November 21, 2014

Polish Weekly Review

Department of Economic Analysis
(research)

Ernest Pytlarczyk, PhD, CFA
chief economist
tel. +48 22 829 01 66
ernest.pytlarczyk@mbank.pl

Marcin Mazurek, PhD
senior analyst
tel. +48 22 829 01 83
marcin.mazurek@mbank.pl

Piotr Bartkiewicz
analyst
tel. +48 22 526 70 34
piotr.bartkiewicz@mbank.pl

Karol Klimas
analyst
tel. +48 22 829 02 56
karol.klimas@mbank.pl

Department of Financial Markets
(business contacts)

Bartlomiej Malocha, CFA
head of interest rates trading
tel. +48 22 829 01 77
bartlomiej.malocha@mbank.pl

Marcin Turkiewicz
head of fx trading
tel. +48 22 829 01 67
marcin.turkiewicz@mbank.pl

Department of Financial Markets Sales
(business contacts)

Inga Gaszkowska-Gebska
institutional sales
tel. +48 22 829 01 67
inga.gaszkowska-gebska@mbank.pl

Jacek Jurczyński
structured products
tel. +48 22 829 15 16
jacek.jurczynski@mbank.pl

mBank S.A.
18 Senatorska St.
00-950 Warszawa
P. O. BOX 728
tel. +48 22 829 00 00
fax. +48 22 829 00 33
http://www.mbank.pl

Table of contents

Comment on the upcoming data and forecasts

On Tuesday the CSO will publish its monthly Statistical Bulletin along with data on unemployment and retail sales. Preliminary data from the Ministry of Labor and Social Policy indicate that unemployment declined a tad faster than we (and most analysts) originally anticipated. Absent any revision from the CSO, 11.3% is the number. Retail sales have probably mildly accelerated in October but mainly due to base effects in several categories (clothing and footwear, other). We do not see any reasons for sales to rebound more strongly, at least not at the moment. The week ends with detailed GDP data for the third quarter. With monthly data strongly pointing out to a deceleration in both consumption and investment, we assume that the surprise in headline growth rate is due to either public consumption or inventories, or a combination of both.

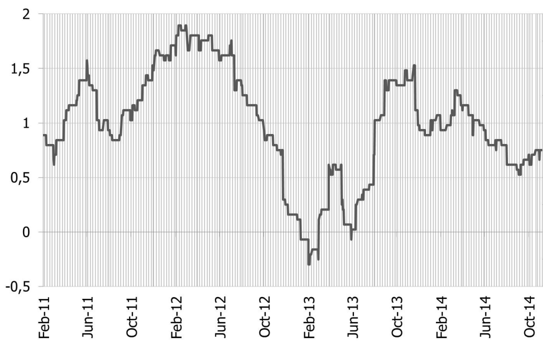
Polish data to watch: November 24th to November 28th

Publication	Date	Period	mBank	Consensus	Prior
Retail sales YoY (%)	25.11	Oct	2.1	2.1	1.6
Unemployment rate (%)	25.11	Oct	11.3	11.4	11.5
GDP YoY *final* (%)	28.11	Q3	3.3	3.3	3.3
NBP inflation expectations (%)	28.11	Nov	0.2	0.2	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

Lots of opportunities, but not a single significant surprise – the index stays flat after the week. Next week brings two releases that could move Polish surprise index: retial sales and unemployment.

* 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).

mBank.pl

Our view in a nutshell

Fundamentals

- We stick to our view that Poland entered softpatch but recovery will not be derailed. The soft patch, which contrasts with high frequency data, looks shallower than we expected. Growth stalled around 3%.
- Despite regional (Russia, Ukraine) and European headwinds (soft euro zone growth), stable domestic demands lets economy pass through relatively unscathed. The source of strengh lies in consumption (both private and public) and relatively good moods among firms (production continued but so far accumulated as stocks) that commonly used sentiment indices probably understated.
- 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 in 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 got stuck in decision process but the combination of local and global factors should be enough the break the stalemate and lead to new cuts. The timing is hard to pin down precisely, we see 2x25 (December and January or January and February) and 1x50 bps cut as equally likely. The whole easing cycle will amount to 100 bps.

Financial markets

- Bearish flattener has run its course. We see significant downside in short end yields (2Y-5Y) due to local (50 bps rate cuts ar even bolder bets to be priced in, very low inflation) and global factors (European QE likely to be centered on the belly of the curve). At the same time, the prospect of Fed normalization should keep the long end more anchored. All in all, bullish steepener is the name of the game now.
- The ECB is firmly on the path towards sovereign QE or at least a broader asset purchase programme. Apparent opposition is kept out of the public and might only slow down the evolution of ECB policy. This makes positive spillovers on Polish markets very likely - offering a lot of support for Polish bonds.
- Expectations for monetary easing proved to be important factor of PLN weakness but the Zloty should be seen as too strong (and both MoF and NBP are encouraging its weakness). There is very little price action and zloty stays at the mercy of carry trades (high real rates) stimulated by structural trades for European QE. At this very moment the real risk if for PLN appreciation. However, appreciation would only make MPC easing case more compelling. All in all, between rock and a hard place – 4,20 is the natural habitat of EURPLN.

mBank forecasts

	2010	2011	2012	2013	2014F	2015F
GDP y/y (%)	3.9	4.5	2.0	1.6	3.2	3.5
CPI Inflation y/y (average %)	2.8	4.3	3.7	0.9	0.1	0.2
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	11.9	11.5
Repo rate (end of period %)	3.50	4.50	4.25	2.50	1.75	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	3.5	3.3	3.2	3.0	3.3	3.5	4.1
Individual consumption y/y (%)	2.6	2.8	2.5	2.4	2.2	2.3	2.4	2.6
Public Consumption y/y (%)	0.7	0.8	2.5	2.4	2.0	3.0	3.0	3.0
Investment y/y (%)	10.7	8.4	7.2	6.0	6.0	7.5	8.0	9.0
Inflation rate (% average)	0.6	0.2	-0.3	-0.3	-0.3	0.0	0.5	0.7
Unemployment rate (% eop)	13.9	12.0	11.5	11.9	12.6	11.8	10.9	11.5
NBP repo rate (% eop)	2.50	2.50	2.50	1.75	1.50	1.50	1.50	1.50
Wibor 3M (% eop)	2.71	2.68	2.28	1.85	1.64	1.66	1.70	1.70
2Y Polish bond yields (% eop)	3.01	2.51	2.00	1.68	1.61	1.71	1.83	1.96
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.50	2.55	2.71	2.83	2.96
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

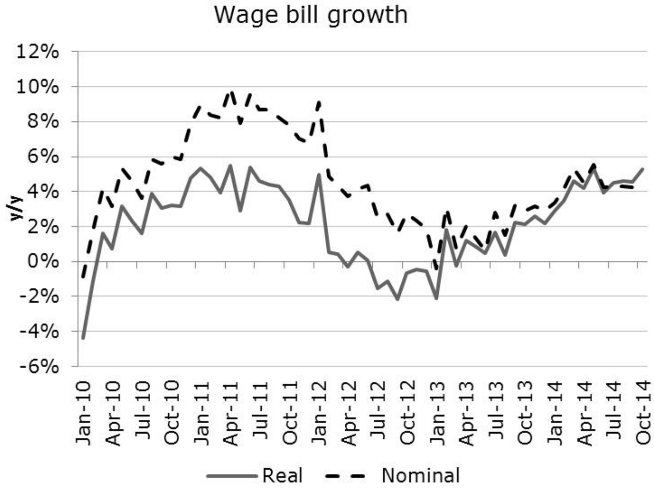
Economics

The economy remains sluggish and lacks momentum. More rate cuts will occur and their timing is the only truly unknown variable.

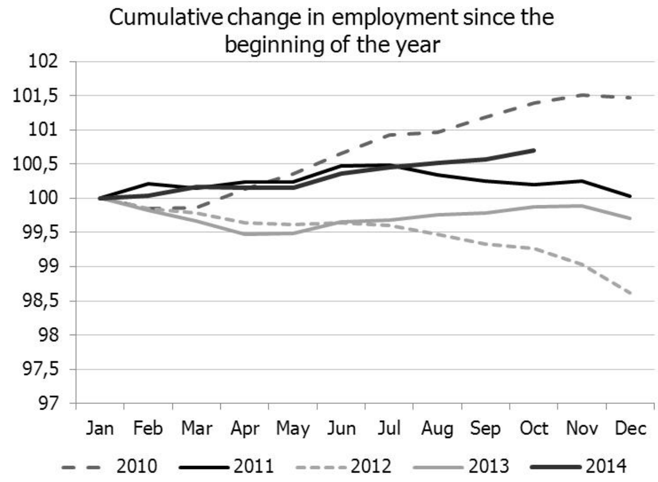
Last week's data showed that the economy lacks a clear direction and that there is genuine weakness beyond the veil of strong GDP numbers. Granted, labor market data were strong, with wage growth surprising to the upside and employment registering the best October since 2010, but that is a cushion, not a key driver of the economy. Industrial data, on the other hand, essentially confirmed the old story of stagnation, both in manufacturing and construction. Signals from the MPC became clearer this week: the Minutes from November meeting showed three separate motions (-25, -50 and -100 bps) being turned down; MPC members (Belka, Zielinska-Glebocka, Osiatynski) sounded generally dovish but refused to pre-commit. What conclusions can we draw from it? There is a strong push for more rate cuts among the doves and a clear rationale, quite similiar to ours (negative risks from Europe, negative inflation and its effects, risks of significant PLN appreciation due to ECB QE). Chojna-Duch, the dove who probably switched sides 2 weeks ago (it wasn't a fundamental disagreement, we hear), can conceivably be persuaded to rejoin Belka's camp. The timing is impossible to determine on the basis of macro factors alone, though. For us, a 100 bps easing cycle is still on and we cannot discount the possibility that cuts will be resumed in December.

As usual, here's our take on this week's data.

Average gross wage increased by 3.8% in October, up from 3.4% in September. The figure is slightly better than analysts' forecasts but consistent with recent trends and the surprise can be reasonably attributed to usual volatility in sections such as mining and energy generation. In the coming months (apart from November and December when wage data are bound to be influenced by delays in mining bonus payments - in the media there have been reports pointing out to such problems) one cannot expect wage growth to decrease significantly. Current range (ca. 3.5%) is consistent with neutral momentum in the most sectors of the economy - we are still waiting for a more dynamic rebound in the economy, although the recent soft patch is probably coming to an end.



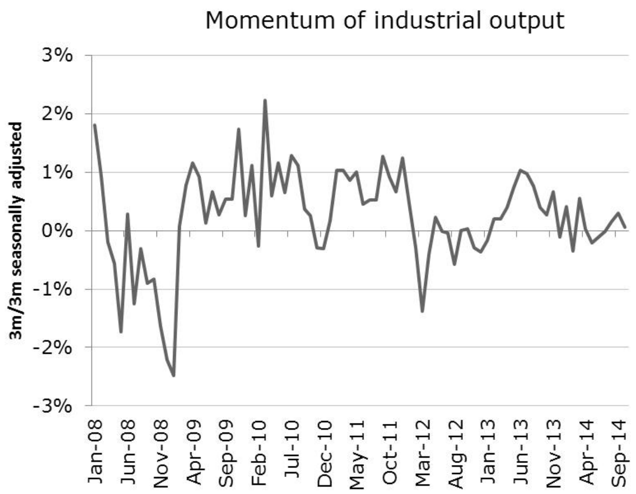
Decent wage growth, hence decent growth in real wage bill and real income (low inflation, especially in non-core categories is very favorable here) should support consumer demand even if one takes into consideration the recent increase in savings rates.



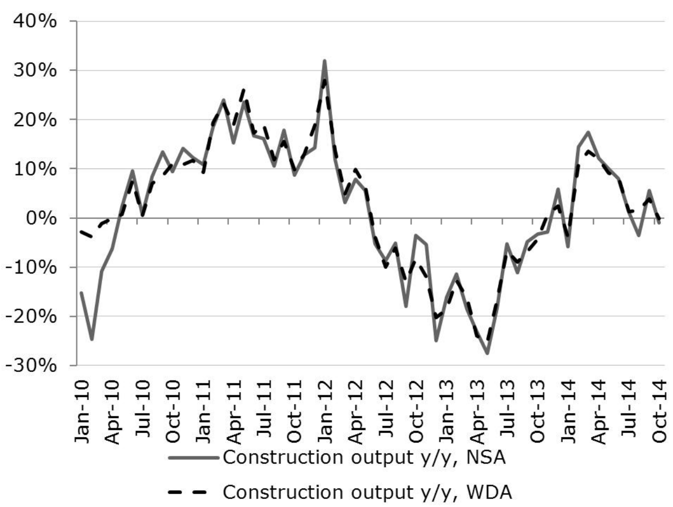
Employment grew by 7 thousand jobs on a monthly basis (the best October since 2010) which translated into a 0.8% print in annual growth rate (in line with market consensus). The release, although it suggests stability, should be interpreted in a rather optimistic manner. The structure of employment growth in the previous month had already painted a positive picture (increases in several important sections such as manufacture of electrical equipment and furniture). Moreover, strong labor demand was reported in various sentiment surveys. Finally, employment figures could have been boosted by the opening of Amazon's logistic centres (several thousand jobs in total, it is however unclear if, when and how were they recorded by GUS). We expect the labor market to remain moderately buoyant in the coming months (an unspectacular 0.8-1% annual growth in employment).

Industrial output grew by 1.6% y/y in October after a 4.2% increase in September (largely in line with market consensus and our forecast, both at ca. 2% y/y). On a seasonally adjusted basis growth was similar to last month and amounted to

1.5% y/y (0.3% m/m s.a.). Such a result can be interpreted as confirmation that there is no upward momentum in the Polish industry - our favorite measure hovers around zero (see the graph below). Industrial output grew in 20 out of 34 sections, most of them export-oriented. Declines were recorded mostly in domestic-oriented branches such coke, energy, food products and energy generation (warm weather doubtlessly contributed to this result), as well as other transport equipment - industry with the largest exposure to Russia and Ukraine.



Construction output dropped by 1% on annual basis (seasonally adjusted: -0.2% y/y and +0.9% m/m), below forecasts that indicated a modest increase. Construction remains in stagnation and if anyone hoped that local elections would bring a boost to the sector, he's in for a disappointment. That did not happen (and previous experience indicated that there is no statistically significant „pork barrel effect") and it is easy to see why - these investments are typically small and spread over time, thus insignificant compared to the overall investment activity. It seems that until public investment kicks in in Spring 2015, no significant boost to the sector can happen.



Producer prices declined by 1.2% y/y, accelerating from -1.6% noted in the previous month, but only due to base effect. There is sign of a turnaround in deflationary / disinflationary trends in the economy. Polish producers remain stuck in a bad equilibrium with no independent pricing power, no incentives to raise prices and a downward pressure on margins and expectations. Only an exogenous shock (such as significant EURPLN spike) could change the situation.

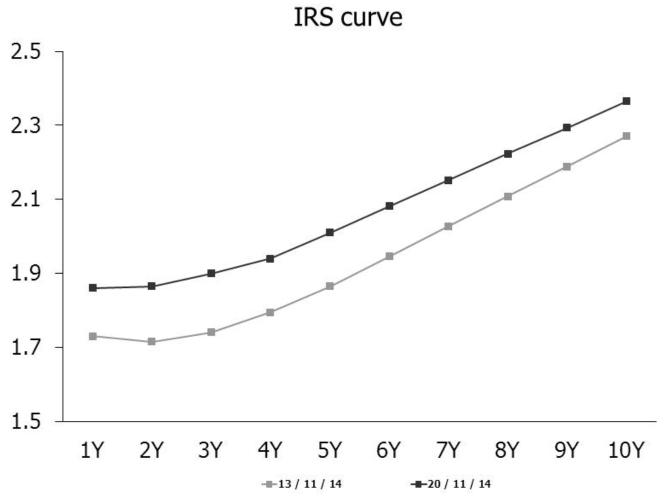
We believe that while the worst in the economy is probably over, a more dynamic rebound will have to wait. Flat momentum in the economy implies that the bottom in y/y GDP growth should occur at the turn of 2014 and 2015 when base effects will be the strongest. It is still true that enterprises have no independent pricing power which negatively affects their profit margins and discourages investment. No cost pressure is also in sight (on the contrary, actually).

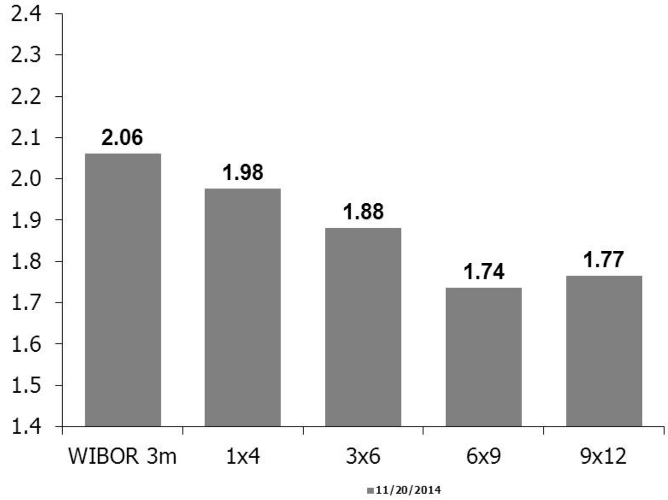
Fixed income

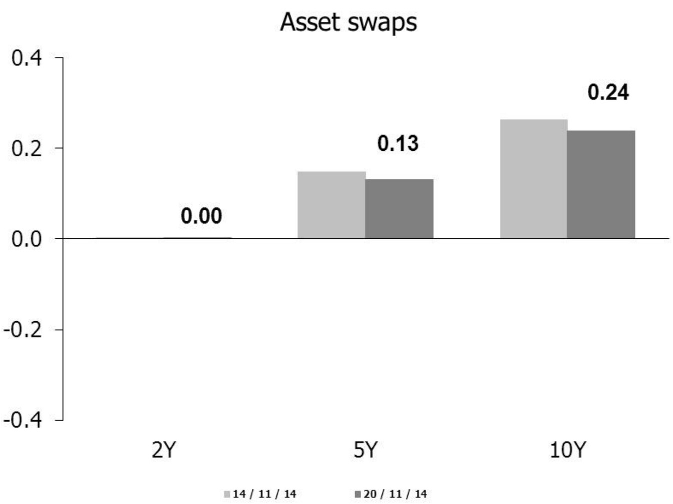
End of the Year

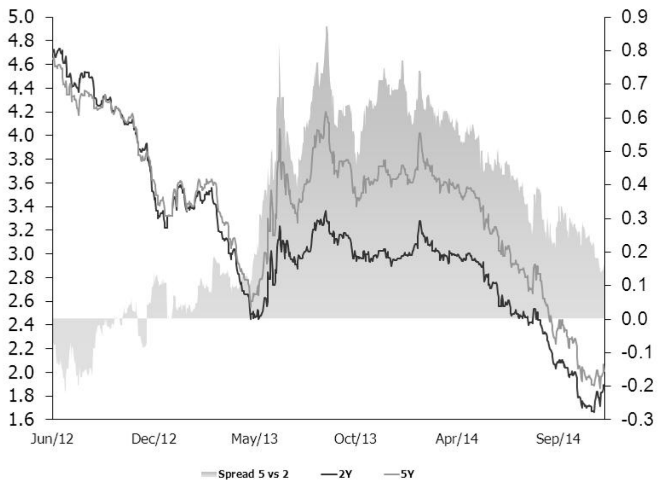
This week on Fixed Income market we had well deserved profit taking/correction. Main reasons were temporary weakness on core bond markets and supply of 5Y bonds on switching auction (almost 7bln of PS0719 and WZ0119 were sold). Yield of PS0719 reached 2.19% but at this level long term investors, attracted by positive carry trade, supported bond market. Currently PS0719 trades around 2,03%.

At the end of the year turnover should be lower than regular, but it doesn't mean lower volatility. We still see a chance for rate cut even in December, PMI yet again can be pivotal data. With ECB more and more dovish we see not much risk in keeping long position on 5Y bonds, Santa Claus rally on bonds is still possible.







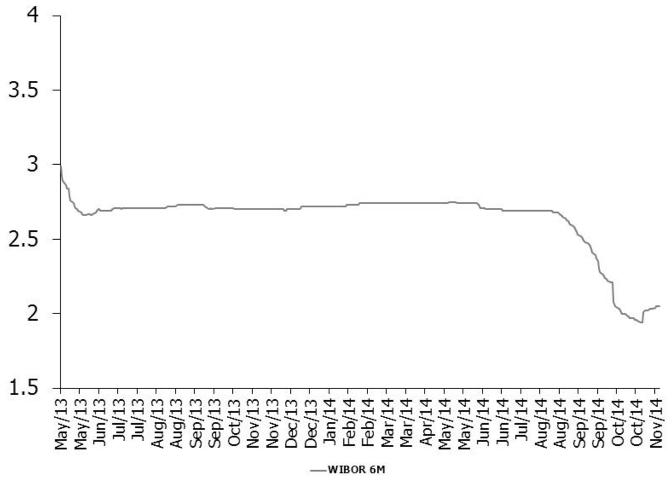


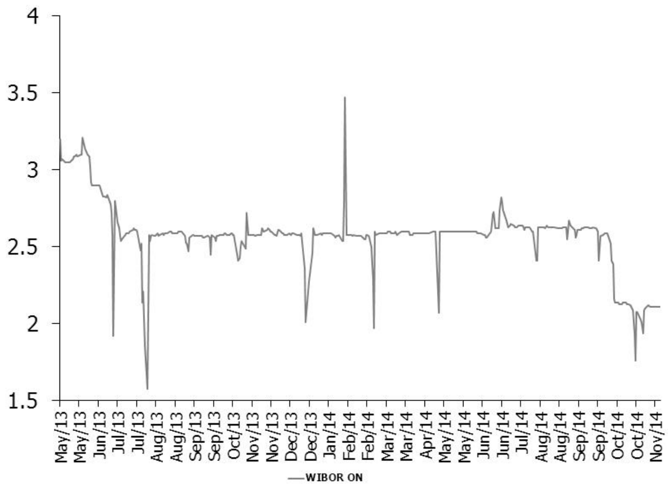
Money market

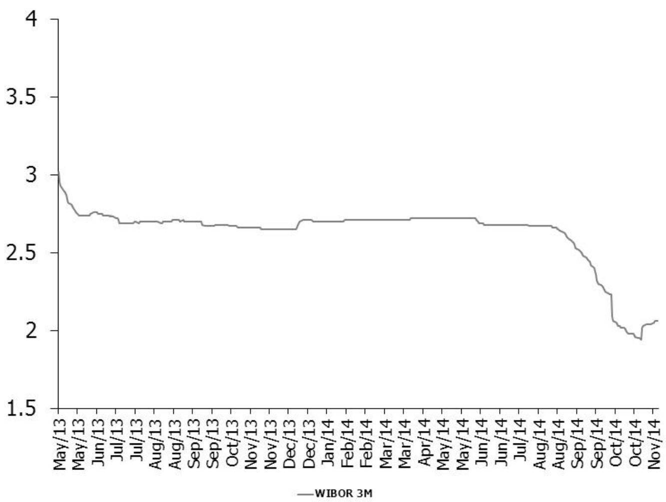
Stable week for cash market

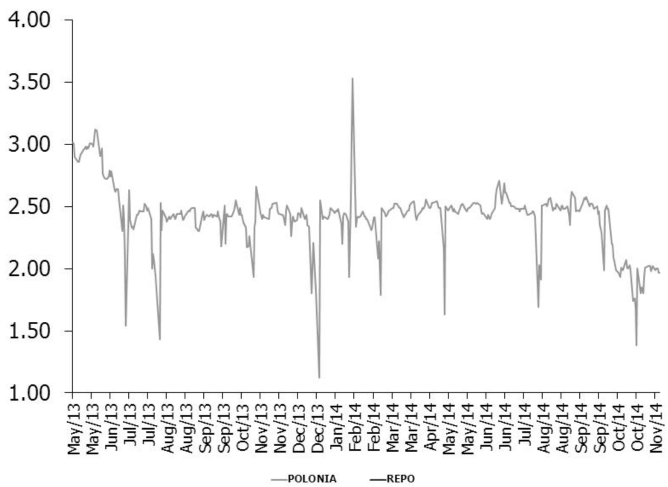
Polonia fluctuated around 2.00 despite large cash surplus. Next week should be stable as its last week of reserve and last day is Friday. Polonia should stay around 2.00 or even a bit higher.

Interesting week for Polish rates. As we have just postponed potential rate cuts to unpredictable future after great GDP, yesterday we started to play rate cuts in December. OIS and FRA are 10 bps lower than they were on Wednesday. 1Y OIS is now 1.60/1.65.





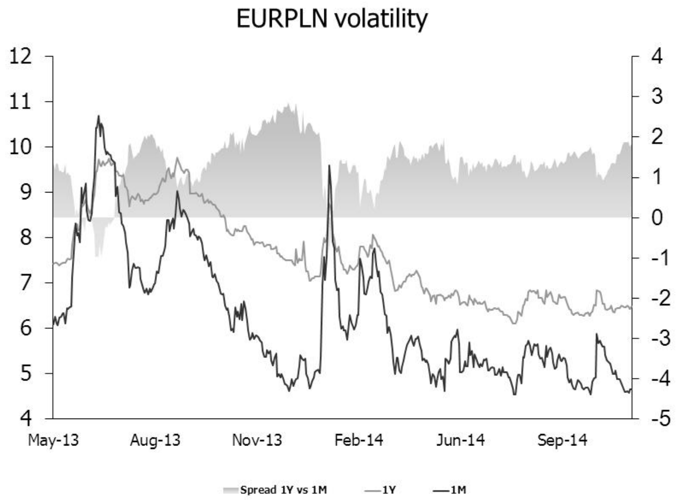




Forex

PLN stronger The positive climate for ZĹ‚oty continues. After a very robust GDP figure from last week, EUR/PLN kept on sliding from the 4.34ish top of the range to 4.2020, breaking on the way the 4.21 support that was holding for a couple of weeks. The dovish speech from Head of ECB Mario Draghi on Friday acted as catalyst for the final push to the downside. We believe it will be much harder work with 4.18/4.20 support zone. Especially that we are still expecting a December cut from the Polish MPC. We still think we are in the range but it is now more likely 4.19-4.22 than 4.21-4.24. I know it is hardly an exit...

Vols – lower The good old correlation that stronger PLN is leading to lower vols, has proven right one more time. But this time it was also helped by the extremely low realized volatility. As a result, the selloff was mostly concentrated in the front end. 1 month EURPLN is this Friday at 4.3% mid (0.3% lower), 3 month are 4.8% (0.2 lower) and finally 1 year is fixing at 6.5% (0.1% lower). The skew is better offered, so is the currency spread (USD/PLN vol minus EUR/PLN vol).



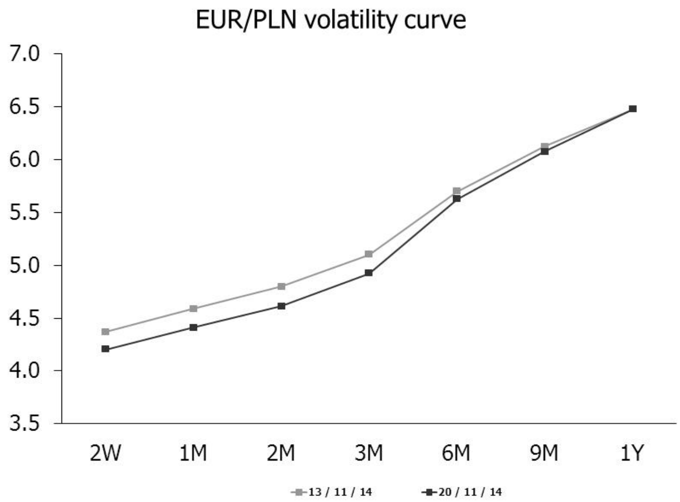
Short-term forecasts

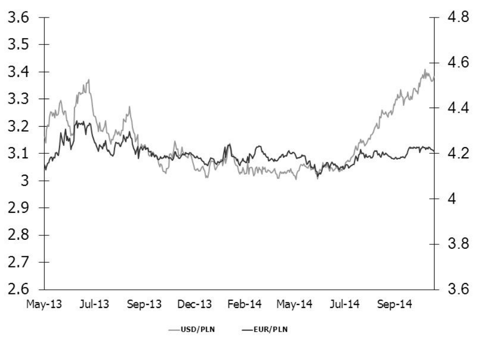
Main supports / resistances:
EUR/PLN: 4.18 / 4.26
USD/PLN: 3.30 / 3.45

Spot – flat. Position closed with profit. EUR/PLN – Short from 4.2300 fully covered at 4.2050. We still believe in the rangy nature of the market. So, even though we are PLN bulls in medium term, we are ready to buy EUR/PLN at 4.1900 add 4.1750 with a stop below 4.1650 for a move to 4.2300.

USD/PLN – we are sidelined at the moment.

Options – Core long 1y Vega We stick to our core long in Vega in the backend. In 1 month - 3 month sector the vols are looking low, but we are not overall convicted that they are cheap. December with Christmas and New Year's holidays are not really that encouraging to be long gamma.





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
11/14/2014	2.13	2.04	2.11	1.93	1.97	1.91	2.00	1.85	1.73	1.75	1.74	1.74
11/17/2014	2.04	2.05	1.98	1.94	2.06	1.92	2.02	1.87	1.74	1.77	1.75	1.76
11/18/2014	2.18	2.06	2.14	1.95	2.08	1.93	2.01	1.90	1.75	1.76	1.79	1.76
11/19/2014	1.92	2.06	1.93	1.95	2.02	1.93	2.01	1.92	1.79	1.83	1.82	1.82
11/20/2014	2.00	2.06	2.02	1.95	2.12	1.93	1.98	1.88	1.74	1.77	1.77	1.75

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
11/14/2014	1.910	1.873	1.830	1.833	1.970	2.118	2.350	2.613
11/17/2014	1.920	1.855	1.840	1.865	1.990	2.111	2.350	2.599
11/18/2014	1.930	1.843	1.865	1.898	2.005	2.116	2.355	2.616
11/19/2014	1.930	1.957	1.895	1.939	2.070	2.182	2.440	2.665
11/20/2014	1.930	1.903	1.865	1.866	2.010	2.140	2.365	2.604

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
11/14/2014	4.61	5.10	5.73	6.50	6.50	2.32	0.54
11/17/2014	4.58	5.00	5.68	6.48	6.48	2.32	0.54
11/18/2014	4.65	5.00	5.60	6.43	6.43	2.32	0.54
11/19/2014	4.65	4.99	5.61	6.49	6.49	2.32	0.54
11/20/2014	4.41	4.93	5.63	6.48	6.48	2.32	0.54

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
11/14/2014	4.2290	3.3933	3.5179	2.9164	1.3820	0.1530
11/17/2014	4.2255	3.3819	3.5176	2.9136	1.3816	0.1526
11/18/2014	4.2180	3.3706	3.5109	2.8822	1.3789	0.1525
11/19/2014	4.2170	3.3655	3.5108	2.8633	1.3821	0.1524
11/20/2014	4.2155	3.3680	3.5094	2.8426	1.3832	0.1523

Disclaimer