Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

11 – 17 January 2016

After the calm end of December 2015, at the start of the New Year the world financial markets have been rattled by a renewed concerns about the situation in China. As a result, prices of equities and commodities tumbled (crude oil price fell to its lowest since 2004) and emerging market currencies weakened. The recent data releases, while showing downside surprises on the inflation front, at the same time confirmed that economic activity remains decent.

The nearest week will be quite busy in terms of data releases and other important events. Investors in Poland will probably focus on developments in the parliament, where the work on the bank tax proposal will enter the final stage. Additionally, the hearings of the candidates for MPC members will be held by both Sejm's and Senate's committees on Tuesday. This will be an opportunity for the market to get the basic idea about the potential new central bankers' views on monetary policy and economic outlook (as most of the candidates proposed by the ruling PiS are not widely known). The last MPC meeting in the current line-up will be a non-event and is not likely to bring any changes in monetary policy. Domestic data releases are also unlikely to introduce a significant market volatility. Final inflation reading for December should not deviate much from the flash reading (-0.5%YoY) which was in line with our forecast but lower than market expected. We think that in the nearest months inflation will be lower than currently priced-in by the market, which is likely to reignite rate cut expectations. If deflation in Poland persists even until 2H16 (as our current forecast suggests), there will be arguments to cut interest rates lower even regardless of the new MPC nominations. Balance of payments data should confirm healthy growth of both exports and imports and a relatively low current account deficit, but in our view it should not be a major impulse for the zloty.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (11 January)					
		No important data releases					
		TUESDAY (12 January)					
9:00	CZ	CPI	Dec	%YoY	0.1	-	0.1
9:00	CZ	GDP	Q3	%YoY	-	-	4.6
12:00	**PL**	**Hearings of MPC candidates**					
		WEDNESDAY (13 January)					
11:00	EZ	Industrial output	Nov	%YoY	0.1	-	0.6
14:00	**PL**	**Current account**	**Nov**	**€m**	**-265**	**-381**	**-113**
14:00	**PL**	**Exports**	**Nov**	**€m**	**14761**	**15092**	**15 344**
14:00	**PL**	**Imports**	**Nov**	**€m**	**14390**	**15000**	**14 861**
20:00	US	Fed Beige Book					
		THURSDAY (14 January)					
	PL	**MPC decision**		**%**	**1.50**	**1.50**	**1.50**
9:00	HU	CPI	Dec	%YoY	0.9	-	0.5
14:00	**PL**	**Money supply**	**Dec**	**%YoY**	**9.9**	**9.7**	**9.8**
14:30	US	Initial jobless claims	week	k	-	-	287
		FRIDAY (15 January)					
14:00	**PL**	**CPI**	**Dec**	**%YoY**	**-0.5**	**-0.5**	**-0.6**
14:30	US	Retail sales	Dec	%MoM	0.1	-	0.2
15:15	US	Industrial output	Dec	%MoM	-0.2	-	-0.6
16:00	US	Flash Michigan	Jan	pts	93.0	-	92.6

Source: BZ WBK, Reuters, Bloomberg

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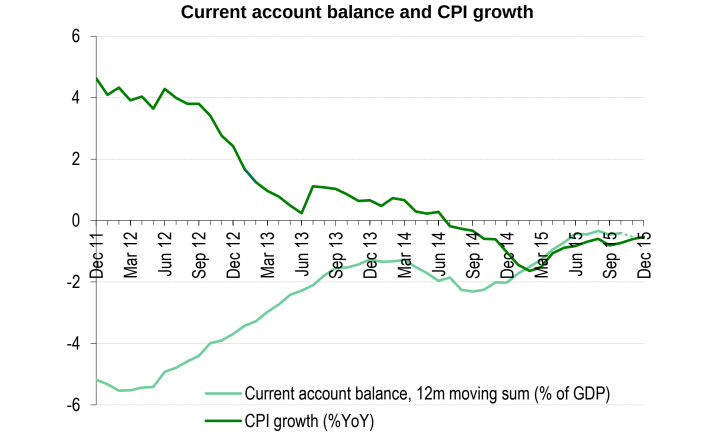
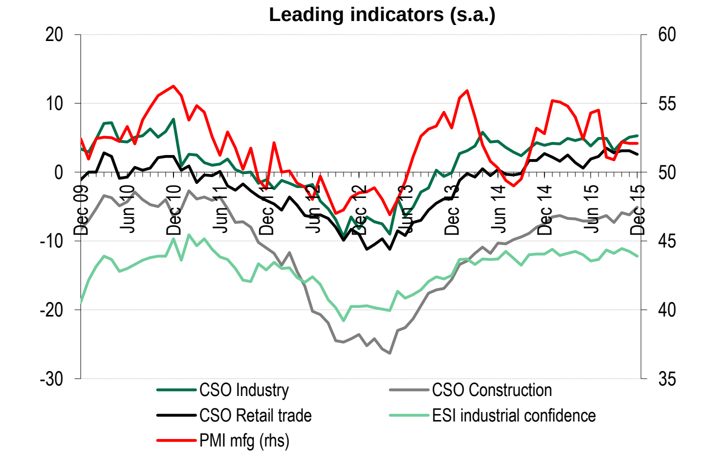
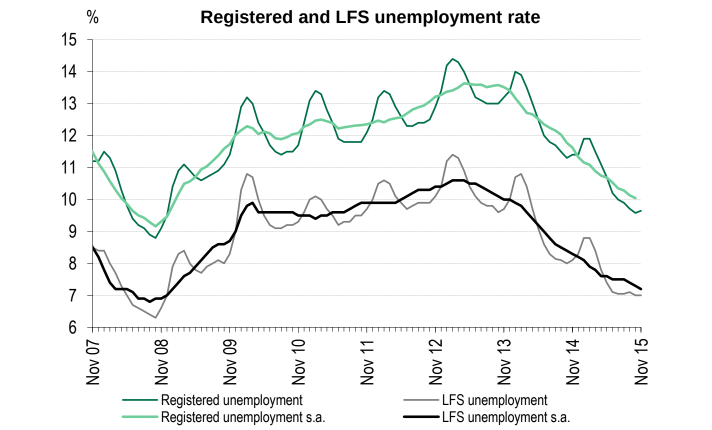
What's hot this week – Hearings of MPC candidates in the spotlight



- The last MPC meeting in the current line-up will be a non-event for the market, just as its few previous meetings. Instead, investors will focus on the hearings of MPC candidates by the Sejm and Senate committees, due on Tuesday, to get a taste of the new central bankers' views on the monetary policy outlook.
- Flash CPI reached -0.5%YoY in December, in line with our forecast but lower than the market had expected. The final release should confirm this result and we think that inflation will in the nearest months be lower than is currently priced-in by the market. This is likely to reignite rate cut expectations (regardless of the new MPC nominations).
- We forecast a slightly higher current account gap in November than the market, but export and import growth should recover, driven by healthy domestic and external demand and, in general, the data should have a limited market impact, in our view.

Last week in the economy – Economic growth remained solid at the end of 2015





- PMI for Poland's manufacturing remained unchanged in December at 52.1pt (below expectations). The survey showed that output was supported by an acceleration in new export order growth. At the same time, domestic orders decelerated slightly from November. The release confirmed that the labour market was still strong (with the employment sub-index at its five-month high) and that price pressure remained low (production costs and prices of finished goods fell sharply).
- Other business climate indicators for December also confirmed that economic activity at the end of 2015 remained decent – the statistics office's business climate indices improved for most sectors (except retail trade) and EC's ESI decreased slightly, but remained compatible with the c.3.5% GDP growth.
- The registered unemployment rate stayed at 9.6% in November, below market forecasts and the Labour Ministry's estimate. In monthly terms, unemployment climbed by 13.7k, the smallest rise in November since 2007. The number of job offers remains high. The 12-month indicator of the number of job offers per 1000 unemployed increased to 46, i.e. the highest level ever. Meanwhile, the Labour Force Survey (LFS) unemployment rate fell in November to 7.2%, its lowest since January 2009 (data for the previous months was revised up). We expect the unemployment rate to fall further amid stable economic growth.
- NBP's report on the companies' financial situation in Q3 pointed to further improvement of the business climate. Firms were still investing (showing an acceleration vs. Q2) and this trend was supported by high capacity utilisation and strong domestic demand.

Quote of the week – Interest rates close to optimal

Marek Belka, NBP Governor, financialobsever.eu; 23 Dec. 2015

Without getting into details the budget itself seems to be presentable, the deficit is under control, but the devil is in the details. (…) I hope nothing fundamental has changed in the Polish economy that would indicate a loss of trust and confidence among foreign investors.

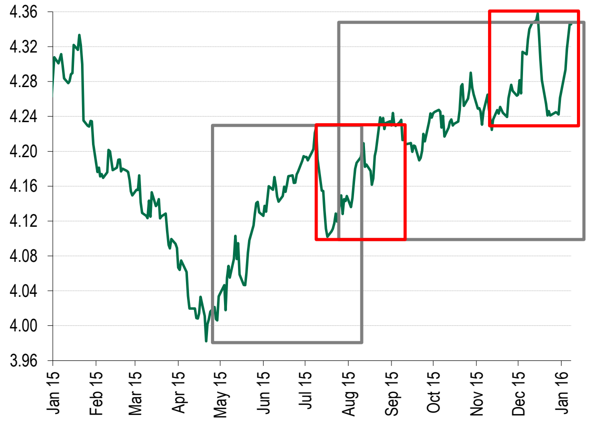
I don't think Poland is extremely fragile. (…) But let me be clear – what is happening in Poland with the Polish zloty, interest rates and Polish securities depends to a large extent also on internal factors. If we overdo the budget then Polish securities will suffer, as well as the Polish currency.

I think the best thing is to continue the current monetary policy. The level of interest rates seems to be close to optimal.

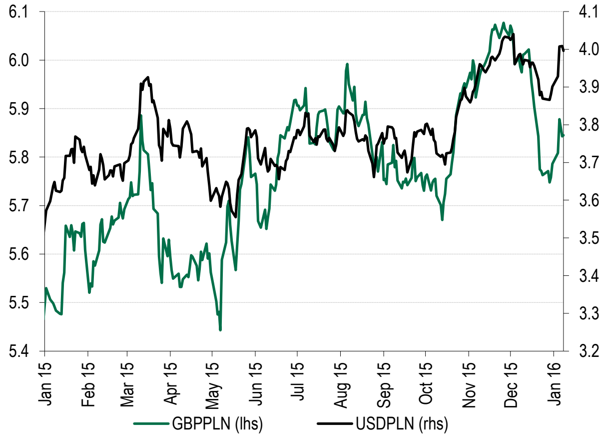
Just before Christmas, the Governor of the Polish central bank, Marek Belka, gave a long interview for financialobserver.eu portal. He commented in details on fiscal policy of the new government. While he said that the budget deficit has to be within limits, he noticed an increase in the spending limit by PLN16bn and a necessity to find the corresponding amount of revenues. According to Belka, a promise to increase the effectiveness of tax collection "is probably the most contentious part of the budget". Belka supported the government's idea regarding the "zero tax bracket" (higher tax free income), assuming this is a solution "almost neutral to the budget".
In terms of monetary policy, Belka said the current level of rates is close to optimal and that next steps will depend also on the preferences of new members of the MPC. Does "close to" optimal means Belka will support a small rate in March, after the new inflation projection?

Foreign exchange market – China in the spotlight

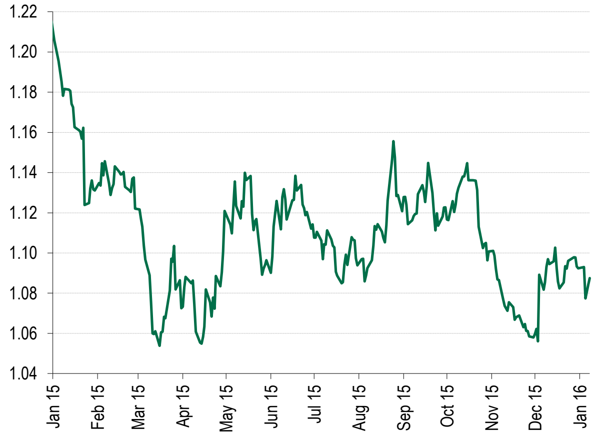
EUR/PLN



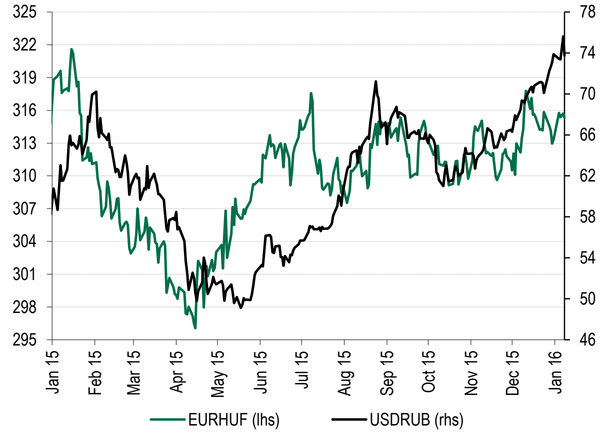
GBP/PLN and USD/PLN



EUR/USD



EUR/HUF and USD/RUB



Volatile EUR/PLN

- In our last weekly report in 2015, we showed that after the EUR/PLN's temporary rise to 4.37, the most recent upside wave (developing since late July) and the one seen in late April/early July are nearly equal. We suggested that this raised the odds that 4.37 could be a local peak for the exchange rate and, following the same logic, that EUR/PLN should fall in the next weeks in the same scale as it did back in July to reach c4.23. The first chart shows that this scenario materialised as the global market mood was quite positive due to the "dovish" rate hike by the Fed.
- USD/PLN jumped temporarily to 4.05, its highest since mid-December on the stronger dollar globally. The Polish currency gained vs. the British pound, which was hit by some disappointing macro data. GBP/PLN fell temporarily to 5.70 from 5.90. At the same time, CHF/PLN stayed in the 3.90-4.0 range.
- The beginning of 2016 brought fresh worries about China, pushing EUR/PLN back to 4.35. Interestingly, the reason of the correction was exactly the same as in July, when the drop of EUR/PLN before the rebound was nearly equal in size and time.
- We think EUR/PLN could stay in the 4.23-4.37 range in January and that only a significant improvement in the global market sentiment could support the zloty. Locally, important political factors this week will include the final work on a bank tax (rather neutral for FX market) and MPC members' hearings. The latter, if confirms a dovishness of new members, might would not be supportive for the zloty, in our view. As regards upcoming data publications, our forecasts of the C/A deficit are close to the market consensus and, as such, the release should not trigger any significant market reaction.

Dollar slightly stronger

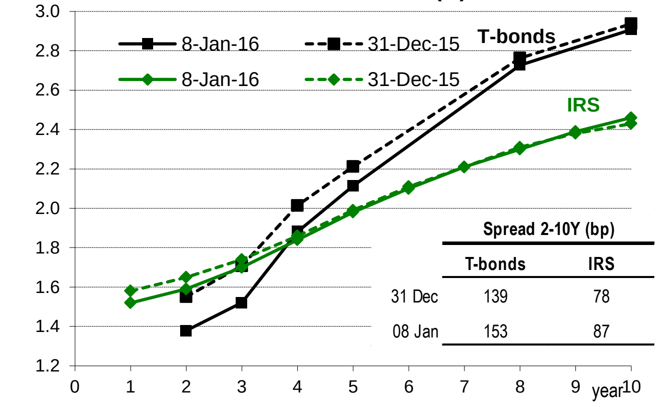
- The dollar has been firming gradually in the last few weeks thanks to the Fed's rate hike, while the euro was pressured by low oil prices and the below-expectations flash December HICP number. As a result, EUR/USD broke the local bottom at 1.08 and temporarily reached 1.07 early this year. This means that the euro has lost more than 50% of its gains after the ECB's last decision. Still, concerns about China weakened market expectations for more quick rate hikes by the Fed and helped EUR/USD to rebound to c1.09.
- The U.S. nonfarm payrolls data surprised well to the upside and so investor expectations for a March Fed rate hike strengthened. We think that U.S. monetary policy could be an important factor driving EURUSD this week as there are numerous FOMC members' speeches due in the coming days. EURUSD broke the support at 1.08 and so we think there is more bias to the downside..

Ruble pressured by low oil prices

- The Brent oil price drop to its lowest level since April 2004 had a very negative impact on the ruble. USD/RUB surged above 76 and established its all-time high weekly closing at c74. We think that commodity prices will remain the core drivers of USD/RUB in the nearest future. It might be tough for the ruble to recover noticeably should concerns about China not fade for longer and halt the oil price decline.
- The forint stayed close to its weak level reached after the ECB's disappointing decision and EUR/HUF remained in the 311-318 range. Hungarian inflation data is on the agenda this week, but we do not expect this release to have any meaningful impact on the forint.

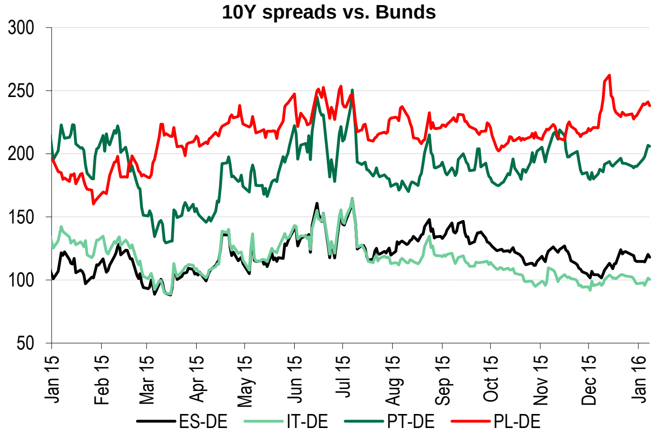
Interest rate market – Positive start to 2016 for short-term bonds

Domestic curves (%)

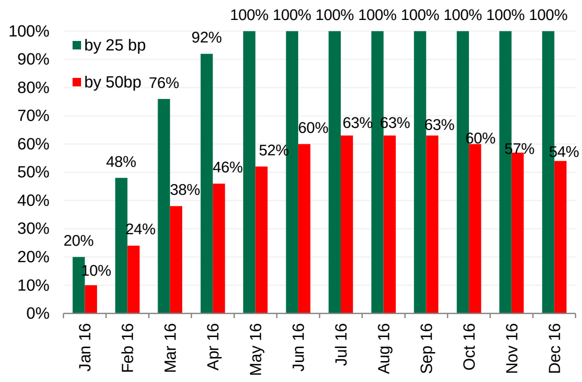


	Spread 2-10Y (bp)	
	T-bonds	IRS
31 Dec	139	78
08 Jan	153	87

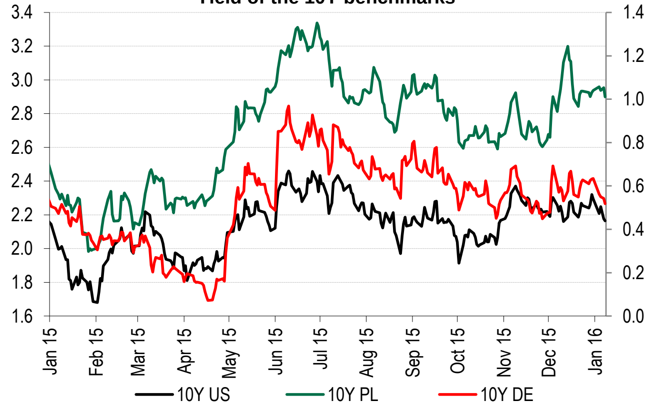
10Y spreads vs. Bunds



Probability of rate cuts
(implied by FRA rates on January 8)



Yield of the 10Y benchmarks



Curves steeper, risk premium higher

- The start of 2016 was favourable for the front end of the yield curve after the volatile end of 2015. The 2Y benchmark yield reached a fresh historical low of 1.39% due to expectations that banks could switch their liquidity from NBP bills to T-bills and short-term T-bonds, which would not be taxed. What is more, the front end of the curve was also supported by expectations for an interest rate cut in the first months of the year due to the lower-than-expected December flash CPI and further falls in oil prices to their lowest level since 2004. At the same time, the belly and the long end of the curve moved sideways, under pressure from global mood changes.
- Both curves steepened markedly as the long-term assets underperformed the short-term ones. The 2-10Y spread widened over 150 bp for the T-bonds and over 85 bp for the IRS. Moreover, the risk premium for Poland, but also other CEE and peripheral debt rose as indicated by the further widening in the spread over Bunds in the 10Y sector.
- The first T-bond auction this year proved successful. The ministry of finance sold 5Y benchmark PS0421 worth PLN4.56bn, slightly more than the upper limit of the originally planned offer (PLN2.5-4.5bn). The recorded demand stood at PLN7.2bn and the average yield was at 2.382%. In our view, after Thursday's tender, the annual gross borrowing needs may be covered in c25%.
- As regards the money market, WIBORs remained stable at the turn of the year, while the FRA rates were more vulnerable to changes in investors' mood. However, the deeper-than-expected deflation in December (according to flash data) and better sentiment on the IRS pushed FRAs slightly lower. The market currently sees nearly 80% odds of a 25 bp reduction on a three-month horizon.

Global mood and Poland's parliament session are key

- This week is quite busy with macro data releases (C/A gap, final CPI) and events (MPC meeting, Sejm session). In our view, the parliament's 3-day session, starting from January 13, will be crucial. The Sejm will discuss the Senates amendments to the banking tax, while both the Sejm and Senate will start interviewing candidates for the new MPC. We think that the new MPC will be more dovish than is the current council, supporting our view that the new MPC will likely cut rates by 50 bp from current level. News from the parliament will likely overshadow the macro data releases as the final reading of December's CPI should confirm the flash rate of -0.5%YoY. The MPC meeting, in our view, will also be a non-event as we do not expect any changes in monetary conditions.
- Given the above factors, we think that the WIBOR rates should remain more or less stable this week. However, FRAs and the front end of the curves will continue to be under downward pressure as interest rate cut expectations could intensify, in particular if oil prices continue to fall.
- The belly and long end of the curves should remain in a horizontal trend in the upcoming weeks, in our view, as the (slightly) positive impact of the bank tax exemption for bonds should be offset to a large extent by a higher political risk premium. We expect the asset swap spread to narrow under the impact of the introduction of the bank tax. Global market sentiment also will be important.

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.