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Polish Weekly Review

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Comment on the upcoming data and forecasts

After a busy past week, the forthcoming one is going to be much calmer. The Statistical Bulletin will be published on Tuesday, including the data on February's retail sales and unemployment rate. The latter was already estimated by Labor Office at 14.0%, which is also expected by us. According to our forecasts, retail sales had accelerated to 6.1% yoy. Favorable calendar effect (no difference in the number of working days, vs. -1 last month) contributes to the high reading. On the other hand, still absent boost in the automobile sales due to higher VAT deductions and modest descent of food sales pose some headwinds to the aggregate figure.

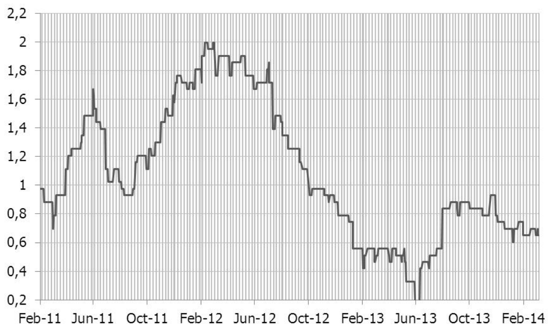
Polish data to watch: March 24th to March 28th

Publication	Date	Period	mBank	Consensus	Prior
Retail sales y/y (%)	25.03	Feb	6.1	6.0	4.8
Unemployment rate (%)	25.03	Feb	14.0	14.1	14.0

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

Up after wage data, down after lower PPI. The horizontal trend in PL surprise index continues amid low inflation and accelerating economy - surprises on both sides more or less balance out.

* 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). We are bullish on Polish short term bonds and neutral on Polish long end bonds due to global factors including the indolence of ECB, possibility of an end of mixed-data period in the U.S and shift in FOMC rhetoric.
- 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

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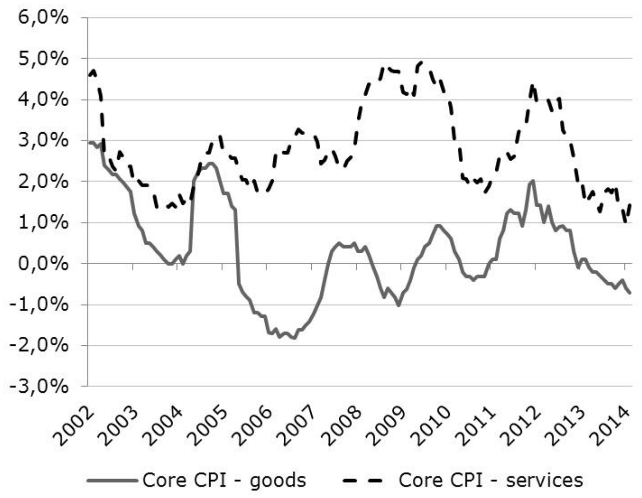
Economics

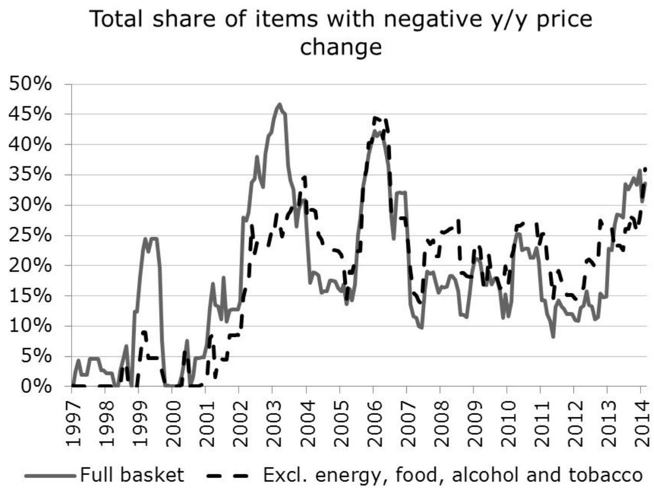
Polish inflation skewed to the downside (at least for the next 1-2 quarters)

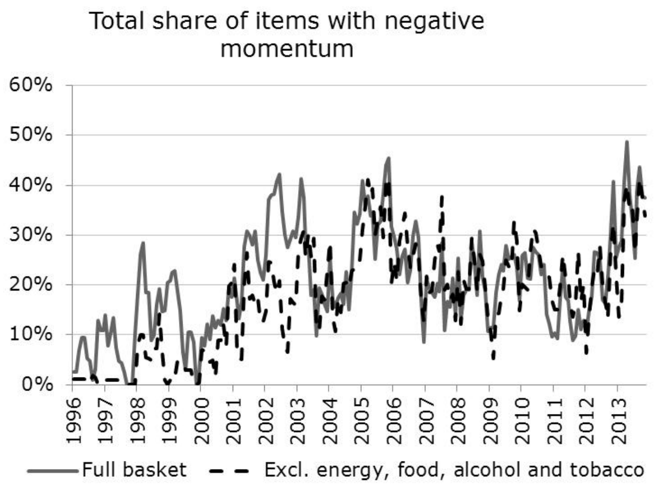
With Polish inflation running at 0.7% (and core inflation at 0.9%), no one really can find inflationary pressures anywhere. It seems also the MPC is fully buying the scenario of non-inflationary growth. Although we believe in economic mechanisms in medium term, short-term we can only support such a scenario. We think that implications are threefold: 1) MPC may be happy to leave rates low for longer and stress it via forward guidance, 2) MPC may be more tolerant when zloty weakens, 3) However, eventually rates will be lifted up in 2015 but in current equilibrium the market may be less interested in such distant period given the current complacency of inflation processes. Low momentum of inflation fits our scenario for 2014 in which we divided the year into two distinctive parts. We are still in environment supporting (selectively) fixed income instruments, at least locally.

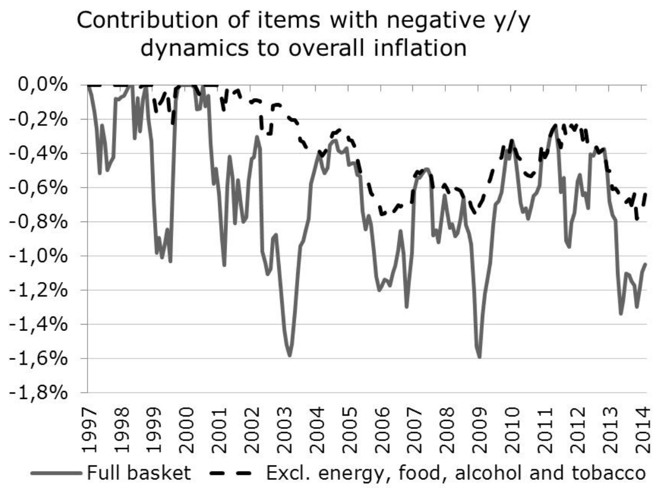
When we look at core inflation, there is deflation in goods running for more than a year whereas prices in services grow in a steady but low pace. It seems (similar patterns can be found in other countries, e.g. the US) that prices of core services are mostly related to output gap and wage dynamics, whereas core goods are more prone to short-term cycles. These, in turn, correspond to the level of capacity utilization in the global manufacturing sector (one can approximate it with global PMI index). There are, of course other factors such as commodity prices and exchange rate dynamics but this seems to be the main driver for prices of industrial goods.

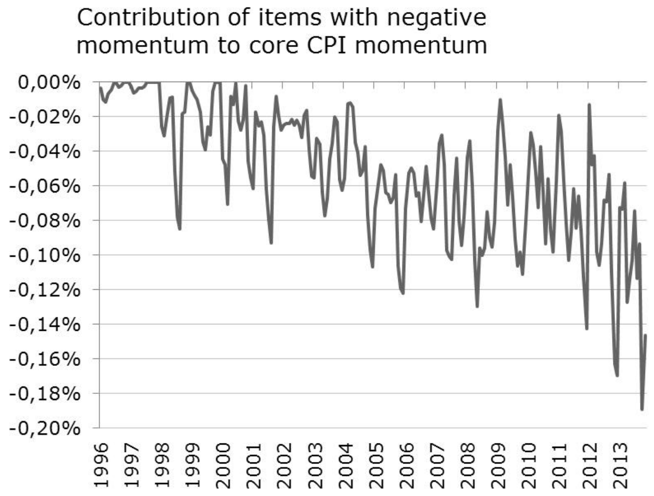


Moreover, using detailed HICP data from Eurostat we calculated the sum of weights of core and headline items of inflation basket that undergo deflation in y/y terms (i.e. growth rate in annual terms is negative). We repeated the same exercise using momentum measures(3m/3m growth rate) to escape base effects and this time we ended up with the total weight of items in core and headline inflation basket whose momentum is negative (we take non-seasonally adjusted series, but still we were looking for tendencies, so it is sufficient). Results are presented on the respective graph. What we see is a solid deflationary pressure in 35% of the basket (calculation on annual basis) and 40-50% of the basket (calculation on momentum basis); the former does not reach an extreme level, the latter is equal to historical tops. The former categories shave off 1pp. from the current headline inflation reading and 0.6pp. of the core ones. In terms of momentum it is even more important to look at the tendency, not the number itself.







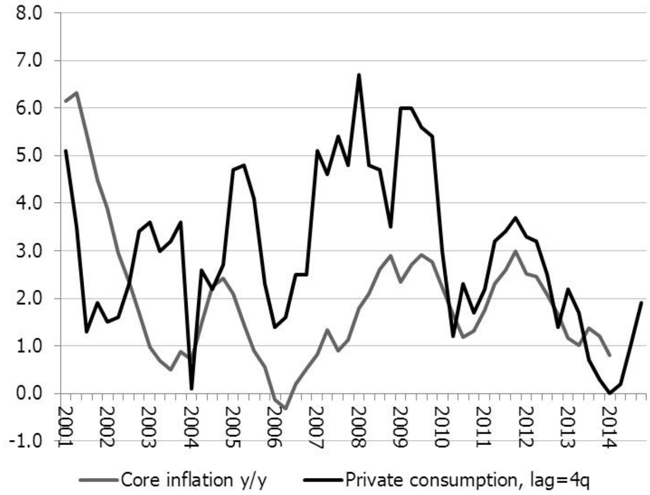


We think that the graphs above carry some important messages.

First of all, the deflationary component in Polish inflation is strong and relatively broad, especially in terms of momentum (at the moment the most important metrics, in our opinion) and it is concentrated mostly in the goods sector (mostly tradables). This almost clears the situation for inflation in the coming months and underpins its low level in the short-term. Services - as in any economy converging towards developed markets and undergoing faster wage growth - are a constant positive contributor to inflation. The strength of this contribution varies along with labor market strength, possibly with a lag. Such a point of view also clears short-term outlook for inflation in services. However, in the medium term we await a cyclical rebound.

Secondly, only a part of deflationary pressure in goods sector stem from the slack in the economy (in turn, only a part of it is going to be reversed when the economy accelerates). The remaining part may be linked to transition of Poland from emerging to developed market. We think that, as market gets broader (as measured by the volume of GDP, not its growth), elasticity of demand rises and firms operating in a competitive environment are made to go for volumes (sell more but at a lower price) and this strategy generates more revenue. Such thinking automatically raises question when (if at all) firms may be forced or willing to drive up prices when the economy accelerates. It is a point when microeconomics and macroeconomics may differ in opinions. So far we think the former takes the upper hand - e. g. competitive forces are thawing producer prices very effectively (they should have already started their march upwards, given the strength of the economy, but the actual trend is downwards).

In such circumstances the good old reasoning measuring the levels of inflation on the basis of output gaps may be misleading (see the graph in which lagged consumption serves as a proxy for output gap or labor market strength). It points to rising core inflation in 2014. However, even if we do not take into account the discussion from the former paragraph, the level of core inflation is not at all impressive. A more decisive increase in inflation and tightening of labor market is needed to force MPC to act (we still believe rates will be raised in 2015 as a part of normalization of policy). As cyclical rebound of inflation may be much more muted than in recent cycles, risk-free interest rate can be expected lower in mid-term horizon (than it used to be in the past). The MPC is therefore poised to remain dovish at the moment, more tolerant to exchange rate depreciation, more willing to act too late than too soon, and finally - more open to really shallow rate hike cycles (so far the most hawkish members put 50bp tightening cycle on the agenda).

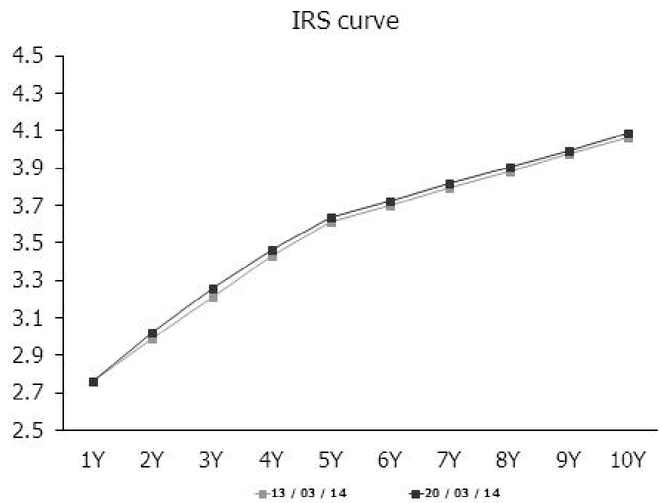


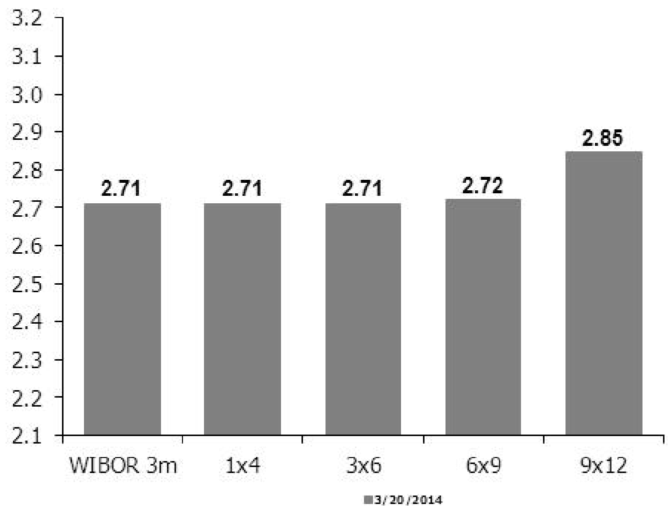
Fixed income

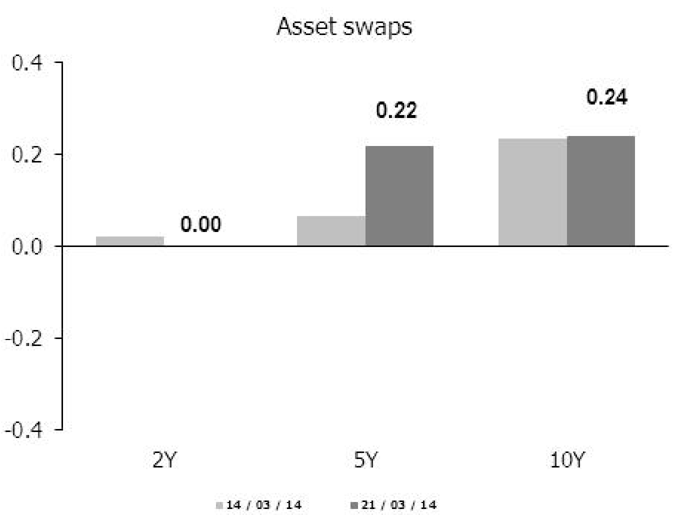
Neverending Demand

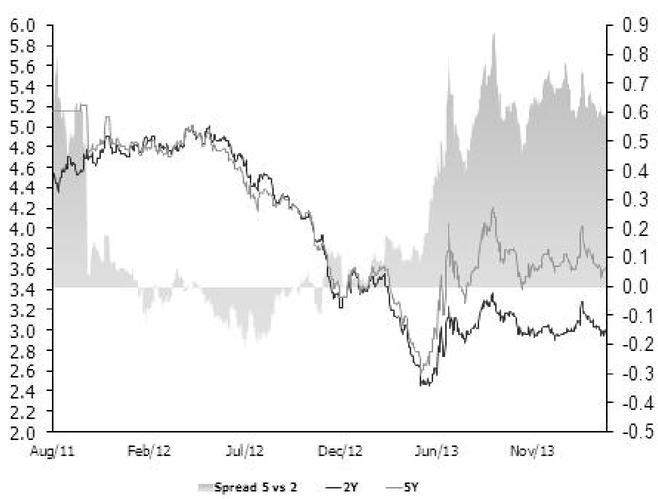
Despite incoming switching auction, this week on FI market started with positive sentiment. DS1023 was trading around 4.20%. On Wednesday evening, more hawkish than expected statements from Fed's chairwoman pushed bond yields higher. MinFin did not want to help the market and offered unattractive prices for buying bonds (some 5 ticks below secondary market) on the auction. Despite all that, the auction met huge demand, 4.5 bln of long end bonds were sold and in our opinion that shows very good sentiment on PolGBs. We feel that 5 year bond sector offers good mix of safety and juicy yield and that is why we like to buy those bonds at current levels.

Recommendation: Buy PS0718 at 3,62%.







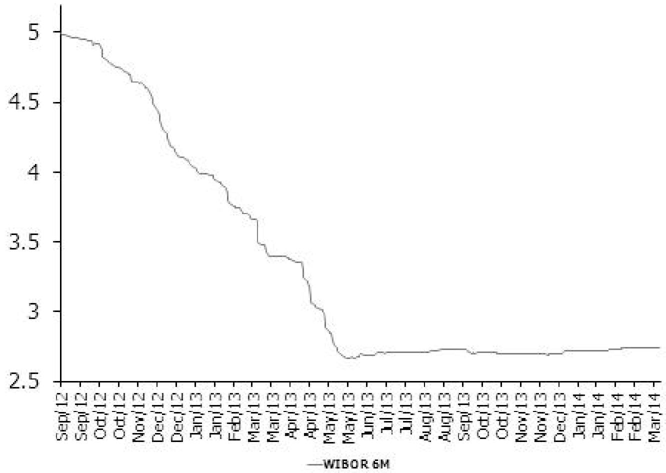


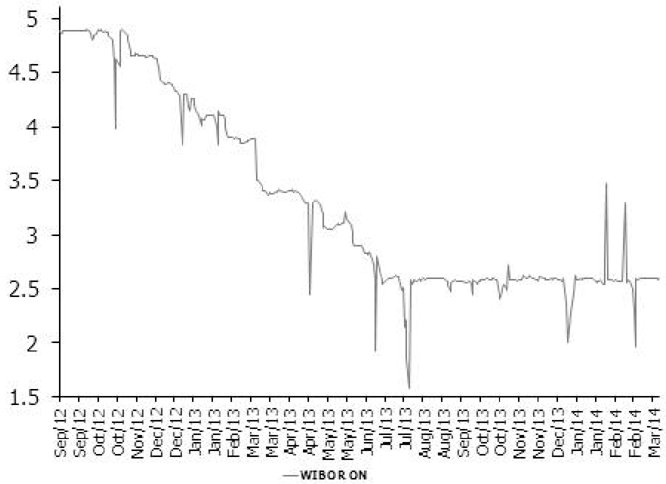
Money market

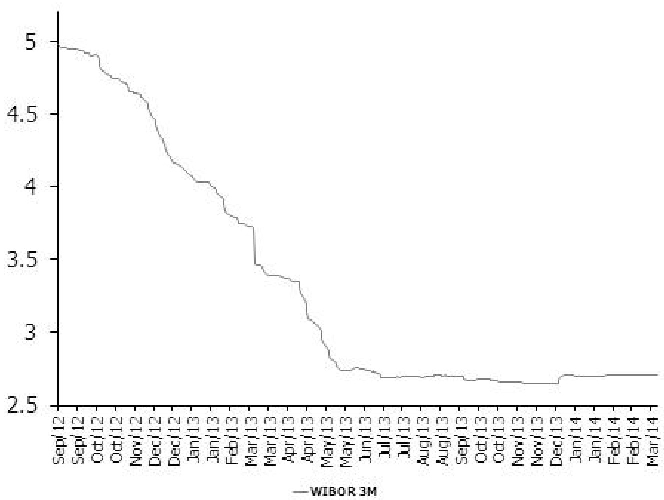
Squaring OMO makes a fragile boarder for the cost of cash next week Today the central bank squared the market during regular open market operation (PLN 116.5 bln). Since we have the last week of the reserve requirement's settlement period ahead, we think that shortest rates will remain relatively stable this month and near the main market rate. However, any settlement disorder in the system can easily cause rapid growth of those rates.

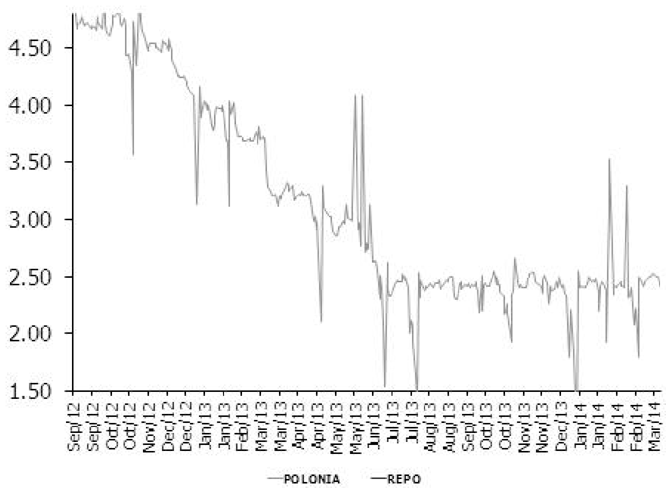
Bearish signs not so bearish Front end of the curve quite volatile this week: moving up after the Fed and Mr Bratkowski's comments referring to local monetary policy and down after weaker then expected industrial output figure. Two first events, if read carefully, were not as hawkish as they might appear at the first glance (especially Mr Bratkowski who in fact moves his rate hike plans toward 2015 rather then strongly opt for Q4 hike). Therefore, after a healthy correction the front end should again be back down to the levels from last Friday's closing. In line with this view a plethora of money is also observed on the market, which could easily turn into short bond purchases.

Buy short bonds (2-3Y sector) reduce bpv with 3*6 fra.





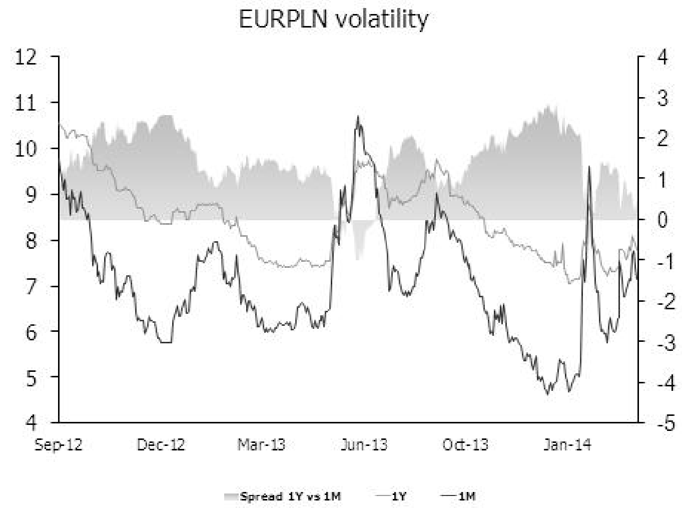




Forex

PLN stronger The geopolitical tension in Ukraine eased a little, as a result EUR/PLN rejected last week's high at 4.2470 and moved back to the middle of the range. The hawkish FOMC caused a brief spike of EUR/PLN to 4.2150, but it was relatively quickly faded and we are now back in 4.20ish region. The MPC member Bratkowski's hawkish comment was taken out of context, and we don't see any support for the PLN from this side. The wider range 4.15/4.25 still dominates and we don't expect it will be broken anytime soon.

Lower vols Stronger PLN and low realized volatility were the reasons behind the move down in vols. The 1 month EUR/PLN ATM mid is this Friday 6.7% (0.7% lower than last week), 3 months are 7.0% (0.3%) lower and 1 year is fixing at 7.8 %(0.3% lower). The skew was also better offered, especially in the frontend.

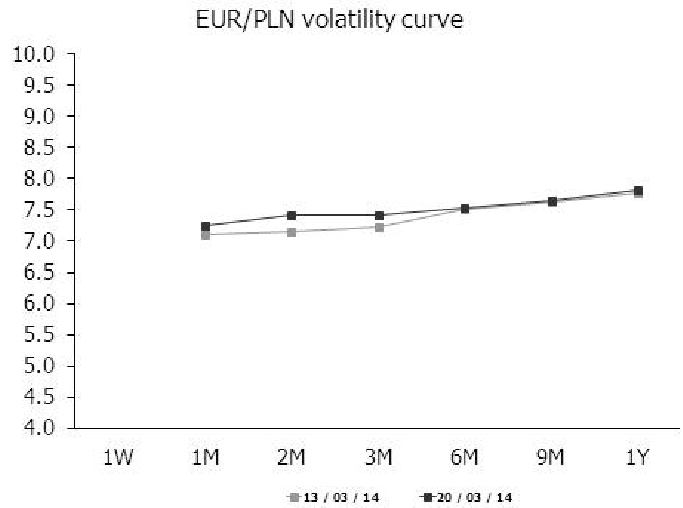


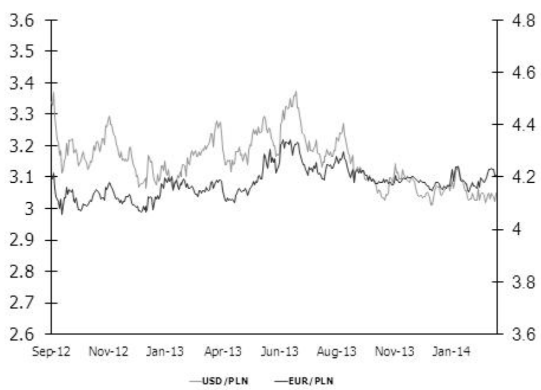
Short-term forecasts

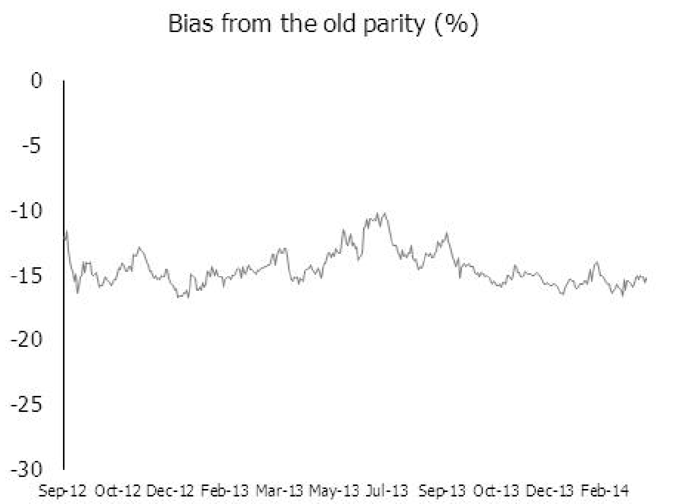
SPOT Main supports / resistances:
EUR/PLN: 4.1400 / 4.2600
USD/PLN: 3.0000 / 3.1500

Play range EUR/PLN shorts from 4.2350 partially closed with profit at 4.1950. We are hoping to cover the remaining short at 4.1750 or add to shorts 4.23 with a stop at 4.25. We still keep our slight PLN bullish tone, of course the geopolitical situation is to be watched, but we think unless something dramatic happens it will slowly drift out of the market's radar.

Cautious bids Our call to cut half of the Vega long proved to be a good one. Now, with lower volatility levels we are slowly, (no rush at all) leaning into showing cautious bids again. We think vols still may properly test this year's lows before any stronger bounce would eventually take place. The realized volatility is to be carefully examined and before we enter the more significant Vega position, one need to see a supporting rise in realized volatility in the first place.







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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
3/17/2014	2.62	2.71	2.65	2.64	2.70	2.69	2.72	2.72	2.73	2.80	2.95	2.77
3/18/2014	2.73	2.71	2.78	2.64	2.85	2.69	2.71	2.71	2.72	2.80	2.92	2.76
3/19/2014	2.47	2.71	2.59	2.64	2.80	2.69	2.71	2.71	2.73	2.80	2.93	2.77
3/20/2014	2.85	2.71	2.90	2.64	2.92	2.69	2.71	2.71	2.72	2.85	3.00	2.79
3/21/2014	2.85	2.71	2.90	2.64	2.92	2.69	2.71	2.71	2.72	2.85	3.00	2.79

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
3/17/2014	2.690	2.727	2.963	2.994	3.575	3.603	4.015	4.256
3/18/2014	2.690	2.722	2.920	2.967	3.530	3.559	3.980	4.216
3/19/2014	2.690	2.713	2.930	2.974	3.520	3.789	3.980	4.247
3/20/2014	2.690	2.714	3.025	3.025	3.635	3.854	4.085	4.326
3/21/2014	2.690	2.714	3.025	3.025	3.635	3.854	4.085	4.326

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
3/17/2014	7.78	7.65	7.68	8.00	8.00	3.16	0.76
3/18/2014	7.40	7.60	7.63	7.93	7.93	3.16	0.76
3/19/2014	7.15	7.38	7.43	7.80	7.80	3.06	0.80
3/20/2014	7.25	7.43	7.53	7.83	7.83	3.05	0.76
3/21/2014	7.25	7.43	7.53	7.83	7.83	3.05	0.76

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
3/17/2014	4.2295	3.0430	3.4806	2.9902	1.3547	0.1546
3/18/2014	4.2295	3.0396	3.4786	2.9986	1.3533	0.1544
3/19/2014	4.2065	3.0245	3.4538	2.9772	1.3545	0.1533
3/20/2014	4.2089	3.0500	3.4510	2.9776	1.3504	0.1530
3/21/2014	4.1970	3.0425	3.4468	2.9766	1.3448	0.1527

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