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Polish Weekly Review

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Comment on the upcoming data and forecasts

Week begins with the release of the latest NBP's Inflation Report. Although the outline of the projection has already been made public in the MPC's statement on Wednesday (see the Economics section), the whole report will include much more details as well as description of underlying assumptions. CPI probably increased in February - despite still low food and fuel prices, low statistical base in the Communications section leads to a marked increase in core CPI. M3 slightly accelerated in February on top of base effects in certain categories, as household deposits stabilized. Transfer of assets from pension funds into the state pension fund probably neutral from the point of view of the broad supply.

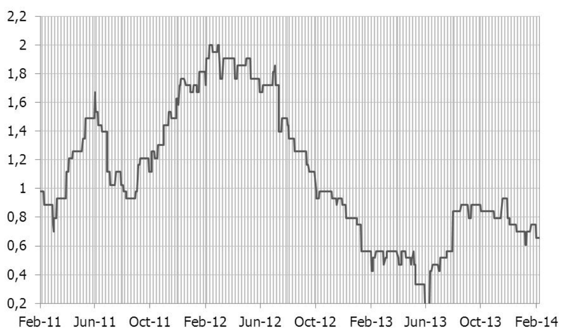
Polish data to watch: March 10th to March 14th

Publication	Date	Period	mBank	Consensus	Prior
Inflation Report	10.03	Mar			
CPI y/y (%)	14.03	Feb	1.1	0.8	0.8
M3 y/y (%)	14.03	Feb	5.9	5.4	5.5

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	-	3500	3.066	3/6/2014
5Y T-bond PS0718	-	2000	3.882	2/13/2014
10Y T-bond DS1023	-	2000	4.541	2/13/2014
20Y T-bond WS0429	-	150	3.464	5/16/2013

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



Comment

Slightly up after the PMI. Thus, the trend is still horizontal. CPI print, with large variability of estimates, offers the best chance for upward surprises next week.

* 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).

mBank.pl

Our view in a nutshell

Fundamentals

- Available data confirm that the long-awaited recovery began at the turn of Q2/Q3. The upswing is going to be continued.
- However, the events in Ukraine made us put a slight downside risk to our near term forecasts in a form of a short soft patch. We therefore flattened GDP growth path in H1 and assume a catch up thereafter. Therefore we are still 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 strengthening. 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 re-launch of EU funding. Thus, 2-3 years of solid economic growth are our baseline scenario.
- Inflation stays subdued for the next few months supported by a possibility of lower meat prices.
- MPC has already acknowledged low inflation and possible negative spillovers from Ukraine events. As a consequence forward guidance has been strengthened – that practically means stable rates till the end of the year. Possibility of rate hikes is going to come back to the agenda no sooner than when soft patch is over and inflation reaccelerates. This pins down the start of discussion on hikes at late 2014. We forecast NBP rates to stay flat in 2014. Normalization of monetary policy in a form of rate hikes is going to start in 2015.

Financial markets

- Liquidation of OFEs' bond portfolios changed the structure of Polish debt funding (higher percentage of foreign investors and possibly lower market liquidity). Thus, Polish bonds are set to be more than ever exposed to global trends.
- Local factors still speak in favor of Polish bonds including a continuation of positive credit story and Poland's status a regional safe haven. Poland is seen as a satellite of euro zone, not a typical EM. Therefore it can absorb part of funds originally re-directed from EMs to Europe (cross-over investors set to generate marginal demand). Stable rates and low inflation only support such equilibrium. However, we are at the moment neutral on Polish bonds due to global factors including the indolence of ECB and possibility of an end of mixed-data period in the U.S.
- Zloty should gradually strengthen on the back of cyclical recovery in Poland. However, basket sell-offs (all EMs) might temporarily weigh negatively on the Zloty. 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	2013	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	1.4
Current account (%GDP)	-1.6	-4.5	-4.9	-3.5	-1.5	-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	2.50

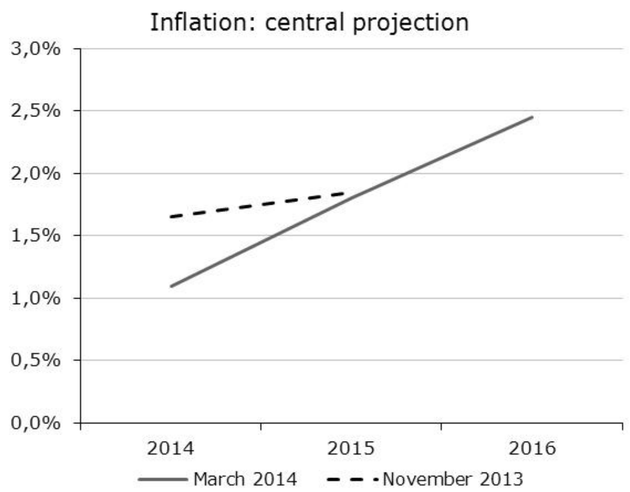
	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1 F	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.5	0.8	1.9	2.7	3.0	3.1	3.6	4.3
Individual consumption y/y (%)	0.0	0.2	1.0	2.1	2.3	2.6	2.8	3.1
Public Consumption y/y (%)	-0.1	4.3	1.7	2.1	2.0	2.0	2.0	3.0
Investment y/y (%)	-2.1	-3.2	0.6	1.3	3.8	5.3	7.5	8.5
Inflation rate (% average)	1.3	0.5	1.1	0.8	1.0	1.5	1.2	2.0
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	2.50
Wibor 3M (% eop)	3.39	2.73	2.67	2.71	2.65	2.65	2.65	2.65
2Y Polish bond yields (% eop)	3.19	3.07	3.06	3.05	3.00	3.00	3.10	3.10
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.30	4.30	4.80	5.00
EUR/PLN (eop)	4.18	4.33	4.22	4.15	4.15	4.10	4.05	4.00
USD/PLN (eop)	3.26	3.32	3.12	3.02	2.97	2.96	2.94	2.97

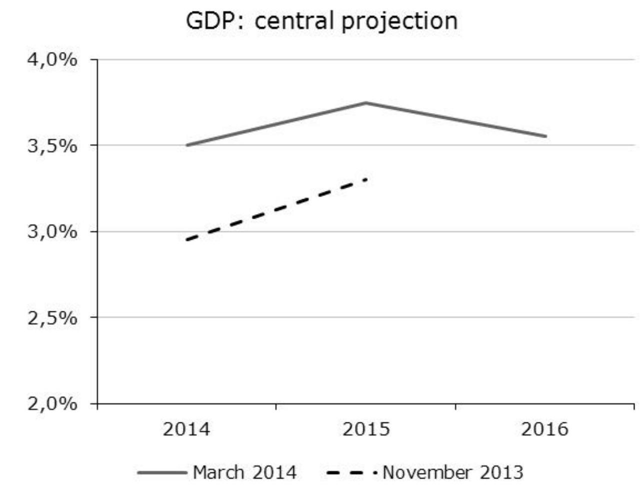
F - forecast

Economics

The MPC sees no need to raise rates

In line with expectations, the MPC did not change interest rates during this week's meeting (main reference rate steady at 2.5%). The Council has extended its forward guidance and now expects that rates will remain unchanged until the end of the third quarter, adding that the period might actually be even longer. The statement contains new, very dovish wording: „interest rates should be kept unchanged for a longer period of time". Granted, Belka distanced himself from the possibility of further cuts but: (1) questions about cuts were not particularly catchy; (2) some members of the MPC might support a cut.





Such an approach to monetary policy is justified by the latest inflation projection, once again showing a completely inflation-free recovery (its results alone preclude any rate hikes even in 2015). In line with our expectations, despite higher growth forecasts (NBP's central tendency for 2014 is now identical to our forecast of 3.5%), CPI reaches the central bank's target only in late 2016 and average inflation for 2016 is still below target. Despite positive assessment of business climate (slight acceleration in credit was explicitly mentioned), the press conference was dominated by downside risks from the Ukrainian turmoil. Estimates of negative growth impact of these events cited by Belka amounted to 0.2-0.4 pp. very similiar to ours but there is a lot of uncertainty regarding the estimates and the negative scenario itself. We are under the impression that Ukraine (and a possible soft patch in the upswing phase of Polish business cycle) was the pivotal factor that affected MPC's perception and supported the dovish wing (that already has the advantage in numbers).

As for the perspectives of monetary policy, we are focused on the possible soft patch in the Polish recovery. It is a novel element and still has the potential to affect the path of interest rates. The more so since we don't know how the situation on the East is finally resolved and Belka was silent on the potential impact of a recession in Russia on Polish exports. Thus, we now believe that rates will remain on hold throughout the entire 2014 (such scenario was put forth immediately after the events on Ukraine and Crimea). In current situation, where bond yields might continue to be relatively low amid strengthening PLN, the second part of our macroeconomic scenario for 2014 (economy accelerating after a soft patch, strong fundamentals of Polish economy, tightening labor market and higher inflation at year end) might affect market valuations only in a few months, after the US slowdown is over and uncertainties regarding the dangers to Polish exports abate.

Ukraine and Russia still carry a significant portion of risk

The first phase of conflict between Russia and Ukraine (or Russia versus the west if you wish) is slowly deescalating. The use of force seems less likely now, diplomacy sets in and various political scenarios can be considered. But it is in our opinion too early to send an "all clear" signal. Since we do not really know how the situation is going to unfold, we still focus on risks whose impact we try to assess basing on actual data and anecdotal evidence we got so far. The major message is twofold. 1) Exogenous trade problems in Ukraine and accelerated slowdown in Russia can generate a small soft patch in the Polish cycle at the turn of Q1/Q2 2014, to be overcome in H2. Trade links coincided with a possibility of extension of an embargo on Polish pork exports to Russia (and to China). The latter might translate into lower inflation path. The real risk here lies not really in the slowdown in the eastern economies involved but the possibility (vague but still) of bilateral trade sanctions. 2) The possibility of a patchier GDP trajectory has already influenced MPC and to a large extent triggered an earlier extension of forward guidance, practically till the end of the year (more on this - see the piece on MPC). Since a lot is priced in and the ECB failed to deliver, we suspend (at least tactically) our call for overweighing long bonds. Maybe we will be interested in later stage when valuations turn relatively more attractive.

Trade and business links. When we first approached the subject, we concentrated on bilateral trade linkages between Poland and Ukraine. Such an analysis should be widened to include a risk from Russia's slowdown (recent issues can make it faster via higher rates and currency depreciation) and indirect linkages through the links of Ukraine and Russia to the German economy. We present the results (in terms of negative value, as measured by the percentage of Polish GDP) with a breakdown into direct and indirect links considering various slowdown scenarios in Russia and Ukraine.

Direct effect

Slowdown of Russian Imports (%)	Slowdown of Ukrainian Imports (%)								
	5	10	15	20	25	30	40	50	100
5	0,2	0,3	0,4	0,5	0,6	0,7	0,8	1,0	1,9
10	0,4	0,5	0,6	0,7	0,7	0,8	1,0	1,2	2,0
15	0,6	0,7	0,7	0,8	0,9	1,0	1,2	1,3	2,2
20	0,7	0,8	0,9	1,0	1,1	1,2	1,3	1,5	2,4
25	0,9	1,0	1,1	1,1	1,2	1,3	1,5	1,7	2,5
30	1,0	1,1	1,2	1,3	1,4	1,5	1,6	1,8	2,7
40	1,4	1,5	1,5	1,6	1,7	1,8	2,0	2,1	3,0
50	1,7	1,8	1,9	1,9	2,0	2,1	2,3	2,5	3,3
100	3,3	3,4	3,5	3,6	3,6	3,7	3,9	4,1	4,9

Indirect effect

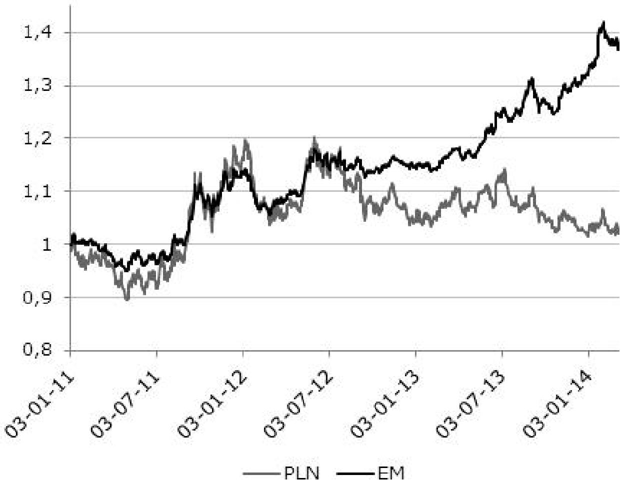
Slowdown of Russian Imports (%)	Slowdown of Ukrainian Imports (%)								
	5	10	15	20	25	30	40	50	100
5	0,0	0,0	0,0	0,0	0,0	0,0	0,1	0,1	0,1
10	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1
15	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,2
20	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,1	0,2
25	0,1	0,1	0,1	0,1	0,2	0,2	0,2	0,2	0,2
30	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2
40	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,2	0,3
50	0,3	0,3	0,3	0,3	0,3	0,3	0,3	0,3	0,3
100	0,5	0,5	0,5	0,5	0,5	0,5	0,6	0,6	0,6

Total effect

Slowdown of Russian Imports (%)	Slowdown of Ukrainian Imports (%)								
	5	10	15	20	25	30	40	50	100
5	0,3	0,4	0,5	0,5	0,6	0,7	0,9	1,1	2,0
10	0,5	0,6	0,6	0,7	0,8	0,9	1,1	1,3	2,2
15	0,6	0,7	0,8	0,9	1,0	1,1	1,3	1,5	2,4
20	0,8	0,9	1,0	1,1	1,2	1,3	1,5	1,6	2,5
25	1,0	1,1	1,2	1,3	1,4	1,5	1,7	1,8	2,7
30	1,2	1,3	1,4	1,5	1,6	1,7	1,8	2,0	2,9
40	1,6	1,7	1,8	1,9	1,9	2,0	2,2	2,4	3,3
50	2,0	2,0	2,1	2,2	2,3	2,4	2,6	2,8	3,7
100	3,8	3,9	4,0	4,1	4,2	4,3	4,5	4,6	5,5

Under the most plausible scenario assuming a moderate slowdown of Russian and Ukrainian demand (considering indirect effects) the negative effects calculated only from exports side shall not exceed 0.6-0.8pp. However, we penciled in only a moderation in GDP trajectory in our baseline since we get more and more anecdotal evidence that labor market is tightening (supporting consumption), private investment activity is rising (leasing demand on the upside!) and the pipeline for public investment is being filled even more quickly than we thought.

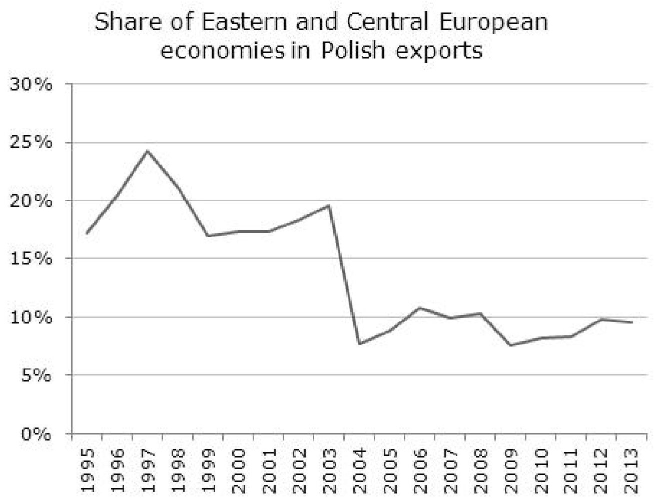
Uncertainty. Having said that we have to at least mention the risks that escape quantitative analysis. First of all we cannot really estimate the negative effects of zloty's appreciation against regional peers and its relative strength in the whole EM universe (see the graph below). Consider, however, that over the past year Polish zloty rose by 28% against the Turkish lira, by 23% against the Russian ruble and by ca. 20-30% against the Ukrainian hryvnia. It is too early to write about foregone market shares but the blow to financial results of companies operating on EMs can be felt in the coming months. We feel that this may be felt more in the valuations of companies on the stock exchange than impose any meaningful, economy-wide effects (mind that the corporate sector has large financial buffers), since the exposure of Polish companies in terms of FDI on Ukraine and Russia is rather small with relation to GDP (EUR 800 mln in Ukraine, and around EUR 1bn on Russia).



There is also a problem concerning trade that does not can be easily transferred on numbers and hangs as a big unknown. We dub it business location problem. Many firms built their factories in Ukraine to use it as a gateway to Russia since so far the customs on trade between Russia and Ukraine were negligible what cannot be said about duties on Polish eastern border, being at the same time the frontier of European customs union. In case of any further tensions between Ukraine and Russia, duties can be imposed. They will be introduced if Ukraine decides (recent developments suggests it is the path that will be followed) to tie more closely with EU drifting towards a trade union. And here comes another delicate issue. Since Poland was very active in negotiations between Ukraine and EU, it may be unwelcome by the Russian authorities which would make the life of Polish companies harder in Russia. In such a scenario Polish firms loose in Ukraine and in Russia. Of course linking Ukraine with UE in a form of free trade area is going to lead to positive trade-creation effects but this is a medium-term scenario whereas we concentrate on short-term risks.

Food prices. The uncertainty concerning business sanctions imposed on Russia may be fuelling downside pressure on prices of meat. So far the embargo on exports Polish red meat to Russia has been conditional on African swine fever. Under the same reasoning also the Chinese market has been recently closed for Polish pork. One does not really need an overly imaginative mind to conclude that such an embargo may continue as retaliatory measure from Russia's (and closely related China's) side, especially given the very active role Poland is playing in a process of ”stealing” Ukraine from the Russian sphere of influence. Between February and March, pork prices in Poland dropped by almost 10% lowering the path of food prices at least in the first half of the year (poultry is a close substitute for red meat and their prices can be highly correlated especially given the prospective overhang of pork supply).

A repeat of 1998 unlikely. Such an uncertainty on corporate side may negatively weigh on sentiment indices. That is why we think that e.g. PMI has reached a local maximum and this is going to be consistent with as small patch in Polish cycle in H1. However, given the reduction of Polish trade links with the east (see the graph) a significant reaction in GDP is not our base case. Moreover, it is not very likely that we are going to see a financial meltdown this time, at least not in Ukraine. Leaving the possibility of business sanctions, European leaders would do anything to ”steal” Ukraine from Russia, therefore financial aid may be disbursed more quickly and under lesser conditionality.



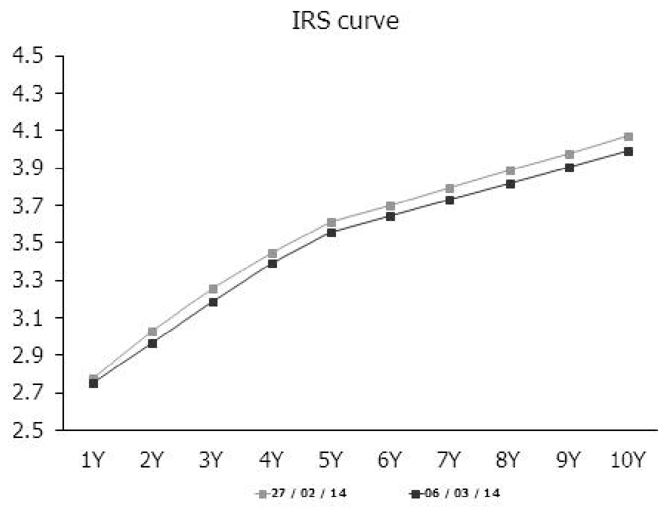
Fixed income

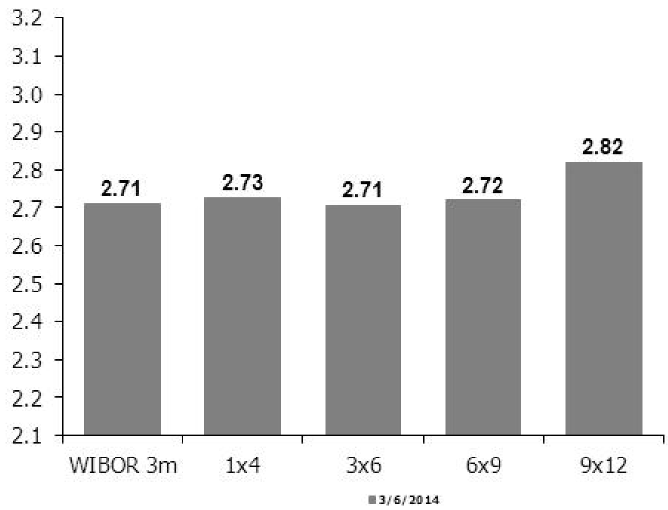
Keep calm?

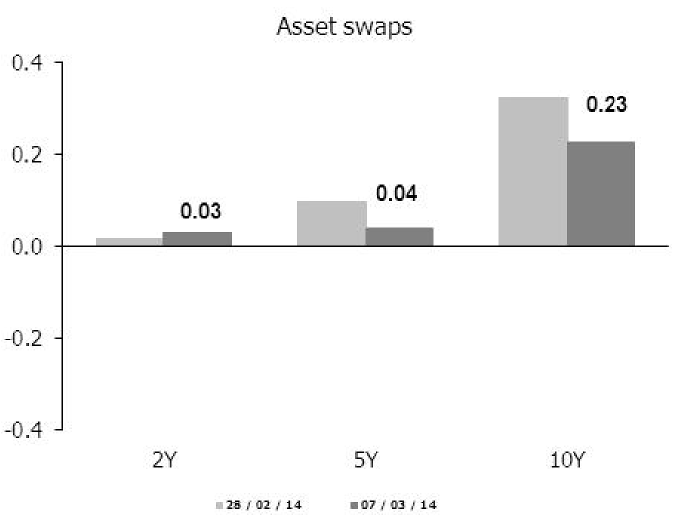
Polish Fixed Income market was massively caught on a bad position. Investors betting on POLGBs' weakness, because of the Russian-Ukrainian conflict, were surprised by MPC press conference. The MPC not only extended forward guidance to Q3, but also warned that crisis in Ukraine is going to decrease our CPI and lower economic growth.

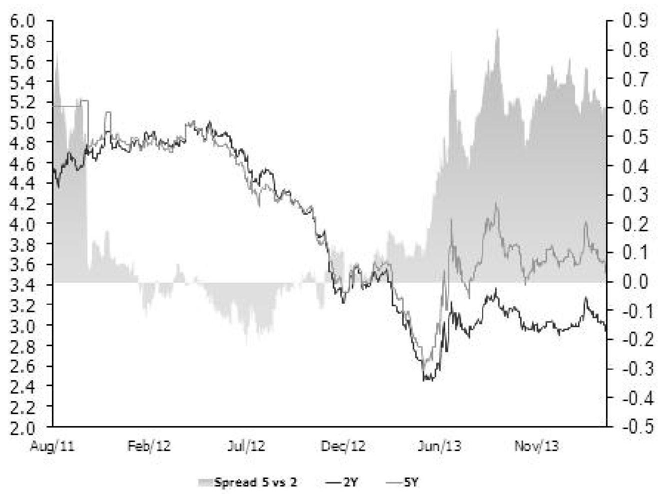
Yields of DS1023 fell from 4.35 down to a record low 4.13 and are trading now around 4.20. Ironically, while market started to believe that we should be totaly calm while trading POLGBs, we advice short position. After the recent rally the Minfin is going to be happy selling long end bonds on a switching auction. We can't see many real buyers of this sector, so expect yields to go higher yet again.

Recommendation: Sell DS1023 (yield 4,22) ahead of the auction, profit taking at 4.38, S/L 4.18.





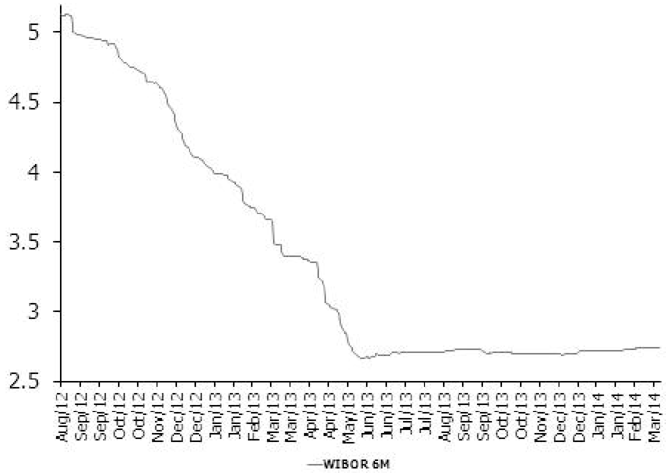


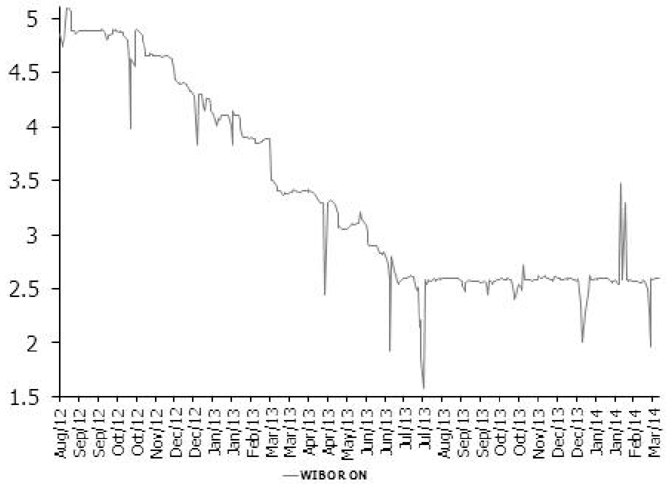


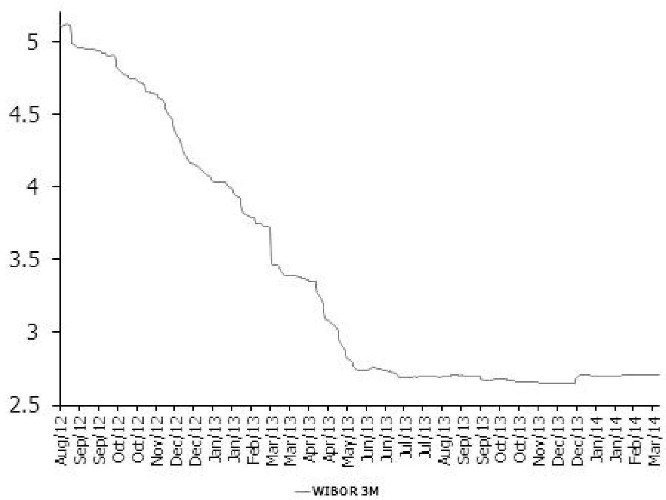
Money market

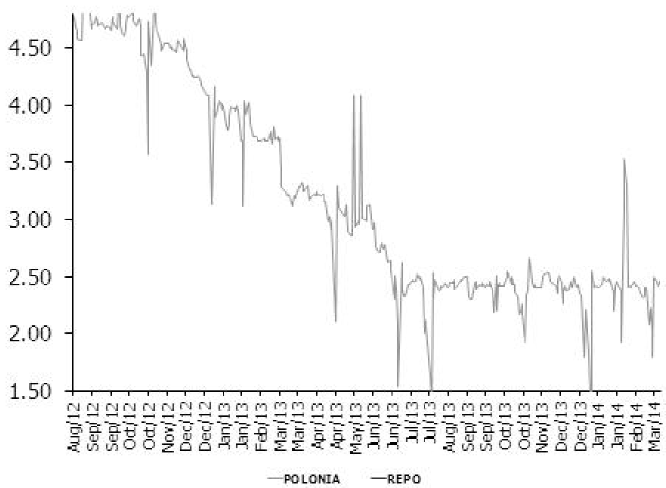
Back to square one Stable beginning of new reserve period. Polonia fluctuated between 2.40 and 2.50 as last OMO was just a bit underbid. Next week should be the same as the Central Bank offered just enough money bills to square the market.

After the last MPC conference, rates came back to levels from the beginning of the year. Our recommendation now is buy 1Y Polonia at 2.43 – 2.46 and 9x12 at 2.80.









Forex

Still in range We had a spike in EUR/PLN last week to 4.2275 on the back of Ukraine crisis. It was quickly corrected as situation „deescalated", and we are right back in the middle of the range. The ECB produced a choppy price action but well contained in the 4.17 / 4.19 range. Better then expected NFP were a reason for slight PLN weakening as tapering fears are coming back. The bigger picture is unchanged: we are in the 4.16/4.24 range with Ukraine being the additional risk factor.

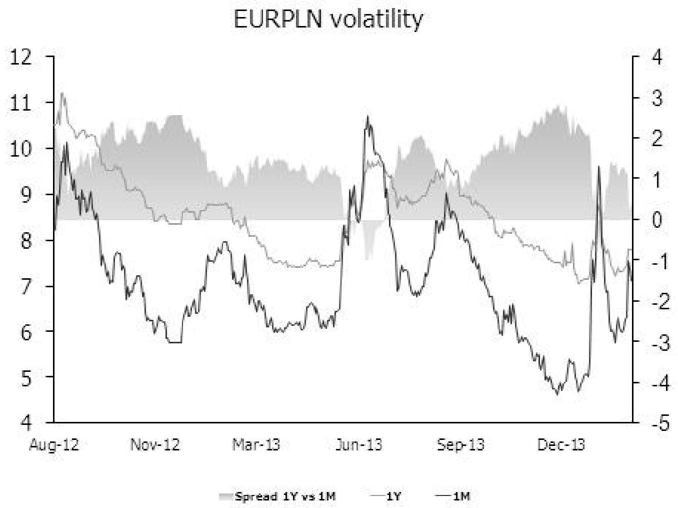
Vols higher Volatility curves are higher due to geopolitical risk with Ukraine. It's most likely going to stay till the situation clarifies. The 1 month EUR/PLN ATM mid is today 6.5% (0.5% higher), 3 months EUR/PLN are 6.7% (0.5% higher) and 1 year is fixing at 7.6% (0.1% higher). The skew is also supported as a result.

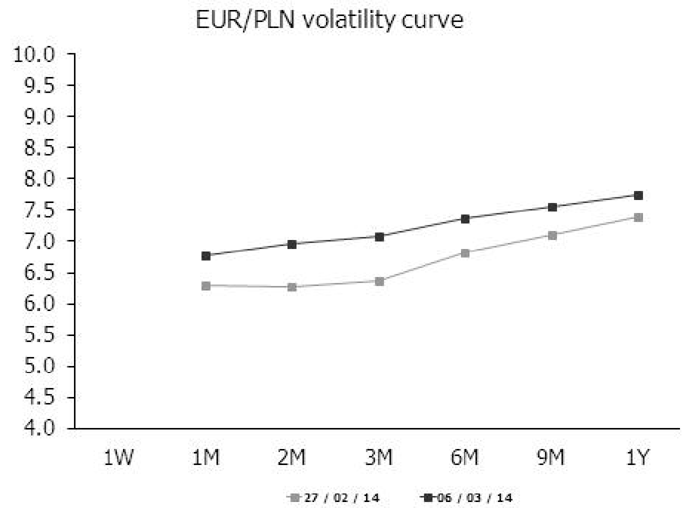
Short-term forecasts

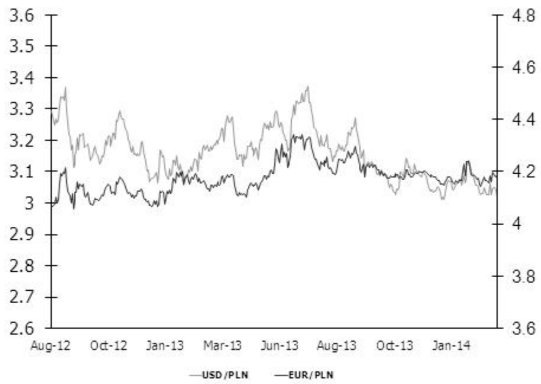
SPOT Main supports / resistances:
EUR/PLN: 4.1400 / 4.2400
USD/PLN: 3.0000 / 3.1500

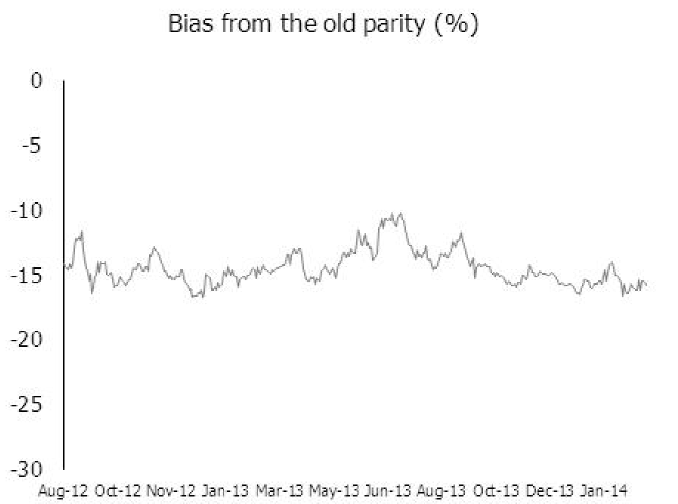
Play range from the long side. We are long EUR/PLN at 4.1850, we are ready to add at 4.1650 with a stop at 4.15 and hopes for a move back to 4.23. The reasons are political and better than expected NFP, which should support USD/EM. We simply feel more comfortable with a long then a short, as the risk of situation deteriorating rapidly are much bigger then finding the magic solution to the current problem, unfortunately.

Cautious bid. The same logic as above applies to options. We prefer to be cautiously long mid/long Vega and slightly long Gamma. The vols are still low on the multi-year basis, but one have to admit that realized volatilities are not really surging higher by much.









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
3/3/2014	2.53	2.71	2.68	2.64	2.93	2.68	2.72	2.72	2.75	2.89	3.03	2.81
3/4/2014	2.54	2.71	2.67	2.64	2.93	2.68	2.72	2.73	2.77	2.88	3.02	2.80
3/5/2014	2.43	2.71	2.57	2.64	2.82	2.68	2.73	2.73	2.76	2.81	2.91	2.78
3/6/2014	2.52	2.71	2.64	2.64	2.89	2.68	2.73	2.71	2.72	2.82	2.95	2.81
3/7/2014	2.52	2.71	2.64	2.64	2.89	2.68	2.73	2.71	2.72	2.82	2.95	2.81

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	3/6/2014	7/25/2016	93.07	3.07	3500	6104	3754
PS0718	2/13/2014	7/25/2018	94.45	3.88	2000	4405	2220
DS1023	2/13/2014	10/25/2023	95.80	4.54	2000	3702	1791

Fixed income market rates (closing mid-market levels)

Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
3/3/2014	2.680	2.835	3.010	3.085	3.640	3.771	4.090	4.423
3/4/2014	2.680	2.801	3.008	3.026	3.600	3.705	4.010	4.372
3/5/2014	2.680	2.759	2.947	2.984	3.516	3.556	3.940	4.262
3/6/2014	2.680	2.792	2.968	2.997	3.560	3.599	3.990	4.217
3/7/2014	2.680	2.792	2.968	2.997	3.560	3.599	3.990	4.217

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
3/3/2014	7.55	7.55	7.58	7.80	7.80	2.97	0.75
3/4/2014	7.38	7.43	7.48	7.80	7.80	2.97	0.75
3/5/2014	7.10	7.18	7.43	7.80	7.80	2.97	0.75
3/6/2014	6.78	7.08	7.38	7.75	7.75	2.97	0.75
3/7/2014	6.78	7.08	7.38	7.75	7.75	2.97	0.75

PLN Spot performance

Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
3/3/2014	4.1978	3.0462	3.4607	3.0082	1.3406	0.1536
3/4/2014	4.1926	3.0489	3.4474	2.9948	1.3438	0.1532
3/5/2014	4.1860	3.0477	3.4344	2.9765	1.3512	0.1530
3/6/2014	4.1788	3.0427	3.4267	2.9627	1.3522	0.1527
3/7/2014	4.1893	3.0185	3.4361	2.9314	1.3540	0.1532

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