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Polish Weekly Review

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Table of contents

Comment on the upcoming data and forecasts

The forthcoming week will be abundant with data. Wednesday's current account figures will exhibit some seasonal weakening. Trade account will be most likely flat on monthly basis, while low EU transfers and wider income deficit will contribute to higher current account deficit. The CPI data are scheduled for Wednesday - a crucial event this week. Stubbornly low food prices will be partially offset by more expensive fuel. According to the Statistical Office the recent cut in roaming charges will not be mirrored in July's inflation rate. Even though, the high base from last year (garbage collection and disposal fees) will bring the inflation rate down to -0.3% and core CPI down to 0.4%. Thursday will bring M3 release. Most of sub-categories are following their seasonal patterns and trends, thus M3 remains broadly stable.

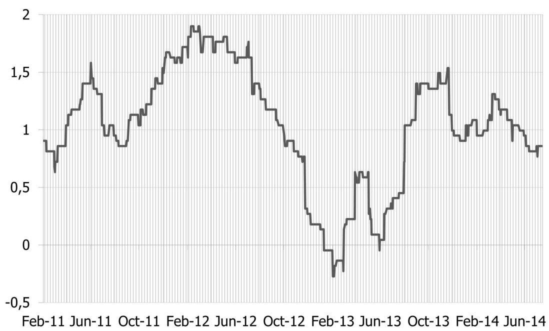
Polish data to watch: August 11th to August 15th

Publication	Date	Period	mBank	Consensus	Prior
Current account(m EUR)	13.08	Jun	-678	-285	280
Export (m EUR)	13.08	Jun	13700	13751	13642
Import (m EUR)	13.08	Jun	13500	13368	13467
CPI y/y (%)	13.08	Jul	-0.3	-0.2	0.3
Core inflation y/y (%)	14.08	Jul	0.4	0.4	1.0
M3 y/y (%)	14.08	Jul	5.3	5.5	5.2

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

Unchaged as no data were realeased this week. The forthcoming one brings CPI, which poses some opportunity for a surprise (in both directions).

* 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 and Q3 (sub 3%). Loses are expected to be made up in the latter part of the year but high real interest rates generate some new risks. External environment (with German economy contracting in Q2) was not so great as well. Recession in Ukraine and Russia do not seem to exert any visible pressure on overall Polish exports for now but Russia's food ban and possible escalation of trade war between EU and Russsia suggest a downside risk for Polish exports.
- Final quarte is 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

- Geopolitical risks dominate the near term outlook for Polish bonds.
- Polish along with European fundamentals, including zero inflation and downside risks to GDP, are more than ever supportive for lower rates. Due to higher volatility we may however not revisit July's yield minima instantly.
- Geopolitical risks, increased volatility, ECB easing fatigue and possibility of incoming downward revisions for the Polish growth are going to weigh negatively on the zloty. In such circumstances expectation of further easing may do more harm than good to Polish currency. Zloty is set to stay weaker.

mBank forecasts

	2009	2010	2011	2012	2013	2014F
GDP y/y (%)	1.6	3.9	4.5	2.0	1.6	3.2
CPI Inflation y/y (average %)	3.5	2.8	4.3	3.7	0.9	0.2
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	3.0	3.0	3.7
Individual consumption y/y (%)	0.0	0.1	1.0	2.1	2.6	2.5	2.6	2.8
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	5.0	5.0	8.5
Inflation rate (% average)	1.3	0.5	1.1	0.8	0.6	0.2	-0.2	0.4
Unemployment rate (% eop)	14.3	13.2	13.0	13.4	13.9	12.0	11.5	12.2
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	4.15	4.15
USD/PLN (eop)	3.26	3.32	3.12	3.02	3.04	3.12	3.17	3.15

F - forecast

Economics

Sanctions, countersanctions and their impact on the Polish economy

It often seems that the Polish economy cannot catch a break. Since the onset of Ukrainian - Russian conflict, Poland has been hit by adverse shocks. In addition to "simple" demand shocks stemming from recessions in both economies, political and regulatory shocks have kicked in as well. Our previous piece (see: Polish Weekly Review, March 7th) briefly pointed out to the role of pork meat ban in lowering the CPI path. As all readers are aware, this has already happened. In addition, Russia has also embargoed Polish fruit and vegetables (announced on July 30th, the ban is effective from August 1st). Finally, Russia banned food and agricultural imports from Western countries (which includes Poland as a member of the EU). The last ban is also the broadest as it extends to fish and dairy products as well. Similiarly to our previous piece, we consider GDP and CPI impacts separately.

Trade links et al.

In terms of demand shortfall, bilateral trade linkages between Poland, Russia and Ukraine are the most important channels. In our March piece, we indicated that, under reasonable assumptions about the severity of recessions in both countries, Polish GDP could be affected by as much as 0.6-0.8% - this assumed that exports to Ukraine could fall by around 20%, whilst Russian imports from Poland declined by 10%.

Total effect									
Slowdown of Russian Imports (%) \ Slowdown of Ukrainian Imports (%)	5	10	15	20	25	30	40	50	100
5	0,2	0,2	0,3	0,4	0,4	0,5	0,6	0,7	1,3
10	0,3	0,4	0,4	0,5	0,5	0,6	0,7	0,8	1,4
15	0,4	0,5	0,6	0,6	0,7	0,7	0,9	1,0	1,6
20	0,6	0,6	0,7	0,7	0,8	0,9	1,0	1,1	1,7
25	0,7	0,7	0,8	0,9	0,9	1,0	1,1	1,2	1,8
30	0,8	0,9	0,9	1,0	1,0	1,1	1,2	1,3	1,9
40	1,1	1,1	1,2	1,2	1,3	1,4	1,5	1,6	2,2
50	1,3	1,4	1,4	1,5	1,5	1,6	1,7	1,8	2,4
100	2,6	2,6	2,7	2,7	2,8	2,8	3,0	3,1	3,7

Today it is clear that our initial guesstimates were too optimistic. First, as the Ministry of Economy indicates, actual declines could be twice as high as we suspected (40 and 20%), respectively. This puts the number at as much as 1.5% - it must be noted, however, that this is a gross figure that doesn't include dynamic and second order effects. Net effect of weakness in both economies should be smaller, perhaps a half of the gross number - still significant, though. Secondly, there is no reason to suspect that Russian and Ukrainian demand have bottomed out - trade figures are clear here (see the graph below).

The more so, since the embargoes will accelerate that process. One has to remember, however, that food exporters and producers, albeit visible and important from the political point of view, do not contribute to Polish GDP in a signifcant way. Total exports of food to Russia amounted to a mere 0.3% of GDP in 2013. Since the sanctioned goods have already been produced or are well-advanced in the process (i.e. apples hanging on trees), indirect effects (intermediate inputs) are probably non-existent.

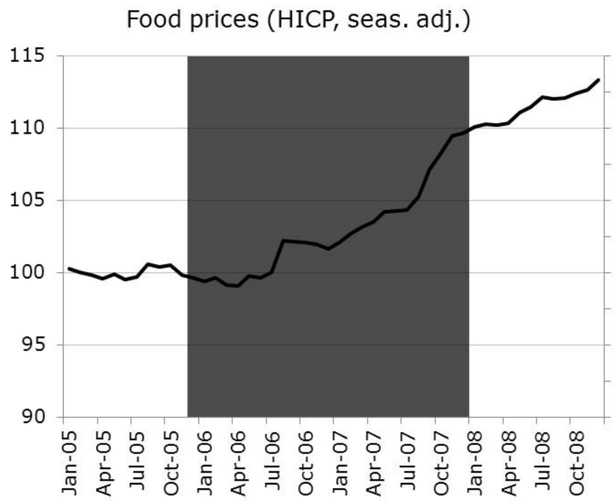
If Russian counter-sanctions remain restricted to food, they themselves should not affect Poland significantly. However, Russian authorities have already outlined further possible steps that include protective measures in aircraft, automotive and shipbuilding industries. These are bound to impact Poland more severely - directly (Poland exports a lot of machinery and equipment to Russia) and indirectly (through Poland's place in value chains of large Western producers in these sectors). Finally, several Polish industries have significant exposure to Russia (chemical and chemical products - 15.4% of total exports to Russia; simple manufactured goods e.g. building materials - 17.7% of total exports). If these goods were targeted, the impact would be larger and more widespread, as high-value-added industries have siginificant links and are deeply embedded in the country's industrial structure.

Last but not least, there is an elephant in the room, a €10-trillion one (the approximate size of Eurozone economy). It is easy to attribute the recent slowdown in the Polish economy to Russian and Ukrainian troubles. This, however, is only a partial explanation, as domestic issues also played a role. Furthermore, sustained demand from the Eurozone has been crucial for the Polish recovery so far. Next week's data is bound to show that the block's economy was brought to a standstill in Q2, with outright contraction in Germany being the consensus view now. Any negative shock to the Eurozone will feed in to Poland.

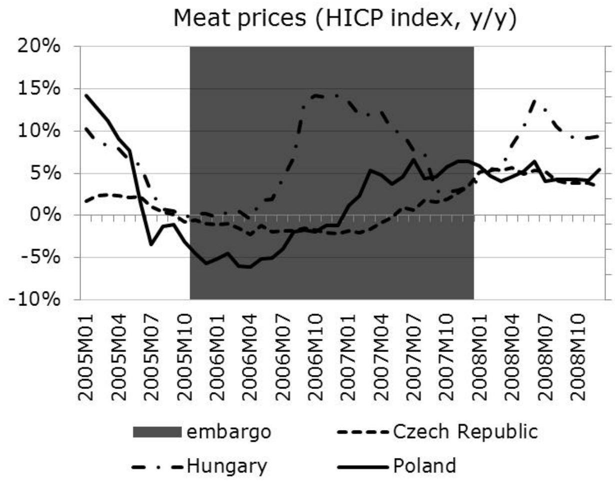
CPI and prices

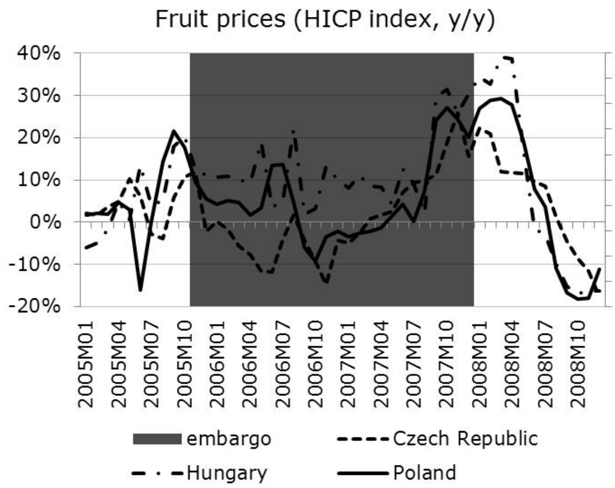
While embargoes are rather insignificant as a demand dampener, their impact on prices could potentially be much higher. The embargoes affect, directly or indirectly, as much as 40% of foodstuffs available on the Polish market (10% of CPI basket). Their impact is of course difficult to estimate, as it depends on conditions on several different and separate markets. Furthermore, prices of goods affected had already been falling when countersanctions were announced - many areas of agriculture have been plagued by oversupply since the beginning of the year.

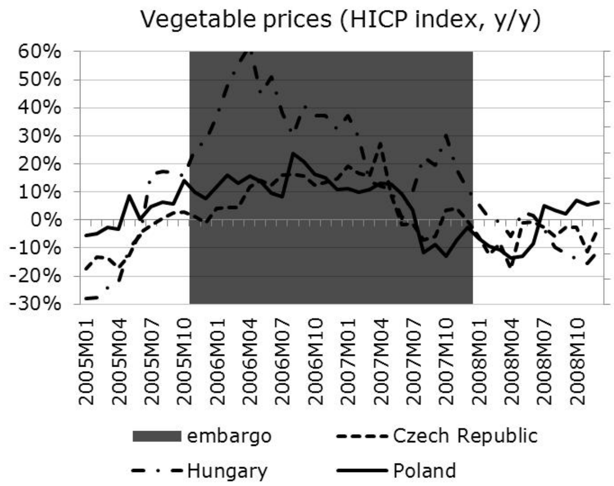
When looking for historical analogies, one can point out to the previous Russian ban on Polish food products. Announced in November 2005, it lasted for more than a year (it was lifted in December 2007) and included roughly the same products as the first two of recent embargoes, i.e. meat, fruit and vegetables. Furthermore, the ban came at a moment when food prices have generally been flat for about a year (also globally) - a situation very similiar to observed today. On the other hand, no other country was affected. Hence, the sudden oversupply on other European markets was not a problem.



What can we learn from the past? As soon as the embargo was put in place, general food price level remained essentially flat throughout 2006 and early 2007 (see graph below). In regional comparisons, Poland stood out as a country with exceptionally low meat prices (with growth rates about 5pp. lower than in regional peers) and rather subdued prices of fruit and vegetables (see graphs below). Furthermore, the 2005-2007 episode clearly shows that the adjustment in prices is not instantenous - meat prices have been falling for a few months before reaching a new bottom (4% below pre-embargo peak). So far this year, meat prices have fallen by less than 1%.







All in all, the embargoes are bound to depress food prices further with uncertain impacts pertaining to EU-wide effects. All in all, this means a lower CPI path. Because of that, we have lowered our year-end forecast of CPI to 0.4 y/y (statistical base effects, not a change in momentum). In addition, the starting point for 2015 CPI is even lower. It is needless to say that the incredibly low CPI path from last NBP's projections will be undershot.

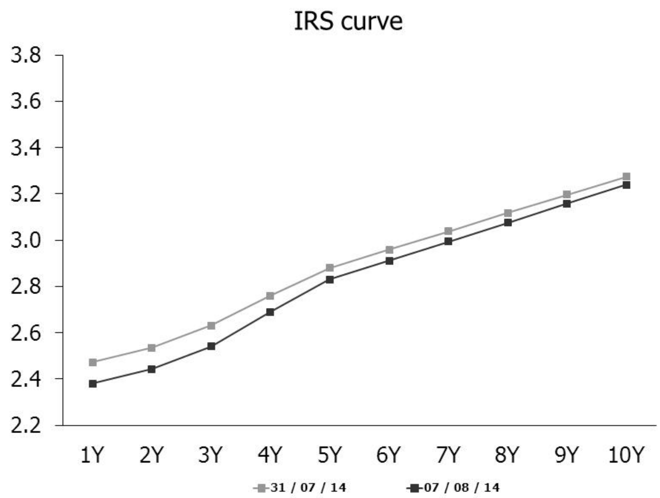
With stubbornly low inflation and mounting risks for growth (Q3 will at best be marginally better than Q2 and acceleration in Q4 hangs on fiscal stimulus via infrastructure) it is easy to see what the MPC should do now. Many analysts might thus be wrong when claiming that deflation will not be linked to weaker growth at all - it will be, through a common cause / common shock. The only question, as we repeatedly said, is when. It would be desirable to do so in September but history has shown a few times that the Council takes its time to observe the economy, therefore October is equally likely as a time for rate cut.

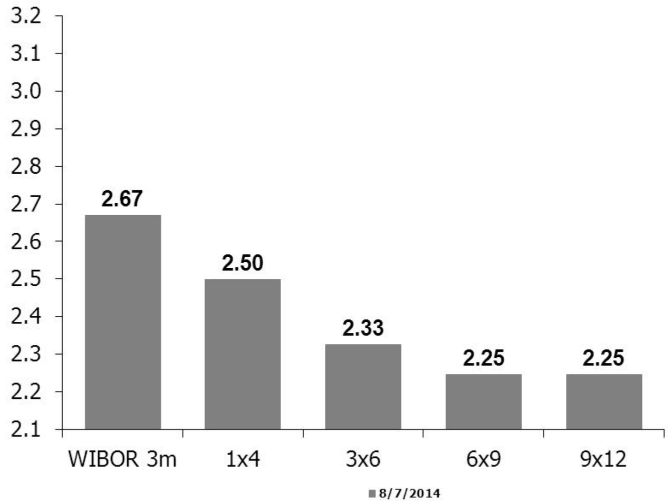
Fixed income

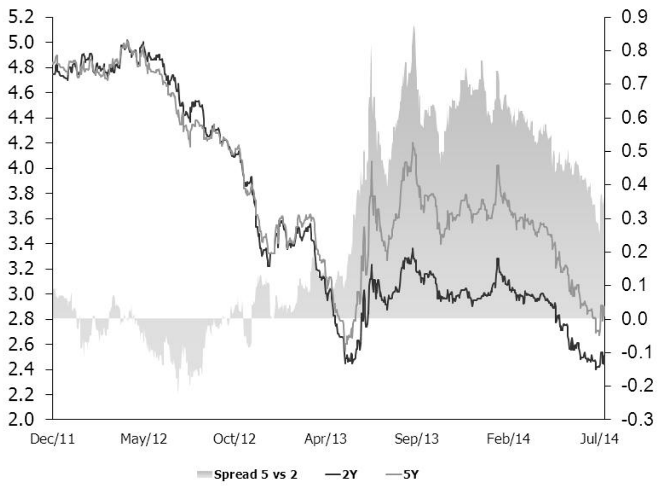
Volatility, volatility, volatility ...

Another nervous and flow driven week on Polish fixed income market is behind us. We started quite optimistic - yields went down 20 bps (DS 1023 3,24%) but it was just a short term rally as Polish Minister of Foreign Affairs Sikorski mentioned the risk of escalation of Russia-Ukraine conflict (we were back in the 3,45% area on DS1023). Second part of week was much calmer while yields fluctuated in 10bps range; ECB meeting had only minimal positive impact on market.

We still like Polish bonds from the fundamental point of view (CPI and GDP figures are to be published next week while Russia sanctions are to have downward impact on them in the future). The one and only question is whether Russia-Ukraine conflict is going to escalate as persistently higher volatility is not welcome by long term foreign investors on debt market.



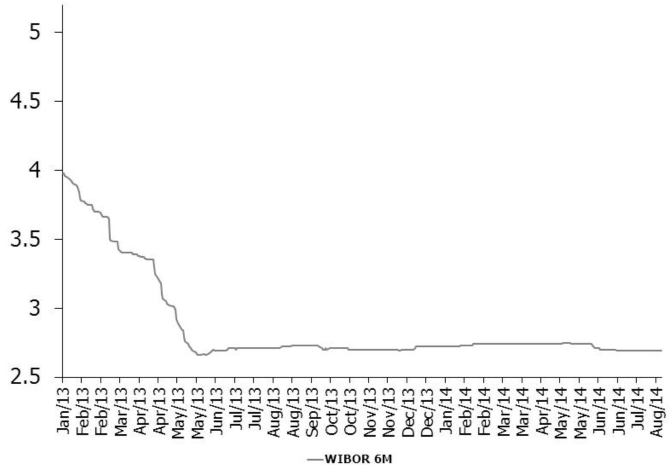


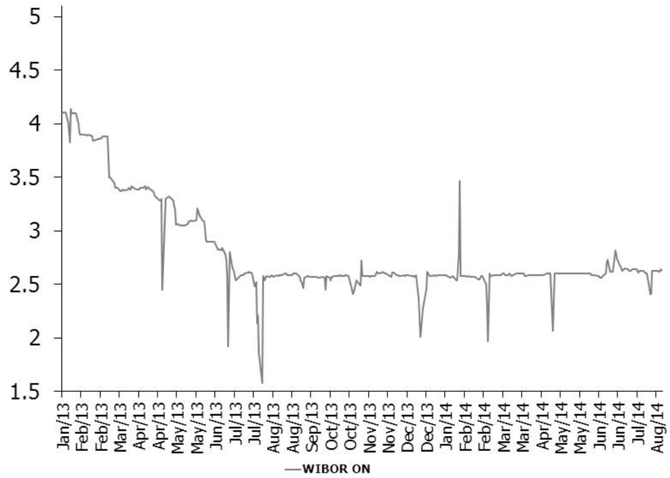


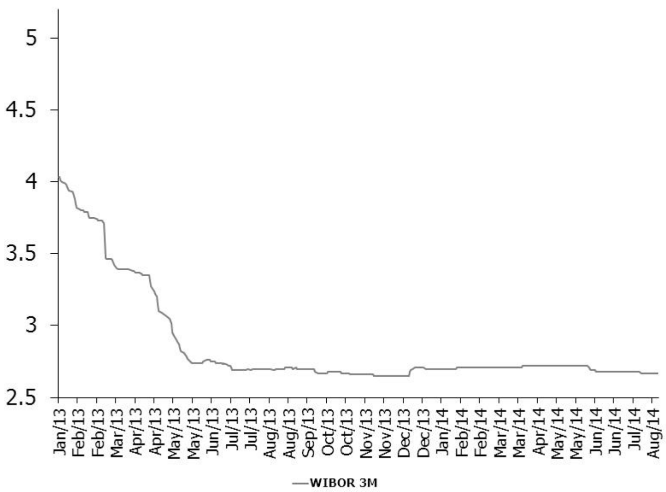
Money market

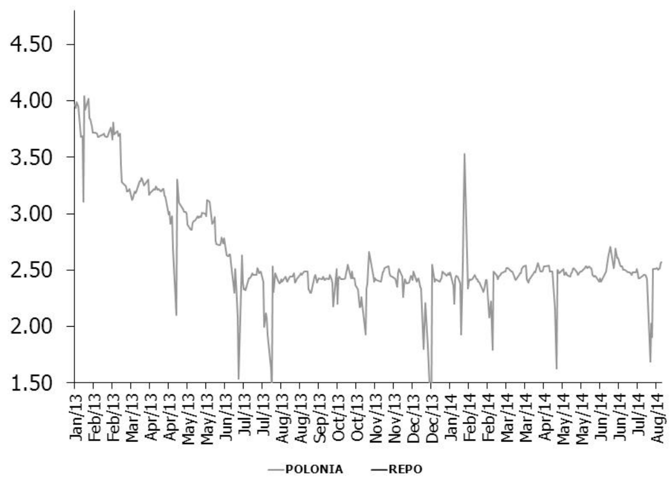
Expensive carry Cost of carry rather high for the whole week, therefore the central bank decided to leave some surplus for the next one. However, to relief the market OMO should be reduced much deeper than by PLN 1 billion. And that is why we do not expect significant change in coming days.

Ukrainian turmoil Lots of volatility for longer rates coming mainly from fear of further escalation in the Ukraine. As of now we end the week again with very bullish sentiment on bonds and derivatives and not so much for currency. Important figures that may change the MPC perception will be published next week. CPI (expected to be negative but the scale may surprise both ways), 2q GDP with strong psychological barrier at 3%. If both figures come as expected by mBank analysts, they would definitely increase probability of monetary easing in September. The only missing part would be the currency...





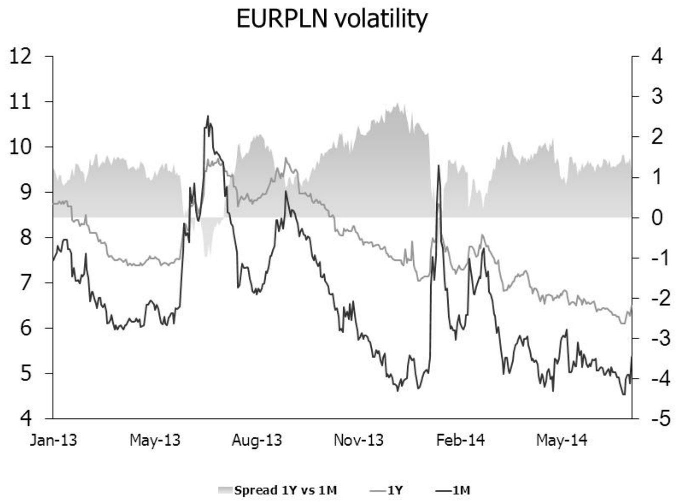




Forex

Volatility is back EUR/PLN has managed to correct lower to 4.1600 just to shoot higher to finally breach 4.20 resistance and even scratch 4.2250 on Friday. Then it nosedived to 4.1930 on some rumor on the peace talk. One thing is certain, the volatility is back and moves amounting to a 2/3 of big figures are happening on the daily basis. The geopolitical tension is out of the sudden taken into the consideration, and the potential black scenario is quite scary not only market wise. We expect, volatility is here to stay.

Vols – higher The Gamma and Vega is in demand. Even the short term PLN recoveries are not helping to lower the vols. The big trade on the vols was a 1 year EUR/PLN atm paid and bid on at 6.6%, in good amount. In general, 1 month EUR/PLN mid is 5.6% (0.5% higher than last Friday), 3 months are 5.8% (0.3% higher), 1 year 6.6% (0.4% higher). The Skew is also bid, as market is reviewing its books, and trying to trim risk exposure.



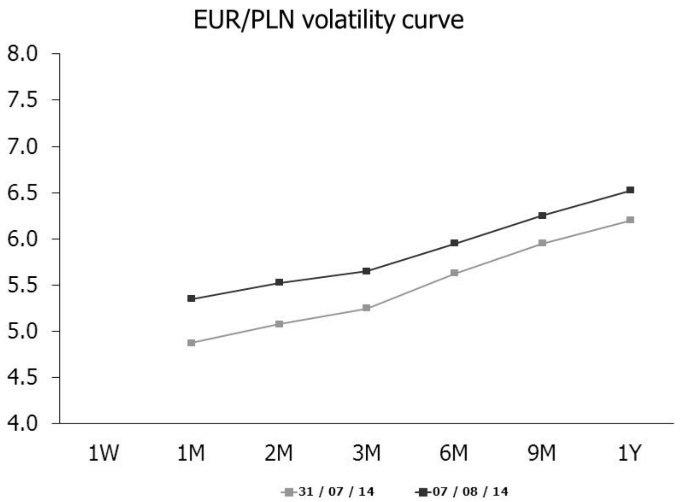
Short-term forecasts

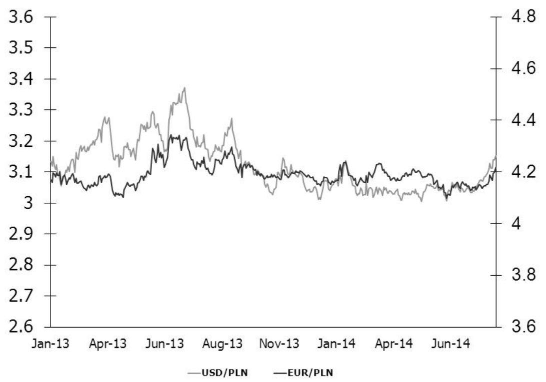
SPOT Main supports / resistances:
EUR/PLN: 4.16 / 4.25
USD/PLN: 3.07 / 3.24

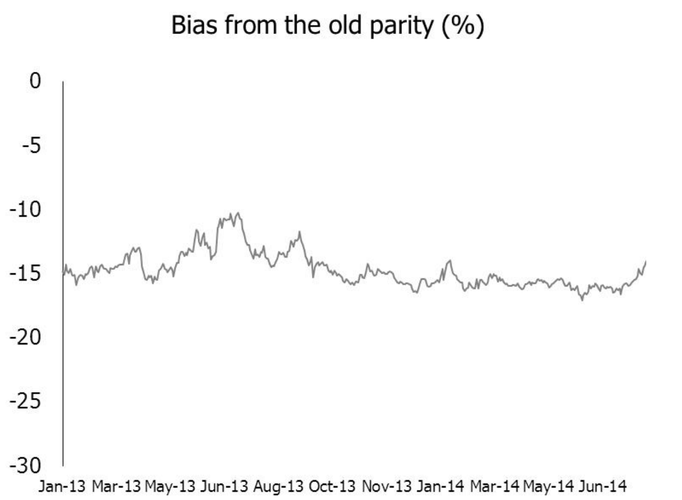
Spot – EUR/PLN Long. We are still core long from 4.1650 but with half of the position we try to be more flexible and play range with the assumption that we are slowly but surely moving up. We still need a close above 4.22 to confirm the move. And if that happens we may see attempt on this year high, 4.25/4.27 resistance zone, which is our ideal target. We have the stop on the entry level at 4.1650.

Options – long We are long Vega and Gamma in EUR/PLN. We are gradually adding to the position as realized volatilities are also creeping higher. We still see a good reasons to be long Vega, nominal levels are still historically low, realized volatilities are improving, there are a lot of potential volatility triggers.

Still buy on dips approach.







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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
8/4/2014	2.70	2.67	2.70	2.59	2.77	2.62	2.54	2.39	2.29	2.27	2.33	2.31
8/5/2014	2.70	2.67	2.71	2.59	2.62	2.62	2.51	2.38	2.30	2.30	2.37	2.32
8/6/2014	2.61	2.67	2.61	2.59	2.69	2.62	2.54	2.37	2.30	2.29	2.38	2.31
8/7/2014	2.71	2.67	2.71	2.59	2.79	2.62	2.50	2.33	2.25	2.25	2.30	2.27
8/8/2014	2.71	2.67	2.71	2.59	2.79	2.62	2.50	2.33	2.25	2.25	2.30	2.27

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
8/4/2014	2.620	2.380	2.450	2.484	2.785	2.620	3.180	3.316
8/5/2014	2.620	2.365	2.510	2.426	2.895	2.942	3.290	3.460
8/6/2014	2.620	2.404	2.505	2.429	2.900	2.985	3.305	3.442
8/7/2014	2.620	2.502	2.443	2.655	2.830	2.922	3.240	3.411
8/8/2014	2.620	2.502	2.443	2.655	2.830	2.922	3.240	3.411

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
8/4/2014	4.98	5.28	5.65	6.33	6.33	2.11	0.71
8/5/2014	4.79	5.18	5.63	6.28	6.28	2.11	0.71
8/6/2014	5.38	5.70	5.93	6.50	6.50	2.24	0.69
8/7/2014	5.35	5.65	5.95	6.53	6.53	2.31	0.72
8/8/2014	5.35	5.65	5.95	6.53	6.53	2.31	0.72

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
8/4/2014	4.1783	3.1114	3.4345	3.0334	1.3346	0.1511
8/5/2014	4.1679	3.1121	3.4233	3.0346	1.3319	0.1508
8/6/2014	4.1940	3.1377	3.4501	3.0628	1.3290	0.1510
8/7/2014	4.1990	3.1397	3.4551	3.0681	1.3292	0.1509
8/8/2014	4.2184	3.1509	3.4764	3.0955	1.3382	0.1516

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