

WEEKLY ECONOMIC UPDATE

2 – 8 February 2015

As expected, the FOMC refrained from making any changes in its monetary policy and maintained the newly-introduced “patient” forward guidance. But the overall tone of the official statement was a bit less dovish than the market had anticipated. The market’s initial reaction was negative, prompting a decline in EURUSD, weakening emerging market currencies and fuelling gains on the bond markets. However, both core and the domestic debt markets were under positive impact from the ECB’s substantial monetary policy easing, which caused a rally in the Polish bonds and dragged the 10Y benchmark yield below 2%. Domestic macro data were overall in the shadow of the external events, although the flash 2014 GDP growth at 3.3%YoY (in line with our expectations) was a decent figure.

This week will be relatively light in macro data releases and events. Investors will focus on the central bank meetings in Poland and in the Czech Republic, with the non-zero odds for an interest rate cut by the Polish MPC prevailing this month. However, in our view, both central banks will keep rates unchanged in February. Flat rates should be positive for the zloty, but neutral to negative for the domestic bonds (but only in the short-term) as we expect a rate cut in March. Manufacturing PMI releases for the European economies and the US labour market data could add some volatility on the market.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD	FORECAST		LAST VALUE
				MARKET	BZWBK	
MONDAY (2 February)						
2:45	CN	PMI – manufacturing	Jan	pts	49.8	49.6
9:00	PL	PMI – manufacturing	Jan	pts	52.8	52.8
9:55	DE	PMI – manufacturing	Jan	pts	51.0	51.2
10:00	EZ	PMI – manufacturing	Jan	pts	51.0	50.6
14:30	US	Personal income	Dec	%MoM	0.2	0.4
14:30	US	Consumer spending	Dec	%MoM	-0.2	0.6
16:00	US	ISM – manufacturing	Jan	pts	54.8	55.5
TUESDAY (3 February)						
16:00	US	Industrial orders	Dec	%MoM	-2.0	-0.7
WEDNESDAY (4 February)						
	PL	MPC decision		%	2.0	2.0
9:55	DE	PMI – services	Jan	pts	52.7	52.1
10:00	EZ	PMI – services	Jan	pts	52.3	51.6
14:15	US	ADP report	Jan	k	220	241
16:00	US	ISM – services	Jan	pts	56.5	56.2
THURSDAY (5 February)						
8:00	DE	Industrial orders	Dec	%MoM	0.8	-2.4
11:00	PL	Bond auction				
13:00	CZ	Central bank decision		%	0.05	0.05
14:30	US	Initial jobless claims	week	k	-	265
FRIDAY (6 February)						
8:00	DE	Industrial output	Dec	%MoM	0.4	-0.1
9:00	CZ	Industrial output	Dec	%YoY	6.7	-0.4
14:30	US	Non-farm payrolls	Jan	k	231	252
14:30	US	Unemployment rate	Jan	%	5.6	5.6

Source: BZ WBK, Reuters, Bloomberg

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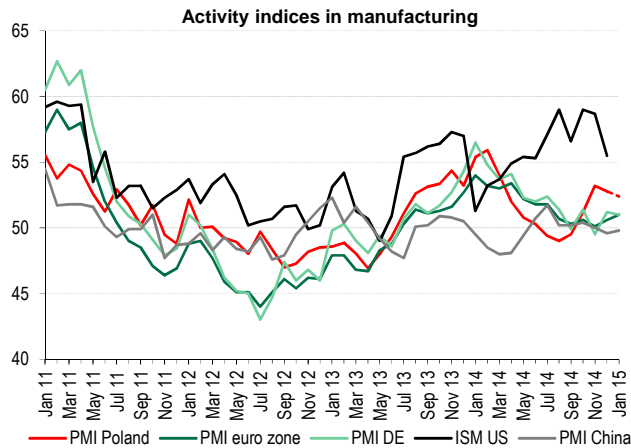
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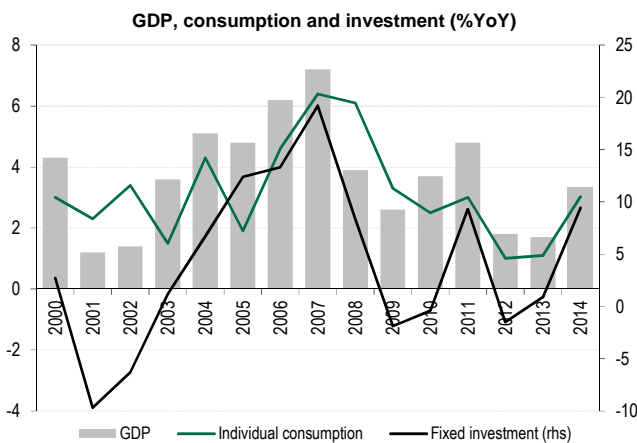
What's hot this week – PMI index and MPC decision



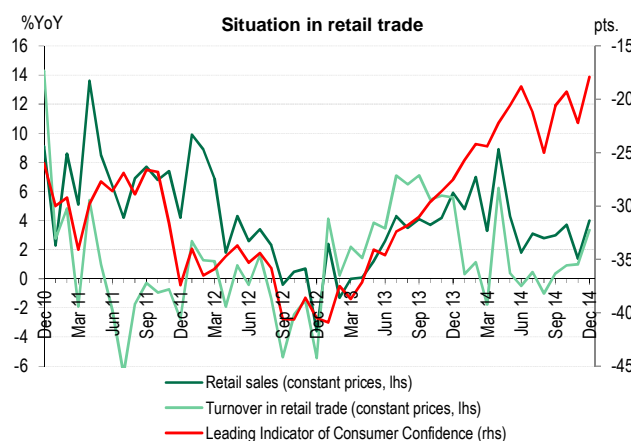
■ We expect the Polish manufacturing PMI index to have fallen a bit in January, though it likely remained clearly above 50pts. In our view, the recent turmoil on the financial markets may have temporarily weighed on sentiment, but the index should continue to reflect the incoming recovery.

■ Recent events, such as growth of industrial output in December and depreciation of the PLN, offer strong arguments for delaying changes in interest rates. On the other hand, the ECB's decision to launch QE supports MPC action. That said, even Andrzej Bratkowski, who is one of the two most dovish MPC members and who was recently calling for rate cuts of 100bps, is currently in favour of smaller moves (25bps each). We, therefore, expect the MPC to leave rates unchanged in February. We believe March to be a good time to cut rates and that is when the MPC will likely deliver a cut of 25bp.

Last week in the economy – GDP for 2014 points to a slight slowdown in Q4



■ Poland's GDP expanded by 3.3% in 2014, as expected. Domestic demand proved to be the main engine of growth, fuelled by private consumption (up 3.0%) and investment (up 9.4%) amid a negative contribution of net exports. Our estimate for Q4 shows that the Polish economy slowed to 3.1% from 3.3%YoY in Q3. Private consumption most probably decelerated a bit, to 3.0% vs. 3.2%YoY in Q3, similar to investments, which likely slowed to 8.8%YoY from 9.9%YoY. We expect the net exports' contribution to be similar to Q3 (-1.5pp). We also assume that the deceleration may continue into 1Q15 but it should only be marginal and short-lived since optimism among the domestic consumers and entrepreneurs is improving. What is more, the labour market situation is positive and real disposable income is expanding at a solid pace, which will support domestic demand, stabilising GDP growth near 3%YoY. In the following quarters, we expect the economy to gradually accelerate due to the recovery in the euro zone.



■ In December 2014, retail sales rose 1.8%YoY vs. -0.2%YoY in November. In real terms, sales increased 4%YoY, the strongest since May 2014. In all of 4Q, retail sales were up 1.3%YoY vs. 1.8%YoY in 3Q. The current labour market situation and the continuous rise in real disposable incomes should support sales in the coming months. We expect retail sales to accelerate to c5%YoY in 2015 from c.3%YoY in 2014.

■ The registered unemployment rate rose in December to 11.5%, from 11.4% in November. Growth of the unemployment rate at the end of the year is seasonal but this time around it posted its lowest rise in monthly terms since 2007. Moreover, in annual terms, the unemployment rate declined by 1.9 percentage points and that was the most considerable decline since 2008. In general, unemployment data show that labour market is in good shape.

Quote of the week – Deflation to last longer

Andrzej Bratkowski, MPC member, 26.01.2015, forward-looking.pl

There is much room to cut rates, but turbulence due to the franc's strengthening supports less significant moves of 25bps, monthly.

Andrzej Raczeko, deputy NBP governor, 26.01.2015, Reuters

Over a two years' time horizon, the inflation path will be lower than had been expected by the NBP in November. We thought deflation would stay until May. It is now certain that it will last longer.

Jerzy Hausner, MPC member, 29.01.2015, IRS report

Deflation (both of demand- and supply-side) is temporary and does not reflect the actual equilibrium between GDP/labour market/price developments – the higher the interest rate is, the better the approach given the risk that global price trends could reverse.

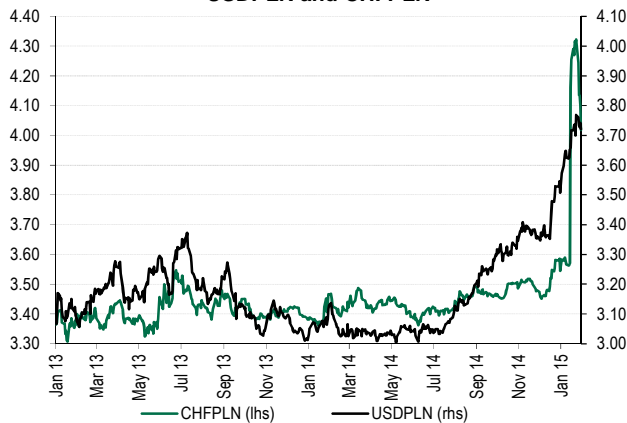
We think that an interest rate cut is unlikely in February due to the quite positive macro data and turbulence on the FX market. Still, let us keep in mind that the last MPC statement said that if the expected period of deflation proves longer and the incoming data confirm economic activity is slowing, while weak growth in the environment of the Polish economy persists, the Council could cut rates. Andrzej Raczeko's comment clearly proves that the upcoming NBP projection in March will show a longer deflation period. The economic slowdown in Q4 was already confirmed by full-2014 GDP data and upcoming data for January will most likely be weak, as well. We, therefore, predict there will hardly be an argument against an interest rate cut in March.

Foreign exchange market – Under impact from important data releases and central bank meetings

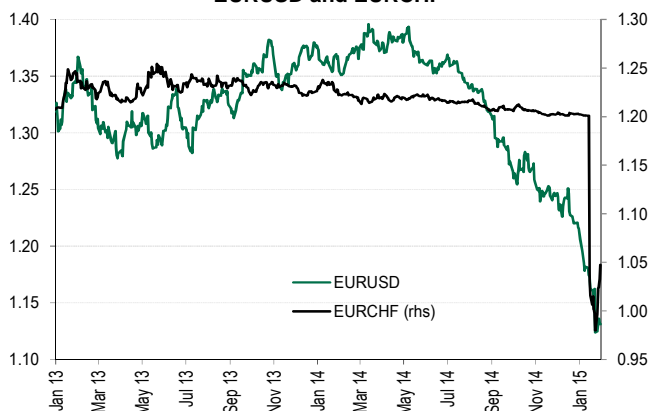
EURPLN



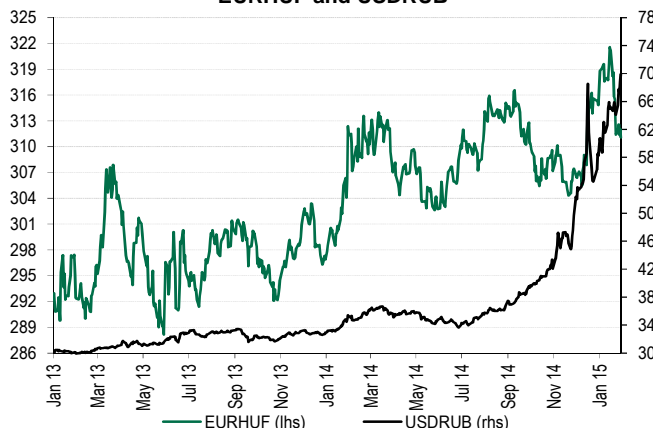
USDPLN and CHFPLN



EURUSD and EURCHF



EURHUF and USDRUB



Zloty stable vs. EUR, stronger vs. USD and CHF

▪ The zloty was mixed over the past week. It lost a bit at the beginning of the week due to the outcome of the Greek elections, but then stabilised at an elevated level ahead of the FOMC meeting. Its initial reaction to the Fed meeting's outcome was negative with EURPLN temporarily rising slightly above 4.25. At the same time, USDPLN rose towards 3.76, tracking the downward move of EURUSD. However, investor sentiment slightly improved at the end of the week, which means that overall the zloty was roughly stable on a weekly basis vs. the euro. It gained vs. the US dollar, however, despite the Russian ruble's weakening.

▪ The zloty also gained vs. the Swiss franc, mainly thanks to the higher EURCHF, offering a breather to CHF loan holders. CHFPLN temporarily fell towards 4.00 from 4.32 at the end of previous week. In weekly terms, the zloty gained c6% vs. the franc and 3.8% since the unexpected SNB decision to drop the 1.20 floor (on January 15).

▪ FX investors will focus on the domestic MPC meeting and the January PMI reading this week. Lack of a rate cut in February and a relatively solid reading of Poland's manufacturing PMI should support the zloty. The zloty's support at 4.20 is currently an effective break on a more significant EURPLN decline. We think that, if our forecasts materialise, this level could be tested this week. Moreover, macro data releases due abroad for both Europe and the US (with non-farm payrolls for January among them) might add some volatility to the zloty's quotations.

Range trading in EURUSD, EURCHF up

▪ The European currency firmed slightly last week, with EURUSD rising to 1.136 from 1.124 at the end of the previous week. But intra-day volatility was quite significant, with EURUSD falling temporarily below 1.13 after the FOMC communiqué. At the same time, the euro also gained against the Swiss franc. There were some speculations that the Swiss National Bank was intervening to weaken the CHF and, consequently, EURCHF rose towards 1.05 from c0.98 at the end of the previous week.

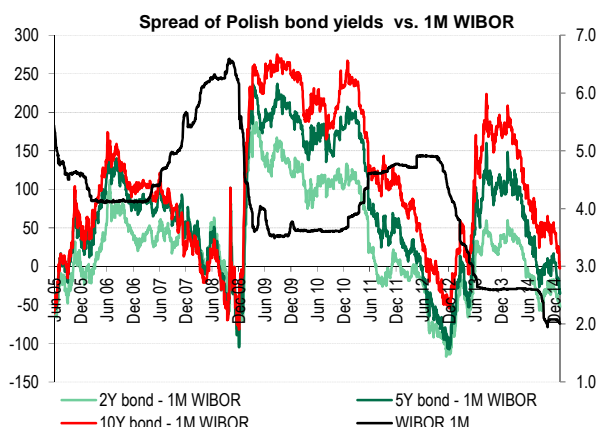
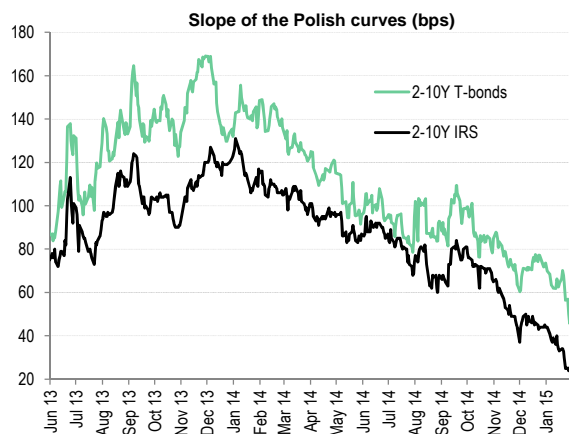
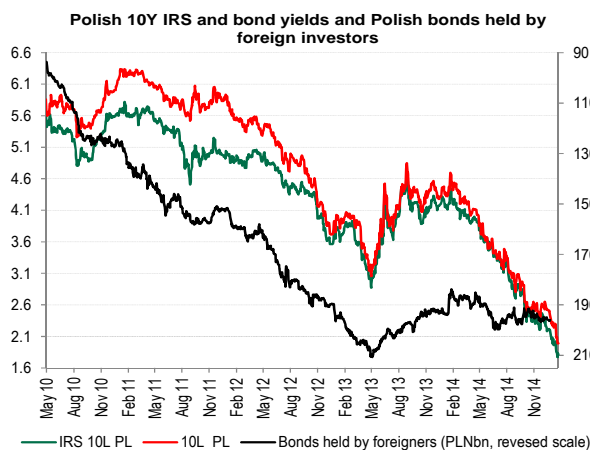
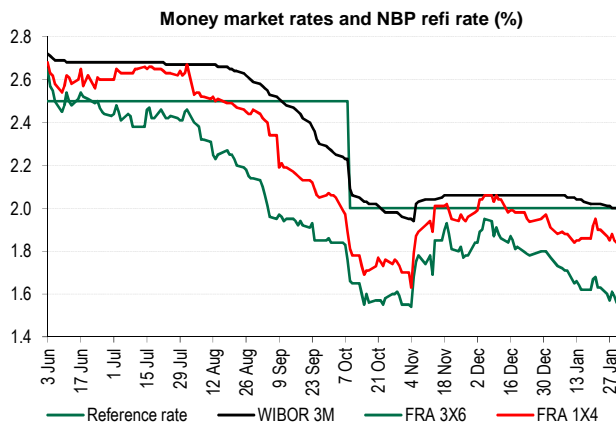
▪ From the technical point of view, there is some room for EURUSD to rise towards 1.16 in the coming weeks. However, further improvement on the US labour market could cause the exchange rate to drop towards its strong support level near 1.10. All in all, EURUSD is likely to keep being traded in a range of 1.10-1.16 (strong resistance level) as investors are awaiting more signals from the economy and central banks.

High volatility on RUB, HUF slightly stronger

▪ Last week was heavy with news affecting the Russian ruble. For starters, S&P decided to downgrade Russia's sovereign rating to junk. Secondly, the Russian central bank cut rates by 2pp to 15% from 17%, causing USDRUB to rise above 70 at the end of the week. At the same time, the Hungarian forint gained in weekly terms as the NBH decided to keep rates unchanged at its January meeting. The FOMC statement also had a negative impact on the EM currencies, including the forint and the Czech crown, though only in the short term.

▪ This week will be quite light for Hungary and the Czech Republic as far as macro data releases are concerned. Manufacturing PMI releases for both these economies might add some volatility to HUF and CZK. The Czech crown could suffer from the outcome of the CNB meeting as investors speculate that the floor on EURCZK at 27 may be shifted up due to deflation fears. In our view, external factors, especially macro data from the US, could also have a strong impact on the CEE currencies since investors remain undecided on when the Fed could start its monetary tightening later this year.

Interest rate market – More strengthening and more flattening still likely



Bond rally continues, rates lower along the curves

- WIBOR rates eased further in the past week – by 1-3bp, mostly on the 12M rate – and FRAs expanded the scale of the priced-in monetary policy easing (75bp in cuts within 6 months' time is currently factored in). At the same time, the rally of the Polish bonds continued, dragging the yield of the 10Y benchmark below 2%. On a weekly basis, the IRS curve moved down 3-6bp and the bond curve 4-10bp as the FI market continued to be under positive impact from the ECB's substantial monetary policy easing and the non-zero odds of an interest rate cut by the Polish MPC in February.

Long end on the auction, Asia purchases more Polish debt

- The Ministry of Finance said it would offer bonds worth a total of PLN6-11bn in February. This week, long-term WZ0124, DS0725 and WS0428 bonds will be on offer, worth a total of PLN3-5bn. The offer at the next week's auction will depend on market conditions but bonds offered this week will not be excluded from the offer.

- According to data released by the Ministry of Finance, holdings of Polish, PLN, marketable bonds did not change much throughout December as foreign investors reduced their portfolios by a mere PLN623mn, while domestic banks had sold debt worth PLN181mn in nominal value, that is 0.12% of their total portfolio. Among non-residents, the most noticeable change in the value of bonds held was visible in the case of the Asian central banks (excluding the Middle East) as this group purchased bonds worth more than PLN1.4bn (+12% MoM). This was the 3rd biggest monthly purchase since data is available (May 2014). Director Piotr Marczak from the Ministry of Finance, said that the 3rd decade of January 2014 saw one of the biggest inflows of foreign capital into the Polish bond market.

More strengthening and more flattening still likely

- The bond and IRS curves continued to flatten, mainly due to the significant strengthening in the belly and long ends, while the short ends moved at a smaller scale. The 2-10 and 2-5 bond spreads fell 45-55bp since mid-December and for the IRS, the respective changes reached 30-35bp. Flattening is a trend that has been recently seen globally. The Polish 2Y IRS and bond yields are close to 1.50% and we do not think further decline is justified. We expect the MPC to leave rates unchanged this week and, in our base case scenario, we assume the MPC will launch a 25bp adjustment in March only. Leaving rates flat this week might cool market expectations as far as the scale of the possible monetary policy easing is concerned.

- However, one cannot exclude that the 2-10 and 2-5 spreads will fall more also due to further falls of the 5Y and 10Y yields. The substantial monetary policy easing announced by the ECB had a noticeable and positive impact on the global FI market and this should also continue to support the Polish medium- and long-term debt.

- When estimating financing costs with the 1M WIBOR, we see that the current yields of bonds of up to 10 years are below or close to this rate. Note, however, that there has already been cases since 2005 when yields were below the cost of financing. These periods did not last long, but the current situation is not exceptional and further strengthening should not surprise also given also the expected inflow of cash into the European market from the ECB in the coming years.

- We also think that the Polish macro data for January will point to a drop in CPI further below zero and to weak industrial output. This should keep hopes for more rate cuts alive and prevent yields and IRS from rising.

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