Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

17 – 23 November 2014

Even though the week behind was shorter than usually due to Polish national holiday on Tuesday, it was by no means less interesting. We have seen two crucial data releases: October's CPI and 3Q GDP, and both of them delivered quite significant surprises. Inflation rate fell to the new record low -0.6%YoY, and signalled that period of negative CPI growth may persist longer than expected. Meanwhile, GDP data were better than forecast, showing 3.3%YoY growth in 3Q and upward revisions in previous quarters. Earlier, the NBP released Inflation report with details about new medium-term projections. For the first time the projection included a pessimistic scenario, with GDP growth sliding below 2% and inflation running below 1% throughout the projection horizon. What was striking to us was surprisingly high probability of this scenario (40%). Yet, it was apparently not high enough for the MPC, which – as we all know – kept interest rates on hold at its last meeting.

After big surprise from GDP, investors will closely eye next monthly data on economic activity to judge the monetary policy outlook. Our forecast of industrial output is above market consensus, which implies a risk of further correction in the fixed income market. The data could be also slightly positive the zloty, however on the other hand the currency may be negatively affected by persisting geopolitical risk in the region. Indicators of economic activity in the euro zone (flash PMI, German ZEW) will be also important, affecting market expectations about GDP growth outlook in Poland and in Europe.

Economic calendar

CET TIME	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (17 November)					
15:15	US	Industrial output	Oct	%MoM	0.2	-	1.0
		TUESDAY (18 November)					
11:00	DE	ZEW index	Nov	pts	1.3	-	3.2
		WEDNESDAY (19 November)					
14:00	**PL**	**Wages in corporate sector**	**Oct**	**%YoY**	**3.3**	**3.3**	**3.4**
14:00	**PL**	**Employment in corporate sector**	**Oct**	**%YoY**	**0.8**	**0.7**	**0.8**
14:30	US	House starts	Oct	k	1025	-	1017
14:30	US	Building permits	Oct	k	1038	-	1031
20:00	US	FOMC minutes					
		THURSDAY (20 November)					
2:45	CN	Flash PMI – manufacturing	Nov	pts	50.2	-	50.4
9:30	DE	Flash PMI – manufacturing	Nov	pts	51.5	-	51.4
10:00	EZ	Flash PMI – manufacturing	Nov	pts	50.9	-	50.6
11:00	**PL**	**Bond auction**					
14:00	**PL**	**Industrial output**	**Oct**	**%YoY**	**1.4**	**2.1**	**4.2**
14:00	**PL**	**Construction and assembly output**	**Oct**	**%YoY**	**2.1**	**1.6**	**5.6**
14:00	**PL**	**PPI**	**Oct**	**%YoY**	**-1.2**	**-1.1**	**-1.6**
14:00	**PL**	**MPC minutes**					
14:30	US	CPI	Oct	%MoM	-0.1	-	0.1
14:30	US	Initial jobless claims	week	k	-	-	290
16:00	US	Home sales	Oct	k	5.15	-	5.17
16:00	US	Philly Fed index	Nov	pts	18.5	-	20.7

Source: BZ WBK, Reuters, Bloomberg

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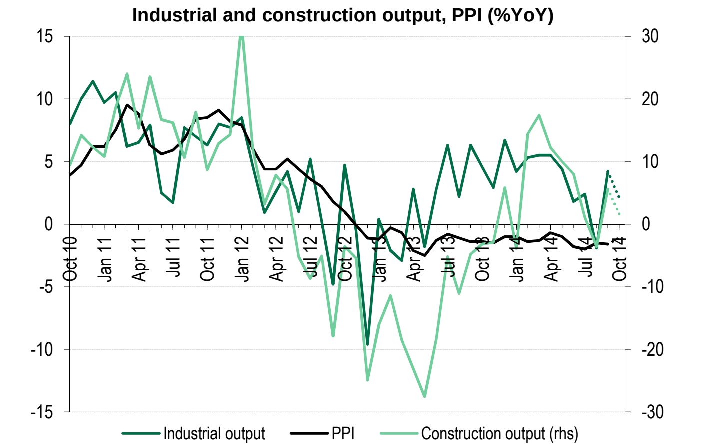
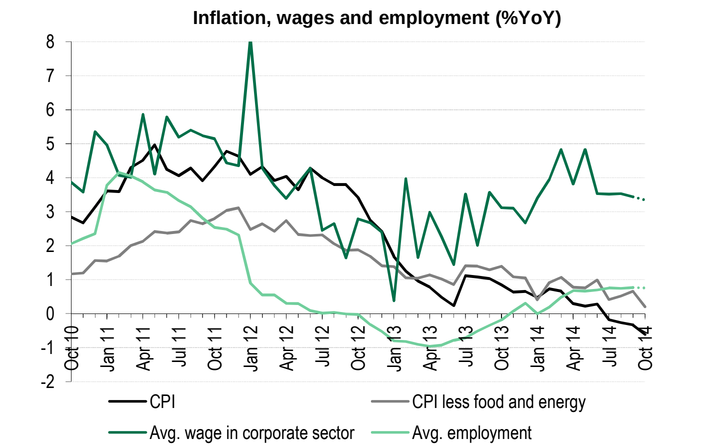
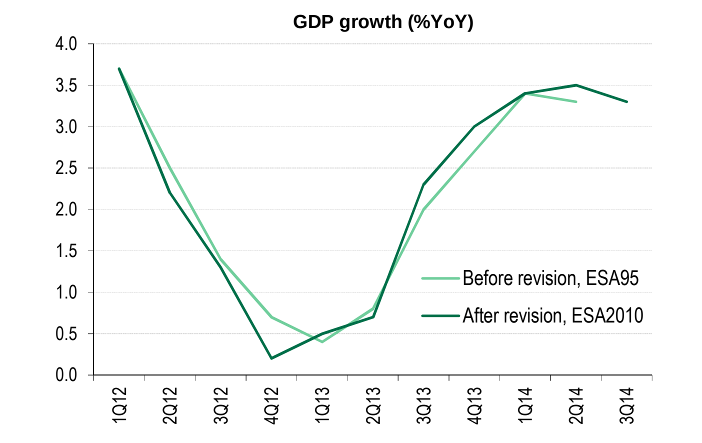
What's hot this week – Labour market and production data



- We expect no significant change of trends in the Polish labour market in October: slight deceleration of average wage growth in corporate sector, with stable employment growth. Such data will be still supportive for moderate growth of private consumption.
- Production growth in industry and construction decelerated in October, in our view, in comparison with September's results, as the positive working days effect has disappeared. However, our forecasts are above market consensus, which (after much better than expected GDP) may reinforce market expectations that interest rate cut in December is not very likely.
- MPC minutes from November's meeting may clarify a bit what influenced the Council discussion the most and what arguments decided about keeping rates on hold. But we think more significant for the market may be potential new comments and interviews of MPC members.

Last week in the economy – Bitter-sweet symphony





- CPI inflation fell in October to a new record low of -0.6% YoY, which was below our forecast of -0.5% and consensus at -0.4%. This was still, to a large extent, due to the declining prices of food and fuels, both of which will keep on pushing inflation lower in the near term as well. Prices in other categories also show no upward momentum. Core CPI (excluding food and energy prices) fell to 0.2% YoY in October, the lowest in eight years. We expect CPI inflation to remain below zero until the end of 1Q15.
- GDP growth in 3Q14 surprised to the upside, reaching 3.3%YoY. Data for the past six quarters was also revised up substantially. The seasonally adjusted QoQ growth also rose in 3Q to 0.9% (vs 0.7% in 2Q) and, according to Eurostat, Poland was again the fastest growing economy in Europe in the third quarter in YoY terms (although a few countries have not released their data yet). The flash release offers no details on the GDP breakdown, so it is hard to say what the main source of the surprise was. However, we suspect it was caused by two things: a methodological change (this was the first release according to ESA2010) and probably a stronger-than-anticipated rise in fixed investments.
- Export and import growth accelerated in September (to 5.5% YoY and 5.8% YoY, respectively), but this was largely due to the higher number of working days. Meanwhile, the underlying trend in export growth seems to be weakening: exports grew 3.5% YoY in 3Q14 vs. 6.1% YoY in 2Q and 8.4% YoY in 1Q. This is caused by weaker economic activity in the euro zone and so we believe that sales of goods abroad may stay modest in the upcoming quarters. At the same time, import growth should be supported by the robust domestic demand, effectively decreasing the net exports' contribution to GDP growth.

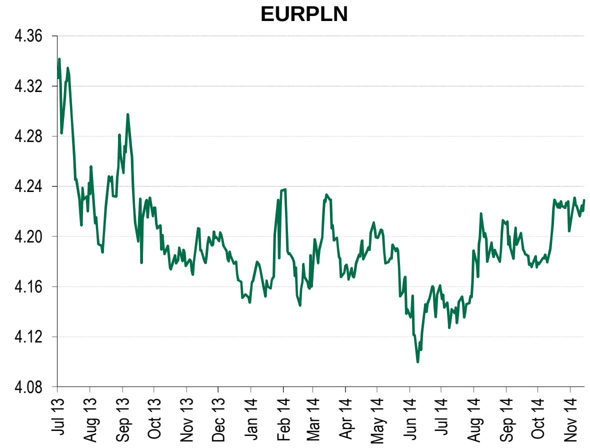
Quote of the week – Thinking of 'wait-and-see' in December

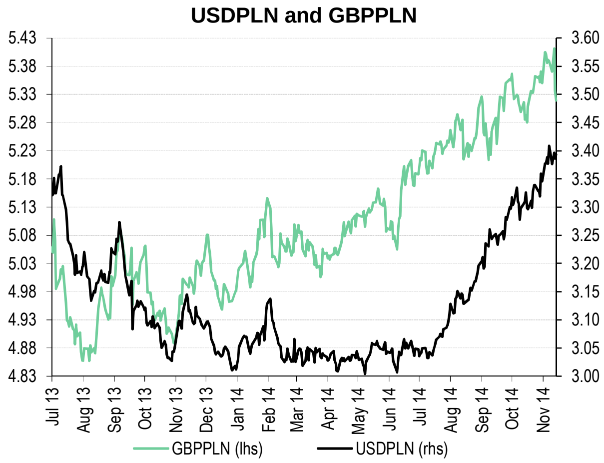
Andrzej Bratkowski, MPC member, 12 Nov, Wall Street Journal
There is room to cut interest rates to 1% (…) I see no reason not to lower rates considering the central bank's baseline scenario puts Poland's growth rate around 3% for each of the next two years and inflation significantly below the 2.5% target (…) All the risks to the projection are to the downside, none to the upside.
Andrzej Kaźmierczak, MPC member, 13 Nov, Bloomberg
[There are no] signs of collapse in economic growth that could justify additional monetary easing (…) cutting rates when the economy is poised to grow 2.8-3% next year, after a strictly temporary slowdown, would betray needless anxiety.
Elżbieta Chojna-Duch, MPC member, 14 Nov, Reuters
It seems we can consider a continuation of 'wait and see' in December and wait for new data.
Anna Zielińska-Głębocka, MPC member, 14 Nov, Reuters
MPC has now time to observe the situation, though it's hard to say how long.

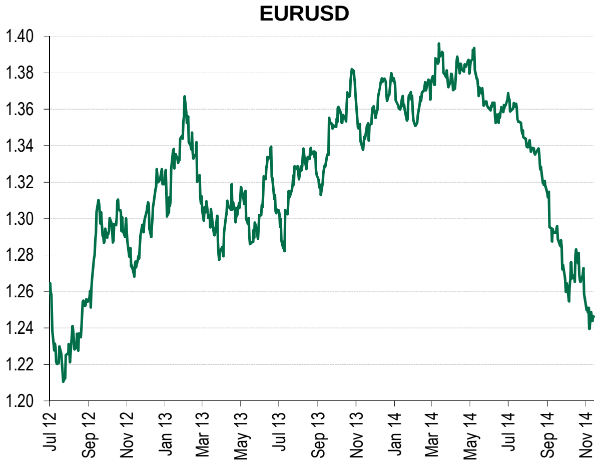
The 3Q GDP data came as huge support for Elżbieta Chojna-Duch's stance, who has become the key member of the MPC by the fact that she was probably the one responsible for keeping rates on hold in November. With the GDP numbers she may be even less eager to support a rate cut in December.

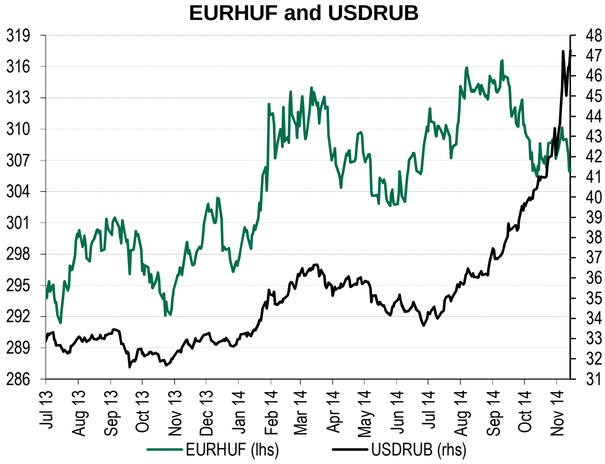
However, the interest rate outlook in the following months will depend on the inflation and GDP outlook. If incoming data confirm the scenario depicted in NBP's latest projection, we think the MPC will cut rates again. In the NBP's Inflation report, the central bank for the first time showed the GDP and CPI paths in a pessimistic scenario, where GDP growth slides below 2% and inflation runs below 1% throughout the projection's time horizon. The bank attributed a 40% probability to this scenario (vs. 55% for the baseline scenario), which shows that the central bank's staff sees huge downward risks for the forecasts.

Foreign exchange market – Will upcoming Polish data support the zloty?









Polish macro data drive the zloty

- Poland's macro data releases had the biggest impact on the zloty this past week. First, the lower-than-expected CPI in October hit the domestic currency with strengthening expectations for a rate cut in December – the EUR/PLN surged sharply to 4.24 (highest since March) from c4.22. But this depreciation was soon reversed thanks to the much better-than-expected flash 3Q GDP data released the next day. The strong figure prevented the EUR/PLN from breaking its crucial resistance at c4.24 and the exchange rate remained in the 4.20-4.24 range (where it has been since mid-October).
- We expect that this will not be the end of the better-than-forecast economic data releases. Our forecast for October's industrial output is above the market consensus and, if it materialises, it could make the zloty continue its appreciation momentum initiated by the GDP data and near 4.20 against the euro. Retail sales data are due the following week and we expect the numbers to come in clearly above the consensus here as well.
- Beware, however, of the still high tensions in Eastern Europe. NATO has reported Russian army activity in Ukraine or close to its border and this may weigh on sentiment in the CEE region, preventing the zloty from a more noticeable appreciation.

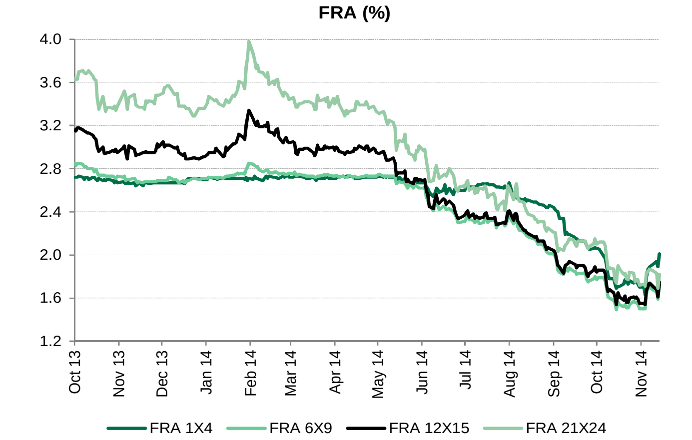
EUR/USD waiting for an impulse

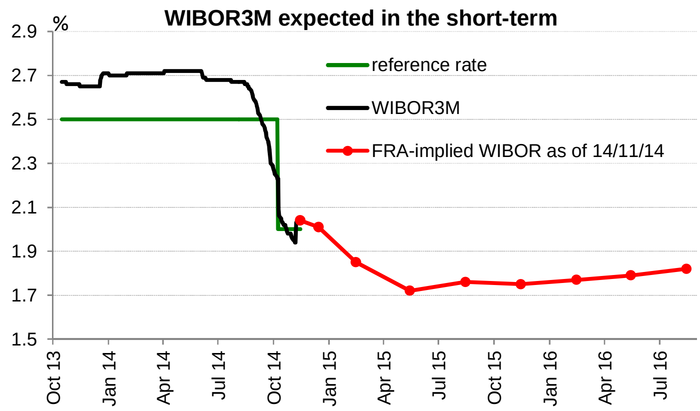
- The EUR/USD remained stable in a narrow range of 1.24-1.25 in the past week as the global data releases did not deviate much from the consensus.
- The period of subdued volatility may end this week, however, as plenty of European and U.S. economic activity data are due. The euro zone releases have been recently delivering slight upside surprises, strengthening hopes that the economy has passed the trough. Should the flash manufacturing PMI for November confirm a rebound, the single currency could gain vs. the dollar. At the same time, the U.S. macro data will also be followed closely.
- The EUR/USD trading range has been gradually narrowing over the last few days. This indicates that a more noticeable move could emerge soon. Important levels to watch are at c1.24 and 1.25.

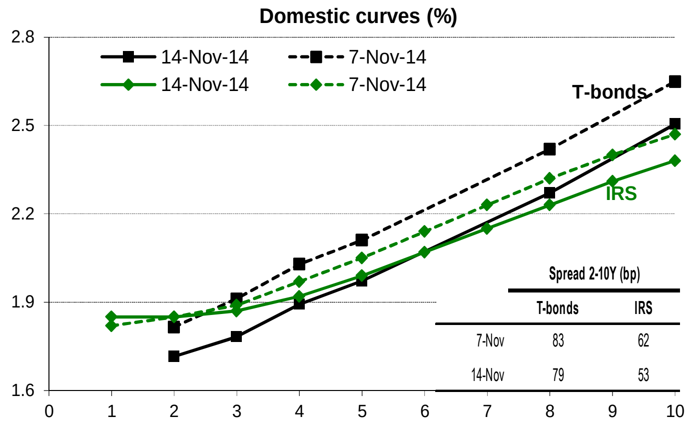
Pause in ruble's depreciation

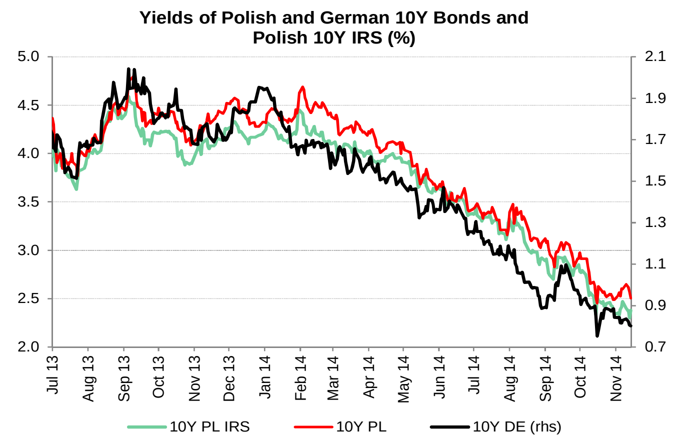
- The USD/RUB stayed below its all-time high of 48.6 this past week. The Russian currency was supported by the central bank's actions to limit speculative activity on the FX market. But even though the exchange rate retreated to 44.95, the move was only short-lived as falling oil prices and news about the Russian army's activity in Ukraine (or close to its border) weighed on the ruble. The USD/RUB was above 47 at the end of the week.
- The Hungarian forint gained vs. the euro in the last sessions. Hungary's flash 3Q GDP data surprised nicely to the upside (3.2%YoY vs. expected 2.9%YoY), but failed to support the forint. There was also some profit taking at the end of the week. The EUR/HUF, therefore, failed to break the local minimum at c305 (the exchange rate was close to 309 at the beginning of the past week).

Interest rate market – Data affect rate cut expectations









Market prices in smaller rate cut after GDP data

- Last week the WIBOR rates continued their gradual rise (by 1 bp across the curve). At the same time, the FRAs fell quite substantially, in line with the IRS market trend. However, the surprisingly strong flash GDP data for 3Q14 put an end to the downward trend on fading expectations for interest rate cuts. That said, the current FRA market pricing still suggests that the MPC could ease monetary policy by 25bp over the next three months.
- This week will be interesting in terms of domestic data releases (labour market data, industrial output, construction output, PPI). Our forecast for industrial output is above the market consensus and, if it proves right, could be a negative impulse for FRAs. On WIBOR, we expect rates to remain more or less stable on a weekly basis.

Unexpected higher 3Q GDP growth trims earlier gains

- Both the T-bonds and the IRS gained in the first part of the week due to further strengthening on the core markets and expectations that CPI and GDP data would reaffirm the need for further adjustment in monetary policy. October CPI surprised the market with a deeper-than-expected decline, which accelerated the decline in both yields and the IRS rates. However, the flash GDP growth for 3Q 2014 was much stronger than predicted, reducing expectations for a rate cut in December. It caused yields/rates to rise considerably, trimming most of the earlier gains. After the flash 3Q GDP data release, yields rose around 10bp on average across the board
- In weekly terms 2-10Y spread for both T-bond and IRS narrowed slightly as the front end of the curves underperformed other sectors. Moreover, last week the spread over Germany Bunds narrowed after a significant widening in the first week of November (for 10Y sector spread narrowed by 5bp after widening by 13bp in the previous week).

Domestic data stays in focus

- Investors will stay focused on domestic data this week. We forecast above-consensus growth of industrial output in October, which, if it materialises, may be a negative impulse for the domestic fixed income market, especially on the front end of the curves. Losses on the long end might be limited by the continuously positive mood on the core market. However, the FOMC minutes from the October meeting might add some volatility on the market.
- Odds for a rate cut in December weakened after the stronger-than-expected 3Q GDP 2014 data. In our view, there is still room for a rate cut till the end of 1Q 2015 as deflation will last longer than previously expected. We, therefore, think that any negative surprises in terms of macro data releases would activate the demand side. Some investors may also use the upward correction on the fixed income market to accumulate T-bonds/IRS.
- The switch auction may also be an important event this week. At the start of next week, the Ministry of Finance will show which T-bonds it will offer instead of the repurchased WZ0115, PS0415 and OK0715. In our opinion, the Ministry will offer T-bonds from the middle of the curve and floating rate instruments. The auction results are likely to have a rather limited impact on investor sentiment on the secondary market.

Additional information is available on request. Please contact Bank Zachodni WBK S.A. Rates Area, Economic Analysis Department, Al. Jana Pawła II 17, 00-854 Warsaw, Poland, phone +48 22 534 18 88, email ekonomia@bzwbk.pl, http://www.bzwbk.pl.