Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

10 – 16 March 2014

Crisis in Ukraine was the main driver of financial market situation at the start of the week, after an unexpected escalation of tension over the weekend (Russian parliament's approval for use of military forces, pro-Russian troops effectively taking control over Crimea). Even though the high uncertainty persisted about how the situation evolves, in the following days we saw some rebound, together with rising hopes that the conflict will be resolved. Thus, the focus shifted to central banks, which surprised a bit – statement of the Polish MPC proved more dovish and the ECB's more hawkish that expected. Extension of forward guidance and words of the NBP president raised probability that interest rate hike in Poland will not be implemented before the year-end.

Until Friday's release of inflation data, the domestic market will stay under impact of events in Ukraine and global moods. The zloty, which was under pressure of events in Ukraine and global moods last week, may remain vulnerable to any information about the conflict, especially as regards Russia's reaction to sanctions imposed by the West and to demands to withdraw troops from Crimea. Our CPI forecast is in line with consensus, so the data should not affect the market considerably. However, the annual CPI basket reweighting means higher uncertainty about the final reading.

Economic calendar

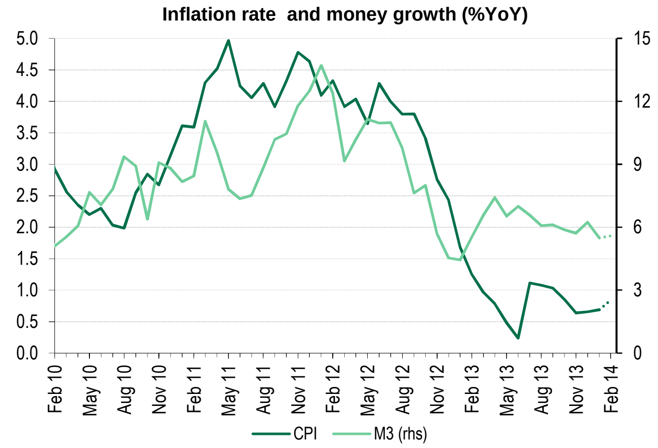
TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (10 March)					
9:00	CZ	CPI	Feb	%YoY	0.2	-	0.2
10:30	EZ	Index Sentix	Mar	pts	14		13.3
		TUESDAY (11 March)					
8:00	DE	Exports	Jan	%MoM	1.2	-	-0.9
8:00	DE	Imports	Jan	%MoM	1.2	-	-0.6
9:00	HU	GDP	Q4	%YoY	2.8	-	1.7
9:00	HU	CPI	Feb	%YoY	-	-	0.0
15:00	US	Wholesale inventories	Jan	%MoM	0.3	-	0.3
		WEDNESDAY (12 March)					
11:00	EZ	Industrial output	Jan	%MoM	0.5	-	-0.7
		THURSDAY (13 March)					
14:30	US	Import prices	Feb	%MoM	0.5	-	0.1
14:30	US	Retail sales	Fe	%MoM	0.3	-	-0.4
14:30	US	Retail sales ex autos	Feb	%MoM	0.2	-	0.0
14:30	US	Initial jobless claims	week	k	330	-	323
		FRIDAY (14 March)					
8:00	DE	HICP	Feb	%YoY	1.0	-	1.2
14:00	**PL**	**CPI**	**Feb**	**%YoY**	**0.8**	**0.8**	**0.7**
14:00	**PL**	**M3 money supply**	**Feb**	**%YoY**	**5.4**	**5.6**	**5.5**
15:55	US	Flash Michigan	Mar	pts	81.8	-	81.6

Source: BZ WBK, Reuters, Bloomberg, Parkiet

ECONOMIC ANALYSIS DEPARTMENT:
ul. Marszałkowska 142. 00-061 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

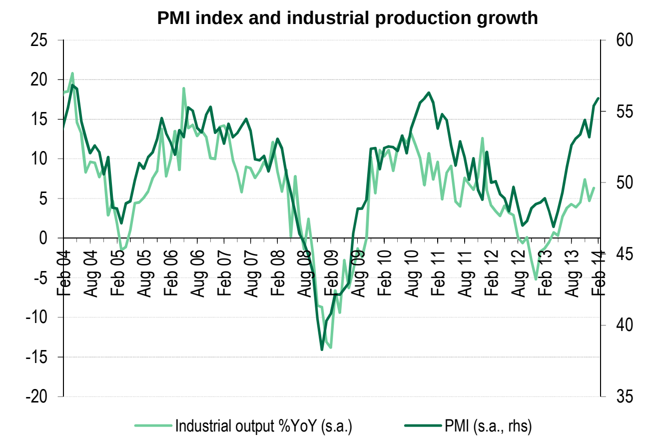
TREASURY SERVICES:
Poznań +48 61 856 5814/30
Warszawa +48 22 586 8320/38
Wrocław +48 71 369 9400

What's hot this week – Inflation will pick up slightly



- Friday's inflation data will include not only reading for February, but also the new composition of CPI basket and revised January's reading. Our forecast is suggesting a slight rise of inflation in February to 0.8%YoY, mainly due to higher prices of tobacco and alcohol (lagged effects of hike of excise duties introduced in January).
- Reweighting of inflation basket, similarly as in previous years, should be rather insignificant for the CPI dynamics. According to our estimates, this factor can raise inflation by ca. 0.04 percentage points this year. Analysis of changes in relative price level in 2013 suggested a higher share of spending on food and beverages, tobacco and alcohol. However, survey of households' spending indicates lower relative spending on food and transport, but higher on housing costs. Still, effect of both these changes on the CPI basket is similar.

Last week in the economy – Further recovery in industry, interest rates will remain low for longer



- PMI index for Polish manufacturing climbed in February to 55.9pts from 55.4pts in January, beating our and market expectations. Further rise was caused by new orders, advancing at the fastest pace since April 2004. This category was positively affected by both domestic and foreign demand (the export orders indicator was rising at the second fastest pace in more than three years). Thanks to that, February's output expanded at the strongest pace since November 2010. Data on employment are still surprising to the upside. Subindex for this category – after a strong acceleration in January – fell, but remained at a high level in February.
- Apart from showing an improving economic climate, data confirmed there is no inflationary pressure at this stage of economic recovery. The survey showed that input prices fell most considerably since April 2013.

NBP projections in consecutive *Inflation Reports*

	GDP growth			
	Mar 13	**Jul 13**	**Nov 13**	**Mar 14**
2014	1.4-3.7	1.2-3.5	2.0-3.9	2.9-4.2
2015	1.9-4.4	1.6-4.2	2.1-4.5	2.7-4.8
2016				2.3-4.8
	CPI inflation			
	Mar 13	**Jul 13**	**Nov 13**	**Mar 14**
2014	0.8-2.4	0.4-2.0	1.1-2.2	0.8-1.4
2015	0.7-2.4	0.7-2.4	1.1-2.6	1.0-2.6
2016				1.6-3.3

- The Monetary Policy Council extended its forward guidance until the end of Q3-2014. The GDP growth projection was raised – average forecast for 2014 is now at 3.5% (versus 2.5% expected in November), which is in line with our forecast (and considerably above market consensus). A somewhat quicker GDP growth is expected for 2015. What is interesting, the inflation projection assumes that despite economic recovery the CPI growth will stay significantly below the official target in 2014-2015 (similarly as in the previous projection) and will rise towards the target in 2016.
- In our view, rebound of inflation may be quicker than forecast in the central bank's projection. Still, the tone of the Council's statement and comments of its president at the press conference (see below) are indicating that prospects for the first interest rate hike became more distant.

Quote of the week – The Council will not jolt into action immediately after Q3

Marek Belka, NBP president, 05.03, MPC press conference

I think that the projection is strongly indicating that economic conditions in the short-term are quite predictable. And it seems that we do not have to worry about upward pressure on inflation in the upcoming quarters. We thought that if we wait longer, then market reactions will be become impatient. Projection show a non-inflationary growth path, so why should we have waited (…)

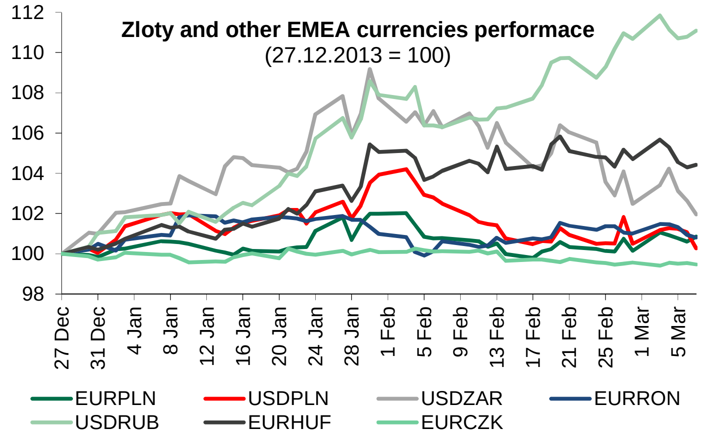
This option was approved unanimously. We were discussing whether to prolong our declaration until the year-end, but the world is so unpredictable. (…)

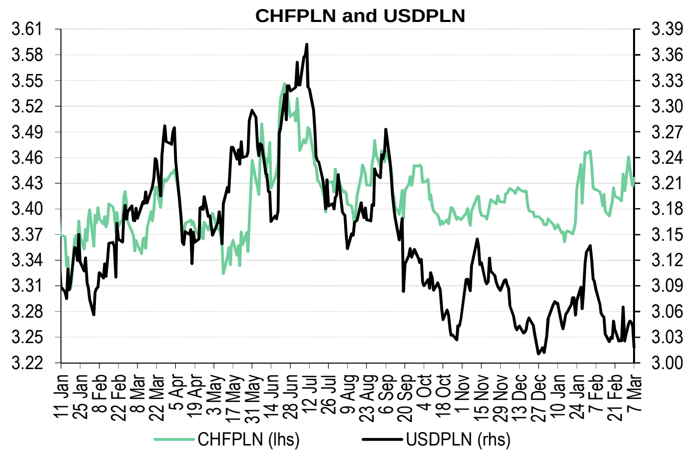
We did not promise we will hike rates after Q3 (…) One should not expect that the Council will jolt into action (immediately after Q3) and hike rates.

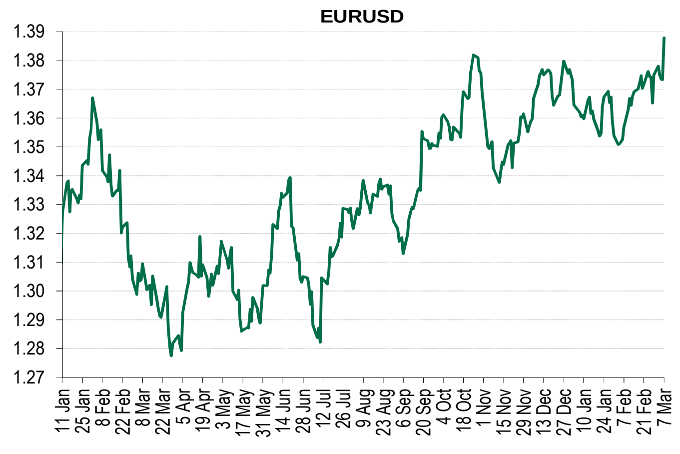
NBP governor Marek Belka said during the press conference that the key paragraph of the statement – that communicates that the forward guidance is extended – includes also a new element: interest rates should be kept unchanged "for a longer period of time". Belka stressed this is a signal that the market should not expect interest rate hikes immediately after the end of Q3. Taking into account the timing of release of next NBP projections (November) it seems that indeed the first rate hike will probably not take place immediately after the third quarter. We see growing probability that NBP rates will remain stable until the year-end.

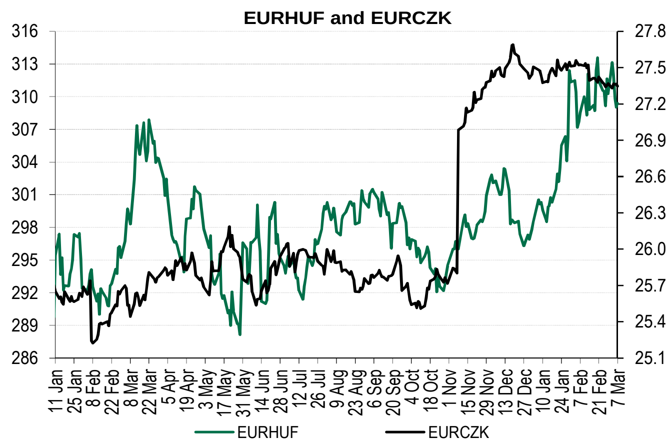
Let us note that Marek Belka suggested also that cuts should not be taken under consideration as monetary easing amid robust economic recovery would be a "strange" procyclical behaviour and a mistake.

Foreign exchange market – Zloty, next to ruble, depreciated the most









Zloty under the pressure of situation in Ukraine

- Last week the zloty has remained under the impact of external factors. Higher risk of military conflict in Ukraine contributed to weakening of emerging market currencies. The EURPLN rose above 4.22. Depreciation was short-lived and due to relative stabilisation of mods the rate has settled in range 4.17-4.19. On Friday the moods in domestic FX market deteriorated again and the zloty weakened, with EURPLN climbing almost to 4.20.
- USDPLN displayed even more volatility. Due to strengthening of European currency the USDPLN fell towards 3.01 after temporary rise to 3.065 (the minimum was 3.007). The end of the week saw a slight rise of this rate, slightly above 3.02. In course of the week, the Polish currency lost 0.9% versus the euro, 0.4% versus dollar and Swiss franc, and 0.3% against British pound.
- Uncertainty about situation in Ukraine due to events in Crimea is still fuelling volatility on markets. A possible new wave of rise in risk aversion may generate move of EURPLN towards local peak at 4.226. If situation in Ukraine does not change considerably, we do not rule out a quick return of EURPLN towards important support at 4.17.

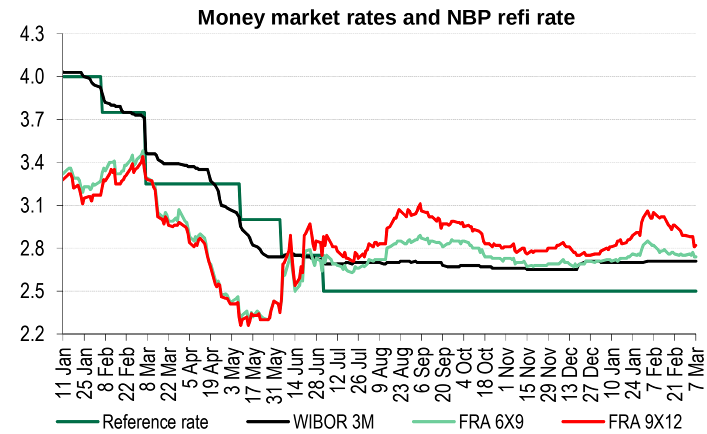
Significant strengthening of the single currency

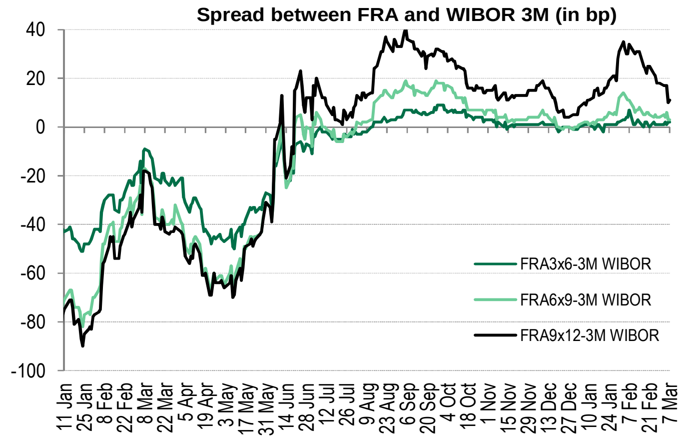
- Last week brought a significant strengthening of the euro versus the dollar. The euro was supported by weaker-than-expected data from the USA and by the ECB decision to keep monetary policy unchanged. Moreover, the market interpreted Mario Draghi's rhetoric as more hawkish, In due course, EURUSD climbed slightly above 1.39 on Friday (the highest level this year). The better-than-expected data on US labour market triggered some weakening of the euro. However, the decline was not considerable due to rising US unemployment rate (to 6.7% versus expectations at 6.6%).
- There are not may key macroeconomic releases this week. Data from the USA (retail sales, flash Michigan index) will be shown at the end of the week. Until this time, investors will be eyeing events in Ukraine, where development of situation remains unsure and difficult to predict. Still, a possible next wave of risk aversion would direct capital towards safer assets, which can have an impulse for profit-taking on EURUSD after significant strengthening of the euro last week.

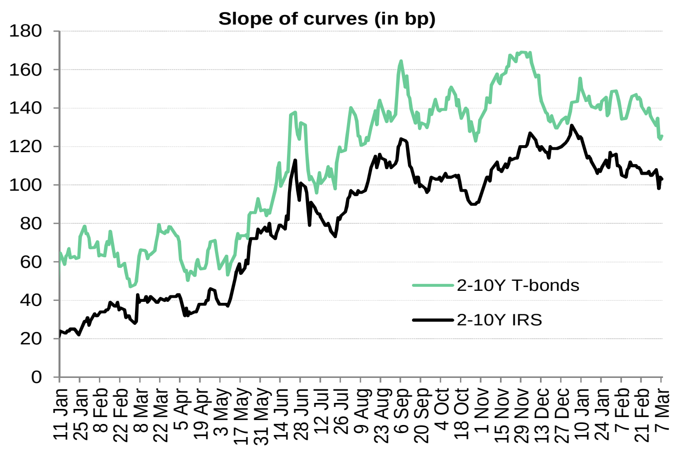
Koruna and forint are waiting for important information

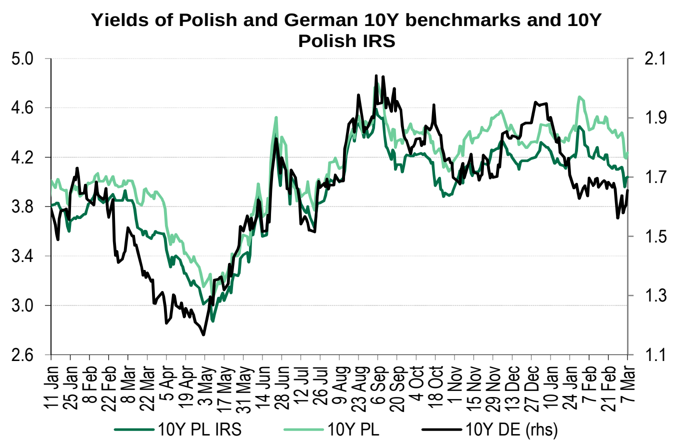
- At the start of new month the forint and the Czech koruna were losing, similarly as other emerging markets' currencies. This was due to escalation of conflict in Ukraine. A significant weakening of the ruble was partially offset by Russian central banks' decision, which has raised interest rates by 150bp. In the following days some rebound took place, but investors' moods (mainly on Hungarian market) remained fragile to data incoming from Ukraine. Released data from local economies did not affect the forint and the Czech koruna significantly.
- Events in Ukraine remain in the centre of attention, but investors may also focus on domestic data. Inflation data will be crucial for investors, as they can affect the forint and the Czech koruna in the short term.

Interest rate market – Weakened expectations for interest rate hike









Interest rate hike expectations declined

- Last week the key local event was Polish MPC meeting. The Council surprised market players, deciding to extend its forward guidance at least till the end of third quarter 2014. While WIBOR 1M – 12M remained stable after the MPC's decision, FRAs adjusted to new environment. Consequently, spread between FRA and WIBOR 3M narrowed substantially, particularly for 9x12 tenor. It reached the level of 10 bp (the lowest level since the beginning of January) at the end of the week, showing that investors again withdrew from pricing-in the start of monetary tightening in 9 months' time (i.e. till year-end).
- This week investors' mood will depend on external factors as domestic inflation CPI data will be released on Friday afternoon. We believe that CPI reading should confirm lack of inflationary pressure in Polish economy (our forecast is at 0.8%YoY), which may stabilize FRAs near current levels. However, till this time situation on T-bonds and IRS will be crucial and set down direction for the money market. Any re-escalation of crisis in Ukraine might cause pressure on FRAs increase (effect of debt weakening).

MPC's decision and auction results support debt

- The beginning of last week brought substantial weakening of Polish debt in reaction to escalation of conflict in Ukraine. However, market rebounded next days due to relative stabilisation of the situation in Ukraine. Unexpected MPC's decision to extend its forward guidance by a quarter and favourable results of bond auction also supported T-bonds and IRS, giving strong impulse to further decline in both yields and IRS rates. Consequently yield of 10Y benchmark temporary fell to 4.13%, the lowest level since end of October 2013. However, the ECB's decision to keep monetary conditions unchanged and zloty weakening at the end of week caused some profit taking.
- Changes in yields and IRS rates resulted in curves flattening. Spread 2-10Y for T-bonds narrowed to nearly 120 bp, down from 135 bp at the end of February, reaching the lowest level from the end of October 2013. As regards IRS, spread 2-10Y after declining to 98 bp due to the MPC's decision, again shifted up towards the level observed at the end of February (ca 105 bp).
- Poland's Finance Ministry placed OK0715 bonds worth PLN3.75bn (in total with top-up auction) with yields at 3.066% and bonds WZ0119 worth PLN2.82bn at 98.97. Total demand at both auctions exceeded PLN10bn. We estimate that after this auction borrowing needs for 2014 are covered in 65%.

Elevated uncertainty may persist

- Market situation remains volatile. The threat of growing geopolitical tension due to situation in Ukraine may generate another wave of risk aversion. This, consequently, may trigger a rise in yields of domestic debt, mainly at the long end of the curve, which would lead to steepening of curves again. In the opposite case, we expect slight changes in yields / IRS rates in expectation for next economic data from Poland and FOMC meeting next week.
- The monetary policy outlook has changed after the MPC decision to extend the declared period of rates' stability. This factor, together with still low inflation (we expect CPI rise in February to 0.8%YoY) should be stabilising the short end of the curve close to current levels.

Additional information is available on request. Please contact Bank Zachodni WBK S.A. Rates Area, Economic Analysis Department, ul. Marszałkowska 142, 00-061 Warsaw, Poland, phone +48 22 534 18 88, email ekonomia@bzwbk.pl, http://www.bzwbk.pl.