WEEKLY ECONOMIC UPDATE

13 – 19 October 2014

The Monetary Policy Council took the market by surprise by cutting the reference rate by 50bps and the lombard rate by 100bps last week. We think that the decision to cut more deeply was better than the possibly more gradual cycle of smaller, 25 bps steps, which we had expected the council to deliver. But despite the surprise, we stick to our view that the total scale of the refi rate reduction will reach 75bps, which points to just one more, 25bps rate cut in November. And since the market is pricing-in a deeper rate adjustment ahead, we think that a correction on the FI market is likely, if not in the nearest week (after slightly better-looking economic data and possible MPC members' comments), then after the next MPC meeting in early November.

There are several important data releases due this week. The market has already largely priced-in a deeper drop in CPI below zero and so we expect that the labour market data will prove more important, especially in light of the signals from the Labour Ministry that we may be in for a positive surprise. Industrial output data, which we expect to come in much higher than the market consensus, will be significant as well. Data from the US economy will be equally important as they may shape investors' expectations about the possible timing of first Fed's interest rate hike – a crucial factor for EM sentiment.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (13 October)					
		No important data releases					
		TUESDAY (14 October)					
11:00	DE	ZEW index	X	pts	16.0	-	25.4
11:00	EZ	Industrial output	Aug	%MoM	-1.7	-	1.0
14:00	**PL**	**Current account**	**Aug**	**€m**	**-340**	**-841**	**-173**
14:00	**PL**	**Exports**	**Aug**	**€m**	**12 600**	**12 431**	**14 071**
14:00	**PL**	**Imports**	**Aug**	**€m**	**12 400**	**12 468**	**13 678**
14:00	**PL**	**Money supply**	**Sep**	**%YoY**	**7.7**	**7.1**	**7.4**
		WEDNESDAY (15 October)					
14:00	**PL**	**CPI**	**Sep**	**%YoY**	**-0.5**	**-0.4**	**-0.3**
14:30	US	Retail sales	Sep	%MoM	-0.2	-	0.6
20:00	US	Fed Beige Book					
		THURSDAY (16 October)					
11:00	EZ	HICP	Sep	%YoY		-	0.3
14:00	**PL**	**Core inflation**	**Sep**	**%YoY**	**0.6**	**0.8**	**0.5**
14:00	**PL**	**Wages in corporate sector**	**Sep**	**%YoY**	**3.5**	**3.5**	**3.5**
14:00	**PL**	**Employment in corporate sector**	**Sep**	**%YoY**	**0.8**	**0.8**	**0.7**
14:30	US	Initial jobless claims	week	k	-	-	287
15:15	US	Industrial output	Sep	%MoM	0.4	-	-0.1
16:00	US	Philly Fed index	Sep	pts	20.0	-	22.5
		FRIDAY (17 October)					
14:00	**PL**	**Industrial output**	**Sep**	**%YoY**	**3.1**	**4.7**	**-1.9**
14:00	**PL**	**Construction and assembly output**	**Sep**	**%YoY**	**0.5**	**2.2**	**-3.6**
14:00	**PL**	**PPI**	**Sep**	**%YoY**	**-1.5**	**-1.6**	**-1.5**
14:30	US	House starts	Sep	k	1002	-	956
14:30	US	Building permits	Sep	k	1035	-	1003
15:55	US	Flash Michigan	Oct	pts	84.2	-	84.6

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

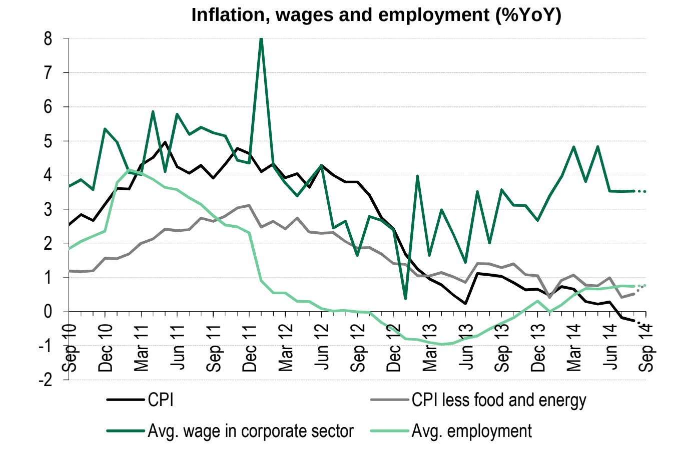
TREASURY SERVICES:

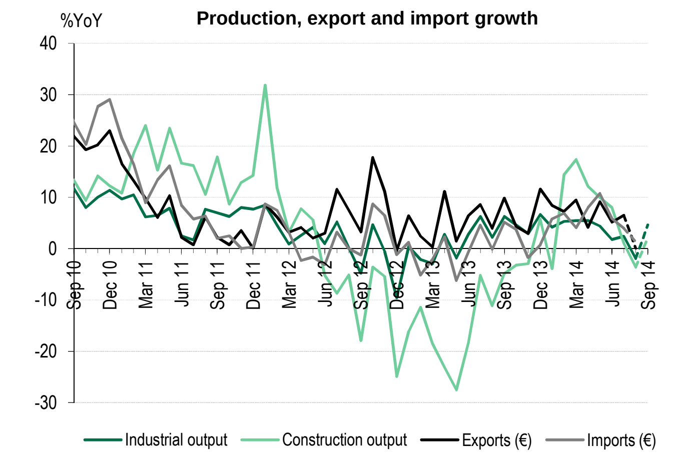
Poznań +48 61 856 5814/30

Warszawa +48 22 586 8320/38

Wrocław +48 71 369 9400

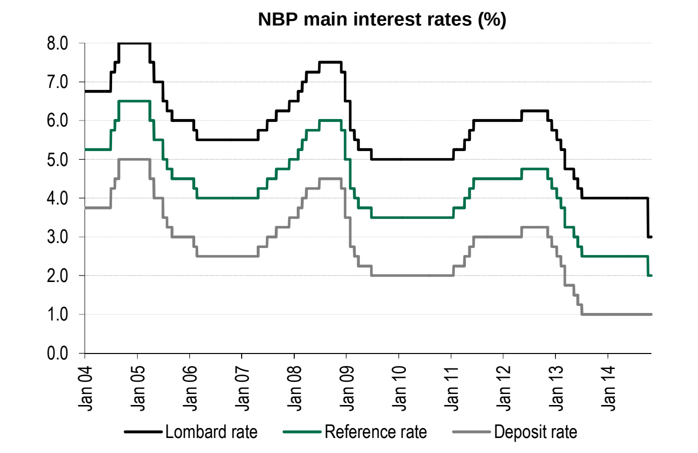
What's hot this week – A bit more upbeat set of data?





- The NBP recently introduced substantial methodological changes to its balance of payments data. This means that the accuracy of analysts' forecasts is likely to suffer in the coming months, at least, due to the very short time-series of the revised data that are now available. For the very same reason, the significance of these data for the market will likely be lower. We expect the current account and trade balances to worsen, with export growth slowing down in August thanks to the big slump in industrial output.
- Inflation fell even further below zero in September, according to our forecast (to -0.4%YoY), mainly due to the sustained decline in food and fuel prices. The FAO's food price index fell sharply in September, to its lowest level since August 2010, while the price of Brent oil collapsed below $95 p/b, the lowest in two years. Meanwhile, core inflation excluding food and energy prices accelerated to 0.8%YoY, according to our estimate, chiefly due to the low base effect in prices of education.
- Labour market data are likely to add some colour to the economic picture and show that companies continue to create new jobs, helping to keep the average wage growth robust. Please note that the Ministry of Labour recently said that there was a surprisingly strong surge in new job offers in September. This signals an upward risk to our employment growth forecast.
- The week could end on an even stronger note after output in the industrial and construction industry rebounded in September. Our forecast here clearly stands above the market consensus and, even though the rebound will partly be due to the higher number of working days, when released, the data could trigger a market reaction by reducing expectations for a deeper rate cut in November (similar to the calendar-driven production decline in August that strengthened hopes for a rate cut a month earlier).

Last week in the economy – 3-2-1...Cut!



- The MPC cut the lombard rate by 100bp, the reference rate by 50bp and kept the deposit rate unchanged. As a result, rates are currently at 3%-2%-1% respectively. Narrowing of corridor between the deposit and the lombard rate was aimed at adjusting it proportionally to lower level of rates.
- The key sentence of the MPC's statement was the one that said the Council did not rule out further adjustment in monetary policy if incoming data, including the NBP's projection, confirm there is a significant risk of inflation remaining below the central bank's target for a longer period of time. This means that the MPC has left the door for further policy easing open. We believe it is likely that the MPC will cut the official rates again in November, but the scale of the reduction should not be bigger than 25bp. We, therefore, stick to our forecast of the total scale of monetary easing and expect the reference rate to reach 1.75% at the end of this year.

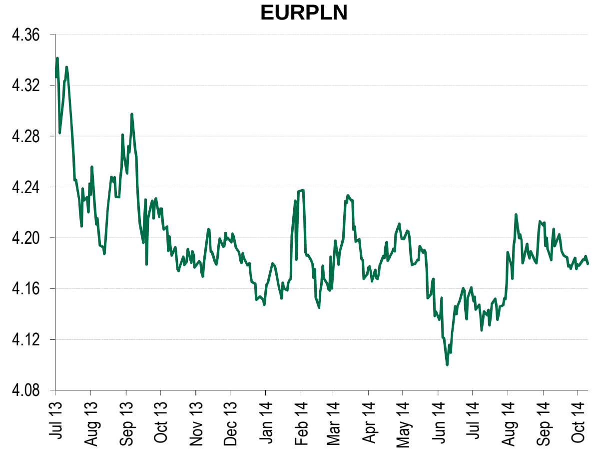
Quote of the week – Rate adjustment should be condensed in time

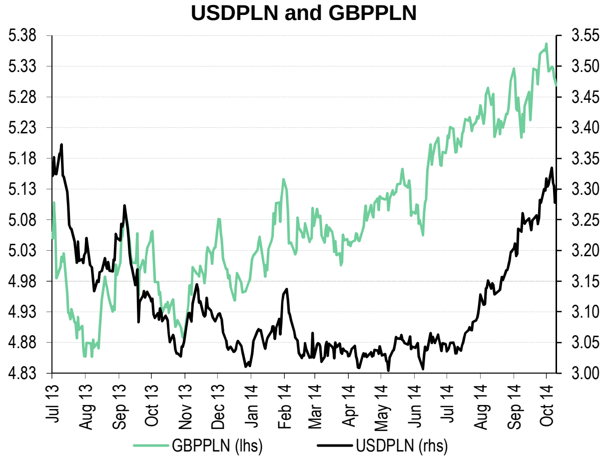
Marek Belka, NBP Governor, MPC conference, Oct 8

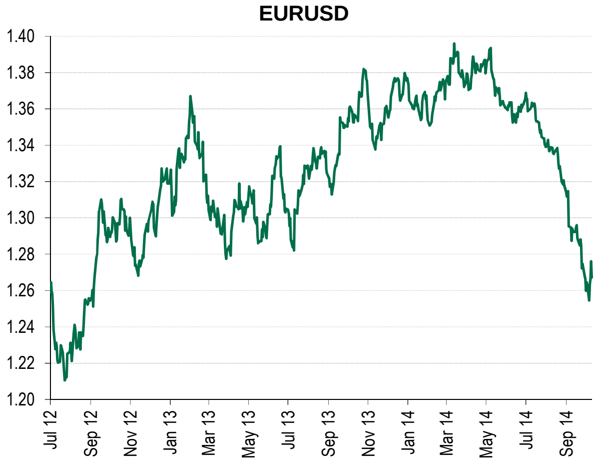
On the scale of the rate cut (...) I want to make it clear that the decision was not unanimous. But those who were in favour agreed that it should be time-condensed. (...) I think that the monetary policy adjustment should be condensed in time. We should make our decisions quickly and the cycle – if this is not just one move, there could be more, although not necessarily – should be finished quickly in order to remove pressure from the bond market. Excessive expectations for rate cuts can trigger (market) behaviour that is not necessarily positive. (...) If most of MPC members were convinced that there would be a rebound in economic growth sometime in the foreseeable (near) future, there would have been no interest rate cut today.

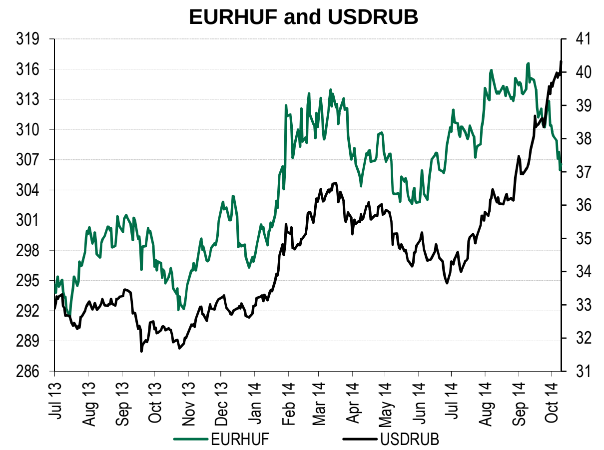
Marek Belka made it clear during the press conference that the MPC wanted to keep the renewed cycle of interest rate cuts as short as possible. The NBP governor was also very cautious when speaking about the possibility of further cuts and repeated several times that they were not warranted. It seems like Belka wanted to avoid fuelling excessive market expectations for more easing ahead. It will be very interesting to see if other MPC members will sound similar in their first interviews/comments, which we expect to follow the releases of new data. If so, and if new data appear slightly more upbeat than in the recent past (and we expect they will), market hopes for rate cuts may weaken.

Foreign exchange market – EUR/PLN still above 4.17









Zloty stable versus the euro, stronger against the dollar

- There were no significant changes in the EUR/PLN market in the past week. The exchange rate tested its crucial support at 4.17 but failed to break through. The zloty's weakening that followed the deeper-than-expected NBP rate cut proved temporary. The dovish FOMC minutes helped the EM currencies, including the zloty, slightly recover from their recent significant losses against the dollar. The USD/PLN rate fell to 3.264 from 3.35 and so the zloty finally ended its 12-week long streak of weakening vs. the US currency.
- Lots of Polish and US data releases are due this week. We expect the domestic releases to paint a slightly more optimistic picture than was the case in the previous month (even if partly thanks to calendar effects) and this should trim market expectations for more NBP rate cuts in Poland. A more positive outlook should also support the zloty. At the same time, the zloty may not be fully shielded from data releases and developments in the US, along the rest of the EM universe.
- Support at c.4.17 remains crucial for EUR/PLN. Once broken, 4.12 would be the next target.

Euro takes a breather

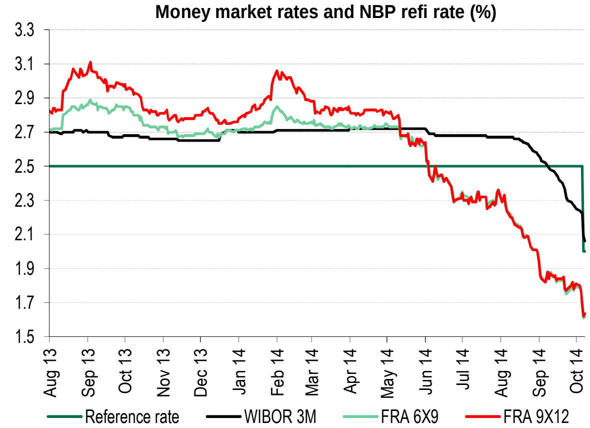
- The euro recovered vs. the dollar during the past week. Despite the series of clearly disappointing macro data from Germany, the EUR/USD rate rebounded temporarily to 1.28 from 1.25 amid profit-taking spurred by the recent slump and the dovish FOMC minutes.
- Worries that the Fed could raise rates sooner than in mid-2015 faded last week and a series of important US data will be in the centre of attention in the coming days. Positive surprises are likely to overshadow the dovish message from the FOMC minutes and trigger a restart of the dollar's appreciation trend vs. the core and EM currencies. The recent signals from the IMF (rising risk of recession and deflation in the euro zone) could also prevent any significant and long-lasting recovery of the single currency.

Ruble still on the downside, forint appreciates

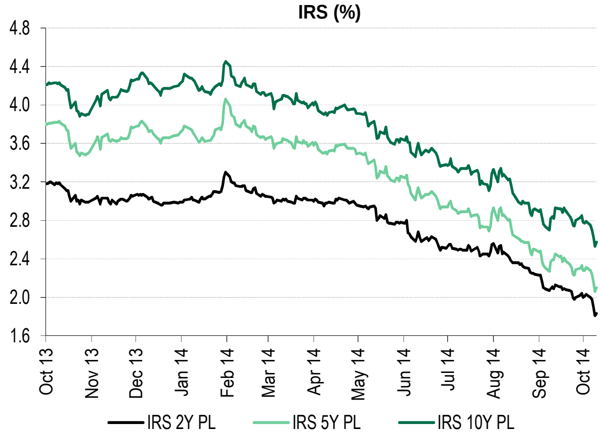
- The Russian ruble continued to be under significant pressure vs. the euro and the dollar due to foreign capital outflows, falling crude oil prices and the gloomy outlook for the Russian economy in general. The USD/RUB and EUR/RUB reached fresh all-time highs at 40.464 and 51.174, respectively. Predicting a recovery in the ruble is like trying to catch a falling knife and so we believe that there is potential for further depreciation of this currency - as long as the conflict in eastern Ukraine remains unresolved (the cease-fire is only a temporary solution) and for as long as the EU/US sanctions undermine confidence towards the Russian economy.
- All in the same time, the Hungarian forint firmed against the euro for the second week in a row. The EUR/HUF rate fell from 310 to 305, its lowest since late June. The performance of the forint was clearly supported by the strengthening of the Hungarian debt market after CPI data surprised on the downside. Hungary recorded its deepest deflation in history in September, when prices fell 0.5% YoY. This caused the forint to end the week in black. And while the forint was benefitting in the recent week from the announced monetary policy easing of the ECB, this week the market will be focusing on the US data releases. The impact of these publications on the Fed monetary policy outlook could prove key for EUR/HUF in the coming days.

Interest rate market – New data may trigger a correction

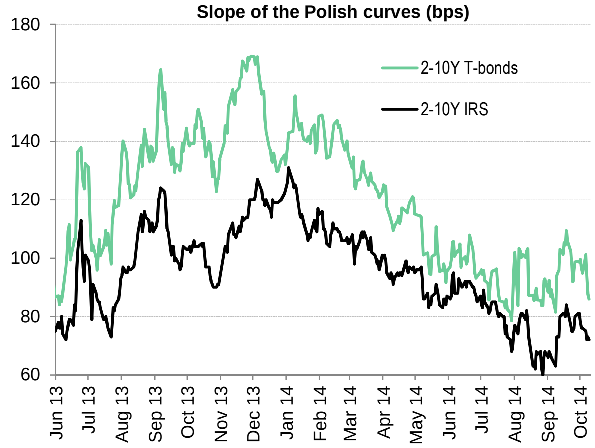
Money market rates and NBP refi rate (%)



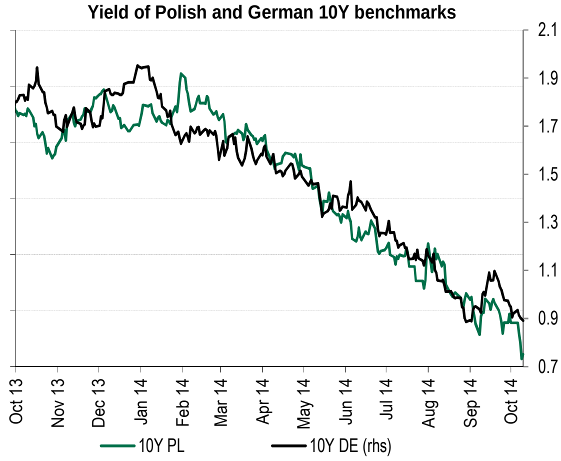
IRS (%)



Slope of the Polish curves (bps)



Yield of Polish and German 10Y benchmarks



Rates lower along the curves after the MPC decision…

- Although the WIBOR rates had already fallen by 26 bps on the 1M rate and 45-54 bps on the remaining rates all the way to 12M before the MPC's rate cut (they were on decline since July, when the MPC had dropped the forward guidance), the money market's reaction to the cut was significant last week. The 1M WIBOR fell 28bps, while the 3-12M rates by 17-19bps on a weekly basis.
- The MPC also left the door open for more monetary policy easing ahead and, despite the noticeable adjustment in the WIBOR rates, the FRA market expects the 3M WIBOR to drop by another c30bps in one month's time and by nearly 50bps in six months' time.
- The MPC' rate cut also pushed the IRS and bond yields to their record lows. The scale of the move reached as many as c.20-30bps on a weekly basis, with the biggest drop recorded on the long-end of curve. To top it off, the dovish FOMC minutes coupled with weak German data and their impact on the core markets offered additional fuel for the downward move, pushing yields on the 10Y German bonds to a new all-time low (0.858%). The Polish yield curves flattened, with the 2-10, 2-5 and 5-10 spreads dropping to their lowest levels since the turn of August and September.

… but Polish data may trigger a correction

- In our opinion, the FRA market pricing is excessive as we expect a 25bps rate cut in November and no further reductions afterwards. It is also worth noting that the yield on the 2Y benchmark bond reached a low of 1.75% during the course of the week and this is exactly the level of the NBP's key rate that we expect to see at the end of the year. We, therefore, see limited room for further falls on the short end of the curve.
- In fact, even if the market started betting on deeper monetary easing, it would be just temporary, we think. There could be a correction already this week as numerous Polish macro data are due as we expect the data to paint a generally more optimistic picture for the economy than was the case in the previous month. The release of industrial output data on Friday may be of particular importance, as we predict the reading to be significantly above the consensus. We also expect core inflation to be higher than the median market forecast. What is more, a positive surprise from the labour market cannot be excluded either. In general, these publications may bring back to memory what the NBP Governor Marek Belka had said - that a rate cut in November was not warranted. This means that there could be some correcting on the FRA market and on the short ends of the IRS/bond curves, in our view.
- What is more, the looming policy easing by the ECB and the recently dovish signals from the Fed may continue to provide support for the belly and the long end of the IRS and bond curves. However, a series of important US releases are due this week, which may affect how the market views the outlook for the Fed monetary policy. These data could end up triggering bigger volatility in the 5Y and 10Y tenors of the Polish curves. The two-month correlation of the 10Y Polish and German bonds is at nearly 70%.

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.