National Bank of Hungary Preview: A last-minute decision

Favourable domestic developments strengthen the case for a larger rate cut, while FX stability warrants a more cautious approach. If market stability prevails, we expect the National Bank of Hungary to embrace the present and deliver a 100bp cut

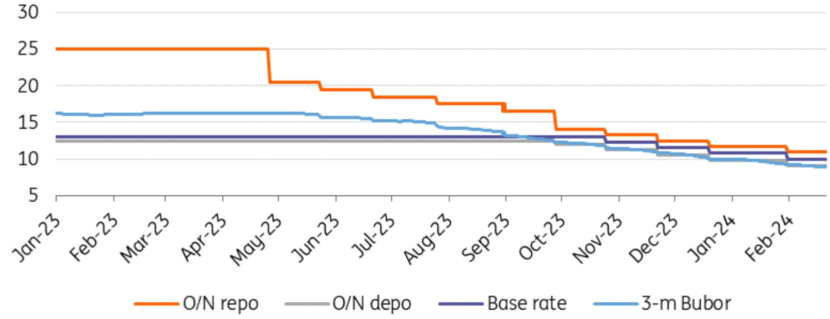
Budapest, Hungary

The decision in January

The National Bank of Hungary (NBH) cut its key interest rate by 75bp to 10.00% in January, maintaining the pace of easing seen since October. The main reason for erring on the side of caution was the domestic risk environment, as we discussed in our latest NBH Review.

In our view, the central bank continues to weigh both domestic developments and international factors in its reaction function, emphasising data dependency in its decision-making. In this regard, we believe it is very important for the NBH to assess current developments on a relative basis (compared to the last rate-setting meeting).

The main interest rates (%)



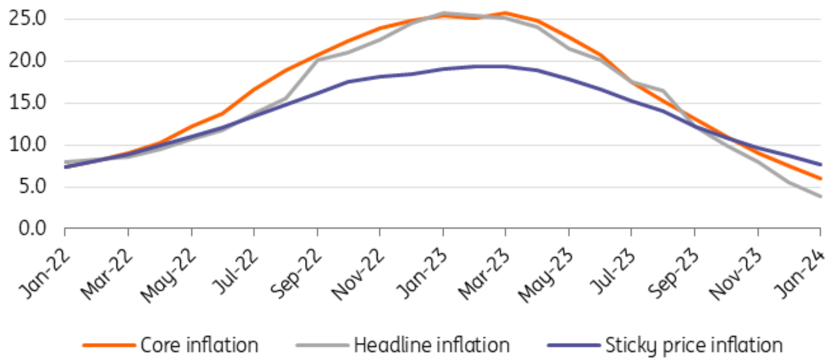
Source: NBH, ING

Domestic developments strengthen the case for a larger cut

Headline inflation fell by 1.7ppt to 3.8% year-on-year in January, which means that inflation fell within the central bank's tolerance band for the first time since March 2021. In fact, this was such a downside surprise that January's figure was even 1ppt lower than the central bank's own estimate, published in the latest Inflation Report back in December.

Other measures of price pressure also look favourable. Core inflation decelerated to 6.1% YoY in January, while the NBH's measure of inflation for sticky prices also decreased, displaying a reading of 7.7% YoY. Overall, the short-term picture looks appealing, and we expect headline inflation to remain within the tolerance band in both March and April. In our view, this may strengthen the case for front-loaded rate cuts, but our mid-term picture remains unchanged and we expect two rounds of reflation in 2024.

Headline and underlying inflation measures (% YoY)



Source: HCSO, NBH, ING

The latest fourth quarter GDP data for 2023 would also strengthen the case for a larger rate cut, as it shows that the Hungarian economy is still struggling to recover from the four-quarter technical recession. However, we are aware that GDP data is likely to carry less weight in the NBH's current reaction function.

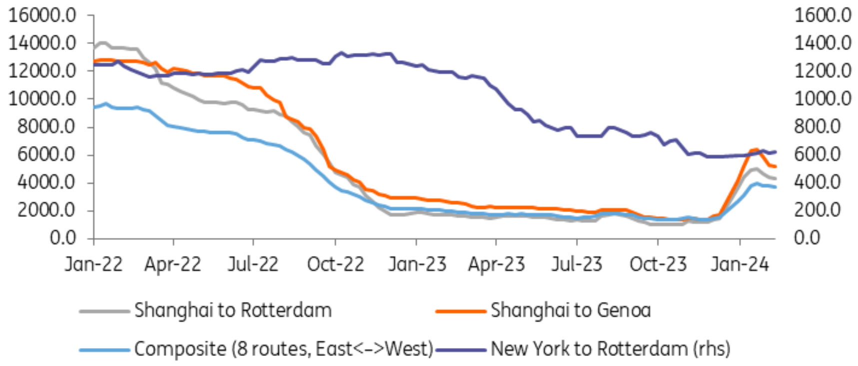
The country's external balances are also improving on a trend basis, but the latest December trade balance data was a big disappointment. Unfortunately, the details will only be released on 1 March, so we don't yet know the main reasons for the monthly trade deficit. In our view, this is likely to be related to the underperformance of Hungarian industry, while seasonal effects may also have played a role.

International factors warrant a more cautious approach

In our view, international factors still remain a mixed bag. The external inflation environment remains better than expected, while long-term yields in developed markets are still significantly below their peaks.

However, given the recent flow of US data (post NFP, CPI, PPI), markets have pushed back the timing of the Federal Reserve's first rate cut to June, while also lowering cumulative rate cut expectations through 2024. In the short term, the scaling back of rate cut expectations is keeping the dollar firmly bid, but as we expect the Fed to cut rates in the first half of the year, this will eventually ease pressure on emerging market currencies – including the HUF.

Container freight benchmark rate per 40 foot box (USD)



Source: Drewry, ING

In terms of geopolitical tensions, the picture remains unchanged. There has been no escalation in either conflict zone, but at the same time de-escalation seems unlikely at this stage. With regard to the Red Sea conflict, trade diversion appears to be the new status quo, resulting in longer transit times and therefore modest supply chain disruptions. However, as shipping costs are currently plateauing and given that the conflict has not worsened on a relative basis, we believe that the NBH may give less weight to this component in its reaction function.

Forint still fragile, but the situation looks slightly better than in January

The most important takeaway from the January rate-setting meeting was when the NBH explicitly stated that "only focusing on macroeconomic fundamentals would have enabled a larger decrease". In this regard, the tension in domestic financial markets was the main reason for the central bank maintaining its previous pace with a 75bp rate cut. This tension was likely spurred by the reference rate change story, which was amplified by the Financial Times article. In the end, the forint was rapidly leaking as uncertainty increased.

This time, EUR/HUF has been trading between 386 and 390 since 5 February, which means that the forint has not been on a clear weakening path in recent weeks, as the market seems to have accepted these levels as the new normal. However, this was not the case before the January rate-setting meeting, when the HUF weakened by more than 3% over a similar period.

Going forward, we do not see any particular news to support the HUF. In this respect, the only saviour of the forint (at these levels) is likely to be a more hawkish than expected central bank. We believe that the majority of the Monetary Council is likely to assess the situation on a relative basis and conclude that the pressure on the HUF is currently somewhat less than at the January rate-setting meeting. This is a new development; the previous unanimous decisions are now gone and split voting is back. Last time it was 7-2 favouring 75bp, so only three more members should think on this relative basis.

Our call

Against this backdrop, we see the National Bank of Hungary cutting the base rate by 100bp on 27 February. This could bring the key rate down to 9% after the rate-setting meeting, while we expect the Monetary Council to also cut both ends of the rate corridor by 100-100bp. There remains one major factor that poses a downside risk to our call and that is FX stability. We believe that if we were to see a further marked deterioration in the forint, this would encourage the central bank to remain more cautious and maintain the previous pace of 75bp of easing, like as they did back in January.

However, at the current 387-388 levels we believe that the majority of the Monetary Council will likely opt for a larger rate cut, therefore front-loading rate cuts, while current inflation developments are very appealing. In our view, this does not mean that 100bp cuts will be automatic going forward – the central bank will definitely remain in its data-dependent mode and it will put emphasis on this temporary nature of acceleration in the easing cycle in its communication. Looking ahead, we expect the NBH to cautiously assess both domestic developments and international factors and act accordingly on a meeting-by-meeting basis.

Our longer-term view remains unchanged

Our view on the pace of disinflation has not changed, and we still expect disinflation to continue in the first quarter – but we then expect two rounds of reflation this year. For this reason, we believe that the NBH is likely to front-load rate cuts as long as disinflation remains with us and, of course, if FX stability prevails.

However, as our year-end inflation forecast for December is around 5.7% YoY, this leads us to believe that the terminal rate cannot go lower than that. In this regard, we expect the base rate to be lowered to 6.5% by mid-year, after which we expect a sustained pause by the NBH, which in turn would still maintain a positive real interest rate environment supporting HUF assets.

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