# Economy and financial markets

03/2021

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# Economy

During the fourth quarter, many world economies have been slowing down, some countries have even experienced GDP decline. GDP growth deacceleration was caused by the new social distancing measures implemented in Europe and North America. However, the slow-down was much milder than many economic forecasts expected, including December's ECB and FED predictions. This time, industry was much less effected (compared to the spring of 2020) than the service sector. At the start of 2021, the numbers of infected in many countries are on a declining path (not valid for the Czech Republic), the positive effect of vaccination is starting to become visible and even the first countries (Israel) started to ease up social distancing measures. At the same time, major support factors of expansive fiscal policy (fiscal deficits, government support programs spending) and the unprecedently easy monetary policy (low interest rates, quantitative easing – purchases of not only government bonds financing fiscal deficits) are not going to be released anytime soon. Positive sentiment will be supported by GDP growth data (on a y/y basis) in the first half of 2021 (a statistical effect due to low base data from the first half of 2020).

A major risk remains the worse development of the pandemic and the associated need for stricter social distancing measures due to new coronavirus mutations.

Financial markets continued in their growth; the slow-down in economic growth in Q4 2020 did not have any negative impact due to persisting positive expectations for 2021. Very high budget deficits and purchases of financial assets by central banks are increasing inflation expectations and support risk asset prices compared to safe assets with low yields (bonds with high credit ratings/low yield to maturity). The fiscal and monetary (quantitative easing) policies are expansionary and there is no evidence that they will be cut anytime soon, which means support for risky asset prices will remain in place despite frequently weak fundamentals. Fiscal consolidation, monetary policy normalization and the very high growth of real interest rates could derail the current path of the financial markets. The tightening of fiscal or monetary conditions by governments or central banks is unpopular and it is hard to imagine that they would be implemented in a short period.

# Macro-economic data/world

## GDP

**US** – US Economy GDP increased by **1.0% q/q** in 4Q 2020, full year **2020** GDP at **-3.5%**

**Eurozone** – Eurozone GDP growth in 4Q 2020 reached **-0.6%** q/q (-5.0% y/y), full year **2020** GDP at **-6.8%**

| | 2021 | 2022 |
|---|---|---|
| GDP – FED forecast[1] | 4.2 % | 3.2 % |
| HDP – ECB forecast[2] | 3.9 % | 4.2 % |

[1] December 2020 forecast, the new forecast will be released in March 2021

[2] December 2020 forecast, the new forecast will be released in March 2021

## Inflation

**US** – consumer inflation in January 2021 reached **1.4 % y/y**

**Eurozone** – consumer inflation in January 2021 decreased to **0.9 % y/y**

| | 2021 | 2022 |
|---|---|---|
| PCE y/y – FED forecast | 1.8 % | 1.9 % |
| Inflation y/y – ECB forecast | 1.0 % | 1.1 % |

## PMI – Purchase Manager Index

The economic activity in production sectors is on a rising path. The impact of the Covid-19 wave in Europe is visible in Markit PMI service data, which indicates a significant drop in economic activity (contrary to the USA). The Markit Manufacturing PMI in the Czech Republic is above the level of Eurozone data and very close to Germany's Markit Manufacturing PMI (57.1).

Markit PMI – 01/2021

| | Markit PMI Composite | Markit PMI Manufacturing | Markit PMI Services |
|---|---|---|---|
| US | 58.7 | 59.2 | 58.3 |
| Eurozone | 47.8 | 54.8 | 45.4 |
| Czech Republic | | 57.0 | |

(PMI index above 50 is an indication of growth ≠ production or services reached pre-Covid-19 levels)

# Czech Republic

- The CNB has published the new forecast of Czech economic development (Monetary Policy Report I 2021) after the monetary meeting in February 2021
- The most important change compared to the previous forecast (November 2020) – the decrease of the expected EUR/CZK foreign exchange rate in 2021 to 25.80 (decrease by 80 halers) and in 2022 to 24.90 (decrease by 1 crown)
- The major risk of the CNB forecast is longer anti-pandemic measures in the Czech Republic and major trading partners, which can cause the worse financial situation of companies and population

## CNB forecasts overview

| | 2021 | 2022 |
|---|---|---|
| **Headline inflation** (%) | 2.0 | 2.2 |
| **GDP** | 2.2 | 3.8 |
| **Average nominal wage** | 5.2 | 3.3 |
| **Exchange rate** (EUR/CZK) | 25.8 | 24.9 |
| **3M Pribor** (%) | 0.7 | 1.5 |

## GDP

- The base case scenario expects, after a drop in the GDP in 2020 (the first estimate -5.0%), a return to growth in 2021 at **2.0%**, and in 2022 at **2.2%**
- The impact of Covid-19 on Manufacturing in H1 2021 significantly lower than in spring 2020 will support GDP growth (statistical base effect); services will start to improve after the release of social distancing measures, which are expected in H2 2021, the positive impact of fiscal policy on GDP growth will weaken during 2021
- Return to 2019 GDP level expected at the end of 2022

## Gross domestic product

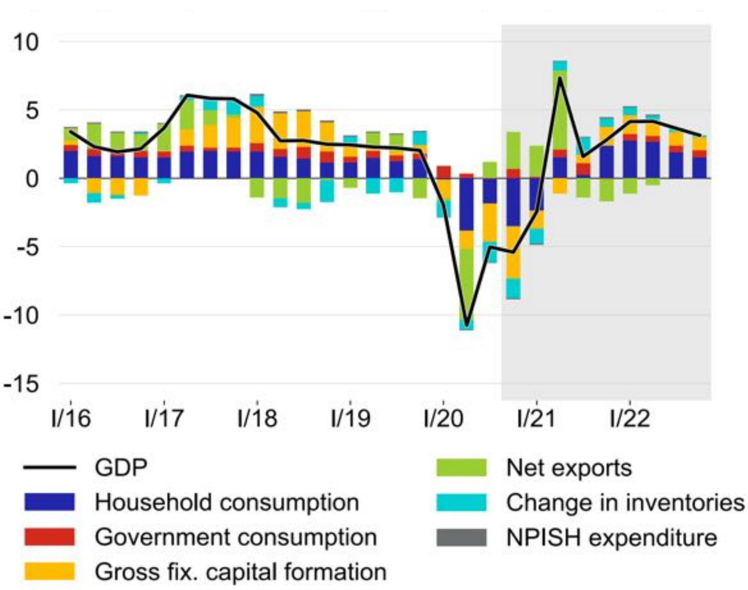



Chart: CNB

# Czech Republic

## Inflation

- Inflation in January 2021 decreased to **2.2%** p.a. and returned to the CNB inflation target (2%)
- Inflation during 2021 should be close to the CNB's inflation target, disinflation pressures caused by lower demand (the impact of Covid-19) should gradually wane, though a stronger CZK foreign exchange rate should mute the inflation rate
- The base case scenario expects inflation in 2021 at **2.0%** p.a., and in 2022 the forecast is at **2.2%** p.a.

### Structure of inflation and the inflation forecast

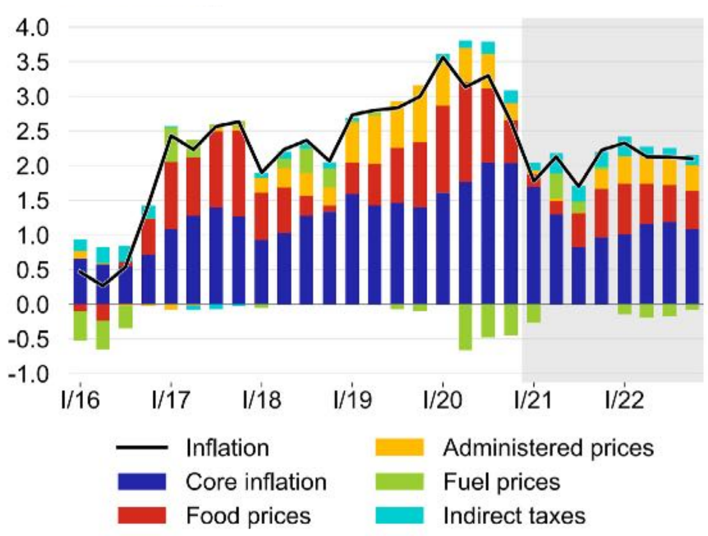



Chart: CNB

## Labor Market

- Employment in 2021 will decrease and the unemployment rate will increase until mid-2021 despite government programs for employment support
- Wage growth in non-market sectors (compared to the non-market sectors) will significantly increase in 2021 to **5.2%** one-off income tax changes (expected shift of bonus payments from Q4 2020 to Q1 2021 due to lower income tax), without the impact of tax changes the wage dynamic would stay muted in 2021-22

### Labor market forecast

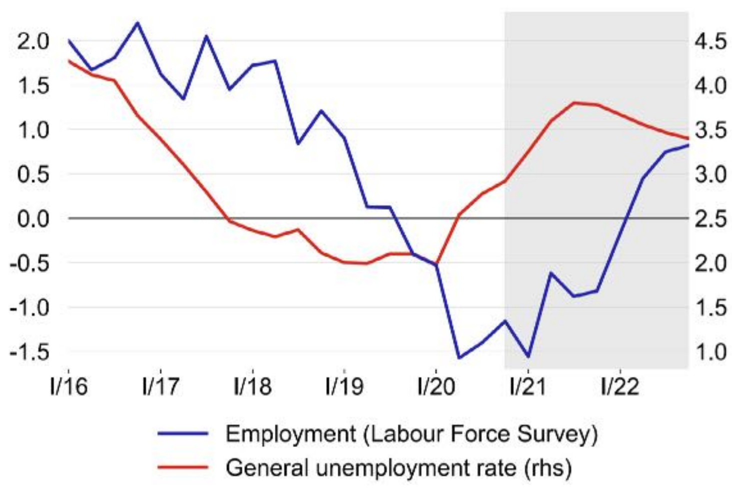



Chart: CNB

# Czech Republic

## Interest rates

- The CNB's repo rate (two weeks) will be stable, according to the forecast, at **0.25%** p.a. until mid-2021. In the second half of 2021, the diminishing impact of Covid-19 will enable the gradual normalization of the monetary policy – higher interest rates (average repo rate in Q4 2021 forecasted at **1.06%** p.a.)
- The CNB Bank Board considers the risks of the longer-lasting Covid-19 impacts to be significantly higher than the assumptions of the base case. In this scenario, the interest rate hikes would be significantly postponed, compared to the base case forecast. The financial markets also expect a slower interest rate normalization than the analytical team of CNB

## Interest rate forecast


Chart: CNB

## The Foreign Exchange Rate

- The exchange rate forecast for Q1 2021 is set at EUR/CZK 26.3 – more than 1 percent higher than the exchange rate prevailing in mid-February 2021
- According to the CNB, the Czech crown should appreciate gradually over the entire forecast horizon
- The Czech crown should strengthen on the forecast horizon. The EUR/CZK foreign exchange rate should be close to 25.40 by the end of 2021, and 24.70 in Q4 2022

## Exchange rate forecast

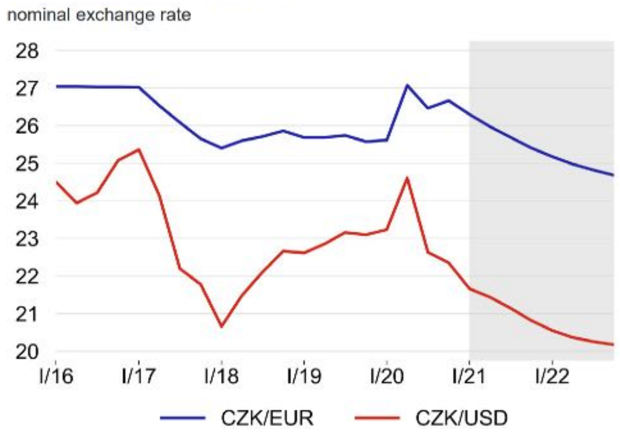


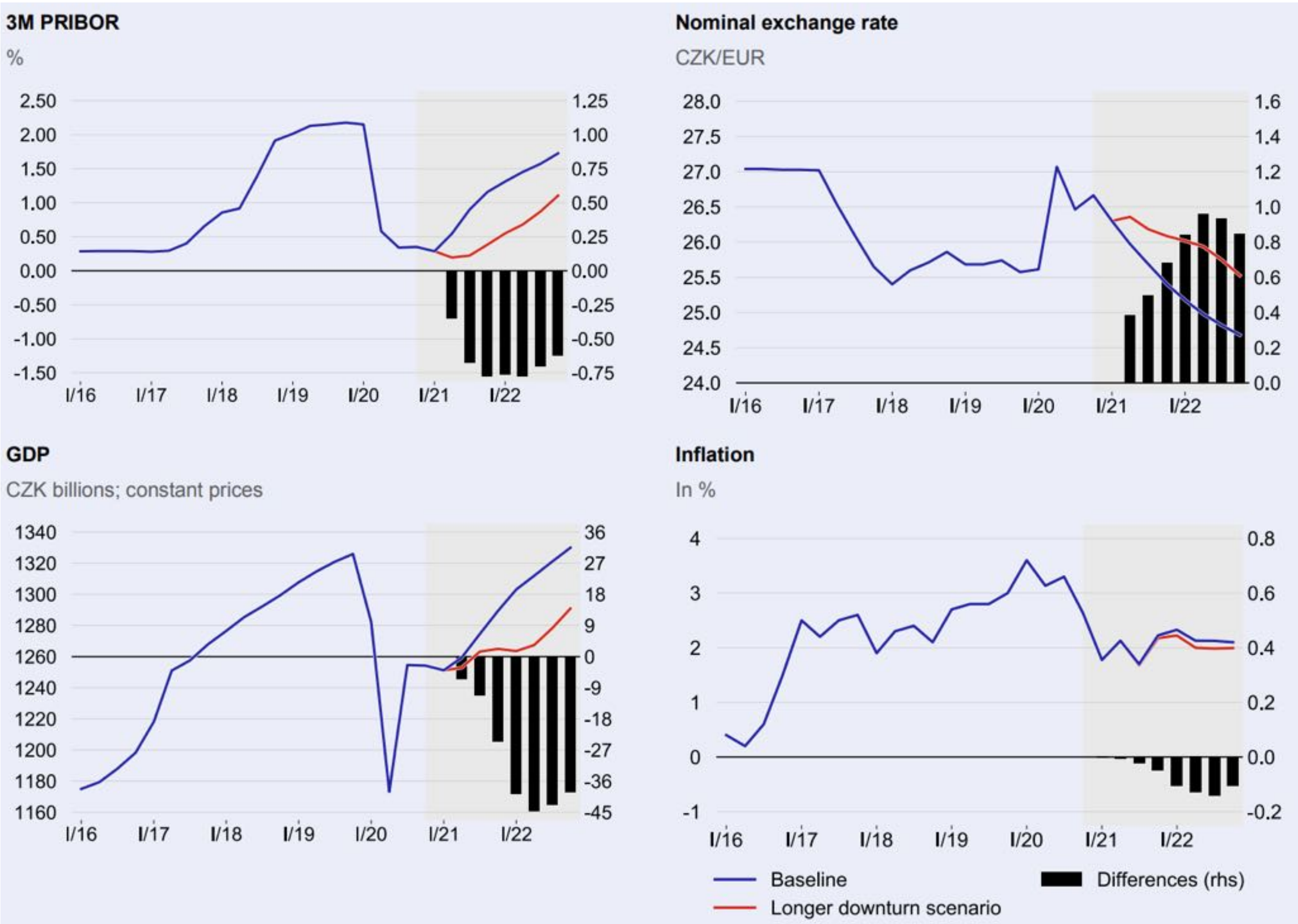

Chart: CNB

## The longer-lasting pandemic-induced downturn scenario

- A longer-lasting Covid-19 infection leads to more subdued developments in Czech industry, the Czech economy, and the Eurozone economy than in the baseline scenario
- Lower foreign demand will be reflected in lower foreign trade dynamics and lower domestic economic activity. This scenario is consistent with a weaker Czech crown, lower inflation outlook, and stability of the repo rate at the current levels

## The unchanged rates Scenario

- Prepared based on the CNB Bank Board, this scenario examines the hypothetical situation of interest rates staying at their current levels until the end of this year, which will lead to distinctly higher inflation close to the upper boundary of the tolerance band and a weaker EUR/CZK exchange rate (impact of the lower interest rate differential) but a similar GDP path as in the base case scenario
- The CNB Bank Board has the power to set the CNB interest rates according to their judgement

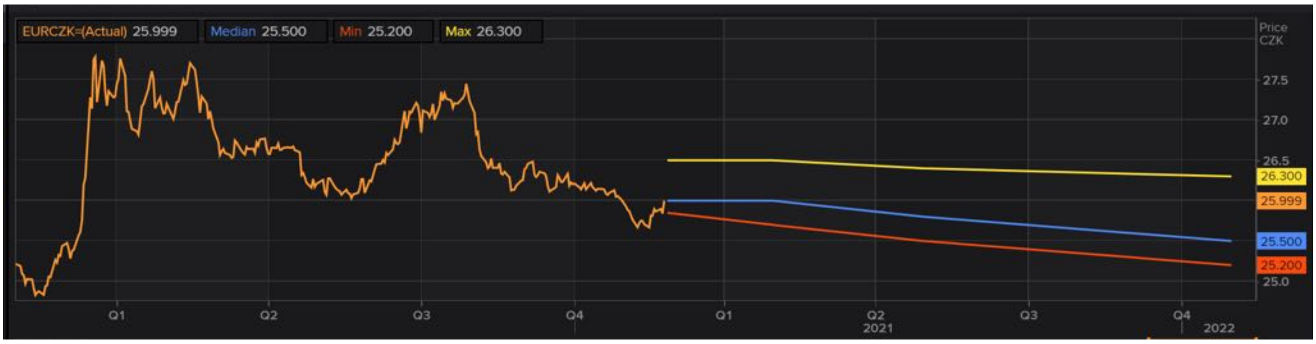


# Financial Markets

## EUR/CZK foreign exchange rate

- Financial analysts (Reuters FX Poll as of February 4th, 2021) expect, in line with the CNB forecast, a stronger Czech crown against the euro during 2021, the median EUR/CZK in one year (at the end of January 2022) estimate at 25.50

## Reuters FX Poll 04/02/2021




Data: Refinitiv

## The Czech crown strengthened till mid-February and reached levels around 25.65 thanks to

- Positive sentiment on the financial markets, which caused the good performance of risk assets
- The better than expected trade balance of the Czech Republic, the export-oriented Czech industry was not hit by social-distancing measures at the end of 2020, imports to the Czech Republic were decreasing

In line with the CNB forecast and financial analysts´ forecast, EUR/CZK should strengthen, though the strengthening will not be straightforward. Fluctuations in the prices of the risky assets on the financial markets or negative information about new Covid-19 mutations/delays in vaccination should cause corrections in the value of the Czech crown.

# Financial Markets

## Interest rates

- Short term interest rates are close to historical lows and the major central banks (FED, ECB) do not expect any changes in the base interest rates in their forecasts
- Inflation expectations after the sharp drop in Q1 2020 are on a steady rise and, together with budget deficit financing needs, are causing the rise of long-term interest rates on the financial markets, in the case of higher long-term interest rates it is impossible to exclude yield curve control by another central bank (currently the Bank of Japan)
- Fiscal consolidation is not expected anytime soon; the pressures on the steepening of the yield curve without central bank interventions should prevail
- The CNB repo rate remains at 0.25%; the new tax changes increased budget deficit and thus higher financing needs, together with the CNB repo rate expectations, are pushing long-term interest rates up, the yield curve is getting steeper (10Y Czech Government Bonds yield to maturity at 1.60% p.a.)

## CZK 10-year interest rate swap


Data and chart: Refinitiv

# Financial Markets

## Equity markets

- Equity markets continue to grow, supported by fiscal stimulus, and ongoing quantitative easing reached new historical highs, the contribution to growth by big technological companies FAANG is much lower than in H1 2020
- The S&P500 EPS estimates for FY 2021 are still lower than the expectations at the beginning of 2020; investors must rely on unstable capital gains (expectations) than on the current cash flow generation
- The higher household domestic saving rate (government support, lower expenditures on services) and low-cost trading platforms (Robinhood, ETrade, etc.) increased the participation of retail investors (which is visible not only on the infamous Gamestop shares)

## MSCI World


Data and chart: Refinitiv

# Financial Markets

## Credit markets

- Credit spreads on the financial markets, despite not great fundamentals, are close to the very tight levels reached at the beginning of 2020

## Credit spread of portfolio of 125 European corporate noninvestment grade corporates


Data and chart: Refinitiv

# Contacts

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