

WEEKLY ECONOMIC UPDATE

9 – 15 March 2015

Poland's Monetary Policy Council decided to cut interest rates by 50bp, but, at the same time, to announce the end of the easing cycle. The decision triggered zloty gains and weakening of the long- end of the yield curve. The biggest threat to the pledge probably now is the risk of sharp zloty appreciation. The ECB starts its large-scale asset purchases on Monday and, if it triggers a substantial drop of EURPLN, it could significantly complicate the central bank's job. However, this is not our base-case scenario and we think that it was probably the last change in interest rates before the end of this Council's term. Polish manufacturing PMI fell only slightly in February, confirming that economic activity remains strong and employment growth continues. We expect incoming data on economic activity to confirm that a recovery is underway.

This week will be quite dull in terms of new data releases, but it may still be quite exciting for the markets because of the start of the ECB's full-fledged QE on Monday. Investors will likely be eager to see its initial impact on the European financial markets. We expect that the flood of money from the ECB may trigger bull-flattening in the euro zone's core debt markets and further spread compression. As a result, the Polish debt market may strengthen as well. On Monday, the NBP presents its new Inflation report, including details of the new medium-term projections. It will be interesting to see what factors were behind the surprisingly low CPI forecast of the central bank. On Friday, CPI data will be released. Now that the MPC had strongly declared the easing cycle was over, these data may have a smaller impact on the market than usually. We expect inflation to drop to -1.5%YoY in February, slightly below market consensus. But, at the same time, we think it will be the end of the downward trend and that the coming months should bring a gradual rebound in price growth. As every year, the statistics office will revise the weights of the CPI basket, based on the structure of last year's household expenditures. The impact of these changes is hard to estimate, but, in our view, it should only slightly increase this year's inflation (by less than 0.01pp).

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD	FORECAST		LAST VALUE	
				MARKET	BZWBK		
MONDAY (9 March)							
8:00	DE	Exports	Jan	%MoM	-1.5	-	3.4
9:00	CZ	CPI	Feb	%YoY	-0.1	-	0.1
10:00	PL	Inflation report					
TUESDAY (10 March)							
9:00	HU	CPI	Jan	%YoY	-1.2	-	-1.4
WEDNESDAY (11 March)							
No important data releases							
THURSDAY (12 March)							
11:00	PL	Bond auction					
11:00	EZ	Industrial output	Dec	%MoM	0.2	-	0.0
13:30	US	Initial jobless claims	week	k	-	-	320
13:30	US	Retail sales	Jan	%MoM	0.4	-	-0.8
FRIDAY (13 March)							
9:00	CZ	Industrial output	Jan	%YoY	2.5	-	7.3
14:00	PL	CPI	Feb	%YoY	-1.3	-1.5	-1.3
14:00	PL	Money supply	Feb	%YoY	8.6	8.8	8.5
15:00	US	Flash Michigan	Mar	pts	96.0	-	95.4

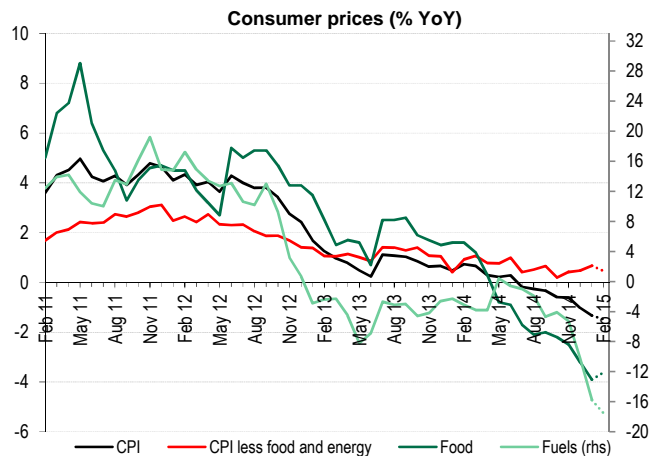
Source: BZ WBK, Reuters, Bloomberg

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 Luzziński +48 22 534 18 85
 Marcin Sulewski +48 22 534 18 84

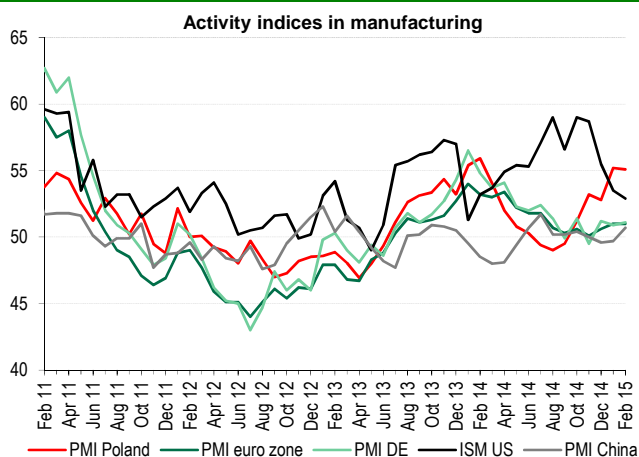
TREASURY SERVICES:

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

What's hot this week – Bottoming out deflation

▪ According to our estimate, CPI fell to a record low of -1.5%YoY in February (market consensus is slightly higher), mostly on the back of lower transport prices and a high base effect in tobacco and alcohol (no excise tax hike this year). This was also most likely the deepest level of deflation that we will see this year since we expect CPI to be gradually rebounding in the months to come to reach 1.0%YoY in December. Since mid-February, fuel prices have risen thanks to the growing price of crude oil. The labour market is booming, employment and wage growth are both solid. Additionally, the lower interest rates could prop up consumption. These factors should support faster CPI growth in the coming months. We can already see some slight uptick in price growth in some categories and we believe this is a sign that the deflation trend is reversing.

▪ We expect the M3 money supply growth to accelerate a bit in February on the back of stronger deposits.

Last week in the economy – MPC cuts rates by 50bps, PMI falls less than expected

▪ The PMI index for the Polish manufacturing sector eased in February only marginally, to 55.1pts from 55.2pts, beating expectations. The pace of growth of output and orders (including export orders) slightly decelerated vs. January but remained robust. At the same time, the employment subindex rose noticeably – to its highest level since January 2014 and the second highest level ever. The data indicate that Poland's manufacturing sector is still in an expansion phase and that companies are optimistic enough as regards the outlook for the coming quarters. They are also raising their employment levels at a faster pace.

▪ The Polish Monetary Policy Council cut interest rates by 50bp in a surprise move. It looks as if the MPC preferred to concentrate monetary easing and to adjust rates in a single move to the new environment (deeper deflation) and new forecasts (the bank's new inflation projection points to CPI at c1% in 2016-17). The MPC communiqué said explicitly that the monetary easing cycle had been concluded, so this looks like the last change in interest rates by this MPC (which ends its tenure at the end of the year).

▪ The MPC statement revealed the main conclusions from the new NBP projections. Inflation projection shows very low CPI path with mid-point of predicted range below 1% in 2016, only slightly 1% in 2017, and no chance to reach the official target in medium term. NBP's forecast for 2016-2017 is thus below our forecast (we expect the target would be reached in 2017). The NBP scenario does not take into account effects of 50bp rate cut, but NBP governor said that even if decision is taken into account, the inflation projection would not change substantially. As regards GDP projections, the mid-point increased moderately, especially for 2015 (by c0.5pp), while the first projection for 2017 showed moderate GDP growth continuing. Path of GDP growth is roughly consistent with our expectations.

Inflation and GDP projections in the subsequent Inflation reports

	GDP growth			
	Mar 14	Jul 14	Nov 14	Mar 15
2015	2.7-4.8	2.6-4.5	2.0-3.7	2.7-4.2
2016	2.3-4.8	2.3-4.5	1.9-4.2	2.2-4.4
2017	-	-	-	2.4-4.6
	CPI inflation			
	Mar 14	Jul 14	Nov 14	Mar 15
2015	1.0-2.6	0.5-2.1	0.4-1.7	-1.0-0.0
2016	1.6-3.3	1.3-3.1	0.6-2.3	-0.1-1.8
2017	-	-	-	0.1-2.2

Quote of the week – No more room for interest rate cuts**Marek Belka, NBP president, 06.03.2015, MPC press conference**

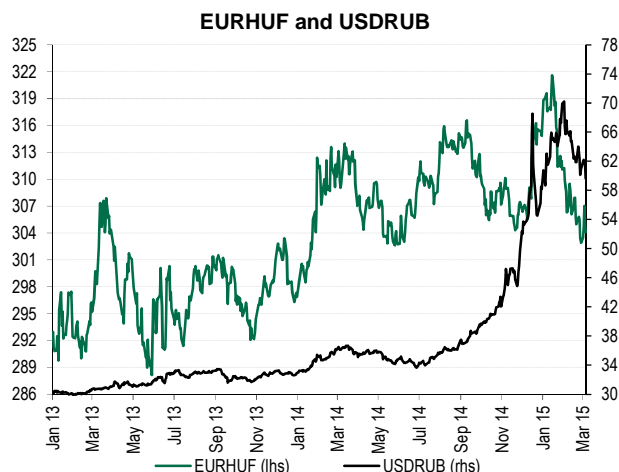
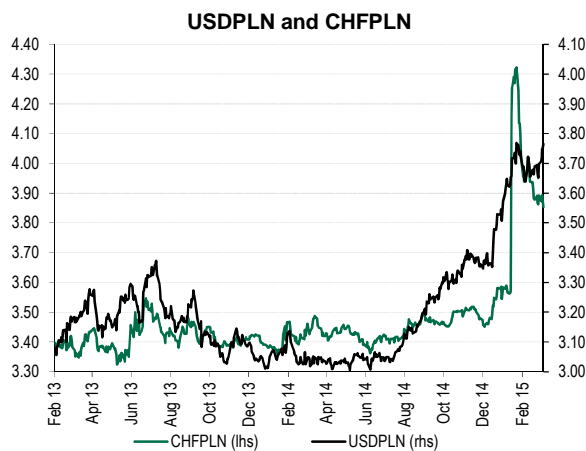
Inflation will not reach the target in 2017, but there is a chance that it will be above the lower end of the tolerance range. (...) The impact of the 50 bps interest rate cut is not strong enough to modify the inflation path drastically.

Taking into account the economic situation and what we can expect based on the new projection and observation of the economic trends, I see no more room for interest rate cuts. (...) I cannot imagine any realistic scenario that could undermine the statement's conclusion (about the end of the easing cycle).

We do not target any exchange rate. As regards (FX) interventions, we have actually forgotten what that is.

The MPC decided to conclude the easing cycle even though the NBP projections indicate that inflation will not return to target in the next three years (sic!). Governor Belka admitted that the Council had asked the NBP to project the impact of a possible 50bps rate cut and it turned out that it did not affect the projection too much. Thus, either the MPC did not fully believe in the projection's results (which used to happen in the past) or it simply gave up and decided to leave it up to the next MPC to try to bring CPI to its target. Belka stressed during the press conference that the bank was not targeting any FX rate and that he didn't even remember what FX intervention was. That was quite unfortunate, in our view, as, in fact, sharp zloty appreciation potentially is exactly what could complicate monetary policy the most in the nearest months.

Foreign exchange market – EURPLN below important support



EURPLN lowest since July 2014...

▪ The decision of the Polish MPC was the most influential event for the zloty last week. The bigger-than-expected rate cut weighed on the domestic currency, but the depreciation was temporary because the MPC's strong declaration that the easing cycle had come to its end proved more important. The zloty also drew support from the NBP governor, who said during the post-meeting press conference that there may be an "appreciation pressure" on the zloty from the ECB's easing and that the NBP "had already forgotten" what FX intervention was (suggesting the bank would not respond to substantial zloty appreciation). Consequently, EURPLN broke its support level at 4.14 and reached 4.11 (lowest since July 2014). The zloty also slightly gained vs. the Swiss franc. The downward move in CHFPLN (to 3.84 from 3.86) was fuelled by the falling EURPLN amid a roughly stable EURCHF. The latter did not track the EURUSD drop due to rumours that the Swiss government was pressuring the SNB to implement the EURCHF floor again to support the economy.

▪ Before this week's rate cut, the market had expected that policy easing in Poland would total even slightly more than 50bps. The EURPLN reaction to the MPC's decision shows that the announcement of the end of the easing cycle was the most important conclusion from the Council's meeting. We had expected EURPLN to move sideways even until April due to the outlook for interest rate cuts in Poland, among others. But now that expectations for further easing had dissipated, we adjusted our forecasts of the average EURPLN for the coming months – to 4.13 from 4.15 in May and to 4.12 from 4.14 in June.

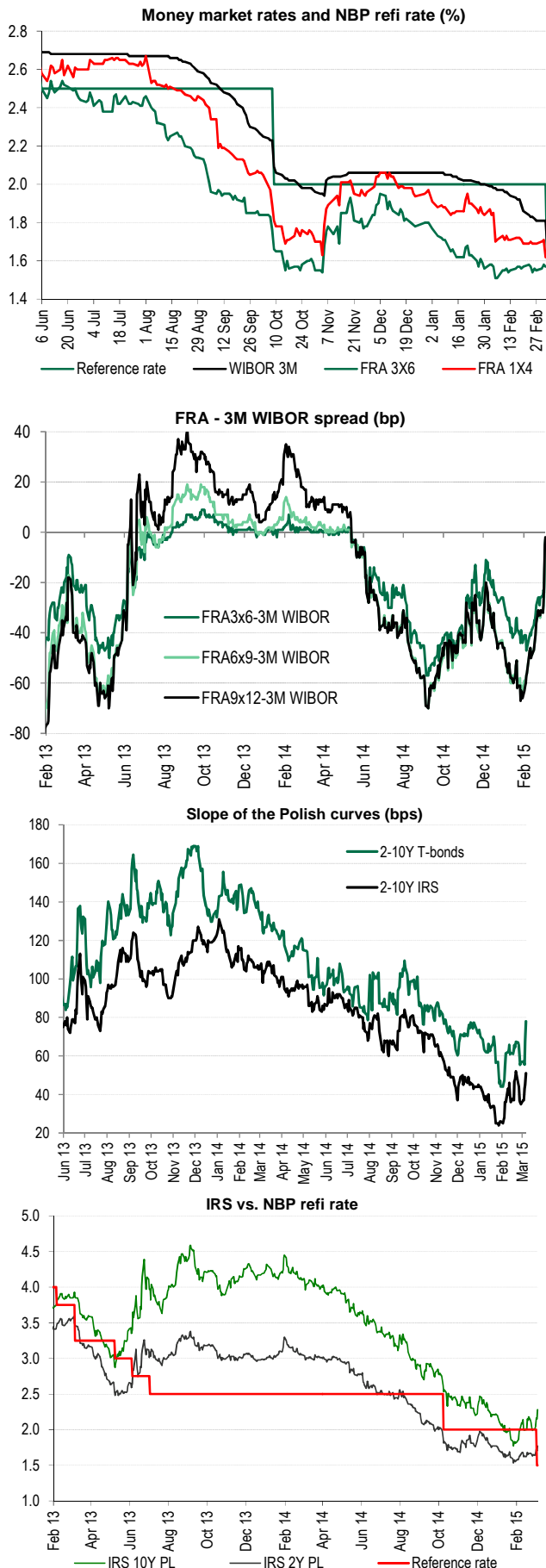
▪ The past week was the third consecutive when EURPLN kept falling. Since March 2014, there have been five (including the recent one) three-week long downward waves of EURPLN that were followed by at least one week of a correction. Only in 2013, there were three four-week long EURPLN downward waves. This week's calendar is rather light and so the absence of fresh impulses could prove to be a reason to take profit. On Monday, though, is when the ECB's QE will finally start. The bank will start injecting cash into the European market and, as a result, we expect some bigger portfolio inflows into the Polish assets. The first week of QE may be some indication of what impact this programme could have in the coming months.

... and EURUSD lowest since September 2003

▪ After eight consecutive months of falls, EURUSD was also down in the first week of March, reaching its lowest level since September 2003 (below 1.09). The dollar continued to appreciate on the back of the clear divergence in the monetary policies of the euro zone and the U.S. Also, the outlook for the ECB's QE start on Monday (March 9) and the much better than expected US nonfarm payrolls data have additionally pressured the single currency.

▪ So far, the EURUSD downward trend has been largely driven by expectations for monetary policy easing by the ECB. The euro's recovery after the extended QE was announced in January was only temporary and was soon followed by the EURUSD's return to its trend. The ECB will now finally start buying euro zone's debt in amounts bigger than the net monthly supply of bonds. The actual inflow of cash into the market and the negative deposit rate is likely to weigh on the single currency in the coming week. The next support for EURUSD is at 1.076.

Interest rate market – Will ECB's QE push Polish yields lower?



WIBOR plunge, IRS/bond curves steepen after the MPC

■ The MPC's rate cut by 50bps had a noticeable impact on the WIBOR rates – the curve plunged 11-22bps in the 1M-12M segment, with the biggest move on the short-end and the smallest on the long-end. Following these change, the shape of the WIBOR curve is normal again, i.e. the shortest rate is the lowest (1.64%), while the longest is the highest (1.68%). Given the strong pledge that the March cut was the last one in the cycle, we expect WIBORs to stay close to their current levels in the coming months and to start gradually rising in 2Q16 when rate hikes will be nearing. FRAs had already priced-in the 50bps cut and the MPC's decision did not trigger any noticeable moves. As the WIBOR rates were forced to adjust significantly, the FRAs now see stable rates over the next 12 months. For the first time since June 2014, the FRA market even sees some room for rate hikes – the FRA18x21 and 21x24 are above the 3M WIBOR by 13bps and 19bps, respectively. We think that market expectations for stable WIBOR this year and some gradual increase in 1H16 are justified.

■ The IRS and bond curves steepened noticeably last week as rates in the short-ends increased less (c10bps) after the MPC's rate cut than in the belly and long-ends weakened sharply (by roughly 25-30bps). The yield on the 10Y benchmark broke 2.40% and that on the 5Y reached 2.13%. The 10Y IRS reached 2.28% and 5Y 2.05%. Next to the MPC's declaration of the end of the easing cycle, the Polish market was also under the pressure from the weakening Bunds and strong US nonfarm payrolls data.

Domestic factors no longer support lower IRS/yields

■ Now that the MPC had concluded the easing cycle, we think that domestic factors will no longer support gains in the fixed income market. We predict that February's CPI, to be released this week, will be below consensus. We do not think, however, that this could have a noticeable and long-lasting impact on the FI market as further rate cuts are off the agenda. The new CPI projection prepared by the NBP forecasts a very low inflation path for the coming years (below our forecasts), which did not stop the MPC from ending the easing cycle. Thus, the lower CPI in February should not have much impact on the IRS/bond market. At the same time, we expect quite favourable macro data to be released in the coming weeks, which could have upside pressure on rates. We also think that the swap curve is too low given the likely bottoming-out of inflation soon and the continuation of strong growth driven by domestic demand. The only reason why bond yields could resume the downtrend is, in our view, inflow of portfolio money into the Polish market due to the monetary policy easing in the euro zone. The ECB's QE starts this week and we could see some initial impact of this programme on the Polish market.

■ This week on Thursday, the Finance Ministry will offer DS0725, WZ0124 and WS0428 bonds. The most recent data from the Ministry showed that non-residents held nearly 80% of DS0725 outstanding at the end of January. This group of investors has been buying this bond since September and ever since it was issued in June 2014, there was only one month when some marginal selling was recorded. Among the non-residents, mutual funds hold the biggest amount of DS0725 – 31% of the foreign investors' holdings and 24% of this bond outstanding. In the case of WS0428 and WZ0124, Polish investors are majority holders (77% and 98% of the amount outstanding, respectively). Easing of the euro zone's monetary policy should, in our view, result in quite a solid demand for the Polish bonds at this week's auction.

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Additional information is available on request. Please contact Bank Zachodni WBK S.A. Rates Area, Economic Analysis Department, Al. Jana Pawła II 17, 00-854 Warsaw, Poland, phone +48 22 534 18 88, email ekonomia@bzwbk.pl, <http://www.bzwbk.pl>.