

WEEKLY ECONOMIC UPDATE

18 – 24 August 2014

Although the data published in Poland last week were not surprising (negative 12 CPI in July, moderate GDP slowdown in Q2), we think the balance of risks for growth/inflation in the following months/quarters has recently changed. This is mostly due to sanctions imposed by Russia on food products from EU (or the conflict in Ukraine in general), as well as due to weaker economic data releases in core European countries, particularly Germany. In the last few quarters a deceleration of Polish exports to Russia/Ukraine was offset by growth to EU market, but this will be more challenging in future and at the same time the decrease of exports to Eastern economic partners intensifies. Therefore, this is not surprising that Polish bond and swap curves moved downward last week. The zloty is a bit stronger than a week ago, but geopolitical risks still remain.

This week the Polish market will be driven by three group of events: next data releases with industrial production in focus, the Jackson Hole conference with possible hints on future Fed's policy, and finally a continuation of geopolitical risks in Ukraine. The Polish data will be important to assess whether the MPC might deliver interest rate cut already in September or they would prefer to wait until November's projection for a confirmation that economic scenario has really changed.

Economic calendar

Time CET	COUNTRY	INDICATOR	PERIOD	FORECAST		LAST VALUE	
				MARKET	BZWBK		
MONDAY (18 August)							
No important releases							
TUESDAY (19 August)							
14:00	PL	Wages in corporate sector	Jul	%YoY	3.8	4.0	3.5
14:00	PL	Employment in corporate sector	Jul	%YoY	0.8	0.8	0.7
14:30	US	CPI	Jul	%MoM	0.1	-	0.3
14:30	US	Building permits	Jul	k	1000	-	973
14:30	US	House starts	Jul	k	970	-	893
WEDNESDAY (20 August)							
8:00	DE	PPI	Jul	%YoY	-	-	-0.7
14:00	PL	Industrial output	Jul	%YoY	2.0	2.9	1.7
14:00	PL	Construction and assembly output	Jul	%YoY	5.3	5.2	8.0
14:00	PL	PPI	Jul	%YoY	-1.8	-1.8	-1.7
20:00	US	FOMC minutes					
THURSDAY (21 August)							
3:45	CN	Flash PMI for manufacturing	Aug	pts.	-	-	51.7
9:30	DE	Flash PMI for manufacturing	Aug	pts.	-	-	52.4
10:00	EZ	Flash PMI for manufacturing	Aug	pts.	51.6	-	51.8
14:00	PL	MPC minutes					
14:30	US	Initial jobless claims	week	k	-	-	289
16:00	US	Conference Board index	Jul	%	0.6	-	0.3
16:00	US	Home sales	Jul	m	5.00	-	5.04
16:00	US	Philadelphia Fed	Aug	pts.	18.0	-	23.9
	US	Jackson Hole conference (21-23 August)					
FRIDAY (22 August)							
14:00	PL	CSO business climate indices					

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

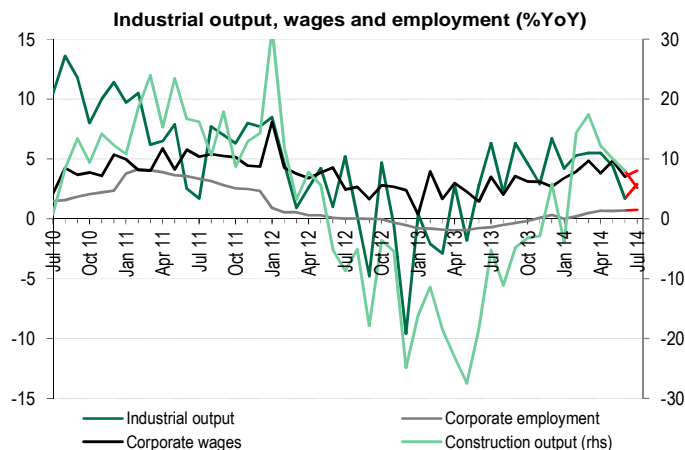
Marcin Sulewski +48 22 534 18 84

TREASURY SERVICES:

Poznań +48 61 856 5814/30

Warszawa +48 22 586 8320/38

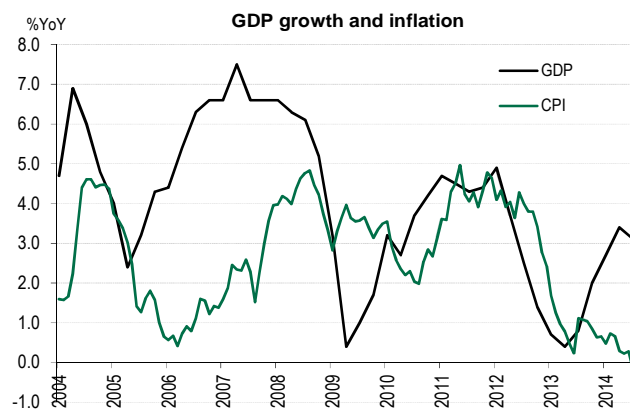
Wrocław +48 71 369 9400

What's hot this week – Key data on output and on the labour market

July's industrial output data will be one of the key indicators, affecting market interest rate expectations. We forecast a slight acceleration of domestic industrial output as compared to June, but its growth rate will remain rather low, confirming that the domestic economy was decelerating further at the beginning of Q3 amid weaker export growth (lower demand from main trading partners). Still, our forecast is above the consensus, so its realisation may trim market expectations on interest rate cuts.

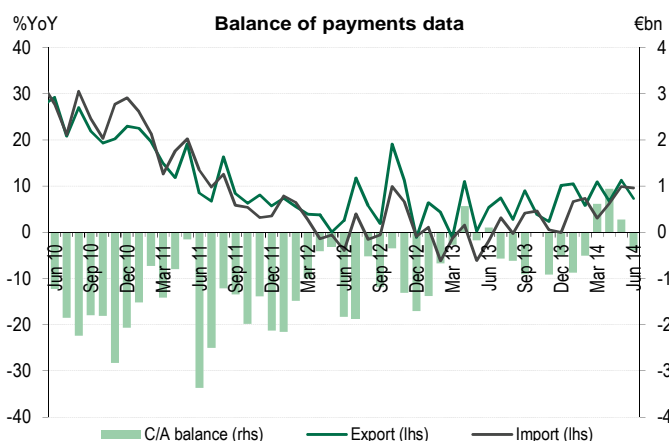
We are expecting a deceleration of construction output in July, mainly under impact of the base effect.

In our view, July's labour market statistics will be still positive, showing an acceleration of both employment and wages. Good labour market situation will be supportive for growth of private consumption in Q3.

Last week in the economy – Deflation for the first time in history, decent GDP and exports

12M CPI inflation in July was negative for the first time in history, at -0.2%YoY. Decline of prices resulted from positive supply shocks (fall of food and fuel prices by 1-2%YoY). Because of sanctions imposed by Russia the oversupply of food on the domestic market (and European) will last in upcoming months, prolonging period of deflation for a few months. The CPI path for 2015 will also decline as a result.

GDP growth slowed to 3.2%YoY in 2Q from 3.4% in 1Q. We do not know detailed data yet but suspect the slowdown resulted from weak tendencies in exports and investments. The third quarter will most likely show growth on similar level and the economic acceleration that we expected for the following quarters may not occur because of the sanctions and worse situation in Germany. Growth in 2015 can be nearer to 3% than to 4%.



The Polish exports equalled €13.7mn (+7.3%YoY) and imports €13.4mn (+9.6%YoY). Growth of exports was quite decent, whereas imports showed almost a two-digit growth rate, suggesting still healthy growth of the domestic demand.

Lowering of exports dynamics in comparison to May (11.5%YoY) resulted mainly from decline of exports to Russia and Ukraine. Such a development was widely expected, more important, however, is what was happening on western markets. The recently released CSO data on Polish foreign trade in H1 suggested that exports to these countries slowed down considerably in June, but exact statistics will be released later. Confirmation that exports to main markets are slowing down would be a strong indication that the soft patch in the Polish economy may last for a longer time.

Quote of the week – Should we fear weaker zloty?

Andrzej Kaźmierczak, MPC member, 13.08, Bloomberg

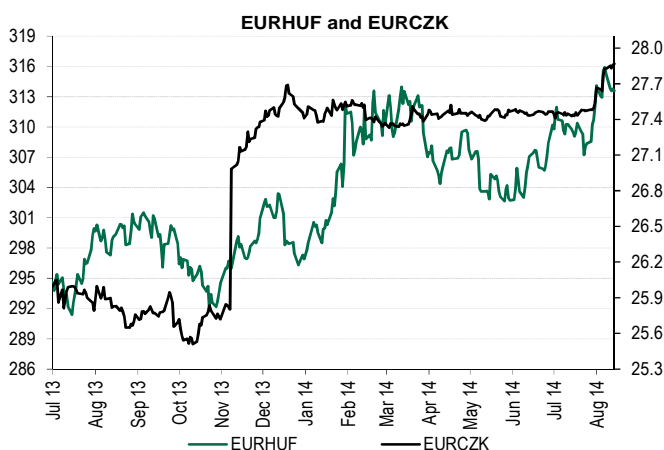
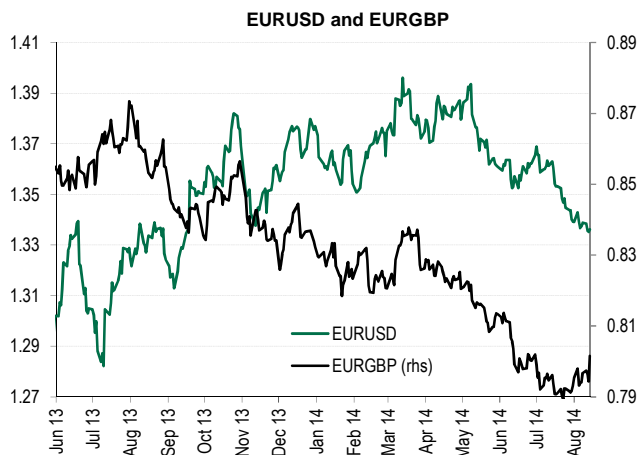
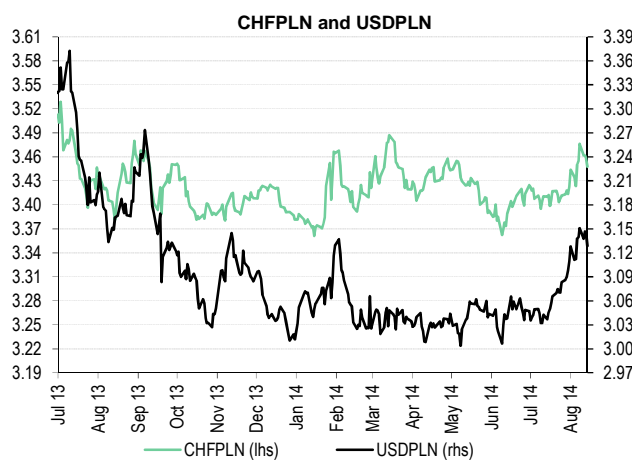
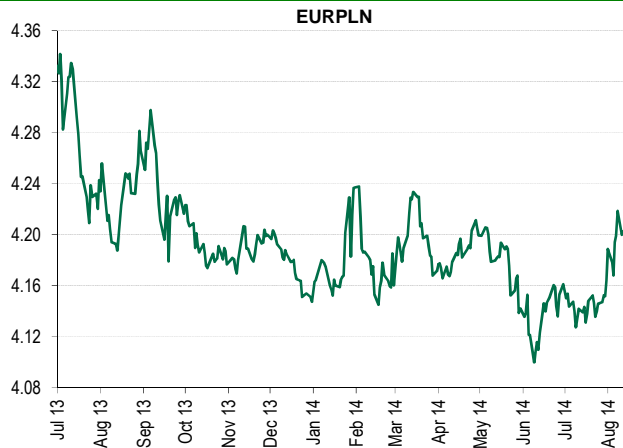
GDP slowdown is a fact and now we should wait for Q3 data in order to see if it will be prolonged (...) Zloty's behaviour given higher uncertainty in Ukraine is crucial, as risk on emerging debt markets increased and this can cause an outflow of capital. This should make us very cautious when making decision on rates. In my opinion, the zloty exchange rate calls for maintaining Poland-euro zone interest rate disparity.

Elżbieta Chojna-Duch, MPC member, 14.08, Reuters and 13.08, PAP

Current relatively high rates can extend deflation beyond 2014. Keeping rates at current high level is unjustified (...) Data on GDP will be crucial. We have one month to analyse. I will try to convince other MPC members to take an action adequate to current macroeconomic conditions, i.e. to ease the monetary policy. But there is a question if we are not late already.

Under impact of latest data and Russian sanctions, the expected inflation and economic growth paths in Poland slid lower, which in turn is translating into higher risk of interest rate cut. Discussion on this matter is almost certain in September, but it is possible that given quite good data on GDP in Q2, the Council will wait with decisions until November, when new inflation projection will be released and more information concerning Q3 will be known. Andrzej Kaźmierczak's worries that too low interest rates can trigger a sell-off of the zloty seem unjustified, in our view. Escalation of conflict in the East and/or hawkish signals from the Fed can undermine the zloty. But isn't it what we need amid weakening economy and no inflation?

Foreign exchange market – Moderate zloty recovery, geopolitical factors still crucial



Data supported the zloty

During the previous week the zloty was under pressure of geopolitical factors (Ukraine, Iraq, Middle East). Uncertainty as regards intention of Russian humanitarian help for Ukraine (there exist worries it can become a pretext for intervention) and weak data from Germany (ZEW Index below expectations) caused a temporary increase of EURPLN to 4.2125. However, improvement of moods and good macro data for Poland (still decent exports YoY dynamics, only slight slowdown of GDP in 2Q) gave an impulse for zloty's appreciation and EURPLN fell below 4.18.

The zloty temporarily appreciated against the US dollar down to 3.12 because of weak retail sales in the US, which gave EURUSD an impulse to a sharp increase above 1.34. Moreover, a significant depreciation of the British pound made GBPPLN fall down to 5.21 from 5.30 (weekly maximum).

This week zloty's quotation will remain under influence of data from the domestic market (labour market, industrial production). Disappointing data concerning PMI in July suggests that there is a downside risk for our industrial production forecast. In the case of another negative surprise, strengthening expectations for rates cuts might be an impulse for EURPLN to move towards 4.19. Depreciation of the zloty could be partly offset by inflow of capital on the domestic debt market.

EURUSD in a horizontal trend, sharp pound's weakening

Last week EURUSD fluctuated in a quite narrow range 1.3335-1.3415. For the majority of the time the rate was remaining under 1.34 and only weak data from the US made EURUSD fall to 1.334.

Definitely much more interesting situation was visible in the case of British pound. The British currency started depreciating after the BoE had highlighted it will not hurry to raise interest rates, emphasizing that recent pound's increase does not support building UK's economic potential. As a result, GBPUSD fell to 1.6668 – the lowest level since mid of April.

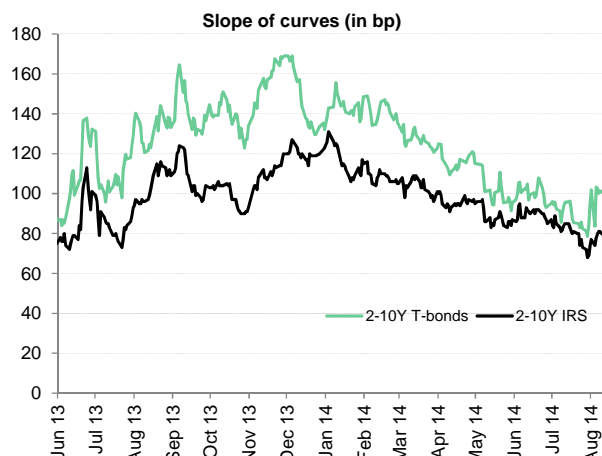
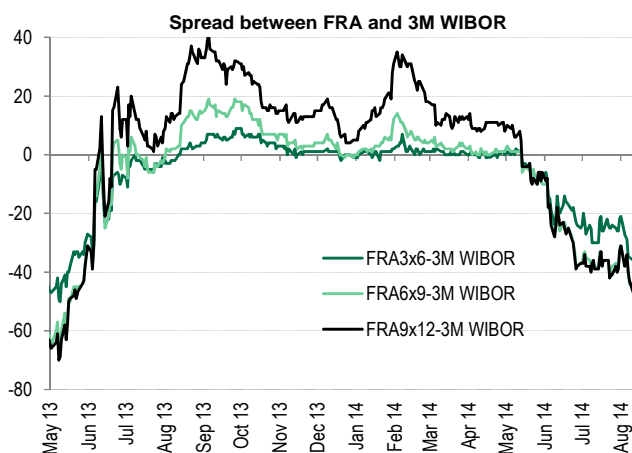
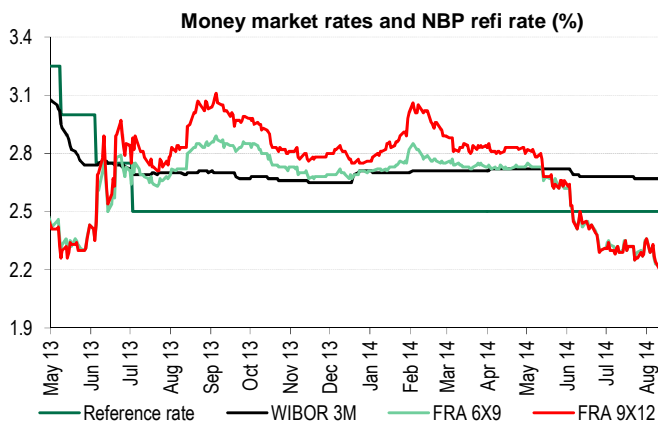
Weakening prospects for the euro zone and relatively good data from the US can hold EURUSD in 1.333-1.344 fluctuation band also next week. We think the rate should stabilise near the mid of the range. Flash industrial PMI data for the euro zone economy should confirm the continuation of slowdown in 3Q. Apart from that, FOMC members' speeches in Jackson Hole can add some volatility to EURUSD. However, we do not expect the rate to leave this range.

CEE currencies under influence of domestic factors

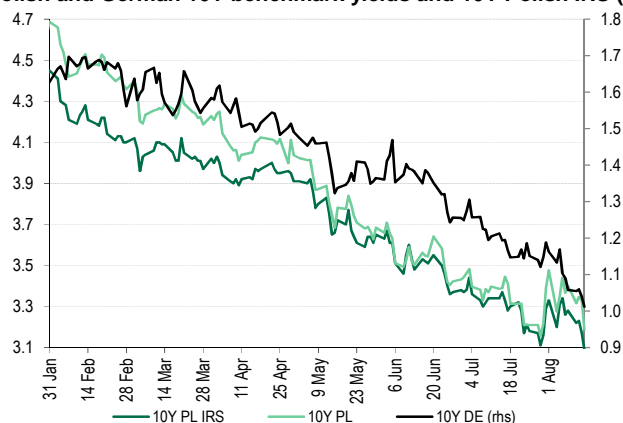
Similarly to the zloty, other currencies in the region appreciated last week as a result of improvement of moods on global markets. The better-than-forecasted Hungarian GDP in 2Q gave an impulse for decline of EURHUF down to 312 after earlier growth to almost 315. EURCZK rose sharply to 27.94 after weak GDP release, but it returned to 27.8, which is an important support for the exchange rate. USD RUB fell below 36 after reaching a local maximum at 36.3.

Risk factors for emerging market currencies stay unchanged. Geopolitical risk is still high, which will negatively impact their valuations.

Interest rate market – New all-time lows



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



Expectations for swift rate cuts have strengthened

▪ Last week WIBOR 3M and 12M fell by 1bp after July's CPI readings, while other rates (1M, 6M and 9M) remained unchanged. At the same time FRAs shifted down by 2-10bp as compared with the previous week due to strengthening expectations for rates cuts later this year after CPI inflation data. Currently, market is pricing-in rate reduction by nearly 50bp in 3 months' time. What is more, FRA valuation suggests that rates will remain at low level in two-year horizon (FRA21x24 is at 2.40%).

▪ This week another set of domestic data from real economy (wages and employment in enterprise sector, industrial output) will be released, and they should underpin expectations for monetary easing in upcoming months. In our opinion, FRA rates may slightly decline this week if global mood does not deteriorate significantly.

New historic minimums at short end of the curves

▪ The previous week brought a significant consolidation on the domestic interest rate market. 2Y rates for bonds and IRS reached 2.25% and 2.34%, respectively and 10Y bonds moved close to this year's minimum, reaching temporarily 3.19%. The main support for market rates came from local macro data (CPI was negative for the first time in the history) and consolidation on core financial markets (German 10Y bonds tested 1%).

▪ The middle and the longer ends of curves gained more considerably than short ends, causing a narrowing of 2-10Y spreads both for bonds and for IRS to 93bp and 73bp, respectively. Let us note that over last weeks longer ends were prone to higher volatility due to their stronger vulnerability to geopolitical risk. As a result, investors have been easily switching between flattening and steepening strategies.

Geopolitical risks and data in focus

▪ This week investors will focus on the domestic macro data. As we have mentioned earlier, labour market and output data readings should not affect investors' expectations about future MPC's monetary policy, anchoring the shorter end of curves close to current levels (with yield of 2Y benchmark close to 2.25%).

▪ The middle and the longer end of curve will be under stronger impact of external factors. Provided there is no further escalation of conflict in Ukraine, we do not rule out that 10Y bond may break this year's minimum at 3.16% at the start of next week.

▪ As regards the longer end, apart from geopolitical factors, core markets are the main risk element. As we have been mentioning for a couple of times already, there is a strong positive correlation between yields of 10Y domestic bond and yields of 10Y German and US papers. This week we will see minutes of the July's FOMC meeting and Thursday (21 August) is the first day of Jackson Hole conference, with Fed's Governor Janet Yellen as one of main speakers. No confirmation of soon interest rate hikes by Yellen can provide an additional impulse supporting the longer ends of curves. In the case of the opposite scenario, we might see yields of 10Y climbing towards the first support at 3.30%, which is less likely.

This publication has been prepared by Bank Zachodni WBK S.A. for information purposes only. It is not an offer or solicitation for the purchase or sale of any financial instrument. Information presented in the publication is not an investment advice. All reasonable care has been taken to ensure that the information contained herein is not untrue or misleading. But no representation is made as to its accuracy or completeness. No reliance should be placed on it and no liability is accepted for any loss arising from reliance on it. Forecasts or data related to the past do not guarantee future prices of financial instruments or financial results. Bank Zachodni WBK S.A., its affiliates and any of its or their officers may be interested in any transactions, securities or commodities referred to herein. Bank Zachodni WBK S.A. or its affiliates may perform services for or solicit business from any company referred to herein. This publication is not intended for the use of private investors. Clients should contact analysts at and execute transactions through a Bank Zachodni WBK S.A. entity in their home jurisdiction unless governing law permits otherwise. Copyright and database rights protection exists in this publication.

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>.