Weekly | 2018 | Week 42

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Calendar

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Tuesday	23-Oct-18	16:00	EMU	(Flash) Consumer confidence, Oct'18,	-3.2	N/A
Wednesday	24-Oct-18	9:00	CZ	Consumer / Business Confidence, Oct'18	N/A	N/A
	24-Oct-18	10:00	EMU	(Flash) Manufacturing PMI, Oct'18	53.0	N/A
	24-Oct-18	10:00	EMU	(Flash) Services PMI, Oct'18	54.5	N/A
Thursday	25-Oct-18	10:00	GER	IFO Business Climate, Oct'18	106.0	N/A
	25-Oct-18	13:45	EMU	ECB Monetary-policy seeting meeting, Refinanicng / Marginal Lending / Deposit rate	0% / 0.25% / -0.4%	0% / 0.25% / -0.4%

* 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

"(Twitter) So, Saudi Arabia's ESG score stands for Electrocution, Suffocation and Garroting. ↗ "

WEEK AHEAD

ECB's meeting is clearly No.1 event of this week, followed by October's soft indicators.

Although there will be no change of the actual setting of the monetary policy, I am curious about how (or whether at all) will the ECB comment on the fact that inflation hasn't gone anywhere in last year. See, ECB's been earnestly persuading the investors that inflation will climb sustainable back toward the target soon for at least a year. Heck, it was what's motivated the announcement, back in early summer, to stop QE. The truth, however, is that since announcing that decision (core) inflation's been disappointingly persistent – at around 1%, i.e. far from ECB's target.

My view is that this won't matter: ECB will just repeat what it said before, i.e. be patient, core inflation will rise towards 2% and hence headline inflation will be sustainable.

And it will say so even if this week's releases of October soft indicators will likely show that economy is not accelerating, and, possibly, that it is doing just the contrary.

WEEK BEHIND

CZ: effect of weaker FX on consumer prices is over for now… ▶

….while effect of this year's drought is about to be felt ▶

CZ: current account still in large FX-relevant surplus ▶

EMU: inflation still very low ▶

| FX

EURCZK continued to weaken last week, getting within an arm's reach of 26.

Nothing in particular seems to have driven it – looks like merely the extension of the trend from previous week.

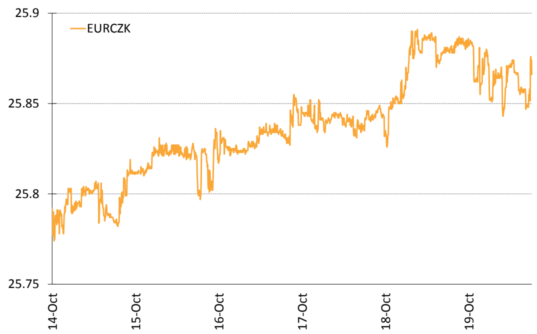
See, there weren't many FX-worthy news last week. Dedek's interview in Reuters ↗ certainly wasn't anything like that. Dedek, one of the very few Board members who actually studied monetary policy, and, coincidentally, also the only member who voted against the last hike, repeated in the Reuters interview why he was against the hike at September meeting. The reasons were 1) the foreign risks (disorderly Brexit, trade war) and 2) weaker CZK, the latter having been blamed by him on "external" factors. He didn't say how he he'd vote at the next meeting on Nov 1, but said his objections to the current tightening path related to the speed of tightening rather than to general direction of travel. With which he is ok.

| FI

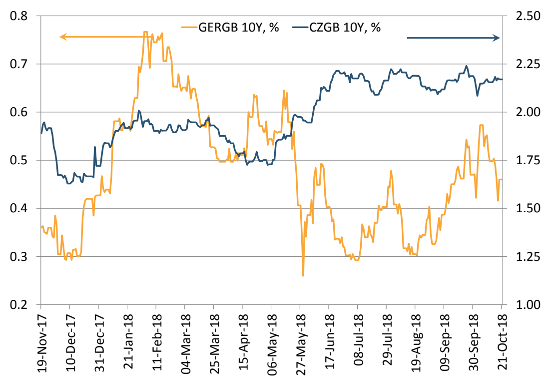
German yields extended their decline from previous week…

…hitting close to 40 bps. at 10Y at one moment last week. Italian bond market seems to have been the driver of German one last week, just like the week before.

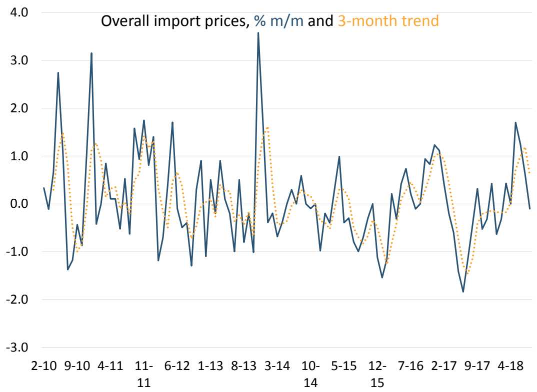
EURCZK CLOSE TO 26.



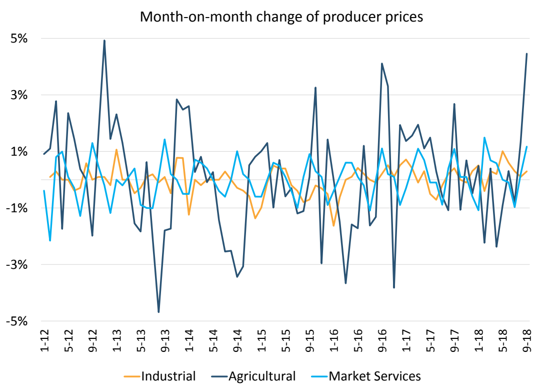
GERMAN 10YS YIELDS EXTEND THEIR DECLINE.



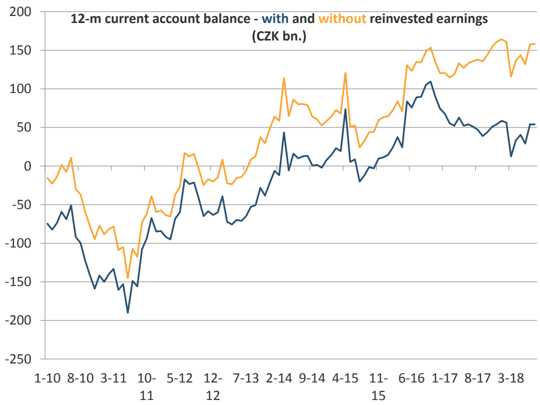
IMPORT PRICES FALL FOR THE FIRST TIME SINCE FEBRUARY AS WEAKER FX EFFECTS FADE



AGRICULTURAL PRODUCERS' PRICES RISE AS A CONSEQUENCE OF DROUGHT



CZECH CURRENT ACCOUNT STILL IN LARGE FX-RELEVANT SURPLUS



| CZECH ECONOMY

The effect of weaker exchange rate on the consumer prices is over for now, the effect of this year's drought is about to be felt.

The former conclusion comes from the August's import prices, the latter follows from September's PPI.

Import prices fell 0.1% m/m in August, their first decline since February of this year. This was mostly due to 1.4% monthly decline of import prices of raw materials and 0.8% decline of import prices of beverages and tobacco, but pretty much all categories (except for mineral fuels) stagnated or declined. This is thus clearly the consequence of weakening of CZK having filtered into prices quickly over the summer. Now, with CZK again weakening in October, import prices will have probably moderately increased, but it shouldn't be anything as large as to meaningfully influence the CPI in the remainder of this year.

Agricultural prices, on the other hand, most certainly will [push consumer price level up in the coming months]. This is clear from the September prices of agricultural producers: they went up 4.5% m/m (most since November 2012), mainly because of higher prices of cereals, oil plants, fresh vegetables. Although this sometimes happens in September, it is always the reflection of harvest: and 2018 harvest certainly wasn't strong. This will show up in consumer food prices soon.

In other production segments, nothing extraordinary happened: market services went up 1.2% m/m, usual September seasonality due to higher ad prices (market services always go up approx. 1.1% m/m in September). Industrial producers' prices rose 0.3% m/m in September, i.e. in line with previous months.

Current account remains strongly pro-CZK.

And that is despite the fact that the headline surplus did worsen in last two years, from 12-month surplus of around CZK 80-100 bn. at the end of 2016 to the current one of CZK 50 bn.

But this worsening is not a reflection of worse trade balance, it is the reflection of higher reinvested earnings (i.e., earnings stemming from FDIs not paid out as dividends). See, 12-month current account surplus *without* the reinvested earnings is now close to an all-time high (CZK 164 bn.) at CZK 158 bn. And since it is this surplus that matters for FX (as reinvested earnings don't impact FX), it is clearly pro-CZK. Except CZK is not influenced by domestic fundaments right now, but by external environment and unwinding of positions of speculators built up during last months of the CNB's interventions.

| EUROZONE ECONOMY

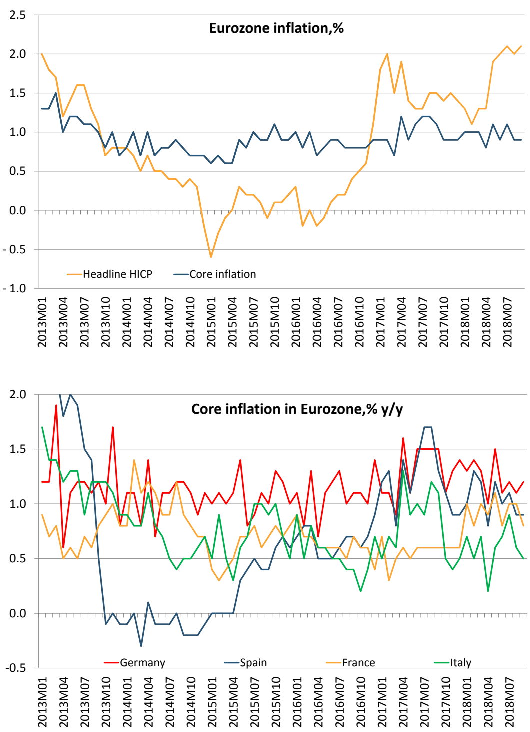
Eurozone core inflation remained far below levels forecast by ECB, as has been the case for last 5 years.

Final data for September showed the core inflation had risen just 0.9% y/y in September, the same rate of growth as in August. And it also meant that that core inflation hasn't been higher than 1.2% since March 2013. In last year, it remained in a tight range of 0.8-1.1%.

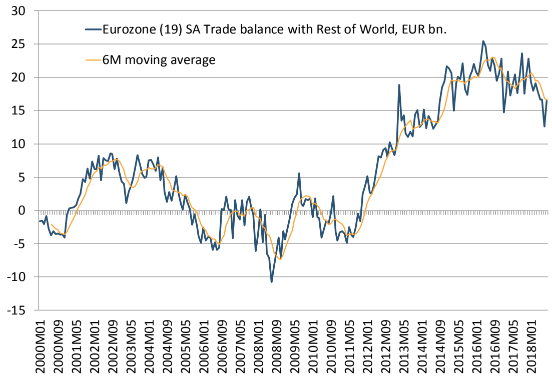
No wonder: none of the big economies' core inflation is higher than 1.2%. And 1.2% rate is one seen in Germany, i.e. economy that has been at full employment for at least three years now. That Italy's core inflation is merely 0.5% then doesn't come as a surprise.

Not that this ongoing undershooting of ECB target will make ECB refrain from pulling the plug on QE this December. But it does - or, more accurately, should - postpone the first hike beyond 2019. "Should" instead of "does" because ECB may easily do what CNB did: hike even when from strictly inflationary viewpoint it is not necessary. Because it will want to create maneuvering space for when next recession hits.

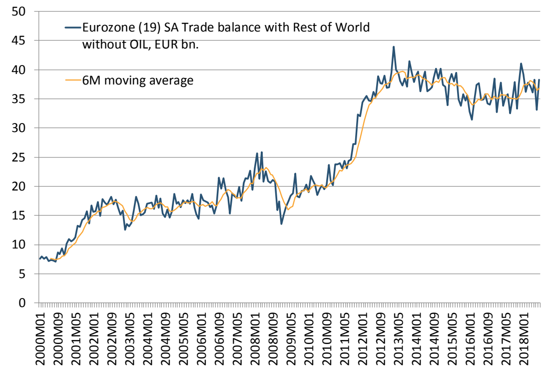
EUROZONE CORE INFLATION PERSISTENTLY LOW



EUROZONE TRADE BALANCE SURPLUS CONTINUES TO WORSEN,…



…BUT ONLY BECAUSE OF OIL.

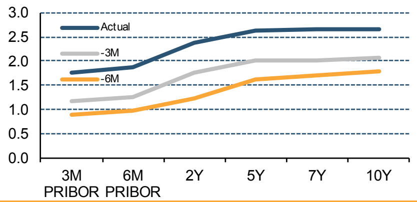


Eurozone trade balance continues to worsen, but only because of oil.

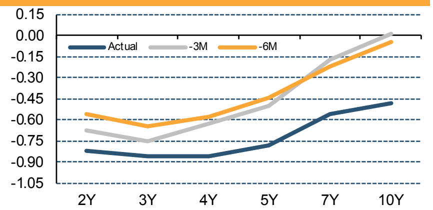
The 6-month rolling surplus fell to EUR 100 bn., which, although still very strong, is lowest surplus in 4 years. Now, if one were to believe ECB narrative, it might have been caused by the rise of imports due to strengthening domestic demand. But that is not the case: looking at the trade balance surplus *without* the oil, it is clear oil is the reason why surplus fell recently. See, 6-month surplus without oil is running at EUR 221 bn., only marginally (approx. EUR 15 bn.) below the all-time high from mid-2013. Which, if you think of it, is actually a pretty good result considering the weaker German exports of late.

| MARKETS ‡

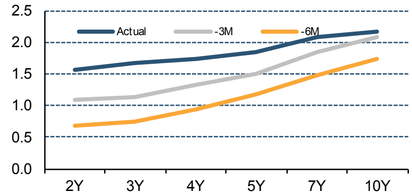
MM / IRS (%)	3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
Actual	1.770	1.860	2.385	2.640	2.648	2.655
-1M	1.560	1.680	2.230	2.410	2.417	2.428
-3M	1.180	1.270	1.757	2.010	2.025	2.080
-6M	0.900	0.990	1.235	1.620	1.700	1.795



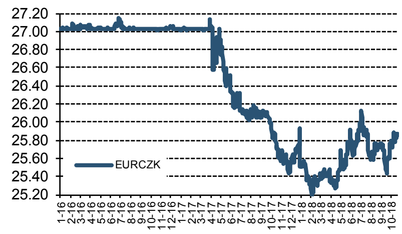
ASW spread* (bps.)	2Y	3Y	4Y	5Y	7Y	10Y
Actual	-0.823	-0.864	-0.859	-0.787	-0.561	-0.485
-1M	-0.717	-0.814	-0.632	-0.554	-0.320	-0.227
-3M	-0.676	-0.752	-0.630	-0.503	-0.174	0.010
-6M	-0.560	-0.648	-0.578	-0.448	-0.225	-0.052



CZGB** (%)	2Y	3Y	4Y	5Y	7Y	10Y
Actual	1.562	1.660	1.739	1.853	2.087	2.170
-1M	1.513	1.518	1.750	1.856	2.097	2.201
-3M	1.081	1.129	1.335	1.507	1.851	2.090
-6M	0.675	0.742	0.947	1.172	1.475	1.743



FX	EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
Actual	25.873	4.297	323.22	4.668	6.499	1.152
-1M	25.601	4.307	324.24	4.656	7.395	1.175
-3M	25.876	4.318	325.56	4.653	5.616	1.172
-6M	25.358	4.173	310.84	4.658	5.009	1.229



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

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