Investment | Macro report

Czech Republic

November 2016

The Switzerland of CEE?

Will there be an early breaking of the CZK “currency cap“?

We see a reasonably high chance that the Czech National Bank will take the first opportunity it has to remove the three-year old “cap“ on the key Euro-Czech Koruna currency cross rate (currently at EURCZK 27.0). The CNB has guided this will not be before 2Q 2017. A break even before then, as inflationary pressures build cannot be ruled out in our view. Switzerland surprised the world by removing its own currency cap against the Euro in January 2015.

What are the implications?

If the cap is removed sooner rather than later, then inflationary pressures will have had less time to build up. Already, the growth of money supply observed in the Czech Republic relative to the rate of consumer price inflation is very reminiscent of the 2006-08 boom period, which ended with a spike in inflation and interest rates. We conclude that the longer the cap is left in place, the more likely that “bubble conditions” are fostered. Thus the greater the potential “overshoot” above the expected EURCZK 23-24 level, or that much higher interest rates will be warranted.

As a removal of the cap looks inevitable to us regardless of timing, we discuss the implications for real estate assets and activity, including the possible upward path of interest rates (from 0.05% presently, ranging up to 4%), yield compression in the Czech marketplace coming to a halt and specific clues for the effects on the major commercial real estate asset classes.

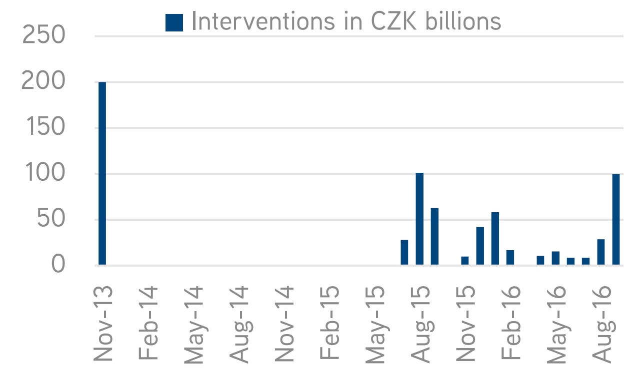
The cap, reserves and inflation

The CNB has set out clearly in regular statements that the currency "cap" as it stands will be removed in the second half of 2017. And will definitely not be removed before the second quarter of the year. The "street consensus" is mid-year 2017. To stick to this timetable and deal with the increasing demand for CZK assets, the interventions have grown in size recently.

The History

Just over three years ago the Czech National Bank ("CNB") put in place a "currency cap", seeking to stimulate moderate inflation (a 2.0% Consumer Price Inflation "CPI" target) through economic growth whilst holding policy interest rates at the nominal 0.05% level. To maintain the cap, preventing the Czech Koruna ("CZK") from rising above the Euro/Koruna ("EURCZK") 27.0 level, the Central Bank has intervened frequently in the last 15 months, to sell CZK and buy EUR or other foreign currencies (such as US Dollars "USD" or Swiss Francs "CHF"). This has been stimulated by an apparent desire on the part of foreign investors to seek exposure to CZK financial assets, be they cash, debt, equities, land, real estate (so-called indirect investments) or operating companies (foreign direct investment). To find CZK to sell to these investors, the CNB has been required to increase the money supply circulating in the Czech economy, essentially "printing money"

Amount of CZK used to buy foreign exchange by CNB



Source: Czech National Bank, Colliers International

The CNB created CZK 691bn thus far intervening to hold the currency down, including CZK 200bn right at the beginning of the regime, in November 2013. Of the remaining CZK 491bn of interventions, the CNB sold CZK 99.5bn in September 2016, a

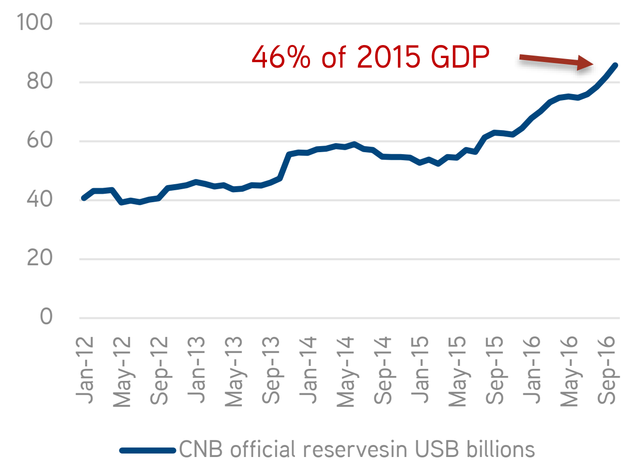
"The Czech Republic's USD 85.9bn of Central Bank reserves computes at USD 8,126 per capita, ranking 17th out of 190 countries globally" fraction below the most significant monthly intervention seen in August 2015. So, over 20% of the money created in the lifetime of the regime appeared on the scene this September.

In that month, Czech foreign exchange reserves rose by USD 3.4bn to a level of USD 81.9bn. The CNB is not scheduled to release October's data on money supply or intervention levels until the beginning of December but has already released October's foreign exchange reserves, up to USD 85.9bn. October's addition, USD 3.9bn, was bigger than September's. This points to accelerating creation of CZK money supply.

Rich Czechs?

Most Czech citizens probably do not realise that their Central Bank's policy has propelled the country right up the international wealth charts. When considering the level of reserves, the Czech Republic's USD 85.9bn computes at USD 8,126 per capita, ranking 17th out of 190 countries globally (15th if San Marino and Macau are ignored). In absolute terms, the Czech Republic has the 28th-largest treasure chest globally. The country has more foreign exchange reserves than the likes of Canada, Norway, Sweden, Australia or even, officially, the Eurozone. Reserves have nearly doubled in size since 2013 and at the end of October are now equivalent to 46% of the size of the whole economy in 2015. September's figure was 44%, so the accumulation was the equivalent of 2% of GDP in just one month!

The CNB's treasure chest – official FX reserves

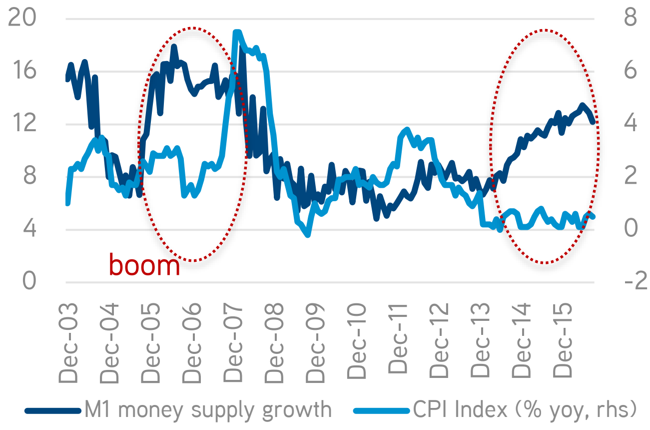


Source: Czech National Bank, Colliers International

Will inflation return?

Regardless of arguments as to whom might have benefited from the CNB's policy, accumulating reserves is no bad thing for any country, if considered in isolation. But if the pace of demand for CZK continues and the salting away of even more USD, EUR and CHF occurs, then the country's CZK money supply accelerates, causing inflation.

The paths of CPI inflation and M1 money supply



Source: Czech National Bank, Colliers International

Targeting 2% inflation was the intention of ex-Governor Miroslav Singer's team when the cap regime came into force in 2013. CPI inflation has stayed below that target for all of that time.

But even a cursory glance at the history suggests we have been here before: between 2005-07, the Czech Republic saw substantial inflows of capital. The Koruna in that time appreciated by 2%-3%, as creation of CZK occurred as a policy by the CNB. This was a boom time for Czech assets, including equities and real estate. Only in 2008 did inflation catch up, spiking from around 2% y-o-y, to over 7% y-o-y. Interest rates rose 1.75% between 2006 and 2008, eventually contributing to the calming of inflation. From 2008 up to 2013, money supply (the dark blue line on the chart above) and CPI inflation stayed broadly in lockstep. Now as 2016 draws to a close, the gap between the two is yawning again and as suggested already, the dark blue line may well rise further as more CZK is "printed".

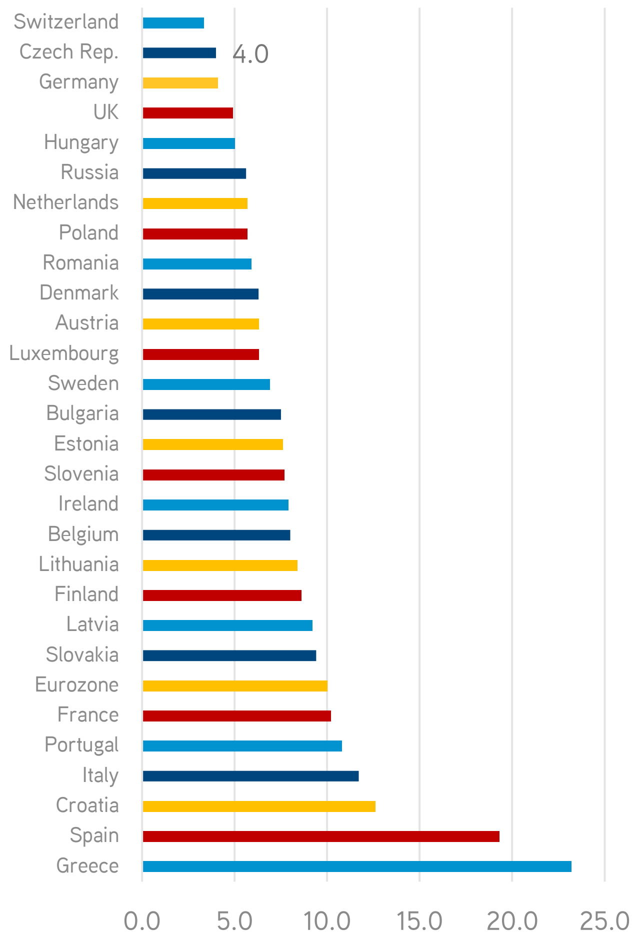
Only by reducing the interventions (to nothing?) by raising or removing the "currency cap" or events dictating a reduction in the attraction of the CZK can drag the dark blue line down to the light blue line. Will the light blue line rise instead or in addition? Are higher CPI levels in the pipeline? Czech CPI stood at 0.8% y-o-y in October, the highest level since 2013. Whilst some inflation is desired, CPI levels approaching even, say, half the spike of 2008 (a 3%-4% range) would be a big shock for participants in the economy. Interest rates would most likely rise. A lot.

Symptoms of inflation and a boom

One argument for considering that the yawning gap between money supply growth and CPI inflation is not a problem is that the pattern can be observed in other countries (such as Japan, in the Eurozone and even the USA, the "G3") right now, as G3 Central Banks have sought to stimulate inflation. There are though crucial differences between these examples and the Czech Republic to consider which may impact the path of inflation and pressures on the currency in the shorter term.

Wage pressures are clearly evident in the Czech Republic. In the public sector, wage hike settlements for 2017 have come in the 5%-8% range. Given the loss of skilled workers to other EU countries in key professional sectors such as health and education over the last decade, further hikes of similar magnitude in succeeding years cannot be ruled out. In the manufacturing sector, wages have risen consistently in the last decade at a 4.2% annual rate in EUR terms and it would be a major surprise if this momentum slowed. The Czech Republic has the lowest rate of unemployment in the EU, according to Eurostat. All signs point to a labour shortage, which is generally inflationary. Unless a large influx of migrants is accepted, a shortage of workers will force wages up further.

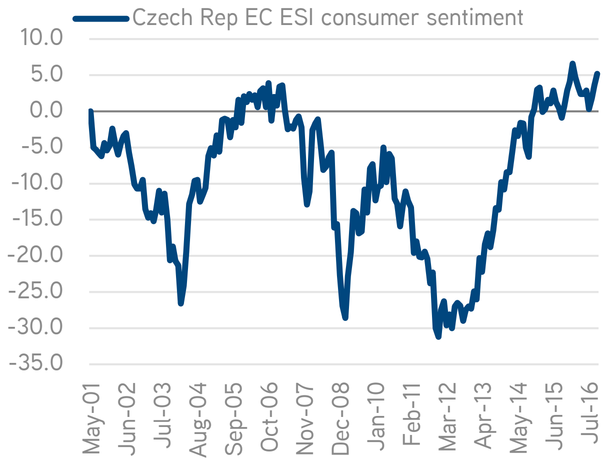
EU member unemployment rates (%) (Switzerland added)



Source: Eurostat, data as of November 2016

Czech consumers are at present also in buoyant mood, in marked contrast to their peers in G3 and compared to the past. Consumer sentiment, as measured by the EU's monthly ESI surveys are at a cyclical high. This points to likely support for economic growth and spending from consumption in the near term (and is also a positive for judging the timing of investment into Retail real estate assets).

Consumer sentiment leading indicator for Czech Rep.

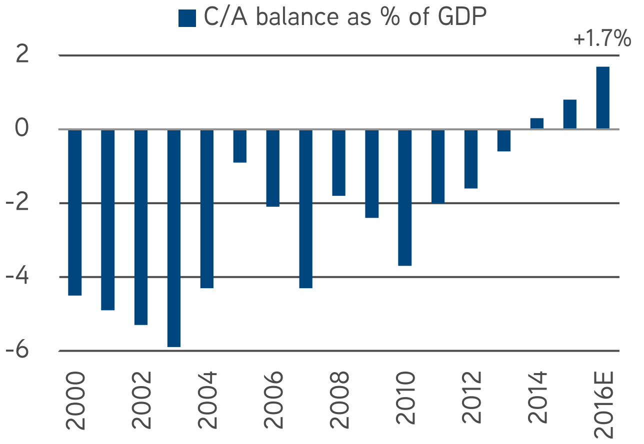


Source: Bloomberg

Other symptoms of a successful economic policy pointing towards the removal of the currency cap can be easily found when looking at the country's external balances. As might be expected with an economy where exports are valued at over 80% of GDP, a low exchange rate with major trade partners that is capped has produced current account surpluses in the 2014-16 period, where the value of exported goods and services exceeds the value of imported goods and services.

By itself, an improving Current Account does not trigger currency appreciation automatically. But substantial empirical evidence exists, particularly from Asia in the past 25 years, that improving or persistently positive Current Account situations create the conditions for local currencies to rise, in freely-floating foreign exchange regimes.

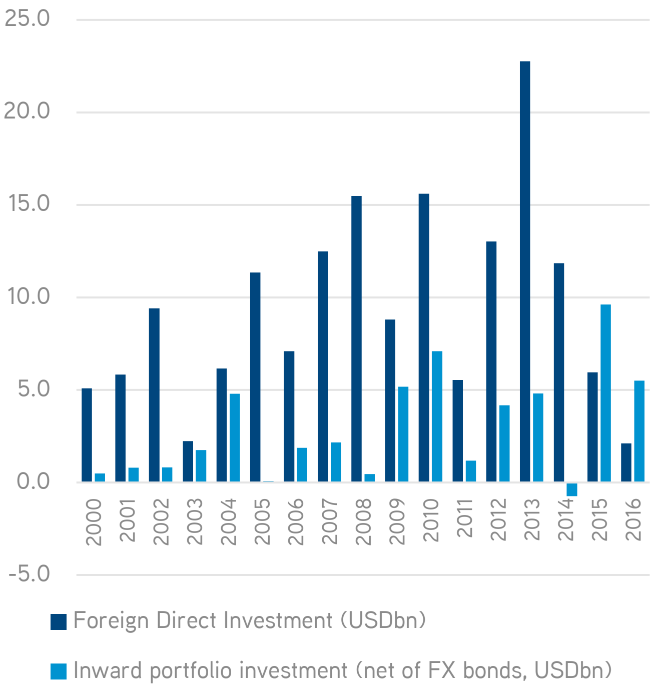
The improvement in the Czech Current Account



Source: Oxford Economics

The other element in the Balance of Payments, the Capital Account, also reveals some pointers to a higher CZK level. Whilst the flow of Foreign Direct Investment ("FDI") has waned from very high levels in the last few years, a reduction partially due to the closing of the last EU Structural Funds cycle, the opposite can be said for portfolio investment. So-called "hot money" flows are running at record levels and thus consistent with the pattern seen by the CNB in their intervention efforts. Total flows (FDI + "hot money") in 2016 look to be on track to breach the USD 15bn level seen in most years this decade.

Inward portfolio investment and FDI into Czech Rep*

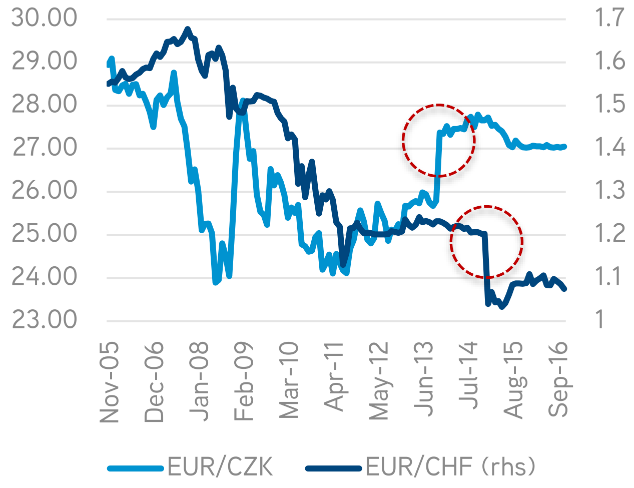


Source: Oxford Economics
* data for 2016 is for 1H 2016 only

Will the CNB move early?

The Swiss precedent

Czech Koruna and Swiss Franc vs Euro



Source: Investing.com, Colliers International

Thus far, the guidance of the Czech National Bank regarding the removal of the "currency cap" has been credible in terms of promoting stability and postponing the timing of any removal. Subdued inflation both in the Czech Lands and in the Eurozone has made their decision-making relatively easy. The move of the European Central Bank ("ECB") to introduce „Quantitative Easing" (or QE) in the last 18 months has complicated matters and probably contributed to some of the relative attractiveness of CZK assets versus those denominated in EUR.

It was that looming QE decision by the ECB that forced the hand of the Swiss National Bank in January 2015. The Swiss removed their own currency "cap" versus the Euro with immediate consequences for the valuation of the Swiss Franc, which swiftly rose and remains over 10% higher even today. Not one commentator expected this event to occur with that timing.

There is no reason why the Czech National Bank might not act in the same fashion as the Swiss and surprise market participants. After all, commentators expect a removal of the currency "cap" anyway and therefore perhaps more speculative positions in the CZK might be built up beforehand in anticipation of the currency rising, in the first half of next year. To short-circuit this potential speculation and avoid excess "money printing", the CNB may well move early. Which would mean a move early in 2017.

In parallel with the Swiss Franc within Western Europe, the CZK is seen in the CEE region as a "safe haven", a place to consider investment for the long run, or a fortress to seek shelter in the shorter run if the outlook for markets becomes uncertain. The current rout in global and Emerging Market bond markets triggered by Mr Trump's election success in the US is very likely to herald a more significant period of volatility in credit markets, Emerging Markets and riskier assets generally. The upcoming political schedule in Europe (Italian referendum, Austrian Presidential election, Dutch election, French election, German election) looks, at first glance, full of potential pitfalls and concerns for the stability of the Eurozone, in the wake of Brexit and the US election results. These factors may further increase the flows into CZK from elsewhere in the short run.

Reasons to not move early

Several factors might well stay the Central Bank's hand and see the CNB's Board elect to keep the "currency cap" in place at least until 2H 2017 (or even later):

A "safety first" sentiment might well pervade. A tough global environment, including for Emerging Markets, credit markets in general and European markets/banks might persuade the CNB Board members that it is better for reasons of maintaining stability to leave the currency regime untouched. Removing the cap or even shifting it to a different level could be construed as casting the economy into the unknown at a tricky time. Such a decision might not be the most optimal for controlling future inflation but seen as prioritising the shorter term.

Lower worker remittances from a post-Brexit UK might well slow the demand for CZK in the near run. In addition, perhaps returning workers from the UK, which houses around 300,000 Czech nationals at present, might also affect the very tight labour market situation. In addition, the imminent local EET (electronic receipt evidence) reform might shift individual entrepreneurs back into the general labour force.

As already noted, the previous cycle of incoming EU Structural Funds is coming to an end. That pulse helped generate high levels of FDI. Flows in the new cycle may well be lower than before. Lower flows would lessen the expected and future actual demand for the CZK.

An external deflationary "shock", such as renewed significant weakness in crude oil prices might well snuff out the recent uptick in Czech CPI and further wage-led inflation pressures.

Other external risks, such as a further escalation of tensions between NATO and Russia, could also act to slow enthusiasm for assets denominated in CZK.

There is some chance that the ECB may choose to taper or even remove its QE programme sooner than commentators expect. If that were the case, an expectation of higher European interest rates would quickly build and thus allow the CNB's Board to consider raising rates itself.

Unless the above factors reduce the actual demand for CZK relative to other currencies, the pressure on "printing", money supply and thus inflation will not disappear.

Implications of a "cap" removal

A higher CZK

There would be two options to consider in the event of a CNB decision to adjust the regime either early or "on schedule" in 2017. Either the EURCZK "cap" could be set at a different level or the currency is allowed to float freely. To avoid future distortions, the free float option would look more likely to us.

Commentator opinions on the valuation of the CZK versus the EUR range from EURCZK 26 up to EURCZK 21, depending on methodology. As noted, the Current Account surpluses that the Czech Republic presently generates would point to currency appreciation. If the path of the Swiss Franc versus the EUR in the last 10 years is some form of benchmark, it would suggest around EURCZK 23-24 as a level at which the currency settles. This translates to an 11%-15% revaluation.

A perceived constraint on a more significant overshooting of this EURCZK 23-24 level is the very high (over 80% of GDP) export component to the Czech economy. Commentator estimates suggest that a 10% rise in the EURCZK would knock 0.5% off Czech GDP growth per annum. This figure is not larger due to the high imported goods component in exports. The true effect would take some time for markets to establish, thus allowing the potential for a perceived overshoot of the EURCZK 23-24 range.

Higher interest rates likely

As the reason for any removal of the “currency cap“ is to ultimately control the money supply and thus inflation, the conventional monetary policy playbook would see the introduction of positive real interest rates, those defined as higher than the prevailing inflation rate. Even now, the CPI rate stands at 0.8%, thus suggesting an immediate and significant rate hike from the current nominal 0.05% to say 1.0%. Wage growth, as indicated, is strong in the economy at present and would be a major factor in the likely destiny of interest rates in the medium term. If inflation does range up to 3%-4% in a strong demand environment, or as a result of significant money supply growth beforehand, then much higher interest rates (2%-5%) might be on the cards.

One potential restraint on higher interest rates is in fact the level of the currency. A much higher EURCZK rate, at 23-24 for example, reduces the prices of imported goods being purchased by the Czech populace. Reducing these prices would be disinflationary, meaning a lower CPI, thus reducing the propensity to raise interest rates. Thus, the street would need to arrive at a balanced view of CZK appreciation versus level of interest rates in a freely-floating currency environment. The more the CZK spikes in the wake of a cap removal, the lower the eventual interest rate outcome may be, ceteris paribus.

On Real Estate

Considering inward investment, there would probably be a very short run “rush“ into CZK-denominated assets. In the real estate world at present, this encompasses residential real estate and perhaps land. Recent activity in these arenas is buoyant to the extent that the CNB has hinted to the banks that it wishes to tighten already-high capital requirements to slow activity down. In the commercial real estate sphere, it is only local Czech-based investors who thus far price and assess assets in CZK terms.

Interest rates substantially above the nominal 0.05% present level will of course throw down a challenge to even the most conservative funding scenario assumptions for real estate developers. Central Bank interest rates ranging up to 4% would have to be modelled into “all-in-cost” valuations and cash flows. The present mortgage rate premiums of 1.3%-2.0% would need to be added on top when considering the residential markets.

For real estate investors, with access to EUR funding (including Slovaks), there may still be the ability to secure very low rates but most probably from financial institutions outside of the Czech Republic. The Czech banks might well be constrained by capital requirements.

There may be some eventual questioning of the current denomination of rents in EUR or the linkage of rents to Eurozone CPI. Landlords of high-quality, high-occupancy assets in the retail sector, for example, will be well aware of the likely consumption boom coming as a result of lower import prices and may seek to raise rents. Demand for high quality retail space from foreign brands, already apparent, would intensify. Whilst rents are of course subject to a slower rate of change due to lease terms being in place, it can be recalled that towards the end of the 2005-07 boom period landlords were indeed considering a shift towards rents denominated in CZK.

Increased infrastructure spending may well benefit the Industrial & Logistics arena in the medium term. The government’s tax receipts would most likely be bigger than present medium-term projections due to higher inflation, creating some room for spending on capital projects if the tax surpluses are not eaten up by wage hikes.

A higher CZK would accentuate a recent trend of Office BPO/SSC and in particular manufacturing companies becoming more concerned about wage levels in the Visegrad-4 countries and perhaps relocate south-eastwards towards the Balkan region.

The upward shift in funding rates that we foresee would probably put a floor under yields across the sectors in the short to medium term. Firming rents would underpin capital values though, particularly in the Retail sector.

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