Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

16 – 22 January 2017

Inflation started picking up in Poland and it seems that it will be higher than expected in 2017, nearing 2% in March/April. However, the Polish central bank is not going to think about interest rate hikes anytime soon, keeping rates stable in 2017.

The rating agencies Fitch and Moody's are scheduled to review Poland's ratings today in the afternoon and their decisions will be the key driver for the Polish market at the start of the new week. We have pointed out earlier that we see arguments for lowering the outlook (Fitch) and/or the rating (Moody's) such as the retirement age reduction and worse economic growth prospects. Let us remind you that since the 2015 elections Fitch has not changed the outlook or the rating (A-, stable), while Moody's lowered its outlook in May 2016 (A2, negative). However, after yesterday's comment of PM Szydło stating that she expected "good news" from the agencies, the call is not so simple, as the government should know the rating decision in advance. The market consensus is strongly in favour of no changes in rating assessments, so any negative decision would be a big surprise, triggering depreciation of the Polish assets.

Tuesday will be an important day for FX markets, as Theresa May's speech about Brexit plans may influence the British pound and possibly other currencies. Economic data releases abroad on Wednesday-Thursday may be important for expectations about future Fed's policy. Meanwhile, ECB meeting should not bring about new important impulses, in our view.

Domestic data to be released on Thursday will be interesting. While retail sales is likely to remain strong (Christmas spending boosted by 500+ for the first time), we expect a rather weak production growth (near zero), after surprisingly good November, which will confirm, in our view, that GDP growth in 4Q16 was slightly below 2% y/y. Such a result may slightly support the short end of the yield curve.

Economic calendar

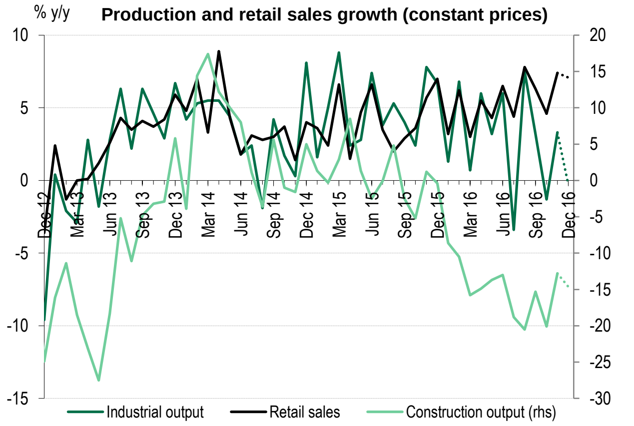
TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (16 January)					
	US	Market holiday					
14:00	**PL**	**Core inflation**	**Dec**	**% y/y**	**0.0**	**0.0**	**-0.1**
		TUESDAY (17 January)					
11:00	GE	ZEW index	Jan	pts	65.1	-	63.5
		WEDNESDAY (18 January)					
11:00	EZ	HICP	Dec	% y/y	1.1	-	1.1
14:00	**PL**	**Wages in corporate sector**	**Dec**	**% y/y**	**4.0**	**3.7**	**4.0**
14:00	**PL**	**Employment in corporate sector**	**Dec**	**% y/y**	**3.1**	**3.1**	**3.1**
14:30	US	CPI	Dec	% m/m	0.3	-	0.2
15:15	US	Industrial output	Dec	% m/m	0.7	-	-0.4
		THURSDAY (19 January)					
13:45	EZ	ECB decision			0.0	-	0.0
14:00	**PL**	**Industrial output**	**Dec**	**% y/y**	**1.6**	**-0.3**	**3.3**
14:00	**PL**	**Construction and assembly output**	**Dec**	**% y/y**	**-13.3**	**-14.6**	**-12.8**
14:00	**PL**	**Real retail sales**	**Dec**	**% y/y**	**6.7**	**7.1**	**7.4**
14:00	**PL**	**PPI**	**Dec**	**% y/y**	**2.6**	**3.0**	**1.7**
14:30	US	Initial jobless claims	week	k	-	-	247
14:30	US	House starts	Dec	k	1195	-	1090
14:30	US	Building permits	Dec	k	1220	-	1201
14:30	US	Philly Fed index	Jan	pts	15	-	21.5
		FRIDAY (20 January)					
		No important data releases					

Source: BZ WBK, Reuters, Bloomberg

ECONOMIC ANALYSIS DEPARTMENT:
al. Jana Pawła II 17, 00-854 Warszawa fax +48 22 586 83 40
email: ekonomia@bzwbk.pl Web site: http://www.bzwbk.pl
Maciej Reluga (Chief Economist) +48 22 534 18 88
Piotr Bielski +48 22 534 18 87
Agnieszka Decewicz +48 22 534 18 86
Marcin Luziński +48 22 534 18 85
Marcin Sulewski +48 22 534 18 84

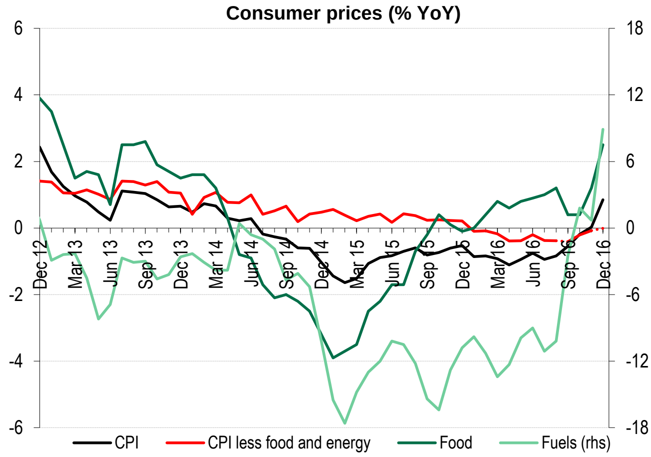
TREASURY SERVICES:
Poznań +48 61 856 5814/30
Warszawa +48 22 586 8320/38
Wrocław +48 71 369 9400

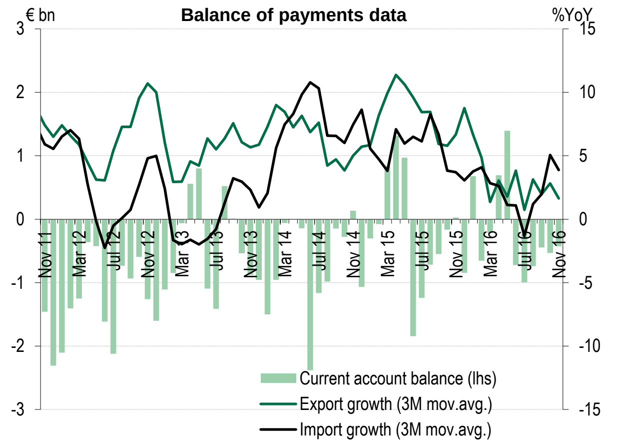
What's hot this week – Bitter-sweet set of data



- We expect the core inflation to remain stable in December at -0,1% y/y, as the spike in CPI was caused by food & fuels.
- Employment growth in corporate sector should remain near 3% y/y in December, while average wage growth may slow slightly below 4% (mainly due to the calendar effect).
- Still, we expect the December retail sales to accelerate, as the 500+ programme has probably boosted Christmas shopping, even if households were quite reluctant to spend this money in the previous months.
- After stronger-than-expected industrial production growth in November, December will see deceleration again, in our view, partly because of lower number of working days. The same would apply to the construction output. Such results would confirm our estimate of GDP growth below 2% y/y in 4Q16.

Last week in economy – MPC more dovish as CPI goes higher





- The Monetary Policy Council kept main interest rates on hold in January, with the main reference rate at 1.5%. The Council still sees the slowdown of economic growth in Poland as temporary. It also expects inflation to rise further, but only gradually and moderately. In general, the message from the central bank was neutral or even mildly dovish – they do not see reasons to change the monetary policy this year and policy tightening in 2018 would be possible only when inflation picks up clearly due to growth acceleration.
- CPI increased to 0.8% y/y in December from 0% in November, in line with the flash estimate. The main reason for the significant inflation rise was a spike in prices of fuels and food. Prices in the remaining categories were quite stable so we estimate that core inflation excluding food and energy did not move much and reached 0.0% y/y (vs -0.1% in November). The inflation pick-up will most likely continue at the start of 2017, boosted by very low base effect and price hikes in some categories (electricity, tobacco). Also, the upward trend in global food prices is quite clear. Even the unexpected cut in gas prices from February (by c.6%) approved by the Energy Regulatory Office (URE) is not likely to stop inflation from rising to around 2% in March/April, in our view. Later on, we expect CPI to stabilise around 2% y/y for a few months, and then to drop towards 1.5% in December 2017 due to very high base effect.
- Current account deficit in November was higher than expected and the deficit for October has been revised up. Import and export growth accelerated in November, but mainly due to the calendar effect, in our view. The signals about economic recovery abroad should support a revival of Polish exports in 2017. Import will also be growing faster thanks to solid domestic demand.

Quote of the week – Absolutely no reason for a rate hike

Adam Glapiński, NBP governor, MPC press conference; 11.01

Everything suggests that the CPI will touch the lower range of the band this year (1.5%), but I don't think that we will touch the inflation target itself this year. … A rise in oil price has stopped, there is not much room for further inflation rise in my opinion, as long as there is no strong recovery in the world economy. Meanwhile, the world growth is meagre.

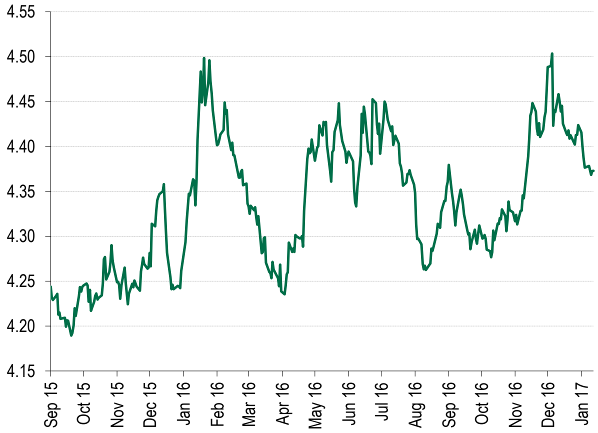
I see absolutely no such reason for rate hike (in 2017). Inflation will slowly rise in my opinion, and the interest rates will be stable, so the real rates will be decreasing, thus encouraging growth. If economic growth accelerates and triggers price growth, then it will be the time for rate hikes… possibly in 2018, but only in a positive scenario.

I think the MPC press conferences in the future months will focus on CHF loans.

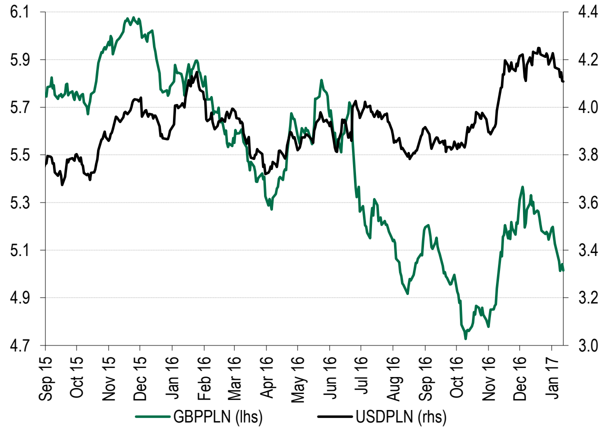
The tone of the MPC statement and central bank governor's comments seem to have softened somehow. It may look quite odd that the central bank's rhetoric used to be very hawkish when Poland was in deep deflation and is turning more dovish in the very moment when inflation started picking up. It is hard to escape the impression that the central bank's strategy is not pure inflation targeting (as suggested by the official policy guidelines), but the bank has plenty of other objectives, including economic growth and banks' stability. It is quite telling that just when the inflation story started being interesting (according to our forecast CPI will reach 2% in 1H17), the NBP governor spent so little time during his super-long speech talking about inflation and so much time on other issues, and hoped that FX loans would be the theme for next conferences. It suggests that the MPC will not hurry with rate hikes, in our view.

Foreign exchange market – Watch out for January's spike in volatility

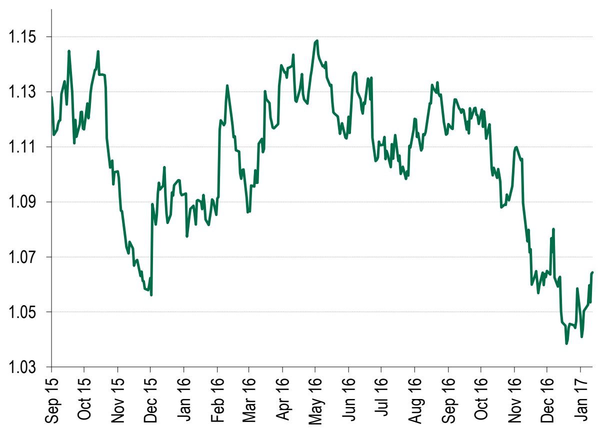
EUR/PLN



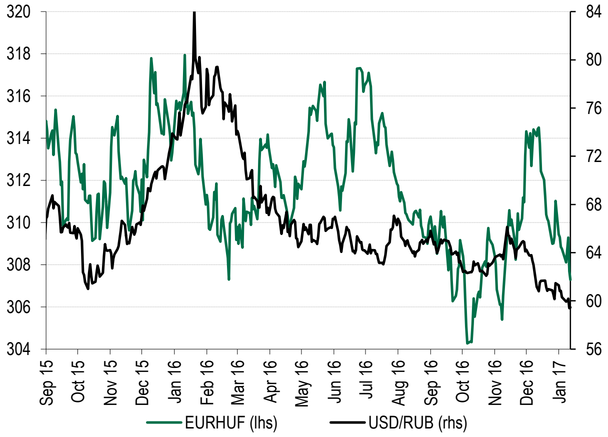
GBP/PLN and USD/PLN



EUR/USD



EUR/HUF and USD/RUB



Will higher volatility hit zloty again?

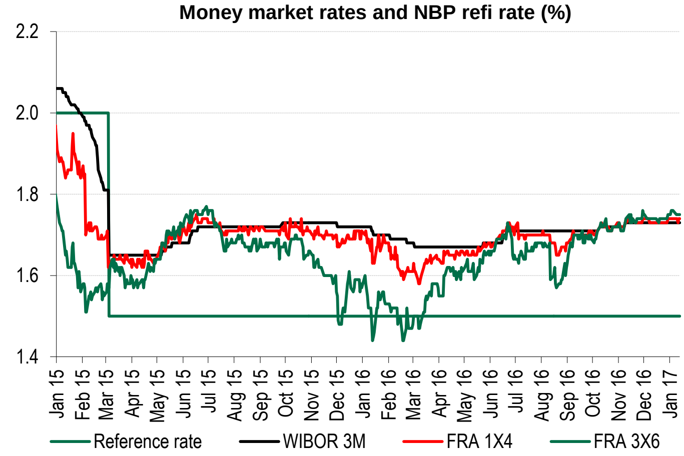
- The zloty gained in December with EUR/PLN falling to 4.40 from 4.50 (the best zloty's performance vs the euro in the final month of the year since 2013). The year-end was positive for the equities and higher risk appetite was also supporting the CEE currencies. The zloty's appreciation continued in early 2017 when the exchange rate was testing support at 4.36 and USD/PLN fell temporarily to 4.09.
- You may recall from our last Weekly released in 2016 that historically January tends to be more volatile for the zloty compared to other months; and for the EM currencies a jump in volatility usually means depreciation. The most obvious trigger for substantial swings in the Polish FX market would be Moody's and/or Fitch decision to revise rating and/or credit outlook, which could be driven by the retirement age cut and deteriorated growth outlook.
- The market consensus is that the Polish rating and outlook will stay unchanged so if the agencies take a different view, the zloty could suffer, but probably to a lesser extent than it did last year after the unexpected S&P downgrade. However, if no adverse decisions are announced this time, the market reaction should be muted and we do not expect any significant zloty appreciation.
- As long as the economic activity is concerned, this week the stats office will release the December's data on the retail sales and industrial output. We are slightly more optimistic compared to the consensus when it comes to the sales growth but our forecast for the industrial output is well below the market expectations. After the surprisingly strong manufacturing PMI jump in the final month of 2016, the output growth below zero could be found as clearly disappointing.
- Apart from a big move of EUR/PLN, we think that the volatility of GBP/PLN is also likely to rise when the UK Prime Minister, Theresa May, delivers a speech on her Brexit vision on Tuesday. She has recently said that she was ready to give up access to the single-market for more control over its borders which was negative for the pound helping GBP/PLN to fall temporarily below 5.0 (its lowest since mid-November).

US factors key for EUR/USD

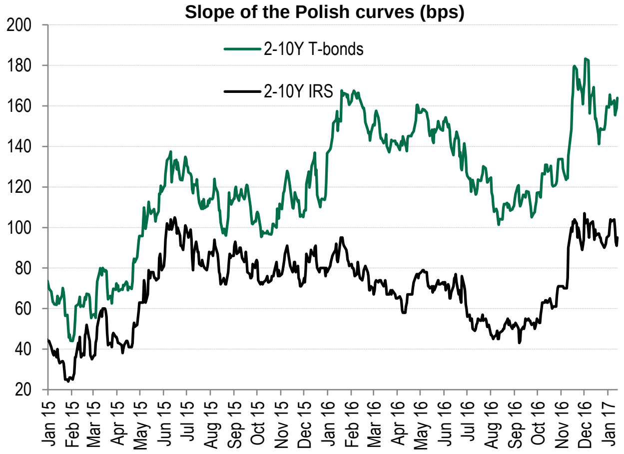
- In December EUR/USD remained near 1.04 but early 2017 brought about its pretty quick rise to nearly 1.07. The main driver for the euro appreciation was profit taking from the recent dollar strengthening amid lack of fresh supportive factors, Donald Trump's disappointing speech (where he gave no details on his plan to boost the US economy) and ECB minutes showing that the decision to extend the asset purchase program in December was not unanimous.
- EUR/USD was on the decline for the last three months of the year. A similar situation was last recorded in 2H15 and followed by a rebound lasting for five months.
- This Friday Donald Trump will have an opportunity to provide more insight in his economic plan which next to the numerous FOMC speakers and US macro data could be key for EUR/USD in the short term.
- The ECB is unlikely to deliver any significant information after it expanded its QE program in December.
- We do not expect the dollar appreciation to resume in our base scenario.

Interest rate market – Rating agencies set market direction

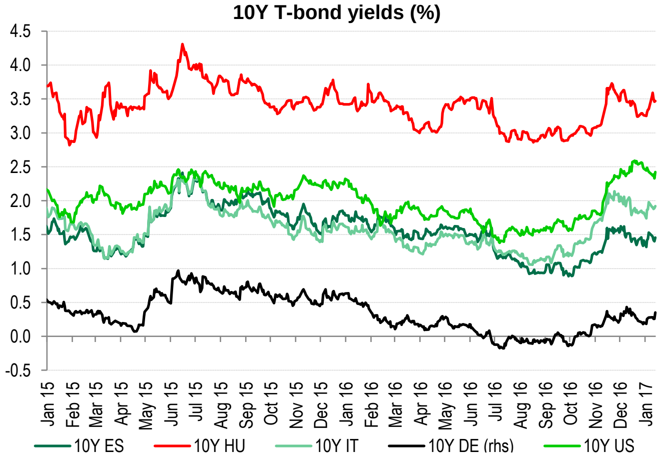
Money market rates and NBP refi rate (%)



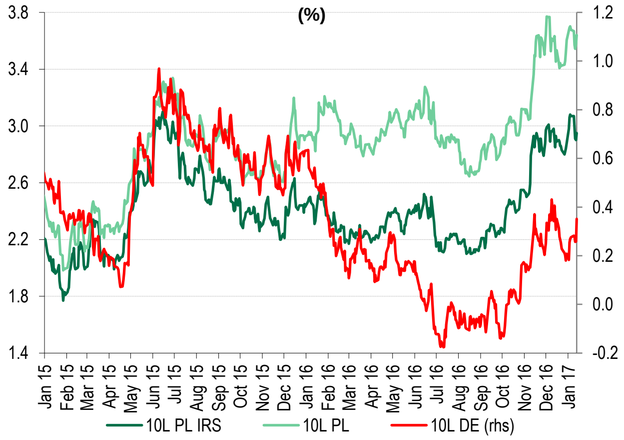
Slope of the Polish curves (bps)



10Y T-bond yields (%)



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



Yields down in early January

- Situation on the domestic interest rate market was mixed in the first two weeks of January. An unexpected increase in the flash CPI and PMI for manufacturing (both figures for December) pushed yields and IRS rates significantly up, with the 10Y benchmark yield growing towards 3.80%. However, core market strengthening, together with favourable auction results (details below) and less-hawkish-than-expected MPC rhetoric helped the market to rebound visibly. As a result, losses recorded at the start of the year were fully trimmed and Polish yields ended the week at lower levels than at the beginning of 2017.
- Bond market outperformed IRS and, as a result, asset swap spread tightened somewhat, in particular for the 5Y and 10Y sectors. Moreover, the 2-10Y spread for both T-bonds and IRS did not change much as compared to the end of 2016. However, risk premia, implied by the spread over Bunds for 10Y sector and CDS, decreased for Poland's assets quite visibly as both indicators tightened.
- Poland's Ministry of Finance successfully launched bonds at the first auction this year. It sold papers worth PLN6bn (on both regular and top-up tenders), with demand at cPLN15bn and prices close to the level on the secondary market. Auction results (including quite high sale of floaters) suggest that domestic commercial banks were one of the main purchasers. The deputy finance minister Piotr Nowak said that after the auction this year's borrowing needs are covered in 29%, which "allows us to watch the market situation in the coming months with big calm".
- On the money market, the WIBOR rates remained stable, while the FRA rates declined somewhat as a result of gains on the IRS market. Investors slightly cooled their expectations for monetary tightening and now they price in a c70% chance for rates to hike by 25 bps in one-year horizon.

Heavy week ahead, but rating agencies set direction

- The key driver of the Poland's assets will be the rating agencies' (Fitch and Moody's) decision, which we will learn tonight. In our view there are arguments, including lower retirement age and worse economic growth prospects, to revise Poland's credit outlook or even the rating downward. In our view any downward revision will result in sell-off of Polish assets. Otherwise, if Fitch and Moody's affirm rating and outlook, the market may gain slightly, but its response should be subdued as such decision is widely expected by market players.
- This week another set of important domestic macro data is due (wages and employment in enterprise sector, industrial and construction output, retail sales). In our view, retail sales for December should report solid growth, but industrial output remains a question mark. Our forecast is well below the market consensus and weak production growth should support the front end of the curves.
- The belly and the long end of the curves will be more vulnerable to the situation on the core markets. Therefore, investors' attention will focus on the ECB meeting, comments by FOMC members and macro data releases in both Europe and the USA. In our view, this time the ECB outcome will be rather neutral for market players as it is widely expected that the Council will keep monetary conditions unchanged. However, more hawkish comments from the Fed together with strong data from the US economy might put some upward pressure on the UST yields and this may result in spill-over effects to Poland's assets.

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