Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

11 – 17 August 2014

The elevated volatility seen at the turn of July-August has continued also during recent sessions. Strong fluctuations were fuelled by weak data from Europe (Germany and Italy in particular), further positive surprises from the US and an increased geopolitical risk (mutual sanctions imposed by Russia and the West, an approval for intervention in Iraq from President Obama). As a result, EM currencies (including the zloty) depreciated and intraday changes of Polish IRS rates and bond yields exceeded 10bp.

Macro calendar is full of important data publications so the fluctuations in the markets can stay high. German ZEW index will show if manufacturing PMI for July was something more than a temporary rebound and flash GDP will indicate how strong was the slowdown of economic growth in Europe during 2Q14. Apart from external factors, data from Poland can have an impact on the zloty and domestic interest rate market. We expect data to show deflation in July and slower pace of the GDP growth in 2Q14 which should be enough to sustain market expectations of rate cuts in Poland later this year. In recent weeks the negative impact of expectations of monetary policy easing on the zloty was smoothed out by the inflow of foreign capital into the Polish debt market. We expect this relationship to be maintained in the coming days.

Economic calendar

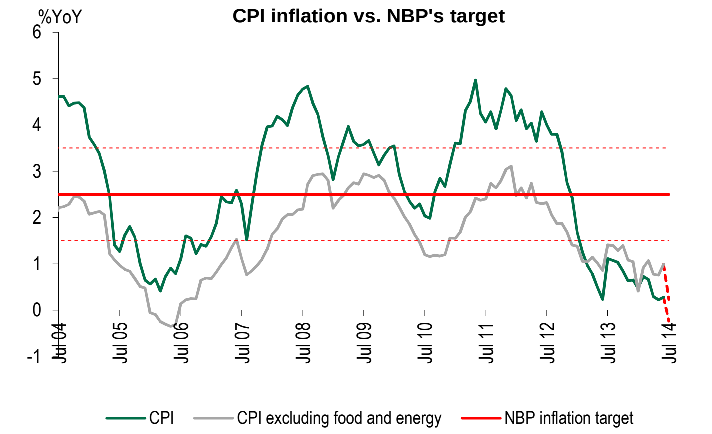
CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (11 August)					
9:00	CZ	CPI	Jul	%YoY	0.3	-	0.0
		TUESDAY (12 August)					
9:00	HU	CPI	Aug	%YoY	-0.1	-	-0.3
11:00	DE	ZEW index	Aug	pts	57.0	-	61.8
		WEDNESDAY (13 August)					
11:00	EZ	Industrial output	Jun	%MoM	0.4	-	-1.1
14:00	**PL**	**CPI**	**Jul**	**%YoY**	**-0.2**	**-0.2**	**0.3**
14:00	**PL**	**Exports**	**Jun**	**€m**	**13 751**	**13 933**	**13 642**
14:00	**PL**	**Imports**	**Jun**	**€m**	**13 387**	**13 332**	**13 467**
14:00	**PL**	**Current account**	**Jun**	**€m**	**-249**	**-157**	**280**
14:30	US	Retail sales ex autos	Jul	%MoM	0.4	-	0.4
		THURSDAY (14 August)					
8:00	DE	Flash GDP	Q2	%YoY	1.4	-	2.5
9:00	HU	Flash GDP	Q2	%YoY	3.4	-	3.5
9:00	CZ	Flash GDP	Q2	%YoY	3.0	-	2.9
10:00	**PL**	**Flash GDP**	**Q2**	**%YoY**	**3.2**	**3.1**	**3.4**
11:00	EZ	Flash GDP	Q2	%YoY	0.6	-	0.9
11:00	EZ	HICP	Jul	%YoY	0.4	-	0.5
14:00	**PL**	**Core inflation**	**Jul**	**%YoY**	**0.4**	**0.2**	**1.0**
14:00	**PL**	**Money supply**	**Jul**	**%YoY**	**5.5**	**5.7**	**5.2**
14:30	US	Initial jobless claims	week	k	-	-	289
		FRIDAY (15 August)					
	PL	**Market holiday**					
15:15	US	Industrial output	Jul	%MoM	0.3	-	0.2
15:55	US	Flash Michigan	Aug	pts	82.5	-	81.8

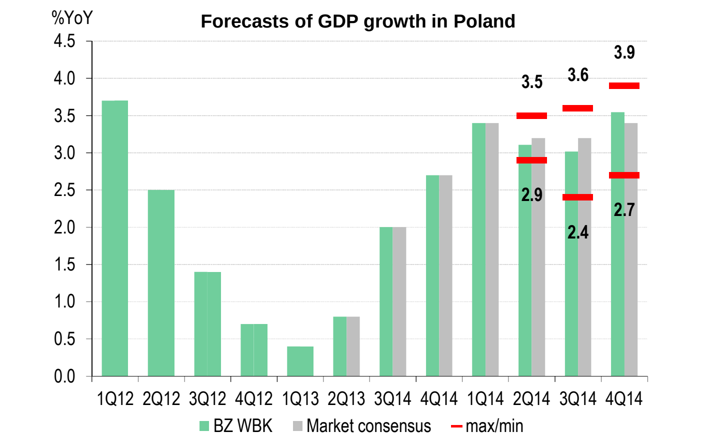
Source: BZ WBK, Reuters, Bloomberg

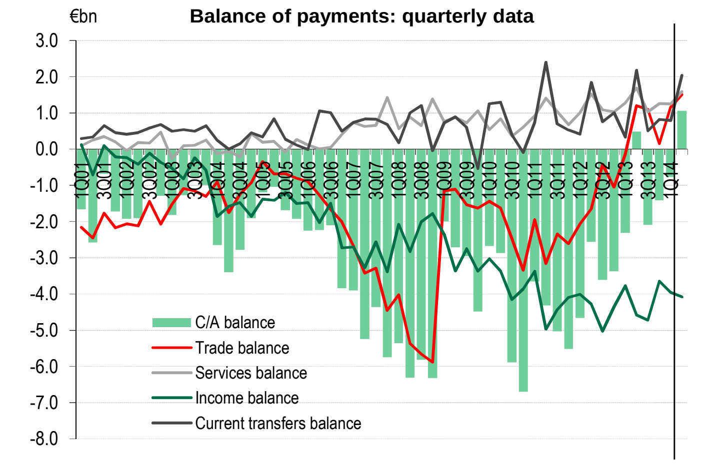
ECONOMIC ANALYSIS DEPARTMENT:
ul. Marszałkowska 142. 00-061 Warszawa fax +48 22 586 83 40
email: ekonomia@bzwbk.pl Web site: http://www.bzwbk.pl
Maciej Reluga (Chief Economist) +48 22 534 18 88
Piotr Bielski +48 22 534 18 87
Agnieszka Decewicz +48 22 534 18 86
Marcin Luziński +48 22 534 18 85
Marcin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







- The release of July's CPI inflation data is likely to be important for the market sentiment. We expect the annual CPI dropped below 0% last month, for the first time in history. Our forecast (-0.2%YoY) is in line with the consensus. We expect deflation to be only a temporary phenomenon (probably a two-month long, although sanctions imposed by Russia on Polish vegetables and fruits may extend this period). We expect the core inflation after excluding food and energy prices plunged to 0.2%YoY from 1.0%YoY.
- Next to the CPI, flash estimate of 2Q GDP will be the most awaited publication this week. Disappointing macro data (PMI, industrial output, retail sales) released in May and June hint that pace of the economic growth has slowed down in 2Q vs. 1Q. However, we anticipate the GDP still expanded slightly more than by 3%.
- In our opinion, the first monthly data for 3Q14 will be more important, indicating whether the economy is decelerating further or not. It is true that the recent extension of economic and financial sanctions against Russia by the EU and US generates additional risk for the economic recovery in Europe and in Poland, but we still believe that after a temporary soft patch in 2Q-3Q14, Poland will start growing faster again, with GDP expanding by 3.3% in 2014E.
- We expect a current account deficit in June mainly due to the deeper (when compared to previous months) income deficit and noticeably lower current transfers surplus. Our forecast at -€157mn is above the Bloomberg survey median at -€249mn.
- In our view, the trade surplus was recorded in June for the sixth consecutive month. This was mainly thanks to still strong exports (growing 2.1%MoM and 9.1%YoY). We forecast a slowdown in imports by 1%MoM but this still means annual growth by 9.3% (due to the low base effect).
- If our forecasts materialize, then 2Q shows a C/A surplus at over €1bn (best result since data is available). Rolling 12-month C/A deficit may narrow to 0.8% of GDP from c1% at the end of 1Q.
- We expect the M3 money supply grew by 5.7%YoY (vs. 5.2%YoY in June). Regarding main components, we expect growth in deposits by 6.4%YoY (stronger than in the previous months). Positive trends should also be sustained in the money creation components. In our opinion, loans pace of growth reached 5.8%YoY.

Quote of the week – Will Polish GDP grow 0.6pp less due to Russian sanctions?

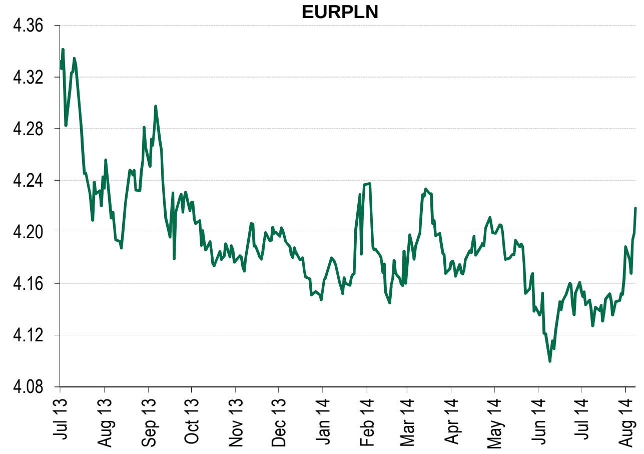
Janusz Piechociński, deputy PM and minister of economy, August 1-5, Polish Press Agency

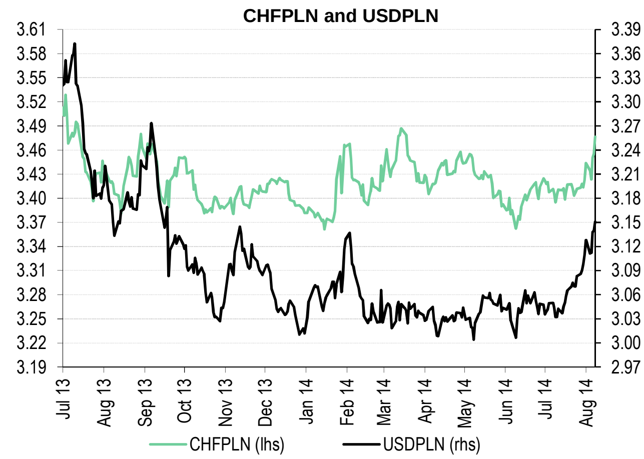
Answering the question asked by "Rzeczpospolita" about the cost of sanctions imposed on Russia for Polish economy Piechociński said: 0.6% till the end of the year. Presently, we experience a decline of exports to Russian and Ukrainian markets by 7% and 26-29%, respectively. Second half of the year will strengthen and solidify the trend.

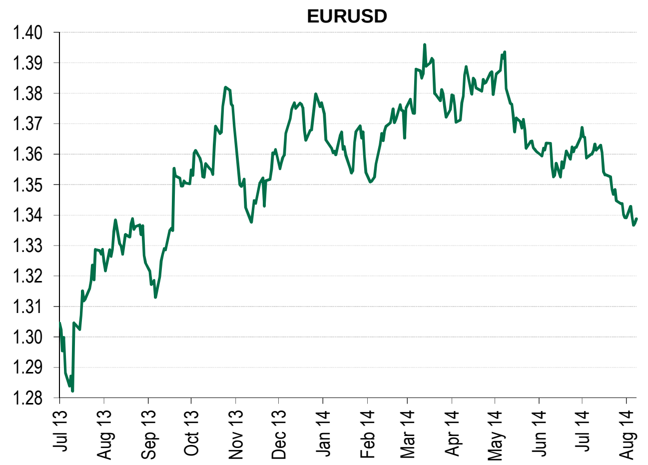
If not the situation in Ukraine, Polish economy could grow by 3.5%, exports could reach $170bn and trade surplus might have been recorded this year. We should be all aware, that due to the crisis in Ukraine, there may be no economic recovery in Europe. The crisis in the east will have a significant impact on the Polish GDP this year. According to my estimates, growth will be 0.5-0.6pp lower.

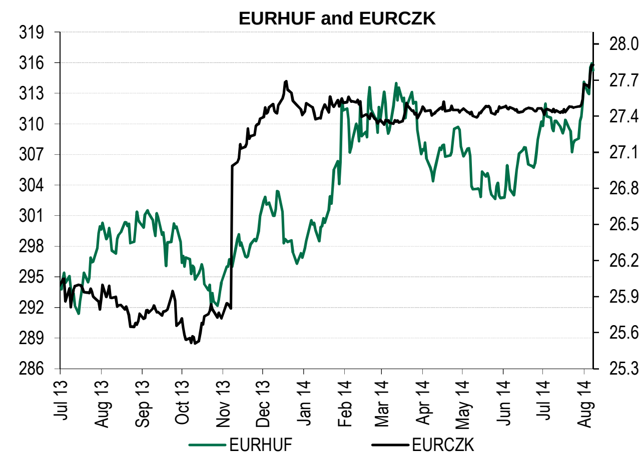
Economic effects of sanctions imposed on Russia by the US and EU and Russia's embargo on Polish fruits and vegetables are difficult to estimate. Data concerning foreign trade after 5 months indicate that the decline in exports to Russia and Ukraine is smoothed out by the growth of exports to the Eurozone (more than 11%YoY). Taking into consideration calculations of Ministry of Economy (drop of exports to Russia and Ukraine by 20% and 40%YoY, respectively) we estimate economic slowdown caused by sanctions to be around 0.4-0.6% this year and it can grow up to 0.65-1.15% next year. Our GDP growth forecast in 2014 (3.3%YoY) includes sanctions' effects only partly. Data on the 2Q14 GDP growth can be the factor that will induce us to revise our forecast of GDP growth in Poland in 2014 and 2015 if they deviate significantly from our expectations.

Foreign exchange market – Geopolitics and data crucial









Zloty under pressure of external factors again

- Last five sessions saw a significant further weakening of the zloty. The domestic currency suffered a depreciation for already second consecutive week vs. the euro, Swiss franc, British pound and already fourth week vs. the dollar. EURPLN broke 4.22, CHFPLN 3.48 and GBPPLN 5.31 (its highest since September 2012). Most important factor weighing on the zloty was rising geopolitical tensions (Ukraine, Iraq). At the end of the week EURPLN plunged to 4.19, it was rumored that Polish state owned BGK bank was active in the market.
- Since June, when the ECB cut interest rates and EURPLN reached 4.09 (its lowest since April 2013), the exchange rate stays in the upward trend. Currently, the zloty is fifth weakest currency vs. the euro in the EM universe (only Ukraine hryvnia, Russian ruble, forint and Chilean peso perform worse).
- Coming days may be also quite volatile. Crucial data are due to be released in Europe – German ZEW index and flash 2Q GDP for the European countries. The market is aware that quarterly numbers will show a deceleration from 1Q and the scale of this slowdown will be key. The statement from the last ECB meeting showed that the central bank has intensified preparations for its asset buying program. In our view, even if this week's publications disappoint, then the market sentiment may actually not deteriorate much given the investors' faith in the ECB and other central banks' ability to provide support when needed. Thus, the recent dovish ECB rhetoric is a chance for the zloty to pare at least part of losses. Developments in the market may be also determined by the risk of BGK intervention if the zloty depreciates too fast. The domestic currency might be also supported by the current account data (we expect lower deficit than the market). However, it seems that foreign factors will remain core drivers of the zloty with geopolitics playing the main role. Vital levels for EURPLN are resistance at 4.23 and support at 4.16.

EURUSD relatively stable

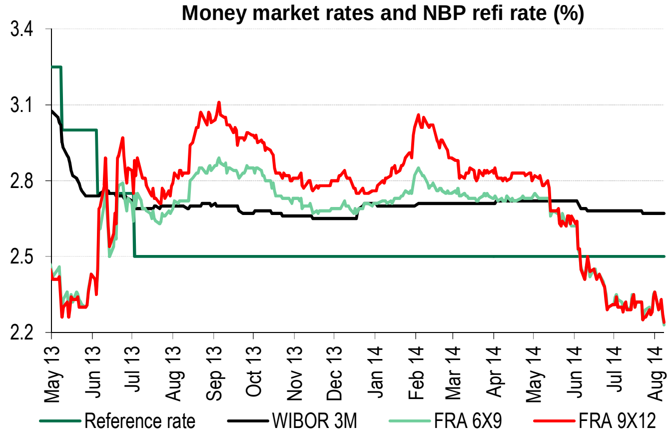
- While the global stock indexes were falling heavily, 10Y German bond yields were reaching fresh record lows and EM currencies were under significant pressure, EURUSD remained relatively stable. The euro depreciated slightly vs. the dollar (EURUSD reached 1.333, its lowest since November 2013), but the pace of changes was low. The single currency was under the pressure mainly due to disappointing German macro data and the ECB rhetoric. The statement pointed to the intensified preparations for the QE program and that US and the euro zone monetary policy will remain divergent for a several years.
- The exchange rate did not show a noticeable reaction to higher tensions in Ukraine or Middle East. If the European data disappoint, then expectations for more ECB actions may strengthen – particularly after recent hints on higher pace of works on the bond buying program – and hit the euro vs. the dollar.

Forint, ruble and even koruna under pressure

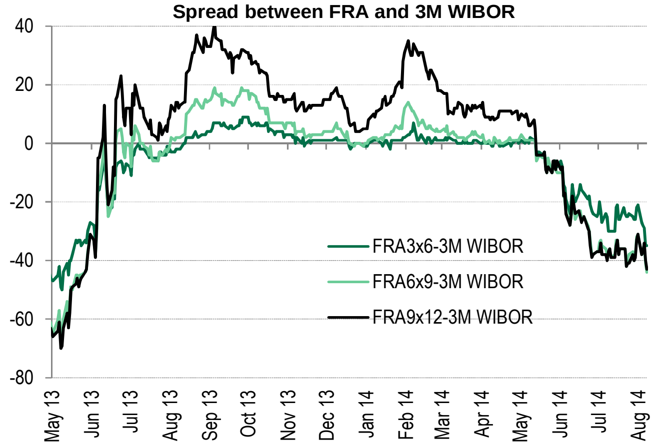
- Substantial depreciation was recorded also in the case of forint, ruble and even Czech koruna. EURHUF surged to 317 from 312.5 and USDRUB reached 36.55 (highest since March and only slightly below its all-time high at 36.73). The koruna started to weaken already in the previous week, but recent days brought a more visible move of EURCZK – it reached 28 (its highest since March 2009). So far, EURCZK was stable around 27.4 since November 2013 when the Czech central bank has introduced a floor for the exchange rate at 27.0.
- This week data on the July CPI are due in Hungary and Czech Republic. However, it seems that regional factors – related to the situation in Ukraine – will be still most important for the forint, koruna and ruble.

Interest rate market – High volatility may continue

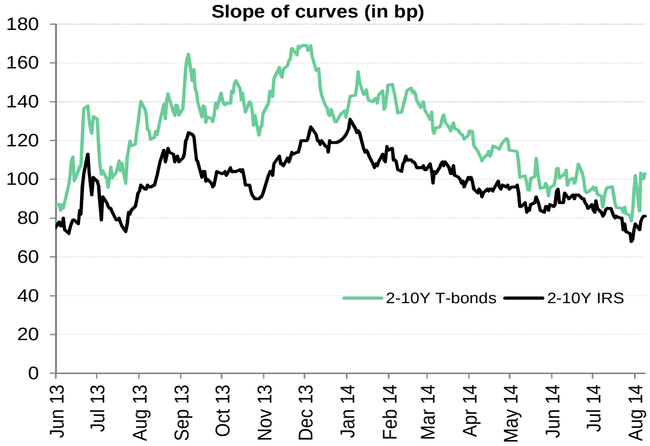
Money market rates and NBP refi rate (%)



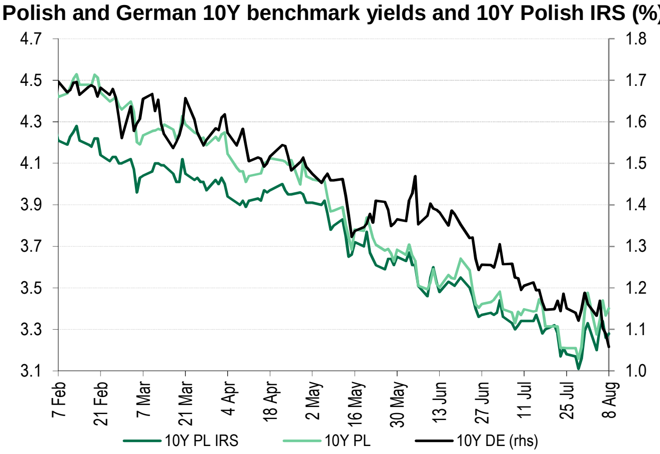
Spread between FRA and 3M WIBOR



Slope of curves (in bp)



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



WIBORs remained stable …

- Last week WIBOR rates remained stable, while the FRA rates followed changes in the IRS and T-bond markets. Expectations of interest rate cuts in coming months strengthened, and what is more, market is pricing-in deeper decline in WIBOR3M in 3 months' time than previously. FRA3x6 declined towards 2.30% versus 2.46% at the end of the previous week.
- This week calendar is full of domestic macro data releases, including July's CPI inflation and flash 2Q14 GDP. In our opinion, current FRAs levels pricing–in deflation in summer months (starting from July) and slowdown in 2Q GDP growth (it is widely expected). Therefore, only considerable deviation from the market consensus might cause more significant market reaction to these data. We think that investors' activity will significantly decrease at the end of the week due to long weekend in Poland (Polish market is closed on Friday).

High volatility of bonds and IRS

- The past week in the domestic interest rate market was quite volatile. At the beginning of the week a strong recovery was recorded after decline at the July/August turn. Following days brought intraday changes of 10bp in the middle and in the end of the curve while the short ends of both curves were relatively stable. Expectations of monetary policy easing anchored the short ends of the curves near current levels. As a result, after a significant flattening at the beginning of the week, 2-10Y spreads returned above 100bp for bonds and 80bp for IRS in the following days.
- The factor driving significant changes in T-bond and IRS markets was German bonds. Due to the recent elevated geopolitical risk German debt was purchased aggressively and the 10Y bond yields fell to nearly 1% at the end of the week (its lowest level in history). On the other hand, weak data from the Eurozone's peripheries (Italy in particular) initiated a strong correction. Yields of Italian and Spanish 10Y bonds surged above 2.7% and up to 2.5%, respectively (the highest level since the mid-July in the both cases).

Moods under influence of macro data and core markets

- We expect high volatility to stay in the market this week, mainly in the mid and long end of the curves because of high geopolitical risk. In our opinion the beginning of the coming week should bring a rebound in the case of both domestic curves. The strength of this recovery will be determined by the situation in the core markets. We would like to recall that there is a high positive correlation between both IRS and bond yields and German 10Y benchmark. Thus, any decrease in geopolitical risk can cause a correction in the German debt market (after recent strong consolidation). However, we think that it will be rather short-run.
- Before the long weekend, publications of the domestic macro data (mainly GDP and inflation) will stay in focus. We think the data will not influence market expectations of future monetary policy (deflation and slower GDP growth has already been priced in), anchoring the short end near the present level. The consolidation of expectations for the rate cuts can activate demand from foreign investors (they focus mainly in mid and long end of the curve) what could lead to the 2-10Y spread narrowing.

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.