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Polish Weekly Review

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Comment on the upcoming data and forecasts

February starts with manufacturing PMI release on Monday. We expect a half point drop due to escalation of political risks in January. Companies may have been concerned about the fast pace of implementation of election promises: additional taxation (banking and retail sectors), further labour market tightening (child support, extension of social security payments to larger set of contracts), tighter tax controls (closing VAT gap and loopholes) and possibility of tighter credit conditions (bank tax and CHF conversion plans); those fears were somehow reinforced and corroborated by S&P's downgrade decision. February's MPC meeting will be held in mixed set-up (3 new members were already sworn in by the Senat, two others are scheduled to be put to a vote in the Sejm today). New members will already have a majority over old ones (excluding governor Belka), but we do not expect immediate changes in monetary policy. A bit softer tone may be in the cards, though. There will be no *flash* CPI release this month, because of change in CSO inflation basket.

Polish data to watch: February 1st to February 5th

Publication	Date	Period	mBank	Consensus	Prior
Manufacturing PMI (pt.)	01.02	Jan	51.5	51.9	52.1
MPC decision (%)	03.02	Feb	1.50	1.50	1.50

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 OK1018	2/4/2016	1000	1.770	1/28/2016
5Y T-bond PS0720	2/18/2016	3500	2.382	1/7/2016
10Y T-bond DS0726	2/4/2016	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

Surprise index dropped after higher than expected unemployment rate in December. Better than expected 2015 GDP growth was not able to offset this, because we take into account only quarterly releases. Next week brings only one opportunity to move the index – manufacturing PMI (Monday).

* 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 2016. At the same time, global headwinds do not seem to be detrimental for Polish exports (exports benefit from better euro zone momentum and weak zloty). Public infrastructure outlays have shifted towards the latter part of 2016 and private investment seems to be locally, negatively affected by political uncertainty. However, positive impulses from consumption and exports are set to encourage private capital formation amid stretched capacity utilization.
- 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

- We turn constructive on 10y bonds and go for an outright long position.
- Although we still wait for the final ruling on CHF conversion programme, domestic risks are well defined now. S&P's rating downgrade was a forward-looking move accounting for possible negative fiscal developments in the months to come. As a consequence, sentiment turned sour. We think it is time to await de-escalation. Macro momentum is quite strong suggesting tighter credit spreads. Deflation will last longer than expected even a month ago. As expected, central banks turned more dovish globally and the next round of global monetary easing is ongoing.
- Polish bonds' valuations are now attractive vs. HU (most accurate benchmark) and euro peripherals. The share of foreign investors decreased over the last 2 months. As the most important uncertainty for the Polish economy is mostly tied to the exchange rate (CHF conversion programme), zloty may be underperforming for some time. As soon as uncertainty fades, we await stronger domestic currency. Breaking 4.44 to the downside can be a trigger for deeper correction.

mBank forecasts

	2011	2012	2013	2014	2015F	2016 F
GDP y/y (%)	5.0	1.6	1.3	3.3	3.6	3.8
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	-0.1	-0.7
Unemployment rate (end of period %)	12.5	13.4	13.4	11.4	9.8	8.7
Repo rate (end of period %)	4.50	4.25	2.50	2.00	1.50	1.25

	2015	2015	2015	2015	2016	2016	2016	2016
	Q1	Q2	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
GDP y/y (%)	3.7	3.3	3.5	3.9	3.6	3.8	3.8	3.9
Individual consumption y/y (%)	3.1	3.1	3.1	3.2	3.4	3.8	4.0	4.0
Public Consumption y/y (%)	3.7	2.5	2.7	3.8	0.5	2.0	2.0	2.0
Investment y/y (%)	11.5	6.1	4.6	4.8	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	4.45	4.35	4.30	4.25
USD/PLN (eop)	3.80	3.76	3.80	3.92	4.05	3.95	3.91	3.86

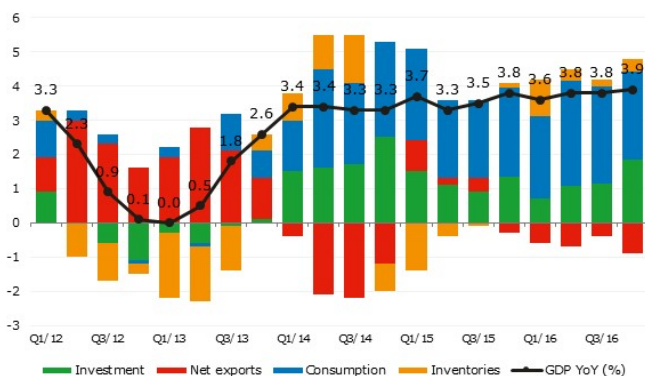
F - forecast

Economics

Solid GDP growth acceleration at the end of the year

Polish GDP grew in 2015 3.5% y/y comparing to 3.3% a year before. This result is slightly better than market expectations. Composition of growth is favoring consumption, both private (3.1%) and public (ca. 3.5%). Investment growth fell to 6.1% (from amazing outcome in 2014: 9.8%). Net export contributed by 0.3%pp and inventories by -0.4pp.

As always, yearly publication is the base for extracting growth in the last quarter. Gross domestic product could have grown in 2015 Q4 by even 4.0% y/y (our official forecast at 3.9% is a bit more modest). There are few interesting conclusions that could be drawn here. Firstly, private consumption growth repeated its Q3 value (near 3% with large acceleration of retail sales). Secondly, public consumption accelerated to probably this year's high - close to 4.0%. Thirdly, investment growth is still diminishing (cosmetic change from previous quarter 5.0%). Lastly, stocks contribution was positive (+0.2 pp difference thanks to favorable base effects) while net export contributed negatively (-0.3 pp although we think that upward revision is quite possible because of positive trade balance).



Today's data do not change our outlook on growth in 2016, which we think will be driven by consumption and exports. Though economy ended last year with a stellar result, beginning of 2016 will be most probably less spectacular. Government "500+" programme will kick in only in Q2. Moreover, we see a temporary ease in corporate investment plans (in our opinion only temporal in private sector because of uncertainty connected to the change of government). Trajectory of GDP growth in 2016 will, except slight slowdown in first quarter - be increasing; we expect impulses from consumption and exports to spill over the economy.

Such good GDP data should narrow credit spreads and lower risk priced in Polish govies. Due to this development, and among other reasons (see Our View in a Nutshell), we turn constructive on 10y bonds.

Fixed income

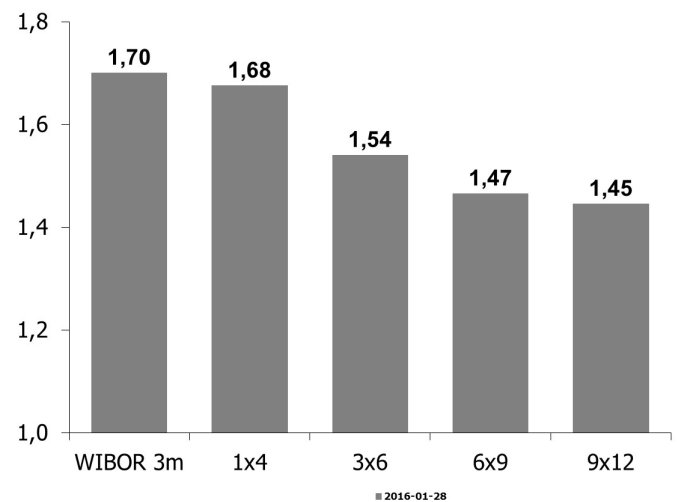
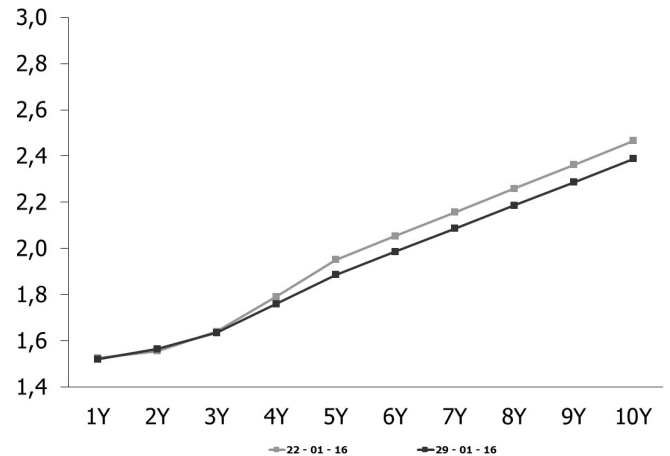
Long end's relief

Last week of January was the first calm week this year. Due to ECB comments, Polish long end bonds' yields declined by 15 bps, front end bonds remained stable. Today Bank of Japan cut its rate, so longer end of the curve moved 5 bps lower again.

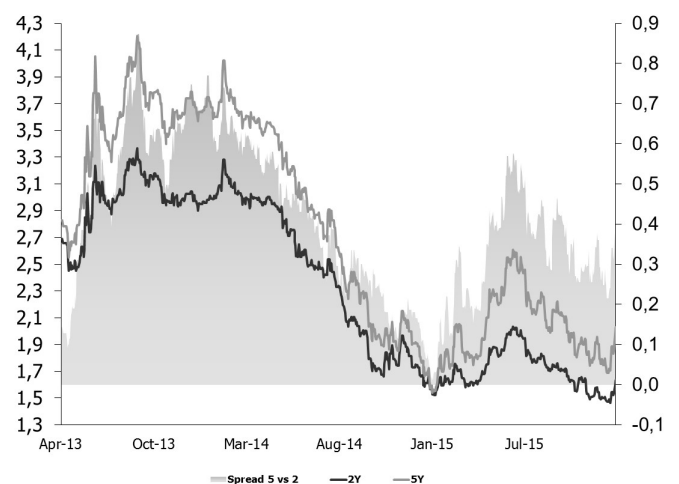
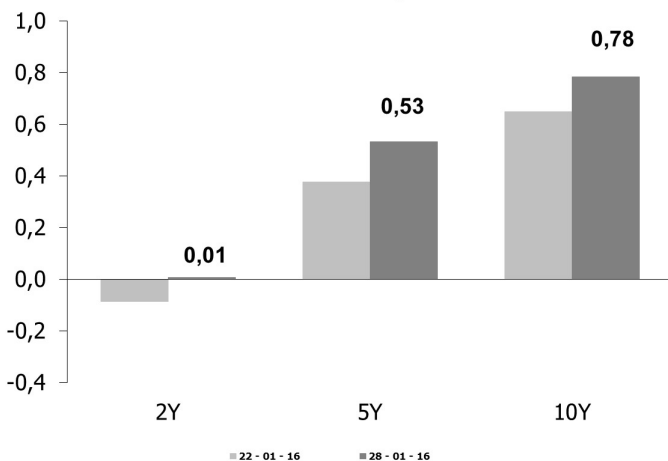
Because of ECB suggestion that they can cut rates in March, market became very bullish and it looks like rates will be falling for the whole February until the next ECB meeting. We are bullish on Polish government bonds but we suggest caution as German bonds are extremely low (in yields) and demand for Polish long end bonds is in our opinion not very strong. Any sell off on core markets might be painful for Polish ones.

We had bonds auction on Thursday which went well. MinFin sold OK1018 with 1.69 yield (new 2y benchmark) and longer floaters (WZ0120 and WZ0126). Demand was 11.7 bn and supply 8 bn.

IRS curve



Asset swaps



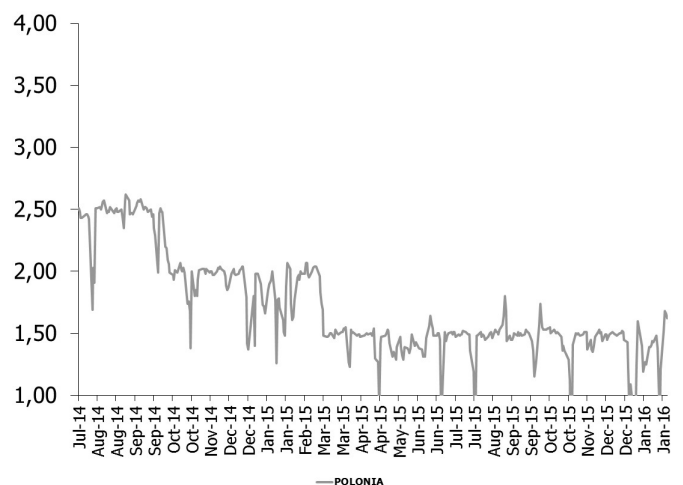
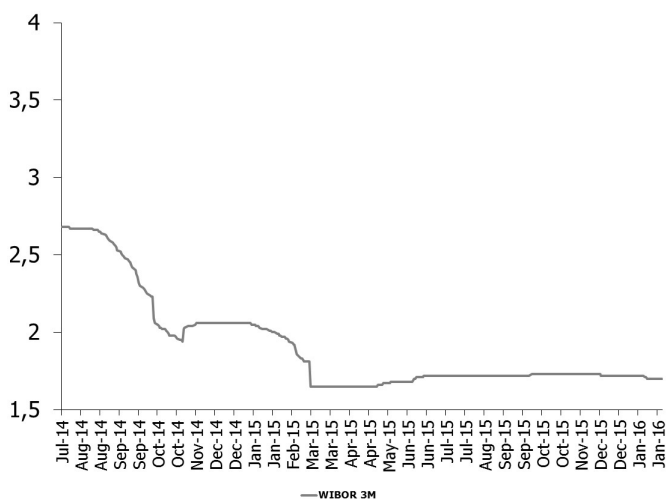
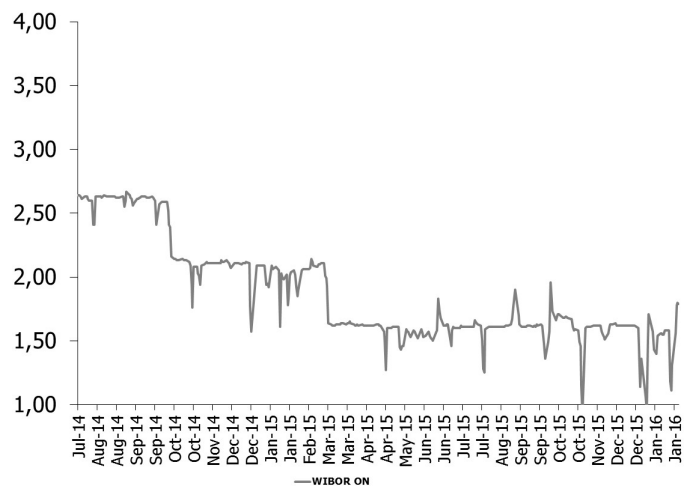
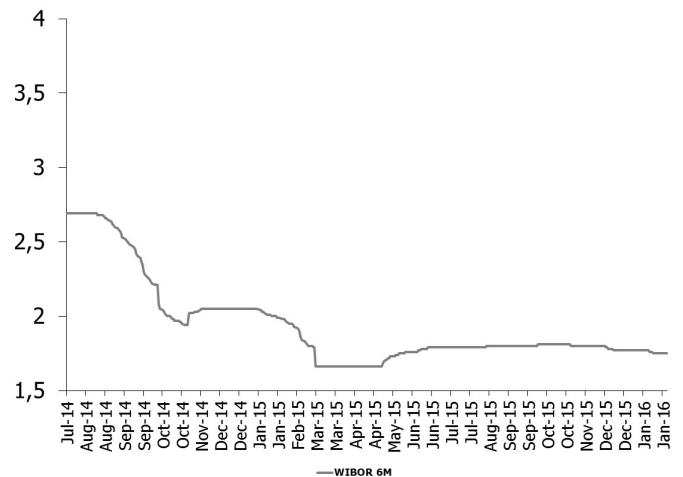
Money market

Expensive cash

As one could expect, after a cheap week we had an expensive one. Banks left all liquidity in NBP on last OMO and ON rates went significantly higher. Today we have the last day of the month and a reserve period, so after regular 7-day auction there will be additional 1-day auction.

Due to a build-up in reserve we will start the new month with significant level of spare liquidity (10 bio PLN). This should support lower financing cost and we will see if NBP acts in case of too low rates.

We still favour buying short term bonds hedged with OIS. Recent bull market after ECB and BoJ decisions may be a nice opportunity to get some OIS on nice low lvls.



Forex

Spot – PLN recovery The week started with the retest of 4.5010 high in EUR/PLN (on bad China news), but thanks to dovish signals from ECB/FOMC/BOJ, global sentiment improved. Political tensions in Poland also somehow eased. Several high rank members of government spoke about delaying/correcting the President CHF conversion project (critical for PLN). All the above should support at least short term PLN recovery (EUR/PLN 4.4320 low so far). The mean reverting, rangy nature of the EUR/PLN is likely to kick in. We expect the test of the lower band of the current 4.37 – 4.50 range.

Options – ATMs stuck at the highs 1 months EUR/PLN ATM mid is this Friday at 8.9% (0.3% lower than last Friday), 3 months are also 8.9% (0.35% lower), and finally 1 year is 9.1% (0.15% lower). Looks like we have found short term equilibrium. The USD/PLN 1 year ATM was paid at 12.2% and 12.3% in good amount. Currency spread (difference between USD/PLN vol and EUR/PLN vol) is roughly unchanged. The skew was slightly better offered (1m 25d R/R traded at 1.45%).

Short-term forecasts

Main supports / resistances:

EUR/PLN: 4.37 / 4.53

USD/PLN: 3.90 / 4.20

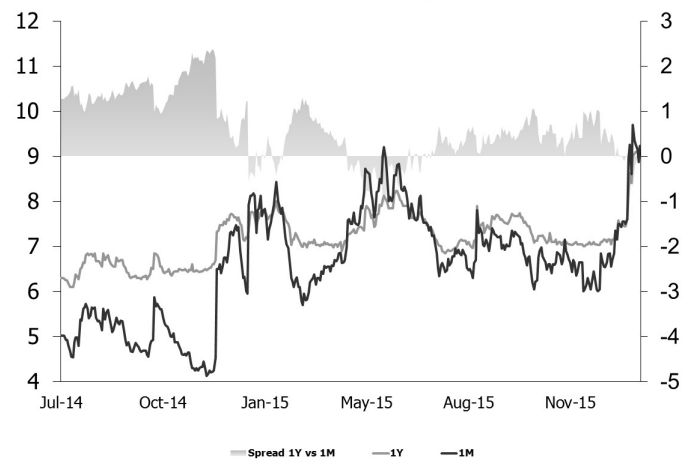
Position Spot Spot Still short EUR/PLN at 4.4775. Fresh stop at 4.5050 and P/T at 4.3975.

It was a bumpy ride. The poor liquidity, and contradicting flow is to blame for choppy, nervous trading. Nevertheless, we are seeing some Zloty recovery on the back of brighter investment sentiment. The lack of fresh bad news, is all we need. We especially hope for some political risk reduction, which would calm a bit the nerves of foreign investors.

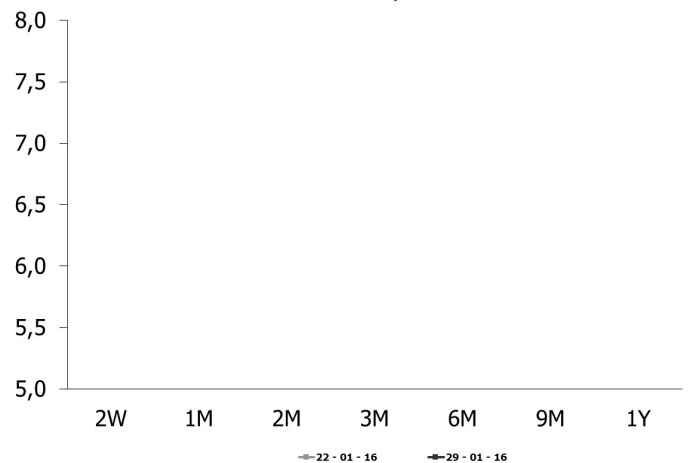
Options

We are short frontend Vega in EUR/PLN (up to 4 months). The realized volatilities are currently matching the implied ones, so we don't expect the collapse in vols. Nevertheless, we hope that EUR/PLN vols will move lower with stronger PLN and calmer markets (it will take some time). Ideally, we would like to buy back this Vega by longer term options but we need realized volatility to correct downwards beforehand. We would assume 7.9% for 6 month EUR/PLN or 8.3% in 1 year as good reentry points to get long (longer term) vols.

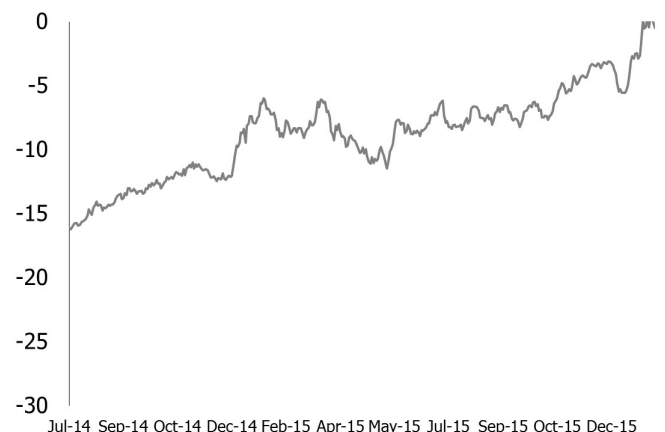
EURPLN volatility



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
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
1/25/2016	1.73	1.70	1.66	1.65	1.57	1.67	1.70	1.57	1.50	1.48	1.47	1.53
1/26/2016	1.73	1.70	1.78	1.65	1.67	1.67	1.70	1.56	1.47	1.47	1.49	1.52
1/27/2016	1.42	1.70	1.47	1.65	1.56	1.67	1.69	1.54	1.47	1.45	1.44	1.50
1/28/2016	1.55	1.70	1.59	1.65	1.57	1.67	1.68	1.54	1.47	1.45	1.44	1.50

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
1/21/2016	1.670	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/25/2016	1.670	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/26/2016	1.670	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/27/2016	1.670	1.474	1.635	1.638	1.990	2.290	2.447	2.985
1/28/2016	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	1Y
1/21/2016	9.35	9.10	9.00	9.05	9.05	2.18	0.44	0.44
1/25/2016	9.15	9.05	9.05	9.10	9.10	2.18	0.44	0.44
1/26/2016	8.88	8.93	9.00	9.10	9.10	2.18	0.44	0.44
1/27/2016	9.23	9.25	9.25	9.23	9.23	2.28	0.44	0.44
1/28/2016	9.05	9.05	9.08	9.08	9.08	2.18	0.44	0.44

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
1/21/2016	4.4987	4.1303	4.1084	3.5341	1.4306	0.1663
1/25/2016	4.4720	4.1346	4.0775	3.4918	1.4320	0.1655
1/26/2016	4.4961	4.1475	4.0861	3.5087	1.4380	0.1664
1/27/2016	4.4730	4.1144	4.0516	3.4801	1.4247	0.1655
1/28/2016	4.4588	4.0872	4.0265	3.4411	1.4235	0.1650

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