42 Financial Services

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Czech Republic Market Outlook | 2H18

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Economy settled into 2 – 2.5% q/q annualized growth rate in recent quarters. The major driver remains the domestic demand, both of households and of companies.

Private demand shall remain the growth driver in 2018 and 2019, but it will not grow as strongly as in 2017. Household demand will lead the slowdown as unemployment and savings rates have nowhere to fall anymore and as monetary conditions gets tighter.

In line with my expectations for weaker CZK, EURCZK rose to as high as 26.20 by the end of 2Q18, driven by rising US yields against the backdrop of 1Q18 disinflation. Going forward, nothing changes: long-term tendency to strengthen continues, as does the vulnerability of CZK to sudden shifts of mood. Baseline scenario is one of strengthening towards 25 in next two years, punctuated with episodes of weakening, large if sufficiently powerful shock arrives.

Czech bond yields continued to rise in 1H18, taking the 10Y CZ-GER spread to 6 year high. Because ECB is unlikely to hike before 2020 and because CNB is likely to continue tightening at a moderate pace, spread will remain wide well into 2019.

Key macroeconomic indicators – outlook (42FS)

Average, in % unless noted otherwise	2015	2016	2017	2018f	Δ	2019f	Δ
Real GDP growth	5.4	2.5	4.5	3	*0*	2.5	*-0.3*
CPI	0.3	0.7	2.5	2.2	*0.4*	2.5	*0.5*
EURCZK, absolute level	27.3	27	26.33	25.5	*-0.4*	25.2	*-0.3*
10Y IRS	0.9	0.67	1.37	2.1	*0.35*	2.5	*0.5*
10Y CZGB	0.75	0.44	1.05	2	*0.65*	2.3	*0.5*
2W Repo	0.05	0.05	0.17	1.5	*0.75*	2	*0.85*

Note: Δ = change against previous forecast (in percentage points or, in case of EURCZK, in absolute numbers). 2015-2017 are actual numbers.

DATA CUT-OFF: JUL/27/2018

REAL ECONOMY

Economy settled in 2-2.5% annualized growth driven by domestic demand. This will continue in next two years, with risks being singularly to the downside.

Economy grew at 2-2.5% annualized growth in 1H18

First half of this year saw the dynamics of the economic growth remain at the levels from the 2nd half of 2017, i.e. at levels significantly weaker than those seen in the 1st half of last year. The final GDP growth in 1Q18, which is the only quarter for which we have final data, was 0.5% q/q, not different from 3Q17 growth of 0.5% and 4Q17 growth of 0.7% q/q. Recall, though, that in first half of 2017 the economy grew at 1.3 and 2.3% q/q, historically unprecedented quarterly expansions and ones that, clearly, couldn't last. And did not.
Furthermore, based on the monthly data from 2Q18, it is safe to say, even in the absence of any GDP data for 2Q18, that the economy grew in 2Q18 at the similar annualized rate, i.e. between 2% y/y and 2.5% y/y. Which is about what the potential growth rate is.

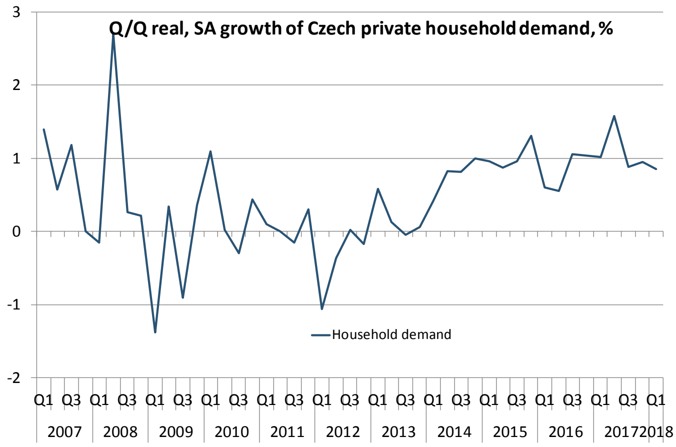
…driven by demand of households…

The growth in the first half of 2018 was driven by domestic demand, both of companies and of households. The demand of households was supported by the combination of number of factors:

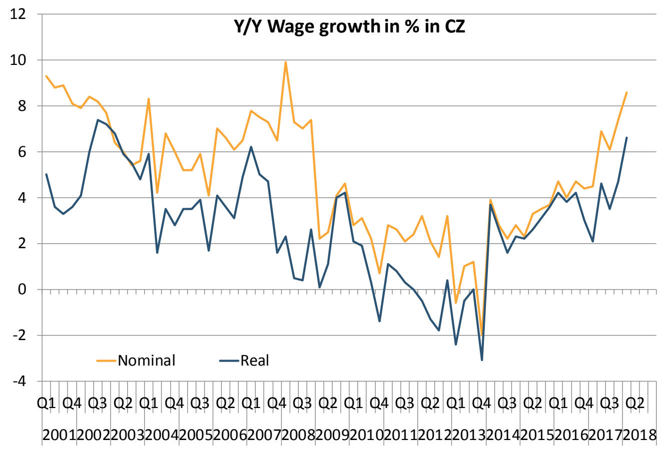
- extremely low **unemployment rate**, which, according to Eurostat, was – and is – the lowest among all of the EU countries;
- strong growth of **nominal wages** (the nominal wages grew 8.6% y/y in the 1Q18, primarily because of double-digit growth in the public sector);
- **low inflation** and, consequently, strong real wage growth (the CPI averaged just 2.1% in the 1H18);
- highly optimistic **mood** (consumer confidence reached an all-time high of 11.3 pts in May and averaged 10.1 pts in the entire 1st half, higher than anytime in the past);
- **dissaving** of the households, a consequence of low interest rates and high optimism.

It should thus come as no surprise that household demand grew 0.9% q/q in 1Q18 (and only somewhat more slowly in 2Q18)**,** marking 7th quarter with growth at least 0.9% q/q-strong: real household demand is more than 8% higher now than it was at the end of 1st half of 2016. That is indeed a very strong growth.

Household demand grew strongly this year…



…amid accelerating wage growth and subdued inflation.



Source: Czech Statistical Office, 42 Financial Services

…and of firms.

Second component of the domestic demand – investments – rose strongly as well. Fixed investments increased by 3.4% q/q in the 1Q18, and cumulatively by estimated 12% in the two years ending in June. Although all of the components of fixed investments did well, the category that grew most were fixed investments in buildings, both for dwelling as well as for other purposes. That is a reflection of strong demand for real estate from households as well as strong demand for new factory / office space from companies.

Net exports, naturally, are a drag on growth, then.

As for remaining components of the domestic demand, it wasn't surprising that net exports were a net drag on growth in 1H18, strong demand having pushed up exports and marked slowdown of German industry having dragged local industry down (manufacturing rose only about 1% in 1H18 vs 2H17). Finally, **government demand rose at the fastest rate since the crisis in 1H18**, a testament to government profligacy but also a short-term boost to the growth.

Growth in next two years will at best be like in last two quarters, courtesy of non-accelerating household demand.

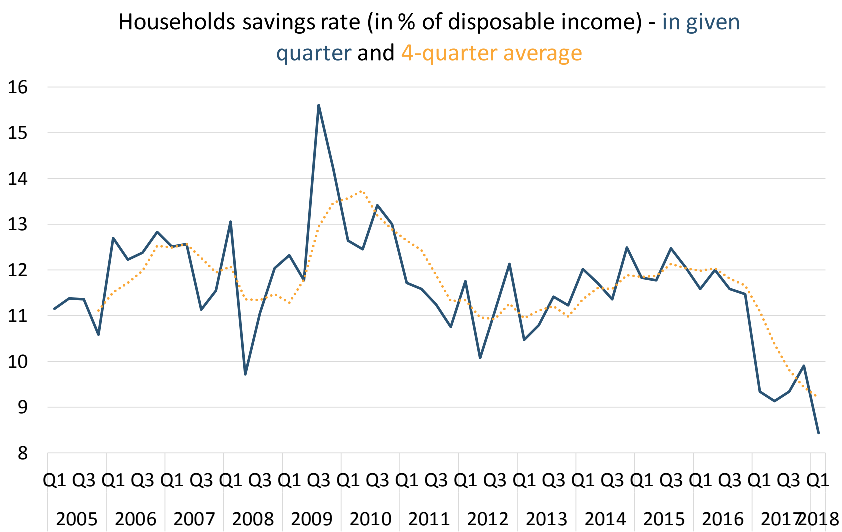
In next two years, I think we will be happy with the same growth as in the first half of 2018 (i.e. about 2.5% annualized), and that it is not impossible that we will see growth markedly weaker than that.

First reason for that is that I don't see much of a space for household consumption to continue growing as fast as it did in last 6 quarters. The reasons aren't anything new but let me just summarize them here.

- The **unemployment rate** now **has nowhere to fall**. Czech labor market has for some time been in the state of full employment and thus impossible to support the growth of the aggregate household demand the way it'd done it previous years (i.e. via increasing # of workers).

- **Savings rate,** historically always above 10% in Czech Republic, **fell to an all-time low in 1Q18.** Although 8.4% that we saw in the 1Q18 is still not extraordinarily low by European standards, it is certainly low by Czech ones. Czech households basically threw the prudence out of window and adopted the "YOLO" mentality. That said, I cannot imagine them being much more profligate going forward, with rising rates and all.

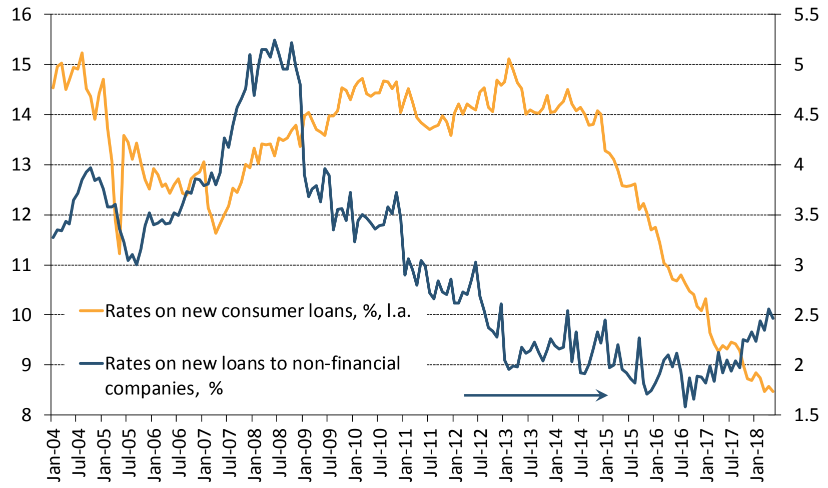
Households dissaving is unlikely to continue



Source: Czech Statistical Office

- **Tighter monetary conditions should facilitate this mean reversion**. CNB began tightening of the policy last year and managed to increase the key repo rate to 1% by the end of 1H18. Considering that real estate prices continue to rise (which, via imputed rents, is reflected in the CPI) and considering the weakness of CZK feeding through import prices into domestic inflation, this is unlikely to be the end of it. So far, true, the rates available to consumers in the real economy didn't reflect this: they continued to fall throughout the first half of 2018 as if CNB repo didn't move. But with CNB likely to tighten further, it should change and be reflected in rates available to consumers.

Interest rates on consumer loans still don't reflect tightening of CNB…But eventually will, just like the corporate ones already do.



Source: Czech Statistical Office, 42 Financial Services

- The **growth of nominal wages will be limited by**
  - falling profitability of the non-financial companies, thereby lowering their willingness and / or capacity to increase wages further;
  - employers being incentivized by strong wage growth to increase the import of workers from abroad and to substitute labor with capital.

What goes against this, and what makes the assertion that nominal wage growth will be slower going forward less certain, is the fact that government continues to exert pressure on private-sector wages via increasing salaries of the public sector workers. This is unlikely to change soon, as evidenced, for example, by billboards scattered around Prague promising to raise average salary of teachers to CZK 45 ths. in next four years (from around 33 ths. now). Other public-sector workers are being promised the same. I originally thought that with 2017 elections out of the picture, government of ANO, in line with its promises to run country as a firm, would return to fiscal prudence. Not so: just as Trotsky invented permanent revolution, Babis seems to have invented permanent campaign. And pay hikes are integral part thereof.

- The **confidence of the consumers** is at all-time high and unlikely to increase tangibly further, in good part also because of what was written above.

Risks of slowdown increased with hard Brexit, trade war.

Furthermore, the risks of more marked slow-down increased, with two main risks (Brexit and trade war) both threatening to dent the labor market. The working assumption of myself has always been that in the UK the reason will prevail and that there will be a withdrawal agreement in place by the time of exit (March 29, 2019) to make the transition as smooth as humanly possible. The events of the first half of the year, however, raise the probability of UK crashing out of the EU without a deal real: UK government is torn between hardliners and pragmatists and has a hard time formulating the negotiating strategy with EU. This is a risk for EU and Czech republic - although the effect on EU are smaller than on UK, the disruption in flows of goods and the possibility of contagion via financial sector in case of hard no deal Brexit cannot be excluded.
As regards trade war, US President, emboldened by strong economy and outraged by perceived slights US economy has allegedly been suffering in foreign trade for a long time, embarked on the trade war, picking fights with enemies and friends alike (and conflating those two terms in the process). Although so far this hasn't had great impact, if it continues, it will erode confidence and thus growth.

Fixed investments are likely to slow as real estate boom ends.

Fixed investments will also slow their growth, though to a lesser degree than household demand.
First, the boom in the residential real estate sector should slow amid higher mortgage rates and tighter conditions on mortgages that CNB imposed, as of this October, on lenders.
Second, the investments in manufacturing capacity was recently driven by increase in capacity utilization that in June reached highest (86.2%) since the Great Financial Crisis. Going forward, though, the pressure to invest will be smaller: the slowdown of industry we saw in the first half of 2018 is unlikely to reverse and so the capacity utilization should decrease from current elevated levels. Moreover, tighter financing will also have an effect.

Government demand will remain strong as ANO is on permanent campaign.

Government demand is likely to stay strong: as said before, this government is as far from fiscal prudence as possible and is on a permanent campaign trail, hence unlikely to cut down on spending anytime soon. With economy doing well, it is unlikely that fiscal conservativism will soon prevail. Unless it is forced upon the government by marked slowdown of economic growth.

Net exports will remain a net drag on growth. On the one hand, the strength of the domestic demand means imports will remain strong. On the other hand, the exports' growth will remain muted as weakness of industry and trade war fears weigh on global demand.

The economy settled in the 2%-2.5% annualized growth range and a lot of signs point towards it being behind its cyclical peak. In other words, if the growth gets out of this range, it will more likely be to the downside. Considering the risks (chaotic Brexit, trade war) such an outcome is pretty likely in next two years.

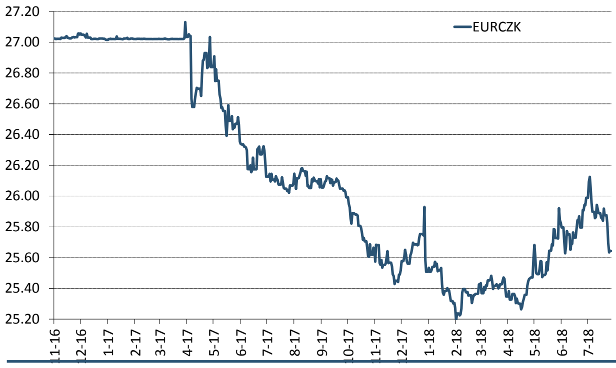
EURCZK EXCHANGE RATE

CZK weakened in 1H18, as forecast, but going forward will be supported by tighter CNB policy. Vulnerability to mood shifts, however, remains.

CZK strengthened in the 12 months since the end of interventions…

The biggest surprise to a lot of the observers, including me, was the evolution of EURCZK since the end of interventions in early April 2017. After the CNB let the currency go, CZK embarked on almost uninterrupted strengthening streak which took it from 27 shortly before the exit in April 2017 to 25.20 in April 2018.

CZK strengthened to 25.20 in 12 months after the interventions' end



Source: 42 Financial Services (EURCZK)

As mentioned before, this development had three main reasons.

…due to resurgent convergence story,…

- **The resurgence of the real convergence story.** Before the crisis, the Czech economy had been converging to the economy of the Eurozone. The real convergence, caused by faster growth of productivity here than in Eurozone, was accompanied by nominal convergence which, because of the nature of the Czech economy, was happening via strengthening of the currency (and not via higher inflation here than in the Eurozone, another possibility). The process had stalled since 2008, and had restarted in earnest only in 2016. This brought back the memories of pre-crisis years when CZK was strengthening tangibly, and attracted additional speculators.

…hawkish CNB and…

- **The hawkishness of the CNB.** Czech National Bank must have broken the record in going from fighting deflation (via FX interventions) to fearing inflation and fighting it via increases of the repo rate. Whereas it took 14 months for FED to go from halting asset purchases under QE to deliver the first hike and then another year to deliver the next one, CNB accomplished the same thing in under 6 months. CNB thus began tightening the monetary policy in summer 2017 and managed to raise the repo rate from zero to 1% by beginning of summer

2018.

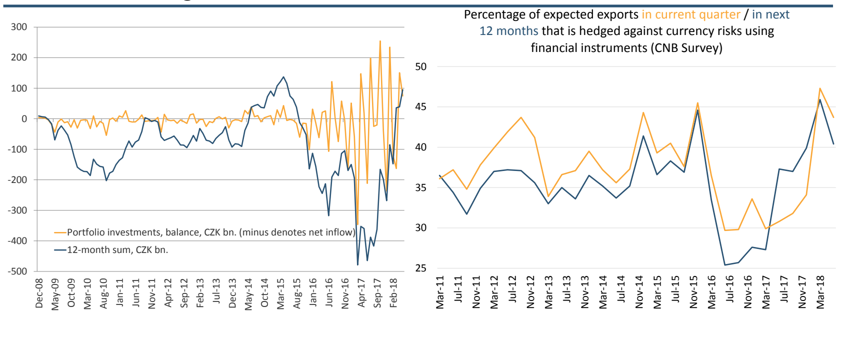
..demand from exporters.

The demand for CZK from exporters. While previous two factors primarily caused investors to stay put and not take profit (and only some additional demand), the fact that exporters, astonishingly, went into April 2017 (the month when interventions ended) under-hedged caused additional demand for CZK in the subsequent months: a self-reinforcing loop was created whereby small initial (post-exit) strengthening of the CZK, coupled with improved business (=export) expectations, led to increased demand for hedging, further strengthening CZK and completing the loop.
Considering that nominal Czech exports are approx. CZK 4000 bn., the increase of share of hedged expected exports in the total exports from 27% in 1Q17 to 45.9% in 1Q18 meant sizeable (≈ 0.19*4000 bn.) additional demand for CZK.

2Q18 saw weakening of CZK amid rising US yields

Only in the 2nd quarter of 2018 was this trend interrupted. **Against the backdrop of falling inflation in 1Q18, rise of US yields led to the outflow of capital from the region, weakening the CZK and thus setting in motion the reverse of the self-reinforcing circle just described**: as CZK weakened, exporters began to hedge a little less, dropping the share of hedged expected exports to 40% in 2Q18 as against 45.9% in 1Q18. Because at the same time slowdown of industry occurred and trade war fears increased, the overall expectation as to what exports are going to be in the coming 12 months were also likely revised downward. Smaller share of smaller base meant less demand for CZK - EURCZK went from 25.20 to almost 26.20 by beginning of summer before settling in the range of 25.50-26 as I write this.

Outflow of speculative money and less hedging demand from local exporters caused weakening of CZK in 2Q18



Source: CNB

Overbought CZK remains vulnerable to mood shifts…

Now, what next? **The outlook remains unchanged – long-term strengthening with possibility of large weakening if shock of sufficient magnitude arrives.**

Although there were some outflows from the CZK (CZK 100 bn., i.e. EUR 4bn. in last 12 months, as seen in the picture on the previous page) there is still a lot of speculative capital in CZK – recall that in few months between September 2016 and April 2017, approximately EUR

...but since speculators are apparently here to stay…

54bn. of capital came in. CZK thus continues to be highly vulnerable to mood shifts.
That said, it appears, to my surprise, that **speculators betting on CZK are here to play the long game**. They certainly have a threshold of pain, but it must be well above 26 and likely closer to 27. Yes, at such a level of EURCZK they would very likely take whatever profit they still would have at that point and fold it, accelerating the weakening of CZK and pushing it easily much lower, but to get there, something else must happen.

..it'll have to be a powerful external shock before CZK weakens to 27.

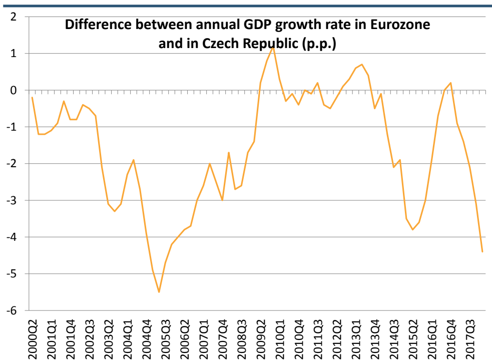
And it'd have to be something from abroad. See, domestic economy doesn't give many reasons for investors to not like CZK. Yes, there is an unsavory coalition government of ideologically amorphous one-man ANO and desperate Social Democrats, backed by Communists (for the first time since 1989…), but considering the region, even that is not that bad…

Otherwise, case for moderate strengthening of CZK remains.

Real convergence and…

Economy's been growing well, surpassing growth of EU in almost all quarters since 2014. Real convergence is thus alive and well – and likely to continue.

Real convergence continues, providing support to currency



Source: CNB

…CNB tightening to provide support to CZK.

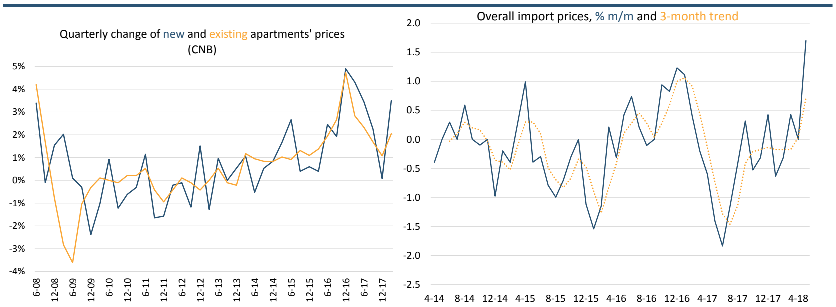
CNB is likely to continue tightening the policy, widening the CZ-EU differential as ECB is unlikely to hike in 2019. The main reason for CNB's tightening is higher-than-expected inflation caused by **real estate prices and weak CZK**. As for the latter, and as is well known, CZK and inflation are tightly linked. The way things unfold here is that initially weaker CZK means, cet.par., higher import prices and, often, higher inflation, which, in turn, means tighter policy and, then, stronger CZK. Quite often (though certainly not always), just the threat to hike is enough to "discipline" CZK deviating from fundaments.
In 1Q18, and as I expected in previous Outlook, annual inflation slowed dramatically, heavily undershooting CNB forecast. This then contributed to weaker CZK as market revised previously hawkish CNB repo rate trajectory downwards. Because CZK then in 2Q18 weakened further to as low as 26.20, import prices stopped falling, meaning that

even though Eurozone inflation remained unchanged and low throughout 1H18 (Eurozone core inflation is around 1%), import prices ceased to exert dampening effect on local price level.

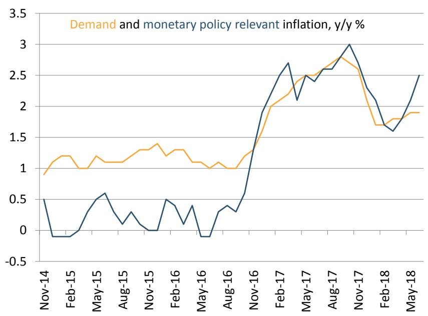
As for the **real estate prices**, rate of their growth **surprisingly quickened in 1H18**, showing up, via imputed rents, in consumer inflation. And so even though demand inflation is below 2% and even though without real estate prices there is no threatening demand inflation spiral to speak of, CNB will fell compelled act, if for nothing else than to create some maneuvering space for when next recession comes. Sensitivity of CNB to real estate prices was amply demonstrated in June when CNB issued further restrictions on local lenders that will see, by various accounts, 25-30% of applicants rejected when these come into effect in the Fall.

Strong wage growth and tight labor market, on the other hand, aren't that important: in a small open economy like ours, stronger domestic demand tends to translate into larger imports, not into higher inflation. Though CNB will use this to justify further hikes.

Weak CZK and quickening of growth rate of real estate… behind 2Q18 increase of inflation



…. behind 2Q18 increase of demand inflation



Source: CNB

CZK remains vulnerable to mood shifts but also well supported by domestic fundaments and CNB. CZK will continue to have a tendency to strengthen against EUR at a moderate rate that will be slower the stronger CZK gets (speculators taking profit acting as a brake) but may easily weaken above all bounds (above 27) should a shock of sufficient magnitude arrive. I don't foresee sustainable strengthening below 25 before 2020, and foresee periodic episodes of weakening.

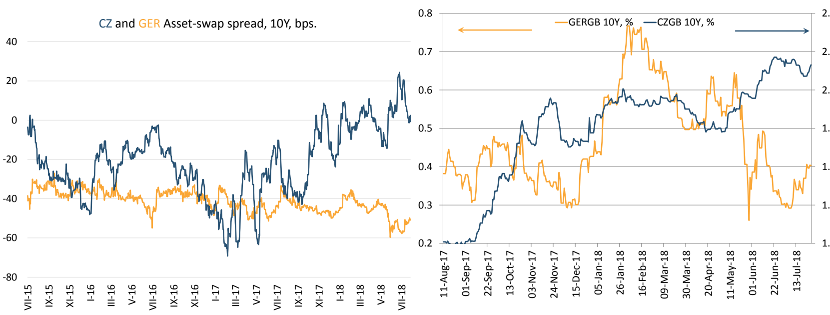
RATES AND YIELDS

CZK weakened in 1H18, as forecast, but going forward will be supported by tighter CNB policy.

Czech yields continued to rise in 1H18 as well, primarily because of rising risk premium

After rising in the 2nd half of 2017, Czech yields rose further in the 1st half of this year. Although in neither period was the development of German yields the primary reason, there are differences between these two periods.
In 2nd half of 2017, the increase in Czech yields was driven by reassessment of the monetary policy path of the CNB upwards. Out of the approximately 80 bps. increase in 10Y yields between September 2017 and the end of 2017, roughly 20 bps. was ascribable to increased risk premium (as captured by asset-swap spread), the rest being due to reassessment of the future interest rate trajectory. The increase of approximately 40 bps (from 1.75% in January 2018 to around 2.15% in June) was, on the other hand, mostly (30 bps.) due to higher risk premium.
Also, the entire increase over 1st half of 2018 was concentrated to May and June and thus coincided with the outflow of capital from the region, mentioned above and reflected in weakening of the CZK.

Czech yields rose further in 1H18, but unlike in 2H17 it was mostly due to higher risk premium

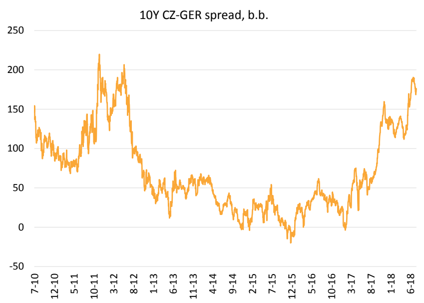


Source: 42 Financial Services data (generic yields)

…which widened to 6Y maximum in June.

The developments just described meant that 10Y spread to German government yields rose to highest in 6 years (approx. 170 bps.).

CZ-GER 10Y spread widened to 170 bps., largest in 6 years



Source: 42 Financial Services data (generic yields)

The question thus is whether this remains so in the coming quarters.

Since ECB will stay put until 2020 and…

As regards Eurozone yields, Eurozone remains a low-inflationary environment and considering the rate at which labor market is improving (the unemployment rate is falling at 0.8 pp per year, below -1 pp we saw last year) we are still at least couple of years away from the moment when labor market can be viewed as at or close to full employment. Since history of US of last few years shows that even with tight labor market the inflationary rise of wages (i.e., wage growth in excess of productivity growth) is not guaranteed, I think we will not see any tightening of the policy of ECB until 2020, and even then it will be slow. ECB, at its June 2018 meeting, decided to discontinue its asset purchases by December of 2017 and said that the rates will remain unchanged 'through the summer' 2019. Considering the evolution of Eurozone inflation (core inflation is still at 1% and there hasn't been any improvement in this measure in last four years) I think ECB will stay put throughout 2019. **There should thus be no abrupt increases in the Eurozone yields this year or next – all I think we will see is a slow upward drift. The catching up of ECB with the CNB would narrow the CZ-GER spread, but this won't begin before 2020.**

…because CNB will continue to tighten moderately…

Locally, on the other hand, unless economy slows down so much that it'd require monetary easing, CNB will probably continue tightening, though at the moderate rate (75 bps. in 2018-19). As soon as the real estate prices stop increasing (which, considering the restraints on lenders, should happen at the latest after October), the demand inflation will again be much less of an issue that it is now. Furthermore, although CZK remains vulnerable to mood shifts and can easily weaken, the main scenario is for it to continue strengthening towards 25 in next two years. Coupled with non-inflationary Eurozone, these things mean that inflation won't prompt CNB to tighten more than what is now priced in the market (three hikes in next 12 months). Therefore, the interest rate component of the Czech yields shouldn't push Czech yields higher in next quarters. And if there is a renewed interest in CZK – the share of Czech government bonds held by non-residents fell from 45% last October to 35% in May – the yields will decrease, although likely not by much.

In sum, thus, the CZ-GB spread shall remain wide as a central point of the forecast, with risk being that it will narrow modestly.

..CZ-GER spread shall remain wide.

The big uncertainty, obviously, is CZK. Any weakening of CZK triggered by outflow of speculative money would by definition mean rising government bond yields. But this would likely be short-lived as CNB would intervene (should CZK weaken, say, to 27) by tightening the policy, threat thereof, or by outright FX intervention. And local banks, awash with cash (and one avenue of lending – mortgages – partially closed), would likely jump in, taking opportunity to buy bonds with yields they've not seen in a long time.

Czech bonds will remain elevated, supported by CNB expectations. However, the risk premium to German bunds should narrow somewhat.

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