Weekly | 2018 | Week 32

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CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	13-Aug	10:00	CZ	Current account, Jun'18, CZK bn.	-12.0	N/A
Tuesday	14-Aug	8:00	GER	(Preliminary) GDP, 2Q18, q/q	0.4%	N/A
	14-Aug	8:00	GER	(Final) HICP, Jul'18	2.1%	N/A
	14-Aug	9:00	CZ	(Preliminary) GDP, 2Q18, q/q	0.8%	0.5%
	14-Aug	9:00	SPA	(Final) HICP, Jul'18	2.3%	N/A
	14-Aug	11:00	EMU	(2nd estimate) GDP, 2Q18, q/q	0.3%	N/A
Thursday	16-Aug	9:00	CZ	PPI, Jul'18, y/y	3.1%	3.0%
	16-Aug	9:00	CZ	Export / Import prices, Jun'18	N/A	N/A
	16-Aug	11:00	EMU	Trade balance, Jun'18, EUR bn.	16.5	N/A
Friday	17-Aug	10:00	EMU	Current account, Jun'18, EUR bn.	N/A	N/A
	17-Aug	11:00	EMU	(Final) HICP, Jul'18	2.1%	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

"TURKISH LIRA FELL RIGHT THROUGH THE INTEREST RATE LOBBY TO DEBASEMENT."

WEEK AHEAD

In the Czech Republic, first estimate of 2Q18 GDP and import prices will be released this week.

That the growth in 2Q18 was driven by domestic demand is pretty clear. But, some questions of interest do remain: 1] how much did the investments expand after strong, 3.4% q/q expansion in 1Q18 (I fully expect slowdown), 2] how much did household demand expand, with retail sales having disappointed in June (household demand grew 1% q/q on average in last 7 quarters, so slowdown is likely), 3] what did exports do (two strong months of industry suggest they – or inventories - did better than in 1Q18).

I think **weaker growth of retail was compensated by stronger exports or inventories** (reflection, on supply side, of stronger industry), so the GDP growth stayed around 0.5% q/q in 2Q18.

Import prices most likely rose again in June, courtesy of weak CZK.

In Eurozone, German GDP is of greatest importance. Though the fact that we know the Euro area estimate and the estimates for France, Spain and Italy makes this a little less of an interest. Plus, retail sales remained weak and industry didn't grow in 2Q18 as against 1Q18, so don't expect much in terms of growth. 0.3-0.4% q/q is what we shall see.

WEEK BEHIND

CZ: while industry defies expectation of slowdown…

CZ: …retail sales disappoint

CZ: demand inflation in unprecedented monthly rise, but…

CNB: minutes show CNB wants to continue tightening, via repo, preferrably

Germany: industrial data weak, both actual (production) and future (orders)

| FX

Calm week behind us.

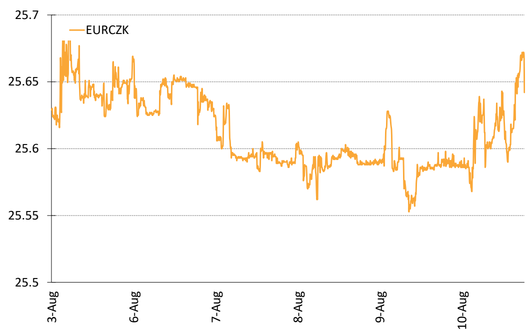
CZK remained calm around 25.60 despite CNB's fairly hawkish minutes from August 2nd meeting.

| FI

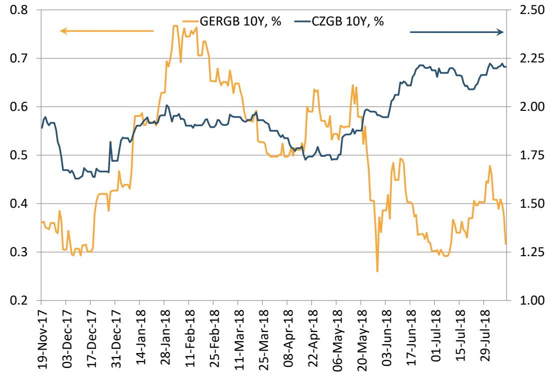
Safe haven flows to Germany pushed their 10Y yields low.

This was driven primarily by the sell-off in Turkey where lira continued to weaken massively (down 18% in a day at one point on Friday) amid escalating row with US and clear inability of Turkish government to do anything about the situation. Russian ruble also got under pressure when US announced new sanctions on the country. In other words, emerging markets didn't do all too well last week.
This also explains why Czech bonds didn't move. We're not safe haven, you know.

EURCZK STABLE AROUND 25.60



GERMAN YIELDS FALL ON EMERGING MARKET TURMOIL.



| CZECH ECONOMY

Czech industry surprised in June with a second strong month in a row, defying weakness seen at the end of 1st half in Germany.

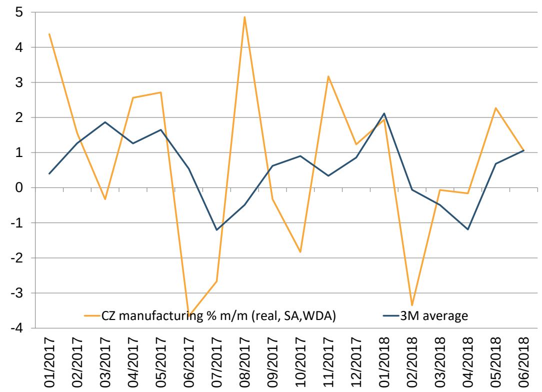
Industry grew 1.5% m/m and 6.9% y/y (adjusted, real). Hot weather did help, yes, but it wasn't primary effect, as some observers suggested. The production of electricity (+gas, steam, air-conditioning) did rise 16.5% y/y (and almost 6% m/m) in June, so that did help, but there was strong increase in manufacturing component as well. See, after May when manufacturing grew 2.3% m/m, it increased by another 1.1% m/m in June. This is pretty surprising considering the weakness of PMI in recent months (July PMI having been lowest since August 2017, new exports sub-index lowest in 1 ½ years) and weakness in German industry in June ►, as explained below.

So far, thus, it doesn't appear that German industrial woes had equal impact on Czech industry. Did our industry thus decouple from its German counterpart, then? No – I think it is only a matter of time before German weakness shows up here. Historically, it hasn't happened that the Czech industry, which to a good extent is essentially merely a sub-contractor to German one, would shrug off the slow growth to the West of us.

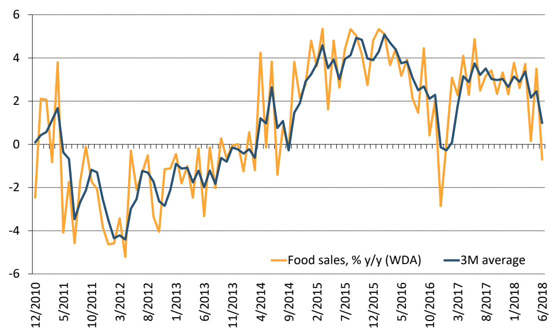
Unlike industry, retail sales disappointed in June, and although this was primarily due to weak food sales, the core sales also seem to have the best behind them.

Core retail sales rose 5.5% y/y in June, taking the three-month average annual growth to 'just' 7.1% y/y, second slowest quarterly average since March 2017. Obviously, one cannot claim this to be weak, not by a long shot, but there's no denying that core sales slowed from ultra-fast growth seen in previous three quarters. This isn't that surprising, though. **First**, unemployment rate isn't falling anymore (it's already at such low levels that it

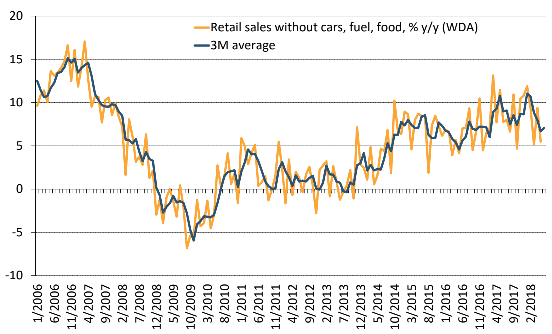
CZECH MANUFACTURING POSTS SECOND STRONG MONTH, DEFYING EXPECTATIONS



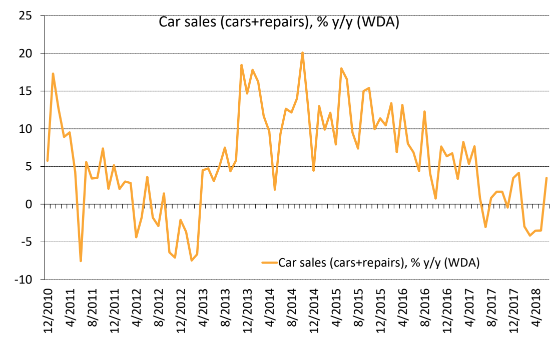
FOOD SALES SURPRISINGLY FELL IN JUNE



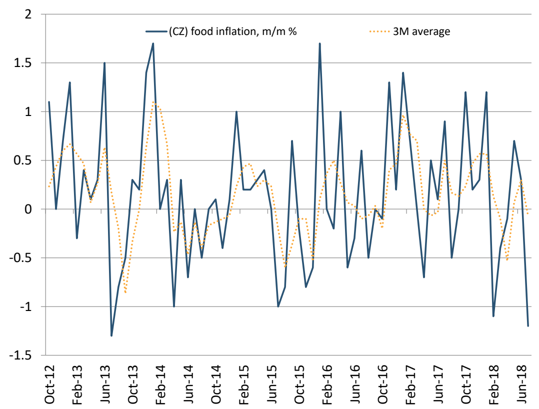
CORE RETAIL SALES REMAINED STRONG, BUT CLEARLY SLOWED THIS YEAR



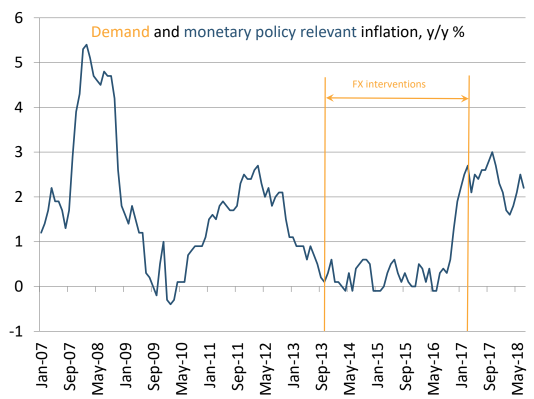
CAR SALES FINALLY RETURNED TO Y/Y GROWTH IN JUNE



FOOD PRICES FALL MOST IN 5 YEARS,… TAKING OVERALL MPRI DOWN TO 2.2%



…TAKING OVERALL MPRI DOWN TO 2.2%.



simply can't). **Second**, wage growth of 7-8% y/y is about as fast as it can get – profitability of non-financial corporations worsened noticeably recently, so it is hard to increase wages much further. **Third**, savings rate cannot fall much further – it fell to an all-time low in 1Q18. **Fourth**, consumer confidence slipped from all-time highs recently.

As regards other segments outside the core sales, food sales surprisingly declined 0.7% y/y, first y/y decline since December 2016. This doesn't seem to have clear cause: I don't think weather could've had the impact as some observers suggested since a] it wasn't that hot in June and b] people gotta eat no matter what…Anyway, considering all else, I think it will be reversed in July.

The **only clearly bright piece of news in June release thus was return to growth in car sales**. After having been negative since February, car sales & repairs grew 3.5% y/y in June, fastest annual rate of growth since January (4.2%). It was about time.

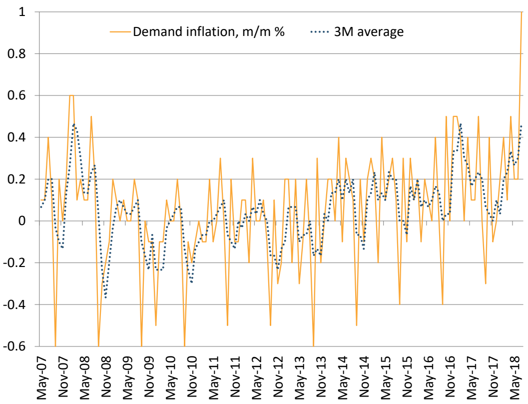
All in all, I think household demand will be one of the most important drivers in the coming quarters, but for reasons stated above the growth of the demand won't be as fast as in 2017.

Annual inflation slowed in July due to the fall of food prices, but demand inflation shot up unprecedentedly month-on-month.

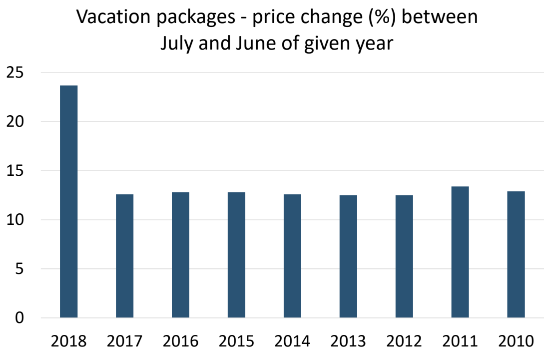
Food prices fell 1.2% m/m in July, their biggest monthly decline in 5 years, dragging the monetary policy inflation relevant inflation (=headline less indirect taxes) from 2.5% at the end of first half of this year to 2.2% at the beginning of 2nd. This being non-demand factor, CNB won't pay much attention to it.

What it will pay attention to, though, is the biggest rise of demand (core) inflation since at least 2007. The demand inflation (=MPRI less fuel and food prices) rose 1% m/m, contributing 0.5 pp to the overall monthly increase of price level.

THE DEMAND INFLATION POSTED FASTEST MONTHLY GROWTH ON RECORD,…



…DUE TO SEASONALITY-DEFYING 25% MONTHLY INCREASE OF VACATION PACKAGES.



Consequently, annual core inflation shot from 1.9% in June to 2.4% in July. Is this the demand inflation coming unhinged? Should CNB hike 50 bps. or more, asap?

No. Looking closer at the structure this was due to extraordinarily large growth of prices of vacation packages. This is usual seasonality (always happens in July in the up direction, and in September in the down direction) but magnitude of this year's growth was unprecedented, almost to the point of disbelief: historically, holiday packages increased around 12% m/m between June and July, ± 1%, but this year, their prices shot up almost 25% m/m. I mean, it makes no sense, with regularity seen in previous years and with CZK stronger y/y, to see double the usual monthly rate of increase. It almost feels like data entry mistake.

Anyway, if this is the mistake or not, CNB will likely continue tightening this year, depending on how much CZK strengthens in the coming months.

This much was clear from the minutes from the August 2, 2018 meeting, released last week.

What did the minutes say that makes me thinks so? Well, first, Board members in general saw the risks to the new forecast as balanced (but remember, this is in relation to new forecast, i.e. one with weaker CZK and two more hikes this year) while one, likely Hampl, saw them as pro-inflationary due to wage growth. Second, while "*majority of the members were of the opinion that the fundamental story of the Czech economy – despite the substantial revision of some of the figures in the forecast – remained broadly unchanged*", some of the board members „*had perceived a qualitative change in the forecast and emphasized the shift in the forecast towards higher domestic inflation pressures*". This also shows Board as a whole being inclined to see more hikes through. After all, minutes said that "*all Board members agreed that it was desirable to raise interest rates*" and agreed that „ *purely mechanistic interpretation of the* *forecast was indicating a need for a more substantial rate increase of up to 50 basis points*". That it didn't happen was because of few arguments that were made for gradual increase. These were

a) fear of market over-reaction to 50 bps. hike,

b) need to be prudent and go gradual in the situation of increased uncertainty

c) concerns of Board members that 50 bps. hike might be interpreted by public as proof that CNB targets exchange rate, not inflation.

Finally, minutes made it pretty clear that 50 bps. hike was not done also because CNB doesn't entirely disapprove of weaker CZK. As was clear from the minutes, CNB prefers interest rate channel of the monetary conditions to the exchange rate one when tightening the policy, the reason being that the former lets CNB 1) bring interest rate higher, i.e. closer to neutral level and thus create maneuvering space for when next recession hits, and 2) higher rates have "macroprudential" implications, i.e. help tame real estate market.

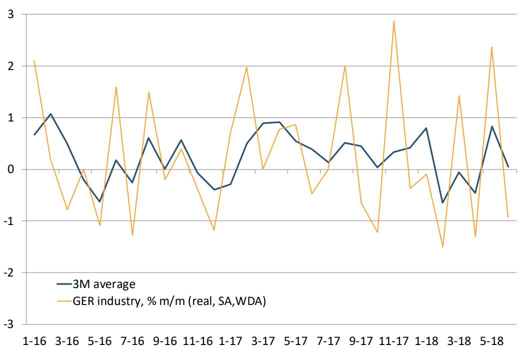
Hence, even if CZK does strengthen towards 25.20, hike wouldn't be excluded.

| EUROZONE ECONOMY

German industrial data were weak at the end of 1H18, with orders suggesting weakness will not end soon.

First, last Monday, orders were reported to have fallen 4% m between May and June, in what was the biggest decline since January 2017 (-4.8% m/m). The cold came from outside the Eurozone (5.9% decline of foreign orders from outside the Eurozone speaks clearly to that), but orders from Eurozone and from within Germany fell as well (2.7% and 2.9% m/m, respectively). In last three months, however, these two categories fell more (approx. 4.5% and 3%, respectively) so while trade war didn't help, it doesn't look like it is the primary cause of German industrial soft patch (to say the least). **Together with weak recent PMI & IFO ↗,**

GERMAN INDUSTRIAL DATA WEAK IN JUNE, WITH PRODUCTION FALLING…



…AND ORDERS PLUMMETING, BODING ILL FOR 2H18.

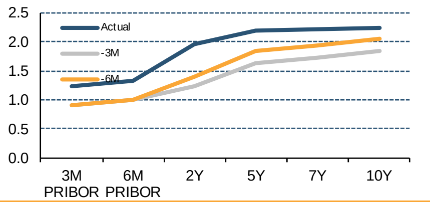
the orders now make weak industry and weak GDP growth in 3Q18 pretty certain.

The weak orders of previous months showed up in actual production, too. **June industrial production was reported last Tuesday to have fallen 0.9% as against May** (which saw strong, but one-off growth of 2.4% m/m) and thus didn't grow at all during the first half of the year; the overall y/y growth was just 2.5%, noticeably slower than in 6.6% y/y seen as recently as in December.

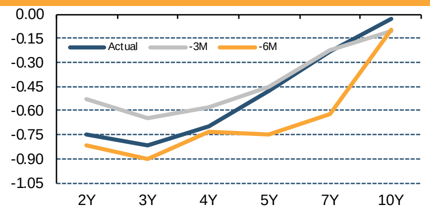
This slowdown isn't that surprising considering the decline of leading indicators such as IFO and PMI in Germany throughout the first half of 2018. Structure-wise, production fell in June in all sectors except for consumer non-durables, with manufacturing having declined 0.9% m/m for the 1H18 cumulative decline of 0.7%. **The y/y growth in manufacturing in June was 3.2%. Nothing to write home about, really.**

| Markets ‡

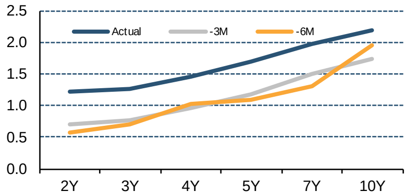
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	1.240	1.320	1.955	2.180	2.203	2.225
	-1M	1.160	1.250	1.740	1.975	2.019	2.065
	-3M	0.900	0.990	1.240	1.635	1.725	1.830
	-6M	0.910	0.990	1.390	1.835	1.930	2.050



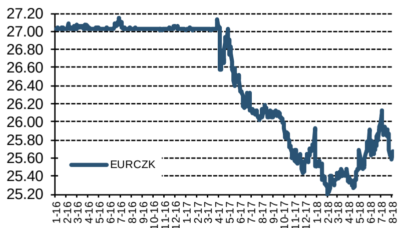
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-0.747	-0.815	-0.695	-0.482	-0.236	-0.027
	-1M	-0.524	-0.662	-0.505	-0.368	-0.095	0.133
	-3M	-0.529	-0.644	-0.584	-0.452	-0.227	-0.104
	-6M	-0.820	-0.904	-0.731	-0.749	-0.623	-0.097



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

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