds continued to get pricier,…

…with 10Y falling below 10 bps. for the first time since October 2016. Weak industrial data (see below) were the reason for this continuing flight to safety.

| CZECH ECONOMY

Czech retail sales continued to grow solidly at the end of 4Q18, though the difference remained wide between core and non-core items.

Real growth of total retail sales (adjusted for the working days) was just 1.6% y/y in December 2018, far cry from 5.8% annual growth rate seen in December of 2017. However, looking at the structure, it is clear that only fuel sales (+1.7% y/y, slowest growth since early 2016) and car sales (-5.3% y/y, one of the slowest growth rates since end of 2012) were to blame.

Apart from these two items and ignoring food sales (which, however, grew quite strongly, at almost 3% y/y, in December), core retail sales continue to grow nicely. Although it is slower than in 2017, the growth of 6.5 % y/y (real, WDA) is certainly not slow.

Looking at monthly dynamics, there are no signs of households pulling back: the growth of core retail sales in last quarter of 2018 was 2.5% (growth in December alone 0.2%). This is not surprising: household demand is a lagging, not leading indicator of the overall economic conditions.

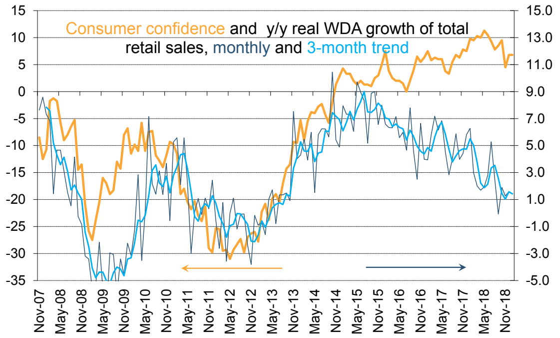
On the other hand, industrial production hasn't grown much in 4Q18.

The growth in December of 0.6% m/m (real, WDA, SA) brought the 4Q18 growth to around 0.3% q/q. This is true of industry as a whole as well as of manufacturing component thereof.

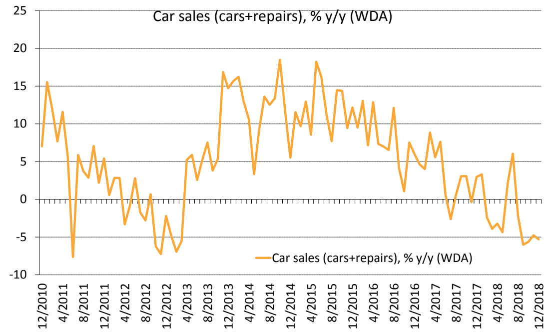
Looking ahead, with PMI under 50 in both December and January, **the outright contraction of the production in 1Q19 is almost assured.**

In a separate release, **trade balance** (national concept) **ended the 2018** in a surplus of CZK 132.7 bn., lower by about CZK 31 bn. than in 2017. The main reason for the lower surplus is obviously oil: the balance of trade with mineral fuels ended up in

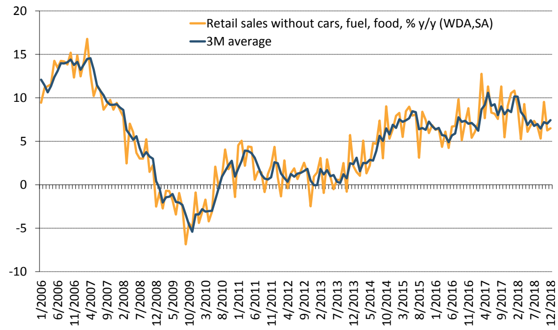
RETAIL SALES GROWTH CONTINUES TO SLOW …



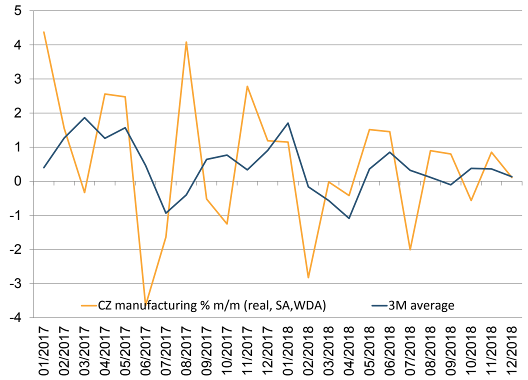
…BUT IT IS ONLY DUE TO FUEL SALES AND CAR SALES.



CORE RETAIL SALES REMAIN STRONG



INDUSTRY BARELY GREW IN 4Q18



a deficit that was CZK 24.5 bn. larger than in 2017.On the other hand, and bit surprisingly, the balance of trade with machinery and transport equipment actually improved by approx. CZK 9 bn., consequence of improvement on the export side (exports rose CZK 85 bn., imports CZK 75 bn.).

This year, machinery and transport balance will worsen as exports will slow (se German weakness) more than the imports (see Czech households' resilience). As regards balance of trade with mineral fuels, the slower growth will lower the imports and the average 2019 CZK price should be lower than in 2018 even if CZK doesn't strengthen. Right now, Brent CZK price is about the same as it was this time last year, but if it doesn't grow in the coming months, as I expect, the average price throughout 2019 will be well below one in 2018. **Therefore, the balance of mineral fuels should improve this year.**

Someone probably switched the Bloomberg off at CNB and unsubscribed from all the newsfeeds. That's the main takeaway from last week's CNB meeting.

With even government now aware that something is happening with the economy, it is hard to explain the optimism of the CNB at its first 2019 meeting otherwise.

See, the same week during which the CNB meeting was held, Germany reported second largest decline in new industrial orders since the financial crisis of 2008-9, and that industry fell 6 times out of last 7 months. PMIs are at 5+ year lows, labor market improvement has slowed, and confidence of households is declining.

This all nonetheless, CNB remained optimistic. The new forecast it prepared only made cosmetic changes to the growth outlook (GDP growth still seen around 3% this year and next), and, consequently, to the outlook for inflation. As is by now tradition, CZK is forecast to start strengthening, but not right away (CNB learnt that

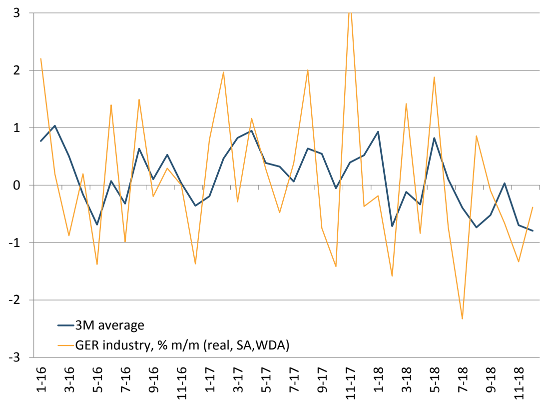
much already from its missed forecasts of last two years…) but only when, according to the statement, "*negative sentiment on foreign exchange markets towards emerging markets will gradually fade out in the quarters ahead*." So, you know, "then".
I'd add that even if that sentiment fades out, it will not help. Look no further than at PLN with its wide interest rate differential over years, and no strengthening. Add the massive amount of speculative capital still in CZK and top it off with worsening public finances where this year's deficit may easily be CZK 100 bn. if economy slows to 0-1% growth, as it may. All of a sudden, the attractiveness of the CZK proposition isn't stellar.

CNB also sees *"persisting substantial domestic inflation pressures [which] continue to reflect above all a tight labor market",* conveniently ignoring that half of the inflation is due to housing (and, hence, unlikely to be due to *just* labor market). No wonder, then, but certainly surprising to me given what's happening in Germany, that B*oard* assessed the risks to the February forecast as *"being slightly inflationary and tilted towards slightly higher interest rates compared to the forecast."* That two Board members voted for hike was then just natural outcome.

See, this is what happens when you blindly extrapolate from past into the future and put your trust blindly in models. CNB reminds me of ECB in spring 2011 when the latter hiked twice to contain the non-existent inflation threat from higher oil prices, only to take those hikes back fast, and then to cut all the way to zero as debt crisis flared up.

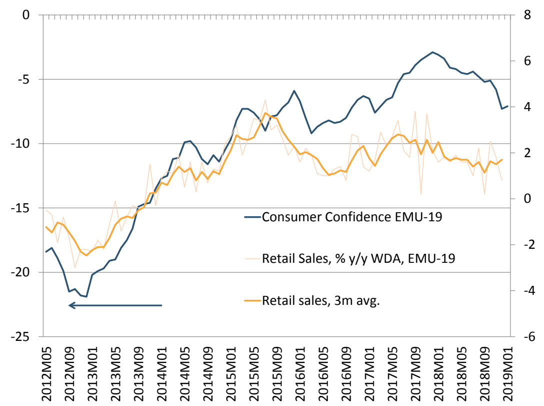
CNB also exaggerates the inflation threat which is mostly about housing, and may, in my view, discuss *lowering* rates late this year when it sees the growth falter.

GERMAN INDUSTRY CONTINUES TO WEAKEN, WAS DOWN 4% Y/Y IN DEC'18,…



…AND GERMAN ORDERS SUGGEST MORE WEAKNESS AHEAD

EUROZONE RETAIL SALES' GROWTH STILL WEAK.



| EUROZONE ECONOMY

Another recessionary news from German industry.

In December 2018, industrial production fell (0.4% m/m) for the **sixth time in last 7 months**, and for the fourth time in a row. It is now 4% lower than in December 2017, with all components down at least 3% y/y except for consumer durables, which only fell 0.75% y/y. This last fact corroborates the story of weakness coming from trade and, thus, from abroad (i.e., imported weakness, not domestically made one).

And it ain't going to change for better any time soon. Just the contrary. Not only did the PMI and IFO indices worsen at the end of 2018 and beginning of 2019, but **December orders also confirm additional weakness ahead.** Orders declined another 1.6% m/m in December, making them **7.4% lower y/y, which is almost the largest y/y decline since GFC** (largest being the 7.5% y/y decline in June 2012, during debt crisis). Here, too, German demand held up relatively well: domestic orders are down "only" 3.8% y/y whereas foreign ones are down 8.9% and 11.3%, for non-euro ones and euro ones, respectively.

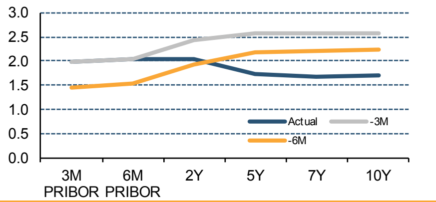
German recession is a certainty in 1H19, if you ask me.

Eurozone retail sales confirm core inflation won't rise any time soon.

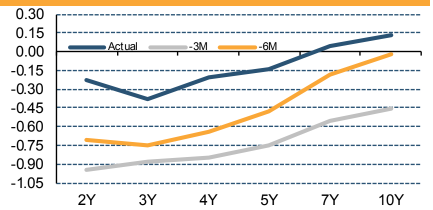
Retail sales rose just 0.8% y/y in December 2018, the average growth rate in last three months thus being mere 1.7% y/y. That is far, far from the rate that could be expected to produce sustainable inflation increase. ECB will stay put this year, no doubt about it now.

| MARKETS ‡

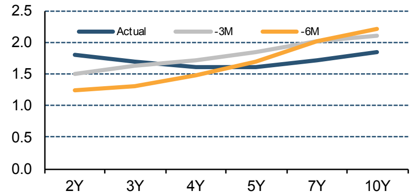
MM / IRS (%)	3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
Actual	1.990	2.050	2.028	1.740	1.678	1.708
-1M	2.010	2.070	2.155	1.950	1.880	1.870
-3M	1.990	2.050	2.440	2.585	2.576	2.568
-6M	1.460	1.550	1.938	2.170	2.202	2.228



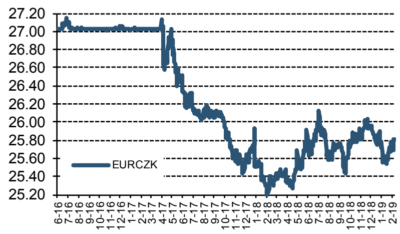
ASW spread* (bps.)	2Y	3Y	4Y	5Y	7Y	10Y
Actual	-0.227	-0.375	-0.205	-0.142	0.045	0.133
-1M	-0.465	-0.389	-0.293	-0.198	-0.089	-0.006
-3M	-0.945	-0.885	-0.849	-0.753	-0.555	-0.459
-6M	-0.709	-0.748	-0.646	-0.473	-0.188	-0.022



CZGB** (%)	2Y	3Y	4Y	5Y	7Y	10Y
Actual	1.801	1.698	1.605	1.598	1.722	1.840
-1M	1.690	1.686	1.727	1.752	1.791	1.864
-3M	1.495	1.635	1.711	1.832	2.021	2.109
-6M	1.229	1.304	1.480	1.697	2.014	2.206



FX	EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
Actual	25.812	4.312	318.90	4.748	5.943	1.132
-1M	25.628	4.300	321.44	4.673	6.326	1.154
-3M	25.931	4.288	321.49	4.658	6.188	1.134
-6M	25.589	4.278	320.89	4.655	6.405	1.153



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

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