

November 13 | 2017

## Weekly | 2017 | Week 46

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## CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Tuesday	14-Nov	8:00	GER	(1st est.) GDP, 3Q17, q/q (SA)	0.6%	N/A
	14-Nov	9:00	CZ	(1st est.) GDP, 3Q17, q/q (SA)	0.3%	-0.2%
	14-Nov	10:00	ITA	(2nd est.) GDP, 3Q17, q/q (SA)	0.5%	N/A
	14-Nov	11:00	EMU	Industrial production, Sep'17, m/m (SA)	-0.6%	N/A
	14-Nov	11:00	EMU	(2nd est.) GDP, 3Q17, q/q (SA)	0.6%	N/A
Wednesday	15-Nov	11:00	EMU	Trade balance, Sep'17, EUR bn. (SA)	21.00	N/A
Thursday	16-Nov	9:00	CZ	PPI, Oct'17, y/y	1.4%	1.6%
	16-Nov	9:00	CZ	Export / Import prices, Oct'17, y/y	N/A	N/A
	16-Nov	11:00	EMU	(Final) HICP, Oct'17, y/y	1.4%	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

“HOW AMERICA LOST ITS MIND” ↗.

## WEEK AHEAD

The growth of the economy for 3Q17 is to be released, and I expect q/q contraction.

This is the consequence of two facts. First, the retail sales were weaker in 3Q17 than in 2Q17. Obviously, retail sales aren't ideal proxy for household demand, but I don't expect household demand to have diverged from retail sales so much as to actually increase against 2Q17 when sales haven't. Second – and this is very uncertain – I think fixed investments contracted after 6.4% q/q growth in 2Q17. Here, because of the lack of monthly data, I can be wrong.

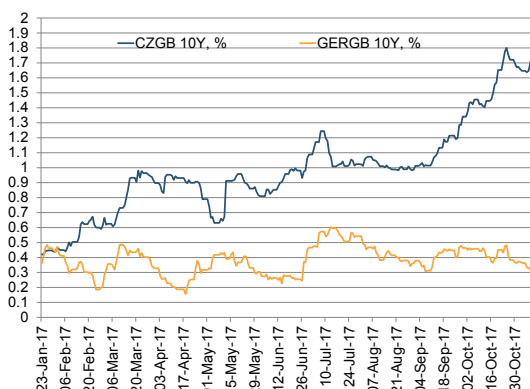
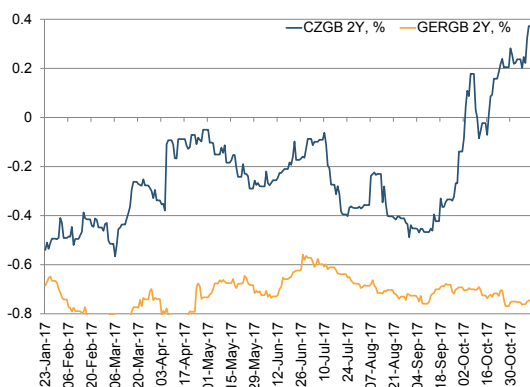
As for the other data this week, export / import prices are of importance. We've seen eight consecutive monthly declines of import prices of manufactured consumer goods this year, and with CZK stronger in September, we'll probably see ninth one once import prices' data for September are released on Thursday.

In Eurozone, first structural data on growth in the 3Q17 will be released. So far, only French data are available, and they show domestic demand (of both households and of firms) to have been the driver. The retail sales data for September, released last week, showed growth, but even with that the 3Q17 retail sales' growth was slower than in 2Q17. The growth, of course, it was, though.

**EURCZK FALLS ON HIGHER THAN EXPECTED INFLATION, 25.50 HOLDS**



**SELL-OFF IN BOND MARKETS RESUME AFTER HIGHER-THAN-EXPECTED INFLATION READING**



**WEEK BEHIND**

- ▶ **Czech inflation peaked in November**
- ▶ **Retail sales roared back to strong growth in September**
- ▶ **Industry grows in line with PMI-derived expectations**
- ▶ **Eurozone sales quicken after two weak summer months**
- ▶ **Bonds' sell-off resumes on higher-than-expected inflation**

**| FX**

**Faster than expected inflation sent EURCZK towards 25.50.**

But it wasn't enough to break the level. And no further stimulus could have come from the minutes from the CNB's recent MP meeting as no new information was contained therein. In a nutshell, CNB sees local wage growth as inflationary factor counterbalanced by anti-inflationary import prices. It expects the inflation to slow from now on and sees the future evolution of EURCZK as a big unknown. Hiking by 50 bps. at the November meeting was ruled due to fiscal stability concerns (*"it could be counterproductive from the financial stability perspective by putting an excessive load on indebted entities"*), because of the fact that inflation expectations are well anchored; it was also noted that frequent meetings (every 6 weeks) allow CNB to respond fast if inflation pressures increase. I would add that the increase of market rates (IRS) surely also played a role.

Not that my EURCZK forecasts have been much good lately, but with my inflation outlook (read below) I think EURCZK @ 25.50 is about as low as it gets: revaluation of inflation and rate outlook will send it higher soon.

| FI

**Post-CNB correction in bond markets was cut short by higher than expected September inflation.**

As indicated with CZK, I don't think this will hold. Next few months will see repo rate outlook revised down, and so will move the yields.

| CZECH ECONOMY

**Czech (monetary-policy relevant) inflation (MPRI) peaked in October. It will start decreasing in November, eventually convincing the EURCZK market that 2018 won't see CNB hiking as much as is now expected.**

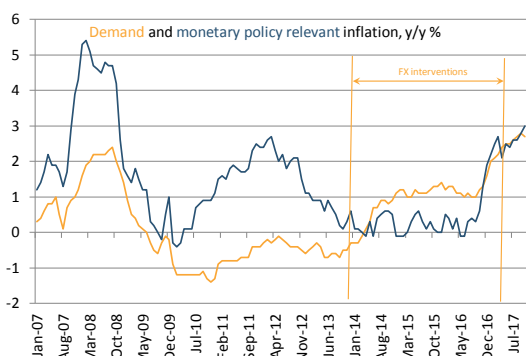
October MPRI (i.e., headline less indirect taxes) rose to 3%, highest since October 2008. The headline inflation rose too - 0.2 pp to 2.9%, primarily on higher food prices.

As things stand now, the headline inflation is only caused by two things: demand inflation and food prices. Their contributions are split evenly, with demand inflation's adding 1.41 pp and food inflation adding 1.42 pp to the annual inflation of, as said, 2.9%. In other words, had the food prices stagnated y/y (as they did, for example, last year in October), the current headline inflation (as well as MPRI) would be half what it is now (i.e., well below the CNB target...).

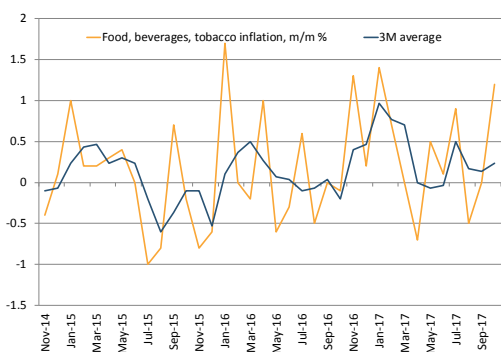
As regards the demand inflation, it retreated 0.1 pp. to 2.7% in October, a reflection of the the monthly gain of just 0.4% m/m this October as against 0.5% in October of 2016 (October is always a month with positive inflation gain, a reflection of clothing / footwear price increases with new, Fall, collections hitting the stores).

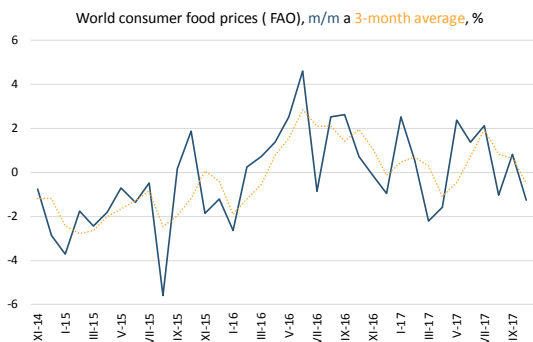
**More important, however, for the future of inflation is the monthly dynamics of the key**

**MP-RELEVANT INFLATION ROSE TO 3% IN OCTOBER, BUT THAT WAS LIKELY A PEAK ...**

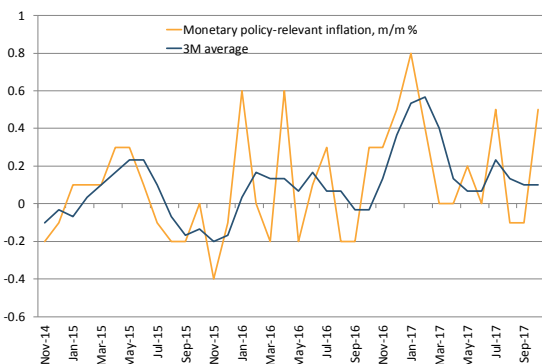


**...AS MONTHLY DYNAMICS OF FOOD PRICES...**

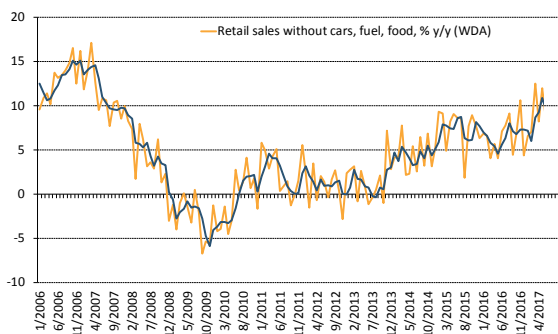




...AND OF DEMAND INFLATION INDICATES.



**AFTER TWO WEAK MONTHS, HOUSEHOLDS ROAR BACK TO LIFE WITH 10% CORE SALES GROWTH.**



**components. And here, all hint the disinflation ahead.**

First, food prices are growing, but unless November-January sees their substantial acceleration – which is unlikely with world food prices slowing and CZK stronger – their increase over November-January will be much slower than a year ago. This will result in a **negative base effect becoming visible in MPRI soon**. Same is true of fuel prices, though recent increase of oil prices is of concern.

Finally, and most importantly, despite all the talk about the increasing domestic inflation pressures, **the monthly dynamics of the demand inflation is the same now as a year ago**: the average monthly demand inflation for August-October 2016 was 0.03% m/m as it was for August-October 2017. IN other words, the fact that demand inflation is higher now y/y reflects what has already happened (mainly in the beginning of the year).

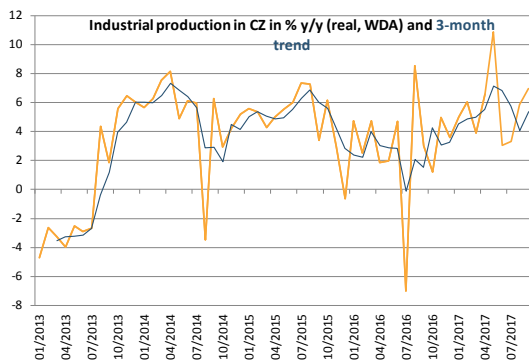
Looking forward, unless the demand inflation quickens in next 4 months as much as it did over November 2016 – February 2017, the powerful base effect will be visible in annual demand inflation numbers as well. Can demand inflation quicken as much as it did last year? Hardly: there is no EET this year, imputed rents will gradually stabilize and the additional improvement of wages / unemployment will be small.

**Put together, I expect the inflation to return below 2% by March 2018**, which should put to bed the expectations of 4 hikes of CNB in 2018 (as well as those of massive divergence between CNB and ECB). **Consequently, profit-taking on CZK should follow.**

After two weak summer months, retail roared back to growth in September. But despite that, in 3Q17 they remained below 2Q17.

The sales excluding cars, food and fuel rose 10.6% y/y (WDA, real), among the fastest growth rates since 2007. The remaining segments also appear

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**INDUSTRY IMPROVES AS PMI SUGGESTED**

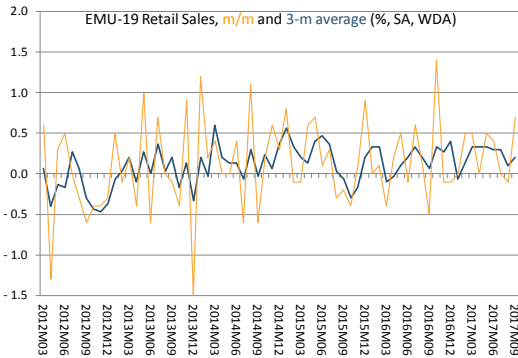
stabilized: food sales grew at about 2.5% y/y, quite OK considering the 5% food inflation, car sales returned to growth in September (1.6%) and fuel sales have been stable at around 6.5% y/y. The fuel sales may be negatively impacted in the coming months by pricier oil, but this should only have small effect on overall sales.

**The underlying strength stemming from tight labor market** (Eurostat unemployment lowest in EU), strong growth of wages and hence high confidence will thus continue to be the dominant factor.

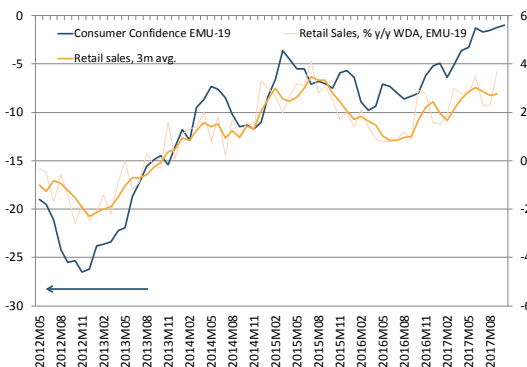
**As suggested by PMI, industrial production grew at 7% y/y in September. Strong performance should be seen in 4Q17 as well.**

The manufacturing itself grew at 5.4% y/y (real, WDA), almost identical growth rate with the ones seen in previous 2 months. With PMI improving further in October to highest in 6 years, nothing changes in my expectation that the growth of industrial production will average about 7-7.5 % in 4Q17.

**EUROZONE RETAIL SALES RETURNED TO GROWTH IN SEPTEMBER AFTER TWO WEAK SUMMER MONTHS...**



**...BUT THE OVERALL GROWTH REMAINS SUBDUED.**



**EUROZONE ECONOMY**

**Eurozone retail sales returned to growth in September, with the strongest monthly expansion (0.7% m/m) since last October.**

This, however, came after two weak months (stagnation in July and decline by 0.1% in August), so the growth of household demand was slower in 3Q17 as against 2Q17 (albeit only marginally so). Final GDP data should prove that this week.

The discrepancy between the overall level of consumer confidence and the actual growth of retail sales thus persists. The y/y growth of 2.8% in last three months ending in September is still substantially below where the confidence at its highest in 17 years would put it.

With unemployment declining only very slowly (1 pp./year) and very weak wage growth, I don't expect retail sales to close that gap soon. Therefore, I don't expect much in terms of demand inflation over next two years in Eurozone. Which is another reason why I think the current Czech expectation of 75-100 bps. in tighter policy of CNB next year are misguided: Czech inflation cannot - will not - deviate so much from Eurozone one to justify such a spread.



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MARKETS ‡

MM / IRS	3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y		
%	Actual	0.720	0.800	1.205	1.553	1.669	1.800	
	-1M	0.490	0.560	0.990	1.315	1.433	1.570	
	-3M	0.450	0.500	0.785	1.075	1.195	1.350	
	-6M	0.300	0.370	0.635	0.955	1.090	1.260	
ASW spread*	2Y	3Y	4Y	5Y	7Y	10Y		
bps.	Actual	-0.833	-0.735	-0.699	-0.690	-0.550	0.026	
	-1M	-1.075	-0.811	-0.839	-0.842	-0.735	-0.158	
	-3M	-1.015	-0.940	-0.940	-0.967	-0.957	-0.340	
	-6M	-0.748	-0.859	-1.039	-1.032	-0.780	-0.588	
CZGB**	2Y	3Y	4Y	5Y	7Y	10Y		
%	Actual	0.372	0.627	0.771	0.863	1.119	1.826	
	-1M	-0.085	0.322	0.396	0.473	0.698	1.412	
	-3M	-0.230	-0.040	0.060	0.108	0.238	1.010	
	-6M	-0.113	-0.109	-0.174	-0.077	0.310	0.672	
FX	EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD		
	Actual	25.553	4.226	311.54	4.646	4.509	1.167	
	-1M	25.880	4.269	309.24	4.585	4.328	1.186	
	-3M	26.162	4.282	304.55	4.574	4.182	1.182	
	-6M	26.578	4.226	310.26	4.547	3.888	1.086	

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

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