Long EUR/CZK

Thesis: As the Czech hiking cycle comes to an end (and likely replaced by an easing cycle), the ECB has begun its own monetary tightening with reduced net purchases and possible hikes before the end of 2022. EUR/CZK will be supported as the difference between the two currencies' key rates narrows.

Czech hiking cycle coming to a close

Projections from the CNB suggest that the central bank expects inflation to accelerate throughout the first quarter, but slow in the second-half of the year. It expects to hike once more, then hold rates for Q2, before beginning to cut in H2 (A, B). However, CNB inflation estimates have a significant hawkish bias: for the year, the bank places annual inflation at 8.5%, significantly above analyst estimates of 5-6%. There is a strong risk that the CNB has/will pursue overly contractionary policy leading to a sharper pull-back of rates within 3-6 months, before the 1-2 year mark implied by markets.

Euro hiking cycle beginning, risks of excessive pricing, lower inflation

At the same time, the ECB has pivoted hawkishly, with PEPP net purchases being discontinued next month and at least one hike this year implied by policymakers. Currently, the Eurozone MIPR prices in ~40bps of hikes in the next 6-12 months, and ~60bps in the 1-2 year range (C). While these are not without the realm of possibility, we saw with earlier and current major central bank pivots that the market tends to initially price in an excessive amount of hikes before pulling back later and there is a risk of a similar development here, which would support the currency in the near-term. Continued supply-chain disruptions and risk of elevated energy prices should support overall inflation and monetary tightening, though inflation will remain markedly below the very high (nearly 10% in Jan) Czech inflation rate, providing additional support for the euro/koruna.

Key rate differential and currency movements

High betas of -0.68, -0.43 and R^2 of 0.4, 0.6 since pre-pandemic and end of debt crisis, respectively. See D-F.

Possible recession, risk of outflows

There is a non-negligible risk that excessive tightening may slow down the Czech economy in H2 leaving the country in a minor recession – especially if rates aren't cut rapidly enough due to persistent inflation fears. This will lead to capital and investment outflows and a depressed current account, further weakening the currency.

Other risks

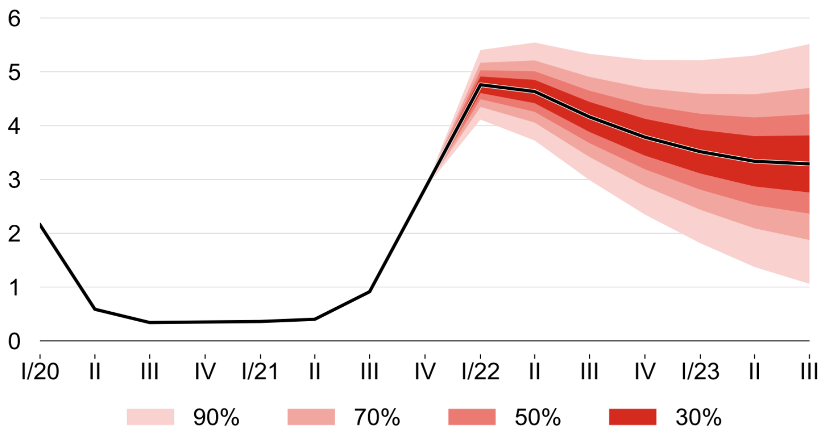
The CNB has previously (2013-2017) intervened in the FX market, setting a currency floor on koruna/euro exchange rate in order to avoid deflation. The central bank's actual intervention via purchasing euro reserves to keep the koruna elevated only lasted for the first several days.

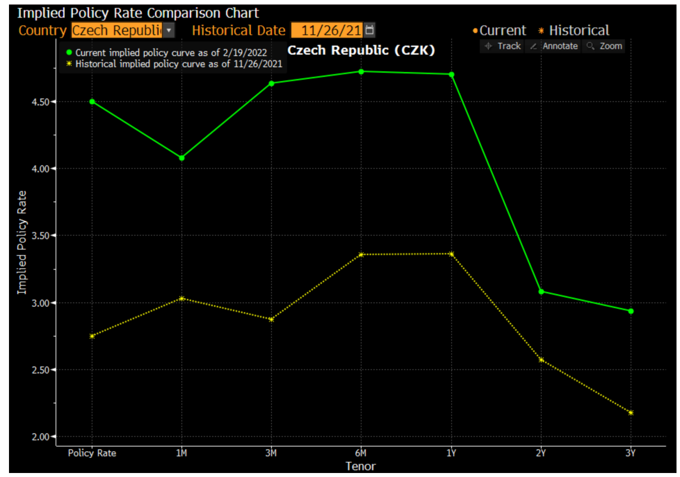
In my opinion, it's possible that ECB rate hawkishness for H2 is more of a forward guidance tool aimed at anchoring inflation expectations than a legitimate rate forecast.

Conclusion: The concurrence of the start of ECB tightening with CNB easing in the next two quarters should lift EUR/CZK into the end of the year. Entry prior to the start of April, however, comes with greater exposure to one or two possible remaining Czech hikes.

Appendix

A. CNB key rate projection vs Czech MIPR





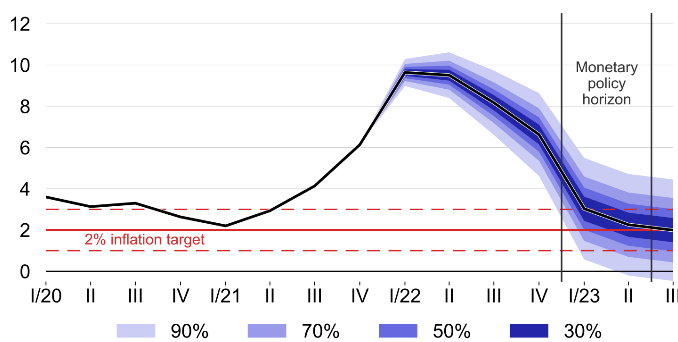
B. CNB inflation projections

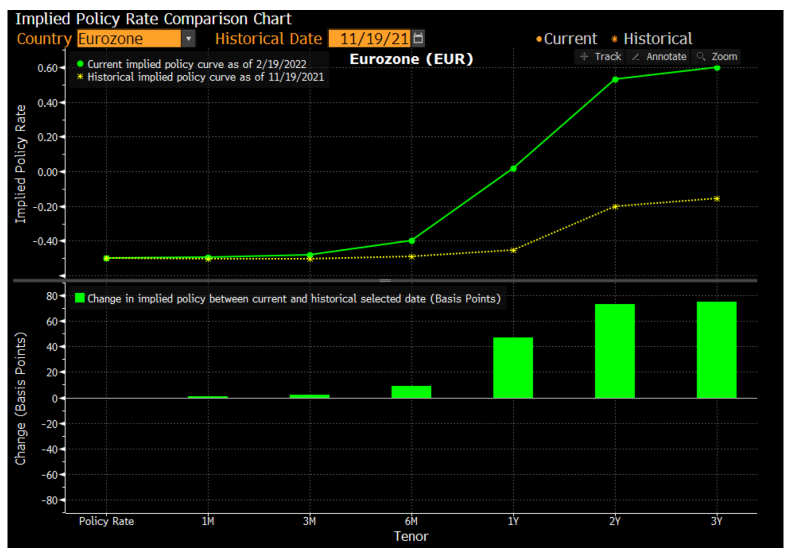
C. Eurozone MIPR

Headline inflation (in %)

Headline inflation in 2022 Q1 and at the monetary policy horizon (in %)				
Jan 2022	Feb 2022	Mar 2022	2023 Q1	2023 Q2
9.4	9.7	9.8	3.0	2.3

Inflation will rise significantly further at the start of this year and exceed 9%. This will be due to a further increase in core inflation and sharp growth in administered prices. Inflation will peak in 2022 H1 and then fall gradually. This will be aided by an appreciating koruna and the stabilising effect of monetary policy manifesting itself via domestic demand. Inflation will fall close to 2% over the monetary policy horizon.





D. Interest rate differential

E. Relationship between EURCZK and IR diff. since end of euro debt crisis

F. Determination, Correlation in relationship over time