Weekly | 2018 | Week 22

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

CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	4-Jun	9:00	CZ	Real monthly wage, 1Q18, y/y	6.2%	5.5%
Tuesday	5-Jun	9:00	CZ	Retail sales, Apr'18, y/y	6.6%	6.0%
	5-Jun	10:00	EMU	(Final) Services / Composite PMI, May'18	53.9/54.1	N/A
	5-Jun	11:00	EMU	Retail sales, Apr'18, t/t	1.7%	N/A
Wednesday	6-Jun	9:00	CZ	Trade Balance, Apr'18, CZK bn.	13.0	10
	6-Jun	9:00	CZ	Industrial production, Apr'18	9.0%	8.0%
Thursday	7-Jun	8:00	GER	Industrial orders, Apr'18, y/y WDA	3.6%	N/A
	7-Jun	11:00	EMU	(Final) GDP, 1Q18, q/q	0.4%	N/A
Friday	8-Jun	8:00	GER	Industrial production, Apr'18, y/y WDA	2.8%	N/A
	8-Jun	8:45	FRA	Industrial production, Apr'18, y/y WDA	3.7%	N/A
	8-Jun	9:00	CZ	Unemployment (15-65), May'18	3.0%	3.00%

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

JUNE 2018 AUCTIONS

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
CZGB 2018-2021**	6-Jun	8-Jun	23-Feb-21	CZK 4 bn. max	0.75%
CZGB 2014-2025**	6-Jun	8-Jun	17-Sep-25	CZK 4 bn. max	2.40%
CZGB 2018-2029**	6-Jun	8-Jun	23-Jul-29	CZK 4 bn. max	2.75%
SPP 797	7-Jun	8-Jun	7-Dec-18	CZK 0-5 bn.	N/A
CZGB 2007-2022**	13-Jun	15-Jun	12-Sep-22	CZK 4 bn. max	4.70%
CZGB 2017-2027**	13-Jun	15-Jun	10-Feb-27	CZK 4 bn. max	0.25%
CZGB 2015-2030**	13-Jun	15-Jun	15-May-30	CZK 4 bn. max	0.95%
SPP 798	14-Jun	15-Jun	14-Dec-18	CZK 0-5 bn.	N/A
CZGB 2018-2021**	20-Jun	22-Jun	23-Feb-21	CZK 4 bn. max	0.75%
CZGB 2013-2028**	20-Jun	22-Jun	25-Aug-28	CZK 4 bn. max	2.50%
CZGB 2017-2033**	20-Jun	22-Jun	13-Oct-33	CZK 4 bn. max	2.00%
SPP 799	21-Jun	22-Jun	21-Dec-18	CZK 0-5 bn.	N/A
SPP 800	28-Jun	29-Jun	28-Dec-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

"YOU KNOW HOW MUCH YOU UNDERESTIMATED HOW UNPREDICTABLE TRUMP IS WHEN, 1 ½ YEARS IN THE OFFICE, HE HAS MORE CORDIAL RELATIONSHIP WITH DPRK THAN WITH CANADA."

WEEK AHEAD

In the Czech Republic, first monthly data for the 2Q18 will be released.

Industrial production will be shown to have rebounded y/y from March's -1.1%, but only because of higher number of working days in April 2018 vs. April 2017. Adjusting for that effect, the y/y growth will be just around 2-3% y/y and the monthly growth should be only around zero. Nothing to write home about, but this is in line with recent German weakness. **Retail sales** should show another strong month (cca. +2% m/m), with weaker inflation, high confidence and strong wage growth all factors. Speaking of **strong wage growth**, the fact that **unemployment** will be shown on Friday to have decreased further to 3% in May, i.e. lowest in Eurozone, and that public sector is spending (not only but also) on wages like there is no tomorrow ► make me expect strong 1Q18 real wage growth release today.

In the Eurozone, **April 2018 retail sales** will show another weak month ►, adding to worries of ECB about the sustainable convergence of Euro area inflation towards the target it expects. There will be April **German industrial data** as well (orders / production), unlikely to be strong as leading indicators suggest. Finally, the structure of the **final 1Q18 GDP** in Eurozone will be released, but since big economies already released this data, it won't be anything surprising.

WEEK BEHIND

CZ 1Q18 GDP: revised down, dragged down by net exports ▶

CZ BUDGET: government spending like there is no tomorrow ▶

CZ PMI: manufacturing still losing steam in middle of 2nd quarter ▶

EMU INFLATION: back to 2%, but only due to oil prices ▶

April retail in Eurozone likely weak, Spanish / German data showed ▶

| FX

EURCZK started to test 26 last week.

The weakening to 25.95 was short-lived, but real. See my recent report for view on EURCZK going forward.

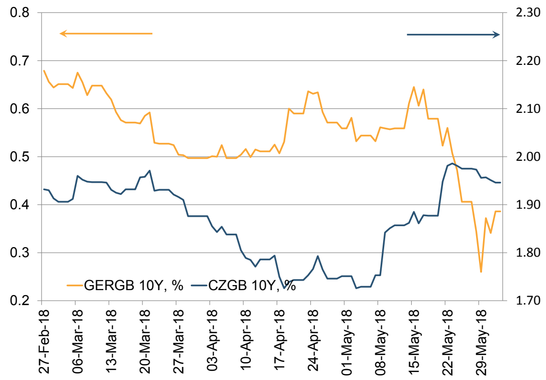
| FI

Prices of German Bunds continued to rise last week.

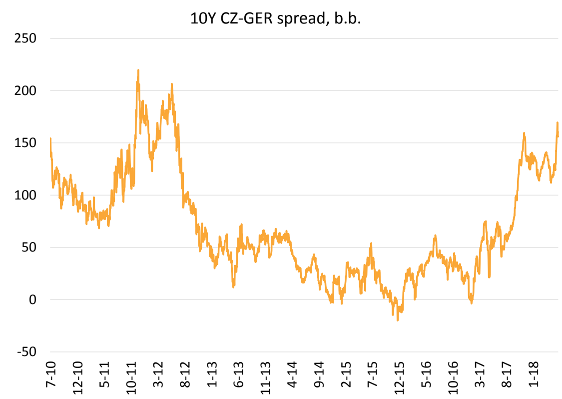
The yields on the 10Y fell to as low as 25 bps., levels last seen in June 2017. The reasons were clear: weak data from Eurozone and, foremost, the rise of political uncertainty, both in Italy (threat of snap elections that could become a de facto referendum on euro) and in Spain (Rajoy confidence vote). Situation calmed down towards the end of the week when Five Star Movement and Northern League resurrected the Italy coalition deal that fell apart only few days before. Still, German 10Y ended last week slightly below 40 bps. Czech yields remained stable, hence the widest 10Y CZ-GER spread (170 bps.) since June 2012.

EURCZK STARTED TO TEST 26

GERMAN YIELDS FELL FURTHER ON EU POLITICS, WEAK DATA

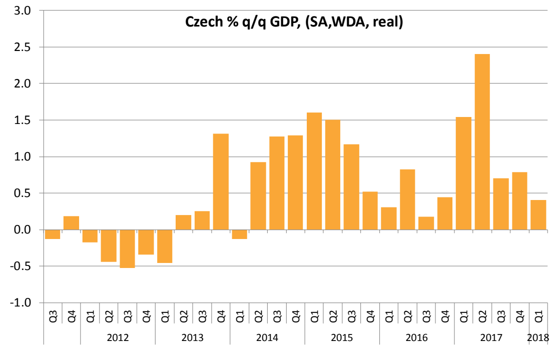


10Y CZ-GER BOND SPREAD WIDEST IN 6 YEARS.

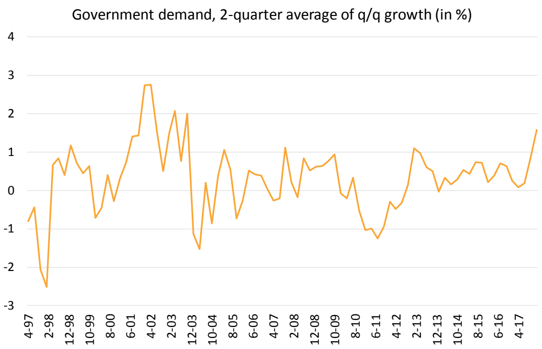


| CZECH ECONOMY

CZECH 1Q18 GDP REVISED DOWN TO 0.4% Q/Q, MARKEDLY LOWER THAN ELSEWHERE IN CEE-4, DESPITE…



…STRONG GROWTH OF GOVERNMENT DEMAND…



Czech 1Q18 GDP growth was revised down in its second estimate, confirming the loss of dynamics against 2017 that can hardly make CNB's case for tighter policy stronger.

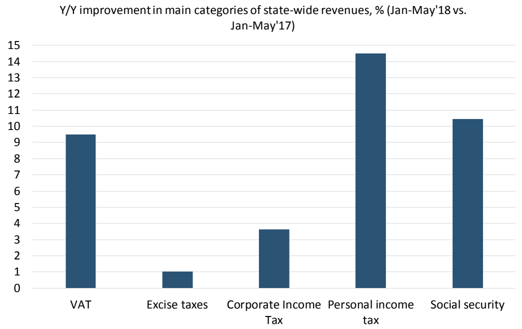
The growth was 0.4% q/q, down 0.1 pp against the first estimate and thus markedly slower than in Hungary or Poland or Slovakia, where it was at or above 1% q/q. Structure-wise, the main driver of the 1Q18 quarterly expansion were fixed investments (+3.5% q/q), and among these the investments into vehicles.

That alone would be anti-inflationary (expanding the productive capacity of the economy, making substituting labor with capital easier) but, and more importantly for CNB, the growth of household demand, while not weak (0.7% q/q), didn't quicken much against the end of 2017 (+0.6% q/q) and remained well below the 2014-2017 as well as 2016-2017 average growth rates (both 0.9% q/q).

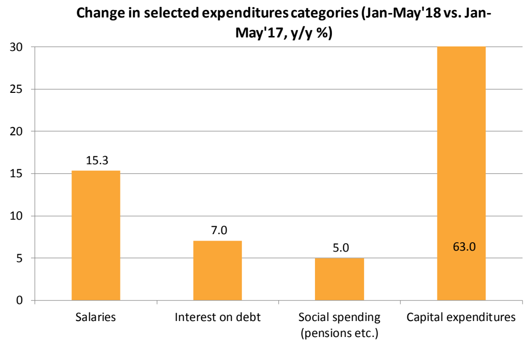
All in all, thus, the economic growth in 1Q18 doesn't indicate that the inflation should quicken so much that tightening of the policy would be needed this year. In other words, 1Q18 GDP release is anti-CZK, being as it is that CZK strengthening case relies heavily on expected widening of the CZ-EU interest rate differential. More so when considering that net exports were a drag on growth in 1Q18: growth of exports (0.5% q/q), while surprisingly good in light of German export weakness in 1Q18 (-1% q/q), was no match for 1.4% q/q growth of imports (a reflection of strong domestic demand). **Hence, net exports the biggest drag on 1Q18 growth**.

Looking forward, **German loss of dynamics continued in 2Q18**, with PMI and IFO worsening further (though, in the case of the latter, mainly in expectations' sub-index). Hence, **no rebound in sight for Czech growth** in the remainder of this year. Unless, that is, government steps in even more than it already had: growth of its demand was strong again in 1Q18, with 1.4% q/q expansion

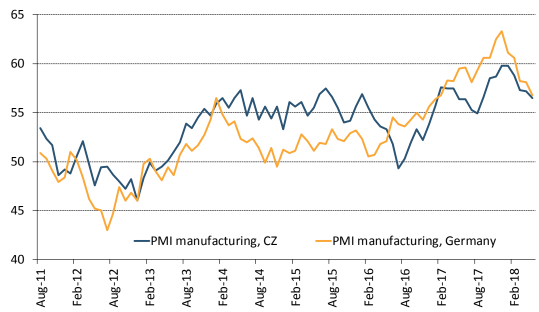
BUDGET REVENUES CONTINUE TO RISE STRONGLY,...



...BUT EXPENDITURES MORE THAN KEEP UP.



CZECH INDUSTRY CONTINUES TO LOSE STEAM, MIRRORING ITS GERMAN COUNTERPART



after 1.7% q/q growth in 4Q17. Actually, **the growth of government demand in last two quarters was strongest since 2004** – and without it, the loss of dynamics would've been even larger.

So much for running this country as a firm (Babis motto when coming into politics). The May deficit (adjusted for EU money) was massive CZK 51.5 bn., almost 16 bn. more than in the first 5 months of 2017.

Now, it certainly isn't problem of the revenues: **state-wide tax revenues are up 26 bn.** (7.8%), with VAT revenues up 9.5% y/y (nominal household demand is up 6.6% y/y so there isn't that much of anti-tax-evasion measures' effect here) and personal income tax up 14.5% y/y.

This last point also hints at where the problem is. True, labor market is tight and wages in private sector rise as well, but 15% (CZK 5.6 bn.) increase of spending on salaries in the public sector is big reason why expenditures "manage" to keep up with the revenues so perfectly. Also, 5% y/y increase in social spending may not look like a big deal in comparison, but the problem is that this 5% means CZK 11 bn., the base being very large (pensions belong to 'social spending'). All in all, **current expenditures are now 9% higher than in January-May of 2017**...

The only consolation in May budget figures is thus to be found in capital expenditures which finally rose 9 bn., i.e. 63% y/y. How that money is spent is other problem, but at least the investments unfroze.

To conclude: next recession and the budget deficit will fly over CZK 100 bn. mark faster than you'll say "Babis". By the way, the first budget proposal for 2019 came out last week. MinFin is shooting for another CZK 50 bn. deficit...That is almost a budgetary crime in times like these.

Czech industry is still losing steam midway through the 2Q18.

The **PMI index slowed down to a 9-month low** of 56.5 in May, 0.7 pts. lower than in April and over 3 pts. lower than the December peak of 59.8. Now, that 56.5 is still historically consistent with strong, cca. 7-8% y/y growth of industry in the coming three months (May-July). But the message that the quickening of the growth of industry is not in the offing is unmistakable. For CNB, the key information in the release is that the **output inflation eased to its weakest since last August**. That is another supporting evidence that Czech inflation will be less of a problem than CNB thought (thinks?).

| EUROZONE ECONOMY

Inflation shot up to almost 2% in May. But it was not because of the demand.

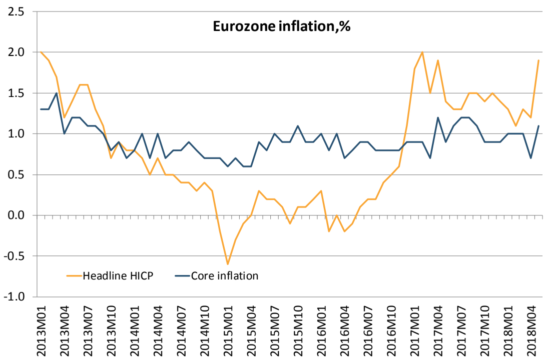
The only reason why annual headline inflation jumped to 1.9%, its highest since April 2017, was the rise of energy prices (from 2.6% y/y in April to 6.1% y/y in May), which, in turn, was due to rise of oil price. There was also an increase in food prices of 2.6% y/y, marginally faster than 2.4% seen in April 2018.

More importantly, though, is the fact that core inflation returned above 1% as expected (1.1% in May): the Easter-related dip to 0.7% in April, due to services, was thus fully reversed. But don't expect any celebration at ECB: 1.1% means that core inflation only returned to the average level seen in last 4 years. There is no trend to speak of. For ECB, thus, nothing changes: staying put for long time it will.

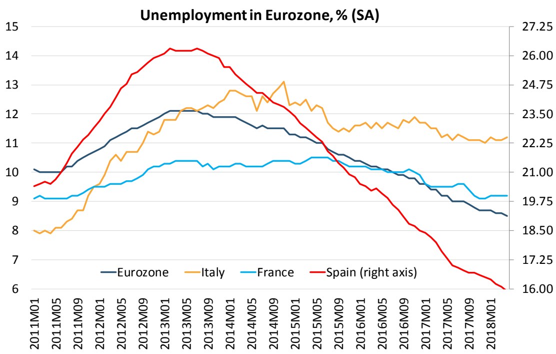
And the newest unemployment and retail sales data show why.

Unemployment did fall further in May, hitting new post-crisis low of 8.5%. That said, this is still at least 2 full percentage points away from anything like full employment and it will take long to get there. See, the y/y rate at which unemployment falls has slowed down significantly in recent half a year – the unemployment rate is now only 0.7 pp. lower than in May 2017, whereas it was improving at the y/y rate of minus 1 pp throughout 2017. Another clear

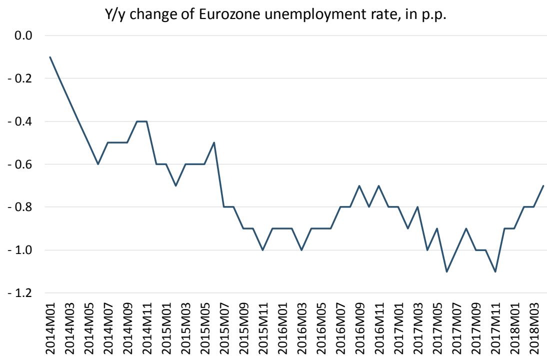
EUROZONE INFLATION SHOOTS UP TO ALMOST 2% IN MAY.



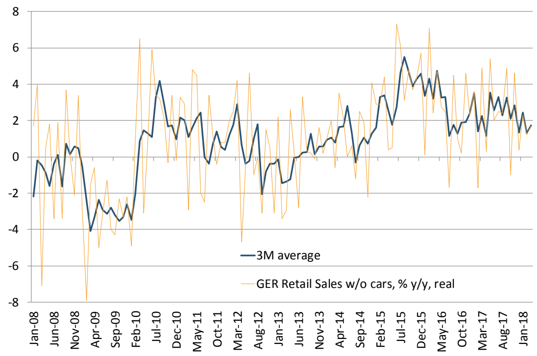
UNEMPLOYMENT IN EUROZONE CONTINUES TO FALL, BUT…

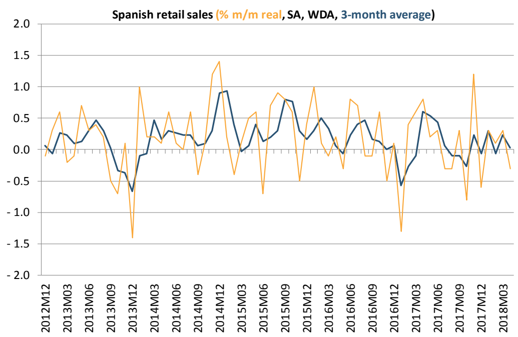


…AT SLOWING Y/Y RATE.



WEAK APRIL RETAIL SALES DATA STRENGTHEN ECB DOVISH CASE.





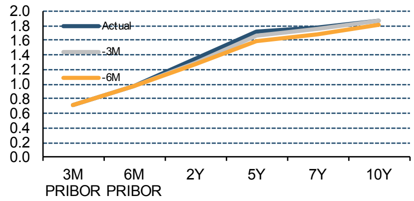
indication that economy lost momentum.

April retail sales data for Spain and Germany disappointed, an ill-omen for 2Q18 household demand. Spanish retail grew just 0.5% y/y while German one just 1.2%, both well under respective market forecasts (1.8% and 1.6%, respectively).

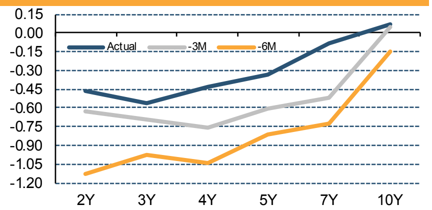
Oh, and by the way, **French 1Q18 growth was revised down to 0.2% q/q last week**. Spanish & Italian were kept unchanged (0.7 % and 0.3% q/q, respectively). Also not conducive to faster ECB tightening.

| Markets ‡

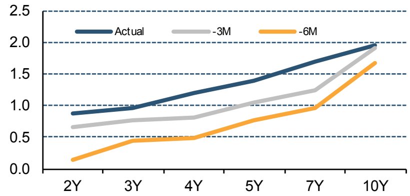
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	0.709	0.969	1.350	1.718	1.785	1.878
	-1M	0.709	0.969	1.245	1.633	1.724	1.823
	-3M	0.709	0.969	1.293	1.663	1.753	1.863
	-6M	0.709	0.969	1.275	1.590	1.688	1.820



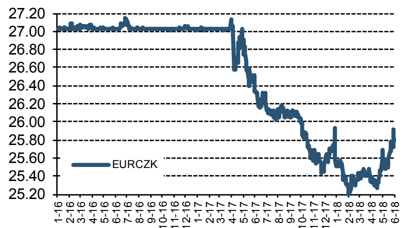
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-0.470	-0.558	-0.431	-0.331	-0.084	0.069
	-1M	-0.513	-0.642	-0.587	-0.435	-0.213	-0.072
	-3M	-0.632	-0.691	-0.764	-0.612	-0.518	0.044
	-6M	-1.131	-0.973	-1.039	-0.816	-0.724	-0.147



CZGB**		2Y	3Y	4Y	5Y	7Y	10Y
%	Actual	0.880	0.959	1.194	1.387	1.701	1.946
	-1M	0.732	0.767	0.952	1.198	1.511	1.751
	-3M	0.661	0.772	0.814	1.051	1.235	1.906
	-6M	0.144	0.447	0.479	0.774	0.964	1.673



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25.796	4.304	320.02	4.664	5.428	1.166
	-1M	25.613	4.269	314.61	4.663	4.994	1.195
	-3M	25.369	4.189	313.71	4.661	4.692	1.232
	-6M	25.577	4.214	313.89	4.633	4.655	1.190



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

| Contacts

Martin Lobotka, Analyst (+420) 777 027 165, MLobotka@42fs.com

Research Research@42fs.com

Available at Thomson Reuters Eikon Messenger

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