Bank Zachodni WBK

Weekly economic update

8 – 14 October 2012

The event that had the biggest impact on domestic market last week was the MPC's decision to keep interest rates on hold, which surprised the market, triggering a correction in the short end of the yield curve (mainly in FRA market, to a smaller degree also in bond market) and initiating significant zloty appreciation. Nevertheless, the tone of the MPC communiqué has been softened again. Moreover, the Council said in the statement that it is going to relax the policy if new information (including November NBP's projection) will confirm persistence of economic slowdown, while risk of inflationary pressure remains limited, which in our view is a clear signal of a likely rate cut in November. EBC also kept rates unchanged (in line with expectations), and its president's strong view that the program of bond purchases will be effective improved the market moods. Better-than-expected monthly US non-farm payrolls also contributed to higher demand for risky assets.

Market has positively reacted to Mario Draghi's words, who revived expectations for making further steps towards resolving euro zone's debt crisis. This subject will most likely remain in focus this week, due to planned meetings of the Eurogroup and the Ecofin. The issue of debt crisis will be probably the main factor influencing global financial market, overshadowing macroeconomic data releases. Due to sharp strengthening seen last week, the EURPLN approached the lower limit of consolidation band, in which it has been staying since early September (4.05). It is possible that this level will be tested in the nearest days. This time, events abroad may be more important than domestic factors. Domestic interest rate market will stay under influence of global events. In our view oscillations range 3.95%-4.15% for 2Y bond, 4.15%-4.35% for 5Y and 4.65-4.85% for 10Y remain valid.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (8 October)					
		Meeting of the Eurogroup					
	US	Market holiday					
8:00	DE	Exports	Aug	%MoM	-0.7	-	0.5
10:30	EZ	Sentix index	Oct	pts	-20.4	-	-23.2
12:00	DE	Industrial output	Aug	%MoM	-0.8	-	1.3
		TUESDAY (9 October)					
10:30	IT	GDP	Q2	%YoY	-2.6	-	1.0
		WEDNESDAY (10 October)					
		Meeting of the ECOFIN					
16:00	US	Wholesale inventories	Aug	%MoM	0.4	-	0.7
20:00	US	Fed Beige Book					
		THURSDAY (11 October)					
		Meeting of members of G7 group					
14:30	US	Trade balance	Aug	$bn	-43.9	-	-42.0
14:30	US	Initial jobless claims	week	k	-	-	367
14:30	US	Import prices	Sep	%MoM	0.8	-	0.7
		FRIDAY (12 October)					
11:00	EZ	Industrial output	Aug	%YoY	-4.3	-	-2.3
14:00	**PL**	**Money supply**	**Sep**	**%YoY**	**8.5**	**7.9**	**9.5**
15:55	US	Flash Michigan	Oct	pts	-	-	78.3

Source: BZ WBK, Reuters, Parkiet

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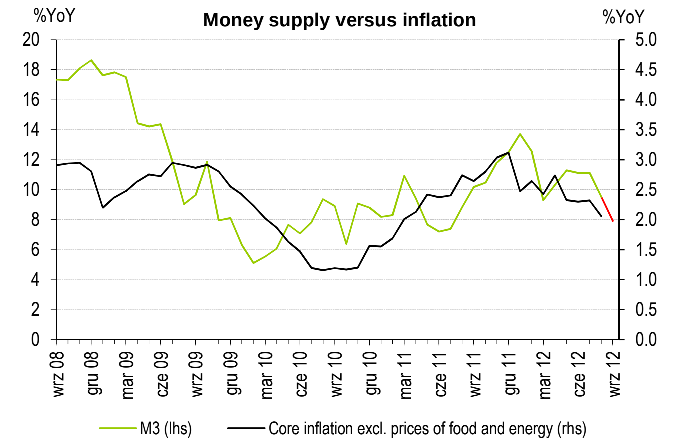
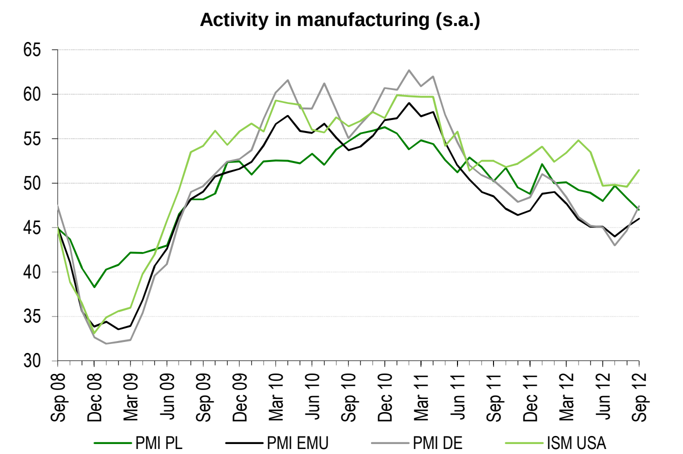
What's hot this week – Important week for the euro zone

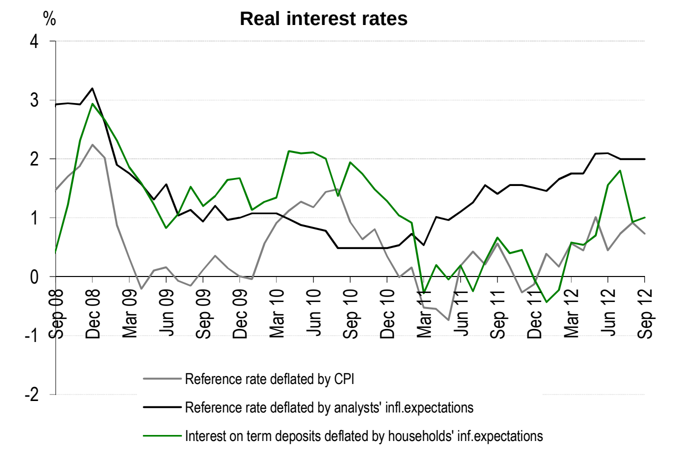


- This week the market participants will probably focus on the euro zone crisis again, as – given relatively light calendar of macroeconomic data releases – meetings of the Eurogroup and Ecofin are ahead (on Monday and Wednesday, respectively). European policymakers are likely to discuss problems of the banking union, single banking supervision, financial help for Spain and Greek progress in implementing reforms (but decision about disbursement of another tranche of bailout for this country will be taken on the EU summit next week at the earliest).
- The only release of domestic data this week – M3 money supply in September – will not affect the trade, as usual. We expect to see a continuation of deceleration of M3, deposits and loan growth.

Last week in the economy – No cut in October, but high chance for November



- PMI for Polish manufacturing declined in September to 47.0 (below our forecast and market expectations) and this is the lowest level since July 2009.
- Apart from categories, which have been moving in a downward trend for a long time (subindexes for output and new orders plunged in September to lowest levels since June 2009) it is worth to notice that for the first time since March the subindex for employment declined below neutral level of 50pts (it reached lowest level since the beginning of the year and second lowest in last 32 months).
- Data from the Polish manufacturing confirm further slowdown of economic activity and a minimal risk of second-round effects.
- PMI indexes for the euro zone and Germany proved to be slightly better than flash estimates and recorded a second increase in a row.



- MPC left the interest rates unchanged in October.
- The tone of the statement was more dovish as compared to September's one. The MPC expects gradual decline of inflation in coming quarters, despite still high risk from elevated commodities prices on the global market. There was a modification of the last, most important sentence of the statement, where the MPC stated that 'should incoming data, including the November inflation projection, confirm that economic slowdown would become protracted, while the risk of increase in inflationary pressure be limited, the Council will ease monetary policy'. This is a very clear hint that main interest rates will most likely be reduced at the next meeting.
- We expect that the MPC will cut rates by 25bps at the November's meeting, while until the end of 1Q2013 the main rate will be trimmed by 75bps.

Quote of the week – We are awaiting the November projection

Marek Belka, NBP president, 03.10, conference after NBP meeting

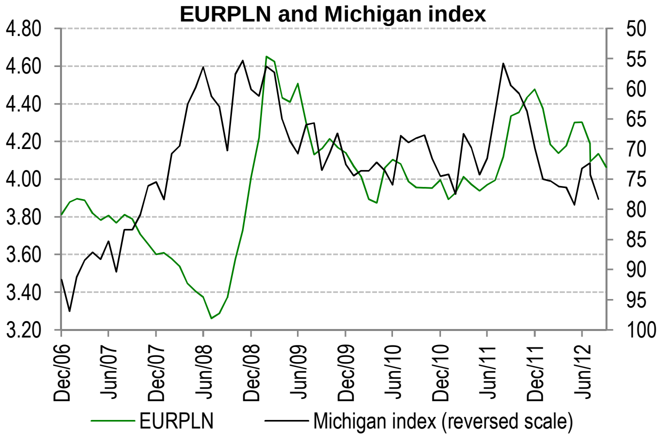
Still high inflation and a willingness to feel sure about tendencies in GDP and inflation – that is why we are awaiting the November projection.

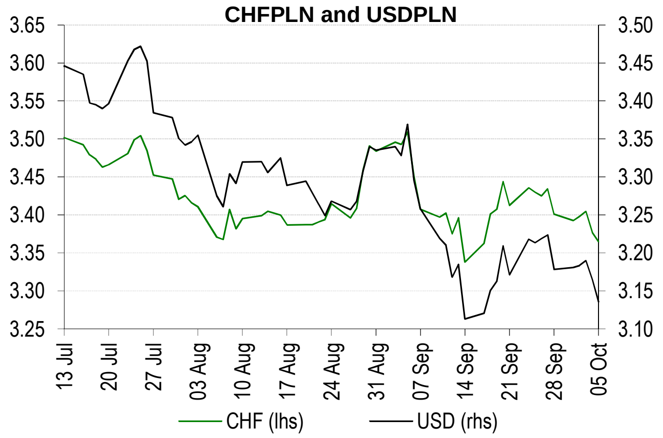
I do not think so [that the May hike was a mistake].

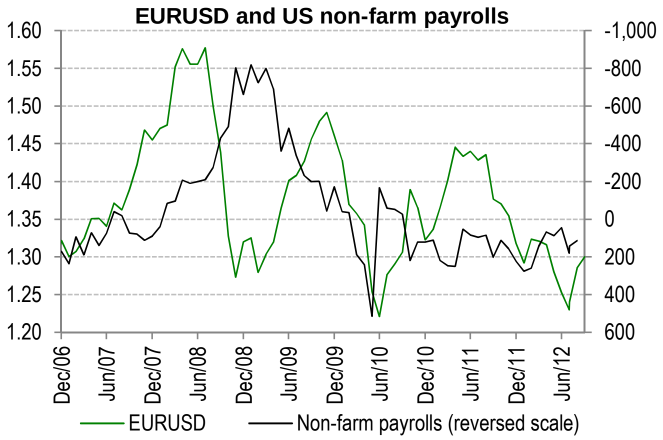
A willingness to keep real interest rates positive is one of the criteria of our policy. Hence, you can guess what is a potential room for interest rates cuts.

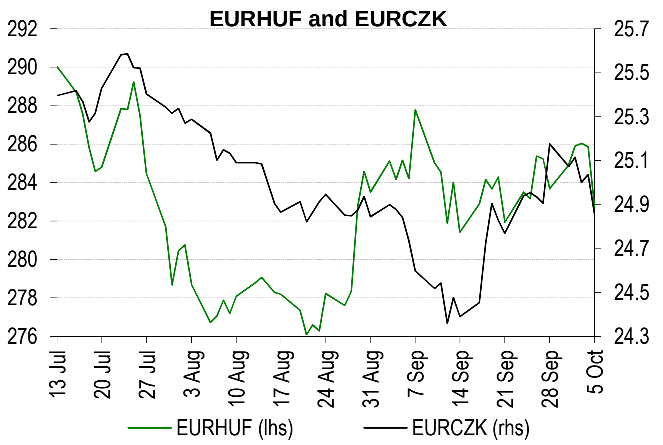
It is puzzling that it is so important for the MPC to see the new NBP projection before implementing a rate cut. Let us remind that the March projection showed a significant economic slowdown and inflation reduction while the July projection confirmed this trend even stronger. Still, MPC decided for a hike in May. So why is this document crucial currently? Possibly a short distance between the hike in May and a rate cut would be a too obvious admission of a mistake. Therefore, there was a need for arguments to cover the bad impression. The NBP president confirmed also that it is important for the MPC to keep real interest rates positive. This is indicating that a theoretical room for cuts amounts to ca. 100 basis points (but bear it in mind that real rates will start rising when inflation decreases).

Foreign exchange market – Meetings of the European leaders in the spotlight









Zloty stronger due to decision of the MPC

▪ In the past week the EURPLN stayed in the downward trend lasting since second decade of September. Visible contribution to this momentum was provided by the decision of the MPC, which, contrary to market expectations, kept the interest rates unchanged. Uncertainty about the scale of possible rate cuts emerged on the market and had a positive impact on the zloty. The EURPLN was also dragged down by monthly US labour market data. Consequently, the EURPLN plunged from weekly peak at 4.12 to ca. 4.06.

▪ The domestic currency gained even more versus the dollar. The USDPLN declined from 3.215 seen at the beginning of the week to 3.13.

▪ In late September the domestic currency was influenced by release of consumer confidence index calculated by The Conference Board. This publication surprised to the upside and supported the zloty. This week flash estimate of Michigan index will be released. Just like two weeks ago, the data on US consumer confidence may have an impact on the domestic currency this time as well. The zloty will be also under visible influence of global events, including information from European policymakers' meetings.

▪ Though the EURPLN stayed inside the consolidation with narrowing range trading, at the end of the week it was close to its lower band. This week the exchange rate may test 4.05-4.04.

Attention turns to European leaders meetings

▪ The euro was clearly appreciating versus the dollar since the beginning of the week due to better than flash estimates PMI for German and euro zone's manufacturing and mainly after the ECB press conference which fuelled hopes for solving the debt crisis. Consequently, just before the US non-farm payrolls data the EURUSD was close to 1.30.

▪ Monthly data from the US labour market surprised to the upside. The chart shows that as long as the situation on the US labour market does not improve for good, hopes for more Fed action will persist. Consequently, if this week hopes for prompt solution of the debt crisis will emerge – after meetings of European politicians – then the euro will continue to appreciate versus the dollar.

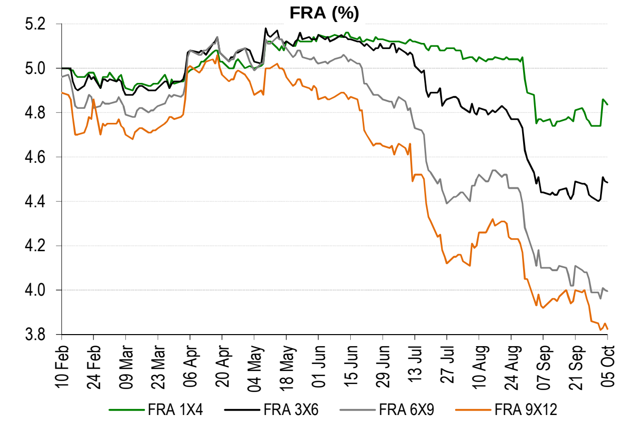
▪ Since late June the EURUSD stays in the upward trend. Vital levels for this week are 1.28-1.29 and 1.307.

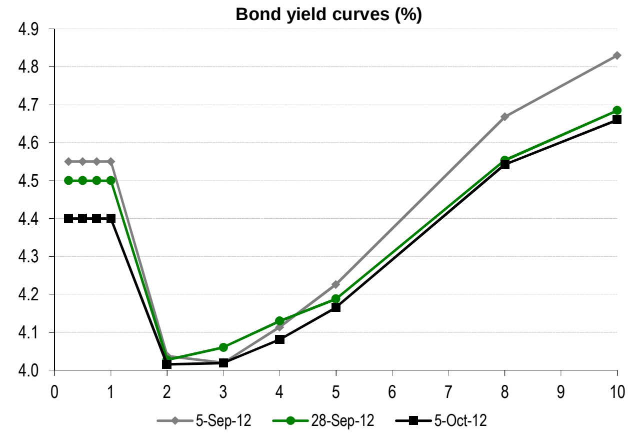
Forint gains after decision of Hungarian government

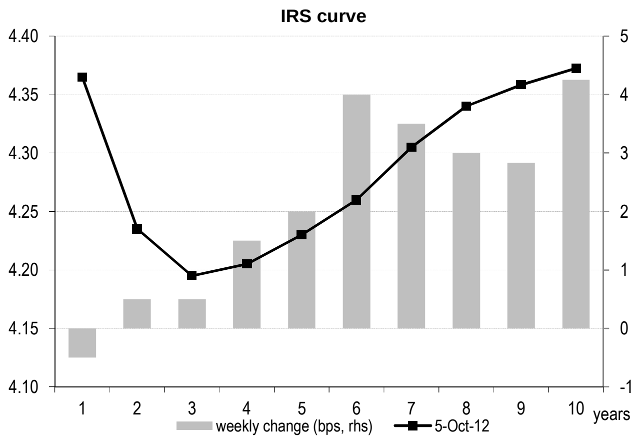
▪ The EURHUF plunged to the lowest level since late September (from 285.9 at the beginning of the week to 281.85). The move was partly fuelled by decision of Hungarian government on resigning from imposing a tax on transactions carried by MNB. That was interpreted by investors as a step towards agreement with the IMF on the loan.

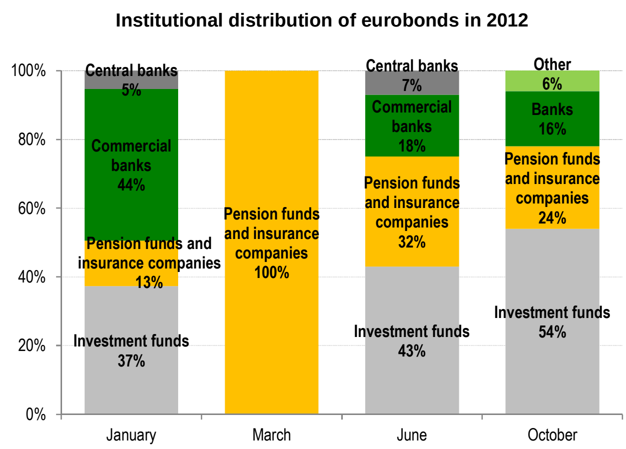
▪ Czech koruna recovered slightly after severe losses suffered after the CNB cut interest to record low at 0.25%. The EURCZK declined to 24.9 from 25.17.

Interest rate market – Only short-lived upward corrective move after the MPC









Lack of rates cut caused upward move in FRA…

▪ The MPC's rate-setting meeting was the key event of the last week. The Council decided to keep interest rates unchanged despite strong market expectations for a monetary easing. In the day of the MPC's decision WIBOR rates fell by 1-5bps, while FRA rates were relatively stable, after earlier significant decline.

▪ The MPC's decision disappointed the market players, despite a clear (but still conditional) suggestion that interest rates can be cut in November. Consequently, investors decided to take profit after significant strengthening. FRA rates increased by 1-12bps, with the highest growth in case of 1x4 and 3x6. While the market revised downward its monetary easing expectations till year-end (currently it is pricing-in rate cuts by only 25bps), it still expects rates reduction by 100bps (or even a bit more) in 9 months' horizon.

▪ We believe that correction on the market will be only short-lived. Macroeconomic data for September will prove to be worse than figures for the previous month, confirming deceleration of economic activity. Upcoming data should support arguments for interest rate cuts.

… and also in yields along the curve

▪ Market expectations for monetary easing in October resulted in significant strengthening on the front-end of the curves (bond and IRS). Before the MPC's decision yield of 2Y tested 3.95% (minimum was reached at 3.94%). However, after the announcement of MPC decision yield of 2Y bonds increased sharply above 4% (by 6bps in daily term). The scope of increase on the short-end of IRS curve (up to 3Y) was smaller than on the bond market.

▪ Adjustments after the MPC's decision on the mid and long end of the curve strongly depended on type of market. 10Y yield increased more considerably than yields of 2Y and 5Y bonds. In the same time changes of 10Y IRS were much smaller than in case of instruments with maturity up to 3Y.

▪ The end of the week brought some rebound (particular in 10Y sector). However, bond yields and IRS were higher than at the beginning of the week. In coming days we foresee yields of bonds at 3.95-4.15% for 2Y, 4.15-4.35% for 5Y and 4.65-4.85% for 10Y, with possibility of testing the bottom of the channels. The long-end of the curve will remain under influence of situation on Bunds.

The MF successfully raises funds for pre-financing

▪ Last week Poland's Ministry of Finance was very active on the primary market, both domestic and foreign. Taking advantage of the high demand for Polish government bonds, the MF sold 12Y euro-denominated bonds worth €1.75bn. It was launched with yield of 3.385% (or 143bps above mid-swap), the lowest level in history. After this transaction borrowing needs for 2012 were financed in 100%.

▪ Finance Ministry placed bonds worth PLN5.9bn on the domestic market (regular and top-up auctions). WZ-series bonds, similarly as during the previous auction, met a high demand (in our view mainly from domestic banks), with WZ0117 as outperformer (this bond made ca. 53% of the total sales). Means raised on this auction will be used to finance next year's gross borrowing needs.