Weekly | 2018 | Week 40

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| CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	8-Oct-18	8:00	GER	Industrial production, Aug'8, y/y (WDA)	-0.1%	N/A
	8-Oct-18	9:00	CZ	Retail sales, Aug'18, y/y	5.0%	4.6%
	8-Oct-18	9:00	CZ	Industrial production, Aug'8, y/y (WDA)	2.9%	3.5%
	8-Oct-18	9:00	CZ	Unemployment rate, Aug'18	3.0%	N/A
Tuesday	9-Oct-18	9:00	CZ	CPI, Sep'18, y/y	2.5%	2.4%
	9-Oct-18	9:00	CZ	Trade Balance, Aug'18, CZK bn.	1.5	3.6
Friday	12-Oct-18	11:00	EMU	Industrial production, Aug'8, y/y (WDA)	-0.3%	N/A

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

| OCTOBER 2018 AUCTIONS

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
CZGB 2018-2029**	10-Oct-18	12-Oct-18	23-Jul-29	CZK 5 bn. max	2.75%
CZGB 2017-2033**	10-Oct-18	12-Oct-18	13-Oct-33	CZK 3 bn. max	2.00%
CZGB 2018-2021**	24-Oct-18	26-Oct-18	23-Feb-21	CZK 3 bn. max	0.75%
CZGB 2014-2025**	24-Oct-18	26-Oct-18	17-Sep-25	CZK 5 bn. max	2.40%

* 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

"US WILL NEED TO HIRE DESMOND TUTU TO HEAD US VERSION OF TNC ONCE TRUMP'S TERM IS OVER." (HEARD IN SAN FRANCISCO)

WEEK AHEAD

Lots of Czech data to be released this week.

The most important release is clearly that of inflation: if inflation remains at the August level (2.5%) and EURCZK doesn't fall to 25, Nov'1 hike is almost certain. Other data won't surprise much: industry should slow, reflecting past German weakness and worse PMI of late. Retail sales will remain strong but should again confirm that 2017 growth of household demand will not be repeated any time soon.

WEEK BEHIND

CNB: new Board members' names known ▶

CZ: profitability of firms fell to all-time low in 2Q18 ▶

CZ: industry in for further slowdown ▶

EMU: retail sales under 2% y/y for 8th month in a row ▶

| FX

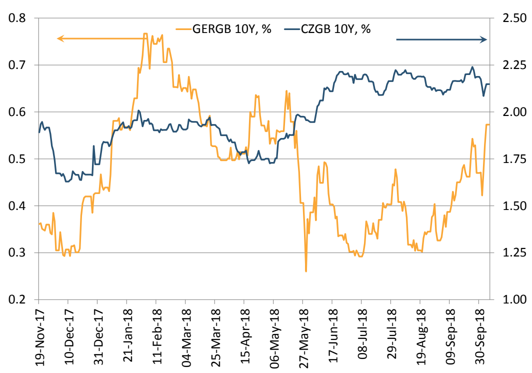
EURCZK RANGE-BOUND AROUND 25.75

CZK remained in a tight range around 25.75,…

…ignoring both the announcements of the CNB Board changes and the release of minutes from the September CNB meeting. Not that any of these should (will) have an impact on monetary policy in the future.

| FI

GERMAN 10YS HIGHEST IN 4 MONTHS AMID US TREASURIES SELL-OFF



German 10Y yields rose to highest since end of May, hitting 57 bps. last Friday.

The reason was the sell-off in US, prompted by hawkish FED comments and good data, which sent the US 10Y Treasury yields to the highest (3.22%) since summer 2011. There were increases in other countries' yields as well (France, Spain), but less pronounced. Czech yields couldn't care less.

| CZECH ECONOMY

Busy week at the Czech National Bank – two new Board members' names were published, as was the account from September 26 meeting.

Vice-governors Hampl and Vladimir Tomsik, both of them being two-terms' members of the CNB Board (and both since December 1, 2006) are going to leave the Board after twelve years at the end of November. So, naturally, media started to search for the names of those who'll replace them, and it didn't take them long to ferret them out. Two new members are Aleš Michal and Tomáš Holub.

The former is an ex-analyst of Raiffeisenbank of Czech Republic and currently the external advisor of Minister of Finance (Andrej Babis was Minister of Finance in 2014-2017). His appointment is one of those clear political nominations that we are sadly inured to.

He is known to be extrovert and, to me, much more of a journalist than monetary policy expert (he used to be a journalist with daily Hospodarske noviny after graduation form University after all). But, hey, there were stranger names in the Board in the past - though, personally speaking, I have to admit not that many…. His views on the monetary policy aren't known. What is is that he opposed FX interventions of the CNB, claiming, inter alia, that they made us poorer, that they enabled the "laziness" among the exporters etc. So, while I concur that interventions didn't make sense, it was for very different set of reasons.
If I had to describe him, I'd say that he's an armchair economist preoccupied with ingratiating himself to the general public and media, a self-stylized popularizer of economics with a fairly extrovert streak. Which, to me, pretty often comes at the cost of the resulting analysis being based more on feelings that on rigorous information-derived analysis.

Mr. Holub, on the other hand, is very

methodological and quantitative. A veteran of CNB (he’s been there since 2004) and its de facto chief economist, he’s first insider to make it to the Board in a long time. Since he’s headed the monetary policy section of CNB for years (i.e., been in charge of the modelling and forecasting), he’s got the intimate knowledge of (and faith in) the DSGE model used by Czech National Bank for forecasting. Because of that, he’ll be unlikely to deviate in its voting from what the forecast of the day recommends. And since forecasts of last years tended to be a bit more hawkish than what turned out to be the case, he’ll probably be more hawkish than dovish in its vote.

Account from the September meeting which brought the third hike in as many meetings confirmed the tightening bias of CNB.

CNB basically said that the hike in September was in fulfillment of the August forecast which called for two 25 bps. hikes in total – and since first 25 bps. hike was delivered in August, second one was delivered then. The risks to the August forecast were seen as balanced and insignificant, hence no need to deviate from the interest rate path envisaged.

It wasn’t a clear unanimous decision, though. There were two outliers: one member thought that 50 bps. hike was necessary already in September, the other one (Oldrich Dedek) thought no hike was needed at all.

Regarding the future path, Board was non-committal but with clear tightening bias: “*CNB would steer a gradual course towards the long-run equilibrium interest rate, although this would be conditional on the paths of all key macroeconomic variables, including the exchange rate of the koruna. If the next forecasts materialized and information from the external environment allowed further steps to be taken, the Board would continue to normalize monetary policy. However, this did not represent any commitment for the next meeting.*“ Obviously not, but the direction of travel seems to be clear.

Finally, the bank again confirmed what I’ve thought for a long time: the desire to tighten is not driven so much by actual threat of runaway inflation (which there clearly does not exist in an open economy surrounded and dwarfed by non-inflationary giant that is Eurozone), but by financial stability concerns (read: real estate prices) and by wish to create a maneuvering space for future recession. The former is reflected in the line in the minutes that *"increasing interest rates was consistent with the financial stability perspective"*, the latter seen in the mention than "*the process of normalizing interest rates was simultaneously a means for the CNB to be prepared for any future recession".*

Bottom line: Unless something significant happens in October, next hike on Nov 1 is assured.

Not much new in the final GDP release for 2Q18, as usual.

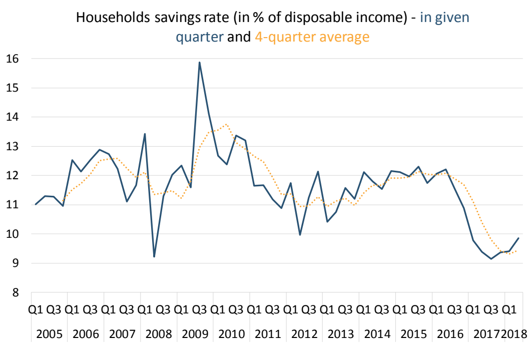
Although there were some changes in the structure of the economic growth, the overall rate of growth didn't change against the 2nd estimate from three weeks ago: 2Q18 quarterly growth is still 0.7%, annual one 2.4%. Which means that both are markedly lower than growth rates in Poland and Hungary (both of which have not been blessed with artificially weakened currencies in last years…).

But, two important pieces of new information were released nonetheless.

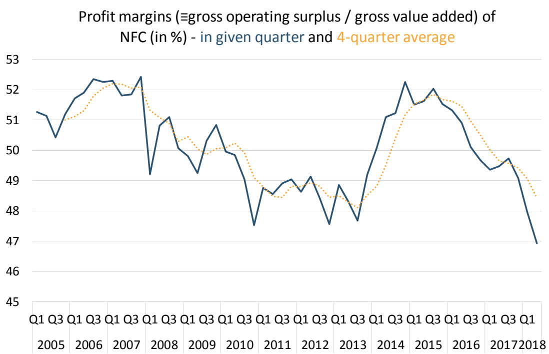
First, **household savings rate**, though still low by historical standards, **didn't fall further**; on the contrary it increased to highest since end of 2016. This is in line with my expectation and, as written repeatedly, one of the reasons why household demand (as reflected for example in retail sales) isn't as strong this year as it was in 2017 – there just isn't the additional push that came from dissaving.

Second, **profitability of non-financial companies continues to worsen**: the profit margins (defined as gross operating surplus divided by gross value added) fell to their lowest on record. This is certainly at least partially due to fast growth of

HOUSEHOLDS SAVINGS RATE STILL LOW, BUT OFF 4Q17 ALL-TIME LOWS



PROFITABILITY OF NON-FINANCIAL FIRMS FALLS TO NEW LOW.



wages which isn't covered by growth of productivity. And it is unlikely to get any better soon, as public sector continues to push wages up and as…

…manufacturing appears to be in for further slowdown.

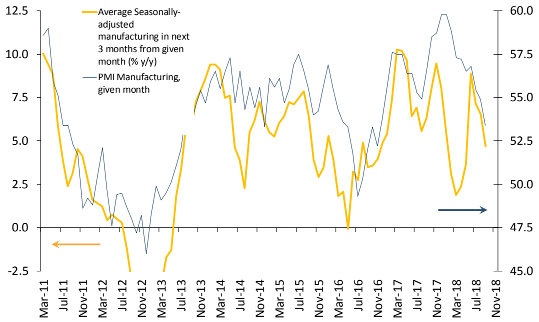
In September, manufacturing PMI fell to lowest (53.9) since November 2016 (52.2), pointing to the annual growth of manufacturing of just 3-4% in 4Q18. This is a substantial deceleration from 8% growth seen at the end of 2017.

The further weakening of the index in September was caused primarily by very weak growth of new orders. Their growth slowed for the third time in a row and is now weakest since November 2016. This was then compounded by weak growth of employment (weakest in over 2 years), though whether this is demand- or supply-related constraint couldn't be ascertained from the data.

Regarding inflation, the input one was one of the fastest in last 7 year as energy & metals were reported to have gone up. This translated into higher output inflation, though not one for one.

All in all, it seems that the weakness in Germany (2.1% annual decline in orders in August, reported last week, speaks clearly here…) is feeding into industrial weakness here. And, as a consequence, it all means that the overall GDP growth is very unlikely to quicken in the coming quarters. Just the opposite.

CZECH MANUFACTURING TO SLOW IN THE COMING MONTHS, PMI SHOWS

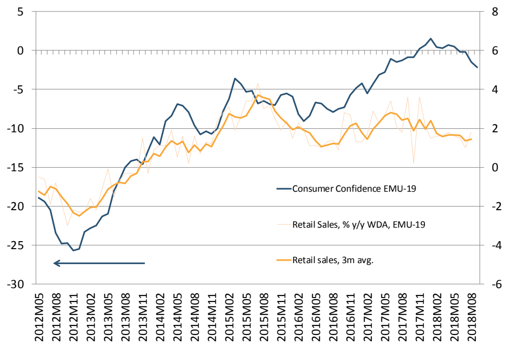


| EUROZONE ECONOMY

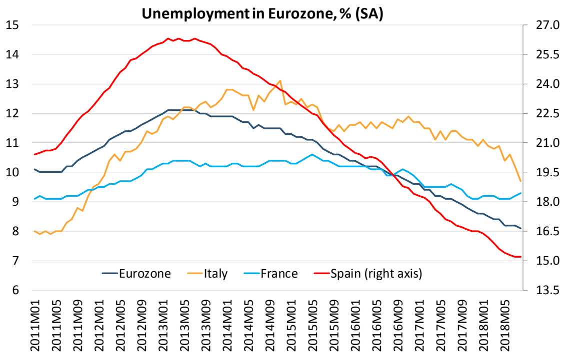
Household demand remains weak, and the pace of labor market improvement doesn't indicate this will change soon.

Retail sales' growth remained under 2% y/y in each month this year, the August one having been reported at 1.8% last week. This is still very weak and unlikely to bring core inflation to 2% any time

EUROZONE RETAIL SALES UNDER 2% Y/Y FOR THE 8TH MONTH IN A ROW



UNEMPLOYMENT CONTINUES TO DECLINE, BUT ONLY SLOWLY

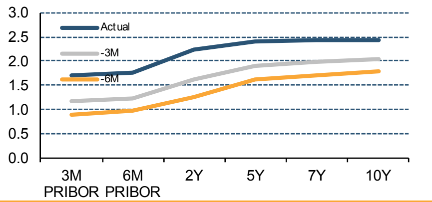


soon, ECB saying otherwise nonetheless.

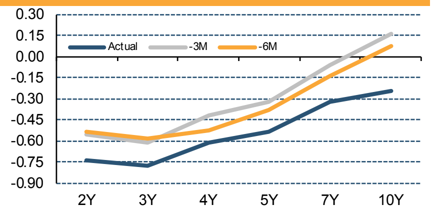
And it is no wonder. See, the unemployment rate continues to decline, but the problem is that it is only happening at the slow rate – unemployment fell to post-crisis low of 8.1% in August, but this was only 0.9 pp better than a year ago. At this rate, it will take another 3 years for unemployment rate to fall to around natural rate of unemployment, and only then can wage growth pick up. At least theoretically, so: as US shows, it doesn't necessarily need to. In US, the unemployment is lowest since 1969 and wage growth is still under 3%. This means that we're still *some* (substantial) time from seeing sustainable inflation increase in Eurozone.

| Markets ‡

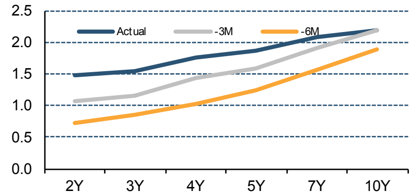
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	1.700	1.770	2.225	2.400	2.419	2.435
	-1M	1.490	1.590	2.040	2.230	2.261	2.300
	-3M	1.160	1.240	1.630	1.910	1.971	2.030
	-6M	0.900	0.990	1.270	1.630	1.715	1.800



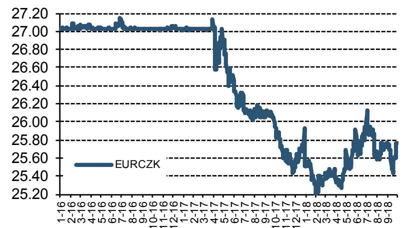
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-0.743	-0.776	-0.613	-0.537	-0.329	-0.248
	-1M	-0.714	-0.805	-0.698	-0.533	-0.272	-0.173
	-3M	-0.555	-0.610	-0.425	-0.329	-0.063	0.158
	-6M	-0.538	-0.581	-0.527	-0.384	-0.144	0.076



CZGB**		2Y	3Y	4Y	5Y	7Y	10Y
%	Actual	1.482	1.534	1.753	1.863	2.090	2.187
	-1M	1.326	1.329	1.491	1.697	1.989	2.127
	-3M	1.075	1.151	1.424	1.581	1.908	2.188
	-6M	0.732	0.851	1.022	1.246	1.571	1.876



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25.765	4.281	323.41	4.654	7.034	1.160
	-1M	25.732	4.290	325.74	4.630	7.576	1.171
	-3M	25.989	4.372	329.26	4.664	5.368	1.168
	-6M	25.394	4.210	312.33	4.660	4.857	1.230



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

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