Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

7 – 13 July 2014

The Monetary Policy Council meeting was the main event of the week, as we expected. The MPC kept interest rates unchanged in July and in line with our expectations dropped the forward guidance. However, the market did not interpret this change as a signal of rising chances for interest rate cut after summer vacation, as the NBP president Marek Belka firmly stated that probability of cuts remains very low and suggested an introduction of a quasi-neutral bias. In our view, monetary policy easing could take place only if next data on economic activity would be very weak (inflation below zero will be no surprise!). Sadly, last data releases were not too optimistic – PMI for domestic manufacturing fell for the fourth time in a row, activity indices for the euro zone also contracted. On the other hand, output and employment subindices of the domestic PMI increased somewhat in June, similarly as the CSO business climate indicators. We are still expecting that after a temporary soft patch in 2Q14 the economy will return to moderately fast growth, which means that interest rates will remain stable at least until mid-2015.

This week's calendar of domestic and global events is light. On Monday the NBP will release the Inflation Report, which will show more details about the CPI and GDP projection. Abroad, investors may focus on the Fed minutes and speeches of the FOMC members, given context of expectations about possible monetary policy tightening in the USA. In Europe the key figures will be national industrial production data and final inflation readings.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (7 July)					
8:00	DE	Industrial output	Apr	%MoM	0.2	-	0.2
9:00	**PL**	**Publication of Inflation report**					
9:00	CZ	Industrial output	Apr	%YoY	5.6	-	7.7
10:30	EZ	Sentix index	Jul	pts		-	8.5
		TUESDAY (8 July)					
8:00	DE	Exports	Apr	%MoM	0.0	-	3.0
8:00	DE	Imports	Apr	%MoM	0.5	-	0.1
8:00	DE	Trade balance	Apr	€bn	17.0	-	17.7
10:30	GB	Industrial output	May	%YoY		-	3
		WEDNESDAY (9 July)					
9:00	CZ	CPI inflation	Jun	%YoY	0.1		0.4
20:00	US	FOMC minutes					
		THURSDAY (10 July)					
13:45	GB	Bank of England decision		%	0.50		0.50
14:30	US	Initial jobless claims	week	k	315		315
16:00	US	Wholesale inventories	May	%MoM	0.6		1.1
		FRIDAY (11 July)					
8:00	DE	HICP inflation	Jun	%YoY	1.0		1.0
9:00	HU	CPI inflation	Jun	%YoY	-0.1	-	-0.1

Source: BZ WBK, Reuters, Bloomberg

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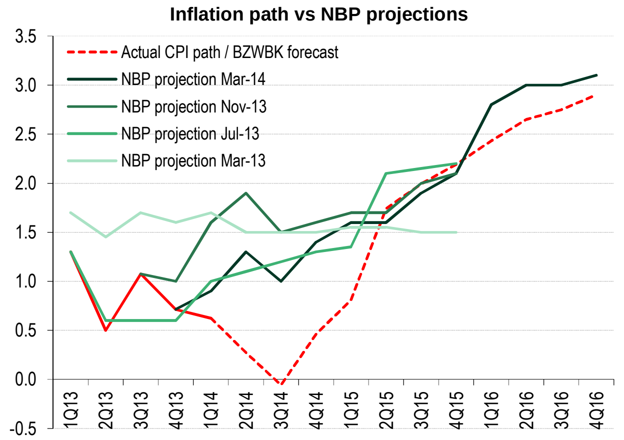
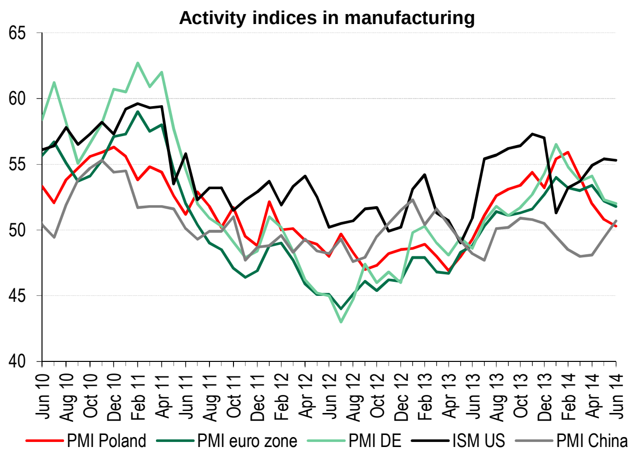
What's hot this week – New Inflation report



- On Monday the NBP will release the new Inflation report, which will show more details about the new projections of CPI and GDP. Main conclusions, presented in the MPC statement, are indicating lower path of CPI inflation and slightly slower growth of GDP in comparison with March's predictions. According to the central bank, inflation rate can temporarily drop below zero, but in the following months it should start gradually increase towards NBP's target.
- It should be emphasized that after receiving such forecasts, assuming stabilisation of economic growth rather than its significant acceleration and subdued pace of inflation pickup from the sub-zero level, the MPC still thinks that the probability of further rate cuts is very low. It confirms our opinion that to make decision about further monetary easing the Council would need to see a significant deterioration of economic growth in the incoming data.

Last week in the economy – PMI lower again, MPC abandoned forward guidance



- Polish manufacturing PMI disappointed again in June, falling to 50.3pts, a one-year low. New orders index fell near 50pts, while new export orders index declined and is below 50pts for the second straight month. Employment and output indices climbed slightly, but this does not change the fact that the reading increased doubts regarding pace of economic growth in 2Q14.
- PMI is still running above 50pts, the border between expansion and contraction. Let us note that the signals sent by the PMI survey are not in line with the CSO business climate indices, which recorded an improvement in all sectors in June. In our view, the economic recovery will be continued in the second half of the year after some slight weakening of the economic growth in the second quarter of the year.

Inflation and GDP projections in the subsequent *Inflation reports*

	GDP growth			
	Jul 13	**Nov 13**	**Mar 14**	**Jul 14**
2014	1.2-3.5	2.0-3.9	2.9-4.2	3.2-4.1
2015	1.6-4.2	2.1-4.5	2.7-4.8	2.6-4.5
2016			2.3-4.8	2.3-4.5
	CPI inflation			
	Jul 13	**Nov 13**	**Mar 14**	**Jul 14**
2014	1.2-3.5	2.0-3.9	0.8-1.4	-0.1-0.4
2015	1.6-4.2	2.1-4.5	1.0-2.6	0.5-2.1
2016			1.6-3.3	1.3-3.1

- The Monetary Policy Council kept interest rates unchanged in July, with the reference rate still at 2.5%. The sentence declaring stable interest rates until end of 3Q14 was removed from the statement. Instead, the MPC wrote that its decisions in the coming months will depend on the incoming information and its impact on economic growth and inflation outlook in the medium term. Marek Belka stated that all types of actions are to be expected. Thus, one can say that the MPC returned to the neutral bias in the monetary policy.
- In our view, monetary policy easing could take place only if next data on economic activity would be very weak (inflation below zero will be no surprise!). However, if coming data confirm a continuation of moderately fast growth (which is our baseline scenario) then rates will remain stable at the current level for some time (until 2H15).

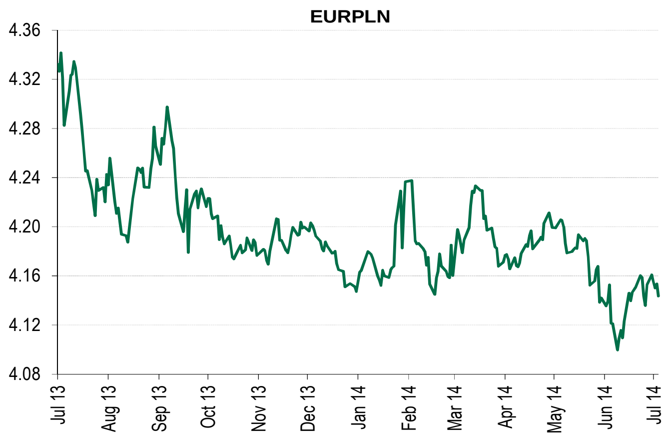
Quote of the week – We see very low probability of rate cut

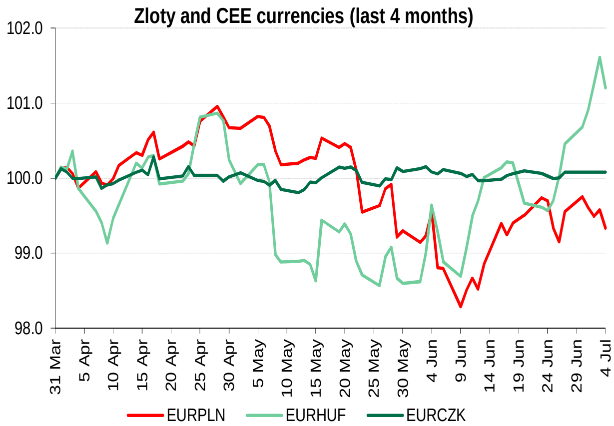
Marek Belka, NBP President, 02.07, MPC press conference

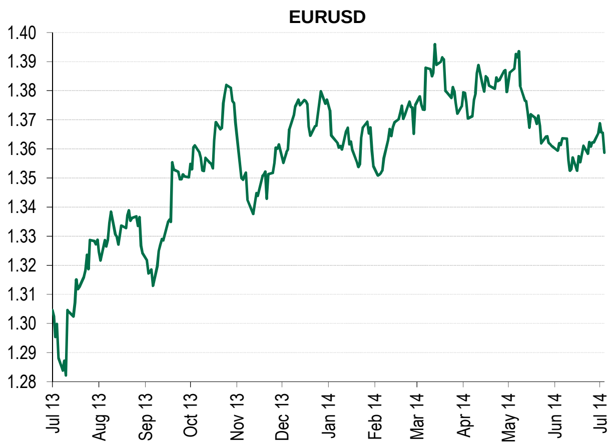
Risk structure has changed. Two months ago we saw an accelerating economy and inflation still running at level giving hope for a return to target in foreseeable future. Today, as shown by the projection, we face prospects of low and very low inflation for a longer time. (…) One month ago we announced that this method of suggesting our plans, i.e. promise of flat rates (forward guidance) is coming to an end. It is true that we dropped that from the statement. But this does not mean that a rate cut should be expected in September. We assess the probability of such a move as low. But all types of actions can be expected in the future.

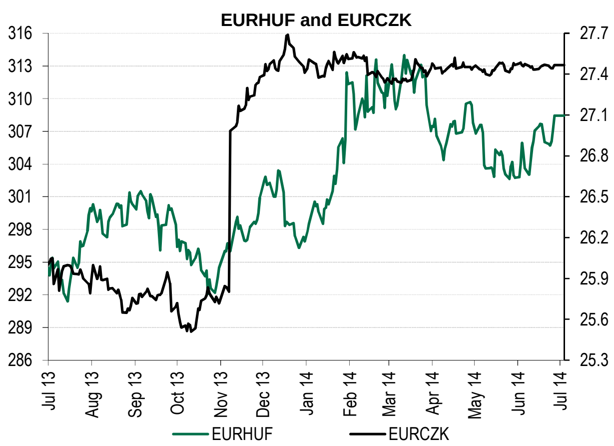
The NBP president stressed during the press conference that change of the statement and abandoning the forward guidance does not means that an interest rate cut should be expected in September. Belka reiterated the last month's sentence that probability of such a move is assessed as very low by the Council and he added this change means that all types of actions can be expected by the MPC in the upcoming months. Belka underlined that there is a "strong convergence of views" about the monetary policy in the MPC. These comments cooled down market expectations for possible rate cuts, supporting our opinion that the data have to disappoint strongly in order to trigger monetary policy easing.

Foreign exchange market – Central banks' actions supported the zloty









Zloty stronger after MPC and ECB

- At the start of the last week the zloty was under pressure of the weakening forint (see details below). As a result, EURPLN climbed temporarily to 4.166 (the weekly maximum). In the following days the domestic currency was gradually gaining, supported by the central banks' rhetoric. The slightly less dovish than expected rhetoric of the MPC (Belka suggested that interest rate cuts are still unlikely) and, in particular, the dovish tone of the ECB gave an impulse for a short-term decline of EURPLN to 4.141. At the same time, the zloty weakened temporarily versus the dollar (USDPLN climbed towards 3.06 after decline of EURUSD below 1.36).
- To sum the 2Q up, we can see that EURPLN was quite volatile – in April the rate reached maximum at c4.22 (effect of worries about further escalation of conflict in Ukraine) and in June a minimum at 4.09 (effect of the ECB actions). However, at the end of June the zloty was stronger by only 0.2% versus the single currency than at the end of March.
- At the end of the last week EURPLN was at 4.142. This means a strengthening of the zloty by 0.3% in relation to the euro in weekly terms. However, situation on the EURPLN chart did not change much, the rate is still running in a wide range between 4.09 (minimum reached after the June's ECB decision) and 4.17, oscillating slightly below the middle of this range. There are no important domestic data on cards this week, so the zloty will remain under impact of global moods. We still see a room for further strengthening of the domestic currency towards 4.13 and break of this level would open to door to further decline towards the lower limit of fluctuation range.

Dollar gained after better labour market data

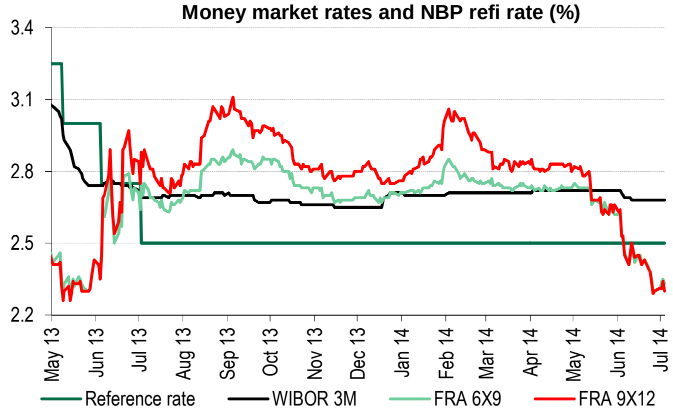
- Start of last week brought an increase of EURUSD towards 1.37 (effect of the dovish comment of Fed's Williams). However, this increase proved short-lived and further days brought a decline towards 1.36. This level was broken after better-than-expected data from the US labour market but also the dovish ECB rhetoric. Strengthening of the dollar was not significant, as the single currency is supported by inflow of capital on the European stock and bond market.
- Situation on the EURUSD chart did not change much. EURUSD still has a potential for further declines towards 1.35, but uncertainty about further Fed actions and inflow of capital on the European market can limit potential declines of the rate. Minutes of the FOMC meeting, due for release this week and comments of Fed members can be crucial for further behaviour of EURUSD, which stays in horizontal trend, oscillating between 1.35 and 1.37.

Forint under impact of the government's policy

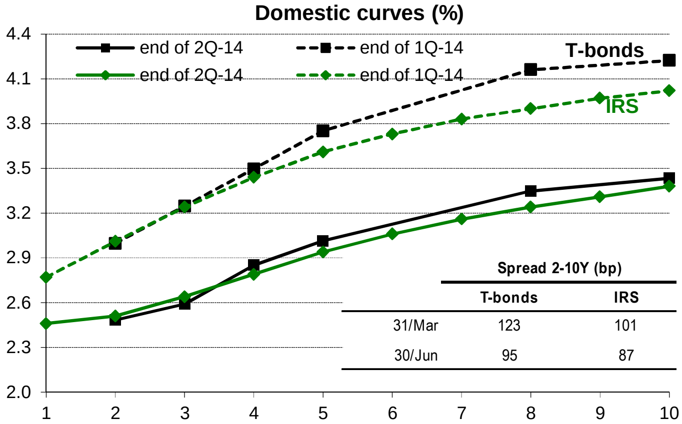
- Nothing interesting occurred in the Czech koruna quotations last week. However, situation on the HUF market was much more volatile. The Hungarian currency lost quite considerably due to actions of the government, planning a conversion of FX loans. Moreover, the European Commission threatened that Hungary may again fall into excessive deficit procedure, if no further steps in fiscal consolidation are taken. As a result EURHUF climbed temporarily to 312.5. However, data on current account surplus limited the earlier losses on HUF.
- This week the CEE currencies will be under impact of domestic data releases (CPI, output). Inflation data can be key for the region's central banks. Inflation below zero in Hungary can fuel expectations for further interest rate cuts. This can slightly negatively affect the forint.

Interest rate market – MPC scales back expectations for rate cuts

Money market rates and NBP refi rate (%)

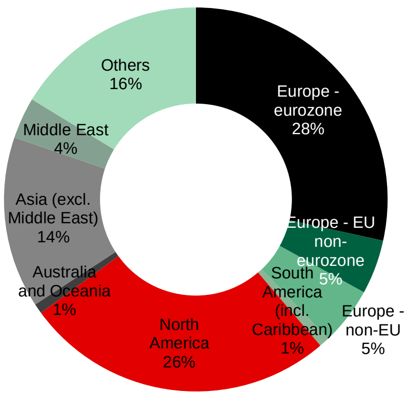


Domestic curves (%)

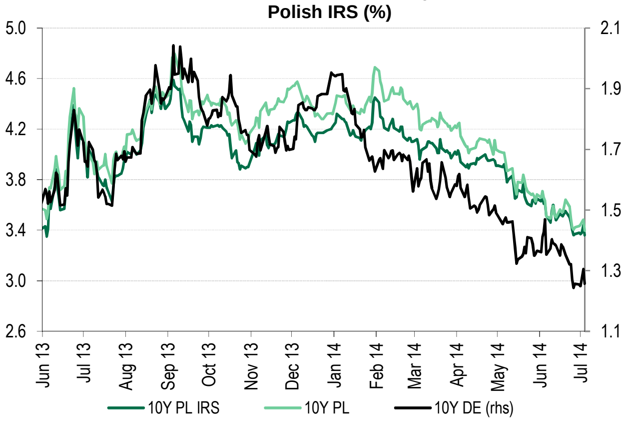


	T-bonds	IRS
31/Mar	123	101
30/Jun	95	87

Geographical structure of non-resident T-bond holdings (end of May 2014)



Polish and German 10Y benchmark yields and 10Y Polish IRS (%)



Short-lived correction after the MPC decision

- Last week the domestic interest rate market was under impact of the central banks' rhetoric. Contrary to our expectations, the MPC decision to resign from forward guidance did not support the market. Comment of the NBP president that interest rate cut is unlikely triggered profit taking after recent considerable strengthening of bonds, IRS and FRA. However, correction was not long-lasting or deep as the dovish ECB rhetoric gave an impulse for a renewed strengthening (10Y bond yields approached 3.40%). WIBOR rates remained stable.
- The domestic interest rate was subject to strong swings in 2Q. However, strengthening expectations for interest rate cuts and ECB actions caused a considerable decline of bond yields, IRS and FRA rates. As compared to end of 1Q, yield curve shifted down by 50-80bp, IRS curve by 50-70bp with the most considerable strengthening on the middle and the longer end of curves. At the same time, FRA rates declined by 10-80bp (mostly in longer tenors), with WIBOR rates declining by 3-5bp.

Limited supply of Treasury Securities in 3Q14

- In line with expectations, supply of Treasury Securities in 3Q14 is more limited than in previous quarters. Poland's Ministry of Finance plans to launch T-bonds worth PLN10-15bn (vs sale of PLN28.2bn in 2Q14) in three auctions, two of which will be held in July and one in September (pausing in August). In September the Ministry may organise a switch tender, buying back T-bonds maturing in 2015. As regards foreign financing in 3Q14, the Ministry expects €0.7-0.8bn from international financial institutions and may consider issuing debt on foreign markets or road bonds denominated in €, depending on market conditions.
- The first auction this month was less successful than expected. The Ministry launch DS0725 worth PLN 2.4bn with auction yield of 3.649% (with recorded demand at PLN3.5bn). Demand on WS0428 amounted to only PLN250m, however, the Ministry rejected all bids. Consequently, the Ministry has secured 92% of this year gross borrowing requirements. It is still likely that this year's target will be fulfilled till end-July.
- In May foreign investors bought Polish T-bonds worth PLN2bn and domestic investors worth PLN3.7bn. According to Finance Ministry, inflow of foreign capital on the Polish market in June was stronger than in May.

Under rhetoric of the ECB and core markets

- At the beginning of the week, positive investors' mood after the July's ECB meeting may continue. This factor should support domestic interest rate market. Admittedly the MPC tried to cool down expectations for rate reductions, investors still do not rule out materialisation of such scenario. FRA 3x6 clearly implies further WIBOR 3M decline by nearly 25 bp in 3 month time. The prospect of low inflation should stabilize the short end of curves close to current levels in the coming weeks.
- We expect the mid and long end of the curve to be more volatile. These instruments will be under influence of situation on core markets due to lack of domestic macro data releases. One should notice that in recent weeks correlation between yields of Polish T-bonds and Germany T-bonds in 10Y sector remains strongly positive (c0.80 for the period June-July). Still dovish tone of the EBC should stabilize 10Y German benchmark close to 1.25%. Consequently, we also foresee domestic yields/rates stabilisation or even gradual decline if mood improves (but in our opinion the scope for further decline of Polish yields is rather limited).

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