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## Polish Weekly Review

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### Comment on the upcoming data and forecasts

Real sphere data move into the spotlight next week. On Tuesday the CSO will release labor market data. We expect a slight slowdown in wage growth (last month's stunner was driven not by mining but by manufacturing, hence it is likely to be a more persistent acceleration) and marginally faster employment growth. On Wednesday industrial output data will be released. As mining output probably normalized and working day count decreased, industrial output decelerated to ca. 5.5% y/y. The accompanying PPI data will likely show that disinflationary pressures remained unchanged (a result of higher PLN-denominated oil prices and lower copper prices with stagnating manufacturing prices). Finally, retail sales data will be overwhelmingly influenced by negative Easter effect - high statistical base will probably drive annual growth down to zero again.

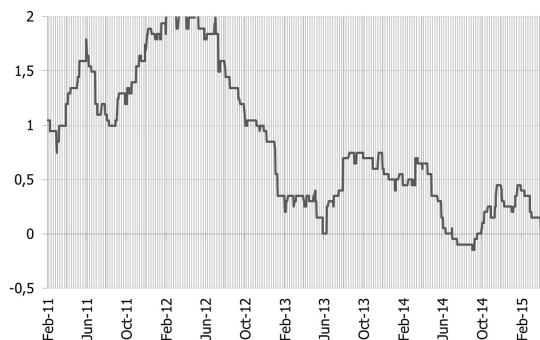
### Polish data to watch: May 18th to May 22th

Publication	Date	Period	mBank	Consensus	Prior
Average gross wage y/y (%)	19.05	Apr	4.3	3.8	4.9
Employment y/y (%)	19.05	Apr	1.2	1.1	1.1
Industrial output y/y (%)	20.05	Apr	5.5	5.9	8.8
PPI y/y (%)	20.05	Apr	-2.4	-2.2	-2.4
Retail sales y/y (%)	20.05	Apr	-0.2	1.0	3.0

### 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	4/23/2015
5Y T-bond PS0720	-	3500	1.987	4/23/2015
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

Positive surprise in inflation data lifts our surprise index for Poland (it is still in consolidation, though). Next week offers a few more opportunities for surprise: wages, industrial output, PPI and retail sales.

\* 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 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. GDP growth accelerates.
- 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.
- Inflation recorded a slight turnaround and we await higher readings in coming months. However, output 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

- Recent sell-off was triggered by reflation bets (surging oil prices) and dependency of Polish bond market on foreign flows (after OFE revamp there is clear asymmetry in reaction to outflows).
- We turn more constructive and aggressive on POLGBs and suggest buying 10y sector as we have strong reasons to disagree with market valuations. 1) Long term real yields in euro peripherals turn positive which bodes not well for stabilization of debt to GDP ratios, 2) Rising oil prices seem to be driven by speculative factors, not a supply side adjustment 3), Bunds valuations are consistent with JGBs, T-notes etc if adjusted for the time that passed since QE start.
- We also question fast rate hikes. We see them unlikely in 2016 as QE-connected inflows, high real interest rates and improving cyclical position of the Polish economy should translate into stronger PLN offsetting a need for rate adjustment.

### mBank forecasts

	2010	2011	2012	2013	2014	2015F
GDP y/y (%)	3.7	4.8	1.8	1.7	3.4	3.8
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 (%)	3.5	3.6	3.3	3.3	3.5	3.7	3.9	4.3
Individual consumption y/y (%)	3.0	3.0	3.2	3.0	2.8	3.1	3.3	3.5
Public Consumption y/y (%)	0.5	6.4	5.3	6.4	5.5	3.0	3.0	2.0
Investment y/y (%)	11.4	8.7	9.2	8.6	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	1.66	1.67	1.67
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	2.50	2.70	2.70
EUR/PLN (eop)	4.17	4.16	4.18	4.29	4.07	4.00	4.00	3.95
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.80	3.77	3.88	3.95
F - forecast								

## Economics

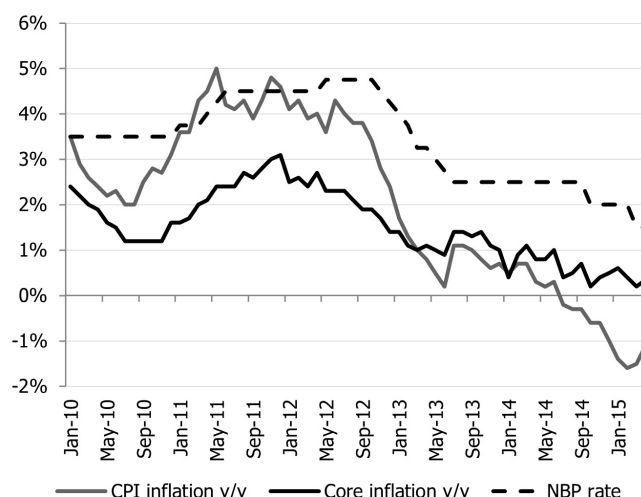
### Acceleration of growth does not have to entail higher inflation

Recent GDP data confirmed the strength of the economy. Decent domestic demand met with strong exports in Q1 and resulted in acceleration of growth. It is only a start of better readings from the real sphere. Growth is set to be stronger, but not strong enough to generate inflationary pressures on the spot. Our scenario is historically unusual but conceptually simple: accelerating GDP growth (3.8% this year) coupled with slow growth of inflation in the following months. Inflation will stay negative at least until autumn (food prices are low/stay under influence of normal seasonality), effects of rise in oil prices should reveal themselves till June but are still very timid at gas stations (as fragile is the current growth in oil prices). We still think that strengthening of the Zloty (caused by cyclical factors) will postpone the return of inflation to its target and vastly neutralize growth of prices driven by wage inflation. This affects the timing and pace of rate hikes. In general, interest rate normalization in Poland is still far away because of Poland's openness and (in our opinion still very likely) disinflationary euro environment. Such a setup should be supportive for Polish debt, especially for bond investors willing to accept currency risks (at this juncture the risk of a less favorable outcome is inferior one). More pronounced price action is at this very moment limited by political risk.

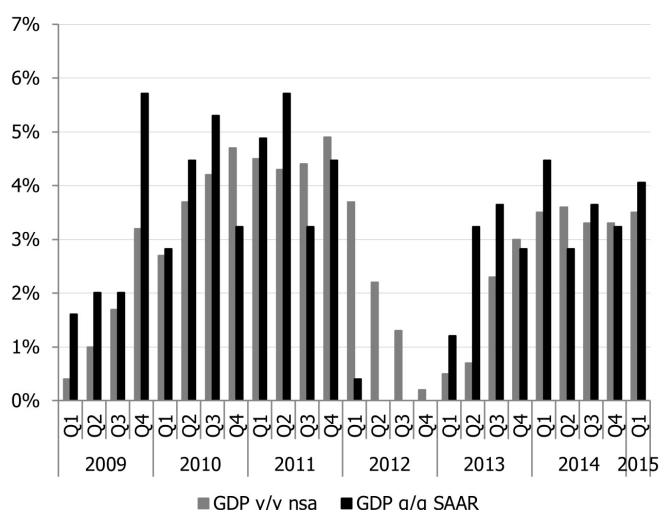
Details of recent publications concerning inflation and GDP are presented below.

Polish **inflation** amounted to -1.1% y/y in April after 1.5% y/y in March. This was slightly higher than expected (-1.2%). However, the pace of return from deflation (reflation) is very sluggish.

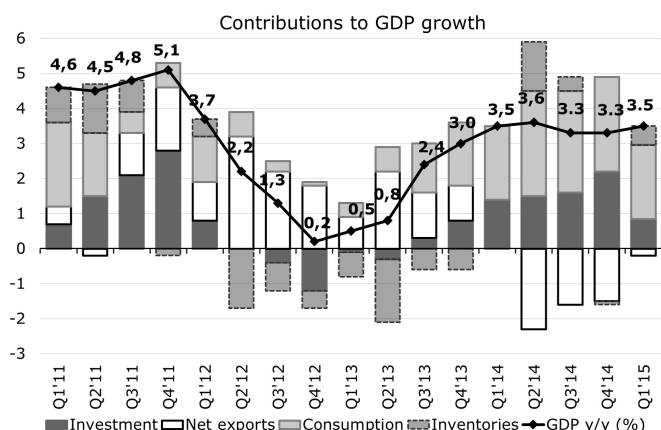
The main reason for this surprise was a higher than expected rise in food prices (0.6% m/m). This spike was driven mainly by seasonal categories (fruits and vegetables), which is in line with regional patterns (e.g. Czech Republic and Hungary). Large gyrations of prices in marketplaces and low base from previous year also were responsible for this rise (still rather noise not trend). However, food prices are still far away from accelerating sharply. This requires regular rises in prices of meat, bread, pasta and dairy products, which we have not seen seeing. A vast majority of core categories showed neutral drift (0-0.2% m/m). Core inflation grew from 0.2% to 0.4% y/y, after the rise in communication category (very noisy one).



Flash **GDP** showed growth of 3.5% y/y. We cannot really exclude that preliminary data published in the end of the month will be a tad higher. Stellar trade data may have not been incorporated in the flash reading since they were known just 2 days ahead of flash GDP publication.



Better Q1 marks only the very beginning of GDP acceleration. Growth is set to exceed 4% in the final quarter of the year and top 3.8% on average in 2015. Even with some flattening in exports trajectory in subsequent quarters (euro zone recorded a head start this year; also the zloty was a little bit weaker in Q1) domestic demand is expected to stay strong, backed by loose fiscal policy ahead of elections. Acceleration of growth should be linked to real appreciation of the currency. Given the price trends in euro zone and Poland, nominal appreciation is also our preferred scenario. In such a way small open economies share their success with the world.



Flash reading does not offer the details of GDP components. However, we expect net exports (higher exports, stable imports) to be the driver of growth; contribution shifts from highly negative to positive in just one quarter (record high trade surplus in trade and services). Not only exports fuels Polish growth. Momentum in domestic demand stays high, although statistical base effects lower the annual figures. This affects mostly investment (which growth rate halves towards 4%) and to a lesser extent consumption, growing still in around 3% pace. We estimate that government consumption stayed high due to specificity of political business cycle.

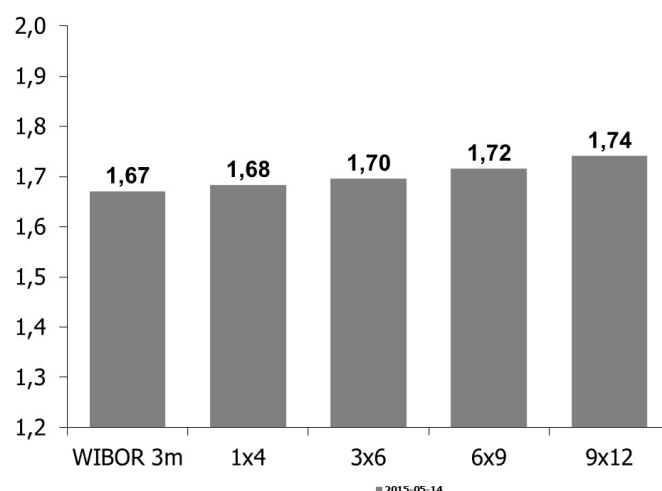
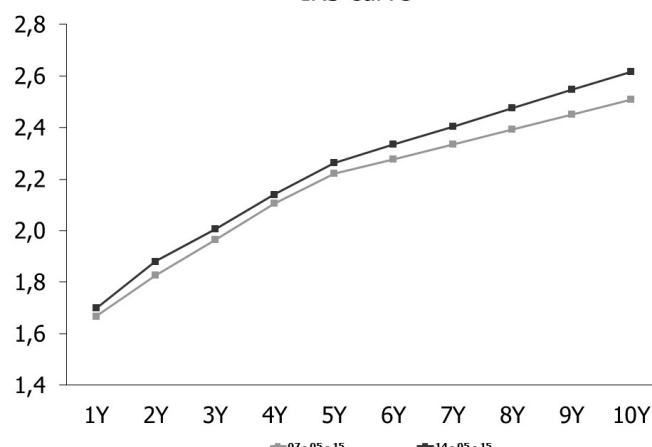
## Fixed income

### Even more volatility

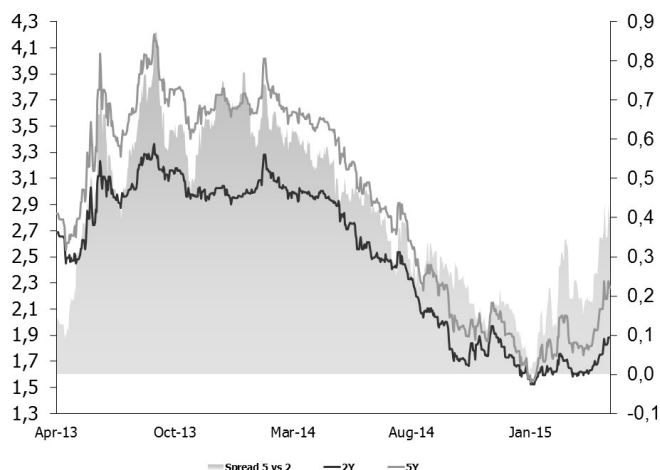
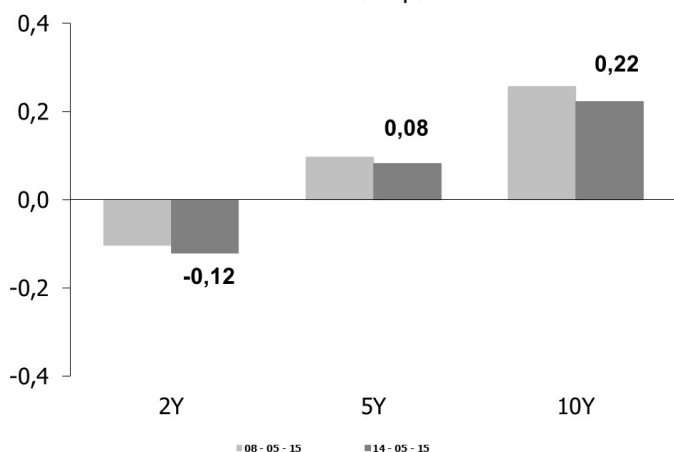
We had another very interesting week in fixed income markets. Volatility on core markets (especially on German bunds) fueled similar behavior on Polgbs. Results of the first round of presidential elections did not help either. DS0725 found some support around 2.90% yield, rallied from there for just a few hours, but after most recent data – higher than expected CPI (-1.1% yoy) and good GDP (3.5% yoy) – the pressure to sell bonds resumed. It seems that economies of CEE countries are developing very well but the question remains if it is going to fuel inflation in the long-term.

Obviously situation in the core markets is going to be crucial next week. Investors are going to speculate on structure of the bond supply (auction on 21st may) and possibly reduce positions before 2nd round of presidential elections. We like 'buy dips' strategy as we feel that buying interest comes from strong, long term investors.

IRS curve



Asset swaps

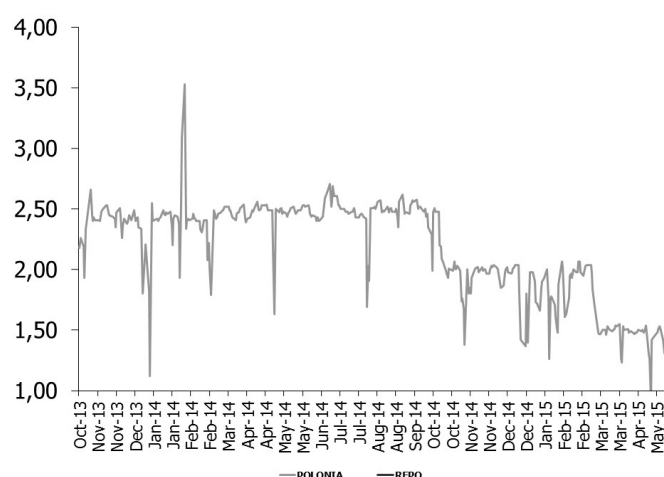
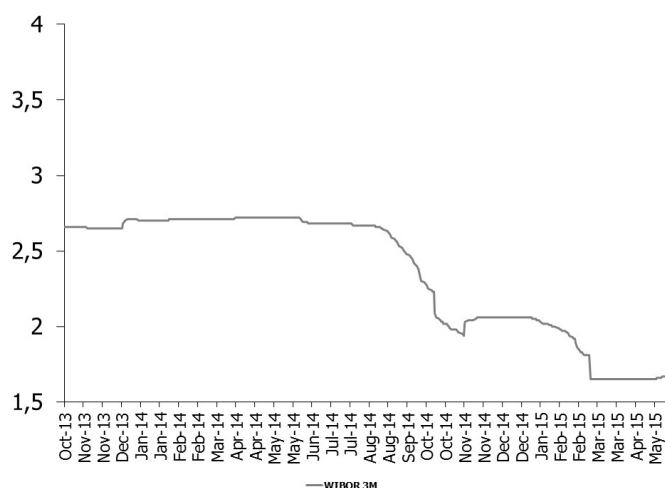
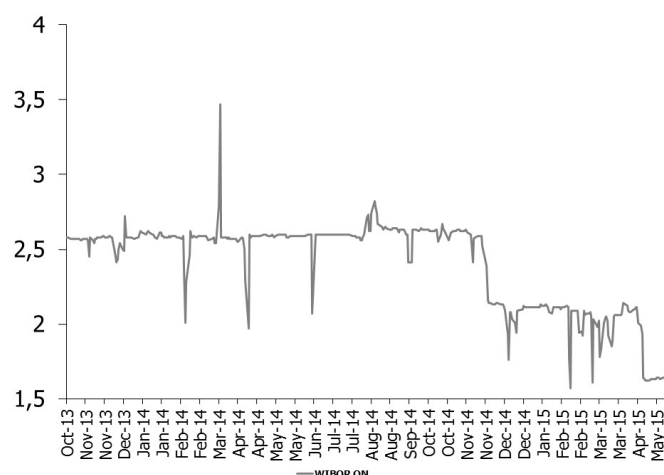
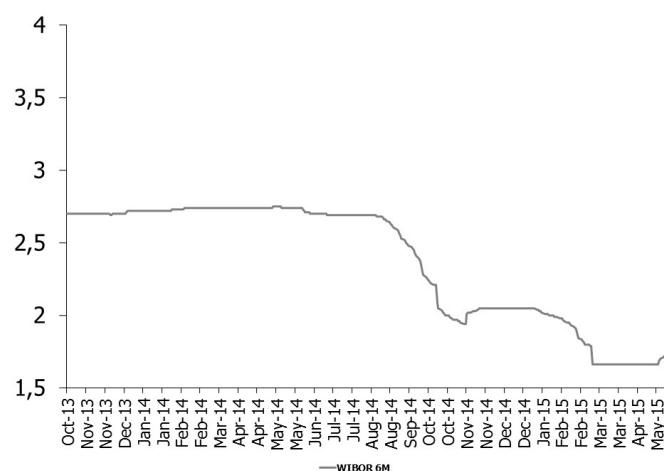


## Money market

### Cheap week behind us

Polonia fluctuated under 1.4 as last OMO was underbid. Today's one was underbid as well, so cash should stay also a bit under reference rate. As WIBORs have risen since last Friday FRAs moved higher. OIS remained unchanged, discounting a 50% probability of rate hike in the end of 2015 and beginning of 2016.

We recommend to sell whole front end of the curve as we don't believe in any potential rate hikes and WIBORs should stop rising. Also our favorite bond OK0116 with 1.60 yield looks very attractive especially when cost of financing is low.



## Forex

**EUR/PLN - volatility is in the driving seat** We have finished last week at 4.0460, have tested 4.11 twice during a week, only to mark 4.0380 low on Friday (on better than expected GDP number). Technically, we are still in a mild uptrend and only a decisive close below 4.0350 will prove otherwise. The bond market is now really the leading one, higher bond yields are a potential threat to the EM world. The sell-off in POLGBs is usually neutral for FX but this time around had serious implications for PLN. We still stick to the rangy nature of EUR/PLN, and still think the current trend to be slightly up.

**Options** The choppy trading continues, 1 month EUR/PLN ATM mid is this Friday at 7.7 (lower by 0.8% than last Friday), 3 months EUR/PLN are also 7.7% (0.5% lower) and finally 1 year is 7.7 (0.3% lower). All with sympathy with stronger PLN, and more resilient bond market. The currency spread (difference between USD/PLN vol and EUR/PLN vol) was sliding further getting as low as 4.0% (use to be 6.5% few weeks ago). The skew was roughly unchanged, spiked with EUR/PLN testing 4.11 and melted as EUR/PLN dropped to 4.05.

## Short-term forecasts

Main supports / resistances:

EUR/PLN: 4.00 / 4.12

USD/PLN: 3.50 / 3.80

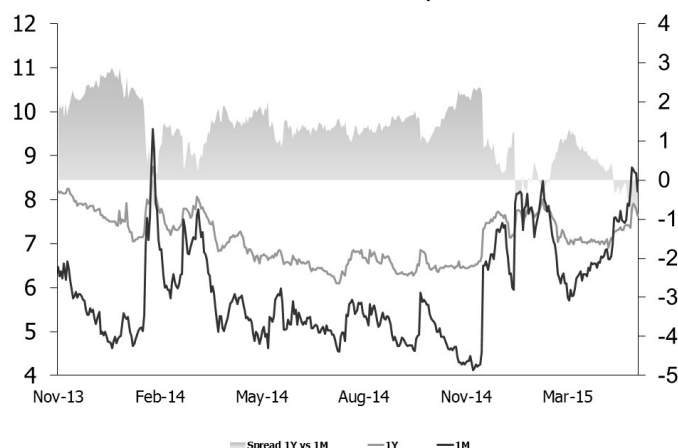
**Spot** Long EUR/PLN – from 4.04 closed with profit at 4.10.

**Position** – we are long again EUR/PLN at 4.0570 and we are ready to add at 4.0370 with a stop below 4.0250 and hopes to revisit 4.10 again. It is purely technical/tactical trade, and even though we admit Polish fundamentals seems sound. Current positioning (still long PLN we believe), creates room for further position liquidation.

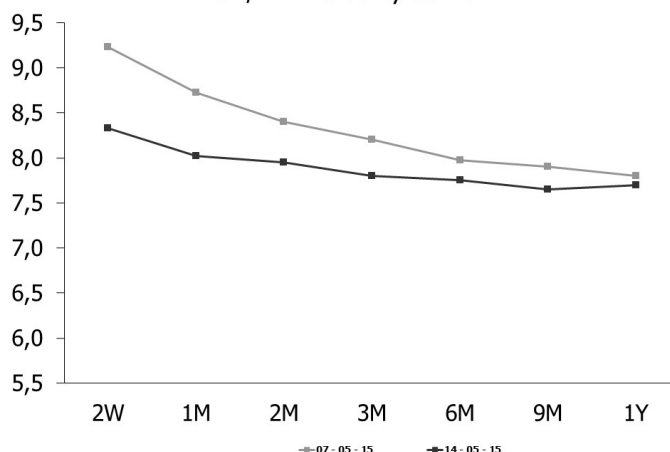
**Options** Being long Vanna (long R/R in both EUR/PLN and USD/PLN) still a core position. We also have preference to be better bid in backend vols in both currency pairs. Especially USD/PLN is getting more attractive as lower currency spread is making outright USD/PLN vol even cheaper. The uptrend in realized volatilities that have started last December, is still supporting the implied volatilities longer term.



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
5/7/2015	1.66	1.66	1.70	1.58	1.61	1.62	1.70	1.69	1.67	1.69	1.79	1.70
5/11/2015	1.76	1.66	1.92	1.61	1.98	1.65	1.68	1.69	1.71	1.73	1.79	1.74
5/12/2015	1.62	1.67	1.80	1.62	2.01	1.66	1.67	1.69	1.71	1.74	1.84	1.75
5/13/2015	1.49	1.67	1.66	1.62	1.86	1.67	1.70	1.71	1.70	1.74	1.82	1.76
5/14/2015	1.56	1.67	1.62	1.63	1.66	1.67	1.68	1.70	1.72	1.74	1.85	1.74

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
5/7/2015	1.620	1.701	1.825	1.730	2.220	2.371	2.507	2.803
5/11/2015	1.650	1.636	1.840	1.736	2.223	2.341	2.523	2.806
5/12/2015	1.660	1.699	1.883	1.769	2.313	2.419	2.668	2.893
5/13/2015	1.670	1.675	1.883	1.783	2.289	2.395	2.639	2.895
5/14/2015	1.670	1.720	1.880	1.760	2.262	2.345	2.617	2.840

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY	
Date	1M	3M	6M	1Y	1M	1Y	1Y	
5/7/2015	8.73	8.20	7.98	7.80	7.80	2.14	0.61	
5/11/2015	8.63	8.08	7.95	7.85	7.85	2.14	0.61	
5/12/2015	8.60	8.08	7.95	7.80	7.80	2.14	0.56	
5/13/2015	8.18	7.85	7.73	7.63	7.63	2.01	0.62	
5/14/2015	8.03	7.80	7.75	7.70	7.70	1.94	0.59	

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
5/7/2015	4.0685	3.5830	3.9285	3.0017	1.3261	0.1484
5/11/2015	4.0767	3.6489	3.9216	3.0438	1.3380	0.1486
5/12/2015	4.1030	3.6447	3.9399	3.0362	1.3359	0.1496
5/13/2015	4.0765	3.6300	3.9126	3.0310	1.3344	0.1488
5/14/2015	4.0945	3.5921	3.9295	3.0121	1.3298	0.1492

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