

National Bank of Hungary Preview: Treading carefully

We believe that the upside inflation surprise in July and the slight deterioration in the country's risk perception may prompt the central bank to err on the side of caution this time. As a result, we expect the base rate to remain unchanged at 6.75%, while our call for the 2024 terminal rate remains at 6.25%

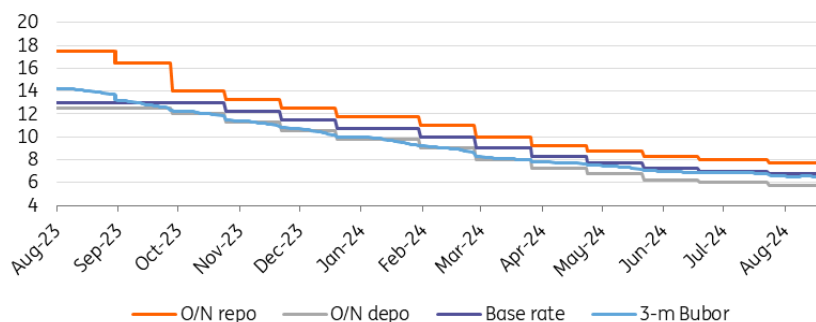


The National Bank of Hungary in Budapest

NBH kicked off new phase with another 25bp rate cut in July

The National Bank of Hungary (NBH) cut its key interest rate by 25bp to 6.75% in July. The decision was justified by a downside inflation surprise, in addition to an improvement in the country's risk perception, which essentially allowed for the frontloading of rate cuts, as we discussed in our previous [NBH Review](#).

The main interest rates (%)



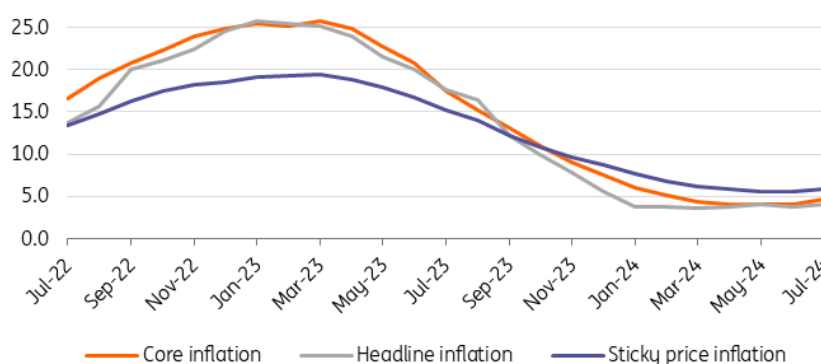
Source: NBH, ING

Upside surprise in July inflation print

Headline inflation rose by 0.4ppt to 4.1% year-on-year in July, matching our own expectations but an upside surprise versus the NBH’s own forecast. The difference is more pronounced in the headline rate (0.3ppt) than in core inflation (0.1ppt). Although the bulk of the surprise came from items outside the core inflation basket, the recent acceleration in core inflation and the deterioration in other inflation measures (such as sticky price inflation, or the 3M/3M annualised core inflation measure) signal that Hungary still has an underlying inflation problem.

On the other hand, weak economic activity may dampen inflationary pressures from the domestic demand side. However, this still contrasts with strong wage outflows and government tax increases, both of which pose upside risks to services inflation. In our view, monthly repricing over the rest of the year remains subject to considerable uncertainty, so the two-way risks surrounding the inflation outlook may also justify a patient and cautious monetary policy stance, which this time may be reflected in leaving rates unchanged.

Headline and underlying inflation measures (% YoY)



Source: NBH, ING

Start of expected Fed easing could be relief to NBH

Since the last NBH rate-setting meeting (23 July) core rates have been on a rollercoaster ride, with the US 2-year yield falling almost 60bp by 5 August, and the SOFR curve indicating as much as

150bp rate cuts for 2024 from the Federal Reserve. Of course, this extreme pricing was prompted by fears of a US recession and then exacerbated by the unwinding of the yen carry trade - fears which have subsided for the time being.

However, with the vast majority of the FOMC signalling a willingness to ease, we are getting closer to the start of the Fed's easing cycle, which will also take some pressure off the forint in the medium term. What is more important in the short term is the fact that the market has reduced bets for a 50bp cut for September, and as we move back towards a standard 25bp cut size, the NBH's room for manoeuvre is more limited at this point than it was at the height of the Fed's extreme pricing.

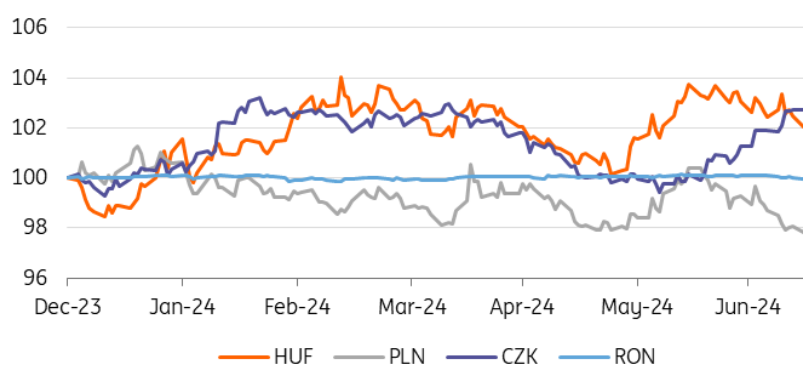
HUF vulnerable to domestic rate expectations and external shocks

Since the July rate-setting meeting, EUR/HUF has moved higher, reaching as high as 399 on 5 August amid heightened volatility emanating from the core markets, as the FRA curve pointed to around 100bp of cuts in 2024. What's striking is that the correction in the SOFR curve started immediately after Monday's sell-off, while Hungarian rate cut bets remained relatively stable at elevated levels until Thursday when the July inflation surprise caught the markets off guard.

In this regard, this reinforces our view that the stretched FRA pricing was not only driven by core markets but rather by hopes for further rate cuts from the NBH following the July rate cut. However, after the July inflation surprise, there was a sharp correction in the short end of the curve, which also helped the forint to fall to around 393.

The spread between 10-year HUF and PLN government bond yields has widened by around 15bp compared to the July rate-setting meeting, which could indicate a slight deterioration in the country's risk perception. Overall, we believe that the forint remains in a vulnerable position as the risk premium needs to be carefully managed as evidenced by the events of the past few weeks.

Performance of CEE FX versus EUR (end-2023 = 100%)



Source: NBH, ING

Our call

Altogether, we see the National Bank of Hungary leaving rates unchanged on 27 August. This means that the key rate would likely remain at 6.75% after the rate-setting meeting, while we

expect the Monetary Council to also leave both ends of the rate corridor unchanged. Nevertheless, the level of EUR/HUF poses a downside risk to our call, as a further strengthening of the forint could eventually tilt the Monetary Council's assessment towards another 25bp rate cut.

We maintain our 2024 terminal rate call at 6.25%

As the July inflation print exactly matched our own expectations, we still maintain our year-end inflation forecast for December in the range of 5.0-5.5% YoY. As much uncertainty surrounds the repricing strategies of companies in the post-Covid era we believe that the monthly repricing during the second half of the year will be higher than pre-Covid norms would indicate. This is why we see both headline and core inflation rising above 5% by the end of the year, with elevated wage growth dynamics and the side effects of tax measures further increasing the chances that monthly repricing in the second half of the year will not normalise to pre-Covid norms.

As for the rest of 2024, we still expect the NBH to deliver two additional 25bp rate cuts, but we believe that the central bank is likely to wait for more information to factor into its rate-setting decision. In this regard, a new Inflation report to be published in September, accompanied by new inflation forecasts, could provide additional information on the state of the economy.

We believe that although the timing of the two additional rate cuts remains highly uncertain, we would favour the September and December rate-setting meetings for further easing. By then, developments in the external interest rate environment will be much clearer, as will the repricing patterns in the Hungarian economy, which both impact the central bank's room for manoeuvre.

Our market views

EUR/HUF moved from just below 400 to 393 during August and we believe we can get to 390 by the NBH meeting, the level before the last meeting in July. Of course, the market has priced out roughly one rate cut and at the same time the rally in core rates has helped the forint with support from higher EUR/USD. Altogether, overall conditions for the HUF are supportive, which again may trigger NBH openness to rate cuts despite higher inflation numbers. A rate cut in August seems unlikely, but the question for this meeting is when to expect another rate cut over the rest of the year. In our view, levels in the range of 390-392 EUR/HUF will be a reason for an upside reversal. In the medium term, we retain a trading range view of 390-400 EUR/HUF for the rest of the year as we expect two additional rate cuts and a more complicated situation with rising inflation and a weaker economy than markets currently expect.

After a correction in very dovish pricing, the market is now expecting two or slightly more rate cuts this year, roughly close to our economists' expectations. The terminal rate has come back from the early August lows of 4.60% to the current 5.00%, but the slope of the IRS curve remains almost unchanged. We believe the entire curve thus has room to go lower again and may offer the best valuations within the CEE region, especially at the longer end of the curve and at a premium over core markets. Thus, if we see further signals from the Fed and European Central Bank, we think this will attract receivers into the HUF market again, supported by NBH dovishness.

We are similarly positive on Hungarian government bonds (HGBs), which retain the most market interest in the CEE region. On the supply side, the debt agency has covered roughly 80% of this year's HGBs issuance, according to our calculations. Meanwhile, the latest budget data showed an improvement and raises hopes for meeting this year's fiscal deficit target of 4.5% of GDP. This would allow for a reduction of supply over the rest of the year or a focus on pre-funding next

year's needs, freeing the debt agency's hands. Overall, we thus see conditions for HGBs rallying while valuations remain rather neutral versus CEE peers.

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