Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

19 – 25 January 2015

The completely unexpected decision of the Swiss National Bank to abandon the 1.20 floor for EURCHF was last week's main event that led to high volatility across the FX and FI markets around the world. But we think that dropping the fixed peg versus the euro does not mean that the Swiss central bank will tolerate significant currency strengthening against its basket of currencies in the long run, so the Swiss franc may be pushed weaker over time either by direct FX interventions or even deeper negative interest rates. Still, EURCHF may not return to 1.20 quickly, unless the euro appreciates sharply versus dollar following the ECB's decision. This implies that we expect CHFPLN to get lower in the following months, although the currency will probably remain above the levels seen just prior to the SNB's unexpected move. Even if we assume that CHFPLN stabilises at 4.3, it implies additional cost of CHF-loan servicing for households of c.PLN1.5bn per annum. Meanwhile, households should save at least PLN3bn on the servicing of other loans thanks to the recent drop of PLN interest rates and save at least PLN6bn per year (or more) on the lower costs of fuel. All this at a time of recovery on the labour market, which is well under way. As a result, we think that the outlook for private consumption growth this year is still relatively optimistic.

The market's attention will be focused on the ECB this week. The market is strongly betting on an initiation of QE, especially now that some interpreted SNB's latest move as a signal of comprehensive action by the ECB. Any disappointment could potentially have a huge impact on the market, prompting higher volatility and risk aversion. In contrast, if the ECB delivers according to expectations, the zloty should gain but room for further decline of yields seems limited. Polish data to be released before the ECB decision should be relatively strong, showing an improving labour market and a rebound in output growth in December.

Economic calendar

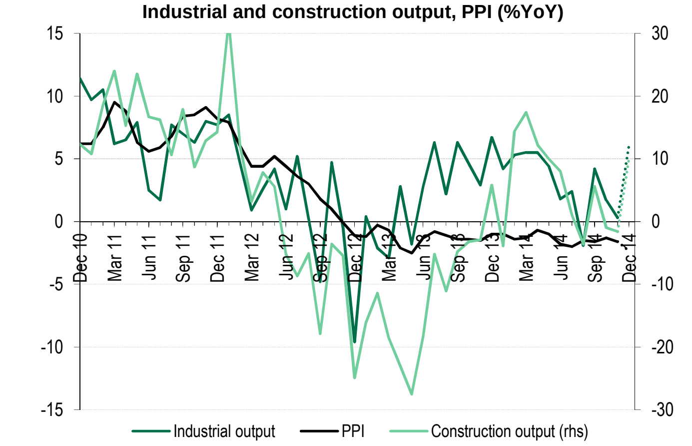
TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (19 January)					
		No important data releases					
		TUESDAY (20 January)					
11:00	DE	ZEW index	Jan	pts	12.0	-	10.0
14:00	**PL**	**MPC minutes**			**-**	**-**	**-**
14:00	**PL**	**Wages in corporate sector**	**Dec**	**%YoY**	**3.1**	**2.6**	**2.7**
14:00	**PL**	**Employment in corporate sector**	**Dec**	**%YoY**	**1.0**	**0.9**	**0.9**
		WEDNESDAY (21 January)					
14:00	**PL**	**Industrial output**	**Dec**	**%YoY**	**4.9**	**6.1**	**0.3**
14:00	**PL**	**Construction and assembly output**	**Dec**	**%YoY**	**4.3**	**10.1**	**-1.6**
14:00	**PL**	**PPI**	**Dec**	**%YoY**	**-2.1**	**-2.3**	**-1.6**
14:30	US	House starts	Dec	k	1040	-	1028
14:30	US	Building permits	Dec	k	1055	-	1052
		THURSDAY (22 January)					
11:00	**PL**	**Bond auction**					
13:45	EZ	ECB decision		%	0.05	-	0.05
14:30	US	Initial jobless claims	week	k	-	-	316
		FRIDAY (23 January)					
2:45	CN	Flash PMI – manufacturing	Jan	pts	49.5	-	49.6
9:30	DE	Flash PMI – manufacturing	Jan	pts	51.6	-	51.2
10:00	EZ	Flash PMI – manufacturing	Jan	pts	51.0	-	50.6
16:00	US	Home sales	Dec	%MoM	2.4	-	-6.1

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

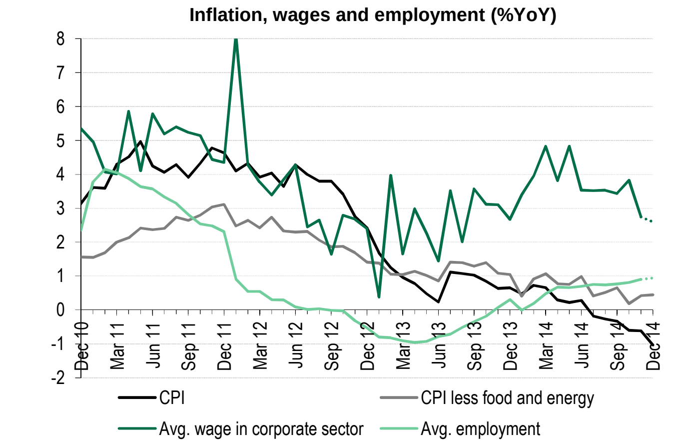
What's hot this week – Central banks remain in the spotlight

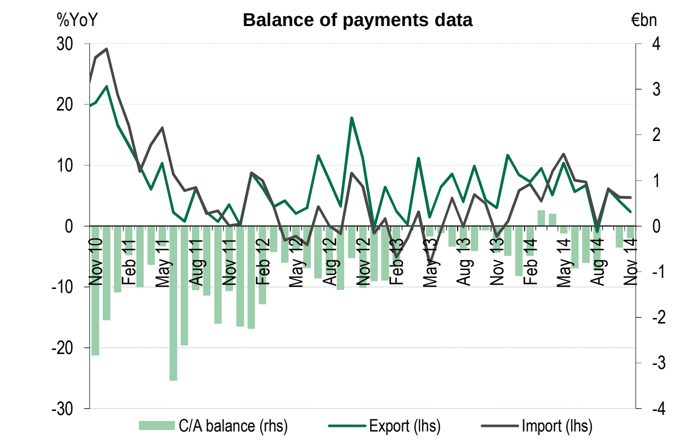


▪ Polish macro data releases scheduled for this week should be relatively strong, showing a rebound in output growth in the manufacturing and construction sectors (our production forecast is well above market consensus) and a continuation of employment growth in the corporate sector. These data should confirm, in our view, that GDP growth in Poland probably remained above 3% at the end of 2014. On the other hand, PPI deflation is likely to deepen, approaching an all-time low.

▪ Domestic data may trim expectations for an interest rate cut, at least temporarily, but in fact they may be overshadowed by the ECB's decision on Thursday. The market is strongly betting on an initiation of QE, especially now that some interpreted SNB's latest move to scrap its currency peg as a signal of comprehensive action by the ECB. Any disappointment could potentially have a huge impact on the market, prompting higher volatility and risk aversion.

Last week in the economy – Interest rates on hold, prices keep falling





▪ The MPC kept interest rates on hold in January, with the reference rate still at 2.0%. However, changes in the official statement and comments of the NBP governor during the press conference suggested, in our view, that the majority of the Council members could vote for more policy easing should new data point to deeper and longer deflation and weaker economic growth. In fact, this is exactly the scenario that we anticipate. And CPI data released one day after the MPC meeting seems to confirm that this scenario is already materialising. We think that one more interest rate cut is possible in March, when the central bank's new projections will be available. A cut in February also cannot be ruled out, but only if incoming data on activity disappoint and the financial markets stabilise.

▪ CPI inflation decreased in December 2014 to -1.0%YoY from -0.6%YoY in November, coming in below expectations. In monthly terms, consumer prices fell 0.3% and the deflation deepened mainly due to falling prices of fuel, footwear and clothing, as well as stable food prices. Core inflation, excluding food and energy prices, remained at 0.5%YoY. We expect the deflation to deepen further in upcoming months, even to c.-1.5% in February) and to persist until 3Q or 4Q 2015.

▪ Exports rose 2.3% YoY to €13.6bn in November and imports rose 4.7% YoY to €13.7bn. Imports surprised to the upside and this probably reflects the continuously strong domestic demand in 4Q14, which, in our view, to some extent offsets the weaker external demand. Poor economic growth in Europe may continue to weigh on exports in the nearest months. The current account deficit in November amounted to €268m. According to our estimates, the 12-month current account deficit stood at 1.3% of GDP.

▪ M3 money supply rose 8.4%YoY in December, unchanged vs. November. Data showed minor deceleration in loan growth.

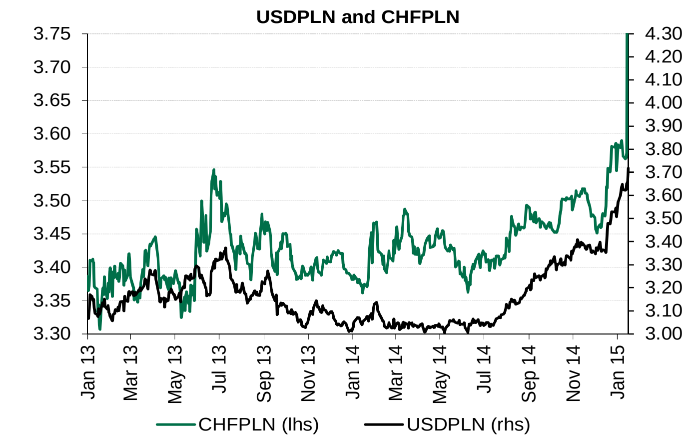
Quote of the week – Deflation may be a factor encouraging the MPC to act

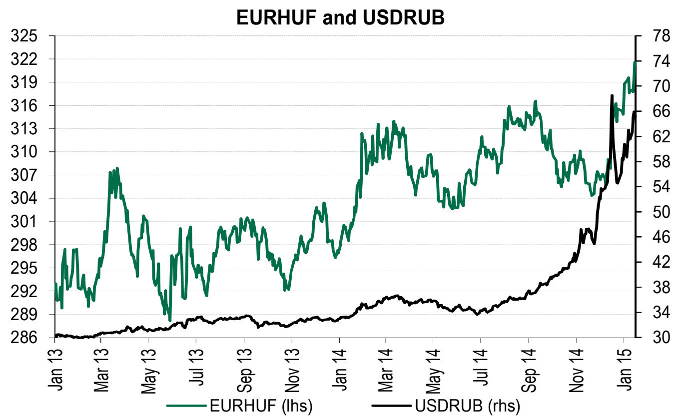
Marek Belka, NBP governor, 14.01.2015, MPC conference

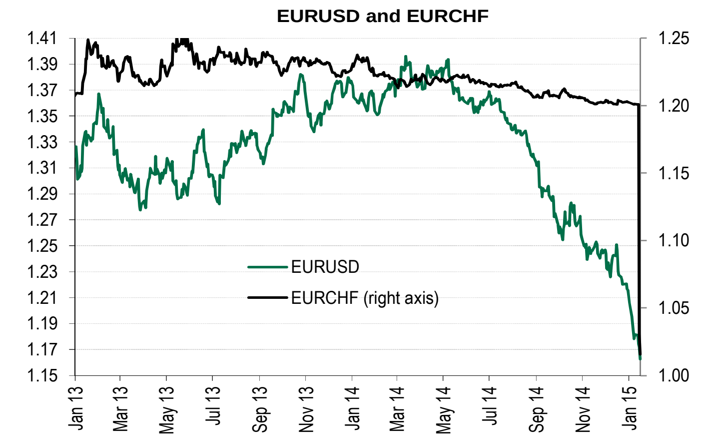
The prolonging deflation is important and may be an important factor, encouraging the MPC to act (…) Last weeks saw destabilisation in the financial markets – and so this is not the best moment to modify rates, most MPC members had agreed (…) Financial stability, not currency stability, is an argument for those MPC members, who do not want to cut rates. Ultra-low interest rates worldwide cause overly big yet difficult to forecast capital flows. (…) The crucial argument against rate cuts is that interest rates are so low that they can destabilise behaviour of the economic agents. (…) Myself, I think there is a room to cut rates.

Deflation seems to have finally become one of the MPC's major concerns and the expected persistent period of negative price growth was mentioned in the official statement as one of the conditions that could lead to even lower rates. In our view, the depth and length of deflation will indeed surprise the central bankers, as it may last even until 4Q15, and this should finally encourage the MPC to ease policy. Volatility on the financial markets (if it persists) and the likely decent economic data due for release soon (December's production, 2014 GDP) could be factors that will prevent the MPC from acting, at least in February. Results of the MPC's voting in December showed that only Andrzej Bratkowski backed the motion to cut rates by 100bp. But this does not mean that other MPC members no longer support further easing: they simply may have decided to "wait and see".

Foreign exchange market – Will the EBC satisfy investors?







Zloty under pressure from the SNB …

- Poland's zloty did not benefit from the global mood improvement at the start of last week due to weakening of the other CEE currencies (Hungarian forint, Russian ruble) and expectations for rate cuts by the MPC. The Council's decision to keep interest rates unchanged last Wednesday helped the zloty rebound slightly but its gains were short-lived due to the unexpected decision of the SNB that caused a wide range of assets to sharply weaken, including the Polish zloty. As a result, EURPLN quickly rose towards 4.35, while USDPLN climbed towards 3.73. CHFPLN was the most volatile, with the exchange rate temporarily reaching nearly 5. However, the sharp move vs. the Swiss franc was only short-lived because it happened when liquidity had nearly dried up as investors were completely surprised by the SNB's move. At the end of Thursday's session some recovery was recorded and CHFPLN fell to 4.20. Towards the end of the week the zloty remained under pressure, staying at elevated levels against the main currencies, with CHFPLN staying near 4.25.
- This week might again change the situation on the domestic FX market quite visibly. First, we expect decent growth of industrial output and construction. If so, the data might cool interest rate cut expectations. Second, the ECB is widely expected to announce its QE programme. These two factors should be supportive for the zloty and are likely to help the domestic currency rebound, pushing EURPLN down towards 4.25. Changes vs. the Swiss franc are far more unpredictable right now, but we believe the Polish currency will also recover here.

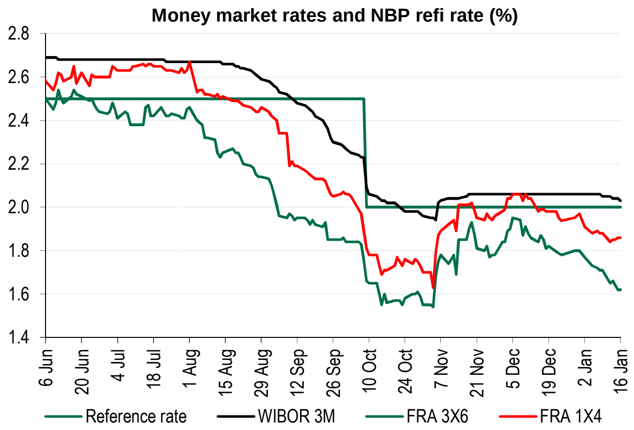
… like other emerging market currencies

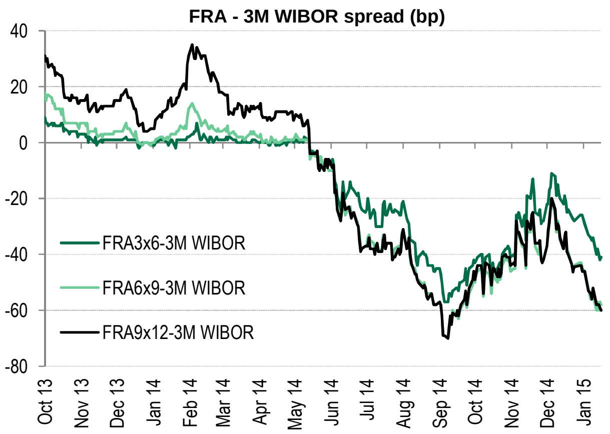
- The SNB's shocking decision caused significant weakening of the other CEE currencies, especially the Hungarian forint, which hit an all-time low versus both the euro and the Swiss franc. The panic triggered by the SNB sent HUF temporarily to 327.60 against the euro, while CHFHUF reached 393.
- CZK remained weak this past week due to expectations that the increasing deflation risk would allow the CNB to shift the EURCZK floor up. At the same time, the Russian ruble was under pressure from the falling oil prices (which temporarily fell below 45 $ per barrel).
- This week, the situation on the CEE market will mainly depend on the global sentiment, with the ECB meeting being the key event. We believe that the QE announcement by the ECB would likely help the CEE currencies recover slightly.

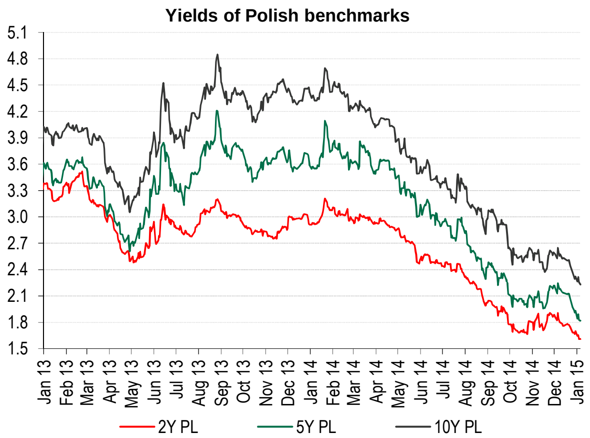
SNB scraps cap on franc, drops bombshell on markets

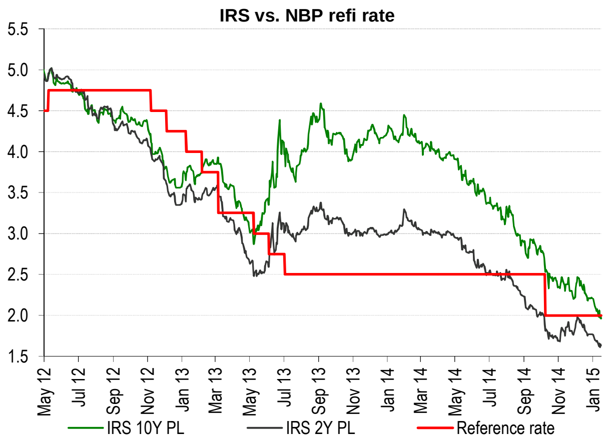
- Last week, the SNB shocked the markets by scrapping its long-held EURCHF floor at 1.20. It also cut rates by 50bp. Unsurprisingly, the CHF firmed significantly against the EUR on the announcement. EURCHF dropped almost 30% to 0.85, but quickly rebounded back to 1.02. Meanwhile, USDCHF fell to 0.7406 (from 1.0240), a level previously seen in 2011, but then also rebounded to 0.8778, where it is staying for now. At the same time, the US dollar continued its gradual strengthening against the euro. EURUSD tested 1.15 at the end of the week (down from 1.186 at the start of the week).
- The ECB will be the key event this week. The market expects the ECB to deliver its QE programme, particularly since the EU Court of Justice released a positive opinion on the legality of the OMT measures. In our view, this decision is already largely priced-in, we, therefore, do not exclude a gradual upward move in EURUSD after the announcement. However, any negative surprises from the ECB could increase volatility on the market.

Interest rate market – ECB may set the medium-term direction









IRS and bond yields at record lows

- Rates in the Polish fixed income market fell this past week along the curves as expectations for more easing by the MPC and ECB kept strengthening. The 1-12M WIBOR rates dropped by 2-4bp, mostly on the long-end, while the scale of the drop in 3M WIBOR priced in by the FRA expanded by nearly 10bp (to above 40bp in the next 3 months and nearly 60bp in 6 months). The IRS and bond yields were very volatile during the past week but, in the end, both curves were 5-12bp lower than on the previous Friday and reached their fresh all-time lows (2Y IRS at 1.61%, 5Y at 1.70%, 10Y below 2%).
- The Monetary Policy Council's decision to keep interest rates on hold did not surprise. However, changes in the statement and comments of the NBP governor during the press conference suggest, in our view, that the majority of the Council members could vote for more policy easing should new data point to deeper and longer-lasting deflation and weaker economic growth. This is exactly the scenario that we anticipate and the latest CPI data for December confirmed that this scenario was in fact materialising.
- The unexpected SNB decision to drop the 1.20 floor was interpreted by some as a step aimed to make defending the floor less costly ahead of this week's ECB decision to extend its asset purchase programme, which is likely to depreciate the euro further. Thus, expectations for decisive action of the ECB also supported the Polish FI market.
- The Finance Ministry sold long-term WZ0124, DS0725 and WS0428 bonds worth PLN4.2bn in total, slightly less than previously planned (the maximal value of the offer amounted to PLN5.0bn). The auction drew high demand, at PLN9.4bn, with most bids on the WZ0124 (over PLN5bn) and least on the WS0428 bond (PLN860mn). Yields of the DS0725 and WS0428 bonds reached 2.295% and 2.308%, respectively, and were slightly above the secondary market's levels. We estimate that this auction helped the Ministry cover nearly 35% of its 2015 borrowing needs.
- As the sale missed the initial plan at the auction, the supply level planned for the next auction (Jan. 22) will probably remain unchanged (the Ministry had suggested earlier that supply on Jan. 22 may be trimmed if they sell the full amount on Jan. 15).

ECB may set the medium-term direction

- The FI market sentiment has clearly been on the dovish side recently. However, we expect some hawkish signals this week as, in our view, industrial output data for December could surprise to the upside, weakening market hopes for swift interest rate cuts. Such a positive surprise could make the market remember that the NBP governor said during the last press conference that there was no rush with rate cuts.
- Still, the effect may be only short-lived since the market's attention will largely be focused on the ECB in the second half of the week, which, in our view, may be an event that will determine market trends on the global FI markets in the coming weeks or even months. The global FX and core FI markets have already priced in a lot of easing that the ECB is expected to announce, so that the central bank would have to start truly substantial purchases to push yields in the global market even lower. Perhaps the somewhat desperate step of the SNB suggests that this will actually happen later this week. If not, profit taking should be expected, especially if we add the potentially hawkish Polish data that could push the domestic IRS and bond yields up at least in the short term.
- Note that this will be also the last week before the Greek parliamentary elections and investors may be also quite sensitive to any news ahead of this important event.

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.