

CNB preview: Looking ahead matters despite the uppish January

The Czech National Bank is likely to reduce rates on Thursday while getting January's inflation print on the same day. This is the first flash CPI estimate at hand, with January showing strong price moves within a wide range. However, given the inflationary pressure in agriculture, January alone does not decide this year's inflation profile



The Czech National Bank in Prague

Inflation set to slow down, but upward risks are behind the scenes

Headline inflation likely softened in January, which will be shown in the first flash CPI estimate, with 2.5% as our best guess. In contrast, core inflation likely picked up in the same month, driven by continued price growth inertia in the service sector and more potent annual rent dynamics. Food prices presented the main downward surprise in December's reading across categories, be it food, alcoholic beverages, or tobacco. We believe that part of this price decline was linked to Christmas discounts that will be compensated over the coming months, making food a potential driver of January's consumer prices. Imputed rents are another candidate for an upward surprise for January, as the growth in residential property prices gained traction. Our model, which includes property prices, nominal wages, producer prices, and loans to households as explanatory variables, indicates that imputed rents annual growth is set to pick up to 3% or above in January, from 1.7% at the year-end, yet also affected by a positive base effect.

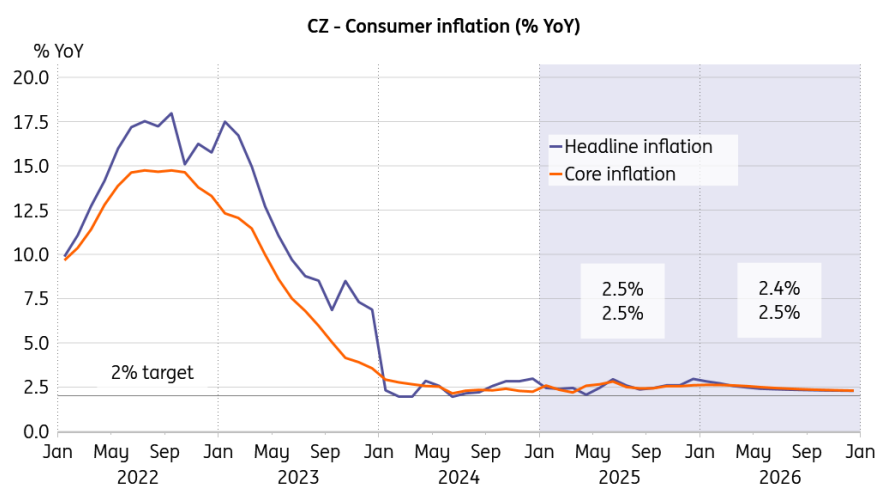
Headline rate about to moderate in January

Jan-25	% YoY	% MoM
Headline	2.5	1.0
Core	2.6	0.5
Food	3.5	2.6
Regulated	0.3	-0.4
Fuels	-0.6	1.6

Source: ING, Macrobond

If there is no nasty upward surprise in January's CPI reading, the CNB will likely resume its cutting cycle to boost the struggling supply side of the economy and reduce the policy rate to 3.75% from 4%. The governor, Ales Michl, was unusually clear about this, according to his latest comments. At the same time, the range for the monthly change in inflation in January is between 0% and 6%, with a 1.5% long-term average. Our 1% for the monthly change of the headline rate is a decent take, but there is quite some space for variable outcomes. We include the announced reductions in electricity end prices by major distributors in the regulated prices outlook. However, the expected but hard-to-quantify increases in heating prices, water and garbage collection fees, and some other charges might at least partially offset the effect of lower electricity prices.

Both headline and core rate to remain above the target



Source: ING, Macrobond

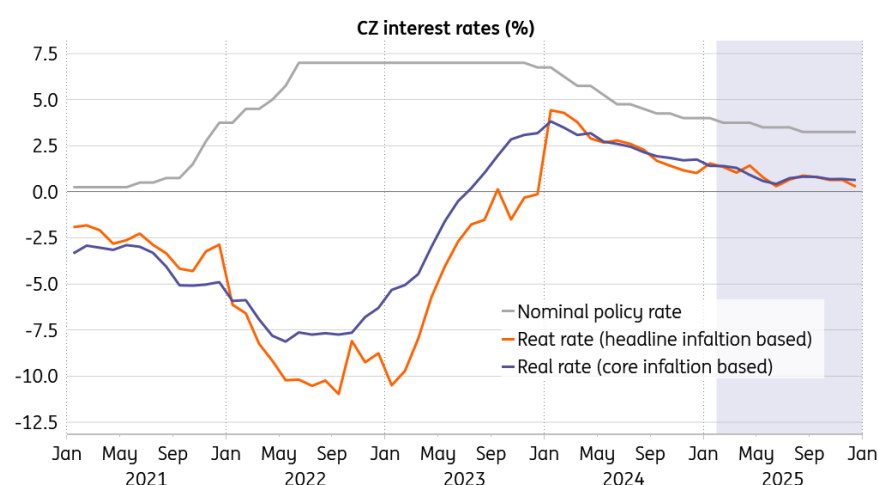
December inflation came in below both market and CNB expectations. We see the new CNB forecast to come up with a softer inflation outlook for this year, just a tick below the current 2.6% for the whole year, mainly driven by an outlook for weaker price growth in the food segment.

Meanwhile, the performance of the economy is in line with the CNB's expectations, but the worse situation and confidence in the industry might imply a reassessment toward a somewhat milder recovery outlook for this year. The koruna against the euro is almost 1% stronger than in the CNB assumptions, and euro rates are almost a quarter percentage point below the previous forecast. Standing alone, all of this would contribute to a more dovish outlook for the rates path and make the reduction on Thursday more likely. At the same time, the wage dynamics came in stronger than expected, providing fuel for further consumption gains.

Rising production costs to be taken seriously as margins shrink

Looking ahead, we see some inflationary pressures gaining momentum, mainly from the more potent prices of Brent crude oil and natural gas prices for Europe as compared to the December lows, rising prices of emission allowances, along with a weaker koruna vis-à-vis the dollar. Rising input costs amid tough competition driven by limping demand from European trading partners and tough overseas rivals will increase pressure on profit margins in the industry. Well, and as we are aware, the cascade of negative feedback can evolve from here onward. Companies would think twice before granting robust wage increases, which would pressure household budgets. Layoffs across the Czech industry have been ongoing for some time. Add the elevated general uncertainty and diminishing prospects for the labour market: the implication is households curtailed spending, even for precautionary reasons, initially. That is not good news in a situation where the consumer has predominantly driven the recent expansion.

Nominal and real rates are likely to decline



Source: CNB, ING, Macrobond

Considering this type of accumulated inflationary pressure, we expect the CNB to proceed carefully toward the terminal rate in a cut-skip-cut-skip modus operandi, with the terminal rate of 3.25% likely reached at the August meeting. However, if inflation pressures materialise in the food and energy domain, 3.50% could also become the final destination for the policy rate.

Czech economic recovery so far on track

Czech real GDP gained 0.5% quarter-on-quarter and 1.6% year-on-year in the last quarter of 2024. The Czech economy is estimated to have expanded by 1.0% in 2024. The quarterly gain was

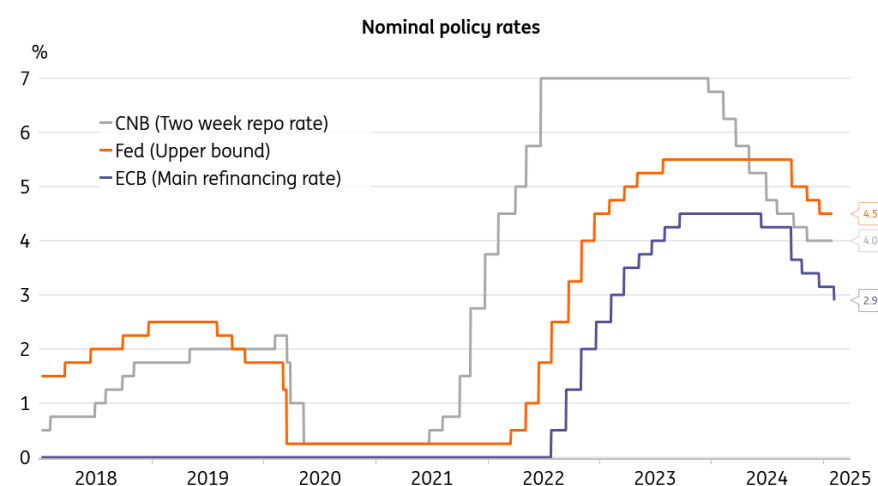
propelled by domestic demand, especially by more potent household expenditure, while foreign demand declined. Employment was flat from the preceding quarter and up 0.4% YoY.

The GDP reading is in line with our projection and assessment of the economy. The question is whether and when the layoffs in the industry start to be tangible in aggregate income and consequently in the diminished willingness or ability of households to drive spending. The worries of households are already seen in the slump in consumer confidence at the beginning of the year.

The free, the constrained, and those between the two

The CNB does not proceed with its decision in a vacuum, so the moves of the Fed and the European Central Bank are, in any case, entering the CNB's decision function. The Fed kept rates unchanged at the recent meeting, taking a rather hawkish stance in light of a robust growth outlook, solid labour market, and resilient inflation. In contrast, the ECB reduced rates by another quarter percentage point in an attempt to support the limping eurozone economy. One could say that the Fed is currently free to decide as it pleases, with the double mandate for price stability on the one side and full employment on the other.

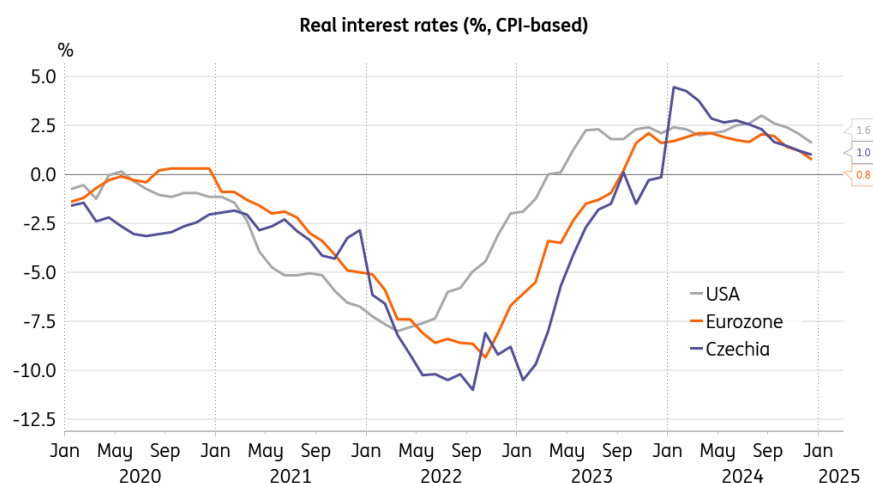
Fed pauses, ECB cuts, CNB likely to cut



Source: Macrobond

Meanwhile, the ECB seems to be in a schizophrenic position, pressured by a low growth outlook for the eurozone on the one side and a risk of deflation in some of the major countries on the other. It seems risky for the ECB to drift close to zero with real rates once again. So, if things evolve in the right direction from the growth perspective, with (i) Germany coming up with a credible and bold economic plan after the election and starting to bottom out and (ii) France getting back on track in terms of fiscal development, it seems that the ECB would not need to get with the nominal rate below 2%. The alternative is that things get even more difficult in Germany and France. The ECB's rate below 2% looks like an option then, but maybe as the onset of another *whatever-it-takes* moment.

Real rates come close to the zero-bound



Source: Macrobond

The ECB terminal rate is not a make-it-or-break-it for the CNB, nevertheless the rates differential matters, of course. It has a direct impact on the attractiveness of the currency, especially when considered in real terms. Still, it seems that the CNB would not follow suit, should the ECB decide – for any reason – to slash its nominal rate below the 2% threshold, with the euro real interest rate likely drifting into negative territory once again. Given the Czech economic situation and inflation outlook, the CNB stands somewhere between the Fed and the ECB. The odds are that the CNB will not be willing to get even close to the sub-zero-real-rates modus operandi in the foreseeable future. This conviction, also supported by the proclamations of the CNB governor Ales Michl, brings us to take the 3.25% as the ultimate landing runway for the Czech base rate.

Our market view

The koruna saw some weakness after weaker-than-expected inflation numbers for December but quickly recovered along with the entire CEE region after the global story brought some relief and a rebound in EUR/USD. However, the local story is heading in a dovish direction and we have been seeing divergence between rates and EUR/CZK valuations for some time. Still, market pricing points to more cuts and we think EUR/CZK should be more around 25.300-400 already. Moreover, if the CNB delivers a rate cut with a dovish forecast, the market may overreact and start pricing even more rate cuts. Therefore, we believe that next week will create pressure on FX and we will see a weaker CZK in hopes of more rate cuts, possibly as early as the March meeting. However, we believe that the CNB will be more cautious despite favourable inflation numbers in January and next month and the market will be surprised later on the hawkish side, which would bring the CZK back to stronger levels.

In the rates space, the market has basically priced in an entire rate cut for the February meeting in recent days and terminal rates are headed somewhere slightly below 3.25% at the end of this year. As mentioned, we expect a dovish impact on the market next week despite the hawkish tone of the central bank, which will likely lead to a further repricing of rate cuts. We think moving the terminal rate to 3.00% should be relatively easy for the market, but going forward pricing will be more cautious given the negative experience of

the past year. If this is the case, we prefer to reverse direction and look at CZK rates from the payers side given the balance of risks. We believe the February cut does not signal a switch in CNB thinking and inflation risks may instead switch the central bank to be more hawkish given the approach to a neutral rate range. At the same time, we believe the IRS curve still has some potential for steepening, but again this is a view only for next week and we may see some correction in dovish pricing later.

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