

14 January 2021

EM FX & Rates Trader

Pay 10y CZK IRS

Upbeat local and global macro outlooks intact

We pay 10y CZK as entry levels became attractive after the recent correction lower. The third Covid wave and the downside surprise in Dec Czech CPI don't change our view that the CNB will deliver 50bp tightening this year. Core CPI remains high (3.6%) and as the economy strongly rebounds in Q2, the case for hikes will grow. Long-end CZK IRS payers should have the added advantage of benefiting from the global reflation theme narrative and high CZGB issuance. We target 1.55% within 6 months.

We see the dip in CZK rates caused by the [Dec CPI undershot](#) as exaggerated and fade the move. The main surprise in CPI came from volatile food prices but core CPI in the CNB definition remains high (3.6% YoY vs 3.7% previously). Even if we expect prices to correct lower in coming months, they should start rising from March onwards (Fig 1). We see **headline CPI at 2.3% and CPI ex. food and fuel at 2.9% this year**. With real rates deeply negative and some CNB board members already commenting that the current level of the policy rate is low, we continue to **see two hikes in 2H21 and three more in 2022**. For this year, our base case is for two 25bp hikes but we don't rule one post October election 50bp hike in either the November or December CNB meeting. Given current market pricing (17bp of hikes priced over 12 months) **12x15 CZK FRA payer is also attractive**.

While the Czech Rep is one of the negative outliers in terms of Covid cases globally, the **severity of restriction does not diverge from its European peers** (hence not a more detrimental effect on the Czech economy at this point). As the vaccination process is to speed up and winter restrictions are to ease in Q2, **we look for a sharp rebound from Q2 onwards** (6.5% YoY - Fig 2), spilling over into the CZK curve and pushing 10y higher.

Despite the third Covid wave, we see little scope for the CNB to downgrade its new forecast (to be published in the Feb meeting) as the last forecast didn't account for the vaccine effect and the fiscal stimulus. Hence, the forecast should be at least unchanged (which means signalling hikes for this year - Fig 3) or, as **we expect, be more hawkish**. Although we acknowledge that the koruna is stronger vs the Nov forecast, we expect this to be more than outweighed by the improving medium-term macro outlook

10y CZK IRS payer should also benefit from global reflation dynamics and the grind in core rates higher (mainly in the US). Moreover, with the **Czech government announcing large fiscal stimulus** (worth CZK 100bn this year), leading to a record deficit for 2021 (around 7% of GDP - higher than last year), **large CZGB issuance** should keep pushing CZK rates higher. As was the case last year, we look for a **frontload issuance** in 1H21.

Following the correction in 10y CZK IRS lower this year, the level of 10y is around early December levels. **Although the third Covid wave is under way, the impact on the 10y CZK IRS should be more limited** vs the first and the second waves given the vaccine roll out and the potential for the strong recovery. Even if the global environment modestly deteriorates, **we don't expect 10y CZK IRS to drop below 1.10%** (the level seen after the US Presidential election result) as this would mean (a) fully discounting the vaccine news; (b) fully discounting Czech fiscal stimulus; and (c) partly discounting pro-growth Biden policies and their effect on the core rate - Fig 4.

Pay 10y CZK IRS; Entry level - 50% of notional at current spot of 1.21% (incl. bid-offer spread) and other 50% notional at 1.17% Target 1.55%; Stop loss 1.05%. The position exerts 3.4% negative carry and roll over 3 months (vs -6.2bp on 2y payer).

Petr Krpata, CFA

Chief EMEA FX and IR Strategist
London +44 20 7767 6561
petr.krpata@ing.com

Jakub Seidler

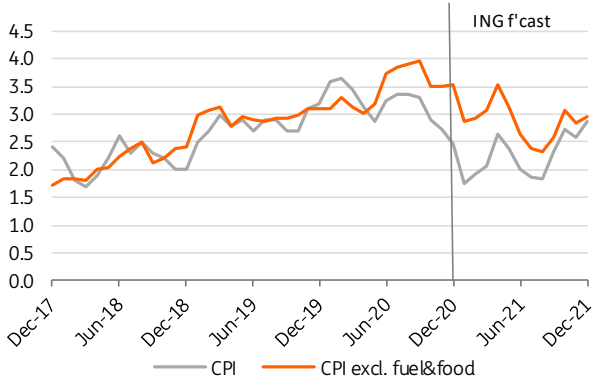
Chief Economist Czech Republic
Prague +420 257 474 432
jakub.seidler@ing.cz

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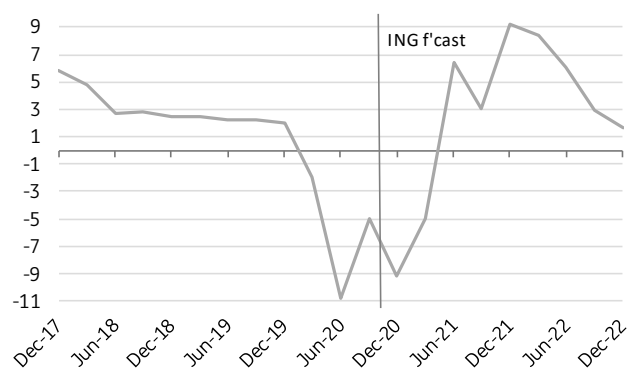
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Fig 1 After Q1 slowdown, CPI should rebound



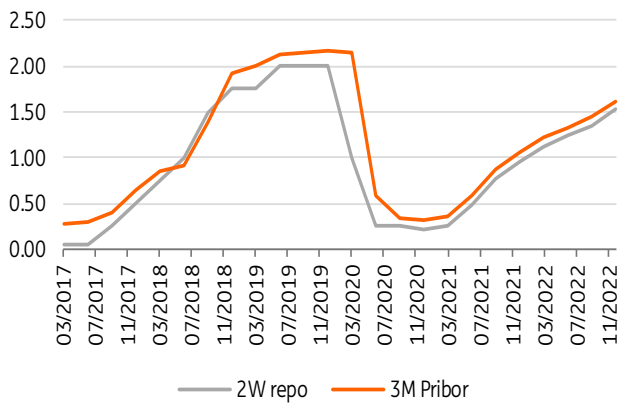
Source: ING, CZSO

Fig 2 Czech GDP growth (% YoY)



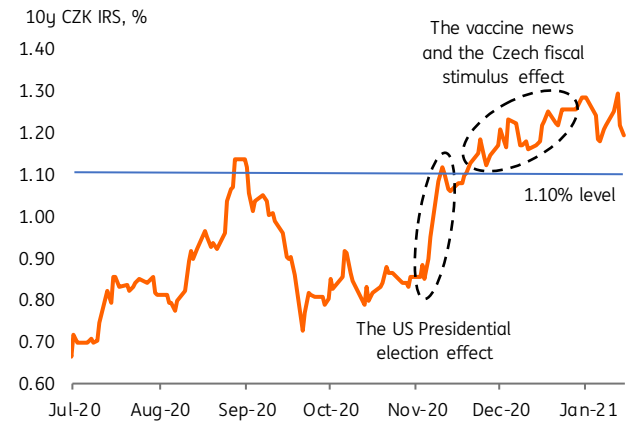
Source: ING

Fig 3 CNB rate projection from the November forecast



Source: ING, CNB

Fig 4 We see limited downside to 10y CZK IRS from here



Source: ING, Refinit

Research Analyst Contacts

Developed Markets		Title	Telephone	Email
London	Chris Turner	Global Head of Markets and Regional Head of Research, UK & CEE	44 20 7767 1610	chris.turner@ing.com
	James Smith	Economist, Developed Markets	44 20 7767 1038	james.smith@ing.com
	Carlo Cocuzzo	Economist	44 20 7767 5306	carlo.cocuzzo@ing.com
	Petr Krpata	Chief EMEA FX and IR Strategist	44 20 7767 6561	petr.krpata@ing.com
	Francesco Pesole	FX Strategist	44 20 7767 6405	francesco.pesole@ing.com
	Wenyu Yao	Senior Commodities Strategist	44 20 7767 6909	wenyu.yao@ing.com
	Antoine Bouvet	Senior Rates Strategist	44 20 7767 6279	antoine.bouvet@ing.com
	Oleksiy Soroka	Senior High Yield Credit Strategist	44 20 7767 5695	oleksiy.soroka@ing.com
Amsterdam	Marieke Blom	Chief Economist, Netherlands	31 20 576 0465	marieke.blom@ing.com
	Bert Colijn	Senior Economist, Eurozone	31 20 563 4926	bert.colijn@ing.com
	Maarten Leen	Head of Global IFRS9 Macroeconomic Scenarios	31 20 563 4406	maarten.leen@ing.com
	Raoul Leering	Head of International Trade Analysis	31 20 576 0313	raoul.leering@ing.com
	Joanna Konings	Senior Economist	31 20 576 4366	joanna.konings@ing.com
	Timme Spakman	Economist	31 20 576 4469	timme.spakman@ing.com
	Marcel Klok	Senior Economist, Netherlands	31 20 576 0465	marcel.klok@ing.com
	Jeroen van den Broek	Global Head of Sector Research	31 20 563 8959	jeroen.van.den.broek@ing.com
	Maureen Schuller	Head of Financials Sector Strategy	31 20 563 8941	maureen.schuller@ing.com
	Teunis Brosens	Head Economist, Digital Finance & Regulation	31 20 563 6167	teunis.brosens@ing.com
	Suvi Platerink Kosonen	Senior Sector Strategist, Financials	31 20 563 8029	suvi.platerink-kosonen@ing.com
	Julie Cichon	Sector Strategist, Financials	31 20 563 8993	julie.cichon@ing.com
	Nadège Tillier	Head of Corporates Sector Strategy	31 20 563 8967	nadege.tillier@ing.com
	Hendrik Wiersma	Senior Sector Strategist, TMT	31 20 563 8961	hendrik.wiersma@ing.com
	Alyssa Gammoudy	Sector Strategist, Consumers	31 20 563 8902	alysa.ouled.gammoudy@ing.com
	Timothy Rahill	Credit Strategist	31 20 563 8170	timothy.rahill@ing.com
	Benjamin Schroeder	Senior Rates Strategist	31 20 563 8955	benjamin.schroeder@ing.com
Roelof-Jan van den Akker	Head of Technical Analysis	31 20 563 8178	roelof-jan.van.den.akker@ing.com	
Brussels	Peter Vanden Houte	Chief Economist, Belgium, Luxembourg, Eurozone	32 2 547 8009	peter.vandenhoute@ing.com
	Julien Manceaux	Senior Economist, France, Belgium, Switzerland	32 2 547 3350	julien.manceaux@ing.com
	Philippe Ledent	Senior Economist, Belgium, Luxembourg	32 2 547 3161	philippe.ledent@ing.com
	Steven Trypsteen	Economist, Spain, Portugal	32 2 547 3379	steven.trypsteen@ing.com
	Charlotte de Montpellier	Economist, France, Switzerland	32 2 547 3386	charlotte.de.montpellier@ing.com
Frankfurt	Carsten Brzeski	Chief Economist, Eurozone, Germany, Austria, and Global Head of Macro	49 69 27 222 64455	carsten.brzeski@ing.de
	Inga Fechner	Economist, Germany, Austria	49 69 27 222 66131	inga.fechner@ing.de
	Franziska Biehl	Economist, Germany, Austria	49 69 27 222 68035	franziska.marie.biehl@ing.de
	Leon Ernst	Junior Economist, Eurozone	49 69 27 222 68230	leon.ernst@ing.de
Milan	Paolo Pizzoli	Senior Economist, Italy, Greece	39 02 55226 2468	paolo.pizzoli@ing.com
New York	Padhraic Garvey	Regional Head of Research, Americas	1 646 424 7837	padhraic.garvey@ing.com
	James Knightley	Chief International Economist	1 646 424 8618	james.knightley@ing.com
Emerging Markets		Title	Telephone	Email
New York	Gustavo Rangel	Chief Economist, LATAM	1 646 424 6464	gustavo.rangel@ing.com
London	Trieu Pham	Emerging Markets Sovereign Debt Strategist	44 20 7767 6746	trieu.pham@ing.com
	Egor Fedorov	Senior Emerging Markets Credit Analyst	44 20 7767 6150	egor.fedorov@ing.com
Czech Rep	Jakub Seidler	Chief Economist, Czech Republic	420 257 47 4432	jakub.seidler@ing.com
Hong Kong	Iris Pang	Chief Economist, Greater China	852 2848 8071	iris.pang@asia.ing.com
Hungary	Péter Virovác	Senior Economist, Hungary	36 1 235 8757	peter.virovacz@ing.com
Philippines	Nicky Mapa	Senior Economist, Philippines	632 479 8855	nicholas.mapa@asia.ing.com
Poland	Rafal Benecki	Chief Economist, Poland	48 22 820 4696	rafal.benecki@ing.pl
	Piotr Poplawski	Senior Economist, Poland	48 22 820 4078	piotr.poplawski@ing.pl
	Dawid Pachucki	Senior Economist, Poland	48 22 820 4608	dawid.pachucki@ing.pl
	Karol Pogorzelski	Economist, Poland	48 22 820 4891	karol.pogorzelski@ing.pl
Romania	Valentin Tataru	Chief Economist, Romania	40 31 406 8991	valentin.tataru@ing.com
Russia	Dmitry Dolgin	Chief Economist, Russia and CIS	7 495 771 7994	dmitry.dolgin@ingbank.com
Singapore	Rob Carnell	Regional Head of Research, Asia-Pacific	65 6232 6020	robert.carnell@asia.ing.com
	Prakash Sakpal	Senior Economist, Asia	65 6232 6181	prakash.sakpal@asia.ing.com
	Warren Patterson	Head of Commodities Strategy	65 6232 6011	warren.patterson@asia.ing.com
Turkey	Muhammet Mercan	Chief Economist, Turkey	90 212 329 0751	muhammet.mercan@ing.com.tr

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Research offices: legal entity/address/primary securities regulator**Amsterdam** ING Bank NV, Bijlmerdreef 106, Amsterdam, 1102 CT, Netherlands. *Netherlands Authority for the Financial Markets***Brussels** ING Belgium SA/NV, Avenue Marnix 24, Brussels, Belgium, B-1000. *Financial Services and Market Authority (FSMA)***Bucharest** ING Bank NV Amsterdam - Bucharest Branch, 48 Ianca de Hunedoara Bd, 011745, Bucharest 1, Romania. *Financial Supervisory Authority, Romanian National Bank***Budapest** ING Bank NV Hungary Branch, Dozsa Gyorgy ut 84/B, H - 1068 Budapest, Hungary. *National Bank of Hungary***Frankfurt** ING-DiBa AG, Theodor-Heuss-Allee 2, 60486 Frankfurt, Germany. *Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)***Hong Kong** ING Bank NV, Hong Kong Branch, 8/F, Three Pacific Place, 1 Queens' Road East, Hong Kong. *Hong Kong Securities and Futures Commission***Istanbul** ING Bank AS, ING Bank Headquarters, Resitpasa Mahallesi Eski Buyukdere Cad. No.8, 34467 Sariyer, Istanbul, Turkey. *Capital Markets Board***London** ING Bank NV London Branch, 8-10 Moorgate, London EC2R 6DA, United Kingdom. *Financial Conduct Authority***Manila** ING Bank NV Manila Branch, 20/F Tower One, Ayala Triangle, Ayala Avenue, 1226 Makati City, Philippines. *Philippine Securities and Exchange Commission***Milan** ING Bank NV Milano, 250, Viale Fulvio Testi, 20126, Milano, Italy. *Commissione Nazionale per le Società e la Borsa***Moscow** ING Bank (Eurasia) JSC, 36, Krasnoproletarskaya ulitsa, 127473, Moscow, Russia. *The Central Bank of Russia***New York** ING Financial Markets LLC, 1133 Avenue of the Americas, New York, NY 10036, United States. *Securities and Exchange Commission***Prague** ING Bank NV, Prague Branch, Českomoravská 2420/15, Prague 9, Czech Republic. *Czech National Bank***Singapore** ING Bank NV Singapore Branch, 1 Wallich Street, 12-01 Guoco Tower, Singapore 078881. *Monetary Authority of Singapore***Warsaw** ING Bank Slaski SA, 34, ul. Sokolska, Katowice, 40-086, Poland. *Polish Financial Supervision Authority***Disclaimer**

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