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# Polish Weekly Review

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## Table of contents



## Comment on the upcoming data and forecasts

On Tuesday, along with the release of Statistical Bulletin, unemployment and retail sales figures will be made public. The former was already pre-announced by Ministry of Labour at 11.9%, slightly above market consensus and our forecast (recently, the Ministry has, however, often erred in this regard). We expect the retail sales to modestly rise over a year in July. Presumably, falling volume of trade at Poland's eastern border, which accounts for a significant part of retail sales of furniture and electronic appliances, has put downward pressure on sales in June. The magnitude of pay-back for July reading remains uncertain. On Friday, the revised Q2 GDP figure with detailed decomposition will be released (hitherto, 40% of flash reading were subject to revision). We expect stable consumption growth, falling investment, significant contribution of inventories and, for the first time in a few years, negative net exports.

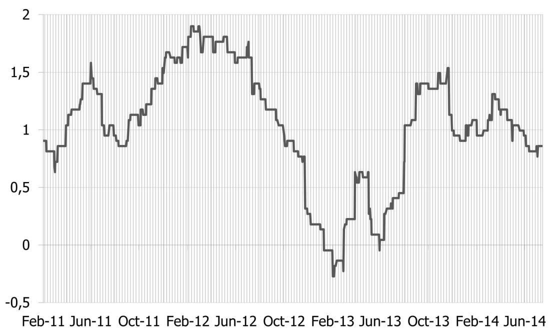
### Polish data to watch: August 25th to August 29th

| Publication | Date | Period | mBank | Consensus | Prior |
|---|---|---|---|---|---|
| Retail sales y/y (%) | 26.08 | Jul | 1.3 | 2.1 | 1.2 |
| Unemployment rate (%) | 26.08 | Jul | 11.9 | 11.9 | 12.0 |
| GDP y/y (%) | 29.08 | Q2 | 3.2 | 3.2 | 3.2 |
| NBP inflation expectations (%) | 29.08 | Aug | 0.1 | 0.1 | 0.1 |

### 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 with market consensus. Two releases are scheduled for next week: retail sales and unemployment rate. Both offer some room for surprise.

* 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 (exports to the east contracts strongly, though) but Russia's food ban and possible escalation of trade war between EU and Russia 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. We expect 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

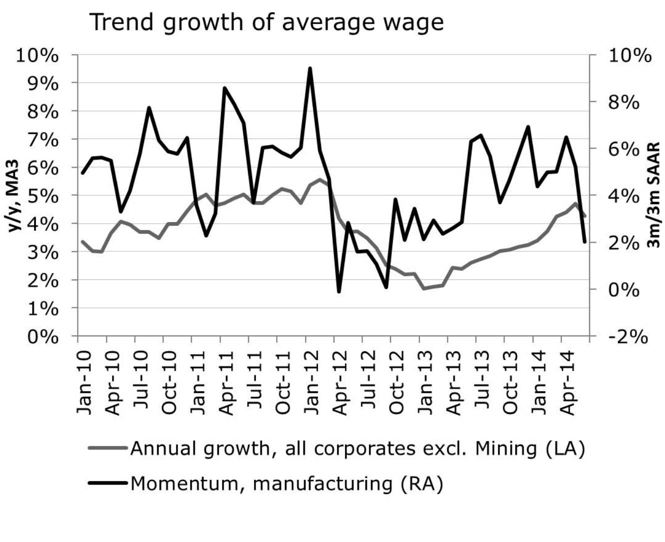
# Economics

## This time, no major surprises in labor market and industrial data. But market expectations have visibly shifted towards lower growth and the only missing piece is the Council's reaction.

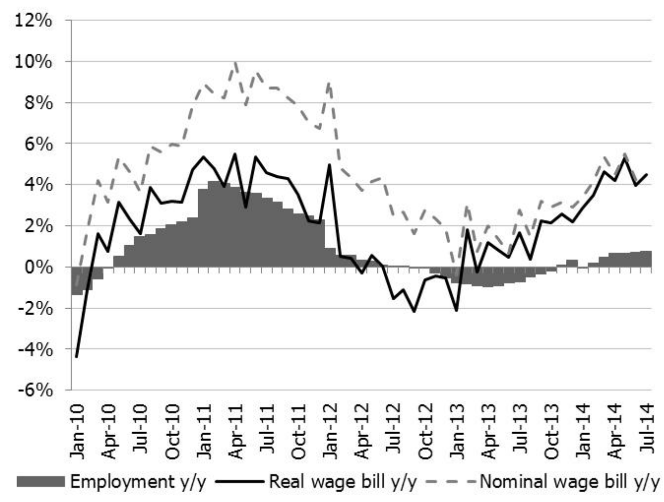
The string of July data brought no major surprises, positive or negative. Labor market data showed some weakness in wage growth and solid growth in employment but sector composition (unknown at this point) matters greatly here. Industrial output partially rebounded but not in a convincing way - industry is now heading into its fourth quarter of stagnation. Moreover, construction has also run into trouble in July. With huge base effects from Q3'13, we are tracking third quarter GDP below Q2 reading. Question is, what will the Council do? While we continue to see rate cuts this Autumn (75bps total), perhaps as early as in September, recent comments from MPC members indicate that the Council may opt to wait a little bit longer for confirmation of the slowdown. One month sooner or later does not make any difference from the market's point of view. Rate cut is going to trigger expectations for a whole easing cycle beyond 50bps currently priced in.

As usual, below is our take on recent releases.

**Average gross wage** increased by 3.5% y/y in July, slightly below market consensus and our forecast (both at 3.8% y/y). The surprise is so slight (well within the typical margin of error generated by volatile industries such as mining and energy) that it is pointless to speculate on its sources. What we can do, however, is note that our intuitions formulated in the previous month were vindicated and trend measures of wage growth snapped in June (see the graph below). Due to rather unspectacular conditions in industry one cannot expect a marked re-acceleration of manufacturing wages (historically the primary driver of aggregate wages).

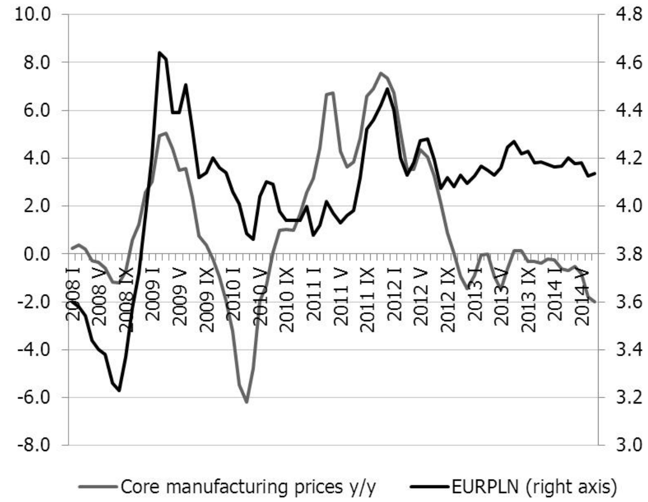



As far as real wages (up by 3.7% y/y in July vs. +3.2% in June) and real wage bill (+4.5% y/y vs. 3.9% in June) are concerned, the sharp drop in inflation cushioned recent slowdown in nominal wage growth. Nevertheless, all circumstances point to a flat path of income growth in the coming months, supporting our forecast of slight deceleration of consumption in H2 (towards 2%).

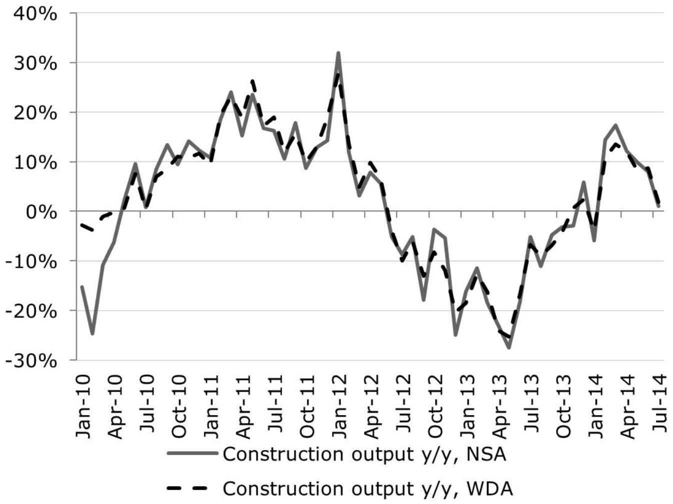



**Employment** in the private sector rose in July by 0.8% y/y (vs. 0.7% y/y in previous month), in line with our forecast. It is equivalent to an increase of 5k payrolls over last month. The details were not revealed today but one can expect that growth was driven by both manufacturing and seasonal sections (retail, construction). Although higher on a monthly basis, the reading does not contradict the undergoing soft patch in Poland. Labor market is a rather lagging indicator of business cycle. Nevertheless, had the economy not slowed down in Q2, employment would probably have risen a bit faster. Currently, we are also able to revise down our earlier forecast regarding employment growth in second half of the year. Although slowing GDP should not induce lay-offs, rising uncertainty about the future prospects of the economy (plummeting trade with the east, geopolitical risks and a soft patch in EU) may make entrepreneurs wary of hiring (it will also contribute to reduced demand for capital goods). As a result, exceeding annual 1% growth rate of employment seems doubtful and we expect its dynamics to settle within the 0.6-0.8% range. The above mentioned scenario will be subject to revision, if any signs of growth bounce-back occur. It is not the case for the time being, however.

**Industrial output** grew by 2.3% y/y in July, close to market consensus (around 2%, depending on the source) and above our forecast (+0.7%). Adjusting for calendar and seasonal factors, output grew by 1.1% m/m, almost exactly as much as in July 2013. The result is actually relatively good, given the drag from mining (-8.1% y/y) and energy (-3.7% y/y) sectors - hence, manufacturing accelerated to 3.3% y/y. Nevertheless, one cannot ignore the bigger picture. Firstly, industrial output remains in stagnation (lasting nine months already) and its momentum remains very close to zero. Secondly, industries with highest exposure to Russia and Ukraine (food, chemicals, transport equipment excl. cars) are suffering from recessionary environment beyond Polish eastern border. Third, a particularly unfavorable arrangement of working days will depress industrial output further in August - a 0% growth is not unlikely.


**Construction output** grew by a mere 1.1% y/y, below forecasts (ours: +3.8%; market: +5.3%). The main cause of the slowdown is, however, a base effect - the third quarter of 2013 was a time of major positive surprises and significant acceleration in construction activity. Current readings point out to stagnation (average of last three m/m s.a. growth rates is just -0.5%). It is hardly surprising. While residential construction has emerged from its slump (induced by very early Spring) and housing starts and permits are growing robustly, there is no significant progress regarding infrastructure investment. Road tenders are still open (even though some of them were announced almost a year ago) and one shouldn't expect a breakthrough on this front before Spring. Thus, we believe construction output growth is bound to stay close to zero for the time being. The more so, since the boost from commercial investment (offices) will likely fade next year as vacancy rates climb to multi-year highs.




Producer prices went down in July by 2.0% y/y (market consensus -1.8%, our forecast -1.9%). Manufacturing stays the main driver of price falls with still negative price momentum. Absent of negative price shocks, current equilibrium is going to be continued as firms have no pricing power in a contracting market and a competitive environment. In such circumstances we think that growth rate of producer prices can only become positive in the year end but only owing to statistical base effects.

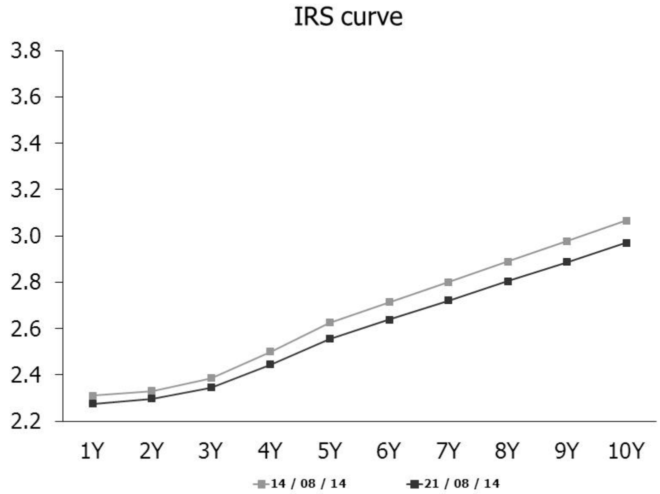
Higher reading on industrial output does not make the picture of the Polish economy any better. Momentum in manufacturing stays weak, business tendency indicators are falling and recent days have brought plenty of information confirming that retaliatory measures from Russia are set to be far from benign (e.g. there are rumors that EU import ban may be also applied to goods in transit). Overall, the perspectives of Polish economy are looking worse than a few months ago. We still bet that MPC is going to embark on a new easing cycle (50-100bp). The most reasonable solution would be to return with easing at the speed of 50 in September and then another 25 when inflation projection sees the light in November. However, anything delivered by the MPC should make the market extend the current pricing beyond 50bp and towards a mini-cycle - and this is what we are hoping for.

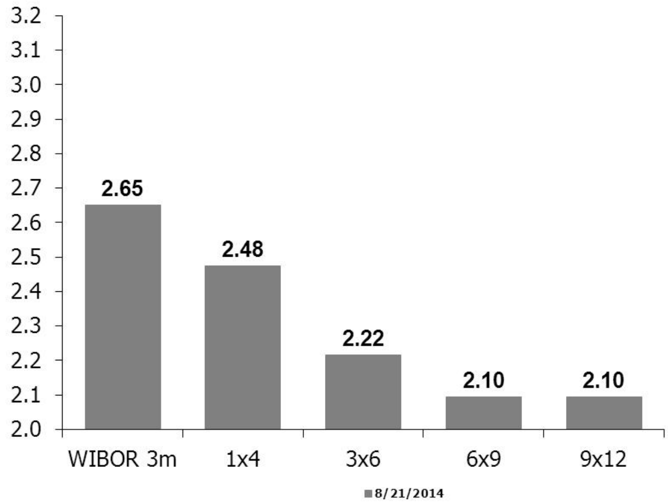
# Fixed income

## Flattening - is it a right direction?

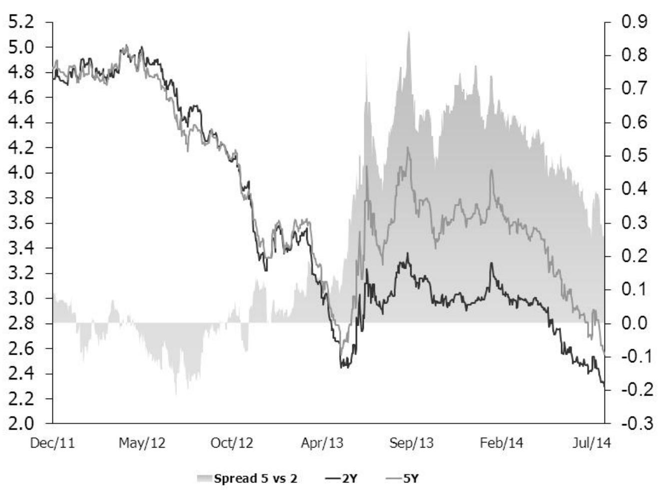
During first part of week we saw massive receive flow on l/e IRS (10y dropped to 2.92% vs 3.10% last Friday), market rallied - DS1023 was traded at 107.60 (3.04% vs 3.20% last Friday and 3.10% now) in a poor liquidity. As a result 2v10 went down 10 bps (60 vs 70 last Friday and 66 now). The main reasons for such situation were low core market yields (ytm of ten-year Bunds fell below 1%) and periphery yields before Jackson Hole Symposium and less negative news from Ukraine.

We still think that majority of positive news are priced in while investors ignore risks like escalation of Russia-Ukraine conflict, supply in September and better than expected figures from U.S. therefore more flattening is not a right view for us any more.



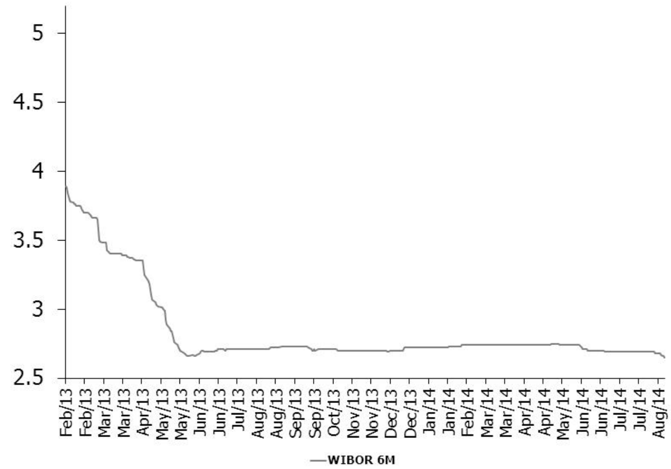


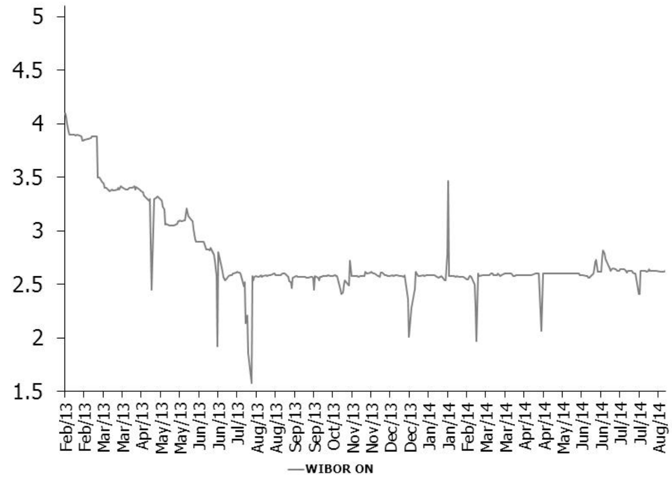


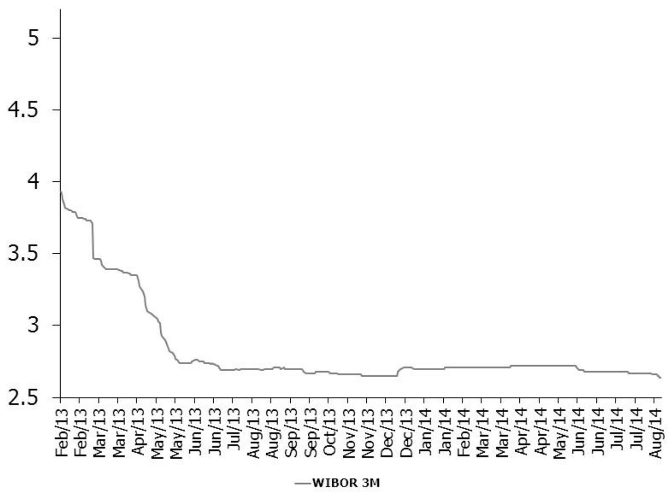
# Money market

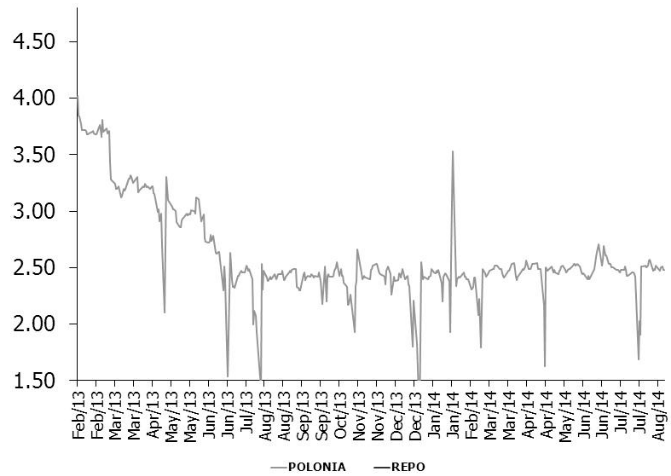
**A quiet week behind us** Polonia fluctuated under 2.50 as last OMO was underbid. Next week should be very similar as banks bought 3 bn PLN bills, sufficient to square the market.

Market was very bullish last week. 1Y OIS was traded at 2.0 and longer FRAs were under 2.1, discounting more than 50 bps rate cut after Mr. Bratkowski's announcement about probability of 50 - 100 bps rate cut cycle in the near future, if poor data confirm that economy is slowing down.



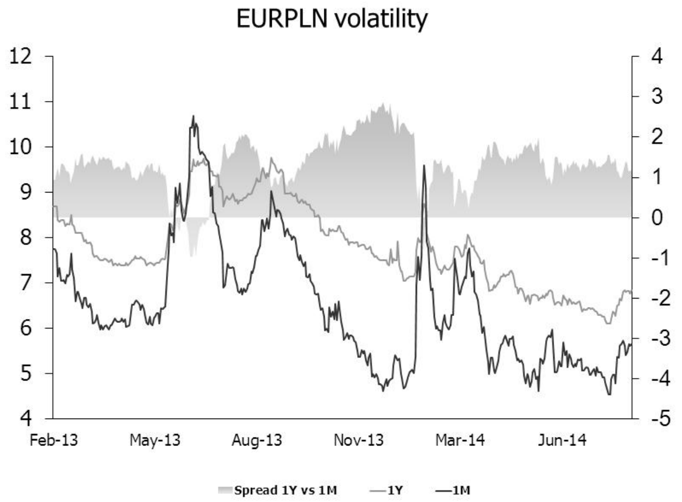



# Forex

**Consolidation continues** 4.1690 - 4.2090 was the range for EUR/PLN this week. The panic spike, after the clash between Ukrainian and Russian forces from last Friday, was not able to reach above main resistance zone 4.20/4.22. As a consequence, we slipped into 4.17-4.21 range and we are looking for fresh triggers to show us direction. World central bankers speaking in Jackson Hole are the obvious suspects. The scary situation in Ukraine is more in the dark, and it seems most of market participants have chosen to ignore it but the potential effect on markets and our lifes could be colossal.

**Vols – choppy** The vols seem to find their equilibrium at current levels as curve has not changed much from last week. 1 month EUR/PLN atm is today at 5.4% (unchanged from last week), 3 months are 5.8 also unchanged, 1 year is bit lower 6.6% (0.2% lower). The trade of the week was 6 months paid at 6.2% in the good amount. The skew was slightly better offered, and currency spread (difference between USD/PLN and EUR/PLN) slightly better bid.

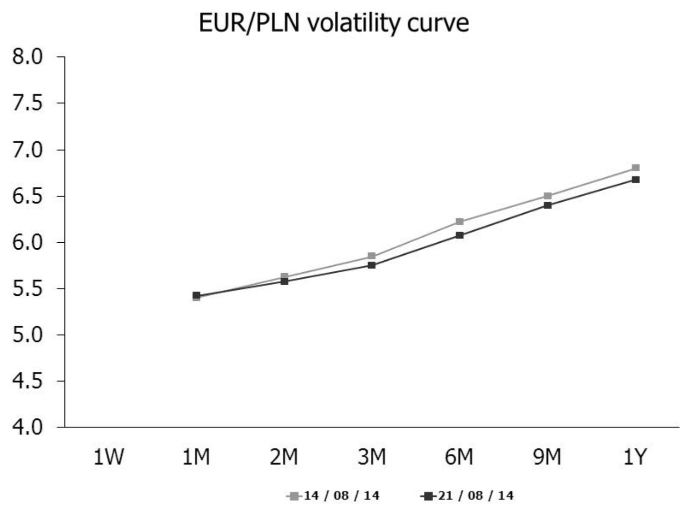


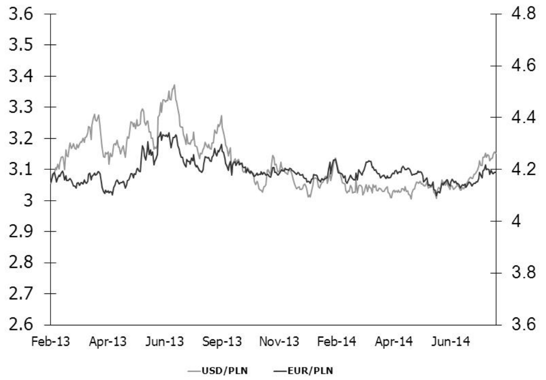

## Short-term forecasts

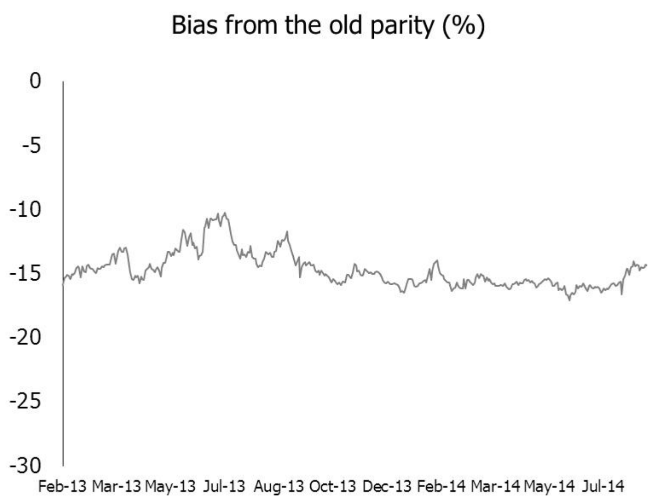
SPOT Main supports / resistances:
EUR/PLN: 4.16 / 4.25
USD/PLN: 3.07 / 3.24

**Spot – still 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. This week vols melted a bit, but our approach has not changed. We still see good reasons to be long Vega, nominal levels are still historically low, realized volatilities are improving, there are a lot of potential volatility triggers.



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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 |
| 8/18/2014 | 2.62 | 2.66 | 2.65 | 2.58 | 2.66 | 2.61 | 2.49 | 2.27 | 2.15 | 2.14 | 2.19 | 2.16 |
| 8/19/2014 | 2.79 | 2.65 | 2.74 | 2.57 | 2.66 | 2.60 | 2.50 | 2.24 | 2.13 | 2.13 | 2.16 | 2.16 |
| 8/20/2014 | 2.49 | 2.65 | 2.45 | 2.56 | 2.52 | 2.60 | 2.49 | 2.25 | 2.15 | 2.15 | 2.17 | 2.17 |
| 8/21/2014 | 2.68 | 2.64 | 2.45 | 2.56 | 2.33 | 2.59 | 2.48 | 2.22 | 2.10 | 2.10 | 2.15 | 2.11 |
| 8/22/2014 | 2.68 | 2.64 | 2.45 | 2.55 | 2.33 | 2.58 | 2.48 | 2.22 | 2.10 | 2.10 | 2.15 | 2.11 |

| 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 |
| 8/18/2014 | 2.610 | 2.309 | 2.340 | 2.327 | 2.600 | 2.837 | 2.965 | 3.132 |
| 8/19/2014 | 2.600 | 2.260 | 2.325 | 2.263 | 2.585 | 2.629 | 2.960 | 3.116 |
| 8/20/2014 | 2.600 | 2.255 | 2.330 | 2.317 | 2.565 | 2.650 | 2.945 | 3.161 |
| 8/21/2014 | 2.590 | 2.287 | 2.298 | 2.299 | 2.555 | 2.627 | 2.970 | 3.148 |
| 8/22/2014 | 2.580 | 2.287 | 2.298 | 2.299 | 2.555 | 2.627 | 2.970 | 3.148 |

| EUR/PLN 0-delta stradle | | | | | | 25-delta RR | | | 25-delta FLY |
|---|---|---|---|---|---|---|---|---|---|
| Date | 1M | 3M | 6M | 1Y | | 1M | 1Y | | 1Y |
| 8/18/2014 | 5.65 | 5.85 | 6.20 | 6.83 | | 6.83 | 2.25 | | 0.69 |
| 8/19/2014 | 5.63 | 5.85 | 6.15 | 6.78 | | 6.78 | 2.25 | | 0.69 |
| 8/20/2014 | 5.65 | 5.90 | 6.20 | 6.85 | | 6.85 | 2.43 | | 0.69 |
| 8/21/2014 | 5.43 | 5.75 | 6.08 | 6.68 | | 6.68 | 2.40 | | 0.69 |
| 8/22/2014 | 5.43 | 5.75 | 6.08 | 6.68 | | 6.68 | 2.40 | | 0.69 |

| PLN Spot performance | | | | | | |
|---|---|---|---|---|---|---|
| Date | EURPLN | USDPLN | CHFPLN | JPYPLN | HUFPLN | CZKPLN |
| 8/18/2014 | 4.1951 | 3.1342 | 3.4649 | 3.0589 | 1.3346 | 0.1504 |
| 8/19/2014 | 4.1871 | 3.1356 | 3.4581 | 3.0556 | 1.3340 | 0.1500 |
| 8/20/2014 | 4.1838 | 3.1470 | 3.4560 | 3.0473 | 1.3352 | 0.1497 |
| 8/21/2014 | 4.1893 | 3.1569 | 3.4587 | 3.0396 | 1.3332 | 0.1502 |
| 8/22/2014 | 4.1874 | 3.1520 | 3.4602 | 3.0386 | 1.3340 | 0.1506 |

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