Monitoring Hungary: Gloom with some silver linings

In our latest update, we reassess our Hungarian economic and market forecasts, as we downgrade the full-year growth outlook. Economic activity has been disappointing lately, while inflation has proven stickier than expected. As market stability improves, we see rate cuts ahead

Hungary: At a glance

- Economic activity has markedly slowed down, while the rebound from the technical recession will not be as robust as previously expected, hence our 2023 growth outlook downgrade.
- Both retail sales and industry underperformed throughout the first quarter, and we expect continued weakness in the first half of 2023.
- Inflation has proven stickier than expected with core inflation hitting a new peak in March, while pending price increases in services could slow disinflation.
- As inflation will gradually decline throughout the year, real wage growth will flip back into positive territory at the end of 3Q, which in our view will boost household savings.
- The central bank's dovish pivot has started by cutting the top-end of its rate corridor by

450bp, and we see effective rate cuts starting either in May or June.

- Lower energy prices will continue to improve the country's external balances in the coming months as reflected in the latest trade balance data.
- We still see the 3.9% deficit-to-GDP target as roughly realistic, as expenditures are always front-loaded, while revenues are back-loaded.
- The labour market has been gradually weakening, but it is nowhere near a crisis scenario, and we see a turnaround in late summer.
- We expect EUR/HUF to oscillate in the current range of 370–380, depending on the progress in the EU story and the NBH's boldness in the coming months.
- In our view, HGBs can benefit the most from the combination of funding under control, monetary policy normalisation and positive news regarding EU funds.

Quarterly forecasts

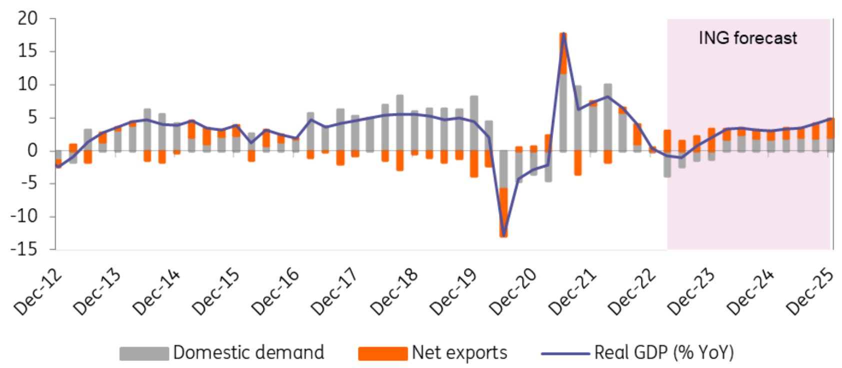
	1Q23	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	3Q24F	4Q24F
Real GDP (%YoY)	-0.8*	-1.0	0.8	2.0	3.3	3.5	3.2	3.0
CPI (eop, %YoY)	25.2	21.2	14.3	9.3	6.1	5.7	3.7	3.2
Central bank key rate (eop, %)	13.00	13.00	13.00	11.50	8.00	6.75	6.00	5.25
3m interest rate (eop, %)	16.30	15.40	13.00	11.00	7.50	6.25	5.50	4.75
10yr yield (eop, %)	8.50	7.60	7.25	7.05	7.05	7.00	6.80	6.75
EUR/HUF exchange rate (eop)	381.0	370.0	383.0	375.0	370.0	365.0	365.0	370.0
USD/HUF exchange rate (eop)	349.9	336.4	342.0	326.1	321.7	309.3	309.3	321.7

Source: National sources, ING estimates *1Q23 GDP is forecast

Full-year growth outlook worsens

Hungary has been in a technical recession for three quarters (3Q22-1Q23) due to sky-high inflation suffocating economic activity. First quarter GDP data is not due until 16 May but we see a contraction both annually and quarterly. Economic activity in the first quarter was widely disappointing, whether looking at retail sales, industrial or construction data. Going forward, we anticipate a modest economic rebound in the second half of 2023 as inflationary pressures are alleviated, but domestic demand will remain weak throughout the year. In our view, the positive real wage growth in the fourth quarter will more likely boost households' savings rather than fuel consumption. As a result, we're downgrading our full-year growth outlook from 0.7% to 0.2% due to the combined effect of subdued consumption and investment activity.

Real GDP (% YoY) and contributions (ppt)



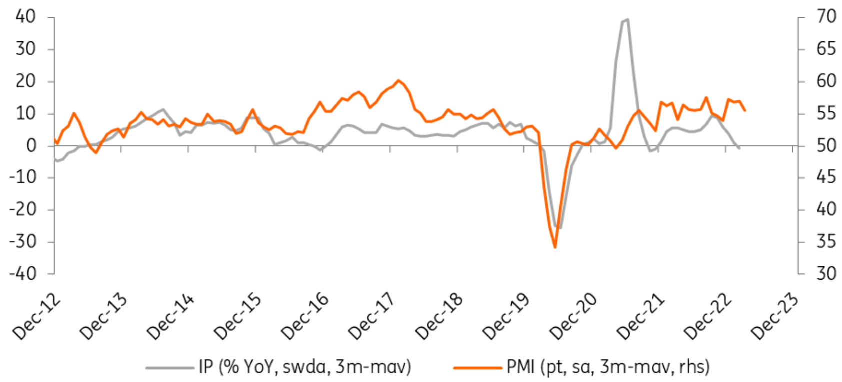
Source: HCSO, ING

Industry shows broad-based weakness

Industrial performance continued to disappoint in February as production fell by 4.6% year-on-year, with most manufacturing subsections contributing to the decline. This points to broad-based weakness amid the ongoing technical recession, with only industrial output related to the automotive sector showing any sign of life. Nevertheless, this is not enough to keep the yearly figure above water, and we expect continued underperformance in the coming months. In this regard, the full-year industrial outlook is getting gloomier by the day, as both internal and external demand for manufactured goods continues to deteriorate. The latter is a major drag on net exports, which is expected to be the only silver lining supporting the full-year growth profile.

The freefall of Hungary's industry continues

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



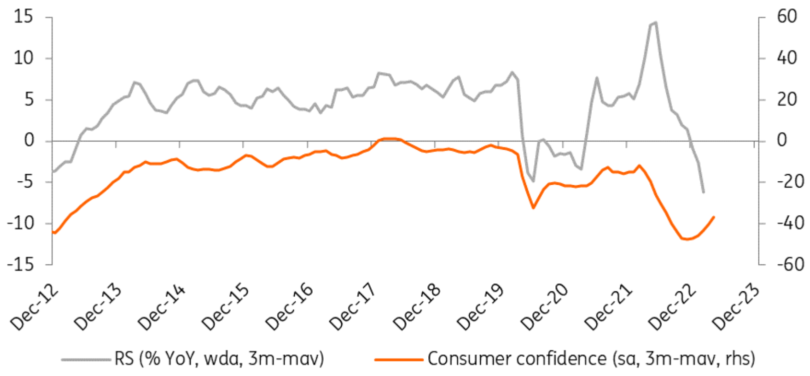
Source: HALPIM, HCSO, ING

Contracting retail sales point towards subdued consumption

The retail sector continues to suffer amid the cost-of-living crisis as the volume of sales in February fell by 10.1% YoY. Regarding food and fuel retailing, the yearly drops are almost entirely due to base effects, but non-food retailing displays weakness on a monthly basis too (-2.8%) with manufactured goods registering a 6.5% month-on-month plunge. In our view, this is indicative of the lack of domestic demand towards manufactured goods, which can explain the industry's weakness. Recent data shows negative momentum as February was the third month in a row in which the volume of retail sales has been contracting both on a yearly and monthly basis. Therefore, it is evident that the loss in household purchasing power is constraining overall consumption, which in our view will continue in the coming months.

Hungarian retail sales fall off a cliff

Retail sales (RS) and consumer confidence



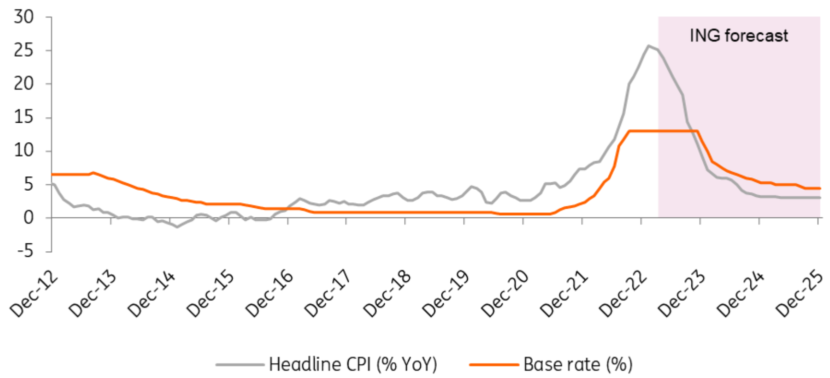
Source: Eurostat, HCSO, ING

Inflation proves stickier than previously expected

Although January's 25.7% YoY inflation reading marked the top for headline inflation, the underlying price dynamics look worrying. Core inflation accelerated to new highs (25.7%) in March, which we think was the top. Food inflation has continued to moderate for a third month, while both fuel and household energy prices retreated. As the services sector is trying to pass last year's cost burden onto consumers with a lag, we expect this component to remain elevated. In this regard, the pre-announced price increases by telecom companies and financial services providers, along with seasonal repricing in holiday packages underscores our thinking. Going forward, we expect a gradual deceleration in both headline and core inflation in the coming months widely driven by base effects. We continue to expect full-year average inflation to come in around 19% in 2023, with December's figure dipping into the high single-digit area.

Hungarian inflation proves stickier than expected

Inflation and policy rate



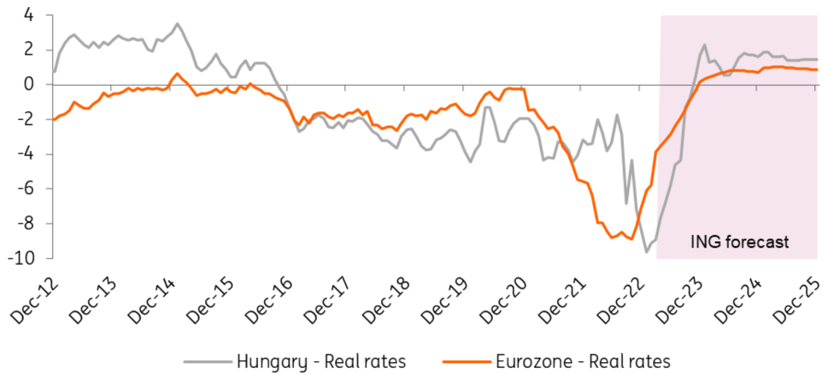
Source: NBH, ING

The central bank's dovish pivot has started with a symbolic step

The National Bank of Hungary (NBH) cut the overnight collateralised lending rate (top-end of rate corridor) by 450bp to 20.5% sending a clear signal that the dovish pivot is here. The central bank continues to distinguish between the issues of price and market stability, as the former will be resolved by the 13% base rate, while the latter is managed by the overnight tools (mainly by the 18% quick deposit rate). Due to the convincing improvement in market stability, the NBH was able to make the first move in preparing the effective rate cut cycle, but their approach echoes caution and patience. In this regard, the central bank will constantly monitor a range of risk indicators, along with market expectations. In the coming weeks, we expect continued improvement in risk perceptions that are closely followed by the NBH. Therefore, we expect the central bank to start effective rate cuts in the quick depo rate either in May or June, depending on FX stability and market perception.

National Bank of Hungary Review: A new beginning without commitment

Real rates (%)

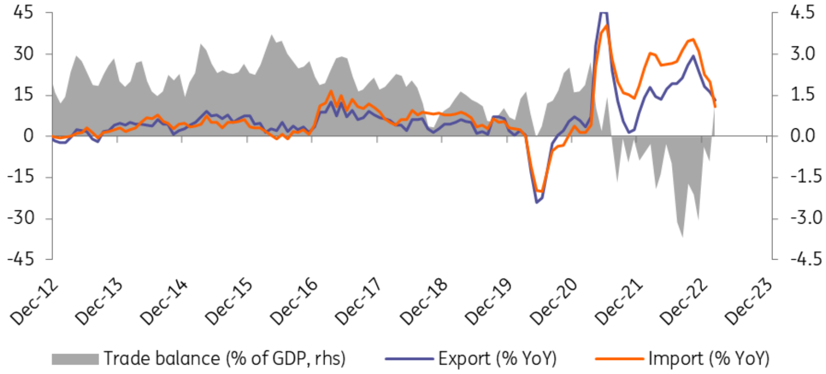


Source: ECB, NBH, ING

After 19 months of deficits the trade balance is back in surplus

The marked retreat of global energy prices alleviated the pressure on the country's external balances. This is clearly reflected in the latest trade balance data, which showed a surplus of EUR 513m in February. Energy import prices in Hungary follow the Dutch TTF gas prices largely by a two-month lag, therefore December's 116 EUR/MWh average price was reflected in February's trade balance result. In this regard, as TTF gas prices currently hover around 40 EUR/MWh we expect continued improvement on this front. Ailing domestic demand and the continuing reduction in the energy-related trade deficit will help to narrow the current account deficit. After the 8.1% of GDP shortfall in 2022, we see a 4.5% of GDP deficit this year.

Trade balance (3-month moving average)



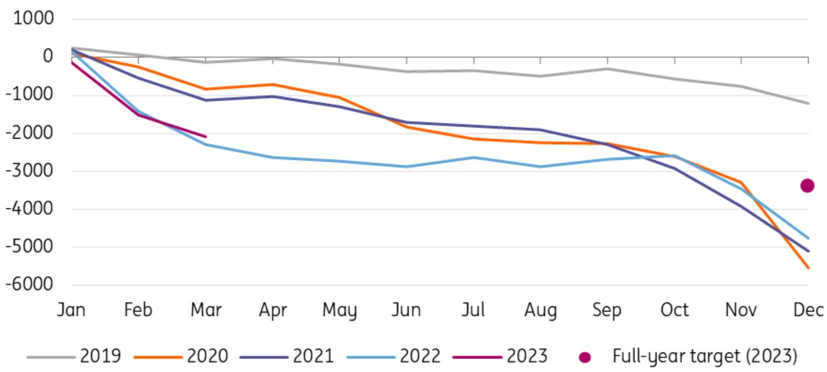
Source: HCSO, ING

The budget trajectory of 2023 follows in last years' footsteps

Hungary's budget posted a HUF 564.6bn deficit in March, bringing the year-to-date cash-flow base to 61% of the full-year target. According to the Ministry of Finance, expenditures increased by 12% YoY during the first quarter of this year mainly due to costlier heating-related expenditures and significant pension increases. As expenditures are always front-loaded, while revenues are back-loaded, we see some improvement in the coming months, especially with the heating season behind us. Furthermore, we expect automatic stabilisers to kick in during the economic rebound in the second half of 2023. The biggest challenges remain the debt service cost, planned at net HUF 2,074bn, along with inflation. The latter is important because the government calculated a 15% full-year reading, whereas it increasingly looks like this will be around 19%. This in turn will trigger an additional HUF 200-300bn adjustment need in pensions as the government must preserve the real purchasing power of pensions by law.

This year's Hungarian budget is manageable, but 2024 looks bleaker

Budget performance (year-to-date, HUFbn)



Source: Ministry of Finance, ING

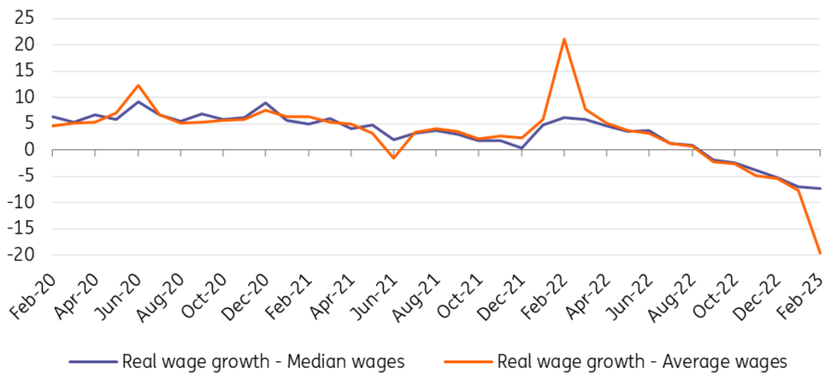
Real wages have dropped for the sixth month in a row

The Hungarian labour market remains resilient amid a technical recession, although it shows a mild and gradual weakening. The three-month unemployment rate was at 4.1% in the first quarter of 2023. We expect the unemployment rate to rise further, albeit at a slow pace, peaking around 4.5% in the summer. As some sectors still face labour shortages, average wage growth remains strong with a 15.6% YoY increase in February, after excluding last year's 'service premium' for the armed forces. Nevertheless, after adjusting for inflation and for this one-off effect, real earnings dropped by 7.8% in February, marking the sixth month in a row in which real wage growth was negative. Going forward, we expect real earnings growth to flip back to positive territory at the end of the third quarter in line with retreating inflation. In our view, this will likely trigger households to replenish their depleted savings, which in turn might have negative effects on growth prospects.

Hungary's unemployment does not budge

Base effects distort Hungarian wages data

Growth of real wages in Hungary (% YoY)

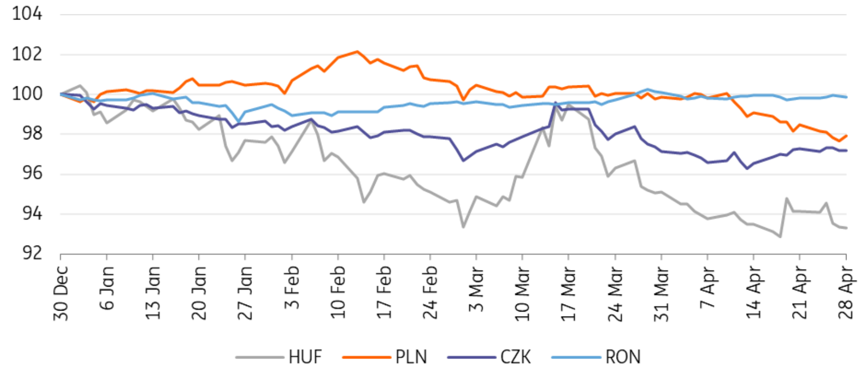


Source: HCSO, ING

HUF can remain strong despite the start of the rate-cutting cycle

At the global level, conditions for the region remain generally positive, with the forint benefiting the most among its Central and Eastern European peers, along with positive news on the EU story. At the local level, FX carry in Hungary remains by far the highest in the CEE region and nothing will change in the coming months on this front. Thus, overall, we believe the right conditions persist for the forint to continue to retain market interest. On the other hand, the market's position is probably already long despite last week's sell-off and the direction of monetary policy is clear after the last central bank meeting. Thus, given the NBH's cautious approach, we can remain positive on the HUF, but we cannot expect a continuation of the rally as in recent weeks but rather a sideways move in the current range of 370 and 380 EUR/HUF depending on the progress in the EU story and the NBH's boldness in the coming months.

CEE FX performance vs EUR (30 December 2022 = 100%)

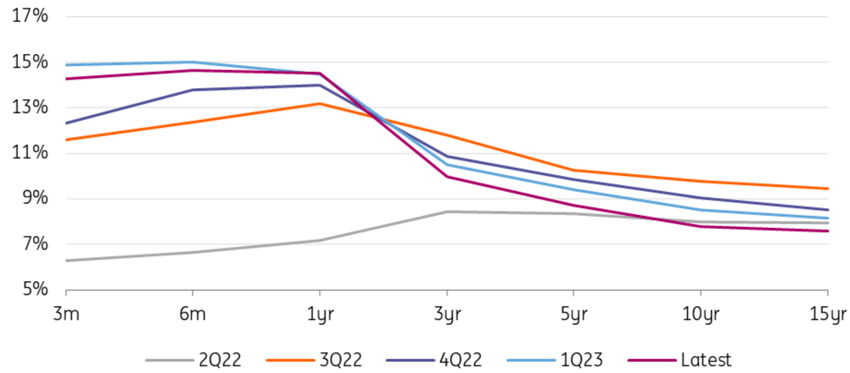


Source: NBH, ING

Hungarian Government Bonds can benefit a lot in the coming months

In the aftermath of the latest NBH meeting, the IRS curve moved up slightly after the press conference, indicating that the market was expecting more. However, even so, it appears the market may be disappointed again later that monetary policy normalisation is not proceeding as quickly as priced in, just as we saw in the first quarter. The direction at the moment is clear - a lower and steeper curve, but market volatility and liquidity may be tricky again in this case.

Hungarian sovereign yield curve



Source: GDMA, ING

On the Hungarian government bond (HGBs) side, although we see some fiscal risks, funding is safely under control. Nevertheless, in case any slippage might occur regarding the flow of EU money, the debt agency (ÁKK) might resort to FX debt issuance. According to our calculations, ÁKK has secured about 29.4% of the planned HGBs issuance since the beginning of the year. However, if we take into account the strong activity in retail and FX bonds, ÁKK has roughly secured about half of its total borrowing needs for this year. Thus, the combination of funding under control, monetary policy normalisation and a positive EU story can be expected to generate more interest from real money investors and HGBs can benefit the most from this situation.

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