Bank Zachodni WBK

Weekly economic update

21 – 27 February 2011

Last week saw a further strengthening of investors' belief that improvement in condition of the global economy will be durable. This was driven by inflow of positive news from companies while the set of new macro figures from major economies somewhat disappointed. Amid higher risk appetite, major stock indices and EURUSD were in the upward trend. After poor start of the week, the zloty gained in the following days, but in this case the key driver was not improvement in sentiment on the global markets, but surprisingly strong rise in domestic CPI inflation, which strengthened expectations for hikes in NBP interest rate. Inflation acceleration above the most pessimistic forecasts and continuation of relatively high wage growth in enterprises increased probability of the next rate hike by 25bps as soon as at the nearest MPC meeting at the beginning of March, even despite disappointing data on construction production.

Macro data in major economies due for release this week will be, in our view, supportive for further rise in risk appetite in the global markets. On the other hand, a negative factor for risk sentiment, and thus for the zloty and Polish assets, will be possible continuation of recent deterioration in situation on the Portuguese debt market, particularly ahead of debt auction in Italy. The domestic debt market should be stable with investors awaiting the MPC decision next week.

Economic calendar

Time CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (21 February)					
9:28	DE	Flash PMI – manufacturing	Feb	pts	60.0	-	60.5
9:58	EZ	Flash PMI – manufacturing	Feb	pts	57.0	-	57.3
9:28	EZ	Flash PMI – services	Feb	pts	55.6	-	55.9
10:00	DE	Ifo index	Feb	pts	110.3	-	110.3
11:00	**PL**	**Tender of 52-week T-bills worth PLN1.5-2.0bn**					
14:00	**PL**	**Business climate**	**Feb**	**pts**	**-**	**-**	**-**
	US	Market holiday				-	
		TUESDAY (22 February)					
8:00	DE	GfK index	Mar	pts	5.8	-	5.7
15:00	US	S&P/Case-Shiller home price index	Dec	%MoM	-0.5	-	-0.5
16:00	US	Consumer confidence index	Feb	pts	61.5	-	60.6
		WEDNESDAY (23 February)					
10:00	**PL**	**Unemployment rate**	**Jan**	**%YoY**	**12.9**	**12.8**	**12.3**
10:00	**PL**	**Retail sales**	**Jan**	**%YoY**	**8.5**	**9.9**	**12.0**
11:00	EZ	Industrial orders	Dec	%MoM	-2.0	-	2.1
16:00	US	Home sales	Jan	m	5.3	-	5.28
		THURSDAY (24 February)					
8:00	DE	Final GDP	Q4	%QoQ	0.4	-	0.8
11:00	EZ	Economic sentiment	Feb	pts	106.8	-	106.5
14:30	US	Initial jobless claims	week	k	400	-	410
14:30	US	Durable goods orders	Jan	%MoM	2.4	-	-2.3
16:00	US	New home sales	Jan	k	300	-	330
		FRIDAY (25 January)					
14:30	US	Preliminary GDP	Q4	%QoQ	3.3	-	2.6
15:55	US	Final Michigan index	Feb	pts	75.1	-	74.2

Source: BZ WBK, Parkiet, Reuters

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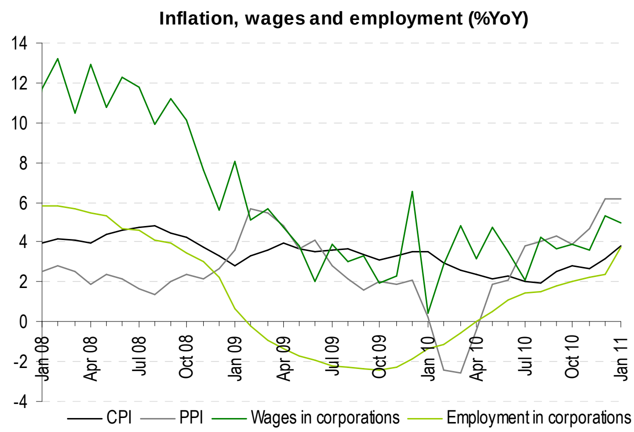
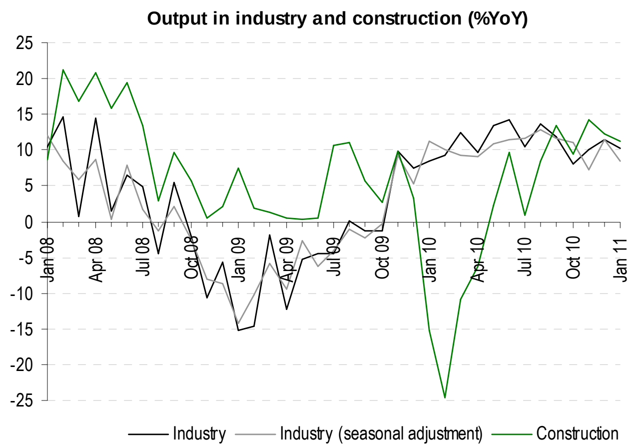
What's hot this week – Many important data abroad and domestic retail sales

- This week the key focus of attention locally will be retail sales figures for January. We predict a noticeable lowering of annual growth rate of retail sales due to a shift in demand from first months of 2011 to last months of 2010 amid consumers fears of VAT hike and price increases. However, the nearly two-digit growth predicted by us will be still a solid result and the expected continuation of firming in labour market conditions should keep supporting consumer demand later this year.
- Apart from retail sales figures, it will be also worth to watch the registered unemployment data for January. As there was strong rise in the unemployment in recent months (stronger than solely due to seasonal factors), this factor is being mentioned by some MPC members as a dovish argument. On the other hand, a hawkish argument may be NBP data on households' inflation expectations.

Economy last week – Surprisingly strong rise in CPI inflation



- Annual CPI inflation rate rose to 3.8% in January from 3.1% in December, well above market consensus (3.4%) and our forecast (3.5%). The increase was caused mainly by supply-side factors (food prices rose much more sharply than we estimated), but the higher level of the current inflation, the stronger may be concerns of the MPC members about possible occurrence of the second-round effects and thus more permanent rise in inflation.
- Annual wage growth in the corporate sector reached 5.0%YoY in January, which confirms that a strong acceleration in wage growth in December (to 5.4%YoY) was not a one-off phenomenon. Annual employment growth accelerated sharply to 3.8% from 2.4%, but it is hard to say to what extent it reflects an underlying labour demand, as the data is affected by the effect of change in statistical sample of companies.



- PPI growth remained in January at elevated level 6.2%YoY, showing strong cost pressure on producers, which in time may start feeding through consumer prices.
- Growth in industrial production (10.3%YoY) was roughly consistent with expectations, showing continuation of expansion in Polish industry, fuelled mainly by external demand. In subsequent months we predict a slowdown in production growth, amid deceleration in economic growth abroad. However, it should a gradual process.
- Output in construction sector rose in January more than in industry (by 11.2%YoY), but it was a big disappointment, taking into account a very low base from the previous year. It puts a question mark over the hypothesis about strong investment revival at the start of this year

Quote of the week – Rate hike in March or in Q2

Elżbieta Chojna-Duch, MPC member; PAP, 15 February

In March one cannot exclude either leaving interest rates on hold or an interest rate hike.

Jan Winiecki, MPC member; PAP, 17 February

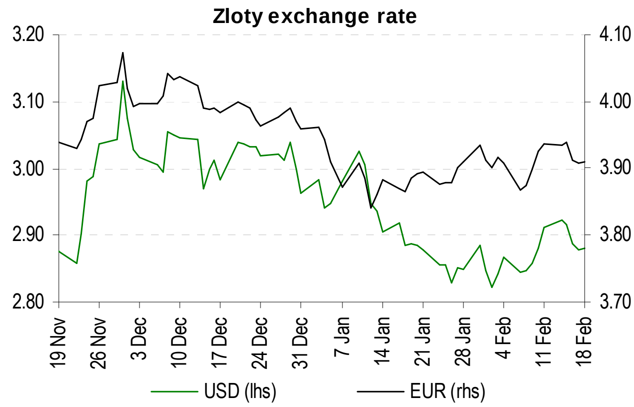
If there is such a motion [to hike interest rates in March] I will surely vote for it.

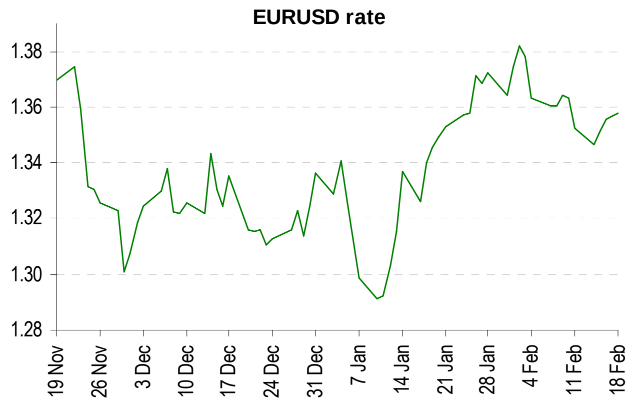
Anna Zielińska-Głębocka, MPC member; PAP, 16 February

MPC will have a serious challenge already in March, there will be long discussion. Either March or the next quarter requires a decision [to hike rates]. A tightening of monetary policy is inevitable. We will see whether it will be totally 100bps or slightly less. The MPC cannot be late and allow inflation to accelerate. (…) We all were somewhat surprised by the scale of inflation rise in January. I predicted 3.4-3.5%. (…) The MPC should seriously consider how to anchor inflation expectations.

Strongly surprising inflation data triggered many comments from MPC members. Prof. Zielińska-Głębocka said explicitly that the level of CPI inflation in January surprised all central bankers. One may suppose that this led to some changes in opinions of MPC members on needed timing and overall scale of interest rate hikes. Indirectly this is indicated by comment from prof. Chojna-Duch, who said that in March a rate hike is equally likely as leaving rates on hold, while earlier she claimed that rates may be keep unchanged for some time. This confirms that probability of a rate hike in March has increased, although it is worth to note that comments from moderate hawk (Zielińska-Głębocka) does not indicate that a hike is a done-deal. Only radical hawk Winiecki said he is already know convinced to hike in March.

Market monitor

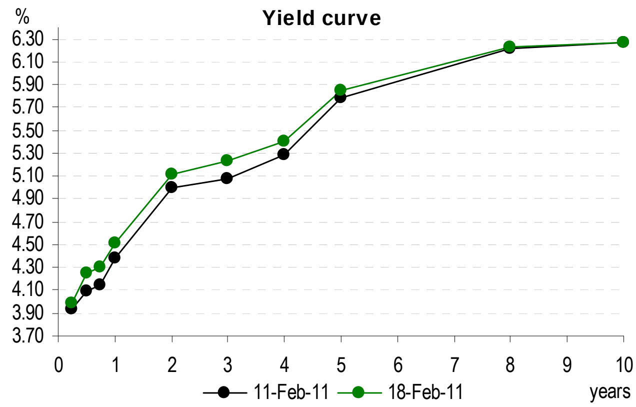


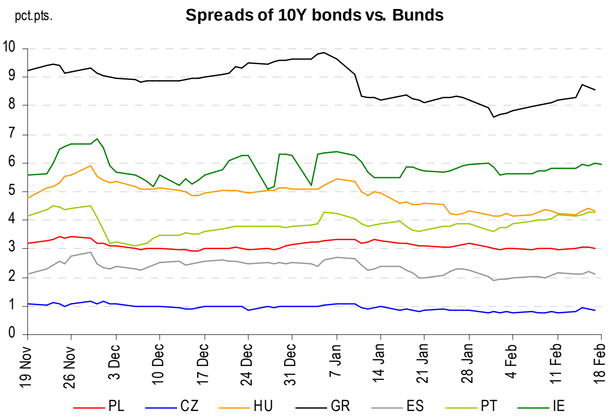


CPI supports the zloty

▪ After an initial weakening of the zloty to 3.95 against the euro and to 2.93 against the dollar due to diminishing market expectations of interest rate hikes and news on difficulties of German WestLB bank, the domestic currency rebounded thanks to the CPI which was strongly above expectations. The expectations of rate hikes in Poland revived and brought EURPLN to almost 3.89. The Hungarian forint and Czech crown weakened along with the zloty earlier in the week. Later during the week the GDP figures in Q4 2010 supported the forint and the lower than expected growth in the Czech Republic weakened the crown further. We are of opinion that the zloty weakening which occurred on Friday will be continued this week. The EURPLN exchange rate rebounded from the support and upward trend line at 3.89. We expect that it may approach resistance at 3.95 in the coming days.

▪ On Monday EURUSD tested the support at 1.35 but failed to break it and in due course climbed throughout the week to resistance at 1.36. The euro was supported by the overall improvement of global markets' sentiment which was triggered by a better outlook for the US economy presented in the Minutes from the last Fed's meeting. The Friday's decision of China's Central Bank to hike reserve requirement ratio supported the dollar only for a while as Lorenzo Bini Smaghi of the ECB stated that the bank is ready to hike interest rates if needed. If the EURUSD remains above 1.36, then it could come close to 1.375 this week. Otherwise it might drop to 1.35.





Flattening of the domestic yield curve

▪ Over the past week the domestic yield curve flattened quite visibly due to surge of short term yields after higher than expected data January's CPI. The long end was relatively stable despite some deterioration of market sentiment that occurred later in the week (uncertain situation in the Middle East and worries over PIIGS countries). In case of higher risk aversion, this week yields in that segment of the curve may increase, but widening of spread versus Bunds may be perceived as an opportunity to purchase 10Y bonds and consequently that securities may pare loses. We expect that a week before the MPC meeting the FRA rates and short term yields will maintain at present elevated level.

▪ Yields on the core fixed income markets plunged over the past week. That was due to higher risk aversion at the beginning of the week, positive results of Bunds' auction and deterioration of situation on the debt market of peripheral Europe.

▪ Auctions of Portuguese and Spanish bonds were pretty good received by the market, but spreads versus 10Y Bunds increased. That was mainly due to Bunds' yields drop, but deterioration of sentiment in case of Portugal also put a negative pressure on the debt market of the European periphery. At the end of the week uncertainty if that country manages to collect from the market sufficient amount of cash and some worries it may need external help emerged. We expect, that this story may play main role also this week and even amid expected by us good macro data the market sentiment may deteriorate further. Especially as on Thursday and Friday Italy will try to sell its bonds.

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