Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

20 – 26 October 2014

It was a very turbulent week in the financial markets. Risk aversion surged and investors fled from emerging markets on rising worries that weak growth and deflationary pressures may spread from Europe to the US and elsewhere. Fears about the spread of the Ebola virus and a new wave of concerns about the euro zone peripheries also contributed to the sell-off. Sentiment turned more positive towards the end of the week again after investors began to believe that the main central banks would safeguard markets from future turmoil (Fed's James Bullard said the bank should delay ending its QE programme, while BoE's economist Haldane suggested UK interest rates may have to stay low for longer). Economic data that were released in Poland showed a (calendar-driven) rebound in production, the situation on the labour market stayed positive and the sub-zero inflation stable.

In regards to the data releases this week, it seems that the domestic publications will be overshadowed by data from the core markets since the latter may be very relevant for gauging the pulse of the economy from the perspective of where the concerns over the recovery's future have emerged. The flash PMI indices for the euro zone countries may be of particular importance. While the situation in Ukraine seems to have recently receded to the background, it cannot be ruled out that some instability may arise again just ahead of the parliamentary election due on October 26. Friday's talks between Russia and Ukraine in Milan failed to reach a breakthrough on ending the crisis.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (20 October)					
		No important data releases					
		TUESDAY (21 October)					
16:00	US	Home sales	Sep	mn	-	-	5.05
		WEDNESDAY (22 October)					
14:30	US	CPI	Sep	%MoM	0.0	-	-0.2
		THURSDAY (23 October)					
3:45	CN	Flash PMI – manufacturing	Oct	pts	50.1	-	50.2
9:30	DE	Flash PMI – manufacturing	Oct	pts	49.5	-	49.9
10:00	EZ	Flash PMI – manufacturing	Oct	pts	50.0	-	50.3
10:00	**PL**	**Retail sales**	**Sep**	**%YoY**	**2.4**	**2.5**	**1.7**
10:00	**PL**	**Unemployment rate**	**Sep**	**%**	**11.6**	**11.5**	**11.7**
11:00	**PL**	**Bond auction**					
14:00	**PL**	**MPC minutes**					
14:30	US	Initial jobless claims	week	k	-	-	264
		FRIDAY (24 October)					
16:00	US	New home sales	Sep	k	470	-	504

Source: BZ WBK, Reuters, Bloomberg

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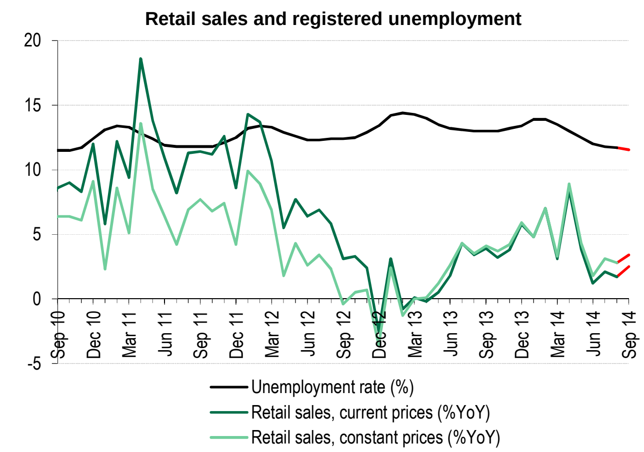
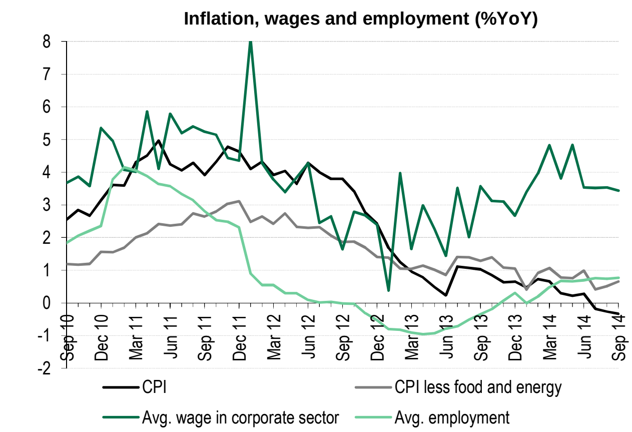
What's hot this week – Higher retail sales, lower unemployment

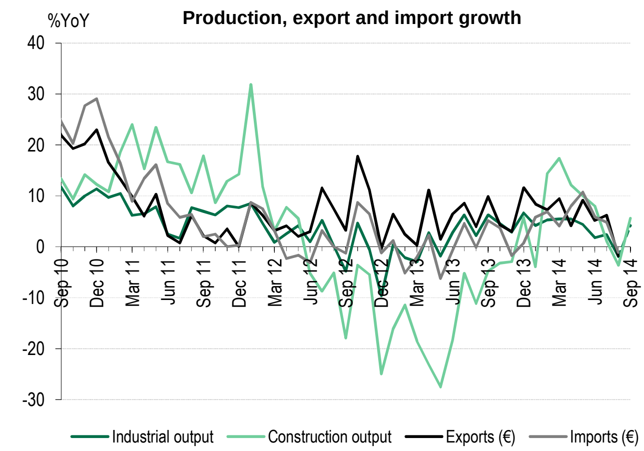


▪ We expect the growth rate of retail sales to slightly rebound in September but to remain relatively low, nevertheless. Still, the outlook for retail sales is not that bad considering the positive situation on the labour market, which should support private consumption in the final quarter of the year. Data on car sales showed a decent rebound in September, which also supports our retail sales forecast.

▪ We expect the registered unemployment rate to continue its march south and reach 11.5% in September, the lowest level since 2010. All the main indicators confirm that the labour market remains in good shape. We expect these positive trends to continue, but the risk is skewed downwards given the possible negative impact of the weakening economic activity on the demand for labour. On the other hand, the newest NBP report on the economic climate showed that companies were still willing to hire, despite the weaker economic outlook.

Last week in the economy – Inflation still below zero, output growth higher





▪ CPI inflation remained unchanged in September at -0.3% YoY. Food prices interrupted a seven-month-long series of downward trend and inched marginally up in September (by 0.1% MoM). Other categories also show no significant upward movement. CPI growth is likely to stay below zero until December, in our view. Core inflation (ex food and energy prices) climbed in September to 0.7% YoY from 0.5% in August. The upward move was due to the base effect in education, as September 2013 saw a major fall in kindergarten fees due to changes in education legislation. Other core inflation measures declined or were stable, showing a lack of underlying price pressure.

▪ Employment in the corporate sector rose by 0.8% YoY and wages by 3.4% YoY in September.

▪ The pace of exports growth decelerated in August from over 6% YoY to -1.8% YoY and imports from 4.8% YoY to -1.1% YoY. This was the weakest export growth since the comparable data has become available (2011). Even taking into account that the data were affected by lower number of working days, it seems the slowdown in the euro zone weighs more and more on Polish foreign trade. Further decline of economic activity in Europe (indicated by the falling business climate indices, among others, by Tuesday's poor German ZEW Index) does not bode well for the reversal of this trend.

▪ Industrial output grew 4.2% YoY in September, with the construction output up 5.6% YoY. Both these figures were above market expectations. One should remember, however, that the September's data were positively affected by the number of working days, in opposition to August, when this factor worked against the numbers. Overall, the data point to GDP growth below 3% in Q3, which, given the no-inflation environment, justifies further monetary policy easing.

Quote of the week – To rush or not to rush (with interest rate cuts)?

Andrzej Kaźmierczak, MPC member, 17.10, PAP
We should not rush with another cut (…) I will not support a cut in November.

Anna Zielińska-Głębocka, MPC member, 15.10, Reuters
If we want to cut rates, we should do it in November and then also keep the door open to further changes down the road.

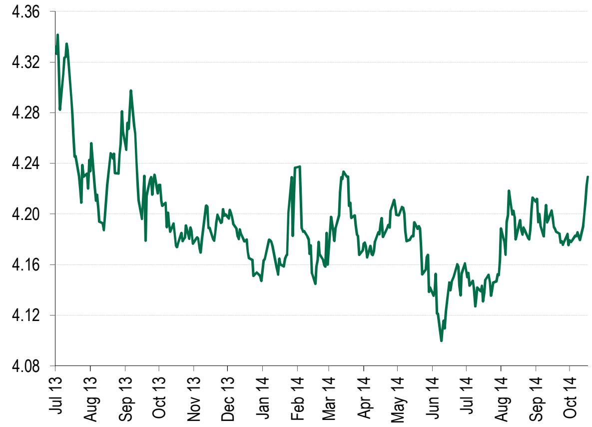
Jerzy Osiatyński, MPC member, 13.10, Bloomberg
There is room to cut rates by 75bps.

Andrzej Bratkowski, MPC member, 13.10, Bloomberg
The MPC could cut rates by 75bps, if GDP growth was to slow down below 3% in 2015.

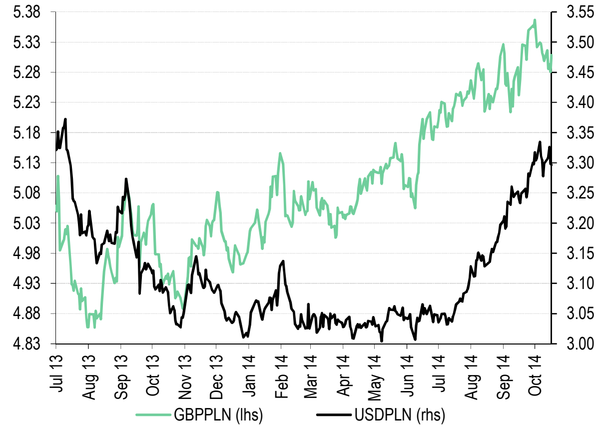
The days when the MPC members were unanimous in their views on monetary policy prospects are gone. We believe that the various Council members' comments that appeared in recent days brought about bigger uncertainty rather than more clarity. While it is quite obvious that both Osiatyński and Bratkowski are in favour of further policy easing, even by 75bp, the latter suggested that "no more big moves" should be expected. Belka said he felt comfortable with the market pricing-in a 50bps cut by year-end. Interestingly, Chojna-Duch, who was among those pushing for cuts the strongest in September-October, now said it would be better to keep rates on hold in November and wait. Zielińska-Głębocka said a rate cut is equally likely as keeping rates stable. We think that the recent data and the new NBP projection will give the MPC arguments to cut rates again in November, most likely by 25bp.

Foreign exchange market –The global market rout weighed on the zloty

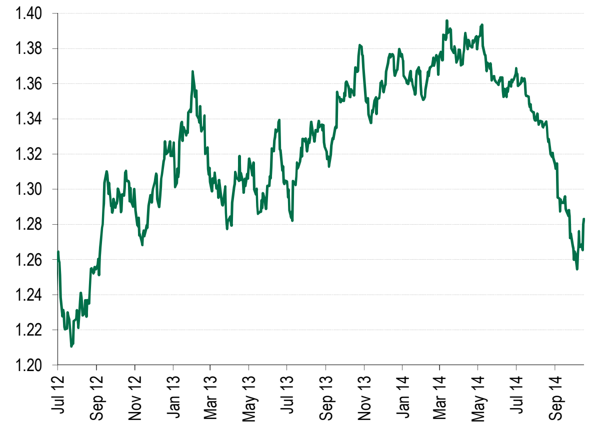
EURPLN



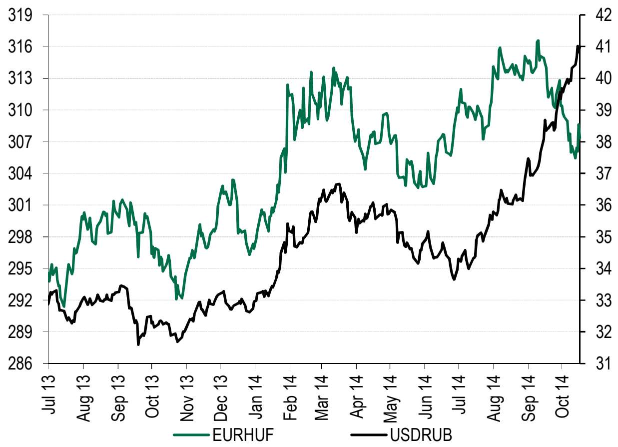
USDPLN and GBPPLN



EURUSD



EURHUF and USDRUB



Stronger move of EUR/PLN, finally

- Following several weeks of unusual stability on EUR/PLN with a narrowing trading range and the exchange rate getting closer to the strong support at 4.17, last week finally brought about a significant surge in volatility. EUR/PLN jumped to nearly 4.24, its highest level since March, from 4.18. The 1M and 3M implied volatilities increased to 5.88 from 4.84 and to 6.04 from 5.13, respectively (highest since June and April, also respectively). The Polish FX market was mainly driven by the deterioration of investor sentiment on the international markets (worries over global economic growth and euro zone stability), which triggered risk-off moves and a retreat from the emerging markets. On a weekly basis and among the EM currencies, only the Czech crown avoided a drop vs. the euro. Changes vs. the dollar were more diversified. EUR/USD increased on a weekly basis and roughly one third of the emerging currencies managed to appreciate vs. the greenback - the Polish zloty among them (USD/PLN fell temporarily to c3.26 vs. last week's peak at 3.33).
- Though the calendar for the coming week is rather thin, data scheduled to be released are likely to keep the volatility high. We expect the flash manufacturing PMIs to be in the centre of attention. Indices for Germany and the euro zone have been falling since February and further deterioration is expected this month by the market. It would have been quite obvious just a few days ago that poor euro zone data could support hopes for more action from the ECB, backing risky assets. However, since worries over the global economic growth have risen so much and there is renewed speculation on euro zone stability, more disappointment from European data may spur another wave of risk aversion, potentially hitting the risky assets, including the zloty. EUR/PLN broke the resistance at 4.23 last week. 4.24-4.26 are the next levels to watch.

The euro gains after weak US sales data

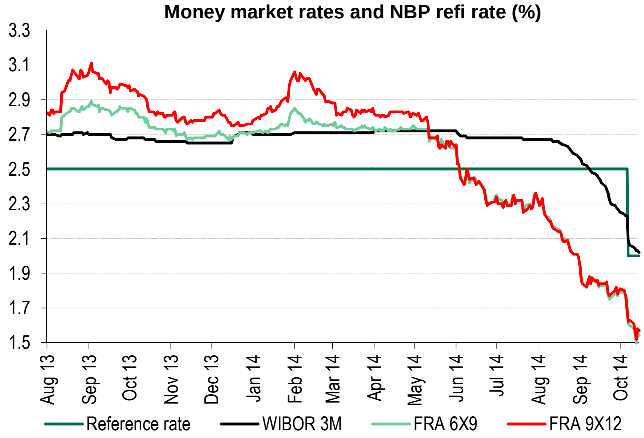
- Despite the fact that stocks recorded a significant plunge amid concerns over economic growth, the euro recovered vs. the dollar. EUR/USD rebounded to nearly 1.29 from c1.26 and this was mainly due to just one poor US macro data release – retail sales. This publication caused the exchange rate to record its widest daily trading range since February 2013.
- The flash manufacturing PMIs for the euro zone and Germany are due this week and they may trigger significant changes on the EUR/USD rate. Important levels for the exchange rate are at 1.25 and 1.30.

Ruble still depreciates

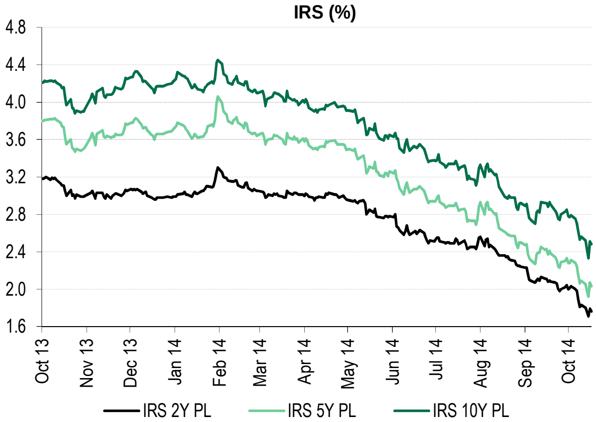
- The ruble's sixth consecutive week of depreciation brought about yet another record high in the USD/RUB rate. It reached c41.16 amid worries over the global economic growth and falling oil prices that are likely to put additional pressure on the already fragile Russian economy. Interventions by the Russian central bank to prevent the ruble's depreciation are unable to stop the currency's falls.
- The forint depreciated slightly vs. the euro, but, thanks to the appreciation in the previous weeks, the EUR/HUF is still close to its lowest level since June. The exchange rate surged to nearly 310 from 305, but ended the week close to 307.
- Just like in the case of the zloty, the ruble and forint are set to be mainly driven by swings in the global market sentiment in the coming days.

Interest rate market – Polish data in the background

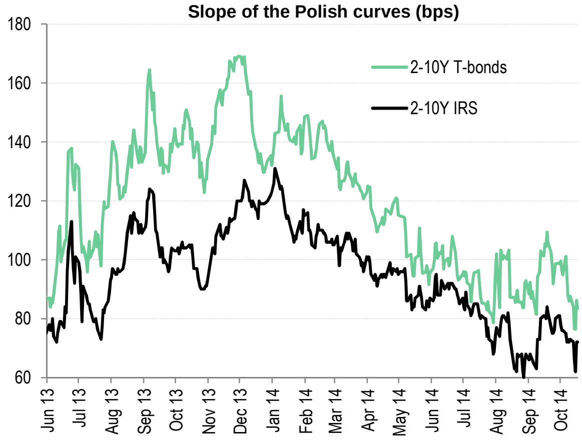
Money market rates and NBP refi rate (%)



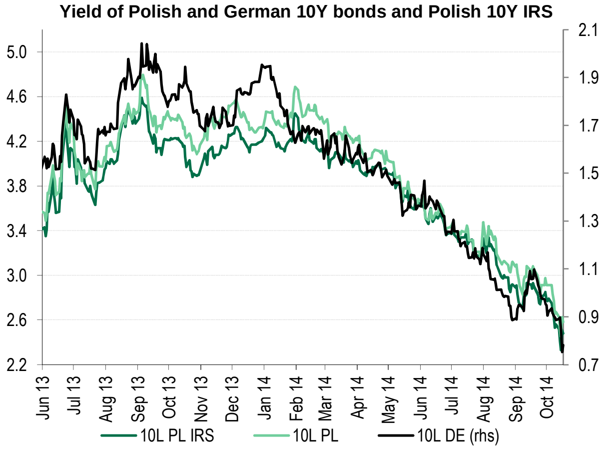
IRS (%)



Slope of the Polish curves (bps)



Yield of Polish and German 10Y bonds and Polish 10Y IRS



WIBOR on gradual decline

▪ The 1-12M WIBOR rates continued their adjustment after the MPC decision and fell 3-5bps on a weekly basis (12M is now 1bps below 2%). Despite the high volatility in the bond and IRS market, the FRA market is still pricing-in a fall in the 3M WIBOR by over 30bps in one month's time and almost 50bps in the next 3 months.

High volatility in the IRS/bond markets

▪ The past week was very volatile in the Polish IRS and bond market. The first three sessions saw a substantial drop in the IRS and bond yields, by 10-20bps from Friday's closing levels. The 2Y IRS reached c.1.7%, the 5Y dropped slightly below 2% and the 10Y to nearly 2.30%. The market was underpinned by the strengthening core markets amid high expectations for more monetary policy easing. However, a sharp correction took place as the rout in global financial markets continued, triggering a surge in risk aversion and investor retreat from emerging markets. The upward move was also supported by rising yields in Europe's developed markets (France, Belgium, Austria) and in the euro zone peripheries (Greece, Spain, Portugal, Italy). As a result, the 2Y, 5Y and 10Y bond yields and the IRS returned to levels last seen in the final days of the past week.

Global sentiment more important than domestic data

▪ We expected last week that a set of above-consensus macro releases from Poland may trigger a correction in the Polish fixed income market. Meanwhile, the impact of domestic data was marginal and the market fluctuated mainly on changes in investor sentiment abroad. Our forecasts for retail sales data due this week is marginally above market expectations and, as such, should not trigger any significant move. However, it will match the positive message offered by data that was released over the last few days and so may make the market less convinced that the MPC will cut rates by another 50bps in November.

▪ We think that the global market sentiment may continue to be the main driver for the Polish IRS and bonds in the coming days, with the domestic macro data playing a rather insignificant role. The recent week showed that once global risk aversion breaks through a certain level, it ceases to be favourable for the domestic fixed income assets.

▪ There is a bond auction scheduled for Thursday and it seems to be a good opportunity to test market attitude towards the Polish debt. The initial plan of the Ministry of Finance is to issue bonds worth PLN2-6bn, with the choice of the series on offer to depend on the market situation. The Ministry will rather not offer long-term bonds at the auction because such were already sold earlier this month at the ministry's switch auction. We believe the 5Y and/or 2Y benchmarks are more likely to be offered. The latest available data show that foreign investors held 26% of PS0719 and 27% of OK0716 outstanding at the end of August.

Additional information is available on request. Please contact Bank Zachodni WBK S.A. Rates Area, Economic Analysis Department, Al. Jana Pawła II 17, 01-854 Warsaw, Poland, phone +48 22 534 18 88, email ekonomia@bzwbk.pl, http://www.bzwbk.pl.