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Polish Weekly Review

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Comment on the upcoming data and forecasts

Busy week ahead of us. Monday begins with the release of core CPI data for the previous two months. After CPI releases from GUS we expect core inflation to have dropped to 0.8% y/y in January and to surged back up to 1.1% y/y on low statistical base in prices of communication services. At the same time the NBP will also publish CA data for January. We expect the deficit to narrow somewhat on large trade surplus offset by low transfers from the EU. Note that our forecast of imports and hence the entire CA balance were revised (higher imports) after whis week's GUS data on trade. On Tuesday the Central Statistical Office will release labor market data. After last month's setback related to statistical sample changes we expect employment to increase by 0.2% y/y. This will be accompanied by another strong reading on wages - broadly similiar to the previous month (3.5% vs. 3.4%). On Wednesday industrial data will move into focus. We expect output to have accelerated somewhat owing to working days and low base from the previous year. As for producer prices, high base has probably lowered y/y dynamics to -1.1% amid stable commodities and exchange rates. Finally, MPC Minutes (due on Thursday) will probably have a dovish tone.

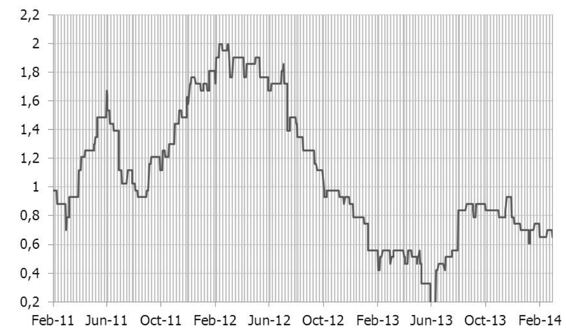
Polish data to watch: March 10th to March 14th

Publication	Date	Period	mBank	Consensus	Prior
Core CPI y/y (%)	17.03	Jan	0.7	0.9	1.0
Core CPI y/y (%)	17.03	Feb	0.9	1.0	
Current account (mio EUR)	17.03	Jan	-638	-761	-843.0
Exports (mio EUR)	17.03	Jan	13300	13057	11662.0
Imports (mio EUR)	17.03	Jan	12700	12570	11894.0
Average wage y/y (%)	18.03	Feb	3.5	3.3	3.4
Employment y/y (%)	18.03	Feb	0.2	0.2	0.0
Sold industrial output y/y (%)	19.03	Feb	7.4	6.1	4.1
PPI y/y (%)	19.03	Feb	-1.1	-1.1	-0.9

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 down after today's CPI. Thus, the trend is still horizontal. Next week is abundant with data from the real economy – readings from labour market and industrial sector offer some opportunity for a surprise.

* Surprise index presents in a synthetic way how the market was surprised by macroeconomic releases (it is constructed on daily basis as weighted average of differences between selected releases and Bloomberg forecast consensus).

Our view in a nutshell

Fundamentals

- 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 setwe are bullish on Polish short term bonds and neutral on Polish long end bonds due to global factors including the indolence of ECB and possibility of an end of mixed-data period in the U.S.
- Polish fundamentals (low CA deficit, high real rates, low short-term foreign debt, accelerating GDP growth) speak in favor of the zloty in mid-term on cyclical basis and as far as potential differentiation among EMs is concerned. Short-term, however, Ukraine events and ensuing risk aversion changes dynamics against the zloty that may be trading weaker. The more so since the PLN is at highs towards its peers in CEE, tempting to be the first best solution to limit investors's exposition on the region.

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

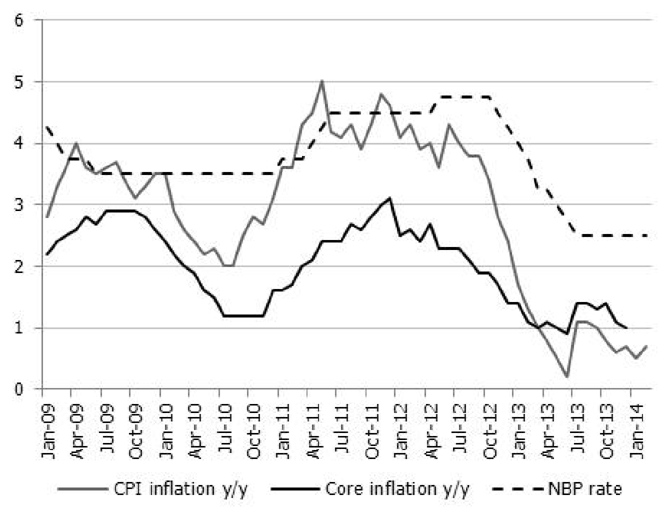
Economics

Inflation still running very low

Revised inflation in January hit 0.5% y/y (previously 0.7%) - that drove February reading towards 0.7% y/y. Revision stems from two factors: 1) a change in the system of weights towards a more detailed COICOP (we spare you the details since the effects are minor), 2) a change of the weights themselves (it the core driver of revision). Quite surprisingly, the share of expenditures on food, communications and housing rose whereas the share devoted to recreation and culture, restaurants and hotel â€“ fell. One may say that Poland reverses its convergence towards DM in terms of composition of expenditures. Well, sometimes such odd readings happen.

As for the reasons for the low reading in February, low food prices are to be blamed. Core categories rose moderately showing absolutely no signs of inflation pressure. Low food prices and subdued demand side pressures speak in favor or low inflation in coming months. As for the former factor, swine embargo exerts significant pressure on red meat prices (a fall of 10% between March and February, possibly not the last significant one as export ban is unlikely to be lifted fast). As for the latter, a growing economy (and tightening labor market) translates into higher prices with a lag, beyond H1 2014. The combination of those factors suggests that CPI may even decelerate further in March despite the effects of low statistical base from the last year. In the months ahead, low inflation scenario is going dominate despite recent weakening of the zloty against the euro (zloty stayed relatively strong against the dollar in which the bulk of energy commodities is denominated; zloty is also a strong performer vis-a-vis regional peers and the whole basket of EMs).

What about the scenario of higher inflation in year end? As we already mentioned, economic activity translates into inflation with a lag. Therefore, we still see inflationary pressure building within some quarterâ€™s time. We do not see the reason to be more specific on the subject since inflationary worries are irrelevant now when Europe is pre-occupied with deflationary fears.



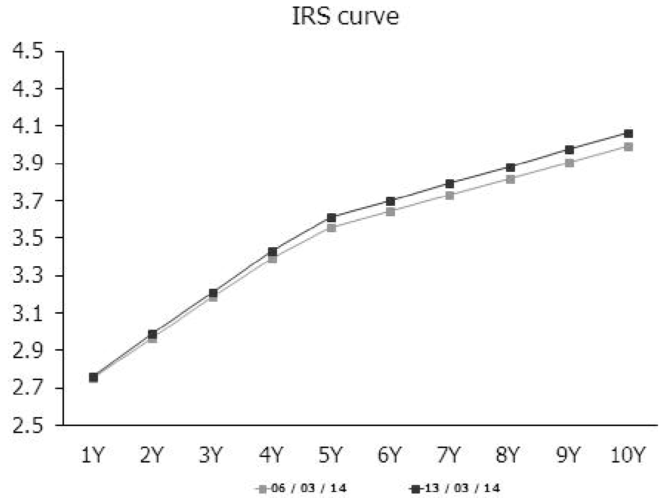
The data support the low-rate scenario in Polish economy. Latest MPC decision showed the body dominated by doves. It makes rate hikes off the agenda for 2014 and postpones rate hikes expectations towards 2015. Given the low inflation and ECB action still in the pipeline we cannot rule out that some expectations of even rate cuts arise. In such circumstances short interest rates may fall and short-term bonds constitute a safe bet. Any escalation in Ukraine should not lead to a rise in short interest rates as long as zloty stays relatively stable. To be honest, zloty seems to be a regional safe haven now, and even if some depreciation pressure occurs, we believe that owing to very low inflation there is much more tolerance from NBP's side for such an outcome. Different economic environment and different reaction function of NBP suggests that MPC is not going to even try to compensate investors with higher rates just as Russian CB recently did and Hungarian CB used to do in the past.

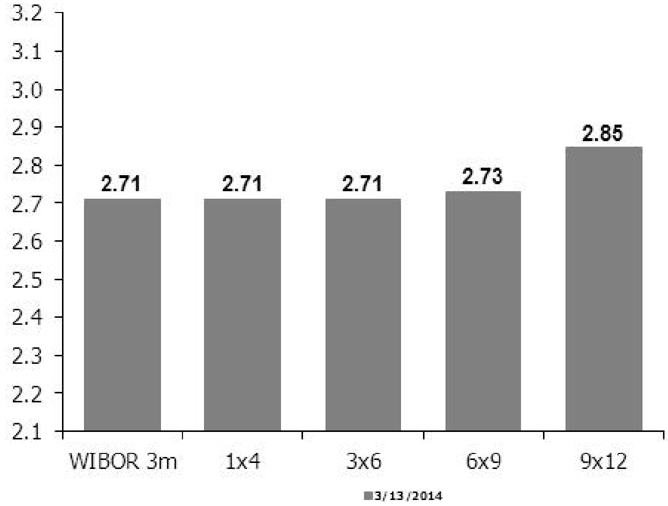
Fixed income

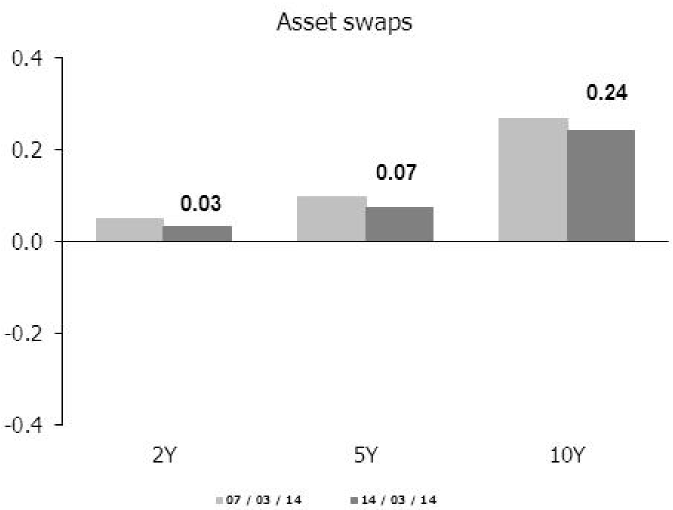
Slow down

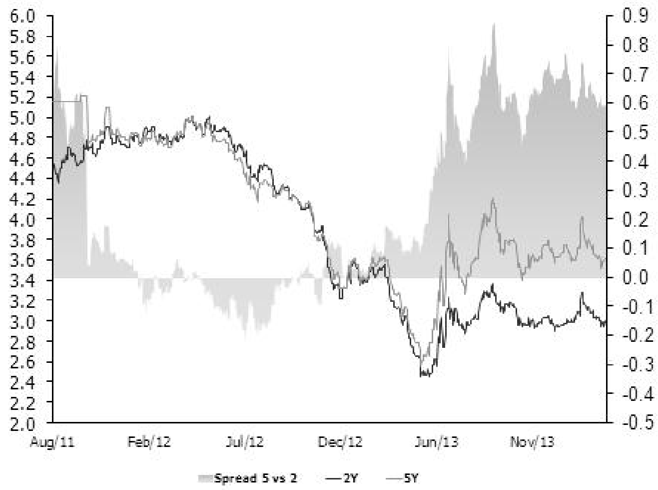
This week we had some profit taking / risk aversion trading on Polish FI market. Yield of DS1023 went from 4.20% up to 4.33%. Unfortunatelly it did not reach our target of 4.38% before another surprisingly low CPI data (0.7% YoY). Is this a game changer? Probably not, rate hikes before September were out of the question anyway. Carry trade on 2 year bonds is definitelly not juicy enough. That is why we prefer longer end trades. Our previous recommendation to sell DS1023 performed well, but with current conditions it is only a bet on Ukrainian crisis output. With the feeling that it can go both ways (escalation way less probable, but with more price action potential) we are now happy to take earlier than expected profit on DS1023.

Recommendation: Close DS1023 trade at current levels (4.29%).









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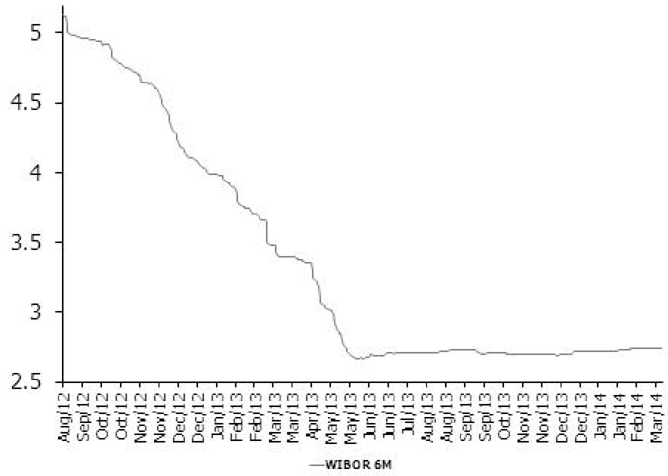
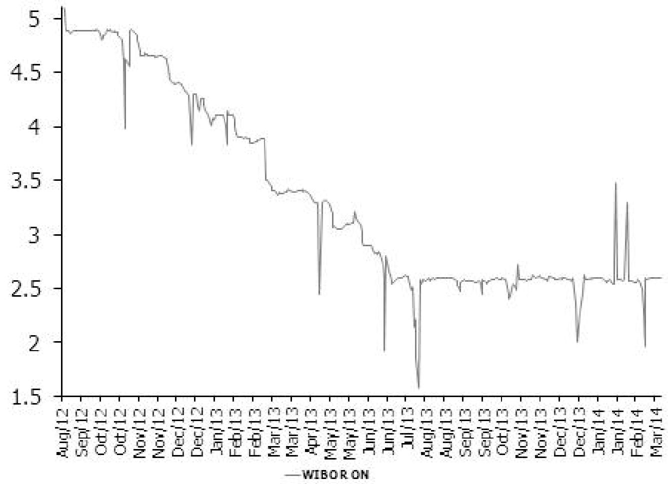
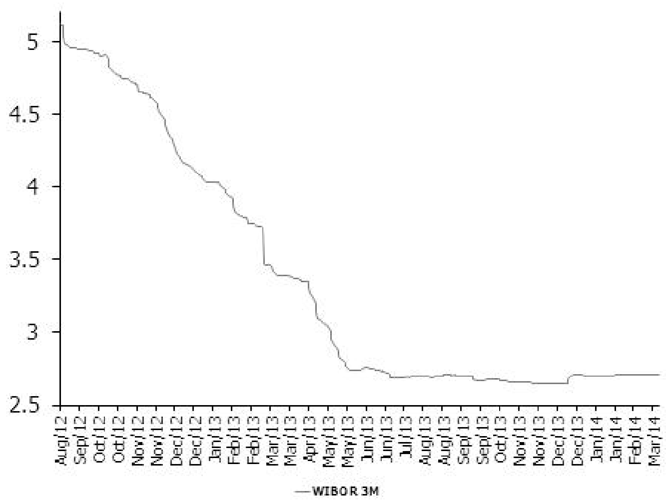
Money market

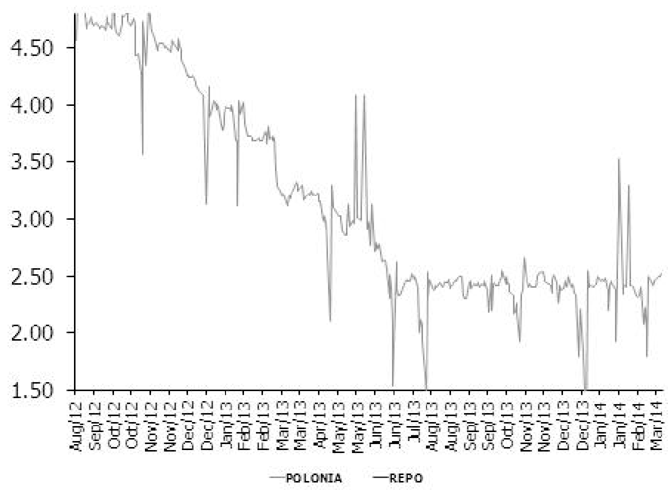
Stable and unfortunately expensive week for cash rates while POLONIA fluctuated around reference rate. Next week should be cheaper as NBP offered 2 bn less money bills than we expected.

Our recommendation is to sell 1Y OIS and buy 9×12 FRA (BPV neutral) as spread between these instruments is at the lowest levels (33-34 bps). Also buy PS0415 at 2.74-2.75.







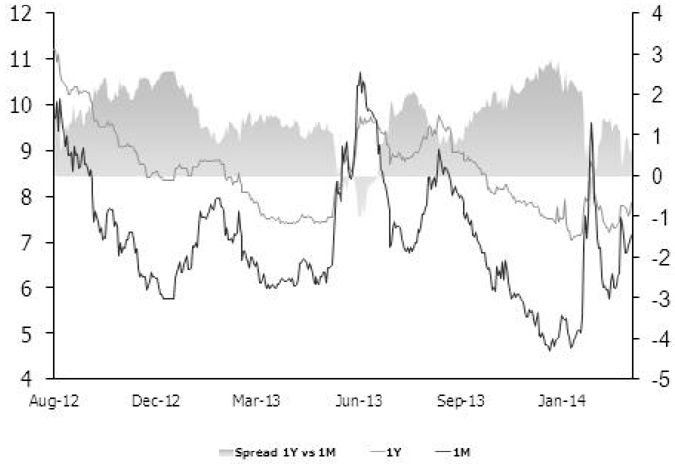


Forex

PLN weaker Geopolitical fears (because of Ukraine which will face the referendum in Crimea this weekend) plus the worries about China were the main drivers of what we used to label a ”risk off” mood. PLN was weaker as a result. EUR/PLN ascended from 4.17 last week to 4.2470 so far. 4.25/4.27 is a resistance zone that proved unbreakable during the ”Turkish crisis”, and is expected to be tough to crack this time as well. EUR/PLN closer to 4.30 may attract official attention (MOF and/or NBP), so we do not see much room for a move higher unless something really bad happens.

Higher vols Weaker PLN inevitably led to higher vols in EUR/PLN and USD/PLN. The frontend was an obvious winner as the market participants rushed to cover their Gamma short. 1 month EUR/PLN was paid and bid on at 7.5% (it was 6.5 mid last Friday), 3 month EUR/PLN mid is 7.3% (0.5% higher) and 1 year fixed 8.1% (0.5% higher). The skew was also in demand as 1m RR was paid at 2.3.

EURPLN volatility



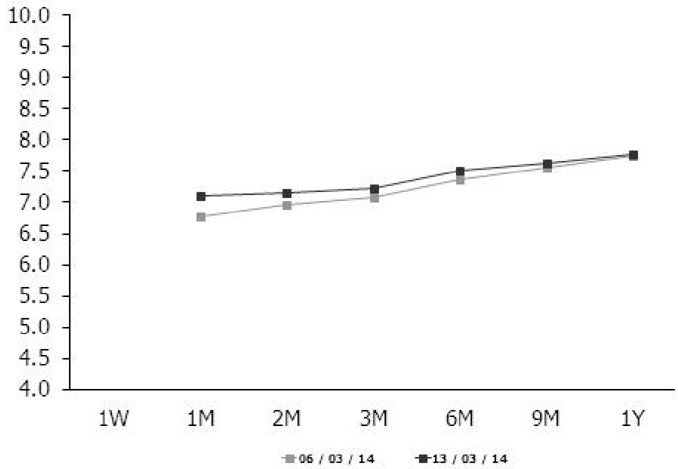
Short-term forecasts

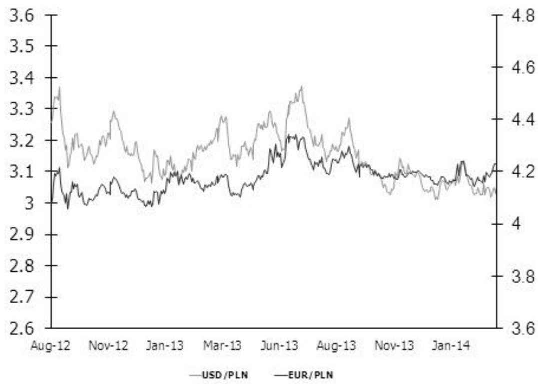
SPOT Main supports / resistances:
EUR/PLN: 4.1400 / 4.2600
USD/PLN: 3.0000 / 3.1500

Play range from the short side. EUR/PLN longs from 4.1850 closed at 4.23. Now, we are short EUR/PLN at 4.2350 and ready to add 4.2550 with a stop above 4.27 and hopes for a move back to 4.1800. The bigger picture is unchanged, we believe we are in the range of 4.14/4.26, there is no ”Polish factor” in current losses of PLN. EUR/PLN is not a pure emerging market anymore and even if global sentiment becomes sourer, the semi-safe heaven function of PLN may kick in again.

Partially closed long Vega. We sold 50% of our long Vega position in mid/backend Vega. The bigger picture is unchanged, we think current low volatility levels (from a multiyear point of view) are these levels are rather to be long / square Vega. That was the reason why we got long in the first place, but the rise in implied volatility without the significant confirmation from the realized volatility is making us skeptical.

EUR/PLN volatility curve





Bias from the old parity (%)

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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
3/10/2014	2.53	2.71	2.66	2.64	2.91	2.68	2.72	2.72	2.74	2.83	2.98	2.76
3/11/2014	2.56	2.71	2.68	2.64	2.91	2.68	2.71	2.71	2.73	2.83	3.00	2.77
3/12/2014	2.47	2.71	2.60	2.64	2.81	2.69	2.71	2.71	2.73	2.84	3.00	2.77
3/13/2014	2.56	2.71	2.69	2.64	2.94	2.69	2.71	2.71	2.73	2.85	2.99	2.77
3/14/2014	2.56	2.71	2.69	2.64	2.94	2.69	2.71	2.71	2.73	2.85	2.99	2.77

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
3/10/2014	2.680	2.771	2.950	2.989	3.580	3.634	4.030	4.255
3/11/2014	2.680	2.765	2.998	2.997	3.610	3.632	4.065	4.263
3/12/2014	2.690	2.752	2.988	2.968	3.610	3.628	4.065	4.256
3/13/2014	2.690	2.742	2.993	3.027	3.610	3.684	4.065	4.307
3/14/2014	2.690	2.742	2.993	3.027	3.610	3.684	4.065	4.307

EUR/PLN 0-delta stradle / **25-delta RR** / **25-delta FLY**

Date	1M	3M	6M	1Y	25-delta RR 1M	25-delta RR 1Y	25-delta FLY 1Y
3/10/2014	6.93	7.18	7.28	7.58	7.58	3.13	0.78
3/11/2014	7.03	7.18	7.30	7.63	7.63	3.13	0.78
3/12/2014	7.15	7.20	7.45	7.85	7.85	3.20	0.78
3/13/2014	7.10	7.23	7.50	7.78	7.78	3.19	0.79
3/14/2014	7.10	7.23	7.50	7.78	7.78	3.19	0.79

PLN Spot performance

Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
3/10/2014	4.1991	3.0266	3.4465	2.9303	1.3469	0.1536
3/11/2014	4.2171	3.0449	3.4626	2.9473	1.3470	0.1541
3/12/2014	4.2290	3.0508	3.4774	2.9687	1.3469	0.1546
3/13/2014	4.2277	3.0284	3.4787	2.9533	1.3537	0.1545
3/14/2014	4.2334	3.0481	3.4870	2.9998	1.3502	0.1548

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