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Polish Weekly Review

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Comment on the upcoming data and forecasts

On Wednesday the CSO will publish labor market data. We expect both wage and employent growth to trounce market consensus. The former is driven primarly by statistical base effects (in manufacturing) and strong upward trend (retail trade and transport), the latter is boosted by the shift from the so called „trash contracts" into regular employment. On Thursday the CSO will release industrial and retail sales data. Both are set to accelerate despite unchanged working day difference. For industrial output there are two factors at work: high statistical base from last year and reverse Easter effect. Retail sales will probably accelerate because of base effects alone - the disbursement of child subsidies has been limited in April. The accompanying PPI data will show a slight deceleration in PPI inflation.

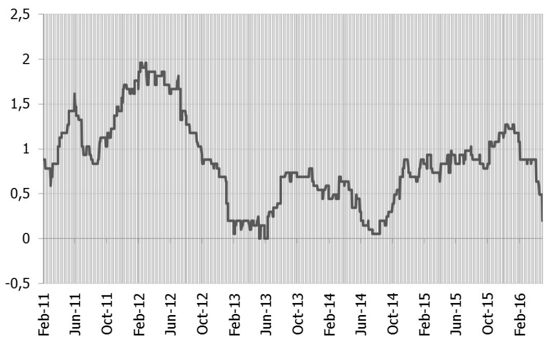
Polish data to watch: May 16th to May 20th

Publication	Date	Period	mBank	Consensus	Prior
Average gross wage y/y (%)	18.05	Apr	4.1	3.8	3.3
Employment y/y (%)	18.05	Apr	2.9	2.8	2.7
Sold industrial output y/y (%)	19.05	Apr	4.9	3.6	0.5
PPI y/y (%)	19.05	Apr	-1.2	-1.3	-1.7
Retail sales y/y (%)	19.05	Apr	3.2	3.1	0.8

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	-	1500	1.645	5/5/2016
5Y T-bond PS0720	5/26/2016	4800	2.219	4/21/2016
10Y T-bond DS0726	-	3000	3.134	5/5/2016
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Flash GDP massively surprised to the downside and Polish surprise index crashed this week. Next week offers several opportunities for a rebound: industrial output, retail sales, PPI, wages.

* 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

- 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 the MPC is still sticking 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 saw 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	3.6
CPI Inflation y/y (average %)	2.8	3.7	0.9	-0.1	-0.9	-0.5
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

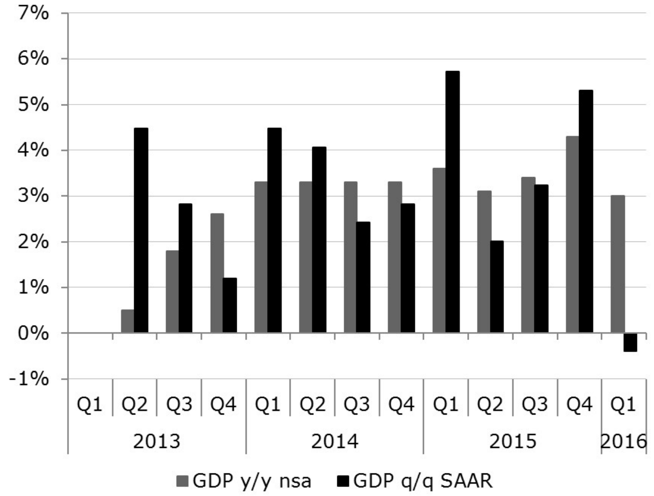
	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1 F	2016 Q2 F	2016 Q3 F	2016 Q4 F
GDP y/y (%)	3.6	3.1	3.4	4.3	3.0	3.5	3.8	3.9
Individual consumption y/y (%)	3.1	3.1	3.1	3.0	3.4	3.8	4.1	4.3
Public Consumption y/y (%)	1.8	0.8	0.9	8.7	3.2	2.9	4.0	4.0
Investment y/y (%)	11.8	5.8	4.4	4.4	-1.0	2.0	3.0	4.0
Inflation rate (% average)	-1.4	-0.9	-0.7	-0.6	-0.9	-0.9	-0.6	0.6
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	4.35	4.25	4.20
USD/PLN (eop)	3.80	3.76	3.80	3.92	3.73	3.82	3.79	3.82

F - forecast

Economics

GDP growth crashed in the first quarter. Last stand of the hawks is falling.

According to the flash estimate, Polish economy grew by a mere 3.0% y/y in the first quarter of the year (prev. 4.3%, consensus 3.4%). Since GUS recently revised the fourth quarter up, the decline looks even more spectacular. The slight decline on a quarterly basis (-0.1%) is also impressive.



As usual, the flash estimate offers no details as to the structure of growth. We believe that the 3% growth is a result of strong private consumption growth (easily above 3%) with a huge slowdown in investment activity – after today's release we believe that a y/y decline is likely. As we've repeatedly shown in our comments, the trouble in investment can be traced back to the hiatus in EU spending on both central (with emphasis in state railways) and local levels. Note that Hungary suffered a similar setback in Q1, only larger because of different spending trajectory and a much higher footprint of EU funds in 2015. Higher uncertainty also weighed on private investment to some extent. Finally, smaller contribution of inventories and net exports could drag on growth.

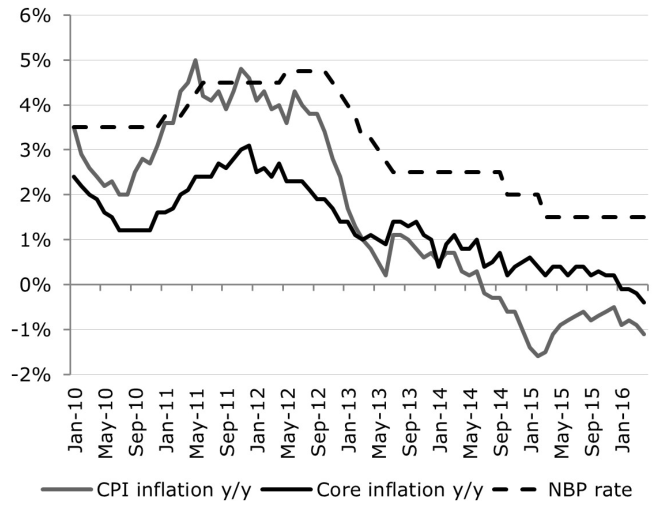
Even though most comments are shrugging off the drop in GDP growth, the slowdown in investment – as related to EU funds – is a more permanent feature of Polish economic landscape and will not last one quarter. Because of that – as we already said so - the child subsidy programme arrived right on time. Without it, it is hard to imagine more than 3% growth this year. Weaker than expected growth in the first quarter led us to slash our forecasts for the year – we now believe the economy to grow by 3.6% (prev. 3.8%).

Market implications are obvious. While the MPC is stuck in a wait-and-see mode and seems ready to ignore the prolonged deflation (see our comment on final CPI data for a more detailed analysis, why it shouldn't), waving away GDP figures would be far more difficult since GDP growth has been the MPC's darling. Patience is a virtue and it seems we will be rewarded. We never changed our view on rates this year (i.e. rate cuts) and expectations should drift towards our position. Right now, the market is overestimating the MPC's determination to keep interest rates at current levels. Rate cut bets will receive a boost if Poland's rating is not cut today.

April CPI confirmed at 1.1% y/y. Core inflation at a shameful all–time low.

According to final release, inflation fell from -0.9% to -1.1% y/y, in line with our forecast and the flash release published on 29th April.

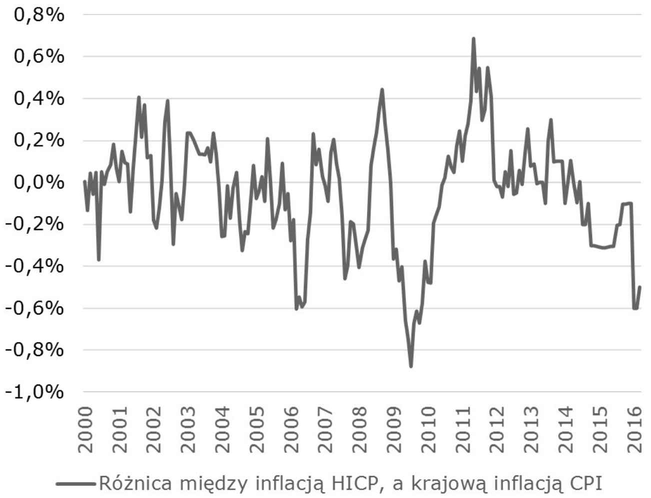
When looking into the details, we see several surprises. Food prices rose by less than implied by seasonal pattern. We opted for such a development (although of somehow higher magnitude) reaching for 2014 as an example. At least we were partially right. Next month is going to bring relatively higher food prices (such a pattern dominated since the start of the year) although it would be fresh fruits and vegetables that would have the last word in May. Fuel prices grew slower than data from petrol stations indicated (+2.3% m/m). The main cause for another fall in inflation is core inflation. Prices in Recreation and culture category fell by 0.8% on a monthly basis (cable TV prices lower by 5.5%), communications prices fell by 0.6% m/m. As a result, core inflation fell in April from -0.2% to -0.4%, the lowest print in the official series.



Deflation is set to last until October when base effects in energy prices will lift inflation back towards 1%. CPI target is drifting away again. We reiterate our view that the downside effects of deflation are stronger than commonly believed (Mr Belka's comment that the NBP is closely monitoring corporate finances and the impact of deflation on it, is a confirmation of our suspicions).

Is the Central Statistical Office underestimating inflation?

Several recent articles alleged that the Central Statistical Office might be underestimating Polish inflation. The controversy gained traction to the extent that the CSO issued an explanatory statement on Thursday. The hypothesis of downward bias in CPI figures is only the latest excuse coined by the proponents of the so called "good deflation" (i.e. the idea that deflation is unequivocally beneficial for the economy, has external sources and no implications for monetary policy) is based on several arguments. None of them persuades us.

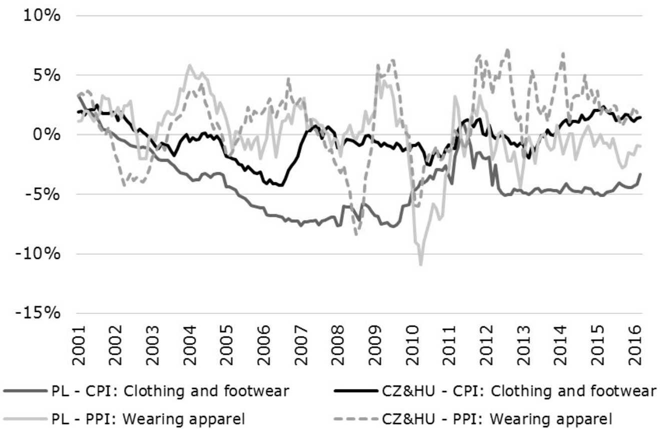


First, the difference between national CPI inflation and HICP inflation is not a record high (see the graph above).

Second, never before was it an argument for or against monetary policy action – for instance, in periods when national CPI was higher than HICP inflation it was not an argument against rate hikes. Historically, the average spread between the two measures is precisely zero.

Third, the fact that inflation is lower than labor market variables or economic growth would imply is not an argument for ignoring inflation.

Finally, it has been claimed that the CSO is mismeasuring clothing and footwear prices. At first glance, the argument seems reasonable since price growth in that categories is significantly smaller than in other countries of the region - the difference is equivalent to 0.2 p.p. in headline CPI. In details, the argumentation falls apart since similiar (albeit smaller) bias exists in PPI data which are collected independently. No explanation as to why Polish clothing and footwear prices are behaving that way has been given so far, but our bet is that it is related to the behavior of Polish producers: focus on the low-end and middle segment of the market, high competition, delayed outsourcing of production to East Asia.



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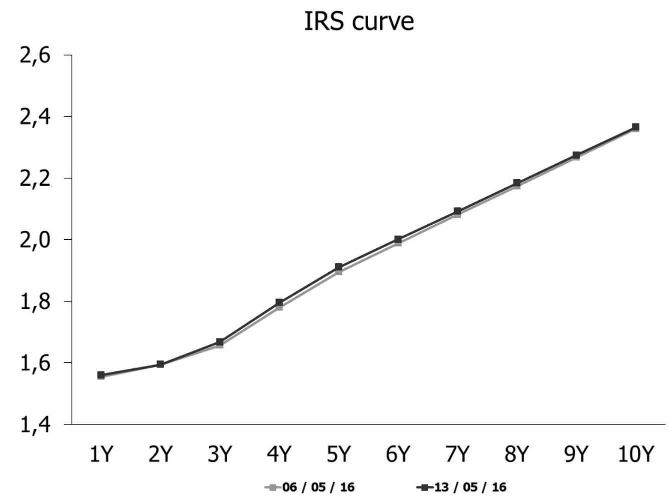
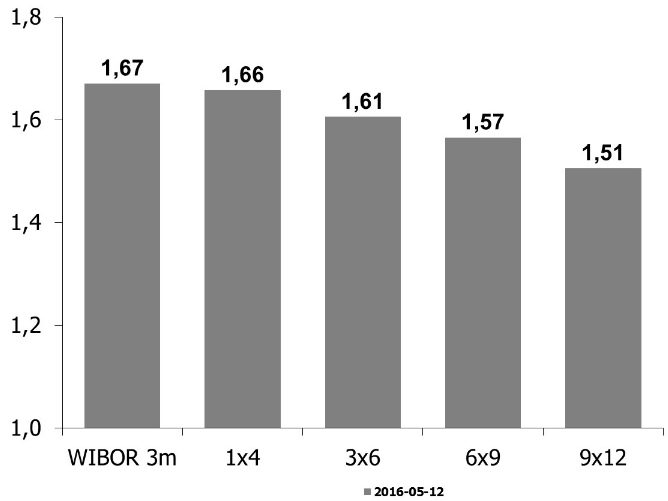
Fixed income

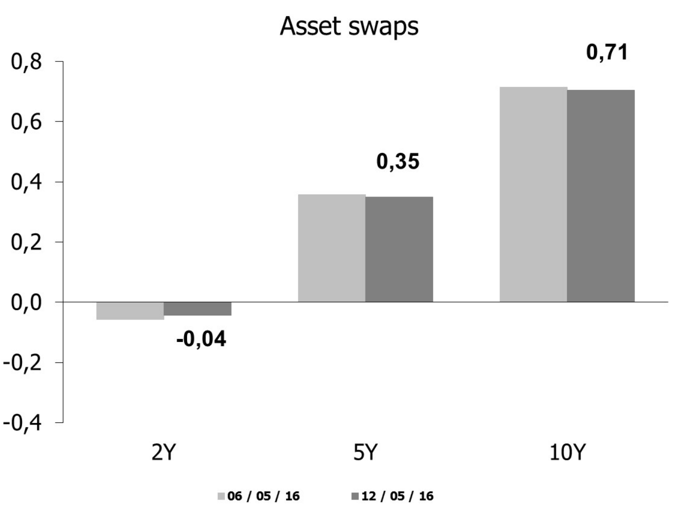
Belly up

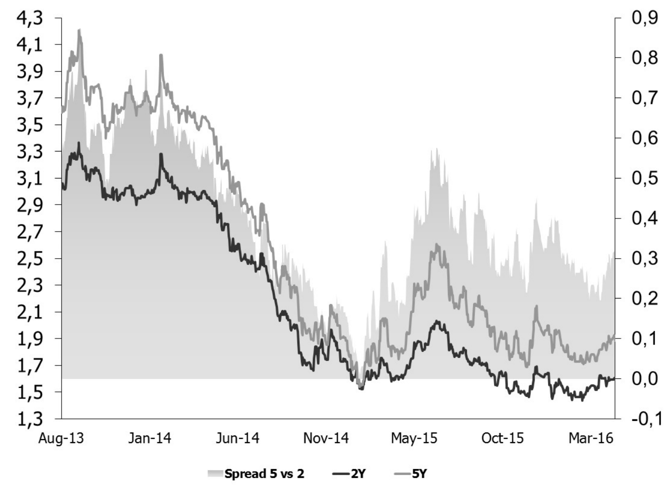
The FI market state is quiet before Moody's announcement. After quite a big sell-off which took place before the DS0726 auction, market returned to levels from the beginning of April. We were right to close our long position in 2y10y swap spread. After hitting 80 bps, it fell down to 70. Maybe it's a good time to buy it again? Especially after poor GDP data which might suggest rate cuts in near future.

We don't agree with that the potential rating cut is priced in. 5y bonds are trading on the tops and much higher than they have before S&P cut Poland's rating. So, if you would like to take a position, we recommend to sell belly curve.









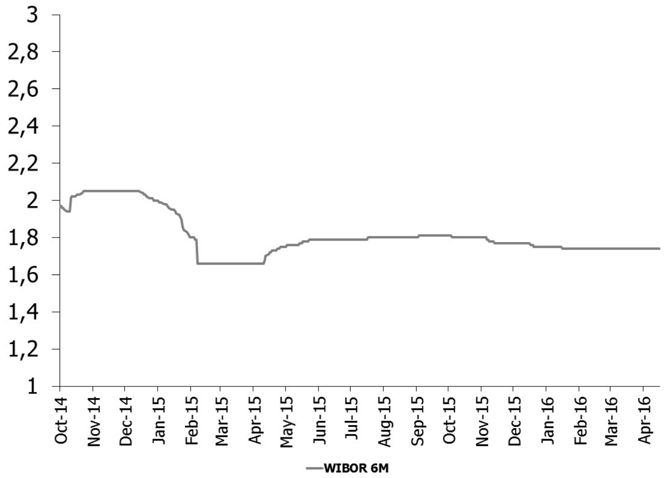
Money market

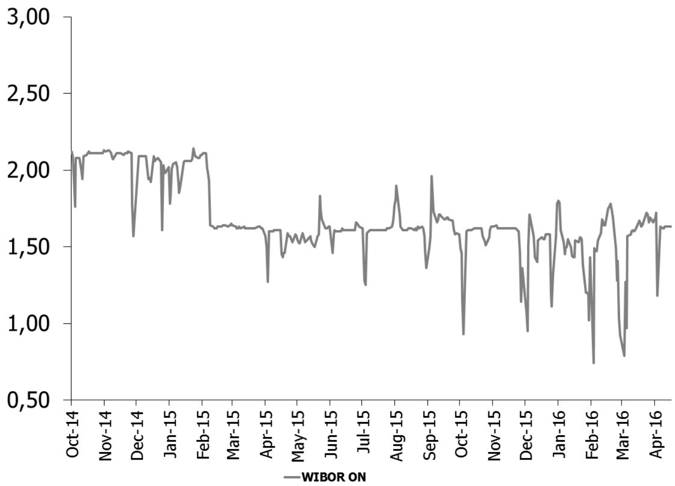
Calm week ahead of us

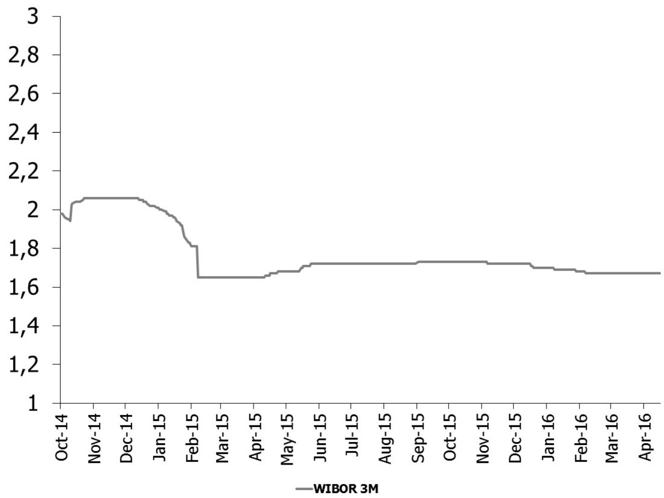
Front end of the bond curve was recently well offered, so we took a chance and re-bought our portfolio at 1.40+ yield. We are happy to hold it for a while, especially after today's weak print of GDP (3.0% vs 3.5% expected). Slowdown in the real economy might be the long awaited trigger for the MPC to act or at least give some dovish statement in the first place.

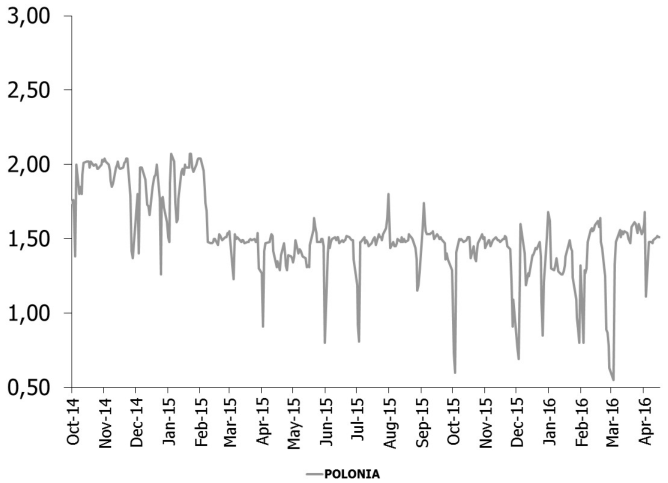
At today's OMO banks bought PLN 68bn bills out of 74 offered. It seems that liquidity is secured so we expect quite relaxed funding next week at 1.50%.

Ref rate vs Polonia averages:
30 day: 0 bp()
90 day: 12 bp(-1)





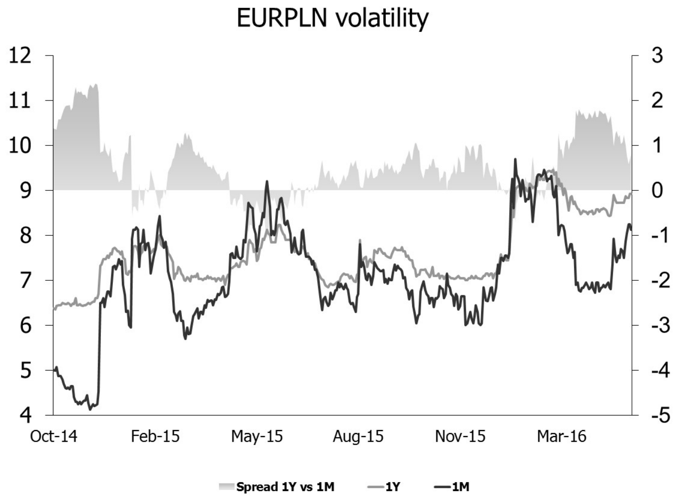




Forex

Spot – PLN's fate in Moody's hands. EUR/PLN has been moving in tight 4.3950 - 4.4350 range. The market decided to sit on its hands, and wait for this Fridays Moody's decision about Poland's rating. There are really different perspectives of what may happen, from double notch cut to unchanged. This creates a base for a volatile market reaction to whatever the decision may be. Technically, tight range of 4.41-4.43 seems to be quite pivotal, and when broken on either side, we may expect the extension to 4.36 or 4.46. The positioning is much clear, after a week of profit taking and consolidation. We are looking forward to fade extremes, but we are a little skewed to buy EUR/ PLN at dips (as a slightly safer strategy).

Options – EUR/PLN vol lower Decreased realized volatility, stronger PLN and profit taking were the reasons behind melting EUR/PLN vols. 1 month EUR/PLN ATM mid is this Friday at 7.7% (0.5% lower), 3 months EUR/PLN is 8.25% (0.25% lower) and finally 1 year is 8.75% (0.1% lower). The skew and currency spread (difference between USD/PLN and EUR/PLN vol) were also better offered.



Short-term forecasts

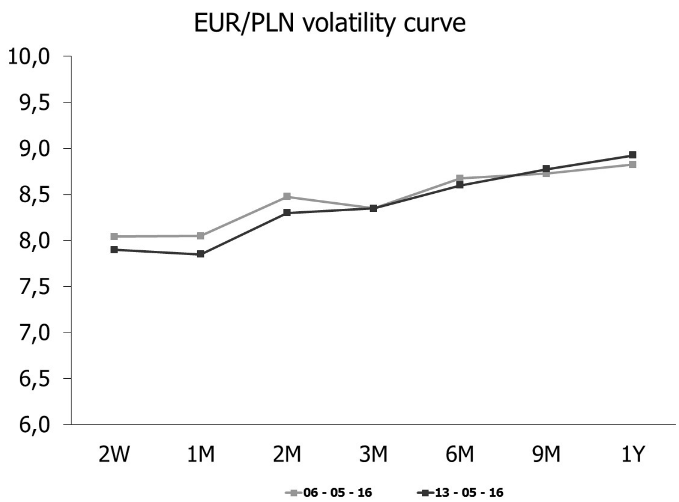
Main supports / resistances:
EUR/PLN: 4.35 / 4.45
USD/PLN: 3.70 / 4.00

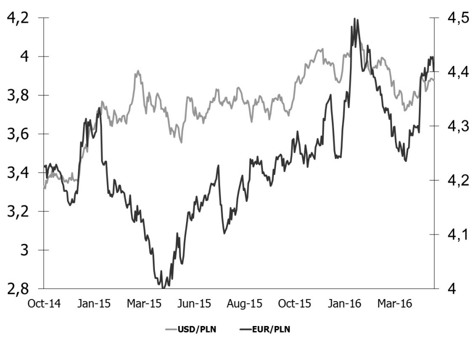
Spot Current position: Long EUR/PLN from 4.2450, ready to add 4.3650 with a stop bellow 4.3400, and hopes to see 4.50 +.

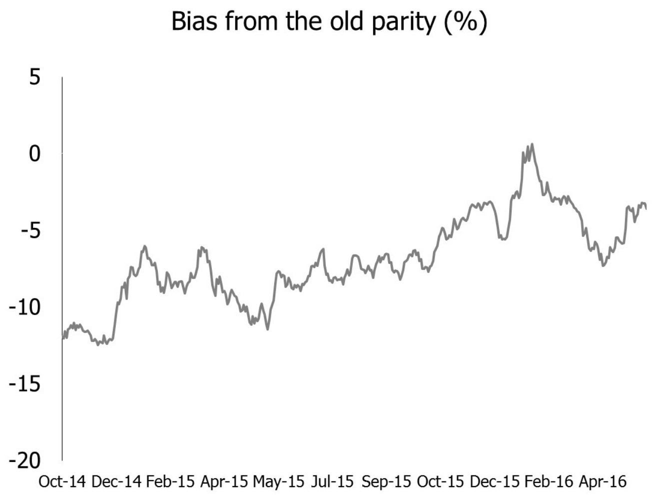
It was not an easy call again. We have decided to keep our position, even thought the temptation to take small profit in the face of the Moody's decision was almost irresistible. We simply think that even the lack of action from Moody's will not solve other PLN problems i.e. pending CHF credit legislation, MPC potentially turning dovish.

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). Reviews of Poland's ratings by major rating agencies are a potential risk factor for Zloty, our long term financial stability is not that warranted. In this environment the only thing, we can be sure, is increased volatility. We are now outright long Vega (in majority backend Vega).







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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
5/5/2016	1.75	1.67	1.84	1.64	1.73	1.66	1.66	1.64	1.56	1.51	1.50	1.60
5/9/2016	1.67	1.67	1.71	1.64	1.60	1.66	1.65	1.61	1.55	1.49	1.48	1.58
5/10/2016	1.70	1.67	1.72	1.64	1.62	1.66	1.65	1.59	1.56	1.50	1.49	1.59
5/11/2016	1.45	1.67	1.52	1.64	1.52	1.66	1.66	1.62	1.55	1.50	1.48	1.59
5/12/2016	1.72	1.67	1.50	1.64	1.50	1.66	1.66	1.61	1.57	1.51	1.50	1.59

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
5/5/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
5/9/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
5/10/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
5/11/2016	1.660	1.474	1.635	1.638	1.990	2.290	2.447	2.985
5/12/2016	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
5/5/2016	7.88	8.38	8.65	8.88	8.88	2.32	0.64
5/9/2016	8.25	8.43	8.70	8.83	8.83	2.32	0.64
5/10/2016	8.24	8.43	8.61	8.93	8.93	2.34	0.67
5/11/2016	8.13	8.38	8.68	8.93	8.93	2.31	0.64
5/12/2016	7.85	8.35	8.60	8.93	8.93	2.31	0.64

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
5/5/2016	4.4003	3.8475	4.0005	3.5853	1.4074	0.1627
5/9/2016	4.4123	3.8730	3.9961	3.5907	1.4038	0.1633
5/10/2016	4.4275	3.8853	4.0001	3.5655	1.4036	0.1638
5/11/2016	4.4241	3.8855	3.9877	3.5745	1.4040	0.1637
5/12/2016	4.4275	3.8811	4.0008	3.5621	1.4040	0.1639

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