July 7, 2016

Polish Weekly Review

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Comment on the upcoming data and forecasts

Week kicks in on Monday with final CPI data. We expect flash estimate to be confirmed at -0.8% y/y. Core inflation will be published the next day, it should remain at the same level as in May (-0.4%). Thursday brings rest of publications. Money supply M3 should keep accelerating driven by government "Family 500" programme, mainly through households' but also local governments' deposits. Trade balance data would be hampered by weaker absorption of EU funds. However, growing surplus in services category, would raise slightly final current account outcome.

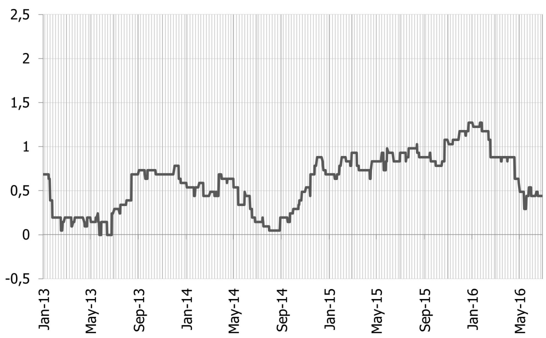
Polish data to watch: July 11th to July 15th

Publication	Date	Period	mBank	Consensus	Prior
CPI y/y (%) *final*	11.07	Jun	-0.8	-0.8	-0.9
Core inflation y/y (%)	12.07	Jun	-0.4	-0.3	-0.4
Money supply M3 y/y (%)	14.07	Jun	11.8	11.4	11.5
Current account (mio EUR)	14.07	May	288	442	594
Exports (mio EUR)	14.07	May	14300	14368	15143
Imports (mio EUR)	14.07	May	14250	14000	14523

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	-	1600	1.706	7/7/2016
5Y T-bond PS0721	7/28/2016	4800	2.219	5/25/2016
10Y T-bond DS0726	-	2700	2.923	7/7/2016
15Y T-bond WS0428	-	200	3.027	7/7/2016

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



Comment

Just as expected, MPC has not changed interest rates, thus Polish surprise index remains at the same level. Next week brings several publications that should change it: inflation data, money supply and trade balance.

* 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 fuelled consumption growth (child subsidy and brisk wage growth), 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

- Although the markets escaped thinking of Brexit in terms of really borderline scenarios due to promised central bank interventions, the whole scope and timeline of Brexit repercussions is still unclear. Therefore we stay on sidelines. We still think that Brexit is negative for credit risk among EMs and Polish assets are facing other, idiosyncratic risks (rating, pending CHF bill).
- We feel that foreign investors may be still reluctant to add Poland to their portfolios despite some recent outperformance.
- Zloty to be range bound. Headwinds due to upcomming event risks but fundamentally attractive levels.

mBank forecasts

	2010	2012	2013	2014	2015	2016 F
GDP y/y (%)	3.7	1.6	1.3	3.3	3.4	3.4
CPI Inflation y/y (average %)	2.8	3.7	0.9	-0.1	-0.9	-0.4
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

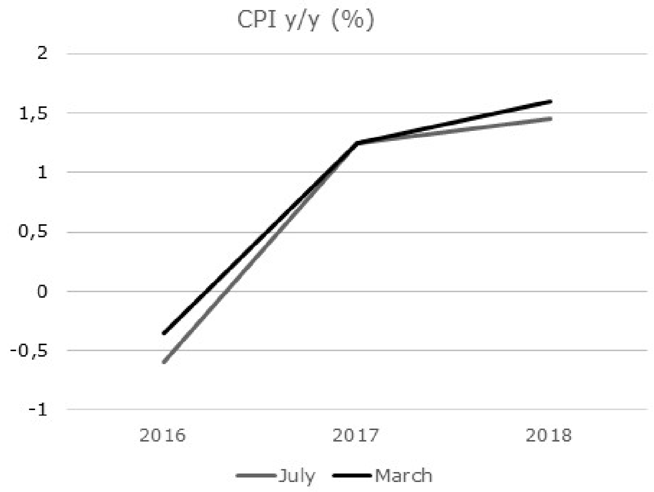
	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1 F	2016 Q2 F	2016 Q3 F	2016 Q4 F
GDP y/y (%)	3.6	3.1	3.4	4.3	3.0	3.3	3.4	3.5
Individual consumption y/y (%)	3.1	3.1	3.1	3.0	3.2	3.6	4.1	4.4
Public Consumption y/y (%)	1.8	0.8	0.9	8.7	4.4	4.0	4.0	4.0
Investment y/y (%)	11.8	5.8	4.4	4.4	-1.8	0.5	2.0	3.5
Inflation rate (% average)	-1.4	-0.9	-0.7	-0.6	-0.9	-0.9	-0.5	0.6
Unemployment rate (% eop)	11.5	10.2	9.7	9.8	10.0	8.9	8.6	8.7
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.25
Wibor 3M (% eop)	1.65	1.72	1.73	1.72	1.67	1.71	1.71	1.44
2Y Polish bond yields (% eop)	1.61	1.99	1.76	1.62	1.45	1.65	1.50	1.40
10Y Polish bond yields (% eop)	2.31	3.31	2.84	2.94	2.84	2.91	2.80	2.80
EUR/PLN (eop)	4.07	4.19	4.25	4.26	4.24	4.38	4.35	4.30
USD/PLN (eop)	3.80	3.76	3.80	3.92	3.73	3.94	3.99	3.98

F - forecast

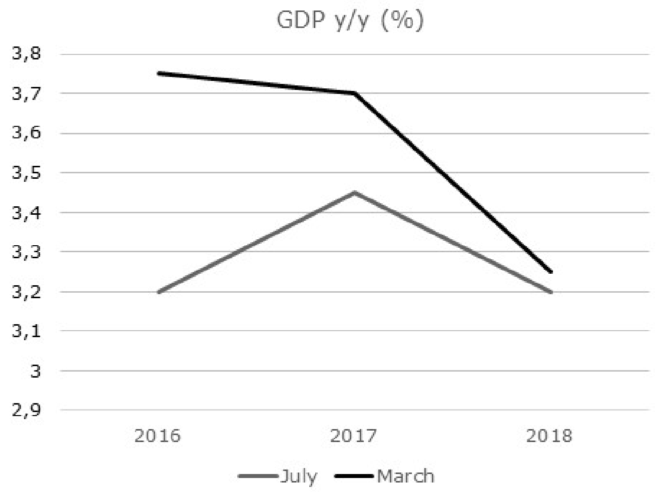
Smooth change of power in NBP. No changes in monetary policy.

On its first meeting under governor Glapinski, MPC left interest rates unchanged. According to MPC, Poland has a perfectly balanced economy. Currently, every rate adjustment would be not only unnecessary but also harmful, because it could disturb this equilibrium. This consensus is nothing new as it was inherited form previous Council (prof GlapiĹ„ski was one of its members).

The statement after the meeting seemed at first glance quite disturbing, because UK membership referendum was mentioned as many as three times. The bigger surprise occured when Governor Glapinski said that there is absolutely no direct impact on Polish economy from Brexit. Therefore, by this single statement, all quantitative assessments of Brexit costs (calculated by analysts form private sector, government sector but also by NBP's Economic Institute) were discredited. According to governor Glapinski, Brexit will have long-lasting and important geopolitical effects and will raise uncertainty. However, Polish economy will not be affected directly.



Fresh inflation and economic growth projections were also presented. The first one was, just as in several previous cases, revised downwards but those were merely cosmetic changes. GDP growth forecast for 2016 was slashed by more than 0.5pp. This should have been anticipated after weaker Q1 release. The blame was put on one factor â€“ lower EU funds absorption (the switch between two EU budgets, usually linked with a pothole in spending), thus this is only a temporary slowdown. Governor Glapinski regards forecasts from NBP NECMOD model as views of an additional MPC member. Personally prof Glapinski sees growth in 2016 closer to 3.6 – 3.8% (upper range of NECMOD forecast).



Two very important issues remained also unchanged. Deflation is still viewed as beneficial. MPC could imagine that in case of rapid GDP acceleration and higher inflation a rate hike would be necessary. On the other hand, adverse scenario would not straightforwardly imply rate cuts: macro prudential approach and stability of banking sector should be also taken into account.

In environment with relatively low economic growth and low (or even negative) inflation we still see a chance for a downward rate adjustment. On the other hand, MPC stubbornly holds its ground and lowering rates will not be straightforward and will not come ease. However, markets could easily price cuts (they already do), because Polish monetary policy cannot stay detached from global trends.

A new government program aimed at boosting national savings announced

The new program, just announced under the aegis of the Ministry of Development, assumes another revamp of pension system and introduction of several financial instruments that were so far absent in the Polish market. As for the former, the new common and voluntary pension funds (aka third pillar of the pension system) are going to see the light. Such funds were already functioning in the system, although their reach was very limited. The program assumes substantial broadening of their size and scope. At the beginning, they are going to take over the lion's share (approx. 3/4) of funds currently functioning as the second pillar of pension system (open pension funds – OFE). As for the mentioned new instruments, Polish REITs, premium and infrastructure bonds are set to be introduced in order to reinvigorate the process of savings formation and broaden the investment possibilities of freshly set up pension funds. We do not want to dwell on the details. Instead we are going to focus on implications of the new program for financial markets.

Financial markets are most interested in the changes in pension system. Open pension funds are set to become part of the third pillar of the pension system in 2018 (the second pillar will still be made by funds managed by ZUS, although those gathered under the name of individual pension accounts, accompanying the pooled ones from the first pillar). Therefore 2018 marks the year when contributions of 2,5mln people stop flowing out from ZUS. Each and every employed under the age of 55 is going to be (by default) signed up for the third pillar of the system a will be allowed to divert 4 to 7% of remuneration to third pillar funds (the choice of the exact number is truly sovereign decision of employer and employee). Some of current OFE assets (approx. PLN 35 bn hold currently as cash, bonds and foreign equity) are set to be moved to ZUS and fuel the Demographic Fund (FRD).

We think that the announced program is ceteris paribus positive (medium term) for Polish bonds. PLN 35bn diverted to FRD (Demographic Reserve Fund) lowers the public debt by 2%. At the same time, keeping (from 2018 onwards) the contributions of 2.5 mln people in ZUS (currently diverted to OFEs) is going to lower ZUS deficit and, in turn, is set to lower the budget transfer to ZUS therefore sending public deficit also down. Implementation of the program generates an improvement in fiscal performance, at least mid-term.

As it is possible (and to be honest – even pretty obvious) that newly set-up third pillar funds will be allowed to invest not only in equities and corporate bonds (possible portfolio expands to REITs, infrastructure and possibly even sovereign bonds), the supply of sovereign bonds may shrink and a strong group of investors investing domestically (strong hands) is going to emerge, boosting demand.

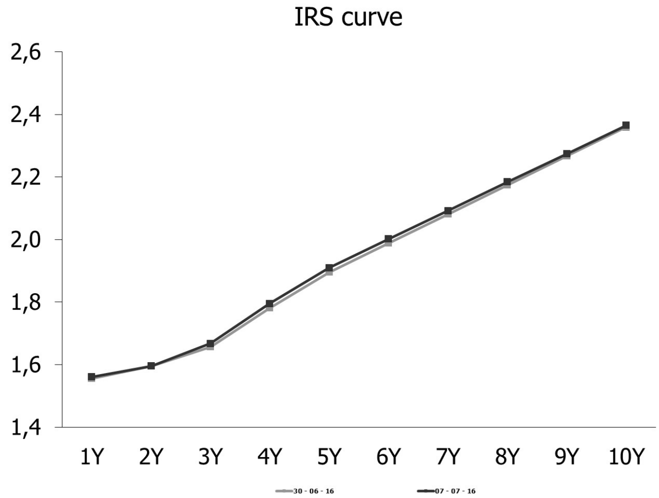
In our opinion, the new program is neutral/positive for equities. First and foremost, it seems that borderline scenario of OFE nationalization is off the table. So far it was considered detrimental for equities not only via possible supply concerns but also governance problems connected with state representatives' presence in firms' boards. It seems also that uncertainty regarding the fate of OFE fell substantially, as well.

In our opinion the short term reaction may be negative due to unfavorable exchange rate developments. The new design of pension system means more government involvement in the economy. This also induces fear and demands more careful approach towards Polish equities.

As far as negative consequences are concerned, the hold-up of compulsory contribution to OFE and possibility of paying out up to 25% of funds at the time of retiring (OFE/third pillar funds) is negative. Possible changes in allocation policy of funds (less equities, more new instruments) is also not directly encouraging for equity investors. However, those factors can be easily counterbalanced by the voluntary inflows to the third pillar. We remind the readers that every employed (19 to 55 years old) will be assigned there by default. A rule of thumb perfectly reflecting the behavior of the donors of organs suggest that 80% of them respects the decision of the state and does not contest the status quo (being the donor or the member of the third pillar). Such an assumption translates into the inflow which may actually be three times larger than currently.

Tax teasers stay still imprecise (apart from lowering the capital gains rate for third pillar investments). However, in the world of zero interest rates, even marginal improvement of net profitability may entail more supply of private capital. Of course, to secure the working of the mentioned mechanisms, proposed changes have to be perceived as stable and carved in stone. Yet, this may take time.

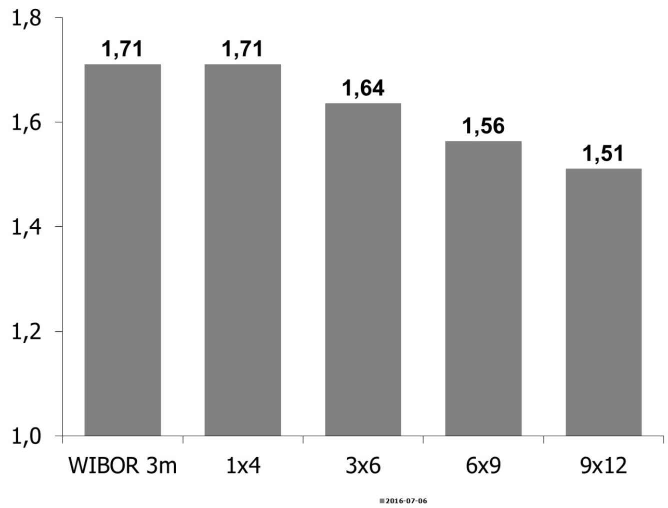
Fixed income

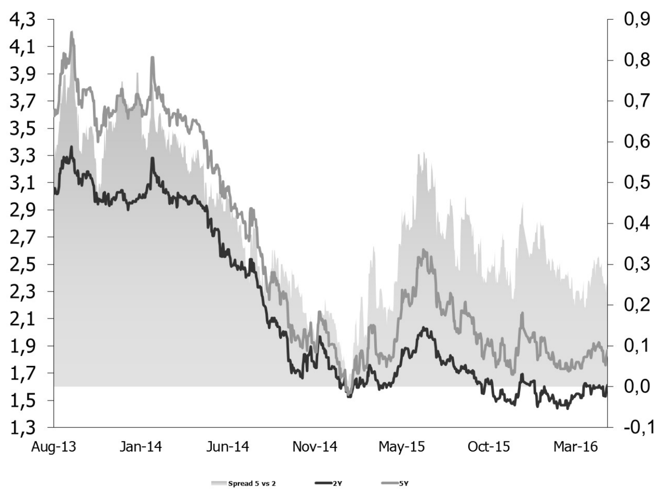


What's next? Fitch?

Today Ministry of Finance sold OK1018 1,56 bio at 1,70% (px 96,20), DS0726 2,65 bio at 2,92% (px 96,35) and WS0428 214 mio at 3,02% (px 97,26).

As we suggested last week buying 2y swaps at 1,56%, market moved to our way to 1,63%. After positive view of MPC conference we think to pay short-term an asset swaps (2y 8 bps and 3y 20 bps). In the last few days market was quite illiquid on bonds and IRS. ASW widened a bit, mostly on the 10y to 74 bps from 70 and 5y to 45 bps from 41 bps. On 15th of July Fitch will announcement rating for Poland, any cut rating will be negative for POLGBs. In our opinion, world is hunting high yield bonds, having positive investment grade.



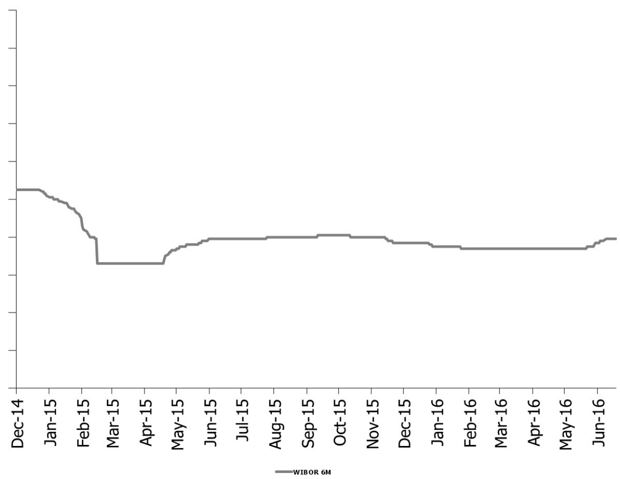


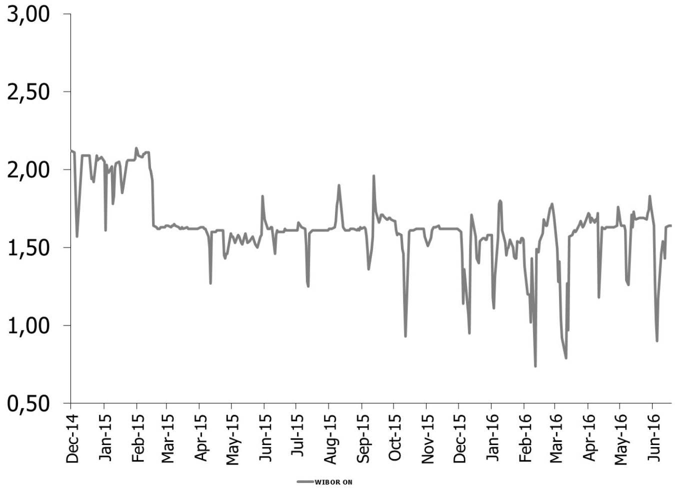
Money market

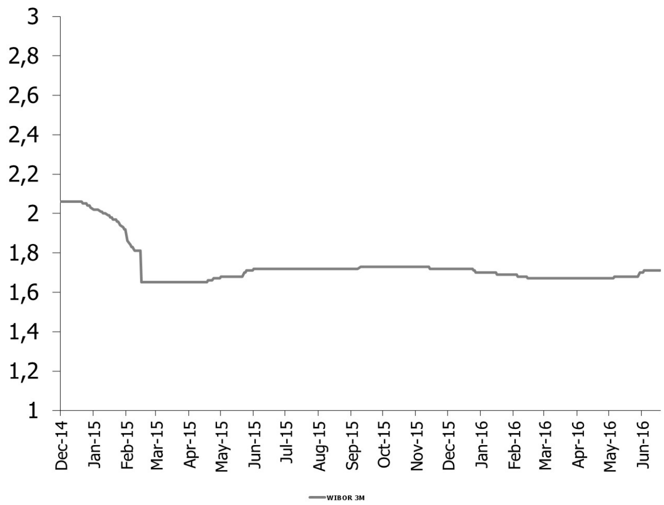
MPC

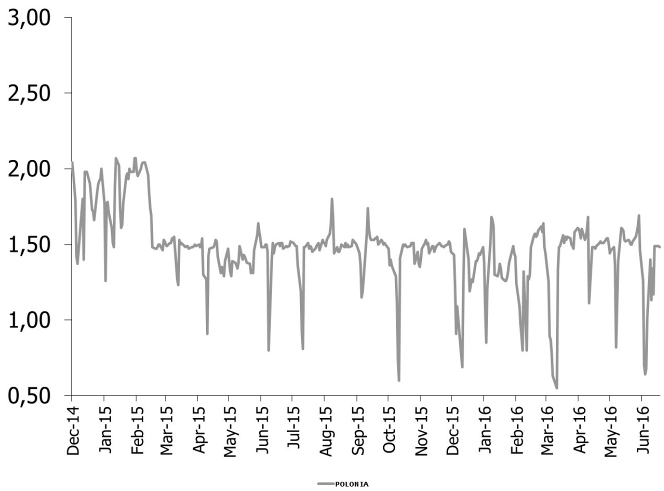
Under new governor, NBP left rates unchanged at 1.50%. MPC is happy with its current position reiterating that our economy is well balanced with solid growth ruling out any rate adjustment in the near future. Short after the press conference front end yields rose 5 bp taking down bets for rate cuts to 15 bp within a year.

Overnight funding held steadily around 1.48%. Tomorrows open market operation will determine the cost of cash for next week. Safe stance still persist on the market so we donâ€™t expect any squeeze.





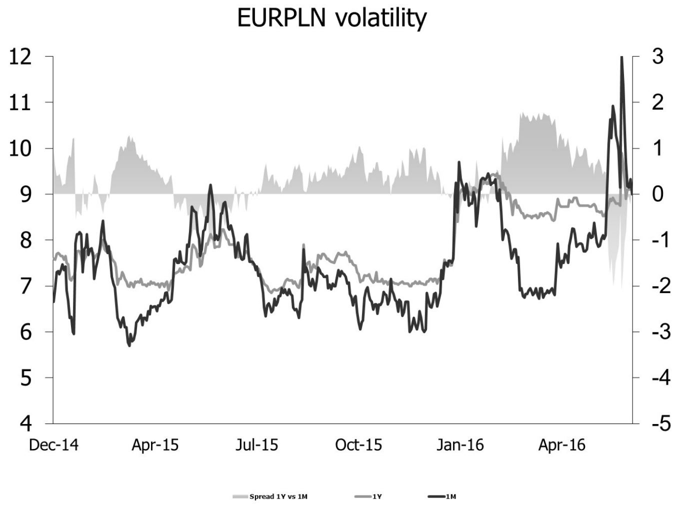




Forex

Spot – PLN still unsettled Caution was recommended and indeed needed. The 4.3675 low in EUR/PLN was really short lived as the single currency renewed its ascend towards 4.4570 (this week high) before some consolidation took place. We are of the view that range for EUR/PLN should be shifted higher because of Brexit. The 4.43-4.45 is the most likely central point of the new range. After risk/reward calculation, we are more keen to fade PLN strength than weakness. The local politics is still the Achilles heel of the Zloty.

EUR/PLN vol sell off runs off steam After the heavy selling last week, the supply is still the dominating force for EUR/PLN VOLs but it seems that it is slowly running out of stream. Today (Thursday), 1 month EUR/PLN ATM mid is this at 8.6% (0.2% lower), 3 months EUR/PLN are 8.65% (0.35% lower), and finally 1 year is 8.9% (0.2% lower). Skew is roughly unchanged and currency spread (difference between USD/PLN vol and EUR/PLN) caught same bid in the backend. 1 Year USD/PLN was paid and bid at 12.6% .



Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.35 / 4.55
USD/PLN: 3.80 / 4.20

Spot

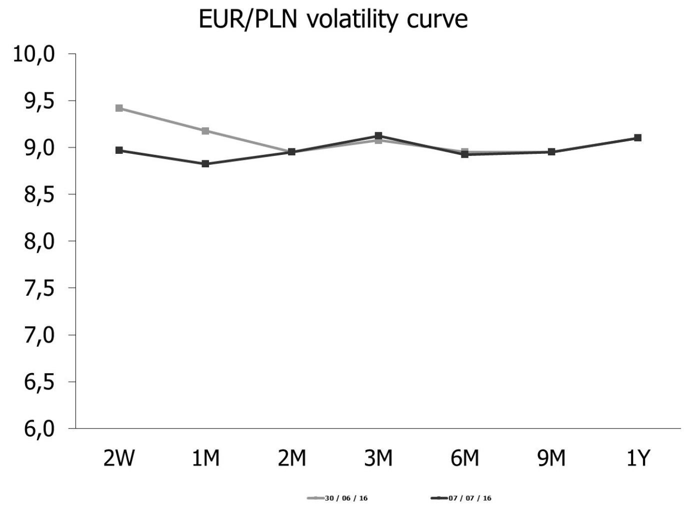
New position: None.

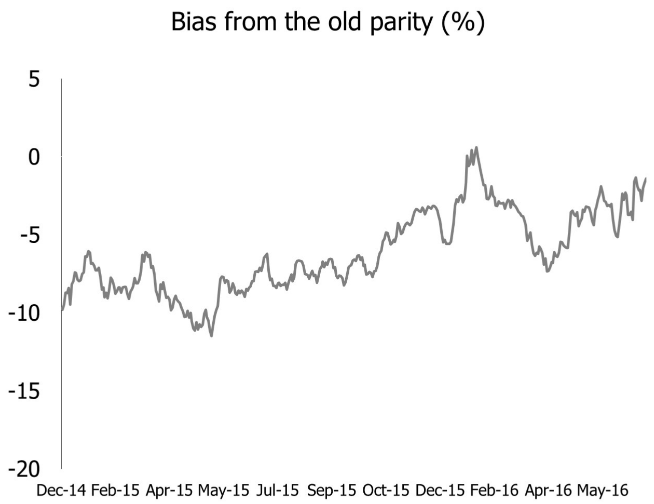
Long EUR/PLN from 4.3770 was cashed at 4.45.

We would like to get long EUR/PLN again at 4.4050. with room to add at 4.3700 . The stop loss is set below 4.3475 and we hope to see 4.47 with possible extension to 4.5400 . We see a series of higher lows and higher highs what makes us think we are in a messy up-trend. We still aware of Polish factor (ratings, CHF re-denomination projects), and because of that we are in opportunistic PLN bears camp.

Options Vols – Long Vega in the backend

We are still long Vega in the backend of EUR/PLN vols. The vols spike was really short lived, and the vols melted as the result. It is frustrating but we think that our view has received a fundamental back up. There is a lot of uncertainty surrounding the Brexit and it will have its influence on Poland as well.. We stick to our position.





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
6/29/2016	1.89	1.71	1.76	1.69	1.76	1.71	1.69	1.66	1.58	1.53	1.49	1.62
7/3/2016	1.98	1.71	1.75	1.69	1.85	1.71	1.70	1.64	1.53	1.49	1.47	1.59
7/4/2016	1.98	1.71	1.95	1.69	1.85	1.71	1.73	1.64	1.55	1.51	1.49	1.60
7/5/2016	1.78	1.71	1.74	1.69	1.77	1.71	1.72	1.63	1.53	1.49	1.47	1.58
7/6/2016	1.62	1.71	1.69	1.69	1.74	1.71	1.71	1.64	1.56	1.51	1.49	1.60

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
6/29/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
7/3/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
7/4/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
7/5/2016	1.710	1.474	1.635	1.638	1.990	2.290	2.447	2.985
7/6/2016	1.710	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
6/29/2016	9.70	9.30	9.15	8.90	8.90	2.39	0.68
7/3/2016	9.15	9.13	8.95	9.10	9.10	2.39	0.68
7/4/2016	9.33	9.20	9.00	9.10	9.10	2.45	0.63
7/5/2016	9.00	9.15	8.95	9.10	9.10	2.47	0.66
7/6/2016	8.83	9.13	8.93	9.10	9.10	2.40	0.60

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/29/2016	4.4140	3.9905	4.0712	3.8904	1.3919	0.1629
7/3/2016	4.3921	3.9548	4.0547	3.8561	1.3878	0.1622
7/4/2016	4.4304	3.9886	4.0884	3.8836	1.3987	0.1636
7/5/2016	4.4501	3.9963	4.1165	3.9286	1.4034	0.1644
7/6/2016	4.4469	4.0225	4.1042	3.9931	1.4040	0.1645

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