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Polish Weekly Review

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Table of contents

Comment on the upcoming data and forecasts

Last week of February begins with the release of retail sales data along with the Statistical Bulletin. The retail sales figure is a result of contradictory tendencies: negative calendar effects and a possible pause after a strong December on one hand; strengthening domestic demand and buoyant car sales due to tax breaks introduced this year. Unemployment rate has already been estimated by the Ministry of Labor and one shouldn't expect a revision in GUS data. Finally, the week will end with the release of final GDP figures. While the headline growth probably will not change, details of the release might be important. From annual data we can calculate that consumption grew by about 2% and investment by 1.3%. Modest domestic demand will likely be accompanied by a surprisingly high contribution from net exports.

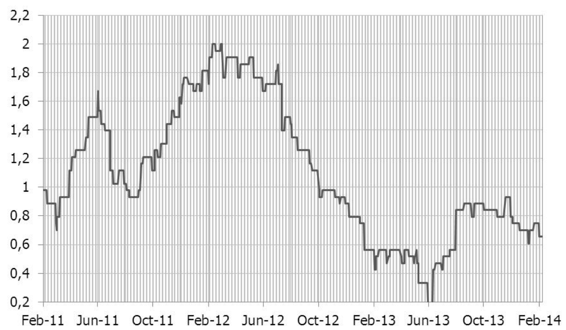
Polish data to watch: February 24th to February 28th

Publication	Date	Period	mBank	Consensus	Prior
Retail sales y/y (%)	24.02	Jan	5.4	4.6	5.8
Unemployment rate (%)	24.02	Jan	14.0	14.0	13.4
GDP y/y *final* (%)	28.02	Q4	2.7	2.7	2.7
NBP inflation expectations (%)	28.02	Feb	0.4	0.6	0.5

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
52 Week T-bills	-	3000	3.485	3/4/2013
2Y T-bond OK0716	-	1200	3.181	2/6/2014
5Y T-bond PS0718	-	2000	3.882	2/13/2014
10Y T-bond DS1023	-	2000	4.541	2/13/2014
20Y T-bond WS0429	-	150	3.464	5/16/2013

Reality vs analysts' expectations (surprise index* for Poland)



Comment

Unchanged. A relatively quiet week ahead with one possible surprise: retail sales data. The consolidation phase of the surprise index is still on.

* Surprise index presents in a synthetic way how the market was surprised by macroeconomic releases (it is constructed on daily basis as weighted average of differences between selected releases and Bloomberg forecast consensus).

Our view in a nutshell

Fundamentals

- Available data confirm that the long-awaited recovery began at the turn of Q2/Q3.
- GDP growth accelerated to 2.7% in the final quarter of 2013. We are also bullish on 2014 and expect the Polish economy to grow by 3.5% (4% in the final quarter). Consensus view has been converging to our bullish scenario.
- The upswing has recently been driven by exports that behaves much better than in previous upswing episodes (Polish economy is more competitive and more geografically diversified). Consumption has already joined and we see no obstacles for its further, gradual strenghtening. We expect the support from investment activity to kick in more substantially at the start of 2014. Private investment is to be supported by receding uncertainty, public investment is to benefit from new EU co-financed projects.
- The turmoil in Ukraine made us put a downside risk to our forecast. We see a potential fallout amounting to 0.2-0.4pp. of 2014 GDP growth. We are going to monitor situation closely as prolonged conflict is also very likely to negatively affect: 1) Polish trade with other eastern partners (e. g. Kazakhstan, Russia), 2) Polish investment activity through the uncertainty channel; we cannot exclude that such an effect would be far more devastating than trade linkages (though less likely).
- Pension reform, along with the political cycle, opens room for fiscal stimulation. We expect significant fiscal stimulus from 2014 onwards, focused mainly on public infrastructure spending and fueled by the re-launch of EU funding. Thus, 2-3 years of solid economic growth are our baseline scenario.
- Inflation stays subdued for the next few months and this is going to dominate the outlook for Polish rates supporting stable NBP benchmarks.
- We expect first rate hikes to materialize at the turn of 2014/2015. The MPC is dovish, inflation projection is going to emphasize non-inflationary growth and MPC members are afraid of massive inflows of portfolio capital that could overly strengthen the zloty. We still believe than in longer horizon the MPC is going to be caught off guard by upward sloping inflation path that should eventually result in tightening.

Financial markets

- We are constructive on Polish bonds (outright in a few month perspective and vs. German bunds in a longer perspective). The main reasons are positive Polish credit story (sustainable recovery, lower debt to GDP ratio due to OFE revamp, good chance of a rating upgrade) along with European low yield environment, still dovish MPC (much more than the official statement suggest) and decent real yields.
- Correlation of Polish bonds with other EM countries ought to be much lower than in the past. At the end of the day, Poland should be seen rather as a satellite state of the euro zone, not a typical EM and absorb part of funds originally re-directed from EMs to Europe (cross-over investors set to generate marginal demand).
- Liquidation of OFEs' bond portfolios changes the structure of Polish debt funding (higher percentage of foreign investors and possibly lower market liquidity). Thus, Polish bonds are set to be more than ever exposed to global trends (positive now and negative due to globally rising yields in H2). In the short term the issue of rebalancing global bond indices is worth to be monitored.
- Zloty should gradually strengthen on the back of cyclical recovery in Poland. However, basket sell-offs (all EMs) might temporarily weigh negatively on the Zloty. Any depreciation is unlikely to be deep (as in the "Fragile Five") as Poland's fundamentals are comparably strong (record low CA deficit, high real rates, low short-term foreign debt, etc.). Let's not forget about the possibility of NBP interventions should things get out of line with reason.

mBank forecasts

	2009	2010	2011	2012	2013	2014F
GDP y/y (%)	1.6	3.9	4.5	1.9	1.6	3.5
CPI Inflation y/y (average %)	3.5	2.8	4.3	3.7	0.9	1.7
Current account (%GDP)	-1.6	-4.5	-4.9	-3.5	-1.5	-2.3
Unemployment rate (end of period %)	12.1	12.4	12.5	13.4	13.4	13.0
Repo rate (end of period %)	3.50	3.50	4.50	4.25	2.50	2.75

	2013 Q1	2013 Q2	2013 Q3	2013 Q4 F	2014 Q1 F	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.5	0.8	1.9	2.7	3.1	3.3	3.5	4.0
Individual consumption y/y (%)	0.0	0.2	1.0	2.0	2.5	2.5	2.5	2.8
Public Consumption y/y (%)	-0.1	4.3	1.7	1.2	2.0	2.0	2.0	3.0
Investment y/y (%)	-2.1	-3.2	0.6	1.3	4.5	5.9	7.1	8.0
Inflation rate (% average)	1.3	0.5	1.1	0.8	1.2	1.7	1.6	2.4
Unemployment rate (% eop)	14.3	13.2	13.0	13.4	13.9	12.6	12.4	13.0
NBP repo rate (% eop)	3.25	2.75	2.50	2.50	2.50	2.50	2.50	2.75
Wibor 3M (% eop)	3.39	2.73	2.67	2.71	2.65	2.65	2.65	2.95
2Y Polish bond yields (% eop)	3.19	3.07	3.06	3.05	3.10	3.10	3.20	3.25
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.30	4.50	4.80	5.00
EUR/PLN (eop)	4.18	4.33	4.22	4.15	4.15	4.10	4.05	3.95
USD/PLN (eop)	3.26	3.32	3.12	3.02	3.11	3.21	3.24	3.25

F - forecast

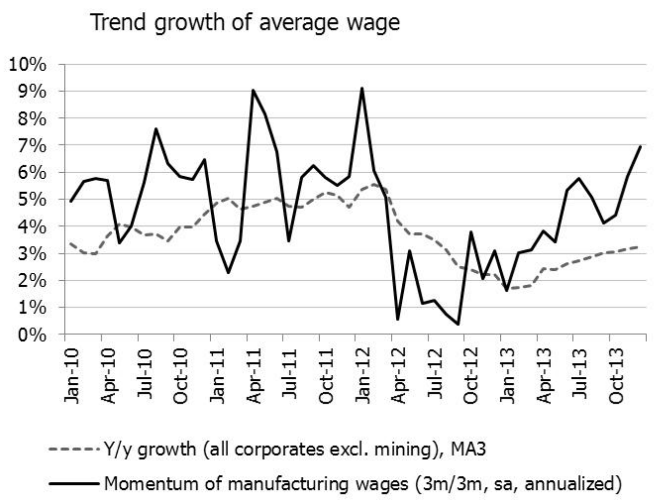
Economics

The economy hasn’t lost momentum in January but rate hikes are nowhere in sight

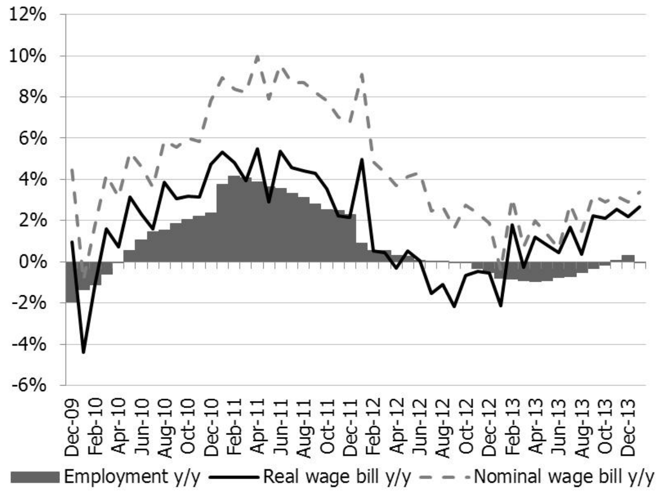
At first glance, last week’s releases were a mixed bag. Employment remained flat on annual basis, industrial output slowed down and construction output contracted, despite expectations of sustained annual growth. But January is in many ways special: strong seasonality, base effects and methodological changes (the case of employment). Below the mixed headlines there is a sustained momentum that should carry the Polish economy onwards. Monetary policy, on the other hand, remained pleasantly boring. The MPC is waiting for the new staff projections but this - in light of some comments from some policy makers (Hausner) - is unlikely to change the Council’s dovish stance.

As usual, we present a brief summary of this week’s data.

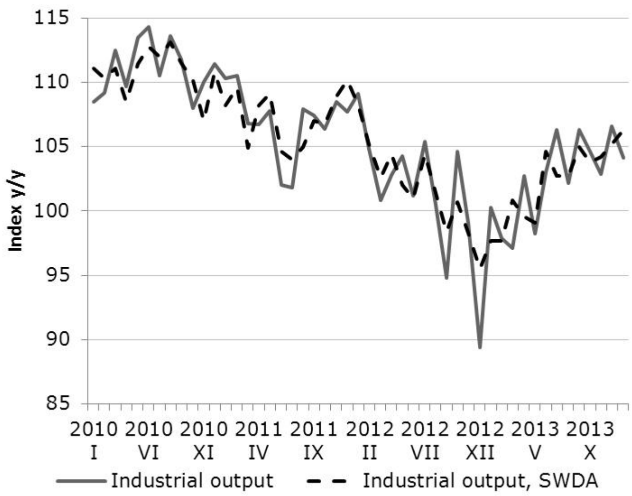
Wages grew in January by 3.4% y/y after 2.7% in the previous month (acceleration was recorded despite a negative annual difference in the number of working days). The increase was a little bit higher than market consensus had stipulated. However, it was lower than our forecast. In our view, a slight disappointment could have been triggered by higher volatility of wages in mining at the start of the year. Hence, the divergence can be exogenous in nature. Therefore we sustain our view that the trend in manufacturing wages is steepening and now hovers around 3.5% versus 2.5% some months ago. Wages are set to grow by 4.5% in the second half of the year.



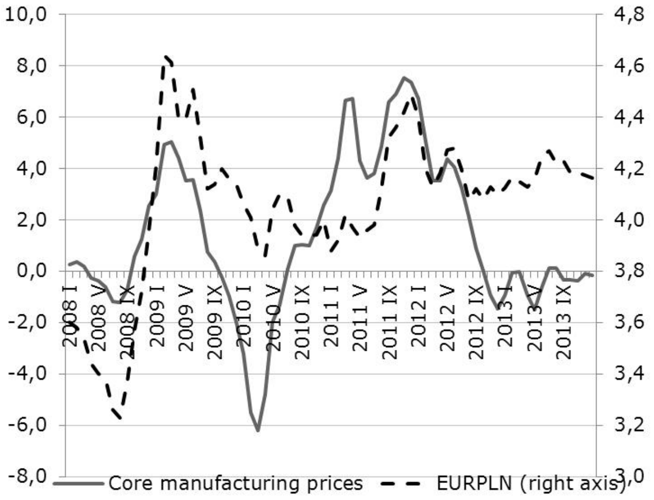
Employment in the enterprise sector stayed flat on annual basis in January (our call 0.6%, market consensus 0.6%). Compared to December’s reading (+0.3% y/y), current growth of employment may be read by some as disappointing. However, as we already stressed in our previous comment, January is the month when the statistical office changes the control sample of enterprises. Therefore the series of employment always records a jump whose size is usually correlated with the strength of the labor market in the previous year but does not reflect the strength of the current employment momentum. We stick to our scenario of gradually improving employment. Such a trend is portrayed with a lead by employment component of PMI index that is creeping higher and steepening (the latest reading of the index concerned posted another local maximum). Lower reading for January does not reflect momentum in employment but - unfortunately - distorts annual growth figures to the downside for the whole year. After the data we expect the annual metrics to stay below 2% in the end of the year.



Industrial output grew by 4.1% y/y in January after a +6.6% gain in December. The reading was slightly better than market consensus had predicted and very close to our forecast. Seasonally adjusted data point to an acceleration of output from 5.2% y/y in December to 6.3% in the following month. Therefore January saw a continuation of re-steepening of industrial output growth which we have been witnessing for several months (see the graph). Next months are going to bring the growth of output to the vicinity of 8% (7-9%) supporting the notion that economic upswing is gaining traction. In such circumstances GDP growth may exceed 3% in Q1 2014.



Producer prices went down by 0.9% y/y in January, just as we had forecast. Monthly momentum of producer prices in close to zero (in manufacturing 0.0% growth m/m, again, excluding sections driven by global prices +0.1% m/m, historically very low). We do not see any inflationary pressures building on the producers’ side despite an accelerating economy (also the gap between exchange rate and the growth of core producer prices is not closing).



Construction output fell by 3.9% y/y (curiously, seasonally adjusted y/y dynamics is exactly the same), slightly below expectations (+1.3%) but in line with our forecast (-3.5%). Obviously, there is no catching up after the abysmal December reading but we haven't hoped for any - in January seasonal effects are particularly strong, rendering the print largely insensitive to the state of the economy, calendar or weather. In other words, in January for m/m nsa dynamics we normally pick a random number from the (-70%; -60%) range. Apart from these considerations, construction is in for a good year. Private investment has been rebounding: anecdotal evidence indicate strong activity in the commercial real estate sector, while residential investment just recorded the best month in almost two years (very good data on housing starts - see the graph below). Finally, with each new tender for road construction it is increasingly more likely that infrastructural investments will accelerate from mid-2014 on.

Stable producer prices and low overall CPI inflation constitute a very comfortable situation for the MPC and for investors as well corroborating - at least at this very moment - that the holy grail of macroeconomics (non-inflationary growth) is possible. In current circumstances it is going to be a baseline scenario for financial markets. We stress that still low inflation, very dovish MPC, European and regional context (another ECB cut expected, maybe even a continental QE; Hungarian rates closer and closer to Polish repo) should restrain expectations for swift monetary policy tightening and support Polish debt. At the moment we like long-dated papers most since we can expect further risk premium compression, including the exchange rate one.

Potential impact of Ukrainian revolution on the Polish economy

Growing conflict in Ukraine poses a risk to Poland as in recent years Polish trade expanded on the east. In direct terms, Ukraine is a destination of 2% of Polish exports (mainly manufactured goods). In rough numbers it gives an annual figure of EUR 3.5bn (neglecting second-order trade effects filtering through Polish exports to other countries). The figures on registered trade should be accompanied by expenditures of non-residents crossing the Polish-Ukrainian border that are not subject to customs (therefore are not counted officially as exports and have to be estimated; such estimates are published by the Central Statistical Office). Those expenditures make up to EUR 1.5 bn annually. Should all this money disappear (when the border is closed or trade restrictions imposed for the whole year), it would be worth 1.5 pp. of Polish GDP growth in 2014. Of course this is a black swan scenario that assumes a state of the world when Ukraine ceases to exist at all (the high end of negative estimates). Depending on the duration of the conflict and the scale of the slowdown imposed via this channel on Ukrainian economy it would be more reasonable to bet on a number from the vicinity of 0.2-0.4%. That is why we would like to emphasize a downside risk to our 2014 Polish GDP call at 3.5% y/y. We are going to monitor situation closely as prolonged conflict is also very likely to negatively affect: 1) Polish trade with other eastern partners (e.g. Russia, Kazakhstan), 2) Polish investment activity through the uncertainty channel; we cannot exclude that such an effect would be far more devastating than trade linkages (though less likely).

Fixed income

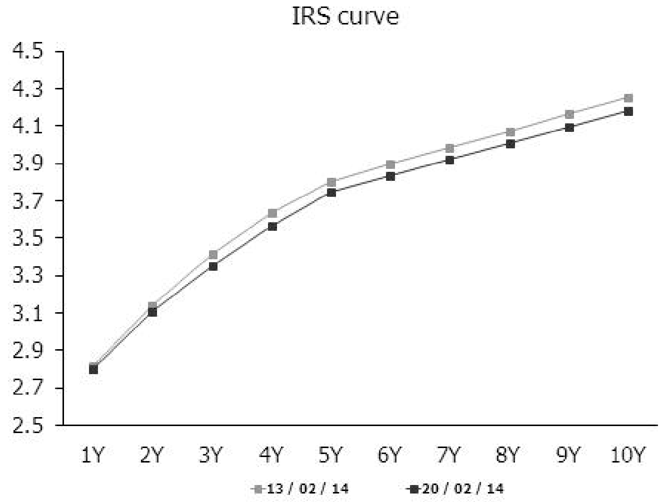
Keep it on

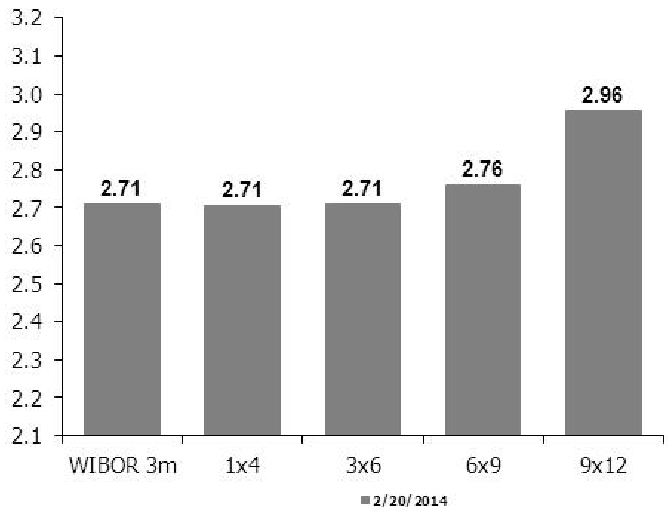
Not much to add here.

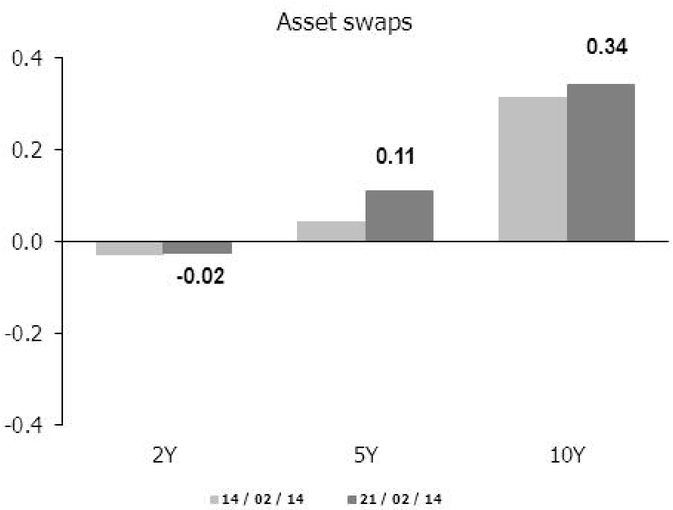
POLBGs trade close to last auction's levels but market has faced decent bid there. We have traded some credit woes (Ukraine)but it has traded surprisingly well. As a result, bonds outperformed its EM colleagues. So one may say we are trading more converging than emerging now. I would say... yes.

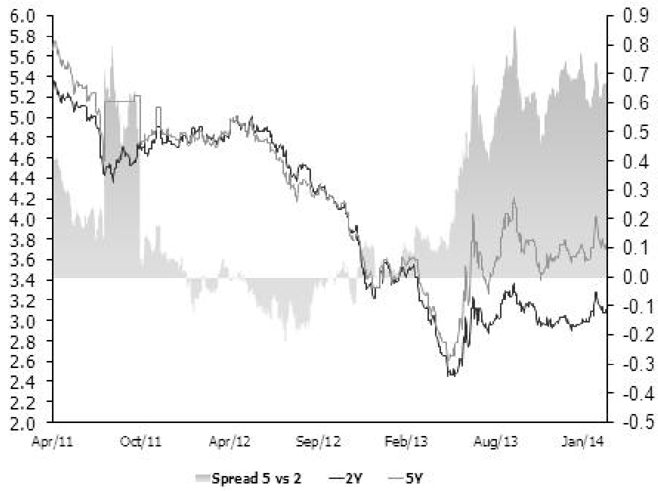
A bigger picture has not changed at all: dovish MPC, economy preforms well, core markets (that is where we aspire) at the same stance as week before.

We maintain our view then: Keep long bond position.





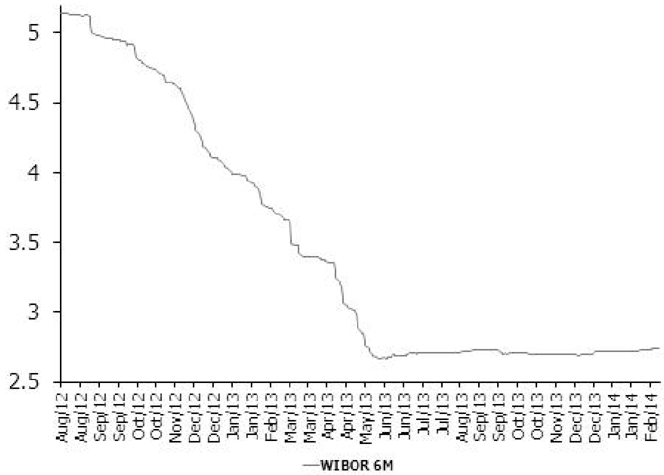


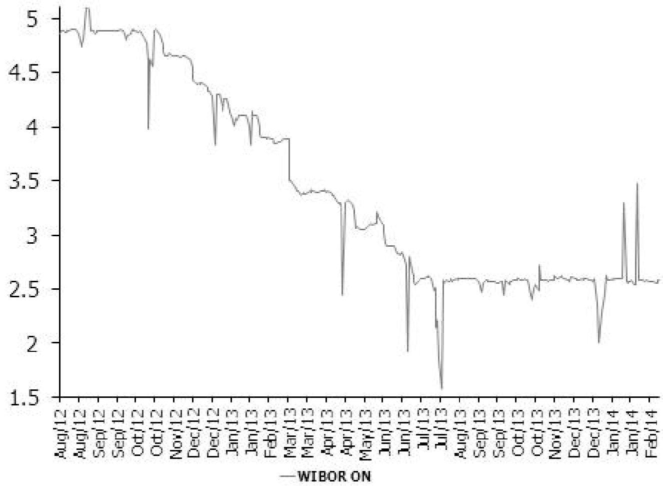


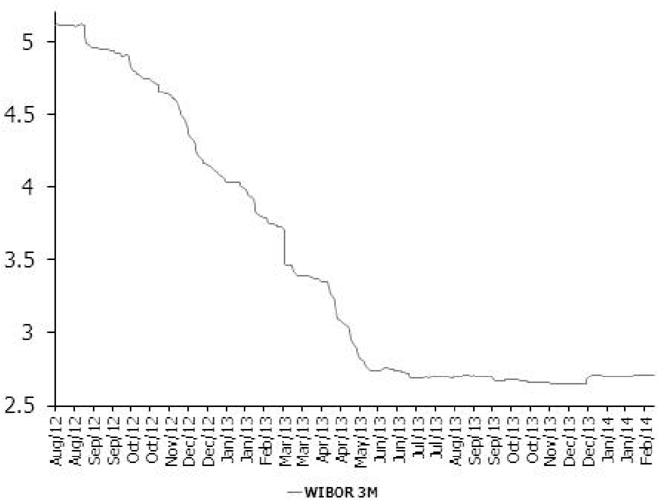
Money market

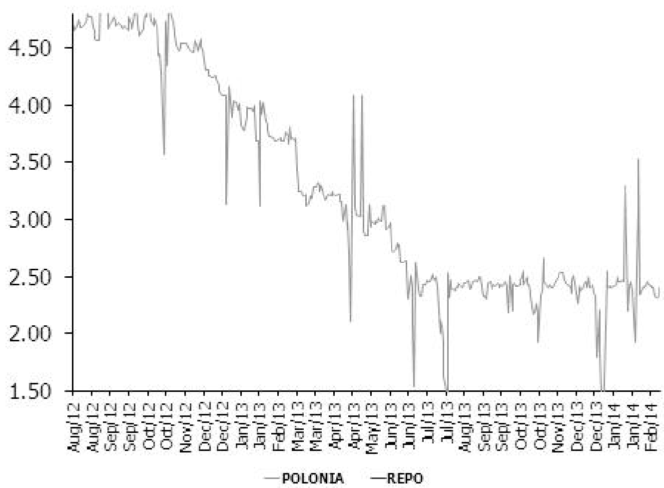
Cheaper week behind us. As last week OMO was underbid, Polonia fall to 2.30. Central Bank conducted additional OMO on Wednesday what moved cash rate to 2.42. Today's OMO was underbid by 8 bn PLN, what will move Polonia under 2%. We expect additional OMO on Monday but after last month situation (Polonia at 3.50) it shouldn't squeeze the market.

Our recommendation is same like last week: buy PS0415 and 1Y OIS.









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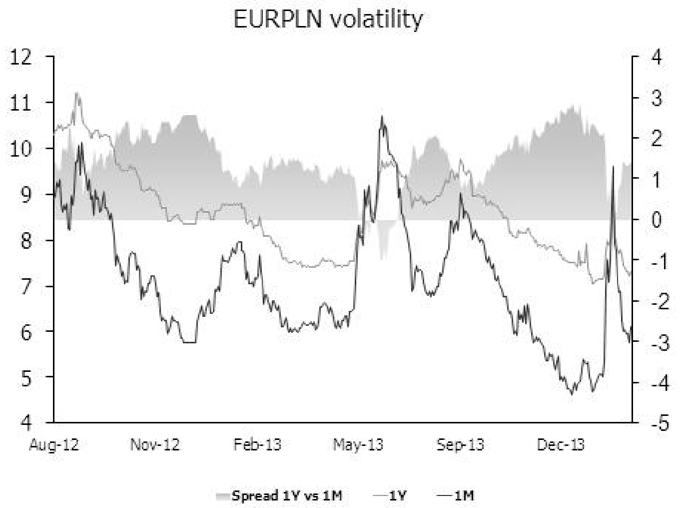
Forex

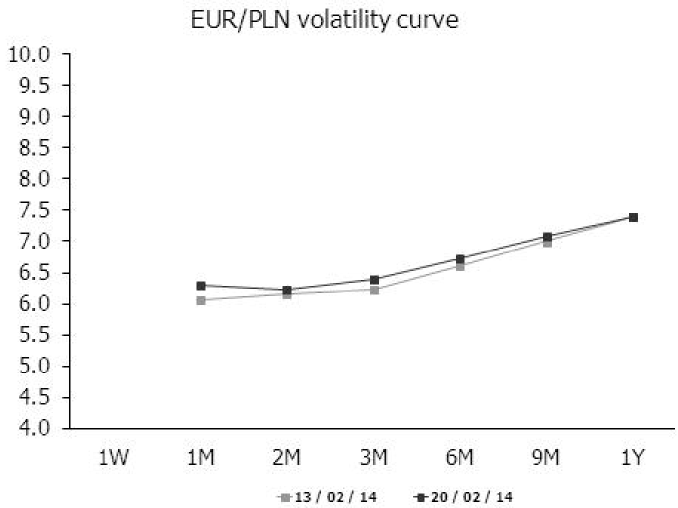
Choppy market. After the strong PLN gains at the beginning of the week, when EURPLN reached 4.1394 (the lowest level this year), the situation has changed. The conflict in Ukraine and worse Europe and China data have deteriorated market sentiment and EURPLN was pushed again to the 4.1850 level. Since Thursday afternoon when some glimmers of hope for a deal in Ukraine appeared EUR/PLN has eased back to 4.16.

The vol of the vol. The volatility of the volatility, especially in the frontend of the curve, is something we haven't seen for months. At the beginning of the week EURPLN 1 month ATM was offered at 5.75% and on Thursday, with weaker PLN, 1m atm was bid at 6.25%. On Tuesday, during risk on when generally volatilities were under pressure, 1y atm was given at 7.15% which is the lowest level for years and now 1y atm is 7.3% mid. The skew and currency spread (USD/PLN vol minus EUR/PLN vol) are little higher than week ago.



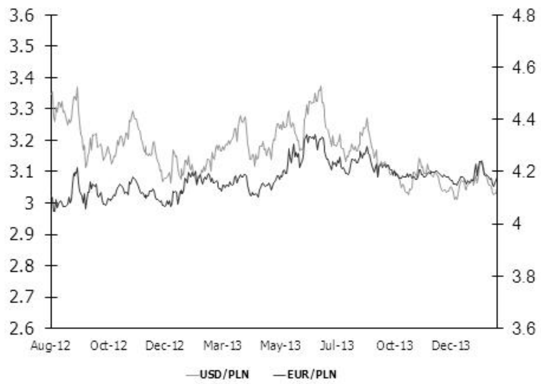
Short-term forecasts

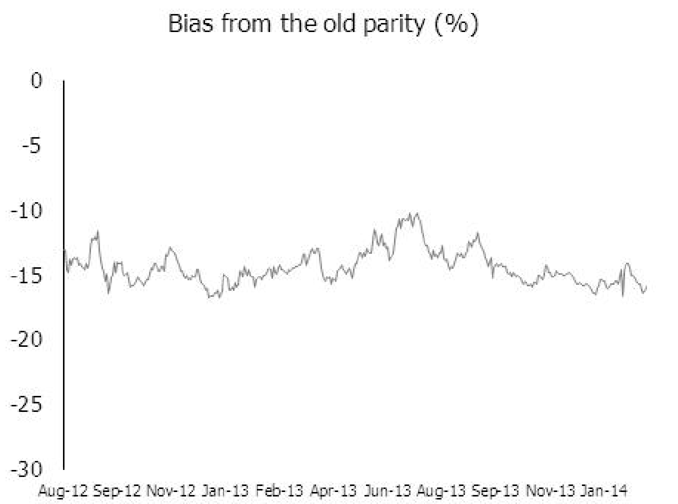
SPOT Main supports / resistances:
EUR/PLN: 4.1400 / 4.2000
USD/PLN: 3.0000 / 3.1500



Play range The bigger picture favors 4.14 - 4.20 range for EUR/PLN. We would like to play that range, by selling 4.1800, adding 4.190 with stop above 4.2050 and hopes for 4.1400. Or alternatively buy EUR/PLN at 4.1470, add 4.1250 with stop below 4.1070 and eyes firmly on 4.1750. There XXX/PLN is mostly driven by position liquidation, customer flow and global sentiment, there is little to „play on" fundamentally.

Cautious bid We are shocked with the speed in which the vols have melted in EUR/PLN and USD/PLN. It starting to tempt us to put same bids in the mid/backend of the curve. We had a period of the healthy pick up in realized volatility, and we think the market seems to have forgotten about it a little too quickly. From the realized volatility now it's better case to be on bid in Vega, Gamma then in January, when we were at realized volatility lows. Additionally we assume that lower systematic liquidity (without or with a smaller US QE) will raise the volatility in all asset classes.





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Market prices update

Money market rates (mid close)								FRA rates (mid close)				
Date	FXSW 3M	WIBOR 3M	FXSW 6M	WIBOR 6M	FXSW 1Y	WIBOR 1Y	1x4	3x6	6x9	9x12	12x15	6x12
2/17/2014	2.58	2.71	2.69	2.64	2.94	2.68	2.71	2.72	2.75	2.94	3.12	2.83
2/18/2014	2.54	2.71	2.68	2.64	2.92	2.68	2.71	2.72	2.75	2.94	3.11	2.83
2/19/2014	2.51	2.71	2.54	2.64	2.59	2.68	2.72	2.72	2.77	2.96	3.15	2.84
2/20/2014	2.53	2.71	2.67	2.64	2.91	2.68	2.71	2.71	2.76	2.96	3.17	2.85
2/21/2014	2.53	2.71	2.67	2.64	2.91	2.68	2.71	2.71	2.76	2.96	3.17	2.85

Last primary market rates							
Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
52W TB	3/4/2013	8/28/2013	98.33	3.49	3000	7324	3084
OK0716	2/6/2014	7/25/2016	92.60	3.18	1200	4594	1384
PS0718	2/13/2014	7/25/2018	94.45	3.88	2000	4405	2220
DS1023	2/13/2014	10/25/2023	95.80	4.54	2000	3702	1791

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
2/17/2014	2.680	2.838	3.070	3.051	3.725	3.805	4.155	4.495
2/18/2014	2.680	2.694	3.075	3.049	3.698	3.796	4.160	4.500
2/19/2014	2.680	2.830	3.100	3.087	3.740	3.857	4.180	4.543
2/20/2014	2.680	2.839	3.110	3.086	3.745	3.855	4.185	4.527
2/21/2014	2.680	2.839	3.110	3.086	3.745	3.855	4.185	4.527

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
2/17/2014	5.95	6.10	6.50	7.30	7.30	2.77	0.70
2/18/2014	5.75	6.00	6.50	7.20	7.20	2.77	0.70
2/19/2014	6.13	6.23	6.63	7.30	7.30	2.77	0.70
2/20/2014	6.30	6.40	6.73	7.40	7.40	2.95	0.77
2/21/2014	6.30	6.40	6.73	7.40	7.40	2.95	0.77

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
2/17/2014	4.1450	3.0250	3.3917	2.9702	1.3405	0.1512
2/18/2014	4.1584	3.0300	3.4017	2.9596	1.3471	0.1517
2/19/2014	4.1638	3.0286	3.4083	2.9670	1.3328	0.1520
2/20/2014	4.1780	3.0490	3.4247	2.9929	1.3323	0.1526
2/21/2014	0.0000	0.0000	3.4247	2.9929	1.3323	0.1526

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