Weekly | 2017 | Week 49

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Calendar

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	4-Dec	10:00	CZ	Average Real Wage, 3Q17, y/y	5.1%	4.7%
Tuesday	5-Dec	11:00	EMU	Retail sales, Oct'17, m/m (y/y)	-0.7% (1.6%)	N/A
	5-Dec	10:00	EMU	(Final) Composite PMI, Nov17	57.5	N/A
Wednesday	6-Dec	8:00	GER	Factory orders, Oct'17, y/y (WDA)	7.0%	N/A
	6-Dec	9:00	CZ	Retail sales, Oct'17, m/m (y/y)	7.7%	8.0%
Thursday	7-Dec	8:00	GER	Industrial production, Oct'17, y/y (WDA)	4.3%	N/A
	7-Dec	9:00	CZ	Industrial production, Oct'17, y/y (WDA)	10.5%	11.2%
	7-Dec	11:00	EMU	(Final) GDP 3Q17, q/q (SA)	0.6%	N/A
Friday	8-Dec	8:45	FRA	Industrial production, Oct'17, y/y (WDA)	2.9%	N/A

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

December 2017 Auctions

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
SPP 775	7-Dec	8-Dec	20-Apr	CZK 5bn. max	N/A
SPP 776**	14-Dec	15-Dec	N/A	N/A	N/A

* For T-Bills, this is maximum amount per primary dealer.
** Depending on market conditions.

Thought of the Week

"Black Friday is the Special Olympics of capitalism. "

WEEK AHEAD

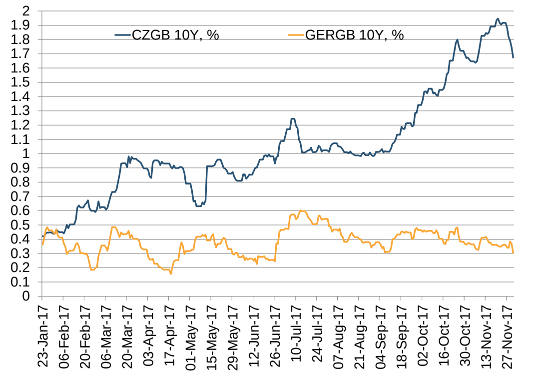
First October 2017 real economy data – retail sales and industrial production – are to be released in the Czech Republic this week.

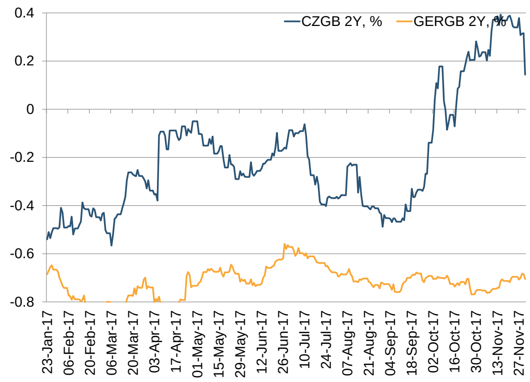
Industrial production should rise strongly on the back of two more working days this October vs. October of 2016, but, also, and more importantly, on strong PMI. Retail sales should be strong as well due to the former as well as due to the strong labor market, wage growth and high consumer confidence. All in all, this week's data should confirm economy growing further at a solid rate in 4Q17.

In Eurozone, retail sales and industrial production (Germany, Spain, France) shall be released. Even though the consumer confidence is at levels that should see 4% growth of sales, expectations are set much lower. This reflects the fact that there's been divergence between what consumer confidence predicted and what actual sales turned out to be for months now. And I don't think it will close now.
Same story is true of industrial production in Germany, another laggard (see page 6 ↗)– PMI is at 60 yet we're having a hard time seeing even 5% y/y growth there…

EURCZK RETURNS ABOVE 25.50

YIELDS FALL AS IR EXPECTATIONS ARE REVISED





WEEK BEHIND

▌ 3Q17 CZ growth driven by households, inventories buildup ▶

▌ Manufacturing PMI highest since April 2011 ▶

▌ Leading indicators suggest quicker growth in Eurozone in 4Q17-1Q18 ▶

▌ Spanish retail takes a hit after Catalonia referendum ▶

▌ Eurozone inflation still not going anywhere ▶

| FX

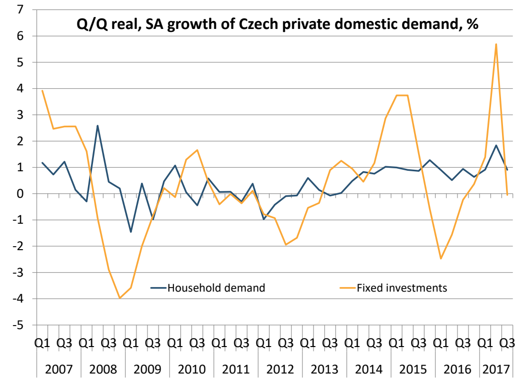
EURCZK returned back above 25.50, despite positive data from the Czech economy. This puts EURCZK back to where it was two weeks ago. The only thing that I expect can move CZK noticeably before year end are central bankers' comments in the run-up to the last CNB meeting this year (December 21). And Czech inflation – which should already show the base effect from last year's EET.

| FI

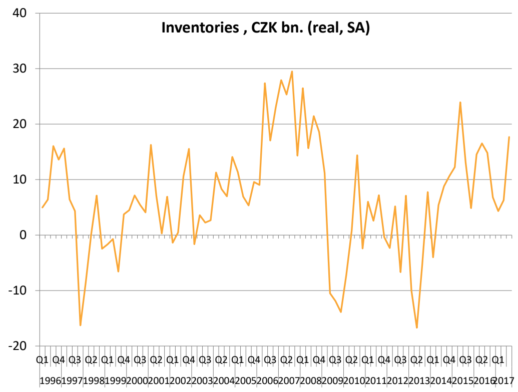
Czech bond market finally noticed it'd overdone it. I mean, 150-160 bps. risk premium over Germany, really?

Last week, 10Y returned below 1.7% while 2Y fell below 20 bps., due to repricing of interest rate expectations in CZ (= IRS fell too) which low November inflation in Eurozone compounded. I would expect this to continue: we are now in for four months of disinflation and it will become clear that (demand) inflation threat is much less acute than what markets are now (still) pricing in.

3Q17 GROWTH DRIVEN BY HOUSEHOLD DEMAND…



…AND INVENTORIES.



| CZECH ECONOMY

Czech growth in 3Q17 was driven by household demand and by the build-up of inventories.

This is what 2nd estimate of the Czech GDP growth in 3Q17, released last Friday, confirmed. The overall growth rate hasn't changed from the first estimate: it is still 0.5% q/q and 5% y/y.

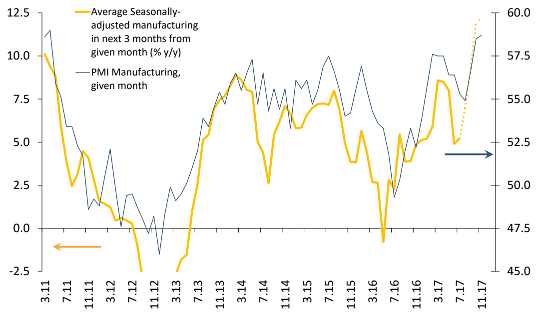
As for the structure, that household demand should be good (+0.9% q/q, just like in 1Q17 and vs. 1.8% q/q in 2Q17) followed from the macro picture in the 3Q17 (if not from the retail sales which were weak due to weak summer months): confidence at or close to all-time high, unemployment lowest among all EU countries, real wage growth solid.

Inventories build-up was something that was flagged by 3Q17 PMI reports which repeatedly said companied mentioned the build-up of pre-production inventories as a way to ensure there are no disruptions in their flow. It is mentioned again PMI November report, by the way: "*pre-production inventories rose at a strong rate, with firms increasing their stockpiles to ensure supplier constraints do not restrict future production*"(page 2 here ↗).

Fixed investments stagnated q/q, but that comes as no surprise after almost 6% quarterly (!) growth in 2Q17.
Surprisingly, on the other hand, exports fell 1.4%, but a) this came after three strong quarters (+1.7%, +3.7% and + 3.1% q/q in 4Q16-2Q17, respectively) and b) the same thing happened last year in 3Q17. Looking around the world, there is no reason why Czech exports should not perform well.

All in all, the structure could be used to justify easily by CNB to hike in December…

PMI HIGHEST SINCE APRIL 2011, HINTING AT IP GROWTH OF 10%

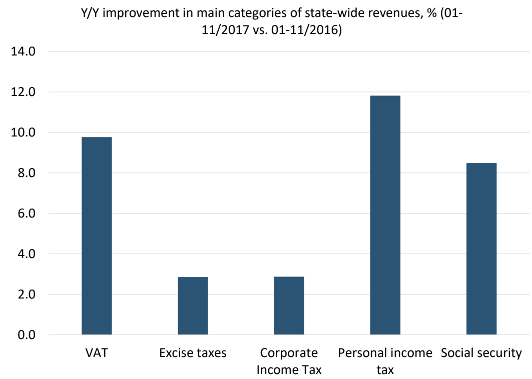


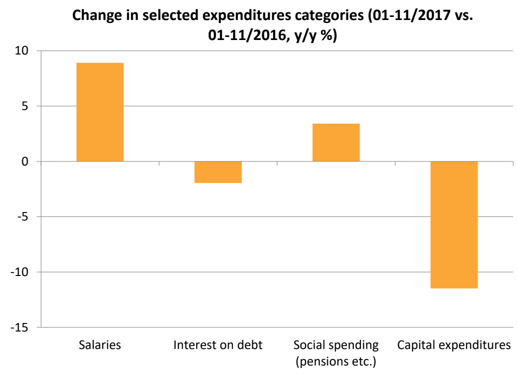
Manufacturing PMI rose to highest since April 2011.

The index climbed to 58.7, just shy of April 2011's 59 points and improvement, though a small one, on October's reading of 58.5. Backlogs of work are highest since January 2011 and, as suggested above, buying activity of manufacturers increased sharply (and inventories rose). From CNB perspective, the fact that "*output prices increased further, though with rate of inflation slightly lower than in October*" is theoretically positive, but the link between respondents' views summarized in PMI and the actual consumer price level developments is very tenuous.

The overall level of the index is at level consistent with 9-10% growth rates in late 4Q17, early 1Q18.

BUDGET IN DEFICIT DESPITE STRONG GROWTH





5% annual economic growth apparently isn't enough to balance the budget of the government, the November budget data revealed.

The budget ended up in a deficit of CZK 11.6 bn. (CZK 13 bn. adjusted for the effect of EU money).

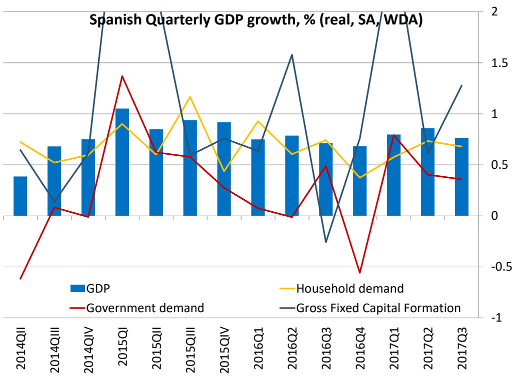
The y/y worsening isn't that important (there was surplus of CZK 55.5 bn. in January-November of 2016) since the 2016 number was heavily influenced by EU money inflows. Adjusting both sides of the budget for the effect of EU money, the 2017 and 2016 deficits aren't dissimilar (CZK 13 bn. vs. CZK 14.7 bn.)

What is also not that important is whether EET worked or not – there appears to be some positive effect from it, but considering the rate at which nominal household demand is growing (6.3% y/y in first 9 months), the growth of VAT receipts by 9.8% (state-wide) doesn't show big effect (few billions at most).

What, on the other hand, profoundly important is, is that **all of the additional revenues** (CZK 74 bn. in tax revenues at central government level in 2017)

Retail sales take a hit in Spain after Catalonian referendum

Spanish 3Q17 GDP growth driven by domestic demand



weren't enough to balance the budget! And that even at the time when government is not investing: capital expenditures *fell* CZK 8.8 bn. in first 11 months of 2017 as against the same period of 2016.

In other words, the government is raising revenues unlike in a long time, not spending where it should but squandering them on bribes to pensioners & state sector workers instead.

| EUROZONE ECONOMY & FED

Homage to Catatonia.

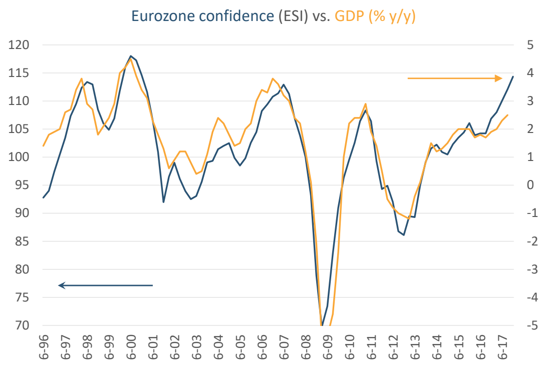
Spanish retail sales essentially stagnated in October as Catalonia referendum of October 1st, 2017 plunged the country into constitutional crisis, their worst result since summer 2014. Not that I think this should last – the situation, although far form solved, pretty quickly reverted to normal.

And as data from Eurozone labor market also showed last week, the Spanish labor market, although having improved massively over last couple of years, still has a long way to go and, unlike in Germany, this channel of support to household demand isn't yet exhausted (rate of unemployment stood at 16.7% in November). There is no reason to expect this was anything but a short-lived fluke.

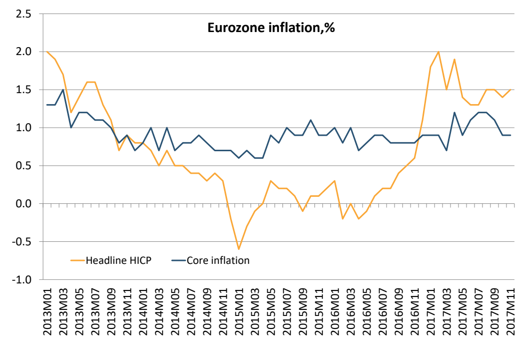
Last piece of release from Spain last week was *3Q17 structure of GDP*. The overall growth remained at 0.8% q/q (as in the first estimate), slightly lower than in 2Q17 (0.9%). The structure was closer to France than to Germany: the primary driver were fixed investments and household demand (whereas it was foreign demand and inventories for Germany).

Leading indicators and labor market suggest the recovery in Eurozone shall continue, though with no immediate inflationary consequences.

EUROZONE ESI RISES TO HIGHEST IN 17 YEARS, CALLING FOR QUICKENING OF GDP GROWTH…



..BUT THE INFLATION REMAINS UNMOVED & LOW.



Economic sentiment indicator (ESI) **climbed to a 17-year high of 114.6,** a level consistent with GDP growth of about 4% y/y.

The **unemployment rate defied expectations and improved by 0.1 pp to 8.8% in October**, the lowest since January 2009. Lowest unemployment among all EU countries is still seen in Czech Republic (2.7% on this measure), then in Malta (3.5%) and in Germany (3.6%). On the opposite end is Greece, Spain and Italy, with 20.6%, 16.7% and 11.1%, respectively.

The labor market in Eurozone thus continues to slowly improve – but the rate at which it does is not accelerating. The y/y improvement of the unemployment rate is 1 p.p. which is almost the 2016-2017 average (it was exactly 0.9 pp if you go month by month and measure the annual improvement each month of the unemployment rate).

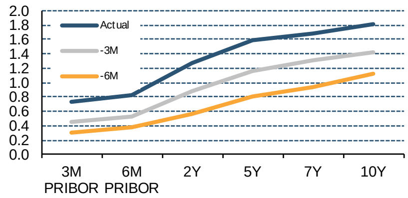
It is thus not that much of a surprise that inflation hasn't gone anywhere in November either.

The core inflation remained below 1% for the 2nd month (0.9%) whereas the headline inflation returned to 1.5% where it was in August and September (after which it briefly dipped below that level). The fluctuation of the headline inflation is only the reflection of energy prices: they rose 4%, 3.9% and 4.7% in August, September and November, and dipped to 3% in October, thus largely explaining the short-lived dip of headline that month.

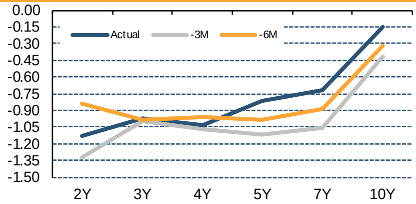
The overall story, however, doesn't change: the demand pressures are non-existent and hence the sustainable return of inflation to ECB target is a long, long way off. The pricier oil will lift the headline if it continues to rise, but that is not what ECB is after (and certainly not would prompt it to tighten the policy sooner than I think – which is sometime in late 2019 at the earliest).

| MARKETS ‡

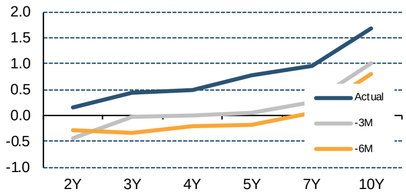
MM / IRS (%)	3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
Actual	0.740	0.830	1.275	1.590	1.688	1.820
-1M	0.590	0.670	1.200	1.530	1.641	1.770
-3M	0.460	0.520	0.875	1.158	1.305	1.430
-6M	0.300	0.370	0.565	0.805	0.934	1.125



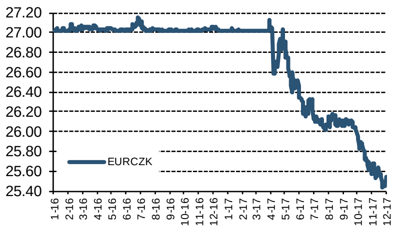
ASW spread* (bps.)	2Y	3Y	4Y	5Y	7Y	10Y
Actual	-1.131	-0.973	-1.039	-0.816	-0.724	-0.147
-1M	-0.981	-0.805	-0.785	-0.769	-0.657	-0.096
-3M	-1.327	-1.003	-1.074	-1.119	-1.057	-0.418
-6M	-0.845	-0.987	-0.956	-0.984	-0.892	-0.315



CZGB** (%)	2Y	3Y	4Y	5Y	7Y	10Y
Actual	0.144	0.447	0.479	0.774	0.964	1.673
-1M	0.219	0.546	0.667	0.761	0.984	1.674
-3M	-0.452	-0.023	0.006	0.039	0.248	1.012
-6M	-0.280	-0.329	-0.221	-0.179	0.042	0.810



FX	EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
Actual	25.544	4.215	313.89	4.633	4.656	1.189
-1M	25.574	4.233	311.01	4.604	4.432	1.162
-3M	26.056	4.253	305.70	4.595	4.068	1.186
-6M	26.339	4.193	307.90	4.570	3.954	1.121



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

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