

July 16 | 2018

Weekly | 2018 | Week 28

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CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	16-Jul	10:00	CZ	Current Account, May'18, CZK bn.	-12	-15
	16-Jul	10:00	EMU	Trade Balance, May'18, EUR bn.	18.5	N/A
Tuesday	17-Jul	12:00	ITA	(Final) HICP, June'18, y/y	1.5%	N/A
Wednesday	18-Jul	11:00	EMU	(Final) Headline / Core HICP, June'18, y/y	2%/1%	N/A
Thursday	19-Jul	9:00	CZ	Industrial PPI, June'18, y/y	2.6%	N/A
	19-Jul	9:00	CZ	Export Prices, May'18, y/y	N/A	N/A
Friday	20-Jul	10:00	EMU	Current Account, May'18, y/y	2.1%	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

“LOOKS LIKE THE NEW SPLIT IN US IS BETWEEN DEPLORABLES AND DEPORTABLES.”

WEEK AHEAD

Not much happening here. Export prices probably rose in May, being one of the reasons why domestic inflation reaccelerated in recent three months. Producer price indices will probably also show noticeable rise in June, but that will be primarily due to oil prices and food prices.

In **Eurozone**, final inflation won't bring any surprises, merely the confirmation that core inflation is still much below 2% where it'd need to be for me to believe headline inflation is sustainably at target.

WEEK BEHIND

CZ Inflation: monthly dynamics of demand inflation raises probability of another hike in August ▶

INDUSTRY: Czech ▶ and Eurozone industries ▶ post strongest m/m growth since Nov'17.

CZ TRADE BALANCE: Large surplus persists ▶

CNB MINUTES: Hike in June confirmed having been due to CZK and real estate prices ▶

ECB MINUTES: Still no idea why EURUSD market was so shocked in June ▶

| FX

EURCZK remained a bit below 26 throughout last week, oscillating between 25.85 and 25.95.

Tight range, nothing to comment on.

| FI

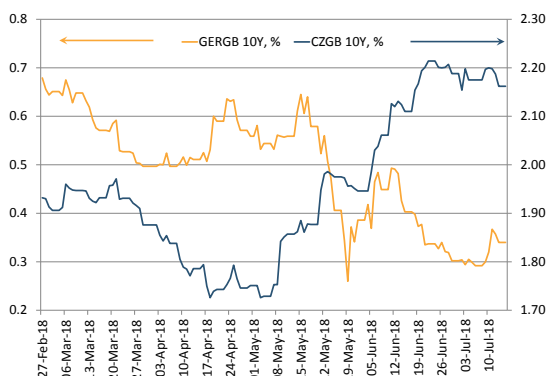
Yields remained unchanged last week.

Not much of a movement in either German or Czech bond markets. German 10Y did rise few bps. on Reuters report that some policymakers at ECB consider rising rates as early as July 2019 - market immediately went to speculate whether the notion of "rates remaining unchanged in Eurozone through the summer" seen in June ECB press statement could mean July. The speculations were proved unfounded by ECB minutes ↗ released shortly thereafter last week, after which German 10Y yields returned to 35 bps.

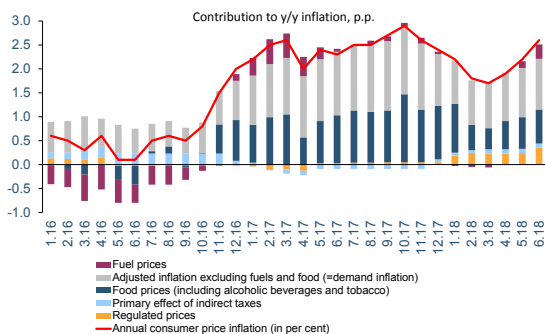
EURCZK RETURNS BACK BELOW 26



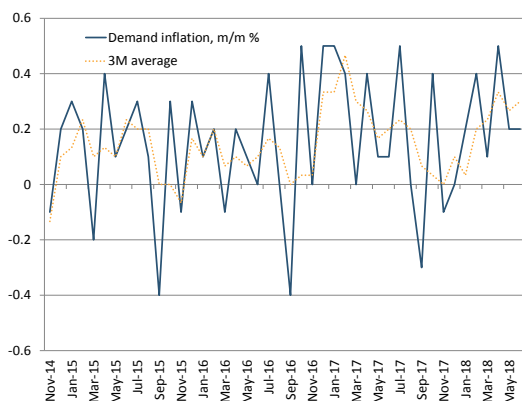
BOND YIELDS UNEVENTFUL LAST WEEK



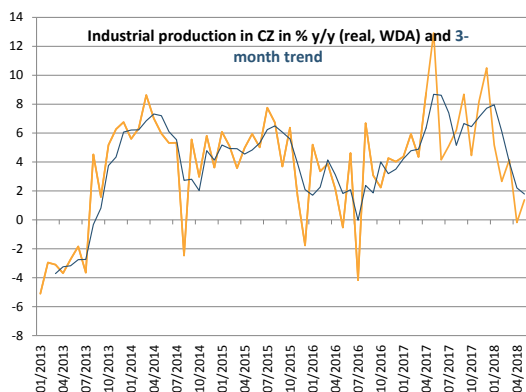
ANNUAL HEADLINE INFLATION HIGHEST IN 7 MONTHS, THE INCREASE BEING DUE TO NON-DEMAND FACTORS.



THAT SAID, MONTHLY DYNAMICS OF DEMAND INFLATION IS HIGH, COURTESY OF HOUSING & WEAKER CZK.



INDUSTRY STABILIZES IN MAY AFTER STRONG DECELERATION THIS YEAR,...



CZECH ECONOMY

As expected, the annual inflation quickened further in June, but mostly due to non-demand factors.

Annual headline inflation rose to joint-highest (2.6%) since November last year (2.6%), but the structure of the inflation is different.

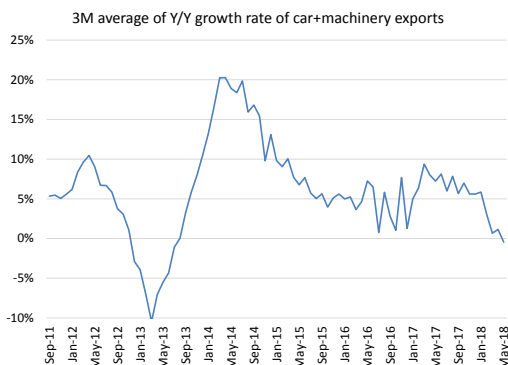
In November, *demand* inflation contributed 1.4 pp to the overall headline reading, as against contribution of just 1.1 pp in June 2018. Since this was also merely 0.1 pp higher contribution to headline inflation than in March (when headline inflation bottomed at 1.7%), it is clear that most of the increase of total inflation between March and June was due other factors: these were, in the order of size of the contribution to June inflation, fuel prices (contribution change from March -0.1 pp to June +0.4 pp), food prices (0.4 pp → 0.7 pp) and regulated prices (0.2 pp → 0.4 pp).

Also, the entire increase of the total inflation between May (2.2%) and June (2.6%) was accounted for by fuel prices (contribution of 0.3 pp in June vs. 0.1 pp May) and by regulated prices (0.4 pp. vs 0.2 pp in May). The former was obviously due to pricier oil (most of the increase in CZK oil price happened in May but fully showed up in consumer prices only in June), the latter due to increase of electricity prices announced back in April ↗.

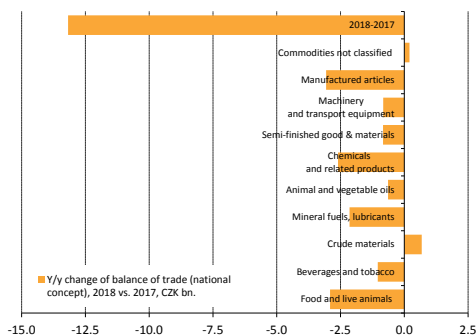
Much more important than this is, obviously, the evolution of demand inflation. Its annual rate remained unchanged in June at May's 1.9% y/y, i.e. 0.2 pp above the March level. But the monthly dynamics remained elevated: partially due to housing prices (via imputed rents) and partially reflecting weaker CZK, demand inflation is running at faster rate than in June 2017: the quarterly increase of demand inflation in 2Q18 was almost 1% m/m, as compared with 0.7% in 2Q17. This will give lots of ammo to CNB to those at CNB Board who wish to deliver another hike. More so that in August CNB will have new forecast.

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...ONE THAT IS EVIDENT IN EXPORT DATA AS WELL.



TRADE BALANCE REMAINS IN HEALTHY SURPLUS, THOUGH ONE CZK 13 BN. LOWER THAN IN 2017.



In May, industrial production posted the best month in half-a-year. But that merely prevented the y/y rate from stagnating.

Monthly gain of 2.9% (2.5% m/m in manufacturing) was good enough just to push the y/y WDA rate of growth to 1.4% y/y. The fact that at the end of last year, i.e. merely 5 months before, the industry was growing at 8% y/y rate tells you how strongly the industrial growth decelerated. The y/y growth is now weakest since mid-2016.

With PMI having stabilized here (but not in Germany) and with weaker CZK, there is hope that the industry will not decelerate further in 3Q18. But the risk remains of trade war escalating further, undermining the world trade. With Trump and China exchanging tariffs ↗ this is a risk that is very real. Hence, the growth of 3-4% y/y is what one can reasonably expect in the 2H18.

Trade balance remains in healthy surplus, but one that is smaller this year than in 2017.

National concept trade balance surplus was CZK 80.9 bn. over 01-05/18, some CZK 13 bn. lower than in first five months of 2017. Except for crude materials, all major categories saw their balances worsen, with biggest worsening (by CZK 3.1 bn.) in manufactured goods (due to bigger imports). Of interest, and confirming the above data from industry, is the fact that three-month average y/y growth rate of exports of cars and machinery was negative in May for the first time since summer 2013.

CNB minutes ↗ showed what I thought: that the main motivator to hike in June was the real estate and weak CZK.

As succinctly written in the minutes, “*There was a consensus that the weaker exchange rate was creating room to tighten the monetary conditions in their interest rate component, which would also support achievement of the financial stability objective.*” Hence, the hike. CNB doesn't seem to

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be overly concerned with the CZK yet (“swings of several per cent are common under a free float and the current weakening of the koruna in Q2 could be regarded as moderate from the perspective of historical volatility.”) so any thoughts of CNB intervening against the weakness of CZK are premature. This could happen above 27.

Looking forward, higher June inflation (though mostly due to non-demand items), persistent weakness of CZK and new forecast to be published in August all point towards another hike then.

| EUROZONE ECONOMY

Just like the Czech one, the Eurozone industry posted the strongest growth in May since November 2017.

The monthly increase of 1.4% m/m was primarily due to Germany’s 2.7% m/m gain, and helped by 0.8% and 0.7% monthly expansions in, respectively, Spain and Italy. French industry fell 0.6%.

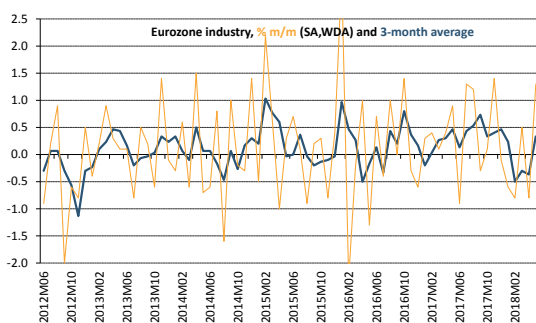
The annual growth remains weak, with Euro area as a whole at mere 2.4% y/y, ranging from 3% y/y in Germany to -0.6% y/y in France (French growth is little bit of enigma since it was strongest of big-4 as recently as in February, at +4% y/y).

Looking forward, leading indicators don’t give much hope of quick turnaround – manufacturing PMI in Germany and Italy continued to fall in June while French one merely stabilized (at 54.4). Hence, I’d expect some rebound in France over summer but little in Germany or Italy. Weaker euro might help, but the trade war fears certainly won’t. I think Eurozone industry will grow so-so (2-3% y/y) for the remainder of this year.

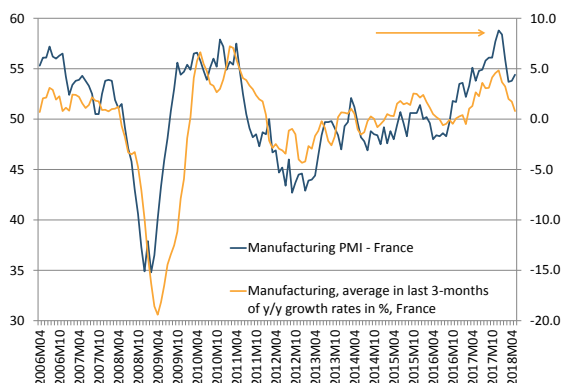
ECB minutes from its mid-June meeting were a prime example of how it looks like when one tries very hard to see the empty glass at least half-full.

Minutes really read like “let’s just find the economic justification for what we want to do” which is to end

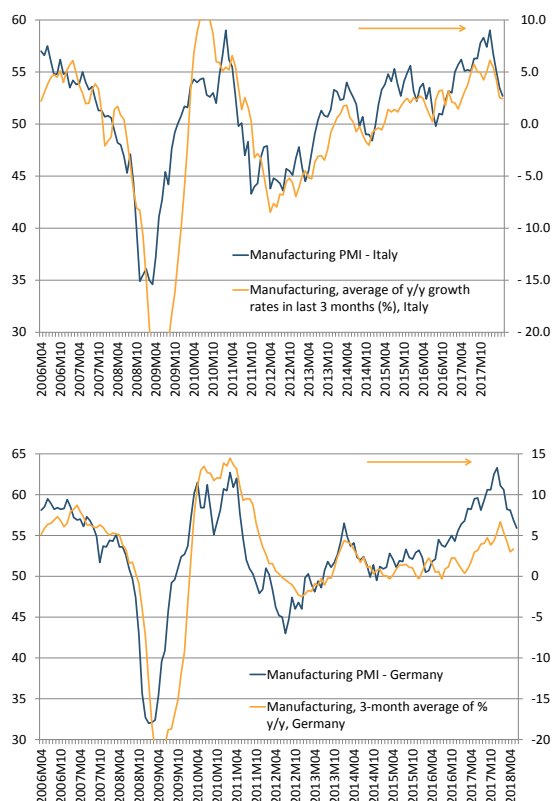
EUROZONE INDUSTRY IN STRONGEST GROWTH SINCE NOV’17



PMIS DON'T GIVE MUCH HOPE OF QUICK TURNAROUND



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the QE. So, to justify the announcement of the end to QE, ECB said that it became sufficiently confident that inflation will converge to 2% sustainably, and that is it.

ECB chief economist Praet said that although *“measures of underlying inflation remained generally muted, they had been increasing from earlier lows”*. The first part of the sentence is true, the second part less so – core PCE inflation remained around 1% with no trend whatsoever in last 4 year. So, where does the confidence comes from?

First, SPF – Survey of Professional forecasters. As if that is any authority ☺ Anyway, ECB said that the distribution of the SPF replies moved to the right (i.e., towards higher expected inflation) and became narrower (i.e., there is more confidence around that expectation). But, if one takes a look at the historical accuracy of SPF when it comes to forecasting inflation, it is just as bad as that of ECB's forecasting team. To me, reference to SPF as a justification for the increased confidence is just a fig leaf to cover that there's been really no change in inflation outlook when looking at hard facts / data. And such is also the reference to inflation-linked swap rate having been *“stable at around 1.7%”* or to the fact that *“other market-based measures have been progressively moving in favorable direction”*. See, 5Y swap rates have been even poorer predictor of actual inflation since GFC than me ;) And market-based measures, c'mon – these follow oil prices more than anything else.

Second, ECB said its forecast shows convergence to 1.7% and 1.9% for 2019 and 2020, respectively, for core inflation. Well, ECB has been forecasting return to these levels ever since economy emerged from recession – with very little success. Also, ECB claimed, without any supporting evidence, that *“the expected convergence of inflation to the inflation aim had become increasingly less reliant on further extensions of net asset purchases.”* There is no evidence for that but I understand this is the only thing you can say when you want to end QE...

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Regarding the risks of the forecast, obviously, the trade protectionism was prominent, with members of the Governing Council being concerned “*about the possibility that tensions could lead to a more general decline in confidence throughout the global economy, beyond any direct effects from the imposition of tariffs.*” Otherwise, though, the minutes exuded confidence: “*The medium-term outlook was seen to be still supported by strong consumption fundamentals, related to expanding employment, rising wages and consumer confidence remaining at high levels.*” **Where that is coming from beats me: real wages are barely growing and retail sales averaged 1.6% y/y growth in last three months.**

Second important message from the minutes was regarding the other component of the monetary conditions, i.e. interest rates. This was what took the EURUSD market by surprise after the ECB meeting in mid-June. In minutes, the **forward guidance was made more explicit** in terms of timing of the first hike (“*ECB interest rates to remain at their present levels at least through the summer of 2019...*”) **and** was also made **state-contingent** (“*... in any case for as long as necessary to ensure that the evolution of inflation remained aligned with the current expectations of a sustained adjustment path.*”). But I still fail to see anything in the minutes, just like I didn’t see anything in the post-meeting statement and at the press conference, that should have shocked the market as much as it did back in mid-June: recall that EURUSD fell most since Brexit after ECB announced decision. **With current core inflation around 1%, weak retail sales’ growth, non-existent wage growth and unemployment still 2-3 years away from full employment, I think the first hike anytime in 2019 is unlikely.**

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MARKETS ‡

MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y	
%	Actual	1.180	1.270	1.770	2.023	2.040	2.090	
	-1M	0.920	1.010	1.495	1.880	1.970	2.065	
	-3M	0.900	0.990	1.250	1.605	1.689	1.780	
	-6M	0.760	0.860	1.315	1.635	1.710	1.820	
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y	
bps.	Actual	-0.645	-0.686	-0.546	-0.426	-0.129	0.072	
	-1M	-0.471	-0.571	-0.446	-0.368	-0.123	0.045	
	-3M	-0.531	-0.639	-0.563	-0.430	-0.196	0.006	
	-6M	-0.822	-0.783	-0.651	-0.665	-0.490	0.094	
CZGB**		2Y	3Y	4Y	5Y	7Y	10Y	
%	Actual	1.125	1.184	1.419	1.597	1.911	2.162	
	-1M	1.024	1.114	1.354	1.512	1.847	2.110	
	-3M	0.719	0.770	0.965	1.175	1.493	1.786	
	-6M	0.493	0.688	0.921	0.970	1.220	1.914	
FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD	
	Actual	25.889	4.314	322.86	4.653	5.650	1.169	
	-1M	25.729	4.286	322.52	4.664	5.495	1.161	
	-3M	25.301	4.168	310.81	4.661	5.054	1.233	
	-6M	25.533	4.172	308.86	4.639	4.660	1.226	

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

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