Weekly | 2018 | Week 50

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| CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	17-Dec-18	9:00	CZ	PPI, Nov'18, y/y	3.7%	3.5%
	17-Dec-18	9:00	CZ	Export prices, Oct'18, y/y	N/A	N/A
	17-Dec-18	11:00	EMU	(Final) HICP, Nov'18, y/y	2.0%	N/A
Tuesday	18-Dec-18	10:00	GER	IFO Business Climate, Dec'18	101.7	N/A
Thursday	20-Dec-18	13:00	CZ	CNB rate-setting meeting, 2W repo rate	1.75%	1.75%
Friday	21-Dec-18	8:45	FRA	(Final) 3Q18 GDP, q/q	0.4%	N/A
	21-Dec-18	16:00	EMU	(Flash) Consumer confidence, Dec'18,	-4.3	N/A

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

| DECEMBER 2018 AUCTIONS

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
SPP 803***	20-Dec-18	21-Dec-18	4.1.19-21.6.19	CZK 5 bn. max	N/A
SPP 804***	27-Dec-18	28-Dec-18	4.1.19-21.6.19	CZK 5 bn. max	N/A

* 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.
*** DEPENDING ON HOW 2018 BUDGET TURNS OUT.

| THOUGHT OF THE WEEK

“SO WITH THE TITANIC’S STERN HIGH ABOVE THE ICY WATER, THE HULL CREAKING AS THE GREAT VESSEL SLIPS BELOW THE WAVES, THE CREW HAVE TAKEN TIME OUT FROM ARGUING OVER HOW THE DECKCHAIRS SHOULD BE REARRANGED TO DECIDE WHO GETS TO HOLD THE VIOLIN?” [ON TORY CHALLENGE OF THERESA MAY]

WEEK AHEAD

The release schedule getting lighter as we move close to Christmas.

CNB’s meeting is major event in the Czech Republic. The expectation is that CNB will take a pause in its hiking campaign as momentum is worsening in Germany, risks remain prominent (chaotic Brexit being one of them) and as the central bank waits to see whether weakness of CZK seen in last weeks is only due to end-of-year effects (Resolution fund) that have manifested somewhat earlier this year than in 2017.

In Eurozone, soft indicators from Germany (**IFO**) and from Euro-area consumers (**consumer confidence**) will probably both show worsening against November, in what will be another confirmation that Eurozone growth has weakened further at the end of 4Q18.

WEEK BEHIND

Czech inflation still heavily due to housing ▶

Eurozone industry remains moribund… ▶

…and PMI don't indicate it will improve soon ▶

Nonetheless, ECB confirmed end of QE and remained optimistic on inflation outlook ▶

| FX

EURCZK fell below 25.80 for the first time since early November 2018.

This is pretty strange for this time of the year as this time last year, the Resolution fund effects ↗ were pushing the EURCZK higher. It looks like the same happened this year, but earlier, and now a small correction is taking place.

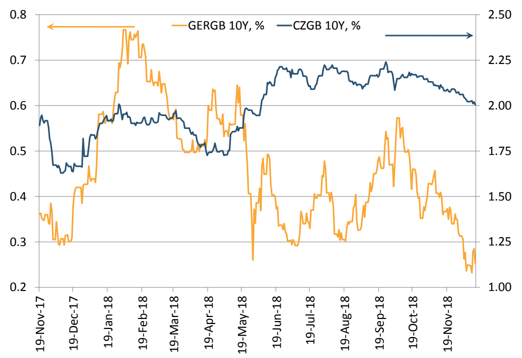
| FI

German yields remained close to 6-month low…

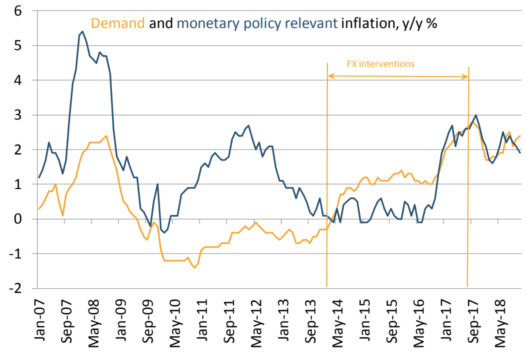
...despite the ECB's reaffirmation of the end of QE. Apparently, the renewed market turmoil and weak PMI had much more of an impact on the bonds. As, indeed, they should – end of QE was already pre-announced in summer 2018, so last week's reaffirmation was nothing new, whereas weak PMIs continue to strengthen the conviction that ECB won't be able to hike next year.

EURCZK DROPS BELOW 25.80 FOR THE 1ST TIME SINCE EARLY NOV'18

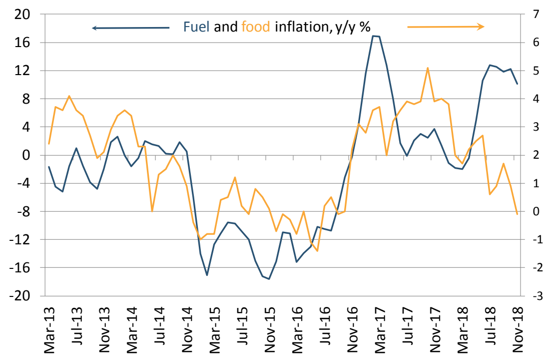
BUND YIELDS REMAIN LOW AMID MARKET TURMOIL, WEAK PMIS.



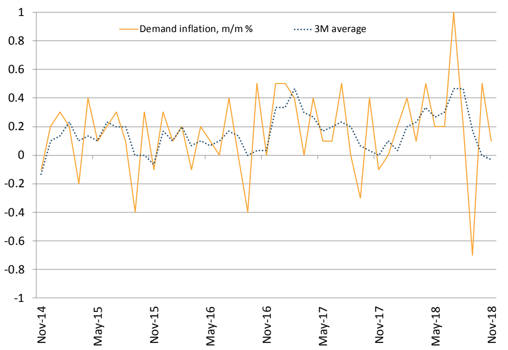
Monetary policy relevant inflation lowest since April…



…as food prices decelerate further.



Demand inflation decelerated recently as well.



| CZECH ECONOMY

So, where is the inflation CNB warned about and hiked against?

November monetary-policy relevant inflation (MPRI), i.e. inflation without primary effect of indirect taxes, fell 0.2 pp to 1.9% in November; the total inflation (including the taxes) was just shy higher at 2%. The November MPRI was thus lowest since April 2018 and lower than CNB forecast.

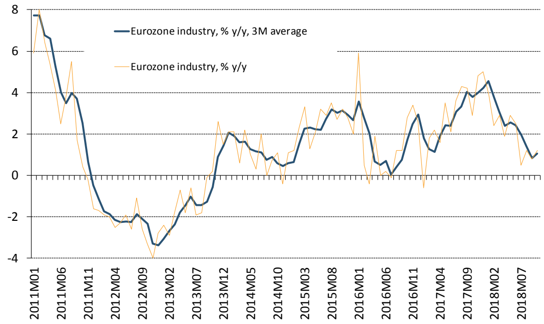
This is primarily due to further fall of food prices, one that CNB did not foresee: recall that in latest forecast (page 15 here ↗) CNB said that "*food price inflation will increase markedly on the back of expected rise in food commodity prices*" and expected the average 4Q18 food price inflation of 1.6%. Well, truth is that October food inflation was 0.9% y/y and November one was -0.1% y/y so unless December sees gigantic rise of food prices, this will have been another pretty inaccurate forecast of CNB…And it will not: global food prices continue to fall.

Looking ahead, adding the outlook for fuel prices (= fall reflecting the recent oil price drop; November -0.3% m/m is nothing yet) makes it clear that MPRI will certainly decline further once December data are out.

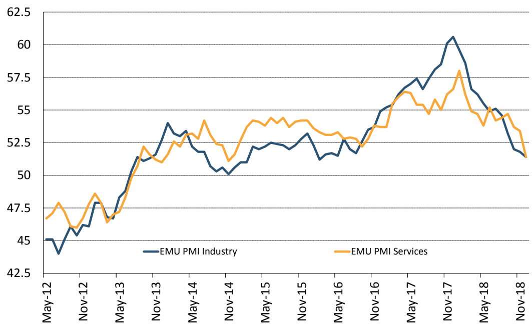
Ok, so MPRI doesn't seem to be such an issue as CNB thought, but what about demand inflation (i.e., MPRI without food, fuel prices)? Demand inflation was 2.4% y/y in November, 0.1 pp higher than in October. So, that looks like CNB was right to tighten, right? Well, look at the structure: half of the increase is due to housing and related services (water, energy, sewage etc.). Rents are up 3.3%, water 1.8%, electricity 5.6% etc. - these are not the categories that CNB influences much via its monetary policy. And, by the way, looking at the monthly figures, the demand inflation didn't rise at all in last three months.

So, will CNB hike in December? I don't think so, there are too many signs of weakness in the external environment. And that will prevail over continuing weakness of CZK.

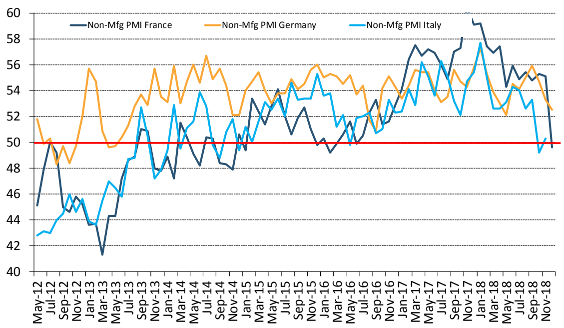
Industry growth moribund in EMU,…



…And PMI doesn't indicate it should improve soon.



Services fell dramatically in December, most in France.



| EUROZONE ECONOMY

Eurozone industry growth remains moribund.

October growth of 1.2% y/y is the same rate as in August and only slightly above the September's 0.8%, and in any case the weakest growth since 2016. It's been truly a marked deceleration: this time last year Eurozone growth was above 4%. Manufacturing component isn't doing differently (i.e. better): the growth of 0.2% m/m in manufacturing in October translated into mere 1.5% annual growth.

And it does not look like we can hope for anything better once November data are released early next year. See, PMI fell further in November, with Germany (51.8) and France (50.8) close to the 50-line separating growth from contraction, and Italy being below it for the second month in a row (48.6 in November, lowest since December 2014).

Furthermore, December PMIs show weakness in manufacturing didn't go away, and spread to services.

The decline in manufacturing PMI was relatively small, but decline it was nonetheless: from November's 51.8 the manufacturing PMI fell to 51.4 in December, lowest level since February 2016. This decline was driven by another (third consecutive) decline in new export orders (which fell to a four-year low). Add the fact that the optimism fell to a 6-year low and you can see why being optimistic on the short-term growth prospects of industry is hard: if I had to guess, we'll see further weakening of the manufacturing PMI. Country-wise, France saw the biggest decline which may or may not be attributable to the protests of the yellow vests. Be it as it may, this was the first time since June 2016 to have French PMI below 50 in services and industry.
German manufacturing PMI also declined, though only marginally: from 51.8 in November to 51.5 in December.
All this is not very encouraging, but manufacturing

is only relatively smaller part of the economy. If services held up, it would…

But **service PMI declined in December as well, and it was a dramatic decline**: from November's 53.4 to December's 51.4, lowest since November 2014. The optimism regarding the future and the new orders were also at 4-year lows. This was mainly driven by drop in France where PMI fell from 55.1 to 49.6. Although German service PMI also declined (to 52.5), there is no explanation for the drop in France but the protests of the "**yellow vests**". **If so, and if situation returns to normalcy, the weakness indicated by December PMI will prove exaggerated.**

Put together, the GDP growth in 4Q18 looks like 0.2% q/q and the December itself points at 0.1% q/q going forward.

Despite all this, ECB confirmed the end of QE and offered another dosage of (unjustified, if you ask me) optimism.

The key rates remained unchanged and ECB did officially confirm that the asset purchases under Asset Purchase Program (APP) would end at the end of this year. The small tightening implicit in this was offset by the reaffirmation of the ECB's intention to "*continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when we start raising the key ECB interest rates, and in any case for as long as necessary to maintain favorable liquidity conditions and an ample degree of monetary accommodation*." In other words, even after beginning to tighten the policy via outright increased of the key rate(s) – which ECB still does not expect to begin before summer 2019 – ECB will continue to reinvest the principal of its massive holdings of assets. For how long it wouldn't specify: Draghi at the press conference said it is the wish of the ECB, and unanimous one at that, to keep length open.

Now, the explanation for the stance. ECB did admit that *"incoming information has been weaker than*

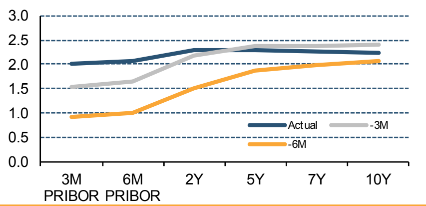
expected" and that *"uncertainties related to geopolitical factors, the threat of protectionism, vulnerabilities in emerging markets and financial market volatility remain prominent"* but insisted that, with significant monetary policy stimulus that it intends to maintain going forward, the inflation will converge sustainably to the target. Hence, nothing new: this is merely ad-nauseam repetition of what we've seen in the statements over last 12 months. And core inflation is still at 1% where it was this time last year… Makes one wonder when will the confidence be shattered by reality…
ECB, however, struggles to explain why core inflation should lift off. And when it does, it is a ridiculous explanation: *"the underlying strength of domestic demand continues to underpin the euro area expansion and gradually rising inflation pressures."* Well, the contribution of household demand to q/q growth in 3Q18 was smallest since 1Q14! How do you explain that?

ECB points at wages to explain where inflation should come from: "*Compensation per employee in the third quarter of this year went up for the eurozone to 2.5% from the second quarter, it was 2.2%. Negotiated wages again for the eurozone, at 2.1% in the third quarter".* I mean, fine, but look at Poland…You have nominal wage growth in Poland at triple the Eurozone rate, non-existing unemployment and core inflation still below 1%. Would I really be as convinced as Draghi that Eurozone inflation will soon "converge sustainably" to ECB's target when there is still lot of slack in Eurozone economy (labor market at least 2, possibly 3 years from full employment at current level of improvement)? No, I wouldn't.

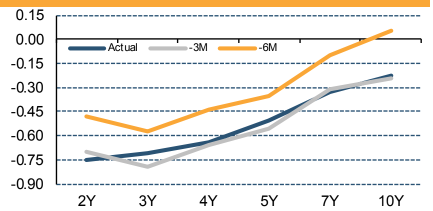
Anyway, on hiking, Draghi repeated that exact timing of the first hike wasn't discussed and said that "*it's both date contingent and it's also state contingent, namely depending on the situation of the economy."* So, no sooner than in summer and possibly later, as dictated by data. And I think it will not be in 2019 as data won't permit that.

| MARKETS ‡

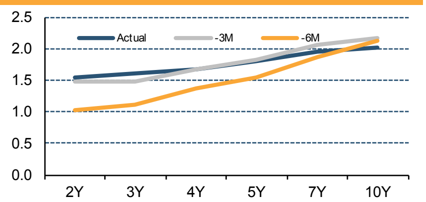
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	2.020	2.080	2.295	2.300	2.275	2.235
	-1M	1.990	2.060	2.435	2.570	2.561	2.555
	-3M	1.540	1.650	2.170	2.373	2.380	2.408
	-6M	0.930	1.010	1.515	1.885	1.975	2.070



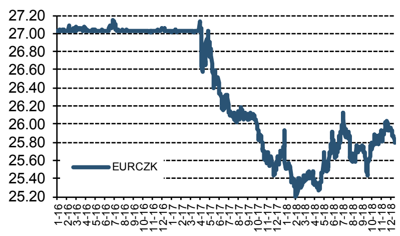
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-0.754	-0.711	-0.641	-0.506	-0.325	-0.230
	-1M	-0.956	-0.877	-0.852	-0.758	-0.553	-0.452
	-3M	-0.700	-0.797	-0.661	-0.557	-0.315	-0.244
	-6M	-0.482	-0.573	-0.436	-0.350	-0.103	0.054



CZGB**		2Y	3Y	4Y	5Y	7Y	10Y
%	Actual	1.541	1.599	1.669	1.794	1.950	2.005
	-1M	1.479	1.637	1.697	1.812	2.008	2.103
	-3M	1.470	1.482	1.675	1.816	2.065	2.164
	-6M	1.033	1.120	1.370	1.535	1.872	2.124



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25.791	4.291	323.78	4.656	6.071	1.130
	-1M	26.023	4.296	322.45	4.660	6.180	1.131
	-3M	25.477	4.306	324.85	4.640	7.175	1.163
	-6M	25.764	4.284	323.00	4.665	5.470	1.157



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

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