July 4, 2014

Polish Weekly Review

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Table of contents

Comment on the upcoming data and forecasts

A very calm week ahead of us. On Monday Economic Institute of Polish central bank (NBP) will release the details of its inflation report. Moreover the forthcoming week will bring car production data (the precise date of release is unknown, however).

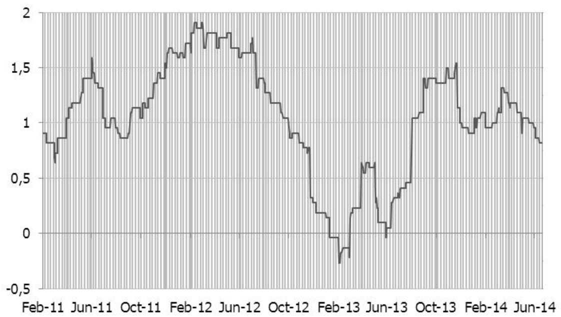
Polish data to watch: June 7th to July 11th

Publication	Date	Period	mBank	Consensus	Prior
NBP's Inflation Projection	07.07				

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 DS1025	-	2000	3.649	7/3/2014
20Y T-bond WS0429	-	150	3.464	5/16/2013

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



Comment

Unchanged - the PMI surprised to the downside but not significantly. Next week, as no important release is scheduled, will extend the period of stabilization. The renewed downtrend is intact, though. Please note that we have recalculated our surprise index. Because of that, last year's swings now seem larger.

* 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 fairly 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.

Financial markets

- Political jitters should be viewed as noise. One must look beyond it.
- We are bullish on Polish bonds due to: 1) continuation of 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	-0.9
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	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	2.68	2.22	2.22
2Y Polish bond yields (% eop)	3.19	3.07	3.06	3.05	3.01	2.51	2.50	2.50
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.23	3.45	3.60	3.70
EUR/PLN (eop)	4.18	4.33	4.22	4.15	4.17	4.16	4.10	4.05
USD/PLN (eop)	3.26	3.32	3.12	3.02	3.04	3.01	3.00	3.01

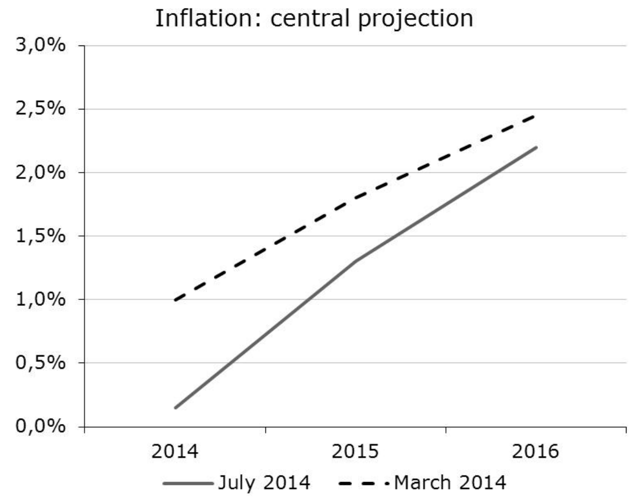
F - forecast

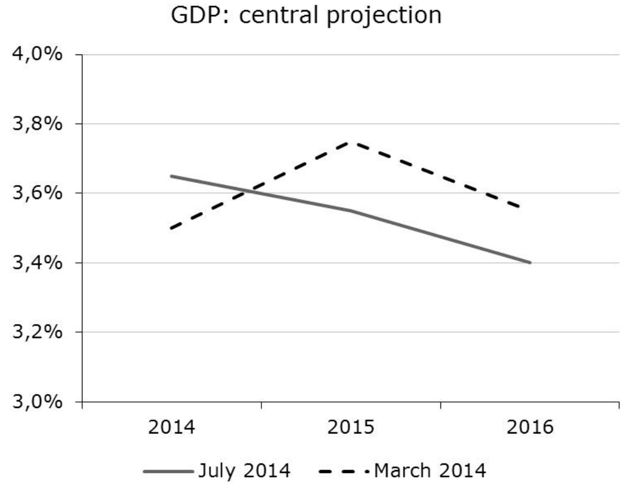
Economics

MPC abandons forward guidance

As expected, the MPC left interest rates unchanged (repo rate at 2.50%). And just as we predicted, forward guidance (the commitment to leave rates unchanged until the end of Q3 2014) was erased from the statement. It is a straightforward indication that future MPC decisions are going to be data dependent.

The statement itself was more dovish than the previous one. Apart from abandoning forward guidance, risks to the ongoing upswing and missing CPI target were mentioned. Interestingly, MPC directly points out to softer business tendency indicators. Inflation projection reveals a slightly better GDP growth in 2014 but - at the same time - somewhat lower path of expansion afterwards. Inflation rate forecast was lowered in the whole period 2014-2016 and is projected to miss the target in 2016 (on average) by 0.2pp; the statement even points to an outright risk that inflation is going to temporarily run below zero. The scenario portrayed by the projection suggests that, if not cut, rates can be left on hold throughout the whole projection time span.





Dovish flavor of the statement was a bit diluted by governor Belka during the conference. He pointed that the likelihood of rate cuts is low. At the same time, however, he did not dare to even mention rate hikes. Instead, he offered important arguments in favor of rate cuts: non-existent inflationary pressure, lower GDP growth, high real rates, and another (fourth in a row) negative surprise in PMI. We think that while analyzing the specifics of Belka's wording one has to bear in mind a simple fact: it would not be really rational to abandon the self-imposed limitation on the conduct of monetary policy (forward guidance) only to embark on a fresh pre-commitment (to cut rates).

Therefore, the lack of pre-commitment does not imply the future failure to deliver. First of all, the merits of discussion on the level of rates may have been overshadowed by the recent tape scandal (although we will never know). Secondly, by erasing forward guidance the MPC directly leans towards the data and deviations from the baseline are going to matter. In our opinion, there is plenty of room for negative surprises (although slightly lesser due to internalization of risks by the MPC) including a soft patch in GDP growth, low levels of PMI (other indicators have flatlined as well) and meagre growth of industrial output. Thirdly, in current conditions zloty may appreciate. Such a scenario may be treated by some MPC members as na outright risk for exports and growth.

Market-wise, the stakes are higher now (market is still pricing in a cut, this is a different starting point that some weeks ago) and more dependent on the data. It is not about guessing market expectations but the sequence of data. Therefore the directionality on the front end of the curve may not be as easy to trace as in the last months (some investors may turn to analyzing MPC member comments that can be noisy). As for the longer tenors, current valuations contrast only with the play for higher rates in the US (third time this year). This should, however, be overwhelmed by liquidity supplied by the ECB, first in the form of TLTRO and later in European-style QE.

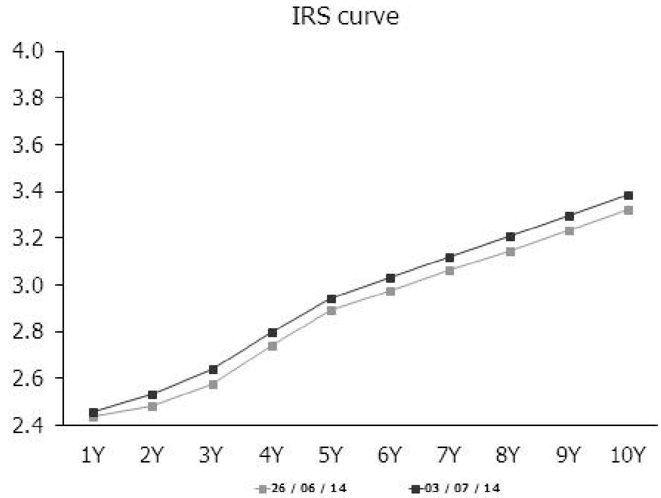
Fixed income

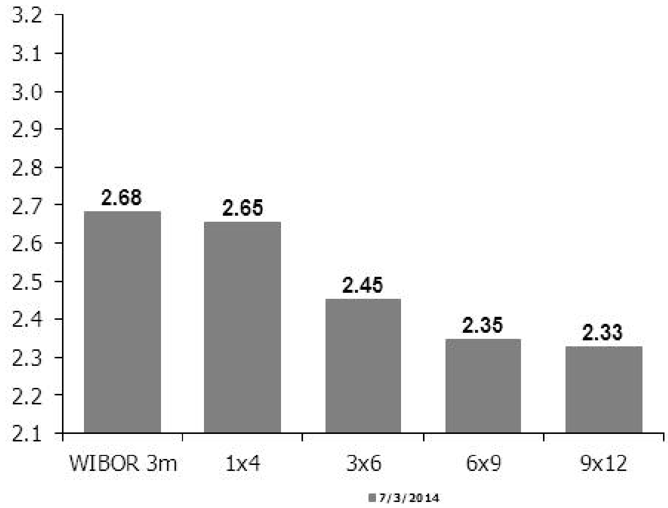
Unlikely?

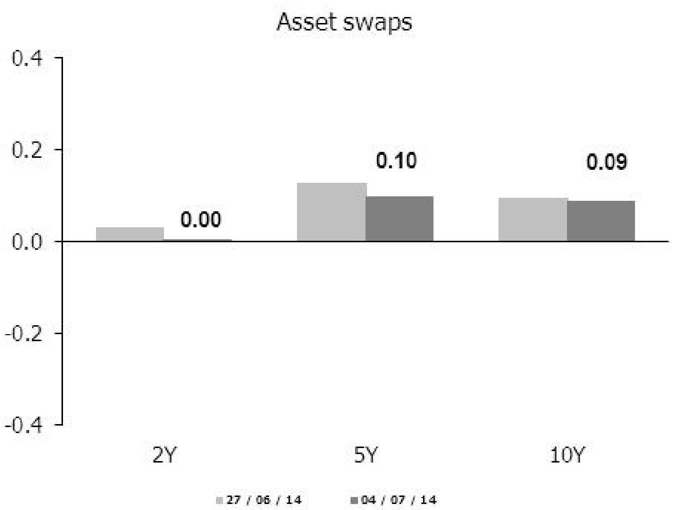
This week on Fixed Income market was interesting and volatile. At some point (after MPC press conference) it seemed that mid-term, bullish trend has come to an end. Marek Belka said that rate cut in September is 'unlikely' and that triggered one-day long profit taking. Yield of PS0719 went up from 2.97% to 3.07%. 10Y bond auction was not fully successful as only 2.5bln of DS0725 was sold (3.0 bln max offer), but that was barely a surprise, considering unfortunate timing (auction was held just before ECB's decision and press conference). Impact of positive data from U.S. market for our bonds was only temporary.

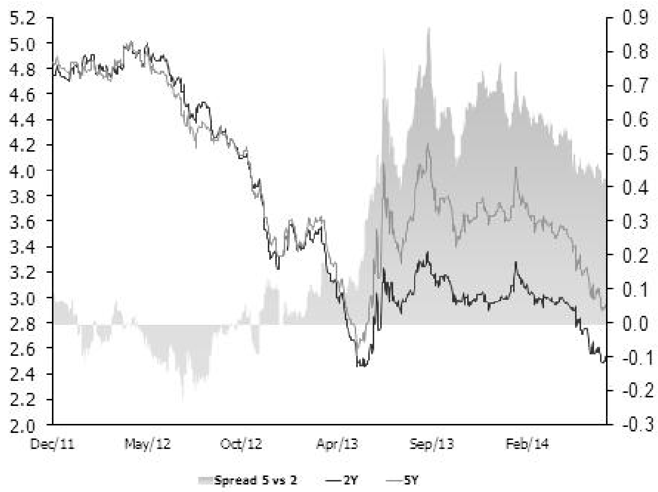
It is clear that MPC would like to keep rates steady as long as possible. This is 'their' base scenario, but they also 'opened the door' for other one. In case of very low CPI (this is almost certain now) and lower than expected GDP growth MPC did not keep their forward guidance. With constant inflows on PolGBs market, lower bond supply in coming weeks, we feel that buying 10Y bonds is now quite a safe bet.

Recommendation: Buy DS0725 at current level (3.57%).





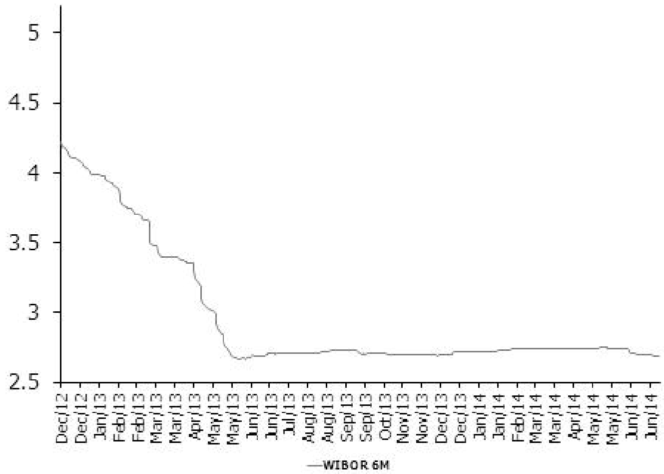


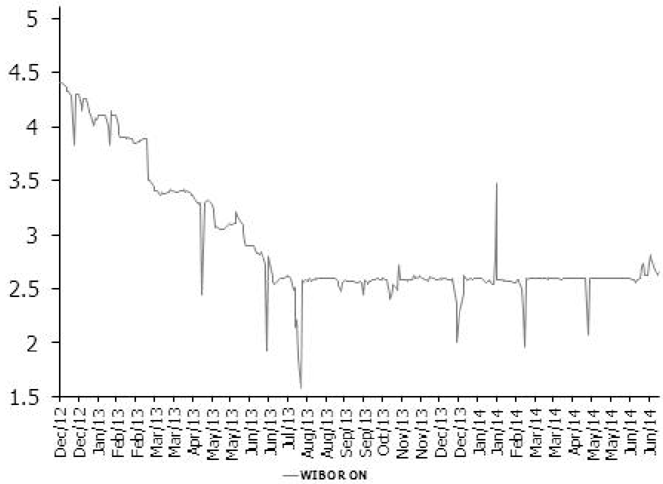


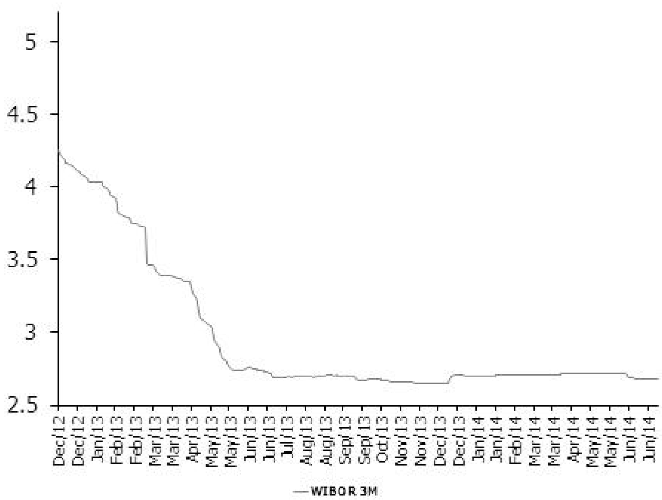
Money market

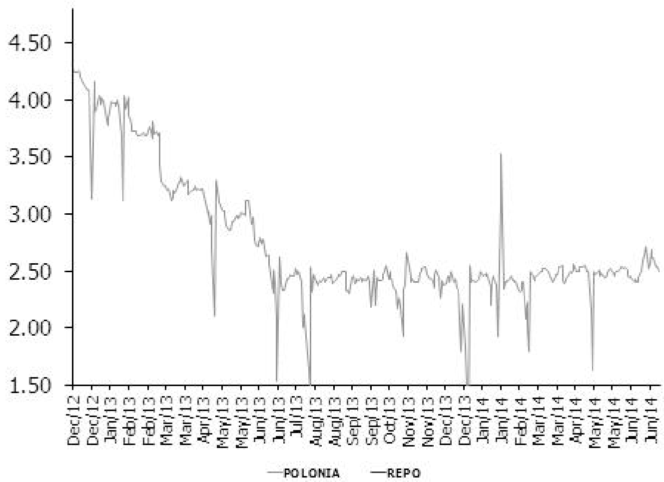
Cheap week ahead of us Despite huge cash surplus Polonia fluctuated around 2.50% as it was a beginning of new reserve. At today's auction banks bought PLN 3.5 bn bills less than was offered what should push Polonia a bit under reference rate.

As there was no rate cut WZ0115 looks very attractive as last coupon is fixing in the end of July so our recommendation is to buy that bond.





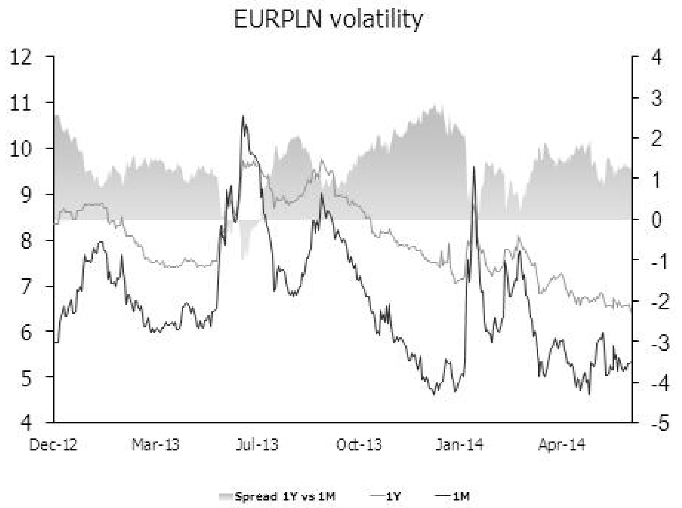


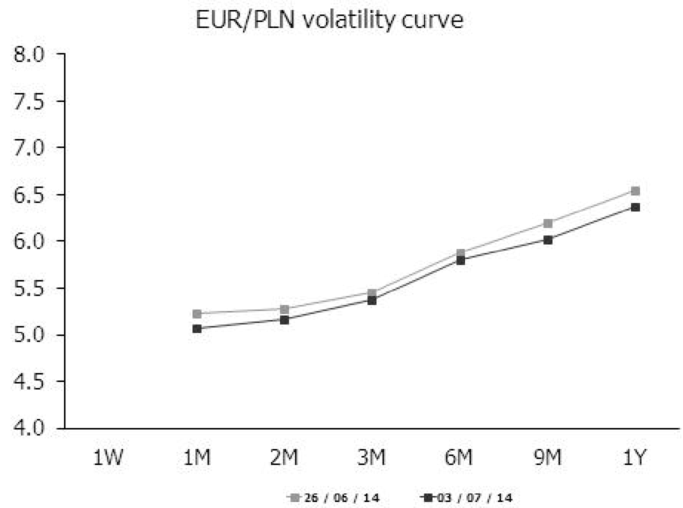


Forex

PLN choppy in range It has been a choppy week for the Zloty but it has traded in a narrow range. At the beginning of the week, after worse PMI data and with fear of possibility of cutting interest rate by MPC, the sellers of Zloty have moved the rate of EURPLN to almost 4.17. However, at this level demand for Zloty has appeared and the market has seen a recovery to the level of 4.15. After MPC hasn't cut interest rate EURPLN has quickly gained slightly, but support at 4.1430 seems still to be firm. Finally on Thursday, the dovish statement from Draghi has given the PLN fresh power and it has reached 4.1350. We think the less dovish MPC and more dovish ECB should support PLN versus EUR in the mid-term. It will not be a straight, fast move but a slow bumpy slide...

Vols - roughly unchanged The market is hovering above the years lows in volatilities and we don't expect much, unless the realized volatility really outperforms current levels. Till payrolls data and Draghi press conference we have seen a big demand for short-term gamma. After these events short term volatility has decreased. 1 week EURPLN has fallen from 5.5% to 4.7%, 1month has decreased from 5.2% to 4.8%. Besides that all is more less flattish: 3 month is 5.4% (unchanged) and 1 year 6.4% (0.1% lower). The skew has been slightly better offered and currency spread (difference between USD/PLN vol and EUR/PLN vol) has been unchanged.



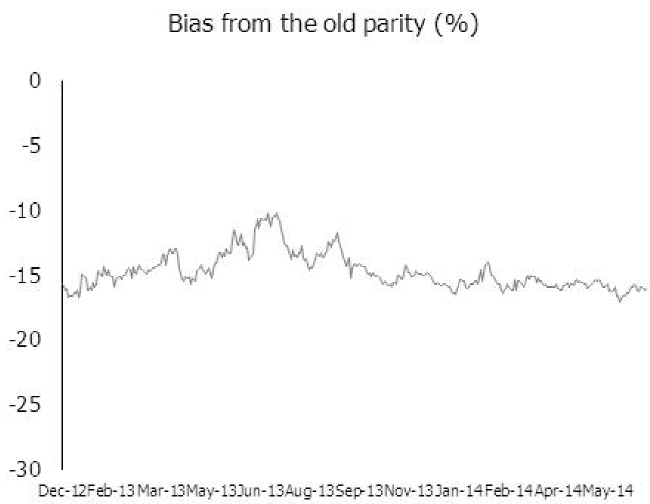


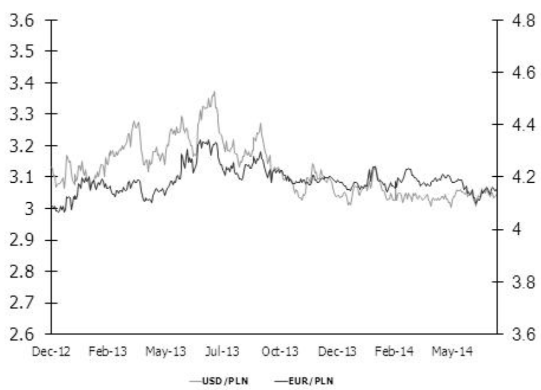
Short-term forecasts

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

Sell EUR/PLN spikes The range 4.1330 - 4.1900 is really mighty, and so far it contained all the moves. We will still try to play it, but our favored strategy is to sell spikes EUR/PLN. Ideally we would like to sell 4.1630, add 4.18 with stop above 4.19 with humble desire to finally dent the 4.1300 - 4.1350 support zone.

Options: tactical long. Still small tactical long in mid curve Vega. The market is not really moving, we trade in very tight price ranges. The bigger picture is that 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
6/30/2014	2.60	2.68	2.60	2.59	2.66	2.64	2.60	2.43	2.31	2.31	2.36	2.32
7/1/2014	2.60	2.68	2.58	2.59	2.66	2.64	2.62	2.44	2.33	2.32	2.36	2.34
7/2/2014	2.50	2.68	2.50	2.59	2.56	2.64	2.66	2.49	2.38	2.38	2.42	2.38
7/3/2014	2.60	2.68	2.60	2.59	2.71	2.64	2.65	2.45	2.35	2.33	2.40	2.36
7/4/2014	2.60	2.68	2.60	2.59	2.71	2.64	2.65	2.45	2.35	2.33	2.40	2.36

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
DS1025	6/5/2014	7/25/2025	94.90	3.82	2000	2743	1693

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
6/30/2014	2.640	2.331	2.495	2.501	2.910	3.037	3.345	3.510
7/1/2014	2.640	2.406	2.505	2.505	2.920	3.022	3.350	3.510
7/2/2014	2.640	2.422	2.515	2.534	2.930	3.052	3.349	3.476
7/3/2014	2.640	2.432	2.533	2.534	2.945	3.043	3.385	3.474
7/4/2014	2.640	2.432	2.533	2.534	2.945	3.043	3.385	3.474

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
6/30/2014	5.31	5.50	5.90	6.58	6.58	2.44	0.68
7/1/2014	5.30	5.53	5.90	6.60	6.60	2.44	0.68
7/2/2014	5.33	5.50	5.83	6.45	6.45	2.43	0.65
7/3/2014	5.08	5.38	5.80	6.38	6.38	2.35	0.63
7/4/2014	5.08	5.38	5.80	6.38	6.38	2.35	0.63

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/30/2014	4.1609	3.0473	3.4246	3.0065	1.3413	0.1515
7/1/2014	4.1550	3.0355	3.4219	2.9897	1.3412	0.1514
7/2/2014	4.1500	3.0387	3.4180	2.9954	1.3340	0.1514
7/3/2014	4.1536	3.0418	3.4201	2.9836	1.3314	0.1513
7/4/2014	4.1435	3.0495	3.4076	2.9881	1.3335	0.1509

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