Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

18 – 24 January 2016

Last week there were no major surprises on macroeconomic front with the MPC keeping rates unchanged and CPI figure confirming deflation of -0.5%YoY. We see deflation to last at least until 3Q16 and we still expect the new MPC to deliver a rate cut in March, when the new (dovish) inflation projection will be published. However, a move by 25bp (or even more in a longer horizon) is already largely priced-in by the market.

Balance of payments data were positive with a significant current account surplus and strong exports, but this did not help the zloty. The situation on the Polish financial market was very turbulent, bringing a significant volatility to the interest rate market (mostly long-term rates) and a weakening of the zloty. This was driven by two factors. First, draft bill on FX mortgage loans (even if it is 'only' a draft, which will be a subject to further consultations, among others by the regulator) and expectations that S&P rating agency may lower Poland's credit outlook to stable from positive. The market sentiment towards Polish assets seem quite negative at the moment.

It is hard to say if the upcoming data, which will confirm a good shape of the Polish economy at the end of 2015 (strong output, and retails sales) would be enough to change the sentiment against the Polish currency. Especially, as they could be overshadowed by global releases (including GDP in China and flash PMI for the euro zone) and events (ECB meeting). Any negative surprises in these data might result in higher risk aversion and push EURPLN even towards another resistance at 4.45. The weaker the zloty, the lower probability investors might attach to the scenario of rate cut, trimming recent gains at the short-end of the yield curve. We don't think S&P's decision should have a long-lasting consequence, as the natural/stable outlook is rather natural in current circumstances. After all, nobody expect Poland's rating upgrade.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (18 January)					
14:00	**PL**	**Core inflation**	**Dec**	**%YoY**	**0.2**	**0.2**	**0.2**
		TUESDAY (19 January)					
11:00	DE	ZEW index	Jan	pts	54.0	-	55.0
		WEDNESDAY (20 January)					
14:00	**PL**	**Wages in corporate sector**	**Dec**	**%YoY**	**3.6**	**3.6**	**4.0**
14:00	**PL**	**Employment in corporate sector**	**Dec**	**%YoY**	**1.2**	**1.2**	**1.2**
14:30	US	CPI	Dec	%MoM	0.0	-	0.0
14:30	US	House starts	Dec	k	1198	-	1173
14:30	US	Building permits	Dec	k	1200	-	1282
		THURSDAY (21 January)					
11:00	EZ	HICP	Dec	%YoY	0.2	-	0.2
13:45	EZ	ECB decision			0.05	-	0.05
14:00	**PL**	**Industrial output**	**Dec**	**%YoY**	**5.5**	**6.8**	**7.8**
14:00	**PL**	**Construction and assembly output**	**Dec**	**%YoY**	**2.4**	**3.0**	**1.2**
14:00	**PL**	**Retail sales (real)**	**Dec**	**%YoY**	**5.3**	**5.1**	**5.7**
14:00	**PL**	**PPI**	**Dec**	**%YoY**	**-0.9**	**-0.8**	**-1.8**
14:30	US	Initial jobless claims	week	k	-	-	284
14:30	US	Philly Fed index	Jan	pts	-3.2	-	-5.9
		FRIDAY (22 January)					
9:30	DE	Flash PMI – manufacturing	Jan	pts	53.0	-	53.2
10:00	EZ	Flash PMI – manufacturing	Jan	pts	53.0	-	53.2
16:00	US	Home sales	Dec	m	5.20	-	4.76

Source: BZ WBK, Reuters, Bloomberg

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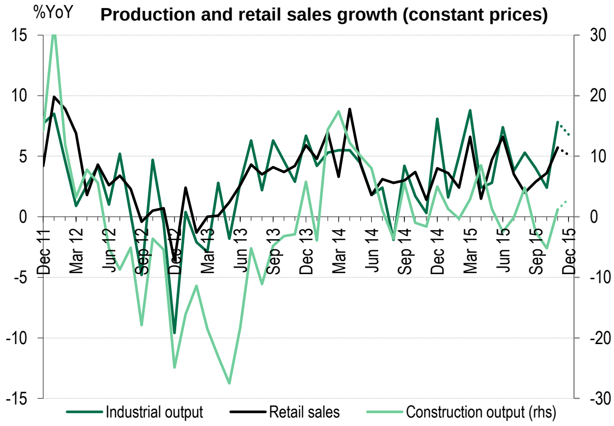
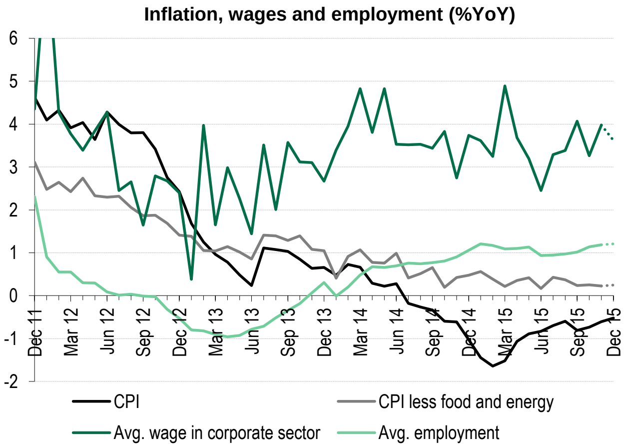
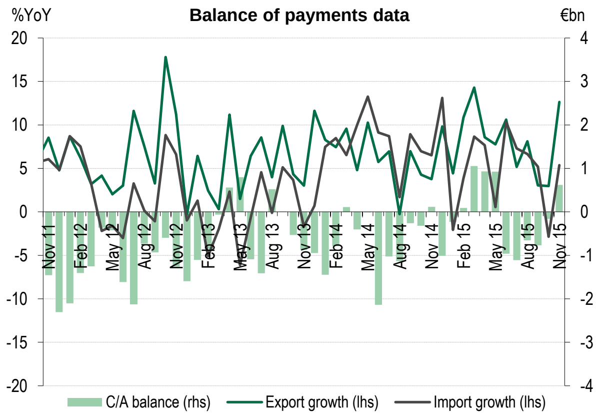
What's hot this week – New set of positive data



- Data from the labour market should confirm continuation of positive trends in December, with employment rising 1.2%YoY, and average wage growth at a solid 3.6%YoY.
- Decent growth in households' labour income should keep supporting consumption spending. We predict retail sales growth in constant prices at a solid 5.1%YoY in December, with risk skewed to the upside, as the new car sales rose surprisingly strong at the end of the year, according to Samar car market analyst.
- Industrial production growth should be also strong, at 6.8%YoY according to our forecast, supported by higher number of working days than last year as well as strong export orders amid reviving growth in the euro zone. Construction output is likely to accelerate to 3%YoY, amid low base effect.

Last week in the economy – Stable rates, low inflation, high exports





- The Monetary Policy Council kept main interest rates on hold in January, at its last meeting before the change of its like-up. The tone of the press conference seemed quite dovish, however, as the Council acknowledged that inflation rate in the coming quarters may be lower than earlier expected due to renewed decline in commodity prices.
- Final CPI data confirmed flash estimate at -0.5%YoY. In MoM terms prices fell by 0.2% mainly due to declining prices of food and fuels. At the same time, in other categories there were completely no signs of upward pressure on prices. According to our estimate, core inflation excluding prices of food and energy remained at 0.2%YoY, the same as in November. We expect that CPI growth will remain very low in the coming months, depressed by very low prices of commodities and food, plus a reduction of gas and electricity prices since January. Thus, deflation is not going to end before 3Q16.
- Balance of payments data for November surprised showing €620m surplus (vs. market consensus -€230m). Export growth accelerated sharply to 12.6%YoY, while import growth reached 5.4%YoY. The data suggest that external demand for Polish goods remains strong, probably supported by accelerating growth in the euro zone and weak zloty. They also imply that that the GDP growth in 4Q15 may be higher than expected, nearing 4%YoY, as the net exports' contribution will be probably higher than anticipated.
- M3 money supply rose by 9.1%YoY in December versus 9.4%YoY in November. Generally, slowdown was seen in most categories, but was not significant. Thus, pace of growth of households' and companies deposits and loans remained pretty unchanged versus November.

Quote of the week – Deflation will end later

Marek Belka, NBP governor, MPC press conference; 14.01

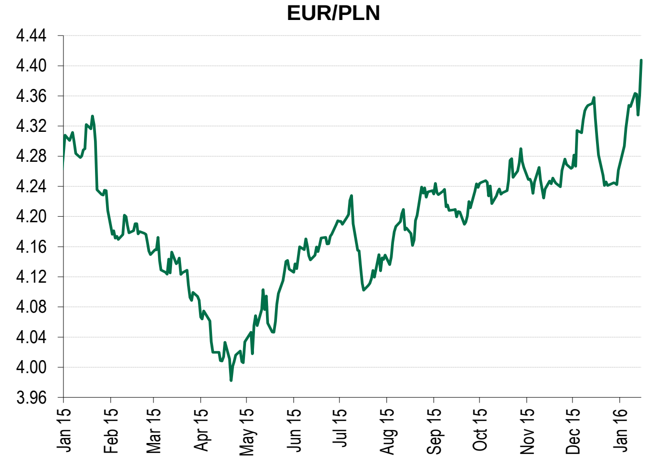
Deflation will end later, CPI indicator will stay low for the better part of the year. (…) The very low inflation and prospects that it will stay low should intuitively suggest more easing. On the other hand, turbulence on the global market, reflected in the weakening PLN, should encourage cautiousness and wait-and-see.

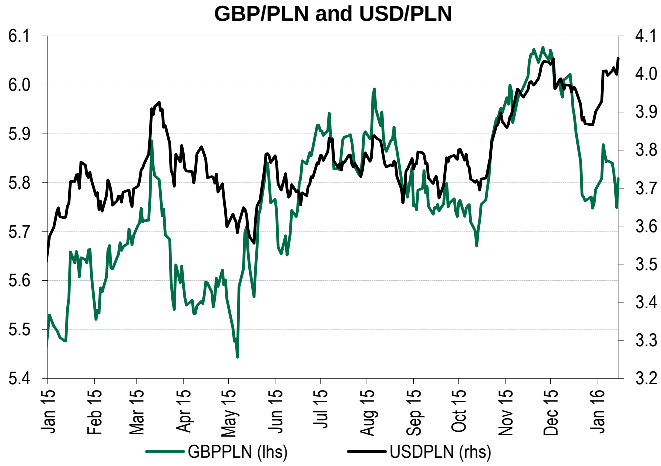
Marek Chrzanowski, MPC member, PAP; 15.01

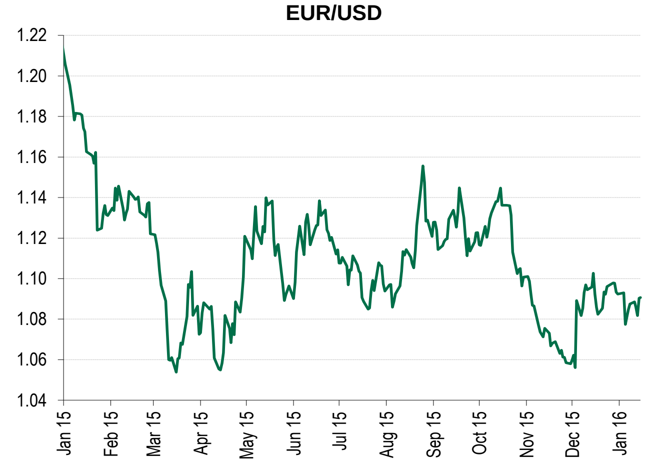
Currently we should eye situation in the economy and its environment, analyse the incoming information and be very cautious about decisions concerning interest rate cuts (…) we will look at the data and if we will decide that our intervention is needed, then we will cut rates.

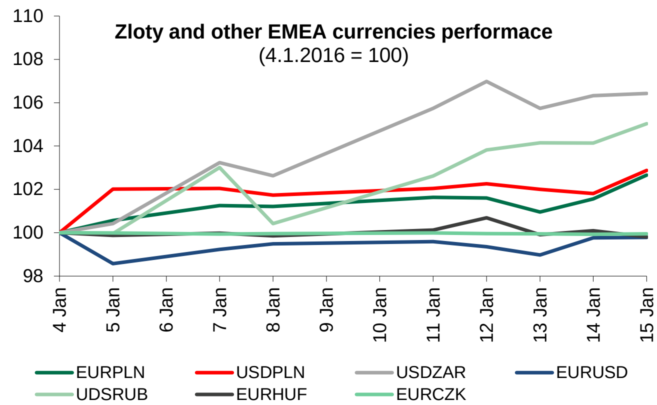
The Senate approved three new MPC members (PiS candidates, as expected), and the Sejm will vote on its nominations on January 29. During the hearings in the parliament, some of MPC candidates sounded surprisingly hawkish (mainly G. Ancyparowicz and J. Kropiwnicki), suggesting no changes in monetary policy are needed. On the other hand, the other three (M. Chrzanowski, E. Gatnar and E. Łon) were rather dovish. At the same time, comments of the NBP governor at the last MPC press conference were surprisingly dovish, as the confirmed deflation will be longer than expected. We still believe there will be a majority in the new MPC to cut interest rates in Poland in the nearest months, as the new NBP Inflation report in March will show much lower inflation path, delivering arguments to ease policy further. The first rate cut by 25bps is possible in March, when the new Inflation report will be published.

Foreign exchange market – Market jitters may persist









EURPLN at the highest level since 2012

- Last week brought significant weakening of Polish zloty. This resulted from, among others, signals about the reluctance of the ECB to ease monetary policy further in the near future, uncertainty about the President Duda's draft bill on FX mortgage loans and speculation that S&P rating agency could lower Poland's credit outlook to stable from positive. Consequently, EURPLN increased temporarily to almost 4.42 (up from weekly low of 4.33), the highest level since 2012. In weekly terms zloty lost 1.4% against euro and the 1.1% against US dollar. USDPLN increased towards December's peak at 4.058.
- From the technical point of view, EURPLN broke important resistance level 4.37 and the next important threshold is 4.45. In our view both domestic and global factors will key for the zloty next week. We would not rule out that the negative reaction to S&P decision may take place over the weekend and during the Asian session, and there may be a rebound of the zloty at the domestic session on Monday – assuming there will be no new negative signals from global markets. Domestic macro data due for release in nearest days (labour market data, industrial production, retail sales) should confirm solid growth of Poland's economy. However, these data could be overshadowed by global releases (including GDP in China and flash PMI for the euro zone) and events (ECB meeting). While no policy action by ECB is widely expected, data on 4Q15 economic activity in China will be crucial. Any negative surprises in these data might result in higher risk aversion and push EURPLN even towards another resistance at 4.45.

Euro stronger on monetary policy expectations

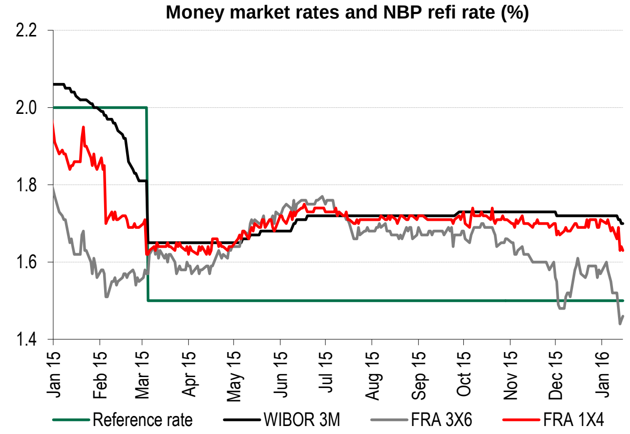
- Worries about global economic outlook due to turmoil in China cooled down expectations for Fed tightening in upcoming months, sending EURUSD higher last week. Signals that many ECB officials were sceptical about the need to ease monetary policy further additionally supported the euro. As a result, EURUSD ended the week near 1.095.
- Risk sentiment and oil prices remain main drivers for all the major currencies at the moment. This week calendar of macro data releases and events is quite heavy. Another weak set of Chinese macro data could renew worries over global outlook and deterioration in sentiment should tend EURUSD lower, but less Fed tightening and ECB easing would affect EURUSD in the opposite direction. As a consequence we might see another week of horizontal trend in EURUSD.

USDRUB closer to record high

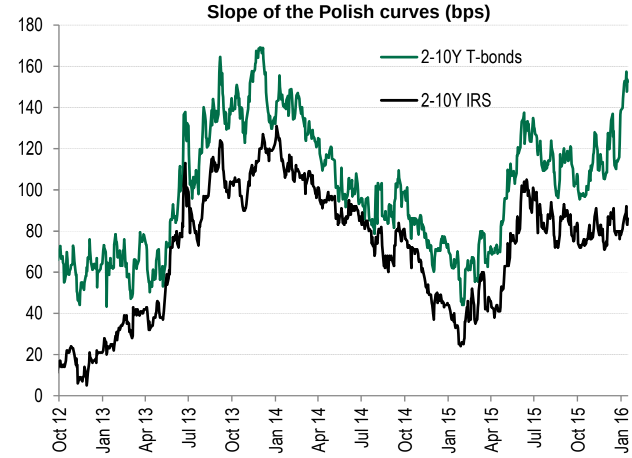
- The Russian rouble (like other global commodity-driven FX rates) is experiencing prolonged depreciation pressure. USDRUB increased toward 78 due to selloff in crude oil price (the price of Brent oil fell below $30, the lowest level since 2004). It is not so far from record high close to 80 reached in December 2014. Hungarian forint was under pressure at the very start of the week, but it rebounded in the next days and EURHUF fell below 314 on Friday. At the same time EURCZK has remained in narrow range between 26.98-27.05. Information about FX reserves suggested that the value of the CNB intervention in December was lower than during the summer.
- This week will only feature limited economic data out of CEE (including Russia). Therefore global factors are the key. The ECB meeting on 21 January will be a closely watched event, even though we would not expect any relevant changes for this meeting. All in all, market jitters are expected to remain for the CEE region until we see a stabilisation in the oil price with a normalisation of inflation and reduction of fears over the economic conditions in China.

Interest rate market – Little room for bonds to gain

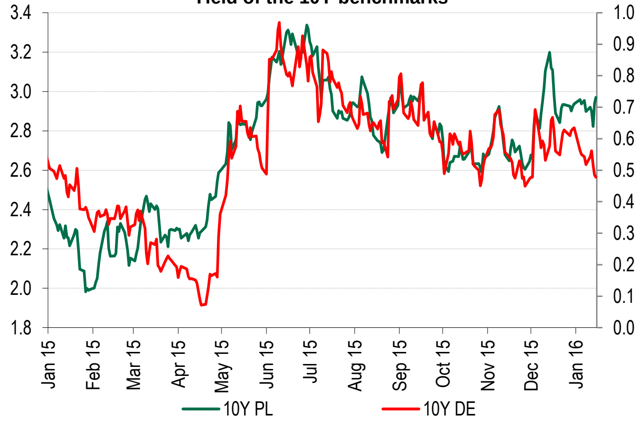
Money market rates and NBP refi rate (%)



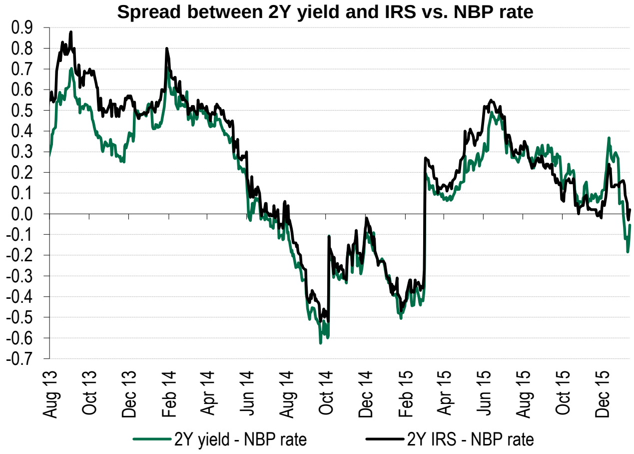
Slope of the Polish curves (bps)



Yield of the 10Y benchmarks



Spread between 2Y yield and IRS vs. NBP rate



Curves steeper after a volatile week

- The past week was quite volatile for the Polish IRS and yields along the curves. Initially, the short ends were gaining sharply on the rising odds for more NBP rate cuts amid falling prices of oil and in reaction to hearing of MPC candidates in the parliament. As a result, the 2Y IRS reached a fresh all-time low at 1.45%. Later in the week a significant profit taking was recorded as hopes for more easing in the euro zone faded after signals from the ECB. On weekly basis 10Y IRS fell 8bp, but from the weekly low the rate jumped 7bp. The bond curve steepened and the 2-10 spread reached its highest since late 2013.
- Finance Ministry sold 10Y and 20Y bonds denominated in EUR for €1.75bn. 10Y debt was sold for €1bn and priced 65bp above the swap curve and 20Y bond was priced 100bp above the swap curve. Recently the Ministry informed that it could enter the foreign markets in 1Q and this auction was the first.

Little room for bonds to gain

- Numerous Polish, U.S. and European data is on the agenda this week and the ECB holds a meeting. Last week Reuters reported that some members of the European Central Bank are sceptical about chances to take additional measures to stimulate the economy in the near future, which triggered a sharp market reaction. In our view, there should be no sharp market reaction if Mario Draghi repeats this opinion this week as the market has already priced in a delay in any actions that the ECB could take.
- FRAs fell 5-15bp last week and now the market is now fully pricing-in a 25bp cut within 3 months, which is in line with our scenario. Longer rates, however, see less than 70% probability of the second 25bp reduction later in the year while we expect the refi rate to be trimmed by 50bp in total in 2016. However, the fact is that depreciating zloty is lowering chances for more significant monetary policy easing.
- Our forecast of retail sales is close to market consensus while our estimate for the industrial output is higher than the market expects. We do not think these numbers could have a significant impact on the front end of the curve as expectations for more easing amid low inflation should still play the main role. At the same time, the potential for the 2Y IRS/yields to decline looks rather limited. The spread between 2Y yield and NBP refi rate is already negative and we think it should not drop much further without a clear strengthening of expectations for further monetary easing (which seems not very likely, at least in the short run, as weakening zloty seems to reduce odds for more decisive rate cuts).
- We think that it could be difficult for the long end to gain in the coming weeks. Notice that the 10Y Bund yield is just above the local low from December while the Polish 10Y benchmark yield is somewhere 30bp above the bottom seen in late 2015. It seems that the local factors – concerns about the fiscal situation in Poland, worries about credit outlook – could have been the reasons for the recent domestic 10Y bonds underperformance vs. Bunds. S&P is likely to downgrade the outlook to stable from positive – or at least signal such risk – and so we do not think that internal issues could turn positive for the long term bonds in the near term.
- Chinese 4Q GDP data is due on Monday and we also see risk for this release to weigh on the long end of the Polish curve – demand for safe assets could strengthen if the number disappoints and odds for Fed rate hikes may rise if it surprises to the upside.

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.