Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

29 September – 5 October 2014

As the geopolitical tensions faded, investor sentiment improved somewhat this week, supporting risky assets. The domestic FI market firmed quite considerably, mirroring the Bunds as expectations for QE implementation by the ECB strengthened due to weak macro data. The decline in yields was also driven by expectations for NBP rate cuts in Poland and the recent comments of the MPC members, which boosted speculation that the scale of easing might turn out even bigger than is currently priced-in by the market.

This week is filled with key macro data releases from the euro zone and the US, with a very light domestic calendar. The flash September PMIs for the European economies were unimpressive again and we think that the index for Poland will again show stagnation in industrial activity. On the other hand, macro data from the US (including the September non-farm payrolls) should confirm that the US economy is on an upward track, strengthening expectations for earlier monetary tightening. This may pressure the CEE currencies, as well as the longer- end of the yield curves. The ECB meeting will also be a key event as the bank will provide details on its new ABS and covered bond asset purchase programmes.

Economic calendar

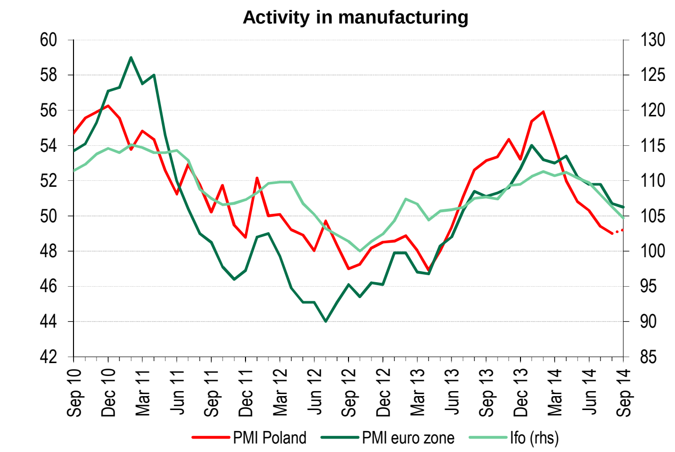
CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (29 September)					
14:30	US	Personal income	Aug	%MoM	0.3	-	0.2
14:30	US	Consumer spending	Aug	%MoM	0.4	-	-0.1
16:00	US	Pending home sales	Aug	k	-0.5	-	3.3
		TUESDAY (30 September)					
9:00	CZ	GDP	Q2	%YoY	2.7	-	2.9
11:00	EZ	Flash HICP	Sep	%YoY	0.3	-	0.4
14:00	**PL**	**Current account**	**Q2**	**€m**	**674**	**674**	**-766**
14:00	**PL**	**Inflation expectations**	**Sep**	**%YoY**	**-**	**-**	**0.2**
16:00	US	Consumer confidence	Sep	pts	92.4	-	92.4
		WEDNESDAY (1 October)					
3:45	CN	PMI – manufacturing	Sep	pts	50.5	-	50.2
9:00	**PL**	**PMI – manufacturing**	**Sep**	**pts**	**48.6**	**49.2**	**49.0**
9:55	DE	PMI – manufacturing	Sep	pts	50.3	-	51.4
10:00	EZ	PMI – manufacturing	Sep	pts	50.5	-	50.7
14:15	US	ADP report	Sep	k	204	-	204
16:00	US	ISM – manufacturing	Sep	pts	58.5	-	59.0
		THURSDAY (2 October)					
13:45	EZ	ECB decision		%	0.05	-	0.05
14:30	US	Initial jobless claims	week	k	-	-	293
16:00	US	Factory orders	Aug	%MoM	-9.0	-	10.5
		FRIDAY (3 October)					
9:55	DE	PMI – services	Sep	pts	55.4	-	54.9
10:00	EZ	PMI – services	Sep	pts	52.8	-	53.1
14:30	US	Non-farm payrolls	Sep	k	210	-	142
14:30	US	Unemployment rate	Sep	%	6.1	-	6.1
16:00	US	ISM – services	sep	pts	58.5	-	59.6

Source: BZ WBK, Reuters, Bloomberg

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

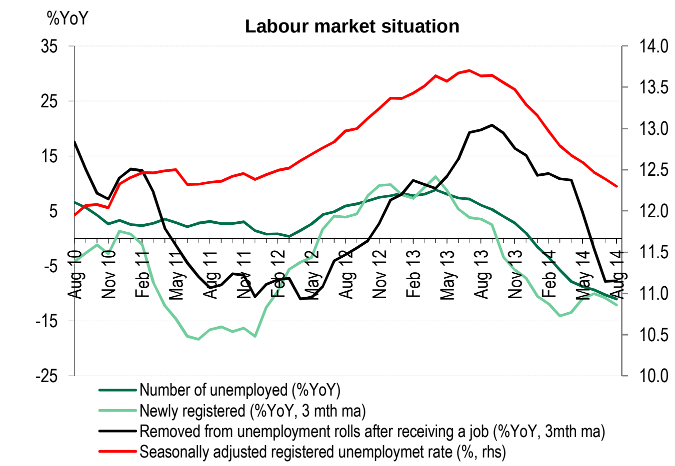
TREASURY SERVICES:
Poznań +48 61 856 5814/30
Warszawa +48 22 586 8320/38
Wrocław +48 71 369 9400

What's hot this week – PMI and the quarterly current account



- We expect the September's domestic manufacturing PMI index to stabilise near its current levels and stay below the 50bp mark, signalling further contraction in economic activity and reinforcing expectations for monetary policy easing in Poland. The CSO business climate indicator for manufacturing declined further in September, to the lowest level this year. Moreover, PMI for Germany and the euro zone was down. In our view, the new orders sub-index of the Polish PMI will be of special importance as it usually offers the first signs recovery. We do not expect it to rebound at this stage of the economic cycle, though.
- The balance of payments data for Q2 will be interesting, provided it shows considerable revisions against the monthly data released earlier that showed strong exports and imports (growth rates at 8.4% and 9.1%, respectively), together with surpluses in both trade and current accounts.

Last week in the economy – Retail sales slowing down, but labour market still strong



- Annual growth of retail sales slowed down in August to 1.7%YoY (from 2.1%YoY in July). In real terms sales added 2.8%YoY as compared to 3.1%YoY one month before. The slower growth came mainly from a sharp decline in sales of motor vehicles, which fell by 15.1%MoM. According to our estimates, growth of retail sales excluding cars remained quite stable at 2.2-2.4% YoY on average in the last three months (still below the average for January-May at c5%YoY).
- Retail trade turnover declined in August by 0.8%YoY (vs -0.9%YoY in July). The seasonally adjusted figures showed an increase by 1.1%YoY after falling by 1.2%YoY one month ago.
- The registered unemployment rate declined in August to 11.7% from 11.8% (the stat office revised data for the previous month down), in line with estimate of the Ministry of Labour and our forecast. The number of unemployed dropped by 25.3k MoM, much more than a year ago (9.9k) when the recovery in the labour market was just starting. However, it is worth to notice that stronger reduction in the number of the unemployed was mainly due to lower number of registrations (redundancies) while the number of people removed from the unemployment rolls was lower than a year ago. This means that the pace of both job creation and destruction decelerated. In general, these data show that the labour market is still in a relatively good shape and this should support private consumption. We expect a stabilization of the unemployment rate in the next two months and then a rebound in line with the seasonal pattern to slightly above 12% at the year end.
- The data were in line with our scenario for the Polish economy. We expect a gradual improvement of retail sales, which should be supported by good labour market situation and rise in households' disposable incomes in real terms. This, in our view, should support a stable growth of private consumption of around 3%YoY in the upcoming quarters.

Quote of the week – Adjustment should be expected

Marek Belka, NBP president, 23.09, PAP

No change in monetary policy equals its tightening.

Andrzej Bratkowski, MPC member, 24.09, PAP

In my opinion, it should be as follows: we begin the cycle with 25bp, maybe – if there was majority for this – with 50. The cycle should amount to at least 100bp, maybe even more.

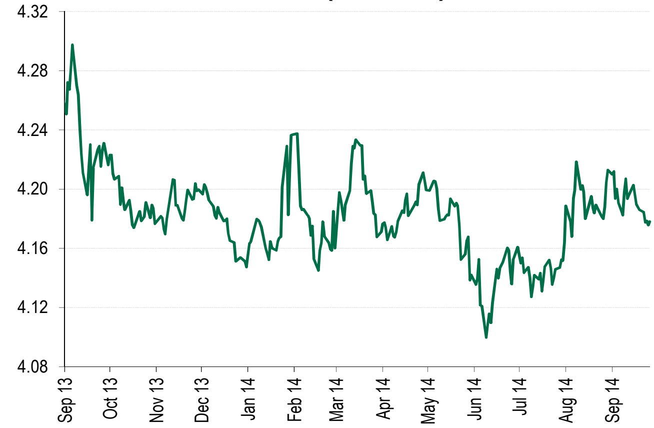
Jerzy Hausner, MPC member, 22.09, PAP

Adjustment should be expected. This means that we will probably cut rates. And most probably this will begin in October.

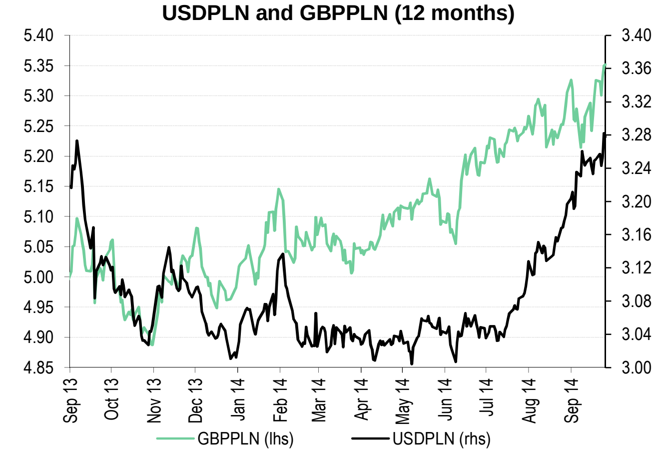
The comment of Jerzy Hausner clearly shows that he has joined the MPC's pro-easing camp, making it 6-strong now. Nevertheless, the **cut in October was already a done deal** before, given the casting vote of the NBP Governor. The only question that remains is whether the MPC will cut rates by 25 or 50bp. But Bratkowski's comment makes a bigger cut less likely, especially in light of the fact the MPC chose not to act in September (when they should have cut, but decided to wait). Thus, **we would rather bet for 25bp rate cut** (though with subjective odds 60-40 in favour of 25bp vs. 50bp). As regards the cumulative scale of easing indicated by Bratkowski (100-150bp), we think this would not be shared by the majority of the MPC and we stick to our scenario of the total 75bps easing.

Foreign exchange market – Zloty still extremely stable versus euro

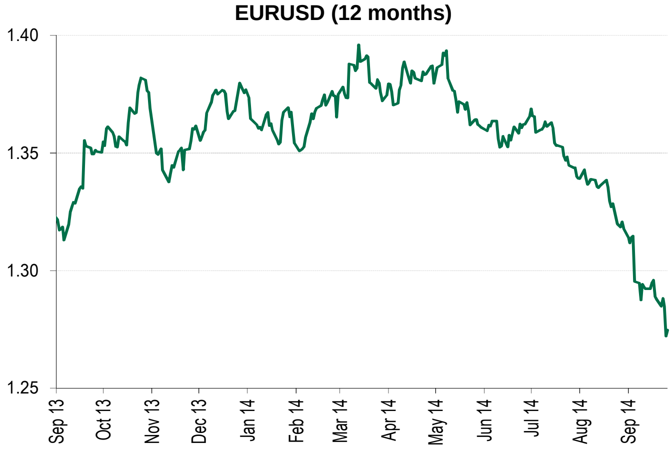
EURPLN (12 months)



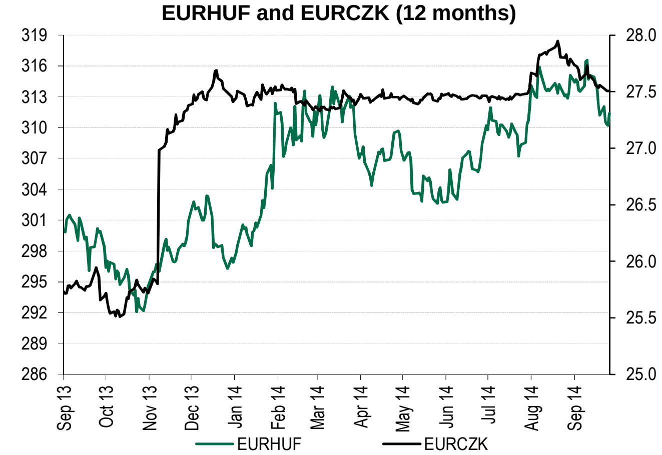
USDPLN and GBPPLN (12 months)



EURUSD (12 months)



EURHUF and EURCZK (12 months)



The zloty should stay in a narrow range against the euro

- The start of last week brought gradual zloty strengthening, mainly against the euro. The better-than-expected (though not changing the dovish sentiment) sales figure and further strengthening of the debt market supported the Polish currency. The EURPLN was testing crucial support at 4.17 and, temporarily, even broke this level, touching 4.163. However, the EURPLN decline was only short-lived as the domestic currency (like the other EM currencies – forint, rouble or the Turkish lira) was under pressure from the strengthening dollar and so it quickly returned towards 4.18. The zloty lost vs the US dollar and the British pound (0.8% and 0.5%, respectively) over the past week. The USDPLN temporarily broke the peak at c3.286 reached a year ago, while the GBPPLN rose above 5.35 (its highest since July 2012). However, the weakening of the zloty was less significant as compared to others EM peers.
- In the coming week, the zloty will remain under influence of external factors (ECB, US macro data). No ECB decision to implement full-blown quantitative easing and strong US labour market data (boosting expectations for earlier rate hikes by the Fed) could result in some correction on the zloty but the EURPLN should stay below 4.23, the top boundary of its fluctuation channel of 4.17 and 4.23. Domestic data (still low PMI index for manufacturing) may also add some volatility to the FX market. We believe, however, that the continuously strong demand for Polish assets can partly offset the negative impact from the macro data releases.

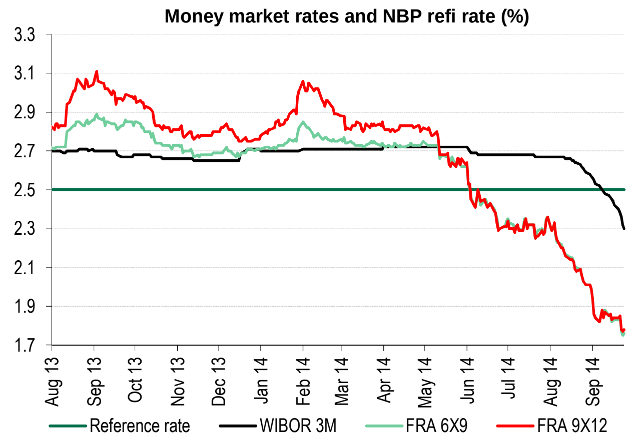
The US dollar continues to strengthen

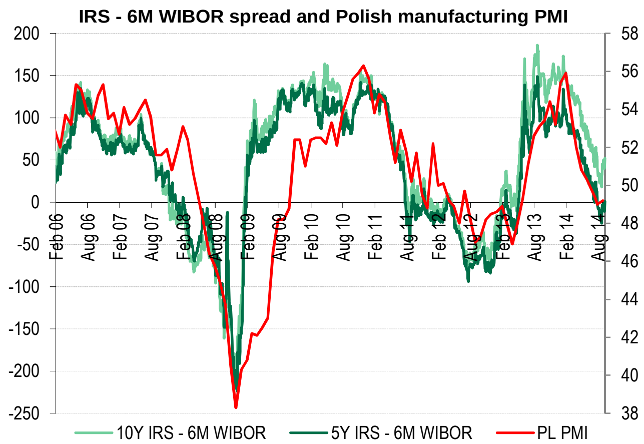
- The euro is under considerable pressure from the loose ECB monetary policy and prospects for monetary tightening in the US. The macro data flow from the US is boosting bets that the Fed could start hiking rates earlier than was just recently expected. Consequently, the EURUSD declined temporarily below 1.27 (the lowest level since November 2012) but quickly returned above 1.27 at the end of week.
- The macro calendar is very heavy this week, with the ECB's meeting and the US non-farm payrolls data its key events. Disappointing data from the euro area are driving speculations that the ECB might be forced into full-blown quantitative easing and start T-bond purchases later this year. However, we do not expect the ECB to announce such a decision at its October meeting and absence of this announcement may bring temporary support for the euro. At the end of the week, we expect a rather strong reading of the US non-farm payrolls for September, with a potential upward revision of the August numbers. This should support the US dollar, with the EURUSD testing again the support level at 1.27. Once broken, the next support would be at 1.266.

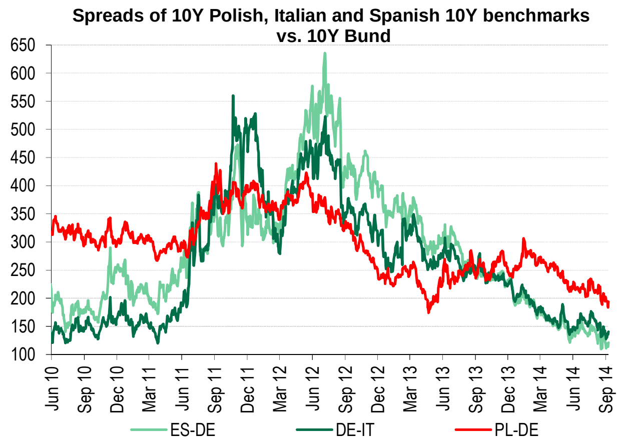
CEE currencies rebound slightly

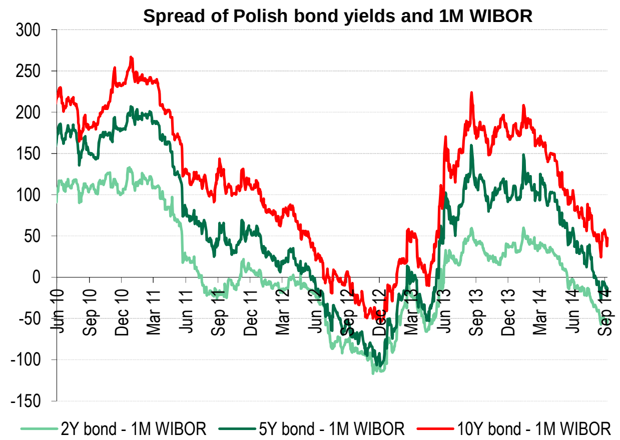
- The CEE currencies (forint, koruna) rebounded as the geopolitical risks eased somewhat on the back of the ceasefire in eastern Ukraine, the Scottish referendum's "No" to independence and the continuously solid demand on the debt market. Consequently, the EURCZK returned to 27.5, while EURHUF fell towards 310. The central banks' meetings (NBH, CNB) brought nothing new. Both the Hungarian and the Czech central banks decided to keep their monetary conditions unchanged. Moreover, the CNB reaffirmed its previous intention to keep using the exchange rate as a monetary policy instrument until at least 2016. Therefore, we expect the EURCZK to stabilise near 27.5.
- In our opinion, the forint will remain more (than the CZK) sensitive to demand for EM assets, the outlook for US rates and developments in the Russian-Ukrainian conflict. In our opinion, external factors point to more forint weakness but this should be partially offset by an improvement in the external position, the strengthening growth recovery and the ECB's policy easing.

Interest rate market – The market believes in aggressive monetary easing









Market pricing-in odds of deeper rate cuts

- The Polish interest rate market firmed in the past week as investors' expectations for rate cuts in Poland were fuelled by dovish comment of MPC member Andrzej Bratkowski and the 10Y German bond yield dropping back below 1%. The Polish 2Y, 5Y and 10Y IRS rates plunged c10bps on a weekly basis, while the respective bond yields fell by 6-14bps. The 2Y and 5Y tenors reached their all-time lows. The 2Y IRS dropped temporarily slightly below 2%, the 5Y rate was just above 2.2% (just like the respective bond). The strengthening market expectations for NBP rate cuts was were also clearly reflected in the plunge of the money market rates. On Thursday, the 1-12M WIBOR rates fell by 3-5bps, compared with 1-2 bps daily drops up until then.
- The 3-12M WIBOR rates have fallen by 38-48bps since July when the MPC dropped its forward guidance, assuming stable rates until the end of 3Q. The FRA market is currently pricing-in a further drop of the 3M WIBOR by nearly 50bps over the next 3 months. This means that the market is anticipating interest rate cuts of almost c100bps until the end of this year, with a high probability of a 50bp rate cut in October. According to our baseline scenario, the total adjustment will reach 75bps with the central bank more likely to deliver cuts in small steps - by 25bp in each of the next three months. We, therefore, see the risk of correction (at least short-term) if the MPC decides to cut rates by 25bp only at the nearest meeting. But before this happens, further falls in money market rates are possible, especially if September PMI disappoints.

Yield hunting likely to support Polish bonds

- Spreads of the Polish 2Y, 5Y and 10Y benchmark bond yields vs. the 1M WIBOR (used as an approximation of financing costs) are at their lowest since May 2013. Only the spread on the longer-term debt is positive. But even if the residents' demand for Polish bonds fades, foreign investors could continue to be interested in zloty-denominated debt as the looming abundance of cheap liquidity in the euro zone favours yield hunting. Although the PL-DE 10Y spread has been on the downside since the beginning of the year, domestic bonds still look more attractive when compared to the Italian or Spanish debt. The latter may actually underperform in the coming days as the market may focus on the possible independence referendum in Catalonia. Thus, we see potential for further flattening of the Polish curves as the ECB is expected to start injecting fresh cash into the euro zone market as soon as from October. This should have the biggest impact on the 5Y and 10Y tenors.
- The risks for this scenario, apart from the situation in Eastern Europe and the Middle East, are signals from the US. The September non-farm payrolls data are due this week. Last month, the release disappointed, causing expectations for prompt Fed rate hikes to temporarily fade. The ISM will also be watched closely after it reached its highest level since March 2011 last month.
- In Poland, the manufacturing PMI for September is due on Wednesday and we expect it to have the biggest impact on the short-end of the domestic curves as this will be the final data release before the MPC meeting. The PMI could prove decisive whether the market will continue to expect a 50 bps rate cut in October or whether the market will reduce its expectations to 25bps (in line with our forecast).
- The Finance Ministry will present its bond supply plan for 4Q this week.

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.