April 1, 2016

Polish Weekly Review

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Comment on the upcoming data and forecasts

Only one publication next week – on Wednesday MPC will decide about interest rates. We expect benchmark rate to remain unchanged at 1.50%. Numerous MPC members' comments are a sign of intention to stabilize rates. This opinion is supported by solid momentum in Polish economy. However, prolonged deflation and global macroeconomic environment (QE in euro zone and rate cuts in the region) will allow painless cuts and thus lower debt service cost. In our opinion, this should persuade MPC to cut interest rates and pave way to unconventional monetary policy instruments in the second half of the year.

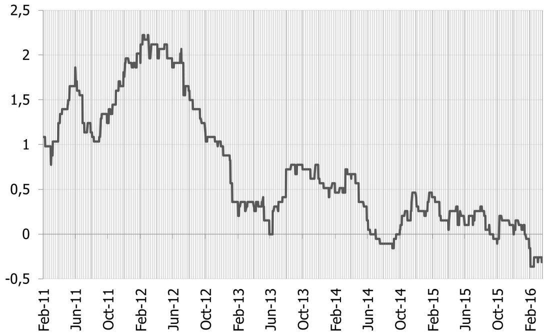
Polish data to watch: April 4th to April 8th

Publication	Date	Period	mBank	Consensus	Prior
MPC decision (%)	06.04	Apr	1.50	1.50	1.50

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
(32/37/52) Week T-bills	-	1500	1.350	3/14/2016
2Y T-bond OK1018	4/7/2016	2700	1.553	3/3/2016
5Y T-bond PS0720	4/21/2016	4800	2.219	2/18/2016
10Y T-bond DS0726	4/7/2016	5500	3.014	3/3/2016
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Both flash CPI and the PMI releases surprised markets this week, but in different ways. They balanced each other, thus surprise index remains at the same level. Next week brings only one relevant announcement (MPC decision), but the index should remain unchanged.

* 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 perspectives brightened recently.
- 500+ programme 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 stay positive on 10Y POLGBs.
- Risk premium looks too high. Polish yield curve is extremely steep.
- Foreign investors' perception of Polish bonds improved recently (one cannot say the same on equities where sectoral story is still determined by politics).
- Polish zloty lately trades decently, supported by strong economic fundamentals, ECB stimulus and MPC's communication.

mBank forecasts

	2011	2012	2013	2014	2015	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	-0.1
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

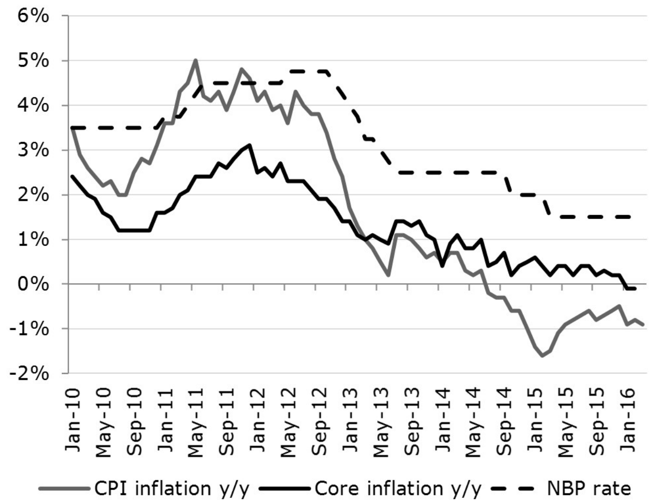
	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1 F	2016 Q2 F	2016 Q3 F	2016 Q4 F
GDP y/y (%)	3.7	3.3	3.5	3.9	3.7	3.8	3.9	3.9
Individual consumption y/y (%)	3.1	3.1	3.1	3.1	3.4	3.8	4.1	4.3
Public Consumption y/y (%)	3.7	2.5	2.7	4.8	3.2	2.9	4.0	4.0
Investment y/y (%)	11.5	6.1	4.6	4.9	3.0	3.6	4.0	4.5
Inflation rate (% average)	-1.4	-0.9	-0.7	-0.6	-0.9	-0.5	-0.1	1.0
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	1.50	1.25	1.25
Wibor 3M (% eop)	1.65	1.72	1.73	1.72	1.67	1.66	1.44	1.44
2Y Polish bond yields (% eop)	1.61	1.99	1.76	1.62	1.45	1.35	1.35	1.55
10Y Polish bond yields (% eop)	2.31	3.31	2.84	2.94	2.84	2.80	3.00	3.20
EUR/PLN (eop)	4.07	4.19	4.25	4.26	4.24	4.25	4.25	4.20
USD/PLN (eop)	3.80	3.76	3.80	3.92	3.73	3.86	3.86	3.82

F - forecast

Economics

Another negative surprise in inflation data, changes in monetary policy are a matter of time

According to the flash estimate (return after two months of absence) Polish CPI fell to -0.9% yoy in March (in line with our forecast and slightly lower than market consensus). Final data will be published in the second week of April, so now we can only speculate about reasons for this surprise. In our opinion, two factors are responsible for this slide: very modest fuel price growth (+1.0% mom, much lower than a year before) and third month in a row with negative core inflation (-0.1% yoy). The food price rise expected by us (+1.0% mom), although larger than in 2015, was not enough to balance out other factors and even eased the base effect of fuel prices.



Those are only small gyrations and the general view is that momentum of inflationary processes is zero in Poland right now. Moreover, there are no signals of a change here. In the next months inflation will be driven by statistical base effects. Comparing to previous year, fuel prices growth will be postponed by a month (largest rise in April, not March). However, we still expect positive CPI releases only September.

The data hardly matter for current monetary policy. At the moment, the new Monetary Policy Council is focused on establishing its "credibility", which means hawkishness in Polish circumstances, and promoting its predecessors' view of a balanced economy and optimal interest rates. In our view, this is a purely tactical maneuver. First, the deep and persistent deflation is a fact. The longer it lasts, the more uncertainty about second round effects it will generate (consider the fact that inflation in Poland is lower than in the advanced economies â€“ a major aberration by historical standards). Moreover, the fact that the NBP keeps forecasting its own failure in attaining the inflation goal (i.e. no inflation apart from base-related uptick in the Autumn), even though the bank is not short of conventional and unconventional ammunition, puts its credibility at risk. Second, global tendencies, i.e. structurally low growth and interest rates, major central banks adopting an extremely cautious stance, as well as regional developments (rate cuts in Hungary and likely easing in Czech Republic), imply that there aren't any good reasons for Poland to have interest rates that high. It would reduce government debt service costs as well. As soon as market conditions allow for it, the issue of rate cuts will come back into spotlight, along with revisions to monetary policy strategy (to allow for a wider unconventional toolbox, similar to the one employed by the Hungarian central bank).

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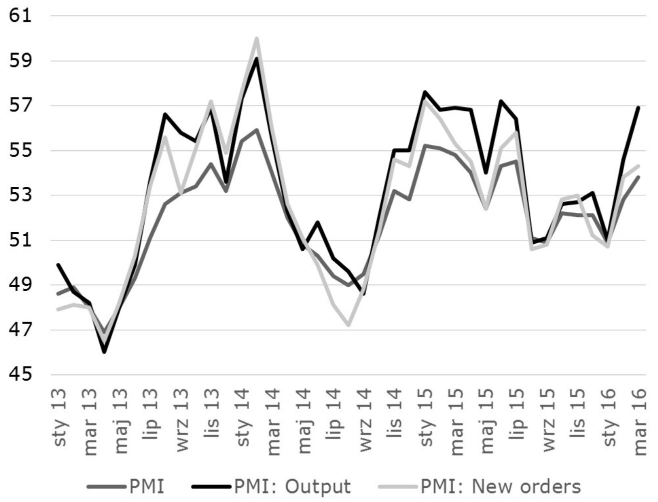
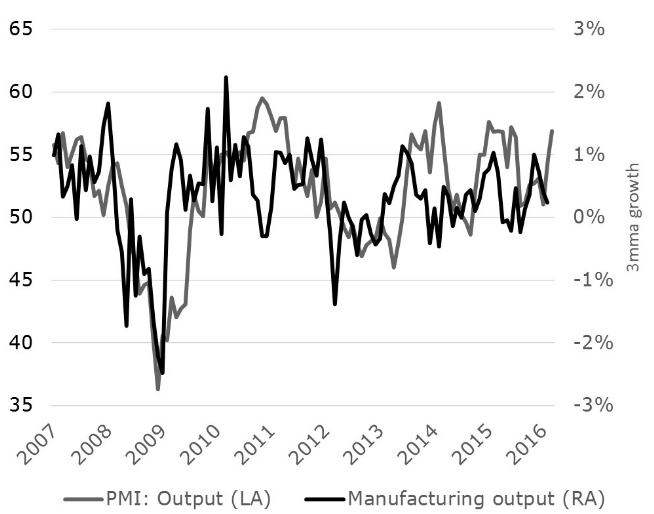
Manufacturing PMI at 8–month high

In March Polish PMI rose from 52.8 to 53.8, upsetting the market's pessimism (median of forecasts: 52.6). Just as in February, the increase in the PMI was driven by better assessment of production (the subindex grew from 54.6 to 56.9) and new orders (marginally up, from 53.8 to 54.3). The latter was particularly impressive, as output assessment rose to late 2014/ early 2015 highs already. Hiring activity was also robust, reaching a one-year high in March. Comments on the data look solid too. For instance, new order inflow was driven by domestic and foreign orders alike. Other areas of interest have showed little change recently â€“ the slight increase in input prices does not change the general picture of a deflationary equilibrium in which Polish industry is stuck.



As usual, it is hard to link hard data to soft indicators like the PMI. However, with acceptable precision we can conclude that current PMI levels are consistent with solid momentum in the Polish industry. Given the fact that the swings in the PMI are probably overestimating real changes in business climate (as any comparison with other business tendency indicators will reveal) and that GDP and the labor market have been largely insensitive to these swings in the past two years, the upturn in the PMI is probably inconsequential for monetary policy. For now, the MPC is focused on increasing its credibility – which means stable rates.



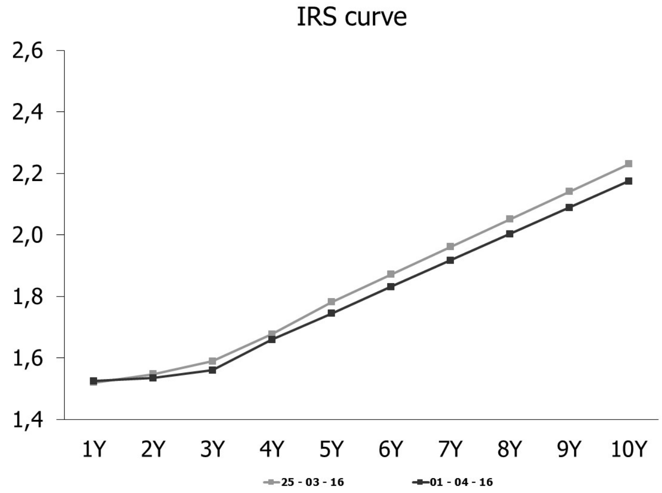
Fixed income

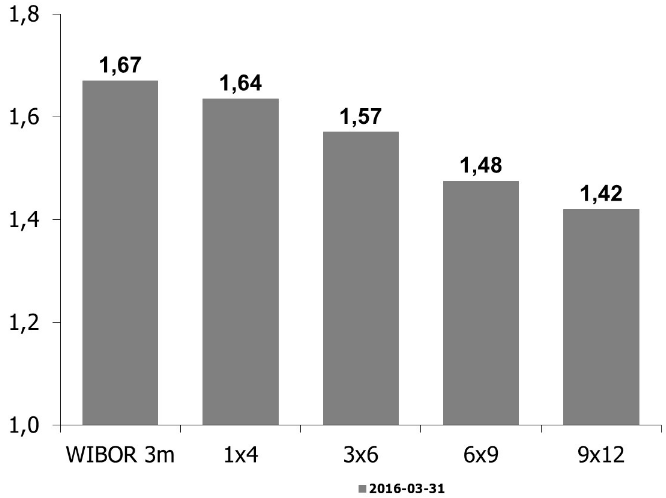
Looks like our weekly recommendation was right again.

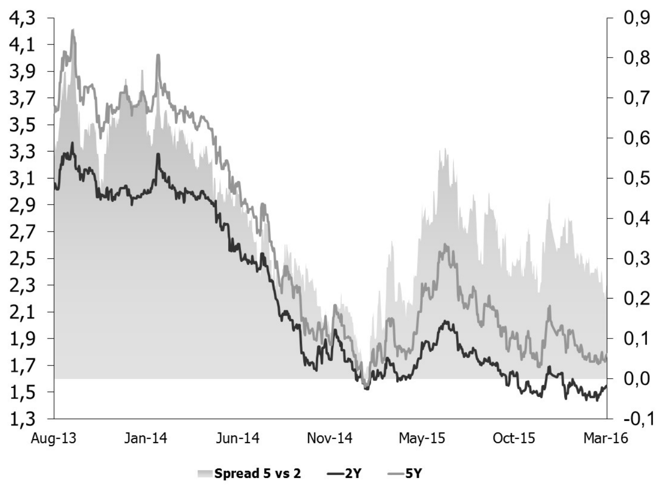
Due to good global sentiment and vanishing political tensions long end of the curve moved 5 bps lower, both swaps and bonds. Demand for Polish bonds is still huge and it shouldn't decrease in the nearest future as our bonds are still very attractive with yields around 2.80 (DS0726).

10Y ASW widened to 62 as a new bond auction will take place next week and then small pressure appears on DS0726. The MoF will offer longest and shortest bonds. We are pretty sure that demand will be huge. Local banks will buy OK1018, foreign ones – DS0726. We recommend to join this auction.

To hedge bonds we recommend to buy 5Y IRS at 1.75 as rate around 6M WIBOR looks pretty safe.







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Money market

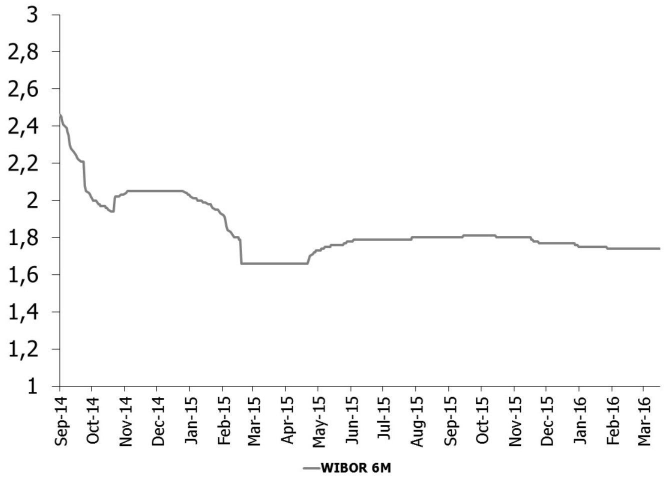
Q3 financing plan

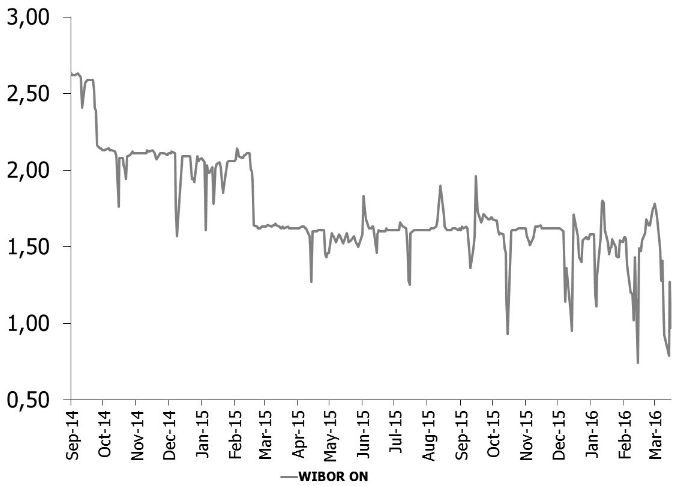
As we predicted, last OMO was well underbid and cash was lying on the floor. Now we change to normal overnight regime and rate should stay around 1.50%. In fact, we predict that the whole month will be relatively expensive due to unfavorable end of reserve day schedule.

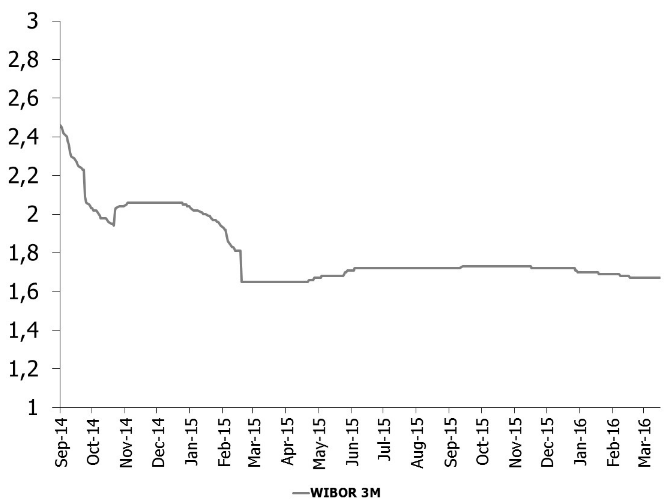
Yesterday the MoF announced financing plan for the next quarter. They are skipping a t-bill auction in April, this might have something to do with poor results of the previous one. Next thing affecting short end is the lack of switching auctions in April and May. Switch in June is not excluded.

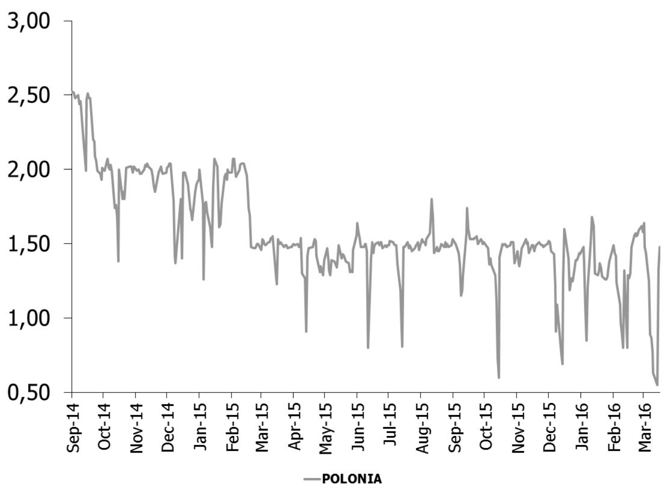
We are waiting patiently aside now, but would like to reenter our long position on short bonds (especially 1016 and 0417). Attractive lvl which generates small funding risk would be 1,35-40% ytm.

Polonia vs Ref rate averages: 30 day – 20bp(+4); 90 day – 19 bp(+1)









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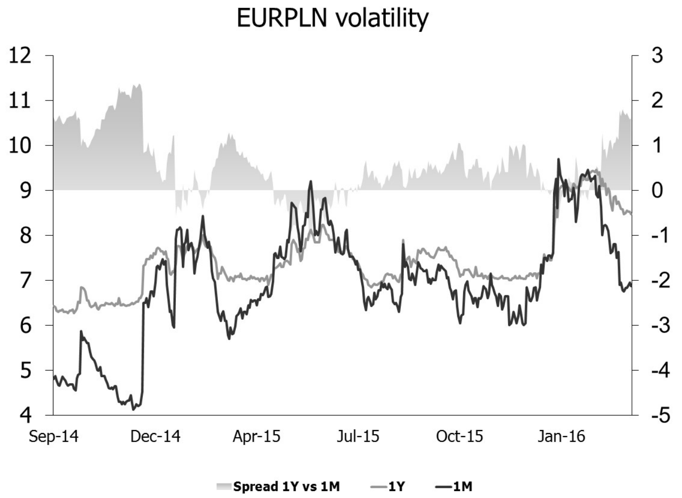
Forex

Spot – PLN at fresh highs PLN march continues, as EUR/PLN set the new YTD low at 4.2296. The fresh impetus was added by Fed Chairman Janet Yellen, and her dovish speech. It already has been a really long streak of positive, pro-risk news. Can we go on like that? Maybe we could, but we will not bet money on that. We are still looking for ranges in EUR/PLN and current 4.23-4.33 was not really defeated as of yet. We are skewed to buy dips.

Options – EUR/PLN Vol curve weaker by a tiny bit The expected rebound in vols after Easter has not materialized, the opposite happened. We even managed to ease a bit in the frontend, mostly because realized volatility was so low. 1 month EUR/PLN ATM mid, is at 6.7% (0.1% lower), 3 months EUR/PLN is 7.6% (0.1% lower) and finally 1 year is 8.7% (unchanged). Skew is roughly unchanged, and currency spread (difference between USD/PLN and EUR/PLN) is also treading water.



Short-term forecasts

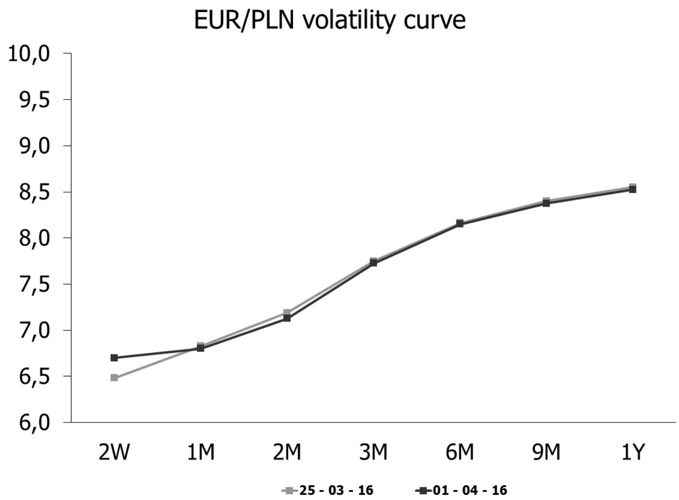
Main supports / resistances:
EUR/PLN: 4.23 / 4.33
USD/PLN: 3.70 / 4.00

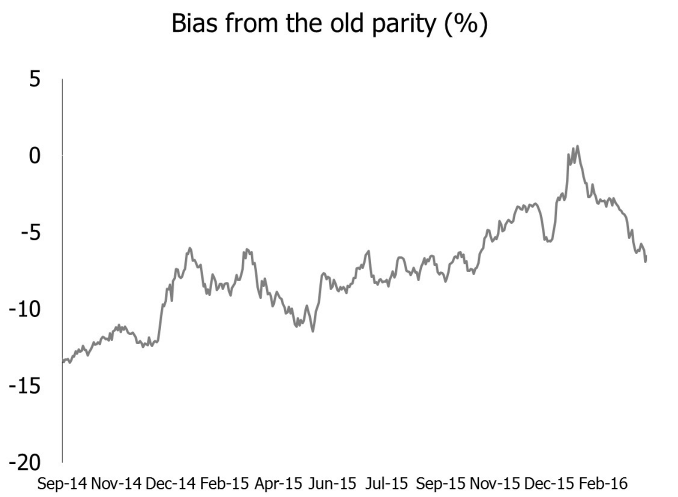
Spot Current position: Long at 4.2550, and at 4.2350 and with stop below 4.2050 and hopes to get above 4.32+.

We just still think the risk/reward is for being long EUR/PLN at current levels. The downtrend in EUR/PLN is losing momentum, and it may indicate at least some short-term reversal. I know, it sounds like a broken record...

Options

We are now outright long Vega (mostly in backend Vega). We are getting closer to the planned reviews of Poland's ratings by major rating agencies. It's a potential risk factor for Zloty, our long term financial stability is not that guaranteed. We are just a little more pessimistic than the others... Adding long R/R in 1 Year to the book.





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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
3/24/2016	1.38	1.67	1.51	1.64	1.54	1.66	1.64	1.58	1.49	1.46	1.43	1.52
3/28/2016	1.57	1.67	1.62	1.64	1.64	1.66	1.64	1.57	1.49	1.44	1.42	1.53
3/29/2016	1.72	1.67	1.79	1.64	1.69	1.66	1.64	1.57	1.48	1.44	1.42	1.51
3/30/2016	1.19	1.67	1.10	1.64	1.35	1.66	1.64	1.58	1.49	1.44	1.42	1.52
3/31/2016	1.46	1.67	1.58	1.64	1.57	1.66	1.64	1.57	1.48	1.42	1.41	1.51

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	2/18/2016	4/25/2021	98.93	2.22	4800	9169	5143
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
3/24/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
3/28/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
3/29/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
3/30/2016	1.660	1.474	1.635	1.638	1.990	2.290	2.447	2.985
3/31/2016	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
3/24/2016	6.83	7.75	8.18	8.50	8.50	2.20	0.62
3/28/2016	6.90	7.78	8.18	8.53	8.53	2.20	0.62
3/29/2016	6.95	7.80	8.18	8.53	8.53	2.20	0.61
3/30/2016	6.88	7.73	8.13	8.48	8.48	2.19	0.61
3/31/2016	6.80	7.73	8.15	8.53	8.53	2.19	0.61

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
3/24/2016	4.2715	3.8240	3.9201	3.3924	1.3605	0.1579
3/28/2016	4.2630	3.8174	3.9087	3.3778	1.3601	0.1575
3/29/2016	4.2535	3.8037	3.9025	3.3451	1.3559	0.1572
3/30/2016	4.2445	3.7495	3.8890	3.3412	1.3537	0.1568
3/31/2016	4.2684	3.7590	3.9040	3.3463	1.3586	0.1578

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