Weekly | 2018 | Week 10

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CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Tuesday	13-Mar	9:00	SPA	(Final) HICP, Feb'18, y/y	1.2%	N/A
Wednesday	14-Mar	8:00	GER	(Final) HICP, Feb'18 ,y/y	1.2%	N/A
	14-Mar	9:00	SPA	Retail sales, Jan'18, y/y	2.5%	N/A
	14-Mar	11:00	EMU	Industrial production, Jan'18, y/y	4.7%	N/A
Thursday	15-Mar	8:45	FRA	(Final) HICP, Feb'18 ,y/y	1.3%	N/A
	15-Mar	9:00	CZ	Industrial production, Jan'18, y/y	5.4%	6.0%
	15-Mar	9:00	CZ	Retail sales, Jan'18, y/y	6.0%	6.5%
Friday	16-Mar	9:00	CZ	PPI, Feb'18, y/y	0.1%	N/A
	16-Mar	10:00	CZ	Current Account, Jan'18, CZK bn.	29.0	N/A
	16-Mar	11:00	EMU	(Final) Core / Headline HICP, Feb'18 ,y/y	1% / 1.2%	N/A

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

MARCH 2018 AUCTIONS

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
SPP 784	1-Mar	2-Feb	31-Aug-18	CZK 0-5 bn.	N/A
CZGB 2015-2023**	7-Mar	9-Mar	25-Oct-23	CZK 4 bn. max	0.45%
CZGB 2013-2028**	7-Mar	9-Mar	25-Aug-28	CZK 4 bn. max	2.50%
CZGB 2017-2033**	7-Mar	9-Mar	13-Oct-33	CZK 4 bn. max	2.00%
SPP 785	8-Mar	9-Mar	7-Sep-18	CZK 0-5 bn.	N/A
SPP 786	15-Mar	16-Mar	14-Sep-18	CZK 0-5 bn.	N/A
CZGB 2018-2021**	21-Mar	23-Mar	23-Feb-21	CZK 4 bn. max	0.75%
CZGB 2014-2025**	21-Mar	23-Mar	17-Sep-25	CZK 4 bn. max	2.40%
CZGB 2018-2029**	21-Mar	23-Mar	23-Jul-29	CZK 4 bn. max	2.75%
SPP 787	22-Mar	23-Mar	21-Sep-18	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.

THOUGHT OF THE WEEK

“ SOROS GOTTA BE ONE HELL OF A BUSY GUY, UNDERMINING HUNGARY, SLOVAKIA AND IN THE MEANTIME STILL ORCHESTRATING THE MIGRATION CRISIS…”

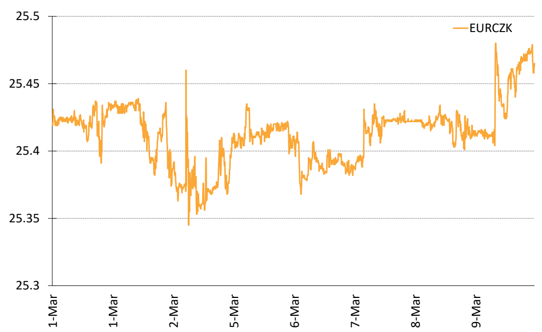
WEEK AHEAD

Second batch of usual monthly releases for Czech Republic will be released this week.

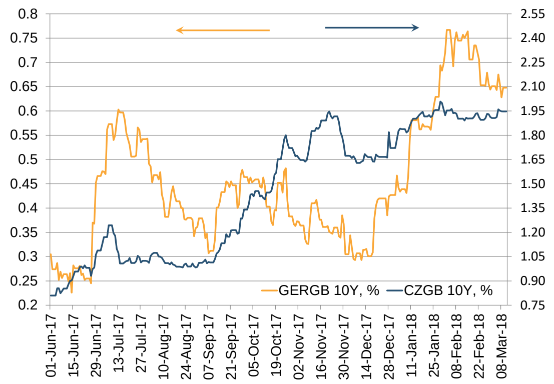
January **retail sales and industrial production** will both show the negative effect of one less working day this year than in 2017. Adjusting for this, we'll be close to double-digit growth as PMI and consumer confidence (supported by all-time low unemployment and strong growth of nominal wages) indicate.

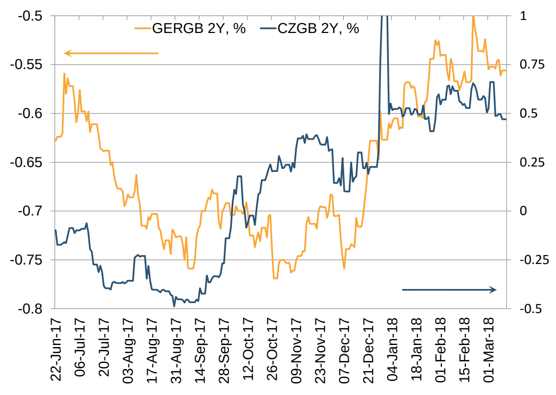
In Eurozone, final February inflation data will merely confirm that there is no inflation to speak of and that despite the removal of easing bias at the last week's ECB meeting, the ECB's policy will remain very loose for very long. **Industrial production** is of no consequence as 3 out of four big economies already reported the national data (France +1.2% y/y, Germany 5.5%, Spain 1.2% all local data, i.e. not harmonized).

EURCZK WEAKENS MARGINALLY.



ANOTHER CALM WEEK IN THE BOND MARKETS





WEEK BEHIND

- **Czech February inflation well below CNB forecast ▶**
- **ECB removed the easing bias… ▶**
- **..but because of weak growth of household demand and… ▶**
- **…non-inflationary GDP structure will remain dovish for long ▶**
- **German January industry data weak ▶**

| FX

EURCZK weakened further above 25.45, i.e. just a cosmetic weakening.

The reason was the low February inflation.

| FI

As in previous two weeks, nothing happened in the bond markets.

Czech / German 10Y remained around 195 / 65 bps, their 2Y counterparts around +50 / -55 bps.

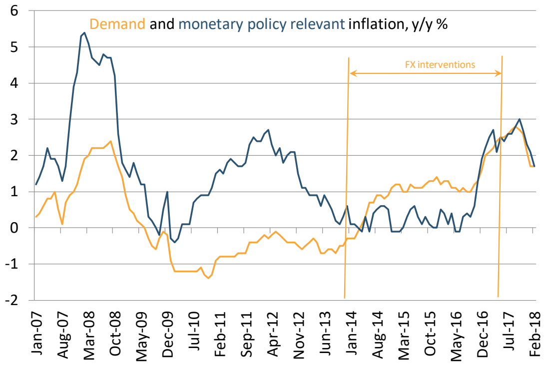
| CZECH ECONOMY

Inflation continued to decelerate, in line with our expectation and to the surprise of CNB... And that even while Czech Statistical Office increased weight of imputed rents and average growth topped CZK 30ths. for the first time ever…

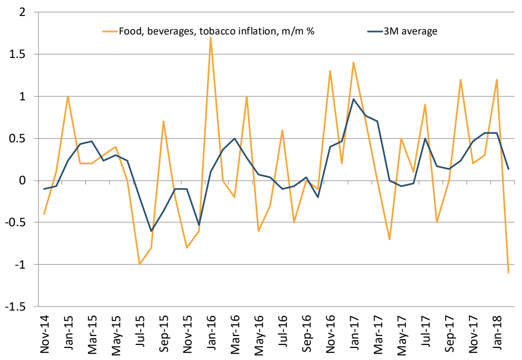
So much for strong fundaments translating into domestic demand pressures, as CNB repeatedly warned last year…This time around, CNB blunblty admitted that “*inflation came in well below the CNB forecast*” (we are talking forecast released in February…) and that this was “*due to a combination of downward deviations from the forecast for all consumer basket items“.* CNB admitted that the current level represent an anti-inflationary risk to CNB forecast (i.e., that there should be fewer hikes over the next 6 quarters). Therefore, the next line in its commentary ↗ strikes one as nonsensical: *“Nevertheless, the overall fundamental inflation pressures remain strong, mainly reflecting accelerating wage growth amid robust economic growth.“* Well, shouldn’t we see those “strong pressures” reflected in inflation by now, considering that wages grew 7% last year (and 8% in last quarter) ???

Anyway, annual **monetary-policy relevant inflation (MPRI)** fell to **lowest** (1.8%) **since November 2016** (time when CNB was still frantically intervening to stave off the alleged *deflation* threat…) while demand inflation remained at joint-lowest (1.7%, as in January) since December 2016. The decrease of MPRI and the stability of demand inflation tells you that what was behind the February deceleration of the former were prices of either food or fuel (these two are in MPRI but not in demand inflation). Last month, the former was the case - the contribution of food prices to annual CPI fell to 0.5 pp, half of what it was in January and the smallest contribution since October 2016…This was long called for as global food prices decelerated some time ago.

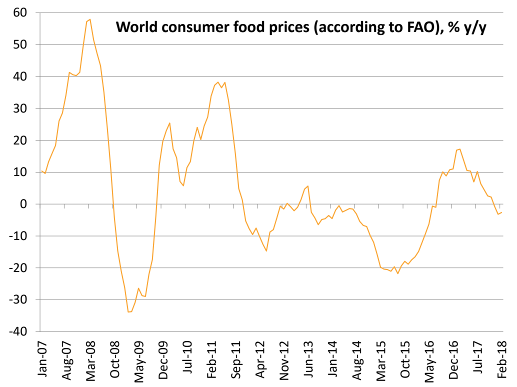
CZECH ANNUAL MPRI CONTINUED TO DECELERATE IN FEBRUARY…



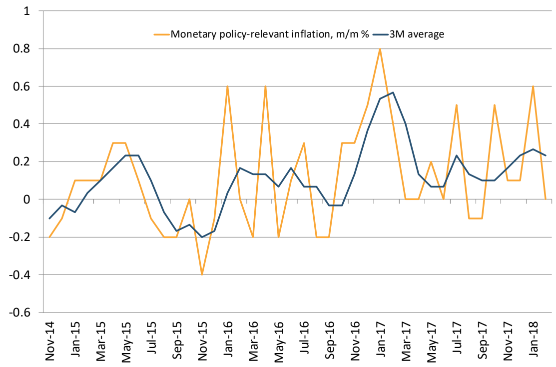
…DUE TO SLOWDOWN OF FOOD PRICES, COURTESY OF …

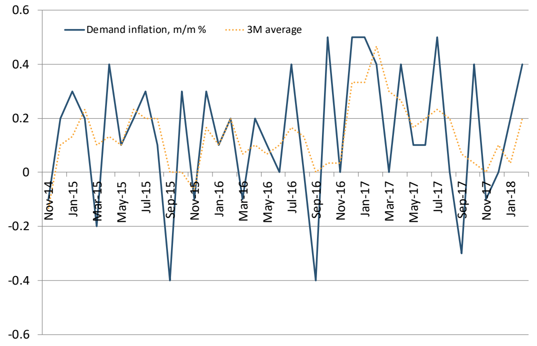


…GLOBAL FACTORS.



MONTHLY DYNAMICS REMAINS SUBDUED, ALL THE TALK ABOUT STRONG WAGE GROWTH AND LOW UNEMPLOYMENT NONETHELESS





As regards **demand inflation**, it remained at January 1.7% y/y, the m/m increase being the same as in February 2017 (0.4% m/m) and due to usual seasonal increase of vacations prices. The average monthly gain over last three months ending February is now at 0.2% m/m, as opposed to 0.5% in February 2017.

Also, bear in mind that we wouldn't see demand inflation at 1.7% had the Czech statistical office (CSO) not again increased the weight of imputed rents in the CPI basket. This is now 10.4% of the basket (as opposed to 8.7% last year) and this, together with the continuing (if decelerating) growth of real estate prices, pushed demand inflation up. It almost looks like CSO was tasked to produce demand inflation ☺ I am not saying real estate prices aren't a problem, but I don't think they should be tackled by general tightening of the policy – what do we have macro-prudential measures for?

To sum, what I wrote last Fall (and what I'd been saying throughout last year) about the inflation outlook played out: there was no inflation threat in the Czech economy last year, despite record-low unemployment and strong wage growth (7% nominal, 4.4% real), and CNB just availed itself of the non-demand nature of the increase of MPRI (EET, imputed rents, food prices) to push through some normalization of policy. In other words, it just used the window of opportunity, so to speak, that by now closed. Hence, the increase of repo will be very gradual, possibly not at all this year.

Looking forward, some observers say there will be reacceleration of inflation because of strong growth of wages. Well, we've had strong growth of wages before, we've seen wages grew at 7% in 2017 and 3.7% in 2016 and we have little to show for it. Because this is not how it works. What always happens – and what will happen again - is increase of imports (from still non-inflationary Eurozone). The only domestic source of demand inflation would be if CZK weakened dramatically – but it looks like most of the speculators are playing a long game with EURCZK here…

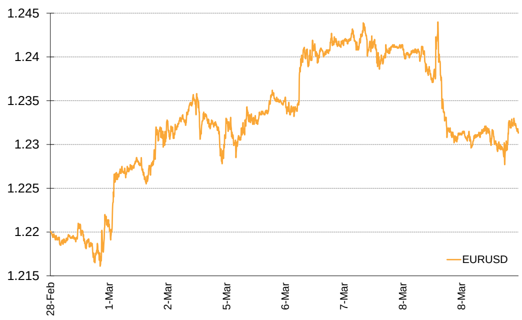
| EUROZONE ECONOMY

ECB meeting didn't produce any surprises – ECB made a first small step towards normalization of the policy.

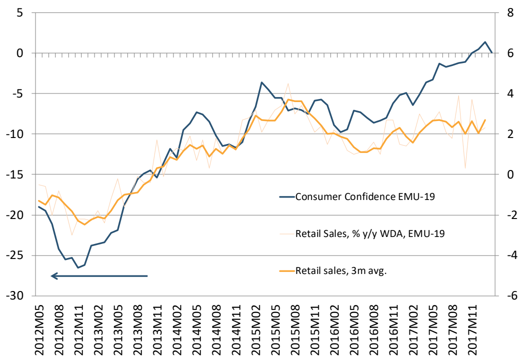
A step very small (btw, made unanimously), indeed. ECB removed the easing bias from its statement ↗, i.e. removed the line that was there since '16 & one that said that ECB 'stood ready to increase the size or duration of the asset purchases program' if necessary. With deflation risks banished, ECB felt, as it indicated already back in December, that time is now ripe for its removal.
That said, the stance remains very dovish – QE continues and is promised to run until Sep'18 or later, if needed to hit inflation goal, the guidance on rates is still there as is the dovish assessment of the inflation situation (Draghi: "*The underlying inflation measures remain subdued. Even though we have strong growth, we still have subdued inflation and our mandate is in terms of price stability, so victory cannot be declared yet*").

Therefore, my conviction that the tightening of the policy is still far out in the future was reinforced. Draghi, as seen above, again acknowledged – and it is indeed hard to do anything else with core inflation stuck to 1% for last 3 years – that inflation pressures are non-existent and that loose policy is here to stay. The gradual withdrawal from extraordinary measures will continue, but will come later than what market expects. For one, I think the complete removal of asset purchases in September is not at allwritten in stone, courtesy of low inflation, and that first outright tightening of the policy (read :hike) is unlikely even next year.

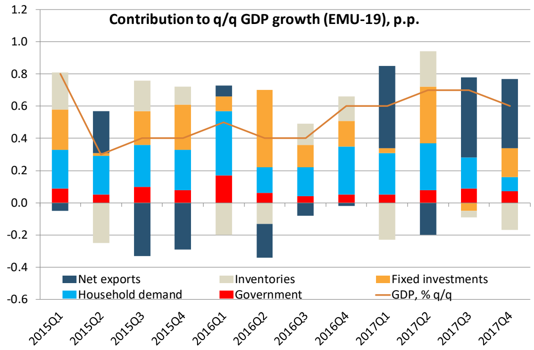
Getting more political than usual, Draghi took an aim at US President at the press conference when he names as two biggest risks to global growth the protectionism ("when you put up tariffs against your friends, you wonder who your enemies are") and "*financial deregulations in other major jurisdictions*". I was expecting a torrent of tweets from the other side of the Atlantic following this,

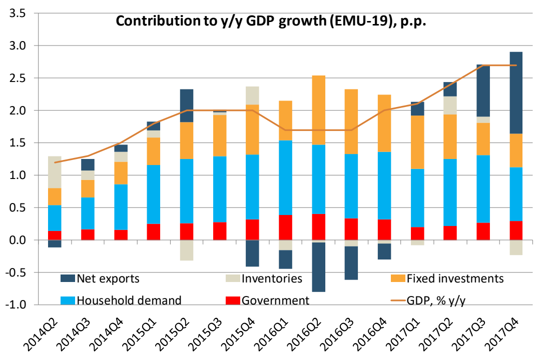


RETAIL SALES GROWTH STILL MORIBUND…



…AND 4Q17 GDP GROWTH WAS RESOUNDINGLY NON-INFLATIONARY IN STRUCTURE.





really, but Trump probably was busy celebrating the steel tarrifs.

As for the EURUSD, the dollar strengthened to 1.23 last week, the combination of dovish ECB and, obviously, Trump's signing of order for metal tariff plan (of 25% on steel and 10% on aluminum).

That demand pressures have a good reason to not exist in the Eurozone is clear from both January retail sales and structure of 4Q17 GDP growth.

As for the former, January saw growth of just 2.3% y/y, just like in December and in line with the growth in 2017. Seeing that the consumer confidence in January was at its highest since August 2000, there clearly is disconnect between how optimistic people claim they are and how able / willing they are to open the wallets / purses. The implications for ECB are clear: **2% annual retail sales growth is unlikely something that would threaten inflation stability** anytime soon.

The **structure of the Eurozone growth in the final quarter of 2017** also left much to be desired in terms of inflationary impacts thereof. The quarterly growth was driven by net exports (despite Spanish drag from Catalonian referendum), just like in each quarter of 2017 except for the 2nd, and the contribution of household demand to growth was mere 0.1 pp, the lowest since 1Q14. Although some commentators said this was due to warm weather impacting energy consumption (it wasn't really that warm...) and clothing sales, I don't think this had such an impact: first, there's been a clear divergence between consumer confidence and actual spending for a long time now and, second, how much clothing can really subtract, given its weight in the basket….
No, no - it is clear that households don't walk the talk since wage growth is sluggish and unemployment is falling only slowly (1pp/year). They'd want to spend more – but can't.

The annual picture looks almost the same.

Household demand contributed 0.8 pp to annual growth of 2.7% in last quarter, and it was similar in the previous quarters as well. Moreover, the decisive impact of net exports on the GDP growth in 2H17 was due to both slowdown of imports and quicker exports, suggestive of slowdown in domestic demand and acceleration of global one.

To sum, there are no signs of inflation acceleration ahead. Furthermore, the growth dynamics appeared to have slowed in 1Q18, at least if leading indicators (are) still anything to go by, and as Italy will continue to act as a drag on overall Eurozone performance.

In my eyes, **ECB will only stop buying assets before 1H19 and will not hike until after it has new Governor (end of 2019).**

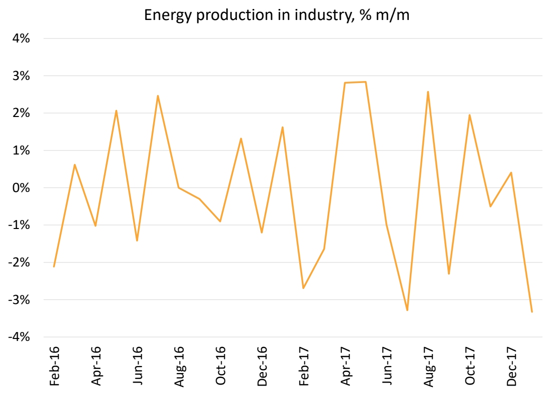
January industrial data from Germany were fairly weak, with both production and orders falling more than expected.

The orders fell almost 4% m/m, so from the expected annual growth of 11.5% we only saw 8.2% y/y. Good omen for next two, three months, however.

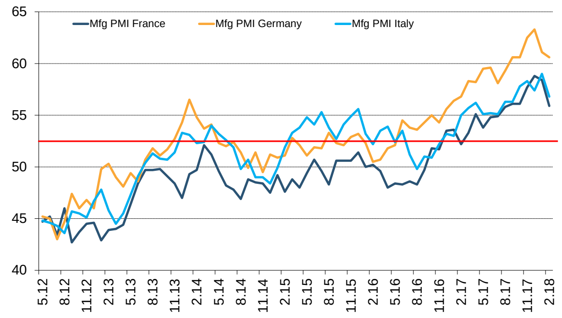
As for the production itself, it fell 0.1% m/m (after 0.5% m/m decline in December but + 2.8% m/m in November), with consumer non-durables (-1.7% m/m) and intermediate goods (-1.2% m/m) leading the fall. However, for both of these components, it was the correction of growth in December (+2.9% and +0.6% m/m, respectively). **The main culprit thus was energy production**: warm January weather led to 3.3% m/m decline of energy production.

Put together, t**he retreat of PMI and 8% growth of orders suggest** that a] y/y growth of industry will accelerate from current 5.5% to around 7.5% in the coming two months but that b] it will thereafter slow down.

GERMAN INDUSTRY FELL IN JANUARY ON ENERGY PRODUCTION

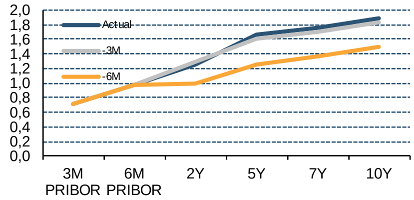


PMI SUGGESTS THAT PRODUCTION GROWTH WILL SLOW IN 2Q18

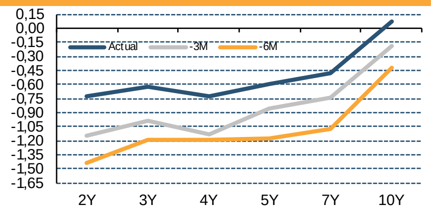


| MARKETS ‡

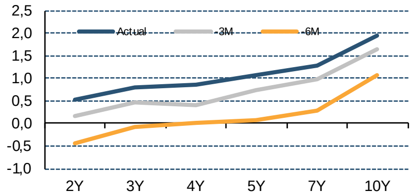
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	0,709	0,969	1,255	1,655	1,750	1,880
	-1M	0,709	0,969	1,325	1,735	1,835	1,935
	-3M	0,709	0,969	1,300	1,605	1,706	1,840
	-6M	0,709	0,969	0,988	1,260	1,358	1,499



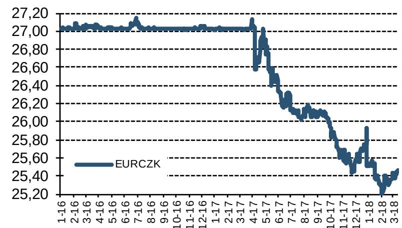
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-0,731	-0,632	-0,722	-0,601	-0,477	0,067
	-1M	-0,762	-0,798	-0,668	-0,662	-0,547	-0,032
	-3M	-1,150	-0,987	-1,128	-0,863	-0,736	-0,198
	-6M	-1,441	-1,194	-1,198	-1,180	-1,081	-0,430



CZGB**		2Y	3Y	4Y	5Y	7Y	10Y
%	Actual	0,524	0,798	0,848	1,066	1,273	1,947
	-1M	0,563	0,712	0,972	1,073	1,288	1,903
	-3M	0,150	0,452	0,407	0,742	0,970	1,642
	-6M	-0,453	-0,081	0,000	0,080	0,277	1,069



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25,468	4,190	311,58	4,661	4,702	1,233
	-1M	25,377	4,168	311,88	4,655	4,673	1,229
	-3M	25,631	4,210	313,98	4,630	4,519	1,174
	-6M	26,108	4,258	307,14	4,601	4,109	1,197



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

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