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Polish Weekly Review

Department of Economic Analysis (research)

Ernest Pytlarczyk, PhD, CFA
chief economist
tel. +48 22 829 01 66
ernest.pytlarczyk@mbank.pl

Marcin Mazurek, PhD
senior analyst
tel. +48 22 829 01 83
marcin.mazurek@mbank.pl

Piotr Bartkiewicz
analyst
tel. +48 22 526 70 34
piotr.bartkiewicz@mbank.pl

Karol Klimas
analyst
tel. +48 22 829 02 56
karol.klimas@mbank.pl

Department of Financial Markets (business contacts)

Wojciech Dunaj
head of interest rates trading
tel. +48 22 829 07 51
wojciech.dunaj@mbank.pl

Marcin Turkiewicz
head of fx trading
tel. +48 22 829 01 67
marcin.turkiewicz@mbank.pl

Department of Financial Markets Sales (business contacts)

Inga Gaszkowska-Gebska
institutional sales
tel. +48 22 829 01 67
inga.gaszkowska-gebska@mbank.pl

Jacek Jurczyński
head of treasury sales
tel. +48 22 829 15 16
jacek.jurczynski@mbank.pl

mBank S.A.
18 Senatorska St.
00-950 Warszawa
P. O. BOX 728
tel. +48 22 829 00 00
fax. +48 22 829 00 33
<http://www.mbank.pl>

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Comment on the upcoming data and forecasts

Only one publication this week – the MPC will announce its decision on Wednesday. We expect rates to remain unchanged. During its two day meeting, Council will learn of the newest NBP projections (basic paths for GDP and inflation will also be included in the press release). We expect lower GDP growth forecast and rather unchanged inflation path (lower near term, still below target over the entire forecast horizon. Governor Glapinski's recent comments (temporarily slower GDP growth in 2016 and no reason to hike rates in 2017) are a flavor of what one could expect from the press conference. We still see a chance of rate cuts in first quarter of 2017, if growth rate drops further or global reflation scenario is abandoned. However, easing monetary policy in Poland also has some domestic prerequisites like improvement in the cooperative banking sector. Friday is a public holiday in Poland.

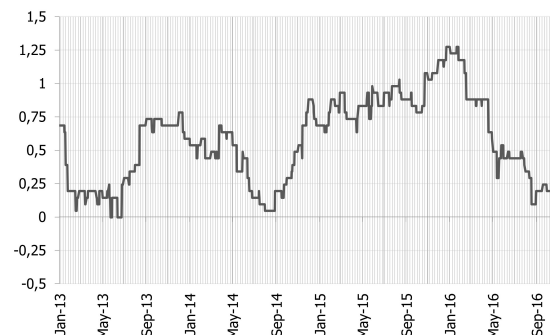
Polish data to watch: November 7th to November 11th

Publication	Date	Period	mBank	Consensus	Prior
MPC decision (%)	09.11	Nov	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	-	2000	1.742	10/6/2016
5Y T-bond PS0722	11/17/2016	4000	2.499	10/21/2016
10Y T-bond DS0727	-	4000	3.098	10/6/2016
15Y T-bond WS0428	-	200	3.027	7/7/2016

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



Comment

Polish manufacturing PMI staggered markets coming well below market consensus. Surprise index moved down by a few points, and we see it at current levels throughout the next week, since the MPC will not change rates.

* 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. Despite weak Zloty, exports growth ground into a halt. Public infrastructure outlays have shifted towards 2017, and private investment seems to be locally, negatively affected by spillovers from public investment gap, lower absorption of EU funds and political uncertainty. Hence, we expect 2-3 quarters of sub-3% growth.
- 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 are still a possibility (but MPC is very unwilling to ease). We expect the MPC to finally acknowledge downside risks for Polish GDP growth.

Financial markets

- Global reflation trades weakened the Zloty by raising risk-free rates and encouraging capital outflows from EM assets. Due to the weakness in exports and country risks still present, we expect Zloty to remain weak for the time being.
- The prevailing event risk for PL assets, the CHF conversion, moved to the background, as its details are unlikely to be announced soon.
- As the expectations for Fed hike moved towards December, market focus is now on US elections, their possible impact on the economy and geopolitics. With the race as tight as it is now, the elections pose a major risk for EM assets, probably higher than Brexit.

mBank forecasts

	2012	2013	2014	2015	2016 F	2017 F
GDP y/y (%)	1.6	1.4	3.3	3.9	2.8	3.2
CPI Inflation y/y (average %)	3.7	0.9	-0.1	-0.9	-0.6	1.3
Current account (%GDP)	-3.7	-1.3	-2.0	-0.1	-0.7	-0.9
Unemployment rate (end of period %)	13.4	13.4	11.4	9.8	8.7	8.1
Repo rate (end of period %)	4.25	2.50	2.00	1.50	1.50	1.25

	2016	2016	2016	2016	2017	2017	2017	2017
	Q1	Q2	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
GDP y/y (%)	3.0	3.1	2.7	2.5	2.7	3.1	3.4	3.5
Individual consumption y/y (%)	3.2	3.3	3.8	4.2	4.3	4.1	3.8	3.5
Public Consumption y/y (%)	4.4	4.4	4.0	1.0	2.4	2.4	2.4	2.4
Investment y/y (%)	-1.8	-4.9	-6.5	-4.0	-2.0	2.0	6.0	6.5
Inflation rate (% average)	-0.9	-0.9	-0.8	0.2	1.3	1.4	1.2	1.1
Unemployment rate (% eop)	9.9	8.7	8.3	8.7	8.9	8.2	7.8	8.1
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.25	1.25	1.25	1.25
Wibor 3M (% eop)	1.67	1.71	1.71	1.71	1.44	1.44	1.44	1.44
2Y Polish bond yields (% eop)	1.45	1.65	1.76	1.65	1.55	1.50	1.50	1.50
10Y Polish bond yields (% eop)	2.84	2.91	2.92	3.00	2.90	2.90	2.90	2.90
EUR/PLN (eop)	4.24	4.38	4.30	4.35	4.35	4.30	4.25	4.25
USD/PLN (eop)	3.73	3.94	3.82	3.95	4.03	3.98	3.94	3.94

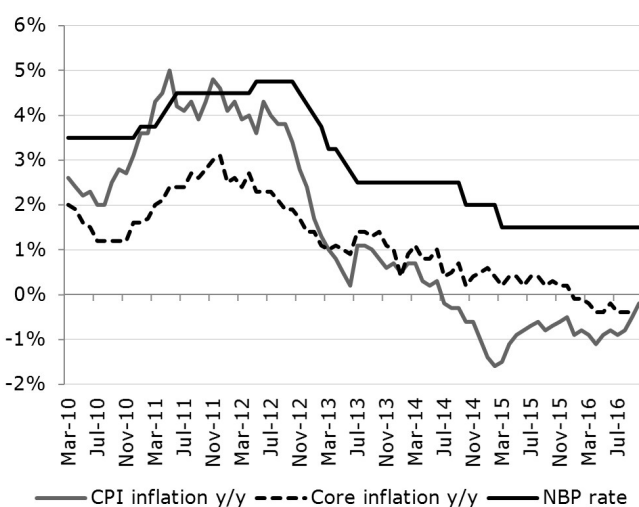
F - forecast

Economics

Deflation softened in October

According to flash estimate, yearly CPI in October was -0.2%, in line with our forecast and slightly higher than market consensus.

As always we need to wait until the middle of the month to know the details, but some patterns could be already expected. We see risk of higher food prices (0.4% m/m) as well as 3% growth of fuel prices. Other categories (except hotels and restaurants) should remain unchanged. According to our estimates, core inflation also moved slightly upward – from -0.4% to -0.3% on a yearly basis. Price pressure in Poland (also in Eurozone) is still very sluggish, inflation indices are growing only because of statistical base effects.

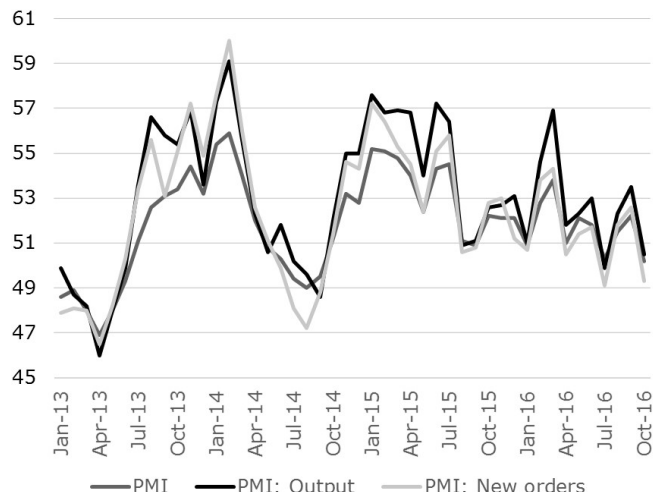


When Polish CPI will return to positive territory? We expect that it will take 1 or 2 months. More important is the question about core inflation, for which it could take much longer. The answer could cast a shadow on monetary policy in the upcoming months (not only in Poland but also Eurozone). Prolonging low core inflation would be a huge setback for currently developing reflation scenarios. Those are fueled by rebound in oil prices, CPI inflation and betterment of real sphere publications. Expectations about changes in policy of major central banks (ECB, BoJ, Fed) also contribute to those storylines.

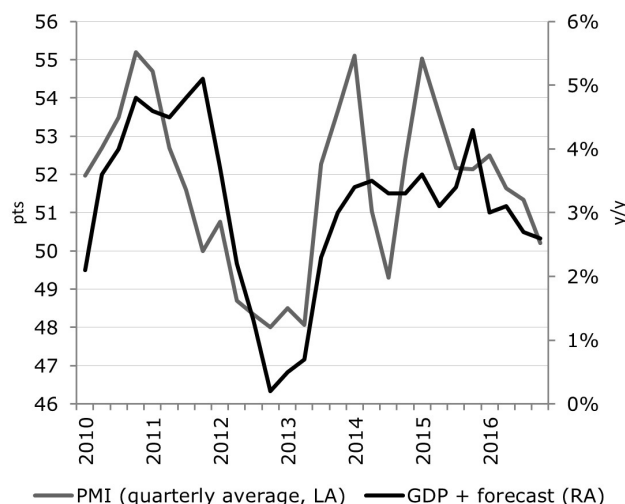
When it comes to Polish MPC, it will acknowledge no need to move interest rates. NBP needs to cope with stability of cooperative banks in Poland. However, softpatch in Polish GDP creates tactical opportunity to bet on more dovish MPC comments.

PMI continues to defy hopes for faster GDP growth in the second half of the year

Polish manufacturing PMI unexpectedly declined from 52.2 in September to 50.2 in November. Market consensus and our forecast both indicated a slight increase (to 52.5), consistent with the behaviour of European sentiment indices. October's poor outcome is at the same time both an 2 year low for the Polish PMI, and one of larger declines in the history of the series.



As in every month, the change in the PMI is mostly driven by the behaviour of output and new orders (both declined, from 53.5 to 50.5 and from 52.6 to 49.3, respectively). Employment subindex declined for the second time in a row and fell to 27-month low. The general picture of stagnating industry is complemented by weaker purchasing activity. As far as inflationary processes are concerned, there is no breakthrough. In fact, we can reiterate last month's comment: subdued input price growth and fifth consecutive decline in factory gate prices, both consistent with flat PPI and fading impact of weak PLN.



October's reading can be dismissed as noise but there is some signal there. Since the beginning of 2015, the PMI has been drifting lower. While it is futile to forecast GDP on the basis of quarterly PMI averages, trends tend to match over the medium term. In Poland's case, the downtrend in the PMI coincided with declining economic growth. Thus, we feel comfortable with our forecasts of a 2.5-2.7% growth in Q3 and Q4. Finally, the discrepancy between the employment component of the PMI and other labor market related sentiment indicators is still very pronounced. Until there is confirmation from hard data (LFS in particular), we will remain sidelined on that matter.

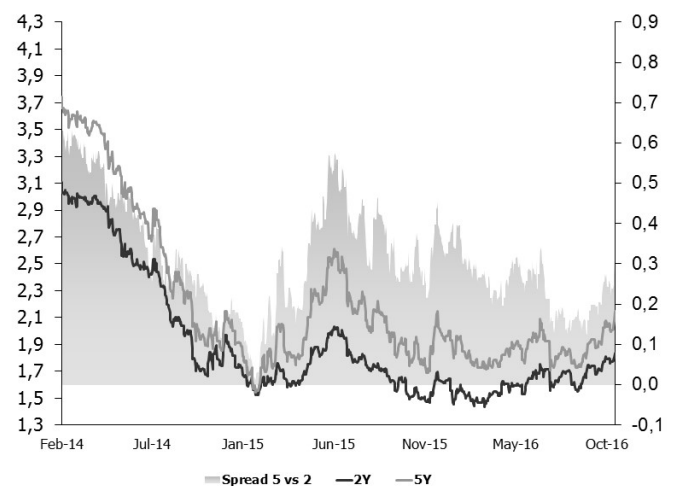
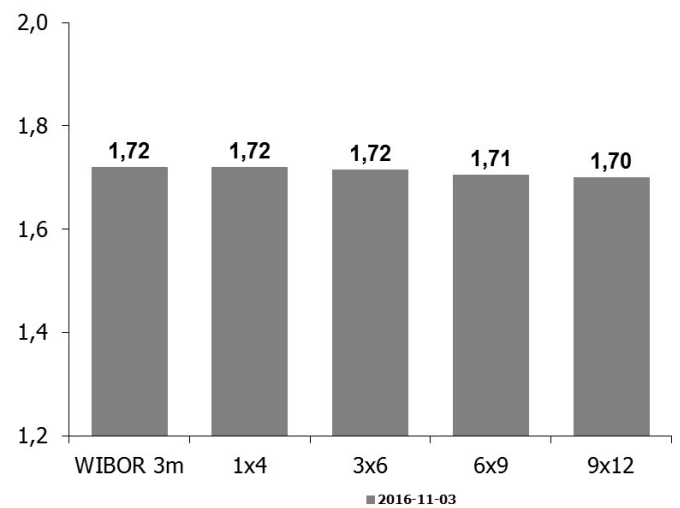
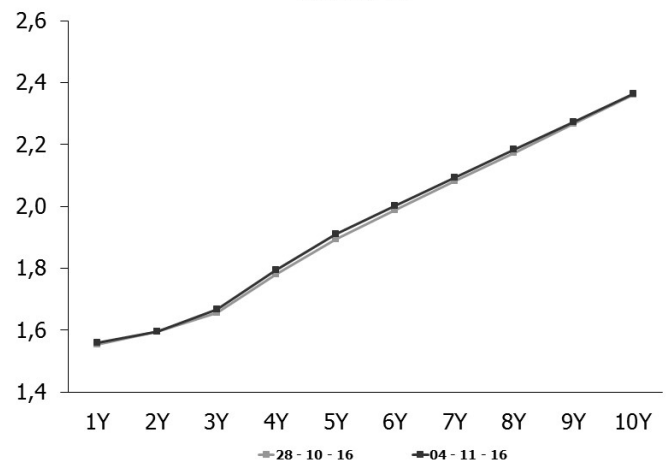
Fixed income

Switching auction

We had an auction this week. DS0727, OK1018 and IZ0823 were sold. We saw some uncovered demand on DS0727. After the auction market is higher and curve is flatter. It is possible that this flattening process may bring PS0721/DS0726 again to 54-53bps. DS0726/DS0727 spread also looks wide; we would rather expect it around 10bps in the long term than currently 18-19bps.

We do not see a chance for a rate hike in 2017, so short end bonds (OK1018 at 1.8% currently) seem to be cheap. Floaters, on the other hand, may be preferred trade for some funds as they switch from fixed bonds at current lvls.

IRS curve



Money market

Mixed signals

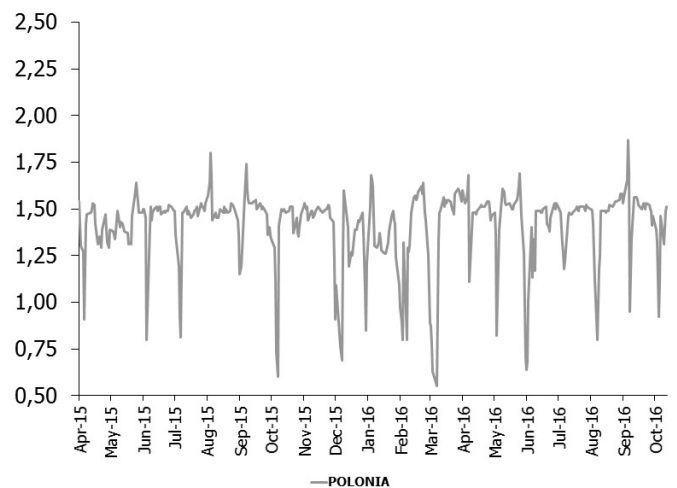
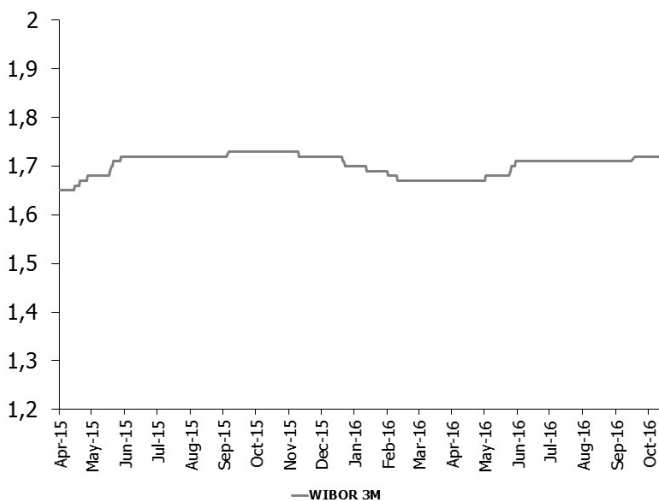
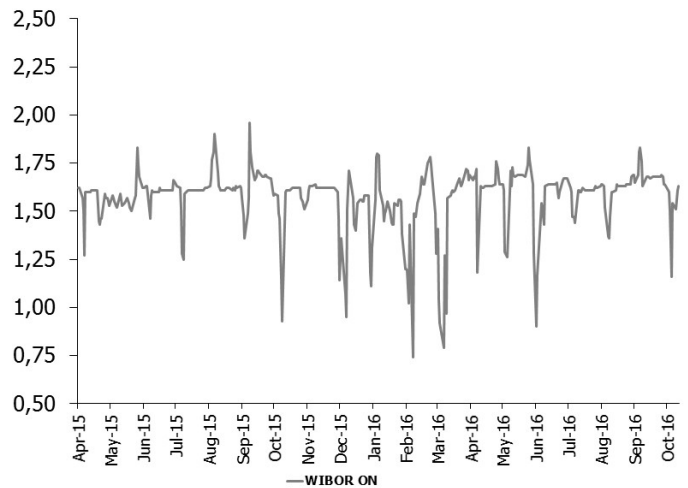
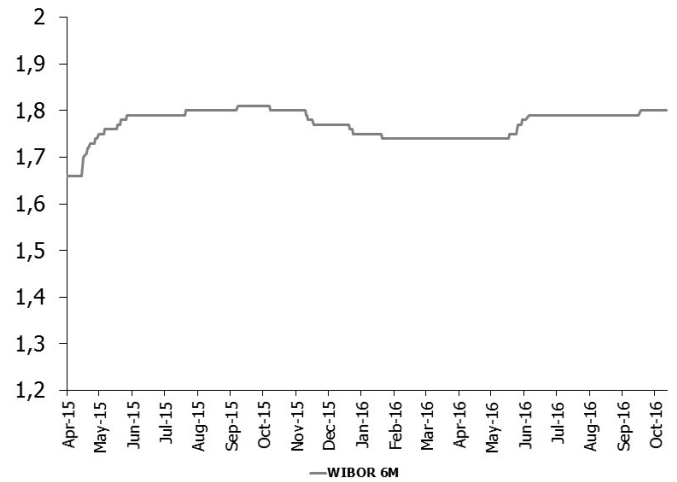
The data which came out last week gave us some mixed signals for future rates. Inflation surprised to the upside but the PMI came out weaker, hardly exceeding the 50 mark. Two year swap is trading at 1.81 and that's around 3 BP lower than in the previous week. Some small pressure for lower rates has started to build recently, which might have to do something with declining expectations for Q3 GDP (publication on November 15th).

At today's OMO banks bought 65bn of NBP bills out of 73bn offered, so some spare cash is left on the market. However, it's the beginning of the month, so any excess money will be used to build up reserves.

Ref rate vs Polonia averages:

30 day: 6 bp

90 day: 4 bp



Forex

Spot – EUR/PLN – Still no fireworks The most recent market jitters over the race to the White House that started in earnest last Friday didn't impact the Zloty at all. The sleepy, directionless moves continue – EURPLN was traded again in a narrow 4.2940-4.3350 range last week. This calm seems to be a little strange. Trump's victory can cause significant turbulence on the market. Once the drama of the election dies down, the focus is going to shift back over to the Fed/ECB policy discussions. The local Polish flavor is not adding much, with politics being calm. We see a range of 4.26-4.41 to more or less cover the moves for now, but we see more room to the upside, as that would be more painful for the market.

Options – EUR/PLN vols unchanged, USD/PLN vols shot up in the front end The CBOE Volatility Index, VIX, widely considered the best gauge of fear in the market, has gained more than 21% during last week, so it's not strange that 1w USDPLN implied volatility has shot up from 8.55% to 14.0%. 1M USDPLN has increased from 8.7% to 10.6%. The rest of the USDPLN curve is also better bid. Nevertheless, realized EURPLN volatility is still at its lows. The frontend of implied EURPLN volatility curve was also supported by fast approaching US elections, but in the rest of the curve the sellers still prevail. 1 month EUR/PLN ATM mid is at 6.0% (0.1% higher), 3 months EUR/PLN are 6.15% (unchanged) and, finally, 1 year is fixing at 7.1% (0.05% lower). Skew was roughly unchanged.

Short-term forecasts

Main supports / resistances:

EUR/PLN: 4.26 / 4.41

USD/PLN: 3.75 / 4.10

Spot Position: Long EUR/PLN.

We are long EUR/PLN from 4.3170 and 4.2870. The stop is now at 4.2550, we are hoping to see 4.38/4.40 and, depending, on the momentum possibly 4.41/4.43.

Our position is showing a quite mixed performance, but we are consequently keeping it, especially because financial markets across the globe have remained quite skittish. EURPLN is lacking momentum, but we think the Zloty rally is bit fatigued. The positioning on the market is also most likely skewed to PLN longs, and all we need is a spark.

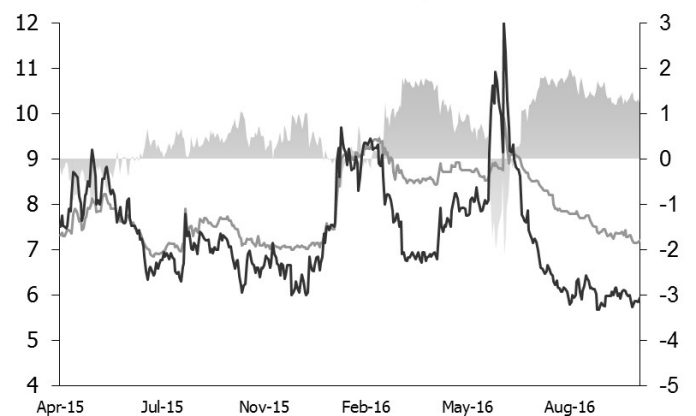
Options Selectively long Vega

Implied volatilities have come off significantly over the past weeks. There is a lot of uncertainty surrounding the Brexit, postponed decision on forced conversion CHF mortgages, Constitutional Court conflict, U.S. elections, so we stick to our position – we have still selective longs in backend EURPLN curve.



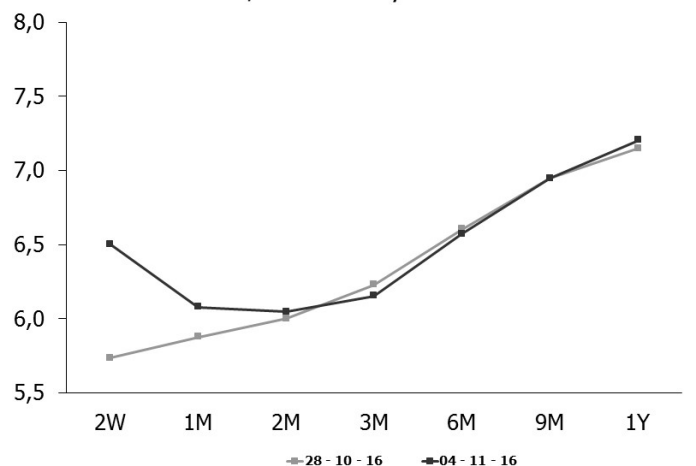
—USD/PLN —EUR/PLN

EURPLN volatility



■ Spread 1Y vs 1M —1Y —1M

EUR/PLN volatility curve



■ 28 - 10 - 16 ■ 04 - 11 - 16

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
10/28/2016	2.17	1.72	2.21	1.70	2.14	1.74	1.72	1.72	1.72	1.71	1.74	1.80
10/31/2016	2.24	1.72	2.26	1.70	2.16	1.74	1.72	1.72	1.72	1.72	1.74	1.80
11/1/2016	2.12	1.72	2.13	1.70	2.17	1.74	1.72	1.72	1.72	1.72	1.74	1.80
11/2/2016	1.52	1.72	1.60	1.70	2.05	1.74	1.72	1.72	1.71	1.70	1.72	1.79
11/3/2016	2.24	1.72	2.25	1.70	2.17	1.74	1.72	1.72	1.71	1.70	1.72	1.80

Last primary market rates							
Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
32W TB	3/14/2016	11/30/2016	99.04	1.35	1500	1757	1692
OK1018	10/6/2016	10/25/2018	96.54	1.74	2000	4838	2448
PS0421	8/18/2016	7/25/2021	98.31	2.11	3500	4968	3844
DS0727	10/6/2016	7/25/2027	94.57	3.10	4000	5916	4359

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
10/28/2016	1.740	1.474	1.635	1.578	1.960	2.232	2.405	2.949
10/31/2016	1.740	1.474	1.635	1.578	1.960	2.232	2.405	2.949
11/1/2016	1.740	1.474	1.635	1.578	1.960	2.232	2.405	2.949
11/2/2016	1.740	1.474	1.635	1.638	1.990	2.290	2.447	2.985
11/3/2016	1.740	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
10/28/2016	5.88	6.23	6.60	7.15	7.15	2.05	0.65
10/31/2016	5.88	6.15	6.53	7.15	7.15	2.05	0.65
11/1/2016	5.85	6.18	6.58	7.18	7.18	2.06	0.60
11/2/2016	5.94	6.00	6.54	7.20	7.20	2.01	0.69
11/3/2016	6.08	6.15	6.58	7.20	7.20	2.10	0.64

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
10/28/2016	4.3293	3.9696	3.9927	3.7730	1.4001	0.1603
10/31/2016	4.3267	3.9488	3.9953	3.7605	1.4005	0.1601
11/1/2016	4.3267	3.9488	3.9953	3.7605	1.4005	0.1601
11/2/2016	4.3169	3.8954	4.0066	3.7623	1.3996	0.1597
11/3/2016	4.3238	3.8965	4.0067	3.7867	1.4036	0.1600

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