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Polish Weekly Review

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Comment on the upcoming data and forecasts

The main story for the next week is the presidential election. Beside that we have a rather light week. On Tuesday Central Statistical Office will publish its monthly Statistical Bulletin. However unemployment rate was released by Ministry of Labour and Social Policy earlier. On Friday details for Q1 GDP will be published.

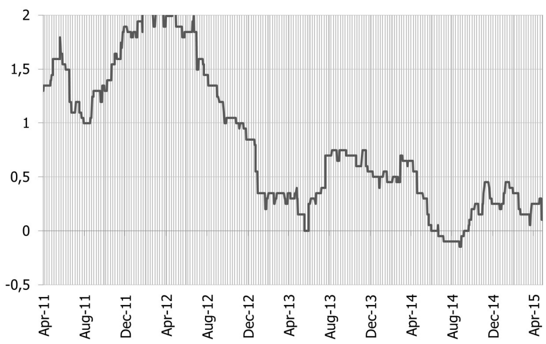
Polish data to watch: May 25th to May 29th

Publication	Date	Period	mBank	Consensus	Prior
GDP yoy (%) preliminary	29.05	Q1	3.5	3.5	3.5

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	5/21/2015
5Y T-bond PS0720	-	3500	1.987	5/21/2015
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

Surprise index fell deep down after real sphere data. Releases of producer prices, industrial output and retail sales were much worse than expected. Data from labour market did not change the index – employment was in line with market consensus and average wages were just slight below it. Next week brings no opportunity to move the index.

* 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 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. 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 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.
- Political risk (presidential election) may locally play a role for Polish assets.
- We also question fast rate hikes. W 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	-0.6
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

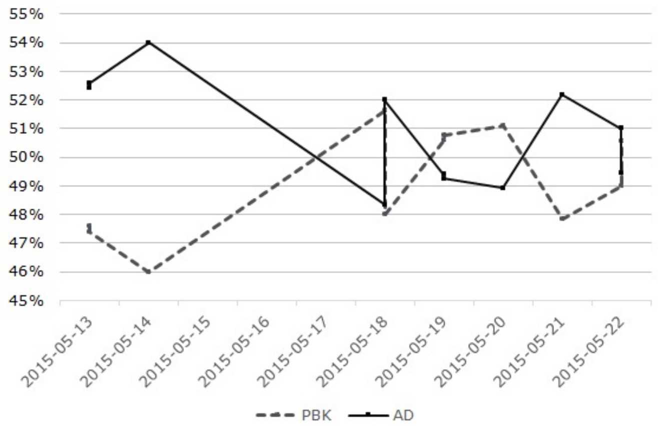
	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1 F	2015 Q2 F	2015 Q3 F	2015 Q4 F
GDP y/y (%)	3.5	3.6	3.3	3.3	3.5	3.7	3.9	4.3
Individual consumption y/y (%)	3.0	3.0	3.2	3.0	2.8	3.1	3.3	3.5
Public Consumption y/y (%)	0.5	6.4	5.3	6.4	5.5	3.0	3.0	2.0
Investment y/y (%)	11.4	8.7	9.2	8.6	6.0	7.5	8.5	10.0
Inflation 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

Polish presidential election. We have no idea who will win. We may well wait for the results till Wednesday.

The outcome of presidential election seems to be a very close call. Contrary to the first round when the support for the incumbent president was rapidly falling, this time around opinion polls display no clear tendency. Support for B. Komorowski and A. Duda oscillates around 50% (among voters who revealed their preferences).



Presidential election results might have significant impact on financial markets, though. Mr Duda's victory could be treated as a forecast of parliamentary elections in the Autumn. Rightly or not, foreign investors could associate Law and Justice's success with developments in Hungary (so called Orban era) and expect a negative impact on the banking sector (this is the main channel for harming markets). The issues of CHF mortgages and "repolonisation" of foreign-owned banks returned during the campaign and it is very likely that this card will be played again. We could also expect a surge in fiscal spending caused by election campaign (higher probability of new, pro-social government in the end of the year in each scenario). Consequently, we may see weaker zloty and a bond and equity market selloff.

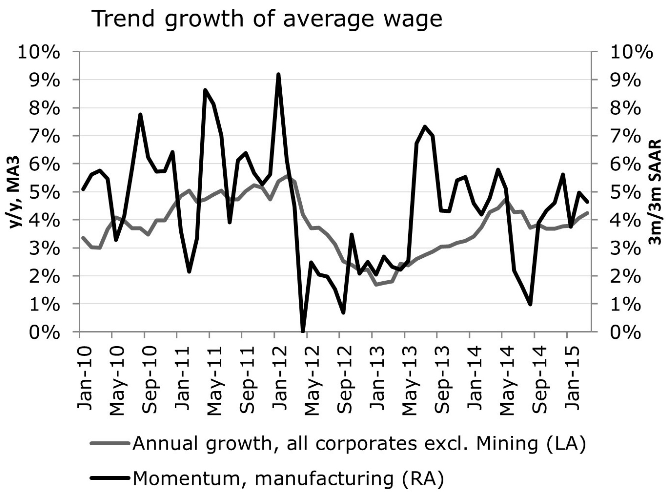
The incumbent's victory may lead to some relief on zloty, stocks and bonds. Where the latter may simply catch up with the developments on core markets. It is very likely that exit polls will show a very narrow lead of one or the other candidate (well within statistical error). Thus, investors will have to wait for confirmation till Wednesday (maybe Tuesday) which may well increase uncertainty and hurt Polish assets.

More disappointments from the real sphere. What is the case for rate hikes, exactly?

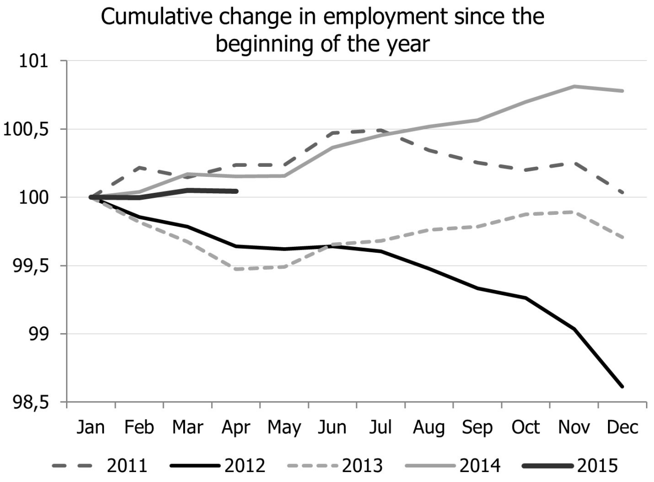
On balance, the large set of April data must be seen as disappointing. Industrial output, wage and retail sales growth all fell significantly, employment failed to accelerate and PPI showed the full impact of PLN appreciation. That construction is shaping up to be this year's star performer among cyclical sectors, is hardly a consolation. While it is true that April data are distorted by the timing of Easter, there is some genuine weakness in the releases, in some cases - a long-lasting one. The bottom line is not that the recovery is in danger but that it is not as strong and dynamic as some commentators often suggest. With sizable output gap and inflation miles away from target, there is no need to think about rate hikes right now.

As usual, below you will find our take on this week's releases.

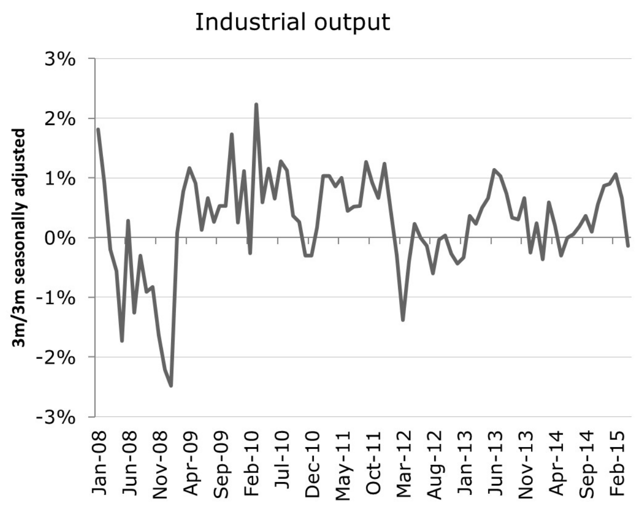
In April average **wage growth** declined from 4.9% to 3/7% y/y, in line with most forecasts. This slowdown is, however, mild and, despite having only the preliminary release, we can hypothesize that slower wage growth is a result of high statistical base in mining (it shaved off ca. 0.3% from the headline), negative working day effect and negative payback after a very strong march. Nevertheless, if short-term swings are discounted, the April growth rate is consistent with underlying trend which we believe lies a tad below 4% y/y. Nominal wage bill slowed down from 6 to 4.8% y/y and even more when adjusted for inflation (from 7.5% to 5.9%) because of a marked rebound in the latter.



Employment in the enterprise sector rose by 1.1 y/y. Compared to previous month, however, employment fell a bit, repeating the pattern from the previous year. As usual, the publication does not offer a breakdown. Nevertheless we feel that it was not manufacturing that contributed to the decline. Having said that it is rather strange that with the economy growing by 3+%, momentum in employment stagnates (see the graph portraying the change from the beginning of the year). Statistics on employment from the different survey (on unemployment rate) tell a different story. Reasons can be various, but at least some of them look compelling. First of all, due to scarcity of labor supply, higher volatility of production, firms fetched for other forms of employment - elastic ones - far different than a payroll and temporary. This conforms well with unemployment statistics. Moreover, various surveys suggest that firms invest a lot to increase labor productivity (mind the high investment rate in 2014); such a change is not going to be stimulating labor demand in the mid-term. More scarce and dearer labor force is unlikely to be expanded quickly.

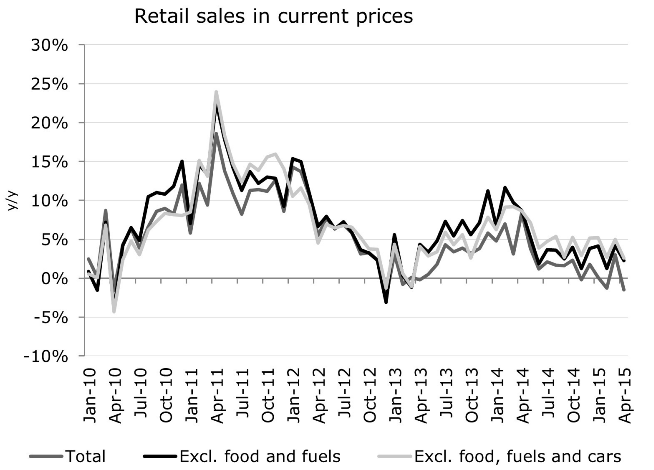


Industrial output rose by a moderate 2.3% yoy in April as compared with roaring 8.8% yoy recorded in March. Reading was significantly worse than expected by analysts (5.5%). In SA terms industrial output expanded by 2.7% yoy, i.e. below 4-5% pace seen over the last few months (mom momentum actually contracted).

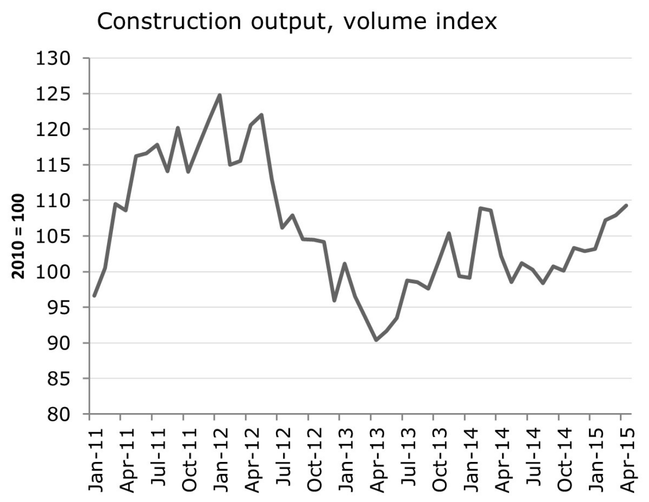


Surprisingly weak industrial output data may be to some extent explained by contraction in mining (March data were boosted by longer working week resulted from February strikes), but manufacturing tumbled in April as well. 26 out of 34 industry section recorded annual growth rates in April. Expansion was seen mostly in export-oriented sections. Chemical industry and energy sector contracted, which partially correlates with weaker mining. Another culprit is the timing of Easter which depressed food and beverage output. All of the above do not explain the entirety of April's weakness. Regardless of see them as normal volatility (we saw 7 consecutive months of expansion in manufacturing) and to a lesser extent as a proof for weakening international environment (expect weaker euro area in Q2).

Retail sales dropped by 1.5% in nominal terms in April as compared to a 3% rise in March. April data were much worse than expected even though we were the only ones to forecast an annual drop in retail sales. Lower food and fuel sales weighed on weak April number. The former may, however, be explained by Eastern effect. Core measures of retail sales expanded by a moderate 2.5% as compared with 4%-plus expansion last month. We stick to our view of only moderate consumption growth in this cycle which contrast with historical patterns for the Polish economy. We continuously see changes in households behavior and higher propensity to save.



Construction output grew by 8.5% y/y in April, in line with our forecasts and slightly below market consensus. After seasonal adjustments, growth amounted to 7.4% y/y and 1.3% m/m. Apart from strong momentum (output index is at multi-year highs) the acceleration stems from a strong base effect (previous April was disastrous: -5.9% m/m). The same base effects should lift construction output growth towards 15-20% y/y in the summer. The more so since new infrastructural projects are scheduled to be launched at the turn of Q2 and Q3.



Fixed income

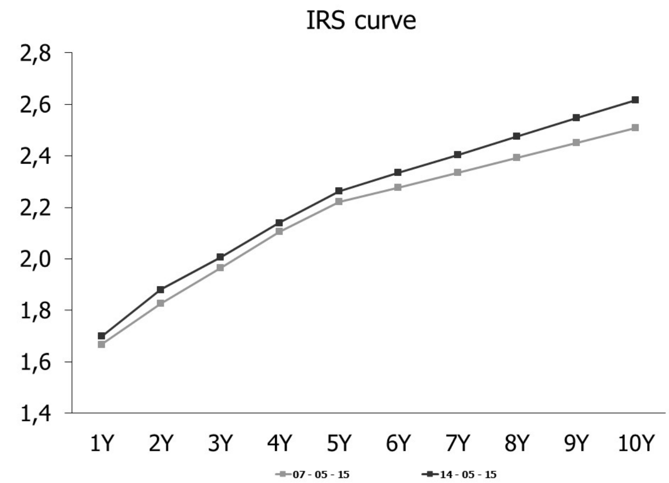
Presidential elections

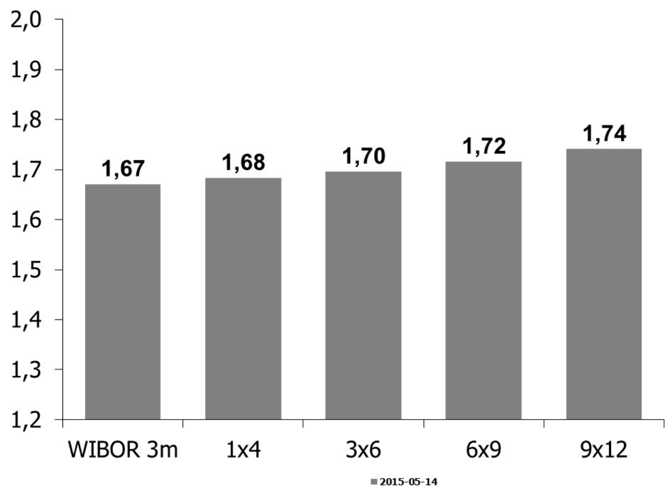
After several weeks of higher volatility, Polish fixed income market become much calmer; DS0725 was trading in 2,74-2,83 range. We had some domestic data (gross wages 3,7% yoy vs 3,9% forecast; industrial output 2,3% vs. 5,5%, PPI -2,6% vs. -2,2% and retail sales -1,5% vs. 1,0%) - majority of them surprised on the downsides, but impact on market was quite shallow. This week Ministry of Finance returns to bond sales (previous auction was cancelled due to global sell-off and high market volatility) – MoF sold 4,06 bio of bonds (2,96 bio in PS0420 and 1,09 bio in OK0717).

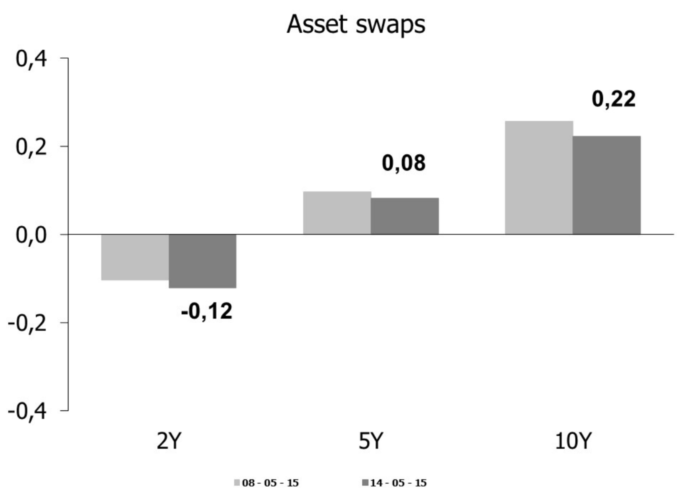
On the one hand we have uneven economic data from US which support core markets on the other political risk is rising. Federal Reserve is going to rise rates later this year, however June lift-off is almost ruled out and currently December is most probable.

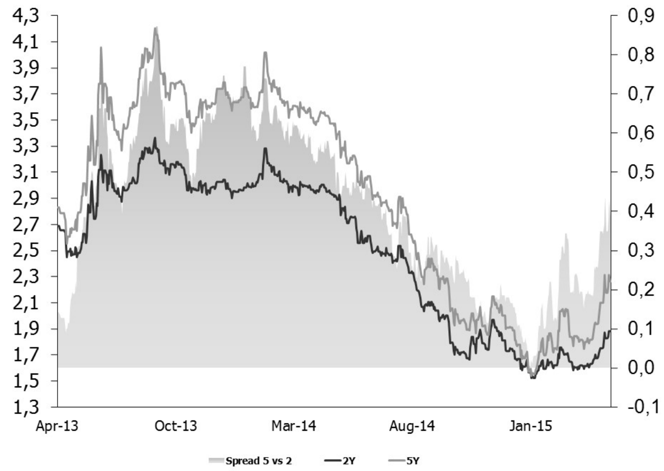
It is worth notice that Civic Platform has been governing since 2007 and no political risk has been traded during last 8 years. It's hard to avoid the conclusion that political turmoil before parliamentary election in September is to materialize.

We are constructive on POLGB's from the fundamental point of view but uncertainty related to second round of presidential election has pushed us to stay away for moment.









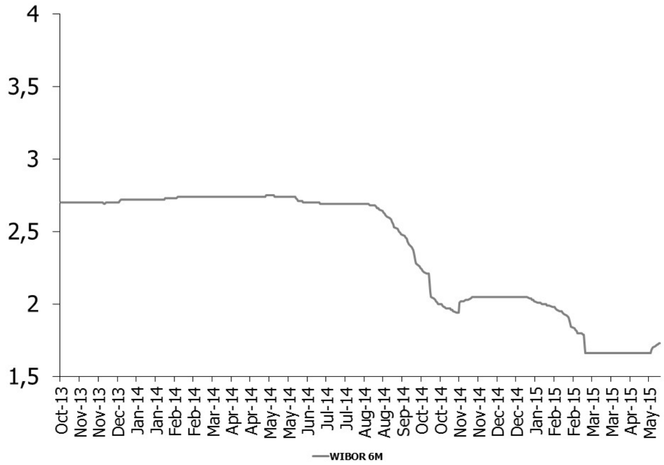
Money market

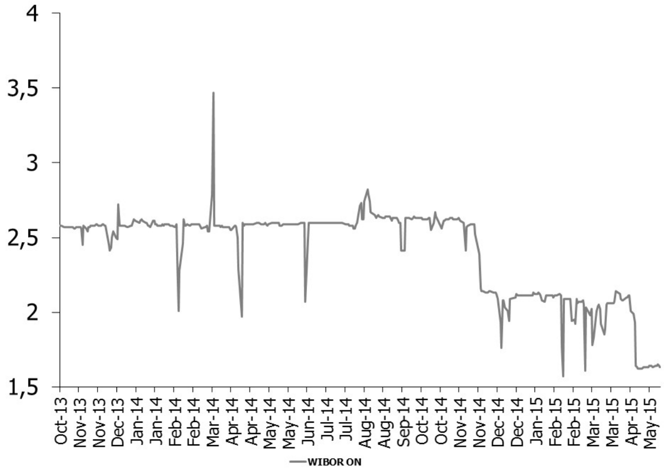
Cheap week behind us

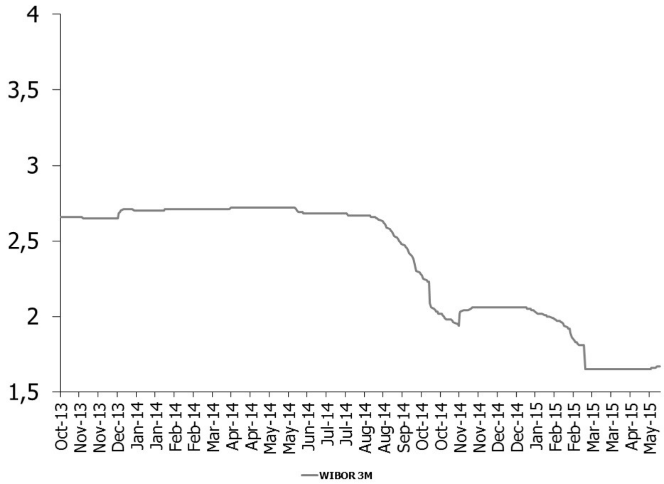
As last OMO was underbid, cash rate fall under 1.40. Today's one was underbid as well so rates should stay under 1.50 until next Friday.

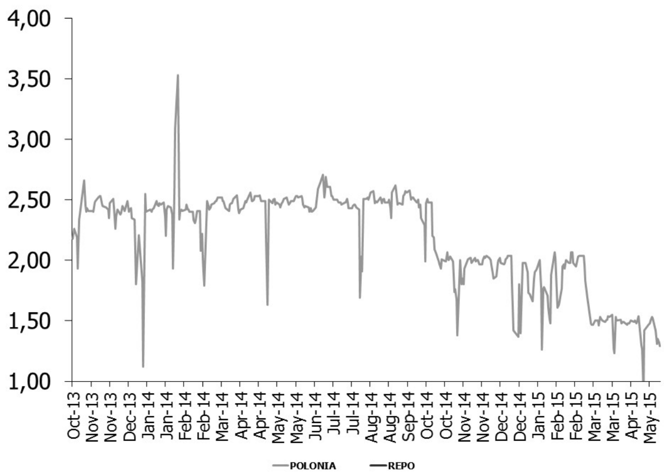
Rates moved back this week. 9x12FRA fall to 1.71, 1Y OIS is now 1.45/1.50 so looks like we stopped discounting rate hikes in the end of 2015. Our recommendation from last week to receive whole front end seems to be good. As FRAs are now near WIBOR's maybe it is a time to buy them and sell OIS with 20 bps spread (9x12 and 1y OIS).

On Sunday we have election and we recommend to have square position as probability is 50/50.









Forex

EUR/PLN – volatility continues Choppy price action still dominates on the market. EUR/PLN has hold is major support at 4.0300 (4.0375 low) and we are revisiting now the upper band of the range 4.10/4.12 (4.1080 high so far). The election fears are dominating the market, with both candidates running neck to neck. Duda's win will of course be negative for the markets, however such possibility, for sure was already partially discounted by bonds and PLN. Nevertheless, we think that the potential sell off would be limited. The global factors are leading ones, the Polish political factor for EUR/PLN is not that significant (unless something extreme happens). Autumn's parliamentary elections will have (and require) much more attention from the markets. For now we still believe in the rangy nature of EUR/PLN, and we see 4.02/4.12 range as still prevailing.

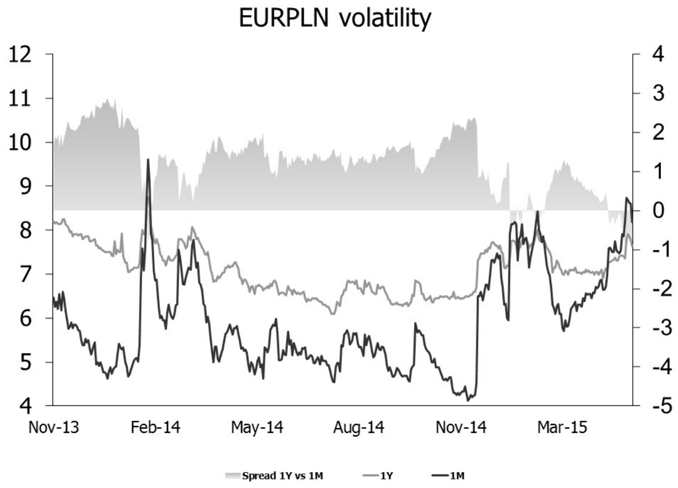
Options – high demand for Gamma 1 month EUR/PLN ATM mid is this Friday 8.4% (0.7% higher than last week), 3 month are 8.1% (0.3% higher) and finally 1 year is 7.85% (0.15% up). Weaker Zloty and presidential elections are to blame for this rise in Vols. The market was really hunting for gamma, with 2/3 weeks (post ECB dates) being the favorite options. The currency spread (difference between USD/PLN and EUR/PLN) has jumped back roughly 0.75%. The skew was roughly unchanged.

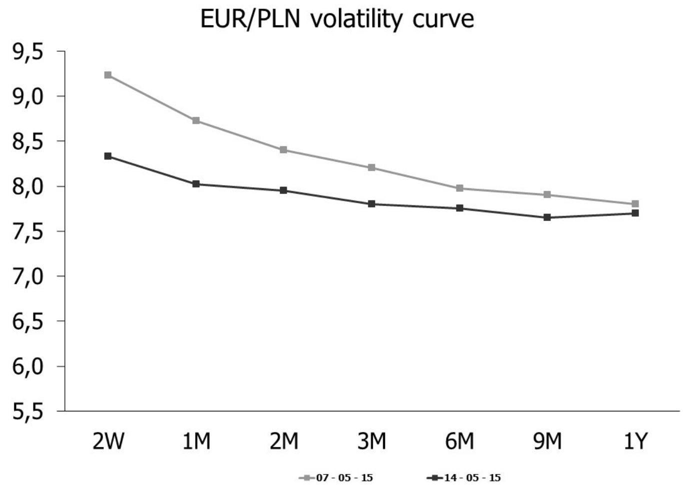
Short-term forecasts

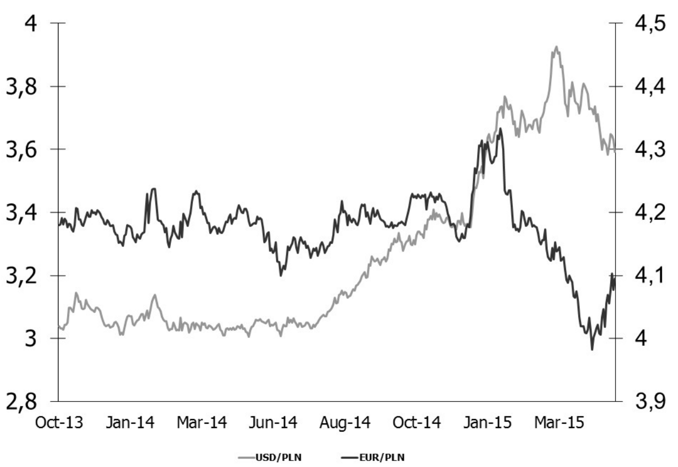
Main supports / resistances:
EUR/PLN: 4.00 / 4.12
USD/PLN: 3.50 / 3.75

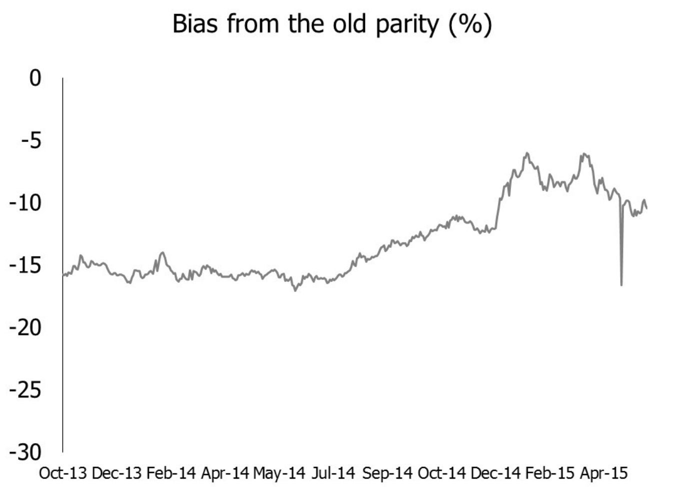
Spot Longs from 4.0570 closed with profit at 4.1030.
Position. Short EUR/PLN at 4.1030.

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.









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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
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
5/18/2015	1.58	1.67	1.73	1.63	1.96	1.68	1.68	1.70	1.72	1.74	1.82	1.78
5/19/2015	1.71	1.68	1.87	1.64	1.96	1.68	1.69	1.70	1.70	1.72	1.79	1.76
5/20/2015	1.48	1.68	1.64	1.64	1.87	1.69	1.71	1.71	1.71	1.72	1.76	1.77
5/21/2015	1.58	1.68	1.74	1.64	1.96	1.69	1.68	1.69	1.69	1.70	1.75	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
5/14/2015	1.670	1.720	1.880	1.760	2.262	2.345	2.617	2.840
5/18/2015	1.680	1.642	1.870	1.781	2.279	2.388	2.649	2.865
5/19/2015	1.680	1.686	1.843	1.772	2.225	2.373	2.600	2.828
5/20/2015	1.690	1.629	1.821	1.756	2.205	2.369	2.577	2.815
5/21/2015	1.690	1.658	1.810	1.766	2.195	2.420	2.550	2.816

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
5/14/2015	8.03	7.80	7.75	7.70	7.70	1.94	0.62
5/18/2015	7.80	7.50	7.48	7.48	7.48	1.94	0.62
5/19/2015	8.20	7.85	7.75	7.70	7.70	1.85	0.56
5/20/2015	8.23	7.90	7.80	7.73	7.73	1.93	0.59
5/21/2015	8.50	8.10	8.03	7.93	7.93	1.94	0.59

PLN Spot performance

Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
5/14/2015	4.0945	3.5921	3.9295	3.0121	1.3298	0.1492
5/18/2015	4.0468	3.5550	3.8642	2.9693	1.3221	0.1479
5/19/2015	4.0465	3.6152	3.8787	3.0124	1.3220	0.1479
5/20/2015	4.0606	3.6538	3.8977	3.0234	1.3230	0.1484
5/21/2015	4.0836	3.6605	3.9260	3.0286	1.3322	0.1495

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