Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

26 September – 2 October 2016

The economic data released last week were a mixed bag; while industrial production and retail sales in August were better than expected, construction output strongly disappointed, which, in our view, signals investment weakness and implies the risk that the GDP growth in 3Q16 was below 3% y/y. On a positive note, GUS indicators of the economic climate improved in September in all sectors, and flash manufacturing PMI in Germany surprised on the upside, which suggests the slowdown should not be too significant.

Sentiment in the financial markets improved visibly after investors perceived the Bank of Japan and the FOMC as relatively dovish. As a result, the zloty appreciated against majors (EUR/PLN fell to its record low since mid-August) and bonds gained.

This week will see a release of only one set of the domestic data (flash inflation for September), plus a number of data releases in the USA and numerous comments made by central bank officials (Fed, BoJ, ECB). We expect a significant pickup in Polish CPI growth to -0.2% y/y (from -0.8% in August), mainly due to very low base effect. It would confirm the fact that deflation is likely to end before the end of 2016 and chances for interest rate cuts in Poland are very small. The most anticipated news of the week on the Polish market will be the announcement of the government reshuffle. In our view, the reshuffle should not have significant market implications, as we see the replacement of several ministers in the cabinet rather as a technical issue than a signal of a major turn in the government's policy line. Surely, in the case of the finance minister's dismissal, the name of his successor will be important, but we assume that the main strategy of keeping the fiscal deficit below 3% of GDP will remain intact.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (26 September)					
10:00	DE	Ifo index	Sep	pts.	106.2	-	106.2
16:00	US	New home sales	Aug	k	595	-	645
		TUESDAY (27 September)					
16:00	US	Consumer confidence index	Sep	pts.	98.8	-	101.1
		WEDNESDAY (28 September)					
14:30	US	Durable goods orders	Aug	% m/m	-1.0	-	4.4
		THURSDAY (29 September)					
13:00	CZ	Central bank decision		%	0.05	-	0.05
14:30	US	GDP	Q2	%	1.3	-	1.1
14:30	US	Initial jobless claims	week	k	-	-	252
16:00	US	Pending home sales	Aug	% m/m	-0.3		1.3
		FRIDAY (30 September)					
9:00	CZ	GDP	Q2	% y/y	2.5		2.6
11:00	EZ	Flash HICP	Sep	% y/y	0.3	-	0.2
14:00	**PL**	**Flash CPI**	**Sep**	**% y/y**	**-**	**-0.2**	**-0.8**
14:30	US	Personal income	Aug	% m/m	0.2		0.4
14:30	US	Consumer spending	Aug	% m/m	0.2		0.3
16:00	US	Michigan index	Sep	pts.	90.0		89.8

Source: BZ WBK. Reuters. Bloomberg

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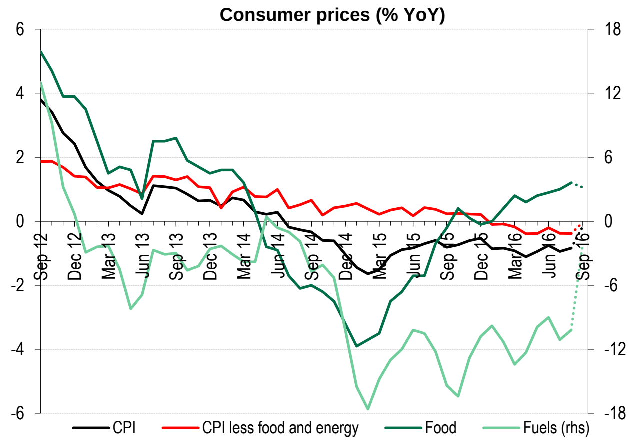
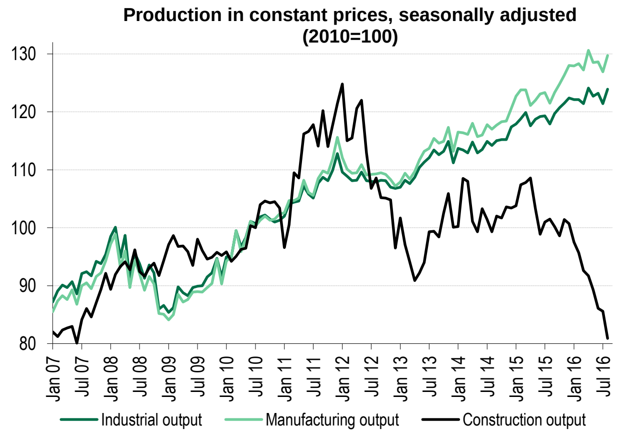
What's hot this week – Rebound of CPI, government reshuffle

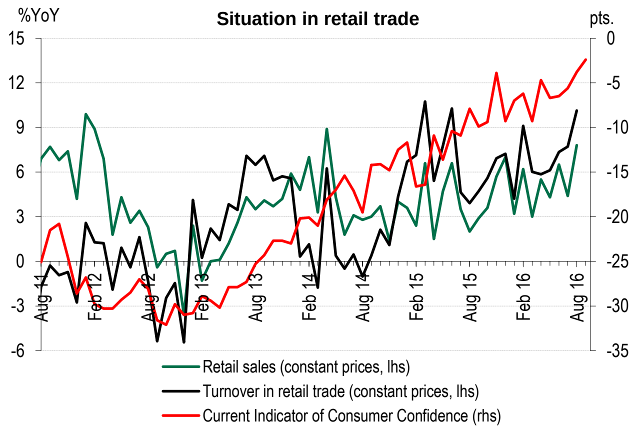


▪ We expect CPI to rebound markedly in September and reach -0.2% y/y vs -0.8% y/y in August. The upward move will be driven by fuel prices, with low base effect from September 2015 and relatively strong m/m growth in September 2016. Low base effects will also be present in gas prices (cut of tariffs last year) as well as in recreation and culture (introduction of free books to schools). There is a chance that September will be the last month of deflation in Poland after 27 months in a row of negative price growth. In general, the upward move of inflation will support the market expectations that chances for interest rates cuts in Poland are small.

▪ PM Beata Szydło declared to announce a government reshuffle. We think the changes will not be announced before the government meeting on Tuesday, at which the draft budget for 2017 should be approved.

Last week in the economy – Improvement in industry and retail trade, collapse in construction





▪ Data about industrial production growth (7.5% y/y) and retail sales growth (7.8% y/y in constant prices) for August were clearly above expectations, while construction output (-20.5% y/y) strongly disappointed. Seasonally-adjusted production in construction sector returned to the level from mid-2007.

▪ A rebound in retail sales may be (at least partly) attributed to the '500+' programme. Turnover in retail trade (including small shops) also strongly rebounded in August (+10.1% y/y), and consumer confidence in September rose to its all-time high. Thus, we expect private consumption growth to accelerate markedly in 2H16.

▪ However, stronger consumption will be not enough to speed up the Polish GDP growth if investments keep falling and if export growth falters. A deepening collapse in construction output suggests that the investment drop may be accelerating in 3Q. Therefore, even though industrial output and retail sales in August were better than expected, a huge disappointment in construction increased the risk, in our view, that the GDP growth in 3Q16 may be below 3% y/y.

▪ The registered unemployment rate declined in August to 8.5%, in line with the expectations. The unemployment is still falling, but at a slowing-down pace. The number of vacancies per unemployed is still on the rise, proving that a slower fall of unemployment is caused by the drying up pool of jobseekers. We expect this indicator to be close to 8.5% at the year-end.

▪ Detailed data on employment in the corporate sector showed that the surprising decline in August was caused by one segment only: communication and information. Employment in this sector fell by 5k, while situation other sectors was stable or slightly positive. In our view, this proves that the August's results was only a one-off.

Quote of the week – There will be changes in the government

Beata Szydło, Prime Minister, 23 September, Polskie Radio 1

There will be changes in the government, not only personnel changes but also systemic. I will inform about them next week. (…) My impression is that Law & Justice machinery isn't working well. We did make some mistakes and we need to correct them, we won't be sweeping things under the carpet. We must be transparent and humble.

Rafal Bochenek, government spokesman, 23 September, Bloomberg

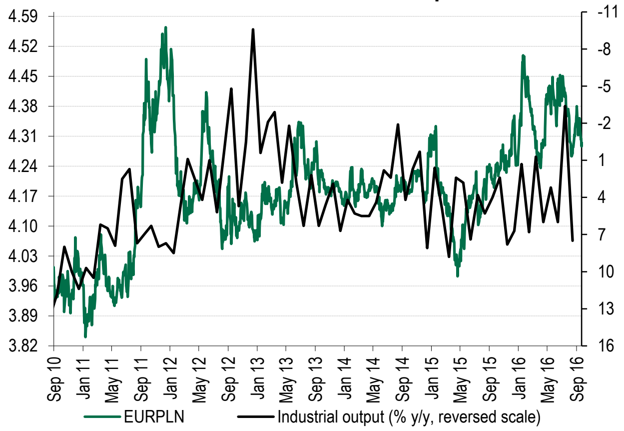
There are no such plans (to dismiss finance minister Paweł Szałamacha). The government is working as usual.

Investors will be certainly awaiting the information about the government reshuffle; however, in our view, the decision itself should not have significant market implications, even if it includes replacement of the finance minister Paweł Szałamacha (which is not so certain, as on Friday the rumours about his dismissal were denied by the government's spokesman).

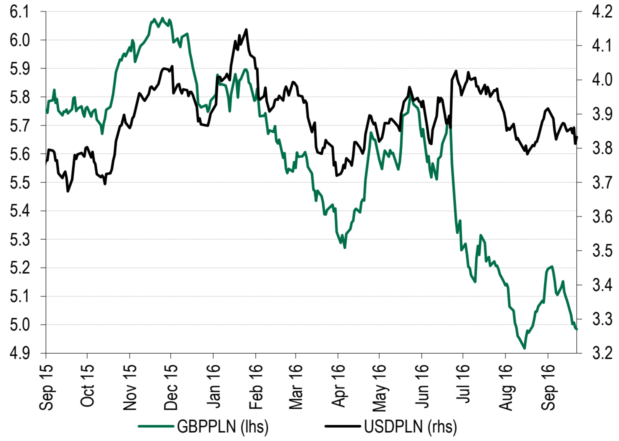
We see the replacement of several ministers in the cabinet rather as a technical issue than a signal of a major turn in the government's policy line, so it should not affect investors' assessment of Polish assets significantly. Surely, in the case of Szałamacha's dismissal, the name of his successor will be important, but we assume that the main strategy of keeping the fiscal deficit below 3% of GDP will remain intact.

Foreign exchange market – More volatility ahead

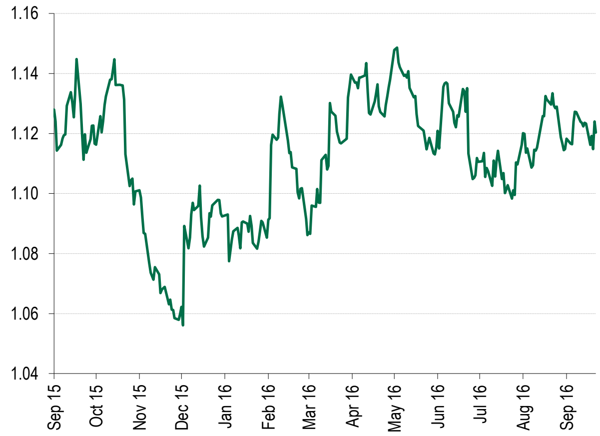
EURPLN and industrial output



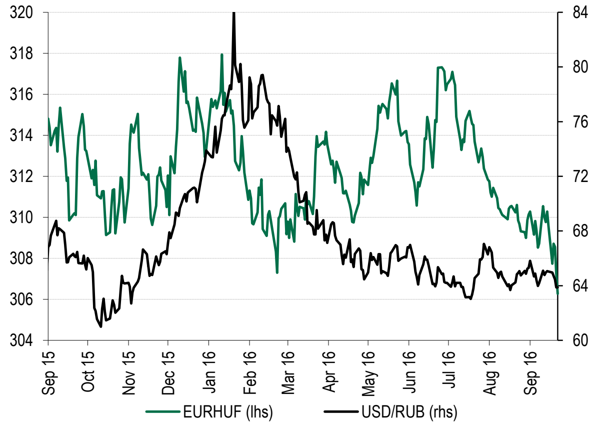
USDPLN and GBPPLN



EURUSD



EURHUF and USDRUB



Zloty gains, but this might stop soon

- Last week, the outcome of the FOMC meeting provided the biggest boost for the zloty which gained vs the euro, the dollar and the British pound. EUR/PLN fell to 4.27, reaching its fresh low for September, but at the end of the week some profit taking was recorded and the exchange rate bounced back to 4.29.
- Large number of the US data is on the agenda this week and many central bankers (not only from the Fed) are due to speak. After the September FOMC's decision, there seems to be a consensus that the Committee is on the way to raise the rates this year and provide more hikes in 2017/2018 though at a slower pace than expected so far. Thus, in our view, the next US data may have a bigger short-term impact on the market if they prove disappointing than when they beat expectations. If this is the case, the EM currencies, including the zloty, might continue to appreciate.
- However, we are not expecting EUR/PLN to fall below the August bottom at c4.25. We think that the coming weeks will show that the Polish economy is underperforming and in the very short term investors could pay more attention to the political issues related to the government reshuffle.
- The current EUR/PLN's downside wave is nearly equal in size to the one in the first week of September, so it would be a good moment for the exchange rate to reverse.

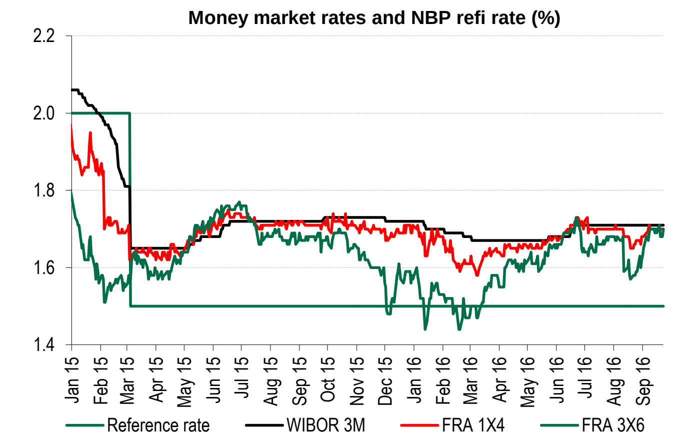
EUR/USD up, but still no breaking changes

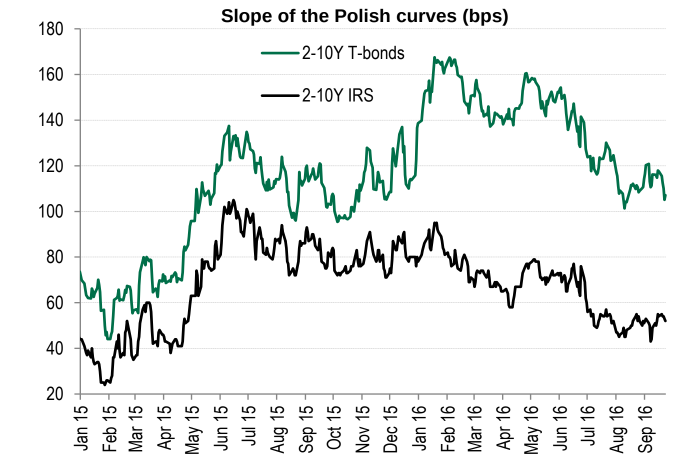
- EUR/USD jumped on the outcome of the FOMC meeting as the looming Fed's rate hike this year proved less important than the downward revision of the pace of the monetary policy adjustment for 2017/2018. However, the exchange rate failed to rise above the previous Friday's high at 1.125.
- Numerous US data are due next to the ECB, SNB and Fed central bankers' speeches. The issues related to the monetary policy could again trigger more volatility. The exchange rate failed to break c1.115 so we think it will stay above this level for yet another week. At the same time, room for the increase should be limited to the 1.13-1.135 area.
- Interestingly, market volatility seems to have faded after the UK referendum as EUR/USD is still moving within the "Brexit bar" range.

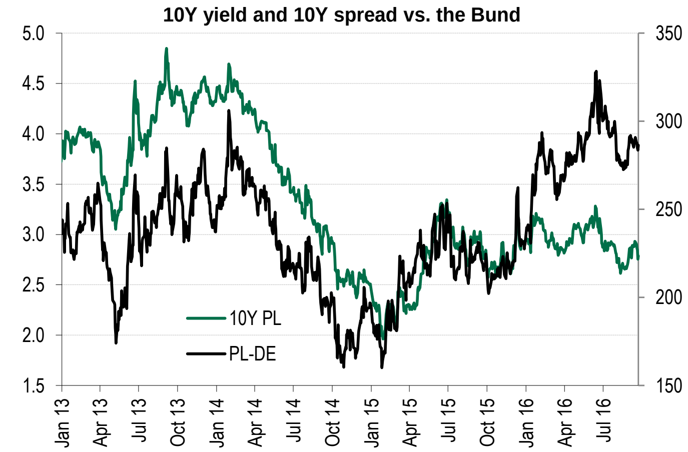
Dovish MNB and dovish FOMC key for forint

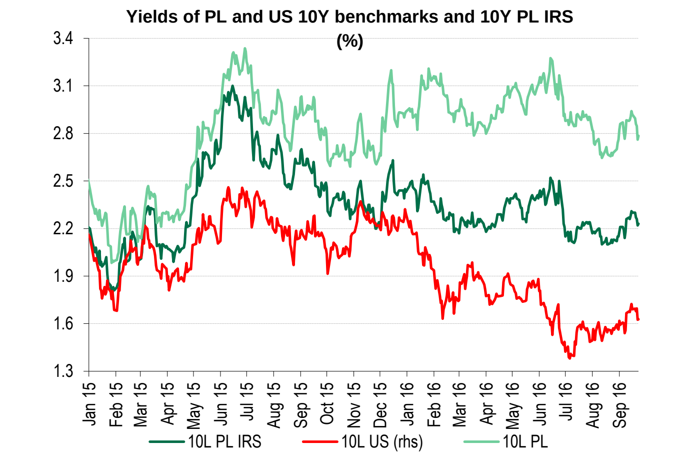
- In line with the expectations, the central bank of Hungary (MNB) left the interest rates unchanged, and the main reference rate is still at 0.90%. However, the bank limited the size of the deposit facility to HUF900bn from HUF1.6trn meaning that some extra cash should be injected into the market. Such a decision was pretty surprising and was interpreted as a dovish signal from the CB that weighed on the forint. However, the dovish signal from the FOMC more than neutralized this internal factor and at the end of the week EUR/HUF reached its fresh 2016 low at near 305.
- The Hungarian central bank presented new forecasts for inflation, and both 2016 and 2017 forecasts have been lowered, from 0.5% to 0.4% and from 2.6% to 2.3%, respectively. The GDP forecasts have not changed and the bank expects the economic growth at 2.8% in 2016 and 3.0% in 2017.

Interest rate market – Busy week ahead









Strong rally after Fed

- Last week was favourable for the interest rate market as Poland's assets, following global trend, gained markedly. The rally in yields was driven both by the FOMC's decision to leave the rates unchanged and by lowered dot plot projections that had been taken as very dovish. As a result, the 10Y German yield declined by 8bp, back to the levels seen prior to the ECB meeting two weeks ago. At the same time, the yield of the Polish 10Y benchmark fell by 10bp to 2.76%, its lowest since end-August. The Polish market was also supported by the favourable switch auction results (details below). The announcement made by PM Beata Szydło about the next week's government reshuffle caused some profit taking.
- The yield curve flattened visibly, as the belly and the long end of the curve outperformed the front end. What is more, the bond market gained more than the IRS one and, as a consequence, the asset swap spread tightened visibly, in particular for the 10Y sector. Risk premia for Poland's assets also have narrowed a bit over the past week as implied by the spread over Bund.
- On the money market, the FRA rates were more vulnerable, while the WIBORs remained stable. Along with the changes on the IRS market, FRAs fell significantly on the FOMC meeting and, as a result, the 3M WIBOR path implied by FRA shifted down.

Macro data releases, Poland's government reshuffle …

- This week is quite busy of macro data releases and events domestically and abroad. Investors will focus on the announced government reshuffle suggested by PM Beata Szydło. The market reaction will depend on whether the changes will affect the main positions in the government, including the Ministry of Finance, and candidates appointed to these posts. Uncertainty regarding the government's reshuffle might add to the market volatility, in particular on the long end of the curves.
- As regards the domestic macro data, only flash CPI for September is due later this week. In our view, the headline CPI will rebound significantly on the previous month. This can again scale back the market expectations for rate cuts in the upcoming months. As a result, FRA and short-term instruments may lose a bit, trimming majority of gains reached after Fed.
- The US macro data releases and the central bankers' statements will be in the focus. After the September Fed's meeting, the market expects further rate hike later this year. Therefore, in our view, greater market reaction is possible only if the data turn out to be significantly different from the market consensus.

… and issuance of 4Q16 plan in focus

- Poland's Ministry of Finance successfully launched T-bonds (the 5Y benchmark PS0721 and floaters WZ0120 and WZ0126) through switch auction. The ministry sold bonds worth PLN12.7bn in total, out of which nearly PLN6bn was collected from the sale of the 5Y benchmark PS0721. In our view, both domestic commercial banks and foreign investors were the most active ones at the auction. We estimate that after September Poland has covered c90% of this year's gross borrowing needs worth PLN182.7bn.
- At the end of this week, Poland's Ministry of Finance will announce the issuance plan for the last quarter of this year. We expect the total supply in the October-December period to be similar to the sale in 3Q16 (cPLN28bn), with a majority to be offered in October. This will reflect the liquidity situation in the market as the next month flows from both redemptions (PS1016) and coupon payments (DS series) will amount to PLN21.1bn. What is more, the high offer in 4Q16 will also result from the ministry's plan to pre-finance c20% of the 2017 gross borrowing needs of PLN178.5bn.

Additional information is available on request. Please contact Bank Zachodni WBK S.A., Economic Analysis Department, al. Jana Pawła II 17, 00-854 Warsaw, Poland, phone +48 22 534 18 88, email ekonomia@bzwbk.pl