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January 25, 2016

Polish Weekly Review

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Comment on the upcoming data and forecasts

Week kicks in on Tuesday with the release of CSO's Statistical Bulletin, which contains, among others, the final reading on unemployment rate for December. Preliminary data given by MFLSP indicates that the rate rose to 9.8%, but taking into account other labour market data we stay with our initial forecast (unchanged vs November) as we are betting on a large upward revision of labor force size. The bulletin will also shed more light on stellar real sphere and labour market data. MPC Minutes (Thursday) will most likely be unnoticed by most market participants.

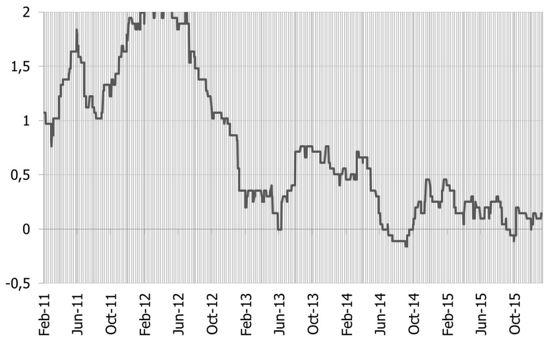
Polish data to watch: January 25th to January 29th

Publication	Date	Period	mBank	Consensus	Prior
Unemployment rate (%)	26.01	Dec	9.6	9.7	9.6

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
32 Week T-bills	-	2000	1.365	1/18/2016
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

After a busy weak surprise index climbed up thanks to big surprise in employment and retail sales. Other publications (better industrial production and worse wage growth) were not able to move the index. Next week brings only important release– unemployment rate could surprise in either 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).

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

- S&P decision on rating cut generated a one-off spike in yields across the whole curve proportional to duration.
- New bout of zloty weakness suggests caution and we stay sidelined in CASH at the moment.
- General policy uncertainty remains high. MPC refrains from directional comments.
- New round of global monetary policy easing is in the offing, though. Therefore rate cuts expectations in Poland should not evaporate completely and a scenario of lower rates for longer should apply to Poland as well what makes us alert to seek possibilities to re-enter long POLGBs positions at better risk/reward ratio.
- Given the current account and growth statistics, zloty's attractiveness ranks just after the Hungarian forint in the basket (PLN, HUF, TRY, ZAR, RUB). And although risk sentiment improved given expectations for another round of global policy easing, idiosyncratic factors, including the political ones, play negative card at the moment. That is why we expect the zloty to stay weak in the coming months exploring levels around 4.40.

mBank forecasts

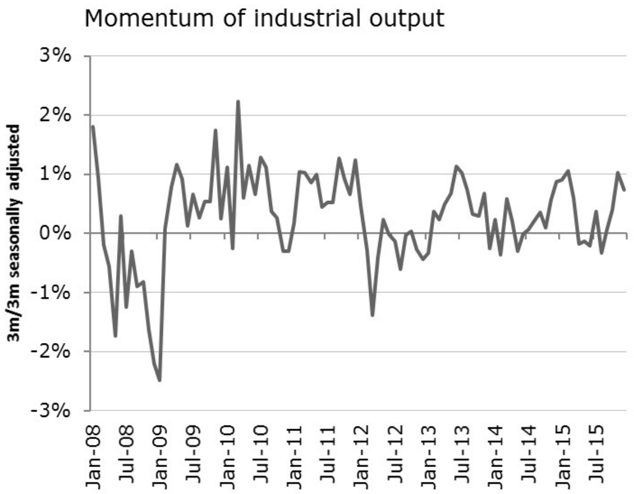
	2011	2012	2013	2014	2015F	2016 F
GDP y/y (%)	5.0	1.6	1.3	3.3	3.5	3.6
CPI Inflation y/y (average %)	4.3	3.7	0.9	-0.1	-0.9	0.5
Current account (%GDP)	-5.2	-3.7	-1.3	-2.0	-0.6	-1.1
Unemployment rate (end of period %)	12.5	13.4	13.4	11.4	9.6	8.7
Repo rate (end of period %)	4.50	4.25	2.50	2.00	1.50	1.25

	2015 Q1	2015 Q2	2015 Q3	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	3.3	3.4	3.8	4.0	4.0
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	5.5	6.0	6.0	6.6
Inflation rate (% average)	-1.4	-0.9	-0.7	-0.6	-0.4	0.0	0.5	1.7
Unemployment rate (% eop)	11.5	10.2	9.7	9.6	10.0	9.0	8.6	8.7
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.50	1.25	1.25	1.25
Wibor 3M (% eop)	1.65	1.72	1.73	1.72	1.68	1.44	1.44	1.44
2Y Polish bond yields (% eop)	1.61	1.99	1.76	1.62	1.30	1.10	1.35	1.55
10Y Polish bond yields (% eop)	2.31	3.31	2.84	2.94	2.90	2.80	2.00	3.20
EUR/PLN (eop)	4.07	4.19	4.25	4.26	4.40	4.30	4.30	4.25
USD/PLN (eop)	3.80	3.76	3.80	3.92	4.00	3.91	3.91	3.86

F - forecast

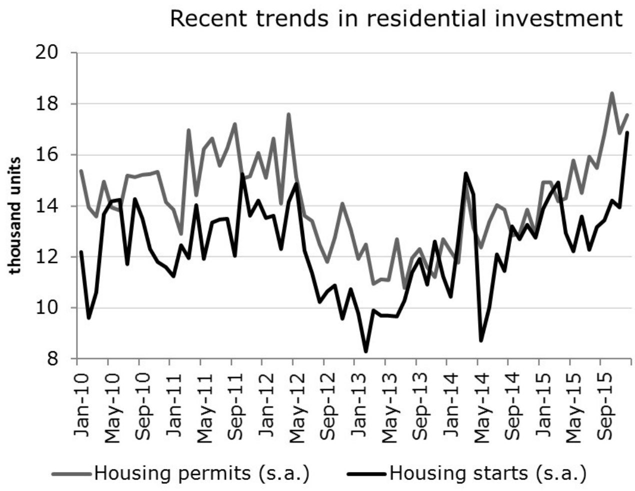
Output regains vigor amid strengthening labor market

Polish industrial output grew in December by 6.7% y/y. The only small deceleration in industrial output growth was driven by weak mining output and sharp decline in electricity and heat production (a straightforward result of very mild winter). Manufacturing barely moved at all (9.0% vs. 9.3% y/y in November) mainly because of continued strong growth in the production of other transport equipment (the massive order from the national railway operator is being finished by the two main domestic producers). Regardless of idiosyncratic factors, industry showed robust momentum in the end of 2015.

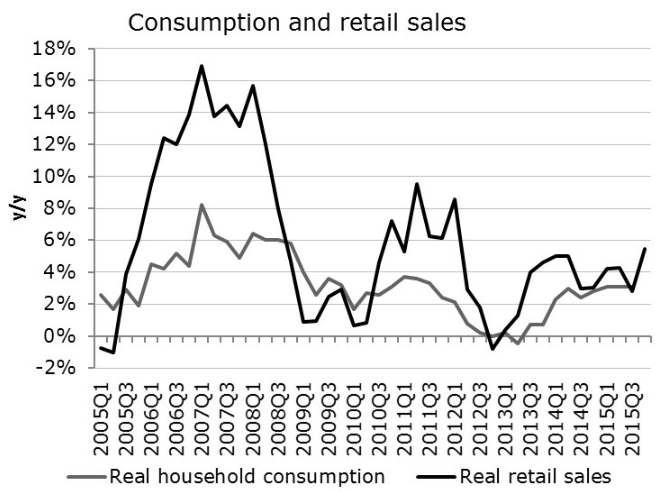


January, because of a disastrous arrangement of working days, should bring IP growth down to zero. Yet, we believe that industry prospects for 2016 are favorable. The expected changes in the structure of economic growth (more consumption, less investment) should favor domestic industrial production as consumption is significantly less import-intensive than investment. One has to consider the positive effects of recent PLN depreciation (more than 10% in REER terms since June 2014) on export competitiveness as well.

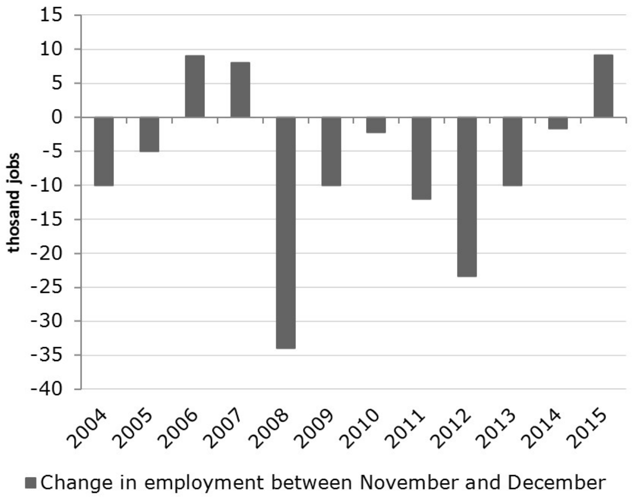
Construction output barely moved on annual basis (-0.3% y/y), which was broadly consistent with our forecast and market consensus. After seasonal adjustments, construction output growth is a meagre -2.0% y/y and -0.4% m/m. Thus, the whole fourth quarter can at best be described as one of stagnation. The divergence between very strong housing investment and solid road spending, on the other hand, and poor results of non-residential construction and railway investment on the other, persisted in 2015 and will extend itself for 2016. The other limiting factor for construction is a sharp decline in local government expenditures due to the transition to the next EU budget.



Retail sales grew in December by 4.9% y/y in nominal terms. Composition is consistent with recent trends. We see a revival of auto sales (again more than 15% y/y in December) and decent sales of other durable goods (furniture, electronics) and semi-durables (clothing, shoes). However, some categories stayed below zero. It applies to fuel prices, "other" category (could later catch up after very weak 2015) and food sales (this time the fall amounted to 5.9%). We have noticed an interesting pattern in the latter. It seems that some part of specialized food sales is being shifted to the unspecialized category. The latter compensated for falls in the former in the last 2 months. It is hard to find a reasonable explanation of this phenomenon. This could be connected with CSO methodology (companies are classified based on their main activity, while supermarkets have been recently diversifying their activity), because consumers do not use to change their habits so often. Putting aside the reasons for this pattern, it artificially inflates aggregates excluding food, automobiles and fuels, so we will refrain from publishing those before we can adjust them properly. All in all, our opinion about very good retail sales in 2016 remains the same. It would be supported not only by labor market tightening but also the return from deflation and government 500+ programme (which should kick in by the end of first half of 2016).

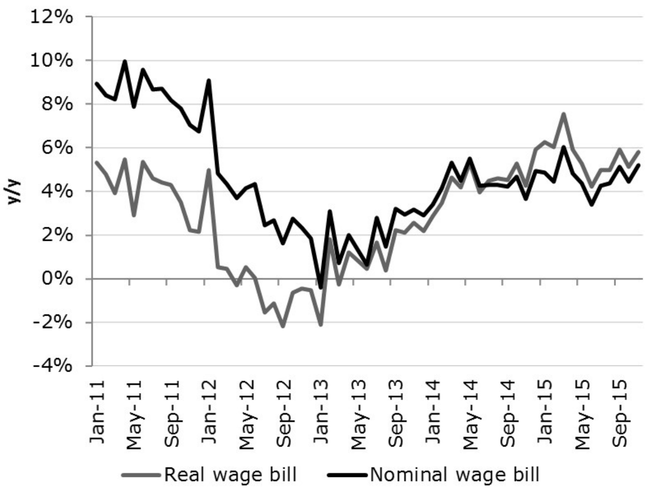


Solid growth in output goes hand in hand with developments in the labor market. **Employment** in enterprise sector rose by 1.4% y/y in December. It was the best December ever and the best quarter since 2007. In is no coincidence that NBP indicators are at elevated levels, and rising.



Since exports and consumption perspectives brightened, we expect better momentum in the labor market to thrive in 2016. Planned changes in the labor market (heightened security) should be beneficial for employment and we are heading towards 1.5% plus growth in employment in 2016.

Beneficial changes in the labor market only at first sight seem to bypass wage developments. In December **average gross wage** rose by 3.1% y/y. This slowdown (compared to previous month) is in our opinion driven mainly by base effect in manufacturing (December 2014 was one of the best releases ever). Contribution of other sections (including mining, where bonus payments went on as usual) was most probably minimal. This forecast does not change our general view that the whole 2015 year exhibited a solid trend around 3.5%-4.0%. As a result, wage bill growth was very solid (in December +4.5% in nominal and +5.0% real terms).



In 2016 we expect faster wage growth, caused mostly by further tightening of labor market. Unemployment rate is already falling by 1.6-1.8 pp. yearly, and measures of labor supply constraints (favored by us) are at all-time highs or close to them. Moreover, other factors will support this process - government "500+" programme will increase reservation wage and thus lead to exits from labor force at the margins (mainly among women). Shrinking labour supply, in addition to a well-developed demographic trend, will - at least in the short term - boost wages. To sum up, the expected acceleration in nominal wages will balance out inflation rise in second half of 2016.

Q4 growth will more or less match the results from the third quarter; the additional, unexpected support should come from exports and consumption. The data has no relevance for monetary policy stance - here FX volatility matters most. Because expectations for monetary easing from major central banks (including the ECB) have recently been renewed, the window for opportunistic rate cuts is open again.

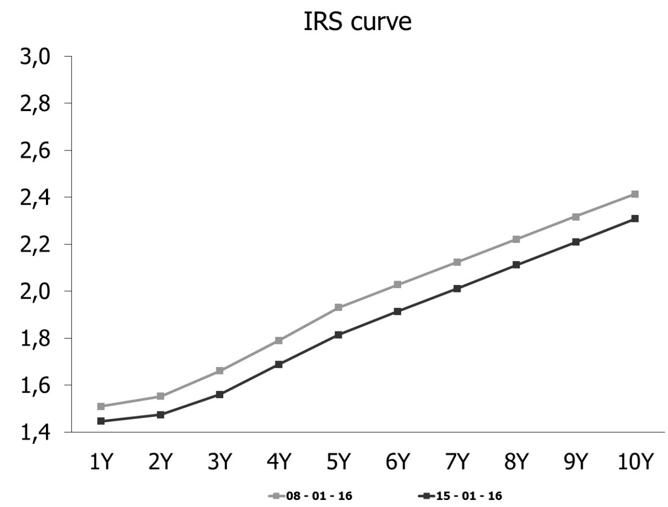
Fixed income

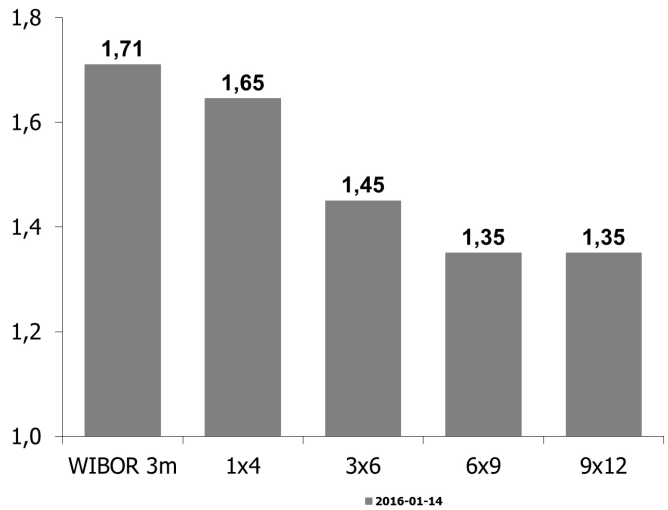
S&P downgrade

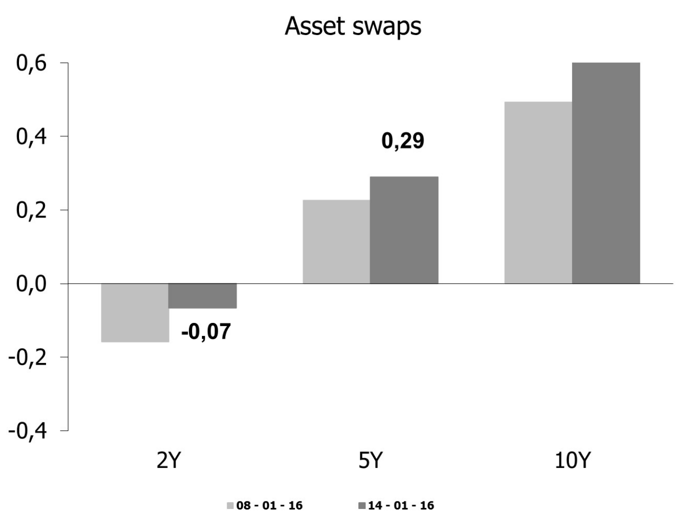
The totally unexpected rating cut to BBB+ from A- by S&P (outlook changed to negative from positive) surprised majority of market players and resulted in 20-25 bps yields surge across the curve (PS0421 2.65% vs 2.40% Fridays close; DS0725 3.25% vs 3.00%). Fitch and Moody's didn't follow S&P, however on Thursday Fitch warned that rating could be cut "if planned forex mortgage conversion law badly harms banking sector".

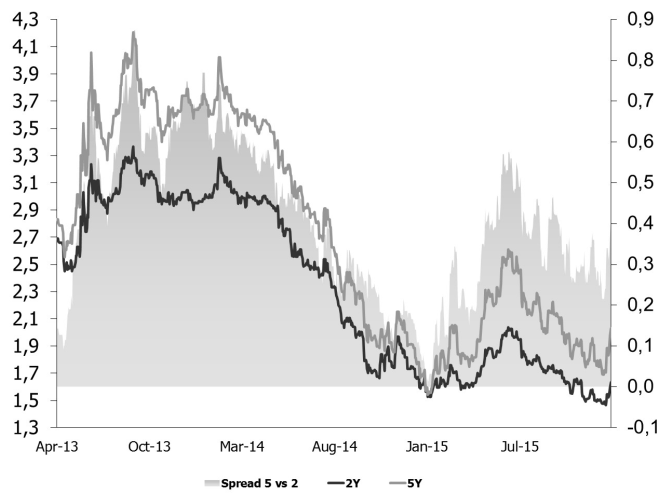
The colour of the market was changed by Mr Draghi who wants to reconsider policy stance in March as downside risk increased again. ECB was clearly dovish and the message is similar to the October one – we can expect rate cut or/and changes in asset purchase programme – during low liquidity period yields declined 10-15 bps and are only 5-8 bps higher compared to Fridays close (OK0717 1.37%; PS0421 2.48%; DS0725 3.07%).

We are still bearish on POLGBs. With EURPLN above 4.40, rate cuts seem doubtful. MPC member Osiatyński (dove) sees rate increase rather than cut if bias would change due to fiscal risks. We still don't know the ultimate details of CHF conversion bill. However, nobody believes that presidential draft will be voted as presented. We still like paying 2y, currently at 1.56% and 12x15 FRA at 1.44%. Remember about auction on Thursday.









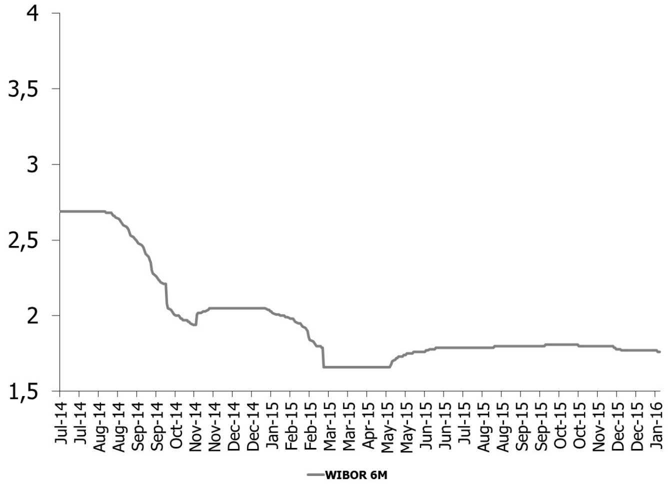
Money market

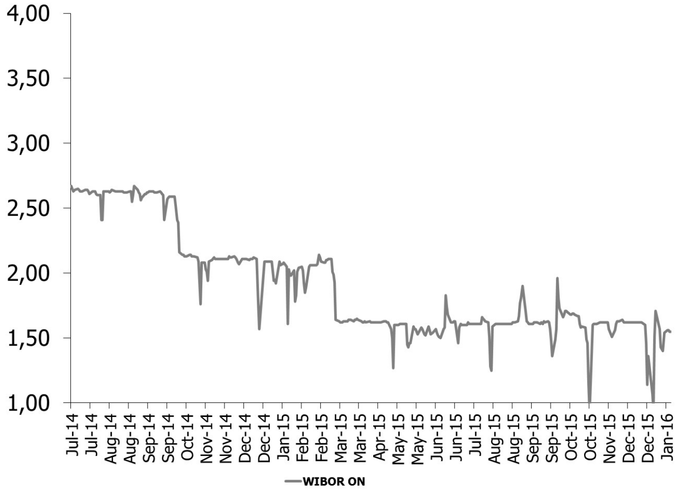
Cheap week behind us

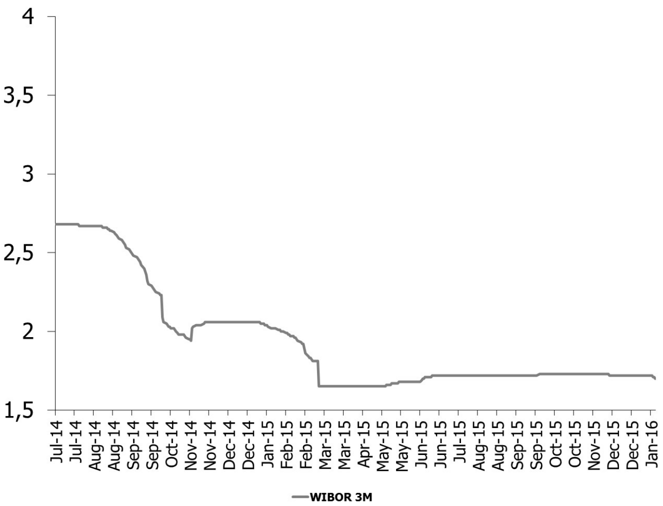
As last OMO was underbid cash fell to 0.8 on Thursday. Today's one was on the other hand overbid so it shouldn't be so cheap next week. On Monday we will see 13 bn cash from OK0116. Market should absorb that.

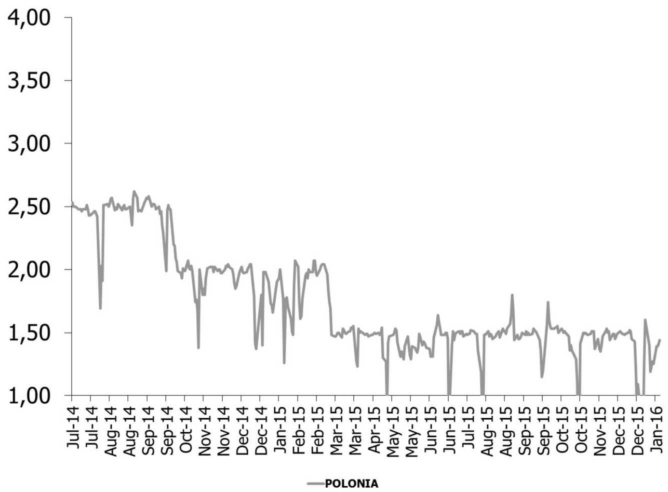
Generally, it looks like market is over-liquid, so we recommend selling all OISs and buying short bonds and T-bills.

Last T-bills auction conducted on Monday went well. Demand was huge (10.5 bn) comparing to 2 bn offered. Rate was 1.365 – pretty good comparing to short term bonds and bad mood after SP rating cut.



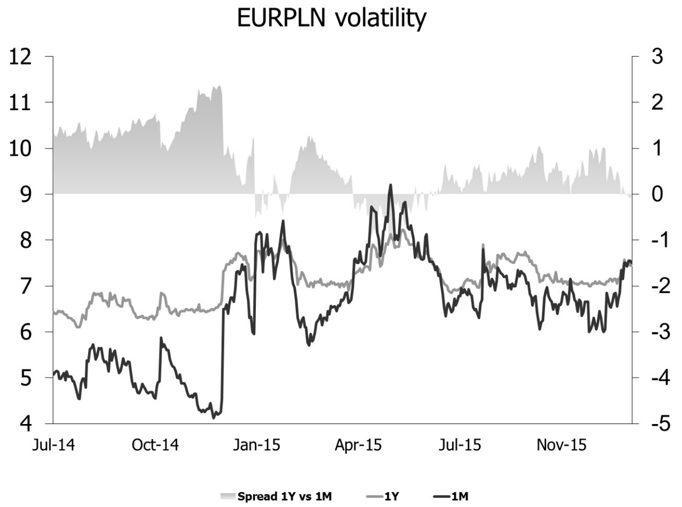




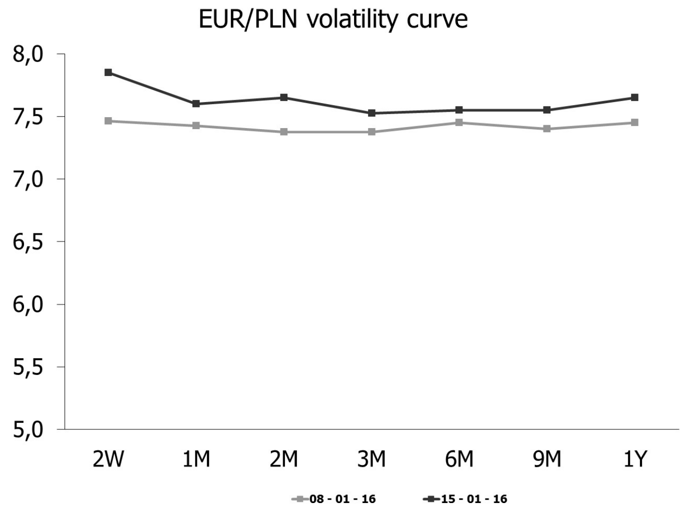


Forex

Spot – PLN at support level Lots of negative news: first of all the downgrade from S&P, president's CHF loan draft, stormy stock markets. All these factors were responsible for severe PLN losses, bringing EUR/PLN to 4.5120 high (last seen in 2011). The political risk is being one of the major driving forces for PLN at the moment. The biggest unknown is CHF loans conversion project, although the probability of implementation in the current shape is not that high. The downgrade decision effect should fade in time, as market anyhow has its own opinion. We expect the current selloff in PLN should to somehow slow, possibly reverse as positioning factor (we believe, market is already short PLN) may kick in. We expect range 4.36 – 4.51 as a possible range into the next week's key event: FOMC meeting.



Options – ATMs sharply higher The vols are in crisis mode. The EUR/PLN curve is already reversed. 1 months EUR/PLN ATM mid is this Friday at 9.2% (1.2% higher than last Friday), 3 months are at 9.25% (1.5% higher), and finally 1 year is 9.25% (1.5%). The 1 year was traded at 9.25%, 3 month was traded several times at 8.85%. The Skew was better bid and moved right by roughly 0.25%. The only thing moving other direction was a currency spread (difference between USD/PLN vol and EUR/PLN vol), which dropped by more or less 1%.



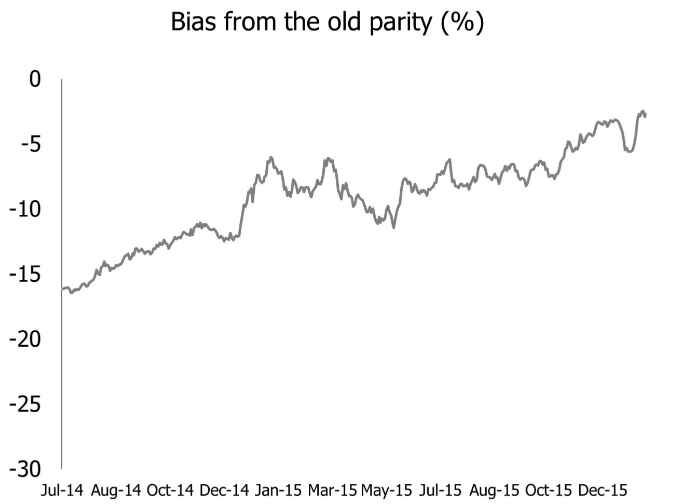
Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.36 / 4.53
USD/PLN: 3.90 / 4.20

Position **Spot** Short EUR/PLN at 4.4775.

We are ready to add 4.5125 with a firm stop at 4.5275. We are hoping to see it lower to 4.4075 and possibly to 4.3775. We have decided to dip a toe into the water again. We still believe in rangy, mean reverting nature of the EUR/PLN, that have prevailed at so many occasions in the past years. Of course we recognize political risk, possibly further deterioration of global sentiment. On the other hand lots of it is already discounted.

Options Our prejudice for being short Vega and Gamma paid off nicely. Nevertheless, we have decided to take full profit on long Vega, Skew positions .There is always a level to sell Vol, and we think we may be close to such a level in EUR/PLN. But only in frontend vol! Everything above 6 months should be – in our opinion – bought or left alone because of political risk. High bid/offer spread does not favor active trading.



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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
1/14/2016	1.81	1.70	1.71	1.66	1.61	1.67	1.65	1.45	1.35	1.35	1.36	1.38
1/18/2016	1.67	1.70	1.58	1.65	1.60	1.67	1.68	1.57	1.45	1.45	1.47	1.47
1/19/2016	1.64	1.70	1.74	1.65	1.61	1.67	1.66	1.52	1.43	1.40	1.42	1.46
1/20/2016	1.50	1.70	1.47	1.65	1.48	1.67	1.70	1.55	1.47	1.46	1.46	1.50
1/21/2016	1.63	1.70	1.78	1.65	1.67	1.67	1.66	1.54	1.45	1.43	1.44	1.48

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
1/14/2016	1.670	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/18/2016	1.670	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/19/2016	1.670	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/20/2016	1.670	1.474	1.635	1.638	1.990	2.290	2.447	2.985
1/21/2016	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
1/14/2016	7.60	7.53	7.55	7.65	7.65	2.09	0.44
1/18/2016	9.25	8.75	8.65	8.63	8.63	2.09	0.44
1/19/2016	8.60	8.40	8.40	8.40	8.40	2.09	0.44
1/20/2016	9.70	9.20	9.10	9.00	9.00	2.18	0.46
1/21/2016	9.35	9.10	9.00	9.05	9.05	2.18	0.44

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
1/14/2016	4.3605	3.9990	3.9800	3.3927	1.3796	0.1614
1/18/2016	4.4835	4.1133	4.0945	3.5064	1.4201	0.1660
1/19/2016	4.4490	4.0917	4.0617	3.4727	1.4121	0.1646
1/20/2016	4.4659	4.0877	4.0822	3.5023	1.4168	0.1652
1/21/2016	4.4987	4.1303	4.1084	3.5341	1.4306	0.1663

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