Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

22 – 28 September 2014

The deepening deflation and the strong decline of industrial and construction output in August reinforced market expectations of interest rate cuts in Poland. Minutes from the last MPC meeting also left little doubt that most Council members will be ready to support monetary policy easing in October. Interestingly enough, two motions to cut rates were already submitted at the September meeting (by 25bp and by 50bp) and it seems very likely that the situation will repeat next month. We still expect a total of 75bp in interest rate cuts in the fourth quarter and, after the recent economic data releases, we believe that chances for a deeper rate cut (50bp) in October have increased. Apart from the domestic factors, the financial market was affected last week by important events abroad (Fed meeting, Scottish independence referendum, first TLTRO operation), which triggered higher volatility on the fixed income market. At the same time, the zloty exchange rate remained surprisingly stable.

The domestic macro calendar for the next few days is light and the upcoming data releases should have little impact on the market, in our view. We expect retail sales growth to be slightly above consensus, but the reading will still be weak and should not dampen market expectations of interest rate cuts. News from the euro zone and the US may prove more important (especially the flash PMI economic activity indices for September), as it could affect expectations of future decisions of the main central banks.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (22 September)					
16:00	US	Home sales	Aug	m	5.20	-	5.15
		TUESDAY (23 September)					
3:45	CN	Flash PMI – manufacturing	Sep	pts	50.0	-	50.2
9:30	DE	Flash PMI – manufacturing	Sep	pts	51.4	-	51.4
10:00	EZ	Flash PMI – manufacturing	Sep	pts	50.6	-	50.7
10:00	**PL**	**Retail sales**	**Sep**	**%YoY**	**1.3**	**1.8**	**2.1**
10:00	**PL**	**Unemployment rate**	**Sep**	**%**	**11.8**	**11.7**	**11.9**
14:00	HU	Central bank decision		%	2.10	-	2.10
		WEDNESDAY (24 September)					
10:00	DE	Ifo index	Sep	pts	105.7	-	106.3
16:00	US	New home sales	Aug	k	430	-	412
		THURSDAY (25 September)					
13:00	CZ	Central bank decision		%	0.05	-	0.05
14:30	US	Initial jobless claims	week	k	-	-	280
14:30	US	Durable goods orders	Aug	%MoM	-17.0	-	22.6
		FRIDAY (26 September)					
14:30	US	Third estimate of GDP	Q2	%YoY	4.6	-	-2.1
15:55	US	Michigan index	Sep	pts	85.0	-	82.5

Source: BZ WBK, Reuters, Bloomberg

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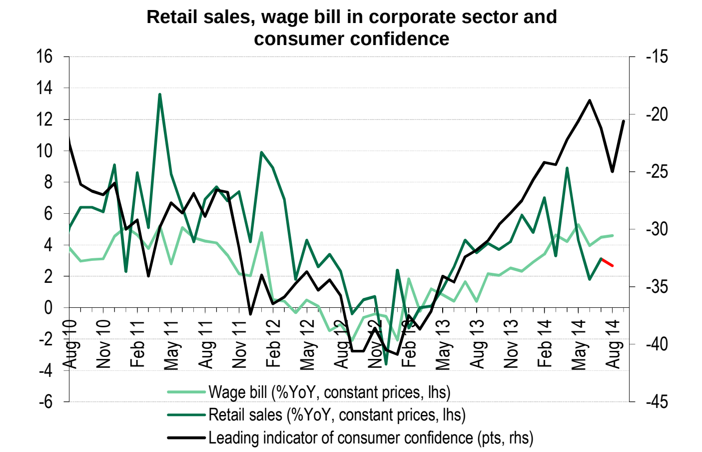
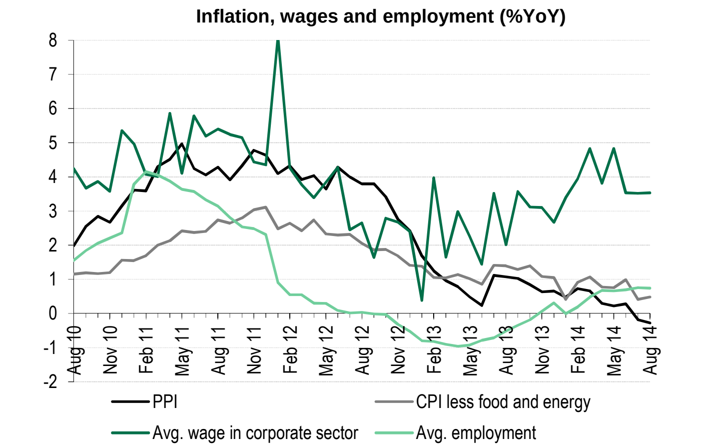
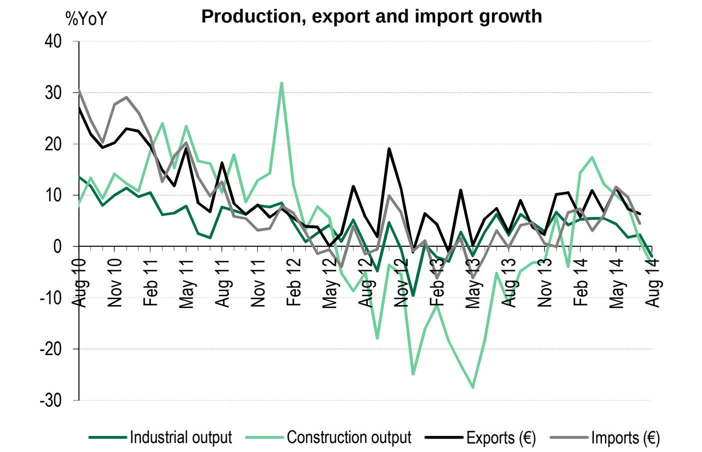
What's hot this week – Final data for August



- We expect the unemployment rate to drop to 11.7% in August, in line with the Labour Ministry's estimate. We think the data will confirm what other labour market figures have shown - that the situation in this sector of the economy is still relatively good. This will be a factor supporting moderate consumption growth in the second half of the year.
- As regards retail sales, we predict that they will come in slightly above market consensus, but, in general, retail sales will post a rather non-impressive growth (below 2%), well below their average for the first five months of the year (5.4%YoY). Surely, the data will not be an argument against an interest rate cut in October. Consumer sentiment deteriorated in last two months, but in September it rebounded strongly. It reinforces our view that retail sales growth should accelerate in coming months, supported also by a moderate rise of households' real disposable income.

Last week in the economy – CPI and industrial output lower, stabilisation on the labour market





- The CPI inflation rate fell in August to -0.3%YoY. The drop was mainly driven by declining prices of food and fuel. It seems that these two factors (plus the lack of clear demand-side pressure) could keep the inflation rate in sub-zero territory even until the end of this year. Core inflation, excluding prices of food and energy, reached 0.5%YoY, while PPI growth was at -1.5%YoY, which also confirmed there was no inflationary pressure.
- The current account deficit narrowed in July to -EUR173m and was lower than expected. Export growth slowed to 6.4%YoY, which shows that the impact of the economic slowdown abroad remains moderate. Meanwhile, import growth decelerated to 4.5%YoY, which may reflect a gradual weakening of domestic demand.
- Average wages in the corporate sector grew by 3.5%YoY and employment by 0.7%YoY in August. These indicate that the labour market is stabilising after a very good start to the year. The real wage bill growth accelerated slightly. We do not expect any significant changes to the labour market in the coming months. Employment growth should remain stable, in our view, due to the high base effect in 2013, while wages should grow moderately by 3% on average.
- Industrial production fell in August by 1.9%YoY, while construction output declined by 3.6%YoY. These data were affected by one working day less as compared to August 2013, but the seasonally adjusted output growth was nevertheless at a meagre 0.7%YoY, the lowest in more than a year. This shows that the slowdown in production in August was not only a seasonal phenomenon. The data confirmed a decline in Poland's economic activity mainly due to the fall in exports orders (as suggested by the recent PMI data). We maintain our forecast of GDP growth in 3Q14 at 2.8%YoY and we think that the market consensus (which remains above 3% according to Bloomberg) will probably start decreasing soon.

Quote of the week – An interest rate cut is needed and it should be significant one

Elżbieta Chojna-Duch, MPC member, 17.09, TVN BiS

An interest rate cut in the near term is necessary and it must be a significant one. I would suggest 50bp, and then let's see what happens.

Andrzej Rzońca, MPC member, 15.09, Reuters

I don't think Poland is threatened by a major slowdown. As far as it goes GDP growth is above 3% and practically all forecasts show that also next year Polish economy will keep growing at speed faster than 3%. (...) There is neither a catastrophe ahead, nor we have the means to counter the slowdown expected for the nearest quarters.

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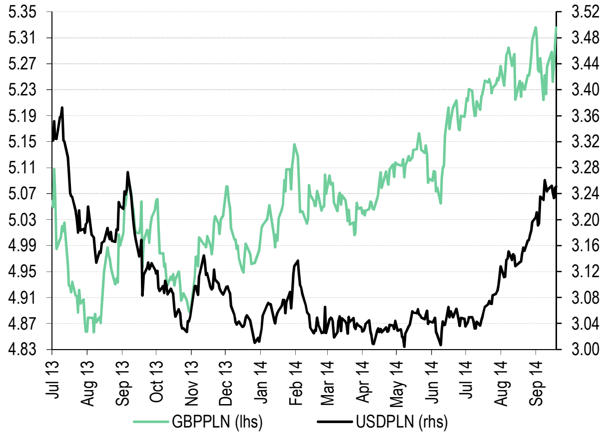
Minutes from the last MPC meeting cast some more light on the Council's motives. Signals of the economic slowdown in Poland and in the euro zone, escalation of the conflict in the East, as well as the lowered inflation path were among the arguments listed in support of monetary policy easing by the **majority** of the MPC members. And, in fact, two motions to cut rates (by 25bp and 50bp) were submitted already at the September meeting. They both failed to muster majority support due to the earlier pledge to keep rates stable until end of 3Q14. But this argument will no longer hold in October. Even though there are still some MPC members who think that monetary easing is not justified (like Rzońca), we think they are in the minority by now.

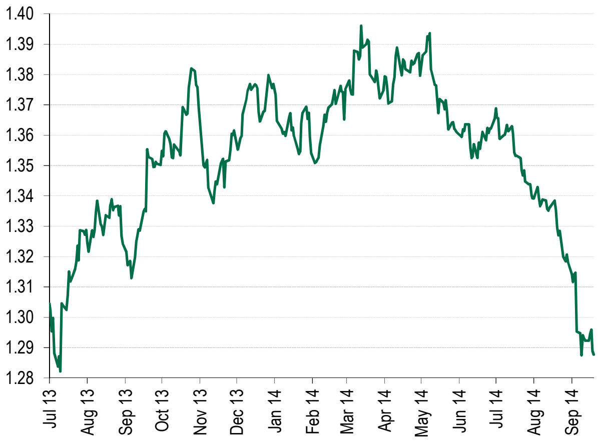
Foreign exchange market – Will fresh data put an end to the slow September?

EURPLN

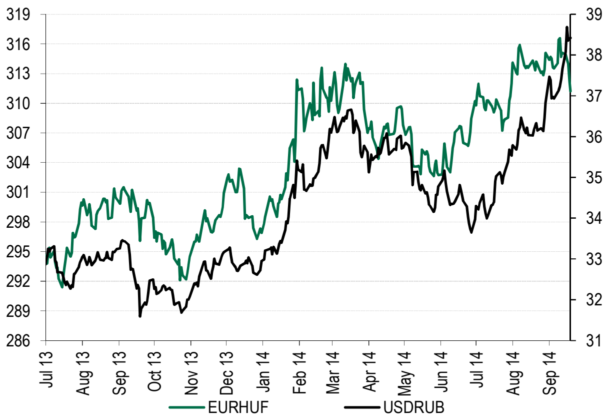
USDPLN and GBPPLN



EURUSD



EURHUF and USDRUB



Zloty stable vs. euro, weaker vs. pound

- No big changes were recorded in the EURPLN market, where the exchange rate stayed within the 4.17-4.23 range, though closer to its lower boundary. Much more volatility was observed in the case of GBPPLN. The zloty depreciated vs. the pound as the British currency gained vs. the euro and dollar due to the "No" vote in the Scottish independence referendum. GBPPLN surged temporarily to 5.38 (its highest since July 2012) from 5.29 at the start of the week.
- The EURPLN trading range has so far been the narrowest monthly range since November 1996 and the spread between the peak and the low is just below PLN0.05. Only significant surprises in upcoming data releases could probably change this situation. Our forecast for the Polish retail sales is slightly above the market consensus, but their growth rate (below 2%) will probably be low enough to keep hopes for a 50bps rate cut in October alive. This is unlikely to support the zloty substantially. European and US data releases will be interpreted from the perspective of possible central banks' decisions.
- In the meantime, 4.17 and 4.23 are still the important levels to watch. The next support is at 4.12.

US data to support the dollar?

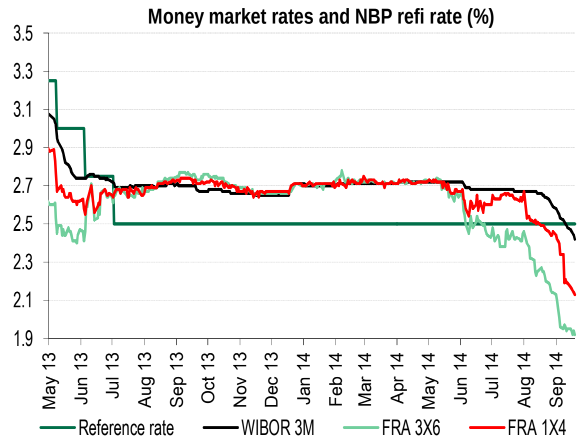
- The dollar continued to appreciate vs. the euro but at a slower pace than in the previous weeks. However, the single currency has kept its status as the third weakest G10 currency versus the greenback since May (when the downward move in EURUSD started).
- The FOMC maintained its pledge to keep interest rates low for a "considerable time" after the QE program ends, but the market focused on the dot chart showing that the Committee members now expected faster rate hikes than three months ago. Consequently, EURUSD dropped to 1.283.
- Elsewhere, EURGBP plunged to 0.781 (its lowest level since August 2012) as the majority of Scots voted to stay in the UK. After the referendum results were officially announced, the pound gave up some of its earlier gains.
- A large number of important macro data abroad is due this week. Flash PMI and Ifo index will give a hint on how the 3Q ended in Europe and whether the slowdown in manufacturing that started in January continued in September. In the US, the third GDP estimate will be published. It has already been revised up in the 2nd release and any further improvement could add to the greenback gains.
- EURUSD is getting gradually closer to the 1.275-1.28 area, which has been tested several times in April-July 2013. The next reference level to watch is at 1.266.

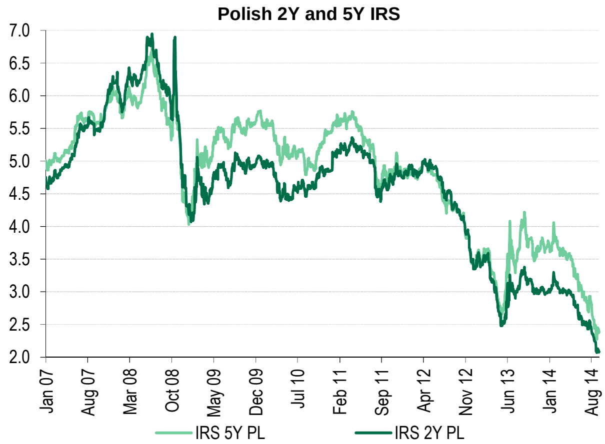
Ruble record weak vs. the dollar

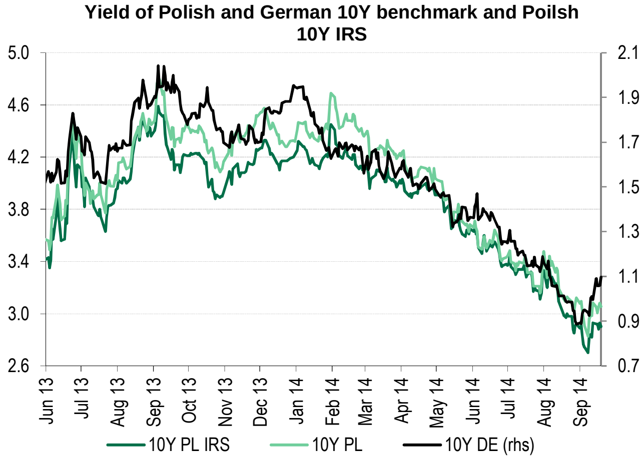
- The Russian ruble reached its all-time low vs. the dollar last week. USDBRUB reached 38.87 and it is rumoured that Russian companies were forced to turn to the spot market to buy foreign currencies once access to the international credit market was significantly limited due to the sanctions imposed by the EU and US. The Russian central bank announced it expected $20bn capital outflow in 2H and $90bn in the whole 2014. It sees an upward risk to these estimates.

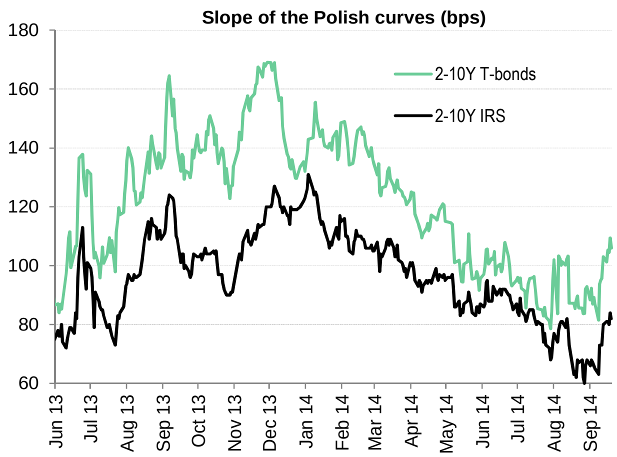
The forint gained last week vs. the euro, EURHUF dropped from 314 to 310 before the central bank meeting. Latest data from Hungary were positive, so the rhetoric of the MNB should be somewhat supportive of the currency.

Interest rate market – Strong expectations for rate cuts, core markets key for long end of the curve









Domestic data supporting expectations for cuts

- Money market rates fell last week, when several data releases (CPI, output) supported expectations for interest rate cuts in upcoming months and which was reflected in a deeper decline in the WIBOR rates with longer maturities. As a result, by the end of the week, the 12M rate was by 12bps lower than the 1M rate and by 11bps lower than the reference rate. The data were also priced-in by FRA.
- This week will bring the final domestic data releases for August (retail sales, unemployment), and these, in our view, should back expectations for interest rate cuts at the upcoming MPC meeting. The market is currently pricing-in that the central bank's interest rates will be cut by more than 50bp over the next year. We, however, think that rates may be cut by as much as 75bp by year-end, so there is still some room for the WIBOR to fall, with the 3M rate sliding below 2% by the end of the year.

2Y yield below 2%, focus remains on core markets

- Last week saw a strengthening of bonds mainly with maturities of up to 5Y. The decline of yields in the 2- and 5Y segments was fuelled by weak output data (amplifying chances of a more substantial cut in October), deeper decline in inflation (to -0.3%YoY in August), successful switch auction (details below) and minutes of the September's MPC meeting, all of which support rate cuts in upcoming months. As a result, the 2Y bond yield reached its new all-time low at 1.99%, while the 5Y yield approached 2.40% (compared to 2.50% at last week's close). Changes on the IRS market were less significant – the 2- and 5Y rates fell by 3-4bp on average throughout the week.
- The longer ends of curves proved more volatile, as they are vulnerable to developments on the core markets. Prior to the FOMC decision, results of the Scottish independence referendum and the first TLTRO, bond yields and IRS rates had fallen somewhat due to strong increases at the end of the previous week. However, rising Bund yields after the FOMC decision triggered a temporary rise in the 10Y yield towards 3.10%, with the 10Y IRS climbing above 2.90%. Only the Scottish referendum provided an impulse for strengthening on the long ends.
- The bond switch auction proved quite successful. Even though prices of the redeemed bonds (PS0415 and WZ0115) were set below market levels, the Finance Ministry managed to sell PS0719 worth PLN1.16bn (yield at 2.439%) and WZ0119 worth PLN2.34bn. This was another auction aimed at pre-financing of the 2015 gross borrowing needs. So far, the Ministry has raised PLN5.8bn, some 4% of the planned PLN154.8bn gross borrowing needs of (according to draft 2015 budget).
- Final data from the domestic economy (retail sales and unemployment) should support expectations for interest rate cuts in October, which should stabilise the 2Y yield slightly below 2% and anchor the 5Y yield at c2.40%.
- The longer ends will probably remain more volatile, depending on core market sentiment, which will be determined by data from the European and US economies. A lack of upward impulses for German yields would support prices of the domestic 10Y bond (new declines towards 3%), narrowing the 2-10Y spread.

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.