WEEKLY ECONOMIC UPDATE

19 – 25 May 2014

Last week was rich in releases important for the European and domestic economies. Flash GDP reading for the euro zone proved a negative surprise, mainly due to disappointing results of France and Italy, clearly contrasting with improving situation in Germany and Spain. Domestic data also delivered a lot of surprises (especially the CPI inflation, which approached zero again), confirming the non-inflationary revival of domestic economy. It seems that it will take more time before CPI reached NBP target again. This encouraged us to shift our expectations for interest rate hikes in Poland to the second half of 2015, which is still earlier than currently priced-in by the market. Correction on the euro zone peripheral debt market (triggered, among other factors, by rumours that the Greek government plans to introduce a retroactive capital gains tax on bondholders) and weaker readings of US data caused a rise of risk aversion, giving an impulse to take profit on emerging markets at the end of the week.

Important data from the domestic economy will be released this week. We are expecting a further improvement in manufacturing and on the labour market, amid continuation of decline in producer prices. Abroad, flash PMI readings for May in the euro zone will be crucial. They can significantly affect investors' moods on the global market and set a direction for trade in the short run. End of the week can be marked by higher market volatility due to uncertainty before the presidential election in Ukraine, which will be held on the same day as European Parliament election (25 May).

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (19 May)					
14:00	**PL**	**Wages in corporate sector**	**Apr**	**%YoY**	**4.0**	**4.3**	**4.8**
14:00	**PL**	**Employment in corporate sector**	**Apr**	**%YoY**	**0.8**	**0.8**	**0.5**
		TUESDAY (20 May)					
14:00	**PL**	**Industrial output**	**Apr**	**%YoY**	**5.1**	**6.2**	**5.4**
14:00	**PL**	**Construction and assembly output**	**Apr**	**%YoY**	**19.7**	**24.0**	**17.4**
14:00	**PL**	**PPI**	**Apr**	**%YoY**	**-0.7**	**-0.8**	**-1.3**
		WEDNESDAY (21 May)					
20:00	US	FOMC minutes					
		THURSDAY (22 May)					
3:45	CN	Flash PMI – manufacturing	May	pts	48.3	-	48.1
9:30	DE	Flash PMI – manufacturing	May	pts	54.0	-	54.1
10:00	EZ	Flash PMI – manufacturing	May	pts	53.2	-	53.4
11:00	**PL**	**Road bond auction**					
14:30	US	Initial jobless claims	week	k	-	-	
16:00	US	Home sales	Apr	m	4.68	-	4.59
		FRIDAY (23 May)					
8:00	DE	GDP	Q1	%YoY	2.3	-	
10:00	DE	Ifo index	May	pts	111.0	-	111.2
16:00	US	New home sales	Apr	k	428	-	384

Source: BZ WBK, Reuters, Bloomberg, Parkiet

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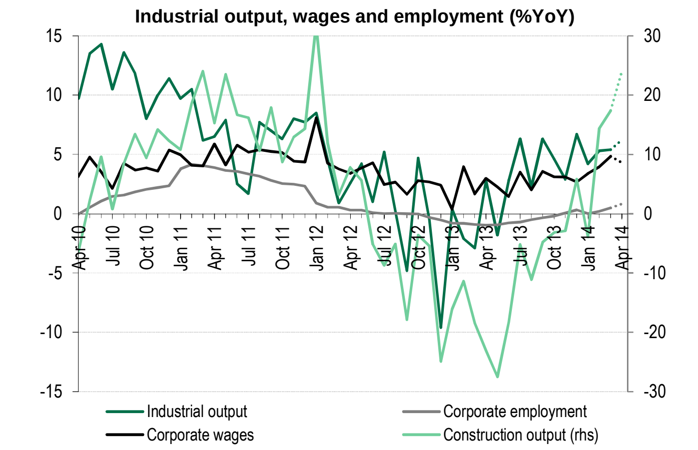
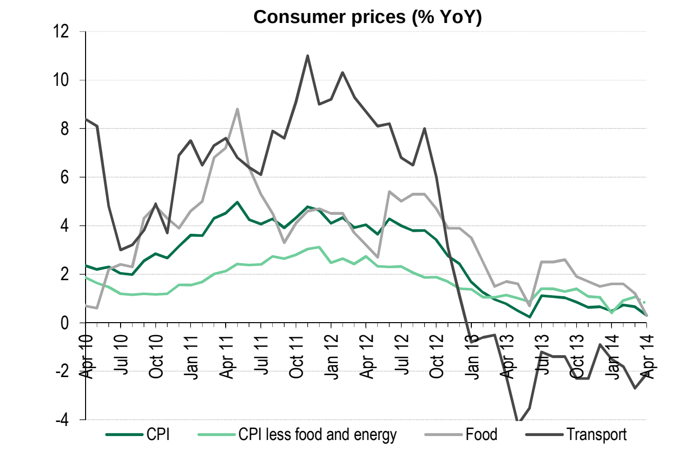
What's hot this week – Output and employment in upward trend

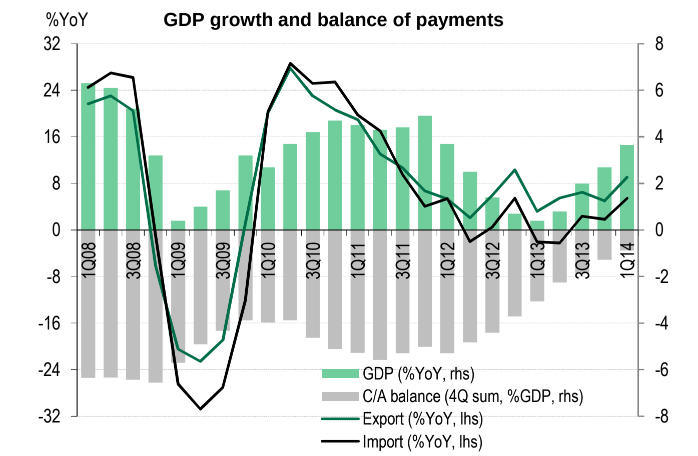


- Data to be released this week should confirm that positive tendencies in economic activity in Poland were continued at the verge of Q2. Employment growth rate probably accelerated in April, which, given still quite fast wage growth (yet a bit slower than in March) and low inflation means that consumers' purchasing power is expanding. This factor will support private consumption throughout the year.
- We are expecting very favourable output in industry and construction, on one hand confirming that foreign demand for Polish products stays high, while on the other hand showing that the investment activity is still on the rise (construction output will be additionally supported by the weather conditions, better than one year ago). Still low PPI should confirm the lack of cost pressure on producers.

Last week in the economy – Faster, but still non-inflationary economic growth



- Inflation plunged unexpectedly in April to 0.3%YoY, well below expectations. The biggest surprise came from lower food prices, but core inflation excluding food and energy prices also declined, to 0.8%YoY, with two our core inflation gauges close to zero and at the lowest level ever recorded. This indicates a continuation of noninflationary economic recovery. It looks like the inflation may need more time than we had so far assumed to reach the NBP target and this may justify longer period of stable interest rates.
- Flash data on money supply showed that loan growth in the banking sector is accelerating visibly – in April households' liabilities advanced by 5.7%YoY (by most since June 2012) and companies' liabilities by 6.4%YoY (by most since November 2012). Increasingly strong recovery of the demand for credit is probably the result of rising domestic demand.



- GDP growth in 1Q14 accelerated to 3.3%YoY and was faster than expected. After the seasonal adjustment, growth accelerated to 1.1%QoQ. Polish economy seems to have exited the slowdown phase of the economic cycle and is now operating at a pace close to its potential. In our view, role of domestic demand (consumption and investment) strengthened, but exports still remain an important growth driver.
- Such a scenario is confirmed by foreign trade numbers. Export growth rebounded to high level of almost 11%YoY in March, after a temporary slowdown in February, while current account balance was positive again (EUR517m). As for the time being, decline of exports to Russia and Ukraine (-7.1%YoY and -20.6%YoY in Q1, respectively) is more than offset by rise of exports to the Western Europe. However, stricter sanctions against Russia can weigh on growth in the euro zone and hence also on Polish GDP.

Quote of the week – Long period of low inflation ahead

Marek Belka, NBP governor, 15.05, Reuters
Data (on GDP) made us certain that the economy is expanding vigorously. On one hand, we see an ultra-low inflation, but on the other an economy, which is expanding strongly and this is not a bad signal. We have a long period of low inflation ahead.

Anna Zielińska-Głębocka, MPC member, 15.05, PAP
Necessity to adjust monetary policy can appear in 1H2015, but if it will be Q1 or Q2, we do not know yet. Changes in the GDP and output gap, employment growth, wages are most important.

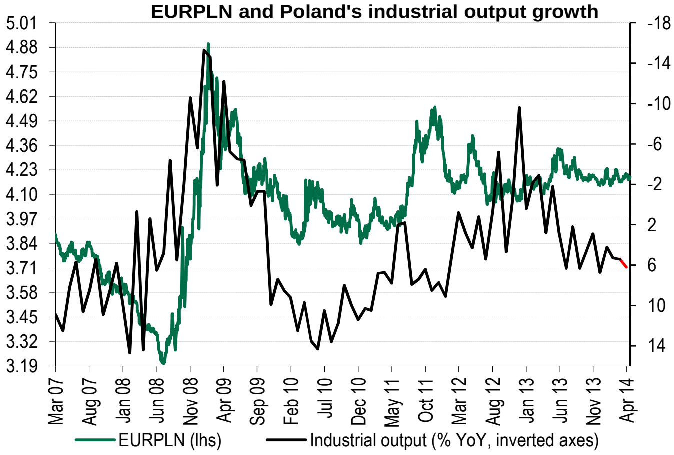
Elżbieta Chojna-Duch, MPC member, 14.05, PAP
I do not rule out a possibility to return to discussion on interest rate cuts, should the ECB cut rates in June and lean towards non-conventional monetary policy, while inflation in Poland remains low and GDP growth sits below projection.

IMF mission report, 15.05, Reuters
Monetary policy has appropriately supported the economy, but rate cuts would be needed if the recovery falters or inflation fails to pick up.

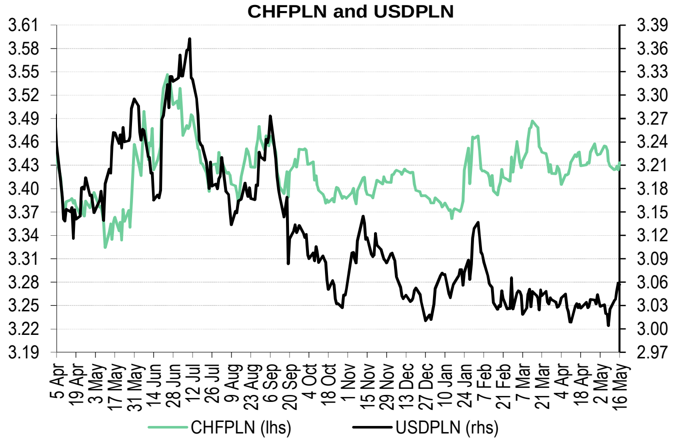
The surprisingly low March's inflation, comment of Elżbieta Chojna-Duch and IMF statement caused that market started mulling possibility of interest rate cuts in Poland. In our view the scenario of cuts is still distant, even if the ECB implements further easing in June, as the Polish economy is expanding at a decent pace (amid accelerating domestic demand) and Poland is not threatened by deflation. At the same time, prospects of hikes became actually more distant. Even if price growth accelerates in the upcoming months, the inflation's return to NBP target will take more time than we previously expected. In due course, the MPC will probably be able to keep interest rates unchanged until mid-2015.

Foreign exchange market – Presidential election in Ukraine may increase market volatility

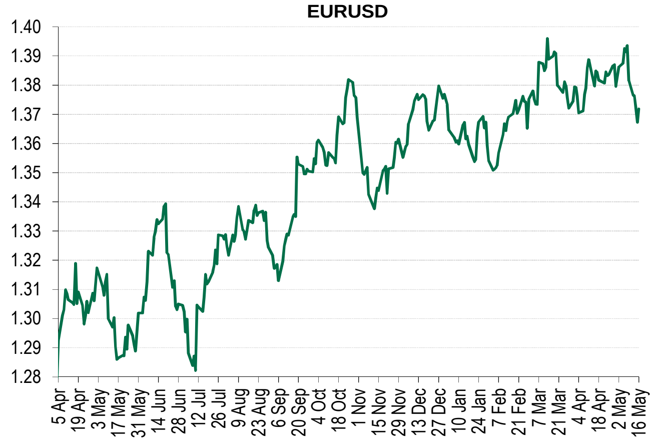
EURPLN and Poland's industrial output growth



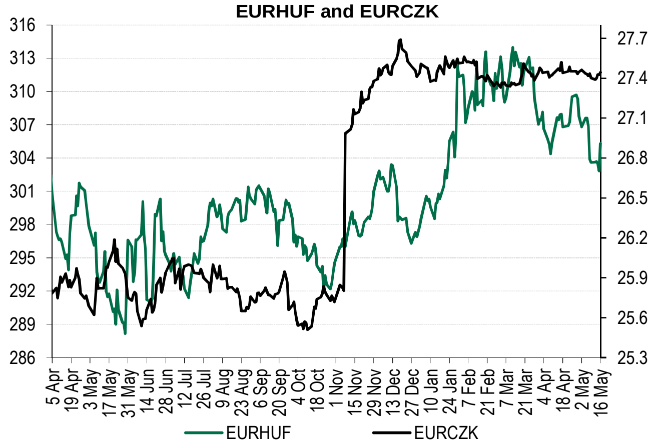
CHFPLN and USDPLN



EURUSD



EURHUF and EURCZK



Zloty weakened due to CPI data and higher risk aversion

- Last week Polish zloty was under pressure of domestic macro data. Lower than expected April's CPI reading caused EURPLN increase towards 4.20, while after better than forecasted 1Q GDP growth the exchange rate fell to nearly 4.17. However, higher risk aversion on Thursday's session (effect of weak data from the US economy and correction on peripheral euro zone debt markets) resulted in trimming most of the gains on zloty. The week ended with EURPLN near 4.19.
- In weekly terms domestic currency lost the most against the US dollar. USDPLN increased by 1.1% due to considerable decrease of EURUSD, reaching weekly maximum at the level of 3.065 (highest since mid-March). As regards other currencies (CHF, GBP) zloty lost 0.3% on average.
- Zloty's behaviour clearly suggests that impact of domestic macro data on currency is short-lived. Notwithstanding, this week domestic macro data releases, in particular production and from labour market (our forecasts are above market consensus) may strengthen zloty in short run. Higher impact may have data from European economy (flash PMI readings). Strengthening expectations that ECB will cut rates next month will support Polish zloty. Risk factor remains unchanged – it is uncertain situation in Ukraine, especially that presidential election will take place on 25 May (the same time as election to European Parliament). As a consequence we do not exclude higher volatility at the end of the week, which may bring impulse to EURPLN increase towards the upper limit of fluctuation channel between 4.16 and 4.22.

EURUSD fluctuating around 1.37

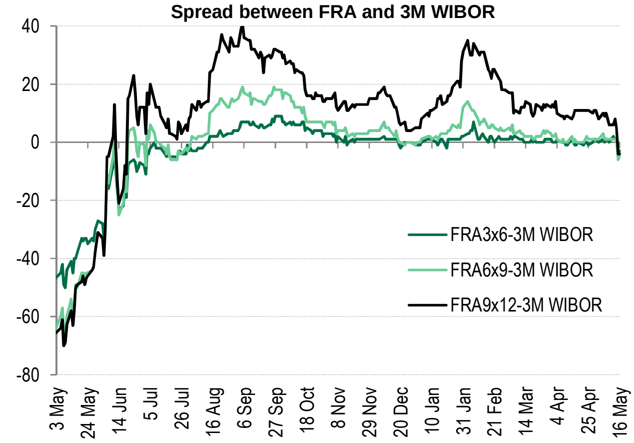
- Last week the EURUSD broke through 150-day moving average – being currently around 1.37 – and reached 1.365, the lowest level since the end of February. Drop was triggered mainly by expectations for June's ECB action, which was also affected by information that Bundesbank is ready to support the ECB in actions fighting persistently low inflation, and by reaction to weaker than expected data from Germany. However, after slightly weaker data about US industrial output the euro trimmed some losses and at the end of the week the EURUSD returned slightly above 1.37.
- This week there will be new important data from the global economy. Investors' attention will focus on flash PMI in the euro area, which have affected the EURUSD many times in the past. We think that the outlook of ECB easing in June will be limiting euro gains. The trading range for EURUSD remains unchanged at 1.365 and 1.40.

Higher risk aversion weakened currencies in the region

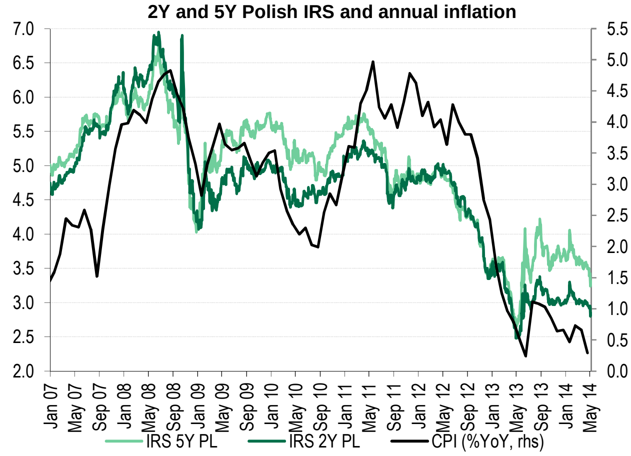
- Forint, similarly as the zloty, was depreciating in the last week. Higher risk aversion at the end of the week pushed the EURHUF above 306 from c302.8 reached after better GDP data for 1Q14. At the same time the Czech koruna remained roughly stable – EURCZK was fluctuating in narrow range 27.39-27.44, and did not react to slightly weaker than expected 1Q GDP (2.0% vs expected 2.3%) and low inflation in April.
- This week global market sentiments will remain crucial for the CEE region currencies. Data from the euro zone and from the US, due for release this week, will be interpreted in the context of future central banks' actions, which, given strengthening of expectations for further ECB actions, can give an impulse to rebound after recent rises of exchange rates. On the other hand, situation in Ukraine can undermine the markets, causing an elevated volatility, especially at the end of the week.

Interest rate market – Low inflation and ECB rhetoric support lower market rates

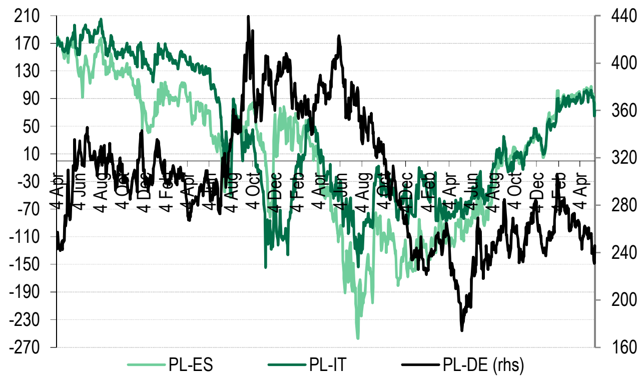
Spread between FRA and 3M WIBOR



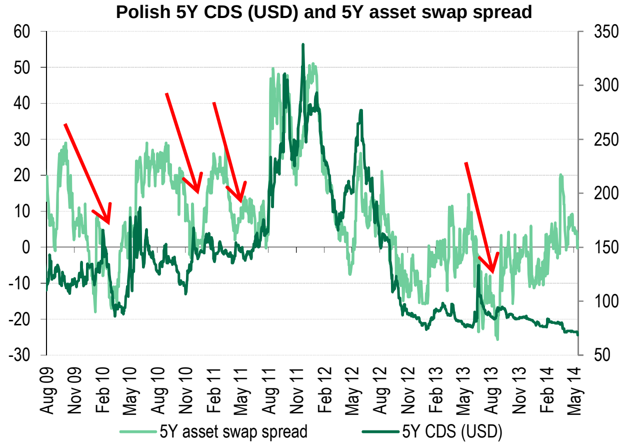
2Y and 5Y Polish IRS and annual inflation



Spread between Polish and German, Spanish and Italian 10Y bonds



Polish 5Y CDS (USD) and 5Y asset swap spread



Significant decline of IRS and bond yields

- Dovish ECB rhetoric and clearly lower than expected April's inflation were main factors driving the interest rate market last week.
- FRA market has revised its expectations for the timing and scale of rate hikes. In early May FRAs were pricing 25bp hike in 12 months and 25bp more in next 6-9 months. Currently, the market expects first hike after around 18-21 months and shorter FRA rates (up to 9 months) have declined even slightly below WIBOR.
- IRS rates have plunged significantly in the first part of the week due to expectations for more ECB monetary policy easing, strengthening of German bonds and surprisingly low Polish inflation. However, the two last days of the week brought a correction and ultimately on a weekly basis IRS declined by 8-9bp and bond yields by c10bp.
- 5Y and 10Y IRS declined already by nearly 100bp and 2Y by c50bp from the September's peak. Spreads between these rates and 6M WIBOR are at their lowest since mid-2013. Mid- and long-term bonds have retraced around 50-60% of the upward wave initiated in May 2013 after the comment of Ben Bernanke saying that QE3 tapering is looming. 10Y German bonds has pared c80% of losses.

Correction may be short-lived

- Data from the Polish labour market and on output, which will be released this week, will be better than market consensus, in our view. This can deepen the debt market correction seen at the end of the last week. However, we think that his move may prove temporary and later investors will return to expectations for further monetary easing by the ECB and continuation of non-inflationary economic growth in Poland, which will not trigger risk of interest rate hike for a long time. A possible escalation of tensions in Ukraine ahead of the upcoming presidential election can on one hand fuel the risk aversion in CEE region and on the other hand increase investors' worries about deterioration of economic growth and lowering of inflation path in the longer perspective, which can support lower market interest rates.
- After release of much worse-than-expected May's ZEW index last week, flash PMI indices for the euro zone may prove important for the market expectations about prospects of recovery. Possible declines of indices will boost market expectations for ECB's actions in June.
- Further strengthening of, for example, 5Y bonds seems to be supported by the fact, that the 5Y asset swap spread has drifted away from the 10Y Polish dollar CDS. In the past, such divergences have not been corrected without narrowing of the asset swap spread.

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