Weekly | 2018 | Week 38

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CALENDAR

DAY	DATE	TIME (CET)*	MARKET	RELEASE	CONSENSUS**	42FS
Monday	24-Sep-18	9:00	CZ	Business / Consumer Confidence, Sep'18	N/A	N/A
	24-Sep-18	10:00	GER	IFO Business Climate, Sep'18	103.2	N/A
Wednesday	26-Sep-18	13:00	CZ	CNB rate-setting meeting, two-week repo	1.5%	1.5
Thursday	27-Sep-18	11:00	EMU	(Final) Consumer confidence, Sep'18	-2.9	N/A
	27-Sep-18	14:00	GER	(Flash) HICP, y/y, Sep'18	1.9%	N/A
Friday	28-Sep-18	8:45	FRA	(Flash) HICP, y/y, Sep'18	2.6%	N/A
	28-Sep-18	9:00	SPA	(Final) GDP 2Q18, q/q (SA)	0.6%	N/A
	28-Sep-18	9:00	SPA	(Flash) HICP, y/y, Sep'18	2.3%	N/A
	28-Sep-18	11:00	EMU	(Flash) Headline / Core HICP, y/y, Sep'18	2.3%1.1%	N/A
	28-Sep-18	11:00	ITA	(Flash) HICP, y/y, Sep'18	1.7%	N/A

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

SEPTEMBER 2018 AUCTIONS

NAME	DATE OF AUCTION	DATE OF ISSUE	MATURES ON	AMOUNT OFFERED*	COUPON
CZGB 2007-2022**	5-Sep-18	7-Sep-18	12-Sep-22	CZK 3 bn. max	4.70%
CZGB 2018-2029**	5-Sep-18	7-Sep-18	23-Jul-29	CZK 5 bn. max	2.75%
SPP 800	13-Sep-18	14-Sep-18	14-Dec-18	CZK 0-5 bn.	N/A
SPP 801	20-Sep-18	21-Sep-18	21-Dec-18	CZK 0-5 bn.	N/A
CZGB 2018-2021**	19-Sep-18	21-Sep-18	23-Feb-21	CZK 3 bn. max	0.75%
CZGB 2014-2025**	19-Sep-18	21-Sep-18	17-Sep-25	CZK 3 bn. max	2.40%

* 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

EU, SEP'16: FOUR FREEDOMS ARE INDIVISIBLE. CHERRY-PICKING IS NOT AN OPTION. ↗
UK, JUL'18: WE WANT SINGLE MARKET WITHOUT FREE MOVEMENT OF PEOPLE. ↗
EU, SEP'18: NO, WE TOLD YOU HUNDRED TIMES IT IS IMPOSSIBLE. ↗
UK, SEP'18: EU DOESN'T RESPECT US. ↗

WEEK AHEAD

CNB meeting is the No.1 event this week.

The question is not whether there will be another 25 bps. tightening of the policy – governor Rusnok basically promised that two weeks ago – but how hawkish the Board is. In other words, how many more hikes can one expect from the Board in next 6 months.

In Eurozone, most important release is the preliminary Eurozone inflation for September. Considering the weakness of the soft indicators in previous months, it is unlikely that the economic growth picked up and so it is impossible the core inflation accelerated meaningfully. In other words, this will be another release that will support my view that ECB hike is far out in the future (2020).

WEEK BEHIND

CZ: weak CZK continued to filter into import prices in summer ▶

EMU: consumer confidence returns to Earth ▶ as manufacturing PMI continues to worsen ▶

Brexit: the pretense is over ▶

| FX

CZK strengthened to the strongest level since April as market almost fully priced in 2 hikes suggested by CNB Governors Rusnok the week before.

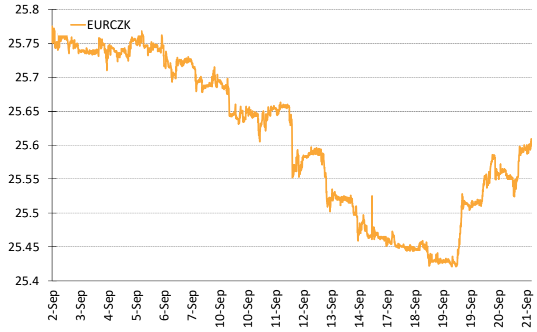
This sent CZK to almost 25.40 midway through last week. Thereafter, EURCZK rose back above 25.50 and reached 25.60 by the end of the week amid what clearly was profit-taking. CNB is thus manifestly having a hard time persuading the market to do its work, i.e., to push CZK higher against EUR so that it (=CNB) wouldn't need to hike as much.
This confirms my long-held view that CZK won't strengthen towards 25 this year as, as expected, any dips in EURCZK are snapped up by those wishing to exit long-CZK trade.

| FI

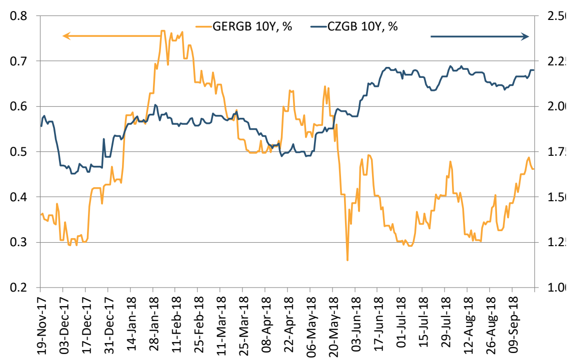
Yields remained unchanged last week.

On long end, at least. On short-end, the CZGB curve moved up 10 bps to 1.5% (2Y) as market priced in the forthcoming hikes.

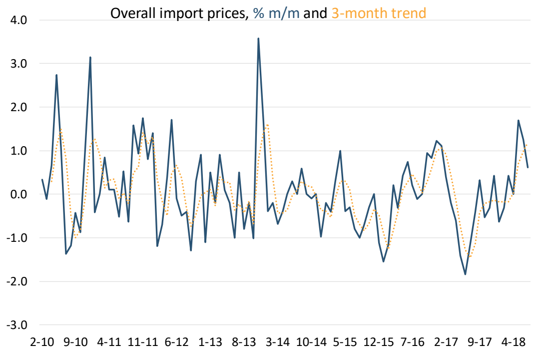
EURCZK FALLS TO LOWEST SINCE APRIL BEFORE RETREATING UPON PROFIT-TAKING



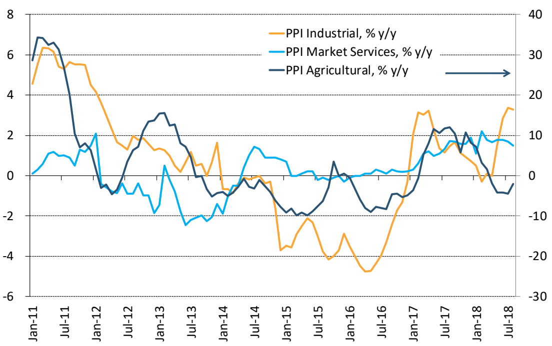
GERMAN YIELDS CLIMB HIGHER ON ECB

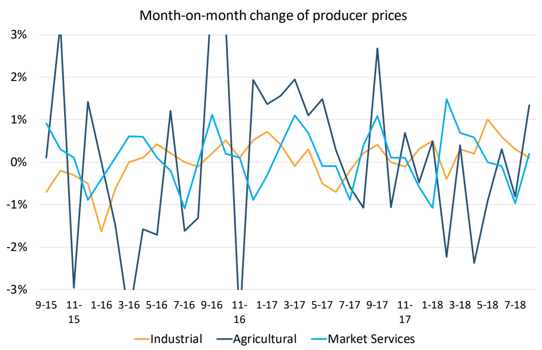


Import prices in fastest quarterly growth since CNB interventions



PPI shows on signs of cost pressures apart from Agriculture





| CZECH ECONOMY

Weak CZK continued to filter into prices, pushing domestic inflation higher even as Eurozone remained non-inflationary.

Import prices rose for the third time in a row in July, having increased by another 0.6% m/m (after 1.3% and 1.7% monthly gains in previous two months). The increase in last three months ending in July was thus largest since 4Q13, i.e. since short-lived increase in import prices causes by CNB interventions.

The impact of 2Q18 weakening of CZK on import prices was fairly uniform: yes, the increase of 15.3% seen in import prices of fuel over May-Jule was largest by far, but that was an exception caused by higher oil prices, not by weaker currency. Most other categories saw increases between 2 and 4% over May-July, in good part due to weaker CZK exchange rate.

This should be it for now: CZK recently strengthened to strongest against EUR since April/May, so the reverse impact on import prices than the one seen in last three months is to be expected in the next three months.

As regards **producer prices**, there was a **notable increase in agricultural producers' prices in August**, with 1.3% monthly gain being largest since September of 2017. This for now does not appear to be driven by drought experienced by Czech Republic in the summer (the prices rose because of poultry, eggs, oils). But, looking forward, the drought will certainly have an impact on food prices in the coming months.

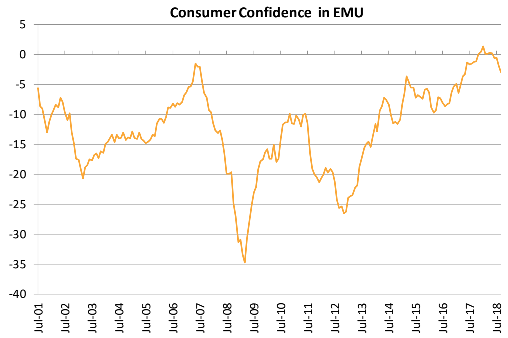
For **industrial producers**, prices moderated to slowest growth (of just 0.1% m/m) since February, the moderation being due to oil price growth that was slower than in previous months. With CZK stronger now and oil prices stabilized, we should see slowdown in annual growth of industrial producers' prices soon. And the growth should be close to 1% by the end of 1Q19.

In **market services**, prices rose 0.4% m/m, mainly due to higher prices of advertising. Excluding these, the prices of market services stagnated m/m.

All in all, I don't see buildup of supply side inflationary pressures in the data. Where increases will likely happen is the agriculture, but that is due to vis major, i.e. weather.

| EUROZONE ECONOMY

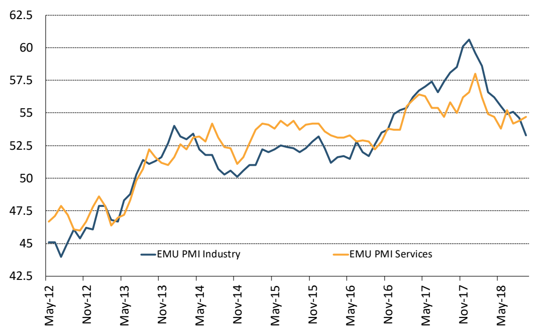
CONSUMER OPTIMISM RETURNS TO EARTH



The optimism of the Eurozone consumers is finally returning to Earth.

According to the preliminary data, consumer confidence in Eurozone fell in September to its lowest (-2.8 pts.) since May 2017.
This is finally happening. I mean, not that I'd wish for consumers to be unhappy, but the stratospheric heights to which the confidence climbed in the 1st half of the year was unjustified as there never was much macroeconomic reason for such an optimism: wage growth has been moribund for ages now, unemployment has been falling, but only very slowly etc. After all, retail sales grew at just 1% annual real rate in recent months, clearly showing that unbridled optimism of consumers rested on very weak macro foundations. The correction now came and, if I had to guess, I'd expect it to continue in the coming months: consumer confidence is still very high from historical perspective.

MANUFACTURING PMI LOWEST IN 2 YEARS



Eurozone PMI offers no hope that growth will quicken beyond what we see currently.

Although services remained roughly unchanged in September at 54.7 (vs. 54.4 in August and 54.2 in July), **manufacturing PMI continued to slide, falling to the lowest level (53.3) since September 2016**.

The actual manufacturing output index was 52.8, i.e. lowest in 28 months. This being the reflection of past weakening in the orders growth, it is not important when assessing the future prospects of the manufacturing. And neither is the fact that backlog of work fell for the first time since April 2015. Both reflect the same thing: weak orders growth of previous months.

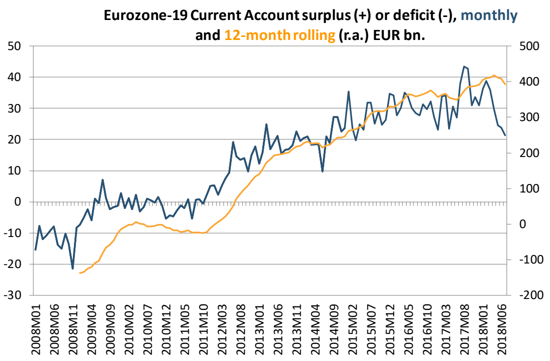
And this growth didn't get any better, suggesting further weakness in actual output in the coming months. See, orders in manufacturing grew at the (joint-) weakest rate since May 2016 while **export orders fell for the first time since June 2013**. Hence, the question that remains is this: will this manufacturing weakness filter into services eventually?

I wouldn't rule it out. What is certain at this point is that economic growth will not quicken and that neither will the inflation. If ECB goes by the inflation outlook alone (which it might not, tightening the policy even with persistently low inflation because it just can and because it wants to move away from the zero to have some maneuvering space when next recession hits), it won't be able to hike next year.

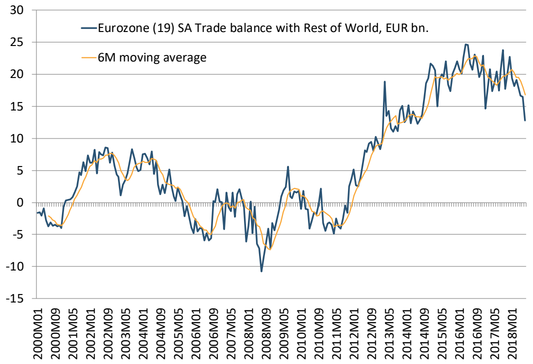
Gloves are off in the Brexit negotiations and the pretense that just the details remain for the final deal to be concluded is over.

The hopes of UK PM May that her hard-won Brexit deal proposal from Chequers ↗ from early July (that led to departure of her ministers Johnson and Davis) were dashed for good last week.
Not that EU hasn't been saying for ages ↗ that you can't choose the freedoms to adhere to in the single market (it's either all four – freedom of movement of people, capital, services and goods – or none) but it has in last two years been trying not to be blunt and nudge May in the desired direction, hoping that adults in what passes for UK government will eventually prevail and will stop seeking the impossible (i.e., will not cherry pick).
That was not to be, so last week in Salzburg the exasperation with the self-delusionary May government that refuses to accept reality and to

EUROZONE CURRENT ACCOUNT SURPLUS FALLS TO LOWEST SINCE SPRING 2015…



… AS TRADE BALANCE SURPLUS FALLS ON PRICIER OIL, SLOWER EXPORTS.



choose from what is (rather than what it wanted to be) on the table reached EU limits. Hence, the hard talk from Salzburg ↗ where May was (finally) told outright that either she comes up with a proposal compatible with EU principles (and comes up with solution to Northern Ireland / Ireland border) or the talks are over. And to add insult to injury, she was given four weeks to rework the plan and told, by Macron, that Brexiteers were bunch of snake oil salesmen

To me, it was about time. Two years after the referendum, UK government still behaves as a child who wants to eat the cake and have it.

Considering the reality in UK where nobody wanted Chequers (to some, it did not go far enough in keeping UK in EU orbit, to Brexiteers it was much more than is palatable), that EU killed it may be for the good, eventually – if it leads to EEA deal for UK.

But I wouldn't bet on it: to me, chances of hard Brexit, always high, have increased further to make it by far the most probably outcome. Essentially, now the choice UK has is between EEA membership (which would really be Brexit in name only) or hard border in Ireland, with both of these alternatives being opposed by sizeable number of MPs.

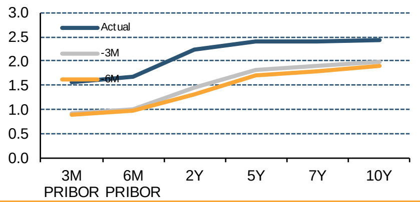
If I were May, I'd either call another referendum or, better still for herself, general election – and hope I'll lose it 😉. Jokes aside, cards need to be dealt anew if there is to be any way found out of the mess Tories got themselves and the country into. But even if that ever happens, hard Brexit is now No.1 scenario everyone should work with.

Eurozone current account fell precipitously in July as trade balance worsened.

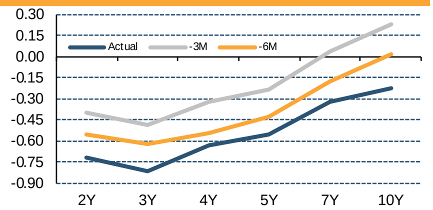
This was due to worsening trade balance, partially due to higher oil imports and partially due to fall in exports (while non-oil imports continued to rise). Still, the 12-month surplus stands at EUR 390 bn., i.e. at 3.5% of GDP. Hardly any reason to worry about euro.

| MARKETS ‡

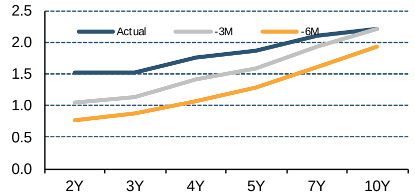
MM / IRS		3M PRIBOR	6M PRIBOR	2Y	5Y	7Y	10Y
%	Actual	1.560	1.670	2.230	2.410	2.417	2.428
	-1M	1.480	1.580	2.023	2.218	2.248	2.278
	-3M	0.930	1.010	1.450	1.810	1.895	1.983
	-6M	0.900	0.990	1.315	1.715	1.795	1.910



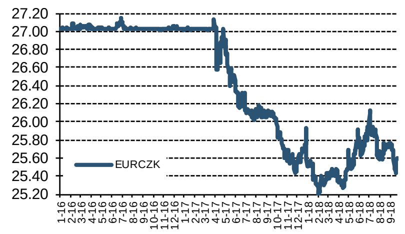
ASW spread*		2Y	3Y	4Y	5Y	7Y	10Y
bps.	Actual	-0.717	-0.814	-0.632	-0.554	-0.320	-0.227
	-1M	-0.673	-0.771	-0.670	-0.496	-0.246	-0.097
	-3M	-0.397	-0.485	-0.323	-0.233	0.031	0.232
	-6M	-0.552	-0.627	-0.549	-0.430	-0.179	0.019



CZGB**		2Y	3Y	4Y	5Y	7Y	10Y
%	Actual	1.513	1.518	1.750	1.856	2.097	2.201
	-1M	1.350	1.351	1.507	1.722	2.002	2.181
	-3M	1.053	1.142	1.416	1.577	1.926	2.214
	-6M	0.763	0.873	1.076	1.285	1.616	1.929



FX		EURCZK	EURPLN	EURHUF	EURRON	EURTRY	EURUSD
	Actual	25.601	4.307	324.24	4.656	7.395	1.175
	-1M	25.721	4.271	322.79	4.646	7.021	1.160
	-3M	25.796	4.322	324.81	4.662	5.453	1.165
	-6M	25.405	4.223	312.10	4.668	4.845	1.230



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

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