

WEEKLY ECONOMIC UPDATE

2 – 8 June 2014

Market sentiment has remained quite positive during the past week. High expectations for more monetary policy easing by the ECB supported risky assets, including the zloty and Polish bonds (yields reached their lowest levels in a year). Polish 1Q14 GDP data surprised to the upside. Pace of growth reached 3.4%YoY (slightly more than initially estimated by the CSO) showing rising contribution of the domestic demand (particularly investments). Higher tensions in Ukraine had a negative impact on the ruble but did not hit other CEE currencies.

Plenty of crucial macro data are due to be released this week, but the ECB meeting seems to be of a particular importance. Expectations for more central bank actions are very high so the extent of monetary policy easing will be key for the market. The rate cuts seems to be a deal-done, so nonstandard measures taken to fight the risk of deflation seem to be crucial. The ECB decision may set a direction for the market for the coming weeks. The MPC meeting is likely to be boring, just like the previous one, as the Council waits for fresh macro projections.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
MONDAY (2 June)							
9:00	PL	PMI-manufacturing	May	pts	52.2	51.6	52.0
9:55	DE	PMI-manufacturing	May	pts	52.9	-	54.1
10:00	EZ	PMI-manufacturing	May	pts	52.5	-	53.4
16:00	US	ISM-manufacturing	May	pts	55.5	-	54.9
TUESDAY (3 June)							
	PL	MPC decision		%	2.50	2.50	2.50
3:45	CN	PMI-manufacturing	May	pts	49.6	-	48.1
11:00	EZ	Flash HICP	May	%YoY	0.7	-	0.7
16:00	US	Industrial orders	Apr	%MoM	0.5	-	0.9
WEDNESDAY (4 June)							
9:00	CZ	GDP	Q1	%YoY	2.0	-	1.2
9:00	HU	GDP	Q1	%YoY	3.5	-	2.7
9:55	DE	PMI-services	May	pts	56.4	-	54.7
10:00	EZ	PMI-services	May	pts	53.5	-	53.1
14:15	US	ADP report	May	k	218	-	220
16:00	US	ISM-services	May	pts	55.5	-	55.2
20:00	US	Fed Beige Book					
THURSDAY (5 June)							
11:00	PL	Bond auction					
13:45	EZ	ECB decision		%	0.1	-	0.25
14:30	US	Initial jobless claims	week	k	315	-	300
FRIDAY (6 June)							
8:00	DE	Exports	Apr	%MoM	0.5	-	-0.5
8:00	DE	Industrial output	Apr	%MoM	-	-	-1.8
9:00	CZ	Industrial output	Apr	%YoY	-	-	8.7
14:30	US	Non-farm payrolls	May	k	218	-	288
14:30	US	Unemployment rate	May	k	6.4	-	6.3

Source: BZ WBK, Reuters, Bloomberg, Parkiet

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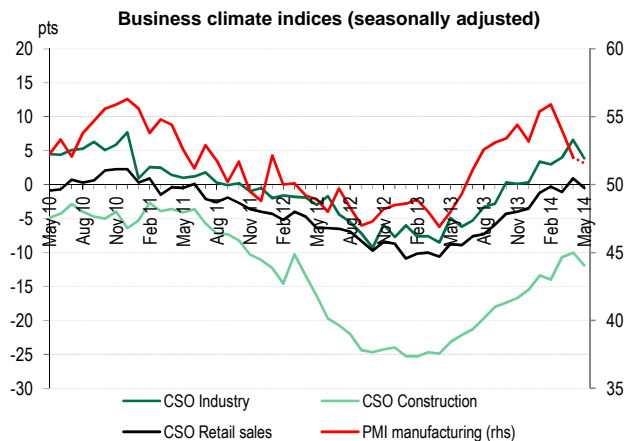
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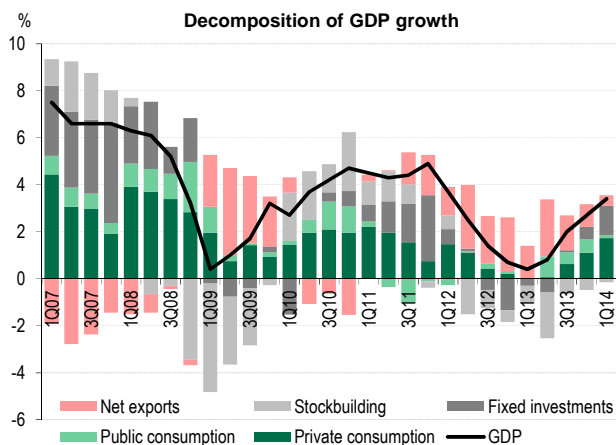
What's hot this week – PMI index and MPC meeting



■ We expect a slight decline of Polish PMI manufacturing index in May, following similar indicators for the euro area and Germany and other gauges of business climate in Poland (CSO survey showed a drop of indices in all major sectors). The index should stay well above 50 though, confirming that the activity in domestic industry continues growing.

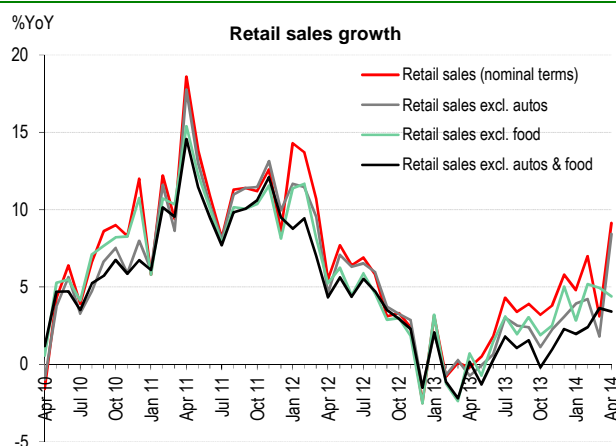
■ We agree with vast majority (if not all) of analysts and investors that the Monetary Policy Council will make no important decisions at the nearest meeting. We also expect no major adjustments in the official statement. We still think the Council will wait until July's meeting, when it will receive new central bank's projections of inflation and GDP, and then it will extend the forward guidance until the end of this year.

Last week in the economy – Investments sharply up, retail sales affected by Easter



■ GDP growth accelerated in Q1 to 3.4%YoY, above forecast. The biggest surprise was provided by fixed investment, which jumped by 10.7%YoY (the fastest growth rate since mid-2008), which however may have been partially due to weather conditions, much better than a year before. Consumption growth also accelerated (2.6%YoY), and as a result the growth of domestic demand accelerated to 3.0%YoY, highest level in three years. Export growth also posted a solid growth (7.6%YoY), however the contribution of net exports to GDP growth decreased to 0.5pp due to acceleration of imports.

■ In our view, these are conditions that suggest neither deflationary threat in Poland nor necessity to cut interest rates. We maintain our forecast of GDP growth at 3.5%YoY in 2014 (it is still one of the market's highest), but we see a rising chances for even better result, provided there is no softening of economic recovery in the euro zone.



■ Retail sales increased in April by 8.4%YoY. Significant acceleration vs. March (3.1%YoY) was mainly due to the different timing of Easter and this boosted sales of food and in non-specialized stores (April saw two-digit growth in those two categories after a notable plunge recorded in March). According to our estimate, retail sales excluding autos and food increased by 3.4%YoY, which is the second best result in the last 20 months.

■ Registered unemployment rate declined in April to 13% and was lower by 1pp than in the previous year (it was the deepest fall in annual terms in five years). In monthly terms the number of unemployed dropped by 103.2k, i.e. by the most since 2007. These data clearly show that situation on labour market improves more quickly in 2Q, which is positively influencing consumption demand. We expect further unemployment drop in next months.

Quote of the week – Stabilising interest rates is the best policy

Jerzy Hausner, MPC member, 26.05, PAP

The best policy is the policy of stabilising [interest rates], which is doing well for the economy.

Elżbieta Chojna-Duch, MPC member, 27.05, Reuters

In my opinion rate cuts would be needed in Poland if the strength of recovery would weaken and inflation would stay low. We will probably see no deflation in the months to come, despite expected negative base effect due to last year's hike in waste maintenance costs. This [interest rate cut in the euro zone] would be an argument in favour of monetary policy easing in the upcoming months

Anna Zielińska-Głębocka, MPC member, 27.05, Reuters

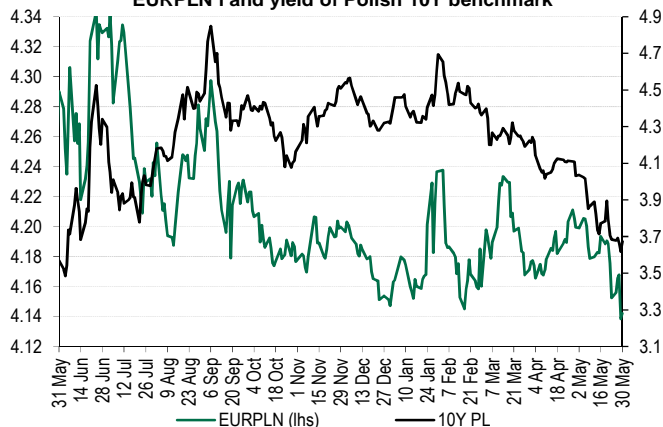
Economy is very strong, everything is suggesting a fast growth. Recent inflation readings are only a minor flaw and have nothing to do with economic fundamentals.

Next week's ECB meeting may have a clear impact on market expectations regarding next MPC moves, not only through a possible rise of interest rate disparity, but also due to possible reaction of FX market. Further significant zloty appreciation would increase the pressure on the MPC. However, a short-term correction cannot be ruled out in the currency market if the ECB action does not meet buoyant market expectations.

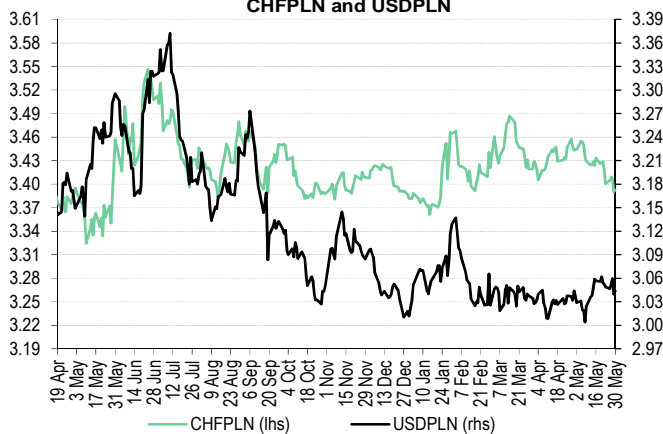
MPC meeting in July will be crucial. In our view, if the MPC decides to extend forward guidance until the end of the year (and we expect it to happen), it would be a declaration that it is not leaning towards easing policy in the next months (even if July's CPI will be near zero or slightly below), which should calm down market speculation about possible rate cuts in Poland.

Foreign exchange market – Waiting for the ECB and the US labour market data

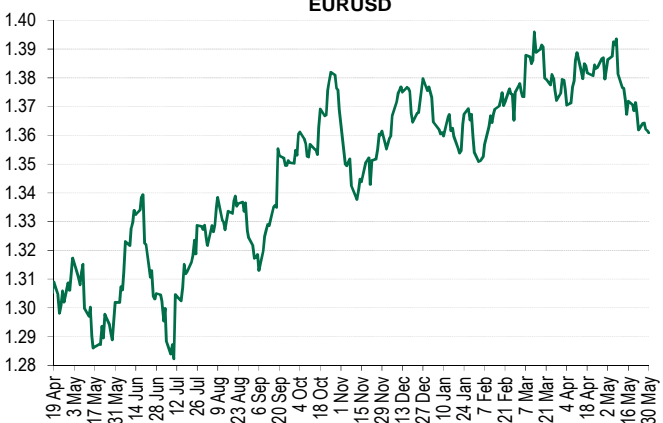
EURPLN i and yield of Polish 10Y benchmark



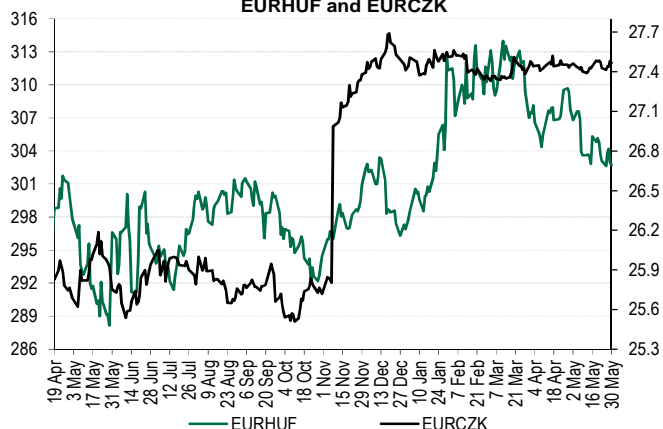
CHFPLN and USDPLN



EURUSD



EURHUF and EURCZK



Zloty supported by hopes for ECB action

▪ The zloty gained quite significantly vs. main currencies during the past week due to hopes for more monetary policy easing by the ECB as well as thanks to an inflow of foreign cash into the Polish debt market (yields of the 10Y benchmark reached the lowest level in a year – see chart beside). Consequently, EURUSD broke through the lower band of the narrowing trading range and temporarily reached 4.134 (the lowest level since December 2013). Later, the exchange rate stabilized close to 4.14 as investors are awaiting the decisions of the central banks (ECB, BOE and Polish MPC). The zloty remained resilient to news from Ukraine on continuation of fights.

▪ On weekly basis, the zloty has gained most vs. the British pound (0.9%). Versus the euro, dollar and the Swiss franc the domestic currency gained 0.2-0.3%. On monthly basis, the zloty gained 1.5% vs. the franc, 1.4% vs. the euro and 0.5% vs. the pound. USDPLN remained stable around 3.04.

▪ This week plenty of vital macro data are due to be released and major central banks are announcing their decisions. It seems that data publications will be overshadowed by the ECB decision. Expectations for more easing in the euro zone are very strong and thus the extent of actions taken will be crucial. The lesser easing, the bigger risk of correction in the global market and weakening of the zloty after recent significant strengthening. Correction could push EURPLN even to 4.20. However, in our view this would be only a temporary depreciation because fundamental and technical factors indicate an appreciation in the medium term.

EURUSD relatively stable around 1.36

▪ The single currency continued to depreciate vs. the dollar during the past week, but the pace of weakening was lower than a week earlier. EURUSD dropped below 1.36 temporarily and reached the weekly low slightly below 1.359. Despite significant downward revision of the US 1Q GDP growth, the exchange rate stayed close to 1.36.

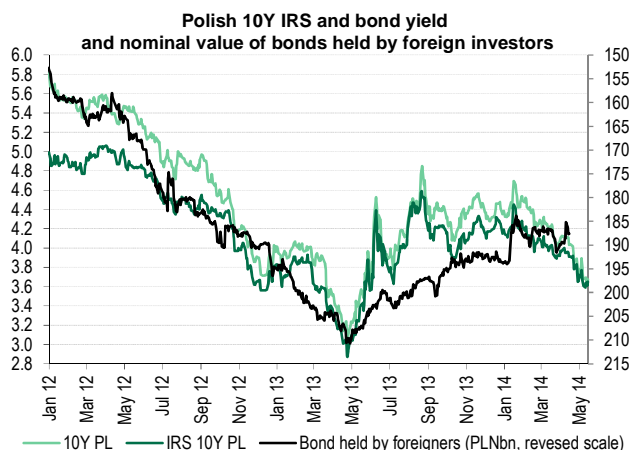
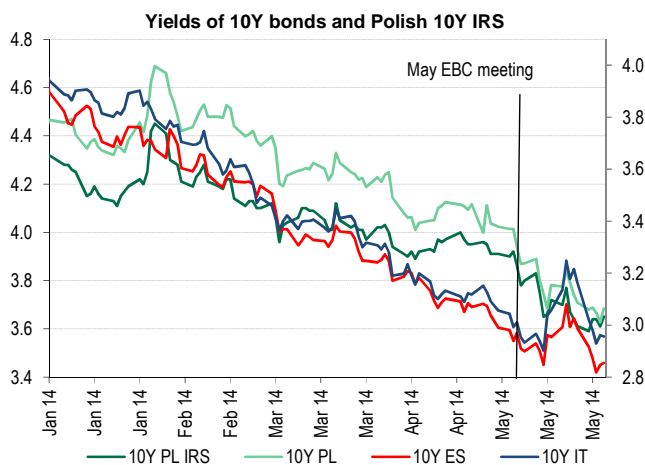
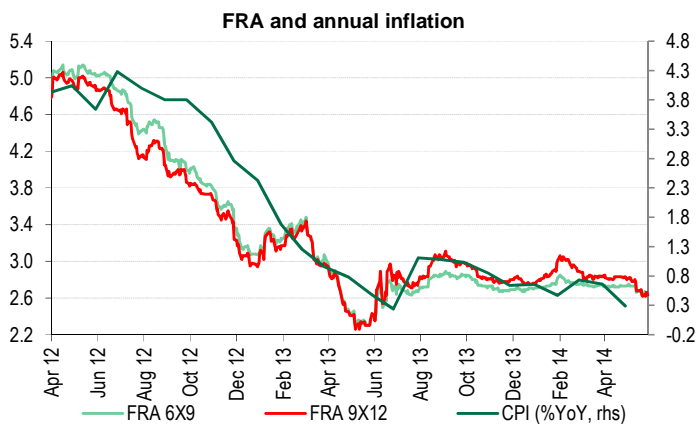
▪ Many important macro data are due to be released in coming days (among other, the US nonfarm payrolls) and decisions of the central banks are awaited. The scale of the ECB monetary policy easing will be probably key for the market. Rate cut seems to be a deal-done so information about nonstandard measures aimed at fighting the risk of deflation seem to be more important. US labour data should show a further improvement. Crucial support area for EURUSD is at 1.348-1.35.

Stronger forint, stable koruna and weaker ruble

▪ The Hungarian forint, just like the zloty, gained due to hopes for the ECB actions and high demand of non-residents for the government debt. During the week EURHUF reached 304 temporarily but soon continued the downward momentum. The exchange rate was close to 302.7 at the end of the week.

▪ The Czech koruna remained stable, EURCZK hovered in a narrow 27.41-27.48 range. At the same time, the ruble was influenced by the situation in Ukraine. Continuation of fights between Ukrainian army and pro-Russian separatists triggered a weakening of the ruble – USDRUB increased slightly above 34.8.

Interest rate market – ECB more important than the MPC



Changes of EURPLN also vital for FRA

- 1-12M WIBOR rates have remained unchanged during the past week while longer FRA have been quite volatile. Beginning of the week saw a further decline of these rates, meaning that a deeper decline in 3M WIBOR was priced-in. Some correction was recorded at the end of the week following the upward move of IRS and bond yields.

- Key event of this week is the ECB decision. Next to the reaction of global and domestic interest rate market, FRA rates may be also influenced by changes in the Polish FX market. Recent macro data show that the noninflationary recovery is continued and if the zloty gains significantly after the ECB decision, then the outlook for higher CPI may deteriorate and support market expectations for rate cuts in Poland.

Higher volatility before the ECB meeting

- First half of the week in the Polish interest rate market, just like in the core market and euro zone's peripheries, saw a decline in domestic bond yields and IRS to fresh 2014 lows. Investors have ignored the fact that euro-sceptics gained high support in the European Parliament elections and continued to price-in that the ECB will ease monetary policy further in June. During the week IRS and bond yields have been falling by as much as nearly 10bp, but some correction came on Friday (triggered by the weakening of 10Y Bunds). Consequently, bonds gained only marginally on a weekly basis and IRS ended the week close to level seen on previous Friday.

Direction depends on the ECB

- In May the ECB governor suggested quite clearly that in June the central bank may take further action towards monetary policy easing. After this surprising comment, the market has started to price-in a cut of the deposit rate below 0%. The following weeks were rich in suggestions from other ECB officials saying the central bank may use both standard and nonstandard measures. Since May ECB meeting, Polish IRS plunged by 15-20bp and bond yields by 15-25bp in 2-10Y tenor. At the same time, Italian and Spanish 10Y debt is now close to levels seen in the first decade of May as in mid-month there was a sudden correction triggered by GDP and PMI data. Among the European countries, Hungarian bonds recorded a bigger gain (10Y yields plunged by c40bp). So if the ECB decision triggers profit-taking in the euro zone, then Polish yields – and IRS – may be very prone to a visible surge. On the other hand, cutting deposit rate below 0% would in our view limit the upside potential for the Polish IRS and bond yields in the medium term. Meeting of the domestic MPC is likely to be a non-event and should be neutral for the market.

- On the day of the ECB decision, the Ministry of Finance will offer long term bonds – new 10Y benchmark DS0725 and WS0428/WZ0124 worth PLN3-5bn in total. This offer may attract high demand as the auction will be held only a few hours before the ECB decision and there are high expectations for more monetary policy easing in the euro zone.

- Data released by the Ministry of Finance showed that in April foreigners bought Polish debt worth PLN740mn in nominal terms. There was an outflow of foreign capital in 1Q14 of PLN6.3bn and the 2Q starts with the lowest inflow since July 2013. Non-residents bought short- and long-term bonds. They purchased OK0718 for cPLN700mn, and strongly increased their WZ0119 holdings (from less than 1% of the bond outstanding to nearly 12%, i.e. to PLN1.3bn from PLN58mn). Polish investors focused on the middle of the curve, holdings increased by cPLN840mn. Size of banks' bond buying has disappointed – only PLN1.2bn vs. PLN19.6bn purchased in 1Q14.

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