UniCredit Bank

Weekly

N . o . t . e . s

English translation by an external party

HIGHLIGHTS OF THE WEEK

02/2016

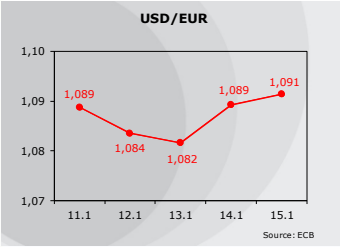
> Chart of the Week: Milk production in Europe on the rise, milk prices down

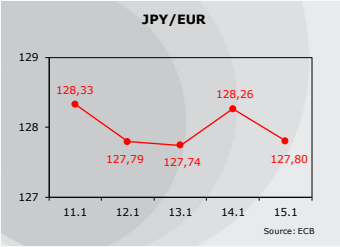
> Industry growing dynamically in November, mainly thanks to automotive

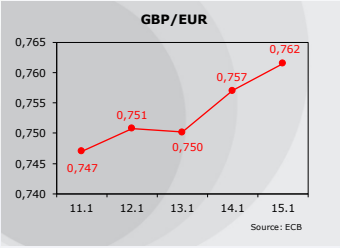
> Construction growth decelerating - infrastructure weakening together with the end of EU-funded projects; building construction is gaining momentum

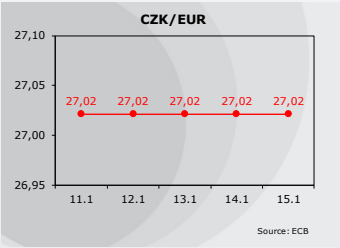
> Prices keep falling, cheap oil postponing the return to positive inflation

WEEK ON THE MARKETS









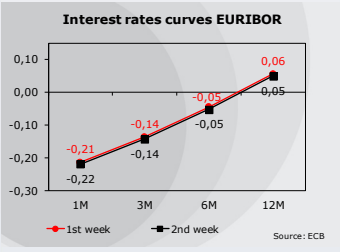
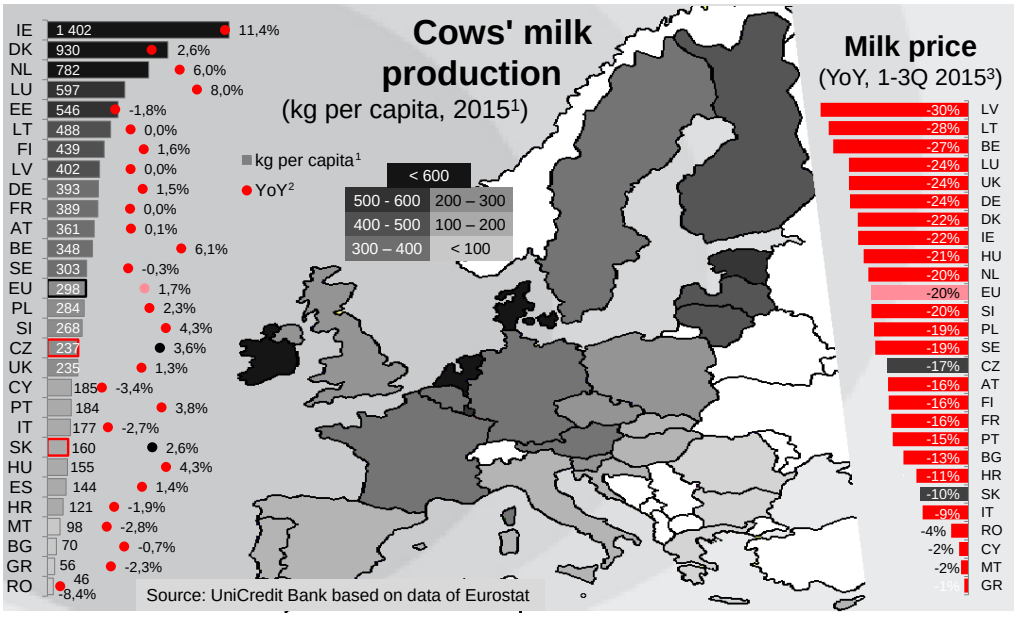


CHART OF THE WEEK



Note: 1. Milk production in the last 12 months – December 2014 until November 2015; for EU, DE, EE, IE, GR, FR, HR, IT, CY, AT, SE and UK for the period from November 2014 until October 2015
2. The average yoy modification in the first 11 months of 2015; for EU, DE, EE, IE, GR, FR, HR, IT, CY, AT, SE and UK for the first 10 months of the year.
3. Milk price of primary producers; EU as a weighted average of the EU countries – calculation of UniCredit Bank

In last year's April, the milk quota regime has come to an end. This step made the surpluses of cow's milk in Europe even higher, with the market trying to find a new equilibrium after the cancellation of quotas. The higher surpluses also led to a sharp decline in milk prices in most European countries.

The main milk producers in the EU include countries of northern Europe, with Ireland being clearly the top producer of cow's milk per capita, as much as 1.4 tonnes a year. However, a strong production of cow's milk is reported also by Denmark (930 kg per capita a year), the Netherlands (782 kg), Luxembourg (597 kg) or the Baltic states and Finland (402-546 kg). On average, the EU countries produce 298 kg of cow's milk per capita. The lowest volumes of cow's milk are produced by countries of south-eastern Europe – Romania (46 kg per capita a year), Greece (56 kg) and Bulgaria (70 kg). However, milk production in V4 countries is lagging behind the EU average, too – mainly in Hungary (155 kg) and in Slovakia (160), but also in the Czech Republic (237 kg).

Milk production in Slovakia is lagging behind the EU average considerably, but its milk consumption is even worse. According to 2011 FAO data, an average Slovak drinks only 132 kg of cow's milk a year, which is the lowest volume from among all EU countries. On average, an EU resident drinks as much as 242 kg of milk a year, with

residents of northern European countries drinking the most – 396 kg in Finland, 349 kg in the Netherlands, 343 kg in Sweden and 327 kg in Lithuania. Besides Slovakia, a relatively low consumption of cow's milk is reported also by Bulgaria (143 kg) and Hungary (166 kg). Only a little higher consumption of cow's milk is reported by the neighbouring Czech Republic (180 kg) and Poland (199 kg). Production of milk in Slovakia is still theoretically sufficient to cover domestic consumption. It is proved also by the foreign trade statistics, with Slovakia reporting more exports than imports of raw milk in the last 12 months (more than 80 thousand tonnes more, i.e. around 16 kg more per capita); at the same time, the foreign trade balance has not deteriorated yet after the quota cancellation, it has even improved a little. Slovakia is worse when it comes to milk processing, being a pure importer of dairy products (excluding cheese and curd) in the longer term – around 4 kg per capita a year.

In the first ten months of the last year, production of milk went up by almost 2% in the EU countries; the most part of the increase is attributed to the post-milk-quota-cancellation period, i.e. after last year's April – from March until October 2015, after adjustment for the traditional season, the production of milk in the EU increased by more than 5%. Production of milk was rising mainly in the bastions of dairy industry of the Western Europe – in Ireland and Benelux countries; on the contrary, it was falling in an already undersized countries of south-eastern Europe (mainly in Bulgaria and Romania). Both Slovakia and the Czech Republic reported a slightly faster yoy growth of production than the EU average (by 2.6% or 3.6%). Unlike most of the EU countries, Slovakia, and partially also the Czech Republic, reported an increased production even prior to the quota cancellation; after adjustment for the season, the production of milk more or less stagnated compared to the pre-quota-cancellation period. As for the Central European countries, a considerable increase in the production of milk after the quota cancellation was reported mainly by Poland and Austria (both slightly more than by 5%).

Increase in the production of milk and thereby also in its surpluses in the European market has accentuated the pressure on the price of milk even more. The average price of milk in Europe in the first three quarters of the last year was lower by around 20% yoy. Unlike milk production, there was a considerable decline in milk prices in several countries even prior to the quota cancellation. The earlier decline in milk prices already in the 2H14 is mainly due to the Russian-European sanctions preventing EU countries from exporting their milk surpluses to Russia. It is the countries of Central Europe that form an exception in this respect, where the surpluses of milk in Europe did not translate into the prices of milk to a larger extent only after the quota cancellation (probably also due to the negligible exports of milk to Russia from these countries). After adjustment for seasonal effects, the most significant reduction in the prices of milk in 3Q15 (the most recent known data) compared to 1Q15 (the last quarter before the quota cancellation) was in Ireland and the Czech Republic (by around 16%), with a considerable decline being reported also by Finland (12%) and Hungary (11%) or in Slovakia and Bulgaria (both by 8%) – on average in the EU, the milk prices went down by “only” 4% after the quota cancellation (after adjustment for seasonal fluctuations).

Theoretically, the market in cow's milk in Europe should stabilise gradually after the cancellation of quotas. The low price of milk should cause the less efficient farms to be dissolved, moderating the milk surpluses on the European market and stabilising the milk prices. However, the agricultural commodity market (including milk) in Europe is still deformed by high (and unequal) subsidies in agriculture, making the natural market environment inoperative and the natural adaptation of the milk market to the quota cancellation more difficult. (lk)

ECONOMIC CALENDAR

Week	Indicator	Period	Market Consensus	UniCredit Bank Estimate	Reality
2.	Industrial production (January 11)	November	-	3.5% yoy	11.9% yoy
	Construction production (January 12)	November	-	23.1% yoy	15.1% yoy
	Consumer prices (January 15)	December	-0.2% yoy	-0.1% mom -0.3% yoy	-0.3% mom -0.5% yoy
3.	Harmonised index of consumer prices (January 19)	December	-	-0.3% mom -0.4% yoy	-
	Unemployment (January 15-20)	December	-	10.8%	-

Source: Bloomberg, Reuters, NBS, SOSR, UPSVaR, MinFin SR, UniCredit Bank Slovakia

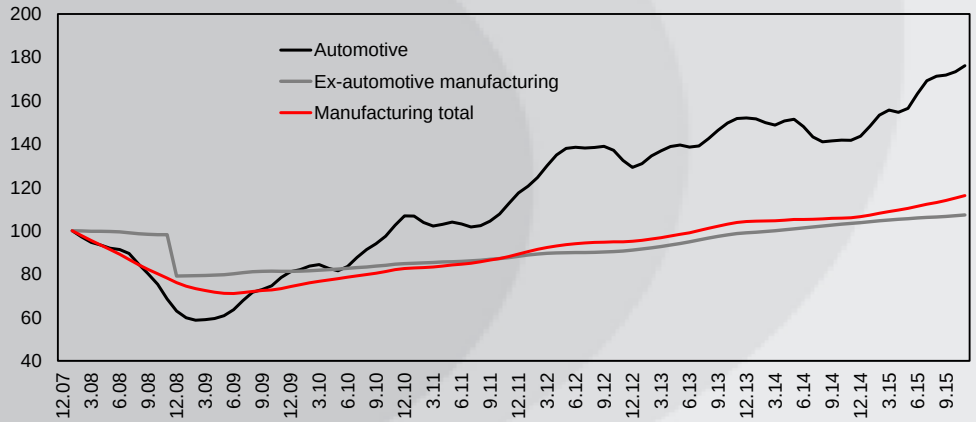
ECONOMY

Unexpected strong growth of industry in November, with mainly automotive industry on the rise

INDUSTRIAL AND CONSTRUCTION PRODUCTION

Industry was a pleasant surprise in November. According to data of the Statistical Office of SR, industrial production increased by considerable 1.9% (seasonally adjusted) compared to October, with the dynamics of its yoy growth accelerating from 4.1% to as much as 11.9%. Industry reported the fastest yoy growth during this year, confirming neither the weaker export figures (it is not excluded that, as was the case in October, exports will be revised well upwards in November), nor any material deterioration in industry sentiment in November.

Chart 1: Industrial production (Jan 2008 = 100, seasonally adjusted, trend)



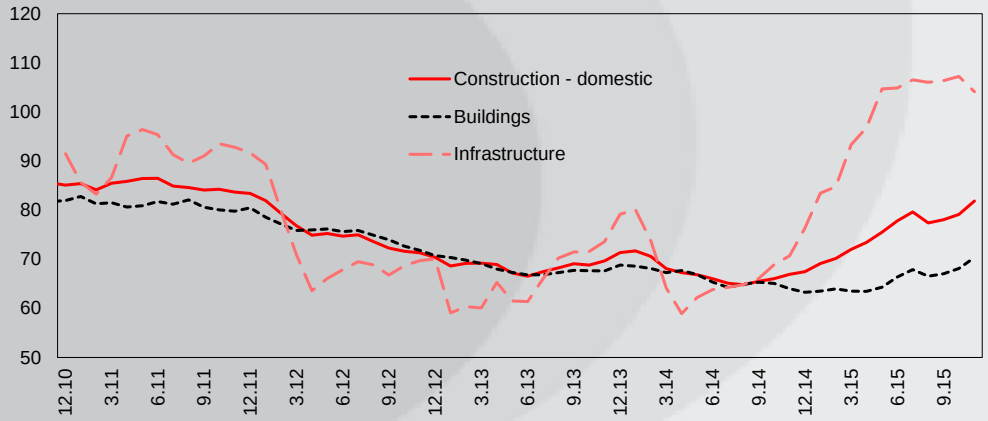
Source: UniCredit Bank based on data of SO SR

The automotive industry was still the main driver of growth in November, rising by 27.5% yoy and accounting for almost 2/3 of the yoy growth of the entire industry (contributing with 7.4 pp to the yoy growth). So it seems that the VW affair has had no substantial adverse effect on the Slovak automotive industry, at least so far. If, by chance, there was any output loss by the local VW plant, the plants of other car companies located in Slovakia have more than fully made up for this loss, mainly owing to the strong European demand. In November, a relatively strong growth was reported also by machineries which were supported by the last year's lower benchmark in a yoy comparison, reporting thus a yoy growth by 21.6%. A yoy growth exceeding 20% was reported also by the pharmaceutical industry, looking for a new output level after years of decline and reporting quite a strong volatility in recent months.

Although the industry benefited mainly from the growing automotive industry in November, the fact that, unlike October (when the automotive industry was nearly the only growth sector), growth was reported by almost all industry sectors can be appreciated – compared to October, production (seasonally adjusted) dropped slightly only in the production of chemicals and furniture, and, in a yoy comparison, in

consumer electronics production (still pushing the boulder of the relocation of a portion of production to cheaper Poland in this year's spring).

Chart 2: Construction production - domestic (12/2008 = 100, seasonally adjusted, 3M MA)



Source: UniCredit Bank based on data of SO SR

Growth of construction starts decelerating at the end of the year due to the end of EU-funded projects

With a gradual completion of EU-funded projects at the end of the year, construction has started to decelerate. According to data of the Statistical Office, its November production dropped by as much as -4.9% (seasonally adjusted) compared to October, with the dynamics of its yoy growth decelerated from the record October level of 28.7% to 15.1%. The view on the growth structure confirms the assumptions concerning the gradual deceleration of growth of the infrastructure segment – with a more than 10 percent mom decline (seasonally adjusted – calculation of UniCredit Bank), the dynamics of its yoy growth decelerated from 55.3% to 22.6%, which has been the slowest yoy growth in this segment since this year's February. After a record strong October, the building construction segment reported a moderate mom decline as well, maintaining, however, its strong double-digit yoy growth by 11.5% (the second fastest yoy growth since the outbreak of the crisis in 2008).

OUTLOOK

This year, we expect that the growth of the industry continues to be supported by the cyclical recovery of European economies. However, the substantial deterioration of sentiment of the Slovak industry at the end of the last year could be a warning bell (confidence in the industry reported more than 2-year lows in November and December) - however, as already indicated by November, hard figures do not always have to follow the soft indicators. So far, we assume that the European demand supported by the weaker euro (and the ECB's relax monetary stance) and cheap energy should be able to fully make up for the potential deceleration on markets outside Europe. However, as in 2015, we could see an increased volatility of the Slovak industry – at the same time, it can happen that the current worse sentiment of the industry could be translated into a slower growth of its production at the turn of the years.

In the following months, we expect that the infrastructure construction segment will be weaker due to the end of EU-funded projects; at the beginning of this year, it could report quite a strong yoy decline – last year, no construction of a substantial new highway section has been initiated in Slovakia, the assessment of tenders for several sections has been postponed to the beginning of this year, as well as the final decision on the construction of the Bratislava bypass, financed through PPP. After the feast last year, a brief loss in the large infrastructural projects is expected at the beginning of this year, with these projects gradually restarting in the course of the year. This loss should be, at least partially, replaced by the increasing building construction segment, reporting a significant recovery in the recent months. However, it is highly probable that it will not be able to fully make up for the decline in the infrastructure segment at least at the beginning of the year, and therefore we expect the construction to return to slightly negative figures at the beginning of this year. (lk)

Deflation deepening in December, due to lower oil and food prices

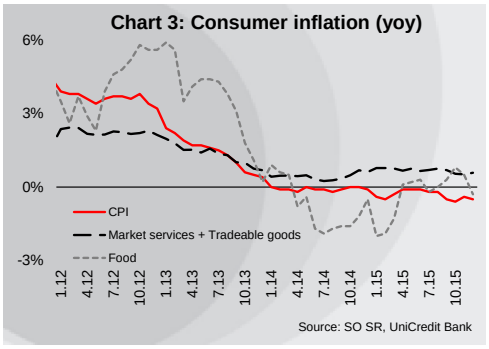
CONSUMER PRICES

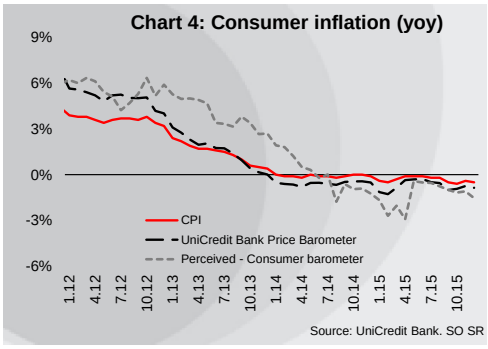
According to data of the Statistical Office of SR, consumer prices went down by -0.3% mom in December, with the dynamics of their yoy decline deepening again from -0.4% to -0.5%, while the market expected, on average, the dynamics to decelerate slightly. On average, prices went down by -0.3% last year (-0.1% in 2014). Last time Slovakia reported a yoy price growth was in December 2013, i.e. exactly two years ago.

The dynamics of the yoy decline in consumer prices in December could not be moderated even by the base effect in transport, with the effect of free train tickets finally diminishing in the last month of the year. However, it has at least moderated the dynamics of the yoy decline of regulated prices from -2.0% to -1.8%. Thus, the increase of deflation in Slovakia in December is solely attributed to the core inflation, resuming its yoy decline by -0.2% (being unchanged on a yoy basis in November). However, also in the case of core inflation, we may still talk, almost exclusively, about supply-side factors (oil, food) pulling inflation down. Although the demand-pull inflation (measured by the index of prices of tradable goods (without fuels) and market services (without imputed lease) – calculation of UniCredit Bank) went down by -0.2% mom in December, the dynamics of its yoy growth accelerated from 0.5% to 0.6%. Thus, the demand-pull inflation remains subdued, in particular due to the transition of secondary effects of low energy prices, but relatively stable, anchored just above zero (ranging in a relatively narrow corridor of 0.5-0.8% during last year).

In December, the Brent oil price headed south once again, falling by as much as around 15% mom in EUR. This, of course, translated also into the end prices of fuel in Slovakia, falling by -3.5% compared to November. It was the same as in December a year ago and the originally expected base effect in relation to fuel prices did not occur after all. Dynamics of the yoy decline in fuel prices remained unchanged in December, maintaining its double-digit level (by -14%). The fuel prices themselves were thus reducing the overall yoy inflation by -0.3 pp. A part of the December decline in oil prices on global markets will not be translated into the end prices of fuels in Slovakia (considering the standard delay) until the beginning of this year; moreover, the oil prices were dropping further also on the first days of the new year.

However, the biggest surprise in December were the prices of food. Compared to the previous month, they fell by as much as -1.0%, while only a part of this decline can be attributed to the traditional seasonal fluctuations. At the same time, the structure implies that it is not even an early (marketing) price reduction due to the planned VAT cut from January. In a yoy comparison, prices returned to negative rates after 4 months, falling by -0.3%. Compared to November, lower price tags could be seen in all food categories in December, save for fruit (due to the traditional price hike) - after adjustment for the seasonal fluctuations, the most significant mom decline in prices was reported by vegetables (correction of their strong growth from the end of summer), oils and fats and milk and eggs); on the contrary, meat prices reported a negligible mom decline. In a yoy comparison, lower prices are reported mainly by milk and eggs (see the Chart of the Week for the reasons); on the contrary, despite correction in the last two months, prices of vegetables keep rising by around 17% yoy.





The UniCredit Bank Price Barometer (i.e. the perceived inflation measured through frequently bought goods and services), went down considerably in December – by as much as -0.5% mom (due to the higher weight of food and fuels); compared to the same period a year ago, its decline deepened from -0.7% to -0.9%. According to the consumer barometer of the Statistical Office, the perception of price decline increased

as well in December - from -1.1% to -1.5% (calculated based on the balance of answers). Inflation expectations moderated slightly, too – from 0.4% to 0.3%, but they are still slightly above zero.

OUTLOOK

There is no stronger inflation driver and this situation should persist during most of this year; moreover, the deflationary pressure will be increased also by the lower VAT on certain food, applied since this year's January. The current further decline in oil prices on global markets has only postponed the return to the positive inflation rates. It is the oil price development that is going to decide on the end of the slight deflation in Slovakia. It seems that with such price, oil extraction is no longer economically effective in many locations, and therefore a moderate oil price correction upwards (to USD 50 per barrel) might occur during the first half of the year. On the contrary, if the oil price maintains, for political reasons (mainly due to decisions of the OPEC countries), its current low level, the return to positive inflation rates would be postponed to the turn of this and the next year, with another potential oil price decline pushing it to the beginning of the next year.

Even if the moderate deflation persists in Slovakia (provided there is no oil price correction, it should even push historical lows once again in the spring) together with low oil prices, such form of deflation is not harmful to the economy so far. Supply-side deflation does not decrease household consumption; on the contrary, it supports it - with low energy prices, households have more available funds to purchase other goods and services. The risks of occurrence of the harmful deflationary spiral still seems to be relatively low. Although the secondary effects of low energy prices prevent the substantial recovery of demand-pull inflation (even with an increasing demand); however, it is still relatively stable just above zero. Also, inflation expectations of Slovak households are close to historical lows, but still slightly positive. (lk)

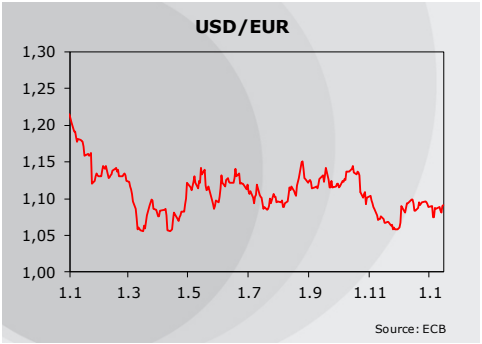
ECONOMIC OUTLOOK

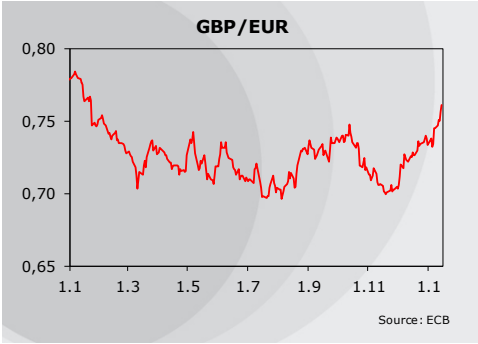
Slovakia	2011	2012	2013	2014	2015F	2016F	2017F
Real GDP growth	**2,8**	**1,5**	**1,4**	**2,5**	**3,4**	**3,0**	**3,0**
GDP per capita	13 052	13 398	13 643	13 947	14 372	14 788	15 291
Household consumption	**-0,6**	**-0,4**	**-0,8**	**2,4**	**2,5**	**2,9**	**2,6**
Government consumption	-1,7	-2,6	2,2	5,9	3,8	1,7	0,5
Gross investments	7,6	-14,0	1,5	2,6	11,4	-2,5	6,8
Exports	12,0	9,3	6,2	3,6	6,4	5,6	4,1
Imports	9,6	2,5	5,1	4,3	8,1	4,1	4,5
Industrial Production	**6,9**	**13,4**	**5,3**	**3,7**	**5,8**	**5,5**	**6,5**
Construction	-1,7	-12,5	-5,3	-4,2	15,1	2,7	6,5
Retail Sales	-2,8	-1,0	0,1	3,6	1,7	2,3	2,5
CPI (average)	**3,9**	**3,6**	**1,4**	**-0,1**	**-0,3**	**0,3**	**1,5**
CPI (Dec.)	4,4	3,2	0,4	-0,1	-0,2	0,9	1,6
Real Estate inflation	-3,0	-1,1	-0,9	-0,8	0,9	2,3	2,4
Average Wage level	786	805	824	858	880	904	930
Nominal Wage growth	**2,2**	**2,4**	**2,4**	**4,1**	**2,5**	**2,8**	**2,9**
Real Wage growth	-1,6	-1,2	1,0	4,2	2,8	2,5	1,4
Employment growth (LFS)	1,5	-1,0	0,0	1,5	2,2	1,0	1,0
Unemployment (average, LFS)	**13,5**	**14,0**	**14,2**	**13,2**	**11,6**	**10,8**	**9,9**
Fiscal deficit (% of GDP)	-4,1	-4,2	-2,7	-2,8	-2,7	-2,0	-1,0
Public Debt (% of GDP)	43,3	51,9	54,6	53,5	53,1	52,9	51,7
Foreign Direct investment (EURbn)	2,8	3,2	-0,3	0,2	2,0	2,5	3,3
ECB Refi rate (%, Dec.)	**1,00**	**0,75**	**0,25**	**0,05**	**0,05**	**0,05**	**0,50**
3M EURIBOR (%, Dec.)	1,2	0,2	0,3	0,1	-0,2	-0,2	0,5
3Y SK gov't bonds(%,Dec.)	1,1	0,3	0,7	0,5	-0,1	0,0	1,5
10Y SK gov't bonds(%,Dec.)	4,8	2,2	2,6	1,3	0,8	1,0	2,0

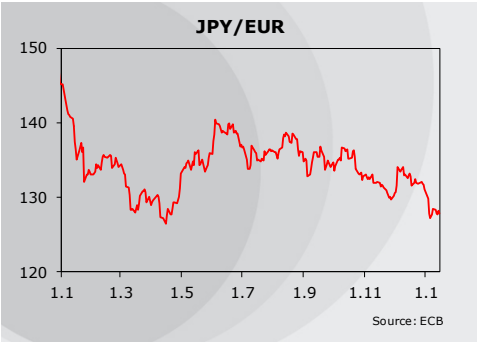
Abroad	2011	2012	2013	2014	2015F	2016F	2017F
Eurozone GDP	**1,5**	**-0,6**	**-0,4**	**0,9**	**1,5**	**1,9**	**1,6**
German GDP	**3,1**	**0,9**	**0,5**	**1,6**	**1,7**	**2,1**	**1,4**
Czech R GDP	1,7	-1,0	-0,9	2,0	4,3	2,3	3,0
USA GDP	1,7	2,8	1,9	2,4	2,5	2,6	2,4
Eurozone Inflation	2,7	2,5	1,3	0,4	0	0,9	1,4
EUR/USD (average)	**1,39**	**1,28**	**1,33**	**1,33**	**1,11**	**1,08**	**1,16**
EUR/USD (Dec)	1,32	1,31	1,37	1,21	1,09	1,12	1,18
EUR/CZK (Dec)	25,8	25,1	27,5	27,7	27,0	27,0	26,5
EUR/HUF (Dec)	304,2	285,8	300,2	315,5	314,0	320,0	325,0
EUR/PLN (Dec)	4,5	4,1	4,2	4,3	4,3	4,2	4,2

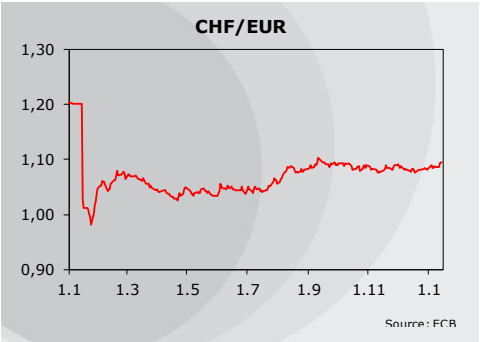
Source: NBS. SOSR. ÚPSVaR. MinFin SR. Eurostat. ECB
Forecasts: UniCredit Bank Slovakia – Slovakia. Eurozone. USA (EURIBOR. USDLIBOR. Brent. USD/EUR); UniCredit Group (CEE Economic Research. CIB) – Eurozone. USA

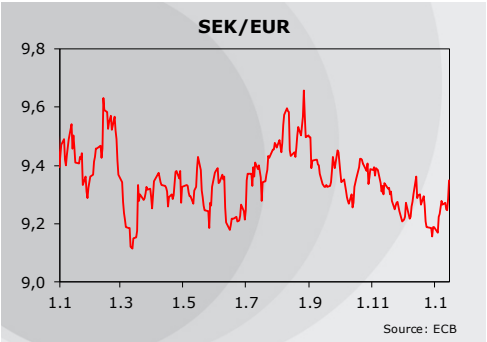
FOREIGN EXCHANGE

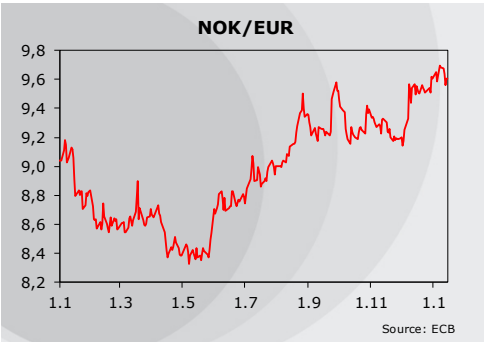


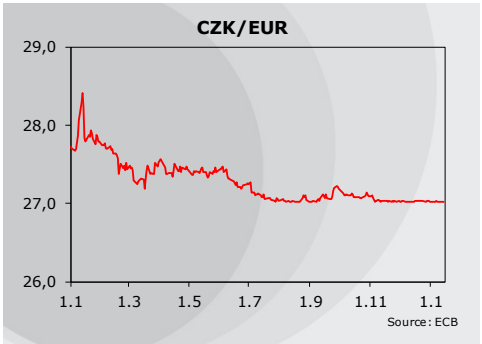


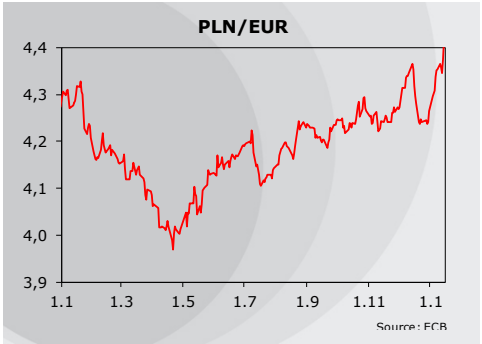


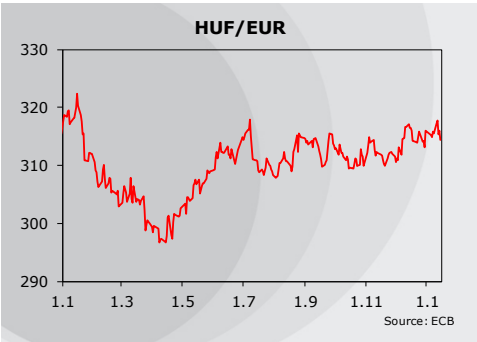


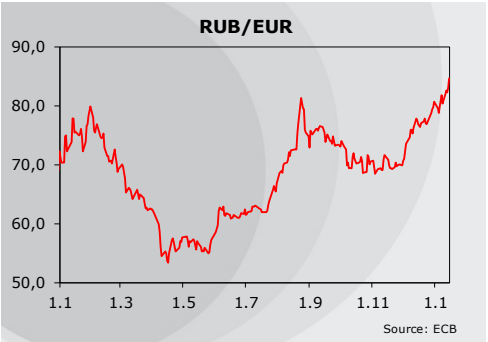












MONEY MARKET

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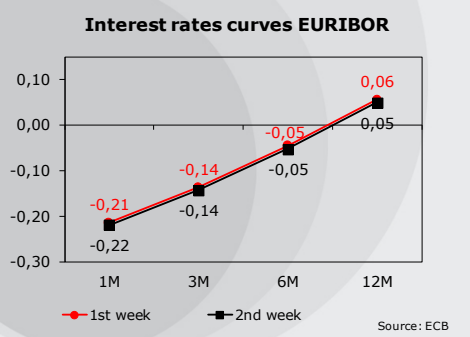
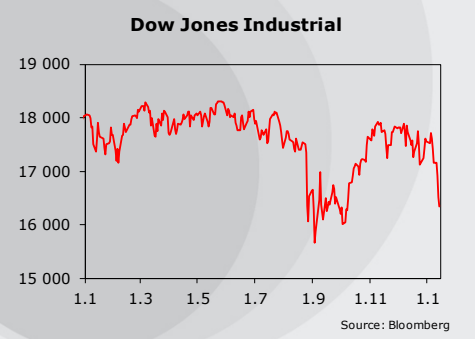
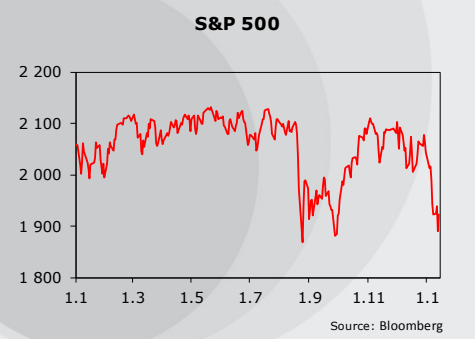
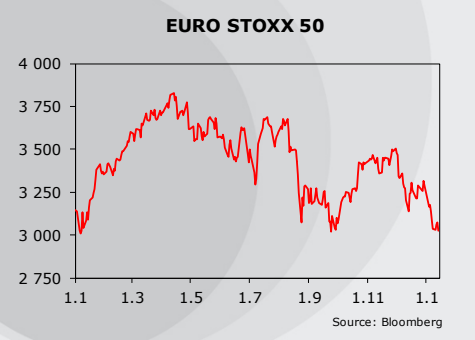
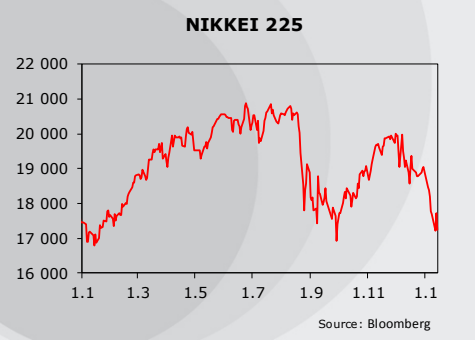


EQUITY









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