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Polish Weekly Review

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Table of contents

Comment on the upcoming data and forecasts

A calmer week ahead of us. On Tuesday, the CSO will publish business sentiment data - the first measure of economic sentiment for August. On Wednesday the Statistical Bulletin will be published. Apart from unemployment data, it is useful to delve into the details of some earlier releases, incl. labor market data. Finally, on Thursday the NBP will release the Minutes from July MPC meeting. Given the deterioration in Polish macro data in recent weeks and MPC's stubborn stance, this document is purely of historical significance.

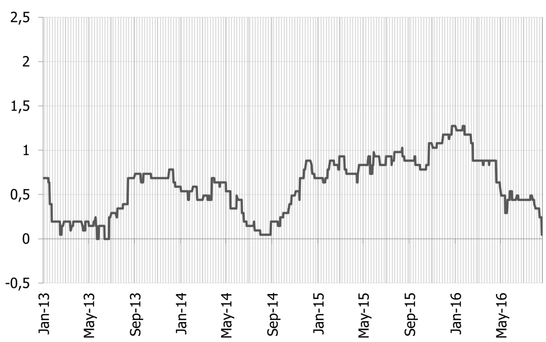
Polish data to watch: August 22nd to August 26th

Publication	Date	Period	mBank	Consensus	Prior
Unemployment rate (%)	24.08	Jul	8.6	8.6	8.8
MPC Minutes	25.08	Jul			

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	-	2000	1.666	8/18/2016
5Y T-bond PS0721	-	3500	2.114	8/18/2016
10Y T-bond DS0726	-	2000	2.704	8/18/2016
15Y T-bond WS0428	-	200	3.027	7/7/2016

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



Comment

Polish surprise index crashed as industrial output and retail sales surprised to the downside. Next week, with only unemployment data, offers some respite.

* 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

- 500+ programme is set to support private consumption in 2016. Despite weak Zloty, exports growth ground into a halt. 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 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 and brisk wage growth), many years of moderate 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 is 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. We expect the MPC to finally acknowledge inflation risks amid temporary weakness in GDP growth and another round of monetary policy stimulation globally. Lower risk premia will certainly help.

Financial markets

- Zloty is set to perform well in the near term.
- The details of the CHF conversion are unlikely to be announced soon. Therefore globally easy central bank policy is going to propel all non-zero yielding assets.
- Owing to ultra easy path of Fed funds already priced in, we see the more hawkish Fed as the prevailing risk short-term (mind the Jackson Hole conference next Friday). We do not expect any moves concerning the possible repricing of U.S. rates to be of such magnitude as the ones we saw at the start of the year. EMs are at different cyclical position and enjoy higher interest rates.

mBank forecasts

	2010	2012	2013	2014	2015	2016 F
GDP y/y (%)	3.7	1.6	1.3	3.3	3.4	3.2
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	2016 Q2 F	2016 Q3 F	2016 Q4 F
GDP y/y (%)	3.6	3.1	3.4	4.3	3.0	3.1	3.3	3.4
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	-2.0	0.5	2.4
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	4.25	4.25
USD/PLN (eop)	3.80	3.76	3.80	3.92	3.73	3.94	3.90	3.94

F - forecast

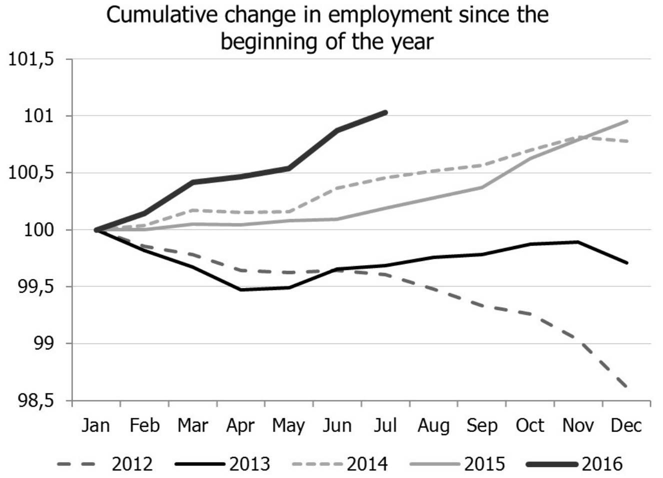
Economics

The Polish conundrum: labor market remains strong, but real activity data disappointed massively. The MPC's favorite scenario is increasingly out of touch with reality.

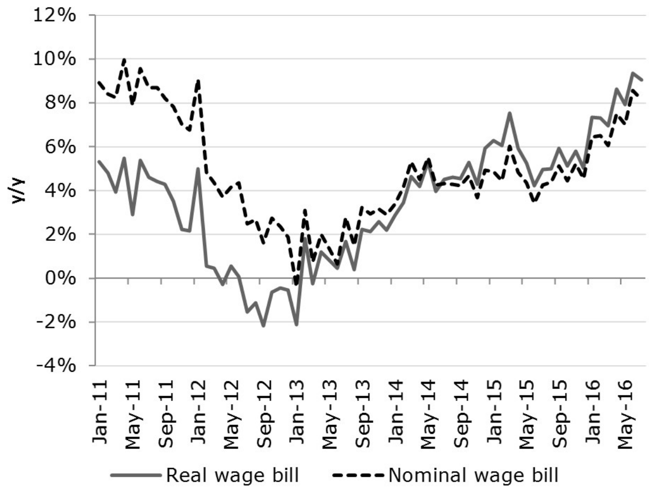
It was a rollercoaster for Polish economy watchers. While labor market data surprised to the upside with a nice wage print and yet another acceleration in employment growth, real activity data were a major shocker, with industrial and construction output posting worst yoy figures since 2012 and 2013, respectively. Retail sales also failed to live up to expectations and we don't see any sign of the massive government child subsidy programme in the data. All in all, any acceleration in economic growth in the second half of the year will be modest at best. Where does this leave the MPC? Completely on the wrong foot as the preferred forecast of the MPC (3,6-3,8%) is almost certainly impossible to materialize. We ourselves have lowered our GDP growth forecast for 2016 – to 3.2% y/y. Given this and the stubbornness of deflationary processes, we stick to our long-cherished view of renewed rate cuts in Poland. Such a move seems adequate even if it does not jump start investment activity but only support exporters (by weakening the PLN) that may find it hard to sustain margins after the recent PLN appreciation.

As usual, below you will find our detailed comments on last week's releases.

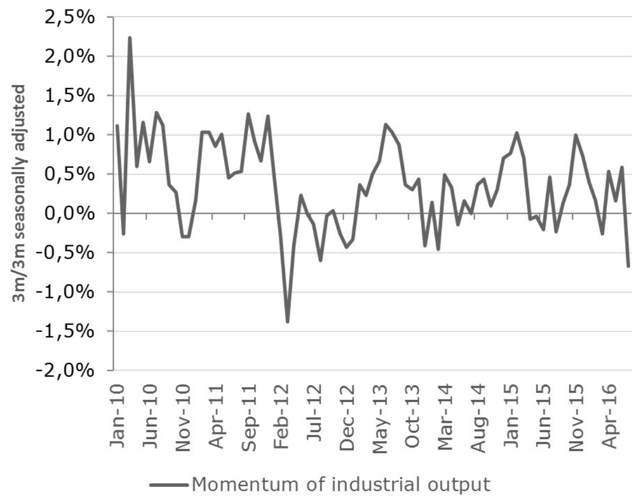
Employment in the enterprise sector rose by 3.2% in July, above our forecast. On a monthly basis, 9k jobs were created. There was no strong pullback after the jump in June (which we targeted). Sadly, we can't pin down the reason at this very moment as we do not have detailed data on hand. We'd rather bet on stronger than usual seasonal effects in trade, tourism and support services that inflated the figures. Owing to rather swift growth of employment in H2 2015, further acceleration of employment this year is going to be rather hard. Nevertheless, 3.2% y/y employment growth with ≈ 3% GDP growth looks more than okay.



Average gross wage grew by 4.8% y/y, a bit above forecasts (ours and market consensus, respectively, 4.6 and 4.7% y/y). Each month we are unable to comment on the details of the figure and, once again, we are forced to speculate. We believe that wage growth was dragged down by a strong calendar effect (difference in the number of working days dropped from +1 to -2 y/y) that primarily affected manufacturing and construction wages. Statistical base effects in retail trade, hotels & restaurants and communications probably mitigated the drag from unfavorable calendar. Finally, a lot has already been written about the wage pressures in the Polish economy and we'll simply note that demographic and institutional factors still favor high wage growth in Poland. It also means that consumption growth will continue to be supported by wage bill growth, in July exceeding 8% in current and 9% y/y in constant prices.

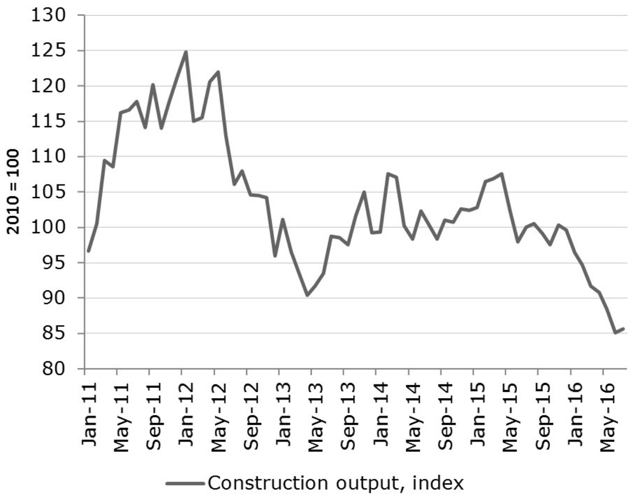


Industrial output fell by 3.4% y/y, significantly below forecasts – even the most pessimistic forecasters (including us) expected a small decline. The slowdown vis-a-vis June reading (+6.0% y/y) is to a large extent a result of very unfavorable calendar (difference in the number of working days fell from +1 to -2 y/y) but it does not explain the surprise. In fact, if calendar and seasonal effects are stripped, what remains is pretty weak: 1.6% y/y (down from 3.6%) and -1.6% m/m. Our favorite momentum measure, led by the latter figure, is at 4 year lows. In the coming months industrial output growth should pick up but one should not expect miracles – base effects (especially in transport equipment) will become more and more pronounced towards the end of the year.

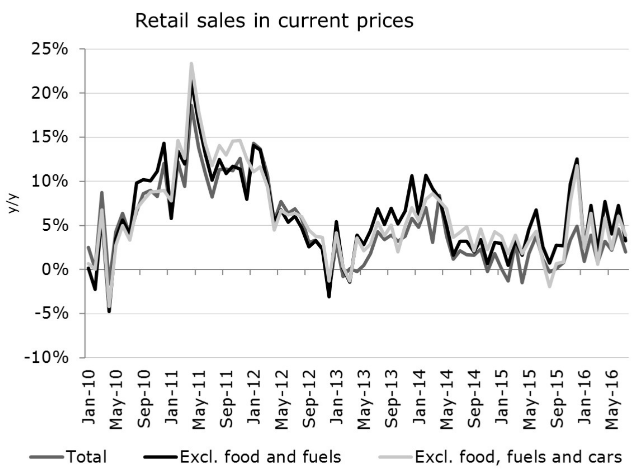


Construction output fell by 18.8% y/y, below consensus and close to our forecast. On a monthly basis, it increased by 0.6%

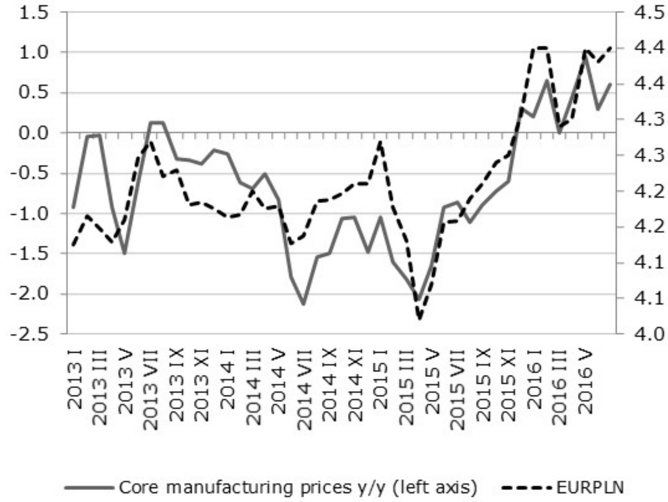
but that does not constitute a meaningful rebound. Reasons for the weakness in construction are well-known but worth repeating: cutbacks in public (railways and local governments) and quasi-public investment. The latter is primarily the state-owned energy companies (investment in e.g. power lines alone has shaved 0.3 pp. off growth in H1). Any rebound in the coming months will be statistical and doubtful given the strong base effects. It is possible that 2016 will turn out weaker than 2013 had been.



Retail sales rose by 2.0% in July, below market consensus. The details of the release are weak and dominated by negative working day effect; it is really hard to find any effects of 500+ programme. The variation still follows the seasonal pattern and working days closely. Although the sales of goods seems dismal, services more than make up for this and consumption is slowly accelerating. Given the constant flow of new money connected with 500+ (base effects begin to bite only from Q2 2017 onwards) and strong labor market, consumption is set to accelerate further this year. And given the hiatus in investment this is the only factor keeping GDP growth above 3+ at the moment.



Producer prices accelerated to -0.4% y/y in July. However, improvement owes much to base effects from last year. As we strip prices by those dominated by exogenous factors we end with the old truth – producer prices in manufacturing closely follow exchange rate (see the graph). As base effects continue, we may expect some further improvement in PPI growth. However, it obscures the fact that momentum is still at most neutral, and stronger zloty is set to make it negative again. Summing up: despite higher headline, no improvement in inherent inflation trends.



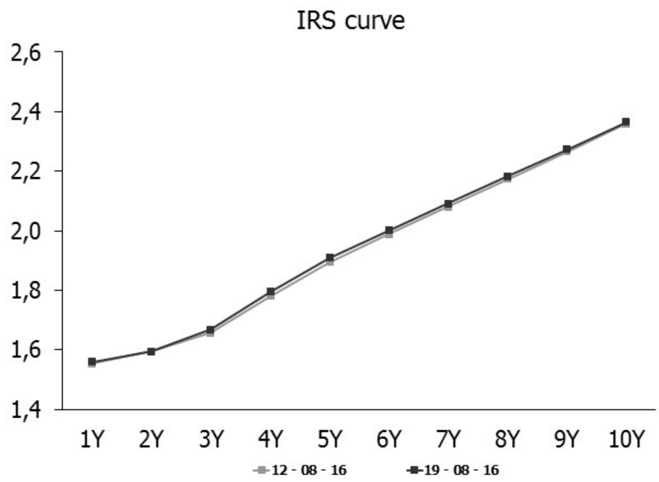
Fixed income

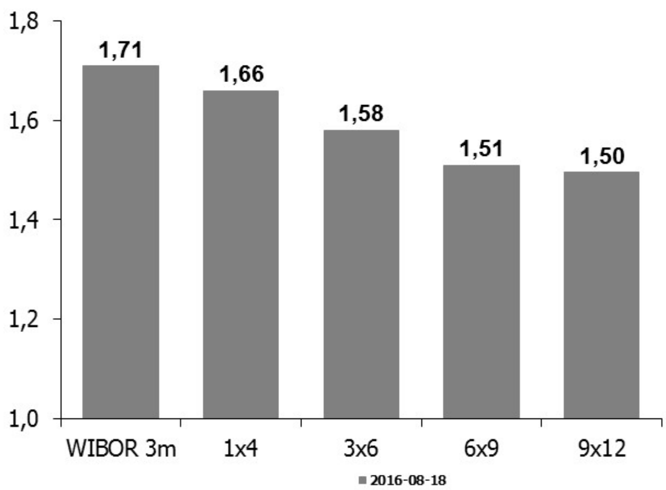
Yet another good auction

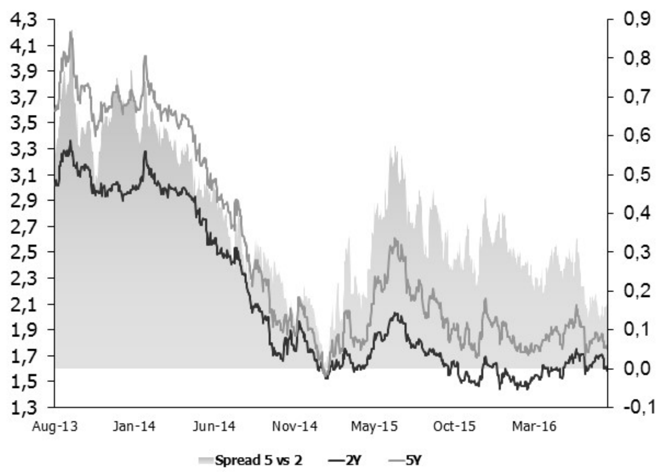
We had a very good auction this week, 8 bn pln was sold. OK1018 was sold at 1.67%, PS0721 at 2.11% and DS0726 at 2.70%. Good demand, not fully covered.

We still expect steepening of PS0721/DS0726 spread, current level is 59bps. We think the spread will be mostly driven by PS0721 (lower yield). Low yields on the core markets, inflows to EM funds, Polish GDP and rate cut expectations should drive 5y towards 2%.

ASWs remain expensive, 5y PS0721 33/31 and 10y DS0726 59/57.







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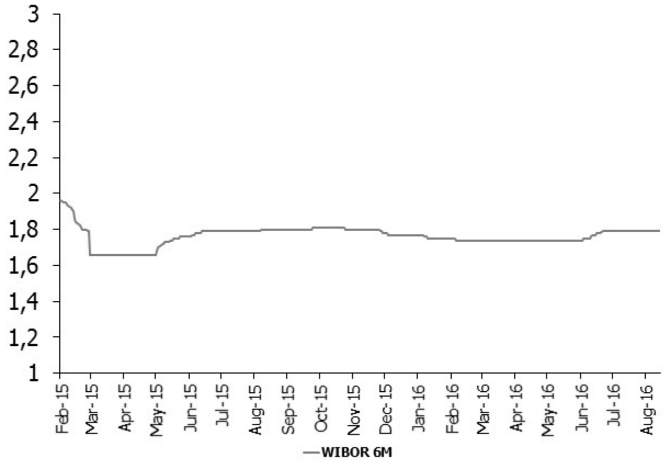
Money market

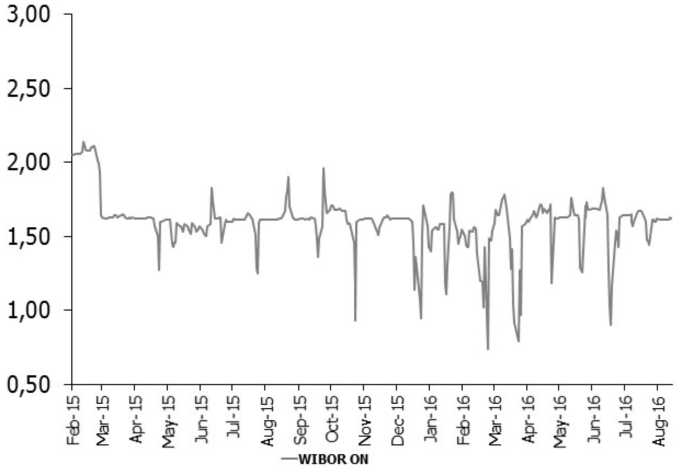
25 bps cut

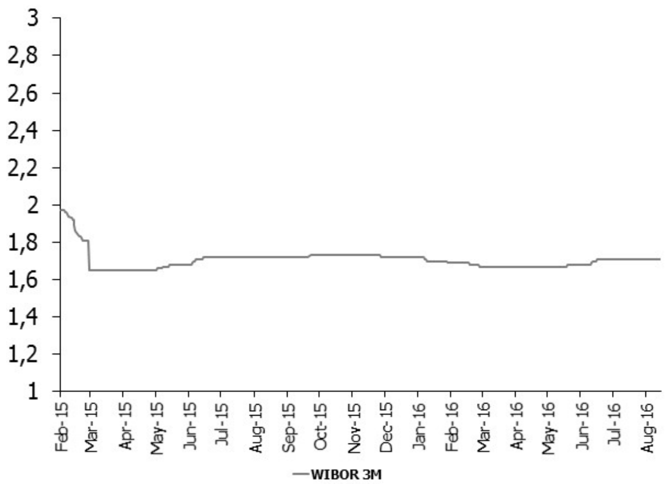
In the previous week we witnessed front end rates breaking out of the medium term range as bets on rate cuts intensified. With downside momentum and weaker prints from industrial output and retail sales the move was continued until 25 bp rate cut was priced in 12x15 FRA. While we still see some chances for rates to get even lower to price in 40bp cut (risk on, stop losses, weaker data), risk reward is starting to change gradually in favor of payers.

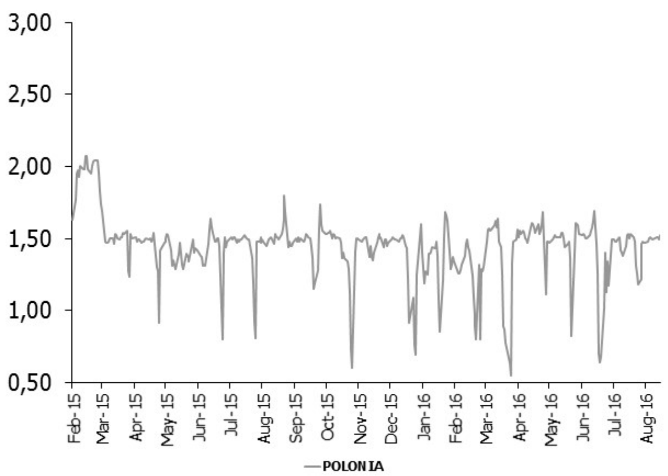
August turned out to be calm and rather cheap month as far as funding is concerned. Next week the market should also hold close to the reference rate. However, nearing end of the month, the volatility may increase.

Ref rate vs Polonia averages:
30 day 6 bp
90 day 9 bp





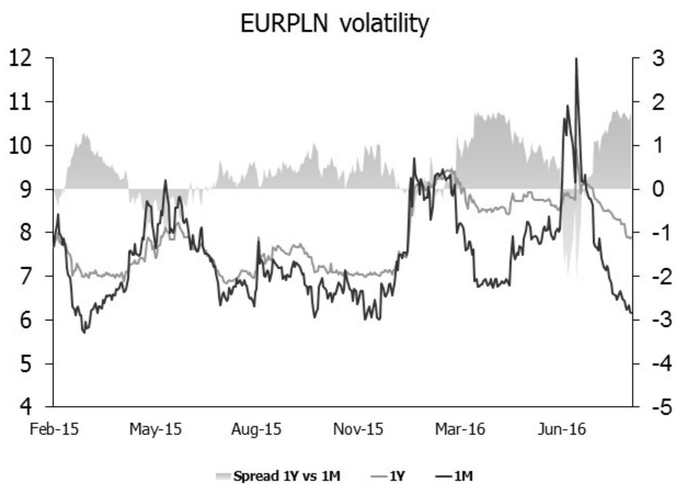




Forex

Spot – PLN weaker The worries of US rate hike expectations pushed EUR/PLN from 4.2560 to 4.3025. Even though the FOMC „Minutes" turned out relatively dovish and the dollar was sold, the zloty did not manage to trim its losses. Additionally, disappointing retail and industrial output figures boosted bets on monetary easing in Poland and they contribute to the weakness of the zloty at the moment. The big events, namely ECB and FOMC September meetings, the Constitutional Court conflict, the U.S. elections are just around the corner, so better keep ammo for them. On the other hand, the worries of the CHF mortgage bill are out of the way at the moment and global sentiment stays good. In this environment it is difficult to have a strong view and we are planning to be flexible and opportunistic but with a little PLN bullish tone.

Options – EUR/PLN vols – lower again It's strange but the higher realized volatility and weaker zloty did not take the Vols higher. In fact, we are even lower than a week ago. 1 month EUR/PLN ATM mid is 5.9% (0.1% lower), 3 month EUR/PLN are 6.4% (0.1% lower) and, finally, 1 year is fixing at 7.9% (0.1% lower). The skew and currency spread were at the last week's level.



Short-term forecasts

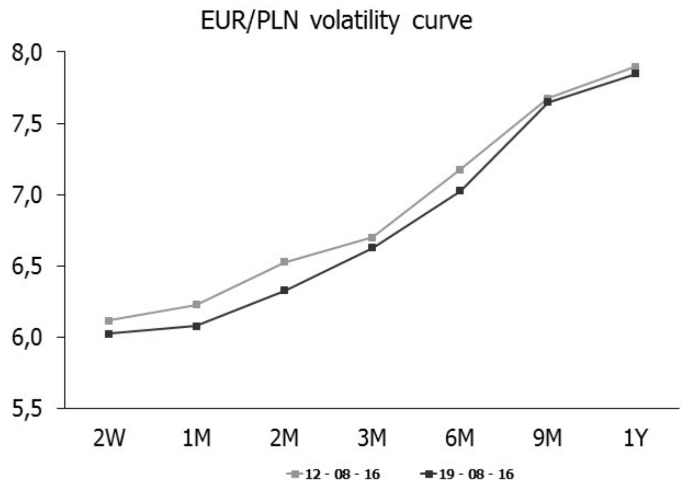
Main supports / resistances:
EUR/PLN: 4.23 / 4.35
USD/PLN: 3.75 / 4.00

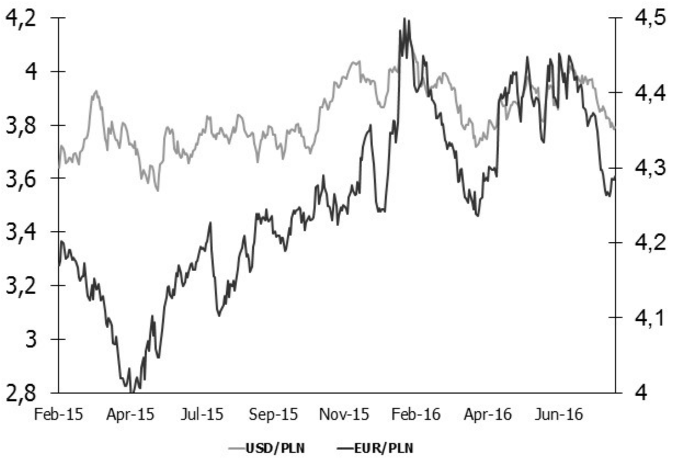
Spot New position: Short EUR/PLN.

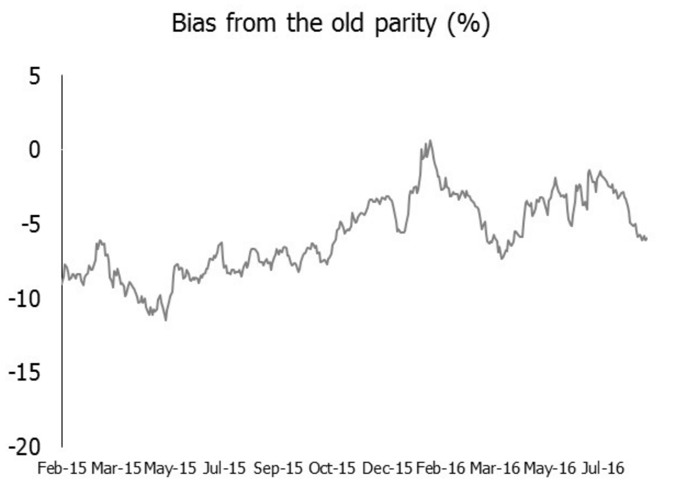
We are short EUR/PLN at 4.29, ready to add at 4.32 with stop at 4.35 and hopes to see 4.23. During the last days PLN struggled to make meaningful headway below 4.29 but we think it is a matter of time. The main reason for our faith in the Zloty is the fact that we got rid of the mammoth risk connected with CHF mortgages conversion.

Options Selectively long Vega

Implied volatilities have come off significantly over the past weeks. For some tenors realized volatilities are significantly higher than implied volatilities (for example 2m 9.3% realized versus 6.2% implied, 3m 8.8% realizedversus 6.4% implied). There is a lot of uncertainty surrounding Brexit, postponed decision on forced conversion of CHF mortgages, Constitutional Court conflict, the U.S. elections, so we stick to our position – we have still selective longs in backend EURPLN curve.







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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
8/12/2016	1.94	1.71	1.99	1.69	2.05	1.71	1.67	1.57	1.54	1.52	1.50	1.62
8/15/2016	1.93	1.71	1.96	1.69	2.01	1.71	1.67	1.57	1.52	1.53	1.50	1.57
8/16/2016	2.02	1.71	2.11	1.69	2.04	1.71	1.68	1.60	1.55	1.53	1.51	1.62
8/17/2016	1.80	1.71	1.88	1.69	1.95	1.71	1.68	1.62	1.57	1.54	1.53	1.64
8/18/2016	1.74	1.71	1.81	1.69	1.73	1.71	1.66	1.58	1.51	1.50	1.48	1.58

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
8/12/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
8/15/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
8/16/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
8/17/2016	1.710	1.474	1.635	1.638	1.990	2.290	2.447	2.985
8/18/2016	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
8/12/2016	6.23	6.70	7.18	7.90	7.90	2.24	0.58
8/15/2016	6.33	6.73	7.23	7.90	7.90	2.24	0.58
8/16/2016	6.18	6.70	7.05	7.88	7.88	2.23	0.58
8/17/2016	6.15	6.68	7.08	7.90	7.90	2.24	0.58
8/18/2016	6.08	6.63	7.03	7.85	7.85	2.24	0.58

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
8/12/2016	4.2626	3.8219	3.9205	3.7449	1.3745	0.1578
8/15/2016	4.2626	3.8219	3.9205	3.7449	1.3745	0.1578
8/16/2016	4.2700	3.7929	3.9295	3.7821	1.3778	0.1579
8/17/2016	4.2863	3.8075	3.9525	3.7763	1.3808	0.1585
8/18/2016	4.2837	3.7826	3.9476	3.7753	1.3795	0.1585

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