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Polish Weekly Review

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Comment on the upcoming data and forecasts

A very light week ahead of us. The NBP will publish data on household inflation expectations on Friday. One can expect them to remain low and stable, just as CPI inflation has been in the summer.

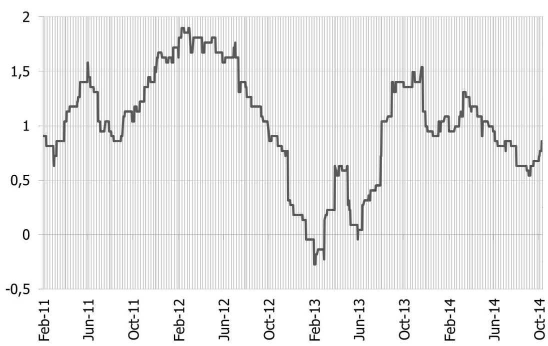
Polish data to watch: October 27th to October 31st

Publication	Date	Period	mBank	Consensus	Prior
NBP inflation expectations (%)	31.10	Oct	0.1	0.1	0.2

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	-	2000	1.653	10/23/2014
5Y T-bond PS0719	-	3000	2.007	10/23/2014
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 again – unemployment came out lower than expected and the negative surprise in retail sales was not big enough to register on our index. Next week the index should remain stable as no important macro releases are scheduled.

* 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 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 risk repricing (contagion from EZ peripherals to Poland), especially if global economy does not pick up (downside growth and inflation surprises across the board).
- EURPLN under counter-balancing 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

Economics

Retail sales stable - at best

Retail sales grew by 1.6% y/y in September, having grown by 1.7% in the previous month. The figure came out below market consensus and close to our forecast of 2.0%. It is worth noting that sales have not accelerated despite a very favorable difference in the number of working days (+1 vs. -1 y/y). Current growth remains below the YTD average (3.7%) and very close to last year's average (1.8%). Thus, it is still too early to see a turning point in the local downtrend.

Usually, it is prudent to look for positives in subsequent pessimistic releases, as to not miss the recovery. Nevertheless, details of Thursday's release indicate that such positives are not present as of yet. Granted, car sales accelerated to +1.3% y/y (from -5.5%) but this is consistent with seasonal and calendar factors and was thus expected. Retail sales was also boosted by food sales (the upswing was seasonal and easy to guess, its magnitude more or less random), which grew by 5.4%, and highly similar sales in non-specialized stores. Sales of textiles, clothing and footwear collapsed (-3.9% y/y vs. +19% y/y in Aug), probably because of seasonal shifts between August, September and October. The same thing happened to furniture, radio, TV and household appliances - a month ago we warned that August growth rate was suspiciously high (now we're seeing negative payback). Highly volatile „others" category declined for the third time in a row. Our favorite measures of core retail sales tumbled in September (see the graph below).

Flattening path of real disposable income growth, high real interest rates and mounting uncertainty regarding the future developments in the economy are factors that are working towards flatter consumption path in the coming months. Retail sales data confirm that picture. We can expect consumption to decelerate to 2% at the turn of 2014 and 2015, when negative tendencies in the economy and high base effects will be at their strongest. Relative resilience of consumption (relative to exports and investment) is an important characteristic of current slowdown and such scenario seems to be realizing. Such stability will be facilitated by lower fuel prices that boost disposable income. Nevertheless, we view such factors as cushioning, not accelerating consumption. The reaction to lower interest rates (including the Lombard rate) will appear with a significant lag. Turning points in retail sales should appear at the turn of the year or maybe in Q1.

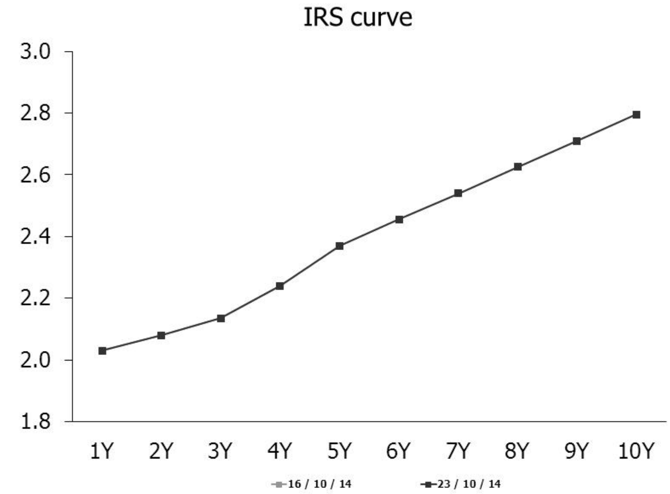
Retail sales data confirm the picture of an economy that is unable to break free of negative momentum. With low inflation projection there is no need to keep rates on hold next time and the easing cycle should be extended by a 25-50 bps cut in November.

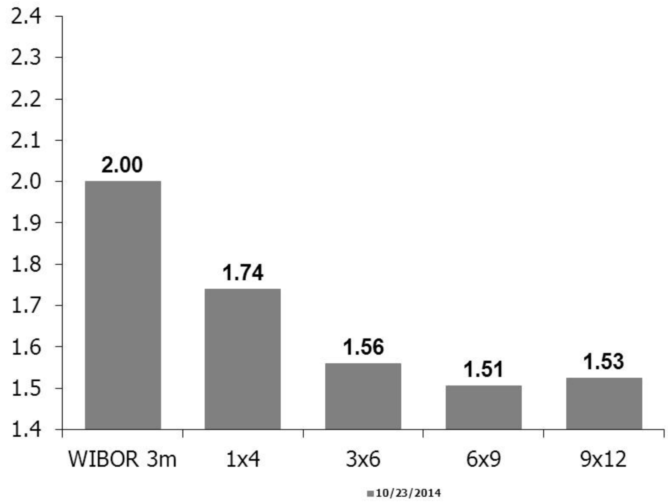
Fixed income

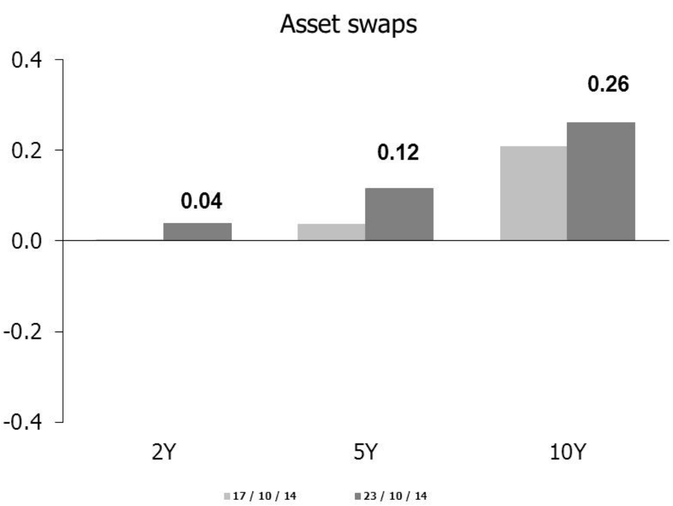
New range?

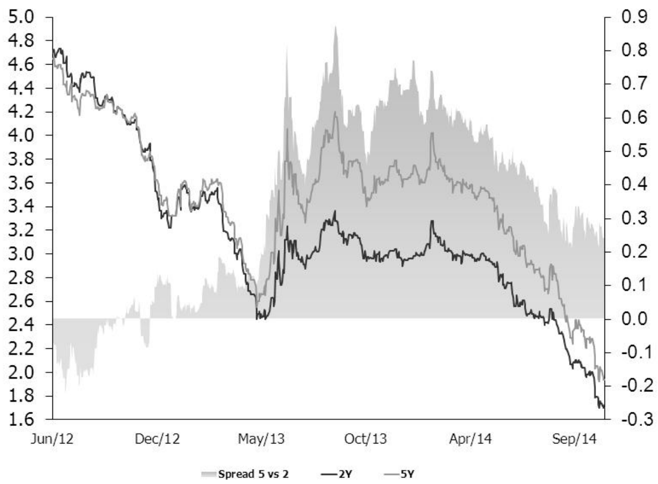
This week investors came back to Poland (after nervous selling in the previous one) because of better situation on global markets. Polish yield curve reached lows just before 2Y and 5Y bond auction. Surprisingly, despite coupon payments this month, demand on the auction was not that huge (10.5 bn demand vs 6 bn sold). Yield of 5Y bond benchmark reversed from 2.00% to 2.06%.

With MPC that want to set new stable level of repo rate as fast as possible (probably before end of this year) we should see more range trading in coming months. In such scenario we like to keep 5Y bonds, with its relatively low risk and still reasonable premium over EUR denominated bonds.









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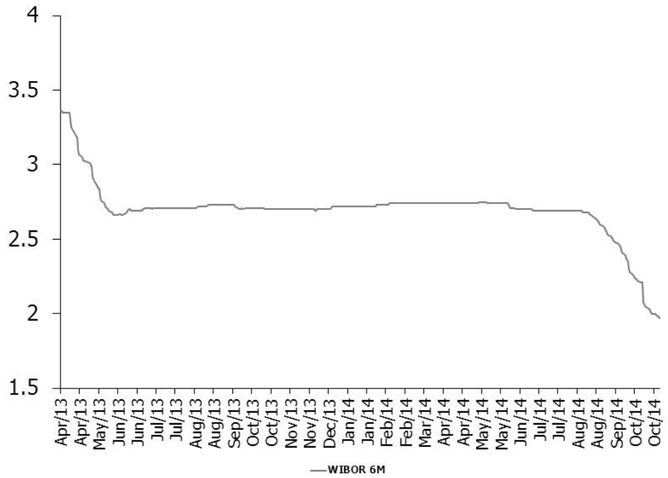
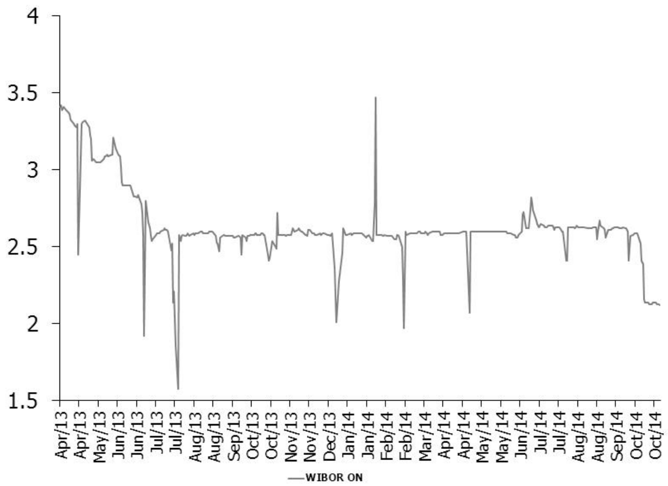
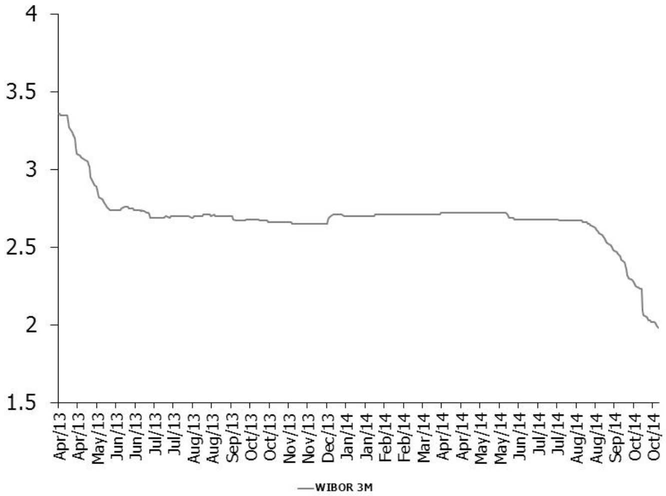
Money market

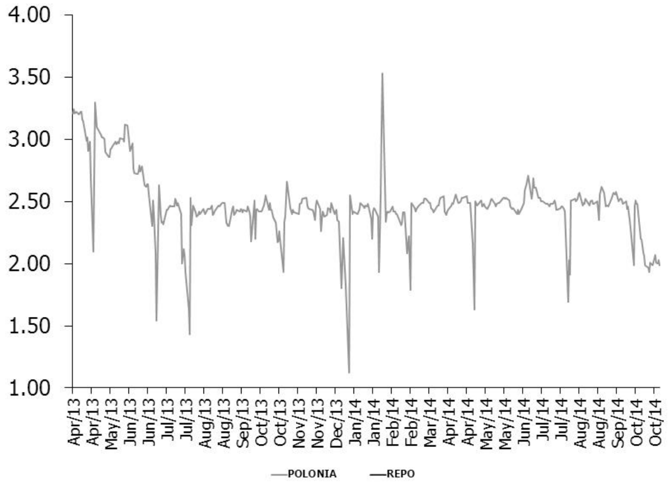
Stable week behind us. Polonia fluctuated around 2.00 as it was the middle of the month and the surplus of cash was small. As the end of reserve is on Thursday 30th and today's OMO was underbid by 7.5 bn PLN, next week rates fell to 1.5% Friday afternoon. Additional OMO on Monday or Tuesday?

OIS and short FRAs were stable last week. 1Y OIS was around 1.50-1.55 and 9x12 FRA at similar level. After bearish Hausner statement rates moved up a little bit (3-4 bps) on the whole of the curve.





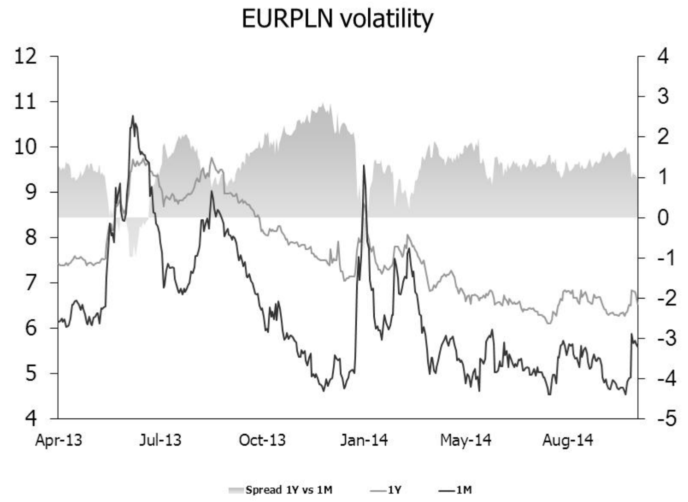




Forex

PLN consolidating EUR/PLN managed to hold to most of its last week gains. It's consolidating in a 4.2110 - 4.2390 range. The lack of pullback is a little worrisome for PLN. USD/PLN also was able to marginally breach this year high (3.3525) reaching as high as 3.3598 (new high) before retreating to 3.3300. All eyes are now on next week FOMC meeting, to lead all EM further from current equilibrium.

Vols – lower Calmer markets inevitably lead to sell off in vols. 1 month is ending this week at 5.4% mid (0.5% lower than last Friday), 3 moths EUR/PLN ATM are 5.5% (0.5% lower) and 1 year 6.5% (0.45% lower). The Skew is stable but currency spread (difference between USD/PLN vol and EUR/PLN vol) was healthy bid.

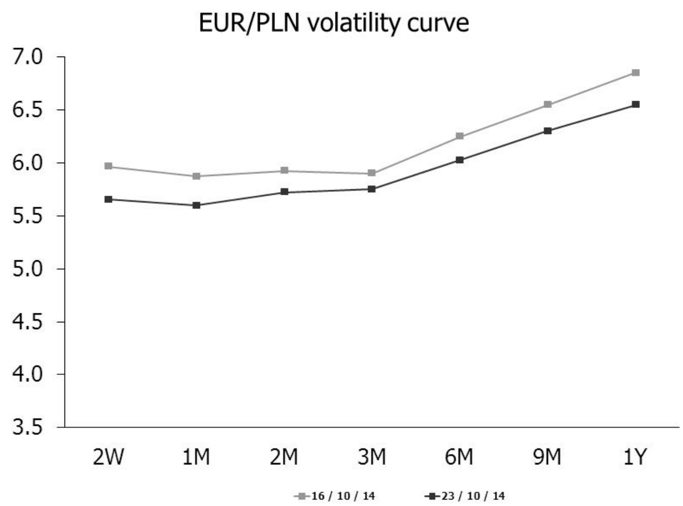


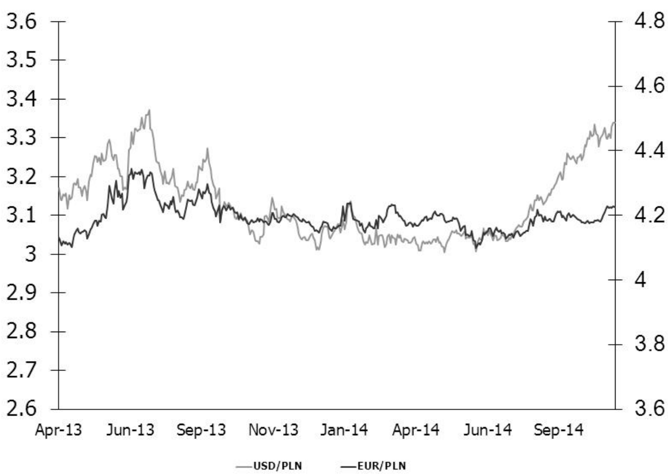
Short-term forecasts

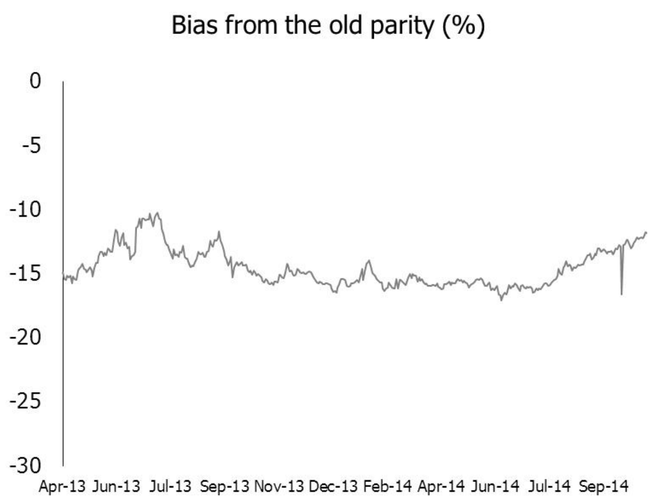
SPOT Main supports / resistances:
EUR/PLN: 4.18 / 4.26
USD/PLN: 3.20 / 3.37

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. (it was close, 10 pips to S/L)

Options – Still short 3 months Vega ag 1y long Vega. We are still short 3 month EUR/PLN against long 1 year. And it has proven to be a profitable deal so far as the structure decays positively, and works as a hedge against long 1year Vega. We will look for a level to buy back 3 month and be outright long in 1 year again.







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
10/17/2014	1.95	2.02	1.91	1.90	1.89	1.89	1.71	1.55	1.52	1.54	1.60	1.54
10/20/2014	1.85	2.02	1.80	1.90	1.89	1.89	1.71	1.56	1.53	1.55	1.59	1.54
10/21/2014	1.94	2.01	1.91	1.89	1.86	1.88	1.74	1.58	1.54	1.56	1.59	1.53
10/22/2014	1.70	2.00	1.70	1.88	1.78	1.88	1.74	1.54	1.51	1.53	1.57	1.53
10/23/2014	1.95	1.99	1.93	1.88	1.86	1.87	1.74	1.56	1.51	1.53	1.59	1.53

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
10/17/2014	1.890	1.743	1.740	1.742	2.015	2.051	2.450	2.658
10/20/2014	1.890	1.713	1.715	1.725	1.980	2.056	2.420	2.677
10/21/2014	1.880	1.708	1.720	1.755	1.961	2.065	2.415	2.658
10/22/2014	1.880	1.703	1.700	1.721	1.940	2.056	2.390	2.628
10/23/2014	1.870	1.692	1.700	1.739	1.940	2.055	2.400	2.660

EUR/PLN 0-delta stradle						25-delta RR			25-delta FLY
Date	1M	3M	6M	1Y		1M	1Y		1Y
10/17/2014	5.68	5.88	6.28	6.83		6.83	2.56		0.62
10/20/2014	5.73	5.90	6.25	6.80		6.80	2.56		0.62
10/21/2014	5.68	5.85	6.23	6.75		6.75	2.53		0.61
10/22/2014	5.60	5.75	6.08	6.55		6.55	2.53		0.61
10/23/2014	5.60	5.75	6.03	6.55		6.55	2.53		0.61

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
10/17/2014	4.2293	3.2964	3.5025	3.0942	1.3761	0.1539
10/20/2014	4.2232	3.3109	3.5012	3.0932	1.3769	0.1532
10/21/2014	4.2263	3.2987	3.5022	3.0925	1.3749	0.1531
10/22/2014	4.2228	3.3275	3.5003	3.1138	1.3787	0.1530
10/23/2014	4.2280	3.3390	3.5046	3.1054	1.3753	0.1524

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