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January 15, 2016

Polish Weekly Review

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Comment on the upcoming data and forecasts

Week begins with the official release of core CPI data - using last week's GUS release, we can surmise that core CPI stood at 0.2% y/y in December. On Wednesday the Central Statistical Office will release labor market data. We expect employment growth to edge up slightly in December, driven mostly by strong seasonal hiring and mild weather, while wage growth probably slumped due to high statistical base in manufacturing. Thursday marks the publication of trade and industry data. Due to base effects and negative payback from one-time surge in other transport equipment production, industrial production is forecast to decelerate mildly. The accompanying PPI data will show a marked acceleration (albeit PPI growth remains firmly in the negative territory) on the back of base effects (massive decline in energy prices in December 2014). Finally, retail sales probably grew slightly faster than in the previous month.

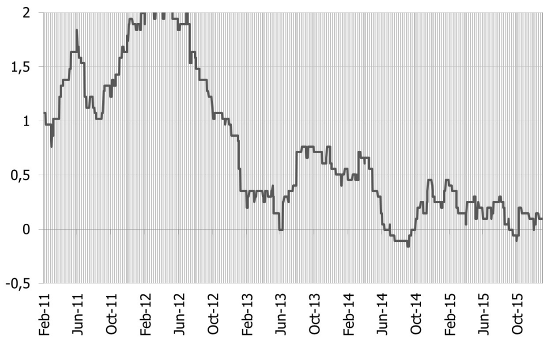
Polish data to watch: January 18th to January 22nd

Publication	Date	Period	mBank	Consensus	Prior
Core inflation y/y (%)	18.01	Dec	0.2	0.2	0.2
Average wage y/y (%)	20.01	Dec	2.9	3.7	4.0
Employment y/y (%)	20.01	Dec	1.3	1.2	1.2
Industrial output y/y (%)	21.01	Dec	6.5	5.4	7.8
PPI y/y (%)	21.01	Dec	-1.0	-1.0	-1.8
Retail sales y/y (%)	21.01	Dec	4.5	3.3	3.3

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	1/28/2016	1000	1.770	10/29/2015
5Y T-bond PS0720	1/28/2016	3500	2.382	1/7/2016
10Y T-bond DS0726	1/28/2016	2000	3.076	10/29/2015
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Final CPI data repeated *flash* release, so surprise index remained unchanged. Next week brings lots of opportunities to move the index: labour market data (Wednesday) and real shpere data (Friday).

* 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

- GDP growth perspectives brightened recently.
- 500+ program is set to support private consumption in 2015. At the same time, global headwinds do not seem to be detrimental for Polish exports (see constantly decent business activity in euro zone). Although public infrastructure outlays have shifted towards the latter part of 2016, private investment outlook brightened due to expected faster growth path and burst of consumer optimism.
- Given the current lags of infrastructure spending and constantly fueled consumption growth (child subsidy now, higher tax-free allowance from 2017), many years of economic expansion are our baseline scenario for the Polish economy. The upswing 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.
- Current GDP growth is sufficient to keep inflation and credit risk in check. Globally low to moderate growth amid low commodity prices are set to further underpin deflationary environment. Headline inflation is going to slowly rise only on the back of statistical base.
- Rate cuts in 2016 are still a possibility. Polish monetary policy is going to converge with the one run by the NBH. Therefore, we expect the newly elected MPC members to be more responsive to low inflation and government financing costs.

Financial markets

- Valuations of POLGBS (5Y and longer) look attractive already and credit risk looks overpriced again (local factors already led to sharp correction this week). Banks substituted NBP bills with short-end bonds, which are bank tax exempt.
- Wider ASW already improved attractiveness of POLGBs vs IRS. POLGBs cheapened vs DM and euro peripherals.
- Given the European low-yield environment, rate cuts expectations in Poland should not evaporate completely (although they may be more FX-dependent than previously believed, and the new MPC looks also less willing to cut rates aggressively than before) and a scenario of lower rates for longer should apply to Poland as well (that is why we suggest long end bonds).
- Given the current account and growth statistics zloty's attractiveness ranks just after the hungarian forint in the basket (PLN, HUF, TRY, ZAR, RUB). Other idiosyncratic factors including the political ones play negative card at the moment. Common risk aversion spoils demand for the whole basket of currencies. That is why we expect the zloty to stay weak in the coming months exploring levels close to 4.40.

mBank forecasts

	2011	2012	2013	2014	2015F	2016 F
GDP y/y (%)	5.0	1.6	1.3	3.3	3.5	3.6
CPI Inflation y/y (average %)	4.3	3.7	0.9	-0.1	-0.9	0.5
Current account (%GDP)	-5.2	-3.7	-1.3	-2.0	-0.6	-1.1
Unemployment rate (end of period %)	12.5	13.4	13.4	11.4	9.6	8.7
Repo rate (end of period %)	4.50	4.25	2.50	2.00	1.50	1.25

	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 (%)	3.7	3.3	3.5	3.5	3.5	3.5	3.7	3.8
Individual consumption y/y (%)	3.1	3.1	3.1	3.2	3.3	3.8	3.6	3.6
Public Consumption y/y (%)	3.7	2.5	2.7	1.2	0.5	2.0	2.0	2.0
Investment y/y (%)	11.5	6.1	4.6	4.0	6.0	7.0	7.5	8.0
Inflation rate (% average)	-1.4	-0.9	-0.7	-0.6	0.1	0.3	0.4	1.0
Unemployment rate (% eop)	11.5	10.2	9.7	9.6	9.8	9.0	8.6	8.7
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.25	1.25	1.25	1.25
Wibor 3M (% eop)	1.65	1.72	1.73	1.72	1.44	1.44	1.44	1.44
2Y Polish bond yields (% eop)	1.61	1.99	1.76	1.62	1.45	1.45	1.45	1.45
10Y Polish bond yields (% eop)	2.31	3.31	2.84	2.94	3.10	3.00	3.00	3.00
EUR/PLN (eop)	4.07	4.19	4.25	4.26	4.35	4.30	4.25	4.20
USD/PLN (eop)	3.80	3.76	3.80	3.92	4.18	4.22	4.25	4.08

F - forecast

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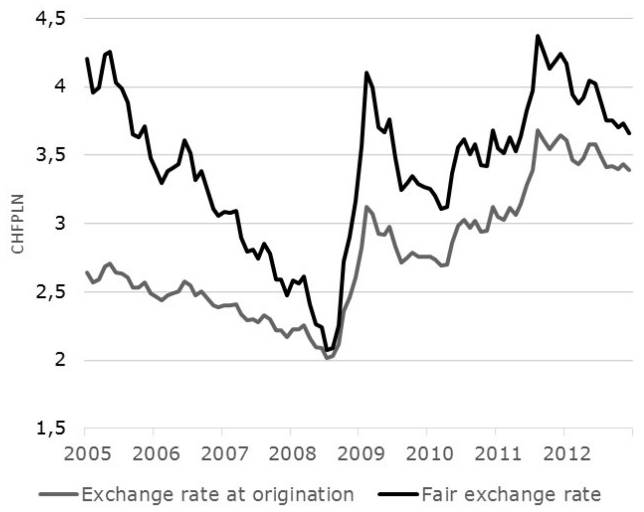
Economics

New FX loan conversion plan creates massive risks for the banking sector

The Chancellery of the President presented a new proposal on FX loan conversion. The plan consists of three pillars: (1) refund of fx spreads charged by banks; (2) conversion of CHF loans using the so called "fair" exchange rate; (3) conversion of mortgage loans into nonrecourse debt (so that the borrower can give up the property in exchange for debt cancellation).

We decided to calculate the approximate costs for the banking sector with the assumption that only the second pillar will be triggered. Compared to our crude calculations, the true „fair" exchange rate will be calculated individually as a ratio of the value of a hypothetical PLN loan adjusted for the benefits accrued thanks to lower installments on FX loans and current value of the individual's FX loan. The remaining installments of the FX loan would then be converted into PLN using the „fair" exchange rate and WIBOR3M interest rate. Micro-based calculations may prove little bit off ours, however, we got the total scale of adjustment pretty correctly and the results are presented below:



1. The "fair" CHFPLN exchange rate is universally above the origination exchange rate but much below the current spot CHFPLN. The average (weighted by origination) difference between the fair exchange rate and spot rate is 0.98 PLN. The difference between the fair exchange rate and the origination exchange rate is around 0.60 PLN.
2. For the overwhelming majority of borrowers the conversion would be beneficial. Those from the 2007-8 (the mortgage boom) would benefit the most.
3. If all CHF borrowers decide to convert their loans, total losses of the banking sector from writedowns would amount to 32 bn PLN, more than three times the total (after the new banking tax) profit of the sector.

Of course, the cost for each loan will be spread over its remaining life cycle, making writedowns themselves distributed over several years. Given the average duration of the credit, annual cost of around PLN 1.5bn can be considered. However, such a setup implies also that the banks will bear all the FX and interest rate risks, a problematic scenario form regulator's point of view (therefore a potent venue in upcoming valuations of the bill). Hedging those risks is a cost in itself.

This of course is the preliminary version of the bill, neither the MoF, nor the supervisor (KNF) and the NBP consulted the bill. No impact assessment has been prepared, either. It certainly looks costly (our estimate is understated) and difficult to implement in Polish institutional setup (the third pillar). In addition, the costs would spill over to the public through lower tax revenue, making the 2016 budget impossible to complete. There is also little enthusiasm for the conversion in the parliament and the government. All in all, the most likely scenario is that the first pillar (refund of FX spreads) is eventually implemented and its burden on the banks spread out over time.

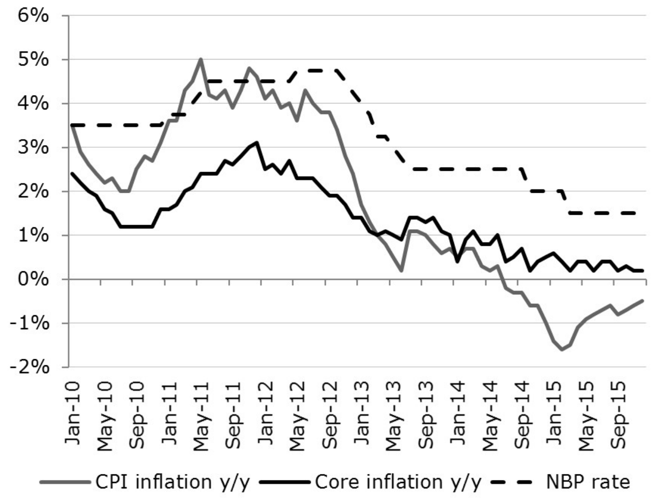
MPC keeps rates unchanged

During its last (in the old makeup) meeting the MPC acknowledged than no conclusions about economic development or inflation warranted any changes in NBP rates nor other monetary police parameters. Key points from press release were the following: divergence between monetary policy in the US and euro area, possible slowdown in emerging markets, stable economic growth in Poland with favourable labour market conditions and threat of lower inflation caused by low commodity prices. However, MPC will need March inflation projection to draw further conclusions. The conference following the meeting did not bring any additional information. There is no deviation from deep rooted and comfortable paradigm about optimality of current rates.

By the time the next NBP inflation projection will be released, most (8 out of 10) of the makeup will be changed (3 candidates were already appointed, 2 more are most likely to be chosen soon). This could be supportive to interest rate adjustment to combat the prolonged low inflation. We think that any rate cuts will be done in an opportunistic way. The Council will need to fit them into market sentiment (pressure on PLN) as well as current actions of other central banks (Fed hike timing and ECB decisions about the extent and duration of QE).

Polish deflation to last until September 2016

Polish CPI inflation amounted to -0.5% y/y, which matches the flash release. The reasons for persistently low price growth is still the same: further declines in food prices (-0.1% m/m – one of the lowest release excluding shocks) and fuel prices (-2.6% m/m). Core inflation, despite weakening of PLN since April 2014 (more than 10% total), remained at a record low (0.2% y/y).



January is another month with steep decline in fuel prices (this category could drop even by 4-5% monthly) and even taking into account a slight increase in fuel prices in 2016 further on, Polish CPI will return to positive values in... September. Of course we could discuss the influence of weaker Zloty on CPI basket and effects of rising wages and more expansionary fiscal policy. However, those arguments are now futile. Moreover, the scale of domestic competition could not be calculated exactly, thus taken into account. Exporters, which benefit from higher margins, are also often active on the domestic market as well, which in the end will dilute the exchange rate pass-through (we must exclude role of importers because of e.g. unknown effects of ”supermarket” tax).

When such calculations are pointless, markets and also the MPC will be reacting to current inflation releases. Even if low inflation will be called ”harmless”, rate cuts could find justification in such environment (see our comment on the MPC meeting).

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Fixed income

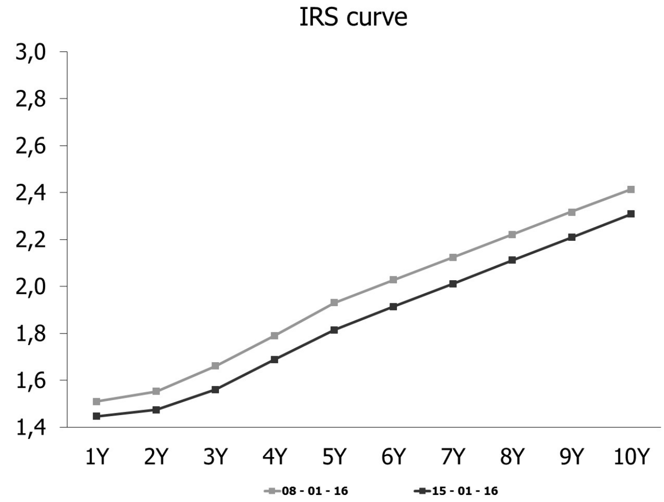
Disaster is coming

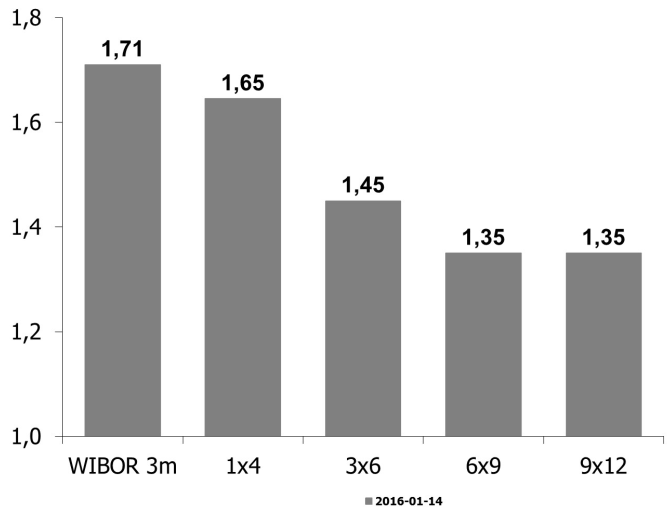
Well... It doesn't look good. After a huge rally on bonds and IRSs the market collapsed yesterday afternoon. This morning we did not get any prices on longer bonds for 2 hours on MTS. Liquidity looks poor.

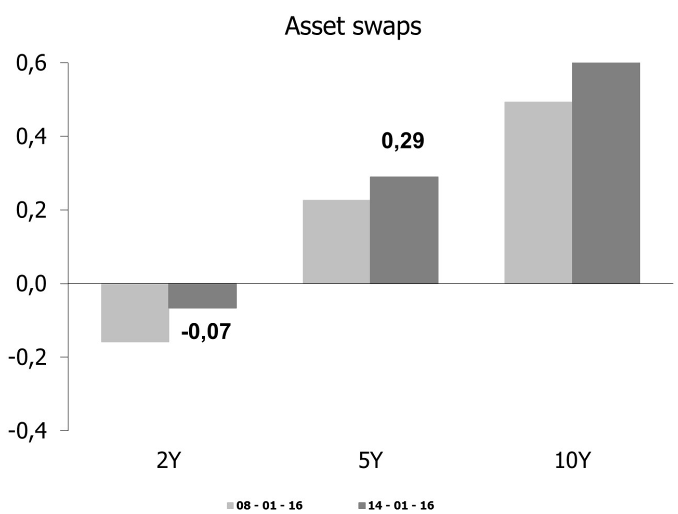
News from the parliament doesn't sounds optimistic as well. New bank tax is just waiting for President Duda signature with 0.44% rate on assets. His office also presented today the new proposal for CHF mortgages. It looks like banks will pay most of the cost of conversion.

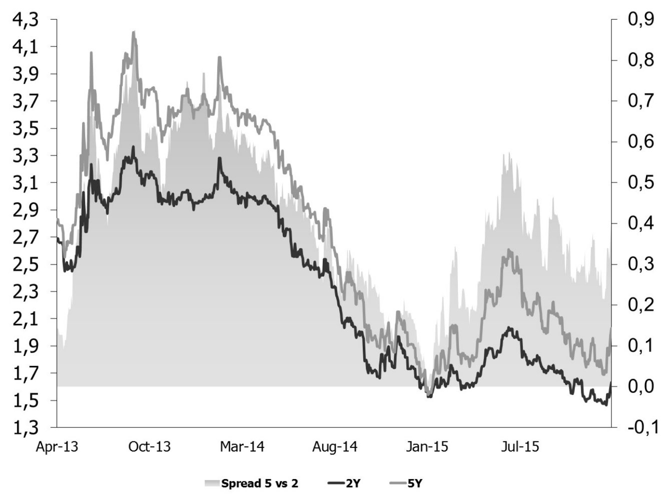
Now we are at levels where we were last Friday on bonds and 15 bps lower on longer IRSs. Derivatives discount now 80% probability of 50bps rate cuts until July. In our opinion they are not justified now especially due to fiscal loosening. Moreover, candidates to the new MPC are concerned about any monetary easing.

We are bearish on Polish long term bonds. We also see value in derivatives at especially the front end (1y1y). 12x15 FRA at 1.37 looks very optimistic from our point of view.









Money market

T - bills auction

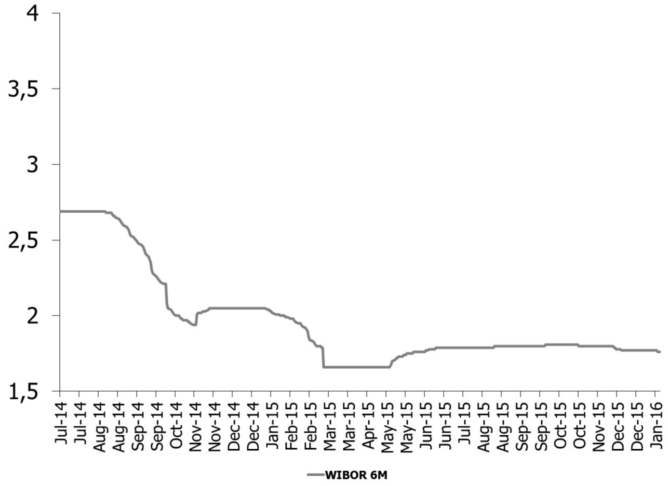
Introduction of Polish banking tax triggered rally on government bonds, which will be an attractive option for Polish ALM desks instead of buying NBP bills. Yields on short bonds stopped at around 1.30%, reflecting the desire to switch from NBP bills (taxed 0.44%) on the one hand and a liquidity premium (carry till first taxation period) on the other.

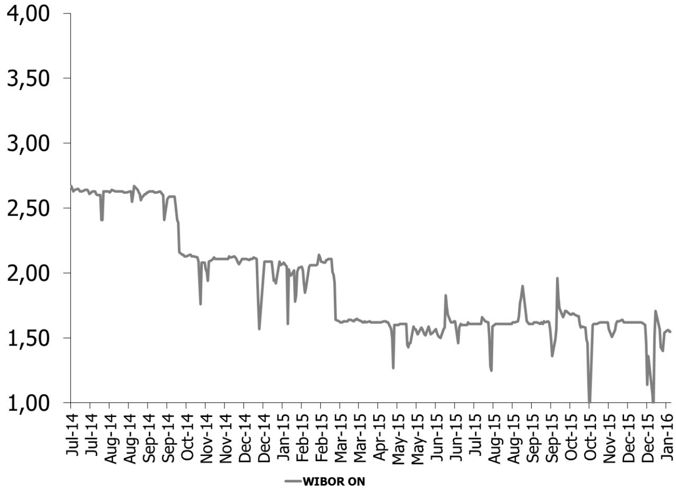
We are keen on buying these very short bonds (maturing in 2y max) if any opportunity arises. When we get closer to the end of February, more banks should switch for those instead of holding other assets. Possible delay in rate cuts, which is currently priced for 40bp in next 6 month, is a risk for this strategy. You can hedge it by buying corresponding tenor in OIS Polonia.

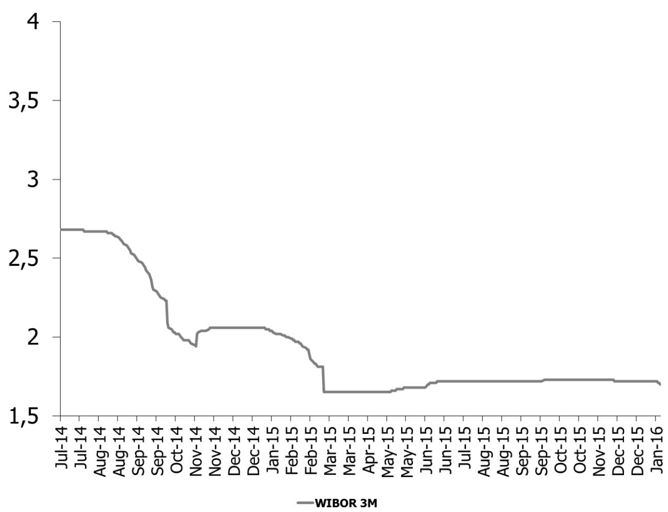
On Monday we have first in few years treasury bills auction.

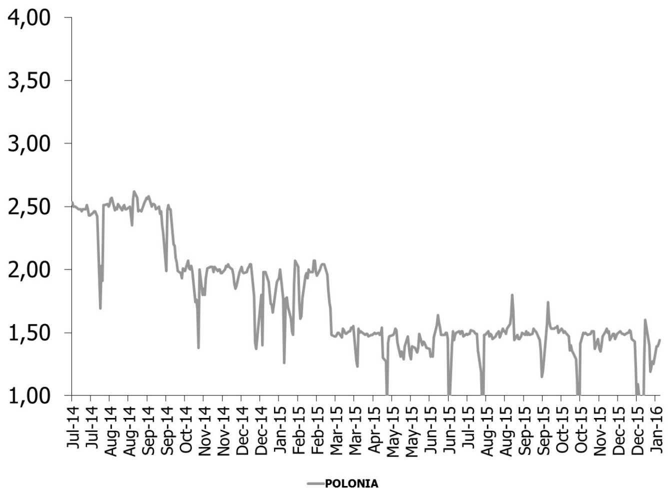
Ministry of Finance will offer 1-2 bio PLN of 32-week bills, and they should easy find a buyers because of reasons mentioned above. We expect yield to be around 1.30%.

Good luck.







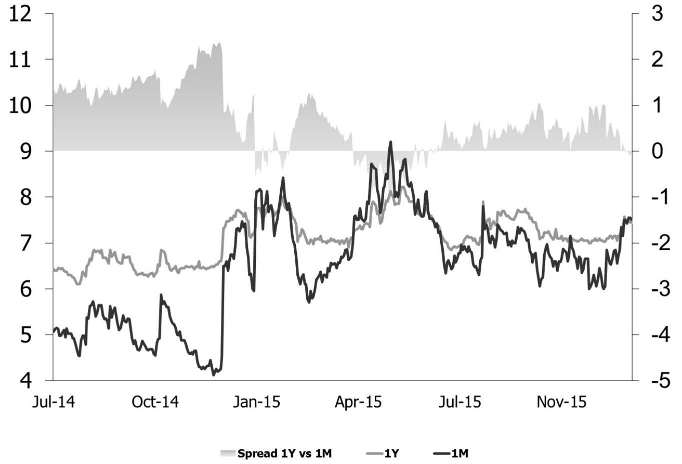


Forex

Spot – PLN is on fire PLN had a small relief rally against EUR, falling from the high of 4.3770 to 4.3310, only to shoot up higher, breaking the 4.37/4.39 resistance zone to reach 4.4225 (a multi-year high). There are reasons behind this: tensions between EU and the Polish government, new presidential bill for CHF loans. Looks like we have political risks in full swing. In this environment the only thing we can be sure of is increased volatility. We think the range moved higher and we may now expect 4.30-4.50 to be in play.

Options – ATMs higher again With much weaker PLN, no wonder we see higher vols again. 1 month EUR/PLN ATM mid is this Friday at 8.00% (0.6% higher), 3 months are 7.8% (0.4% higher) and finally 1 year is fixing at 7.75 (0.35% higher). The skew is also healthy bid (i.e. 2 months 1.2% bid), roughly 0.3% higher from the last week. The currency spread (difference between USD/PLN and EUR/PLN vol) was better offered.

EURPLN volatility



Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.30 / 4.50
USD/PLN: 3.90 / 4.10

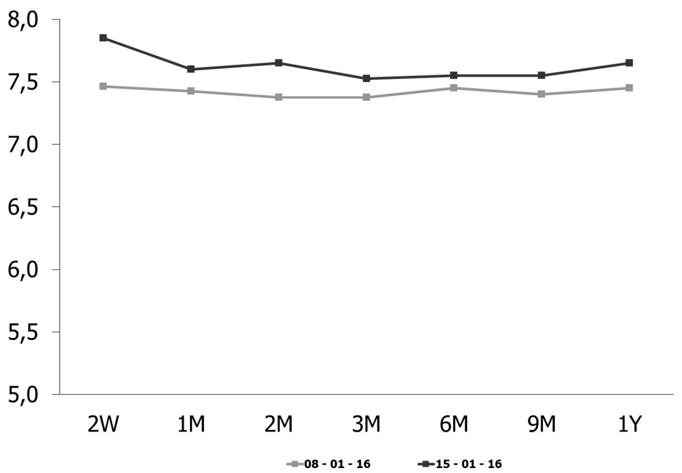
Position **Spot** – Still sidelined

Our last week's short EUR/PLN recommendation had not been implemented as the potentially game changing factor of local political risk materialized. We are now neutral/tactical for EUR/PLN. The CHF loan project would be a black swan for PLN. We cannot really say, what it means for the currency, volatility or bonds. It is a Pandora's box.

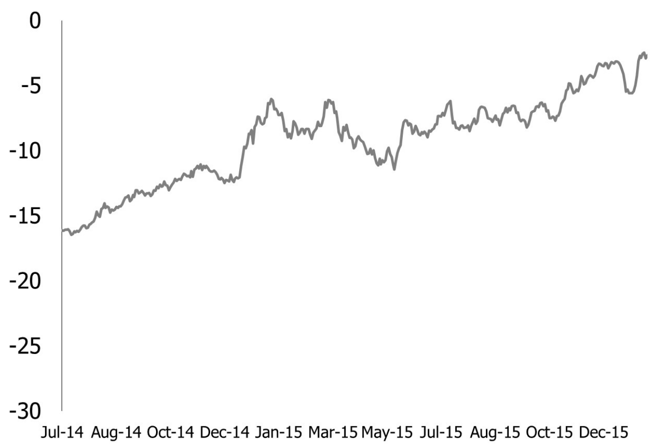
Options

EUR/PLN above 4.40 is a real trigger for volatility. We still think buying dips in Vols is recommendable in current stormy waters. Depending of political developments, we may see a quick PLN recovery or sharp deterioration towards 4.50.

EUR/PLN volatility curve



Bias from the old parity (%)



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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
1/7/2016	1.74	1.72	1.79	1.67	1.69	1.69	1.69	1.56	1.47	1.47	1.50	1.51
1/11/2016	1.61	1.72	1.57	1.67	1.65	1.69	1.65	1.49	1.38	1.38	1.40	1.40
1/12/2016	1.78	1.71	1.73	1.66	1.62	1.69	1.64	1.47	1.34	1.34	1.36	1.38
1/13/2016	1.48	1.71	1.45	1.66	1.57	1.68	1.63	1.44	1.37	1.33	1.35	1.35
1/14/2016	1.81	1.70	1.71	1.66	1.61	1.67	1.65	1.45	1.35	1.35	1.36	1.38

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
1/7/2016	1.690	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/11/2016	1.690	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/12/2016	1.690	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/13/2016	1.680	1.474	1.635	1.638	1.990	2.290	2.447	2.985
1/14/2016	1.670	1.474	1.635	1.525	2.000	2.269	2.460	2.964

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
1/7/2016	7.50	7.46	7.48	7.48	7.48	1.79	0.47
1/11/2016	7.55	7.35	7.45	7.50	7.50	1.79	0.47
1/12/2016	7.55	7.40	7.40	7.45	7.45	1.79	0.45
1/13/2016	7.50	7.33	7.40	7.45	7.45	1.79	0.47
1/14/2016	7.60	7.53	7.55	7.65	7.65	1.88	0.45

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
1/7/2016	4.3475	4.0085	3.9979	3.4102	1.3771	0.1609
1/11/2016	4.3635	4.0085	4.0159	3.4014	1.3802	0.1614
1/12/2016	4.3621	4.0170	4.0170	3.4131	1.3720	0.1614
1/13/2016	4.3345	4.0068	3.9782	3.3875	1.3739	0.1604
1/14/2016	4.3605	3.9990	3.9800	3.3927	1.3796	0.1614

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