Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

16 – 22 May 2016

Last week investors sentiment globally slightly deteriorated, affected by mixed data from Europe and USA. Despite this Poland's zloty moved sideways, while interest rate market strengthened gradually ahead of domestic key issues. While the headline CPI confirmed the flash numbers (-1.1% y/y), core CPI reached a historical low at -0.4% y/y. What is more, 1Q16 GDP growth disappointed, showing only 3% y/y (less than expected of 3.5% y/y and down from 4.3% y/y in 4Q15). Interestingly, after weaker-than-expected data the zloty kept quite stable at c4.40, while the interest rate market strengthened amid renewed expectations for monetary easing later during the year.

The downward trend in yields has continued today in the morning (10Y bond yield close to 2.90%), as market reacted positively to Moody's rating agency decision to keep Poland's rating unchanged. The rating outlook was changed to negative from stable, but some market participants expected a more negative decision and therefore also the Polish zloty gained Monday morning (to 4.37). We think, however, that a further strengthening of Polish assets will be limited by many risk factors (mentioned also in Moody's comment), which will be closely analysed by the market players.

This week industrial output for April will be the most important figure, given the strong deceleration of economic growth in Q1. Leading indicators for April were rather disappointing, so data on economic activity in industry will be eyed, whether they will confirm a downward trend. Also, we expect construction output to remain depressed, retail sales to rebound after weak March and the labour market to remain strong. As regards global events, after a very calm Monday, data releases will intensify particularly in the US. FOMC minutes to be published on Wednesday will be also very important.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (16 May)					
		No important data releases					
		TUESDAY (17 May)					
9:00	CZ	Flash GDP	Q1	% y/y	2.7	-	4.0
14:30	US	House starts	Apr	k	1125	-	1089
14:30	US	Building permits	Apr	k	1135	-	1086
14:30	US	CPI	Apr	% m/m	0.3	-	0.1
15:15	US	Industrial output	Apr	% m/m	0.3	-	-0.6
		WEDNESDAY (18 May)					
11:00	EZ	HICP	Apr	% y/y	-0.2	-	-0.2
14:00	**PL**	**Wages in corporate sector**	**Apr**	**% y/y**	**3.8**	**3.7**	**3.3**
14:00	**PL**	**Employment in corporate sector**	**Apr**	**% y/y**	**2.8**	**2.8**	**2.7**
20:00	US	FOMC minutes					
		THURSDAY (19 May)					
14:00	**PL**	**Industrial output**	**Apr**	**% y/y**	**3.4**	**3.8**	**0.5**
14:00	**PL**	**Construction and assembly output**	**Apr**	**% y/y**	**-13.4**	**-14.1**	**-15.8**
14:00	**PL**	**Real retail sales**	**Apr**	**% y/y**	**5.5**	**5.8**	**3.0**
14:00	**PL**	**PPI**	**Apr**	**% y/y**	**-1.3**	**-1.3**	**-1.7**
14:30	US	Initial jobless claims	week	k	275	-	294
14:30	US	Philly Fed index	May	pts	3.0	-	-1.6
		FRIDAY (20 May)					
16:00	US	Home sales	Apr	% m/m	1.3	-	5.1

Source: BZ WBK, Reuters, Bloomberg

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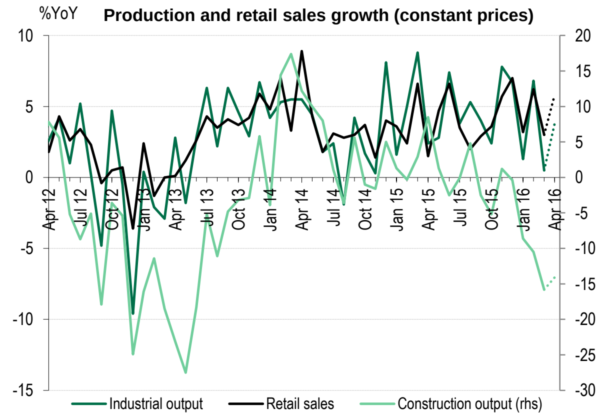
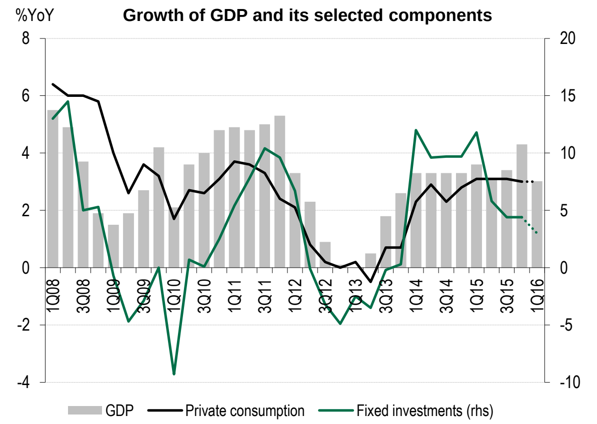
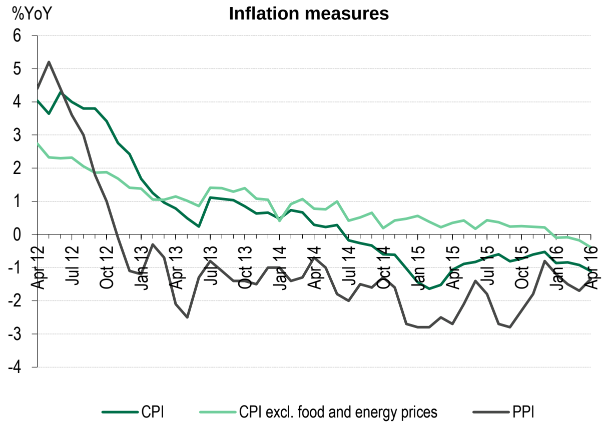
What's hot this week – Activity in industry and construction, retail sales and labour market



- Data on industrial output for April will be the most important figure of the week, given the strong deceleration of economic growth in Q1. Leading indicators for April were rather disappointing, so data on economic activity in industry will be eyed, whether they will confirm a downward trend. Construction output will remain depressed, in our view.
- We expect a rebound in retail sales in April after weak March, which was undermined by Easter holidays, in our view. Retail sales should remain strong this year, supported by the child benefit programme.
- Data on labour market in April are likely to show a strong performance, similarly as in the previous months. Strong labour market will be supportive for private consumption at the start of Q2.

Last week in the economy – Disappointing GDP, core CPI at all-time low





- Economic growth reached 3.0% y/y in 1Q16, considerably below consensus (3.5% y/y). We were expecting a slowdown, mostly due to weaker public investment, which was undermined by the shift in two EU funds' perspectives. Such a low figure suggests that the slowdown was also visible in private investment. On the other hand, there are no signs of deceleration in private consumption, which we estimate increased by c3% y/y in the first quarter. We forecast a rebound in GDP growth to c3.5% y/y in the coming quarters. Private consumption is likely to accelerate under the impact of the strong labour market and the 500+ programme.
- April's CPI reached -1.1% y/y, in line with the flash estimate, while core CPI excluding food and energy prices fell in April to -0.4% y/y, the lowest level since comparable data are available (2001). All other core inflation measures are below zero. It seems that deflationary tendencies intensify in sectors which so far have remained weak or moderate.
- In March the current account showed a €103mn deficit due to lower trade surplus (€204mn) and higher deficit on the primary incomes account (€928mn). Exports were only slightly above our forecasts (€15.4bn vs our forecast at €15.3bn), but imports surprised well to the upside (€15.2bn vs our forecasts at just below €15bn).
- Flash data on M3 money supply in April showed a rise by 11.5% y/y versus 9.1% y/y in March. Slower growth in March was mainly due to a surprising slump in companies' deposits. In April this effect was reversed. Data on loans showed an acceleration, both in households (to 5.9% y/y from 4.2% y/y) and companies (to 10.8% y/y from 9.5% y/y). This was partially driven by FX effect, but in our view also data corrected for FX movements would show an acceleration.

Quote of the week – Negative and balanced assessment by Moody's

Moody's rating agency, 14 May

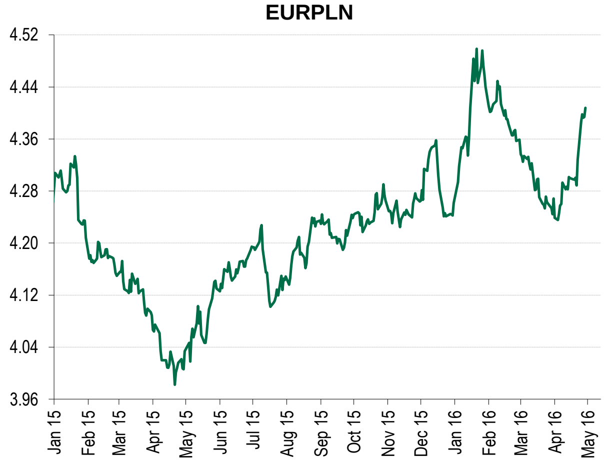
The key drivers for the decision to change the outlook (…) are the following: (1) fiscal risks related to a substantial increase in current expenditures as well as the intention to lower the retirement age, the latter raising age-related costs over time; (2) impairments to the investment climate from a shift towards more unpredictable policies and legislations, as reflected in the ambiguity with respect to the conversion of foreign-currency denominated mortgages and in the prolonged stalemate between the government and the country's constitutional court.

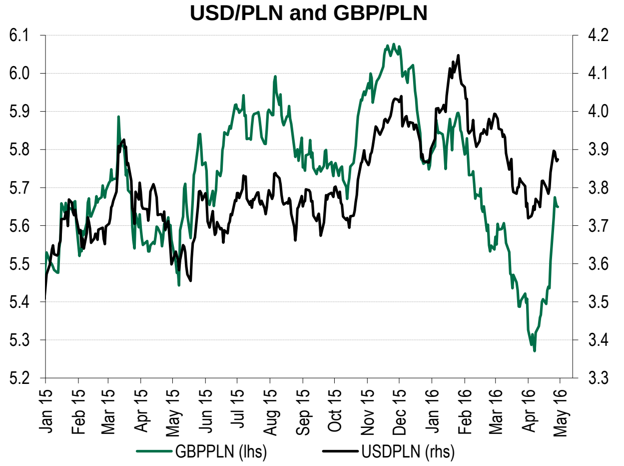
Paweł Szałamacha, minister of finance, 14 May, PAP

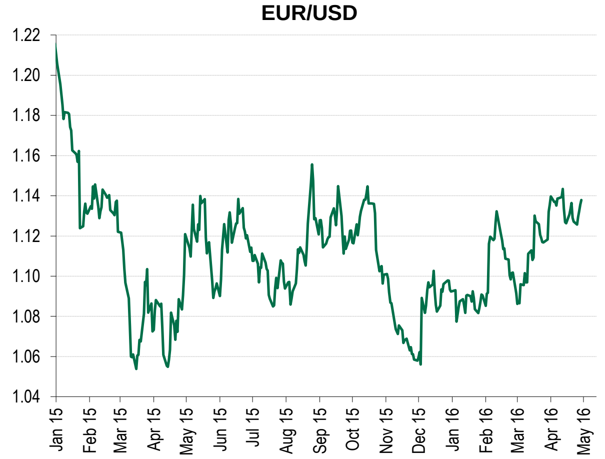
Poland finds the Moody's slashing of its ratings outlook to 'negative' as "highly debatable" as it is based on policy concerns which have not yet materialized and which the government is actively addressing.

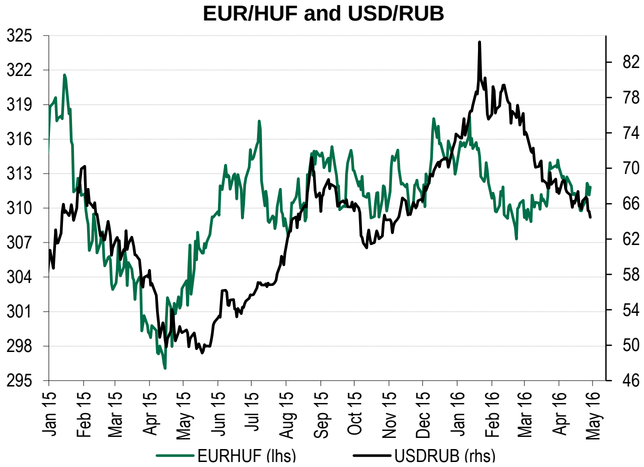
Moody's rating agency decided on Friday night to keep Poland's rating unchanged, but changed rating outlook to negative from stable. As one could have expected, given Moody's methodology, the key drivers of the decision were fiscal risks (possible substantial increase in spending and lowering of retirement age), as well as "unpredictable policies and legislations" (issue of CHF-loans, conflict around the constitutional court). The next calendar day for the rating action by Moody's is not very distant and is scheduled for September 9th. By then, we should have more clarity of several above-mentioned steps in government's policy. That is why, it made sense, in our opinion, to cut outlook only and wait for government's actions, while the risks of possible negative impact was reflected in outlook change.

Foreign exchange market – Moderate zloty gains on Moody's









EURPLN lower on Moody's decision

- EURPLN was range-bound between 4.402 and 4.433 for most of last week, awaiting the key events, such as the release of Poland's flash GDP and Moody's decision. The flash 1Q16 GDP growth disappointed, but the market's reaction was subdued with EURPLN temporarily falling to nearly 4.39 to later end the session slightly above 4.40. On a weekly basis, the zloty gained against the euro (0.5%), GBP (0.4%) and CHF (0.3%), while lost against the US dollar by 0.1%.
- In line with our expectations, ratings agency Moody's reaffirmed Poland's credit rating at A2 and only downgraded the outlook to negative from stable. This helped the zloty firm at the start of this week. In our view, EURPLN could fall slightly further in the upcoming days. We expect the monthly domestic macroeconomic data releases later this week to be rather neutral. Most of our forecasts (data on the labour market, production) are close to the consensus expectations, so the market's response is likely to be rather limited. However, the zloty's gains could be limited due to several domestic and external risk factors, including (1) uncertainty about the Polish government's future proposals (FX-loan conversion bill, retirement age); (2) the generally weak sentiment towards EM currencies; (3) growing possibility of a rate hike in the US on strong macro data and (4) the approaching EU referendum in the UK.

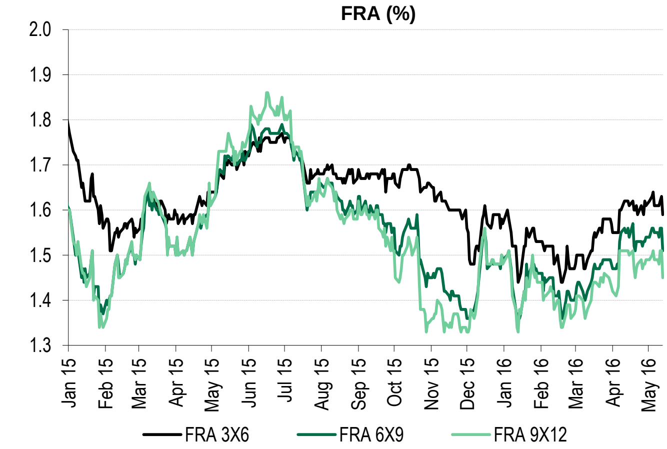
FOMC minutes in the spotlight

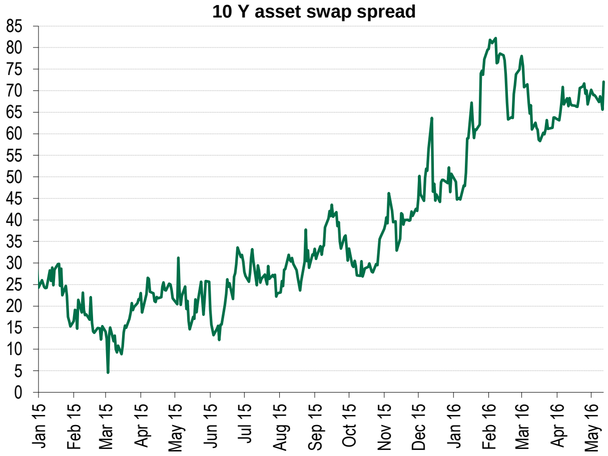
- EURUSD was quite volatile over the past week. Initially the rate went up to almost 1.145 due to profit taking on significant US dollar strengthening in the previous days. But at the end of the week, EURUSD fell below 1.13 for a while on stronger-than-expected retail sales data in the US.
- Several important key figures from Europe and the US are due this week. The FOMC minutes and some Fed members' speeches will be also in the spotlight as investors will look for any hint about the timing of monetary tightening. If the data confirm the possibility of an earlier rate hike, EURUSD might fall towards the lower boundary of the 1.12-1.16 fluctuation channel.

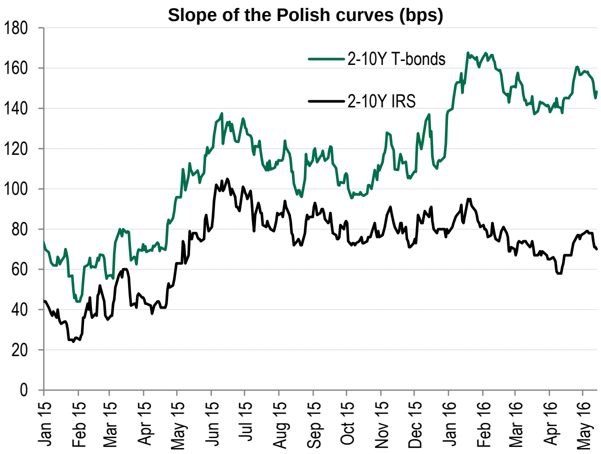
RUB tracks Brent prices, HUF under pressure

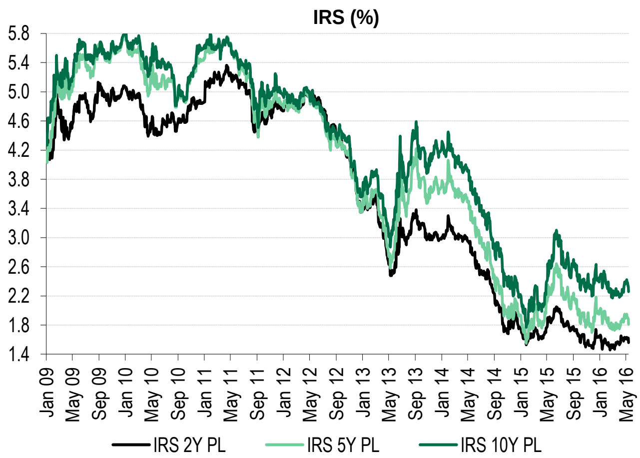
- The Russian ruble strengthened quite visibly last week on the significant rise in the Brent prices (which reached a fresh high above US$47/bbl). Consequently, USDRUB fell to 64.5 for a while, but ended the week slightly above 65. At the same time, the Hungarian forint was under pressure from higher-than-expected CPI reading in April and much weaker flash GDP growth for 1Q16 (only 0.9% y/y vs 3.2% y/y in 4Q15). As a result, EURHUF stayed close to 316 after reaching its weekly minimum at 312.
- The CEE currency markets will remain under the influence of global factors, as well as country-specific macro data that are due this week (flash GDP for the Czech Republic and Russia). Any negative surprise in the flash GDP (like in Hungary or in Poland) might pressure both CZK and RUB, especially since the market broadly expects economic activity in Russia to gradually rebound in the January-March period. All in all, Russia's flash GDP data might offer an impulse for profit taking after the significant ruble strengthening in the previous week. At the same time, HUF might remain quite weak, depending on the global factors.

Interest rate market – Curve flattening may persist









Rates down on data and Moody's

- Polish 10Y yields and IRS fell last week even by more than they had risen in the previous two weeks. The market was hoping that Moody's would not downgrade Poland's rating and also benefited from Friday's much weaker-than-expected flash 1Q16 GDP number. The economic growth data from the first three months of the year fueled market expectations for rate cuts and so the FRA curve moved 5-10bp down on Friday alone – the market is now pricing in a 65% probability for a 25bp cut in six months and c90% in nine months.
- The market's opening at the beginning of the new week was very strong thanks to the Moody's decision. In line with our view, the agency only downgraded the outlook, not the rating, and this pushed yields 6-7bp lower. The 10Y benchmark yield is below 2.95%, more than 15bp lower than in late April. The IRS market's response is much more muted (2-3bp down), but the 10Y IRS is near 2.25% (its lowest since mid-April). The 5Y rate is close to 1.80% (the lowest since early April).

Curve flattening may persist

- The Polish IRS and bond curves have flattened since late April and we think this process could continue in the very short term, though rather as a result of weakening on the short end rather than more gains on the long end. As mentioned above, the FRA market is pricing in quite a high probability of rate cuts later this year/in early 2017, but so far this is not our base case scenario. Data for 1Q16 confirmed that economic growth was weaker when compared with the strong end of 2015, but, in our view, 2Q will be key for monetary policy. We think that there could be some profit taking on the short end as we are above the consensus with our forecasts for this week's releases of Poland's April industrial output and retail sales. These data could neutralise (at least partly) the dovish GDP numbers.
- At the same time, the belly and long end should be supported by the Moody's decision. Also, recent US data were mostly disappointing and this was also what drove the yields' down trend on the core markets. This was, to some extent, also positive for the Polish bonds and IRS.
- Plenty of US data releases are on the agenda this week, which could trigger significant swings on the global FI market. Several FOMC members are also due to speak. At the same time, there are only a few readings due in Europe, so market attention should shift towards the US this week. According to Bloomberg, the market expects the Fed to hike rates no sooner than at the turn of the year and if the incoming data fail to surprise to the upside, the US monetary policy outlook is unlikely to change, which would not weigh on the global and domestic bonds.
- We also remain less optimistic about the FI market in the months to come and expect the yields and IRS to rise later in the year driven mainly by the Fed's interest rate hikes, stable economic growth in the euro zone, and Poland's internal issues (CHF-bill, concerns about the 2017 budget).

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.