Czech National Bank Preview: Day of Reckoning

We expect the CNB to start the cutting cycle with a 25bp move at the November meeting. The central bank will also unveil a new forecast with a significant revision in the dovish direction. We see the geopolitical situation and the impact on energy prices and EUR/CZK as the main risk to our call at the moment

CNB headquarters in Prague

Cutting cycle starts

The Czech National Bank will meet on Thursday next week when it will present its last forecast published this year. We go into the meeting expecting the first rate cut of 25bp to 6.75%, a view we have held since June.

On the data front, a lot has changed in the economy since the CNB's August forecast, and almost everything is pointing in a more dovish direction. GDP is expected to be revised significantly downwards, especially for the first half of the next year and not only because of domestic weakness but also the outlook for abroad. The labour market, while still tight, is showing slower wage growth than the CNB expected in August. Most importantly, inflation is below the central bank's forecast. Headline inflation for Q3 came in at 0.1pp, and core inflation at 0.3pp on average below expectations. Add to that, energy prices! They look set to fall faster than expected in the coming months and in January.

6.75%

Key rate

25bp rate cut expected

New forecast will convince the undecided votes

Moreover, the CNB is already behind the curve, given that the Bank's model indicates rate cuts earlier. This, combined with other deviations from the forecast, should lead to a significant revision in the path of interest rates of around 50bps on average over the forecast horizon. On the other hand, this is countered by a weaker CZK, which the CNB expects to reach current levels only in Q1 next year.

However, the board's communication seems to suggest that the weaker koruna is not a problem for now. We believe the pain threshold for delaying a rate cut would be the 25.0 EUR/CZK level, which we don't see on the table for now. Board members are basically unanimous in their statements that the November meeting is the first live one for a rate cut and we believe the new forecast will convince the undecided votes. Otherwise, we believe a rate cut will be delayed only until December, but next week's meeting should already show some votes for a rate cut. In general, we see the main risks more at the global level, especially the impact on energy prices and EUR/CZK, which is probably the CNB's main focus these days.

What to expect in FX and rates markets

The Czech koruna has been in a narrow range of 24.60-70 EUR/CZK for the past two weeks, which we believe is still an acceptable level for the CNB to start a cutting cycle. The current level of market rates indicates slightly stronger levels below 24.60. Thus, if global conditions allow, the koruna could still strengthen by next week's meeting. However, if the CNB delivers a rate cut, we see room to price in more cuts in the future, which would push EUR/CZK into the 24.80-25.00 range, based on the current strong relationship between the CZK and market rates. On the other hand, if the CNB does not deliver a rate cut, we believe the central bank has little to offer on the hawkish side, given that a cut seems inevitable. Thus, in response, the koruna may strengthen below 24.50; however, we do not expect it to stay there for longer.

The market is currently pricing in a rate cut of more than 30bps for the November meeting, indicating a strong dovish bias in the market, and also about 25bps for a rate cut in December. Looking ahead, the market may be overestimating the size of the rate cut in 1Q next year, but generally speaking, we see expectations for the year ahead as fairly priced. However, looking forward, the CZK IRS curve, in our view, shows a significant underestimation of the CNB's cutting cycle. Specifically at the long end of the curve, we think the 10y has the potential to trade 100bps lower and at the moment this is probably the biggest mispricing in the CEE space. However, the condition here is the start of a CNB cutting cycle and also a noticeable drop in core rates, which seem unlikely to be met for a while. Thus, the most interesting segment is probably 1-3y, which can still be influenced by the CNB itself and we see room for more rate cuts to be priced in here.

In bond space, our view has remained unchanged for a long time. This year's issuance is almost covered, plus the state budget has been surprising on the positive side in recent months. Thus, the supply of CZGBs is starting to decline, and MinFin is pre-funding next year, which already indicates a significant decline in borrowing needs and supply of CZGBs. Together with the start of the cutting cycle, we thus see CZGBs as cheap in ASW and also relative to CEE peers at the moment.

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