Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

4 – 10 July 2016

The post-Brexit market turbulence did not last long. Growing hopes for more monetary stimulus by the main central banks triggered a rally in the bond markets with Polish bond yields falling to April lows and the spread vs the 10Y Bunds returning below 300bp. EM currencies also rebounded, although the zloty and the CEE region's currencies gained less than, for example, their LatAm counterparts. They were probably held back by worries about the looming economic slowdown in Europe. In our view, the risk for Poland's growth outlook is indeed rising – GDP growth in 2017-18 may be closer to 3% than the government-envisaged 4%. 2016 may also be weaker, as recent data have signalled that the 2nd quarter may not be much better than the disappointing 1Q16.

The Monetary Policy Council is likely to keep interest rates on hold on Wednesday. However, this meeting has the potential to be a bit more interesting that the previous ones, as the MPC will get to see the bank's new CPI and GDP projections (which are likely to show somewhat lower inflation and growth paths).The Council may also comment on the possible consequences of the Brexit. The FRA market has already started to price-in rising chances for rate cuts, even though the MPC's members have recently denied that the Brexit could have an impact on Poland. However, if the upcoming macro data keep on disappointing, expectations for rate cuts will likely gain steam, in our view.

The US nonfarm payrolls data for June will be the key event on the global markets. After the UK referendum, markets no longer believe in FOMC rate hikes and if the jobs data disappoint again, hopes for a more accommodative Fed monetary policy may even strengthen. On the other hand, a positive surprise from the data could trigger a deterioration of sentiment on the emerging markets.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (4 July)					
	US	Market holiday					
		TUESDAY (5 July)					
9:55	DE	PMI – services	Jun	pts	53.2	-	55.2
10:00	EZ	PMI – services	Jun	pts	52.4	-	53.3
16:00	US	Industrial orders	May	% m/m	-0.8	-	1.9
		WEDNESDAY (6 July)					
	PL	**MPC decision**		**%**	**1.50**	**1.50**	**1.50**
8:00	DE	Industrial orders	May	% m/m	0.5	-	-2.0
16:00	US	ISM – services	Jun	pts	53.4	-	52.9
20:00	US	FOMC minutes					
		THURSDAY (7 July)					
8:00	DE	Industrial output	May	% m/m	0.0	-	0.8
11:00	**PL**	**Bond auction**					
14:15	US	ADP report	May	k	150	-	173
14:30	US	Initial jobless claims	week	k	-	-	268
		FRIDAY (8 July)					
8:00	DE	Exports	May	% m/m	0.4	-	0.1
9:00	CZ	Industrial output	May	% y/y	8.2	-	4.2
9:00	HU	CPI	Jun	% y/y	-0.1	-	-0.2
14:30	US	Non-farm payrolls	Jun	k	180	-	38
14:30	US	Unemployment rate	Jun	%	4.8	-	4.7

Source: BZ WBK, Reuters, Bloomberg

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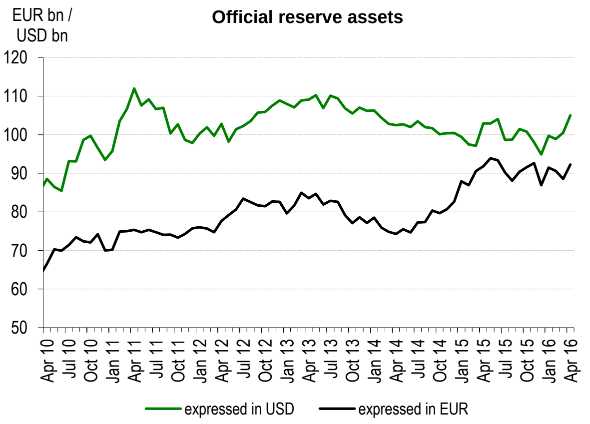
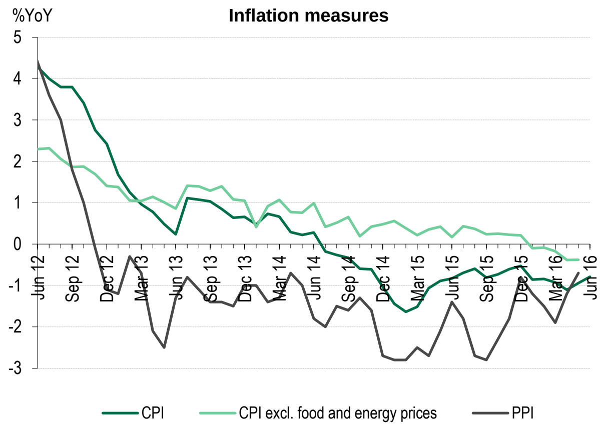
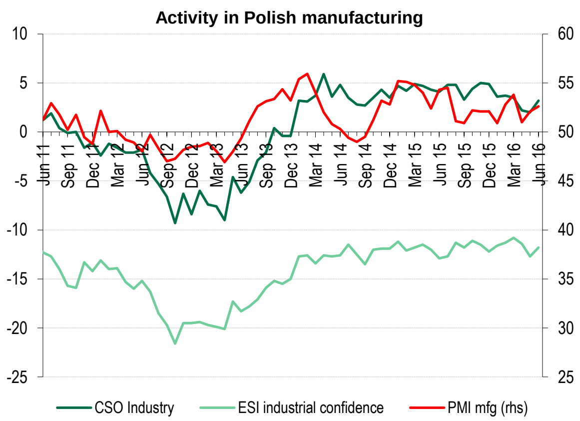
What's hot this week – MPC decision and new NBP projection



- The Monetary Policy Council is likely to keep interest rates on hold on Wednesday. However, this meeting could be a bit more interesting that the previous ones, as the MPC will already know the bank's new CPI and GDP projections (which are likely to show somewhat lower inflation and growth paths) and may comment on the possible consequences of the Brexit. The FRA market has already started to price-in rising chances for rate cuts, even though the MPC's members have recently denied the possibility of a Brexit impact on Poland. However, if the upcoming macro data keep on disappointing, expectations for rate cuts will likely gain steam.
- NBP will release data on Poland's international reserves in June on Thursday. These numbers are currently a bit more interesting, given the possibility of a CHF loan conversion. The last two months saw a considerable rise of FX reserves.

Last week in the economy – CPI slightly up, PMI disappointed





- Polish CPI growth reached -0.8% y/y in June, according to the flash estimate, in line with our forecast, and up from -0.9% y/y in May. We do not know the details yet (to be announced on July 11), but according to our estimates, the pickup was mainly the result of low base effects in prices other than food and fuels. As a result, core inflation may have picked up to -0.2% y/y in June from -0.4% y/y in May, according to our estimates. Nevertheless, Poland remains in deflation territory, which may last until 4Q16, according to our forecast.
- PMI for the Polish manufacturing sector slid in June to 51.8pts from 52.1 in May. The most important sub-indices, like new orders, new export orders, employment and output were quite stable or even up, with the fall of the headline index caused by suppliers' delivery times. In general, the index is signalling stabilisation of economic growth in Poland. We expect GDP growth in Q2 to be only marginally higher than in Q1.
- The NBP released its quarterly balance of payments data for 1Q16. The revision versus the monthly data was insignificant, with the current account balance going a bit up (to €296mn from €150mn) thanks to an upward revision in exports. The 12M rolling current account deficit reached 0.4% of GDP in 1Q2016. The net international investment position was equal to -61.7% of GDP in 1Q16 versus -61.2% in 4Q15, with the slight deterioration mainly due to an increase in value of foreign direct investments. On the other hand, Poland's gross external debt fell to 70.3% of GDP in 1Q16 from 70.5% in 4Q15, which was mostly due to the fact that foreign investors sold large amounts of Polish government bonds.

Quote of the week – Rate cuts possible if growth slows down

Eryk Łon, MPC member, June 27, PAP

The current level of interest rates seems optimal for the economy. Rate cuts would be possible with risk of economic slowdown. We will look at the new inflation and GDP projections. My eagerness to think about cuts has recently weakened, and stabilisation of rates in the upcoming few months would be positive.

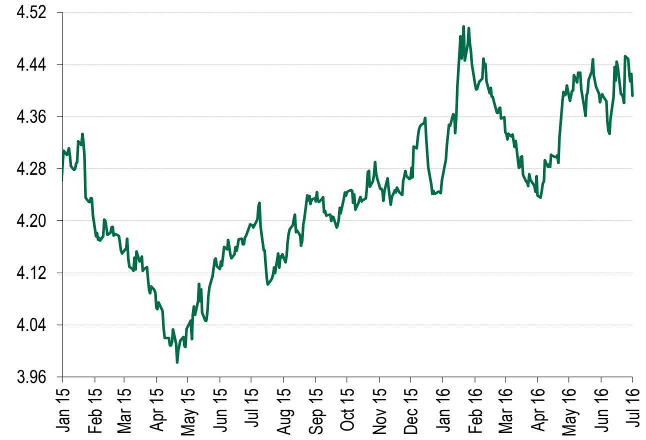
Łukasz Hardt, MPC member, June 28, Rzeczpospolita

As regards interest rates: first, the disparity between Poland and Europe is an insurance in the event of PLN depreciation. Second, and more importantly, I doubt that further rate cuts would revive investments and the economy. Moreover, there are some factors, which should push inflation up.

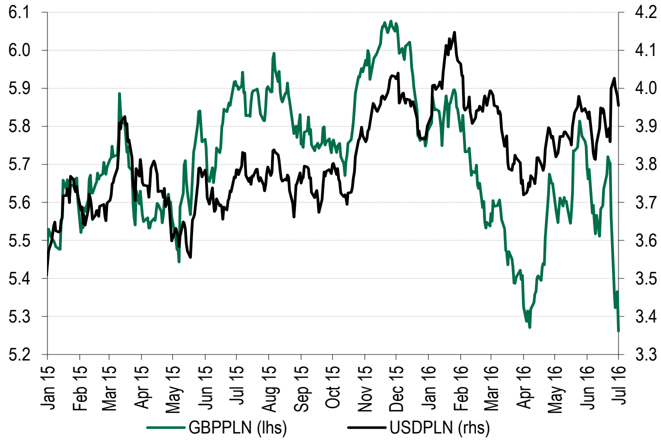
For the Monetary Policy Council, it is the GDP growth outlook that is probably more important than inflation (the Council believes deflation is not a reason to cut rates further). After the recent Brexit vote, we see a growing risk of an economic slowdown in Europe, which may also affect Poland. If GDP growth fails to pick up significantly from the disappointing 3% y/y recorded in 1Q16, the chances for a rate cut in the autumn may rise. However, the MPC's decisions will be additionally complicated by the issue of zloty depreciation, CHF loans and banking system stability. We do not know whether the new NBP projection will be taking into account the possible consequences of the Brexit vote, but even if not, both the CPI and GDP paths may be revised downwards (lower starting points). Still, we guess that the MPC's official stance may remain unchanged until they see evidence of an economic slowdown in statistical data.

Foreign exchange market – Back to range-trading

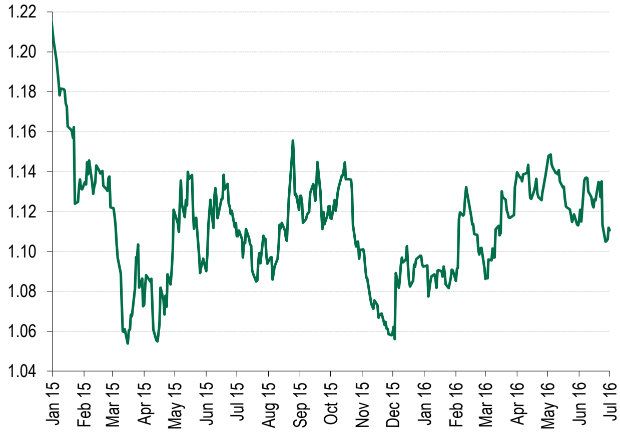
EURPLN



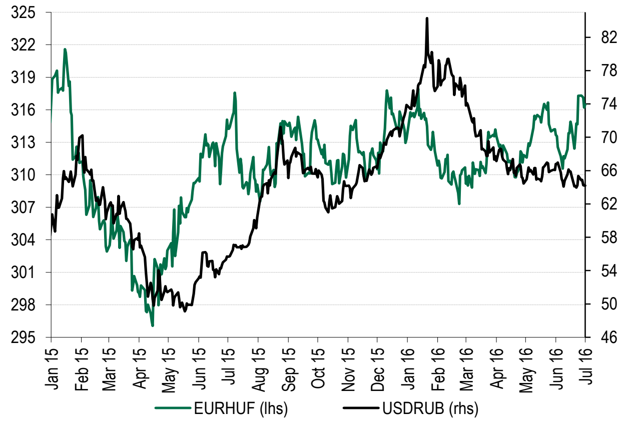
USDPLN and CHFPLN



EURUSD



EURHUF and USDRUB



Temporary zloty losses

- Last week's UK referendum triggered significant turmoil on the global markets, but it did not take long for stabilisation and then a noticeable recovery to emerge. EURPLN was quick to return to its almost pre-Brexit levels. The zloty gained on reviving demand for cheaper risky assets and, mostly, on mounting expectations that central banks would soon step in to support the global economy to try to minimise any negative effects from the Brexit on economic activity. At the end of the week, EURPLN is hovering near 4.38 and USDPLN at 3.94 (half-way between last week's peak and low). Nearly all of the EM currencies gained this past week, though the LatAm ones outperformed their CEE peers.
- The UK vote's impact proved sharp but very short-lived. The timing of the UK actually leaving the EU and the final conditions of the "divorce" are uncertain, which means that more stimulus from the central banks may have a considerable impact on the markets (at least in the short term). And this could be why the markets' negative reaction to the Brexit vote proved to be only temporary.
- The US nonfarm payrolls are due this week and this is likely to be the key event of the coming days for the markets. Last month's job report was a disappointment and the market is now looking for improvement. Chances for Fed rate hikes this year have fallen to zero, according to Bloomberg, though the market was even pricing in 40% odds for rate cuts in 2016 just after the UK referendum (this was, again, only for a while). Considering all this, we think that a positive surprise from the nonfarm payrolls could trigger a bigger market impact than a better-than-expected number.
- EURPLN only temporarily left the wide 4.31-4.46 trading range after the Brexit vote and we expect the exchange rate to continue to move sideways within these boundaries in the weeks to come.

Euro gains despite outlook for more easing

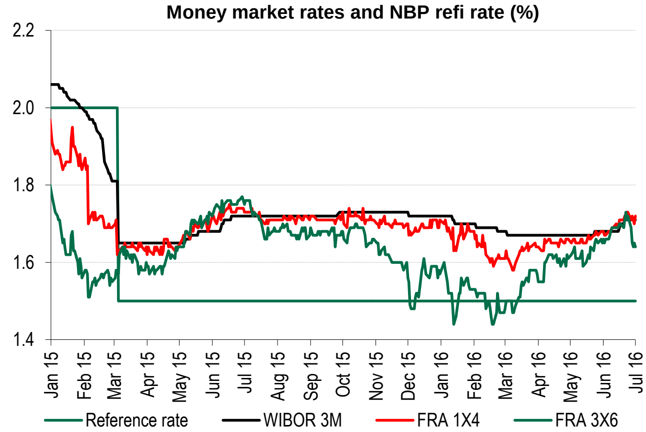
- The euro recovered slightly vs the dollar after suffering significant losses the previous Friday. EURUSD rose to 1.11 from 1.09 even despite speculations that the ECB was likely to extend its easing programme, and thanks to lower demand for safe assets.
- Just like the other currencies, EURUSD stabilised pretty quickly after the Brexit vote and now the market's attention may turn to the other, less ambiguous factors that affect the global central banks' monetary policies. The US nonfarm payrolls are on the agenda this week and, as the market is not pricing in any Fed rate hikes this year, a weak release should not have much impact on EURUSD. At the same time, if the positive global market sentiment persists, the exchange rate could move higher on lower demand for safe assets.

Forint underperforms CEE3

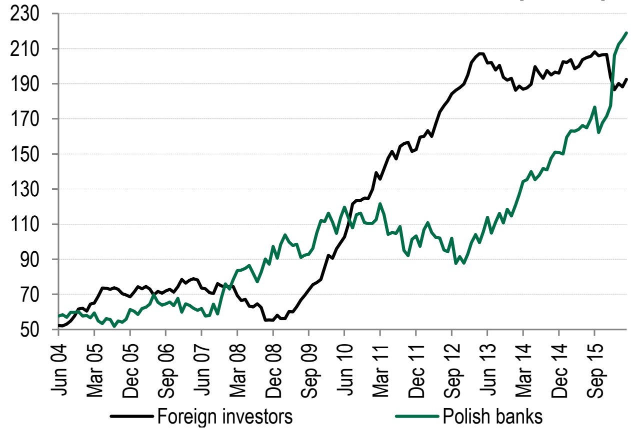
- The forint's and ruble's reaction to the Brexit vote proved short-lived, but the Hungarian currency did not manage to recover all of the losses it had suffered last Friday.
- The Czech central bank left interest rates unchanged with the main refi rate still at 0.05%. The CNB reiterated that the EURCZK floor at 27.0 could be abandoned in mid-2017, but the outcome of the UK referendum added uncertainty to the economic outlook.

Interest rate market – Expectations for rate cuts re-emerge

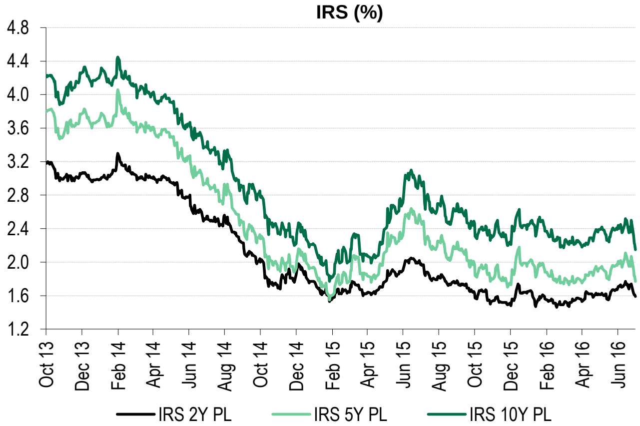
Money market rates and NBP refi rate (%)



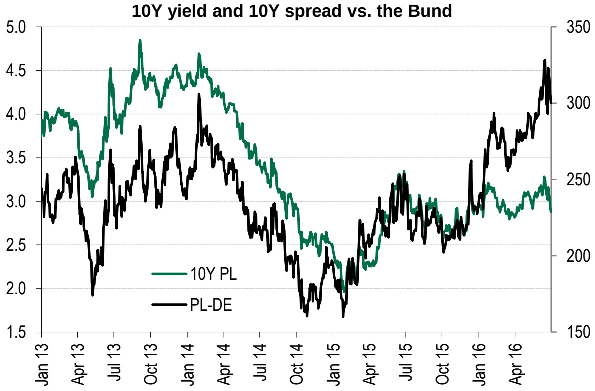
Holders of Polish PLN, marketable bonds (PLNbn)



IRS (%)



10Y yield and 10Y spread vs. the Bund



Rates back below pre-Brexit levels

- The worldwide recovery from the sharp rise is risk aversion in response to the UK referendum also supported Poland's fixed-income market. The IRS and bond curves moved 10-30bp down from last Friday's peaks and are now 10-15bp below the pre-Brexit levels – the 2Y IRS fell to 1.60%, 5Y to nearly 1.80% (lowest since mid-May) and 10Y to c2.15% (lowest since mid-April). Gains on the cores and peripheries, fueled by speculation that more monetary easing could be needed to minimise the negative effects of the Brexit on the global economy, pushed the IRS and yields down. This was also true in Poland's case, where FRAs started to price in rising chances for NBP rate cuts – 70% for a 25bp cut in 6 months and nearly 100% in 9-12 months. WIBORs were growing gradually before the UK vote, but, since last Friday, only the 1M and 6M rates have risen and only by 1bp.
- The Ministry of Finance published new data on the structure of holders of the Polish marketable zloty-denominated bonds. In May, foreign investors bought bonds for almost PLN4.3bn, which was the biggest monthly increase since January 2015. As a result, the total value of bonds held by non-residents is near the level from just before the S&P's rating downgrade in January. In May, the biggest buyers within this group were investment funds (PLN1.6bn – the biggest monthly increase since January 2015) and central banks (cPLN1.2bn – mostly Asia, excluding the Middle East). Banks were the most active among all the domestic players (PLN 3.6bn), as their bond holdings rose to a record level of cPLN219bn. May was the seventh month in a row of bond purchases. Deputy Finance Minister Piotr Nowak said the ministry had now 70% of its 2016 borrowing needs covered (June).
- At the this week's auction, the Ministry of Finance will offer OK1018/DS0726/WS0428 bonds for PLN3-6bn in total. According to the most recent data, at the end of May, non-residents held 60% (PLN15.4bn) of DS0726, 9% (PLN1.2bn) of OK1018 and 5% (PLN52.6mn) of WS0428 outstanding.

Global trends to remain key

- Global trends were key for the Polish rates last week and we think this will not change in the days to come as the upcoming meeting of the Monetary Policy Council should not have a big impact on the domestic curves (at least on the long ends) and there are no Polish data on the agenda this week.
- We think that the short ends of the IRS/bond curves could remain stable or even move slightly down on speculations that rates could be cut in Poland in the months to come. At the same time, the belly and long ends might be more sensitive to the global trends, which could this week be at least to some extent driven by the US labour market data.

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.