Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

2 – 8 November 2015

Poland's general elections ended in a clear victory for Law and Justice (PiS), in line with the opinion polls. PiS won outright majority in the Sejm (235 out of 460 seats), which will allow the party to form a majority government on its own. The elections' outcome underpinned the bond market, in particular the front-end of the curve, on rising expectations for monetary policy easing next year, but weakened the zloty against the main currencies, with EURPLN climbing to 4.296, its highest since January. Contrary to our expectations, the Fed surprised the market with hawkish rhetoric, indicating that a rate hike in December was still on the cards. This led to a rise in core yields, which pointed to higher yields on the domestic market, especially in the 10Y sector. At the same time, the zloty, similar to other EM currencies, rebounded visibly, with EURPLN falling towards 4.26.

The domestic financial market is still waiting for more details about PiS's economic policy. The party's spokeswoman said that candidates for government ministers could be presented after the weekend, something that investors will eye closely. The MPC is not likely to change its policy till the end of its term, even though NBP's new projections will show "slightly lower" paths for both inflation and GDP growth. However, the clear elections' victory by PiS changed our view on the 2016 interest rate outlook. We think the new MPC will cut the reference rate to 1% in 1Q16. In our view, the higher odds of rate cuts will support further falls in yields/IRS rates, mainly on the short-end of the curve. But global factors should be limiting the potential for strengthening on the belly- and long-ends of the curves (mainly macro data from the U.S., in particular Friday's monthly non-farm payrolls). In our view, there is still room for the zloty to firm in the upcoming weeks, if global macro data confirm that economic activity remains decent.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (2 November)					
2:45	CN	PMI – manufacturing	Oct	pts	47.6	-	47.2
9:00	**PL**	**PMI – manufacturing**	**Oct**	**pts**	**51.5**	**51.3**	**50.9**
9:55	DE	PMI – manufacturing	Oct	pts	51.6	-	52.3
10:00	EZ	PMI – manufacturing	Oct	pts	52.0	-	52.0
14:00	**PL**	**Flash CPI**	**Oct**	**%YoY**	**-0.7**	**-0.6**	**-0.8**
16:00	US	PMI – manufacturing	Oct	pts	50.0	-	50.2
		TUESDAY (3 November)					
16:00	US	Industrial orders	Nov	%MoM	-0.9	-	-1.7
		WEDNESDAY (4 November)					
	PL	**MPC decision**		**%**	**1.50**	**1.50**	**1.50**
9:55	DE	PMI – services	Oct	pts	55.2	-	54.2
10:00	EZ	PMI – services	Oct	pts	54.2	-	53.7
14:15	US	ADP report	Oct	pts	180	-	200
16:00	US	ISM – services	Oct	pts	56.5	-	56.9
		THURSDAY (5 November)					
8:00	DE	Industrial orders	Sep	%MoM	1.0	-	-1.8
13:00	CZ	Central bank decision		%	0.05	-	0.05
14:30	US	Initial jobless claims	week	k	-	-	260
		FRIDAY (6 November)					
8:00	DE	Industrial output	Sep	%MoM	0.5	-	-1.2
9:00	CZ	Industrial output	Sep	%YoY	3.5	-	6.3
14:30	US	Non-farm payrolls	Oct	k	180	-	142
14:30	US	Unemployment rate	Oct	%	5.1	-	5.1

Source: BZ WBK, Reuters, Bloomberg

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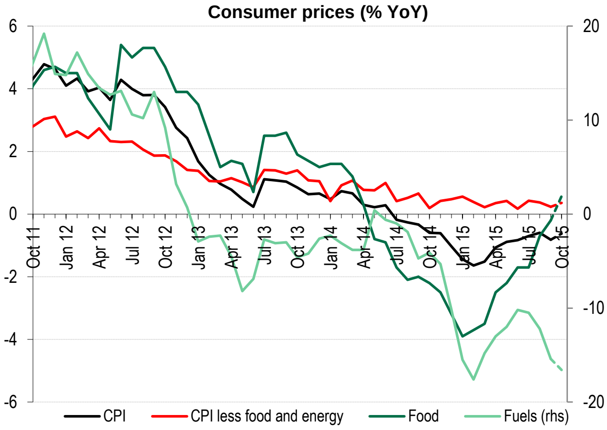
What's hot this week – PMI and CPI may rise

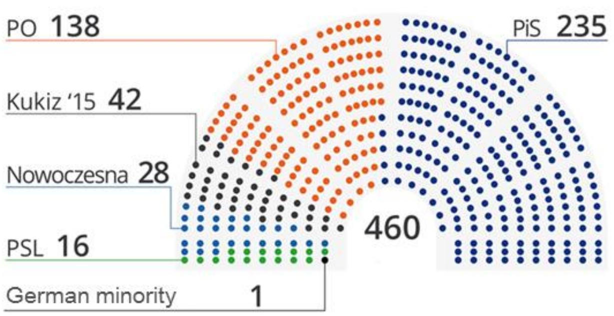


- We expect a slight upward correction in PMI in October, given the rebound in the European Commission's ESI and the Polish statistics office's business climate indicators.
- We expect inflation to go up to -0.6%YoY in October, mainly due to rising food prices. The following months are likely to show an even stronger upward correction in CPI: in our view, Poland's CPI will near 0% (but can remain negative) in November.
- The MPC meeting will be a non-event as regards its monetary policy. However, we will get to see the central bank's new inflation projection, likely to be revised downwards (based on the comment of A. Raczko). Moreover, the conference may prove interesting as some MPC members had recently protested comments made by PiS representatives about the possible makeup of the new MPC. Journalists are likely to ask

Last week in the economy – The winner takes it all

Note: for our full report about election results please follow **this link**.

Breakdown of seats in the Sejm (lower house) after October elections



PiS' proposals and financing (annual figures, calculation by PiS)

Proposals	Financing
■ hike of tax free income fromPLN3091 to PLN8000 – **cost PLN7.0bn** ■ return to lower retirement age (60Y for women and 65Y for men) –**PLN5.5bn** (in 1 year) ■ PLN500 allowance for every second and subsequent child and for every child in the poorest families – **PLN21.5bn** ■ Free drugs for elderly – **PLN0.25bn**	■ better VAT tax collection – **PLN19bn *(note: PLN50bn in previous version)*** ■ better CIT tax collection – **PLN4.5bn** ■ better excise duty collection – **PLN8bn** ■ introduction of bank tax (most likely 0.39% of assets) – **cPLN5bn** ■ introduction of large shops tax – **cPLN3.5bn**
TOTAL PLN34.25bn	**TOTAL PLN40bn**

- The conservative Law and Justice (PiS) won the general elections with 37.8% of the votes, beating the Civic Platform (PO, 24.1%), the Kukiz'15 movement (8.8%), .Nowoczesna (7.6%) and the Peasants Party (PSL, 5,13%).
- PiS will have outright majority in both the Sejm (235 out of 460 seats) and the Senate (61 out of 100), which means it will be able to form a government without a coalition partner.
- We expect the new government (led by Beata Szydło as the new Prime Minister) to be formed by the end of November. PiS would like to form the cabinet as soon as possible, as they would like to propose an amendment to the 2016 budget to include some of their pre-election proposals.
- The new PM's exposé will be key for assessing PiS's fiscal programme in practice. The first comments of PiS politicians after their victory showed that the "family 500+" project will be their key priority (PLN500 monthly allowance for every child in the poorest families and for the second and subsequent child in the remaining, which would cost the budget c.PLN20bn). PiS also plans to raise the tax-free income (cost c.PLN7bn) and lower the retirement age (cost c. PLN5.5bn, according to PiS). The bank tax also seems to be a priority (to at least partly finance the costly proposals) and may be introduced in 2016.
- PiS emphasises that Poland's fiscal deficit must be maintained at 3% of GDP. However, the ruling PO's budget for 2016 already envisaged a big budget gap, setting the general government (GG) deficit at c3% of GDP against the 2.3% level that was set in the Convergence Programme. Room for additional spending is, therefore, quite limited. Obviously, the new government may assume a much higher tax collection in 2016 (as it suggested during the election campaign), keeping the deficit (on paper) below the threshold. But the problem will arise if the expected much higher tax collection fails to materialise.

Quote of the week – We will use all tools at hand to boost growth

Henryk Kowalczyk, PiS MP, 29.10.2015, PAP

In case of "Plan B", it is possible that the higher tax-free income will be implemented in 2017. But we want to start the 500+ project in 2016, possibly from March 1, 2016. (…) The philosophy of the (spending) rule should be maintained. But because it refers to spending from the past years, not taking into account revenues, we may correct it to raise spending by the amount of the increased revenues, without affecting the deficit. (…) I think there is room for 25-25bp in rate cuts.

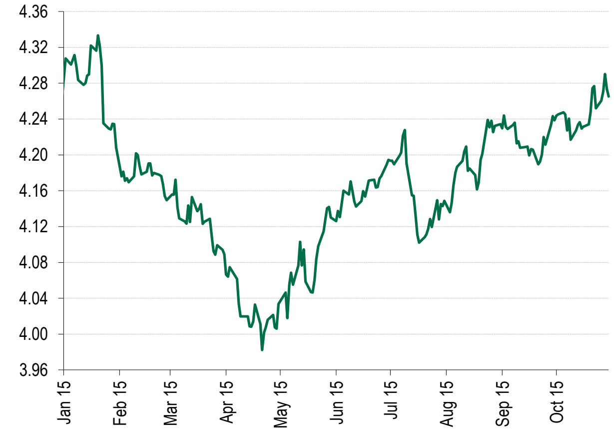
Zbigniew Kuźmiuk, PiS MEP, 29.10.2015, Dziennik Gazeta Prawna

We can afford to have 5-6% GDP growth. We will try to reach it, using all available tools in our monetary and fiscal policies. It will obviously not take place in 2016 or 2017, but I think it will happen during our first term in office.

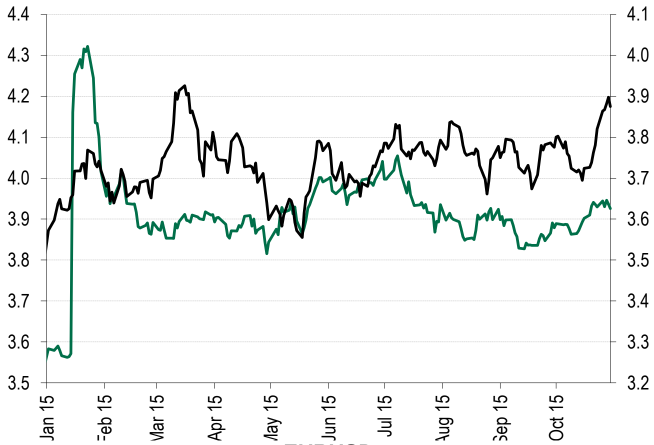
We see a risk of an expansionary policy-mix following the elections. Interest rates are likely to be cut at the start of 2016 (even though we think it is not needed), given PiS's clear declarations about how the new MPC members will be selected. And fiscal policy may be effectively loosened (at least in the short term), if the party's ambitious assumptions on the much higher tax collection do not materialise. It may be positive for economic growth, but only in the short run, in our view, leading to economic imbalances. The government's fiscal policy will have to be adjusted once the EU notices that the fiscal deficit exceeds 3% of GDP and interest rates will have to go up once inflation's upward trend is strengthened by policies aimed at demand stimulation (and by retailers passing through the supermarket tax onto customers).

Foreign exchange market – Global factors still key

EURPLN

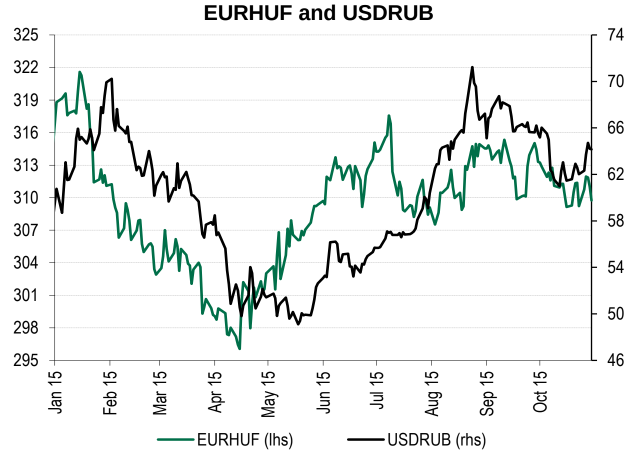


USDPLN and CHFPLN



EURUSD

EURHUF and USDRUB



Zloty slightly stronger on Fed

▪ The zloty lost ground in the first part of the week due to the decisive election victory by PiS (which fueled monetary easing expectations for next year) and investors fleeing riskier assets. As a result, EURPLN rose temporarily to 4.296, its highest since January. However, the second part of the week brought some rebound despite the surprisingly hawkish rhetoric from the Fed, which the market took as a sign of confidence in the U.S. economy. Consequently, the zloty pared most of its earlier losses against the euro and, at the end of the week, EURPLN was already near 4.25. At the same time, USDPLN remained highly volatile over the past week, rising to nearly 3.92 on the outcome of the Fed's October meeting. It fell below 3.85 at the end of the week, however.

▪ In line with our expectations, global factors helped the zloty recover during the last week of October by overshadowing the domestic factors. This week should also be dominated by external events. We expect Poland's MPC meeting to be rather uneventful as it is broadly anticipated that the Council will keep monetary conditions unchanged till the end of its term. Investors are, therefore, likely to pay more attention to macro releases in Europe and in the U.S., especially the U.S. monthly non-farm payrolls data, which could offer some clues on the Fed's future monetary policy. All in all, we think that there is more room for further zloty strengthening in the upcoming weeks. It is possible that EURPLN will fall towards 4.24 and then to 4.21, if signs from both the domestic and global economy confirm that decent growth is set to continue. However, political news flow may add to market volatility.

EURUSD above 1.10 again

▪ USD firmed as the FOMC, while keeping rates unchanged, suggested that a rate hike in December was still on the cards. As a result, EURUSD temporary fell slightly below 1.09, setting a fresh three-week low. However, EURUSD quickly returned to a touch above 1.10 on weaker macro data from the U.S.

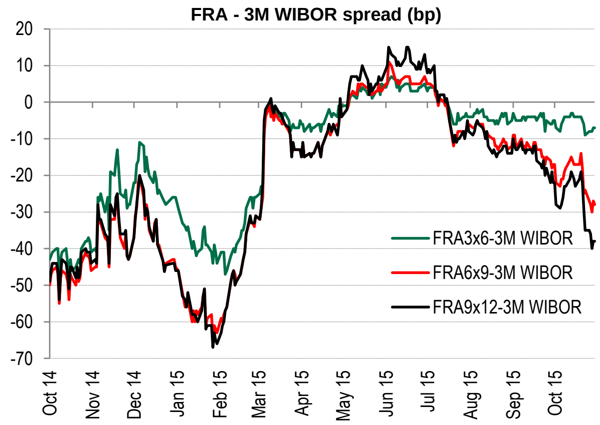
▪ Looking ahead we think that the prospects of more QE from the ECB in early December and the possible rate hike by the Fed later in December are a clear negative for EURUSD. However, this week investors will likely focus on macro data from Europe and the U.S, with Friday's release of the U.S. monthly labour market data being the most crucial. We believe EURUSD might continue to trade sideways till the non-farm payrolls are released. The important levels for the exchange rate are at 1.08 and 1.135.

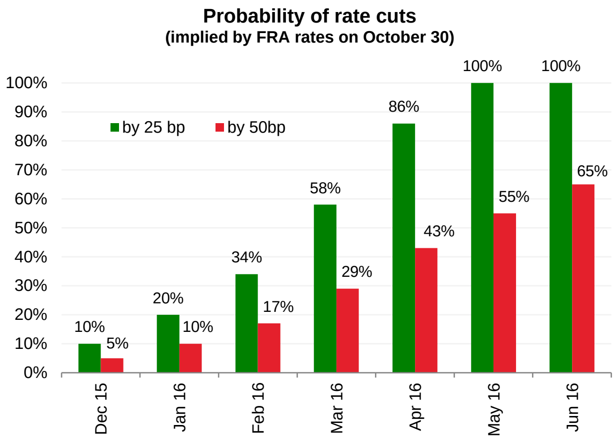
Czech central bank meeting on the agenda

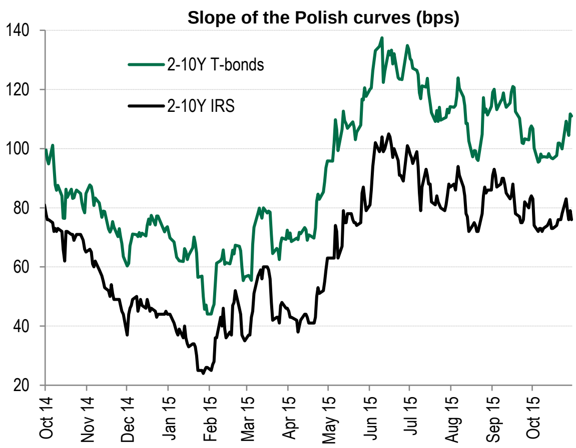
▪ The CEE region's currencies rebounded visibly after a weak start to the week. EURHUF fell below 310 at the end of the week from its local peak at nearly 313. On a weekly basis, the Hungarian forint was the region's best performer against the euro. The Russian ruble gained against the U.S. dollar thanks to rebounding oil prices globally. The rate tested 63.5, a level which effectively stopped the downward trend. The ruble was slightly firmer after the Russian central bank's decision to keep rates on hold. On the other hand, EURCZK moved sideways between 27.06 and 27.11.

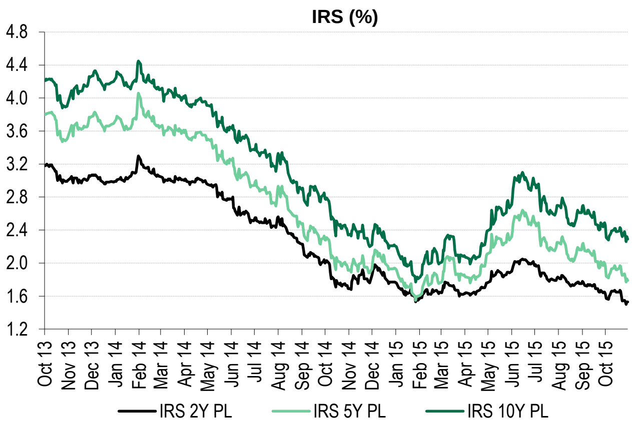
▪ Investors are set to focus on the global factors this week. Macro data releases, especially in the U.S., will be key, setting market direction for the upcoming days. In the Czech Republic, investors should focus on the central bank meeting, which we, however, expect to be uneventful because we do not expect any changes in monetary conditions.

Interest rate market – Belly and long end could remain volatile









PiS victory underpins short end, Fed pressures long end

▪ Poland's parliamentary election outcome proved supportive for the short ends of the bond and IRS curves. 2Y yields and IRS fell 1-4bp on rising odds for monetary policy easing in 2016, while the FRA curve was 3bp lower. The long tenors were more volatile on the back of the FOMC rhetoric and swings in the global market sentiment.

▪ Two weeks ago we wrote that the Polish curves could steepen and that the 10Y spreads vs. Bunds might rise. We suspected that the domestic long ends could underperform due to uncertainty ahead of the Polish parliamentary elections. The 2-10Y bond spread indeed rose c15bp since then, but this was due to significant strengthening of the short-term bonds on the back of higher odds for more monetary policy easing in 2016. The 10Y spread vs. Bunds widened by 6bp as German debt performed better than the Polish long-term benchmark.

▪ The Finance Ministry sold OK0717, PS0421 and DS0726 bonds for nearly PLN8.1bn, including PLN125mn at the top-up auction. Total demand at the standard auction amounted to more than PLN10.6bn. The 5Y benchmark PS0421 attracted the most attention as it was sold for PLN5.6bn amid demand at PLN6.7bn.

▪ The Finance Ministry data showed that foreign investors raised their holdings of government marketable, PLN-denominated bonds by PLN2.6bn in September and that the nominal value of their portfolio stood at PLN208.1bn at the end of 3Q. As far as this group is concerned, the sharp selling by commercial banks (PLN2.5bn) and strong purchases by central banks (PLN7.2bn mainly thanks to the Asian central banks) are worth mentioning. Significant buying, the most intense since February, was also seen from the Polish commercial banks that bought bonds worth PLN6.7bn, with their total portfolio reaching a fresh all-time high of PLN176.7bn.

Belly and long end could remain volatile

▪ We decided to change our scenario for the NBP interest rates next year and we now think that the new MPC will cut rates by 50bp in 1Q16. There will be five new MPC members already at the January meeting and they are likely to be very dovish. FRAs are currently pricing in monetary policy easing in 2Q and so we think there is still room for the shorter FRAs to drop.

▪ As mentioned above, the curves steepened in the last two weeks due to noticeable strengthening of the 2Y sector, with the longer tenors more volatile due to external factors. We do not see a trigger that could push the short ends higher in the nearest future. In our view, expectations for more monetary policy easing could now only strengthen and the flash CPI due on Monday should not initiate any noticeable market reaction. We think that as long as the annual inflation does not rise above -0.6% (local peak from August), the market will not pay much attention to it.

▪ We think the belly and long ends could remain volatile due to external factors. The FOMC's statement from the October meeting left the doors open for a December hike, which had a negative impact on the Polish 5Y and 10Y bonds. Investors are now likely to be very sensitive to U.S. numbers. The monthly non-farm payrolls are due this week and markets could remain roughly stable, awaiting this release, and only the end of the week could see higher volatility. At the same time, should PiS talk more about its plans to taper with the fiscal spending rule, it could weigh on bonds.

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.