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Polish Weekly Review

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Comment on the upcoming data and forecasts

On Wednesday the CSO will publish its monthly consumer and business confidence reports - these will be the first readings on economic sentiment in March. On Thursday, the CSO will publish its monthly Statistical Bulletin. Apart from the details of recent publications, it will reveal data about unemployment rate in February. Preliminary estimates given by MFLSP indicates that the rate fell by 0.1 pp, in line with our forecast, whereas market consensus indicated stabilization at 8.6%. MPC Minutes, published the same day, will be most probably unnoticed, since many members of the Council have already made comments after last meeting.

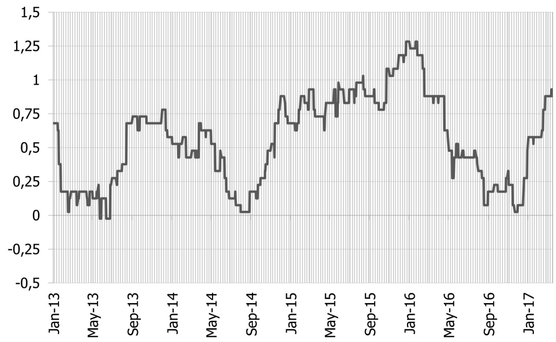
Polish data to watch: March 20th to March 24th

Publication	Date	Period	mBank	Consensus	Prior
Unemployment rate (%)	23.03	Feb	8.5	8.6	8.6
MPC Minutes	23.03	Mar			

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
(29–37/52) Week T-bills	-	700	1.500	2/22/2017
2Y T-bond OK1019	3/23/2017	600	2.183	2/16/2017
5Y T-bond PS0422	3/23/2017	1400	3.177	2/16/2017
10Y T-bond DS0727	3/23/2017	1600	3.854	2/16/2017
30Y T-bond WS0447	-	2100	4.257	2/16/2017

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



Comment

Positive surprise in CPI was erased by worse than expected industrial output data, which means that surprise index remained at the same level as a week ago. Next week brings just one opportunity to surprise with February's unemployment rate (preliminary data deviated from market consensus).

* 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. This year, growth will accelerate to the vicinity of 3.5% on average, as investment returns to growth. Given the upside surprises in construction, one can expect investment growth to turn positive in Q2 already and GDP growth to exceed 3% in Q1. With consumption already solid, we expect GDP 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). The case of accelerating core inflation is strengthening. Stellar employment performance shows no respite but wage growth remains moderate. Such equilibrium is unsustainable. If 2007 and 2008 are taken as guidance, wages are ready to take off this year as current demand for labor meets limited supply.
- MPC stays calm and waits rises in headline inflation out carrying steady message of stable rates. Such rhetoric can stay in place for some months. However, as trend in core inflation emerges as evident and labor market strengthen further, the case for rate hikes is set to strengthen as well. All we need is a small change in MPC's wording to make rate expectations wander somewhat more freely.
- Solid labor market performance and prospect for faster growing wages support personal income taxes and VAT on consumption. With much higher headline inflation already in place (deflationary 2016!), further improvements in tax income seem a safe bet for 2017 even without any stringent assumptions on the efficiency of tax collection.

Financial markets

- Zloty should stay above 4.30 in coming weeks. Bets on tighter ECB policy, steady path of rate hikes in the U.S. amid domestic (deepening) negative real interest rate are zloty negative. PLN can be boosted in the latter part of the year as this negative factor will be balanced by better GDP growth, lower fiscal risk and faster rate hikes bets.
- CHF risks are set to come back to the agenda once more within 2 weeks as joint conference of president Duda and NBP governor Glapinski is looming. However, we expect the conference to be long on words and short on actions. More precisely, rather nothing more than spread regulation and threats of using higher capital weights in SREP process.

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	2.25

	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	1.75	2.00	2.25
Wibor 3M (% eop)	1.73	1.73	1.73	1.73	1.73	1.98	2.23	2.48
2Y Polish bond yields (% eop)	2.15	2.20	2.25	2.30	2.30	2.35	2.40	2.45
10Y Polish bond yields (% eop)	3.90	3.95	4.00	4.05	4.10	4.15	4.20	4.25
EUR/PLN (eop)	4.30	4.25	4.25	4.20	4.20	4.20	4.20	4.20
USD/PLN (eop)	4.06	4.01	4.05	4.04	4.08	4.12	4.12	4.12

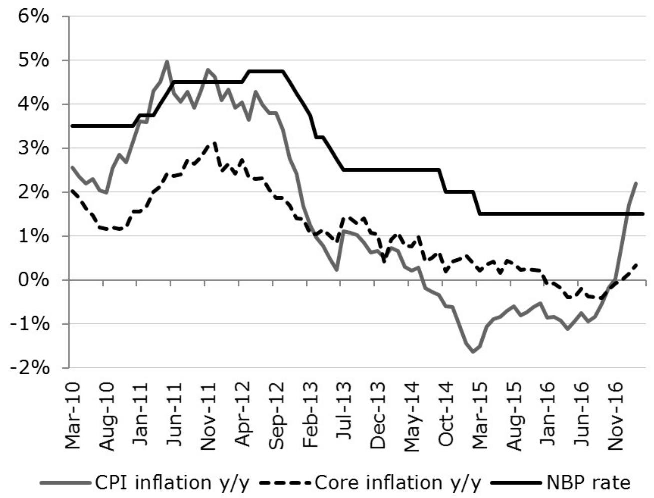
F - forecast

Accelerating inflation amid solid real activity growth and booming labor market. The status quo in monetary policy will crack in H2.

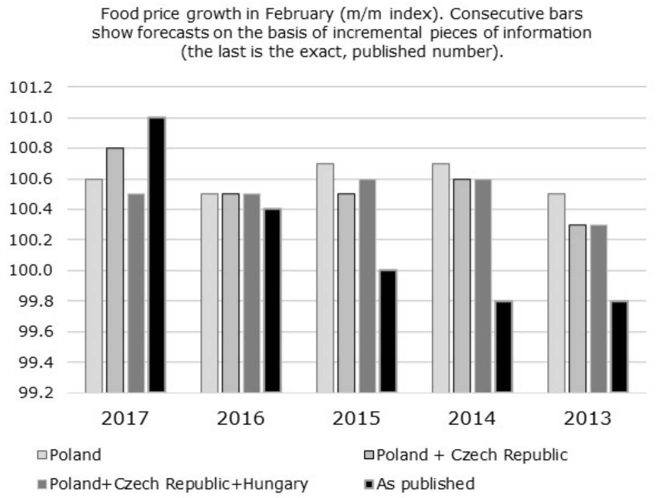
After the recent bout of data we can safely say that current MPC rhetoric stays safely anchored in current publications. However, conclusions that can be drawn from the data are more and more uncomfortable for such line of thought. First of all, inflation is accelerating and core measures momentum is tracking close to target in annualized terms. Secondly, GDP growth acceleration is confirmed and labor market performance is much better than the sheer activity growth from other sectors of the economy may suggest. Simple comparison of labor market performance with 2007-2008 (corrected for difference labor supply conditions) leads us to conclusion that wage pressure is at the verge of kicking in. Therefore as long we think the MPC may be still following current paradigm, we are also tempted to indicate that this rhetoric will be changing in H2 into a more hawkish one.

As usual, here's our detailed take on each of this week's publications.

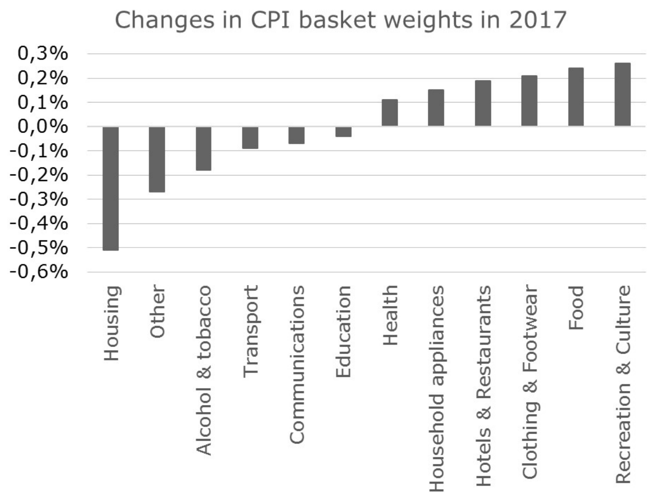
In February, **inflation** rose to 2.2% y/y from the revised reading of 1.7% in January. This is above market consensus and our forecast.



Our forecast missed on the basis of wrong food inflation forecast. We utilized, as always, incremental information flowing from Czech Republic and Hungary to tweak our initial forecast based on Polish data. The graph shows that the trend in consecutive forecasts (bars from left to right on the graph) should be consistent with the direction of final surprise (therefore we bet on a lower reading). To our astonishment, food prices shot up, reflecting broader European trends (supply limitations in Spain plus something more). However, it seems we pinned down fruits and vegetable prices correctly (they should normalize as supply shock fades and local productions jump starts seasonally). It was other prices of processed foods that surprised us and lead to higher reading. That leads us to conclusion that first sign of second round effects in inflation are becoming visible. Not surprisingly, we base our higher-than-consensus CPI forecast on faster growing core inflation.

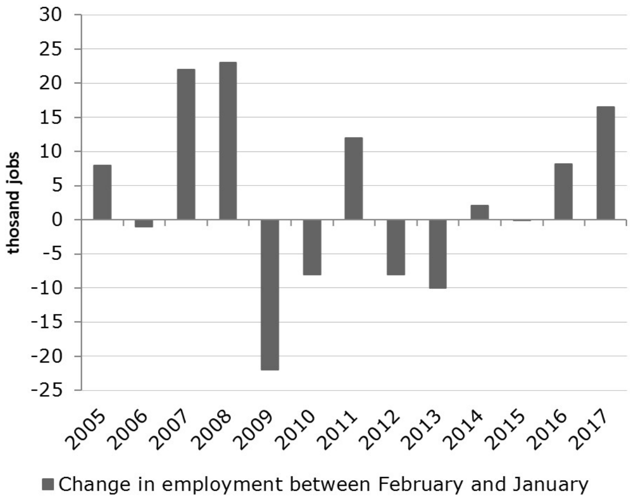


The revision of CPI basket weights shaved off 0.1 pp. off the January reading. The new basket is marked by higher share of the following categories: Recreation and culture (+0.26 pp.), Food and nonalcoholic beverages (+0.24 pp.), Clothing and footwear (+0.21 pp.) as well as Hotels and restaurants (+0.19 pp.). On the other hand, the share of Housing fell by 0.51 pp., while the role of alcoholic beverages and Others category also declined (by, respectively, 0.18 pp. and 0.27 pp.). Such a pattern is more or less consistent with both long-term tendencies that favor discretionary spending on goods and services and with the behavior of some categories last year (lower prices of energy, higher prices of foodstuffs).

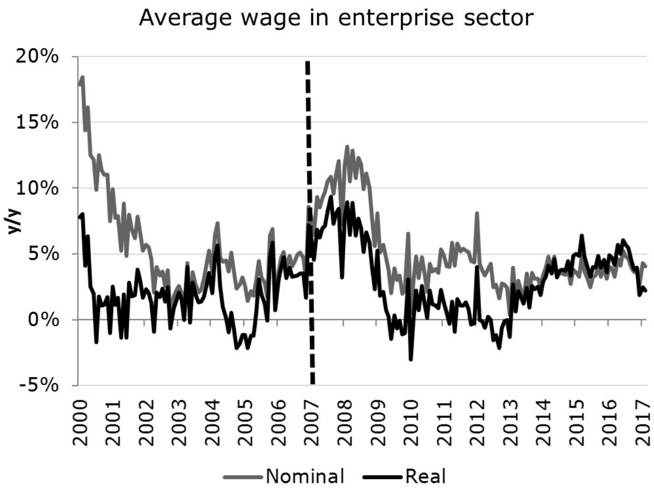


In February **core inflation** increased to 0.3% from 0.2% in January. The increase is broad-based and can be traced to a number of different categories (recreation and culture, tobacco products, transport services, housing). We are betting that core inflation will continue to rise in the coming months. This is supported by both macro fundamentals (consumption outlook, strong and tight labor market) and typical short-term correlates such as surging producer prices and environment conductive for their pass-through into consumer prices. CPI target will likely be hit in March already, but core inflation should continue throughout the year even after base effects boosting headline CPI fade away. At the end of the year core inflation will close on 1.5% y/y (NBP's scenario is 0.9% at end-2017 and 1.5% at end-2018).

Employment in enterprise sector rose in February by 4.6% y/y (+17k on monthly basis). Such employment growth was recently seen in 2007 and 2008 (see the graph). At the same time, **wage** growth stayed relatively low (4.0% y/y, close to our forecast and market consensus), dampened partially by working days effect in manufacturing. Looking at the experience of 2007 and 2008, such an equilibrium is hardly sustainable and we expect wage growth to accelerate substantially in the coming months.

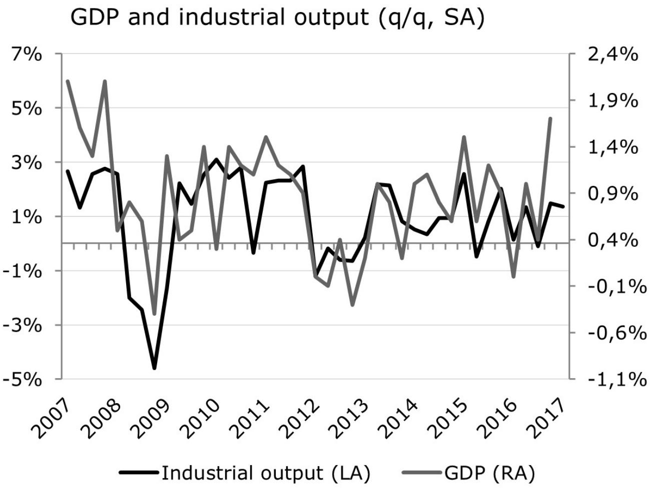


We therefore think that the labor market is at the verge of pro-inflationary transformation which, at the moment, seems to be neglected by the NBP (and naturally also by the MPC). In our opinion, currently long times spend in the search for job by the unemployed mirror rather structural than cyclical factors. The more so, firms are able to fill vacancies at spectacular pace while unemployment rate falls fast. So far **wage growth** remained muted because firms were still able to cherry pick in the labor market and implement cost saving measures via employing part of the Ukrainian workforce. This reservoir of cheap and still skilled labor is drying out while demand stays spectacular. Do you remember 2007 and 2008? We do. We remember wage forecasts being beaten by 1.0-1.5 bp at single month. All popped up out of the blue and abruptly, without earlier notice.

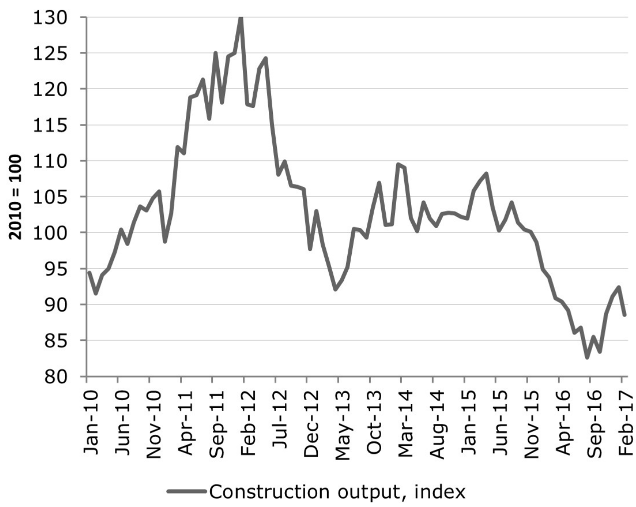


Sold industrial output grew by 1.2% y/y in February, somewhat below forecasts (our forecast: 2.5%; market consensus 2.8% y/y). The deceleration from Januaryâ€™s elevated pace is of course a result of calendar effects. The difference in working day count declined from +2 to -1 y/y, back to December's pace.

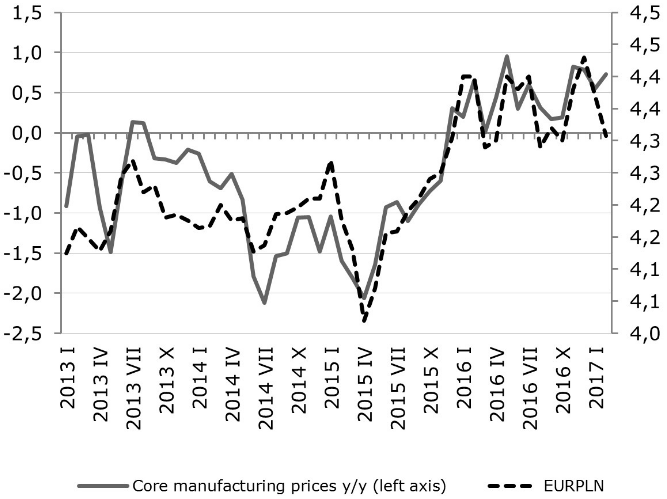
We would argue that the surprise can also be traced to calendar effects – such swings in working day count are often underestimated by forecasters. Note that the February surprise matches the one from January (albeit then it was positive), and seasonally adjusted industrial output increased by 0.6% m/m. The latter is impressive as it came after three months of very strong gains. As a result, industrial output momentum remains solid and, on a quarterly basis, output barely slowed down in Q1.



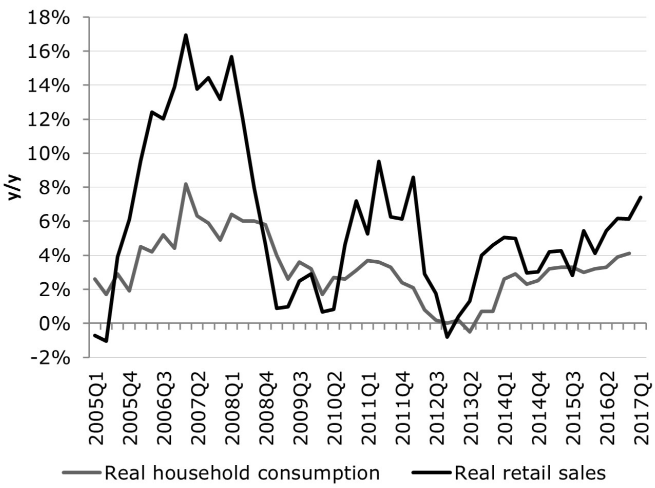
Construction output declined by 5.4% y/y, upsetting market consensus and our forecast (both -0.1% y/y). After seasonal and calendar adjustment, the decline amounts to -2.3% m/m. Working days also played a role in the deceleration of construction activity, but it is also possible that cold weather (last February was among the coldest in a few years) played a role. In any case, the reading is not outside the normal variability of the series. We reiterate our view that construction is set up for a good year: base effects are very favorable, residential construction indicators are close to pre-crisis highs, and railway and local government spending will likely increase markedly this year. All in all, we are expecting a 7-10% increase in construction output this year.



Producer prices accelerated in February to 4.4% y/y. It is bit of a disappointment for us (our forecast 4.7%). However, our forecast was based mainly on pro-cyclical revisions of producer prices which were common in the past. To our surprise, data for January was revisedâ€¦downwards. Seems like a truly one-off experience. It is the upward trend in PPI that is important. What is more, for the first time since many months (see the graph) producer prices in manufacturing excluding energy related goods accelerated a bit while PLN strengthened. We think it is just another among small bits of evidence that second round effects in pricing start to be visible leading to higher inflation in Poland.



Retail sales rose by 7.3% in February. As other real sphere data it was off our forecast (9.5%) and the market consensus (8.3%). We would like to avoid jumping into conclusions and only indicate that in case when the difference in working days is large between months, precise calculation of the intrinsic "value" of such a day is tricky. Therefore it is wise to look at retail sales figures on average in both January and February. Such a metric clearly indicates 9.3% nominal growth and 7.4% real growth. That means acceleration over Q4 2016 and had been earlier penciled in in our consumption forecasts. Therefore our consumption outlook for 2017 stays unchallenged. We are heading towards 4% growth on average. In our opinion, the combination of tightening labor market and child benefits gives households confidence that lifts marginal propensity to consume (in metric from different economic theory: consumption smoothing over time rises). Therefore we think it is rather unwise to bet on a substantially lower consumption growth in H2 as real income growth is dampened by prices and base effects kick in.



Despite the disappointment in February, the prospects for economic growth are fairly good this quarter. Due to higher investment growth (we are unable to assess if it will be positive in Q1 already) and further acceleration in private consumption, economic growth will accelerate to above 3% in Q1. Growth is bolstered by the following, very simple arithmetic: Q1'16 brought a small contraction in GDP (-0.1% q/q), Q1'17 is market by solid momentum (industrial output up by 1.8% q/q, construction output up by 3.1% q/q, therefore GDP might increase by 0.5% or more).

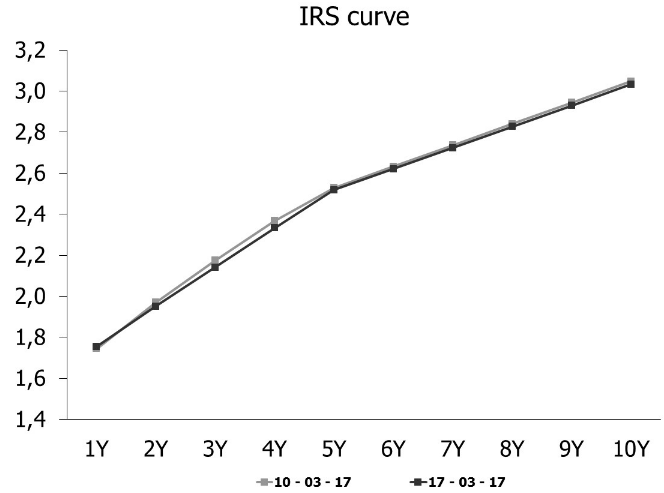
Fixed income

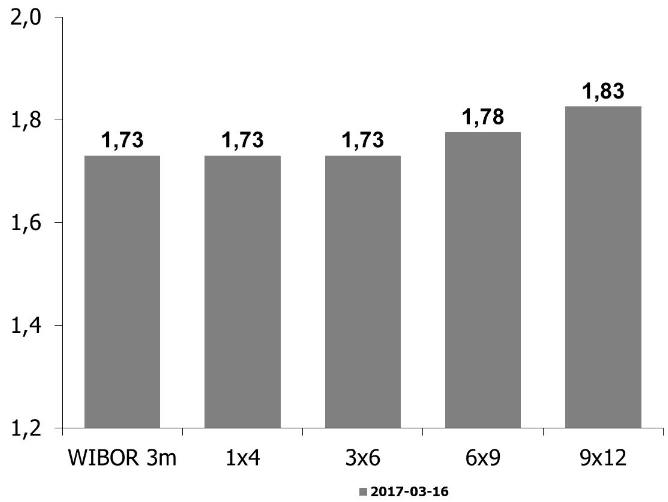
Bit tighter spreads ahead of next week's auction

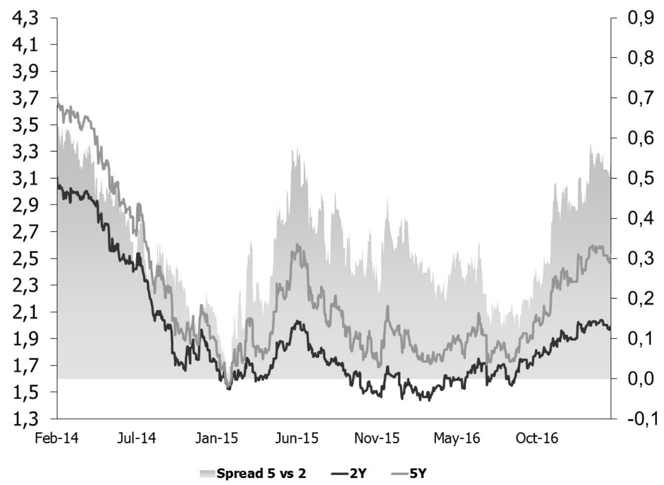
The Fed increased rates on Wednesday and it looks like they will do two more hikes this year. Polish bonds are following core markets, BUND/DS0727 is 329 bps and it hasn't changed since last week.

Next week we have an auction. The Ministry of Finance is selling OK0419/PS0422/DS0727/WZ1122/WZ0126.

The PS0422/DS0727 spread narrowed from 65 to 64, ASW PS0422/5y is at 53bps and DS0727/10y is at 65 bps (narrowed 3 bps). OK0419 is trading at 2,09% (3 bps up), PS0422 is trading at 3/08% (1 bp down) and DS0727 is trading at 3.72% (4 bps down).







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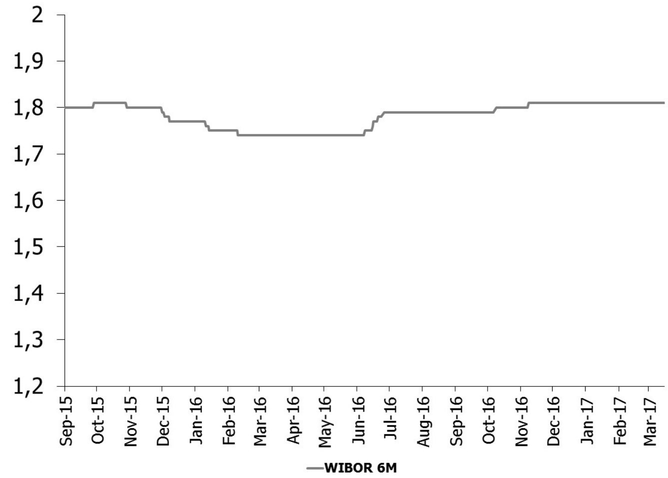
Money market

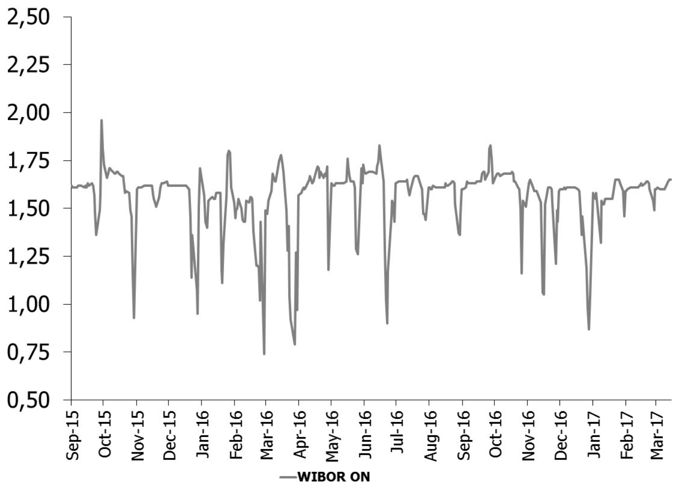
CPI & Fed

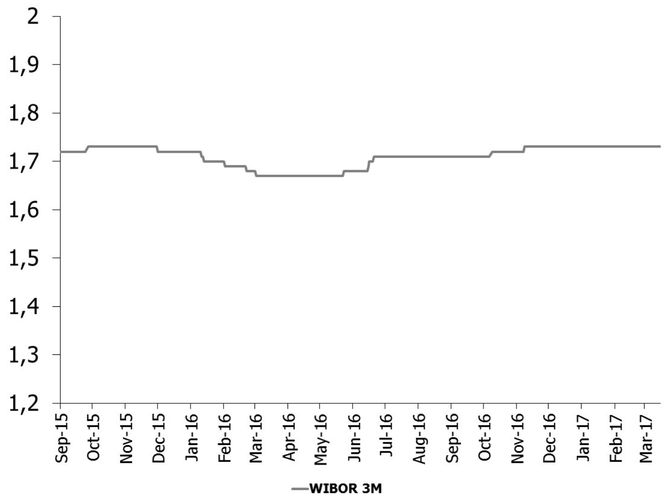
Polish market stayed relatively calm in the last days. Recent data publications weren't able to enforce any major move. We had an upside surprise in the CPI but the MPC remains calm and far from announcing any rate movements. Another factor was the Fed rate hike, but the reaction to it was very muted as well. The turnover on bonds is realy low, we hope it will pick up soon. Next week we have a bond auction, on Thursday. The Ministry should offer PLN 3-5 bio of bonds.

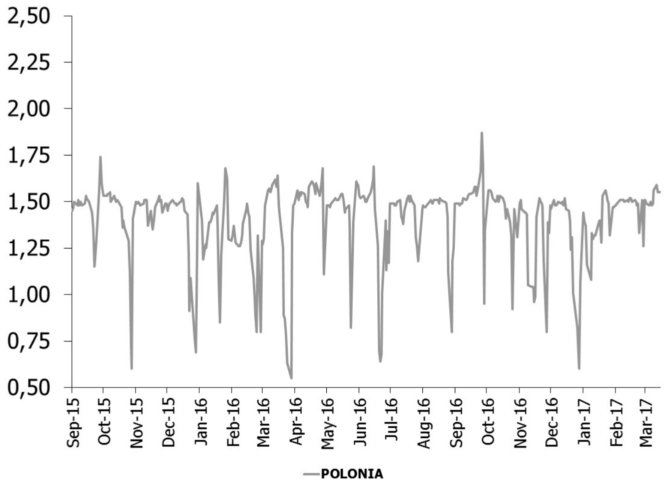
Last week was quite expensive. Situation should change now as banks bought 69 bn out of 73.5 bn of NBP bills offered at today's auction.

Ref rate vs Polonia averages:
30 day 2 bp
90 day 12 bp









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Forex

Spot – Stronger Zloty has received a healthy boost from FOMC "dovish hike". Biggest gains were seen against the USD (4.0790 high vs 3.9900 low) but EUR/PLN also slid from 4.3530-high to 4.3940-low. The 4.2700-4.30 strong support zone is now exposed. We think EUR/PLN should base somewhere around here. We are of the opinion the EUR/PLN is a rangy animal and not really heading anywhere far.

EUR/PLN vols – Lower FOMC and Dutch elections have failed to produce the volatility that was expected from them. As the consequence the vols, especially in the frontend, were sold with vengeance. 1 month EUR/PLN ATM mid is 5.00% (0.25% lower), 3 months EUR/PLN are 6.3% (0.2 lower), and finally 1 year is fixing at 7.25% (0.15% lower). The currency spread (difference of USD/PLN minus EUR/PLN) crashed as FOMC passed by without fireworks. Both EUR/PLN and USD/PLN riskier are roughly unchanged.

Short-term forecasts

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

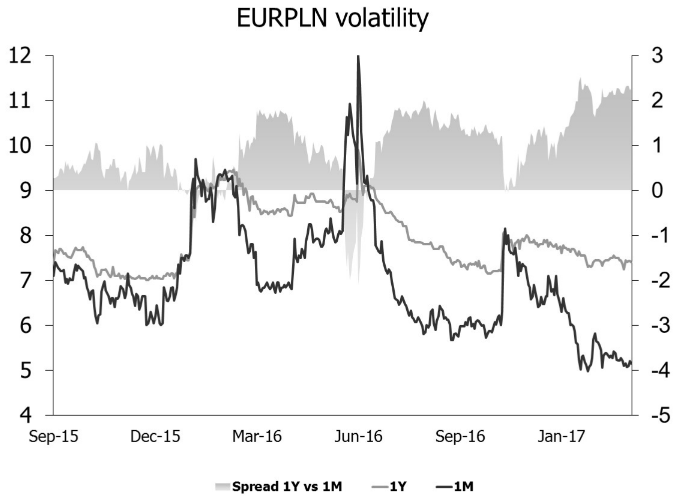
Spot Position: Long EUR/PLN.

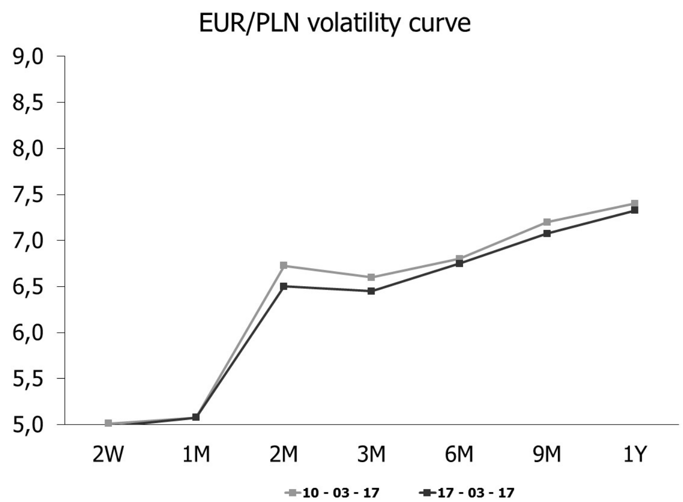
We are long EUR/PLN at 4.2930, ready to add at 4.2600 and we have a stop at 4.2350. We are hoping to revisit 4.35 on the way to 4.39.

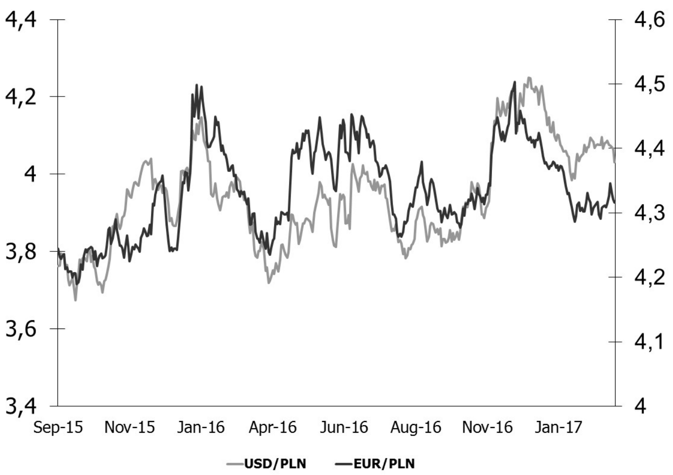
Our hopes are based on the rangy nature of EUR/PLN. Technically, 4.25-4.27 is a mighty support zone, that was not even scratched until now. The PLN seems to be over-owned and hence exposed to possible weakness. The FOMC and Dutch election did not really help the case. But it is not a game changer in our eyes.

Options Vol – Long 9 month EUR/PLN vol.

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. We are encouraged by the fact that backend vols are holding well, even with a current low realized volatility.







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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
3/10/2017	1.77	1.73	1.83	1.71	2.04	1.75	1.73	1.74	1.77	1.84	1.91	1.86
3/13/2017	1.83	1.73	1.88	1.71	2.13	1.75	1.73	1.74	1.76	1.83	1.92	1.85
3/14/2017	1.88	1.73	1.93	1.71	2.14	1.75	1.74	1.74	1.77	1.83	1.91	1.87
3/15/2017	1.73	1.73	1.77	1.71	1.98	1.75	1.73	1.74	1.77	1.84	1.94	1.86
3/16/2017	1.96	1.73	1.99	1.71	2.19	1.75	1.73	1.73	1.78	1.83	1.93	1.86

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
3/10/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
3/13/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
3/14/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
3/15/2017	1.750	1.474	1.635	1.638	1.990	2.290	2.447	2.985
3/16/2017	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
3/10/2017	5.08	6.60	6.80	7.40	7.40	1.94	0.54
3/13/2017	5.10	6.54	6.85	7.43	7.43	1.94	0.54
3/14/2017	5.20	6.60	6.85	7.43	7.43	1.99	0.49
3/15/2017	5.15	6.60	6.80	7.40	7.40	1.98	0.52
3/16/2017	5.08	6.45	6.75	7.33	7.33	1.84	0.51

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
3/10/2017	4.3260	4.0761	4.0281	3.5337	1.3867	0.1601
3/13/2017	4.3460	4.0747	4.0449	3.5550	1.3913	0.1608
3/14/2017	4.3295	4.0697	4.0366	3.5362	1.3869	0.1602
3/15/2017	4.3208	4.0646	4.0310	3.5470	1.3909	0.1599
3/16/2017	4.3165	4.0300	4.0320	3.5531	1.3925	0.1598