Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

3 – 9 November 2014

Central banks are in the fore again! The FOMC concluded its quantitative easing programme last week, as expected. This does not mean, however, that liquidity in the world financial markets will not be supported by central banks in the near term. Shortly after the Fed's decision, the Bank of Japan surprised markets by increasing the scale of its balance sheet expansion and, in the nearest week, the ECB may present more details concerning its own plans. The ECB meeting will probably be the key event of the week in Europe. Investors hope that the bank's statement will be even more dovish than before, especially in the context of the recent weak data from the euro zone. However, we see the risk that the central bank will want to wait for the December's TLTRO round before making any further moves, after it had announced the asset purchases programme in September. If this is the case, the zloty and bonds may trim some of their recent gains. Obviously, from the perspective of the Polish market, the MPC meeting will be the important event. We expect the MPC to cut the key rate by 25bp and keep the door open for further adjustment, if incoming economic data bring negative surprises.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (3 November)					
2:45	CN	PMI – manufacturing	Oct	pts	50.4	-	50.2
9:00	**PL**	**PMI – manufacturing**	**Oct**	**pts**	**50.0**	**49.7**	**49.5**
9:55	DE	PMI – manufacturing	Oct	pts	51.8	-	49.9
10:00	EZ	PMI – manufacturing	Oct	pts	50.7	-	50.3
16:00	US	ISM – manufacturing	Oct	pts	56.5	-	56.6
		TUESDAY (4 November)					
16:00	US	Industrial orders	Sep	%MoM	-0.5	-	-10.1
		WEDNESDAY (5 November)					
	PL	**MPC decision**		**%**	**1.75**	**1,75**	**2.0**
9:55	DE	PMI – services	Oct	pts	54.8	-	55.7
10:00	EZ	PMI – services	Oct	pts	52.4	-	52.4
14:15	US	ADP report	Oct	k	214	-	213
16:00	US	ISM – services	Oct	pts	58.0	-	58.6
		THURSDAY (6 November)					
8:00	DE	Industrial orders	Sep	%MoM	2.0	-	-5.7
9:00	CZ	Industrial output	Sep	%YoY	3.8	-	-5.2
11:00	**PL**	**Bond auction**					
13:00	CZ	Central bank decision		%	0.05	-	0.05
13:45	EZ	ECB decision		%	0.05	-	0.05
14:30	US	Initial jobless claims	week	k	-	-	287
		FRIDAY (7 November)					
8:00	DE	Exports	Sep	%MoM	2.3	-	-5.8
8:00	DE	Industrial output	Sep	%MoM	1.8	-	-4.0
14:30	US	Non-farm payrolls	Oct	k	230	-	248
14:30	US	Unemployment rate	Oct	%	5.9	-	5.9

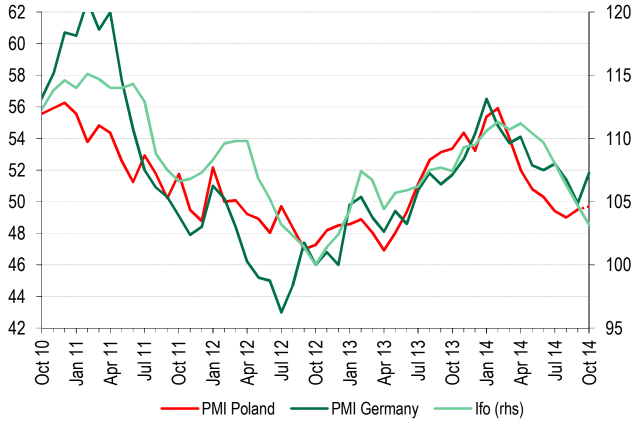
Source: BZ WBK, Reuters, Bloomberg

ECONOMIC ANALYSIS DEPARTMENT:
Al. Jana Pawła II 17, 00-854 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

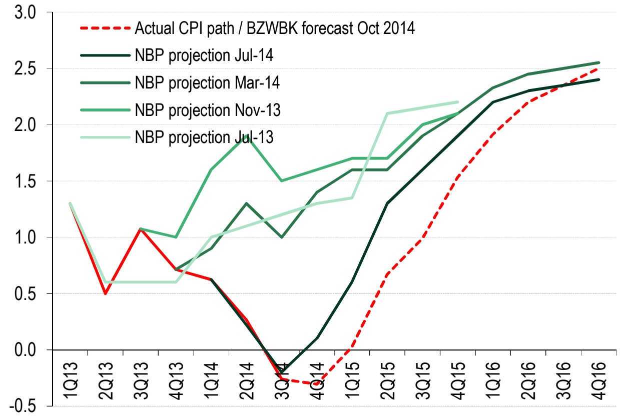
What's hot this week – Interest rates down, but how much?

Activity in manufacturing



- Flash PMI manufacturing indices for the euro zone and Germany rebounded in October and so did the Eurostat confidence indicators, which surprised to the upside. The German Ifo index, however, dropped sharply to its lowest level since December 2012, which, together with the earlier publication of the ZEW index, is quite a gloomy signal, pointing to a significant slowdown in activity in Europe's biggest economy.
- We expect the Polish manufacturing sector PMI to follow the European PMIs higher in October, but the rise will probably be very modest, with the index most likely remaining below its neutral level of 50. This hints at a rather narrow scope for a rebound in industrial production. The earlier-released statistics office's business climate index in manufacturing also showed a moderate rebound in October, with assessment of the current and future production going up from the local lows seen in September.

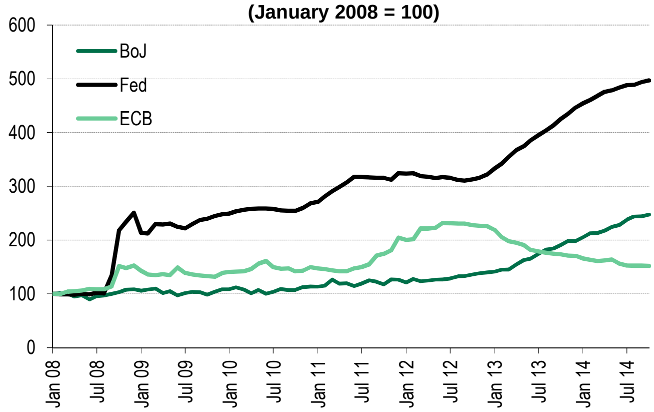
Inflation path vs NBP projections



- In our view, the MPC's decision to cut rates by 50bp in October was a very tight call, delivered most likely thanks to the casting vote of the NBP governor. Building a majority for further easing might, therefore, not be easy.
- We think the Council will cut rates by 25 bp in November, a scenario already priced-in by the market and expected by most of analysts. According to a Reuters poll, 17 out of 26 surveyed analysts expect the MPC to cut rates by 25bp in November. Six of them bet on a 50bp cut and three believe that rates will remain on hold.
- We expect the new NBP projection to show a considerably lower GDP path for the upcoming quarters (even by 1pp in 1Q15) and lower inflation, which will provide arguments for further monetary easing. That said, the MPC will probably leave the door open for more rate cuts, but only if the economic situation deteriorates further.

Last week in the economy – This is not the end of the global QE

Balance sheets of the main central banks
(January 2008 = 100)



- The last FOMC meeting concluded the QE3 programme and the post-meeting statement proved to be a bit more hawkish than the market had expected. It stressed that the US economy was recovering, yet failed to mention the recent turmoil in the financial markets. It also did not change its wording concerning interest rates (these will remain unchanged for 'a considerable time'). Still, global liquidity in the financial system is not likely to diminish, as:

1) the Fed will still be reinvesting its QE principal payments in the ABS market and in the rolling-over the US Treasuries.

2) the Bank of Japan unexpectedly decided to increase its QE programme from JPY60-70trn to JPY80trn per year.

3) the ECB is continuing its asset purchases programme and there are expectations that it will be extended to corporate bonds (or even sovereign bonds).

Quote of the week – (Narrower) room for a rate cut in November

Andrzej Rzońca, MPC member, 29.10.2014, Gazeta Wyborcza
I do not understand why we should cut rates further.

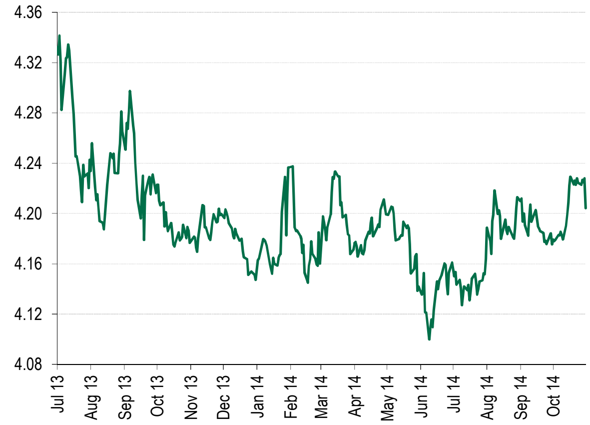
Jan Winiecki, MPC member, 27.10.2014, Reuters
We are very close to entering unconventional but ineffective action.

Elżbieta Chojna-Duch, MPC member, 27.10.2014, PAP
There is room for interest rate cuts in November, but it is significantly narrower after the significant reduction of the main interest rate in October. In my opinion, options are still open here, there is nothing determined yet.

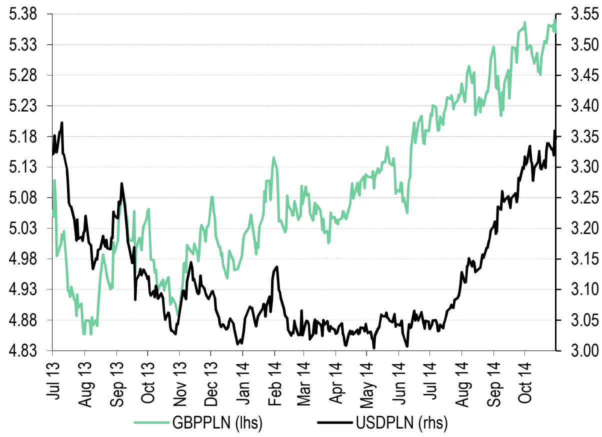
We bet that the October's decision to cut rates was a very close call, with 5 members in favour (M. Belka, A. Bratkowski, E. Chojna-Duch, J. Osiatyński, A. Zielińska-Głębocka). In our view, the very same five are likely to support more easing in November. But if only one of these members changed his/her mind, there could be no cut. But we do not think this will be the case. Though E. Chojna-Duch seemed less dovish in her previous comments, the last one was quite clear that we will have more easing in November. The new GDP and CPI projections prepared by the NBP will also most likely support the additional cut. And though we expect the MPC to cut rates in November, we believe that market expectations for more than 50bp in easing over the next 3 months are exaggerated.

Foreign exchange market – ECB crucial for the zloty

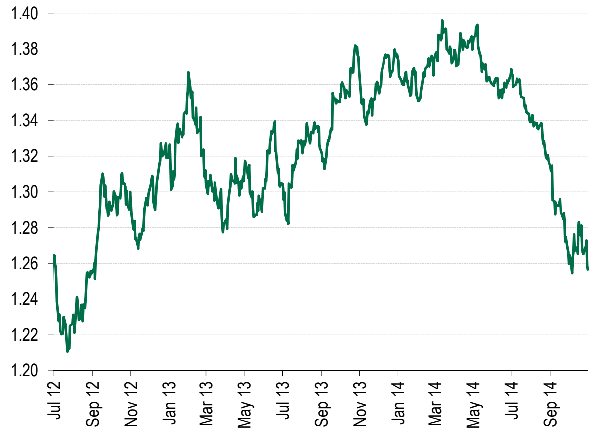
EURPLN



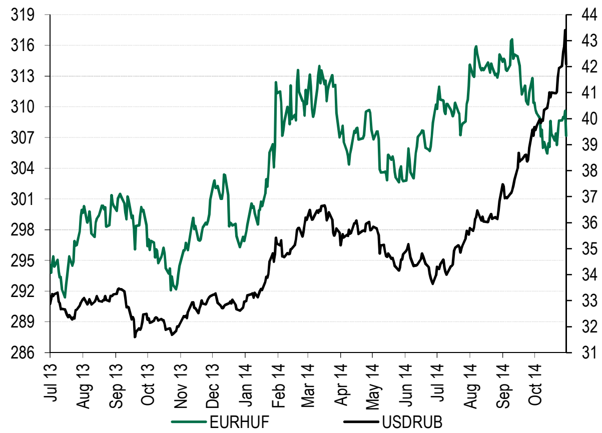
USDPLN and GBPPLN



EURUSD



EURHUF and USDRUB



The zloty gains slightly vs. the euro

- The zloty appreciated vs. the euro last week and EUR/PLN ended Friday's session close to 4.20, its lowest since mid-October. The domestic currency shrug off the hawkish tone of the FOMC statement and benefited from the surprising decision of the Bank of Japan to extend its asset purchase programme. On the other hand, the zloty lost vs. the greenback as the fall of EUR/USD neutralised the decline of EUR/PLN. As a result, USD/PLN climbed temporarily above 3.36 (highest since July 2013).
- The zloty reacted positively to the decision of the BoJ and perhaps this tells us something about which event will be key for the domestic currency in the coming week. Investors hope that the ECB may sound even more dovish than last time given the recent disappointing data from the euro zone. However, we think there is a risk that the central bank will want to wait until December for the next TLTRO auction before taking more actions after it had announced the ABS/covered bond purchase programme in early September. If the ECB disappoints, the zloty may pare at least part of its gains from last week. Important levels to watch for EUR/PLN are at 4.20 (next support at 4.17-4.18) and 4.24.

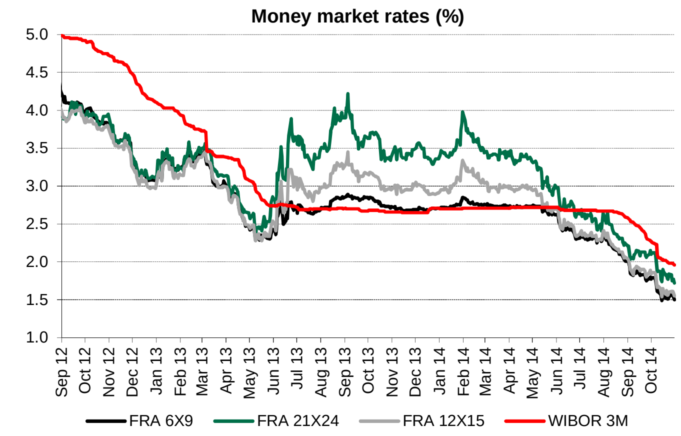
Dollar gains due to the hawkish FOMC

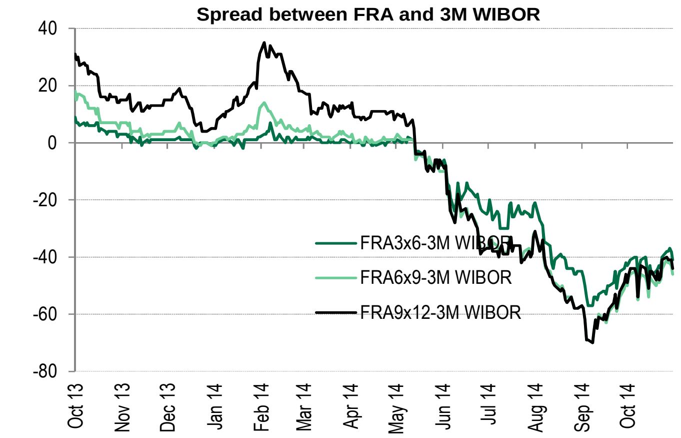
- EUR/USD fell last week mainly on the back of the more hawkish than expected tone of the FOMC statement. The exchange rate, which fell for the second week in a row, was dragged down to c1.255 from 1.276.
- The coming week is full of important events. Expectations for the ECB to extend its asset purchase programme have recently strengthened on the disappointing euro zone macro data and have already weighed on the single currency. Notice that the much better-than-expected advance 3Q US GDP data failed to further support the dollar. This suggests that much of the monetary easing in the euro zone and the strong US fundamentals have already been priced in. It, therefore, seems that only a significant surprise in the ECB rhetoric and/or substantial deviation of the US monthly nonfarm payrolls from the consensus could push the exchange rate significantly below 1.25 (next support levels are at 1.246 and 1.226). If this does not happen, the first resistance to watch is at 1.29.

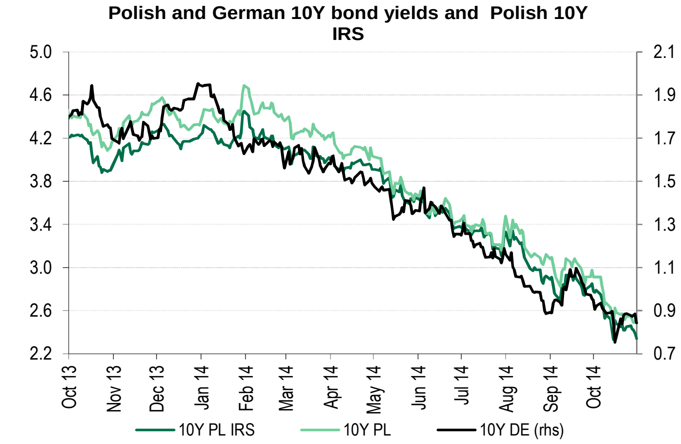
Ruble under pressure despite the rate hike

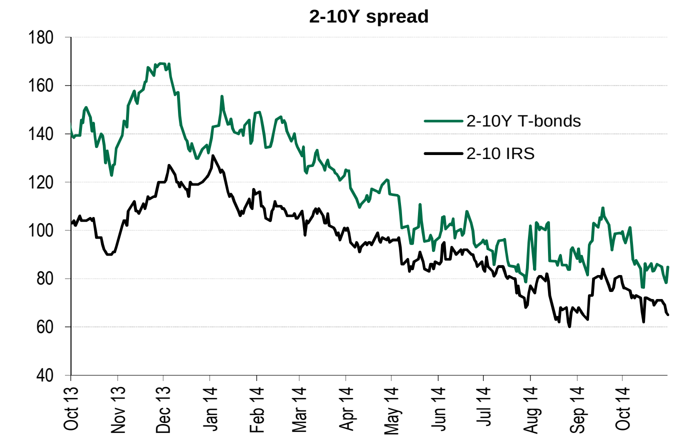
- USD/RUB reached its new all time-high at 43.87 last week and ended the week near this record. In the meantime, the exchange rate plunged temporarily to c41.5 (the biggest daily drop since March 1999) on the back of speculation that presidents Putin and Poroshenko reached an agreement on the status of Crimea. The Russian central bank hiked interest rates by 150bp to 9.5% (vs. 100bp expected by the market) in an attempt to stop the currency's depreciation and to prevent the exchange of households' savings from rubles to foreign currencies. Nevertheless, the move failed to support the ruble and USD/RUB rebounded back to 42.9 at the end of the week.
- EUR/HUF stayed roughly stable at a touch above 305, the lowest level since June. At the same time, EUR/CZK recorded its second consecutive week of a noticeable rise – to 27.8 from 27.6. Investors may be concerned that sluggish economic growth in the euro zone will force the Czech central bank to lift the 27 floor. Industrial output data is due this week and it may have impact on the koruna.

Interest rate market – Outcome of the MPC meeting important for market direction









Money market rates remain in a downtrend

- Money market rates continued to slide in the past week as investors continue to strongly expect the MPC to ease monetary policy in November. The hawkish comments from some MPC members caused FRAs to rise at the start of the week, but the upward correction was only short-lived due to still alive expectations for interest rate cuts in the coming months. During the week, FRAs fell across the board by 1-7bp, with the biggest decline on the longer tenors.
- The FRA market is currently pricing-in a rate cut of 25bp in November and of more than 50bp over the next three months, which means that the possible scale of further monetary easing is already reflected in the market prices. One should note that there still is uncertainty over the scale of further adjustment in monetary policy. Investors will, therefore, closely watch the MPC's press conference and the statement (together with the new CPI and GDP projections) for clues whether the Council had just ended its easing campaign or not. We believe that the Council will keep the door open for further cuts. As a result, we still expect a gradual decline in the WIBOR rates in the coming weeks.

Positive trend on the domestic debt market continues

- One might have expected that the FOMC outcome would be the main FI market driver last week. But the core and, consequently, the domestic bond market reaction to a bit more hawkish Fed statement was very modest and short-lived as macro data releases for both the euro zone and the US proved supportive for the FI market. Additionally, the unexpected Bank of Japan decision to expand its easing measures by increasing its QE stimulus programme helped the market return to a strong rally, with the yield on the domestic 10Y benchmark reaching a fresh record low level.
- In weekly terms both the T-bond and the IRS curves shifted down by 1-10bp and 1-7bp, respectively. The long- end of the curves firmed the most and, consequently, the spread on the 2-10Y narrowed quite considerably as compared with the previous week. It means that investors returned to their bull-flattener strategy, using the weaker valuation of the 10Y sectors to rebuild their position.

The MPC meeting remains the key event this week

- Investors will focus on the MPC meeting this week. Further adjustment in monetary policy is widely expected, though the scale of the cut remains uncertain. Most market players (including us) expect a cut of 25bp, but some forecast another cut by 50bp. If our scenario materialises and the door to more easing stays open, it will support both the T-bond and the IRS markets, especially if the monthly data releases later this month should confirm a further slowdown in economic activity. On the other hand, only a clear signal that rate cuts are over could reverse the current trend on the FI market.
- Market sentiment after the MPC will affect the T-bond auction results. Using the favourable market conditions, the Ministry of Finance decided to offer long-term T-bonds (fixed rate DS0725 and WS0428 and floating rate WZ0124) worth PLN2-4bn. It should be kept in mind that the raised funds will pre-finance the 2015 gross borrowing needs. We estimate that at the end of October, the Ministry had pre-financed nearly 13% of the target, assuming that this year's budget deficit will be cPLN10bn lower. Market conditions and the relatively low offer should attract demand and allow the Ministry to launch the T-bonds near maximum level.

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.