Bank Zachodni WBK

Weekly economic update

23 – 29 July 2012

Another week of clear appreciation on the Polish financial market is behind us. In spite of persisting investors' fears about debt crisis in the euro zone, general moods on global markets remained quite positive, supported by hopes for economic stimulus by central banks and positive financial results of US companies. It is worth pointing out that for some time news concerning problems of the euro zone have influenced mainly pricing of euro and bonds of euro zone's peripheries, while other world markets, among others stock exchanges, bonds and currencies including Polish assets seem to be quite resilient to this kind of information. Significant strengthening of Polish interest rate market was supported, apart from global moods, also by the release of weak data confirming on-going slowdown of the domestic economy (weak employment and production figures), as well as dovish comments of some MPC members. Consequently, the money market started to price-in the possibility of interest rate cuts by the MPC at September's meeting and as much as 75bp rates' reduction in nine-months horizon. In our opinion these expectations are overdone. Although weak macro data are increasingly worrying some MPC members, we do not think that the MPC will decide to withdraw from May's rate hike, thus admitting the mistake, until the Council sees significant fall in inflation data. However, the latter will not occur before the year's end because according to our forecasts CPI will remain elevated, above 4%, until late autumn.

In the following week a series of July's leading indicators for main economies will show up. They will provide markets with important hints about prospects of economic growth in H2. Domestic data on business climate in July, released on Friday, have indicated the deteriorating situation in industry and continuation of collapse in construction sector. On Thursday the CSO will release data on retail sales and unemployment rate (temporary improvement is expected among others as a result of EURO 2012) as well as monthly Statistical Bulletin, which will allow to look at the labour market situation in details.

In coming week stable mood on global market (ahead of Fed and ECB decisions) may support appreciation trend of the zloty. Breaking support zone at 4.144-4.147 could open the way to further decline of the EURPLN towards 4.126. In the case of profit taking the rate may increase towards 4.18-4.20. On debt market we expect the consolidation.

Economic calendar

Time CET	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (23 July)					
16:00	EZ	Consumer confidence	Jul	pts	-20.0	-	-19.6
		TUESDAY (24 July)					
4:30	CN	Flash PMI in manufacturing	Jul	pts	-	-	48.2
9:28	DE	Flash PMI in manufacturing	Jul	pts	45.3	-	45.0
9:58	EZ	Flash PMI in manufacturing	Jul	pts	45.3	-	45.1
		WEDNESDAY (25 July)					
10:00	DE	Ifo index	Jul	pts	104.7	-	105.3
16:00	US	New home sales	Jun	k	372	-	369
		THURSDAY (26 July)					
8:00	DE	GfK index	Aug	pts	5.8	-	5.8
10:00	**PL**	**Retail sales**	**Jun**	**%YoY**	**9.0**	**9.0**	**7.7**
10:00	**PL**	**Registered unemployment rate**	**Jun**	**%**	**12.2**	**12.3**	**12.6**
14:30	US	Durable goods orders	Jun	%MoM	0.2	-	1.3
14:30	US	Initial jobless claims	week	k	380	-	386
16:00	US	Pending home sales	Jun	%MoM	0.2	-	5.9
		FRIDAY (27 July)					
14:30	US	Advance GDP	Q2	%QoQ	1.5	-	1.9
14:30	US	Core PCE	Q2	%QoQ	2.0	-	2.3
15:55	US	Michigan	Jul	pts	72.0	-	72.0

Source: BZ WBK, Reuters, Parkiet

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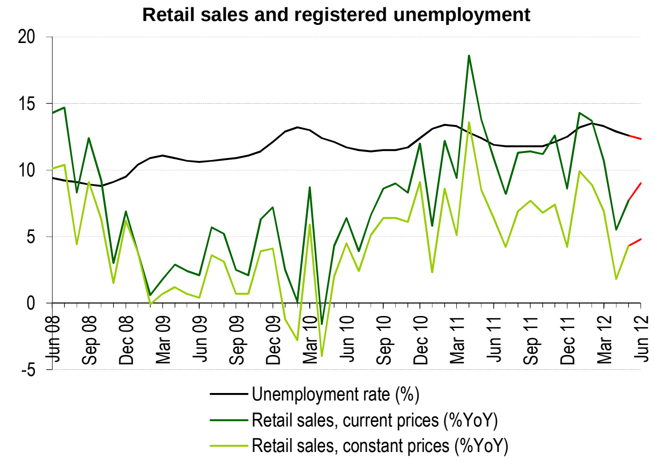
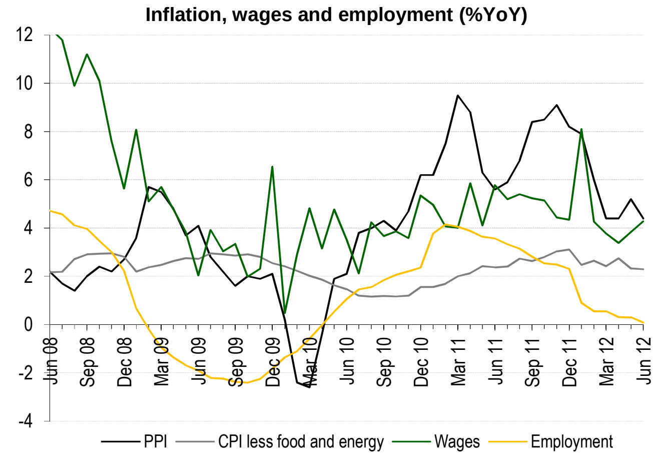
What's hot this week – Retail sales and unemployment under influence of EURO 2012

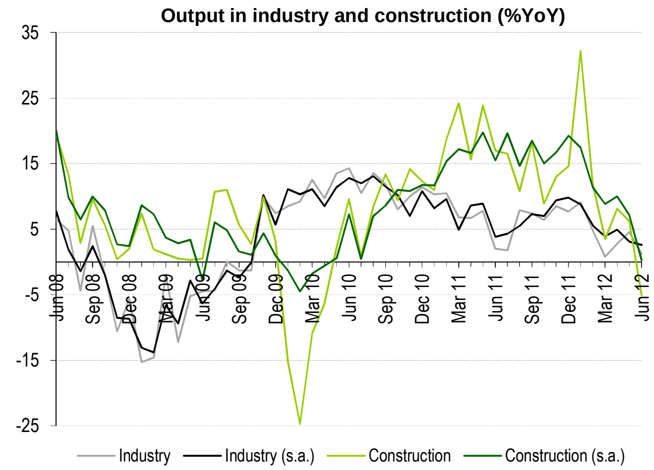


- The increase of retail sales probably accelerated in June (temporarily), supported by among others fans' spending during EURO 2012 and higher growth in retail prices. However, the pace of real sales growth remains limited, clearly below average seen in the last quarters, what proves a general weakening of consumption demand. In following months we expect further deceleration of retail trade's dynamics.
- We expect the drop of the registered unemployment rate in June, being supported, apart from seasonal factors, by more workplaces during EURO 2012. However, lack of demand for new employees in the corporate sector suggests that one should predict another wave of unemployment increase in the second half of the year.

Last week in the economy – Labour market in stagnation, slowdown in production



- Employment decelerated to 0.1%YoY from 0.3%YoY in May. Monthly rise amounted to only 1.4k. Seasonal effects usually boost employment rise in June, so this result looks quite poorly. The figures have confirmed that demand for labour remains weak, which in our view is resulting from strengthening impact of economic slowdown abroad, but also a poor condition of construction sector.
- Wages in corporate sector accelerated in June to 4.3%YoY from 3.8%YoY in May. The rise may be partially related to EURO 2012 (payment for overtime in retail trade) or with bonuses in some sector of the economy. We assess June's wage growth as moderate. In our opinion the risk of second round effect is rather small.
- Real wage bill rose by a mere 0.1%YoY, supporting our forecast of slowdown in consumer demand in Q2.



- Industrial output growth decelerated in June to 1.2%YoY. The weakening resulted partially from lower number of working days. Still, seasonally adjusted output growth amounted to 2.6%YoY, which is the lowest pace of growth since 2009. Activity in the Polish industrial sector is decelerating more and more as a result of economic stagnation in the euro area. Therefore, one should not expect that in the remaining part of this year the situation will improve.
- A strong surprise was delivered by construction output, which fell by 5.1%YoY. In our view this was due mainly to the stop of infrastructural investments (roads, stadiums for EURO 2012). This is a worrying signal for investment outlook for second year-half.
- PPI inflation dropped to 4.4%YoY in June from 5.2%YoY in May, while core inflation maintained at 2.3%YoY.

Quote of the week – Slowdown may be deeper than we thought

Anna Zielińska-Głębocka, MPC member, 18.07, Reuters, 19.07 TVN CNBC
Slowdown may be deeper than we had thought. (…) If the slowdown is deep, the MPC must take possibility of rate cuts into consideration.

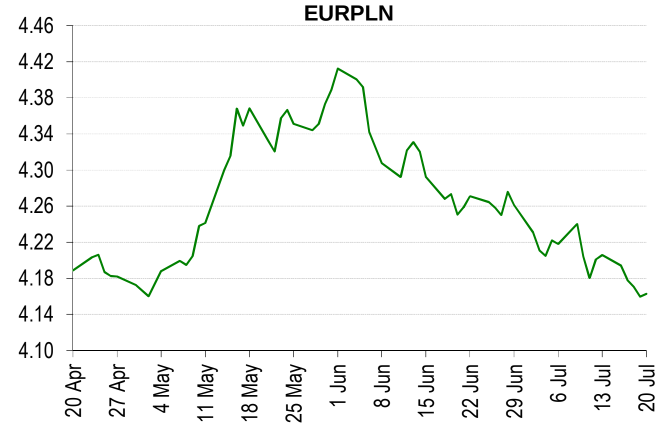
Elżbieta Chojna-Duch, MPC member, 18.07, TVN CNBC
In horizon of following months rate cut must be taken into consideration, e.g. by 25bp.

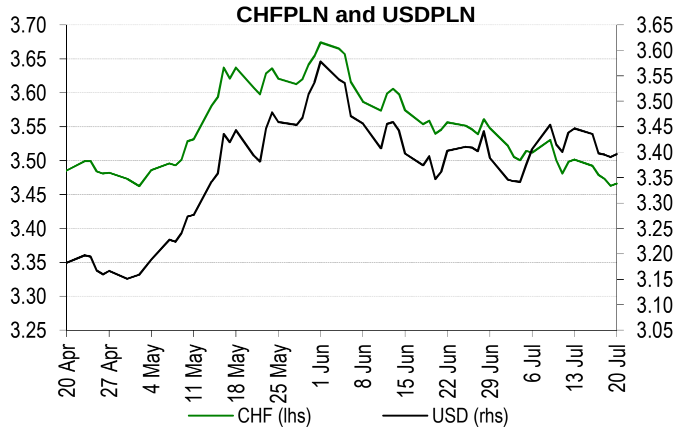
Andrzej Kaźmierczak, MPC member, 17.07, Bloomberg
We can't start easing just because just a lower inflation forecast on paper. The slowdown in price growth has to happen. Another rate increase will be essential if inflation stays at 4 percent or higher after the third quarter.

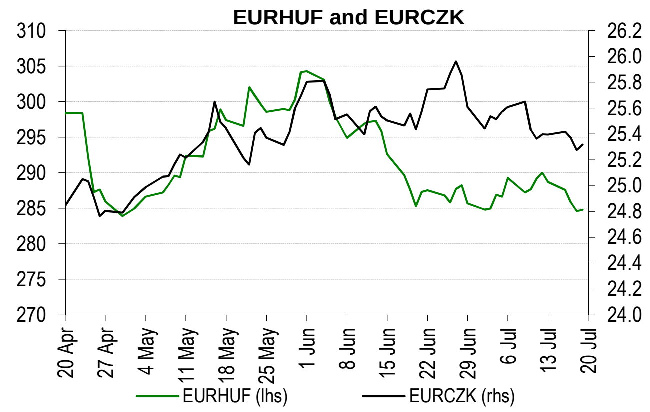
Andrzej Bratkowski, MPC member, 17.07, Obserwatorfinansowy.pl
In my opinion we should worry more about the fact that our economic growth will be by 2-3pp below potential growth instead of worrying about the inflation which will decrease slightly slower that we wish.

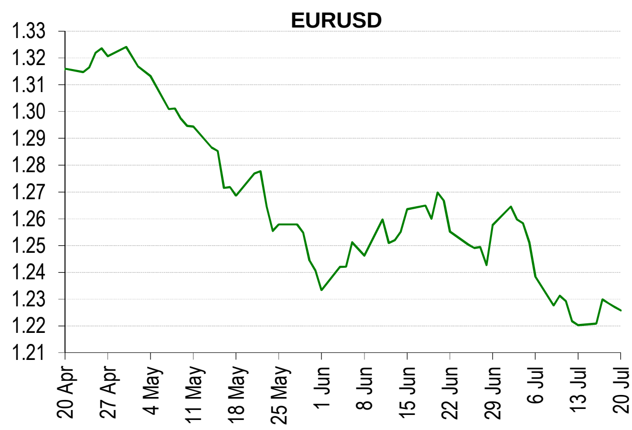
Weak domestic economic data seem to be increasingly worrying some MPC members – A. Zielińska-Głębocka, who did not see any space for cuts last week, now takes into consideration a possibility of monetary easing after summer holidays. However, one should remember that until next meeting new data will appear, among others CPI still over 4% and July's output, which will probably look better than June's. Statement of Kaźmierczak shows that for some MPC members current inflation level is of key importance and chances for rate cuts are rather low until CPI starts clearly falling. It confirms our scenario which assumes unchanged NBP interest rates until the end of the year.

Foreign exchange market – The zloty resilient to euro zone's problems









Strengthening of the zloty continues

▪ Last week the Polish zloty strengthened in relation to the main currencies. It was supported by relatively stable (or even a slightly positive) mood on global market and strong inflows of foreign capital to the Polish debt market. As a consequence the EURPLN declined to 4.144, the lowest level since April. However, its move below 4.15 was temporary and the rate quickly came back towards 4.16 due to worries about situation in Spain. In weekly terms zloty gained 1% against the euro.

▪ The Polish currency also strengthened in relations to other main currencies. In weekly terms it gained 1.5% in relations to the US dollar and 1% against the CHF. One should notice that the USDPLN tested 3.37, reaching the weekly minimum at 3.3695.

▪ It is worth noting that for some time the news concerning the euro zone are affecting mainly the single currency and euro zone peripheries' assets, while international stock markets and the zloty proved to be relatively resilient to this kind of information. In our opinion, the specificity of current situation in the euro zone has led the financial markets to divergence across member-states, including Poland's one. Poland still positively stands out from other both the euro zone and the EU countries in case of the economic activity and it could be a reason of high demand on Polish debt from non-residence. One should notice that similar trends on the FX and bond markets have been observed in the other countries in the region. However, on the Hungarian FX market volatility is much higher compared to other countries due to talks with the IMF.

▪ In coming week stable mood on global market (ahead of Fed and ECB decisions) together with still strong demand on the Polish assets could support appreciation trend of the zloty. Breaking support zone at 4.144-4.147 could open the way to further decline of the EURPLN towards 4.126. However, in the case of profit taking the rate may increase towards 4.18-4.20.

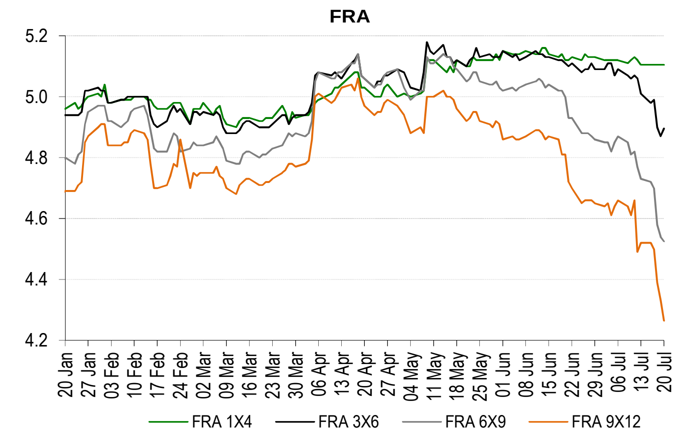
EURUSD is consolidated between 1.216-1.233

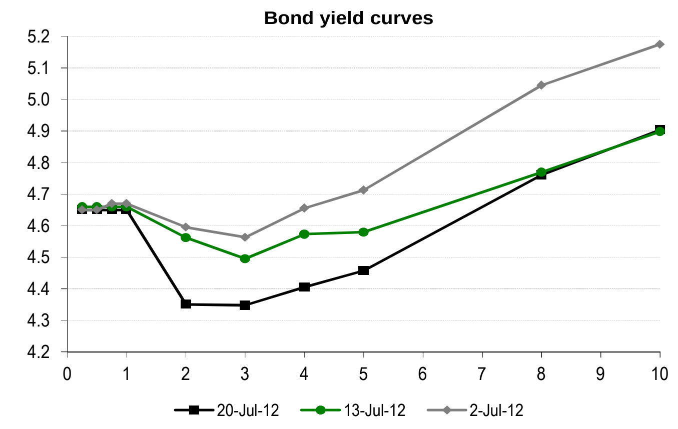
▪ Over the last week the EURUSD has been trading in horizontal trend between 1.216-1.233. On the one hand, the market players still believe that FOMC will decide to implement QE3 (if not in August, than in September). The last testimony of Fed's Governor confirmed the Fed's readiness to support the US economy if needed. Market expectations are also supported by relatively weak macro data from the US economy.

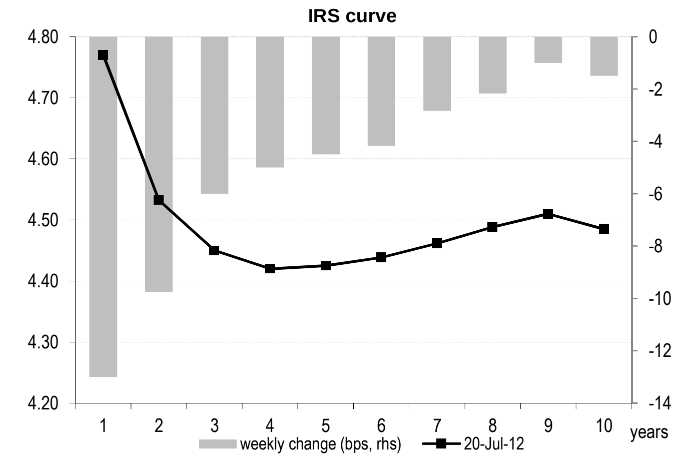
▪ On the other hand, the European currency has been under pressure of situation in the euro zone, mainly in Spain. Last auction of Spanish debt disappointed. After announcement of its results yield of 10Y Spanish benchmark increased above 7%, which could generate some problems with receiving capital from the market. What is more, approval of bailout for Spanish banking sector was in line with expectations, but it does not mean that all the problems will be solved.

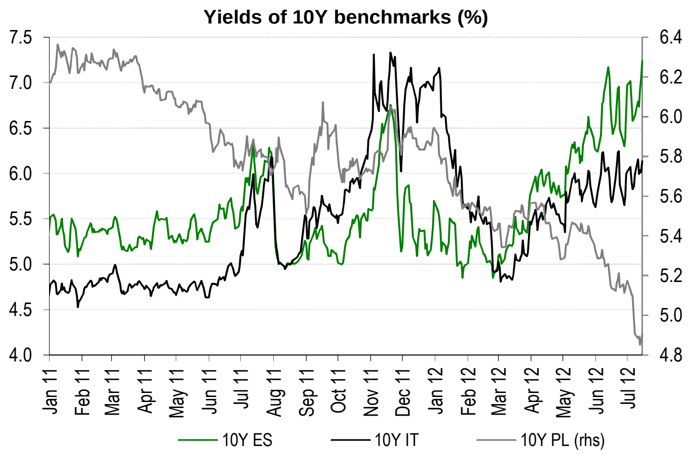
▪ Clashing of the above-mentioned factors resulted in horizontal trend of EURUSD. We believe that if the EURUSD breaks the upper limit of the channel, it will open the room for further increase towards 1.24. From the technical analysis point of view braking short-term support level at 1.223 will cause the EURUSD to test the bottom bounce of channel. In short term both scenarios are likely and impulse to the materialisation of one of them could come from the upcoming macro data.

Interest rate market – Expectations for significant rate cuts









Money market has priced-in rate cut in September

- Last week brought changes of expectations about future monetary policy. Coming macro data (mainly weaker than expected data of employment and industrial output) and MPC members' statements (Chojna-Duch, Bratkowski and softer tone of Zielińska-Głębocka) strengthened expectations for rate cuts, which had been strong anyway, with the possibility of first reduction in September. It caused significant fall of FRA rates, which indicate the reductions in total by 75bp in horizon of 9 months.
- Currently it is hard to predict a persistent correction on FRA market. Nevertheless, retail sales data release (similarly to the market we expect sales' increase by 9% YoY) may in short-run limit the FRA rates' decline.

Bonds yields lower and lower

- Yields' falls have been also recorded on debt market. During the week the curve moved downward by 0-21bps, securities from short-end and the middle of the curve gained on value the most. It is worth noticing that week's end brought profit-taking at long-end and 10Y yield increased toward 4.90%, after earlier fall to ca. 4.80% (the lowest level since 2006).
- The increase of expectations for swift interest rate cuts caused quite significant fall at short-end of the curve. After industrial output release and announcement of OK0714 auction's result, the 2Y benchmark's yield decreased to ca. 4.30%, the lowest level since 2006. Consequently yield curve steepened and 2-10Y spread increased above 50bp, while at the end of last week it was slightly above 30bp.
- In line with expectations OK0714 auction enjoyed significant interest of investors. The Ministry of Finance sold bonds, in total on regular and additional auctions, worth PLN5.84bn with the yield of 4.361% (against 4.759% on April's auction), the lower since 2006. After OK0714 auction this year's gross loan needs are so far financed in almost 85%.
- The week's end brought also profit-taking at long-end of IRS curve. During the week the IRS curve decreased by 5-12bp, the highest falls concerned short-end of the curve. 2-10Y spread remains negative, however, it yielded to slight decrease.

Macro data and global factors are significant

- This week we will see the last macro data releases for June (retail sales and unemployment rate). Attention will be paid mainly to retail sales data, which will fill up the picture of consumption demands. If data proves better than our and market expectations (9.0%YoY), impulse to short-term corrections may be generated.
- Long-end of the curve, except for domestic factors, will remain under influence of information which will inflow from base markets. Although 10Y bond yields remained quite resilient to situation on euro-zone's peripheries, risk-aversion's increase may generate temporary correction.
- All in all, following days should rather bring the consolidation of yields in ranges 4.30-4.40% for 2Y, 4.40-4.50% for 5Y and 4.85-4.95% for 10Y.