Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

9 – 15 June 2014

Last week was driven by central bank's decision. The ECB meeting was the key event, as expected, as euro zone's central bankers decided to cut the deposit rate below zero. Apart from that, the ECB took a series of actions, which not only met high investors' expectations, but even went slightly beyond. This triggered a wave of optimism on markets, with a considerable strengthening of the zloty and of Polish bonds. Decline of domestic bond yields was also supported by results of the Monetary Policy Council meeting – contrary to Marek Belka's suggestion from the last month, the meeting did not prove unexciting, as the central bank eased the tone of its statement and did not rule out rate cuts in future. This strongly supported market expectations for monetary policy easing (an interest rate cut is priced-in in Q4). It seems that the MPC is worried about possible slowdown of economic growth and persistence of ultra-low inflation and will be scrutinising the upcoming data, looking for hints about direction we are heading for. We are expecting the GDP and domestic demand growth in Q2 to remain at least as high as in Q1, which should confirm our scenario that interest rate cuts are not very likely.

Calendar of macro releases for this week is rather light. As for Poland, at the end of the week we will see two important figures – May's inflation and balance of payments for April. We are forecasting a slight rise in CPI, but consensus is a bit higher, which can strengthen expectations for cuts. On the other hand, balance of payments will be in our view better than market consensus, which can support Polish currency. Potential for a further strengthening of the zloty seems limited in the short run by, among others, a risk of NBP FX intervention. On Tuesday the government will be working on assumptions for 2015 budget.

Economic calendar

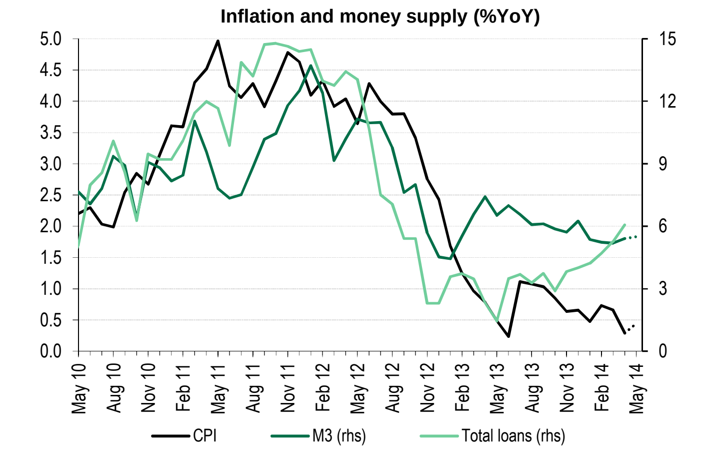
CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (9 June)					
9:00	CZ	CPI inflation	May	%YoY	0.4	-	0.1
10:30	EZ	Sentix index	Jun	pts	13.2	-	12.8
		TUESDAY (10 June)					
16:00	US	Wholesale inventories	Apr	%MoM	0.5	-	1.1
		WEDNESDAY (11 June)					
9:00	HU	CPI inflation	May	%YoY	0.0	-	-0.1
		THURSDAY (12 June)					
11:00	EZ	Industrial output	Apr	%MoM	0.4	-	-0.3
14:00	US	Initial jobless claims	week	k	310	-	312
14:30	US	Retail sales ex autos	May	%MoM	0.4	-	0.0
		FRIDAY (13 June)					
8:00	DE	CPI inflation	May	%YoY	0.9		0.9
15:55	US	Flash Michigan	Jun	pts	83.0	-	81.9
14:00	**PL**	**CPI inflation**	**May**	**%YoY**	**0.5**	**0.4**	**0.3**
14:00	**PL**	**Current account balance**	**Apr**	**€m**	**426**	**537**	**517**
14:00	**PL**	**Money supply M3**	**May**	**%YoY**	**5.5**	**5.5**	**5.4**

Source: BZ WBK, Reuters, Bloomberg, Parkiet

ECONOMIC ANALYSIS DEPARTMENT:
ul. Marszałkowska 142. 00-061 Warszawa fax +48 22 586 83 40
email: ekonomia@bzwbk.pl Web site: http://www.bzwbk.pl
Maciej Reluga (Chief Economist) +48 22 534 18 88
Piotr Bielski +48 22 534 18 87
Agnieszka Decewicz +48 22 534 18 86
Marcin Luziński +48 22 534 18 85
Marcin Sulewski +48 22 534 18 84

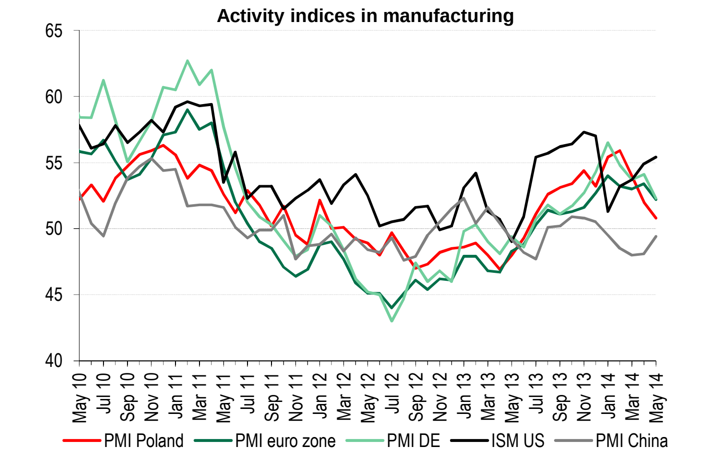
TREASURY SERVICES:
Poznań +48 61 856 5814/30
Warszawa +48 22 586 8320/38
Wrocław +48 71 369 9400

What's hot this week – Inflation and balance of payments on Friday

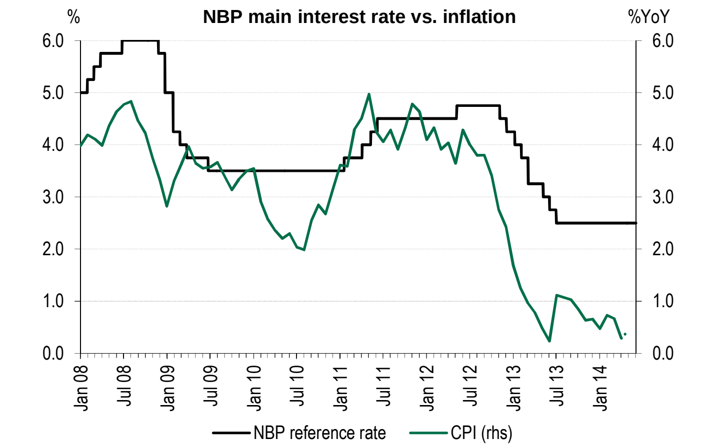


- We are expecting the May's CPI inflation to rebound slightly, to 0.4%YoY, among others due to low base effect in prices of fuels and cable television. However, the market consensus is a bit above our forecast and surprise in such an important data can trigger a further strengthening of expectations for interest rate cuts.
- However, the low CPI reading may be offset on balance of payments data, due for release at the very same moment. We are expecting this figure to be better than expected by the market (higher exports and current account surplus in April). However, its impact may be more visible on the FX than on the FI market.
- Data on money supply are usually ignored by the market, but if they confirm the continuation of recovery in loans, this will back the scenario of further acceleration in domestic demand, not supportive for cuts.

Last week in the economy – Weaker activity in industry, MPC more dovish



- May's PMI for Poland reached 50.8pts, i.e. considerably below expectations. Decline was posted by all main sub-indices: for employment, output and new orders. We have suggested for a couple of months already that PMI was too high as compared with pace of economic recovery. However, now the indicator approached the 50pts mark, a border between expansion and contraction, and this is worrying. Current level of the gauge is still more or less in line with expansion of industrial output by ca. 5%YoY, but a continuation of downward trend can suggest that the recovery is waning. In our view next few months will be crucial, as they will show if we are dealing with a downward trend in activity or only with a temporary deterioration of moods, due to worries about conflict between Russia and Ukraine (which was suggested by respondents). We view the latter effect as temporary, as data show that decline of orders from Russia and Ukraine is more than offset by rising demand from the euro zone.



- Poland's Monetary Policy Council kept official interest rates unchanged, but it changed the rhetoric of the statement towards more dovish. The Council upheld its declaration of stable rates till the end of the third quarter of 2014, but the NBP's governor did not rule out rate cuts in the medium term. It seems that the MPC is worried about further development of situation and about necessity to cut rates, but is still not sure that such a scenario can materialize. In our opinion, to see monetary policy easing we would need a series of disappointing data on economic activity, lower than predicted inflation rate and significant zloty appreciation in months ahead. Therefore we agree with the MPC that the scenario of rate cuts is neither baseline nor possible one. In our view, Q2 will be at least as good as Q1 in terms of GDP growth, while inflation will start going up after summer vacation. Strengthening of the zloty is also moderate, so far.

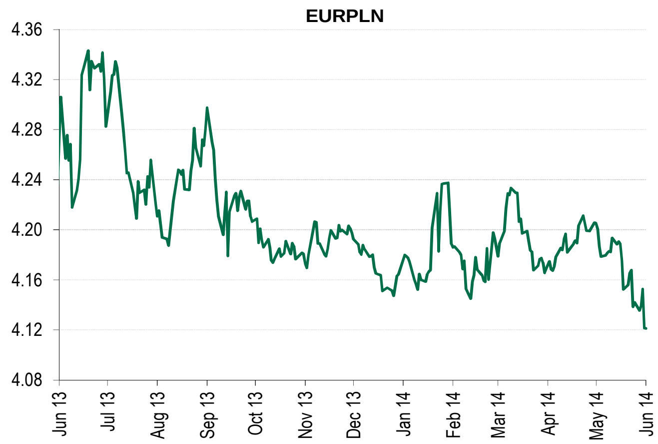
Quote of the week – We are not planning cuts

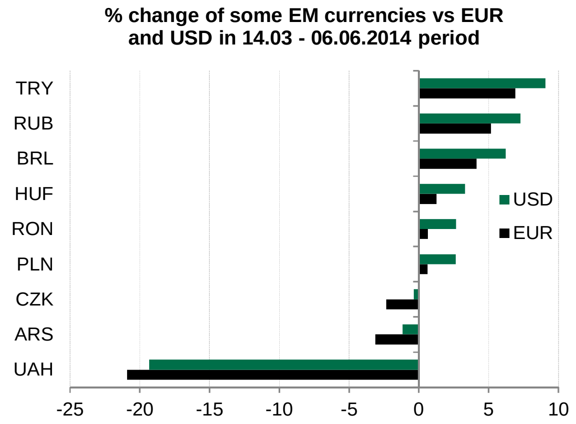
Marek Belka, NBP governor, 03.05, MPC conference
We are not planning cuts, this is not a probable scenario, but honestly we cannot rule out a rate cut. I would like to stress that the statement shows clearly this is neither a probable nor a baseline scenario. Please do not treat it as a suggestion of monetary policy easing.

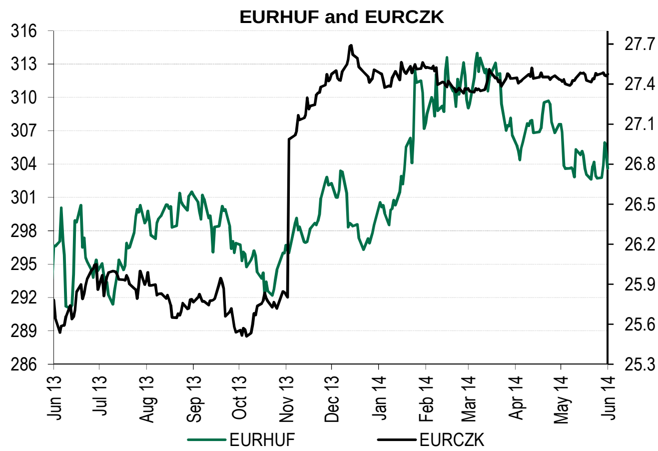
Jerzy Osiatyński, MPC member, 03.05, MPC conference
Growth breakdown came as a surprise, at least for some of us. We cannot say precisely what is the underlying trend, if it is strong enough to let us base our forecast on it. If it is, then we are in another reality than we thought we were and this is the context that should be taken into account while interpreting the statement.

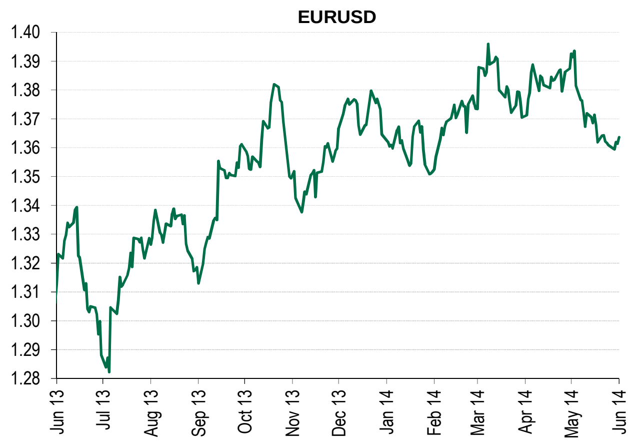
The MPC clearly eased its tone in June, but – as Marek Belka stressed during the press conference – change in the statement is not a suggestion of cuts. Let us note that even Jerzy Osiatyński, one of the most dovish members, admitted GDP growth breakdown in Q1 was much better than expected and if it turns out this is not a one-off distortion, then we are dealing with a completely different scenario than assumed before. We understand that if upcoming months confirm the quick rise of domestic demand, circumstances will become considerably less supportive for monetary policy easing. Macro data for the upcoming months will in our view be crucial for the MPC's stance. We are expecting the domestic demand to say at least as high as in Q1, which should confirm our scenario that cuts are not necessary.

Foreign exchange market – After strengthening due to the ECB, the zloty and CEE currencies await CPI









Actions announced by the ECB supported the zloty …

- Last week the Polish zloty was under influence of central banks' outcomes. Weaker than expected PMI reading for May and more than expected dovish rhetoric of the MPC brought impulse to EURPLN increase towards 4.16. But the exchange rate rise was only short-lived as strong expectations on broad package of conventional and nonconventional measures strengthened emerging markets currencies, including zloty. EURPLN fell below 4.12 before ECB's press conference, while after announcement of a number of unconventional policy measures by Mr Draghi the exchange rate reached nearly 4.10 (the lowest level since April 2013). However, after the end of press conference we observed some correction, and as a consequence EURPLN increased towards 4.13. slightly weaker than expected non-farm payrolls in the US caused that EURPLN again tested 4.105.
- Zloty is the strongest in a year. However, let us note that since re-escalation of conflict in Ukraine (mid-March, EURPLN at 4.23), the domestic currency gained both in relation to the euro and to the US dollar less considerably than other EM currencies (see chart beside).
- Technical situation on EURPLN changed slightly after recent decisions of central banks (MPC, ECB), In our view, the rate is consolidating in 4.10-4.16 range, where is should remain in the upcoming weeks. The lower-than-expected CPI for May can support expectations for cut by the MPC, giving an impulse to correct recent gain, which however should offset by good numbers on balance of payments.

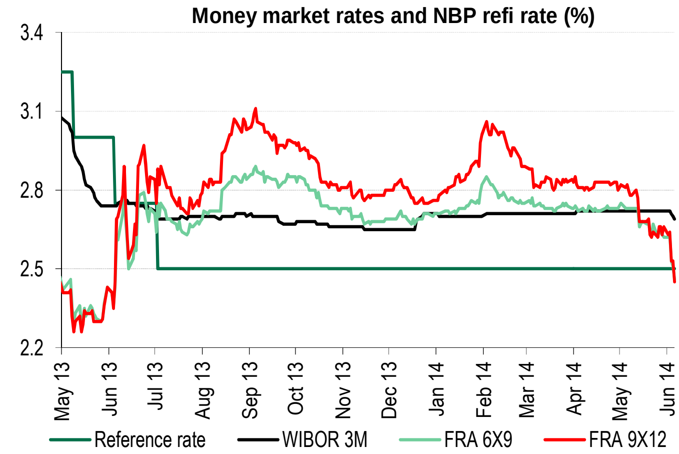
… and CEE currencies

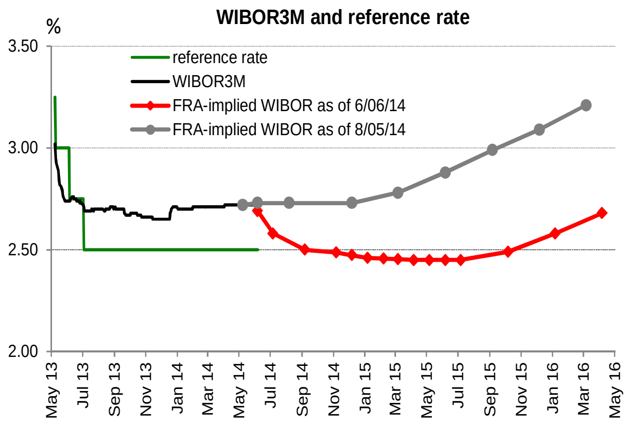
- Expectations for the ECB decision provided an impulse for strengthening also of other CEE currencies. However, let us remind that the decision of Hungarian supreme court about mortgage loans fuelled a rise of EURHUF almost to 306 at the start of the week. However, this increase was not persistent. The ECB decision (implementation of a wide spectrum of tools aimed at curbing risk of deflation and supporting the economic growth) dragged the forint down to 302.1 per euro. At the end of the week the forint was quoted at 302.8 per euro. The Czech koruna also gained. Apart from the ECB actions, the currency strengthened after slightly better-than-expected GDP for Q1 (data were revised upwards to 2.5% from 2.0% estimated earlier).
- Inflation data will be important for the forint and the koruna this week. A further decline of inflation in Hungary can support expectations for another rate cut in this country (currently the base rate is at 2.40%, below reference rate in Poland).

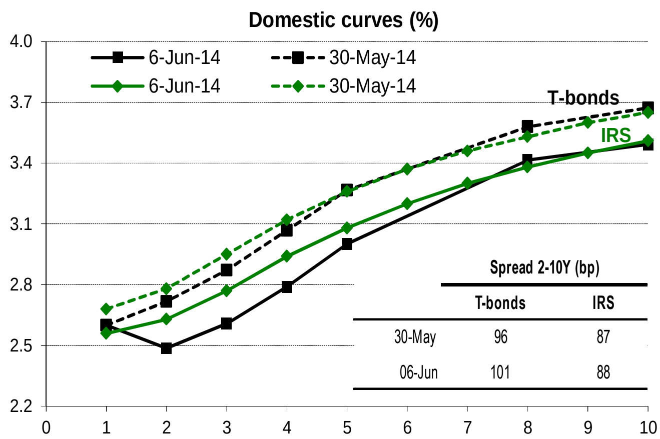
Direction depends on the ECB

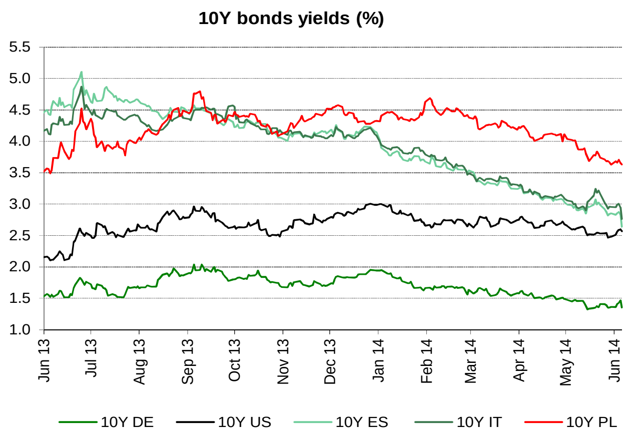
- Thursday's ECB decision was the most important event for the market. Earlier the single currency was under pressure of weaker-than-expected data from the euro zone (final PMI indices proved weaker than flash estimates). A wide range of tools applied by the ECB, both conventional and non-conventional caused a dynamic decline of EURUSD to 1.35. However, the rate returned to 1.36 soon, which may have been due to a technical correction after recent declines of EURUSD. The rate stabilized slightly above 1.365 after data from the US
- June's ECB decision did not change our expectations about EURUSD in the upcoming days/months. We are expecting the dovish ECB policy, contrasting with more hawkish Fed (FOMC meeting scheduled for 17-18 June), will keep EURUSD under pressure close to 1.36 in the upcoming weeks.

Interest rate market – Investors believe in rate cuts more and more









Market not ruling out rate cut before year-end

- June's MPC meeting proved to be a turning point for the interest rate market. The Council not only changed the tone of the statement to more dovish, but also did not rule out a rate cut in future. Expectations for MPC's policy easing even strengthened after the ECB decision (rate cut and use of non-standard measures to curb deflation risk). As a result, WIBOR 1M-12M fell by 1-4bp, with the biggest decline in 12M rate.
- FRA market went through much bigger adjustment to new market conditions and changing monetary policy outlook. Rates fell by 5-21 bp, with the biggest drop in longest rates (FRA21x24). Investors started pricing-in almost one interest rate cut until the end of the year, and rates not higher than currently in the next five quarters (FRA15x18 below WIBOR3M, for the first time since June 2013, when the MPC was still continuing monetary easing cycle).
- This week the CPI data will be crucial. Inflation lower than consensus may strengthen market expectations for rate cuts, generating impulse for drop in WIBOR and FRA, however in our view the potential for decline is quite limited.

Bond yields and IRS rates lowest for one year

- Surprising change of MPC rhetoric and the fact that the Council did not rule out rate cuts, together with ECB decision to ease monetary policy considerably, were the main factors that pushed domestic yields and IRS rates lower. At the end of the week yield of 10Y bond and corresponding IRS was below 3.50%.
- During the week, both curves moved down by 17-27bp for bonds and 17-20bp for IRS (in both cases the biggest move was in 5Y segment). The curves steepened slightly as compared to end of May, which reflected global tendencies (for German debt 2-10Y spread widened to 140bp, for US to 221bp).
- Thursday's auction of DS0725, WS0428 and WZ0124 met a moderate investors' demand. Demand amounted to PLN6.84bn (with PLN3.9bn at WZ0124) as compared to PLN5bn of maximum supply. The Finance Ministry placed bonds worth PLN4.99bn in total, including the new 10Y benchmark worth PLN1.7bn at 3.818%. After the auction the deputy finance minister Wojciech Kowalczyk informed that this year's borrowing needs are covered in over 90% (as compared to 86% at the end of May), which brings us closer to full coverage at the end of June.

Inflation data in focus

- May's inflation will be the key event of the week. Interest rate cut is already priced-in, so a strong impulse will be necessary to continue a downward trend on domestic curves. This can come from the domestic data (lower readings) or from core markets (further decline of Bund yields).
- Dynamic strengthening of the domestic debt over last days can encourage to take profit. Ahead of the June's FOMC meeting (17-18.06) markets can be stabilizing close to current levels.

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.