Monitoring Hungary: An uncertain recovery

In our latest update, we reassess our Hungarian economic and market forecasts at a time when the economy has emerged from stagnation, again, but we still can't be sure this will last. The end of disinflation is near, as is the period of monetary easing

Source: Shutterstock

Hungary: At a glance

- The economy has started to emerge from stagnation based on the preliminary first-quarter GDP data, but we know too little to materially change our full-year GDP forecast.
- Recent data on retail sales and industrial production still paint a rather mixed picture, so we haven't yet seen a general upturn.
- The very tight labour market has eased recently, thus we expect a gradual moderation in the pace of wage growth during the second half of this year.
- The sustainability of the recent huge uptick in the trade balance remains to be seen. We remain sceptical, as external demand still remains subdued.
- The structure of inflation has deteriorated recently, with services inflation heating up. Moreover, the re-emergence of price pressures is on our doorstep.

- Considering all the risks, the central bank slowed the pace of easing in April and delivered a hawkish message. Thus, we raise our mid-cycle terminal rate to 7.00%.
- The government officially raised the 2024 ESA-based deficit target to 4.5% of GDP. However, we still see a risk of around 0.5-1.0ppt even to the updated target.
- S&P affirmed Hungary's 'BBB-' rating along with a stable outlook, matching our expectations. However, we are concerned about the risk of a downgrade by Fitch.
- We see EUR/HUF back in the 395-400 range as a number of unfavourable factors are likely to affect the currency in the coming months.
- The forint is entering a complicated period facing fiscal risk and a further decline in the rate differential. We expect EUR/HUF to move back into the 395-400 range.
- The IRS curve should invert again. HGBs continue to benefit from strong auction demand, but fiscal risk and a rebound in inflation may keep yields higher for longer.

Quarterly forecasts

	1Q24	2Q24F	3Q24F	4Q24F	1Q25F	2Q25F	3Q25F	4Q25F
Real GDP (%YoY)	1.1	2.3	2.2	3.1	3.2	3.3	3.9	4.8
CPI (eop, %YoY)	3.6	4.7	4.3	6.0	4.8	4.3	3.7	3.0
Central bank key rate (eop, %)	8.25	7.00	7.00	7.00	6.75	6.00	5.75	5.25
3m interest rate (eop, %)	7.83	6.95	6.95	6.95	6.65	5.95	5.75	5.25
10yr yield (eop, %)	6.69	7.20	6.95	6.90	7.00	7.10	7.15	7.15
EUR/HUF exchange rate (eop)	395.8	400.0	393.0	395.0	405.0	405.0	400.0	410.0
USD/HUF exchange rate (eop)	367.3	370.4	357.3	359.1	368.2	368.2	363.6	372.7

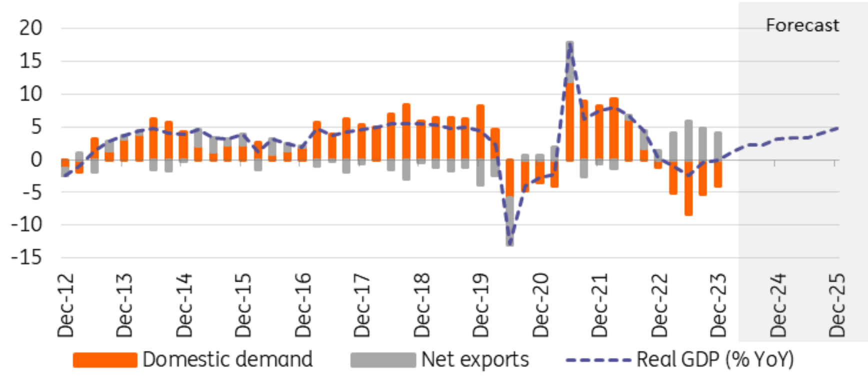
Source: National sources, ING estimates

Economic stagnation ends in the first quarter of 2024, again

The Hungarian economy has once again emerged from stagnation, as evidenced by the latest GDP data for the first quarter of 2024, which showed a growth rate of 0.8% quarter-on-quarter (QoQ), adjusted for seasonal and calendar effects. As a result, the year-on-year (YoY) indicator improved significantly to 1.1%.

As the preliminary report was rather short, we didn't get much information on the structure of growth, so we'll have to wait for the second estimate on 4 June. But connecting the dots, we expect a positive contribution from investment activity and a negative one from net exports. Without the details, we believe it is premature to revise substantially our economic growth forecast for this year. We are simply making a technical update based on incoming data and therefore our current growth projection for 2024 is 2.2%.

Real GDP (% YoY) and contributions (ppt)



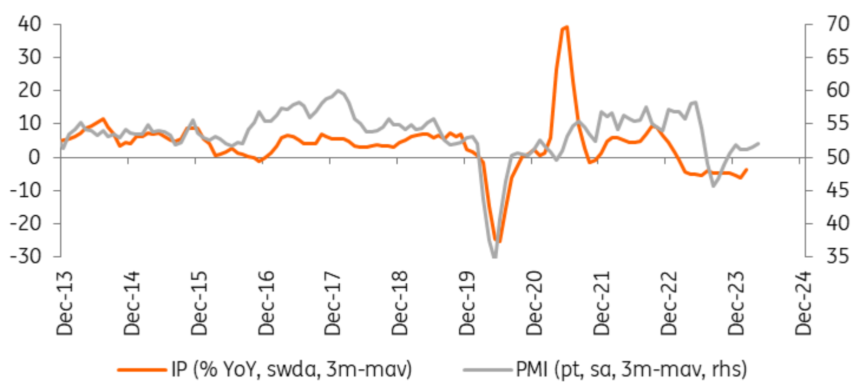
Source: HCSO, ING

We think it's too early to call for a turnaround in industrial production

Industrial production surprised on the upside in February, as production volumes surged by 3.5% month-on-month (MoM), contributing to a rise in output of 1.4% year-on-year on a working day basis. The expansion in production was supported by the majority of sub-sectors, breaking the negative momentum seen in previous months.

However, with external demand still subdued, we think that February's data should be taken with a pinch of salt, as it might be too early to call for a trend reversal. The outlook isn't too bright: the total order book deteriorated further compared, falling 19.6% YoY. Anecdotal evidence from the German-Hungarian Chamber of Industry and Commerce supports this view, as their survey shows that German firms are suffering most from a lack of demand.

Industrial production (IP) and Purchasing Manager Index (PMI)



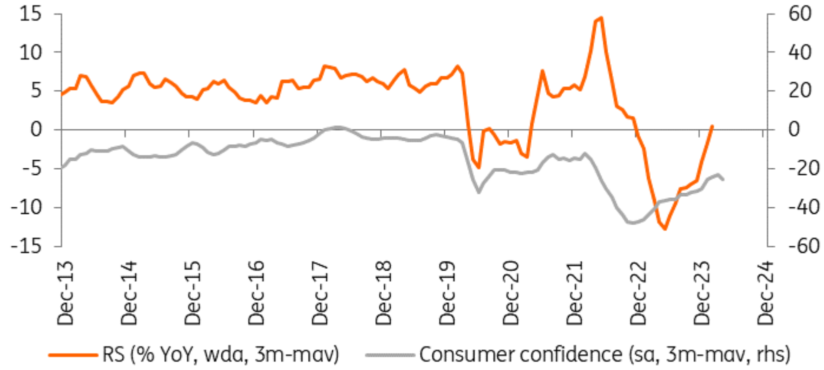
Source: HALPIM, HCSO, ING

Retail sales remain sluggish despite sizeable real wage growth

The volume of retail sales fell by 0.6% MoM in February, bringing the YoY figure to 1.1%, adjusted for seasonal and calendar effects. At the component level, food retailing grew on a monthly basis, but sales volumes still only correspond to the levels seen in early 2019. At the same time, volumes in non-food shops fell, along with a drop in fuel retailing as fuel prices inched higher in February.

As households' precautionary savings haven't eased too much, it looks like the recovery in consumption will remain very slow and gradual. We suspect that consumption may have disappointed in the first quarter. While we expect a gradual improvement in retail sales on the back of a sustained period of positive real wage growth, the recent decline in consumer confidence may be an early warning signal.

Retail sales (RS) and consumer confidence



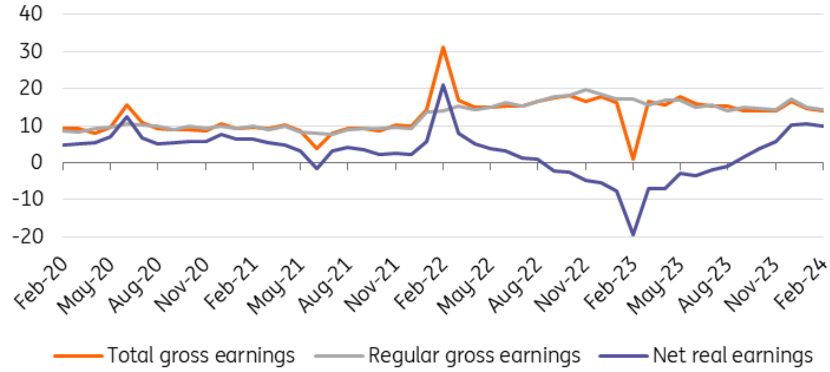
Source: Eurostat, HCSO, ING

We expect a gradual slowdown in the pace of wage growth

The recent deterioration in labour market statistics stalled in March, with the three-month (Jan-Mar) unemployment rate sitting at 4.6%. We believe that the recent improvement might be only temporary, as we expect further slow erosion in the upcoming months, followed by significant improvement in the second half of this year. As the tightness in the labour market continues to ease, this is putting downward pressure on wage growth, limiting the chances of consumption-led reflation.

However, this marked slowdown won't be reflected in incoming wage data until late spring when last year's substantial wage increases (10-15%) to compensate for the inflationary shock will be incorporated into the base and offset this year's lower increase in compensation packages (5-10%). In our view, double-digit wage growth will gradually slow in the coming months, and end the year markedly below 10% YoY.

Nominal and real wage growth (% YoY)



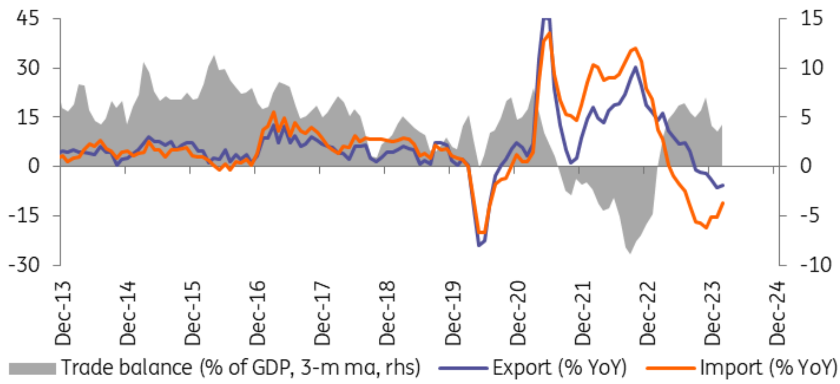
Source: HCSO, ING

Sustainability of the recent trade surplus remains to be seen

As we mentioned earlier, February brought a surprise upturn in industrial production, resulting in a large trade surplus of EUR 1.7bn. In fact, this was the largest monthly trade surplus ever recorded in Hungary, fuelled by a massive 6% MoM increase on the export side.

However, as we would caution against calling for a turnaround in industrial performance, we believe that the upside for the trade balance remains limited. Given that the industrial export order book has been deteriorating since August 2023 (currently -20.1% YoY), this clearly doesn't bode well for the export outlook. However, if we were to see a sustained improvement in the German economy, this would have a clear positive spillover effect on Hungary as well.

Trade balance (3-month moving average)



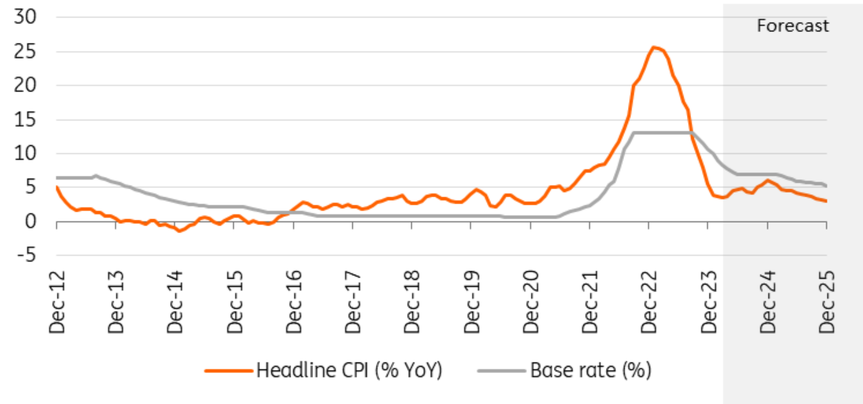
Source: HCSO, ING

As services inflation heats up, the structure of inflation worsens

Headline inflation decelerated further, with the year-on-year rate falling to 3.6% in March. However, the monthly repricing was 0.8%, indicating a slight acceleration compared to the already high repricing seen in the previous two months of this year. At the component level, services inflation stands out with a monthly repricing of 1.8%, which now explains 72% of total inflation in terms of annual headline inflation.

We expect services repricing to remain elevated in the coming months due to retrospective repricing by service providers. In addition, fuel inflation was strong again in April, so we see the disinflation coming to an end. Later, two waves of base effect-driven reflation (May and October) will push inflation steadily higher, with the year-end rate in the range of 5.5-6.0%. Nevertheless, the pricing power of companies will depend very much on the state of the economic recovery, which remains a two-sided risk.

Inflation and policy rate



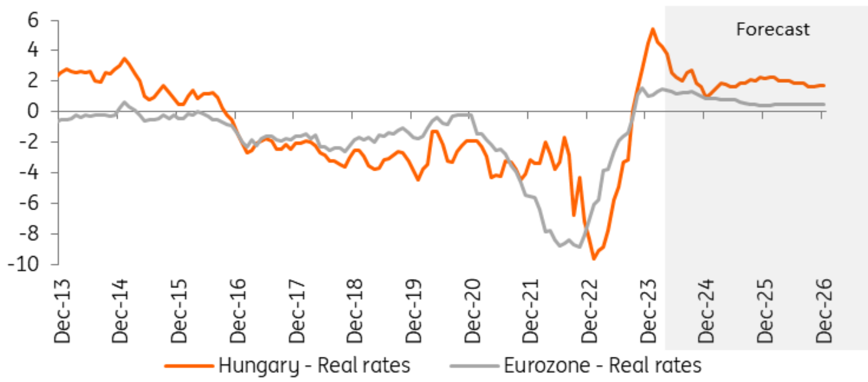
Source: NBH, ING

We raise our end-June forecast for the policy rate to 7.00%

At its March meeting, the National Bank of Hungary (NBH) reduced the pace of rate cuts to 50bp, bringing the base rate to 7.75%, while maintaining the +/- 100bp symmetric interest rate corridor around the base rate. We believe that the changing Hungarian inflation structure and the markets' reassessment of the Fed interest rate path are the main reasons for the cautious and patient approach.

Taking these risks into account, we revise our end-June forecast for the base rate to 7.00%, as we now expect the most hawkish outcome of the 6.50-7.00% range signalled by the NBH. As we expect two rounds of reflation, we believe that 7.00% could be a mid-cycle terminal rate, which would offer a reasonable risk premium over regional peers and maintain a positive real interest rate environment even into year-end.

Real rates (%)



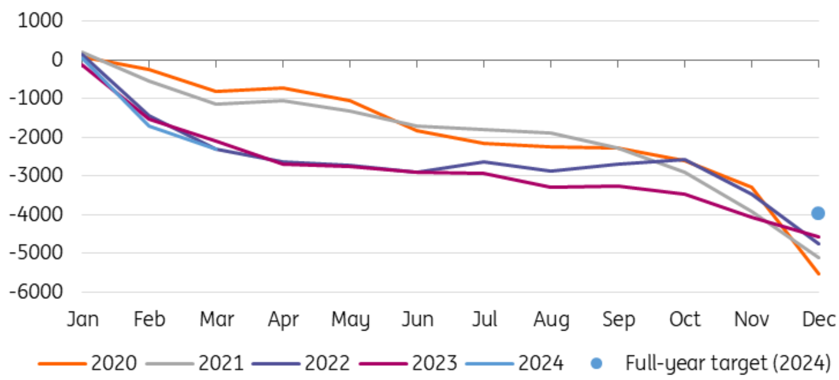
Source: ECB, NBH, ING

We still see around 0.75ppt risk even to the updated deficit target

As the Government Debt Management Agency (GDMA) increased this year's financing needs to HUF 3.98tr, this provides a very accurate estimate of the cash-flow-based deficit target. As a result, the ESA-based deficit target has also been raised to 4.5% of GDP, but based on our technical projections we still see a slippage of around 0.5-1.0ppt even to this updated target. On the expenditure side, although the government has already announced some investment cuts, this won't be enough to bring the deficit down to 4.5%.

If the government were to miss the updated deficit target, or if nominal GDP were to be lower than previously expected, the debt-to-GDP ratio could easily rise. Of course, this would most likely increase the chances of a downgrade by the rating agencies, as Fitch has already highlighted this issue and has a negative outlook.

Budget performance (year-to-date, HUFbn)



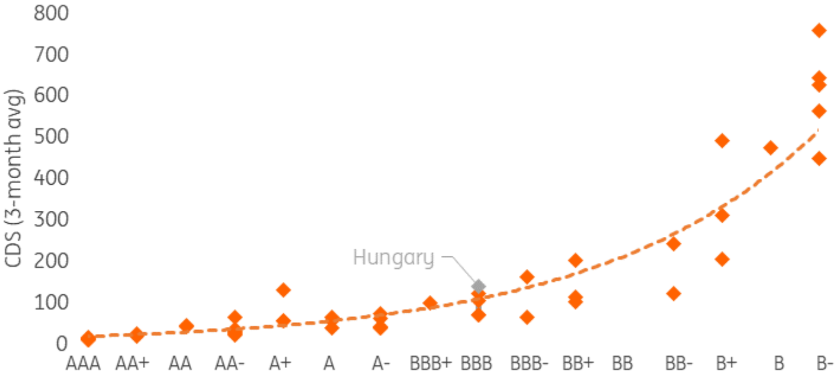
Source: Ministry of Finance, ING

S&P affirmed the current rating, but Fitch's decision poses a threat

At the April review, S&P Ratings affirmed Hungary's credit rating at 'BBB-' with a stable outlook. The report clearly emphasises that the country's fiscal position is currently the main driver of the credit and outlook ratings. In this regard, the rating agency highlights that it believes this year's fiscal slippage will be temporary and that public finances will improve from 2025 onwards.

In light of these comments, it's interesting to note that S&P's forecasts for the budget deficit between 2024 and 2027 are always moderately higher than the government's current projections. Not to mention the fact that the agency expects the debt-to-GDP ratio to remain on an upward trajectory until 2026. Although S&P has confirmed the current rating, we are less optimistic about the upcoming decisions by Moody's and Fitch. We think there's a clear risk of an outright downgrade when Fitch makes its decision on 14 June.

CDS and sovereign credit ratings of Fitch Ratings



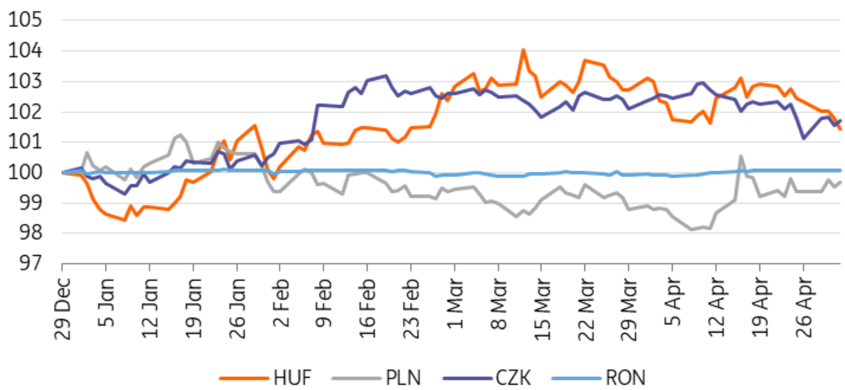
Source: Bloomberg, Fitch Ratings

HUF once again enters a complicated period

EUR/HUF has returned below 390 in the last few days, but for most of March and April, it traded more around 395 with a few moves towards 400. We believe this will be the range for the coming months given the issues we mentioned earlier. On the local side, we think the risk of looser fiscal policy and a potential sovereign rating downgrade will keep the HUF under pressure.

At the same time, we believe that the current IRS curve levels already indicate weaker FX, and with the exception of FRA pricing up to one year, which is still pricing in too many rate cuts, the rest of the curve should go lower, further worsening the interest rate differential. Moreover, at the global level, HUF is not helped by global central bank hesitations and thus only a European Central Bank rate cut may offer limited relief to the forint, but that is priced in already. Overall, we thus believe EUR/HUF will be more in the 395-400 range in the coming months with 395 at the end of this year in our forecast.

CEE FX performance vs EUR (29 December 2023 = 100%)



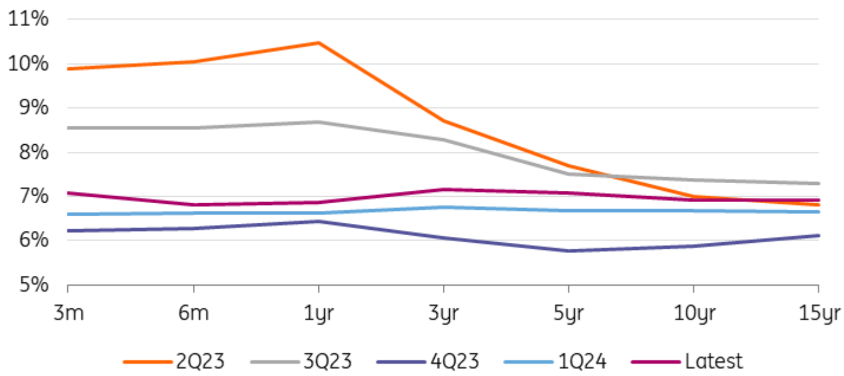
Source: NBH, ING

Fewer rate cuts now but more later policy may support flatteners

The global sell-off has hit the HUF market hard in recent weeks and market pricing has moved up significantly across the IRS curve, well above our forecast. However, the FRA curve still overestimates too many rate cuts over the one-year horizon in our view, which should be challenged by the next two NBH meetings and inflation prints showing a rebound in inflation.

On the other hand, over the longer term, we believe the markets are underestimating the amount of rate cuts we will see and a return to a neutral rate supported also by changes in the NBH council. Although we believe the NBH base rate is trending closer to 5%, the 5y5y IRS is still high around 7%, mainly due to global developments in our view. At the same time, 2s10s recently switched into positive territory, which we believe could provide attractive opportunities. Therefore, flatteners in the IRS curve might be preferred, which could also provide positive carry.

Hungarian sovereign yield curve (end of period)



Source: GDMA, ING

In the Hungarian government bonds (HGB) space, on the supply side, we estimate that the debt agency has covered about 50% of the planned issuance after the recent revision of the funding plan, confirming a comfortable situation despite the unfavourable fiscal developments. Demand in primary auctions remains the second highest among CEE peers after Czech government bonds, and given the currently higher levels of HGB yields, we expect demand to remain decent. On the other hand, fiscal developments, rating downgrade risk and rebound inflation complicate the HGB story and may keep yields higher for longer, resulting in wider ASW especially at the longer end of the curve, in our view.

Forecast summary

	1Q24	2Q24F	3Q24F	4Q24F	1Q25F	2023	2024F	2025F
Real GDP (%YoY)	1.1	2.3	2.2	3.1	3.2	-0.9	2.2	3.8
CPI (eop, %YoY)*	3.6	4.7	4.3	6.0	4.8	17.6	4.5	4.2
Central bank key rate (eop, %)	8.25	7.00	7.00	7.00	6.75	10.75	7.00	5.25
3m interest rate (%)*	7.83	6.95	6.95	6.95	6.65	13.98	7.73	6.11
10yr yield (%)*	6.69	7.20	6.95	6.90	7.00	7.56	6.72	7.06
EUR/HUF exchange rate*	395.8	400.0	393.0	395.0	405.0	382.0	393.3	403.0
USD/HUF exchange rate*	367.3	370.4	357.3	359.1	368.2	353.3	360.1	366.4

Source: Source: National Sources, ING estimates

*Quarterly data is eop, annual is avg.

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