Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

31 July – 6 August 2017

Events that had the biggest impact on Polish assets last week were the surprising decision of the president Duda to veto two out of three bills against which protests broke out recently in Poland and dovish statement from the FOMC meeting. The European Commission warned it could take action against Poland which prevented the zloty from benefiting from dovish signals from the Fed. Polish bonds underperformed their European peers, but similarly to the FX market, volatility was not higher than in the previous week.

As regards global issues, market will remain focused on the US where important macro data will be released. In Poland, we will learn PMI and flash CPI for June that in our view will not have any material impact on the zloty and bonds.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (31 July)					
11:00	EZ	Flash CPI	Jul	% y/y	1.2	-	1.3
14:00	**PL**	**Flash CPI**	**Jul**	**% y/y**	**1.7**	**1.6**	**1.5**
16:00	US	Pending home sales	Jun	% m/m	1.0	-	-0.8
		TUESDAY (1 August)					
9:00	**PL**	**PMI – manufacturing**	**Jul**	**pts**	**53.5**	**54.0**	**53.1**
9:00	HU	PMI – manufacturing	Jul	pts	-	-	57.2
9:30	CZ	PMI – manufacturing	Jul	pts	-	-	56.4
9:55	DE	PMI – manufacturing	Jul	pts	58.3	-	59.3
10:00	EZ	PMI – manufacturing	Jul	pts	56.8	-	57.3
11:00	EZ	First GDP Estimate	2Q	% y/y	2.1	-	1.9
14:30	US	Personal income	Jun	% m/m	0.4	-	0.4
14:30	US	Consumer spending	Jun	% m/m	0.2	-	0.1
14:30	US	Core PCE inflation	Jun	% y/y	-	-	1.4
16:00	US	ISM – manufacturing	Jul	pts	56	-	57.8
		WEDNESDAY (2 August)					
14:15	US	ADP report	Jul	k	195	-	158
		THURSDAY (3 August)					
09:55	DE	PMI – services	Jul	pts	53.5	-	53.7
10:00	EZ	PMI – services	Jul	pts	55.4	-	54.7
11:30	**PL**	**Bond auction**					
13:00	CZ	Central Bank decision		%	0.25	-	0.05
13:00	UK	Central Bank decision		%	0.25	-	0.25
16:00	US	ISM – services	Jul	pts	56.5	-	57.4
		FRIDAY (4 August)					
08:00	DE	Factory orders	Jun	% m/m	-	-	1.0
14:30	US	Change in nonfarm payrolls	Jul	k	183	-	222
14:30	US	Unemployment rate	Jul	%	4.3	-	4.4

Source: BZ WBK, Reuters, Bloomberg

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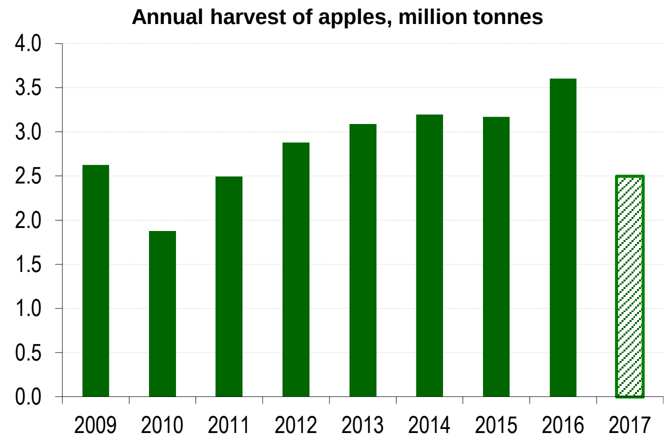
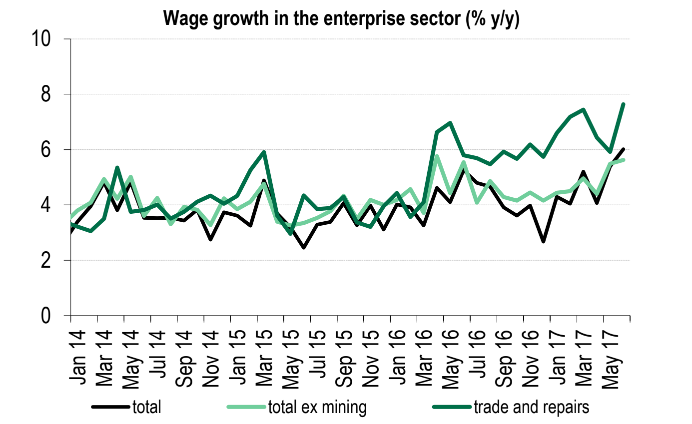
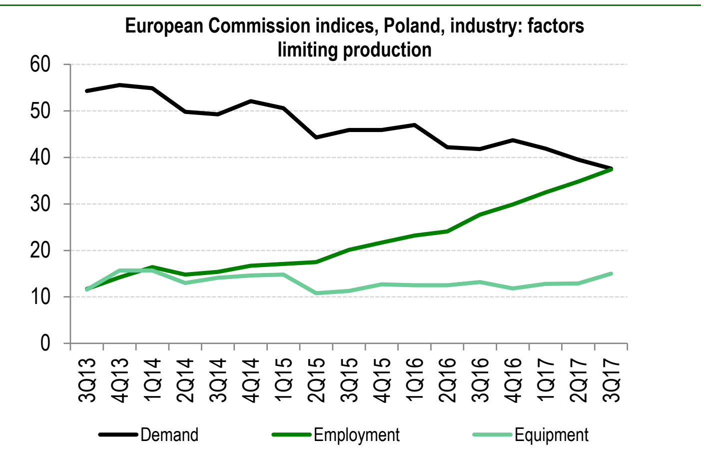
What's hot next week – Flash CPI and PMI



- We expect July's CPI to inch up to 1.6% y/y, mostly because of higher annual growth of food prices (especially meat and fats). In our view, the upward trend in fats may run out of fuel soon, but could be replaced by rising fruit prices. According to the Statistics Office, freeze in April and May caused massive losses in case of cherries (crops lower by 60% y/y), apricots and peaches (50%), plums (40%), apples (30-35%), pears (25-30%), currants (20%), raspberries (20%) and strawberries (10%). On the other hand, the rainy weather prevented many farmers from spraying of parasites, so quality of fruit will be lower and this factor is likely to limit the upward price tendencies.
- We expect PMI for Polish manufacturing to go up to 54.0 in July. Our forecast is supported by improving moods in Europe (e.g. Ifo) and rising climate indices for Poland (e.g. ESI, Statistics Office measures).

Last week in economy – Business climate still positive, rising wage pressure





- The registered unemployment rate reached 7.1% in June vs 7.4% in May. On a monthly basis the number of unemployed dropped by 50.5k versus 64.4k a year before, which is a sign that it is losing momentum. We expect that the unemployment rate will end the year at 7.0% while the seasonal factors can keep it in the 6.7-7.0% range throughout the second half of the year.
- Detailed information on wages in June showed that the surprisingly strong acceleration from 5.4% y/y to 6.0% resulted partially from one-off factors (wage growth by 86% y/y in non-coal mining). However, the wage increase in non-mining sectors reached 5.6% y/y from 5.5% in May and 4.4% for April. This was also a significantly higher pace than the average wage growth recorded in 1Q (4.6%). The June acceleration of wages was reflected in a few sectors, which in our opinion is a prognostic of increasing wage pressure. Wages in the retail trade sector pushed from 5.9% to 7.6% y/y which happens to be the highest result since late 2008.
- July business sentiment indices from GUS showed no correction in an already very optimistic picture and further progress when it comes to the manufacturing sector. Producers expressed more optimism when it comes to future output and future employment. This sub-index went to the highest level since 2007 suggesting that the labour demand remains strong. Similar indices published by the European Commission were also quite stable in July with the exception of retail trade where a slight decline was reported, same as in consumer confidence). The quarterly EC survey revealed that already 37% of industrial enterprises are feeling labour market shortages, which is a rise by 10pp in a year.

Quote of the week – The systemic threat to the rule of law in Poland rising

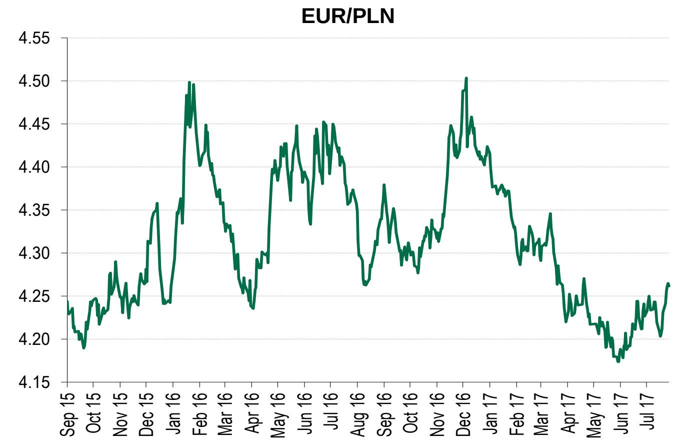
European Commission, press release, 26 July 2017

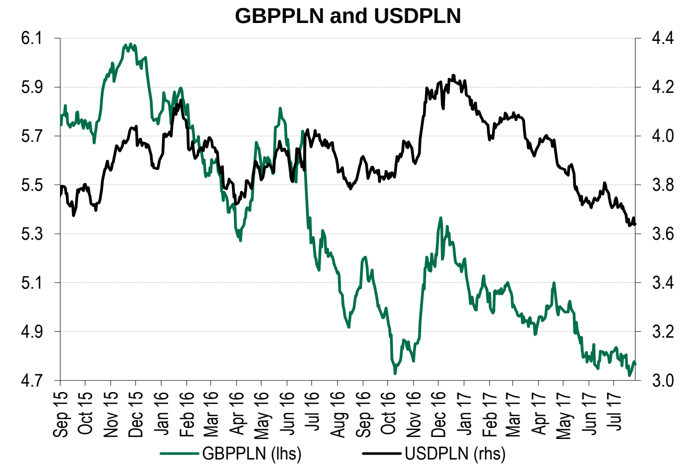
The Commission substantiates its grave concerns on the planned reform of the judicial system in Poland in a Rule of Law Recommendation addressed to the Polish authorities. In the Commission's assessment, this reform amplifies the systemic threat to the rule of law in Poland already identified in the rule of law procedure started by the Commission in January 2016. The Commission requests the Polish authorities to address these problems within one month. The Commission asks the Polish authorities notably not to take any measure to dismiss or force the retirement of Supreme Court judges. (…)

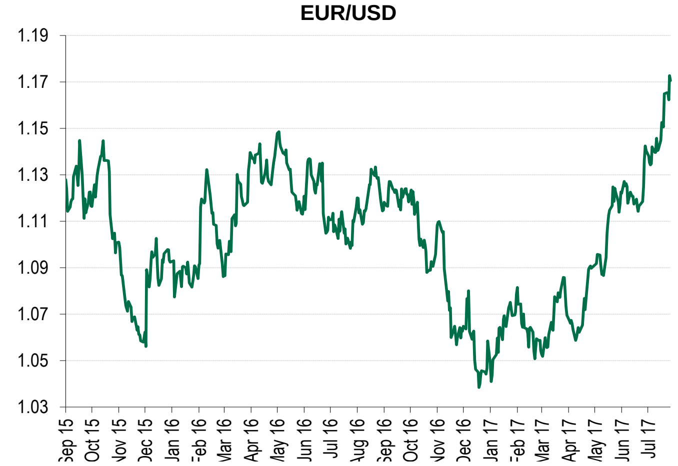
The Commission also decides to launch an infringement proceeding against Poland for breaches of the EU law. The College will immediately send a Letter of Formal Notice once the Law on the Ordinary Courts Organisation has been published.

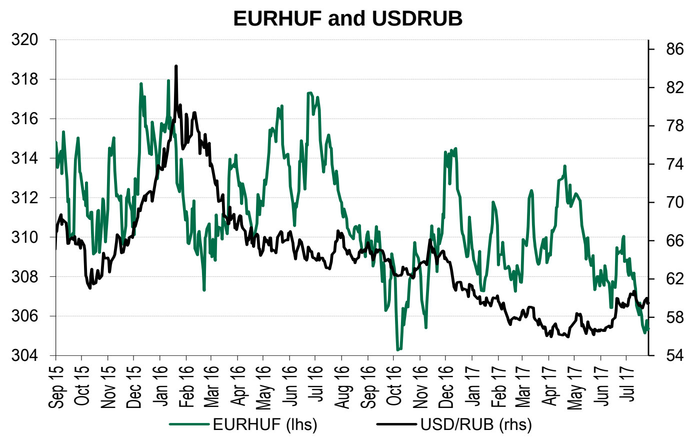
The European Commission has issued the Rule of Law Recommendation, decided to launch an infringement proceeding against Poland and set a one-month deadline for the government to address the controversial issues. What happens if the government does not listen to the suggestions? The risk of further EC actions will increase, including the triggering of the Article 7 of the EU Treaty. Initially, it will be the Article 7(1), which is a formal warning by the EU that can be issued by four fifths of the Member States in the Council of Ministers, while ultimately it may end up with the Article 7(2), i.e. the sanctioning mechanism (however, it requires a unanimous decision of the EU members). Summing up, the perspective of substantial economic consequences for Poland is still quite distant, and seems not extremely likely.

Foreign exchange market – Awaiting US data









Zloty stable vs euro

- EURPLN stabilized after the biggest weekly rise this year and the exchange rate stayed in the 4.24-4.27 range. Surprisingly, president Andrzej Duda declared he would not sign two out of three bills against which protests broke out recently in Poland. This decision pushed EURPLN to the weekly low but the zloty did not manage to maintain its gains as the European Commission said it was ready to take action against Poland. At the same time, USDPLN stayed in the 3.62-3.66 range while CHFPLN plummeted to c3.73, its lowest since January 2015 when the Swiss central bank dropped EURCHF floor.
- Polish lawmakers are now out for holidays and we expect no progress to be made anytime soon in the relationship between the Polish government and the EC. However, uncertainty concerning the next moves of both parties may limit the potential for the zloty's appreciation.
- This week we will learn Polish PMI and flash CPI for July but we do not expect them to have any material impact on the zloty.
- The US figures could be more important. Market interpreted the FOMC statement as dovish which had only temporary and limited positive impact on the zloty vs the euro. Considering that the internal factors generate rather upside pressure on EURPLN, we think that the US data may have a more noticeable impact on the zloty if they surprise to the hawkish side.

Dovish Fed hits dollar

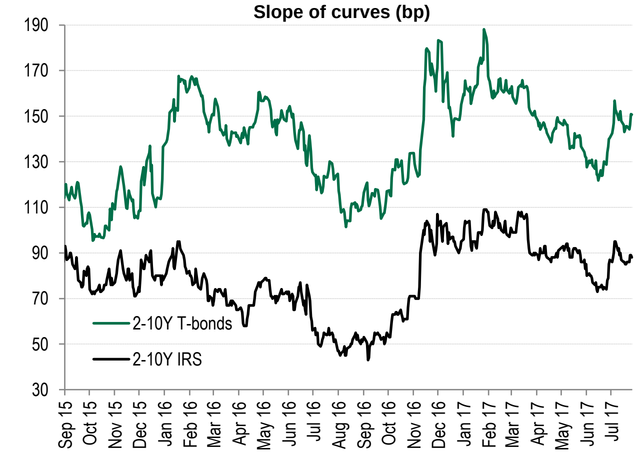
- EURUSD continued the upside trend, although at a slower pace than in the previous weeks. In contrast to what we had expected, investors interpreted the FOMC statement as rather dovish which pushed the exchange rate to nearly 1.18, the highest since January 2015. Strong upside trend is observed also in the case of EURCHF – the exchange rate jumped to nearly 1.14 after the biggest weekly rise since January 2015.
- US events should remain in the spotlight with market attention now focused on the macro data. Given the recent rally, in our view, strong data should have a bigger impact on EURUSD than the below-consensus readings.

CE3 stable

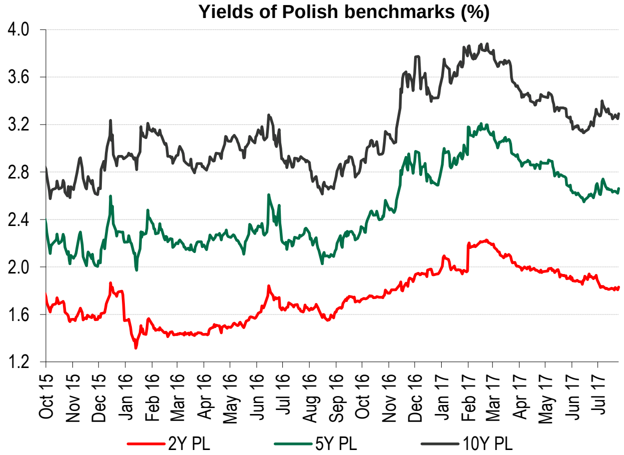
- EURHUF, EURCZK and USDRUB remained stable.
- In line with expectations, the central bank of Russia (CBR) left interest rates unchanged with the main refi rate still at 9%. The bank pointed to inflation uncertainty and geopolitical issues as the main reasons for refraining from rate cuts this time. Still, CBR left the door open for monetary policy easing to be delivered depending on the inflation outlook. There was no reaction of the ruble to the CRB rhetoric.
- The main event of the week in the CEE region will be the decision of the Czech central bank (CNB) on the interest rates. After the CNB dropped the floor in April, the market has started to price in a possible faster monetary policy tightening. The recent comments made by Czech central bankers were pretty straightforward, suggesting that rate hike should be expected this year. The market is not pricing in that a hike could be delivered already this week but if it is, then koruna may gain vs the euro and 26 could be tested again.

Interest rate market – Bond auction in the spotlight

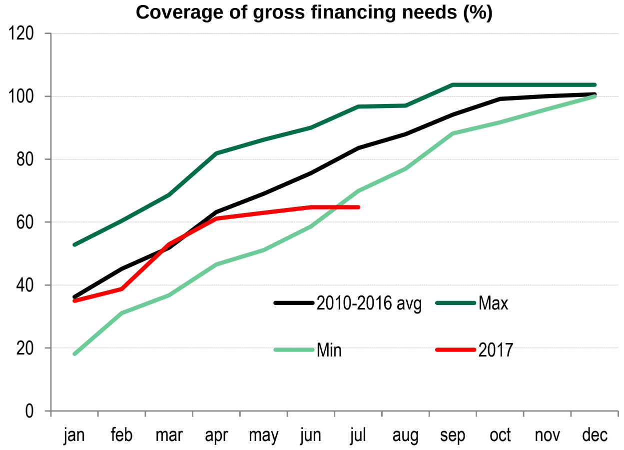
Slope of curves (bp)



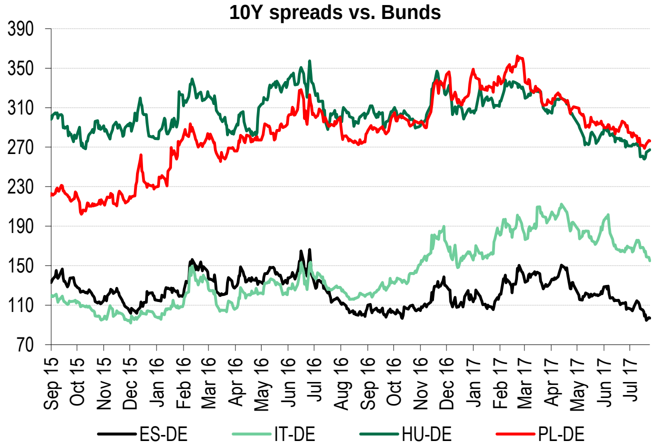
Yields of Polish benchmarks (%)



Coverage of gross financing needs (%)



10Y spreads vs. Bunds



Demand for short end bonds

- Last week, the Polish bond market was under pressure from both domestic and foreign factors. Bond curve steepened clearly more than IRS curve due to the demand for short end bonds and dovish FOMC rhetoric. The bond redemption together with coupon payments resulted in strengthening of 2Y bond by 4bp and increase in 2-10Y spread to 151bp, the highest level since March this year.
- Recent political turmoil in Poland regarding the judicial system weakened Polish bonds that underperformed its peers. Long end rose by 3bp, while Hungarian and Romanian benchmarks increases by 0.5bp and 1bp, respectively. The risk premium for Polish assets measured with 10Y spread to Bund increased markedly to 278bp while it remained stable for other markets.
- Despite the dovish rhetoric of the Fed 10Y Treasuries yield increased by 8bp to 2.32%. Euro zone bonds also lost with the strongest yield rise of Spanish and Italian bonds. Bund outperformed its peers, but the yield rose to 0.57%

Bond auction on Thursday

- On Thursday the Ministry of Finance will sell bonds on the first auction since June this year. Probably the new 5Y benchmark bond will be issued as deputy finance minister informed last month that PS0422 would no longer be offered.
- In our view, the debt supply amount will be limited to PLN3-10bn due to the state budget surplus after June and high amount of funds in PLN and in foreign currency on budgetary accounts at the end of 1H17 (PLN85.1bn).
- This year's borrowing needs are now covered in 70%, slightly below the pattern seen in the previous years. Last week deputy PM Morawiecki stated this year's budget deficit may be lower than planned by over PLN10bn. We think it may be even by PLN30bn lower than planned, as long as current tendencies hold, so the MinFin may start pre-financing of the borrowing needs earlier and to the larger extent than previously assumed.

Market volatility to remain high

- Last week FOMC meeting resulted in weakening market expectations regarding US interest rate hike this year. The probability of interest rate change in December dropped to less than 40%. The Fed statement of the "relatively soon" start of its balance reduction pushed bond yields up with 10Y UST close to 2.32%.
- At the beginning of the week we will find out the July flash CPI reading in Poland. Our estimate of inflation moves up to 1.6%, but it does not affect the general outlook. The impact on Polish bond curve should be neutral, in our view.
- In our view the front end of the bond curve should remain stable and close to 1.75-1.77%. The recent unrest in Poland may weaken foreign investors' appetite for Polish assets, so the belly and the long end will be driven by internal and external factors. We see the risk of further widening asset swap spread and 10Y PL-DE spread above 275bp.

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 87, email ekonomia@bzwbk.pl