Bank Zachodni WBK
Grupa Santander

WEEKLY ECONOMIC UPDATE

7 – 13 November 2016

Flash CPI inflation for September was higher than expected, as it rebounded to -0.2% y/y, raising probability that deflation in Poland will end by the end of this year. Meanwhile, manufacturing PMI strongly disappointed, falling in October to almost 50. Other business climate indicators for manufacturing also fell (although less significantly), which suggests that industrial production growth in October may be weak again (we predict reading slightly below zero). Despite economic growth slowing down slightly, situation in the labour market is still very good, as seasonally adjusted unemployment fell in September to a new record low 5.7%.

Global market sentiment has been the most important driver for the Polish financial market recently and such situation is likely to continue, with the US presidential election in the spotlight this week. The election result may determine the market direction for the coming weeks.

The Monetary Policy Council meeting will be the only important domestic event this week. The MPC decision is unlikely to surprise – it is almost certain that main interest rates will remain unchanged. However, the meeting will be much more interesting than in the previous months, as the Council will have the results of the new NBP projection at its disposal. We think the new projection will show lower paths of GDP growth and inflation (in July, the projection predicted average inflation at 1.3% in 2017 and 1.5% in 2018, and GDP growth at 3.5% in 2017 and 3.3% in 2018). In July the MPC downplayed the results of the projection, saying that it expects more optimistic scenario. But recent data confirmed that scenario will not be as good as they had thought. New projection and new economic data may fuel market speculation that the MPC stance may change towards more dovish.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (7 November)					
8:00	DE	Industrial orders	Sep	% m/m	0.2	-	1.0
11:00	EZ	Retail sales	Sep	% m/m	-0.5	-	-0.1
		TUESDAY (8 November)					
8:00	DE	Industrial output	Sep	% m/m	-0.2	-	2.5
8:00	DE	Exports	Sep	% m/m	-0.7	-	5.4
9:00	CZ	Industrial output	Sep	% y/y	3.8	-	13.1
9:00	HU	CPI	Oct	% y/y	0.8	-	0.6
	US	Presidential elections					
		WEDNESDAY (9 November)					
	PL	**MPC decision**		**%**	**1.5**	**1.5**	**1.5**
9:00	CZ	CPI	Oct	% y/y	0.7	-	0.5
		THURSDAY (10 November)					
14:30	US	Initial jobless claims	week	k	-	-	265
		FRIDAY (11 November)					
	PL	**Market holiday**					
16:00	US	Flash Michigan	Nov	pts.	87.3	-	87.2

Source: BZ WBK. Reuters. Bloomberg

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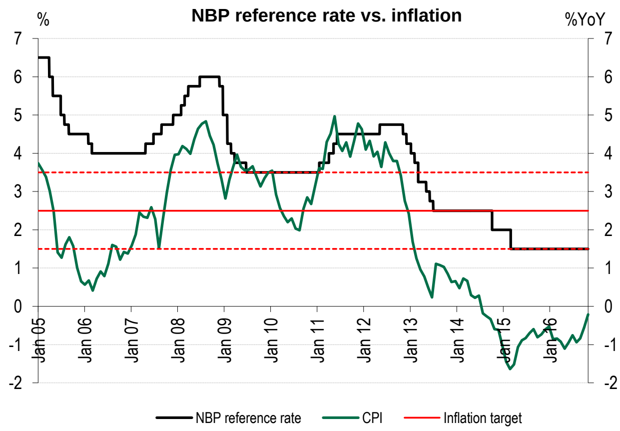
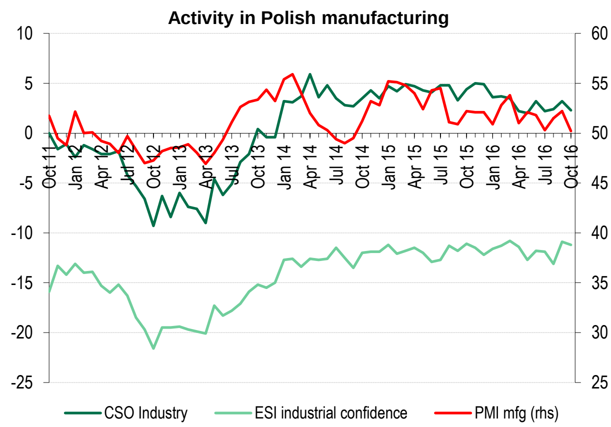
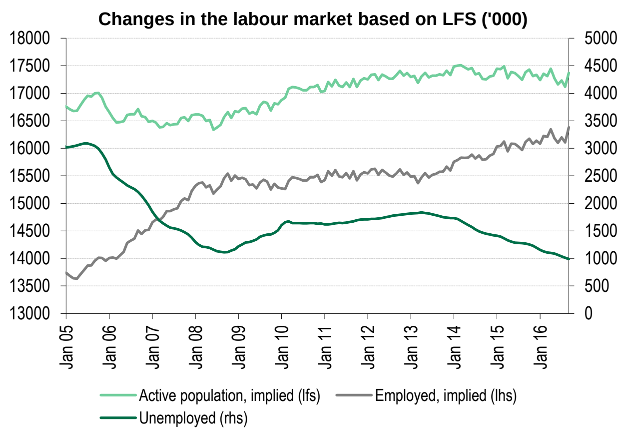
What's hot this week – MPC meeting and US elections



- Meeting of the Monetary Policy Council will be the only major domestic event this week. While it is quite obvious that the monetary policy will remain unchanged, the meeting will be more interesting than in the last few months as the Council will have the results of the new NBP projection at its disposal. We think the new projection will show lower paths of GDP growth and inflation. In July the MPC downplayed the results of the projection, saying that it expects a more optimistic scenario. But the recent data confirmed that scenario will not be as good as they had thought. New projection and new economic data may fuel market speculation that the MPC stance may change towards more dovish.
- The key event of the week will be the US presidential elections. Its result may have significant impact on the financial markets' behaviour.

Last week in economy – CPI higher, PMI and unemployment lower





- Flash October CPI reached -0.2% y/y vs expected -0.3% y/y and -0.5% y/y seen in September. We do not know yet what was the source of the surprise, but this number rises chances for deflation in Poland to end this year.
- Polish manufacturing PMI strongly disappointed in October, falling to 50.2 from 52.2 and reaching its lowest level since September 2014. Such a weak outcome resulted from deterioration of most of indicator's components, but mainly from a lower number of new orders (which fell as compared to September at the highest pace in two years). As a result of the weak inflow of new orders the output rose only slightly and was close to stagnation. Employment rose at the slowest pace since August 2014. Recent months saw quite significant fluctuations of Polish PMI. The general trend suggests a gradual decline of economic activity and we think that October's reading confirms our view that 2H16 will see no acceleration of the economic growth in Poland.
- Other business climate indicators (GUS, ESI) also showed a worsened situation in manufacturing in October, which signals that industrial production reading for this month may be again quite weak (especially that if it is negatively affected by the calendar effect).
- According to Eurostat's Labour Force Survey, the seasonally-adjusted unemployment rate in Poland fell in September to fresh all-time low at 5.7%. The number of unemployed fell by 280k y/y to below 1mn for the first time ever. Data imply that the number of employed was still rising at a solid pace – c2% y/y, i.e. c300k per year. Should this trend continue, the unemployment rate in Poland would fall to zero in the next three years.

Quote of the week – 3.5% GDP growth will not justify rate hikes

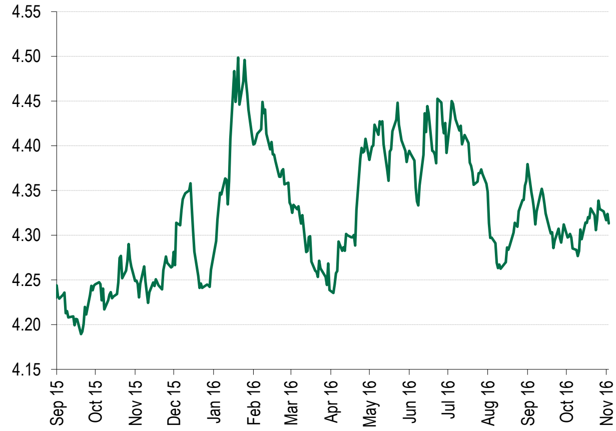
Adam Glapiński, NBP governor, 3 Nov, PAP

If there is continuation of trends seen in 2016, then I think that there will be no reason to raise interest rates in 2017. In case of a very positive scenario: if GDP growth quickly rebounds and inflation raises, then yes (rate hike may be needed). But unfortunately the growth rate is unlikely to exceed 4%. I am sure that GDP growth will exceed 3% next year, and if investments kick in, then it may reach 3.5%. But still, it will not be a reason to change interest rates.

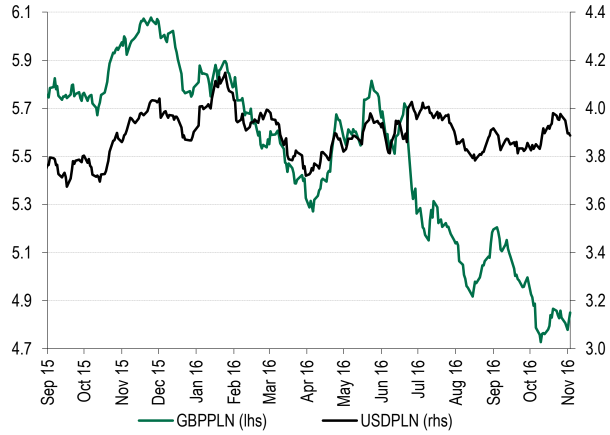
The NBP governor still seems to be relatively optimistic about economic growth outlook (being "sure" that growth will be above 3% next year), but it is important to note that he would see no reason to tighten monetary policy next year even if growth accelerates to 3.5%. However, the key question right now is not about rate hikes but about chances for policy easing if growth disappoints further. The new, lower NBP projection and coming data releases may fuel market speculation that rate cuts are not completely off the table.

Foreign exchange market – EUR/PLN still waiting for the trigger

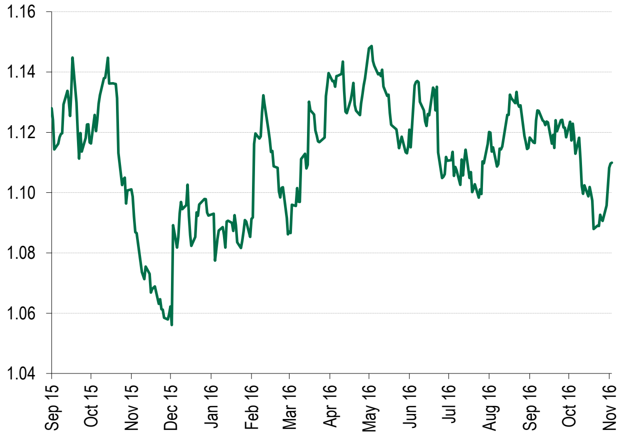
EURPLN



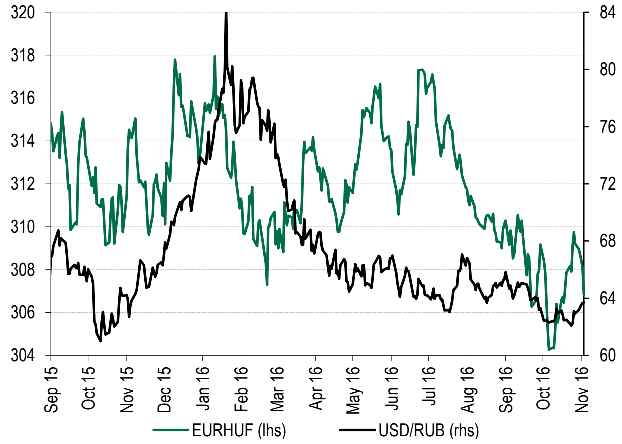
USDPLN and GBPPLN



EURUSD



EURHUF and USDRUB



Zloty still stable vs euro

- Last week saw no big changes on the EUR/PLN market and the exchange rate continued to move sideways around 4.32. There was only a marginal negative reaction to the weaker than expected PMI for Polish manufacturing. At the same time, USD/PLN fell for the second week in a row and reached 3.875, but the zloty lost vs the British pound with GBPPLN rising above 4.87.
- EURPLN's 1M ATM implied volatility is oscillating not that far above its lowest level since March 2015 while the 2M and 3M vols last week reached their lowest since 1Q15. Periods of low volatility are followed by times of elevated market moves. For the EM currencies, spike in volatility usually means they are under pressure.
- This week market attention will focus on the US presidential elections. We have already seen in the last few weeks how rising support for Donald Trump drove the Mexican peso weaker and this could be a good hint on how the EM currencies could react if the result of the elections spurs risk aversion. Clinton's victory could, in view, trigger the opposite market response.
- Important levels to watch for EUR/PLN this week are 4.34 (next resistance at 4.36) and 4.29 (next support at 4.26). We are still negative on the zloty in the remainder of the year.

Dollar weaker ahead of the elections

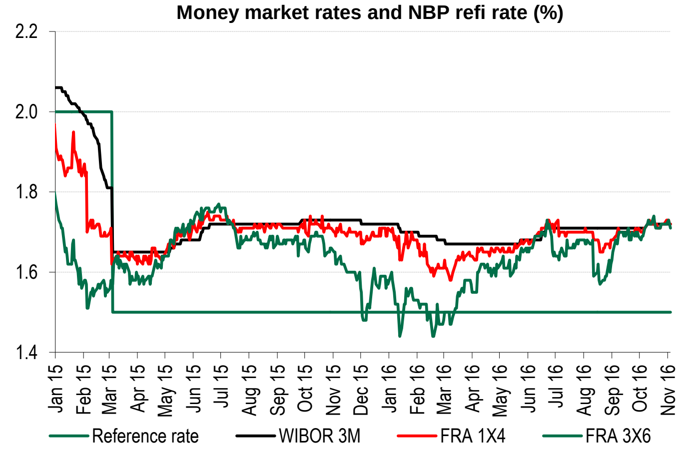
- Rising support for Donald Trump weighed on the dollar, and EUR/USD approached 1.11 after a second consecutive week of rising.
- In the UK, the British High Court ruled that the government needs parliament's approval to trigger Brexit attracted attention. The information caused a decrease in fears that Brexit will be initiated quickly, which triggered significant strengthening of the pound – GBP/USD climbed to almost 1.25 (its highest since early October) while EUR/GBP fell below 0.89 (its lowest for a month).
- The outcome of the US presidential elections might be crucial for EUR/USD in the short term. Last week, the dollar has depreciated vs its G10 peers – biggest losses were seen vs NZD, GBP, JPY, CHF and EUR. We think this trend might continue if Donald Trump wins with the euro still lagging behind.
- First resistance for EUR/USD is at 1.114 (next one at 1.12) while support at 1.095 (next one at 1.085).

Forint gains, ruble weakens

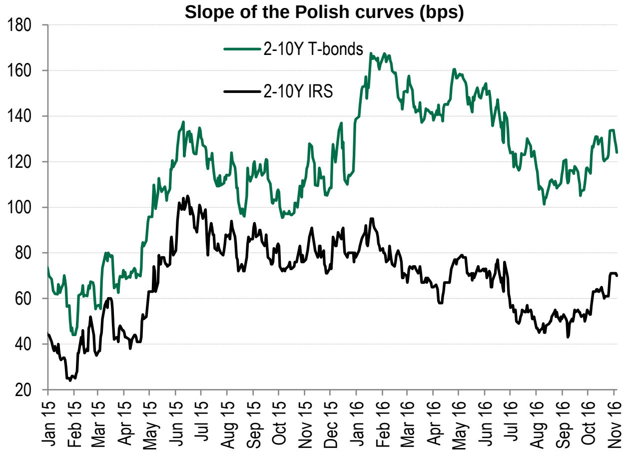
- The ruble depreciated vs the dollar for the second week in a row amid falling oil prices. As a result, USD/RUB rose to 64, its highest since late September. At the same time, the forint finally gained vs the euro after three weeks of depreciation witch EUR/HUF falling to 306 from 310. The Hungarian currency was supported by a robust PMI reading.
- The outcome of the US presidential elections should have a key impact on the HUF and RUB this week.

Interest rate market – Higher volatility ahead of the US presidential election

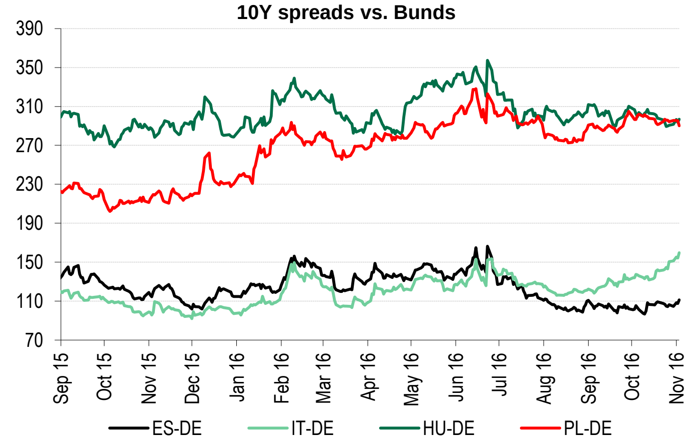
Money market rates and NBP refi rate (%)



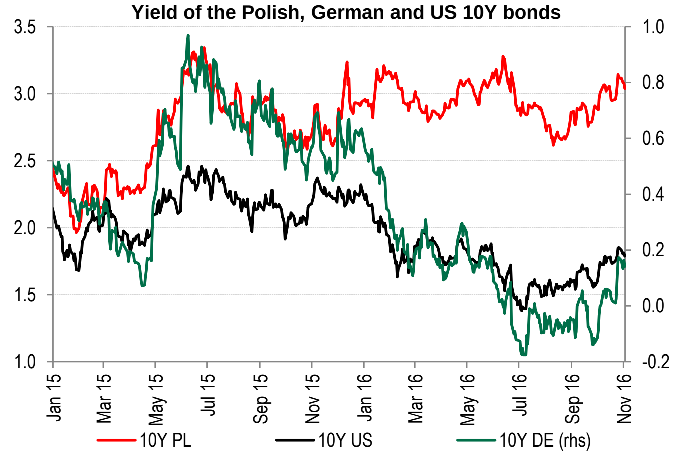
Slope of the Polish curves (bps)



10Y spreads vs. Bunds



Yield of the Polish, German and US 10Y bonds



Poland's curves moved down, following global changes

- Last week, domestic interest rate market strengthened gradually. On a weekly basis, yields and IRS rates shifted down across the board, following global trends. Core market gained somewhat as investors sought protection in safe-haven assets despite the still hawkish FOMC. However, the downwards momentum faded later in the week as the BoE signalled that it would not cut interest rates this year. Quite weak results of domestic switch tender (details below) were more or less neutral for the market players. Market response to the weaker than expected US non-farm payrolls was muted.
- Bull flattener developed on Polish debt market as belly and the long end of the curve gained the most thanks to the global mood improvement. The front end was under pressure by stronger than expected flash CPI reading for October. What is more, changes on the Poland's FI market were smaller than on Bunds and the 10Y spread tightened towards 290bp.
- At the first auction in November, Poland's Ministry of Finance repurchased WZ0117, PS0417 and DS1017 for the total amount of PLN3.7bn and sold OK1018, IZ0823 and DS0727 for PLN3.9bn. The results were poor as compared with the September's sell worth PLN12.7bn in total. The ministry did not accept less attractive bids and so the final sale was clearly below the PLN6bn target. This suggests that the ministry is not determined to pre-finance the 2017 borrowing needs at any price. According to our estimation, the level of pre-financing through switch auctions is at c5%.
- On the money market, last week situation did not change much. On a weekly basis, both WIBOR and FRA rates remained more or less stable.

The US presidential election and the MPC in the spotlight

- Poland's debt recovered somewhat as we suggested in previous weekly. However, this trend may be disturbed taking into account important events in Poland and abroad due this week. The US presidential election (November, 8) is the key. Worries about the outcome will add to market volatility early this week. Recent days once again confirm that the long end of the curves is under impact of global factors, in particular the trend on core market. Trump's win could result in significant turbulence on the market and risk-off mode and consequently, capital would be shifted towards safe haven assets. Consequently, the Polish bond market can suffer, and yield of Poland's 10Y benchmark may again test 3.15%. However, the room for significant upwards move in yields should be limited as significant sell-off on the market (especially US equity) could mean delay in monetary tightening by Fed. Otherwise, domestic 10Y yield should remain in horizontal trend, fluctuating between 3.00%-3.15%. However, scale of Polish bonds weakening may be lower than German debt, and consequently spread over Bunds may continue to tighten.
- As regard Poland's event, investors will focus on the MPC meeting. It is broadly expected that the Council keeps NBP's rates unchanged. But this month meeting will be more interesting than the previous as the new NBP macro forecasts will be released. Expected by us lower path of both GDP and probably CPI should support the front end of the curves in the short run.
- The second half of the week will bring lower liquidity due to market holiday on Friday. Therefore, Polish IRS/yields may be even more exposed to the global trends.

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