Weekly | 2018 | Week 07

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| CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**
Monday	18-Feb-19	9:00	CZ	Export/Import prices, Dec'18, y/y	N/A
Wednesday	20-Feb-19	16:00	EMU	(Flash) Consumer confidence, Feb'19	-7.7
Thursday	21-Feb-19	10:00	EMU	(Flash) Manufacturing / Service PMI, Feb'18	50.3/51.3
Friday	22-Feb-19	8:00	GER	(Final) 4Q18 GD , q/q (SA, WDA)	0.0%
	22-Feb-19	10:00	GER	IFO Business Climate, Feb'19	99.0
	22-Feb-19	11:00	EMU	(Final) HICP, Jan'19, y/y	1.4%

* 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

“ NATION THAT CAN PRODUCE POP-TARTS IS CAPABLE OF ANY DEPRAVITY.” [HEARD ON A TRAM].

WEEK AHEAD

Locally, just the import prices are to be released.

With EURCZK averaging around 25.90 with little volatility in November-December, exchange rate didn’t cause any change in import prices. Lower oil prices, however, did. Expect import prices to have fallen in December.

In Eurozone, Germany will release structure of 4Q18 GDP growth. More important will be the release of leading indicators for February – Eurozone’s PM indices and Germany’s IFO. These will show whether economic slowdown stopped midway through 1Q19, or whether it kept worsening.

WEEK BEHIND

Czech inflation grew further in January, but is still primarily due to housing ▶

Czech GDP growth surprised on the upside in 4Q18 while… ▶

…Germany barely escaped outright recession ▶

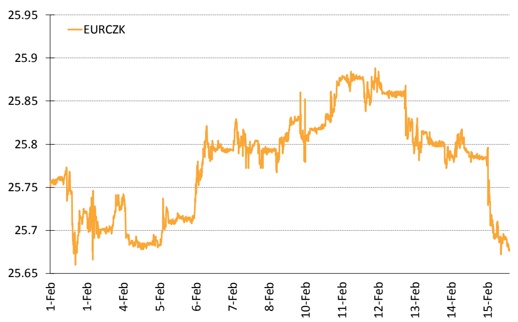
Eurozone industry ends 2018 on a very weak note ▶

| FX

EURCZK fell back below 25.70,…

…after strong Czech 4Q18 GDP growth release at the very end of last week. But, even with this move the EURCZK remains far, far above the exchange rate CNB has in past 8 quarters repeatedly forecast it'd be trading at by this time.

CZK STRENGTHENS A BIT AFTER STRONG GDP DATA,…

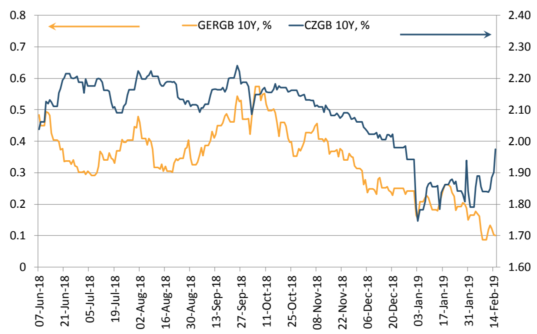


| FI

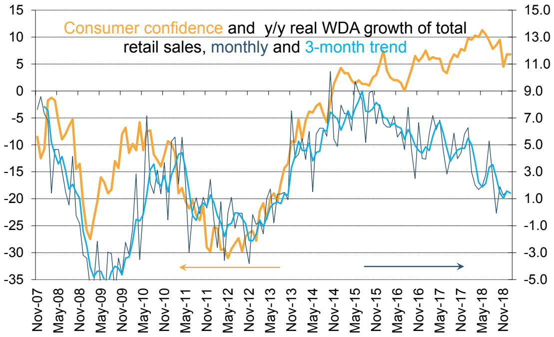
Strong Czech growth at the end of 2018…

…pushed local yields up, with 10Y ones rising to within few bps. of 2%. German Bunds, in the meantime, stayed glued to 10 bps.

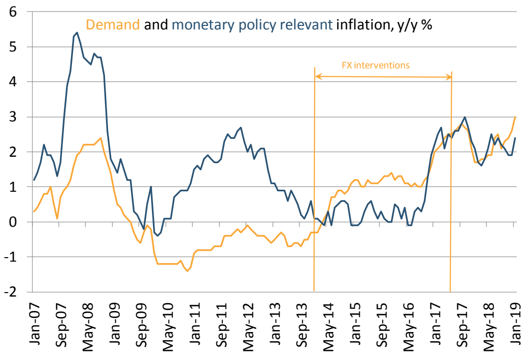
…WHICH ALSO SEND CZGB YIELDS UP.



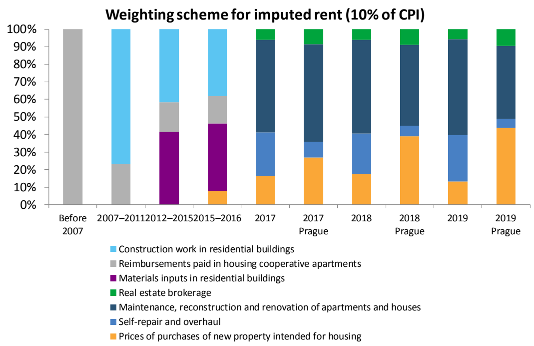
Inflation rises further,…



…But it is still predominantly due to housing, an effect…



… reinforced by yet another change of weights in imputed rent sub-index.



| CZECH ECONOMY

Czech inflation rose further at the beginning of this year. And while rise of demand inflation to 3% looks ominous, it is still primarily due to housing. And to incessant government's tampering with the consumer basket.

Headline inflation jumped 0.5 pp to 2.4% y/y, demand inflation jumped 0.4 pp to, as said above, 3%. So, casual reader might just conclude that, weakness in German industry or not, inflation is accelerating in here and CNB should do something about it.

Well. Causal reading is seldom enough. Looking under the surface, one can see most of the inflation is still due to housing. See, housing rose another 1.6% m/m in January, and with 5% growth y/y it remained the fastest growing component of the consumer basket. But why so fast?

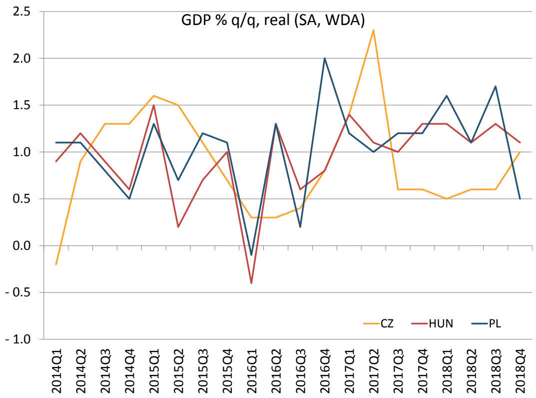
Well, house prices continue to grow, CNB's measures implemented last October nonetheless. And, as has been good tradition in last years – almost so much that one might begin to suspect that Statistical office is doing it to accommodate CNB's desire to see more inflation – Czech Statistical office again increased the weight of new house prices, especially in Prague where price increases have been particularly large, in the imputed rent sub-index of CPI, sub-index that is over one-tenth of the total consumer basket. What used to have 8% weight in the imputed rent sub-index as recently as in 2016 – i.e. new house prices in Prague – has since January 2019 weight of 44%!

Add fast January growth of electricity (+5.3% m/m), of actual (not imputed) rents (+0.7% m/m) and other utilities (+2.5-2.8% m/m), and it then comes as no surprise that without housing, overall inflation would have been mere 1.3% y/y. And that 1.3% includes 0.3 pp contribution from alcohol and tobacco which is 100% due to taxes, not demand…"Broad inflationary pressures", really?

All in all, while this certainly can provide CNB with a justification, on the surface of things, to hike again, the structure of inflation together with unambiguous signs of economic slowdown coming in from abroad *should* rule any further tightening out.

"Should" because if you want to hike, you will find the rationale. Czech headline inflation is certainly one such rational. Czech GDP in 4Q18 is another.

CZECH GROWTH SURPRISES AT THE END OF 2018



Czech GDP growth surprised on the upside in 4Q18 to such extent that it surpassed Polish growth for the first time in 6 quarters. Growth of 1% q/q was not only surprisingly high (and fastest since 2Q17) but also showed remarkable resilience vis-à-vis the slowdown in Germany (see below), one that is, however, not unique to Czech Republic: growth in Poland (0.5% q/q) or Hungary (1.1% q/q) was also much stronger than to the West of us.
But, it needs to be added here, it is just the lag in the process, not immunity to the West: in neither of these countries, especially not in the small and open Czech Republic, will the growth remain so high in 2019. Just the contrary, massive slowdown will come in 1H19. And the growth of 3% seen in 2018 will not be repeated this year.

The structural data were not released, but Czech Statistical Office said the foreign trade was main contributor to 4Q18 growth, with fixed investments having been second important one. This reinforces the forecast from above, namely that the contribution of the former (foreign trade) will not be repeated. See, the exports are living off the past, and with Germany teetering on the brink of recession (and almost certainly falling into one in 1H19), our exports will slow. Germany is our No.1 trading partner, by far – and there can be no escaping the German cold.

Minutes from the February meeting showed most of the Board in wait-and-see mode.

Two Board members voted for a hike – Michl and

Benda. Both having formerly been private sector analysts, it makes me smell some kind of private sector hawkish bias of sort….😉
Most of the Board, on the other hand, voted no change, but said the risks to the forecast were slightly to the upside, i.e. that they felt rates should rise slightly faster than what the forecast implies (which is for the rates to not grow at all this year). There were two opinions on either side of this: one, that “*monetary policy interest rates might not reach their neutral level at all in the current phase of the cycle*”, the other one, of Michl if I had to guess, that “*given the current and neutral interest rate level, one more increase in rates did not constitute monetary restriction, but only a softening of the still expansionary effect of monetary policy”.* Interestingly, opinion was also expressed that “*the koruna appreciation trend observed in the pre-crisis period might not be renewed”*, which is interesting because a] this is the first time I heard it from CNB and b] because it implies faster growth of repo rate.

Risks were extensively discussed, to the point where I wondered how the Board could come to the conclusion that overall risks are to the upside. See, Brexit was mentioned, slowdown in Germany, China was mentioned – and yet the Board saw overall risks to the upside…Beats me.

Finally, the mention of real estate was there, but only a brief one: minutes said that “t*argeted financial stability instruments were more effective at suppressing the risks stemming from developments on the residential property market, and data indicated they were effective”.* Nobody praises you like yourself… Strangely, there was no mention of inflation being 50% due to the housing sector, half of that due to just new house prices alone.

All in all, strong growth data and weak-ish CZK may push the Board to hike this year – in line with the tradition of previous year where nominally high inflation was used as the pretext to get repo as close to “normal level’’ as possible to make the probability of ever having to resort to interventions again in the future as small as possible.

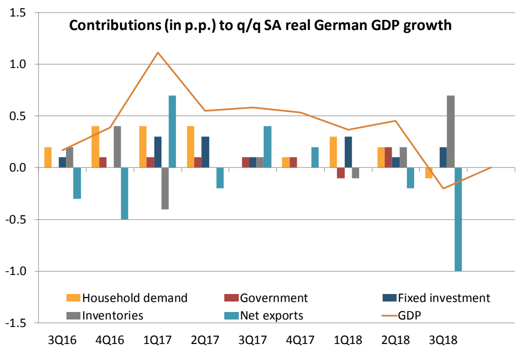
But since Board certainly knows, even if it doesn't explicitly mention it, that inflation is 50% due to housing (where effectiveness of broad repo increases is questionable), the tightening this year, if any, will be small. And, if the weakness in Eurozone persists, as to me seems more likely than that it quickly disappears, easing bias will set in in the 2H19.

| EUROZONE ECONOMY

Germany barely escaped recession in 2nd half of 2018.

After contracting 0.2% q/q in 3Q18, its economy merely stagnated in 4Q18, undershooting the expectations and bringing the annual growth to just 0.6% y/y in the final quarter of last year. This is marked slowdown against the first two quarters of 2018 when the growth was 0.4% and 0.5% q/q, respectively. The structure wasn't released yet, but German Statistical Office said that the major drag on 4Q18 q/q growth came from net exports, just like in 3Q18. Considering further worsening of soft indicators at the end of 4Q18 and the beginning of 1Q19, outright recession in 1st half of 2019 is pretty much a certainty.
Growth of EMU remained at 0.2% q/q according to the 2nd release released also last week. Structural data for EMU will only be released on March 7.

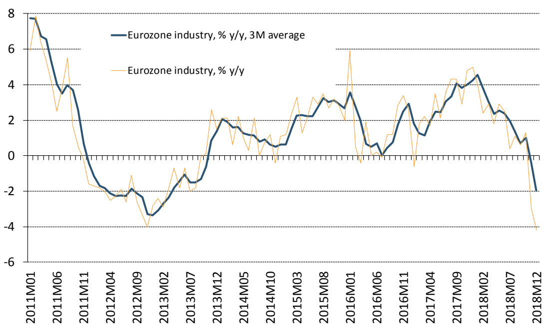
GERMAN ECONOMY BARELY ESCAPES OUTRIGHT RECESSION IN 2H18



In December, Eurozone industry fell at the sharpest annual rate since GFC.

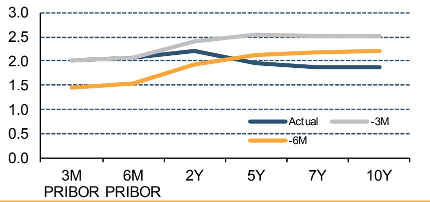
The contraction of 4.2% y/y was not due to weakness in only one country. Germany fell almost 4%, Spain 6.7%, Italy 5.5% and France 1.7%. It is also hard to argue this is just the effect of new emissions tests…It is not. This is widespread weakness that nobody at CNB wants to admit will come here soon. And with PMI indices worsening at the end of 1Q19, it is impossible to see 1Q19 turning out better than 4Q18.
And, if you ask me, it is only matter of months before this shows up in household spending, moribund as it's been hitherto.

EUROZONE INDUSTRY IN SHARPEST DECLINE SINCE GFC IN DECEMBER

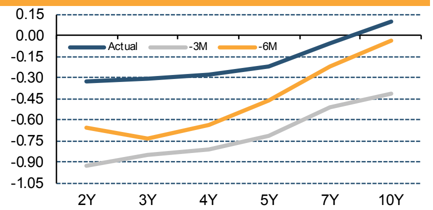


| Markets ‡

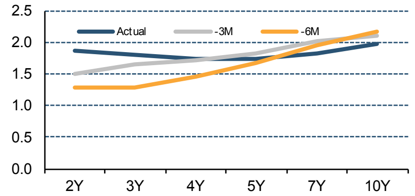
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	2.000	2.060	2.195	1.960	1.868	1.880
	-1M	2.010	2.070	2.100	1.790	1.715	1.730
	-3M	2.000	2.060	2.415	2.540	2.525	2.515
	-6M	1.460	1.550	1.935	2.135	2.178	2.210



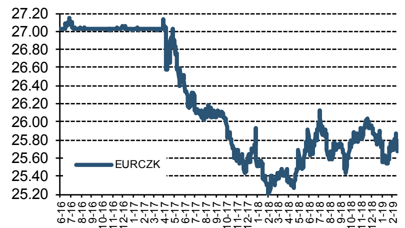
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-0.329	-0.312	-0.280	-0.219	-0.056	0.094
	-1M	-0.327	-0.298	-0.159	-0.085	0.015	0.054
	-3M	-0.927	-0.853	-0.814	-0.714	-0.512	-0.416
	-6M	-0.655	-0.740	-0.636	-0.461	-0.222	-0.034



CZGB**		2Y	3Y	4Y	5Y	7Y	10Y
%	Actual	1.866	1.793	1.740	1.741	1.812	1.974
	-1M	1.773	1.682	1.716	1.705	1.730	1.784
	-3M	1.488	1.638	1.708	1.826	2.013	2.099
	-6M	1.280	1.290	1.457	1.674	1.956	2.176



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25.678	4.334	318.28	4.741	5.969	1.130
	-1M	25.545	4.293	323.08	4.681	6.221	1.141
	-3M	26.005	4.289	321.97	4.663	6.075	1.133
	-6M	25.768	4.322	324.44	4.666	6.748	1.135



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

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