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Polish Weekly Review

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Comment on the upcoming data and forecasts

Another quiet week ahead of us. The MPC meeting is widely expected to be a non-event - interest rates probably won't be changed until next year and gov. Belka already indicated that forward guidance would be reviewed in July, with the release of new inflation projections. We, on the other hand, believe that a dovish surprise is possible. What form would that take? A recognition of even less pronounced inflationary pressures is one possibility. It also likely that the recent weakness in real sphere data (exports, industrial output, PMI) would also be mentioned, albeit it is far too early to spell out risks to economic growth.

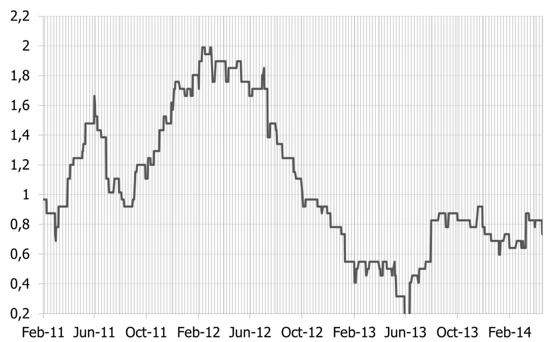
Polish data to watch: May 5th to May 9th

Publication	Date	Period	mBank	Consensus	Prior
MPC's interest rate annoucment (%)	07.05	May	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	-	800	3.024	4/23/2014
5Y T-bond PS0719	5/9/2014	5300	3.549	4/23/2014
10Y T-bond DS1023	-	3500	4.261	4/3/2014
20Y T-bond WS0429	-	150	3.464	5/16/2013

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



Comment

Another negative surprise in PMI data brings the index down, ending a short-lived rebound here. The index will stabilize next week but only because of the lack of data. More negative surprises this month cannot be ruled out, though.

* 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 2013. 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 (or even very low) for the next few months supported by a possibility of lower meat prices and deflating tradables basket.
- The 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. We feel the MPC is focused on strenghtening low rates environment and stay very dovish (this includes a risk of a rate cut). Although we await normalization of monetary policy in 2015, low inflation, strong zloty (vs EM basket) makes discussion of rate hikes non-existent at the moment.

Financial markets

- 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 redirected from EMs to Europe (cross-over investors). We are bullish on Polish short term bonds due to a non negligible risk of a rate cut in Poland (negative spillovers from Ukraine amid strong zloty vs. EM currecies may be seen by the MPC as an excuse to abandon stable rates policy). Although a cut itself is not our baseline, it may draw investors' attention from time to time.
- We are positive on longer bonds due global signals (there is still a possibility of further easing from the ECB and the Fed tries to talk down rate hikes by drawing attention to fundamental weaknesses in the labor market) and local factors (the possibility of softer growth in mid-year due to Ukraine / Russia). Furthermore, given low yields in Italy or Spain, Poland might be increasingly seen as a high-yield alternative to euro area, especially if very low FX volatility is considered.
- Escalation of conflict in Ukraine would be disruptive for Polish assets in the short-term. Mid-term it translates into lower growth and underpins lower rates for longer.
- 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 still close to local 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	2.0	1.6	3.5
CPI Inflation y/y (average %)	3.5	2.8	4.3	3.7	0.9	1.0
Current account (%GDP)	-1.6	-4.5	-4.9	-3.5	-1.3	-1.9
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

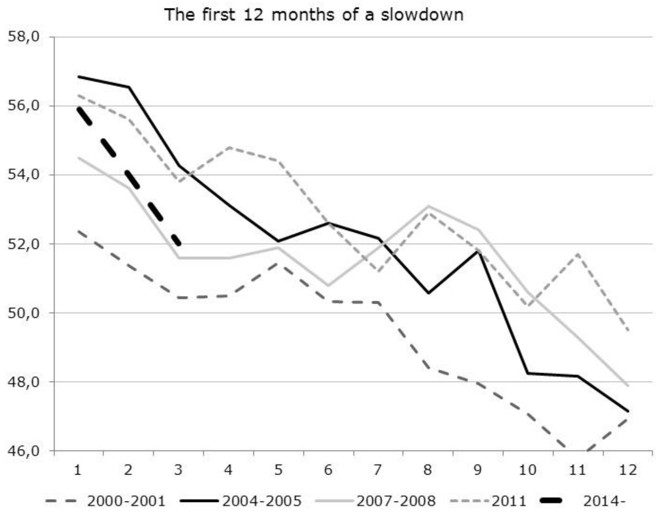
	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1 F	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.4	0.8	2.0	2.7	3.0	3.0	3.6	4.3
Individual consumption y/y (%)	0.0	0.1	1.0	2.1	2.3	2.6	2.8	3.1
Public Consumption y/y (%)	0.1	5.0	3.0	3.1	2.0	2.0	2.0	3.0
Investment y/y (%)	-2.4	-3.3	0.5	2.0	3.8	5.3	7.5	8.5
Inflation rate (% average)	1.3	0.5	1.1	0.8	0.7	1.0	0.8	1.6
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	2.71	2.72	2.72	2.72
2Y Polish bond yields (% eop)	3.19	3.07	3.06	3.05	3.01	2.90	2.95	3.10
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.23	3.90	4.30	4.80
EUR/PLN (eop)	4.18	4.33	4.22	4.15	4.17	4.20	4.10	4.00
USD/PLN (eop)	3.26	3.32	3.12	3.02	3.04	3.01	2.96	2.97

F - forecast

Economics

PMI disappoints again. The soft patch becomes a reality.

In April Polish Manufacturing PMI declined again, this time reaching 52.0 (market consensus: 54.2; our forecast: 54.5). Against the local maximum recorded in February, the index decreased by 3.9 points already, making it a rather sharp drop (and one of the largest two-month declines), when compared to previous slowdown episodes.



Just as in the previous months, the decline was driven mainly by the two key components: output and new orders. As for the former - the assessment of output growth was the weakest in the current expansion phase (i.e. lowest since June '13). As for the latter - the decline in New Orders subindex, albeit sizeable, did not break the 10-month sequence of 50+ readings and its value still sits above the long-term average. Furthermore, the overall weakness in order intake can be attributed to very weak growth in export orders. Entrepreneurs link the weakness in export orders mainly to the Ukrainian / Russian weakness and, somewhat surprisingly (given solid growth in most Western export markets), to softer demand from Europe. Domestic orders were strong, just as in the previous months, which suggests that domestic demand remains mostly unaffected by external disturbances. This is, again, supported by robust job creation in manufacturing - the relevant index eased from recent highs but remains well above historical averages. Finally, nothing new can be said about inflationary pressures (conspicuously absent in light of today's release).

Our baseline scenario for the coming months (flat growth path and significant support from domestic demand) seems well supported by the data. However, the second consecutive decline of the PMI index is yet another confirmation of the fact that the Polish economy does not function in a vacuum and that the events at the Eastern border have a measurable impact on business sentiment. Even though certain details of the release can be reassuring for the optimists, as the divergence between foreign and domestic demand is clearly visible, the overall tone is rather pessimistic. A slowdown in the second quarter (especially in q/q terms) seems quite likely. This also stands in direct contradiction to the most optimistic scenarios presented by some members of the MPC (up to 3.8% average growth this year). The more so, since markets are well aware of the possibility of growth slowing down in the coming months. Such a scenario, going forward, should lead to more dovish stance of monetary policy (the statement and the press conference after next week's meeting are something to watch closely) and - given the global environment - support Polish bonds.

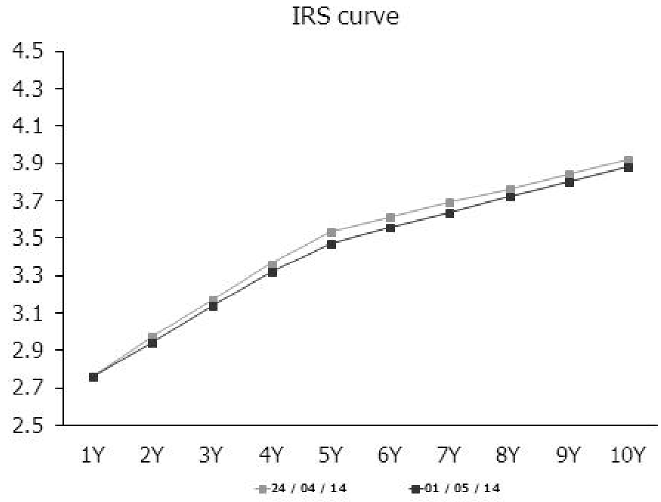
Fixed income

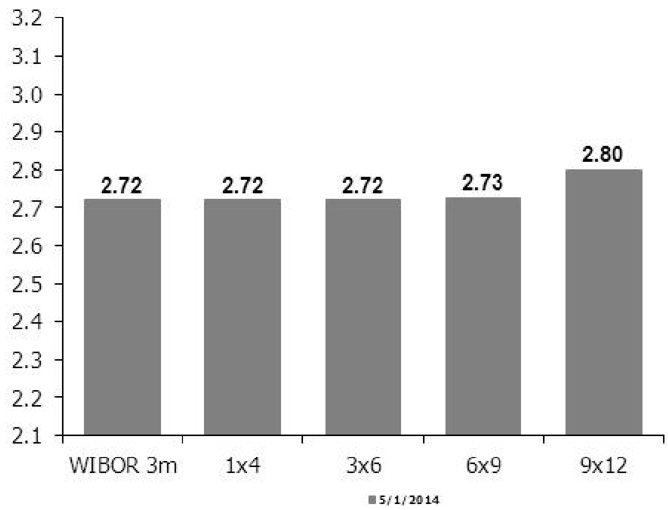
Strong and calm

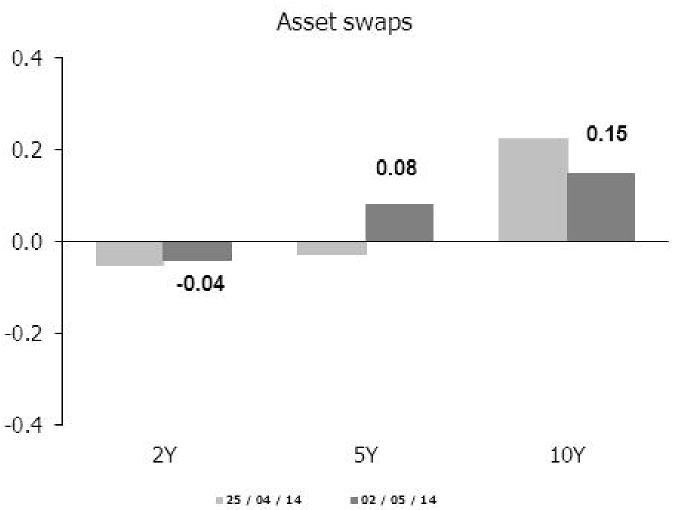
This week we had positive sentiment on Fixed Income market. Bond investors are not afraid of the 'Ukrainian conflict' anymore, core market bonds are more and more expensive. As a result, yield of PS0718 went down from 3.56% on the auction to 3.39% and is currently at 3.45% after surprisingly good nonfarm payrolls.

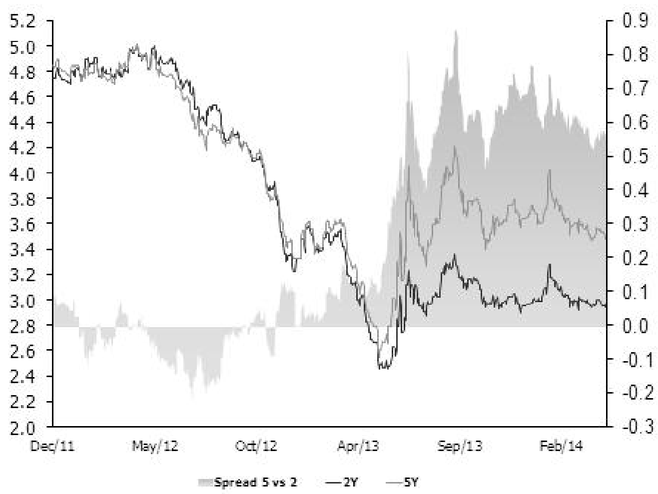
We expect next week to be calm before an auction (new PS0719 and floater WZ0119 on the offer, up to 5bln). Usually investors 'make room' for new bonds and that sell-off pushes the prices lower, but we don't think we are going to see that scenario this time. Size of an offer is not huge, MinFin may sell more floaters if they see not enough bids on PS0719.

Recommendation: Keep 5Y bonds. Opportunity to buy more on the auction.





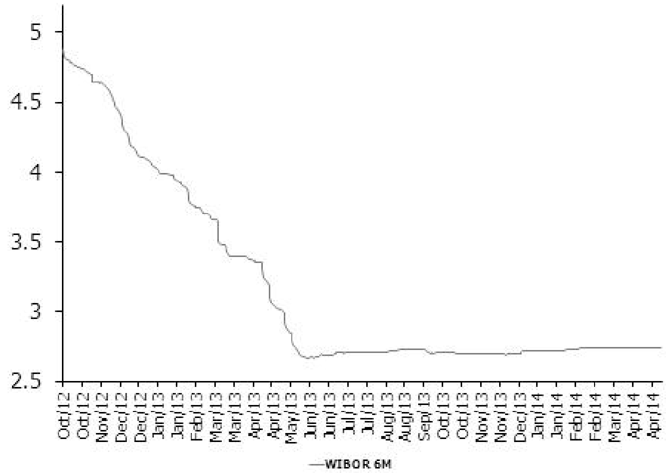


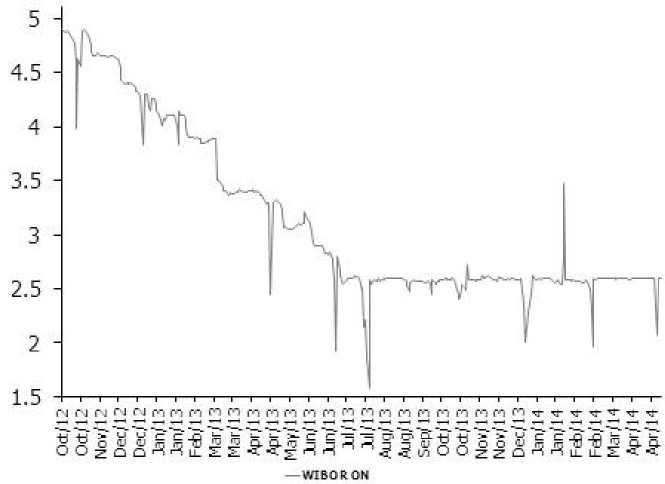


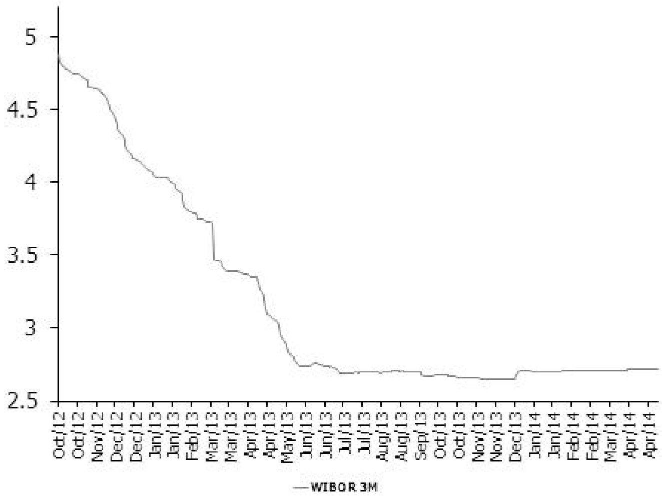
Money market

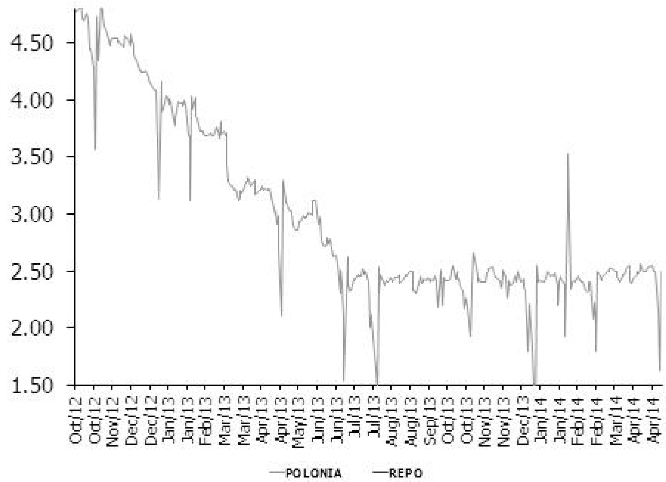
Tedious lack of volatility As we expected last days of reserve were cheap. Polonia fall to 2.16% on Friday and 1.63% on Monday. Today OMO was underbid by 1 bn. Next week won't be cheap as it is a beginning of new reserve (last day of reserve is on Sunday). As a result, our strategy to buy 1-3W OIS and sell 1M at the beginning of each month won't be successful in May.

Recommendation: Comparing to OK0714 and OK0715, PS0415 (coupon bond) looks attractive at 2.68 for carry trades.





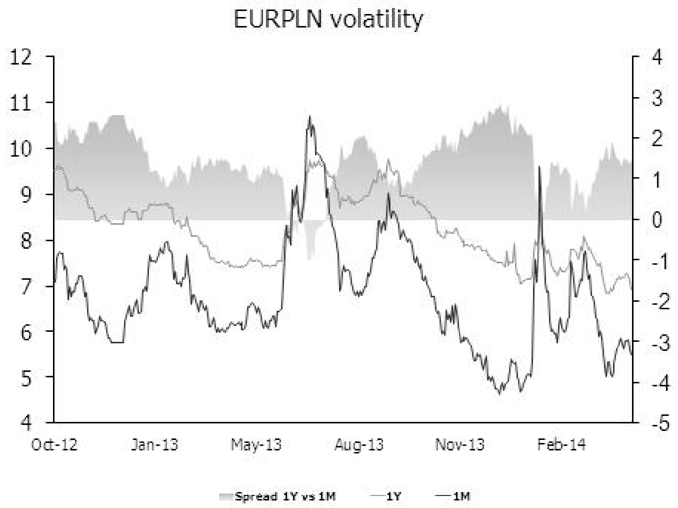




Forex

PLN stable As Thursday was a public holiday in Poland, activity during the whole week was subdued. EURPLN was traded in the narrow range of 4.1880â€“4.2100. The average daily percentage change is around 0.2% - the realized volatility is extremely low (1w around 3.5%). The main drivers for PLN can be the possible easing action from ECB, and the geopolitical tensions in Ukraine.

Vols lower The sellers are back in control. As a consequence, the EURPLN 1 month ATM was given today at 4.0% (1.5% lower then a week before), 3 month ATM fixed at 5.75% (0.35% lower), 6 month is 6.3% (0.3% lower) and 1 year lowered by 0.45% to 6.8%. The biggest move was on the USD/PLN volatilities curve after currency spread (difference between USD/PLN and EUR/PLN) dropped by 0.5% all over the curve. The skew was roughly unchanged.

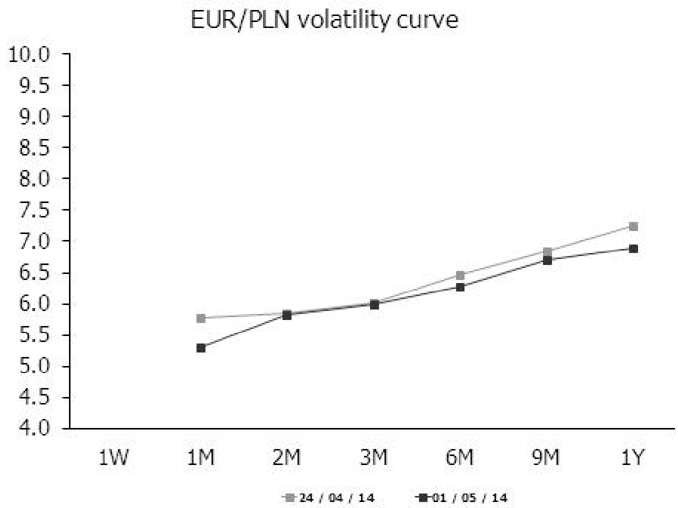


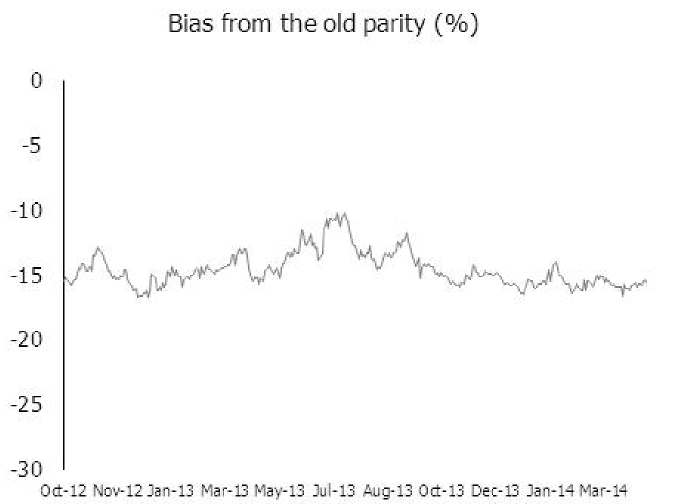
Short-term forecasts

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

Play range We still assume we are in the range, which now would be the most probably 4.16 - 4.24. We are more keen to sell spikes with ideal entry level at 4.23-4.24 and stop above 4.25 and hopes for a move below 4.19. Or alternatively buy EUR/PLN at 4.18, add 4.16 with stop below 4.15. Last time the move is painfully slow, so patience is required.

Neutral We have changed our selective Vega buying recommendation to a neutral one. The realized volatility is constantly descending (especially if we look at a daily basis). It does not bode well for Vega longs. The vols are cheap in comparison to the historic ones but they are quite expensive to the realized volatilities. The Theta/gamma ratio was also not that attractive any more with such a low realized volatility. Stay aside.





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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
4/28/2014	2.83	2.72	2.88	2.64	2.69	2.69	2.73	2.73	2.73	2.83	2.99	2.79
4/29/2014	2.61	2.72	2.74	2.64	2.69	2.69	2.72	2.72	2.73	2.82	2.96	2.77
4/30/2014	2.50	2.72	2.64	2.64	2.68	2.69	2.72	2.72	2.73	2.80	2.93	2.77
5/1/2014	2.74	2.72	2.88	2.64	2.95	2.69	2.72	2.72	2.73	2.80	2.93	2.77
5/2/2014	2.74	2.72	2.88	2.64	2.95	2.69	2.72	2.72	2.73	2.80	2.93	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
4/28/2014	2.690	2.625	2.955	2.898	3.520	3.686	3.930	4.024
4/29/2014	2.690	2.703	2.960	2.928	3.510	3.647	3.925	4.125
4/30/2014	2.690	2.584	2.940	2.899	3.475	3.557	3.885	4.036
5/1/2014	2.690	2.584	2.940	2.899	3.475	3.557	3.885	4.036
5/2/2014	2.690	2.584	2.940	2.899	3.475	3.557	3.885	4.036

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
4/28/2014	5.83	6.14	6.54	7.20	7.20	3.00	0.73
4/29/2014	5.64	6.06	6.44	7.13	7.13	3.00	0.73
4/30/2014	5.50	5.88	6.33	6.93	6.93	2.80	0.71
5/1/2014	5.30	6.00	6.28	6.90	6.90	2.85	0.72
5/2/2014	5.30	6.00	6.28	6.90	6.90	2.85	0.72

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
4/28/2014	4.2112	3.0368	3.4578	2.9694	1.3598	0.1534
4/29/2014	4.2053	3.0318	3.4474	2.9535	1.3592	0.1533
4/30/2014	4.1994	3.0440	3.4433	2.9701	1.3644	0.1530
5/1/2014	0.0000	0.0000	3.4433	2.9701	1.3644	0.1530
5/2/2014	0.0000	0.0000	3.4433	2.9701	1.3644	0.1530

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