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Polish Weekly Review

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Comment on the upcoming data and forecasts

An eventful and exciting week ahead of us. Monday brings the release of balance of payments data (for February). We forecast a larger current account surplus on the back of large trade surplus and better EU flows (read more in the Economics section). On Tuesday, the NBP will publish M3 data – we expect, in line with consensus, a slight deceleration in annual growth rate of M3, mainly on base effects. Watch the other side of M3 (credit), though. Wednesday brings the release of March CPI - due to higher fuel prices we expect CPI to move up somewhat but risks are tilted to the downside (again, more on this in the Economics section). Finally, on Friday the CSO will publish its monthly labor market data. We expect employment growth to stabilize at 1.2% and wage growth to accelerate to 3.6% due to working day effects and low statistical base in mining. Last but not least, the MPC meeting will also be held this week. This one is shaping up to be a non-event, though. One can expect an upbeat assessment of the economy and a relaxed stance on PLN strength.

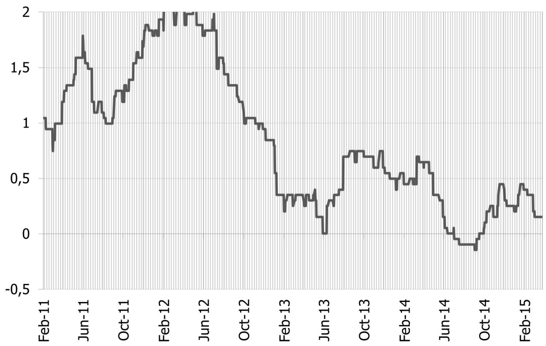
Polish data to watch: April 13th to April 17th

Publication	Date	Period	mBank	Consensus	Prior
Exports (mio EUR)	13.04	Feb	13900	13475	13472
Imports (mio EUR)	13.04	Feb	13100	12836	12451
Current account (mio EUR)	13.04	Feb	500	46	56
M3 y/y (%)	14.04	Mar	8.5	8.5	8.8
MPC decision (%)	15.04	Apr	1.5	1.5	1.5
CPI y/y (%)	15.04	Mar	-1.3	-1.3	-1.6
Core CPI y/y (%)	16.04	Mar	0.3	0.3	0.4
Average gross wage y/y (%)	17.04	Mar	3.6	3.3	3.2
Employment y/y (%)	17.04	Mar	1.2	1.1	1.2

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 OK0717	4/23/2015	1500	1.667	2/12/2015
5Y T-bond PS0720	4/23/2015	3500	1.987	2/12/2015
10Y T-bond DS0725	-	2000	2.262	4/9/2015
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Unchanged - no data releases. Next week brings plenty of opportunities for Polish surprise index to be moved: wages, employment, 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).

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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 sings 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 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1 F	2015 Q2 F	2015 Q3 F	2015 Q4 F
GDP y/y (%)	3.4	3.5	3.3	3.1	3.1	3.5	3.7	4.1
Individual consumption y/y (%)	2.9	3.0	3.2	3.1	2.6	2.8	2.8	2.8
Public Consumption y/y (%)	0.1	3.7	3.5	3.7	2.0	3.0	3.0	2.0
Investment y/y (%)	11.2	8.7	9.9	9.0	6.0	7.5	8.5	10.0
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	11.7	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	1.65	1.65	1.65	1.65
2Y Polish bond yields (% eop)	3.01	2.51	2.00	1.79	1.61	1.60	1.60	1.70
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.52	2.31	2.10	2.30	2.40
EUR/PLN (eop)	4.17	4.16	4.18	4.29	4.07	3.90	3.80	3.90
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.80	3.68	3.69	3.90

F - forecast

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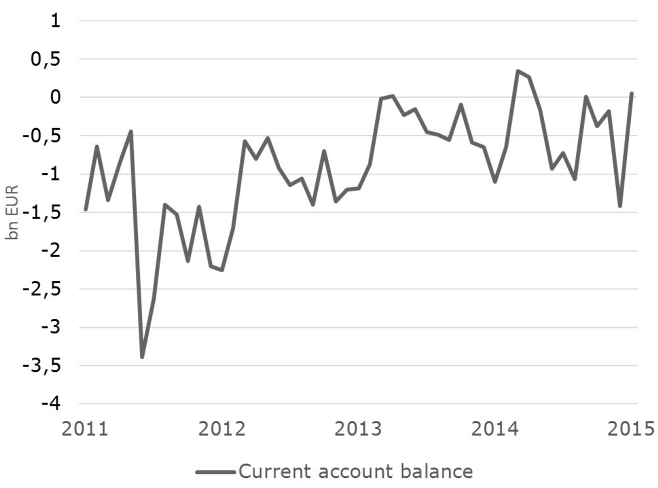
Economics

Upcoming data preview

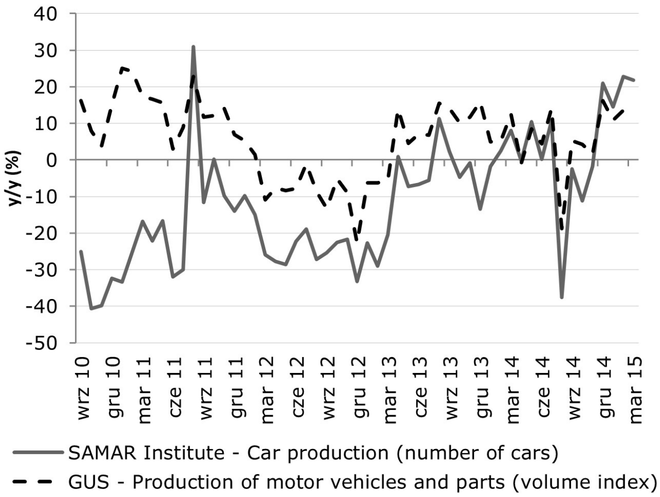
Yes, we did write about our expectations regarding the upcoming data releases two weeks ago. Since then, however, new information arrived and we are able to make our calls more precise (or at least pin down the risks better). Let's make a quick look at what we additionally learned.

CPI inflation. Regional data (Czech Republic, Hungary) saw the light and were mixed. However, leaving aside surprises, two issues are worth mentioning: 1) we see no signs that a downward momentum in inflation receded; 2) low food prices (in particular concerning vegetables and fruits) suggest our +0.5% call on monthly food price growth in Poland may be placed on the high side of possibilities. Therefore we see dominant downside risks to our forecast.

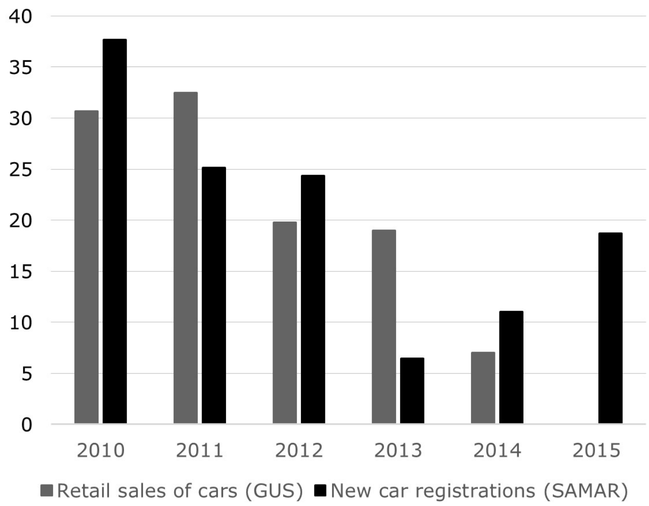
Current account. Due to lags in publication of data on EU transfers, we saw them this time quite late. Therefore, our proxy for account of EU funds was worse than actually released. Therefore our call for surplus of EUR 200mln in the whole current account can be shifted upwards to ca. 500mln EUR. Of course, the main question is whether the substantial surplus on trade account can be maintained but we think that, on average, within the realms of Q1/Q2 it can. If not in particularly in February, larger inflow of EU funds is going to be a welcome development working as a shield. The same applies to C/A surplus Poland is running. We cannot exclude this is a crucial game changer in terms of PLN strength/invulnerability, especially in the light of looming rate normalization in the U.S.



Industrial output. The data on car production (+21.9% y/y) are consistent with fast industrial output growth in March. However, the numbers aren't extraordinary and actually a shade below the previous month's figure (+22.7% y/y), therefore we feel comfortable with our 6.9% y/y forecast for the whole IP.



Retail sales. To our surprise, our call for 4.3% y/y sales was a positive odd one out in the consensus (ca 2.0%). We pointed to favorable Easter calendar and overall making up for a downside surprises in the prior month (e.g. in case of food sales) to account for better reading. Recently, our call was reinforced by the data on car registrations: it corroborates the fact that car sales were locally weaker in March 2014 (constituting a base effect) because the VAT-exemption rush wore off in March after the head start in January and February.

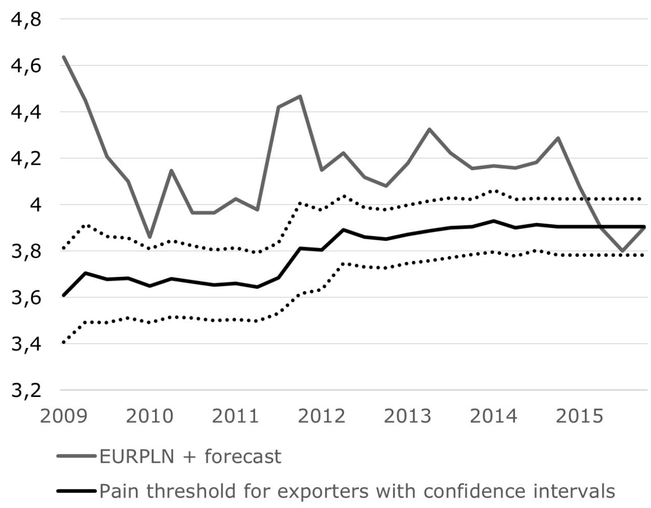


PLN appreciation is not over and it has a potential to be a game changer for Polish monetary policy

Recent banging of EURPLN on 4 threshold is no coincidence in our opinion. For a few weeks we have been repeating that the zloty strengthening has merits and this is not going to change. So far, the rally stalled at 4.00, fueled possibly by well entrenched faith in the market that this very level constitutes an important resistance. But even opportunistic selling of PLN ahead of (seemingly) important barrier and (possibly) increase in hedging activity of enterprises are not going to stand in front of a more pronounced flow: ECB's EUR 60bn monthly purchases that is going to leak into Poland in one way or the other. This trigger („enabler") in conjunction with specifics of local factors speak in favor of zloty strengthening via many channels.

High real rates. Compared to euro area, Polish real rates (measured simply as deposits) are higher by 3 bps (zero vs 3%). Current stance of Polish MPC almost guarantees that nominal rates are going to stay at current levels whereas inflation is going to journey more or less in sync. At the same time even deposits in euro zone (not mentioning the bonds) are going deep into negative (real or nominal interest) rates, making Poland even more attractive.

The curse of small open economies. Of course the current (high) nominal interest rate level is not cast in stone. Strong PLN generates fairly strong macroeconomic effects, mainly on prices (Poland is a small open economy). So far zloty gained around 7% since the start of the year which – if sustained (and this is in our opinion a minimum scenario) shaves off 0.7% of CPI growth within 6 quarters and 0.2% from GDP growth (according to impulse response functions estimated by NBP's models). This is enough to at least take into consideration a rate cut (by this MPC or the next one). Apart from the fact that 3.80-90 are pain levels for exporters, below which margins or competitiveness vanish quickly, there are also other channels to make thinking about lower rates a tempting scenario. That is why exchange rate is the prime monetary policy variable in small open economies and nominal rates are used to steer it. Czech Republic constitutes an extreme case, where zero rates were not enough to ease monetary policy and exchange rate targeting had to be used. Of course, Poland is larger and less open than its southern neighbor but not enough to stop thinking about „czechisation" of Polish rates and PLN at least.



Something for speculative players too. Stubborn MPC and indigenous market player offer possibilities both for zloty lovers via deposits and bonds. We dealt with the former issue in a paragraph before. The latter is based on a play on the new, likely more dovish MPC. The combination of stubborn current one (flat rates) and more open subsequent one influences forward rates. That is why longer bonds can serve as a proxy for lower upcoming rates in Poland (or later hikes) and stronger zloty as well, for those believing in local currency and entering Polish market unhedged.

Cyclicality – equities. Apart from considerations on rates, zloty reacts to cyclical developments in the economy. On strong consumption and private investment, coupled with government expenditures carried by political business cycle ahead of general elections and general support from infrastructure investment (late 2016), GDP growth is going to exceed 4% in the final quarter of 2015 and still (on average) stay below potential GDP generating no inflationary pressures (strong zloty works in the same direction). Strong cyclical position of the Polish economy is going to support cyclical sectors in equities, somehow underperforming in the last quarters. Equity investments seem to have unambiguous influence on the PLN – in order to buy equities, one needs currency. The flow on equities is going to be connected with stronger PLN.

Insurance against the Fed. Each scenario has its shortcomings and risk. We feel that the major one is the Fed and the moment when zero rates are lifted up. After several years at zero, EMs got used to cheap financing and higher rates are going to be shocking at first stage (regardless of the pace of hikes which we think will be very gradual). We have no doubts that zloty (despite not being a pure EM) is going to be hit. However, the transformation from classic EM to aspiring DM coincided in Poland with C/A balance turning from deficit to surplus. It is a sufficient indemnity that the havoc wreak with Fed hike will be manageable for the zloty and the subsequent differentiating phase will be beneficial for Polish currency.

You may find our updated forecasts for PLN on the second page of the report.

Fixed income

Trapped

Current picture seems bit discouraging.

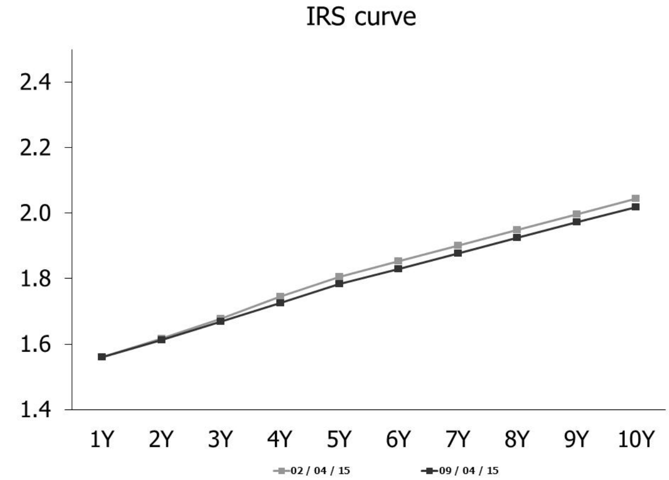
As the MPC set rates at target level, local story became irrelevant. Trading PLN rates by FX level or by deviations in macro data bring hardly any value. Reflecting global developments is not necessary taken by POLGBs either. As a result, we see decreased foreign interest which leaves steer wheels for local ones. Lower turnover lowered volatility, so we are trading close to any shorter moving averages highlighting mid of range for 2,30 for 10Y benchmark.

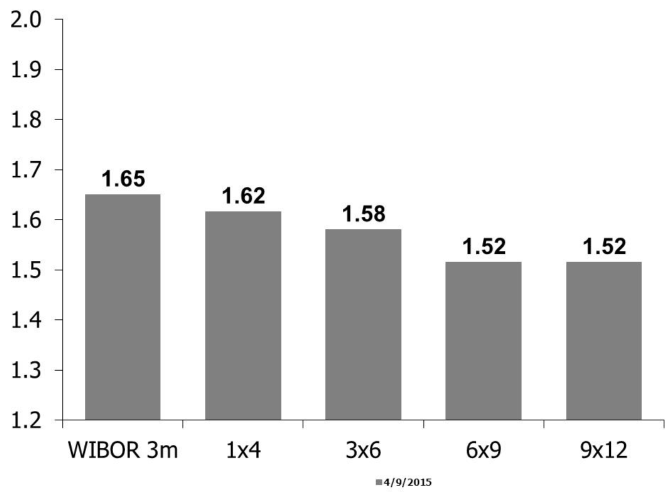
Speaking of steer wheel... seems that moving us away from the central point of foreign interests caused a change of course toward EM markets, leaving „periphery" waters as too difficult to sail without ECB steaming engines. So we all do wonder when the Fed hikes rates (and how high) but trade less violent now.

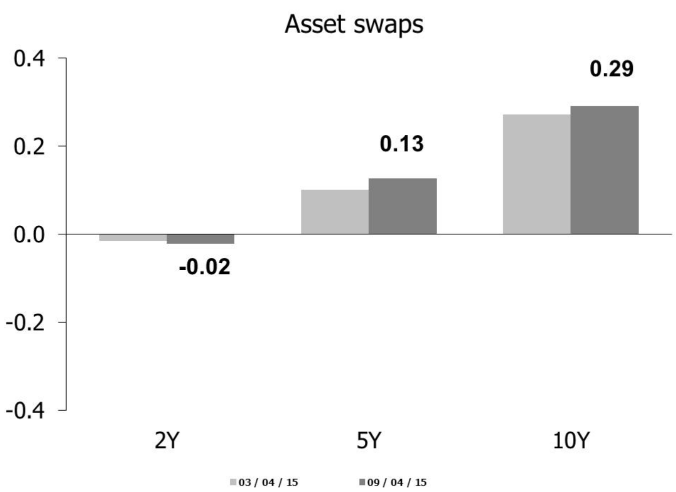
Locally, at last, we had 10Ys bond auction on Thursday. Luckily coincided with some foreign inflow, the auction has been taken as neutral, 3.8 PLN yards of bonds were sold and buyers feel comfortable. Strong FX supports the front end a bit, where volatility is close to zero.

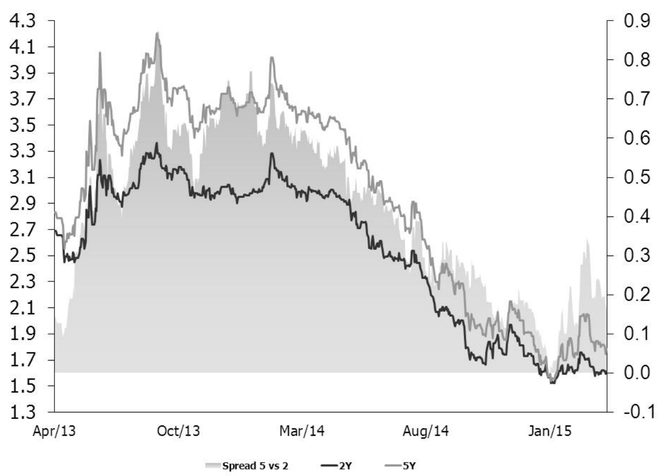
Where the money lays then?

Considering the environment, bonds are likely to form a horizontal trend. And if volatility is sufficient, the 10Y benchmark should trade 2.50-2.20, 5Y 2.10-1.85 and these boundaries we plan to counter.







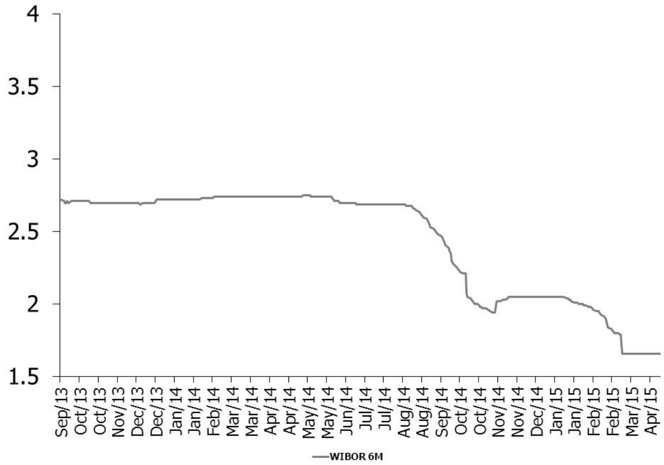


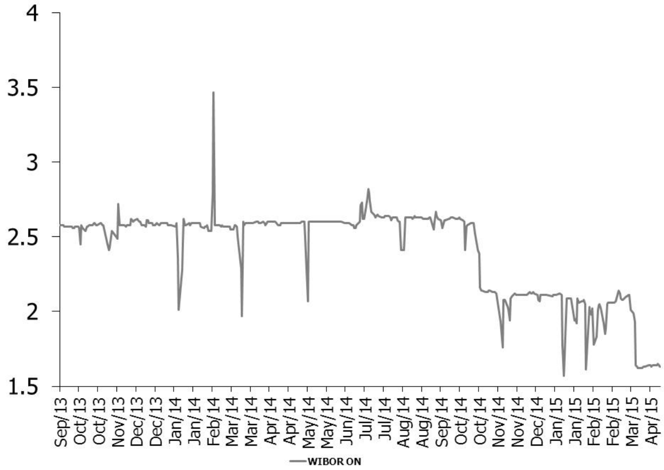
Money market

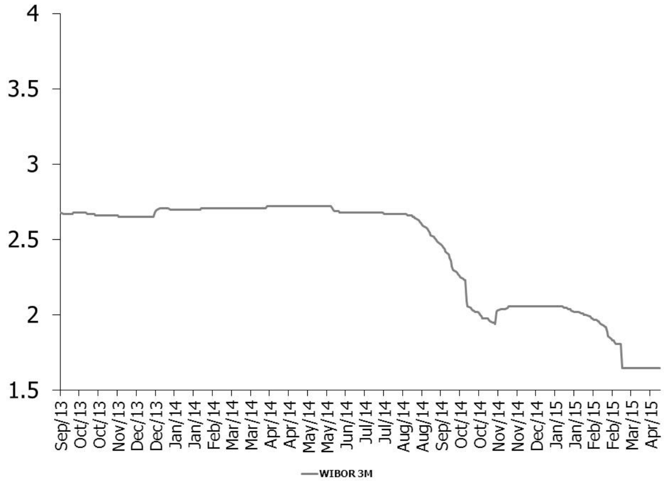
Stable week behind us and ahead of us

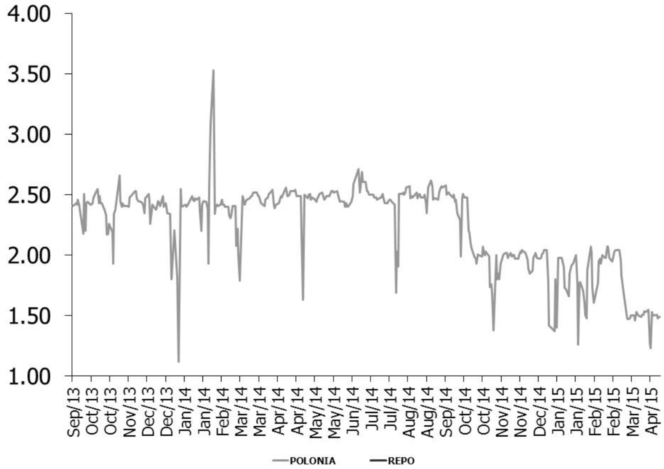
As we expected, last week on the cash market was stable. Polonia fluctuated a bit under the reference rate as last week OMO was underbid. Today's one was underbid as well so market will not change.

Despite the fact that 9x12 FRA was traded under 1.50, OIS curve remained stable discounting a small probability of rate cut before end-2015. Next week we have the MPC meeting and few important data (CPI, Wages) so hopefully market will be more interesting.









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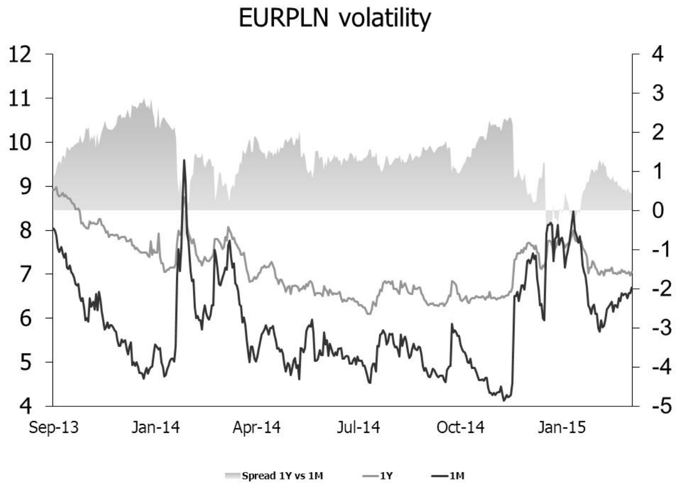
Forex

PLN spikes The long awaited target for EUR/PLN (namely 4.0000) is within reach. YTD low in is 4.0015, just 15 pips shy of this big psychological target. The slide in EUR/USD, is also adding fuel to EUR/PLN move lower. Relatively less tense geopolitical situation in Ukraine, strong RUB, also can be considered, as possible catalyst behind the PLN strength. The decisive break of 4.00 will be the technically a really important signal, opening way to 3.9300 and even 3.85. This may eventually provoke MPC to cut rates again, but this seems to be distant future from now.

Options – higher The relatively strong PLN is no longer enough to melt EUR/PLN vol curve. The historic volatility is providing the support for implied volatility curve, as long Gamma positions are able to finance the Theta bills (for example 3m realized volatility is 7.75% vs implied 6.7%). The current volatility is rising hopes for more, and these hopes could be fulfilled. 1 month EUR/PLN ATM mid is this Friday at 6.6% (0.2% higher), 3 months are 6.7% (0.2% higher) and finally one year is fixing at 7% (the same as week ago). The currency spread (difference between USD/PLN and EUR/PLN vols) dipped by roughly 0.5%. Skew was also better offered.

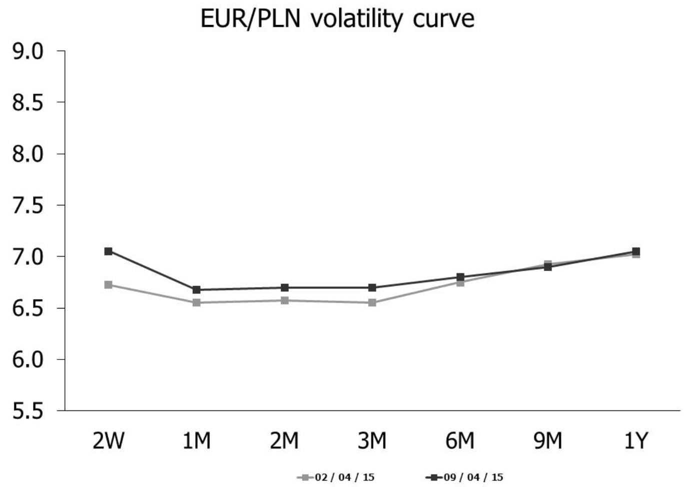


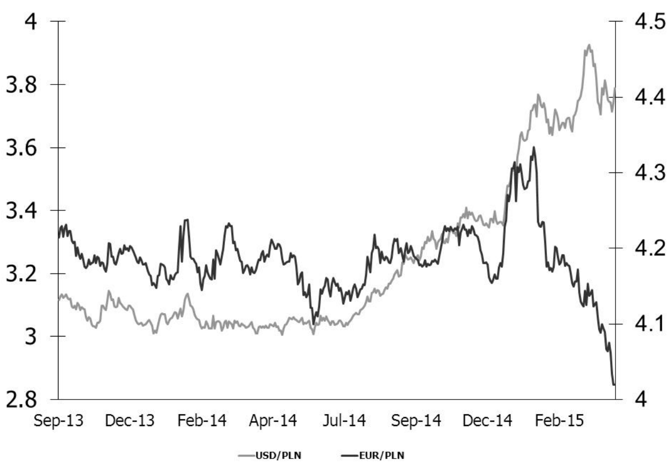
Short-term forecasts

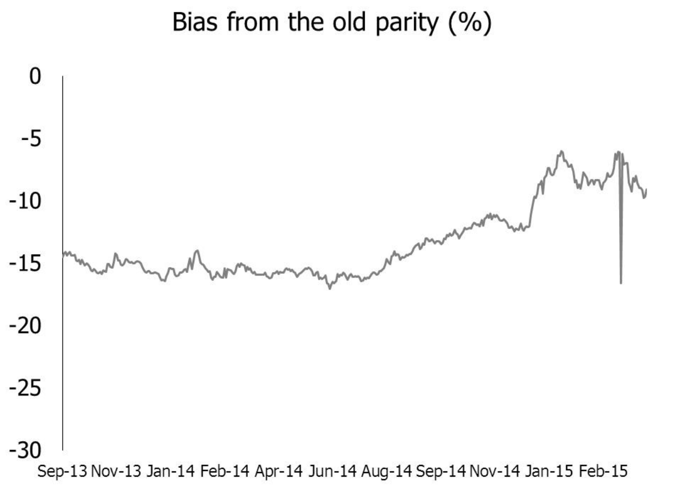
Main supports / resistances:
EUR/PLN: 4.00 / 4.10
USD/PLN: 3.60 / 3.95

Spot We were effectively long EUR/PLN at 4.0395, we have cut this position at 4.0280. We are moving to the sidelines, for the time being.

Options The closer to 4.00 in EUR/PLN the more market gets nervous of possible break out to the downside, or the rebound (which also can be of volatile nature). As the result the Gamma is strongly bid, and the Vols are moving higher, even though it is against the rule of thumb that stronger PLN should translate into lower Vols. We are keeping to our neutral Vega and long Skew position in both EUR/PLN and USD/PLN.







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
4/3/2015	1.68	1.65	1.68	1.56	1.57	1.58	1.63	1.57	1.50	1.50	1.52	1.52
4/6/2015	1.68	1.65	1.68	1.56	1.57	1.58	1.62	1.59	1.52	1.52	1.55	1.53
4/7/2015	1.72	1.65	1.82	1.56	1.99	1.58	1.64	1.60	1.53	1.53	1.57	1.54
4/8/2015	1.61	1.65	1.70	1.56	1.89	1.58	1.63	1.58	1.52	1.51	1.54	1.52
4/9/2015	1.81	1.65	1.90	1.56	2.25	1.58	1.62	1.58	1.52	1.52	1.55	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
4/3/2015	1.580	1.617	1.623	1.609	1.818	1.919	2.042	2.313
4/6/2015	1.580	1.617	1.615	1.609	1.810	1.919	2.042	2.313
4/7/2015	1.580	1.562	1.616	1.610	1.795	1.917	2.030	2.289
4/8/2015	1.580	1.581	1.594	1.599	1.745	1.886	1.975	2.274
4/9/2015	1.580	1.570	1.613	1.593	1.783	1.909	2.019	2.310

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
4/3/2015	6.45	6.45	6.70	7.03	7.03	2.06	0.62
4/6/2015	6.58	6.53	6.73	7.05	7.05	2.06	0.62
4/7/2015	6.56	6.50	6.68	6.98	6.98	2.06	0.62
4/8/2015	6.70	6.68	6.80	7.05	7.05	2.06	0.62
4/9/2015	6.68	6.70	6.80	7.05	7.05	2.01	0.62

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
4/3/2015	4.0748	3.7449	3.9040	3.1295	1.3592	0.1479
4/6/2015	4.0748	3.7449	3.9040	3.1295	1.3592	0.1479
4/7/2015	4.0615	3.7435	3.8872	3.1205	1.3568	0.1480
4/8/2015	4.0340	3.7135	3.8592	3.0987	1.3564	0.1475
4/9/2015	4.0198	3.7414	3.8533	3.1114	1.3520	0.1471

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