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Polish Weekly Review

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Comment on the upcoming data and forecasts

Another light week ahead of us in terms of economic data. We expect the PMI to decline from June's surprise reading. Other indicators suggest stable, albeit unspectacular momentum, and German data has been weak in July.

Polish data to watch: August 3rd to August 7th

Publication	Date	Period	mBank	Consensus	Prior
Manufacturing PMI (pt)	03.08	Jul	53.0	54.3	54.3

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

Unchanged (no relevant data). New week brings the release of PMI index - since this is a major driver of Polish PMI, we should see some surprise.

* 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 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 stay 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	-0.8
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 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2 F	2015 Q3 F	2015 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	-0.8	0.1
Unemployment rate (% eop)	13.9	12.0	11.5	11.5	11.7	10.3	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	1.70	1.70
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.52	2.31	3.31	3.00	2.90
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

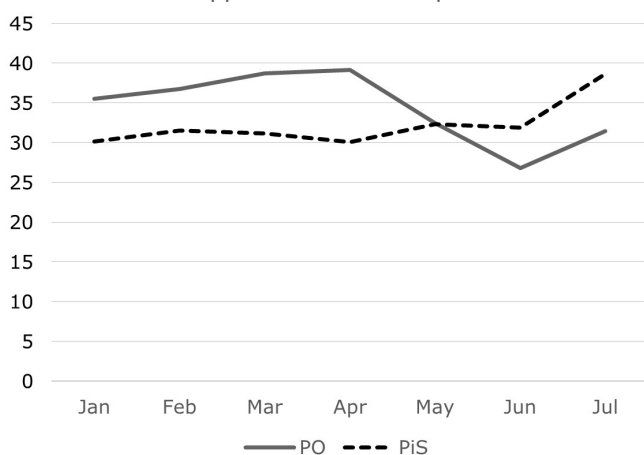
Economics

Adapting and quantifying political risks in Poland.

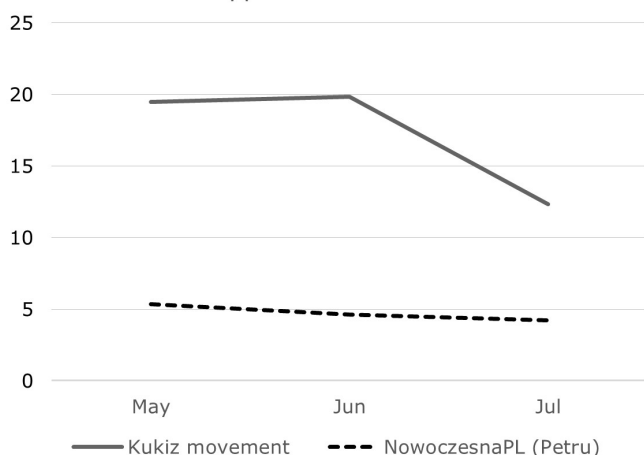
In this week's Economics piece we offer an update on the topic of political risks in Poland, first covered in the May 29th edition of our weekly report.

More than two months have passed since the groundbreaking presidential elections which led to a marked shift on Poland's political scene, i.e. the surge in support for PiS and the emergence of new parties (one led by Mr. Kukiz and one founded by Mr. Petru). While the former development seems to be a lasting one, the new entrants have clearly lost momentum. In addition, the incumbent party (PO) recovered several percentage points in late June and July (see the results of our aggregation of recent polls below). It should be clear by now that strategic voting will play a significant role in the elections, further undermining support for the smaller players. All in all, the likely outcome of the elections is a PiS-led government either with or without a small partner.

Support for two main parties



Support for new entrants



We also decided to take a closer look at the party's campaign promises. Instead of typical approach, i.e. taking them at face value and computing the highest possible cost, we decided to inject a little realism into the calculations. The most important highlights of the PiS programme are the following:

1. Changes in the pension system (lower retirement age, higher minimum pension, strictly voluntary participation in private pension fund system).
2. Higher tax-free threshold in personal income tax.
3. Support for families via monthly subsidies for all second and subsequent children.
4. A new tax on financial institutions (aka bank tax) and a tax on large retailers.
5. Increase in tax revenues as a result of crackdown on tax evasion and improved collections.

The first one can reasonably be discounted as impractical, damaging in the long term and unacceptable to international institutions. The others have a varying price tag. The tax-free threshold pertains to all households and is currently proposed to be raised to PLN 8k (from today's ca. 3.1k). Estimates from the Ministry of Finance and independent think tanks suggest a cost of PLN 22 bn. Of course, the smaller the raise, the lower the cost (e.g. raising the threshold to PLN 5k would cost PLN 8bn). Taken at face value (PLN 500 per month per 3.5 million recipients), the child subsidy would cost additional PLN 21 bn. If made income-contingent it could still fulfill its desired goals while at the same time being less costly. The new expenditures could thus amount to anything between PLN 15bn and 34bn.

Based on estimates from retailers themselves and from the KNF (regarding the bank tax) we estimate that the two new taxes could bring ca. PLN 8-9 bn in new revenue. The increase in net transfers to households would be partly recovered via increased VAT revenues – depending on one's assumptions on marginal savings rate and the size of the transfer it would amount to PLN 2-7 bn. The crackdown on tax avoidance and increase in tax collection rates is the Holy Grail of Polish fiscal policy and, as such, is mostly guesswork. We believe that anywhere between PLN 3 and 15 bn could be raised that way but only after a few years of meticulous reforms.

All in all, we can expect that the actual costs of PiS' package could reach PLN 10-12 bn – a sizeable but manageable amount. The main impact of the change in government would thus be not in the form of higher credit risk but in the equity space (specifically, bank stocks that weigh on the whole Warsaw stock indices).

Fixed income

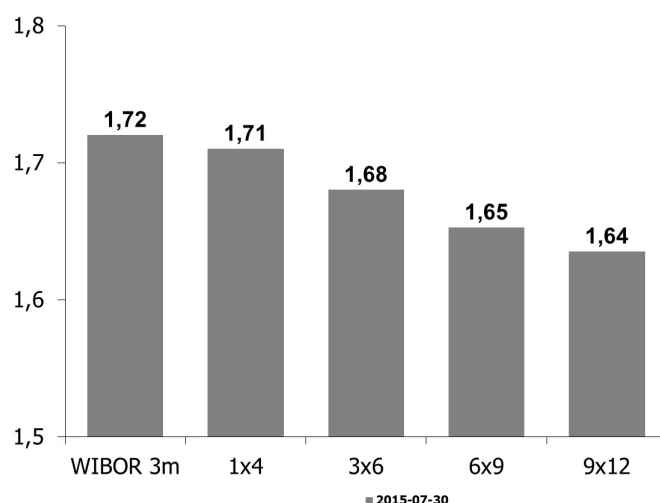
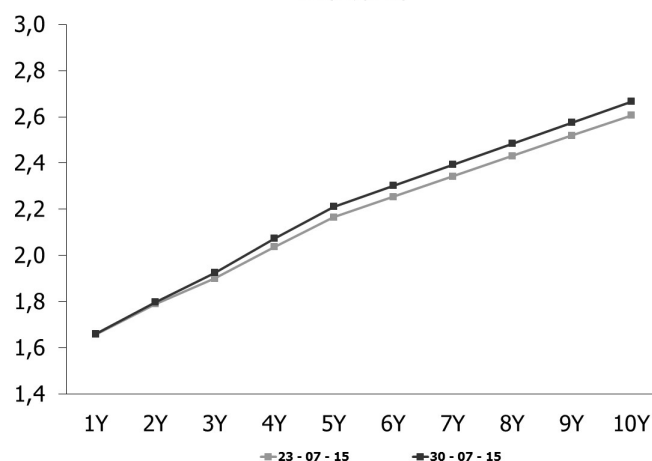
Positioning, again ...

This week was supposed to shed some light on possible US rates development. It did not... Fed statement was a bit more bearish, GDP data were mixed. Again, combination of cheap cash and cheap commodities was supposed to bring some better bonds performance. It did not

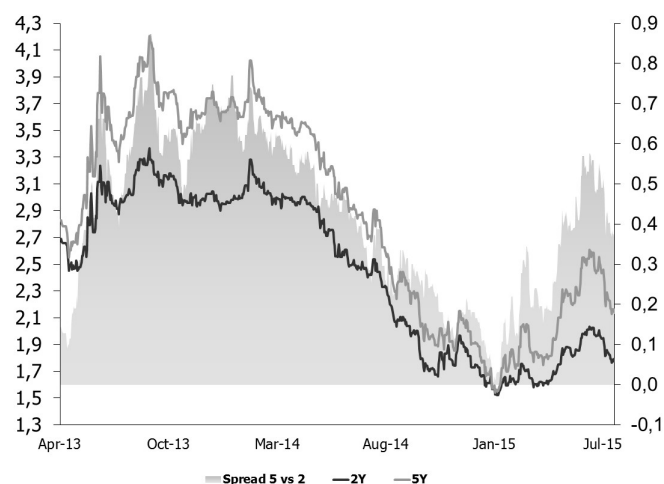
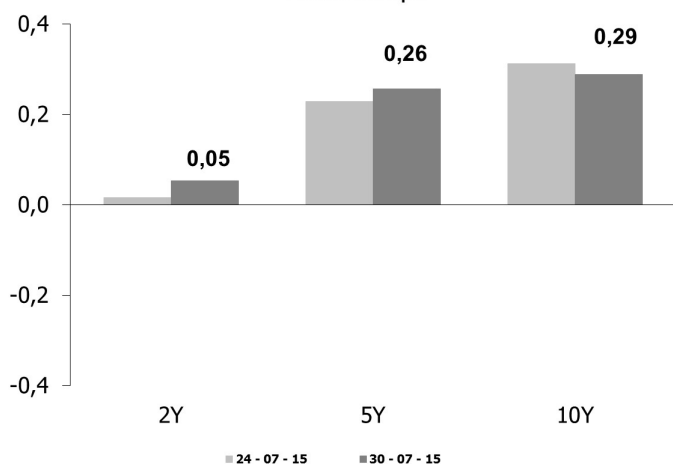
Some sellers have appeared (probably PT order) and seed of doubt has been spread. And those doubts are interpreted against bonds so far. Despite cores trading relatively calm and pretty positive, POLGBs are strongly offered - we trade 14 bps off lows.

Cash is cheap, elections are in two months... it seems mostly positioning is weighting here. Especially as another auction is scheduled for next Thursday. Supply is sure then and coming data are less significant. Will there be enough buyers to cover it? Depends on the level. Last auction was sold at 2.90 (DS0725), we trade 3.00 now. Given current price action next supports at 101.70 and 101.00 are under threat.

IRS curve



Asset swaps

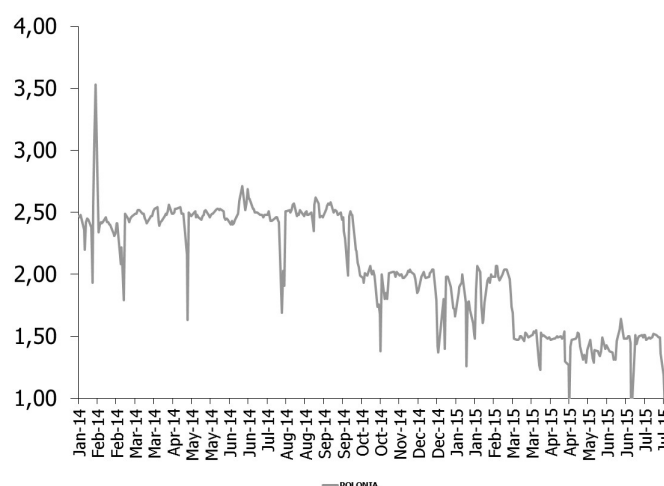
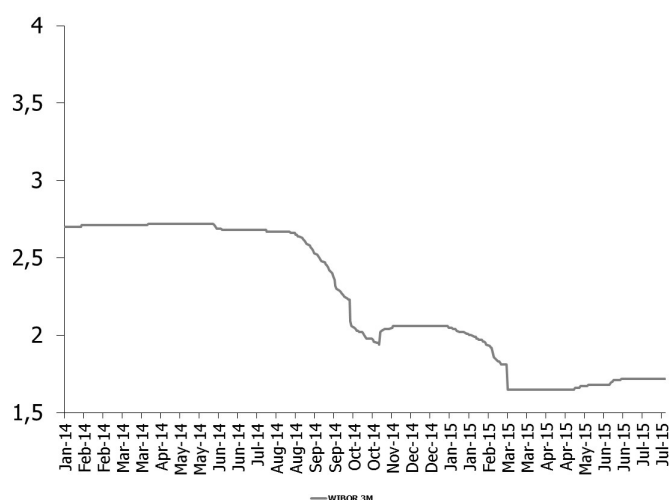
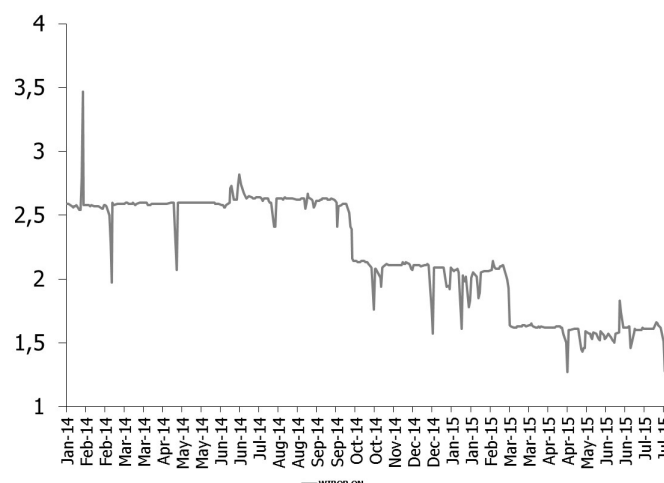
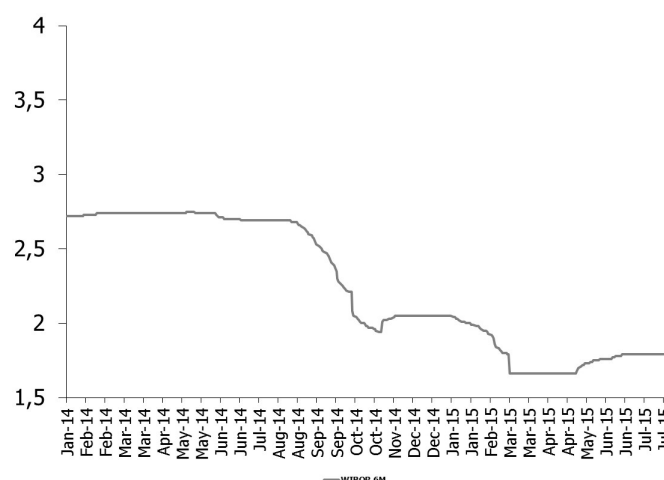


Money market

Cheap week behind us

Nothing exciting on the cash market. We had an end of reserve period on Thursday which always tends to be cheap. Liquidity desks are stacking excess cash to feel safe. Now we are getting back to normal lvls around 1.45/1.55 overnight. What one might predict is that August end won't be as cheap as July's one as the last day of reserve period comes on Friday.

On the FRAs market, selloff found support around 1.60 lvls on the 6x9 and even bounced back a bit. We are now around 1.64 (8 bp below Wibor) on the 6x9 and there is not much interest/view to push the market in either direction. This might change rapidly if we would have any upside surprise in CPI as these would erase all doubts about whether the next move on rates would be up or down.



Forex

PLN – still consolidating Even highly anticipated FOMC meeting was not able to push PLN from its current 4.1050-4.1550 range against the EUR. Poor liquidity and end of month randomness sum up to the choppy price action. We are trading global sentiment with FOMC "lift off" being the centrum of it. The Polish factor is relatively low, but do not forget the autumn parliamentary elections are approaching fast. We still expect nervous, choppy trading in the wide 4.1050-4.1750 range.

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

PLN vols market is turning higher, but the bounce is still tepid, at best. We noted better bids for short term low delta EUR puts PLN calls, 6 months EUR/PLN ATM were paid at 6.7%. 1 moth EUR/PLN ATM mid is today at 6.8% (0.4% higher than last Friday), 3 months are 6.8% (0.2% higher) and finally 1 year is 7.0% (0.15% higher). Skew in EUR/PLN is roughly unchanged but skew is USD/PLN was hammered because of rising R/R in EUR/USD. We have seen 1 year offered at 2.5%. The currency spread (difference between USD/PLN vol and EUR/PLN vol) was still better offered and stabilizing at this year lows around 4.9%.

Short-term forecasts

Main supports / resistances:

EUR/PLN: 4.08 / 4.18

USD/PLN: 3.65 / 3.85

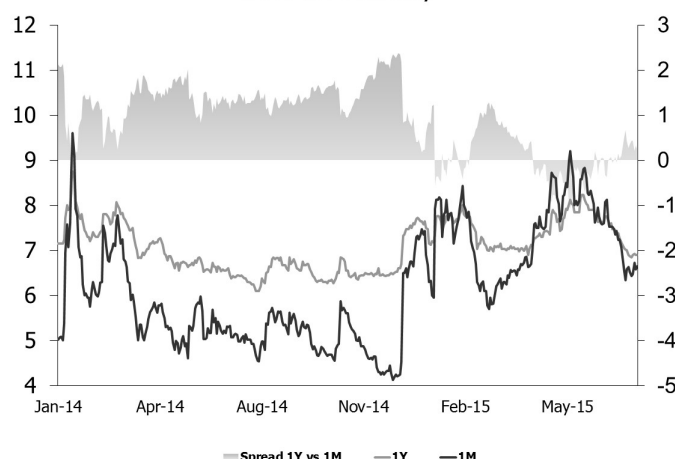
Position We would like to play the range. We are ready to sell 4.1700, add 4.1850 with a stop above 4.20 and hopes for a move to 4.12.

Or

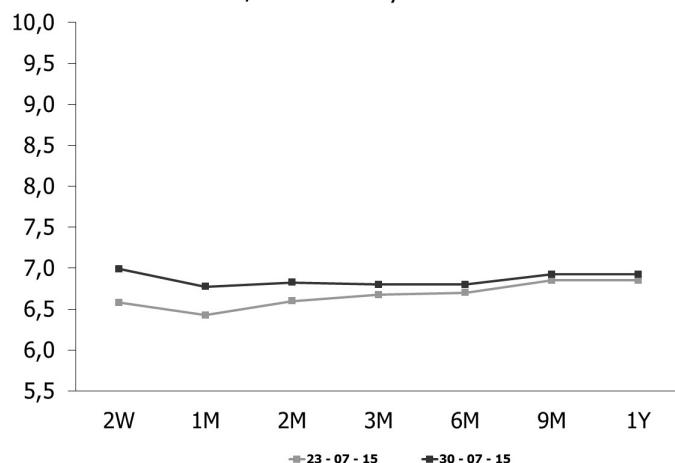
We would like to buy 4.1150, add at 4.1000 with stop below 4.0850, aiming a move to 4.1650.

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 backend. 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.

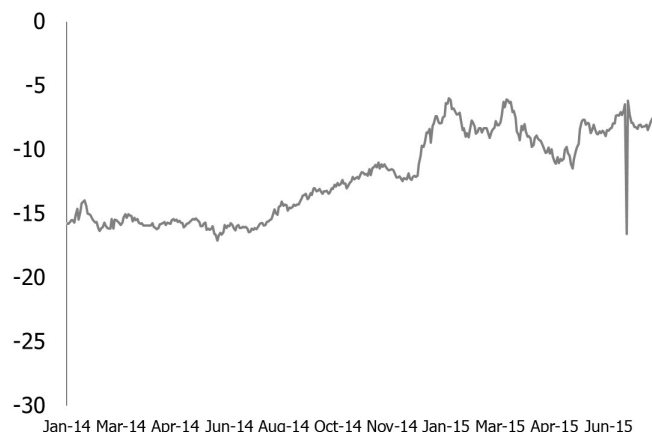
EURPLN volatility



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
7/23/2015	1.75	1.72	1.82	1.69	1.72	1.73	1.70	1.67	1.64	1.64	1.71	1.70
7/27/2015	1.58	1.72	1.66	1.69	1.70	1.73	1.71	1.68	1.64	1.64	1.70	1.70
7/28/2015	1.71	1.72	1.79	1.69	1.73	1.73	1.71	1.68	1.64	1.62	1.71	1.68
7/29/2015	1.46	1.72	1.55	1.69	1.71	1.73	1.71	1.67	1.64	1.65	1.71	1.69
7/30/2015	1.61	1.72	1.68	1.69	1.72	1.73	1.71	1.68	1.65	1.64	1.73	1.73

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
7/23/2015	1.730	1.718	1.790	1.781	2.166	2.431	2.607	2.942
7/27/2015	1.730	1.690	1.765	1.780	2.125	2.362	2.550	2.891
7/28/2015	1.730	1.695	1.763	1.783	2.140	2.351	2.577	2.896
7/29/2015	1.730	1.716	1.770	1.806	2.160	2.384	2.600	2.936
7/30/2015	1.730	1.719	1.798	1.851	2.210	2.466	2.665	2.953

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY	
Date	1M	3M	6M	1Y	1M	1Y	1Y	
7/23/2015	6.43	6.68	6.70	6.85	6.85	2.00	0.54	
7/27/2015	6.73	6.70	6.81	6.93	6.93	2.00	0.54	
7/28/2015	6.58	6.65	6.80	6.90	6.90	1.99	0.54	
7/29/2015	6.65	6.65	6.75	6.90	6.90	1.97	0.52	
7/30/2015	6.78	6.80	6.80	6.93	6.93	1.97	0.53	

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
7/23/2015	4.1285	3.7559	3.9357	3.0343	1.3371	0.1527
7/27/2015	4.1495	3.7455	3.9150	3.0330	1.3315	0.1535
7/28/2015	4.1280	3.7303	3.8679	3.0152	1.3328	0.1527
7/29/2015	4.1452	3.7471	3.8946	3.0308	1.3394	0.1532
7/30/2015	4.1429	3.7754	3.8928	3.0412	1.3432	0.1531

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