WEEKLY ECONOMIC UPDATE

7 – 13 December 2015

The ECB's decision in December overshadowed macro data releases last week. Disappointment with the scale of the monetary easing delivered by the ECB triggered a major selloff across the global financial markets. The euro gained sharply against the U.S. dollar on the ECB, while bond yields climbed, stocks tumbled and CEE currencies lost. As a result, EURPLN rose above 4.30, with the Polish 10Y benchmark yield rising sharply above 2.90%. The growing risk of fiscal policy loosening in Poland also contributed to higher yields. Meanwhile, the domestic macro data releases were mixed as the faster-than-expected GDP growth in 3Q15 was mainly fuelled by net exports, while investment growth disappointed. We still expect GDP growth to stabilise near 3.5% YoY in the quarters to come. On the other hand, the flash November CPI inched higher, though the rise's pace was slower than expected, which implies that deflation may last a little bit longer, ending at the start of 2016 instead of 4Q15. Poland's November manufacturing PMI also surprised on the negative side (the reading was below our forecast), although its main components remained solid. The MPC kept the main interest rate unchanged as was widely expected.

This week is relatively quiet in terms of data releases. In Poland, investors will focus on the parliament, which is due this week to discuss some important economic proposals of PiS, including the 2015 budget amendment, change in the fiscal spending rule, proposal to lower the retirement age and to increase the tax-free income level. According to the government's declaration, the general government deficit could only slightly exceed 3% of GDP in 2015 and next year. However, the proposed changes in the fiscal spending rule open the door to higher spending growth than previously expected (financed by one-off revenues). Monetary policy of the major central banks (ECB, Fed) remains the key driver on the global financial markets. The approaching FOMC meeting will add to market volatility, especially that the probability of a December rate hike by the Fed has grown to 76% on the ECB. Ahead of the Fed decision. we expect EURPLN to oscillate near its current level. As regards the bond market, the front end of Poland's curves is well anchored by expectations for rate cuts in early 2016, while the long end remains vulnerable to developments on the core markets and the government's policies. In our view, worries about Poland's fiscal policy might add to higher yields in the upcoming weeks.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (7 December)					
8:00	DE	Industrial output	Oct	%YoY	0.7	-	-1.1
9:00	CZ	Industrial output	Oct	%YoY	-	-	0.6
		TUESDAY (8 December)					
9:00	HU	CPI	Nov	%YoY	0.6	-	0.1
11:00	EZ	GDP	Q3	%YoY	1.6	-	1.5
		WEDNESDAY (9 December)					
	PL	**Sejm session**					
8:00	DE	Exports	Oct	%MoM	-0.6	-	2.6
9:00	CZ	CPI	Nov	%YoY	0.4	-	0.2
		THURSDAY (10 December)					
	PL	**Sejm session**					
11:00	**PL**	**Bond switch auction**					
14:30	US	Initial jobless claims	week	k	-	-	269
		FRIDAY (11 December)					
14:30	US	Retail sales	Nov	% /mm	0.3	-	0.1
16:00	US	Flash Michigan	Dec	pts	92.0	-	91.3

Source: BZ WBK, Reuters, Bloomberg

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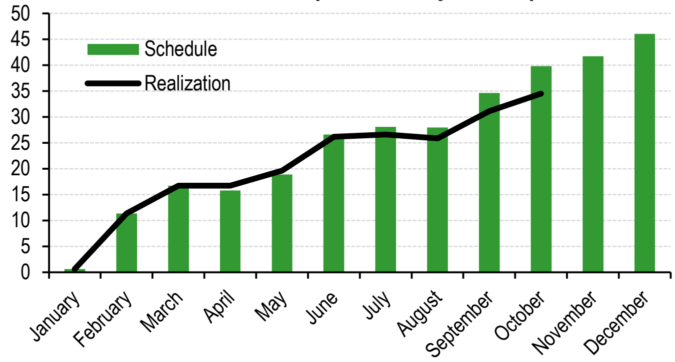
What's hot this week – Parliament to start work on the key proposals of PiS

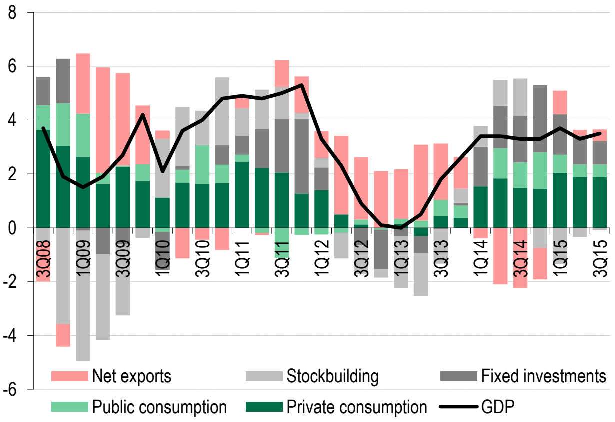
Realization of 2015 budget deficit vs. the schedule (cumulatively, PLNbn)



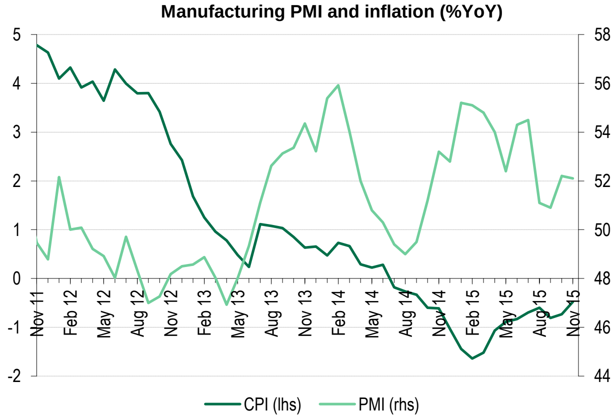
- The next Sejm meeting starts on Wednesday, with important PiS economic proposals on the agenda, including the 2015 budget amendment, change in the fiscal spending rule, proposal to lower the retirement age and increase the tax-free income level. The latter two proposals – according to earlier declarations – are not likely to be implemented before 2017, so the focus will probably be on the budget and the spending rule.
- The budget amendment draft assumes raising of the 2015 deficit by PLN3.9bn. We do not believe this to be a necessary move, as savings in spending (at c.PLN10bn below the schedule after October) could allow the government to avoid raising deficit despite lower revenues. The move is probably aimed at boosting revenues in 2016, e.g. by shifting revenues from the LTE auction. The MoF declared that the fiscal deficit may be "only slightly" above 3% of GDP.

Last week in the economy – GDP growth above, CPI and PMI below forecasts

Decomposition of GDP growth



Manufacturing PMI and inflation (%YoY)



- Poland's GDP growth accelerated in 3Q15 to 3.5% YoY, above forecasts, mainly due to better net exports' contribution. Investment growth decelerated to 4.6% YoY despite news on the revival of fixed asset spending in big companies, which suggests that some slowdown could have taken place in public investments. Private consumption growth stabilised at a moderate level and the sound labour market should help this trend continue in the coming quarters. We still expect GDP growth to stay close to 3.5% YoY in the quarters to come.
- November's flash CPI rose to -0.5% YoY. Inflation is rising more slowly than had been expected and deflation may end at the start of 2016 instead of 4Q15, as we had previously anticipated.
- Poland's manufacturing PMI fell in November to 52.1pts from 52.2pts in October. The result was clearly below expectations. What is interesting is that output and new orders rose at the fastest pace in months. Employment growth was also high. Deterioration was, however, observed in suppliers' delivery times and stocks of purchases.
- The Monetary Policy Council did not surprise and left interest rates unchanged (refi rate still at 1.50%). The tone of the statement did not change significantly either. The MPC took note of the solid economic growth driven by consumer demand and inflation, which remains below zero, but will likely rise gradually in the upcoming months. In the last sentence of the statement, the Council added that the current level of interest rates was conducive to keeping the Polish economy on a sustainable growth path and sustaining the macroeconomic balance. Governor Marek Belka reiterated that there was no need to cut rates and that lower borrowing costs would not offer any significant support for the economy. We still expect a 50bp rate cut in 1Q16.

Quote of the week – More room for fiscal spending

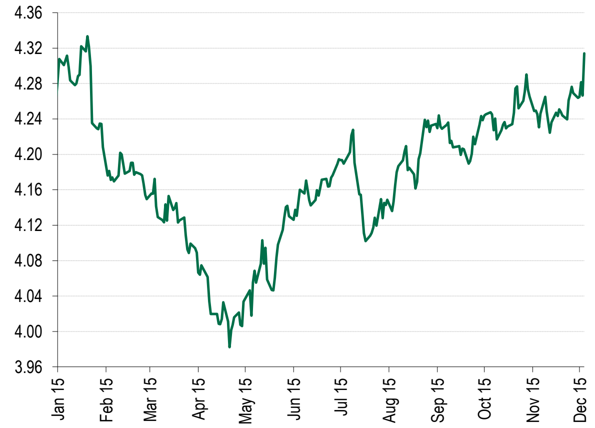
Justification of the amendment to public finance law, sejm.gov.pl

It was proposed to replace the annual CPI indicator, as well as corrections connected with past forecast CPI errors, with the CPI inflation target (currently 2.5%). (…) The second aim of the bill aims at allowing an increase of the spending limit in the case of expected realization of one-off, temporary revenues. (…) The forecasted amount of one-off measures, which equals (each of measure) at least 0.03% GDP, would increase the spending limit. This will not increase, however, the amount of spending according to the rule. Therefore the increase in spending would not affect the amount of expenditures for the consecutive year.

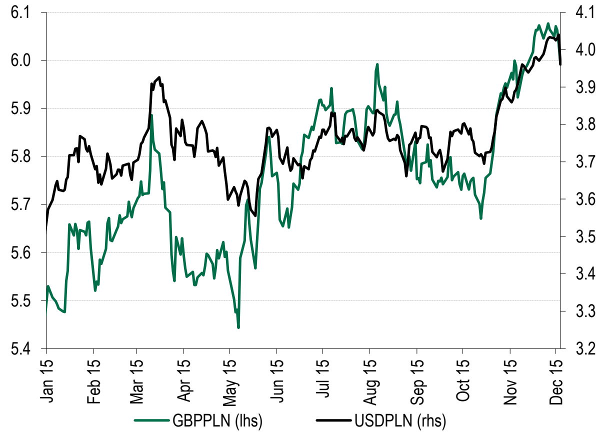
PiS deputies submitted a motion to change the so-called "stabilization" spending rule, embedded in the Public Finance Law. The motion may be discussed by the parliament already this week. The proposal changes the formula, which determines the ceiling of public spending growth, by using the NBP's inflation target instead of actual and expected inflation, and by allowing for higher spending if it is financed by one-off revenues. Effectively, it would allow the government to plan additional spending for the next year, while the current "stabilisation" rule left almost no room for extra expenditure. According to our estimate, change of inflation indicator increases the spending limit for 2016 by c.PLN5.5bn. Additional rise may result from adding expected one-off revenues (e.g. PLN9bn from LTE auction).

Foreign exchange market – Sharp swings on the Polish FX market

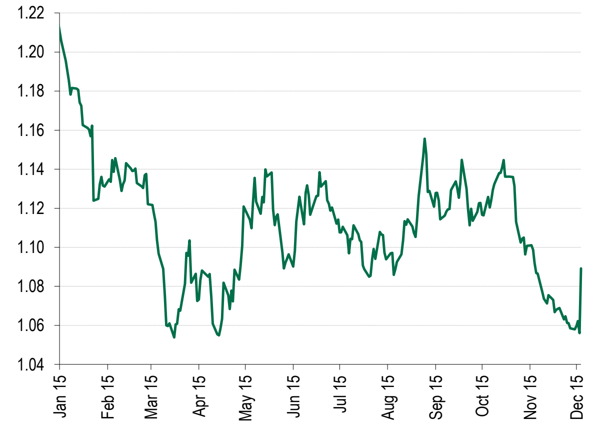
EUR/PLN



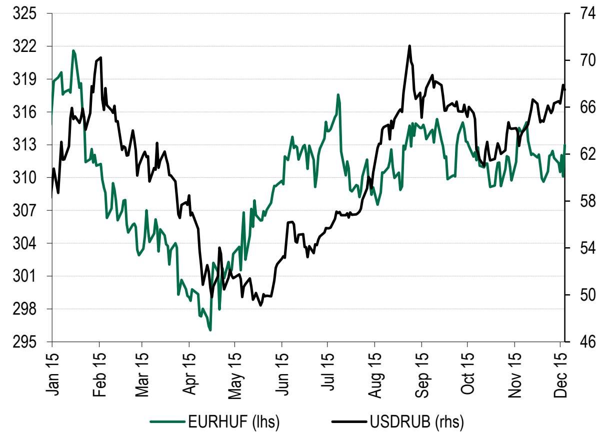
GBP/PLN and USD/PLN



EUR/USD



EUR/HUF and USD/RUB



Sharp swings on the Polish FX market

- Volatility on the Polish FX market rose significantly in the last few days. EUR/PLN jumped temporarily to 4.34 and its weekly trading range was above PLN0.08 (the widest since mid-July) due to the market's reaction to the ECB decision. At the same time, USD/PLN plummeted to 3.93 on higher EUR/USD. The zloty's weekly gain vs. the dollar was the biggest since early September and the weekly trading range was the widest since early November. The euro gained on the ECB decision also vs. the pound and this pushed GBP/PLN down after a 7-week series of increases.
- Among the main EM currencies only the Czech koruna did not lose vs. the euro in the past week. In the CEE region, the forint lost 0.3% and the zloty 1%. At the same time, the Polish currency gained less that the koruna and forint vs. the dollar. The ruble was the weakest EM currency vs. the dollar and euro in the past week.
- The EUR/PLN's reaction to the ECB decision showed how important expectations of the euro zone's monetary policy easing are for the zloty. If it were not for the hopes for more ECB action, EUR/PLN might have already been higher due to uncertainty about the new Polish government's fiscal policy and outlook for rate cuts in early 2016.
- This week's calendar is pretty empty, but more news from the Polish parliament should be expected. The parliament will be discussing proposals to lower the retirement age and modify the spending rule. We, therefore, see risk that the zloty could weaken should the odds for thee ideas' fast implementation appear high. Also, Chinese foreign trade data are due on Tuesday and we have been claiming last week that part of the zloty's recent underperformance was caused by concerns about the emerging economies.

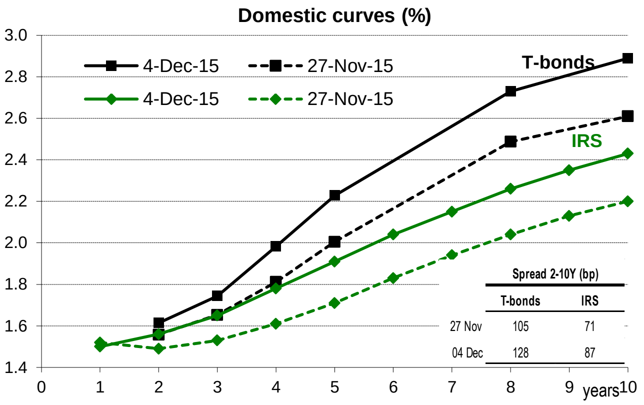
Euro gains on the ECB

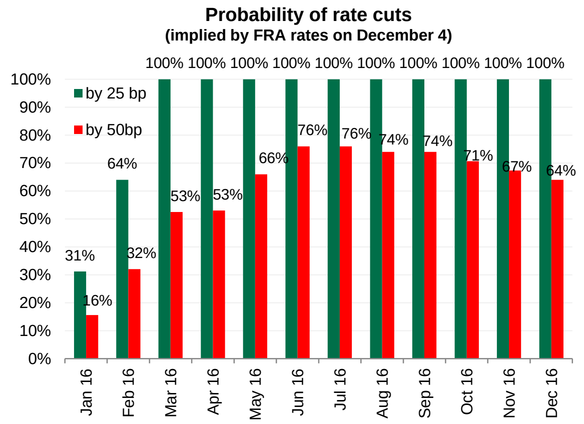
- EUR/USD jumped to nearly 1.10 on the disappointing extension of the asset purchase programme announced by the ECB. Thursday's daily rise was the biggest since March 2009 and the daily trading range was the widest since mid-March, when the FOMC dropped the word "patient" from its statement.
- This week's calendar does not contain any breaking data releases or events, but this will be the last week before the December FOMC rate decision. The odds for a rate hike are very high and so we do expect EUR/USD to rise noticeably and sustainably above 1.10.

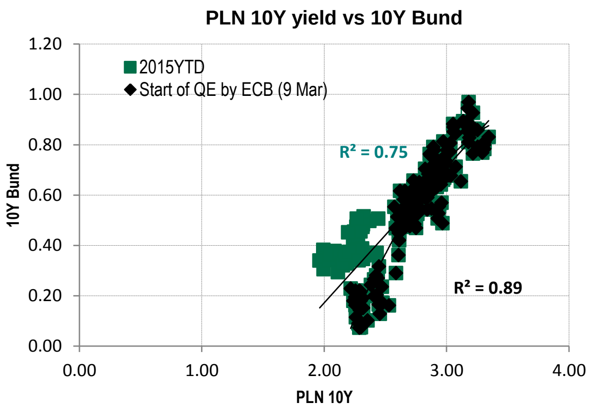
Ruble under pressure ahead of the central bank decision

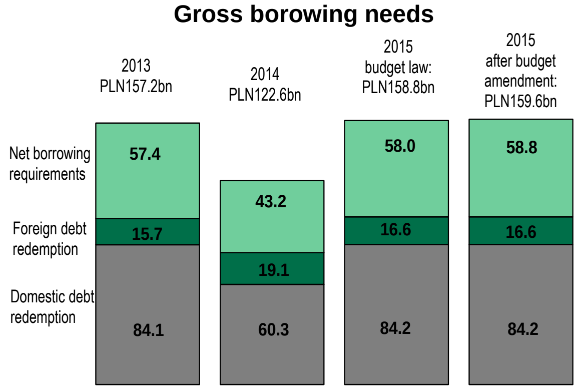
- The forint also depreciated vs. the euro on the ECB with EUR/HUF rising to 314 from 309, but it stayed within the wide 307-317 trading range.
- USD/RUB rose temporarily above 68 from 65.7 (to its highest since mid-September) despite the dollar's weakening on the global market and some rebound in the oil price that took place in mid-week.
- The CBR is due to announce its interest rate decision on Friday. The market expects a 25bp cut to 10.75%, but we think that the central bank may rather refrain from taking any action due to the recent weakening of the ruble and the still high inflation. In recent months, the CBR has been communicating very clearly that brining CPI to its target remains its main focus, while an interest rate cut could hit the ruble and generate an upside pressure on prices.

Interest rate market – ECB and FOMC setting market direction









Yields and IRS rates sharply up on ECB

- Global events (in particular ECB, U.S. macro data) were the key drivers on the Polish debt market last week. Poland's T-bond and IRS lost ground because the easing package delivered by the ECB was lighter than many market participants had expected. Polish bond yields and IRS rates rose sharply (by 3-16 bp), tracking core markets. Uncertainty about the U.S. non-farm payrolls data pushed the 10Y benchmark yield above 2.90% (the highest level since early November) in the first part of Friday's session. What is more, the growing risk of fiscal policy easing in Poland could also add to higher yields. Market reaction to the November job report in the U.S. was muted, with the yields/IRS rates a touch higher following a gradual rise on the core markets. However, increase was only short-lived and Friday's session ended with slightly lower Yields/IRS rates.
- Long maturing instruments underperformed the front end of the curves and, as a result, a bear-steepener developed on the Polish IRS and T-bond markets. The 2Y-10Y spread rose to nearly 130 bp for the T-bonds and towards 90 bp for the IRS. What is more, the asset swap spread for the 10Y widened markedly, growing towards 50 pb, the highest level since August 2012.
- Meanwhile, there was little change on the money market. WIBOR rates fell 1-2 bp over the past week, while FRA 3x6 fell visibly, suggesting that expectations for further monetary easing in early 2016 have grown stronger. The FRA market is now fully pricing-in a 25bp cut in three months' time and it sees over 50% odds of a 50bp reduction in that time horizon.

Quiet week ahead of FOMC meeting

- This week is quite light with macro data releases both in Europe and the U.S. During this period, investors will be trying to guess what the ECB's decision would mean for the FOMC. In our view, the higher EURUSD should speak in favour of a Fed rate hike in December (after the ECB's decision, the probability of a December rate hike by the FOMC reached a fresh high of 76%). Consequently, approaching of the FOMC meeting will be adding to market volatility and keeping yields on the long end at an elevated level. We think that both the T-bond and IRS curves in Poland could remain quite steep as the front end of the curves is well anchored by expectations for rate cuts in early 2016, while the long end may be affected by fiscal policy worries.
- The correlation between the 10Y Bund and 10Y Polish bond is positive and strong (R2 has been equal to 0.89% since the start of the ECB's QE programme in March). This means that changes in the German 10Y benchmark yield will likely have a strong impact on the domestic 10Y benchmark. Thus, an increase/fall in the yield of the German 10Y benchmark may lead to a rise/fall in the domestic 10Y yield.
- Poland's parliament starts a two-day session on Wednesday, during which it is to discuss an amendment of the 2015 budget law. According to the amendment, this year's budget deficit could be raised by cPLN4bn, while the net budget requirements could climb by only c PLN0.8bn to PLN58.8bn. Thus, a minor rise of the deficit is unlikely to affect financing of the 2015 borrowing needs, which was already completed in October 2015.
- Poland's Ministry of Finance plans a T-bond switch auction this week, offering an earlier repurchase of OK0116, PS0416 and OK0716. Its T-bond supply will depend on the market conditions, but we think that the Ministry's approach to the auction will probably be flexible in that it will be offering a wide range of instruments, as was the case at the previous switch tender.

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