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Polish Weekly Review

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Comment on the upcoming data and forecasts

Manufacturing PMI for January is set to increase after December's setback, along with sharp increases in European indices published earlier. It also shouldn't be affected by recent turmoils in financial markets, as data has been gathered prior to the acute phase. The MPC meeting is unlikely to bring any new information. The Council might take note of stronger GDP growth but hawkish signals are unlikely (growth is not strong enough to warrant tightening soon). Finally, recent depreciation of the Zloty is not significant enough to influence the Council (see the Econ section for more discussion of the topic).

Polish data to watch: February 3rd to February 7th

Publication	Date	Period	mBank	Consensus	Prior
PMI manufacturing (pts.)	03.02	Jan	54.4	54.0	53.2
MPC rate decision (%)	05.02	Feb	2.50	2.50	2.50

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
52 Week T-bills	-	3000	3.485	3/4/2013
2Y T-bond OK0716	-	3000	3.087	1/23/2014
5Y T-bond PS0718	-	2400	3.474	1/23/2014
10Y T-bond DS1023	-	4000	4.348	1/23/2014
20Y T-bond WS0429	-	150	3.464	5/16/2013

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

Comment

Unchanged - GDP surprised to the upside but only marginally. Next week offers only one opportunity to move the index - the PMI.

* 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

- Available data confirm that the long-awaited recovery began at the turn of Q2/Q3.
- GDP growth accelerated to 3.0% in the final quarter of 2013. We are also bullish on 2014 and expect the Polish economy to grow by 3.5% (4% in the final quarter). Consensus view has been converging to our bullish scenario.
- The upswing has recently been driven by exports that behaves much better than in previous upswing episodes (Polish economy is more competitive and more geografically diversified). Consumption has already joined and we see no obstacles for its further, gradual strenghtening. We expect the support from investment activity to kick in more substantially at the start of 2014. Private investment is to be supported by receding uncertainty, public investment is to benefit from new EU co-financed projects.
- Pension reform, along with the political cycle, opens room for fiscal stimulation. We expect significant fiscal stimulus from 2014 onwards, focused mainly on public infrastructure spending and fueled by the relaunch of EU funding. Thus, 2-3 years of solid economic growth are our baseline scenario.
- Inflation stays subdued for the next few months supporting stable NBP rates. We see potential for upside surprises in 2014, though.
- We expect first rate hikes to materialize in late 2014 as we believe that NBP projections of both GDP and inflation for 2014 are too pessimistic and an upward sloping inflation path should eventually result in tightening.

Financial markets

- Despite recent rise, correlation of Polish bonds with other EM countries ought to be much lower than in the past. At the end of the day, Poland should be seen rather as a satellite state of the euro zone, not a typical EM. That is why we see current uptick on yields as artificial and temporary.
- Liquidation of OFE's bond portfolios changes the structure of Polish debt funding (higher percentage of foreign investors and possibly lower market liquidity). Thus, Polish bonds are set the be more than ever exposed to global trends. The mid term upward trend in yields (globally and locally) is not going to be linear, creating at least some possibilities to catch correction/stabilization phases. One of them, given the substantial rise in yields along the whole curve connected with risk-off phase, may be ensuing now given the fact that MinFin and NBP are prepared to smooth aberrations resulting not only from changes in the structure of debt but also from non-differentiating basket sale of EMs.
- Zloty should gradually strengthen on the back of cyclical recovery in Poland. However, current disruptions may temporarily weigh negatively on the Zloty as basket sell-off (all EMs) proceeds. Any depreciation is unlikely to be deep (as in the "Fragile Five") as Poland's fundamentals are comparably strong (record low CA deficit, high real rates, low short-term foreign debt, etc.). Let's not forget about the possibility of NBP interventions should things get out of line with reason.

mBank forecasts

	2009	2010	2011	2012	2013F	2014F
GDP y/y (%)	1.6	3.9	4.5	1.9	1.6	3.5
CPI Inflation y/y (average %)	3.5	2.8	4.3	3.7	0.9	1.7
Current account (%GDP)	-1.6	-4.5	-4.9	-3.5	-1.7	-2.3
Unemployment rate (end of period %)	12.1	12.4	12.5	13.4	13.4	13.0
Repo rate (end of period %)	3.50	3.50	4.50	4.25	2.50	3.00

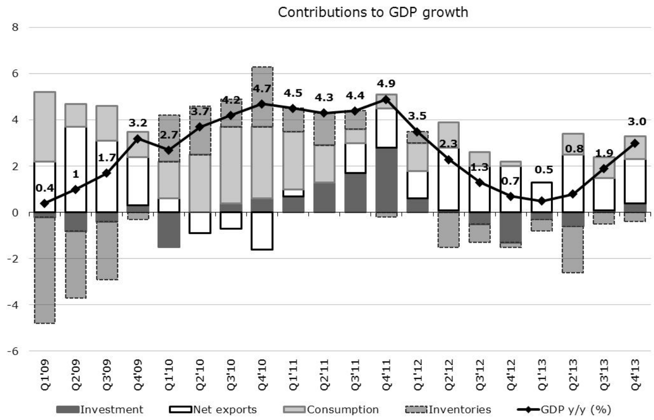
	2013 Q1	2013 Q2	2013 Q3	2013 Q4 F	2014 Q1 F	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.5	0.8	1.9	3.0	3.1	3.3	3.5	4.0
Individual consumption y/y (%)	0.0	0.2	1.0	2.0	2.5	2.5	2.5	2.8
Public Consumption y/y (%)	-0.1	4.3	1.7	1.2	2.0	2.0	2.0	3.0
Investment y/y (%)	-2.1	-3.2	0.6	1.3	4.5	5.9	7.1	8.0
Inflation rate (% average)	1.3	0.5	1.1	0.8	1.2	1.7	1.6	2.4
Unemployment rate (% eop)	14.3	13.2	13.0	13.4	13.9	12.6	12.4	13.0
NBP repo rate (% eop)	3.25	2.75	2.50	2.50	2.50	2.50	2.50	3.00
Wibor 3M (% eop)	3.39	2.73	2.67	2.71	2.65	2.65	2.65	3.20
2Y Polish bond yields (% eop)	3.19	3.07	3.06	3.05	3.10	3.10	3.20	3.25
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.30	4.50	4.80	5.00
EUR/PLN (eop)	4.18	4.33	4.22	4.15	4.15	4.10	4.05	3.95
USD/PLN (eop)	3.26	3.32	3.12	3.02	3.11	3.21	3.24	3.25

F - forecast

Economics

2013 GDP above expectations, sharp acceleration in Q4.

GDP grew by 1.6% in 2014 (expected 1.5%). Although this is a deceleration in terms of full-year figures (vs. 1.9% in 2012), it is the trajectory that matters most, not the average. While 2012 was the year of declines, GDP growth kept accelerating throughout 2013: we started the year with a meagre 0.5% y/y only to end it with an impressive 3.0% y/y (estimate based on annual figure) in the last quarter. Let us analyze the trajectories of all components. Household consumption accelerated from 0.0% y/y to ca. 2.0%, gross fixed capital formation ended the year with a 1.3% increase (-2.1% in Q1). The latter is actually the only main expenditure category that accelerated in 2013 (-0.4% vs. -1.6% in 2012). The behavior of residual categories is curious. While a slightly higher contribution of inventories is not a surprise (a procyclical variable, after all), the fact that net exports (anticyclical) contributed almost 2 pp. to headline growth is puzzling. Perhaps it is a measurement issue, however, positive surprises in domestic demand indicate that net exports is still driven by strong external demand and exports continues to support the domestic upswing.



We expect these positive tendencies to continue in the next quarters. Consumption is supported by rising wages, tighter labor market, a marked improvement in consumer sentiment and - a non-trivial factor - low debt service costs (a byproduct of loose monetary policy). Investment is set to increase on supply constraints which might have occurred in the previous quarters (or even years), as enterprises largely refrained from investing. The fact that the recent downturn barely managed to make a dent in capacity utilization is a strong confirmation of that scenario. We stand firm by our baseline scenario of a 3.5% growth in 2014 with an upward trajectory of subsequent quarterly releases.

Even though the surprise is small, the economy is growing faster than NBP's analysts and the MPC are inclined to believe. This factor, along with inflation accelerating and reaching the target by year end, should lead to rate hikes in Q4. Recent turmoil on EMs has a miniscule (or zero) chance of translating into emergency tightening (what Turkey and South Africa already did and what the market is apparently forcing Hungary and Russia to do). For one, the impact of recent PLN depreciation on inflation is no more than 0.1 pp. (within measurement error). Two, the MPC has never compensated higher risk premia by raising rates. FX interventions have always been the preferred instrument and, judging from the most recent attempt in June '13, are considered to be successful. In this context, the extent to which the Polish FI market has sold off might seem excessive - foreign investors are betting that the Polish MPC will wear someone else's shoes.

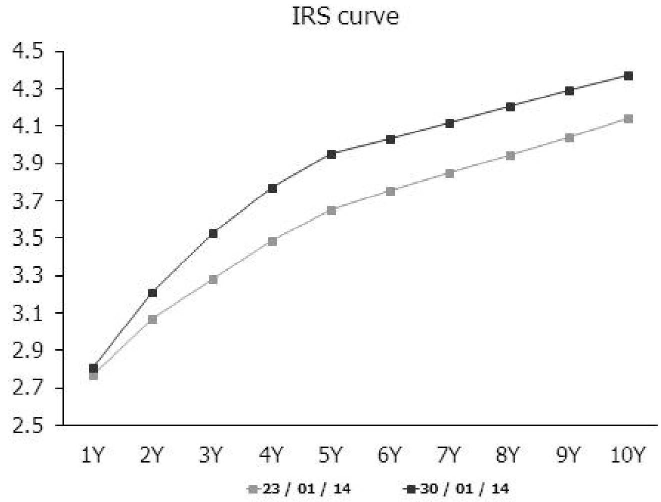
Fixed income

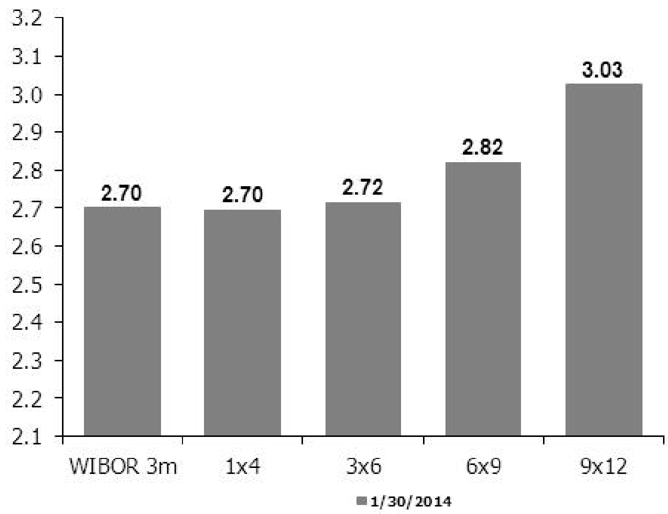
Blood on the trade floor

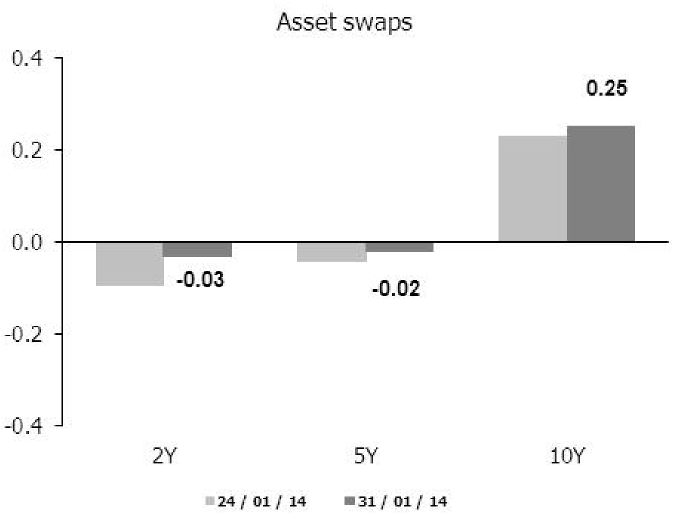
It was supposed to be a calm week with stable bids on bond market. Low inflation in Poland, German Bund performed nicely, pension funds prepared to give bonds to MinFin, but... Turkish bonds got slaughtered. Fed did taper QE by 10bln monthly (widely expected). Market sentiment changed rapidly, aggressive investors were caught on the wrong foot and started to sell in panic. Stop losses pushed the market lower. As a result DS1023 yield went up from 4.35% to 4.70%.

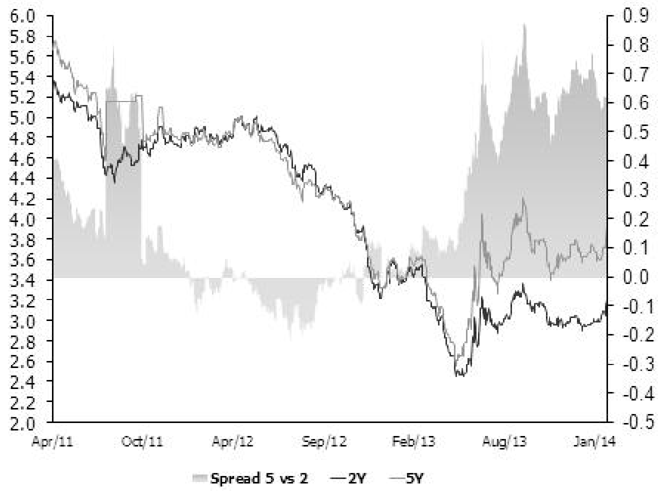
What's next? With local Pension Funds out of the market we are left with foreign investors' leading role on the fixed income market. They follow global sentiment so feel free to guess what mood next week is going to be.

Recommendation: Sell DS1023 position, if you haven't already.





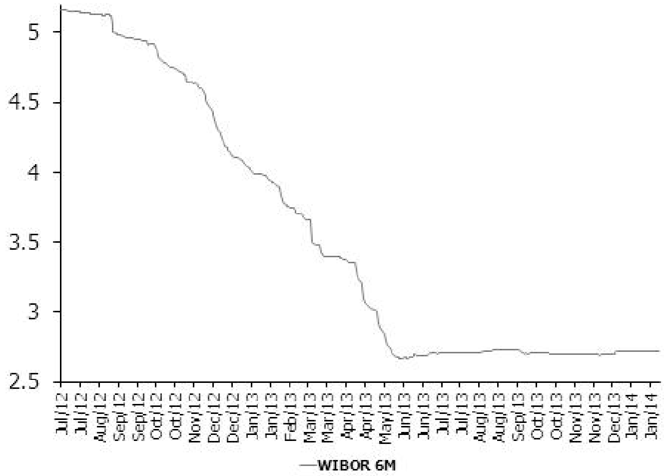


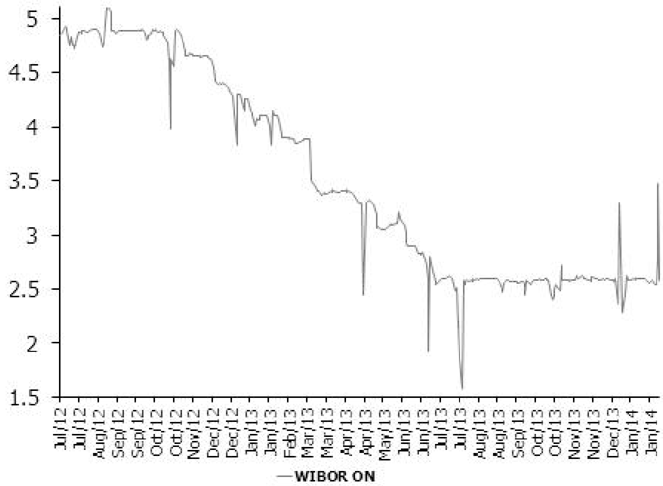


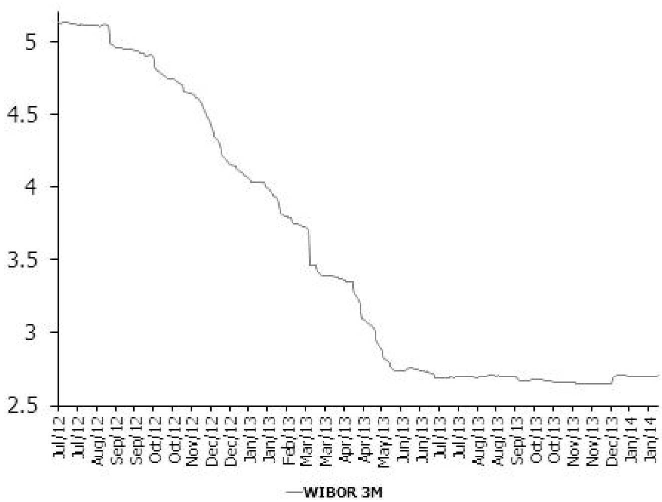
Money market

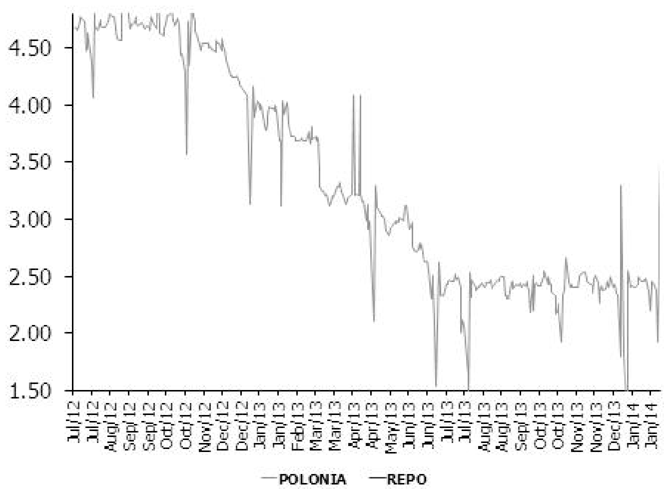
Crazy week Crazy week behind us. After underbid Friday OMO (124 vs 127.5) Polonia fell to 1.9% on Monday. As we expected, the Central Bank made an additional OMO that extremely squeezed the cash market for 3 days pushing Polonia rate to 3.53% on Thursday as additionally that was the last day of reserve.

Our expectation for next weeks is to sell short Polonia (1W/1M) as it should be cheap after last week's disaster. On the longer end sell 1Y Polonia at 2.59/2.61, wait until it falls to 2.50 and then buy it back.





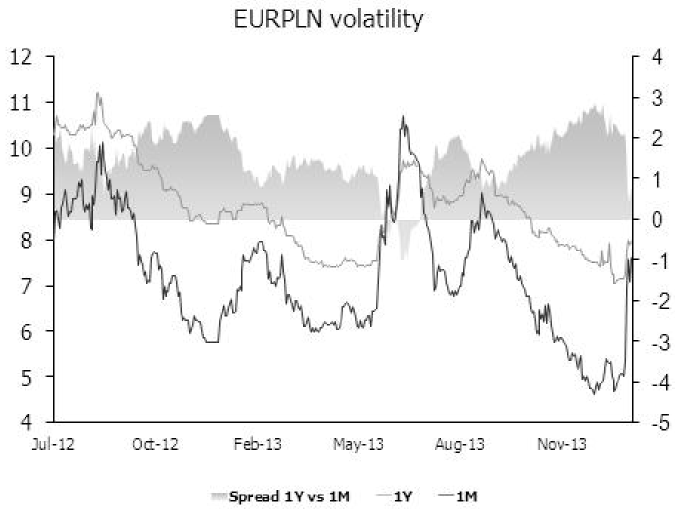




Forex

PLN sell-off, volatility is back The market sentiment changed from bad to worse. The moves in emerging markets have already been severe. EUR/PLN finally managed to break the 4.25 resistance (4.2620 high so far) but the market was far from panic. We think EURPLN will settle down this time, and we see a return to 4.2 as most likely. Anyway, the global sentiment is a core driver of PLN.

Shot higher Volatilities on the zloty blasted higher for a second week in the row, a very rare thing in the last months. The frontend, namely EUR/PLN 1 month ATM jumped higher by 2.5% in comparison to last week and was paid at (!!!) 9.75% on Friday. The mid and the end of the curve both shot up by 1.25% to 8.65% (6 month) and 8.75 (1 year). The skew is better bid by roughly 1.5% along the curve. 3m 25RR jumped from 1.3% to 3.0%. The currency spread (difference between USD/PLN vol and EUR/PLN vol) was the same as week before.

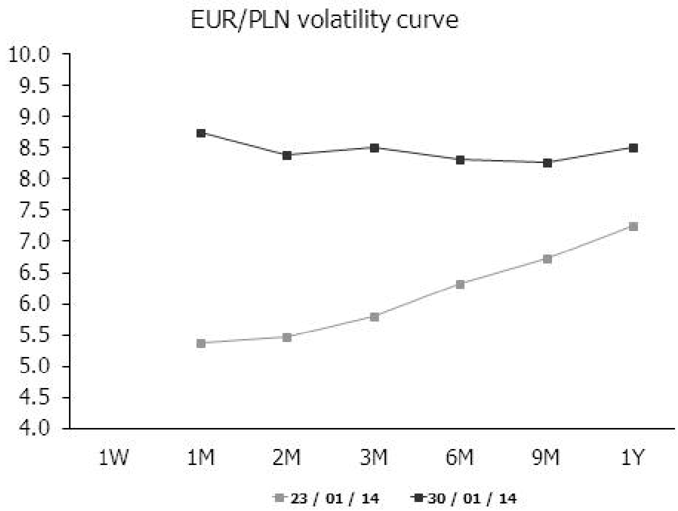


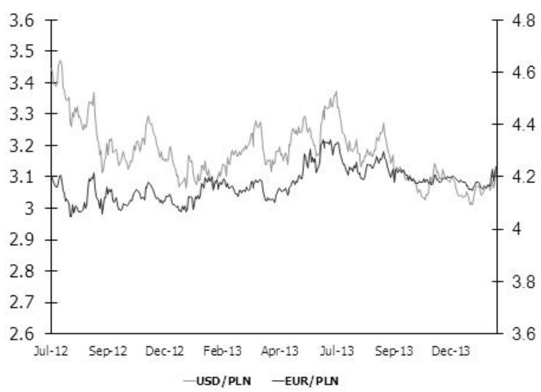
Short-term forecasts

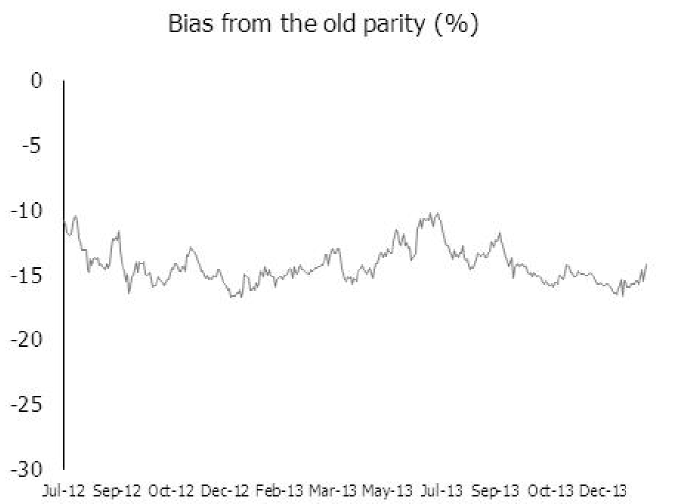
SPOT Main supports / resistances:
EUR/PLN: 4.1800 / 4.2800
USD/PLN: 3.0000 / 3.2000

Hold long USD/PLN The long on USD/PLN from 3.04 is still on. We are moving our stop to 3.09 and now hoping to see USD/PLN above 3.18. If EURPLN slides back to 4.2 level we are also ready to tactically buy it with stop 4.18 and hopes for revisiting 4.26. We are not calling it a "new crisis", at least not yet, but we think the range will move up and simply get wider.

Buy vega on dips The wild upswing in Vol was shocking in its magnitude. Short term realized volatility shot up significantly! The EUR/PLN 1 week realized vol jumped from around 3.5% to almost 10.0%. If the realized volatilities stay that high we can have the next leg higher in XXX/PLN vol space. We look for a correction/consolidation to show the bid for Vega but in general our preferred tenors are in the backend. In such volatile environment it might be sensible to have also positive position in gamma.







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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
1/27/2014	2.57	2.70	2.68	2.62	2.88	2.65	2.71	2.71	2.76	2.93	3.11	2.87
1/28/2014	2.53	2.70	2.63	2.62	2.85	2.65	2.71	2.71	2.75	2.89	3.08	2.84
1/29/2014	2.47	2.70	2.59	2.62	2.81	2.65	2.71	2.71	2.79	2.98	3.19	2.90
1/30/2014	2.61	2.70	2.73	2.62	2.92	2.65	2.70	2.72	2.82	3.03	3.30	2.92
1/31/2014	2.61	2.71	2.73	2.63	2.92	2.66	2.70	2.72	2.82	3.03	3.30	2.92

Last primary market rates							
Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
52W TB	3/4/2013	8/28/2013	98.33	3.49	3000	7324	3084
OK0716	1/23/2014	7/25/2016	92.70	3.09	3000	4087	3375
PS0418	1/23/2014	4/25/2018	101.00	3.47	2400	3160	2440
DS1023	1/23/2014	10/25/2023	97.25	4.35	4000	5290	4125

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
1/27/2014	2.650	2.784	3.085	3.050	3.730	3.754	4.195	4.496
1/28/2014	2.650	2.792	3.050	3.080	3.710	3.701	4.170	4.432
1/29/2014	2.650	2.854	3.155	3.151	3.805	3.843	4.245	4.526
1/30/2014	2.650	2.544	3.210	3.179	3.950	3.931	4.375	4.628
1/31/2014	2.660	2.544	3.210	3.179	3.950	3.931	4.375	4.628

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
1/27/2014	7.58	7.53	7.50	8.00	8.00	2.72	0.72
1/28/2014	7.08	7.19	7.33	7.90	7.90	2.72	0.72
1/29/2014	7.60	7.40	7.40	7.95	7.95	2.85	0.73
1/30/2014	8.75	8.50	8.33	8.50	8.50	3.30	0.74
1/31/2014	8.75	8.50	8.33	8.50	8.50	3.30	0.74

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
1/27/2014	4.2291	3.0884	3.4520	3.0112	1.3805	0.1536
1/28/2014	4.1827	3.0635	3.4065	2.9713	1.3755	0.1522
1/29/2014	4.2155	3.0829	3.4348	2.9947	1.3766	0.1532
1/30/2014	4.2365	3.1166	3.4663	3.0480	1.3561	0.1538
1/31/2014	4.2368	3.1288	3.4644	3.0509	1.3609	0.1540

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