

WEEKLY ECONOMIC UPDATE

10 – 16 November 2014

The central banks' meetings were the most important market drivers last week, both when it comes to the global and the domestic market. The ECB did not introduce any new measures, but noted a deterioration of the economic outlook in the euro zone, stressed that risks were skewed downwards and fuelled market hopes that it would take more action in the future. The Polish Monetary Policy Council took investors by surprise and kept interest rates on hold, while a cut was widely expected and priced-in. It seems that some doves changed their minds (after having supported a cut by 50bp in October) on their more optimistic growth outlook (as compared with the new projection, which justified further easing). We expect the upcoming data to show no significant improvement and so we still believe in one more rate cut, if not in December, then in the first quarter of 2015.

Due to the national holiday on Tuesday, market liquidity in the first part of the upcoming week will be very thin. However, the last two days will see publications of very important data, with the CPI figure being the most important release. We expect the deflation to deepen to -0.5%YoY. The flash GDP for Q3 will also be released. We think that the Polish economy slowed in Q3 below 3%YoY and we expect a similar pace of growth also in Q4, which would support our forecast that more monetary easing is probable. This week may, therefore, bring a correction of the recent sell-off in the bond market. The euro zone unexpectedly stagnated in Q2 and more weak European data will support hopes that the ECB will finally act.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD	FORECAST		LAST VALUE	
				MARKET	BZWBK		
MONDAY (10 November)							
9:00	CZ	CPI	Oct	%YoY	0.6	-	0.7
TUESDAY (11 November)							
	PL	Independence Day					
9:00	HU	CPI	Oct	%YoY	-0.3	-	-0.5
WEDNESDAY (12 November)							
11:00	EZ	Industrial output	Sep	%MoM	0.7	-	-1.8
THURSDAY (13 November)							
14:00	PL	CPI	Oct	%YoY	-0.4	-0.5	-0.3
14:00	PL	Current account	Sep	€m	-460	28	-986
14:00	PL	Exports	Sep	€m	13 825	14 505	11 560
14:00	PL	Imports	Sep	€m	13 473	13 708	11 624
14:30	US	Initial jobless claims	week	k	-	-	278
FRIDAY (14 November)							
8:00	DE	Flash GDP	Q3	%YoY	1.1	-	1.2
9:00	CZ	Flash GDP	Q3	%YoY	2.5	-	2.5
9:00	HU	Flash GDP	Q3	%YoY	2.9	-	3.9
10:00	PL	Flash GDP	Q3	%YoY	2.7	2.8	3.3
11:00	EZ	Flash GDP	Q3	%YoY	0.7	-	0.7
11:00	EZ	HICP	Oct	%YoY	0.4	-	0.4
14:00	PL	Money supply	Oct	%YoY	7.9	8.1	7.8
14:30	US	Retail sales	Oct	%MoM	0.2	-	-0.3
15:55	US	Flash Michigan	Nov	pts	87.5	-	86.9

Source: BZ WBK, Reuters, Bloomberg

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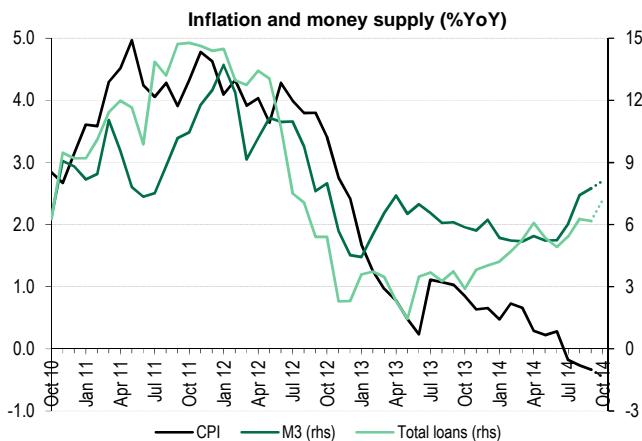
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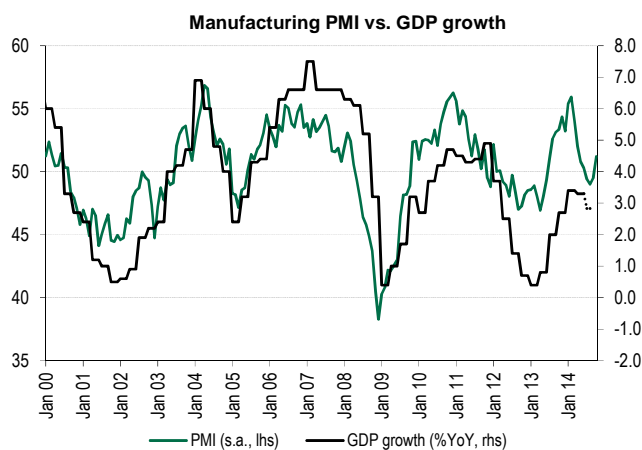
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What's hot this week – Important data after the long weekend

- We expect inflation to have fallen further in October, reaching a new all-time low of -0.5%YoY. Our forecast is below market consensus, so it may trigger gains on the fixed income market. While we believe that food prices rose moderately in October, pushing inflation a bit higher due to the category's low base effect, there were also opposite effects (a high base) in two other categories: communication and clothing, footwear, which dragged the YoY CPI lower.

- The balance of payments data will probably show improvement in September, with the trade and current account balances swinging to surpluses again, though largely due to a seasonal effect. Export and import growth accelerated, in our view, boosted by a higher number of working days. We may see a slowdown here in upcoming months, however, because the weak economic activity in the euro zone is negatively affecting Poland's foreign trade.



- The statistics office will publish its flash GDP estimate for Q3 on Friday. We expect GDP to slow below 3%. It must be remembered, however, that there is a significant risk of a surprise and in any direction at that because this will be the first quarterly GDP data release based on a new methodology (ESA2010 plus other adjustments). And since the statistics office has so far not published data for the past quarters, we are unable to precisely estimate the Q3 result without knowledge of the recent past.

- The money supply data usually is not overly significant for the market. But we think it may now be useful leading indicator of activity in the domestic market. Should money and credit growth continue to accelerate in October, we would look at it as an indication that domestic demand remains relatively strong towards the end of the year.

Last week in the economy – Did the MPC hit a PAUSE or STOP button?**Inflation and GDP projections in the subsequent Inflation reports**

	GDP growth			
	Nov 13	Mar 14	Jul 14	Nov 14
2014	2.0-3.9	2.9-4.2	3.2-4.1	2.9-3.5
2015	2.1-4.5	2.7-4.8	2.6-4.5	2.0-3.7
2016		2.3-4.8	2.3-4.5	1.9-4.2
	CPI inflation			
	Nov 13	Mar 14	Jul 14	Nov 14
2014	1.1-2.2	0.8-1.4	-0.1-0.4	0.0-0.2
2015	1.1-2.6	1.0-2.6	0.5-2.1	0.4-1.7
2016		1.6-3.3	1.3-3.1	0.6-2.3

- The Monetary Policy Council decided to keep interest rates unchanged last week, which came as a big surprise. It did so despite the fact that the new projection of the central bank clearly supported additional easing.

- There are two scenarios for the upcoming months. In the first, the MPC already delivered its "condensed", one-shot monetary policy easing in October (which would be weird given the economic outlook). In the second, the MPC simply took a breather and will sooner or later get back to policy easing. We bet on the latter, though looking at how difficult it was to build a majority on the Council in November shows that significant easing should not be expected ahead. We maintain our forecast that the reference rate will reach 1.75% in this cycle. This is also in line with our better-than-NBP's forecasts for growth in the upcoming quarters.

Quote of the week – The art of communication at its peak?**Marek Belka, NBP governor, 6 Nov, MPC press conference**

The fact that the slowdown in economic growth could be temporary was key for the majority on the Council. Nobody argued with the unavoidability of the low rate of price growth, but the slowdown in GDP caused some controversy (within the council). (...) If the pessimistic scenario from the NBP projection materialises... if the economic situation follows this scenario, then further adjustment in monetary policy could be possible.

There is no risk that inflation will be below the target. There is certainty. For me, yes (there is room for further rate cuts). (...) It is not my view (that the MPC should keep some ammunition for an economic downturn). For the Council today, trends in GDP were more important than in inflation. The art of communication is at its highest level, but it is all about the decision, which was taken.

The communication during the MPC press conference in November was far from ideal (except for the body language of the NBP Governor that showed he was clearly unhappy with the decision). The MPC was simply not consistent on a number of points. To illustrate, Marek Belka said that it was certain that inflation would be below the target, but the statement read that the risk of inflation remaining below the target has decreased.

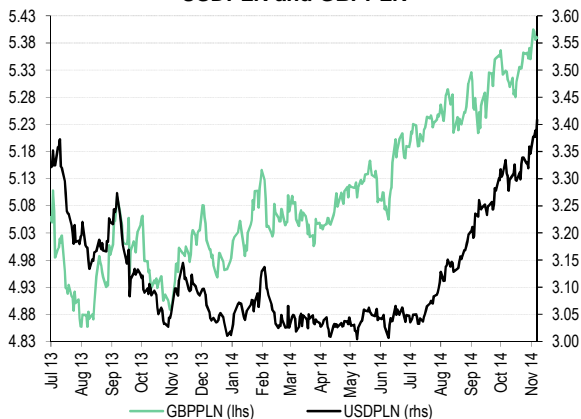
It seems that the MPC simply did not believe the new NBP projections. For example, Elzbieta Chojna-Duch (who was probably against a cut this time) said she believed that GDP growth should accelerate in 4Q14. We think that incoming data should rather underline that the situation is worse, which, in turn, should convince the Council to deliver another cut. It is hard to say whether this could happen already in December, though.

Foreign exchange market – EUR/PLN stable at an elevated level

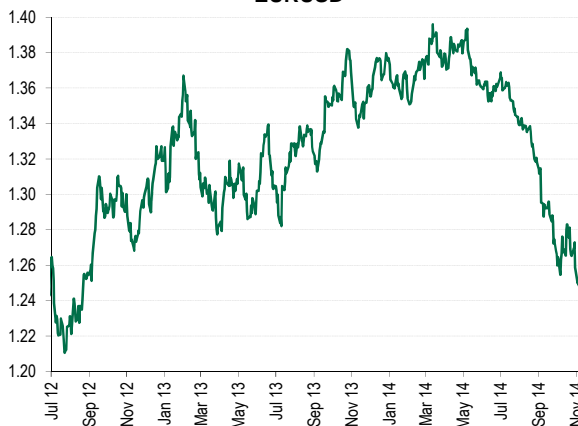
EURPLN



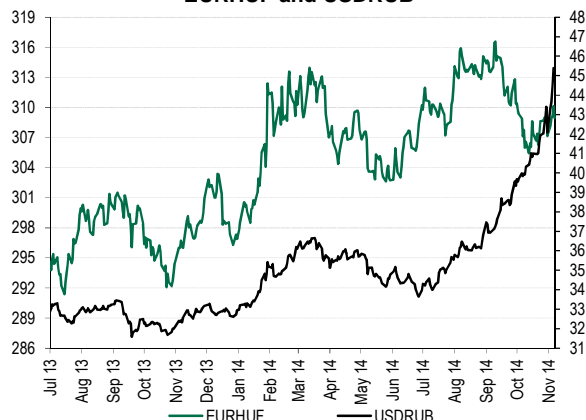
USDPLN and GBPPLN



EURUSD



EURHUF and USDRUB



Zloty stable vs. the euro despite the MPC and the ECB

▪ Despite important events on the agenda, the EUR/PLN was quite stable last week, fluctuating in a relatively narrow range around 4.22. Support from the surprising MPC decision that kept interest rates unchanged and the dovish ECB signals was neutralized by the weakening of the Russian ruble (more details on the latter at the bottom of the page).

▪ At the same time, the domestic currency continued to lose value vs. the dollar as the EUR/USD resumed its downward move. As a consequence, the USD/PLN surged temporarily above 3.40, its highest since July 2012. Between now and July (when the upward move of the USD/PLN started), the zloty has been the 5th weakest EM currency vs. the dollar (it lost over 10%).

▪ None of the important events of the past week managed to push EUR/PLN significantly away from 4.22. However, there are some important events due also this week that can trigger a directional move in the market. First, the liquidity in the Polish market may be limited due to the market holiday on Tuesday. Second, our forecast of the C/A deficit is noticeably above the consensus and this can potentially support the zloty. Also, the GDP data may be a surprise as it will be presented according to the new methodology for the first time.

▪ Important levels to watch for EURPLN are at 4.20 and 4.24.

Euro pressured by the ECB

▪ The EUR/USD was roughly stable around 1.25 at the beginning of the week as investors awaited the outcome of the ECB meeting. Dovish signals from the central bank supported the dollar vs. the euro and pushed the exchange rate even below the second support that we mentioned last week (1.246). The EUR/USD reached its lowest level since August 2012 (c.1236). However, there was some rebound seen at the end of the week as the US nonfarm payrolls did not meet market expectations.

▪ Final day of the coming week will be full of macro data that could trigger a significant move in the market. The next important level to watch for EURUSD is as low as at 1.226. Resistance is at 1.28.

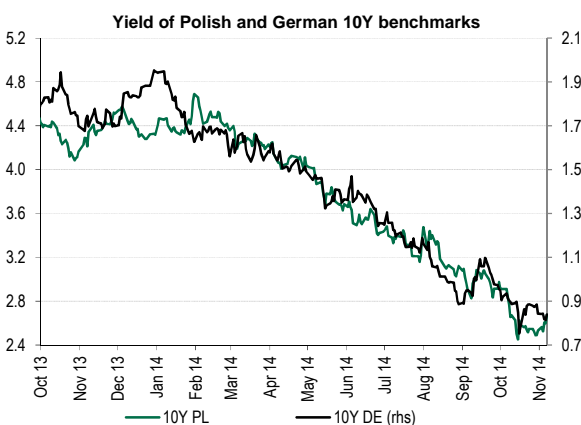
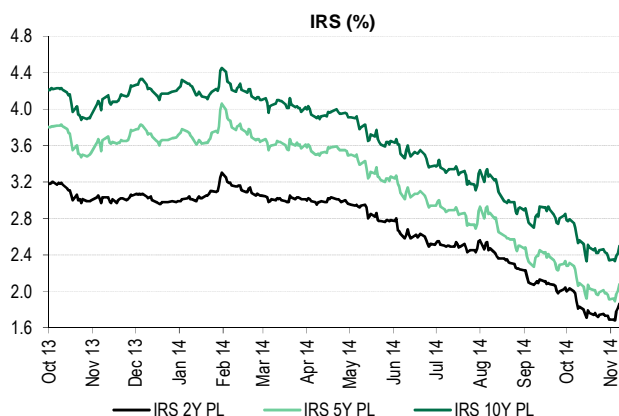
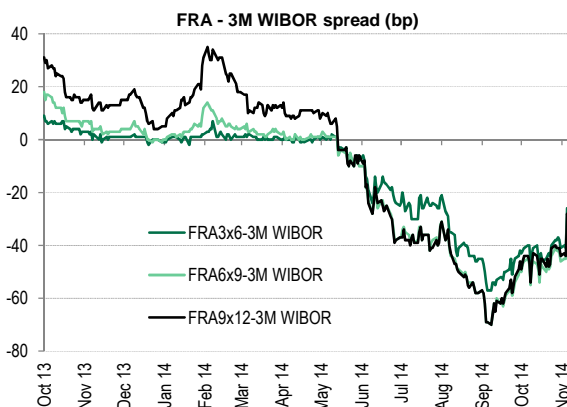
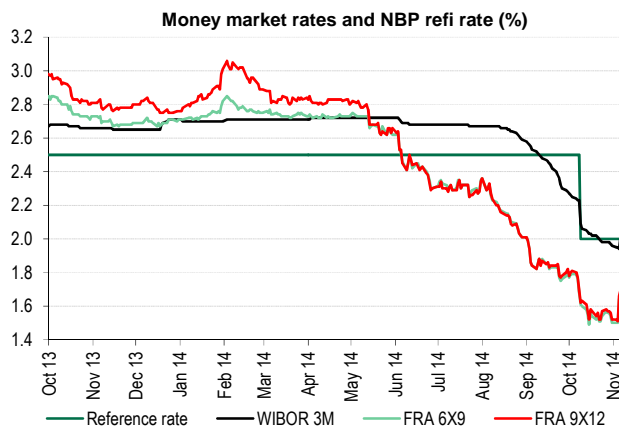
Ruble still under pressure, the EUR/CZK floor still at 27.0

▪ This was a "standard" week in the USD/RUB market as the Russian currency continued to depreciate vs. the dollar and the exchange rate reached a new all-time high at 48.6. The ruble was additionally hit by pressure from the Russian central bank that changed its rules of FX interventions – only \$350m can now be spent per day to intervene in the market. There were no such limits before (the CB used to even spend \$3bn a day).

▪ The USD/RUB upward trend is still strong, which makes predicting of the turning point extremely difficult. Notice, however, that the exchange rate retreated from the peak at the end of the week and the move downward was the biggest in the last nine weeks of the ruble's depreciation. This may be the first signal that the trend is fading.

The Czech central bank kept rates unchanged and left the EURCZK floor at 27.0. Already a month ago the central bank stressed that it saw a downward risk for growth and inflation due to the weaker situation in the euro zone, but it had not decided to take additional steps. Perhaps it was industrial output data (8.3%YoY in September, strongest growth since July, vs. 4.4%YoY expected) that convinced the policymakers to refrain from lifting the EUR/CZK floor.

Interest rate market – MPC decision weighs on the market



Rates surge after the MPC decision

- The money market usually reacts noticeably to a change in the NBP rates, with the WIBOR rates then adjusting to the new level of the central bank's main refi rate. Last week, however, even though the MPC left interest rates unchanged, the 1-12M WIBORs moved up quite noticeably. Two days after the MPC meeting, the 1-12 WIBOR rates were 7-11 bp higher than on the day of the decision. The biggest rise was recorded in the 1M rate, while the smallest on the 12M rate. All WIBOR rates between 1M and 12M are now at 2% or higher.

- The IRS and bond yields also surged substantially after the surprising MPC decision. At the end of the week, the IRS curve was c15bps higher than the previous Friday and 15-20bps above levels seen the day before the Council's meeting. The 2Y IRS rate now sits at c.1.8% (the highest since early October), the 5Y at 2.0% (the highest since late October), while the 10Y at 2.50% (the highest since mid-October). At the same time, bond yields moved sharply higher by c15bps vs. last week's closing and from levels seen before the MPC decision. The dovish ECB rhetoric only had a temporary positive impact on the Polish interest rate market.

Successful bond auction

- The Finance Ministry sold bonds worth almost PLN4.5bn (with PLN4.0bn as the upper limit for the offer). The Ministry sold 10Y benchmark DS0725 bonds worth PLN1.05bn (amid demand at PLN3.9bn and yield at 2.669%), WZ0124 worth PLN1.65bn and WS0428bn worth PLN35mn. This was the last standard auction this year. We estimate that 10% of next year's gross borrowing needs are now covered. In our opinion, it is likely that the Ministry will have reached c15% coverage by the end of the year.

Room for recovery

- It seems that the last sharp weakening of the Polish fixed income market was driven by disappointment with the MPC decision, but also by activation of stop loss orders. We think that the recent upward move in the market rates was too fast to be able to continue for longer at this pace. In our view, there is potential for a recovery in the Polish fixed income market in the coming days due to the coming data releases, among others. Our CPI forecast (at -0.5% YoY) is below the market consensus and should revive expectations for more rate cuts in Poland. We also expect a slowdown of GDP growth in 3Q to below 3%, which, if confirmed, should also send a dovish message to the market.

- Additionally, the ECB rhetoric – suggesting that more easing in the euro zone cannot be excluded – should encourage investors to hunt for above-zero yields, taking advantage of the recent weakening, and to buy Polish debt.

- Please note that there is a market holiday in Poland on Tuesday due to the Independence Day, which means that market liquidity is likely to be very thin at the start of next week.

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