Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

20 – 26 June 2016

It's all about the referendum in the United Kingdom these days. This event is likely to cause a lot of market volatility, especially on Friday, when its flash results will be released. Recent polls show that supporters of the UK leaving the UE are in majority, but bookmakers are still betting on the UK staying in the UE. Already last week, uncertainty about the referendum's outcome led to Polish zloty and bond weakening. With demand for safe assets dominating the global market, the 10Y German bund yield fell below zero and the Swiss franc appreciated. As a result, the spread of the Polish bonds against the German Bunds rose to 330bp and the zloty weakened, particularly against CHF. Even the rather dovish outcome of the FOMC meeting failed to stop the trend. The result of the UK's referendum on its EU membership will set market direction for the upcoming weeks. If the Brits decide to remain in the EU, the Polish bond yields should fall and the zloty should gain against the main currencies, at least towards the lower limit of the 4.31-4.46 range. In case the opposite scenario materialises (the "leave" option wins), continuation of this week's negative sentiment against Poland's assets is likely.

Local factors will remain in the background. However, it is worth noting that recent figures on economic activity were below expectations, putting into question the recovery that was to follow the disappointing 1Q16. Based on data for two months of 2Q16, we believe that a pickup in the second quarter may not be impressive. Still, labour market data are still the most positive. Jobs are being added and there is above-4% nominal wage growth. On the inflation front, we still have negative readings of the annual CPI and PPI, but deflation seems to be dissipating. From the market's point of view, other risk factors are probably more important, including CHF-loans or fiscal prospects. And they will not disappear anytime soon either. As regards the latter, it seems that the risk for the 2017 budget has recently diminished as government officials have announced that neither the lower retirement age nor the higher tax free income level would come into effect next year.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (20 June)					
		No important data releases					
		TUESDAY (21 June)					
11:00	DE	ZEW index	Jun	pts	54.0	-	53.1
14:00	HU	Central bank decision		%	0.90	-	0.90
18:00	**FR**	**EURO 2016: Ukraine – Poland**			**-**	**0-2**	**-**
		WEDNESDAY (22 June)					
16:00	US	Home sales	May	% m/m	1.8	-	1.7
		THURSDAY (23 June)					
	UK	Voting on the EU membership					
9:30	DE	Flash PMI – manufacturing	Jun	pts	52.0	-	52.1
10:00	EZ	Flash PMI – manufacturing	Jun	pts	51.4	-	51.5
10:00	**PL**	**Unemployment rate**	**May**	**%**	**9.1**	**9.1**	**9.5**
14:00	**PL**	**MPC minutes**					
14:30	US	Initial jobless claims	week	k	-	-	277
16:00	US	New home sales	May	k	565	-	619
		FRIDAY (24 June)					
10:00	DE	Ifo index	Jun	pts	107.4	-	107.7
14:30	US	Durable goods orders	May	% m/m	-0.8	-	3.4
16:00	US	Michigan index	Jun	pts	94.1	-	94.7

Source: BZ WBK, Reuters, Bloomberg

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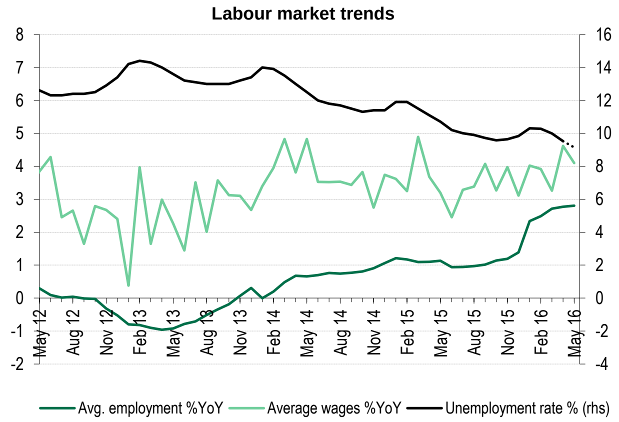
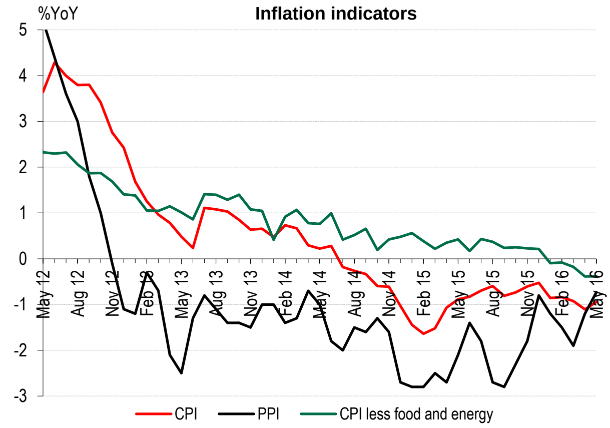
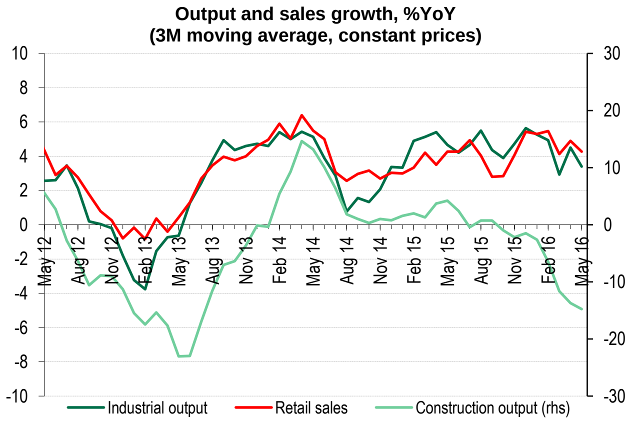
What's hot this week – Eyes on UK referendum



- UK referendum (Thursday, June 23) will be the key issue this week. We expect it to create a lot of uncertainty and market volatility, especially on Friday, when the flash results will be released. Recent polls show that supporters of UK leaving the UE are in majority, but bookmakers are still betting on the UK staying in the UE.
- We expect the unemployment rate in Poland to fall to 9.1% in May versus the Labour Ministry's estimate at 9.2%. The Polish labour market is still bullish and it is approaching full-employment status quickly.
- The statistics office will publish data on consumer confidence and its leading indicators for the industry, construction and retail sales. We expect to see sentiment improvement or at least its stabilisation.

Last week in the economy – Strong labour market, but activity data not so strong





- CPI inflation in May reached -0.9% y/y (vs flash at -1.0% y/y). The main factor pushing prices up, as compared to April, were fuel prices (+4.2% m/m), while prices in most of the other categories remained roughly stable. Core inflation excluding food and energy was at -0.4% y/y, the same as in April, pointing to absence of any price pressure. We think deflation could persist until 4Q16, but this is not likely to trigger any monetary policy easing unless there is further deceleration of GDP growth, which we do not expect to happen.
- Corporate sector employment rose 2.8% y/y, in line with expectations, confirming strong demand for labour. Wage growth disappointed though, slowing to 4.1% y/y. Still, it was above the average growth rate in 2015 (3.5% y/y) and in 1Q2016 (3.7% y/y), so we expect it to be accelerating in the following months given the fact that the Polish economy is approaching the state of full-employment. Wage bill in the corporate sector rose in May 7.0% y/y in nominal terms and 8.0% y/y in real terms. High income growth will be supportive of private consumption throughout 2016.
- Data on production and sales in May were weaker than expected. Industrial output rose 3.5% y/y, retail sales in constant prices rose 4.3% y/y, and the construction output fell 13.7% y/y. To some extent this could have been the result of many public holidays and 'long weekends' in May (we could have underestimated their potential impact on production and sales). However, uncertainty about the economic growth outlook has risen. We still believe that solid economic growth in Europe and the government's new child benefit scheme should help recover Polish GDP growth later this year, but data for the two months of 2Q16 make us believe that the pickup in the second quarter may not be that impressive.

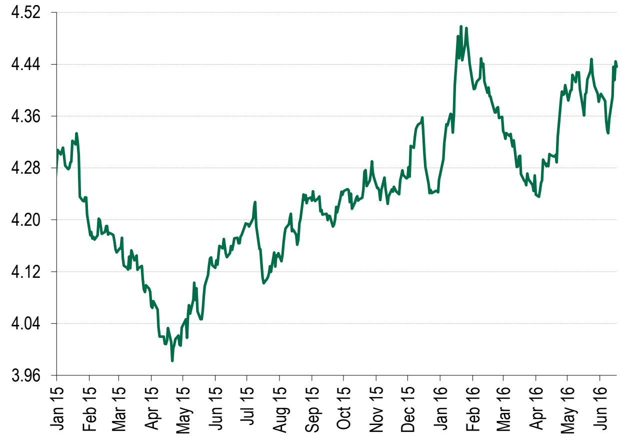
Quote of the week – Lower pressure on budget 2017

Rafał Bochenek, government's spokesman, June 15, Polish Radio 3
We want to adopt the act [lowering the pension age] by the end of this year. As for its entry into force, I believe that 2018 is the earliest possible date.
Henryk Kowalczyk, head of the government's standing committee, June 13, DGP
The decisions on the tax-free income have already been made. We are going to introduce a flat rate tax and we will use that opportunity to increase the income as promised. The entire operation will be neutral for the budget. (…) There will be no changes to the tax-free income in the next year. They would be pointless, as they would last only one year.

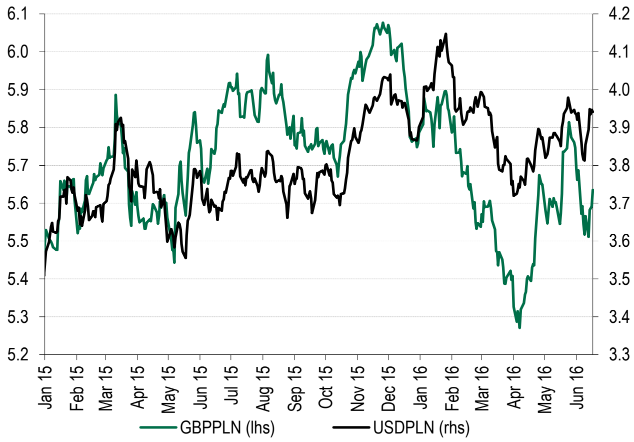
Lowering the retirement age back to 60/65 would mean that 400k people would be granted pension benefits, according to our estimate. In the first year this would cost the budget about PLN10bn. Moreover, it would be a heavy burden on economic growth, given that we are already approaching full employment levels. However, the key element in assessing costs for public finances and the economy will be whether the bill includes additional conditions (for example work experience), which would limit potential impact of the regulation.
Recent comments of government officials suggest that neither the lower retirement age nor the higher tax-free income would affect 2017 budget. While assumptions of the nearly 4% GDP growth and higher effectiveness of tax collection are also ambitious, the government may get additional revenues by scrapping VAT tax reduction scheme (by 1pp), for example. Therefore, risk for 2017 budget seems lower.

Foreign exchange market – Risk off mood dominates

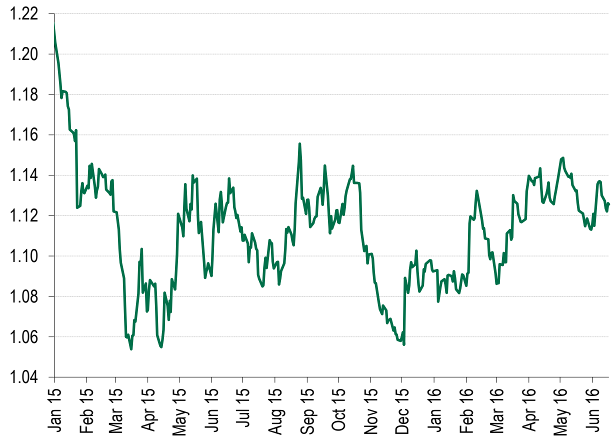
EURPLN



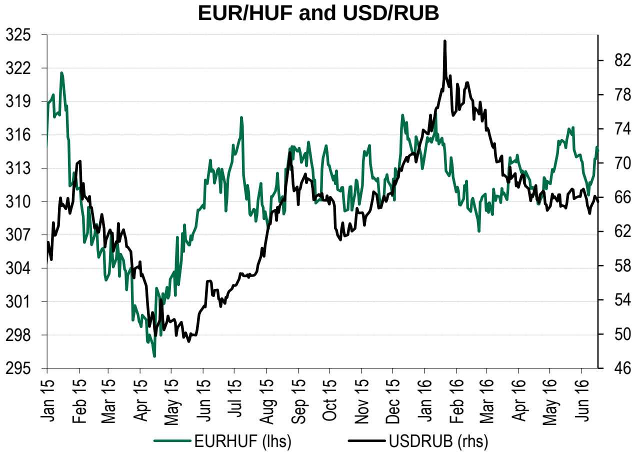
USD/PLN and GBP/PLN



EUR/USD



EUR/HUF and USD/RUB



Zloty under pressure from risk off mode

- The Polish zloty was under pressure over the past week with the risk off mode dominating on the market globally. Neither the dovish Fed nor the disappointing domestic industrial output data had a big impact on the zloty. At the same time intensifying concerns about the outcome of the EU referendum in UK (with polls showing growing support of the UK leaving the EU) have caused weakening of the zloty. As a result, EURPLN climbed to nearly 4.45, its highest level in more than three weeks. The zloty lost ground to the Swiss franc (due to significant CHF strengthening – details below), with CHFPLN rising above 4.10 for a while (the highest level since January 2015). The end of the week brought a gradual revival of the zloty, but nervousness lingers on.
- This week's key issue will be the referendum in the UK. Recent polls offer more evidence that supporters of leaving the EU are pushing ahead just a week before the June 23 vote. Until the referendum day in the UK, we expect volatility on the market to remain high with EURPLN staying close to the upper limit of the fluctuation channel of 4.31-4.46, while macro data releases in both the Euro zone and the US will stay in the background. The UK referendum's outcome will set market direction for the upcoming weeks. If the Brits decide to stay in the EU, the zloty should gain against the main currencies, towards at least the lower limit of the range mentioned above.

Safe haven currencies gain markedly

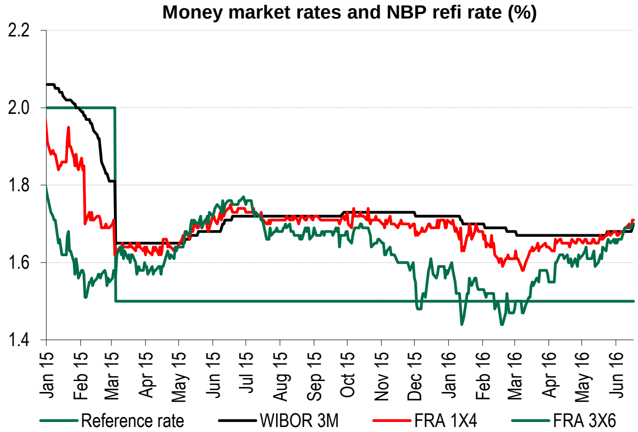
- Last week investors shifted their capital towards safe haven currencies as worries that the UK may leave the EU intensified. As a result, JPY, the US dollar and CHF firmed visibly. At the same time, the British pound suffered from the intensifying expectations that the UK might leave the EU. However, the EURUSD decline was only short lived (with the rate reaching nearly 1.11) and the rate quickly returned above 1.125.
- This week investor focus will be on the referendum in the UK. In our view, the US dollar may surge in the short-term as macro data from the US economy should remain strong. On the other hand, if the UK decides to stay in the EU, the probability of earlier rate hikes by the Fed may reappear. In such scenario, we expect an increase in EURUSD to be only short-lived.

Other CEE currencies suffer from global risk aversion

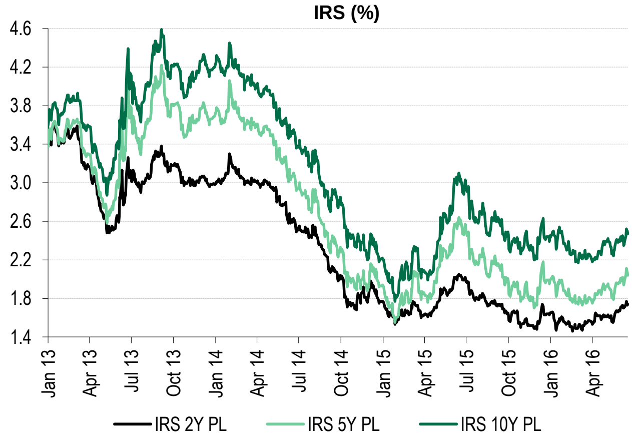
- CEE currencies, similarly to the zloty, suffered from the global sentiment deterioration due to risks related to the UK referendum on its EU membership. As a result, EURHUF rose above 315.5, the highest since the end of May, while USDRUB re-tested the level of 66. At the end of the week, currencies in the CEE region gained gradually.
- This week's macro calendar is almost empty in each of the CEE countries, which means that the market players will clearly be focused on the UK referendum. Its outcome will have a big impact on investor sentiment in the upcoming weeks, so until the outcome is known volatility on the CEE markets will remain high. In our view, if the British vote to stay in the EU, the risk on mood could return to the market globally, supporting CEE currencies. The Hungarian forint will also be under the influence on its central bank's (MNB) decision on rates. It is broadly expected that the MNB will keep rates on hold and such a decision should be rather neutral for HUF.

Interest rate market – Rates rise ahead of UK referendum

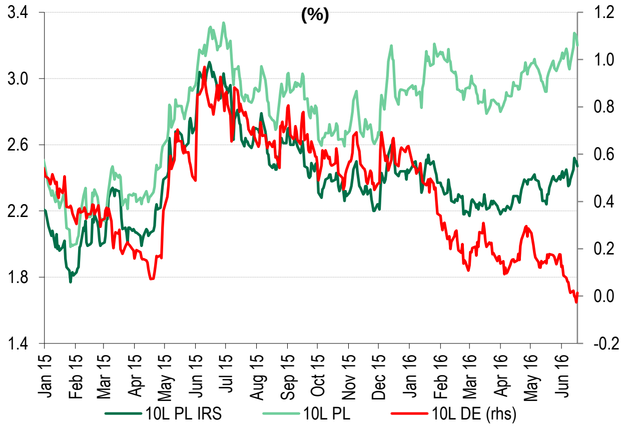
Money market rates and NBP refi rate (%)



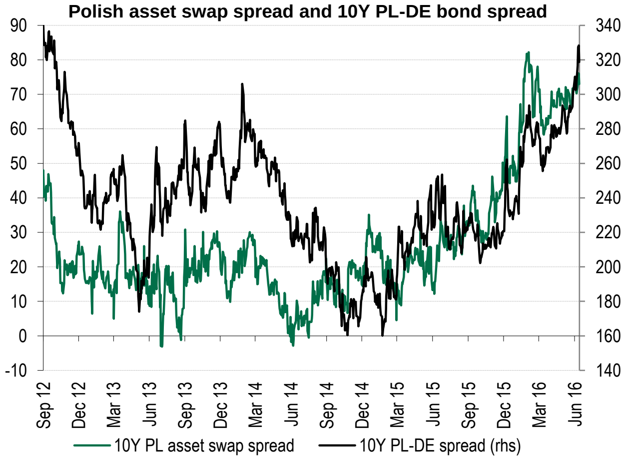
IRS (%)



Yields of PL and DE 10Y benchmarks and 10Y PL IRS (%)



Polish asset swap spread and 10Y PL-DE bond spread



Rates surge…

- Polish 5Y, 10Y IRS and bond yields jumped last week on the sharply deteriorating global market sentiment spurred by rising chances that the UK could leave the EU. As a result, the 10Y IRS reached 2.50% and the 5Y neared 2.10%, their highest since December/January. The respective bond yields jumped to 3.30% and 2.60%. Even the rather dovish outcome of the FOMC meeting failed to stop the trend. At the same time, growing demand for safe assets pushed the 10Y Bund into the negative territory for the first time ever, with the 10Y PL-DE bond spread rising to 330bp, its highest since 4Q12. At the end of the week, UK polls showed a lower risk of the UK leaving the EU, which helped improve market sentiment, pushing the Polish IRS and yields lower.
- The rising IRS and the somewhat hawkish comments of MPC members affected WIBORs that have risen 2bp in the 1-12M segment since last Friday. The FRA market has ceased to price-in rate cuts and now expects the 3M WIBOR to remain roughly stable in the next 21 months.

… ahead of the UK vote, a key event for the market

- Thursday's UK vote on its EU membership will undoubtedly be the key event that will set market direction not only for the week. The referendum itself will be an event without precedence, so trying to look back for historical analogies in an attempt to assess the scale of the likely market reaction in case of a "leave" outcome seems quite futile. Nevertheless, we would expect the biggest market reaction if polls just ahead of the vote were inconclusive, pointing to a 50/50 probability for each option or, of course, if the outcome failed to meet expectations. Liquidity is likely to be very low worldwide at the time of the results' release (middle of the night), which will probably exaggerate swings in the market. However, if earlier in the week support levels clarify either in favour of the "leave" or "remain" option, the market will adjust accordingly. This means that when the final results are announced, the market's reaction may be more moderate than would be the case of a surprise outcome.
- It is quite clear that victory of the "leave" option would likely weigh on Polish debt. Domestic bonds may try to recover at least partly after the recent sharp weakening if the "remain" option won, however. We think that the market's reaction could be bigger in case the first scenario materialises. Room for strengthening would still be limited by the continuously unresolved local risk factors (mainly the FX loan bill), however, and the outlook for the Fed's future rate hikes that the market could start expecting again once the UK risk factor dissipates.
- Poland's Finance Ministry plans to hold a bond switch auction on June 27. It will present details of the bonds on offer on the day of the UK referendum. We think that if the "leave" option won and bonds suffered significantly, the Ministry would not hesitate to change its initial plans or even decide to cancel the auction. Finance Minister Paweł Szałamacha said that Poland was well prepared for the UK leaving the EU by having covered 70% of the government's 2016 borrowing needs so far.

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.