Bank Zachodni WBK

Weekly economic update

15 – 21 October 2012

At the beginning of the week poor market sentiment prevailed on the market. Downward revision of growth forecasts presented by the World Bank and the IMF fuelled worries over global economy. Additionally, the IMF warned that there is even an "alarmingly high risk" of further deterioration of the economic situation. S&P downgraded Spain to BBB-, one notch above junk level. First reaction of the market was clearly negative, but finally this decision was interpreted as a factor that may encourage Spanish government to ask ECB for help (investors have waited for this for a few weeks). Optimism was also backed by better-than-expected US labour market data. On the domestic market, investors focused on comments of MPC members. Their statements clearly show that a majority to support a rate cut motion at the nearest meeting is gathering and this provided clear support for Polish debt market (5Y yields reached record low level).

Main event of this week is the EU summit (18-19 October) and decisions taken there may have much impact on the market. Some investors perceive this event as a good opportunity for Spain to ask for help. If that does not happen, then market may feel disappointed and global market sentiment may deteriorate. There will be also many US and Polish macro data published. In our view, release of industrial output will have biggest impact on the market. Higher than expected pace of contraction will provide further support for expectations for rate cuts and should have positive impact on Polish bonds. The EURPLN remains in the range of 4.06-4.12. Intensification of expectations for a rate cut in November may trigger a move to 4.12. If this level is broken, then the exchange rate may head towards 4.15-4.16.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (15 October)					
3:30	CN	CPI	Sep	%YoY	1.9	-	2.0
14:00	**PL**	**CPI**	**Sep**	**%YoY**	**4.0**	**4.0**	**3.8**
14:00	**PL**	**Exports**	**Aug**	**€m**	**12 012**	**11 709**	**12 325**
14:00	**PL**	**Imports**	**Aug**	**€m**	**12 484**	**12 007**	**12 639**
14:00	**PL**	**Current account**	**Aug**	**€m**	**-1101**	**-900**	**-1027**
14:30	US	Retail sales ex autos	Sep	%MoM	0.6	-	0.8
		TUESDAY (16 October)					
11:00	EZ	HICP inflation	Sep	%YoY	2.7	-	2.7
11:00	DE	ZEW index	Oct	pts	-15.0	-	-18.2
14:00	**PL**	**Wages in corporate sector**	**Sep**	**%YoY**	**2.7**	**2.7**	**2.7**
14:00	**PL**	**Employment in corporate sector**	**Sep**	**%YoY**	**0.0**	**0.0**	**0.0**
14:30	US	Core CPI	Sep	%MoM	0.2	-	0.1
15:15	US	Industrial output	Sep	%MoM	0.2	-	-1.2
		WEDNESDAY (17 October)					
14:00	**PL**	**Industrial output**	**Sep**	**%YoY**	**-4.1**	**-7.1**	**0.5**
14:00	**PL**	**Construction and assembly output**	**Sep**	**%YoY**	**-12.5**	**-18.0**	**-5.0**
14:00	**PL**	**PPI**	**Se**	**%YoY**	**1.7**	**1.7**	**3.1**
14:30	US	House starts	Sep	k	768	-	750
14:30	US	Building permits	Sep	k	810	-	801
		THURSDAY (18 October)					
4:00	CN	GDP	Q2	%YoY	7.4	-	7.6
14:00	**PL**	**MPC minutes**					
14:30	US	Initial jobless claims	week	k	365	-	339
16:00	US	Philly Fed index	Oct	pts	1.0	-	-1.9
16:00	US	Leading indicators	Sep	%MoM	0.1	-	-0.1
		FRIDAY (19 October)					
16:00	US	Home sales	Sep	m	4.75	-	4.82

Source: BZ WBK, Reuters, Parkiet

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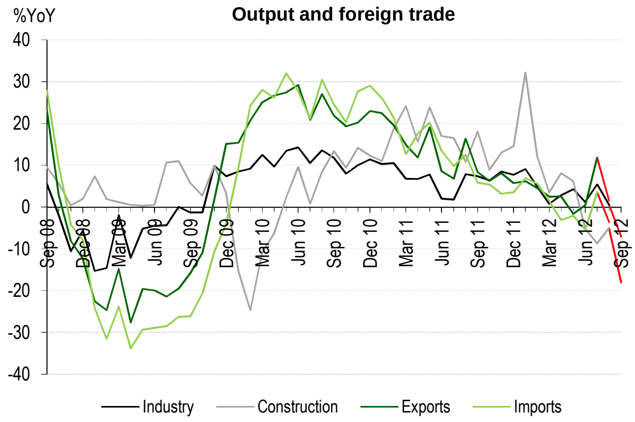
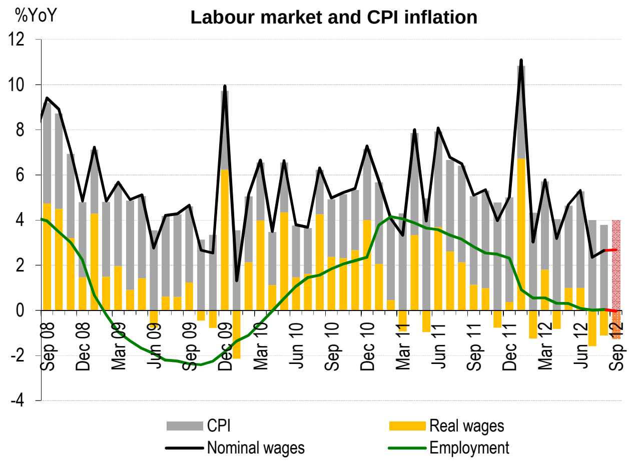
What's hot this week – A row of weak data from the domestic economy

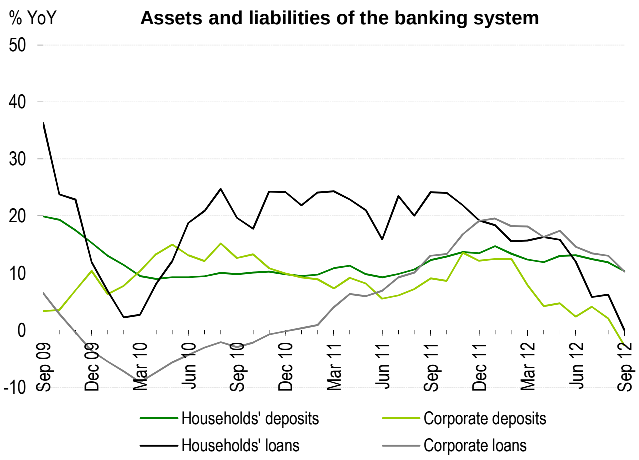


- We will see a row of important domestic macro data this week. In our view they will be weak and should encourage the MPC to cut rates in November.
- We are expecting that figures on industrial and construction output will be really unfavourable, as, apart from general tendency of decelerating economic activity, they will be affected by lower number of working days (difference amounts to two days!). It is worth noting that our forecasts of output are considerably lower than market consensus.
- We are anticipating a return of downward trend in foreign trade (July showed a rebound, only one-off in our view). Our prediction is supported by weak results of Polish industry in August, CSO data on foreign trade and results of PMI survey, showing declining export orders.



- In our view CPI inflation again climbed to 4% in September, but in subsequent months a more persistent downward trend should be established, bringing CPI to ca. 3% in December and to the inflation target at the end of 1Q 2013. PPI inflation is easing since the beginning of the year and will slide below 2% in September. It is difficult to speak about inflationary pressure under such circumstances.
- Labour market data will not probably be surprising and will show a continuation of tendencies present for more than a year. We are expecting that employment declined again, but annual pace of growth remained at zero level. Wage growth remained moderate, but negative in real terms. Weak labour market situation is clearly not supportive for occurrence of second-round effects.

Last week in the economy – Further slowdown in loans and deposits



- The M3 money supply growth slowed in September to 7.6%YoY from 9.8%YoY in August, i.e. slightly stronger than we and the market expected (7.9% and 8.5%, respectively).
- Slowdown is still visible in loans. Growth of companies' loans decelerated to 10.2%YoY from 13.0%, while of households' loans to 1.3%YoY from 3.5%, which is the weakest result since comparable data are available (1997). We are expecting a further deceleration of credit action, as it is being undermined by further tightening of banks' lending criteria and uncertainty about economic outlook, encouraging postponing investments.
- It is also worth to pay attention to deceleration of deposits' growth. Companies' deposits contracted by 2.7%YoY after +2.0% in August (this is also the weakest result ever). Growth rate of households' deposits dropped to 10.8%YoY from 11.9%.

Quote of the week – Projection will enable monetary policy easing

Adam Glapiński, MPC member, 08.10, Reuters

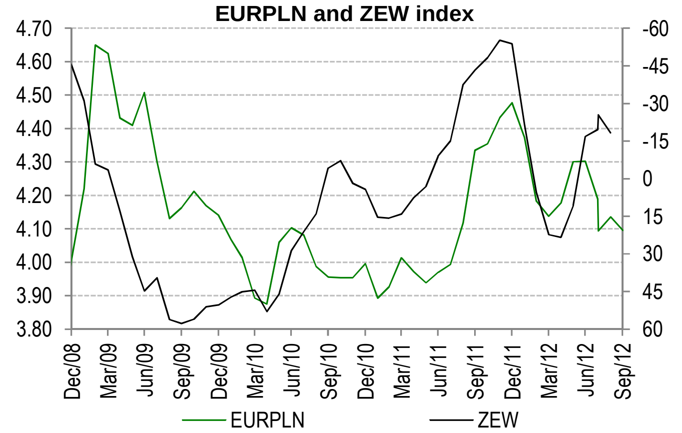
I do not exclude my support for a cut, should the projection show a marked slowdown of GDP growth in 2013 and no threats against reaching inflation target emerge. (…) I think that if we cut, then at least another cut is highly probable. Because 25bps is nothing (…) At least 75bps can be felt by the economy.

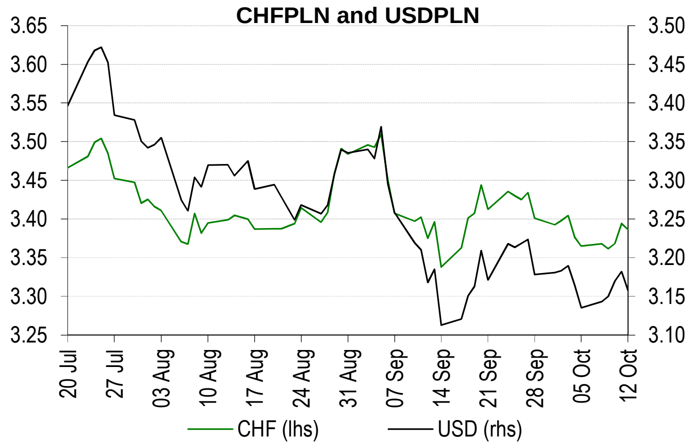
Jerzy Hausner, MPC member, 10.10, PAP

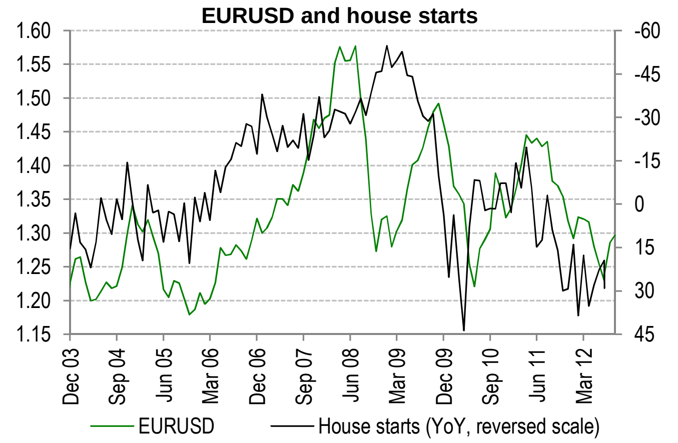
As regards inflation, I am expecting that in one month's time we will have a projection, which will confirm that we are approaching the target. I mean a projection which will enable the Council to take the decision suggested before – to ease monetary policy.

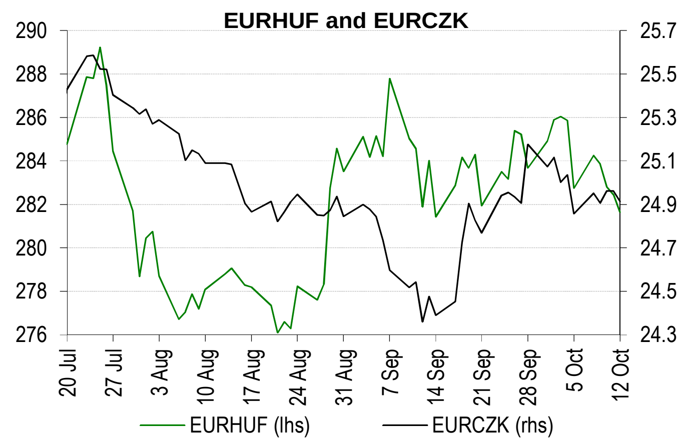
Last week was rich in MPC members' comments and almost all of them confirmed that a cut would mean a beginning of cutting cycle. E. Chojna-Duch specified that rates should be reduced by 100bps in total, while A. Bratkowski stated it should be as high as 125bps. A. Glapiński thinks that rates should be lowered by 75bps at least. Some MPC members (Glapiński, Hausner, Zielińska-Głębocka) stressed in their comments the importance of inflation projections for the decision at the upcoming meeting. If the projection confirms that inflation is returning to target and growth is slowing, then they will vote for a hike. It is visible that a majority to support such a decision in November is gathering. Jan Winiecki is still not convinced and he thinks that only a slowdown to 0.5-1.0% would deliver an argument for a cut.

Foreign exchange market – The EU summit may prove crucial for the markets









Correction on the zloty only short-lived

▪ Global investors' mood deteriorated at the beginning of the week due to increasing fears about global outlook. It came from information that the World Bank and IMF revised downward their forecasts for GDP. Increasing pressure on the global market caused the zloty depreciation in relation to the main currencies. Strong upward move on the EURPLN was fuelled by statements of the MPC members, which intensified expectations for the November's monetary easing. Reaction to the PM's view that exchange rate at 4.50 against the euro is a "safe level" for the Polish economy was rather short-lived (as it turned out later the PM was actually speaking about a channel between 4.00 and 4.50). Consequently, the EURPLN tested 4.10.

▪ The USDPLN, due to decline of the EURUSD, increased towards 3.20 (crucial resistance level). However, the USDPLN's upward march was undermined by the upward move of EURUSD. As a consequence the USDPLN fell below 3.15.

▪ Currently, the EURPLN is still below the important resistance level of 4.12. However, uncertainty on the global market together with domestic macroeconomic data (we expect that September's readings will be worse than in August), which should strengthen expectations for November's cut, will put negative pressure on the zloty. We think that a break of resistance at 4.12 will open the door for the EURPLN to increase further towards 4.15-4.16. However, strong demand for Polish assets from foreign investors might limit zloty depreciation. The channel between 4.06 and 4.12 for the EURPLN is still valid.

Is the EURUSD in horizontal trend?

▪ Fears about global economic outlook after revision of GDP forecasts by the World Bank and IMF as well as S&P's decision to downgrade credit rating for Spain strongly influenced the EURUSD. Consequently the exchange rate fell to 1.2825, only slightly above crucial support level at 1.28. Decline of the EURUSD was only short-lived, the rate quickly returned above 1.29.

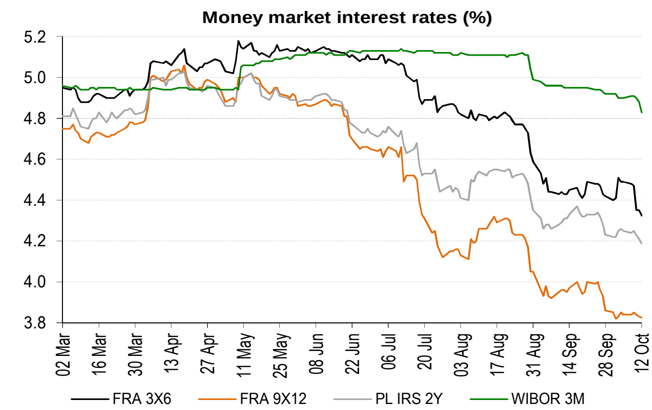
▪ Last week's meetings of the Eurogroup and Ecofin were relatively neutral for the financial markets. However, this week investors will focus on the EU summit (18-19 October). This event is particularly interesting, as it is widely expected that Spain will use this opportunity to apply for help. Hopes for such a scenario made the EURUSD test the upper border of consolidation channel at 1.296 during the Friday's session. If positive moods maintain, the rate may climb towards 1.307 (local peak from early October). Otherwise, the consolidation in 1.280-1.296 range will continue.

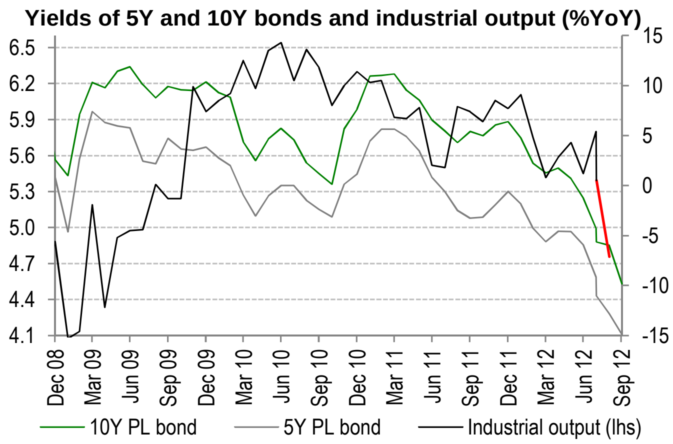
Expectations for further rate cuts in CEE region

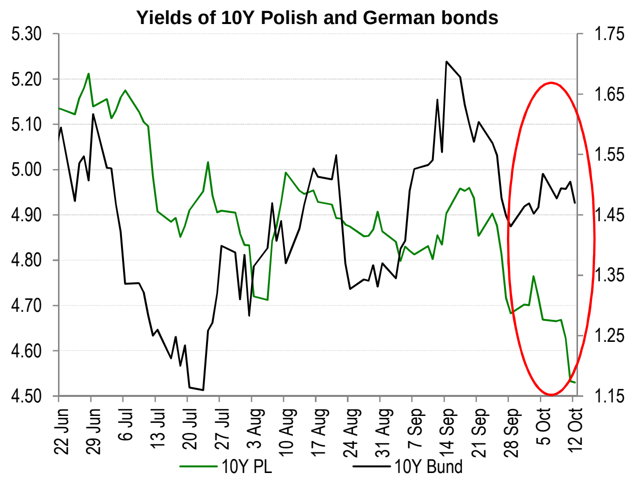
▪ Last week has brought a strengthening of Hungarian currency. EURHUF exchange rate declined to 282.45 from 284.25 at the beginning of the week. Expectations for further MNB rate cuts (despite higher-than-expected CPI reading for September) are limiting the potential for further strengthening of the forint in the upcoming days.

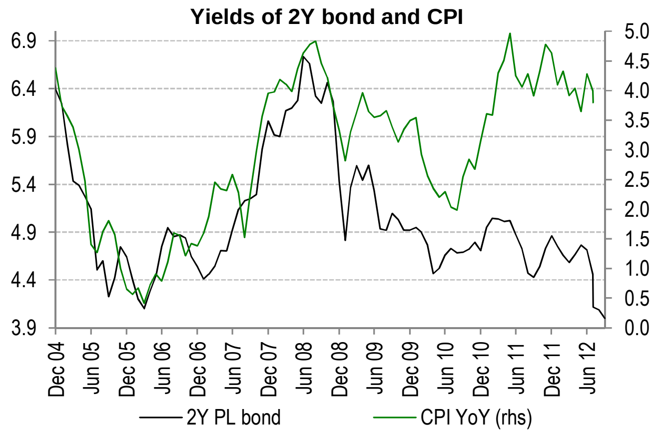
▪ The Czech koruna was more stable than its CEE peers. The EURCZK exchange rate climbed above 24.96 after falling to ca. 24.91. This was due to an announcement of Czech central bank's currency intervention in order to weaken the koruna.

Interest rate market – Macro data will support Polish debt









Comments of MPC members drag curve down

- Domestic yield curve moved down during the past week. That was due to dovish comments of those MPC members who until recent days have been rather not convinced that easing of monetary policy is justified.
- FRA declined by 1-19bps, but it is more interesting that money market rates declined quite visibly. WIBOR rates dropped by from 4bps for 1M to 10bps for 9 and 12 M. It seems that strengthened expectations for NBP rate cuts had clear impact on the cost of money on the interbank market. Currently the market prices-in that interest rates will be lower by slightly more than 50bps in 3 months' time and by marginally more than 100bps in 9 months' time.
- Bond curve clearly flattened (2-10 spread plunged to 54bps from 67bps last week and 5-10 spread declined to 43bps from 52bps). That was due to very visible strengthening of Polish medium- and long-term debt, and this move was fuelled by increasing bets for prompt rate cuts. Consequently, yields of 5Y bonds reached record low last week. In case of 10Y debt, yields declined by 14bps, to 4.53%, lowest since 3Q of 2005. As the yields were falling, the trade volume was rising.
- IRS rates again reacted at smaller scale than the bond market. Thus, the asset swap spread for 10Y declined from 30bps to 24bps, a 5Y spread is close to lowest level since March 2010 (ca. -5bps). 10Y spread versus Bunds is lowest since July 2011.

Data on industrial output supportive for bonds

- This week a set of Polish macro data will be released. In our opinion, publication of September's industrial and construction output will make biggest impression on investors. As presented on the chart, Polish bonds were supported in the last couple of quarters – next to outlook of limited debt supply – also by economic slowdown. We expect that the release of industrial output well below market consensus will provide further support for expectations for soon rate cuts.
- In recent days the relationship of domestic long term debt with 10Y Bunds declined (see next chart). Consequently, even if positive market sentiment emerges on the market, weakening of German bonds does not have to result in higher yields of Polish debt.
- Data on inflation are likely to be neutral for the market. Since many months investors focus rather on data on level of economic activity rather than on inflation. In our opinion in November the MPC will deliver a rate cut so much expected by the market and signal that this is just a beginning of the easing cycle. As market reaction on fundamental information is often exaggerated (in this case on possible scale of rate cuts) we maintain our forecast of 2Y yields falling towards 3.90% in coming weeks.