Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

15 – 21 August 2016

Sentiment on the financial markets was quite positive over the past week, as investors were awaiting the flash 2Q16 GDP releases in Europe. The economic growth data were mostly rather on the stronger side of market expectations (in Germany, Hungary, Romania). In Poland, the reading was slightly below market expectations, but in line with our prediction of 3.1% y/y. The detailed GDP breakdown will be released at the end of August, but we think growth was fuelled mainly by private consumption, with the contribution of investments and net exports close to zero. Poland's assets have remained strong. While EURPLN was flirting with its strong support level of 4.26 (it lowest since April), yields and IRS rates fell visibly, with the 10Y benchmark falling below 2.65% (this year's new low) as a consequence of rallies on the core markets.

This week's macro and events calendar is quite heavy in both Europe and USA. These data might add to market volatility, especially if the FOMC minutes offer a hint about the monetary policy outlook. The market currently sees a nearly 50% chance that the Fed will hike rates by 25 bp in December. In Poland, there is another set of macro data to be released. After the uninspiring 2Q16 GDP growth and dovish comment from MPC member Jerzy Żyżyński expectations for monetary easing by Poland's Council have been renewed. We believe that the nearest macro data could strengthen this expectation (our forecasts of production and retail sales are below the market consensus), keeping yields close to the current level. If this proves to be the case,, it would be negative for the zloty. What is more, PLN and its CEE peers might suffer from the renewed tensions that are growing between Russia and Ukraine.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (15 August)					
	PL	**Market holiday**					
		TUESDAY (16 August)					
9:00	CZ	Flash GDP	Q2	% y/y	2.3	-	3.0
11:00	DE	ZEW index	Aug	pts.	-	-	-6.8
14:00	**PL**	**Core inflation**	**Jul**	**% y/y**	**-0.3**	**-0.4**	**-0.2**
14:30	US	House starts	Jul	k	1175	-	1189
14:30	US	Building permits	Jul	k	1160	-	1153
14:30	US	CPI	Jul	% m/m	0.0	-	0.2
15:15	US	Industrial output	Jul	% m/m	0.2	-	0.6
		WEDNESDAY (17 August)					
14:00	**PL**	**Wages in corporate sector**	**Jul**	**% y/y**	**4.5**	**4.1**	**5.3**
14:00	**PL**	**Employment in corporate sector**	**Jul**	**% y/y**	**3.2**	**3.2**	**3.1**
20:00	US	FOMC minutes					
		THURSDAY (18 August)					
11:00	EZ	HICP	Jul	% y/y	-	-	0.2
11:00	**PL**	**Bond auction**					
14:00	**PL**	**Industrial output**	**Jul**	**% y/y**	**0.9**	**0.5**	**6.0**
14:00	**PL**	**Construction and assembly output**	**Jul**	**% y/y**	**-15.6**	**-17.2**	**-13.0**
14:00	**PL**	**PPI**	**Jul**	**% y/y**	**-0.4**	**-0.3**	**-0.7**
14:00	**PL**	**Real retail sales**	**Jul**	**% y/y**	**5.4**	**5.0**	**6.5**
14:30	US	Initial jobless claims	week	k	-	-	266
14:30	US	Philly Fed index	Aug	pts.	1.5	-	-2.9
		FRIDAY (19 August)					
		No important data releases					

Sources: BZ WBK, Reuters, Bloomberg

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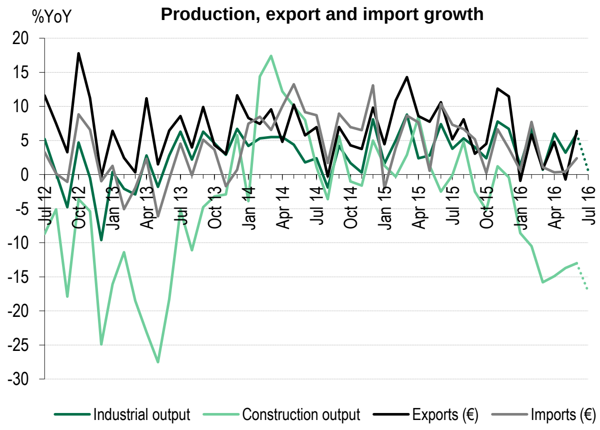
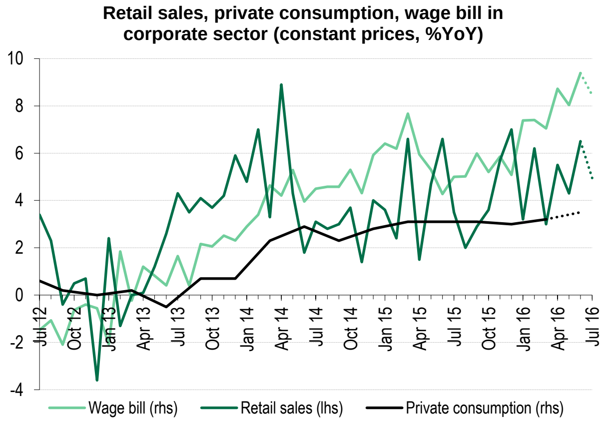
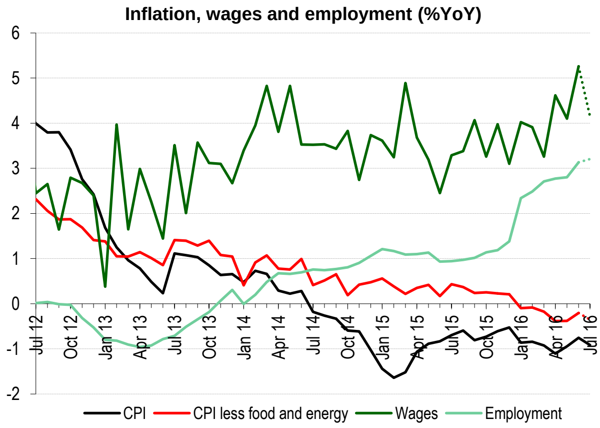
What's hot this week – Calendar effect may weigh on July's data



- A negative calendar effect will likely weigh on the monthly data for July (two working days less than in the corresponding month of 2015). This would mainly affect industrial production and construction, and to some extent wages. After the below-consensus GDP growth reading for Q2 (see below), the unimpressive monthly numbers for July, the first hints about economic activity in Q3, may further reduce market optimism about the GDP growth outlook for the coming quarters.
- Retail sales growth, albeit slower than in June, should remain relatively healthy, increasingly fuelled by money from the 500+ social programme, and supporting expectations that private consumption will accelerate in H2.

Last week in the economy – GDP growth stabilises, inflation falls, exports recover





- GDP growth reached 3.1% y/y in 2Q16 (vs 3.0% in Q1), in line with our forecast and below market consensus. The seasonally adjusted growth reached 0.9% q/q (after -0.1% in Q1). We suspect that private consumption was the main engine of growth, while investments and net exports had a nearly zero contribution. Private consumption is likely to accelerate further in H2 (maybe even close to 5% y/y), fuelled by healthy labour income and money from the 500+ benefits. But it will not be enough to boost GDP growth if exports and investments disappoint. Overall, we expect GDP growth to stabilise near 3% in the nearest quarters, with the forecast for the entire 2016 at 3.1%.
- Exports increased quite significantly in June, but we think that the outlook for the rest of the year is not overly optimistic. At the same time, imports should grow faster as a consequence of higher consumption. All in all, we expect the net exports' contribution to GDP growth not to be positive in the coming quarters.
- July's CPI inflation confirmed the flash reading of -0.9% y/y. As we had expected, the deepening of deflation was caused mainly by a strong base effect in healthcare and communications, and lower fuel prices. On the other hand, prices of recreation and culture surprised to the upside. Food prices fell more or less in line with their seasonal pattern. As a result, we estimate that core inflation after excluding food and energy prices fell in July to -0.4% y/y (returning to the level observed in April-May). We expect negative CPI to persist nearly until the end of the year.

Quote of the week – Monetary policy could be relaxed

Jerzy Żyżyński, MPC member, August 12, PAP

I think we need faster economic growth, maybe even 5%. The question is whether it is possible right now and if growth could be stimulated by interest rates. (…) I think that monetary policy could be relaxed slightly. I would be in favour of an interest rate cut of 50bp. The question is about its effectiveness – this is a subject for discussion.

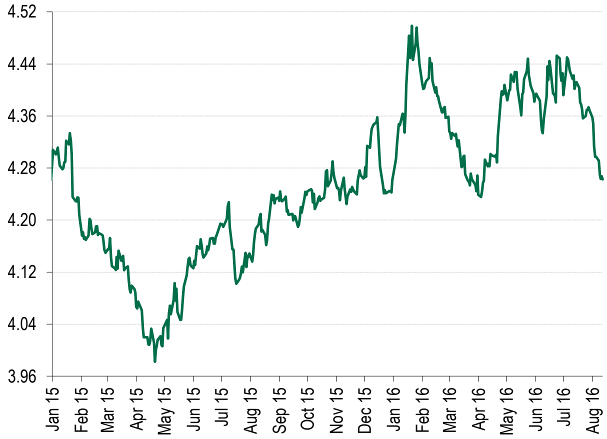
Eryk Łon, MPC member, August 10, Reuters

If the situation on the equity markets keeps improving, which I think is quite likely, then it cannot be ruled out that at the turn of the year there will be some improvements in economic growth forecasts. It would reduce the need to ease monetary policy in Poland, although it would not rule out such possibility completely.

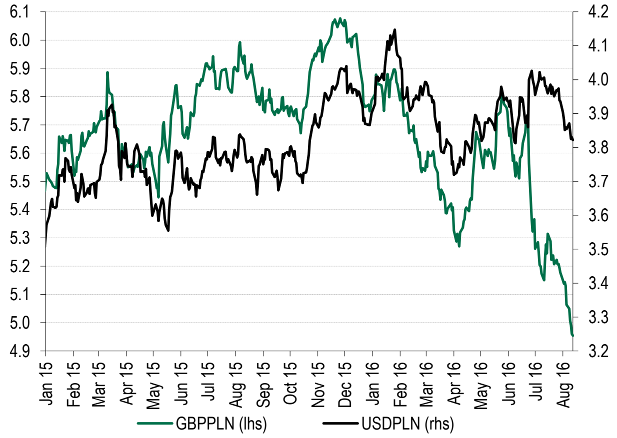
Even though Jerzy Żyżyński is the most dovish member of the Monetary Council Member and his views probably do not represent the consensus of the rate-setting panel, his declaration of support for 50bp in monetary easing had a strong impact on market pricing on Friday. We think it was justified to some extent, given the disappointing (from the MPC's point of view) GDP data. The Polish MPC stressed in July that it was more optimistic than the NBP projection as regards the GDP growth outlook and that it expected the economy to revive after the weaker first quarter. So now that we know that GDP growth failed to pick up in Q2 and that future data releases may point to a similar Q3, the MPC's hawkish bias may start changing into more dovish and the market may gradually start pricing-in rising chances of monetary easing before the year-end.

Foreign exchange market – Back to economic data releases

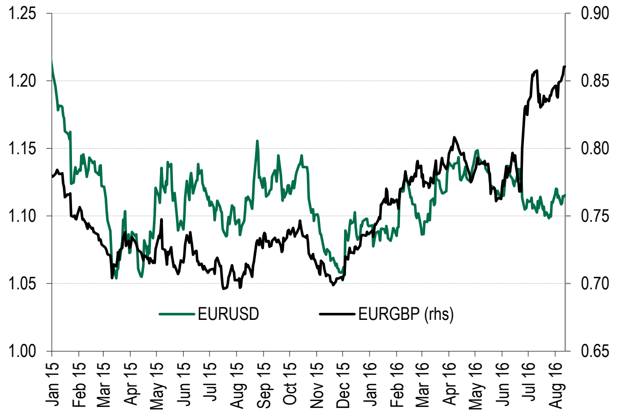
EURPLN



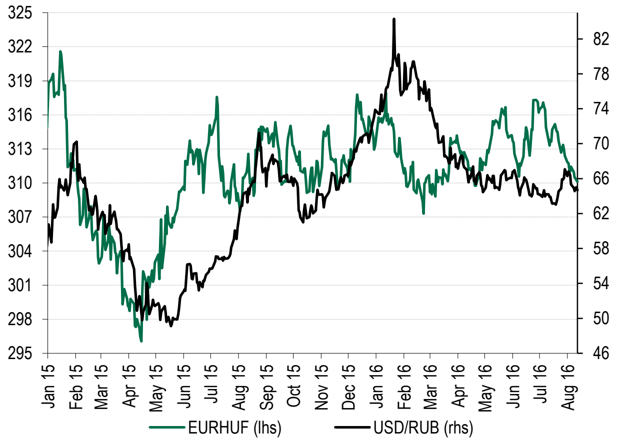
USDPLN and GBPPLN



EURUSD and EURGBP



EURHUF and USDRUB



EURPLN at its lowest since April

- The Polish zloty firmed last week against the main currencies despite a distinct absence of macro drivers for the better part of the week. EURPLN tested its support level at 4.26, reaching 4.255 for a while (its lowest since April 2016). At the same time, USDPLN fell to nearly 3.80 (its lowest since end-June) on rising EURUSD. Meanwhile, GBPPLN fell significantly below 4.94, its lowest level since 2013. This was mainly caused by GBP weakening on the international markets. At the end of the week, the zloty was quite stable against the euro ahead of the flash 2Q16 GDP data release. The outcome was in line with our expectations and its impact on EURPLN was limited, with the rate oscillating around 4.26. The zloty did not react to a dovish statement by the Polish MPC member Jerzy Żyżyński, who pointed out that Poland could afford 50bp in interest rate cuts.
- From the technical point of view, the room for further zloty strengthening is limited. Another set of domestic macro data releases due this week seem to be crucial. Our forecasts are generally slightly below the market consensus and weak readings might renew expectations for monetary easing by the MPC in the upcoming months. This should be rather zloty negative. What is more, the zloty might suffer from renewed tensions between Russia and Ukraine. In our view, the key levels for EURPLN are still 4.26 and 4.35.

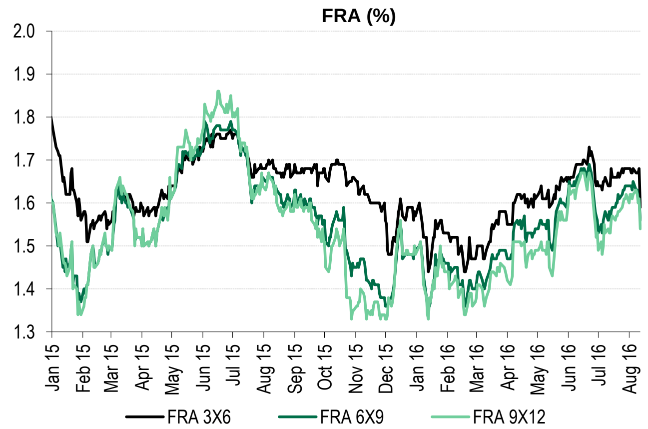
USD and GBP under pressure

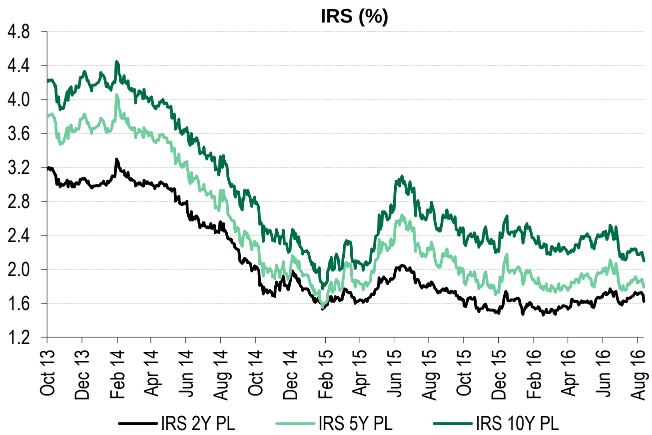
- The US dollar was under pressure over the past week and the performance of the US Treasury bonds was helping undermine it further. Consequently, EURUSD rose to nearly 1.12 for a while, up from 1.105 at the start of the week. At the same time, the British pound also weakened significantly, with EURGBP rising again above 0.86, not so far from July's peak. GBP continued to be driven by expectations of further easing, but also by the Gilt yields going lower due to BOE buying.
- This week's macro calendar is quite heavy, with important macro data releases and events from both Europe and USA. While the macro data could add to market volatility in the short term, investors will focus on the FOMC minutes, in particular after the strong July job report in USA. We think that investors will be eyeing clues about the Fed's monetary policy outlook. We think that EURUSD should fluctuate in the narrow range of 1.105-1.125 in the short term. However, any strong signal that the FOMC could hike rates before the end of the year (the market now sees a nearly 50% chance that rates will rise by 25 bp in December) might push EURUSD down towards 1.105 or even slightly lower.

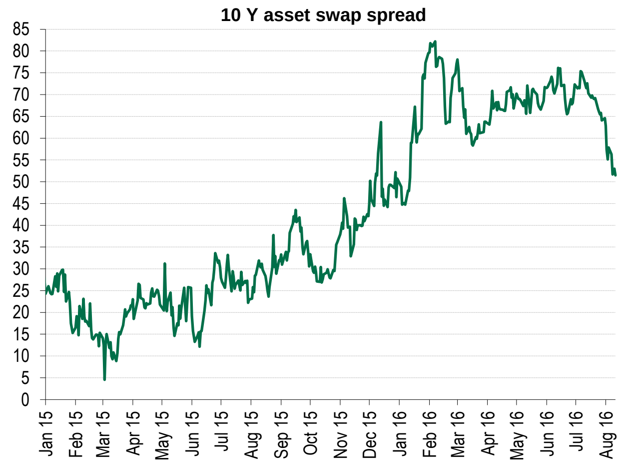
Mixed picture in CEE FX market

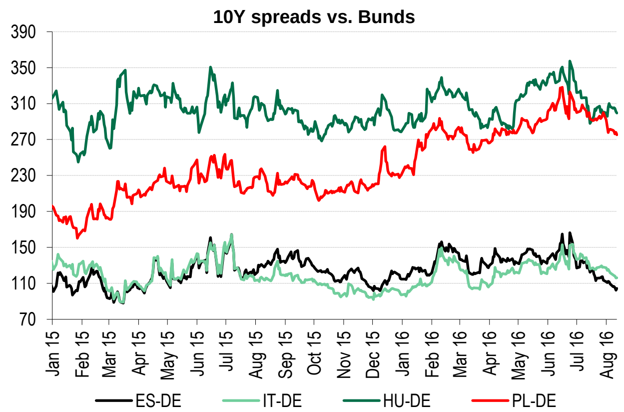
- Last week was mixed across the CEE currencies. The Hungarian forint as well as the Czech koruna was quite stable over the past week. EURHUF stabilised near 310 and the market did not respond to the release of much-better-than-expected flash 2Q16 GDP growth (2.6% y/y vs forecast of 1.9% y/y and 0.9% y/y in 1Q16). On the other hand, the Russian ruble was more vulnerable to oil price changes. The ruble gained slightly against the US dollar as a result of a clear increase in oil prices (rumours reached the market that OPEC may cut pumping).
- This week will feature only limited relevant data releases in CEE with GDP data in the Czech Republic being the highlight together with retail sales figures in Russia. Similarly to PLN, growing tensions between Russia and Ukraine may negatively influence on forint and ruble.

Interest rate market – Attention shifts towards US









Rates near their local bottoms

- The IRS and bond yields fell last week amid hopes for more monetary policy easing in Europe, UK and Japan, on the below-consensus Polish 2Q flash GDP and despite the much stronger-than-expected US nonfarm payrolls data. As a result, the 10Y benchmark reached its fresh 2016 low at below 2.70%. At the end of the week, the 10Y IRS was near 2.10%, the 5Y rate was around 1.80% and the 2Y IRS approached 1.60%.
- Market expectations for an NBP rate cut rose on the Polish GDP data and a dovish comment made by MPC's Żyżyński. However, monetary policy easing in Poland is not our base scenario as the MPC's biggest dove currently has no allies on the Council.
- The 10Y asset swap spread fell c6bp, while the spread vs the Bund did not change much as it fell only slightly below 280bp.

Attention shifts towards US

- Bond yields fell worldwide on the release of the very strong US nonfarm payrolls in July and despite rising chances for a Fed rate hike already this year. Apparently, expectations for more monetary policy easing in Europe, UK and Japan were more important for the bond investors. At the same time, chances for a 25bp Fed rate hike in December are near 50%, according to Bloomberg, even despite the recent sound US macro data. Perhaps the market needs to become even more confident that the FOMC could adjust rates yet this year to push IRS/yields higher.
- Numerous US data is on the agenda this week and they may have a key impact on the global and Polish rates in the short term. It seems that the market's reaction to these numbers should be straightforward – a positive surprise could push rates higher, while a disappointment could shift investors' attention again towards expectations for more monetary policy easing outside the US, causing rates to fall.
- Turing to the Polish market, we think that the domestic bonds could outperform their peripheral/core peers if US data beat expectations thanks to the-weaker-than-expected flash 2Q GDP and dovish comments of MPC's Żyżyński. Also, our forecasts for this week's Polish monthly industrial output and retail sales are below consensus and could strengthen the dovish signal sent by the GDP release. Note that this week will be shorter in Poland due to a market holiday on Monday and so trading volumes could be even lower than recently.
- The sole bond auction planned for August will be held this week. We think that the range of bonds offered could be pretty wide. The recent significant strengthening of the long end may encourage the Ministry of Finance to offer the 10Y benchmark that was last offered in early July. The liquidity situation is quite supportive as PLN4.7bn will flow into the market two days after the auction settlement date and another PLN2.4bn just before the end of the month. The planned supply for this week's auction is at PLN4-8bn.

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.