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Polish Weekly Review

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Comment on the upcoming data and forecasts

July's manufacturing PMI index will be released on Friday. Both domestic and foreign factors influencing Polish economy are ambivalent. On one hand, German PMI surprised to the upside, on the other - Ifo indicator suggests weakening sentiment among German entrepreneurs. Local sentiment data surprised recently to the downside, however they have followed the PMI, rather than the other way round. The aforementioned mixed pieces of evidence point toward a stable reading on the verge of 50 pts. That said, please note that during downtrends the Polish PMI tends to bounce back from the 50 pts. level, suggesting at least a slight payback in July. All in all, we forecast a 50.8 reading.

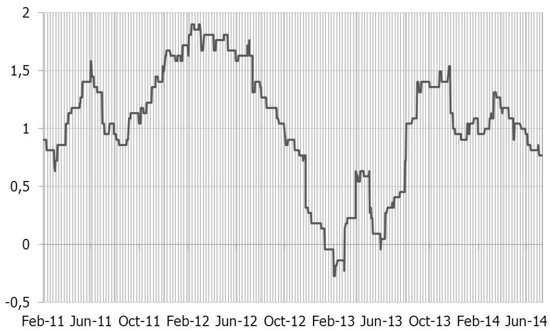
Polish data to watch: June 28th to August 1st

Publication	Date	Period	mBank	Consensus	Prior
Inflation expectations y/y (%)	31.07	Jul	0.3	0.3	0.2
Manufacturing PMI (pts.)	01.08	Jul	50.8	50.5	50.3

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	-	5000	2.793	7/23/2014
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 as retail sales and unemployment rate surprises have offset each other. Next week brings PMI realease, which poses some opportunity for index to move.

* 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).

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Our view in a nutshell

Fundamentals

- The upswing is going to be continued but let's focus on Polish soft–patch (and its implications) now.
- Current business tendency indicators suggest that growth momentum softens and 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 (with German economy contracting in Q2) was not so great as well. On the other hand, recession in Ukraine and Russia do not seem to exert any visible pressure on overall Polish exports.
- Coming quarters are expected to bring more (positive) 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 months 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 in Autumn (rates should be cut by more than 50bps).

Financial markets

- 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 the 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

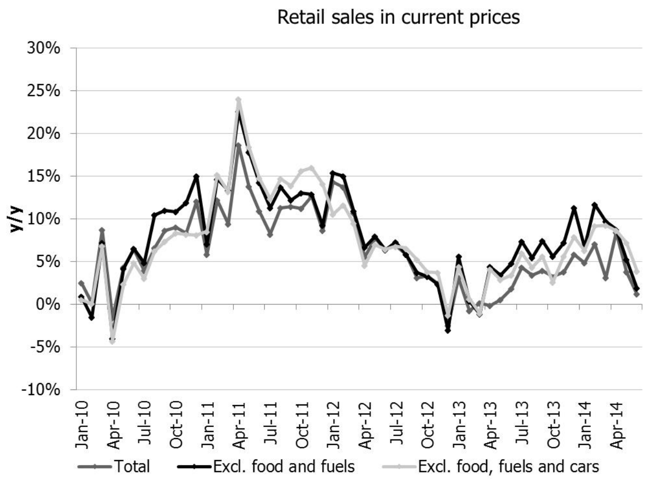
	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.4	0.8	2.0	2.7	3.4	2.9	3.6	4.3
Individual consumption y/y (%)	0.0	0.1	1.0	2.1	2.6	2.6	2.8	3.0
Public Consumption y/y (%)	0.1	5.0	3.0	3.1	0.7	2.0	2.0	2.4
Investment y/y (%)	-2.4	-3.3	0.5	2.0	10.7	6.5	8.5	10.0
Inflation 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	2.30	2.30
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.23	3.45	3.20	3.60
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

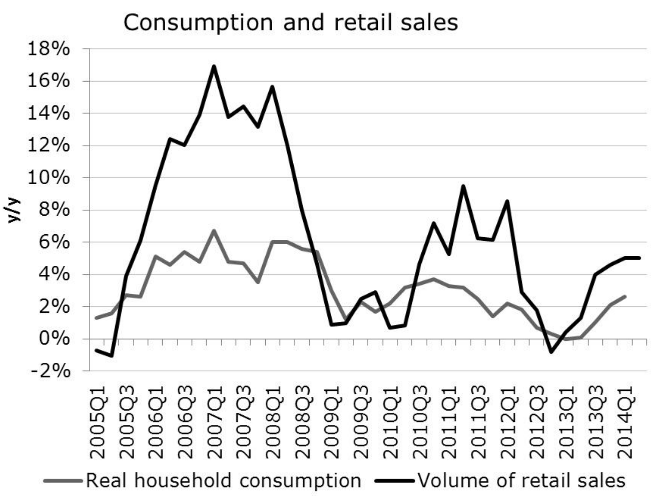
Economics

Retail sales worse than expected. Part of the weakness can be made up in July. However, upward trend is (at least for this very moment) broken.

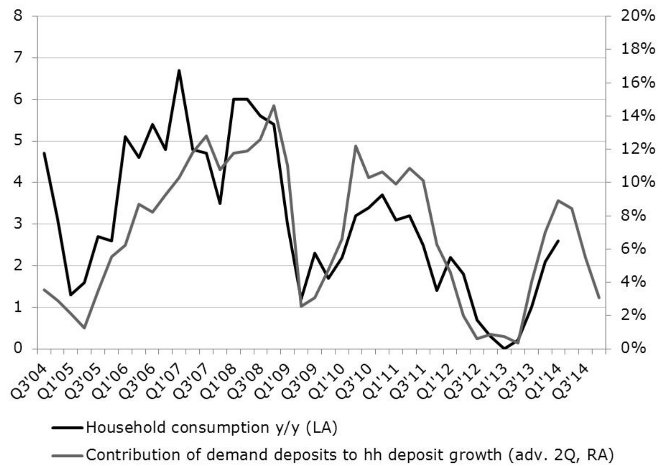
Retail sales grew in June by 1.2% y/y (market consensus 4.1%), down from 3.8% in May. The reading was not anticipated at all: the lowest expectation stood at 3.1%. Factors responsible for deceleration are rather of seasonal and one-off nature. For us, growth rates of food sales, sales in non-specialized stores, clothing and „others" category were seasonally (surprisingly) low. There may be a common factor negatively affecting both industrial output and retail sales at the same time in June. Therefore we may reasonably expect some sort of a rebound is pending.

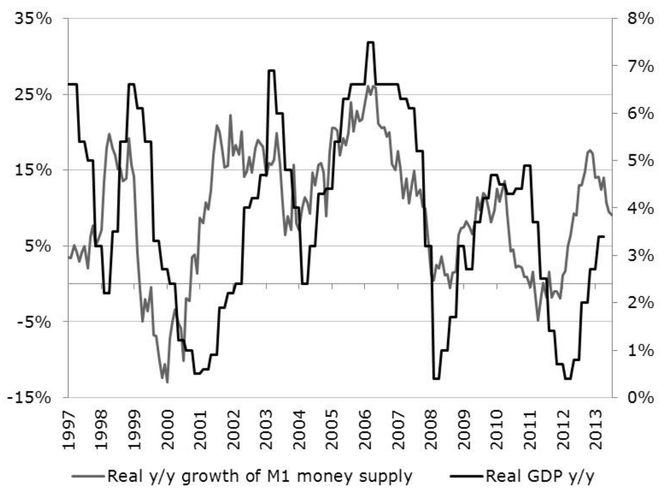


However, we do not want to miss forest for the trees. Leaving seasonals aside, upward trend in retail sales seems to be broken (see the graph). We shall not ask then whether upward trend is going to continue. Rather we should focus on when (or if) it is going to be re-installed. There are good economic reasons to think that consumption perspectives worsened.



Of course, the weakness in retail sales figures does not match the strength of the labor market. However, more than once have we written that labor market is not a good indicator of fast changes in the economy (e.g. consider the enormous decline in US GDP in Q1 that coincided with very fast employment growth). Not the labor market but excessive incentives to save in the form of high real interest rates are a more probable cause of on-going weakness in retail sales. One should point out to the correlation between M1 and GDP (the former as a measure of liquidity preference and the volume of transactions in the economy) and between demand / overnight deposits and consumption. Falling exports to the eastern markets, weakness in construction and investment (effects of favorable weather in Q1 and frontloading car purchases due to VAT discount window) meet the undesirable but nevertheless real increase in the propensity to save. Even now we are witnessing a flattening in consumption growth (see graph above).



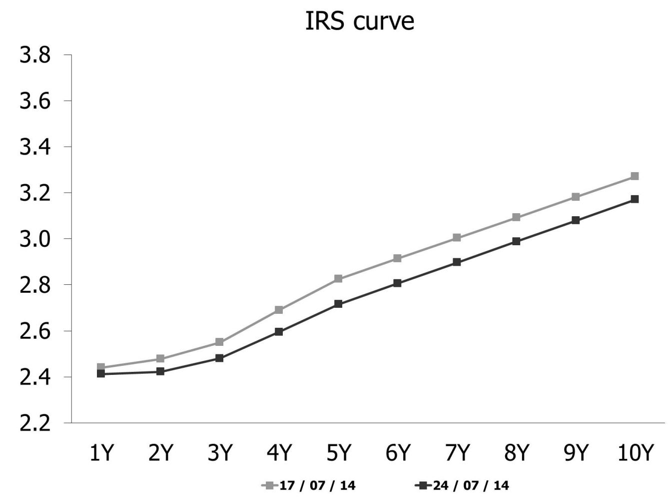


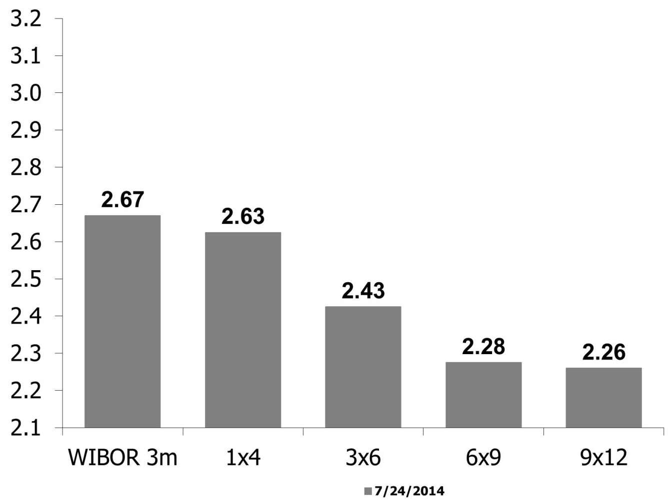
The market reacted vigorously to the weaker data - bond yields fell even as core markets moved in the opposite direction and ahead of 5Y auction - this confirms how strong the local macroeconomic factors are. Polish economy is slowly falling into a pothole, facilitated by overly restrictive monetary policy (compared to Czech Republic and Hungary, Polish rates are the highest, central bank projections the lowest and exchange rate - the strongest on a relative basis). Right now the play is not about the slowdown but about its duration. In our view, macro data has been putting NBP's inflation projections in increasing doubt. As a result, interest rates will be adjusted in Autumn accordingly (i.e. we continue to expect a cut).

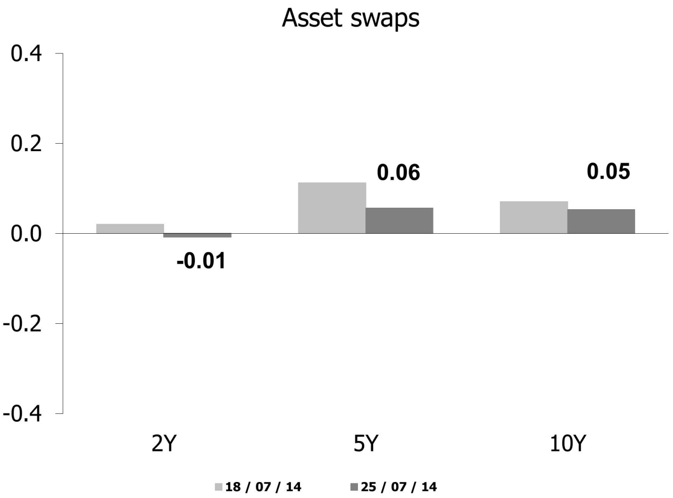
Fixed income

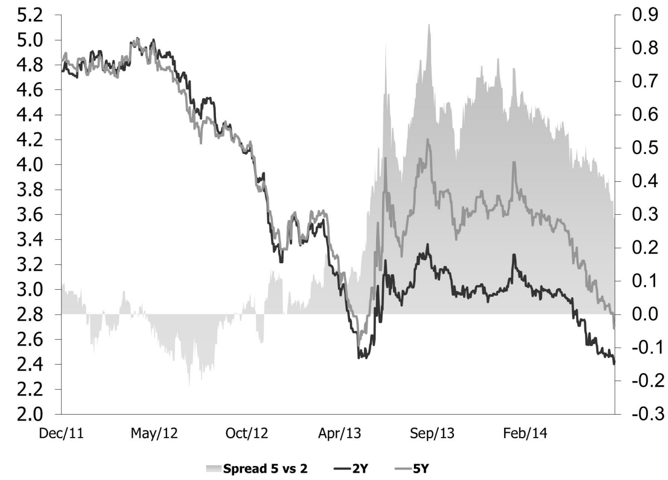
Important data

Main event of this week on fixed income market was the auction of 5Y benchmark. Just before this event, it became clear that supply, pln 5bln, was too low to satisfy all buyers. Price of PS0719 skyrocketed from 101.40, to 101.90 before the auction, 102.10 was min auction price and it is at 102.25 on the secondary market now. Demand for PolGBs is really impressive, investors like 5Y and longer tenors, and with lack of supply on the primary market, they feel safe to buy bonds at almost any price. Yield of 5Y benchmark reached 2.75%, 10Y benchmark is at 3.37%. Bonds at those levels may be viewed as too expensive for regular market users (local banks/clients) so despite huge inflows current price levels may be attractive for profit taking.





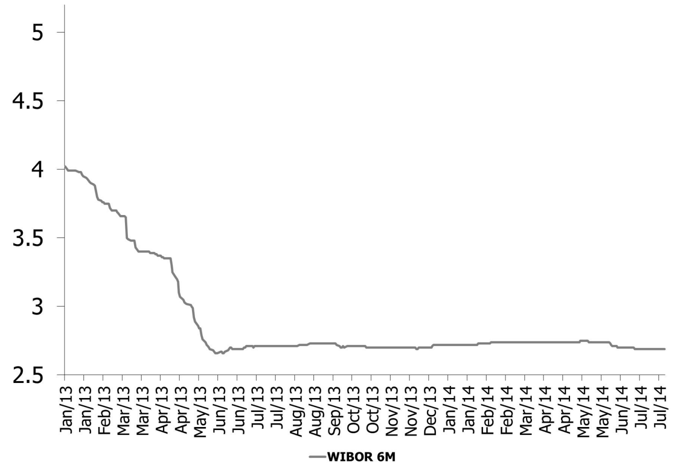


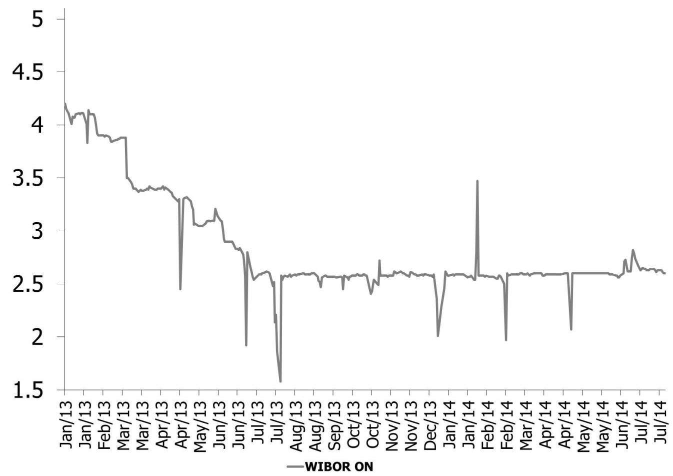


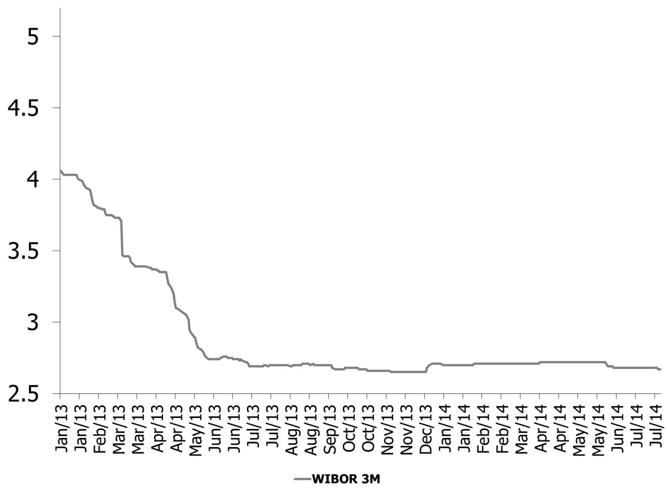
Money market

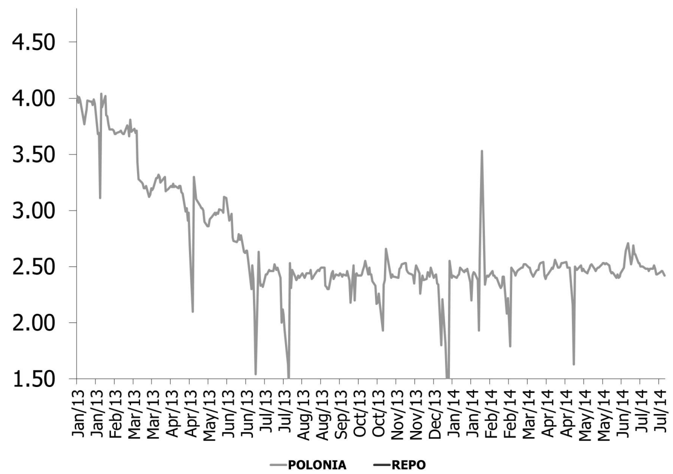
Chances for cheap carry Not seen for quite a long time, cheap cost of carry has pretty good chances to occur next week. After today's OMO (107.6 vs 112 bln pln) market is left over-liquid for about 5-7 billion pln, and we have just the end of the reserve requirement settlement period. We do not expect additional OMO before Wednesday (last day of the current reserve).

All about 2nd quarter GDP Bullish sentiment inflated by very weak retail sales and a very good bond auction. We do not see any short term obstacles to carry on with the trend. PMI should also be supportive and then the highlight of the summer which is Q2 GDP reading (14th of August). We believe that this figure will be crucial for further monetary policy steps and can be a game changer on both sides (pricing in more easing or pricing off current expectations). 3% is an anchor thrown by MPC member Bratkowski (to cut or not to cut) but one should remember that MPC expectations are really high (3.7%) hence there is plenty of room for disappointment even if we do not drop below this anchor.









Forex

PLN frozen 4.1300 - 4.1550 was this week's range for EURPLN. Market did not seem to get scared by worse than expected and really low Polish retail sales (the previous week had seen a very low industrial output reading). Global market ignores the increased tensions and expanding conflict in the Ukraine and does not seem to care about what is in fact a regular war in the Middle East. Psitive sentiment still supports risky assets, as big demand for EM currencies was observed. The bigger picture is that we are still in 4.12- 4.17 range and playing that range seems the most logical approach for us in current environment.

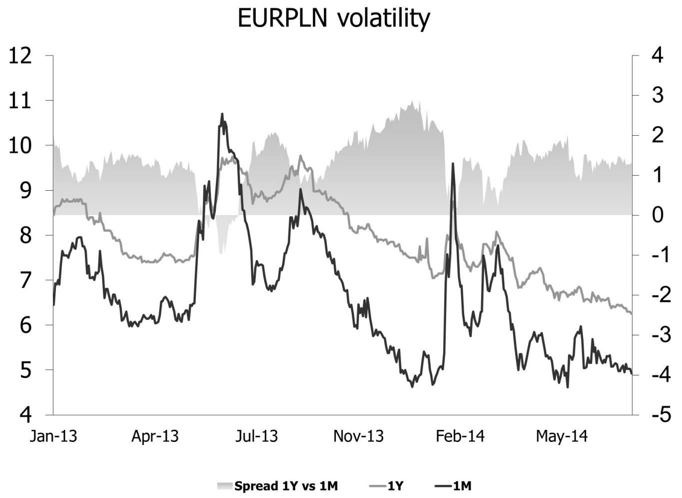
Vols - lower The bid for gamma in the frontend is all gone and the very distant memory already. The frontend got sold massively, with the 1 week being the biggest victim (1% lower). 1 month EUR/PLN ATM mid is fixing at 4.6% (0.7% lower than last Friday), 3 months EUR/PLN is 5.1% (0.4% lower), and 1 year 6.2% (0.3% lower). In theory the currency spread should be better bid after EUR/USD has gone south but it has not as it is the only thing left to sell to cover Theta bills. Skew roughly unchanged, with 6 months EUR/PLN RR 25D at 1.4%.

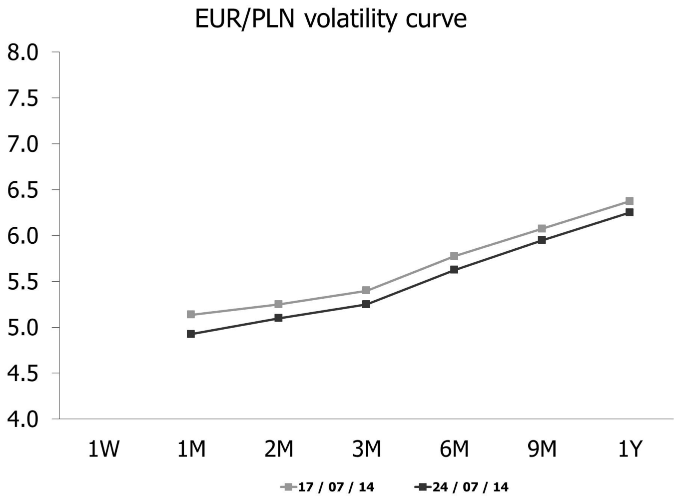
Short-term forecasts

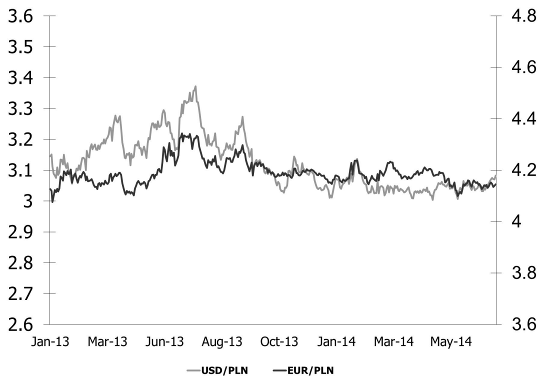
SPOT Main supports / resistances:
EUR/PLN: 4.1200 / 4.1700
USD/PLN: 2.9900 / 3.1000

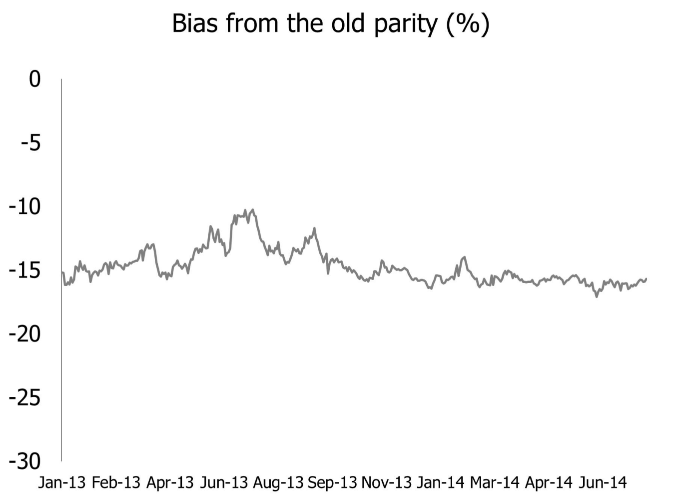
Spot - EUR/PLN: Play range from the long side Our short position in EUR/PLN at 4.1525 was closed at 4.1330. As this level seemed to be a strong support, we saw big supply of PLN there. The range 4.12 – 4.17 is really mighty, and so far it limits all the moves. We will still try to play it, but our favored strategy is to buy trough of EUR/PLN. Ideally we would like to buy 4.1250, add 4.1150 with stop below 4.1070 and eyes firmly on 4.16.

Options - tactical long. Still tactical long in mid curve Vega. The market is not really moving, we are in the very tight price range. Realized volatility is at record low level as well as implied volatility. Nevertheless, taking into account worse Polish economic data, mounting political tensions in Ukraine, and also in the Middle East, we are inclined to buy more Vega. Especially one has to remember about the mean reverting characteristic of volatility curve, and that alone should lift the curve from the current levels. Or at least that's what we are hoping for...









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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
7/21/2014	2.76	2.68	2.81	2.59	2.68	2.63	2.64	2.46	2.34	2.31	2.37	2.34
7/22/2014	2.58	2.68	2.59	2.59	2.62	2.63	2.66	2.42	2.32	2.30	2.34	2.32
7/23/2014	2.47	2.67	2.49	2.59	2.53	2.63	2.63	2.42	2.26	2.26	2.27	2.28
7/24/2014	2.59	2.67	2.61	2.59	2.69	2.63	2.63	2.43	2.28	2.26	2.28	2.29
7/25/2014	2.59	2.67	2.61	2.59	2.69	2.63	2.63	2.43	2.28	2.26	2.28	2.29

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
7/21/2014	2.630	2.403	2.475	2.488	2.815	2.917	3.275	3.330
7/22/2014	2.630	2.410	2.455	2.491	2.800	2.914	3.250	3.329
7/23/2014	2.630	2.343	2.403	2.403	2.690	2.772	3.140	3.224
7/24/2014	2.630	2.363	2.423	2.414	2.715	2.771	3.170	3.223
7/25/2014	2.630	2.363	2.423	2.414	2.715	2.771	3.170	3.223

EUR/PLN 0-delta stradle					**25-delta RR**		**25-delta FLY**
Date	1M	3M	6M	1Y	1M	1Y	1Y
7/21/2014	5.03	5.35	5.73	6.30	6.30	2.18	0.67
7/22/2014	5.03	5.35	5.70	6.29	6.29	2.18	0.67
7/23/2014	4.93	5.28	5.65	6.25	6.25	2.18	0.67
7/24/2014	4.93	5.25	5.63	6.25	6.25	2.18	0.67
7/25/2014	4.93	5.25	5.63	6.25	6.25	2.18	0.67

PLN Spot performance

Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
7/21/2014	4.1521	3.0700	3.4172	3.0306	1.3415	0.1511
7/22/2014	4.1464	3.0748	3.4121	3.0283	1.3406	0.1509
7/23/2014	4.1355	3.0707	3.4034	3.0294	1.3461	0.1505
7/24/2014	4.1398	3.0702	3.4074	3.0232	1.3438	0.1507
7/25/2014	4.1459	3.0831	3.4114	3.0253	1.3445	0.1509

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