Bank Zachodni WBK

Weekly economic update

16 – 22 August 2010

Last week brought deterioration in sentiment on the global markets, which led to clear weakening of stock markets, drop in EURUSD and strengthened the core debt markets. However, the Polish market was quite resistant to the rise in risk aversion. The zloty did not depreciate much and the local debt market gained. The reason for worsening in moods on the global markets were some negative macro data from the US, Asia and the euro zone as well as more cautious assessment of prospects for economic recovery by the Fed. On the other hand, there were some positive news that supported market sentiment (quite upbeat earnings reports and much better than expected data on German GDP in Q2). Domestic data had no impact on the local market. CPI inflation clearly dropped to 2.0%YoY in July, exactly matching our forecast and below market expectations. C/A deficit proved wider than expected, but its negative meaning was weakened by much narrower than predicted trade gap with some positive surprise in exports and slightly weaker than expected imports. Besides, the C/A gap is still much more than fully financed by inflow of FDIs and EU funds.

This week we will get large dose of important domestic figures and some major indicators from abroad. For majority of local data our forecasts are below market consensus (wages, industrial and construction output, PPI) and thus materialization of our forecasts would be positive for the fixed income market. It could be potentially negative also for the zloty, although the key driver for the domestic currency is still sentiment in the global markets.

Economic calendar

Time CET	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (16 August)					
11:00	**PL**	**Tender of 52-week T-bills worth PLN0.7-1.0bn**					
11:00	EZ	Final HICP	Jul	%YoY	1.7	-	1.4
14:30	US	NY Fed index	Aug	pts	8.0	-	5.08
		TUESDAY (17 August)					
14:00	**PL**	**Wages**	**Jul**	**%YoY**	**3.9**	**3.5**	**3.5**
14:00	**PL**	**Employment**	**Jul**	**%YoY**	**1.4**	**1.4**	**1.1**
10:00	EZ	Current account	Jun	€ bn	-	-	-5.8
11:00	DE	ZEW index	Aug	pts	21.0	-	21.2
14:30	US	Building permits	Jul	k	580.0	-	583.0
14:30	US	House starts	Jul	k	560.0	-	549.0
14:30	US	PPI	Jul	%MoM	0.2	-	-0.5
15:15	US	Industrial production	Jul	%MoM	0.5	-	0.1
		WEDNESDAY (18 August)					
14:00	**PL**	**Industrial output**	**Jul**	**%YoY**	**12.3**	**10.8**	**14.5**
14:00	**PL**	**Construction output**	**Jul**	**%YoY**	**7.9**	**5.5**	**9.6**
14:00	**PL**	**PPI**	**Jul**	**%YoY**	**3.3**	**3.0**	**1.9**
		THURSDAY (19 August)					
14:30	US	Initial jobless claims	week	k	478.0	-	484.0
16:00	US	Leading indicators	Jul	%MoM	0.2	-	-0.2
16:00	US	Philadelphia Fed	Aug	pts	7.0	-	5.1
		FRIDAY (20 August)					
14:00	**PL**	**Core inflation**	**Jul**	**%YoY**	**1.3**	**1.2**	**1.6**
14:00	**PL**	**Business climate indicators**	**Aug**	**-**	**-**	**-**	**-**

Source: BZ WBK, Reuters, Parkiet

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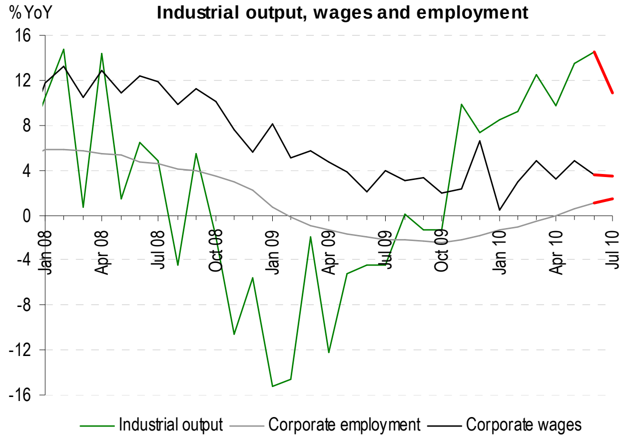
What's hot this week – Large dose of important data



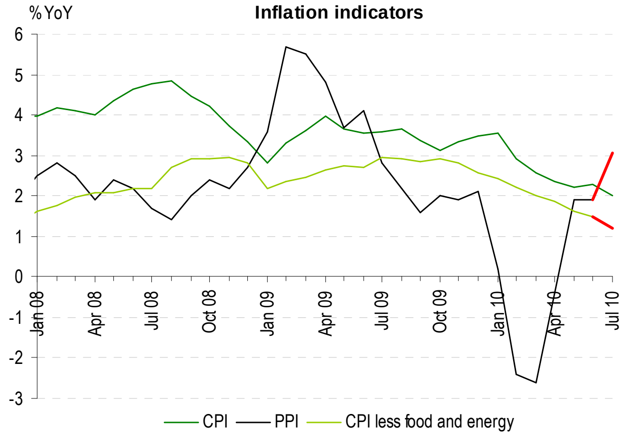
▪ We forecast that the rise in labour demand in the enterprise sector observed for a few months was continued in July. However, recovery in the labour market is still in early stage and wage growth remains limited.

▪ The deceleration in annual output growth that we predict both for industrial and construction sector is mainly due to lower number of working days. Without this effect output growth would accelerate in both sectors.

▪ We estimate that annual PPI inflation clearly rose in July to 3.0% from 1.9% in June, but mainly as a result of low base effect (strong drop in producer prices a year earlier due to rapid zloty appreciation).

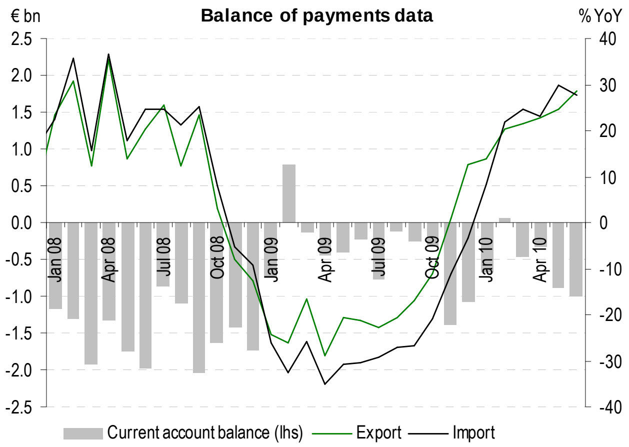
▪ The number of major data releases abroad is not large this week, but the number may significantly affect assessment of the pace and durability of global economic recovery.

Economy last week – Low CPI inflation, wide C/A deficit



▪ In line with our expectations, annual CPI inflation in July fell significantly to 2.0% from 2.3% in June. This was below the FinMin's estimate of 2.1% and below market consensus of 2.2%. Price changes in majority of categories were in line with our forecasts, food price fell by some 1%. In our opinion, 12M CPI inflation reached the bottom in July and the following months will show the upward trend. Food prices performance is still the most important risk factor.

▪ Comments from MPC members after the data release showed that although the figures were clearly below the market consensus, they have not changed views within the MPC. On the one hand, Adam Glapiński did not exclude a rate hike already in August. On the other hand, Elżbieta Chojna-Duch and Andrzej Kaźmierczak suggested there is no hurry to hike rates. Earlier similar opinion was presented by NBP governor, but he did not exclude a hike this year.



▪ C/A gap in June was higher than expected, reaching €1004m. Additionally, deficit for May was revised upwards. This is due to high negative balance on income account (large dividend payments). Lower than expected surpluses in services and current transfers also played some role.

▪ On the other hand, trade deficit in June was narrower than expected amid some positive surprise in exports (annual growth in euro terms accelerated to 28.6%, indicating strong external demand) and slightly disappointing imports (annual growth in euro terms decelerated to 27.8%).

▪ 12M cumulated C/A gap after June widened to 2.3% of GDP from 2.1% after May, but this is still a moderate level and this is much more than fully covered with inflow of long-term capital, i.e. FDIs and EU funds.

Quote of the week – We are preparing a restrictive budget

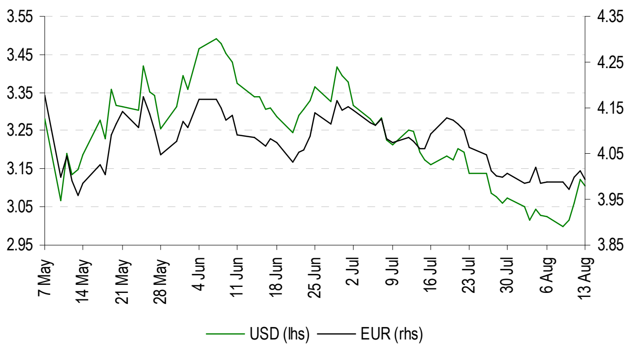
Ludwik Kotecki, deputy finance minister, DGP, 12 Aug

We are preparing a restrictive budget (...) There where it is possible we want to keep spending level at this year's level or reduce spending rise below 1pp induced by the new spending rule. (…) We want to reduce it [funeral allowance] by around half the next year. (…) [Q: Will the payroll in administration be frozen?] We will see (…) Military spending in a longer term has to be at least 1.95% of GDP, but in hard times it will be lower. We proposed 6-year cycle for the settlement of the limit [instead of the currently binding 3-year cycle], as this is more of less the length of business cycle in Poland. (…) We will closer analyse all spending, which are not fixed. There are many such items and we will look for savings for the next few weeks.

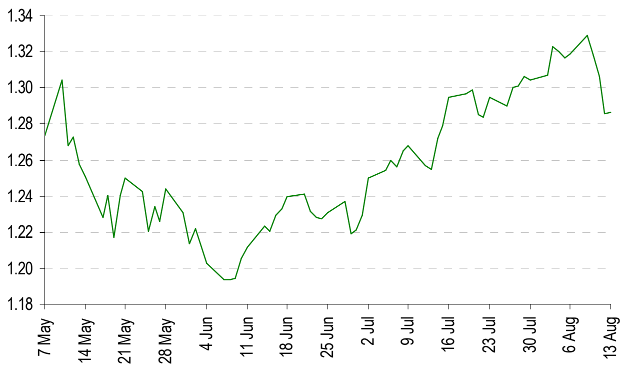
FinMin still tries to reduce the planned budget deficit for 2011 to below PLN45bn tentatively assumed in the Multi-year Financial Plan. Ways to achieve this goal include strict spending limits for budget entities and reduction in funeral allowances. Besides, the freezing of payrolls in administration and reduction in military spending is considered. As to risk of exceeding public debt to GDP safety threshold at 55%, the government tries to reduce the deficit and accelerate privatisation, but also counts on a possible change in the way public debt is calculated (in order to exclude from it costs of pension system reforms). Over the past week there were next signals that Ecofin tentatively accepted such a change. Final decision is expected in October at the earliest. Later on a change in the Polish law would be also needed.

Market monitor

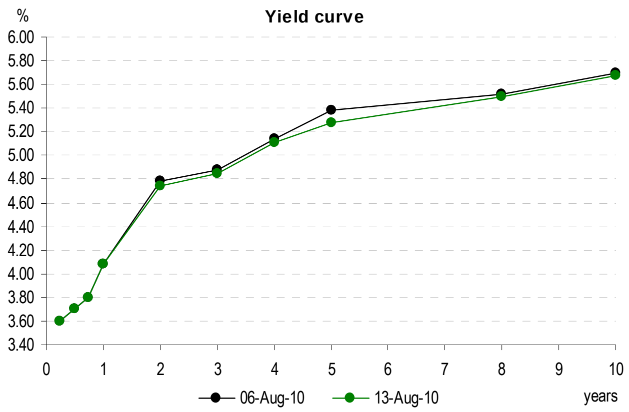
Zloty exchange rate



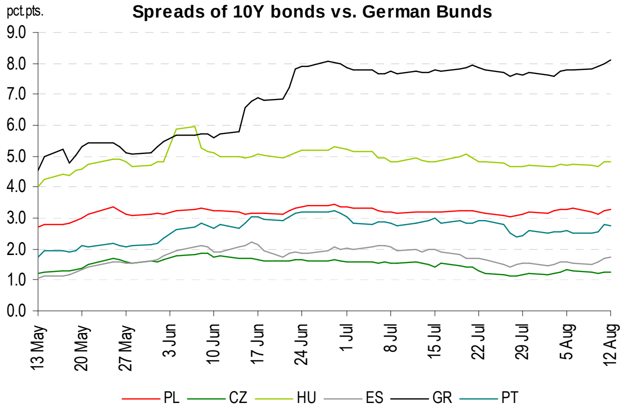
EURUSD rate



Yield curve



Spreads of 10Y bonds vs. German Bunds



EURPLN up, EURUSD down

- Just as we expected, the EURPLN increased during the past week, though the level of 4.04 pointed in the previous report has not been reached. The zloty's depreciation was twice constrained by the level of resistance at 4.02. The negative pressure on the zloty was put mainly by the negative outlook for the US economy stated in the communiqué published after the Fed meeting. Later on, despite some positive data from the euro zone, the EURPLN hovered somewhere above 4.0. This week we do not expect any major improvement of the market sentiment, consequently the negative pressure on the zloty shall prevail. The support for the EURPLN is at 3.96, the resistance at 4.02. We expect that the EURPLN will hover somewhere around the upper band of the consolidation. In case of breaking the resistance, next target for the EURPLN would be the area at 4.04-4.05.
- The euro did not manage to maintain its strength showed at the end of the previous week. Considerable deterioration of the market' mood dragged the EURUSD to 1.28, the lowest level for 3 weeks. The dollar's appreciation was mainly the result of gloomy outlook for the US economy pointed by the Fed. Additionally, the data published overseas (biggest since April 2008 trade deficit, higher-than-expected number of new unemployed) fuelled the surge of the risk aversion. Only the Friday's data on German GDP in the Q2 stabilized the exchange rate. Large amount of important US data is due to be published this week, and if they disappoint the market, they may have o decisive impact on the EURUSD. The level of resistance is at 1.30, the support at 1.25-1.26.

The fixed income market slightly stronger

- The domestic fixed income market was pretty stable during the past week. Only the yields of the 5Y bonds declined, but that was just a correction after the latest increase. This week the positive factor influencing the market will be the domestic data, that according to our expectations would mainly weaker that the market consensus. Additionally, the worries concerning the slowdown of the global economy may dampen the expectations for the interest rates' hikes and consequently support the Polish fixed income market.
- As the demand for safe-heaven assts surged, the yields of the 10Y Bunds plunged to the record low at 2.40%. The 10Y Treasuries reached their lowest level since April 2009 as Fed announced that cash collected from the bonds that he keeps on his balance sheet and are due to mature, will be reinvested in the long-term US securities.
- Hungary sold 5Y and 10Y bonds worth totally HUF54bn (2bn more than initially planned) with yields 31bps lower than on the previous auction. Romania however, managed to gather only $35.1bn versus $242bn planned due to too low yields offered. It is amazing, that the country that has recently been under the pressure after breaking the negotiations with the IMF and the EU preformed better on the debt market. Romania has an access to the credit line worth €20.0bn and last week the Fitch agency confirmed its debt rating.
- The deterioration of the global market sentiment triggered the surge of the yields of the peripheral euro zone countries, what all together will the record low yield of 10Y Bunds caused the increase of spreads.

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