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Polish Weekly Review

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Comment on the upcoming data and forecasts

On Monday CSO will publish its Statistical Bulletin with unemployment rate for March. We expect confirmation of preliminary Labour Ministry data, which implies a fall from 10.3% in February to 10.0% last month. Week ends with CPI *flash* release for April. Our forecast indicates just a minor rise of inflation because of base effect in fuel category.

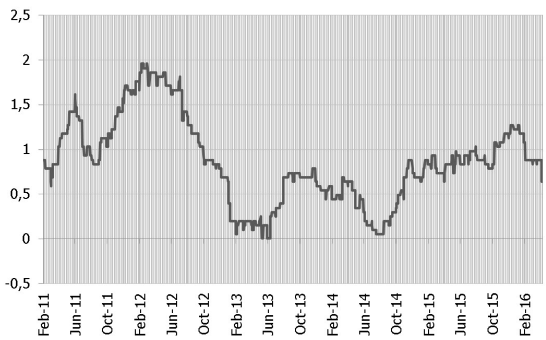
Polish data to watch: April 25th to April 29th

Publication	Date	Period	mBank	Consensus	Prior
Unemployment rate (%)	25.04	Mar	10.0	10.0	10.3
Inflation expectations (%)	29.04	Apr	0.2	0.2	0.2
CPI y/y (%) *flash*	29.04	Apr	-0.7	-0.9	-0.9

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	5/5/2016	2700	1.553	4/7/2016
5Y T-bond PS0720	-	4800	2.219	4/21/2016
10Y T-bond DS0726	5/5/2016	5500	3.014	4/7/2016
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Polish surprise index crashed in April after disappointing data from real sphere. Better than expected unemployment did not moved the index upward. Next week's *flash* CPI brings a sole opportunity to for the index to catch up, unemployment rate shouldn't be a 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).

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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 defensive and like 2y bonds. Sticking to 2y allows us to safely take advantage of the expected play on rate cuts in Poland (nobody believes in them which is a mistake in our opinion) and movements associated with the banking tax.
- Local factors temporarily played out and the pendulum may be swinging to the other side at the moment amid greater volatility (great return of CHF conversion programme) while MPC still sticks to stable rates paradigm.
- Globally, we entered the play for Brexit that may be disastrous for all asset classes. Valuations for U.S. rates seem to be at local bottom given the improvement in financing conditions, inflation expectations, weaker dollar and improvement in the data. At this stage further ECB easing play is conceivable but too distant from tactical perspective.
- We see first signs of nervousness on EURPLN. Although it may be only a profit taking after a persistent PLN rally, we think the Zloty may face headwinds because of looming Brexit referendum and return of CHF-mortgage conversion proposals.

mBank forecasts

	2010	2012	2013	2014	2015	2016 F
GDP y/y (%)	3.7	1.6	1.3	3.3	3.6	3.8
CPI Inflation y/y (average %)	2.8	3.7	0.9	-0.1	-0.9	-0.1
Current account (%GDP)	-5.4	-3.7	-1.3	-2.0	-0.1	-0.7
Unemployment rate (end of period %)	12.4	13.4	13.4	11.4	9.8	8.7
Repo rate (end of period %)	3.50	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 (%)	3.6	3.1	3.4	4.3	3.7	3.8	3.9	3.9
Individual consumption y/y (%)	3.1	3.1	3.1	3.0	3.4	3.8	4.1	4.3
Public Consumption y/y (%)	1.8	0.8	0.9	8.7	3.2	2.9	4.0	4.0
Investment y/y (%)	11.8	5.8	4.4	4.4	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	1.30	1.30
10Y Polish bond yields (% eop)	2.31	3.31	2.84	2.94	2.84	2.90	2.90	2.90
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

A temporary blip in manufacturing and retail sales amid sky-rocketing labor market. Construction weakness a different story, though.

Recent bout of data was surprising. It seemed forecasting should have been boiled down to working days count. As it turned out, it shouldn't. Manufacturing and retail sales posted weakness across the board, even as the latter was boosted by Easter sales. All this happened while labor market posted record high job creation in March (and still fairly decent wage growth).

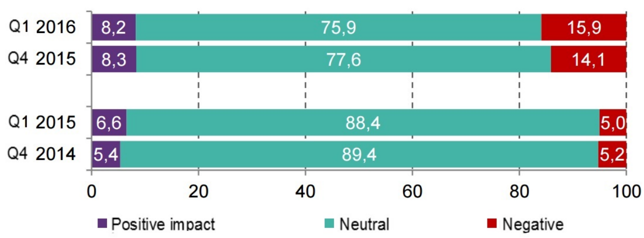
Such aberrations may have been caused indeed by working days, but rather by their tricky nature around such early Easter, than just their count. Such an assumption explains nicely the uniform drop in manufacturing and retail sales. Moreover, recent NBP surveys (released the same day as the horrifying high frequency real sphere data) showed no inflection points in Polish business cycle. Enterprises stay almost as optimistic as they were a quarter ago; investment activity even improved a bit. In such circumstances it hard to jump into conclusions, especially jump too far.

Two things are troubling, though.

First of all, construction activity is in the doldrums. We signalled for long that there will be a problem with public investment spending in 2016 and this is indeed the case. As road investment goes unabated, railroad construction and investment in rolling stock is falling behind. The same problems are seen on local level where regional and local governments expect 30-40% y/y drops in investment activity (possibly a temporary phenomenon but toxic at the moment). In such circumstances private investment is unlikely to make up for the loss in public activity. Lower growth rate of investment has to follow in 2016. As we already signaled, 2016 is going to be marked by a trade-off between investment and consumption.

Secondly, we have for long indicated that producer prices can be moved only by a large shock that unilaterally hit all businesses. Exchange rate shock would do the trick and (possibly) cancel deflationary equilibrium. However, low zloty volatility does not help (recent movements are still too small – see the graph in the following text when producer prices go underwater). Recent NBP surveys show deflation in producer prices is eating into the profits and the scope for lowering costs is shrinking. With all the strength of consumption, a large risk factor for the corporate side is looming, that is so far overlooked by the NBP.

Figure 6 Impact of the decline in producer prices on the economic situation of companies

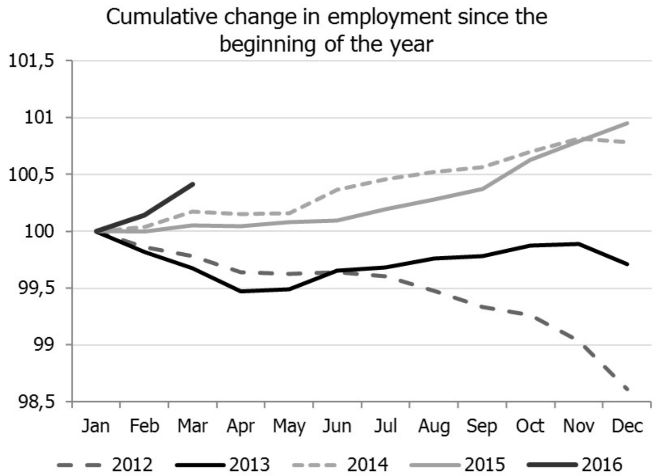


March data point to significantly lower GDP growth rate already in Q1 (3.5% y/y) as compared to the revised figure of 4.3% y/y recorded in Q4 2015. Lower growth rate may be temporary, although one should remember that Polish economy will be functioning with lower public investment outlays and possible spillovers from them in the future. One should also remember about the problems sprouting in the corporate sector (deflation in producer prices). Such a combination of reality and risks has the following implications:

1. We see some analysts' forecasts of 2017 rate hikes in Poland as at least exotic. Polish economy isn't booming. There are weak spots and headwinds. It is the main reason we were not overemphasizing the impact of fiscal stimulation in our economic forecasts few months ago. We see fiscal stimulation (500+ including) as only offsetting infrastructure gap and lower fixed capital formation effects. Contrary to 2012, fiscal policy is now expansionary.
2. Weaker zloty will be seen as a powerful tool supporting economic growth and lower rates may render zloty weaker. That is why we think rate cuts are still, despite MPC comments, quite likely going forward.

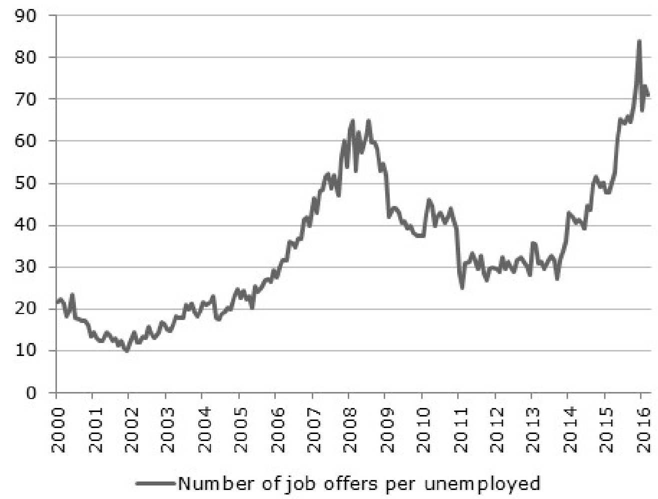
Having said that, let's take a more detailed look at the releases that confused us.

Employment in the enterprise sector rose in March by 2.7% y/y (market consensus and our forecast were just 2.5%). On a monthly basis, 16k jobs were created, which is the best month since 2007. Since the beginning of the year (excluding January because of change of statistical sample) 24k jobs were created – comparing to 3k last year and 9k in 2014. Employment rises in full throttle right now which is consistent with NBP's labour market surveys.

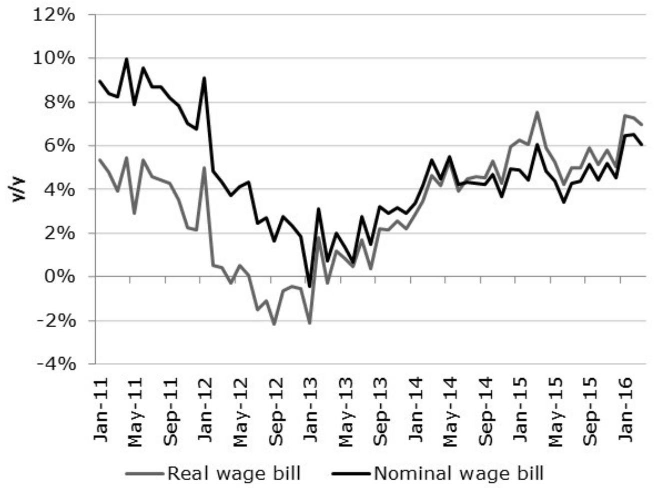


Labour market perspectives have improved significantly. Apart from good economic outlook (higher labour demand) there could also be structural changes, where alternative forms of employment (so called „junk contracts") are being replaced by standard contracts. Taking into account different measures of this phenomenon we estimate the scope of potential flow to amount to 200 – 300k. This number could be spread over several months because of gradual expiration of those agreements. Even if we have overestimated it, Polish economy is in now a specific state, where employment data are (finally) converging with the drops in unemployment data. If we are right, such specific shift in forms of employment is also going to have, beside the statistical effects, positive influence on consumer behavior linked to job security.

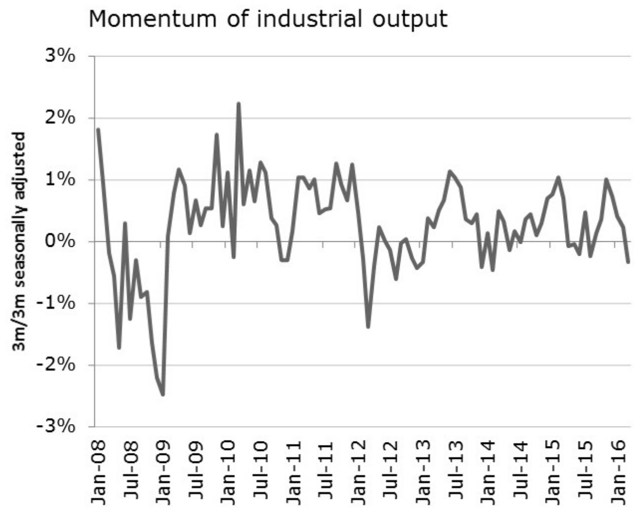
In March **wage growth** declined from 3.9 to 3.3% y/y, slightly below market consensus and our forecast (3.4 and 3.7%, respectively). Industrial data support our idea that the slowdown is due to a calendar effect (working day difference dropped from +1 to 0 y/y), most apparent in manufacturing and construction. Due to its weight in corporate employment, the former is the most likely source of the surprise. At the same time, we do not see that as a harbinger of a deeper slowdown in wages. On the contrary, all the ingredients for faster wage growth are already in place: unemployment will soon breach multi-decade lows and that signifies an increasing mismatch between available labour and rising demand for it; due to demographic reasons, labour supply is set to decline over the coming years; the new child subsidy programme will probably lower labour supply at the margins (for the lowest deciles of wage distribution). As a result, wage growth in excess of 5% this year is very likely.

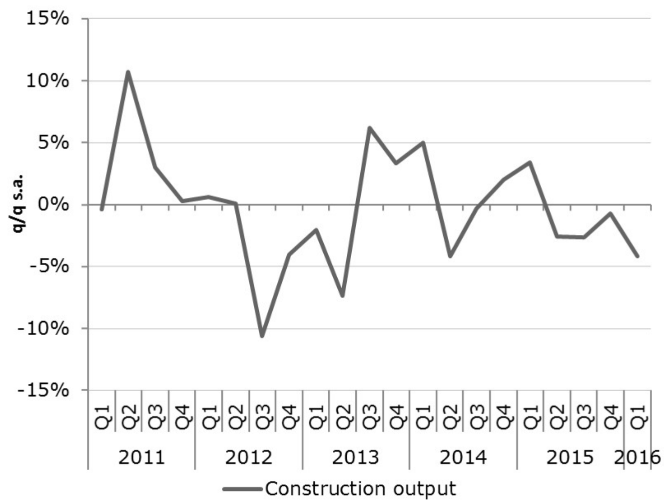


With faster employment growth and extremely low inflation, wage bill decelerated only slightly in March. In current prices annual growth rate declined from 6.5 to 6.1%, in constant prices – from 7.3 to 7.0%. Starting from April, the disbursement of the new child subsidy programme will boost household disposable incomes and, in turn, household consumption (this result holds for any reasonable assumption of marginal savings rates).



Industrial output went up by a meagre 0.5% y/y vs. 6.7% y/y recorded in February. There was no difference in working days (y/y comparison) compared to 1 day more last month. In SA terms industrial output rose by 0.8% y/y vs. 3.0% recorded a month ago. After recent release, industrial output momentum decelerated to below zero (see graph below).

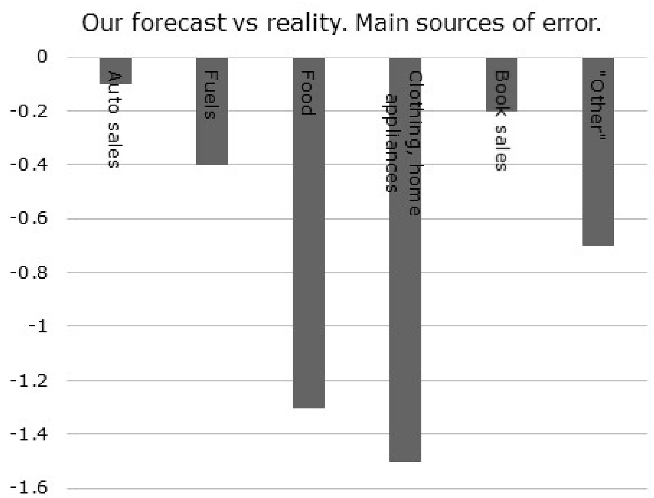




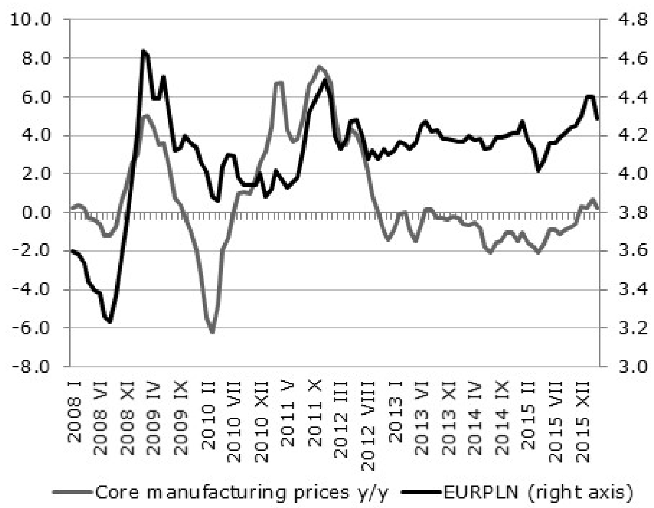
There may be some problems with working days count due to earlier Easter. Also NBP surveys does not show and dramatic decline in economic activity. Although there may be some spillovers from weak construction activity, temporary factors may be at the foreground.

In March **construction output** surprised to the downside as well, having dropped by 15.8% on annual basis (seasonally adjusted -3% m/m). As a result, the first quarter turned out to be one of the worst quarters for the sector in recent years. Taking a broader perspective, we can reiterate our view on the nature of the weakness in construction. We believe it is related to the end of EU spending on the basis of 2007-2013 EU budget. This generates a major pothole in public investment, mainly in railway investment and local government spending, one that cannot be filled by road investment and housing investment. On the whole, we believe that construction output will decline in 2016.

Taking into account the strong labour market, Easter effect and incoming child subsidy programme, **retail sales** for March is very disappointing. Only 0.8% on a yearly basis is a result of relatively low food prices, clothing, electronics and furniture. Although lower „other" category also contributed, its variation is still acceptable and within usual limits (what cannot be said with regard to the previously mentioned categories). Given also weaker industrial output data, there could be another factor responsible for common drop in real sphere activity in March, although we have not identified it yet. It is still too early to cry wolf after poor retail sales, although statistical base form previous year (Easter) could mean that, even if in April most of the categories bounce back, headline publication will also be lower than previously expected.



Deflation in **producer prices** holds strong (-1.7% y/y), lower than our forecast and market consensus (-0.4%). We have identified two main reasons for it: 1) revision of previous month's release (by 0.1 pp downwards), 2) lower rise in prices of coke and refined petroleum products. Manufacturing prices excluding coke fell by 0.6% (in line with our forecast). Once again a familiar scenario repeats itself: strengthening currency = lower core prices in manufacturing (see chart below). Deflationary equilibrium holds while momentum of price change is below or just around zero. It seems that from a general macroeconomic equilibrium perspective, weaker Zloty would now by not only beneficial but also desired.



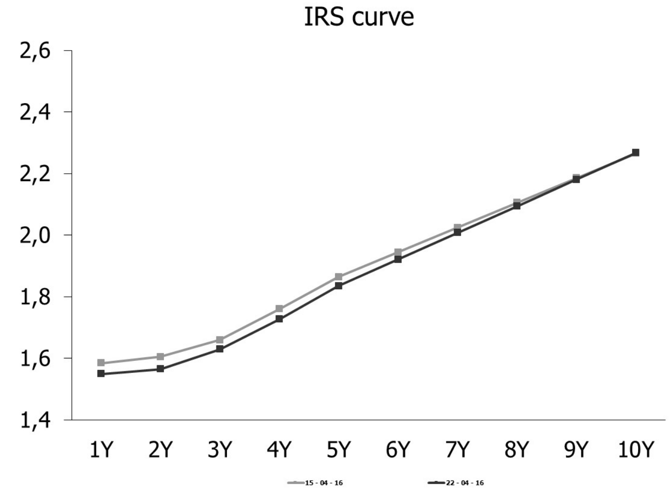
Fixed income

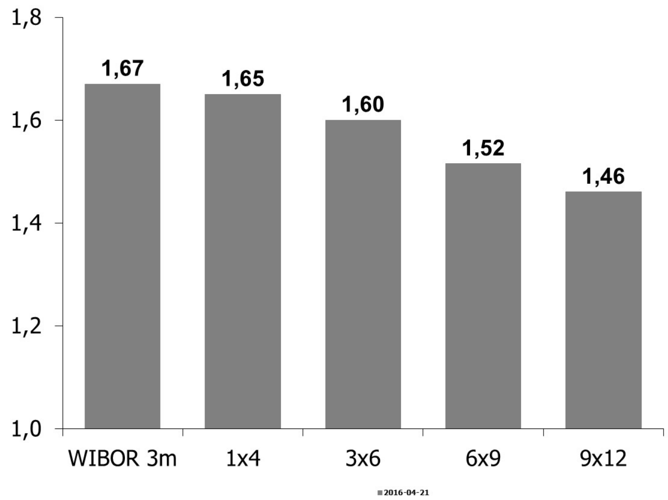
More steepening ahead

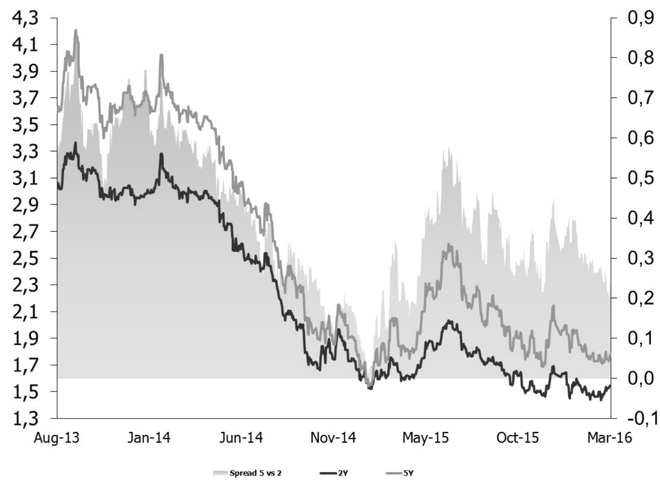
With higher crude oil prices being a worldwide story, l/e core yields 10 bps higher (vs. last Friday close) and a non-eventful ECB meeting, Polish government bonds where welded to last week levels with the long end being an exception (DS0726 +6bps, at 3.02%). Why?

Economic data for March we received this week (industrial output +0.5% y/y vs. +3.9% expected; PPI -1.7% vs. -1.4%; retail sales 0.8% vs. 3.4%) fuelled rate cut expectations (20 bps is priced in 9x12 FRA). Thursday's auction was a MoF success with accepted prices higher comparing to the secondary market, however, you have to remember that PS0721 is extremely cheap vis-a-vis the curve. The ministry sold 8.5 bn PLN, of which: 1.69 bn PLN of WZ0120 SFL 19.1, 6.6 bn PLN of PS0721 with yield 2,32%, 0.38 bn PLN of WZ0126 SFL 62.7.

We still favour buying 2y10y spread which widened another 5bps (currently 72 bps) as the risk regarding the CHF conversion plan is a matter of time and Moody's rating decision is scheduled on 13th of May. The pace of PLN weakness (EURPLN above 4,35) should support our trade idea. Watch Fed and BOJ meetings next week.





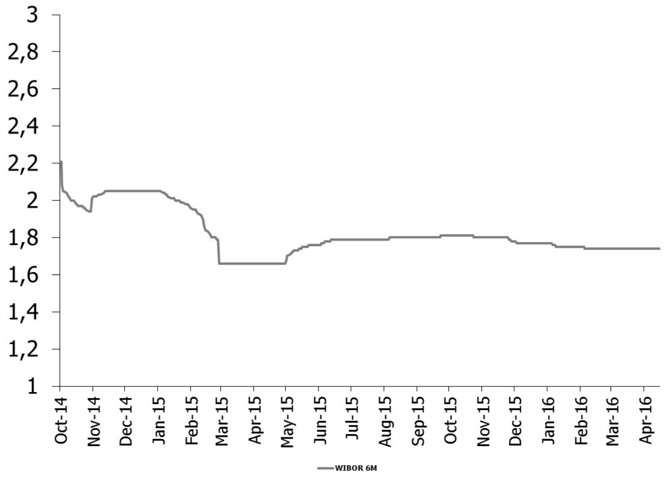


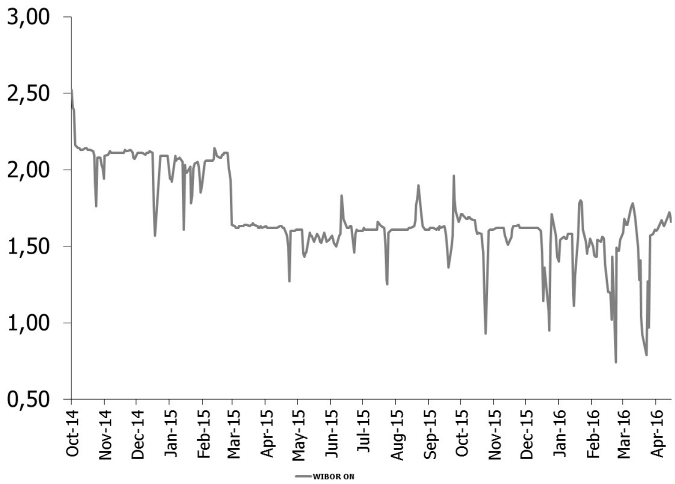
Money market

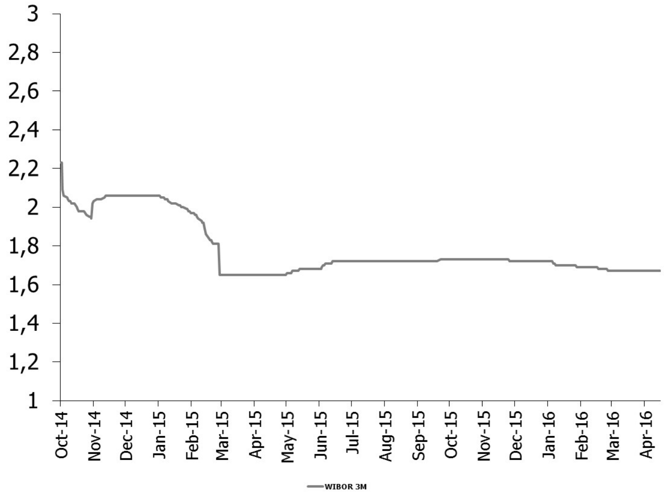
Quite interesting week behind us

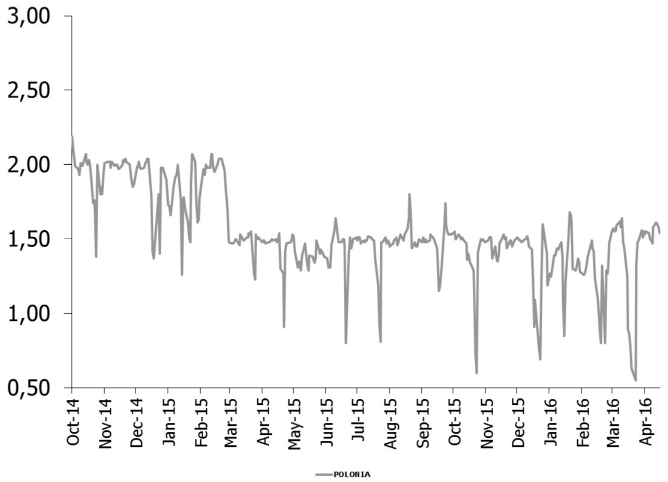
After a calm part of the month we are entering the volatile one. Banks bought PLN 69.5 bio NBP bills out of 73.5 bio offered so financing should be secured for next week. Volatility should be muted somewhat as cash will return to the market on the last day of the reserve period and banks will be able to adjust their balances again next Friday.

Ref rate vs Polonia averages:
30 day: 14bp(-4)
90 day: 14bp(-4)





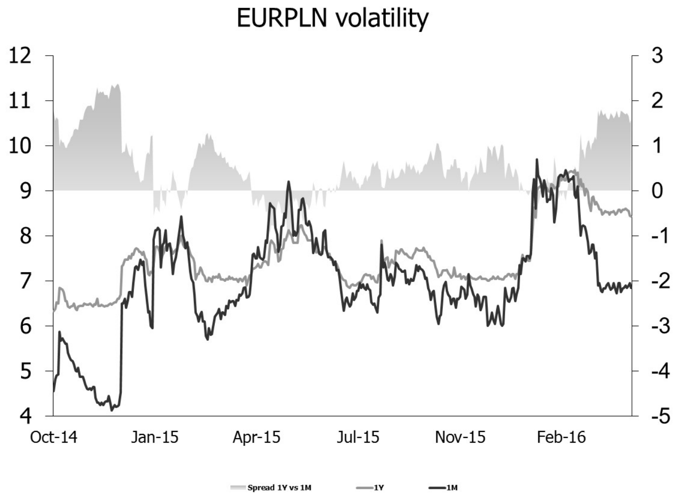




Forex

Spot – Zloty weakness gains traction It was a very interesting week for EUR/PLN with bears and bulls having their moments. The 4.30/4.31 zone was giving tough resistance. We were able to touch 4.2670 (the week's low) before we finally spiked higher to 4.3500 (the high so far). Potential rate cuts by the MPC, renewed fears of CHF denominated loans project and Polish rating revision (Moody's) are getting more and more attention. On global markets, one can look at FOMC meeting that probably cannot be more dovish at the moment (strained valuations). We expect 4.36 resistance zone to be tested.

Options – EUR/PLN Vol curve higher The shy buyers are emerging, as realized volatilities are slowly but surely moving north. 1 month EUR/PLN ATM mid is at 7.1% (0.4% higher), 3 months EUR/PLN is 8.0% (0.0% unchanged) and finally 1 year is 8.7% (0.1% higher). 1 year was actually traded at 8.7% at fair amounts. The skew was a bid higher, especially at the frontend. The currency spread (USD/PLN vol minus EUR/PLN vol) is a bit tricky as BREXIT blurs the picture. The post referendum dates are naturally quoted at premium.



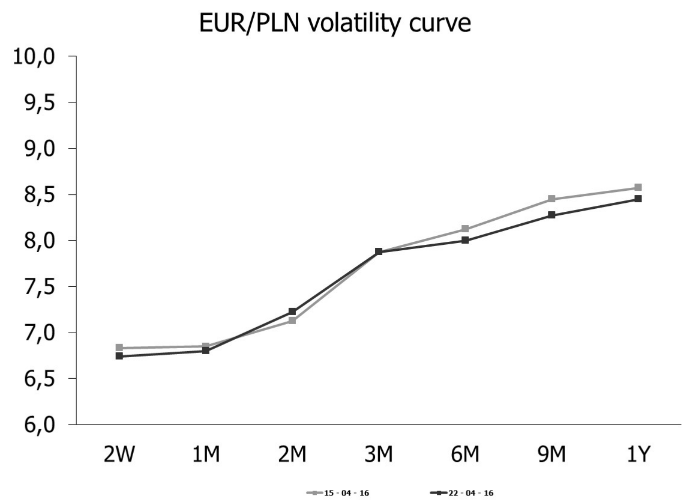
Short-term forecasts

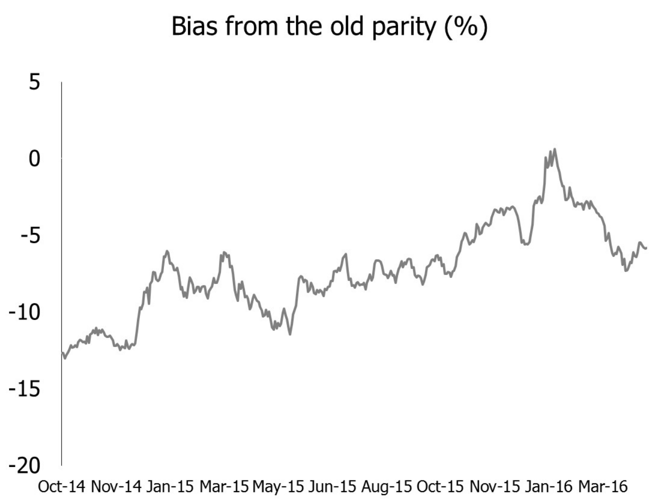
Main supports / resistances:
EUR/PLN: 4.29 / 4.39
USD/PLN: 3.70 / 4.00

Spot Current position: We partially took profit on long EUR/PLN from 4.2450 at 4.3400. We are left with a core long EUR/PLN looking for extension of the move to 3.39+ or correction to 4.2900, where we would like to reload and expand size.
MPC rate cuts, ratings revisions, CHF loans, it was all known for weeks. It was not getting much of attention until very recently. It was prudent to book some profit, but we think EURPLN may still move higher. We expect the volatility to increase, the FOMC meeting is the next BIG event.

Options Vols – Long Vega

The political situation remains blurred at best, with potential sources of problems firmly in place (i.e. Constitutional Tribunal, EU's resolution, CHF legislation draft). We are getting close to the planned reviews of Poland's ratings by major rating agencies. It is a potential risk factor for the Zloty as our long term financial stability is not that warranted. In this environment the only thing we can be sure of is elevated volatility. We are now outright long Vega (in majority backend Vega). We are just a little more pessimistic than others.





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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
4/14/2016	1.73	1.67	1.82	1.64	1.72	1.66	1.66	1.62	1.56	1.51	1.51	1.59
4/18/2016	1.49	1.67	1.54	1.64	1.59	1.66	1.65	1.62	1.56	1.50	1.50	1.58
4/19/2016	1.50	1.67	1.55	1.64	1.58	1.66	1.65	1.61	1.53	1.47	1.47	1.55
4/20/2016	1.37	1.67	1.43	1.64	1.48	1.66	1.64	1.60	1.52	1.46	1.45	1.54
4/21/2016	1.46	1.67	1.56	1.64	1.60	1.66	1.65	1.60	1.52	1.46	1.45	1.55

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
4/14/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
4/18/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
4/19/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
4/20/2016	1.660	1.474	1.635	1.638	1.990	2.290	2.447	2.985
4/21/2016	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
4/14/2016	6.90	7.95	8.18	8.60	8.60	2.22	0.60
4/18/2016	6.90	7.85	8.13	8.55	8.55	2.22	0.60
4/19/2016	6.95	7.93	8.03	8.45	8.45	2.22	0.60
4/20/2016	6.85	7.83	8.00	8.43	8.43	2.22	0.62
4/21/2016	6.80	7.88	8.00	8.45	8.45	2.22	0.62

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
4/14/2016	4.3016	3.8174	3.9511	3.4955	1.3824	0.1591
4/18/2016	4.2978	3.8010	3.9395	3.5074	1.3836	0.1590
4/19/2016	4.2977	3.7925	3.9354	3.4697	1.3849	0.1590
4/20/2016	4.3004	3.7842	3.9352	3.4728	1.3882	0.1591
4/21/2016	4.2885	3.7981	3.9102	3.4592	1.3845	0.1586

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