Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

15 – 21 September 2014

In the first three days of the upcoming week, the most important Polish data for August will be released. The deepening of the CPI deflation and the contraction of industrial output, as predicted by us, should reinforce market expectations for an interest rate cut ahead despite the quite decent readings from the labour market. These figures could lead to the strengthening of the domestic debt market, unless prevented by some global factors, with the FOMC meeting the most important event expected abroad. Last week yields in the core debt markets surged due to rising worries that interest rate hikes in the US could be faster than had been anticipated. The tone of Fed's Yellen press conference (due Wednesday evening) may be key for validating these expectations. There are also two critical events expected on Thursday: the Scottish independence referendum and the first ECB TLTRO operation. Worries about the situation in Ukraine have slightly faded of late thanks to the ceasefire agreement but this remains an important risk factor in our view. The zloty may depreciate this week, under pressure from weak macro data out of Poland and negative news from abroad.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (15 September)					
14:00	**PL**	**CPI**	**Aug**	**%YoY**	**-0.3**	**-0.3**	**-0.2**
14:00	**PL**	**Current account**	**Jul**	**€m**	**-518**	**-431**	**-391**
14:00	**PL**	**Exports**	**Jul**	**€m**	**14 063**	**14 063**	**13 711**
14:00	**PL**	**Imports**	**Jul**	**€m**	**18 850**	**13 834**	**13 378**
15:15	US	Industrial output	Aug	%MoM	0,3	-	0.4
		TUESDAY (16 September)					
11:00	DE	ZEW index	Sep	pts	43.0	-	44.3
14:00	**PL**	**Core inflation**	**Aug**	**%YoY**	**0.4**	**0.4**	**0.4**
14:00	**PL**	**Wages in corporate sector**	**Aug**	**%YoY**	**3.8**	**4.0**	**3.5**
14:00	**PL**	**Employment in corporate sector**	**Aug**	**%YoY**	**0.8**	**0.8**	**0.8**
		WEDNESDAY (17 September)					
11:00	EZ	HICP	Aug	%YoY	0.3	-	0.3
14:00	**PL**	**Industrial output**	**Aug**	**%YoY**	**0.7**	**-0.8**	**2.3**
14:00	**PL**	**Construction and assembly output**	**Aug**	**%YoY**	**1.6**	**0.3**	**1.1**
14:00	**PL**	**PPI**	**Aug**	**%YoY**	**-1.6**	**-1.3**	**-2.0**
14:30	US	CPI	Aug	%MoM	0.0	-	0.1
20:00	US	FOMC decision					
		THURSDAY (18 September)					
11:00	**PL**	**Bond auction**					
14:00	**PL**	**MPC minutes**					
14:30	US	House starts	Aug	k	1035	-	1093
14:30	US	Building permits	Aug	k	1035	-	1052
14:30	US	Initial jobless claims	week	k	-	-	315
16:00	US	Philly Fed index	Sep	pts	22.5	-	28.0
		FRIDAY (19 September)					
		No important data releases					

Source: BZ WBK, Reuters, Bloomberg

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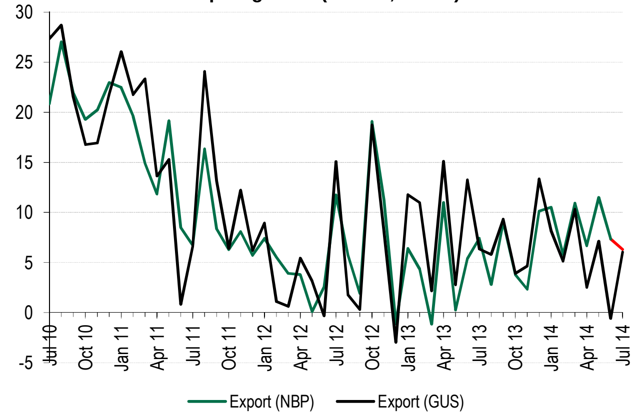
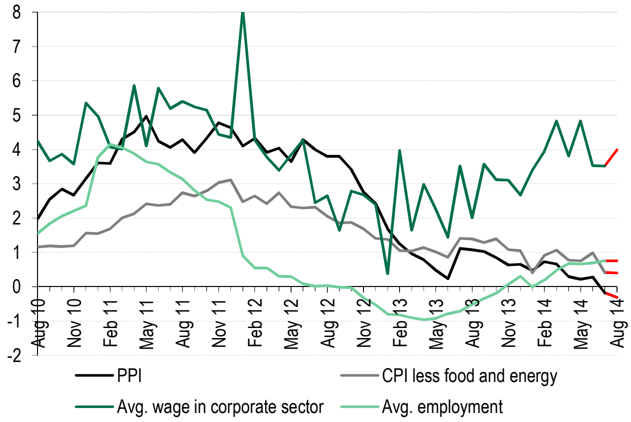
What's hot this week – New arguments for cuts

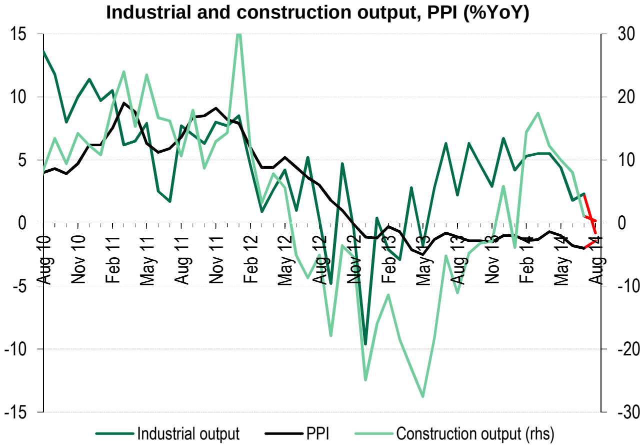
Export growth (in EUR, %YoY)



Inflation, wages and employment (%YoY)



Industrial and construction output, PPI (%YoY)



- The balance of payments data for July should show a small current account deficit and a surplus in the trade balance. Statistics office data on foreign trade, released a month earlier, came as a major surprise, showing a significant weakening of exports to European markets. But the data now shows a rebound in trade with western and central Europe, accompanied by a slight slowdown of the pace of decline of Poland's exports to Russia and Ukraine. It is also worth noting that weaker trade volumes in June, as suggested by the statistics office data, failed to be reflected in the central bank's numbers. It is difficult to say, however, if this would also be the case this time around. Nevertheless, we expect weaker exports compared with the previous months and our forecast is supported further by the slowdown in industrial output in recent months and by the decline of export orders, seen in in business climate surveys.
- Poland's CPI inflation was probably negative again in August and we expect it to stay below zero for the rest of the year before rising a bit afterwards. Overall, however, consumer inflation is to remain below the central bank's 2.5% target for at least a few more quarters to come. At the same time, we expect core inflation to be stable in August and producer prices (PPI) to rise slightly (fuelled by the weaker zloty, mostly versus the dollar). The worse economic outlook and the Russian ban on food imports from the EU are causing downward pressure on prices. The Global food price index, calculated by the FAO, fell in August to its lowest level in four years (-4%YoY). Oil prices also remain at a low level.
- The labour market is still in good shape, so we expect employment to rise further (although its annual growth rate will stay stable) and wage growth to show some acceleration in August as well. The situation on the labour market is supportive for private consumption.
- According to SAMAR (a car industry research institute), output of passenger and transport cars fell in August by 61%MoM and 37%YoY respectively. And even though August usually is a weak month for the car industry, this year's output in the sector was worse when compared with the previous years. This, in turn, could weigh on industrial output in August and supports our forecast of negative industrial output growth (-0.8%YoY) in August (with the market consensus at +0.7%YoY). The August industrial output reading will also be likely dragged lower by the negative working day effect (there was one less working day in August than a year ago). And as the central bank governor said, strong industrial output data could cause the Monetary Policy Council (MPC) to refrain from rate cuts. We do not expect this to happen though. We also expect weak results in the construction sector, which may near stagnation levels. However, upcoming months are likely to show improvement here.

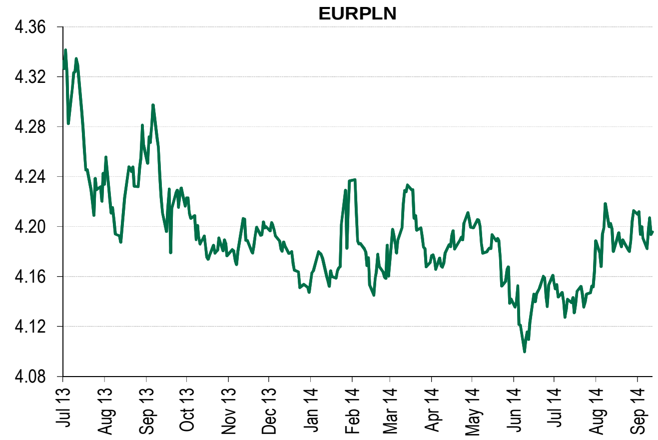
Quote of the week – The MPC will change monetary policy in October

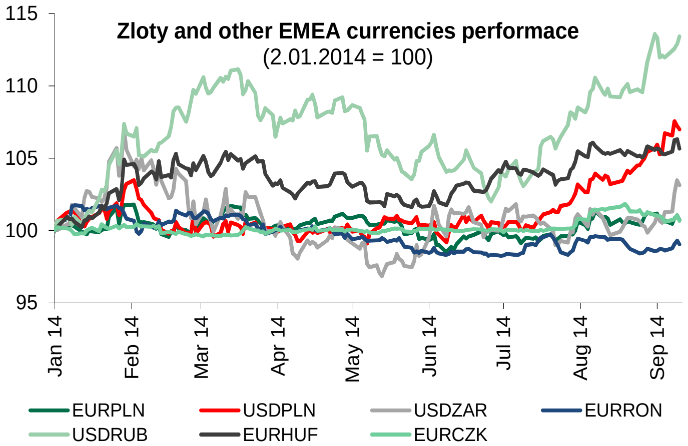
Jerzy Osiatyński, MPC member, 09.09, Reuters
I expect the MPC will not only herald change in the monetary policy in October, but will actually change it.

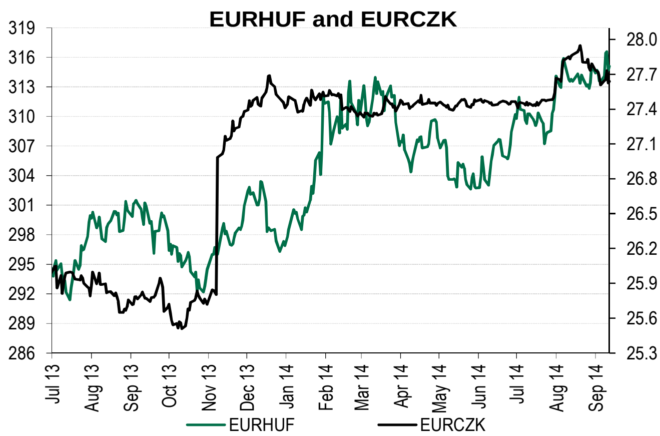
Elżbieta Chojna-Duch, MPC member, 08.09, Reuters
In my opinion the MPC should cut rates by 50bps in October. Cut by 25bps would have been more suitable in June or July. Now the MPC decision should be more decisive, also due to wider interest rate disparity vs. the euro zone.

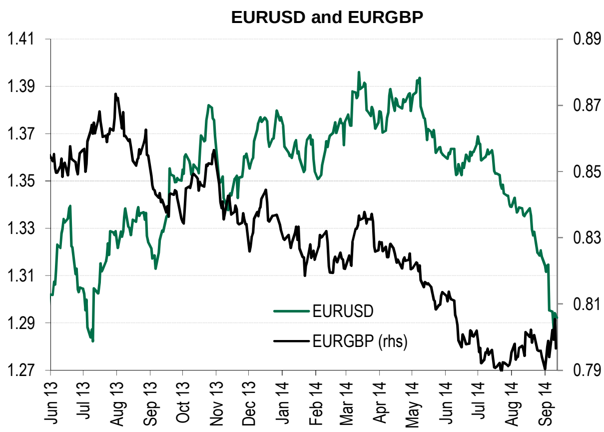
The latest comments of Elżbieta Chojna-Duch and Jerzy Osiatyński confirmed expectations that they will support a rate cut at the MPC's next policy meeting in October. These two rate-setters are the most dovish on the ten-strong Council, in our view, but we do not expect them to be alone. The motion to cut rates will probably also be backed by Anna Zielińska-Głębocka, Andrzej Bratkowski and (governor) Marek Belka. Their votes would be enough to push a rate cut through. It is important to note, however, that other Council members have recently made no comments in public about their view on rates and so it cannot be excluded that some of them could also support monetary easing in October. One way or another, Marek Belka recently said that the only way to avoid a rate cut would be if incoming data proved outstanding. And we do not expect this to happen. There is, however, also the question of how deep the rate cut could be (25 or 50bps). We believe that there will not be sufficient majority to back a larger cut than 25 bps.

Foreign exchange market – The FOMC meeting and Scottish referendum crucial for the market









Zloty and other emerging currencies under pressure

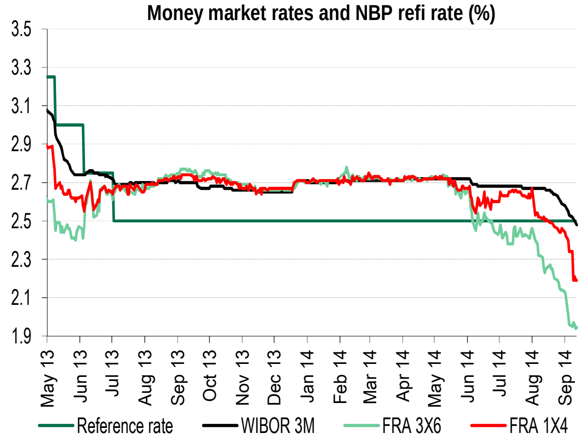
- Last week the zloty, as other emerging market currencies, lost against the main currencies due to the sell-off on the debt markets. This was caused by the San Francisco Fed's „Economic letter", which pointed out that the market was underestimating the timing and pace of rate hikes in the US economy. Consequently, the EURPLN temporarily increased to 4.217, while the news flow concerning changes in the Polish government proved more or less neutral for investors. Market reaction to further sanctions placed on Russia by the UE was also limited. At the same time, the EURHUF temporarily increased to 317 and the EURCZK to 27.7. What is more, the Hungarian forint was negatively affected by the lower-than-expected August CPI release. However, the Russian ruble lost the most among EM currencies – the USDRUB reached a fresh maximum of 37.7 as the EU confirmed it was launching further sanctions on Russia.
- This week the zloty is set to remain under pressure due to external factors, such as the FOMC meeting or the referendum in Scotland. A more hawkish rhetoric by the Fed (increase in the number of its members supporting earlier monetary tightening) could lead to the rise of EURPLN towards 4.23 – a vital resistance level. Additionally, weak domestic macro data (we expect a decline in industrial output in August) should strengthen expectations for a Polish rate cut next month, and, as a result, cause further zloty depreciation. This trend might be limited by strong foreign capital inflows on the domestic FI market, however. Technical analysis namely clearly suggest that EURPLN may increase towards 4.25 after breaking 4.23, with the strong support level at 4.17. The USDPLN could be more vulnerable to changes in investor sentiment. If our scenario materialises, and assuming the EURUSD decrease to 1.28 (or even lower), this could mean that the zloty could increase to 3.30, after breaking 3.26.
- The CEE currencies are also likely to remain under pressure from global events amidst a lack of more important local macro data releases. Just like the zloty, the forint, the koruna and other EM currencies may also depreciate when expectations for faster rate hikes in the US strengthen again – the EURHUF may then test 317 again, while the EURCZK could near 27.8.

Some recovery of the euro, but further declines possible

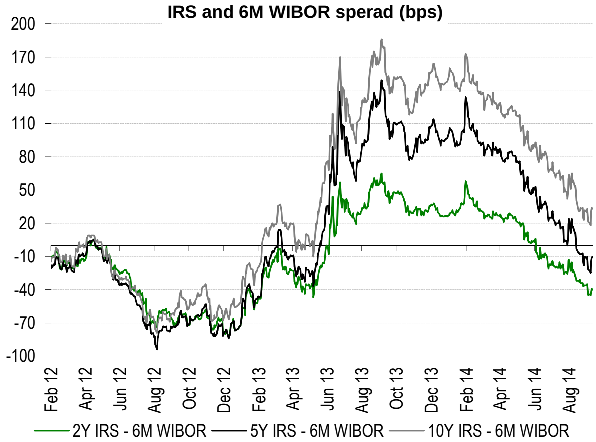
- The single currency was under pressure from incoming information from the US. Suggestions that interest rate hikes by the FOMC may take place faster than the market had expected caused a short-lived decline of the EURUSD to below 1.29 (to 1.286, the lowest level since July 2013). The single currency managed to trim some losses, but EURUSD remained in a narrow trading range between 1.29 and 1.296, awaiting the FOMC meeting, the outcome of the Scottish referendum and the first TLTRO auction by the ECB.
- We certainly have a very interesting week ahead of us. If the FOMC's decision on further tapering of its QE3 programme proves in line with expectations, investors will focus on the macro forecasts for the US and on the press conference. Signs that the FOMC members are more supportive of earlier rate hikes could cause a decline of the EURUSD and lead to testing of the strong support at 1.28-1.275. A defeat of the separatist plans in Scotland may support the euro.

Interest rate market – Polish data set to be dovish but what about the FOMC?

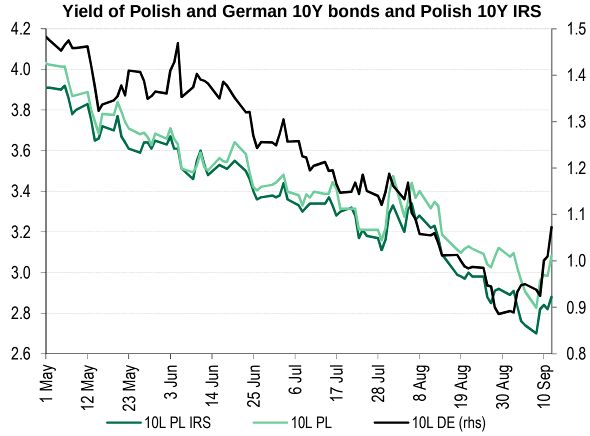
Money market rates and NBP refi rate (%)



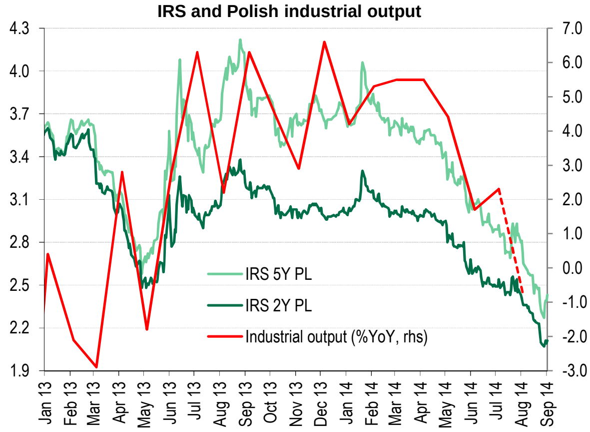
IRS and 6M WIBOR sperad (bps)



Yield of Polish and German 10Y bonds and Polish 10Y IRS



IRS and Polish industrial output



A considerable correction after signals from the Fed…

- The WIBOR rates continued their adjustment that was first initiated by news that the Monetary Policy Council (MPC) could cut interest rates in 2014. The 1M rate fell by 1bp last week, while other rates in the 3-12M segment declined by 5-6bp in the same period. The WIBOR curve is inverted, with the shorter end at 2.54%, and the longer at 2.46%. The correction on IRS and bonds caused the FRA rates to show a slight reduction of the scale of the expected rate cuts. The FRA rates continue, however, to price in a 50 bps decline in rates over the next 3-6 months.
- Last week ended the 5-week-long series of declines on the 5y bond yields and also the first significant increase of the 10y yields. Prior to the recently observed weakening, yields had fallen by c60bps in total since early August. At the same time, the yield on the2Y bond fell by c40bps. The fall on the corresponding IRS rates was similar in scale. The rise of yields and the IRS over the last week – by 12-17bps on the mid and the long-end of the curve – was triggered by the release of the San Francisco Fed Economic Letter. This caused the 10Y Bund and the Treasuries yields to climb by c10bps, with the Polish market following suit. A considerable weakening was also noted in the euro zone peripheries. The long-term Spanish and Italian bond yields rose by c15-25bps. Apart from the hawkish signals from the Fed, pressure on these assets was also high from worries that the Scottish initiative to leave the United Kingdom may encourage a similar drive in Spain. Last week saw releases of several surveys showing that most voters would back Scottish independence on September 18.
- Poland's Finance Ministry placed CHF-denominated bonds worth CHF500mn maturing in September 2021. The yield stood at 1.035% and was at its lowest since the CHF-denominated debt was first issued. Swiss institutions, mostly investment funds, insurers and banks, bought the bulk of the issue (97%).

... with Polish data clearly on the dovish side

- The coming week will see plenty of Polish macroeconomic data releases, including industrial output data for August – the most important of the bunch. Our forecast points to the first annual contraction since May 2013, which, if it ends up materialising, would be a substantial disappointment for the market (the current consensus expects industrial output to have grown on an annual basis in August). There has been some comments of Monetary Policy Council members, such as of Elzbieta Chojna-Duch and Jerzy Osiatynski, which pointed to the possibility that the central bank could cut interest by 50bps in October. Given these comments, the dovish character of the incoming macro data could thus have a significant impact on monetary policy expectations in Poland, in regards to the scale and pace of the rate cuts. Although CPI is unlikely to surprise, the August reading will show a deepening of the annual deflation. The FRA1x4 is close to 2.20% and prices-in a 3M WIBOR drop of 30bps, so there is still room for further decline if macro data proves very weak.
- The short ends of the IRS and the bond curves are slightly above 2%. If the market interprets the coming data as an indicator of higher odds for a 50bps rate cut in October, it could mean that market rates could fall further, especially since the MPC's last statement showed that at least two months of rate cuts should be expected. The long end of the Polish curves may at the same time be under bigger influence from the outcome of the FOMC meeting. The latest US nonfarm payrolls data disappointed and whether the central bank changes its tone towards a less hawkish sound than up to now will be crucial. However, if this is will not be the case, the global and, in turn, the Polish, FI markets could weaken again (particularly the 5Y and 10Y tenors in Poland). Bearing in mind the recent publication of the San Francisco Fed, investors are also likely to analyse how the FOMC members were now forecasting interest rates in the US.

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