Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

19 – 25 December 2016

The markets' response to the "hawkish hike" by the FOMC, the key event last week, proved to be only short-lived. Some weakening on both the bond market and EM currencies in reaction to the information that the Fed would hike rates three times in 2017 (more than anticipated by the market) was used as an opportunity to accumulate bonds and markets rebounded quickly. As a result, the yield of the Polish 10Y benchmark fell towards 3.40%, while EURPLN declined below 4.42. The domestic financial market's reaction to Poland's macro data releases was not significant.. The November's headline CPI confirmed the flash reading at 0.0% y/y, ending the 28-month period of deflation. While the October's current account deficit was better than expected, exports data disappointed, falling 3.1% y/y. We think that the export weakness may continue in the nearest few months (export growth in 4Q16 may be negative in EUR terms, for the first time since 2009), but a gradual revival is possible in 2017 owing to the economic recovery abroad and some pickup in international trade. The domestic labour market remained solid in November, showing employment growth by 3.1% y/y and wages increase by 4.0% y/y in the enterprise sector.

In the last week before Christmas, the macro calendar in Poland and abroad is quite heavy. Our forecasts for industrial and construction output as well as for retail sales are noticeably below the market consensus. These data should confirm weak economic activity in 4Q16. We expect that the Polish data may weigh slightly on the zloty this week and support the interest rate market. On the other hand, a bunch of the US macro data is due this week, but in our view the data should not trigger any persistent response from market players. Falling volatility suggests that investors are entering the holiday mood when liquidity falls and markets stabilize. Therefore, lack of any negative news flow in the upcoming days may bring horizontal trend on both the FX and interest rate markets or even a further gradual strengthening.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (19 December)					
10:00	GE	Ifo index	Dec	pts	-	-	110.4
14:00	**PL**	**Industrial output**	**Dec**	**% y/y**	**2.0**	**0.5**	**-1.3**
14:00	**PL**	**Construction and assembly output**	**Dec**	**% y/y**	**-18.9**	**-23.1**	**-20.1**
14:00	**PL**	**Real retail sales**	**Dec**	**% y/y**	**5.3**	**5.0**	**4.6**
14:00	**PL**	**PPI**	**Dec**	**% y/y**	**1.0**	**1.1**	**0.6**
		TUESDAY (20 December)					
14:00	HU	Central bank decision		%	0.90	-	0.90
		WEDNESDAY (21 December)					
16:00	US	Home sales	Nov	m	5.52	-	5.60
		THURSDAY (22 December)					
13:00	CZ	Central bank decision		%	0.05	-	0.05
14:00	**PL**	**MPC minutes**					
14:30	US	GDP third estimate	Q3	% q/q	3.3	-	1.4
14:30	US	Initial jobless claims	week	k	-	-	254
14:30	US	Durable goods orders	Nov	% m/m	-4.7	-	4.6
14:30	US	Personal income	Nov	% m/m	0.3	-	0.6
14:30	US	Consumer spending	Nov	% m/m	0.4	-	0.3
		FRIDAY (23 December)					
10:00	**PL**	**Unemployment rate**	**Nov**	**%**	**8.2**	**8.2**	**8.2**
16:00	US	New home sales	Nov	k	575	-	563
16:00	US	Michigan index	Dec	pts	98.1	-	93.8

Source: BZ WBK. Reuters. Bloomberg

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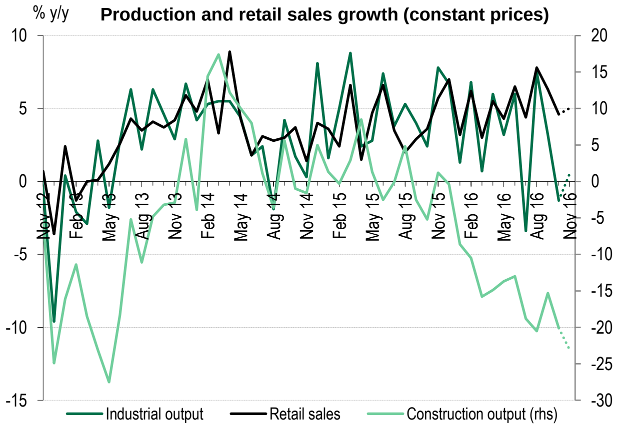
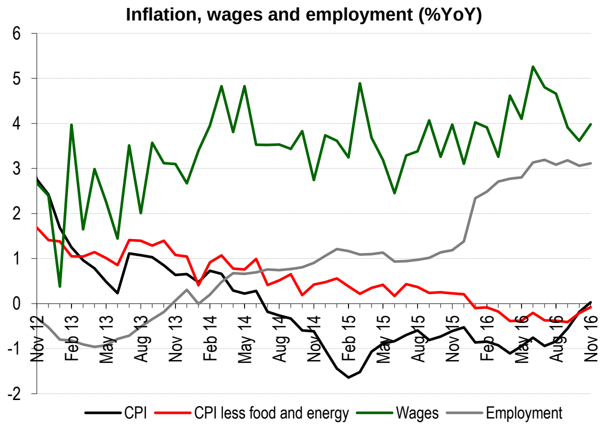
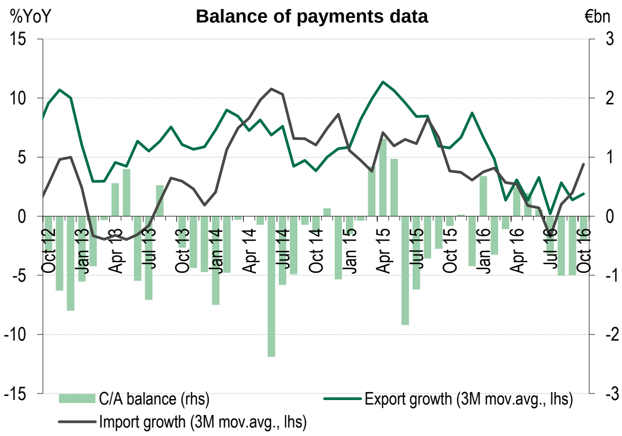
What's hot this week – Weak output, stronger retail sales



- We are expecting the industrial output growth only slightly above 0% y/y in November, before being in red again in December. Polish industrial sector is undermined by weak tendencies in international trade, high level of capacity utilization and labour market squeeze. In case of construction output, we are still expecting it to remain in deep contraction.
- Retail sales growth accelerated a bit in November, in our view. Let us remind that last year the statistics office introduced a temporary reclassification in the data, so we will see highly distorted growth rates of sales in food and other non-specialised sales.
- In our view, the unemployment rate in November stayed unchanged, at 8.2%, . Our forecast is in line with the Labour Ministry estimate, so a surprise is unlikely.

Last week in economy – End of deflation, weak exports





- In November, CPI inflation rose to 0.0% y/y from -0.2% y/y in October, in line with the flash estimate and our forecast. After 28 months, we have a big farewell to deflation and we do not expect its return in the medium term. Food prices, which rose 0.4% m/m, were the main factor pushing CPI up last month. Core inflation climbed to -0.1% y/y. We expect to see further inflation rise in the coming months, to 0.5% y/y in December and c1.5% y/y in January. Inflation rate will go up mostly due to higher food and fuel prices. Positive inflation is an argument to stabilise interest rates in Poland.
- C/A deficit fell in October to -€393m, and was better than expected. Export growth slowed to -3.1% y/y, in line with our forecast, which reflected the general weakness in the Polish foreign trade and industrial production, but was additionally negatively influenced by the calendar effect (fewer working days). Import also decelerated, to +0.2% y/y, and was lower than expected. In general, we think that the export weakness may continue in the nearest few months (export growth in 4Q16 may be negative in EUR terms for the first time since 2009), but a gradual revival is possible in 2017 towing to the economic recovery abroad and some pickup in international trade.
- Average employment growth in the corporate sector stabilized in November at 3.1% y/y, while wage growth accelerated to 4.0% y/y. The latter was to some extent affected by the calendar effect and wage hikes in retail trade. We expect to see growing wage pressure in the coming months. However, inflation will pick up as well, so the real purchasing power of households will not accelerate significantly next year, we think. Still, the private consumption will remain the main driver of economic growth in the nearest quarters, and it may weaken in 2H17 after the positive effect of 500+ programme wanes.

Quote of the week – 2017 to be boring?

Jerzy Kropiwnicki, MPC member, 14 Dec, PAP

I guess 2017 will be a boring year. Average inflation will reach 1.5% in the best case. In my view, the economy may grow at pace slightly below 4% in the whole year.

Grażyna Ancyparowicz, MPC member, 12 Dec, PAP

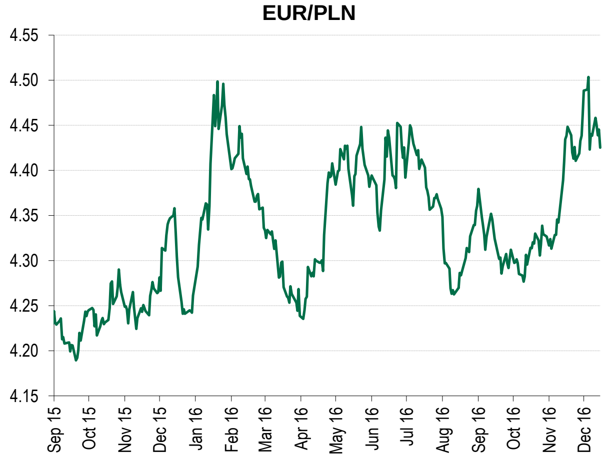
Rates will remain stable at least until 3Q17 and maybe even 4Q17 or 1Q18. The first correction will be a slight move up. However, such a move will be justified if price growth approach the upper limit of tolerance band around target.

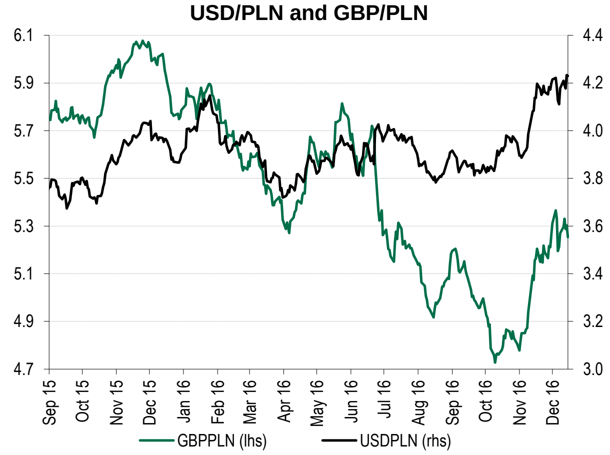
Łukasz Hardt, MPC member, 14 Dec, Reuters

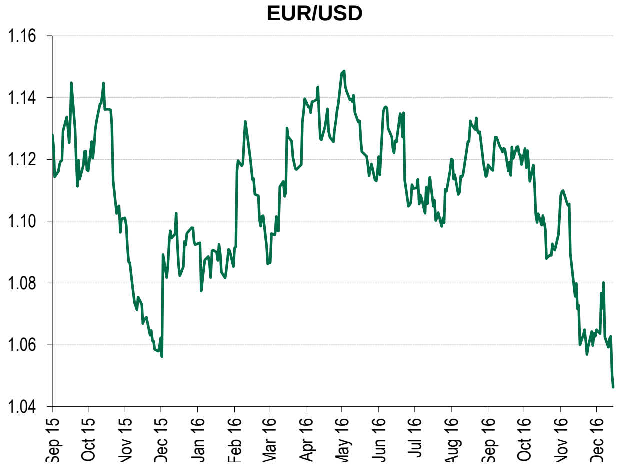
If we are approaching the lower limit of tolerance band around target and our forecasts are pointing to a further acceleration of prices, we should be thinking about hikes. However, in my opinion, it is not probable for inflation to reach 1.5% in 2017, so changes in rates are also unlikely. I am not expecting a major rebound in economic growth in 1H2017.

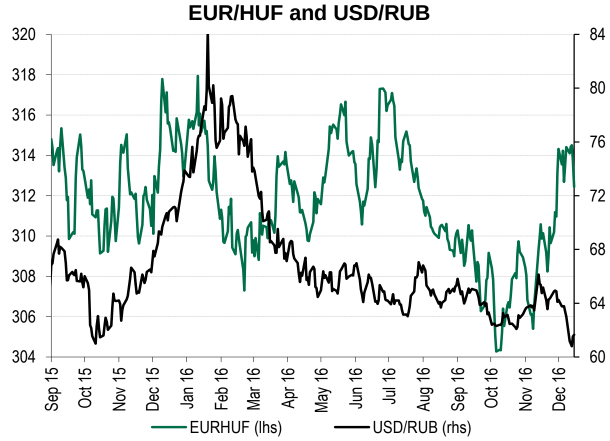
Last week was rich in MPC members' comments on monetary policy outlook. Baseline is that interest rates are unlikely to change in 2017. However, Grażyna Ancyparowicz was surprisingly dovish and stated that inflation needs to go up to 3.5% before she would mull a rate hike. On the other hand, Łukasz Hardt said that inflation already at 1.5% would be an argument to consider hikes. Let us note that we forecast CPI at 1.5% already in January. Hardt is also relatively pessimistic about the economic growth (no major rebound in 1H17), while Kropiwnicki is really sanguine (almost 4% GDP growth in 2017). In our view, and contrary to the words of Kropiwnicki, 2017 will be interesting for the monetary policy, with rising inflation and weak economic growth. Given the comments cited on the left, MPC's reaction to such an environment is not that predictable (though we are expecting rates to stay unchanged).

Foreign exchange market – Volatility likely to fall









EUR/PLN stable, USDPLN up

- Last week EUR/PLN remained fairly stable around 4.43 and the weekly trading range was the narrowest since the second half of October despite the hawkish Fed rate hike. At the same time, USD/PLN resumed the upside trend and rose temporarily to 4.28 due to dollar's worldwide appreciation owed to the FOMC rhetoric. GBP/PLN and CHF/PLN remained flat around 5.30 and 4.10, respectively.
- Falling volatility suggests that investors are entering the end-of-the-year period when liquidity falls and markets stabilize. We think this is actually the case and we expect EUR/PLN to stay within 4.40-4.46 at least this week despite numerous US and Polish data releases. The exchange rate has neared the lower band of the abovementioned range but we think that domestic figures due this week will be rather unsupportive for the zloty. Our forecasts for industrial and construction output as well as for retail sales are noticeably below market consensus and we expect that Polish data may weigh slightly on the zloty this week.
- EUR/PLN's reaction to the hawkish Fed rate hike proved only temporary and we conclude that this week's bunch of the US data should not trigger any persistent response either.

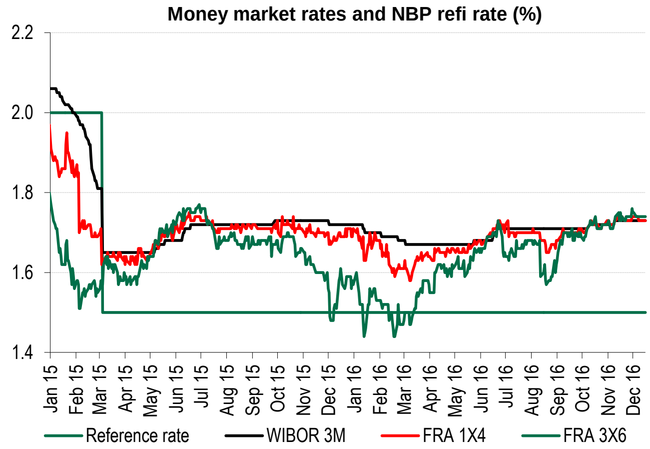
Hawkish hike boosts dollar

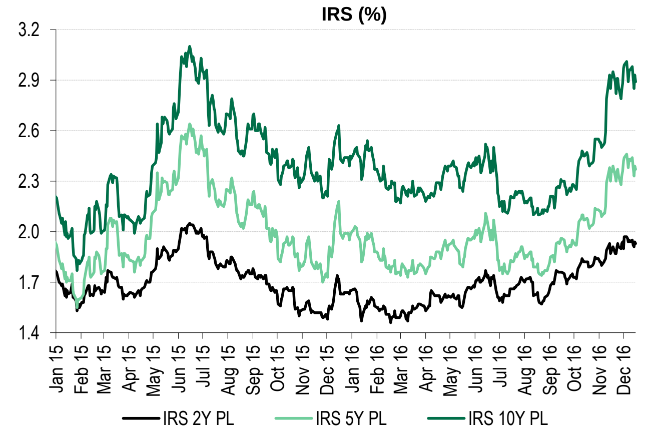
- Thursday's outcome of the FOMC meeting had the biggest impact on EUR/USD last week. The Committee's rhetoric was pretty hawkish which boosted the greenback worldwide. As a result, EUR/USD finally broke the March 2015 low at c1.046 and fell below 1.04, its lowest since early 2003.
- Considering the most recent important global events – US Presidential elections, Italian referendum, and Fed rate hike – the latter caused the least impressive reaction of EUR/USD. This may suggest that the dollar (euro) has already priced much of positive (negative) news that have recently emerged and there is limited potential for further EUR/USD decline (at least in the short term). Numerous US data are on the agenda this week and we think that the figures would have to surprise well to the upside to pull EUR/USD lower before the year-end.

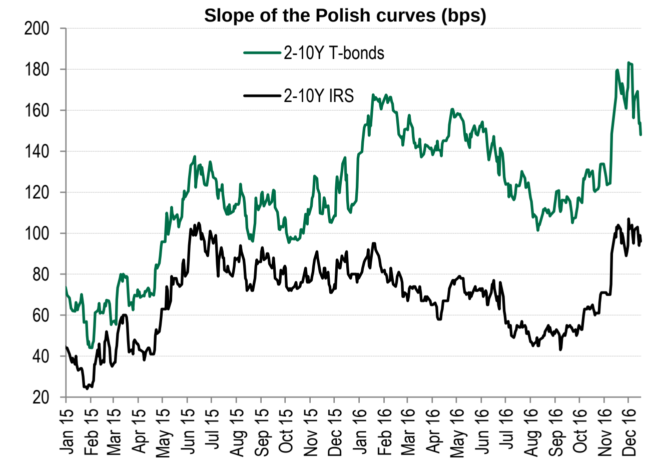
HUF and RUB outperform PLN

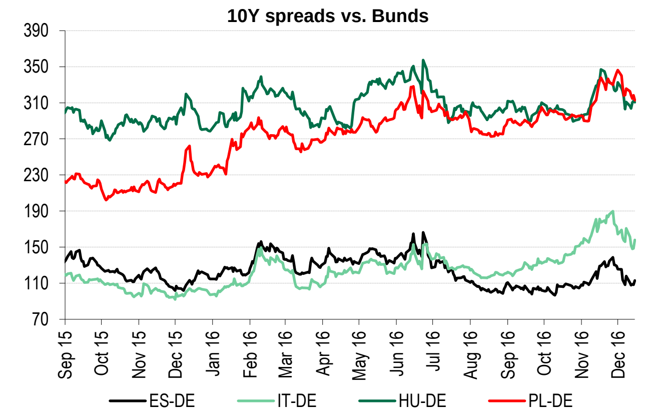
- The Hungarian forint and Russian ruble outperformed the zloty. EURHUF fell to 312 from 315, while USDRUB reached last week its fresh 2016 low at 60.425. The ruble was benefitting from the rising oil prices as the non-OPEC countries also agreed to cut output.
- This week, the Hungarian central bank (MNB) announces decision on the interest rates. For already several months, the MNB has been easing monetary policy by other means than cutting its main refi rate. This month, we think the MNB will refrain from taking any actions.

Interest rate market – Market likely to stabilise before Christmas









Yields lower despite “hawkish hike” by Fed

- Last week was quite volatile on the Polish interest rate market. Both yields and IRS rates fell markedly at the start of the week, following core market strengthening. The yield of the Polish 10Y benchmark reached 3.45% (its lowest since mid-November) before the Wednesday’s Fed decision on rates. Unexpectedly, the rate hike by FOMC (by 25bp, as expected) was interpreted as a hawkish one, since the new dot plot – showing the expectation of individual Fed members for the future path of rates – moved up and suggested three hikes by 25bp each in 2017. The spill-over from higher UST yields (the 10Y increased by 14bp after the decision) made other yields, including the Polish ones, go up. The yield of the domestic 10Y benchmark rose to nearly 3.60%, trimming nearly all the earlier gains. However, it was only short-lived, as investors used higher yields to accumulate bonds. During the Friday’s session, the yield of the 10Y was declining towards 3.40%.
- On weekly basis, both yield and IRS curves flattened somewhat, with the 2-10Y spread narrowing below 155bp for bonds and below 100bp for IRS. In the meantime, risk premia (measured by spread over Bunds) also decreased gradually, with the spread tightening below 320bp for 10Y sector.
- The last week was also quite intense on the primary bond market. Poland priced Green Bonds as the first ever sovereign issuer. It sold a 5Y EUR-denominated bond worth €750m with yield at 0.634% (or 48bp over mid-swap rate). The structure of buyers was well diversified, with 61% allocation (going) to investors who are clearly focused on green bonds. What is more, the results of the switch auction were pretty good. The ministry sold a new 2Y-bond OK0419 worth cPLN5.5bn. Taking into account the Thursday’s auction, we estimate that the ministry has pre-financed c8% of the 2017 gross borrowing needs through the switch tender.
- On the money market, WIBOR 1-12M rates remained stable, while FRAs decreased slightly (by 1-5bp) on weekly basis thanks to IRS market rebound.

Market likely to stabilise ahead of Christmas break

- In the week before the Christmas break, we expect some stabilization on the market. The start of the week is heavy with domestic macro data releases in Poland. In our view, they should confirm weak economic activity in 4Q16 (our forecast of industrial output is well below market consensus) and this might influence domestic curves in the short run.
- The belly and the long end of the curves would be still under influence of global factors as the correlation between the 10Y Polish and US Treasuries and Bund has remained elevated (R^2 at 0.95 and 0.85, respectively, in the last three months). In our view, macro data releases from both Europe and USA may add to the market volatility. However, we would like to point out that the recent market responses to important events (including “hawkish hike” by Fed) are short-lived and market quickly returns to some stabilization or even strengthening. Given that, we think lack of strongly negative news flow in the upcoming days may bring a horizontal move in yields/rate.

Additional information is available on request. Please contact Bank Zachodni WBK S.A., Economic Analysis Department, al. Jana Pawła II 17, 00-854 Warsaw, Poland, phone +48 22 534 18 88, email ekonomia@bzwbk.pl