Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

8 – 14 September 2014

Events in Ukraine and central banks' decisions had key influence on financial markets' behaviour last week. The Monetary Policy Council kept interest rates unchanged, in line with our expectations, but it has clearly signalled that a cycle of rate cuts will start next month. In turn, the European Central Bank took markets by surprise, lowering main interest rates by 10bp already in September and announcing purchases of ABS instruments and covered bonds. Both events were supportive for further strengthening of the domestic debt market, pushing yields to new all-time lows. Exchange rates were fluctuating under influence of impulses from monetary policies and geopolitical factors. Hopes for truce in Ukraine triggered a temporary appreciation of the zloty and other CEE currencies. In turn, unexpected ECB decision sharply weakened the euro versus the euro. Uncertainty regarding looming changes in the government after Donald Tusk has been elected the president of the European Council did not have significant impact on the market.

In the nearest week the number of economic data releases will be limited. Information about money supply and credit growth in August will be distorted by exchange rate fluctuations (significant zloty depreciation at the end of the month). One should take this factor into account before making too quick conclusions from the very likely acceleration of credit growth in August. Amid small number of economic data releases, investors will probably focus on other factors: possible new comments of MPC members, new information about looming government reshuffle, and events in Ukraine. Government's dismissal (which may take place at the end of the week, according to President's office) and announcement of new Prime Minister's name should not, in our view, disturb the market, even though it is highly likely that apart from the government's head also the deputy PM responsible for European Funds will leave for Brussels. More important than domestic factors may be news from Ukraine. Agreement on ceasefire between Ukraine and separatists signed on Friday will favour higher risk appetite, as long as it lasts. This, however, is not so straightforward taking into account possible reaction of Russia to new sanctions from EU and USA and to recent NATO decisions on strengthening the military presence in Central Europe.

Economic calendar

CET TIME	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (8 September)					
8:00	DE	Exports	Jul	%MoM	0.5	-	0.9
9:00	CZ	Industrial output	Jul	%YoY	6.6	-	8.1
		TUESDAY (9 September)					
9:00	CZ	CPI	Jul	%YoY	0.5	-	0.5
		WEDNESDAY (10 September)					
		No important data releases					
		THURSDAY (11 September)					
9:00	HU	CPI	Jul	%YoY	0.2	-	0.1
14:30	US	Initial jobless claims	week	k	-	-	302
		FRIDAY (12 September)					
11:00	EZ	Industrial output	Jul	%MoM	0.4	-	-0.3
14:00	**PL**	**Money supply**	**Aug**	**%YoY**	**6.3**	**6.3**	**6.2**
14:30	US	Retail sales ex autos	Aug	%MoM	0.2	-	0.1
15:55	US	Flash Michigan	Sep	pts	83.0	-	82.5

Source: BZ WBK, Reuters, Bloomberg

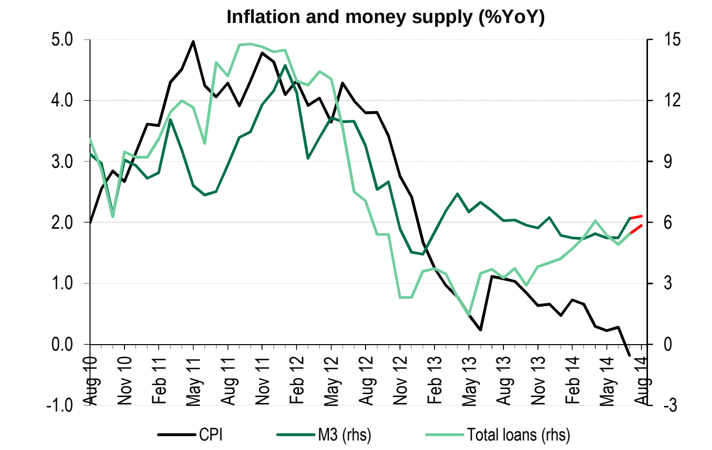
ECONOMIC ANALYSIS DEPARTMENT:
ul. Marszałkowska 142. 00-061 Warszawa fax +48 22 586 83 40
email: ekonomia@bzwbk.pl Web site: http://www.bzwbk.pl

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:

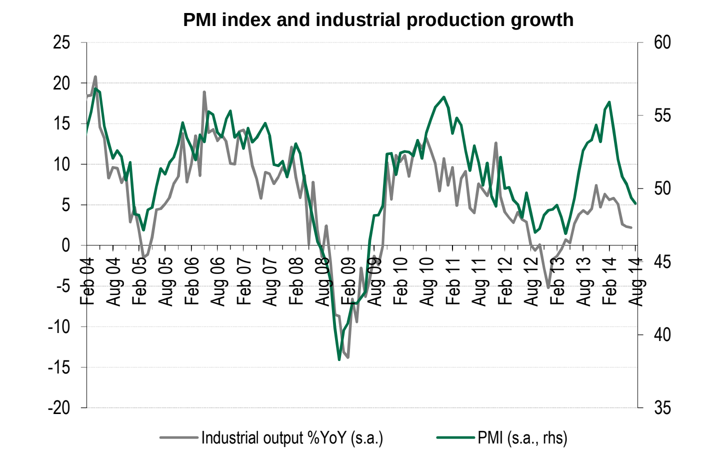
Poznań	+48 61 856 5814/30
Warszawa	+48 22 586 8320/38
Wrocław	+48 71 369 9400

What's hot this week – Data are scarce, politics in the spotlight

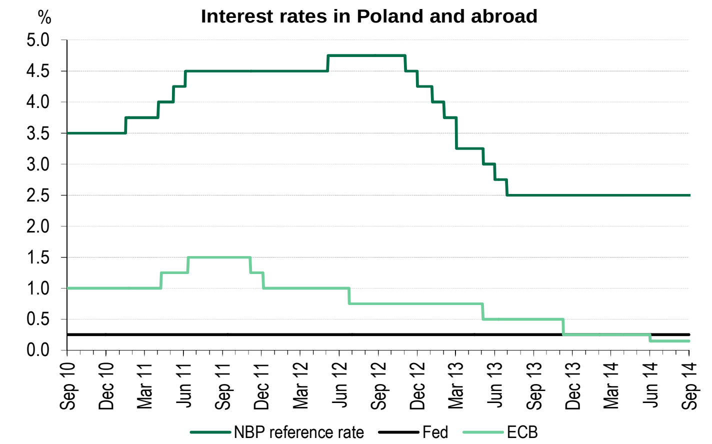


- This week is rather light as regards macro data. As regards Poland, we will only see M3 money supply for August. As for the time being, data from the banking sector have not shown any considerable impact of economic slowdown on the credit market, while growth rate of loans stabilized over the last months. Interpretation of August's data will be difficult due to strong moves of exchange rates – in one month the zloty lost over 1% vs the dollar and over 2% vs the Swiss franc, which will shift the total worth of currency loans.
- While awaiting more important data, the market will focus on information about changes in government (possible resignation of Donald Tusk and announcement of candidate for the new Prime Minister). Situation in Ukraine, the ceasefire and Russia's response to new sanctions and NATO initiatives will remain crucial.

Last week in the economy – PMI declined further, MPC suggested rate cuts



- Polish manufacturing PMI index dropped in August to 49.0 from 49.4pts in July. After six consecutive months of decline, the index is now at the lowest level since May 2013. New orders dropped in August for the 3rd consecutive month and at the fastest pace since April 2013. Export orders contracted for the 4th month in a row, Output index dropped below 50pts first time in 14 months. The Polish companies continued hiring despite clear deterioration in current and expected economic conditions, but the pace of job creation was the weakest in last 13 months. Interestingly, input prices rebounded in August and index reached above 50pts for the first time for 5 months.
- Continuation of declines of PMI indices suggests a further weakness of industrial output in the upcoming months.



- The Monetary Policy Council kept interest rates unchanged in September, in line with expectations. Shift of risk balance for the economic growth and for inflation, which was observed over the last weeks, justified an interest rate cut (even by 50bp) already in September. It seems that such voices in the MPC are still in minority, and other members wanted to see more data from the economy, confirming that the economic scenario has changed.
- The most important sentence of the communiqué states that if upcoming data confirm tendencies observed recently, then the Council "will start an adjustment of economic policy". We maintain our view that NBP interest rates will be cut by 75bp in the upcoming months.

Quote of the week – Interest rate cuts are very likely

Marek Belka, NBP president, 03.09, post-meeting MPC conference
In my view, cuts are highly probable, and this is reflected in the statement. I think that the statement does not rule out there will be more moves than one (…) After the discussion, I have an impression that we do not have to wait until projection with cuts. (…) Decisions (at the September's meeting) were not unanimous.

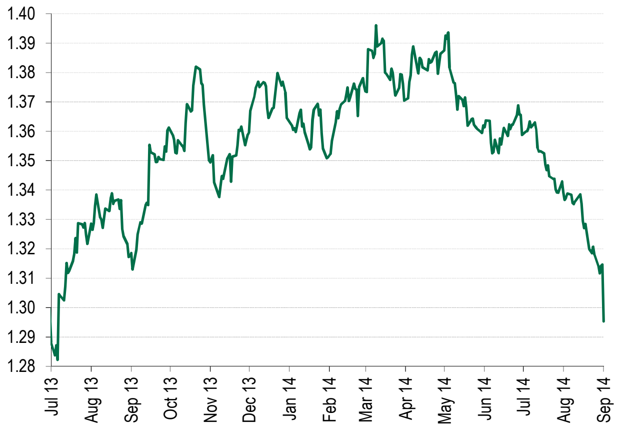
Anna Zielińska-Głębocka, MPC member, 04.09, PAP
Cut by 25bp in October and then 25bp in November is the best solution (…) Later we may think about more. At the year-end rates should be close to 2.0%.

Three anonymous MPC members, 05.09, Bloomberg
During discussion on 3 September, most members declared their support for rate cuts. The MPC is likely to cut rates by 25bp in October and November.

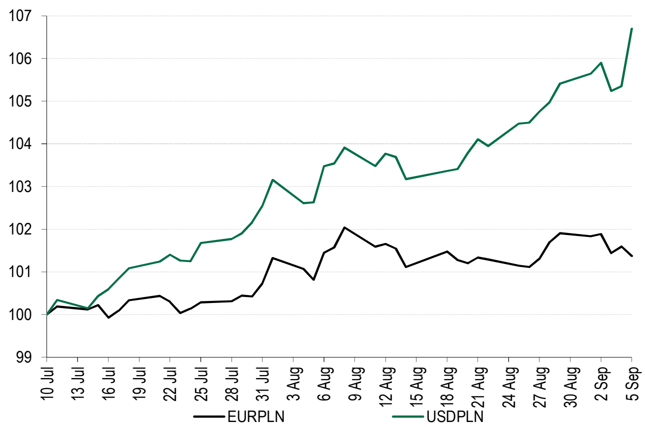
The MPC statement and comments of Marek Belka during the conference show not only that cut in October is very likely, but also this will not be a one-off move, but a start of a cycle. Unofficial comments of MPC members suggest that cuts by 25bp in October and November garnered a majority. It is difficult for us to understand, why the MPC – after agreeing that easing is necessary and justified – did not cut rates immediately and in a larger scale, but again chose a strategy of "small steps". Such a decision would negatively affect the zloty, but would support the economy, without fuelling worries about excessive rise of inflation. M. Belka noted recently that weakness of the PLN does not worry the MPC.

Foreign exchange market – Zloty may recover vs. the dollar

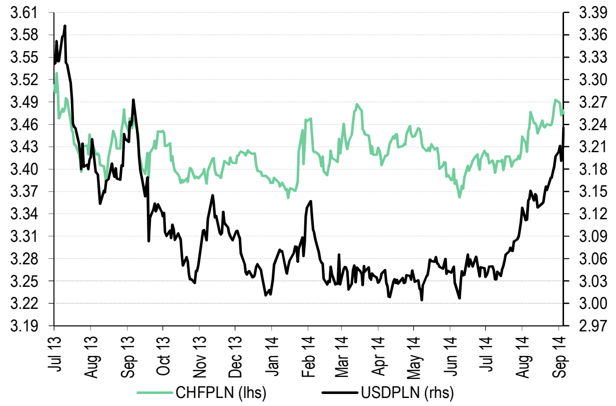
EURUSD



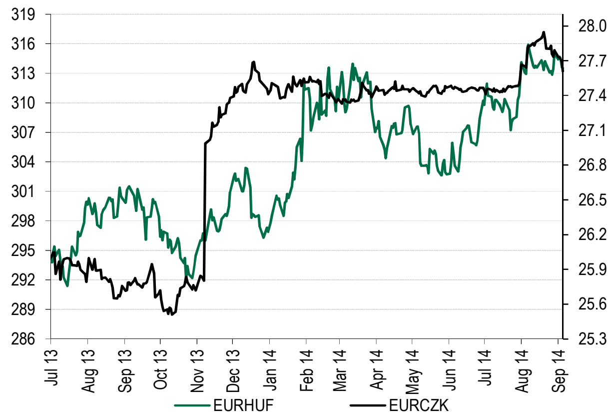
EURPLN and USDPLN (July 10 = 100)



USDPLN and CHFPLN



EURHUF and EURCZK



Dollar strongest vs. euro since July 2013

- The past week was third consecutive when the euro was depreciating vs. the dollar. EURUSD plunged to c1.29 from 1.315 after the surprising ECB decision and this was biggest daily drop since November 2011. Weekly move down was biggest since November 2013.
- In the coming days there will be much less vital macro data releases than in the previous weeks. Thus, the geopolitical factors may be in focus again. The ceasefire agreed on Friday and weaker than expected US nonfarm payrolls data may support euro's recovery after a few weeks of its significant depreciation. However, in case of conflict re-escalation the dollar may strengthen again. Important levels for EURUSD are at 1.29 and 1.317.

Zloty gains vs. the euro and depreciates vs. dollar

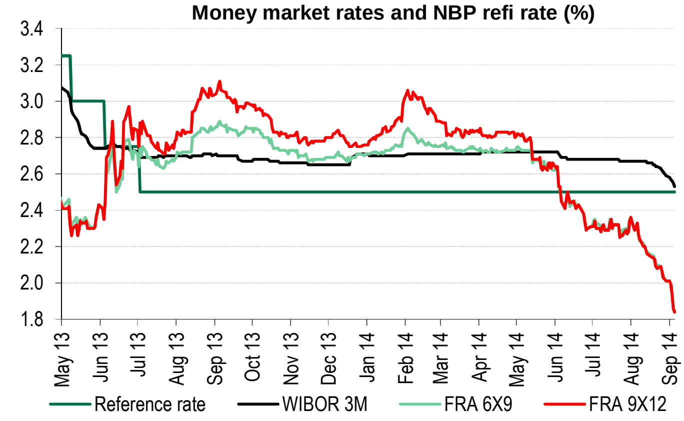
- The domestic currency ended this week stronger vs. the euro, pound and franc. However, it depreciated vs. the greenback (due to strong plunge of EURUSD). The zloty was under the positive impact of lack of a rate cut in Poland and surprising decision of the ECB. Earlier, the demand for CEE currencies was supported by hopes for a ceasefire in eastern Ukraine. Consequently, EURPLN tested support at 4.17, but did not manage to stay for longer below this level.
- The past week was eighth in a row when USDPLN was rising. Similar series was last observed in April-May 2010 (when the debt crisis was driving markets in Europe). Last week the exchange rate broke 3.24 and reached its highest for a year.
- It is worth to notice a divergence between EURPLN and USDPLN. The former increased by 1.6% while the latter by more than 5% since mid-July when the current wave of zloty's depreciation vs. the dollar started. Wider spread between paces of an upward move was last recorded in May 2013 (2% vs. 6%) when worries over QE3 tapering strengthened. USDPLN was rising then not only stronger, but also slightly longer than EURPLN. Last week the latter retreated form the recent peak at 4.23 making the current situation somewhat similar to developments from May 2013.
- This week, amid limited number of important domestic and foreign data, investors are likely to switch their attention to political issues. We do not expect changes in the Polish government to weigh significantly on the zloty. Situation in Ukraine may be more important – and whether it is heading towards stabilisation (Friday's information support hopes for that) or fights continue. Correction in the EURUSD market could support the domestic currency vs. the dollar. In the case of EURPLN, we expect the exchange rate to stay in the 4.17-4.23 horizontal trend.

No big changes in the CEE market

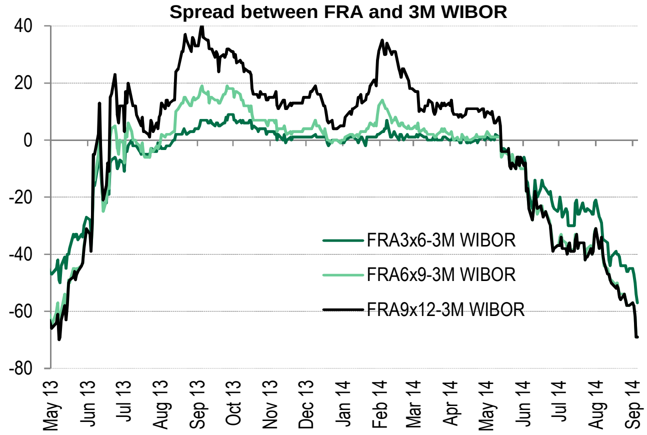
- The forint, the koruna and the ruble, similarly as the zloty, gained after the president of Ukraine announced that he negotiated a ceasefire in Eastern Ukraine with Vladimir Putin. EURHUF fell after this information to 312 (as compared to 315 last week), while USDRUB retreated from the all-time high set one day earlier (to 36.65 vs. 37.515). Kremlin's spokesperson quickly denied this information and said there is no ceasefire between Ukraine and Russia. Impact of this news on the CEE currencies, similarly as of the ECB decision, was only short-lived.
- This week we will see data on inflation in the Czech Republic and in Hungary. After 3-month deflation, ending in July, the market is expecting a further rebound in Hungarian CPI. Such a reading should be supportive for the MNB rhetoric (suspensions of interest rate cuts) and back the forint. Downward surprise in the Czech inflation, may support speculation that the Czech central bank will raise the floor for EURCZK.

Interest rate market – ECB turned on ABS, MPC on hand brake

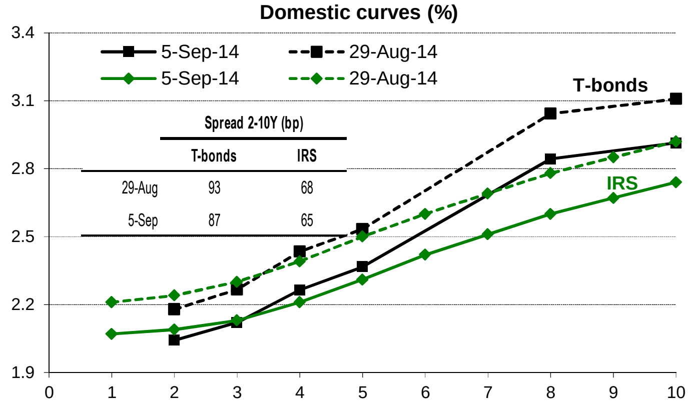
Money market rates and NBP refi rate (%)



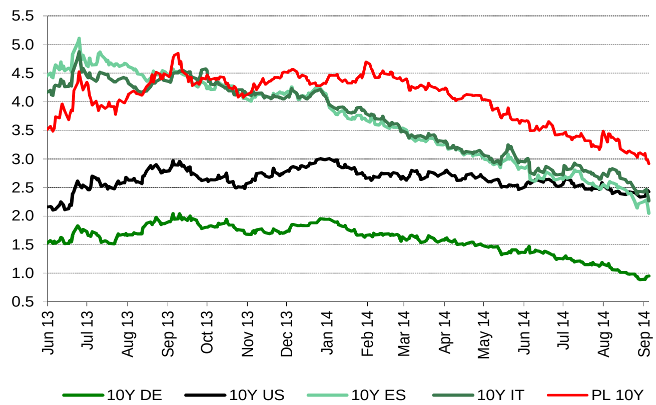
Spread between FRA and 3M WIBOR



Domestic curves (%)



10Y T-bond yields (%)



Money market strong before the rate cuts

- Over the past week money market rates declined quite considerably. Downward trend was supported by the MPC's announcement of interest rate cuts later this year (we expect three cuts by 25bp each month in 4Q). In weekly terms WIBOR rates fell by 3-10bp, with the highest decline on the long end of curve. It is worth noticing that rate of WIBOR 12M declined below the level of WIBOR 3M. Last time such situation had occurred during the cycle of monetary easing, which ended in July 2013.
- Clearly more significant adjustment to the new market conditions was recorded in the case of FRA. Rates dropped by 6-20bp, in which FRA3x6 below 2%, while FRA6x9 and FRA9x12 dropped towards 1.80%. Currently the market prices-in 50bp rate in next 3 months and next 25pb in the next quarter.
- Strong expectations for rate cuts in the coming months shall drag WIBOR rates further down while FRA should stabilize as investors wait for the next macro data.

New all-time lows after the ECB decision

- Last week we saw another wave of strengthening on the domestic interest rate market, after a short-lived correction at the end of August. Yields and IRS rates reached new all-time lows due to MPC's suggestion of cuts. Decline of yields even deepened after the ECB, which unexpectedly cut rates by 10bp and announced purchases of asset-backed securities and covered bonds. This caused a strengthening on core markets and euro zone peripheries (with 10Y Spanish and Italian yields reaching new all-time lows at 2.16% and below 2.30%, respectively). As a result, 10Y Polish yields declined to 2.90% (the lowest level ever recorded), while 10Y IRS fell slightly below 2.75%.
- During this month's only regular auction the Finance Ministry sold debt for PLN3.6bn. Roughly PLN2.6bn was collected from selling DS0725 (amid demand at nearly PLN3.7bn and yield at 3.114%) and cPLN1bn from WZ0114 (demand amounted to nearly PLN2bn). Recent data of the Finance Ministry show that non-residents held 43% of DS0715 outstanding at the end of July. Second biggest holder was Polish banking sector (34%), which held also 70% of WZ0124 outstanding. Means from this auction will be used to pre-finance gross borrowing needs for 2015, planned at PLN155bn.

Domestic politics overshadowed by core market moods

- We are expecting that the interest rate market will be still supported by expectations for interest rate cuts in Poland and by last ECB decision. Ample cheap liquidity in the euro zone will be supportive for the risk appetite and investors' search for higher yields, which should put a negative pressure on Polish bonds and cause further flattening of the curve.
- Changes on the domestic political scene can add some market volatility (especially if changes include also for example the minister of finance), but this factor remains neutral for the market. Dismissal of the government is possible at the end of the week. However, the domestic interest rate market will be more focused on changes in global risk aversion, e.g. under impact of events in Ukraine. Should the ceasefire, agreed on Friday, stay valid, we are hoping for a stabilization of yields at current low levels.

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.