Weekly | 2018 | Week 31

MARTIN LOBOTKA, (+420) 777 027 165, MLobotka@42fs.com, Research@42fs.com

CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	6-Aug	8:00	GER	Industrial orders, Jun'18, y/y WDA	3.4%	N/A
	6-Aug	9:00	CZ	Industrial output, Jun'18, y/y	1.5%	2.2%
	6-Aug	9:00	CZ	Retail sales, Jun'18, y/y	2.2%	3.0%
Tuesday	7-Aug	8:00	GER	Industrial production, Jun'18, y/y (WDA)	3.0%	N/A
	7-Aug	9:00	CZ	Trade balance, Jun'18. CZK bn.	15.6	N/A
Wednesday	8-Aug	9:00	CZ	Unemployment, Jul'18	3.0%	N/A
Thursday	9-Aug	9:00	CZ	CPI, Jul'18, y/y	2.3%	2.2%
Friday	10-Aug	8:45	FRA	Industrial production, Jun'18, y/y (WDA)	1.5%	N/A

* LOCAL TIME IS CET
** (REUTERS/ BLOOMBERG) POLL

AUGUST 2018 AUCTIONS

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
CZGB 2011-2023**	8-Aug	10-Aug	18-Apr-23	CZK 4 bn. max	VAR
CZGB 2014-2025**	8-Aug	10-Aug	17-Sep-25	CZK 4 bn. max	2.40%
SPP 799	9-Aug	10-Aug	9-Nov-18	CZK 0-5 bn.	N/A
CZGB 2014-2027**	22-Aug	24-Aug	19-Nov-27	CZK 4 bn. max	VAR
CZGB 2018-2029**	22-Aug	24-Aug	23-Jul-29	CZK 4 bn. max	2.75%

* FOR T-BILLS, THIS IS MAXIMUM AMOUNT PER PRIMARY DEALER.
** MINFIN CAN CHANGE THE ISSUE AT THE LATEST AT THE DAY OF THE AUCTION ANNOUNCEMENT FOR ONE WITH SIMILAR MATURITY.

THOUGHT OF THE WEEK

"I KNOW HOW TESLA ENDS: HITS ALL-TIME HIGH THREE DAYS BEFORE BANKRUPTCY ↗"

WEEK AHEAD

In the Czech Republic, end-of-1H monthly data and July inflation are going to be released.

Both retail and industry headline readings will be influenced by one less working day this June as against June 2017. Adjusting for this, industrial production will be shown to have stabilized after slowdown in 1H18 whereas retail sales will be shown to have grown approx. 2% m/m, with core sales leading the growth.

The key release in light of CNB's last week's meeting ► is **July inflation**. CNB forecasts two more hikes this year, but this is dependent on inflation being in line with the recent forecast of CNB. For July, CNB's forecast is 2.6% which to me looks like asking for it being undershot. I expect 2.3%.

In Eurozone, only German industrial data are of importance. The orders, especially, as they will dictate how will the German industry do in the 3Q18 which, in turn, will dictate how our industry does.

WEEK BEHIND

CZ: industry likely to grow weakly in 3Q18

CZ: CNB hikes to 1.25%

EMU: 2Q18 GDP growth weakest in two years

EMU: labor market improvement loses steam, inflation remains low

EMU: retail sales weak in 2Q18, though May-June data better than expected

| FX

Buy on the news, clearly.

After the CNB hiked, EURCZK rose to 25.70. Looks like two more hikes promised for the rest of this year weren't enough to induce more CZK buyers out there. This isn't surprising: all those who wanted to speculate on CZK strengthening are already in & everyone exporting anything is hedged by now.

EURCZK RISES DESPITE CNB HIKE

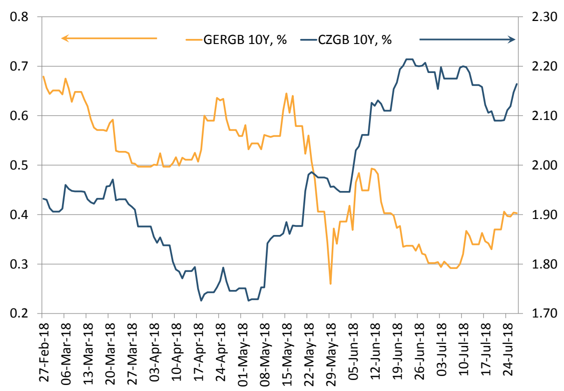
| FI

Small movements in Germany and CZ.

Weak Eurozone growth and inflation data caused German bonds to pare losses from the previous week. **10Y yields thus slid back to 40 bps.** And Italian sell-off helped as well. Italian 10Y yields were pushed over 3.1% by mid-Friday, highest since beginning of June, before retreating back to 2.90%, while 2Y yields shot from 80 bps. mid-way through last week to over 1.3% by mid-Friday. The panic was caused by uncertainty about the fate of Minister of Finance Giovanni Tria amid the news that ruling coalition parties began discussing budget. Market recalled the government promises from back in May that budget will be expansionary.

Czech 10Y bonds rose 5 bps to 2.21% after CNB meeting.

GERMAN YIELDS FALL ON ITALY SELL-OFF, WEAK DATA



| CZECH ECONOMY

Czech industry is set for the weakest performance in 3Q18 since August last year.

At least, if PMI is worth anything when it comes to forecasting the future performance (it is): July PMI was 55.4, down from 56.8 in June. The decline was equally driven by actual output (which is just the reflection of the previous PMI readings that indicated that the production will slow), and by weakest growth of new business. This latter was weakest in almost a year and will show up as weak *actual* output in coming months. The **weakness** is clearly **coming from abroad**: new export business grew at the weakest rate since November 2016.
Weaker growth is now also reflected in output inflation – although the sub-index of output inflation is still above long-term average, it slowed in the recent months. Finally, hiring activity also moderated in industry, which may be due to weaker growth or due to natural limits imposed by the labor market at full employment.

All in all, it now looks quite likely that industry won't grow faster in 2H18 than it did in 1H18, and may well grow more slowly. This will be a drag on overall economic growth in 2H18.

This didn't stop CNB from tightening, though.

At its Thursday meeting, CNB raised the key two-week repo rate to 1.25%, highest since the end of November 2009 and the first time it did hike at two subsequent meetings in over ten years. The decision was unanimous.

The decision was, the way I read the statement of the Board, clearly driven by weak CZK: recall that CNB forecasts from February and May 2018 expected CZK to be below 25 by this time of the year. The reality, however, is that it is 2.5-3% weaker than that as I write this. That is a clear pro-inflationary risk, one that is reflected in import prices which, having been falling continuously for over a year until last April, rose strongly in May, partially reflecting CZK (and partially fuel prices).

Second reason, according to CNB, was strong wage growth. That to me, however, was added to the mix so that CNB can point to two factors rather than just to one they mis-forecast. True, annual wage growth of 8% seems fast, but I don't see many signs that this would be causing excessive inflation growth – as is to be expected in open Czech economy.

What I do see, though, and what in my view did weigh heavily on CNB, are the rising **real estate prices**, being reflected in the CPI via imputed rents. Even if it doesn't explicitly mention them, CNB is afraid of them, as evidenced by the restraints it is imposing on lenders come this October. **Hiking the repo helps in this respect as well.**

Looking forward, CNB significantly increased the short-term trajectory of repo and **lowered the degree to which it expects the currency to strengthen**. Essentially, one component of the monetary conditions is exchanged for the other, while end-of-forecast-horizon points don't change. Hence, 3M PRIBOR is forecast to be 1.8% in 4Q of 2019, whereas it was forecast to be 2.1% at that time in the previous forecast. EURCZK is now expected to be 24.30 in last quarter of 2019, same as in May forecast. **As regards this year, changes in forecast are large to account for CNB getting CZK completely wrong:** 3M PRIBOR is forecast at 1.8% in 4Q18, i.e. approximately two more hikes from current 1.23%. For EURCZK, CNB finally got real and expects CZK to remain above 25 this year, with 4Q18 at 25.30.

That CZK won't strengthen as fast as CNB expected has been repeated by me ad nauseam. Going forward, CZK will surely be supported by interest rate differential and ongoing real convergence, but it will at the same time remain vulnerable to mood shifts. To me, long-term appreciation potential is intact, but it will be hard to get significantly below 25 as deeper you get, the more speculators will want out, taking profit. Also, the two more hikes this year, while widening the interest rate differential, won't by themselves cause much downward movement in EURCZK: first, see polish zloty (rate differential's been wide for ages now) and, second, if CZK indeed strengthens back to, say, 25.20, CNB will take even those two expected hikes back.

And I am not even talking about the overly optimistic expectation of CNB that growth will remain above 3% this year and next. I don't think it will, with trade war already denting confidence and chaotic Brexit, a real possibility now, not exactly morale boosters. Slower growth would lower the expected repo trajectory further still.

In other words, two hikes this year are possible, but risks are certainly to the downside.

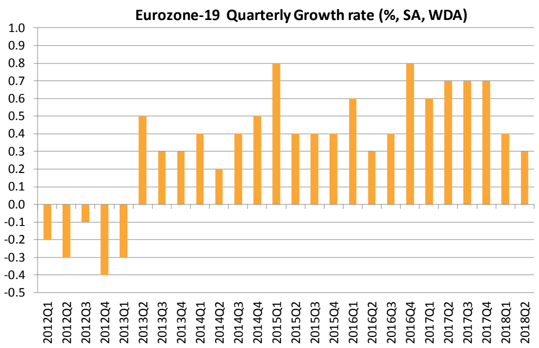
| EUROZONE ECONOMY

Eurozone GDP rose just 0.3% q/q in 2Q18, slowest expansion since 2Q16 and adding to concerns that sustainable inflation will prove more elusive than ECB expects.

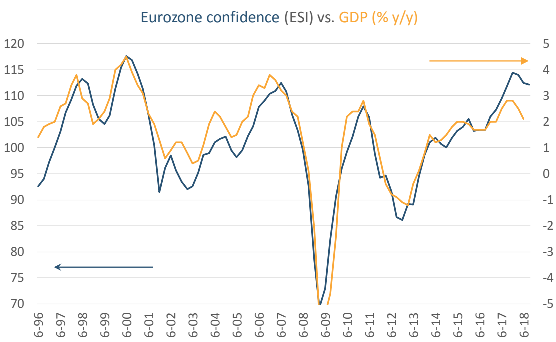
The structure of the growth isn't known yet, but both industry and retail monthly data throughout the 2Q18 weren't anything strong (retail growth was slower than in 1Q18), so it looks like both exports and household consumption contributed weakly to the overall growth. Investments are harder to guess, but I wouldn't be surprised if they contracted in 2Q18 with uncertainty about the trade war having escalated in 2Q18.
Country-wise, **Spain weakened to slowest growth since 2Q14**, Italy slowed to 0.2% (weakest since 3Q16) and France remained at 0.2% q/q, just like in 1Q18. German growth wasn't released yet, but it is likely it was 0.3% q/q.

For ECB, this is certainly a disappointment, but not such a big one as to force it to revisit its June decision to discontinue asset purchases as of the end of this year. What this does is that it shifts the first hike further in the future (I always said 2020 is

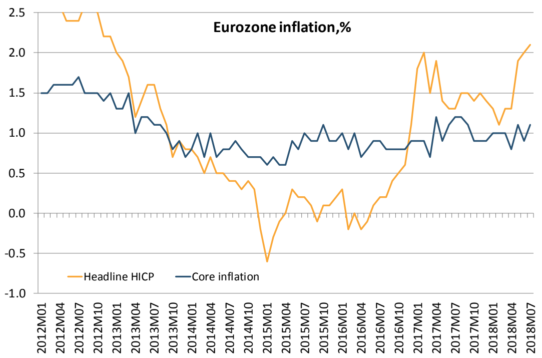
EUROZONE IN A SLOWEST GROWTH IN 2 YEARS IN 2Q18



CONFIDENCE STABILIZED AT THE BEGINNING OF 2H18



JULY CORE INFLATION STABLE AND LOW



LABOR MARKET IMPROVEMENT LOSES STEAM AS GROWTH FALTERS

earliest date for an outright tightening in Eurozone) and leaves the door open for continuing asset purchases should economy slow down further.

But will it? Hard to say. Trade war probability was lowered after Trump and EC President Juncker agreed a ceasefire in July, but rose again when Trump threatened last week to more than double the tariffs ↗ on USD 200bn. worth of Chinese imports into US. Be it as it will, what is very likely is that Eurozone growth will not quicken from current levels – after all, leading indicators don't point to a turnaround. **See, last week, final July confidence data from Eurozone showed Economic Sentiment Indicator remaining at around 112 pts, lowest in a year.**

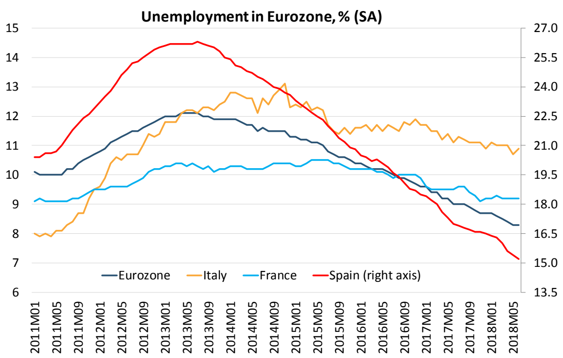
Preliminary July inflation confirmed that inflation indeed remains subdued.

Although headline inflation rose to 2.1% y/y in July, fastest since December 2012, this was, as in previous two months, driven only by energy prices: the annual growth of energy prices was 2.6% y/y in April, 6.1% in May, 8% in June and 9.4% y/y July. **More importantly for the ECB, core inflation was 1.1% y/y**, same as in May and 0.1 pp *lower* than in July 2017. In other words, there still isn't any demand inflation to speak of and no progress has been made in last twelve months toward making inflation more sustainable.

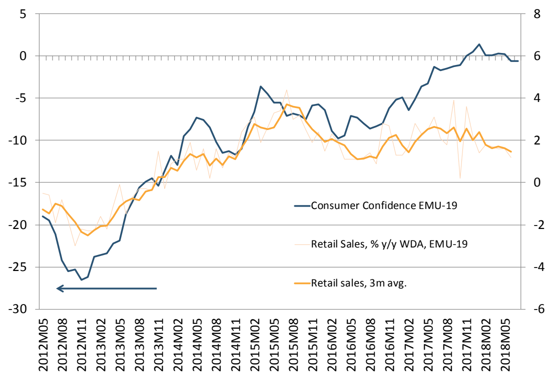
And it doesn't look like there will be any progress soon. **Unemployment remained at post-crisis low of 8.3% in July**, but the annual rate of improvement is weakest in almost two years in what is certainly a disappointing piece of news for those expecting unemployment to soon fall to such low levels as to start engendering demand pressures. See, whereas last year the unemployment rate was falling at 1 pp annual rate, in July it was merely 0.7 pp lower than in July 2017.

But this is natural: as growth falters, so does the hiring activity. Moreover, the only country that's been improving continuously in this regard is Spain:

SPAIN THE ONLY DRIVER OF THIS YEAR'S LABOR MARKET IMPROVEMENT IN EUROZONE



RETAIL SALES CONTINUE TO GROW WEAKLY DESPITE SKY-HIGH CONSUMER CONFIDENCE



Spanish unemployment fell to 15.2% in June (from 16.9% in June 2017 and 16.4% in January). Remaining big economies (Germany, France, Italy) saw unemployment rate going sideways this year.

To sum it up: core inflation won't accelerate any time soon. And ECB won't be able to hike next year.

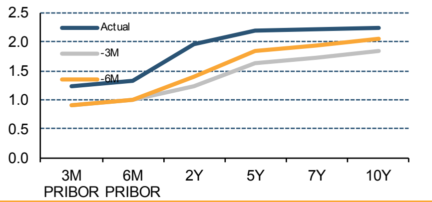
Retail sales annual dynamics remained weak at the end of June, but monthly one improved.

First, May monthly growth was revised from (previously reported) stagnation to +0.3%, so April (which was revised down from -0.1% m/m to -0.2% m/m) and May together saw some growth combined. Add to that June growth of 0.3% m/m, released last week, and 2Q18 retail sales growth was only somewhat weaker than in 1Q18.
That said, though, it was well below what the consumer confidence at all-time high might lead one to believe: the annual growth of 1.2% y/y is hardly something economist would find in line with such elevated confidence levels.

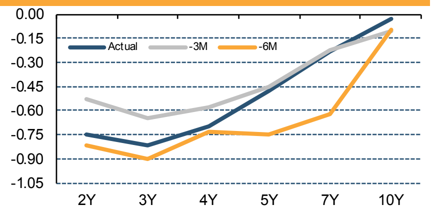
As regards outlook, wouldn't say ECB should expect inflationary household demand anytime soon. Unemployment continues to improve, but at a weaker rate. Wage growth remains weak. Inflation picked up due to fuel prices. All in all, not many reasons why it retail should pick up soon.

| MARKETS ‡

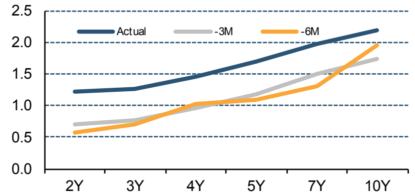
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	1.240	1.320	1.955	2.180	2.203	2.225
	-1M	1.160	1.250	1.740	1.975	2.019	2.065
	-3M	0.900	0.990	1.240	1.635	1.725	1.830
	-6M	0.910	0.990	1.390	1.835	1.930	2.050



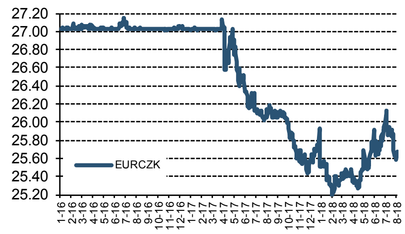
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-0.747	-0.815	-0.695	-0.482	-0.236	-0.027
	-1M	-0.524	-0.662	-0.505	-0.368	-0.095	0.133
	-3M	-0.529	-0.644	-0.584	-0.452	-0.227	-0.104
	-6M	-0.820	-0.904	-0.731	-0.749	-0.623	-0.097



CZGB**		2Y	3Y	4Y	5Y	7Y	10Y
%	Actual	1.208	1.258	1.446	1.698	1.967	2.198
	-1M	1.216	1.193	1.423	1.607	1.924	2.198
	-3M	0.711	0.773	0.960	1.183	1.498	1.726
	-6M	0.570	0.696	1.019	1.086	1.307	1.953



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25.625	4.263	320.06	4.615	5.882	1.158
	-1M	26.125	4.395	327.30	4.659	5.447	1.166
	-3M	25.501	4.266	313.92	4.666	5.055	1.199
	-6M	25.237	4.171	309.91	4.647	4.697	1.246



‡ As of Sunday night
* Spreads to generic bonds
** Generic bond

| CONTACTS

MARTIN LOBOTKA, ANALYST (+420) 777 027 165, MLobotka@42fs.com

RESEARCH Research@42fs.com

AVAILABLE AT THOMSON REUTERS EIKON MESSENGER

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