WEEKLY ECONOMIC UPDATE

14 – 20 July 2014

The second week of July was extremely poor in terms of domestic data releases, however we saw numerous comments of MPC members, which reinforced our view that the Council will not hurry with interest rate cuts until it sees signals of strong economic slowdown and/or rapid zloty appreciation. Unfortunately, some new disappointing data were released abroad, adding to the concerns about a loss of momentum in the euro zone recovery.

After week of empty agenda, this week will be full of key data releases. We expect to see most of indicators higher than market consensus, which should weaken investors' concerns about slowdown in Polish economy. Effectively, it should have positive impact on the zloty exchange rate, and may be a trigger for a correction in the debt market, especially at the short end of the curve. Next data from the euro zone and USA may be also very important for moods, affecting the outlook of economic recovery in Europe and investor's views on possible monetary tightening in the USA.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (14 July)					
11:00	EZ	Industrial output	May	%MoM	-1.2	-	0.8
14:00	**PL**	**Current account balance**	**May**	**€m**	**623**	**522**	**1028**
14:00	**PL**	**Exports**	**May**	**€m**	**13 724**	**13 735**	**14 207**
14:00	**PL**	**Imports**	**May**	**€m**	**13 247**	**13 302**	**13 351**
14:00	**PL**	**Money supply**	**Jun**	**%YoY**	**5.3**	**5.5**	**5.3**
		TUESDAY (15 July)					
11:00	DE	ZEW index	Jul	pts	67.9	-	67.7
14:00	**PL**	**CPI**	**Jun**	**%YoY**	**0.2**	**0.3**	**0.2**
14:30	US	Retail sales ex autos	Jun	%MoM	0.6	-	0.1
		WEDNESDAY (16 July)					
14:00	**PL**	**Core inflation**	**Jun**	**%YoY**	**0.8**	**0.9**	**0.8**
14:00	**PL**	**Wages in corporate sector**	**Jun**	**%YoY**	**4.5**	**4.9**	**4.8**
14:00	**PL**	**Employment in corporate sector**	**Jun**	**%YoY**	**0.7**	**0.7**	**0.7**
15:15	US	Industrial output	Jun	%MoM	0.3	-	0.6
20:00	US	Fed Beige Book					
		THURSDAY (17 July)					
11:00	EZ	HICP	Jun	%YoY	0.5	-	0.5
14:00	**PL**	**Industrial output**	**Jun**	**%YoY**	**3.9**	**4.4**	**4.4**
14:00	**PL**	**Construction and assembly output**	**Jun**	**%YoY**	**7.8**	**8.2**	**10.0**
14:00	**PL**	**PPI**	**Jun**	**%YoY**	**-1.8**	**-2.0**	**-1.0**
14:30	US	Initial jobless claims	week	k	310	-	304
14:30	US	House starts	Jun	k	1020	-	1001
14:30	US	Building permits	Jun	k	1045	-	1005
16:00	US	Philly Fed index	Jul	pts	16.0	-	17.8
		FRIDAY (18 July)					
15:55	US	Flash Michigan	Jul	pts	83.0	-	82.5

Source: BZ WBK, Reuters, Bloomberg

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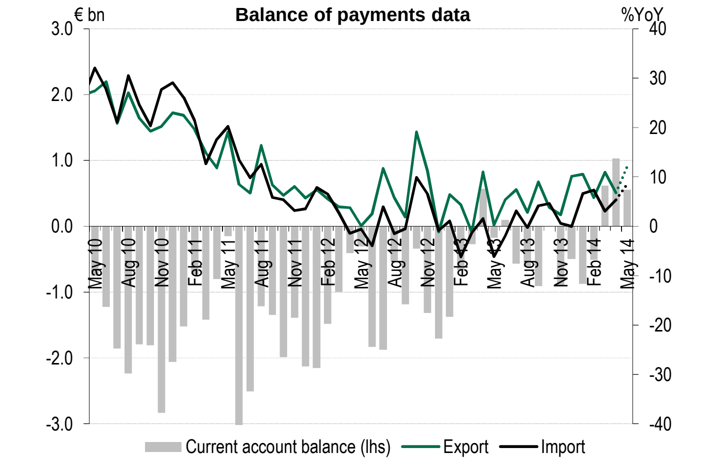
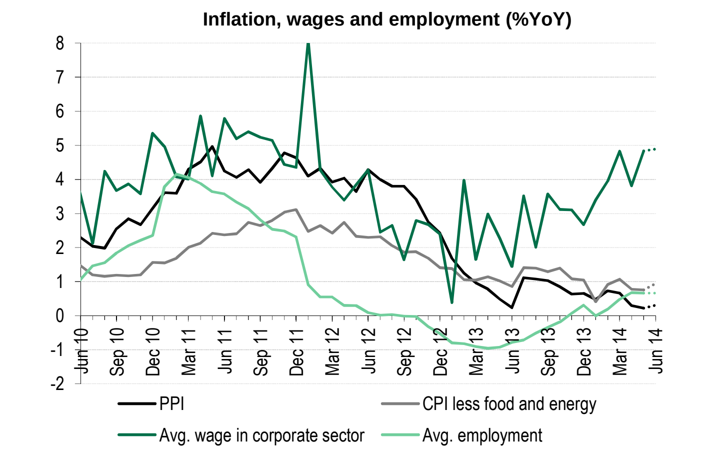
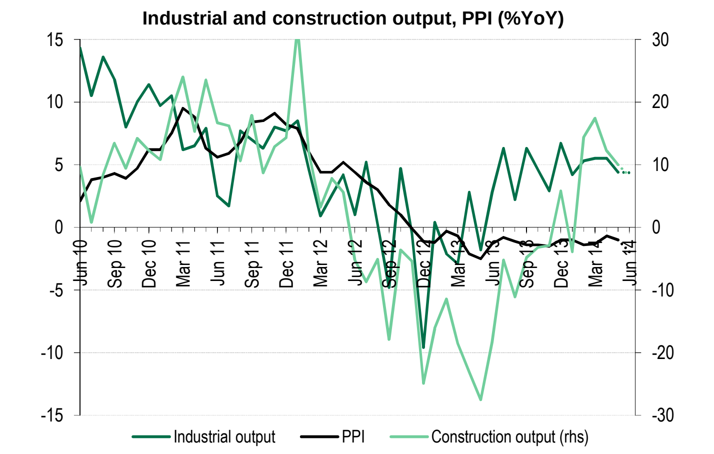
What's hot this week – A row of important data from the domestic economy







- We are expecting a strong reading of balance of payments data for May. Our forecasts are suggesting an acceleration of both export and import growth. Surpluses on trade and current account balances should still be maintained, reflecting a further decline of Poland's dependency on foreign financing. Our forecasts are very close to market consensus. The newest CSO statistics seem to confirm our estimates for export, but they suggest an upward risk for imports, which climbed by over 8%MoM in May, according to the CSO. If NBP data are close to CSO data, then May could show a considerable deficit (over €600m) instead of a surplus. However, CSO's data for April were considerably below NBP estimates, which in our view lowers the credibility of this signal.
- We are expecting some acceleration of M3 money supply growth in June and continuing recovery on the credit market.
- In our view CPI inflation climbed slightly in June, to 0.3%YoY from 0.2%YoY in May. Our forecast is slightly higher than market expectations. For the following months we are expecting a decline of annual CPI inflation rate below zero, but this will be a temporary move only (lasting for two months, in our view). As regards core inflation excluding food and energy prices, we are also forecasting a slight increase, to 0.9%YoY from 0.8%YoY.
- Labour market situation in June was in our view very similar to that in May – we are expecting some stabilization of employment growth and a slight acceleration of wage growth. It seems that pace of improvement on the labour market is decelerating, but it remains strong enough to provide a considerable support for real households' incomes (especially taking into account low inflation) which should positively affect private consumption.
- According to our estimates, industrial output expanded in June at the same pace as in May. Pace of industrial output growth was probably again undermined by mining. However, in our view results of export-oriented industry sectors are crucial. We think that as long as situation in these branches is positive (and some of them record even two-digit growth rates), there is no worry about the economic slowdown.
- Growth of construction and assembly output declined in June, in our view. Construction is no longer supported by positive weather effect observed in the previous months and undermined by slow growth rate of new flats construction.
- PPI inflation declined to -2.0%YoY, according to our estimates. This gauge still points to no upward pressure on prices in the industry.

Quote of the week – To wish a cut or a hike?

Elżbieta Chojna-Duch, MPC member, 07.07, PAP

Given latest data from the NBP projection (…) interest rates in Poland may seem high (…) Cuts of rates seem inevitable (…) I hope that the upcoming macroeconomic data will encourage other MPC members to abandon the stable rate policy.

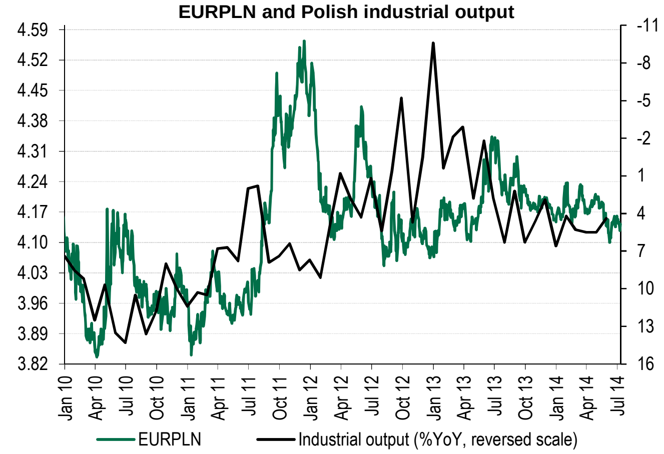
Andrzej Rzońca, MPC member, 10.07, PAP

Based on assessment of available information on Polish economy I cannot rule out that the need to normalise interest rates may appear in 4Q2014 already. I will say even more – I wish that interest rate hike in Q4 would prove the strength of Polish economy.

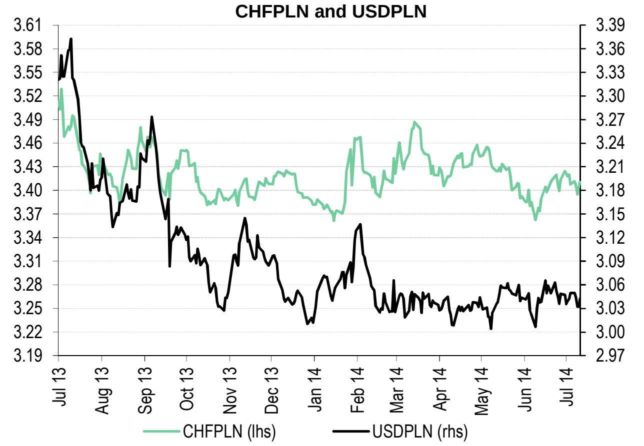
After July's MPC meeting we saw a series of members' comments. These confirmed that majority of Polish central bankers support the idea of keeping interest rates unchanged and think that cuts are unlikely and they can be implemented only in a scenario of strong economic slowdown and/or rapid zloty appreciation. In this context, the wish expressed by Elżbieta Chojna-Duch (the sole supporter of cuts) that the upcoming data will encourage other members to cut seems rather dubious (like the MPC member hopes for economic slowdown). Our view on interest rates and our hopes about the economic performance are currently closer to those of Andrzej Rzońca.

Foreign exchange market – Zloty waiting for new data

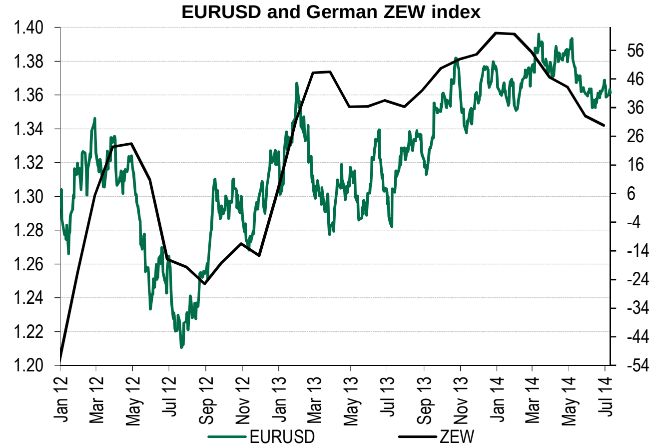
EURPLN and Polish industrial output



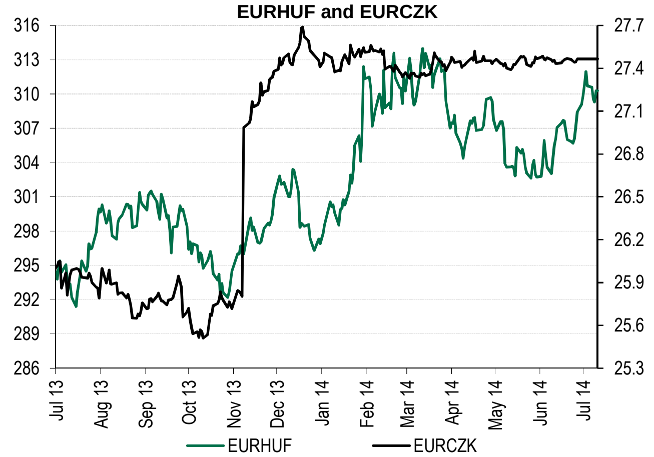
CHFPLN and USDPLN



EURUSD and German ZEW index



EURHUF and EURCZK



Zloty waiting for the next impulse

- No major changes occurred in the Polish FX market on weekly basis. The zloty appreciated temporarily to 4.12 per euro and nearly 3.01 per dollar. The domestic currency was supported by falling Polish bond yields. However, the global market sentiment deteriorated suddenly at the end of the week due to worries over the euro zone peripheries and EURPLN returned to 4.14 and USDPLN to 3.05.
- The set of important domestic macro data is due to be released this week. Recent economic activity numbers have disappointed and inflation has surprised to the downside. These data has strengthened expectations for a NBP rate cuts and this was one of the factors driving zloty's depreciation. We expect coming monthly data to be above consensus showing that the economy is not heading for a major slowdown. This may have a moderately positive impact on the zloty. One should notice, however that the impact of this on the exchange rate may be twofold. On the one hand, above-consensus releases may cool expectations for a rate cuts and support the zloty. On the other hand, publications may trigger some profit taking in the debt market and this may put negative pressure on the domestic currency. Continuing geopolitical tensions (conflicts in Ukraine, Iraq, Israel) may continue to weigh on Emerging Market currencies in the short run.
- Since the second week of June – that is when the "tape scandal" broke out in Poland – EURPLN hovers in 4.11-4.17 range. The trading range is narrowing gradually and this indicates that soon the upper or lower boundary may be broken.

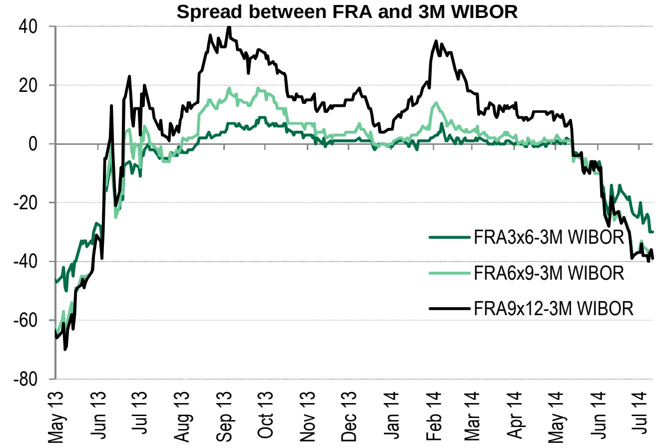
No big changes in EURUSD too

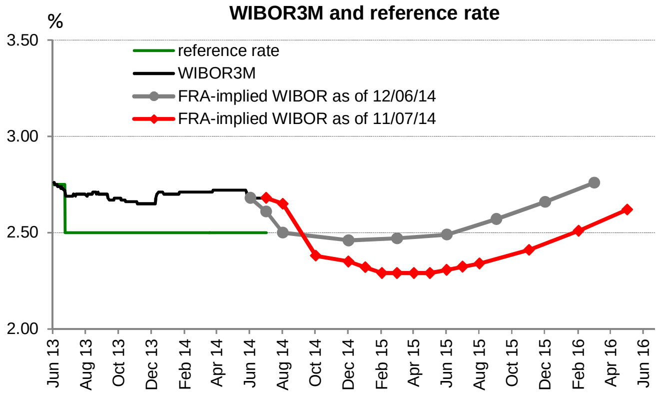
- Despite poor macro data being released since the beginning of the past week, the euro was gaining vs. the dollar. Consequently, the exchange rate reached 1.365 vs. 1.357 seen last Friday. However, appreciation of the single currency proved only temporary. The dollar started to recover when worries over the euro zone's peripheries started to play main role and EURUSD was close to 1.36 at the end of the week.
- First economic activity index for July will be released this week (German ZEW). Recent signals from the euro zone and Germany were not too optimistic and if some improvement is recorded this time (which the market is hoping for) then it may be a positive signal for the single currency. Large number of data will be also released in the US and they will be interpreted in the context of future FOMC monetary policy. Positive surprises are likely to support the greenback. Vital levels for EURUSD are 1.35 (minimum reached after the June ECB decision) and 1.37 (150-day moving average is running at this level).

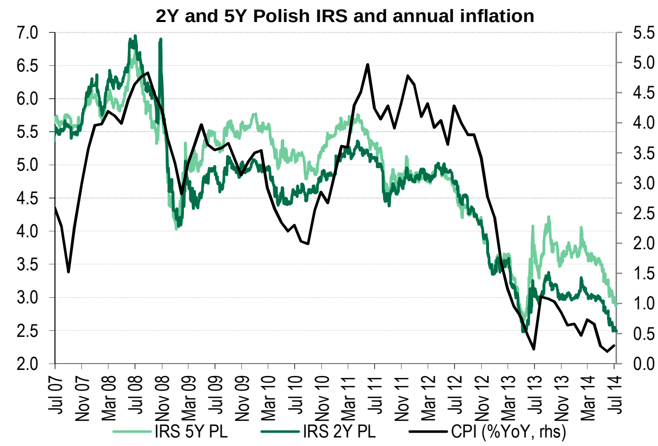
EURHUF slightly up due to internal issues

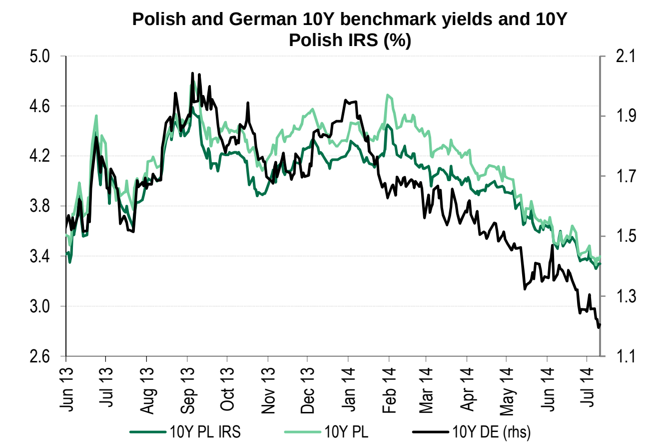
- The forint depreciated slightly vs. the euro during the past week. The Hungarian currency was under pressure of the uncertainty over the effect of the state government actions on the commercial banks' balance sheets (due to compensations for illegal foreign currency mortgage loans agreements) and lower than expected data on inflation (that leave the door open for further rate cuts). EURHUF redounded from 308.5 to 310.5. Czech koruna stayed unchanged, EURCZK hovered around 27.42.
- Coming days will not bring any important macro data from Czech Republic and Hungary. EURCZK is likely to remain stable close to 27.4 while EURHUF may move up further amid still alive negative internal factors.

Interest rate market – Macro data releases on the agenda









Expectations for rate cuts still strong

- Situation on the money market did not change significantly last week. WIBOR rates were more or less stable – only WIBOR1Y declined by 1bp. FRA rates also did not change considerably (in weekly terms they dropped by 1-3bp). FRA3X6 and FRA6x9 were more than 30bp below current level of WIBOR3M. It clearly suggests that market is pricing-in rates cut by 25bp in 3 months horizon despite mixed signals from comments of the MPC's members (in particular Chojna-Duch, Rzońca).
- Continued strong expectations for rate cuts later this year caused subdued decline in IRS rates. In weekly terms IRS curve shifted down by 1-4bp, with the highest decline in 5Y rate, while scope of changes on the front end and long end was small (decline by 1-2bp). As a consequence 2-5Y spread narrowed by 3bp, while spread 5-10Y slightly widened (by 2bp).
- As regards T-bond market, the first part of the past week brought significant strengthening. It came from strong demand for the Polish assets from foreign investors. A bull steepener developed on the T-bond market as the front end and mid of the curve gained more than the long end. Spread 2-10y widened to nearly 95 bp. What is more, yield of 2Y benchmark declined below the level recorded in May 2013, reaching a new historical low (2.43%).
- Longer end of the curve saw a correction at the end of the week, due to deterioration of moods on the euro zone peripheral markets after information about financial troubles of Banco Espirito Santo (BES), which fuelled investors' worries about the whole Portuguese financial sector and gave an impulse to take profits and increase risk premium. Let us note however that the scale of weakening of Polish bonds and IRS was small as compared to the peripheral market. Spread of the Polish 10Y bond to its German counterpart widened to almost 220bp after reaching 210bp, the lowest level since June 2013). For comparison, spread versus Bunds widened by 20bp in case of Spain and Italy in 10Y sector.

Under influence of macro data and core markets

- A very interesting week ahead with a bunch of macroeconomic data releases. Overall, our forecasts are above market consensus in the case of almost all Polish indicators to be published in the next few days. If our estimates are correct, this should limit worries as regards the scale of economic recovery and might give an impulse to a correction on interest rate market, especially at the short end of the curve. Additionally, market liquidity is rather limited in holiday season, so any moves may be more significant.
- It is worth to notice that swap rates and bond yields in the five- and ten-year segments are only marginally above the minima recorded in May 2013. Therefore, we think that the scale for further strengthening is rather limited.
- The long-end of the bond curve will be still influenced by core markets. Uncertainty as regards developments in the Portuguese banking sector (financial problems of BES) will still affect the market. On the other hand, additional strengthening of the German bond market would support Polish 10Y bonds (still high positive correlation between the two) and may limit a possible correction.).

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