Inflation to push Czech rates to their peak

Energy prices continue to help push Czech inflation higher, and we're not sure we've reached the top. But we do think the market is underestimating the central bank's willingness to cut rates when price pressures start to ease

The Czech National Bank's headquarters in Prague

Widening CPI deviation from the CNB forecast may bring a bigger rate hike

We're expecting inflation in the Czech Republic to rise only slightly above market expectations from 14.2% to 15.6% YoY when we get the figures tomorrow. Food prices are continuing to rise similarly to previous months. Fuel prices resumed their rise in May (2% MoM), and energy prices remain the main upside risk as usual. A 30% average increase in gas prices was announced for May by a major supplier in the country. Therefore, we expect energy prices to rise more than in February (1.4%) and March (1.5%) but less than in April (2.3%).

Our current forecast is for inflation to peak at 15.9% in June, but recent reports suggest this level may be higher. The fuel tax cut that took effect at the beginning of the month has not had much effect on prices, and fuel costs have instead continued to rise. In addition, the recent announcement by the largest energy supplier to raise prices from July has started another round of price hikes for consumers; we expect to see further announcements from other energy suppliers in the coming weeks. This extra effect is being written into the CPI with a lag due to the contract fixing of some customers. Thus, we cannot expect the pressure on headline CPI to ease on this account. Upside risks are also heightened by recent inflation surprises in the region, which have been working well as a leading indicator in the past few months. In both Poland and Hungary, inflation surprised 0.3pp higher than market expectations.

The Czech National Bank expects a 14.9% YoY number for May. April's inflation print delivered a 0.3pp deviation from the forecast. Very likely, this deviation will widen significantly in May, which we believe will be the determining factor for the size of the June rate hike. Our forecast is "at least 100bps", but a higher CPI print tomorrow, and yesterday's announcement of changes in the makeup of the CNB's board, may result in a higher move of 125bps or more. Regardless of the outcome, tomorrow's inflation would thus be an opportunity to complete the puzzle for the June CNB meeting.

What to expect in markets

Over the past week, rates have increased considerably, closing the gap between our forecast and the market's view. The market is now fully expecting a 100bp rate hike in June and the odds perhaps suggest an even bolder move. Tomorrow's inflation numbers and the June CNB meeting may be the last trigger for payers before the new CNB board starts on July 1. On the other hand, we believe the market is still underestimating the CNB dovish shift, and the market's first clash with the new board may be a reason for it to reassess its expectations.

Although we are sceptical about a slowdown in inflation in the second half of the year compared to the CNB's forecast, the delay in data releases may bring dovish summer months. And once we do see that inflation has peaked, we would expect an immediate rate cut as per the CNB model, similar to what we see in its current forecast. This should make it easier for the doves coming to the board to change rates' direction. This means that the first rate cut may come sooner than the market currently thinks, namely before the middle of next year.

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