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Polish Weekly Review

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Comment on the upcoming data and forecasts

Another light week in terms of economic data. On Tuesday the NBP will release balance of payments data for Q4 (revision of monthly figures). One can expect that slight narrowing of CA deficit indicated by monthly data will be confirmed in quarterly series. On Wednesday Manufacturing PMI (for March) will be published. Given the on-going improvement in euro area sentiment and some encouraging signals in CSO's business surveys, we bet on further increase in the PMI.

Polish data to watch: March 30th to April 3rd

| Publication | Date | Period | mBank | Consensus | Prior |
|---------------------------|-------|--------|-------|-----------|-------|
| Current account (mio EUR) | 31.03 | Q4 | -1332 | -1332 | -1777 |
| Manufacturing PMI (pts.) | 01.04 | Mar | 55.3 | 55.3 | 55.1 |

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 OK0717 | - | 1500 | 1.667 | 2/12/2015 |
| 5Y T-bond PS0720 | - | 3500 | 1.987 | 2/12/2015 |
| 10Y T-bond DS0725 | - | 2000 | 2.366 | 3/12/2015 |
| 20Y T-bond WS0428 | - | 20 | 2.092 | 3/12/2015 |

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



Comment

Unchanged - unemployment rate was confirmed at 12.0% (unchanged from last month). Next week brings the PMI release and another opportunity to surprise analysts.

* 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

- Growth stalled around 3% and we are close to the bottom in terms of annual growth rate.
- We see more and more signs of a cyclical upswing driven by better momentum in the euro zone (Poland is highly geared especially towards Germany) and backed by solid domestic demand.
- H2 2015 is expected to bring more (positive) exogenous components to the Polish cycle. Lower costs of financing, generally lower budget deficit and the beginning of a new round of infrastructure spending are expected to give way to expenditures related to political business cycle ahead of presidential and general elections.
- Given the schedule of infrastructure spending and stable consumption growth, 2-3 years of economic expansion are our baseline scenario for Polish economy. Upswing phase can be flatter than we historically got used to but longer. Such an outcome almost guarantees that the likelihood of bottlenecks in the economy is small.
- Momentum of inflation recorded a slight turnaround and we await higher readings in coming months. However, GDP gap is too wide to generate inflation pressure and therefore inflation is going to stay low (very low). Prices are going to stay in deflation in the next 2-3 quarters.
- MPC did its part delivering 50bps cut in March. Official communication states that the cycle has been concluded and rates are going to stay at 1.5%. At the same time rate hikes are miles away since there is no inflation in sight and the new MPC (starting job in 2016) may be even more dovish.

Financial markets

- We are semi-defensive on Polish bonds and prefer the 5Y sectors as we do not believe in prompt monetary tightening, way ahead of the ECB.
- MPC concluded the easing cycle at 1.5% and rate cut expectations can only be fueled by substantial PLN strengthening due to QE-connected inflows, high real interest rates and improving cyclical position of the Polish economy.

mBank forecasts

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015F |
|-------------------------------------|------|------|------|------|------|-------|
| GDP y/y (%) | 3.7 | 4.8 | 1.8 | 1.7 | 3.3 | 3.5 |
| CPI Inflation y/y (average %) | 2.8 | 4.3 | 3.7 | 0.9 | -0.1 | -0.6 |
| 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 | 11.5 | 10.3 |
| Repo rate (end of period %) | 3.50 | 4.50 | 4.25 | 2.50 | 2.00 | 1.50 |

| | 2014 | 2014 | 2014 | 2014 | 2015 | 2015 | 2015 | 2015 |
|--------------------------------|------|------|------|------|------|------|------|------|
| | Q1 | Q2 | Q3 | Q4 | Q1 F | Q2 F | Q3 F | Q4 F |
| GDP y/y (%) | 3.4 | 3.5 | 3.3 | 3.1 | 2.8 | 3.1 | 3.5 | 4.4 |
| Individual consumption y/y (%) | 2.9 | 3.0 | 3.2 | 3.1 | 2.8 | 2.8 | 3.2 | 3.4 |
| Public Consumption y/y (%) | 0.1 | 3.7 | 3.5 | 3.7 | 2.0 | 3.0 | 3.0 | 3.0 |
| Investment y/y (%) | 11.2 | 8.7 | 9.9 | 9.0 | 6.0 | 6.0 | 7.0 | 9.0 |
| Inflation rate (% average) | 0.6 | 0.2 | -0.3 | -0.7 | -1.4 | -0.9 | -0.4 | 0.5 |
| Unemployment rate (% eop) | 13.9 | 12.0 | 11.5 | 11.5 | 12.1 | 11.0 | 10.2 | 10.3 |
| 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 | 1.60 | 1.60 | 1.60 | 1.70 |
| 10Y Polish bond yields (% eop) | 4.23 | 3.45 | 3.05 | 2.52 | 2.10 | 2.10 | 2.30 | 2.40 |
| EUR/PLN (eop) | 4.17 | 4.16 | 4.18 | 4.29 | 4.10 | 4.05 | 4.05 | 4.05 |
| USD/PLN (eop) | 3.03 | 3.04 | 3.31 | 3.54 | 3.87 | 3.82 | 3.93 | 4.05 |

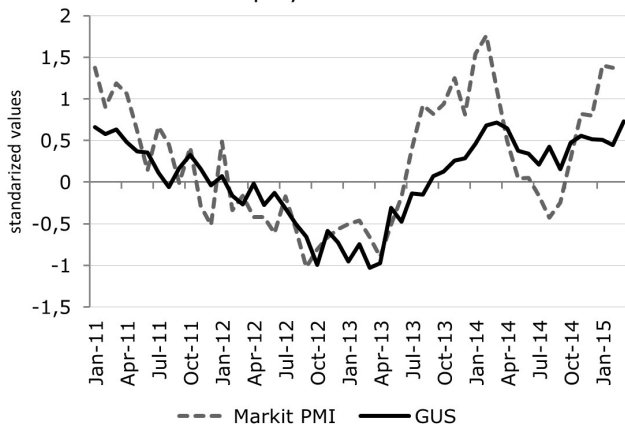
F - forecast

Economics

Next week's PMI release to confirm positive momentum in the economy. Don't hold your breath, though. Rate hikes aren't coming any time soon.

The only notable macro release next week is the Manufacturing PMI. The last two readings have been exceptionally strong, indicating a broad-based recovery in the industrial sector, and there are good reasons to expect another solid reading for March. First, upswing in the euro area is still gaining steam and positive spillovers can be expected. Second, the CSO's survey of manufacturers is corroborating the rosy picture for the Polish economy, as assessment of output and new orders jumped to new multi-year highs in March.

Weighted average of output, new orders and employment subindices



As we repeatedly showed, there has been a broad-based improvement in "hard" data as well. We expect that to be confirmed by March data, coming up later next month. In a nutshell, this is what we are expecting:

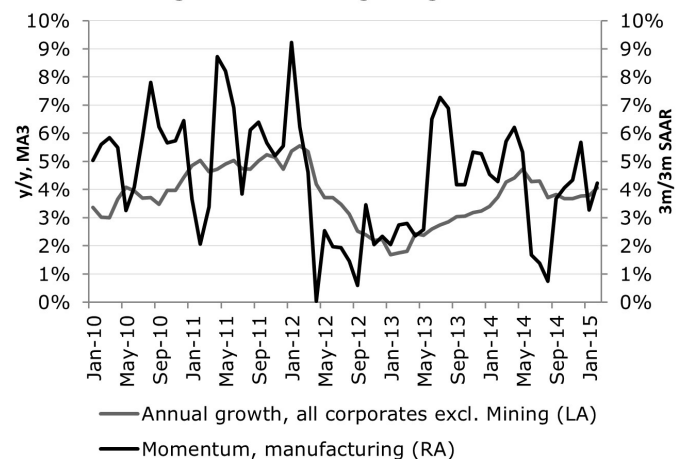
- Industrial output is set to accelerate further on the back of calendar effects and favorable momentum. Note that energy generation (very warm weather) and mining output (strikes and outages) are a major drag on industrial production at the moment.
- Employment growth is set to stabilize. Last month was negatively biased by lay-offs in transportation and odd behavior of some services; at the same time manufacturing added 5k jobs and momentum seems strong. The only troubling signs we see are in business tendency indicators concerning employment (the ones that CSO produces) which constantly trend down. Since it is not corroborated by other sources and outright falsified by the strong momentum in the economy we are not really worried at the moment.
- Wages will probably accelerate again, exceeding 3.5% in nominal y/y terms. This will put wage growth closer to trend which we currently estimate at 3.5-4% y/y.
- Retail sales have oscillated around 0% growth for the past few months but this is set to change in March. Low base in car sales, timing of Easter and working day effects will

work together to push retail sales growth towards and above 4% y/y. Not a change in trend, but headlines will seem more optimistic nevertheless.

Momentum of industrial output



Trend growth of average wage



Thus, there is (and there will be after next month) little doubt that the Polish economy has accelerated in the past few months and summer lull has been overcome. Strong real sphere data and a turnaround in inflation appear to be vindicating the MPC's decision to end the easing cycle. Poland, however, is miles away from raising rates back again. First of all, inflation is set to remain low in the coming quarters and the NBP's target could very well be permanently undershot (as indicated by the last staff projections). The market might disagree with such a rosy path of inflation but the NBP was right more often than the market in this respect. Secondly, by declaring the end to the easing cycle the MPC has effectively tightened monetary conditions via the FX channel – EURPLN has dropped by almost 3% since the announcement and by almost 7% since January highs. The extent and the pace of PLN appreciation are approaching levels that matter for both growth and inflation. Third, the risk of rapid PLN appreciation is still present and it is anyone's guess as to how low EURPLN can end up if expectations of monetary tightening take hold. Tightening well ahead of the ECB is an open invitation for capital inflows and currency appreciation. Last but not least, the new MPC might be more dovish than the current one and even if that is not true, the mere lack of continuity will delay any decision on rates. All in all, expecting rate hikes in 2016 is in our opinion a folly (and the market seems to be in agreement).

Fixed income

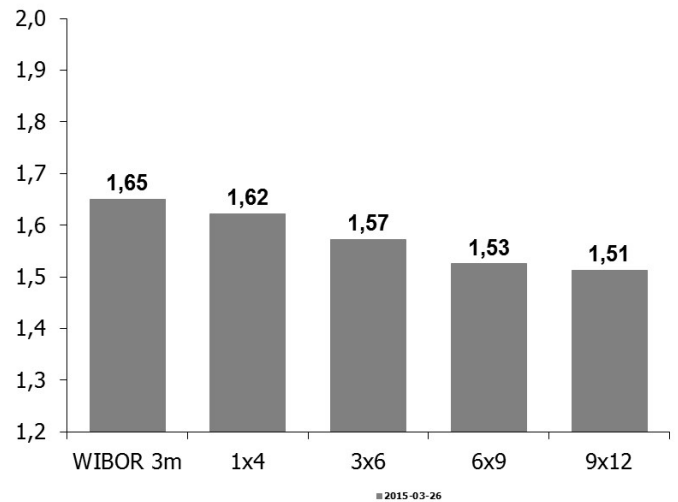
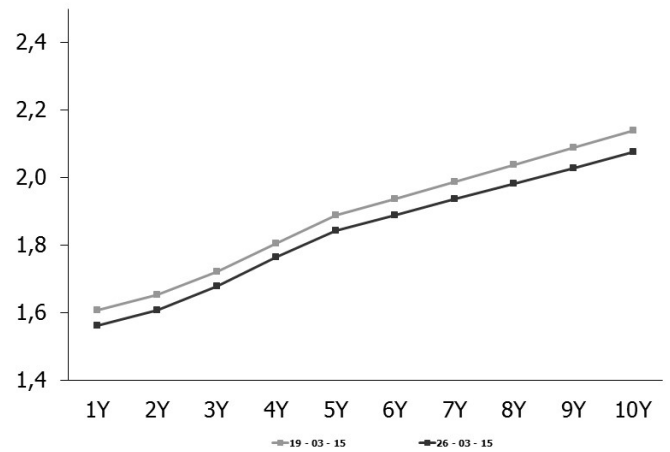
Following US Treasuries

With no local story, this week Polish fixed income market was reflecting global moves, especially UST. Main event for domestic investors was switch auction on Thursday, when Ministry of Finance sold 6,5 bio PLN of WZ0120 and PS0420 bonds.

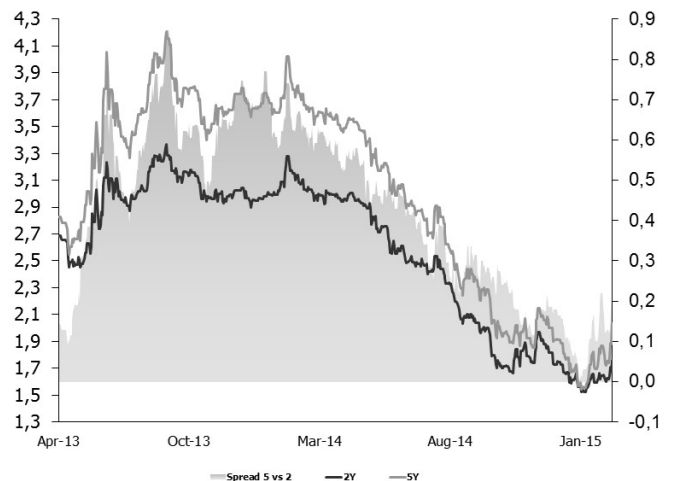
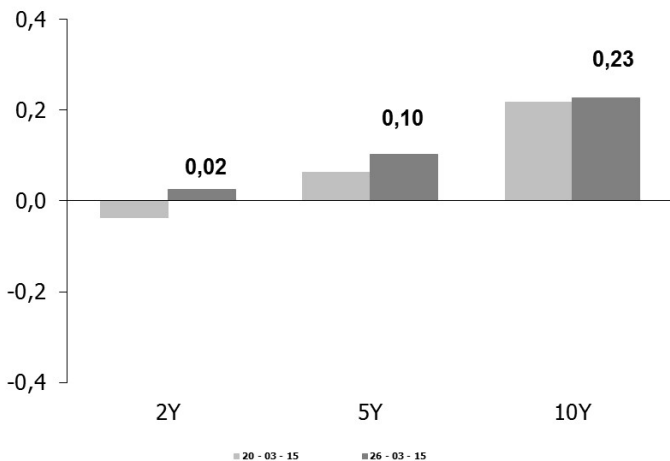
During first part of the week we saw huge interest to receive IRS especially in 1-5y area - FRA started to price in a rate cut (15 bps in 6x9 contract) - market started to believe that strong PLN can push MPC to cut rates further. On the other hand we saw inflows in POLGB's related to stronger US Treasuries-DS0725 touched 2.20% level. Auction went in line, however 4 bio of fresh fixed income 5y bond in conjunction with rising US yields pushed market 13 bps higher.

With the open question about timing and scale of US tightening the next week US payrolls data seems to be extremely important. Until then we suggest playing ranges: 5Y IRS 1.80%-2.00%; DS0725 2.20%-2.40%.

IRS curve



Asset swaps

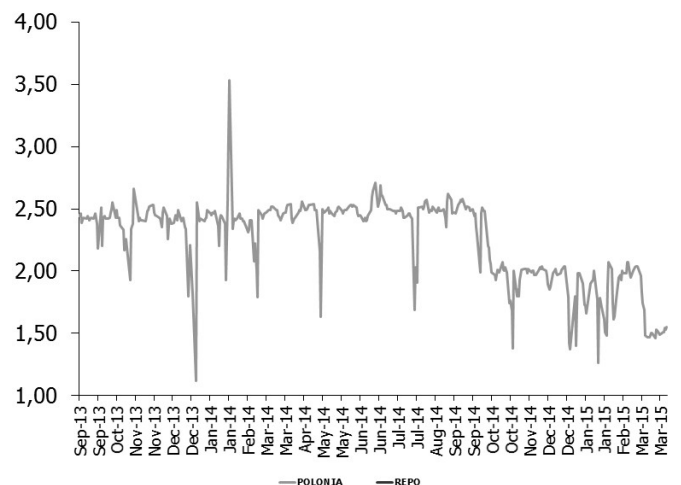
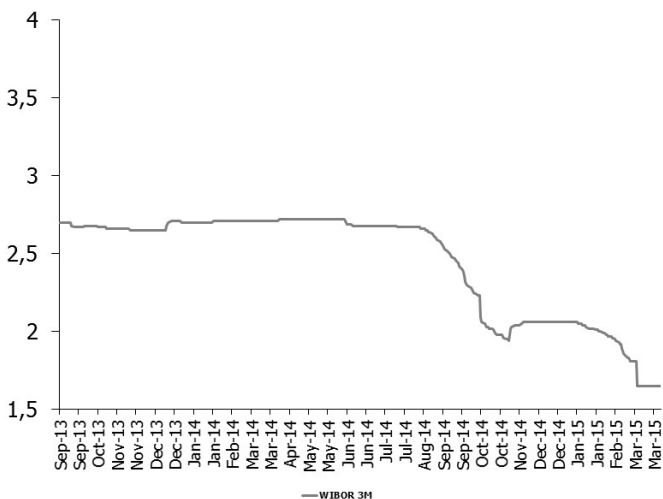
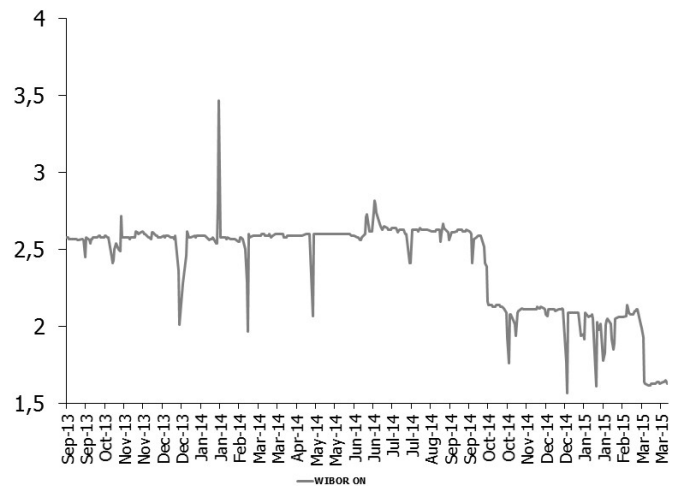
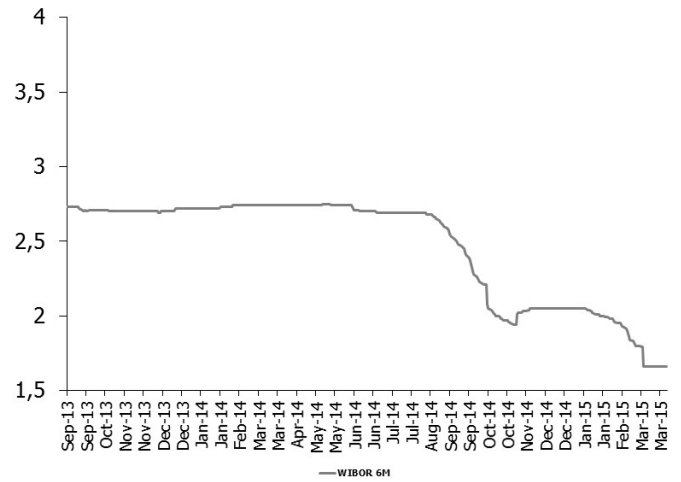


Money market

Expensive week behind us

Polonia fluctuated around the reference rate for the whole week. Next week should be stable as well as it's the end of reserve on Monday and the beginning of a new one. Market started to discount new rate cuts. 6x9 and 9x12 FRA are 13 bps under current WIBOR rate. 1Y OIS also discounts a small possibility of rate cuts.

We recommend to buy OK0116 as it will be the next switching bond. Current ones (DS1015, OK0715, PS0415) look very expensive.



Forex

PLN – strong gains EUR/PLN hit its two year low at 4.0710, as the combination of extremely dovish ECB and significantly less hawkish FOMC gave PLN additional boost. The big question is, is it substantial?

We are skeptical. It is likely that USD will resume its march higher, and therefore will restrain the PLN gains, at least against USD. The geopolitical tension is still really high (Middle East!) and that also can translate into some "risk off" scenario. As a consequence, we are slowly but surely steering into PLN bearish camp.

Options – higher USD/PLN front end vols were real stars of the week. Currency spread (difference between USD/PLN vols minus EUR/PLN vols) has climbed from 6.75% to almost 7.75%. USD/PLN gamma was in great demand. 1 month EURPLN ATM has climbed 0.3% to 6.4%, 3 months EUR/PLN ATM are at 6.5% (0.2% higher than week ago) and 1 year is fixing at 7.0% (the same level as week ago). The skew was at the same level as week ago.

Short-term forecasts

Main supports / resistances:

EUR/PLN: 4.08 / 4.18

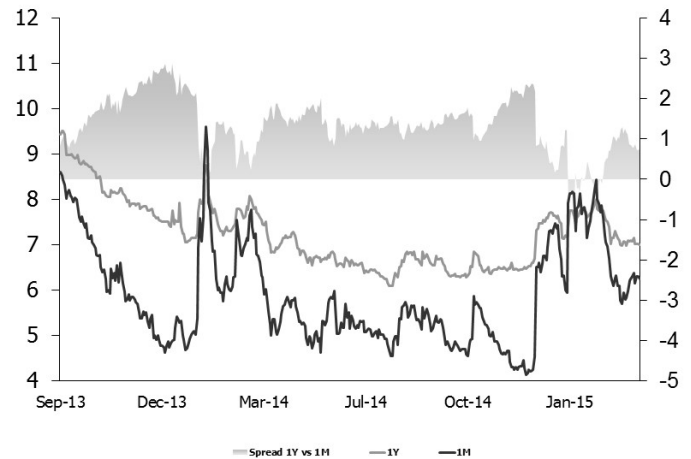
USD/PLN: 3.60 / 3.95

Spot Long USD/PLN.

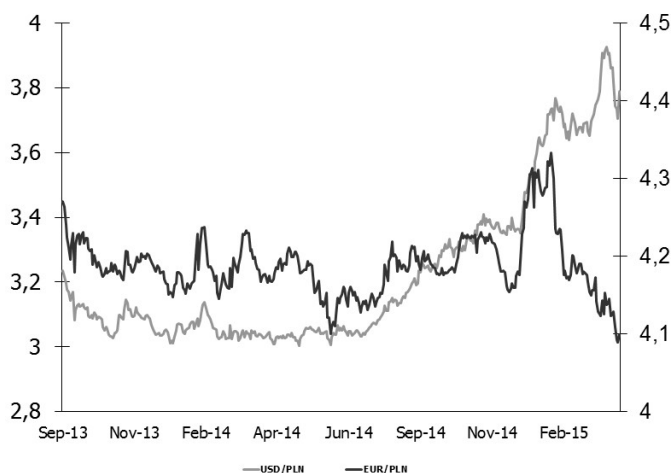
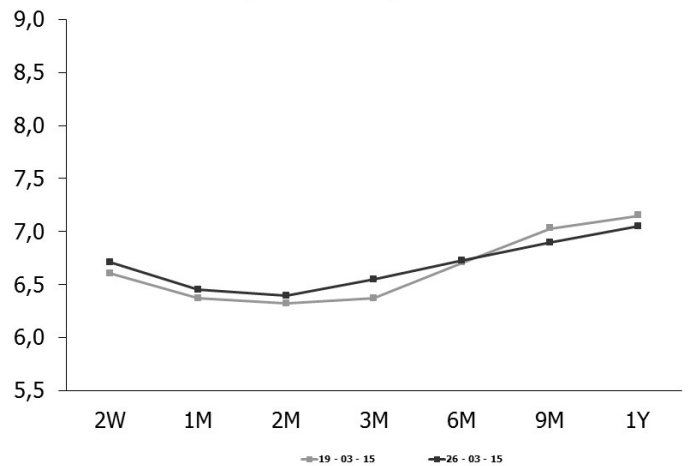
We are now long USD/PLN at 3.7200 ready to add 3.6800 with a stop at 3.6550 with hopes to get back above 3.8500.

Options The FOMC has created enormous realized volatility, especially in EUR/USD and other USD/XXX crosses. It is very likely that the market will continue to be choppy at best. But in the longer term, the relative nature of the FOMC policy should reduce substantially the heat of the markets. We are trimming our long Vega in the backend but sticking to long Vanna in both EUR/PLN and USD/PLN.

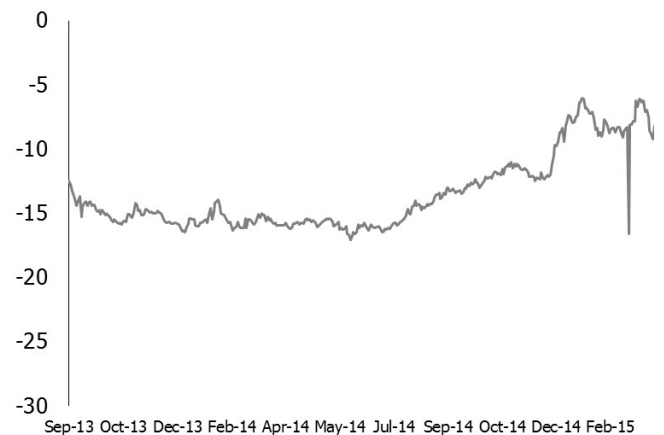
EURPLN volatility



EUR/PLN volatility curve



Bias from the old parity (%)



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 |
| 3/20/2015 | 1.73 | 1.65 | 1.73 | 1.56 | 1.60 | 1.58 | 1.65 | 1.62 | 1.60 | 1.60 | 1.63 | 1.61 |
| 3/23/2015 | 1.74 | 1.65 | 1.82 | 1.56 | 1.56 | 1.58 | 1.63 | 1.59 | 1.60 | 1.57 | 1.62 | 1.58 |
| 3/24/2015 | 1.54 | 1.65 | 1.55 | 1.56 | 1.57 | 1.58 | 1.65 | 1.58 | 1.55 | 1.55 | 1.58 | 1.56 |
| 3/25/2015 | 1.65 | 1.65 | 1.75 | 1.56 | 1.48 | 1.58 | 1.62 | 1.58 | 1.51 | 1.50 | 1.53 | 1.52 |
| 3/26/2015 | 1.68 | 1.65 | 1.68 | 1.56 | 1.58 | 1.58 | 1.62 | 1.57 | 1.53 | 1.51 | 1.56 | 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 |
| 3/20/2015 | 1.580 | 1.594 | 1.648 | 1.611 | 1.840 | 1.903 | 2.060 | 2.278 |
| 3/23/2015 | 1.580 | 1.586 | 1.640 | 1.621 | 1.832 | 1.939 | 2.062 | 2.279 |
| 3/24/2015 | 1.580 | 1.537 | 1.611 | 1.626 | 1.810 | 1.922 | 2.037 | 2.288 |
| 3/25/2015 | 1.580 | 1.642 | 1.580 | 1.620 | 1.770 | 1.899 | 1.995 | 2.254 |
| 3/26/2015 | 1.580 | 1.654 | 1.608 | 1.632 | 1.842 | 1.944 | 2.075 | 2.301 |

| EUR/PLN 0-delta stradle | | | | | 25-delta RR | | 25-delta FLY | |
|-------------------------|------|------|------|------|-------------|------|--------------|------|
| Date | 1M | 3M | 6M | 1Y | 1M | 1Y | 1Y | 1Y |
| 3/20/2015 | 6.15 | 6.28 | 6.60 | 7.03 | 7.03 | 2.24 | 0.63 | 0.63 |
| 3/23/2015 | 6.30 | 6.28 | 6.63 | 7.03 | 7.03 | 2.24 | 0.63 | 0.63 |
| 3/24/2015 | 6.30 | 6.33 | 6.63 | 7.03 | 7.03 | 2.24 | 0.65 | 0.65 |
| 3/25/2015 | 6.25 | 6.35 | 6.63 | 7.00 | 7.00 | 2.21 | 0.65 | 0.65 |
| 3/26/2015 | 6.45 | 6.55 | 6.73 | 7.05 | 7.05 | 2.19 | 0.63 | 0.63 |

| PLN Spot performance | | | | | | |
|----------------------|--------|--------|--------|--------|--------|--------|
| Date | EURPLN | USDPLN | CHFPLN | JPYPLN | HUFPLN | CZKPLN |
| 3/20/2015 | 4.1255 | 3.8645 | 3.9101 | 3.1898 | 1.3599 | 0.1503 |
| 3/23/2015 | 4.1287 | 3.8180 | 3.9055 | 3.1822 | 1.3581 | 0.1504 |
| 3/24/2015 | 4.1090 | 3.7453 | 3.9011 | 3.1341 | 1.3534 | 0.1499 |
| 3/25/2015 | 4.0927 | 3.7355 | 3.8995 | 3.1228 | 1.3674 | 0.1493 |
| 3/26/2015 | 4.0886 | 3.7050 | 3.8985 | 3.1268 | 1.3633 | 0.1490 |

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