Weekly | 2017 | Week 45

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Calendar

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	6-Nov	8:00	GER	Factory orders, Sep'17, y/y (WDA)	7.1%	N/A
	6-Nov	9:00	CZ	Retail sales, Sep'17, y/y	2.6%	4.0%
	6-Nov	9:00	CZ	Industrial production, Sep'17, y/y	3.5%	4.0%
	6-Nov	10:00	EMU	(Final) Services PMI, Oct'17	54.9	N/A
Tuesday	7-Nov	8:00	GER	Industrial production, Sep'17, y/y (WDA)	4.5%	N/A
	7-Nov	10:00	ITA	Retail sales, Sep'17, y/y (SA)	0.5%	N/A
	7-Nov	11:00	EMU	Retail sales, Sep'17, y/y (SA)	2.8%	N/A
Wednesday	8-Nov	9:00	CZ	Unemployment, Oct'17, y/y	3.6%	N/A
	8-Nov	9:00	SPA	Industrial production, Sep'17, y/y (WDA)	3.2%	N/A
Thursday	9-Nov	9:00	CZ	CPI, Oct'17, y/y	2.7%	2.6%
Friday	10-Nov	8:45	FRA	Industrial production, Sep'17, y/y (WDA)	3.1%	N/A
	10-Nov	10:00	ITA	Industrial production, Sep'17, y/y (WDA)	4.8%	N/A

* Local time is CET
** (Reuters/ Bloomberg) Poll

November 2017 Auctions

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
SPP 772	2-Nov-17	3-Nov-17	8-Dec-17	CZK 5bn. max	N/A
CZGB 2015-2023	8-Nov-17	10-Nov-17	25-Oct-23	CZK 4bn. max	0.45%
CZGB 2017-2027	8-Nov-17	10-Nov-17	10-Feb-27	CZK 4 bn. max	0.25%
CZGB 2017-2033	8-Nov-17	10-Nov-17	13-Oct-33	CZK 4 bn. max	2.00%
SPP 773	16-Nov-17	20-Nov-17	29-Dec-17	CZK 5bn. max	N/A
CZGB 2017-2020	22-Nov-17	24-Nov-17	10-Feb-20	CZK 4 bn. max	0.00%
CZGB 2015-2026	22-Nov-17	24-Nov-17	26-Jun-26	CZK 4 bn. max	1.00%
CZGB 2015-2030	22-Nov-17	24-Nov-17	15-May-30	CZK 4 bn. max	0.95%

* For T-Bills, this is maximum amount per primary dealer.

Thought of the Week

" Wish there was a way to short people queuing up for iPhones X. "

WEEK AHEAD

The usual monthly data from Czech economy including, most importantly, inflation, are to be released this week.

Retail sales as well industrial production in September were influenced by one less working day in 2017 as compared with 2016. Ignoring that, the September rebound of PMI from August 2017 low should be reflected in strong performance of industry while tight labor market (lowest Eurostat unemployment rate in the whole EU) and high confidence continue to support the household demand.

The most important release is that of October inflation, though it will not yet show the base effect (from food prices and EET) that will set in from November on. The evolution of monthly dynamics of demand inflation is, however, of key interest: demand inflation dynamics has been slowing since the peak at the beginning of this year, but remains higher than last year nonetheless. How high the inflation will be once base effects disappear (spring next year) will be determined by how strong the demand inflation really is. And October release is important in that respect.

In Eurozone, industrial and retail sales data will confirm that the economy continued to grow at the end of 3Q17. The data being for September (for which the 1st estimate of GDP growth is already available) the releases are, however, not that important (even if they were to surprise on the upside, the effect on GDP growth revision would only be small).

WEEK BEHIND

CNB delivers a hike, but surprises with a dovish forecast ▶

CZ manufacturing PMI highest since April 2011 ▶

Trade balance still in a large surplus, machinery exports offset pricier commodities ▶

CZ government still squandering the growth-induced tax revenues ▶

Eurozone growth slowed in 3Q17,but remains solid and on track to beat US one for 2nd year in a row ▶

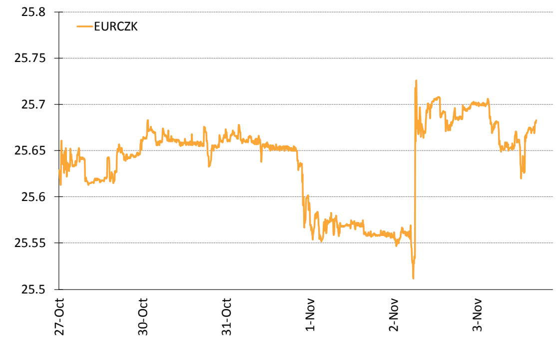
Strong growth and improvement of labor market nonetheless, EMU inflation remains very weak ▶

| FX

EURCZK weakened above 25.70 in response to the CNB meeting.

This was nothing spectacular, but shows that the market was positioned for more aggressive communication from CNB.

EURCZK STRENGTHENS…

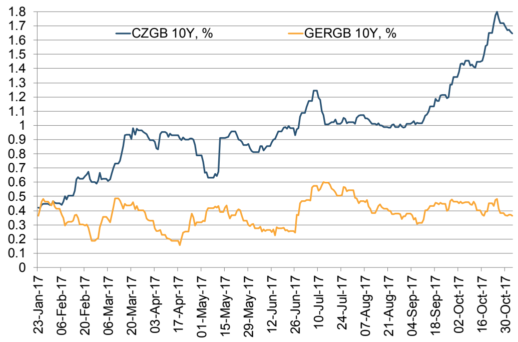


| FI

Czech long-dated bond prices fell in response to CNB meeting.

As with EURCZK, the market was apparently disappointed with the fairly dovish outcome of the CNB meeting. They, however, still remain substantially higher than few weeks back. The market obviously still continues to think that CNB will hike aggressively in the end – and so do most of the analysts (ING forecasting three, KB four hike next year).

…AND YIELDS ON LONGER CZGBS FALL AFTER THE DOVISH CNB MEETING



| CZECH ECONOMY

CNB hiked, but otherwise was fairly dovish. To my liking, and a bit of a surprise.

The hike of the key two-week repo rate by 25 bps. to 50 bps. was a foregone conclusion, as the previous meeting already saw the vote on tighter policy that didn't pass with only the smallest margin possible (3 for, 4 against). The recent weeks saw intensification of speculation that the hike might actually be 50 bps. and CNB admitted that it did discuss this possibility at the November meeting, though it hasn't voted on it.
In my eyes, 50 bps. was never going to happen, considering the recent ECB QE extension, the Czech inflation peaking (as CNB itself acknowledged in the forecast), the message of panic 50 bps. hike would convey and the blow to CNB professionalism it would mean. On this last point, please recall that as recently as in 1Q17 CNB was busy buying hundreds billions of CZK worth of foreign currency to ward off the alleged deflation threat…To say not even 9 months later that hike of extraordinary size is needed to ward off inflation wouldn't be exactly the proof of forecasting prowess of CNB…

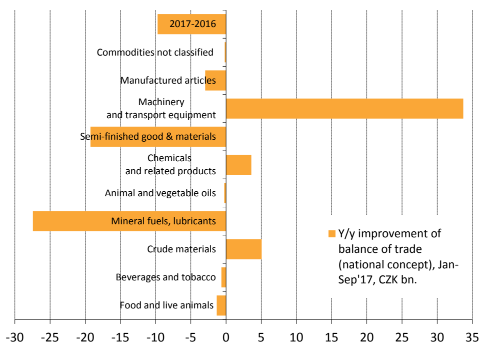
What was fairly surprising was the new forecast. Although it does see higher trajectory of the repo rate in 1H18, it is only marginally so (25 bps.) and thus is at odds with the previous statement of some Board members (like Benda) who spoke about more dramatic one. Either the extension of QE by ECB or the expectation of the strong CZK could have imparted dovishness to the forecast. While the latter is not yet known since CNB didn't release the trajectory of EURCZK implicit in the forecast (it will start doing so from February next year), it in my eyes couldn't have been the reason for the dovish inflation forecast since CNB indicated elsewhere in the statement that it continues to worry about massive speculative positions in CZK and its potential weakening.

To me, the dovish forecast is really a reflection of few things: 1) the expectation that CZ inflation will soon head down on EET / food base effects 2) import prices (which have fallen over 6% this year, and fell each month through August, the last data available), 3) the realization that economic growth doesn't automatically imply high inflation (see FED) and 4) the fact that longer interest rates rose strongly over last two months (for mortgages, what matters are IRS, for example).

Personally, I think these two hikes we saw this year were more of CNB trying to normalize the policy while it can and less of a reflection of its conviction of the need to nip the inflation threat in a bud. Contrary to others in the market, I see very little further hikes next year (one at the maximum).

Trade balance remains in only slightly smaller surplus than last year, the strong growth of domestic demand nonetheless.

TRADE BALANCE 2017: GROWTH OF MACHINERY EXPORTS OFFSETS PRICIER COMMODITIES



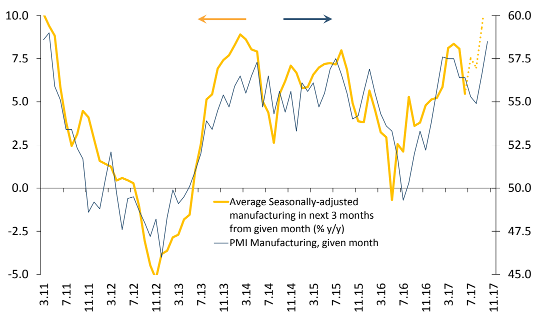
The balance in September was about 0.8 bn. higher than in September 2016, i.e. CZK 20.2 bn., bringing the (national concept) trade balance surplus in the first three quarters of this year to CZK 139.25 bn., only about CZK 10 bn. less than in the same period of 2016.

Although the number is not much different from 2016, the structure of the trade balance surplus is. On the one hand, the change in oil/commodity prices and the stronger economic growth resulted in the 40% (CZK 27 bn.) larger deficit in the trade with mineral fuels and CZK 20 bn. increase in the deficit of trade with materials and semi-finished goods. On the other hand, the CZK 95 bn. in more machinery exports this year coupled with just CZK 60 bn. in growth of machinery imports mean that the increase of machinery trade surplus almost offset the negative impacts of pricier commodities on Czech trade balance.

Externally, thus, the Czech Republic is in a perfect shape.

Manufacturing PMI improved further, suggesting Czech manufacturing will finish

MANUFACTURING PMI HIGHEST SINCE APRIL 2011



2017 on a strong note.

The increase of PMI to 58.5 brought the level to highest since April 2011 (59) and is now at levels indicating the growth of manufacturing of about 7.5% y/y in the final quarter of 2017. New orders' growth is fastest since May 2014, output prices rose at the fastest level since April 2011 (due to rise in raw material costs) and backlogs rose at the one of the fastest rate since that month.

Very interestingly, the suppliers' delivery times were longest in PMI series history. This led to further increase in stock levels of companies which indicates that inventories may have been substantial positive contributor to 3Q17 GDP growth.

Budget ended up in a surplus of CZK 26.5 bn. in first ten months of the year. Whatever the surplus, government running the country is doing it as irresponsibly as ever.

The year-to-date budget surplus was significantly smaller than one seen in January-October 2016 (surplus of CZK 98.3bn.), but this is only because of EU money impacting cash balance. In 2016, EU reimbursed Czech government for the money the government spent on projects in previous years – this obviously resulted in huge y/y bump in non-tax revenues in 2016 and corresponding drop in 2017. Adjusting for effects of EU programs on both expenditures' side and revenues' side of the budget reveals the budget balance is similar in both 2016 and 2017: **CZK +13.5 bn. surplus in first ten months of 2016 as against CZK 16.8 bn. in first ten months of 2017.**

However, considering that the economic growth this year is significantly faster than in 2016, it means government is anything but frugal and responsible.

See, the overall *state* tax revenues are up 7.7% this year, with VAT up 9.1% y/y (26.3 bn.), personal income tax up 11.6% (16 bn.) and social security contributions up 8.4% (29.5 bn.). **The *central* government tax revenues** (a subset of state tax revenues as these are split between central government and municipalities) **are up 7.3%, i.e. CZK 64.3 bn.** (the non-tax revenues are down 85.8 bn. due to CZK 79.5 bn. less in EU money this year). The spending, however, is also up, with 5.2% increase being primarily due to **6.6% (CZK 60 bn.) increase in current expenditures.** This increase is due to the election year spending increases (wages +8.4% y/y, social spending + 4.8% y/y etc.).

In other words, government managed to spend almost all of the additional tax revenues (CZK 64.3 bn.) **on higher current expenditures** (CZK 60 bn.). So much for running this country as a firm…

| EUROZONE ECONOMY

Eurozone is well on track to outpace US for the 2nd year. The quarterly growth in 3Q17 (0.6% q/q) was just 0.1 pp below 2Q17, while the annual one was fastest since 2011.

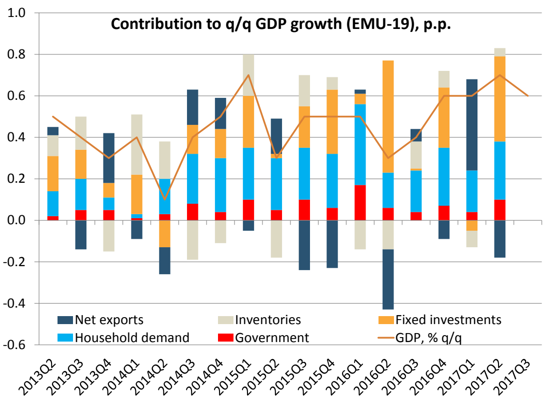
Moreover, last few quarters saw upward revisions (though small ones) between first and last GDP growth estimates, so we may see this revised up again.

To a good extent, the solid growth is due to 1) France which grew very solid 0.5% q/q (and which trend y/y growth is now above 2%) and 2) Spain (0.8% q/q, 3.1% y/y).

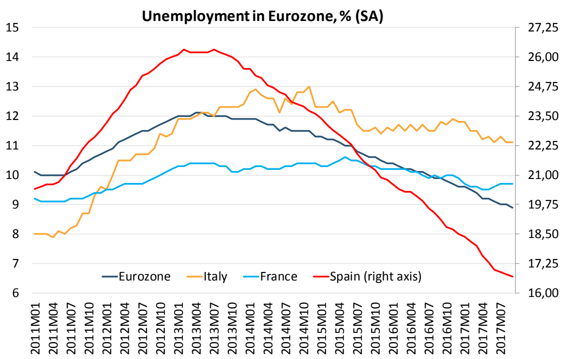
In case of the latter, the Catalonian political crisis might have taken a toll on the economy in the 4Q17. For the former, the growth was driven by further improvement of aggregate domestic demand (households +0.5% q/q, fixed investments +0.8% q/q) whereas the net exports were a drag (unsurprisingly, given the strength of the domestic demand and stronger euro). The structure of the growth of the entire Eurozone is not available but it will not be too different from French one.

Economic growth and labor market improvements don't automatically guarantee

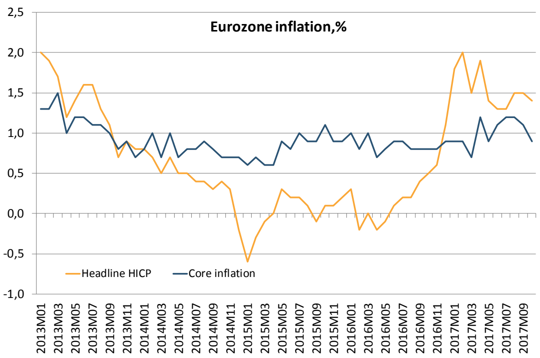
EUROZONE 3Q17 GROWTH JUST A BIT SLOWER AGAINST 2Q17



DESPITE STRONG GROWTH AND LABOR MARKET IMPROVEMENT…



…EUROZONE INFLATION REMAINS VERY WEAK.

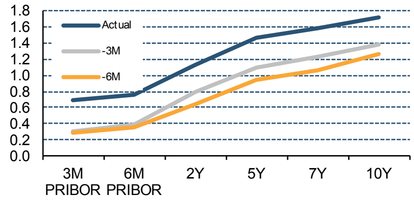


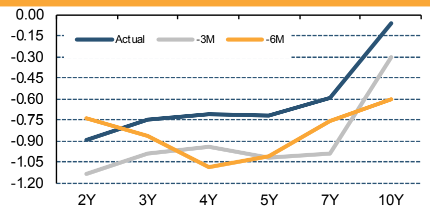
faster inflation, though.

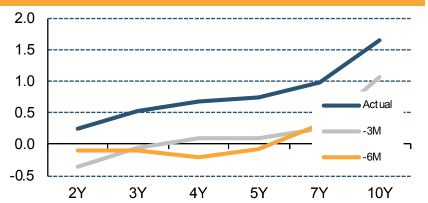
Eurozone **unemployment** fell below 9% for the first time since early 2009, with y/y improvement of the unemployment rate being 1 p.p. (i.e., just like in the previous months). **Inflation**, however, fell as well, with headline one edging down to 1.4% and, more importantly, the core one falling back below 1% to joint-lowest since May (0.9%). So much for Weidmann's calls for a complete end to QE soon, and another support for our view that ECB is years away from any meaningful tightening of the policy.

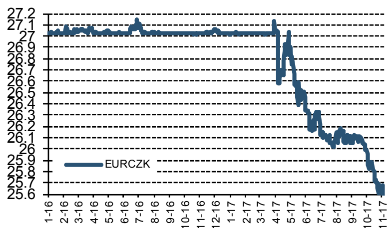
| Markets ‡

MM / IRS	3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%						
Actual	0.690	0.760	1.130	1.460	1.577	1.710
-1M	0.470	0.530	1.000	1.360	1.475	1.620
-3M	0.310	0.390	0.785	1.103	1.231	1.373
-6M	0.290	0.360	0.640	0.940	1.065	1.265
ASW spread*	**2Y**	**3Y**	**4Y**	**5Y**	**7Y**	**10Y**
bps.						
Actual	-0.893	-0.749	-0.710	-0.717	-0.598	-0.063
-1M	-0.959	-0.905	-0.953	-0.947	-0.820	-0.187
-3M	-1.141	-0.988	-0.942	-1.020	-0.995	-0.306
-6M	-0.742	-0.868	-1.088	-1.012	-0.755	-0.600
CZGB**	**2Y**	**3Y**	**4Y**	**5Y**	**7Y**	**10Y**
%						
Actual	0.237	0.527	0.670	0.743	0.979	1.647
-1M	0.041	0.251	0.317	0.413	0.655	1.433
-3M	-0.356	-0.065	0.083	0.083	0.236	1.067
-6M	-0.102	-0.095	-0.218	-0.072	0.310	0.665
FX	**EURCZK**	**EURPLN**	**EURHUF**	**EURRON**	**EURTRY**	**EURUSD**
Actual	25.683	4.244	310.78	4.594	4.515	1.161
-1M	25.927	4.316	312.09	4.587	4.195	1.174
-3M	26.046	4.241	303.81	4.560	4.205	1.187
-6M	26.747	4.207	311.88	4.546	3.849	1.089









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

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