June 15, 2007

Fixed Income and Foreign Exchange

CEE Insights

- **Special Section on recent market jitters**
- **Croatia:** Exchange rate and bond market under pressure
- **Czech Republic:** New era for CZK, or 'just' digression?
- **Hungary:** Short-term consolidation depends on US yield formation; space for gains in mid run still expected
- **Poland:** Zloty moving with region, but should gradually stabilize and return to appreciation track
- **Slovakia:** Koruna currently subject to regional mood

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Overview

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Croatia:

- Exchange rate and bond market under pressure
- CPI in line with expectations
- 12% credit growth limit calculation modified

Czech Republic:

- New era for CZK, or 'just' digression?

Hungary:

- CPI inflation rose 8.5% y/y in May
- Short-term consolidation depends on US yield formation; space for gains in mid run still expected

Poland:

- Inflation remained stable in May, net inflation likely up…
- …fitting picture painted by other data and making October rate hike more likely
- Zloty moving with region, but should gradually stabilize and return to appreciation track

Slovakia:

- HICP inflation at record low, inflation criterion to be met soon
- Trade balance improved further
- Koruna currently subject to regional mood

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Thursday's close		Current	w/w	m/m	ytd	Spreads vs. Euroland		
						current	- 1m	02/01/2007
Czech Republic	EUR/CZK	28.58	-0.6%	-1.0%	-3.4%			
	3Y (yield bp)	3.83	11	0	61	-71	-64	-66
	10Y (yield bp)	4.66	13	38	95	1	-2	-23
Croatia	EUR/HRK	7.34	0.1%	-0.2%	0.1%			
	3Y (yield bp)	4.23	8	22	-31	-31	-21	66
	10Y (yield bp)	5.25	12	28	n/a	60	71	n/a
Hungary	EUR/HUF	251.91	0.8%	-1.6%	-0.2%			
	3Y (yield bp)	7.14	2	19	-41	261	270	368
	10Y (yield bp)	6.85	10	32	44	221	223	276
Poland	EUR/PLN	3.82	0.6%	-1.1%	0.4%			
	3Y (yield bp)	5.11	12	20	47	58	66	78
	10Y (yield bp)	5.53	13	32	36	89	103	124
Romania	EUR/RON	3.24	0.9%	1.1%	4.4%			
Slovakia	EUR/SKK	34.26	0.1%	-2.1%	0.6%			
	3Y (yield bp)	4.47	9	32	9	-7	-7	50
	12Y (yield bp)	4.87	20	39	56	21	21	38

Source: Reuters, Bloomberg (+ means strengthening / - means easing of the exchange rate)

Trading Ideas

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Positions

#	Recommendation	Date of opening	Instruments	Entry values	Today's values	flat P/L (%)	flat P/L inc. carry (%)	P/L p.a. inc. carry (%)	Target values	Target P/L flat inc. carry (%)	Target P/L p.a. (%)
12	short EUR/SKK	04/06/07	6m Bribid/ 6m Euribor	3,9/ 4,28%			-1.0%	-32.2%	32.8	3.2%	6.4%
			EUR/SKK	33.92	34.25	-0.96%					
13	short EUR/CZK	07/06/07	12m Pribid/ 12m Euribor	3,21/4,47%			-0.7%	-31.5%	26.8	4.7%	4.7%
			EUR/CZK	28.39	28.58	-0.65%					

Rationale at inception

12) The Slovak koruna might soon become an attractive buy. While we do not rule out short-term weakening, we see these eventual dips into the 34.0-34.2 EUR/SKK range as a good opportunity to buy the Slovak currency, as we expect it to strengthen in the euro run-up. We advise profit taking at 32.8 EUR/SKK, as the previous ERM-2 band at 32.69 EUR/SKK could be defended by the central bank. The expected time horizon is six months.

13) EUR/CZK is currently by roughly 0.30 CZK weaker that we estimate its fundamental level should be. Even though we expect milder appreciation this year than what we have seen over previous years, we still see Koruna strengthening owing to the convergence of Czech economy and real and monetary flows. Our prognosis for July 2008 sees CZK at 26.80 and hence we recommend entering long positions in CZK against EUR.

Closed positions

#	Recommendation	opened	closed	P/L inc.carry
1	long: PLGB10y / 4m Euribor	16/09/2005	27/10/2005	-3%
2	short: CZGB15y / 6m PRIBID	16/09/2005	21/11/2005	5.97%
5	long: SKK/CZK	09/11/2005	20/01/2006	1.90%
3	short EUR/SKK	29/09/2005	07/02/2006	3.45%
4	EUR/PLN options	21/10/2005	28/07/2006	-2.69%
6	SKK/CZK long	23/03/2006	30/10/2006	2.16%
7	FRA 9*12 short	28/07/2006	08/11/2006	8bp
8	long HUGB 5y	13/10/2006	29/01/2006	5.70%
9	short CZGB/ long GDBR	09/01/2007	27/02/2007	1.80%
10	long CZK/EUR	27/02/2007	19/03/2007	2.30%
11	short CZGB/ long PLGB	07/03/2007	10/05/2007	5.5%

To be included in the trading ideas mailing list, please, mail to rainer.singer@erstebank.at, subject: trading ideas

Forecasts

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Capital markets forecasts

	Exchange Rate vs EUR												Intervention Rate					
	CZK	Forward	HRK	Forward	HUF	Forward	PLN	Forward	RON	Forward	SKK	Forward	CZ	HR	HU	PL	RO	SK
Spot	28.6		7.33		252		3.82		3.24		34.3		2.75	3.50	8.00	4.25	7.25	4.25
Sep-07	27.7	28.5	7.25	7.25	251	254	3.80	3.83	3.29	3.28	33.1	34.3	2.75	3.50	7.50	4.25	7.25	4.25
Dec-07	27.6	28.4	7.40	7.40	253	256	3.75	3.83	3.27	3.30	32.5	34.3	2.75	3.50	6.75	4.50	7.00	4.25
Mar-08	27.2	28.3	7.40	7.40	255	258	3.74	3.83	3.25	3.32	32.4	34.2	3.00	3.50	6.50	4.75	6.75	4.25
Jun-08	26.9	28.3	7.30	7.30	255	259	3.73	3.83	3.25	3.33	32.5	34.2	3.25	3.50	6.50	5.00	6.50	4.25

	3m Money Market Rate										10y Govt. Yield				
	CZ	Forward	HU	Forward	PL	Forward	RO	Forward	SK	Forward	CZ	HR	HU	PL	SK
Spot	2.92		7.80		4.47		7.25		4.25		4.65	5.25	6.80	5.53	4.79
Sep-07	2.75	3.24	7.50	7.53	4.60	4.71	6.85	7.00	4.30	4.25	4.15	5.00	6.40	5.25	4.70
Dec-07	3.13	3.54	6.80	7.08	4.85	4.94	6.55	6.62	4.30	4.27	4.50	5.10	6.10	5.20	4.70
Mar-08	3.30	3.74	6.50	6.83	5.05	5.14	6.45	6.52	4.30	4.33	4.50	5.00	6.00	5.30	4.80
Jun-08	3.38	3.74	6.40	6.75	5.15	5.05	6.35	6.33	4.30		4.75	4.90	5.90	5.40	4.80

Long-term forecasts

GDP growth (%)	2005	2006	2007f	2008f
Czech Republic	6.1	6.1	5.1	3.5
Croatia	4.3	4.8	4.6	5.0
Hungary	4.2	3.9	2.5	3.2
Poland	3.6	6.1	6.2	5.6
Romania	4.4	7.7	6.5	6.3
Slovakia	6.0	8.3	8.9	6.5

C/A (%GDP)	2005	2006	2007f	2008f
Czech Republic	-2.5	-4.0	-3.5	-2.7
Croatia	-6.4	-7.6	-8.6	-9.4
Hungary	-6.9	-5.8	-4.5	-4.1
Poland	-1.7	-2.3	-2.6	-3.0
Romania	-8.7	-10.3	-11.4	-11.4
Slovakia	-8.5	-8.4	-3.6	-2.4

CPI (%), eoy	2005	2006	2007f	2008f
Czech Republic	2.2	1.7	3.3	3.4
Croatia	3.6	2.0	3.0	3.0
Hungary	3.3	6.5	5.2	3.4
Poland	0.7	1.4	2.5	2.6
Romania	8.6	4.9	3.7	4.2
Slovakia	3.7	4.2	2.8	3.3

Budget Balance (%GDP)	2005	2006	2007f	2008f
Czech Republic	-2.2	-3.3	-4.0	-3.1
Croatia	-4.2	-3.0	-2.8	-3.0
Hungary	-7.8	-9.2	-6.5	-5.0
Poland	-4.3	-3.9	-3.4	-3.4
Romania	-0.8	-1.6	-2.8	-2.7
Slovakia	-2.2	-2.3	-1.7	-1.7

Diaries

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Looking ahead

Country	Date	Release/event/figures	Our expectation	Consensus*
Czech Republic	June-18	Retail Sales (04/2007)		10.00%
Croatia	Jun-20	Industrial production	6.2% y/y	
	Jun-21	Unemployment rate	15.3%	-
Hungary	June-19	Nominal wages (04/2007)	7% y/y	
Poland	Jun-19	Average wage (05/2007)	8,2% y/y	8,2% y/y
	Jun-20	Industrial output (05/2007)	16,5% y/y	10,7% y/y
	Jun-20	PPI (05/2007)	2,2% y/y	2,4% y/y
	Jun-21	Minutes from CB meeting	16,0% y/y	15,6% y/y
	Jun-21-25	Retail sales (05/2007)		
Romania	Jun-20	Current account (April)	EUR 1,281 million	
Slovakia	No data releases scheduled			

**Sources: Bloomberg, Reuters*

Auction diary

Country	Code	Auction-date	Pay-date	Maturity	Cupon	Offer	Forecast
Czech Republic		Jun-20	Jun-25	2009-Nov-27	3.25%	CZK 6bn	-
Hungary		Jun-19	Jun-27	Sept-26-2007	-	HUF 30bn	7.70%
		Jun-21	Jun-27	Aug-24-2010	6.25%	HUF 75bn	7.15%
		Jun-21	Jun-27	Nov-24-2023	6.00%	HUF 20bn	6.55%
Poland		Jun-20	Jun-22	2012-Apr-25	4.75%	PLN 1.0-2.0bn	-
Romania		Jun-21	25.06.2007	3Y	6	RON 100 mill.	710.00%
Slovakia		No auction scheduled					

Major markets

Sentiment indicators to stabilize

Next week, the two most important sentiment indicators will be released. ZEW will be reported on Tuesday; it is expected to show a further increase in the expectation component and a stable high reading in the current assessment component. The Ifo survey will be released on Friday and is expected to move sideways, more or less. Aside from the ZEW expectation component, the other indicators are already at very high levels, pointing to a solid expansion. Therefore, a stabilization of these indices already confirms our expectation of further impressive growth.

After series of releases today, calendar for next week is empty

For the US, the release calendar is virtually empty for next week. However, today's releases could give the market some guidance, albeit within a technical framework. CPI has the potential to boost the market in either direction. This week's yield highs could be tested again, or the bond market could recover more of the recent losses. Net foreign purchases of US securities, industrial production and the Univ. of Michigan Index should be of lesser importance, but could dampen or reinforce any direction the market takes in response to technicals and CPI data. For our view on recent events and our short- and medium-term outlook for majors and CEE markets, we would like to refer you to the special section of these Insights on page 6.

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Forecasts

	Intervention Rate		3m Money Market Rate				10y Govt. Yield		FX	
	EUL	USA	EUL	Forwards	USA	Forwards	EUL	USA	EUR/USD	Forwards
Spot	4.00	5.25	4.15		5.36		4.68	5.24	1.331	
Sep-07	4.00	5.00	4.35	4.40	4.90	5.38	4.50	4.80	1.33	1.335
Dec-07	4.25	4.75	4.35	4.60	4.60	5.40	4.60	4.70	1.33	1.339
Mar-08	4.25	4.50	4.30	4.70	4.30	5.40	4.70	4.70	1.30	1.342
Jun-08	4.25	4.25	4.30	4.70	4.30	5.45	4.70	4.70	1.30	1.344

Outlook for majors and CEE after recent market jitters

US yield increases exaggerated

To start with the most important, we think that recent US yield increases were exaggerated. Neither our expectations for economic growth nor for inflation support the current yield level. We see the recent more favorable economic data as a counter-movement to the very weak growth in 1Q and the poor start to the second quarter. This data therefore does not show the beginning upswing of the US economy; instead, we expect continued moderate (below potential) growth during the coming quarters. The main reason is that - while investment should stabilize - private consumption growth should slow, as households will draw to a lesser extent on their assets (homes) to finance consumption since housing prices will at best stagnate. Secondly, job growth has already peaked and disposable income will get less of an impetus form this side in the period ahead. We also expect core inflation to slow, as the developments of housing prices will dampen the inflation rate, especially when considering the high weighting of this component.

We expect a gradual decline of yields

We think that markets are currently focusing too much on the risks mentioned by the Fed - namely that inflation may not recede, as expected. But what if the core scenario of the Fed - lower inflation and continued moderate growth - does materialize (which is what we think)? In such an environment, we expect the Fed to start cutting interest rates, even if this is in stark contrast with the current market assessment. However, with our outlook for fundamentals, everything points to lower interest rates and correspondingly lower yields.

Whether the upcoming indicators already support this scenario remains to be seen, but in 3Q we definitely expect a change of sentiment on the US bond market. For the short term, it is difficult to judge if yields have already peaked. The market's reaction to the recent better than expected retail sales numbers point in this direction; after the release, yields declined, which points to an oversold market. The next litmus test for the stabilization of the market will be today's CPI release, which, in the current market environment, bears risks in both directions. A higher number would likely trigger a yield rise, just as a lower number would push further in the direction started on Wednesday.

Short-term consolidation auf EUR-bonds seems probable

Euro government bonds were able to stabilize at mid-week, again following the US Treasury market. Taken together, the correction on the Euro bond markets was significantly smoother than in the US, resulting in a widening of the yield gap from 40bp to 60bp for 10-year government bonds. The yield curve steepened to a 10Y - 2Y time spread of 15bp.

Euroland interest rate expectations increased in the run up to the ECB Council meeting in June and stand at 4.5% for the end of the year at present, while we still see a chance of a peak at 4.25% in the repo rate. Economic sentiment did not change over the last few weeks, expecting a pickup in consumer spending on the back of healthy employment gains and improving sentiment towards the service sector. At the same time, the industrial sector seems to have peaked and shows signs of consolidation.

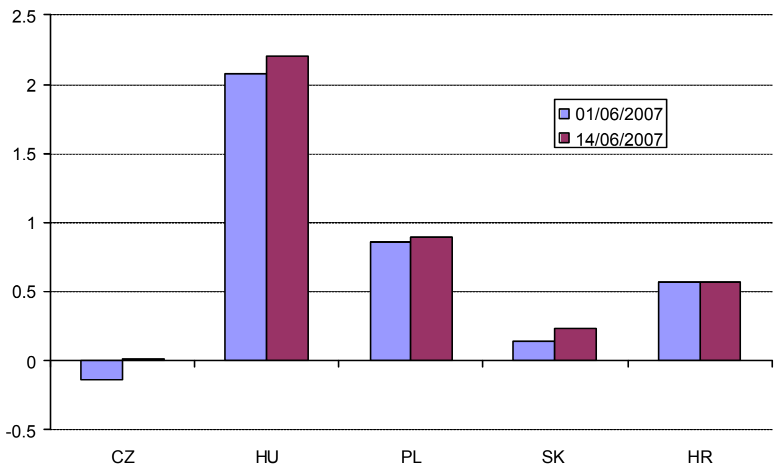
Risks mainly seen for longer EUR maturities

In the short term, we see a good chance of a consolidation at the current yield level of around 4.65% for 10-year German bonds. However, in the longer run, there seems to be little scope for significantly lower yields, as the still flat yield curve does not offer a sufficient liquidity premium at an only slightly restrictive level (especially if the 4.5% in the repo rate materializes) of key interest rates. While our core scenario is for yields to remain at current levels, the main risk for longer-term bonds seems to be a decline of excessive liquidity. The issue of asset price inflation is not new, of course, but has become more topical in the last few weeks, as interest rates around the globe (except in the US) have been rising and warnings from central bank officials in this direction have become common. So, longer-term bonds could remain exposed to an increase in risk premiums. In contrast, short- to medium-term bonds already offer an attractive risk/return ratio, in our view (see Euro-Visions, June 2007).

After recent jitters, our outlook for CEE markets remains favorable

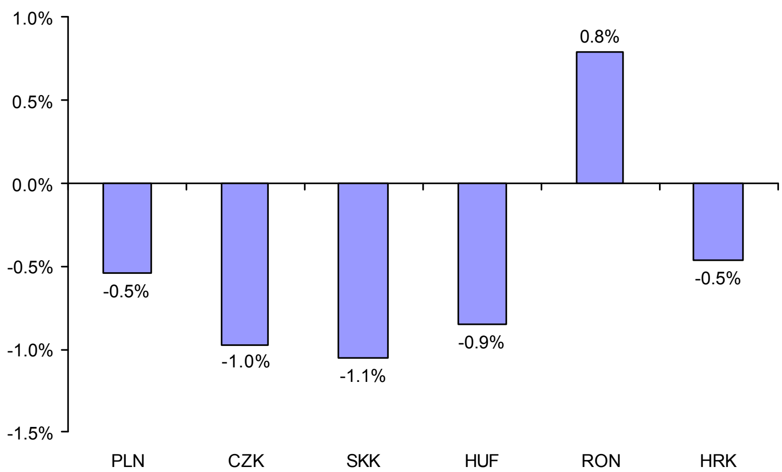
CEE markets weathered the recent storm on global markets pretty well. While yields increased, spread changes have been modest in total. Hungary, the usual top candidate for sensitivity to global jitters, has seen spread increases by 15bp since the beginning of June. Polish and Croatian spreads were more or less unchanged; in Slovakia, yields went up by about 10bp more than in Euroland. The development on the Czech market was surprising, as it had proven immune to regional volatility in the past. Yields there were 15bp below Euroland's at the beginning of June, but now stand at the same level.

10y Spreads vs. Euroland in bps



The situation was similar for currencies. The currencies of the fundamentally balanced economies of the Czech Republic and Slovakia lost just as much as the risk appetite-sensitive Hungarian forint and more than the Polish zloty. The Romanian leu was unimpressed and firmed further.

Exchange rate change, Euro vs. CEE Currencies (1.June - 15.June)



We think that the weakening of the two korunas is not justified and have already issued trading ideas in the previous week. With the benefit of hindsight, this was a bit too early, but we remain confident on the CZK and SKK appreciating during 3Q. The same is true for bond markets. As soon as the situation calms down globally, the individual fundamentals point to lower yields.

Veronika Lammer, Rainer Singer

Croatia

Exchange rate and bond market under pressure

Exchange rate movements have surprised somewhat in the last two weeks, as the exchange rate depreciated slightly, due to solid demand from the corporate sector (to finance imports) and from institutional investors as well. However, the extent of the depreciation was mild (<0.5%) and the exchange rate moved in the upper part of the 7.30-7.35 range. The bond market also posted losses in terms of yield, while spreads remained roughly unchanged or even slightly narrowed. The kuna bond market continued to suffer from rather low market liquidity, which was boosted somewhat by major market movements. The long end of the kuna yield curve (10Y issue) stands considerably above the rest of the curve, due mostly to the bond issue announced for July, as the market is going for the more favorable pricing of the issue (the yield is usually determined as the yield average in the period prior to the bond issue). Yields in the upcoming period (especially for FX-linked issues) will be determined by movements in the Eurozone, while the pure kuna market will likely be under some pressure from the ongoing low liquidity.

CPI in line with expectations

May CPI inflation came in as expected, posting 2.2% y/y and 0.5% m/m increases. As for the CPI structure, m/m inflation pressures came from clothing and footwear (+2.2% m/m) and transportation prices (+0.8% m/m), as was broadly expected. Also, tobacco prices (+2.9% m/m) and food and non-alcoholic beverages (+0.2% m/m) contributed to the increase of consumer prices. Hence, the outlook remains unchanged for 2H07 - the base effect should disappear and observations in y/y terms should pick up (we expect figures in the region around 3.0%). Average inflation in 2007 is expected at around 2.5%.

12% credit growth limit calculation modified

Last week, the CNB modified the calculation for the 12% p.a. credit growth (please recall, any credit growth beyond that level is subject to the obligatory purchase of CNB bills in the amount of 50% of excess credit) by separating balance sheet and off-balance sheet items (these will now be looked at separately). Hence, banks will lose part of their maneuvering space in terms of structuring their business. Other than that, the CNB Council meeting held this week brought the usual wording, which did not actually reveal any possible new monetary steps.

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Czech Republic

New era for CZK, or 'just' digression?

During the recent turmoil, the EUR/CZK broke through 28.50. What's next? Putting on our fundamentals glasses, we can see an improving current balance, the economy still growing at a fast pace and a hawkish CNB. Domestic factors play in the appreciation direction and my estimates of the recent fundamental level is between 27.7 and 28.0 EUR/CZK. Sticking to fundamentals, I see the EUR/CZK at 27.4 at the end of this year. However, what if we change to our technical pair of glasses? Breaking 28.50 implies further weakening pressures, with a weak support level at 28.65 and strong ones at 28.85 and 29.10.

In my view, the recent global uncertainty (which has increased the risk premium) and the CZK seasonality (involving a worsening of the trade balance and dividend outflow during the summer) will not change the CZK's direction in the one- or two-month horizon. However, the usual seasonality assumes a turnaround in August and another appreciation wave during the last months of the year. Our expectations for the global markets (see the US part) lean in the same direction. By the way, I see similarities between the current developments and last year's May-June correction, which turned around in August.

I believe we are currently witnessing a digression and I am still optimistic on the CZK in the medium term. However, the short-term strategy should be based more on range trading. Therefore, my recommendation is to take advantage of recent developments to build a long-term long CZK position.

The weaker CZK heightens the risk of earlier rate hikes (which could come as early as July). We expect more hawkish comments from the CNB. Please recall, our estimates show that a 3% weakening of the koruna necessitates a rate rise of 100 basis points.

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Hungary

CPI inflation rose 8.5% y/y in May

Consumer prices rose 0.8% m/m in May, while the 12-month inflation rate slowed down to 8.5% (from the 8.8% published for April). The May y/y figure was slightly lower than my expectation of 8.6% and was in line with the market consensus. For the details, see our Short Note published June 12. The main point is that May inflation was basically driven by (seasonal) food and administrative services prices, as had been broadly expected. The high monthly increase in food prices was due to the strong rise in seasonal food prices, while the monthly inflation of services can basically be explained by the 16.1% m/m average increase in long-distance travel prices. At the same time, price increases among core factors remained relatively moderate. The formation of the seasonally-adjusted core inflation supports this view, as it rose by 0.2% m/m and 5.7% y/y in May (after 5.9% y/y in April).

The question now is whether the May CPI figure in itself will be enough for the central bank to be persuaded about declining inflation risks. Keep in mind that, after keeping the base rate on hold last month, the main message of the central bank was that the Monetary Council would like to see more information about inflation trends before starting rate cuts - despite the basically favorable tone of the latest Inflation Report. Thus, we tend to believe that the delay in starting the rate cutting process could be more than one month (compared to May), unless the coming wage figures (due on June 19) show spectacular improvement (from the point of view of inflation). On the other hand, the central bank should of course watch the global risk appetite factor, which has worsened compared to one month ago. Given the above factors, after the postponement of the rate cut in May, we think that a start of the rate cutting process would be more credible one or two months from now.

Short-term consolidation depends on US yield formation; space for gains in mid run still expected

The FX and FI markets have remained fragile during the week. This week's movements have reflected changes in the 10Y US bond yields; thus, the volatility on both markets was higher than usual. However, there is no sign of any collapse, with the forint reaching the 255 EUR/HUF level in the middle of the week and firming to around 252 EUR/HUF on Friday morning. In the very short run, the US CPI inflation data (due this afternoon) will be the decisive factor concerning the direction of the exchange rate. One should note, however, that the forint could be seen as strong below 260-265 EUR/HUF, and the exchange rate currently seems unlikely to break these levels for any longer period of time.

For the short term, as it is difficult to judge if US yields have already peaked, short-term consolidation on domestic markets depends on US yields and upcoming US macro data. The usual lower liquidity on markets during the summer months does not suggest strong improvement in the coming period. However, we have not changed our mid- and long-term forecasts concerning the exchange rate and bond yields. As we expect a change of sentiment on the US bond market in 3Q, we think that this could again make high-yielding emerging markets more attractive, given their promising mid-term fundamental outlook.

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Poland

Inflation remained stable in May, net inflation likely up…

Contrary to market expectations, inflation failed to decline in May. Consumer prices increased by 0.5% m/m, which implies a yearly inflation rate at 2.3%, the same level as witnessed in April. This was higher than the market anticipated (median at 2.1%) and also surpassed our more pessimistic forecast (2.2%). The detailed structure shows that base effects kicked in, just as expected. Even though prices of both food (a category with a relatively big weighting) and fuels increased in comparison to the previous month, this rise was smaller than that seen a year ago. Hence, their annual dynamics moderated, exerting a dampening pressure on the overall inflation rate. Net inflation represented the main reason behind the discrepancy between our forecast and the actual figures. According to our calculations, it sped up to 1.7% y/y, from the 1.5% y/y witnessed in April. The hike in housing prices and the acceleration in the dynamics of several service items (including recreation and culture) were the main culprits.

…fitting picture painted by other data and making October rate hike more likely

Even though the headline inflation in May did not differ dramatically from our expectations, its structure pointed to a notch higher growth of demand-led items than we had originally assumed. We still stick to the opinion that inflation will slow down further in the summer months, as base effects will continue to be in play. However, the scope of decline is likely to be lower than the central bank's latest prognosis projected (it foresaw a dip of the inflation rate to below 1.5%). A less favorable inflation structure, together with other pieces of data released over the previous month (growth of unit labor costs in the economy in 1Q, stronger household consumption) motivated us to alter our key interest rate outlook a bit. We currently see a scenario involving one additional 25bp rate hike this year as the most likely. As inflation will be in a downtrend over summer, we regard October (when the new quarterly inflation prognosis will be published) as the best timing from the communication point of view. However, we do not change our longer-term outlook and still expect the key rate to stand at 5.0% and 5.75% at the ends of 2008 and 2009, respectively.

Zloty moving with region, but should gradually stabilize and return to appreciation track

The decline in the risk appetite and the turbulence on major markets did not leave the Polish currency unscathed. As had already been signaled by technical analysis, the zloty became overbought following the rally to a nearly five-year high of 3.73 EUR/PLN at the beginning of May. The gloomier atmosphere in the region simply represented a trigger for the correction that had been hanging in the air. Unless global developments provide a reason for an additional spike in risk aversion, consolidation of the EURPLN exchange rate is likely in the short term. There are two support levels that should be difficult to break and which limit the scope for further weakening - 3.84 (the lower end of the consolidation band from the beginning of the year, upper edge of the 1-year trend channel) and 3.85 (big figure, edge of Bollinger bands, Fibonacci level, 200-day moving average line). As there are no major changes to our longer-term view on major markets (i.e. start of a cutting cycle in the US this year and the EMU close to the peak of its hiking cycle), we think that Polish fundamentals will again come to the forefront later on. As we already described in last week's Insights, this should provide reasons for the zloty to appreciate to 3.75 EUR/PLN by year-end (with risks tilted toward even stronger levels).

Similarly to the currency, bonds also suffered losses. Since the beginning of May, the yield curve underwent an almost parallel shift of 20-25 basis points. Only about half of this move is attributable to wider spreads, while the other half is simply the reflection of an upward move in the yield curve of the Eurozone. As the domestic issuance/demand ratio is still supportive (with budgetary development much better than expected and government borrowing needs subsequently lower), we bet on slightly declining spreads at the long end and middle part of the curve by year-end. However, the resumption of monetary policy tightening and the prospects of continuation in the hiking cycle in the years ahead will push the shorter tenors up further. Thus, the curve will become flatter by December.

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Slovakia

HICP inflation at record low, inflation criterion to be met soon

Consumer prices stayed flat in May on a monthly basis, which means a 2.3% annual increase. The figure was lower than our estimate and the market forecast (both at 2.5%). The increase in the prices of food did not repeat to the same extent as was seen in April, alleviating the pressure from the CPI index. Also, prices in healthcare declined, compensating for the higher prices of fuels and imputed rents. In line with this, HICP inflation also scored better than forecasts, as it declined to 1.5% y/y, which is its record low. The central bank said that the figure was lower than its prediction, but it expects an uptick in June. Our own HICP forecast for June is 1.6-1.7% y/y. On a 12M basis, average inflation reached 3.2%, slightly above the Maastricht criterion (currently at 2.9%, although the coming months will probably bring a decline of the limit), which Slovakia should start meeting already in summer. We regard the release as neutral for monetary policy and expect the NBS to follow ECB moves (i.e. no rate change until the ECB hikes to 4.25%).

Trade balance improved further

In other data, the April foreign trade balance posted a SKK 1.2bn deficit. This is a significant improvement over a year ago, when the deficit stood at SKK -9bn and the 12M cumulative deficit narrowed from 4.2% in March to 3.7% of GDP in April. Further improvement to around 2% is expected by the year-end (thanks to increased exports of automobiles and electronics) and should be one of the key drivers behind this year's strong GDP growth.

Koruna currently subject to regional mood

This week, the koruna moved within a range of 34.1-34.4 EUR/SKK, hovering near the middle of the range on Friday morning. At present, the development is influenced by the overall sentiment on the Central European markets, which we expect to continue in the coming days (we see no clear short-term trend at present). However, once the US rate expectations moderate (as we expect), the koruna should renew its strengthening.

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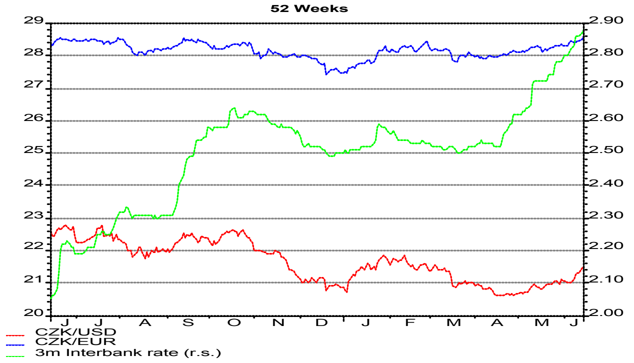
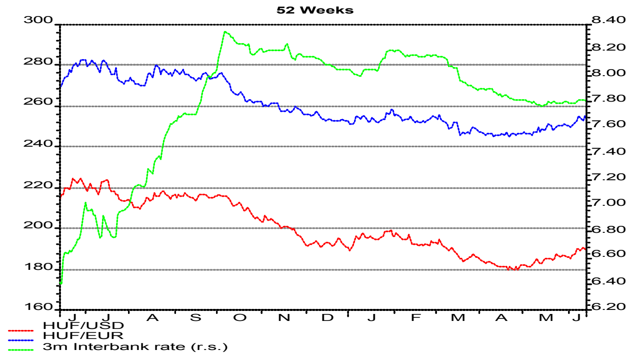
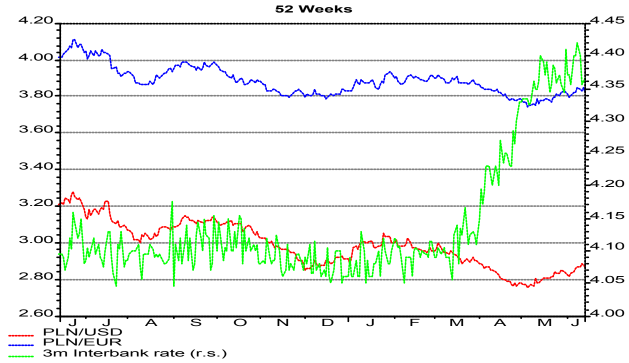
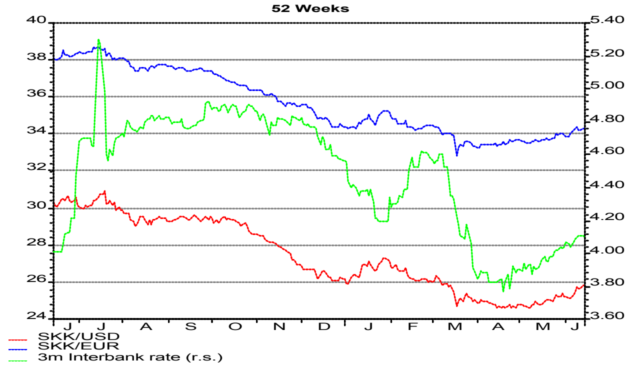
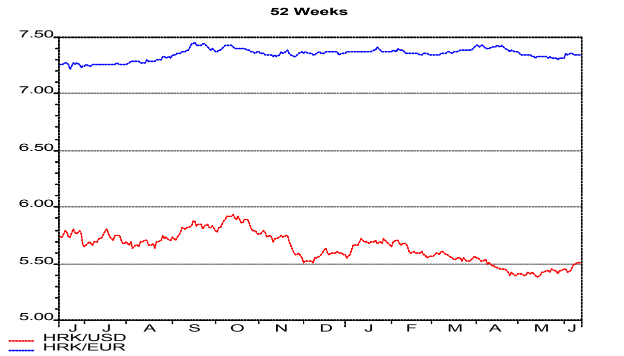
Exchange rates and interest rates (52 weeks)

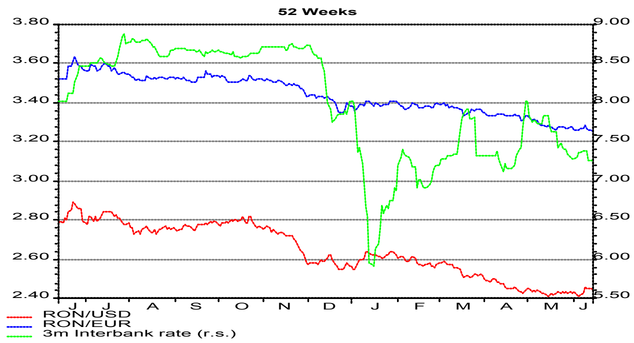








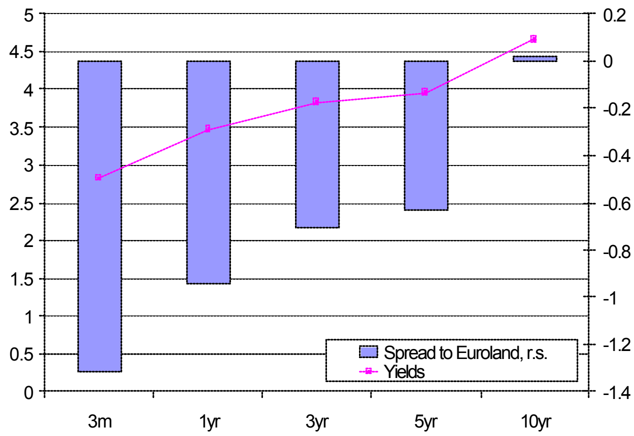




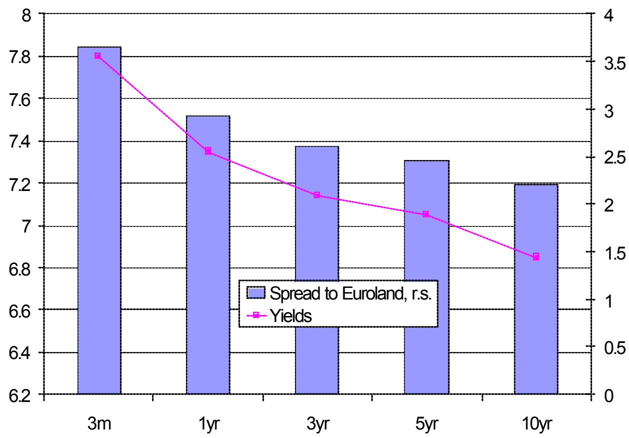
Source: *Datastream*

Benchmarks

Czech Republic



Hungary



Appendix Forwards

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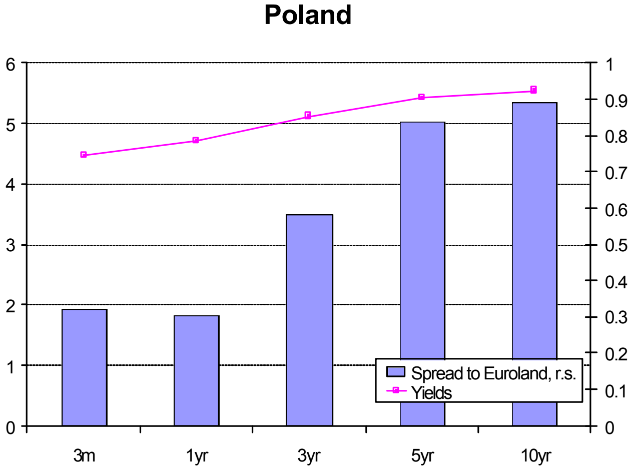

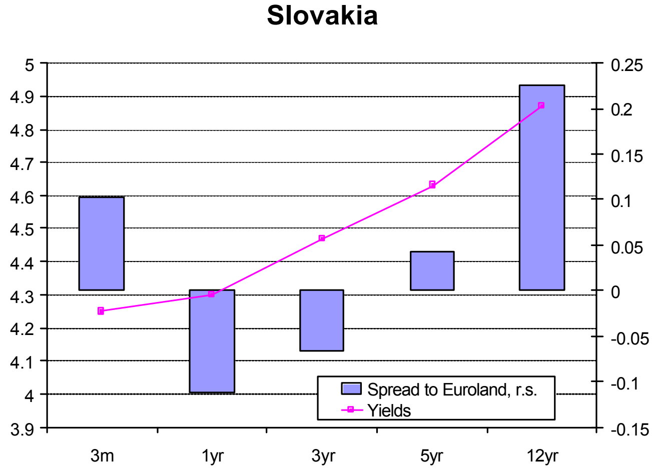

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