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Polish Weekly Review

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Comment on the upcoming data and forecasts

The highlight of the week is the MPC meeting. We think the overall message is going to be dovish. The MPC may abandon forward guidance as it does not shape rate expectations at all. FRA curve lies below current interest rate and the longer the guidance is maintained in current shape, the more ineffective it is and generates nothing more than confusion. Moreover, a rate cut motion is going to be submitted and even if we bet on September as a convenient month of at least 50bp rate cut, chances for such easing already at July's meeting are non-negligible. They are heightened by the simultaneous release of inflation projection that is going to show lower inflation path (at least near term) and be filled with downside risk across the board. Although it may seem negligent at first sight, we do not expect the „tape scandal" to generate nothing more than press headlines. Majority in the MPC internalized the tape issues and stands firm behind the governor. Even if there is a discussion along the lines of NBP credibility, we may not even have a chance to hear it. The bottom line is the following: macroeconomic conditions and global environment favor policy easing and MPC used to follow such clues, sometimes with a lag, but almost always effectively in the end. Just before the MPC meeting PMI data see the light. Polish logistics managers somehow front-ran the tendencies in Germany and Eurozone. Therefore our favored scenario is more or less flattish reading. Monday is going to bring a publication of inflation expectations and quarterly balance of payments; both without any significance.

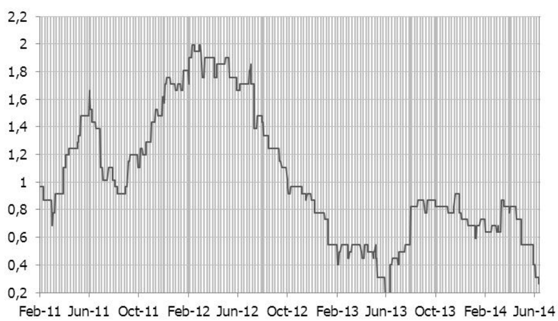
Polish data to watch: June 30th to July 4th

Publication	Date	Period	mBank	Consensus	Prior
NBP inflation expectations (%)	30.06	Jun	0.3	0.3	0.5
Current account balance (mio EUR)	30.06	Q1	-771	-771	-1071
Manufacturing PMI (pts.)	01.07	Jun	51.2	51.1	50.8
MPC decision (%)	02.07	Jul	2.5	2.5	2.5

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	-	800	3.024	4/23/2014
5Y T-bond PS0719	-	4000	3.406	5/8/2014
10Y T-bond DS1023	-	2000	3.818	6/5/2014
20Y T-bond WS0429	-	150	3.464	5/16/2013

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



Comment

Down after retail sales data (see the Econ section for more information). The index has fallen considerably this year and we are getting close to last year's minimum. Next week brings only one opportunity for surprises - Manufacturing PMI.

* 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

- The upswing is going to be continued.
- However, current business tendency indicators suggest that growth momentum softens and sequential GDP growth is going to be lower in Q2 (sub 3%). Loses are expected to be made up in the latter part of the year but stronger PLN and high real interest rates generate some new risks. External environment seems to be still favorable, though. Recession in Ukraine and Russia do not seem to exert any visible pressure on overall Polish exports.
- Coming quarters are expected to bring more exogenous components to the Polish cycle. 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 very low for the next few months supported by low food prices and still benign core inflation. The turnaround expected at the turn of Q2/Q3 is not going to be spectacular. Possible below or near zero readings in the summer month strengthen the feel of high real interest rates.
- MPC got stuck in a very positive GDP growth scenario in times when GDP may temporarily lose some momentum and when inflation pumps up real rates generating risks for growth. Therefore we await adjustment of the policy at September's meeting in a scale of at least 50bps. The move can be brought forward to July's meeting but it is not our baseline scenario.

Financial markets

- Political jitters should be viewed as noise. One must look beyond it.
- We are bullish on Polish bonds due to: 1) renewed play on monetary easing (we bet on more than 50bps rate cut), 2) very low inflation and hefty real yields, 3) improving risk profile of Polish assets (low fiscal deficit, low C/A deficit, lower dependence on short term foreign funding).
- Furthermore, Poland might be increasingly seen as a high-yield alternative to euro area, especially if Polish track record of stable growth and very low FX volatility is considered.
- Finally, It is possible that 'carry trade' encouraged by the ECB easing will spill over into CEE region.
- ECB easing and chasing for yield compression in the region (betting on rate cuts in Poland) may propel Polish zloty as well. In the background, the mid-term cyclicality constitutes another, hidden engine for appreciation.

mBank forecasts

	2009	2010	2011	2012	2013	2014F
GDP y/y (%)	1.6	3.9	4.5	2.0	1.6	3.5
CPI Inflation y/y (average %)	3.5	2.8	4.3	3.7	0.9	0.4
Current account (%GDP)	-1.6	-4.5	-4.9	-3.5	-1.3	-1.9
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	2.00

	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1 F	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.4	0.8	2.0	2.7	3.4	2.9	3.6	4.3
Individual consumption y/y (%)	0.0	0.1	1.0	2.1	2.6	2.6	2.8	3.0
Public Consumption y/y (%)	0.1	5.0	3.0	3.1	0.7	2.0	2.0	2.4
Investment y/y (%)	-2.4	-3.3	0.5	2.0	10.7	6.5	8.5	10.0
Inflation rate (% average)	1.3	0.5	1.1	0.8	0.6	0.2	0.0	0.6
Unemployment rate (% eop)	14.3	13.2	13.0	13.4	13.9	11.9	12.3	13.0
NBP repo rate (% eop)	3.25	2.75	2.50	2.50	2.50	2.50	2.00	2.00
Wibor 3M (% eop)	3.39	2.73	2.67	2.71	2.71	2.72	2.22	2.22
2Y Polish bond yields (% eop)	3.19	3.07	3.06	3.05	3.01	2.50	2.50	2.70
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.23	3.35	3.60	4.00
EUR/PLN (eop)	4.18	4.33	4.22	4.15	4.17	4.10	4.10	4.05
USD/PLN (eop)	3.26	3.32	3.12	3.02	3.01	3.01	3.00	3.01

F - forecast

Retail sales dip after temporarily inflated winter months but stay within upward trend. Current GDP tracking suggests worse Q2.

Retail sales grew in May by 3.8% y/y disappointing market consensus (6.4%) and our forecast (5.4%). We do not want to sketch any disastrous scenarios at the moment. In our opinion, current deceleration of retail sales is a mere reflection of a payback after the temporary factors in Q1 (auto sales) and Easter-induced shifts in expenditures (April food sales). It can be easily gleaned from synthetic retail sales aggregates with exclusion of food and cars (see the graph). Therefore we spare the usual look at single categories and focus on implications that seem far more interesting.

First, there is no reason for the uptrend in consumption (retail sales) to be stopped. Consumer spending is supported by labor market trends coupled with falling inflation and rising household sentiment (from available data we can deduce that incomes are sufficient for consumption and for slight increase in savings, as reflected in growing household deposits). Second, GDP is calculated from actual data and shifts in expenditures from Q2 to Q1 do not favor it. We've already noticed the potential of payback from the first quarter in investment data and â€“ perhaps â€“ consumption. This will be driven by construction and lower business spending on transport equipment (the boom in car sales induced by VAT discount window in Q1 ended as abruptly as it had begun). Due to the fact that it might be impossible to distinguish investment from consumption when it comes to car sales, it is not inconceivable that consumption could slow down from the first quarter. In such a scenario investment wouldn't slow down as much and the soft patch would be more fairly distributed among all major spending categories. A pothole is a pothole and composition itself would probably not influence the MPC's decisions.

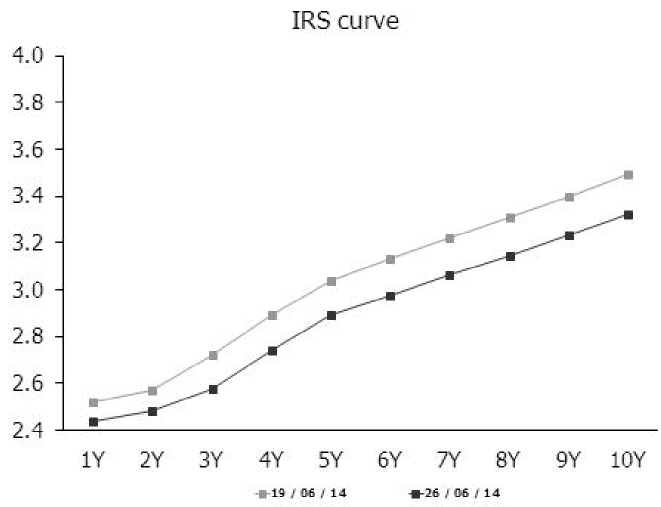
The more so since consumer goods deflation seems to be accelerating (see the graph above). These are the price categories that are the fastest to react to economic situation and reflect global tendencies as well (the same tendencies that are used by central banks as an excuse to continue stimulating economies). Would a hypothetical welfare loss be allowed by the Council? We believe not and retail sales data support our forecast of rate cuts in Poland. Slowdown in growth in the second quarter (to below 3% y/y) is important, as it should cool the MPC's optimism. In our view, the MPC will decide to cut rates by 50 bps within the next three months. The „tape affair" is just noise and shouldn't affect monetary policy decisions.

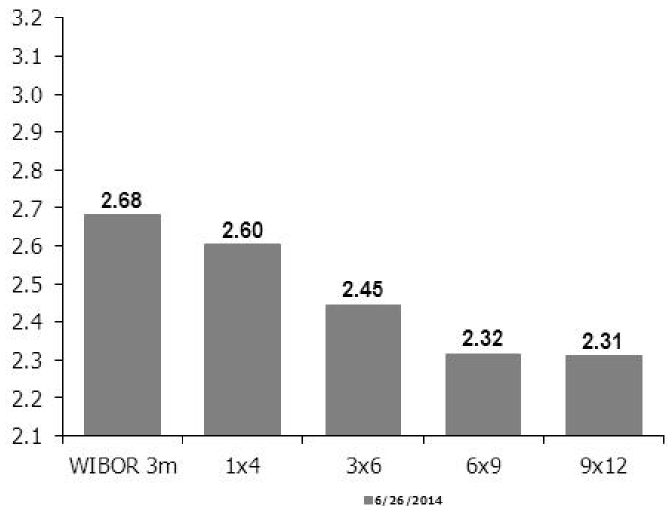
Fixed income

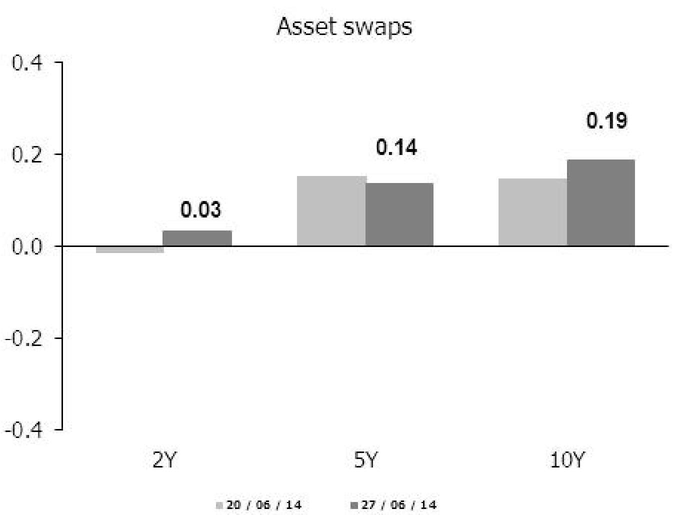
One way?

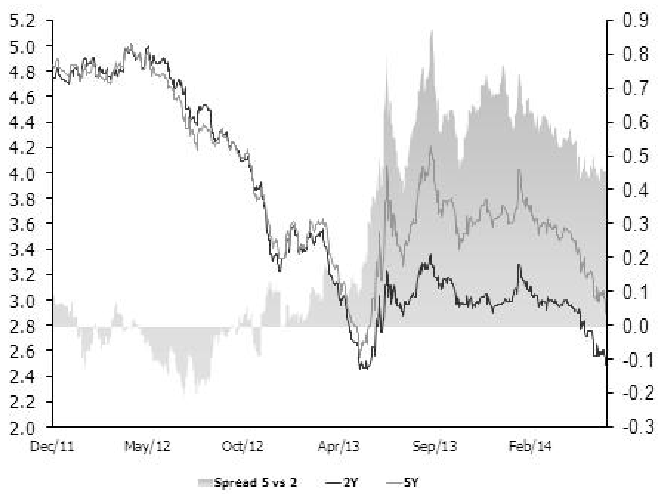
On our Fixed Income market bullish is unstoppable. Investors do not care about local problems ('tape scandal' is an old story already). Global sentiment was supportive (the rally on US Treasuries) and we had a surprising IRS auction in Hungary. As a result, the yield of our 5Y bond benchmark fall from 3.15 to 3.00%.

It is really difficult to find any reason currently to sell Polgbs. But it might be a good moment to take profit on bonds. Rate cut on September meeting is already priced in, so there is a risk that market is going to be weaker if MPC doesn't change its 'steady approach'. With huge bond supply this year and nice rally we feel that market could be vulenarable for profit taking scenario.







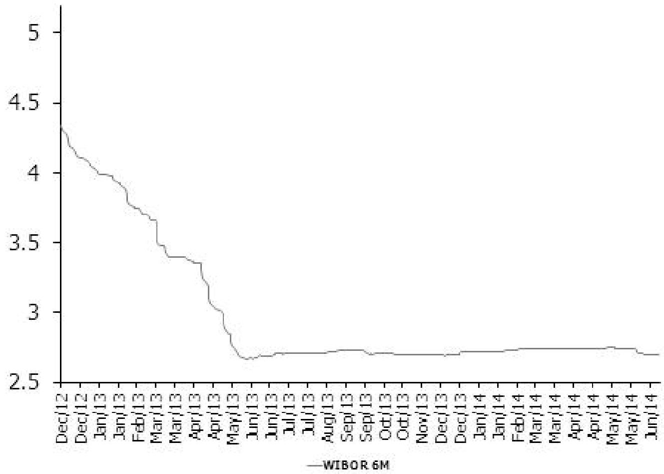


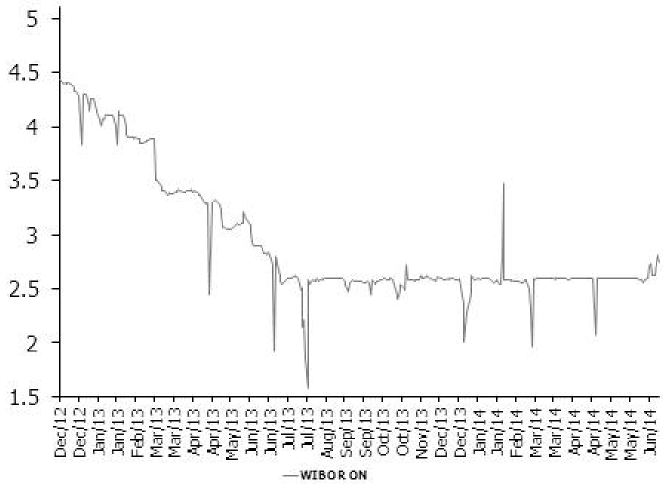
Money market

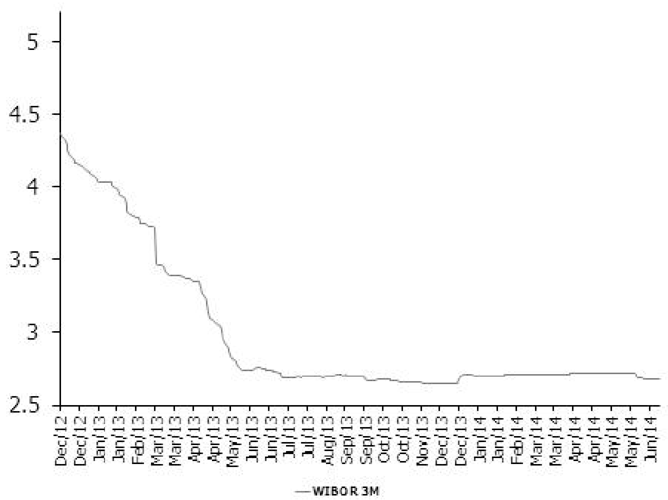
Very expensive week behind us Polonia rose to 2.6% and remained there for the whole week. At today's auction banks bought 10 bn less bills than were offered so it will be huge cash surplus next week. It will not be cheap week, however, as it is a beginning of new reserve and Monday is the last day of second quarter.

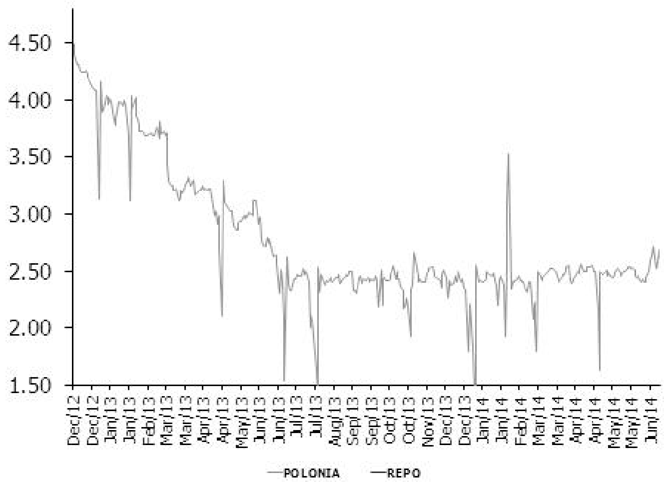
Short part of the curve fell in the last week by 10 bps due to weak retail sales, situation with Hungarian rates and falling core market yields.

Our short term strategy to sell 1Y OIS and buy FRA's (6x9, 9x12) looks very attractive now as spread fall to 14-15 bps. But the most interesting asset on the curve is PS0415 as its yield (2.37) comparing to FRA's (2.30) looks extremely attractive.





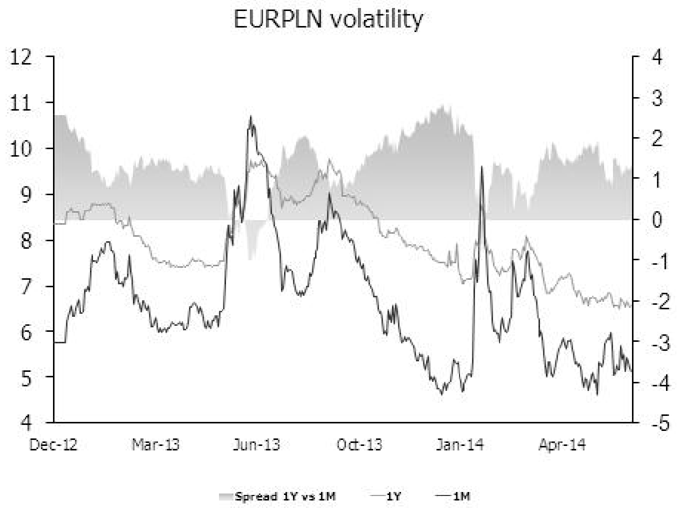




Forex

PLN consolidating EUR/PLN reached as high as 4.1744 before retreating back to 4.1330 and now entered the consolidating phase. The political risk is lighter now after Prime Mister Tusk had managed to win confidence vote in the Parliament. Bullard (Fed) on the other hand expressed his hawkish view about US interest rates (producing the squeeze on short EUR/PLN from 4.14 to 4.1615). Our base scenario is the range 4.13/4.18 till major risk events next week (ECB, NFP) lead us further...

Vols roughly unchanged The market is hovering above the year lows in vols and we don't expect a change unless the realized volatility really outperforms current levels. The dates just after ECB/NFP are getting bid, but beside that all is more or less flattish. 1 month EUR/PLN ATM mid is 5.2% (0.1 higher than last week), 3 month are 5.4% (unchanged) and 1 year 6.5% (unchanged). The skew was slightly better offered and currency spread (difference between USD/PLN vol and EUR/PLN vol) was better offered (after 1 month USD/PLN ATM was given at 6.25%).

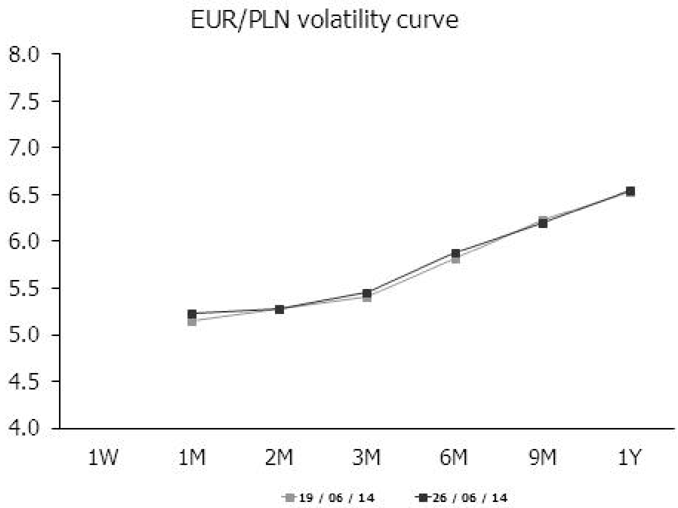


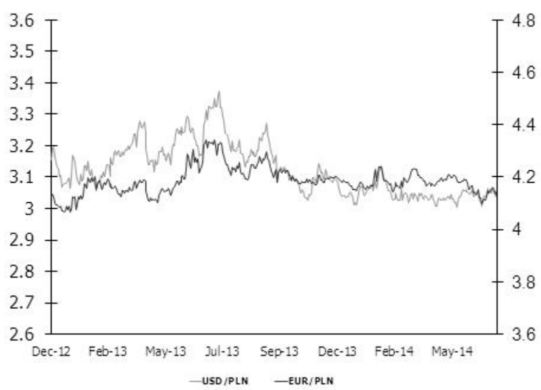
Short-term forecasts

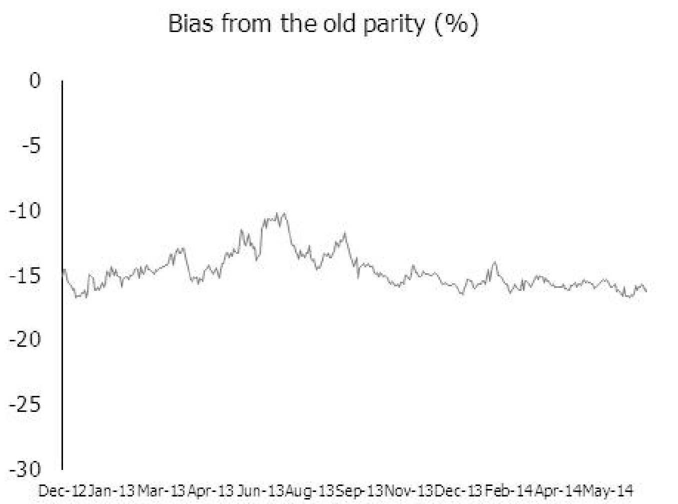
SPOT Main supports / resistances:
EUR/PLN: 4.1200 / 4.1900
USD/PLN: 2.9900 / 3.1000

Play 4.12/4.19 range Shorts from 4.1475 closed at 4.1450 with tiny profit. We are sidelined at the moment, but we are ready to get back to our playing range approach with no clear preference towards the side. We would sell 4.1750 and 4.1900 with a stop above 4.20 or buy 4.12 and 4.1050 with a stop below 4.0950. In both cases we bet on a move of 5 big figures.

Options: tactical long. We still hold small tactical long in mid curve Vega. The market is not really moving and we trade in very tight price ranges. Generally we are much more keen to enter bigger long Vega trade but timing is key. Till now we are sticking to our small tactical long.







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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
6/23/2014	2.71	2.68	2.73	2.60	2.64	2.64	2.57	2.49	2.40	2.41	2.47	2.41
6/24/2014	2.81	2.68	2.86	2.60	2.73	2.64	2.60	2.50	2.38	2.38	2.43	2.40
6/25/2014	2.58	2.68	2.63	2.60	2.63	2.64	2.59	2.45	2.35	2.34	2.37	2.35
6/26/2014	2.57	2.68	2.57	2.60	2.67	2.64	2.60	2.45	2.32	2.31	2.35	2.32
6/27/2014	2.57	2.68	2.57	2.59	2.67	2.64	2.60	2.45	2.32	2.31	2.35	2.32

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	4/23/2014	7/25/2016	93.51	3.02	800	2136	836
PS0719	5/8/2014	7/25/2019	99.25	3.41	4000	5807	4075
DS1023	4/3/2014	10/25/2023	97.95	4.26	3500	4905	3480

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
6/23/2014	2.640	2.444	2.570	2.582	3.025	3.151	3.475	3.594
6/24/2014	2.640	2.451	2.543	2.533	2.990	3.031	3.435	3.505
6/25/2014	2.640	2.398	2.500	2.500	2.930	3.022	3.370	3.428
6/26/2014	2.640	2.407	2.483	2.515	2.890	3.027	3.320	3.510
6/27/2014	2.640	2.407	2.483	2.515	2.890	3.027	3.320	3.510

EUR/PLN 0-delta stradle						25-delta RR			25-delta FLY
Date	1M	3M	6M	1Y		1M	1Y		1Y
6/23/2014	5.33	5.50	5.90	6.60		6.60	2.47		0.67
6/24/2014	5.21	5.43	5.83	6.54		6.54	2.47		0.67
6/25/2014	5.15	5.45	5.81	6.58		6.58	2.47		0.67
6/26/2014	5.23	5.45	5.88	6.55		6.55	2.49		0.67
6/27/2014	5.23	5.45	5.88	6.55		6.55	2.49		0.67

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/23/2014	4.1603	3.0627	3.4179	3.0078	1.3603	0.1515
6/24/2014	4.1587	3.0526	3.4198	2.9948	1.3604	0.1515
6/25/2014	4.1437	3.0451	3.4064	2.9871	1.3537	0.1510
6/26/2014	4.1358	3.0361	3.3993	2.9839	1.3467	0.1507
6/27/2014	4.1528	3.0485	3.4137	3.0063	1.3464	0.1512

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