Quarterly report

Czech Economic Outlook

On thin ice

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■ **Czech economy set to continue on a sustainable growth path** While strong investment drove growth in 2018, we expect much more balanced growth supported by domestic and external demand this year. We expect tension on the labour market to persist, creating more inflationary pressure, keeping inflation above the CNB's 2% target.

■ **CNB to gear down rate hikes** We believe the CNB will take a breather from hiking at the beginning of the year, owing to global uncertainty, but we expect two hikes over the year.

■ **Koruna set to appreciate gradually** Ongoing excess CZK liquidity likely will impede the koruna's appreciation, especially given external economic weakness and other looming risks. We expect the CZK to reach EUR/CZK25.20 towards end-2019.

■ **Yield curve to stay inverted in near future** We see only limited potential for an increase in CZK IRS, with the short end supported by CNB hikes in 2019. In 2020, rates are expected to come under pressure again on the back of a global slowdown.

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SOCIETE GENERALE GROUP

Let's cross that bridge when we come to it

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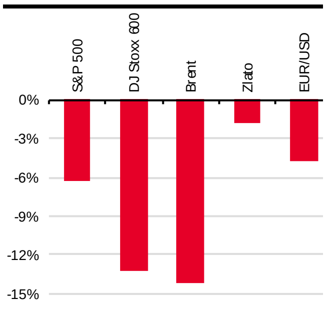
Investors will not exactly remember 2018 as a good year because they had difficulty finding assets that could offer a positive full year performance. Equity markets, commodities, and the euro were under constant pressure.[1] Safe haven assets, such as the US dollar and Treasuries, can be viewed as the winners.

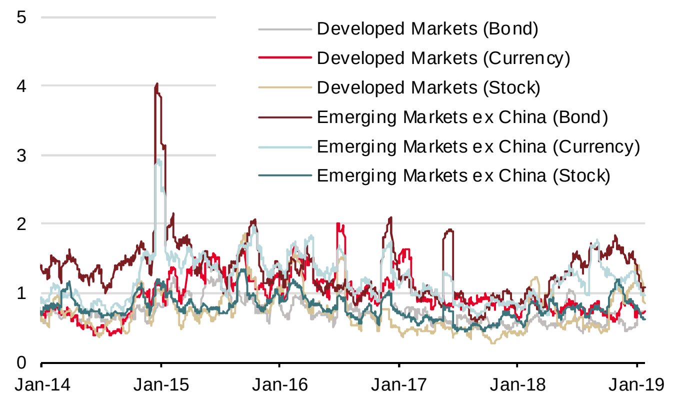
Difficult to appreciate investments last year



Source: Economic & Strategy Research, Komerční banka, Bloomberg

Increased volatility on the financial markets was driven by growing global uncertainties. The trade wars between the US and its trading partners, primarily China, gradually gathered steam. Seeking certainty in Europe was futile too, with Brexit, unrest in France, and the rift between the Italian government and Brussels regarding its 2019 budget. In addition, the German automotive industry was impacted by the change in the type of approvals needed and new certification requirements for internal combustion engines.

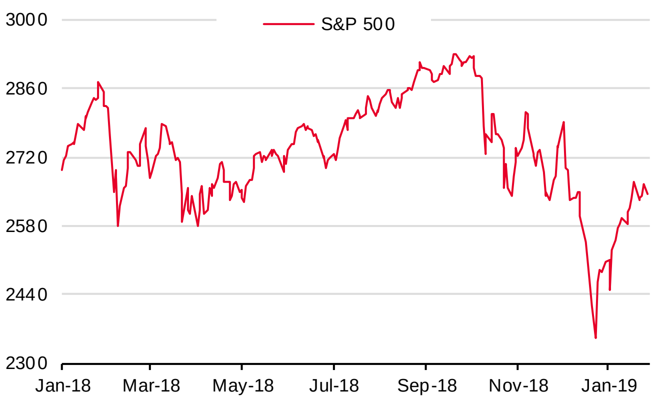
Increasing volatility was mainly apparent on emerging currency and bond markets (in %)



Source: Economic & Strategy Research, Komerční banka, Macrobond

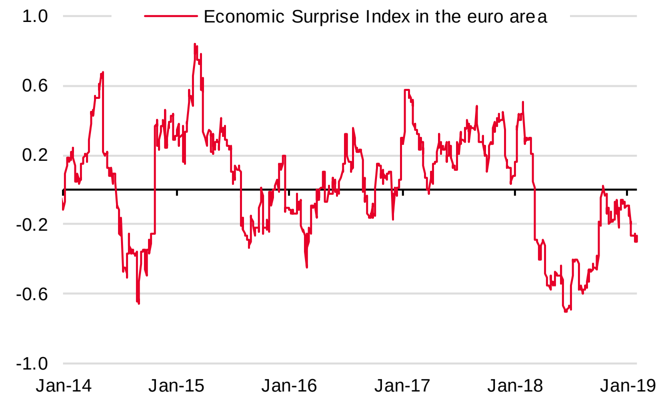
In the light of this and the Fed's continued tightening of its currency policy, 2018 saw mainly increasing volatility on emerging markets, most notably in currencies and government bonds. Equity markets and developed markets were affected only to a limited extent. However, most importantly, 2019 has so far seen financial markets calming down somewhat. We discuss the risks above in the special boxes of this *Czech Economic Outlook* edition. These risks have been factored into the prices of financial market instruments to a considerable extent and, if they do not continue to grow, **this year financial markets may eventually outperform last year.**

Following a fall in 2018, the US equity market is recovering



Source: Economic & Strategy Research, Komerční banka, Macrobond

Euro area economic data keeps disappointing



Source: Economic & Strategy Research, Komerční banka, Bloomberg

The Czech economy seems to be resistant to the deteriorated external environment for the time being. And, rather surprisingly, the fact that German industry is currently in recession has not

[1] More detailed analysis focusing on stock markets is available here: http://bit.ly/EQ_H119EN

yet been felt by Czech industry and exports. We therefore have no reason to change the key parameters of our forecast for the real economy. However, despite our small revisions to growth prospects and expected inflation (which we have cut slightly, although it remains robust and above the CNB's target rate), we have had to revise our expectations of the CNB's future steps. We do not believe the CNB will hike rates at its Board's February meeting on prudential grounds, although voting will likely be very tight. Hence, the Czech koruna will not appreciate as fast as we indicated in our preceding forecast.

Contents

External Environment and Assumptions

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Solid growth risks despite

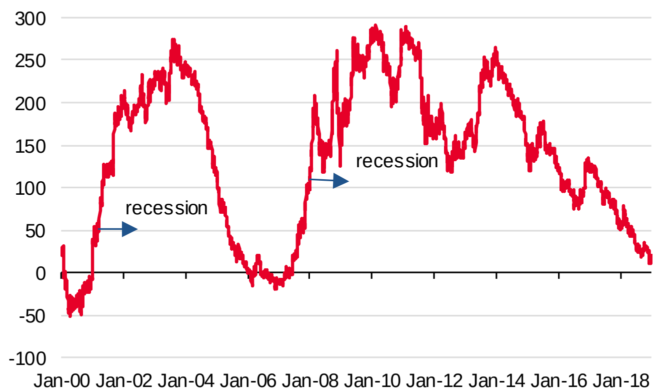
The US economy is set to continue with solid GDP growth this year. However, we forecast the beginning of a recession in mid-2020. We have postponed our expectation for the next rate hike in the US from March to June, mainly due to slower growth in consumer prices. Our view on how the ECB's policy will evolve remains unchanged. This year, the euro area economy will have to struggle with a number of risks. The SG's expected growth of 1.7% thus might be in a danger due to Brexit, the slowdown in China, the introduction of tariffs on cars, or no improvement in German industry trends. However, domestic fundamentals, together with an eased fiscal policy, should help the euro area economy dodge these pitfalls. The Central European region will continue to hit capacity limits amid an extremely tight labour market and we expect its economy to fare well this year.

The outlook for the US economy for this year is solid. Fiscal expansion will support household consumption, although its impact will gradually diminish. Investment has also been robust up to now, especially in IT technologies and oil drilling. On the other hand, net exports are likely to remain a modest drag on GDP growth. Based on this dynamic, we see GDP reaching 2.4% this year. However, in the first half of next year, we expect recession to kick in. Profit margins are one of the most important indicators in pinpointing at which stage the US economy is in the economic cycle. Margins reached a peak in 2014 and have declined gradually since then. They surprised us positively last year, backed by productivity growth, but this is unlikely to be repeated.

Profit margins will decline

Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

Spread between 2Y and 10Y bonds will become negative (bb)



Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

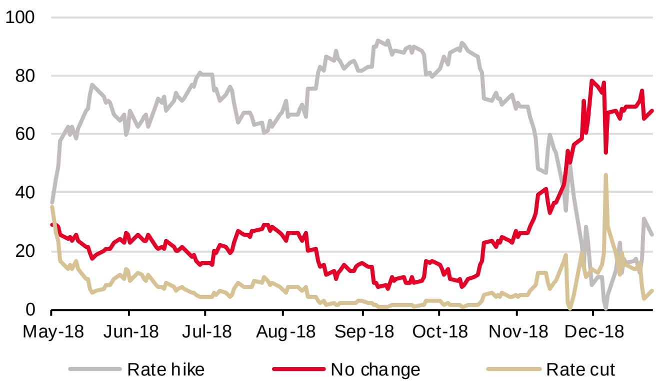
The US labour market is tight. January's report was actually one of the best in the current economic cycle. Not only was the number of newly created jobs high, but growth in hourly earnings was solid, as well. Higher wages will subsequently act as a downward catalyst on corporate profit margins. Higher interest rates will add to this dynamic and stifle companies' access to finance, so a decline in investment activity will follow. In addition, the credit cycle in the US is almost exhausted. Another useful indicator that points to upcoming recession in the US is the difference between the yields of two- and ten-year government bonds. Once the spread between the yields of these bonds falls into negative territory, recession typically follows within the space of a few months. For now, the spread is still slightly positive. However, when the Fed raises interest rates, and investors begin to fear the economic slowdown, the slope of the yield curve will, in the end, begin to invert. Overall, therefore, we expect GDP growth to print at just 0.4% next year.

Consumer price growth has decelerated in the US. Although this development was mostly driven by volatile energy prices, many Fed officials said that the Fed can take a pause on rate hiking. This is also the reason why we have changed our Fed call. In our previous prognosis, we had expected the Fed to hike rates in March and June – we now see this happening in June and September. September's rate hike will also be the last in the current business cycle. The Fed itself forecasts (according to the dot plot) two rate hikes this year and one next year.

Inflation in the US decelerated (%)

Source: Bloomberg, Economic & Strategy Research, Komerční banka

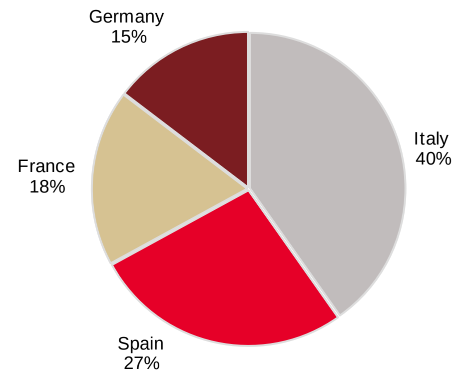
Market expectations of rate hikes declined (probability, in one year horizon, %)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

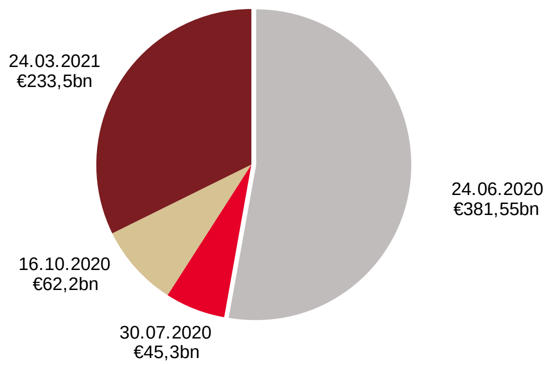
While the Fed is approaching the end of the tightening part of the monetary cycle, all these steps are still ahead of the ECB. Last year, the ECB ended its quantitative easing program, but its key interest rate is still in negative territory. The rate could break free of this at the end of this year, when we expect the ECB to increase the deposit rate by 15bp (in September), followed by all three key rates by 25bp in December. We expect the next and last rate hike in March 2020. Until then, the ECB will have to decide what to do with the TLTRO2 program or whether to replace it with a TLTRO3 program or not.

TLTRO2 holders



Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

TLTRO2 by maturity



Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

TLTRO2 will gradually end (in June, September and December 2020 and March 2021). The total amount of the program will be €736bn. After the maturity of TLTRO2 falls below one year, banks will not be able to book it into the Stable Finance Ratio (NSFR) and will need to seek liquidity elsewhere. This could be a problem, especially for Italian banks, as they hold 40% of the total TLTRO2 package. We believe, therefore, that the ECB will decide at its March meeting to launch TLTRO3. At the same time, the hawks in the Governing Council could demand promises of higher interest rates in exchange for such a provision.

Box 1: Brexit: deal or no deal?

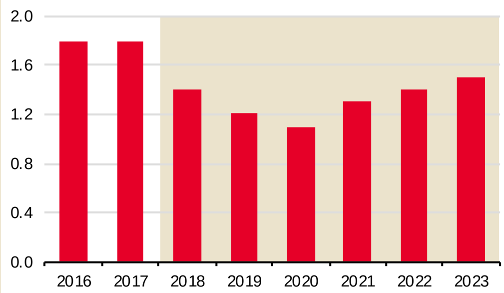
Is Britain going to exit the EU with or without a deal? We still expect the former. It will not be a smooth process, but in our opinion British politicians will in the end find common ground among themselves and with the EU. We assign this scenario a probability of more than 70%. Nonetheless, it might not come about immediately. The British parliament has approved an amendment requesting the renegotiation of the Irish backstop. However, the EU, at least initially, has come out against this. The EU is likely to offer an extension of the 29 March deadline for leaving the EU, and Britain will sooner or later accept this option, in our opinion. Another vote on the Brexit deal will take place in parliament on 14 February. Meanwhile, agreement with the EU will probably not be achieved by then. The road to the deal will thus be long and bumpy.

Delaying Brexit would also mean a longer period of uncertainty for the Bank of England (and for emerging markets, the Czech koruna and the Czech National Bank). As a result, we have postponed our expectation of a hike in UK interest rates from May to November. However, with a recession expected in the US, it is possible that the Bank of England will leave rates unchanged. We see UK GDP growth at 1.2% this year after last year's 1.4%. However, in the event of a no-deal Brexit, the UK economy could fall into recession, and the central bank would likely respond by easing monetary policy.

Exchange rate to be stable around EUR/GBP 0.90

Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

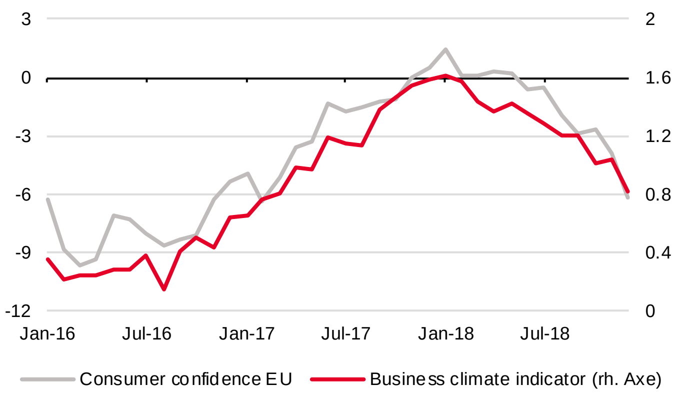
UK: GDP growth to decelerate this year and next (%)



Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

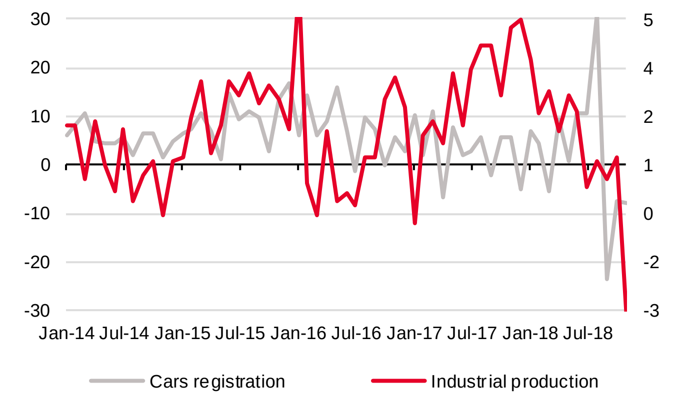
Like the US, the euro area is no bed of roses either. There are negotiations on Brexit (more on this topic in our box no. 1), 'yellow vest' protests in France, trade war fears, and stricter emissions regulations in the euro area. In fact, Germany probably only just avoided a technical recession in 4Q18. All this is reflected in consumer and business confidence, which has fallen to its lowest level since the beginning of 2017. Industry has also suffered due to problems in the automotive sector and weaker foreign demand.

Confidence in the euro area has dropped



Source: Bloomberg, Economic & Strategy Research, Komerční banka

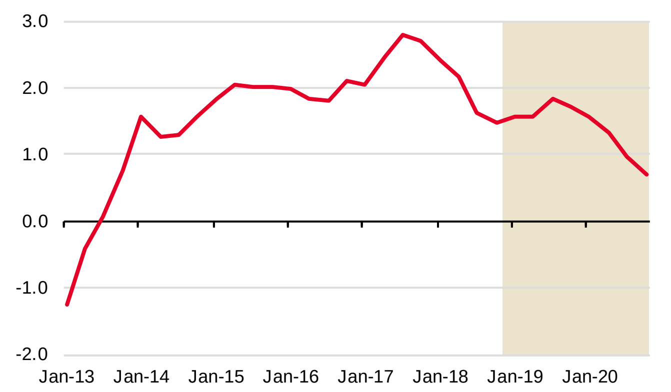
Automotive sector has dragged on euro area industry



Source: Bloomberg, Economic & Strategy Research, Komerční banka

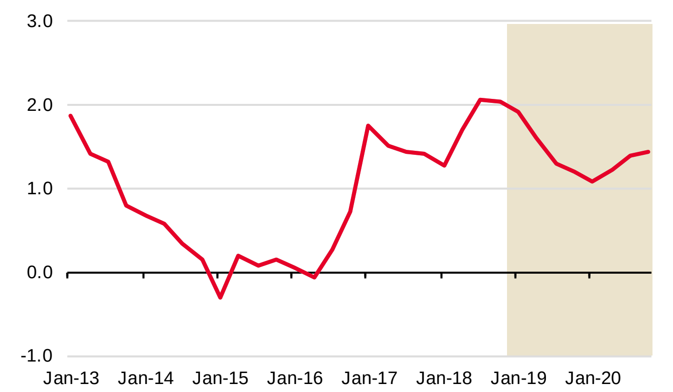
Despite these factors, there are grounds for optimism on the euro area. In our view, the factors behind the business slowdown were just temporary. In fact, domestic fundamentals remain strong: the situation on the labour market is very good, wages are growing and unemployment is falling, while low inflation will improve the real income of households. Credit activity is trending to come in above 4.5% and should also increase. The eased fiscal policy in the major countries could also provide support. For these reasons, we see euro area GDP growth reaching 1.7 %.

Euro area: solid GDP growth will continue (%, yoy)



Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

Euro area inflation has peaked and should slow from here (%, yoy)



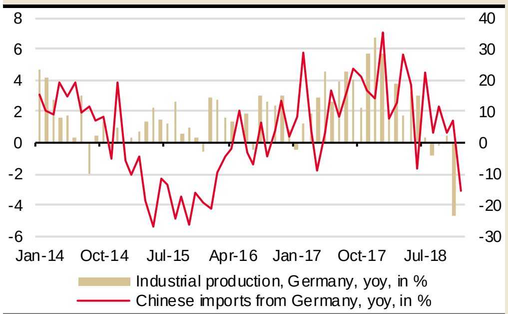
Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

The weak performance of the German economy at the end of last year will also mean lower year-on-year GDP growth this year. We have therefore revised our estimate from 1.5% to 1.2%. We discussed the problems of the German economy in Box 1. The risk to our forecast is (in addition to the geopolitical risks mentioned above) a slowdown in China. China is Germany's third-largest export partner (after the US and France). However, the introduction of tariffs (25% tariffs on goods valued at $250bn, reducing China's GDP by 0.5pp), the slowdown on the housing market, and the plans to deleverage the country will weigh on the Chinese economy this year. Consequently, we expect GDP growth to decelerate from the 6.6% last year to 6.2% this year. Nevertheless, the risks are concentrated on the downside, which could ultimately have a negative effect on German exports. In addition, we cannot completely rule out the possibility of tariffs being imposed on the automotive industry. The US administration should decide by 17 February whether the low tariffs on cars imported from Europe to the US is a threat to national security. The final decision on whether or not to introduce tariffs should be made by President Trump by 17 May. An increase in customs duties from 10 to 25% would be another blow for German industry and exports.

Box 2: German industry is in recession, but the country's economy as a whole is not and will not be

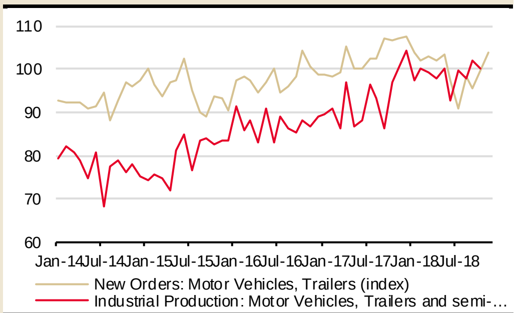
Last year, the German economy's growth slowed to 1.5% following the 2.2% posted in the two previous years. In particular, the second half of last year was quite dramatic: 3Q18 saw a drop of 0.2% qoq. But in 4Q18, the German economy is likely to have improved by 0.1% yoy, thereby avoiding overall recession by a hair's breadth. German industry, however, has indeed fallen into recession. The **automotive industry has borne the brunt of the downturn, impacted by the need for new certifications for internal combustion engines**. **Another major factor was the Chinese economy's slowdown** in the wake of the escalating trade war with the US. Chinese imports plunged.

Plunging Chinese imports had an adverse effect on German industry



Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

The auto sector on the rise again this year



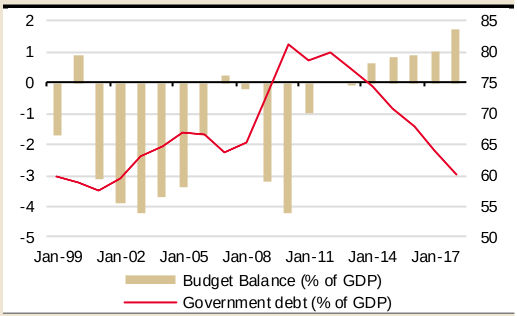
Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

We expect the German economy to grow by 1.2% this year, and by 0.35% qoq in 1Q19 alone. **We regard the automotive sector's difficulties as temporary only**: the sector is undergoing a wave of massive investment (largely in new technologies), while external demand and orders are robust and will help reduce inventories. These are all indications that **German industry will grow again in 2019. Moreover, the December data from China are encouraging.**

Industrial recession has not affected the German labour market

Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

Germany's fiscal position is robust



Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

For the economy as a whole, a positive signal is that the **recession in industry has not affected the labour market**, with unemployment rates still at or near the lowest levels since German reunification. **Public funds management** enjoys surpluses and has grown continuously over the last five years. This **is a major trump card for the German government** in the event of any significant slackening of external demand, whether due to Brexit, protests in France, or another downturn in China.

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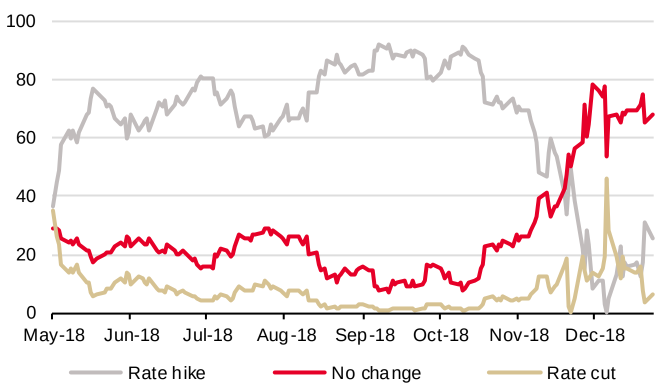
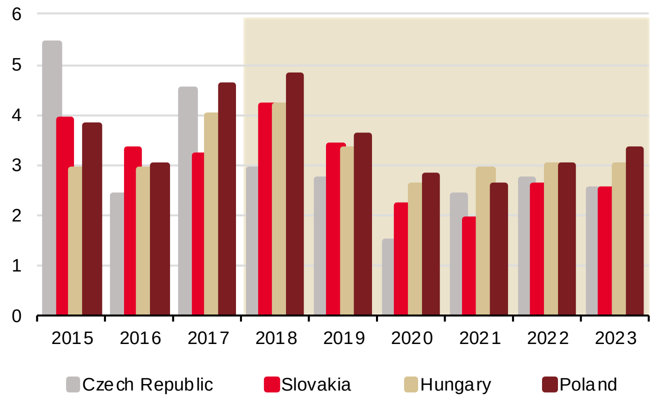
Like the rest of the euro area, the CEE region too has felt the fallout from geopolitical shocks, the troubled German automotive industry and weaker foreign demand. This is reflected in industrial PMI indicators, which in the Czech Republic and Poland fell into a band that indicates a decline in activity. Overall, however, the region is still doing well: data on GDP growth in 3Q18 was positive, especially in Poland and Hungary (GDP growth of 1.7% qoq in Poland and 1.3% qoq in Hungary). The marked slowdown in economic activity in Germany (a decline of 0.2% qoq in 3Q18) did not leave much of a mark on activity in the region. Growth was driven by household consumption as in the past, investment posted a solid increase and government consumption also contributed positively. Net exports, in contrast, represented a drag on growth in the CEE region. We expect to see a similar picture on GDP this year.

PMI in the region dropped, with only Hungary improving



Source: Bloomberg, Economic & Strategy Research, Komerční banka

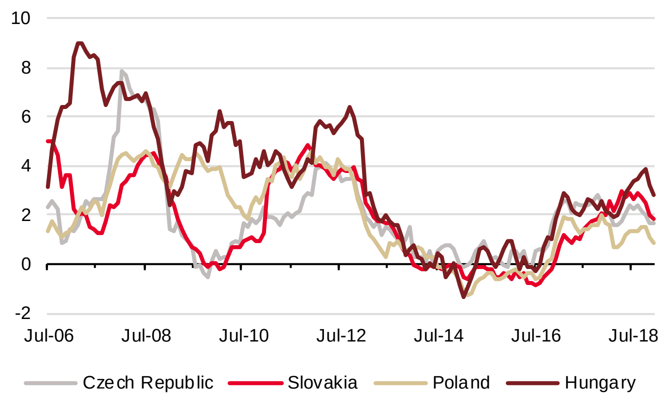
CEE growth prospects remain solid (%, yoy)



Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research/Economics

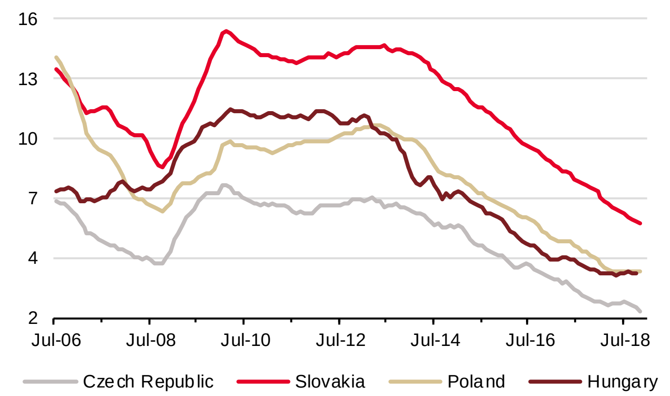
Inflation in the region slowed at the end of last year. In 1Q19, however, it should start to gather pace once more. On the strength of this, we expect the Hungarian and Polish Central Bank to join the Czech National Bank and tighten monetary conditions this year. According to our forecasts, the Hungarian Central Bank will increase the overnight deposit rate, which is now in negative territory (-0.15%), in the middle of this year. At the same time, it could reduce the offer of FX swaps. The key interest rate is likely to be raised before the end of this year (now at 0.9%). In November, according to our estimates, Poland's central bank will increase rates from the current 1.5%.

Inflation in the region slowed in the latter half of 2018 (%, yoy)



Source: Macrobond, Eurostat, Economic & Strategy Research, Komerční banka

Unemployment rate in the region is bottoming out (%)



Source: Macrobond, Eurostat, Economic & Strategy Research, Komerční banka

Macroeconomic outlook

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Main changes

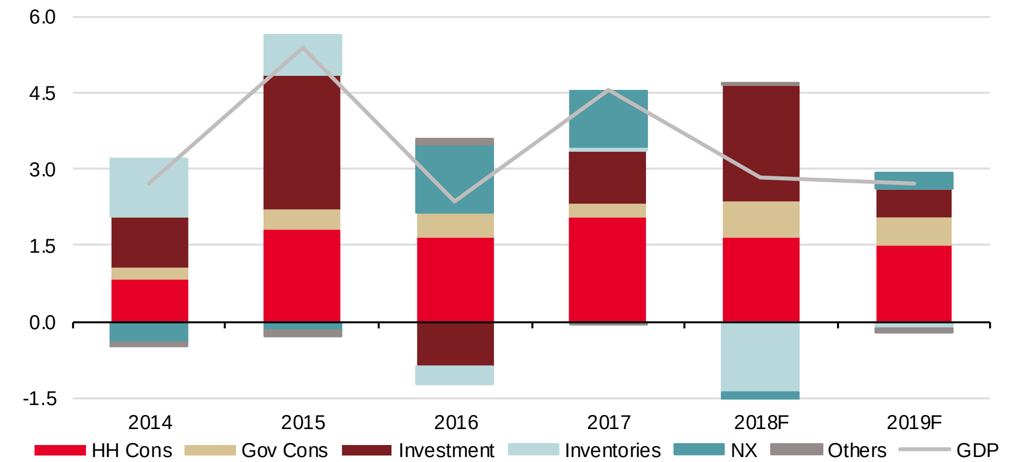
GDP:
We maintain our GDP forecasts, estimating that in 2018, the economy advanced 2.8% vs our forecast of 2.7% for 2019.

Inflation:
We increase our full-year forecast by one tick to 2.3%. The spike in inflation at the beginning of the year looks set to be slightly smaller than we previously expected, whereas it is now likely to be stronger than initially forecast at the end of the year.

Limited but sustainable growth

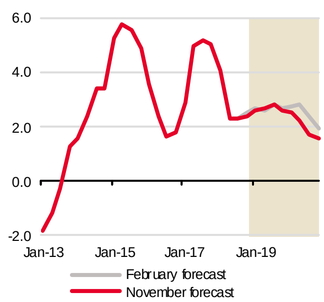
The Czech economy slowed in 2H17 and since then, GDP dynamics has remained very close to its potential growth. The recent slowdown in the euro area, in Germany in particular, has not spilled over into the Czech economy. We expect growth to remain on an even keel this year too, as further growth is constrained by high capacity utilisation and external demand eases, although ongoing tension on the labour market is driving wage growth. That said price pressures remain strong, with inflation set to remain at above the CNB's 2% target.

GDP growth to remain stable this year despite the slowdown in the euro area (% yoy)



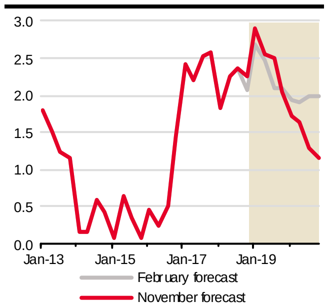
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Change to our GDP outlook (%)



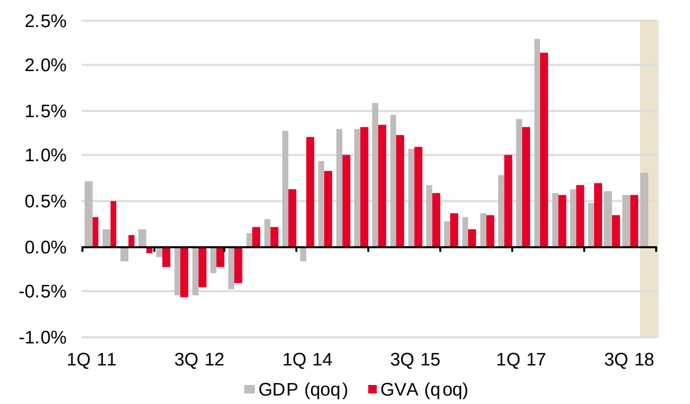
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Change in our inflation outlook (%)



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

GDP growth not affected by slump in Germany, so far



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

We forecast Czech GDP growth of 2.8% for FY18, driven primarily by domestic demand, as was the case in 2017. **Ongoing labour market tightness fuelled household consumption, which likely accelerated in late 2018, in our view. Investment activity was strong throughout the year. While private investment was supported by the demand for new production capacities, there was also a strong increase in public investment in the second half of the year, as the public sector tapped much of the EU funding.** Monthly statistics for 4Q also showed surprisingly good external trade results. We believe that this resilience in the face of the slowdown in Germany supported GDP growth in 4Q. That said, we expect a slight acceleration in GDP both in qoq and yoy terms in 4Q. We estimate qoq growth of 0.8% for while the yoy increase is likely to stand at 2.5%.

Czech industrial production has remained resilient in the face of the slowdown in Germany. We expect a similar dynamic in 2019 to that of 2018.

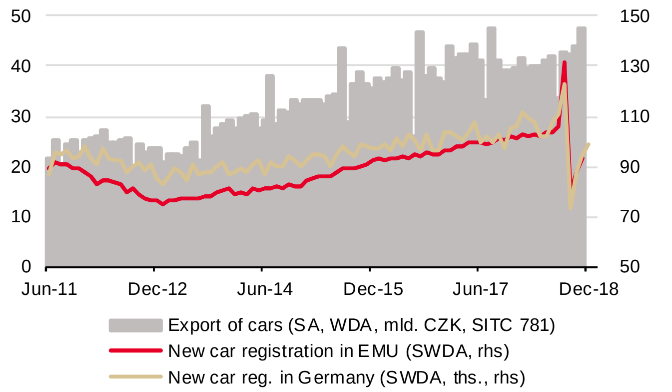
Industry facing increasing number of challenges

After very strong 2017, industrial production slowed in 2018 in line with overall economic growth. Capacity constraints are still visible in many industrial segments. The rapid slowdown in German industry also played a role, although **the Czech economy showed surprising resilience in the**

face of recent external developments. The pillars of Czech industry, automotives and machinery, fared decently in 2018. The number of cars produced in the Czech Republic reached a new high in 2018, showing that domestic producers were able to deal with new homologation standards. The monthly statistics from industry suggest that even components manufacturers were not terribly affected.

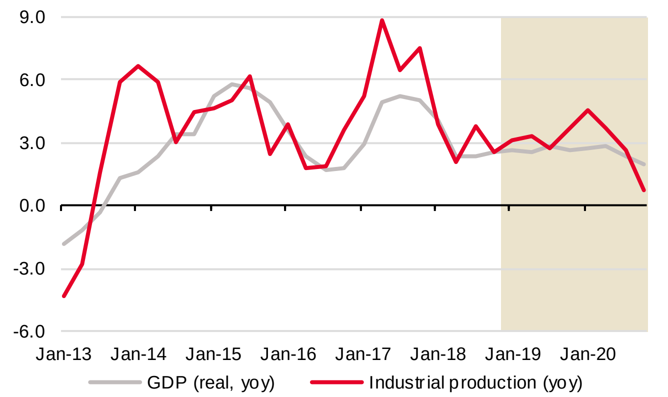
In 2019, we assume that the industrial sector will follow a similar growth pattern to that of 2018. A pick-up in external demand should lend some support and confidence, while supply constraints will likely limit the growth dynamics. An eventual slowdown in car demand in the euro area would pose a challenge, but we believe that Czech manufacturers will continue to gain market share and so they could increase production even in the event of a slight decline in demand in the euro area. Industrial production should also be supported by strengthening investment activity as businesses seek to extend their capacities. **That said, we believe Czech industry will continue to expand at a rate of 3.2% this year after an estimated 3.3% last year.**

Automotive industry in Germany shaken, …



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

… Czech production virtually unaffected



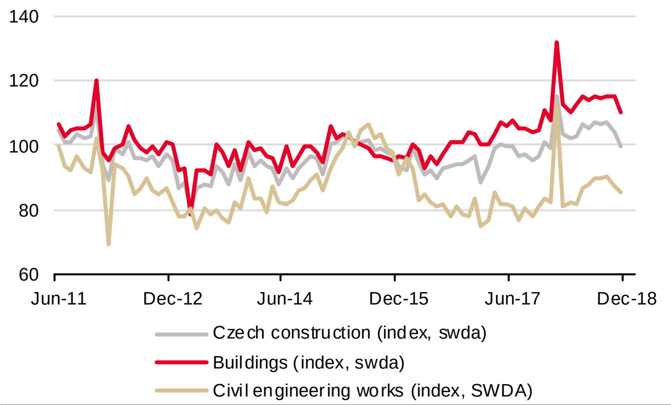
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Construction output growth curbed by hard capacity constraints.

After the summer rally, construction activity plunged in both buildings and civil engineering works. **The sector has benefited from strong investment in capacity and infrastructure, but we note that when the construction season ended, these additional works stopped immediately as well. Overall, we estimate that the construction sector experienced an 8.8% increase last year.**

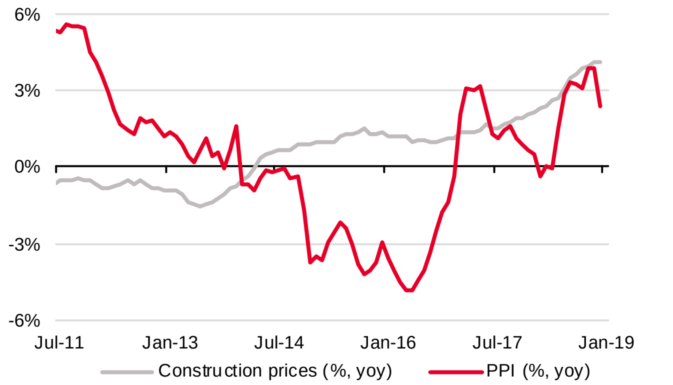
The construction sector is set to achieve much slower growth this year. Whereas in 2018, the mild winter made an early start to the construction season possible, this does not seem likely in 2019. **Moreover, the construction sector has hit hard capacity constraints.** We note that even when the construction output lags behind its pre-crisis levels, the construction work prices continue to increase at a decent pace. This could be because the capacity of the sector has shrunk in 2011-2015 years due to insufficient orders. The construction sector employs many foreigners who probably left the country during the lean period and hence it is unable to serve the current growing demand. **That said, we see not much room for growth this year, with construction set to rise by only 0.5%.**

Construction output increasing



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Construction prices go swiftly up



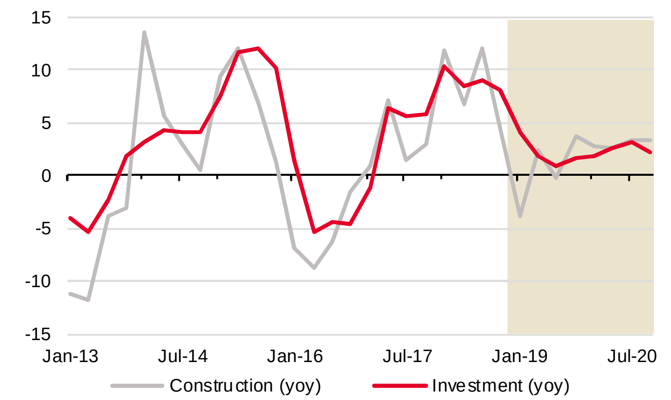
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Investment curbed by uncertainty

Private investment to be curbed by significant uncertainty.

Investment likely became the biggest growth contributor last year. The public sector contributed significantly to the development as the government needed to tap the EU funds, and private companies sought capacity extensions to meet growing domestic and external demand. Thus we estimate that investment activity increased 9% last year.

We expect slower investment and construction dynamics (%, yoy)



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

We expect the situation to be much more challenging for investment in 2019. Global uncertainty will likely curb private-sector investment, due to fears of a drop in demand linked to a possible recession in the euro area. The high capacity utilisation in the construction sector will also play a role in the private investment slowdown. Moreover, domestic firms must spend more on wages and their profit margins have shrunk as consequence. Together with uncertainty over growth in the euro area, this will probably lead to a slowdown in private investment. **The public sector statistical base of comparison is high from the last year, following the rush to tap EU funds.** There will no doubt be some investment spill-over in early 2019, but this could fade quite quickly. **That said we expect investment to see only 2% growth this year.**

Fiscal policy: Deficit in 2019 after all

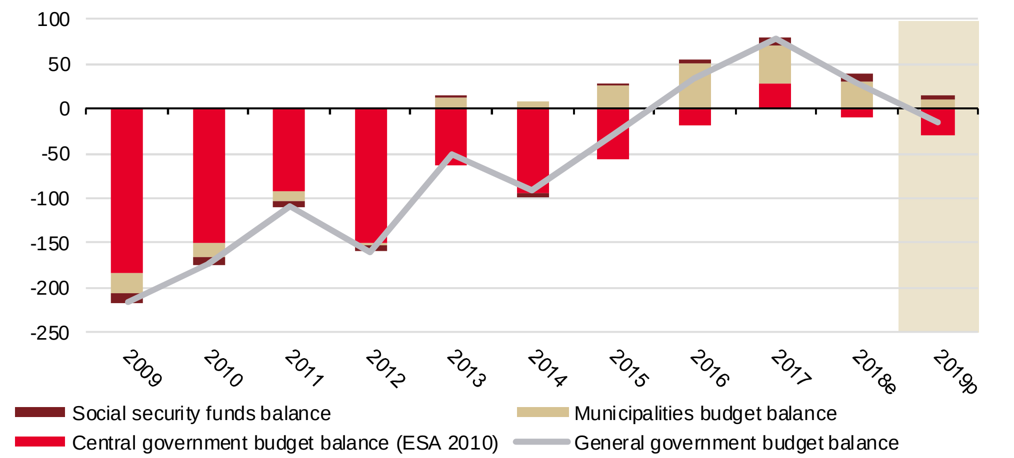
The government can celebrate. Last year's budget ended up in a mild surplus in contrast to the planned CZK50bn deficit. For 2019, we are more cautious. The expected economic slowdown would curb tax and social contributions collection. We call for a CZK40bn deficit this year, in line with the approved budget. In the following years, however, we don't share the optimism of the Finance Ministry's GDP outlook. In addition to a deeper economic slowdown, we see a risk of a greater need for expenditure. As a result, fiscal governance could become more difficult in the years to come.

Local government surpluses add to positive central budget balance

The central government budget ended up with a surplus in 2018 thanks to faster-than-expected revenue growth. The expanding economy has provided a solid backdrop, though it has slowed compared to 2017. Wages have kept increasing at a fast pace, contributing to growing tax and social contributions collection. With the EU fund drawdown accelerating, investment expenditures have soared along with the cash inflows from the EU. Overall, the central government budget ended up with a CZK2.9bn surplus instead of the planned CZK50bn deficit.

We expect that, based on ESA methodology, the central government budget will print a slight deficit for 2018, as some of the cash inflows (mostly related to EU funded projects) will be attributed to previous years. Local government budgets likely continued to contribute positively to the general government budget results, although with their surplus gradually fading as municipalities speeded up investment. **Based on ESA methodology, we expect the 2018 general government budget to end up with a CZK30bn surplus, amounting to 0.6% of GDP. General government debt accordingly declined to 32.1% of GDP.**

General government budget balance composition (CZKbn, ESA 2010)

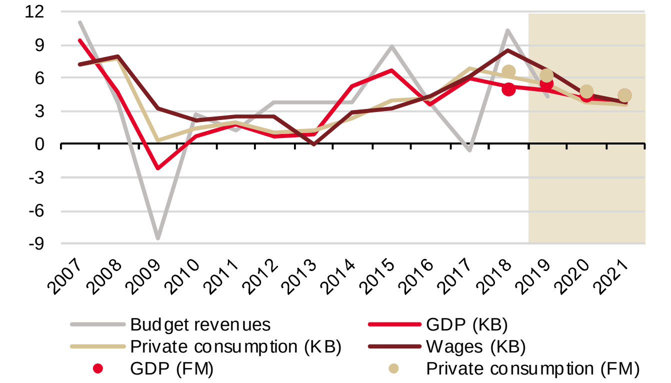


Source: Finance Ministry, Macrobond, Economic & Strategy Research, Komerční banka

Budget to stay robust in 2019

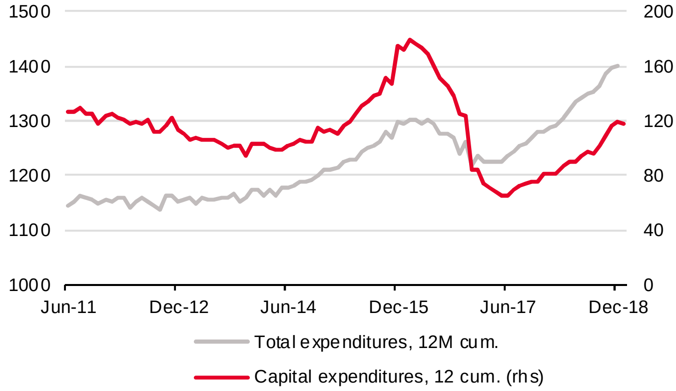
In recent years, budgets have ended up better than planned. This was thanks to faster economic growth, strong wage dynamics, cash inflows related to the EU fund drawdown and administrative changes to tax collection. However, the 2019 budget reveals less caution, incorporating very strong expenditure growth, with a large portion of it allocated to increases to mandatory spending. Teachers' wages are to increase by 15%, while other public servants will get an 8% boost on average. The government also plans to increase investment. We have now become more cautious on revenues. Our GDP growth assumption is less optimistic than that of the Finance Ministry for the current year and even more so for 2020 and 2021. **We think that the official budgetary outlook for the coming years lacks the buffers of previous budgets.**

Budget revenues and macroeconomic situation (%, yoy)



Source: Finance Ministry, Macrobond, Economic & Strategy Research, Komerční banka

Public investment speeding up (CZKbn)

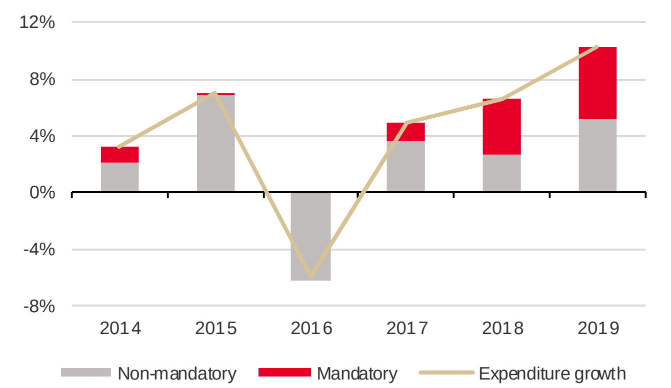


Source: Finance Ministry, Macrobond, Economic & Strategy Research, Komerční banka

Capital expenditure has accelerated rapidly. Public investment grew by a massive 37.4% in 2018. Over half was co-financed by EU funds, with capital expenditure related to these funds up a whopping 72.9%. It was mainly due to EU-funded projects that public investment exceeded the budgeted amount. The N+3 rule also contributed, according to which a large portion of projects needed to be concluded before the end of the year. In the 2019 budget, the investment allocation is CZK31.9bn above last year's figure, which was around CZK90bn. That marks growth of 35%. However, 2018 investment expenditures exceeded the budgeted amount by CZK26.2bn, so the increase this year does not seem dramatic at just below 5%.

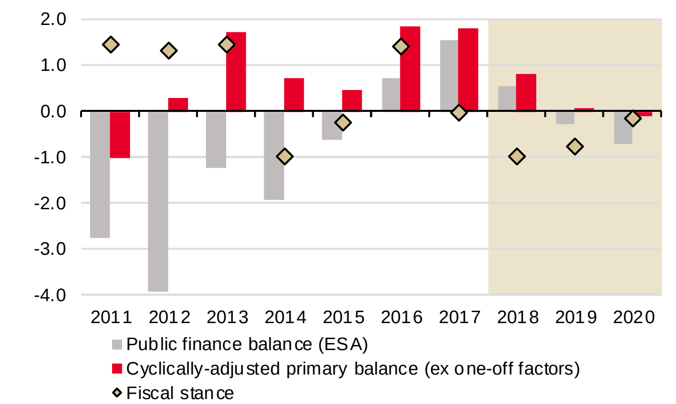
The Finance Ministry's outlook for 2020 and 2021 assumes that the investment allocation drops back to around CZK90bn. We think this unlikely. The costs of investment projects are often delayed and transferred to following years. **Moreover, the infrastructure investment gap warrants long-term, sustained investment that cannot be covered in one or two years.** This is why we believe that the investment allocation will need to be increased again, probably with an adverse impact on the budget balance. **Investment activity is also strengthening at the municipal level,** partly owing to easier administration of the projects co-funded by the EU at the local government level. Due to the related impact on own expenditures, the contribution of local governments to the general government budget surplus is set to fade.

Structure of budget expenditures (%, yoy)



Source: Finance Ministry, Macrobond, Economic & Strategy Research, Komerční banka

Cyclically adjusted balance and fiscal stance (% of GDP)



Source: Finance Ministry, Macrobond, Economic & Strategy Research, Komerční banka

Revenue collection to slow hand in hand with weaker economic growth

Revenues have repeatedly surprised on the upside in recent years. In 2018, collection rose by 10.2% and surpassed the budgeted figure. Tax revenues rose by 5.3% and social contributions by 10.0%. This was due to the economy seeing the peak of the business cycle, with wages and consumption growing at a fast pace. **This cannot last indefinitely. We expect lower growth in the coming years than the Finance Ministry does.** That is why we see a significant risk for the public budgets in 2020 and 2021**. In the coming years, we expect budget revenue growth of around 3-4%, far below the double-digit prints seen recently.**

The main surprise last year, however, was the rapid growth of cash inflows related to the EU fund drawdown. These rose by 55% as a result of many projects being finished due to the N+3 rule. The rule does not indicate such a rapid drawdown in coming years. This could contribute to slowing budget revenues in the coming years.

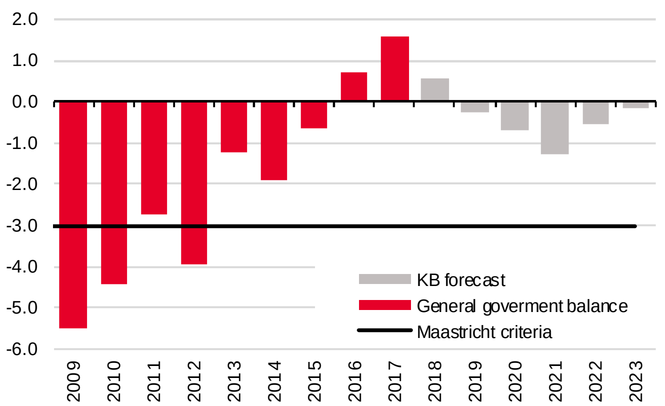
Public finance forecasts

	2018e	2019f	2020f	2021f	2022f	2023f
Balance (% GDP)	0.6	-0.3	-0.6	-1.3	-0.6	-0.2
Fiscal effort (pp GDP)	-1.0	-0.8	-0.2	-0.4	0.7	0.4
Public debt (CZKbn)	1 707	1 732	1 767	1 842	1 877	1 887
Debt ratio (% GDP)	32.1	31.1	30.7	31.1	30.3	29.2

Source: CZSO, Macrobond, Finance Ministry, Economic & Strategy Research, Komerční banka

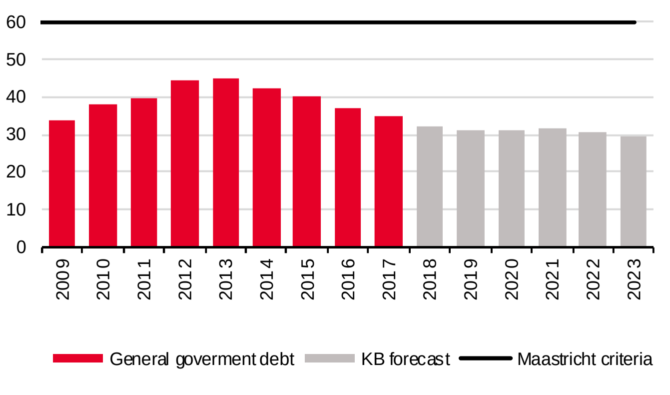
This year, we expect the deficit to stay close to the planned CZK40bn. In 2020, however, we see expenditures exceeding revenues by CZK50bn, which is more than the government outlook assumes. This would be the result of weaker tax collection growth related to a more severe economic slowdown. In terms of expenditure, increased investment would weigh on the budget balance. Also, public sector wages will likely need to increase again, as the labour market remains tight and private-sector wages continue to grow rapidly. In 2021, the pressure on budget could further intensify as the economy is hit by economic slowdown abroad.

Public finance balance (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

Public debt (% of GDP)



Source: CZSO, Economic & Strategy Research, Komerční banka

After contributing positively to the general government balance this year, the local government surplus should fade in 2020 and slide into deficit in 2021. Increased investment could become a driver of the local government balance deterioration. In the coming years, a deeper economic slowdown and lower revenues could take a toll. **We expect the general government budget (Maastricht definition) to end up in a deficit 0.3% of GDP. The negative balance could further deepen to 0.7% of GDP in 2020 and 1.2% in 2021.**

Public debt could increase because of the general government deficit but should continue to decline as a share of GDP. We expect it to reach 31.1% of GDP and remain

close to this level in 2020. In 2021, amid a backdrop of a higher deficit and an economic slowdown, that figure could increase slightly to 31.4% of GDP.

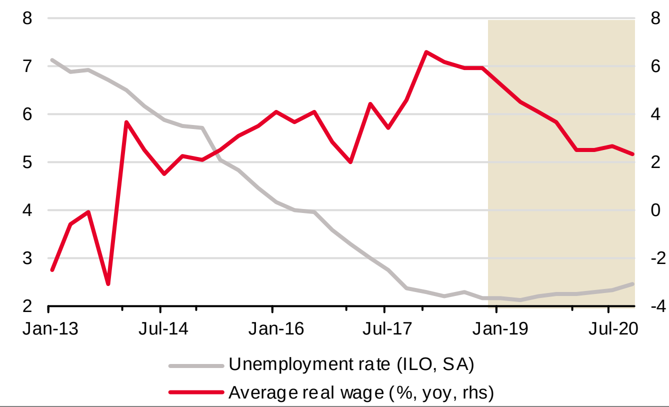
Jakub Matějů

The labour market remains tight, but households are slowly starting to put aside precautionary savings.

Wage growth will remain strong this year

Monthly indicators still point to decreasing unemployment. The Czech statistical office's latest figures already point to an unemployment rate of under 2% in November. The number of unemployed registered with the Labour Office has also shrunk, with the share of unemployed dropping below 3% after seasonal adjustment. Both unemployment measures reached their lowest levels in history. We also observe a continuing trend of higher employment, but as there are now only minimal reserves in the labour market, we believe that the unemployment rate will stabilise at just above 2%, while the share of registered unemployed will remain just below 3%.

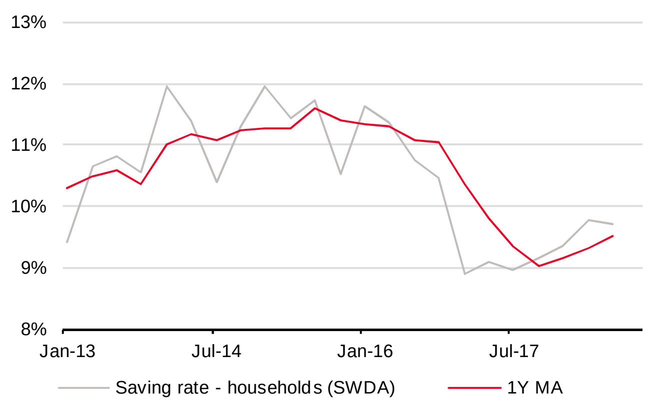
Mild deceleration in wage growth



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

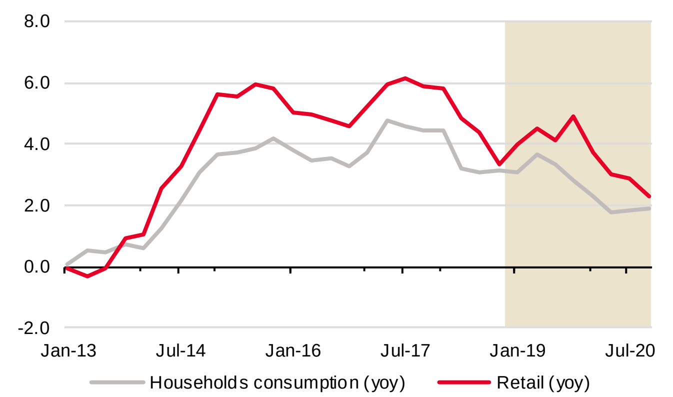
The labour market tightness points to domestic wage growth, which we estimate came to 8.5% last year, surprising on the upside throughout the 12m period. The government raised public employee salaries once again starting in January 2019 by an average of 11%. The lion's share of the increase is to be distributed to teachers (avg. salary increase of 15%), but other public servants will also receive a solid increase (c.8%), much the same as in 2018. The public sector pay rise increases the country's average wage significantly, and also pushes private firms to raise their remuneration in remain competitive on the labour market. **Company profit margins have plunged in the last two years. Hence firms have limited scope for further wage increases. Moreover, at some firms, bonuses are computed from profit, so they may not grow much either. That said, we expect average nominal wage growth to decelerate slightly, albeit still coming in at a sound 6.9% this year.** Real wage growth should decelerate from an estimated 6.2% in 2018 to 4.4% in 2019. We note that in addition to increasing public sector wages this year, the government also significantly raised retiree pensions.

Savings rate bottoming out



Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Private consumption slowing (%)



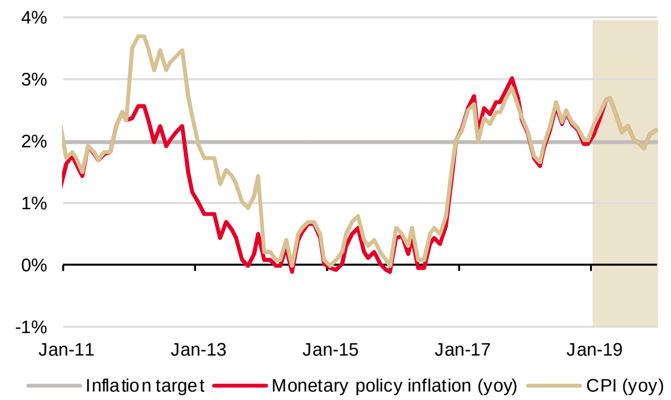
Source: CZSO, Macrobond, Economic & Strategy Research, Komerční banka

While higher purchase power stemming from a slightly stronger employment rate and higher wages is likely to drive consumption up, the uncertainty about economic growth will boost the savings and curb consumption dynamics. **That said, we expect real consumption to increase 3.2% this year after 3.5% likely recorded in 2018.**

Inflation likely accelerated strongly at the beginning of the year

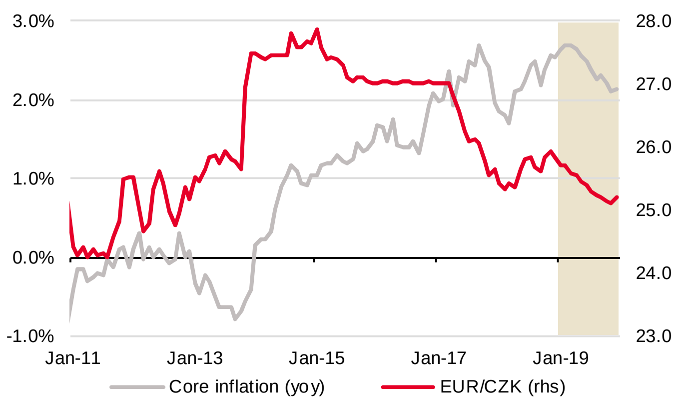
The last few months of 2018 saw a deceleration of headline inflation. Yet, only the volatile components were to blame. Food price inflation fluctuated significantly, although overall, prices still remained surprisingly low, while fuel prices fell following the slump in oil prices. In contrast, core inflation accelerated reflecting ongoing domestic price pressures. We expect core price dynamics to remain strong and administered prices to surge, while food prices will curb inflation at least in the first few months of the year. We expect full-year average headline inflation of 2.3%, with a peaking in March or April.

Inflation to remain above 2%



Source: CZSO, CNB, Macrobond, Economic & Strategy Research, Komerční banka

Core inflation remaining very strong



Source: CZSO, Bloomberg, Macrobond, Economic & Strategy Research, Komerční banka

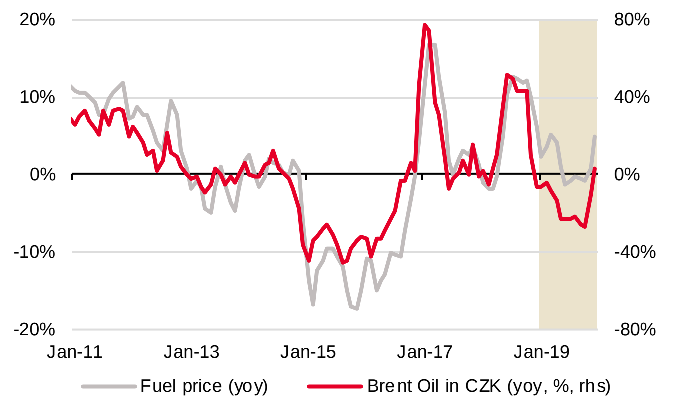
Core inflation to remain the main price growth driver.

Higher wages and other production costs will pass into **core inflation**. Profit margins have dropped significantly and now provide less of a cushion to absorb the price shocks. We do not expect the CZK to appreciate much this year, but do expect slowing import prices as a result of weak inflation in the euro area to curb core inflation so that it does not increase uncontrollably. We forecast a 2.5% increase in core prices this year.

Poor harvest suggests higher food prices.

Food prices have been very volatile recently and are likely to remain so, yet, on average, they have surprised with only relatively modest increases and the preliminary survey for January suggests a decrease. Nonetheless, we believe that last year's poor harvest will still push food prices up in the 1H19. **All in all, we expect food prices to grow only by 0.7% in FY19.**

Fuel prices to increase continuously



Source: Bloomberg, CZSO, Macrobond SG Cross Asset Research/Economics, Economic & Strategy Research, Komerční banka

The fuel price has fallen sharply but it is still higher than a year ago.

Brent prices surprised dramatically falling by c.40% in the last quarter of 2018. While we did expect lower oil prices in October, we had not imagined such a sharp correction. Domestic **fuel**

prices followed suit, but remain higher than they were a year ago. We expect the oil price to stabilise at c.USD70/bbl. Thus, we expect fuel prices inflation to remain positive at the beginning of year but decelerate towards year-end. On average, fuel price inflation should print at 2.9%.

Electricity prices likely surged in early 2019.

Administered prices likely increased notably at the beginning of the year, in our view. Energy prices have surged globally, and Czech distributors usually make significant changes to their price lists at the beginning of the year. **The unregulated portion of electricity prices (c.40%) increased by 15%, according to our estimates.** The regulated part (60%) increased by 2%. Altogether, this generates strong upward pressure on administered prices, which we calculate should grow by 3.4% this year.

Risks: The number of risks on the horizon continues to rise

There are persistent risks emanating from the external environment. Their number and significance have been growing. Domestically, capacity constraints and propagation of higher energy costs are also a risk. The main risks include:

Koruna highly volatile during political turmoil.

- **CZK volatility.** The koruna has shown that it is prone to react to political turmoil. The risk of strong depreciation is therefore high should an unfavourable global economic/political event arise.
- **Ongoing sluggish EMU growth.** While the Czech economy has so far resisted the slowdown in the euro area, in Germany in particular, a prolonged period of sluggish growth will surely reflect on weak dynamics of the domestic economy as well.
- **A fall in demand for cars or car parts.** This would significantly hit the Czech automotive industry, one of the main drivers of the current economic boom, and could arise from saturation of the market or new environmental regulations.
- **Low or no productivity growth.** This would slow growth, as the economy would lose competitiveness. It would also cause a short-term spike in inflation. In contrast, inflation in the longer term would be lower due to weaker demand.
- **Propagation of high energy prices into other price categories.** The increase in electricity prices might propagate through the economy more quickly than we expect, in which case inflation would be stronger than we currently anticipate.

Key economic indicators

	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	2018	2019	2020	2021	2022	2023
GDP and its breakdown														
GDP (real, yoy)	2.4	2.5	2.7	2.6	2.8	2.7	2.7	2.9	2.8	2.7	2.5	1.9	2.8	2.8
Household consumption (real, yoy)	3.1	3.1	3.1	3.7	3.4	2.8	2.3	1.8	3.5	3.2	1.9	1.7	2.2	2.4
Government consumption (real, yoy)	5.2	4.6	3.6	3.5	1.5	2.6	2.1	2.5	3.8	2.8	2.3	2.6	2.0	1.6
Fixed investments (real, yoy)	9.0	8.1	4.1	1.9	0.9	1.7	1.9	2.7	9.0	2.2	2.5	0.3	1.6	2.5
Net exports (contribution to yoy)	-1.0	0.2	0.3	-0.5	1.3	0.1	0.5	0.7	-0.5	0.3	0.6	1.2	1.1	0.7
Inventories (contribution to yoy)	-1.5	-2.1	-0.6	0.3	-0.5	0.3	0.1	0.1	-1.4	-0.1	0.0	-0.7	-0.4	-0.2
Monthly data from the real economy														
Foreign trade (CZK bn) (*) (***)	86	108	102	104	105	107	108	108	393	415	436	514	561	588
Exports (nominal, yoy) (*)	4.8	9.7	12.1	7.2	6.8	1.9	3.1	2.8	3.7	7.0	3.1	4.8	7.8	6.9
Imports (nominal, yoy) (*)	7.8	10.5	13.1	7.9	5.3	2.4	2.9	2.7	5.5	7.2	2.9	3.6	7.7	7.1
Industrial production (real, yoy)	3.5	4.7	3.2	3.3	2.8	3.9	4.5	3.7	3.3	3.3	2.9	2.2	7.0	5.2
Construction output (real, yoy)	12.1	4.6	-3.9	2.4	-0.1	3.8	2.9	2.5	8.8	0.5	3.0	2.1	3.8	6.2
Retail sales (real, yoy)	3.7	5.6	3.8	5.0	4.7	2.6	3.7	3.0	4.9	4.0	3.0	1.2	1.7	2.0
Labour market														
Wages (nominal, yoy)	8.5	8.2	8.1	7.1	6.4	6.1	4.8	4.8	8.5	6.9	4.8	3.8	3.6	4.3
Wages (real, yoy)	5.9	6.0	5.3	4.5	4.2	3.9	2.8	2.8	6.2	4.5	2.8	1.9	1.7	2.1
Unemployment rate (MLSA)	3.0	3.1	2.9	2.5	2.7	3.1	3.1	2.7	3.1	2.8	3.0	3.4	3.5	3.4
Unemployment rate (ILO 15+)	2.3	2.2	2.2	1.9	2.1	2.1	2.2	2.1	2.3	2.1	2.2	2.6	2.7	2.6
Employment (ILO 15+, yoy)	0.9	0.7	0.6	0.5	0.4	0.4	0.0	-0.3	1.2	0.5	-0.3	-0.5	-0.1	0.1
Consumer and producer prices														
CPI Inflation (yoy)	2.4	2.1	2.7	2.5	2.1	2.1	1.9	1.9	2.1	2.3	2.0	1.9	1.8	2.2
Taxes (contribution to yoy inflation)	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.9	1.8	2.2
Core inflation (yoy) (**)	2.4	2.5	2.9	2.6	2.3	2.2	2.1	2.0	2.2	2.5	2.0	1.9	2.1	2.7
Food prices (yoy) (**)	0.6	-0.5	0.4	1.1	0.7	0.6	1.2	1.5	1.3	0.7	1.8	1.4	0.5	1.2
Fuel prices (yoy) (**)	12.2	9.4	6.6	3.8	0.7	0.5	2.2	1.2	6.2	2.9	2.0	-1.0	-3.0	-1.4
Regulated prices (yoy) (**)	2.2	1.7	3.5	3.5	3.1	3.6	2.1	2.2	1.7	3.4	2.1	3.0	2.9	1.8
Producer prices (yoy)	3.3	3.4	3.3	2.5	1.6	1.9	2.0	2.1	2.1	2.3	2.1	1.2	1.4	2.0
Financial variables														
2W Repo (%, average)	1.16	1.66	2.00	2.25	2.25	2.25	2.25	2.25	1.06	2.19	2.20	2.2	2.9	3.2
3M PRIBOR (%, average)	1.39	1.92	2.15	2.40	2.40	2.40	2.40	2.36	1.27	2.34	2.33	2.3	3.0	3.3
EUR/CZK (average)	25.72	25.87	25.67	25.47	25.25	25.15	25.12	25.58	25.7	25.4	25.7	25.2	24.0	23.8
USD/CZK (average)	22.12	22.67	22.72	22.54	21.96	20.61	20.09	20.30	21.7	22.0	20.2	19.6	18.5	17.7
External environment														
GDP in EMU (real, yoy)	1.6	1.5	1.6	1.6	1.8	1.7	1.6	1.3	1.9	1.7	1.1	0.8	1.5	1.7
GDP in Germany (real, yoy)	1.3	0.9	0.9	0.8	1.3	1.6	1.7	1.5	1.5	1.2	1.2	0.9	1.8	1.6
CPI in EMU (real, yoy)	2.1	2.0	1.9	1.6	1.3	1.2	1.1	1.2	1.8	1.5	1.3	1.5	1.5	1.6
Brent oil price (USD/brl, average)	77.0	67.3	60.0	62.0	65.0	70.0	70.0	70.0	71.5	64.3	70.0	65.0	65.0	65.0
EURIBOR 1Y (%, average)	-0.17	-0.14	-0.03	0.13	0.29	0.38	0.38	0.36	-0.17	0.19	0.39	0.9	1.8	2.7
EUR/USD (average)	1.16	1.14	1.13	1.13	1.15	1.22	1.25	1.26	1.18	1.16	1.27	1.3	1.3	1.3

Source: CZSO, MLSA, Bloomberg, Macrobond, Economic & Strategy Research, Komerční banka

Note: (*) foreign trade according to cross border statistics;

(**) these parts of inflation are adjusted for the primary effect of indirect tax changes;

(***) the quarterly data are seasonally adjusted.

CNB Focus

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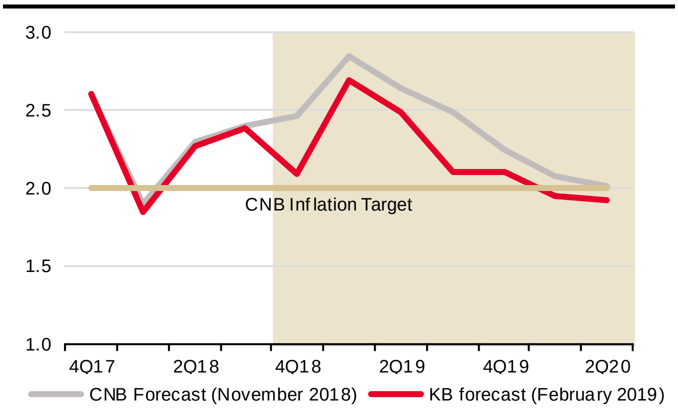
CNB slowing down but still heading towards a neutral rate

The CNB has started moving its policy rate towards its normal level as a first central bank in the EU. Last year, it increased the hiking pace when it increased the rate five times. CNB tightened its monetary policy despite a slowdown of domestic and global economic growth and rising uncertainties causing volatility in financial markets. The domestic inflationary environment was decisive for its steps. The CNB is now much closer to a neutral rate and the uncertainty about external environment has strengthened. Inflationary pressures driven by wage growth persist and the CNB is thus set to continue in its hiking cycle. We believe that it will raise rates two times this year, while there is a risk that there will be three hikes.

Domestic conditions still point to more tightening, external conditions worsen

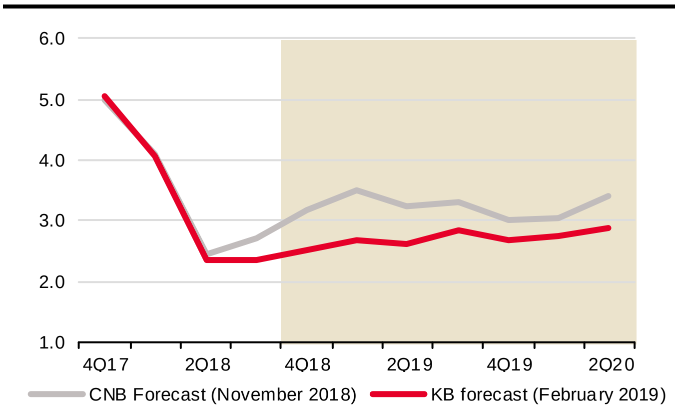
After a boom in 2017, the Czech economy slowed in mid-2017 while its regional peers have continued to see strong growth. However, inflationary pressures have persisted and the CNB continued hiking despite rising uncertainty in the external environment. Some of these risks have materialised in the second half of last year, namely the slowdown of the automotive industry in Germany, but the Czech economy has so far remained surprisingly resilient. Wage growth continued surprising on the upside and core inflation has strengthened significantly. The price pressures are hidden behind the slowing headline inflation due to the plunge in fuel prices and an unexpected drop in food prices. The headline inflation thus decelerated to 2% and creates the impression of diminishing price pressures. The development of the EUR/CZK rate also provides much clarity with its unexpected moves around the turn of the year. Yet, compared to the last CNB forecast, the koruna still remains a pro-inflationary factor. The CNB expected the koruna at EUR/CZK25.10 on average in 1Q, while in fact the koruna has struggled to get below EUR/CZK25.5 at the moment. **That said, there are still inflationary pressures which are set to drive the CNB bank board to more hikes this year, but the imminent slowdown in Germany and persistent risks create doubts about a hike at the February meeting.** Current comments from the CNB create a mixed picture, but concerns about the external environment prevail.

Inflationary pressures to remain strong … (%)



Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka

… despite slowing GDP dynamics (%)



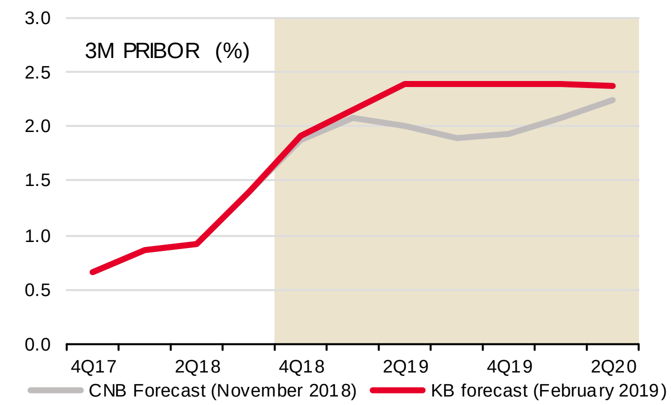
Source: CNB, CZSO, Macrobond, Economic & Strategy Research, Komerční banka

Board members talk about hikes, but the market remains unpersuaded. Current market pricing suggests only an 8 point increase in 3M PRIBOR. During the last month, several board member talked about the outlook for monetary policy. **CNB Governor Rusnok stated in the Ekonom weekly that with current outlook for the CZK, it looks like the board can hike twice this year.** For the Czech public broadcast, he said that the rates are set to go up. It is possible that it will be once, twice or three times. Board member Benda confirmed his traditionally hawkish stance at the Euromoney conference in Vienna where he said that he sees several rate hikes within 18 months.

Later he stated for roklen24.cz that by the end of the year, two to three hikes are possible. **In contrast we have noticed several dovish statements even from the board member from whom we would not normally expect it.** Tomas Holub who as a Chief Economist of the CNB promoted the hiking path toward neutral rates spoke in favour of caution in an interview for Hospodarske noviny daily. He even said that he can imagine that the CNB might not increase rates in next two or three meetings. It corroborates the long-term view of the board member Oldrich Dedek that the hiking pace should be slower as the external environment remains fragile. Yet, even the most dovish member of the board, Dedek, acknowledges that the CNB rates should aim towards a neutral rate (the estimates of neutral rate vary from 2.5 to 3.5%).

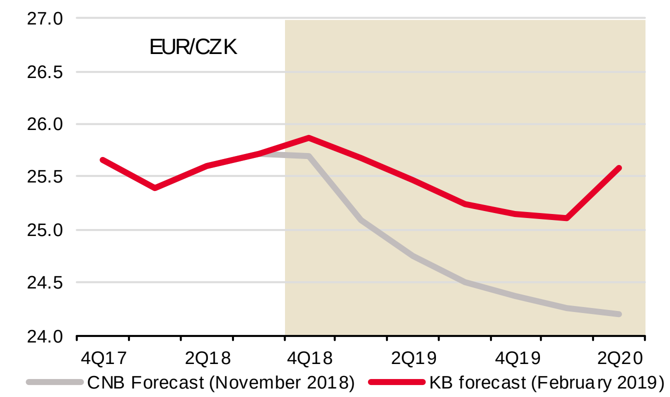
The new CNB forecast will probably not change much. The rates path will remain roughly flat for this year, but the forecast will traditionally assume rapid currency appreciation. In our report (http://bit.ly/2Ehx4zb), we described why we think that the koruna will not appreciate as fast as the CNB assumes. **Thus, when the external environment clears, the CNB will again feel the need to tighten monetary policy. We believe it will continue the hiking cycle this year with two hikes.** They should occur at the meetings where the forecast updates are presented in May and August. The February meeting is a close call, but current statements from the CNB suggest that the rates will remain unchanged.

Monetary conditions to be tightened by interest rates …



Source: CNB, Bloomberg, Economic & Strategy Research, Komerční banka

… as CZK is set to appreciate only slowly



Source: CNB, Bloomberg, Economic & Strategy Research, Komerční banka

Czech FX Market

Jakub Matějů

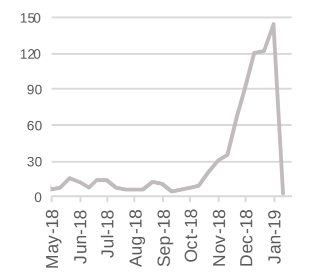
Koruna stronger for the time being

Year-end effects have faded and the koruna is now stronger. Foreign risks prevail however and restrict the space for further appreciation. Excess CZK liquidity is preventing the FX rate from converging towards equilibrium. We do not expect the koruna to strengthen to below EUR/CZK25 this year. Next year, we think the currency could weaken again due to the expected global economic slowdown.

Koruna recovers from year-end effects but remains under pressure amid foreign uncertainties

After the CZK sold off last spring together with other emerging market currencies, the CEE FX rates have diverged again since autumn. **More than any other currency in the CEE region, the CZK was hit by year-end effects. These dominated the CZK spot and forward FX rates from September.** Given negative rates over year-end, CZK liquidity holders were motivated to carry out short-term swaps into foreign currencies and back again. The effect was weaker this time than in 2017 (for more about the year-end effect, see http://bit.ly/2FCzlaK). Part of the CZK liquidity was absorbed by foreign institutions, which have a direct line to the CNB deposit facility and don't need to pay year-end deposit fees related to Resolution Fund contributions. The foreign institutions may have been central banks or international organisations. These organisations have increased their deposits at the CNB to CZK140bn.

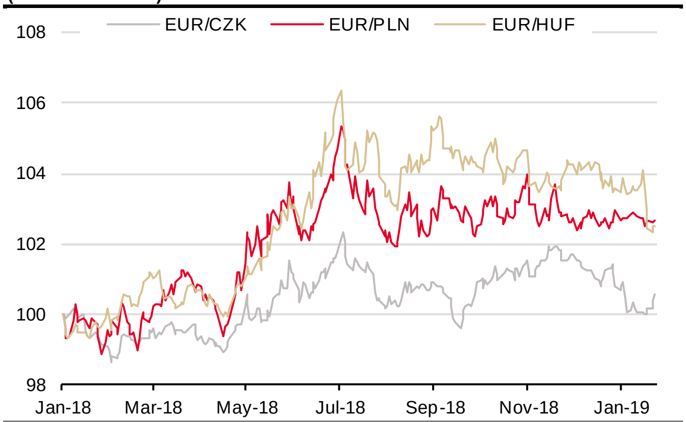
CNB liabilities abroad (CZKbn)



Source: Ten-day CNB balance sheet, Economic & Strategy Research, Komerční banka

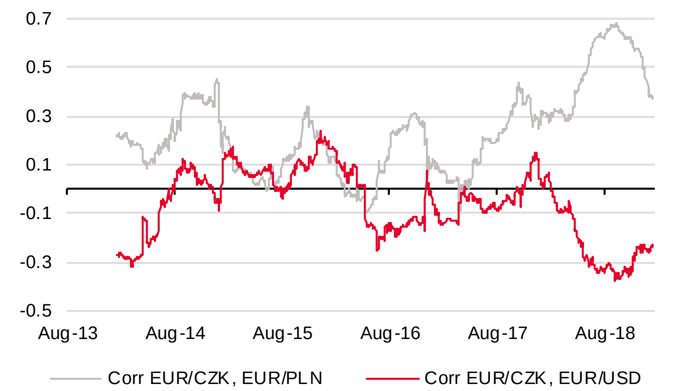
Last year's co-movements with other regional currencies has weakened in effect. Although the correlation of EUR/CZK with EUR/PLN remains positive, it is obvious that the currencies are now again affected by idiosyncratic events. **The negative reaction of EUR/CZK to EUR/USD FX rate prevails.** When EUR weakens, it is likely that CZK will lose too. That is also why CZK is being adversely affected by elevated global uncertainty. This relates to still present threat of hard Brexit (although the probability of Article 50 extension increases), German recession, China's hard landing and the risk of 25% customs tax being levied on automotive imports to the United States.

CEE FX rates have diverged again since autumn (1.1.2018 = 100)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

CZK again affected by idiosyncratic events



Source: Bloomberg, Economic & Strategy Research, Komerční banka

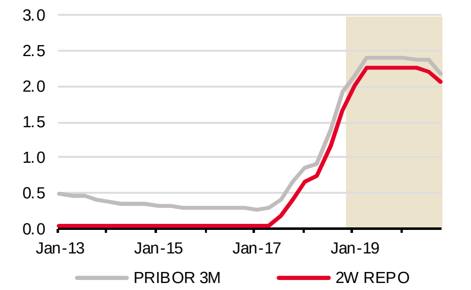
CNB communication is not supporting the koruna either. Some MPC members have not ruled out a longer pause in rate hikes. Others see no reason to wait and are ready to vote for further tightening in February. The CZK FX market is uncertain about what to take from this debate. We expect that, despite the hawkish voices, the MPC will not vote for a hike in February. **That would be a disappointment for the koruna and would prevent it from strengthening in the near future.** Read more about the CNB outlook in the CNB Focus section of in this document.

Koruna to be supported by widening interest rate differential and current account surpluses.

Current account and interest rate differential to support koruna

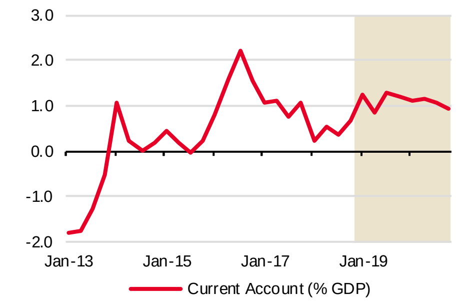
The koruna has fundamental reasons to appreciate. **The current account surplus indicates that real money inflows supply enough EUR liquidity to domestic companies.** The current account also looks set to print in positive territory in 2019. **At the same time, the interest rate differential against EUR has widened further.** The spread between CZK and EUR IRS amounts to more than 200bp at the shorter end of the curve. Moreover, CZGB yields are attractive and low risk. We expect a limited further rise in both IRS and government bond yields on the back of further tightening of CNB monetary policy, which is not yet fully priced.

Expected path of Czech money market rates



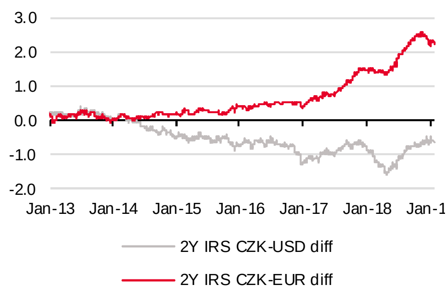
Source: CNB, Economic & Strategy Research, Komerční banka

Balance of payments C/A outlook



Source: CNB, Economic & Strategy Research, Komerční banka

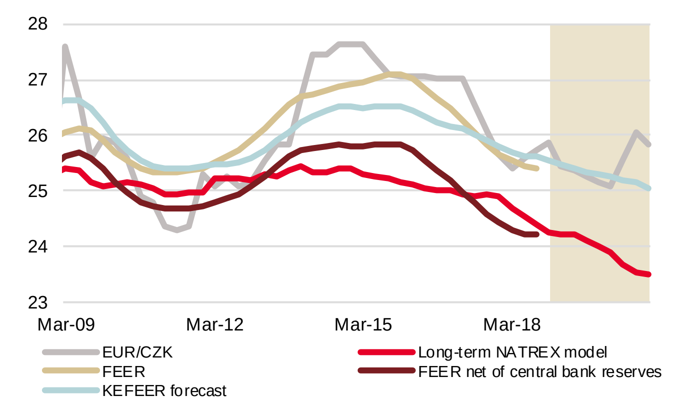
Interest rate differentials of 2y CZK IRS against EUR and USD IRS



Source: Bloomberg, Economic & Strategy Research, Komerční banka

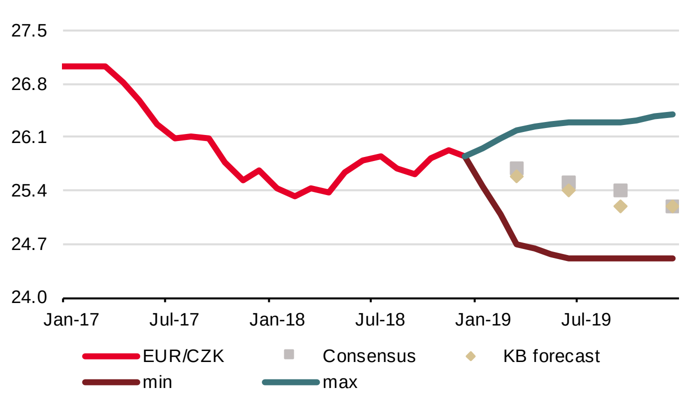
Non-euro holders of CZK liquidity are playing an increasing role – US holders have gained prominence, Latin American funds have been active recently and interest is also expected from Asian funds. Thus, it is important to watch the differential against USD rates. Looking at shorter IRS, CZK rates remain around 50bp below USD rates. The CNB seems to be at a similar phase in the tightening cycle as the Fed, slowing the pace of hikes and approaching neutral rate levels. **That said, the CNB has a bit more distance to cover in terms of monetary policy normalisation.** We expect the currently negative CZK-USD rate differential to move towards zero or become slightly positive during 2019. That should support the CZK during this year.

EUR/CZK equilibrium exchange rate estimates from NATREX, FEER and KEFEER models



Source: Bloomberg, Economic & Strategy Research, Komerční banka

Expected EUR/CZK exchange rate – market consensus, Bloomberg (24 January 2019)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

The NATREX equilibrium exchange rate model indicates a level close to EUR/CZK24 and foresees further gradual appreciation of the equilibrium over the forecast horizon. According to our simulations using the FEER (fundamental equilibrium exchange rate) model, a large part of the current exchange rate gap can be attributed to the central bank's excess FX reserves, which prevent strengthening towards the model's equilibrium. **The unadjusted FEER, with the current level of CNB reserves, points to a value of around EUR/CZK25.50. Similarly, the KEFEER**

Although long-term equilibrium estimates point to stronger levels, the gap is not expected to close soon

(Kalman-filtered FEER) model suggests that the equilibirum exchange rate will slowly rise. We have written more about these results and the implications for CNB policy here http://bit.ly/2Ehx4zb.

Koruna unlikely to strengthen below EUR/CZK25 this year

In line with market consensus, we expect the koruna to gradually strengthen. The FX rate should be supported by the current account surpluses, widening interest rate differentials and the Fed rate hiking cycle approaching an end. Still, the CZK will remain vulnerable to foreign uncertainty, mainly the prospects for the German economy and euro area as a whole. The US economy appears to be at the peak of the business cycle and is at risk of a significant slowdown or even recession in the years to come. Signs of global growth weakness could emerge more often this year. That is why we expect only mild and gradual CZK gains. **The koruna will not strengthen below EUR/CZK25 this year, in our view.**

Risks to exchange rate developments on both sides

Risks to the CZK outlook stem from the foreign environment – if the situation deteriorates, the koruna will weaken; if the risks recede, the currency will gain

Large volumes of excess CZK liquidity makes the Czech currency vunerable. The CNB's FX floor regime and interventions caused positions of foreign investors to soar. At first, the majority comprised bets on rapid EUR/CZK gains after the lifting of the floor. These have since transformed into long-term positions. We see risks to the koruna from any financial market shocks and from the global slowdown expected for 2020 striking earlier or being more severe. The materialisation of existing risks (hard Brexit, 25% customs on US automotive imports, German recession) would send the koruna to weaker levels too.

On the other hand, a revival of German growth, progress with the Brexit deal or signs of a stronger global economy could lead to a stronger koruna than currently expected.

EUR/CZK Technical Analysis *(updated on January 30 at 11:54am)*

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Has come up against the 200-DMA and a trend near 25.82

EUR/CZK has been showing signs of steady rebound after finding support at the 1Y up channel near 25.57/25.50 which also denotes the 61.8% retracement from February 2018 lows. The pair could be forming a potential hammer this month and with weekly RSI still holding a multiyear support trend, 25.57/50 remains a short-term support level. Only in the event of a break below will EUR/CZK drift towards the next key support of 25.10/25.00, lows of last year.

Shorter term, EUR/CZK is flirting with the 200-day MA and is at a descending trend near 25.82. With daily stochastic having room for further upside, a move beyond 25.82 will take the pair towards 25.95 and even towards 26.05/26.09, trend drawn since July 2018. Graphical levels of 26.20, highs of August 2017 and 2018 and 26.40/26.48 are significant resistance levels. 25.70 is an immediate support.

EUR/CZK, weekly and monthly charts

EUR/CZK, daily chart

Source: SG Cross Asset Research/Technical Analysis

Important Disclaimer: The recommendations in the part Technical analysis is based only on analytical methods of technical analysis and may be different from the fundamental opinion of KB (or SG) presented in other part s of this documents or of other documents of KB (or SG).

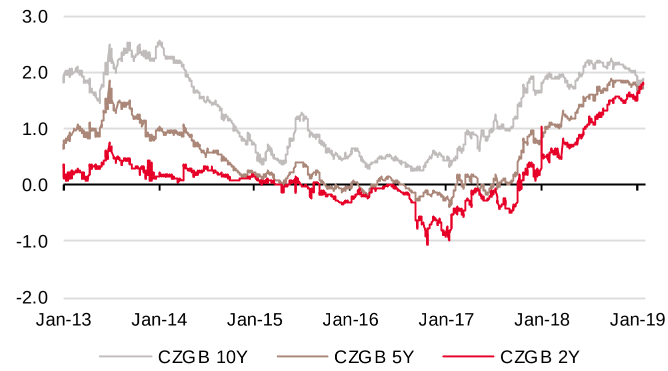
Czech government bonds and the IRS market

Jakub Matějů

Inverted yield curve translates to flatter CZGB yields

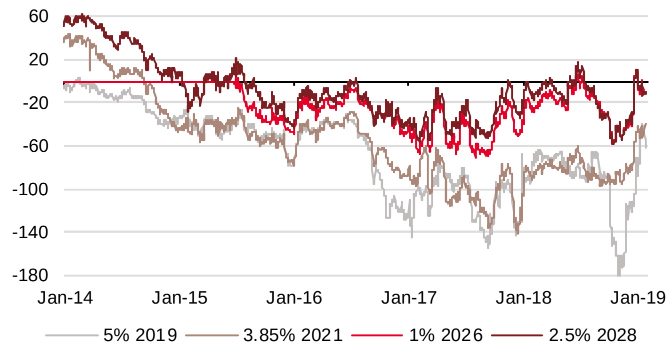
The IRS yield curve has inverted. The 2y10y slope fell into negative territory towards the end of 2018 and continues to flatten. While the long end is being squeezed by a pessimistic global outlook and low inflation expectations, CNB rate hikes have supported the short end. Although the market pricing of CNB hikes has been very conservative so far, few market players expect a cut any time soon. We expect two hikes this year. Lower IRS is also squeezing CZGB yields, mostly in the longer end. If and when the market prices in CNB hikes this year, we expect IRS and CZGB yields to drop again as signals of a foreign slowdown intensify.

CZGB yields, Bloomberg generic (%)



Source: Bloomberg, Economic and Strategy Research, Komerční banka

ASW spreads (bp)



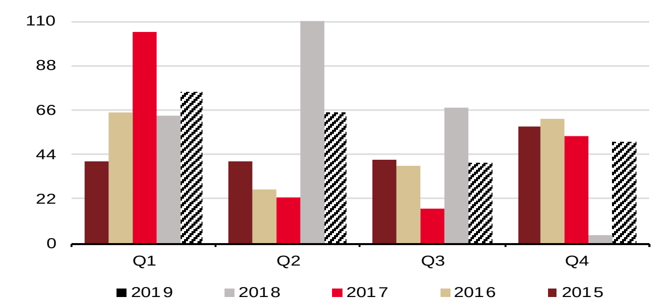
Source: Bloomberg, Economic and Strategy Research, Komerční banka

The increase in Czech government bond yields that began in the last quarter of 2018 has come to a halt. The longer end of the CZGB yield curve has been squeezed by the fall in corresponding IRS. CZGBs are considered a low-risk asset, suitable for placing free CZK liquidity. We have seen strong demand for CZGBs recently, as CZK liquidity is still good, and we expect it to remain so. Therefore, demand for CZGBs should always dominate IRS at comparable YTM. This is why we don't expect ASW to return to positive territory any time soon (for maturities up to 10y). We could also observe a preference for longer tenors given uncertainty about the future macroeconomic situation and rates developments.

2019 supply: large volume to be refinanced

In 2019, CZK238.1bn of maturing CZGBs need to be refinanced. In addition, we expect a budget deficit of CZK40bn and a further CZK10bn of redemptions of T-Bills, retail bonds and EIB loans. EUR redemptions will include short-term loans used to refinance eurobonds maturing last year. These amount to more than CZK40bn.

Quarterly CZGB issuance in primary market (CZKbn)



Source: Finance Ministry, Economic & Strategy Research, Komerční banka * 1Q-4Q19 is KB forecast

Overall financing needs are relatively high, exceeding last year's. They will be only partly be

Finance Ministry to issue CZK 230bn in CZGB auctions and raise a further CZK20bn in retail bonds

covered by new CZGB issuance, of which we expect CZK230bn to be offered. A lower volume (CZK10bn) will be on tap in the secondary market. The Finance Ministry also plans to increase direct debt ownership by retailers to around 5%. That would amount to close to CZK80bn. A series of new retail bond issues should help the move towards these targets. Three subscription rounds are planned for 1H19. We expect the ministry to raise CZK20bn in retail bonds this year. **Because of the retail bonds, net CZGB issuance should come out close to zero – we foresee a negligible CZK2bn to be sold above redemptions.** Additionally, the ministry plans to tap an EIB loan for railroad network investment, but the volume will be a rather negligible CZK11.5bn over the 2019-2025 period.

Gross borrowing needs and financing (CZKbn)

	2019f	
	MF December 2018	KB February 2019
Borrowing needs		
Budget deficit	40.0	40.0
Buybacks of CZGBs		0.0
Redemption of CZGBs	238.1	238.1
Redemption of Eurobonds		0
Redemption of retail bonds	2.7	2.7
Redemption of T-bills	45.7	4.2
Redemption of other money market instruments		41.6
Redemption of EIB loans	4.7	4.7
Total	**331.2**	**331.2**
Financing		
Gross T-bill issuance		10.0
Gross CZGB issuance (in auctions)		230.0
Tap sales		10.0
Gross issuance of bonds in EUR		25.0
Gross issuance of retail bonds		20.0
Other money market instruments		25.0
EIB loans		2.0
Tapping of financial reserve		9.2
Net effect of CZGB switches		0.0
Total financing		**331.2**
Net CZGB issuance		*1.9*

Source: Economic & Strategy Research, Komerční banka, Finance Ministry

No Eurobond planned; the Finance Ministry will instead issue CZGB in EUR on domestic market

There will be no new Eurobond in a classical sense. The ministry considers the related fees to be prohibitively high given the low interest rate environment. On the other hand, the ministry can issue government bonds denominated in EUR under Czech law, with Czech banks as primary dealers. This was always an option, but it will now be used for the first time. A relatively large amount of maturing EUR loans was used last year to refinance Eurobonds. The ministry has been receiving a negative yield on these so far, but this will not last indefinitely. It therefore makes sense to extend the tenor of the EUR liability portfolio by issuing in EUR, making use of the low-yield environment. The ministry has therefore announced a first auction of Czech government bonds on the domestic market, denominated in EUR, to be held in February. **We expect the total volume of EUR CZGB issuance to be close to EUR1bn this year.** Remaining EUR loans should be rolled over.

CZGB yields in 2019 and 2020: temporary increase

CZGB yields to increase before being squeezed again by global economic slowdown.

Yields will be further supported by the relatively strong gross issuance. Also, CNB tightening and the potential for higher IRS could push CZGB yields up. On the other hand, there will be downward pressure on yields from excessive CZK liquidity and the search for yield, mainly driven by foreign investors. CZGB remain a low-risk option for placing CZK while offering solid carry, related to EUR rates. **We expect the 10y CZGB yield to increase slightly this year,**

moving above 2.0% again. Next year, CZGB yields should come under pressure again, as the preference for low-risk assets increases given the expected global and domestic growth slowdown.

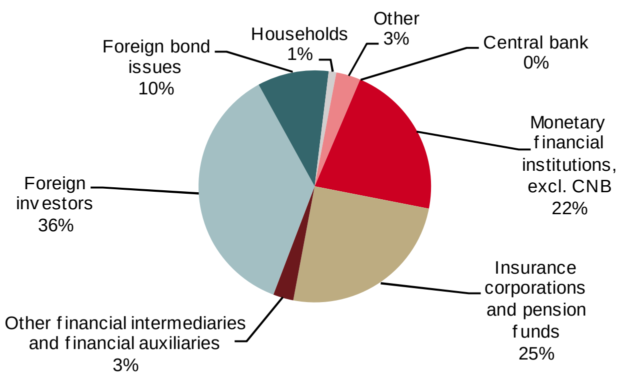
CZGB yield forecast

	1Q19f	2Q19f	3Q19f	4Q19f	1Q20f
2y CZGB yield (%)	1.80	1.95	1.85	1.85	1.75
10y CZGB yield (%)	1.95	1.95	2.05	2.00	1.90
10y CZGB ASW (bp)	-5	-10	-10	-15	-20

Source: Economic & Strategy Research, Komerční banka

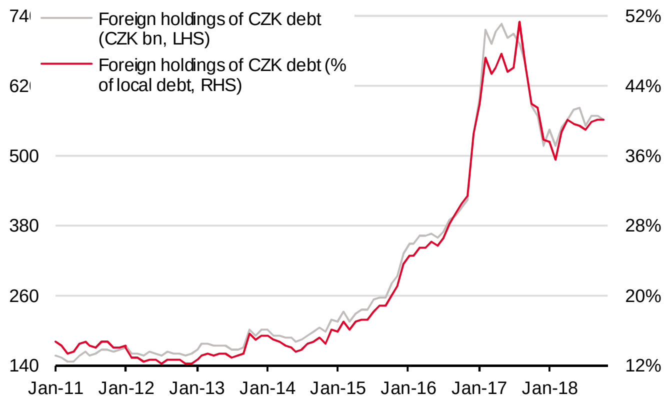
Yields on CZGBs with shorter tenors should start cautiously increasing. The slope of the CZGB yield curve is already very low. As is the case with the IRS curve, we can see the slope falling further. **Nevertheless, we don't expect the CZGB curve to invert but rather to stay roughly flat.** ASWs have richened substantially recently, approaching zero at the longer end. Due to relatively higher demand for government bonds, we expect ASW to tighten again this year and in 2020.

Holdings of CZK government debt, end-November 2018



Source: Finance Ministry, Economic & Strategy Research, Komerční banka

Share of non-resident bondholders stays around 40%

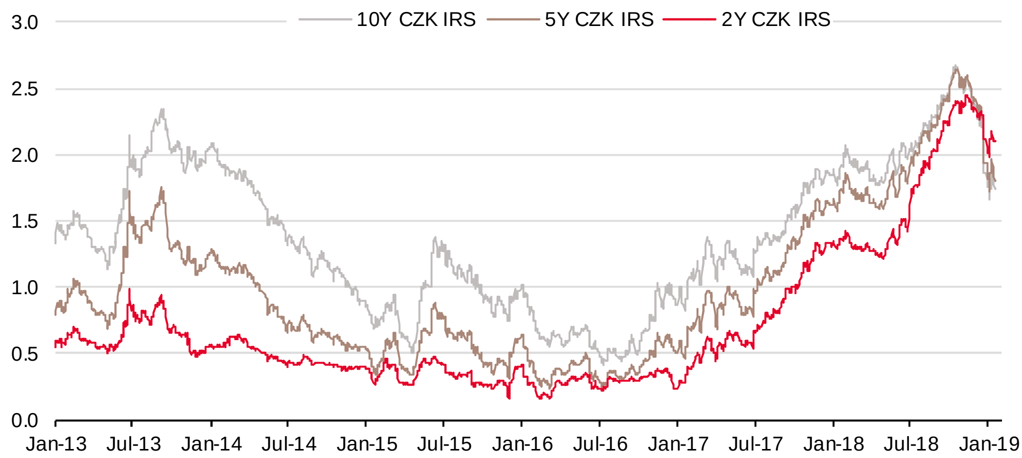


Source: Finance Ministry, Economic & Strategy Research, Komerční banka

CZGB holding structure: foreigners to stay in

The share of non-residents remains at around 40%. That is relatively low compared to 2017, when foreign investors were lured in by expected CZK appreciation related to the CNB exiting its exchange rate floor policy. **Nevertheless, the share of foreign bondholders remains well above pre-intervention levels. We expect it to stay close to 40%.** In our view, the foreign bondholders are mostly index investors, tracking the GBI-EM index and the like. Foreign demand for CZGB is also being supported by the high level of CZK liquidity in the market. The CNB does not plan to reduce its FX reserves substantially, which could partially absorb the ample CZK liquidity.

CZK IRS curve has inverted (%)



Source: Bloomberg, Economic & Strategy Research, Komerční banka

CZK interest rate swaps in the world of an inverted curve

The IRS yield curve slope dropped deeply into negative territory at the end of last year. It has not recovered, and the 2y10y spread is currently around -20 points. That reflects the market's low confidence in future interest rate hikes, inflation developments and the overall macroeconomic situation. Rates were also pushed down by a sell-off at the end of the year, with several large funds closing positions. The bias to receive swaps has not eased much since year-end. **Even the February CNB meeting would not support the IRS as we expect the key rates to stay on hold.**

Further CNB hikes this year should support the short end, the slope to remain negative this year

We expect the 2y IRS to increase mildly this year, moving above 2.5%. That would be the result of additional CNB hikes, which are not yet priced in by the market. At the end of the year and start of 2020, the short end should move south again, reflecting signs of a global slowdown and discussions about potential rate cuts.

CZK IRS outlook (%)

	4Q18f	1Q19f	2Q19f	3Q19f	4Q19f
2y	2.20	2.35	2.35	2.35	2.25
5y	2.05	2.20	2.20	2.25	2.10
10y	2.00	2.05	2.15	2.15	2.05

Source: Economic & Strategy Research, Komerční banka

The curve of the IRS slope looks set to remain negative this year. For a return to an upward sloping curve, we would need to see an improving global macroeconomic outlook, firmer inflation expectations and, importantly, a return of optimism on emerging markets. That could help lift the long end of the curve. This is not our baseline scenario – quite the opposite. The belly and the long end reflect the uncertainty about the foreign environment and the reaction of monetary policy. That does not appear likely to change in the near future. **Longer IRS should therefore increase only very slowly this year, with CNB hikes causing the whole curve to shift in parallel. In 2020, long IRS should decline again.** Only after that will the curve normalise and see a positive slope, in our view.

Banking Sector

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Corporate loans spiked in 2H18 but are set to decelerate again

Corporate loans accelerated strongly in the second half of last year. This move was driven by strengthening investment activity. The private sector was active in tapping the EU funds and used banking credit for co-financing. Although we could see a little more of this dynamic at the start of the year, **overall for 2019, we expect a deceleration in demand for credit from NFCs.** This stems from the uncertain outlook for the economy as well as low available capacity in the construction sector.

One might have expected new mortgage regulations that came into force in October to have restricted access to housing credit – however, the figures from 4Q show that mortgage volumes actually accelerated. That said, we still believe housing credit will ease in the first quarter of the year. It is not only the new rules set by the regulator, but the continuing sharp growth in housing prices that will curb demand for mortgages. Growth in consumer credit also accelerated in the latter half of 2018. Given the tightness of the labour market and strong wage growth, the situation of households is very comfortable. This should prove supportive for consumer credit. Against that, the outlook for the economy has been worsening, which is also reflected in the rising savings rate. Ultimately, we expect to see a slight deceleration in consumer credit this year.

Rising interest rates will support deposits. In particular, we expect deposits by individuals to increase as household income increases further on rising wages and employment. Moreover, the uncertainty about the economy is driving up the savings rate, increasing household deposits. In contrast, the gross profit margins of companies have been shrinking, meaning the growth in corporate deposits will slow this year.

Bank loans and deposits (% yoy)

	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	2017	2018	2019	2020	2021	2022	2023
Bank loans															
Total	8.8	7.1	6.2	4.9	4.0	4.5	5.1	5.8	**6.3**	**5.9**	**5.5**	**5.4**	**5.2**	**4.7**	**5.4**
Households - real estate loans	8.5	6.8	5.8	4.8	3.7	4.6	5.0	5.7	**9.3**	**8.4**	**5.3**	**5.4**	**6.2**	**5.9**	**5.7**
Households - consumer loans	7.8	7.4	6.8	5.8	4.5	4.7	4.9	5.5	**4.4**	**6.1**	**6.1**	**5.4**	**6.1**	**6.5**	**6.8**
Corporate loans	7.7	7.6	5.2	4.3	3.4	4.0	5.6	6.5	**4.9**	**4.9**	**5.1**	**5.6**	**4.4**	**3.6**	**5.2**
Deposits															
Total	7.5	7.8	6.7	6.2	6.0	5.5	5.2	4.7	**12.0**	**6.3**	**6.7**	**4.9**	**3.9**	**4.4**	**4.6**
Households	8.4	8.7	8.2	8.0	7.8	7.1	6.2	5.3	**8.5**	**7.4**	**8.2**	**5.7**	**3.3**	**3.6**	**4.1**
Non-financial corporations	4.0	4.3	2.5	2.7	2.9	2.4	3.5	4.1	**9.9**	**1.9**	**3.1**	**3.4**	**5.1**	**6.5**	**5.5**
Others	9.1	9.2	7.3	5.6	4.9	4.8	4.7	4.2	**22.1**	**8.1**	**6.7**	**4.5**	**4.1**	**4.1**	**4.6**
Ratios															
Loans/GDP	63.2	63.0	63.1	63.3	62.6	62.7	63.2	64.0	**62.7**	**62.6**	**63.0**	**63.4**	**64.2**	**64.3**	**64.3**
Deposits/GDP	84.3	88.3	87.0	86.7	85.2	88.7	87.3	86.8	**85.1**	**85.3**	**86.8**	**86.9**	**86.9**	**86.8**	**86.1**
Loans/deposits	74.9	71.4	72.5	73.0	73.5	70.7	72.4	73.8	**73.7**	**73.4**	**72.6**	**73.0**	**73.9**	**74.1**	**74.7**
Interest rates															
Real estate loans	2.8	2.9	3.0	3.0	3.0	3.0	3.0	3.0	**2.3**	**2.7**	**3.0**	**3.0**	**3.0**	**3.1**	**3.2**
Consumer loans	8.6	9.1	9.4	9.7	9.9	9.9	10.1	10.2	**9.2**	**8.5**	**9.5**	**10.2**	**10.7**	**11.4**	**11.8**
Corporate loans	3.2	3.4	3.7	3.7	3.7	3.7	3.7	3.7	**2.0**	**2.7**	**3.6**	**3.7**	**3.7**	**4.5**	**4.8**
Share of NPL															
Real estate loans	1.6	1.6	1.6	1.7	1.7	1.7	1.7	1.8	**1.8**	**1.7**	**1.6**	**1.8**	**2.0**	**2.2**	**2.4**
Consumer loans	5.1	5.2	5.5	5.9	6.3	6.7	7.0	7.3	**6.9**	**5.4**	**5.7**	**7.2**	**8.5**	**9.6**	**10.1**
Corporate loans	3.6	3.6	3.8	3.9	4.1	4.3	4.5	4.6	**4.6**	**3.7**	**3.9**	**4.5**	**5.4**	**5.9**	**5.9**

Source: CNB. CZSO. Macrobond. Economic & Strategy Research. Komerční banka

Key Economic Indicators

Macroeconomic indicators – long-term outlook

		2016	2017	2018	2019	2020	2021	2022	2023
GDP	real. %	2.4	4.5	2.8	2.7	2.5	1.9	2.8	2.8
Inflation	average. %	0.7	2.5	2.1	2.3	2.0	1.9	1.8	2.2
Current account	% of GDP	1.6	1.1	0.7	1.2	0.9	1.5	1.6	1.4
3M PRIBOR	average. %	0.3	0.4	1.3	2.3	2.3	2.3	3.0	3.3
EUR/CZK	average	27.0	26.3	25.6	25.4	25.7	25.2	24.0	23.8
USD/CZK	average	24.4	23.4	21.7	22.0	20.2	19.6	18.5	17.7

Source: CZSO. CNB. Macrobond. Economic & Strategy Research. Komerční banka. SG Economic Research
Note: KB forecasts are in red

FX & interest-rate outlook

		31-Jan-2019	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
EUR/CZK	end of period	25.7	25.6	25.4	25.2	25.2	25.3
USD/EUR	end of period	1.14	1.13	1.15	1.22	1.25	1.26
CZK/USD	end of period	22.5	22.7	22.1	20.7	20.2	20.2
3M PRIBOR	end of period	1.99	2.10	2.35	2.50	2.75	2.40
10Y IRS	end of period	1.75	2.00	2.00	2.05	2.15	2.15

Source: CZSO. CNB. Macrobond. Economic & Strategy Research. Komerční banka. SG Economic Research
Note: KB forecasts are in red

Monthly macroeconomic data

		IV-18	V-18	VI-18	VII-18	VIII-18	IX-18	X-18	XI-18	XII-18
Inflation (CPI)	%. mom	0.3	0.5	0.4	0.2	0.1	-0.3	0.4	-0.1	0.1
Inflation (CPI)	%. yoy	1.9	2.2	2.6	2.3	2.5	2.3	2.2	2.0	2.0
Producer prices (PPI)	%. mom	0.2	1.0	0.6	0.3	0.1	0.3	0.7	-0.1	-1.1
Producer prices (PPI)	%. yoy	0.0	1.5	2.9	3.4	3.3	3.2	3.9	3.9	2.4
Unemployment rate	% (MLSA)	3.2	3.0	2.9	3.1	3.1	3.0	2.8	2.8	3.1
Industrial sales	%. yoy. c.p.	4.4	-0.6	2.8	11.3	3.9	1.7	9.6	9.1	n.a.
Industrial production	%. yoy. c.p.	5.2	0.7	3.1	10.3	2.0	-0.5	6.7	4.8	n.a.
Construction output	%. yoy. c.p.	6.6	8.2	5.5	14.0	10.7	11.8	10.4	0.0	n.a.
Retail sales	%. yoy. c.p.	5.2	2.3	1.4	7.0	2.4	-2.1	3.1	3.3	n.a.
External trade	CZK bn (national met.)	18.4	10.2	15.8	-5.8	-2.1	13.7	4.2	20.2	n.a.
Current account	CZK bn	30.8	0.1	-23.0	-14.4	-21.1	-9.2	10.0	8.7	n.a.
Financial account	CZK bn	23.2	22.9	-42.8	15.1	-14.9	-29.1	13.8	-1.0	n.a.
M2 growth	%. yoy	3.9	5.0	5.3	4.7	4.9	4.1	5.5	6.2	n.a.
State budget	CZK bn (YTD cum.)	0.8	-23.1	-5.9	16.6	14.8	16.8	5.7	-21.6	2.9
PRIBOR 3M	%. average	0.90	0.90	0.95	1.18	1.45	1.54	1.76	1.99	2.01
EUR/CZK	average	25.37	25.64	25.79	25.84	25.70	25.62	25.83	25.94	25.84
USD/CZK	average	20.66	21.70	22.09	22.12	22.25	21.97	22.49	22.83	22.70

Source: CZSO. CNB. MF. MLSA. Macrobond. Economic & Strategy Research. Komerční banka

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