Bank Zachodni WBK

Weekly economic update

30 July – 5 August 2012

At the beginning of the week pessimistic moods, which were due to fears that Greece may leave the euro zone and that Spain will be forced to ask for bailout, maintained. It caused a further increase of 10Y bond yields of these countries. Spanish yields hit the highest level in the euro zone's history (ca. 7.74%). 2Y bond yields also surpassed 7% and consequently the yield curve flattened and anchored at a high level. On the other hand, German long-term debt saw a record strengthening, 10Y yields decreased temporarily to 1.126%. Situation changed after statements of E. Nowotny, member of the ECB governing council, and M. Draghi, the ECB president. Nowotny said that he sees grounds for giving ESM a banking license. Draghi ensured that the bank will do whatever it takes to protect the euro zone from collapse. Consequently, EURPLN fell almost to 4.12 and domestic bonds continued to rally. New dovish comments of MPC members caused that market currently prices-in a cut of NBP interest rates by ca. 100bps in 9 months' time.

A resolute statement of ECB president caused that post-meeting press conference may be the key event of this week. Investors will be expecting Mario Draghi to reveal what actions is the ECB going to take in order to save the euro zone. At the very same day Spain will offer its bonds on an auction. On the other hand, hopes that Fed will increase its stimulus of the US economy seem rather unjustified, especially as minutes for last meeting showed that only a few FOMC members supported such a solution. Events connected with central banks will probably dominate this week and will be the main factor behind developments of the zloty exchange rate. EURPLN rebounded on Friday from a significant support. Domestic PMI release will be, in our view, a further signal proving that May's NBP rate hike was unjustified and these data may provide some support for the domestic debt market.

Economic calendar

Time CET	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (30 July)					
11:00	EZ	Consumer confidence	Jul	pts	-21.6	-	-19.8
		TUESDAY (31 July)					
11:00	EZ	Flash HICP	Jul	%YoY	2.4	-	2.4
14:00	**PL**	**Inflation expectations**	**Jul**	**%YoY**	**-**	**-**	**3.7**
14:30	US	Personal income	Jun	%MoM	0.4	-	0.2
14:30	US	Consumer spending	Jun	%MoM	0.1	-	0.0
15:00	US	S&P/Case-Shiller home price index	May	%MoM	0.4	-	0.7
15:45	US	Chicago PMI index	Jul	pts	52.5	-	52.9
16:00	US	Consumer confidence index	Jul	pts	61.3	-	62.0
		WEDNESDAY (1 August)					
4:30	CN	PMI - manufacturing	Jul	pts	-	-	48.2
9:00	**PL**	**PMI - manufacturing**	**Jul**	**pts**	**47.4**	**47.6**	**48.0**
9:53	DE	PMI - manufacturing	Jul	pts	43.3	-	45.0
9:58	EZ	PMI - manufacturing	Jul	pts	44.1	-	45.1
11:00	**PL**	**Bonds auction (PS0417)**					
14:15	US	ADP report	Jul	k	120	-	176
16:00	US	ISM - manufacturing	Jul	pts	50.2	-	49.7
20:15	US	Fed decision		%	0.0-0.25	-	0.0-0.25
		THURSDAY (2 August)					
13:00	GB	BoE decision		%	0.50	-	0.50
13:45	EZ	ECB decision		%	0.75	-	0.75
14:30	US	Initial jobless claims	week	k	370	-	353
16:00	US	Factory orders	Jun	%MoM	0.4	-	0.7
		FRIDAY (3 August)					
9:53	DE	PMI - services	Jul	pts	49.7	-	49.9
9:58	EZ	PMI – services	Jul	pts	47.6	-	47.1
14:30	US	Non-farm payrolls	Jul	K	100	-	80
14:30	US	Unemployment rate	Jul	%	8.2	-	8.2

Source: BZ WBK, Reuters, Parkiet, Dow Jones

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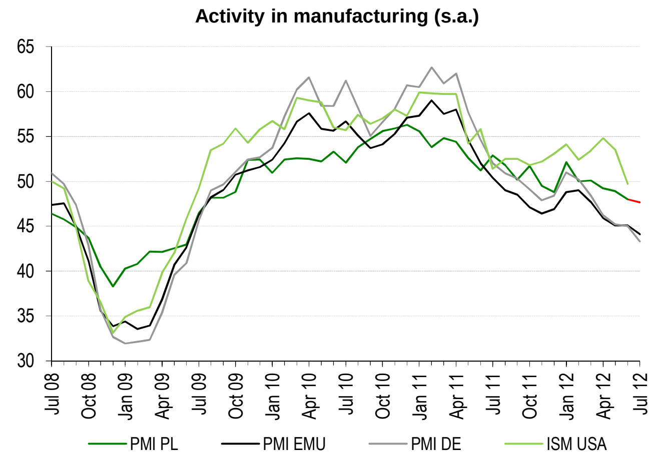
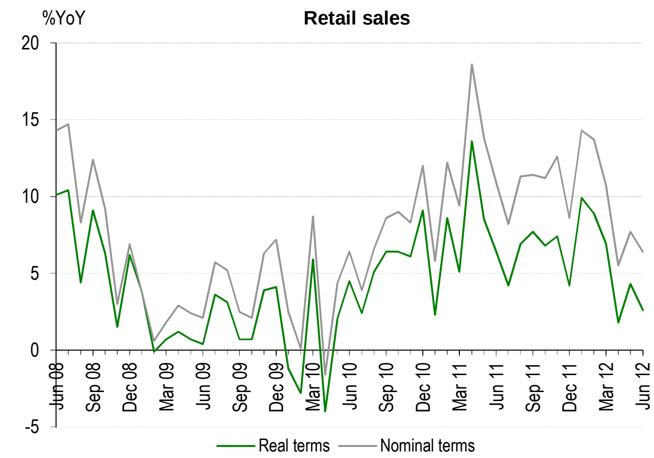
What's hot this week – PMI and inflation expectations

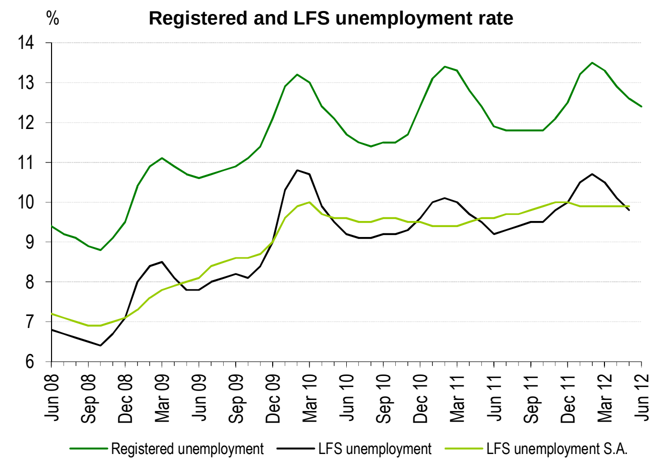


- We expect that PMI for Polish manufacturing in July will fall for a fourth time in a row, mainly as a result of accelerating shrinkage of orders portfolio of Polish investors', both domestic and export ones. We also anticipate that subindices for output and stocks of purchases will decline, while employment will stabilize and suppliers' delivery times index will increase.
- It can be expected that households' inflation expectations measure will show a strong increase. If the survey was conducted after release of June's inflation, then the May's inflation rate (3.6%) will be replaced by June's inflation rate (4.3%) as a calculation base. Still, it is worth stressing that the breakdown of respondents' answers have been improving for last several months and pressure on prices' increase will decrease in face of weakening economic outlook.

Last week in the economy – Retail sales decelerate, unemployment higher than expected



- In June retail sales increased by 0.2% MoM, which translated into deceleration of annual pace of growth to 6.4% from 7.7% in May. June's release proved to be lower than market expectations and our forecasts at the level of 9.0%YoY. Retail sales in real terms increased by 2.6%YoY (against 4.3%YoY in May).
- June's data release indicated that the influence of EURO 2012 on retail sales was rather limited. We expect that following months will bring further gradual fall of sales' growth. Current labour market situation (moderate increase of wages and gradual decrease of employment in corporate sector) does not support an increase of consumer spending. Consequently, a further weakening of consumption demand may be expected in the following quarters.



- In June registered unemployment rate declined to 12.4% from 12.6% in May, anchoring slightly above our expectations (12.3%) and market consensus (12.2%). The number of unemployed at the end of June reached 1964.4k, lower by 2.5%MoM and more by 4.3%YoY. The number of job offers reached at the end of June 44.4k versus 46.8k in May and 47k in June 2011.
- In coming months we expect a further gradual decline of the registered unemployment rate, mainly due to seasonal effects. After summer months the rate may start to climb again and reach just above 13%, but its pace of growth will be probably limited by the rise of Ministry of Labour financial means which are aimed for active forms of promoting the employment.

Quote of the week – We are late with cuts

Elżbieta Chojna-Duch, MPC member, 25.07 Reuters

Taking macroeconomic conditions in Poland and situation in the euro zone into consideration, I would be likely to support a motion for cut in September. I would incline towards a cautious step, i.e. by 25bps.

Marek Belka, NBP President, 25.07 Reuters

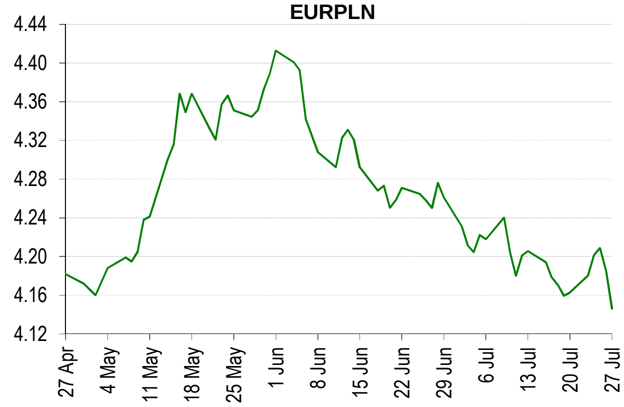
Possibly the NBP is one of last banks that is able to provide conventional monetary policy. Keeping rates at minimally positive level is its effect.

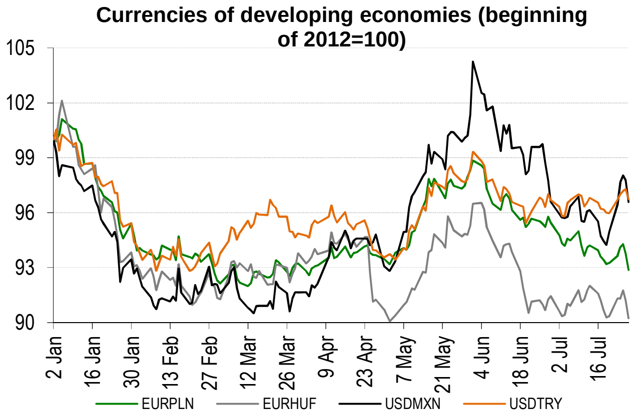
Andrzej Bratkowski, MPC member, 24.07 PAP

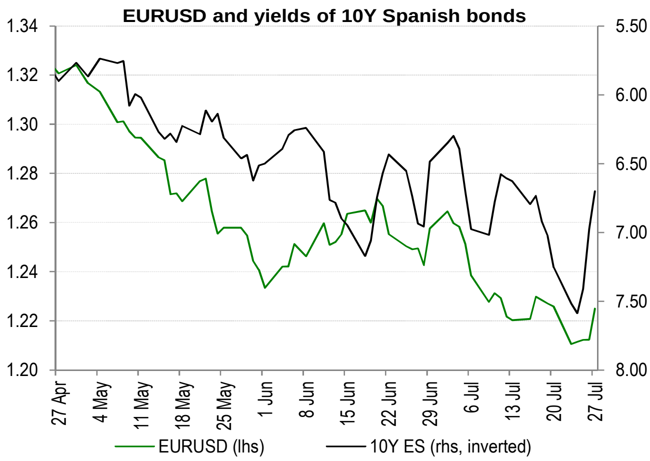
If negative tendencies in economy, which we have observed since March, remain, I will not see any reason why I should not put forward such a motion [for rate cut in Septeber]. If the external factors prove to be permanent, it would be rather a cycle as one cut by 25bp does not change anything. In my opinion we are already late with cuts.

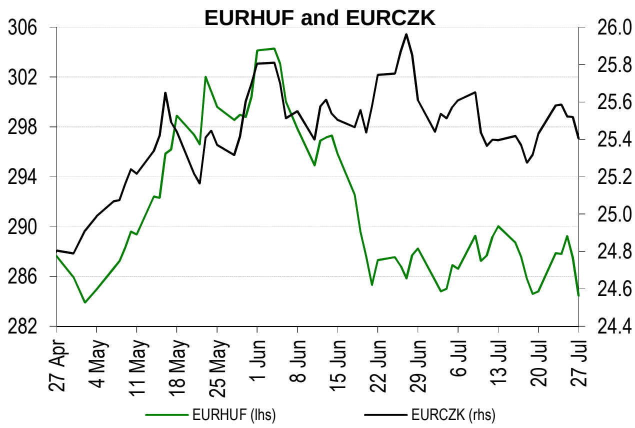
Last week A. Bratkowski and E. Chojna-Duch confirmed their intention to cut interest rates by 25bps during September meeting. A. Bratkowski suggested also that it may be a beginning of cutting cycle. We doubt if there will be a majority to support rate cut in September. In out opinion it would be difficult for other MPC members to change their hawkish rhetoric expressed as early as a few weeks ago (although some of them have already begun to ease their stance), especially when inflation remains above 4%. M. Belka suggested that the assumption of (conventional) monetary policy of the MPC is to keep real interest rates on minimally positive level, so we may guess that he does not see much room for interest rate cuts.

Foreign exchange market – EURPLN close to significant support level









Zloty supported by ECB president

- Only at the beginning of last week EURPLN remained on higher level, close to 4.22. In following days domestic currency clearly gained as a result of significant improvement of moods, which was initiated by statements of Nowotny and Draghi. Downward trend, which has lasted since early June, was continued and consequently the rate fell to ca. 4.12 at the week's end.
- Appreciation of domestic currency against the euro, connected with dynamic EURUSD's increase, caused a significant strengthening of the zloty also against the US dollar. USDPLN decreased temporarily slightly below 3.35 and zloty gained ca. PLN0.15 against the US currency. At the week's end the rate was close to 3.38.
- On daily chart this week's minimum (4.12) is an important support level and a possible EURPLN's attempt to get through this level depends on the market's perceptions of central banks' decisions. Especially conference after ECB meeting may be important this week.
- Since the year's beginning the zloty has gained ca. 7% against the euro and consequently it is the second best-performing currency (after forint) of emerging markets (EURHUF decreased by more than 9%) so the domestic currency will be more prone to profit-taking than others if risk aversion will increase.

Draghi to save the euro zone, euro is gaining

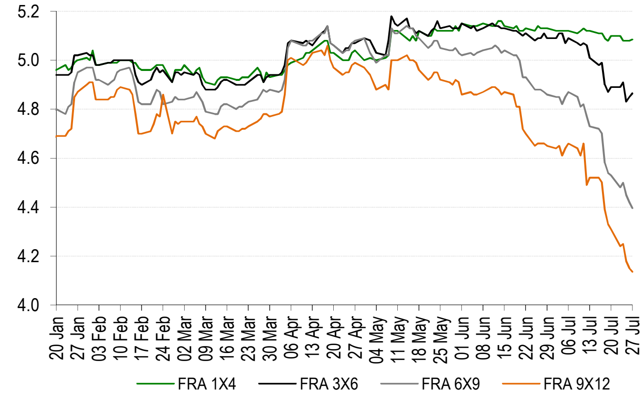
- Since the week's beginning EURUSD has deepened falls from previous days as a result of fears about euro zone peripheries. Consequently it slid slightly below 1.205, the lowest level in last 2 years. Only comments from the ECB were able to support the euro, which more than offset its losses. EURUSD ended the week close to 1.225, earlier it had reached almost 1.235.
- ECB and Fed sittings are key events of the week. Although hopes that Fed will quickly take additional actions supporting the US economy were limited after minutes for the last meeting (where only a few FOMC members opted for taking this step), the resolute declaration of the ECB president caused that the expectations for announcing concrete steps during the upcoming meeting appeared on the market. Fulfilling – or even exceeding – these expectations will be crucial for the euro, which at the previous week's end gave away some of gains that were achieved thanks to Draghi's statement.
- This week EURUSD did not manage to get through support on ca. 1.205 and then to break resistance slightly above 1.23. In horizon of following weeks 1.185 and 1.245 will be significant levels.

Forint the strongest since September 2011

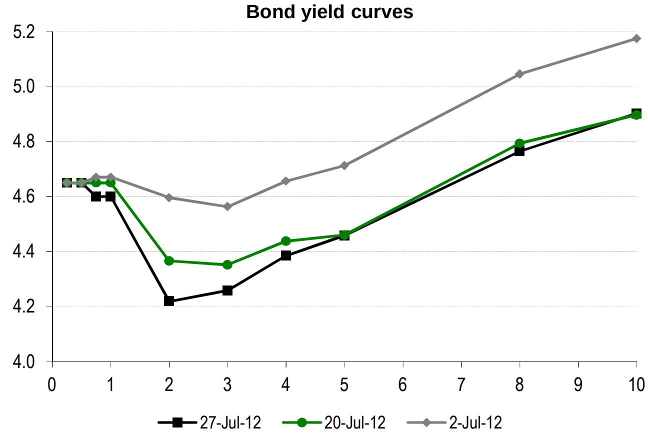
- Dynamic changes occurred also on CZK and HUF markets. EURCZK moved away from local high on 25.6 and at the week's end it was close to 25.38. It is worth stressing that upward trend which has been observed since March stopped in last weeks.
- On the other hand, EURHUF decreased temporarily slightly below 282 and reached the lowest level since September 2011. Hungarian currency gained among others thanks to signals from local government which suggested that it can me more "flexible" during loan negotiations with the IMF.

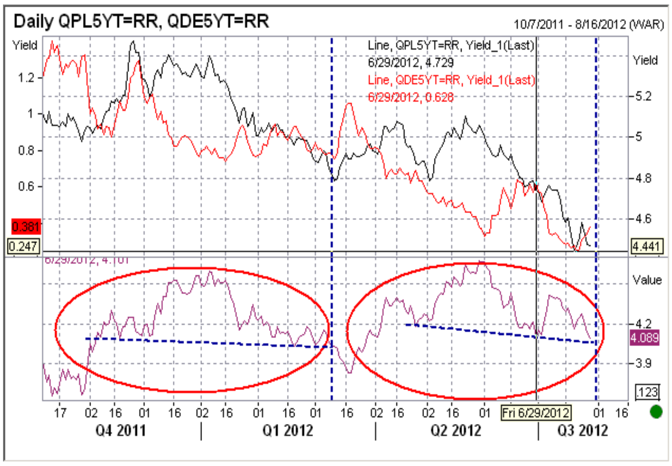
Interest rate market – Strong expectations for rate cuts

FRA

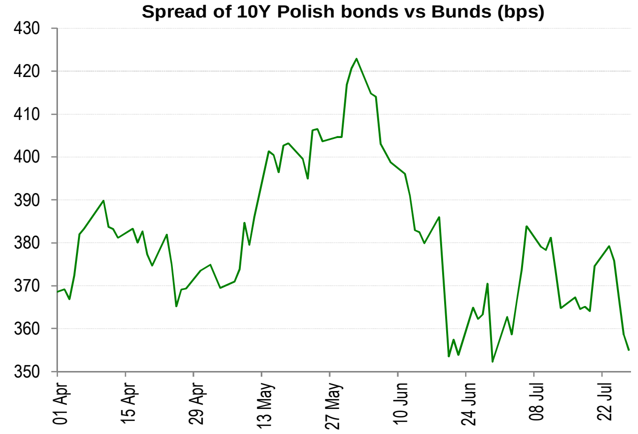


Bond yield curves





Spread of 10Y Polish bonds vs Bunds (bps)



Expectations for quicker cuts…

▪ Once again the MPC members' statements (Chojna-Duch, Bratkowski) gave impulse for further fall of FRA rates. Over the week rates for longer tenors decreased by the most (by more than 10bps). FRA 9x12 at 4.15% indicates that the market prices-in rate cuts by 100bp 9 months' time. It is worth mentioning that the market is awaiting rates' decrease only by 25bps in horizon of 3 following months, which is quite reasonable.

▪ This week investors will pay attention to PMI release. The forecasted by us fall will support the expectations for monetary policy easing and at the same time the downward trend of FRA rates.

…supported short-end of the curve

▪ Last week brought further strengtheningg of bonds, mainly on the short-end and the middle of the curve. MPC members' statement as well as significant improvement of moods on the global markets, which resulted from expected help from central banks (ECB, Fed), supported the market. 2Y bonds' yields decreased towards 4.20%.

▪ This week investors will pay attention to central banks' meetings (ECB, Fed) and macro data releases – as regards domestic data we will see July's PMI. The expected by us drop of the PMI index should support downward trend of yields, mainly on the short-end.

▪ 5Y bond auction (PS0417) will be a significant event. Final offer we will be published on Monday; MinFin planned the offer at the level of PLN 2.0-4.0bn. On the auction we expect high demand – very positive liquidity situation will remain a supportive factor (on 25 July net ca.PLN10bn came into the market, due to OK0712 redemption and interest payments from WZ series).

Interesting situation in 5Y and 10Y sectors

▪ Last significant strengthening in the middle and on the long-end of Polish curve caused a narrowing of spread between domestic 5- and 10Y bonds and their German counterparts. As the graph beside is showing, in sector of 5Y we can observe a similar pattern to the one which formed between the end of 2011 and March 2012. If situation repeats, in near future the domestic 5Y bonds should test last minimum at ca. 4.45%

▪ In case of 10Y the situation is also interesting. Spread 10YPL-10YDE for longer time oscillated between 360 and 380bp and fell below the bottom limit last week. On the other hand, asset swap spread in 10Y sector once again tested level of ca. 40bp, which recently stopped the falls. In our opinion, if situation on the market does not deteriorate significantly, the spread's stabilization slightly above this level can be expected.

▪ To sum up, the upcoming weeks may bring further appreciation in the middle and on the long-end of the curve. Current significant support is located on 4.40% for 5Y and 4.80% for 10Y. Low supply of treasury securities (we estimate that at the July's end realization of sovereign borrowing needs amounted to ca. 85%) as well as favourable liquidity situation (in period August – October in total ca. PLN33bn from redemption of OK1012 and interest payments will come into the market) will be a support for the market. Situation of the euro zone peripheries remains the main risk factor.

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