



| CNB and FX |

Special Report

CNB to complete hat-trick in September



Viktor Zeisel
(420) 222 008 523
viktor_zeisel@kb.cz



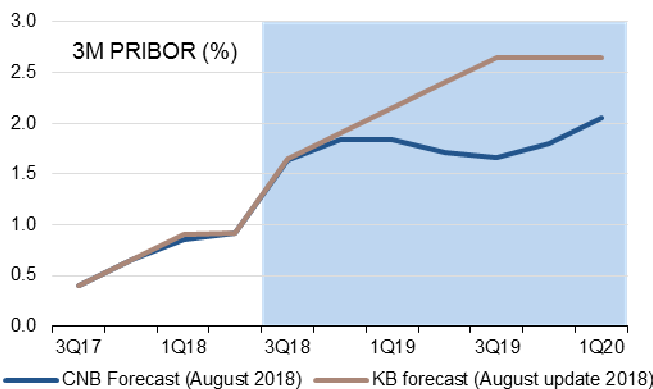
Jakub Matějů
(420) 222 008 598
j_mateju@kb.cz

Despite the CNB hiking rates twice over the summer, the koruna remains rather weak while core inflation is accelerating on the back of rising wages. The CNB’s forecasts assume one more hike in the third quarter, and the market has already priced it in. We expected a hawkish outcome from the latest CNB meeting that would see the koruna strengthen. However, although the bank’s short-term outlook did prove hawkish, the FX market has not reacted. We change our CNB call in accordance with the market view of September hike. We still expect another hike in November.

The CNB’s August forecasts assume two hikes in the third quarter and one more in the final quarter of the year. Compared to our outlook, the CNB projection had expected higher inflation and a weaker koruna. July’s inflation reading proved us right, with inflation decelerating from 2.6% to 2.3%. The slump was mainly due to a drop in food prices, while core inflation accelerated. The CNB has signalled that it will not react to volatility in food prices and that it considers the strength of the core reading to be the key driver of its decisions. We see the trajectory of inflation as supporting a hawkish view.

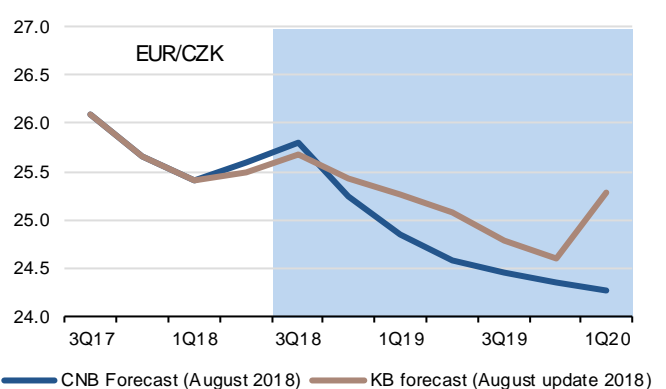
EUR/CZK is a second factor supporting the CNB hawks. Despite the bank’s relatively bullish forecast for this year, the FX rate has not moved notably. It is still being driven more by the risk-off mood affecting all EM currencies than by widening interest rate differentials. Thus, the koruna is not helping tighten overall monetary conditions, implying that more tightening will have to be done through interest rate increases.

We expect continuous rate hikes this year and next...



Source: CNB, Bloomberg, Economic and Strategy Research KB

... while the koruna should appreciate more gradually



Source: CNB, Bloomberg, Economic and Strategy Research KB

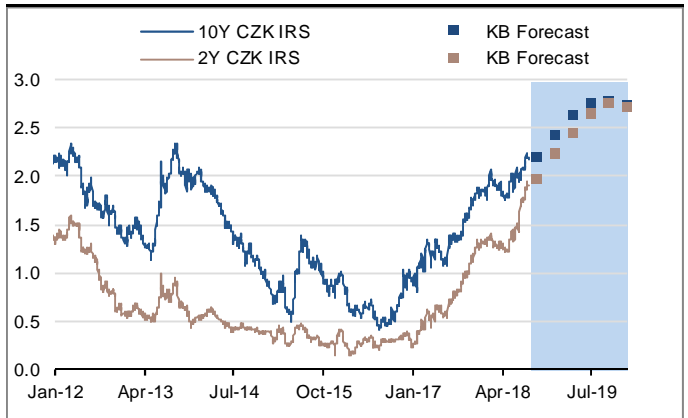
Besides FX, the bank board is very concerned with the labour market. Wage growth does not seem to be easing, propelled by excess demand for labour. Moreover, the government has agreed to raise the salaries of public servants by 8% on average starting next year.

Given strong core inflation, a weak koruna and the prospect of sound wage growth, we change our CNB call and add a September hike to our outlook. We still believe that there will be one more hike in November and three hikes in next year. The repo rate should thus reach 2.5%, which is very close to its neutral rate.

Analogously, we update our call on the IRS and CZGB yield curves. The IRS curve continues to flatten, with the 2y10y spread recently at 25bp. We expect additional CNB rate hikes to accelerate the rise of the short end, with the 2Y IRS set to reach 2.25% by the end of the year and grow further to 2.75% over the course of 2019. This should result in further curve

flattening, and we expect the 2y10y spread to reduce to zero in the second half of next year. Slightly stronger inflation and record-high issuance suggest that CZGB yields will follow the upward trend despite likely good demand, with the yield on the 10y CZGB reaching 2.4% by the end of the year and later increasing to 2.7%.

IRS curve to flatten, driven by rate hikes



Source: Bloomberg, Economic and Strategy Research KB

KB ECONOMIC & STRATEGY RESEARCH

Chief Economist and Head of Research



Jan Vejmelek, Ph.D., CFA
(420) 222 008 568
jan_vejmelek@kb.cz

Economists



Viktor Zeisel
(420) 222 008 523
viktor_zeisel@kb.cz



Monika Junicke
(420) 222 008 509
monika_junicke@kb.cz



Jana Steckerová
(420) 222 008 524
jana_steckerova@kb.cz



Jakub Matějů
(420) 222 008 598
j_mateju@kb.cz

Equity Analysts



Miroslav Frayer
(420) 222 008 567
miroslav_frayer@kb.cz



Jiří Kostka
(420) 222 008 560
jiri_kostka@kb.cz



Sectors
David Kocourek
(420) 222 008 569
david_kocourek@kb.cz

SG IN CENTRAL AND EASTERN EUROPE

Chief Economist of SG Poland



Jaroslaw Janecki
(48) 225 284 162
jaroslaw.janecki@sgcib.com



Head of Research of Rosbank
Evgeny Koshelev
(7) 495 725 5637
evgeny.koshelev@rosbank.ru

Chief Economist of BRD-GSG



Florian Libocor
(40) 213 016 869
florian.libocor@brd.ro

Head of Fin. Markets Research BRD-GSG



Carmen Lipara
(40) 213 014 370
carmen.lipara@brd.ro

Economist



Ioan Mincu
(40) 213 014 472
george.mincu-radulescu@brd.ro

Equity Analyst



Laura Simon, CFA
(40) 213 014 370
laura.simon@brd.ro

SG GLOBAL ECONOMICS RESEARCH

Head of Global Economics



Klaus Baader
(852) 2166 4095
klaus.baader@sgcib.com

Euro area



Michel Martinez
(33) 1 4213 3421
michel.martinez@sgcib.com



Anatoli Annenkov
(44) 20 7762 4676
anatoli.annenkov@sgcib.com



Yvan Mamalet
(44) 20 7762 5665
yvan.mamalet@sgcib.com



United Kingdom
Brian Hilliard
(44) 20 7676 7165
brian.hilliard@sgcib.com

North America



Stephen Gallagher
(212) 278 4496
stephen.gallagher@sgcib.com



Omair Sharif
(1) 212 278 48 29
omair.sharif@sgcib.com



Latin America
Dev Ashish
(91) 80 2802 4381
dev.ashish@socgen.com



India
Kunal Kumar Kundu
(91) 80 6716 8266
kunal.kundu@sgcib.cz

China



Wei Yao
(33) 1 57 29 69 60
wei.yao@sgcib.com



Japan
Takuji Aida
(81) 3-6777-8063
takuji.aida@sgcib.com



Arata Oto
(81) 3 6777 8064
arata.oto@sgcib.com



Korea
Suktae Oh
(82) 2195 7430
suktae.oh@sgcib.com

Inflation



Vaibhav Tandon
(91) 80 6731 9449
vaibhav.tandon@sgcib.com

SG CROSS ASSET RESEARCH - FIXED INCOME & FOREX GROUPS

Global Head of Research



Brigitte Richard-Hidden
(33) 1 42 13 78 46
brigitte.richard-hidden@sgcib.com

Head of Fixed Income & Forex Strategy



Guy Stear
(33) 1 41 13 63 99
guy.stear@sgcib.com

Head of Retes Strategy



Adam Kurpiel
(33) 1 42 13 63 42
adam.kurpiel@sgcib.com



Bruno Braizinha
(1) 212 278 5296
bruno.braizinha@sgcib.com



Jean-David Cirotteau
(33) 1 42 13 72 52
jean-david.cirotteau@sgcib.com



Cristina Costa
(33) 1 58 98 51 71
cristina.costa@sgcib.com

Head of Euro Area Rates Strategy



Jorge Garayo
(44) 20 7676 7404
jorge.garayo@sgcib.com



Ciaran O'Hagan
(33) 1 42 13 58 60
ciaran.ohagan@sgcib.com



Shakeeb Hulikatti
(91) 80 2802 4380
shakeeb.hulikatti@sgcib.com



Head of US Rates Strategy
Subadra Rajappa
(1) 212 278 5241
subadra.rajappa@sgcib.com

Foreign Exchange



Kit Juckes
(44) 20 7676 7972
kit_juckes@sgcib.com



Marc-Henri Thoumin
(44) 20 7676 7770
marc-henri.thoumin@sgcib.com



Kevin Ferret
(44) 20 7676 7073
kevin.ferret@sgcib.com

FX Derivatives Strategy



Alvin T. Tan
(44) 20 7676 7971
alvin-t.tan@sgcib.com



Foreign Exchange
Oliver Korber
(33) 1 42 13 32 88
olivier.korber@sgcib.com

Head of Emerging Markets Strategy



Jason Daw
(65) 6326 7890
jason.daw@sgcib.com



Régis Chatellier
(44) 20 7676 7354
regis.chatellier@sgcib.com



Phoenix Kalen
(44) 20 7676 7305
phoenix.kalen@sgcib.com



Kiyong Seong
(852) 2166 4658
kiyong.seong@sgcib.com



Marek Dřimal
(44) 20 7550 2395
marek.drimal@sgcib.com

Disclaimer

The information herein is not intended to be an offer to buy or sell, or a solicitation of an offer to buy or sell any securities. All information and opinions have been obtained from or are based on sources believed to be reliable, but their completeness and accuracy are not guaranteed by Komerční banka, a.s., even though Komerční banka, a.s. believes them to be fair and not misleading or deceptive. The views of Komerční banka, a.s. reflected in this document may change without notice.

Komerční banka, a.s. and its affiliated companies may from time to time deal in, profit from the trading of, hold or act as market makers of securities, or act as advisers, brokers or bankers in relation to securities or derivatives thereof emitted by persons, firms or entities mentioned in this document.

Employees of Komerční banka, a.s. and its affiliated companies, or individuals connected to them may from time to time have a position in or be holding any of the investments or related derivatives mentioned in this document. The authors of this document are not authorized to acquire the investment instruments mentioned in this document. This does not apply to cases when the investment recommendation mentioned in this document represents dissemination of an investment recommendation earlier produced by third parties according to Chapter III of regulation (EU) 2016/958. Komerční banka, a.s. and its affiliated companies are under no obligation to provide any services to their clients on the basis of this document.

Komerční banka, a.s. does not accept any liability whatsoever arising from the use of the material or information contained herein beyond what is required by law. This research document is primarily intended for professional and qualified investors. Should a private customer obtain a copy of this report, they should not base their investment decisions solely on the basis of this document and should seek independent financial advice. The investors must make their own informed decisions regarding the appropriateness of their investments because the securities discussed in this report may not be suitable for all investors.

The performance attained by investment instruments in the past may not under any circumstance serve as a guarantee of future performance. The estimates of future performance are based on assumptions that may not be realized. Investment instruments and investments are connected with different investment risks, the value of any investment can rise and fall and there is no guarantee for the return of the initial invested amount. Investment instruments denominated in foreign currencies are also subject to fluctuations caused by changes in exchange rates, which can have both positive and negative influences particularly on the prices of the investment instrument and consequently on the investment return.

This publication is issued by Komerční banka, a.s. which is a bank/stockbroker according to the applicable legislation and thus regulated by the Czech National Bank. Komerční banka, a.s. applies various measures to prevent conflict of interests in the process of creating investment recommendations, such as the implementation of an appropriate internal separation including information barriers between different departments of Komerční banka, a.s. in compliance with the requirements imposed by applicable regulation. The employees of Komerční banka, a.s. proceed in accordance with the internal regulations governing conflict of interest.

The evaluation of employees creating investment recommendations is never by any means tied with the volume or profit of the trades with instruments mentioned in this document done by Komerční banka, a.s., or the trades of Komerční banka, a.s. with the issuers of such instruments. However, the evaluation of the authors of this document is linked to the profits of Komerční banka, a.s. which also partially include the results of trading with investment instruments.

The recommendations mentioned in this document are intended for the public and the document before its publication is not available to persons not involved in the creation of this document. As per our practice, the issuers do not receive a copy of research reports prior to their publication. Each author of this research report hereby states that (i) the views expressed in the research report accurately reflect his or her personal views about any and all of the securities or issuers at stake.

This document and its contents is not designed for persons with permanent residence or seat in the United States of America and to persons who are deemed as "U.S. persons", as defined in Regulation S under the US Securities Act of 1933, as amended.

This document is not an investment recommendation according to Regulation (EU) No 596/2014 of the European Parliament and of the Council on market abuse and does not constitute investment advisory according to Act no 256/2004 Coll., on Capital market undertakings as amended.

Please refer to our website <http://www.trading.kb.cz> for more details.