

## EEMEA Strategy Watch

## We prefer Czech to Polish 5y bonds

**Czech 5y bonds to outperform their Polish counterparts**

The main implication of our more bullish view on the front end in Czechia (relative to Poland) is that Czech 5y bonds should outperform their Polish counterparts. However, on the FX side, we continue to prefer the PLN to the CZK. We are still long PLNCZK (open: 5.51; current: 5.63; target: 5.78). For the original trading idea see [EM Alpha: Go long PLNCZK + FRA flattener in Czechia 07 November 2023](#). The risk is a more dovish-than-expected NBP.

We continue to receive the 1y1y swap in Czechia and pay the same swap in Poland. We opened the trade at 0.56 (current: 0.69; target: 1). For the original trading idea, please see [EM Alpha: Receive Czech vs pay Polish 1y1y + close Czech FRA flattener which is near target 08 December 2023](#). The risk is more rapid disinflation in Poland and a more hawkish CNB.

**5y swaps are more sensitive to monetary policy than 10y**

5y swaps in both countries are more sensitive to monetary policy than 10y swaps, which is the main reason that we are more bullish on Czech 5y bonds relative to their Polish counterparts. This view holds under both flat and falling US rates. This is not the case for the 10y tenor as it is more sensitive to core rates than 5y tenor.

Our scenario analysis assumes that 2y swaps in both Czechia and Poland return to their fair value (based on the BofA policy rate forecast) within the next six months. We also run scenarios with different assumptions for US rates. Our US strategy team continues to recommend 5y receivers acknowledging that the pace of decline from here is likely to slow ([Global Rates Weekly: Doves of a feather 08 December 2023](#)).

**ASW spreads are fair in Poland, a little too wide in Czechia**

ASW spread dynamics should also justify Czech bonds outperformance relative to Polish bonds. ASW spreads remain on the wider side relative to history in Czechia despite the fiscal consolidation expected next week. As a result, our bias would be to be long ASW spreads at these levels (Exhibit 1-Exhibit 2). Please see [EEMEA Strategy Viewpoint: ASW spreads to tighten in Czechia, fair valuation in other countries 21 November 2023](#).

In Poland, ASW spreads should stay wide. Fiscal policy should remain loose despite a new more fiscally conservative government coming to power, due to more elections in 2024-25E. Both gross and net borrowing requirements are likely to be higher next year compared with 2023. Moreover, Poland will have pre-financed much less of its 2024 borrowing requirements than usual.

For charts and technical details of our analysis, please see the next page.

12 December 2023

EEMEA Strategy  
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**Abbreviations**

ASW is asset swap

CEE is Central and Eastern Europe

I(1) is time-series with one unit root

CNB is Czech National Bank

NBP is National Bank of Poland

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Timestamp: 12 December 2023 07:11AM EST

## First step: estimate the model for 5y and 10y swaps

There are two main drivers of CEE rates: 1) monetary policy; 2) core rates that are best proxied by US rates. We estimate the models for 5y and 10y swaps in both Czechia and Poland for the period from January 2020 until now on a monthly average frequency. We select the specification that ensures co-integration among variables as all the variables are non-stationary with one unit root. We estimate the model using the Dynamic Ordinary Least Squares approach, which works well for  $I(1)$  series that are co-integrated and present the models together with the charts in Exhibit 3-Exhibit 10.

The first thing to note is that Polish swaps have higher beta to US rates compared with Czech rates. We believe this is because the CNB has higher credibility in the eyes of the market than the NBP. This allows the CNB to control the swap curve better through its monetary policy.

Second, the sensitivity of 5y and 10y tenors to US rates in both countries is similar. This is because we have to include trends into our models to ensure co-integration among variables.

Third, the 10y tenor is less sensitive than the 5y to front-end rates in both countries.

## Second step: run scenarios under different assumptions

We assume that the Czech front-end will reprice towards its fair value within the next six months, which means that it rallies on the margin. We assume that the Polish front-end will grind higher, reaching its fair value in six months.

We assume that US rates remain flat. We also stress test this assumption with alternative scenarios, which assume a decline in US 5y and 10y swaps.

## Results: Czech 5y outperforms Polish 5y

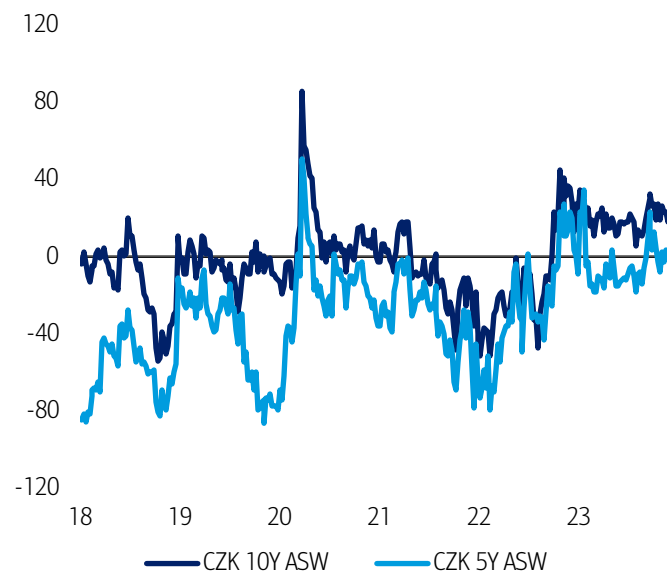
If we assume unchanged US rates for the next six months, then Czech 5y swaps should outperform 5y swaps in Poland (Exhibit 11), while the reverse is true for the 10y tenor (Exhibit 12). We attribute these results to the higher sensitivity of the 5y tenor to front-end rates.

We stress test the above results with different assumptions for core rates given that our US rates strategy team is still bullish US rates, acknowledging that the easy part of the move is behind us. We run the following alternative scenarios: 1) 2bps decline per month in both US 5y and 10y rates 2) 5bps decline per month in both US 5y and 10y rates; 3) 10bps decline per month in both US 5y and 10y rates.

In all the above cases, the 5y swap in Czechia declines more than the 5y swap in Poland, while the results for the 10y tenor are more mixed.

**Exhibit 1: ASW spreads in Czechia have some room to tighten**

Especially for the 10y tenor, fiscal policy should be tight in 2024



Source: Bloomberg, BofA Global Research

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**Exhibit 2: ASW spreads are fair in Poland**

Loose fiscal will keep ASW spreads elevated

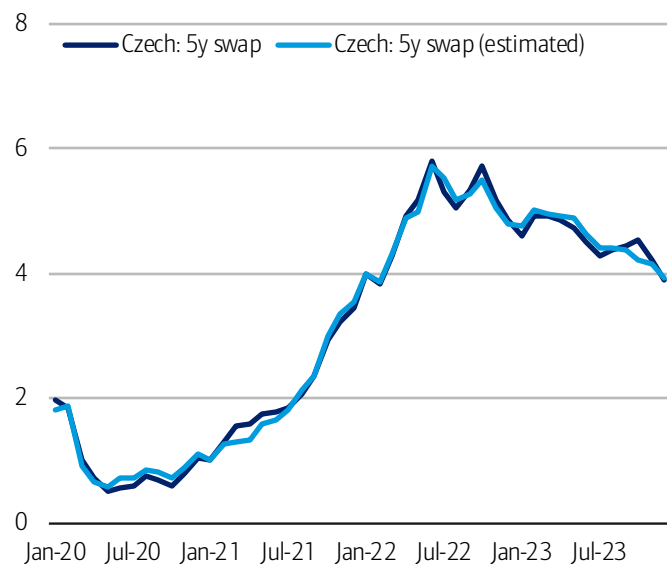


Source: Bloomberg, BofA Global Research

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**Exhibit 3: Czech 5y swap model**

We ensure co-integration among variables as all of them are I(1)



Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 4: Czech 5y swap model**

Estimation output

**Dependent Variable: \_5YEAR\_SWAP\_CZK**

Method: Dynamic Least Squares (DOLS)

Date: 12/11/23 Time: 10:57

Sample: 2020M01 2023M12

Included observations: 48

Cointegrating equation: C @TREND @TREND^2

Fixed leads and lags specification (lead=1, lag=1)

Long-run variance estimate (Bartlett kernel,

Newey-West fixed bandwidth = 4.0000)

No d.f. adjustment for standard errors &amp; covariance

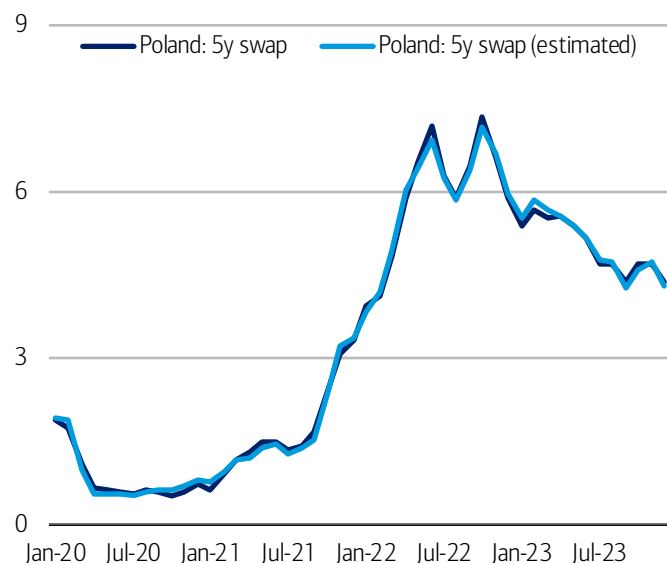
Variable	Coefficient	Std. Error	t-stat	Prob.
_2YEAR_SWAP_CZK	0.58	0.04	13.90	0.00
_5YEAR_SWAP_US	0.31	0.12	2.68	0.01
C	-69.95	18.15	-3.85	0.00
@TREND	0.52	0.14	3.84	0.00
@TREND^2	0.00	0.00	-3.78	0.0
R-squared	0.99	Adjusted R-squared	0.99	

Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 5: Poland 5y swap model**

We ensure co-integration among variables as all of them are I(1)



Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 6: Poland 5y swap model**

Estimation output

**Dependent Variable: \_5YEAR\_SWAP\_PLN**

Method: Dynamic Least Squares (DOLS)

Date: 12/11/23 Time: 11:33

Sample: 2020M01 2023M12

Included observations: 48

Cointegrating equation: C @TREND @TREND^2

Fixed leads and lags specification (lead=1, lag=1)

Long-run variance estimate (Bartlett kernel,

Newey-West fixed bandwidth = 4.0000)

No d.f. adjustment for standard errors & covariance

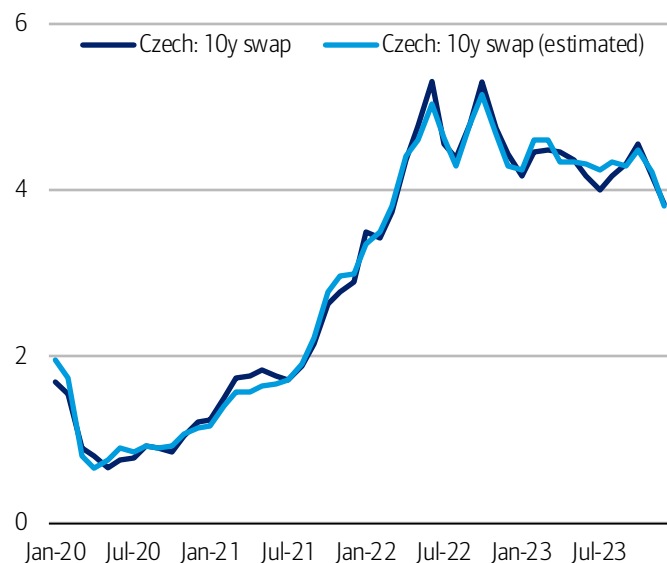
Variable	Coefficient	Std. Error	t-Statistic	Prob.
_2YEAR_SWAP_PLN	0.64	0.03	18.82	0.00
_5YEAR_SWAP_US	0.47	0.12	3.93	0.00
C	-101.04	17.94	-5.63	0.00
@TREND	0.75	0.13	5.58	0.0
@TREND^2	0.00	0.00	-5.49	0.0
R-squared	0.99	Adjusted R-squared	0.99	

Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 7: Czech 10y swap model**

We ensure co-integration among variables as all of them are I(1)



Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 8: Czech 10y swap model**

Estimation output

**Dependent Variable: \_10YEAR\_SWAP\_CZK**

Method: Dynamic Least Squares (DOLS)

Date: 12/11/23 Time: 11:18

Sample: 2020M01 2023M12

Included observations: 48

Cointegrating equation deterministics: C @TREND

Fixed leads and lags specification (lead=1, lag=1)

Long-run variance estimate (Bartlett kernel,

Newey-West fixed bandwidth = 4.0000)

No d.f. adjustment for standard errors & covariance

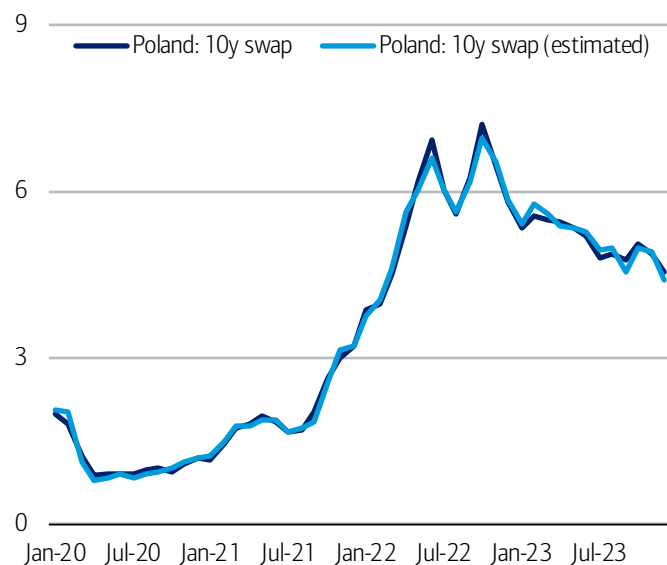
Variable	Coefficient	Std. Error	t-stat	Prob.
_2YEAR_SWAP_CZK	0.49	0.03	17.49	0.00
_10YEAR_SWAP_US	0.20	0.11	1.84	0.03
C	-1.39	1.85	-0.75	0.46
@TREND	0.01	0.01	1.05	0.30
R-squared	0.99	Adjusted R-squared	0.99	

Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 9: Poland 10y swap model**

We ensure co-integration among variables as all of them are I(1)



Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 10: Poland 10y swap model**

Estimation output

**Dependent Variable: \_10YEAR\_SWAP\_PLN**

Method: Dynamic Least Squares (DOLS)

Date: 12/11/23 Time: 11:20

Sample: 2020M01 2023M12

Included observations: 48

Cointegrating equation deterministics: C @TREND @TREND^2

Fixed leads and lags specification (lead=1, lag=1)

Long-run variance estimate (Bartlett kernel,

Newey-West fixed bandwidth = 4.0000)

No d.f. adjustment for standard errors & covariance

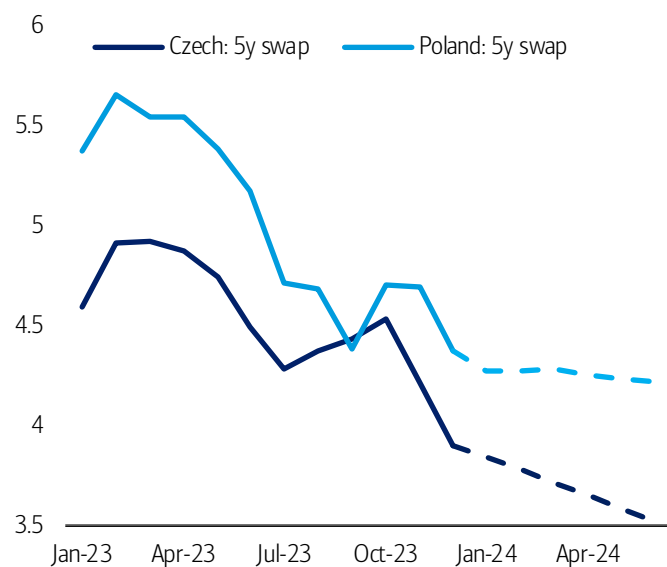
Variable	Coefficient	Std. Error	t-stat	Prob.
_2YEAR_SWAP_PLN	0.54	0.02	31.27	0.0
_10YEAR_SWAP_US	0.53	0.08	6.32	0.0
C	-95.52	10.88	-8.78	0.00
@TREND	0.71	0.08	8.72	0.00
@TREND^2	0.00	0.00	-8.54	0.00
R-squared	0.99	Adjusted R-squared		0.99

Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 11: Flat US rates: Czech 5y outperforms Polish 5y**

This is due to its higher sensitivity to the front end

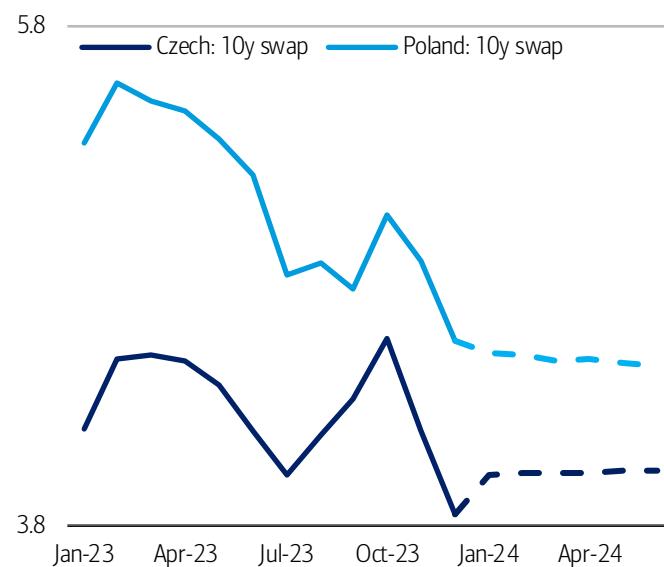


Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 12: Flat US rates: Polish 10y outperforms Czech 10y**

Polish 10y is more sensitive to core rates than Czech 10y

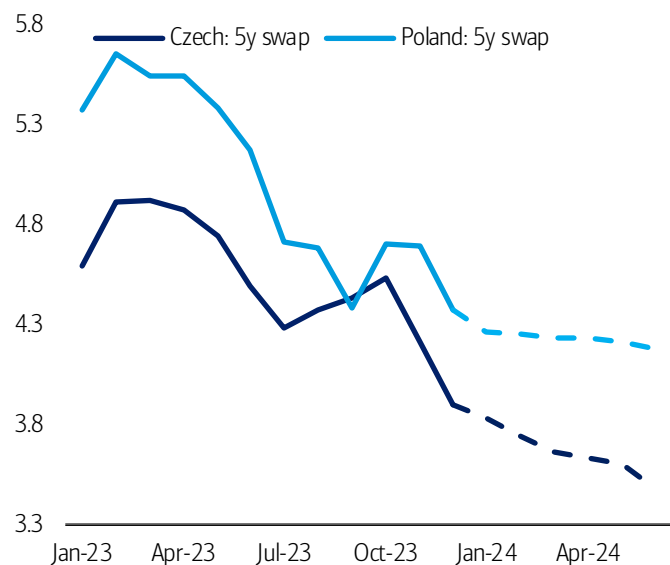


Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 13: 2bps pm decline in US rates: Czech 5y outperforms**

Again, this is due to its higher sensitivity to the front end

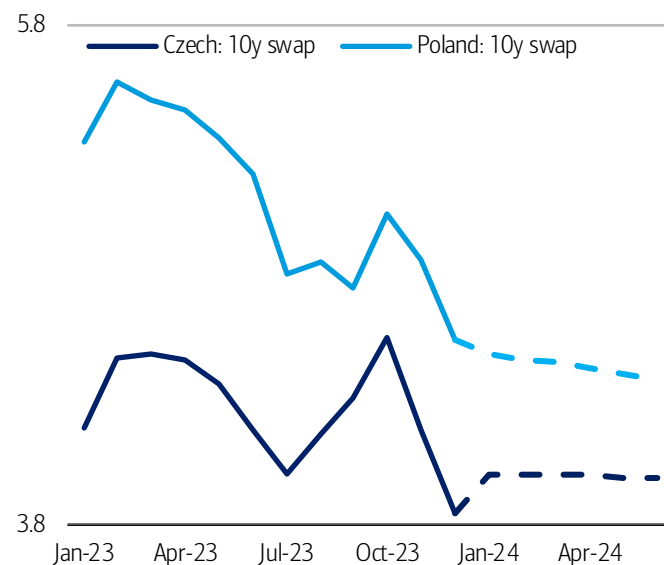


Source: Bloomberg, Eviews, BofA Global Research

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**Exhibit 14: 2bps pm decline in US rates: Polish 10y outperforms**

Polish 10y is more sensitive to core rates than Czech 10y



Source: Bloomberg, Eviews, BofA Global Research

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