Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

4 – 10 August 2014

Despite quite thin calendar of data releases, the last week of July was very important and interesting one as regards the perspectives of economy and financial markets. First of all, the USA and EU decided to impose "phase three" sanctions on Russia in response to escalating fights in Eastern Ukraine. Broader than expected set of economic and financial restrictions deepened worries about their potential impact on the European economy, especially that Russia warned about retaliatory actions (including a rise in energy prices), and in case of Poland has even started such moves (ban on export of fruits and vegetables). Secondly, much better than expected data from the USA, together with slightly more hawkish tone of the FOMC triggered a wave of risk aversion and correction in emerging markets, due to worries about possible earlier interest rate hike from Fed. Third of all, manufacturing PMI index for Poland, i.e. the first important hint about economic situation in Poland in the third quarter, has clearly disappointed, falling below 50. This is yet another indicator fuelling doubts about how deep and how persistent will be economic slowdown in Poland.

Given lack of domestic data releases and events (the Monetary Policy Council is on vacation in August), developments in the first week of August will be probably driven by events abroad. Investors will be awaiting results of the ECB meeting, but we are expecting no important changes in monetary policy stance, given its already dovish bias. Now the ECB will wait with major decisions until effects of TLTRO, scheduled for September, are known, especially given recent more optimistic information about economic and loan activity in Europe. After recent surprises in the US data, sentiments will strongly depend on further statistics from the US economy, influencing expectations about timing of the first rate hike.

Economic calendar

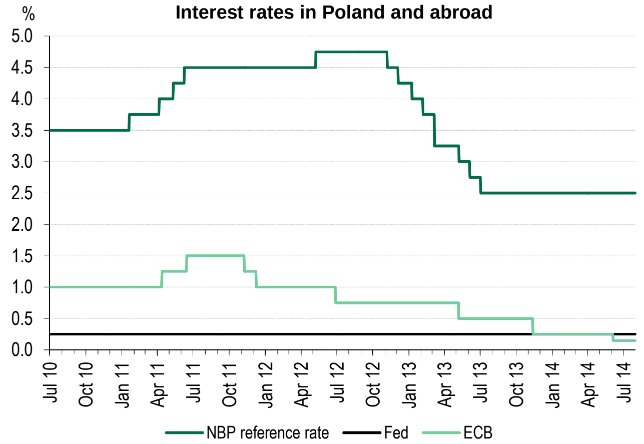
CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (4 August)					
		Lack of important macro releases					
		TUESDAY (5 August)					
9:55	DE	PMI – services	Jul	pts	56.6	-	54.6
10:00	EZ	PMI – services	Jul	pts	54.4	-	52.8
16:00	US	ISM – services	Jul	pts	56.5	-	56.0
16:00	US	Industrial orders	Jun	%MoM	0.6	-	-0.5
		WEDNESDAY (6 August)					
8:00	DE	Industrial orders	Jun	%MoM	0.5	-	-1.7
9:00	CZ	Industrial output	Jun	%YoY	8.0	-	2.5
		THURSDAY (7 August)					
8:00	DE	Industrial output	Jun	%MoM	1.3	-	-1.8
13:45	EZ	ECB decision		%	0.15	-	0.15
14:30	US	Initial jobless claims	week	k		-	302
		FRIDAY (8 August)					
8:00	DE	Exports	Jun	%MoM	1.3	-	-1.1

Source: BZ WBK, Reuters, Bloomberg

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

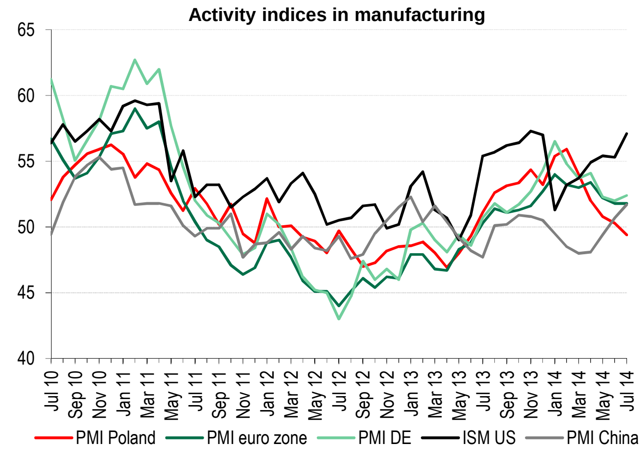
TREASURY SERVICES:
Poznań +48 61 856 5814/30
Warszawa +48 22 586 8320/38
Wrocław +48 71 369 9400

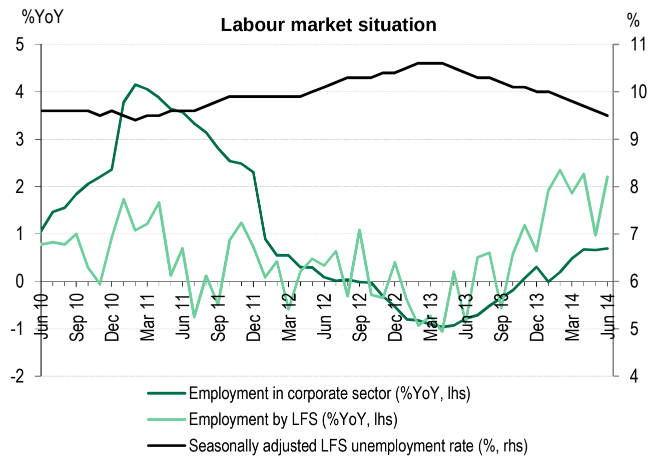
What's hot this week – Focus on events abroad



- Given lack of domestic data releases and events (the Monetary Policy Council is on vacation in August), developments in the first week of August will be probably driven by foreign events.
- Investors will be awaiting results of the ECB meeting, but we are expecting no important changes in monetary policy stance, given its already dovish bias. Now the ECB will wait with major decisions until effects of TLTRO, scheduled for September, are known, especially given more optimistic information about economic and loan activity in Europe.
- After recent surprises in the US data, sentiments will strongly depend on further statistics from the US economy, influencing expectations about timing of the first rate hike.

Last week in the economy – Activity in industry shrinks, but labour market is improving





- July's manufacturing PMI for Poland dropped for the fifth time in a row, to 49.4 (the lowest level in 13 months). The headline gauge was dragged lower by negative developments in four out of five components. Business climate deteriorated to large extent due to declining new orders, both total and export orders. Pace of decline of export orders accelerated and was the fastest since October 2012. As a result, industrial output stagnated, backlogs of work and stocks declined.
- What is interesting, activity indices for manufacturing for most other countries improved in July – an increase was posted e.g. by indicators for the Czech Republic, Hungary, Russia, Germany and China. European Commission's Economic Sentiment Index for the euro zone also improved. However, we worry that announcement of new sanctions against Russia will undermine sentiment indices in the upcoming months.
- Rise of employment index was the only positive surprise in July's PMI report, showing that pace of new job creation in industry was the fastest in three months.
- Continuation of the improvement on the labour market is confirmed by Eurostat data – seasonally adjusted unemployment rate in Poland according to the Labour Force Survey fell in June to 9.5%, the lowest level since April 2011. The data suggest that pace of new job creation is still running at a decent pace (number of employed increased by 2.2%YoY). Also labour market indicator calculated by the BIEC Institute, forecasting future changes in unemployment, followed its downward path, yet pace of decline decreased, suggesting that the improvement of labour market situation may be slower in the upcoming months.

Quote of the week – Slowdown came earlier and will be deeper

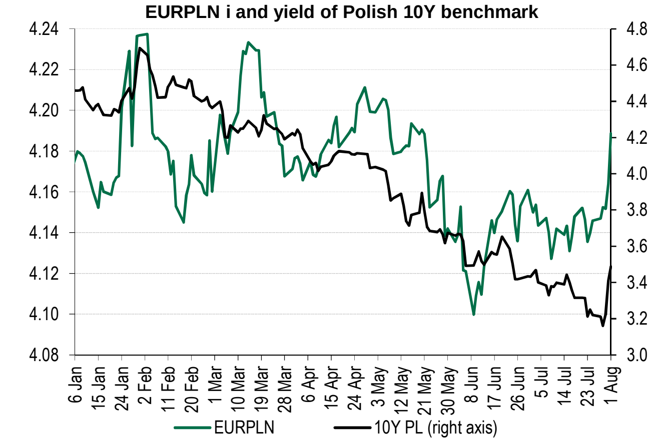
Jerzy Osiatyński, MPC member, 31.07, Wall Street Journal

Earlier I was more worried about economic growth in Q3 and Q4 than about Q2. Sadly, now it is clear that slowdown came earlier than I had expected and it will be deeper. Result between 2.8 and 3.2% in 2014 will not be surprising (…) Prospects of inflation and capacity utilization do not justify so high interest rates (…) On the other hand, too strong rate cuts bear risk of fuelling speculative bubbles on the housing and financial markets.

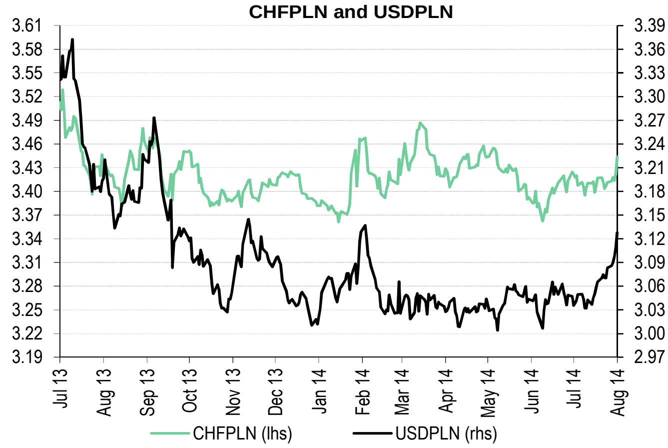
Recent worse-than-expected data from the domestic economy were surely noticed by the Monetary Policy Council members and they are likely to encourage them to think about possibility of interest rate cuts at the upcoming meeting. Recent comments of MPC members show that the Council is not eager to ease monetary policy – even Jerzy Osiatyński, in our view one of the most dovish members, is suggesting that too low rates may fuel occurrence of speculative bubbles. Prior to the upcoming meeting in September the Council will see the whole set of information for August and GDP for Q2. If data prove weak again, then interest rate cut will be taken into serious consideration.

Foreign exchange market – Emerging market currencies weakened due to higher risk aversion

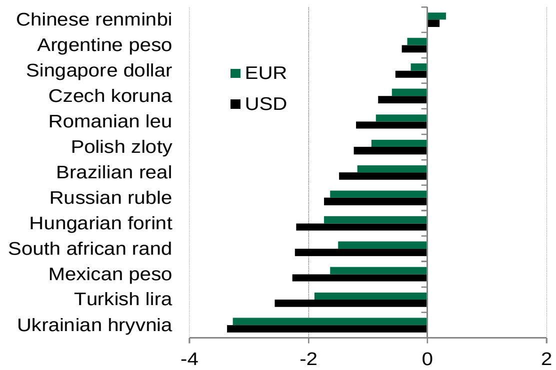
EURPLN i and yield of Polish 10Y benchmark



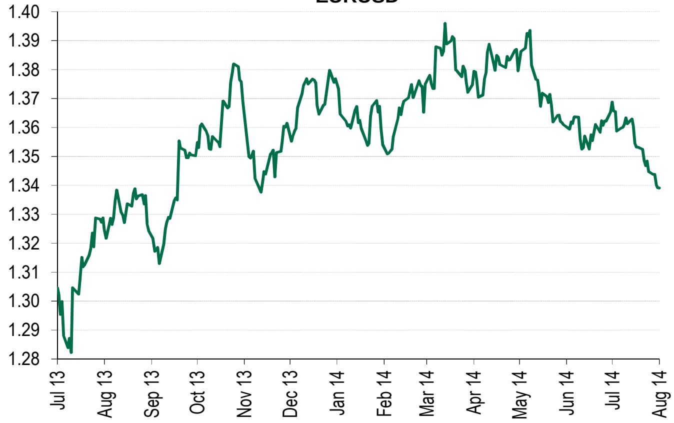
CHFPLN and USDPLN



Weekly changes of some emerging market currencies against $ and € (dated 25.07-01.08, in %)



EURUSD



Significant weakening of zloty …

- Over the past week zloty weakened significantly against the main currencies. EURPLN and USDPLN reached the highest levels since May and January, respectively. Zloty lost due to among others better than expected macro data from the USA and less dovish rhetoric of Fed after July's meeting, but also fears of economic consequences of sanctions on Russia and information about Argentina's default. Domestic currencies also weakened due to sell-off on domestic debt market (yield of 10Y benchmark reached the highest level since mid-July). Weaker than expected July PMI reading did not change situation on the zloty; temporarily EURPLN reached 4.193, while USDPLN increased above 3.13.
- At the end of the last week EURPLN broke a resistance level of consolidation channel between 4.12 and 4.17, which was valid from mid-June. The exchange rate increased temporarily towards a resistance zone between 4.19-4.20. Breaking this zone may open the door to further increase to 4.22-4.23. On the other hand calming the situation on global markets should lead EURPLN to return to consolidation channel, i.e. below 4.17.

… and other emerging market currencies

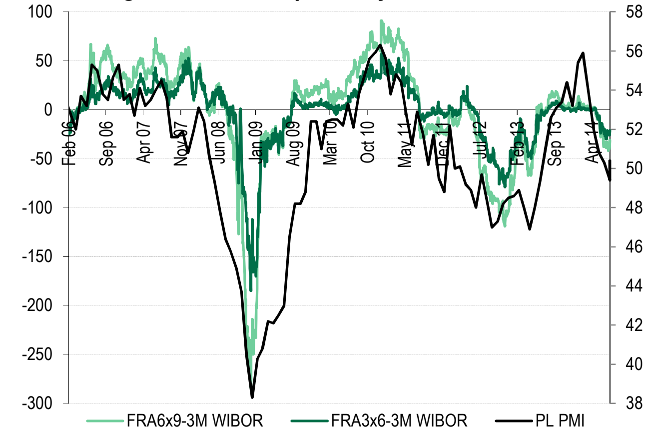
- Other emerging markets also weakened against the euro and US dollar. It came from both external (geopolitical risks, expectations that Fed starts hike rates sooner than previously predicted) and internal factors, specific for each country. For example Russian ruble lost due to extension of sanctions for this country from the US and the UE, which suggest significant worsening of Russian economy outlook. The Czech koruna weakening (which in previous weeks was relatively resistant from global mood deterioration) resulted from the CNB's decision. In July's statement the Czech central bank said that it "will not discontinue the use of the exchange rate as a monetary policy instrument before 2016" (it clearly suggests higher than predicted extension of keeping EURCZK at 27). Better readings of July PMI for Russia, Czech Republic and Hungary supported currencies of these countries in short run.
- In monthly terms the Hungarian forint lost the most (against both euro and the US dollar) among CEE universe, while the Czech koruna lost the less (see chart beside).
- This week emerging markets currencies will be under influence of global sentiment, which may change after August ECB meeting. External factors might shadow domestic data releases and their influence on each currencies should be limited.

Dollar stronger thanks to better macro data

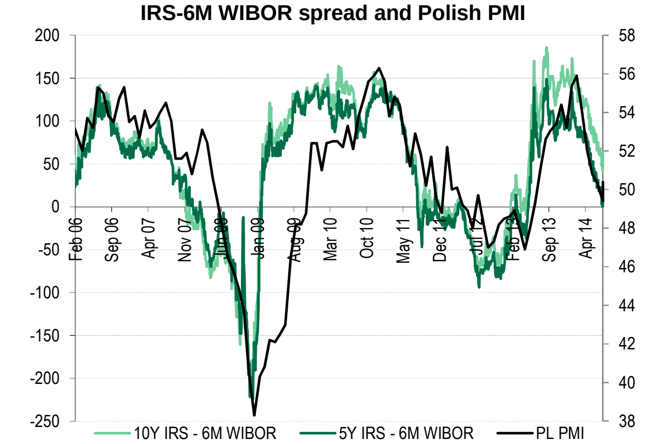
- Last week brought a continuation of downward trend in EURUSD, which broke support at 1.34 and reached almost 1.337 (the lowest level since November 2013). Impulse was provided by positive data from the US (especially by higher than expected flash GDP for Q2), which – given slightly less dovish rhetoric of the Fed (not all FOMC members are supporting keeping interest rates at current levels for an extended period after the end of QE3), encouraged investors to consider that interest rate hikes may be implemented earlier.
- Slightly weaker reading of the US labour market data (lower increase of non-farm payrolls, rise of unemployment rate) provided an impulse for a short-term correction of EURUSD. The rate climbed above 1.34 for a while but then quickly returned towards 1.339. Consolidation in 1.338-1.35 range is possible while awaiting the ECB decision. Similarly as the market, we are expecting no major surprises from the ECB, despite slightly weaker flash HICP for July. This can summon a horizontal trend, unless data from Germany surprise to the upside.

Interest rate market – ECB rhetoric will rather not trigger a recovery

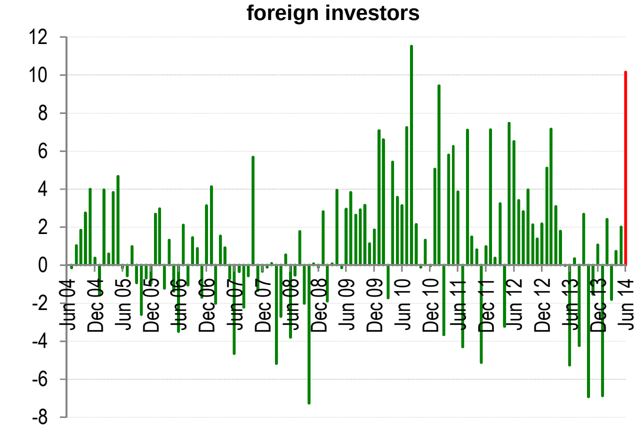
Change of 3M WIBOR priced by FRA and Polish PMI



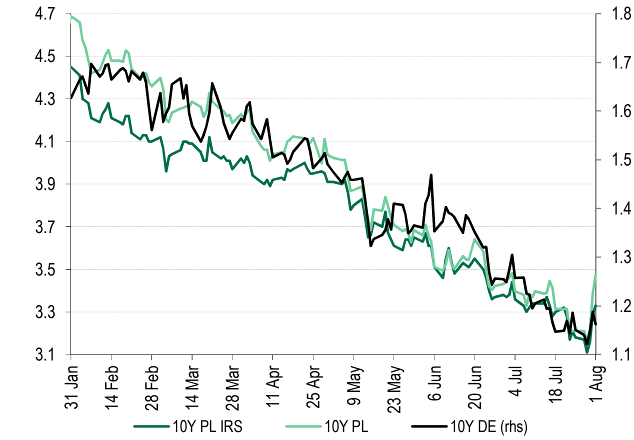
IRS-6M WIBOR spread and Polish PMI



Monthly change of Polish marketable bonds held by foreign investors



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



Sudden surge of IRS and bond yields…

- The past week was very volatile in the domestic interest rate market. IRS and bond yields continued to drop significantly following an appreciation of the 10Y Bunds to record levels. Surprisingly strong US advance 2Q GDP data and hawkish remarks in the FOMC statement triggered a global correction, which hit also Polish market. IRS and bond yields surged by 10-35bp during three sessions and the trade volume in the debt market was very high. Longer FRA rates also increased, but still price-in the decline of 3M WIBOR in next 3-6 months. Among 1-12M WIBIOR rates, the longest dropped by 1bp last week.
- The Ministry of Finance released data showing that in June the nonresidents purchased Polish marketable, zloty-denominated bonds for nominal value of PLN10.2bn. This was the biggest monthly inflow since August 2010. As a result, the foreign investors' portfolio is now close to PLN200bn, highest since September 2013. In June, the nonresidents focused on the PS and DS series. Biggest purchases were recorded in the case of PS0719 (nearly PLN2bn) and PS0718 (nearly PLN1.5bn). The biggest purchases within a group of nonresidents were made by investment funds and banks. Given the geographical criteria, bonds worth PLN3.4bn were bought by investors from the euro zone. In the whole second quarter, nonresidents purchased debt worth nearly PLN13bn, most aggressive buying since 1Q13 when bond for PLN15bn were bought. In 1H14 nonresidents purchased bonds worth PLN6.6bn. Domestic investors reduced their holdings by nearly PLN5.2bn in June and PLN4.5bn of this amount was due to domestic commercial banks selling (first outflow after 5 consecutive months of buying). Banks sold bond from mid and long end of the curve – mainly WZ0115 (over PLN5bn) and PS0718 (nearly PLN1.5bn) In whole 1H14, Polish banks bought bonds worth PLN20.7bn.
- In line with earlier suggestions, the Ministry of Finance announced that there will be no debt auctions in August. Director of the Debt Department, Piotr Marczak, said that covering the 2014 borrowing needs has nearly ended and it will be fully completed after the holidays when the Ministry plans to take a loans from the international institutions.

… and the ECB is rather unlikely to reverse this trend

- This week investors' attention is likely to switch to Europe and will focus on the German data and the outcome of the ECB meeting. PMI indexes rebounded in July in the majority of countries, but the inflation eased slightly further (according to the flash data). We do not think this data will encourage the ECB to change the message meaningfully so the readiness to take further actions (like bond buying) will rather not be underlined stronger than in the previous months. Given the recent hawkish signals from the US, the unchanged rhetoric from the ECB shall rather not support Polish bonds and will not drag IRS lower. It seems that only data due next week – July's CPI and fast estimate of 2Q GDP – may trigger more visible recovery. The annual CPI will drop below zero and the pace of the economic growth will fade compared to 1Q and this may strengthen expectations for rate cuts in Poland. IRS and bond yields may retreat from recent peaks after this data.

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.