



May 29, 2015

Polish Weekly Review

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Table of contents

Our view in a nutshell

Economics

- GDP revised upwards. Very strong investment growth.
- Political risk is back for good

Fixed income

- Sum of all fears

Money market

- More expensive week ahead of us

FX market

- EUR/PLN – political turmoil
- Options – vols higher

page 2

page 3

page 4

page 5

page 6

Comment on the upcoming data and forecasts

The upcoming week starts with May's PMI release. We expect a slight fall in line with declines in German data and CSO business survey (deterioration in assessment of orders, production and employment). On Wednesday MPC will decide about interest rates. Taking into account: end of Zloty's strengthening, very good data from real sphere and weakening of deflationary tendencies; rates will remain unchanged and the conference after the meeting will be optimistic in tone.

Polish data to watch: June 1st to June 5th

Publication	Date	Period	mBank	Consensus	Prior
Manufacturing PMI (pts)	01.06	May	53.4	53.5	54.0
MPC decision (%)	03.06	Jun	1.50	1.50	1.50

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	6/11/2015	1500	1.667	5/21/2015
5Y T-bond PS0720	-	3500	1.987	5/21/2015
10Y T-bond DS0725	6/11/2015	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 surprises from GDP and unemployment data erase most of the previous week's losses. Next week brings only one release - the PMI.

* 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 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 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

- Political risk affects Polish assets. Result of presidential elections is seen as a proxy for general elections' result. Investors see more scope for an increased populism and granulation of parties within the newly elected parliament (foreigners see parallels to discontent movements in Spain and Greece).
- We thus turn defensive on POLGBs. Valuations seem to be quite attractive (especially vs. HGBs). Rally in peripheral euro bonds may well lead to lower rates in POLGBs.
- Zloty should mimic POLGBs dynamics but overall prospects for the currency remain positive (high real rates, monotonic economic recovery).

mBank forecasts

	2010	2011	2012	2013	2014	2015F
GDP y/y (%)	3.7	4.8	1.8	1.7	3.4	3.9
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	2014	2014	2014	2015	2015	2015	2015
	Q1	Q2	Q3	Q4	Q1 F	Q2 F	Q3 F	Q4 F
GDP y/y (%)	3.5	3.6	3.3	3.3	3.6	3.8	4.1	4.3
Individual consumption y/y (%)	3.0	3.0	3.2	3.0	3.1	3.1	3.3	3.5
Public Consumption y/y (%)	0.5	6.4	5.3	6.4	3.3	4.0	4.0	2.0
Investment y/y (%)	11.4	8.7	9.2	8.6	11.4	10.0	10.0	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	1.70	1.70	1.70
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.52	2.31	2.60	2.80	2.90
EUR/PLN (eop)	4.17	4.16	4.18	4.29	4.07	4.10	4.05	4.00
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.80	3.87	3.93	3.95

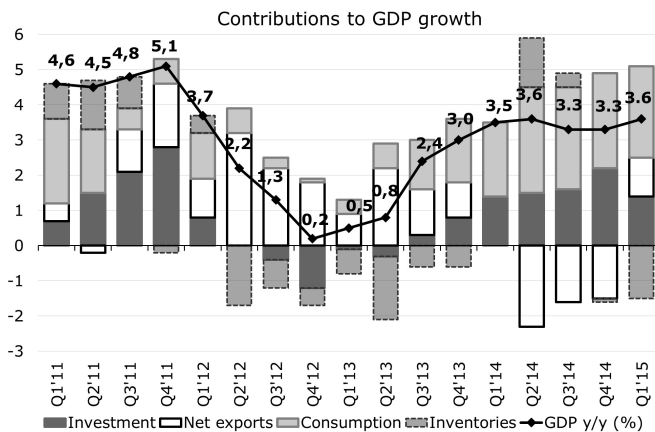
F - forecast

Economics

GDP revised upwards. Very strong investment growth.

According to the latest GUS data, Polish economy grew by 3.6% y/y in the first quarter, which is slightly faster than the flash estimate of 3.5% y/y. Upside revisions of flash releases have become somewhat of a tradition, but it is the structure of growth that carries a positive surprise.

Household consumption grew by 3.1% y/y, slightly above our expectations and in line with recent trend. Investment was, again, the biggest surprise of the release, having grown by 11.4% y/y (forecasts indicated a smaller or bigger slowdown - we were in the latter camp). Because of a monstrous statistical base in construction spending, such a result is somewhat surprising. Previous quarters have taught us that GDP-based investment data can massively diverge from their monthly correlates. We believe that the spike in investment can be attributed to stronger spending on machinery and equipment (incidentally, this category is the hardest to estimate based on imports or industrial output). Domestic demand grew by a meagre 2.6% y/y which is a result of a massive drop in inventories which shaved off 1.5 percentage points from the headline. This is highly unusual as inventories are supposed to grow in this phase of the business cycle. It seems that final demand was partly met by a drawdown in inventories. Historically speaking, such unexpected drops will be corrected in the next quarters and inventories will return to a more appropriate level in the second quarter. GDP growth is completed by a large positive contribution from net exports - this is not a surprise and subsequent monthly releases are suggesting that the trade surplus will decline very slowly.

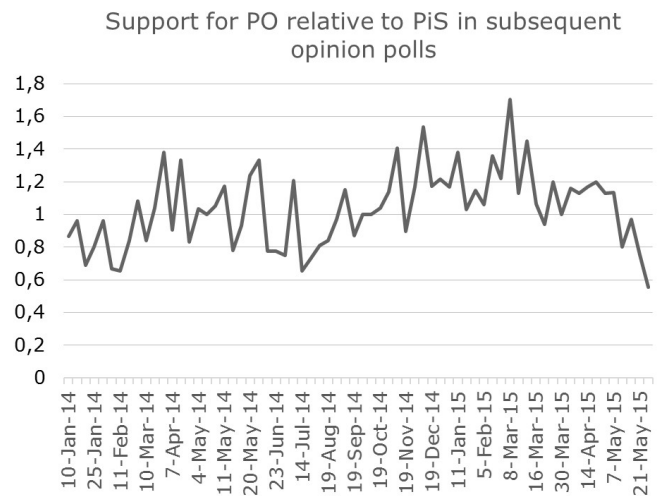


A strong first quarter sets the tone for the whole year. We expect growth to accelerate in the coming quarters, owing to strong private investment, loose fiscal policy (public investment and consumption, the latter freed from the EDP's stranglehold). Consumption growth should remain steady and limited by the drag in real incomes from rising inflation. No impact on FX market from the data but bonds sold off a bit on the news. GDP is surprising to the upside almost all the time and subsequent revisions are also positive. Does this mean that monetary tightening will arrive earlier than expected? In our opinion, no. The key feature of this recovery is that its structure is not pro-inflationary. Instead of consumption growth, which acceleration would eventually lead to inflationary pressures and external imbalances, much more weight is put on investment. The latter, by increasing potential

GDP and output gap, should delay CPI's return to target and allow the economy to shift into a higher gear without an increase in inflation. If we add procedural (a completely new MPC) and political issues as well as the European context, it is easy to see why rate hikes are bound to arrive in 2017 (at earliest).

Political risk is back for good

Final results of presidential elections confirm the defeat of incumbent president, Mr Komorowski (51.5 : 48.5). Mr Duda's victory sharply raises the probability that Law and Justice (PiS) will emerge victorious in parliamentary elections (to be held in Autumn). The balance between the two main parties has shifted towards PiS significantly (see the graph below). But the true source of political risk stems not from the prospect of PiS' victory but from the emergence of a new party, led by Mr Kukiz. Its program is largely unknown at this point but it is widely believed that it would have populist elements and be similar to „protest parties” in the euro area (which doesn't mean that it would act that way - pre-election promises must be always be taken with a grain of salt). Despite all the unknowns, latest opinion polls already suggest that the new party might even outpace the ruling Civic Platform (PO). The political scene in Poland is thus set to be significantly changed. Granulation of parties and higher polarization of programs is what we can expect in Autumn. This way Polish political picture drifts towards truly peripheral one in e. g. Spain and Italy.



Fixed income

Sum of all fears

A 15bps higher on 10Y benchmark – that is where we priced (so far) political risk – DS0725 was sold from 2.81 to 2.96.

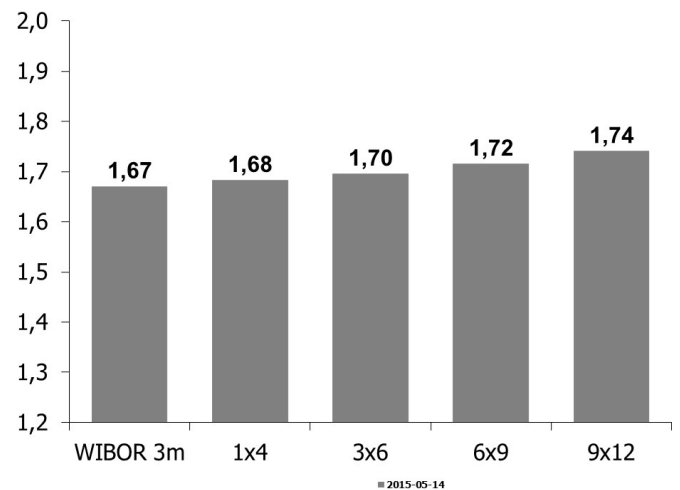
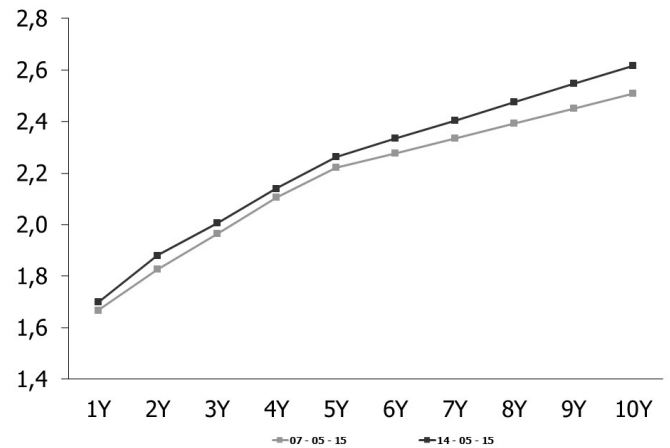
Output of elections is widely discussed, so, in short words - market has to deal now with higher possibility of greater spending of current government and, most of all, with greater chance of replacing ruling coalition for a populist/social one. As a result, from nice, monetary policy related play, we came to something closer to gambling with pretty random scenarios.

Using gamblers vocabulary...

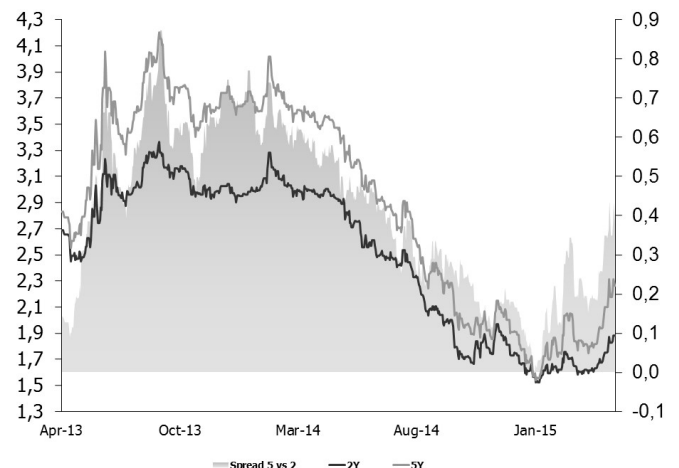
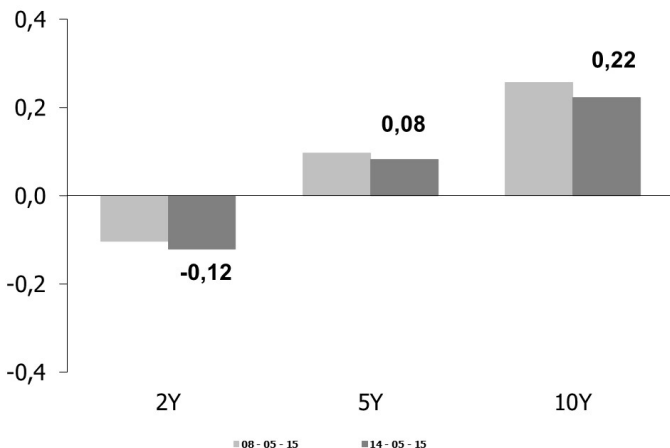
So far we played being in Flop: Accelerating EU economy (though the card seems a bit ripped), slowing down (temporary?) US economy, credit risk related to Greece solvency, and now, unexpectedly (?), political risk card has been played in Turn. Already before River we see players saying pass on POLGBs. Action seems justified, all cards besides US brings potentially more risk on the downside (prices) and we do expect to come nothing but the blot in River (local monetary policy?). Greece story lasts, so EU acceleration story does, local political risk won't solve before November though improving economy may work for current government.

We still prefer to stay away then with buying dips with short Profit taking as our second choice scenario.

IRS curve



Asset swaps

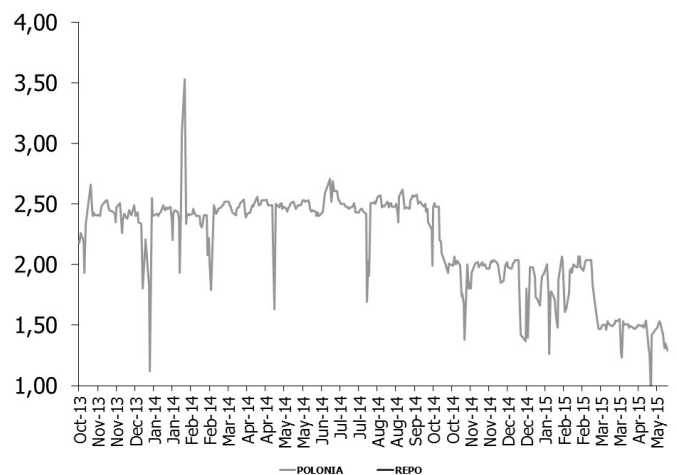
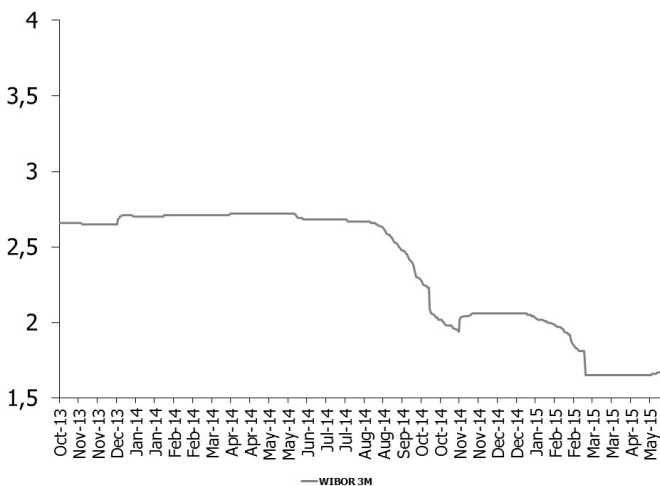
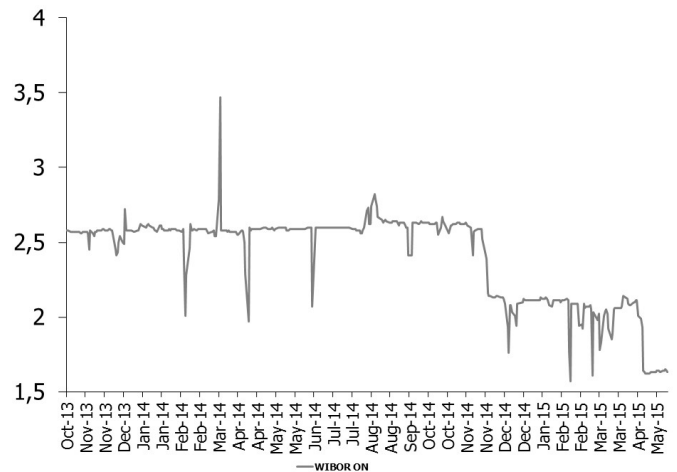
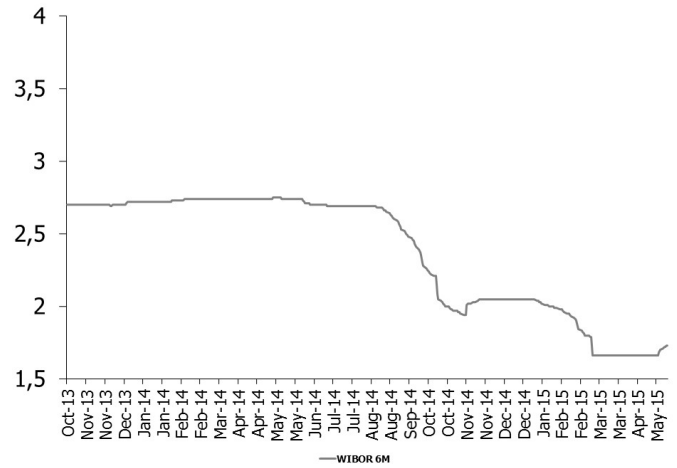


Money market

More expensive week ahead of us

As last OMO was underbid cash was a bit cheaper. Polonia fluctuated under 1.40 for the whole week. Next week shouldn't be so cheap as it's a beginning of new reserve. End of new reserve is on Monday 29th so we recommend to sell 1M OIS.

After last Sunday elections longer end fall by 15bps, front end remained same. 6x9 FRA is 1,72, 1Y OIS is 1,49. We see some risk associated with next elections so we recommend to buy longer FRA's (above 6x9) at the level where WIBOR is (small possibility for rate cuts). To reduce risk sell OIS or buy OK0116 or PS0416 (second one is even better as it is offered with 1.62 yield).



Forex

EUR/PLN – political turmoil Freshly elected President Andrzej Duda had a strong impact on the Zloty. On Monday the reaction was muted because of holiday in London and New York. On Tuesday we have observed a dramatic PLN sell-off, which took EUR/PLN from 4.10 to 4.1550, the high of the week. Now the price action is consolidating that huge move. We think that political risk is already discounted in the current price level and we now should again focus on the global factors. The next week's ECB meeting plus NFP on Friday will be in the spotlight. We see 4.07-4.17 as the most likely range for EUR/PLN in the short term.

Options – vols higher The weaker PLN, political news and Greece, all these reasons have been responsible for EUR/PLN and USD/PLN vols increasing significantly. The sellers have taken the upper hand at the end of the week and we are fixing slightly below last week's levels. On a weekly basis EUR/PLN 1 month ATM is 7.9% (0.3% lower) this Friday, 3 months 7.9% (0.2% lower) and finally 1 year is 7.9% (up 0.05%). The skew was healthy bid.



Short-term forecasts

Main supports / resistances:

EUR/PLN: 4.07 / 4.17

USD/PLN: 3.65 / 3.85

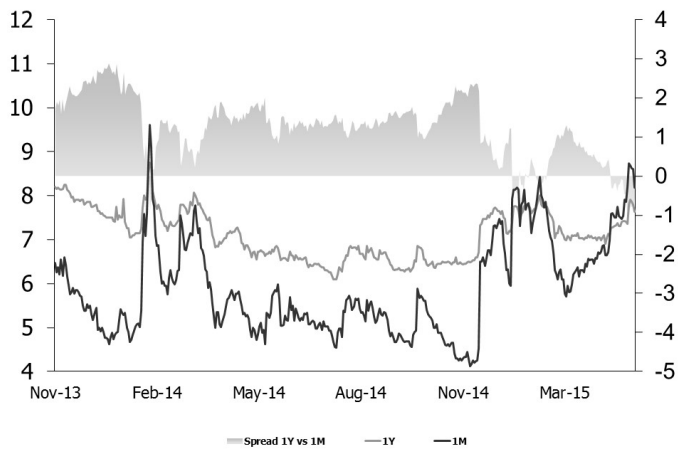
Spot Shorts in EUR/PLN from on average 4.1130 were stopped at 4.1370.

Position in EUR/PLN: we are sidelined.

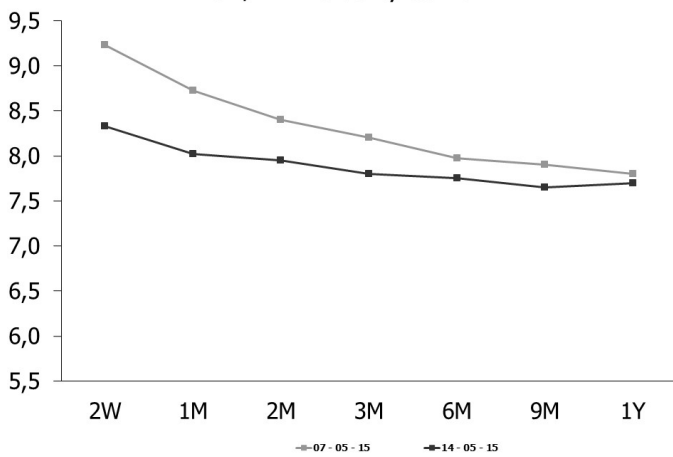
We don't have a position at the moment. The Polish factor in EUR/PLN (current political wows) is about to fade with time. It will come back in the autumn when we will be having much more important parliamentary elections, which will rock the boat much harder than presidential ones. Next week we would like to trade tactically on ECB/NFP, no strong commitment at the moment.

Options We are still long EUR/PLN and USD/PLN Vanna (which proved to be really effective with the current USD spike) and currency spread moved from 4.25 to 5.25 in few days. Our call for being long Vega also got stronger with weaker PLN, and perspective of highly uncertain parliamentary elections in the few month time. On the other hand, we are close to holidays, and expect the Vols to at least stabilize, eventually correct lower short term. We are already bit long in the backend Vega and we are ready to add to this position at any market dip.

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
5/21/2015	1.58	1.68	1.74	1.64	1.96	1.69	1.68	1.69	1.69	1.70	1.75	1.75
5/25/2015	1.58	1.68	1.64	1.65	1.69	1.69	1.71	1.72	1.71	1.73	1.78	1.78
5/26/2015	1.72	1.68	1.76	1.65	1.95	1.69	1.69	1.70	1.72	1.76	1.81	1.77
5/27/2015	1.48	1.68	1.54	1.65	1.59	1.69	1.68	1.73	1.72	1.74	1.80	1.79
5/28/2015	1.71	1.68	1.85	1.66	1.95	1.70	1.69	1.70	1.72	1.74	1.80	1.79

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
5/21/2015	1.690	1.658	1.810	1.766	2.195	2.420	2.550	2.816
5/25/2015	1.690	1.682	1.833	1.861	2.225	2.497	2.585	2.849
5/26/2015	1.690	1.672	1.863	1.857	2.330	2.529	2.730	2.978
5/27/2015	1.690	1.663	1.865	1.853	2.332	2.494	2.738	2.965
5/28/2015	1.700	1.634	1.860	1.789	2.305	2.475	2.695	2.961

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY	
Date	1M	3M	6M	1Y	1M	1Y	1Y	1Y
5/21/2015	8.50	8.10	8.03	7.93	7.93	1.94	0.55	0.55
5/25/2015	9.00	8.40	8.40	8.03	8.03	1.94	0.55	0.55
5/26/2015	9.20	8.60	8.38	8.13	8.13	2.12	0.60	0.60
5/27/2015	8.95	8.58	8.35	8.05	8.05	2.13	0.64	0.64
5/28/2015	8.63	8.35	8.23	8.00	8.00	2.15	0.59	0.59

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
5/21/2015	4.0836	3.6605	3.9260	3.0286	1.3322	0.1495
5/25/2015	4.1149	3.7500	3.9757	3.0830	1.3373	0.1503
5/26/2015	4.1279	3.7898	3.9864	3.0869	1.3379	0.1507
5/27/2015	4.1405	3.7906	4.0014	3.0812	1.3389	0.1509
5/28/2015	4.1419	3.7858	4.0014	3.0559	1.3395	0.1509

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