Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

12 – 18 January 2015

The decision of the Monetary Policy Council and the CPI data release will be the key events for the domestic market in the coming week. We think that an interest rate cut is quite unlikely in January because of the relatively decent economic activity data, depreciation of the Polish currency at the turn of the year and the recent comments of some MPC members. If dovish Anna Zielińska-Głębocka talks of a "wait and see" approach in January and Elżbieta Chojna-Duch sees little arguments for further policy easing, mustering a majority for a rate cut will certainly be difficult this week. However, we still think that the depth and length of deflation in the coming months will surprise the central bank and could eventually tip the balance towards another rate cut in 1Q15, probably in March, when the new NBP projections will be released. Already the CPI data for December, due just one day after the MPC's meeting this week, will show quite a notable drop, to almost -1%YoY, showing that further decline is also likely later in 1Q15. This could support the interest rate market, but probably just temporarily, as other data releases due this month are set to be relatively strong, in our view.

The last three weeks saw quite significant volatility in the Polish FX market, amplified by thin liquidity at the end of the year. We think that the zloty should be gradually recovering in the coming weeks, as investors' activity returns to normal and fundamental factors support the currency (no rate cut in January, quite good activity data, hopes for ECB's QE).

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (12 January)					
		No important data releases					
		TUESDAY (13 January)					
14:00	**PL**	**Current account**	**Nov**	**€m**	**-347**	**-452**	**-435**
14:00	**PL**	**Exports**	**Nov**	**€m**	**13 480**	**13 250**	**14 728**
14:00	**PL**	**Imports**	**Nov**	**€m**	**13 419**	**13 300**	**14 672**
		WEDNESDAY (14 January)					
	PL	**MPC decision**		**%**	**2.0**	**2.0**	**2.0**
9:00	HU	CPI	Dec	%YoY	-0.4	-	-0.7
11:00	EZ	Industrial output	Nov	%MoM	0.3	-	0.1
14:00	**PL**	**Money supply**	**Dec**	**%YoY**	**8.2**	**8.2**	**8.4**
14:30	US	Retail sales	Dec	%MoM	0.1	-	0.7
20:00	US	Fed Beige Book					
		THURSDAY (15 January)					
11:00	**PL**	**Bond auction**					
14:00	**PL**	**CPI**	**Dec**	**%YoY**	**-0.9**	**-0.9**	**-0.6**
14:30	US	Initial jobless claims	week	k	-	-	294
16:00	US	Philly Fed index	Jan	pts	20.0	-	24.5
		FRIDAY (16 January)					
11:00	EZ	CPI	Dec	%YoY	-0.2	-	0.3
14:00	**PL**	**Core inflation**	**Dec**	**%YoY**	**0.5**	**0.5**	**0.4**
14:30	US	CPI	Dec	%MoM	-0.4	-	-0.3
15:15	US	Industrial output	Dec	%MoM	0.0	-	1.3
16:00	US	Flash Michigan	Jan	pts	94.1	-	93.6

Source: BZ WBK, Reuters, Bloomberg

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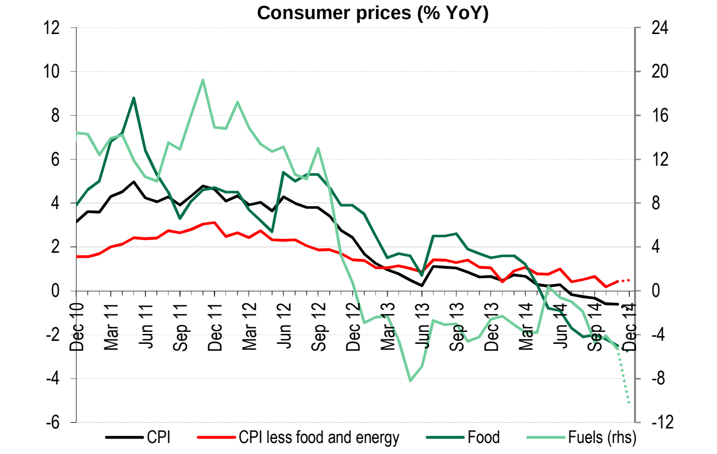
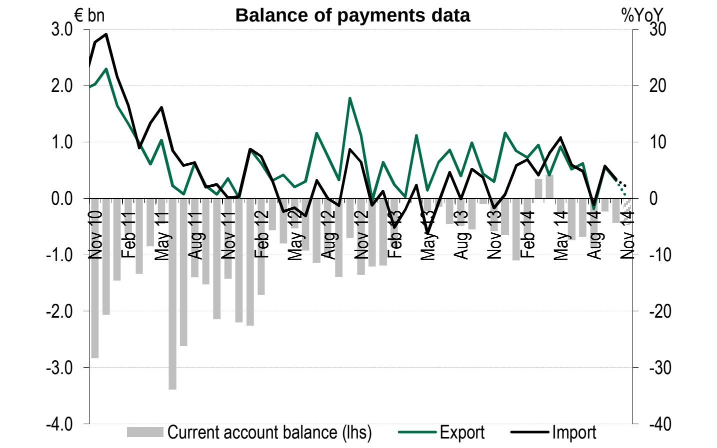
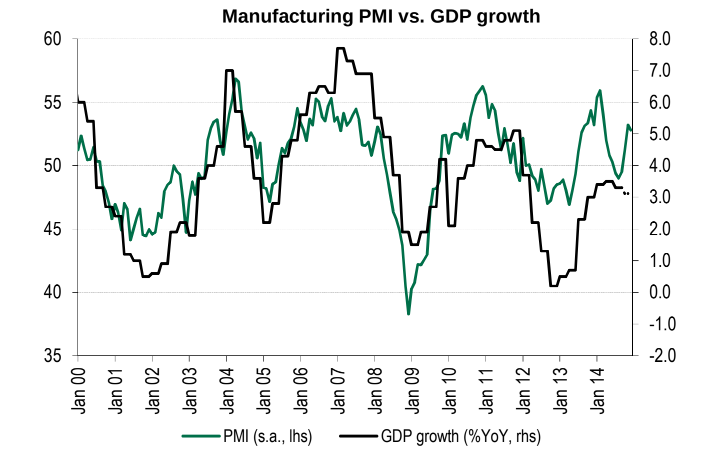
What's hot this week – Interest rates on hold amid deepening deflation





- The Monetary Policy Council's first meeting in 2015 is scheduled exceptionally late in the month. But we still doubt it will bring changes in the Council's policy stance since the recent data on economic activity (which were quite decent) and the year-end zloty depreciation offer little help in convincing enough Council members to launch additional policy easing. However, we think that the scale and the duration of deflation may come as a surprise to the deeply divided Council in the coming months. If so, this could tip the balance in favour of more easing, most likely in March, when the new NBP projections are due for release.
- CPI data for December, to be released just one day after the MPC's decision, is likely to show deflation deepening to -0.9%YoY, which may already be a cold shower for some of the MPC members. Such a reading, even though consistent with the market consensus, could trigger (short-term) strengthening of the interest rate market, especially if the release is followed by dovish comments of the MPC members. We think deflation will deepen even more in 1Q15 (sliding below -1%YoY) and last even till the end of 3Q15, much longer than the central bank anticipates.
- Since the CPI drop is driven chiefly by collapsing fuel prices (-5%MoM in December, according to our estimate) and cheap food, we estimate that core inflation could inch up to 0.5%YoY In December. However, it is likely to remain relatively low, probably below 1%YoY, in the first three quarters of the year.
- We expect the balance of payments' data to show slower export and import growth in November, with the current account deficit at a similar level to that reported for October. Such data would be roughly in line with the market consensus and so are unlikely to trigger any significant market reaction.

Last week in the economy – Retail sales lower, but leading indicators showing improvement



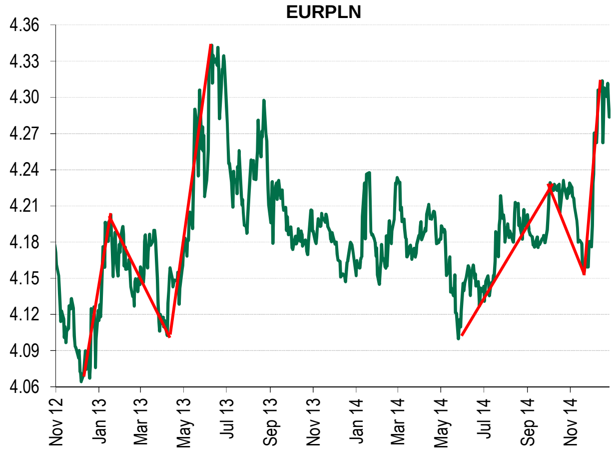
- Polish manufacturing PMI fell to 52.8 in December from 53.2 in November. The index remained above the neutral level for the third month in a row, with its sub-indices for output, new orders and employment remaining stable compared with the previous month. This means, however, that second-tier indices were responsible for the decline of the headline indicator last month. Average PMI in 4Q14 rose to 52.4 from 49.3 in 3Q, which is a good harbinger of economic growth in the upcoming quarters. Other leading indicators (CSO business climate and consumer confidence, BIEC indicator) are also optimistic.
- Retail sales fell 0.2%YoY in November, in nominal terms, and grew 1.4%YoY in real terms.
- The registered unemployment rate climbed to 11.4% in November from 11.3% in October but was 1.8 percentage points lower than one year ago, marking the most considerable decline in annual terms since 2008.

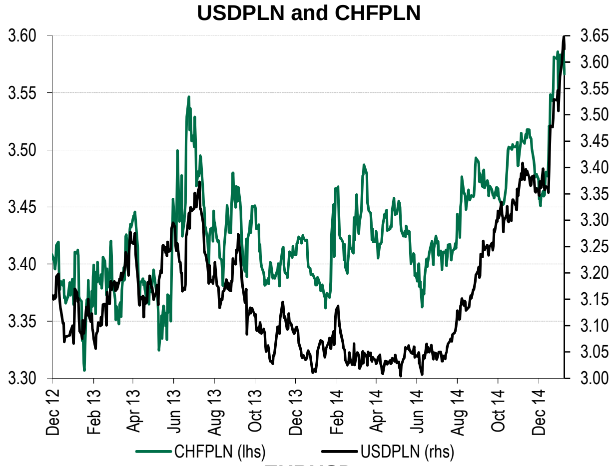
Quote of the week – MPC in "wait and see" mode

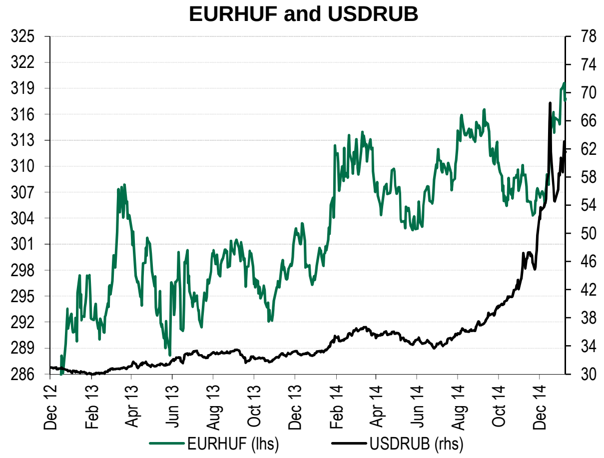
Anna Zielińska-Głębocka, MPC member, 5 Jan, Reuters
The MPC agreed to wait for information from the real economy, adopting a 'wait and see' mode. Currently I think that this strategy will be upheld in January and February. It all depends on new information, mainly from the euro zone.
Andrzej Bratkowski, MPC member, 5 Jan, forward-looking.pl
The zloty is fundamentally undervalued (…) Thus, there is a risk that the zloty may appreciate in the upcoming months, while a moderate but persistent depreciation is favourable for the Polish economy, given the current economic conditions. In my view, this risk is an argument to cut the NBP reference rate by 100bps.
Elżbieta Chojna-Duch, MPC member, 2 Jan, Reuters
Neither the PMI data nor the zloty suggest that rate cuts are necessary.

MPC's Anna Zielińska-Głębocka admitted that the Council was in a 'wait-and-see' mode, awaiting new data from the domestic and euro zone economies, which would be crucial for the Council's future decisions. Let us note that the MPC's last post-meting statement concluded that further adjustment in monetary policy was possible should upcoming data confirm economic weakness. As Zielińska-Głębocka (a dove) believes the "wait-and-see" approach to be the most likely in January-February, we think the view presented by Bratkowski (to cut rates now) is unlikely to find majority backing, especially since the key member needed to form a majority (Chojna-Duch) explicitly said that the strong PMI and weaker zloty were arguments against further monetary easing. We do not expect the zloty's weakening to last , although believe that CPI is probably going to surprise the MPC to the downside, making some easing possible, probably in March.

Foreign exchange market – Zloty may gradually recover from its sharp falls







The zloty's depreciation only temporary?

- The final days of 2014 were very volatile in the Polish FX market as the domestic currency depreciated sharply to above 4.30 vs. the euro and over 3.61 vs. the dollar. The significant upward move in EUR/PLN and USD/PLN was triggered by stronger hopes for more easing in Poland ahead due to the weak retail sales' data and the falling oil price in the global market.
- The scale of the zloty's weakening was exacerbated by the very low liquidity at the very end of the year. But as investors return to their normal activity levels, there will be room for the Polish currency to recover in the coming weeks, with the fundamental factors also offering support. First, we do not expect the MPC to cut rates at its January meeting or change its statement into a more dovish message compared with the previous one. Second, our industrial output forecast for December (due next week) is well above the consensus and this should also work towards a stronger zloty. Third, the ECB is likely to extend its asset purchase programme, supporting the risky assets. Finally, recent developments in the EUR/PLN market resemble, in our view, developments from 1H13, when the zloty had also depreciated sharply. The following weeks, however, saw back then a gradual recovery and we expect this pattern to work this time as well.
- Important levels to watch for EUR/PLN are 4.25 and 4.40.
- At the same time, the zloty may remain under pressure vs. the dollar. USD/PLN reached its highest levels since March 2009 (at c.3.65) and may head further north should the ECB deliver a big enough extension of its asset purchase plan.

EUR/USD lowest since December 2005

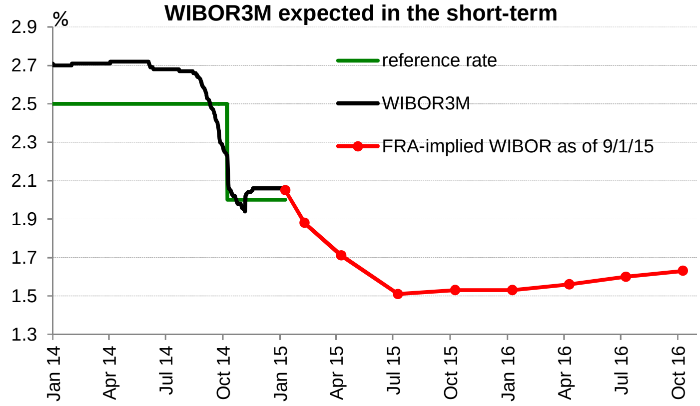
- The euro was under pressure vs. the dollar during the three final quarters of the past year and EUR/USD continues to fall in early 2015 as well. Consequently, it reached 1.175 on strengthening expectations for more easing to be announced by the ECB in January.
- The ECB's decision may determine the direction for EUR/USD for the coming weeks or even months. A lot of the additional easing has already been priced in and it seems that the dollar could gain further only if the ECB delivered more than investors currently anticipate.
- Next support for EUR/USD is at 1.164.

Ruble stabilises, EUR/HUF follows EUR/PLN

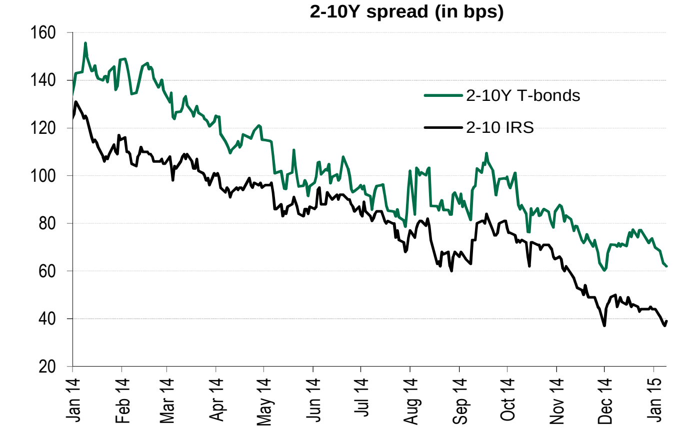
- The ruble's free-fall had stopped in mid-December after the Russian central bank raised interest rates to 17%. This dragged USD/RUB down to c.60 from nearly 80. And although such a sharp recovery may limit the upside potential, there are no factors that could push the exchange rate significantly lower. Thus, we expect USD/RUB to stay close to its current levels in the coming days.
- Next to the zloty, the Hungarian forint also suffered at the end of 2014. EUR/HUF suddenly surged above 320 from c307 on the back of worries that the falling oil prices would force central banks, also in the CEE region, to reinitiate their monetary policy easing cycles. Having said that, the Hungarian CPI data due this week may trigger some moves in the EUR/HUF market. If the release comes in below the consensus, the forint could depreciate.

Interest rate market – Domestic debt should remain strong

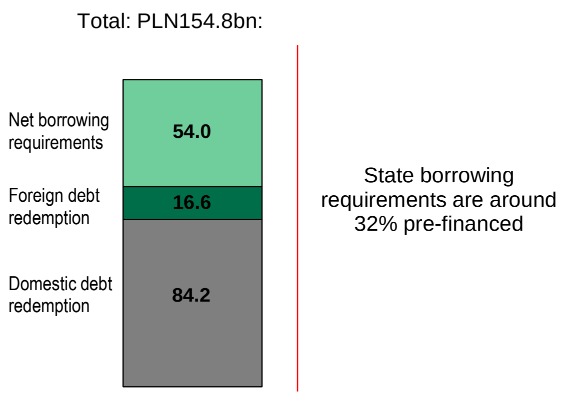
WIBOR3M expected in the short-term



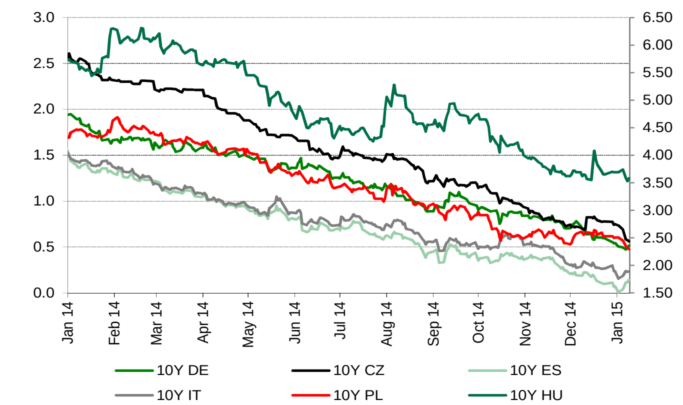
2-10Y spread (in bps)



Gross borrowing requirements in 2015



10Y bonds yields (%)



Excessive expectations for rate cuts this year

- Poland's money market rates were largely stable in the pre-holiday period. But the first week of 2015 brought more significant changes, especially on the FRA market. And while the WIBOR rates fell 1bp (only the 1M and 3M rates), the FRAs dropped 10-15bps across the curve compared with the end of 2014.
- The market is currently pricing-in slightly more than one rate cut of 25bps in the next three months and almost 75bps in total monetary easing in the nearest 6-9 months, which we think is excessive.
- This week investors will mainly focus on the MPC meeting and inflation data. In our view, the Council will leave interest rates unchanged. We expect the headline CPI to fall further below zero (to almost -1%YoY), which should keep expectations for more monetary easing alive. The FRAs will, therefore, remain at a low level even in absence of monetary easing this month. At the same time, the WIBOR rates might gradually decline, in particular on the back of the CPI data.

Domestic debt reaches fresh lows

- The end of 2014 brought gradual strengthening of the domestic interest rate market, with both yields and IRS rates slightly down when compared with the pre-holiday period. But the Polish FI market firmed significantly at the start of the year thanks to the sharp plunge of yields on the core debt markets, caused by hopes that the ECB would expand its asset purchase programme as soon as in January. Consequently, yields of the Polish 2Y, 5Y and 10Y bond benchmarks reached fresh all-time lows of 1.67%, 1.91% and 2.29%, respectively (11-22bps lower than at the year-end). The same trend was observed on the IRS market, where the 10Y rate reached a new record low of 2.05%.
- The long end of the curves benefited from the strengthening on the core debt markets the most. As a consequence, the 2-10Y spreads narrowed quite considerably, following the global trend.
- Poland's Ministry of Finance plans to hold five or six bond auctions, offering a total of PLN25-30bn (the structure of the offer will depend on market conditions) in bond supply in 1Q 2015. What is more, a switch auction is only planned in March. Poland is in a comfortable position when it comes to foreign debt issues and has no significant FX financing needs in the early months of 2015. However, the ministry could consider launching private placements abroad.

Busy week for debt

- This week's calendar is very heavy, with investors expected to focus on the MPC meeting, macro data releases (including the headline CPI for December) and the bond auction. It is broadly expected that the Council will keep its official rates unchanged. This, coupled with the possibly strong call for QE by the ECB later this month, should support the domestic bond curves (especially the mid and long-ends), with the yields / IRS rates remaining near their low levels. Moreover, a sharp drop of December's CPI should anchor the front end of the curves near their current levels, with investors awaiting further monetary easing by the MPC later in 1Q 2015.
- The Ministry is due to offer long-term T-bonds this week, i.e. WZ0124, DS0725 and WS0428, worth PLN2.0-4.0bn (the final offer will be announced at the beginning of the week). In our opinion, the environment for bonds remains favourable thanks to further ECB easing, which is likely, and amid calls for the MPC to cut rates. We, therefore, do not expect demand to be a problem at the auction, even though yields are already close to their record lows.

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.