

WEEKLY ECONOMIC UPDATE

12 – 18 May 2014

In line with expectations, central banks' meetings in Poland, the Czech Republic and the UK were overshadowed by the ECB. Monetary policy in the euro zone remains unchanged, but a clear ECB declaration in June supported the debt markets and gave an impulse for profit-taking on the euro market. An additional support for the markets was provided by Putin's declaration about willingness to end the conflict in Ukraine.

This week the inflation and flash GDP data will be in centre of attention. They will be viewed in regard to future actions of central banks. Our inflation forecast is slightly above market expectations. We are also expecting much better data on foreign trade, which can support the zloty. Situation in Ukraine is still a risk factor, as results of Sunday's referendum about accession of Donetsk region to Russia can change the market prospects at the start of the week.

Economic calendar

| CZAS W-WA | COUNTRY | INDICATOR | PERIOD | FORECAST | | LAST VALUE |
|---------------------------|-----------|------------------------|------------|-------------|--------------|---------------------|
| | | | | MARKET | BZWBK | |
| MONDAY (12 May) | | | | | | |
| 9:00 | CZ | CPI | Apr | %YoY | 0.3 | - 0.2 |
| TUESDAY (13 May) | | | | | | |
| 9:00 | HU | CPI | Apr | %YoY | 0.2 | - 0.1 |
| 11:00 | DE | ZEW index | May | pts | 41.0 | - 43.2 |
| 14:30 | US | Retail sales ex autos | Apr | %MoM | 0.6 | - 0.7 |
| WEDNESDAY (14 May) | | | | | | |
| 11:00 | EZ | Industrial output | Mar | %MoM | -0.1 | - 0.2 |
| 14:00 | PL | CPI | Apr | %YoY | 0.6 | 0.7 0.7 |
| 14:00 | PL | Money supply | Apr | %YoY | 5.2 | 5.3 5.1 |
| THURSDAY (15 May) | | | | | | |
| 8:00 | DE | Advance GDP | Q1 | %YoY | 2.2 | - 1.4 |
| 9:00 | CZ | Advance GDP | Q1 | %YoY | 2.3 | - 1.2 |
| 9:00 | HU | Advance GDP | Q1 | %YoY | 2.7 | - 2.7 |
| 10:00 | PL | Advance GDP | Q1 | %YoY | 3.1 | 3.1 2.7 |
| 11:00 | EZ | Advance GDP | Q1 | %YoY | 1.1 | - 0.5 |
| 11:00 | EZ | HICP | Apr | %YoY | 0.7 | - 0.5 |
| 14:00 | PL | Core inflation | Apr | %YoY | 0.9 | 1.0 1.1 |
| 14:00 | PL | Current account | Mar | €m | -186 | 283 -572 |
| 14:00 | PL | Exports | Mar | €m | 13700 | 14100 12 773 |
| 14:00 | PL | Imports | Mar | €m | 13734 | 13900 12 594 |
| 14:30 | US | CPI | Apr | %MoM | 0.3 | - 0.2 |
| 14:30 | US | Initial jobless claims | week | k | - | - 319 |
| 15:15 | US | Industrial output | Apr | %MoM | 0.0 | - 0.7 |
| 16:00 | US | Philly Fed index | May | pts | 12.5 | - 16.6 |
| FRIDAY (16 May) | | | | | | |
| 14:30 | US | House starts | Apr | k | 983 | - 946 |
| 14:30 | US | Building permits | Apr | k | 1015 | - 997 |
| 15:55 | US | Flash Michigan | May | pts | 84.5 | - 84.1 |

Source: BZ WBK, Reuters, Bloomberg, Parkiet

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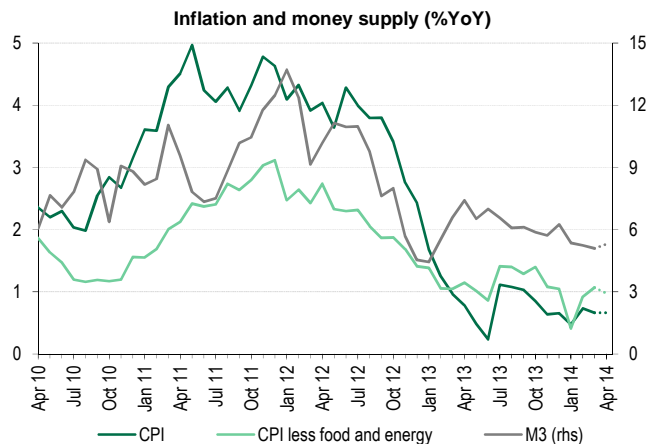
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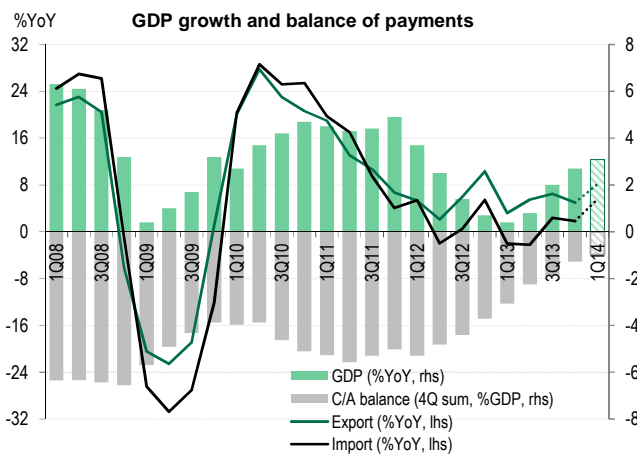
What's hot this week – Inflation, GDP, balance of payments



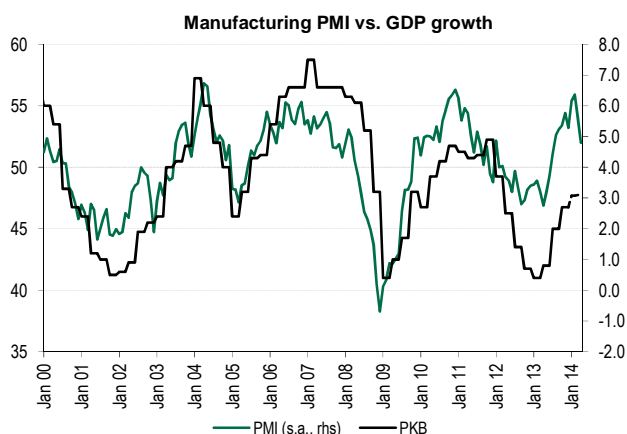
- We are expecting the CPI to stabilize in April at 0.7%YoY, for the third time in a row, while market consensus according to Reuters and Parkiet is at 0.6% and some forecasts point even to 0.5%. A reading in line with our forecast can be a bit surprising, but should not trigger any important correction, as this still will be a low figure, way below the NBP target. According to our estimates, after two months of declines, prices of food increased in April again (e.g. pork prices). Upward pressure on prices was not visible in other categories (apart from seasonal hikes of clothing and footwear prices), so core inflation excluding fuel and food prices decreased somewhat in our view, to 1.0% (and we are also slightly above the consensus).

- Foreign trade statistics will complement the set of Q1 data – these will be released on the very same day, when the Central Statistical Office will publish its flash estimate of GDP in Q1. In our view, the significant slowdown of export and import growth in February was a one-off distortion, so for March we are expecting a rebound in foreign trade, to levels we assess in line with expansion of industry and domestic demand. As a result, current account deficit should post a surplus. Data better than market expectations should be a support for the zloty.

- The available monthly data show quite clearly that economic growth accelerated in 1Q2014 to slightly above 3%YoY. This week the CSO will not show detailed growth breakdown, but in our view the domestic demand is still playing the dominant role in the economic recovery – with accelerating consumption and investment.



Last week in the economy – PMI disappointed, MPC with no surprise



- April's PMI index for Poland fell to 52pts, well below forecasts. This was the lowest reading since July 2013. Declines were posted by 4 out of 5 PMI sub-indices, including export orders, which might have partly resulted from negative impact of uncertain situation in Ukraine on expectations. This is another warning signal showed by the PMI index about Polish economic prospects. On the other hand, in our view the index was at exaggerated levels in the preceding months and even after the considerable correction in March and April, the current PMI level is in line with industrial output growth of over 6%YoY.

- The MPC meeting did not bring anything new. The governor Marek Belka clearly suggested at the last two press conferences that change in communication will be considered in July at the earliest, when new NBP projections will be released. Recent comments suggest that this will be another expansion of the forward guidance until end of this year.

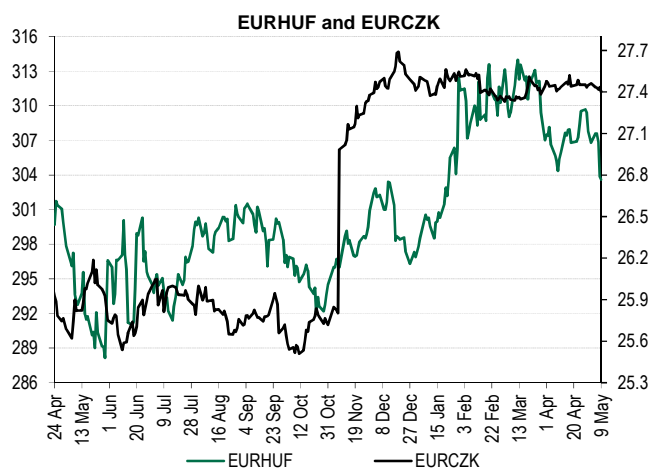
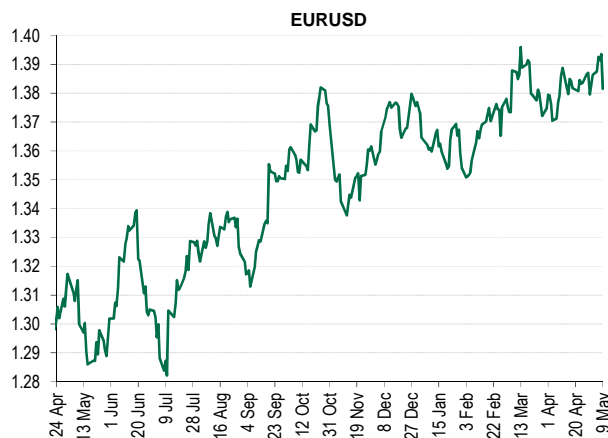
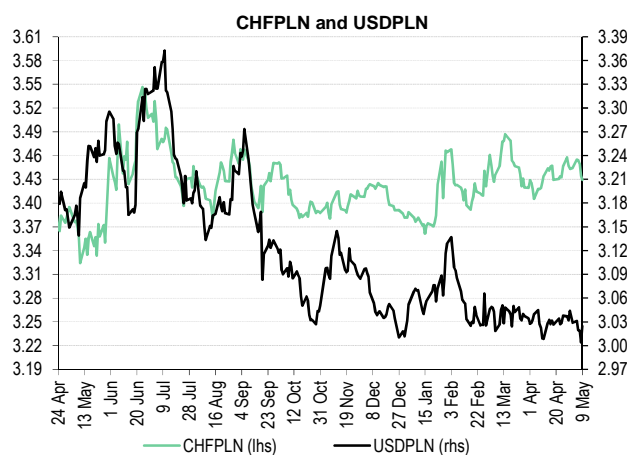
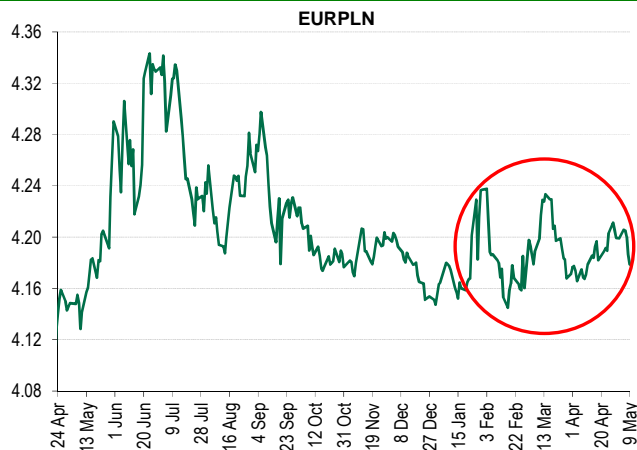
Quote of the week – July will be a good moment to change communication

Marek Belka, NBP governor, 07.05, MPC press conference

I cannot say what will be the opinion of the majority in the Monetary Policy Council in two months, but I stick to my view that July's projection is a good moment to consider a change in communication. That is when you should expect we will show our plans about the interest rate policy. At some point in time we will consider a retreat from this kind of communication, which does not necessarily have to mean a change of interest rates (...) Our *forward guidance* is successful, but mainly due to the fact that the situation is stable and we are stabilizing it even more. But if it turns out we are not sure if the future is foreseeable (...) then promising something for a longer period is risky and not very credible.

The NBP governor maintained his declaration from April that a change in MPC statement (i.e. extension of *forward guidance*) is possible in July at the earliest, when new NBP projections will be released. June's MPC meeting will be a non-event for the market. Belka noted at the same time that the current communication policy is successful, but one has to be conscious it will be abandoned one day – probably when the situation will not be stable and foreseeable anymore. In our view, such a decision can take place after release of another October NBP projection, when inflation path will be going higher, pointing to risk of surpassing the inflation target.

Foreign exchange market – EURPLN still in a narrowing trading range



Draghi supports the zloty

Worries over the situation in Ukraine and the tone of the last ECB meeting had the biggest impact on the zloty during the past two weeks. Clash between Ukrainian army and separatists as well as a referendum on including Donetsk region into Russia scheduled for the coming Sunday pushed EURPLN in late April to nearly 4.22, the highest level since mid-March. However, the zloty pared over half of losses suffered since mid-April (as it dropped to nearly 4.17) due to the ECB rhetoric. Head of the bank, Mario Draghi, said that more monetary policy easing may be launched in June if new inflation forecasts do not show any improvement. The European Commission and the OCED released their inflation forecasts for the euro zone last week. Inflation paths were revised downwards and one should expect the same will be the case with ECB forecasts due for release next month. Thus, expectations that Draghi's comments will materialize shall remain strong and should continue to support the zloty vs. the euro in the following weeks.

Meantime, the attempt to conduct a referendum in Donetsk is likely to be a vital event during the weekend. Russian president called last week to postpone the referendum, but his proposition is likely to be ignored. Situation in eastern Ukraine, where fights still take place, may be the key issue for the zloty at the beginning of the week. In the following days, the domestic currency may be supported by Polish data on flash Q1 GDP and March current account balance (in the latter case, our forecast is clearly above market consensus).

Two weeks ago we signalled the room for a substantial move of EURPLN but due to stronger expectations that the ECB will ease monetary policy in June the exchange rate stayed in the narrowing trading range. Thus, the risk of zloty's visible depreciation vs. the euro has faded. Still, we continue to see potential for a significant move of EURPLN in coming two months. It seems that the impulse will come from the ECB or Ukraine.

ECB rhetoric pressures the euro

After the two weeks of only slight changes, early May saw a substantial volatility of EURUSD. Lack of ECB monetary policy easing in May pushed the exchange rate to nearly 1.40, a fresh 2014 peak. This move was soon reversed when Draghi suggested that some action may be taken in June. The single currency plunged vs. the greenback – EURUSD dropped below 1.38.

We see very limited room for a firm rebound of EURUSD in coming weeks. The euro is likely to remain under pressure (EURUSD may decline to around 1.37). This may result in zloty's stabilization (or even some weakening) vs. the dollar.

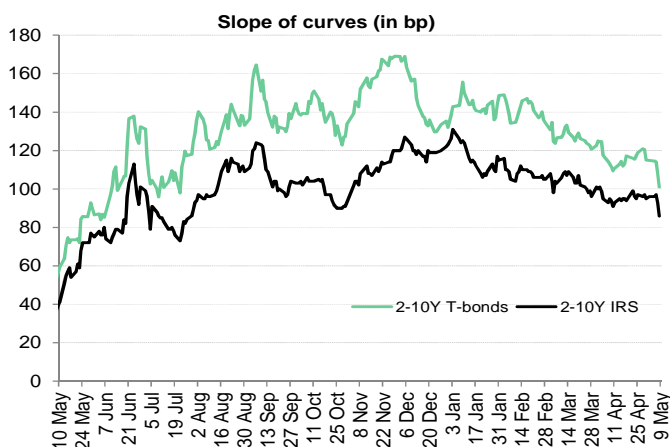
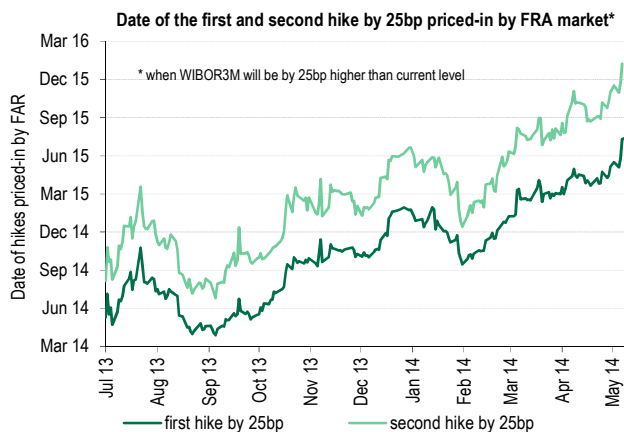
Inflation data and news from Ukraine crucial

The Czech central bank kept interest rates unchanged, main is still at 0.05%. According to the bank, there is a rising risk, that 27.0 floor for EURCZK will be maintained longer than until the beginning of 2015. The head of the CNB has already expressed such an opinion few weeks ago and this was confirmed in the statement. The CNB rhetoric did not have a visible impact on the koruna.

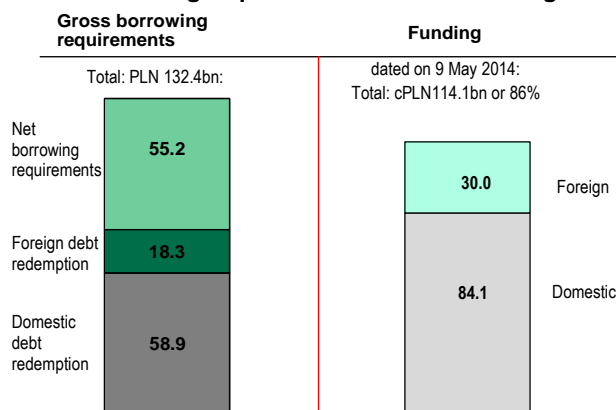
Hungarian central bank trimmed main rate to 2.50% from 2.60% and did not give any clear hint that easing cycle is getting to an end. Despite that, the forint gained vs. the euro during the past two weeks due to, among others, hopes for more monetary policy easing by the ECB.

Data on Czech and Hungarian inflation is due to be released early this week. Any upward surprised should support these two currencies, particularly the forint. At the same time, news from Ukraine shall also be vital.

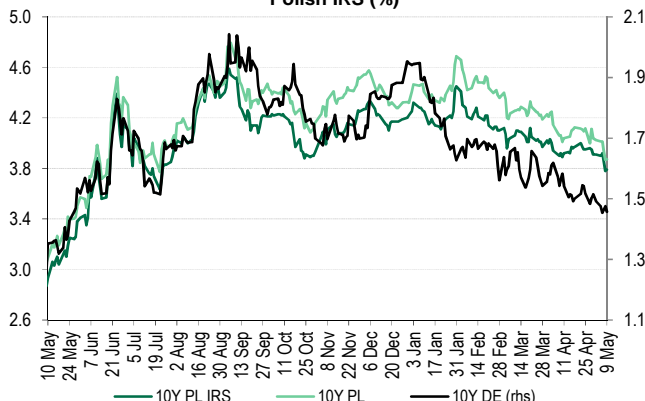
Interest rate market – Domestic debt the strongest since July 2013



Gross borrowing requirements and its financing



Yields of Polish and German 10Y benchmarks and 10Y Polish IRS (%)



Market revised its expectations on rate hikes

▪ End of April did not bring any significant changes in WIBOR rates. However, 6M, 9M and 12M tenors increased by 1bp in the first week of May. The MPC's decision at May's meeting to keep its monetary policy unchanged and Belka's declaration that in July the Council may extend its *forward guidance* did not influence the money market strongly.

▪ FRA market was more vulnerable, in particular in case of longer rates. Narrowing of FRA12x15-WIBOR3M spread to 16bp at the end of the week suggests that investors doubt in rate hike at the turn of 1Q and 2Q2015, betting that the first rate increase will be implemented at the beginning of 2H2015. We would like to highlight that investors expect WIBOR rate to increase by c.50bp in 21 months' time, as compared to 75bp at the beginning of April. This clearly suggests that market players expect lower scale of rate hikes in monetary tightening.

▪ This week important data from domestic economy will be released – CPI inflation and flash GDP for 1Q2014. Our CPI forecast is at the top of market expectations, but this release should not affect money market as data will confirm continuation of non-inflationary economic growth.

Strong performance of Polish debt

▪ Late April and early May saw a significant strengthening of the domestic interest rate market. This was driven mainly by (1) expectations for more ECB monetary policy easing, (2) limited supply of debt by the Ministry of Finance and (3) decent auction results. Consequently, bond yields and IRS rates reached fresh 2014 lows and the lowest levels since July 2013. The biggest plunge was recorded in the middles and long ends of the curves. Consequently, both curves flattened visibly – 2-10 spreads dropped to ca. 100bp for bonds and to 84bp for IRS (see the chart).

▪ In line with expectations, bond supply in May is limited. At the first auction the Ministry of Finance sold new 5Y benchmark PS0719 (with 3.25% coupon) and floating WZ0119 bond. The auction attracted high interest from both domestic and foreign investors, total demand reached nearly PLN11bn. This allowed to issue bonds worth more than initially planned (PLN5.7bn vs. PLN5bn) with prices well above the secondary market. We estimate that after this auction the Ministry has covered around 86% of 2014 borrowing needs. Minister of finance suggested that after June the ratio may reach 100% and we find it quite likely.

Positive correlation with core markets persists

▪ Recent weeks showed a positive correlation of core market (i.e. German bonds) and Polish debt market. This means that falling yields of German Bunds drag yields of domestic bonds lower. This week's Polish macro data shall not distort this tendency – we expect that a gradual economic recovery amid low inflation will be confirmed and this picture should not alter the monetary policy outlook. Bond yields are likely to stabilize close to current levels.

▪ The situation in Ukraine remains a vital risk factor, although Polish bonds seem to be quite immune to negative information from the East. However, the situation is unpredictable and any significant deterioration may trigger a sudden – although rather short-lived – market reaction.

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