Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

17 – 23 October 2016

Investors' mood deteriorated last week in view of the hawkish FOMC minutes and the weak foreign trade data in China. As a result, CEE currencies suffered from a lower risk appetite, and the US dollar strengthened. While EUR/PLN increased above 4.31, the interest rate market rebounded somewhat. The final inflation data for September confirmed the flash reading of -0.5% y/y. However, the balance of payments for August disappointed, with current account deficit higher than expected. This, in our view, implies that the GDP growth in Poland was probably below 3% y/y in 3Q16.

This week is heavily loaded with domestic macro data releases and events, in particular the data from real economy (industrial output, retail sales). In our view, the data will be mixed (stronger production, weaker construction output, flat retail sales), therefore the zloty's response might be rather neutral or slightly positive if our forecast on production output comes true. However, it may put some upward pressure on the FRA market and the front end of the curves. Poland's asset might suffer from the Parliament discussion about the FX loans conversion bill. As regards external factors, the ECB will take centre stage this week, in particular taking into account the earlier Bloomberg story that the ECB is going to gradually taper off its QE programme. In our view, the ECB will keep monetary policy unchanged, and it is broadly expected. All in all, we expect EUR/PLN to stay in a range of 4.25-4.32, and the domestic interest rate market to follow global trends.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (17 October)					
11:00	EZ	HICP	Sep	% y/y	0.4	-	0.4
15:15	US	Industrial output	Sep	% m/m	0.2	-	-0.4
		TUESDAY (18 October)					
14:00	**PL**	**Wages in corporate sector**	**Sep**	**% y/y**	**4.5**	**4.4**	**4.7**
14:00	**PL**	**Employment in corporate sector**	**Sep**	**% y/y**	**3.1**	**3.0**	**3.1**
14:30	US	CPI	Sep	% y/y	1.5	-	1.1
		WEDNESDAY (19 October)					
14:00	**PL**	**Industrial output**	**Sep**	**% y/y**	**3.6**	**4.6**	**7.5**
14:00	**PL**	**Construction and assembly output**	**Sep**	**% y/y**	**-18.5**	**-20.9**	**-20.5**
14:00	**PL**	**Real retail sales**	**Sep**	**% y/y**	**7.8**	**8.0**	**7.8**
14:00	**PL**	**PPI**	**Sep**	**% y/y**	**0.2**	**0.3**	**-0.1**
14:30	US	House starts	Sep	% m/m	2.9	-	-5.8
14:30	US	Building permits	Sep	% m/m	0.9	-	-0.4
20:00	US	Fed Beige Book					
		THURSDAY (20 October)					
13:45	EZ	ECB decision		%	0.00	-	0.00
14:00	**PL**	**MPC minutes**					
14:30	US	Initial jobless claims	week	k	-	-	246
14:30	US	Philly Fed index	Oct	pts.	5.0	-	12.8
16:00	US	Home sales	Sep	% m/m	0.3	-	-0.9
		FRIDAY (21 October)					
11:00	**PL**	**T-bond auction**					

Source: BZ WBK. Reuters. Bloomberg

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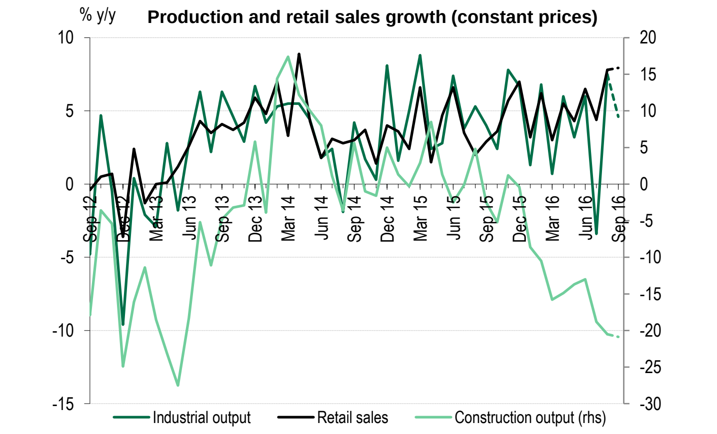
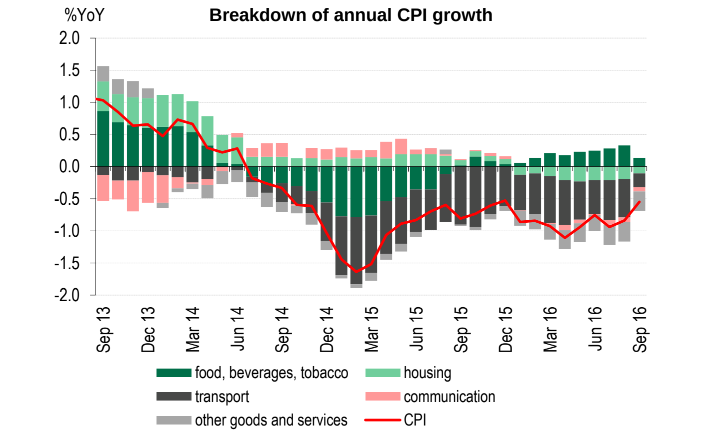
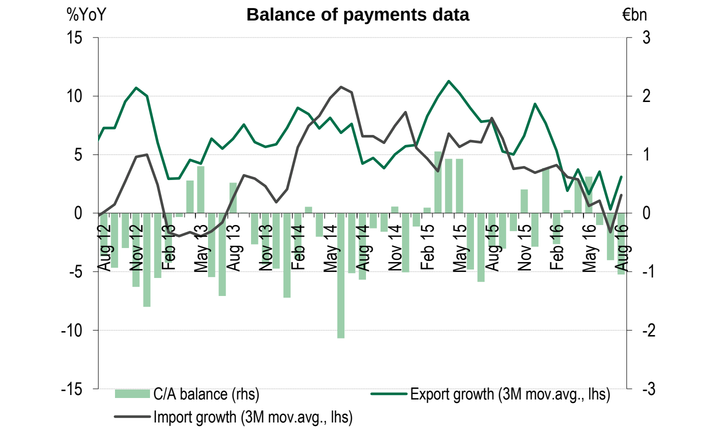
What's hot this week – Labour market, output, retail sales and minutes



- We expect employment to resume upward trend in September after a surprising fall in August. However, annual growth rate may go down, as the potential for employment growth is drying up, in our view. Wage growth is also likely to decelerate a bit, and to remain above 4% y/y.
- According to our forecasts, industrial output will decelerate in September, mostly due to a weaker working day effect. However, the underlying moderate upward trend will remain intact. Retail sales are also likely to post a good result, we will be again looking for signs of 500+ programme. On the other hand, construction output will remain deep under water, confirming that investment recorded no rebound in Q3.
- Minutes from the last MPC meeting may be interesting, especially as regards central bankers' assessment of economic situation.

Last week in the economy – Shrinking deflation, export disappointed again





- Polish deflation narrowed in September to -0.5% y/y, in line with flash estimate, and up from -0.8% y/y in August. Food prices were the biggest surprise for us, as they fell -0.2% m/m (against seasonal pattern, which suggested a moderate rise). We think that upward trend in CPI will be maintained, and it is possible that December may be the first month with inflation above zero after 29 months of deflation. In January CPI will be pushed up by very strong base effects in several categories and possible price hikes (water supply, electricity), so inflation rate may approach 1% y/y. In this environment, the MPC is not likely to start thinking about interest rate cuts, unless we see huge disappointment with economic growth in 3Q16.
- Core CPI excluding food and energy prices remained unchanged at -0.4% y/y.
- Balance of payments data for August were quite disappointing, in our view, showing lower than we expected exports an slightly higher imports. Current account deficit widened in August to -1.05bn, and was much higher than expected (median forecast -€366m according to Bloomberg). Both export and import growth accelerated in annual terms (to 8,0% and 10.4% y/y, correspondingly), but it was mainly due to the calendar effect and a rebound from exceptionally weak July. However, a pickup in exports was smaller than in imports, and less significant than suggested by data about Polish and German industrial output, in our view. It confirms our opinion that contribution of net exports to GDP in the second half of the year will be much lower than it was in H1. The data confirm that GDP growth in Poland in 3Q16 was probably below 3% y/y.

Quote of the week – We have a strong GDP deceleration

Grażyna Ancyparowicz, MPC member, 13 October, PAP
There is a huge uncertainty curbing willingness to invest (…) There is a strong deceleration of economic growth. Uncertainty is is one of the reasons behind that.

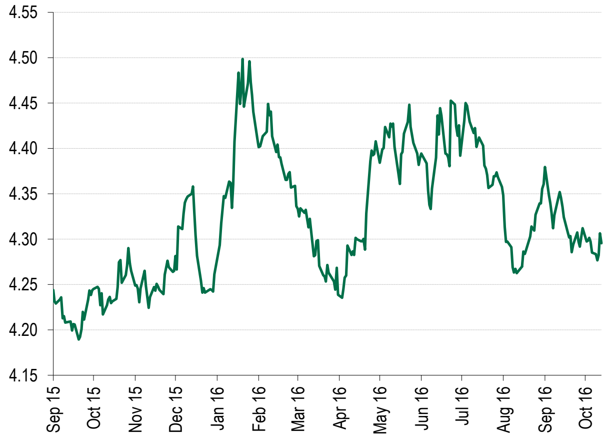
Jerzy Kropiwnicki, MPC member, 14 October, PAP

The scenario of interest rate cuts seems unrealistic. I see no reasons to cut rates. [in response to question whether it is possible that rates will be flat in Poland in 2017] This is beyond my horizon. (…) We have to observe important trends in the economy. For me, developments on the fuel market are especially important. To me, this is the primary reason why price growth should be expected at 1%.

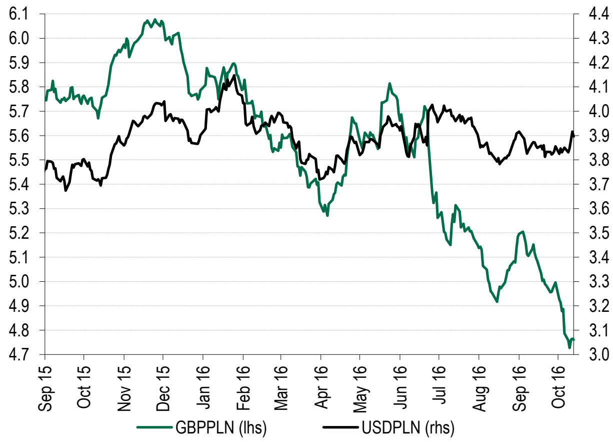
Grażyna Ancyparowicz stated that the economic growth in Poland is slowing down strongly and uncertainty is weighing on investment This comment clearly stays in opposition to the comments of NBP governor, Adam Glapiński, who was really optimistic about the economic growth last week and said that investment falls due to the shift in UE financial frameworks. This shows that the MPC is not unanimous in the assessment of the current trends. Jerzy Kropiwnicki, on the other hand, expressed a few interesting opinions. Contrary to the Governor of NBP, he refused to comment on the future interest rates, stating that 2017 is beyond his horizon. Interestingly, he also said that fuel prices are key economic indicators. We should remember that the MPC said on numerous occasions that deflation stems from shocks in fuel prices, on which the Polish monetary policy has no impact, and that is why the Council did not react to negative price growth with a rate cut.

Foreign exchange market – ECB meeting will take centre stage

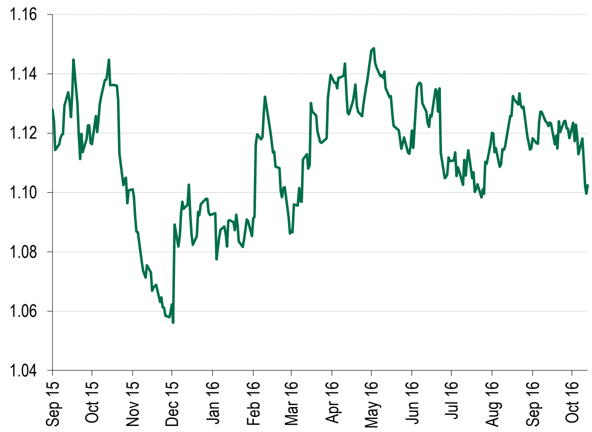
EURPLN



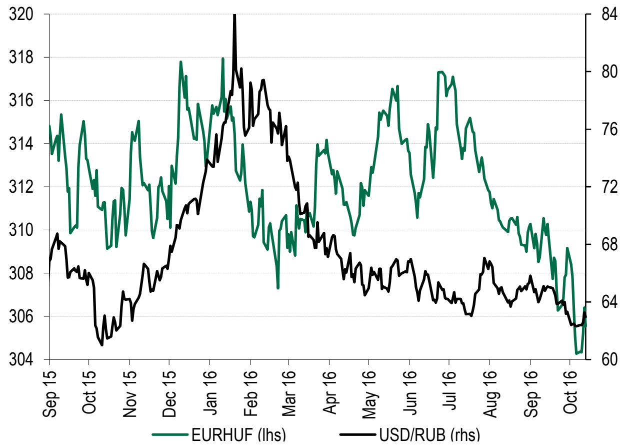
USDPLN and GBPPLN



EURUSD



EURHUF and USDRUB



Zloty weaker against the euro and the US dollar

- Last week zloty weakened markedly against the main currencies, this refers particularly to the US dollar. Zloty, similarly to other emerging market assets, suffered from the hawkish FOMC minutes and weak foreign trade data from China. As a result EUR/PLN increased above 4.31 for a while, not so far from this month's local high of 4.315. At the same time, USD/PLN rose temporarily above 3.92, its highest since end-August.
- This week is heavily loaded with domestic macro data releases, in particular the data from real economy (industrial output, retail sales). In our view, the data will be mixed (stronger production, weaker construction output), therefore the zloty's response might be rather neutral or slightly positive if our industrial output forecast comes true. It is likely that the zloty will take a breather after weakening last week. However, room for EUR/PLN decline is rather limited as investors will be closely watching the Parliament discussion about the FX loans conversion bill.
- As regards external factors, the ECB will take centre stage this week, in particular taking into account the earlier Bloomberg story that the ECB is going to gradually taper off its QE programme. In our view, the ECB will keep current monetary policy unchanged, and such a decision is broadly expected. However, any hints about the future of the QE programme will have a significant impact on market direction in the upcoming days.
- All in all, EUR/PLN still remains in a quite wide range of 4.25-4.32. However, mood is fragile and testing the 4.32 is more likely in the coming week. Next resistance is at 4.36.

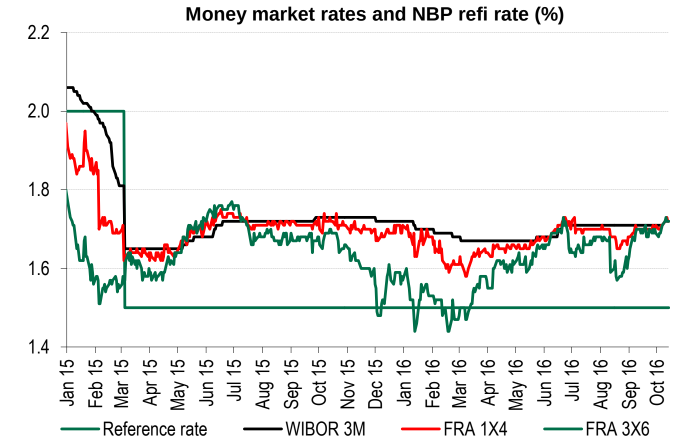
EUR/USD below 1.10 for a while

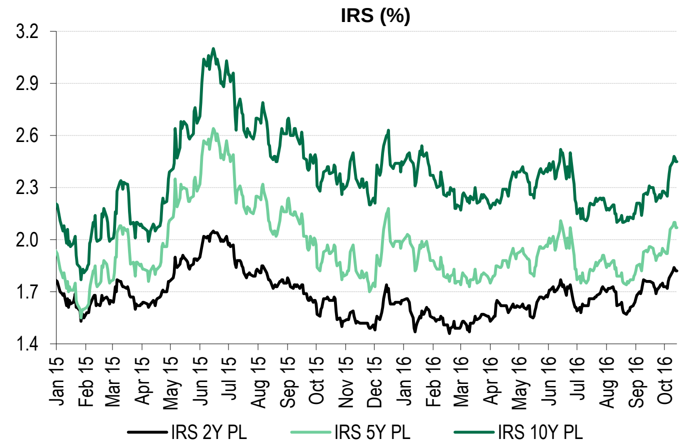
- Last week brought a bit higher volatility on EUR/USD. The rate declined below 1.10 for a while in response to the FOMC Minutes, which reaffirmed market expectations that Fed is likely to hike rates at its December meeting. However, the US dollar appreciations lost its momentum at the end of the week, and EUR/USD oscillated slightly above 1.10 ahead of the US macro data and a speech by Fed Chair, Yellen. At the same time, Brexit uncertainty weighted on the British pound, with USD/GBP flirting with 1.22.
- This week is quite busy with Europe and USA macro data releases and events. The strong data from the US economy, confirming a rate hike by Fed in December, should keep EUR/USD close to 1.10. In Europe, investors focus will be on the ECB meeting scheduled for 20 October.

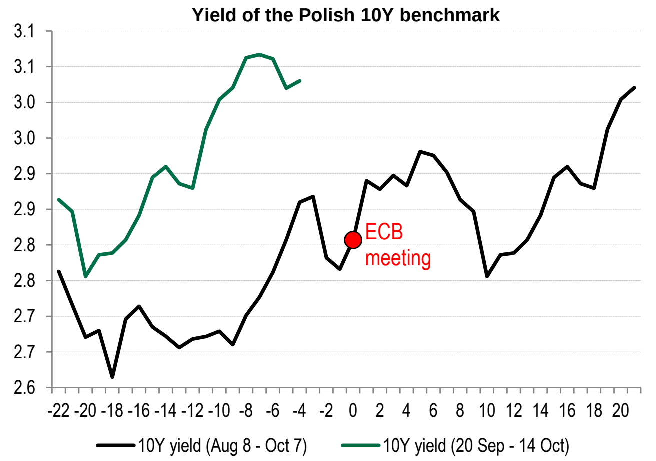
Oil prices weight on RUB

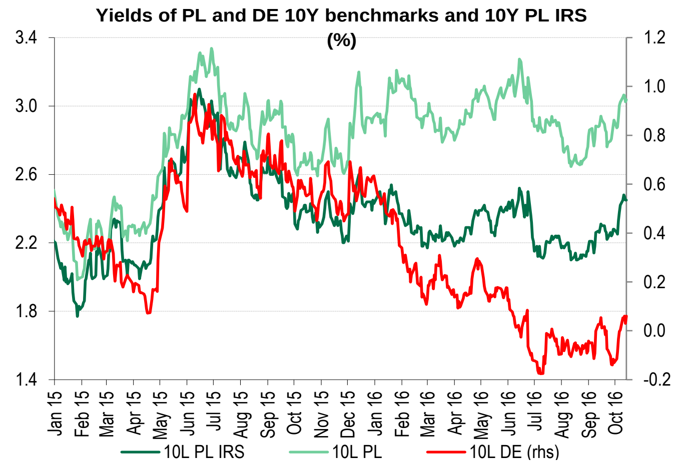
- Last week, other CEE currencies also depreciated. The Hungarian forint trimmed its gain recorded at the start of October, and USDRUB increased above 63 for a while due to oil prices decline (after reaching local peak nearly 54) and the US dollar strengthening globally. High volatility on EUR/HUF resulted mainly from investors' uncertainty about the Hungarian debt market future ahead of the AKK conference. However, the AKK press conference clearly showed that there will be no radical changes and this helped HUF to rebound. Consequently, EUR/HUF ended the week near 305.
- Global factors will be crucial for CEE currencies this week. In our view, EUR/HUF may move sideways between 303 and 310, while oil prices will set direction for USD/RUB.

Interest rate market – Following global trends









High intra-week volatility

- IRS and bond yields did not change much vs last Friday but the volatility was pretty high during the last week. Looming Fed rate hike and media reporting about tapering of the ECB's QE temporarily pushed 10Y yield above 3.10% and the respective IRS neared 2.50%. At the end of the week, however, Polish market rates eased and returned to levels near the previous Friday's closing.
- WIBORs rose last week – 3M and 6M rates moved 1bp up, and the 9M and 12M by 2bp.

ECB in the spotlight

- The ECB meeting scheduled this week will most probably be the key event for the global (and Polish) market. Recently, the media have reported that the ECB may taper its QE program (reported by Bloomberg), or it may discuss its asset purchases this month and leave time for a decision until November (Reuters story). Already in September, Mario Draghi said that some review of the current measures may take place in the weeks to come so that new/adjusted instruments could be used if necessary.
- Last month, the ECB refrained from extending its QE program saying that the market/economic situation does not justify more monetary policy easing. Since its meeting in September, PMIs and the other economic activity indexes performed quite good and so we think the ECB will stay put this time as well. Last month, the market felt disappointed but the same decision this week should be less surprising and it is Mario Draghi's press conference that could trigger some significant market reaction. However, we do not expect ECB's governor to give any more details on what and when the central bank could do.
- If the outcome of the ECB's meeting is roughly the same as last month then the market response may also be similar. The third chart shows how the 10Y yields was trading a month before and after the September's ECB meeting. Just like last month, the yield is rising this time as well. Last month's disappointment triggered an upside move, which could be smaller this time for two reasons – market could be somewhat more prepared for such a decision and the 10Y yields is already above 3%, which could be attractive for foreign investors hunting for yield. Later in the year, we expect yields to rise due to the Fed rate hike.
- 1-month correlations of Polish bond yields with their German and US peers are at 63% and 75% respectively. This shows that as long as there are no important domestic events, global factors may play a key role for the Polish rates.
- The front end of the curve could be more sensitive to the domestic macro releases – our forecast of industrial output is above market consensus which might generate some upside pressure on FRAs, particularly after the recent comments of Polish central bankers.

Second October's auction on the agenda

- This week, the second bond auction this month will take place. According to the initial plan, the Finance Ministry wants to sell debt for PLN5-10bn and the new 5Y benchmark (PS0422) may be offered. Planned supply is pretty high, but cPLN21bn from PS1016 redemption and from coupon payments will inflow to the market on the day of the auction settlement. In our view, this should support the demand and the auction results may be quite decent.

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