Bank Zachodni WBK

Weekly economic update

29 October – 4 November 2012

Last week was marked by a deterioration of market sentiment and a sell-off of risky assets. Losses were seen, among others, on stock markets (S&P500 has fallen to the lowest level since early September) and on PLN market (EURPLN and USDPLN have climbed to the highest levels since end of September). This was triggered mainly by weak financial results of companies, disappointment about the EU summit, downgrade of rating of Spanish regions and French banks, as well as data showing drop in PMI and Ifo business climate indicators for the euro zone and Germany. PMI indices considerably dented the investors' confidence, as the market was expecting a continuation of upward trend after two straight months of improvement, which could have been a herald of economic recovery. Domestic data (retail sales and core inflation) were dovish and underpinned hopes for NBP interest rate cuts at the upcoming MPC meeting in November. Some better data were released only at the end of the week (GDP in the UK and in the USA) and after their releases risky assets recovered slightly.

We will see a row of important data from the USA this week and they may exert a visible effect on the trading. Data from the labour market will be of exceptional importance. It is worth to recall that the activity period of Fed's quantitative easing programme was made conditional on situation of this very market, so a reading differing from the consensus may markedly affect the dollar. Release of October's ISM indicator for the US manufacturing will also be in focus. In September this gauge surpassed the neutral mark of 50 pts so the newest reading will help the investors to judge if this can be treated as a one-off development or a signal of a more persistent tendency. As regards domestic data, we will see PMI for manufacturing in October. Value of this indicator will most probably stay below 50 pts (for the seventh month in a row), thus suggesting a further slowdown of domestic economy and confirming that "economic slowdown would become protracted", i.e. delivering MPC the necessary condition for a cut. Expectations for rate cuts and weak global market moods are putting a negative pressure on the zloty. Further decline in the Polish PMI manufacturing might cause the EURPLN to break strong resistance level at 4.18 and open the room to increase towards 4.20-4.22. Continuation of the zloty depreciation might negatively affect the mid and long-end of the curve. The front end should remain relatively stable ahead of expected November's interest rate cut.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (29 October)					
13:30	US	Personal income	Sep	%MoM	0.4	-	0.1
13:30	US	Consumer spending	Sep	%MoM	0.6	-	0.5
13:30	US	Core PCE	Sep	%MoM	0.1	-	0.1
		TUESDAY (30 October)					
14:00	US	S&P/Case-Shiller home price index	Aug	%MoM	0.4	-	0.4
15:00	US	Consumer confidence index	Oct	pts	72.5	-	70.3
		WEDNESDAY (31 October)					
9:00	**PL**	**PMI – manufacturing**	**Oct**	**pts**	**46.7**	**46.6**	**47.0**
11:00	EZ	Flash HICP	Oct	%YoY	2.5	-	2.6
14:00	**PL**	**Inflation expectations**	**Oct**	**%YoY**	**-**	**-**	**4.1**
13:15	US	ADP report	Oct	k	140	-	162
14:45	US	Chicago PMI index	Oct	pts	51.0	-	49.7
		THURSDAY (1 November)					
	PL	**Market holiday**					
4:30	CN	PMI – manufacturing	Oct	pts	-	-	47.9
13:30	US	Initial jobless claims	week	k	370	-	369
15:00	US	ISM – manufacturing	Oct	pts	51.4	-	51.5
		FRIDAY (2 November)					
9:53	DE	PMI – manufacturing	Oct	pts	45.7	-	47.4
9:58	EZ	PMI – manufacturing	Oct	pts	45.3	-	46.1
13:30	US	Non-farm payrolls	Oct	k	123	-	114
13:30	US	Unemployment rate	Oct	%	7.9	-	7.8
15:00	US	Industrial orders	Sep	%MoM	4.2	-	-5.2

Source: BZ WBK, Reuters, Bloomberg

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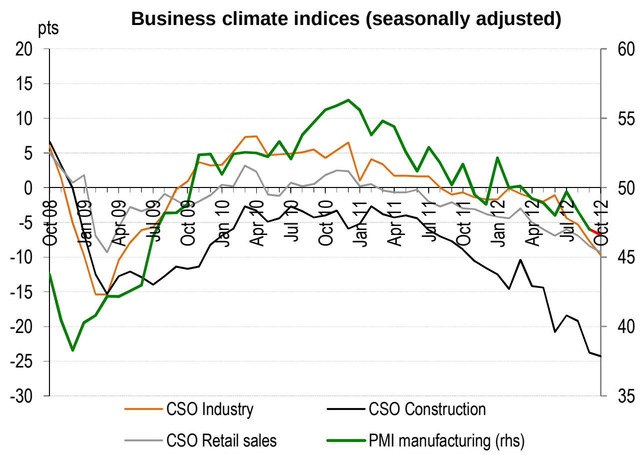
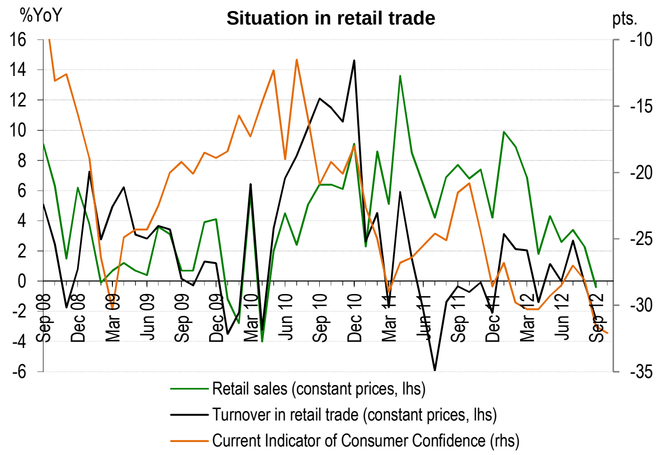
What's hot this week – Seventh month of declining activity in Polish manufacturing

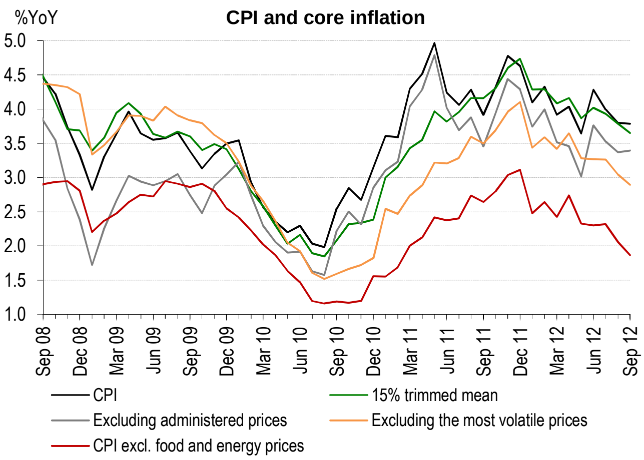


- Flash PMI indices for the euro zone and Germany recorded considerable drops in October (after improvement in two consecutive months). We are expecting that PMI for domestic manufacturing also declined, reflecting contracting domestic and foreign orders and deterioration of labour market conditions. CSO indicators of economic climate (seasonally adjusted) declined strongly again, heralding a continuation of slowdown across the board of economic sectors. Assessment of industrial output posted a considerable drop.
- A slight decline of households' inflation expectations is probable, mainly due to a drop in headline CPI, serving as a base for calculations.
- Domestic market activity will be limited in the second part of the week due to a banking holiday on Thursday.

Last week in the economy – Strong deceleration of consumer demand



- Pace of growth of retail sales decelerated strongly in September (to 3.1%YoY in nominal terms and -0.4%YoY in real terms), reflecting the weakness of consumer demand amid difficult labour market situation and declining real incomes. The data show that growth of individual consumption, which decelerated to 1.2% already in Q2, will remain low in the near term.
- Weak consumption outlook is confirmed by a further deterioration of consumer moods – current confidence indicator fell in October to -32.1 pts, below trough from 2009.
- Registered unemployment rate stayed in September at 12.4%, slightly below forecasts, which can be due, among others, to higher funds for jobless' activation. Still, number of jobseekers rose by 6.3%YoY, most in two years.



- Core inflation excluding food and energy prices fell in September from 2.1% to 1.9%, the lowest in 18 months. Two other measures of the core inflation also declined.
- The CSO revised the GDP data slightly, raising the Q1 growth (from 3.5% to 3.6%YoY) and lowering in Q2 (from 2.4% to 2.3%YoY). It is worth noting that growth rate of individual consumption was revised downward to 1.2%YoY in Q2 (from 1.5%), being the lowest reading in three years.
- Due to the GDP revision, also the general government deficit in 2011 was corrected down to 5% of GDP from 5.1%. According to the forecast sent by Poland to the Eurostat, general government deficit is to shrink to 3.4% of GDP in 2012.

Quote of the week – Interest rate cut is a natural consequence of slowdown

Andrzej Bratkowski, MPC member, 25.10, PAP
Cut of rates by 75bps in one move could be viewed as an extravagance. (…) 50bps in November and 25bps in December would be appropriate in my opinion. We surely need cuts by 100-125bps until the end of the first quarter.

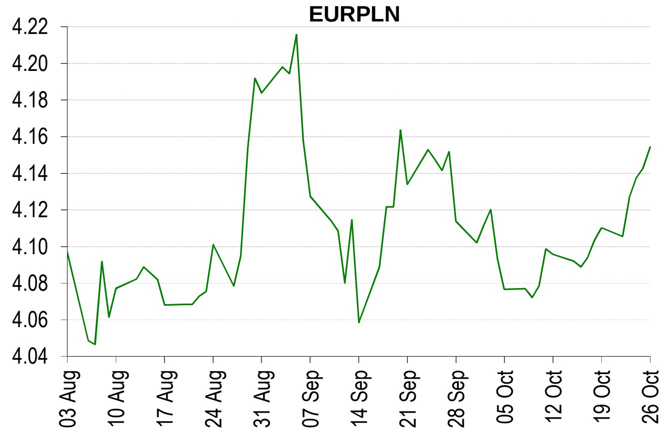
Marek Belka, NBP governor, 25.10, Gazeta Wyborcza
Yes, a rate cut is a natural consequence of slowdown and it would support the economic growth. (…) There is no crisis in Poland. Only a slowdown.

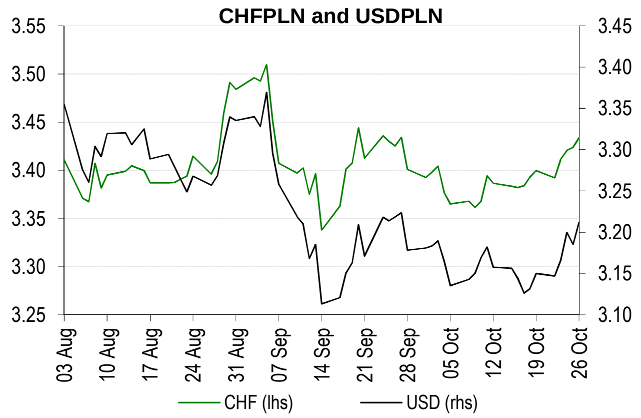
Andrzej Rzońca, MPC member, 24.10, PAP
Slowdown will not be deep enough to bring inflation back to target. (...) Economic growth deceleration is an argument for a rate cut.

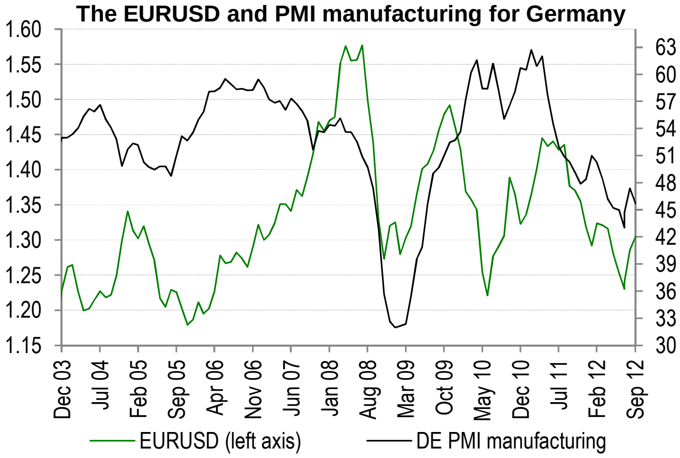
Jan Winiecki, MPC member, 19.10, TVN CNBC
Situation changed so strongly that I am a less zealous enemy of keeping rates unchanged. If I saw that GDP growth is plummeting in Q3, I would vote for a hike.

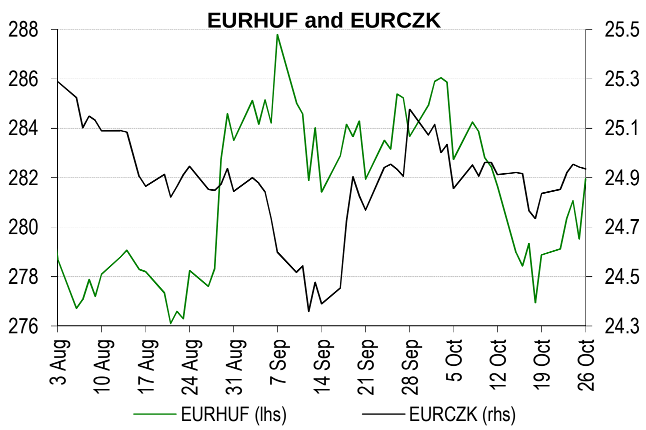
Recent comments of the Monetary Policy Council members are indicating that differences between their views are still huge. The most hawkish members still seem to be losing touch with reality, but even they begin to notice that the economic situation is completely different than they have expected. Still, it is possible to gather a majority for a cut in November even without their votes and we are expecting that this will be the case, as recent economic data are clearly showing that we are entering a period of strong GDP growth deceleration and a quick decline of inflation. Similar conclusions will be probably drawn by the new NBP projection. If CPI declines towards target at 2.5% (or below), then there will be even a risk that rates will be cut more considerably than we are expecting in our baseline scenario (75bps until the end of 1Q2013).

Foreign exchange market – The zloty weaker, global factors and rate cuts expectations are crucial









The zloty at the weakest level since September

▪ As we predicted last week, the zloty had broken triangle formation and depreciated in relation to the main currencies (despite some short-lived corrections). Domestic currency was under negative pressure of global mood deterioration (due to disappointing macro data from European economy) and weaker than expected domestic retail sales data for September. As a consequence the EURPLN tested the level of 4.16, reaching the weekly maximum at 4.164 (the highest level since mid-September). The zloty slightly gained after the US GDP data release, trimming part of earlier losses.

▪ Last week also brought increase in the USDPLN and the CHFPLN. The USDPLN exchange rate, after some stabilization near 3.14, increased above important resistance level at 3.20, reaching the top at 3.224. In case of the CHFPLN, in weekly terms, rate climbed by slightly more than PLN0.03 to ca. 3.434 during Friday's session.

▪ The zloty has remained under pressure of global factors, but also strong expectations for interest rate cuts in nearest future (reinforced by news about downward revisions of GDP forecast for 2012 and 2013). We think that after leaving the triangle formation, the EURPLN might continue upward move towards the upper limit of consolidation channel at 4.20-4.22 in coming days/weeks. However, the rate needs to break important technical resistance level at 4.18 in order to fulfil such scenario. We do not rule out that weak PMI index for Polish manufacturing sector for October could support further upward move of the EURPLN. On the other hand, the first support level is at 4.13, and next at 4.10. We expect investors' activity to significantly decrease in the second part of the week due to market holiday on Thursday.

The US labour data crucial for the EURUSD

▪ Last week the EURUSD was in the downward trend. The euro depreciated due to weak macro data from real economy, especially Germany. As a result the EURUSD, after reaching weekly top at 1.308, has gradually declined towards 1.29.

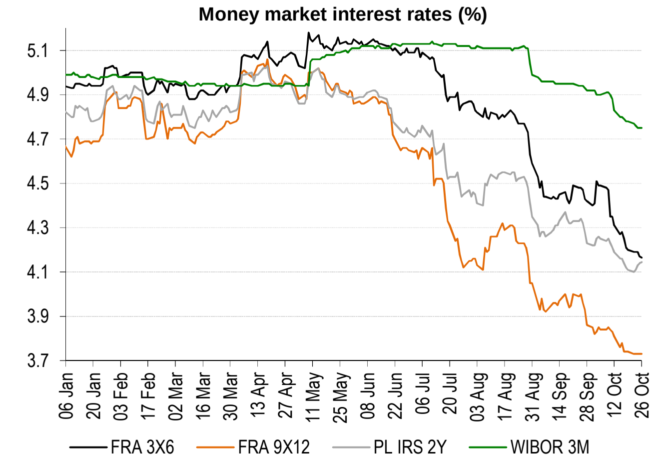
▪ This week investors concentrate on macro data from the USA and Europe. However, data from labour market in the US will be the most important for market players. Last weeks the EURUSD has stayed in the range between 1.28 and 1.307 (with the local top at 1.314). This range is still valid, but October's non-farm payrolls and unemployment rate might determine direction on the EURUSD chart in coming days or even weeks.

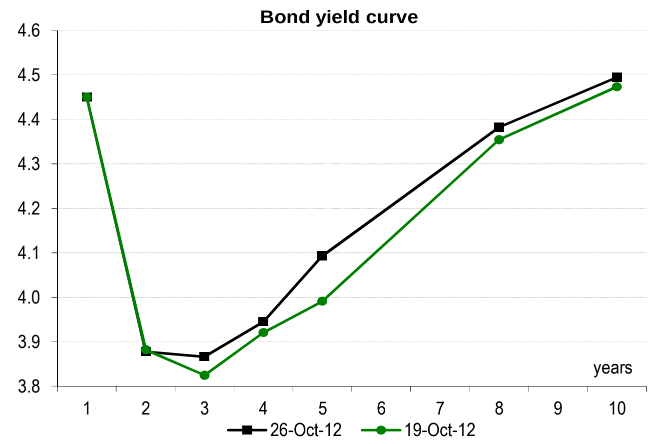
High volatility also on the CEE currencies

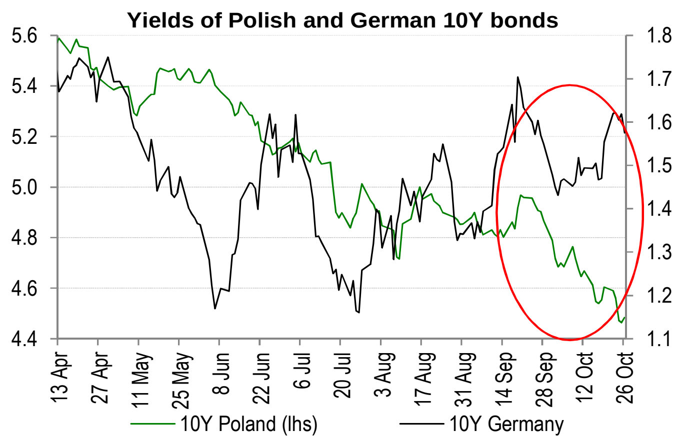
▪ Last week the CEE currencies, similarly to the zloty, had depreciated in relation to the main currencies. Despite some correction the trend on both the EURCZK and the EURHUF was upward. Rates ended the week at the higher level in comparison with the beginning of the week.

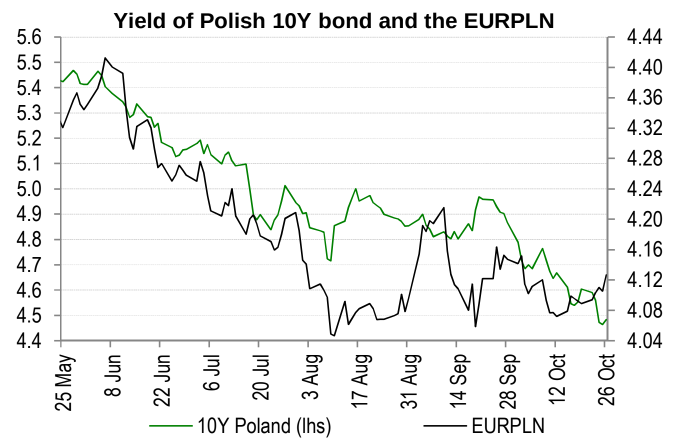
▪ In coming days investors will focus on the central bank meetings (in Hungary on 30 Oct, while in the Czech Republic on 1 Nov). We do not exclude the central banks to implement some measures to adjust to current economic situation (interest rates cuts or probable intervention – mainly in case of the CZK), which might negatively affect quotations of both the Czech koruna and the Hungarian forint.

Interest rate market – Weak zloty may push yields up









Little changes on the FRA and WIBOR market

▪ On the money market no big changes occurred. FRA and WIBOR rates abated by 1-3bps on weekly basis as the market awaits November's rate cut by the MPC. Since the release of weaker than expected data on 2Q GDP growth in late August the 3-12M WIBOR declined already by just above 35bps. The WIBOR curve in this segment is flat at 4.74-4.75%.

▪ This week there will be no releases of crucial data that could initiate any visible move on the domestic money market. In our opinion, only the outcome of November's meeting of the MPC may trigger higher volatility of the WIBOR and FRA. Until then, rates should stay close to current levels with some tendency to drop slightly.

Correction on the bond market…

▪ Depreciation of the zloty seen last week put negative pressure on the domestic debt. The move up of yields was observed mainly in case of 5Y bond, which moved away from record lows by 10bps (from 3.99%). Long end of the curve inched up only slightly (by 2bps) while the 2Y debt remained stable. It is worth to notice that along the week trade volume was rather low.

▪ Developments on the bond market were reflected in changes seen in case of IRS rates, though here the curve moved up in parallel by 3-4bps in 2-10Y segment. As the change on the bond market was bigger, the asset swap spread for 5Y increased by ca. 6bps, to -9bps.

▪ The Ministry of Finance issued last week debt for total value of nearly PLN8bn. From the sale of the 2Y bond (OK0714) PLN2.71bn was collected (there is already PLN10.3bn on the market of this bond) amid demand at PLN3.53bn and yield at 3.856% (on July's auction the yields was at 4.361%). Also new 10Y bond (DS1023) was offered for PLN5.13bn amid demand at PLN6.54bn and yield 4.496%. After yesterday's auction the Ministry has already covered 10% of next year's gross borrowing needs. This year the Ministry wants to finance 20% of 2013 gross borrowing needs.

… that may continue if the zloty keeps weakening

▪ Polish bonds remain quite resilient to developments on the German debt market, but they do react to situation on the Polish FX market. As we expect the zloty will remain under pressure, there is room for further increase of the yields on the middle and long end of the curve.

▪ It is worth to notice that there is market holiday on Thursday and this is likely to limit liquidity even further. If global market sentiment deteriorates (this week many US macro data will be released) and the zloty continues to depreciate, changes of yields may be more visible than recently.