WEEKLY ECONOMIC UPDATE

23 – 29 January 2017

Last week investors' sentiment was mixed. The GBP strengthened after the British PM Theresa May promised a parliamentary vote on Brexit. The USD depreciated temporarily after the Fed Chair Yellen's speech confirming gradual and prudent rate hikes later this year, as well as Donald Trump's comment expressing concern about the dollar strength. However, strong US macro data and still dovish ECB's rhetoric helped the US dollar trim most losses. At the same time, core debt markets weakened quite significantly and mounting yields of Bunds and US Treasuries caused upward pressure on the Polish debt market.

Poland's assets were quite immune to the domestic macro data releases last week. December's labour market data confirmed the still weak wage pressure. Production in manufacturing (2.3% y/y) and in construction (-8% y/y) in December were clearly better than we had expected, while retail sales (6.1% y/y) was below forecast. On balance, the data looked good, as they suggested that the revival of economic activity in Germany and the rest of the euro zone was already triggering a recovery in Polish manufacturing, while investment collapse was probably losing steam. Consumption growth was not as strong as we had expected, but it is decent enough to be the main driver of economic growth in 1H17. After December's data we think that GDP growth in 4Q16 was probably slightly above 2% y/y (earlier we thought it could be slightly below 2%).

We think that this week domestic events are not going to be key for the market.. Investors will focus on external factors, including investors' sentiment after Donald Trump's inauguration as the US President and economic activity data from Europe and the USA, with the US advance 4Q16 GDP data as the most crucial. Stronger-than-expected data might imply growing probability of faster rate hikes by the FOMC , and thus could trigger market reaction. This may bring trigger the zloty's more significant move after EURPLN consolidation in the last two weeks and could also influence Poland's debt market.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (23 January)					
11:30	**PL**	**T-bonds auction**					
		TUESDAY (24 January)					
9:30	GE	Flash PMI – manufacturing	Jan	pts	55.4	-	55.6
10:00	EZ	Flash PMI – manufacturing	Jan	pts	54.8	-	54.9
14:00	HU	Central bank decision	Jan	%	0.90	-	0.90
16:00	US	Home sales	Dec	m	5.55	-	5.61
		WEDNESDAY (25 January)					
10:00	**PL**	**Registered unemployment rate**	**Dec**	**%**	**8.3**	**8.3**	**8.2**
10:00	GE	Ifo index	Jan	pts	111.3	-	111.0
		THURSDAY (26 January)					
14:00	**PL**	**MPC minutes**					
14:30	US	Initial jobless claims	week	k	-	-	234
14:30	US	New home sales	Dec	k	586	-	592
		FRIDAY (27 January)					
14:30	US	Advance GDP	4Q16	q/q	2.1	-	3.5
14:30	US	Durable goods orders	Dec	% m/m	2.9	-	-4.5
16:00	US	Michigan index	Jan	pts	98.1	-	98.1

Source: BZ WBK, Reuters, Bloomberg

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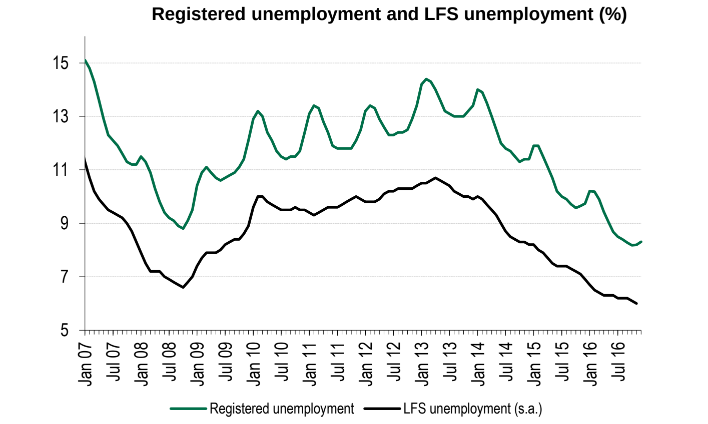
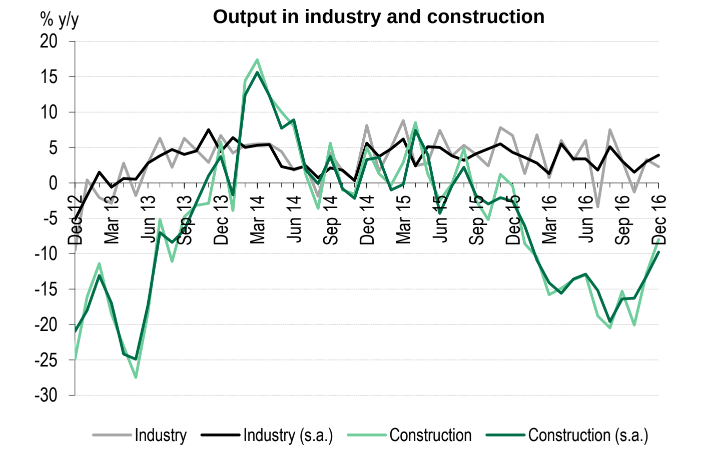
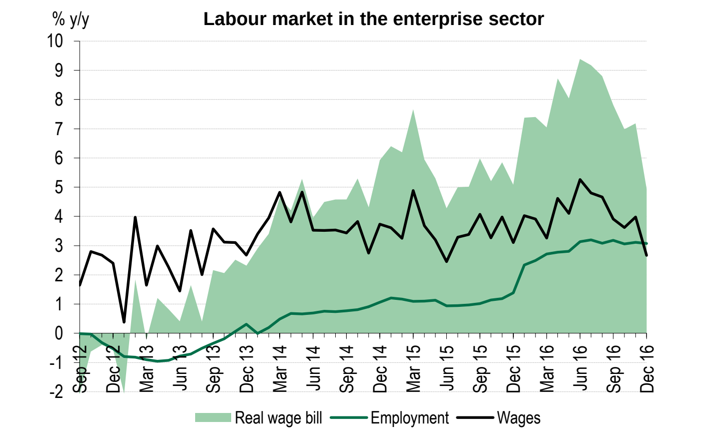
What's hot this week – Unemployment rate and Statistical Bulletin



- There is not many Polish data on the agenda this week. The Statistics Office is releasing its monthly bulletin, so we will get to know a bit more about the surprising deceleration of wage growth in December (details below).
- Additionally, the bulletin will include the seasonally adjusted business climate indices for January. According to our estimate based on unadjusted data the confidence improved in manufacturing, construction and retail trade, with the latter being a very impressing pickup.
- The registered unemployment rate rose to 8.3% at the year-end, in our view. Our estimate is in line with the Labour Ministry's data, so surprise is rather unlikely. This will be the lowest reading in December since 1990. We are expecting the unemployment rate to go further down in 2017, yet not as quickly as in 2016.

Last week in economy – Output above expectations, weak wage growth





- Production in manufacturing (2.3% y/y) and in construction (-8% y/y) in December was clearly better than we expected, while retail sales (6.1% y/y) was below forecast. On balance, the data look good, as they suggest that the revival of economic activity in Germany and the rest of euro zone is already triggering a recovery in Polish manufacturing, while investment collapse is probably losing momentum (construction). Consumption growth was not as strong as we expected, but it is decent enough to be the main driver of economic growth in 1H17. After December's data we think that GDP growth in 4Q16 was probably slightly above 2% y/y (earlier, we thought it could be slightly below 2%). 4Q16 was probably the bottom of the economic cycle, and we expect economic growth to accelerate gradually in 2017.
- In December, average employment rose by 3.1% y/y, in line with expectations, while average wage growth disappointed, slowing to 2.7% y/y (market consensus 4.0% y/y), which is the lowest since mid-2015. It seems extremely odd that despite persistent high demand for new jobs, growing number of vacancies, and deepening shortage of available workforce, the wage growth has been recently decelerating , instead of speeding up. In such environment, it is hard to expect that a commodity-driven surge in CPI at the start of 2017 will be followed by rapid increase in core inflation. Moreover, it suggests that outlook for the private consumption may be less optimistic than expected (especially in 2H17, when the impact of 500+ subsidies wanes).
- PPI inflation surged to 3% y/y in December, its highest since August 2012, mainly due to the pressure from the rising commodity prices. Despite rising inflation and signs of picking up economic activity we do not expect the Polish central bank to start thinking about interest rate hikes anytime soon.

Quote of the week – Inflation at 2.5% is not a reason to hike

Grażyna Ancyparowicz, MPC member, PAP, 16.01

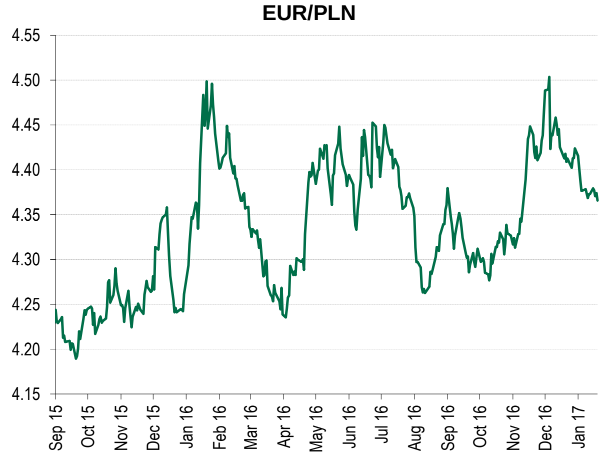
In mid-2017, inflation can reach the lower boundary of tolerance band around target (1.5%) or even exceed it slightly. In 2H2017, inflation can approach the target (2.5%). As inflation target is viewed as the optimal value, there are no reasons to change monetary policy parameters in the months to come.

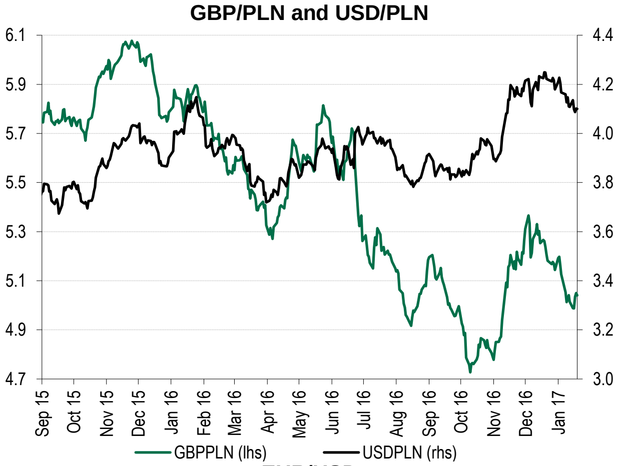
Łukasz Hardt, MPC member, PAP, 16.01

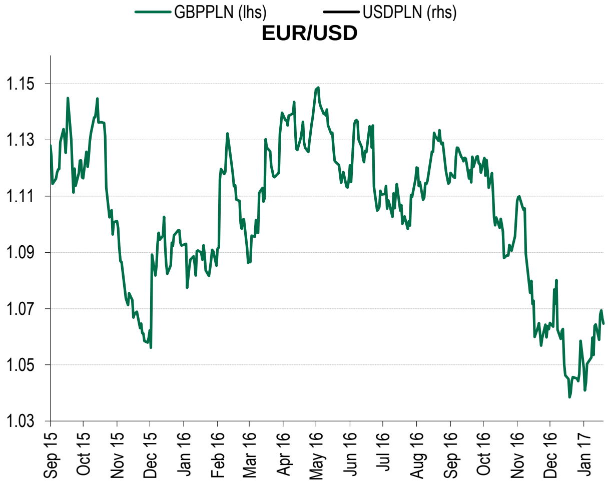
In my view, any change in monetary policy parameters would be bad for the economic stability. Rate cut would destabilize the financial sector, where we still have the unresolved FX loan problem, and this can lead to capital flight. (..) Lower rates would trigger negative events in credit unions or cooperative banks.

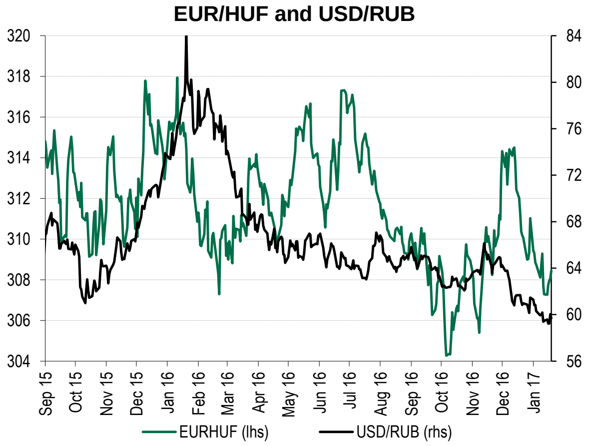
In theory, signals of rebound in economic activity and looming inflation rise may provoke market expectations for interest rate hikes. However, we do not expect the Monetary Policy Council to start thinking about policy tightening anytime soon, as the economic growth is still fragile with many uncertainties on the horizon, while the CPI rebound seems almost entirely commodity-driven, with no signs of building underlying price pressure. The MPC has already softened its tone after the last meeting and, in our view, the recent comments suggest that the central bank will be cooling down expectations for policy tightening, just like it was talking down rate cuts speculations when Poland was in deflation.

Foreign exchange market – Global factors still vital









Zloty waits for impulse

- The Polish zloty was quite stable vs the euro, while it was pretty volatile against the US dollar and the British pound. USDPLN fell temporarily below 4.09, after reaching local maximum slightly above 4.14. This stemmed mainly from the US dollar weakening on the global markets (details below). At the same time the zloty lost quite visibly against GBP (by 0.5% on weekly basis) due to GBP strengthening after PM May's speech and quite strong UK macro data.
- Situation on EURPLN chart did not change much as in the last two weeks the rate moved sideways in range of 4.35 and 4.39. Domestic factors, including rating agencies' review of Poland's rating and macro data releases, did not have a significant impact on the zloty last week. Currently, the rate is close to the bottom of the range, waiting for an impulse. We reckon that weekly fluctuations of EURPLN were smaller than in the previous weeks, so we see rising chances for a more significant move in near future.
- Recent zloty's behaviour clearly shows that PLN is quite immune to domestic factors, but very sensitive to external factors. We believe that Donald Trump's speech after his inauguration as the US President will attract investors' attention and may affect financial market globally, including PLN. What is more, investors will focus on external macro data releases, in particular the US ones, and will interpret these readings with respect to further Fed's actions. Recent Fed members' comments (including Fed Chair Janet Yellen) suggest that rate hikes will be gradual and prudent. However, another set of strong USA macro data could strengthen expectations for faster rate hikes (which is not our baseline scenario) and this might bring impulse for the zloty's more significant move. We uphold our view that FOMC will deliver two hikes of 25bps in 2017, with the first hike in June and the second in December.

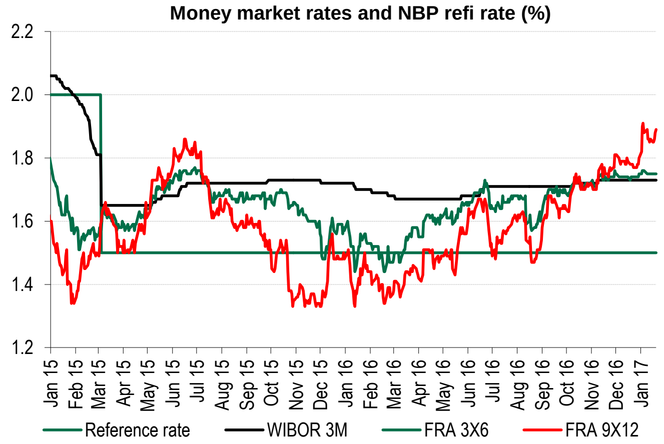
EURUSD close to 1.06 again

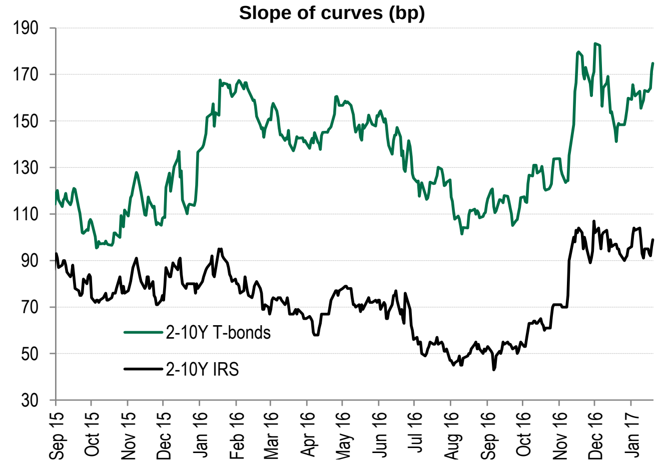
- The US dollar started the week quite strong, with EURUSD falling temporarily slightly below 1.06. However, the rate quickly moved up to above 1.07 for a while, in response to decline in the demand for safe assets and the speech of Donald Trump, in which the President-elect expressed concern about the USD strength. However, strong US macro data and still dovish rhetoric by ECB pushed EURUSD down towards 1.06. At the same time, the British pound gained after PM Theresa May promised a parliamentary vote on Brexit and after strong UK economic data.
- This week is quite heavy on macro data releases in Europe and in the USA, with the US advance 4Q16 GDP data being crucial. The market can react more significantly to stronger figure as it may signal that FOMC could deliver more rate hikes later this year. Consequently, EURUSD may fall towards this year's low of slightly below 1.04.

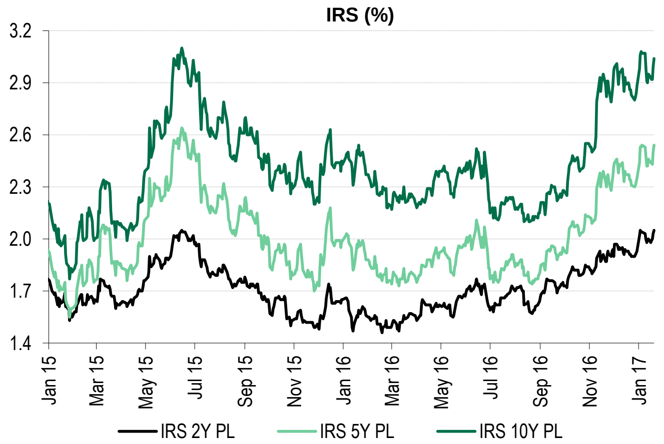
Mixed picture among CEE currencies

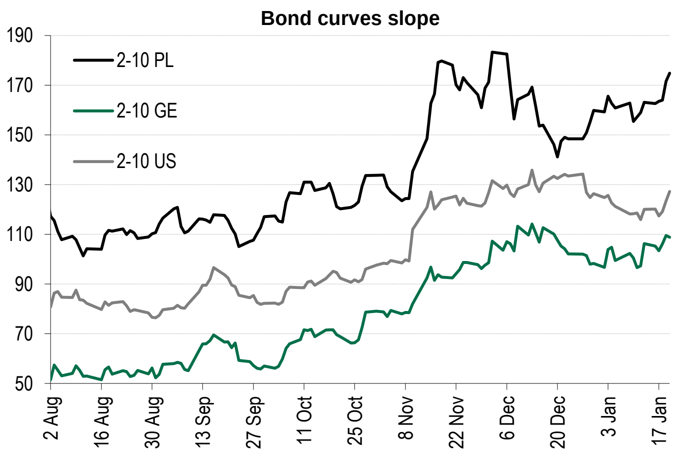
- Last week brought gradual weakening of the CEE currencies. Volatility of EURCZK has increased significantly in the recent weeks, as the faster-than-expected CPI increase spurred some speculation that the CNB would lift the FX floor earlier than the initially planned mid-2017. The Board officials do not exclude such scenario. On the other hand, USDRUB has remained sensitive to oil price changes, with the rate reaching this year's minimum near 59.
- Global factors remain important for investors' sentiment towards CEE. We believe that the central bank (MNB) meeting in Hungary can also influence investors' mood in the short run. We expect MNB to keep its monetary policy unchanged.

Interest rate market – All eyes on the USA









Rates up

- On January 13th, Moody's and Fitch did not change Poland's rating or its outlook which was supportive for the domestic bonds at the beginning of the week. However, the next sessions brought fast rise in IRS and yields driven by hawkish comment of Fed's Yellen, solid Polish and US macro data and market pricing that Donald Trump will fuel expectations for more fiscal boost during his inaugural speech. As a result, IRS and bond curves shifted even 9bp up last week with the biggest changes on the belly and long end. Polish curves continued to steepen as the 2-10 spread rose above 170bp for bonds and to nearly 100bp for IRS.
- 1-12M WIBORs stayed flat last week. FRA curve steepened as the longer rates moved up following the IRS.

All eyes on the USA

- The tone of Donald Trump inaugural speech should set the direction for the market early next week. The market was pretty disappointed after his last press conference when he did not make any reference to his economic strategy while this issue is key for global investors.
- Market attention will focus on the US not only due to Trump's inaugural speech but also thanks to important macro data from the world's biggest economy due to be released at the end of the week.
- Polish bond curve has been steepening since mid-December. At the same time, the Bund 2-10 spread rose only marginally and for the US Treasury curve, it was actually falling for the better part of that time thanks to strengthening on the long end. When we look at the two-month 10Y correlations with German and US benchmarks, the respective figures are at 0.35 and -0.40. Polish debt is not even highly correlated with its CEE peers. However, if signals from the US are really strong, Polish IRS/yields are likely to respond noticeably.
- FRA currently prices in two 25bp rate hikes in Poland in the next 21 months which, in our view, looks exaggerated or at least should not become even more aggressive. We expect the first hike in late 2018 by 25bp as the inflation target should not be reached until then and the GDP growth would be only slightly faster than we forecast it for 2017.
- The Ministry of Finance announced that OK0419, PS0422, WZ1122, WZ0126 and DS0727 bonds worth PLN 6-9bn will be offered at the Monday's auction. According to the most recent data, at the end of November, Polish investors were bigger holders of the offered series than the nonresidents. Polish market participants held 80% of PS0422 outstanding (70% of this by banks), nearly 100% of WZ0126 and WZ0122 (50% by banks and 50% by mutual funds), 64% of DS0727 (45% of this by banks, 28% by mutual funds). The demand from domestic players is likely to decide if the Monday's auction is successful. Inflow of nearly PLN14bn from redemptions and coupon payments will take place on the day of the Monday's auction settlement out of which Polish investors will get a vast majority.

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