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Polish Weekly Review

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Comment on the upcoming data and forecasts

The series of July's macro releases continues. Tuesday brings figures from Polish labor market. Employment most likely grew in July, driven by positive seasonality and still decent momentum visible in latest breakdown. Wages are expected to continue recent trends and rise modestly, in line with some softening in manufacturing output. The data from industrial sector will be released on Wednesday. Although surprising for market participants, June industrial production figures were in line with calendar effects and statistical base. Since the configuration of working days in July was identical to the one observed last year, industrial output will most probably be driven by high statistical base and stagnating momentum. PPI is set to decrease further as zloty remained stable amid falling oil prices. Busy week ends with Thursday's MPC's Minutes release. We will seek information regarding MPC's view on severity and persistency of recent glitch in Polish business cycle as well as members' propensity to cut rates.

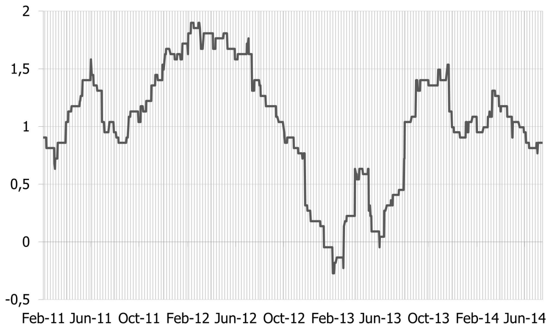
Polish data to watch: August 18th to August 22th

Publication	Date	Period	mBank	Consensus	Prior
Budget performance (%)	18.08	Jul			53.4
Average wage y/y (%)	19.08	Jul	3.8	3.9	3.5
Employment y/y (%)	19.08	Jul	0.8	0.8	0.7
Industrial production y/y (%)	20.08	Jul	0.7	2.2	1.7
PPI y/y (%)	20.08	Jul	-1.9	-1.9	-1.7

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, since all figures were in line market consensus. The forthcoming one brings some opportunity for a surprise as labor market and industrial sector data will be released.

* 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

- Polish economy is already in a soft patch. Although the recovery may not be ultimately derailed, we see important downside risks to a forecast of a more dynamic rebound going forward. In the nearest future we expect economists to cut their growth and inflation forecasts further which may stimulate expectations for monetary easing.
- Current business tendency indicators suggest that growth momentum softened and GDP growth is going to be lower in Q3 (3%). 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 quarter is expected to bring more (positive) exogenous components to the Polish cycle. We may see first effects of credit easing in the euro area. Pension reform, along with the political cycle, opens room for fiscal stimulation. We expect significant fiscal stimulus from 2014/2015 onwards, focused mainly on public infrastructure spending and fueled by the re-launch of EU funding.
- 2-3 years of economic expansion are our baseline scenario but growth rates may prove to be more moderate than we expected few months ago.
- Inflation stays very low (negative) for the next few months. Momentum on inflation is already negative which strengthen the impact of high real interest rates.
- MPC got stuck in a fairly positive GDP growth scenario and is likely to overreact on embargo-related news flow and weaker data releases. We see MPC cutting rates in Autumn. It is posssible that they embark on a whole easing cycle (50-100bps).

Financial markets

- Geopolitical risks still important for Polish bonds.
- Polish fumdamentals, along with European factors - including zero inflation and downside risks to GDP, are more than ever supportive to lower rates across the board.
- Geopolitical risks, increased volatility, ECB easing fatigue and possibility of incoming downward revisions for 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

	2010	2011	2012	2013	2014F	2015F
GDP y/y (%)	3.9	4.5	2.0	1.6	3.0	3.4
CPI Inflation y/y (average %)	2.8	4.3	3.7	0.9	0.2	1.8
Current account (%GDP)	-4.5	-4.9	-3.5	-1.3	-0.9	-1.8
Unemployment rate (end of period %)	12.4	12.5	13.4	13.4	12.2	12.0
Repo rate (end of period %)	3.50	4.50	4.25	2.50	1.75	2.00

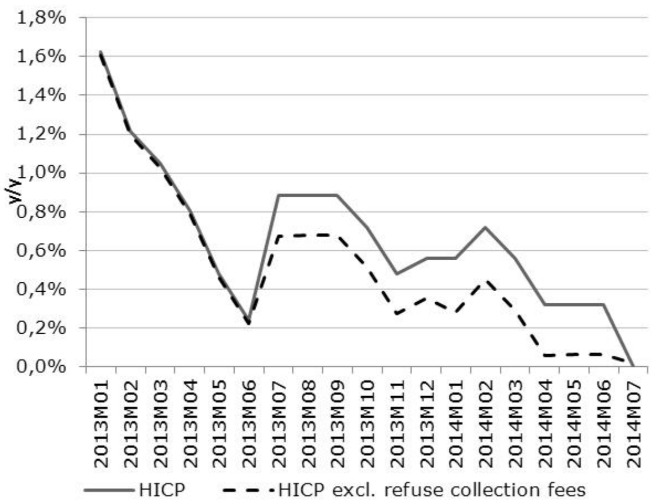
	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.4	0.8	2.0	2.7	3.4	3.2	2.9	3.0
Individual consumption y/y (%)	0.0	0.1	1.0	2.1	2.6	2.5	2.4	1.9
Public Consumption y/y (%)	0.1	5.0	3.0	3.1	0.7	0.6	2.0	2.4
Investment y/y (%)	-2.4	-3.3	0.5	2.0	10.7	5.4	6.3	7.0
Inflation rate (% 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	1.75
Wibor 3M (% eop)	3.39	2.73	2.67	2.71	2.71	2.68	2.22	1.97
2Y Polish bond yields (% eop)	3.19	3.07	3.06	3.05	3.01	2.51	2.20	2.05
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.23	3.45	3.00	3.20
EUR/PLN (eop)	4.18	4.33	4.22	4.15	4.17	4.16	4.20	4.20
USD/PLN (eop)	3.26	3.32	3.12	3.02	3.04	3.16	3.21	3.23

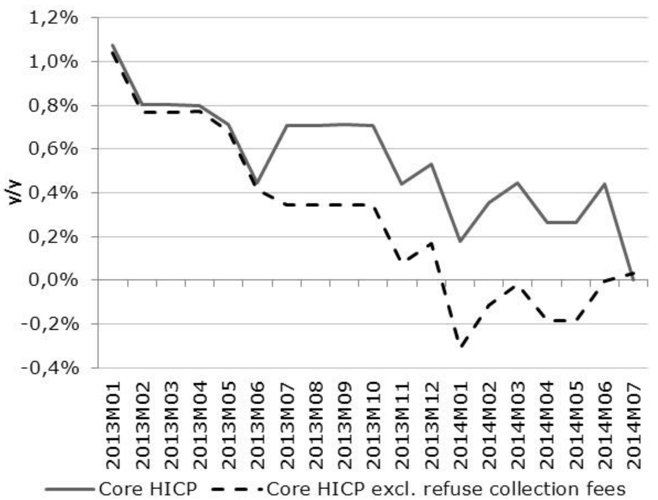
F - forecast

Economics

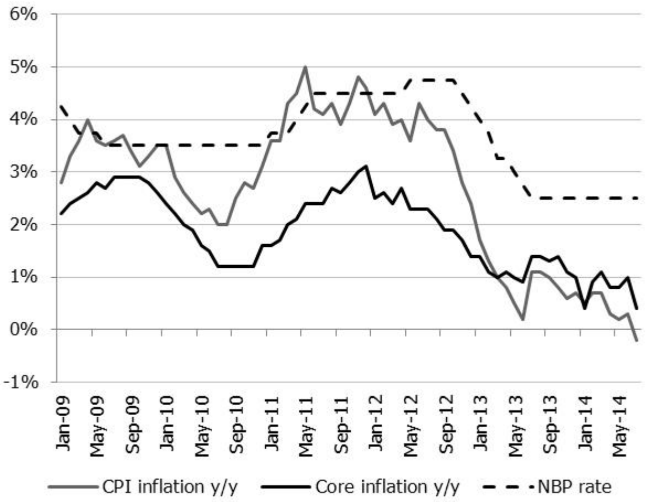
Inflation turns negative in July. Questioning the merits of rate cuts is pointless.

For the first time in modern history, Polish inflation dropped below zero in July, from 0.3% in June to -0.2%. A layperson would dismiss the fall in y/y growth rate as an effect of high statistical base. We, however, prefer to argue that previous readings were artificially boosted by the increase in garbage collection fees introduced a year ago. Only now is inflation returning to a „normal", unbiased level. Its momentum is still low and no signs of a sustained turnaround are in sight.





As for the details of the release, the downtrend in food prices was continued in July (-1.1% m/m). Housing prices were unchanged, energy prices remained stable as well. Fuel prices increased by 1.5% m/m. Hikes in mobile phone charges translated into a modest increase in communications prices (1.2% m/m). Thus, core CPI declined from 1.0% to 0.4%.

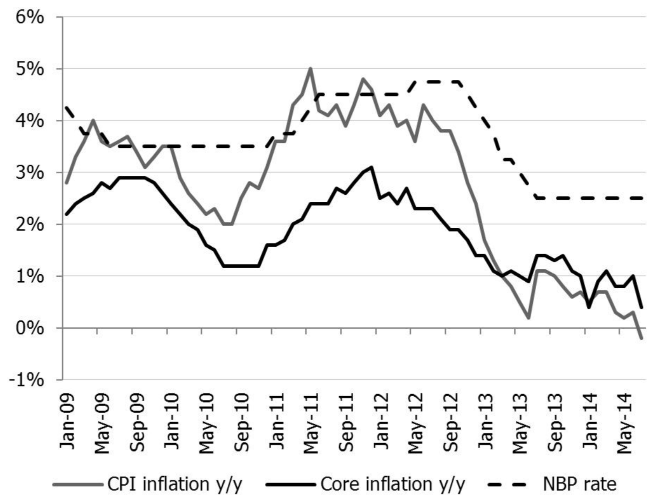


Newly introduced sanctions and the Russian embargoes will facilitate low levels in food prices, extending monthly declines into August, September and possibly further. One has to remember that oversupply will reveal itself slowly, adjustments in relative prices of various foodstuffs will not happen overnight.

Negative inflation readings are here to stay at least until Autumn. Inflationary pressures are unlikely to arise anytime soon. The more so, since output gap is set rather to widen up, not to narrow as expected mere 3-4 months ago. In such circumstances (weaker GDP, possibility of a more persistent output gap, lower and lower prices) we think it is high time to think about a new monetary cycle, not only a corrective cut in September. Ultimately, we believe in lowering NBP rates below 2% in coming months.

GDP growth slowed down to 3.2% in Q2. No signs of a turnaround in factors that contributed to the deceleration.

GDP growth declined from 3.4 in the previous quarter to 3.2%, in line with market consensus. Our forecast, 3.0% with downside risks, turned out to be too pessimistic, although one should honestly admit that high uncertainty regarding inventories (favorable base effect but also weaker demand that should - in principle - decrease inventories) makes this discrepancy unremarkable. The bottom line should be the following: GDP decreased only a bit but is it not good news. And here is why.



A quick review of all components suggests that weaker investment growth is to blame (we pencil it a half the Q1's reading). Household consumption, on the other hand, at best held steady at +2.6% y/y. Finally, large contribution of inventory change (north of 1 pp.) completes the picture of domestic demand. Of course, these are all educated guesses (a flash release without details) but we are fairly sure of the overall picture. There are also quite good indications regarding growth in the following quarters. Sentiment indices have weakened, Russia and Ukraine are spiraling downwards faster and deeper than we initially suspected (the effects of sanctions will be felt in Western Europe as well), real rates are higher and tenders for infrastructure investment (announced at the turn of 2013 and 2014) have barely progressed. Moreover, even a *naïve* forecast (assuming flat trend) points out to a continued slowdown in annual terms in Q3 and to a lower GDP path further on. All in all, we are convinced that current weakening in growth might be something more than a 1-2 quarter soft patch (there are clear risks at least). Obviously, a deep slowdown is not the only alternative â€“ GDP growth could stabilize at disappointingly low levels (2%). Next weeks are bound to bring a wave of downward revisions to analysts' forecasts.

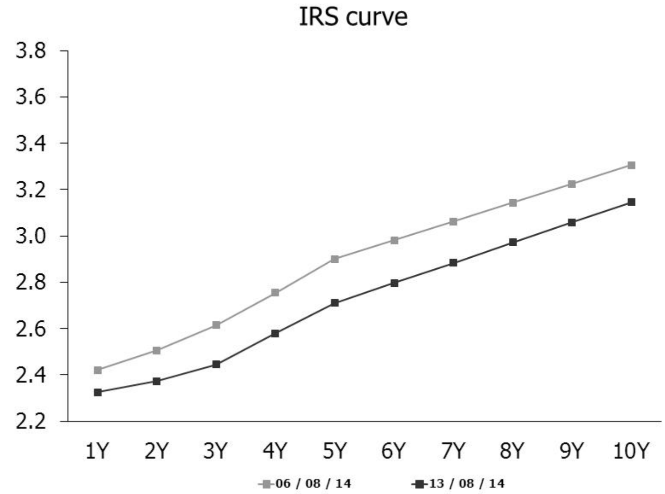
How will the MPC react? Of course, if one applies the so called „Bratkowski criterion" (growth below 3% in Q2), than the logical conclusion is that of no cuts. It would, however, be a *naïve* way of thinking as no sign of a turnaround is in sight. This, in turn, means that no single quarter is pivotal. In light of mounting risks to growth and inflation a single cut would not be enough, and a small easing cycle (up to 100 bps) would be required. We stand firm by this view.

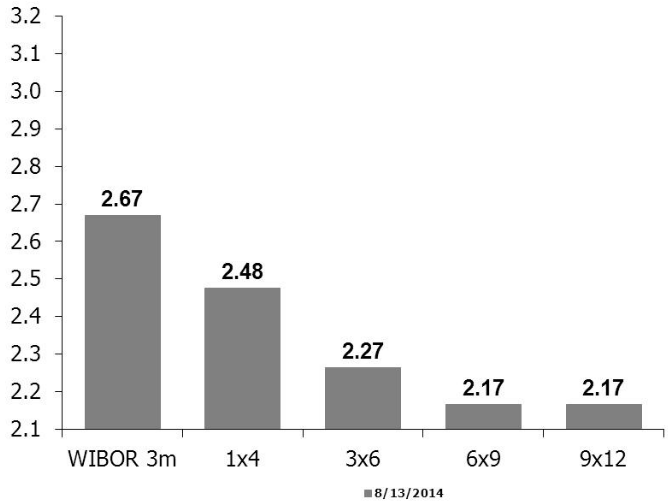
Fixed income

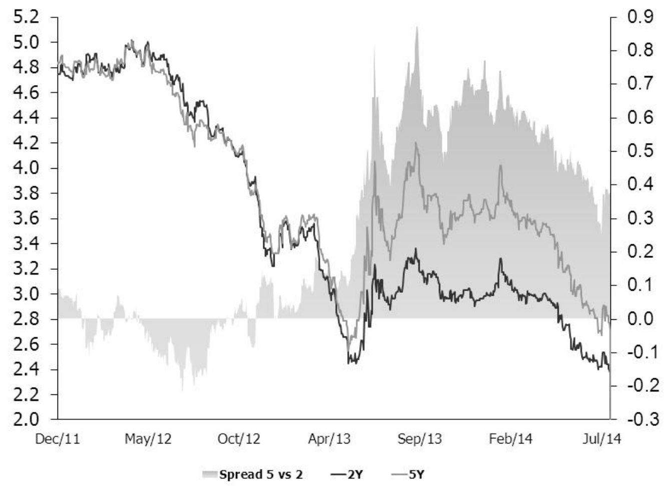
No fear

Another week showed, yet again, that investors have no fear on Polish Fixed Income market. Despite still nervous situation in Ukraine and a set of 'as expected' local data, long end bonds rallied and reached its lows in yields. DS0725 trades around 3,30%, market fully priced in a 50bp rate cut in Poland.

While we generally agree with market direction, we don't expect more rally in comming weeks. Most of positive news are already priced in, soon investors are going to start to think about bond supply in September. We recommend to sell long position at current levels (profit taking from 2 week ago recommendation).



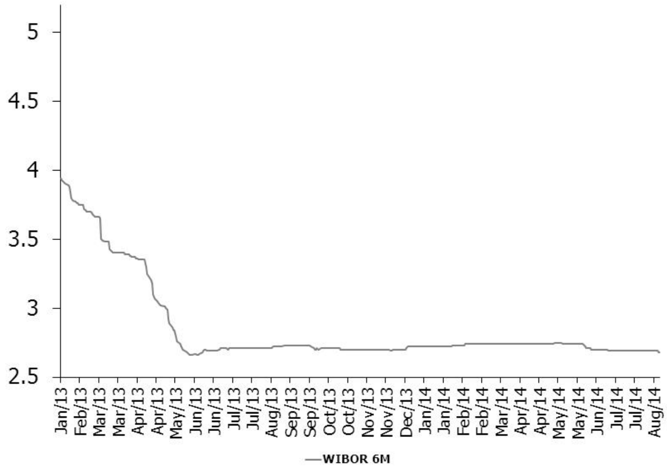


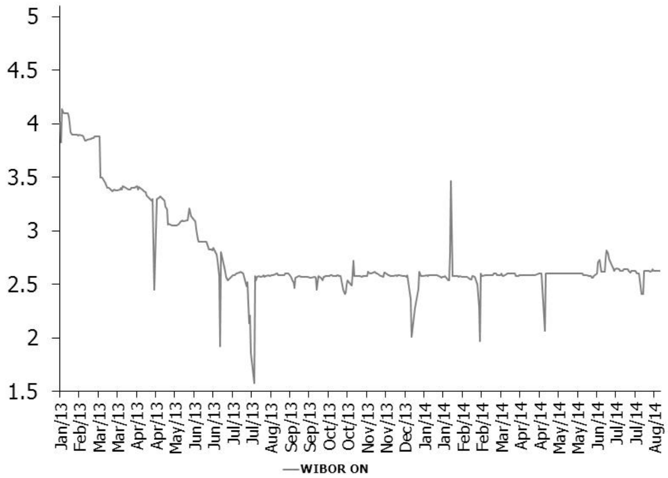


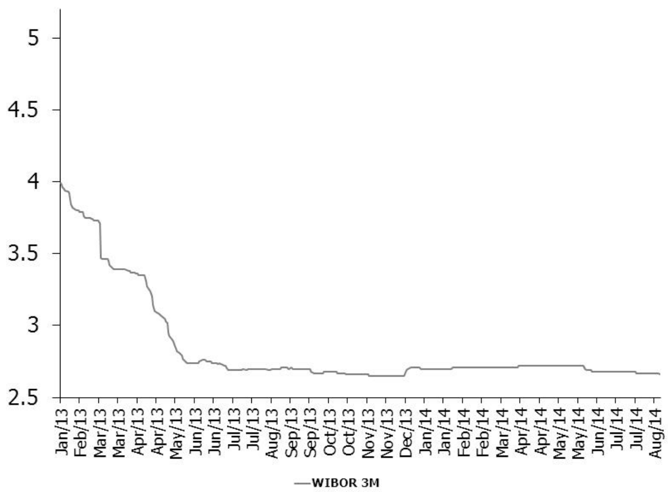
Money market

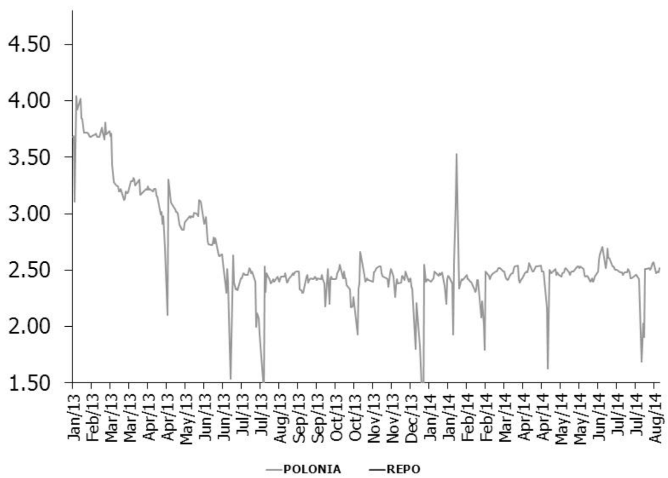
A quiet week Quiet week on Polish cash market after expensive previous one. Polonia fluctuated under 2.50. Next week should be same as todays OMO was underbid by 2 bn PLN.

Market is extremely bullish. Longer FRAs declined under 2.20 and 1Y OIS under 2.10. As economy is slowing down we recommend to buy 1Y OIS and sell 6*9 or 9*12 with 14-15 bps spread.





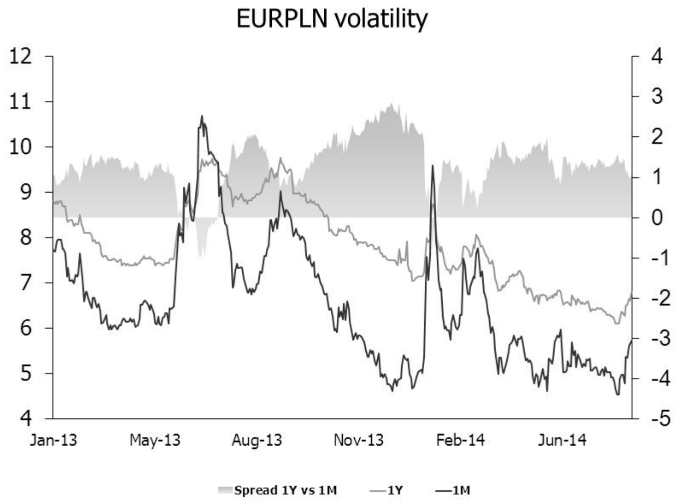




Forex

PLN: is it a recovery or just consolidation? EUR/PLN - after reaching 4.2250 high last week, PLN is slowly recovering, dropping to 4.1730 this Thursday. The improving global sentiment, market forgetting about geopolitical tension, were the reasons behind the move. Polish GDP at 3.2% has also added fuel to the move. The bigger picture is unchanged, markets are assuming it is business as usual but the amount of geopolitical risk (0-1 type) is enormous.

Vols – choppy The demand for vols continued at the beginning of the week, with 1y EUR/PLN traded as high as 6.85%. The whole curve was bid, with 1m EUR/PLN above 6%. The failure to breach 4.2250, and PLN recovery forced the vol curve to melt, with the frontend leading the way. 1 month is today (Thursday) 5.4% mid (0.2% lower than last Friday), 3 months EUR/PLN mid is 5.8% (unchanged) and finally 1 year EUR/PLN is fixing at 6.8 (0.2% higher). The curve is steeper and that seems justified by the current market uncertainty.



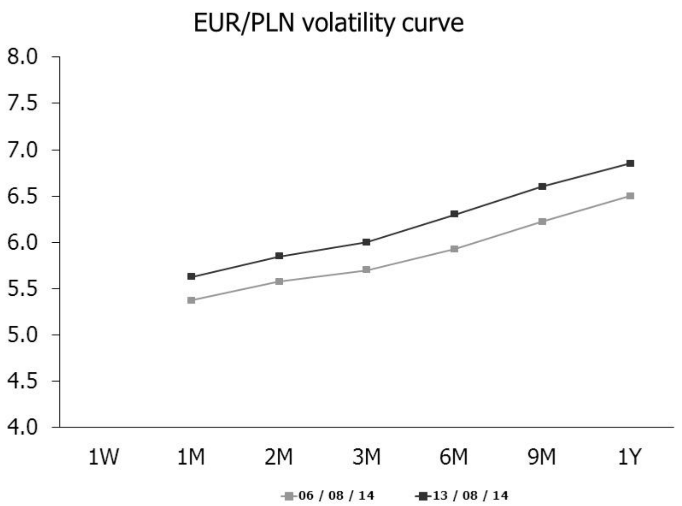
Short-term forecasts

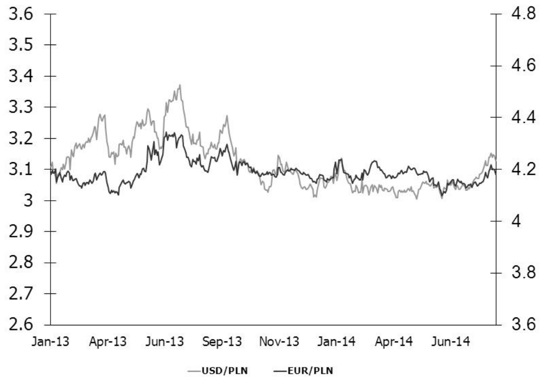
SPOT Main supports / resistances:
EUR/PLN: 4.16 / 4.25
USD/PLN: 3.07 / 3.24

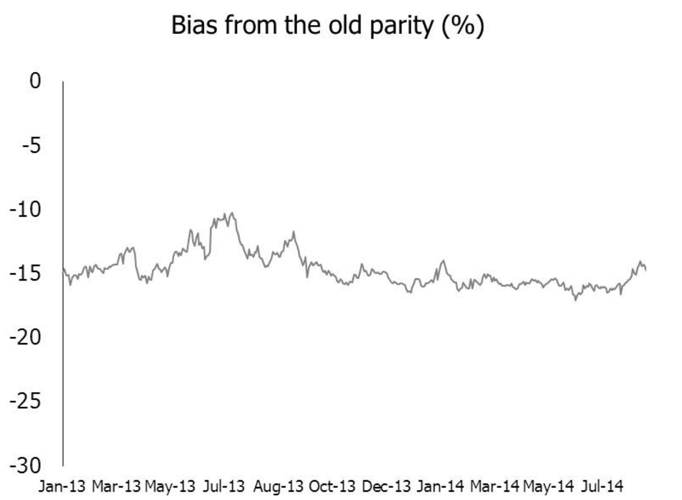
Spot – long EUR/PLN We are still core long from 4.1650, and we have a stop at entry level. The fact how quickly market forgot about geopolitical risk is shocking. We still think EUR/PLN should be above 4.20 and we have a target at 4.2350.

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
8/10/2014	2.76	2.67	2.81	2.59	2.68	2.62	2.52	2.32	2.23	2.24	2.30	2.25
8/11/2014	2.71	2.67	2.71	2.59	2.75	2.62	2.50	2.27	2.21	2.21	2.25	2.23
8/12/2014	2.61	2.67	2.61	2.59	2.65	2.62	2.52	2.26	2.20	2.20	2.24	2.21
8/13/2014	2.66	2.67	2.66	2.58	2.68	2.62	2.48	2.27	2.17	2.17	2.23	2.20
8/14/2014	2.66	2.66	2.66	2.58	2.68	2.61	2.48	2.27	2.17	2.17	2.23	2.20

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
8/10/2014	2.620	2.344	2.443	2.382	2.830	2.874	3.250	3.390
8/11/2014	2.620	2.339	2.405	2.325	2.775	2.823	3.205	3.328
8/12/2014	2.620	2.313	2.390	2.351	2.775	2.858	3.205	3.368
8/13/2014	2.620	2.296	2.373	2.310	2.710	2.837	3.145	3.344
8/14/2014	2.610	2.296	2.373	2.310	2.710	2.837	3.145	3.344

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
8/10/2014	5.63	5.85	6.10	6.65	6.65	2.26	0.73
8/11/2014	5.65	5.80	6.08	6.63	6.63	2.26	0.73
8/12/2014	5.73	5.98	6.23	6.80	6.80	2.48	0.70
8/13/2014	5.63	6.00	6.30	6.85	6.85	2.51	0.72
8/14/2014	5.63	6.00	6.30	6.85	6.85	2.51	0.72

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
8/10/2014	4.2184	3.1509	3.4764	3.0955	1.3382	0.1516
8/11/2014	4.1998	3.1378	3.4618	3.0732	1.3384	0.1508
8/12/2014	4.2025	3.1465	3.4616	3.0762	1.3402	0.1510
8/13/2014	4.1980	3.1442	3.4586	3.0683	1.3379	0.1507
8/14/2014	4.1800	3.1285	3.4478	3.0533	1.3330	0.1500

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