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Polish Weekly Review

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Comment on the upcoming data and forecasts

For any interesting data in Polish economy we need to wait until next Friday, when both final CPI and current account readings will be published. We expect the November inflation to follow the flash reading value of 1.2% y/y, which surprised in many areas, e.g. fuel prices, energy prices, food prices and core categories. Also in context of the October's current account it should be an interesting month. Export models for September data slightly overshot, therefore we expect some revisions of that reading. In October export should reach the 19200 mln EUR and import 20000 mln EUR, with bigger trade deficit current account should widen to -800 mln EUR.

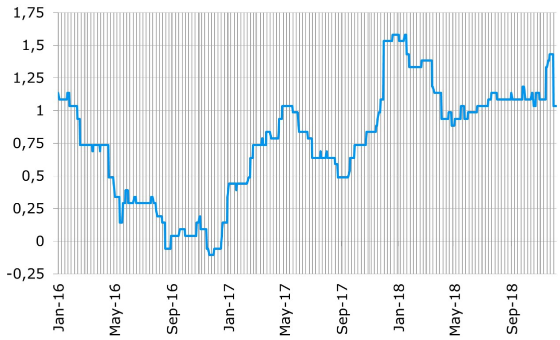
Polish data to watch: December 7th to December 14th

Publication	Date	Period	mBank	Consensus	Prior
CPI y/y *final* (%)	14.12	Nov	1.2	1.2	1.7
Current Account (mio EUR)	14.12	Oct	-850	-472	-547
Export (mio EUR)	14.12	Oct	19200	18724	17683
Import (mio EUR)	14.12	Oct	20000	19040	18132

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	11/15/2018	700	1.456	10/26/2018
5Y T-bond PS0424	11/15/2018	3000	2.604	10/26/2018
10Y T-bond WS0428	11/15/2018	4000	3.179	10/26/2018
30Y T-bond WS0447	11/15/2018	20	3.643	10/4/2010

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



Comment

Final GDP in Q3 was in line with expectations after the flash reading, but the flash CPI for November and manufacturing PMI surprised negatively. Therefore Polish surprise index lost its gains from last weeks.

* 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

- Higher Q3 GDP data may imply a level shift in our GDP projections, but not in the trajectory. We await the details of the release to explore the nature of the surprise: a build-up in inventories is going to have different growth implications than an acceleration in private investment.
- The turn of 2017 and 2018 marked the top of the business cycle. 2018 GDP will grow at ca. 5% and decelerate considerably in 2019. With modestly worse consumption prospects and public investment peaking in annual terms this year, we expect GDP to grow by 3.8% y/y next year. However, the transition towards lower growth is set to be smooth due to substantial potential for fiscal stimulation given currently low and projected GG deficit.
- Core inflation is projected to rise steadily, but CPI inflation is likely to stay low and undershoot the MPC target in 2019. We do not think that energy prices for households are set to increase substantially given the political calendar. We think that second round effects after surge in electricity costs on the firms' side will be marginal. Current trends in food prices and recent turnaround in oil prices suggest that price developments on these fields at the start of the year are set to be very benign or even on the reverse.
- MPC stays calm even after projecting a substantial rise in inflation in 2019 due to „conservative" high energy prices. Our baseline is now flat rates in 2019. The fate of 2020 hikes is set to be known within the coming 3-4 months. Risks are tilted definitely to the downside.
- Fiscal situation continues to be very comfortable with GG deficits below 1% projected even by conservative bodies (European Commission). 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. The impact of PLN-specific factors (other than loose monetary policy) on the currency has been relatively small.
- The PLN proved to be exceptionally resilient in recent months: neither the increase in global rates, nor the subsequent decline and violent repricing of monetary policy expectations managed to break it out of the 2.5% range vis-a-vis the euro.
- While this might be seen as a good omen, the room for PLN to strengthen is not really there: cyclicality, low nominal interest rates, attractiveness of PLN asset markets and worsening terms of trade suggest that PLN strengthening would not be welcome by local stakeholders, big and small. As a result, we expect EURPLN to remain essentially flat within the forecast horizon.

mBank forecasts

	2014	2015	2016	2017	2018 F	2019 F
GDP y/y (%)	3.3	3.8	3.0	4.8	5.1	3.8
CPI Inflation y/y (average %)	-0.1	-0.9	-0.6	2.0	1.7	1.7
Current account (%GDP)	-2.1	-0.6	-0.3	0.2	-0.6	-1.2
Unemployment rate (end of period %)	11.4	9.8	8.2	6.6	5.6	5.0
Repo rate (end of period %)	2.00	1.50	1.50	1.50	1.50	1.50

	2018 Q1	2018 Q2	2018 Q3	2018 Q4 F	2019 Q1 F	2019 Q2 F	2019 Q3 F	2019 Q4 F
GDP y/y (%)	5.3	5.1	5.1	4.8	4.3	4.2	3.6	3.1
Individual consumption y/y (%)	4.7	4.9	4.5	4.3	4.1	3.9	3.5	3.1
Public Consumption y/y (%)	3.0	3.5	3.6	4.0	2.0	2.0	2.0	2.0
Investment y/y (%)	8.2	4.7	9.9	10.0	6.0	6.0	5.0	4.0
Inflation rate (% average)	1.5	1.7	1.9	1.7	1.6	1.7	1.6	2.0
Unemployment rate (% eop)	6.6	5.9	5.7	5.6	5.5	5.0	4.9	5.0
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Wibor 3M (% eop)	1.70	1.70	1.72	1.70	1.70	1.71	1.72	1.73
2Y Polish bond yields (% eop)	1.49	1.63	1.56	1.55	1.60	1.78	2.00	2.20
10Y Polish bond yields (% eop)	3.18	3.22	3.24	3.20	3.30	3.50	3.74	3.96
EUR/PLN (eop)	4.21	4.37	4.28	4.35	4.30	4.25	4.25	4.25
USD/PLN (eop)	3.42	3.74	3.69	3.78	3.71	3.63	3.60	3.56

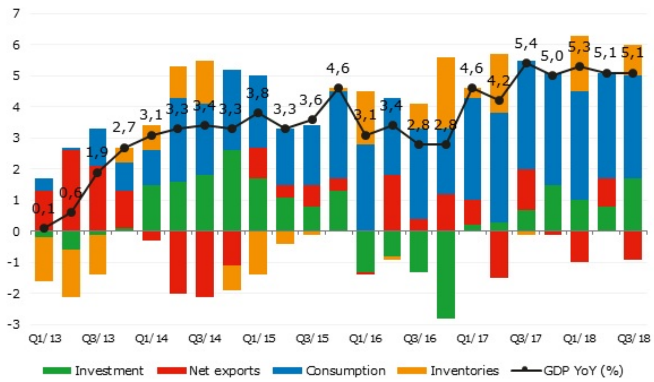
F - forecast

Economics

Recent data present us with a conundrum. While economic growth is defying all expectations quarter after quarter and pulls ahead of estimates based on soft and hard data alike, inflation is nowhere in sight. In fact, it is disappointing across the board, with the latest print being a mere 1.2%. As we repeatedly warned, the CPI path projected by the NBP will be significantly undershot and the consensus is also too optimistic in that regard. Our current forecast calls for inflation to remain steady next year. Against this backdrop, the MPC met this week and put interest rates on hold. Its rhetoric was also unchanged and it should be clear that if the Council was unwilling to react to 3%+ inflation, it won't be bothered by slight undershooting of the target. Interest rates, according tho the NBP governor, will stay at current levels until end-2019 and further on, unless unexpected shocks dramatically alter the inflation outlook.

Q3 GDP was boosted by inventory buildup and public investment

The surprisingly strong Q3 GDP figure of 5.1% y/y was confirmed today in the final release. Its details put many of our doubts and hypotheses to rest.



First, as we expected, household consumption finally slowed down materially for the first time in many quarters. Last quarter it grew by 4.5% y/y (down from Q2's 4.9% y/y) and this was foreshadowed by weaker monthly figures (in particular, retail sales and tourism). This does not mean that Poland's consumer boom is over, but rather that consumption is shifting to a different equilibrium with modestly slower growth. The foundations of consumption growth are still intact, since consumer sentiment remains very high, media talk of impending inflation surge have not yet translated into higher inflation expectations and smaller wage pressure reported by companies surveyed by the NBP is not discouraging spending.

Second, investment surprised to the upside, having grown by 9.9% y/y (market consensus and our forecast were both close to 6% y/y). This is the best result since early 2015 and it explains the surprise in headline GDP perfectly. We suspect that public investment were the key factor behind faster investment growth – we will single out local government spending ahead of the elections, inflow of EU funds and strong increase in investment spending by enterprises from the public sector. At the same time, we know that investment of private companies (be it foreign-owned or not) slowed down significantly in Q3.

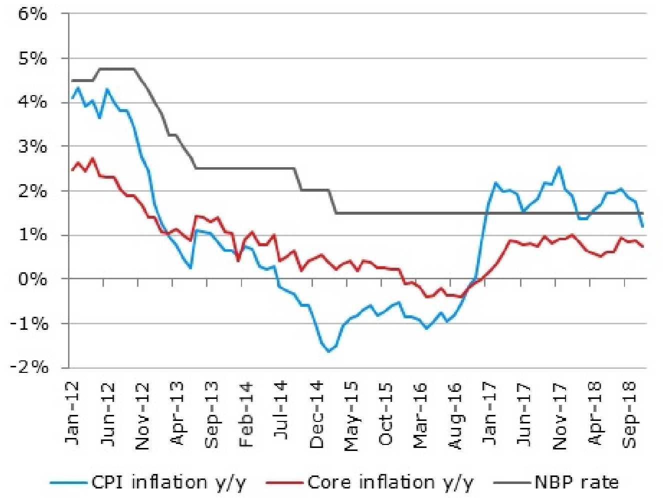
Third, the change in inventories proved to be a large positive contributor to Q3 GDP. This category added 1 percentage point to GDP growth in annual terms and this includes both pre-WLTP purchases of cars by dealers and the likely effects of unanticipated negative demand shock from abroad. Net exports (subtracted 0.9 p.p. from GDP growth) and public consumption (steady at 3.5% y/y) did not surprise at all. Next quarter is likely to bring some pullback in inventories (enough to bring its contribution to GDP growth to zero) and net exports contribution remains an open question.

The structure of Q3 GDP is a consolation for those who forecast slower GDP growth ahead. Even though the large (0.4-0.5 p.p.) surprise was confirmed, there are indications that the boost from public investment and inventories in Q3 might have been transient or at least will fade somewhat in Q4. As a result, GDP growth will likely drift to 4.6-4.7% y/y in Q4 and ca. 4% in 2019. Such a path is consistent with signals from soft data, but not all of them. While the sharp decline in the PMI (this November, the index dropped below 50 for the first time since 2014) caught the attention of market participants and Polish economy watchers. However, we believe that the PMI is overstating both the weakness of the economy and the extent to which Polish industry slowed down. Statistics Poland's and EC's sentiment indices have done a better job of predicting GDP in recent quarters and their verdict is close to 4.5-4.6%.

Inflation: Surprisingly low end of the year to be expected

According to the flash estimate, November inflation surprisingly fell from 1.8% in October to 1.2% y/y (consensus: +1.6%, our forecast +1.5%).

Partly, it is due to the fuel prices (high statistical base from the previous year, this November's reading is +0.7% m/m – a downward revision here is possible in the final reading, and a solid minus is certain in December), relatively low energy prices (+0.1% m/m – decreasing oil prices may generate further revisions in solid fuels prices by the end of the year) and very low dynamics of food prices (-0.1% m/m). Such a low realization of food prices did not shock us, usually volatile unprocessed food prices remain low, which will likely prove to be a source of this surprise. It is worth noticing that with the end of November - low temperature came - prices in this category of food increased, therefore the seasonal uptick might have moved to December. Nevertheless, non-core contribution is just a half of this inflation surprise, compared to our 1.5% forecast. Another half are prices in core categories. We estimate that core inflation might have slowed down to 0.7% y/y, therefore there was quite a rapid move down from the 0.9% y/y recorded in October. We bet that it was due to some one-off factor, probably in health (new list of reimbursed medicines) or in communications.



Because of the trends and relationships listed above, inflation in the end of the year should stay around the level of 1.2%, which will be a strong argument for the MPC to maintain the status quo. Moreover, very low core inflation makes another revision of NBP's inflation path more probable. Bear in mind that with higher than expected GDP growth, core inflation still surprises to the downside. It will be another argument in the discussion about the measure of output gap and its transmission on inflation. Obviously, the key role for inflation in 2019 will be played by electricity prices. Without any knowledge about its levels we can only assume that core inflation will accelerate too slowly to make MPC consider any interest rate hikes in 2019. Prices dynamics could be changed if zloty depreciates, but if it was relative to a basket (i.e. both against the USD and the EUR) or quite permanent. With the global economy slowing down and bets on the interest rate hikes abroad fading, it is hard to imagine such a sudden depreciation of Polish currency.

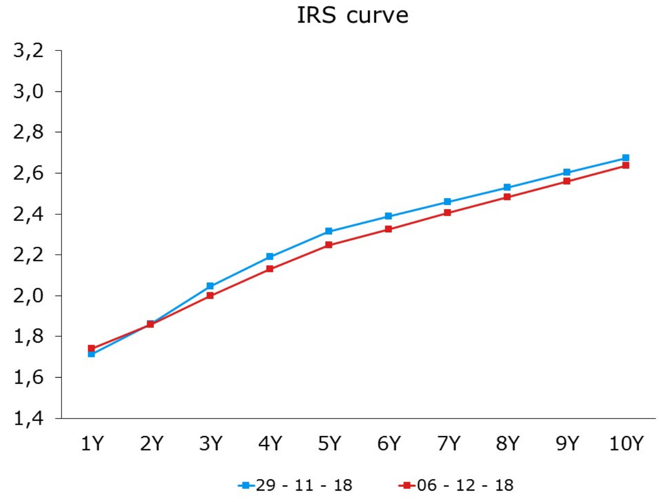
Fixed income

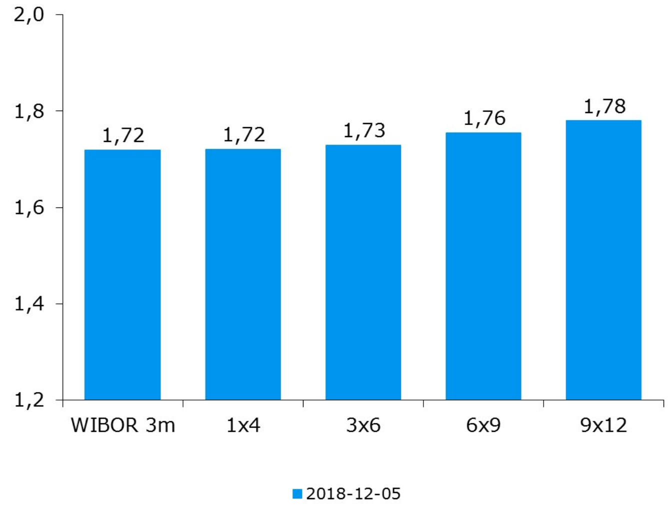
A star is born

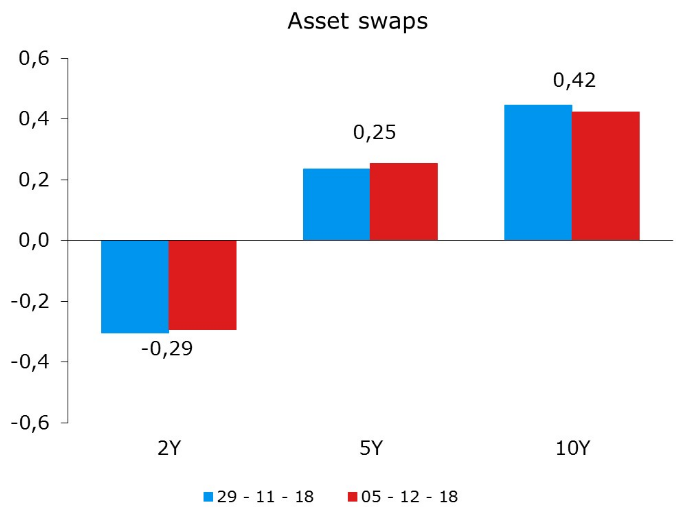
Polish CPI is 1.2% y/y after November and it is a huge surprise. Since that news yields have moved significantly lower. Today, we have seen very low general government deficit (at 0.6% of GDP). Curve should have steepened and ASW should have tightened, but it's not happening. In these circumstances, PS0424/5y and DS1023/5y spreads look inexplicably wide. After December, when all the liquidity issues will be resolved, ASWs will attract a lot of attention!

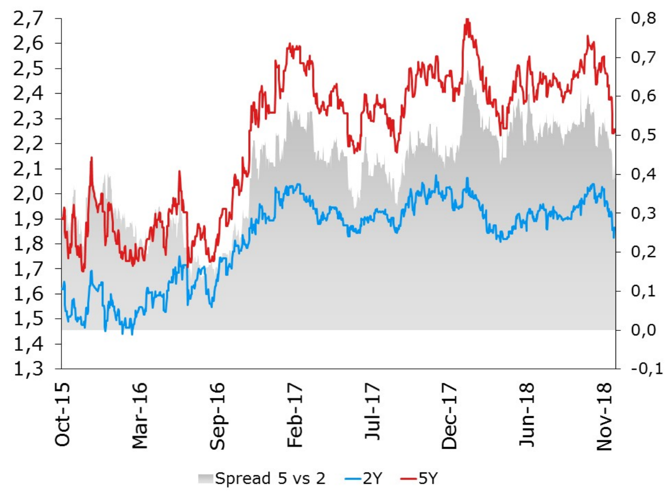
DS1023/5y is 9 bps, WS0428/10y is 39 bps. DS1023/WS0428 is 69 bps. WS0428/Bund is 279 bps.

DS1020 is trading at 1.53% (1 bps down), DS1023 is trading at 2.33% (7 bps down) and WS0428 is trading at 3.02% (13 bps down).









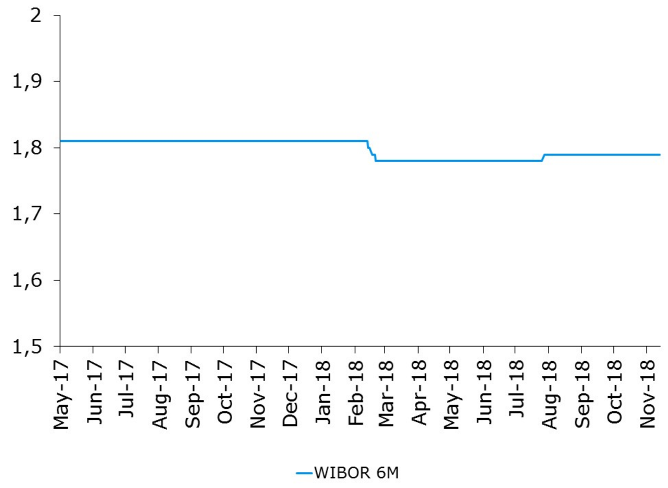
Money market

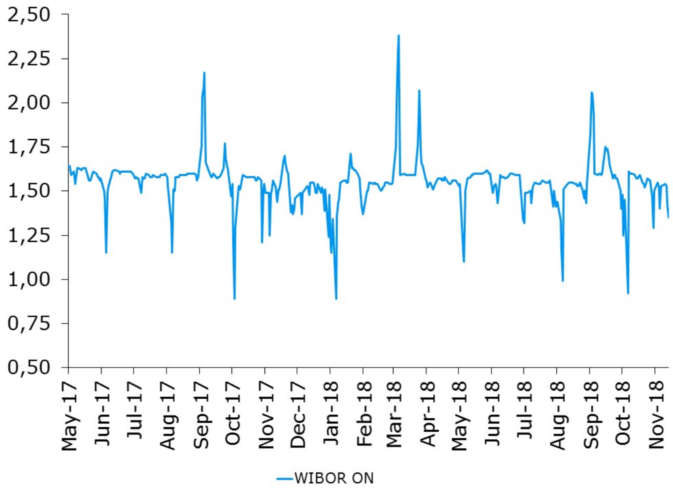
Liquidity will only get thinner from here

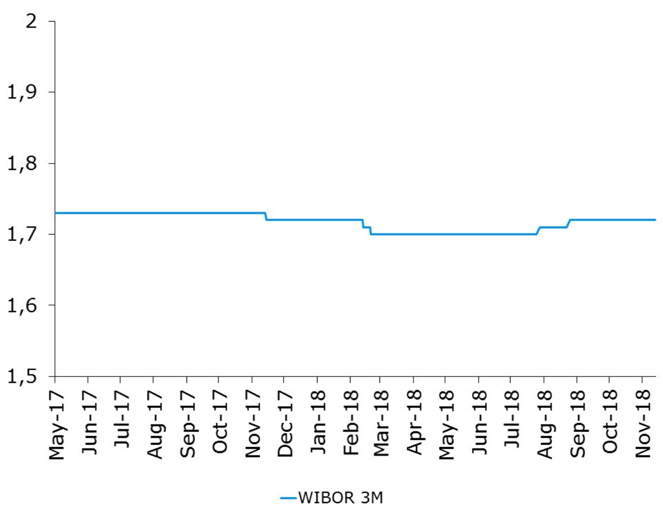
The recent downside move in Polish rates experienced another leg lower due to November's CPI surprise. Figure came out at 1.2% vs. 1.5-1.6% consensus. Dropping core yields intensified the move and we ended with 5y trading at 2.25%. We are getting close to the year end, so liquidity is getting thinner and thinner each day. Flows have a decent impact on market. Many market participants will start betting on higher short-term rates, but only at the beginning of next year, once liquidity comes back to normal.

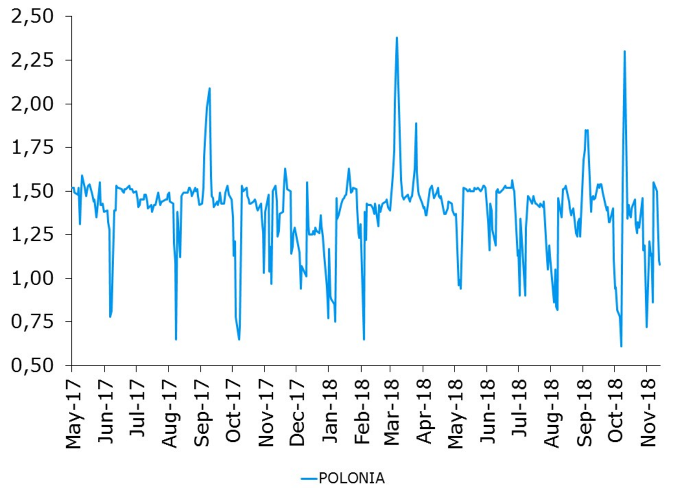
Cash rates have stayed low for the whole week. Surprisingly, the NBP didn't do an additional operation. The closer we get to year end, the thinner liquidity will get and the bigger rate swings will become.

Ref rate vs Polonia averages:
30 day 21 bp
90 day 14 bp



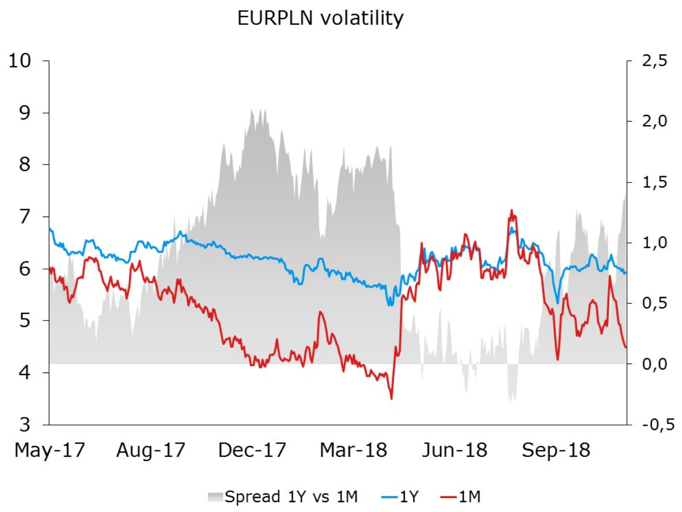






Forex

Spot – EUR/PLN – stable EUR/PLN was treading water another week. Still, dovish rhetoric from the MPC failed to produce any volatility – in fact EUR/PLN rate increased only by 1 figure after MPC conference. The bigger picture is blurred. Healthy fundamentals and generally solid economy are in favor of strong Zloty. On the other hand, there are concerns about global growth, Brexit uncertainty and the trade war. Anyway, we are still trading in the 4.26 – 4.34 range, with slightly PLN-negative skew.



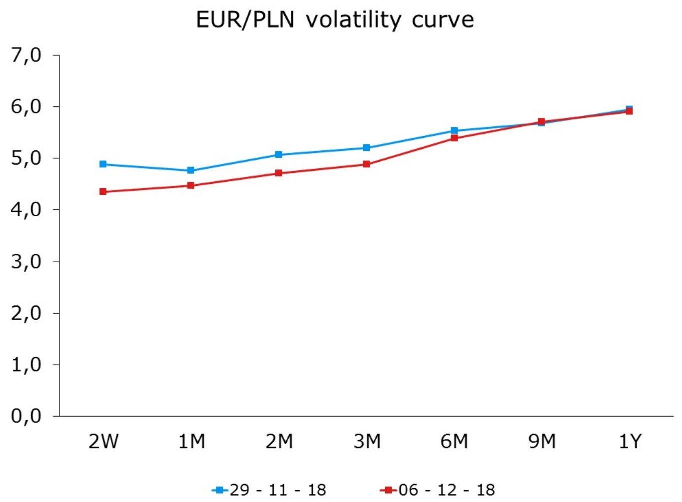
Opts: EUR/PLN vols – treading water The realized volatility is still pretty low. However, the whole EUR/PLN implied volatility curve is quite stable. Today there were two big clips of 1 month EUR/PLN traded at 5.55% and 1y traded at 6.0%. Finally EUR/PLN 1 month ATM mid fixed today at 4.55% (0.25% lower than week ago), 3 months EUR/PLN are 5.0% (0.05% higher) and 1 year is 6.0% (no change). The skew and the currency spread (difference between USD/PLN vol and EUR/PLN vol) are at same level as week ago.

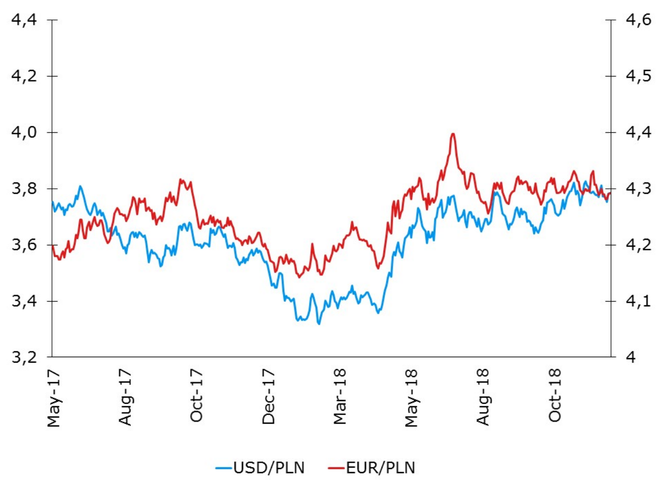
Short-term forecasts

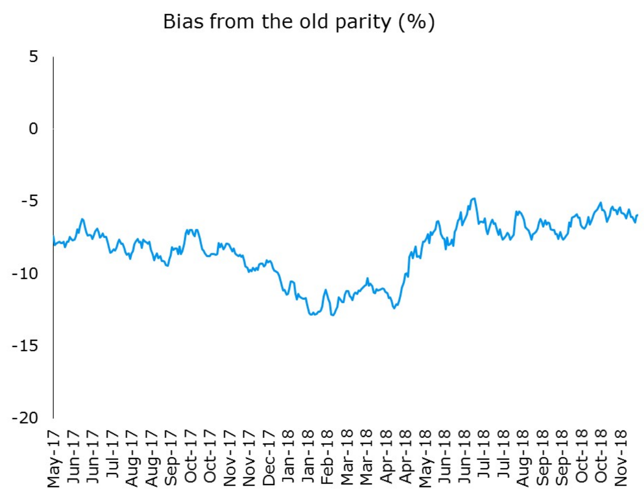
Main supports / resistances:
EUR/PLN: 4.2600 / 4.3400
USD/PLN: 3.6000 / 3.9000

Spot: Current position: None

Our strategy is roughly unchanged, we still believe in the rangy nature of EUR/PLN, with a slight PLN-negative bias. Therefore, we are ready to buy EUR/PLN at 4.27 with stop at 4.24 and hopes to see 4.34-35 again.







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
11/29/2018	1.85	1.72	1.92	1.69	2.08	1.77	1.72	1.73	1.75	1.80	1.85	1.83
12/2/2018	2.05	1.72	2.08	1.69	2.20	1.77	1.72	1.74	1.76	1.78	1.81	1.81
12/3/2018	1.63	1.72	1.71	1.69	1.74	1.77	1.73	1.73	1.75	1.77	1.81	1.83
12/4/2018	1.82	1.72	1.88	1.69	1.99	1.77	1.72	1.73	1.76	1.79	1.82	1.84
12/5/2018	1.98	1.72	2.04	1.69	2.07	1.77	1.72	1.73	1.76	1.78	1.81	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	10/26/2018	7/25/2020	97.52	1.46	700	2600	700
PS0424	10/26/2018	4/25/2024	99.45	2.60	3000	6945	2930
WS0428	10/26/2018	4/25/2028	96.50	3.18	4000	15482	4242

Fixed income market rates (closing mid-market levels)

Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0720	5Y IRS	PS0423	10Y IRS	WS0428
11/29/2018	1.770	1.138	1.861	1.557	2.315	2.550	2.675	3.120
12/2/2018	1.770	1.114	1.855	1.543	2.242	2.477	2.627	3.044
12/3/2018	1.770	1.123	1.825	1.553	2.250	2.482	2.614	3.032
12/4/2018	1.770	1.110	1.867	1.554	2.257	2.484	2.648	3.045
12/5/2018	1.770	1.119	1.858	1.564	2.248	2.501	2.638	3.060

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
11/29/2018	4.76	5.20	5.53	5.95	5.95	1.70	0.56
12/2/2018	4.65	5.06	5.48	6.00	6.00	1.70	0.56
12/3/2018	4.55	5.00	5.40	5.90	5.90	1.73	0.56
12/4/2018	4.49	4.93	5.38	5.93	5.93	1.73	0.56
12/5/2018	4.47	4.89	5.39	5.91	5.91	1.73	0.55

PLN Spot performance

Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
11/29/2018	4.2900	3.7728	3.7960	3.3305	1.3273	0.1654
12/2/2018	4.2904	3.7731	3.7873	3.3246	1.3260	0.1653
12/3/2018	4.2818	3.7672	3.7768	3.3210	1.3281	0.1650
12/4/2018	4.2810	3.7516	3.7765	3.3267	1.3255	0.1651
12/5/2018	4.2896	3.7832	3.7899	3.3489	1.3244	0.1656

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