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Polish Weekly Review

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Comment on the upcoming data and forecasts

Because of holidays, January MPC meeting will take place next week. Although we keep stating that rate cuts should not be ruled out at any meeting, January is quite improbable. The reason for this is that the perception of economic growth as strong and recent weakening of Zloty, which is viewed by some MPC members as substitute of rate cuts. Inflation data will be published day after and they should confirm further fall into deflation (driven by lower fuel prices and stable base inflation) and that return to inflation target will be postponed once again. Week will begin with balance of payments publication. The expected narrowing of current account balance, with unchanged trade balance, is driven by seasonal effects in remaining categories.

Polish data to watch: January 12th to January 16th

Publication	Date	Period	mBank	Consensus	Prior
Exports (mio EUR)	13.01	Nov	13550	13455	14728
Imports (mio EUR)	13.01	Nov	13450	13365	14672
Current account (mio EUR)	13.01	Nov	-282	-450	-435
MPC decision (%)	14.01	Jan	2.00	2.00	2.00
M3 y/y (%)	14.01	Dec	8.6	8.2	8.4
CPI y/y (%)	15.01	Dec	-0.9	-0.9	-0.6
Core CPI y/y (%)	16.01	Dec	0.5	0.5	0.4

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

No surprises, therefore no changes in the index. Next week brings one opportunity for surprise - the CPI.

* 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

- 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%. Note that nominal GDP growth is very low.
- Despite regional (Russia, Ukraine) and European headwinds (soft euro zone growth), stable domestic demand 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 next 2-3 quarters (longer than NBP projects). 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 deflation and global factors points to a resumption of further easing. The timing is hard to pin down precisely. Risk of easing is going to accompany each upcoming meeting. In these circumstances betting on anything less than 50bps makes no sense.

Financial markets

- With the new year we returned to outright long exposure on Polish bonds (10y).
- Prolonged disinflation, MPC's easing bias and euro QE are set to support Polish bonds in the mid term.
- Weaker zloty near term on negative portfolio effects (PLN is the cheapest hedge against Russia risks).
- Zloty to strenghten in the mid-term on euro QE and high real interest rates (carrry trades).

mBank forecasts

	2010	2011	2012	2013	2014F	2015F
GDP y/y (%)	3.7	4.8	1.8	1.7	3.4	3.5
CPI Inflation y/y (average %)	2.8	4.3	3.7	0.9	0.0	-0.1
Current account (%GDP)	-4.5	-4.9	-3.5	-1.3	-1.2	-1.8
Unemployment rate (end of period %)	12.4	12.5	13.4	13.4	11.7	11.1
Repo rate (end of period %)	3.50	4.50	4.25	2.50	2.00	1.50

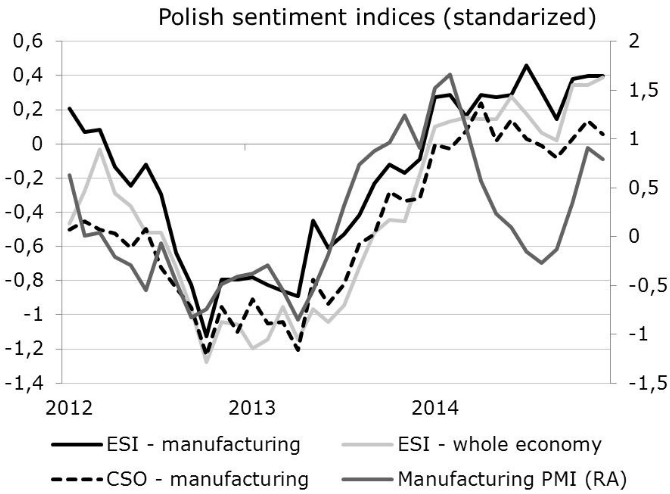
	2014 Q1	2014 Q2	2014 Q3	2014 Q4 F	2015 Q1F	2015 Q2F	2015 Q3 F	2015 Q4 F
GDP y/y (%)	3.4	3.5	3.3	3.0	2.8	3.1	3.5	4.4
Individual consumption y/y (%)	2.9	3.0	3.2	3.0	2.8	2.8	3.2	3.4
Public Consumption y/y (%)	0.1	3.7	3.5	2.4	2.0	3.0	3.0	3.0
Investment y/y (%)	11.2	8.7	9.9	7.0	6.0	6.0	7.0	9.0
Inflation rate (% average)	0.6	0.2	-0.3	-0.6	-0.9	-0.4	0.1	0.8
Unemployment rate (% eop)	13.9	12.0	11.5	11.9	12.6	11.8	10.6	11.4
NBP repo rate (% eop)	2.50	2.50	2.50	2.00	1.50	1.50	1.50	1.50
Wibor 3M (% eop)	2.71	2.68	2.28	2.06	1.64	1.66	1.66	1.66
2Y Polish bond yields (% eop)	3.01	2.51	2.00	1.79	1.55	1.58	1.64	1.74
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.52	2.50	2.40	2.70	2.74
EUR/PLN (eop)	4.17	4.16	4.18	4.29	4.25	4.25	4.20	4.10
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.66	3.73	3.75	3.73

F - forecast

Economics

Slight correction of PMI

No surprises this time the Purchasing Managers Index fell to 52.8 in December from 53.2 in November. This way, PMI shows similar pattern to industrial indices published earlier by the CSO (see chart below), which also showed minor worsening of industrial sentiment.



Too far-reaching conclusions should not be drawn from this slight change. Firstly, even not taking into consideration irregular and not uniform character of PMI growth, December is a very specific month due to very volatile workday influence. This volatility is not always well captured by seasonal adjustments. Secondly, the analysis of PMI structure in December reveals that this small decline had two main drivers: new orders marginally slowed down (after skyrocketing in previous month) and there were declines in both times of delivery and purchases subindices. Two remaining components were rather optimistic: production kept its solid last month value and employment category has risen to highest levels since April 2014.

Still no signs of cost or price pressure could be found in Polish industry: due to low commodity prices (like oil) costs for companies remained almost unchanged, while final goods prices are falling for 25th month in a row. This does not necessarily need to cause a slide in profitability. PMI is a diffusion index, thus it does not take under consideration the size of both revenues and losses of particular enterprises. Nevertheless, this situation puts pressure on some companies to lower their margins.

General situation in Polish economy did not change. Moderate economic growth rate is incapable of creating endogenous inflation pressure. Industrial sector has only begun to recover from the period of weakness at the turn of Q2 and Q3. Meanwhile, enterprises still operate in a deflationary environment and recent weakening of Zloty could only partly offset those problems. It is worth noticing that because strong depreciation of CIS currencies, effective exchange rate (trade – weighted) remained almost unchanged. This leads us to expect further monetary easing, although it is hard to guess exact time of its renewal. March seems to be a quite reasonable month because new inflation projection will be presented then.

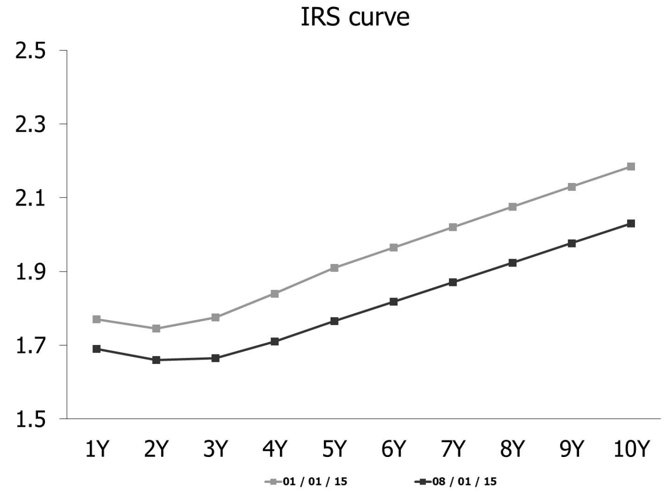
Fixed income

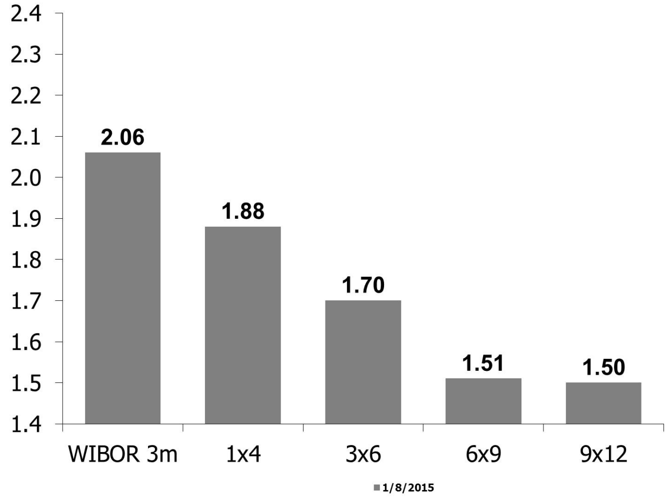
Turning point

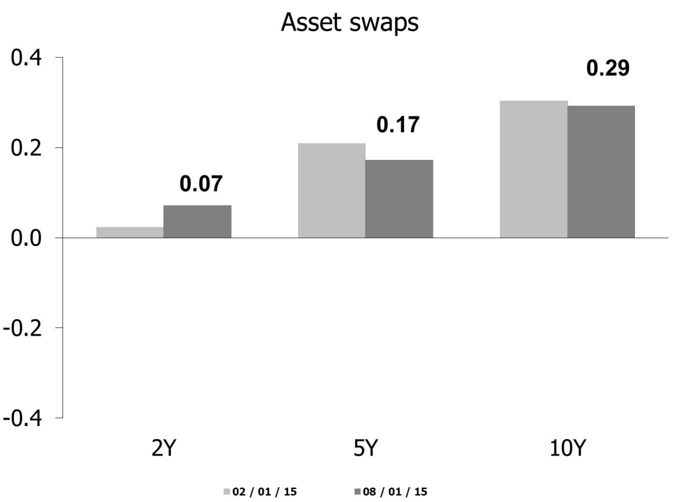
Beginning of this year was positive for Polish fixed income market. Low Oil prices on global market and possible ECB action (QE on the next meeting) fueled expectations for more rate cuts in Poland. Bonds reached new lows so let's highlight it: 10Y bonds record low of 2.30%, 5Y 1.90%, 2Y 1.70%. Is there any barrier for bonds they cannot break? Are those levels even relevant, or investors are just buying Poland because there are inflows no matter what?

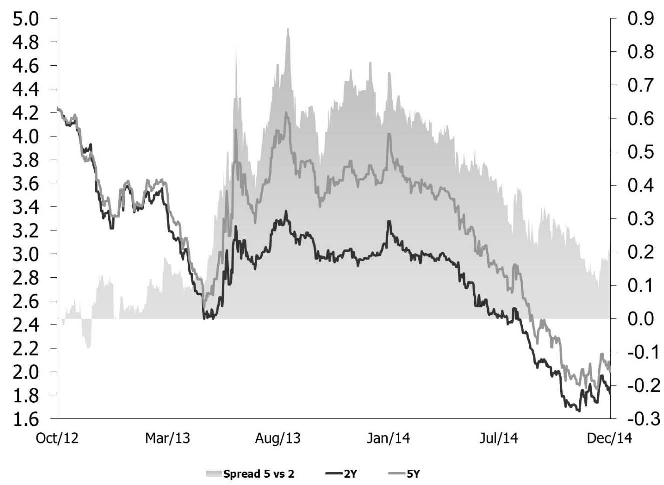
Recent events in Russia and Greece definitely showed how important global capital inflows are for local economy. Weakness of PLN at the end of 2014 shows that Poland is no exception. Investors recently prefer to put money on safest bets and Poland - outside of Eurozone and with bonds not protected by ECB – is a little fragile. It seems that MPC is comfortable with current repo rate as they are convinced that CPI is going to be higher at the end of the year (above 0%). From this point of view recent rally looks like a good opportunity to sell bonds as ECB's Quantitative Easing is widely priced in already.

Recommendation: Sell DS0725.









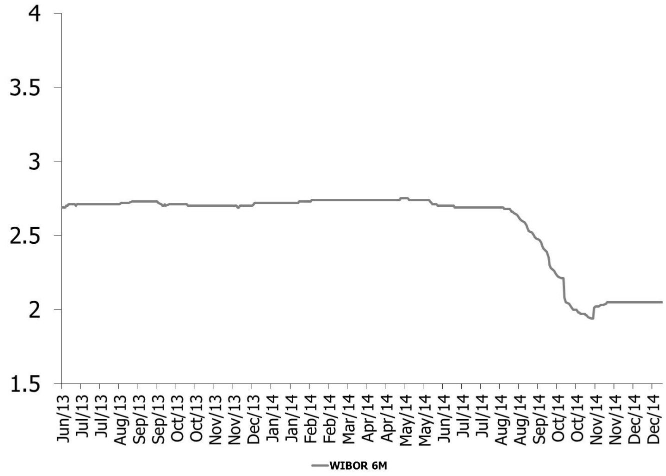
Money market

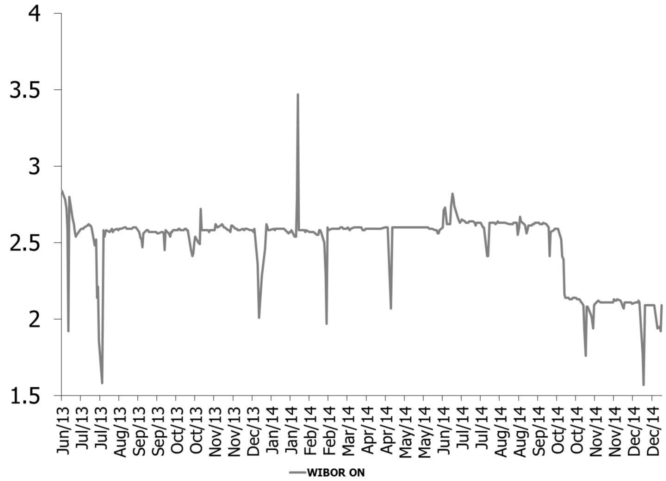
Very cheap end of year and beginning of a new one.

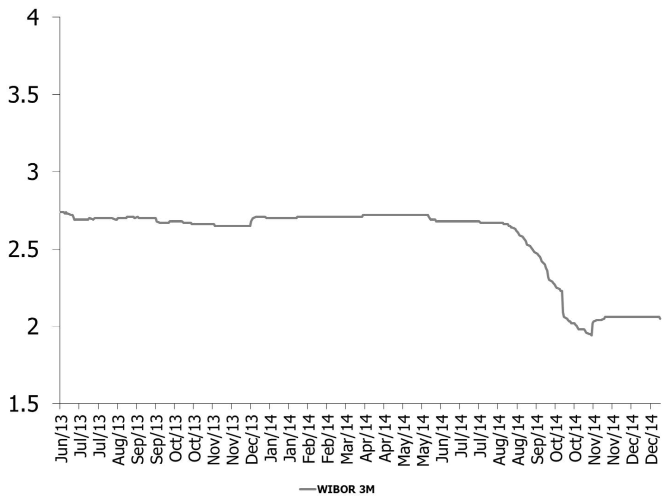
Polonia fluctuated around 1.70 for 3 weeks. Next week cash should stay around 1.90 as there is a MPC meeting on Wednesday. It will fall if the MPC moves rates and rise to 2.00 if they leave rates without changes.

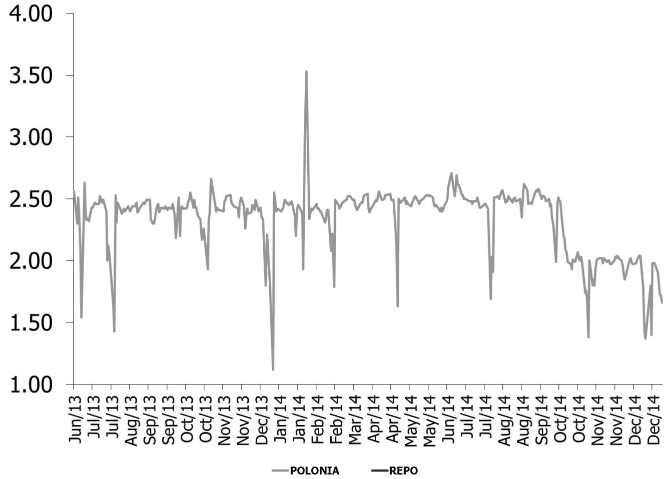
Probability of rate cut in January is just 20% (1W and 2W OIS are quoting around 1.90). Whole curve is discounting 50 bps as 1Y OIS is at 1.51/1.56.

Our recommendation is to buy OK0116 at 1.72 and hedge it by buying 6x9 FRA at 1.52.





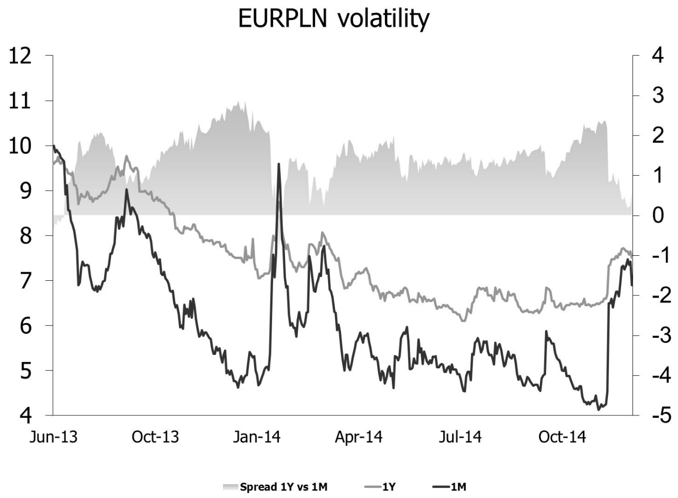




Forex

PLN relief rally? There bigger picture is quite blurred, ECB QE is looming on the horizon just a few days before Greece elections. Polish MPC decision is also a potential risk. EUR/PLN range, 4.3215 high and 4.2580 low for the week. 4.2450-4.2650 support zone witch could be pivotal for EUR/PLN in the near time. Was really 4.40 just a bad Christmas dream? Is volatility back for good? We need to wait to find out.

Vols – melting The reversed correlation with PLN is still alive and kicking. The stronger PLN and generally calmer markets were the reason why the sellers got back in control. The 1 month EUR/PLN ATM is now 6.6% mid (0.5% lower than on the 2nd of January), 3 months ATM EUR/PLN are 6.7% (0.4% lower), 1 year ATM was given this Friday at 7.2% (0.3% lower). The currency spread (difference between USD/PLN and EUR/PLN vol) and skew are roughly unchanged.

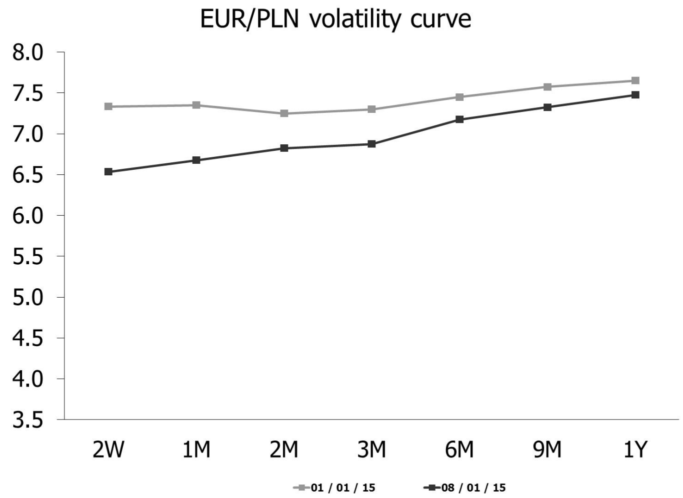


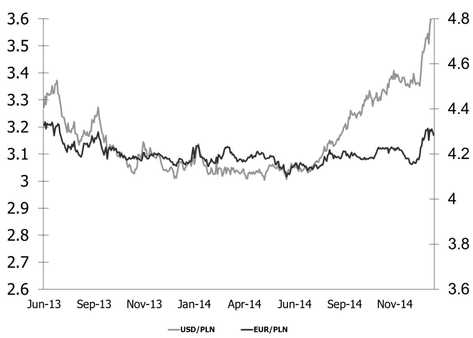
Short-term forecasts

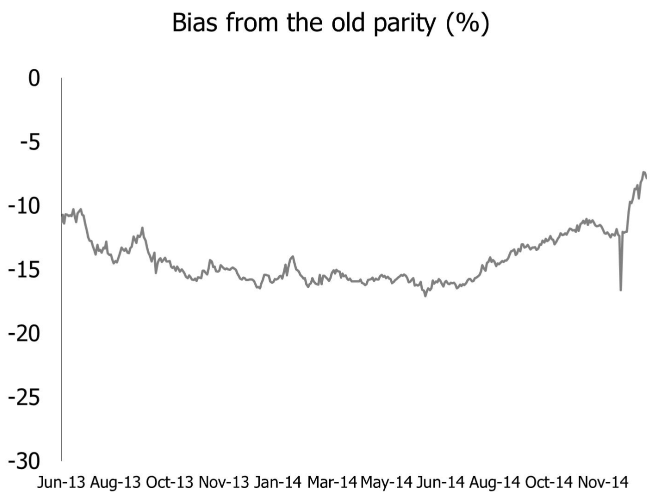
Main supports / resistances:
EUR/PLN: 4.2350 / 4.34
USD/PLN: 3.50 / 3.80

Spot – Long EUR/PLN at 4.2700 We are long EUR/PLN at 4.2700 ready to add 4.2550 with stop loss below 4.2450 and profit taking at 4.33. The trade is purely tactical. We are sidelined in USD/PLN.

Options – Core Long 1y long Vega We stick to our core Long in Vega in the backend. The position has performed well into the year end, 1 year EUR/PLN has reached 7.5% (from 6.25% low) before correcting lower to 7.2%. The move was quite big, but this does not change the bigger picture that we are relatively low in vols. The vols are still nominally cheap, we are sticking to the position.







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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
1/2/2015	1.95	2.06	1.94	1.95	1.93	1.94	1.90	1.77	1.60	1.60	1.62	1.61
1/5/2015	2.04	2.06	1.97	1.95	1.98	1.94	1.88	1.73	1.54	1.53	1.55	1.54
1/6/2015	2.00	2.06	1.91	1.95	1.92	1.94	1.88	1.72	1.54	1.53	1.55	1.54
1/7/2015	1.85	2.06	1.84	1.95	1.83	1.94	1.89	1.73	1.52	1.53	1.52	1.52
1/8/2015	1.95	2.06	1.94	1.95	1.93	1.94	1.88	1.70	1.51	1.50	1.52	1.51

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
1/2/2015	1.940	1.835	1.730	1.753	1.885	2.094	2.165	2.469
1/5/2015	1.940	1.800	1.670	1.732	1.810	1.989	2.080	2.385
1/6/2015	1.940	1.800	1.670	1.732	1.810	1.989	2.080	2.385
1/7/2015	1.940	1.765	1.663	1.717	1.780	1.962	2.050	2.329
1/8/2015	1.940	1.749	1.660	1.731	1.765	1.937	2.030	2.322

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
1/2/2015	7.48	7.40	7.50	7.65	7.65	2.65	0.62
1/5/2015	7.35	7.23	7.35	7.58	7.58	2.65	0.62
1/6/2015	7.43	7.29	7.43	7.65	7.65	2.65	0.62
1/7/2015	6.90	6.93	7.36	7.50	7.50	2.63	0.61
1/8/2015	6.68	6.88	7.18	7.48	7.48	2.59	0.62

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
1/2/2015	4.3078	3.5725	3.5833	2.9671	1.3512	0.1554
1/5/2015	4.3008	3.5975	3.5792	2.9926	1.3476	0.1553
1/6/2015	4.3008	3.5975	3.5792	2.9926	1.3476	0.1553
1/7/2015	4.3115	3.6375	3.5898	3.0604	1.3490	0.1559
1/8/2015	4.2985	3.6482	3.5792	3.0467	1.3535	0.1540

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