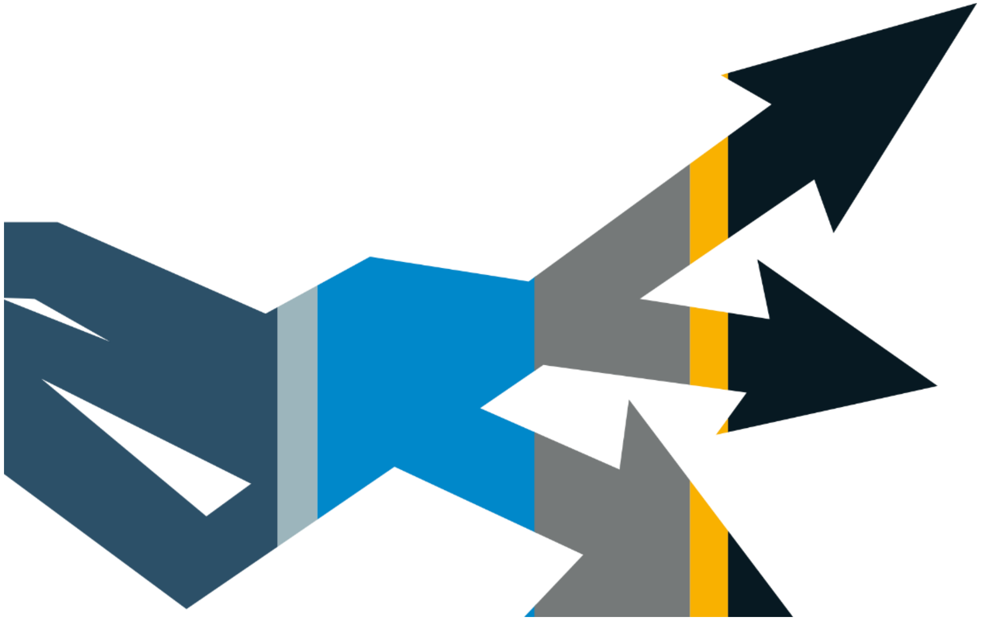
Monthly Pulse Check
Economy. FI. FX

October 31st 2022



mBank Research

For contact details and classification of the report see the last page.

Our view in a nutshell (≥1Y horizon) & major forecasts

Macro

- The global economy keeps losing momentum along with continued and relentless monetary tightening. In China, the macro outlook is in stark contrast to what is going on elsewhere (zero-COVID policy is here to stay, the housing market is bursting).
- Looking at the Polish economy we were offered a disappointing print of GDP for Q2, but 3Q should be better. Looking ahead, we expect the economy to keep losing pace on the back of strong monetary tightening kicking in, simmering geopolitical uncertainty as well as stubbornly high inflation (demand destruction is happening here and there).

Monetary policy: Fed. ECB. NBP

- Fed: Rate tightening to continue. We expect the Fed to lift rates close to the levels of 4.5-5%. This is especially true given the fact that the labor market has not slowed down yet. We deem rate cuts in H2 2023 are possible.
- ECB: Time to say goodbye for negative rates. A degree of „hawkishness" among the Governing Council has increased. We look for further hikes until the year-end, then a pause, and subsequently a resumption of tightening.
- NBP: We are getting closer to the end of monetary tightening. After another 25bps hike in September, MPC stopped. We do not think there will be a consensus to push rates yet higher. Simultaneously, we do not expect any rate cuts in 2023.

FX Market

- Volatility in the FX market remains elevated. The greenback keeps flexing its muscles which acts to the detriment of the zloty. Moreover, Poland is still a long way off from tapping EU funds (legal hurdles have not been addressed yet). The fiscal outlook, and thereby borrowing needs, also remains a challenge. Thus, some depreciation is what we expect from now on.

		2022 Q1 F	2022 Q2 F	2022 Q3 F	2022 Q4 F	2023 Q1 F	2023 Q2 F	2023 Q3 F	2023 Q4 F	2021* Q1-Q4	2022* Q1-Q4	2023* Q1-Q4
GDP y/y	%	8,5	5,5	3,2	0,3	-2,3	-0,1	1,1	2,1	6,8	4,0	0,4
Individual consumption y/y	%	6,6	6,4	2,5	4,5	4,2	2,8	2,4	2,5	6,1	5,3	3,0
Investment y/y	%	4,3	7,1	4,5	3,0	-4,0	-2,0	1,0	3,0	3,8	4,9	-0,5
Inflation rate (eop)	%	11,0	15,5	17,2	18,6	17,2	14,3	11,9	8,1	5,1	14,5	14,2
Unemployment rate (eop)	%	5,4	4,9	5,1	5,5	5,7	5,6	5,5	5,9	5,4	5,5	5,9
NBP repo rate (eop)	%	3,50	6,00	6,75	6,75	6,75	6,75	6,75	6,75	1,75	6,75	6,75
EUR/PLN (eop)	%	4,65	4,70	4,86	4,90	4,80	4,80	4,70	4,60	4,59	4,78	4,73
USD/PLN (eop)	%	4,20	4,48	4,95	4,85	4,66	4,57	4,27	4,11	3,94	4,62	4,40

F - forecast

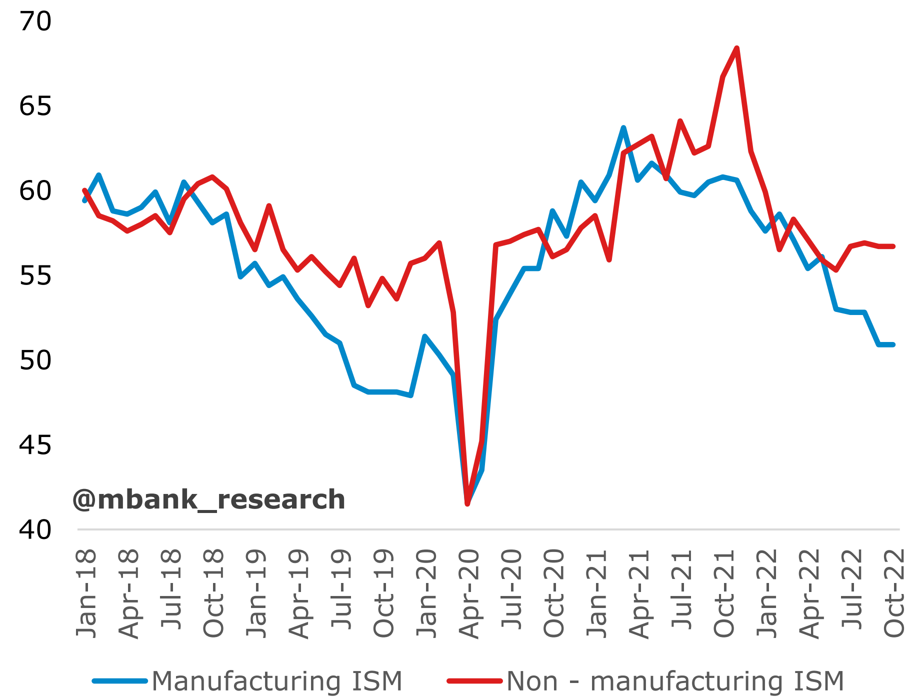
* yearly average for inflation rate, EUR/PLN and USD/PLN

Highlights

- The word „pivot" is more and more frequent when it comes to the U.S. economy (or perhaps more so the Fed). In our view, however, this is not yet the moment for the Fed to let go of the fight to bring inflation back to target. Data from the real economy remain relatively good (especially the labor market). Sentiment indexes may be of concern, but surely they are less important than payrolls. We think the Fed could push rates higher toward 4.5-5%.
- The ECB is moving in the same direction (although it will end up lower, slightly above 3%). The hawkish tone of Lagarde's conference has eased somewhat. But (fortunately for the European economy) gas prices have also eased. Energy prices are still the main elephant in the room that the European Commission will try to tackle.
- In Poland, the MPC has paused in the cycle of rate hikes. In our opinion, it has stopped for longer (for good). MPC members argue that they are waiting for the results of the NBP projection (we will see it in November), and then they will decide on further hikes. However, it seems that at most another 25bp hike is in the game (if any). Market still believes in some hikes.
- The main concern for the MPC is the real economy. GDP data for Q3 should still be relatively good (our estimate around 3.2%), but next quarters are expected to be worse. In the monthly data, construction is taking the hardest hit for now. The MPC does not want to let the unemployment rate rise - for now it is not a problem (the labor market is still solid, with stable employment and high wage growth).
- As for inflation, the Council should not have too many doubts. CPI remains elevated and will remain significantly above the target for many more months (years?). But dovish members of the MPC will also find some arguments for their scenario - inflation in October, although it rose, did not beat the consensus forecast and is still drive to a large extent by fuels, food and energy. In the environment of huge shocks, core inflation cannot be not following. Hence, it is not so easy to disentangle the demand-supply effect in the core measures from sheer reflection of one-off cost increases.
- We write more on fiscal policy and financing costs (PLN financing cost is a double-edged sword). The government admitted that it is focused now on the FX market (OFC to the detriment of the bond market since in current circumstances you cannot have both).

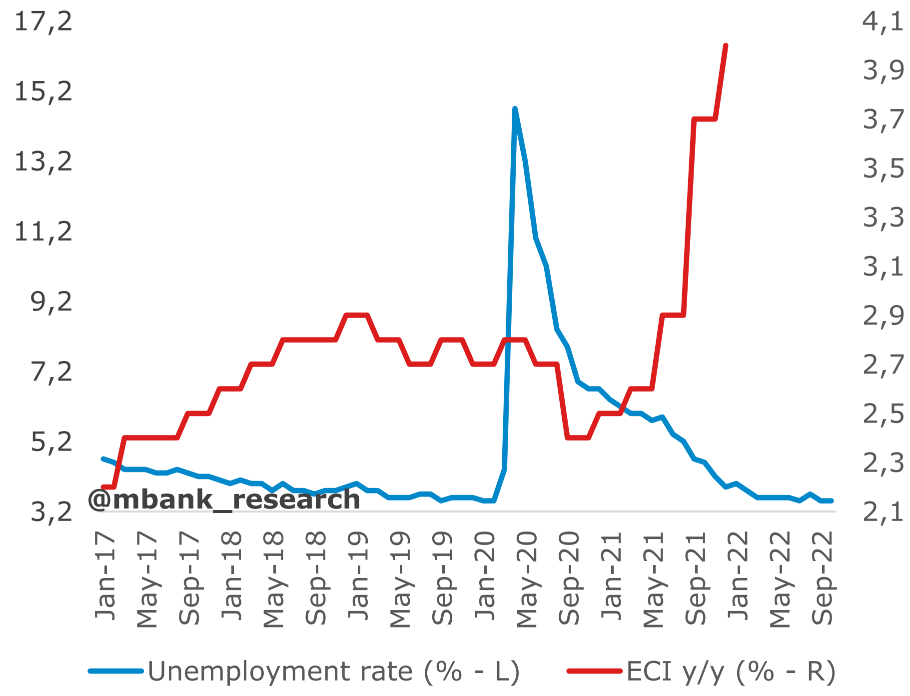
U.S. economy health check

ISM PMI: manufacturing & non-manufacturing



Source: ISM

Labor market: wages & unemployment rate

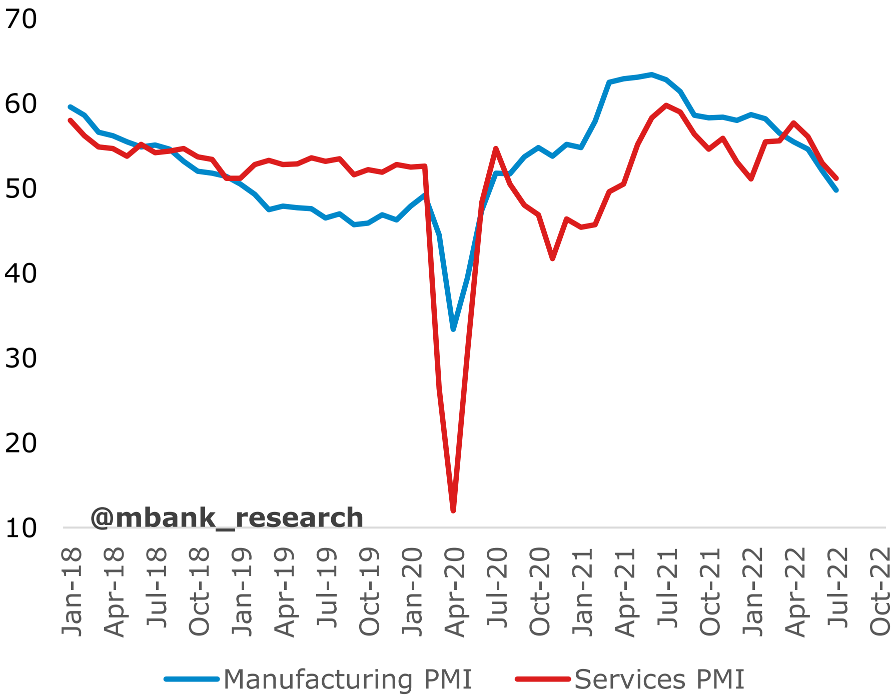


Source: FRED

- The US economy has continued its deceleration, at least in soft indicators. It has been especially seen in October PMIs which surprised strongly to the downside. The details showed first obstacles in passing higher costs onto consumers. The picture is not so gloomy when we delve into „hard" data, albeit some weaker points can be found (falling house prices, lackluster real retail sales, further JOLTS normalization).
- Nevertheless, the overall backdrop of the labor market remains quite steady. September brought an unexpected decline in the jobless rate, though the labor force participation rate also ticked down. The average number of hours worked remains above the pre-pandemic levels, as the wage growth does. As a result, the Fed might bank on further normalization there.
- Over the recent weeks some calls for a so-called Fed pivot have occurred. Taking into consideration a degree of real economy 'destruction' we doubt the time is here. The market pricing of Fed fund rates jumped toward 5% following the latest inflation report. Given the Fed's reaction function (overshooting of rate hikes seems on the cards) we think the Fed could push rates higher toward 4.5-5%. At the same time, we think that this increases the odds for earlier rate cuts thereafter.

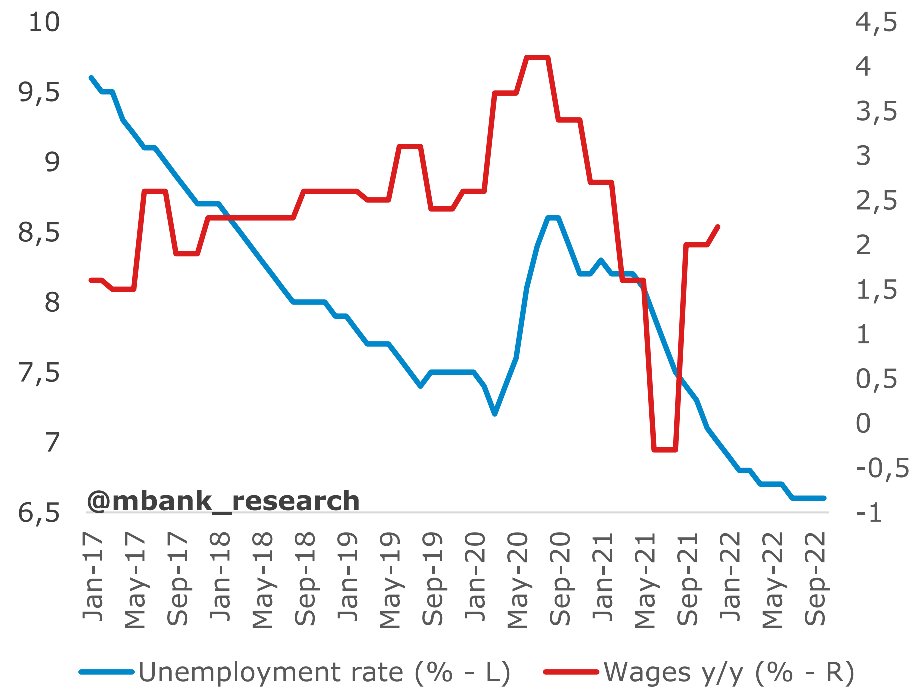
Euro area economy health check

Markit PMI: manufacturing & services



Source: Markit

Labor market: wages & unemployment rate

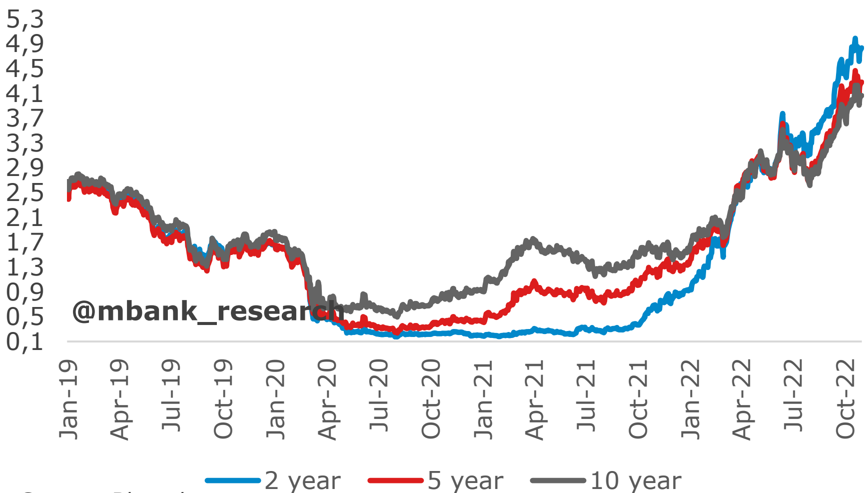


Source: Eurostat

- Energy keeps playing a pivotal role in economic developments in the Eurozone economy. Gas prices have decreased recently, in part due to quite good weather conditions. On to top of that, the EC keeps working on a mechanism aimed at capping gas and/or electricity prices at a certain level. Details have not been unveiled yet.
- Looking beyond, one may notice that soft indicators have kept losing steam. At the same time, wage pressure has been quite contained so far, with negotiated wage growth at 2.4% YoY in the second quarter (neither seasonally nor calendar adjusted). The key factor to consider is a further response from fiscal policy.
- After its September's meeting the ECB appeared to be solely focused on inflation developments notwithstanding slowing economic growth, with Lagarde calling for higher rates over the next 4-5 meetings. The tone softened in October to some extent. Although we got another 75bps hike, the ECB acknowledged „substantial progres in withdrawing monetary policy accomodation". As such, while the ECB is likely to keep rising rates (especially when inflation surprises to the upside), it seems that it is not indifferent to growth developments. We still expect rates to reach or even slightly exceed 3%.

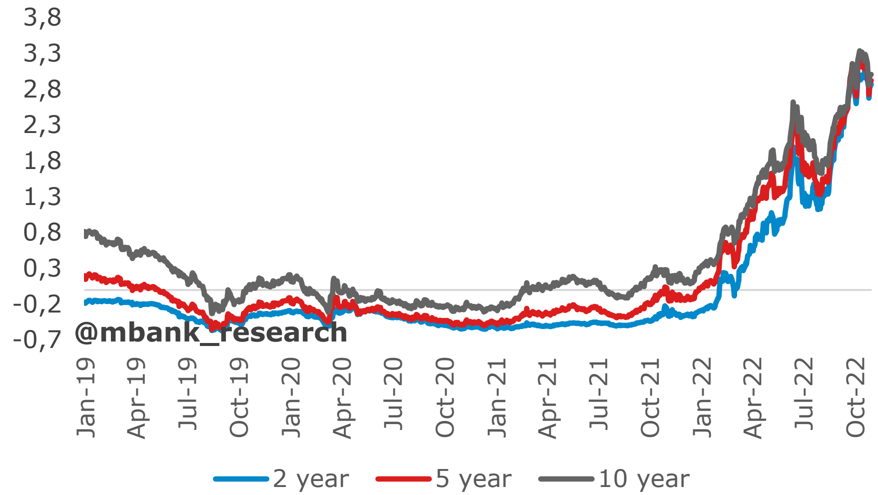
Global rates

US swap rates (%)



Source: Bloomberg

EU swap rates (%)

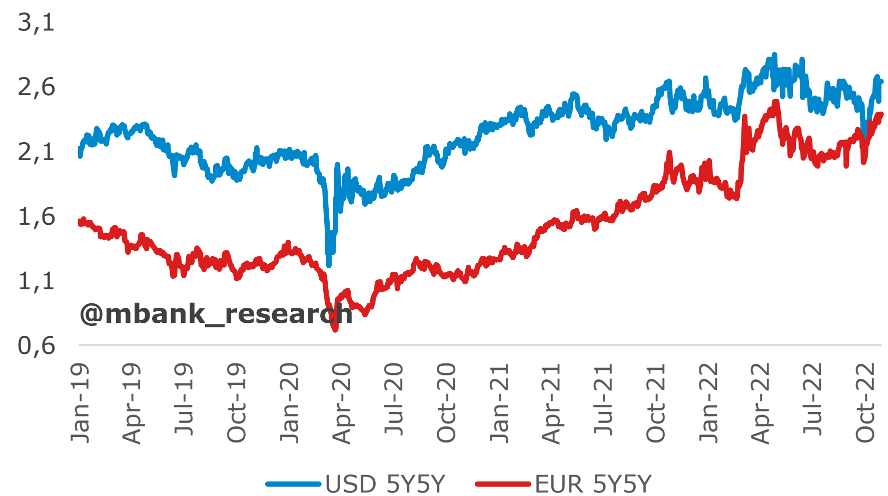


Source: Bloomberg

Swap spreads (10Y-2Y. p.p.)

Source: Bloomberg

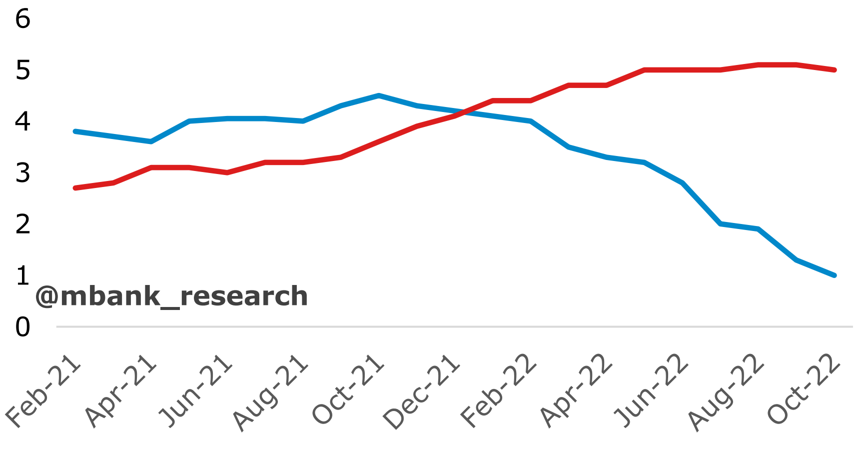
US and EZ inflation expectations (%)



Source: Bloomberg

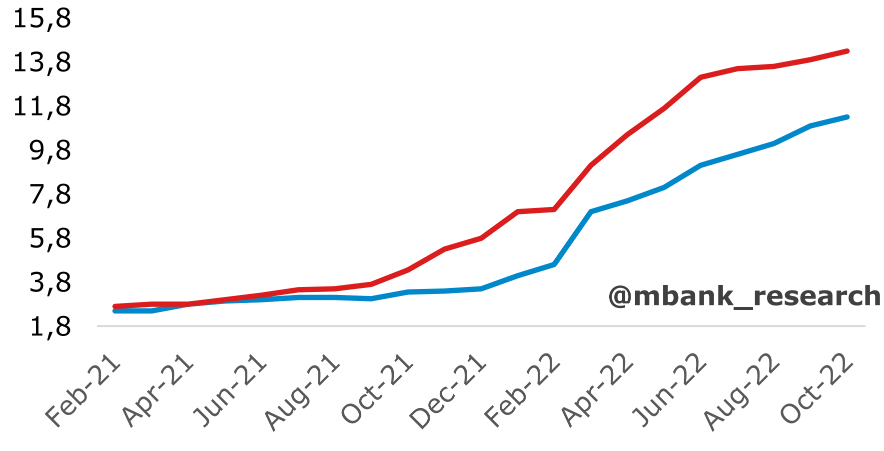
Consensus: what is expected in Poland?

Consensus tracker: GDP growth (% y/y. annual avg)



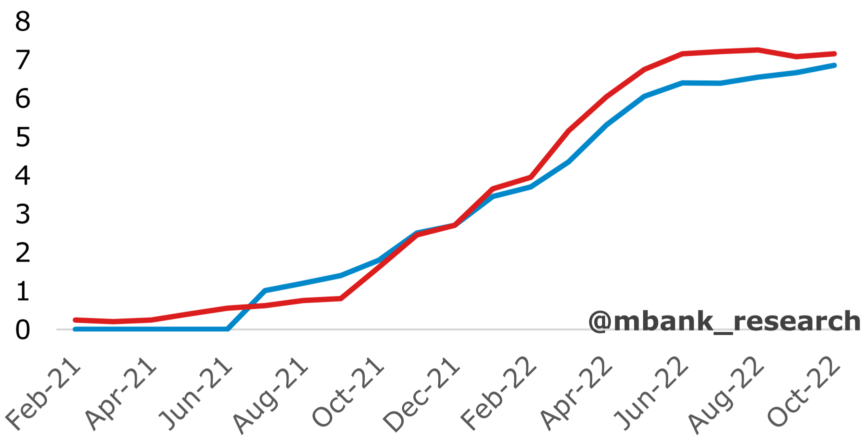
Source: Bloomberg

Consensus tracker: CPI inflation (% y/y. annual avg)



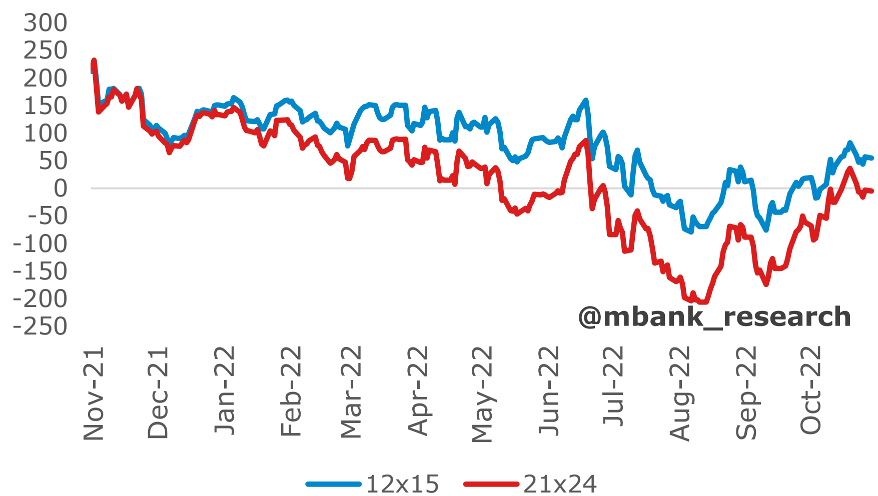
Source: Bloomberg

Consensus tracker: NBP ref. rate (% end of period)



Source: Bloomberg

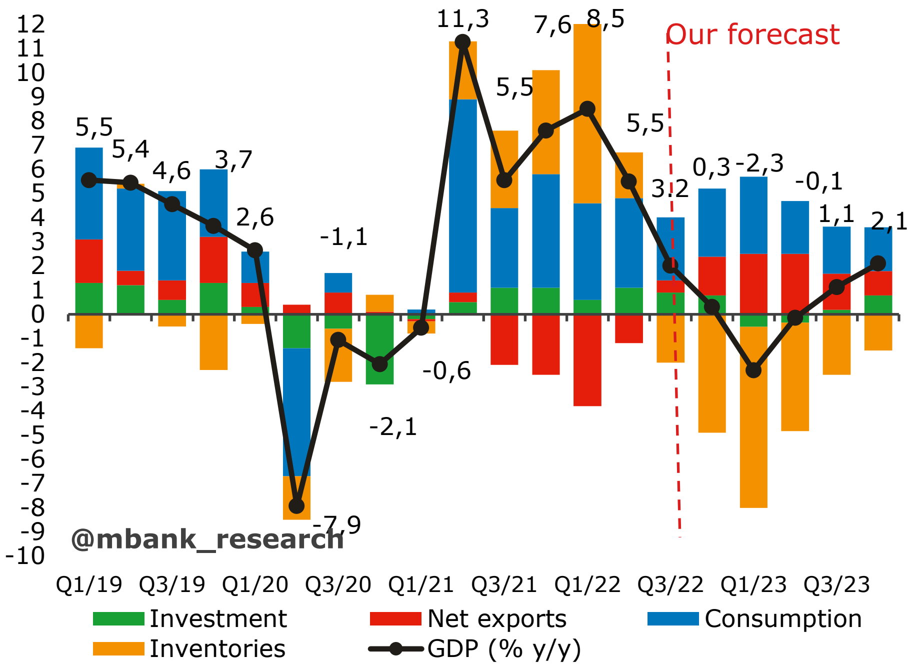
Rate changes priced in by FRA (bps)



Source: Bloomberg

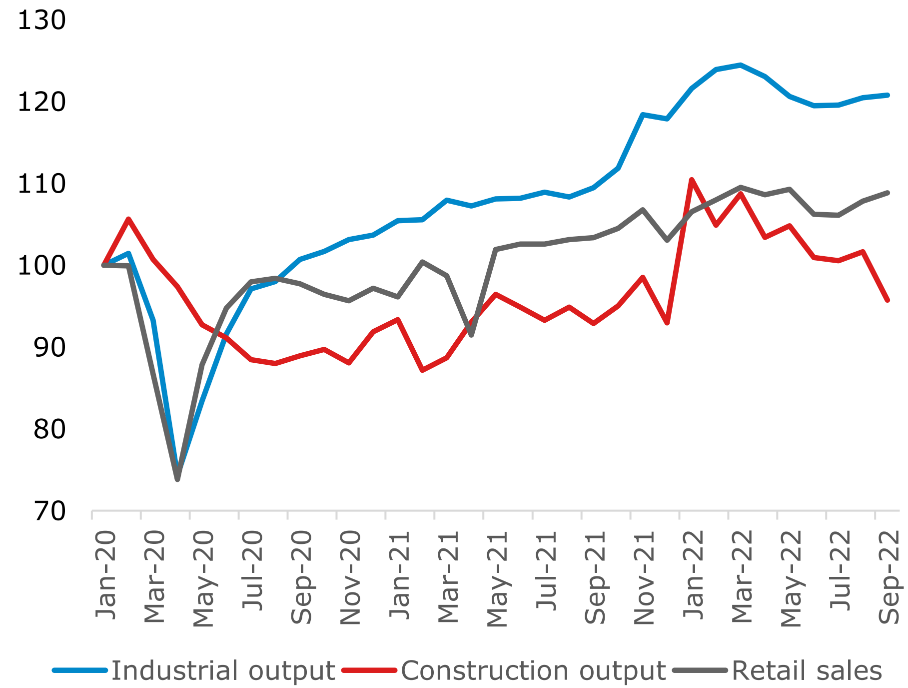
Poland: Monthly data – overview (and GDP nowcast)

GDP forecast



Source: own evaluation

Seasonally adjusted, Jan20 = 100

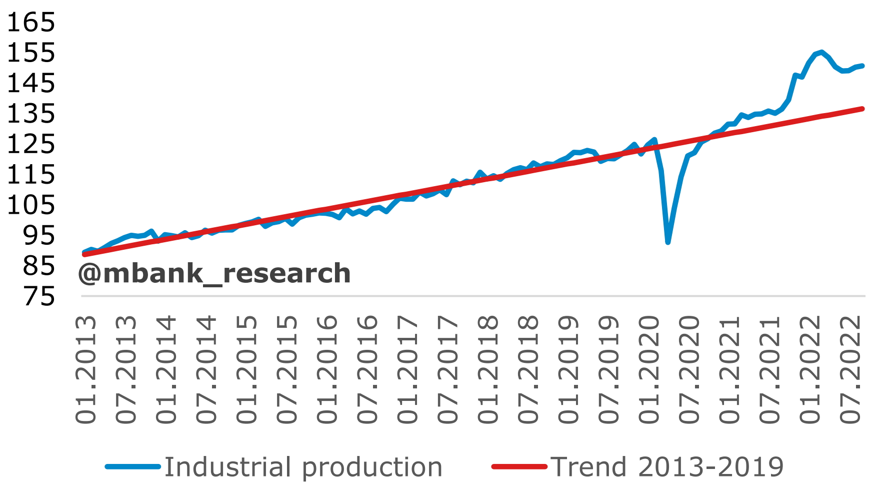


Source: mBank, Statistics Poland

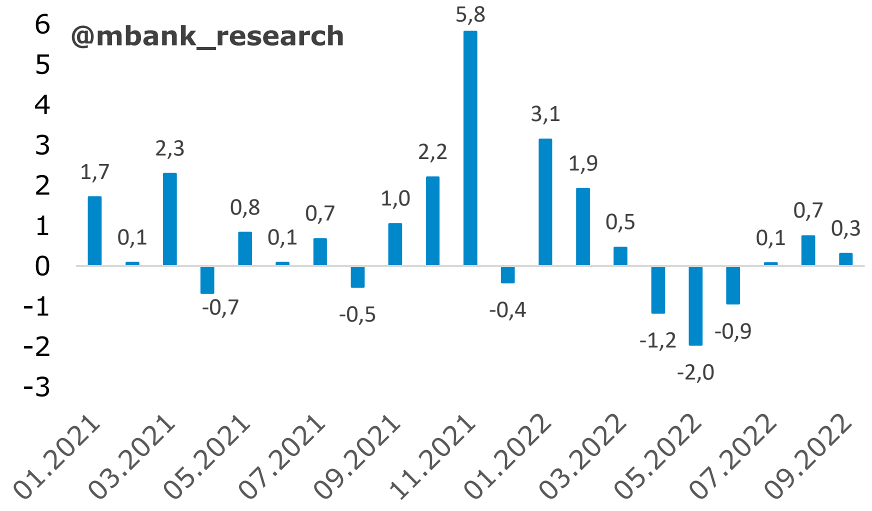
- The Statistics Poland created some confusion, as it revised up Polish GDP data for 2021 by 0.9pp to 6.8%. Revision was mostly the effect of higher public consumption (together with somewhat lower investment). We do not know the quarterly details yet, so we cannot present implications for our GDP forecast for next months.
- Construction came back to the zigzag trend from previous months (after a slight improvement in August). Construction output follows a downward move from previous months – nothing will change here, as high interest rates and therefore low investments are probably the most important obstacles.
- Retail sales and manufacturing are still doing fine. We could have seen some additional consumption in September due to an additional pension payment (paid in August and September). Together with some additional bonuses because of high inflation and other governmental transfers it should help consumption in the short-term. But the impact of the cycle seems to be unavoidable, and a slowdown could affect consumers too.
- The state of play in manufacturing seems to be more obvious. Hard economic prints have been resilient so far, albeit soft indicators have worsened markedly. This coupled with high inventories (declines ahead) suggests a clear direction (down).

Poland: Monthly data - industrial production

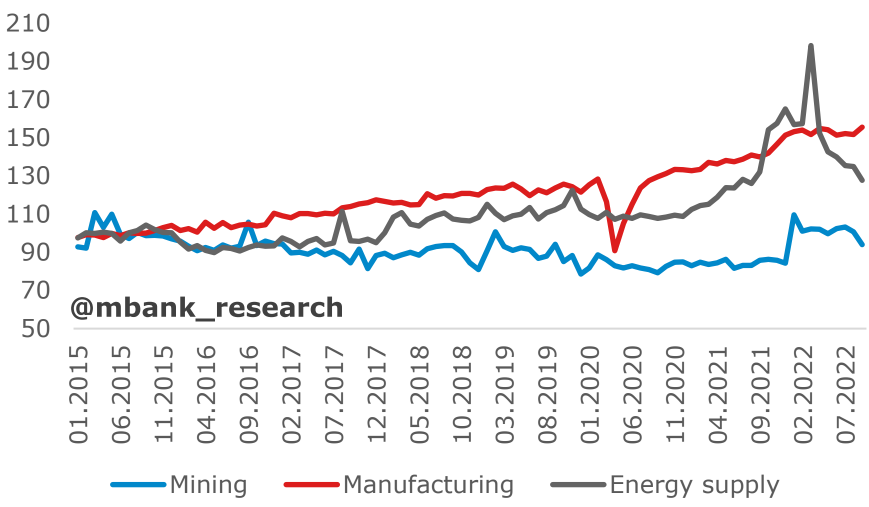
Industrial production (index 2015 = 100, sa)



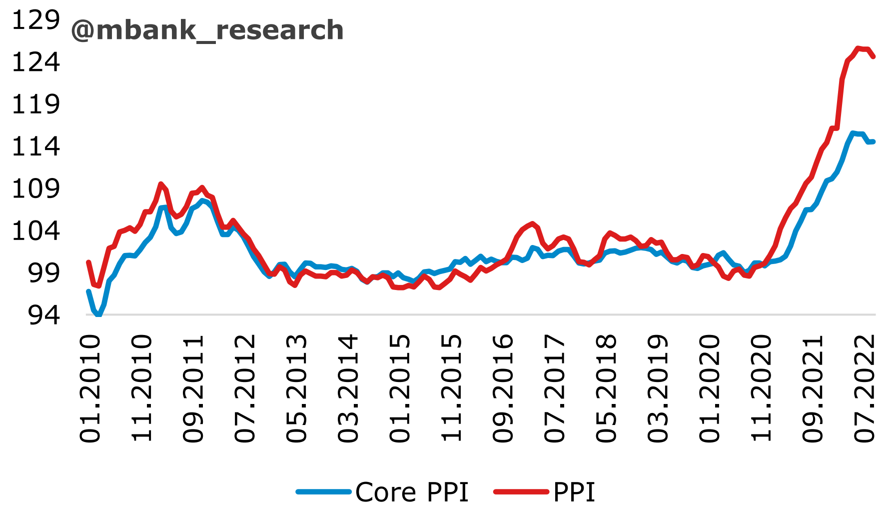
Momentum (m/m growth, seasonally adjusted)



Main categories (index 2015 = 100, sa)



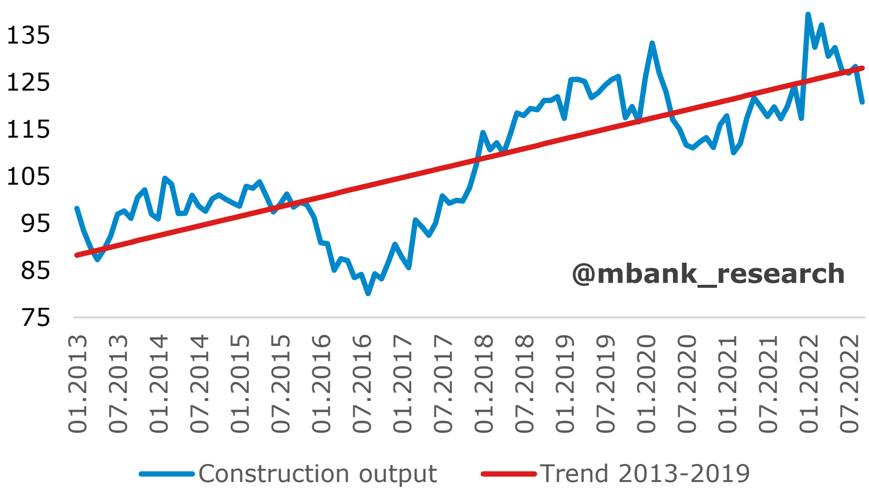
Producer prices (previous year = 100)



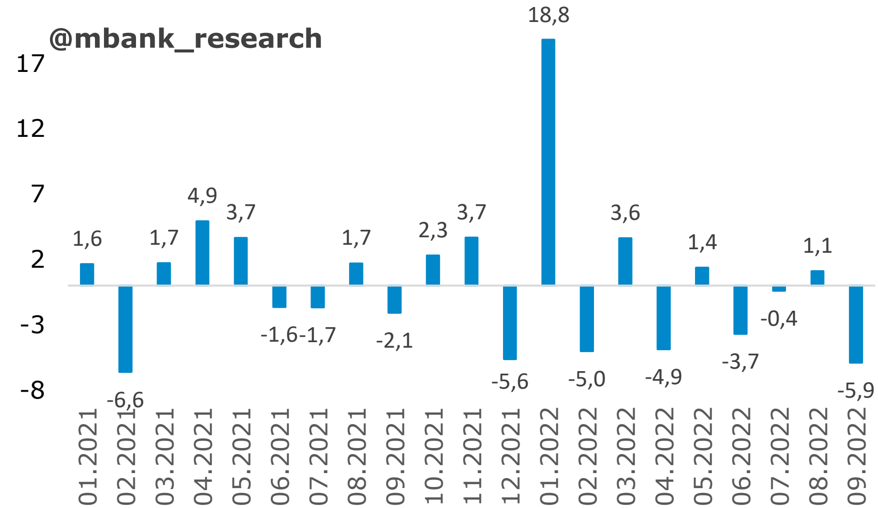
Source: Statistics Poland data. Own elaboration.

Poland: Monthly data - construction

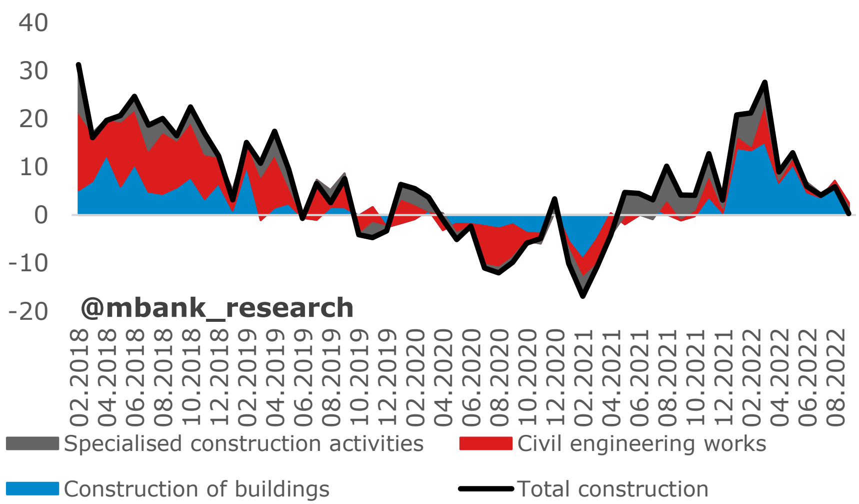
Construction output (index 2015 = 100, sa)



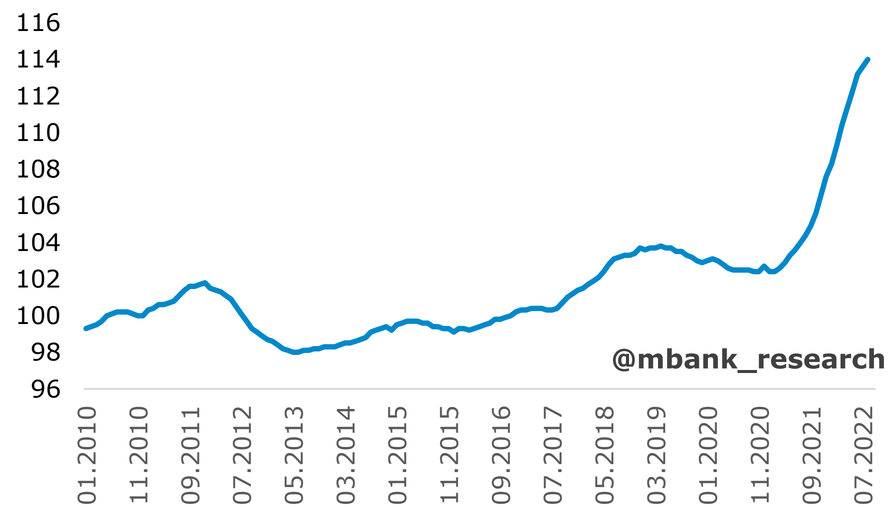
Momentum (m/m growth, seasonally adjusted)



Contribution to y/y growth



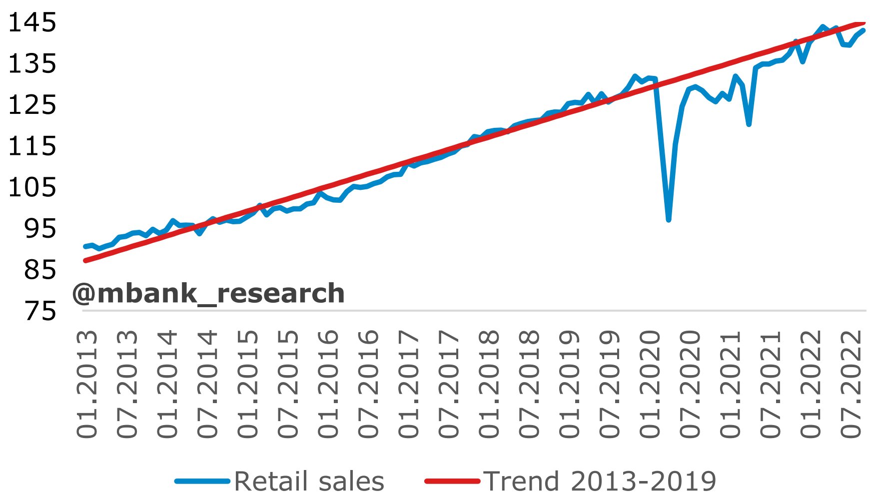
Construction prices (previous year = 100)



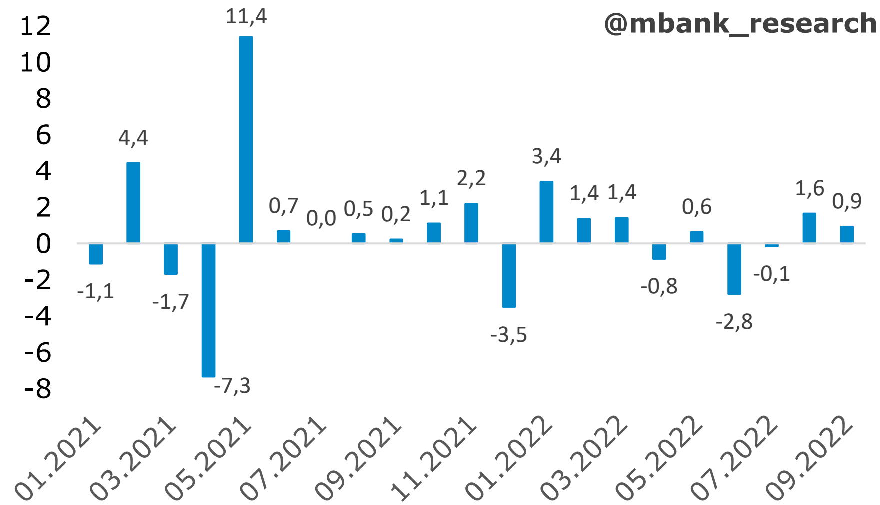
Source: Statistics Poland data. Own elaboration.

Poland: Monthly data - retail sales

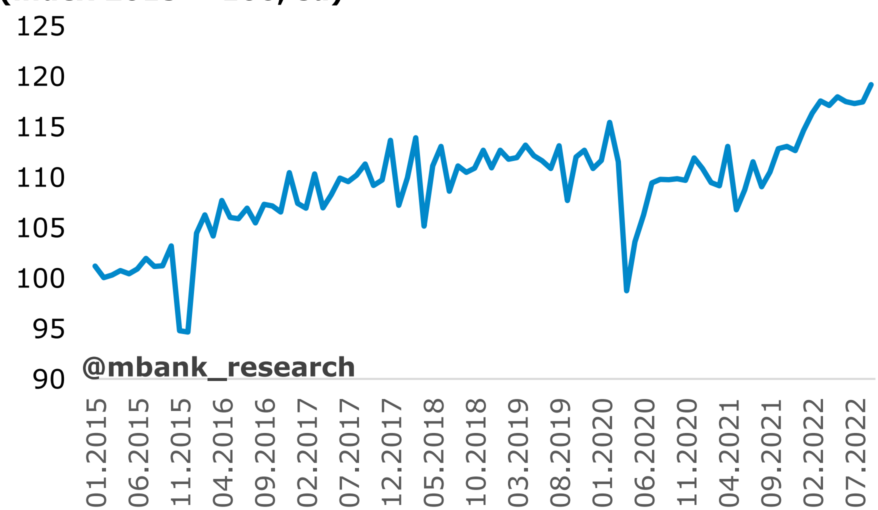
Retail sales (index 2015 = 100, sa)



Momentum (m/m growth, seasonally adjusted)



Retail sales - Food, beverages and tobacco products (index 2015 = 100, sa)

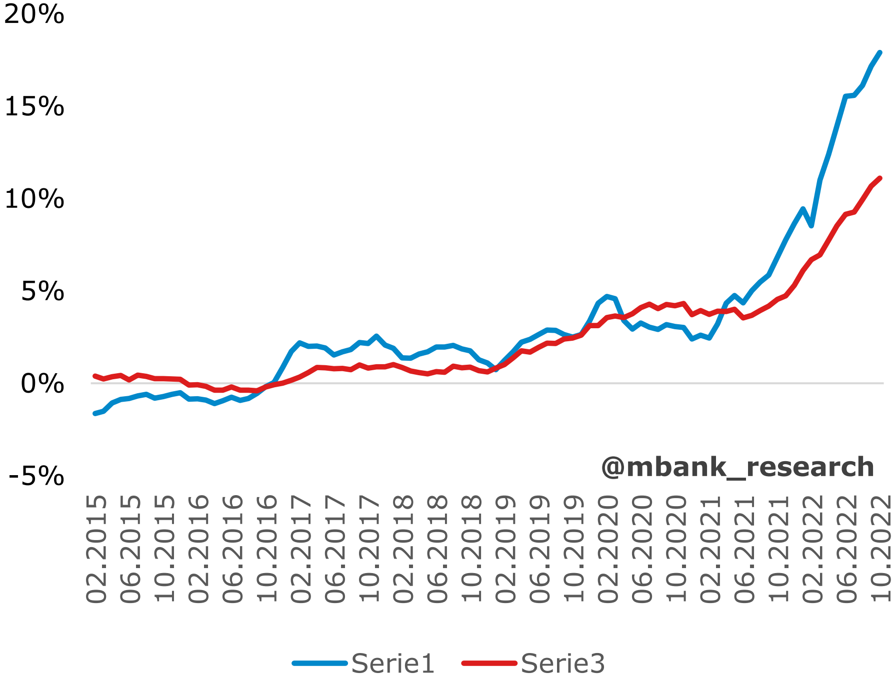


Retail sales - Solid, liquid and gaseous fuels (index 2015 = 100, sa)

Source: Statistics Poland data. Own elaboration.

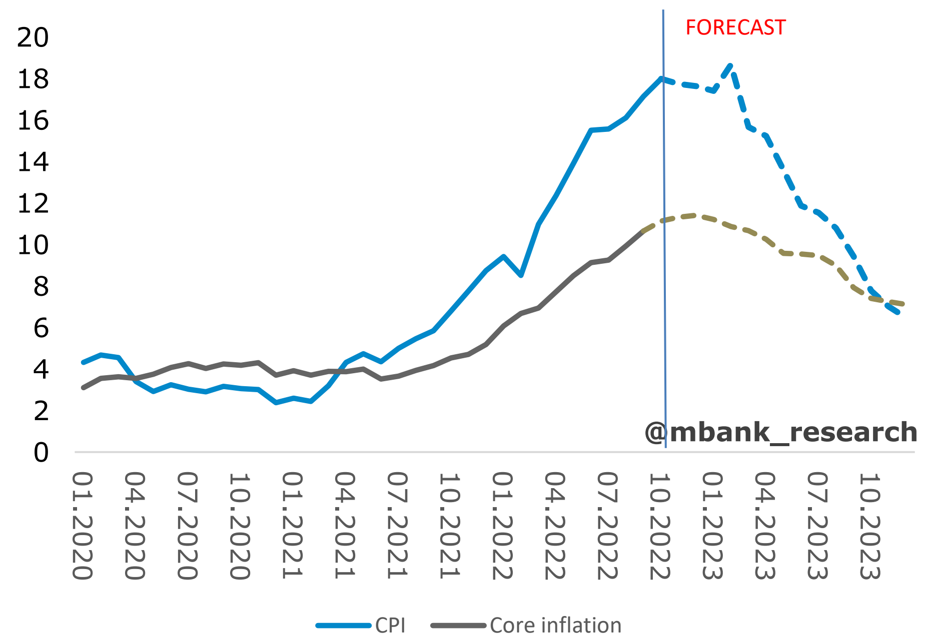
Poland: Inflation tracker #1

CPI and core inflation (% y/y)



Source: Statistics Poland, NBP, own elaboration

Core and headline inflation forecast

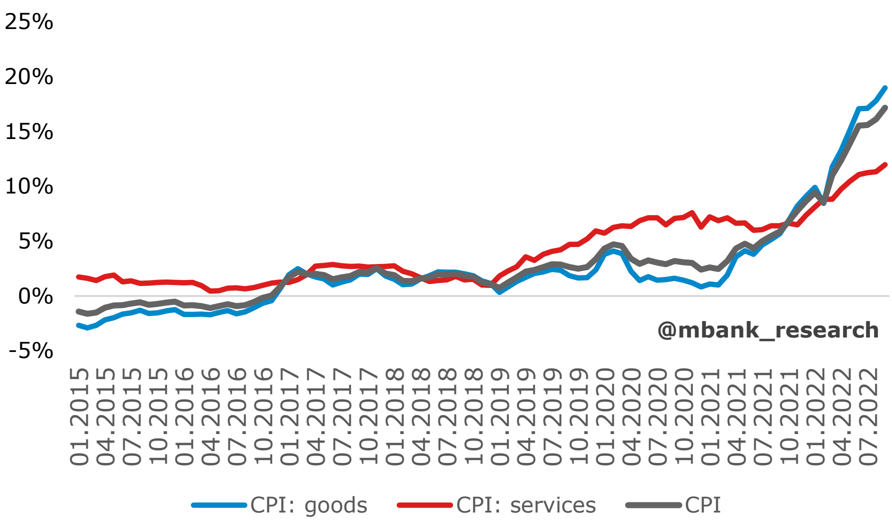


Source: Statistics Poland. own elaboration

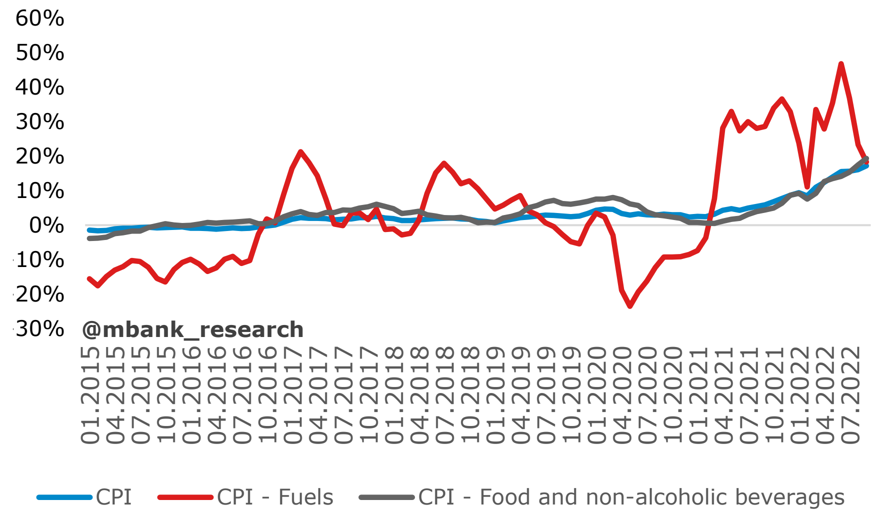
- According to a flash estimate, inflation accelerated to 17.9% y/y in October, compared to 17.2% y/y in the previous month. It was a slight downward surprise for economists. We had expected an increase to 18.1% in annual terms. In out view, core inflation accelerated to 11-11.1% y/y which would translate to a 0.9% m/m pick-up in seasonally adjusted terms.
- We were offered a substantial increase in food and non-alcoholic beverages prices in October (2.7% m/m) and a lower increase in energy prices (2%m/m). There is no doubt that core prices are being accelerated by unprocessed food as well as energy prices, thus having these prices halted seems to be a precondition for core prices to start losing steam. The silver lining here might be coal prices which, in our view, should start surprising to the downside in the coming months. If so, it would offer some relief in the inflation outlook in Poland.
- The govt managed to effectively cap electricity prices for households as well as SMEs. Local governments are to be offered a cap too. As a result, a long-awaited surge in energy prices at the beginning of 2023 is likely to be trimmed. The big unknown, when it comes to an impact on prices, comes from a minimum wage increase coupled with tax rebates households will be offered approximately since mid-February. To sum up, we think rates to be kept unchanged throughout 2023.

Poland: Inflation tracker #2 (unorthodox, additional measures)

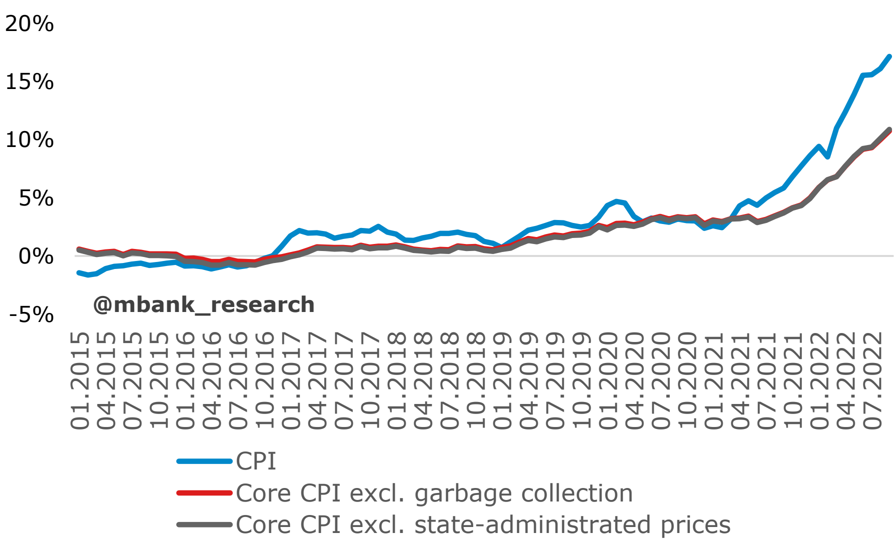
Goods and services prices (% y/y)*



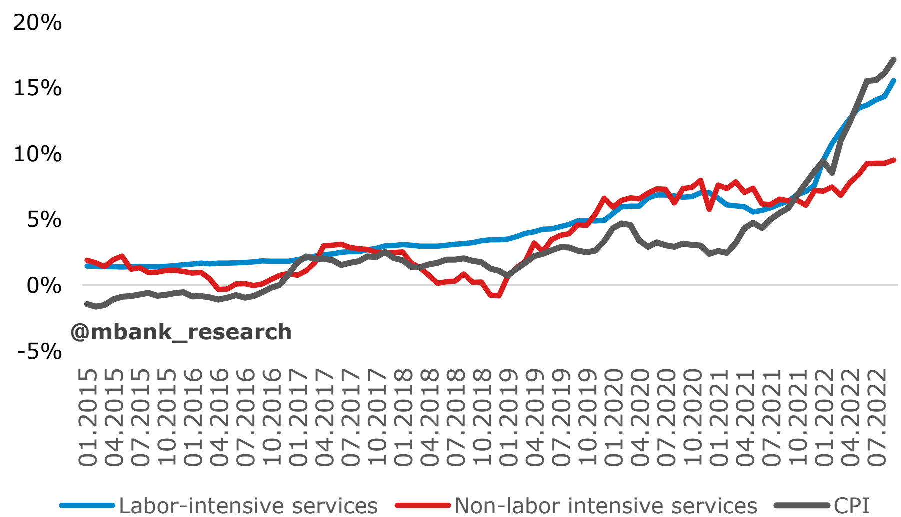
Food and fuel prices (% y/y)



Core inflation without garbage collection fees and without administrated prices (% y/y)



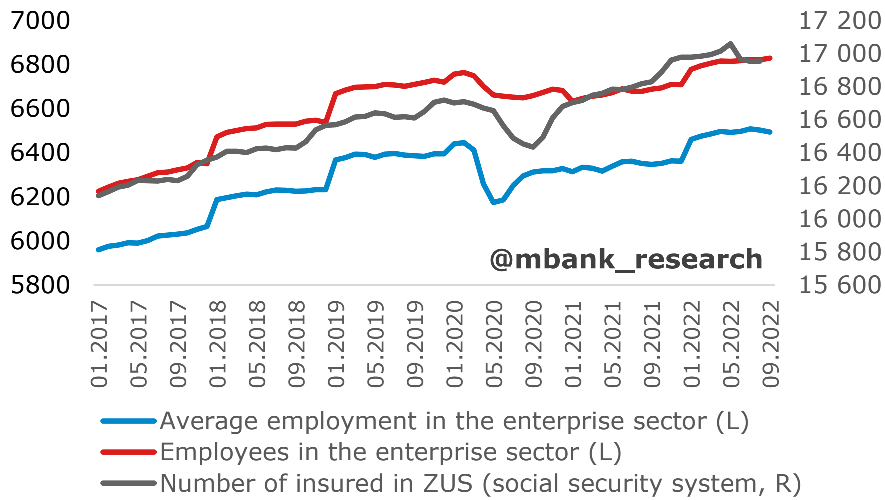
Services (% y/y)



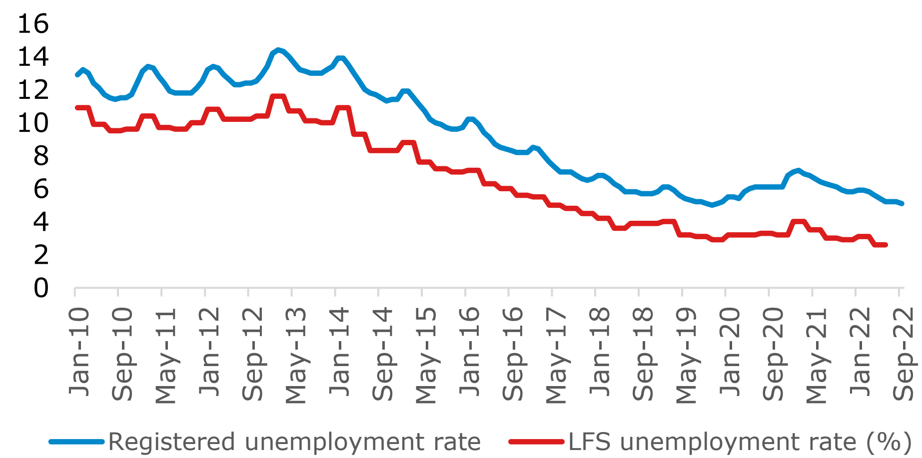
Source: Statistics Poland, own elaboration

Poland: Labor market tracker #1: Employment

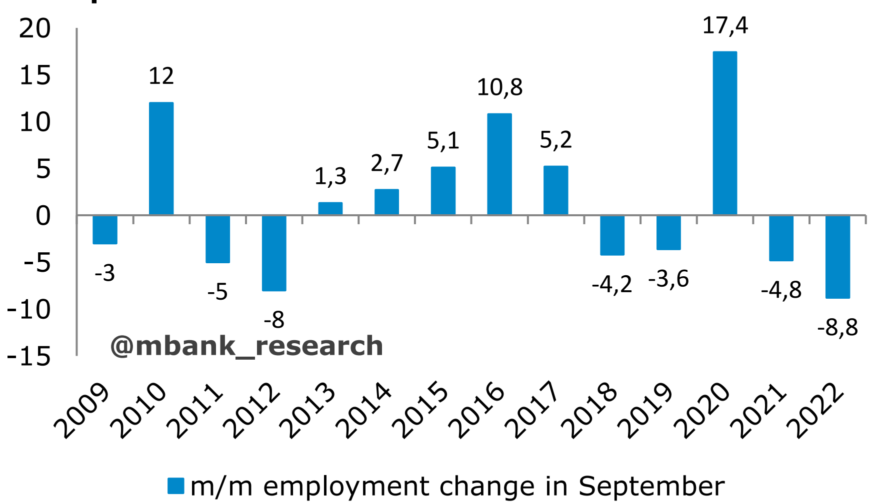
Employment



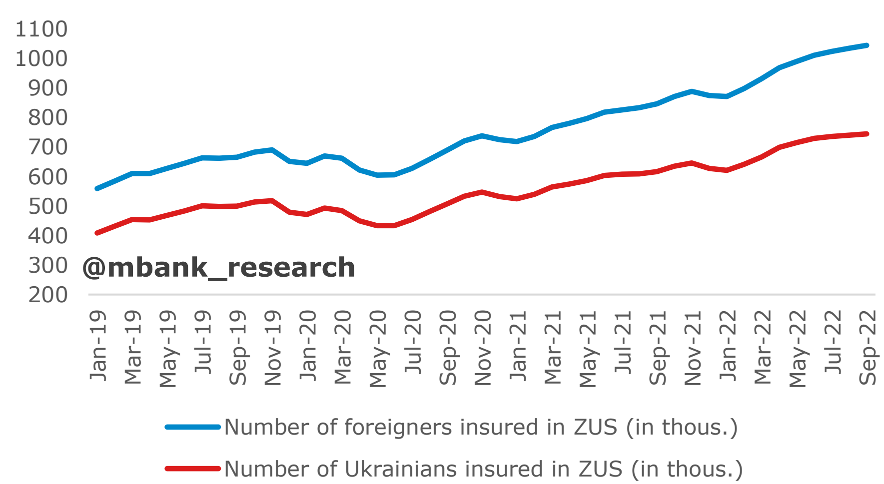
Unemployment rate



Monthly employment change (in thousand jobs), enterprise sector



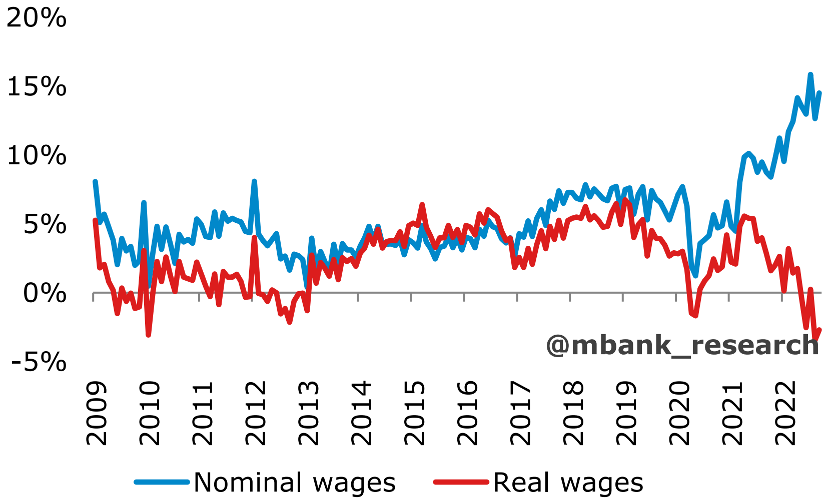
Immigration in the labor force



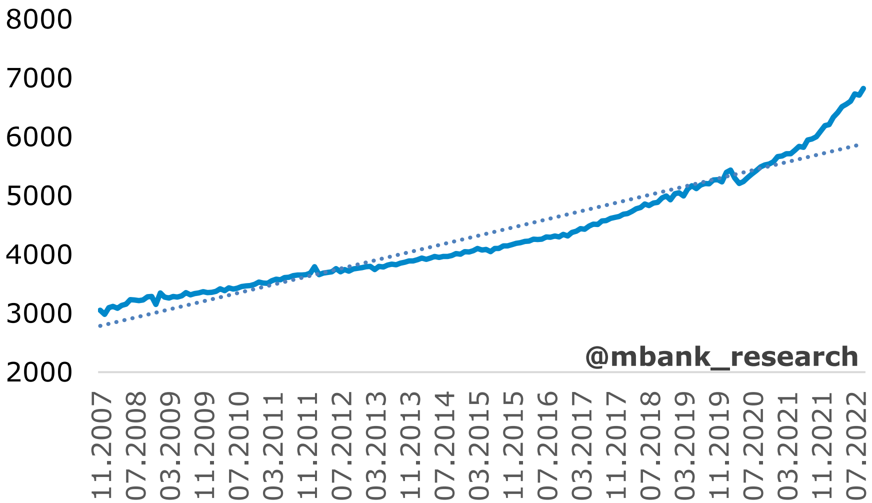
Source: Statistics Poland, ZUS Statistical Portal, own elaboration

Poland: Labor market tracker #2: Wages

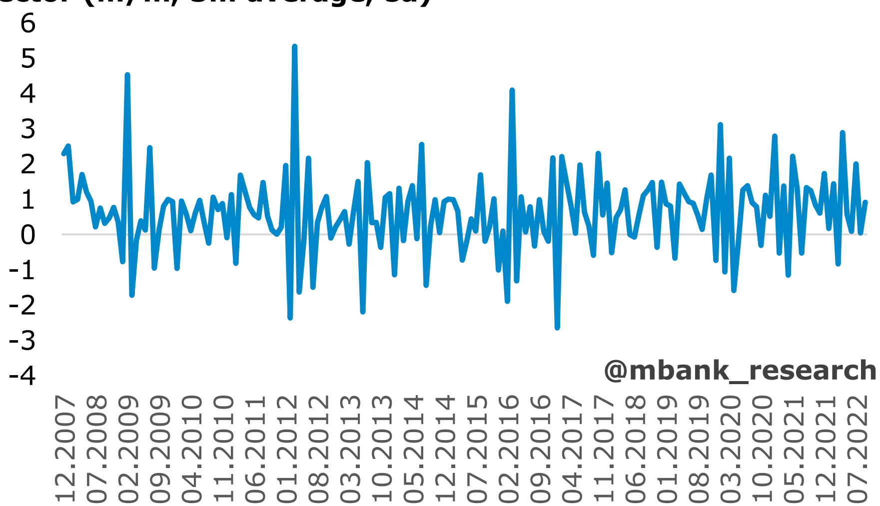
Wage growth (y/y, nsa)



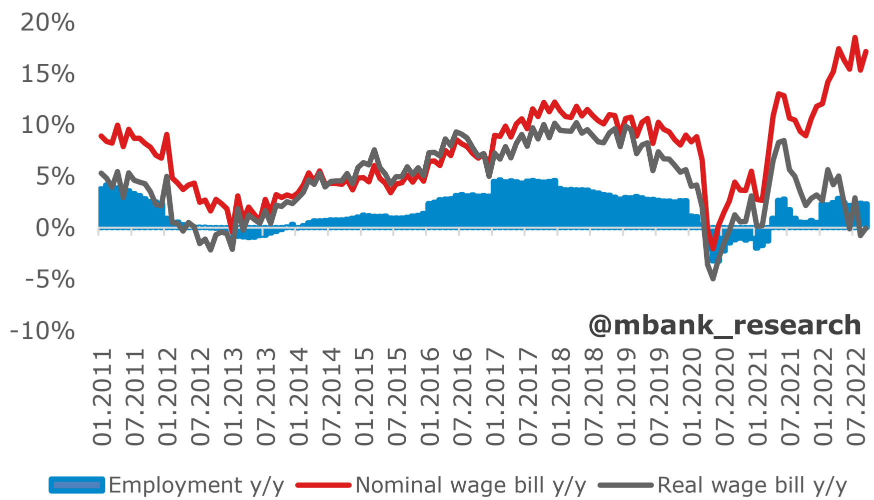
Average monthly wage in enterprise sector (in PLN, sa)



Momentum of average monthly wage in enterprise sector (m/m, 3m average, sa)



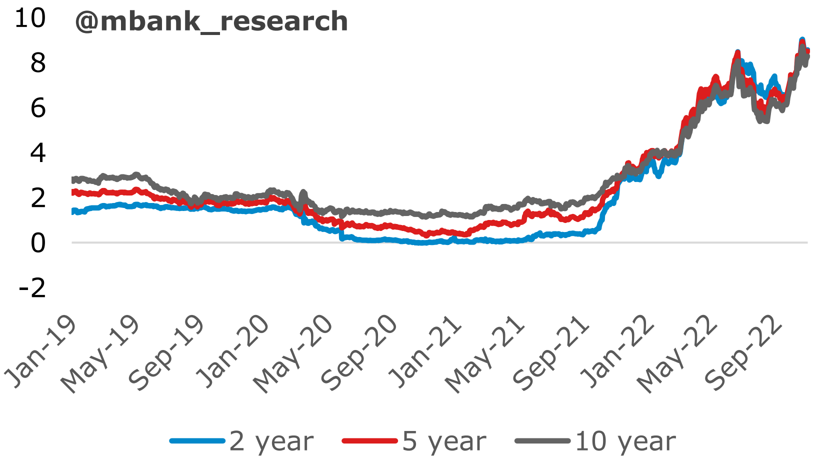
Wage bill



Source: Statistics Poland, ZUS Statistical Portal, own elaboration

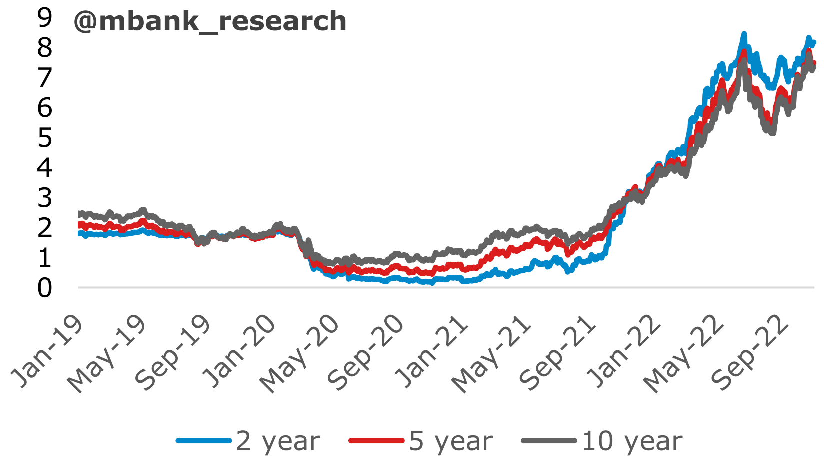
Polish rates, yields and spreads

POLGBs



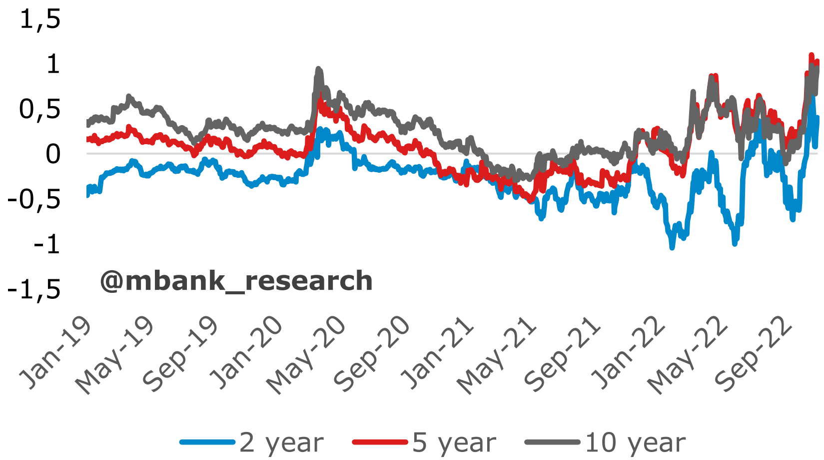
Source: Bloomberg

PL IRS



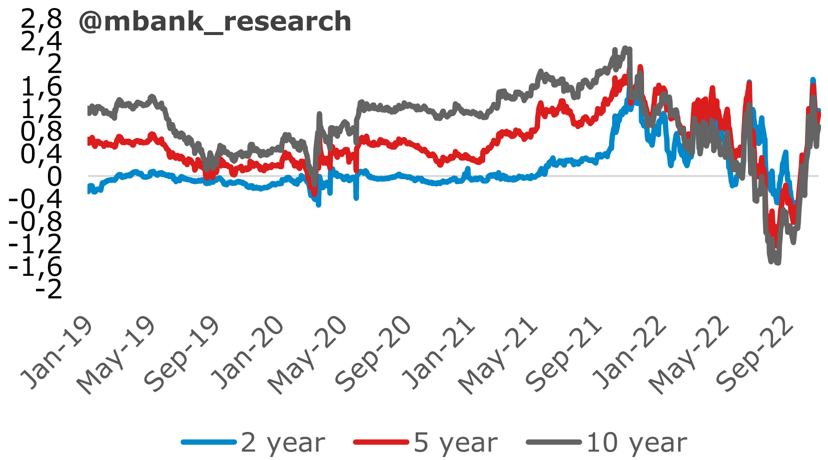
Source: Bloomberg

ASW spread



Source: Bloomberg

POLGB yield minus 3m WIBOR



Source: Bloomberg

Poland: Fiscal balance

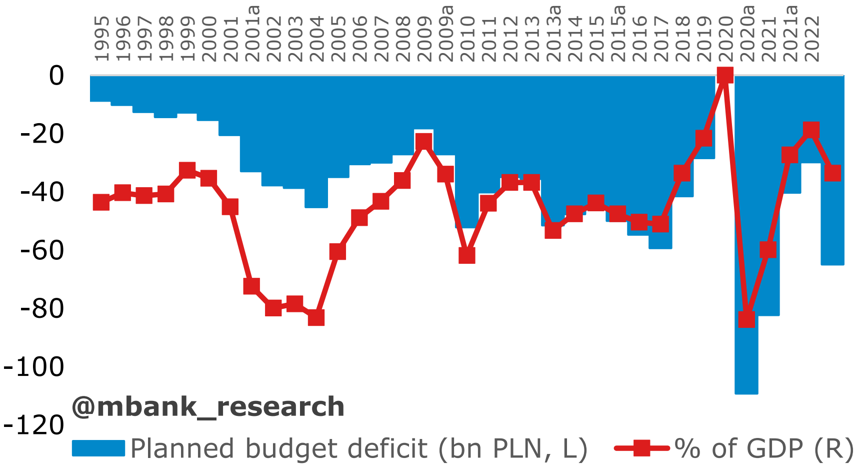
- Over the past weeks, the Ministry of Finance accepted the 2023 budget draft bill. There were no shifts regarding revenue and expenditure though. Thus, additional spending associated to the anti-inflation shield, very likely to be extended well into 2023, was not included. The same concerns increased spending on subsidies to energy companies after the government decided to cap electricity prices not only for households but also for micro, small and medium enterprises as well as local governments. The total cost of this project is estimated at around 43.9 billion PLN.
- Before accepting the bill, the government revised its plans regarding borrowing needs. As a result, net borrowing needs were increased to 110.5 billion PLN from 107.5 billion PLN, while gross needs were slashed to 260.7 billion PLN from 269.6 billion PLN. The structure of net borrowing needs and the associated changes seem to be even more interesting. Namely, the govt now expects to issue 14.2 billion PLN of fixed-rate bonds, meaning a sizeable upward revision from -4.6 billion PLN planned earlier (in net terms). The amount of FRNs issuance was also bumped up by 6.6 billion PLN to 34.4 billion PLN. While the assumed amount of retail bonds issuance was decreased notably by 16.4 billion PLN to 41.3 billion PLN. We pointed out in the last month that risks to retail bonds issuance were tilted to the downside.
- Moreover, we still see a downside risk as for the plan to issue over 41 billion PLN retail bonds next year. Our concerns were solidified by the result of September's sales of retail bonds which reached 2.3 billion PLN in net terms. On a YTD basis, retail bonds issuance (in net terms) has topped 45 billion PLN after September.
- Overall, given the lavish fiscal policy we still see an upside risk for the 2023 general government deficit. In our view, the 6-7% deficit seems possible vs. 4.5% assumed by the government. Finally, it is worth adding that according to the newest Eurostat fiscal notification, the general government deficit will reach 141.4 bilion PLN this year (4.6 – 4.7% of GDP). **Mitigants?** Energy prices are very dynamic. The lower the market goes the less costly will be the cap (lower deficit). Expenditures on military equipment and the construction of nuclear plants is set to be (maybe to substantial extent) financed via vendor financing schemes (lower issuance). It is hard to estimate income side of the equation with v. high nominal GDP growth (risks to the upside, lower deficit).
- Graphical summary of current fiscal data in next two slides (here and here).

Poland: External Balance

- October brought a tectonic shift in the Polish balance of payments owing to the massive revisions made by the NBP. The revision encompassed a 2004-2021 period. We have got numbers only from 2018 onward thus far. The NBP informed that it would be disseminating revised numbers for earlier years in upcoming months. What did we learn? It turned out that during 2018 and 2019 the Polish economy experienced a higher current account deficit than initially thought. It also means that an extent, to which Poland is dependent on foreign capital, is larger.
- Setting the revisions aside, current account deficit in August reached 4 billion EUR, meaning a much worse number than anticipated. Thus, the trends sketched out in previous months remain in place. While the twin deficit set-up is not favorable from the foreign investors' point of view, we expect that a slowdown in economic growth coupled with the weaker zloty will ultimately reverse the adverse trend in the BoP data. However, before it gets better, it is likely to get worse. Further fiscal expansion could also aggravate this trend.
- Graphical summary here.

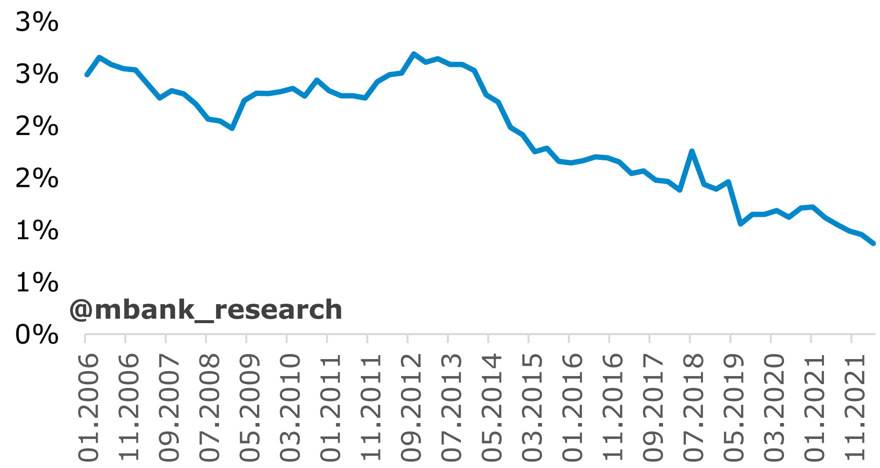
Poland: Fiscal monitor #1

Planned budget deficit



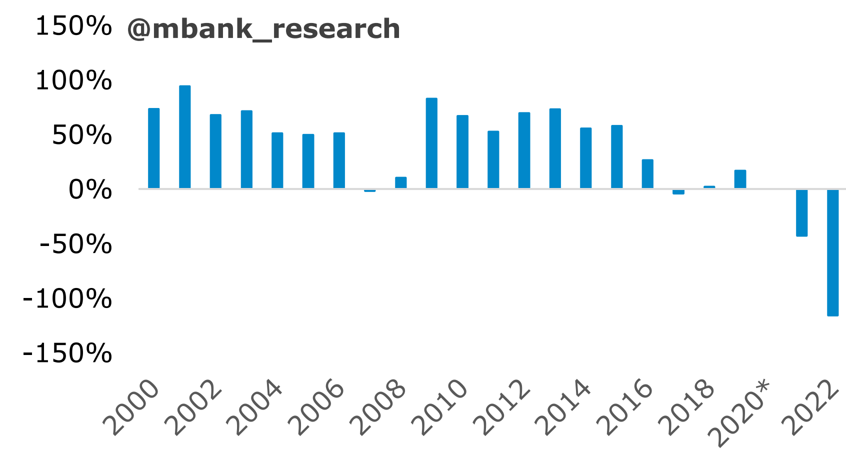
Source: Ministry of Finance, a – budget novel

State debt servicing costs (% GDP)



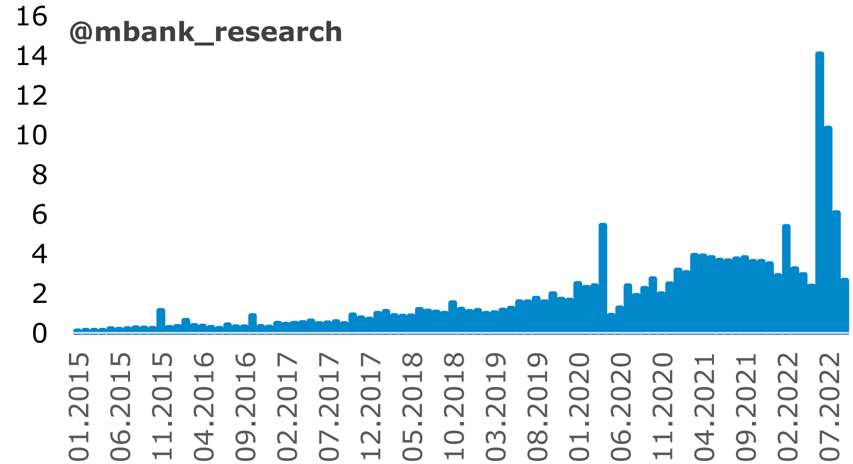
Source: Macrobond

Central budget deficit in August vs yearly planned deficit



*Source: Macrobond, * in 2020 there was 0 budget deficit planned, negative value means surplus*

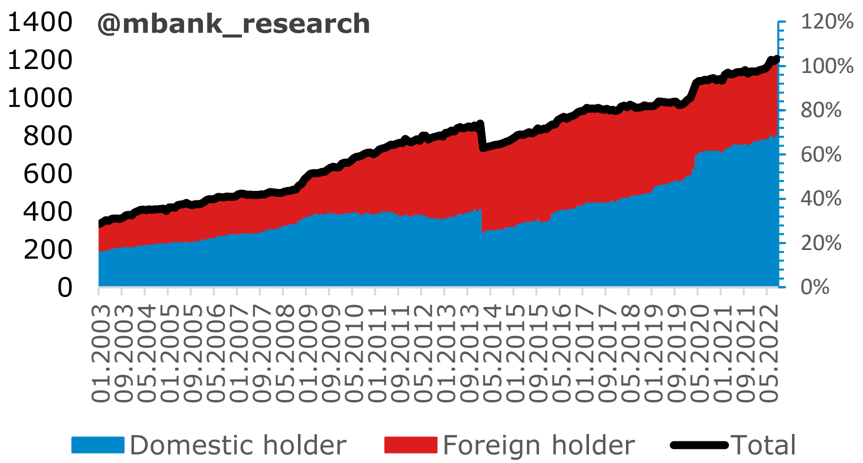
Retail bonds sold per month (PLN bn)



Source: Ministry of Finance

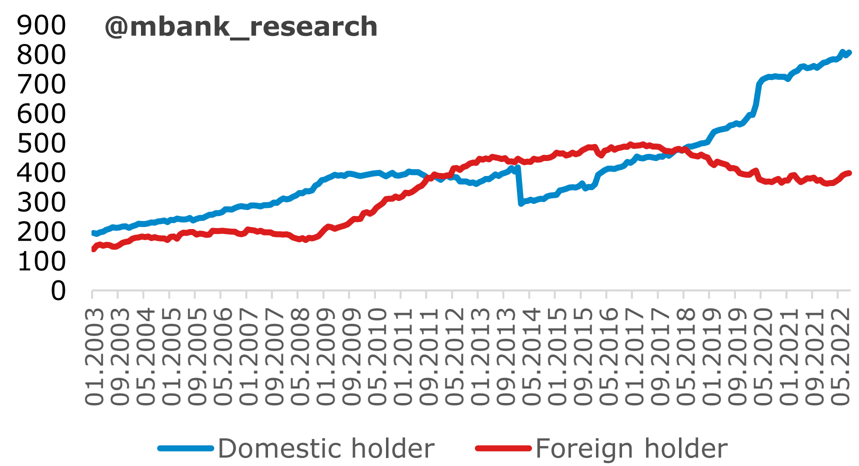
Poland: Fiscal monitor #2

State treasury debt by holder #1



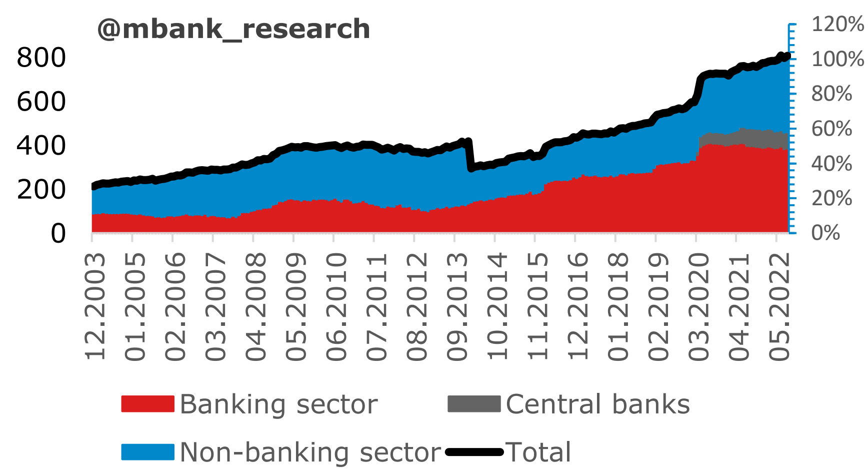
Source: Macrobond

State treasury debt by holder #2



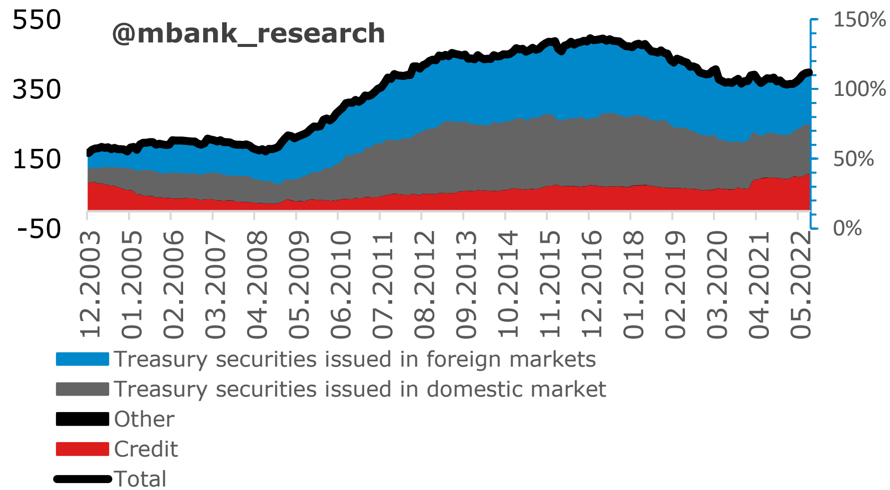
Source: Macrobond

State treasury debt – domestic holders



Source: Macrobond

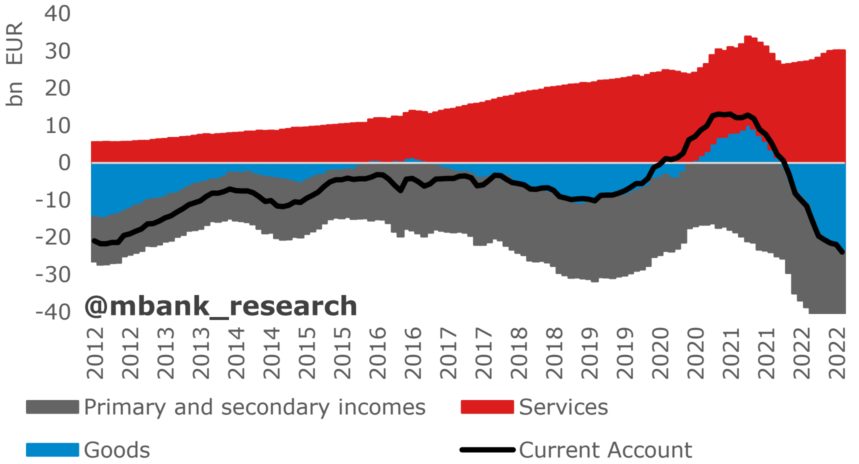
State treasury debt – foreign holders



Source: Macrobond

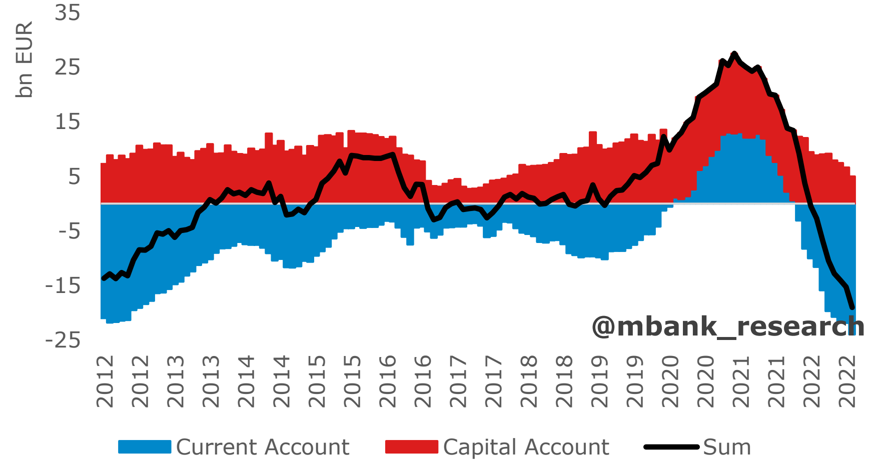
Poland: External balance

C/A decomposition – 12m rolling sum



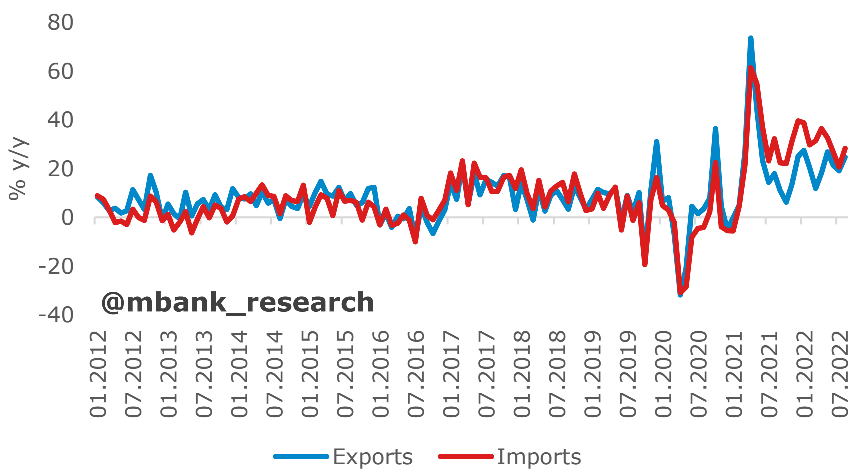
Source: NBP, own evaluation

Current and Capital Account – 12m rolling sum



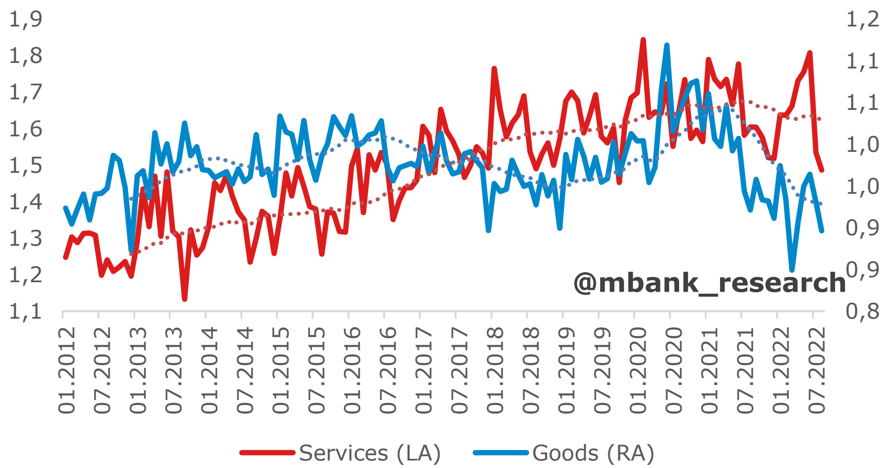
Source: NBP, own evaluation

Exports and imports dynamics



Source: NBP, own evaluation

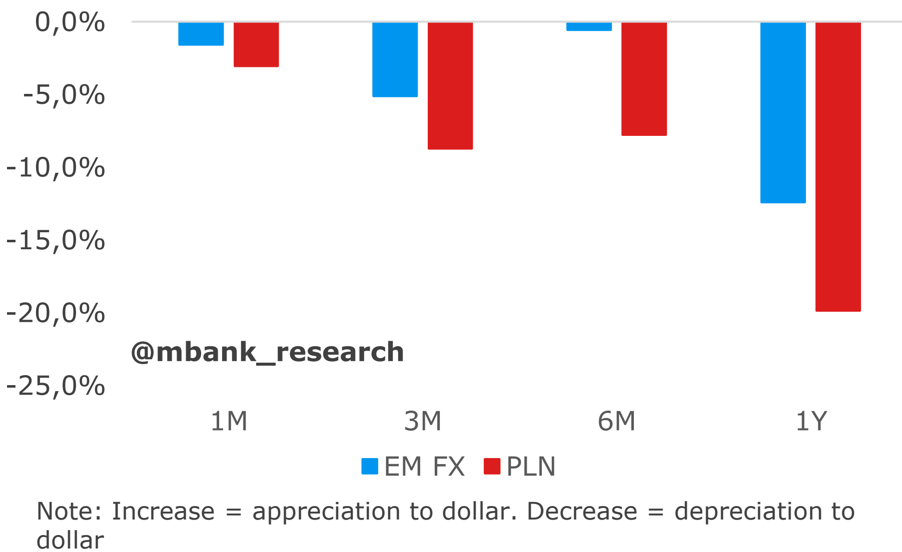
Exports to imports ratio



Source: Macrobond

EURPLN – still weak

Some weakening after previous slight appreciation



Source: Bloomberg

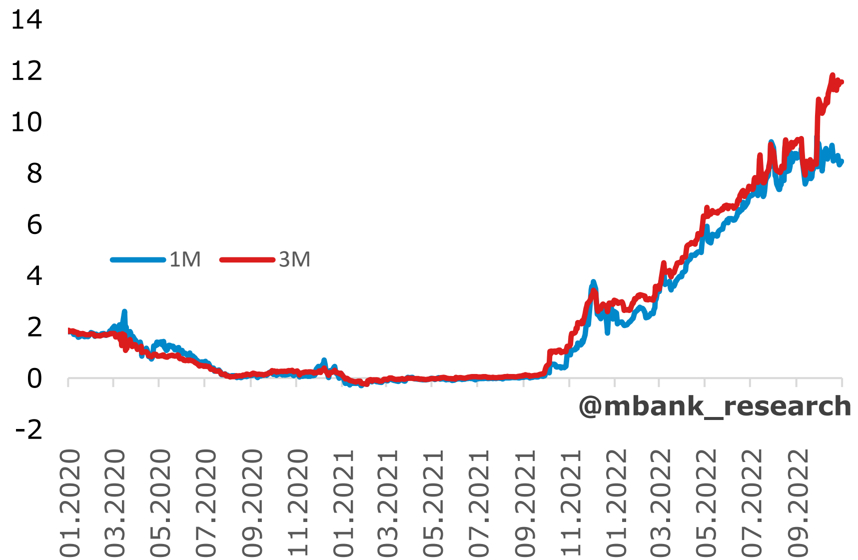
Real effective exchange rate (mind the dates)

Source: BIS

- The Polish zloty has seen a huge swing to the upside since the second half of September coinciding with a sell-off in the local bond market. The EURPLN reached almost 4.9 after subsiding back below 4.8 afterwards. It also worth noting that the aforementioned PLN sell-off came in the wake of another leg higher in the US dollar, reflecting a 'flight to safety' mode.
- On top of external factors, we also got two major domestic events which may have deepened the negative moves across FX and bond markets in Poland. The first one was halting interest rate hikes by the MPC in September, contrary to market expectations. This decision helped the yield curve steepen. A decrease in short-dated bonds yields did not help the zloty either. The second one was media revelations that Poland may see EU funds (not only money coming from the Recovery Fund but also from the Cohesion Policy) effectively frozen for longer. Although it has not been confirmed officially until then, it means that a bar for tapping EU funds at a larger scale can be set rather high. It does not bode well in the face of the deepening current account balance.
- In terms of Polish monetary policy, our base case implies rates on hold throughout the next year (6.75%). The scenario is highly conditioned on economic/inflation performance though. Unless the economic growth slows down materially, the MPC could renew monetary tightening. This is especially true if a new set of macroeconomic projections, set to reveal in November, shows no signs of reaching the inflation target in the foreseeable future.

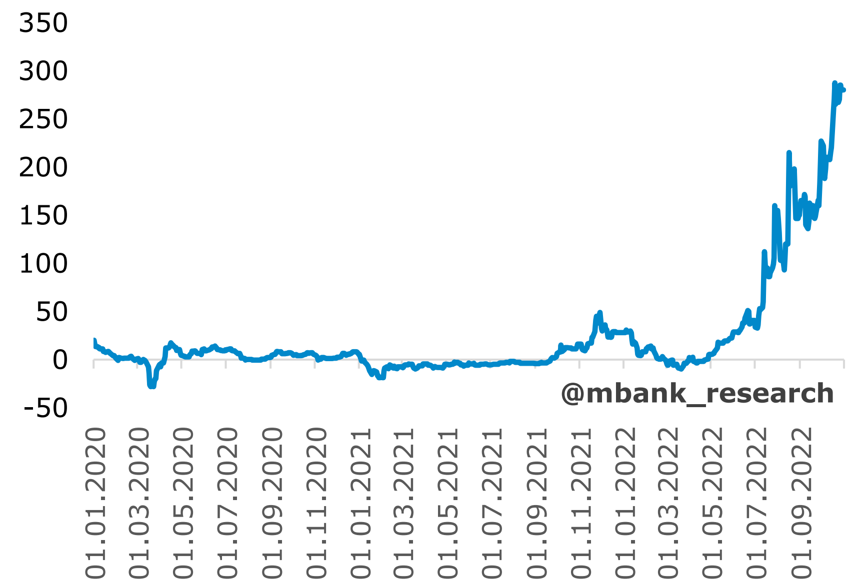
PLN financing cost is a double-edged sword

EURPLN implied yields (%)



Source: Bloomberg

EURPLN 3M1Y Basis Swap (bps)



Source: Bloomberg

- Financing cost in PLN has surged in recent months and nothing suggests that this shock is likely to subside anytime soon. It bears important ramifications for both FX and FI. On the one hand, it helps keep the PLN in check as the negative cost of shorting the zloty soars. On the other hand, it acts as an obstacle for the Ministry of Finance as it reduces Polish bonds' mojo in the eyes of foreign buyers. The second point is especially important given high borrowing needs.
- As per our analysis, the financing cost is driven by several factors: **1)** conversion of PLN retail deposits to FX deposits (the effective drain of PLN liquidity); **2)** PLN liquidity is unevenly split across banks **3)** huge take-up for retail bonds which has led to a decrease in banking liquidity in PLN; **4)** banks' demand for CHF (the effective sale of PLN) associated to provisions related to CHF mortgage loans; **5)** high borrowing needs of the Ministry of Finance – so-called war bonds are expected to be issued over the coming months (roughly 15 billion PLN only until the end of the year) which will obviously drain PLN liquidity even more.
- The Polish authorities seem to be now focused on the FX market rather than the bond market and possible related issues regarding high borrowing needs. This seems to be confirmed by suggestions from Pawel Borys, the governor of the Polish Development Fund, who said that „the low PLN liquidity is one of the priorities in order to keep the FX rate in check".

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