

| Foreign Exchange |

# Special Report

## EUR/CZK call revised higher as major stress hits markets



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**On the back of the recent market turmoil and the increase in political stress, we have revised our EUR/CZK call higher for the coming months. However, the medium-term forecasts remain virtually unchanged.**

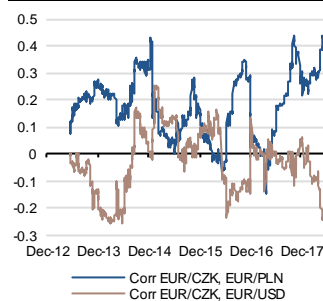
### Sharp koruna depreciation in May



Source: Bloomberg, Economic & Strategy Research, Komerční banka

Since early May, global FX markets have seen a significant increase in volatility and flight-to-quality moves as several risk-off events have emerged. Notably Argentina's debt issues, North Korea tensions, the Turkish lira's plunge, disappointing macroeconomic data and, most recently, the political crisis in Italy have slashed investors' confidence. As a result, market players have been selling EM currencies, returning to EUR and – to the greatest extent – USD assets. **What differentiates May's developments from previous periods of stress is the uniformity of EM sell-offs.**

### Correlations with EUR/PLN and EUR/USD highest in years



Source: Bloomberg, Economic & Strategy Research, Komerční banka

In the past, the koruna has proved resilient against EM-wide losses. The Czech currency provided a straightforward story of long-term undervaluation, nominal convergence and rising interest rates (and the IR differential against EUR). However, we have long argued that the sharp increase in CZK liquidity due in the final months of the Czech National Bank's interventions can result in the koruna's losses if markets are hit by a major stress event. On a relatively small scale, the recent depreciation of the currency has confirmed this risk. The EUR/CZK exchange rate increased to the proximity of the 26 level in May. Importantly, there has been a major increase to multi-year maximums in a positive correlation between EUR/CZK and other CEE currencies and in a negative correlation with EUR/USD. **Apparently, global investors have stopped differentiating between CZK and other EM assets and have been pulling funds to USD.**

### New FX forecasts (EOP)

	3Q18	4Q18	1Q19	2Q19
EUR/CZK	25.20	24.80	24.50	24.50
USD/CZK	21.9	20.3	19.3	18.6
EUR/USD	1.15	1.22	1.27	1.32
EUR/PLN	4.30	4.25	4.20	4.16
EUR/HUF	319.0	321.0	325.0	333.0

Source: Economic & Strategy Research, Komerční banka, SG Cross Asset Research

This week, markets were frightened by the political crisis in Italy. In our view, the stream of risk-off news is not likely to subside in the coming months: We expect snap elections in September, and the M5S and Northern League parties might present the poll as a referendum on euro area membership. That said, we do not believe Italy will leave the euro area, and the situation will calm in 4Q18. **Still, the elevated risk will likely continue to hamper any fast CZK recovery in the coming months.** As a result, we have revised the expected path of EUR/CZK in the remainder of 2018. Due to the risk-off mood on the markets, we have shifted EUR/CZK higher in 2Q and 3Q, but calmer developments in late 2018 and the expected CNB hike are set to drive the currency below 25.

The new SG forecasts for EUR/USD and CEE currencies reflecting the elevated stress are shown in the table on the left-hand side.

If market sentiment significantly worsens and the EUR/USD exchange rate plunges substantially below 1.150, **then it is possible EUR/CZK will test and breach the 26 level.** That would further confirm the risk scenario as per our latest *Czech Economic Outlook*: <http://bit.ly/2JKkaJz>

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