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## Polish Weekly Review

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### Table of contents

#### Our view in a nutshell

#### Economics

■ Hitting this year's low in PLN-denominated Brent crude oil prices to have a minor impact on the CPI path but possibly greater on market expectations

#### Fixed income

■ Lower for longer

#### Money market

■ Stable week behind us... cheaper ahead of us

#### FX market

■ PLN – rally stopped?

■ Options – vols consolidating

page 2

page 3

page 4

page 5

page 6

### Comment on the upcoming data and forecasts

Another light week ahead of us in terms of economic data. Inflation expectations are hardly a market-moving publication.

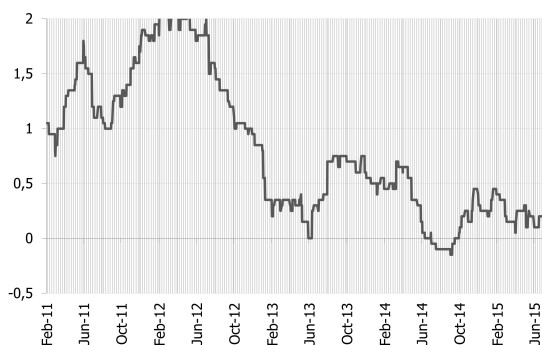
### Polish data to watch: July 27th to July 31th

Publication	Date	Period	mBank	Consensus	Prior
NBP inflation expectations	31.07	Jul	0.2	0.2	0.2

### 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	8/6/2015	1500	1.667	6/11/2015
5Y T-bond PS0720	-	3000	2.355	7/23/2015
10Y T-bond DS0725	-	2500	2.891	7/23/2015
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



### Comment

Unemployment rate came out lower than the preliminary estimate from the Ministry of Labour, thus the index moves upwards a bit. Next week is completely devoid of relevant publications and Polish surprise index will remain in consolidation.

\* 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 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 until winter.
- Rate cut cycle has been concluded and rates are going to stay at 1.5%. 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 turn defensive on POLGBs.
- The recent rally was triggered by positioning (local and foreign investors underweight duration) amid pricing out of (unreasonable) interest rate hikes in 2016.
- At the same time local political uncertainty and Greece risks are here to stay.
- Our twist is tactical since problems in Chinese economy are expected to end up in yuan devaluation or/and significant headwinds for consumption due to massively negative wealth effects. Such a scenario should be beneficial for bonds either from deflation side (yuan) or growth side (consumption). This is a developing story at the moment, though.

### 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	10.0
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	Q2 F	Q3 F	Q4 F
GDP y/y (%)	3.5	3.6	3.3	3.3	3.6	3.7	3.9	4.1
Individual consumption y/y (%)	3.0	3.0	3.2	3.0	3.1	3.1	3.1	3.3
Public Consumption y/y (%)	0.5	6.4	5.3	6.4	3.3	3.0	3.0	2.0
Investment y/y (%)	11.4	8.7	9.2	8.6	11.4	8.5	8.5	8.5
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	10.4	9.9	10.0
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	1.72	1.72	1.72
2Y Polish bond yields (% eop)	3.01	2.51	2.00	1.79	1.61	1.99	1.75	1.80
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.52	2.31	3.31	3.00	3.10
EUR/PLN (eop)	4.17	4.16	4.18	4.29	4.07	4.19	4.10	4.05
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.80	3.76	3.80	3.86

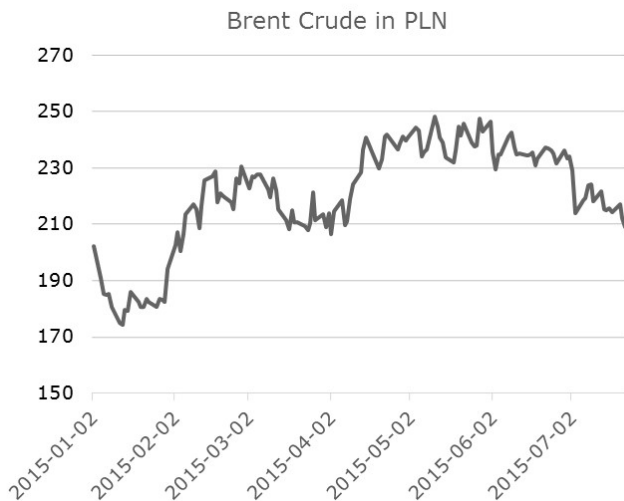
F - forecast

## Economics

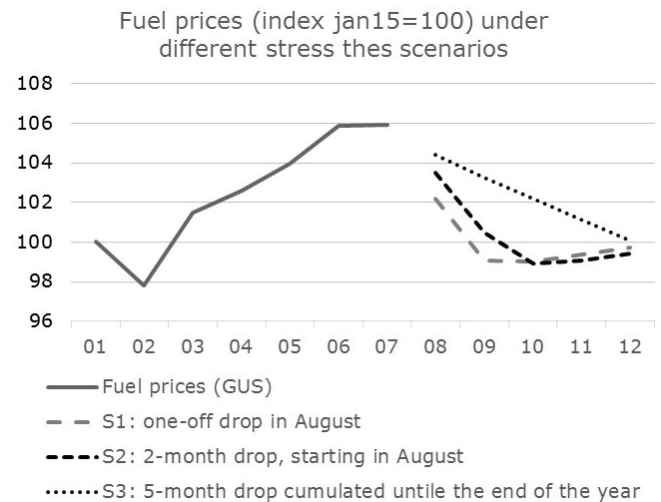
### Hitting this year's low in PLN-denominated Brent crude oil prices to have a minor impact on the CPI path but possibly greater on market expectations.

Recent sharp turnaround in global commodity prices, although widely commented as something temporary, can skew inflation paths materially downwards in many economies. We decided to perform some stress-test scenarios with regard to Polish CPI inflation this year on the basis of some scenarios built upon recent Brent crude behavior. Even if we are heading for this year's bottoms in crude oil price, it would only skew CPI inflation downwards by 0.3-0.4pp. Moreover, a return of CPI inflation back to this year's minimum would require Brent crude prices to shrink by the factor of 4 (four!) and trail 10-15 USD bbl. We cannot imagine such a scenario. The bottom line is, however, that every factor keeping inflation low – and lower crude may do the trick – may expand the imagination of investors beyond this particular MPC's tenure. We still think that we should forget about 2016 rate hikes. Although it may be too early to run with borderline scenarios, we keep our minds open for rate adjustment in the opposite direction.

We ran a simple dynamic model linking fuel prices (as presented by the Central Statistical Office) to Brent crude prices denominated in PLN. We based the stress test on the assumption that the latter returns to this year's lows (see the graph) but at various paces (given the dynamic structure of the model the pace mattered for the first 3 months of adjustment).



Each time, the cumulative drop in Brent price amounted to 20.4% (i.e. the decline that would occur if prices slide further to this year's lows from the average price recorded in July). The results are shown in the following graph.



In each case, sooner or later, prices fall 0.4-0.6pp. below the level from January. The cumulative difference between one-month drop and two-month drop scenario are not meaningful but slightly favor two consecutive drops (in this case the adjustment is slightly more severe); the same applies to gradual drop in prices although in this particular case the complete downward adjustment ends in February 2016 (not shown in the graph). Should such stress test scenarios materialized, and given the 5.5% weight of fuels in CPI basket, inflation would be round 0.3-0.4pp lower in the end of the year than in our baseline (somewhere around 0.5-0.6% y/y).

If one of the first two stress test scenarios materialized, the cumulative effect on CPI in the year end would be almost identical, but August and September readings may be still very deep in deflation (-0.8%). And what if we turned the question and ask what would have to happen to bring CPI inflation back to this year's lows? Given the rigidities in play, around 50% drop in PLN denominated Brent in August, and another almost 50% one would do the trick: this is 4 times lower price than it is now. Can you imagine Brent crude for 10-15 USD bbl? We can't.

The exercise assumes constant exchange rates and effects of lower fuel prices on the other items from the consumption basket. The former would most likely mitigate the fall of Brent crude in PLN (stronger dollar), the latter would be of small magnitude in such a short time span. Pricing behavior of fuel stations is another drop-mitigating factor. PLN prices of Brent crude are trickling down since early May (see the first graph) whereas prices at the pump have been on an almost constant rise since then (only the last week brought a negligible drop in fuel prices). Price rigidities may be in the cards since many companies may be making up the margins lost during the severe adjustment of crude prices at the turn of the year and will be eager to smooth out downward corrections.

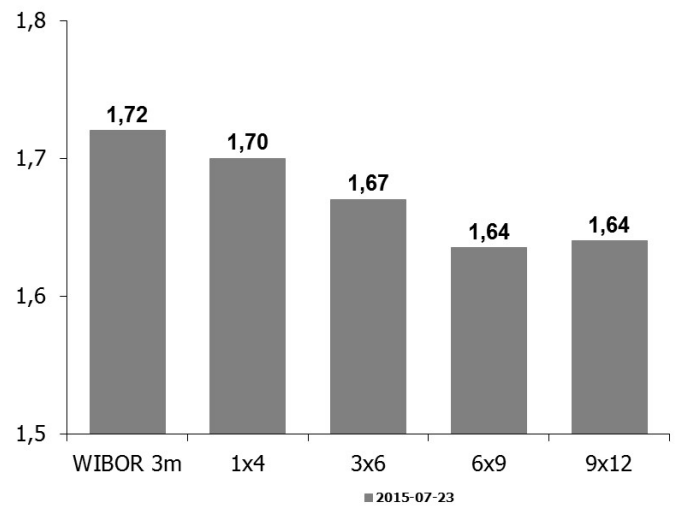
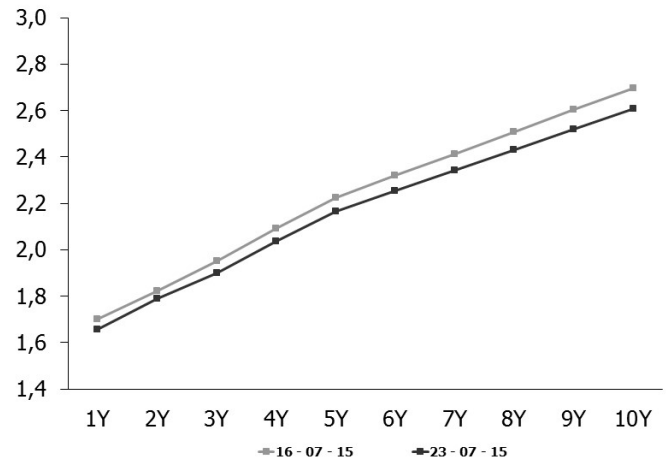
## Fixed income

### Lower for longer

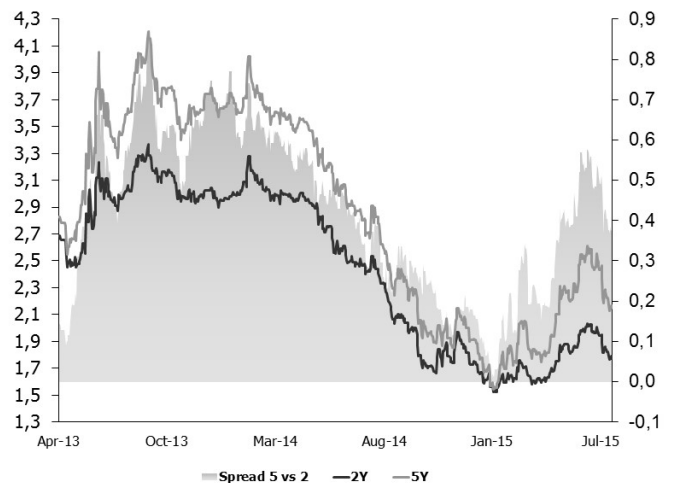
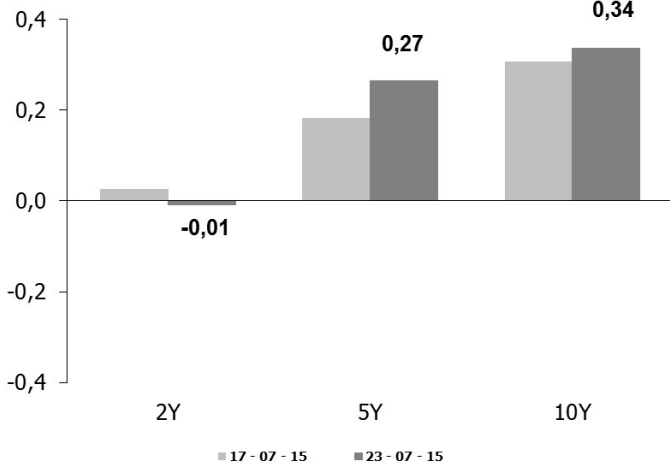
This week on fixed income market positive sentiment (after Greece problems were 'solved for now') met bond supply from Ministry of Finance. Demand, on this first big fixed income auction since may, reached PLN 7bln, 6bln were sold with prices touch below secondary market (especially on longer DS0725). Those results, while not fantastic, were expected because investors are still in 'caution mode'. DS0725 is currently trading near auction levels (2.87% yield).

While repo rate is historically low and it is difficult to imagine rate cuts anytime soon (though fra contract levels give some chances), trend on global commodities market and growth slow down in Asia suggests that low CPI may remain in Poland for longer period of time. We also expect stable cash inflows into Polish bond market and that is why we point to cheapness of 5Y bond benchmark – PS0420.

IRS curve



Asset swaps

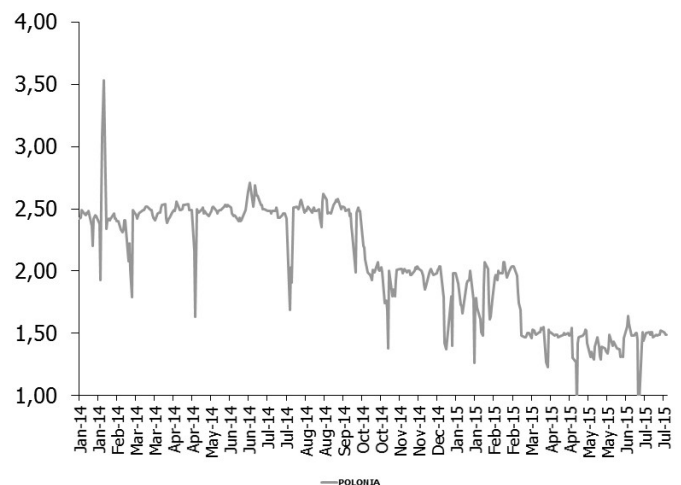
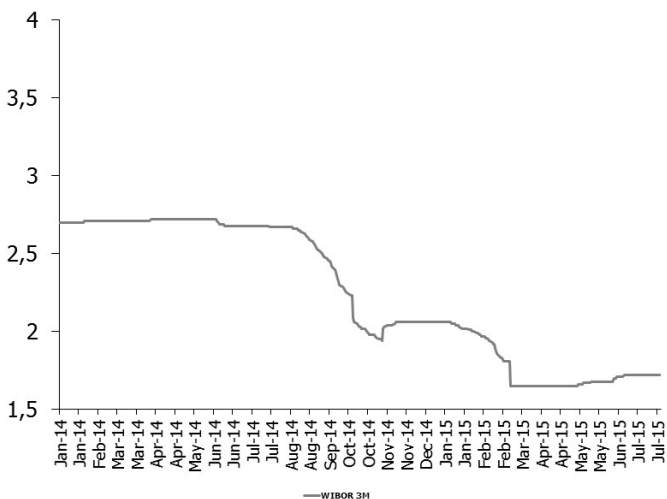
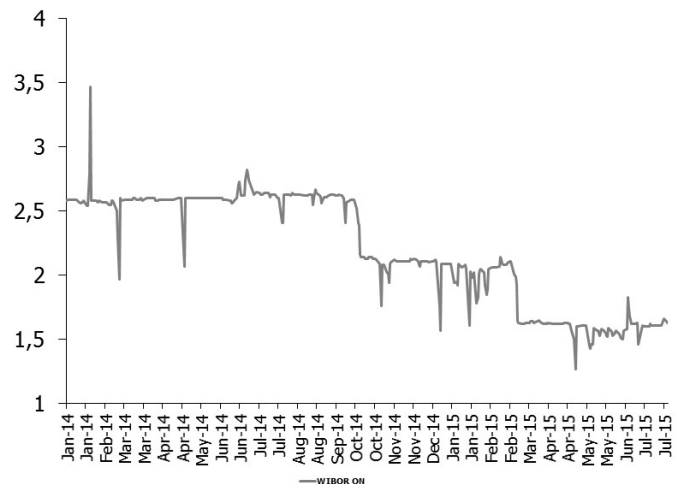
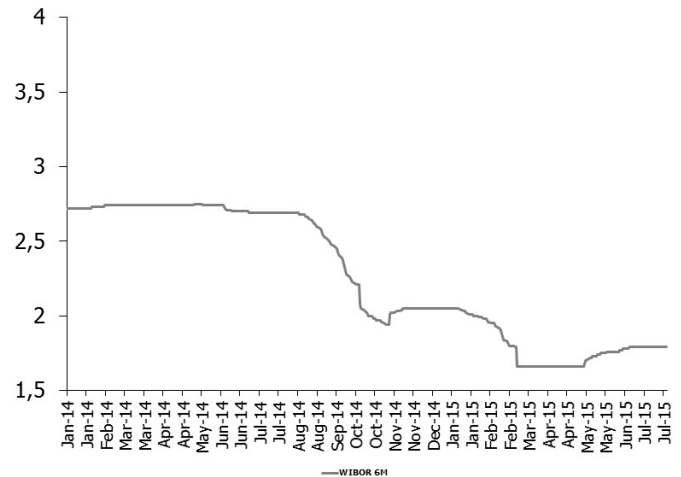


## Money market

### Stable week behind us... cheaper ahead of us

Last week was very stable. Polonia fluctuated around 1.50. Today's OMO was underbid as next week is the last week of reserve period. It should be a bit cheaper next week as on Monday there will be extra cash from OK0715 and coupons from floaters and July bonds. Current coupon from floaters is 1.79.

At the beginning of the week FRA rates continued to decrease. 6x9 FRA (lowest point on the curve) was traded at 1.58. We strongly recommend to buy it, as even now it is 10 bps under current WIBOR (6x9 FRA is 1.62 vs 3M WIBOR at 1.72). 1Y OIS is now 1.41/1.46, same as 6M and 9M OIS.



## Forex

**PLN – rally stopped?** The Zloty march halted or paused in EUR/PLN 4.10/4.14 range. The price action was choppy, with two way interests clashing on the market. The liquidity is really poor, or relatively good as for holiday season, depending on the point of view. We expect more such erratic sessions before we finally will break out of current 4.10-4.14 range. This consolidation period may help PLN gather strength that would put support zone at 4.08/4.10 at risk. Nevertheless, we believe in the rangy nature of EUR/PLN but not exclude that the range may move lower by few groszys i.e. 4.06-4.16.

**Options – vols consolidating** The sell off in vols continues as PLN was getting stronger and EUR/USD vols were still moving south.

Not much to report about XXX/PLN options market. Same bargain hunters appeared on the market with intention to bottom fish some Gamma/Vega, especially in the front end. All they achieved was that vols stopped to slide. As a result, 1 month EUR/PLN ATM mid is this Friday at 6.4% (unchanged from the last Friday), 3 months are 6.6% (also unchanged) and finally 1 year is 6.85% (0.15% lower). Skew and Currency spread (difference between USD/PLN vol and EUR/PLN vol) remained roughly unchanged.

### Short-term forecasts

Main supports / resistances:

EUR/PLN: 4.08 / 4.18

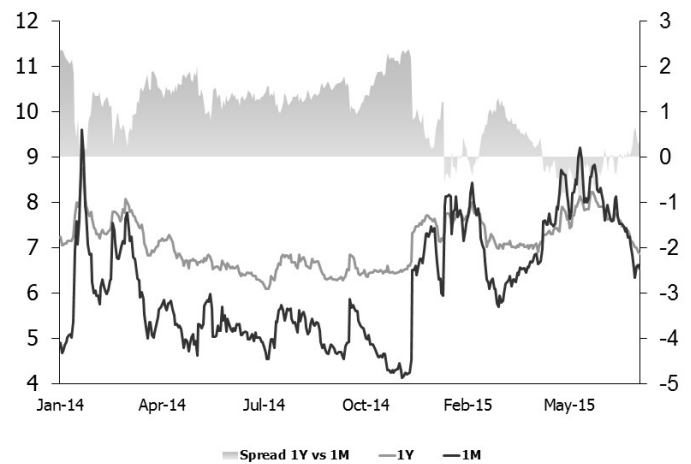
USD/PLN: 3.65 / 3.85

**Position** EUR/PLN - long from 4.15 stopped out at 4.1280.

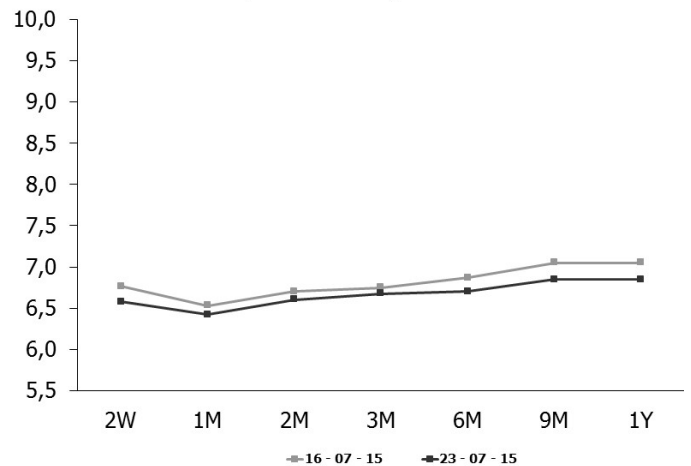
EUR/PLN – we are covering our EUR/PLN long from 4.1010 at the current mkt price 4.1275 and move to the sidelines for the time being.

**Options** We are still long EUR/PLN and USD/PLN Vanna and long longer term Vega. We are ready to add to long Vega in the back. We think that Greece, rate hikes in US, market turbulence in China and parliamentary elections in Poland will support volatility in the longer term. To at least partially cover the Theta bills, we are short 1-2 months EURPLN Vega.

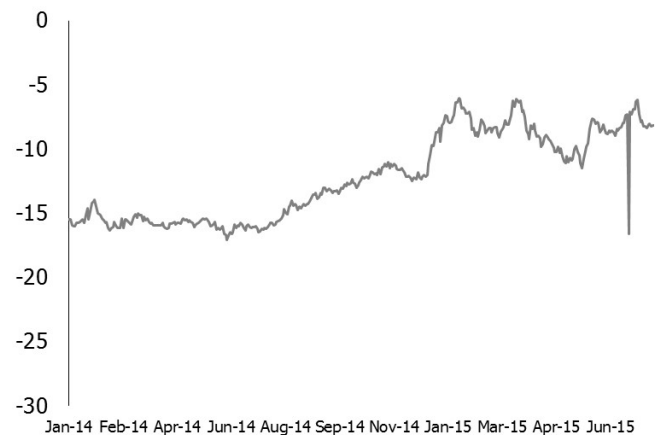
EURPLN volatility



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
7/16/2015	1.50	1.72	1.57	1.69	1.78	1.73	1.72	1.71	1.70	1.71	1.77	1.76
7/20/2015	1.58	1.72	1.66	1.69	1.70	1.73	1.70	1.66	1.63	1.62	1.67	1.69
7/21/2015	1.52	1.72	1.60	1.69	1.80	1.73	1.72	1.66	1.63	1.64	1.71	1.69
7/22/2015	1.52	1.72	1.59	1.69	1.62	1.73	1.70	1.66	1.62	1.63	1.69	1.65
7/23/2015	1.75	1.72	1.82	1.69	1.72	1.73	1.70	1.67	1.64	1.64	1.71	1.70

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
7/16/2015	1.730	1.716	1.821	1.847	2.225	2.406	2.698	3.004
7/20/2015	1.730	1.669	1.763	1.797	2.130	2.324	2.570	2.871
7/21/2015	1.730	1.709	1.778	1.797	2.162	2.380	2.610	2.925
7/22/2015	1.730	1.734	1.775	1.794	2.150	2.367	2.590	2.899
7/23/2015	1.730	1.718	1.790	1.781	2.166	2.431	2.607	2.942

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY	
Date	1M	3M	6M	1Y	1M	1Y	1Y	1Y
7/16/2015	6.53	6.75	6.88	7.05	7.05	2.00	0.52	
7/20/2015	6.58	6.70	6.83	7.00	7.00	2.00	0.52	
7/21/2015	6.63	6.70	6.75	6.90	6.90	2.02	0.52	
7/22/2015	6.53	6.65	6.73	6.88	6.88	2.01	0.53	
7/23/2015	6.43	6.68	6.70	6.85	6.85	2.01	0.52	

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
7/16/2015	4.1111	3.7694	3.9469	3.0419	1.3310	0.1517
7/20/2015	4.1083	3.7868	3.9350	3.0469	1.3282	0.1519
7/21/2015	4.1112	3.7875	3.9402	3.0463	1.3295	0.1518
7/22/2015	4.1174	3.7629	3.9269	3.0417	1.3359	0.1521
7/23/2015	4.1285	3.7559	3.9357	3.0343	1.3371	0.1527

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