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Polish Weekly Review

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Comment on the upcoming data and forecasts

Retail sales and unemployment data will be published in the Statistical Bulletin on Thursday. Initial information from the Ministry of Labor and Social Policy indicates that unemployment rate will amount to 11.5%, which is lower that the market's and our estimates. Retail sales should speed up only slightly, mainly because of working days difference. Still, our opinion is that momentum in retail sales is flat or even negative.

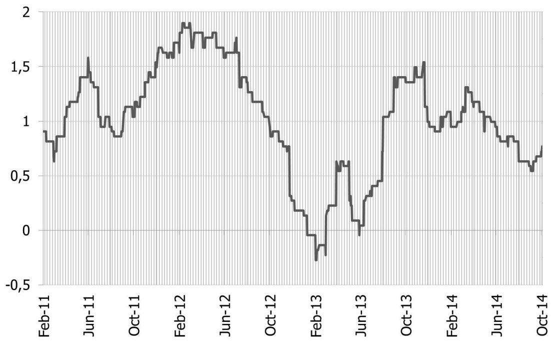
Polish data to watch: October 20th to October 24th

Publication	Date	Period	mBank	Consensus	Prior
Retail sales y/y (%)	23.10	Sep	2.0	2.4	1.7
Unemployment rate (%)	23.10	Sep	11.5	11.6	11.6

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	10/23/2014	800	3.024	4/23/2014
5Y T-bond PS0719	10/23/2014	5000	2.793	7/23/2014
10Y T-bond DS1025	-	2000	3.114	9/4/2014
20Y T-bond WS0429	-	150	3.464	5/16/2013

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



Comment

Up after CPI and industrial output. An upward correction is underway. Next week brings only two opportunities for surprise: retail sales and unemployment. If history is any guide, unemployment data should bring another positive 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).

Our view in a nutshell

Fundamentals

- Polish economy is already in a soft patch. Although the post-2013 recovery may not be ultimately derailed, we see important downside risks in coming quarters. In the nearest future we expect economists to cut their growth and inflation forecasts further what may further propel expectations for monetary easing.
- Current business tendency indicators suggest that growth momentum softened and GDP growth is going to be lower in H2 (below 2.5%). 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.
- 2015 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 of inflation is already negative and strengthens the impact of high real interest rates.
- MPC drifts towards low inflation, low growth scenario. We see MPC continuing easing cycle reaching for at least 100bps of cuts.

Financial markets

- Our strategic view on Polish bonds is unchanged. Polish fundamentals, along with European factors - including zero inflation, monetary easing and downside risks to GDP (and the fact that Polish economic cycles are becoming more synchronized with European ones), are more than ever supportive to lower rates across the board.
- There is scope for short-term upward corrections to Polish yields. The most likely triggers is an increase in global volatility, centered around EMs. Impatience of the markets regarding ECB's QE annoucement may also trigger local bursts of credit risks (contagion from peripherals to Poland), especially should global economy does not pick up (downside growth and inflation surprises across the board).
- EURPLN under counterbalancing forces: expectations for ECB easing and lower rates in Poland amid slowing growth. Zloty is set to stay weaker around 4.20.

mBank forecasts

	2010	2011	2012	2013	2014F	2015F
GDP y/y (%)	3.9	4.5	2.0	1.6	3.0	3.5
CPI Inflation y/y (average %)	2.8	4.3	3.7	0.9	0.2	1.2
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	1.50	1.50

	2014 Q1	2014 Q2	2014 Q3 F	2014 Q4 F	2015 Q1F	2015 Q2F	2015 Q3 F	2015 Q4 F
GDP y/y (%)	3.4	3.3	2.5	2.3	2.1	3.1	3.7	4.6
Individual consumption y/y (%)	2.6	2.8	2.4	2.1	1.8	1.8	2.0	2.4
Public Consumption y/y (%)	0.7	0.8	2.0	2.4	3.0	3.0	4.0	4.0
Investment y/y (%)	10.7	8.4	6.4	5.0	4.0	7.5	9.0	11.0
Inflation rate (% average)	0.6	0.2	-0.4	0.0	0.4	0.9	1.2	1.2
Unemployment rate (% eop)	13.9	12.0	11.5	12.4	13.1	11.8	11.3	12.0
NBP repo rate (% eop)	2.50	2.50	2.50	1.50	1.50	1.50	1.50	1.50
Wibor 3M (% eop)	2.71	2.68	2.28	1.60	1.64	1.66	1.70	1.70
2Y Polish bond yields (% eop)	3.01	2.51	2.00	1.53	1.59	1.69	1.81	1.94
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.53	2.59	2.69	2.81	2.94
EUR/PLN (eop)	4.17	4.16	4.18	4.15	4.10	4.05	4.00	4.00
USD/PLN (eop)	3.03	3.04	3.31	3.32	3.28	3.29	3.33	3.33

F - forecast

Look beyond the noise: rate-setters comments are misleading. Further cut in November, possibly by 50bp, is still our baseline

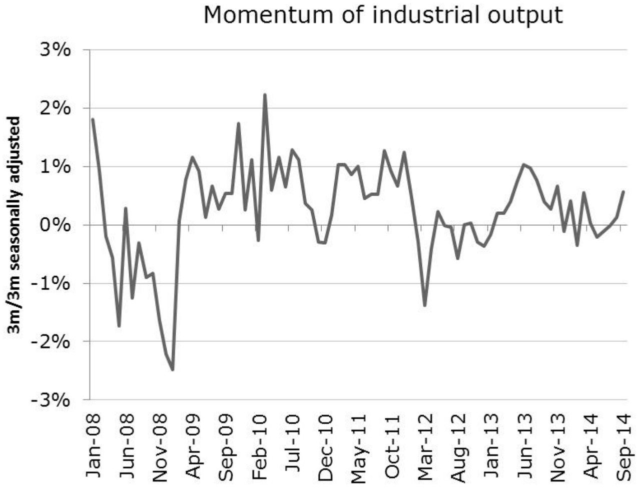
Recent stream of statements from almost all MPC members (with the exception of the biggest hawks) has been anything but coherent and without a doubt might have sown a lot of doubt into investors' hearts and minds. The main message is that we shouldn't treat a rate cut in November as a done deal and that the new inflation and GDP projections could as well force the Council to put rates on hold. Data, however, speak otherwise and continue to demand more easing and more stimulus for the Polish economy. In addition, we believe that the new set of NBP's staff projections will be sufficiently dovish to trigger even a 50 bps cut. After all, the general mood among researchers (mainly IMF but central banks tend to follow) is a pessimistic one, with structurally lower growth, inflation and rates in the forefront.

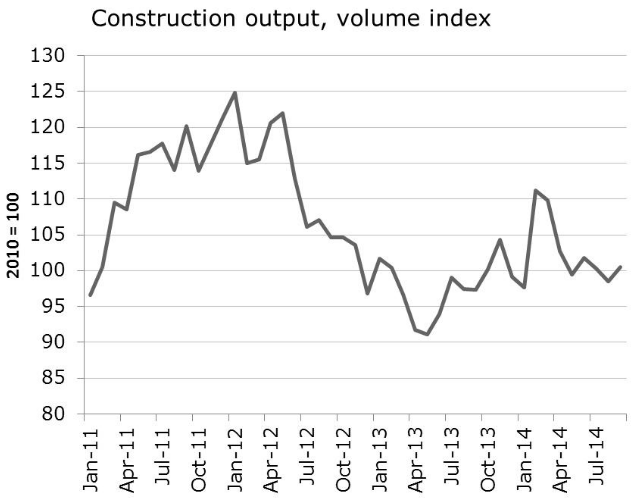
As usual, here's our take on the events of last week.

On Thursday, the National Bank of Poland released its latest „Economic climate in enterprise sector" report. Even though most press releases presented its findings in an upbeat tone, the devil is in the details and they are not pretty as many negative tendencies previously witnessed only deepened. The story fits almost perfectly to data releases published this week.

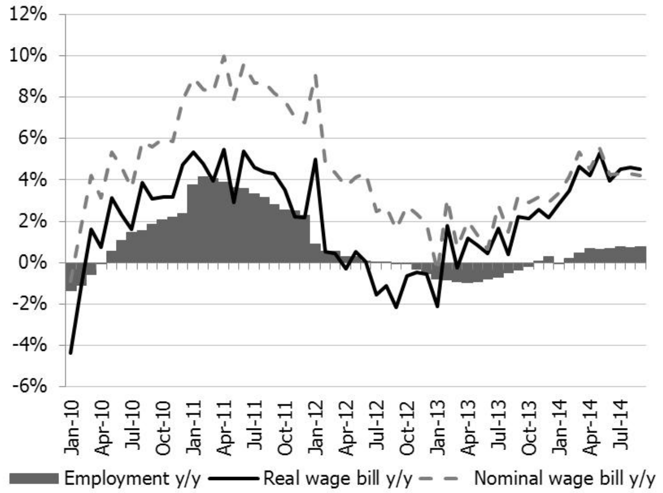
Even though the general sentiment in the enterprise sector improved again, it runs contrary to indices derived from more detailed questions - assessments of new orders, future demand, output and export business dropped significantly and landed below its long-term averages. Curiously, this is very similar to what we observed in monthly indices compiled by GUS, previously often used as proof that the economy is not slowing down (actually it slowed down, didn't it?). Why detailed answers would deviate from the general assessment of economic situation is anyone's guess. This is not sustainable, in our view. In addition, the data on industrial output speak for itself – September brought a sharp rebound in industrial output but mainly due to calendar effects and one-off factors in car manufacturing. The trend here has been flat for almost a year now and optimism must adjust downwards (cannot decouple from harsher reality forever).

Secondly, the Russian-Ukrainian conflict appears to be limited to enterprises with significant exposure to Eastern markets, and there is little evidence that it spilled over to other parts of the economy. This supports our view that the slowdown is due to other factors as well, such as the Eurozone troubles and another downswing in construction. Speaking of the latter, the report paints a grim picture of the sectors, with sharp drops in output and order assessments, and – even more worryingly – first indications that bank credit is not being extended to construction companies. Latest data from GUS strongly suggest that there is no turnaround in the sector as output growth rebounded on working day and calendar effects. Until the state steps up and offers marginal demand in the form of public infrastructure investment (expected starting from 2015), the sector will remain a drag on the economy, especially compared with the second half of 2013.

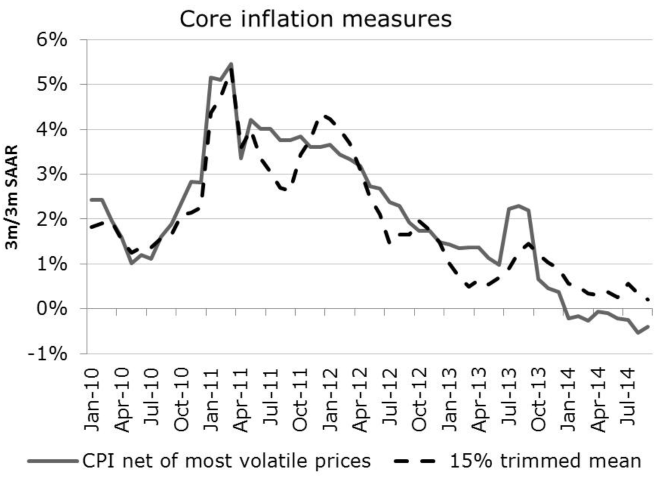




Third, the pace of improvement in the labor market stalled. As enterprises moderate their forecasts of wage increases and labor demand, one cannot expect to see anything but meagre data on that front. In fact, this is exactly what we've seen in the recent bout of monthly labor market data. Employment visibly lost its momentum and recent increases have been quite modest – annual growth of employment remains wedged between 0.7 and 0.8 y/y and we expect it to stabilize in this range in the coming months. As for wages, the fourth consecutive print of ca. 3.5% would indicate stabilization. If, however, transitory effects such as statistical bases in mining and working day effects in manufacturing are stripped, the trend now is no longer pointing upwards. In fact, we expect nominal wage growth to moderate starting from October and to settle close to 2.5% y/y at year end. In such circumstances, real income is boosted primarily by low inflation.



Finally, disinflationary processes have become more and more entrenched in the Polish economy. Even though September's CPI surprised to the upside (due to vegetable prices) and core inflation ticked up by 0.2 pp. to 0.7% (due to statistical base in educational services), there is no reason to celebrate. CPI inflation is still negative (-.3% y/y in September) and no sign of a turnaround is in sight. All momentum measures we can think of continue to point out to very low inflation in 12 months time. The NBP's report in economic sentiment offers even more evidence as several sad records were broken in Q3: lowest forecasts of raw material and commodity prices, lowest forecasts of prices of own goods and services, lowest share of enteprises planning to raise prices, etc. These are independent of size, industry and export exposure. Producer price deflation has become structural.



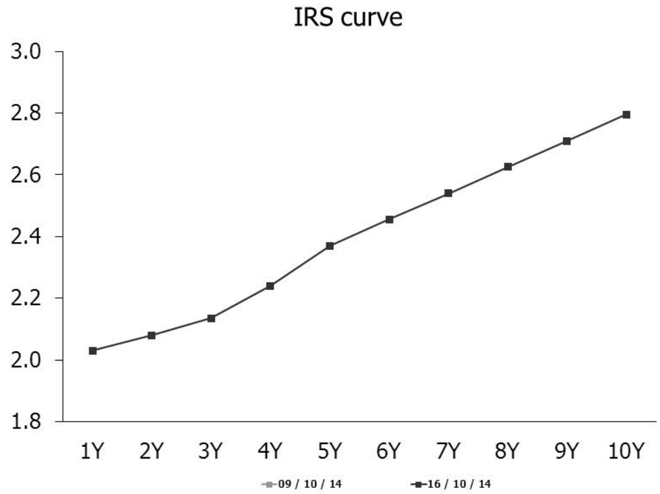
In such circumstances it is logical for the MPC to continue cutting and continue to counteract the disinflationary environment the economy is operating in.

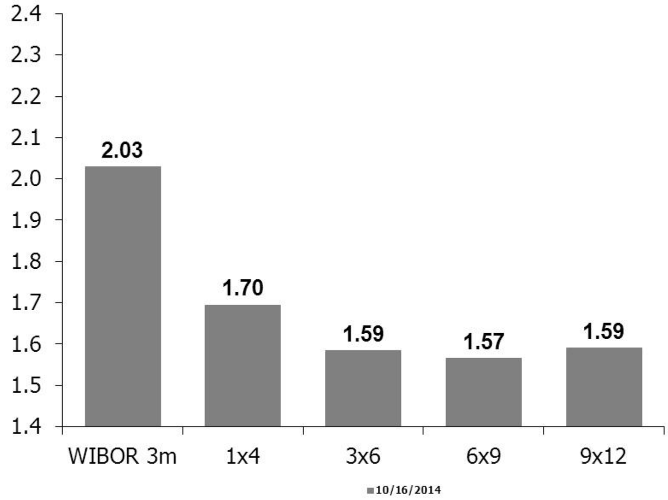
Fixed income

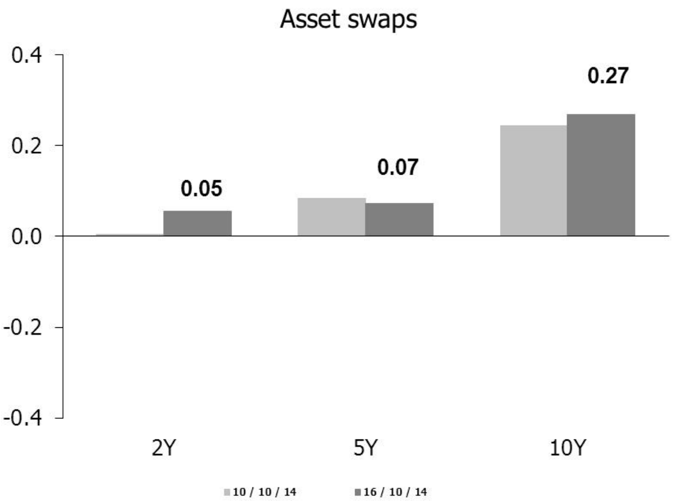
What a week!

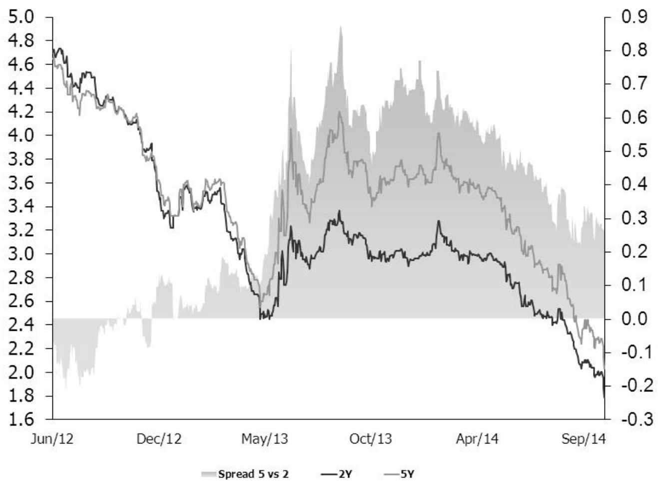
At the beginning of this week it looked like nothing could stop positive sentiment on the bond market. Global slowdown fears pushed yields lower everywhere except... Greece, Italy, Spain. Investors realized that with lower GDP growth, deficit problems are even more scary. Sell-off on long end bonds reached Poland, 10Y bond jumped 32bps up (2.50% low on Wednesday, 2.82% yield reached on Thursday) but then investors decided to rebuild bond positions and we are now trading at around 2.65%.

We feel that with so high volatility is can be difficult to find good bids on the next auction (2Y and 5Y bonds are going to be offered on 23rd Oct).





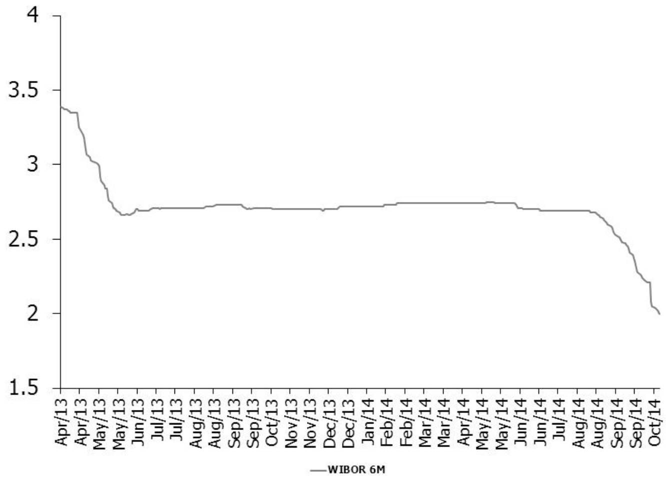


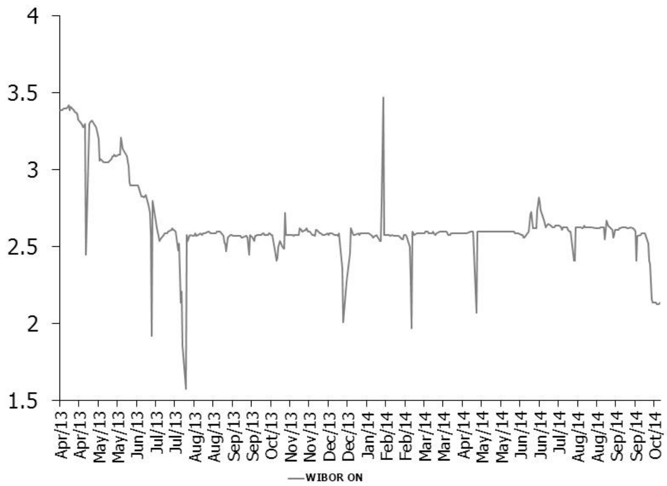


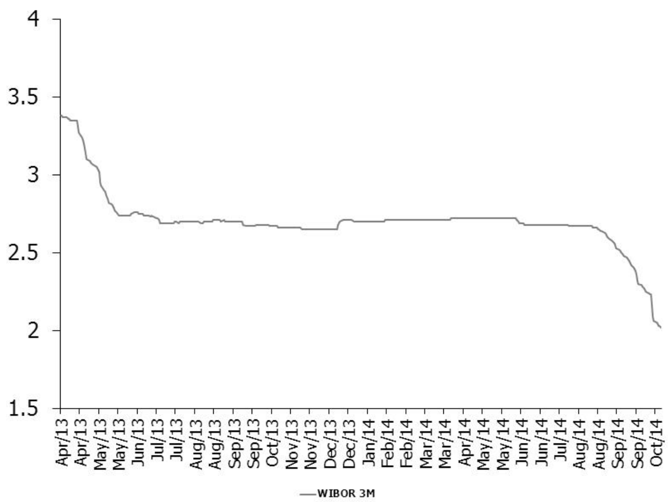
Money market

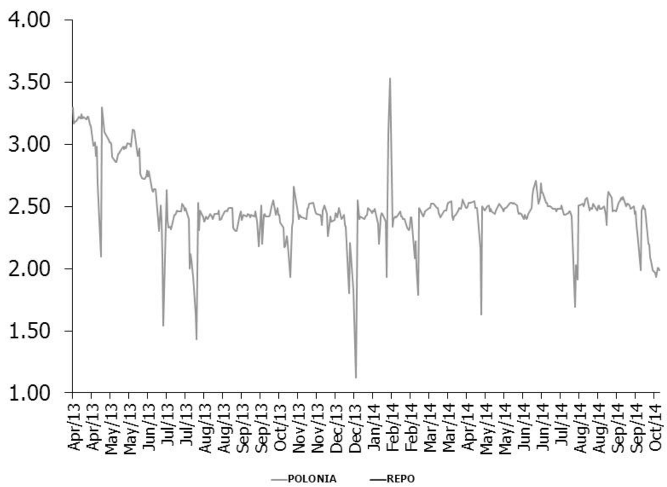
Stable week behind us. After the very volatile last week, Polonia was stable in last days and fluctuated around 2.0%. Today's OMO was underbid by 1.5 bn PLN (100 bn vs 101.5 bn offered) but next week shouldn't be cheap as just 99 bn PLN money bills might have squared the market.

Last few days were very volatile even on the short end of the curve. 1Y OIS fell under 1.5% discounting more than 50bps more rate cuts (it was quoted 1.45 – 1.50) on Tuesday and rose on Thursday to 1.55 – 1.60 after a huge sale of POLGBs. Very significant was also the drop of short FRA rates (1x4 mid was 1.67, 2x5 mid was 1.62). 3M WIBOR was falling by 1bps every day with only one break on Thursday.





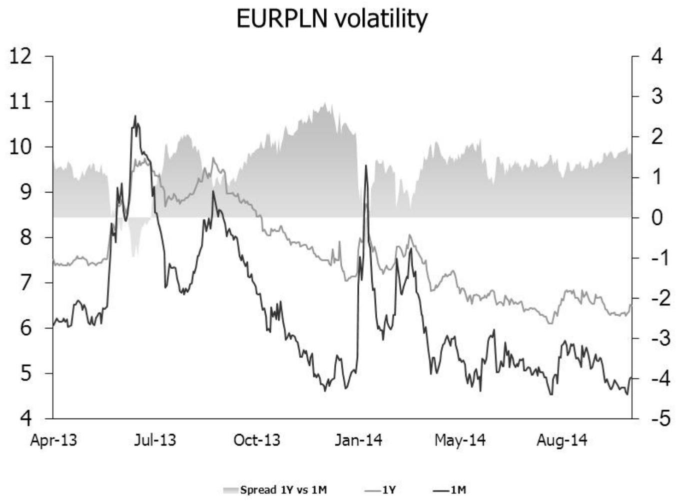




Forex

PLN on fire Market one more time proved a nasty surprise. Weaker than expected figures from US produced risk off wave across all EM currencies, with PLN being no exception. EUR/PLN broke resistance at 4.1970 and spiked as high as 4.2385. Above there is a 4.25/27 zone that constitutes resistance and ytd high (4.2600). We still not expect to see that broken. Our core scenario is that once the dust settles, EUR/PLN should slide towards 4.20 again.

Vols exploded What a difference a week makes. Out of the blue, the whole market would like to buy vol. The result was obvious - the vol curve gapped higher. EUR/PLN 1 month ATM mid reached 5.9% (1.4% change!), 3 months are 6.0% (1% higher) and 1 year is fixing at 6.9% (0.55% higher). The Skew was also healthy bid, and moved higher by 0.25%. The currency spread (difference between USD/PLN vols and EUR/PLN vols) was slightly better offered.

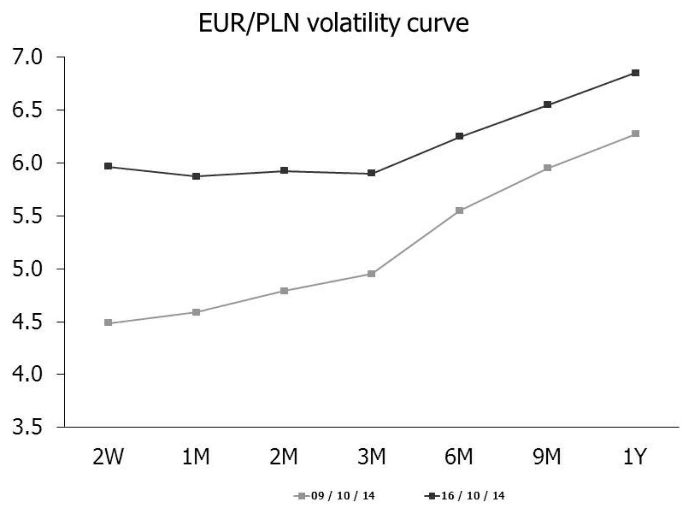


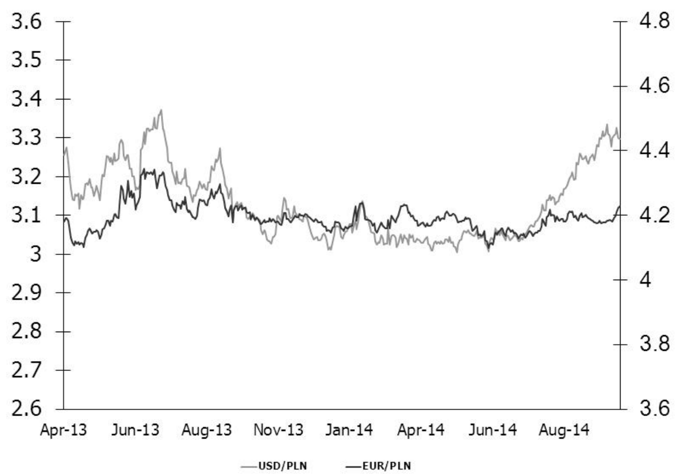
Short-term forecasts

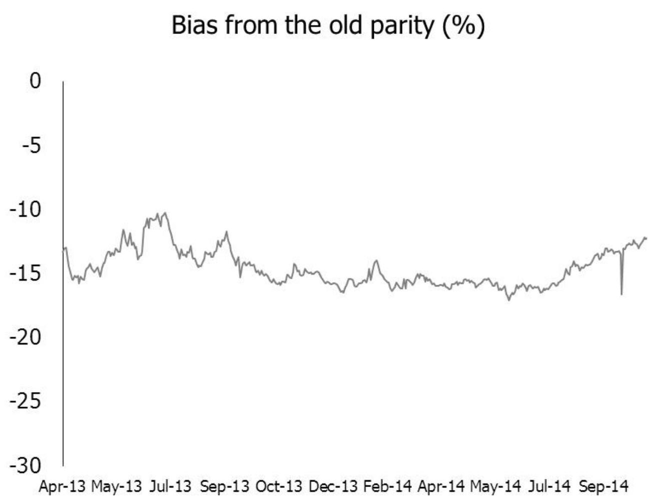
SPOT Main supports / resistances:
EUR/PLN: 4.18 / 4.26
USD/PLN: 3.20 / 3.37

Spot – Long PLN **We like PLN as our fundamentals are relatively strong. And view current spike as occasion to sell hard currency against PLN.** EUR/PLN short at 4.2300, ready to add at 4.2450 with stop at 4.2600 and hopes for a slide back to 4.2000 on the way to 4.1800.
USD/PLN short at 3.3300 with a disciplined stop at 3.3600, and hopes for a move to 3.25 on the way to 3.23.

Options – sold 3 month EUR/PLN. We sold some Vega in the mid curve of EUR/PLN against our long in the backend. In risk off phases the implied volatility usually tends to rise when the historic volatility picks up substantially. So far, with this week's jump in EUR/PLN historic volatility is moderate at best; at least in comparison to the scale of the rise in vols.







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
10/10/2014	2.10	2.06	2.04	1.95	1.97	1.94	1.79	1.65	1.60	1.62	1.68	1.61
10/13/2014	2.06	2.05	2.01	1.94	1.96	1.93	1.78	1.65	1.61	1.63	1.68	1.62
10/14/2014	1.94	2.04	2.04	1.93	1.91	1.92	1.71	1.59	1.53	1.55	1.59	1.54
10/15/2014	1.76	2.03	1.68	1.92	1.78	1.91	1.73	1.57	1.52	1.53	1.58	1.54
10/16/2014	1.95	2.03	2.03	1.91	2.15	1.90	1.70	1.59	1.57	1.59	1.63	1.58

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
10/10/2014	1.940	1.831	1.795	1.800	2.055	2.139	2.525	2.769
10/13/2014	1.930	1.815	1.780	1.800	2.020	2.095	2.490	2.699
10/14/2014	1.920	1.800	1.730	1.781	1.945	2.025	2.380	2.609
10/15/2014	1.910	1.765	1.703	1.802	1.925	2.029	2.340	2.627
10/16/2014	1.900	1.730	1.760	1.815	2.050	2.123	2.490	2.759

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
10/10/2014	4.55	4.93	5.55	6.33	6.33	2.27	0.60
10/13/2014	4.83	5.08	5.63	6.38	6.38	2.27	0.60
10/14/2014	4.90	5.23	5.75	6.53	6.53	2.30	0.61
10/15/2014	4.93	5.28	5.80	6.50	6.50	2.38	0.62
10/16/2014	5.88	5.90	6.25	6.85	6.85	2.54	0.62

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
10/10/2014	4.1795	3.2985	3.4540	3.0552	1.3633	0.1520
10/13/2014	4.1901	3.3062	3.4662	3.0746	1.3718	0.1523
10/14/2014	4.1993	3.3095	3.4781	3.0956	1.3704	0.1523
10/15/2014	4.2089	3.3262	3.4855	3.1036	1.3751	0.1527
10/16/2014	4.2223	3.2985	3.4996	3.1144	1.3681	0.1534

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