

National Bank of Hungary preview: Better safe than sorry

February was a good opportunity for the National Bank of Hungary to accelerate easing, but we can't say the same this time. Developments since the last meeting have been mixed and could, in our view, again justify a more cautious approach. We expect the central bank to deliver a 75bp cut



We expect the National Bank of Hungary to cut rates by 75bp at its 26 March meeting

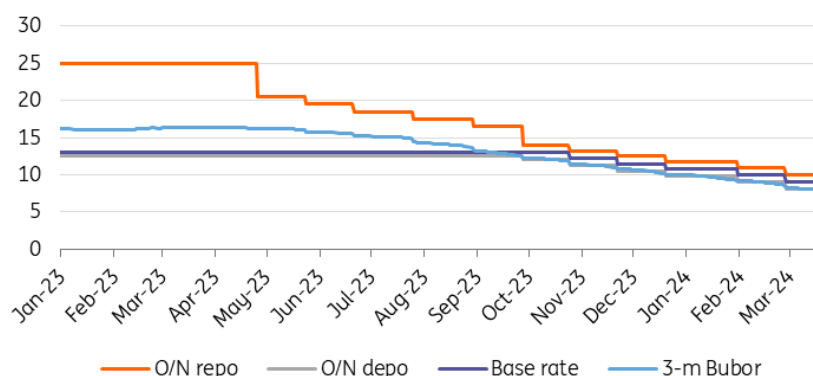
The decision in February

The National Bank of Hungary (NBH) cut its key interest rate by 100bp to 9.00% in February, therefore accelerating the pace of easing seen since October. However, the central bank made it clear that the acceleration in the pace of easing is only temporary, as we discussed in our [latest NBH Review](#).

In our view, the central bank continues to weigh both domestic macroeconomic developments and market stability factors in its reaction function, emphasising data dependency in its decision-making. In this regard, we believe that the Monetary Council will assess current developments on a relative basis (compared information set and market situation at the last rate-setting meeting), as

it did in February.

The main interest rates (%)



Source: NBH, ING

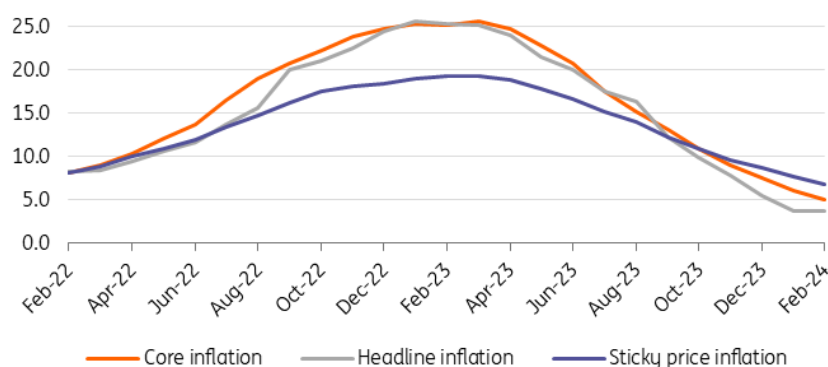
Macro fundamentals argue slightly in favour of sticking to a faster pace of easing

Disinflation has continued in February as headline inflation fell to 3.7% year-on-year (YoY). In fact, February's reading came in 0.7ppt lower than the central bank's own estimate, published in the latest Inflation Report, back in December. As we expect inflation to remain within the central bank's tolerance band in March and April, this may strengthen the case for front-loaded rate cuts.

The latest detailed 4Q23 GDP data, which was disappointing to say the least, also strengthens the case for a front-loaded rate cut. However, it did not contain much new or surprising information. And while the severe tightness in the labour market has eased somewhat (implying downside risks to wage growth and ultimately inflation), we haven't seen any new data since the last rate decision. The rate-setting meeting takes place ahead of the official release of new labour market data.

So, by a razor-thin margin but on a relative basis, the macro fundamentals are pushing the needle in the direction of maintaining the 100bp pace of easing. But the situation is much less compelling than last time. Against this backdrop, we see market stability outweighing macro fundamentals as the decisive factor at the 26 March rate decision.

Headline and underlying inflation measures (% YoY)



Source: HCSO, NBH, ING

Once again, it is not the international risk environment that matters

Hungary's market stability is influenced by both international factors and country-specific risks, but nowadays it's mostly the latter. As far as international factors are concerned, the expected interest rate paths of both the Fed and the ECB are very important for emerging market currencies. In this regard, not much has changed since the last NBH rate-setting meeting (27 February), as the markets continue to price in a 50-60% probability of a first Fed rate cut in June. As for the ECB, a first rate cut in June is still the most likely outcome. In addition, core bond yields – amid increased volatility – are now around the levels seen at the end of February.

In terms of geopolitical tensions, the picture remains unchanged. There has been no escalation in either conflict zone, but at the same time a de-escalation seems unlikely at this stage. Shipping costs have recently plateaued and are now slightly lower than their January peak. Taking all these international factors into account, we need to find the game-changing factors elsewhere.

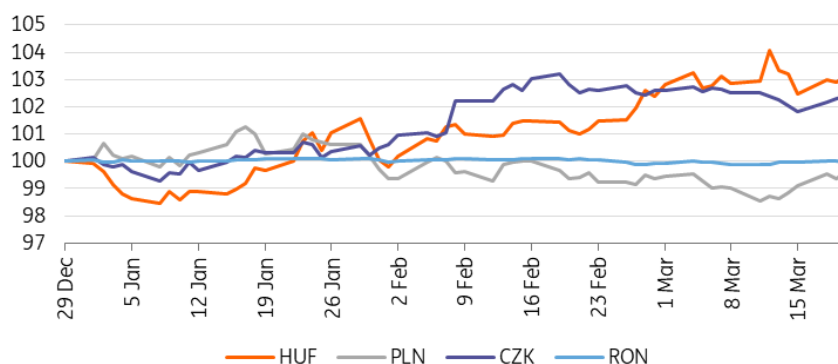
Country-specific risks create the real “noise”

As far as country-specific risks are concerned, there are two major issues that have led to the EUR/HUF reaching almost 400 in the middle of March. One is the forthcoming change in the Central Bank Act, while the other is the emerging possibility of the re-blocking of EU funds. As for the central bank law, the issue seems to have been temporarily shelved, but the risk has not diminished. All is not lost that is delayed.

With regard to the European Parliament's legal action against the European Commission, the problem stems from the uncertainty factor. We haven't received any clarification on the timeline, and the whole process can take more than a year, so this will remain a risk for some time to come.

These two issues have kept EUR/HUF well above 390, and only the verbal intervention of both the NBH and the government have helped to keep the cross below 400. In our view, the forint remains vulnerable, with 400 acting as the gravity line in this noisy environment. The recent desynchronisation of HUF rates and FX also points to vulnerability, as the repricing of FRAs and IRSs did not help the forint as much as it should have.

CEE currencies vs EUR (end-2023 = 100%)



Source: NBH, ING

Our call

Against this backdrop, we see the National Bank of Hungary cutting the base rate by 75bp on 26 March. This could bring the key rate down to 8.25% after the rate-setting meeting, while we expect the Monetary Council to also cut both ends of the rate corridor by 75-75bp. In our view, the March rate-setting meeting will see another split vote, suggesting that divergent views remain as members take different approaches to risk taking.

In our view, the majority of the Monetary Council will see the usual post-cut currency depreciation as too much of a risk so close to both psychological and technical levels at and above 400. Moreover, with cautiousness being the mantra, with the situation less clear than in February, we see the National Bank of Hungary will be rather safe than sorry.

New staff projections see weaker growth and lower inflation

The National Bank of Hungary will publish its latest set of macroeconomic projections for the main measures (GDP and inflation) alongside the interest rate decision. The detailed December Inflation report is due on 28 March.

We see adjustments only to the outlook for 2024, with both the inflation and GDP forecast ranges moving slightly lower based on incoming data. We expect inflation forecast range to show a 3.7-5.2% outlook, thus containing the possibility of being within the tolerance band in case of the most favourable outcome. In terms of economic activity, with weak 4Q23 data, the harsh reality leaves no other option than cut the GDP forecast to the 2.0-3.0% range.

Our long-term view remains unchanged

A new playbook will be in place from the second quarter of this year, as was already well indicated in February. In our view, the NBH will opt for a more hawkish tone at its March rate-setting meeting, a preview of what to expect from the second quarter onwards, supported by the March

Inflation Report. In practice, this means that the 100bp option from the second quarter will be taken off the table for good and the Monetary Council will be presented with a choice of 50bp and 75bp.

Such a hawkish shift in the easing cycle is justified by the inflation outlook, in our view. We expect disinflation to continue over the next few months, but then two rounds of reflation (May and October) will ruin the disinflation party. We therefore believe that the NBH will continue to cut interest rates, but at a slower pace, and only gradually reduce the positive real interest rates. With this strategy, it could maintain a sufficient risk premium on local assets to keep investors interested.

As our year-end inflation forecast for December is still in the range of 5.5-6.0% YoY, this leads us to believe that the terminal rate cannot go any lower. In this context, we expect the key rate to be lowered to 6.5% by June, after which we expect a sustained pause by the NBH, which in turn would still maintain a positive real interest rate environment and keep some risk premium over regional rates supporting HUF assets.

We believe that the NBH is very attentive to regional monetary developments and will try to offer some risk premium over Polish assets in this regard. As our [Polish team doesn't expect](#) the National Bank of Poland to cut rates, this should alarm those betting on a Hungarian year-end rate below 6%.

Our market views

After the headline noise of the last two weeks, EUR/HUF almost touched the 400 level, however, it bounced back very quickly and is heading lower. We expected the sell-off to take us to higher levels in the short term and to us this is evidence that the market still remains very bullish on HUF assets, which is also our understanding from client conversations. Moreover, the aggressive rate repricing very quickly provided support for FX after the noise level was reduced and the global environment became more supportive and the market took the opportunity to enter again.

At this moment, we see HUF fairly balanced, or maybe even strengthened too quickly. However, if the NBH can deliver a hawkish message and bring some anchor to the current situation, it may unlock further potential for HUF to go closer to 390. On the other hand, as our economists mention, the situation remains fragile, especially going into the second quarter with the looming central bank law change, EU funds issues and the approaching EU and local elections.

Rates and government bonds

In the rates space, the market has outpriced a lot of rate cuts in the past two weeks, but in the last two days the market is gradually switching to a buying mode again. Spreads against CEE peers have widened significantly in the Hungarian government bonds and Interest Rate Swaps space, which we believe is attractive enough for the market to come back. In the IRS space, we see room for more flattening of the curve due to the narrative of a slowdown and pause in the cutting cycle now, but more rate cuts later and at the same time still an attractive inflation profile within the CEE peers. Looking at 2s10s, we should see a flatter curve that also provides an attractive carry.

In the HGBs space, we have seen significant frontloading and buybacks in recent weeks, to prepare for the upcoming increase in this year's budget deficit. However, the auctions met with significant demand, almost the highest in the CEE region in bid-to-cover terms. With the

assumption of 4.5% of GDP for this year's deficit, according to our calculations, roughly 40% of the total issuance of HGBs is covered, which provides sufficient comfort for the bond market in case of the risk of further fiscal slippage, which is one of the reasons why we are positive on HGBs at the moment.

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