Time for a pause in the tightening cycle in the Czech Republic

This week

- **The most important event this week will be the meeting of the Monetary Policy Council scheduled for Wednesday**. We expect that the MPC will leave interest rates unchanged. At the same time, the results of the latest NBP projection will be presented during the meeting. We expect that the inflation path will be revised upwards compared to the July projection, due to higher dynamics of energy prices anticipated by the NBP. We believe that the forecasted GDP growth rate will not be substantially revised and its downward trajectory will be maintained in subsequent quarters. Questions about the way the MPC understands inflation target and about the impact of the November projection results on the monetary policy outlook in the nearest quarters (see MACROmap of 15/10/2018) may be raised during the conference. A. Glapiński will repeat his view that interest rates will remain unchanged at least until the end of 2019. We believe that the statement after the Council meeting and the remarks of the NBP Governor during the conference will not have any substantial impact on PLN and prices of the Polish debt.
- **Another important event will be the FOMC meeting scheduled for Thursday.** We expect that after the rate hike in September, the Federal Reserve will maintain status quo in monetary policy this week. The markets will focus on possible changes in the statement's tone, reflecting the impact of the US-China trade war on the US macroeconomic outlook. We believe that the statement will be consistent with our scenario assuming one more of interest rate hike by 25bp in 2018 and further monetary policy tightening in 2019. In our view, the publication of the statement after the FOMC meeting will be neutral for the financial markets.
- **Data on the Chinese balance on trade will be released on Thursday.** We expect it to have increased to USD 35.1bn in October vs. USD 31.7bn in September. We forecast that export dynamics dropped to 8.2% YoY in October vs. 14.5% in September, while import dynamics decreased to 12.3% vs. 14.3%. The marked decrease in export dynamics was largely caused by higher import tariffs imposed in September on selected goods from China. We believe that the materialization of our forecasts will be neutral for the financial markets.
- **Results of US consumer sentiment surveys will be released on Friday.** We expect the preliminary University of Michigan Index (98.0 pts vs. 98.6 pts in October) to indicate a slight deterioration of households' sentiment in November. In our view, the publication of the results of the US consumer sentiment surveys will not have any substantial impact on PLN and Polish bond yields.

Last week

- **Non-farm payrolls in the US rose by 250k in October vs. a 118k increase in September (revised downwards from 134k), running clearly above the market expectations (up by 190k).** The highest increase in employment was recorded in education and health service (+44.0k), tourism and leisure (+42.0k), and business services (+35.0k). Significant increase of employment in "tourism and leisure" shows that the sharp increase in non-farm payrolls in October occurred partly due to the abatement of the negative impact of hurricane Florence (see MACROmap of 8/10/2018). Unemployment rate has not changed in October compared to September and amounted to 3.7%, running clearly below the natural unemployment rate indicated by FOMC (4.5% - see MACROmap of 2/10/2018). At the same time, participation rate rose to 62.9% in October vs. 62.7% in September. The annual dynamics of average hourly earnings rose to 3.1% in October vs. 2.8% in September, which was in line with the market expectations. At the same time, it has been its highest level since April 2009. The data's hawkish impact was responsible for a slight strengthening of USD vs. EUR. The results of business surveys in the US were also released last week. The ISM index for manufacturing decreased to 57.7 pts in October vs. 59.8 pts in September, running below the market expectations (59.0 pts). Conducive to the index decrease were lower contributions of four of its five sub-indices (for new orders, output, inventories, and employment), while lower contribution of the sub-index for suppliers' delivery times had an opposite impact. On the other hand, the Conference Board Index has suggested improvement of consumer sentiment, rising to 137.9 pts in October vs. 135.3 pts in September (revised downwards from 138.4 pts) and hitting the highest level since September 2000. The index increase resulted from higher values of its sub-indices for both the assessment of the current situation and expectations. The last week's readings support our scenario, in which in December 2018 FED will hike interest rates by 25bp, in 2019 the scale of the monetary tightening will amount to 100bp, thus being 25bp higher from that indicated in the FED's latest projection. The market is now pricing in two interest rate hikes in 2019.

- **According to the flash estimate, the quarterly GDP dynamics in the Eurozone decreased to 0.2% in Q3 vs. 0.4% in Q2, running below the market expectations (0.4%).** The annual economic growth rate has also decreased and stood at 1.9% in Q3 vs. 2.1% in Q2. The GDP data are a flash estimate and do not include its structure. The business survey results released in recent months indicate that the reason for a lower-than-expected economic growth rate in Q3 has probably been the stronger-than-assumed decrease in the contribution of net exports. Subsequent GDP estimate for the Eurozone in Q3, reflecting the growth rate in all the countries of the single currency area, will be released on 14 November and data on GDP structure will be released on 7 December. The weaker than we expected data on GDP in Q3, combined with the October Eurozone business survey results released two weeks ago (see MACROmap of 29/10/2018), pose a downside risk to our forecast of economic growth in the single currency area in Q4 (0.5% QoQ) and in the whole 2018 (2.1% vs. 2.5% in 2017).
- **According to the flash estimate, inflation in the Eurozone rose to 2.2% YoY in October vs. 2.1% in September, running in line with our forecast and market expectations.** The increase in inflation resulted from higher price dynamics in the categories "services" and "energy", while its decrease in the food category had an opposite impact. We expect that in subsequent quarters the annual inflation rate within the single currency area will stay between 1.8% and 2.0%. In H2 2019 inflation will decrease, supported by high base effect from the year before, to reach 1.4% YoY in Q4 2019. In addition, we forecast that core inflation in the Eurozone will not exceed 1.5% in the horizon of the next two years. This is consistent with our scenario, in which the first hike of ECB interest rates (deposit rate) will take place in September 2019 and the main interest rate will be hiked in December 2019. The market is now pricing in the first interest rate hike in December 2019.
- **According to the flash estimate, CPI inflation in Poland dropped to 1.7% YoY in October vs. 1.9% in September, running below the market expectations (1.9%) and our forecast (1.8%).** GUS has published partial data on inflation structure, including information about the rate of inflation in the categories "food and non-alcoholic beverages", "energy", and "fuels". Conducive to decrease in total inflation were lower dynamics of prices of food and non-alcoholic beverages (1.7% YoY) in October vs. 2.3% in September) and energy (1.5% YoY vs. 1.8%). Higher growth rate of fuel prices (12.8% YoY vs. 12.0%) as well as higher core inflation, which according to our estimates stood at 0.9% YoY in October vs. 0.8% in September, had an opposite impact. The flash data on inflation do not alter our forecast, in which inflation will decrease to 1.8% YoY in Q4 vs. 2.0% in Q3 and in the whole 2018 will amount to 1.7% YoY vs. 2.0% in 2017. Final data on inflation will be released on 14 November.
- **Polish manufacturing PMI dropped to 50.4 pts in October vs. 50.5 pts September, running above the market consensus (50.2 pts) and our forecast (49.9 pts).** Thus, the index has reached the lowest level since October 2016 and is only slightly above the 50 pts threshold dividing expansion from contraction of activity. Conducive to the index decrease were lower contributions of three out of its five sub-indices (for employment, suppliers' delivery times, and output), while higher contributions of the sub-indices for new orders and stocks of purchases had an opposite impact. Especially noteworthy in the data structure is a deepening monthly

decline in new export orders, which were decreasing at the fastest rate since October 2012. Thus, the increase in the total new orders sub-index resulted from higher domestic orders which have more than offset the decrease in foreign orders (see MACROpulse 2/11/2018). October saw a visible decline in the employment sub-index, which stood slightly below the 50 pts threshold. It points to a first monthly decrease of employment in the Polish manufacturing since July 2013. According to Markit report, the surveyed companies were attributing employment reduction i.a to lower production. The PMI for October stood clearly below its average value in Q3 (51.6 pts), which poses a downside risk to our forecast of GDP growth in Q4 (4.5% YoY vs. 4.4% in Q3).

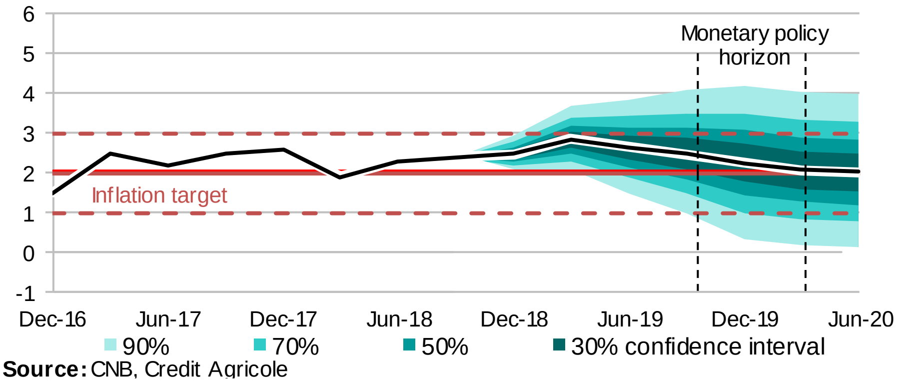
- **Business survey results for Chinese manufacturing have been released in recent days.** CFLP PMI dropped to 50.2 pts in October vs. 50.8 pts in September, running below the market expectations (50.6 pts). In turn, Caixin PMI rose to 50.1 pts in October vs. 50.0 pts in September, running above the market expectations (49.9 pts). The index increase resulted from higher contributions of four of its five sub-indices (for employment, new orders, inventories, and suppliers' delivery times), while lower contribution of the output sub-index had an opposite impact. The index for new export orders has also increased, but continued to stay clearly below the 50 pts threshold which divides expansion from contraction. The continuing decrease in export orders is the effect of the slowdown in global trade and of the negative impact of the US-China trade war on the activity of Chinese exporters. We maintain our forecast that the Chinese GDP growth rate will decrease to 6.6% in 2018 vs. 6.9% in 2017. At the same time we believe that numerous measures planned by the Chinese government to stimulate internal demand (including i.a. higher tax allowance, lower corporate tax, increased lending, launch of new infrastructural investments, or tax preferences for export-oriented companies) and the People's Bank of China (the recent cut of the reserve requirement – see MACROmap of 8/10/2018) as well as marked weakening of CNY vs. USD (by ca. 7% since June 2018) will be reflected by business survey results no sooner than in Q2 2019. The main risk to our scenario is possible further escalation of protectionist measures in global trade.

Time for a pause in the tightening cycle in the Czech Republic

Last week the Board of the Czech National Bank (CNB) decided to increase the two-week REPO rate (hereinafter the interest rate) from 1.50% to 1.75%. This decision was in line with our expectations and the remarks of the CNB representatives in recent weeks. Below we present our scenario for the monetary policy outlook in the Czech Republic and a consistent scenario for PLNCZK exchange rate.

The main argument in favour of the interest rate hike last week was that the macroeconomic conditions in recent months had developed differently from the CNB assumptions. The strengthening of CZK vs. EUR, assumed in the August macroeconomic projection, has not materialized at the CNB-expected scale. The average EURCZK rate stood at 25.8 in October, while the CNB had forecast that EURCZK would, on the average, amount to 25.3 in Q4. In addition, the PPI inflation in the Eurozone and the dynamics of energy prices are likely to run above the central bank's earlier forecasts. The aggregate inflationary impact of the aforementioned factors posed in the CNB opinion a risk to the achievement of inflation target in the medium term.

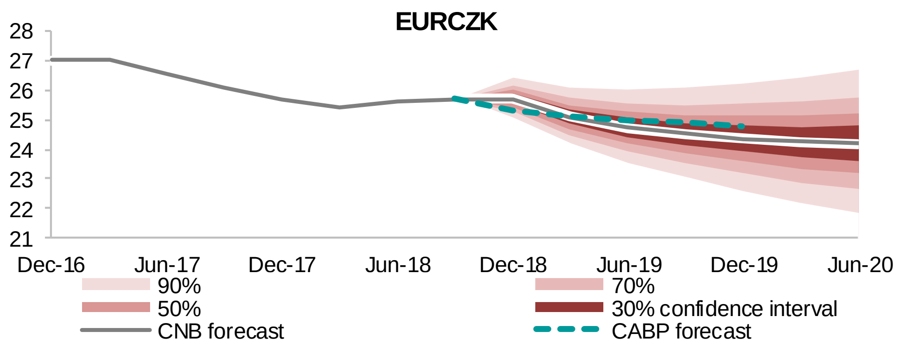
Two issues are of particular importance in the context of the CNB reaction function. Firstly, the CNB is very meticulous about inflation target (2.0 ± 1.0% YoY). According to the central bank, a substantial risk of its even slight and permanent overshooting justifies monetary tightening. Secondly, the CNB is trying to normalize the monetary policy as soon as possible (i.e. to make PRIBOR 3M reach the equilibrium rate of ca. 3.00%), macroeconomic conditions allowing. The purpose of such action is to create a buffer in the monetary policy in the event of future slowdown of economic growth. Considering the CNB reaction function, in accordance with the November inflation projection, further tightening of the monetary policy was justified.



Source: CNB, Credit Agricole

In the scenario presented in the November projection (which reflected the last week's rate hike), inflation will show an upward trend in the coming months and will reach the local maximum close to the upper tolerance band (2.8% YoY) in Q1 2019. It will then be gradually decreasing. The CNB expects that inflation target will be achieved in a sustainable manner with the beginning of 2020.

In accordance with the forecast of 3-month PRIBOR presented in the November projection, the CNB will not hike interest rates until the end of 2019.The remarks of the CNB Governor at the press conference after the meeting last week indicate that interest rates could be raised at the meeting in December 2018 only in a situation of a significant weakening of CZK. However we do not expect such scenario to materialize.



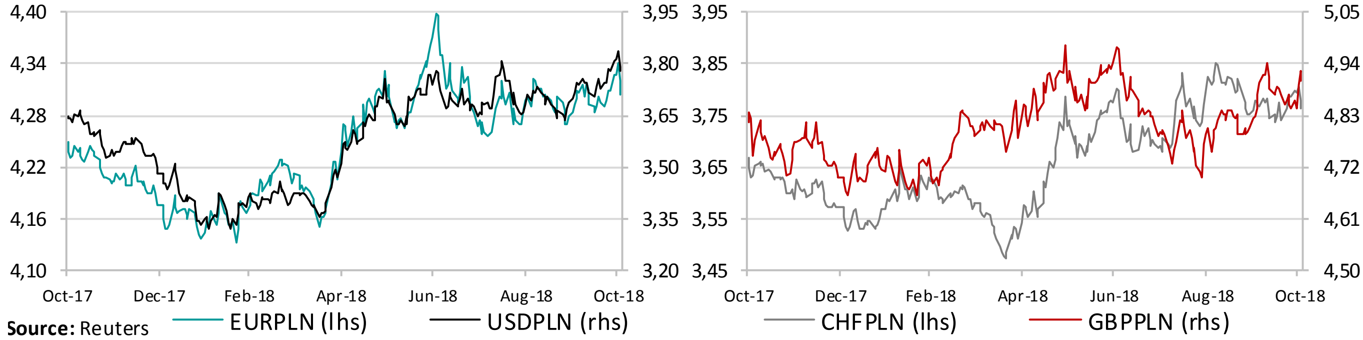
Source: CNB, Credit Agricole

The development of EURCZK exchange rate will be crucial for future monetary policy decisions. Our forecast of EURCZK for 2019 stands above the CNB expectations. The factors limiting the CZK appreciation in subsequent quarters include increased global risk aversion, resulting from growing protectionism in foreign trade, and pressure on emerging markets' currencies, resulting from the expected by us bigger scale of monetary tightening in the US in 2019 from the one being currently priced in by the financial markets (100 bp vs. 50 bp, see above). The CZK potential to strengthen will also be limited by the gradual closing of long currency positions opened due to the expected CZK appreciation after its "de-pegging" in 2017.

Consequently, we believe that the CZK strengthening starting from Q1 2019, assumed in the CNB projection, will not materialize at the central bank-anticipated scale, prompting the CNB to further tighten its monetary policy. In the baseline scenario we expect that the CNB will hike interest rates by a total of 50bp in 2019 (in May and November) up to 2.25% as at year end. This forecast is consistent with our scenario of the ECB monetary policy (deposit rate hiked by 40bp in total in H2 2019 and refi rate by 25 bp in Q4 2019). We believe that the decisions to be taken by the ECB will have a substantial impact on the monetary policy in the Czech Republic. A gradual monetary tightening in the Czech Republic will be conducive to a slight appreciation of CZK vs. EUR (EURCZK amounting to 25.30 as at the end of 2018 and to 24.8 as at the end of 2019). Considering the expected by us EURPLN profile (see the quarterly table), we forecast that CZKPLN will amount to 5.90 as at the end of 2018 and to 5.98 as at the end of 2019.

MPC meeting crucial for PLN

FX rates



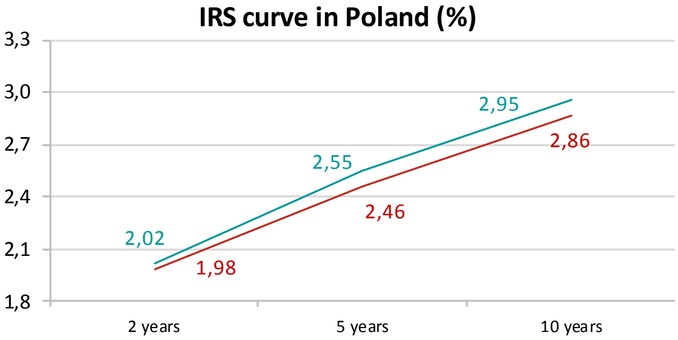
Source: Reuters

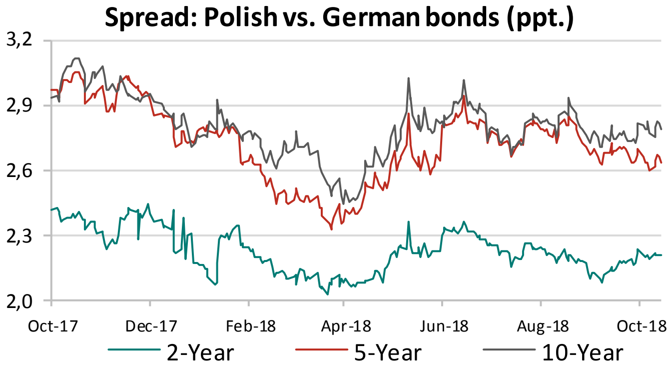
Last week, the EURPLN exchange rate dropped to 4.3047 (PLN strengthening by 0.1%). In the first part of the week, PLN was depreciating with increase in global risk aversion. Lower demand for risky assets was supported by the declaration of the German Chancellor Angela Merkel that she would not seek re-election as the CDU chairman as well as the increase in political risk in Italy (the Italian government, against the European Commission, continues to push forward its draft budget providing for a significant increase in the public finance deficit in 2019). Weaker-than-expected data on GDP in the Eurozone were not market moving. Thursday saw a correction and PLN strengthening. On Friday, EURPLN was relatively stable and oscillated between 4.31 and 4.32. Better-than-expected data from the US labour market had no significant impact on EURPLN.

Especially noteworthy last week was a visible weakening of PLN vs. GBP (by 1.2%), caused largely by a decrease of EURGBP with new information suggesting higher likelihood of an agreement being reached on Brexit as well as a hawkish tone of the Bank of England meeting. It signalled a faster pace of monetary tightening after Brexit, providing an agreement is reached (so-called soft Brexit). That is because an agreement between the United Kingdom and the EU and the ensuing sharp decrease in uncertainty could lead to an overheating of the British economy and a significant increase in inflation.

Crucial for PLN this week will be the MPC meeting, scheduled for Wednesday, which, in our view, will not significantly impact PLN. The FOMC meeting, like the preliminary University of Michigan Index, will not have any substantial impact on PLN, we believe. In our view, the publication of data on the Chinese balance on trade will also be neutral for PLN.

Market focused on MPC meeting





Source: Reuters

Last week, 2-year IRS rates rose to 2.02 (up by 4bp), 5-year rates to 2.55 (up by 9bp), and 10-year rates to 2.95 (up by 9bp). In the first part of the week, IRS levels were low against the backdrop of recent months, supported by unsatisfied demand for Polish bonds, after the debt auction held two week ago (see MACROmap of 28/10/2018). Rates increase at the short end of the curve was also limited by a characteristic for the last days of month higher demand from domestic financial institutions, resulting from assets structure adjustments aimed at reducing banking tax to be paid. On Thursday trading on the domestic market was suspended due to holiday. Friday brought an increase in IRS rates, following the German market, i.a. due to the publication of better-than-expected data from the US labour market.

This week the market will focus on the MPC meeting, scheduled for Wednesday, which will be neutral for IRS rates, we believe. In our view, the FED meeting as well as the publication of the preliminary University of Michigan Index will not have any substantial impact on the curve.

Forecasts of the monthly macroeconomic indicators

Main monthly macroeconomic indicators in Poland

Indicator	Oct-17	Nov-17	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18
NBP reference rate (%)	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	**1,50**
EURPLN*	4,24	4,20	4,18	4,15	4,17	4,21	4,24	4,31	4,37	4,27	4,30	4,28	4,34	**4,31**
USDPLN*	3,64	3,53	3,48	3,34	3,42	3,42	3,51	3,69	3,74	3,66	3,71	3,69	3,84	**3,71**
CHFPLN*	3,65	3,59	3,57	3,59	3,62	3,58	3,54	3,74	3,78	3,69	3,83	3,75	3,80	**3,73**
CPI inflation (% YoY)	2,1	2,5	2,1	1,9	1,4	1,3	1,6	1,7	2,0	2,0	2,0	1,9	**1,8**	
Core inflation (% YoY)	0,8	0,9	0,9	1,0	0,8	0,7	0,6	0,5	0,6	0,6	0,9	0,8	**0,9**	
Industrial production (% YoY)	12,4	9,2	2,8	8,6	7,3	1,7	9,3	5,2	6,7	10,3	5,0	2,8	**6,6**	
PPI inflation (% YoY)	3,0	1,8	0,3	0,2	-0,1	0,5	1,0	3,0	3,7	3,4	3,0	2,9	**2,7**	
Retail sales (% YoY)	8,0	10,2	6,0	8,2	7,9	9,2	4,6	7,6	10,3	9,3	9,0	5,6	**7,5**	
Corporate sector wages (% YoY)	7,4	6,5	7,3	7,3	6,8	6,7	7,8	7,0	7,5	7,2	6,8	6,7	**6,5**	
Employment (% YoY)	4,4	4,5	4,6	3,8	3,7	3,7	3,7	3,7	3,7	3,5	3,4	3,2	**3,2**	
Unemployment rate* (%)	6,6	6,5	6,6	6,8	6,8	6,6	6,3	6,1	5,8	5,8	5,8	5,7	**5,6**	
Current account (M EUR)	-13	95	-1354	2289	-792	-914	291	495	-200	-750	-549	**-189**		
Exports (% YoY EUR)	17,8	17,7	4,8	15,5	6,6	-4,4	9,1	1,1	6,2	9,2	7,4	**3,2**		
Imports (% YoY EUR)	16,9	17,8	13,2	19,0	9,5	0,3	12,4	1,4	7,9	10,3	11,2	**5,4**		

*end of period

Forecasts of the quarterly macroeconomic indicators

Main macroeconomic indicators in Poland

Indicator		2018				2019				2017	2018	2019
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Gross Domestic Product (% YoY)		5,2	5,1	4,5	4,5	3,7	3,5	3,4	3,3	4,8	4,8	3,5
Private consumption (% YoY)		4,8	4,9	4,8	4,7	4,4	3,9	3,7	3,6	4,9	4,8	3,9
Gross fixed capital formation (% YoY)		8,1	4,5	8,0	8,5	6,2	4,4	3,4	2,9	3,9	7,5	3,9
Export - constant prices (% YoY)		1,1	6,9	5,8	4,8	3,7	5,0	5,3	4,8	9,5	4,7	4,7
Import - constant prices (% YoY)		3,5	6,5	7,3	5,9	5,3	6,4	6,1	5,3	10,0	5,8	5,8
GDP growth contributions	Private consumption (pp)	3,0	2,9	2,8	2,3	2,8	2,3	2,2	1,8	2,8	2,8	2,3
	Investments (pp)	0,9	0,7	1,4	2,1	0,8	0,7	0,6	0,7	0,7	1,4	0,7
	Net exports (pp)	-1,2	0,5	-0,5	-0,4	-0,7	-0,5	-0,3	-0,2	0,1	-0,5	-0,4
Current account (% of GDP)***		-0,2	0,0	-0,3	-0,7	-1,0	-0,9	-0,7	-0,7	0,2	-0,7	-0,7
Unemployment rate (%)**		6,6	5,8	5,7	5,9	6,2	5,8	5,8	5,9	6,6	5,9	5,9
Non-agricultural employment (% YoY)		1,4	1,0	0,8	0,6	0,4	0,4	0,4	0,4	1,9	0,9	0,4
Wages in national economy (% YoY)		6,2	7,1	7,3	6,9	7,3	6,7	6,2	6,3	5,3	6,9	6,6
CPI Inflation (% YoY)*		1,5	1,7	2,0	1,8	2,4	2,4	2,2	2,0	2,0	1,7	2,2
Wibor 3M (%)**		1,70	1,70	1,72	1,72	1,72	1,72	1,72	1,80	1,72	1,72	1,80
NBP reference rate (%)**		1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50
EURPLN**		4,21	4,37	4,28	4,29	4,27	4,25	4,20	4,15	4,18	4,29	4,15
USDPLN**		3,42	3,74	3,69	3,61	3,53	3,46	3,36	3,27	3,48	3,61	3,27

* quarterly average
** end of period
***cumulative for the last 4 quarters

Calendar

TIME	COUNTRY	INDICATOR	PERIOD	PREV. VALUE	FORECAST* CA	FORECAST* CONSENSUS**
		Monday 11/05/2018				
10:30	Eurozone	Sentix Index (pts)	Nov	11,4		10,1
16:00	USA	ISM Non-Manufacturing Index (pts)	Oct	61,6	59,5	59,3
		Tuesday 11/06/2018				
8:00	Germany	New industrial orders (% MoM)	Sep	2,0		-0,6
10:00	Eurozone	Services PMI (pts)	Oct	53,3	53,3	53,3
10:00	Eurozone	Final Composite PMI (pts)	Oct	52,7	52,7	52,7
11:00	Eurozone	PPI (% YoY)	Sep	4,2		4,2
		Wednesday 11/07/2018				
8:00	Germany	Industrial production (% MoM)	Sep	-0,3		0,0
11:00	Eurozone	Retail sales (% MoM)	Sep	-0,2		0,1
	Poland	**NBP rate decision (%)**	**Nov**	**1,50**	**1,50**	**1,50**
		Thursday 11/08/2018				
	China	Trade balance (bn USD)	Oct	31,7	35,1	36,3
8:00	Germany	Trade balance (bn EUR)	Sep	18,3		18,1
20:00	USA	FOMC meeting (%)	Nov	2,25	2,25	2,25
		Friday 11/09/2018				
2:30	China	PPI (% YoY)	Oct	3,6		3,4
2:30	China	CPI (% YoY)	Oct	2,5		2,5
16:00	USA	Wholesale inventories (% MoM)	Sep	0,3		0,3
16:00	USA	Wholesale sales (% MoM)	Sep	0,8		0,6
16:00	USA	Initial U. of Michigan Sentiment Index (pts)	Nov	98,6	98,0	98,0

*The forecasts of macroeconomic indicators for Poland were prepared by Credit Agricole Bank Polska S.A. The forecasts of foreign indicators were prepared by Crédit Agricole Corporate and Investment Bank
** Reuters

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