WEEKLY ECONOMIC UPDATE

28 July – 3 August 2014

Over the last week the financial market sentiments stayed under influence of numerous factors, including the geopolitical risk (Ukraine, The Middle East), macro data and financial results of companies (mainly in the US). There were also some surprises from central banks – the central bank of Hungary cut rates more than expected and declared the end of monetary easing cycle, while the Russian central bank hiked rates. Yet, impact of these two decisions was short-lived. As regards Poland, retail sales data, similarly as earlier industrial output and labour market data, surprised to the downside, supporting expectations for interest rate cuts already in 2014. This, combined with very good auction results and declining yields on the core market provided an impulse for a strengthening of domestic debt market (yield of 2Y bond reached the lowest level in history). Reaction of the zloty was very limited – EURPLN remained in a horizontal trend, while USDPLN increased after strengthening of the dollar.

Last days of July will be full of important information from the global economy, which can significantly affect forecasts on pace of recovery in the US and in Europe and expectations about actions of the central banks. Domestic data releases will not be numerous, but the PMI index for manufacturing can strongly affect expectations about economic outlook in Q3. After a major disappointment in June's data on activity, PMI will be scrutinised as a hint about direction of domestic industry in H2. Our econometric models gave no clear hint about this release, so we are expecting stabilization at rather low June's level.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (28 July)					
16:00	US	Pending home sales	Jun	%MoM	0.0	-	6.1
		TUESDAY (29 July)					
16:00	US	Consumer confidence index	Jul	pts	85.5	-	85.2
		WEDNESDAY (30 July)					
14:15	US	ADP report	Jul	k	225	-	281
14:30	US	Advance GDP	Q2	%QoQ	2.9	-	-2.9
20:00	US	FOMC decision					
		THURSDAY (31 July)					
11:00	EZ	Flash HICP	Jul	%YoY	0.5	-	0.5
13:00	CZ	Central bank decision		%	0.05	-	0.05
14:00	**PL**	**Inflation expectations**	**Jul**	**%YoY**	**-**	**-**	**0.2**
14:30	US	Initial jobless claims	week	k	-	-	284
		FRIDAY (1 August)					
3:45	CN	PMI – manufacturing	Jul	pts	52.0	-	50.7
9:00	**PL**	**PMI – manufacturing**	**Jul**	**pts**	**50.5**	**50.5**	**50.3**
9:55	DE	PMI – manufacturing	Jul	pts	52.9	-	52.0
10:00	EZ	PMI – manufacturing	Jul	pts	51.9	-	51.7
14:30	US	Non-farm payrolls	Jul	k	225	-	288
14:30	US	Unemployment rate	Jul	%	6.1	-	6.1
14:30	US	Consumer income	Jun	%MoM	0.4	-	0.4
14:30	US	Consumer spending	Jun	%MoM	0.4	-	0.2
15:55	US	Michigan index	Jul	pts	81.4	-	82.5
16:00	US	ISM – manufacturing	Jul	pts	56.0	-	55.3

Source: BZ WBK, Reuters, Bloomberg

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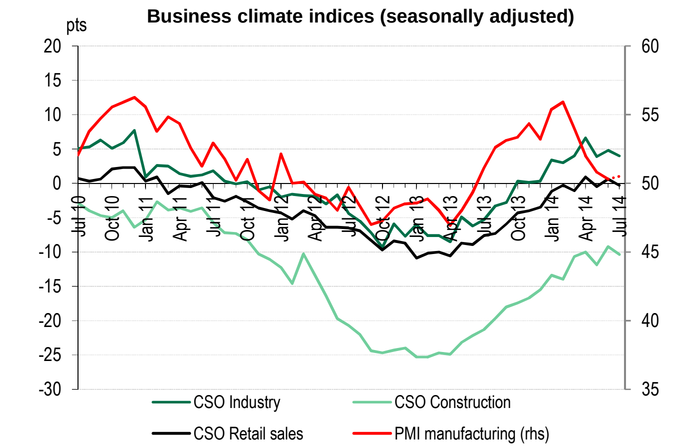
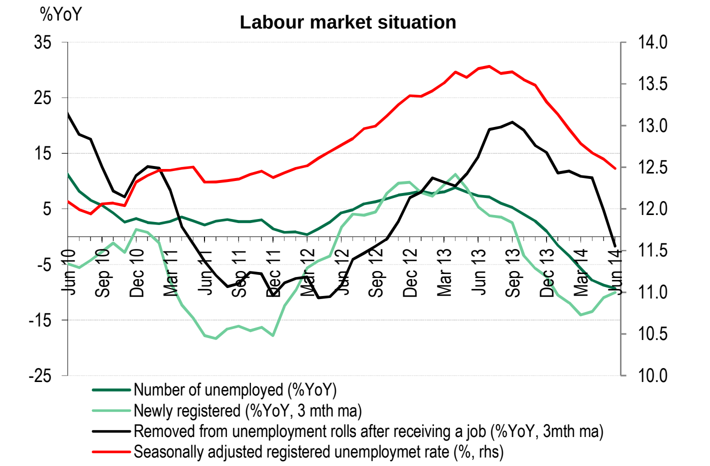
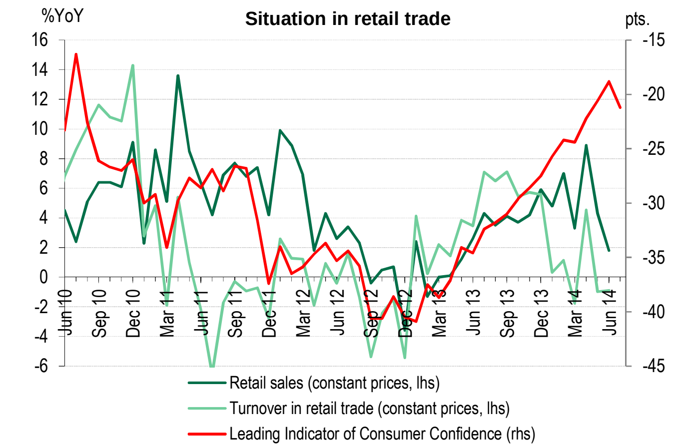
What's hot this week – Higher or lower PMI?



▪ After a series of disappointing data for June PMI for July will be an important hint to state in which direction Polish economy is heading at the beginning of 3Q14. Drop of Ifo index and conflict escalation in the East may weigh on moods in Polish industry. On the other hand, slight increase in PMI for euro zone (and its lower drop in recent months than in Polish index) together with good result of German PMI are positive signals. Moreover, we can see growing difference between CSO's business climate index and Polish PMI. Our two models show contradictory results for July. The problem is that the model which correctly predicted the decline last month (which we didn't believe in) forecasts PMI to be below 50 in July. The forecast of the second model is more optimistic. Eventually, we assume a stabilization of the PMI index. Unfortunately, PMI forecasts always go with high uncertainty.

Last week in the economy – Lower unemployment, but retail sales disappointed





▪ Unemployment rate in June fell to 12% and was slightly lower than forecast. The unemployment rate lowered by 1.2%YoY. There were 1.913mln unemployed, which is 9.3% less than a year ago. Although this was surely a positive surprise, data for June confirm that the tempo of recovery in the labour market is waning, which had been noticeable already in earlier months. It is the momentum of unregistering from the list of unemployed because of found job which lowers in the most significant way (-4.5%YoY versus 1.4%YoY in May). The rate of decline of unemployed was two-digit (-10.1%YoY versus -5.4%YoY in May). It means that enterprises don't reduce employment but they don't increase it either. We expect further decline of seasonally adjusted unemployment rate but it should stabilize near 12% soon.

▪ Retail sales grew in June merely by 1.2%YoY, which is the lowest ratio since May 2013 and largely below forecasts. The monthly decline is noticeable in all categories (with the biggest in furniture and household appliances – by 3.3%) except motor vehicles which increased by 0.6%. Turnover in retail trade (seasonally adjusted) fell 0.6%YoY.

▪ CSO's indices of consumer confidence experienced, which used to be in strong upward trend in recent months, recorded a clear correction in July. Monthly decline of the current index and the leading index was the biggest since September 2012. The weakening of current assessment resulted from growing pessimism about current Poland's economic situation and future financial situation of Polish households. It was a negative outlook for saving money which reduced the leading confidence index.

Quote of the week – No need for the interest rates cut yet

Andrzej Kaźmierczak, MPC member, 23.07, PAP

I think there is no need to change interest rates yet. We must see whether weaker data for 2Q are temporary or persistent. MPC cannot react because of individual data. MPC does act basing on the long-term views.

Jerzy Osiatyński, MPC member, 23.07, PAP

I would surely like to believe the slowdown is temporary but I am afraid that the growth in 2Q and 3Q can be lower than in 1Q.

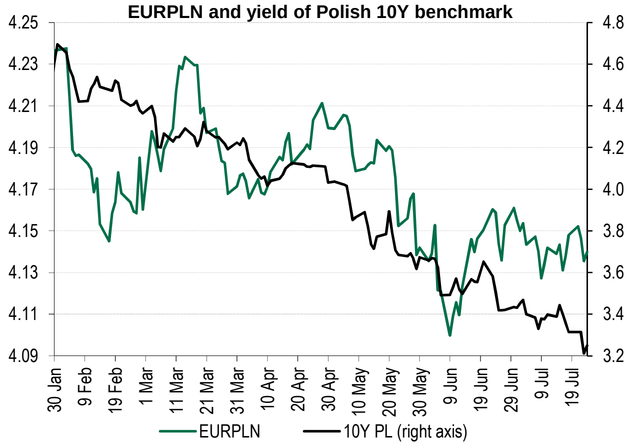
Marek Belka, NBP Chairman, 23.07, speech in the Sejm

It is the care for sustainable economic growth which justifies maintaining positive real interest rates while having very low inflation. Therefore, we avoided the danger of ultra-low interest rates.

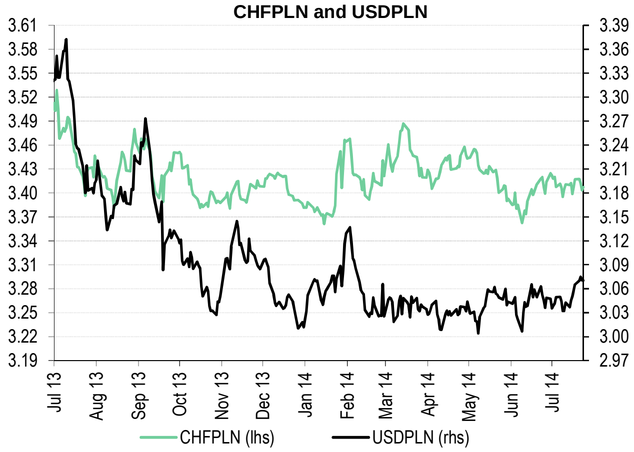
GDP data in 2Q will most probably show slight slowdown. It will not be the most important in terms of monetary policy view, however. It is whether the tendency of slowdown will be continued in 3Q what is crucial. In our opinion we will see the interest rates cut only in such scenario. Second half of August promises to be very interesting as there will be publications of monthly data for July and detailed GDP growth for the second quarter. Last statement of MPC's Andrzej Kazimierczak confirms it. Moreover, Belka's recent comments also do not suggest the NBP president changing his mind as far as monetary policy is concerned. After last MPC meeting Belka said that the cut is possible but it is not the basic scenario for MPC.

Foreign exchange market – Zloty extremely stable despite risk factors

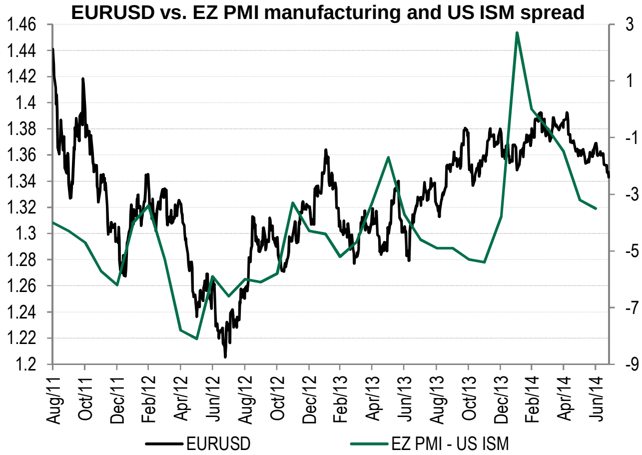
EURPLN and yield of Polish 10Y benchmark



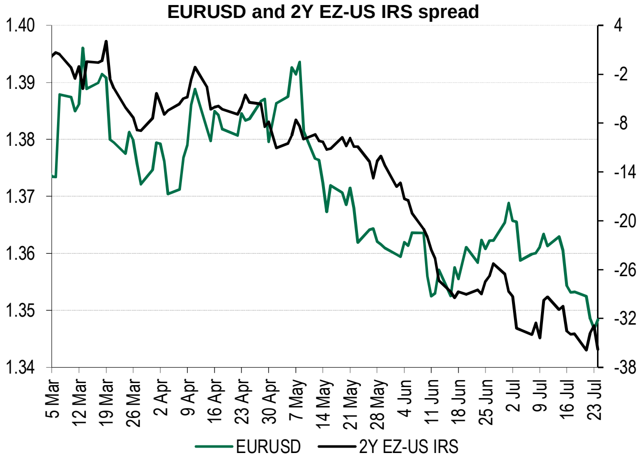
CHFPLN and USDPLN



EURUSD vs. EZ PMI manufacturing and US ISM spread



EURUSD and 2Y EZ-US IRS spread



EURPLN still very stable

- EURPLN stayed within 4.125-4.155 range last week and USDPLN broke 3.08. Despite higher tensions in Ukraine (after shooting down the Malaysian airplane and breakout of the ruling coalition) and poor Polish data, the zloty has remained stable vs. the euro.
- If EURPLN does not break July's low (4.12) or high (4.1656), then the monthly high-low spread reaches its lowest since April 1996 and the ratio between spread and opening level reaches lowest since September 1996. There are no such spectacular records in July for EURHUF, USDRUB or EURUSD, but one should notice that trading range measured this way is falling gradually since the first wave of 2007-2008 crisis and is at its lowest since 90ties for EURUSD. VIX volatility index (called also the index of fear) is currently running at c12pts, similarly like in 1996 (it reached its highest at c60pts in 2007-2008, its lowest level was 10.42pts in July 2007).
- The volatility in the market is low and this may be due to hopes, that if something goes wrong, the central banks come to the rescue. This week, the FOMC is likely to cut QE3 size by next $10bn but what seems more important – it shall repeat that interest rates will remain low for a long time after QE3 ends. PMI for Polish manufacturing is due this week, but it seems that US data will be more important. Strong data may trigger a correction in the debt market and thus hit the zloty, which has recently been resilient to rising risk of a rate cut due to the inflow of capital into the debt market. Conflict in Ukraine may continue to weigh on the zloty. Vital levels for EURPLN are still at 4.11 and 4.17.

FOMC and US data key for EURUSD

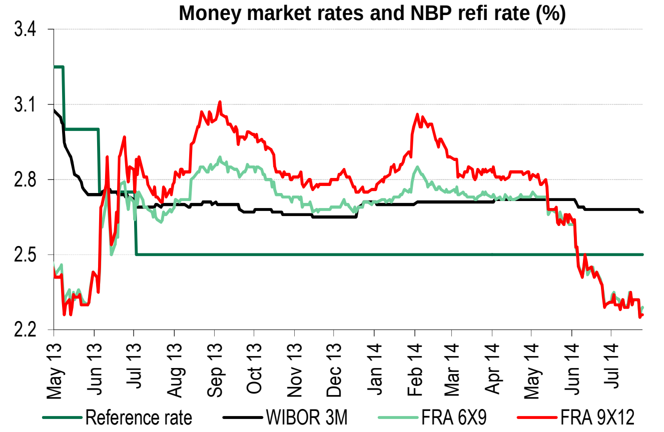
- EURUSD broke the vital support at 1.35 and ended the week close to 1.344, lowest since November 2013. The dollar continued to be supported by the better than expected US macro data.
- In nearest days the attention will shift to the US. The QE programme will be surely reduced by $10bn but the statement will matter the most. Although Yellen assures that the rates are to be low long after QE ends, hawkish FOMC members suggest the hikes can occur earlier than market expects (earlier than in 2H15). The macro data may also be very important. The growth of nonfarm payrolls has been surprising for 5 months and ISM index for industry has been staying in strong upward trend since the beginning of 2014. It seems that the difference of outlook for the US and euro zone economies (meaning also future central banks actions) is an important factor driving EURUSD lower since May. If labour market data and ISM surprise to the upside and FOMC statement is not too dovish, EURUSD may continue falling. Supports are at 1.343 and 1.337.

Forint gains after MNB, CZK waits for the decision

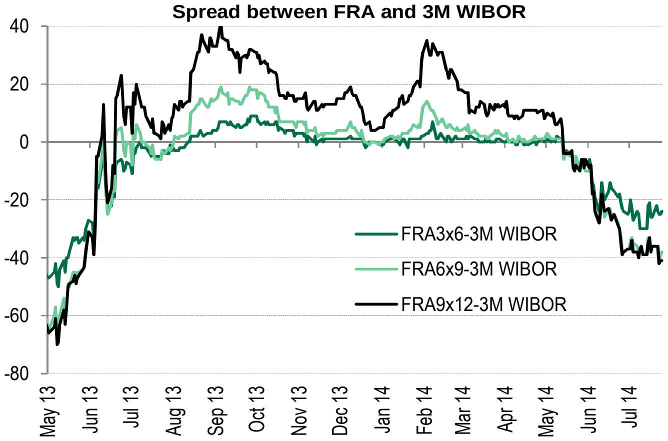
- Hungarian central bank surprised with interest rates cut by 20bp, main to record low at 2.1%. The central bank head said that rates should stay flat until the end of 2015 as long as inflation does not drop further. HUF reacted positively to this statement, EURHUF declined to 306.6 from 310.
- Bank of Russia also surprised markets. It raised the rates by 50bp, main rate to 8% and announced further hikes are possible. The decision was justified by inflation running above the target and a likely negative impact of sanctions and weak ruble on CPI.
- The attention in region will focus on Czech Republic this week. The central bank has prolonged the EURCZK floor regime last month, which was neutral for koruna.

Interest rate market – Internal and external factors supporting debt

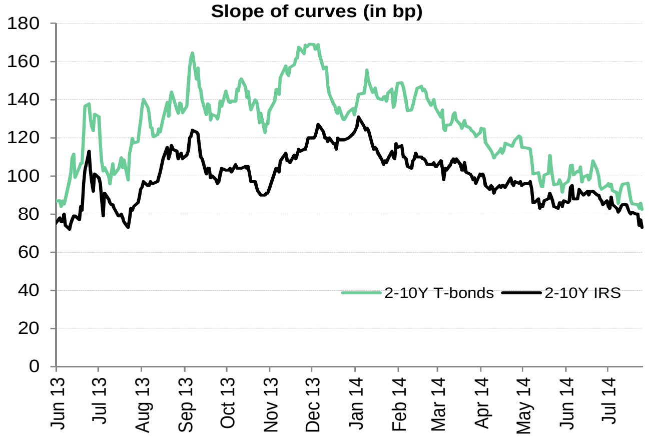
Money market rates and NBP refi rate (%)



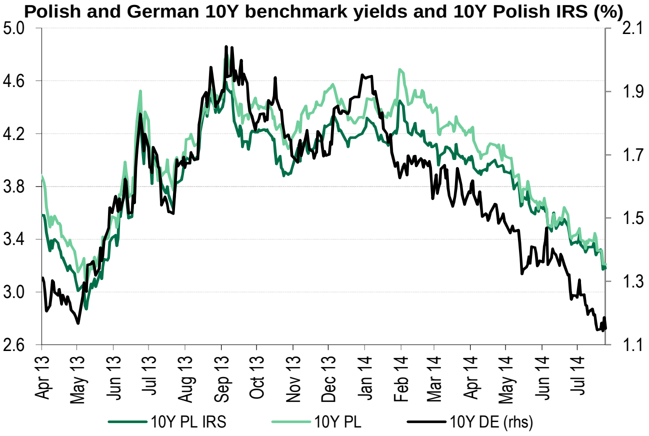
Spread between FRA and 3M WIBOR



Slope of curves (in bp)



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



Weak macro data strengthened rates cut expectations

- Last week domestic interest rate market strengthened significantly after much weaker retail sales data. Strengthening on core markets and very good results of local auction also supported the market. IRS and FRA rates and bond yields declined by 2bp-13bp. FRA market is pricing-in rate reduction by 25bp in 3 month times and approximately by 50bp in 6 to 9 months horizon (with probability 85%). Meanwhile, WIBOR has remained unchanged except of 3M rate which declined by 1bp. After a strong rally there was a temporary correction. The curves moved up under influence of core markets – yields of the US-Treasuries and German bonds rose after better than forecast macro data. At the end of the week, markets once again strengthened.
- As a consequence of changes that occurred on interest rates market last week T-bond yields and IRS rates at short-end reached new historical lows (2.38% and 2.43%, respectively) while mid-end and long-end reached the lowest level this year. Moreover, as we mentioned last week weaker retail sales data contributed to spread narrowing between 5Y IRS and WIBOR6M, which declined to 3bp (the lowest level since May 2013). Furthermore, spread over Bunds also narrowed and for 10Y bonds it reached the lowest level since June 2013.

Situation on core markets still important

- Correction on core markets observed at the end of last week was only short-lived. It came from still alive risk factors (Ukraine, the Middle East). This week is full of interesting economic references, including macro data releases from both the euro zone and the US and FOMC meeting (August 29-30). It seems that Fed will keep official rates unchanged and continues reduction in monthly purchases at the same pace as in previous months. Expected by us better readings from both European and American economies might result in correction on core markets, which consequently influence valuation on domestic curves, in particular on mid and long ends. Consequently, a bear steepener may develop on the domestic market.
- The front end of curves should remain relatively stable. Strong expectations on interest rate cuts later this year may limit yields/rates growth as mood on core market deteriorates.

The 2014 gross borrowing needs are nearly fully financed

- Market environment (strengthening on core markets, weak domestic retail sales data) and funds inflow from OK0714 maturity and interest rate payments from T-bonds of series PS/DS/WZ (cPLN10.5bn in total) supported the last (before one month break) auction in July. Thanks to high recorded demand (around PLN20bn in total) the Ministry of finance sold 5Y benchmark PS0719 worth cPLN4.8bn with average yield of 2.793% and WZ0119 worth cPLN1.2bn. Auction prices were higher than on secondary market, which supported investors' mood during Wednesday's session.
- In July Poland's Ministry of Finance sold T-bonds worth PLN8.4bn in total. It accounts for 56% of total issuance plan for 3Q14. After July's auction the Ministry has covered nearly all this year borrowing needs. Limited supply of T-bonds in upcoming months should support domestic debt 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.