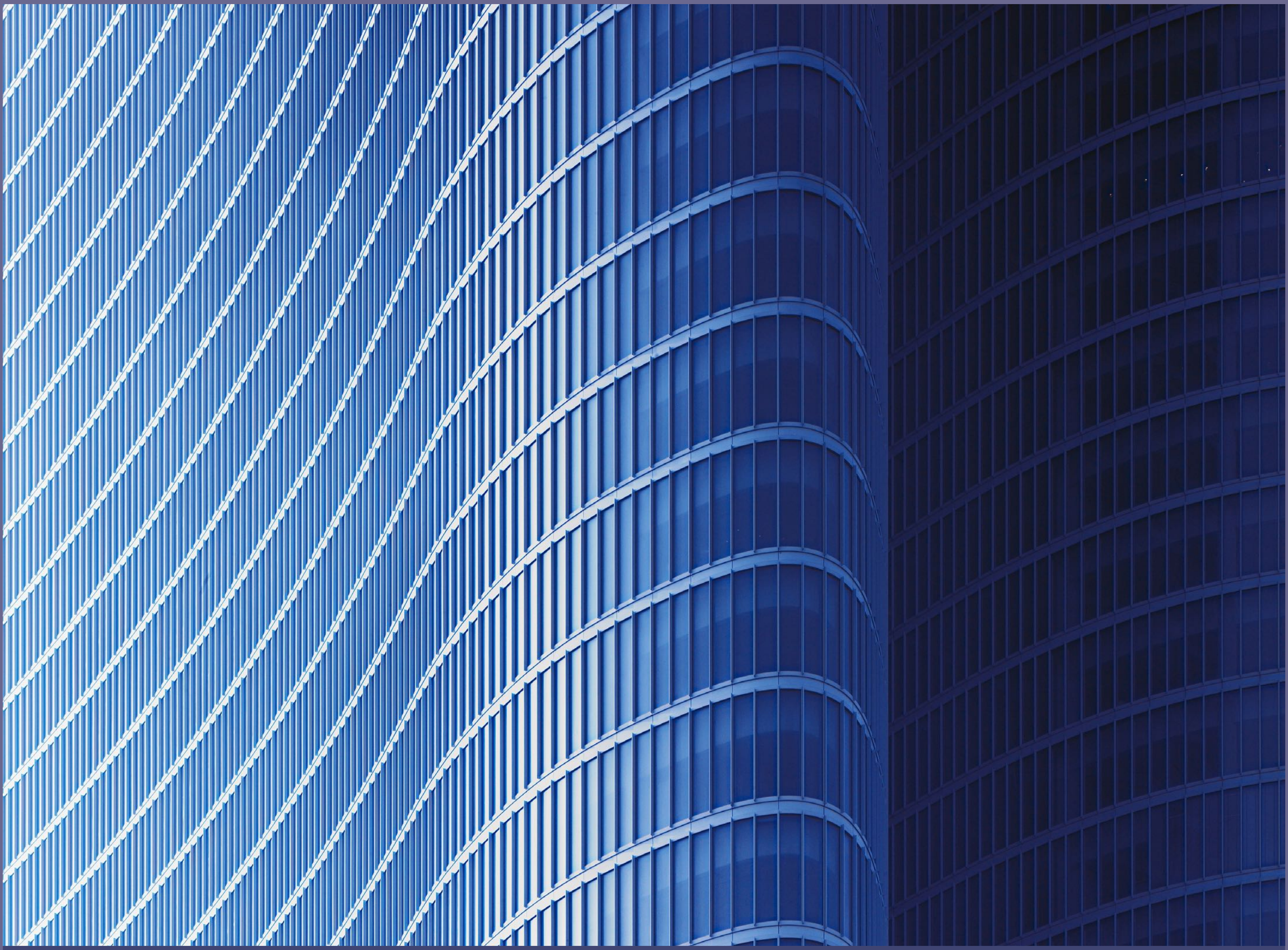


ECONOMY AND FINANCIAL MARKETS

12/2020

mazars

Economy

During the third quarter, many world economies have been recovering. The growth was supported by three major factors – **the release of the social distancing measures** (economy re-opening), **expansive fiscal policy** (fiscal deficits, government supported spending programs) and the unprecedented **monetary policy easing** (quantitative easing – purchases of not only government bonds financing fiscal deficits). The numbers of those infected by Covid-19 started to increase again during the last two months and with the implementation of new social distancing measures, the prospect for a quick recovery started to diminish. As a result - GDP growth forecasts are being cut for 2020 and 2021 again. However, this time, industry seems to be less effected (compared to the spring of 2020) than the sector of services. The announcement of new vaccines (Pfizer, Moderna) is definitively positive news in the long run, but as the implementation of the vaccine will take a long time, the impact on the economy in the near future will be limited. In the period of higher uncertainty, the financial markets corrected the previous positive development, but after the US elections and new vaccine announcement, the prices of risk assets started to quickly grow again, in many cases prices have reached their historical highs. The fiscal and monetary (quantitative easing) policies are expansionary and there is no evidence that they should be cut anytime soon. The key questions for the further economic and financial market development - how quick and effective will the vaccination process be and how distracted can the development of the real economy and prices on the financial markets be.
In the long run the key question is the path of fiscal consolidation and monetary policy normalization.

Macro-economic data / world

GDP

US – the US GDP increased by **7.4% q/q** in 3Q 2020

Eurozone – Eurozone GDP growth in 3Q 2020 reached **12.6% q/q** (-4.4% y/y).

	2020	2021
GDP – FED forecast[1]	-3,7%	4,0%
HDP – ECB forecast[2]	-8,0%	5,0%

[1] September 2020 forecast, the new forecast will be released in December 2020

[2] September 2020 forecast, the new forecast will be released in December 2020

Inflation

US – consumer inflation in October 2020 reached **1.2%** y/y

Eurozone – consumer inflation in October 2020 decreased to **-0.3%** y/y

	2020	2021
PCE y/y – FED forecast	1,2%	1,7%
Inflace y/y – ECB forecast	0,3%	1,0%

PMI – Purchase Manager Index

The impact of the second Covid-19 wave in Europe is visible in the Markit PMI service data; the impact of the new Covid-19 measures on the US economy will be visible in November (and later) data.

Markit PMI – 10/2020

	Markit PMI Composite	Markit PMI Manufacturing	Markit PMI Services
US	56,3	53,4	56,9
Eurozone	50,0	54,8	46,9
Czech Republic		51,9	

(a PMI index above 50 is indication of growth ≠ production or services reached pre-Covid-19 levels)

Czech Republic

- The CNB has published the new forecast of the Czech economic development (Inflation Report IV 2020) after the monetary meeting in November 2020 (before the tax changes approved in Parliament, the impact of tax changes described in the Fiscal Scenario)
- The most important changes compared to the previous forecast (July 2020) – the higher estimate of GDP growth in 2020 (better than expected GDP data in 2Q and 3Q 2020) and lower GDP 2021 forecast (the second wave of Covid-19 is much worse than expected in July 2020)
- The CNB Bank Board members expected a slower normalization of the monetary policy than the base case of the CNB forecast

CNB forecasts overview

	2019 actual	2020 forecast	2021 forecast	2022 forecast
Headline inflation	2,8	3,2	2,3	2,0
GDP	2,3	-7,2	1,7	4,2
Average nominal wage	6,4	3,3	2,8	3,9
Exchange rate (CZK/EUR)	25,7	26,6	26,6	25,9
3M PRIBOR (in %)	2,1	0,8	0,7	1,4

GDP

- The base case scenario expects GDP to decrease for the full year of 2020 by **-7.2%**, and return to growth in 2021 at just **1.7%**
- The impact of the second wave of Covid-19 on Manufacturing significantly lower than in spring 2020 (impact on Services at comparable level)
- Return to 2019 GDP level shifted beyond end of 2022

Impacts of the pandemic on gross value added

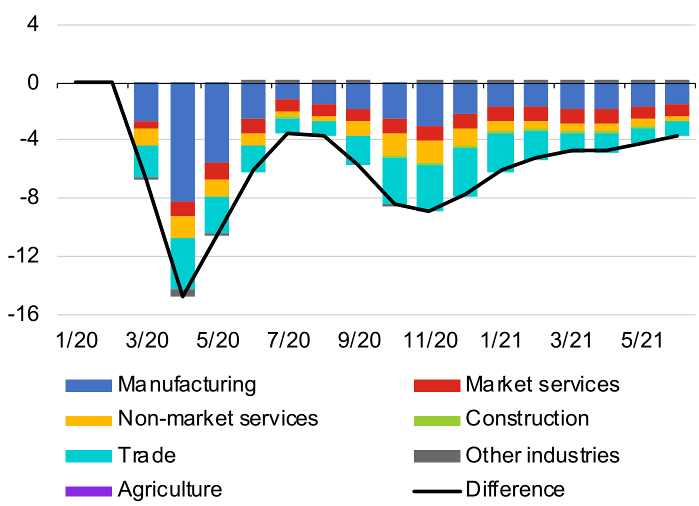


Chart: CNB

Czech Republic

Inflation

- Inflation in October 2020 decreased to **2.9%** p.a. and returned back to the CNB inflation target (1% - 3%)
- Inflation is expected to weaken in 2021 due to the lower household income (caused by Covid-19 restrictions) and the slower growth of food prices, on the other hand fuel prices will not contribute to lower inflation
- The base case scenario expects inflation at the end of 2020 at **2.9%** p.a. and at the end of 2021 at **2.2%** p.a.

Structure of inflation and the inflation forecast

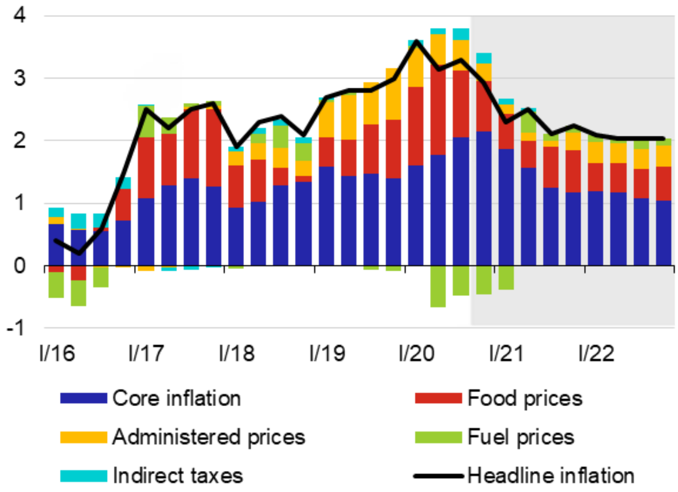


Chart: CNB

Labor Market

- Employment in 2021 will decrease and the unemployment rate will increase markedly due to the lower economic growth
- Wage growth in non-market sectors will significantly decrease in 2020 to **3%** and in the following years will stay significantly lower than in the pre-pandemic period

Labor market forecast

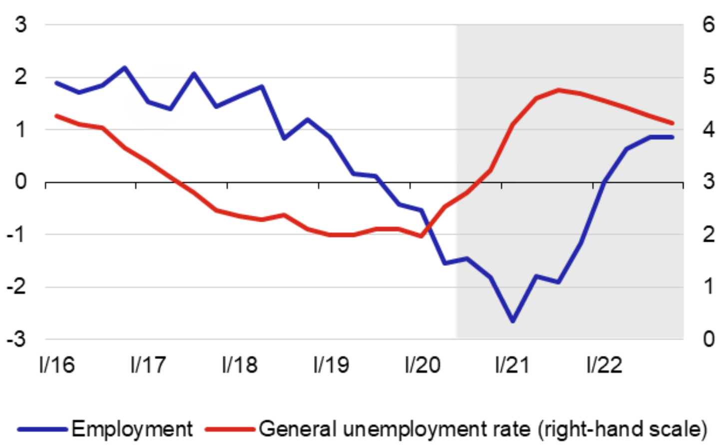


Chart: CNB

Czech Republic

Interest rates

- The CNB repo rate (two weeks) will be stable according to the forecast at **0.25%** p.a. until mid-2021. The diminishing impact of Covid-19 and renewed GDP growth in the Czech Republic as well as in the EU will enable the gradual normalization of the monetary policy/higher interest rates in the second half of 2021
- The CNB Bank Board considers the path of interest rate normalization in 2H 2021 to be too ambitious; it is expected that the CNB Bank Board will be very careful and the rate hikes might be postponed (without impacting the approved tax changes in Parliament)

Interest rate forecast

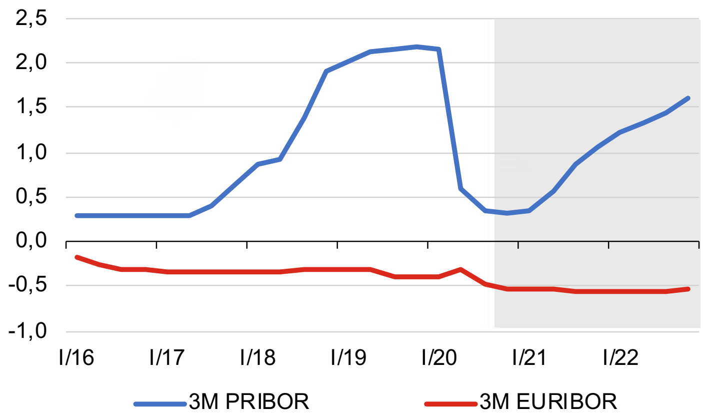


Chart: CNB

Foreign Exchange Rate

- The exchange rate forecast for 4Q 2020 is set at EUR/CZK **27.2** – around 3 percent higher than the exchange rate prevailing in mid-November 2020
- CZK should, according to the CNB, appreciate gradually over the entire forecast horizon.
- The EUR/CZK foreign exchange rate should be close to **26.30** by the end of 2021 (average EUR/CZK exchange rate in 2021 at 26.60)

Exchange rate forecast

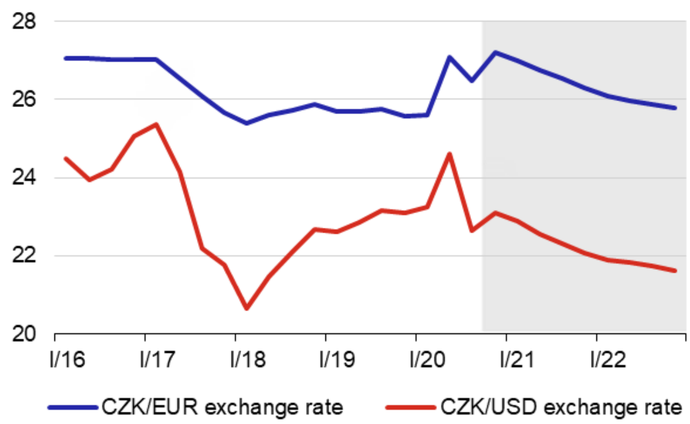


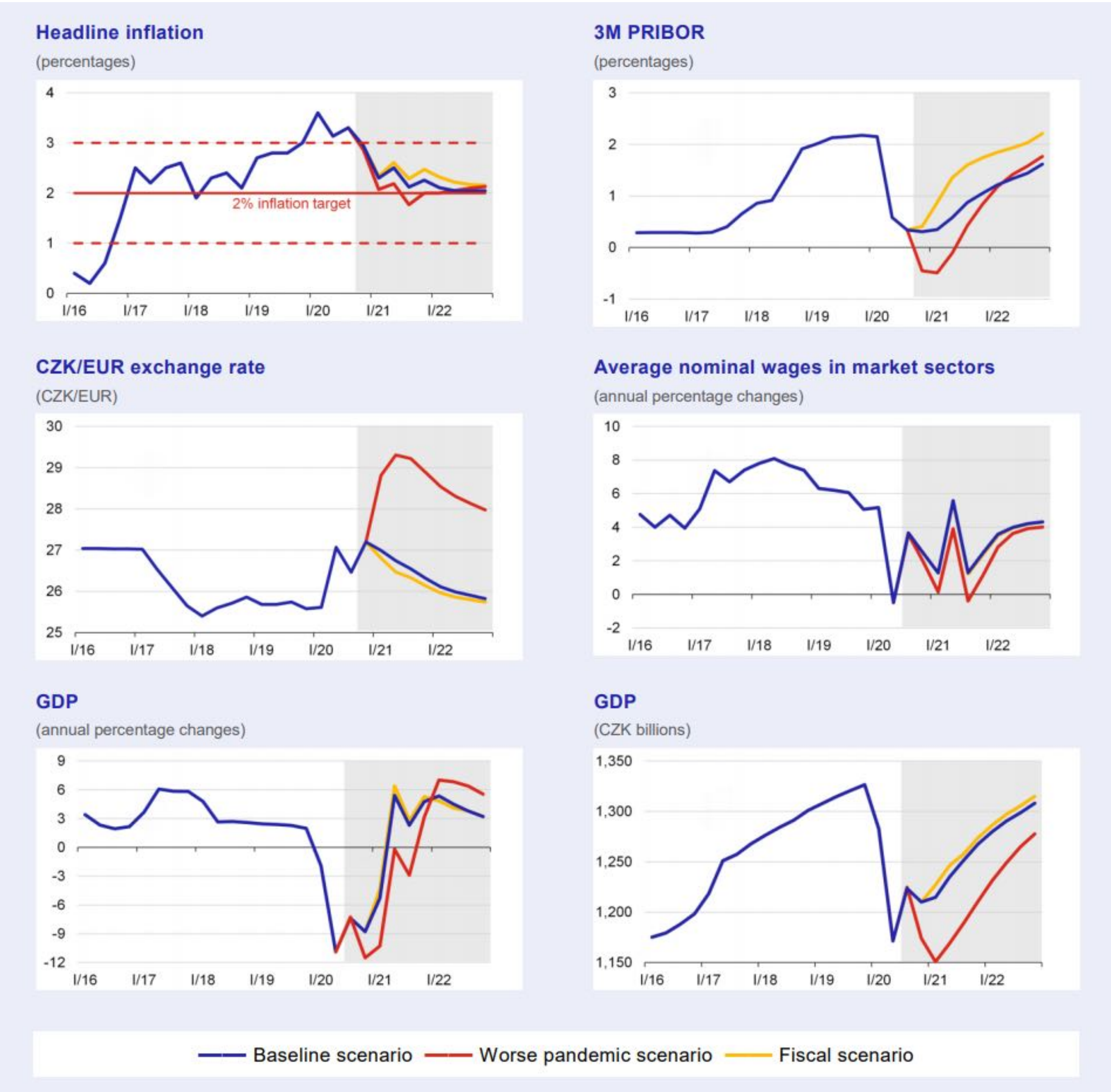
Chart: CNB

Worse Pandemic Scenario

- The worse second Covid-19 wave leads to much more subdued developments in the Czech economy and Eurozone economy than in the baseline scenario
- Lower growth in domestic costs in an environment of temporarily highly subdued demand pressures will be reflected in the weaker CZK and the lower inflation outlook, this scenario may require further monetary easing

Fiscal Scenario

- Assumption of additional fiscal measures in the amount of 2.2% GDP (130 billion CZK) steaming from super-gross wage abolishment or higher tax-deductible amounts, which lead to a higher budget deficit in 2021
- The additional fiscal measures would lead to higher GDP growth, stronger inflation pressures and higher interest rates, which would imply a stronger EUR/CZK exchange rate than in the base scenario

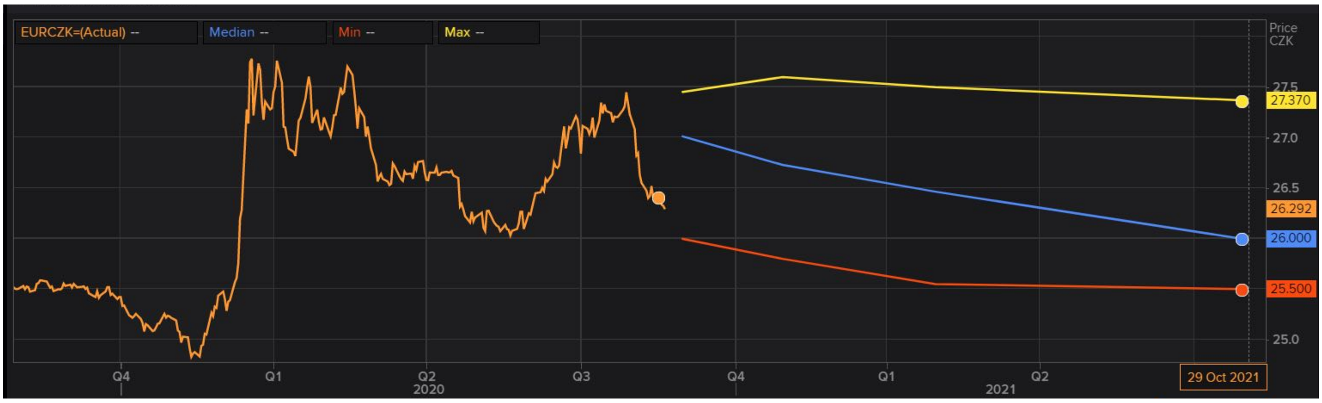


Financial Markets

EUR/CZK foreign exchange rate

- Financial analysts (Reuters FX Poll as of 3 November 2020) expect a stronger CZK against the EUR than in the base scenario of the Czech National Bank during 2021, median EUR/CZK in one year estimate at 26.00

Reuters FX Poll 03/11/2020



Data: Refinitiv

The Czech crown strengthened significantly under 27.00 thanks to

- Positive sentiment on the financial markets supported by new vaccine announcements
- Gradual improvement of pandemic situation in the Czech Republic and better than expected industry performance (based on available data)

In line with the CNB forecast and financial analysts' forecast, the EUR/CZK rate should strengthen, however the strengthening will not be straightforward (financial market expectations are ahead of the real economy, corrections on the financial markets should have a negative impact on CZK). Nowadays EUR/CZK is above the levels reached during August – close to 26.00.

Financial Markets

Interest rates

- Short-term interest rates are close to historic lows and the major central banks (FED, ECB) do not expect any changes to the base interest rates in their forecasts
- The CNB repo rate remains at 0.25%, long-term interest rates started to gradually grow (supported by budget deficit financing needs), thus the yield curve not only in the Czech Republic is getting steeper
- Fiscal consolidation is not expected anytime soon, the pressures on the steepening of the yield curve should prevail

CZK 10 year interest rate swap

Data: Refinitiv

Financial Markets

Equity markets

- Equity markets positively reacted to the US election results and the new vaccine announcement, some of the important equity indices reached historic highs
- Price/Earnings ratios are close to the levels of the year 2000 (Dot. Com bubble)
- Positive sentiment on the markets led to market rotation to cyclical sectors (financial services, airlines, etc.)
- Investors are focused on the long term positive outlook and they ignore negative news from the economy. The market is driven by FOMO (fear of missing out)

MSCI World

Data: Refinitiv

Financial Markets

Credit markets

- Worse macro (lower GDP growth in 2020 and 1H 2021) and micro (interest coverage, corporate leverage) fundamentals and the ongoing growth of defaults are negative for credit spreads, the improvement of credit fundamentals will be a slow process
- Credit spreads on the financial markets, despite very bad fundamentals, are still compressed by purchases of central banks (quantitative easing) and private investments (high savings rates)

Credit spread of portfolio 125 European corporate noninvestment grade corporates

Data: Refinitiv

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