CEE Insights

Fixed Income and Foreign Exchange

Looking ahead this week…

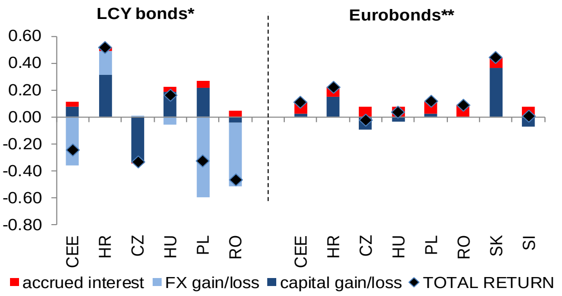
Monday	Tuesday	Wednesday	Thursday	Friday
PL: Wages	**HU:** No rate change **PL:** Industry, Retail Trade	**HU**: Current Account **SI**: Producer Prices		**HR**: Unemployment

Click for: this week's detailed releases/events, market forecasts, macro forecasts

This week will not be packed with important macro releases; only Poland is worth watching in this respect, as industrial and retail sales data will be out on Tuesday. On the same day, the Hungarian central bank will likely not change the 0.9% base rate, but the cap on the 3M deposit facility might be lowered from HUF 500bn to HUF 250bn by end-3Q17. The MPC's statement may potentially contain some comments regarding the strong forint. New economic forecasts will likely include an increased GDP outlook for this year, in our view close to 4%, and the inflation outlook will likely be around 3%. From the political point of view, Romania should be monitored after tensions broke out last week between the government and the ruling party. A no-confidence vote may be held this week to remove PM Grindeanu. The Romanian leu also fell last week due to global factors, but going forward, the currency is also unlikely to benefit from the domestic political and fiscal situation.

In case you missed it last week…

- Serbian President Vucic named non-partisan Public and Local Government Minister Ana Brnabic new PM-designate
- Social-Democratic party head Dragnea to file no-confidence motion against own PM this week in Romania
- Core inflation inched up to 2.5% in Czech Republic in May, rate hike likely in November
- CPI increased faster than forecast in Slovakia in May (to 1.1%), but declined in Serbia (to 3.5%), as expected, and fell more than forecast (to 1.1%) in Croatia
- For other events last week, please check respective countries: HR, CZ, HU, PL, RO, TR, SI, SK, SR



On Radar

Looking at most CEE currencies, a rally in the last 1-2 months is apparent against the euro. Even the Croatian central bank stepped in to weaken its currency, as it perceived that the appreciation pressure on the kuna is more than what seasonal factors would justify. The reasons for this do not just include relatively stable fundamentals, but the unwinding of the so-called reflation trade globally, which is caused by investors' skepticism about President Trump being able to carry out his ambitious plans in the US. However, this might change. The Fed did not just hike the target rate last week, but also pointed at the possible reduction of its balance sheet soon. This already caused some correction in CEE currencies that benefitted from the positive sentiment earlier. We therefore think that the recent appreciation is rather unlikely to continue and currencies might stay at current levels or weaken in the coming months. We see two major outliers from the general trend. The first is the Czech Republic, where monetary tightening should further fuel koruna appreciation (we recently changed our outlook and now see the CNB's first hike in November this year). Romania has already been an outlier from the appreciation trend recently, but we think that it could continue to underperform CEE peers, given fiscal uncertainties and our expectation that the NBR will not hike the base rate even in 2018 (although an increase in the deposit rate, which will effectively be monetary tightening, could come earlier). In Croatia, appreciation in the summer months could be fuelled by seasonal factors, but later on, the Croatian currency could also weaken. (For further details, see the next page.)

Positive international sentiment and the reversal of the reflation trade boosted CEE currencies in recent weeks and months, but this could be overdone, as the Fed goes ahead with tightening

Most CEE currencies should not appreciate further after recent rally

'Can you imagine further appreciation of your currencies against the euro in the coming months?'

Croatia: Taking into account seasonality in the exchange rate pattern, we expect to see further appreciation pressure as tourism season hits full swing, among other supportive drivers. However, as indicated by the recent CNB reaction in terms of two FX interventions, we see the central bank standing ready to tone down any sharp currency volatility. Bottom line, we see an improving fundamental picture (steady external position, improved fiscal developments and EDP exit), coupled with the seasonal effect, driving the exchange rate footprint towards the lower part of the 7.35-7.55 band in the coming months.

Czech Republic: The EURCZK has appreciated recently, due to favorable economic data (mainly GDP and wage growth) and hawkish communication from the CNB. In our view, the CNB will increase interest rates in November, as the pro-inflationary impact of accelerating wage growth together with a significant increase in housing prices should be more important for several bank board members than the loose monetary policy in the Eurozone. We expect that the higher possibility of a hike in 2H17 is now priced in to the EURCZK, and thus there should not be any significant change in the coming months. We expect the EURCZK to stay approx. within the 26.0-26.3 range.

Hungary: The Hungarian forint appreciated until the middle of last week, when the EURHUF cross bottomed out. Since then, there was a correction in the exchange rate, and as a result, the pair edged above 308, which has proven to be a strong support level thus far. We continue to foresee the EURHUF above the 310 threshold in 2H18, as domestic interest rates will stay put at the current depressed levels until end-2018. In addition, the Fed's plans for a balance sheet reduction may roil financial markets and turn international market sentiment to the worse, which could put additional pressure on the forint, causing depreciation against major currencies. The volatility of the Hungarian currency may become elevated as well.

Poland: The zloty has been outperforming other currencies in the region for a while, gaining almost 5% YTD and hitting a 2Y low of 4.17 in mid-May. We expect stabilization of growth potential in the coming months, as domestic factors are unlikely to trigger further strengthening. Moreover, expectations of further rate hikes in the US should limit the potential of the zloty (which depreciated vs. the EUR from around 4.18 to around 4.23 after the FED announcement on Wednesday). We expect the PLN to remain strong throughout the year, with a year-end forecast of 4.21 vs. the EUR. Strong growth in 1Q17 and a good economic outlook are positives. Among possible risks, the biggest one is politics, which could cause risk aversion and a withdrawal of investors.

Romania: Our baseline scenario is consistent with a weakening of the leu against the euro towards 4.62 in December 2017. The RON has been the only currency in CEE not under appreciation pressure recently. A number of factors may have contributed to this: (1) lower portfolio inflows, potentially due to mounting fiscal risks; (2) the current account deficit is gradually moving up, while EU funds inflows have been underperforming; (3) central bank rhetoric, which is unsupportive of RON appreciation, out of fear of further fuelling the widening of the external imbalance. Concretely, the NBR stance is not reflected in hard cash interventions yet, but it lends further reasoning to the central bank's loose (officially dubbed 'adequate') liquidity management, thus supporting the delay of any monetary tightening measures, despite the widening output gap. Looking ahead, we see the aforementioned factors continuing to be relevant and acting in the direction of underperformance of the RON when compared to regional peers. The central bank could hike the depo facility rate or intervene directly in the FX market only in the case of sudden jumps in the EURRON.

Serbia: Stronger appreciation pressures on the Serbian dinar from late April brought the EUR/RSD down from near the 124 mark to near 122, the strongest level since 2015. These pressures are mostly a result of increased LCY lending, better internal and external stability indicators, somewhat stronger capital inflows and the clearer political situation. However, although we expect the dinar to remain under such pressure in the short term, with some seasonal strengthening during summer, until the year-end we expect gradual easing of such pressures, mostly due to the expected stronger imports and limited capital outflows after the expected third FED hike and repositioning before ECB decisions in early 2018. Bottom line, we see the dinar moving towards the 123.5 mark at the end of 2017.

Looking ahead

Date	Time	Country	Indicator	Period	Survey	Erste Est.	Prev.	Pre Comment
19. Jun.	14:00	**PL**	**Wages (y/y)**	May	*4.9%*	***4.8%***	4.1%	
20. Jun.		**RS**	**Current Account Balance**	Apr			-358.8	
		SK	**Unemployment Rate**	May		***7.7%***	7.7%	*Unemployment rate should remain on downward trend as employment growth lends helping hand*
	14:00	**HU**	**Target Rate**	Jun	*0.9%*	***0.9%***	0.9%	*Focus should be on 3M depo cap - expected to be halved to HUF 250bn for 3Q17; we cannot rule out verbal intervention to counter strength of forint*
	14:00	**PL**	**Industrial Production (y/y)**	May	*8.3%*	***6.9%***	-0.6%	
	14:00	**PL**	**Retail Sales (y/y)**	May	*9.4%*	***8.8%***	8.1%	*Retail sales growth supported by improving labor market conditions*
	14:00	**PL**	**PPI (y/y)**	May	*2.9%*	***2.9%***	4.3%	
	14:30	**SK**	**Current Account Balance**	Apr			2	
21. Jun.	8:30	**HU**	**Current Account Balance**	1Q	*1325*	***1300***	688	*Current account surplus should remain massive*
	10:30	**SI**	**PPI (y/y)**	May			2.3%	
22. Jun.			**No releases scheduled**					
23. Jun.	11:00	**HR**	**Unemployment Rate**	May		***11.6%***	13.2%	*Seasonal pattern feeding into strong unemployment rate decline*

Sources: Bloomberg, Reuters

Major markets

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- As expected, the FOMC agreed on a hike of the bandwidth for the Federal Funds Rate by 0.25% to 1-1.25%. This step was seen as consistent with the realized and expected labor market conditions and inflation. In general, expectations of FOMC members hardly changed since the March meeting. Forecasts for inflation and economic growth were revised only marginally for this year and were kept unchanged for the following years. Forecasts for the Fed Funds Rate were only changed slightly for the year 2019 and were otherwise left untouched.
- We believe that the start of the portfolio reduction could be announced and implemented starting with October. We expect one more hike before the end of the year, most likely in September, after which the mentioned slow portfolio reduction should set in. However, due to the recent weak inflation data, the risks have move to the downside. In the event that inflation should disappoint further, it seems more likely that the FOMC would react with a delay of the next rate hike than a delay of the portfolio reduction, in our view.

Croatia

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- The recent inflation release landed a few notches below our expectation, with CPI slightly decelerating to 1.1% y/y in May (vs. 1.4% y/y in April, EBCe: 1.3% y/y). On the monthly level, CPI decreased by 0.2%, with the strongest downside pressure from lower clothing and footwear prices. We expect a similar inflation footprint ahead, with a reversal of cost-side pressures and stronger domestic demand keeping inflation around present levels.
- Yields on the bond market maintained a stable performance throughout the week, with the longer end of the domestic curve remaining unchanged. The exchange rate continued to post gains, with the currency currently hovering at the 7.40 mark. We expect further strengthening down the line, keeping in mind the more pronounced seasonal pattern.

Czech Republic

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- In the new financial stability report, the CNB mentions increasing risks associated with the significant rise in housing prices and, in general, a spiral involving property prices and the volume of property purchase loans. Although the CNB primarily uses other measures (mainly recommendations on LTV) to calm the situation down, these financial stability issues could also be an additional argument for several bank board members to hike interest rates in 2H17, in our view.
- The CNB increased the counter-cyclical capital buffer from 0.5% to 1% with effect from July 2018, due to the continued strong credit growth and need to create buffers for worse times.
- CNB Vice-Governor V. Tomsik said that the interest rate increase could occur in 4Q17, as the recent koruna appreciation lowers the need to hike relatively quickly. We expect the first increase in CNB rates in November.

- PPI inflation arrived at -0.5% m/m and +2.3% y/y, as the decrease in food prices outweighed the positive effects of firm domestic demand and wage growth.
- The current account arrived at CZK 14bn, due to the favorable development in foreign demand.

Hungary

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- The unadjusted volume of construction rose 22.1% y/y, but slipped 2.6% m/m SWDA in April. The strong annual growth rate is thanks to the low base and increased absorption of EU funds compared with last year.

Poland

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- The final CPI reading arrived at 1.9% y/y in May, in line with the flash estimate. We expect inflation to stabilize below 2% in the coming months and drop toward 1.5% by the year-end. The limited inflationary pressure makes us believe that inflation will remain below the central bank's target of 2.5% for a longer period of time.
- Core CPI arrived at 0.8% y/y (below the market expectation of 1% y/y), down from 0.9% y/y in April.

Romania

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- The Social-Democrat Party (PSD) and its partners from the Alliance of Liberals and Democrats (ALDE) withdrew their political support for PM Grindeanu. A review of the performance of the government carried out by Social-Democrat leader Dragnea showed shortfalls in a number of areas. Grindeanu refused to resign, while President Iohannis asked the ruling coalition to solve its internal crisis. The Social-Democrats decided to file a no-confidence vote against the Grindeanu government next week. At least 233 votes are necessary for the no-confidence motion to be adopted, while the actual political configuration shows that PSD and ALDE now have 244 seats in the Parliament.
- The inflation rate was almost unchanged compared to the previous month in May at 0.6% y/y. The market consensus (Reuters) was 0.6% y/y, while we estimated a smaller increase in consumer prices (0.5% y/y). Food prices rose 0.6% m/m in May and accounted for the largest part of the deviation of our forecast from the actual data. Elsewhere, inflationary pressures were muted, suggesting that the emergence of a positive output gap has not translated yet into strong inflationary pressures. We foresee a gradual increase in inflation towards 2.2% y/y in December 2017 and 2.9% y/y in December 2018. Administered energy prices could be on the rise this year after falling in 2016, while food items could add additional pressure on consumer prices, although their development remains surrounded by uncertainties.
- Industrial production fell 0.6% y/y in April (unadjusted series) and erased part of the significant gains from March, when it increased by 10.9% y/y. Easter holidays explained part of the weakness, besides the

modest decline in industrial confidence measured by the ESI in the last two months. In spite of this decline in April, industrial production remains on track for a gradual recovery this year after disappointing results in 2016, and we foresee a positive contribution of around 1.3pp to real GDP growth (estimated at 5.1%)

Serbia

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- Serbian President Vucic named Public and Local Government Minister Ana Brnabic, a non-partisan member of the government, new prime minister-designate. The completely reshuffled government (with potentially a few new ministries) should be known on June 23, when we should also see an inauguration ceremony for President Vucic.
- As expected, inflation slowed down in May, as the headline CPI figure landed at 3.5% y/y, after hitting 4% y/y in April. The somewhat lower inflation figure is a result of the fading base effect of oil prices and the effects of the cold winter on agricultural products. We expect inflation to remain stable, moving in the upper part of central bank's 3%+/-1.5bp target interval. The May inflation figure is supportive for our view that the NBS will keep the key rate unchanged.
- On the bond market, we could see the benchmark RSD 2023 bond yield steadily moving around 5.65%, unchanged from the week before.
- Appreciation pressures on the dinar strengthened again last week and the EUR/RSD reached a new record level in 2017 of 122.11. Part of this development can be explained by the choice of PM-designate, who is an experienced pro-market and pro-investor economist (good relations with US investors).

Slovakia

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- Consumer prices increased by 1.1% y/y in May, marking a marginally higher growth rate than both our expectation and the consensus forecast. On a monthly basis, CPI indicated a 0.2% increase compared to April. Clothing and footwear prices rose by 1.9% m/m and food prices marked an increase of 0.9% m/m. Transport prices fell by 0.6% m/m, as fuel prices decreased by 2.3% m/m. Core inflation increased to 1.9% y/y in May. Harmonized inflation confirmed the higher pace of consumer price growth in May at 1.1% y/y (0.3% m/m).
- Overall, May brought some acceleration in consumer price growth. The higher core inflation in particular suggests that some domestic inflationary pressures reappeared in a more solid form. However, overall price pressures remain volatile and may take time to become more deep-rooted and persistent. Our 2017 forecast remains at 1% (CPI average).

Slovenia

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- The April unemployment rate revealed further improvement on the labor market, with the headline figure moving down on the monthly level to below the 10% mark, i.e. standing at 9.7%, while also trending down 1.7pp on an annual basis. Ongoing positive developments on the labor market side continue to support the consumption profile as the main pillar of growth.

- Yields on the bond market showed no major changes w/w, with the EUR 2027 moving around the 1.1% mark.

Capital market forecasts

Government bond yields	current	2017Q3	2017Q4	2018Q1	2018Q2
Croatia 10Y	2.82	3.00	3.10	3.10	3.20
spread (bps)	252	240	237	226	230
Czech Rep. 10Y	0.94	0.82	0.85	0.88	0.90
spread (bps)	64	22	12	4	0
Hungary 10Y	2.97	3.67	3.67	3.67	3.67
spread (bps)	267	307	294	283	277
Poland 10Y	3.15	3.44	3.62	3.75	3.91
spread (bps)	285	284	289	291	301
Romania10Y	3.73	4.10	4.30	4.40	4.60
spread (bps)	343	350	357	356	370
Slovakia 10Y	0.86	1.23	1.25	1.35	1.38
spread (bps)	56	63	52	51	48
Slovenia 10Y	1.10	1.30	1.40	1.50	1.50
spread (bps)	80	70	67	66	60
Serbia 7Y	5.44	5.80	6.00	6.25	6.25
spread (bps)	515	520	527	541	535
DE10Y (BBG)*	***0.30***	***0.60***	***0.73***	***0.84***	***0.90***

3M Money Market Rate	current	2017Q3	2017Q4	2018Q1	2018Q2
Croatia	0.60	0.40	0.45	0.45	0.45
3M forwards		-	-	-	-
Czech Republic	0.30	0.32	0.49	0.49	0.50
3M forwards		0.38	0.45	0.54	0.62
Hungary	0.15	0.05	0.05	0.05	0.05
3M forwards		0.20	0.25	0.31	0.36
Poland	1.73	1.74	1.75	1.79	1.79
3M forwards		1.79	1.78	1.83	1.87
Romania	0.82	1.00	1.30	1.50	1.70
3M forwards		0.99	1.04	1.41	1.88
Serbia	3.56	3.50	3.50	3.80	4.00
3M forwards		-	-	-	-
Eurozone	-0.33	-0.30	-0.30	-0.30	-0.30

FX	current	2017Q3	2017Q4	2018Q1	2018Q2
EURHRK	7.40	7.50	7.55	7.55	7.40
forwards		7.42	7.43	7.44	7.46
EURCZK	26.24	26.10	26.00	25.80	25.70
forwards		26.22	26.20	26.15	26.15
EURHUF	307.7	313.0	315.0	315.0	315.0
forwards		308.2	308.7	309.0	309.6
EURPLN	4.22	4.23	4.21	4.22	4.18
forwards		4.24	4.27	4.29	4.31
EURRON	4.58	4.60	4.62	4.65	4.67
forwards		4.60	4.61	4.63	4.65
EURRSD	122.1	123.0	123.5	123.5	123.6
forwards		-	-	-	-
EURUSD	1.12	1.10	1.12	1.12	1.12

Key Interest Rate	current	2017Q3	2017Q4	2018Q1	2018Q2
Croatia	0.50	0.30	0.30	0.30	0.30
Czech Republic	0.05	0.05	0.25	0.25	0.25
Hungary	0.90	0.90	0.90	0.90	0.90
Poland	1.50	1.50	1.50	1.50	1.50
Romania	1.75	1.75	1.75	1.75	1.75
Serbia	4.00	4.00	4.00	4.00	4.25
Eurozone	0.00	0.00	0.00	0.00	0.00

Macro forecasts

Real GDP growth (%)	2015	2016f	2017f	2018f
Croatia	2.2	3.0	2.7	2.4
Czech Republic	4.6	2.3	2.9	2.8
Hungary	3.1	2.0	3.7	2.8
Poland	3.6	2.8	3.8	3.4
Romania	3.9	4.8	5.1	3.9
Serbia	0.8	2.8	2.5	3.0
Slovakia	3.8	3.3	3.1	3.7
Slovenia	2.3	2.5	3.7	3.2
CEE8 average	**3.6**	**3.0**	**3.7**	**3.3**

Average inflation (%)	2015	2016f	2017f	2018f
Croatia	-0.5	-1.1	1.4	1.3
Czech Republic	0.3	0.7	2.5	2.0
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	3.4	3.8
Slovakia	-0.3	-0.5	1.0	2.0
Slovenia	-0.5	-0.1	1.5	1.5
CEE8 average	**-0.4**	**-0.4**	**1.9**	**2.2**

Unemployment (%)	2015	2016f	2017f	2018f
Croatia	16.3	13.1	10.9	10.0
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	8.6	7.8
Slovenia	9.0	8.0	7.3	6.6
CEE8 average	**9.3**	**7.7**	**6.9**	**6.6**

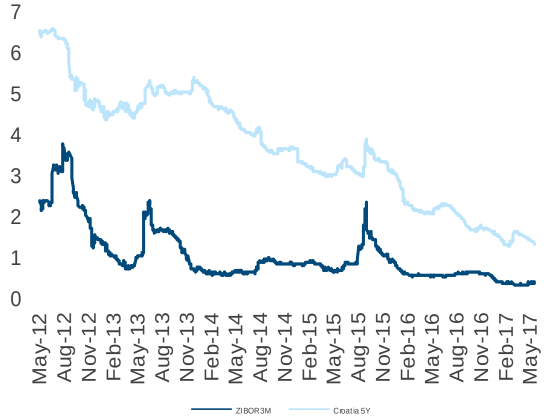
Public debt (% of GDP)	2015	2016f	2017f	2018f
Croatia	86.3	83.7	81.4	79.5
Czech Republic	40.3	37.2	35.7	35.9
Hungary	74.7	74.1	74.0	72.5
Poland	51.5	54.3	54.9	54.1
Romania	38.0	37.6	37.7	38.2
Serbia	74.7	72.9	69.4	68.9
Slovakia	52.5	51.9	51.7	50.5
Slovenia	83.4	79.0	76.6	74.8
CEE8 average	**53.7**	**53.7**	**53.2**	**52.6**

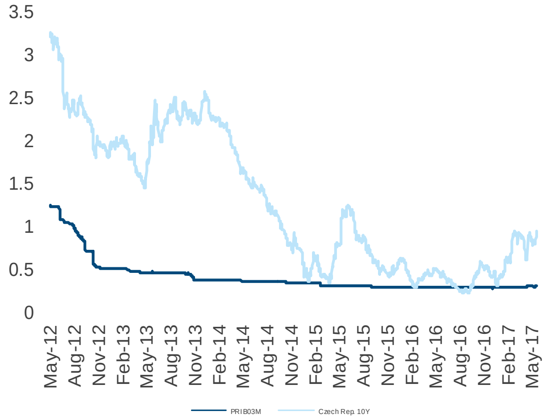
C/A (%GDP)	2015	2016f	2017f	2018f
Croatia	4.8	2.6	4.1	2.5
Czech Republic	0.9	2.1	0.8	0.6
Hungary	3.4	4.9	4.1	3.8
Poland	-0.2	-0.3	-0.6	-0.9
Romania	-1.2	-2.3	-3.2	-3.8
Serbia	-4.8	-4.2	-5.0	-5.2
Slovakia	0.2	-0.7	0.8	1.6
Slovenia	5.2	6.8	6.4	5.9
CEE8 average	**0.5**	**0.5**	**0.1**	**-0.2**

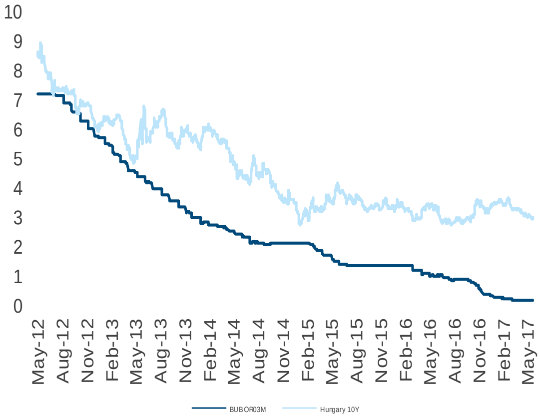
Budget Balance (%GDP	2015	2016f	2017f	2018f
Croatia	-3.4	-0.8	-1.5	-1.5
Czech Republic	-0.4	0.5	-0.4	-0.4
Hungary	-1.6	-1.8	-2.7	-2.5
Poland	-2.5	-2.4	-3.0	-2.9
Romania	-0.8	-3.0	-3.4	-3.4
Serbia	-3.8	-1.2	-0.8	-0.6
Slovakia	-2.7	-1.7	-1.5	-0.8
Slovenia	-2.9	-1.8	-1.3	-1.1
CEE8 average	**-1.9**	**-1.8**	**-2.3**	**-2.2**

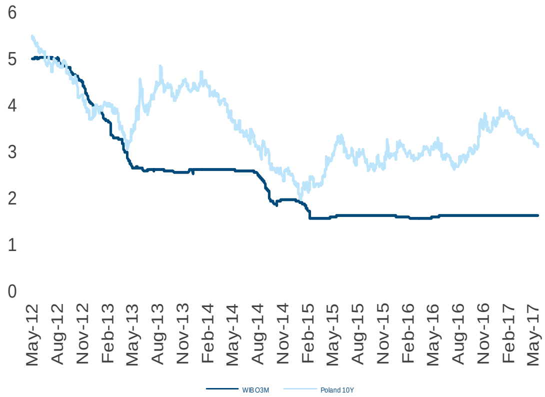
Note:*Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.

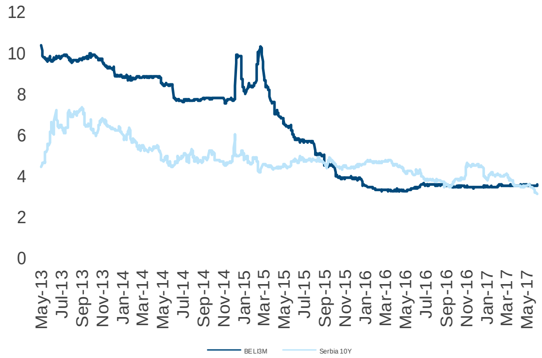
Appendix

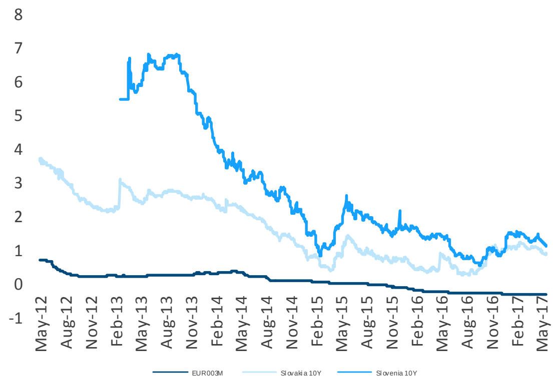












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