Weekly | 2017 | Week 51

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CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	18-Dec	9:00	CZ	PPI Industrial, Nov17, y/y	1.3%	1.2%
	18-Dec	11:00	EMU	(Final) HICP, Nov17, y/y	1.5%	N/A
Tuesday	19-Dec	10:00	GER	IFO Business Climate, Dec'17	117.5	N/A
Wednesday	20-Dec	10:00	EMU	Current Account, Oct'17. EUR bn. (SA)	N/A	N/A
Thursday	21-Dec	13:00	CZ	CNB rate-setting meeting, 2Q repo rate	0.5%	0.5%
Thursday	21-Dec	16:00	EMU	(Flash) Consumer Confidence, Dec'17	0.2	N/A
Friday	22-Dec	8:45	FRA	(Final) GDP 3Q17, q/q (SA)	0.5%	N/A

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

DECEMBER 2017 AUCTIONS

NOTHING SCHEDULED UNTIL THE END OF MONTH.

* FOR T-BILLS, THIS IS MAXIMUM AMOUNT PER PRIMARY DEALER.
** DEPENDING ON MARKET CONDITIONS.

THOUGHT OF THE WEEK

"BITCOIN IS NOW JUST ANOTHER CONFISCATORY TAX ON RETAIL."

WEEK AHEAD

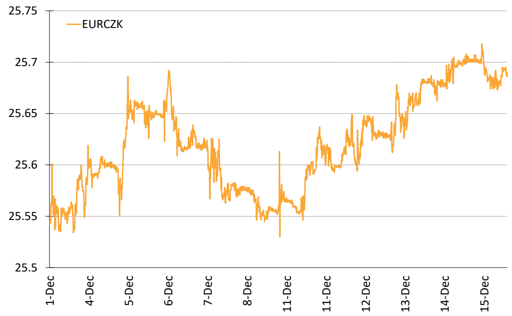
CNB's week.

CNB is holding its last meeting of 2017, and it promises to be an interesting one. Three of the Board members (Hampl, Benda, governor Rusnok) suggested over last 6 weeks – with various degrees of unambiguity – that they're inclined to see rates higher, possibly soon. This means that only one more member is needed for the third hike this year to pass. Whether the hike is indeed delivered or not is 50/50 in my eyes. On the one hand, there are comments mentioned above, strong 3Q17 GDP growth, high confidence and risk of weaker CZK, on the other hand there's disinflation that began in November ► that is about to expose the non-demand nature of the 2017 inflation increase↗.

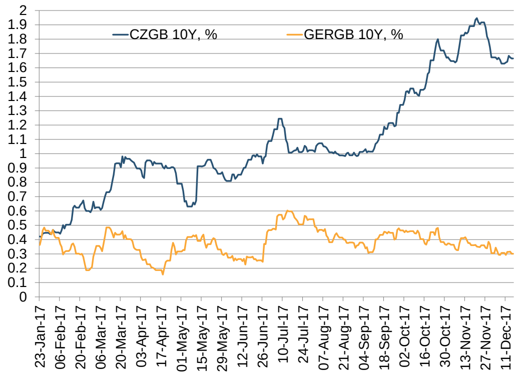
Personally, though I think none of the hikes this year were necessary from inflation-targeting perspective, I think CNB will hike in December: political considerations ("creating maneuvering space for next recession") will again prevail. But it is a very close call.

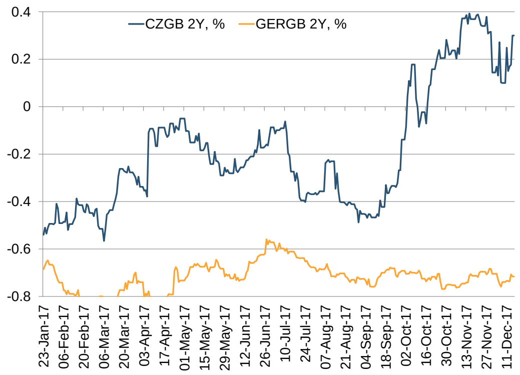
In Eurozone, IFO and confidence are the most important releases.

EURCZK WEAKENS DESPITE HAMPL'S HAWKISH COMMENT



YIELDS FAIRLY STABLE IN THE RUN-UP TO LAST CNB MEETING THIS YEAR





WEEK BEHIND

November inflation begins to expose the demand inflation myth of CNB ▶

Czech current account surplus stable despite growth of demand ▶

ECB meeting a non-event ▶

FED delivers 3rd hike of 2017, remains hawkish for 2018 despite low inflation ▶

Eurozone industry remains in 5% annualized growth despite German soft patch ▶

| FX

EURCZK weakened again to 25.70 despite Hampl calling – again – for (much) higher trajectory of interest rates for 2018.

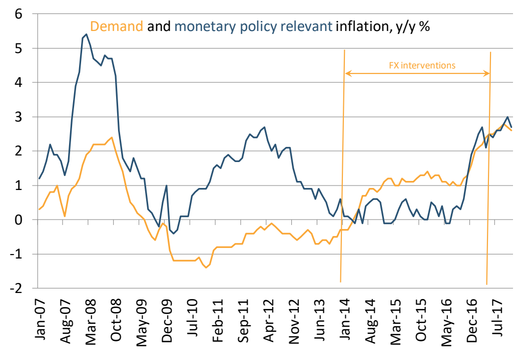
Hampl said in in interview with Bloomberg ↗ that because of the recent data he was now leaning towards an alternative forecast of CNB, i.e. one which sees 6 hikes by the end of 2018 instead of just 2 in the main forecast. Yes, it is the same policymaker who advocated in March of this year the later exit from interventions that what was forecast at that time (middle of 2017)…

Anyway, in light of the non-response of EURCZK to the hawkish comments of Hampl, I don't think there will be any response to this week's CNB meeting, irrespective of the outcome. And, if there is, it will be one of profit taking (i.e., weaker CZK).

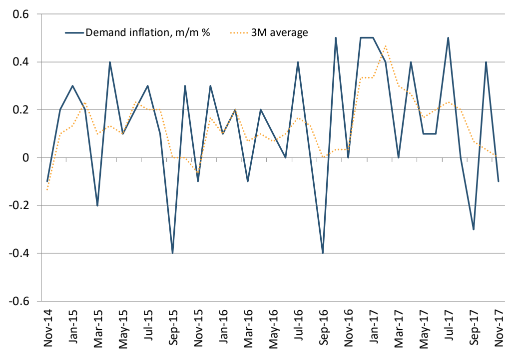
| FI

Czech yields were stable last week on the long-end, rose on the short-end.

INFLATION SLOWS ON SLOWER FOOD PRICES' GROWTH,…



…AND DEMAND INFLATION SLOWS TO ALMOST ZERO, SLOWER THAN THIS TIME LAST YEAR.



| CZECH ECONOMY

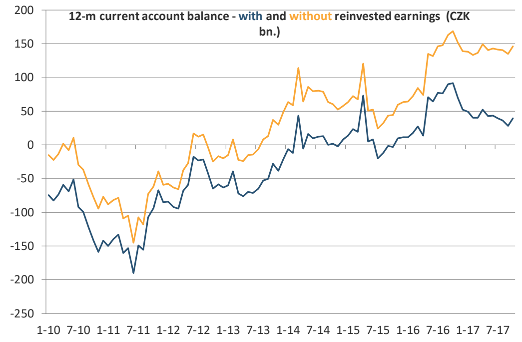
Disinflation is here. And with it, the debunking of the "demand inflation is a threat" myth perpetuated by CNB over last 6 months.

November headline inflation fell from 2.9% to 2.6% while monetary-policy relevant (MPRI) inflation fell from 3% to 2.7%. This was due to the slowdown of food prices' growth, where their contribution fell from 1.4 pp. in October to 1.1 pp in November.
As I explain in greater detail in the recent Special report ↗, the growth of food prices was largest between November and February (the total growth over those four months was 4%) so we're now in for some disinflation just because of this.

More importantly, though, is **the evolution of the demand (core) inflation.** This, let us recall, was the second biggest contributor to the growth of inflation between October 2016 and March 2017 (this is when most of the inflation increase seen in releases as recent as October one occurred).
Annual core inflation slowed from 2.8% in October to 2.6% in November. On top of that, monthly dynamics of core inflation suggest that the 'demand' pressures that CNB used to justify two hikes this year are gone: the three-month average of monthly growth rates of demand (core) inflation is now lower than what it was this time last year! **This confirms that there was no such thing as demand inflation threat this year, and what CNB really responded (somewhat panickily) to was real-estate and food prices.**

Looking forward, next three months – December, January, February - will see inflation falling below 2%. And CNB will have to admit that it – again – exaggerated the threat: just like when, having claimed in November 2013 that there was a deflation threat, CNB was subsequently proven wrong, CNB will now again find it harder to justify the 2017 tightening of the policy by pointing to the 'inflation' threat. When all there really was was 'just' the strong growth of real estate and food prices.

Current Account Surplus stable



Last ECB meeting of 2017 brought nothing new, keeping EURUSD stable despite FED hike.

Current account remains in a stable surplus despite strong growth of domestic demand.

The 12-month rolling surplus has remained at around CZK 135 bn. since late summer 2016, and, at any rate, throughout this year. Even if there is slowdown in exports down the road, there is a long way before external imbalances become an issue. For now, the current account is a clear pro-CZK factor, as it's been since 2013.

| EUROZONE ECONOMY & FED

Last ECB meeting of 2017 was a non-event, but exuded optimism not seen in a long time.

ECB significantly improved the forecast, but mainly for growth: the GDP growth expectation for 2018 is now 2.3% (vs. 1.8% previously) whereas the 2019 was revised up from 1.7% to 1.9%. What is more important, though, is the inflation outlook – because that is what ultimately determines the monetary policy stance. And here, the revisions were modest at nest: the inflation is forecast to average 1.5% in 2019, and 1.7% in 2020.

Since 2020 inflation forecast was made for the first time in this forecast, it drew few questions at the press conference. To question whether 1.7% meets the definition of the ECB inflation target of "close but below 2%" Draghi replied that it depends: it may be good enough (meaning it may be considered that target is met) if inflation is deemed self-sustaining at that level, but it may not be otherwise. In other words, ECB doesn't expect higher repo rates for the long time- and neither do I.

But optimism grew. ECB said that it "*can now safely say that deflation risks have disappeared*" and that it is more "*confident that it will reach its objective than it was two months ago*". Regarding the details of what happens with APP after September 2018 (whether there will be tapering or sudden stop), the answer was as usual: "*we didn't discuss it*".

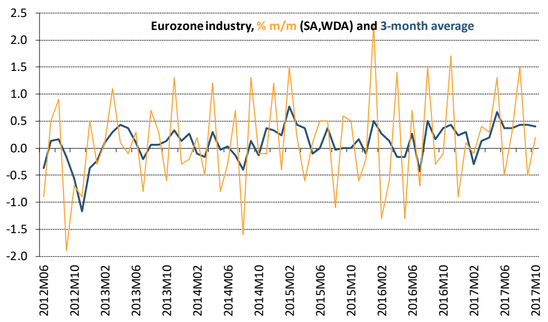
FED raised the FED funds target rate by 0.25 bps. to 1.25%-1.50%, and painted another three hikes in 2019.

If one is looking for a clear case that the current monetary policy is driven by everything but the inflation (outlook), one needs to look no further than at the FED's statements of 2017.
Just like the last one, all of the 2017 statements acknowledged that inflation was low (and, for most of 2017, actually falling), inflation expectations derived from the market were low and so were the survey-based ones. But, this all didn't stop FED from hiking the key rate three times this year, including the third hike at its last week's meeting.
Although FED justified these hikes by saying inflation will get to 2% soon (so, presumably, without tightening it would overshoot the target), it needs to be said that FED has been calling for inflation at 2% for last three years without inflation hitting that level for even one month…This year, core PCE inflation actually fell to 1.4% - which was what prompted two policymakers (Chicago's Evans and Kashkari of Minneapolis) to vote against the hike last week.

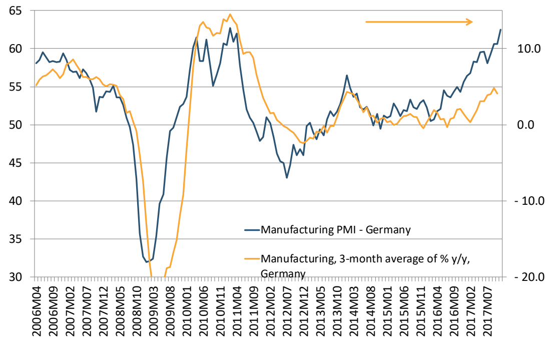
One could be forgiven for expecting more dissenters in light of 100% fail of the inflation forecast over last 36 months, but I think what's happening is that FED wants to a] hike while it can, inflation or not, in an attempt to create maneuvering space for next crisis, 2] tame frothy asset prices and maybe 3] prepare for potential tax reform that is now likely to be passed soon. Except for 3], it's exactly what now makes CNB tick.

As regards 2018, there are another three hikes forecast. And since I don't know whether this forecast includes the tax reform now in its final stages of its journey through the Congress, next FED's forecast may be revised upwards. And, I shall add, FED may well deliver them, seeing how they ignore actual inflation in their policymaking. Dollar is taking all of this in a stride, as seen above.

EUROZONE INDUSTRY KEEPING 5% ANNUALIZED GROWTH FOR THE 5TH MONTH IN A ROW, BUT…



…GERMANY CONTINUES TO LAG PMI



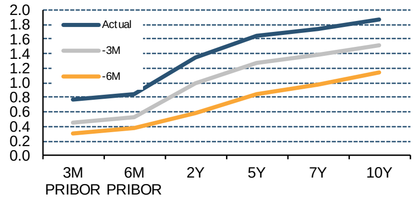
Eurozone industry continues to grow strongly, but German one lags.

The October industrial production rose 0.2% m/m, keeping the average quarterly expansion at around 1.2% for the 5th month running. This is notably faster than the growth seen in 2015-1Q2017 and fairly in line with the recent PMI improvement.

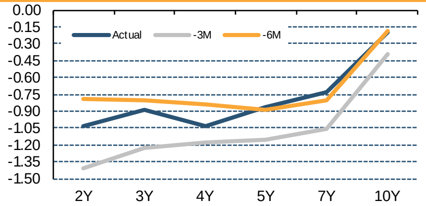
This improvement, however, is not uniform: while France, Spain grew solidly in last three months (the average m/m rate being 0.8% and 0.6%, respectively), Italy (0.1%) and especially Germany (0.1%) lagged behind. Taking into account the manufacturing PMI in excess of 60 in Germany, the stagnation of manufacturing over August-October is certainly nothing short of a disappointment. That said, as mentioned in our previous Weekly ↗ the orders hint at this being a transitory soft patch.

| Markets ‡

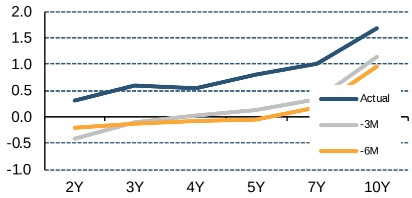
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	0.760	0.850	1.340	1.645	1.740	1.870
	-1M	0.720	0.810	1.270	1.575	1.682	1.815
	-3M	0.460	0.520	0.985	1.280	1.383	1.523
	-6M	0.300	0.370	0.578	0.839	0.973	1.141



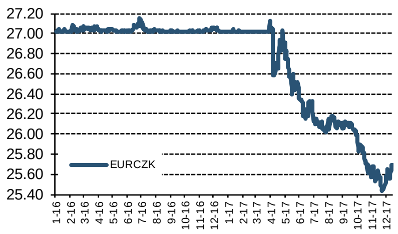
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-1.040	-0.883	-1.032	-0.859	-0.732	-0.205
	-1M	-0.901	-0.749	-0.706	-0.677	-0.513	0.076
	-3M	-1.408	-1.229	-1.185	-1.155	-1.057	-0.390
	-6M	-0.788	-0.809	-0.844	-0.894	-0.801	-0.183



CZGB**		2Y	3Y	4Y	5Y	7Y	10Y
%	Actual	0.300	0.601	0.547	0.786	1.008	1.665
	-1M	0.369	0.660	0.797	0.898	1.169	1.891
	-3M	-0.423	-0.102	0.030	0.125	0.326	1.133
	-6M	-0.210	-0.131	-0.079	-0.055	0.172	0.958



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25.686	4.207	314.13	4.622	4.540	1.175
	-1M	25.564	4.241	311.95	4.638	4.550	1.177
	-3M	26.090	4.276	309.30	4.602	4.107	1.195
	-6M	26.174	4.210	307.79	4.584	3.922	1.120



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

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