Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

25 – 31 July 2016

June data about the Polish economy were not bad, but, in our view, confirmed that GDP growth in 2Q16 was not significantly better than in 1Q. The labour market is heating up more and more, which – together with money from the 500+ programme – will boost private consumption. However, we would argue that strong consumption may be not enough to accelerate GDP growth if exports and investments disappoint in the coming quarters.

The event of the week may be the release of the president's new proposal on FX loans – the president's spokesman said on Friday the draft bill would be sent to parliament 'soon' and the Parkiet daily wrote it could happen before the end of July. We do not know what shape the president's proposal could take. Some comments suggest that it may be less costly for the banking sector than the previous one (M. Magierowski said the new solution "was designed in order to reduce the burden on the debtors, but, on the other hand, to keep the banking system stable"). However, we are not sure if the draft was consulted with the NBP or KNF and so we cannot know with certainty what impact the bill might actually have on the banks. There are very few domestic data releases scheduled for this week – unemployment rate on Monday and flash CPI on Friday. We expect a slight deepening of deflation in July to -0.9% y/y, mainly due to cheaper fuels and a high base effect in drugs and telecommunications. Such deepening of the deflation's bottom in the summer does not change the trajectory for the following months, in our view. We still expect CPI growth to turn positive before the year-end.

Abroad, the FOMC's decision and US data will be in focus. New data and the Fed's rhetoric may be key for expectations about the timing of interest rate hikes in USA (which started to rise recently again) and, thus, for the debt and FX markets.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (25 July)					
10:00	**PL**	**Registered unemployment rate**	**Jun**	**%**	**8.8**	**8.8**	**9.1**
10:00	GE	Ifo index	Jul	pts.	107.5	-	108.7
		TUESDAY (26 July)					
14:00	HU	Central bank decision	Jul	%	0.90	-	0.90
16:00	US	Consumer confidence index	Jul	pts.	95.5	-	98.0
16:00	US	New home sales	Jun	k	560	-	551
		WEDNESDAY (27 July)					
14:30	US	Durable goods orders	Jun	% m/m	-1.0	-	-2.3
16:00	US	Pending home sales	Jun	% m/m	1.8	-	-3.7
20:00	US	FOMC decision		%	0.25-0.50	-	0.25-0.50
		THURSDAY (28 July)					
11:00	**PL**	**T-bond auction**					
14:30	US	Initial jobless claims	week	k	-	-	253
		FRIDAY (29 July)					
11:00	EZ	Flash HICP	Jul	% y/y	0.2	-	-
11:00	EZ	Flash GDP	2Q	% y/y	1.5	-	1.7
14:00	**PL**	**Flash CPI**	**Jul**	**% y/y**	**-**	**-0.9**	**-0.8**
14:00	**PL**	**Inflation expectations**	**Jul**	**% y/y**	**0.2**	**0.2**	**0.2**
14:30	US	Advance GDP	2Q	%	2.6	-	1.1
16:00	US	Michigan index	Jul	pts.	90.5		89.5

Sources: BZ WBK. Reuters. Bloomberg

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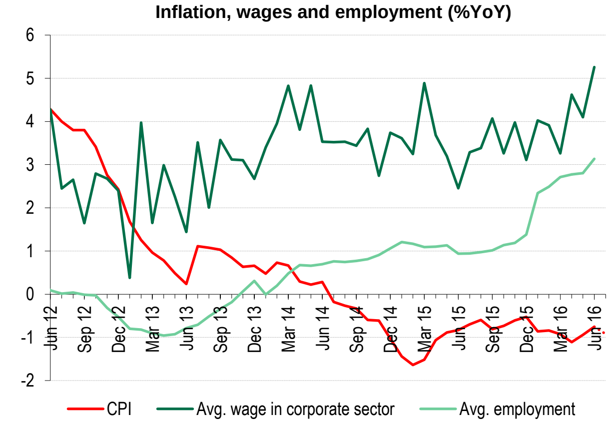
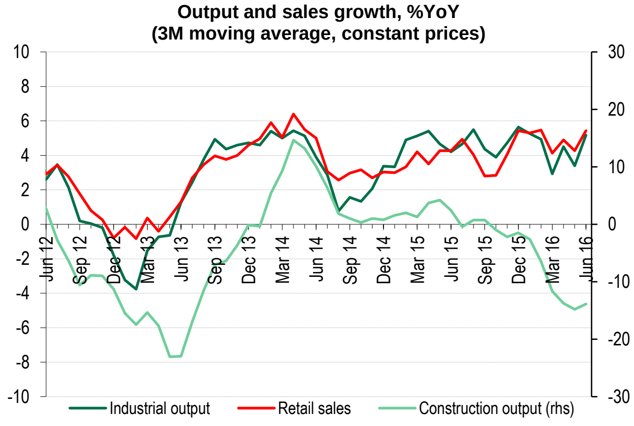
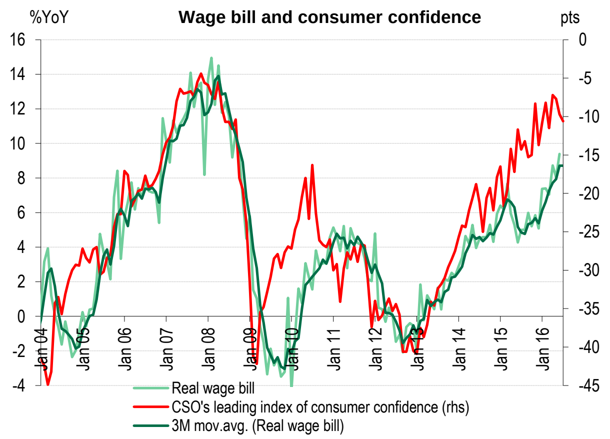
What's hot this week – Flash CPI, unemployment rate and monthly bulletin



- We expect the unemployment rate to fall in June to 8.8% (in line with the Labour Ministry's forecast), with an asymmetric downside risk. The seasonally-adjusted unemployment rate fell to 9.0%, the lowest since early 90s. We expect unemployment to fall further in the months to come.
- We expect CPI in July to inch down, mainly due to falling fuel prices and a high base effect in the prices of drugs. August may also yield a low reading, but, in the following months, inflation will likely go up and be positive at the year-end.
- The statistics office is due to release its monthly bulletin. Employment data will be especially interesting, given the strong rise in June. If the bulk of the rise will be visible in trade and supporting activities, we would assume that it is mostly an effect of change in contract types: from temporary to permanent.

Last week in the economy – Output and sales point to stabilisation of GDP growth in Q2





- Industrial output rose 6.0% y/y in June, in line with market consensus, while construction production disappointed again by falling 13% y/y. Retail sales grew 6.5% y/y, exceeding expectations. Industrial production was affected by the calendar and, after excluding its impact, the rate of output growth remained at the moderate 3.6% y/y that was seen in May. The construction sector remains in free-fall, which is a bad omen for the investment outlook. Admittedly, the pickup in retail sales was stronger than expected, probably due to first spending sprees financed by the 500+ child benefit programme, though we think it will be not enough to accelerate economic growth in Poland if exports and investments disappoint (which seems likely given the recent data and potential Brexit fallout). In general, the data were not overly optimistic, in our view, supporting our forecast that GDP growth in the second quarter of 2016 was not significantly better than in the first (near 3% y/y).
- Data on the Polish labour market surprised positively in June, as employment growth in the corporate sector accelerated to 3.1% y/y and the average wage growth rose 5.3% y/y. The total wage bill in the corporate sector rose 9.4% y/y in real terms, the fastest pace since 2008. The data confirmed that the Polish labour market is red hot and the persisting labour demand is exerting growing pressure on wages (even though to some extent the data were supported by the positive calendar effect). Strong labour income levels should support healthy growth of private consumption in the coming quarters (which will be additionally boosted by the 500+ scheme). On the other hand, we argue that such pace of employment growth will be difficult to sustain given the growing shortages of skilled labour.

Quote of the week – CHF bill to be in the Sejm soon

Marek Magierowski, president's spokesman, July 22, Reuters

It seems that the draft CHF bill will soon be in the Sejm. This bill was designed in order to reduce the burden on the debtors, but, on the other hand, to keep the banking system stable.

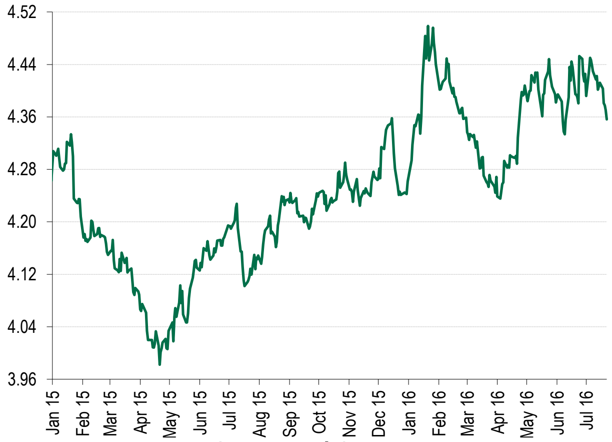
Statement of the government, July 19, www.premier.gov.pl

The government backs the president's draft bill on pensions. At the same time, the government suggests the Sejm can consider supplementing the president's bill with a modification of regulations concerning the possibility of combining pensions with work. The government also suggests that the bill should come into force on October 1, 2017 at the earliest.

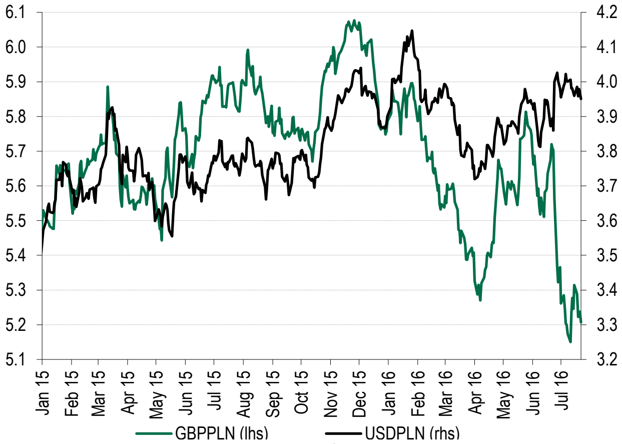
It seems that July can be witness to two major steps in the wrong direction in Poland's economic policies. First, the government backed the president's bill lowering the retirement age to 60 years for women and 65 years for men. We believe that this would be negative for the economy on many levels, including: (1) high fiscal costs; (2) a smaller active population and (3) lower future pensions. This decision could imply a higher path for the fiscal deficit and debt, and a lower path for economic growth. In our view, it could have a negative impact on Poland's sovereign rating. We wrote in more details about the lower retirement age in our instant comment. Second, the president may show his new proposal on CHF loans soon (the Parkiet daily suggested it should be submitted to the Sejm in July). The president's spokesman said that the new solution would not be destabilising for the banking sector, but we are not sure what to expect, especially since it is not certain, in our view, that the proposal has already been consulted with the NBP or the KNF.

Foreign exchange market – Attention turns to Fed

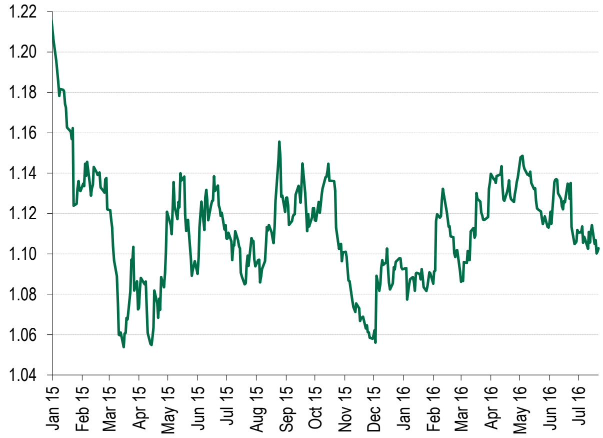
EURPLN



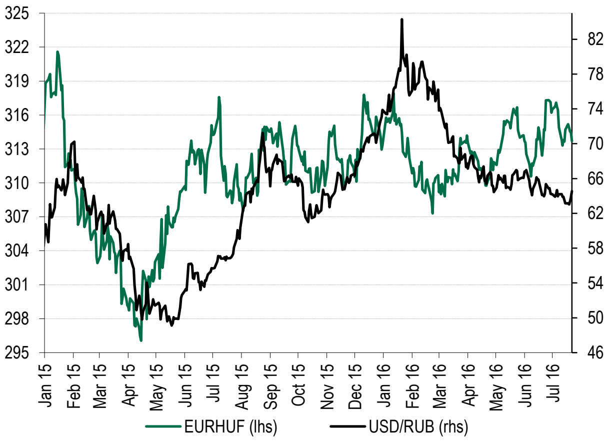
USDPLN and GBPPLN



EURUSD



EURHUF and USDRUB



Zloty stronger on Fitch and ECB

- The zloty gained vs the main currencies last week, underpinned mostly by Fitch's decision to keep Poland's rating and outlook unchanged and the dovish rhetoric of the ECB, which helped EUR/PLN fall to 4.35. In weekly terms, the zloty's gain vs the euro was the biggest since mid-December. At the same time, USD/PLN fell to 3.94 from c4.0, GBP/PLN to 5.20 from 5.30 and CHF/PLN to 4.0 from 4.05.
- The president's office said that it may soon submit its draft bill on FX mortgage loans to parliament (media speculate that this may even take place this week) and this could be an important event for the zloty's performance in the months to come.
- Turning to global events, US data and the FOMC meeting are likely to be in the spotlight and could support EM currencies in case they offer any dovish signals. It should be remembered, however, that we had already noted two weeks ago that the zloty gained very little from the rising hopes for more easing in the euro zone/fewer hikes in the US when compared to its EM peers. That said, any positive impact from the FOMC/US data could be less meaningful for the zloty this week.
- Important levels to watch for EURPLN are now at 4.33 and 4.425.

Attention turns to Fed

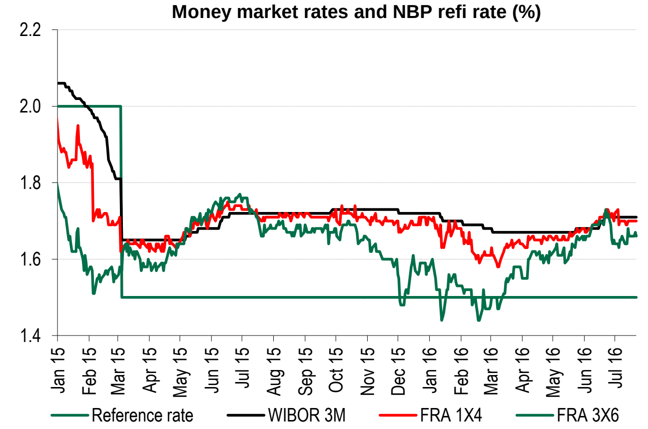
- EUR/USD did not move very far away from 1.103 and the ECB triggered only a temporary rise in volatility.
- The recent hard US data were pretty solid, renewing market expectations for a 25bp Fed rate hike in September (30% according to Bloomberg), but the dollar did not gain much on this. Investors do not expect the FOMC to change rates this week, but the Committee's view on economic performance could give a vital hint on whether the next rate hike is likely later this year. There are also numerous US data on the agenda that may trigger a noticeable and persistent move.

Pressure building on ruble

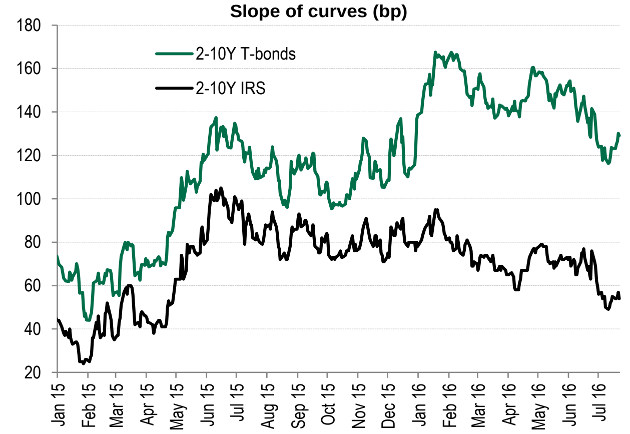
- EUR/HUF fell to 313.5 from above 315 and the Hungarian central bank (MNB) holds its meeting. The MNB has already signaled it may ease monetary policy further, but, since the BoE and the ECB stayed put this month, we think the Hungarian monetary authorities will also choose to wait for more information to better assess if more action is needed due to the Brexit.
- USD/RUB rose above 64 last week, the ruble's first weekly weakening vs the dollar since late May. This might have been due to the lower Brent price (that broke the local low at USD45.9 and reached its lowest since mid-May) as well as some non-economic factors. We have already suggested that the change in the Russian central bank's rhetoric towards more dovish (which resulted in a rate cut in June) might have been, to some extent, motivated by the ruble's appreciation since the beginning of this year. Last week President Vladimir Putin himself said that the authorities should think about how to react to this phenomenon, adding to speculation that the USD/RUB fall is becoming excessive and may curb economic activity and lead to a more decisive official response. Also President Putin's economic aide, Andrei Belousov, said that he believed the Russian currency was getting too strong, hurting competitiveness of the Russian industry. The central bank responded with a statement that it did not plan to intervene on the market, but this failed to prevent the upside move in USD/RUB.

Interest rate market – Eyes on FOMC and T-bond auction

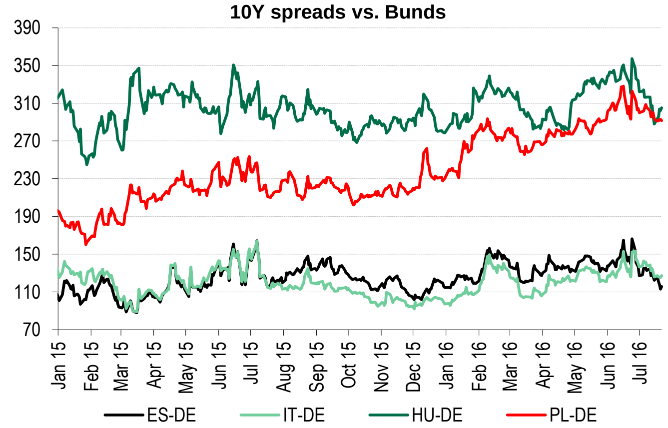
Money market rates and NBP refi rate (%)



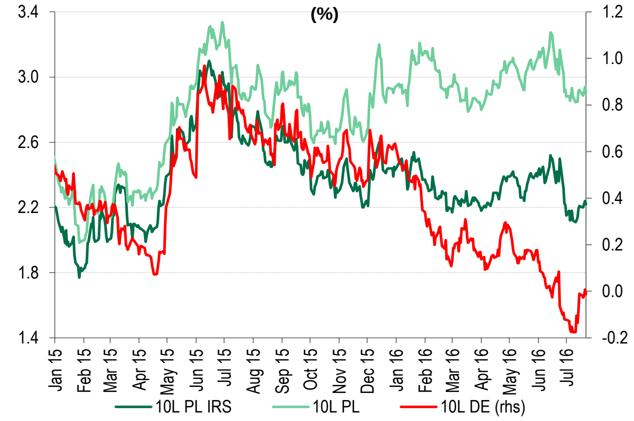
Slope of curves (bp)



10Y spreads vs. Bunds



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



Yields move sideways, curves slightly steepen

- Investor sentiment was quite positive over the past week after Fitch reaffirmed Poland's sovereign rating at A- with a stable outlook. However, strong data from real economy (labour market, industrial output and retail sales) pushed yields on the long end slightly up. Investors' response to the ECB meeting's outcome was mixed. At the beginning, yields rose slightly, but then quickly returned to their downward trend, with the 10Y benchmark yield testing 2.88%.
- On a weekly basis, the yield curve shifted down 1-6bp, while the IRS curve fell 1-2bp across the board. The front end of the curves outperformed the belly and the long ends and, as a consequence, both steepened. The 2-10 spread widened to nearly 130bp for T-bonds and to 54bp for the IRS. What is more, Polish debt was outperforming the German debt, but the spread over the Bunds for the 10Y sector remained more or less stable compared with the level reached a week ago (293bp). On the other hand, Polish assets gained less than the CEE and peripheral euro zone debt.
- On the money market, WIBOR rates remained stable, while FRAs gradually grew. This stemmed from the relatively good domestic macro data releases, which slightly cooled expectations for monetary easing later this year. The market now sees a 52% probability that rates will be cut by 25bp in 9 months' time.

FOMC decision and T-bond auction key

- The Fed meeting is one of the key events this week. In our view, the FOMC will keep interest rates unchanged and the statement accompanying the decision may help the market assess whether the Fed will return to rate hikes this year or not. We expect the Fed to be cautious and opt to wait for more signals that the economy is accelerating. This could imply a delay until its December meeting on its new interest rate hike. All in all, July's Fed rhetoric will set market direction for the upcoming days/weeks. If the Fed confirm that normalisation of monetary policy is still likely this year, core yields could rise. As a result, Poland's assets might also weaken gradually in response, in particular the long-term securities. Recall that the correlation between the Polish and German bonds settles at 70%. The case of US bonds is similar.
- On the domestic side, flash CPI and T-bond auction will be in the spotlight. We think that the further deepening in deflation in July (due to falls in fuel prices) should be a supportive factor for the domestic interest rate market. We think that news about the registered unemployment rate at the end of June will be rather neutral for the market.
- As regards the T-bond auction, the Ministry, in its quarterly issuance plan, assumed it would tap T-bonds, which it did not offer at the first auction (i.e. OK1018, DS0726 and WS0428) worth PLN4-9bn. In our view, the 5Y benchmark (PS0721) might be offered and, probably, floaters. We think that the supply range will be more or less similar to the initial level. We see no problem with launching debt on the primary market given the liquidity. In July, flows from both redemptions (OK0716) and interest payments (WZ, PS, DS) will amount to PLN14.4bn. Assuming that the Ministry sells T-bonds worth PLN9bn, c77% of this year's gross borrowing needs will have been financed.

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