42 Financial Services

Weekly | 2018 | Week 27

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

Calendar

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	9-Jul	9:00	CZ	Industrial production, May'18, y/y	-0.6%	1.0%
	9-Jul	9:00	CZ	Trade Balance, May'18, CZK bn.	14.5	12.0
Tuesday	10-Jul	8:45	FRA	Industrial production, May'18, y/y	0.5%	N/A
	10-Jul	10:00	ITA	Industrial production, May'18, y/y WDA	2.7%	N/A
Wednesday	11-Jul	9:00	CZ	CPI, June'18, y/y	2.5%	2.5%
Thursday	12-Jul	8:00	GER	(Final) HICP, June'18, y/y	2.1%	N/A
	12-Jul	8:45	FRA	(Final) HICP, June'18, y/y	2.1%	N/A
	12-Jul	11:00	EMU	Industrial production, May'18, y/y WDA	2.3%	N/A
Friday	13-Jul	9:00	SPA	(Final) HICP, June'18, y/y	2.3%	N/A

* Local time is CET
** (Reuters/ Bloomberg) Poll

July 2018 Auctions

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
CZGB 2015-2026**	11-Jul	13-Jul	26-Jun-26	CZK 4 bn. max	1.00%
CZGB 2014-2027**	11-Jul	13-Jul	19-Nov-27	CZK 4 bn. max	VAR
CZGB 2011-2023**	25-Jul	27-Jul	18-Apr-23	CZK 4 bn. max	VAR
CZGB 2018-2029**	25-Jul	27-Jul	23-Jul-29	CZK 4 bn. max	2.75%

* 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

"The EU is playing chess while the UK are playing chequers."

WEEK AHEAD

Inflation for June is the release of the week (and, I'd say, of month). The inflation quickened further in June, though in my view predominantly due to non-demand factors: fuel prices rose further in June, as did prices of food, and there was an increase of electricity prices ↗ that CEZ announced back in April. Nevertheless, with CZK weakest in almost a year, the increase of MPRI for whatever reason is exactly what CNB needs to deliver another hike. And such an expectation will probably keep EURCZK below 26 throughout next week.

Industrial production was negatively affected by two less working days in May of 2018 as compared with May 2017, but the strong growth in Germany in May suggests the May was a good month in CZ – I expect something like 5.5% WDA real growth.

In **Eurozone**, May industrial production should see improvement, with Spanish industry having grown 0.9% m/m and German industry having added surprisingly strong 2.6% m/m. Final HICP figure for June is unimportant – it usually doesn't change at all from preliminary estimates, and never changes from it significantly.

WEEK BEHIND

CZ RETAIL: loss of dynamics ▶

CZ PMI: index stabilizes at the end of 1st half ▶

CZ BUDGET: 1H18 deficit of almost 30 bn…No comment. ▶

EUROZONE: retail sales still in an anemic growth ▶

GERMANY: finally some strong data from industry ▶

| FX

Local data didn't push EURCZK below 26,…

…the low liquidity during the two-holiday days (Thursday / Friday) did. This week's inflation, if high enough, might make CZK stay below 26.

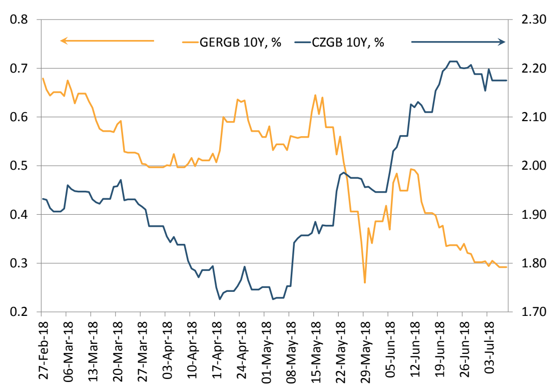
| FI

Yields remained unchanged last week.

No change as far as either Czech of German yields are concerned.

EURCZK RETURNS BACK BELOW 26

BOND YIELDS UNEVENTFUL LAST WEEK



| CZECH ECONOMY

Although the confidence continues to hover around the all-time high, although wages grow and savings rate fall, the growth of retail sales slowed.

This is not to be construed as weakness, not by a long shot: core retail sales (= no food, fuel, cars) still continue to grow solidly. But 5.5% y/y (real, WDA) growth in May means that the average y/y growth in last three months was 'just' 6.7%, the weakest since February 2017. Just kinda gives you the idea of how fast the growth was in last 18 months or so when 6.7% y/y is weakest over that time…That said, it (retail sales growth) was always going to slow down eventually: savings rate can't fall forever (it fell to an all-time in 1Q18, boosting sales), wage growth also cannot be unlimited, labor market is already at full employment and inflation did pick up recently.

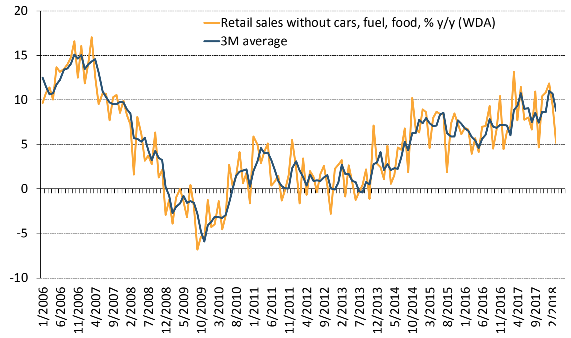
Outside the core sales, situation is not homogenous: fuel sales don't seem to have been impacted much by rising fuel prices (growth of 5% y/y in March-May), retail car sales, on the other hand, remained firmly in red (-3.5% y/y in May).

Looking forward, I don't see almost any reason why retail sales should quicken: see above for the explanation (savings rate, wages, unemployment).

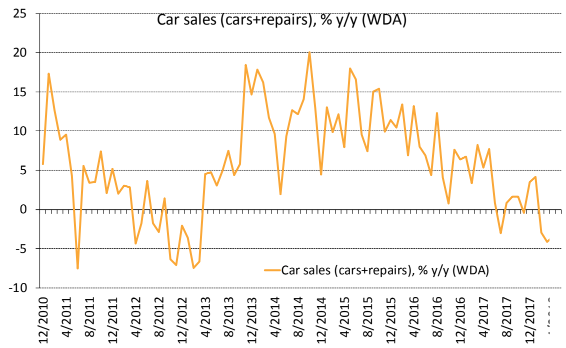
Manufacturing PMI surprisingly improved in June, though only marginally so.

Although the German manufacturing PMI fell further in June, Czech one didn't follow suit. On the contrary, it improved to 56.8 (from May 56.5), meaning that the 2Q18 average PMI was strong 56.8 (though that was still weakest since 3Q17). The soft patch in the industry is now probably over, although I don't expect the growth of the production to return to end-of-2017 rates: with trade war between US and the rest of the world escalating, with carmakers in Germany being in the Trump's crosshairs, this may prove just the temporary

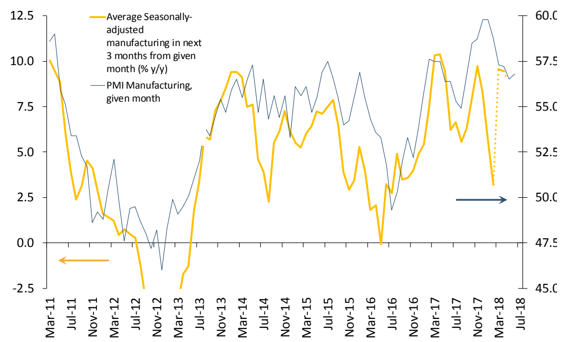
CORE RETAIL SALES GROWTH CONTINUES TO DECELERATE, THOUGH FROM STRATOSPHERIC HEIGHTS



CAR SALES GROWTH REMAINS NEGATIVE



MANUFACTURING PMI STABILIZES AT THE END OF 2Q18



reprieve.

Half-year budget numbers prove that government is as irresponsible as households.

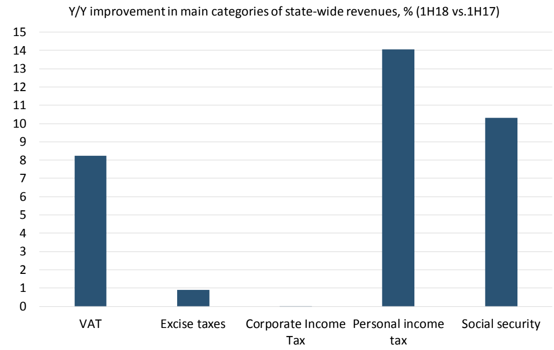
See, last week CSO reported in the final 1Q18 GDP data that savings rate of households fell to lowest ever, this at the time when unemployment rate is at its lowest and wage growth at the rates unseen in a decade. And yet, in the extraordinary good times that Czech economy is living through, households don't save, but do the exact opposite.

Government is behaving similarly. Instead of running a large surplus in these good times, with central government revenues up 8.5% (and the tax revenues up by 6.7% y/y, mostly due to VAT and personal income tax/SS contributions), government had (EU money-adjusted) deficit of CZK 28.8 bn. in 1H18 (as against deficit of 13.2 bn. in 1H17).

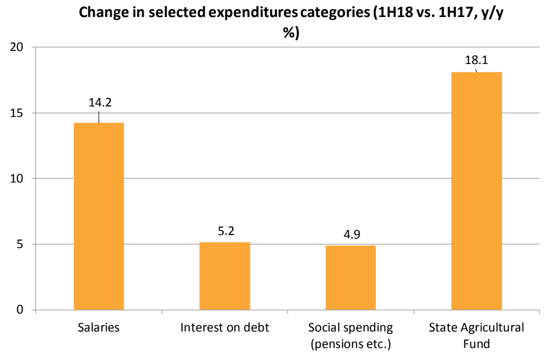
This is of course due to the strong growth of expenditures which more than keeps up with the growth of revenues: no wonder, with salary costs up 14.2% (!) y/y, interest expenditures up 5.2% (remember when government chose to finance itself on the short end to be able to claim that it is being paid to borrow, instead of financing at 10Y for what back then used to be 0.5% yield?), the contribution to the State Agricultural Fund up 18% etc. The biggest issue here is that the salary component is a mandatory one – when revenues do fall (as they inevitably will in a recession), these costs won't. Also, with 10Y yields now over 2%, the interest component of government expenditures will also continue to rise.

To make the long story short: government is unabashedly setting us up for 200 bn. deficit in a recession.

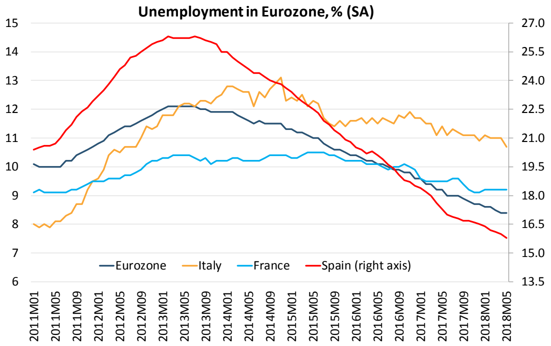
GOVERNMENT RUNNING ALMOST 30 BN. MID-YEAR DEFICIT, EVEN AS REVENUES CONTINUE TO RISE STRONGLY



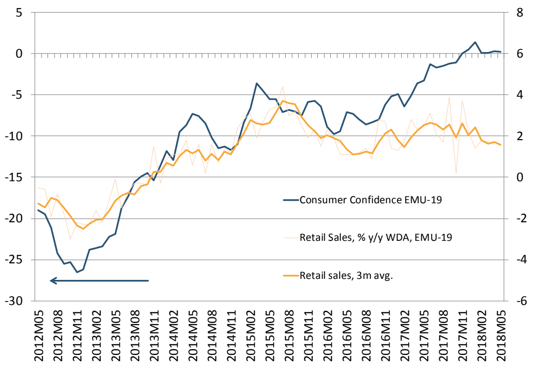
EXPENDITURES, HOWEVER, KEEP UP.



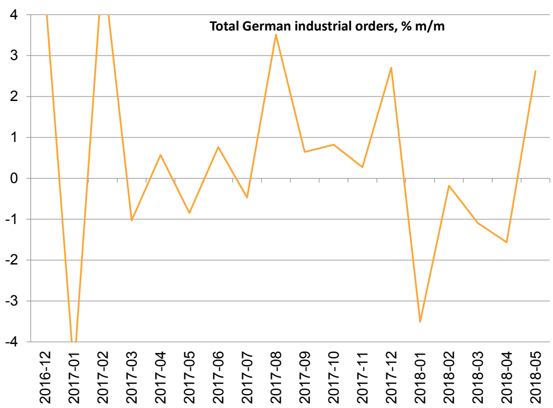
EUROZONE UNEMPLOYMENT STAYS AT 8.4% IN MAY.



RETAIL SALES POST ANOTHER MEDIOCRE GROWTH



FINALLY SOME STRONG DATA FROM GERMAN INDUSTRY



| EUROZONE ECONOMY

Even though the Eurozone unemployment remained at post-crisis low in May, retail sales had another mediocre month.

The unemployment rate was 0.8 pp lower this May than in May 2017, mainly due to fall of the unemployment rate in Italy and Spain; this was the same rate of improvement as in April but lower than in 2017 (when rate of unemployment was falling at the yearly rate of 1%). Still, 8.4% is the post-crisis low.

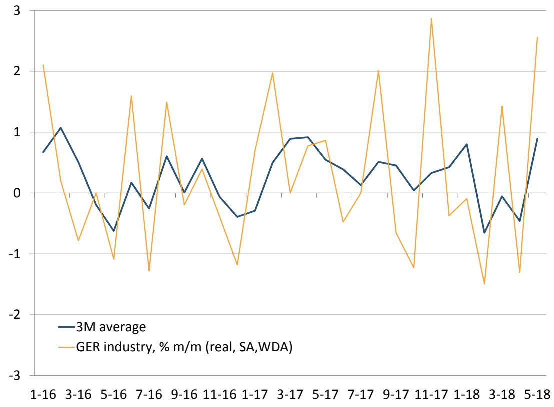
But it sure as hell isn't showing in spending – and for good reason. Although some choose to see the glass half full, I'd say the wage growth in Eurozone is non-existent: I mean, 2% growth of wage costs in 1Q18 ↗ may be fastest growth in 5 years, but it doesn't even cover inflation. Hence, the **retail sales growth of just 1.4% in May**, reported by Eurostat last week, didn't come as a surprise.

Put together, the moment when household demand actually starts threatening the Eurozone price stability is still far, far in the future. At this rate of improvement, it will take three more years for unemployment rate to fall to close the full employment, and even once that happens inflationary wage growth isn't guaranteed.

It took German industry five months of 2018 to show something solid.

Having fallen in each of the first four months (cumulatively by over 6%), German **industrial orders finally rose in May**. The growth of 2.6% m/m, although very welcome, didn't make up for the fall in the previous months though, and meant that the orders were only 4.4% higher than in May 2017. The rebound in May was primarily due to improvement (+6.7% m/m) in Euro-area orders and similar improvement (+4.3% m/m) in domestic ones.

As regards **actual production**, **May was also good month**: the production rose shocking 2.6%

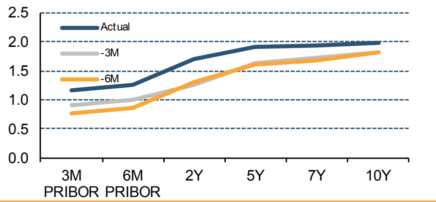


m/m, but that still translated only into y/y growth of 3.1% - which shows how strongly the growth decelerated in last 2-3 quarters (May's monthly gain was only the third gain in last 9 months). The May rebound was mainly due to growth in consumer durables (+5% m/m).

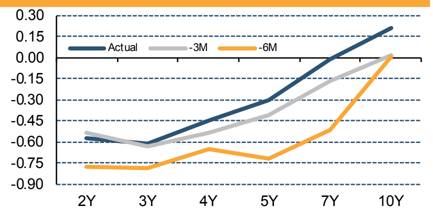
What to make of these data? Well, as said above, the return to growth is certainly positive. But with PMI having fallen further in June and with trade war between US and EU threatening to escalate, I am afraid that May may not be the end of the current soft patch, strong reading(s) nonetheless.

| MARKETS ‡

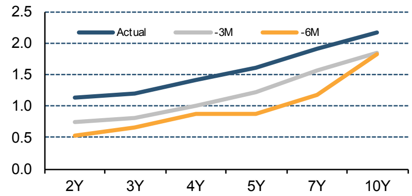
MM / IRS	%	3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
	Actual	1.170	1.250	1.700	1.900	1.926	1.970
	-1M	0.920	1.000	1.463	1.855	1.933	2.023
	-3M	0.900	0.990	1.268	1.635	1.721	1.825
	-6M	0.760	0.860	1.306	1.601	1.686	1.810



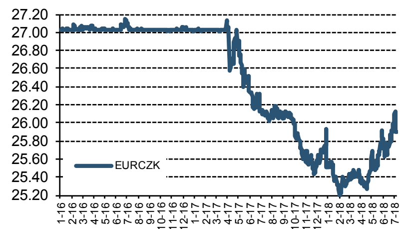
ASW spread*	bps.	2Y	3Y	4Y	5Y	7Y	10Y
	Actual	-0.574	-0.611	-0.454	-0.305	-0.015	0.205
	-1M	-0.549	-0.604	-0.401	-0.377	-0.155	0.039
	-3M	-0.534	-0.634	-0.542	-0.415	-0.169	0.013
	-6M	-0.776	-0.788	-0.656	-0.721	-0.516	0.007



CZGB**	%	2Y	3Y	4Y	5Y	7Y	10Y
	Actual	1.126	1.191	1.411	1.595	1.911	2.175
	-1M	0.914	1.035	1.359	1.478	1.778	2.061
	-3M	0.734	0.798	1.008	1.220	1.552	1.838
	-6M	0.530	0.658	0.883	0.880	1.170	1.817



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25.898	4.355	322.97	4.654	5.374	1.175
	-1M	25.752	4.278	319.75	4.659	5.270	1.177
	-3M	25.364	4.199	312.09	4.662	4.970	1.228
	-6M	25.573	4.172	309.01	4.651	4.483	1.197



‡ 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

PREVIOUS ISSUES OF WEEKLY AND OTHER REPORTS ARE AVAILABLE HERE ↗

| Disclaimer

This publication has been prepared by 42 Financial Services Czech Republic (hereafter referred to as '42 Financial Services' only). This report is for information purposes only.

Publications in the United Kingdom are available only to investment professionals, not private customers, as defined by the rules of the Financial Services Authority. Individuals who do not have professional experience in matters relating to investments should not rely on it.

The information contained herein has been obtained from public sources believed by 42 Financial Services to be reliable, but which may not have been independently justified. No guarantees, representations or warranties are made as to its accuracy, completeness or suitability for any purpose.

This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument or any other action and will not form the basis or a part of any contract.

Neither 42 Financial Services nor any of its affiliates, its respective directors, officers or employers accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith. Any opinion, estimate or projection expressed in this publication reflects the current judgment of the author(s) on the date of this report. They do not necessarily reflect the opinions of 42 Financial Services and are subject to change without notice. 42 Financial Services has no obligation to update, modify or amend this report or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate.

The past performance of financial instruments is not indicative of future results. No assurance can be given that any financial instrument or issuer described herein would yield favorable investment results.

42 Financial Services, its affiliates, principals or employees may have a long or short position or may transact in the financial instrument(s) referred to herein or may trade in such financial instruments with other customers on a principal basis. 42 Financial Services may act as a market maker in the financial instruments or companies discussed herein and may also perform or seek to perform investment banking services for those companies. 42 Financial Services may act upon or use the information or conclusion contained in this report before it is distributed to other persons.

By accepting this report, a recipient hereof agrees to be bound by the foregoing limitations.