Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

30 June – 6 July 2014

Last week the global market was mainly under influence of mixed US data and comments of FOMC members, which influenced market expectations about Fed's monetary policy outlook. The Polish market was under impact of the so-called "tape affair" as well as domestic data. Successful vote of confidence for the cabinet diminished the risk of early election and positively affected Polish assets. On the other hand, the weaker-than-expected retail sales encouraged investors to price-in a rate cut in 3M time.

Most important global events this week will be releases of PMI for China, Germany and the euro zone as well as US labour market data. Activity indices for the euro zone countries used to disappoint recently, but they still show a continuation of recovery in the euro zone. Further changes of these gauges will be crucial as regards assessment of economic outlook in the currency block. On the other hand, US data will be important in context of future FOMC monetary policy. As regards the domestic market, the MPC meeting will be in the foreground this week. The surprisingly low May's inflation and a series of weaker-than-expected data on activity supported the market expectations for a rate cut, fully offsetting worries that after leakage of recordings with Marek Belka the MPC may become less eager to ease monetary policy. Reading of PMI for domestic industry may also prove important. A possible further decline of this indicator (which is not our scenario) could fuel worries about pace of economic recovery. Let us remind that the Governor Belka keeps repeating that interest rate cuts are unlikely. The ECB meeting will be in the focus of attention as well, especially as investors try to gauge when the ECB may try to introduce a QE program.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (30 June)					
11:00	EZ	CPI inflation	Jun	%YoY	0.5	-	0.5
14:00	**PL**	**Current account**	**Q1**	**€m**	**-771**	**-771**	**-1071**
16:00	US	Pending home sales	May	%MoM	0.8	-	0.4
		TUESDAY (1 July)					
3:45	CN	PMI - manufacturing	Jun	pts		-	50.8
9:00	**PL**	**PMI - manufacturing**	**Jun**	**pts**		**51.2**	**50.8**
9:55	DE	PMI - manufacturing	Jun	pts	52.4	-	52.3
10:00	EZ	PMI - manufacturing	Jun	pts	51.9	-	52.2
11:00	EZ	Unemployment rate	May	%	11.7	-	11.7
16:0	US	ISM - manufacturing	Jun	pts	55.8	-	55.4
		WEDNESDAY (2 July)					
	PL	**MPC decision**		**%**	**2.50**	**2.50**	**2.50**
16:00	US	Industrial orders	May	%MoM	0.3	-	0.7
		THURSDAY (3 July)					
9:55	DE	PMI - services	Jun	pts	54.8	-	56.0
10:00	EZ	PMI - services	Jun	pts	52.8	-	53.2
13:45	EZ	ECB decision		%	0.15	0.15	0.15
14:30	US	Non-farm payrolls	Jun	k	213	-	217
14:30	US	Unemployment rate	Jun	%	6.3	-	6.3
		FRIDAY (4 July)					
	US	Market holiday					
8:00	DE	Industrial orders	May	%MoM	-1.0	-	3.1

Source: BZ WBK, Reuters, Bloomberg, Parkiet

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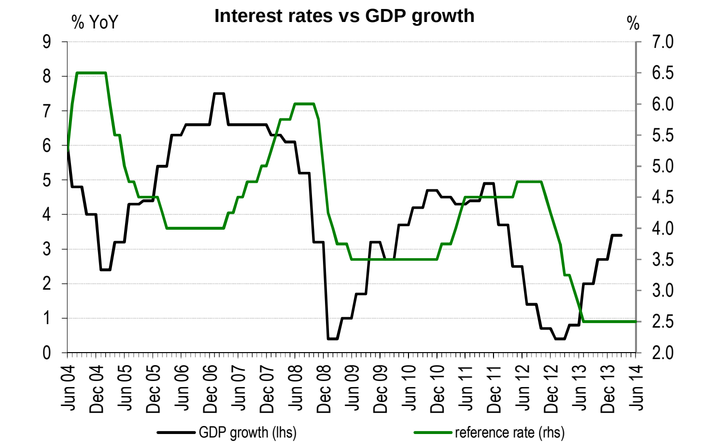
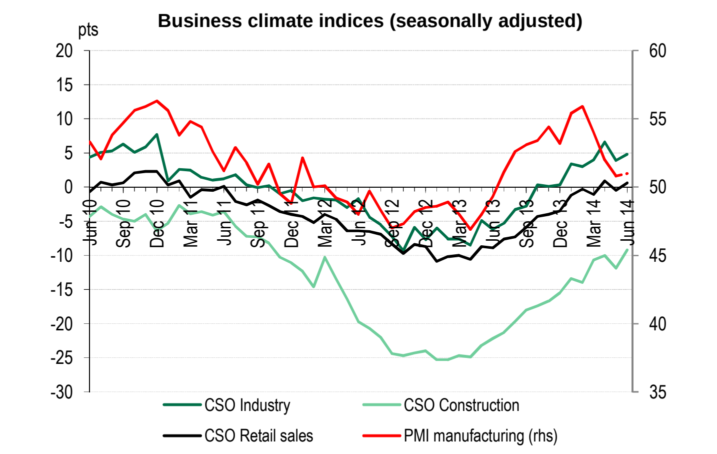
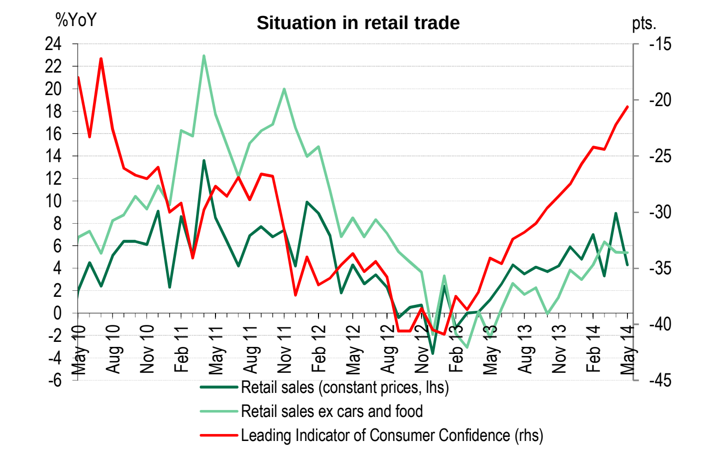
What's hot this week – Will the MPC maintain its forward guidance?





- The MPC has been suggesting already for a while that July's meeting will be crucial and results of the newest CPI and GDP projections can help the MPC assess monetary policy outlook and consider a potential change in communication with the market. Recent comments of the NBP President and of some MPC members suggested that the *forward guidance* is not useful anymore and an "earlier resignation" from this policy is possible even in July. The surprisingly low May's inflation and a series of worse-than-expected data on economic activity can enable the MPC to make such a decision, which can be interpreted by the market as a signal of possible rate cut in September.
- However, in our view macro data will be crucial as regards possible interest rate cuts after summer vacation. During the meeting in September the MPC will know the GDP growth for Q2 and first monthly data for Q3. If our forecasts assuming that recent weaker macroeconomic indicators were only a deviation for the trend materialise, and GDP growth will not persistently decelerate below 3%YoY, then a scenario of rate cuts will remain unlikely.
- We are expecting that PMI for domestic manufacturing will rebound slightly in June after 3 months of strong declines, indicating a continuation of moderately fast expansion of industrial output and further inflow of foreign orders. CSO business climate indicators adjusted for seasonal swings showed an increase in almost all surveyed sectors, including construction.
- On Monday the NBP will release data on balance of payments for Q1 together with revised monthly data. We are expecting further narrowing of current account deficit, to c0.9% of GDP, which will be the lowest reading since mid-90s. In our view, in the upcoming quarters the current account deficit will stabilize but may decline a bit.

Last week in the economy – Cars dragged retail sales down



- Retail sales advanced in May by 3.8%YoY mainly due to declining sales of cars after withdrawal of tax allowances on purchases of transport cars. Rising households' incomes should support further growth of retail sales and consumption later in the year, but as for the time being the recovery of consumer demand is modest and does not generate an upward price pressure (which is shown by the fact that retail sales deflator remains negative).
- In line with expectations, in May registered unemployment rate fell to 12.5%. In our opinion these data have started signalling that positive tendencies on the labour market slowed down. We still are still expecting a further decline in registered unemployment rate, but downward trend will be not as strong as in the previous months (after seasonal adjustment).

Quote of the week – There can be a motion for cut, but easing remains unlikely

Marek Belka, NBP President, 25.06, Bloomberg

July's statement will not diverge from earlier words of the MPC. Until some time ago interest rate hikes were the only option. Now we should also consider cuts. However, we do not plan it and interest rate cut still seems unlikely.

Elżbieta Chojna-Duch, MPC member, 24.06, Reuters

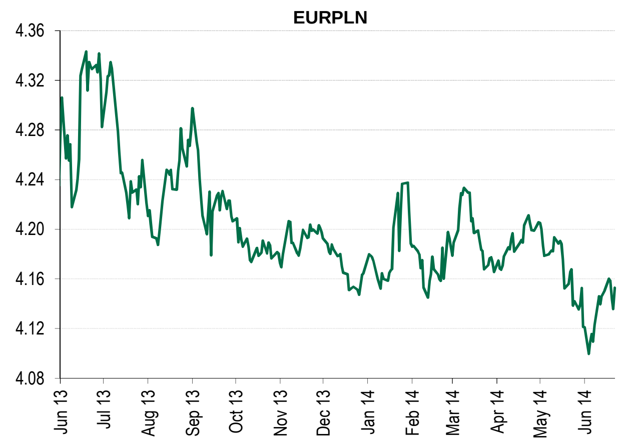
I consider filing in a motion for a cut at the upcoming meeting. Everything will depend on CPI and GDP projection.

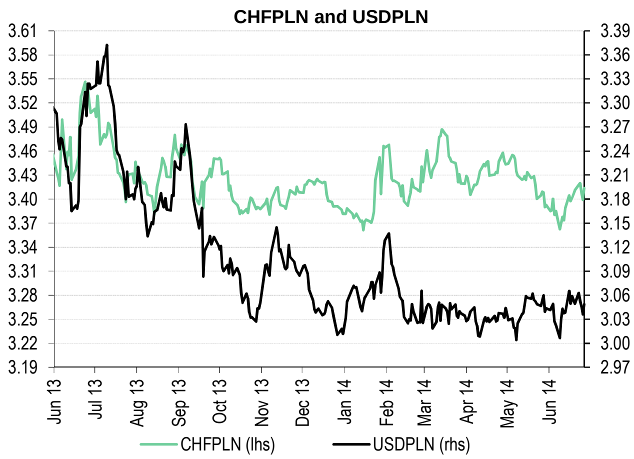
Andrzej Raczko, deputy NBP president, 27.05, PAP

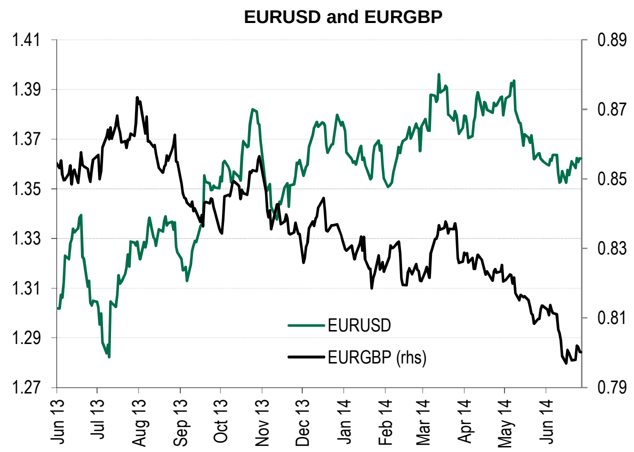
Deflation understood as long-term, persisting negative inflation is simply unlikely. If we assume GDP growth expected currently – our projection shows 3.6% in 2014 – then inflation will gradually return to the target. The pace of this return will be shown by the new projection.

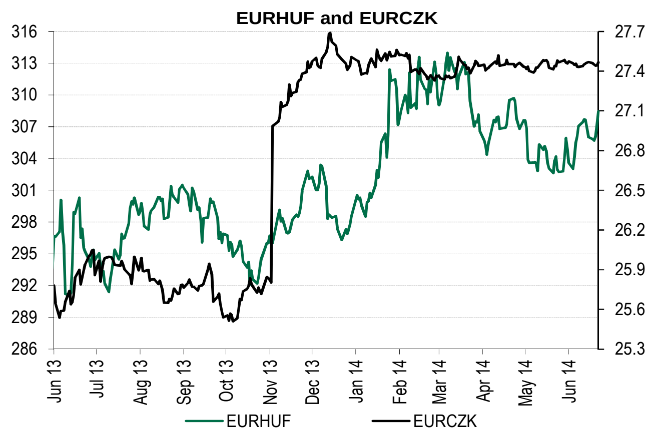
Marek Belka said that "tape affair" will not affect the MPC policy, i.e. the Council will not become more hawkish. It seems that the market believes in this declaration, as after last figures it began to price-in interest rate cut in 3 months' time. Given this context, the statement of Jerzy Hausner, scheduled for 1 July will be important. Hausner is likely to address the words of Belka. We are expecting the MPC member to suggest that the whole issue will not affect his work in the Council. Meanwhile, rate cuts still seem unlikely to us – Belka said that policy easing is unlikely and a motion of Elżbieta Chojna-Duch, if filed in, will not find majority support. We think that the NBP projection will be a support for our forecast – CPI can decline temporarily below zero, but continuation of economic recovery will fuel its rise.

Foreign exchange market – Currencies under influence of central banks' outcomes and PMI









Zloty under pressure of domestic political situation

- Last week zloty was under pressure of political situation in Poland. The influence of „type scandal" on the zloty quotation lowered from session to session and minimized as the Sejm passed the confidence vote for the government. As a consequence, EURPLN decreased to 4.135. However, zloty strengthening was only short-lived. Weaker domestic macro data (retail sales), which strengthened interest rate cut expectations, Fed official suggestion that rate hike may take place in 1Q-15 (earlier than previously expected) and news on the plan announced by the opposition party Law and Justice (PiS) that they would like to put a motion to bring the NBP governor Marek Belka before the State Tribunal caused EURPLN increase temporary to 4.161.
- In weekly terms zloty gained the most against the British pound (by 0.2%), trimming earlier losses (GBPPLN grew above 5.21, the highest level since November 2012) due to comments of the BoE government Mark Carney. As regards euro and Swiss franc zloty lost by 0.05% and 0.08%, respectively.
- Situation on the EURPLN did not change substantially in last week. Waiting for the central banks meetings (Poland's MPC, ECB) the exchange rate should stay in a range of 4.135 and 4.175. Further softening of the MPC's rhetoric and lack of extending of its forward guidance might strengthened expectations on quick rate cuts, and consequently push EURPLN towards the higher limit of fluctuation channel. On the other hand slightly better (as compared with previous months) reading of PMI for Poland's manufacturing sector together with still dovish rhetoric of ECB should limit upward move of EURPLN. What is more, any suggestion that ECB considers QE may result in testing 4.135 by EURPLN.

EURUSD in horizontal trend, sharp volatility on GBP

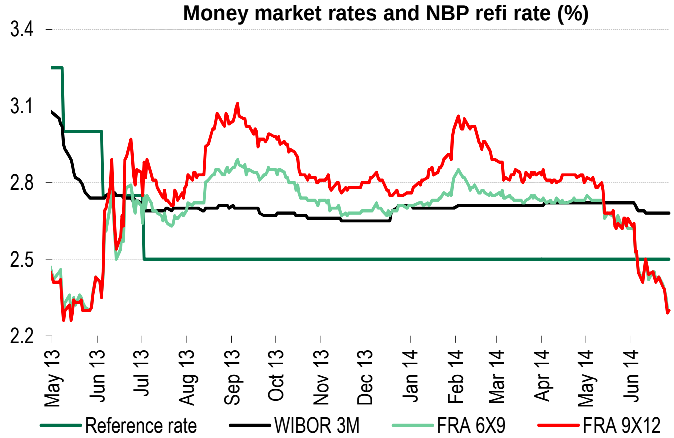
- EURUSD did not manage to break horizontal trend as macro data flow from both the European and the US economies were mixed. Last week the exchange rate has remained between 1.357 and 1.364 range. More hawkish comments from Fed official James Bullard supported the US dollar only in short run.
- The British pound was more vulnerable. Last week GBP weakened considerably due to comments from the BoE Governor. Contrary to market expectations Mark Carney did not suggest interest rate hikes later this year. Consequently, EURGBP increased to slightly above 0.80, up from c0.798 in weekly terms.
- Euro will stay under influence of PMI/ISM indices releases for both the euro zone and the USA. However, ECB meeting later this week and June non-farm payrolls in US (due to holiday on Friday, these data will be released on Thursday) will also add to the market volatility. Information that the US economy continues to accelerate, with further improvement on the labour market (which was suggested by Bullard) should support the US dollar. On the other hand the euro will be under influence of ECB meeting and its suggestion about possible timing of QE programme.

CEE currencies slightly weaker

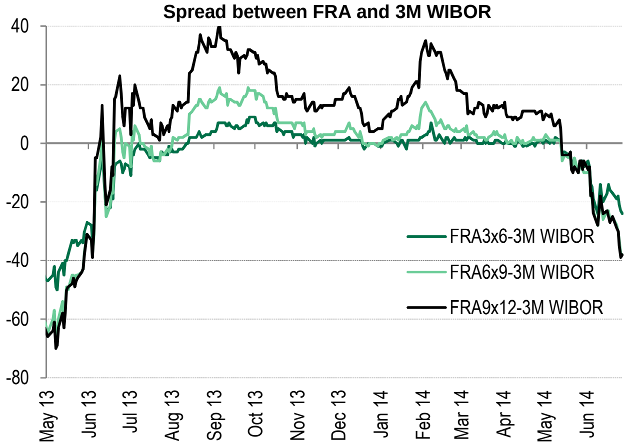
- Last week the Hungarian forint weakened against the euro. It came from worries that Hungary's FX relief package will hurt commercial banks more than previously expected. As a result EURHUF increased towards 308. EURCZK also increased slightly. It results from the CNB's decision to keep FX's regime (EURCZK above 27) until the end of 2Q-15.
- The CEE currencies similarly as the zloty will be under influence of external factors. Any suggestion by the ECB about QE will bring an impulse to further strengthening of these currencies. Otherwise we expect a stabilisation close to current levels.

Interest rate market – Market believes in swift rate cuts

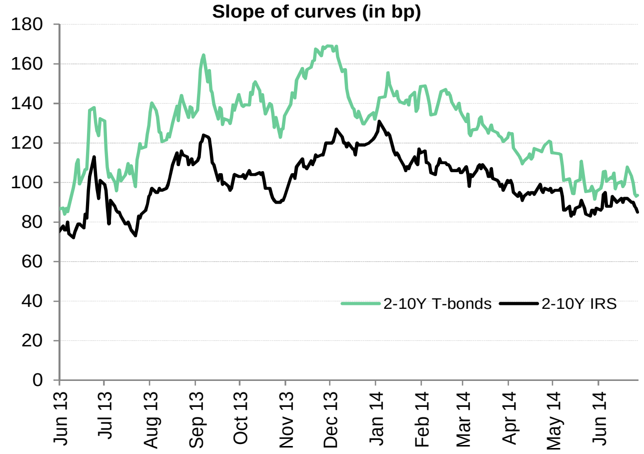
Money market rates and NBP refi rate (%)



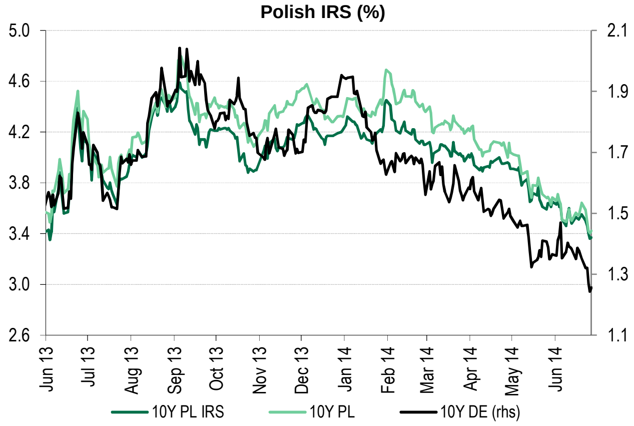
Spread between FRA and 3M WIBOR



Slope of curves (in bp)



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



FRA pricing-in rate cuts in 3 months' time

- The "tape affair" had a limited impact on the money market. In weekly terms WIBOR1M climbed by 1bp, WIBOR6M declined by 1bp, below 2.70% and other rates remained stable.
- Similarly as in previous weeks, changes on the FRA market were more significant. Another weak reading from the real economy, this time on retail sales, caused a rise of expectations for interest rate cuts in the upcoming months. Currently the market is pricing-in a 25bp-cut in 3 months' time and almost another one in 6 months' time.
- In our view, the market is too optimistic about further monetary easing by the MPC. However, overreacting is quite typical for the market. That is why we think that no extension of forward guidance at the July's meeting (and then negative reading of July's inflation) would be a signal for the investors that probability of monetary policy easing is rising. As a result, we may see further declines along the FRA curve.

Bond yields and IRS rates at the lowest level in a year

- Prospects of early election (effect of "tape affair") provided an impulse for a rebound after recent considerable strengthening of Polish debt instruments. Correction did not prove deep, however, as the successful vote of confidence quickly brought bond yields and IRS rates down to the lowest levels in a year. Domestic bonds were additionally underpinned by strengthening bonds on the core markets. As a result, yields of 10Y bond declined temporarily below 3.40%, while 10Y IRS slid to 3.36% (the lowest level since early June 2013).
- Strengthening was mostly visible on the longer end of curves; 10Y sectors lost by most due to "tape affair". Market changes caused a considerable flattening of the curves. 2-10Y spread narrowed to 93bp (from 108bp one week earlier) for bonds and to 87bp (from 92bp) for IRS.

Central banks and T-bond supply for July in focus

- We are facing an interesting week ahead. Start of the week may bring elevated debt market volatility due to end of the quarter and half year on Monday. Some investors are likely to take profits to improve their results. On the very same day we will see information on T-bond supply for Q3, with a special focus on offer in July. We are estimating that at the end of June the realisation of planned gross borrowing needs may be close to 100%, so supply for summer months may be limited. Still, in July it may remain relatively high due to buyback of OK0714 (cPLN8.1bn) and coupon payments on WZ floaters (cPLN1.4bn). Offer may include mainly papers from the middle and the longer end of the curve.
- MPC meeting (2 July) and new GDP/CPI projections will be crucial for investors. We think it is possible that the Council drops its forward guidance, which will increase the probability of interest rate cuts, in market view at least. This factor, combined with prospects of still low inflation readings should support bond yields close to current levels.
- Core market situation will remain important for the domestic debt. Recently this factor was supportive for the domestic papers. Lack of signals about start of QE programme by the ECB can be a bit disappointing for the market and provide an impulse for profit-taking, yet again it can prove short-lived.

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.