Short PLNHUF

Thesis: Fidesz's landslide election win and the ensuing conflict with the EU commission led to a speculation-driven drop in the Hungarian currency. However, strong fundamentals still support the forint over the zloty. Positive carry will be paired with a gradual forint appreciation off of risk repricing.

Overreaction to forint-negative news

- On April 4th, Orban was re-elected to his 4th term by wide margins. Orban's Fidesz party won over 50% of the vote and a supermajority in the parliament, the first since 2010. Orban's illiberalism has long resulted in political conflict with the EU. Tapering EU funding for Hungary and Poland on rule-of-law concerns have long been discussed, but Orban's re-election and his position on Ukraine spurred Brussels to trigger official procedures for withholding EU funds.
- The 'rule-of-law mechanism' was only ruled constitutional by the ECJ this February. The mechanism outlines a process allowing the EU commission to withhold funds from a country seen as backsliding on democratic principles. However, the process is lengthy, bureaucratic, and tedious. Months of correspondences between Hungary and Brussels will be necessary. The EU commission will have to prove, specifically, that EU funds were misused in a corrupt or anti-democratic fashion - something that isn't at all certain. Then, 55% of EU countries representing at least 65% of the EU population will need to vote for it. Even ambitious timeframes place a resolution beyond the year.
- The majority of the EU's COVID relief funds are still being withheld from both Hungary and Poland, but this process could jeopardise some more short-term flows of EU funds to Hungary. Even though these funds are important to Hungary's fiscal position and help support the currency, the >3% spike on the news seems like an overreaction, given the mechanism's timeframe and the base effect (they've already been missing significant funds; Orban victory was already the base case).

Forint strong over zloty on fundamentals

- The Ukraine conflict's capital flight spillover into EEU FX markets, in the context of widespread double-digit inflation, led CBs to double-down on hawkish stances and prop up national currencies using FX reserves. Poland's NBP has hiked substantially, rising by 100bps last meeting vs 50bps expected. The MNB, which had the lowest nominal and import-adjusted FX reserves in the region, turned even more heavily to hikes to support the currency and rein in inflation. The MNB's 6.15% deposit rate is the highest in the Eurozone.
- Moving forward, we can expect only a few more hikes from the MNB through the end of the year. Aggressive pricing has faded to levels on par with MNB guidance. They've stopped hiking at weekly meetings, and fiscal spending, growth are expected to decline now that the elections are over. On the other hand, I expect NBP to accelerate its hiking cycle given the positive surprise in March CPI data. By the end of the year the two countries' rates may be roughly par. However, the near-term downside to the IR differential contracting is minimal: the forint hasn't weakened off of the end of MNB's hiking cycle.
- In the meanwhile, the rate differential between the forint and zloty is historically elevated. Even though I expect this to converge, I think that the repricing of above-mentioned risks paired with this rate differential will lead to the forint appreciating against the zloty while yielding positive carry within our short-term holding period.

Political, geopolitical, monetary risks

- Risks are political/geopolitical and monetary. Accelerating disputes between Brussels and Budapest would justify the market reaction. This is tempered and, in the short-term, somewhat unrelated to rule-of-law issues. As the EU considers further sanctions on Russia, Orban has made his red line on energy clear, that's where I see further conflict developing. But, within our time horizon, I think this risk is lower. (This week the Hungarian FM announced that they will not pay for natgas in rubles, reversing a point of conflict that could hurt the forint in the near-term.) Additionally, a further Ukraine escalation would also jeopardise the thesis. On the monetary front, a rapid Polish hiking cycle is an issue, but the trade should play out before the next MPC meeting on May 5th.