Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

6 – 12 June 2016

Polish zloty was relatively stable, while bonds were weakening for the better part of the last week as investors were digesting news about GDP growth slowdown, lower inflation, higher PMI, and rumours about new FX loans proposal. Only the end of Friday's session saw a significant strengthening of zloty and bonds, after disappointing US labour market data lowered probability of Fed rate hikes and supported global risk appetite. Still, the spread of Polish bonds vs. Germany remained wide, above 300bp.

The calendar of data releases for the coming week (both in Poland and abroad) is very thin, so markets will be awaiting the key events scheduled for the coming weeks – Fed meeting, Polish president's proposal how do deal with FX loans, new economic data, UE referendum in the UK. The last MPC meeting chaired by outgoing Marek Belka is unlikely to surprise. The main message should remain unchanged – deflation has no negative effects, GDP slowdown in 1Q16 was temporary, interest rates are at optimal level. Just after that Adam Glapiński should be approved for the new NBP governor by the Sejm. On June 7 the team of experts working on the new FX loans proposal holds its last meeting and should present their conclusions to the President. First rumours about the possible shape of the solution have already started leaking, but it seems there are still several options under consideration and no final decisions made yet. We think it may take at least few more days until the President presents his final proposal.

We think that both zloty and bonds may remain under pressure at least until the uncertainty about the FX loan issue, about the Fed decision, and about possible result of EU referendum in UK persist.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (6 June)					
8:00	DE	Factory orders	Apr	% m/m	-0.5	-	1.9
		TUESDAY (7 June)					
8:00	DE	Industrial output	Apr	% m/m	0.6	-	-1.3
9:00	CZ	Industrial output	Apr	% y/y	4.0	-	0.6
9:00	HU	GDP	1Q	% y/y	0.9	-	3.1
11:00	EZ	GDP	1Q	% y/y	1.5	-	1.5
14:00	PL	Official reserves	May	bn €	-	-	92.28
		WEDNESDAY (8 June)					
	PL	**MPC decision on rates**	**Jun**	**%**	**1.50**	**1.50**	**1.50**
9:00	HU	CPI	May	% y/y	0.1	-	0.2
		THURSDAY (9 June)					
	PL	**T-bond auction**					
8:00	DE	Exports	Apr	% m/m	-0.9	-	1.9
9:00	CZ	CPI	May	% y/y	0.4	-	0.6
14:30	US	Initial jobless claims	week	k	-	-	267
16:00	US	Wholesale inventories	Apr	% m/m	0.1	-	0.1
		FRIDAY (10 May)					
16:00	US	Flash Michigan index	Jun	pts	94.5	-	94.7

Source: BZ WBK, Reuters, Bloomberg

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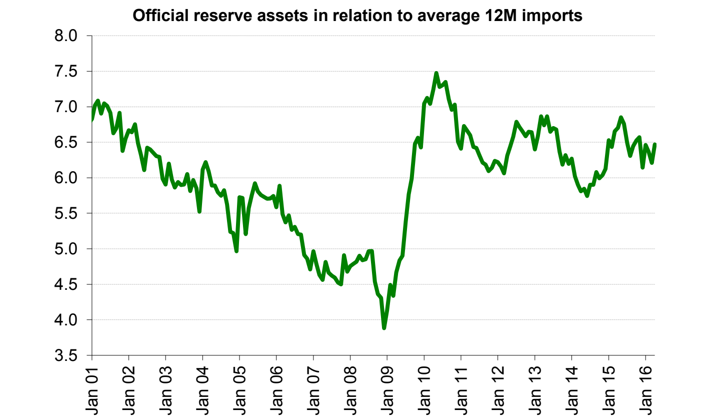
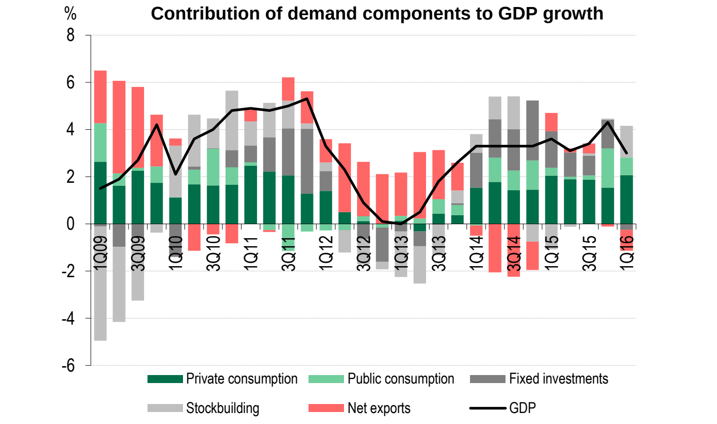
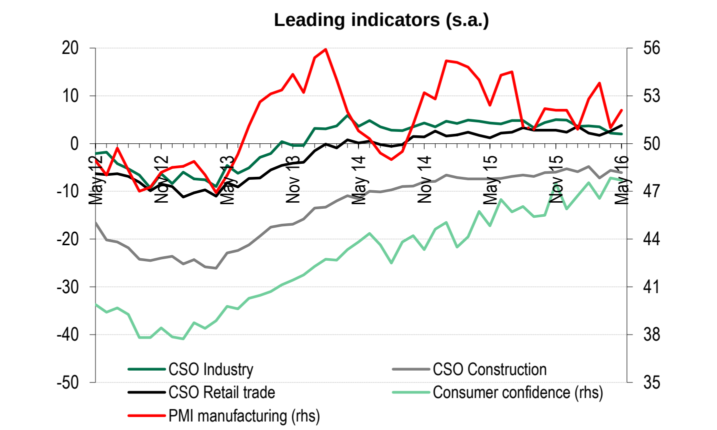
What's hot this week – Rates expected to stay flat



- MPC meeting is the key event in Poland this week. However, it is unlikely to be a game-changer, as interest rates should stay unchanged at 1.50% and the central bank's rhetoric is unlikely to change. Still, we are eager to hear what the MPC members are going to say about the drop in investments in Q1, or lower than expected CPI.
- The Sejm is expected to approve Adam Glapiński for the new NBP head at its meeting on June 9-10. He is an advocate of quite conservative monetary policy. Investors will be particularly interested in his opinion about central bank involvement in solution of CHF loans problem.
- The NBP will release data on international reserves. This statistics is usually of secondary importance, but may gain a bit higher attention at the time when discussion about NBP involvement in FX loans conversion is in the air.

Last week in the economy – Investment fell in Q1, CPI surprised to the downside, PMI went up





- Poland's GDP growth in 1Q16 reached 3.0% y/y. The main source of a slowdown from 4.3% y/y in 4Q15 was drop of investments (-1.8% y/y) and negative net exports' contribution (-0.9 pp). Private consumption growth was stable at 3.2% y/y. We think GDP growth in the coming quarters should accelerate slightly, boosted by faster export growth (effect of solid economic growth in euro zone + competitive exchange rate), and in 2H16 by much higher private consumption (effect of 500+ child benefits programme). The biggest question mark concerns investments. It seems their drop in 1Q16 was mainly the effect of collapse of public investment spending and some rebound is possible before the end of the year if the absorption of EU support funds improves. On average GDP growth in 2016 may be slightly below 3.5%, according to our forecast.
- Inflation rate in May reached -1.0% y/y according to flash estimate. According to our observations prices of food and fuels rose in May, so such low CPI print probably implies a further drop of core inflation – possibly to the new record low -0.5% y/y.
- The seasonally-adjusted LFS unemployment rate fell in April to 6.3%, the lowest level in history. We expect further declines of the unemployment rate in the months to come, yet downward trend should be slowing down due to drying up supplies of labour force.
- Polish manufacturing PMI index rose in May to 52.1, after surprisingly strong drop to 51.0 in April. Growth rates for output, new orders, exports and employment all picked up, signalling improvement in business conditions and confirming our assessment that Polish industry should benefit from solid economic growth in the euro zone and weak zloty.

Quote of the week – Stabilisation of rates is an optimal solution

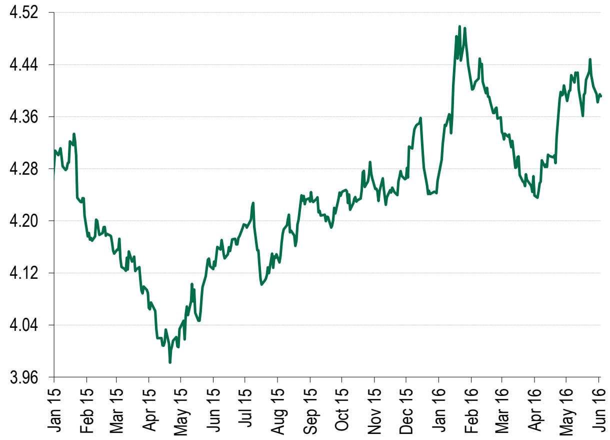
Marek Chrzanowski, MPC member, 30 May, PAP
Further stabilisation of interest rates is an optimal solution. The scenario of interest rate cuts is rather unlikely (…) In this year, the GDP growth rate of 3.8% is achievable. The growth in Q1 was below expectations. It has to be noted that it occurred in the absence of help from EU funds (…). The projects under the new EU financial perspective are planned to start in H2 2016. The role of the 500+ programme as a driver of consumer demand should not be overlooked.

Marek Belka, NBP president, 2 June, Rzeczpospolita
I have no reason to believe that something bad may happen [to the independency of the NBP]. I feel reassured by the statements of Adam Glapiński. (…) In my opinion, the involvement of the NBP is in this case [CHF loans] unnecessary, as there are no social or economic grounds to deal with the issue of CHF loans at all.

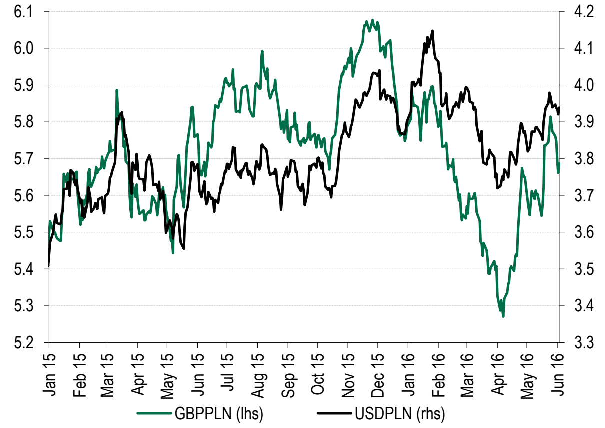
Recent comments of the MPC members confirm that rate cuts are unlikely. This is based on the assumption that the economic growth will be improving in the following quarters, or rather than it will not be slowing down further. We do not expect GDP slowdown, as improving business climate in the euro zone will be a strong support for the Polish economy. Still, we are less optimistic than Chrzanowski (expecting 3.8% y/y), especially after weak data for Q1. Further rate cuts will be also negative for the banking sector, especially in the light of possible FX loan conversion. The current NBP president reiterated that he does not see central bank's involvement in the CHF issue. We find it difficult to imagine a large-scale conversion without NBP involvement, as otherwise PLN would be hit strongly. We will be eyeing comments of Adam Glapiński, who is likely to be confirmed as NBP president in a week's time, in this matter.

Foreign exchange market – Nervousness ahead of the looming FX-loan conversion bill draft

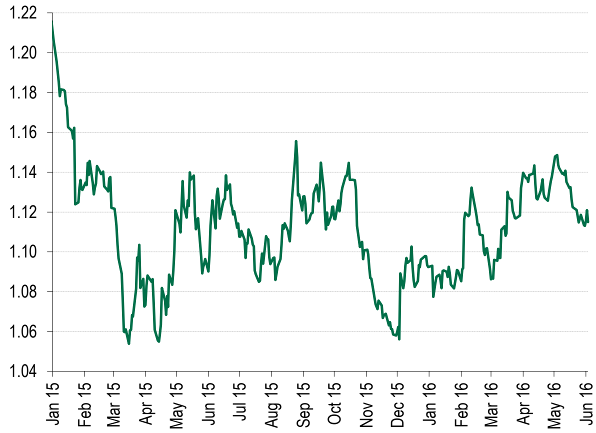
EURPLN



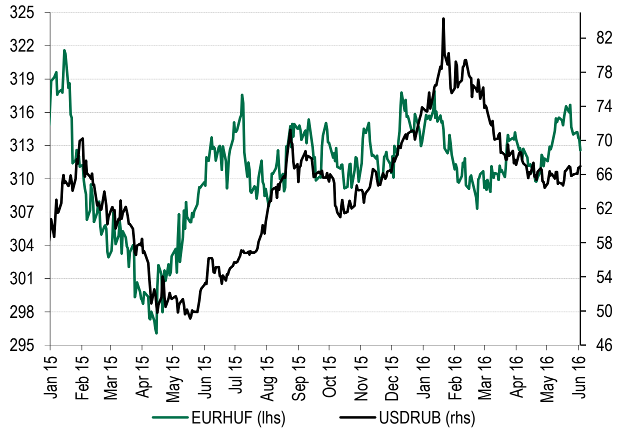
USD/PLN and GBP/PLN



EUR/USD



EUR/HUF and USD/RUB



Zloty stronger after weak non-farm payrolls in the USA

- It was a relatively calm week at the Polish currency market, as EURPLN was hovering in a horizontal band between 4.38 and 4.40, showing quite limited reaction to new data releases (GDP breakdown, flash CPI, PMI) or other news (in particular on FX-loans conversion or ECB outcome). USDPLN was a bit more volatile, amid swings in EURUSD rate during the week – it initially fell from 3.95 towards 3.91, and then returned above 3.94. The zloty gained vs. the British pound (GBP fell below 5.65, its lowest level since mid-May). Zloty gained significantly against the euro and the US dollar on Friday afternoon, after much weaker than expected non-farm payrolls in the US. USDPLN fell below 3.90 for the first time since mid-May.
- This week the calendar of data releases and events abroad is light but markets will pay attention to speeches of Fed members (including Fed's Chair on Monday). On the domestic market, the MPC meeting and in particular the looming proposal for FX loan conversion will be in focus. The president's final offer will be probably announced in mid-June, but new leaks about considered versions are possible. Given both external and internal risks the scope for zloty appreciation seems limited in near term. We think that ahead of FOMC meeting and the UK referendum EURPLN can hover within the range 4.36-4.44, which has been in place since mid-April.

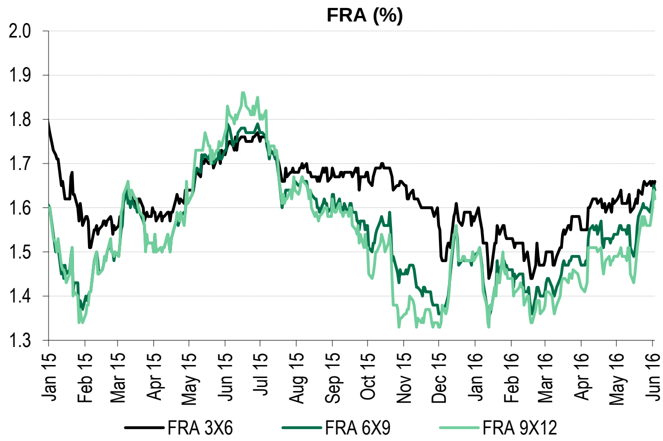
EURUSD under influence on Fed rate hike expectations

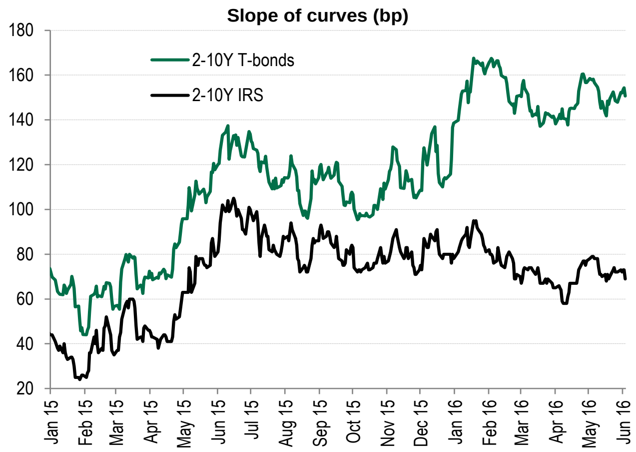
- The US dollar has remained quite strong against the euro until Friday, as good macro data from the US economy supported market expectations that Fed can decide on rate hike at its June/July meeting. It was also the effect of not very optimistic ECB's economic forecasts for the Euro zone and comments of FOMC members, suggesting that interest rate hikes seem reasonable. However, significantly weaker than expected non-farm payrolls data released on Friday afternoon pushed EURUSD up towards 1.13.
- Given light macro events calendar, expectations for rate hikes by Fed should be in the spotlight. The market was pricing in around 22% probability of a 25bp Fed rate hike in June, according to Bloomberg, but it fell to merely 6% after NFP data. Therefore Fed Chair Janet Yellen's speech on Monday will be important in setting the tone for the next Fed rate hike. All in all we expect EURUSD to move in horizontal trend (between 1.11-1.15) ahead of FOMC meeting next week.

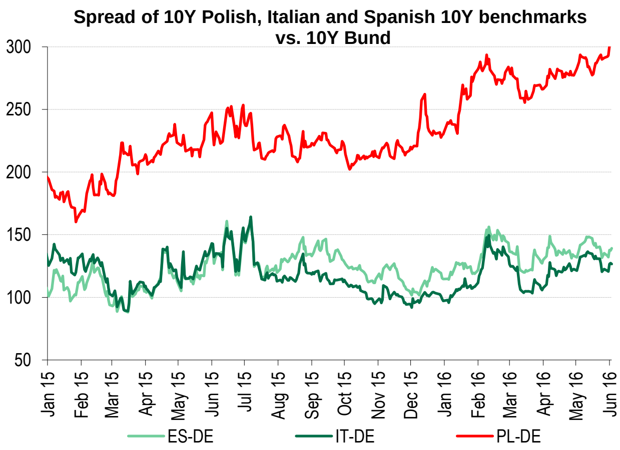
Inflation data in the spotlight in CEE

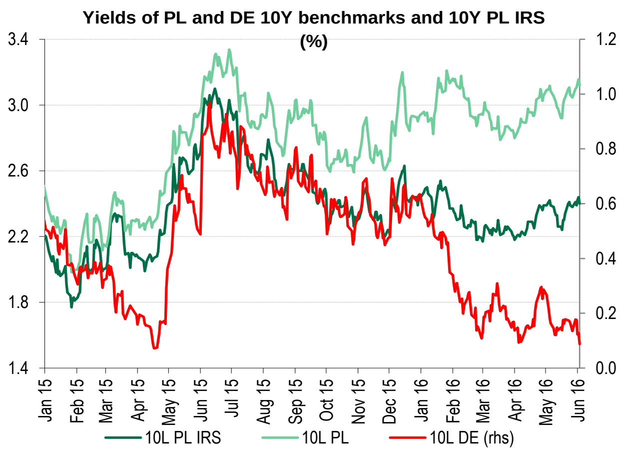
- The Hungarian forint gained visibly at the turn of May and June. The EURHUF tested 312 (the lowest level since early May) as recently released macroeconomic data confirm quite decent rebound in economic activity at the start of the 2Q16. USDRUB followed changes of oil prices as in previous weeks. As a result the rate temporarily grew to 67.8 and then reached 66.6. On the other hand EURCZK was flirting with 27.00.
- There will be new data releases (including CPI) in Czech Republic and in Hungary this week. It is expected that the Czech inflation rate could slow as compared to April, however in our view the market response to this will be neutral and EURCZK should remain slightly above 27.0. In contrast in Hungary the main focus will be on detailed GDP data, which should help clarify the causes of the slowdown in economic activity in 1Q16. On the other hand CPI should be close to April's figure of 0.2% y/y and this data will be rather neutral for the forint.

Interest rate market – Risk premium may remain elevated









Yields up due to higher global risk aversion

- On money market, WIBORs 1M and 3M increased slightly (by 2bp and 1 bp, respectively), while other rates remained stable. At the same time FRA rates rose by 1-11bp, with the highest more on the longest tenors. FRA market suffered from weakening of IRS market. Despite weak 1Q16 GDP growth and slower than we predicted rebound in the headline CPI in May, investors scaled back their expectations on monetary policy easing later this year. Currently, the FRA market sees only 20% chance rates will be lower by 25pb in next 12 months (vs 60% expected two weeks ago).
- Domestic interest rate market lost the ground over the last two weeks due to higher global risk aversion, stemming from rising possibility of Fed rate hike, worries over the referendum outcome in the UK. The global environment, however, was not the only factor responsible for higher yields as the spreads towards Bunds also rose, showing that local factors are still an issue. All in all yield of 10Y benchmark rose to nearly 3.17% for a while, reaching the highest level since early February. However, after much weaker the labour market data in the US, yield of 10Y benchmark fell towards 3.10%
- Both yield and IRS curves shifted up and steepened as the long end of the curves underperformed other sectors. What is more, risk premium inched higher with the spread over bunds for 10Y tenor widening over 300bp, for the first time since January 2014. The scale of weakening for both T-bonds and IRS was more or less the same, therefore assets swap spread remained nearly unchanged.

Poland has completed nearly 70% of borrowing needs

- Poland's Ministry of Finance assumes in its issuance plan to set two auction in June. The ministry will offer 2Y benchmark OK1018 and 10Y benchmark DS0726 worth PLN3-6bn at regular auction on June 9. Later this month it will organize the switch tender, repurchasing OK0716, IZ0816 and PS1016. The choice of offered securities will depend on the market situation. Deputy finance minister Piotr Nowak said that after May the borrowing needs were covered in 68%.
- The value of Polish marketable T-bonds portfolio held by non-residents fell by PLN1.9bn to PLN188.3bn in April due to PS0416 redemption. Foreign investors increased holdings in the medium- and long-term bonds in May according to the Ministry of Finance. At the same time Polish banks increased their portfolio by nearly PLN3bn to slightly above PLN221bn, the highest level in a history.

Poland's central bank meeting and auction in the spotlight

- This week is light in terms of external macro data releases and events, while in Poland investors will focus on the MPC meeting and t-bond auction. In our view, the Council will keep interest rates stable and also remain the rhetoric unchanged. This will be rather neutral for the market.
- On June 7 we will know detailed supply on Thursday's auction. The ministry might narrow the range of supply as it did in previous auctions. In our view demand should be healthy and allow the Ministry to launch the maximum level of offer. Auction results might influence the market in the short run.
- In our view domestic interest rate market could remain under pressure of domestic factors, in particular news about the FX-loans conversion. We expect this issue to add to market volatility this week. As a consequence the spread vs. Bunds, could remain quite wide as political and fiscal risks remain elevated in Poland.

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.