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Polish Weekly Review

Department of Economic Analysis
(research)

Ernest Pytlarczyk, PhD, CFA
chief economist
tel. +48 22 829 01 66
ernest.pytlarczyk@mbank.pl

Marcin Mazurek, PhD
senior analyst
tel. +48 22 829 01 83
marcin.mazurek@mbank.pl

Piotr Bartkiewicz
analyst
tel. +48 22 526 70 34
piotr.bartkiewicz@mbank.pl

Karol Klimas
analyst
tel. +48 22 829 02 56
karol.klimas@mbank.pl

Department of Financial Markets
(business contacts)

Wojciech Dunaj
head of interest rates trading
tel. +48 22 829 07 51
wojciech.dunaj@mbank.pl

Marcin Turkiewicz
head of fx trading
tel. +48 22 829 01 67
marcin.turkiewicz@mbank.pl

Department of Financial Markets Sales
(business contacts)

Inga Gaszkowska-Gebska
institutional sales
tel. +48 22 829 01 67
inga.gaszkowska-gebska@mbank.pl

Jacek Jurczyński
head of treasury sales
tel. +48 22 829 15 16
jacek.jurczynski@mbank.pl

mBank S.A.
18 Senatorska St.
00-950 Warszawa
P. O. BOX 728
tel. +48 22 829 00 00
fax. +48 22 829 00 33
http://www.mbank.pl

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Comment on the upcoming data and forecasts

On Tuesday the Central Statistical Office will publish labor market data. We expect employment growth to accelerate but the key source of variation in January is a technical one - the CSO is updating its sample and we expect the change in total number of employees between December and January to be proportional to net job creation over the previous year (January 2015 saw an unusually low employment growth). Wage growth is set to stabilize on the back of working day and base effects. On Wednesday industry and retail data will be released. We expect both to decelerate due to working day effects (-1 y/y vs. +1 y/y in December) and statistical base (industry - train production, retail sales - car sales).

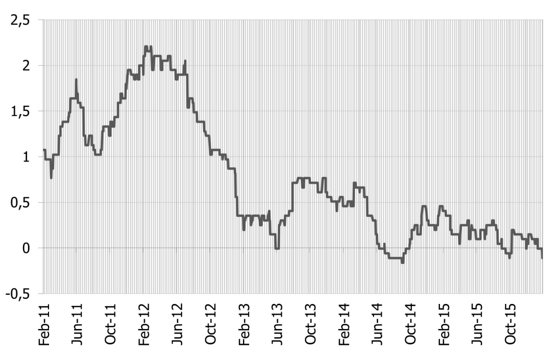
Polish data to watch: February 15th to February 19th

Publication	Date	Period	mBank	Consensus	Prior
Average wage y/y (%)	16.02	Jan	3.1	3.4	3.1
Employment y/y (%)	16.02	Jan	1.6	1.5	1.4
Industrial production y/y (%)	17.02	Jan	1.7	2.9	6.7
PPI y/y (%)	17.02	Jan	-0.9	-0.7	-0.8
Retail sales y/y (%)	17.02	Jan	2.7	2.9	4.9

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
32 Week T-bills	2/15/2016	2000	1.365	1/18/2016
2Y T-bond OK1018	3/3/2016	3000	1.665	2/4/2016
5Y T-bond PS0720	2/18/2016	3500	2.382	1/7/2016
10Y T-bond DS0726	3/3/2016	3000	3.168	2/4/2016
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Surprise index is near October's 2015 minimum – flash GDP surprised only marginally, while CPI dropped significantly from preliminary release. Several major publications are scheduled for next week - wages, industrial output and retail sales could all surprise.

* 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 are 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

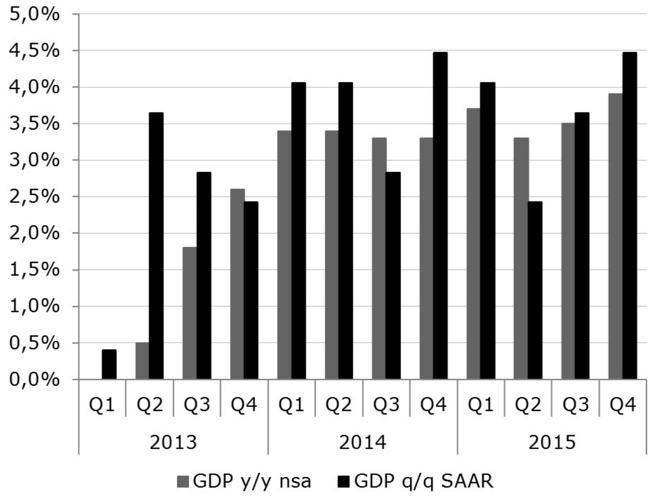
	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1 F	2016 Q2 F	2016 Q3 F	2016 Q4 F
GDP y/y (%)	3.7	3.3	3.5	3.9	3.6	3.8	3.8	3.9
Individual consumption y/y (%)	3.1	3.1	3.1	3.2	3.4	3.8	4.0	4.0
Public Consumption y/y (%)	3.7	2.5	2.7	3.8	0.5	2.0	2.0	2.0
Investment y/y (%)	11.5	6.1	4.6	4.8	5.5	6.0	6.0	6.6
Inflation rate (% 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	9.8	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	3.00	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 at the end of the year

According to the flash estimate, GDP grew by 3.9% y/y in the fourth quarter, in line with our forecast and above the market consensus of 3.8%. On a quarterly basis, GDP growth accelerated to 1.1% q/q (seasonally adjusted).



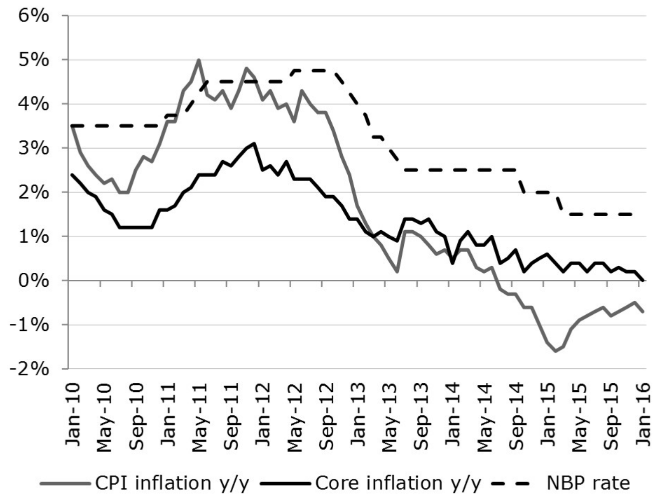
At this point we can repeat our educated guesses regarding the structure of growth. Private consumption dynamics held steady at previous quarter's levels (close to 3.0% y/y), despite the sharp upturn in retail sales. Public consumption likely topped 2015's record and come out at ca. 4% y/y. Investment growth likely remained subdued (at 5% with marginal differences vis-a-vis the third quarter). Finally, change in inventories added a modest .2 percentage points (low statistical base from the previous year was the decisive factor here), while net exports substracted .3 pp. (risks are tilted to the upside here). Changes in economic policies will put an even greater weight on domestic engines on economic growth (more consumption and more private savings due to the child subsidy programme) with a healthy structure in exports. It must be noted that Poland is a net beneficiary of currency depreciation thanks to relatively low FX debt and relatively high share of domestic value added in exports. This means that trade balance might remain positive even if imports accelerated in 2016.

Today's release doesn't affect monetary policy prospects. Rate cuts will be treated opportunistically by the MPC and are unlikely to be pre– announced. Other forms of boosting liquidity are probably considered and policies adopted by the National Bank of Hungary must be treated as a benchmark.

Solid GDP growth and its balanced structure are good news for financial markets. We believe that it should lower the perception of credit risk in Poland (and credit risk is at the centre of current turmoil in global markets). First, economic growth is high. Second, its domestic part is not creating any external imbalances (strong balances are a major criterion for differentiation). Third, recent news supported our scenario of de-escalation in political and fiscal risks in Poland: the presidential bill on CHF loans is believed to be watered down, steps towards closing VAT gap will be taken into effect starting from July. This means that if current global risks do not materialize as substantially weaker GDP growth, future budgets are becoming slightly more doable. As a result, Polish yield curve is currently too steep and Polish long end bonds are too cheap (not only in regional comparisons).

Very, very persistent deflation

CPI inflation amounted to -0.7% y/y in January, below our forecast (-0.6%) and market consensus -0.5%). It is a preliminary reading with scant details given by the Central Statistical Office. It is also subject to revision due to changing basket weights. With a larger than usual degree of error, we can estimate core CPI to amount to 0.0% y/y (even a slight minus is possible).



What contributed to the decline in inflation? First, fuel and transport services prices (fuel prices could have declined by as much as 5-6%) declined, accompanied by lower residential energy prices. Core categories mostly behaved just as they did a year ago, the only major surprise is in healthcare category (a drop in drugs prices). Interestingly, inflation surprised to the downside due to a relatively strong print in the category of food and beverages (+1% m/m). Not much will happen in February but the next months are bound to bring a gradual increase in inflation (base effects, exchange rate pass-through, slight increase in fuel prices, higher path of food prices, a gradual acceleration in services). Inflation will return to positive values in Q3 and today's surprise does not contradict our forecast of a significant acceleration of inflation at year end (towards 1.5-2% y/y). The longer deflation lingers, the harder it will be, however, to believe in any meaningful rebound in inflation.

Just as GDP data published earlier, this information should be neutral for monetary policy. MPC has already taken the prolonged period of deflation into its baseline scenario. Interest rate cuts are still about adjusting the restrictiveness of monetary policy to the deflationary global environment and to quantitative easing in the Eurozone, taking into account exchange rate stability. However, CPI releases such as today's could build up expectations for monetary easing in Poland and should support Polish government bonds.

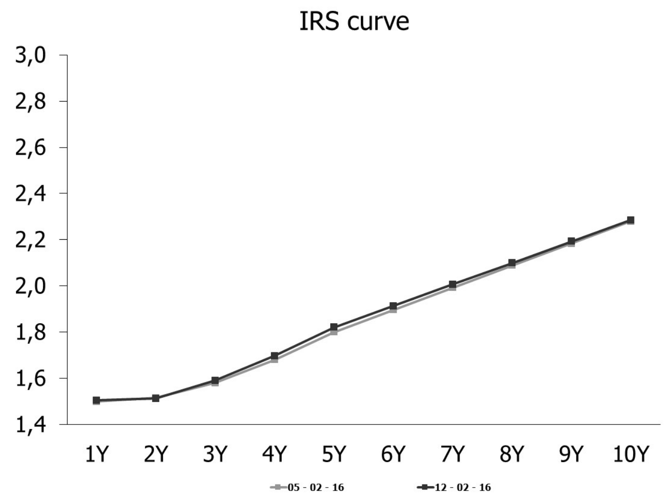
Fixed income

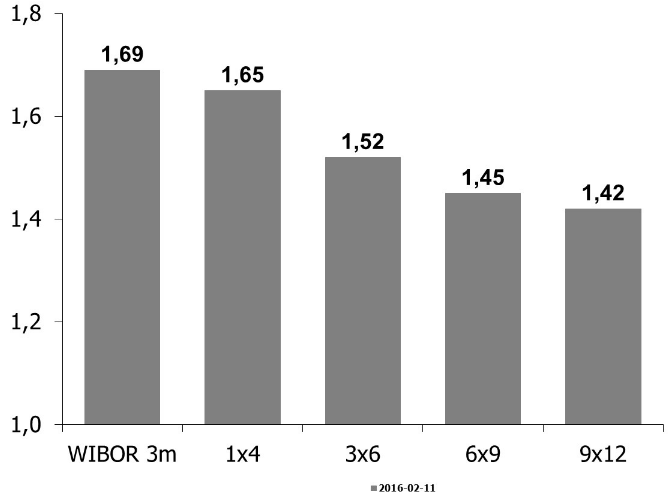
Surprisingly resilient

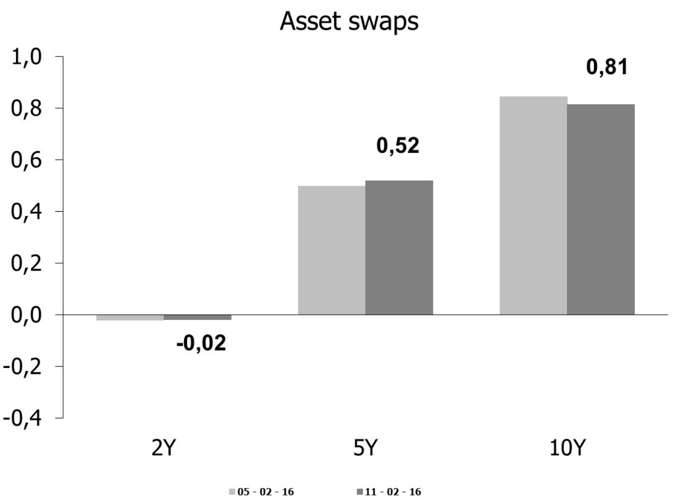
It looks like February will be the most stable month for ages. Although prices on the core markets rose significantly and periphery bonds were beaten hardly, our yields remained surprisingly stable, fluctuating between 3.04 – 3.15 on the longer end bonds (DS0726). We didn't collapse like Spain or Italy despite big bond auctions which took place last week. A simple reason for stability is quite big demand which we noticed on the longer end bonds (DS0726 especially) which hanged in the wires for the whole week.

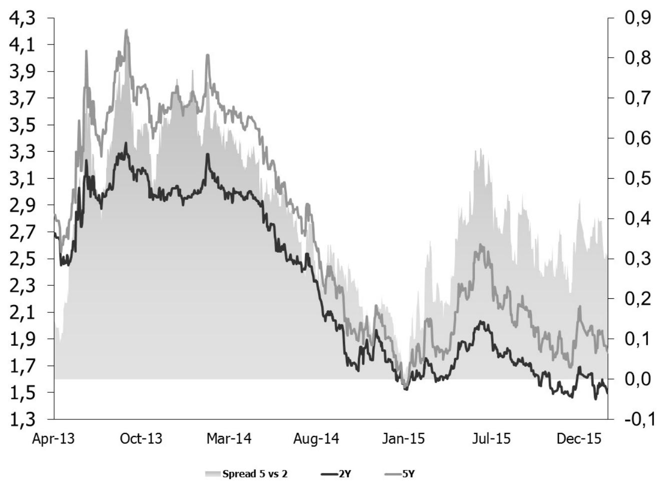
We did not notice any bigger flow one the IRSs. They moved pretty much like bonds. The only thing we noticed are narrowing asset swaps (by 3-4 bps) but they are still quite wide. They should narrow in the near future but we are not really bullish on them.

It is hard to say where we will go now. Swaps are quite low now and in our opinion there is not much room for them to decrease what seems a good opportunity. On the other hand, bonds are cheap and looks like they can do easily 15 – 20 bps but we are not bullish here. Political situation still matters in Poland. Apart from that we should be much higher (in prices) compared to where the whole world is. It is hard to say what will happen in Poland when the rest of the markets turn back. So . . . stay square







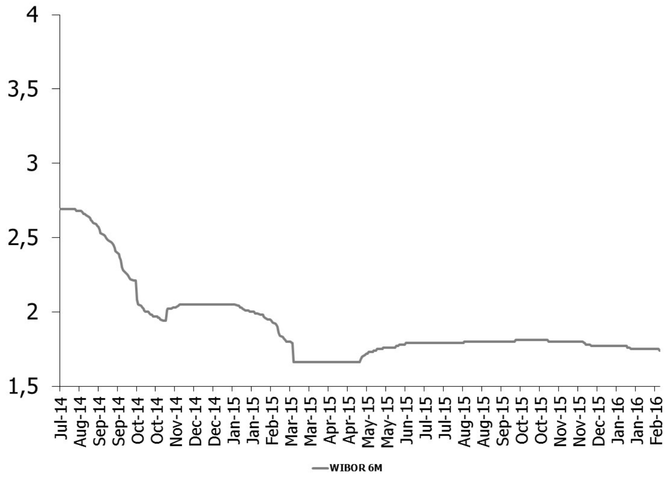


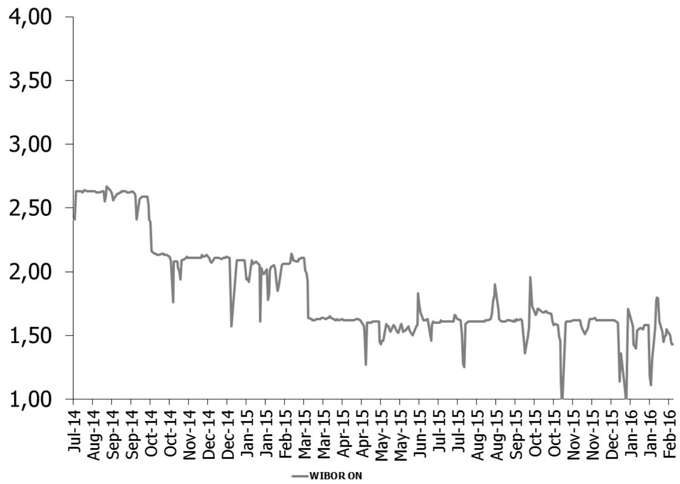
Money market

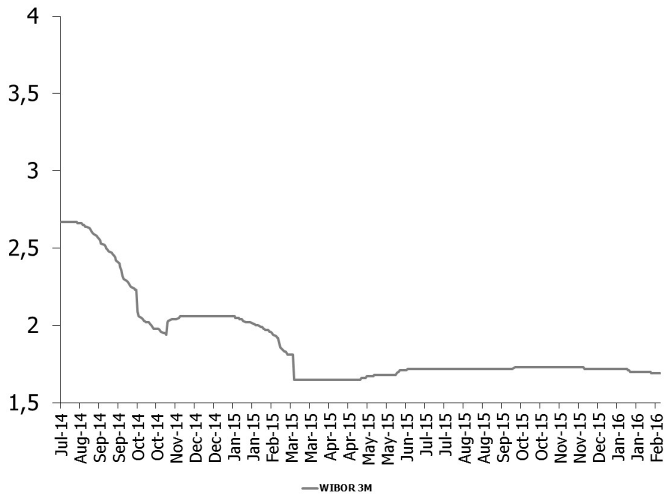
Low CPI

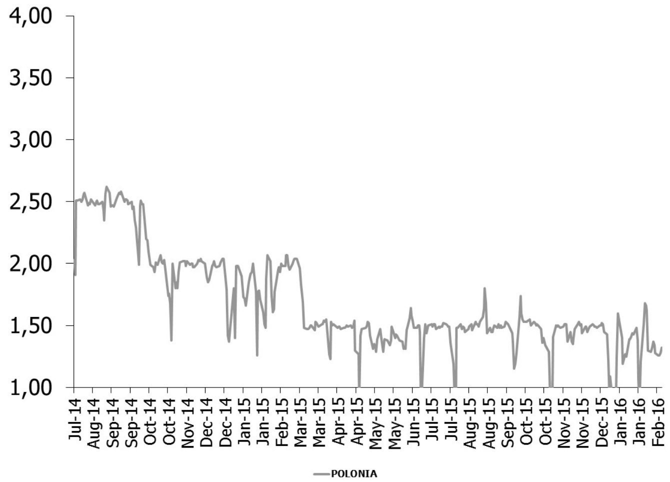
Last week polonia fixed around 1.28%, so again we had low rates in the middle of the month. At today's OMO banks bought 83.5 bio, what leaves around 3 bio spare cash according to our estimates.

As we mentioned last week, we like to stay received especially on short bonds (up to 2 years). After lower than expected CPI reading today (-0.7% ag. -0.5% exp.) we are patiently awaiting month's end and introduction of banking tax. Hopefully some ALMs will have some excessive cash and will buy tax free assets.



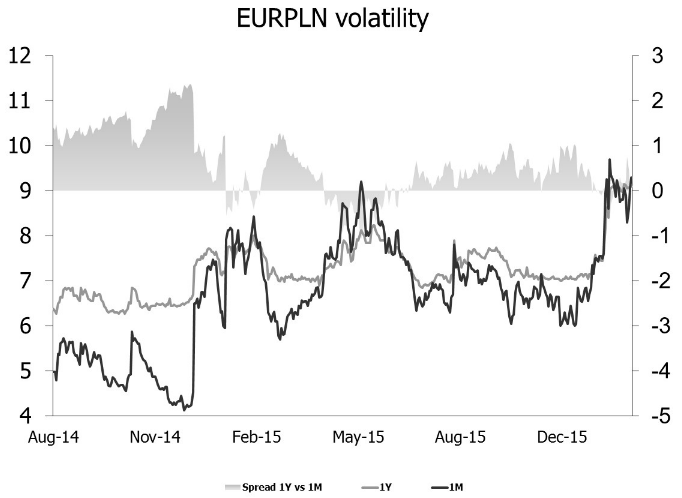






Forex

Spot – Volatility continues EUR/PLN is having a roller-coaster ride within the 4.3990 – 4.4730 range this week. It was driven mostly by global investment sentiment, with JPY and stocks being the centre of attention. The Polish political developments have been quiet this week, with the voices of the need of watering down the presidential CHF loan conversion bill being heard. We still stick to the plan of range trading, roughly 4.37-4.47, trying to fade extremes on both sides.

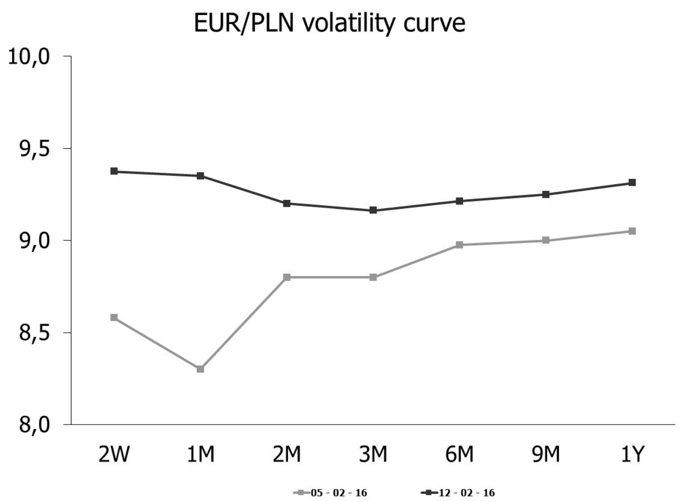


Options – Vol curve creeping higher Vols are creeping higher as realized volatility is still elevated. 1 month EUR/PLN ATM mid is 9.2% (0.9% higher), 3 month EUR/PLN are also 9.2% (0.4% higher) and finally 1 year is fixing at 9.4% (0.2% higher). The skew was in demand, with 6 month EUR/PLN 25D R/R paid at 2.15%. The currency spread (difference between USD/PLN and EUR/PLN vols) is roughly unchanged.

Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.37 / 4.53
USD/PLN: 3.90 / 4.20

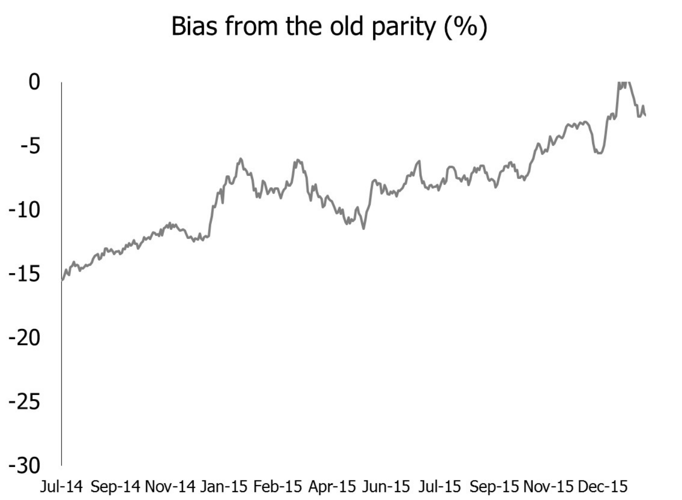
Position **Spot** Long.
We are long EUR/PLN at 4.4090, we are ready to add 4.3890 with a stop below 4.37 and hopes to see 4.46+ again.
At 4.4600 we would like to switch to shorts, with room to add at 4.48 and with stop above 4.4990. T/P on short would be set at 4.3990.



The spot market is really volatile with wider spreads and awful gaps. Since the cut of Poland's rating, EUR/PLN has become closer in beta to the likes of TRY and ZAR. Seems like our CEE safe haven status is gone for a while. Today (Friday 12th) we see the same consolidation and stabilization. But don't be fooled, we expect the volatility is here to stay.

Options Consolidation

The realized volatilities in short end are still high, with 1 month EUR/PLN implied being well below the realized ones. This situation has been going on for a while already, and that's the reason we are slowly trimming our Vega shorts and moving to the sidelines. We are also keeping our core Skew long in EUR/PLN.



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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
2/4/2016	1.73	1.69	1.78	1.65	1.67	1.67	1.67	1.52	1.44	1.41	1.40	1.46
2/8/2016	1.48	1.69	1.60	1.65	1.54	1.67	1.65	1.52	1.45	1.43	1.41	1.47
2/9/2016	1.62	1.69	1.62	1.65	1.58	1.67	1.67	1.53	1.45	1.43	1.41	1.47
2/10/2016	1.50	1.69	1.55	1.65	1.57	1.67	1.64	1.52	1.44	1.41	1.41	1.48
2/11/2016	1.70	1.69	1.80	1.64	1.70	1.66	1.65	1.52	1.45	1.42	1.41	1.47

Last primary market rates							
Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
32W TB	1/18/2016	8/31/2016	99.16	1.37	2000	11765	2400
OK1018	2/4/2016	10/25/2018	95.62	1.67	3000	8160	4645
PS0421	1/7/2016	4/25/2021	98.11	2.38	3500	724	4555
DS0726	2/4/2016	7/25/2026	94.10	3.17	3000	6661	4366

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
2/4/2016	1.670	1.474	1.635	1.578	1.960	2.232	2.405	2.949
2/8/2016	1.670	1.474	1.635	1.578	1.960	2.232	2.405	2.949
2/9/2016	1.670	1.474	1.635	1.578	1.960	2.232	2.405	2.949
2/10/2016	1.670	1.474	1.635	1.638	1.990	2.290	2.447	2.985
2/11/2016	1.660	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
2/4/2016	8.90	8.90	9.04	9.13	9.13	2.28	0.58
2/8/2016	8.60	8.93	9.13	9.08	9.08	2.28	0.58
2/9/2016	9.05	8.88	9.09	9.10	9.10	2.28	0.58
2/10/2016	9.30	8.93	9.03	9.10	9.10	2.10	0.57
2/11/2016	9.35	9.16	9.21	9.31	9.31	2.09	0.57

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
2/4/2016	4.4078	3.9492	3.9431	3.3549	1.4232	0.1631
2/8/2016	4.4185	3.9525	3.9869	3.3858	1.4242	0.1633
2/9/2016	4.4490	3.9771	4.0447	3.4500	1.4285	0.1644
2/10/2016	4.4366	3.9383	4.0445	3.4271	1.4261	0.1641
2/11/2016	4.4407	3.9219	4.0541	3.5220	1.4240	0.1640

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