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Polish Weekly Review

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Comment on the upcoming data and forecasts

On Thursday CSO will publish its monthly Statistical Bulletin. Because of changes in populations and baskets of many statistical categories, its content is especially interesting. Preliminary data about unemployment rate in January given by MFLSP (8.7%) could be corrected downwards because of higher economically active population (visible in jump in employment), thus we are revising our forecast accrdingly (to 8.6%).

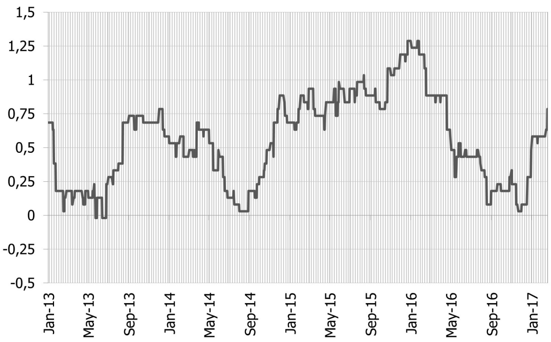
Polish data to watch: February 20th to February 24th

Publication	Date	Period	mBank	Consensus	Prior
Unemployment rate (%)	23.02	Jan	8.6	8.7	8.3

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
(29–37/52) Week T-bills	2/20/2017	2000	1.520	2/6/2017
2Y T-bond OK1019	3/2/2017	600	2.183	2/16/2017
5Y T-bond PS0422	3/2/2017	1400	3.177	2/16/2017
10Y T-bond DS0727	3/2/2017	1600	3.854	2/16/2017
30Y T-bond WS0447	3/2/2017	2100	4.257	7/16/2016

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



Comment

Abundance of economic releases brought few positive surprises – retail sales and producer prices., thus Polish surprise index continues upward trend after short stop. Next week bring s CSO's Statistical Bulletin, we see a possible surprise in unemployment data.

* 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 bottomed out at 2.4% y/y in Q3 2016. Momentum is very positive right now; growth picked up on a q/q basis in Q4 already (2.8% y/y). This year, growth will accelerate to the average of 3.4%, as investment returns to growth. Given the upside surprises in construction, one can expect investment growth to turn positive in Q1 already. With consumption growth already solid, we expect growth to accelerate over the course of the year, touching 4% y/y in Q4.
- Polish deflation has ended. During the next two quarters inflation will be boosted by statistical base effects, weak PLN and commodity price spike (headline inflation to reach 2.5% at the turn of Q1 and Q2). We are still skeptical of genuine inflationary pressures in the Polish economy, though. The fate of inflation in the second half of next year, absent a sustained increase in commodity prices, is by no means certain. Because of the well-known base effects in oil prices, interest should turn to core inflation.
- Rising inflation will prove to be a fertile ground for rate hike bets. It is very unlikely that these will materialize this year, though. We see the MPC's reaction function as symmetrical – see the Glapinski's comments on allowing real rates to run negative. It is more realistic to place bets on monetary tightening in 2018.

Financial markets

- However, local factors should be positive for the Zloty: faster growth, good fiscal figures and potential for more aggresive rate hike bets should lift Zloty later his year.
- The prevailing event risk for PL assets, the CHF conversion, moved to the background. All known details are relatively benign (no forced conversion).

mBank forecasts

	2013	2014	2015	2016	2017 F	2018 F
GDP y/y (%)	1.4	3.3	3.9	2.8	3.4	3.5
CPI Inflation y/y (average %)	0.9	-0.1	-0.9	-0.6	2.2	2.3
Current account (%GDP)	-1.2	-2.1	-0.6	-0.6	-0.9	-1.1
Unemployment rate (end of period %)	13.4	11.4	9.8	8.3	7.8	7.3
Repo rate (end of period %)	2.50	2.00	1.50	1.50	1.50	2.00

	2017 Q1 F	2017 Q2 F	2017 Q3 F	2017 Q4 F	2018 Q1 F	2018 Q2 F	2018 Q3 F	2018 Q4 F
GDP y/y (%)	3.1	3.4	3.4	3.8	3.8	3.6	3.6	3.6
Individual consumption y/y (%)	4.4	4.2	3.8	3.8	3.6	3.5	3.4	3.4
Public Consumption y/y (%)	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Investment y/y (%)	-2.0	3.5	6.3	7.0	7.3	7.0	6.5	5.5
Inflation rate (% average)	2.1	2.4	2.4	1.9	2.1	2.2	2.3	2.4
Unemployment rate (% eop)	8.5	7.9	7.5	7.8	8.0	7.4	7.1	7.3
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.50	1.50	1.75	2.00
Wibor 3M (% eop)	1.73	1.73	1.73	1.73	1.73	1.73	1.98	2.23
2Y Polish bond yields (% eop)	2.05	2.10	2.15	2.20	2.20	2.20	2.30	2.40
10Y Polish bond yields (% eop)	3.90	3.90	3.90	3.90	3.90	3.90	3.90	3.90
EUR/PLN (eop)	4.38	4.30	4.25	4.20	4.20	4.20	4.20	4.20
USD/PLN (eop)	3.91	3.91	3.94	4.04	4.12	4.12	4.12	4.12

F - forecast

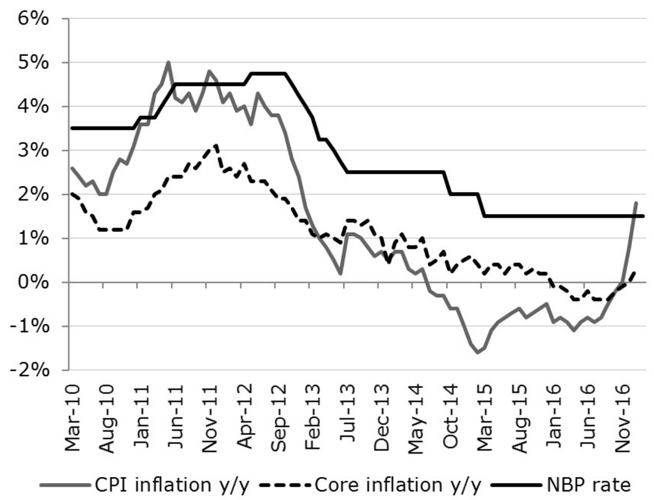
Economics

Economy re-accelerates. Rate hike expectations unleashed.

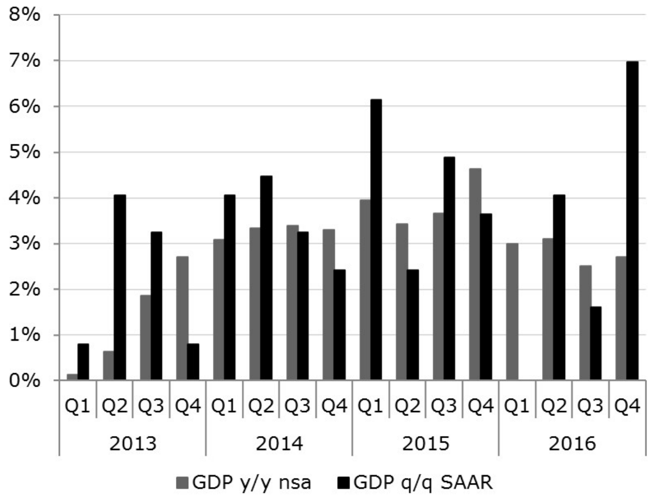
Last week brought important statistical releases from the Polish economy. What have we learned? First of all, inflation accelerates quickly on the consumer and on the producer's side as well. So far the growth of core measures is muted but usual economic correlations with the labor market are set to give core measures a lift as well. Secondly, higher headline inflation falls on fertile ground. Real sphere publications show that turnaround in the economy was reached in Q4 and we are heading for higher growth in 2017. So far the MPC can simply ignore the readings since the latter somewhat fit into their preferred scenario. Therefore we think the MPC is unlikely to change its rhetoric much soon. However, the devil is in the detail. We think that breaching 2% by inflation in March/April will be an important checkpoint. New inflation projection can also serve somewhat higher CPI path (pro-cyclical revisions, adjustment to recent data). That is why market expectations for more restrictive monetary policy may wander somewhat more freely upwards in the coming weeks.

Let's look into details:

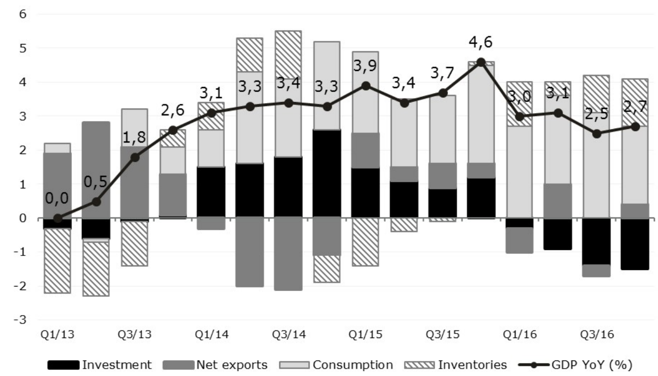
In January **inflation** rose to 1.8% y/y (when basket weights are updated, the reading could be revised). We expected a slightly lower reading, 1.7% (consensus was 1.6-1.7% y/y). The surprise is probably due to higher food prices (+1.8%) and stronger growth in health services (+0.4% m/m vis-a-vis -1.8% m/m a year earlier). These were only marginally offset by cheaper transport services. As it is always the case in January, the breakdown of CPI growth is not very detailed, however we can reasonably put core inflation at 0.3% y/y in January. Inflation will likely cross 2% in February and close on the NBP's target in the upcoming months.



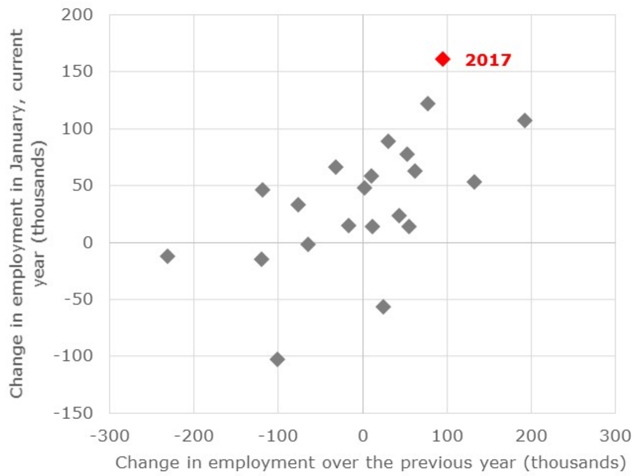
According to the flash estimate, Polish **GDP** grew by 2.7% y/y in last quarter of 2016, which is consistent with annual data published two weeks ago (however, much closer to the upper bound of range implicated by those figures). Growth momentum is much more impressive – after adjusting for calendar and seasonal effects it equals 1.7% q/q, which is the best result in 9 years. Quarterly growth surpassed expectations based on monthly data (a solid rebound in industrial and construction production in Q4).



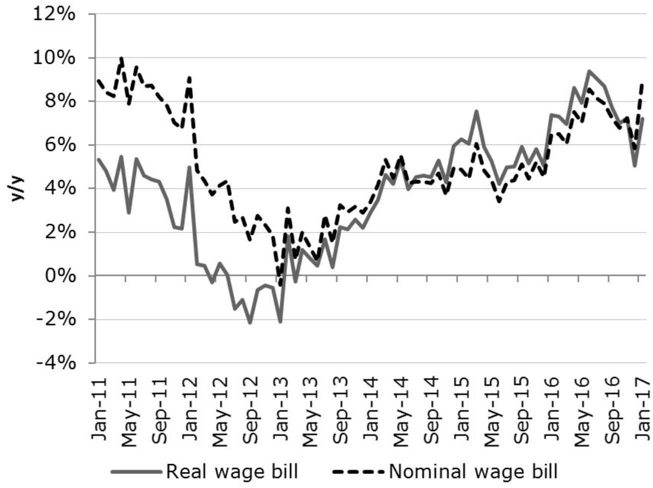
Composition of yearly data allows us to estimate the structure of Q4 GDP growth quite precisely. Firstly, the rebound in investment is meagre (-5.5% in Q4 vis-a-vis -7.7% in Q3) and can be attributed to the fact that buildings and structures were the only category of investment that improved its performance in the last quarter. Spending on machinery and equipment remained flat on y/y basis, as industrial output figures show, which also fits output-based nowcasts of GDP we also rely on. Secondly, private consumption barely accelerated, from 3.9 to 4.1% y/y – so far, spending on goods is a reasonably good predictor of overall consumer spending. Thirdly, public consumption slowed down in Q4 due to statistical base effects, but not as much as one could have feared. Our original forecast (+1% y/y) is close to what can be calculated from annual data (+1.2% y/y). Moreover, net exports added a few percentage points to growth in Q4 and the trump card was inventory formation. The latter category added a whopping 1.4 p.p. to growth and it seems that firms ramped up production, but haven't sold it completely yet. This should not be seen as a negative development, but rather a result of better sentiment. Given the upbeat recent NBP surveys, it should result in acceleration of business sales. Although the composition of GDP growth was probably rather unusual, we are positive on 2017 GDP growth. Growth has already bottomed out in third quarter of 2016. Subsequent GDP reading is going to exceed 3.0% y/y (in Q1) and come close to 4% at the turn of 2017 and 2018.



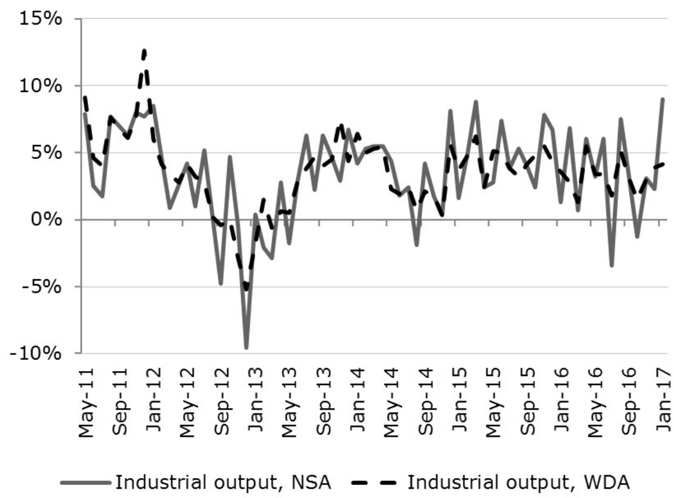
Employment in the enterprise sector grew in January by as much as 4.3% on a yearly basis, beating market consensus (2.9%) and even our most optimistic forecast (3.4%) heavily. On a monthly basis this is a new all-time high (160k jobs were added, which means 2.8% monthly growth rate), while on a yearly basis it is the highest result since the financial crisis (plus 256k jobs). January's releases are to a large extent defined by statistical effects and legal issues – CSO updates its population of 9+ companies (employing 9 workers or more). The jump was inflated not only by good situation on the labour market (existing companies were growing), but also a switch from junk contracts (not counting in this statistic) towards standard employment contracts, which was motivated by legal changes. Such a jump in employment at the start of the year will not only set the tone for following releases but also have a huge impact on other labour market indicators (the denominator of registered unemployment rate).



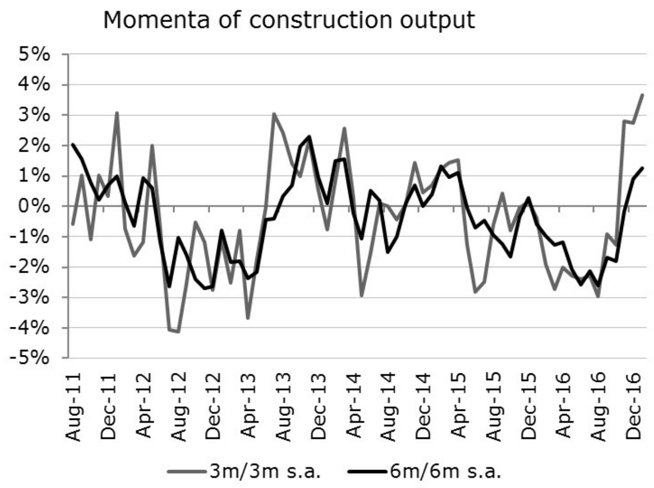
Average gross wage grew by 4.3% y/y, in line with consensus and slightly below our forecast of +4.8%. The acceleration vis-a-vis the previous month is probably a result of several factors: (1) favorable difference in working day count (up from -1 to +2 y/y); (2) big raise in the minimum wage which added at least 0.2 p.p. to annual wage growth (more if it pushed wages slightly above the new minimum); (3) catching up after a weak December in several industries. In addition, it is conceivable that the change in the population of 9+ enterprises (see the previous paragraph) also influenced wage growth. Such a strong increase in employment suggests non-negligible composition effects, although it is unclear in which direction would they work. Detailed wage data might shed some light on this issue but one shouldn't expect a definitive answer. Our structural view on wages is unchanged – demographic factors lead to gradual tightening of the labor market and the imbalance between labor supply and demand will force wages up. Even now the share of enterprises reporting staffing problems is close to all-time highs, despite the sizable inflow of immigrants from Ukraine. The latter factors might as well be the biggest risk, since the upcoming visa regime liberalization might lead to outflow of some Ukrainian workers to other EU states, thereby tightening the market in a rapid fashion.



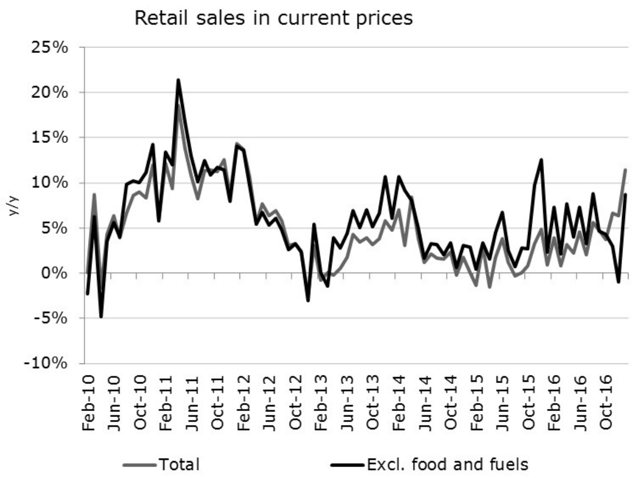
Industrial output accelerated to 9.0% y/y in January. Although much of the acceleration stems from working days count (-1 y/y last month vs +2 this month), seasonally adjusted figures suggest that growth from recent months carried over for the start of 2017. That also applies to **construction output** that accelerated to 2.1% r/r, not only on the back of calendar effects. We think that construction is driven by infrastructure investment, helped by a thaw in local entities' spending.



Looking at industrial output and construction together we see confirmation that the trough in the cycle is behind us and the pattern of surprises suggests some market participants may upgrade their forecast regarding GDP growth in H1. We did it several weeks ago and **claim that 3%+ level is appropriate for Q1 GDP reading.**



Retail sales surprised massively on the upside (11.4% in nominal terms), but was close to our call (12.5%). Apart from calendar effects, a base effect was vital. Remember that last year the pessimism was prevailing. There was high uncertainty regarding the policy of the new government, 500+ program was still far from being a concrete bill and finally the rating cut received very negative publicity in the press. It could not have gone unnoticed by consumers, hence a solid turnaround this year. But retail sales also confirms the strength of the consumer spending. Even after stripping those one-offs, spending rose substantially. We think that consumption growth this year will top 4%. Stories of consumption falling due to base effects on disposable income should not be taken seriously. Consumers smooth consumption over time. This time they have additional buffers (500+ savings) and confidence in the labor market.



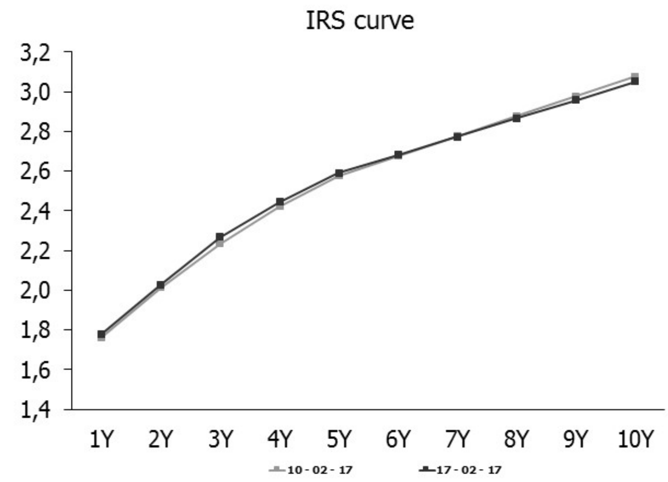
Producer prices topped 4.1% in January, as we forecast. It was partially a result of statistical base and revisions but spill overs among different manufacturing sections also played their part. We almost forgot about their existence during a period of deflation in PPI but as prices go unilaterally upwards, solid economy only strengthens that process. This is one of the reasons core inflation is unlikely to stop growing in the latter part of the year.

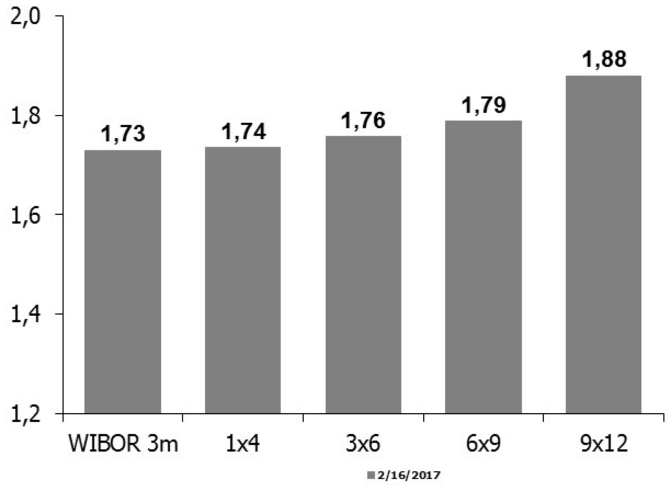
Fixed income

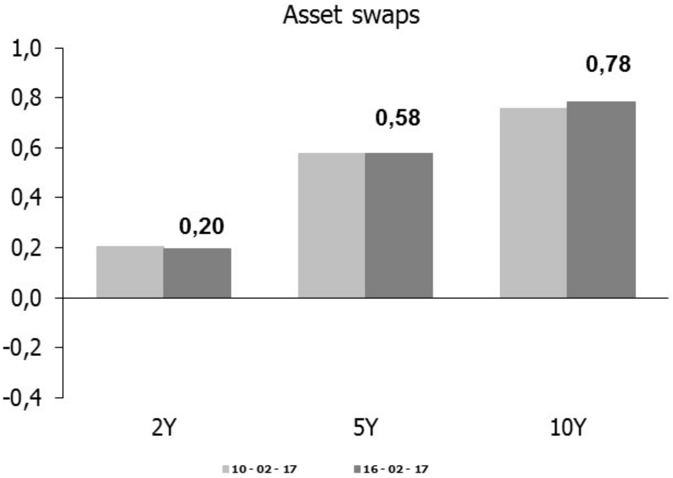
Longest fixed-rate bond ever

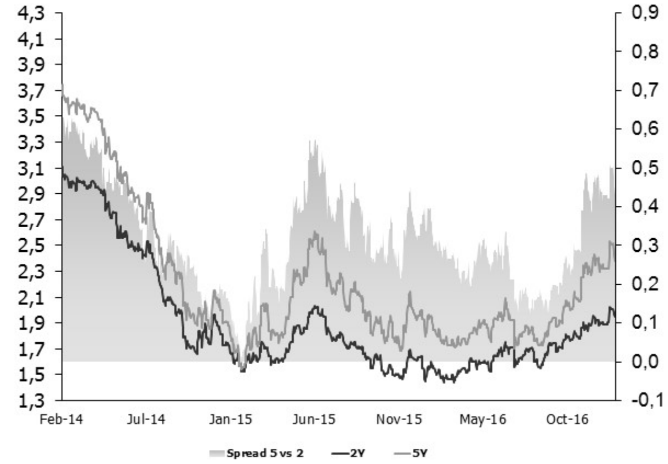
This week we had auction. Ministry of Finance sold 5 regular bonds OK0419/PS0422/DS0727/WZ1122/WZ0126 and NEW 30Y, WS0447. The total supply was 7 bio, with good demand over 12 bio. New 30y was sold at 4.26%, 2.1 bio were issued. Strong demand and bid higher than secondary market moved yields lower.

As we saw high CPI and GDP figures this week, curve is much flatter. The PS0422/DS0727 spread has narrowed from 68 to 64 bps, ASW PS0422/5y is at 57bps and DS00727/10y is at 77 bps. OK0419 is trading at 2. 22% (3 bps up), PS0422 is trading at 3.16% (1 bps up) and DS0727 is trading at 3.81% (3 bps down).









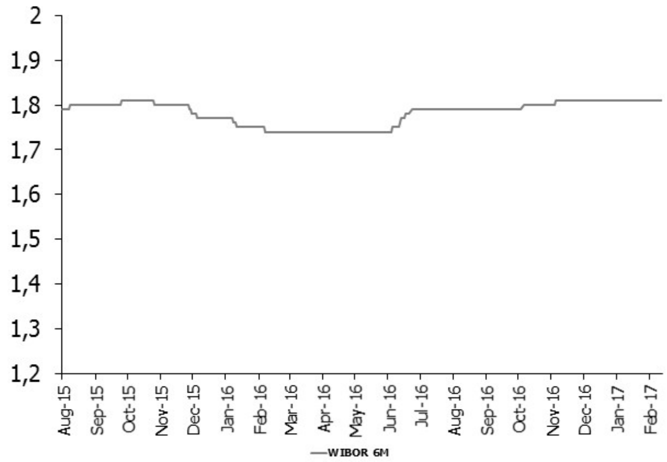
Money market

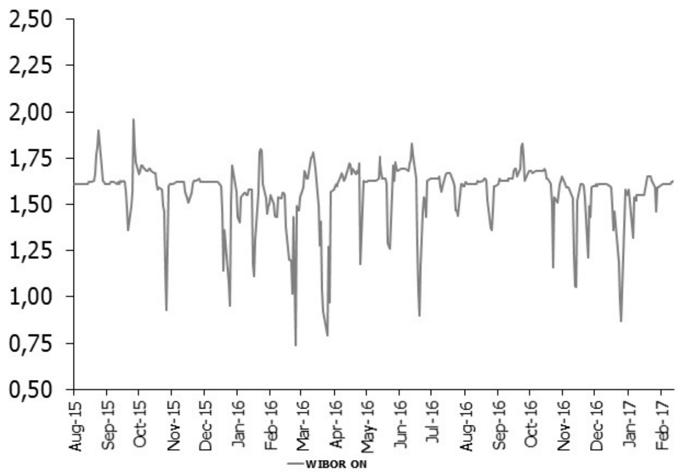
Economic releases are driving the market

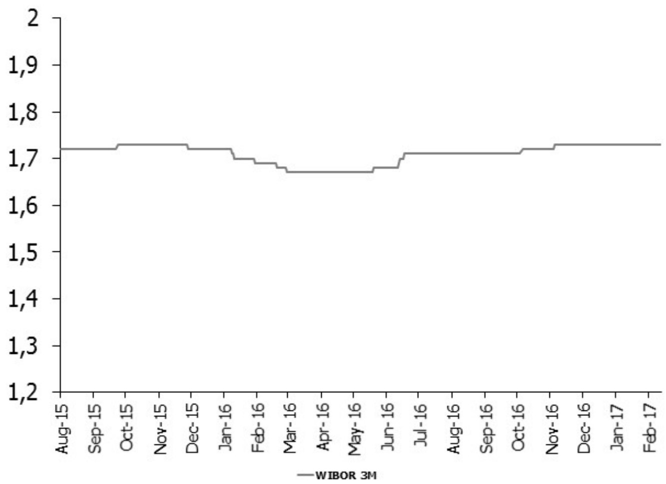
Booom! Last CPI surprised again on the upside coming at 1.8% vs 1.7% expected. This means that we have entered negative real rates territory and will stay here at least for several months. First reaction was 2y bonds moving 5 bp higher in yield terms. MPC members are neglecting that fact and reiterate that their base scenario is no rate change till year end. Maintaining that stance might be difficult in coming months with estimates showing CPI might reach 2.5% soon.

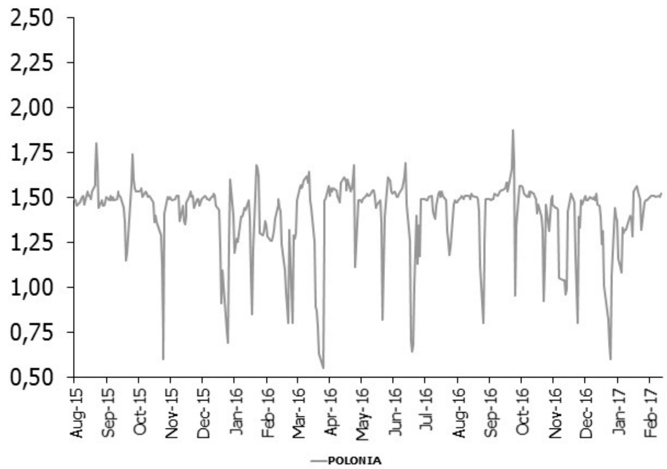
Boring mid-month overnight market. Rates held steady around 1.50%.

Ref rate vs Polonia averages:
30 day   3 bp
90 day   14 bp









Forex

Spot – PLN out of steam EUR/PLN seems to base above 4.27-4.30 support zone, and looks ready to at least test 4.35/4.37 resistance. No particular reason for that and basket-wise (equally weighted by EUR and USD) the changes of value of the PLN are cosmetic. Nevertheless the Zloty train seems to be losing steam as flows are being a little skewed to sell PLN. The momentum is really weak, and we expect the range of 4.28-4.36 to cover the EUR/PLN fluctuations for the next few sessions.

EUR/PLN vols – The U-turn? Still to be decided ... Very low realized volatility was a reason for frontend vols to melt again (after last week's healthy jump) but mid and backend vols are almost unchanged. The 1 month EUR/PLN ATM mid is 5.0% (0.5% lower), 3 months EUR/PLN are 6.7% (0.1% lower) and finally 1 year is fixing at 7.4% (unchanged). The currency spread (difference of USD/PLN minus EUR/PLN) was tic lower. Skew was roughly unchanged.

Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.25 / 4.35
USD/PLN: 3.90 / 4.20

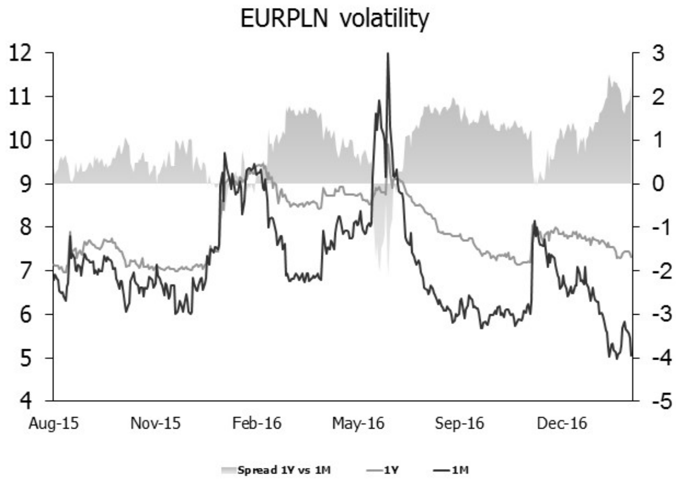
Spot Position: None.

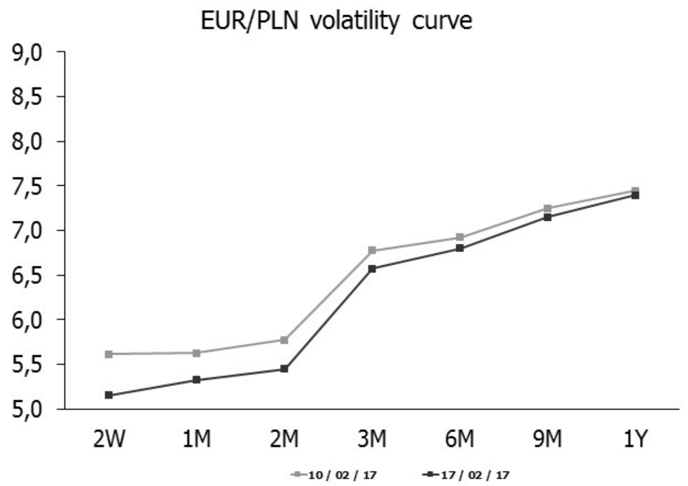
We are willing to buy EUR/PLN at 4.2700, we are ready to add at 4.2400, with a stop at 4.2150, and hopes to see 4.38+ again.

EUR/PLN is a rangy beast, we think it should sooner or later revert to the mean, which currently we can pin around 4.38-4.40, unless something really unexpected happens.

Options Vol – Long 9 month EUR/PLN vol.

We were lucky with closing shorts in frontend vols, as the vols have bounced significantly. We are keeping the backend long as an outright long position. We see French and Dutch elections as a good enough reason to be long vol at current levels.





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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
2/10/2017	1.70	1.73	1.78	1.71	1.82	1.75	1.73	1.75	1.78	1.87	1.97	1.89
2/13/2017	1.97	1.73	1.96	1.71	2.18	1.75	1.73	1.75	1.79	1.88	1.98	1.89
2/14/2017	1.70	1.73	1.78	1.71	1.74	1.75	1.74	1.76	1.79	1.88	1.97	1.90
2/15/2017	1.53	1.73	1.61	1.71	1.64	1.75	1.74	1.75	1.79	1.89	1.98	1.91
2/16/2017	1.95	1.73	1.95	1.71	2.19	1.75	1.74	1.76	1.79	1.88	1.99	1.90

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
OK0419	1/5/2017	4/25/2019	94.88	2.32	1000	2825	990
PS0422	1/5/2017	4/25/2022	95.62	3.16	1500	2880	1570
DS0727	1/5/2017	7/25/2027	89.20	3.76	1500	2787	1544

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
2/10/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
2/13/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
2/14/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
2/15/2017	1.750	1.474	1.635	1.638	1.990	2.290	2.447	2.985
2/16/2017	1.750	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
2/10/2017	5.63	6.78	6.93	7.45	7.45	1.93	0.49
2/13/2017	5.56	6.79	6.95	7.45	7.45	1.93	0.49
2/14/2017	5.45	6.78	6.90	7.40	7.40	1.88	0.49
2/15/2017	5.06	6.55	6.78	7.33	7.33	1.98	0.51
2/16/2017	5.33	6.58	6.80	7.40	7.40	1.88	0.49

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
2/10/2017	4.3030	4.0435	4.0322	3.5577	1.3953	0.1592
2/13/2017	4.3077	4.0496	4.0385	3.5580	1.3966	0.1594
2/14/2017	4.3025	4.0525	4.0340	3.5725	1.3945	0.1592
2/15/2017	4.3025	4.0752	4.0420	3.5603	1.3951	0.1592
2/16/2017	4.3160	4.0567	4.0516	3.5705	1.4015	0.1597

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