WEEKLY ECONOMIC UPDATE

21 – 27 July 2014

CPI inflation climbed in June to 0.3%YoY and core inflation increased to 1.0%YoY, which temporarily scaled back the market's expectations about interest rate cuts (especially, as there are some new comments of MPC members, suggesting it is too early to consider such an option). However, this did not last too long, as data on wage and industrial output growth disappointed strongly, deepening worries about possible slowdown of Polish economic growth. Recent releases from the euro zone gave no reasons for optimism, as they suggested a weaker activity in countries being the main trade partners of Poland. Implementation of new financial sanctions by the US on Russia and shooting down of Malaysia Airlines aircraft in Ukraine, posing a risk of further escalation of international conflict and restrictions, additionally fuelled uncertainty about the economic outlook. However, we still believe that after weaker economic growth in Q2 in Europe and Poland the economy will be back on track in H2.

In the upcoming days we will see new releases of sentiment indices and business climate reports in Europe, which can deliver hints about economic activity at the start of Q3. Investors may be interested in data on credit activity in the euro zone in June, and in inflation data in the US (which recently surprised to the upside). As regards the domestic market, data on retail sales and bond auction will be key. Our forecast of sales is this time slightly below consensus, but in our view it is still a good reading, in line with scenario of GDP growth above 3%YoY in Q2 and upward path of consumption. The zloty may stay under pressure of higher risk aversion due to geopolitical factors and stronger expectations for interest rate cuts. Further declines of yields are possible on the interest rate market, unless sales surprise with a very strong reading.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (21 July)					
		No important data releases					
		TUESDAY (22 July)					
14:00	HU	Central bank decision		%	2.2	-	2.3
14:30	US	CPI	Jun	%MoM	0.3	-	0.4
16:00	US	Home sales	Jun	m	4.97	-	4.89
		WEDNESDAY (23 July)					
10:00	**PL**	**Retail sales**	**Jun**	**%YoY**	**4.1**	**3.8**	**3.8**
10:00	**PL**	**Unemployment rate**	**Jun**	**%**	**12.1**	**12.1**	**12.5**
11:00	**PL**	**Bond auction**					
		THURSDAY (24 July)					
3:45	CN	Flash PMI-manufacturing	Jul	pts	51.0	-	50.7
9:30	DE	Flash PMI- manufacturing	Jul	pts	51.9	-	52.0
10:00	EZ	Flash PMI- manufacturing	Jul	pts	51.7	-	51.8
14:30	US	Initial jobless claims	week	k	-	-	302
16:00	US	New home sales	Jul	k	480	-	504
		FRIDAY (25 July)					
10:00	DE	Ifo index	Jul	pts	109.4	-	109.7
14:30	US	Durable goods orders	Jun	%MoM	0.5	-	-0.9

Source: BZ WBK, Reuters, Bloomberg

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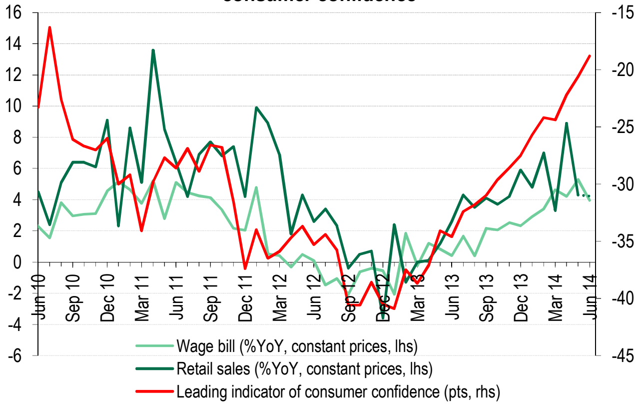
What's hot this week – Falling unemployment supports retail sales growth

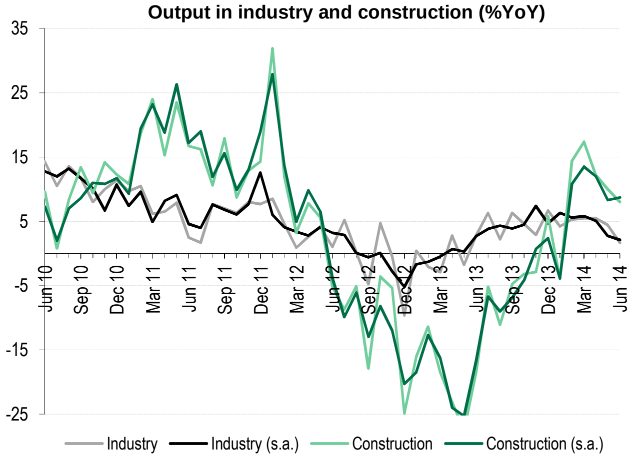
Retail sales, wage bill in corporate sector and consumer confidence



- After a considerable disappointment about June's data on wages and output, which fuelled worries about the economic growth in Q2 and about continuation of the recovery in the following quarters, retail sales will be another important hint about the economic situation. This time, our forecast is slightly below market consensus, assuming a stabilization of growth rate at May's level. Labour market improvement, although slightly weaker, and strong upward trend in consumer sentiments, present for a year already, are still supporting expectations that consumer demand will accelerate gradually.
- Registered unemployment rate will probably fall to 12.1%, in line with estimates of the Labour Ministry. In the summer the unemployment rate will most probably slide below 12%, yet the improvement will not be as fast as earlier.

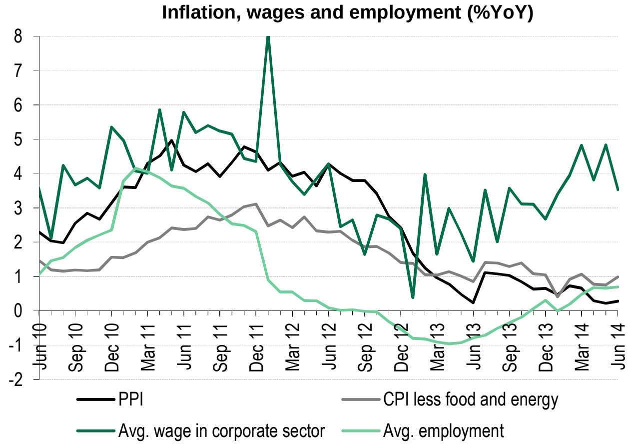
Last week in the economy – Weaker data fuelled worries about the economy

Output in industry and construction (%YoY)



- Current account surplus in May reached €280m and was slightly lower than expected. However, in general the data look quite optimistic in our view, showing a continuation of positive trends in foreign trade despite the Ukrainian crisis – export growth accelerated to 11.3%YoY, import growth to 9.9%YoY. Unfortunately, the decline of industrial output growth in June makes this result less likely to be maintained.
- Industrial output expanded in June by a mere 1.7%YoY. This means that average rise of industrial output in Q2 was by 1 percentage point lower than in Q1. On the other hand, construction and assembly sector did not surprise and increased by 8%YoY and by almost 10% in the whole Q2, slightly better than in Q1. It seems that Q2 will show a slightly lower GDP growth than in Q1, but the difference should not be high. We still hope that the economy will

Inflation, wages and employment (%YoY)



- Employment in the corporate sector climbed in June by 0.7%YoY, in line with expectations, but wage growth decelerated to 3.5%YoY. In our view, this is only a temporary slowdown, possibly due to delays in bonus payments. It seems that the pace of improvement on the labour market began to wane, but it remains strong enough to support the private consumption at the turn of Q2 and Q3.
- Inflation climbed slightly in June to 0.3%YoY, in line with our expectations. Rise in prices was mainly triggered by new tariffs on the mobile phone market. Core inflation excluding food and energy prices climbed to 1.0%. CPI inflation will most probably fall below zero in July and August. However, in the upcoming months the price growth should accelerate gradually, as higher dynamics of domestic demand will be affecting behaviour of sellers and

Quote of the week – Too early for cuts

Andrzej Kaźmierczak, MPC member, 17.07, Bloomberg

Based on NBP projection, cost of money should stay at current level until the end of 2016. Every rate cut in the upcoming months would be a reaction to temporary deflation and to a short-lived slowdown in the Polish economy (…) If data confirm a persistent slowdown, then decision to cut rates should be taken in 2015 at the earliest.

Elżbieta Chojna-Duch, MPC member, 15.07, Reuters

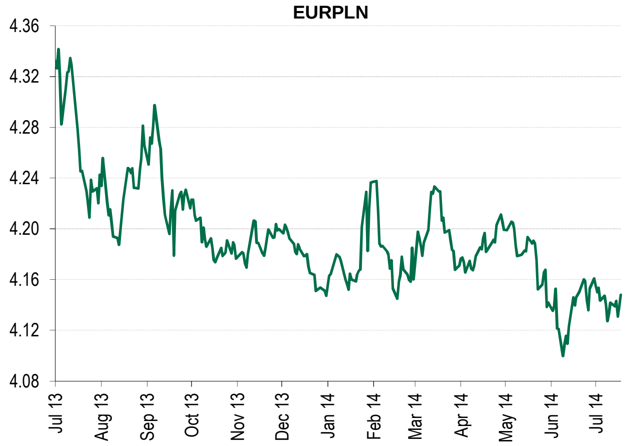
The still low inflation provides arguments to consider interest rate cuts already this year.

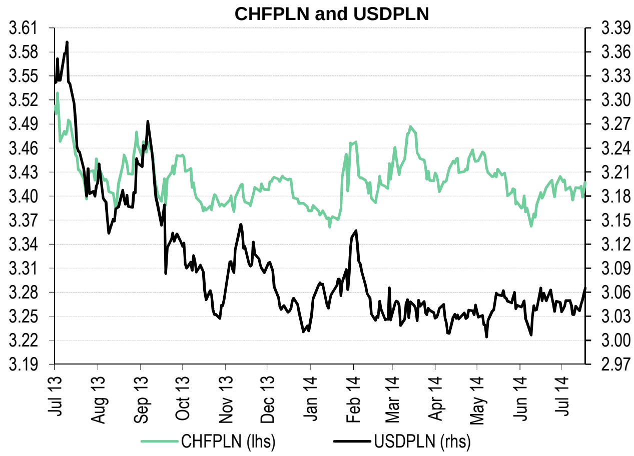
Andrzej Bratkowski, MPC member, 15.07, TVN BiŚ

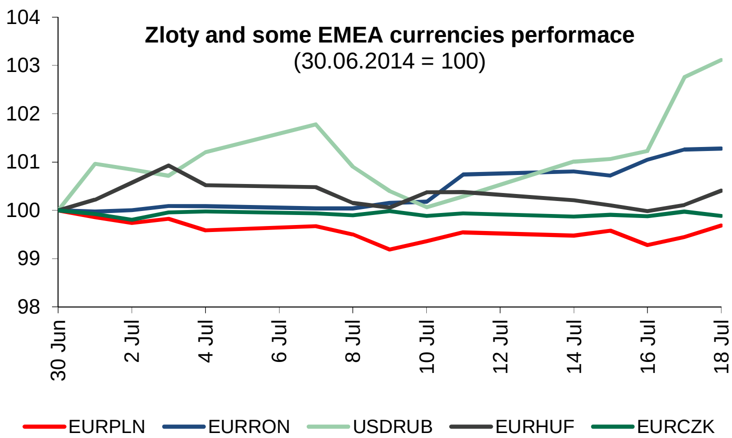
In my view it is too early to forecast a slowdown of economic growth or consider if easing cycle should be continued.

Last comments of the MPC members are showing that a majority of them does not intend to rush with interest rate cuts, so if upcoming data do not confirm a persistent economic slowdown in the upcoming quarters, then rates should remain unchanged. Sub-zero inflation in the summer months is anticipated by the market and should not be so important. Recent monthly indicators (e.g. on output) suggest that the GDP growth in Q2 will be weaker, but should stay above 3%YoY, in our view. However, information on situation in Q3 will be key. We are still expecting that the economy will not slow down further, yet risk of further sanctions against Russia is another risk factor for the economic recovery in Europe.

Foreign exchange market – Currencies under pressure of geopolitical tensions







Zloty weaker due to increase in geopolitical tension

- Last week volatility on the domestic FX market increased. While at the beginning of the week the zloty strengthened against the main currencies (effect of higher than expected June's CPI reading), the end of the week brought a zloty weakening due to risk aversion as geopolitical tensions increased. This was due to (among others reasons) market reaction to aircraft crash in Ukraine and investors' worries that the crisis between Russia and Ukraine may strengthen, but also due to unstable situation in the Gaza Strip. As a consequence of risk-off moods, the emerging market currencies weakened quite considerably, including the Polish zloty. What is more, the domestic currency was also under pressure of much weaker than expected industrial output growth, which renewed expectations on quick interest rate cuts. Consequently, EURPLN reached temporarily 4.156, while USDPLN increased towards 3.075, after reaching weekly minimums at 4.125 and 3.031, respectively, at the beginning of the week. Risk aversion proved to be only short-lived and during Friday's session EURPLN fell below 4.15.
- This week the zloty will be under influence of last set of data from the domestic economy and releases from abroad like flash PMI for euro zone and for China. Other disappointing data, i.e. reading of retail sales below market consensus (which is our basic scenario) may bring an impulse to zloty weakening. The depreciation may strengthen if flash PMI outcomes show lower than expected levels, which can renew worries how permanent and strong is recovery in the euro zone.
- Last week did not bring any significant changes on the EURPLN chart. Still the vital levels are 4.11 and 4.17.

Decline in EURUSD halts

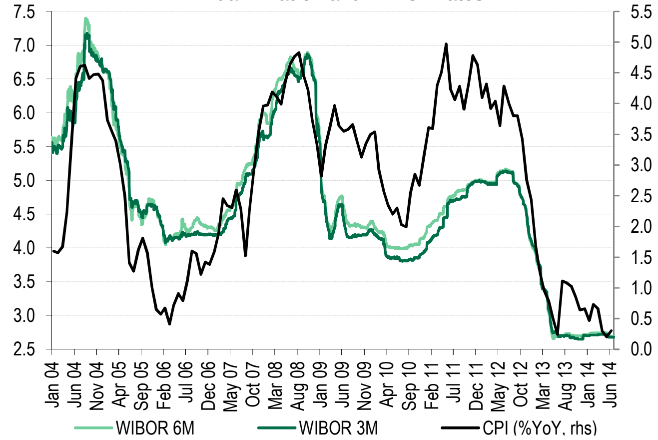
- Last week the European currency lost against the US dollar after a series of weak macroeconomic data for euro zone, in particular for Germany. EURUSD gradually declined from weekly maximum at 1.364 towards support level near 1.35. however, on Friday EUR slightly rebounded and at the end of the week EURUSD was around 1.353.
- Last week's data from the US economy were mixed, but weekly initial jobless claims still show a further improvement on the labour market. This week's data from real estate market and CPI will be crucial for EURUSD valuation. Weaker than predicted readings may support the dovish wing in the Fed, suggesting that the first hike may be delayed. Consequently, EURUSD may increase towards 1.36. On the other hand readings of flash PMI for manufacturing in euro zone below market consensus should limit EURUSD increase.

Depreciation of emerging market currencies

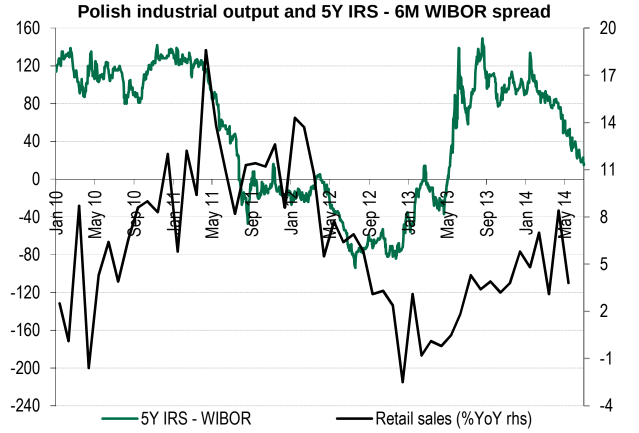
- A considerable depreciation of the ruble (by nearly 2% in daily terms) caused by escalation of Russia-Ukraine conflict and by new sanctions against Russia, imposed by the US and planned by the European Union resulted in weakening of emerging market currencies. EURHUF, after a consolidation between 308.6 and 310.1, increased temporarily to 311.6. Volatility on the Czech koruna was muted as compared to the Hungarian forint or the Polish zloty. EURCZK has stayed in a narrow range of 27.40-27.46, while risk-averse mood caused the exchange rate increase towards the lower level of this range.
- This week the most important event in Hungary will be the central bank meeting. After unexpected decline in CPI for July the expectations about continuation of monetary

Interest rate market – Weak Polish and global data may drag IRS lower

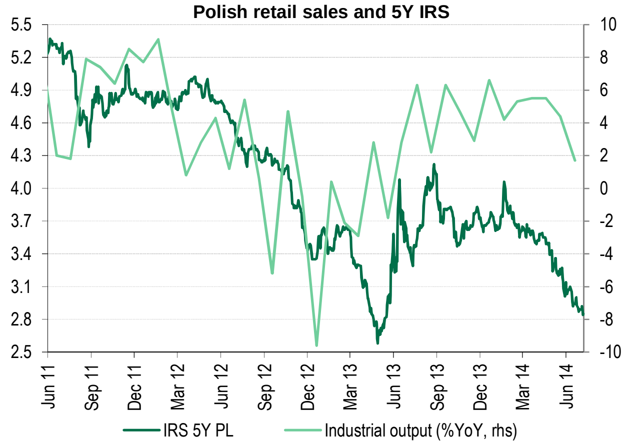
Annual inflation and WIBOR rates



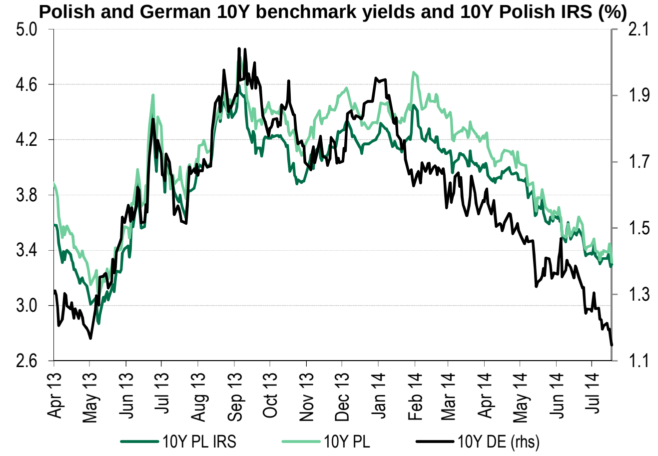
Polish industrial output and 5Y IRS - 6M WIBOR spread



Polish retail sales and 5Y IRS



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



FRA, IRS and bond yields down after Polish data

- Since the previous Friday, only the shortest rate among 1-12M WIBOR changed (it dropped by 1bp). FRA surged quite significantly after the CPI data, but much worse than expected wages and output numbers dragged longer rates down by nearly 10bp. Shorter FRA – pricing already a 25bp rate cut in next 3-6 months – showed more muted reaction to the disappointing data.
- Although inflation increased slightly, the room for higher WIBOR seems to be limited in the coming months, in our view. First, we are likely to face deflation in the summer months. Second, recent set of Polish data has clearly weakened hopes that pace of the GDP growth will accelerate in the quarters to come. Slightly below-consensus data on June retail sales – that we expect this week – may push FRA further down and even lead to a slight drop in WIBOR.
- IRS and bond curves flattened last week. This was due to strengthening of 5Y and 10Y tenors (by 2-6bp) driven by significant plunge of German 10Y bond yields (temporarily below 1.14%, to the all-time low). Interestingly, short ends of IRS and bond curves moved slightly up or stayed unchanged. The increase was recorded after the CPI and was not reversed after poor wages and output numbers. 2-10Y spread dropped by nearly 10bp for bonds and 5bp for IRS.

Polish retail sales and euro zone's PMI crucial

- 5Y IRS is getting closer and closer to the 6M WIBOR and below-consensus reading of the June retail sales may make the spread between those two instruments narrower. Next poor Polish data may strengthen expectations for rate cuts and drag IRS and bond yield curves further down.
- In the global market, it seems that the end of the week will be the most interesting when flash PMI and German Ifo index are due to be released. German and euro zone PMI for manufacturing have stayed in the downward trend already since the beginning of the year and are now just above the neutral level of 50pts (being the border between economic expansion and contraction). Last week, German July ZEW index showed a further deterioration of moods (although it is worth to notice that this survey did not include the result of final match on the World Cup!). If economic indexes fall deeper than market expects, then expectations for ECB rate cuts may strengthen and this may be – next to Polish data – a trigger for lower domestic IRS and bond yields.
- This week the Ministry of Finance will hold the last bond auction before the August break. In the first week of July the ministry sold new 10Y bond and now we expect it may offer mid and/or short term bonds (yield of the 2Y benchmark has recently broken the all-time low reached in 2013). Next to the longer break in debt issuance, the results of the Wednesday's auction may supported by Friday's (that is when the bonds bought at the auction are settled) payments from PS/DS/WZ bonds and maturity of OK0714 amounting to PLN10.5bn in total.

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