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Polish Weekly Review

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Comment on the upcoming data and forecasts

The post-election week will be rich in news but light in terms of economic data. On Friday, the Central Statistical Office will publish the flash CPI reading. We expect annual inflation to inch upward (from -0.8 to -0.7% y/y), mainly on base effects. Low fuel and food prices, as well as stable core inflation are keeping CPI firmly in the negative territory.

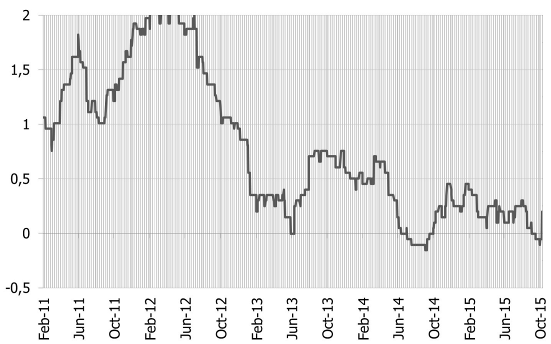
Polish data to watch: October 26th to October 30th

Publication	Date	Period	mBank	Consensus	Prior
NBP inflation expectations (%)	30.11	Oct	0.2	0.2	0.2
Flash CPI y/y (%)	30.11	Oct	-0.7	-0.6	-0.8

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	10/8/2015	1000	1.770	9/24/2015
5Y T-bond PS0720	10/8/2015	3000	2.317	9/24/2015
10Y T-bond DS0726	10/8/2015	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

Sharply up after the final unemployment data showed that unemployment rate dropped much more than expected. As a result, the index regained a lot of its losses from the previous weeks. The flash CPI next week is unlikely to move Polish surprise index in a significant way.

* 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.
- We expect lower rates in 2016 as the new MPC is set to be more responsive for weaker environment amid global trends for monetary stimulation. Moreover, the new parliament is set to have inclination towards selecting more dovish MPC members.

Financial markets

- Still neutral (cash) ahead of general elections.
- We think that POLGBs may still have potential mid-term as monetary stimulus is waiting in the wings and the expected coalition government is likely to push for easier monetary policy that ultimately will be delivered.
- Pro-active ECB stance should be enough to shield the zloty from sharp depreciation in case of higher risk aversion. We see zloty stronger mid-term on solid growth story and differentiation flows. Political risk and potential for easier monetary policy may linger for some days due to general elections on Sunday. Therefore we expect the weaker side of the range (4.25-4.40) to be dominant near term.

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	1.00

	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	1.25	1.00	1.00	1.00
Wibor 3M (% eop)	1.65	1.72	1.73	1.70	1.44	1.20	1.20	1.20
2Y Polish bond yields (% eop)	1.61	1.99	1.76	1.45	1.30	1.13	1.20	1.28
10Y Polish bond yields (% eop)	2.31	3.31	2.84	2.50	2.40	2.23	2.30	2.38
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

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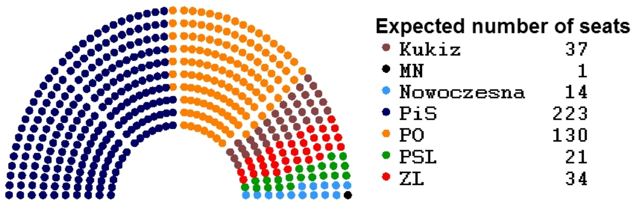
Economics

Forecasting the 2015 parliamentary elections in Poland

We took an in-depth look into the upcoming parliamentary elections in Poland. It was based upon a detailed review of all national opinion polls from the past six months and a proprietary algorithm for simulating the distribution of seats in the lower house of parliament using constituency-level data. The algorithm has been back-tested (errors in the range of 1-2 seats). Our final result indicates that Law and Justice party (PiS) is set to dominate the new Sejm with 223 seats. The new parliament is also very likely to be the most fragmented one since the 90s (six parties – see the graph).

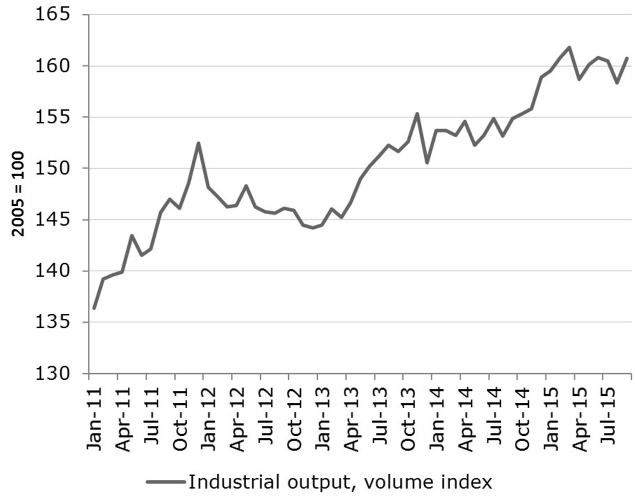


PiS, as a victors, is to be granted a mission to form the new government and we think it will be a successful attempt, either by forming a coalition with one of the smaller parties (Kukiz'15 is the most likely junior partner), or by capturing MPs from other parties.

Such scenario implies a dovish MPC lineup and a shift in NBP policy towards the Hungarian model. As a result, the new round of rate cuts is now our baseline scenario. The implications for Polish financial assets are somehow ambiguous. While the short end of the curve will benefit from the expected rate cuts, the impact on the long end is far from certain. On the one hand, global trends and overwhelming push for monetary easing clearly and consistently favor low long-term interest rates. On the other hand, the textbook reaction of bonds on possible fiscal expansion is negative. Steeper yield curve is to be expected then. In our preferred scenario zloty stays moderately weaker for some time on political risk and rate cuts. Mid-term, however, record high monetary stimulation in global economy and ensuing hunt for non-zero yielding currencies coupled with still attractive GDP growth profile of the economy should attract buyers of domestic currency.

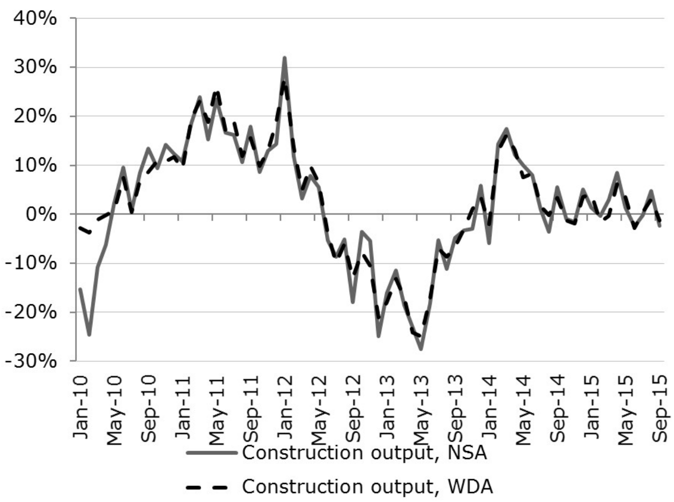
Industrial output and retail sales are catching up - but nothing more. Deflation on the producers' side is deepening.

Industrial output grew by 4.1% y/y in September, close to market consensus and slightly below our forecast (4.0 and 4.8%, respectively). The slowdown relative to previous month is the result of an interplay of three factors: unfavorable working day difference (0 vs +1 y/y), high statistical base in car production and catching up after a disastrous August. The latter pertains to those industries whose output was depressed by power outages, logistical problems and reduced labor productivity. On a monthly basis, output increased by 1.5%, matching August's decline.

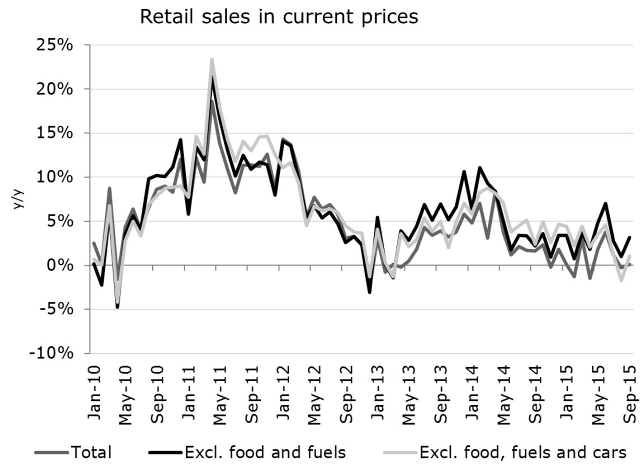


Seen in a broader perspective, Polish industry remains in stagnation. Output is still below the cyclical peak from March '15, current momentum is precisely zero. Prospects of acceleration in industry are meagre - global economy is slowing down, the VW scandal will weigh negatively in CEE industries. In addition, the series of high statistical bases from the previous year will make such an acceleration very difficult.

Construction output declined by 2.3% y/y below our forecasts and market consensus (-0.1 and 1.1% y/y, respectively). The slowdown itself is not a surprise given the arrangement of statistical bases - that factor alone shaved off at least 4 percentage points from the annual growth rate. A true measure of construction's vitality is the m/m growth rate, amounting to -1.2%. Given the on-going strength of residential construction, it is difficult to accurately pinpoint the reasons for the surprise - perhaps non-residential construction and civil engineering (late start to new round of public investment projects) is to blame.



Retail sales barely rose in September (+0.1% y/y); the outcome was worse than forecast. We failed to see a reacceleration of food sales (only 3.1% y/y) and seasonal effect in wearing apparel was rather weak (10% y/y). On the other hand, auto sales was decent (13.6% y/y); we saw some turnaround in „other" category which arrested the almost constant fall in annual growth rate. Obviously, we saw large, dampening effect of low fuel prices on fuel sales (to be continued, although in lesser extent in October). The aforementioned growth rates, this month lower, the other slightly higher, are irrelevant as far as big picture goes. Stripping sales from volatile prices (food, auto sales, fuels) leaves impression of almost zero growth momentum. At this very moment it seems to be the correct line of thinking. Real sales growth is slightly falling but we do not think it is going to considerably affect private consumption since consumer sentiment is high, real wages are running record high and services prove to be a very efficient smoothing factor.



Producer prices fell in September by 2.9% y/y, in line with our forecast but slightly lower than market consensus (2.4% y/y) after falling by 2.8% y/y in August. Three categories were mostly responsible for this month's fall: manufacturing of coke and refined petroleum (both fell by 3.1% mom) as well as mining of coal and lignite (2.2% mom fall). However, mining section rose on a monthly basis (opposite to August) because of a sharp increase in mining of metal ores (5.0% mom). Core manufacturing prices has still zero or negative momentum. Taking into account global deflationary environment, we do not see any inflationary pressure in this part of supply chain.

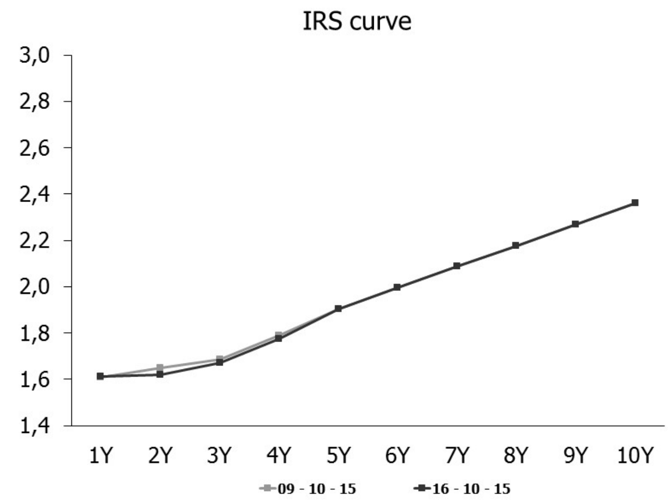
September data should be regarded as neutral. Some losses have been made up, although the economy clearly lacks momentum. GDP growth is unlikely to exceed 3.1% y/y in the final quarters of the year. With latest GUS revisions in mind, GDP gap is wider than thought while deflationary pressures in the global economy are fierce. In such circumstances rates should stay low. We assess the probability of rate cuts in 2016 at 50%. However, parliamentary elections fever is the name of the game at this very moment - we deal with this issue in greater detail in a separate text.

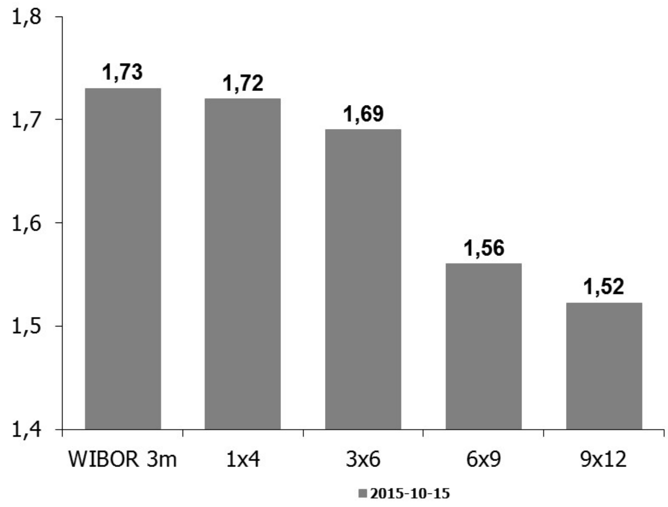
Fixed income

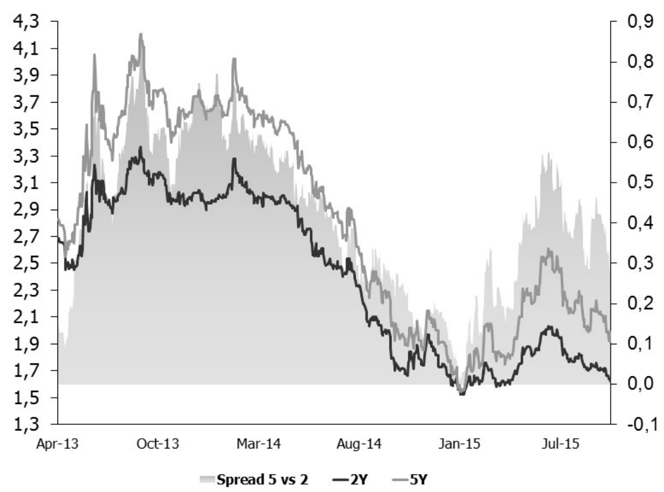
Changing of the guard

Last week Polish FI market was following the current global trends in general. Investors seemed to ignore probability of Law and Justice general election victory with all of the accompanied risks and after ECB released more bullish statement they started to buy longer bonds and sell swaps. As a result the yields went down by 8-10 bp along the curve. We also faced receiving interests in the front end, after L&J leaders announced that they would force new MPC to cut interest rates by another 25-50bp and Central Bank to launch LTRO to give more liquidity into Polish banks in order to push corporate loans.

In our opinion that's too early to price any potential rate moves. Moreover, we don't like influencing MPC members as it looks a bit non constitutionally. Concluding. 8 years of Civic Platform reign is supposed to be over. We think after L&J victory sooner or later the yield curve should stay under steepening pressure as new government will start to execute its pre-election pro-social promises (both president and parliament to have enough power to introduce almost everything) what would very likely hit the public debt. We would keep our 2y10y steepener strategy for the time being.



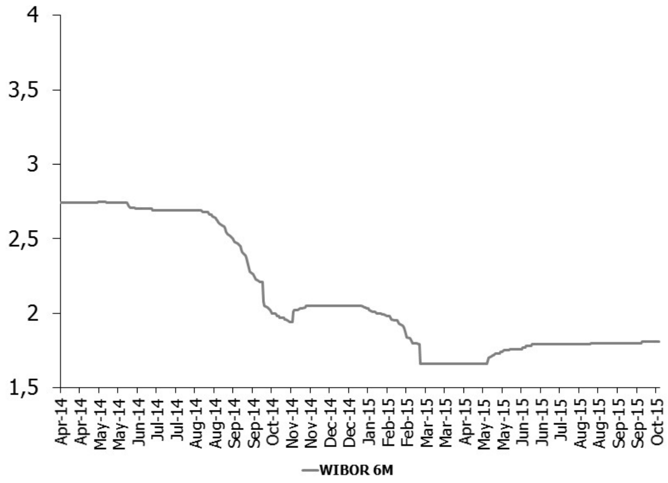


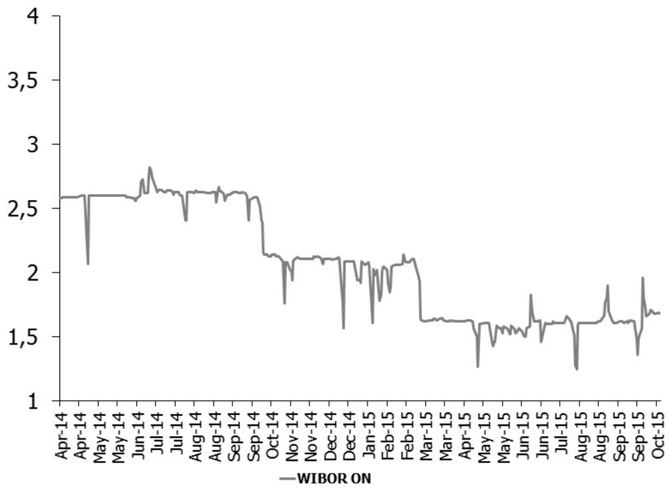


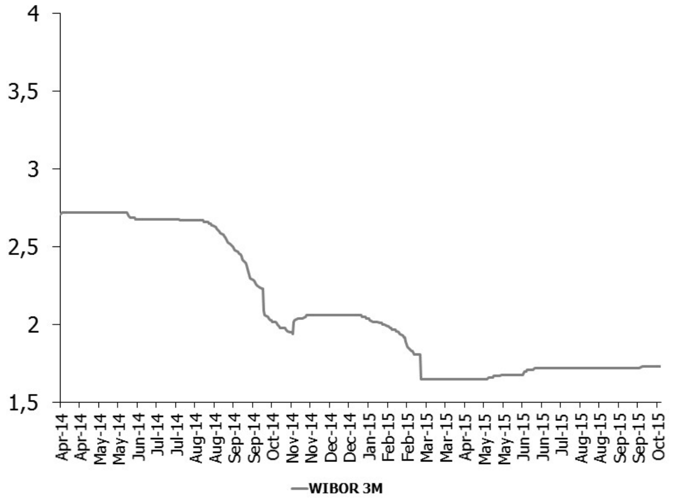
Money market

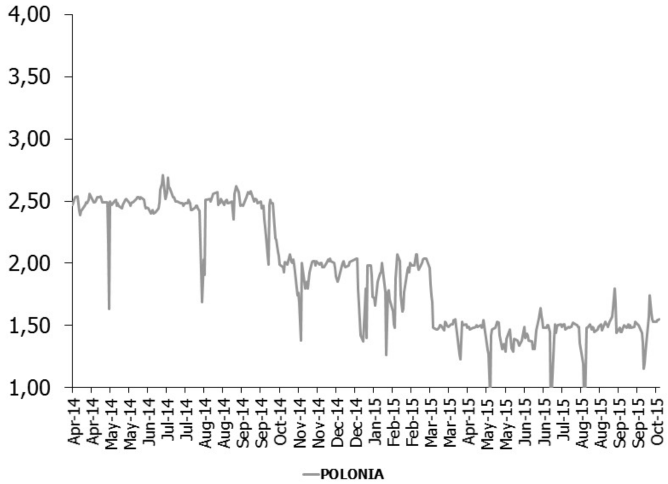
Coupon washing

Coupon washing behind us and ON steady at lower lvls. We head into month end which may be tricky. Last day of reserve period comes at Friday therefore banks may be tempted to buy as much bills as possible. On the other hand we have elections and flow from coupon on Monday which will argue for leaving some liquidity at banks.





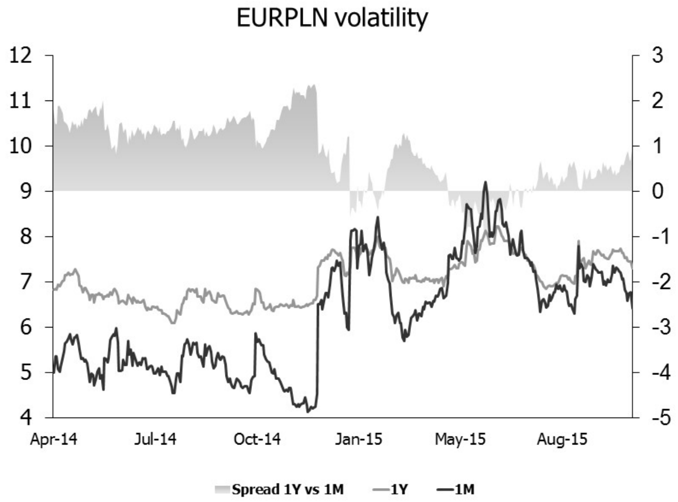




Forex

PLN – Political risk vs ECB In the first part of the week the PLN was losing ground rapidly as political uncertainty because of parliamentary elections was mounting. EUR/PLN had reached as high as 4.2970 before we eventually started to see sellers. On Thursday ECB has announced its dovish note that made the sentiment for EM much warmer in the blink of an eye. As a result EUR/PLN dropped to 4.2410 before slightly rebounding. The political risk is still there, but no one seems to care. We stick to our mantra of rangy nature of EUR/PLN, and expect 4.22/4.29 range for time being, with spikes above 4.30 likely worth fading.

Options The buyers of vols came back with a vengeance. It started slowly with slightly higher bids, but we finally saw 1 month EUR/PLN ATM traded 7.0% (0.8% higher than last Friday). 3 months are 6.8% mid (0.3% higher) and finally 1y is fixing at 7.25% (0.15% higher). The Skew got paid, i.e. 0.85% paid 1 month 25d RR. Currency spread also got paid, as USD was again shining much brighter. The whole curve move up roughly 0.25%.



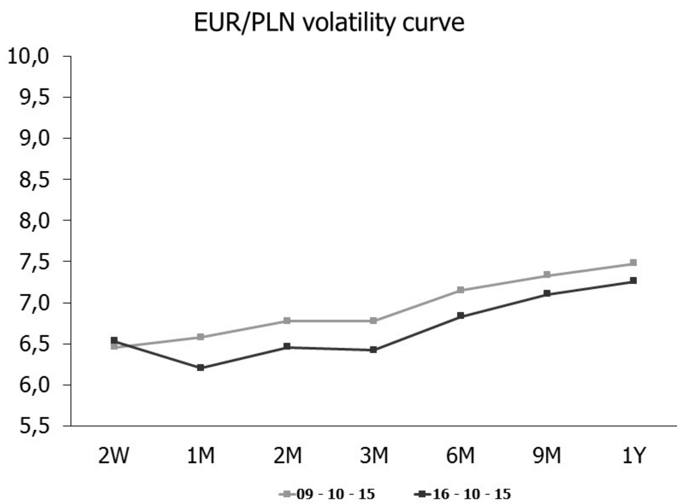
Short-term forecasts

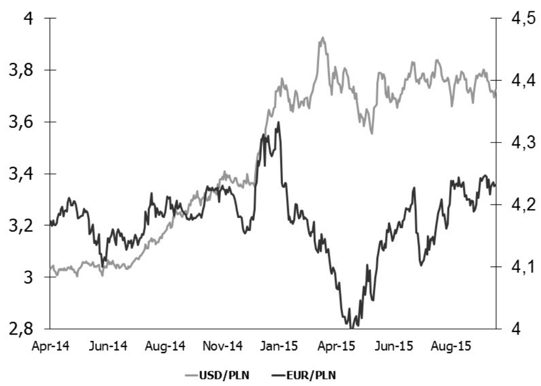
Main supports / resistances:
EUR/PLN: 4.22 / 4.32
USD/PLN: 3.65 / 3.90

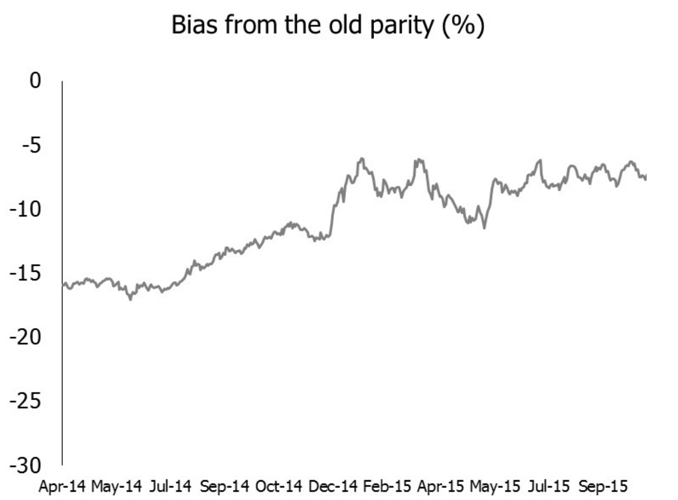
Position Spot – still sidelined.

We are trying to trade opportunistically in current stormy waters. We stick to general idea of the rangy nature of EUR/PLN , currently 4.22/4.29. The move outside this range we consider as overdone and worth fading unless there is some really good excuse for that. We expect that volatility will persist until the new government constitutes.

Options Finally a week where owning Gamma was really a lucrative thing. We expect it will be worth holding for the most of next week, but not really sure how long it will last. Even the most negative political outcome of the elections will at least end uncertainty, and remove vol premia as a consequence. We still keep our long EUR/PLN Vega and Gamma position for a time being.







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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
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
10/19/2015	1.61	1.73	1.67	1.71	1.77	1.74	1.71	1.69	1.56	1.52	1.54	1.59
10/20/2015	1.71	1.73	1.66	1.71	1.77	1.74	1.74	1.69	1.59	1.54	1.56	1.60
10/21/2015	1.48	1.73	1.55	1.71	1.67	1.74	1.72	1.68	1.54	1.51	1.54	1.58
10/22/2015	1.75	1.73	1.83	1.71	1.73	1.74	1.71	1.65	1.48	1.43	1.44	1.51

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
10/15/2015	1.740	1.715	1.621	1.744	1.905	2.228	2.360	2.684
10/19/2015	1.740	1.700	1.629	1.743	1.915	2.274	2.367	2.701
10/20/2015	1.740	1.692	1.649	1.733	1.945	2.295	2.405	2.738
10/21/2015	1.740	1.660	1.634	1.716	1.935	2.268	2.395	2.713
10/22/2015	1.740	1.660	1.555	1.689	1.847	2.196	2.317	2.650

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
10/15/2015	6.20	6.43	6.83	7.25	7.25	2.07	0.54
10/19/2015	6.21	6.26	6.68	7.13	7.13	2.07	0.54
10/20/2015	6.25	6.33	6.68	7.13	7.13	2.07	0.53
10/21/2015	6.75	6.73	6.91	7.24	7.24	2.07	0.57
10/22/2015	6.90	6.73	6.93	7.23	7.23	2.10	0.57

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
10/15/2015	4.2295	3.6948	3.8930	3.1220	1.3636	0.1561
10/19/2015	4.2342	3.7265	3.9097	3.1223	1.3691	0.1565
10/20/2015	4.2472	3.7385	3.9319	3.1280	1.3678	0.1568
10/21/2015	4.2745	3.7627	3.9411	3.1352	1.3730	0.1577
10/22/2015	4.2769	3.7806	3.9357	3.1573	1.3736	0.1580

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