

WEEKLY ECONOMIC UPDATE

20 – 26 July 2015

The Greek drama seems to have come to a pause, at least for some time, after the Eurogroup announced a conditional agreement with Greece and the Greek parliament approved the required reform package, opening the door to further negotiations with the creditors. As a consequence, the Eurogroup decided to establish emergency bridge financing from the European Stability Mechanism (€7bn) that should help Greece avoid a default against the ECB and survive until negotiations on the third bailout package are over. Additionally, the ECB decided to increase its liquidity assistance for the Greek banks by €900mn. The Polish zloty and bonds firmed considerably last week thanks to the falling global risk aversion. These global events overshadowed the domestic macro data releases, but, nevertheless, the balance of payments' further improvement (the 12M cumulative C/A gap at the end of May accounted for only 0.1% of GDP) and strong growth in exports are worth noting because they should support faster GDP growth in the upcoming quarters. Industrial output and retail sales data also confirmed that economic activity was rising. All in all, the zloty firmed against the euro, temporarily dropping below 4.10, the lowest level since May, while the 10Y benchmark yield fell well towards 2.90%. What is more, both curves flattened again, following the global trends, while the spread over Bunds narrowed, confirming some improvement in global sentiment.

This week's macro calendar is very light for Europe and the U.S., with the flash PMI manufacturing for the euro zone and China as the key indicators. In our view, these data should show some rebound, confirming a revival in the global economic activity. What is more, optimism after the Greek deal should also continue this week, supporting risky assets, including Poland's. We, therefore, expect the zloty to remain strong. As regards the Polish interest rate market, Thursday's regular auction will be crucial for investor sentiment. The liquidity situation (OK0715 redemption and interest payments worth cPLN10.1bn in total) should support the auction's results, allowing the Ministry of Finance to sell everything on offer (PLN6bn).

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD	FORECAST		LAST VALUE	
				MARKET	BZWBK		
MONDAY (20 July)							
No important data releases							
TUESDAY (21 July)							
14:00	HU	Central bank decision		%	1.40	-	1.50
WEDNESDAY (22 July)							
16:00	US	Home sales	Jun	m	5.4	-	5.35
THURSDAY (23 July)							
10:00	PL	Unemployment rate	Jun	%	10.4	10.4	10.8
11:00	PL	Bond auction					
14:30	US	Initial jobless claims	week	k	-	-	281
FRIDAY (24 July)							
3:45	CN	Flash PMI – manufacturing	Jul	pts	49.8	-	49.4
9:30	DE	Flash PMI – manufacturing	Jul	pts	52.0	-	51.9
9:30	DE	Flash PMI – services	Jul	pts	54.0	-	53.8
10:00	EZ	Flash PMI – manufacturing	Jul	pts	52.5	-	52.5
10:00	EZ	Flash PMI – services	Jul	pts	54.2	-	54.4
16:00	US	New home sales	Jun	k	540	-	546

Source: BZ WBK, Reuters, Bloomberg

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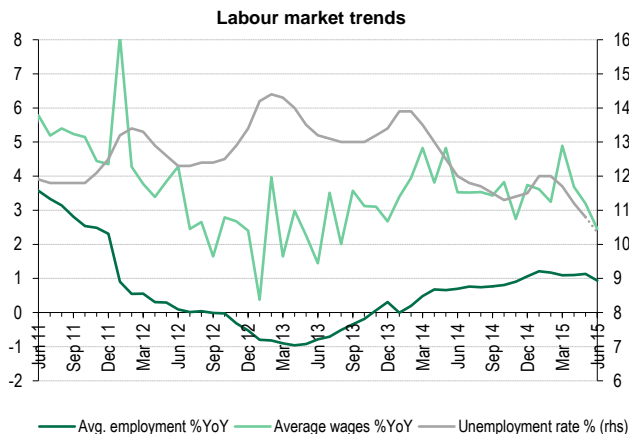
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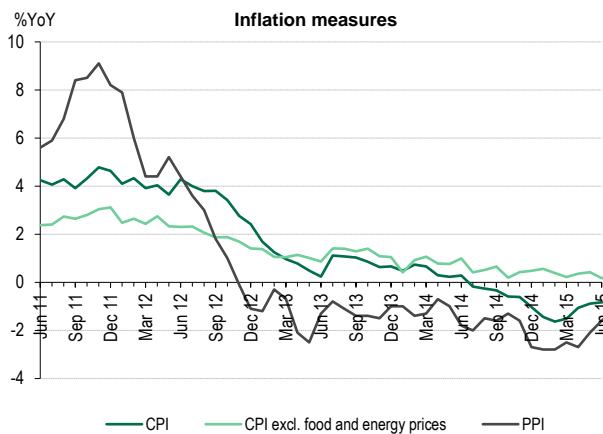
What's hot this week – Summer lull, finally



▪ The registered unemployment rate for June will be Poland's only major data release this week. Our forecast is consistent with the Labour Ministry's flash estimate that points to another drop of the jobless rate to 10.4%, its lowest since early 2009.

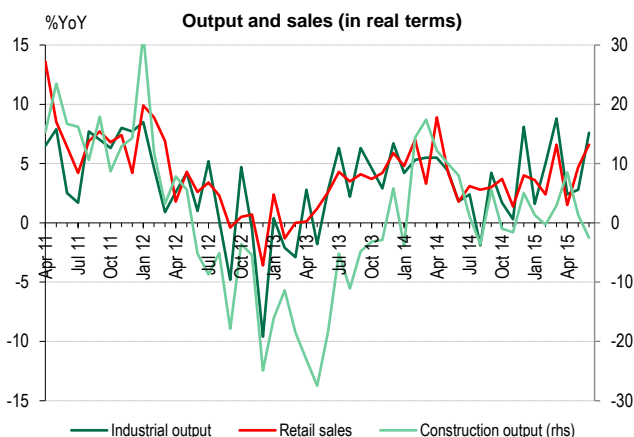
▪ The reading is not likely to have a significant impact on the financial market. However, it will be interesting to see if the official data confirm the Labour Ministry's announcement of a record surge in the number of new job offers, as this would suggest that demand for labour remains strong and that the recent disappointment in employment growth was more about growing shortages of a skilled labour force than falling momentum of economic growth.

Last week in the economy – Labour market disappointed, but economic activity is rising



▪ The C/A surplus reached €1.2bn in May, surprising well to the upside. The 12-month rolling C/A deficit now stands at only 0.1% of GDP, the lowest since the mid-90s. Exports reached €14.1bn (+9.7% YoY) and imports amounted to €13.2bn (flat YoY). The foreign trade surplus reached €946mn and was the highest since comparable data is available.

▪ The inflation rate amounted to -0.8%YoY in June and its rebound was mainly due to a low base effect, especially in food and fuel prices. At the same time, there are no signs of faster price growth fuelled by stronger consumer demand. We also expect a gradual rise of CPI in the upcoming months, yet it will most probably remain below zero until the end of Q3. Core inflation ex food and energy prices fell to 0.2%YoY. In contrast, PPI deflation in June was higher than expected (-1.6%YoY), but we still cannot speak about rising cost pressure on producers.



▪ The labour market numbers disappointed. Corporate sector employment rose in June by merely 600 people MoM (and 0.9%YoY) and this was the weakest increase seen in that month since 2009. This could have been due to the drying up supply of qualified labour. The slowdown in wages (2.5%YoY) may be due to a shift of bonus payments in mining. If true, this would make the slowdown in wages only temporary.

▪ Growth of industrial output accelerated in June to 7.6%YoY, and growth of retail sales in constant prices to 6.6%YoY, confirming that the economic activity is rising, and weaker results in last two months were mostly due to temporary statistical distortions. Construction output disappointed and fell by 2.5%YoY. We still assess that GDP growth in Q2 was very close to that recorded in Q1 and reached c3.6%YoY.

Quote of the week – There may be room to cut rates

Jerzy Osiatyński, MPC member, 17.07.2015, PAP

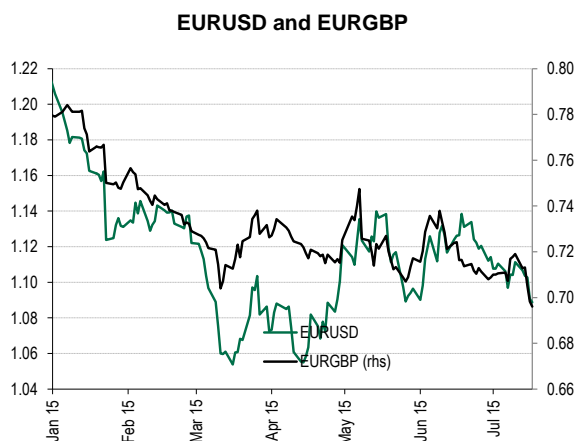
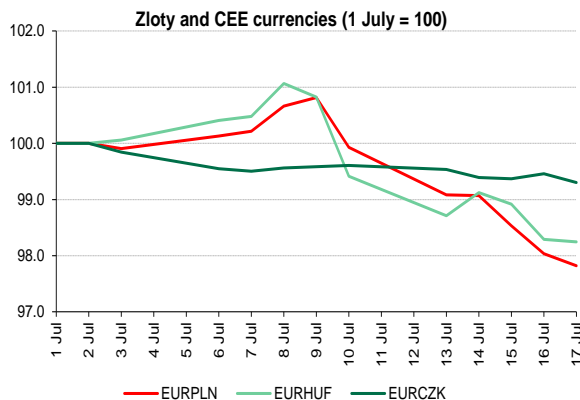
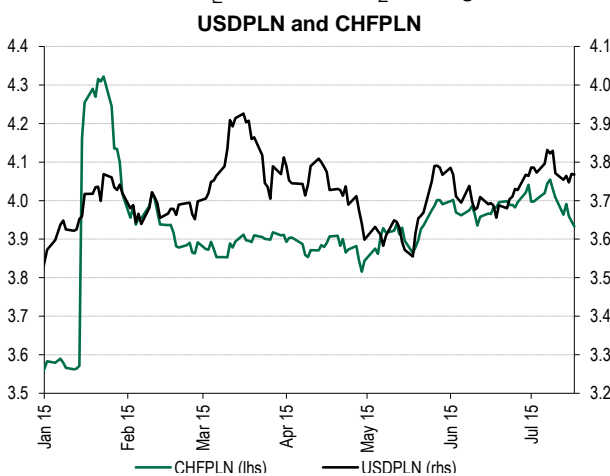
My intuition tells me (...) that there may be room to cut rates by 25-50bps. But we should not make such a decision based on intuition. I guess that keeping rates unchanged is the safest way right now.

Elżbieta Chojna-Duch, MPC member, 15.07.2015, Reuters

I support stabilisation of interest rates, as stable rates are valuable in an environment of high uncertainty and volatility. However, an overly long period of low rates may increase the risk of imbalances in the economy. The possible fiscal policy easing in Poland can also trigger the need to tighten monetary policy, at least slightly.

The two main doves from the MPC, Osiatyński and Chojna-Duch, spoke in favour of keeping rates stable and it seems that this is their baseline scenario. However, while Chojna-Duch warned that some policy tightening could be needed should fiscal policy become more relaxed, Osiatyński even sees some room for more monetary easing. His opinion is of particular importance, as he is the only current MPC member whose term does not end in 2016. Let us keep in mind that the IMF recently said that further interest rate cuts in Poland were justified. The PiS candidate for Prime Minister, Beata Szydło, also said that the central bank should be more active in supporting economic growth. In this context, our assumption of interest rate hikes at the end of 2016 is becoming more and more questionable.

Foreign exchange market – The zloty's upswing could continue



Zloty stronger versus euro ...

- Poland's zloty benefited from the upswing in market optimism following news from Greece (its agreement with the creditors, austerity measures approved by the Greek parliament, a bridge loan worth €7bn agreed to by the Eurogroup) and better-than-expected macro data from China. The domestic macro data releases did affect the zloty too much. As a consequence, EURPLN temporarily fell below 4.10, the lowest level since May. While the zloty gained considerably versus the euro and the Swiss franc (by 2.1% and 1.9%, respectively), it lost significantly against the British pound (1.1% due to GBP strengthening against the EUR and USD) and remained nearly unchanged against the U.S. dollar.
- Last week saw the longest drop of EURPLN since late January (7 sessions in a row). The last time a similar situation took place was in December 2011, when EURPLN fell for 10 sessions in a row. The exchange rate is now oscillating near its support level of around 4.10. If EURPLN breaks this level, it could fall towards 4.03 in the coming weeks. Improvement in July's flash PMI manufacturing for the euro zone and China could further support the FX market rally, including the Polish zloty.

... just like its emerging market peers

- In general, the emerging market currencies, including the CEE region, firmed due to improvement in the global sentiment, with the Chilean peso and South African rand gaining the most (over 3% in weekly terms). As regards the CEE currencies, the Hungarian forint underperformed the Polish zloty (gaining less than 1% vs. the euro), while the Czech koruna was more or less stable, with a modest gap to the floor at 27.0.

- The global market sentiment will be key for both HUF and CZK this week, amid scarce important domestic events. Further risk-on mode should support emerging market currencies, including HUF and CZK. In the case of HUF, investors will also watch the Hungarian central bank meeting. It is broadly expected that NBH will continue its monetary easing and trim rates by 10 bp.

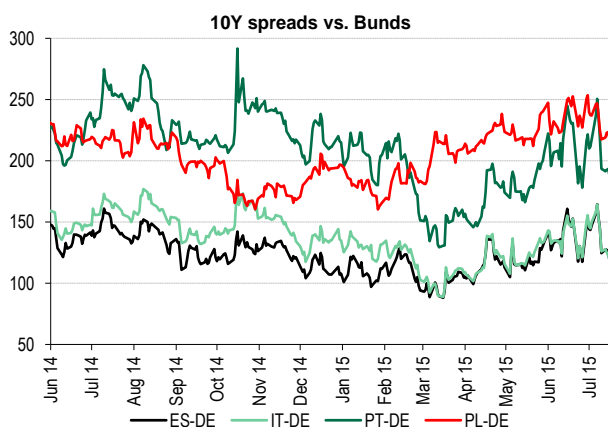
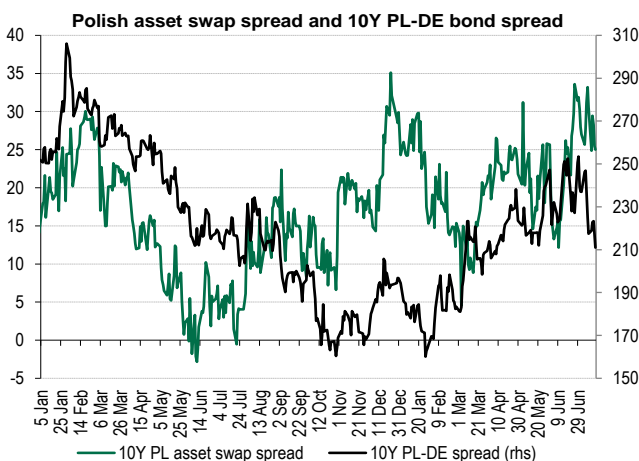
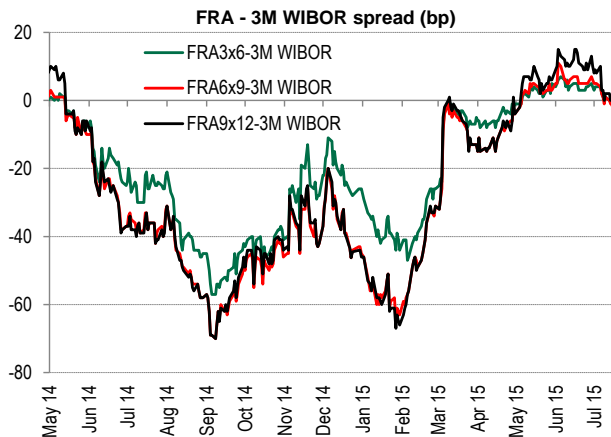
USD and GBP stronger due to rate hike expectations

- The European currency was under pressure over the past week despite the agreement between Greece and its creditors, and the EU's green light for a bridge loan that could help Greece avoid a default against the ECB. At the beginning of the week, EURUSD rose towards 1.12, but the rise was short-lived. The rest of the week saw EURUSD move all the way down, temporarily reaching 1.085 as some investors were quick to shift focus from Greece to the likely U.S. rate hike later this year.

- GBP also gained considerably last week, supported by the BoE's governor Mark Carney. He argued that the first rate hike was getting closer. As a consequence, EURGBP temporarily fell towards 0.696, the lowest since 2007.

This week's macro calendar for both Europe and the U.S. is very light, with the flash PMI for the European economies being the key release. We think that these data should confirm the gradual revival of the European economy and support the euro. We think that EURUSD should move sideways, with the important levels at 1.08 and 1.14.

Interest rate market – Spreads could narrow

**WIBOR stable, IRS and yields lower**

▪ The 1-12M WIBOR rates did not change much last week, with only the longest rate rising 1bp. The end of the gradual upward trend in the money market rates coincided with the 2-4bp drop in the short-term FRAs (after their rise in the second half of June). The market seemed to have been concerned over the recent adverse developments in China, which somewhat reduced optimism about global economic growth. What is more, leaders of the main opposition party, Law and Justice (PiS), suggested the central bank should be more active in supporting economic growth, which also weakened expectations for rate hikes next year.

▪ The IRS and bond curves moved down last week, with the latter falling slightly more. IRS rates eased 7-12bp and bond yields by 7-17bp with the biggest changes on the long end. The 10Y asset swap spread narrowed by 5bp and failed to break the 33bp resistance.

Spreads could narrow

▪ In the first half of July, the FRA market stopped to price in interest rate hikes within the next 12 months. It currently points to only 55% odds for a 25bp rise in 15 months. This was despite the rather hawkish signals from the Fed (Janet Yellen repeated that rate hikes were likely this year) and the NBP governor suggesting that monetary policy tightening in Poland could take place in late 2016. We still expect the first 25bp hike in Poland in 4Q16, which means that, under this scenario, the recent decrease in FRAs and yields seems rather excessive. However the recent changes in the environment (slower inflation pickup, an IMF report suggesting more monetary easing may be needed, PiS' call for a more supportive central bank) make our assumption about rate hikes in 2016 more and more questionable.

▪ The risk of a Grexit has recently diminished significantly, but the impact on the interest rate market could be twofold. On the one hand, the lower risk of global market turmoil should support the higher-risk assets that have recently been under pressure from the tensions in the euro zone. On the other hand, however, the market's attention could now shift to the Fed and the looming U.S. rate hikes could push market rates up.

▪ Nevertheless, the recent agreement on the Greek bailout terms diminishes the credit risk and so we think that the Polish 10Y asset swap spread could start narrowing again. The spread did not break its long-term resistance and it could now head south towards the 20bp area.

▪ The third chart shows that, in the recent months, the Polish asset swap spread and the 10Y PL-DE spread trended in the same direction. With lower risk aversion (and lower credit risk), Polish bonds could perform better than Bunds and this could lead to further declines in the 10Y spread.

▪ The second bond auction planned for this month will be held this week. At the first tender, the Finance Ministry sold debt worth over PLN2.4bn and the results were well-received by the market. The liquidity conditions are very supportive in July as nearly PLN11bn will flow into the market next week from redemptions and coupon payments. The recent strengthening of the Polish bonds gives the Ministry a wide range of bonds to choose from at this week's auction. As we have already mentioned in the previous reports, the last few auctions targeted domestic players as they were the main holders of the bonds offered. Now the market sentiment has improved and from the on-the-run series, the non-residents held 65% of DS0725 outstanding at the end of June. This bond was last time issued in June and so it could be among the bonds offered this week.

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