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Polish Weekly Review

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Comment on the upcoming data and forecasts

On Wednesday, the MPC meeting will be concluded and rates will remain unchanged. The Council's interpretation of incoming data will also most probably remain the same as it was in February. Investment growth and a more balanced structure of GDP growth will, ceteris paribus, decrease inflationary pressures over the medium term. Moreover, the apparent significant acceleration in labour productivity in the second half of 2017 will allow for a more optimistic interpretation of labour market data. New NBP projections, which will be available to MPC members, most probably will not bring any other changes than those implied by surprises in latest economic publications (higher wage growth and labor productivity growth, higher oil price). All in all, a considerable deceleration of GDP within the projection's horizon together with inflation remaining close to the target will support the MPC's dovish rhetoric.

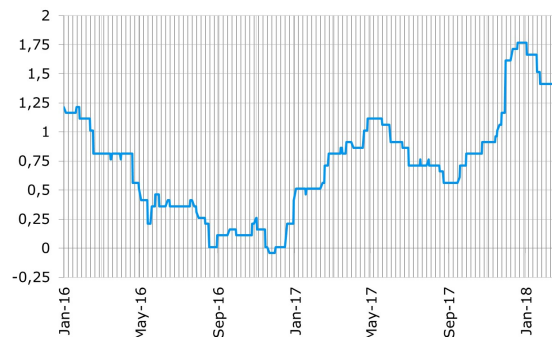
Polish data to watch: March 2nd to March 9th

| Publication | Date | Period | mBank | Consensus | Prior |
|------------------|-------|--------|-------|-----------|-------|
| MPC decision (%) | 07.03 | Mar | 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 OK0720 | 3/15/2018 | 200 | 1.741 | 2/14/2018 |
| 5Y T-bond PS1023 | 3/15/2018 | 1000 | 2.687 | 2/22/2018 |
| 10Y T-bond WS0428 | 3/15/2018 | 400 | 3.430 | 2/22/2018 |
| 30Y T-bond WS0447 | 3/15/2018 | 50 | 3.764 | 2/22/2018 |

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



Comment

Unchanged from previous week after all releases came more or less in line with market consensus (surprise in the PMI was too small to move the index). Next week only brings the MPC decision, thus there won't be any changes once again.

* 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 dollar's weakness. The latter shields Polish currency from repricing along with rising risk-free rates. Moreover, since EM assets survived the equity selloff bravely as a group, they have become much more balanced as a whole of late. In such an environment, PLN remains strong with robust growth and only a hint of higher inflation to come.
- 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

| | 2014 | 2015 | 2016 | 2017 | 2018 F | 2019 F |
|-------------------------------------|------|------|------|------|--------|--------|
| GDP y/y (%) | 3.3 | 3.8 | 2.9 | 4.6 | 4.6 | 3.6 |
| CPI Inflation y/y (average %) | -0.1 | -0.9 | -0.6 | 1.9 | 2.4 | 2.7 |
| Current account (%GDP) | -2.1 | -0.5 | -0.3 | 0.2 | -0.2 | -0.6 |
| Unemployment rate (end of period %) | 11.4 | 9.8 | 8.2 | 6.6 | 6.0 | 5.8 |
| Repo rate (end of period %) | 2.00 | 1.50 | 1.50 | 1.50 | 1.50 | 2.25 |

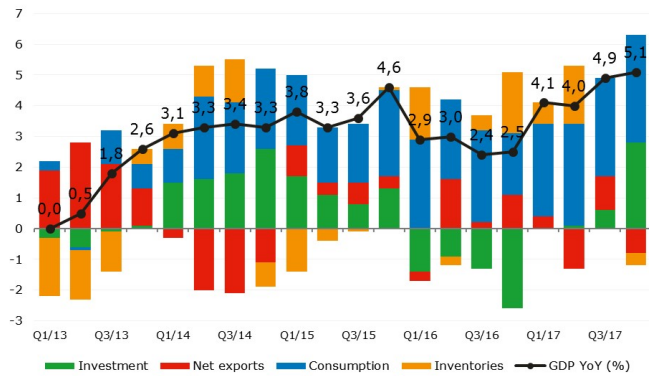
| | 2017 | 2017 | 2017 | 2017 | 2018 | 2018 | 2018 | 2018 |
|--------------------------------|------|------|------|------|------|------|------|------|
| | Q1 | Q2 | Q3 | Q4 | Q1 F | Q2 F | Q3 F | Q4 F |
| GDP y/y (%) | 4.1 | 4.0 | 4.9 | 5.1 | 4.8 | 4.6 | 4.5 | 4.5 |
| Individual consumption y/y (%) | 4.7 | 4.9 | 4.8 | 4.9 | 4.6 | 4.3 | 4.0 | 4.0 |
| Public Consumption y/y (%) | 0.5 | 2.1 | 1.9 | 5.4 | 4.0 | 3.0 | 3.0 | 3.0 |
| Investment y/y (%) | -0.5 | 0.9 | 3.3 | 11.3 | 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 | 3.40 | 3.55 | 3.70 | 3.80 |
| 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

Final GDP release confirms 5.1% growth in Q4 and a rebound in investment.

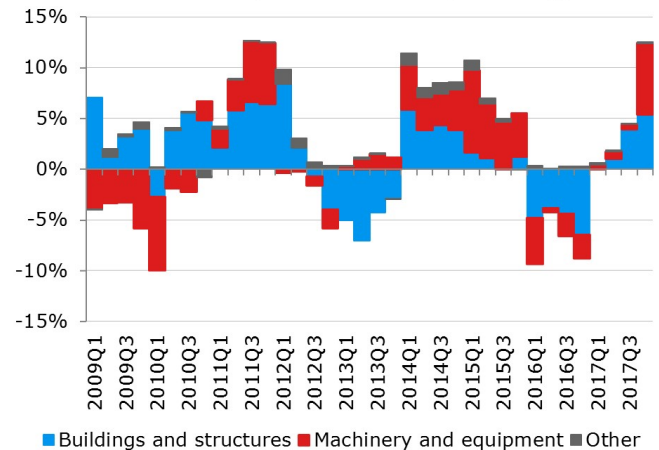
The CSO confirmed its Q4 flash GDP release of 5.1% y/y and 1.0% q/q (seasonally adjusted terms). As usual, the details of the release are far more interesting than the headline - this time there are several surprises hidden in the numbers, even if annual GDP figures are taken into account.



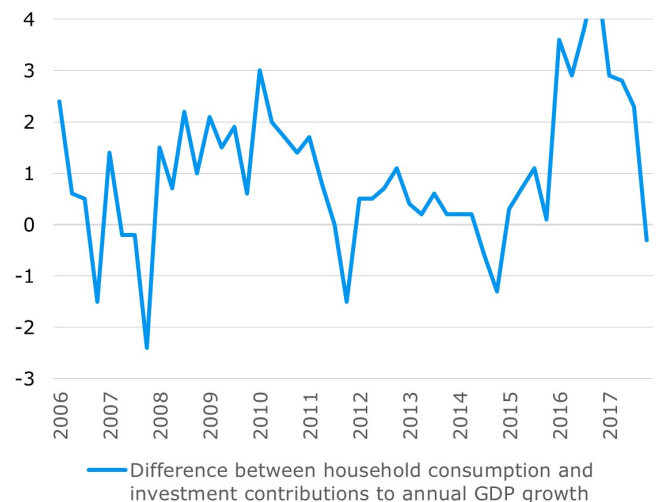
First, household consumption has not slowed down after all - the 4.9% y/y growth rate recorded in Q4 is close to our initial forecast and below the latest estimates (4.5% was our bet after annual figures). However, it is also more consistent with monthly indicators, both hard (retail sales, income growth) and soft (consumer sentiment). In particular, the latter imply that no slowdown in household consumption can be seen on the horizon.

Second, investment growth did not disappoint. The actual figure (11.3% y/y) is very close to our latest estimates (11.5%) and far above the expectations formulated before the annual GDP numbers were released. Perhaps the biggest question regarding the Polish economy today pertains to the causes and nature of Poland's private investment drought since 2016. The breakdown of investment into asset types released by Eurostat today offers some answers. The acceleration in investment can be attributed to machinery and equipment spending. This broad category contributed 7 percentage points to investment growth. Expenditures on transport equipment, perhaps associated with purchases of VIP airplanes by the Ministry of Defense, accounted for 1/5 of this increase. The remainder falls into the broad „other machinery and equipment category”, spending on which is primarily conducted by private enterprises. Thus, following the logic, the surge in investment was to a large part driven by private enterprises. However, this conclusion is contradicted by the CSO's comment suggesting that corporate investment was flat on annual basis. How can we reconcile these datapoints? Perhaps the increase in machinery and equipment spending by the private sector was offset by lower investment in buildings and structures (as already indicated by the deceleration in commercial and industrial construction). The definitive answers to these question will not be known for several weeks, but this is our baseline interpretation of the data at hand.

Gross fixed capital formation by asset type



The other components of GDP also surprised. Public consumption rose by a respectable 5.4% y/y, likely reflecting an increase in central government spending after the budget amendment passed in the Autumn. Net exports subtracted 0.8 percentage points from GDP growth after all and this is disappointing in light of strong monthly trade data from the NBP and the CSO. Finally, inventories subtracted 0.4 pp., less than anticipated.



The general conclusions drawn from the release are unchanged. Polish economy has entered the new year with respectable momentum and two operational engines. This will not change in 2018 and GDP growth is set to exceed 4.5% y/y this year. It is worth noting that GDP growth has become balanced again as the contribution from investment exceeded household consumption contribution for the first time since late 2014 (sic!). The MPC has already welcomed this rebalancing since ceteris paribus it implies lower inflationary pressures over the medium term. In addition, the acceleration in labor productivity in the second half of the year (let's put the issue of understated immigration in labor market statistics aside for now) should further bolster the Council's conviction that Polish GDP growth will not be inflationary. This consensus can only be falsified by above-target inflation and we are not expecting this to happen within months. As a result, NBP rates are set to stay unchanged until the end of the year and possibly beyond.

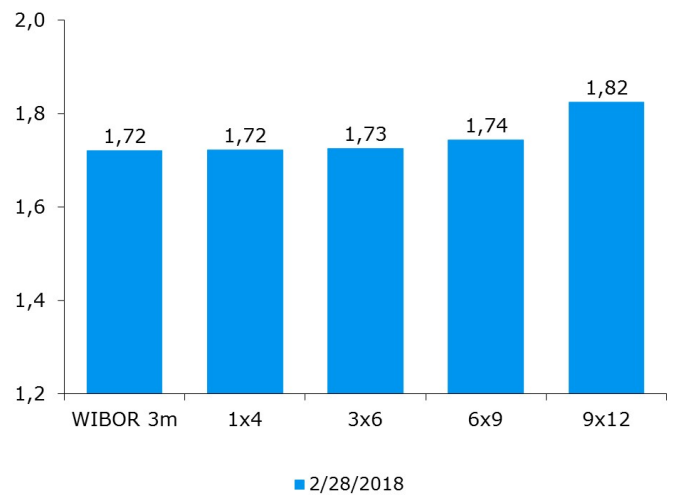
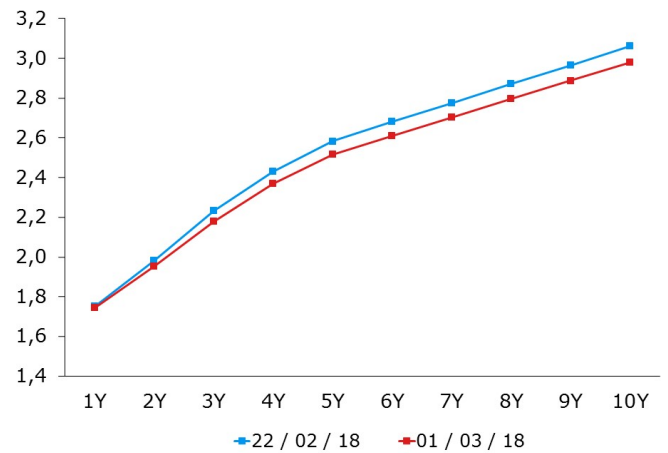
Fixed income

Where have all the POLGBs gone?

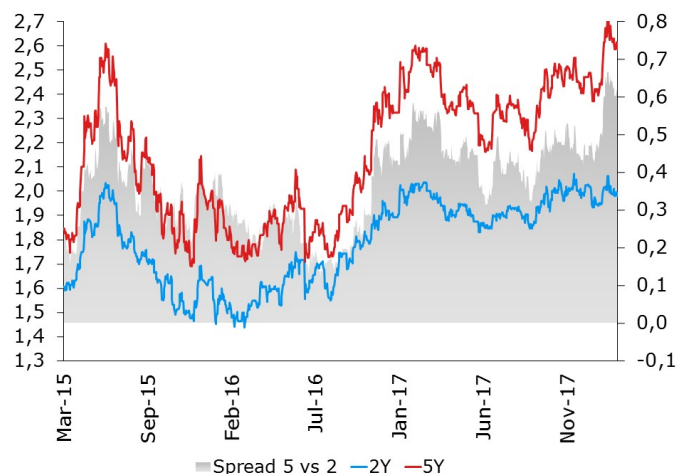
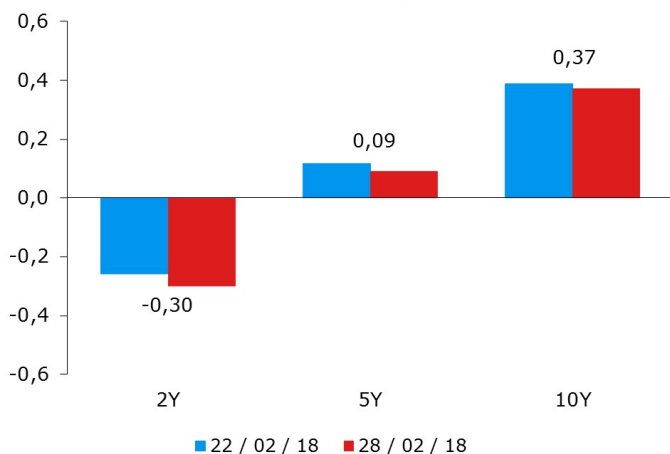
There is only one way on POLGBs. Polish banks are short, international are short, next auction is in 3 weeks, no supply at all. Spreads are tighter and tighter.

PS0123/5y is 6bps and DS0727/10y is 27bps. DS0727/Bund is 265bps. PS0123/DS0727 is 65bps. DS1019 is trading at 1.45% (7bps down), PS0123 is trading at 2.55% (20bps down) and DS0727 is trading at 3.20% (23bps down).

IRS curve



Asset swaps





Money market

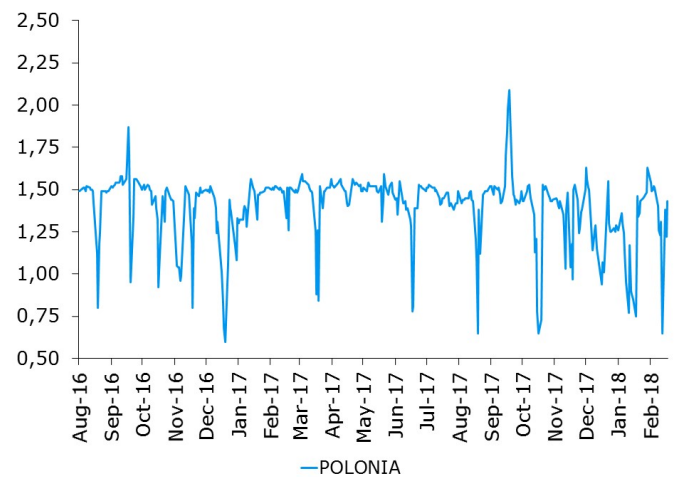
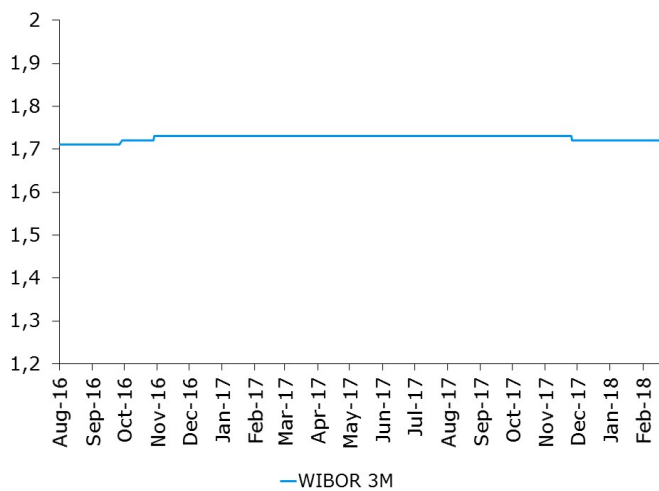
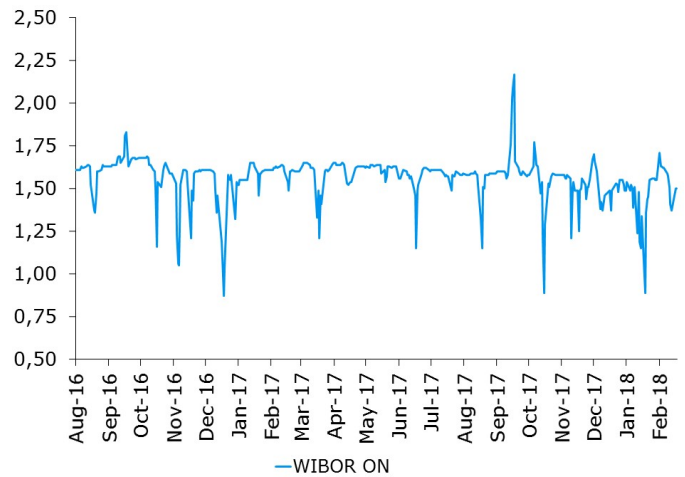
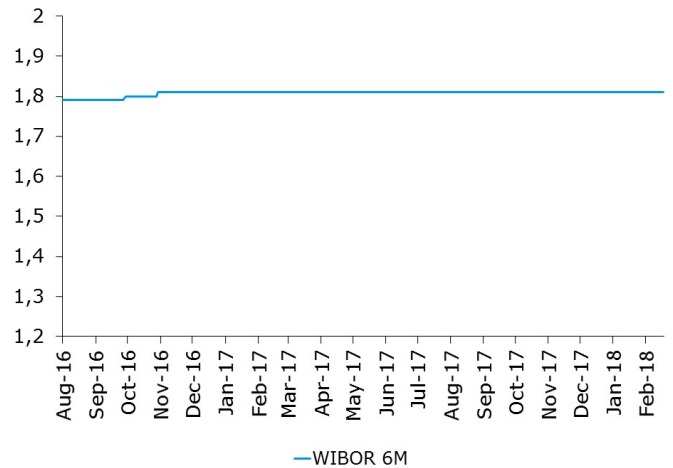
Total rally

It looks like foreign buyers joined the locals, thus we are seeing a big rally on POLGBs. The curve moved around 10-15 bp lower with 5y swap touching 2.50%. While swaps are still few bps higher than this year's low, bonds have already surpassed 2018 tops. Bond yields seem extremely low right now: ASWs are very tight and only 50 bps of hikes are priced in until late 2019.

New month has just started, so cash should stay around 1.45%.

Ref rate vs Polonia averages:

30 day 13 bps
90 day 23 bps



Forex

Spot – Weaker in the range The really strong selling interest in EUR/PLN has run of steam just above the 4.1300 support (the 4.1315 was the low in EUR/PLN). Looking at it, from a purely technical point of view, it has formed a double bottom formation, which could provoke another test at 4.200 and a deeper correction (lower PLN). EUR/PLN reached 4.1880 (high) so far. Whether the momentum will take us above 4.20, is still to be decided. As a result, our baseline scenario is still the 4.14-4.20 range and we will try to play that range.

Options – Volatility melting further The Italian elections on Monday and ECB meeting next week are supporting front end vols. However, the volatility curve above 2 weeks is slightly lower, mostly because of decreasing realized volatility. 1 month ATM mid is 4.2% today (0.4% lower), 3 months are at 4.7% (0.05% lower) and finally 1 year fixed at 5.9% (0.05% lower). The skew and the currency spread (difference between USD/PLN and EUR/PLN) are roughly unchanged.

Short-term forecasts

Main supports / resistances:

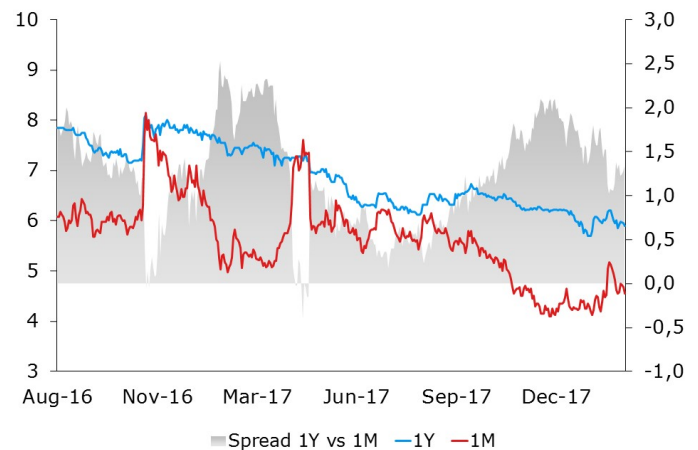
EUR/PLN: 4.13 / 4.23

USD/PLN: 3.35 / 3.60

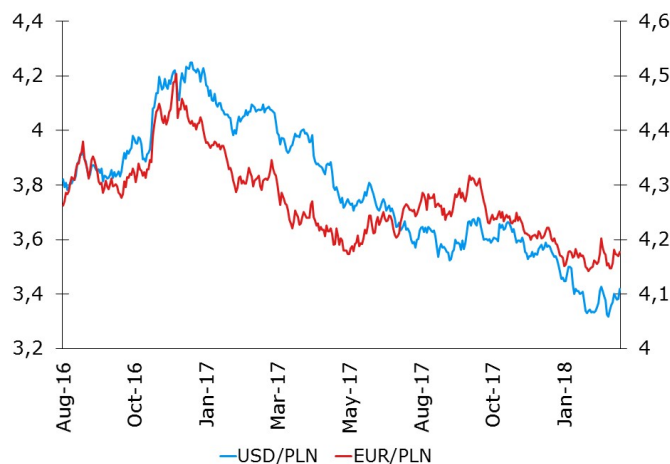
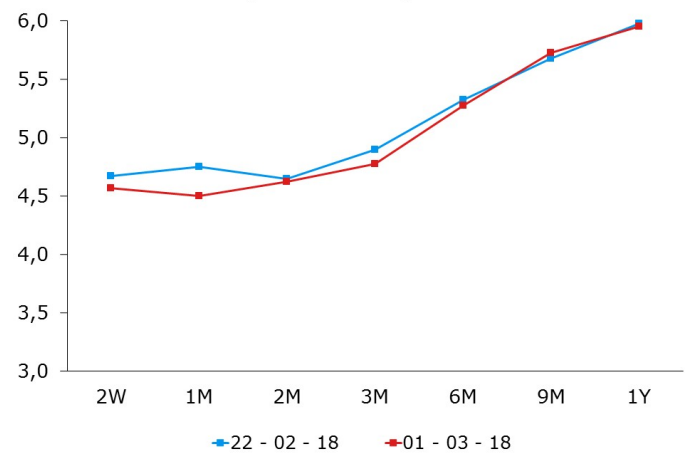
Spot Current position: None.

EUR/PLN is still consolidating in a relatively tight 4.13-4.23 range. It looks quite stable, and we expect neither side of the range to be breached soon. The momentum is simply not there. We are ready to sell at 4.20-4.22 with a 4.2500 a firm stop. The hopes are to go back below 4.15 level.

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 |
| 2/22/2018 | 1.59 | 1.72 | 1.71 | 1.71 | 1.92 | 1.75 | 1.72 | 1.74 | 1.76 | 1.84 | 1.96 | 1.84 |
| 2/25/2018 | 1.59 | 1.72 | 1.70 | 1.71 | 1.91 | 1.75 | 1.72 | 1.73 | 1.76 | 1.84 | 1.95 | 1.84 |
| 2/26/2018 | 1.62 | 1.72 | 1.73 | 1.71 | 1.99 | 1.75 | 1.72 | 1.74 | 1.75 | 1.83 | 1.94 | 1.85 |
| 2/27/2018 | 1.45 | 1.72 | 1.55 | 1.71 | 1.73 | 1.75 | 1.72 | 1.73 | 1.75 | 1.84 | 1.95 | 1.83 |
| 2/28/2018 | 1.63 | 1.72 | 1.75 | 1.71 | 2.02 | 1.75 | 1.72 | 1.73 | 1.74 | 1.82 | 1.92 | 1.83 |

| 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 |
| OK0720 | 2/14/2018 | 7/25/2020 | 95.93 | 1.74 | 200 | 656 | 206 |
| PS0123 | 2/22/2018 | 1/25/2023 | 99.14 | 2.69 | 1000 | 3070 | 1036 |
| WS0428 | 2/22/2018 | 4/25/2028 | 94.22 | 3.43 | 400 | 1017 | 473 |

| Fixed income market rates (closing mid-market levels) | | | | | | | | |
|---|----------|-----------|--------|--------|--------|--------|---------|--------|
| Date | 1Y WIBOR | 1Y T-bill | 2Y IRS | OK0720 | 5Y IRS | PS0423 | 10Y IRS | WS0428 |
| 2/22/2018 | 1.750 | 1.401 | 1.980 | 1.723 | 2.585 | 2.702 | 3.060 | 3.447 |
| 2/25/2018 | 1.750 | 1.422 | 1.975 | 1.676 | 2.555 | 2.664 | 3.027 | 3.425 |
| 2/26/2018 | 1.750 | 1.408 | 1.970 | 1.670 | 2.542 | 2.653 | 3.010 | 3.396 |
| 2/27/2018 | 1.750 | 1.411 | 1.962 | 1.675 | 2.530 | 2.649 | 2.995 | 3.383 |
| 2/28/2018 | 1.750 | 1.397 | 1.952 | 1.652 | 2.517 | 2.607 | 2.980 | 3.350 |

| EUR/PLN 0-delta stradle | | | | | 25-delta RR | | 25-delta FLY |
|-------------------------|------|------|------|------|-------------|------|--------------|
| Date | 1M | 3M | 6M | 1Y | 1M | 1Y | 1Y |
| 2/22/2018 | 4.75 | 4.90 | 5.33 | 5.98 | 5.98 | 1.40 | 0.58 |
| 2/25/2018 | 4.73 | 4.88 | 5.33 | 5.96 | 5.96 | 1.40 | 0.58 |
| 2/26/2018 | 4.68 | 4.88 | 5.35 | 5.95 | 5.95 | 1.36 | 0.54 |
| 2/27/2018 | 4.55 | 4.73 | 5.26 | 5.89 | 5.89 | 1.29 | 0.54 |
| 2/28/2018 | 4.50 | 4.78 | 5.28 | 5.95 | 5.95 | 1.36 | 0.54 |

| PLN Spot performance | | | | | | |
|----------------------|--------|--------|--------|--------|--------|--------|
| Date | EURPLN | USDPLN | CHFPLN | JPYPLN | HUFPLN | CZKPLN |
| 2/22/2018 | 4.1811 | 3.4009 | 3.6252 | 3.1686 | 1.3384 | 0.1651 |
| 2/25/2018 | 4.1738 | 3.3911 | 3.6302 | 3.1721 | 1.3336 | 0.1648 |
| 2/26/2018 | 4.1717 | 3.3799 | 3.6217 | 3.1705 | 1.3320 | 0.1644 |
| 2/27/2018 | 4.1700 | 3.3816 | 3.6093 | 3.1592 | 1.3300 | 0.1643 |
| 2/28/2018 | 4.1779 | 3.4188 | 3.6268 | 3.1926 | 1.3293 | 0.1644 |

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