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Polish Weekly Review

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Comment on the upcoming data and forecasts

Week begins with industry and trade data. We expect industrial output to slow down only marginally in September, despite unfavorable working day difference (0 vs. +1 y/y in August) and high statistical base in car production, as many industries are set to catch up after a disastrous August (likely influenced by power outages and logistical delays). The accompanying PPI release will show slightly deeper deflation on the producers' side - this is because of a cut in natural gas prices and stable commodity prices. Retail trade data are set to show a rebound in sales. The upswing will be concentrated in categories most depressed / affected by the August heat wave, i.e. various durable goods and Others category. Sharply lower fuel prices will partly mitigate that effect. On Thursday the NBP will publish Minutes from October MPC meeting, while the CSO will release its consumer and business sentiment data for October. Finally, on Friday the Statistical Bulletin will be published, along with final unemployment figures from the CSO - we expect them to come out a notch below the preliminary estimate from the Ministry of Labor and Social Policy.

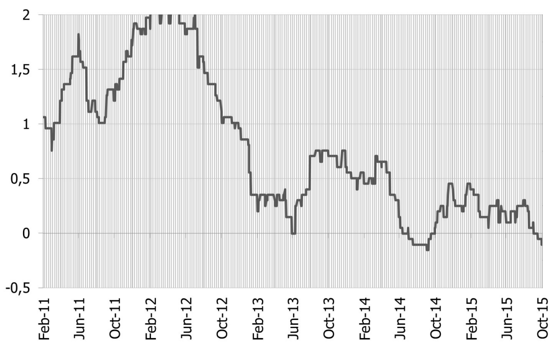
Polish data to watch: October 19th to October 23th

Publication	Date	Period	mBank	Consensus	Prior
Sold industrial output y/y (%)	19.10	Sep	4.8	4.0	5.3
PPI y/y (%)	19.10	Sep	-2.9	-2.8	-2.7
Retail sales y/y (%)	19.10	Sep	1.2	1.4	-0.3
MPC Minutes	22.10	Oct			
Consumer confidence	22.10	Oct			
Business confidence	22.10	Oct			
Unemployment rate (%)	23.10	Sep	9.8	9.9	10.0

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	10/29/2015	1000	1.770	9/24/2015
5Y T-bond PS0720	10/29/2015	3000	2.317	9/24/2015
10Y T-bond DS0726	10/29/2015	2000	3.076	9/10/2015
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Unchanged after the week - a downside surprise in CPI data was matched by a positive surprise in wage data. Polish surprise index hardly moved in recent months, though. Next week offers several chances for the index to resume its movement: industrial output, PPI and retail sales.

* 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).

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Our view in a nutshell

Fundamentals

- GDP growth is set to stay close to 3% per annum.
- Downside risks prevail near term. However, until only selected business tendency indicators are decreasing, Poland is expected to escape a deeper slowdown. Exports is going to be weaker due to international developments, investment activity may be negatively affected by the unanticipated fall of future demand. At the same time consumption is to maintain 3% growth (labor market is tight, households have resources to smooth consumption over time). The schedule for infrastructure spending suggests a steep path of outlays from the turn of 2015/2016 onwards. At this stage it is more likely that outlays will be postponed for later part of 2016.
- Given the schedule of infrastructure spending and stable consumption growth, many years of economic expansion are still 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.
- 3% growth is sufficient to keep inflation and credit risk in check. Global headwinds and low commodity prices are set to further underpin deflationary environment. Headline inflation is going to slowly rise only on the back of statistical base.
- NBP rates stable or lower as upcoming MPC may be more dovish and start its tenure in weaker macroeconomic environment.

Financial markets

- We closed our long 10y bonds recommendation booking 40bp of profit and turn neutral. Once again we decide to step aside mostly to protect profit.
- We think that POLGBs may still have potential mid-term. However, hopes for global stimulus (e.g. fiscal one in China) are flying high while lots of forecasts have been recently downgraded leaving small potential for further downscaling. Locally, one additional cut is priced in in 2016. At this very stage one needs lots of imagination to come up with more and elections are looming fast with some investors eager to take profit just before. That is why we think that it may be wise to stay on the sidelines for a while.
- Pro-active ECB stance should be enough to shield the zloty from sharp depreciation in case of higher risk aversion. In such circumstances stable growth story is going to be enough to trigger positive differentiation flows. Local problems remain unsolved, though. We neutralize our outlook for the zloty betting on the middle of interval 4.10-4.30.

mBank forecasts

	2011	2012	2013	2014	2015F	2016 F
GDP y/y (%)	5.0	1.6	1.3	3.3	3.3	3.1
CPI Inflation y/y (average %)	4.3	3.7	0.9	-0.1	-0.8	1.5
Current account (%GDP)	-4.9	-3.5	-1.3	-1.2	-0.6	-1.0
Unemployment rate (end of period %)	12.5	13.4	13.4	11.5	10.0	8.9
Repo rate (end of period %)	4.50	4.25	2.50	2.00	1.50	1.50

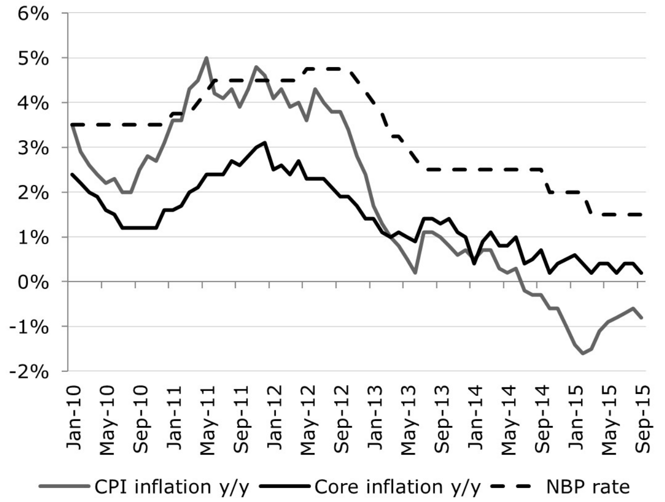
	2015 Q1	2015 Q2	2015 Q3 F	2015 Q4 F	2016 Q1 F	2016 Q2 F	2016 Q3 F	2016 Q4 F
GDP y/y (%)	3.6	3.3	3.1	3.1	3.0	3.0	3.1	3.2
Individual consumption y/y (%)	3.1	3.0	3.0	3.2	3.2	3.3	3.2	3.0
Public Consumption y/y (%)	3.3	2.4	2.5	1.5	1.5	1.5	1.5	1.5
Investment y/y (%)	11.4	6.4	6.5	5.5	4.5	6.5	7.0	7.0
Inflation rate (% average)	-1.4	-0.9	-0.7	-0.2	0.6	0.7	0.8	1.2
Unemployment rate (% eop)	11.7	10.3	10.0	10.0	10.6	9.4	8.9	9.0
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Wibor 3M (% eop)	1.65	1.72	1.72	1.72	1.72	1.72	1.72	1.72
2Y Polish bond yields (% eop)	1.61	1.99	1.70	1.70	1.70	1.75	1.80	1.85
10Y Polish bond yields (% eop)	2.31	3.31	2.90	2.80	2.80	2.90	3.00	3.00
EUR/PLN (eop)	4.07	4.19	4.24	4.15	4.15	4.10	4.10	4.05
USD/PLN (eop)	3.80	3.76	3.78	3.77	3.84	3.90	3.90	3.86

F - forecast

Economics

Fifteenth month of deflation. Core inflation back to multi-year lows.

In September Polish yearly CPI fell from -0.8% from -0.6% month before, just as indicated by flash release. The main reason for this was a drop in core inflation - we expect that it has fallen from 0.4% y/y to 0.2% y/y. Food prices category has deviated from its 3 -year seasonal pattern and grew to 0.7% on a monthly basis. We have correctly foreseen this one - off effect of earlier price adjustment (switch from "summer season" to "fall season").

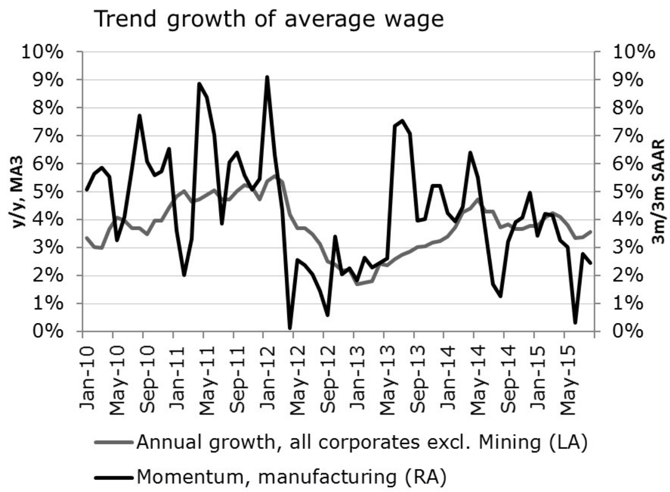


A quick glance at the details of the release suggests that there was a sharp drop in fuel prices (-4.8% m/m) and a decline in Recreation and culture prices (-1.8% m/m). The latter is a result of lower textbook prices, seasonal declines in package holiday prices and another downward correction in prices of cable TV services. Other categories retained their seasonal patterns.

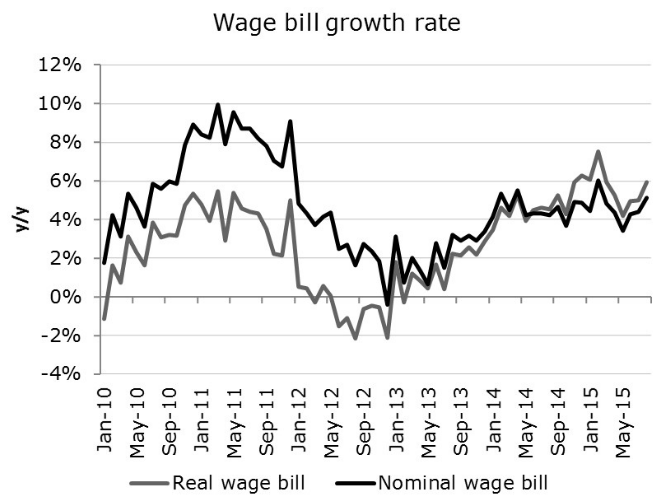
Given the broadly deflationary environment, one cannot count on inflationary momentum in the coming months. Inflation is set to rise only due to base effects (huge declines in fuel prices in late 2014). Thus, we stand firm by our view on NBP rates. The likely delay in US rate hikes increases the likelihood of a cut in Poland. In such an environment the Polish yield curve should be steepening.

Labor market data firmly in trend.

In September average wage growth increased from 3.4 to 4.1% y/y, above market consensus and a bit closer to our forecast (3.3 and 3.7%, respectively). In our opinion (based on the analysis of detailed wage data from the previous months) the acceleration in wage growth can be attributed to a snap-back in several categories of services (hotels and restaurants, information and communication, real estate) after a weak August as well as higher manufacturing wages. Even though the arrangement of statistical bases suggests that October could see a drastic drop in wage growth, the general trend in wages remains firmly in the 3.5-4.0% range.

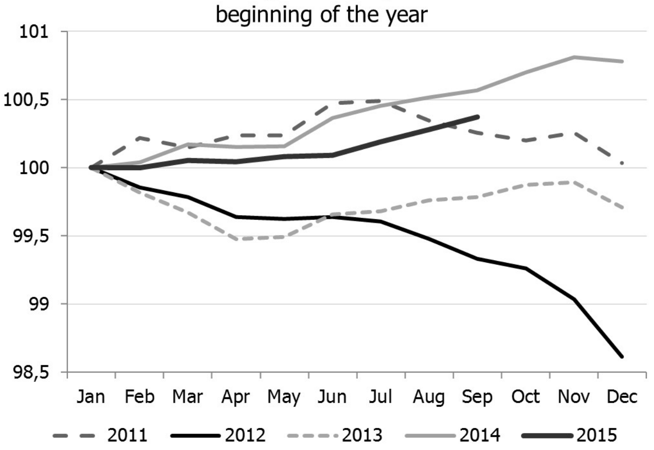


Due to the acceleration in nominal wage growth and slightly lower inflation, wage bill has grown at a fastest rate in six months, i.e. 5.1% in current prices and 5.9% in real terms. We do not see the recent gyrations in wage bill growth as indicative of any changes in consumption trajectory. The marginal increases in real income are probably saved at this point. As a result, September labor market data support our forecast of 3% consumption growth. This will only be challenged if the projected increase in inflation is not matched by a commensurate acceleration in nominal wage growth.



Employment in enterprise sector grew in September by 1% y/y (in line with market consensus and our forecast). On a monthly basis 5k jobs were created. This is third month in a row with such employment increase and we expect that companies will keep on employing at this very pace in the upcoming months. This of course means flat annual reading close to the recent one.

Cumulative change in employment since the beginning of the year



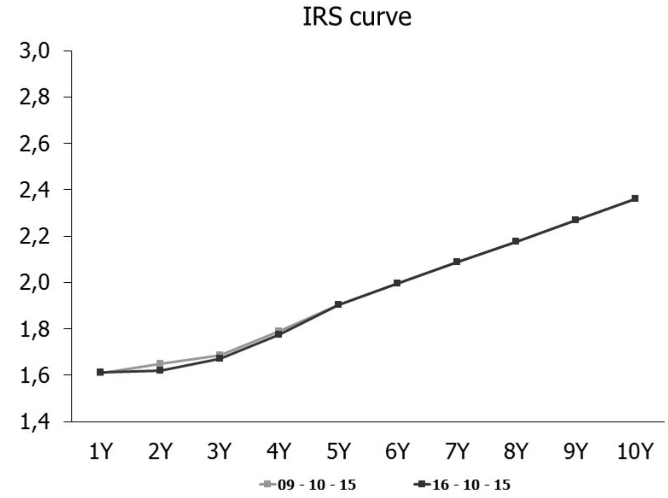
Labour market data is of course completely neutral for Polish monetary policy. We think that changes in activity in global economy are strong enough to influence inflationary processes via investor sentiment (low commodity prices and support for global deflation). On the other hand they are too weak to affect Polish labour market throughout alterations of GDP growth (only flatter but no meaningful slowdown). Labour market should continue tightening. However, because of additional labour supply from the East (Ukraine) we do not expect sharp rise in wages, not even mentioning acceleration of inflation in the aftermath.

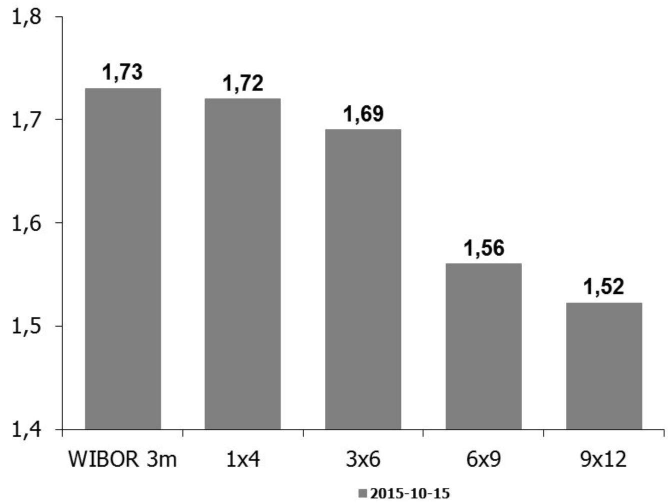
Fixed income

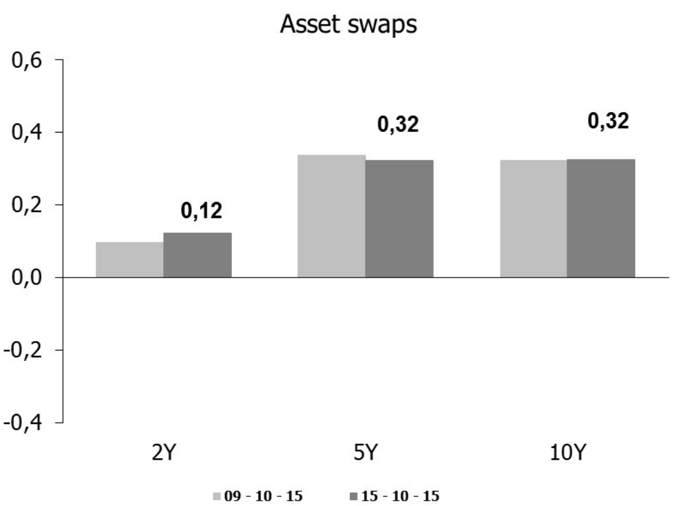
Pre-election

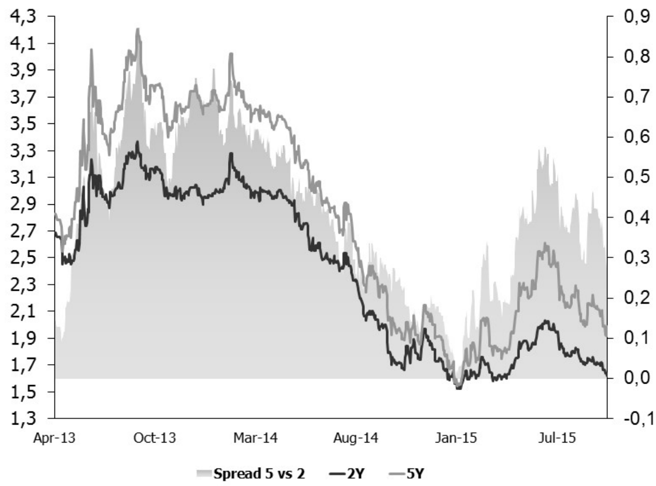
Seems like foreign investors are neglecting the potential deterioration in domestic bond market ahead of broadly expected victory of pro-social spending Law and Justice party. With all they promised in the pre-election campaign (retirement age decrease, subsidies for families with two or more children, introduction of tax on assets for financial institution or a levy on financial transactions) one could expect at least real jeopardy to the central budget or even total collapse of financial markets in Poland. Surprisingly, the picture looks brighter than anybody could predict. Moreover, it looks like investors have given the populists some kind of confidence vote – that they would not decide to deliver what they have promised. As a result, the domestic bond market is doing as well as the current outside mood allows for it. As long as the ECB is expected to deliver more monetary stimulus and the Fed has happened to be so shy in lifting rates, we would expect the PLN yield curve to mirror the downward trend in core market rates. On the other hand one should keep in mind that the unbelievable and highly destructive for the banking sector CHF mortgage conversion bill has made it as far as to the upper House of Parliament.

Concluding. . . As the yield curve is going down, the 5y fixed is trading slightly over the 6M Wibor and long-term PLN/EUR spreads are tightening, we could see growing risk that the long-term yield curve might be hit badly if only half of the pre-election promises were delivered. Tax on financial institutions and/or transaction levy might be even more destructive and hit the market liquidity. Keeping in mind the last CPI reading and quite justified appetite for more easing next year, we prefer to enter a 2y10y steepener as an Autumn strategy.





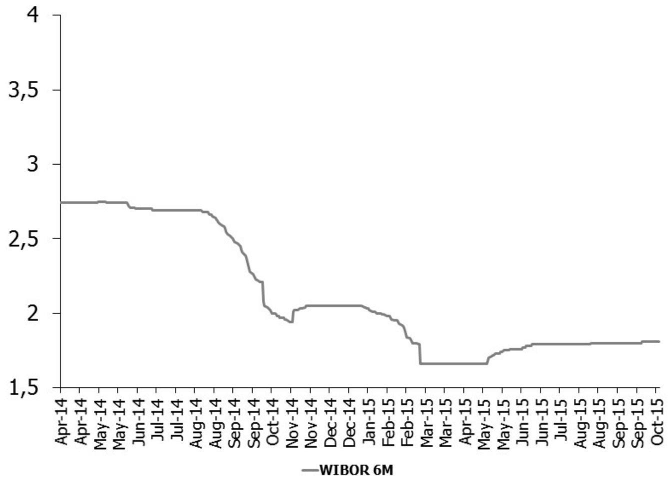


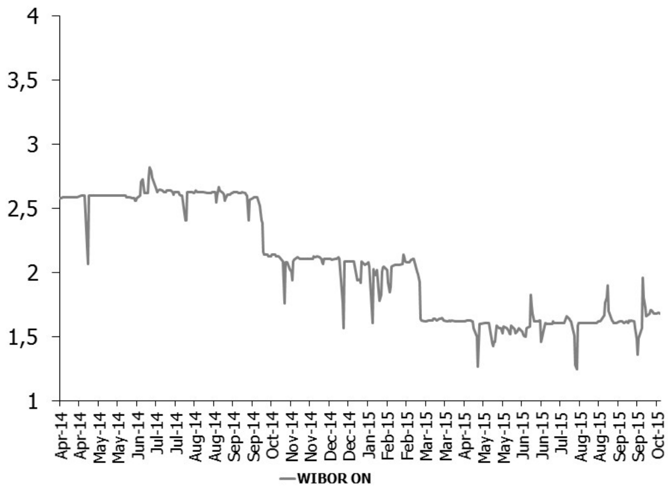


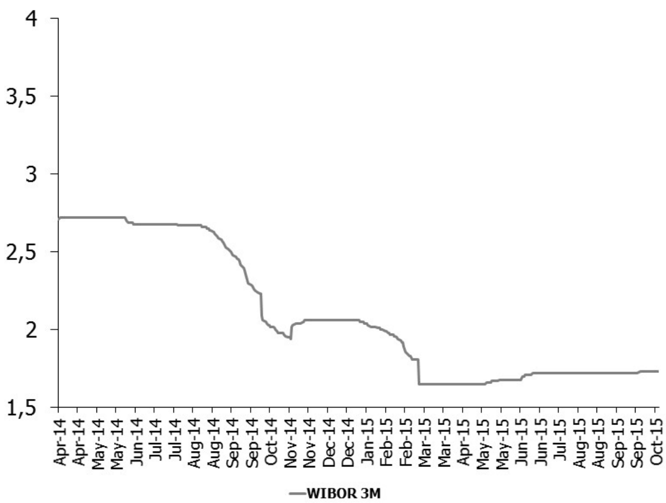
Money market

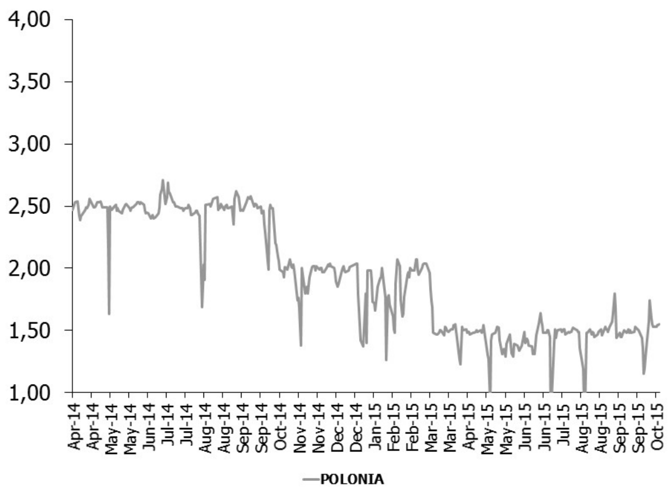
Coupon washing

We had another stable week on the money market. Polonia fluctuated slightly above 1.50% and that should continue till the end of the month. The end of the reserve period comes at Friday and that supports rather high overnight's even on the last week. On the other hand we have coupons from October bonds and maturity of DS1015 coming wich will add some disruption to market.









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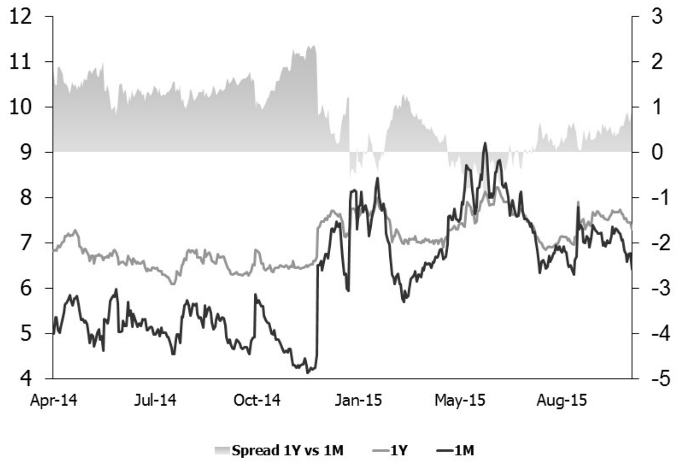
Forex

PLN – weaker The 4.2150 was the low in EUR/PLN this week. The pair was drifting higher (4.2420 high) without any specific reason. The political risk coming from Parliamentary elections in Poland (25th Oct), was widely heralded as overdone by leading world's bank. We hope that is right, but we will not like to get too long PLN ahead of elections. The election fever may provoke politicians to act/say things that, will rock the PLN a bit. In general we are still believers in rangy nature of EUR/PLN (currently 4.17-4.27), but as Law and Justice (Euro skeptical party) is in the clear favor in the polls, we trim our PLN longs for time being.

EURPLN volatility



Options – on bids on horizon We had another week of heavy supply; even post-election dates were offered quite aggressively. 1 month EUR/PLN mid is this Friday at 6.2% (0.2% lower), 3 months are 6.5% (0.2% lower), and 1 year is fixing at 7.1% (also 0.2% lower). So the drag down for EUR/PLN vol was quite parallel. The USD/PLN vols were trying to revert it's losses as the market realized that 2 month already covers December FOMC. The skew is roughly unchanged.

Short-term forecasts

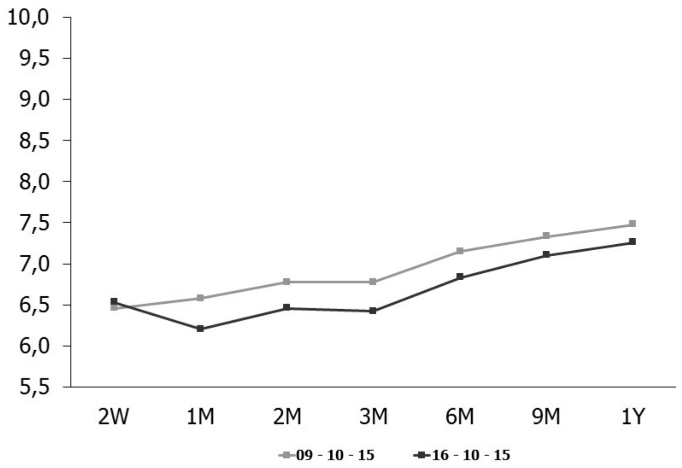
Main supports / resistances:
EUR/PLN: 4.17 / 4.27
USD/PLN: 3.60 / 3.85

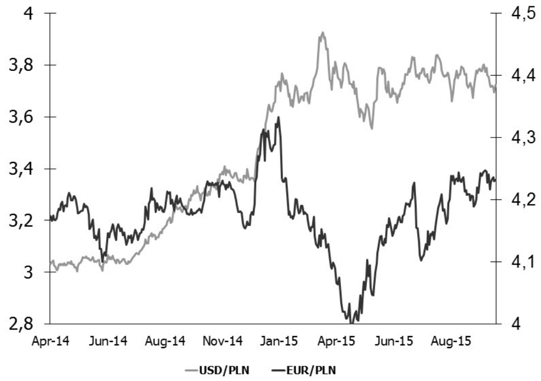
Position Our short EUR/PLN from 4.2550 was closed at 4.2350. Current position - sidelined.

We expect volatility to pick up as politicians will become more vocal. And even if everything is going to boil down to business as usual after elections, there should be some political related volatility. We prefer to be sidelined for the event with nimble approach. We would rather try to fade extreme swings either way.

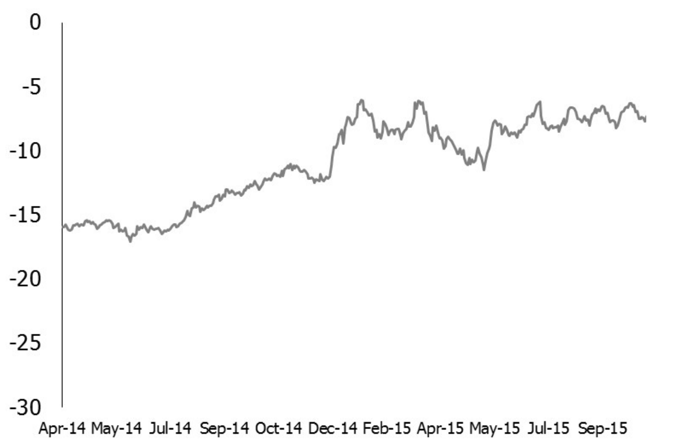
Options The vols keep on sliding, and we are forced to rethink our strategy. We have already trimmed our USD/PLN long vol position. The rate hike in the U.S. is like running rabbit and we are kind of bored trying to catch it. We keep on to EUR/PLN long in Vega as we are one week away from Parliamentary Elections and we would like to see the results before taking final decision.

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
10/8/2015	1.63	1.73	1.71	1.71	1.79	1.74	1.72	1.69	1.54	1.50	1.52	1.57
10/12/2015	1.61	1.73	1.69	1.71	1.72	1.74	1.72	1.69	1.56	1.52	1.53	1.59
10/13/2015	1.62	1.73	1.83	1.71	1.73	1.74	1.72	1.70	1.59	1.53	1.55	1.64
10/14/2015	1.52	1.73	1.60	1.71	1.63	1.74	1.72	1.70	1.57	1.53	1.54	1.62
10/15/2015	1.75	1.73	1.83	1.71	1.74	1.74	1.72	1.69	1.56	1.52	1.53	1.59

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
10/8/2015	1.740	1.626	1.615	1.751	1.875	2.217	2.335	2.671
10/12/2015	1.740	1.610	1.638	1.742	1.925	2.268	2.380	2.682
10/13/2015	1.740	1.728	1.658	1.778	1.952	2.325	2.415	2.765
10/14/2015	1.740	1.730	1.645	1.731	1.927	2.260	2.387	2.702
10/15/2015	1.740	1.715	1.621	1.744	1.905	2.228	2.360	2.684

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
10/8/2015	6.76	6.91	7.16	7.55	7.55	2.12	0.57
10/12/2015	6.75	6.81	7.11	7.45	7.45	2.12	0.57
10/13/2015	6.78	6.85	7.13	7.45	7.45	2.08	0.53
10/14/2015	6.41	6.61	7.00	7.30	7.30	2.07	0.53
10/15/2015	6.20	6.43	6.83	7.25	7.25	2.07	0.53

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
10/8/2015	4.2405	3.7543	3.8772	3.1346	1.3558	0.1565
10/12/2015	4.2273	3.7148	3.8644	3.0914	1.3596	0.1559
10/13/2015	4.2336	3.7199	3.8716	3.1071	1.3601	0.1560
10/14/2015	4.2365	3.7129	3.8819	3.1088	1.3610	0.1562
10/15/2015	4.2295	3.6948	3.8930	3.1220	1.3636	0.1561

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