Bank Zachodni WBK

Weekly economic update

10 – 16 December 2012

As we supposed, news from the central banks proved to be crucial for situation in the financial markets in Poland and abroad in the last week. The Monetary Policy Council did not have courage to cut interest rates by more than 25bp, which triggered a short-lived correction in the interest rate market and temporary strengthening of the zloty. Nevertheless, the announcement that after the second rate cut in the cycle monetary easing will be continued triggered a quick return of downward trend of bond yields and money market rates. Moods abroad have been worsened by a significant downward revision of the euro area's economic growth forecasts by the ECB and also by downward revision of German GDP forecasts by the Bundesbank.

This week we are entering a period of publication of domestic macroeconomic data for the next month. The CPI inflation for November, most anticipated by investors, is likely to record the second strong drop in a row, reinforcing market expectations for more interest rate cuts. Balance of payments data will probably show improvement in growth rates of foreign trade turnover; however it will be hardly an evidence of economic revival, but rather a result of statistical effect, implied by higher number of working days. Therefore, impact of this data on the market should be limited. Crucial events abroad will include meeting of the FOMC and voluntary buyback of debt by Greece. In December the Operation Twist ends and investors will be waiting to see whether Bernanke announces for example extension of QE3 to replace the extinguishing program. In turn, the operation of Greek debt buyback is one of the key elements of agreement reached at the latest Eurogroup meeting and its result may be important for decision when the country will receive the next bailout tranche. Moreover, a whole bunch of new leading indicators for major economies will be released in the coming days, which may deliver new hints regarding economic outlook for the world. Also, news about progress in budgetary talks in the US will be closely watched by investors.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (10 December)					
8:00	DE	Exports	Oct	%MoM	-0.5	-	-2.5
10:30	EZ	Sentix index	Dec	pts	-16.0	-	-18.8
		TUESDAY (11 December)					
11:00	DE	ZEW index	Dec	pts	-12.0	-	-15.7
14:30	US	Trade balance	Oct	$bn	-43.0	-	-41.6
		WEDNESDAY (12 December)					
11:00	EZ	Industrial output	Oct	%MoM	0.2	-	-2.5
18:30	US	Fed decision		%	0.0-0.25	-	0.0-0.25
		THURSDAY (13 December)					
14:00	**PL**	**CPI**	**Nov**	**%YoY**	**2.9**	**2.8**	**3.4**
14:00	**PL**	**Exports**	**Oct**	**€m**	**13 314**	**12 850**	**12 578**
14:00	**PL**	**Imports**	**Oct**	**€m**	**13 276**	**12 950**	**12 494**
14:00	**PL**	**Current account**	**Oct**	**€m**	**-1054**	**-1291**	**-1137**
14:30	US	Initial jobless claims	week	k	370	-	370
14:30	US	Retail sales ex autos	Nov	%MoM	0.0	-	0.0
		FRIDAY (14 December)					
3:30	CN	Flash PMI – manufacturing	Dec	pts	-	-	50.5
9:28	DE	Flash PMI – manufacturing	Dec	pts	47.2	-	46.8
9:58	EZ	Flash PMI – manufacturing	Dec	pts	46.6	-	46.2
11:00	EZ	HICP	Nov	%YoY	2.2	-	2.2
14:00	**PL**	**Money supply**	**Nov**	**%YoY**	**6.6**	**6.5**	**8.0**
14:30	US	Core CPI	Nov	%MoM	0.2	-	0.2
15:15	US	Industrial output	Nov	%MoM	0.2	-	-0.4

Source: BZ WBK, Reuters, Parkiet

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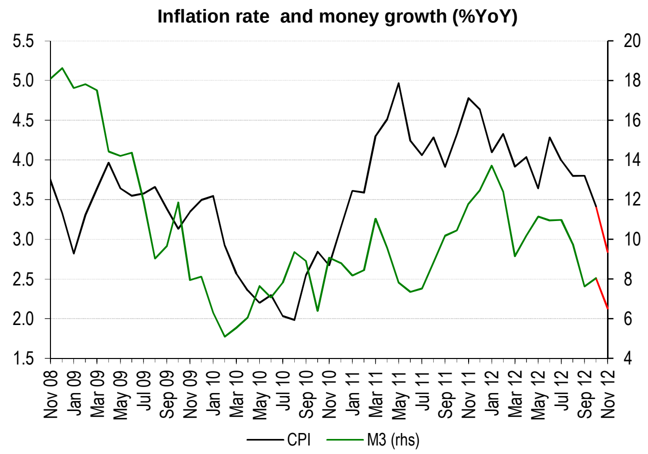
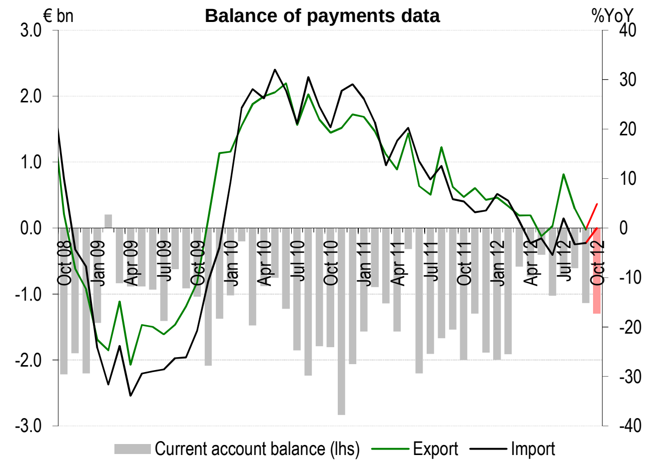
What's hot this week – Inflation finally below 3%?

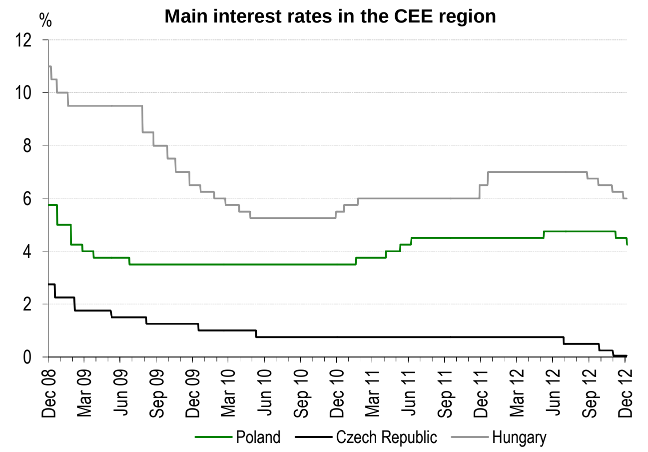


- Inflation rate, which started a downward trend in October, probably declined again in November, posting a considerable drop below 3% for the first time in two years. This was due, among others, to a marked decline of fuel prices (by more than 3%MoM, according to our estimates) combined with a relatively low – as for this month – increase of food prices (below 1%MoM). Changes of prices in other categories of goods and services remained small, so core inflation excluding food and energy prices inched down by one notch to 1.8%YoY. Our forecast of CPI inflation sits slightly below the consensus, so its realization may lightly underpin market's expectations for MPC interest rate cuts.
- Increase of M3 money supply and loans probably slowed down again in November, partly due to stronger zloty and high statistical base from 2011.



- Data on balance of payments in October will probably be, similarly as data on industrial output in the same month, distorted by a higher number of working days as compared with the preceding year. This effect may positively affect values of foreign trade turnovers, thus pace of growth of exports and imports should improve against September. Still, similarly as in case of higher output growth – this should not be treated as a sign of revival in economy, but rather as a one-off statistical effect.
- We are expecting a rise in current account deficit, which will be due to a deficit on transfers account (usually posting a surplus). This deficit is a result of net flow balance between Poland and EU – most means transferred from the EU were classified as capital flows, not as transfers). Trade balance will record some deterioration, but will stay relatively close to zero.

Last week in the economy – Easing cycle will be continued



- The Monetary Policy Council cut interest rates for the second time in a row by 25bps and maintained its suggestion of further monetary policy easing. The statement noted that recent macro data confirmed a marked slowdown of economic activity, weakening price and cost pressures, as well as risk that the inflation may decline below NBP target in the medium term. We will most likely see another cut by 25bps in January. In our view further reductions will come after update of NBP's projections of GDP and CPI in March. Reference rate may thus be lowered to 3.5% in April.
- PMI index for Polish manufacturing climbed in November for the second time in a row and amounted to 48.2pts. Output, employment and orders (including exports orders) declined at a slower pace. Even though the data surprised on the upside, it is still too early to expect an improvement in domestic economy based on this release.

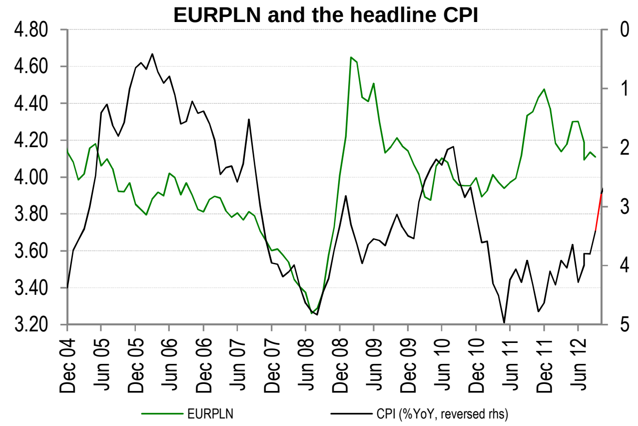
Quote of the week – MPC cannot afford a pause in work

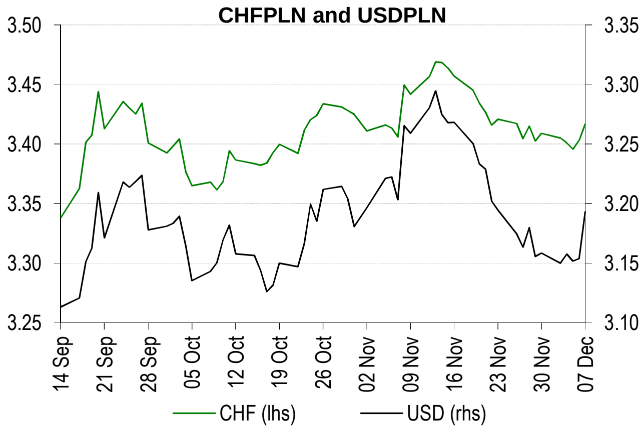
Marek Belka, MPC member, 05.12, press conference

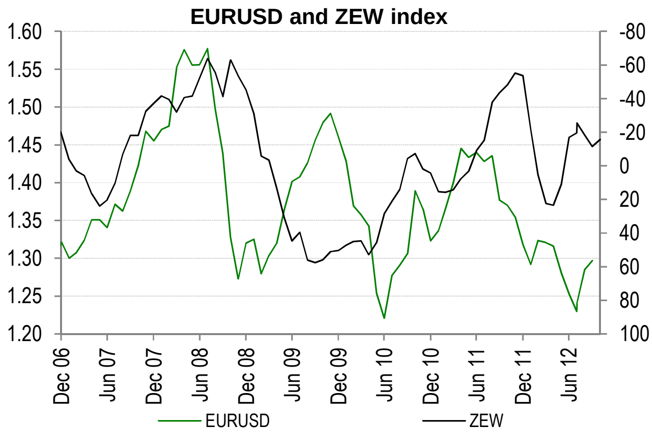
The MPC is working hard, it cannot afford a pause in work, i.e. in monetary policy easing. The last sentence of the statement is not an unconditional commitment, but certainly a suggestion of a consecutive interest rate cut. […] Changes in rates should be enacted in a gradual means, unless something drastic happens. […] This is characteristic today for the Polish economy - there are no serious imbalances that would need to be eliminated before the economy could proceed to acceleration. The situation was not 'dramatic' and recession highly unlikely. […] As you know, many members of the council speak out views with which I agree that we should in a situation that is relatively normal, not [necessarily] good, conduct normal policy which can be defined as positive real interest rates. If inflation will come down stably, the more room there is for rate cuts.

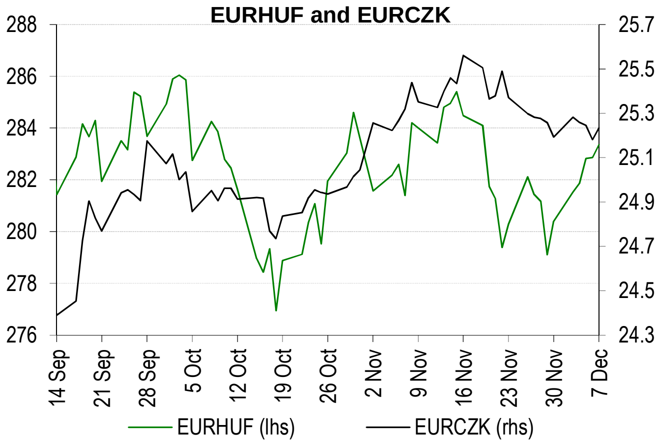
NBP Governor Marek Belka during a press conference after the MPC meeting hinted that another interest rate cut is likely in January, saying (with tongue in cheek) that the MPC is working so hard it cannot afford to make a pause in easing next month. This confirms our expected scenario. The Council will probably decide take a short break after cutting rates again in January and will wait for the results of next CPI and GDP projections (they will be released in March). However, information about further economic slowdown and decline of inflation will most likely convince the Council to continue monetary easing. The majority of MPC members are in favour of gradual movements. The question is whether the MPC will find economic growth close to zero and inflation below 2% at the beginning of 2013 mean that "something dramatic happens", which would justify cutting rates on a larger scale than 25bps.

Foreign exchange market – Fed's decision will be crucial for the FX markets









The zloty weaker ahead of further interest rate cuts

- The zloty has started last week with some weakening. It continued trend from previous Friday when weaker than expected Q3 GDP data intensified expectations for more aggressive monetary easing even in December. As a consequence the EURPLN increased towards 4.14. However, before the MPC's decision it was traded around 4.13. As we expected rate cut by only 25bps resulted in some correction and the EURPLN declined below 4.12. Correction move was only short-lived and rate returned to upward trend after the statement release, which clearly suggested that the MPC will continue monetary easing cycle (we expect the Council to cut rates again in January). The EURPLN ended the week slightly below 4.13.
- The zloty weakening against the US dollar was limited due to the EURUSD increase. However, sharp decline in eurodollar at the end of the week caused the USDPLN to climb slightly above 3.20 (with the local maximum at 3.201).
- This week the zloty will be under influence of both domestic (macroeconomic data releases, including the headline CPI) and external (Fed's meeting and macro data for euro zone) factors, but the latter might overshadow the former. Currently, investors focus on Fed's meeting as Operation Twist program is expiring this month. Extension of QE3 measures should support the euro and consequently the zloty. In medium term the wide range of fluctuation between 4.08 and 4.15 is still valid for the EURPLN.

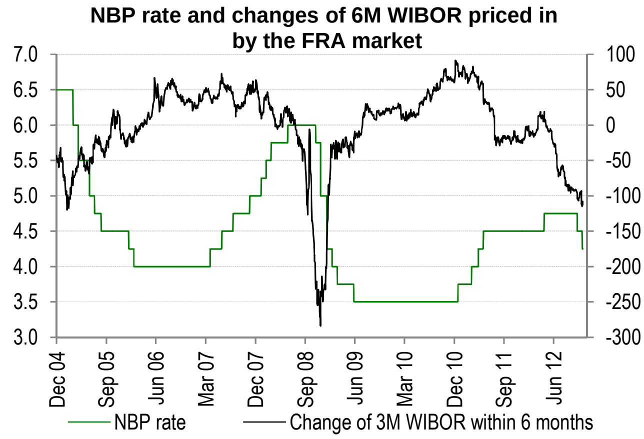
EURUSD ends the week below 1.30

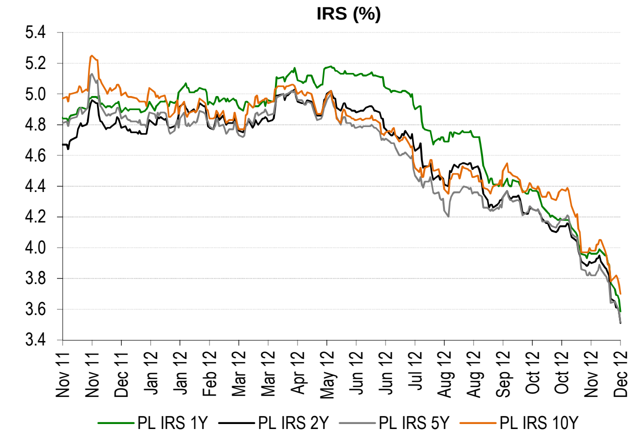
- Last week the EURUSD exchange rate was continuing its upward trend, supported by the upcoming macro data and information about more favourable (from the investors' point of view) conditions of Greek bond buyback. Only a release of ECB's pessimistic forecasts for the euro zone generated a quite strong downward move towards 1.29. The rate was oscillating around this level while awaiting the Friday's labour market data. These turned out to be better than expected, thus triggering another downward impulse for the EURUSD, below 1.29.
- This week the Fed meeting will be crucial for EURUSD exchange rate. This meeting will be particularly interesting, as the Operation Twist programme is expiring this month, co investors are considering what is the Fed going to do – many expect this programme to be replaced with another one. Such a decision should underpin the single currency so EURUSD may move upwards towards the weekly peak.

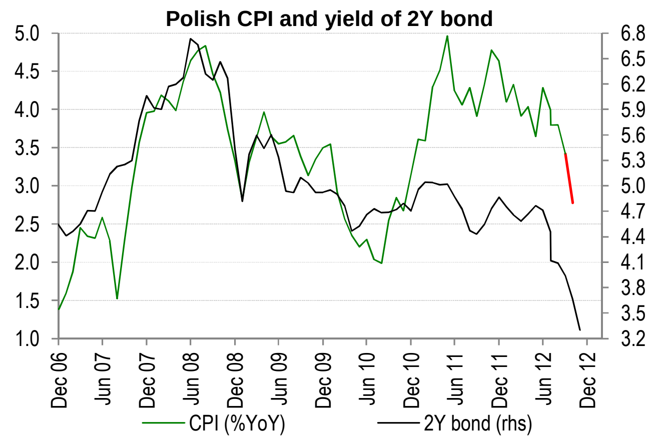
CEE currencies weaker after Q3 GDP data

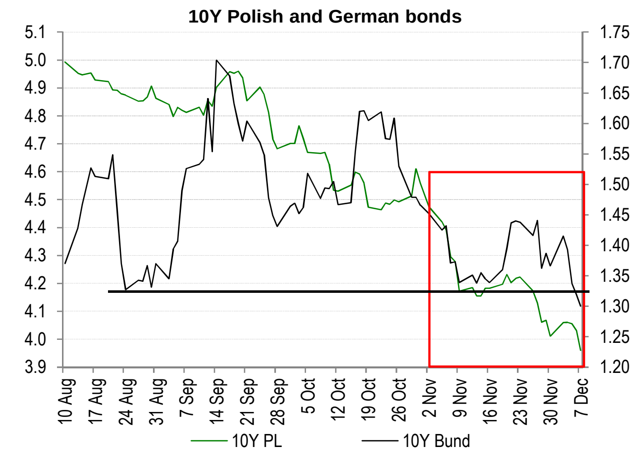
- Releases of Q3 GDP data were the most important events for CEE currencies. In Czech Republic, but also in Hungary, negative GDP growth rates were recorded, which, apart from ECB's information about weaker growth outlook for the euro zone, generated an additional upward impulse for EURCZK (after earlier decline slightly below 25.2) and EURHUF.
- Situation on the international markets will be crucial for CEE currencies. Increases of EURUSD after Fed's decision (replacement of Operation Twist with a new programme) should help both currencies to trim their earlier gains.

Interest rate market – CPI and Fed may support Polish debt









Correction on the FRA market only temporary

▪ Just like we suggested, the decision of the MPC to cut interest rates only by 25bps triggered temporary upward correction of FRA rates. The rates increased by 2-5bps, but in the following days the downward trend was resumed. Quite visible decline was recorded in case of WIBOR. Compared to last Friday, 1M rate plunged by 11bps and 1Y by 16bps. Since the release of 2Q GDP data 1M rate declined already by 50bps (just like the NBP rates) and longer rates by over 75bps since end of August.

▪ The chart shows there is some potential for slightly more aggressive market pricing of future rate cuts (we expect the main NBP rate to reach 3.5% in April). It is worth to remember, that MPC is already late with rate reductions and the market may start to price-in change in bias of monetary policy before the Council actually does switch its attitude. Thus, the market is quite unlikely to price-in as big potential for a decline of WIBOR than it used to in late 2008 (although the pace of GDP growth may fall in Q1-2013 even below the trough established at the turn of 2008 and 2009).

Yields of Polish bond lowest in history (again)

▪ The upward move of yields of bonds was initiated yet before the decision of the MPC and was visible mainly in the middle and long end of the curve. 5Y and 10Y debt was under pressure of slight weakening of Bunds and plans of supply of long term debt at the switch auction. After the decision of the MPC the correction was soon halted, and yields of 2Y, 5Y and 10Y benchmarks plunged to all-time lows. Poland's Ministry of Finance bought back bonds maturing at the beginning of 2013, i.e. OK0113 worth PLN1.2bn (reducing its redemption value to 47% of total amount outstanding) and bonds PS0413 worth PLN917m. The Ministry sold bonds WS0922 and WS0429 worth PLN737m and PLN1.1bn, respectively.

Inflation and the Fed may support Polish debt

▪ We expect a little deeper drop in inflation in November than the market, but more important seems to be the scale of this decline compared to October (from 3.4% to 2.8%). This reading - in the context of the communiqué from the MPC meeting - can fuel market expectations for further easing of monetary policy in Poland. We believe inflation will decrease to about mid-2013 and will be even below 2%. However, the market will price in changing an attitude of the MPC earlier and upward trend will start earlier. In our opinion by the end of 2012, there is little potential for increase of yields of bonds (they will be supported by the CPI data and weak activity in the industry).

▪ Outcome of the Fed meeting will be important for the long end of the yield curve. In December the "Operation Twist" ends and investors will eye whether Bernanke will announce for example the extension of QE3 to replace the expiring program. As a result of deterioration of mood after ECB presented the pessimistic forecasts for the euro area economy, yields on 10Y German bonds reached their lowest level since early August, just below support at around 1.35%. 4-month correlation of 10Y Bunds and US bonds is over 80%, so it is expected that if Treasuries gain in response to the increasing scale of chases of government debt, German bonds will also gain. As a result, Polish long-term bonds may also gain, as their yields fell last week below 4% level driven by strong downward trend.

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