Bank Zachodni WBK

Weekly economic update

12 – 18 November 2012

Last week was rich in important events, both as regards the domestic and global markets. US elections did not bring considerable changes on the political scene – Obama was re-elected president, Democrats maintained their control over Senate and Republicans over the House of Representatives. These results pose a risk of lack of quick agreement about legislative changes to avoid a sharp tightening of US fiscal policy (falling off a fiscal cliff) at the beginning of 2013 (which scale may amount to 4% of GDP). Such a decline of fiscal deficit would drag the US economy back into recession, which would of course be a strong adverse shock for the global economy. Due to worries about such a scenario, and also due to uncertainty about further developments in Greece and Spain, the market was predominated by risk aversion in the second half of the week. The ECB meeting did not bring much in assessment of euro zone situation. The meeting of Polish MPC proved to be much more interesting, as it decided to cut interest rates (by 25bps) for the first time in three years and heralded a beginning of monetary easing cycle, which contributed to a further strengthening on the domestic debt market and to a correction of zloty exchange rate. The MPC was encouraged, among others, by results of new NBP projection, suggesting a considerable slowdown of GDP growth (to ca. 1% at the beginning of 2013) and a decline of inflation below the official target in the medium run.

The new series of domestic monthly data publications is starting this week. Inflation figures are of highest importance. Inflation probably began its downward trend in October, returning to the upper border of tolerance band for the first time in two years. This trend will continue in the upcoming months and in our view will bring CPI down below 2.5% already at the beginning of 2013. As regards global markets, apart from a row of important macroeconomic data, the investors will focus on actions of European policymakers about help for Greece, as the Greek PM warned recently that his country will run out of liquidity in mid-November. Eurogroup and Ecofin meetings are scheduled for Monday, but recent comments of the European leaders suggested that agreement on extension of Greek bailout is not certain.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (12 November)					
14:00	**PL**	**Exports**	**Sep**	**€m**	**12 770**	**12 971**	**12 030**
14:00	**PL**	**Imports**	**Sep**	**€m**	**12 498**	**12 900**	**12 078**
14:00	**PL**	**Current account**	**Sep**	**€m**	**-931**	**-969**	**-633**
		TUESDAY (13 November)					
11:00	DE	ZEW index	Nov	pts	-9.8	-	-11.5
		WEDNESDAY (14 November)					
11:00	EZ	Industrial output	Sep	%MoM	-1.9	-	0.6
14:00	**PL**	**CPI**	**Oct**	**%YoY**	**3.4**	**3.5**	**3.8**
14:00	**PL**	**Money supply**	**Oct**	**%YoY**	**7.4**	**7.5**	**7.6**
14:30	US	Retail sales ex autos	Oct	%MoM	0.2	-	1.1
20:00	US	Minutes Fed					
		THURSDAY (15 November)					
8:00	DE	Flash GDP	Q3	%QoQ	0.2	-	0.3
11:00	EZ	Flash GDP	Q3	%QoQ	-0.2	-	-0.2
11:00	EZ	HICP	Oct	%YoY	2.5	-	2.5
14:30	US	Initial jobless claims	week	k	370	-	355
14:30	US	Core CPI	Oct	%MoM	0.1	-	0.1
16:00	US	Philly Fed index	Nov	pts	2.2	-	5.7
		FRIDAY (16 November)					
15:15	US	Industrial output	Oct	%MoM	0.2	-	0.4

Source: BZ WBK, Reuters, Parkiet

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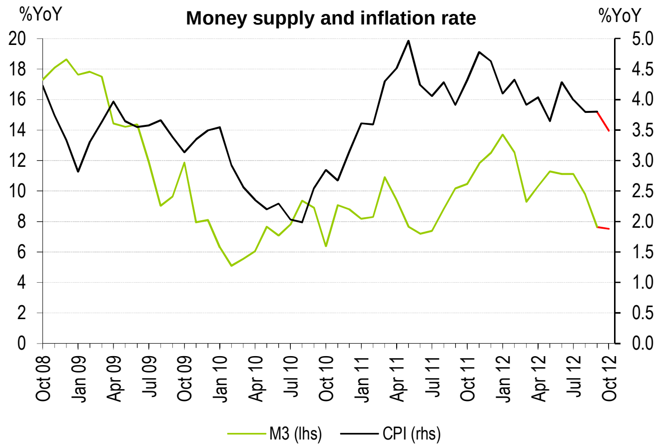
What's hot this week – A beginning of downward inflation trend

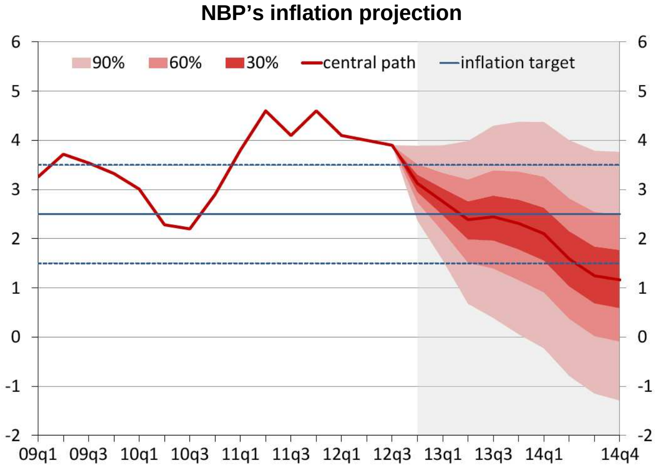


▪ In our view CPI in October will amount to 3.5%, i.e. will reach the upper border of tolerance band around MPC target. Such a reading will amplify market expectations about further rate cuts. We are anticipating that the October's drop will be a beginning of downward inflation trend, which will bring the CPI down to target in a couple of months' time and may encourage the MPC to cut interest rate more significantly.

▪ We are expecting a weak growth of foreign trade volumes. According to our forecasts, Poland could have posted a positive foreign trade balance in September, which was due to stronger deceleration of imports in face of weakening domestic demand.

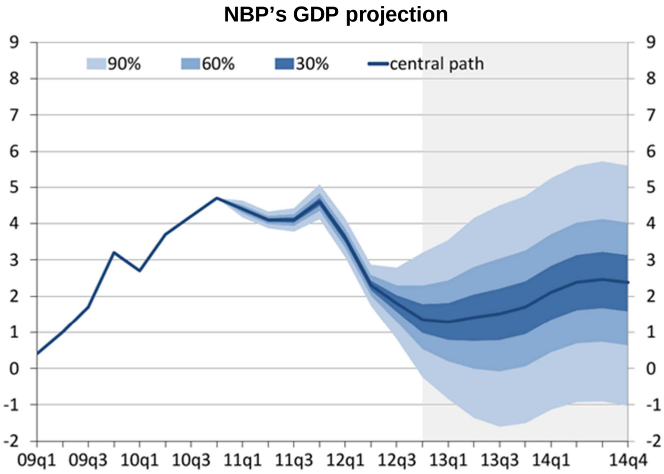
▪ In our view growth rate of M3 money supply, as well as of loans and deposits, decelerated in October.

Last week in the economy – The easing cycle began, lower GDP and CPI projections



▪ At November's meeting the MPC trimmed its interest rates by 25bps and clearly announced a beginning of easing cycle. Tone of the MPC's statement has become more dovish, probably due to weak macroeconomic data and the new NBP's projection, indicating a considerable deceleration of GDP growth and decline of inflation below target in medium term (see below).

▪ The NBP's governor M. Belka said that probability of interest rate cut in December is relatively high and we fully support this view. The next cut may take place in January, and then the Council will wait for the next update of the NBP projections (March), which will determine future moves. If our scenario materialises, assuming GDP growth bottoming out in Q1-2013, then more monetary easing than three more rate cuts by 25bps (total of 100bp in cycle) seems unlikely.



▪ The new NBP projection is showing a markedly lower inflation and GDP growth paths as compared to previous editions.

▪ In 2013 average inflation will be lower than 2.5% with more than 50% probability, and it is forecast to decline to 1% at the end of projection horizon. Inflationary pressure will ease due to deceleration of domestic economic growth, waning negative price shocks, declining oil and agricultural commodities prices on global markets.

▪ GDP growth will approach 1% at the start of 2013, which is in line with our forecast (growth in whole 2013 is expected to reach 1.5%). The downward revision of projection versus July is primarily due to stronger decline of investments, both private and public. According to the NBP a rebound in investment outlays can be expected in 3Q2014.

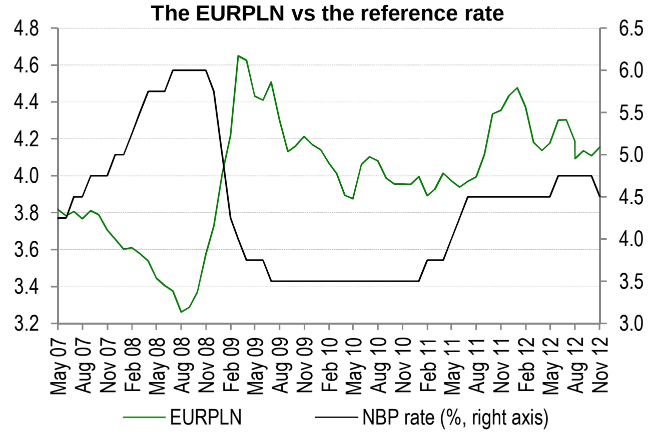
Quote of the week – Start of monetary easing cycle

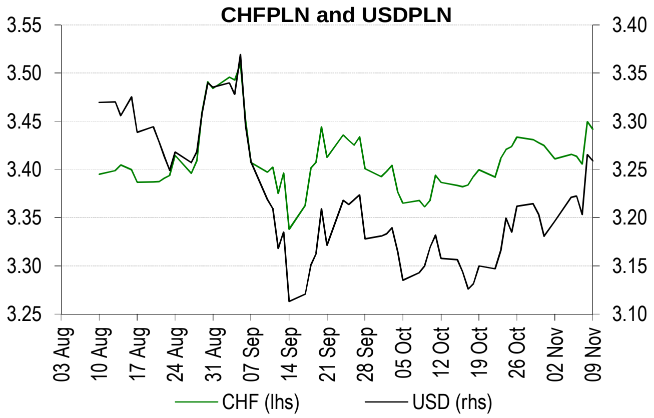
Marek Belka, NBP Governor, 7 Nov, MPC press conference
I think that today's decision is the start of monetary easing cycle. (...) It is hard to say (whether the easing cycle will be deep). For the Council the most important risk factor is the high inflation. Another threat is persistence of real interest rates at historically low levels.

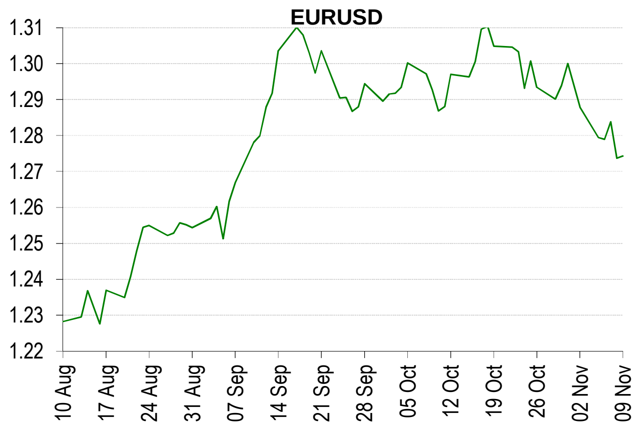
Andrzej Kaźmierczak, MPC member, 7 Nov, MPC press conference
MPC made cautious decision about monetary easing, as the risk factors remain in place. The most important risk factor is definitely the issue of prices of food and agricultural commodities. (...) So far we have sustained costs of disinflation and thus the cautious policy, not to undo the trend.

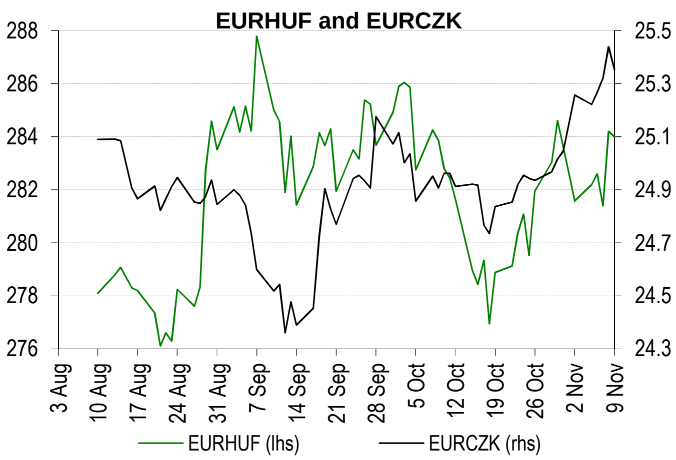
The MPC's official statement and comments of the NBP Governor Marek Belka suggest that the November's rate cut has probably launched a cycle of monetary policy easing. MPC members present at the press conference denied to point how deep the rate cuts may be in total. Nevertheless, they seemed to calm down expectations regarding the total scale of possible policy easing, mainly through pointing out risk factors, out of which the current elevated inflation was the most important. We are not surprised, as the Council has been conducting backward-looking monetary policy for some time. However, it is good that the MPC took into consideration a significant slowdown of economic growth and decided to relax monetary policy, even though it is still behind the curve.

Foreign exchange market – Zloty weaker due to expectations on further monetary easing









Zloty depreciated after the MPC meeting

- Starting from the beginning of the previous week zloty depreciated against the main currencies. Negative pressure on the domestic currency came from expectations for interest rate cut and global moods deterioration ahead of presidential election in the US. Intensification of zloty weakening took place on Wednesday, when the Council decided to cut rates, clearly announcing the start of the monetary easing. Consequently, the EURPLN broke the resistance level at 4.16, increasing towards 4.18 (the maximum level was at 4.174). Despite short-lived correction, the exchange rate ended the week around 4.16.
- Zloty weakened also against other main currencies. In weekly terms it lost ca. 2% in relation to the US dollar and ca. 1% against the Swiss franc.
- Domestic currency is still under negative pressure of expectations for continuation of monetary easing cycle (especially that probability that the Council will cut rates in December increased) and weak global mood. Domestic data releases (balance on payment, CPI inflation) might influence the zloty in short term. From the technical analysis' point of view, breaking the resistance level at 4.16 has opened the room for further increase of the EURPLN towards the next resistance zone between 4.18 and 4.20, and possibly 4.22.
- Global factors are still important for the zloty. Situation in Greece is uncertain as market players are waiting for the European leaders' decision. We would like to recall that Greece on Wednesday approved savings package required to receive another financial aid. Prolonged period of taking decision in this case will negatively influence financial market.

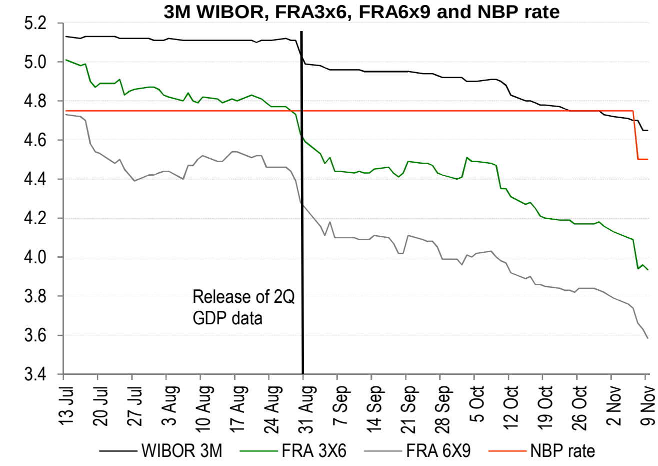
The euro under pressure of situation in Greece

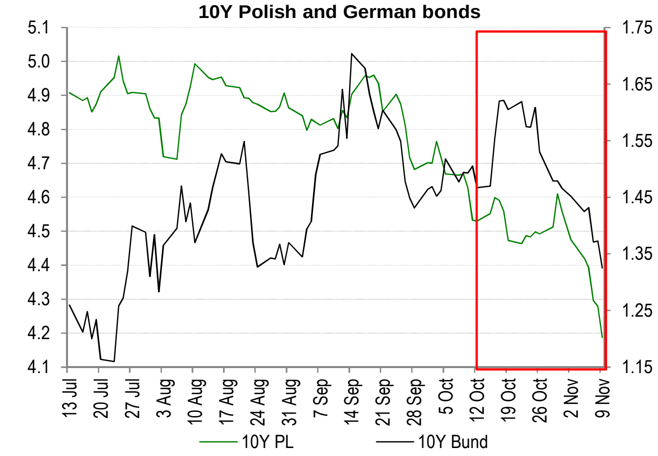
- Elections in the USA were the most important event of the last week. The re-election of Barack Obama was welcomed by the markets with moderate optimism, pushing the EURUSD exchange rate from 1.278 to ca. 1.288. In the following days the situation of Greece came to the fore, as this country agreed on further austerity and is awaiting another bailout tranche. Uncertainty rose after comment of German finance minister Wolfgang Schäuble, who is not expecting a quick euro zone's decision on this matter. This news generated a move of the EURUSD towards support area at 1.272-1.274.
- This week the situation in Greece will still be in focus. Lack of decision about help for the government in Athens on the Monday's Eurogroup meeting can undermine the single currency. Break of support at 1.272 may open the door to test 1.26.

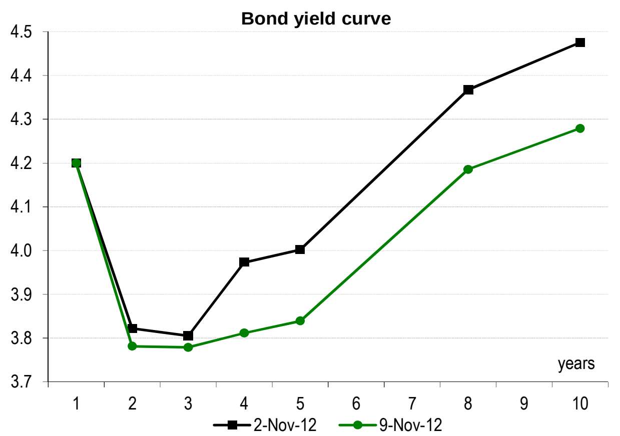
The CEE currencies stay under pressure

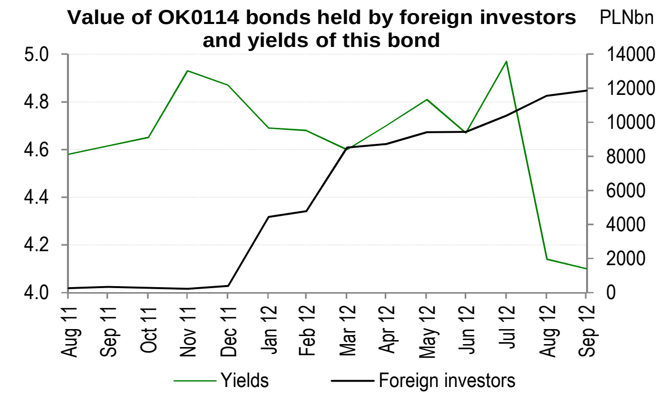
- Deterioration of global moods has also contributed to a weakening of CEE currencies. Additionally, the Czech koruna still stays under pressure of possible central bank interventions. In due course, the EURCZK exchange rate climbed towards 25.5 (the highest level since end-July), while EURHUF surpassed 284.
- This week the CEE currencies, similarly as the zloty, will remain mainly under influence of global events. Lack of decision about further tranche of Greek bailout may generate an impulse for a further weakening. As regards the Czech koruna, the Q3 GDP reading may also prove crucial.

Interest rate market – Downward trend in yields may continue thanks to MPC









WIBOR and FRA down

▪ Decision of the MPC supported the downward move of money market rates, which declined by 5-6bps after the rate cut. Since the release of weaker than expected data on 2Q GDP growth (in late August) 1M WIBOR dropped by 25bps while rates from 3M to 12M by 46-47bps. Now the WIBOR curve is flat at 4.65%.

▪ FRA rates deepened the decline by further 9-13bps but in this case the better part of the move was observed yet before the decision of the MPC.

▪ We expect that in coming weeks and months WIBOR rates will continue their gradual decline. As the MPC suggested that as soon as in December next rate cut may take place, 1M WIBOR may fall most visibly. Regarding the 3-12M segment, further decline may be less visible and more dovish comments from the MPC (suggesting scope for rate cuts) may be needed to see these rates lower.

New record lows of bond yields

▪ Domestic bond curve flattened considerably during the past week due to strong appreciation of medium and long term bonds. Yields of 5Y and 10Y securities plunged by 17bps and 23bps, respectively. Polish debt was supported by announcement of more rate cuts to come and clear plunge of yields of Bunds. Still, the trade volume was rather low during the week.

▪ The Ministry of Finance sold PS0418 bonds worth PLN4.5bn (above the upper band of planned supply at PLN4.0bn) amid demand at PLN6bn and yield at 3.9%. It is worth to notice that after the auction the Ministry has covered 15% of 2013 gross borrowing needs.

Inflation data supportive for Polis debt

▪ After the MPC cut rates, this week the CSO will release data on October's inflation. We expect – just like the market – visible decline of annual pace of growth of prices and this may support short end of the curve, including 2Y bonds. Regarding the outlook for next months, there is room for further decline of yields in this segment. One factor supporting short term debt will be quick decline of CPI (suggested also by NBP projection). Also amid continuation of economic slowdown the MPC will maintain its dovish stance and as long as it does not switch to "wait-and-see" mode the market will rather not start to price in termination (suspension) of easing cycle.

▪ It is worth to notice that foreign investors held 36% of total issuance of OK0714 at the end of September. This figure sits well below non-residents' engagement in other OK bonds (for example, this group of investors holds 54% of OK0114 or even 64% of OK0713). So far, the Ministry of Finance issued only PLN7.6bn of OK0714 (versus PLN21.8bn of OK0114 and PLN13.4bn of OK0713). As next auctions of OK0714 will take place next year, it should not be surprising if foreign investors continue to accumulate this 2Y bond.

▪ Middle and long end of the curve will be also supported by the outlook of lower NBP rates, though additional factors influencing this segment of the curve will be situation on the core bond market and case of euro zone debt crisis.