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Polish Weekly Review

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Comment on the upcoming data and forecasts

On Wednesday the MPC will wrap up its two-day meeting. We do not expect any change in the monetary policy stance: neither in terms of rates, nor in the Council's rhetoric. The February meeting comes after stellar 2017 GDP data and some consideration to this surprise will likely be given. However, the rebound in private investment (see the Economics section for a more detailed comment on the data release) will likely be seen as a welcome development that reduces, on balance, the need to tighten monetary policy in the future. A more detailed assessment of the impact of macro data surprises and the current inflation outlook will likely be postponed to the March meeting, during which the Council will receive the newest staff projections.

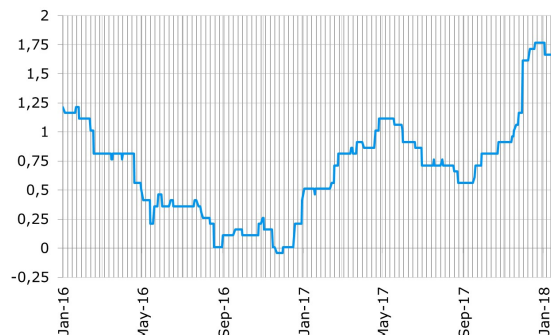
Polish data to watch: February 2nd to February 9th

| Publication | Date | Period | mBank | Consensus | Prior |
|------------------|-------|--------|-------|-----------|-------|
| MPC decision (%) | 07.02 | Feb | 1.50 | 1.50 | 1.50 |

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 | 2/8/2018 | 400 | 1.823 | 1/26/2018 |
| 5Y T-bond PS0422 | 2/8/2018 | 2000 | 2.665 | 1/26/2018 |
| 10Y T-bond DS0727 | - | 800 | 3.338 | 11/23/2017 |
| 30Y T-bond WS0447 | - | 125 | 3.720 | 10/25/2017 |

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



Comment

Polish surprise index stabilized since the PMI surprised only mildly. Next week comes with an empty calendar, therefore the index will be unchanged for several more days.

* 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

- In 2018 Polish GDP is set to grow by 4.6% (with upside risks). Poland is entering the upcoming election cycle (local elections in 2018, parliamentary elections in 2019 and presidential elections in 2020) with very tight labor market, favorable external environment and stimulation on all fronts.
- Inflation reached a local top in November 2017. Base effects suggest that inflation will drop at the turn of the year and reaccelerate briskly from Q2 on. One should look through short-term fluctuations and look at underlying momentum. The case for accelerating core inflation is strengthening. Polish labor market is operating normally and fits regional trends: wage inflation is coming.
- MPC stays calm and waves away any signs of intensifying wage pressure. In our view, as long as inflation stays within the target band and 5% remains a ceiling for GDP growth, the MPC will keep its rhetoric in place. Our current forecast reflects this reality – no change in interest rates in 2018.
- Fiscal situation continues to be very comfortable. We judge that the increase in VAT revenues is 70% consumption growth and 30% crackdown on tax avoidance. The latter has not ended and the prospects for increases in tax collectibility are very good.

Financial markets

- Political issues moved into the background and the markets are clearly unconcerned with local risks, making the PLN a star performer in the region.
- The key reason for the recent PLN strength is the Goldilocks economy, both in Poland and abroad. Strong growth amid low inflation and range-bound global risk free rates is a recipe for inflows and appreciation of EM assets across the board. In such an environment, PLN remains strong.
- Such an equilibrium is unlikely to persist for long, though. Something has to give in and in either scenario (strong growth and inflation, leading to higher rates globally, or lower growth, higher risk aversion and outflows from EMs) negative real interest rates and dovish MPC will become a liability. Thus, before Zloty strengthens again due to cyclical factors, we might see some weakening in the meantime (to 4.20-ish).

mBank forecasts

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 F |
|-------------------------------------|------|------|------|------|------|--------|
| GDP y/y (%) | 1.4 | 3.3 | 3.8 | 2.9 | 4.6 | 4.6 |
| CPI Inflation y/y (average %) | 0.9 | -0.1 | -0.9 | -0.6 | 1.9 | 2.4 |
| Current account (%GDP) | -1.2 | -2.1 | -0.5 | -0.3 | 0.2 | -0.2 |
| Unemployment rate (end of period %) | 13.4 | 11.4 | 9.8 | 8.2 | 6.6 | 6.0 |
| Repo rate (end of period %) | 2.50 | 2.00 | 1.50 | 1.50 | 1.50 | 1.50 |

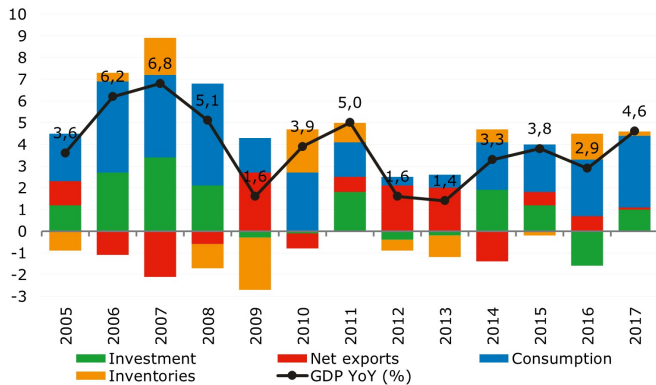
| | 2017 | 2017 | 2017 | 2017 | 2018 | 2018 | 2018 | 2018 |
|--------------------------------|------|------|------|------|------|------|------|------|
| | Q1 | Q2 | Q3 | Q4 F | Q1 F | Q2 F | Q3 F | Q4 F |
| GDP y/y (%) | 4.1 | 4.0 | 4.9 | 5.3 | 4.8 | 4.6 | 4.5 | 4.5 |
| Individual consumption y/y (%) | 4.7 | 4.9 | 4.8 | 4.5 | 4.6 | 4.3 | 4.0 | 4.0 |
| Public Consumption y/y (%) | 0.5 | 2.1 | 1.9 | 3.0 | 4.0 | 3.0 | 3.0 | 3.0 |
| Investment y/y (%) | -0.5 | 0.9 | 3.3 | 11.5 | 10.0 | 10.0 | 9.0 | 8.0 |
| Inflation rate (% average) | 2.0 | 1.8 | 1.9 | 2.0 | 2.0 | 2.6 | 2.6 | 2.2 |
| Unemployment rate (% eop) | 8.0 | 7.0 | 6.8 | 6.6 | 6.8 | 6.0 | 5.7 | 6.0 |
| NBP repo rate (% eop) | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| Wibor 3M (% eop) | 1.73 | 1.73 | 1.73 | 1.72 | 1.72 | 1.72 | 1.73 | 1.73 |
| 2Y Polish bond yields (% eop) | 2.01 | 1.90 | 1.75 | 1.72 | 1.73 | 1.73 | 1.79 | 1.97 |
| 10Y Polish bond yields (% eop) | 3.49 | 3.32 | 3.37 | 3.30 | 3.20 | 3.35 | 3.50 | 3.60 |
| EUR/PLN (eop) | 4.23 | 4.23 | 4.31 | 4.18 | 4.15 | 4.20 | 4.15 | 4.10 |
| USD/PLN (eop) | 3.97 | 3.70 | 3.65 | 3.48 | 3.52 | 3.50 | 3.40 | 3.33 |

F - forecast

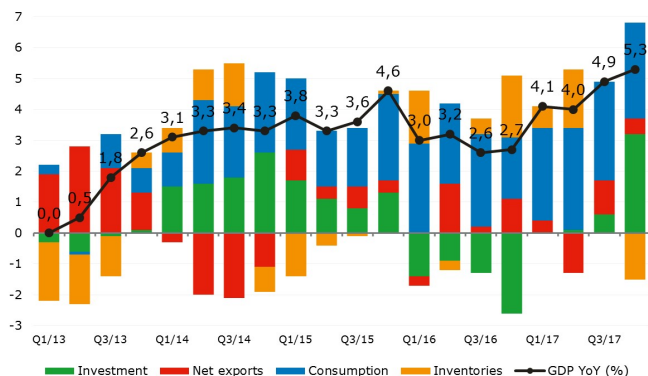
Economics

GDP is growing at a fast pace. Strong rebound in investment at year end

Polish GDP rose by 4.6% y/y in 2017, slightly beating market estimates and our forecast (both at 4.5%). As usual, the annual estimate is useful in calculating the most likely values for GDP and its components in the final quarter of 2017. This time there are major surprises.



GDP accelerated markedly in the final quarter of the year. An interval estimate consistent with annual figures is 5.1-5.4% y/y, while its structure allows as to pin the number at 5.3% y/y, above our original forecast of 5.1% y/y. There are surprises in the composition of growth as well. Investment accelerated from 3.3 to 11.5%. Available data (showing a mild slowdown in construction activity in Q4) suggest strongly that the surge in investment can be attributed to machinery and equipment spending. This, in turn, implies that it was driven by private activity, with public investment remaining in the back seat this time. Private consumption slowed down mildly in Q4 (from 4.8 to 4.5% y/y), which should be seen as normal – quarterly growth rates of 1-1.2% q/q can be sustained in the next quarters. Net exports added 0.5 percentage points to Q4 growth, down from +1.1 p.p. in Q3, which is entirely consistent with accelerating private investment. One can expect it to turn negative in the next few quarters. Strongly negative contribution from inventory change is a result of a base effect and will normalize in 2018.



GDP growth at these levels is far above the „safe” or „sustainable” growth rate as outlined by Mr. Glapinski (3.0-4.5%). On the other hand, the role of consumption in generating economic growth is declining, while enterprises are finally raising their productive potential. The latter element is boosting current GDP growth will alleviate the effects of labor shortages, raise potential GDP and (ceteris paribus) lower demand pressures over the medium term. As a result, the MPC likely would not sharpen its

rhetoric in response. The more so since GDP growth is set to follow a mildly downward-slowing path throughout 2018 – nevertheless, average growth this year will at last match last year’s result.

Fixed income

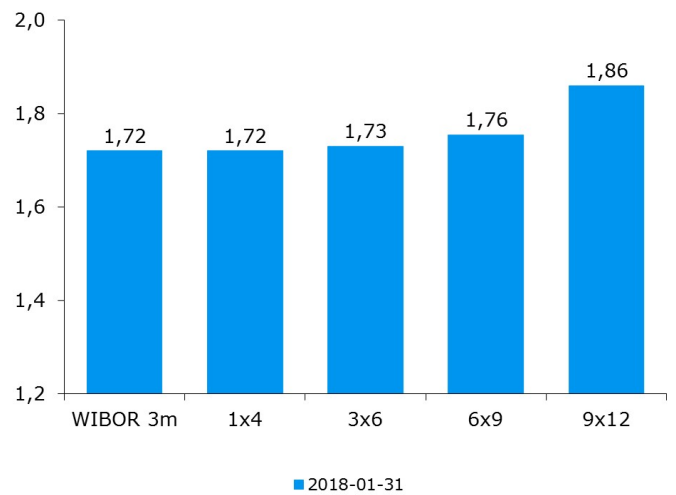
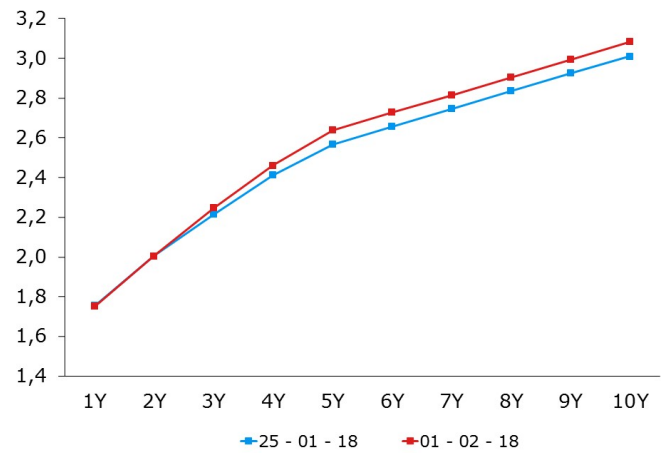
A moderate sell-off

The last auction was a bit heavy. We have seen some sell-off since Friday. DS0727 touched 3.5%, PS0123 touched 2.77%, the curve was extremely steep. Next week, the Ministry will sell 3-6 bn on the first of two auctions this month.

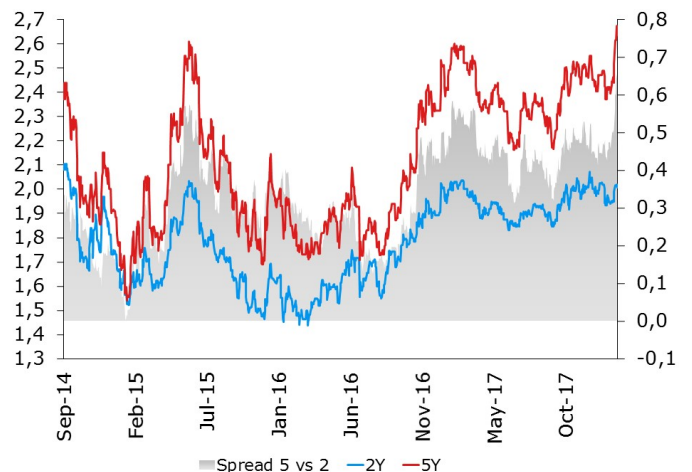
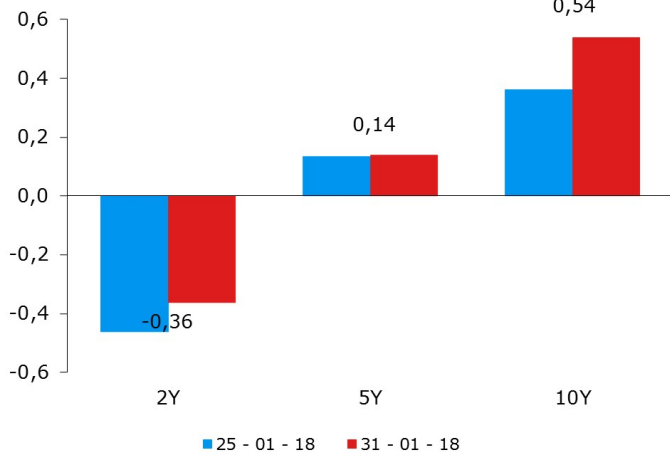
ASWs are very tight: PS0123/5y is 7 bps and DS0727/10y is 30 bps. DS0727/Bund spread is 271 bps. PS0123/DS0727 is 68 bps.

DS1019 is trading at 1.52% (1 bps down), PS0123 is trading at 2.76% (9 bps up) and DS0727 is trading at 3.44% (10 bps up).

IRS curve



Asset swaps



Money market

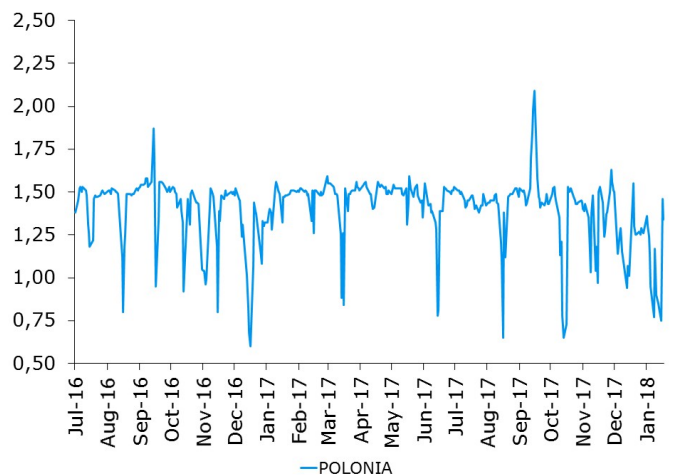
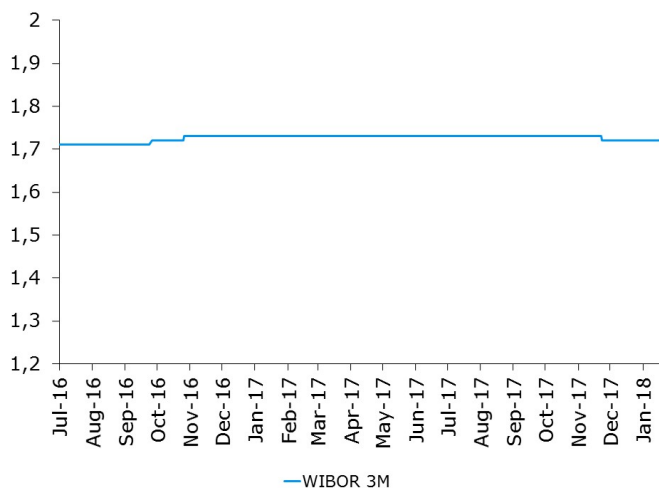
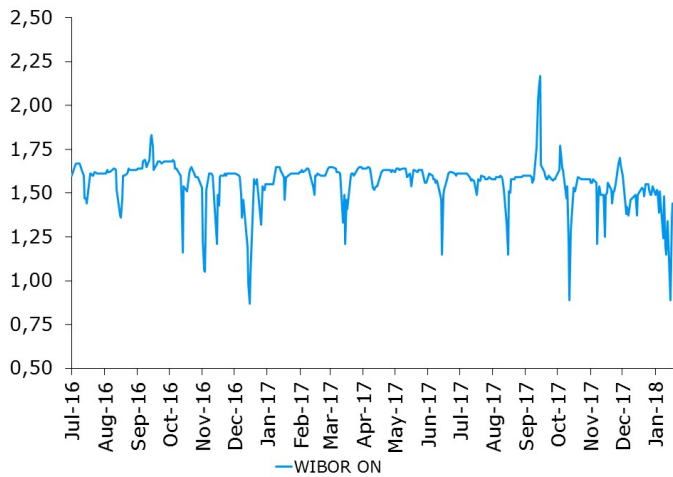
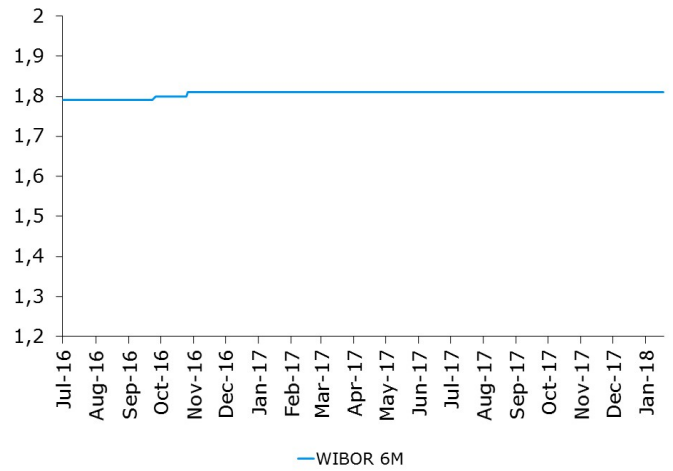
Higher yields and the absence of a local story

Another week of selloff on the core markets. The story about ECB rising rates plus Fed preparing markets for March hike pushed core yields to many month highs. Polish govies couldn't resist such a strong move and followed, although this move didn't have the violence factor. It felt like there was always interest to buy Polgbs at each leg lower. As a result, ASWs have tightened massively, reaching 0 bp in 5y tenor and 30 bps in 10y. There is actually the lack of a local story, with hawks moving into more dovish stance in the MPC. NBP rates are expected to stay flat until the end of 2018 and that's a long time.

January was a very cheap month. That's a common thing and we think things will start to normalize in February.

Ref rate vs Polonia averages:

30 day 27 bps
90 day 22 bps



Forex

Spot – PLN correcting lower Seems like the PLN's advances are being at least slowed down at the moment. The 4.13/4.14 zone acted as a solid support. EUR/PLN spiked to 4.1659 as a result, before stabilizing around 4.1500. The investment climate seems to be bit sourer due to the higher core rates. Stretched long Zloty positions might add to this effect. Play the range, 4.14-4.19 is the most likely one.

Options – backend higher Yesterday's FOMC meeting and expectations ahead of Friday's labor market data pushed EURPLN vol curve tic higher. Nevertheless, the changes are cosmetic. 1 month EUR/PLN ATM mid is 4.2% (unchanged), 3 months EUR/PLN are 4.8% (0.1% higher) and, finally, 1 year is fixing at 6.0% (0.3% higher). The currency spread (difference between USD/PLN vol and EUR/PLN vol) is still steep in the build up to the FOMC meeting. The skew was at the same level as week before.

Short-term forecasts

Main supports / resistances:

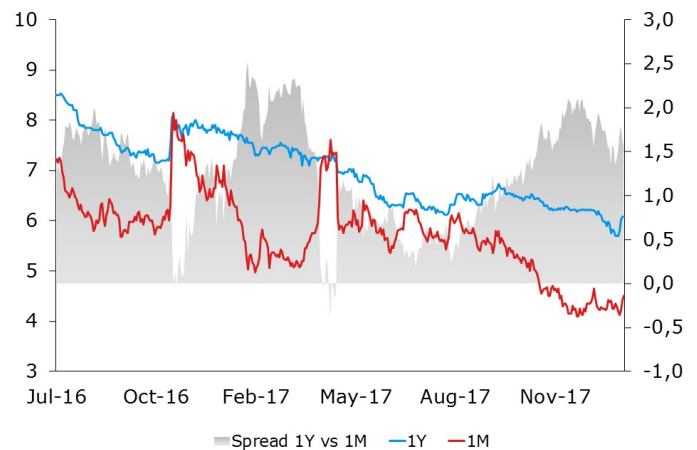
EUR/PLN: 4.13 / 4.23

USD/PLN: 3.35 / 3.60

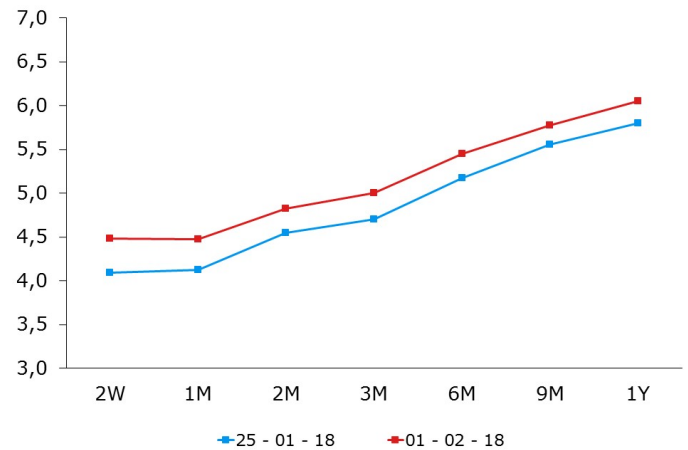
Spot Current position: None.

We are back to our favourite game – range playing. We see 4.14-4.19 as the current range, and we are trying to play that range with an open mind.

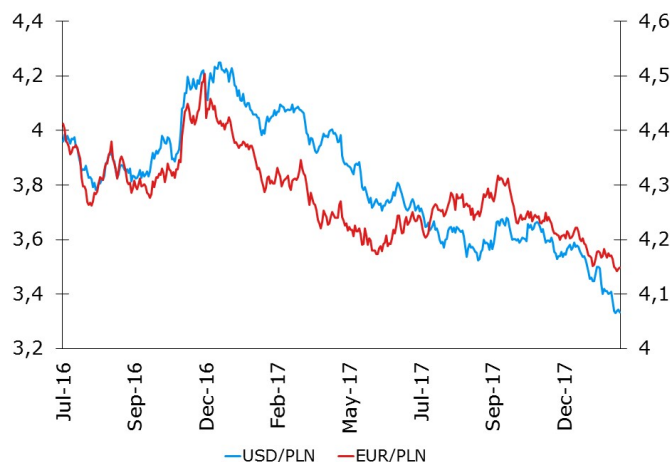
EURPLN volatility



EUR/PLN volatility curve



Bias from the old parity (%)



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 |
| 1/25/2018 | 1.76 | 1.72 | 1.87 | 1.71 | 2.07 | 1.75 | 1.72 | 1.73 | 1.76 | 1.87 | 1.97 | 1.88 |
| 1/28/2018 | 1.72 | 1.72 | 1.88 | 1.71 | 2.08 | 1.75 | 1.72 | 1.74 | 1.76 | 1.86 | 2.00 | 1.88 |
| 1/29/2018 | 1.79 | 1.72 | 1.91 | 1.71 | 2.11 | 1.75 | 1.72 | 1.73 | 1.75 | 1.86 | 2.04 | 1.84 |
| 1/30/2018 | 1.53 | 1.72 | 1.61 | 1.71 | 1.64 | 1.75 | 1.73 | 1.75 | 1.77 | 1.88 | 2.04 | 1.88 |
| 1/31/2018 | 1.69 | 1.72 | 1.85 | 1.71 | 2.00 | 1.75 | 1.72 | 1.73 | 1.76 | 1.86 | 1.99 | 1.87 |

| Last primary market rates | | | | | | | |
|---------------------------|-----------|-----------|------------|------------|--------|--------|------|
| Paper | Au. date | Maturity | Avg. price | Avg. yield | Supply | Demand | Sold |
| 32W TB | 2/22/2017 | 8/30/2017 | 99.21 | 1.50 | 700 | 1832 | 726 |
| OK0419 | 6/9/2017 | 4/25/2019 | 96.62 | 1.86 | 600 | 1505 | 500 |
| PS0422 | 6/9/2017 | 4/25/2022 | 98.47 | 2.59 | 1000 | 1811 | 1085 |
| DS0727 | 6/9/2017 | 7/25/2027 | 94.61 | 3.13 | 600 | 944 | 640 |

| Fixed income market rates (closing mid-market levels) | | | | | | | | |
|---|----------|-----------|--------|--------|--------|--------|---------|--------|
| Date | 1Y WIBOR | 1Y T-bill | 2Y IRS | OK0715 | 5Y IRS | PS0718 | 10Y IRS | DS1023 |
| 1/25/2018 | 1.750 | 1.474 | 1.635 | 1.578 | 1.960 | 2.232 | 2.405 | 2.949 |
| 1/28/2018 | 1.750 | 1.474 | 1.635 | 1.578 | 1.960 | 2.232 | 2.405 | 2.949 |
| 1/29/2018 | 1.750 | 1.474 | 1.635 | 1.578 | 1.960 | 2.232 | 2.405 | 2.949 |
| 1/30/2018 | 1.750 | 1.474 | 1.635 | 1.638 | 1.990 | 2.290 | 2.447 | 2.985 |
| 1/31/2018 | 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 | 1Y |
| 1/25/2018 | 4.13 | 4.70 | 5.18 | 5.80 | 5.80 | 1.35 | 0.53 | 0.53 |
| 1/28/2018 | 4.23 | 4.90 | 5.40 | 6.03 | 6.03 | 1.35 | 0.53 | 0.53 |
| 1/29/2018 | 4.43 | 4.89 | 5.45 | 6.08 | 6.08 | 1.34 | 0.52 | 0.52 |
| 1/30/2018 | 4.50 | 5.03 | 5.48 | 6.08 | 6.08 | 1.39 | 0.52 | 0.52 |
| 1/31/2018 | 4.48 | 5.00 | 5.45 | 6.05 | 6.05 | 1.35 | 0.53 | 0.53 |

| PLN Spot performance | | | | | | |
|----------------------|--------|--------|--------|--------|--------|--------|
| Date | EURPLN | USDPLN | CHFPLN | JPYPLN | HUFPLN | CZKPLN |
| 1/25/2018 | 4.1493 | 3.3376 | 3.5470 | 3.0618 | 1.3414 | 0.1633 |
| 1/28/2018 | 4.1477 | 3.3299 | 3.5644 | 3.0519 | 1.3389 | 0.1635 |
| 1/29/2018 | 4.1423 | 3.3375 | 3.5625 | 3.0677 | 1.3388 | 0.1638 |
| 1/30/2018 | 4.1461 | 3.3442 | 3.5802 | 3.0776 | 1.3371 | 0.1637 |
| 1/31/2018 | 4.1488 | 3.3318 | 3.5755 | 3.0644 | 1.3358 | 0.1640 |

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