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Polish Weekly Review

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Comment on the upcoming data and forecasts

On Thursday the Central Statistical Office will publish inflation data for July. We expect CPI growth to stall at -0.8% y/y. In our view, this is a result of low core inflation (ticks down a bit due to high statistical base in communication services), modest increase in fuel prices (the last one for a while) and still low food prices. The latter (of which the biggest source of variation in June and July are potatoes) are the main risk factor for our forecasts. We took the upside on potatoes. BoP data published at the same time is set to show yet another strong CA surplus - albeit smaller than the previous one due to seasonal deterioration in EU transfers - driven by very high trade surplus (more than 1 bn PLN by our reckoning). The week ends with flash GDP release from the CSO. We expect annual growth to tick up a bit, in line with the pattern of upside surprises (vis-a-vis forecasts from monthly data) from the previous quarters.

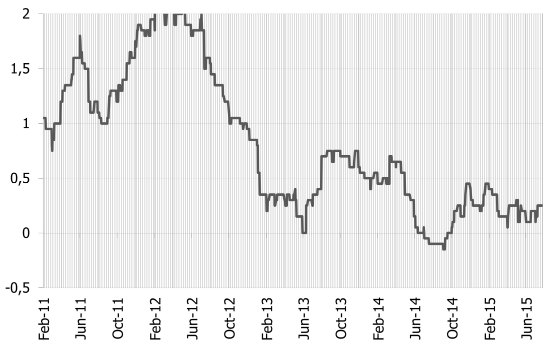
Polish data to watch: August 10rd to August 14th

Publication	Date	Period	mBank	Consensus	Prior
M3 y/y (%)	13.08	Jul	7.8	8.0	8.3
Current account balance (mio EUR)	13.08	Jun	644	200	1184
Exports (mio EUR)	13.08	Jun	14800	14564	14131
Imports (mio EUR)	13.08	Jun	13700	13715	13285
CPI y/y (%)	13.08	Jul	-0.8	-0.8	-0.8
GDP y/y (%)	14.08	Q2	3.7	3.6	3.6
Core inflation y/y (%)	14.08	Jul	0.1	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	9/10/2015	1500	1.667	6/11/2015
5Y T-bond PS0720	9/10/2015	3000	2.355	7/23/2015
10Y T-bond DS0725	-	2000	3.076	8/6/2015
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Unchanged (PMI came out close to analysts' forecasts). Next week could see the index move again, on CPI and GDP data.

* 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 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 looming Fed hike are here to stay and weigh on Polish assets.
- 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	4.15	4.10
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.80	3.76	3.84	3.90

F - forecast

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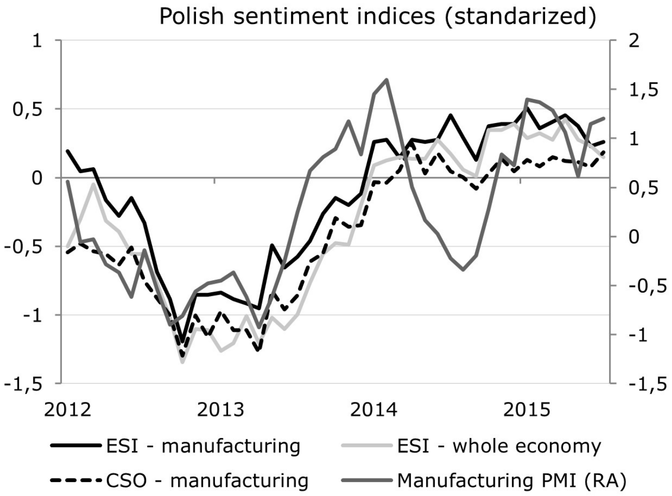
Economics

Polish industry enters the third quarter in good shape

The sentiment of Polish manufacturers (as reflected by the PMI index) remained essentially unchanged from the previous month's reading (July – 54.5, June – 54.3). The slight increase was due to two components, i.e. new orders (grew from 55.1 to 55.8) and employment (according to Markit, this is the fourth highest reading in history), while the assessment of output deteriorated marginally. When considering the monthly volatility of the PMI, one has to take into consideration the fact that the index remains firmly in the range indicated by other sentiment indicators (see the graph below), the latter in turn consistent with economic growth exceeding 3.5%.



The July release of the PMI has two highlights.

Firstly, the assessment export orders jumped to its highest level in more than a year. Given the synchronized deterioration in analogous indices in Europe (Germany, Spain, UK – to name a few), it is a bit surprising but easily explained by buoyant intra-EU demand. This does not contradict the fact that emerging markets are struggling and curtailing imports from European partners. It is also worth remembering that the massive depreciation of the euro in 2014 and early 2015 barely touched the CEE currencies. Because of this, the region remained competitive vis-a-vis other EZ neighbors (for instance, Britain is enjoying the strongest currency in many years).

Secondly, one should mention the fact that output price assessment turned positive for the first time since June 2012. While this is a positive signal, it does not necessarily herald the end of industrial deflation in Poland. In a highly competitive environment shocks impacting pricing behavior will work asymmetrically (it is easier to cut prices than raise them and risk being undercut by others). The balance of risks is after all tilted to the downside here – possible devaluation of the CNY and second round effects from renewed commodity price declines come to mind. Last but not least, the 50 mark in PMI Output Price index is still consistent with negative annual growth of the PPI. Finally, this development is not accompanied by a marked increase in input costs.

To sum up, this is hardly a ground-breaking release, either for real sphere or for inflationary pressures. It suggests stable GDP growth and very slow return to CPI target. Thus, we stand firm by our forecast of unchanged interest rates in 2015 and 2016.

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Fixed income

Global vs. local story

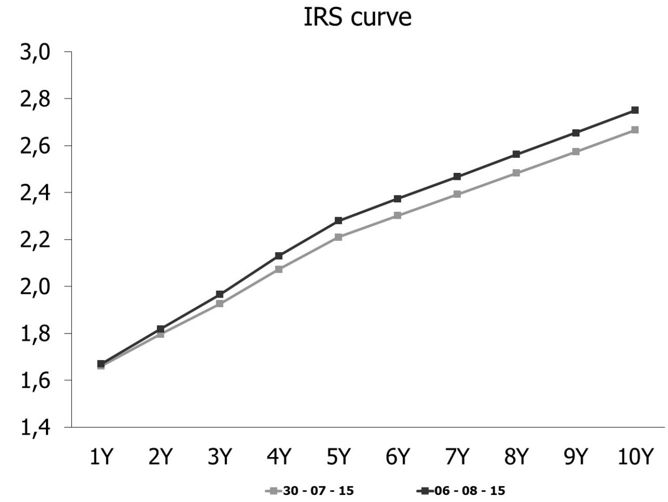
It was a busy week on fixed income market; rates are about 10-12 bps higher vs. last Friday close.

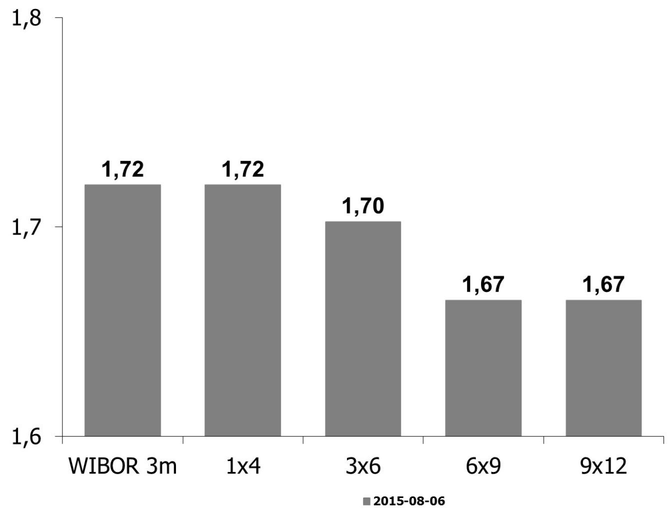
Sell-off started after comments from FOMC voter D. Lockhart suggesting that September could be appropriate time to lift rates. After strong ISM figure all eyes were on Non-farm Payrolls publication which came pretty much in line with market consensus (+215K vs +225K forecast).

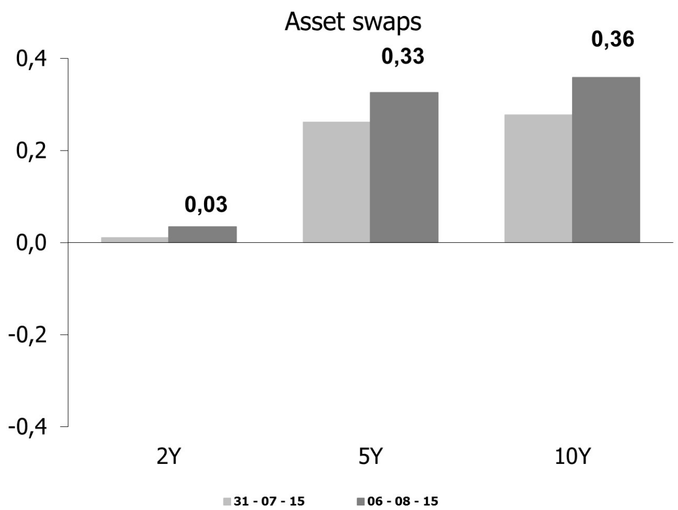
On the domestic side investors focused on:

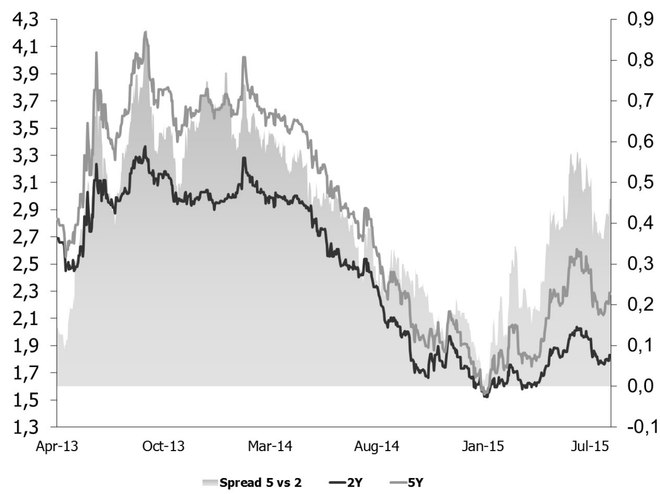
- amendments to new FX mortgage relief program which lower house of parliament approved late Wednesday (cost for banks about 16-20 bio PLN);
- long end bond auction on Thursday. MoF sold PLN 4,7 bio of DS0725 (3,5 bio) and WZ0126 (1,1 bio). Results were slightly positive;
- inauguration of new presidency. Andrzej Duda was sworn in as Poland's new president. His legislative initiatives can hurt fiscal policy - 500PLN for every child per month; 8000PLN tax free allowance. This will put additional pressure on bonds after parliamentary elections this October as, due to last polls, Law and Justice (PiS) is going to take power.

All in all we feel that, building longs at current levels (DS0725 3,06%, PS0420 2,52%) can be a good idea in a short term horizon taking into account global environment, however keep in mind that political risk in Poland is going to rise sooner than later.



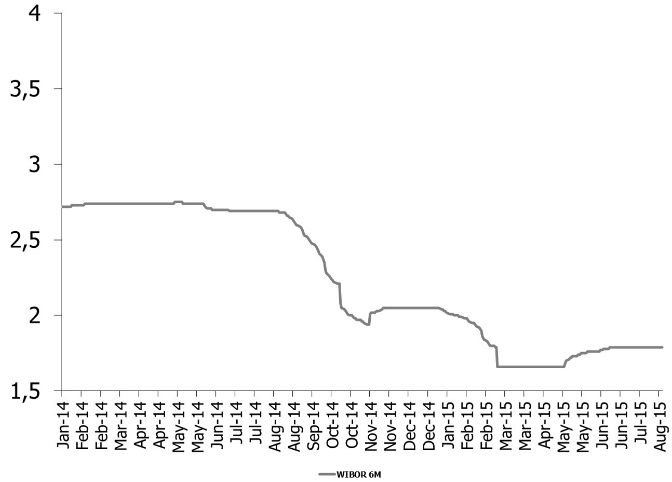






Money market

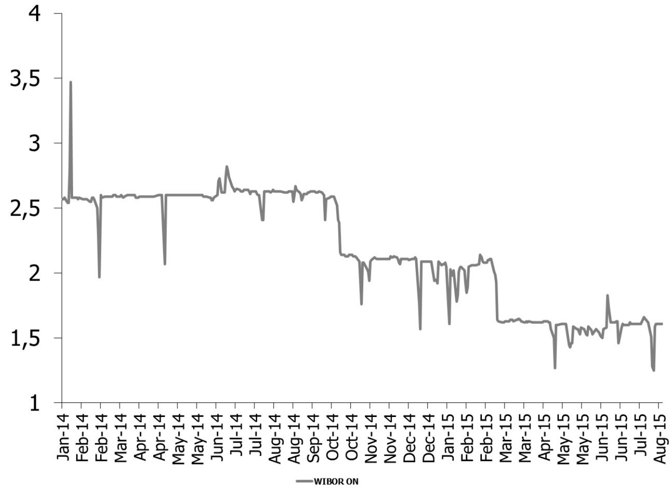
Nothing thrilling for front end rates.

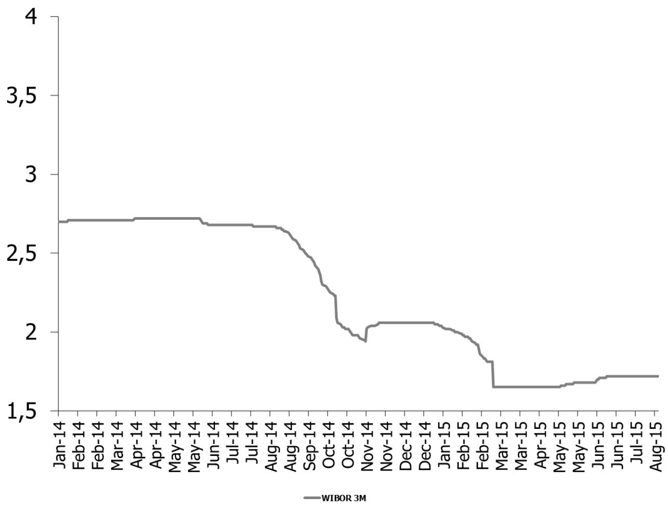


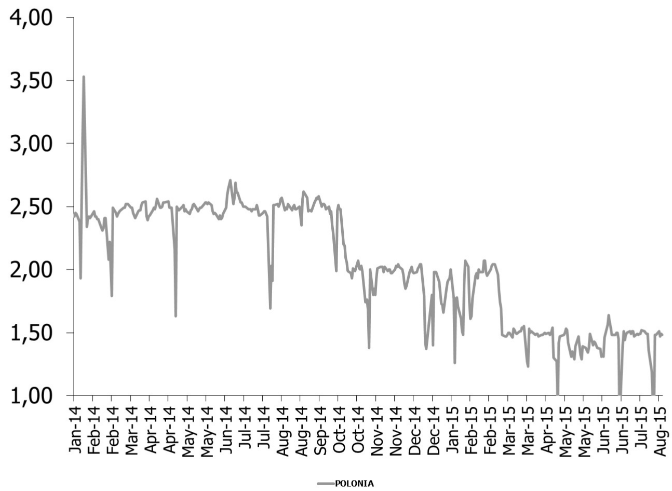
Shortest deposits very close to the main rate since the reserve was pretty much squared. After today's OMO it should not change (83 billion pln of money bills sold, which still means square for the system).

Forward rates up to 1Y still below the current 3 and 6M Wibors, however, the march to par has begun. Still value to pay them as we cannot see any reason for the current pricing. OK0116 is still very attractive, not as much for the carry trade as for fact that it will be a switching paper for the next switching auction by MinFin.

Pay 6*9 FRA, buy OK0116.







Forex

PLN – downside pressure The lower bar for a September „lift off" and the CHF-denominated loans conversion bill (already accepted by Parliament) were the reasons for PLN underperformance this week. As a result, EUR/PLN climbed from 4.13 (the low of the week) to 4.20 (the high of the week) before consolidating in 4.1770-4.1970 region. Important note: global factors, i.e. NFP and future FOMC actions are already discounted in current PLN value, of course PLN will be influenced by them, but it should not create a major shock. With the CHF loans conversion it is a totally different case, there will be much more questions than answers, plainly it would set PLN on fire. The political risk in Poland is clearly on the rise. Until then, we still lean toward the rangy nature of EUR/PLN, and expect 4.13/4.22 range to dominate.

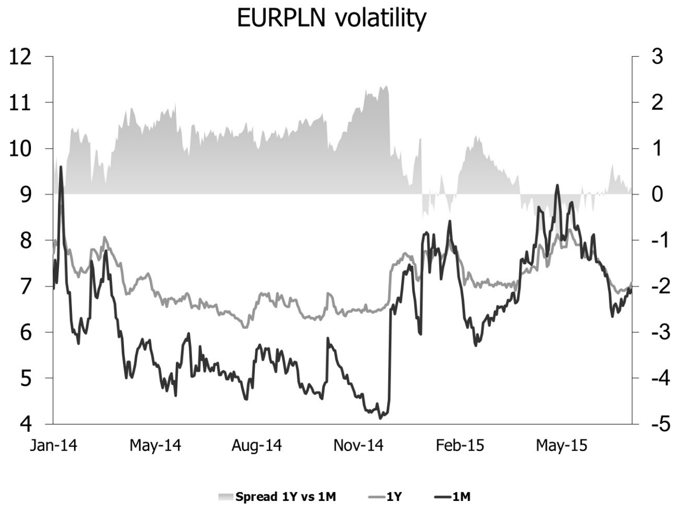
Options – in selective demand PLN losses and the uptick in EUR/USD vols caused the selective demand for PLN vols, with prices moving cosmetically higher. 1 month EUR/PLN ATM mid is fixing this Friday at 6.9% (0.1% higher), 3 months are also 6.9% (0.1% higher) and finally 1 year is 7.1% (0.1% higher). Skew was also better bid, especially in the frontend. The currency spread (difference between USD/PLN vol and EUR/PLN vol) is relatively stable at 4.7-5.2 for the 1 year.

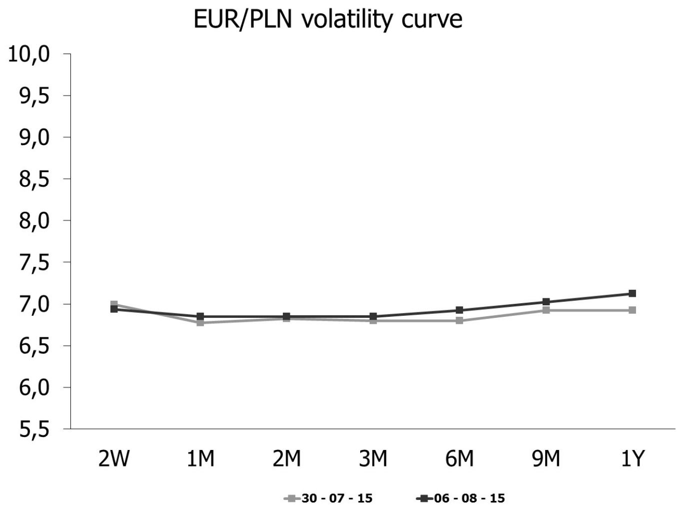
Short-term forecasts

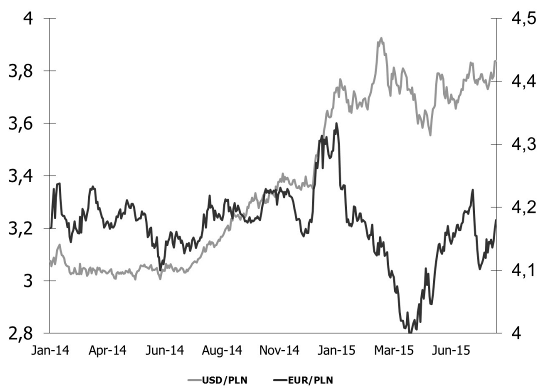
Main supports / resistances:
EUR/PLN: 4.08 / 4.18
USD/PLN: 3.65 / 3.85

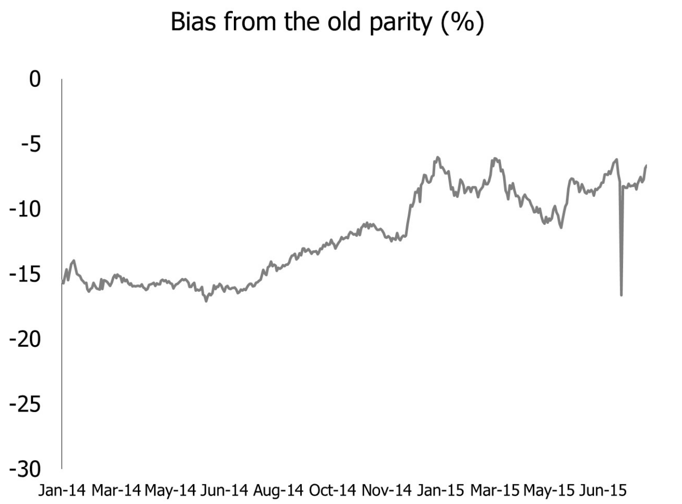
Position We are short EUR/PLN at 4.1775 with a stop at 4.1825 and we set a trailing stop of 2 figures and P/T at 4.14. It is a purely tactical trade, the political barometer is now clearly indicating red alert. That is why we set a trailing stop as opposed to a fixed one. In case e.g. we got to 4.15 and some political bomb explodes, we don't want to be late at the door.

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 are now covering the shorts in 1-2 months, we are closing PINs. That is leaving us with an outright long Vega and Gamma/Vanna position. The political tension in Poland, the proximity of the crucial FOMC meetings, are in our eyes good reasons for that.









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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
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
8/3/2015	1.76	1.72	1.83	1.69	1.74	1.73	1.72	1.69	1.65	1.63	1.73	1.70
8/4/2015	1.72	1.72	1.67	1.69	1.85	1.73	1.72	1.70	1.66	1.64	1.72	1.71
8/5/2015	1.50	1.72	1.59	1.69	1.80	1.73	1.71	1.69	1.67	1.67	1.78	1.73
8/6/2015	1.73	1.72	1.82	1.69	1.96	1.73	1.72	1.70	1.67	1.67	1.74	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
7/30/2015	1.730	1.719	1.798	1.851	2.210	2.466	2.665	2.953
8/3/2015	1.730	1.697	1.790	1.808	2.210	2.485	2.665	2.927
8/4/2015	1.730	1.697	1.790	1.800	2.207	2.490	2.647	2.961
8/5/2015	1.730	1.728	1.831	1.846	2.290	2.579	2.752	3.002
8/6/2015	1.730	1.732	1.820	1.854	2.280	2.606	2.750	3.108

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
7/30/2015	6.78	6.80	6.80	6.93	6.93	1.99	0.52
8/3/2015	6.95	6.83	6.78	6.98	6.98	1.99	0.52
8/4/2015	6.85	6.75	6.78	6.98	6.98	1.98	0.53
8/5/2015	6.93	6.85	6.88	7.08	7.08	1.99	0.54
8/6/2015	6.85	6.85	6.93	7.13	7.13	2.00	0.55

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
7/30/2015	4.1429	3.7754	3.8928	3.0412	1.3432	0.1531
8/3/2015	4.1360	3.7705	3.8977	3.0362	1.3449	0.1529
8/4/2015	4.1463	3.7792	3.9059	3.0490	1.3459	0.1533
8/5/2015	4.1655	3.8359	3.9144	3.0840	1.3497	0.1541
8/6/2015	4.1798	3.8385	3.9033	3.0738	1.3463	0.1546

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