FX news CEE

- CNB has managed exit from intervention policy very smoothly so far
- RON might weaken due to fiscal slippage and current account concerns
- Central bank policy is main reason for divergence between HUF & PLN

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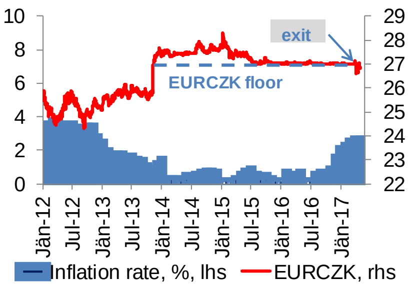
The CNB managed to exit from its EURCZK intervention floor policy in a very smooth manner. The initial volatility was much lower than expected despite the announcement of the CNB that they would tolerate some volatility and let the koruna find a new equilibrium. The major reason why the CZK has appreciated only slightly is the fact that it was severely overbought and any attempts to close some of these positions would work against koruna appreciation, which we would see as fundamentally justified. It will therefore be a question of the patience of investors, where the negative interest rate differential could also hinder appreciation. For these reasons, we expect the koruna to appreciate only to 26.30 EURCZK this year, despite seeing the fair value in the region of 24-25 EURCZK.

It seems that politicians in Romania in their first post-election year have not stopped campaigning and, instead of delivering structural reforms, they plan to proceed with huge tax cuts and double-digit wage increases this year, thus pushing the deficit well above 3% of GDP. We think that the central bank will face the dilemma of whether to raise interest rates in order to tame inflation and cool the economy a bit. Given that the central bank does not want to see the RON too strong (due to the potential negative effect on the CA balance), the tendency to increase rates might be slower, resulting in a weaker RON.

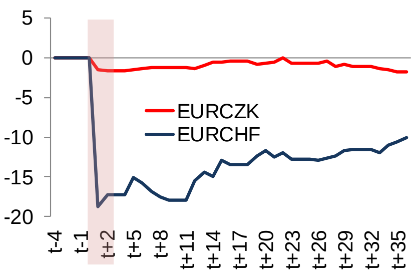
The Polish zloty and Hungarian forint have usually moved very closely together in past years. There has been a divergence in the last few months, however, which is likely due to the carry increasingly favoring the PLN, while the narrowing of the CDS in Hungary has also halted in the last few months. This has contributed to the Polish currency performing much better than its Hungarian counterpart. We expect the zloty to remain roughly at current levels for the rest of 2017, while the HUF could continue to gradually weaken; we therefore do not expect this newly-formed gap to close soon.

All in all, after the hefty appreciation of the zloty and limited gains in the koruna post-exit, we only see further appreciation potential in the koruna.

Czech Republic – Don't speculate vs the central bank

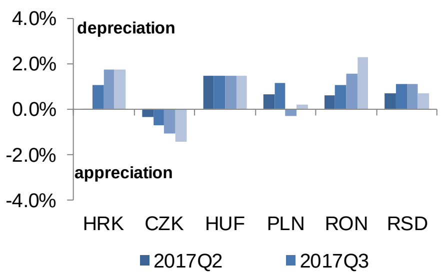


Exits from long CZK positions will limit the appreciation of the koruna (FX vs EUR, percent)

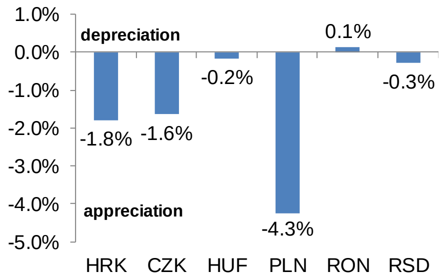


Source: Bloomberg, Erste Group Research

Expected change among CEE currencies



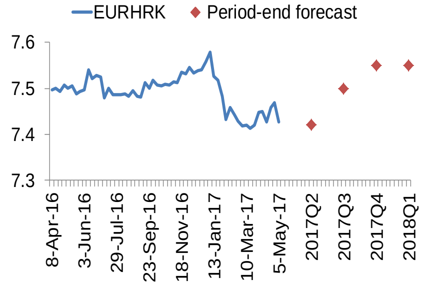
Year-to-date performance of CEE currencies (vs EUR)



Source: Erste Group Research (rates as of 11 May)

Croatian kuna – FX outlook firm, despite woes

EURHRK: FX outlook firm despite Agrokor-related vulnerabilities



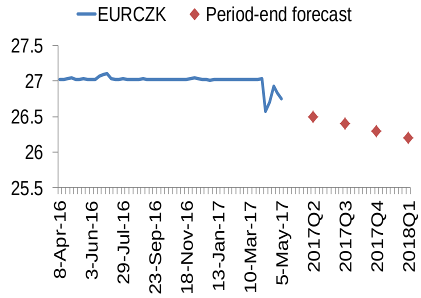
Source: Bloomberg, Erste Group Research

Gradual appreciation pressures remained present in 1Q17, with improving fundamentals working against the seasonal pattern and allowing the EURHRK to move close to 7.40. The beginning of 2Q brought a temporary reversal due to Agrokor restructuring (sentiment effect), but a more material factor was that banks had to do one-off risk provisioning (demand for euro due to mismatch between exposure and provisioning currency). The recent political turmoil could have very limited effect. Thus, following stronger profit repatriation in 2Q, we see the seasonal pattern taking over in the coming months.

As far as the outlook is concerned, the fundamentals are to continue to play a supportive role as the external position continues to improve, the fiscal news flow is supportive to an EDP exit and to the rating, while growth sensitivity to Agrokor restructuring is looking fairly modest, in the baseline scenario of an orderly restructuring. Bottom line: we see the exchange rate moving in the 7.35-7.55 band for the rest of 2017, suggesting that we expect to see some action from the CNB if appreciation pressures mount further. We see the average FX rate gaining approx. 1% vs. 2015. Additionally, with the EDP exit in the pipeline, we could see more visible effort from the central bank and the government towards EMU membership.

Czech koruna – Moderate appreciation after exit

EURCZK: so far so good; exit managed well by CNB



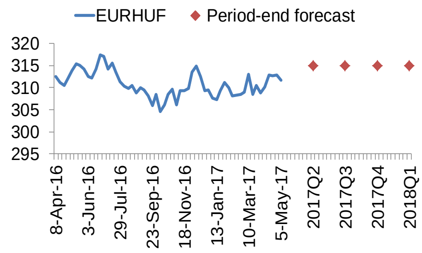
Source: Bloomberg, Erste Group Research

The EURCZK appreciated only slightly after the exit from the FX cap. Although there is a natural tendency towards appreciation, this is significantly mitigated by the fact that the koruna is overbought. The foreign capital awaiting appreciation is much higher than the volume demanded (mainly from Czech exporters). Each appreciation movement is thus followed by the selling of korunas by some foreign investors. The EURCZK will therefore be relatively stable this year, as we expect it to reach approx. 26.3-26.4 by YE. We see a risk on the depreciation side, as possible disappointment on the part of foreign investors could imply an outflow of capital.

We expect the average annual decline in the EURCZK for the next few years to be around 1.7%. The convergence of the economy towards the Eurozone has slowed since 2008, while the effort of foreign investors to sell the CZK at a favorable rate could also limit any hefty appreciation. As foreign capital is four times higher than the demand for korunas at the moment, foreign investors will have to wait quarters or even years to find a counterparty.

Hungarian forint – HUF may remain relatively weak

EURHUF: MNB may continue to closely monitor currency in 2017

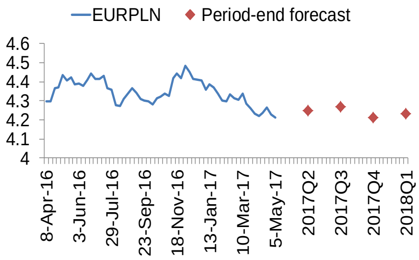


Source: Bloomberg, Erste Group Research

As in 2016, monetary policy could offset any appreciation pressure on the forint. Even though market sentiment has improved (positive outcome of French elections, smooth rate hiking process in the US), the current account and trade surpluses are substantial. We expect the EURHUF to trade between 310 and 320 for the majority of 2017, as the MNB is unlikely to alter the current dovish stance of monetary policy.

By introducing the 6M and 12M FX swap facilities in March, the MNB reinforced its strong commitment to keeping nominal and real interest rates at depressed levels for a longer period. Since the March monetary meeting, previous rate hiking expectations have disappeared from market pricing. Liquidity squeezing from the 3M deposit (the MNB wants to reduce the stock to HUF 500bn by end-June) could also keep rates and yields at low levels.

EURPLN: Zloty to remain relatively strong this year



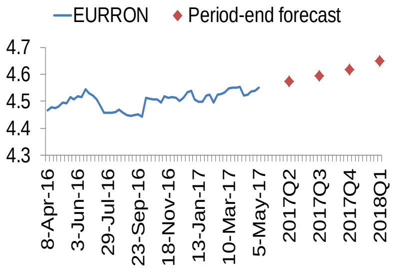
Source: Bloomberg, Erste Group Research

Polish zloty – best performer in CEE this year

The zloty has been outperforming other currencies in the region, with YTD gains of almost 5%. We revise our forecast and expect the zloty to remain strong throughout the year with a YE forecast of 4.21 vs. the EUR. The improving economic outlook and strong growth in 1Q17 (we revised our forecast upwards to 4.0% y/y) is zloty-positive. Further, the victory of Macron in France and positive global sentiment also support lower EURPLN levels. On the other hand, expectations for further rate hikes in the US should limit appreciation potential in the coming months.

In the medium term, robust growth and rising expectations of a rate hike in Poland (we currently expect this in 2H18) should continue to support the zloty, while the end of the QE program in the Eurozone is likely to limit its appreciation potential.

EURRON: NBR may tolerate some FX depreciation



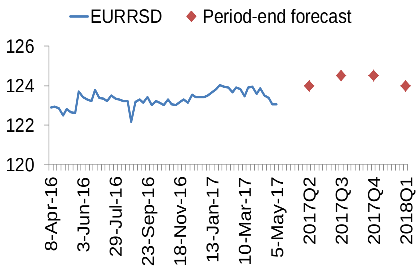
Source: Bloomberg, Erste Group Research

Romanian leu – possible depreciation of leu in 2017

The RON faced further headwinds in March and April, but this time coming from abroad. A combination of the election in the Netherlands, the policy rate hike by the Fed, the triggering of article 50 by Premier May formalizing Brexit and the presidential elections in France led to temporary spikes in the EURRON, as investors turned risk-off. Increasing expectations for another interest rate hike by the Fed in June as part of an interest rate normalization process could keep investors on the back foot in the period going forward. The EURRON pair is currently traded at above 4.54 per 1 euro.

We favor a slight depreciation outlook for the leu in the coming quarters, due to domestic risks to the fiscal deficit and C/A deficit widening, but we expect that the external risk backdrop will be the trigger for any significant directional move in the FX rate. Our new estimate for the EURRON is 4.62 for end-2017. Our forecast assumes that the NBR will be somewhat less keen on fighting 2-3% depreciation, which runs counter to the current mantra of a stable RON, which is why we see risks to our forecast as tilted to the downside.

EURRSD: We expect a slightly weaker dinar going forward



Source: Bloomberg, Erste Group Research

Serbian dinar – NBS to manage currency if needed

In recent weeks, we could see somewhat unexpected appreciation pressures on the Serbian FX market, as the EUR/RSD moved towards the 123 mark, hitting its strongest level in 2017. This prompted the NBS to intervene on the buy side for the first time this year, with a total of two interventions worth EUR 55mn in the last two weeks, after it sold a total of EUR 345mn from the beginning of the year. The factors supporting dinar strength could be somewhat stronger demand for the RSD from local banks, stronger LCY loan activity and seasonal movements. However, the current appreciation pressures could be transitory.

The main factors shaping the FX market going forward should be the usual suspects, namely economic and fiscal performance and the course of NBS policy, from which we still expect a rise in the key rate of 25bp by YE. Also, the stabilizing external position (reduced corporate and sovereign exposure to FX and stabilizing C/A) plays an important role. That said, we see the EUR/RSD remaining broadly stable in the region of 123.5-124 (with the lower part of the band more likely in the coming months), steered by occasional NBS interventions, with the main downsides coming from any potential outburst of new jitters on global markets.

Government bond yields

	current	2017Q2	2017Q3	2017Q4	2018Q1
Croatia 10Y	2.96	2.80	2.80	2.90	2.90
spread (bps)	254	231	218	217	208
Czech Rep. 10Y	0.62	0.80	0.84	0.83	0.88
spread (bps)	20	31	22	10	6
Hungary 10Y	3.11	3.60	3.67	3.67	3.67
spread (bps)	269	311	305	294	285
Poland 10Y	3.41	3.65	3.82	3.98	4.11
spread (bps)	299	316	320	325	329
Romania10Y	3.87	4.25	4.35	4.50	4.75
spread (bps)	345	376	373	377	393
Slovakia 10Y	1.08	1.20	1.23	1.25	1.35
spread (bps)	66	71	61	52	53
Slovenia 10Y	1.34	1.40	1.50	1.60	1.70
spread (bps)	92	91	88	87	88
Serbia 7Y	5.50	5.80	6.00	6.00	6.25
spread (bps)	508	531	538	527	543
DE10Y (BBG)*	***0.42***	***0.49***	***0.62***	***0.73***	***0.82***

3M Money Market Rate

	current	2017Q2	2017Q3	2017Q4	2018Q1
Croatia	0.58	0.45	0.45	0.45	0.45
3M forwards		-	-	-	-
Czech Republic	0.29	0.27	0.27	0.26	0.26
3M forwards		0.33	0.38	0.45	0.53
Hungary	0.16	0.05	0.05	0.05	0.05
3M forwards		0.21	0.25	0.33	0.41
Poland	1.73	1.75	1.79	1.83	1.99
3M forwards		1.78	1.78	1.81	1.88
Romania	0.88	1.30	1.50	1.90	2.10
3M forwards		0.83	1.05	1.43	1.98
Serbia	3.55	3.60	3.80	4.00	4.00
3M forwards		-	-	-	-
Eurozone	-0.33	-0.30	-0.30	-0.30	-0.30

FX

	current	2017Q2	2017Q3	2017Q4	2018Q1
EURHRK	7.42	7.42	7.50	7.55	7.55
forwards		7.43	7.44	7.45	7.47
EURCZK	26.57	26.50	26.40	26.30	26.20
forwards		26.56	26.52	26.48	26.44
EURHUF	310.6	315.0	315.0	315.0	315.0
forwards		310.9	311.4	311.8	312.1
EURPLN	4.21	4.25	4.27	4.21	4.23
forwards		4.22	4.25	4.27	4.29
EURRON	4.55	4.57	4.60	4.62	4.65
forwards		4.56	4.57	4.59	4.61
EURRSD	123.1	124.0	124.5	124.5	124.5
forwards		-	-	-	-
EURUSD	1.09	1.08	1.10	1.12	1.12

Key Interest Rate

	current	2017Q2	2017Q3	2017Q4	2018Q1
Croatia	0.50	0.30	0.30	0.30	0.30
Czech Republic	0.05	0.05	0.05	0.05	0.05
Hungary	0.90	0.90	0.90	0.90	0.90
Poland	1.50	1.50	1.50	1.50	1.75
Romania	1.75	1.75	1.75	1.75	1.75
Serbia	4.00	4.00	4.00	4.00	4.00
Eurozone	0.00	0.00	0.00	0.00	0.00

Real GDP growth (%)	2015	2016f	2017f	2018f
Croatia	1.6	2.7	2.9	2.9
Czech Republic	4.6	2.4	2.7	3.2
Hungary	3.1	2.1	3.4	2.8
Poland	3.6	2.5	3.0	3.4
Romania	3.8	4.5	4.3	2.8
Serbia	0.8	2.7	3.1	3.4
Slovakia	3.8	3.3	3.1	3.7
Slovenia	2.3	2.6	2.6	2.7
CEE8 average	**3.5**	**2.8**	**3.2**	**3.2**

Average inflation (%)	2015	2016f	2017f	2018f
Croatia	-0.5	-1.1	1.5	1.9
Czech Republic	0.3	0.7	2.7	1.9
Hungary	-0.1	0.4	2.5	3.4
Poland	-0.9	-0.6	1.8	1.9
Romania	-0.6	-1.5	1.4	2.7
Serbia	1.4	1.1	2.4	3.1
Slovakia	-0.3	-0.5	1.0	2.0
Slovenia	-0.5	-0.1	1.6	2.0
CEE8 average	**-0.4**	**-0.4**	**1.9**	**2.2**

Unemployment (%)	2015	2016f	2017f	2018f
Croatia	16.3	12.8	10.6	9.4
Czech Republic	5.1	4.1	3.6	3.6
Hungary	6.8	5.1	4.3	4.1
Poland	10.6	8.9	7.9	7.7
Romania	6.8	6.0	5.9	5.8
Serbia	17.7	16.0	14.1	12.8
Slovakia	11.5	9.7	8.7	7.8
Slovenia	9.0	7.9	7.4	6.9
CEE8 average	**9.3**	**7.7**	**6.9**	**6.6**

Public debt (% of GDF	2015	2016f	2017f	2018f
Croatia	86.7	84.0	81.6	79.2
Czech Republic	40.3	37.2	35.7	35.9
Hungary	74.7	74.3	74.0	72.5
Poland	51.5	54.3	54.9	54.1
Romania	37.9	37.1	39.2	40.8
Serbia	74.7	72.9	69.4	68.9
Slovakia	52.5	51.9	51.7	50.9
Slovenia	83.4	79.2	77.9	75.9
CEE8 average	**53.7**	**53.6**	**53.5**	**53.0**

C/A (%GDP)	2015	2016f	2017f	2018f
Croatia	5.1	2.8	2.3	1.5
Czech Republic	0.9	2.1	1.3	1.4
Hungary	3.4	5.0	4.6	4.5
Poland	-0.2	-0.3	-0.6	-0.9
Romania	-1.2	-2.6	-3.3	-3.8
Serbia	-4.8	-4.2	-4.6	-4.8
Slovakia	-1.3	0.6	1.2	2.3
Slovenia	5.2	6.8	6.3	5.7
CEE8 average	**0.4**	**0.6**	**0.2**	**0.0**

Budget Balance (%GD	2015	2016f	2017f	2018f
Croatia	-3.2	-1.4	-1.6	-1.6
Czech Republic	-0.4	0.5	-0.6	-0.6
Hungary	-2.0	-2.2	-2.7	-2.5
Poland	-2.5	-2.7	-3.0	-2.9
Romania	-0.8	-2.8	-3.5	-3.6
Serbia	-3.8	-1.4	-1.2	-1.0
Slovakia	-2.7	-1.7	-1.5	-1.2
Slovenia	-2.9	-2.0	-1.7	-1.5
CEE8 average	**-2.0**	**-2.0**	**-2.4**	**-2.3**

Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

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