Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

11 – 17 July 2016

The Polish MPC kept rates on hold in July. More interestingly, the central bank cut its GDP growth forecast by 0.6pp for 2016 and by 0.2pp for 2017. It expects inflation to rise gradually, but the mid-point of the projection for 12M CPI in 2018 is at a mere 1.5% (against the 2.5% target). It seems the MPC members have a more optimistic view of the GDP outlook than the NBP model would suggest. In our opinion, if the incoming economic data confirm that a significant acceleration of growth is not very likely, market expectations for rate cuts will grow, which would be positive for the front end of the curve. If the NBP's November projection confirms a weaker growth scenario (in line with our forecast, we revised down our GDP forecast for Poland by 0.3-0.4pp in 2016-17), the MPC might consider easing of its policy, given the no-inflation environment. Historically, the Polish central bank has not been forward-looking in its decision-making process, but we believe a 50bp cut might be delivered at the turn of 2016/17.

The Ministry of Development presented its plan of another overhaul of the pension system (more details in the forthcoming MACROscope). This caused some negative market reaction (zloty, equity), but the response was only temporary and the proposal is certainly less harmful than had been expected by some market participants (risk of asset "nationalisation"). We believe it should be neutral for bonds and the zloty in the short term.

The market will be driven this week by the post-payrolls sentiment and if the data disappoint, downward pressure on global yields might be visible. Polish data (BoP, CPI, M3) should be rather neutral. The zloty has returned to its trading range of 4.31-4.46.

At the end of the week, Fitch Ratings will announce its decision on Poland's rating. Albeit there is a risk that it may change the outlook to negative, our base-case scenario assumes this will not happen. In any case, the impact on the market would just be temporary.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (11 July)					
9:00	**PL**	**Release of NBP report**					
14:00	**PL**	**CPI**	**Jun**	**%YoY**	**-0.8**	**-0.8**	**-0.9**
		TUESDAY (12 July)					
14:00	**PL**	**Core inflation**	**Jun**	**%YoY**	**-0.2**	**-0.2**	**-0.4**
16:00	US	Wholesale inventories	May	%MoM	0.2	-	0.6
		WEDNESDAY (13 July)					
11:00	EZ	Industrial output	May	%MoM	-0.7	-	1.1
20:00	US	Fed's Beige Book					
		THURSDAY (14 July)					
14:00	**PL**	**M3 Money supply**	**Jun**	**%YoY**	**11.5**	**11.4**	**11.5**
14:00	**PL**	**Current account**	**May**	**€m**	**386**	**352**	**594**
14:00	**PL**	**Exports**	**May**	**€m**	**14 250**	**14128**	**15143**
14:00	**PL**	**Imports**	**May**	**€m**	**13 852**	**14053**	**14623**
14:30	US	Initial jobless claims	week	k	-	-	
		FRIDAY (15 July)					
11:00	EZ	HICP	Jun	%YoY	0.1	-	0.1
14:30	US	Retail sales ex autos	Jun	%MoM	0.4		0.4
14:30	US	CPI	Jun	%YoY	1.1		1.0
15:15	US	Industrial output	Jun	%MoM	0.2		-0.4
16:00	US	Michigan index	Jul	pts	93.5	-	93.5
	PL	**Fitch rating action**			**-**	**A-(S)**	**A-(S)**

Sources: BZ WBK. Reuters. Bloomberg

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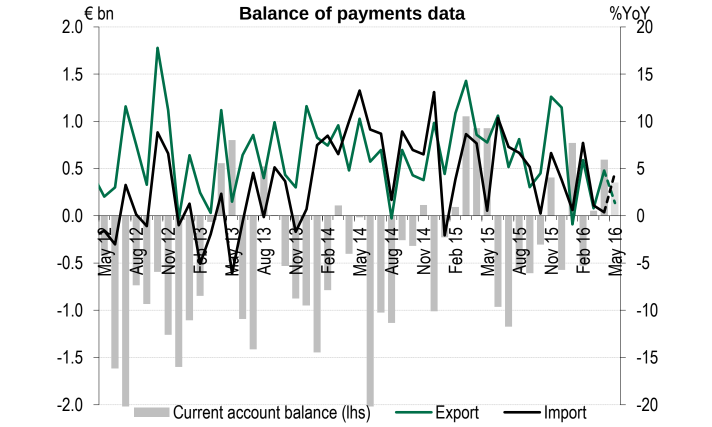
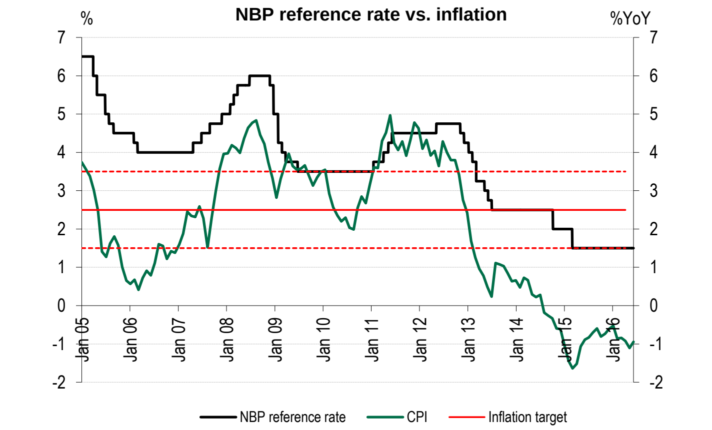
What's hot this week – CPI, balance of payments, M3 and Fitch



- We expect the final CPI in June to confirm the flash estimate at -0.8% y/y, while core inflation should inch up to -0.2% y/y.
- May's balance of payments was likely affected negatively by the working day effect. We, therefore, expect slower export growth, while import growth should accelerate due to the low base effect from May 2015. Foreign trade is one of the key statistics to watch closely given its weak performance in 1Q and its important role in economic growth. Further disappointments in foreign trade would cast a shadow on the economic growth outlook.
- Loan growth will be the most important as far as M3 money supply is concerned.
- We expect the Fitch ratings agency to keep both Poland's rating and outlook unchanged at A-/stable, but we see a considerable downward risk for the outlook.

Last week in the economy – First meeting with new governor



	GDP growth			
	Jul 15	**Nov 15**	**Mar 16**	**Jul 16**
2016	2.3÷4.5	2.3÷4.3	3.0÷4.5	2.6÷3.8
2017	2.5÷4.7	2.4÷4.6	2.6÷4.8	2.4÷4.5
2018	-	-	2.1÷4.4	2.1÷4.3
	CPI Inflation			
	Jul 15	**Nov 15**	**Mar 16**	**Jul 16**
2016	0.7÷2.5	0.4÷1.8	-0.9÷0.2	-0.9÷-0.3
2017	0.5÷2.6	0.4÷2.5	0.2÷2.3	0.3÷2.2
2018	-	-	0.4÷2.8	0.3÷2.6

- At the first meeting chaired by the new NBP governor Adam Glapiński, the Monetary Policy Council kept interest rates on hold. The new NBP projection points to mid-point inflation lower by 0.3pp this year and GDP growth lower by 0.6pp. Inflation is still expected to rise gradually and the mid-point of the projection for 12M CPI in 2018 is at a mere 1.5%. This means that the central bank expects inflation to be below its target (2.5%) for more than two years ahead.
- The NBP's head underscored that the entire Council shared a more optimistic view on the GDP outlook than the NBP model suggested. Glapiński said that the UK referendum created some uncertainty, which could be negative for foreign direct investments in Poland, but, in his view, the impact of Brexit on Poland was "nearly zero". He said there were no significant threats to economic growth on the horizon. At the same time, the official communique stated that: "uncertainty about economic conditions abroad, including the effects of the UK referendum, is a risk factor for domestic economic activity". The MPC still believes that the 'wait and see' mode is the best policy option. Glapiński emphasised the MPC was unanimous in this regard, which was confirmed at the press conference, as the most dovish MPC member Jerzy Żyżyński said there were no reasons to change the Council's policy unless signs of economic slowdown or acceleration of growth emerged.
- The MPC seems to be downplaying risks from the UK's Brexit vote. It repeated in the statement that the GDP growth slowdown in 1Q16 was temporary. However, we would argue that Poland's economic outlook for the next several quarters was deteriorating already before the UK referendum (recent data suggested that GDP growth in 2Q16 could be only marginally above 1Q16's) and that the Brexit vote created an additional negative impulse.

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

Adam Glapiński, NBP president, July 6, NBP conference
The MPC thinks that "wait and see" mode is the best policy. We cannot change model-based forecast, but MPC's members think that GDP growth will be higher. We have cut our expectations – from 4% to 3.5-3.6%.

Łukasz Hardt, MPC member, July 6, NBP conference
Even if economic growth slows down, I will be sceptical about the possibility of stimulating growth and investment with interest rates.

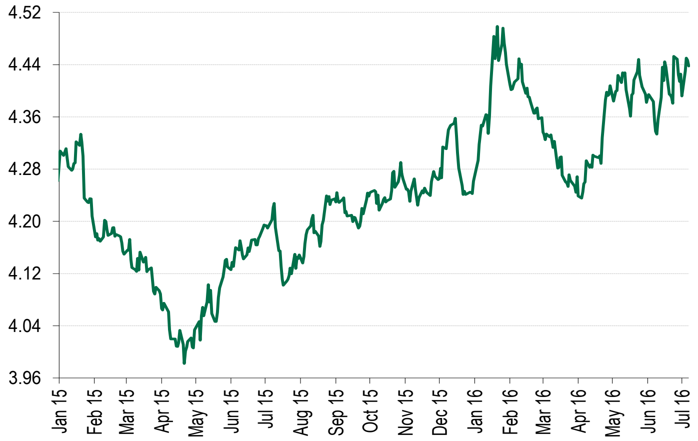
Jerzy Żyżyński, MPC member, July 6, NBP conference
It is best to wait out uncertainty. If growth starts to decelerate, we will start thinking about cuts.

Henryk Kowalczyk, head of govt standing committee July 4, PAP
Until the financial supervision authority shows reliable estimates of CHF loan bill, I would fear to enact a "global" law, as we should not take responsibility for the banking sector; without estimates only a restricted version can come into force.

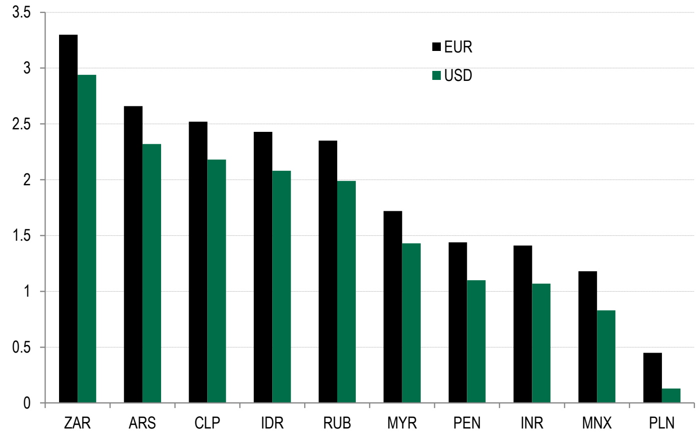
We have just revised down our GDP forecasts for Poland by 0.3-0.4 pp in 2016-17. If the incoming economic data confirm that a significant acceleration of growth is not very likely, market expectations for rate cuts will grow. The next MPC meeting, in September, will take place after the 2Q GDP data release. but we do not think a change in interest rates is possible immediately after the summer break. In November, however, the central bank will release its new projection. If it will point to a weaker growth scenario (in line with our forecast), the MPC might consider easing its policy then, given no-inflation environment. This will also depend on the FX market, especially in the context of the great unknown connected with the CHF-loans. In this respect, we find the comment of Henryk Kowalczyk a bit calming.

Foreign exchange market – Looking at the US payrolls

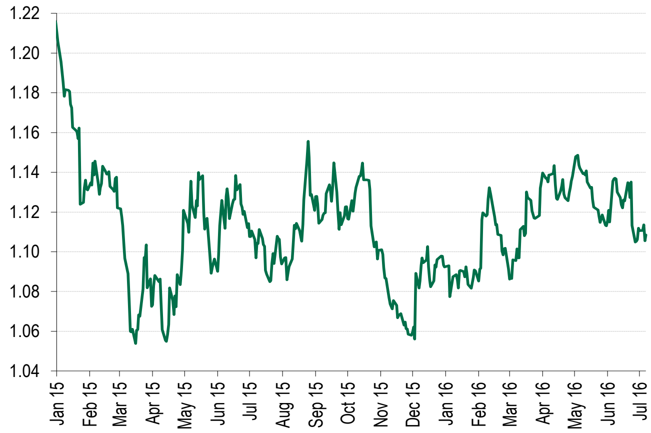
EURPLN



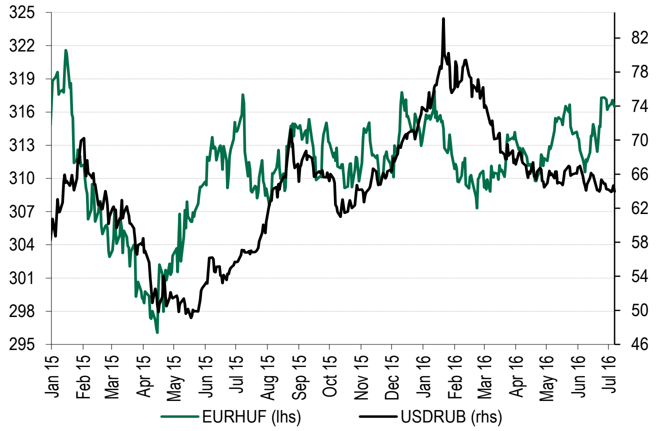
Currency performance vs EUR and USD (%, Jun 24 – Jul 8)



EURUSD



EURHUF and USDRUB



Back to the range-trading

- Last week the zloty depreciated slightly vs the euro and the dollar, while it gained vs the pound. EURPLN and USPPLN trading ranges were narrower than a week ago suggesting the market was stabilising and trying to find equilibrium after the UK referendum.
- There was no big market reaction to Deputy PM Mateusz Morawiecki's presentation of changes to the pension system. As far as the possible impact on FX is concerned, one could expect a sell-off of foreign stocks in the medium term, which could be positive for the zloty. However, in the short run, the outlined changes should be neutral for the Polish currency. At the same time, the zloty gained slightly in response to the still rather hawkish rhetoric of the Polish MPC.
- 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 substantially – less than 5% for a 25bp hike until November and 15% for December, 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 weaker-than-expected number. It should be remembered that since closing levels on the day of the UK referendum's outcome announcement, LatAm and Asian currencies have outperformed their CEE peers suggesting that the zloty may gain less from further monetary policy easing in Europe and fewer hikes in the US.
- 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.

US data to show direction

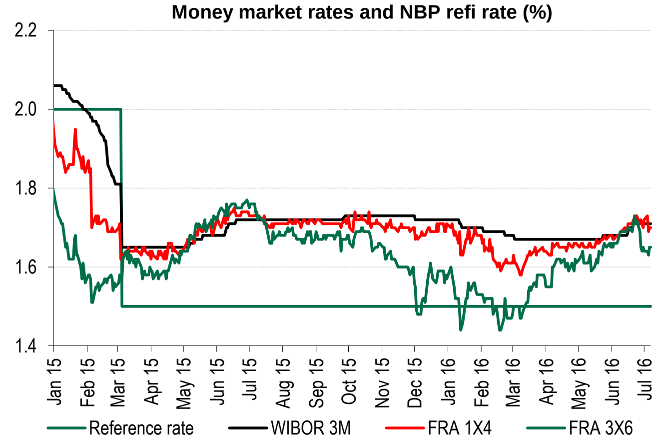
- EURUSD did not change much last week and the trading range was narrower than in the previous week.
- Just like the other currencies, EURUSD stabilised pretty quickly after the Brexit vote and now the market's attention may turn to the other, less ambiguous factors that affect the global central banks' 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.

Global trends key for CEE currencies

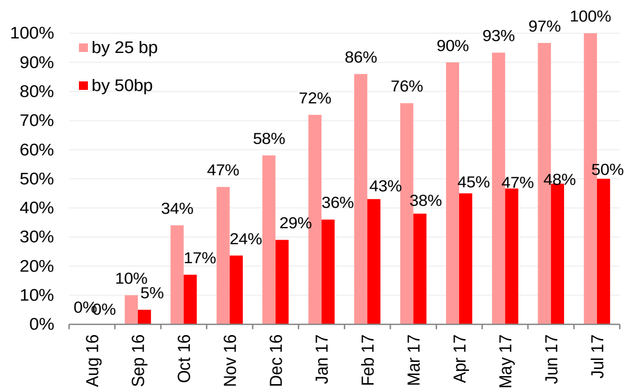
- EURHUF and USDRUB have also remained roughly stable so far this week after the elevated volatility observed earlier this month.
- There are no important macro releases on the agenda next week for HUF, CZK and RUB, so the CEE currencies are likely to be driven mainly by the global trends.

Interest rate market – Profit taking, more easing to be priced-in

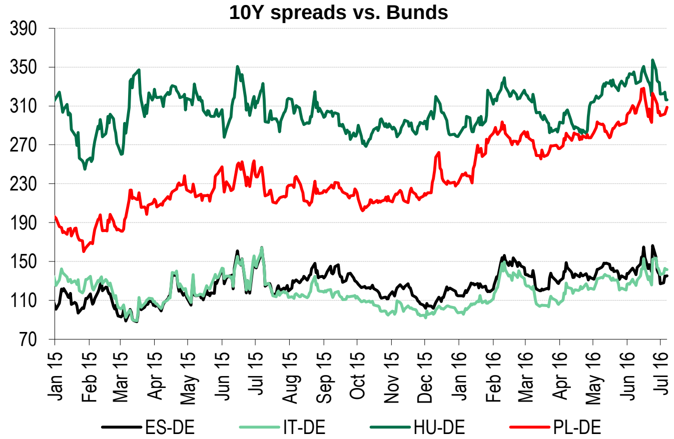
Money market rates and NBP refi rate (%)



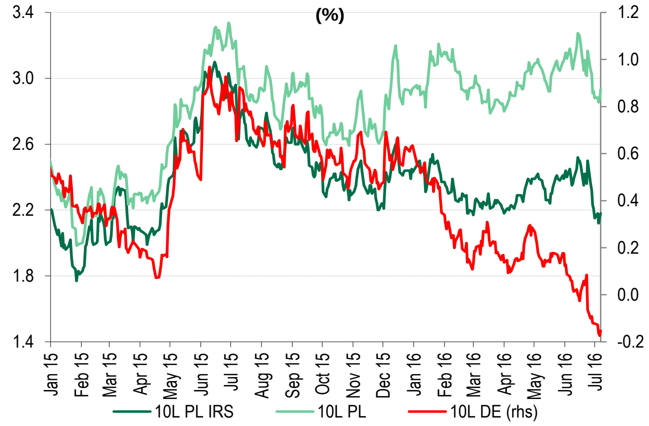
Probability of rate cuts
(implied by FRA rates on 7 July)



10Y spreads vs. Bunds



Yields of PL and DE 10Y benchmarks and 10Y PL IRS (%)



Some profit taking after significant rally

- Last week brought some profit taking on the interest rate market, which followed a significant rally on rising chances for more accommodative monetary policies around the world (delayed interest rate hikes by the Fed, more stimulus from the ECB, BoE and others). Both yields and the IRS rates inched 5-10bp higher across the board, with the 5Y and 10Y bonds as the biggest losers. The 10Y benchmark yield rose slightly above 2.95% for a while, which could partially stem from the high sale at the auction (details below). Despite this, yields remained below their pre-Brexit levels.
- Poland's T-bond market tracked global market developments that also saw some profit taking. The 10Y Bund yield increased gradually to nearly -0.16%, up from its local low of -0.20%. On a weekly basis, shifts in the core, peripheral and CEE bonds were mixed. What is more, the risk premium for both the peripheral and CEE debt remains elevated, with Poland's 10Y benchmark over Bund staying slightly above 300bp.
- The first bond auction in July was quite successful with the Ministry of Finance selling OK1018, DS0726 and WS0428 bonds worth PLN4.43bn. As we had expected, the recorded demand was strong and amounted to PLN7.41bn, exceeding the maximum level of offer set at PLN3-6bn. In line with expectations, demand mainly concentrated on the 10Y benchmark (PLN3.93bn or 53% of the total demand), which implies that foreign investors were bidding at the auction. All in all, the ministry sold the 2Y benchmark for cPLN1.56bn with the yield at 1.708%, the 10Y benchmark for PLN2.66bn with the yield at 2.923% and 15Y bonds (WS0428) for PLN214m with the yield at 3.027%. We estimate that the auction has helped the government cover c72% of its 2016 borrowing needs.
- On the money market WIBORs remained stable this past week, while the FRA rates gradually rose after the July Monetary Policy Council meeting, at which the Council confirmed its 'wait-and-see' bias was still in place. As a result, investors gradually scaled back their expectations for monetary easing in the upcoming months. The market now sees a c60% chance that rates will be cut by 25bp before year-end. We expect the market to price-in more easing (50bp) in the following months.

Macro data and Fitch decision in focus

- This week's domestic macro calendar is quite heavy (inflation, balance of payments, M3 money supply). However, we expect inflation data to be quite neutral for the market players as we expect the headline CPI to confirm the flesh of -0.8% y/y. At the end of the week, Fitch is due to announce its decision on Poland's rating. We think that Fitch will reaffirm both its rating and outlook and this should be neutral to slightly positive as some expect the agency to change the outlook to negative from stable. In any case, the impact of this decision will only be temporary. We expect the front end of the curve to be range-bound in the upcoming days.

However, global trends will continue to play the key role, with the European and US macro data in the spotlight. These data will be viewed from the perspective of future monetary policies by the main central banks. Therefore, the June US labour report should be quite important for market direction in the upcoming days. The market's response to these data will be stronger if the US non-farm payrolls show strong growth. This may again renew expectations on earlier monetary tightening by the Fed and have a negative impact on the global debt market, including Poland's assets, in particular on the belly and long end of the curves.

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.