Bank Zachodni WBK

Weekly economic update

18 – 24 July 2011

Last week saw very large fluctuations in financial markets (especially in the early days of the week) triggered by many important events. On Monday and at the start of Tuesday's session investors were feeling from euro area peripheral countries' bonds and a strong surge in risk aversion took place, which clearly weakened the Polish currency and bonds. This was related to building concerns about Italy's debt problems. The rest of the week, however, saw a rebound in risk appetite after the good results of US companies, quite good results of debt auctions in Greece and Italy, news about chances for approval of savings plan in Italy by the end of the week, and Fed governor's comments about the conditional possibility of introducing QE3. However, there was still a number of bad news around – Moody's and S&P's placed the US rating of the watch lists because of the impasse on raising debt limit. At the end of the week markets remained nervous before events planned for Friday evening, i.e. the final vote on austerity plan in Italy, and the publication of stress tests of European banks. After a sudden rise at the start of the week to almost 4.06, the EURPLN fluctuated subsequently in the range of 4.00-4.06. Domestic bonds not only erased losses from early week but even strengthened, with, apart from improving global sentiment, was supported by much lower than expected CPI inflation.

This week, there is a lot of domestic data releases in the agenda. In case of wage growth, we expect significantly higher reading than the market consensus, which may support the zloty and promote a correction of recent decrease in yields of domestic bonds. However, the most important will be events abroad, including reaction to the publication of stress test results, a vote in Italy, and a meeting of euro zone's finance ministers that was initially anticipated last Friday. In addition, publication of firms' earnings reports and macro data will be important (in particular, activity indicators for the euro zone and the US) that will allow better assessment of the condition of the global economy at the start of the third quarter. The persisting uncertainty in the global market is likely to keep the EURPLN rate between 4.00 and 4.06.

Economic calendar

Time CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (18 July)					
	JP	Market holiday					
14:00	**PL**	**Wages in corporate sector**	**Jun**	**% YoY**	**5.0**	**6.5**	**4.1**
14:00	**PL**	**Employment in corporate sector**	**Jun**	**% YoY**	**3.5**	**3.5**	**3.6**
		TUESDAY (19 July)					
11:00	DE	ZEW index	Jul	pts	-12.4	-	-9.0
14:00	**PL**	**Industrial output**	**Jun**	**% YoY**	**5.8**	**4.9**	**7.7**
14:00	**PL**	**Construction and assembly output**	**Jun**	**% YoY**	**18.4**	**18.4**	**23.9**
14:00	**PL**	**PPI**	**Jun**	**% YoY**	**5.6**	**6.0**	**6.5**
14:30	US	House starts	Jun	k	573	-	560
14:30	US	Building permits	Jun	k	590	-	609
		WEDNESDAY (20 July)					
14:00	**PL**	**Core inflation**	**Jun**	**% YoY**	**2.5**	**2.6**	**2.4**
16:00	US	Home sales	Jun	m	4.90	-	4.81
		THURSDAY (21 July)					
	PL	**Auction of DS1021 bonds worth PLN1.0-3.0bn**					
4:30	CN	Flash PMI – manufacturing	Jul		-	-	50.1
9:28	DE	Flash PMI – manufacturing	Jul	pts	54.0	-	54.6
9:58	EZ	Flash PMI – manufacturing	Jul	pts	51.5	-	52.0
14:30	US	Initial jobless claims	week	k	415	-	
16:00	US	Leading indicators	Jun	%	0.2	-	0.8
16:00	US	Philly Fed index	Jul	pts	5.0	-	-7.7
		FRIDAY (22 July)					
10:00	DE	Ifo index	Jul	pts	113.8	-	114.5
11:00	EZ	New industrial orders	May	% MoM	0.6	-	0.7

Source: BZ WBK, Parkiet, Reuters

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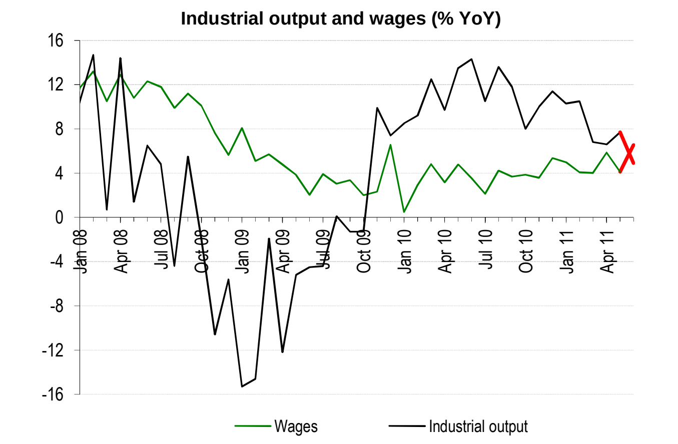
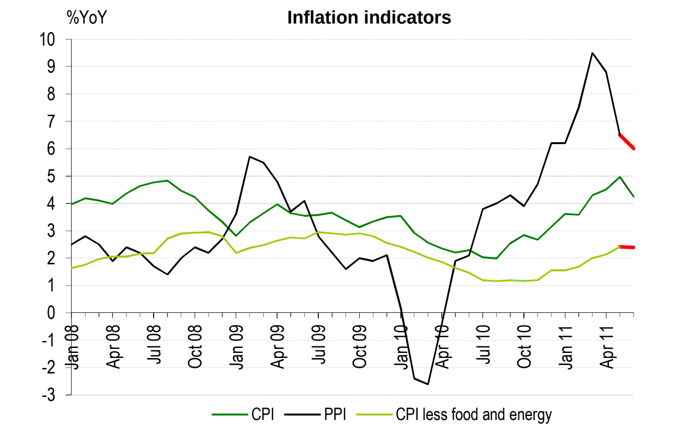
What's hot this week – Domestic data and many crucial events abroad

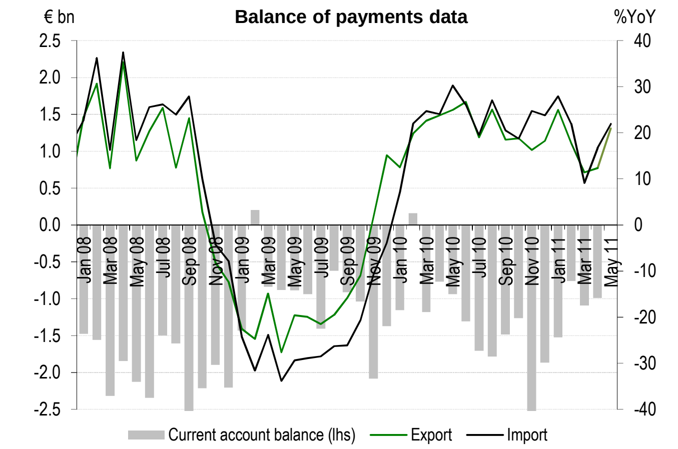


- We expect a slowdown in positive tendencies on the labour market, which is suggested, among other, by a drop in employment subindex of Polish PMI. In our view the pace of employment will decline to 3.5%, but it will remain above 3% in the upcoming months. We see June to bring a considerable acceleration of wages, to 6.5% YoY from 4.1% in May, which resulted mostly from wage rises (and compensation for previous months) as well as bonuses in the mining sector.
- We anticipate a substantial slowdown in domestic industrial output to 4.9% YoY (consensus at 5.8%), which will result from waning foreign demand. Our forecast is supported by drops in new orders and production PMI indices. On the other hand, the construction output will show a solid growth at 18.4% YoY, thanks to buoyant road infrastructure sector.

Last week in the economy – Low CPI, temporarily balanced C/A



- After the surprising rise of inflation in May to 5%, in June we have a downward surprise – a fall to 4.2%. We see three main drivers of that drop: 1. decline of vegetables' prices (a typical seasonal factor, but probably strengthened by "E. coli effect"); 2. decreasing sugar prices (reversal in upward tendency from March-April); 3. Discounts in mobile networks, lowering the prices in communication category. In upcoming months we see inflation above 4.2%.
- According to our estimates the core inflation remained at May level at 2.4%. In the upcoming month we expect it to increase further.
- In June we expect a rise in PPI inflation by 0.5% MoM, due to a zloty weakening. However, the yearly pace of PPI will decrease to 6.0% (high base effect).



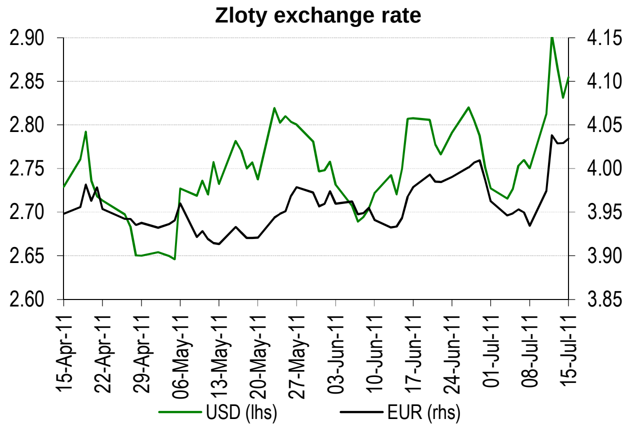
- NBP data showed that C/A was balanced in May with trade gap at €980m (close to our expectations) while exports and imports higher than we predicted. The balanced C/A is temporary due to exceptionally high inflow of EU transfers in May. Coverage of 12M C/A gap by inflow of long term capital deteriorated again with FDIs covering merely 7% of the gap and FDIs plus EU funds covering 53% of the gap.
- According to the NBP data, M3 money supply advanced in June by 7.1% YoY, clearly above forecasts (consensus at 7.9%). While a slowdown was recorded by both deposits and loans, the data have shown a further acceleration of corporate loans, which expanded by 7.0% YoY. An exchange rate adjusted figure showed a growth by 6.9% YoY against 5.1% in May.

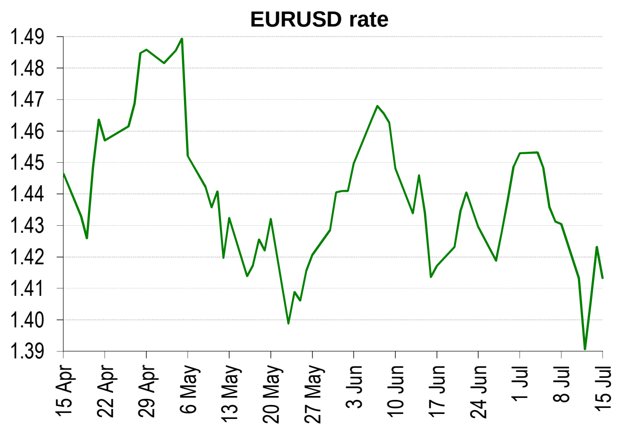
Quote of the week – Monetary tightening should be continued

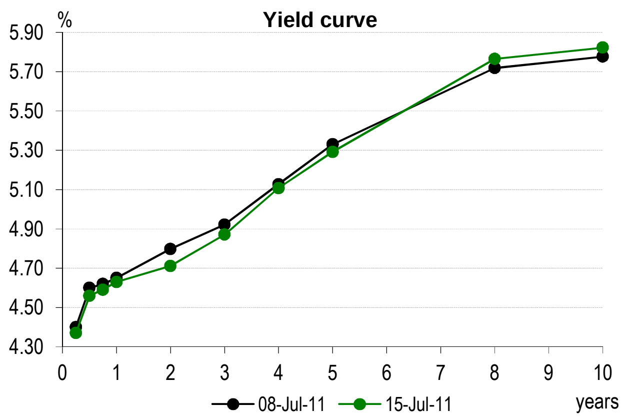
Elżbieta Chojna-Duch, MPC member, Reuters, 13 July
Inflation data show that the MPC decison to pause rate hikes was right. Deep slowdown in inflation and inflationary pressures is a fact. In the next months there will probably be slow decline in consumer and core inflation.
Anna Zielińska-Głębocka, MPC member, Reuters, 13 July
Based on single data it is hard to change bias in monetary policy. Inflation above 4% is still a high level.
Andrzej Kaźmierczak, MPC member, PAP, 11 July
The process of monetary tightening should be continued. (…) The decisive factor will be inflation indicator for July and assessment whether it entered a clearly downward trend or stabilized at elevated level.

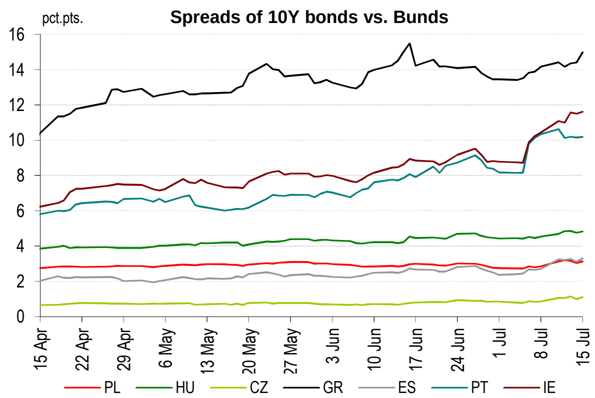
Following surprisingly low reading of CPI for June, the most dovish MPC member, prof. Chojna-Duch was strengthened in her view that further monetary tightening is not needed. According to relatively hawkish prof. Zielińska-Głębocka, CPI data for June do not change (restrictive) bias in monetary policy. Comments from moderate rate-setter,prof. Kaźmierczak, point to a need of further monetary tightening. CPI figures for June released after his comments rather had not changed his views as he declared that CPI inflation above 4% is not acceptable. Meanwhile, our forecasts indicate that CPI inflation will remain above 4% until the end of this year.

Market monitor









Zloty still influenced by global uncertainty

- The beginning of last week showed significant zloty depreciation. EURPLN reached the weekly maximum around 4.06 against 3.95 at the end of the previous week. USDPLN was up even more significantly (weekly max. 2.93) amid sharp weakening of the euro against the US dollar. EURUSD fell below the level of 1.42, which we indicated a week ago and then easily broke the psychological barrier at 1.40, reaching the weekly minimum at 1.384. Investors' concerns as regards Italy's fiscal position was the main reason. The remainder of the week brought the reversal in market sentiment and higher appetite for risky assets after positive data releases and companies' results in the US, information on possibility of adopting austerity plan in Italy until weekend and comments by Fed chief Bernanke on a conditional possibility of QE3. At the same time, decisions by Moody's and S&P on placing the US on the watch list (due to prolonging discussion on debt limit) were negative for the Us dollar. As a result, EURUSD was back to ca. 1.42 and the Polish currency recovered approaching 4.0 against the euro. With some increase in global uncertainty at the very end of the week EURPLN rose to above 4.02.
- This week EURUSD will be still under influence of conflicting impact of sovereign debt problems in the euro zone and the US, which is likely to keep pressure on risky assets. We expect EURUSD to trade in 1.40-1.445 range and with higher risk aversion EURPLN will maintain above 4.0. We see the key resistance level and the upper limit of trading range for this week at 4.06.

Time for corrective rise in yields

- Similarly as in the FX market, also changes in the debt markets were very significant last week. Domestic bonds began the week with clear weakening amid escape to the most safe assets. In the first two days of the week the domestic yield curve shifted upwards by 7-13 bp, with stronger move at the long end than for shorter dated bonds. Bonds of the peripheral euro area countries lost even much more. Their yields, spreads versus Bunds, and CDS rates reached record high levels. Yields in the core debt markets recorded some of the biggest declines during the ongoing crisis. The minimum levels of yields of 10Y Bunds and Treasuries recorded during the week are respectively 2.49% and 2.81%. Amid improvement of market sentiment later in the week, domestic bonds were gradually erasing losses, and this was reinforced by much lower than expected CPI inflation for June. As a result, by the end of the week the yield curve shifted downwards from the maximum levels by 7 to 16 bp, with bigger movement at the short end. All in all, the domestic yield curve steepened last week. Improved sentiment on global markets has triggered a rebound in peripheral euro zone debt markets and a correction of gains in core markets. At the end of the week, yields on 10Y Bunds and Treasuries were respectively 2.69% and 2.96%.
- This week, we expect a correction of recent fall in yields, which will be promoted by the continued anxiety in global markets and domestic data on wage growth.

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