Weekly | 2018 | Week 44

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CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	5-Nov-18	9:00	CZ	Retail sales,Sep'18, y/y	0.9%	1.4%
Tuesday	6-Nov-18	8:00	GE	Industrial orders,Sep'18, y/y (WDA)	-2.8%	N/A
	6-Nov-18	9:00	CZ	Industrial production, Sep'18, y/y	-0.2%	-1.0%
	6-Nov-18	9:00	CZ	Trade Balance, Sep'18, CZK bn.	13.0	10.7
	6-Nov-18	10:00	EMU	(Final) Services PMI,Oct'18	53.3	N/A
Wednesday	7-Nov-18	8:00	GER	Industrial production, Sep'18, y/y (WDA)	0.2%	N/A
	7-Nov-18	11:00	EMU	Retail sales, Sep'18, y/y	0.8%	N/A
Thursday	8-Nov-18	9:00	SPA	Industrial production, Sep'18, y/y (WDA)	0.9%	N/A
	8-Nov-18	10:00	EMU	EC Update of Economic Forecasts	N/A	N/A
Friday	9-Nov-18	8:45	FRA	Industrial production, Sep'18, y/y (WDA)	1.1%	N/A
	9-Nov-18	9:00	CZ	CPI, Oct'18, y/y	2.3%	2.2%

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

NOVEMBER 2018 AUCTIONS

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
CZGB 2018-2029**	21-Nov-18	23-Nov-18	23-Jul-29	CZK 3 bn. max	2.75%
CZGB 2017-2033**	21-Nov-18	23-Nov-18	13-Oct-33	CZK 2 bn. max	2.00%

* 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

"RECREATING A BAR AT HOME SO THAT I WOULDN'T HAVE TO GO TO THE REAL THING TELLS ME EVERYTHING I NEED TO KNOW ABOUT THE MAN. ↗ "

WEEK AHEAD

Lots of data, mainly in CZ - retail sales, production and trade balance for September, and inflation for October.

First two of the releases are important in that we want to see how much of a slowdown was there in real economy at the end of 3Q18. **Industry** obviously must show having been affected by slowdown in Germany, the question is only the extent thereof. For **retail sales**, we've been seeing some loss of dynamics throughout this year, though growth is still very strong (core retail sales at 6-7% y/y is anything but weak). Both sales and production will show effect of one fewer working days in September 2018 vs. September 2017.

As regards **October inflation**, it is still an important release, but CNB seems determined to continue tightening no matter what, accommodation (=mainly imputed rents) being the main reason (accommodation subindex of CPI is responsible for 0.9 pp of 2.2% inflation). Thus, even if inflation fell to 1.5%, CNB wouldn't be dissuaded – hence, from monetary-policy perspective, do not wake up to see the print if you don't need to.

In **Eurozone, September retail sales** are important, but since we already know how retail sales did in September in France, Germany and Spain ►, we can't and will not be surprised. **German Sep'18 industrial production** will also not be anything to write home about: question is only about how weak it is.

WEEK BEHIND

CZ: PMI shows German flu is here…

…but for CNB, it is business as usual,…

…and so it is for MFCR.

EMU: 3Q18 GDP data and October inflation prove ECB unjustifiably optimistic

EMU: retail sales in France, Germany, Spain weak y/y

| FX

EURCZK remained weak despite central bank hike.

CNB is blaming turmoil in the markets, and that may be one reason, but the fact that CZK is still heavily overbought explains another part of the CZK's unwillingness to strengthen. Despite the interest rate differential that CNB resurrected at its last press conference (see below).

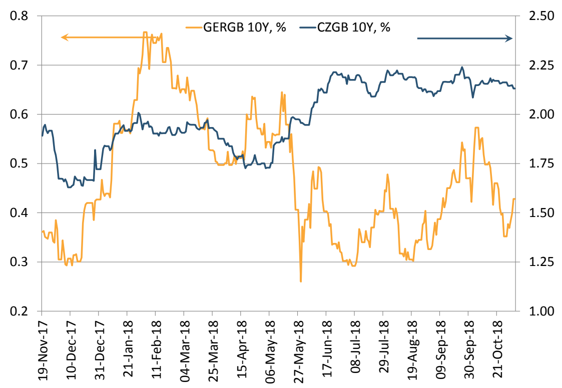
EURCZK WEAK DESPITE CNB HIKE

| FI

German 10Y yields returned back above 40 bps…

…as trade war spat showed some signs of subsiding - at least, if one trusts Trump …I personally don't – to me, this looks more about him feeling the need to respond to stock market dive (when you own the upside, you own the downside…), and also due to strong payrolls (250k new jobs, fastest wage growth in USA in 9 ½ years).

GERMAN 10YS RETURN ABOVE 40 BPS. AMID STRONG US PAYROLLS, RUMORS OF US-CHINA DEAL

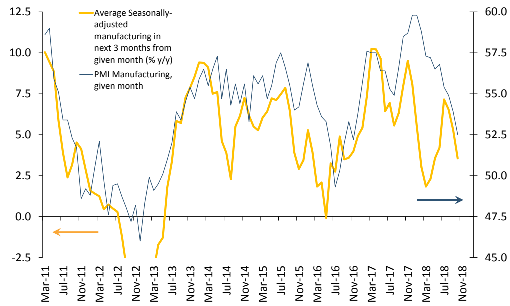


| CZECH ECONOMY

German flu is here for good.

Czech manufacturing PMI fell to almost 2-year low of 52.5 in October (November 2016: 52.2). Which isn't a shock considering that the final manufacturing PMI data from Eurozone showed last Friday that manufacturing there was weakest in October in 26 months (52 vs. 52.1 in first estimate).

CZECH PMI FALLS TO 23-MONTH LOW



Back to Czech PMI. Although the sub index of actual output is still firmly in the expansion territory, new orders grew only marginally and at their weakest rate in 26 months. In other words, when the orders are filled, we're going to see some softer numbers from industry.

Good news is that the weakness in new orders was partially linked to weaker demand from automotive sector. Why is it good? Because it is almost certainly due to production of some models having been halted pending the issuance of new homologations under new emission tests (World harmonized Light vehicle Test Procedure, or WLTP) introduced by EU in the wake of dieselgate. Number of models is still unavailable (AUDI RS6, for instance).

What is bad, mainly for investments, is that the **business expectations fell to lowest since July 2013**, mainly because of trade wars, combined with weaker automotive demand. The weakest subindex of employment since August 2016 is, on the contrary, not necessarily sign of weakness: it may reflect the inability, rather than unwillingness, to hire.

Put together: we will see further slowdown in industry in the coming months. Current levels of PMI are consistent with 2-3% annual growth of industrial production.

And yet, CNB couldn't care less – it is business as usual there "CZK will strengthen, inflation pressures are strong", you name it.

CNB thus chose to ignore the clear signs economy is slowing and hiked for the fifth time this year. The two-week repo thus stands at 1.75%, highest since June 2009. The reasoning? Well, new forecast said so…

Which is about the only reason why I think Michl is not a completely disastrous choice: all these CNB analysts with unwavering faith in models should really be complemented by someone not blinded by glitz of rigor of DGSE models.

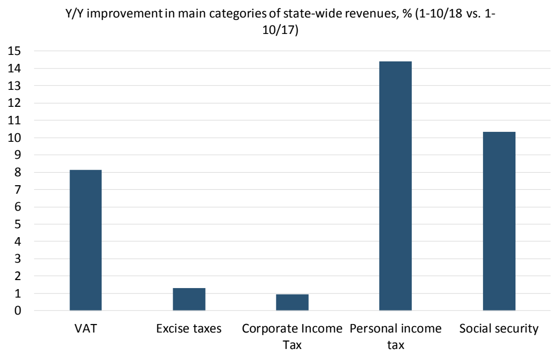
I mean, is the expectation that "*the euro area economy will record ongoing growth, but its pace will continue to slow slightly" really* consistent with 0.2% q/q growth seen in Eurozone in 3Q18 and soft indicators worsening further?

CNB also said that "domestic inflation pressures are strong" due to wages and, of course, weaker CZK. As for the former, CNB somehow forgets that accommodation accounts for 0.9 pp of 2.2% inflation, so hard to talk about "strong domestic pressures" High real estate prices would be more accurate description. As for the latter, CZK continues to defy CNB's overly optimistic expectations (remember February 2018 forecast which said EURCZK would be at 24.6 in 4Q18?) so while CNB still expects it to strengthen, 24.6 is now reserved for 2Q19. For that to happen, it explicitly resurrected interest rate differential: since it is now wide, it will push EURCZK down, CNB says.

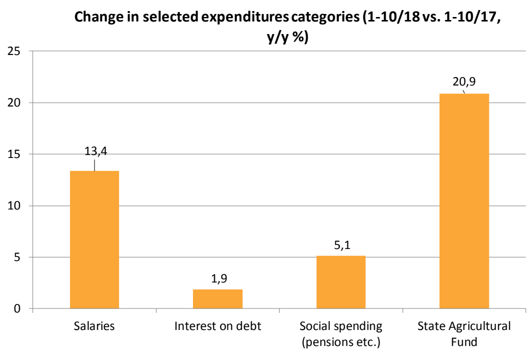
That EURCZK is main motivator for whatever is CNB doing is seen in its assessment balance of risks. See, CNB says Brexit, trade war, Italy are risks to the downside, but since CZK might stay weaker for longer, the balance of risks to forecast is "*pro-inflationary*". As if chaotic Brexit or escalation of Rome-Brussels conflict wouldn't have potential to cause recession in Eurozone (and thus here), and depress inflation even with CZK substantially weaker (see 2009).

Oh, and by the way, one member of Board voted for 50 bps. hike. I wouldn't be surprised if it were Hampl, who two years ago advocated later end of interventions…Doves will be hawks, classic would say.

CZECH BUDGET: CURRENT REVENUES RISE…



…AND SO DO CURRENT EXPENDITURES.



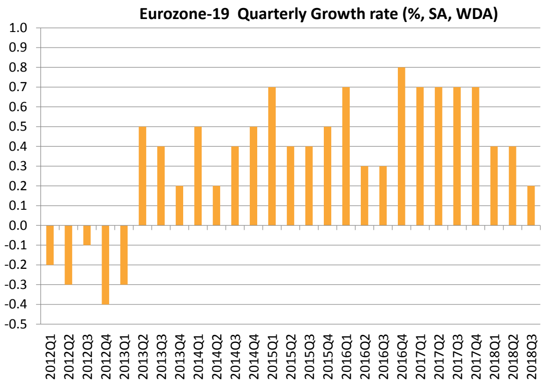
Czech budget ended up in a small surplus of 2 bn. in first ten months of this year.

This figure, adjusted for EU money on both expenditures' and revenues' side of the budget, was CZK 15 bn. smaller than for the same period of 2017.

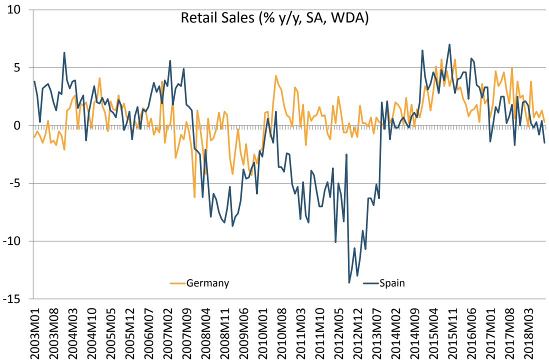
The revenues rose 8.4% y/y, with tax revenues (constituting 90% of all revenues) up 7.2% y/y, i.e. by CZK 68 bn. Since capital expenditures rose CZK 28 bn. while net EU inflows were approx. CZK 20 bn., i.e. offsetting each other to a good extent, we can concentrate on current revenues and current expenditures when talking about the budget.
And despite the Michl's "we're doing great" article in Pravo ↗, when doing so the picture that emerges is bleak. Why?
Well, because government managed to squander all the increase in revenues away and did so to a good extent on things that are next to impossible to adjust back lower if (when) needed, like wages. See, current expenditures are 8.3% (i.e., CZK 80 bn.) y/y higher, with CZK 17 bn. due to higher pensions, CZK 11.5 bn. due to higher salaries of central government employees (+ additional CZK 13bn. for transfers to elementary / secondary schools set up and run by municipalities in order to cover wage increases there), CZK 4 bn. on Agricultural fund etc. Except maybe for this last things, all of the previous increases, totaling CZK 41.5 bn., will stay even if economy slows. And if the economy didn't grow at all now – which it easily may not next year (Brexit, Italy, trade war) – then this would immediately equal the deficit.

In other words, under the veneer of headline budget surplus is a ticking bomb. Because while current revenues can (and will fall), current expenditures have a well-known tendency to be rather (=very) inflexible downwards.

EUROZONE GROWTH SLOWS MUCH MORE THAN EXPECTED.



RETAIL SALES CONTINUED TO WEAKEN IN GERMANY, SPAIN IN 3Q18



| EUROZONE ECONOMY

Last week's Eurozone data were anything but to ECB's liking. After last week, I'd say Governing Council should start to do what it said it had no reason to last week, i.e. to "*doubt [its] confidence that inflation is gradually converging to [its] aim.*" *(page 5* ↗).

See, **GDP growth slowed much more than expected: 0.2% q/q** was half the expectation of 0.4% q/q expansion. This was due to slower growth in all big economies except for Spain (0.6% q/q): Italy ground to a halt (0% q/q) from what was already pretty abysmal growth of previous quarter (0.2%), France came in at 0.4% q/q (vs. expectation of 0.5% q/q and 0.2% q/q in 2Q18) and Germany like did poorly, judging from overall Eurozone data (Germany releases the first preliminary estimate on November 14, so this is just a guess). The structure is not yet known, but from monthly data it looks like foreign trade dragged the growth down further, mainly because of exports.

French structural data, as usual the only data available at the time of Eurozone preliminary growth release, are of no help to decipher the structure for the entire Euro area, because French quarterly growth was the only one that quickened compared with 2Q18. In France, gross fixed capital formation grew at almost the same rate in 3Q18 (0.8% q/q) as in 2Q18 (0.9% q/q), foreign trade contribution to growth switched from negative 0.1 pp. to positive 0.2 pp, and the growth of household consumption recovered to 0.5% q/q from -0.1% q/q in 2Q18. But this is unlikely how whole of EU looked like. We shall see soon.

France was the only country to see retail sales grow in 3Q18, so no wonder its economy quickened in 3Q18. Tight labor market in Germany and improvement thereof in Spain, on the other hand, didn't appear to have translated into faster domestic demand.

Last week's release of September retail sales data for Spain (-0.6% m/m), Germany or France (0.1% m/m each) meant that retail sales fell over 1% q/q in 3Q18 in Germany and Spain, and rose only in France (1% q/q). The y/y growth rates are weak in all of these countries: 0.3% in Germany, 2.3% in France, -1.5% in Spain. How does that rhyme with confidence ECB Governing Council exuded seen at the last meeting (page 4-5 ↗), I don't know.

Time to reconsider the end of QE, if you ask me. Not that I think ECB will. Anyway, EURUSD fell to the lowest (1.132) since end of June 2017.

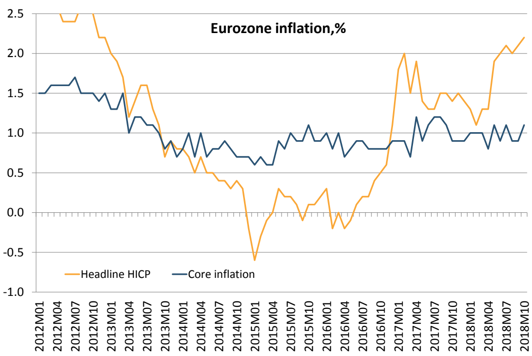
Reconsidering QE? Yes, more so that inflation is still not going anywhere.

The headline inflation did rise in October to highest (2.2%) since December 2012, but that is only due to the fact that energy prices rose further. After three months when they grew at 9.5% y/y, they rose 10.6% y/y in October, the fastest annual growth since November 2011 (12.3%).

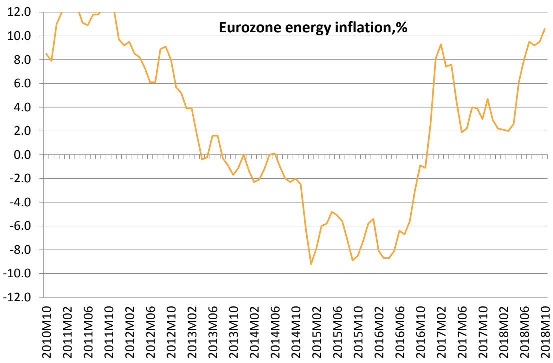
By the way, do you remember that it was in response to the oil prices that ECB *hiked* the rates in April 2011, and then again in July of that year, despite the looming debt crisis – I kid you not. ECB then took the hikes back pretty quickly, starting at around this time in 2011, as oil price base effect was about to set in…Feels somewhat familiar to what we see now – except it is not about hiking prematurely, but about ending the QE prematurely. Both are tightening operations, if, obviously, on much different scale.

Core inflation, it goes without saying, stayed where it's been for years now (around 1%) – in October at 1.1%. And judging from the soft indicators pointing to further slowdown of growth in 4Q18, it doesn't look like it is going to go to 2% soon.

EUROZONE HEADLINE INFLATION HIGHEST IN 7 YEARS, BUT…

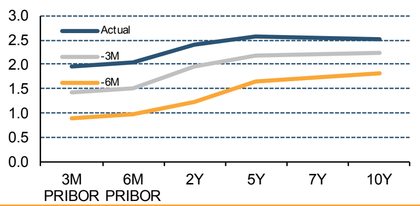


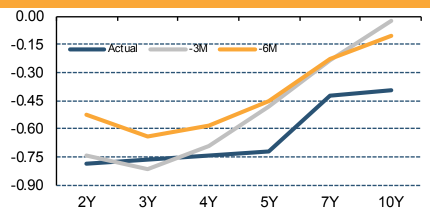
…ONLY BECAUSE OF ENERGY PRICES.

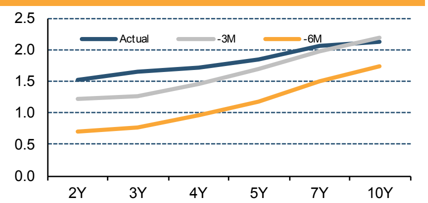


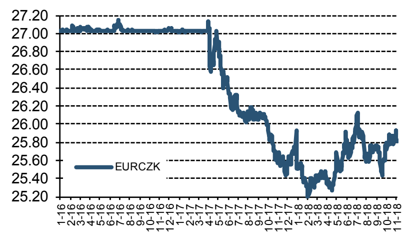
| MARKETS ‡

MM / IRS	3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
% Actual	1.960	2.030	2.393	2.565	2.542	2.525
-1M	1.730	1.800	2.275	2.505	2.518	2.530
-3M	1.420	1.510	1.955	2.180	2.203	2.225
-6M	0.900	0.990	1.240	1.635	1.725	1.830
ASW spread*	**2Y**	**3Y**	**4Y**	**5Y**	**7Y**	**10Y**
bps. Actual	-0.790	-0.763	-0.744	-0.725	-0.425	-0.394
-1M	-0.781	-0.860	-0.816	-0.751	-0.531	-0.445
-3M	-0.747	-0.815	-0.695	-0.482	-0.236	-0.027
-6M	-0.529	-0.644	-0.584	-0.452	-0.227	-0.104
CZGB**	**2Y**	**3Y**	**4Y**	**5Y**	**7Y**	**10Y**
% Actual	1.513	1.658	1.718	1.840	2.051	2.131
-1M	1.494	1.549	1.656	1.754	1.987	2.085
-3M	1.208	1.258	1.446	1.698	1.967	2.198
-6M	0.711	0.773	0.960	1.183	1.498	1.726
FX	**EURCZK**	**EURPLN**	**EURHUF**	**EURRON**	**EURTRY**	**EURUSD**
Actual	25.808	4.309	321.70	4.659	6.187	1.139
-1M	25.723	4.302	322.91	4.667	6.945	1.148
-3M	25.615	4.262	320.21	4.618	5.882	1.157
-6M	25.501	4.266	313.92	4.666	5.055	1.199









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

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