Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

7 – 13 September 2015

Polish manufacturing PMI joined the group of disappointing indicators and dropped in August to 51.1, much below expectations and its lowest since September 2014. We find it very surprising because no other business climate indicator for Poland showed a notable deterioration in August (in fact, most improved slightly) and German PMIs surprised to the upside. We still think that industrial production growth may surprise on the upside in August as the impact of the temporary power shutdown (due to drought) on total output was probably lower than most analysts assume. On a positive note, the seasonally adjusted unemployment rate (according to the Labour Force Survey) fell in July to 7.6%, its lowest since April 2009, while growth in the number of the employed accelerated to 1.4%YoY. The recent data releases prompted us to cut our 2015 GDP growth forecast for Poland to 3.5% from 3.8%. We left the 2016 forecast unchanged at 3.5%. Data releases abroad were a mixed bag, but, in general, they showed improvement in economic activity in both Europe (with the euro zone's composite PMI at a four-year high) and USA (non-farm payrolls below forecast, but unemployment and earnings better than expected). Still, uncertainty about the global economic outlook is growing, mainly because of worries about the situation in China, which was recently confirmed by the IMF and the ECB.

As there are no important data releases in the nearest week, the market in Poland may focus on fiscal policy as the government is due to discuss its preliminary budget draft for 2016. Media speculate that the Ministry of Finance has proposed a PLN57.2bn budget deficit for next year, i.e. PLN10bn higher than this year. Such a large central budget deficit (c3% of GDP) would imply a significant shift from the fiscal consolidation plan outlined in the Convergence Programme (that aims at reducing the general government balance in 2016 to 2.3% of GDP from this year's 2.7%), which may be negative for the Polish bond market. Additionally, the annual Economic Forum in Krynica-Zdrój (the so-called "Polish Davos") starts on Tuesday and it may be a source of various politicians' comments about their post-election economic plans. Abroad, investors will be awaiting any new hints regarding the possible outcome of the FOMC meeting on September 17. China is still a possible source of risk aversion. Investors will also eye polls ahead of the snap elections in Greece (September 20) as falling support for Syriza implies problems with forming a cabinet after election and more political turmoil in the months to come.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (7 September)					
	US	Market holiday					
8:00	DE	Industrial output	Jul	%MoM	0.9	-	-1.4
9:00	CZ	Industrial output	Jul	%YoY	3.0	-	8.1
		TUESDAY (8 September)					
8:00	DE	Exports	Jul	%MoM	1.4	-	-1.1
9:00	HU	CPI	Aug	%YoY	0.4	-	0.4
11:00	EZ	Final GDP	Q2	%YoY	1.2	-	1.0
		WEDNESDAY (9 September)					
9:00	CZ	CPI	Aug	%YoY	0.4	-	0.5
		THURSDAY (10 September)					
11:00	**PL**	**Bond auction**					
14:30	US	Initial jobless claims	week	k	-	-	271
		FRIDAY (11 September)					
12:30	RU	Central bank decision		%	11.0	-	11.0
16:00	US	Flash Michigan	Sep	pts	91.5	-	91.9

Source: BZ WBK, Reuters, Bloomberg

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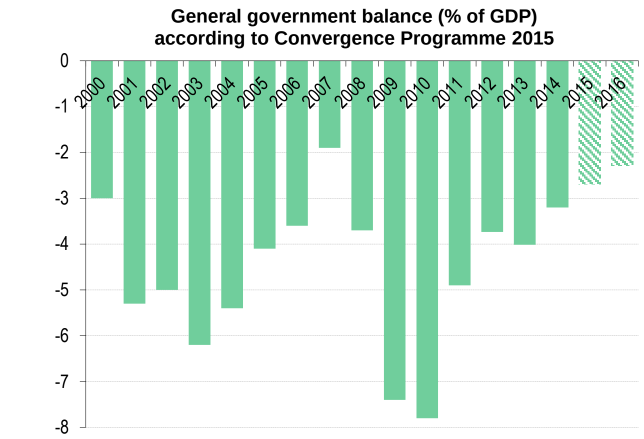
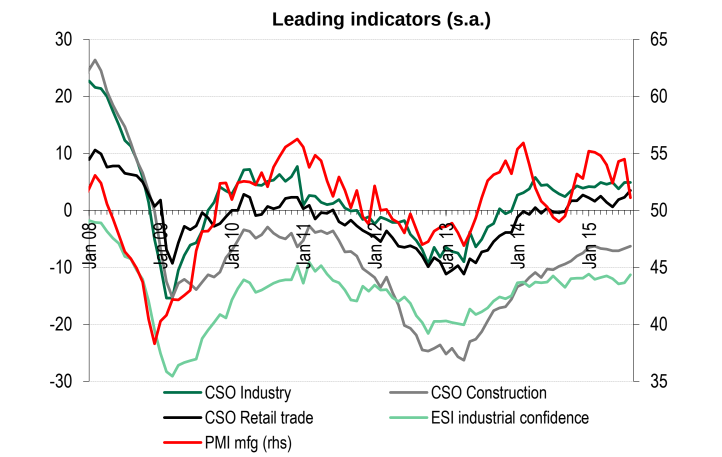
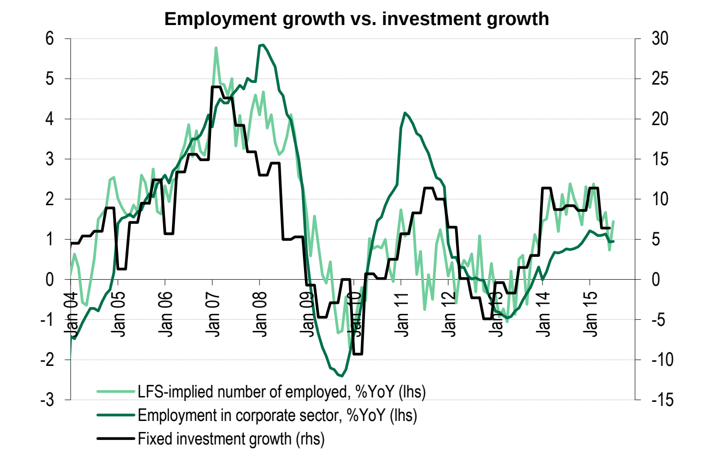
What's hot this week – No data releases, focus on fiscal policy



▪ This week's lack of significant data releases means that market attention will be on fiscal issues. Last week, media reported that the preliminary 2016 budget draft puts the budget deficit at PLN57.2bn, more than PLN10bn higher than in 2015. It corresponds to c.3% of GDP vs. 2.6% this year. Let us keep in mind that the Convergence Programme, approved by the government this spring, aims to cut the general government (GG) deficit 2.3% of GDP from this year's 2.7%. Finance Minister Mateusz Szczurek said that these were only tentative estimates and that the GG gap should not exceed 3% of GDP. The new measures aimed at boosting revenues are supposed to be discussed this week by the government and, if approved, may allow for lowering of the predicted deficit. One cannot exclude the possibility that the final budget draft deficit will be lower than the press is suggesting, but still, we see a rising risk of slower fiscal consolidation that we had initially assumed.

Last week in the economy – Surprisingly low PMI





▪ Poland's manufacturing PMI plunged unexpectedly in August to 51.1 (its lowest since September 2014) from 54.5 in July. It was the biggest drop since January 2005 and the deterioration was broad-based – the pace of growth of production, new domestic and export orders was significantly lower than in July. The smallest decrease affected the employment index. The release was a big disappointment, but it should be noted that no other business climate indicator for Poland showed a significant deterioration in August (in fact, most improved slightly). Thus, the weak PMI reading looks like an outlier. Maybe the poor result was caused by a weaker manager sentiment due to the temporary power shutdown in mid-August (caused by the drought). However, we noticed that despite the shutdown, aggregate power consumption in August rose YoY at the fastest pace since 2011, so the impact on industrial production should not have been significant, in our view.

▪ According to the Labour Force Survey, the seasonally adjusted unemployment rate in Poland fell in July to 7.6%, its lowest since April 2009. The LFS-implied employment growth accelerated to 1.4%YoY, according to our estimate, but, in general, it remains consistent with the sub-10%YoY growth of fixed investments (see chart).

▪ The Monetary Policy Council once again kept interest rates on hold. At the press conference, NBP governor Marek Belka said that the MPC's stance had not changed – that interest rates were likely to remain stable until the end of Council's term. No significant changes were made to the bank's forecasts of inflation (deflation is to end in November, which is in line with our view) and economic growth (3.6% in 2015, which is close to our forecast). The Council started working on its monetary policy guidelines for next year (to be approved in mid-September), but, according to the governor, they will (naturally) include no significant modifications.

Quote of the week – What about the inflation target?

Elżbieta Chojna-Duch, MPC member, 4.09.2015, PAP

In the context of an unspecified deadline for entering the euro zone we must return to discussions on lowering the inflation target to the European level of 2.0%.

NBP Economic Institute, 3.09.2015

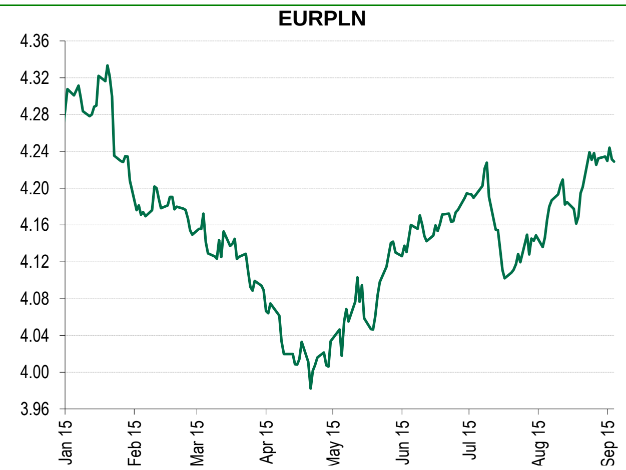
Current inflation target seems to be protecting us well from falling into deflation trap. Potential reduction of the target to 1.5% would trigger a jump of probability to falling into trap.

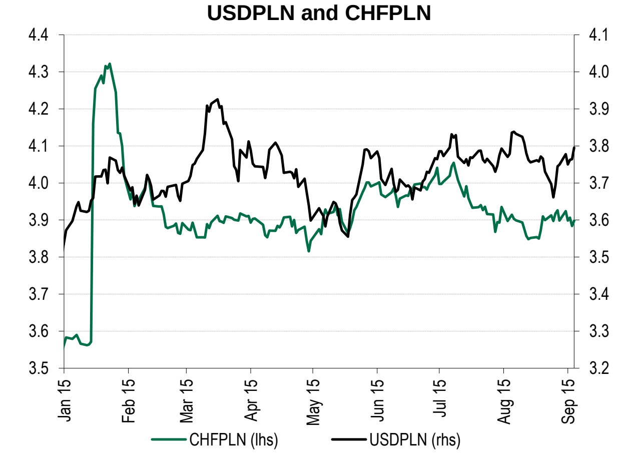
Marek Belka, NBP governor, 1.09.2015, MPC press conference

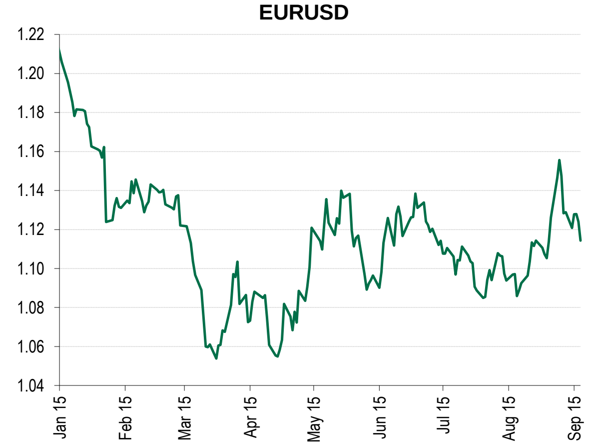
We have discussed Monetary Policy Guidelines (for 2016). There is no support in the Council for revolutionary changes.

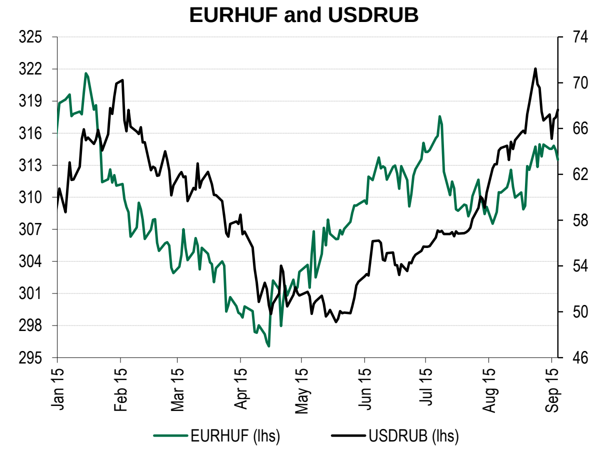
The Monetary Policy Council started working on the Monetary Policy Guidelines for 2016, and NBP governor Marek Belka said after the recent MPC meeting that the document will be approved at the special meeting in mid-September. MPC's Chojna-Duch suggested recently that a discussion about lowering the inflation target is needed, but Marek Belka said clearly at the last press conference that there is no majority in the Council that would support breaking changes. We would not expect a change of the target in 2016 guidelines.

Foreign exchange market – Bigger changes unlikely before FOMC









EUR/PLN still volatile

- Our expectations from last week of a persistently high zloty volatility have proven correct with the high-low EUR/PLN spread even slightly wider than in the previous week. The zloty was mainly driven by concerns about the global economic growth (that pushed EUR/PLN to 4.26) and the ECB's dovish rhetoric (that dragged the rate sharply down to 4.20). EUR/PLN returned to 4.22 at the end of the week. The zloty depreciated vs. the dollar on the back of the sudden drop in EUR/USD that pushed USD/PLN up to 3.80.
- This week's economic calendar is rather light, so the market will likely focus on the situation in China and speculations ahead of the Fed. This will be the last week before the U.S. central bank meets to decide on policy.
- In the previous three years, September was a month of zloty gains vs. the euro. To some extent, this might have been related to the fact that the EUR/PLN level from the end of the month determines the conversion rate for EU subsidies for Polish farmers (the lower EUR/PLN, the lower the amount in zloty that the government has to pay). However, sticking to this strategy may be risky for the government because of this year's election and the fact that farmers are already suffering from a severe drought. Still, our technical analysis suggests that the current EUR/PLN levels could be close to a monthly peak and the exchange rate will be lower at the end of September. Paradoxically, if the Fed's rate hike in September will be seen as trust in the economic recovery, it may help the zloty firm later in the month.
- The important levels to watch this week are at 4.20 (next support at 4.15) and 4.26 (next resistance at 4.33).

EUR/USD still range-bound

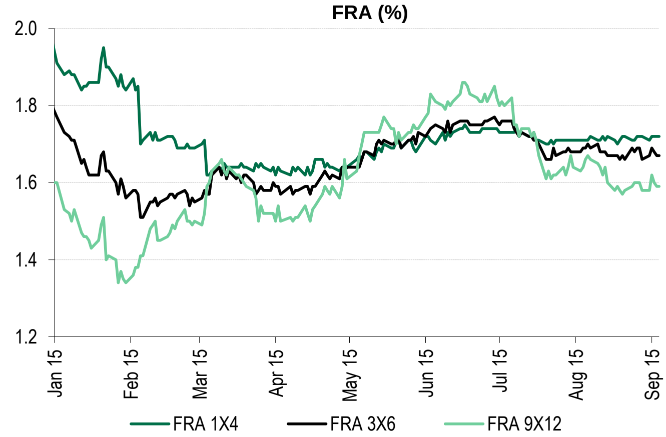
- The sharp surge of EUR/USD from late August to 1.17 from 1.10 proved temporary and the dollar pared last week all the losses that it had suffered in the previous two weeks. The exchange rate plunged to 1.11, mainly dragged down by the dovish ECB.
- Taking a broader look at the chart, EUR/USD has been in the 1.08-1.15 range since May (except for the temporary jump to 1.17). And it seems that just one week before the FOMC's rate decision there will be no major changes here either. Investors may stay focused on China and position themselves ahead of the FOMC meeting, but the exchange rate should stay within the range.

Important events in the CEE region

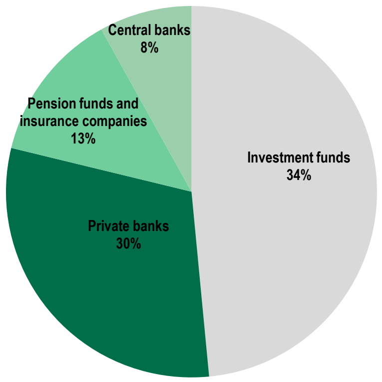
- EUR/HUF has also been quite volatile just below its recent peak at 317-318. Meanwhile, USD/RUB was echoing the global market sentiment and the oil price. Finally, the ruble depreciated vs. the greenback, but stayed below the all-time high closing level at 69 from late January. The Czech koruna was, of course, the most stable CEE currency and EUR/CZK again moved very close to the 27.0 floor.
- Czech and Hungarian CPI data are due this week. Given the recent turmoil in the global market and the dovish tone of the ECB, investor expectations for more actions by the CNB and MNB could strengthen if these data show again no inflationary pressure.
- There are also important events on the agenda in Russia – the second estimate of the 2Q GDP is due for release and the central bank meets on interest rates. Investors do not expect changes to the cost of cash and we also think this to be the likely outcome of the central bank's meeting given the USD/RUB rate's recent stabilisation (although at an elevated level). Moves in the oil price should remain the core driver for the ruble this week.

Interest rate market – Some profit-taking likely to follow significant gains

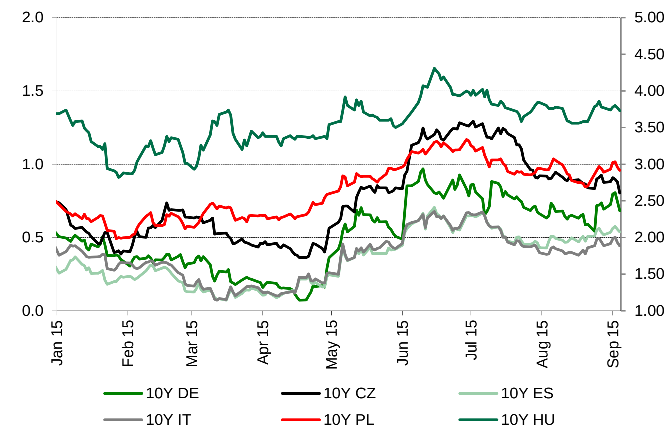
FRA (%)



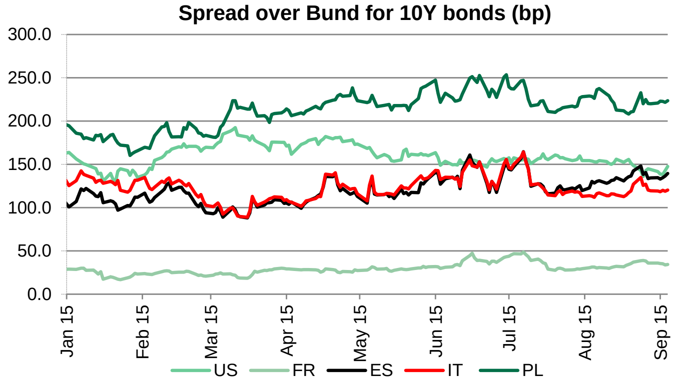
Structure of institucional distribution of 10Y EUR-denominated bond



10Y bond yields (%)



Spread over Bund for 10Y bonds (bp)



Bonds and IRS firm visibly on ECB

- The money market did not change much over the past week. WIBORs remained stable as the September statement only confirmed the MPC's guidance of stable rates until the end of the Council's term in 1Q16. At the same time, FRAs were vulnerable to changes in investor sentiment on the IRS market. Initially, the FRA curve shifted up sharply, but the IRS market's revival on the ECB's dovish rhetoric and mixed data from the U.S. helped FRAs trim their earlier loses and return to the levels seen a week earlier.
- On the T-bond and IRS markets, volatility remained high. Yields and IRS rates rose visibly in the first days of the week due to risk aversion. But the dovish message of the ECB and the labour market data from the US triggered a broad-based rally in the fixed-income markets (including Poland's), mainly in the 5Y and 10Y segments, leading to a significant flattening of the curves. The spread over Bunds for the 10Y sector also narrowed.
- Poland's Ministry of Finance has intensified its activity on the primary market after the summer lull. It launched a 10Y euro benchmark worth €1bn, with demand at €1.3bn. The bond was priced 48pb over mid-swaps, which corresponds to a yield of 1.592%. European investors were the main buyers, especially from Germany (38%). In terms of the type of investor, asset manager accounts dominated the orderbook (48%), with central banks buying 8% in total. The Ministry plans to offer bonds up to PLN10bn at two regular auctions later this month. The ministry's activity on the primary market aims to fulfill the 2015 gross borrowing needs by the end of October, which we believe to be a realistic target.

High volatility persists, domestic auction in focus

- Recent macro data (GDP, PMI and, from earlier, industrial output and retail sales) have prompted us to revise downward our GDP forecast for 2015 to 3.5%YoY (from 3.8%YoY) and to change our monetary policy outlook. We decided to delay the expected start of the monetary tightening cycle to 2017 on the weaker-than-expected macro data and rising uncertainty about the world's economic outlook. However, we do not expect the central bank to reinitiate its monetary easing next year either (contrary to market expectations) as economic growth remains healthy, the inflation rate gradually trends up and there is less fiscal consolidation. Thus, we expect WIBORs to remain more or less stable in the coming months and to gradually rise at the turn of 2015-16.
- Global events are likely to remain in focus in the coming week. The Polish bond market, as in the previous weeks, will likely follow developments on the core markets. The continued downward trend in Bund yields should support the domestic market. However, in our view, investor sentiment is fragile and any piece of negative news from China or better data from the U.S. could quickly reverse the trend. The market will, therefore, be increasingly cautious, which means that high volatility is set to stay till the FOMC meeting next week. What is more, some profit-taking is more likely to follow the significant strengthening than further gains.
- On the domestic side, the regular long-term bond auction will be key. The ministry will offer WZ0126 floaters and a new fixed-rate 10Y benchmark DS0726 worth PLN2-4bn (final supply details will be presented on September 8). Current market conditions (ECB's dovish rhetoric, falling chances of a quick start of monetary tightening by the FOMC) are favourable for the offering and we expect to see decent bids from the foreign investors. According to the Ministry's newest information, non-residents raised their holding in the current 10Y benchmark DS0725 by nearly PLN2bn in July.

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.