# CZK IN FIRST MEANINGFUL POST-EXIT WEAKENING.

## IS THIS THE GATEWAY TO 27?

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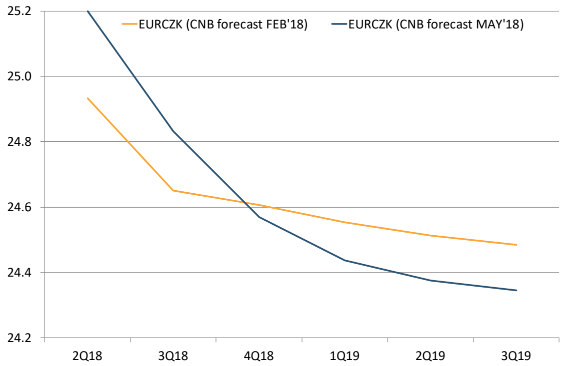
- **EURCZK in a first post-exit weakening…**
- **…raising questions of whether this is finally the big push back towards 27.**
- **Although it is by no means assured, the current situation is conducive to just such an outcome.**

**Since the end of the interventions and especially as the expectations of those (like me) who expected quick post-exit weakening of the CZK were proven wrong**, literally everyone has been saying that CZK would only get stronger from now on. One of the stalwarts in the pro-CZK camp was certainly CNB. In last two forecasts (i.e., since CNB returned to practice of releasing its EURCZK forecast, suspended since November 2013), it called for ever-stronger CZK. In February 2018 forecast, for example, it called for EURCZK average of 24.9 in 2Q18 and of 24.6 in 4Q18. May 2018 update did bring some revision to what was clearly an unrealistic expectation (unrealistic in conjunction with the inflation forecast at the time), but only at the short end of the forecasting horizon: as regards the end of this year and the entire 2019, CZK is still forecast to be much stronger than now.




SOURCE: CNB

**It wasn't only CNB who foresaw CZK rising uninterruptedly forever. Take exporters.** For all the warnings that CNB will end the interventions regime in 2Q17, quite a few of them did not hedge prior to April 6, 2017 exit. But as post-exit weakening of the CZK didn't materialize and as CNB began tightening the policy, attracting further speculative capital and pushing EURCZK lower, they drank the CNB's Kool-Aid that CZK would only get stronger. Since economy was also doing good at the time (2017) and the foreign demand grew, they rushed to hedge the (expected) exports. This had the effect of setting off a self-propelling strengthening of the CZK: the more people hedged, the stronger CZK got, compelling others to hedge too.


SOURCE: CNB

**Good part of the strengthening occurred due to the expectation of the tighter monetary policy of CNB.** CNB not only went from fighting alleged deflation via interventions to fighting alleged inflation via hikes in few months, but towards the end of last year and in the first month of this year, it indicated it would need tighter policy in 2019. This was based upon the expectation of quickening inflation, and the monetary tightening was expected to come via strengthening of CZK. In February 2018 forecast CNB expected 2Q18, 3Q18 and 4Q18 average of CPI at 2.4%, 2.3% and 2.1%, respectively, and, at the same time, EURCZK at

24.9, 24.7 and 24.6; 3M PRIBOR was kept almost unchanged. In other words, what CNB told the market was that inflation might be easily close to 3% if CZK doesn't strengthen sufficiently. Market understood and CZK strengthened. [1]

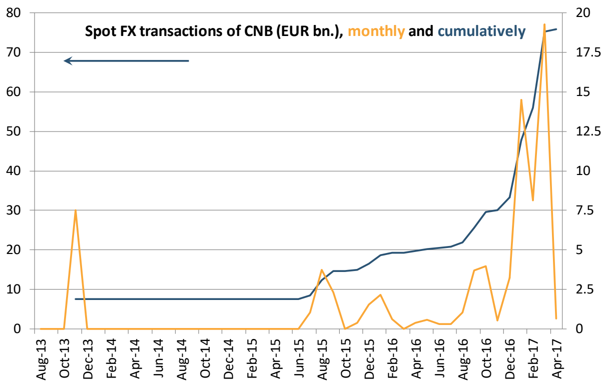
**Then came inflation data for January, February, March and CNB's February forecast was shattered.** See, inflation fell to 1.6% in March, well below the CNB expectation of 2.3%, and thus making the case for tighter policy (via stronger CZK or via higher rates) much weaker. CNB tacitly acknowledged it and the hawkish rhetoric of November – December 2017 gave way to wait-and-see attitude of April 2018 (do you recall how Benda wanted, in October or so, to hike three times before Christmas…?)

**And, in April and May, the overdue normalization of EURUSD finally came**. EURUSD close to 1.25 didn't make any sense whatsoever, but market thought otherwise for few months. Then, sobered by weak Eurozone data, by widening (actual and expected) interest rate differential between US and Eurozone and by post-election turmoil in Italy, EURUSD fell below 1.20 and moved towards 1.15, as I long expected. This triggered CEE sell-off that that CZK couldn't escape. EURCZK shot up to 25.85, level where it is trading now. **Given the peculiar state the EURCZK is in (the amount of interventions money in it is large), the big question on everyone's mind is this: where will it go from here?**


SOURCE: 42FS

Well, either up or down 😉 Let me think about what is more likely.

**The key thing is that lots of speculators still sit in CZK waiting for it to strengthen as 'promised' by CNB**. The amounts of euros that came in during the last months of interventions in early 2017 was insane.




SOURCE: CNB

Although some of these speculators may have already left, the fact that foreign residents still hold 35% of all CZK-denominated Czech government bonds shows most of them are still here. And this is what makes CZK vulnerable. Although it is impossible to find out what they think, the recent weakening must have rattled them: apart from the weakening in December 2017 which was due to technical reasons (lower liquidity, Resolution fund), recent weakening is the only meaningful weakening since the end of interventions in April 2017, and thus the first disruption of the CZK-will-only-get-stronger narrative. We don't need to state this but: let's keep in mind that all of these investors invested in

[1] If you say CZK needs to be 24.6 for inflation to be 2.1%, with link between import prices and consumer inflation, you also say that weaker currency than 24.6 implies higher inflation than 2.1%. Which, in turn, implies higher rates. Market either believes you and CZK strengthens, in which case you don't have to hike, or doesn't, in which case you may have to. Rates and EURCZK are intimately connected.

CZK for one reason only, and that is to profit from expected strengthening of the currency. This strengthening was to be due to post-intervention normalization of artificially-weak CZK and, once CNB began fighting inflation, due to forecast of the tighter monetary policy (=widening interest rate differential to Eurozone).

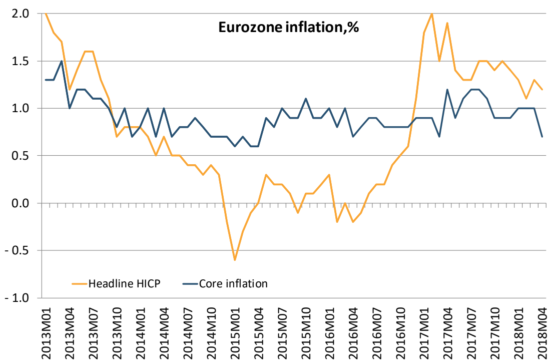
So, while it is impossible to say with any certainty where such a point is, **I am positive the speculators are now close to the tipping point**. If I had to really guess, I'd say 26 could be decisive here and, if broken through, things can move fairly quickly above 26. At 26, the profit from post-exit short EURCZK trade, incl. positive carry, is about 4% - not bad for a year.

**As indicated above, the exporters will not be able to take the other side of the trade once speculators choose to leave**. Their exports are hedged more than ever in the past and my contacts in the market tell me that while hedging did pick up in the recent weeks, the volume is nowhere near the volume that we saw time last year. Moreover, what is important to remember is that the 50% of *expected* exports are hedged[2]: if there is a slowdown in export growth, the higher share of actual exports will be shown to have actually been hedged.

**And the slowdown there appears to be. German GDP growth slowed to 0.3% q/q in 1Q18, a massive loss of momentum compared with 0.6% q/q seen in 4Q17.** Although some of the slowdown was due to unusually weak government demand, big negative drag came from exports. This is feeding into Czech industry as I write, with business confidence or PMI reflecting this (PMI fell over 3 pts since peak in December). After all, the 1Q18 GDP growth here came at just 0.5% q/q, a massive slowdown against 2017.

**Weaker GDP growth in the Czech Republic and in Eurozone means weaker inflation pressures.** Which brings me to about the only realistic thing I can think of that could push EURCZK lower from here: **the actual real need of tighter monetary policy**. If Czech inflation really runs away, then CNB will have to either threaten to tighten the policy or to do it. Both of these would make the (expected) interest rate differential between Eurozone and Czech Republic wider, and hence would push EURCZK lower. But it isn't that easy.

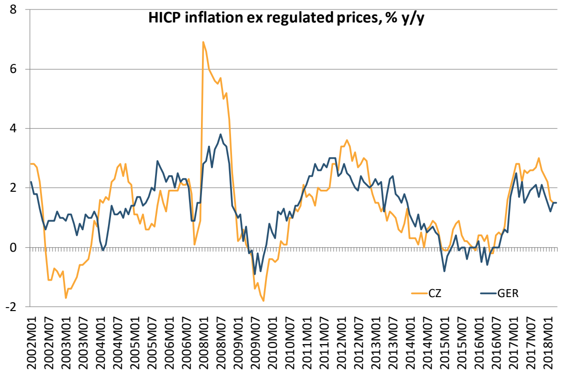
**As far as Eurozone inflation alone is concerned, it is a double-edged thing**. The fact that it is so persistently low (core inflation has been around 1% and without trend for last four years, the assurances of ECB that it will change soon notwithstanding) means the probability that the QE (or, generally, very loose ECB policy) stays longer increases, cet.par. widening the IR differential in favor of stronger CZK. On the other hand, weak Eurozone inflation means Czech republic will not import any inflation whatsoever from Eurozone anytime soon.




SOURCE: EUROSTAT

**Of course, the interest rate hike narrative in Czech Republic would be much stronger if Czech inflation were to detach from Eurozone / German one.** The only problem is that it is very hard for Czech inflation to do so – if history is any guide, Czech inflation tends to follow German one very closely. And besides, even if you do believe German inflation is on the brink of shooting higher, pushing Czech inflation higher, the fact that German inflation is rising would certainly translate into more hawkishness on the side of ECB. Therefore, the net impact on expected IR difference and hence on EURCZK wouldn't be large.

[2] This also means that it is not logical to talk about future trade balance surplus and its impact on CZK: good part of that surplus was hedged: the demand for CZK stemming therefrom already materialized.




SOURCE: EUROSTAT

To sum, for CNB to be able to promise tightening of the policy, which is about the only thing that can push EURCZK back towards 25 in the short- to medium-term[3], it would need idiosyncratic increase of Czech inflation above the German / Eurozone one. Can it happen? Theoretically yes. But practically – very likely no. Therefore, I am of the opinion that EURCZK is likely to stay at these levels or weaken further, potentially much further. I think 27 may be closer than we think.

[3] Long-term, real convergence will bring nominal convergence, and thus lower EURCZK. But first, the market needs to be rid of the massive latent supply of CZK.

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