October 15 | **2018**

Weekly | 2018 | Week 41

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| CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	15-Oct-18	10:00	CZ	Current Account, Aug'18, CZK bn.	-10.0	-7.6
Tuesday	16-Oct-18	9:00	CZ	PPI Industrial, Sep'18, y/y	3.1%	2.9%
	16-Oct-18	9:00	CZ	Export/Import prices, Aug'18,	N/A	N/A
	16-Oct-18	11:00	EMU	Trade Balance, Aug'18, EUR bn. (SA)	14.7	N/A
	16-Oct-18	11:00	ITA	(Final) HICP, Sep'18, y/y	1.6%	N/A
Wednesday	17-Oct-18	11:00	EMU	(Final) HICP, Sep'18, y/y	2.1%	N/A
Friday	19-Oct-18	10:00	EMU	Current Account, Aug'18, EUR bn. (SA)	N/A	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

"LOOKS LIKE THE DAY WHEN HAVE-CAKE-AND-EAT-IT DELUSION IS OVER IS CLOSE ↗ "

WEEK AHEAD

Not much interesting to be released this week.

Analytically, import prices for August are interesting to see whether the May-July increases due to weaker CZK are now a thing of past. I think there may have been some residual rise in August, but if there really was, it was close to zero (m/m). In other words, pro-inflationary effect of weaker currency are now over.

WEEK BEHIND

CZ: demand inflation slows most on record in September ▶

CZ: industry▶, retail▶ August data show economy clearly behind cyclical peak

CZ: trade balance surplus lower this year due to pricier oil, lower car exports ▶

EMU: industry weakness persists ▶

| FX

EURCZK seems eyeing 26 again.

The weakening of the CZK was triggered by weaker than expected inflation, but that, as I write below, is nothing more than the reversal of July's higher-than-expected rise. Nothing to be found here, but it shows again that EURCZK will have a hard time strengthening below 25 as CNB expects will happen in early 2019.

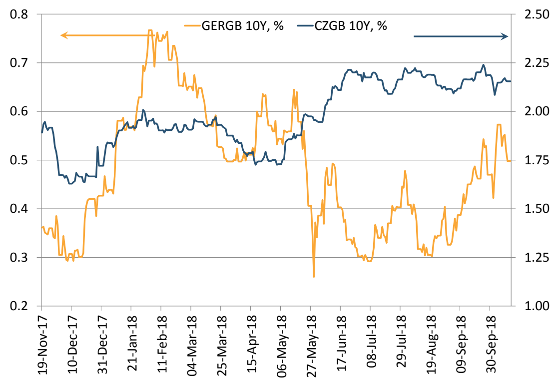
EURCZK EYES 26 AGAIN.

| FI

As expected, the US-sell-off induced increase of German bonds two weeks back proved short-lived.

German yields returned to 50 bps at 10Y last week. Czech yields have remained very stable since the end of May. Which, considering the volatility to our western border and volatility of EURCZK, is pretty strange.

GERMAN 10YS RETURN TO 50 BPS.



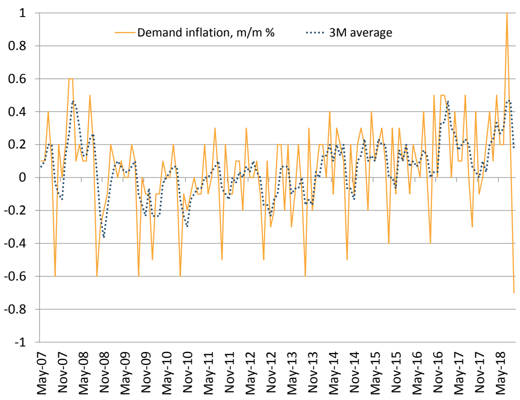
| CZECH ECONOMY

Czech core inflation slowed most on record in September. Any reason to re-assess CNB repo path?

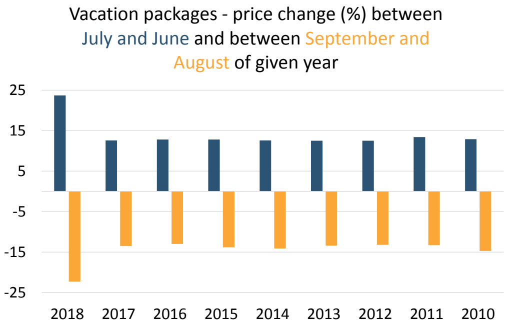
No. Why?

Well, do you remember what happened in July? If not, see Weekly 32 here ↗. Me being nice and all, I will save you time to (re-) read that: let us recall that in July the demand inflation rose at the fastest monthly rate since 2007, and that this increase was due to unusually high seasonal increase of prices of vacation packages. See, normally vacations go up 13-14% between June and July reflecting the beginning of the summer holiday season, and then they come down the same 13-14% between September and August as holidays are over. This year, though, for some strange reason that to my knowledge nobody from the Statistical office explained and I couldn't figure out, vacations went up almost 25% m/m in July. In September, then, they fell 22.3% m/m, thus contributing massively (0.5 pp) to the monthly decline of core inflation of 0.6% m/m. There were also lower prices in the transportation segment (-8.4% m/m) due to the discounts for student and seniors on public transport fares (impact -0.1 pp on monthly inflation). All in all, thus, not exactly "pure" demand effects.

CORE INFLATION DROPS MOST ON RECORD…



…AS VACATION PRICES PLUMMET IN A REVERSAL OF THEIR EXTRAORDINARY RISE TWO MONTHS AGO.



Year-on-year inflation then fell to 2.1% (from August's 2.5%), not quite as low as in June (1.9%) but close to warrant saying that inflation returned to early summer levels (i.e., before two hikes were made by CNB). Monetary policy inflation also decreased, but less so (from 2.4% in August to 2.2% in September) as both food and fuel prices rose (0.8% m/m and 0.6% m/m, respectively) in September. Food prices are set to rise further as a consequence of this year's drought (remember how hot it was in August).

If one realizes that September inflation already reflects early summer weakening of CZK in fullemployment economy and the massive increase of real estate prices - which show up as imputed rents in inflation and which are major reason why “accommodation” component of the inflation added 0.9 pp to the y/y inflation in September – one has to wonder where CNB still sees demand inflation threat.

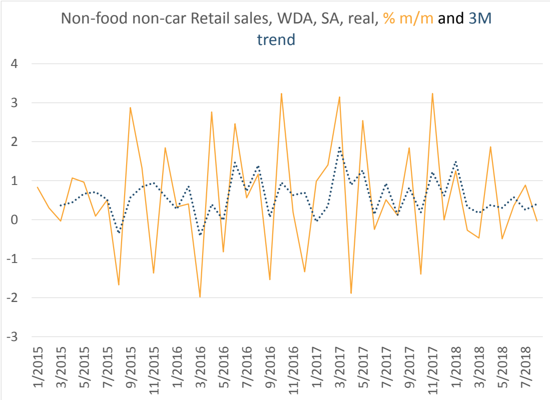
To me, from here, core inflation-wise things can only slow. Yes, headline can accelerate further it (food prices), but “demand” inflation pressures are now at their maximum. And hence tightening policy further makes no sense from inflation perspective. But since CNB is tightening primarily to rein in real estate prices and to create a maneuvering space for next recession, November 1 hike is almost certain now.

August data from the real economy support my view that local economy has already seen its best in this cycle.

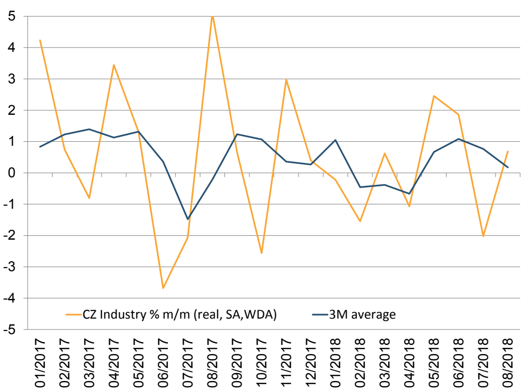
Retail sales posted another strong month in September, with core sales up 6.9% y/y (0% m/m). So, while by general standard not weak by any chance, this was another release that showed that economy has already peaked. See, household demand is not quickening: the three-month average m/m change has been cca. 0.3% (= the annualized growth has been around 4%) in all months of this year. Last year, it was double that and more regularly. That also means that once we move to 2019, unless retail sales accelerate, the annual growth rate of retail sales will slow to 4%.

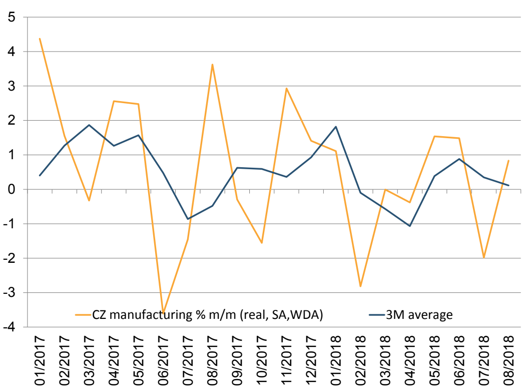
Industrial production / manufacturing also show clear signs of deceleration. It may not be that apparent from y/y numbers, and May/June growth of 1.5% m/m was certainly a surprise considering the weakness in Germany (see below), but taking the look at the entire 2018 makes it clear that growth dynamics slowed. In manufacturing, August growth of 0.8% m/m came after 2% contraction in July, so unless September is strong (which PMI at 1 ½ year low doesn’t suggest it will be), 3Q18 will see manufacturing having contracted over 2Q18.

RETAIL SALES REMAIN IN 4% ANNUALIZED GROWTH

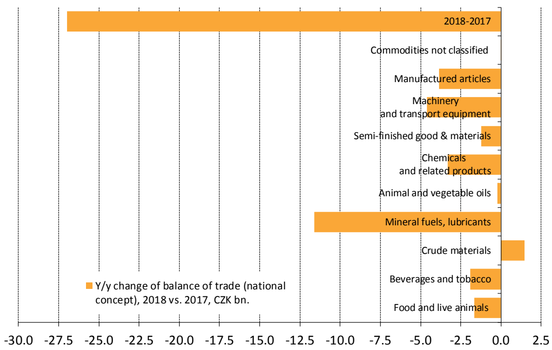


INDUSTRY SET TO CONTRACT FURTHER IN 3Q18

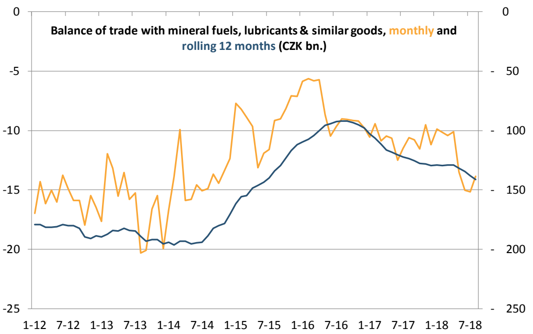




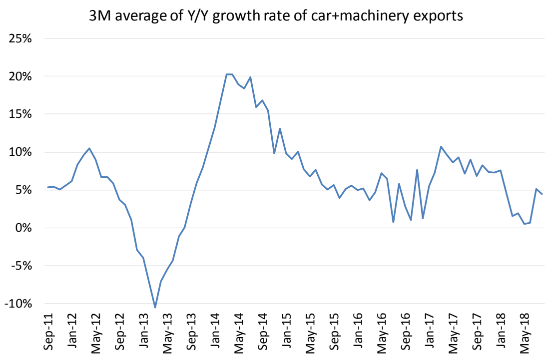
TRADE BALANCE ALMOST 30 BN. WORSE THIS YEAR AS AGAINST 2017,…



…MAINLY BECAUSE OF PRICIER OIL AND…



…SLOWDOWN OF VEHICLE EXPORTS.



Put together, economy is growing, yes, but it is clear the cyclical peak is behind us. Unfortunately, CNB and, more importantly, MinFin behave as if party should never stop.

Trade balance surplus was CZK 27 bn. smaller in the first 8 months of 2018 as against the same period of 2017.

This is the consequence of higher deficit (by CZK 11.6 bn.) in the trade of mineral fuels, a reflection of pricier oil, and of CZK 4.6 bn. smaller surplus in the trade with vehicles and machinery.
This latter is the result of faster growth of imports (4.2% y/y in first 8 months) as against that of exports (2.7% y/y). That imports of vehicles, machinery grew faster is consequence of strong aggregate demand growth, that exports grew weaker the consequence of weaker external environment. The y/y growth of exports of cars in the first 8 months of *2017* as against first 8 months of *2016* was 9.3%, so this year's 2.7% y/y (2018/2017) growth of exports in this category is a large slowdown

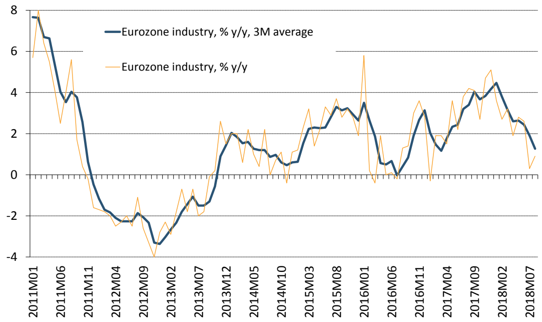
Looking forward, trade balance shouldn't worsen further. Yes, exports will probably slow down a bit further as PMI suggests industry will grow slower still, but so should aggregate demand and hence the imports.

| EUROZONE ECONOMY

Growth of industrial production remains weak across Eurozone.

This was seen in German data reported before the whole of Eurozone did last Friday: German industry stagnated in August after two prior months in which it outright fell; manufacturing component thereof fell for the third time in a row (-0.1%). Hence, industrial production grew only in two months in last three quarters ending in August. No wonder that the actual production is now just 7% higher than *three* years ago and 0.5% *lower* than in August last year.

EUROZONE INDUSTRY REMAINS WEAK IN MID-3Q18



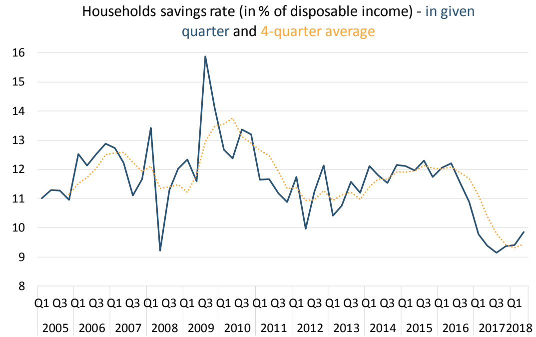
The drivers of that weakness are capital goods (-3.1% y/y) and consumer durables (-4.1% y/y). And looking forward, especially with unemployment having anywhere to fall further and trade war / hard Brexit still looming, it is unlikely we will see turnaround.

Eurozone industrial production did much better in August than its German component, but still barely grew y/y. Industry rose 1% m/m which – while not having made up for the declines (of 0.7% m/m) in July and June – meant that the decline of Eurozone industry in three months ending in August was not as large as in Germany. That Eurozone wasn't dragged much lower in last three months is due to growth over June-August in France, Spain and Italy (1.8%, 0.3% and 0.3%). Performance of French industry in recent months is a welcome surprise, although it only made up for the weak performance earlier this year.

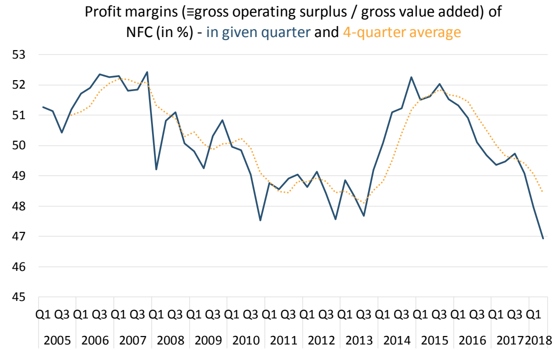
Generally, annual growth in none of these big economies is anything to write home about: true, Italy is really an underperformer (-0.8% y/y) and Germany is not too far behind (-0.5% y/y), but annual growth rate in Spain (+1.2%), France (+1.7%), while positive, leaves a lot to be desired. The overall Eurozone growth rate of 0.9% thus doesn't come as a surprise and is clearly very weak.

And, looking at PMI, it is unlikely that this will change in next 6 months.

Households savings rate still low, but off 4Q17 all-time lows

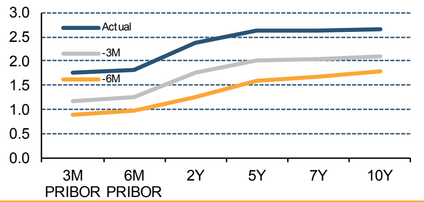


Profitability of Non-financial firms falls to new low.

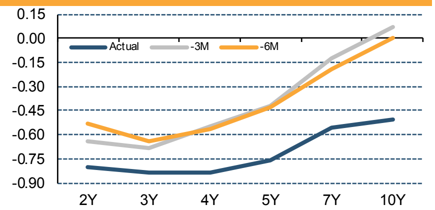


| Markets ‡

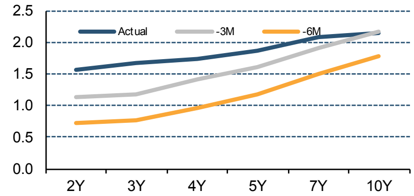
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	1.750	1.830	2.375	2.620	2.638	2.660
	-1M	1.540	1.650	2.170	2.373	2.380	2.408
	-3M	1.180	1.270	1.770	2.023	2.040	2.090
	-6M	0.900	0.990	1.250	1.605	1.689	1.780



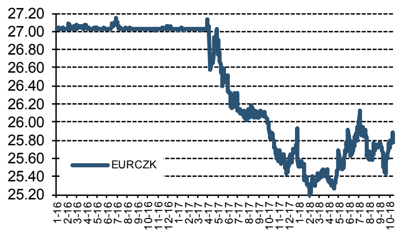
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-0.805	-0.836	-0.835	-0.761	-0.553	-0.505
	-1M	-0.700	-0.797	-0.661	-0.557	-0.315	-0.244
	-3M	-0.645	-0.686	-0.546	-0.426	-0.129	0.072
	-6M	-0.531	-0.639	-0.563	-0.430	-0.196	0.006



CZGB**		2Y	3Y	4Y	5Y	7Y	10Y
%	Actual	1.570	1.670	1.741	1.859	2.085	2.155
	-1M	1.470	1.482	1.675	1.816	2.065	2.164
	-3M	1.125	1.184	1.419	1.597	1.911	2.162
	-6M	0.719	0.770	0.965	1.175	1.493	1.786



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25.784	4.294	324.15	4.663	6.769	1.155
	-1M	25.477	4.306	324.85	4.640	7.175	1.163
	-3M	25.889	4.314	322.86	4.653	5.650	1.169
	-6M	25.301	4.168	310.81	4.661	5.054	1.233



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

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