

National Bank of Hungary preview: Entering phase two

The National Bank of Hungary's latest communication left no doubt as to what will happen in September. The effective rate will be lowered to 13%. While markets may be anticipating some hawkish action, it's difficult to expect anything but words – which could lead to temporary disappointment and market turbulence



A widely expected move, but nothing more

The National Bank of Hungary (NBH) made it clear at its August rate-setting meeting and in the following communication what we can expect on 26 September when the Monetary Council meets again.

The merger of the effective rate and the base rate at 13% is taking place in September, and with that, monetary policy enters the second phase of normalisation. It sounds plain and simple, but it raises some questions. The central bank has pledged that the new phase will involve a simplified monetary policy toolkit. In practice, this could mean that the Monetary Council will get rid of the overnight quick deposit tender while keeping the FX swap tenders and short-term central bank discount bills to help manage the excess liquidity.

However, it's difficult to imagine (due to counterparties, countries and other restrictions) that the central bank will be able to mop up excess liquidity from the market using only FX swaps and bills. This is where the regular overnight deposit facility – the floor of the interest rate corridor comes in – which is now at 12.5%. Without touching this rate, all the excess liquidity remaining in the market could be channelled into this instrument. This would mean a reduction in the effective rate from the recent 14% via the overnight quick deposit tender to 12.5% (the regular overnight deposit facility).

To avoid unintended market reactions that read this – purely technical – step as a dovish move (150bp effective easing instead of 100bp), we see a quick fix on the part of the NBH. It is possible that the Monetary Council will raise the regular overnight deposit rate by 50bp to 13% in parallel with the phasing out of the quick deposit tender, thus merging the floor of the interest rate corridor with the base rate. This could also set a floor for interbank rates (BUBOR). This may increase the NBH's market-moving power through actual rate cuts in the future.

A halt in hawkish action

Other than that, it is hard to expect any further significant hawkish action from the central bank – and that could lead to some excessive market volatility. In August, the NBH said that market expectations of rate cuts in the fourth quarter were overdone, a clear hawkish verbal intervention. What was the market reaction? Barely anything at all. The market still expects the effective rate to be around 10% at the end of the year, which would mean an uninterrupted series of 100bp cuts. The market's view is that it is only actions, not words, from the central bank that could trigger a repricing. Against this backdrop, repeating the message of "excessive expectations of rate cuts" and emphasising agility and a data-driven approach won't be enough to overcome the high bar set by market players.

The central bank could also show some hawkishness towards the markets in its updated GDP and CPI projections. Given the downside surprise in the second quarter, the NBH could downgrade its 2023 forecast, including the possibility of a recession in the new forecast range. It will be crucial to emphasise the importance of inflation over GDP. Moreover, we see a chance that the new forecast will include a higher inflation range in both 2023 and 2024. This could also be seen as a hawkish signal, suggesting the need for "higher for longer" monetary policy and more caution in the second phase of monetary policy normalisation.

We do not expect any meaningful action to take place until October, when the central bank could announce a cut of much less than 100bp or even a pause, which is our base case. The latter could send such a strong message that the central bank would reset the tone. For the time being, the openness to a 0-100bp cut means that the market is pricing in a high probability of a 100bp move. An October pause could turn the tables. Market pricing will be much more hawkish in our view, with even an unchanged 0-100bp rate cut forward guidance.

Our market views

The National Bank of Hungary's monetary policy is approaching a turning point, and the Hungarian forint will continue to be a key variable. The central bank seems committed to maintaining positive interest rates and a high carry for Hungarian assets, which should sustain market demand. Implied FX yields remain almost double in Hungary compared to the rest of the CEE region. Given the dovish market expectations, we see room for upward repricing here when the market realises that NBH is not going to continue the set pace of rate cuts in previous months. Overall, we remain

positive on the HUF despite higher volatility and lower EUR/USD.

In fixed income, we see that the market has fully switched into dovish mode, and the coming months may be disappointing for the market. With the IRS curve almost fully normalised and the 2s10s close to CEE peers for the first time since the middle of last year, we see a chance for some upward correction, especially at the short end of the curve. Moreover, the massive carry for payers at the short end of the curve could attract market attention if this is the case.

On the Hungarian government bond (HGBs) side, we have heard a lot of noise in recent weeks due to the fiscal risk, as well as in other countries in the region. On the positive side, we believe that the increase in borrowing needs should cover at least most of the state budget problem. After the increase in needs, we estimate that the debt management agency has already covered around 77% of the planned issuance of HGBs. The supply side should therefore remain under control.

On the other hand, excessive dovish expectations, the EU money issue expected to return to the table in the coming weeks, and the uncertain fiscal picture all create an uncomfortable mix of risks. Most of this year's positive Hungary story has already been played out in our view, and with current valuations with 10y trading at ROMGBs level, HGBs do not have too much to offer at the moment.

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