Quarterly report

Czech Economic Outlook

Brexit delaying exit

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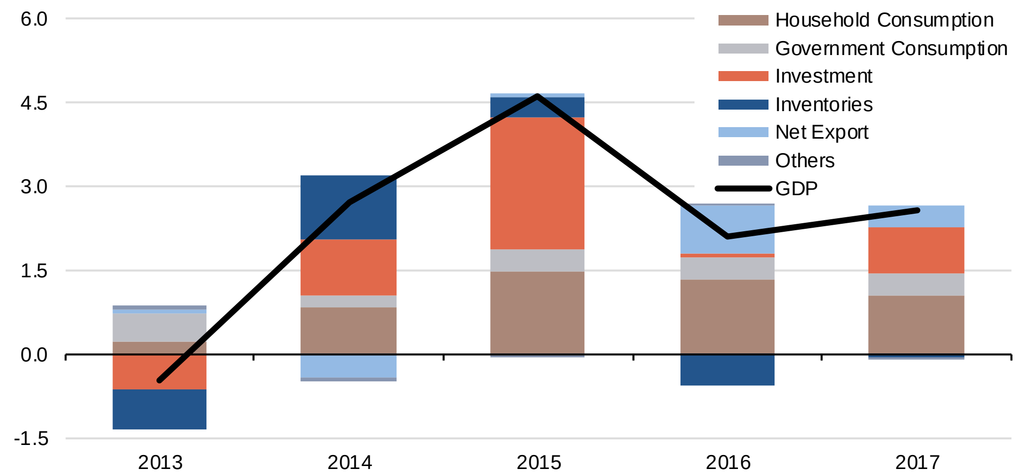
It's official: the UK will be leaving the European Union. Our previous *Czech Economic Outlook* analysed Brexit as a risk scenario. And the UK vote came as a shock to the financial markets, but they got over it in a few weeks. What will the macroeconomic impacts be? Well, analysts have already started releasing downward revisions to growth outlooks, and the first were to UK economic growth. Euro area 2017 outlooks have been revised only slightly, and the same is true for our 2017 Czech macroeconomic forecast.

Our CFO and, we expect, many of his colleagues in other companies are spending the summer tackling the tall order of 2017 budgeting. In this edition of the *Czech Economic Outlook* we focus on what they can factor in their plans via a detailed macroeconomic forecast for next year. The good news is that we don't expect any major twists and turns in macroeconomic developments. The economy may grow a bit faster next year than this year thanks to the gradual resolution of the problems which have prompted this year's shortfall in investments financed from the public purse. This implies a rebound in economic activity. Household consumption, the second component of internal demand, will also develop favourably, as the continuing rise of employment and wage growth boost consumer appetite.

Czech GDP back on a sustainable growth trajectory



Source: CZSO, Economic & Strategy Research, Komerční banka

Brexit's most visible impact on the Czech economy will be a later exit by the CNB from the FX commitment regime. The end-2017 timing reflects our inflation outlook. Consumer price dynamics were unexpectedly weak in the first half of this year, mainly due to cheap fuel and food, with the latter coming as a big surprise. We therefore analyse these items in more detail in special boxes. And the outcome? Going forward, we expect no dramatic price hikes in these groups.

In conclusion, although the 2017 forecast basically follows on from this year's trends, the risks must be highlighted. They primarily can be found in greater political uncertainty. In the Czech

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Republic, this uncertainty is attributable to the start of the next round of the political cycle: regional and Senate elections will be held as early as this autumn, 2017 will see general elections, and early-2018 will be marked by the presidential election. Major political changes can also be expected in the key European countries: we are facing a referendum in Italy while the new Spanish cabinet is still nowhere to be seen. The general elections in Germany and the presidential elections in France will hot up the situation even further next year. Thus, the current geopolitical situation could change profoundly. It will not be easy for companies to make investment decisions.

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External environment and assumptions

Oil prices rescue inflation

A new phenomenon, Brexit, has entered the scene since we published our last outlook. Given the uncertainty surrounding Brexit, SG economists have lowered their growth outlook for the euro area and Germany. They also no longer expect the Fed to hike rates this year, while they see the ECB's policy as likely to be even looser. On the other hand, thanks to the rise in oil prices, the inflationary outlook should be virtually unchanged with prices expected to increase gradually in the United States, the euro area, and in the CEE region as well.

External factor assumptions (average values)

	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17
Brent crude oil prices (USD/brl)	54.9	62.9	51.3	44.7	35.2	46.8	48.0	50.0	52.5	53.0	57.5
GDP yoy - euro area	1.3	1.6	1.6	1.7	1.6	1.6	1.6	1.5	1.3	1.3	1.3
CPI yoy - euro area	0.2	-0.3	0.2	0.1	0.2	0.0	-0.1	0.5	1.2	1.7	1.6
EUR/USD	1.13	1.11	1.11	1.10	1.10	1.13	1.10	1.08	1.05	1.05	1.05

Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics, Bloomberg

United States: no rate hike this year

Inflation in the US is likely to rise to 2% in December 2016.

Inflation in the US has stagnated at 1.0% yoy in the last couple of months. **Given the base effect and the prospect of oil price growth, SG analysts expect CPI inflation to rise to 2% yoy by December 2016,** and for the same reasons it could even accelerate to 2.5% yoy in 1Q17. The development of core prices will probably be more muted and we see them hovering around the current level of 2.2-2.3% yoy. More worrying for the FED than inflation is GDP growth (just 1.2% qoq in 2Q16), risks stemming from the global outlook, and volatility in the labour market.

GDP growth is driven by domestic demand.

May's labour market statistics disappointed. Although the June data surprised on the upside, from the beginning of the year just 160,000 new jobs on average have been created in the private sector, substantially less than the full-year 2015 average of 220,000. Still, the current pace of job creation should be enough to push down the unemployment rate further (currently 4.9%). This should put pressure on wages and support household consumption, currently the key driver of the economy. GDP growth should reach 1.9% in 2016. Business investment, which was negatively affected by investment cuts in the energy sector (due to the drop in oil prices), is still exerting a drag but, with oil prices rising, this negative effect should gradually diminish and investments should start to grow. **This should be reflected in a faster pace of GDP growth in 2017 (+2.2%).**

Next year the FED is expected to hike rates twice.

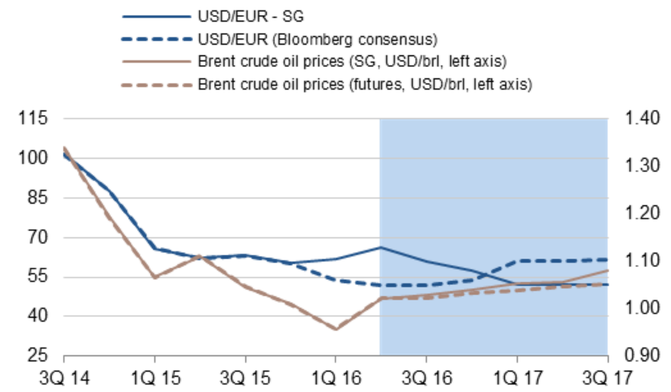
The combination of Brexit and the volatile data from the US labour market has led to a revision of the outlook for interest rates. SG economists now believe the FED will leave rates unchanged this year and that there will be just two rate hikes in 2017 (before Brexit they expected one hike in 2016 and three hikes in 2017). For 2019, they are already anticipating a rate cut as they believe the US economy will fall into a recession in late 2018/early 2019. The widening gap between FED and ECB monetary policy is likely to lead to EUR/USD weakening. The EUR/USD is likely to weaken slightly to 1.08 by end-2016 and average 1.06 in 2017.

Euro area: Brexit hit the GDP forecast

Inflation will go up, but slowly.

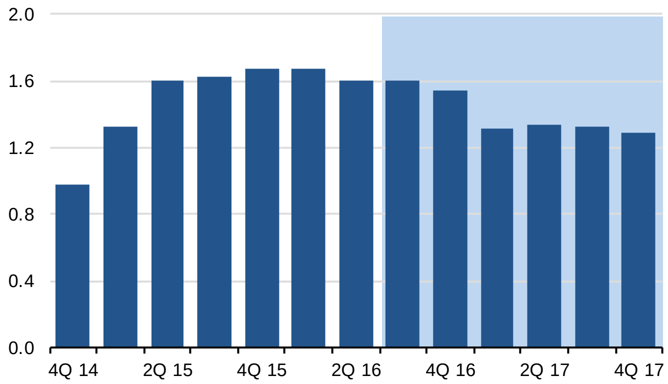
Inflation in the euro area returned to positive territory in June (+0.1% yoy) as a result of the base effects from energy prices. In the coming months it will be mostly oil prices and a higher comparison base that will push euro area inflation higher. Headline inflation is likely to reach 0.4% on average in 2016, but for the period 2017-2020 it stands at 1.5%. Core prices are likely to rise slowly. Unit labour costs are expected to remain subdued while the output gap should close very slowly (estimated at -0.7% of GDP in 2016). For these reasons, SG economists expect core prices to increase only marginally this year (+1.0% yoy), while on a mid-term horizon they should rise 1.2% on average, below the long-term average of 1.4% yoy.

Oil prices and EUR/USD



Source: SG Cross Asset Research/Economics, Bloomberg, Economic & Strategy Research, Komerční banka

Euro area GDP (%)



Source: SG Cross Asset Research/Economics, Datastream, Economic & Strategy Research, Komerční banka

ECB is likely to extend QE program.

At the July meeting the ECB didn't take any actions. Nevertheless given the Brexit vote, the problems facing the Italian banks and inflation deeply under the ECB's target, the ECB is likely to take some steps at its September meeting, when the new ECB inflationary prognosis will be available. The **ECB is likely to extend the QE program until September 2017** (vs March 2017 currently). **At the same time, it will probably have to change the conditions for bond purchases.** Brexit has led to a fall in the yields of many bonds to below the ECB's deposit rate (-0.4%), the rate at which the banks place excess liquidity at the ECB. The ECB cannot buy the bonds below this rate. With the 33% issuer limit and the current rate of purchasing, the ECB is expected to run into issue share limits within two to four months for Germany, the Netherlands and Finland. As a result, it will probably have to raise the issue share limit (to 50% for bonds where there is no risk of gaining a blocking minority).

GDP outlook for the euro area was revised slightly lower.

The GDP forecast for the euro area has been impacted by the Brexit vote. **According to SG economists Brexit will cost 0.1pp on average of euro area GDP per annum by 2020 (0.7pp of GDP on a cumulative basis).** This year, GDP growth is expected to come in at 1.6%, in 2017 it is however likely to decelerate to 1.3%. The hit to GDP is likely to come from higher uncertainty created by Brexit, leading to drop in business investment and in export to the Great Britain (because of weaker British domestic demand). GDP growth is likely to remain driven mainly by household consumption, which is being underpinned by a pick-up in the labour market, easy fiscal policy, low inflation and low interest rates.

BOX 1: Oil – the market is looking for a new equilibrium

Our inflationary prognosis for individual countries is based on the assumption oil prices will move gradually higher. Although world inventories still remain relatively high, oil supply from non-OPEC countries (especially from the US) has started to decline. This year non-OPEC production should decline by 0.8 Mb/d while in 2017 it should increase slightly (0.1 Mb/d). On the other hand, SG economists expected global demand to grow (+1.3 Mb/d in 2016, +1.4 Mb/d in 2017). Demand is rising mainly in China but also in other countries in Asia, including India. This should gradually create pressure on price growth. SG economists expect Brent oil prices to rise to $48/b in 3Q16, $50/b in 2016 and $56/b in 2017. In the longer term, low-cost production in Middle East and medium-cost US shale oil will not be sufficient to meet rising demand. As a result, high-cost deepwater offshore and Canadian oil sands will be needed to fill the gap. As a result, Brent oil prices are likely to jump to $70-80 /b (2018-2020).

Mb/d	3Q16f	4Q16f	2016f	1Q17f	2Q17f	3Q17f	4Q17f	2017f
OECD demand	46.5	46.3	**46.2**	46.3	45.3	46.5	46.3	**46.1**
Non-OECD demand	50.2	50.5	**49.9**	50.0	51.5	51.7	52.0	**51.3**
World demand	**96.7**	**96.9**	**96.0**	**96.3**	**96.8**	**98.2**	**98.4**	**97.4**
World supply	**96.5**	**96.7**	**96.4**	**96.4**	**96.7**	**97.2**	**97.5**	**96.9**
Stock change	**-0.2**	**-0.1**	**0.3**	**0.1**	**-0.1**	**-1.0**	**-0.9**	**-0.5**
NYMEX WTI ($/bbl)	46.00	48.00	**42.94**	50.50	53.00	55.50	58.00	**54.25**
ICE Brent ($/bbl)	48.00	50.00	**44.78**	52.50	55.00	57.50	60.00	**56.25**

Source: Bloomberg, SG Cross Asset Research/Commodities

Domestic demand drives German GDP growth.

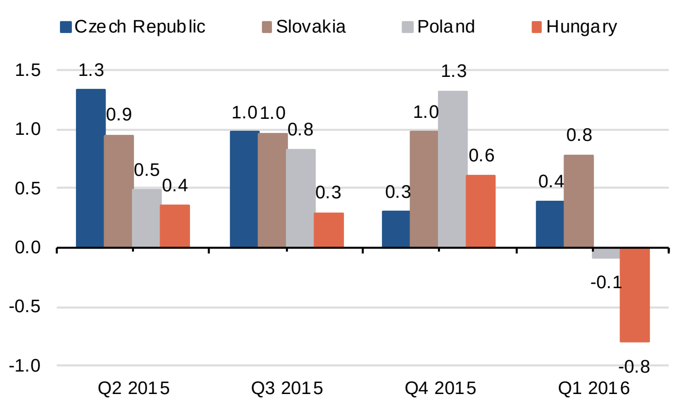
The Brexit vote will impact Czech biggest trading partner, Germany, as well. The uncertainty sparked by the British referendum is expected to cost the German economy 0.2pp of GDP growth this year (1.6% forecast for 2016). The effects of Brexit will mostly be seen in the worsening of the trade balance. However, investments are forecast to decelerate as well. Net exports will therefore contribute negatively to growth. Fortunately GDP growth is driven mostly by domestic demand, which is being supported by the strength of the labour market. Public finances are also in good shape, so there is a space to use them if necessary. Like in the other countries, rising oil prices will play a key role in inflation developments. Inflation is expected to rise on average by 0.5% yoy in 2016 and by 1.6% in 2017.

CEE: Investments are the region's Achilles heel

Investments dragged on GDP growth.

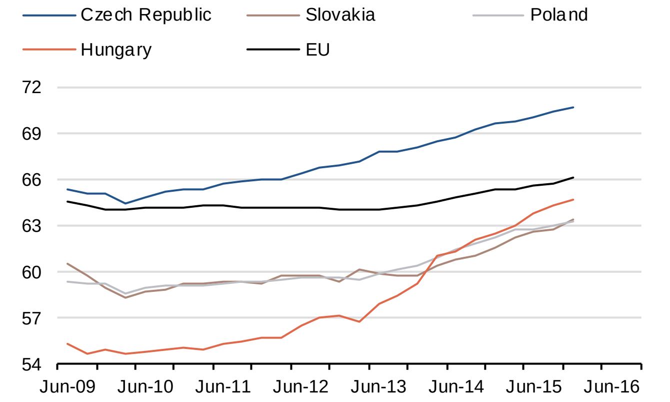
Brexit is likely to hit the CEE's Achilles heel at present – investments. Investments already substantially disappointed in 1Q16, pushing GDP growth to surprisingly low levels. In Poland, investments posted the sharpest drop since 2013 (-1.4% yoy) and for the first time since 2012, the Polish economy declined in qoq terms (-0.1% qoq). Investments were hit by a weak inflow of money from EU funds and the uncertainty linked to Brexit, while lower GDP growth in Germany and the euro area did not provide much cheer. According to SG economists, Brexit will cost Poland 0.2-0.3pp of GDP growth in 2017-2019. Like for other countries, Brexit will have a negative impact on investments and the trade balance. Poland should be the largest net recipient of EU funds (it should receive €82.5bn in the new programming period 2014-2020). As a consequence of Brexit, the level of money received from EU funds is likely to be lower. Investments fared even more badly in Hungary in 1Q16, down 7.2% yoy, their biggest fall since 2010. GDP thus fell by 0.8 % qoq in 1Q16. Investments are likely to remain a drag over the rest of the year. In 2016 we estimate GDP growth for the Czech Republic to be 2.1%, while GDP growth should be 3.4% in Poland, 2.8% in Hungary (according to the central bank's prognosis) and 2.6% in Slovakia.

CEE region: GDP growth (% qoq)



Source: Economic & Strategy Research, Komerční banka, Eurostat

CEE region: employment rate (%)



Source: Economic & Strategy Research, Komerční banka, Eurostat

Central banks in the region are likely to maintain loose monetary policy.

The key driver of GDP growth in the CEE region remains consumption. The unemployment rate is falling, putting pressure on wage growth. Real household disposable income is being further enhanced by inflation which, except for the Czech Republic, is negative (in June: Poland -0.8% yoy, Hungary -0.2% yoy, Slovakia -0.8% yoy). As a result, the region's central banks are likely to maintain a loose monetary policy stance. **The Polish central bank should stay on hold this year (1.5%) but, according to SG economists, it might consider lowering the required reserve ratio** (currently 3.5% in Poland and 2% in the Czech Republic) to support investment activity.

Hungarian central bank supports investment activity.

The Hungarian central bank already adopted a similar measure in July when it modified the terms of the three-month deposit instrument. The tender on three-month deposits will be held just once a month from August (versus once a week up to now), while from October it will also limit the amount of bids by commercial banks accepted at the tender. This should prompt the banks to lend more or to buy government bonds, which could exert downward pressure on interest rates. The Hungarian central bank is likely to keep its key interest rate unchanged at 0.9% for longer, but could take similar measures to support domestic investment activity in the coming months.

Polish zloty is expected to strengthen in the longer term.

Regarding the development of CEE currencies, **rating agency decisions affected the polish zloty this year.** The downgrade of Poland's rating in January 2016 from A- with a positive outlook to BBB+ with a negative outlook by Standard & Poor's rating agency sent the polish zloty to the weakest level since 2012 (EUR/PLN4.5). On the other hand, the July decision by Fitch to leave the rating unchanged at A- with a stable outlook helped the currency. Rating agencies are concerned mostly by the country's public deficit. Nevertheless, according to SG economists, Poland should be able to keep its public deficits close to 3% in the coming years. Due to the risks linked to the Brexit and the worsening trade balance, EUR/PLN is likely to remain traded around EUR/PLN4.4. Next year, it is expected to strengthen towards EUR/PLN4.35 (in June 2017). The Hungarian forint, according to SG economists, should slightly weaken from its current levels of EUR/HUF312.5 to EUR/HUF316 at the end of this year, and towards EUR/HUF320 in June 2017.

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Macroeconomic outlook

Economic slowdown despite resilient consumers

The result of the Brexit referendum represents another hit to the fragile recovery of the European economy. It is set to slow growth in the euro area by 0.7pp by 2020, in our view. But given the resilience to external headwinds that euro area countries showed early in the year, we believe that external conditions will continue to have a moderately positive impact on Czech economic growth. The Czech economy should thus further benefit from continually improving external conditions, albeit most momentum will come from strong domestic consumption. We retain our view that GDP will advance 2.1% this year based on an expected slump in public investment. Next year, growth should be more balanced and reach 2.6%. Inflation is set to accelerate at the turn of the year, but the inflation target will be hit in 3Q17.

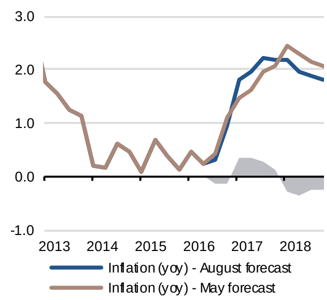
Main changes

GDP:
GDP will decelerate this year due to a considerable slump in investment activity. We keep our forecast for this year at 2.1%. We expect acceleration to 2.6% next year.

Inflation:
We have made a minor revision to our inflation outlook, from 0.6% to 0.5%. Next year, average price growth should reach 2%.

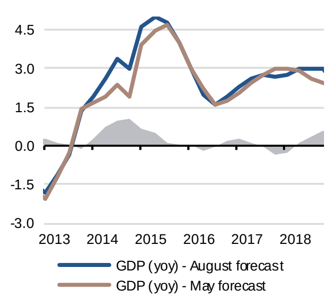
Brexit is set to cut 0.7pp cumulatively from euro area economic growth by 2020 and will also have a direct effect on the Czech economy. **The impact of the Brexit will be spread over several years and thus should not trigger an immediate recession in the euro area.** The euro area will further benefit from labour market improvements accompanied by a drop in the savings rate, which should help boost private consumption. Investment activity is starting to take off, albeit at slower pace than in past recoveries, dampened by policy uncertainty. Also, the German economy is strengthening despite external headwinds to trade and investment. Low oil prices and inflation, the tight labour market, some fiscal easing and easy credit conditions are, according to SG economists, supporting real disposable income and consumption. Trade and investment are likely to weaken on the back of the Brexit vote. Yet the strength of the economy will insulate Germany from weak external conditions. External demand for the Czech products should thus continue in moderate expansion.

Change in our inflation outlook



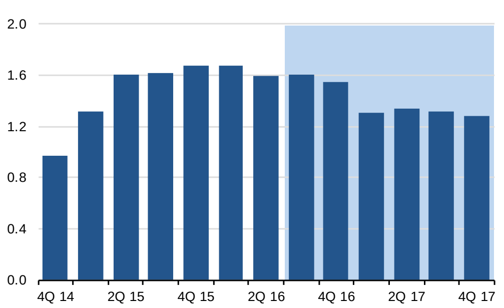
Source: Economic & Strategy Research, Komerční banka, CZSO

Change in our GDP outlook



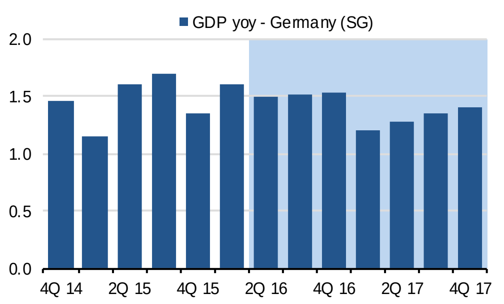
Source: Economic & Strategy Research, Komerční banka, CZSO

Euro area likely to experience a slowdown next year…



Source: SG Cross Asset Research/Economics, Economic & Strategy Research, Komerční banka

… Germany too



Source: SG Cross Asset Research/Economics, Economic & Strategy Research, Komerční banka

Inflation in the euro area will remain low this year at 0.5%, according to SG economists. Strong acceleration expected towards end-2016 should be temporary, and in 2017, headline inflation will likely approach the core measure when it should print 1.5%. **The inflation target should not be reached before 2020, so the ECB will likely remain in easing mode.** We thus see only small inflationary pressures in the Czech Republic stemming from the external environment.

Industry saved by car production

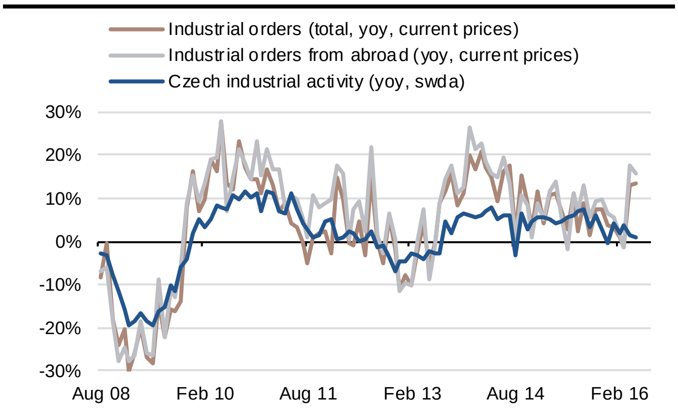
Industrial production growth was weak in the first months in the year. We expect it to print only 2.4% yoy (SWDA) in 3Q16. The **Czech industrial sector is strongly supported by surging demand for cars in the euro area.** Without excellent results from the automotive industry, we would see negative yoy dynamics for total industrial production. The sector has been hit by a slump in investment activity. Our rough estimates show that 1pp slowdown in investment translates into 0.2pp lower industrial production growth. Another reason for weaker output is the shutdown of two main refineries. The Litvinov refinery was closed in August 2015 due to an accident, and the refinery in Kralupy was shuttered in mid-May for a similar reason. Both operations should be reopened in October. **We thus expect slight acceleration in industrial growth at year-end, but overall growth looks set to be 3.6%, and we expect it to accelerate to 5% in 2017.**

The construction sector is contracting due to a slump in public investment. Building construction has decreased due to problems in Prague.

The construction sector has been even more seriously hit by the drop in investment. In spring we saw both building and engineering construction plummet. **Engineering construction dipped due to the drop in public investment in infrastructure.** A reduction in the inflow of EU funds was the main culprit behind this development. Moreover, some infrastructural projects have problems with outdated Environmental Impact Assessments (EIAs). These projects cannot be financed with the EU money, which further delays their realisation. The government negotiated an exception with the European Commission for nine key projects, but other projects will have to be postponed until they go through a new assessment. All in all, we expect a pick-up in engineering construction, but due to sluggish tapping of the EU funds from the new programming period, combined with the problems of outdated EIAs, growth should remain moderate. **Building construction is also going through a rough patch.** It was impeded by uncertainty about building rules in Prague. A new version of these regulations should go into effect in early August, so this one uncertainty will be removed. Another impediment is the metropolitan development plan, which will be discussed as late as autumn, and there is no indication of when it could come into force. **We thus expect construction output to drop 5.9% this year and rebound just 4.2% next.**

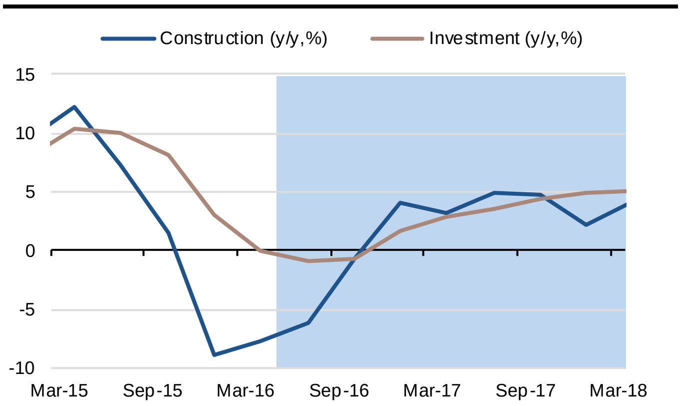
Given the muted development in industry and construction, we forecast a sharp slowdown in economic growth this year. Last year's exceptional growth of 4.6% should be followed by 2.1% this year, we estimate. In 2017, we expect growth to accelerate to 2.6%.

Industrial production remains muted



Source: CZSO, Economic & Strategy Research, Komerční banka

Construction slumps on the back of low investment



Source: CZSO, Economic & Strategy Research, Komerční banka

Consumer spending offset by massive slowdown investment

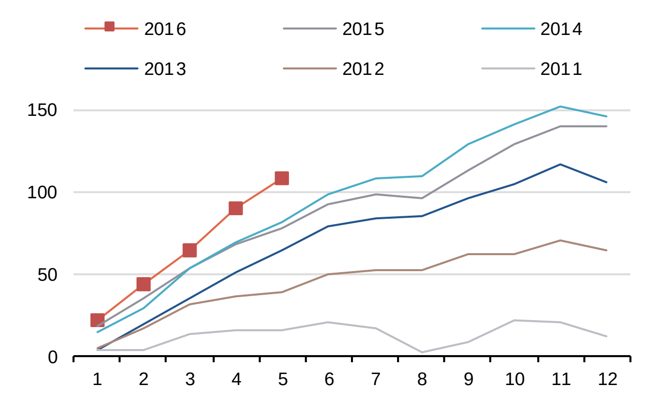
Investment activity to remain muted this year.

Revised 1Q16 data showed that the slowdown in investment activity was not as severe as previously reported and not as bad as we expected in the previous edition of our *Czech Economic Outlook*. The situation with outdated EIAs has also improved, so the slump in public investment should not be as pronounced as we previously expected. The environment for private investment remains favourable. Credit conditions are easy, external demand remains on an upward trend. On the other hand, corporations have to pay more for wages, which is already decreasing their profit margins, and uncertainty about future developments is weighting on corporate investment appetite. We expect overall investment to edge up just 0.4% this year and rise 3.1% in 2017.

Czech exports to report historically high surplus this year.

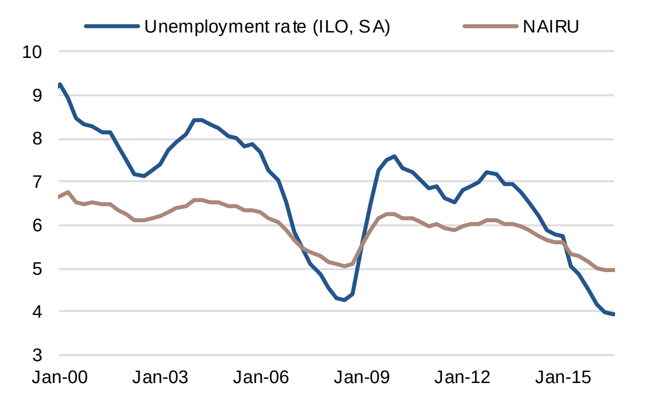
Growing demand for cars in the euro area is boosting Czech exports, stemming from the automotive industry. Although other sectors have not been as successful, the volume of exports increased by CZK35bn yoy in 1M-5M16. In contrast, import growth remained virtually unchanged. Low investment activity is weighing on imports, as is the yoy decline in the price of oil and other commodities. On the other hand, strong domestic demand has boosted imports of consumer goods. The external trade balance is thus on track to record surplus this year, as external demand should continue to grow while domestic investment activity remains muted. Investment activity and commodity prices are set to accelerate next year, in our view, resulting in a smaller surplus in the nominal terms. Yet the contribution to the GDP will likely remain positive, albeit shrinking from 0.8pp this year to 0.4pp in 2017, we estimate.

Czech exports aiming to record surplus this year (CZKbn)



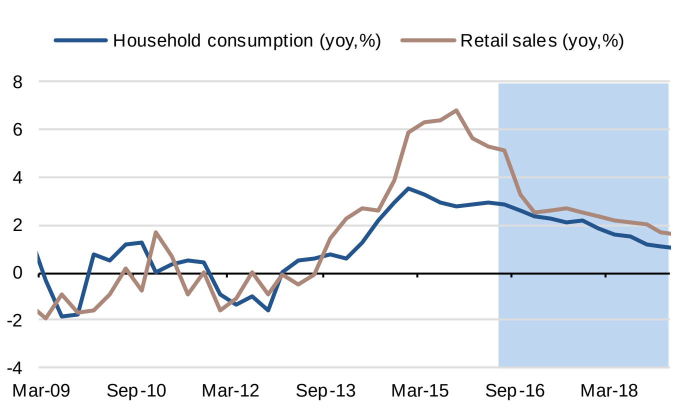
Source: CZSO, Economic & Strategy Research, Komerční banka

Unemployment rate on historic lows (%)



Source: CZSO, Economic & Strategy Research, Komerční banka

Household consumption to remain strong



Source: CZSO, Economic & Strategy Research, Komerční banka

Consumption remains sound. The unemployment rate has declined further, though it is so low that it does not have much more room to fall, as the pool of skilled workers available has shrunk rapidly. The unemployment rate (ILO) should dip below 4% this year, we estimate, and edge down two ticks next year. We thus forecast stronger wage growth, which should also be supported by the government, which is slated to increase salaries for public servants. We see nominal wage growth accelerating to 3.4% from last year's 2.7%. We expect even stronger growth in 2017 of 3.5%. Moreover, inflation remains muted, so households' real disposable income should rise. Although consumer confidence has been on a downward path since peaking in January, we believe consumers feel comfortable with their economic situation and will spend their growing wages. That said, their confidence is being dragged down by uncertainty about future social developments related to the recent wave of terrorist attacks in Europe and the refugee crisis, but we do not expect this to have direct impact on consumer spending. We forecast consumer consumption growth of 2.8% this year and 2.2% in 2017.

Fiscal policy – political cycle to boost spending

We keep our call for this year's budget deficit of just CZK35bn, compared with the official target of CZK70bn.

We keep our call for this year's budget deficit of just CZK35bn, compared with the official target of CZK70bn. Budget revenues have been rising sharply, driven by the inflow from EU funds (mainly from the old programming period of 2007-2013) on one hand, and by higher tax revenues on the other. VAT receipts have seen even greater growth than their economic base due to a favourable yoy comparison and likely improvement in tax collection. The volume of personal income taxes has been rising due to the tightening labour market and the increase in corporate tax revenues has been reflecting the better profitability of firms since early 2014.

While this development is favourable in terms of fiscal stability, we identify a problem on the expenditure side. The drop in public investment (which has been helping to keep the budget balance positive over the past months) is negatively affecting investment and GDP performance. The construction sector specifically is suffering the most. However, we expect the government to perform non-negligible transfers into its infrastructure funds ahead of a pick-up in investment in 2017 (see below).

The expected central government budget deficit underpins our call for the ESA 2010 deficit of 0.6% of GDP in 2016.

General elections will be held in October 2017 should the government remain in place until the end of its term. We expect the political cycle to stimulate government spending next year, and several plans by the government have already confirmed that fiscal easing is on the way. Effective from (as soon as) September 2016, teachers' wages will rise by a total of 8%. The volume of wages in the state administration and security forces are set to inflate by 5% in November 2016. The prime minister promised a 10% increase in healthcare workers as of January 2017, and a boost to pension benefits. **We estimate the total impact of these measures of CZK23.5bn on the expenditure side in 2017**.

We expect government investment to increase in 2017.

Also, government investment should increase in 2017. Several infrastructure projects will begin in late 2016 or in 2017, thus the tapping of EU funds is set to accelerate as the new programming period gets on track.

Public finance dynamics

	2015	2016f	2017f	2018f	2019f	2020f
Public deficit (% GDP)	-0.4	-0.6	-0.8	-0.3	-0.6	-0.5
Fiscal impulse (pp GDP growth)	0.5	-0.2	-0.6	-	-	-
Public debt (CZKbn)	1,836	1,846	1,886	1,901	1,921	1,946
Debt ratio (% GDP)	40.3	39.0	38.0	36.5	35.7	35.3

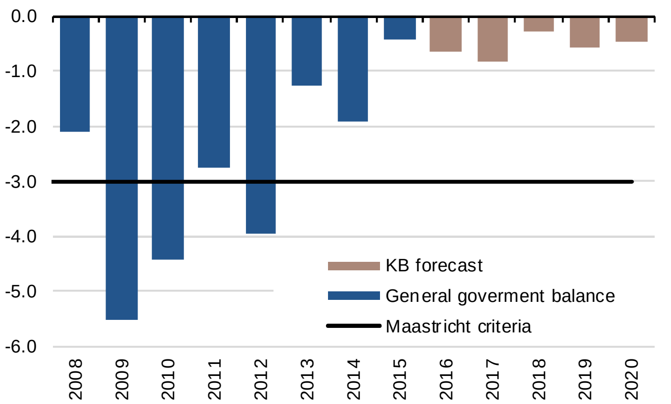
Source: CZSO, MoF, Economic & Strategy Research, Komerční banka

On the revenue side, the government is planning relatively minor changes to the tax system: child tax credits are set to increase in 2017, subtracting a maximum of CZK1bn from the collection. However, the new online-sales reporting system will take effect in December 2016 or January 2017, aiming to improve VAT revenues by several billion CZK.

The ESA 2010 deficit is set to rise to 0.8% of GDP next year, in our view.

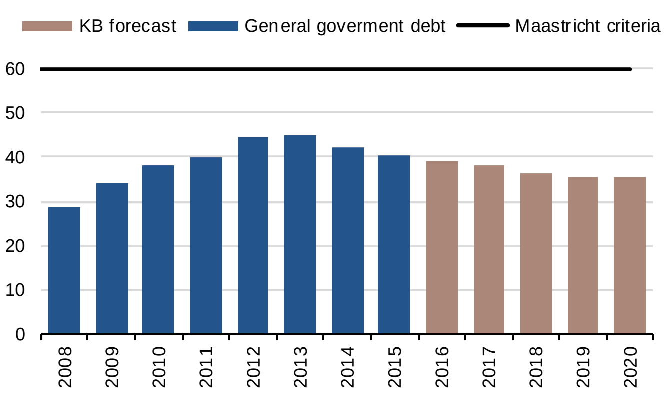
As a result, the fiscal impulse next year should reach some 0.6pp of GDP in 2017 and boost mainly household spending. Central budget shortfall is set to print at CZK45bn (the government plan is at CZK60bn) and the ESA 2010 deficit is set to rise to 0.8% of GDP next year, in our view.

Public finance deficits (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Public debt (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

We expect the debt-to-GDP ratio to drop to just 39% in 2016, as we look for only a CZK10bn increase in the volume of debt (the government is likely to tap its liquidity reserve to cover a part of the budget deficit). Next year, economic growth and a still relatively low deficit should result in yet another drop in the debt-to-GDP ratio to 38%.

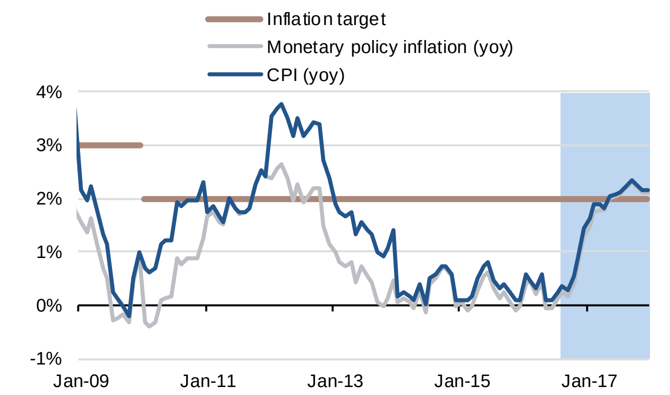
Inflation to accelerate at year-end

Inflation to accelerate at the turn of the year.

Headline inflation decreased once again to almost zero. We have seen declines in core and food inflation, while fuel prices recovered from their yoy slump as global oil prices rose. Regulated prices decreased significantly due to a sharp drop in gas prices for consumers. We expect these to bottom out and inflation to accelerate at the turn of the year due statistical base effects resulting from falling energy prices at end-2015. Headline inflation should start to catch up with core inflation, and we expect it to increase to 1.5% by year-end and further accelerate towards the CNB's 2% target, which we think will be reached in 2H17.

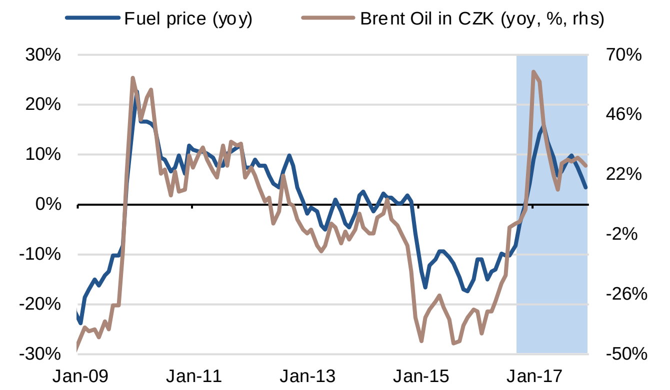
Core inflation slightly eased to 1.4% yoy, we estimate. Core prices thus reflect external developments, as core inflation in the euro area remains below 1%. These exogenous factors will provide only moderate support, according to SG economists, while domestic factors are set to push core prices higher. Rising employment and wages are boosting the purchasing power of households, and this trend is likely to continue over the next two years, in our view. We think core inflation will surpass 2% in mid-2017, providing a significant push for the headline measure. **On average, core inflation should print 1.5% this year and accelerate to 1.9% in 2017.**

Inflation to accelerate at the turn of the year…



Source: Economic & Strategy Research, Komerční banka, Bloomberg, CZSO, CNB

… when fuel price inflation becomes strongly positive



Source: SG Cross Asset Research/Economics, Economic & Strategy Research, Komerční banka, Bloomberg, CZSO

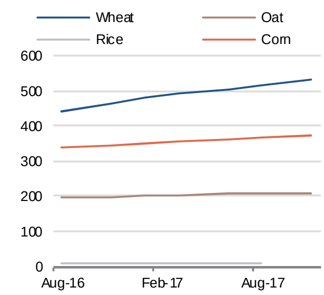
Fuel prices to return to an upward trajectory.

Fuel prices bottomed out in 1Q16 and were on an upward trajectory in 2Q16, but they are still down sharply yoy. The results of Brexit referendum halted the oil price growth on global markets, and the weekly CZSO surveys have already showed three consecutive weeks of declining fuel prices. The coming months should bring stabilisation, in our view. The yoy slump in fuel prices should narrow, and statistical base effects should ensure yoy growth at the turn of the year. We expect this to provide a significant boost to headline inflation.

Food prices continue to surprise on the downside. Risks remain for lower food inflation.

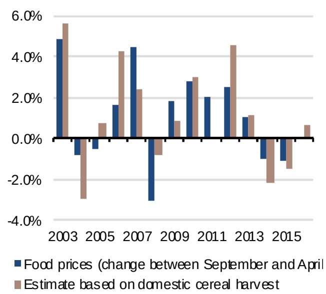
Food prices have continued surprising on the downside. We expect them to pick up slightly, but yoy growth should remain negative, and we forecast average food inflation of -1.6% in 2017. We expect food inflation of 1.7% on average next year. The risks are skewed to the downside, as we show below.

Agricultural commodity price outlook (futures contracts in USD)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

Impact of harvest on food prices



Source: CZSO, Economic and Strategy Research, Komerční banka

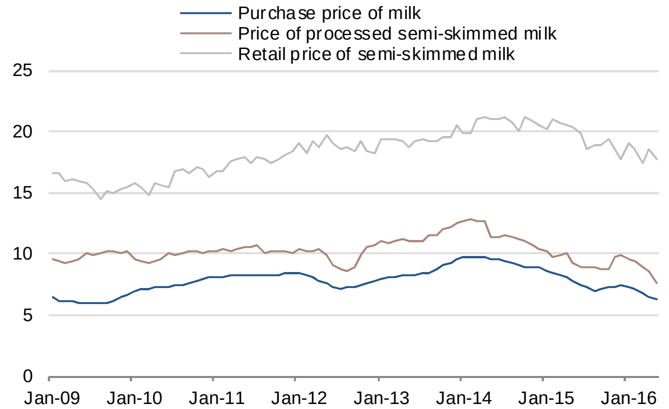
Administered prices were dragged down by a notable decline in gas prices for consumers, which erased much of the widening gap between the gas price on global markets and the price for consumers. As global gas prices have already bottomed, we do not expect a further reduction in energy prices for consumers. We forecast a modest increase in energy distribution prices in early 2017. Rising oil prices might buoy transportation prices. Overall, regulated prices should increase 0.2% this year and 1.2% in 2017, we estimate.

BOX 2: Food prices indicate lack of inflation pressures

Food items represent 16% of the current Czech CPI basket. Slightly less than 7% of the basket consists of food items whose prices can be approximated by world prices, since these items are easy to store, have low transport costs and allow for simple standardization. Examples include food items comprising mainly grains, oil seeds or meat. The futures prices of these commodities have been stable, except for grains, which are showing a mild increase. This trend might to a certain extent be offset by domestic factors. The first estimates of this year's harvest suggest that it will be worse than last year's very good harvest but still 2% better than the average since 2013. This might have only a marginally positive impact on food prices, if any impact.

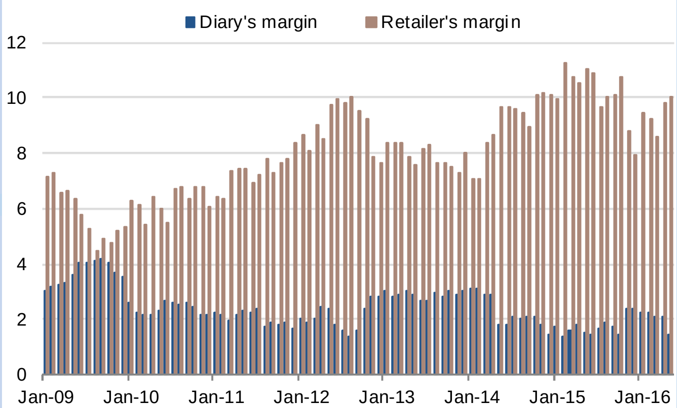
Dairy products accounts for 3.2% of the consumer basket, and it is seeing some specific trends that are worth noting. The dynamics of the milk market are evolving given the removal of milk quotas in April last year, sanctions on exports to Russia and skyrocketing exports to Asian countries that have gradually substituted the fall in Russian demand. The price of milk is also being influenced by increasing dairy farming productivity. Hence, it is under pressure due to production surpluses. The market will stabilize as exports to Asia further increase or if there is a downturn in the breeding of dairy cattle, though this more a long-term factor. In the short term, prices will be influenced by supply-chain margins, which are elevated currently. Thus, milk and derivative products are unlikely to see price increases any time soon.

Development of raw and processed milk prices (CZK / litre)



Source: The Ministry of Agriculture of the Czech Republic, Economic and Strategy Research, Komerční banka

Margin developments in the dairy supply chain (CZK / litre)



Source: The Ministry of Agriculture of the Czech Republic, Economic and Strategy Research, Komerční banka

Perishable food items such as fruit and vegetables account for 2.6% of the consumer basket. However, these food items are not prices at world level. In the pricing process, the size of the local harvest and the level of imports play a key role. Moreover, as in the case of the milk market, prices affect the ability of retailers to absorb price fluctuations in their margins.

Czech Republic – 2016 fruit harvest estimate (tonnes)

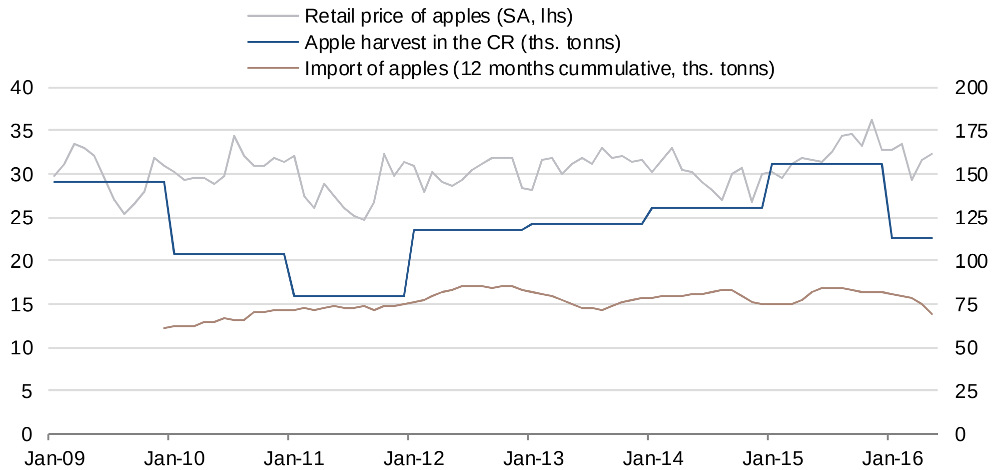
	apples	pears	cherries	sour cherries	apricots	peaches	plums	gooseberries	currants	forest fruits
∅ harvest 2009-2015	121781.7	5631.4	1887.3	5298.4	2317.3	1731.4	6068.1	0.8	2212.1	26.3
2015	155640.0	10002.0	2306.0	5847.0	2210.0	1282.0	8742.0	2.1	2385.0	45.7
Estimate for 2016 on 15 June	113045.0	6272.0	2353.0	4654.0	708.0	421.0	5786.0	1.2	1678.0	69.0
Estimate/harvest 2015 (%)	72.63	62.71	102.04	79.60	32.04	32.84	66.19	59.05	70.36	150.98
Estimate /∅ harvest in 2009-2015	92.83	111.37	124.68	87.84	30.55	24.32	95.35	147.37	75.85	262.79

Source: CZSO, Central Institute for Supervising and Testing in Agriculture, Fruit Union of the Czech Republic, Agricultural Association of the Czech Republic, Economic and Strategy Research, Komerční banka

Fruit prices could pose a risk of inflation growing faster than expected because preliminary data for this year's harvest indicates a poorer harvest than last year. According to data from the Central Institute for Supervising and Testing in Agriculture, this year's crop will be worse than last year's for almost all fruits. For many kinds of fruit, the harvest will be below the seven-year average.

Besides the size of the harvest, the other key factor influencing retail prices is the amount of imports, which can compensate for domestic shortfalls in production. However, the example of apples, the fruit with the highest level of production, shows that imports have not been offsetting local shortfalls in such a way as to stabilize prices (see graph below). Retail prices are also influenced by fluctuations in supply-chain margins. Unfortunately, we are not able to estimate this factor in this case.

Czech apple market



Source: CZSO, Central Institute for Supervising and Testing in Agriculture, Fruit Union of the Czech Republic, Agricultural Association of the Czech Republic, Economic and Strategy Research, Komerční banka

Overall, across the various food segments, we are not able to identify any significant upside risk to inflation. The grain harvest should fall but remain of a sound average size. There is no upside risk in the milk market either. The only source of food price growth might be fruit.

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The developments around Brexit will fuel uncertainty

Developments around Brexit to remain the largest risk.

The result of the Brexit referendum introduced nervousness on financial markets and brought uncertainty about the future economic developments. The type of arrangement negotiated between the UK and EU will decide Britain's future economic growth, but also affect the outlook for all other countries in Europe. If the UK decides to stay out of the single market, growth prospects would erode further.

On the domestic front, we still see risks regarding investment. An early start to tapping EU funds from the new programming period would help investment activity and create upside risk for the economic growth. Conversely, problems with EU funds are not rare in the Czech Republic, and they may not get off to a full start right away. Infrastructure construction has been crucial for recent economic growth, and the infrastructure deficit is hindering potential economic growth.

Key economic indicators

	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2015	2016	2017	2018	2019	2020
GDP and its breakdown														
GDP (real, yoy)	2.0	1.6	1.9	2.3	2.6	2.8	2.7	2.7	4.6	2.1	2.6	2.9	1.8	1.5
Household consumption (real, yoy)	2.9	2.9	2.6	2.3	2.3	2.1	2.2	1.9	3.1	2.8	2.2	1.6	1.0	1.3
Government consumption (real, yoy)	1.9	1.6	2.3	2.4	2.6	1.7	1.5	1.3	2.0	2.1	2.0	1.5	1.9	2.4
Fixed investments (real, yoy)	-0.1	-0.9	-0.6	1.6	2.9	3.5	4.3	5.0	9.1	0.4	3.1	4.8	3.3	2.8
Net exports (contribution to yoy)	1.5	0.6	0.4	0.5	0.3	0.4	0.3	0.3	0.1	0.8	0.4	0.5	0.7	0.7
Inventories (contribution to yoy)	-1.3	-0.5	0.1	-0.2	0.0	-0.1	0.0	-0.2	0.4	-0.6	-0.1	-0.1	-0.5	-0.8
Monthly data from the real economy														
Foreign trade (CZK bn) (*) (***)	125.8	124.6	124.3	123.9	122.9	121.7	118.5	116.6	425.5	512.8	488.2	466.4	488.6	517.4
Exports (nominal, yoy) (*)	4.2	0.2	-1.4	2.3	4.7	8.1	9.6	9.0	7.5	1.9	6.2	9.3	4.4	2.9
Imports (nominal, yoy) (*)	1.6	-2.3	-2.0	4.2	5.7	9.5	11.2	11.1	8.7	-0.4	7.7	11.0	4.4	2.6
Industrial production (real, yoy)	5.0	2.0	4.4	5.8	2.4	5.2	6.5	5.7	4.6	3.6	5.0	6.8	4.1	2.2
Construction output (real, yoy)	-7.7	-6.2	-0.7	4.0	3.2	5.0	4.7	2.3	7.7	-5.9	4.2	3.6	3.1	1.6
Retail sales (real, yoy)	6.0	5.1	3.3	2.5	2.6	2.7	2.6	2.3	6.3	5.3	2.6	2.2	1.5	1.5
Labour market														
Wages (nominal, yoy)	3.1	2.9	3.0	3.4	3.6	3.7	3.6	3.4	2.7	3.4	3.5	3.0	2.3	2.6
Wages (real, yoy)	2.9	2.6	2.0	1.5	1.5	1.4	1.3	1.2	2.4	2.9	1.5	1.0	0.7	1.4
Unemployment rate (MLSA)	5.2	5.1	5.4	5.3	4.7	4.7	5.2	5.3	6.4	5.5	4.9	4.9	4.9	5.2
Unemployment rate (ILO 15+)	3.9	4.0	3.9	4.0	3.7	3.7	3.7	3.9	5.1	4.0	3.8	3.7	3.7	4.0
Employment (ILO 15+, yoy)	2.1	1.2	0.8	0.2	-0.4	0.2	0.1	0.0	1.4	1.5	0.0	0.0	0.0	-0.4
Consumer and producer prices														
CPI Inflation (yoy)	0.2	0.3	1.0	1.8	2.0	2.2	2.2	2.2	0.3	0.5	2.0	2.0	1.6	1.1
Taxes (contribution to yoy inflation)	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.2	0.1	0.0	0.0	0.0	0.0
Core inflation (yoy) (**)	1.5	1.4	1.4	1.5	1.8	2.1	2.2	2.2	1.3	1.5	1.9	2.2	1.9	1.0
Food prices (yoy) (**)	-2.4	-1.9	-0.4	1.1	1.8	2.0	1.8	1.9	-1.1	-1.6	1.7	1.8	1.2	1.2
Fuel prices (yoy) (**)	-12.2	-10.2	0.1	12.9	9.0	8.4	5.5	1.9	-13.3	-8.7	8.9	0.2	-4.5	-2.1
Regulated prices (yoy) (**)	0.2	0.0	0.1	0.6	1.2	1.5	1.5	2.1	0.2	0.2	1.2	1.8	2.2	2.4
Producer prices (yoy)	-4.6	-2.7	-0.6	3.1	3.7	3.8	3.8	3.7	-3.2	-3.0	3.6	2.8	1.1	1.3
Financial variables														
2W Repo (average)	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.28
3M PRIBOR (average)	0.29	0.29	0.29	0.29	0.29	0.29	0.14	0.20	0.31	0.29	0.25	0.27	0.29	0.43
EUR/CZK (average)	27.04	27.00	27.00	27.00	27.00	27.00	26.80	26.73	27.3	27.0	27.0	26.2	24.7	23.8
USD/CZK (average)	23.95	24.55	25.00	25.71	25.71	25.71	25.28	25.21	24.6	24.5	25.6	24.5	21.1	19.6
External environment														
GDP in EMU (real, yoy)	1.6	1.6	1.6	1.3	1.4	1.3	1.3	1.3	1.6	1.6	1.3	1.2	0.8	0.8
GDP in Germany (real, yoy)	1.5	1.5	1.5	1.2	1.3	1.4	1.4	1.3	1.5	1.5	1.3	1.2	0.8	0.4
CPI in EMU (real, yoy)	-0.1	0.6	1.2	1.7	1.6	1.5	1.4	1.4	0.0	0.4	1.5	1.5	1.4	1.5
Brent oil price (USD/brl, average)	46.8	48.0	50.0	52.5	53.0	57.5	62.0	63.2	53.4	45.0	56.3	65.0	70.1	75.0
EURIBOR 1Y (average)	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	0.17	-0.01	-0.02	-0.02	-0.02	0.15
EUR/USD (average)	1.13	1.10	1.08	1.05	1.05	1.05	1.06	1.06	1.11	1.10	1.05	1.07	1.17	1.21

Source: Economic & Strategy Research, Komerční banka
Note: (*) foreign trade according to cross border statistics;
(**) these parts of inflation are adjusted for the primary effect of indirect tax changes;
(***) the quarterly data are seasonally adjusted.

CNB Focus

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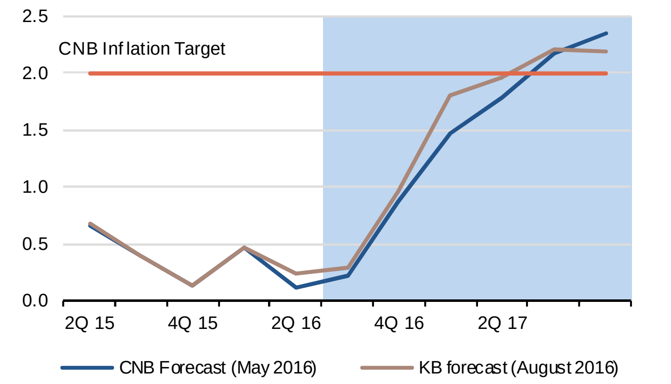
New bank board to pursue the old policy

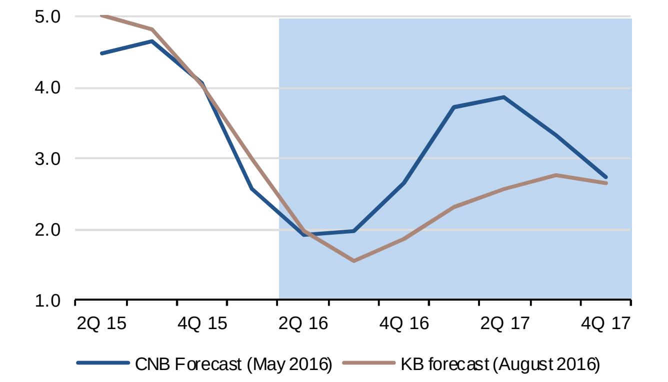
After Brexit, we expect the CNB to stay in wait-and-see mode, with no imminent change in policy or its guidance. We assume that its new economic outlook has not gone through significant changes to give the bank board reason to postpone the expected exit from the FX commitment. The central bank will thus wait until the economic effects of the Brexit referendum result start to materialise. Yet, the outcome from the bank board meeting will stress the risks of a later exit and the possibility of negative rates will be mentioned once again.

Inflation outlook



Source: Economic & Strategy Research, Komerční banka, CNB, CZSO

GDP outlook



Source: Economic & Strategy Research, Komerční banka, CNB, CZSO

The August meeting will be the first monetary policy meeting with the new composition of the CNB board. However, **the new board will likely continue in the old policy**.[1] New Governor Rusnok reiterated several times that the floor will not be scrapped before end-2016. The expected date is mid-2017. In his previous interviews, he also stated that the chances are even skewed towards a later exit. New board member Benda (Rusnok's former advisor) has, in his public appearances, shown that his views are fully in line with the CNB's recent stance. Although we do not have any information about new board member Nidetzky, he will probably not deviate much from the institution's view.

The new forecast, which will be presented at the meeting, should not significantly differ from the old one, in our view. **We expect the CNB to wait for to the effects of Brexit to start materialising before adjusting for this.** The bank board should thus not change its stance about the expected exit either. We believe it will be repeated that the commitment will stay at least until year-end, and the expected exit will occur in mid-2017.

We expect the effects of Brexit to drag down inflation slightly, and we believe the CNB will announce a delay in the FX floor exit at its November meeting. **We assume that the floor will be scrapped in 4Q17.** After that, the CNB will be still present on the market to mitigate excessive volatility and appreciation with outright interventions.

[1] Read more about the new board members in our report:
http://trading.kb.cz//api/file/147409?hash=c3617902ba93b4ca7c22e1492679c5e8

Exit risks on both sides

We see risks for the timing of exit on both sides.

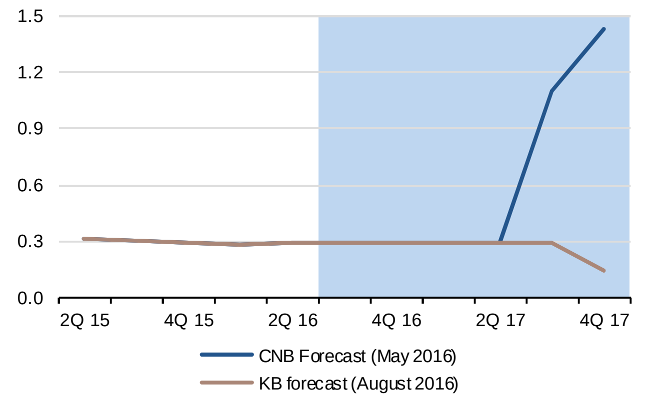
We see almost zero chance that the FX commitment will be scrapped this year. We see the risk of exit in 1Q-3Q17 as minor (25% probability). The risk is that the board would like to surprise the market in a Swiss-type scenario, abolishing the FX floor without prior notice. The board might prefer this scenario, as it possibly limits the inflow of speculative capital that would come in as an expected exit approaches.

We estimate the probability of a later scrapping of the floor, as late as 2018, at the same 25%. Stronger-than-expected effects of Brexit and low commodity prices only slowly being passed onto final consumers would impede inflation from hitting the CNB target, which would make the bank maintain the floor longer.

Negative rates only during exit

While the new bank board did not change its stance about the FX commitment, the new board members are more open towards using negative rates. Yet they would not like to use negative rates as a monetary policy tool to ease credit conditions, but rather as a tool to deter inflow of speculative capital. Former Governor Singer was strongly against using negative rates, but new Governor Rusnok and board member Benda did not rule out using negative rates for a short period around the time of the FX floor exit. We still believe the CNB will introduce negative rates to smooth the exit process. Should the need to ease monetary policy arise, most of the board members would be in favour of moving the floor to a weaker level. But we do not expect this to happen.

The rates should decrease during exit



Source: Economic & Strategy Research, Komerční banka, CNB, Bloomberg

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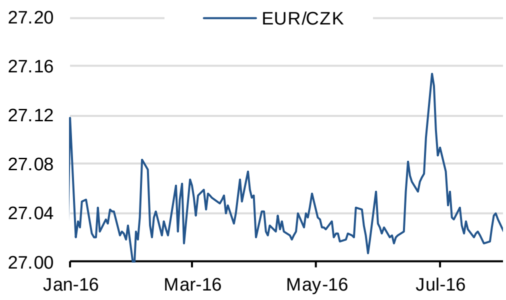
Czech FX Market

Stable exchange rate development till almost the end of next year

The Brexit referendum had a modest and temporary impact on the CZK exchange rate.

The British referendum provided temporary relief for the Czech National Bank. The referendum and its outcome momentarily lowered the pressure on its exchange rate commitment. As a result, the exchange rate exceeded intervention levels and climbed to EUR/CZK27.15 in the second half of June, it highest level since last September. However, the situation quickly calmed down in July and the exchange rate moved back to pre-Brexit levels.

EUR/CZK in 2016

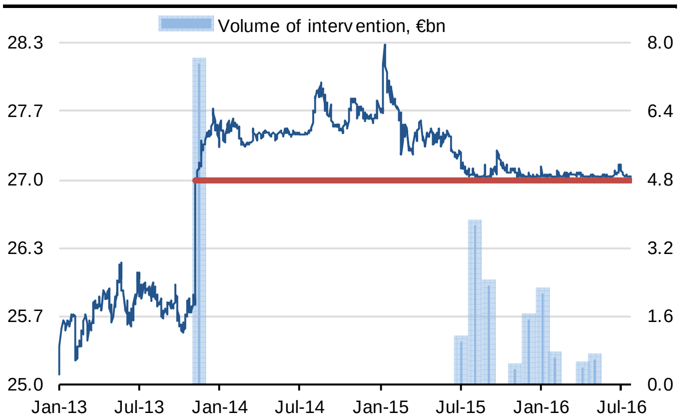


Source: CNB, Economic & Strategy Research, Komerční banka

CNB intervention on the forex market is not all that dynamic.

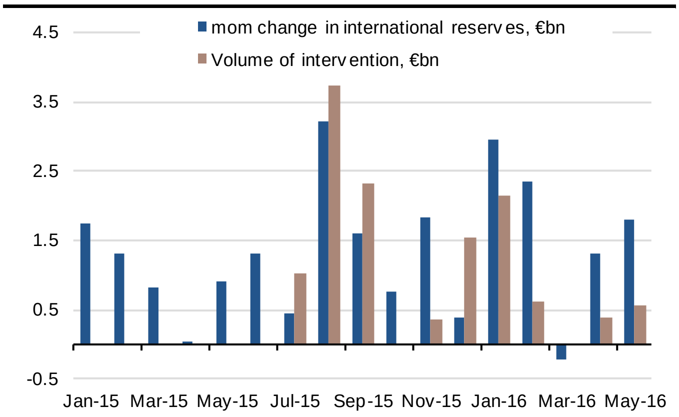
The CNB is not (yet) facing speculative attacks. A closer look at CNB's intervention activity shows it has been present in markets since the second half of the year, when the exchange rate decreased to the intervention floor. From July 2015 until last May, the CNB bought €12.7bn on the market, an average of €1.2bn each month. This is definitely not a level that would limit the central bank's intervention regime, and indeed it is arguable whether such volume exists from the CNB's point of view. The level of foreign exchange reserves was €67.7bn at the end of June, which according to our estimates corresponded to 40.3% of GDP. If the average intervention volume stays constant until the expected exit from the commitment towards the end of 2017, the foreign exchange reserves volume would climb to 50% of GDP, which is still deeply below the level at which the Swiss national bank was pressed to end its intervention regime last January (also for reasons not relevant to the CNB's situation). The CNB invests and appreciates euros held. As a matter of fact, the appreciation of euro reserves in 2015 reached 1.25%, without the influence of exchange rates.

EUR/CZK exchange rate development and intervention volumes



Source: CNB, Datastream, Economic & Strategy research, Komerční banka

Not only intervention activity pushing up international reserves

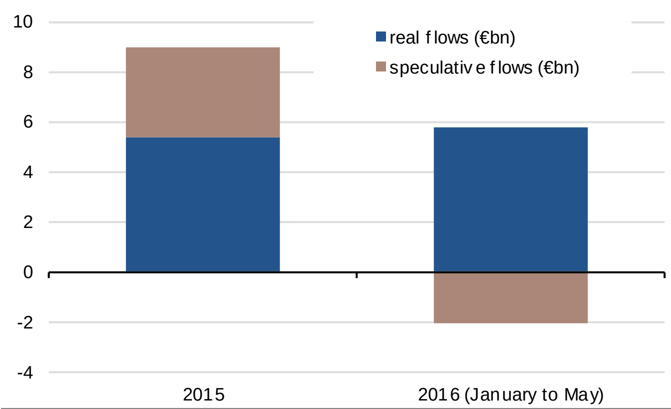


Source: CNB, Economic & Strategy research, Komerční banka

International reserves are also climbing due to money from EU funds.

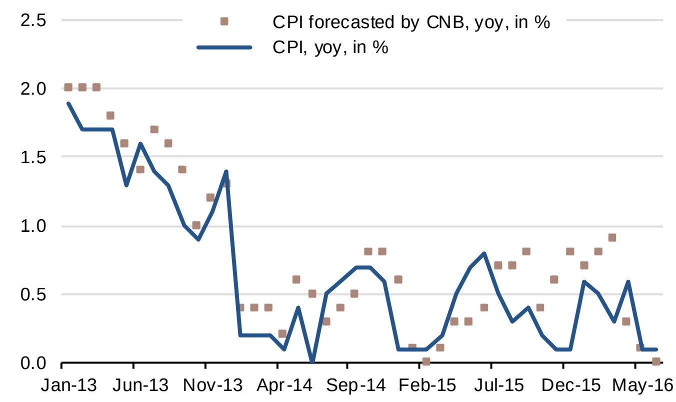
Foreign exchange reserves are growing faster than they would with only CNB intervention activity. Reserves increased by €16.7bn since last July. Money from EU funds led to an increase of €4bn and the rest was produced by intervention. However, while intervention reached €9bn in 2H15, it was only €3.7bn during the first five months of this year, with July probably seeing no significant increase. Intervention volume is decreasing while the balance of payments current account surplus is growing. This discrepancy can be explained, in our opinion, by the squeeze on speculative positions opened last year (see the chart, below). This goes along with a change of expectations, in the first few months of the year, that the intervention regime exit would be brought forward, the main reason for this being the low inflation environment of the Czech economy. For most of the first half of 2016, we witnessed a disinflationary trend (May and June yoy growth in the consumer price index was only 0.1%), with real inflation development below the CNB's expectations. This obviously affected market expectations.

Estimate of real and speculative flows to the Czech economy in 2015 and 2016



Source: CNB, CSO, Economic & Strategy research, Komerční banka
Note: The sum of current and capital accounts of the balance of payments is viewed as a proxy for real flows. Proxy for speculative flows are counted as a difference between CNB intervention volumes and real flows.

Inflationary development versus CNB expectations



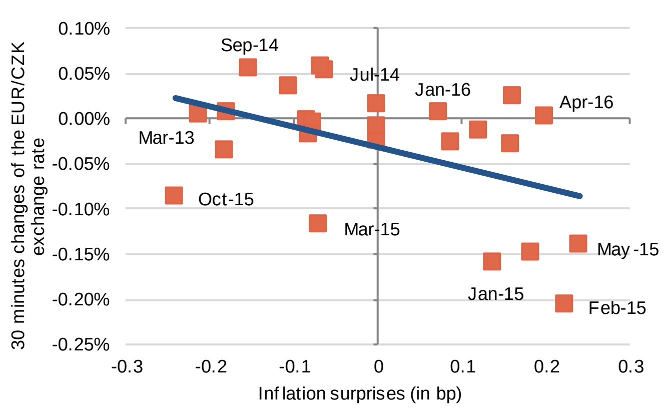
Source: CNB, CSO, Economic & Strategy research, Komerční banka

Exchange rate will remain stuck to the FX commitment level

The current account surplus and inflation bottoming out will keep the EUR/CZK exchange rate at the floor.

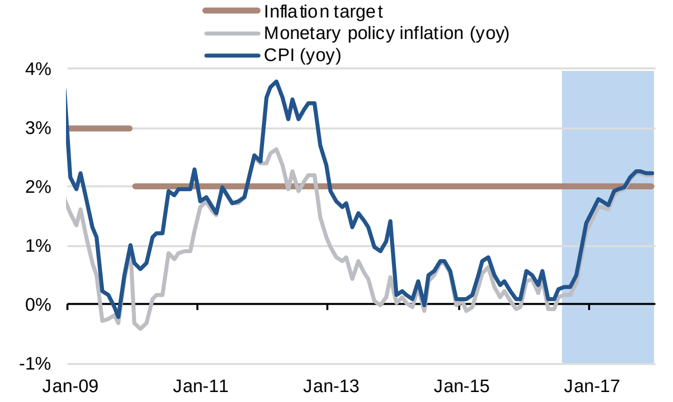
We do not expect any significant weakening of the Czech crown until the end of the FX commitment. The continuing surplus in the current account of the balance of payments will generate euros, which the central bank will need to acquire. An expected rise in inflation towards the inflationary target over the next year will be another factor that will not let the EUR/CZK exchange rate significantly deviate from the intervention level. As shown in the chart below, higher inflation is accompanied by a strong domestic currency (and vice versa). However, since the CZK cannot appreciate below the floor of the intervention regime, it will stay right on it.

EUR/CZK reaction to the inflation figures announcement



Source: CSO, Economic & Strategy research, Komerční banka
Note: Inflation surprises indicator is defined as a difference between actual inflation and inflation expected by CNB, time frame from July 2014 to June 2016

Inflation outlook

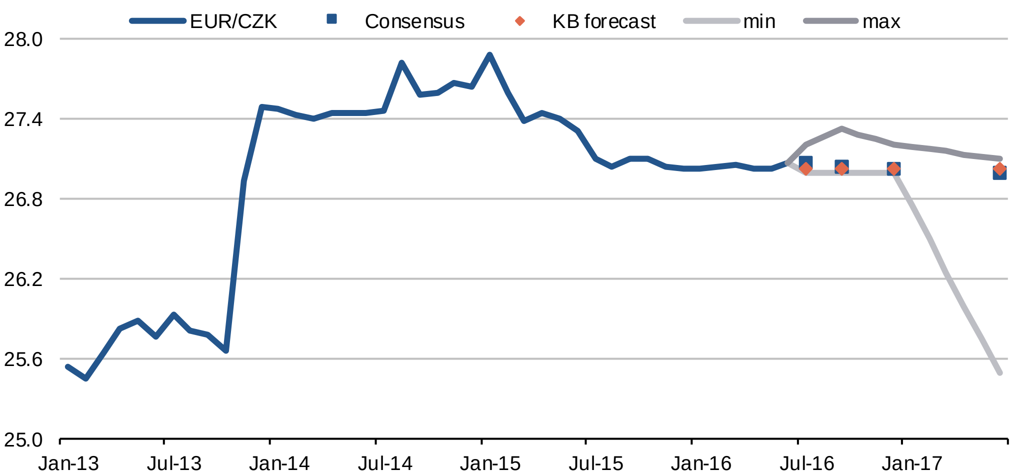


Source: CSO, Economic & Strategy research, Komerční banka

Exit from the intervention regime in one year's time is not even expected by the market.

A revision of the macroeconomic outlook and increasing external risks led us to shift our expectation of an exit from the FX commitment towards the end of 2017. It is unlikely the CZK would significantly depreciate during this time. Such a scenario could be expected only in the case of a more significant external shock, which could create strong deflationary pressure, or in the case of increased risk aversion in global financial markets. A closer look at the market consensus suggests an exit from the intervention regime is not expected over the next 12 months. Only five out of 19 analysts canvassed expect the exchange rate to be below EUR/CZK27 within a year.

EUR/CZK – market consensus, July 2016



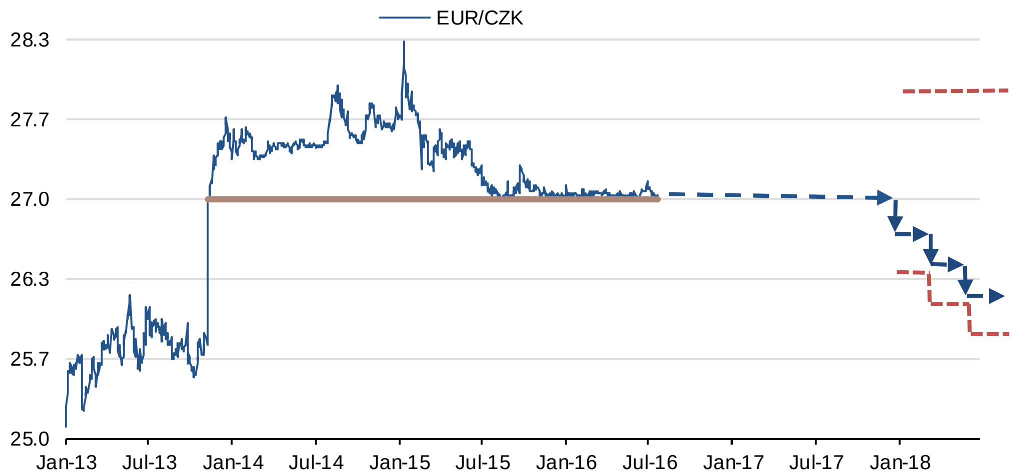
Source: CNB, Reuters, Economic & Strategy research, Komerční banka

Exchange rate volatility will increase after the exit, eliminated by the CNB

After the exit, the CNB will calm increased exchange rate volatility with interventions.

As we published in the previous issue of *Czech Economic Outlook*, **the end of the exchange rate floor will not result in an exit from intervention.** As central bankers have already mentioned several times, they will not allow a fast appreciation of the CZK right after the exit. The CNB will not give up intervention activity and indeed will use it as an instrument to eliminate increased volatility after the exit.

Expected EUR/CZK development after the exit



Source: Macrobond, Economic & Strategy research, Komerční banka

The development of the exchange rate right after the exit will be significantly affected by speculative capital. As discussed above, the CNB does not face a problem with an inflow of speculative capital at the moment. However, once the date of the exit starts approaching, capital inflows can be expected once again. In the event of significant speculation on an appreciation of CZK in relation to the exit from the floor, the crown could paradoxically (temporarily) depreciate due to the closing of these speculative positions.

The CNB has nearly unlimited resources to prevent excessive appreciation of the Czech crown, and with growing foreign exchange reserves it also has the power to eliminate significant depreciation (over EUR/CZK28). In our opinion, the CNB will not let the Czech crown appreciate below EUR/CZK26.5 during the first quarter following the exit or below EUR/CZK26 during the second quarter. We also believe the CNB will stop interventions only after the situation stabilises, which should take about two quarters.

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EUR/CZK technical analysis

27 will decide if another round of correction unfolds

EUR/CZK formed monthly shooting star near ascending channel resistance (currently near 28.80) and since then it has been witnessing a retracement. The pair is sustaining above the pivotal level of 27, the 50% retracement from October 2013. With Monthly MACD inching towards equilibrium level, 27.00 will be an important support which decides if next leg of correction takes shape towards 26.63 and even towards 2011 highs of 26.15.

Near term upside, if any, should be restricted to previous lows of 27.25/27.35, also the 23.6% retracement from 2015 highs. Only a move above will lead to a meaningful recovery.

EUR/CZK, monthly chart.

EUR/CZK, weekly chart.

Source: SG Cross Asset Research/Technical Analysis

Important Disclaimer: The recommendations in the part Technical analysis is based only on analytical methods of technical analysis and may be different from the fundamental opinion of KB (or SG) presented in other part s of this documents or of other documents of KB (or SG).

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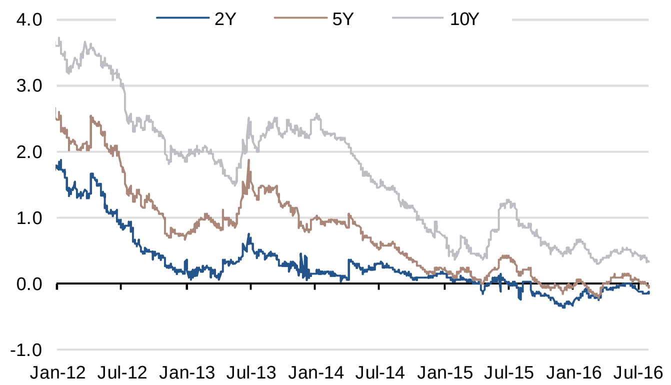
Czech Government Bond and IRS Markets

Lower yields for longer

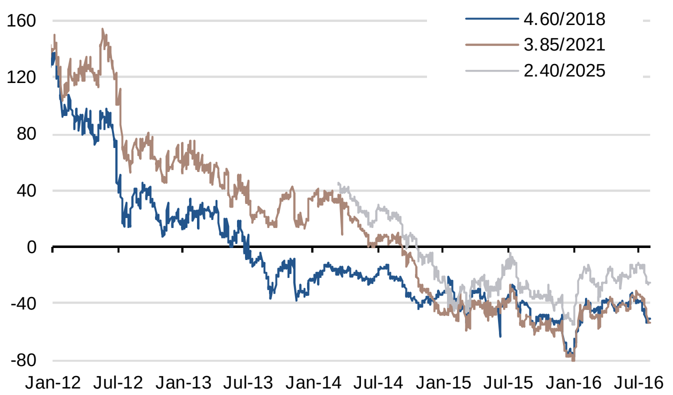
While the impact of Brexit on the real economy will likely be limited, the Czech fixed income market is set to echo the global headwinds to a greater extent. While we call for an increase in CZGB supply in 2H16 and in the all borrowing needs in 2017, we have revised down the expected trajectory of CZGB yields.

CZGB yields, Bloomberg generic (%)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

ASW spreads (bp)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

With a minor lag, CZGB yields followed the drop in Bund yields post-Brexit, **approaching their historical lows in July**. The global Brexit stress, prospects for accommodative monetary policy for longer (even in the Czech Republic), and low supply stood behind the recent bullish move.

Increase in supply in the remainder of 2016

According to our calculations, the Finance Ministry has covered just 38% of 2016 financing needs year-to-date. We thus expect issuance activity to accelerate in 2H16. We look for CZK70bn of CZGBs to be sold in 3Q and CZK59bn in 4Q, respectively, in the primary market together with CZK47bn of T-bills (maturing in 2017). This would be roughly in line with what the ministry indicated in its updated debt management strategy document in June, except for a lower budget deficit and the presumed tap of liquidity in our outlook.

Despite the heavier supply, we have cut the expected trajectory of yields in 2H16.

Despite the heavier supply, we have cut the expected trajectory of yields mainly due to the post-Brexit revision in SG's outlook for EUR yields. Meanwhile, we assume domestic investors will continue to be crowded out to long-end bonds due to negative yields at the short end of the curve driven by non-resident demand (cheap XCCY financing). Moreover, demand will likely rise in the final months of 2016, as banks are expected to switch from free liquidity to bonds before payments to the new resolution fund are due. Now we call for a year-end level of a 10Y CZGB yield of just 0.35% (a revision of -25bp).

2017: another rise in gross borrowing needs and financing

We expect gross borrowing needs to increase by CZK20bn to CZK322.2bn next year.

We expect gross borrowing needs to increase by CZK20bn to CZK322.2bn next year due to higher budget deficit and bond redemptions. The ministry's outlook calls for an even a larger number at CZK337.2bn on the back of the official expected budget deficit of CZK60bn.

2016 gross borrowing needs and financing, CZKbn

	MinFin Jun	KB Aug
Borrowing needs		
Budget deficit	70.0	35.0
Buybacks of CZGBs	-	0.0
Redemption of CZGBs	155.8	136.8
Redemption of Eurobonds		12.2
Redemption of retail bonds	30.0	30.1
Redemption of T-bills	84.4	84.4
Redemption of other money market instruments	-	2.2
Redemption of EIB loans	1.7	1.7
Total	**342.0**	**302.4**
Financing		
Gross T-bill issuance		50.0
Other money market instruments		0.0
Gross CZGB issuance (in auctions)	min 150.0	220.0
Tap sales		11.0
Gross issuance of eurobonds		0.0
Gross issuance of retail bonds		0.0
EIB loans		0.0
Tapping of financial reserve		25.0
Net effect of CZGB switches		-3.5
Others		0.0
Total financing		**302.5**
Net CZGB issuance		*94.2*

Source: Economic & Strategy Research, Komerční banka, Finance Ministry

On the financing side, the ministry has given no indications of its plans yet**. In our view, it will again focus on the CZGB market, offering as much as CZK240bn in primary auctions next year**. We assume demand will remain favourable with non-residents bidding for short-end bonds even at sub-zero yields due to the negative XCCY basis and domestic investors concentrating only on the longer maturities. While we look for massive gross CZGB issuance, the surge in bond redemptions will result in lower net bond supply year-on-year.

The forecast increase in Bund yields (as per SG's strategists) and accelerating inflation should result in a bear-steepening of the CZGB yield curve in 2017.

The forecast increase in Bund yields (as per SG's strategists) and accelerating inflation should result in a bear-steepening of the CZGB yield curve in 2017. Further driving this trend will be the increase in bond supply. Still, we expect the 10Y CZGB yield to rise to only 0.70% by the end of next year.

2017 gross borrowing needs and financing, CZKbn

	MinFin Jun	KB Aug
Borrowing needs		
Budget deficit	60.0	45.0
Buybacks of CZGBs		0.0
Redemption of CZGBs	208.6	208.6
Redemption of Eurobonds		0.0
Redemption of retail bonds	16.9	16.9
Redemption of T-bills	50.0	50.0
Redemption of other money market instruments	-	0.0
Redemption of EIB loans	1.7	1.7
Total	**337.2**	**322.2**
Financing		
Gross T-bill issuance		50.0
Other money market instruments		0.0
Gross CZGB issuance (in auctions)		240.0
Tap sales		10.0
Gross issuance of eurobonds		0.0
Gross issuance of retail bonds		0.0
EIB loans		0.0
Tapping of financial reserve		22.2
Others		0.0
Total financing		**322.2**
Net CZGB issuance		*41.4*

Source: Economic & Strategy Research, Komerční banka, Finance Ministry

As we noted in previous editions of our *Economic Outlook*, a large (CZK70bn) issue of the CZGB 0.0% Nov 2017 will mature in 4Q17, followed by as much as CZK60bn of the CZGB 0.0% Jan 2018, i.e. if the ministry taps the full amount possible; to date, the ministry has sold CZK40.8bn of this bond. We assume the bonds are held mostly by non-residents, who have benefited from cheap XCCY financing. However, with the end of the FX floor, this trade will become less attractive, in our view, prompting lower non-resident demand for (short-end) CZGBs starting in 4Q17. **The need to refinance such an amount during the expected decline in non-resident demand is a risk for a faster increase in CZGB yields**.

CZGB yield forecast

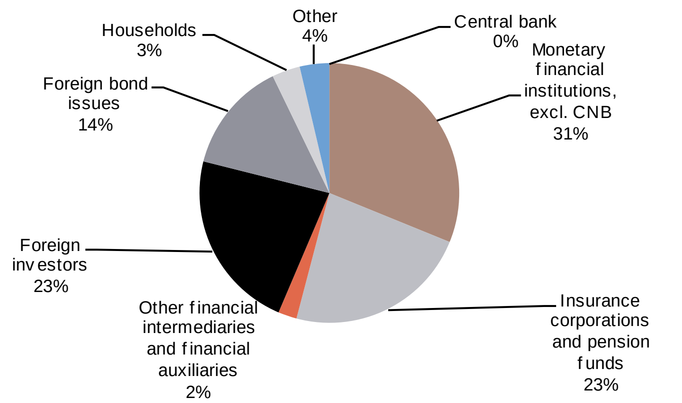
	3Q16f	4Q16f	1Q17f	2Q17f	3Q17f	4Q17f
2y CZGB yield (%)	-0.15	-0.10	-0.10	-0.10	-0.15	-0.15
10y CZGB yield (%)	0.35	0.35	0.50	0.60	0.65	0.70
10y CZGB ASW (bp)	-20	-30	-30	-35	-30	-30

Source: Economic & Strategy Research, Komerční banka

Non-resident holdings continue to grow

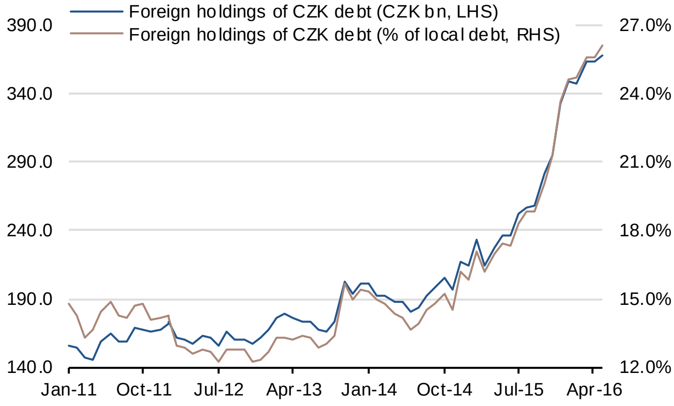
The ministry has continued to focus bond issuance at the short end, benefiting from non-resident demand even at negative nominal yields. We expect this trend to continue but at a slower pace, as the finance ministry has already sold majority of the 2018 paper and the CZGB 0.0% 2019 is likely to see only limited interest from investors due to its relatively longer maturity (this is likely to apply to all potential new bonds with a maturity longer than early 2018).

Holdings of Czech Republic's debt securities, end-June 2016



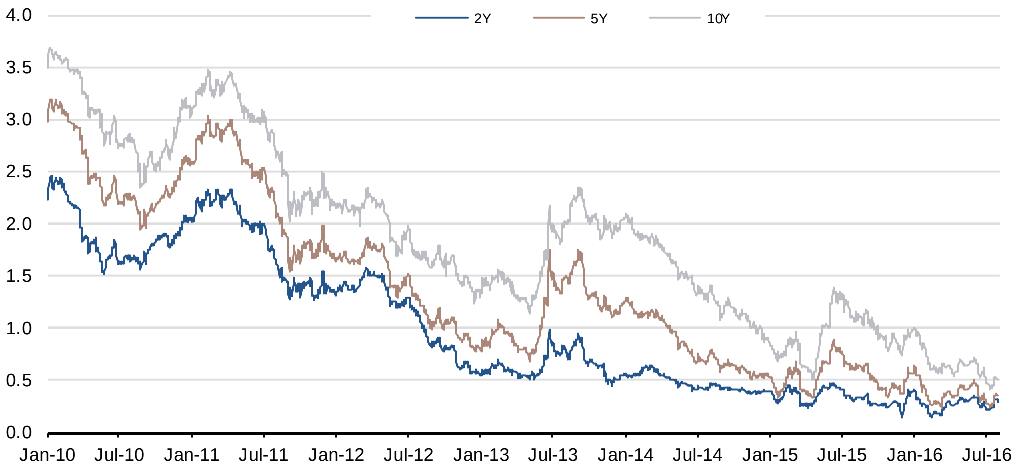
Source: Finance Ministry, Economic & Strategy Research, Komerční banka

Share of foreign holdings keeps on growing



Source: Finance Ministry, Economic & Strategy Research, Komerční banka

Recent developments of CZK IRS (%)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

CZK interest rate swaps: downward revision

The slope of the CZK IRS curve dropped to the lowest level in history in July due to the longer end catching up with the fall in its EUR counterpart. **Based on the revision of the EUR IRS outlook and our call for inflation and the CNB, we have cut our expectations for the CZK swap rates**. The 2Y IRS is set to remain virtually unchanged through 2017, and the 10Y IRS should rise to 1% by the end of next year (down by 45bp compared with our previous call).

CZK IRS outlook (%)

	3Q16f	4Q16f	1Q17f	2Q17f	3Q17f	4Q17f
2Y	0.25	0.30	0.30	0.35	0.35	0.35
10Y	0.55	0.65	0.80	0.95	0.95	1.00

Source: Economic & Strategy Research, Komerční banka

Banking sector

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Lending growth to slow in 2017

Credit creation in the Czech economy has accelerated significantly over the past three years since the latest recession. Yet, data shows the growth of total volume of loans peaked in 2H15 (+7.8% yoy on average), with a minor slowdown in 1H16 (+7.3% yoy on average). Notably, the growth of credit to non-financial corporations eased in 2016 amid a slowdown in the economy and in investment, and elevated global risks. On the other hand, credit to households continued to increase, driven by mortgage lending, as rising purchasing power (enhanced by the strong improvement in the labour market) in an environment of low yields has made real estate an attractive investment. Consumer loans are set to rise less quickly this year due to a high base in 2015.

We expect credit creation to slow further in 2017 due to slower growth in mortgage and corporate lending. Credit for real estate purchases is set to grow more slowly given this year's high base, a presumed (moderate) increase in interest rates and growing market saturation. Consumer credit growth should accelerate as last year's high base effect fades out. Non-financial corporate lending is expected to decelerate as a result of corporates' still-solid profitability and improving cash positions, which creates less space for external financing. Economic growth should speed up marginally and we expect a recovery in investment activity to be driven by the public sector only.

Bank loans and deposits (SA, yoy, %)

	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	2015	2016	2017	2018	2019	2020
Bank loans														
Total	6.5	6.6	5.8	6.9	6.3	5.9	5.7	5.4	**6.1**	**6.5**	**5.8**	**5.6**	**5.5**	**4.6**
Households - real estate loans	7.9	7.9	7.8	8.1	7.5	7.4	6.8	6.1	**7.0**	**7.9**	**6.9**	**6.6**	**7.0**	**5.3**
Households - consumer loans	9.9	1.2	2.4	3.8	4.1	5.2	5.0	5.1	**6.5**	**4.3**	**4.8**	**5.7**	**7.7**	**5.6**
Corporate loans	7.8	7.4	4.9	7.0	4.9	4.1	4.7	4.6	**6.1**	**6.8**	**4.6**	**5.0**	**3.7**	**3.8**
Deposits														
Total	8.4	9.9	7.7	6.9	2.7	2.4	3.0	5.6	**3.2**	**8.2**	**3.4**	**3.4**	**3.6**	**3.2**
Households	6.2	6.7	6.1	6.0	5.3	5.2	5.2	4.9	**5.1**	**6.2**	**5.1**	**4.3**	**3.7**	**3.1**
Non-financial corporations	7.0	7.6	4.9	7.8	4.7	4.6	3.7	3.3	**10.9**	**6.8**	**4.1**	**3.8**	**2.9**	**2.6**
Others	14.2	19.2	13.5	8.2	-4.4	-4.7	-1.5	10.7	**-7.1**	**13.8**	**0.0**	**1.2**	**4.0**	**3.8**
Ratios														
Loan-to-GDP ratio	61.4	62.0	62.7	62.9	62.8	63.1	63.4	63.4	**61.1**	**62.3**	**63.2**	**63.5**	**64.1**	**65.2**
Deposit-to-GDP ratio	81.8	82.4	82.8	79.4	80.9	81.0	81.6	80.2	**78.7**	**81.6**	**80.9**	**79.6**	**78.9**	**79.2**
Loan-to-deposit ratio	75.0	75.3	75.7	79.2	77.7	77.9	77.7	79.0	**77.6**	**76.3**	**78.1**	**79.8**	**81.2**	**82.4**
Interest rates														
Real estate loans	2.6	2.6	2.6	2.7	2.7	2.8	2.8	2.9	**2.6**	**2.6**	**2.8**	**3.1**	**3.5**	**4.0**
Consumer loans	11.9	11.9	11.8	11.7	11.6	11.6	11.5	11.4	**12.4**	**11.8**	**11.5**	**11.2**	**11.2**	**11.4**
Corporate loans	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.4	**2.2**	**2.5**	**2.5**	**2.5**	**2.5**	**2.7**
Share of NPL														
Real estate loans	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	**2.9**	**2.8**	**2.8**	**2.8**	**3.0**	**3.2**
Consumer loans	11.9	11.9	11.1	10.8	10.4	10.0	9.8	9.8	**11.9**	**11.4**	**10.0**	**9.6**	**9.7**	**10.0**
Corporate loans	5.6	5.6	5.7	5.8	5.8	5.8	5.7	5.6	**5.9**	**5.7**	**5.7**	**5.3**	**5.0**	**5.4**

Source: CNB, Economic & Strategy Research, Komerční banka

Where real estate loans and credit to the corporate sector are concerned, the share of non-performing loans is expected to decline marginally in 2016 and remain stable in 2017. NPLs in consumer credit are set to improve both this year and next year on the back of rising wages and falling unemployment. As a result, the cost of risk for the Czech banking sector should remain low.

Key Economic Indicators

Macroeconomic indicators – long-term outlook

		2014	2015	2016	2017	2018	2019	2020	2021
GDP	real, %	2.7	4.6	2.1	2.6	2.9	1.8	1.5	1.9
Inflation	average, %	0.4	0.3	0.5	2.0	2.0	1.6	1.1	1.2
Current account	% of GDP	0.2	0.9	2.4	0.9	0.8	1.3	1.6	1.6
3M PRIBOR	average, %	0.4	0.3	0.3	0.3	0.3	0.3	0.4	1.4
EUR/CZK	average	27.53	27.28	27.0	27.0	26.2	24.7	23.8	23.1
USD/CZK	average	20.75	24.59	24.5	25.6	24.5	21.1	19.6	18.7

Source: CSO, CNB, Economic & Strategy Research, Komerční banka, SG Economic Research
Note: KB forecasts are in blue

FX & interest-rate outlook

		1-Aug-2016	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
EUR/CZK	end of period	27.03	27.0	27.0	27.0	27.0	27.0
USD/EUR	end of period	1.116	1.10	1.08	1.05	1.05	1.05
CZK/USD	end of period	24.21	24.6	25.0	25.7	25.7	25.7
3M PRIBOR	end of period	0.29	0.29	0.29	0.29	0.29	0.29
10Y IRS	end of period	0.50	0.55	0.65	0.80	0.95	0.95

Source: CSO, CNB, Economic & Strategy Research, Komerční banka, SG Economic Research
Note: KB forecasts are in blue

Monthly macroeconomic data

		X-15	XI-15	XII-15	I-16	II-16	III-16	IV-16	V-16	VI-16
Inflation (CPI)	%, m/m	0.0	-0.4	-0.1	0.6	0.1	-0.1	0.6	-0.2	0.1
Inflation (CPI)	%, yoy	0.2	0.1	0.1	0.6	0.5	0.3	0.6	0.1	0.1
Producer prices (PPI)	%, m/m	-0.2	-0.4	-0.4	-1.6	-0.6	0.0	0.1	0.4	0.3
Producer prices (PPI)	%, yoy	-3.9	-3.7	-2.9	-3.4	-4.0	-4.5	-4.7	-4.8	-4.4
Unemployment rate	% (MLSA)	5.9	5.9	6.2	6.4	6.3	6.1	5.7	5.4	5.2
Industrial sales	%, yoy, c.p.	1.8	1.6	-1.0	-1.6	3.2	-1.4	0.3	4.9	n/a
Industrial production	%, yoy, c.p.	3.7	5.5	1.8	1.6	5.9	1.2	4.2	8.6	n/a
Construction output	%, yoy, c.p.	-0.8	2.4	3.3	-10.8	-2.4	-12.4	-13.7	-4.3	n/a
Retail sales	%, yoy, c.p.	8.0	9.4	9.7	5.6	11.5	5.8	8.5	11.1	n/a
External trade	CZK bn (national met.)	15.8	11.2	0.4	22.3	21.4	21.3	25.7	18.2	n/a
Current account	CZK bn	5.8	4.9	3.9	35.7	43.9	34.2	0.9	0.8	n/a
Financial account	CZK bn	-13.3	14.7	40.8	27.7	66.7	14.7	-21.5	11.4	n/a
M2 growth	%, yoy	8.2	8.6	6.9	7.9	7.6	7.6	7.4	7.6	n/a
State budget	CZK bn (YTD cum.)	-29.1	-29.5	-62.8	45.9	27.7	43.6	30.5	22.4	40.6
PRIBOR 3M	%, average	0.29	0.29	0.29	0.29	0.28	0.29	0.29	0.29	0.29
EUR/CZK	average	27.11	27.04	27.03	27.03	27.04	27.05	27.03	27.03	27.06
USD/CZK	average	24.16	25.21	24.80	24.88	24.35	24.28	23.84	23.92	24.07

Source: CSO, CNB, MF, MLSA. Economic & Strategy Research, Komerční banka

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