WEEKLY ECONOMIC UPDATE

26 May – 1 June 2014

During the final week before the Ukraine elections (with so much unpredictability about the vote itself and its results), global market sentiment was quite positive. The European and US stock indexes have increased, emerging markets assets have also gained, including the zloty, the forint and the ruble. It seems that the optimism was supported mainly by still strong expectations for more monetary policy easing in the euro zone. Those hopes have been fuelled further by weak flash May's manufacturing PMI for Germany, France and the whole euro zone. On the other hand, US and Chinese releases proved quite strong. Also the Polish debt market firmed due to comments of the NBP governor. Marek Belka said that the risk of deflation cannot be ruled out and this – together with hopes for more ECB action – fuelled expectations that also the Polish MPC may adjust the interest rates (rather unlikely, in our view). Consequently, earlier increases of IRS and bonds yields have been (in some cases even more than) neutralized.

The atmosphere related to the Ukrainian elections (and results of voting) is likely to have a visible impact on the market sentiment at the beginning of the week. Any further fights between separatists and the Ukrainian army may fuel worries over political destabilization in this country. The market is also somewhat worried whether radical parties post good results in European Parliament elections in the euro zone's peripheries and this may also weigh on the market mood. Notice, however, that this will be the last week before the June's ECB meeting, so expectations for more monetary policy easing may limit the impact of the political issues. Domestic data will confirm in our opinion that recovery of the private consumption had a significant positive impact on the pace of the GDP growth in Q1 and that this tendency may be sustained later in the year.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (26 May)					
10:00	**PL**	**Retail sales**	**Apr**	**%YoY**	**8.4**	**9.1**	**3.1**
10:00	**PL**	**Unemployment rate**	**Apr**	**%YoY**	**13.0**	**13.0**	**13.5**
		TUESDAY (27 May)					
14:00	HU	Central bank decision		%	2.50	-	2.50
14:30	US	Durable goods orders	Apr	%MoM	-0.2	-	2.5
16:00	US	Consumer confidence index	May	pts	83.0	-	82.3
		WEDNESDAY (28 May)					
		No important data releases					
		THURSDAY (29 May)					
14:30	US	Preliminary GDP	Q1	%QoQ	-0.6	-	2.6
14:30	US	Initial jobless claims	week	k	320	-	326
16:00	US	Pending home sales	Apr	%MoM	0.0	-	3.4
		FRIDAY (30 May)					
10:00	**PL**	**GDP**	**Q1**	**%YoY**	**3.3**	**3.3**	**2.7**
10:00	**PL**	**Private consumption**	**Q1**	**%YoY**	**2.5**	**2.4**	**2.1**
10:00	**PL**	**Fixed investments**	**Q1**	**%YoY**	**3.5**	**1.5**	**1.3**
14:00	**PL**	**Inflation expectations**	**May**	**%YoY**	**-**	**-**	**0.5**
14:30	US	Personal income	Apr	%MoM	0.3	-	0.5
14:30	US	Consumer spending	Apr	%MoM	0.2	-	0.9
15:55	US	Michigan index	May	pts	82.5	-	84.1

Source: BZ WBK, Reuters, Bloomberg, Parkiet

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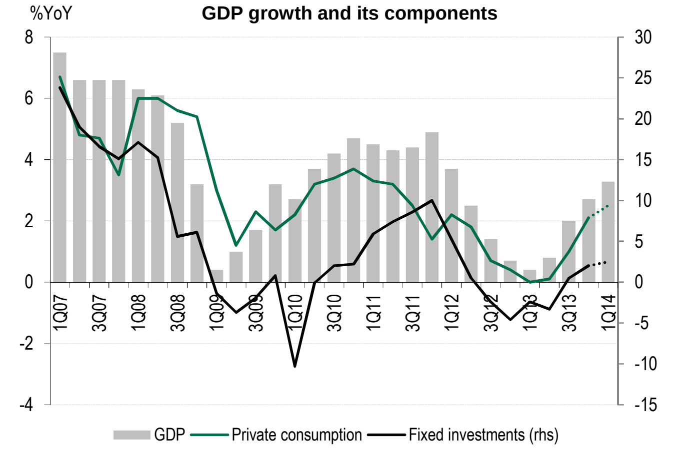
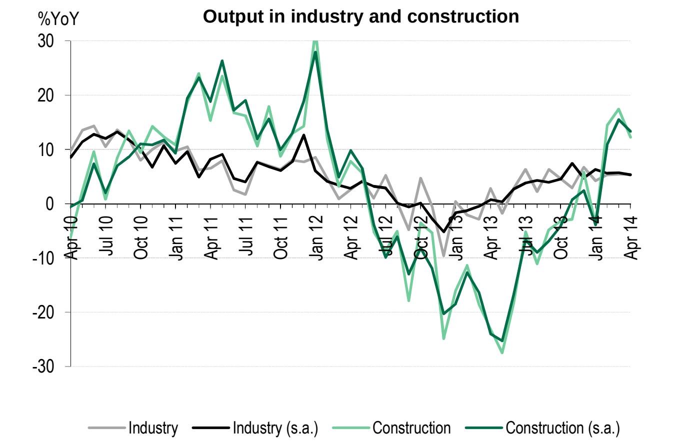
What's hot this week – GDP growth breakdown, retail sales and unemployment rate

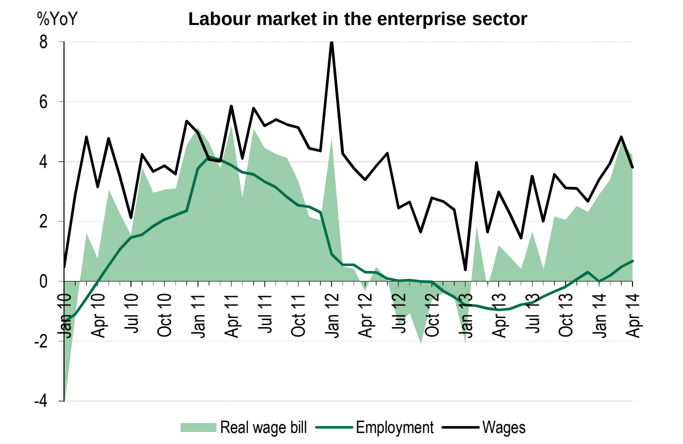


- This week we will see the first reading of domestic GDP for Q1. We do not expect it to diverge from the flash reading (3.3%YoY), but this time the Central Statistical Office will reveal the growth breakdown. In our view, this will show a further increase of contribution of domestic demand – both of consumption and of investment.
- April's growth rate of retail sales will be probably strong, mainly due to base effect connected to timing of Easter. Still, in our view numbers adjusted for this effect will also show an acceleration.
- We are expecting a further strong decline of registered unemployment rate in April to 13.0%. Our forecast is in line with estimates of the Labour Ministry.
- Improvement on the labour market and acceleration of retail sales will support the recovery of consumption in Q2.

Last week in the economy – Further improvement on the labour market, industry still does well



- In April industrial output increased by 5.4%YoY. Manufacturing added over 7%YoY, which is a good signal for the future. Contrary to our expectations, April saw more decline of electricity, gas, steam and air conditioning supply (-5.6%YoY after -7.3%YoY in March).
- Pace of growth of construction and assembly output reached 12.2%YoY, clearly below expectations. However, detailed data have shown that entities dealing mainly with specialised construction activities and those specializing in civil engineering performed quite well, growing 16.8%YoY and 14.5%YoY, respectively. This suggests that public investments may be starting to revive.
- PPI inflation amounted to -0.7%YoY in April. Upward pressure on prices in industry is still weak.



- Pace of growth of average employment in the corporate sector accelerated in April to 0.7%YoY from 0.5%YoY in March. 37k of workplaces have been added on an annual basis, this is the best result since the beginning of 2012. On monthly basis, employment declined by 1k, but still this was the best April since 2011.
- Wages in the corporate sector increased by 3.8%YoY in April. Wages continue to perform strongly at the beginning of Q2 – April's growth is only slightly below the Q1 average at 4.1%YoY.
- Taking into account April's employment and wage data in enterprise sector, wage bill grew by 4.5%YoY in nominal terms and by 4.2%YoY in real terms. This could support further recovery of consumer demand in Q2.

Quote of the week – Deflation cannot be ruled out

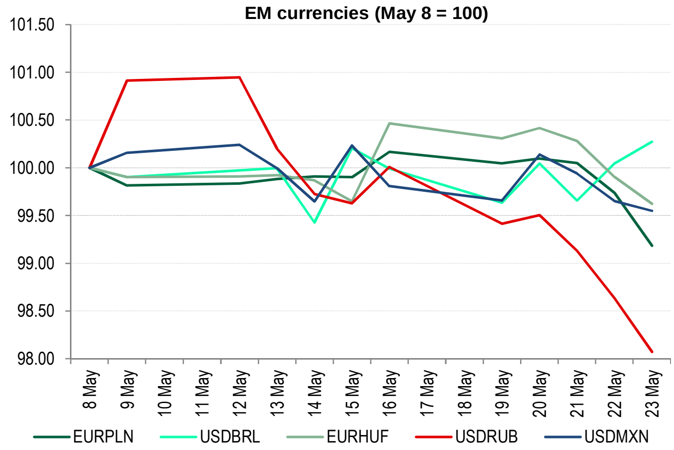
Marek Belka, NBP governor, 21.05, Reuters
I cannot rule out deflation.

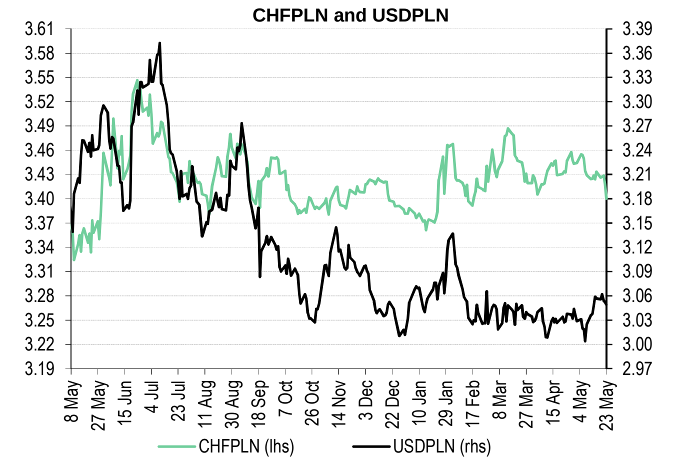
Adam Glapiński, MPC member, 22.05, Reuters
Interest rate may remain unchanged until end of 2015 and it is probable they will remain stable in 1H2015 (…) It is almost sure that we will extend forward guidance in July. Deflation is on the horizon. I do not expect it to show up, but we are close.

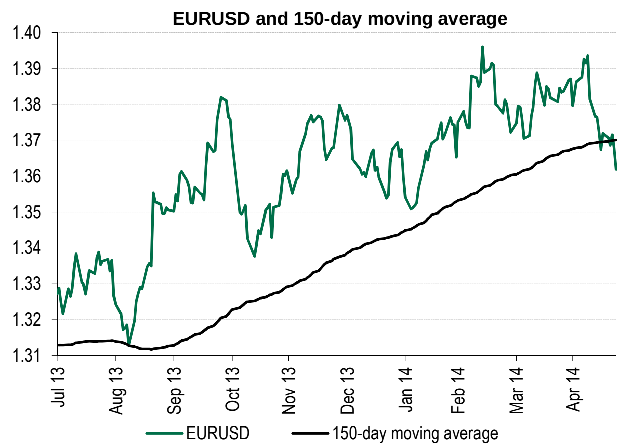
Andrzej Bratkowski, MPC member, 23.05, Reuters
I think that if economic recovery continues, then even a slight deflation is not a problem. In a scenario, which seems most feasible for me, i.e. hikes in Q1, I would support dropping forward guidance in July. I think that information we will see in July, will not suggest a need of hike in Q4, so we may be able to extend forward guidance until end of 2015. However, this extension will not add any value, unless it is longer than one quarter.

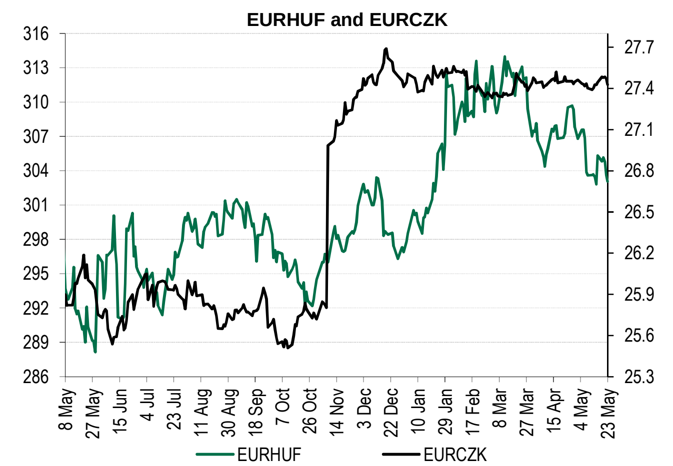
In the eyes of investors, the comment of Marek Belka about possibility of deflation increased the risk that the MPC can keep rates unchanged for a longer time or even cut them. Risk of deflation was also suggested by other MPC members (Glapiński, Bratkowski) and even we find it possible (yet this is not our baseline scenario). Assuming a weak price growth in May and June, we can actually see deflation in July – this will be a base effect caused by rise in waste maintenance costs and change in registration of potato prices, introduced one year ago (so-called peelings inflation). We think that the NBP governor meant this one month (or even two), but not that deflation will become a long-lasting phenomenon. We do not expect rate cuts, and we are in line with A. Bratkowski here. Let us remind that president Belka said that given such an economic recovery, it would be a sin to cut rates pro-cyclically.

Foreign exchange market – Results of elections and hopes for ECB action crucial









EURPLN below the lower band of trading range

▪ During the last week before the Ukrainian presidential elections the zloty has recorded the biggest weekly appreciation versus the euro since February. Three days before the weekend have been particularly impressive when EURPLN recorded a fast decline by PLN0.04. The appreciation of the domestic currency vs. the euro has not been distorted even by falling EURUSD as the positive global market sentiment and hopes for more ECB easing proved crucial.

▪ Although the weekly zloty's appreciation vs. the euro (nearly 1%) may be surprising given the outlook for the Ukrainian elections, it is worth to notice that the domestic currency still remains well behind other emerging market currencies. Since the May's declaration of the ECB head that more easing may come in June, the zloty has gained less than 1% while LatAm or EMEA currencies appreciated 1.5%-4.5%. Even the Russian ruble gained nearly 4%. The zloty and other CEE3 currencies have performed poor also vs. the dollar (higher losses than other EM currencies).

▪ Strong zloty's appreciation seen in the last week (the 4th biggest appreciation vs. the euro and dollar among EM currencies) might have thus been simply catching up the missed gains. Due to the downward move, EURPLN has broken the lower band of the narrowing trading range and reached c4.15, its lowest since late February.

▪ The atmosphere related to the Ukraine elections is likely to have a visible impact on the market sentiment at the beginning of the week. Any further fights between separatists and the Ukrainian army may fuel worries over political destabilization in this country. The market is also somewhat worried whether radical parties post good results in the European Parliament elections in the euro zone's peripheries and this may also weigh on the market mood. Notice, however, that this will be the last week before the June's ECB meeting, so expectations for more monetary policy easing may limit the strength of the political issues. Technical analysis indicates that if EURPLN stays below 4.15-4.16 for longer, then it may head towards 4.12. In the alternative scenario, the exchange rate may continue to hover within the 4.16-4.22 range.

Euro depreciates vs. the dollar for a third week in a row

▪ EURUSD stayed below the 150-day moving average broken last Thursday and recorded a third consecutive week of decline. Poor data from, for example, German (flash manufacturing PMI and Ifo index) and decent US data pushed EURUSD below the last week's minimum and the exchange rate reached nearly 1.36, the lowest level since mid-February.

▪ There is a room for lower EURUSD, particularly if market sentiment remains weak due to political issues and hopes for more easing in the euro zone are strong. Next support after 1.36 is at 1.35.

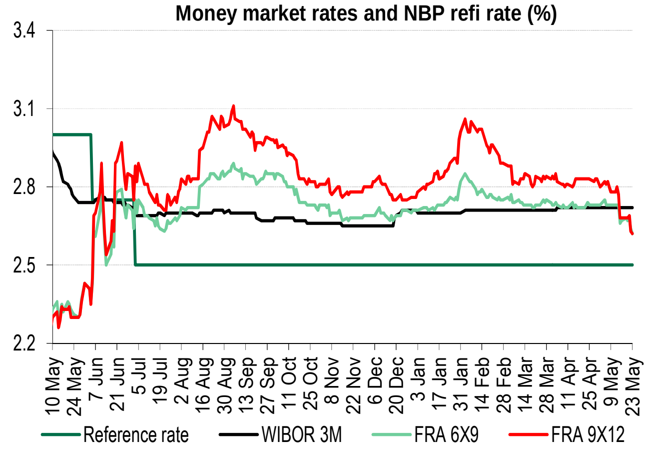
Head of MNB suggests a rate cut

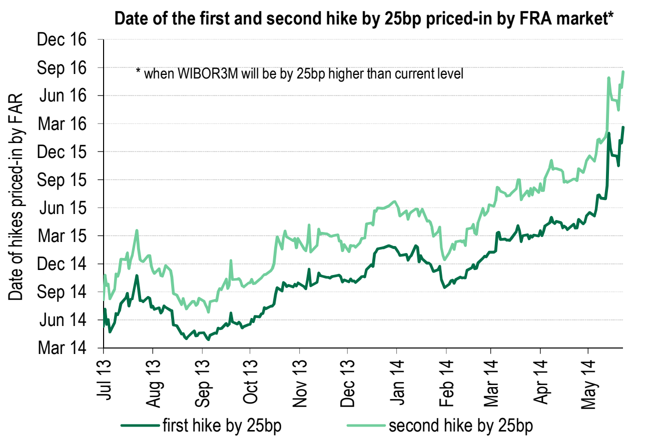
▪ The forint, similarly like the zloty, has been catching up the missed gains and appreciated slightly vs. the euro (EURHUF declined from 306 to 303). One week before the Magyar National Bank meeting, its head said that there is still room for a slight rate cut. In its recent statements, the MNB has been claiming the rate is close to the level appropriate for providing support for the economy and keeping prices stable. The market expects a 10bp rate cut and such a decision should not surprise given the recent comment of the MNB head.

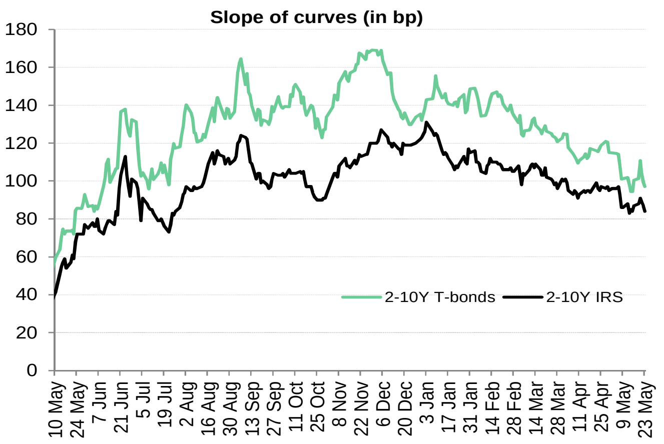
▪ The Russian ruble gained vs. the dollar for the 4th week in a row and is the strongest since late January vs. the US currency.

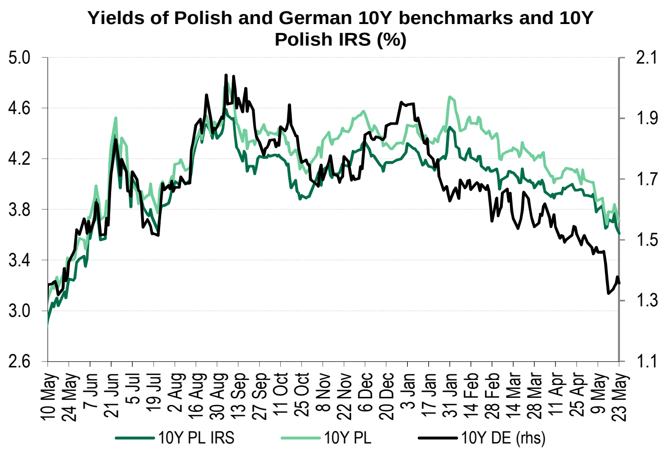
▪ Both forint and ruble will be under the impact of the Ukrainian elections results and market assessment of a chances for stabilization.

Interest rate market – Consolidation after a significant strengthening









FRA strongly affected by NBPs' governor comment

- Last week did not bring any significant changes in quotations of WIBOR 1M-12M. Rates remained stable despite significant decline of FRA and IRS after the NBP governor comment. Belka suggested possibility of deflation in Poland. Consequently, this strengthened expectations for a rate cut, which appeared after the weaker-thanexpected April CPI reading.
- Investors on FRA market quickly adjusted their valuation to new market conditions. One should notice that FRA12x15 declined below WIBOR3M, for the first time since June 2013, when the monetary easing cycle took place. Moreover, market (despite Bratkowski's statement) is still pricing-in the first hike in 21 months horizon (i.e. the beginning of 2016).
- This week we will see the last set of domestic data for April (retail sales, registered unemployment rate), which should not change market perspectives. We expect both WIBOR and FRA rates to stabilise ahead of central bank's meetings (next week domestic MPC, ECB).

Rate cut expectations strengthened domestic debt

- Previous week brought unexpected changes on the domestic interest rate market. At the beginning of the week T-bonds and IRS rates increased quite considerably, following weakening on both peripheral and core markets. However, in the second half of the week mood changed significantly after Belka's comment (strengthening of expectations that the Council might cut rates) and Bunds strengthening. As a consequence yields of T-bonds and IRS rates fell sharply, fully offsetting the earlier upward move.
- In weekly terms long ends of curves performer better than the front ends and thus bullish flattener dominated on both markets. As a result 2-10Y spread narrowed to slightly below 100bp for T-bonds and to 87bp for IRS. Moreover, spread vs. German bonds for all sectors also narrowed, to 235bp for 10Y, the lowest level since end-October 2013.
- State-owned BGK bank successfully launched road bonds. It sold IDS1024 for PLN1.27bn amid demand at PLN2.7bn and yield at 4.094% (25bp above the interpolated government curve). This was the last such an auction this year, but BGK did not exclude issuing bonds in the foreign markets in 2H14 or in early 2015.

Consolidation ahead of ECB outcome

- This week is the last one before central bank's meetings, i.e. Poland's MPC (3 June) and ECB (5 June). In our opinion the last set of April's data (retail sales, unemployment rate) or release of 1Q GDP breakdown will not change the general picture of Poland's economy and thereby monetary policy perspectives.
- Last sessions clearly show that situation in Ukraine becomes less important for investors. Notwithstanding, it remains a risk factor, therefore presidential election in this country may influence market mood in the short run. What is more, the same story is valid as regards parliamentary election in the European Union. Good results of populist and radical parties may deteriorate the market sentiment.
- All in all, expectations that ECB will act (conventionally or non-conventionally) next week may overshadow and offset the possible negative impact of election outcomes. We expect that this week both yields of T-bonds and IRS rates will stabilise near current levels as market is pricing-in further easing in monetary conditions by the ECB. Moreover, low supply of domestic Treasury Securities in June will be also supportive for bond market.

Additional information is available on request. Please contact Bank Zachodni WBK S.A. Rates Area, Economic Analysis Department, ul. Marszałkowska 142, 00-061 Warsaw, Poland, phone +48 22 534 18 88, email ekonomia@bzwbk.pl, http://www.bzwbk.pl.