19 July 2019

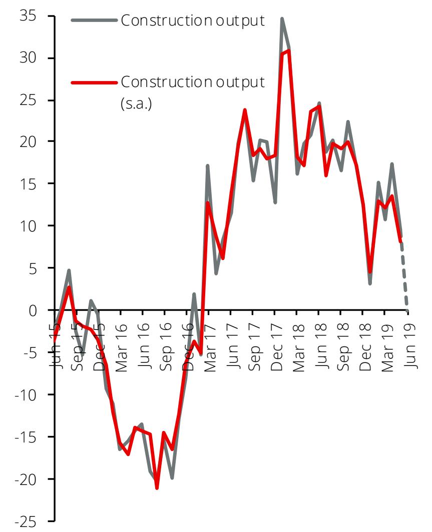
Weekly Economic Update

ECB to open door for rate cuts

What's hot next week

- The last week's set of data releases for June confirmed slowdown of economic activity in Q2 and at the same time the upward trend of inflation. In our view, the weak readings of wages industrial output and retail sales were largely caused by one-off disruptions (lower number of working days, calendar favouring longer holiday breaks, extremely hot weather). Nevertheless, they will negatively affect GDP growth in Q2 – according to our forecast growth slowed to 4.5% y/y from 4.7% in Q1.
- In the coming weeks we will see few more domestic data, which will complement the information set for the second quarter, including **construction output**, which – likewise manufacturing or retail trade – probably slowed sharply in June. Our forecast (0% y/y) is at the low end of market expectations' spectrum. Moreover, the Statistical Bulletin will reveal a bit more detailed information helping to investigate sources of surprising weakness of wage growth in June. **Business climate indicators for July** will be released as well, casting some light on economic activity at the start of Q3.
- After the last data releases some economists, which used to lift their forecasts of this year's GDP growth to 5% not so long ago, started withdrawing from such optimistic predictions. Our forecast of this year's GDP growth remains safe at 4.3%.
- In Europe a bout of leading indicators are due for release, including **German Ifo and flash PMIs**. The market consensus is expecting some improvement in industry and services, signalling that the trough in the euro zone business climate is behind us.
- **ECB meeting** on Thursday is the key event of the week. Even if business sentiment indicators in the euro zone come out strong, the market will not abandon its expectations for imminent rate cuts. In our view, cuts in July are not very likely but, but **we are expecting a shift in the ECB rhetoric** and modification of the forward guidance, opening the door to further policy easing after the summer. Such a change is widely expected and should be market-neutral.
- Meanwhile, investors will eye situation in the United Kingdom, where we will get to know the name of the new PM on Tuesday. Most likely this will be **Boris Johnson**, so worries about hard Brexit will stay. The pound is probable to stay under pressure at least until autumn.
- The week will end with the **first release of the US GDP in 2Q19**, which is likely to show a slowdown. This could boost market expectations for rate cuts in the USA. Chances for cuts at the incoming meeting scheduled for 30 July are already perceived high.

Construction output, % y/y



Source: GUS, Santander

Market implications

- The zloty gained thanks to dovish signals from the ECB and the Fed as well as to weaker dollar, but we are not expecting this trend to hold. The market is already aggressively pricing-in easier monetary policy of main central banks. At the same time, Polish data will deliver further arguments to correct the excess optimism about GDP growth this year. As regards debt, we are expecting yields to stabilise at current low levels.

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Last week in economy

June was an interesting month, as a combination of low number of working days (-2 in annual terms), Corpus Christi holiday creating an opportunity for long weekend leaves and record-high temperatures have strongly negatively affected data on industrial output, wages and retail sales, which generally backed our expectations that GDP growth decelerated to 4.5% y/y in 2Q19.

Industrial output contracted by 2.7% y/y in June, markedly below expectations and versus growth by 7.7% y/y in May. In our view the fact that the deceleration was broad-based across the sectors, both in export- and domestic-oriented branches suggest that the slump was not due to a sudden slowdown in foreign demand. Statistics covering orders in industry, also those coming from abroad, show no deceleration, or even some improvement, so we blame the weak results mostly on one-offs and expect a rebound in the months to come.

Real retail sales decelerated to 3.7% y/y in June, in line with our expectations and versus 5.6% y/y in May. The slowdown was especially pronounced in durables, which expanded by 6.8% y/y after three months in a row with growth rates above 15% y/y. Non-durables slowed only slightly, to 2.6% y/y from 3.0% y/y and the deceleration was mild thanks to clothing sales, which advanced by 12.9% y/y, setting this year's high. Behaviour of clothing sales has strongly deviated from the seasonal pattern. This could have been caused by record high temperatures in June.

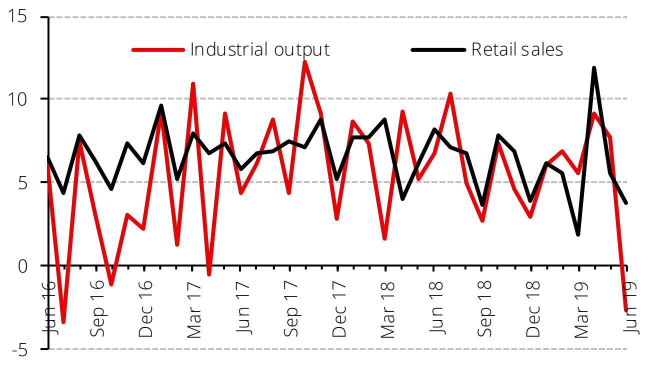
Wage growth slowed in June to 5.3% y/y, well below expectations, while employment accelerated to 2.8% y/y, slightly more than predicted. We gather that the wage growth slowdown was only temporary and next months should see re-acceleration. Anyway, the data are clearly dovish and will probably reassure the central bank in its view that there is no significant risk of evolving price-wage spiral. Despite weak wage growth **consumers remain quite optimistic**. In July consumer confidence deteriorated slightly both as regards the assessment of the current and future situation. However, both indicators are still close to record high levels. Thus the outlook for private consumption remains optimistic, as it will be strongly supported by social transfers.

CPI inflation rose in June to 2.6% y/y, in line with the flash estimate, and for the first time in seven years it exceeded the inflation target. The growth was driven by prices of food (5.7% y/y) and core inflation, which reached 1.9%. The surge in core is fuelled mainly by services prices, which accelerated to 3.9% y/y. We stick to our view that inflation will continue climbing in the coming quarters faster than the central bank predicts. CPI may stabilise during the summer months, but it will near 3% y/y in December 2019 and may reach even 4% in January 2020. For the most hawkish MPC members it would be more than enough to file in motions for rate hikes. However, we think that the majority of the MPC will stick to NBP President's view that the higher inflation will be temporary and should be looked through, especially in the environment of slowing global economy and mode dovish Fed and ECB.

The government accepted a draft bill **reducing the lowest PIT rate** from 18% to 17% and raising tax deductible expenses. The changes should be effective since October 1st. The cost of those reforms will total PLN9.7bn in the full year.

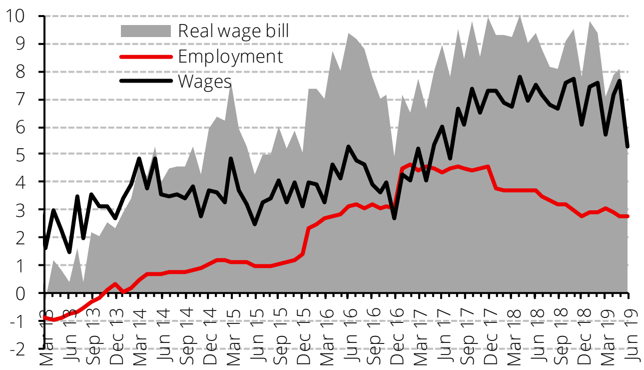
Poland's current account reached EUR1bn surplus in May, almost twice as much as expected. Both exports and imports beat expectations, showing a clear revival to 13.3% y/y and 11.2% y/y, respectively. The rolling 12M current account balance reached almost zero. The strength of export growth is especially noteworthy, as it not only decoupled from the trend in German exports but also clearly outperformed Polish manufacturing. We still think that such impressive performance will be hard to maintain for much longer and the trade balance will deteriorate later this year.

Industrial output and retail sales, % y/y



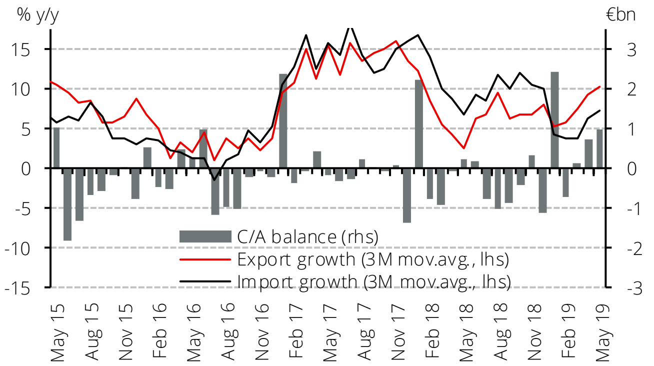
Source: GUS, Santander

Labour market statistics, % y/y



Source: GUS, Santander

Balance of payments data



Source: NBP, Santander

Quote of the week:

Łukasz Hardt, MPC member, PAP, 15/07/2019: July inflation projection shows CPI persistently above 2.5% and not returning to the target until end of 2021. In my view, if CPI actually follows this path, then the monetary policy should respond with hikes, maybe at the end of 2019. However, currently it is too early to make such a decision and there are numerous uncertainty factors. However, if we see data supporting the view that inflation will remain above 2.5%, then we need to react.

Kamil Zubelewicz, MPC member, PAP, 18/07/2019: Currently I am not expecting interest rate changes, but it is highly probable that motions for hikes will appear in the final months of the year, if prices develop in line with the current NBP forecasts. However, the current MPC's propensity to react is low, even though some MPC members feel uncomfortable about the price growth outlook. In my view there is a high probability that the current MPC will not change rates until the end of the term.

FX and FI market

Last week on the market

FX The zloty recovered somewhat after the previous week noticeable depreciation and EURPLN eased to 4.255 from 4.27, USDPLN pulled back below 3.80, CHFPLN stabilized around 3.84 and GBPPLN stayed close to 4.75. The Polish currency benefited from the dovish signals from the ECB and Fed and weaker dollar.

FI Polish IRS and bond yields did not continue the upside correction that started in the previous week and returned to or even below their local lows reached in the first part of July. In contrast to our expectations, yields rise on the core markets was only temporary with Bunds and Treasuries resuming strengthening driven by the dovish signals from the central banks. In Poland, the 2-10 bond yield spread stopped to decline, just like the 10Y PL-DE bond spread. The Polish 10Y asset swap spread continued to fall and reached its lowest since October 2018.

Key events

In the recent days, EURPLN and EURUSD were moving in the range but the events scheduled for the coming week could trigger higher volatility.

On Thursday, the ECB will hold a post-meeting press conference. In the recent weeks, we have heard some dovish (but often unofficial) signals from the central bank. We think that in July, the ECB would only soften its rhetoric, probably suggesting there is room for lower interest rates.

On Wednesday, we will see flash July manufacturing and services PMIs. Services indexes for Germany and the whole euro zone look good but the manufacturing ones are dangerously close to their multi-month lows. The Ifo index (due the next day) is also far from reassuring us that the bottom of slowdown is behind. Consensus expects manufacturing PMI and Ifo rose slightly and the release could set the economic outlook for Europe at least in the short term.

The week will end with the first estimate of the US 2Q GDP growth. The market is already pricing 25bp Fed rate cut to be delivered on 31 of July and sees c50% probability of a 50pb cut.

In Poland, data on the construction output will be the last missing piece in the 2Q picture. On Friday, the Ministry of Finance will hold a bond auction.

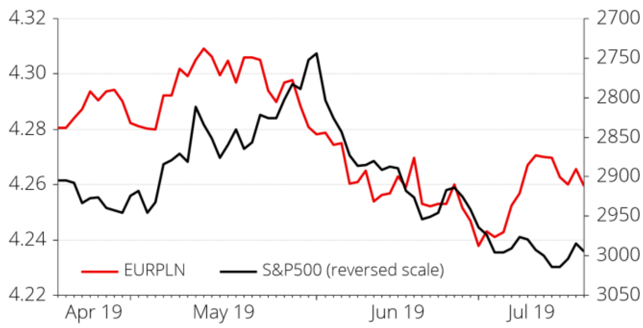
Market implications

FX Last week, EURPLN remained in the trading range determined by the high and low from the previous week. We think the zloty could be weaker in the weeks to come. The recent Polish macro data provided pretty strong evidence that the economic growth probably slowed down in 2Q. At the same time, inflation continues to climb and the MPC rhetoric remains neutral. The combination of the weaker GDP growth and rising CPI shall not be supportive for the zloty, particularly after the noticeable appreciation recorded in the previous weeks. We do not assume the coming signals from the central banks to exceed investors' expectations and provide support for the zloty. Interestingly, according to Bloomberg, the CEE currencies are underperforming the rest of their EM peers vs the euro and the dollar in month-to-date terms.

FI We do not expect the core bond yields to break the early-July lows since the ECB rhetoric could be market neutral. As a consequence, the room for further drop of the Polish bond yields looks to be limited since the 10Y PL-DE spread is near the c250bp support.

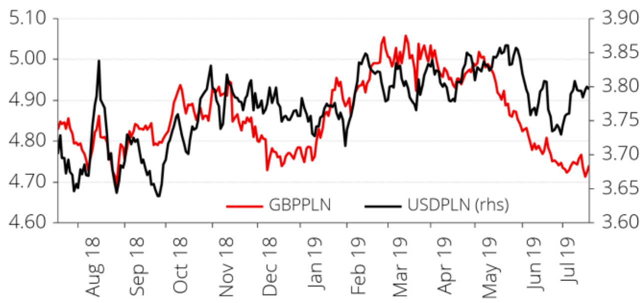
The Polish bond auction should be pretty successful at least for two reasons. First, the bond supply in 3Q, as announced by the Ministry of Finance, shall range PLN7-13bn with PLN4-7bn planned for Friday. That day, cPLN10bn from maturing PS0719 and coupon payments are due and this should support the demand.

EURPLN and S&P500



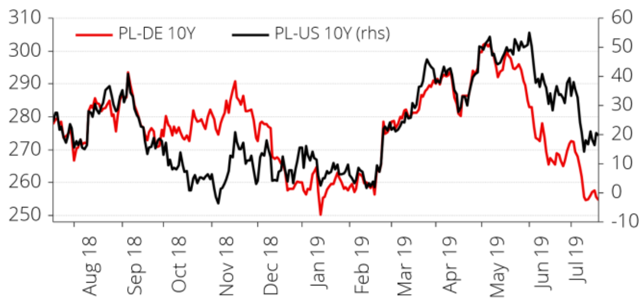
Source: Refinitiv Datastream, Santander Bank Polska

USDPLN and GBPPLN



Source: Refinitiv Datastream, Santander Bank Polska

10Y PL-DE and PL-US bond yield spreads (bp)



Source: Refinitiv Datastream, Santander Bank Polska

2-10 spreads (bp)

Source: Refinitiv Datastream, Santander Bank Polska

Economic Calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST SANTANDER	LAST VALUE
			MONDAY (22 July)				
14:00	**PL**	**Money Supply M3**	**Jun**	**% y/y**	**10.2**	**10.3**	**9.9**
			TUESDAY (23 July)				
10:00	**PL**	**Construction Output**	**Jun**	**% y/y**	**3.1**	**0.0**	**9.6**
10:00	**PL**	**Unemployment Rate**	**Jun**	**%**	**5.3**	**5.3**	**5.4**
14:00	HU	Central Bank Rate Decision		%	0.9	-	0.9
16:00	US	Existing Home Sales	Jun	% m/m	0.1	-	2.5
			WEDNESDAY (24 July)				
09:30	DE	Flash Germany Manufacturing PMI	Jul	pts	45.2	-	45.0
09:30	DE	Flash Markit Germany Services PMI	Jul	pts	55.3	-	55.8
10:00	EZ	Flash Eurozone Manufacturing PMI	Jul	pts	47.8	-	47.6
10:00	EZ	Flash Eurozone Services PMI	Jul	pts	53.5	-	53.6
16:00	US	New Home Sales	Jun	% m/m	5.27	-	-7.8
			THURSDAY (25 July)				
10:00	DE	IFO Business Climate	Jul	pts	97.2	-	97.4
13:45	EZ	ECB Main Refinancing Rate		%	0.0	-	0.0
14:30	US	Durable Goods Orders	Jun	% m/m	0.8	-	-1.3
14:30	US	Initial Jobless Claims	week	k	215	-	216
			FRIDAY (26 July)				
11:00	**PL**	**Bond auction**					
14:30	US	Advance GDP	2Q	% q/q	1.8	-	3.1

Source: Santander Bank Polska, Reuters, Parkiet, Bloomberg

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