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Polish Weekly Review

Department of Economic Analysis
(research)

Ernest Pytlarczyk, PhD, CFA
chief economist
tel. +48 22 829 01 66
ernest.pytlarczyk@mbank.pl

Marcin Mazurek, PhD
senior analyst
tel. +48 22 829 01 83
marcin.mazurek@mbank.pl

Piotr Bartkiewicz
analyst
tel. +48 22 526 70 34
piotr.bartkiewicz@mbank.pl

Marek Ignaszak
analyst
tel. +48 22 829 02 56
marek.ignaszak@mbank.pl

Department of Financial Markets
(business contacts)

Bartlomiej Malocha, CFA
head of interest rates trading
tel. +48 22 829 01 77
bartlomiej.malocha@mbank.pl

Marcin Turkiewicz
head of fx trading
tel. +48 22 829 01 67
marcin.turkiewicz@mbank.pl

Department of Financial Markets Sales
(business contacts)

Inga Gaszkowska-Gebska
institutional sales
tel. +48 22 829 01 67
inga.gaszkowska-gebska@mbank.pl

Jacek Jurczyński
structured products
tel. +48 22 829 15 16
jacek.jurczynski@mbank.pl

mBank S.A.
18 Senatorska St.
00-950 Warszawa
P. O. BOX 728
tel. +48 22 829 00 00
fax. +48 22 829 00 33
http://www.mbank.pl

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Comment on the upcoming data and forecasts

As for the first tier releases, this week inflation numbers and GDP data see the light. GDP growth may have topped 3.1% in Q1 with decent growth of consumption and further re-acceleration of investment activity. We think it may be too early to look for negative effects stemming from Ukraine, though. As for inflation, low food prices and stable fuel prices speak for a moderate reading. Market consensus is a tad below our forecast at 0.6% – we do not think food prices can as low to justify such a reading, though. As for second tier data, in balance of payments we are going to look for any softness in exports; in M3 money supply we are going to be mainly interested in corporate loans, including investment credit. Overall the data are not going to derail the current consensus of low inflation and accelerating growth; the latter may be proceeding somewhat slower than in the very first stages of the cycle which may – over coming months – generate some confusion among MPC members that shifted their forecasts up.

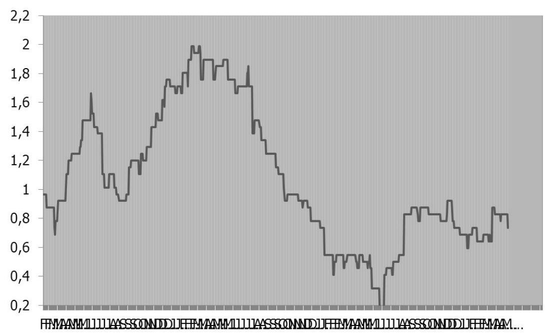
Polish data to watch: May 5th to May 9th

Publication	Date	Period	mBank	Consensus	Prior
CPI Inflation	14.05	April	0.70	0.60	0.70
M3 Money supply	14.05	April	5.3	5.2	5.1
GDP growth (flash)	15.05	Q1	3.1	3.1	2.7
C/A balance, EUR mln	15.05	March	-185	-186	-572
Core inflation	15.05	April	1.0	0.9	1.1

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	-	5000	3.406	5/9/2014
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

Index unchanged without any new releases.

* 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

- We are positive on Polish bonds due to global signals (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	3.1	3.3	3.6	4.3
Individual consumption y/y (%)	0.0	0.1	1.0	2.6	2.6	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	5.8	6	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

MPC on hold, as expected.

As expected, MPC did not change interest rates. Nor it did change forward guidance which still pins down interest rates at current level until end Q3. The statement is somewhat more optimistic with regard to labor market. However, the series of latest slightly softer data also can be found in the statement, although only in a form of a mere indication of negative surprises in releases.

The conference was not controversial at all and governor Belka is still more dovish than neutral. He pointed that MPC remains cautious on the back of the situation in Ukraine and also noted the high underlying level of uncertainty. In his opinion the possible consequences of the conflict tilt towards lowering the risk of monetary tightening. In the same vein he cited the ”expert” projections of inflation which stay under the one prepared on the basis of NECMOD model in inflation report by NBP research. We think that a remark on monitoring quarterly sequential growth rates of GDP was important. Such statistics trace better (and faster) any deviations from the cycle and mentioning this fact suggests the MPC stays on the alert. As far as forward guidance is concerned, Belka reaffirmed that its revision can be made in July along with new inflation projection. Governor also pointed out that June meeting is going to be non-event.

We think that low inflation and hard-to-quantify negative effects on growth stemming from Ukraine (see e.g. recent PMI readings) would keep MPC dovish. It would not be so hard to generate negative surprises in times when rate-setters recently corrected their expectations towards much more optimistic scenario.

As for market expectations, ECB factor is going to play an important role (of course on the dovish side). Low yields on the peripheral bonds should also help the debt of the countries-satellites of the euro zone (Poland, Hungary) via expectations on shifting down the expected path of interest rates. In such circumstances we would await further drop of 5-year market rates, where it is the most obvious that current, expected path of interest rates still stands at the pre-crisis level, above the current natural rate of interest.

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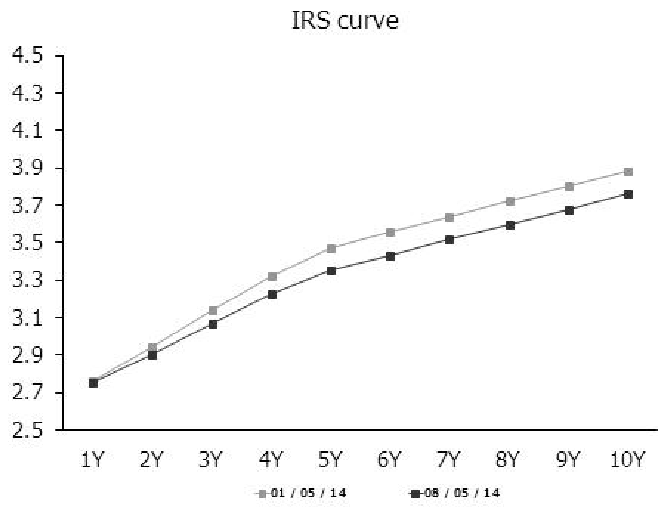
Fixed income

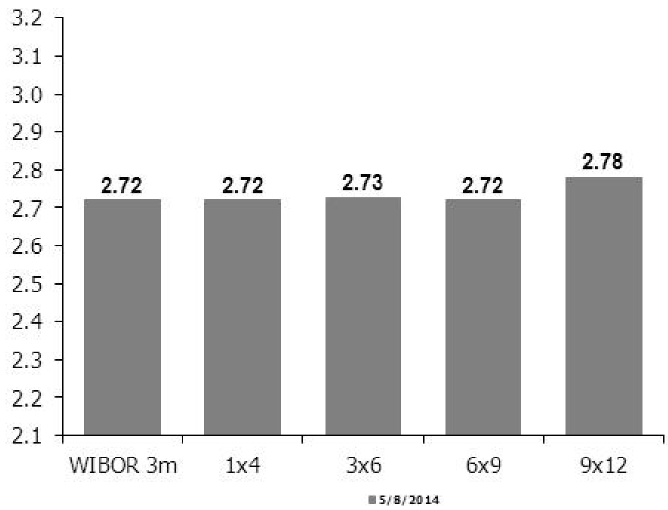
Sell in May and go away?

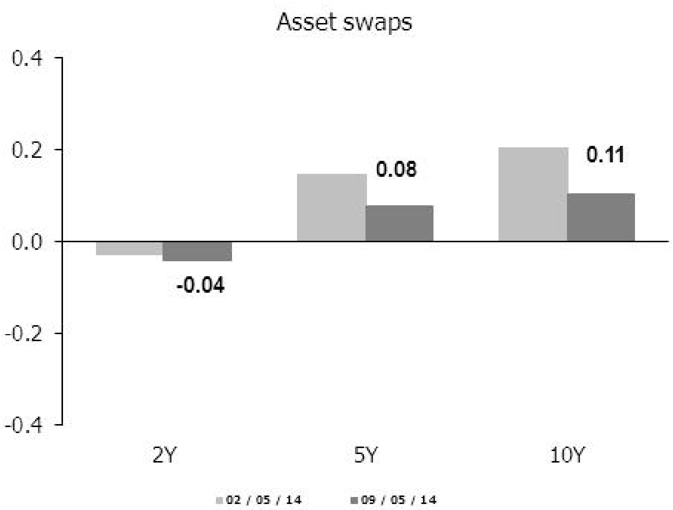
We are about 20 bps lower comparing to post payrolls levels (PS0718 3.26% vs 3.43%, DS1023 3.82% vs 4.04%). What happened? Market players are taking bet on ECB (MPC meeting and PS0719/WZ0119 auction were non-event). MoF sold PLN 5.7 bn bonds maturing in 2019 (1.62 bn WZ0119 and 4.06 bn new 5 year benchmark PS0719). Total demand was above 5 bn each, and prices were similar to secondary market.

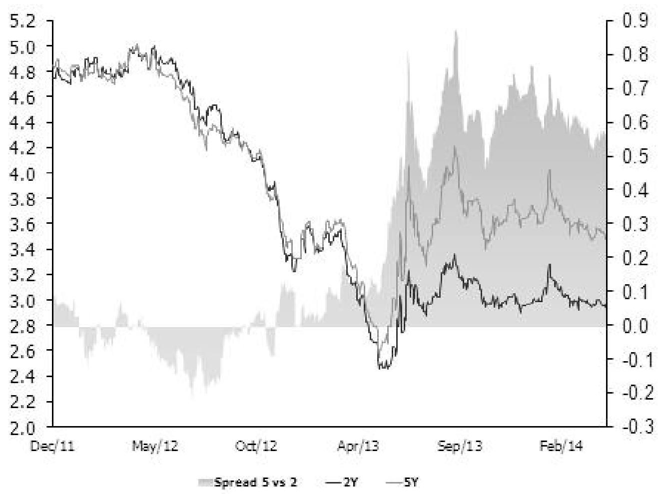
On Thursday Mr Draghi mentioned that Governing Council is comfortable with acting next time - it means in June they have to do something (cut or QE).

Usually easing rally lasts a little bit longer and is topped by a wave of S/L - it hasn't happened yet but the question is if market has overreacted as we don't know what type of action ECB is to take (possible disappointment?) while levels are decent.









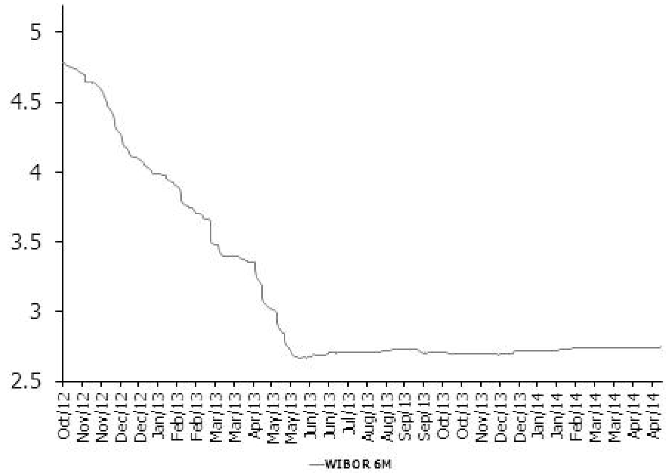
Money market

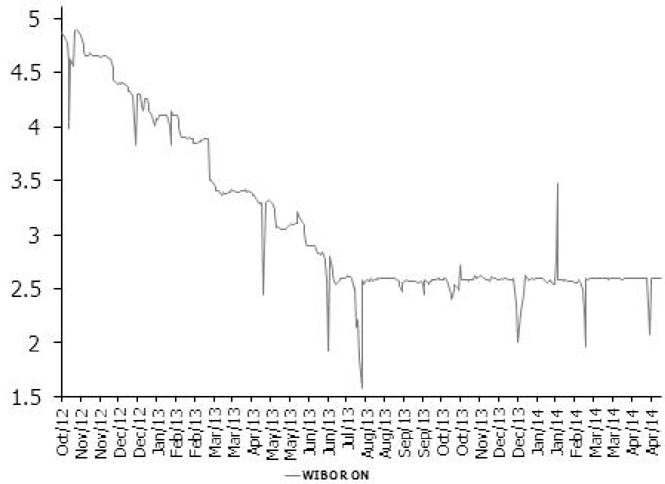
Finally some volatility Boring for liquidity and on the contrary for longer rates. Cost of carry remained stable nearby the main market rate. Today's OMO did not bring any change since the market was squared.

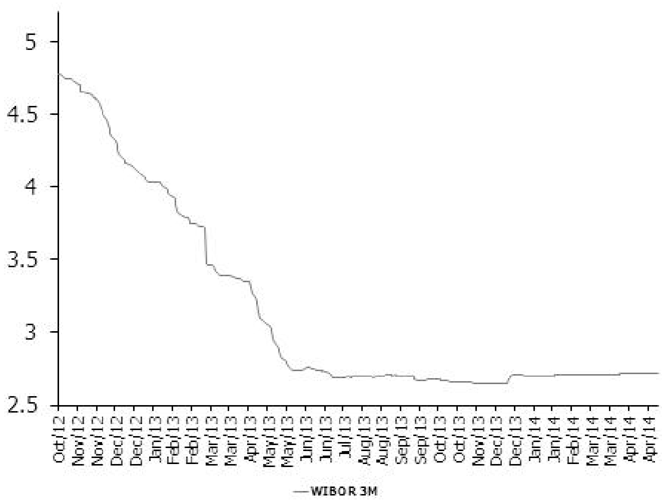
Huge inflow of the cash to EM and EU peripheries plus growing expectations for monetary easing by ECB next month pushed the bond prices aggressively up. The flow is on and the biggest question is when it stops. The expected scale of the easing creates room for disappointment though.

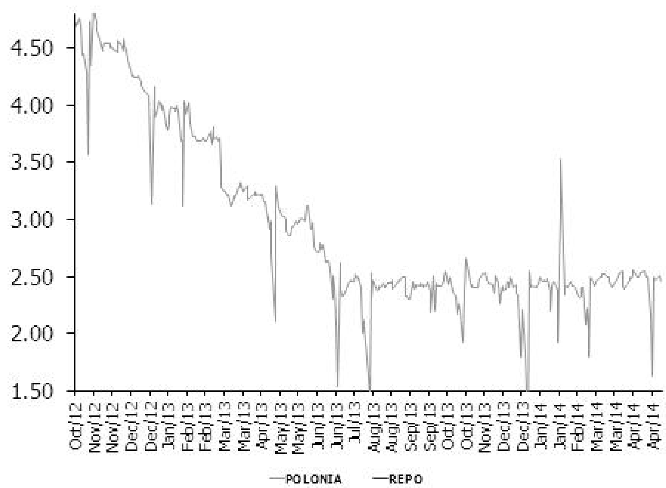
This inflow pushed derivatives to the levels that from the technical perspective look massively oversold. On the other hand if bond purchases are carried on technical aspects loose value. Next week we will see low inflation and solid 1Q GDP (impressive mainly by its quarterly dynamics). Nonetheless the local market will remain under huge influence of the core markets and potential further fresh cash inflow.

If one is cautious may be good idea to take the profit now, if the risk appetite remains dominant flattener still has potential.









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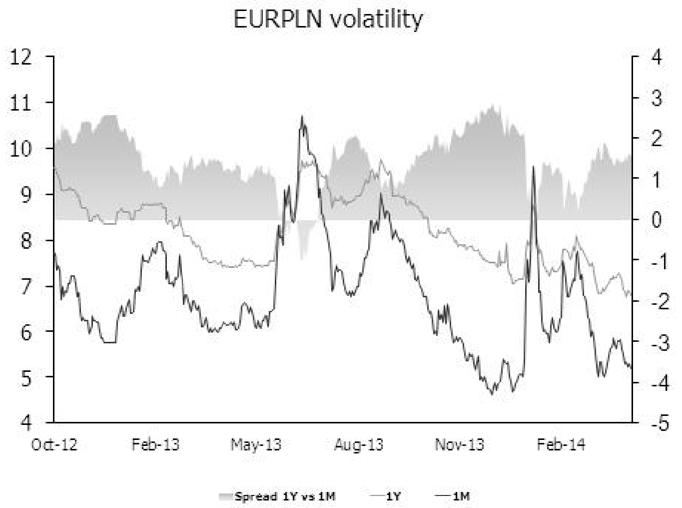
Forex

PLN stronger PLN stronger - EURPLN looked heavy above 4.20 and after marking a high of a week at 4.2095 it started a slow descent. It intensified after the ECB dovish message and we reached 4.1760 low. The move would be much deeper if would not be a little cushioned by a USD/PLN which after briefly dip below 3.00 climbed to 3.0375 (thanks to EUR/USD). The hopes of a dovish move from a ECB are really high, and the market is "buying a rumor" quite viciously , maybe they will be later "selling the fact" but it will take some time. EUR/PLN bigger picture is unchanged (4.14 - 4 .24), and we may test the lower part of the range.

Vols lower The slide in vols was almost parallel, the stronger PLN, low realized vol, and the bullish EM are to be blamed. 1 month EUR/PLN ATM mid is lower by 0.2% to 4.6%, 3 months are today at 5.5% (0.25% lower) and finally 1 year fived 6.6% (down by 0.2%). The skew was also better offered, with 6 month EUR/PLN 25D given at 2.2%.

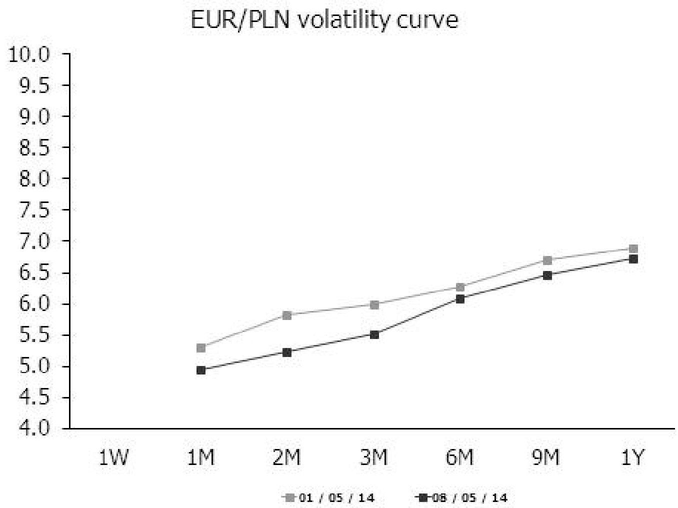


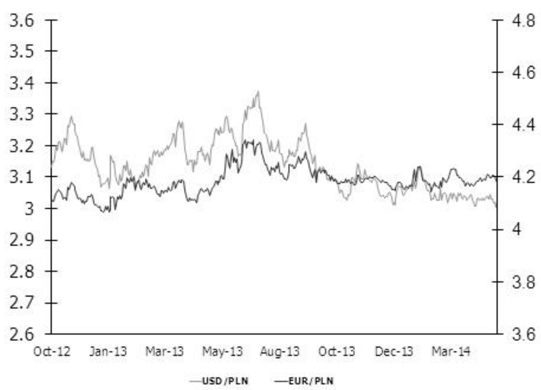
Short-term forecasts

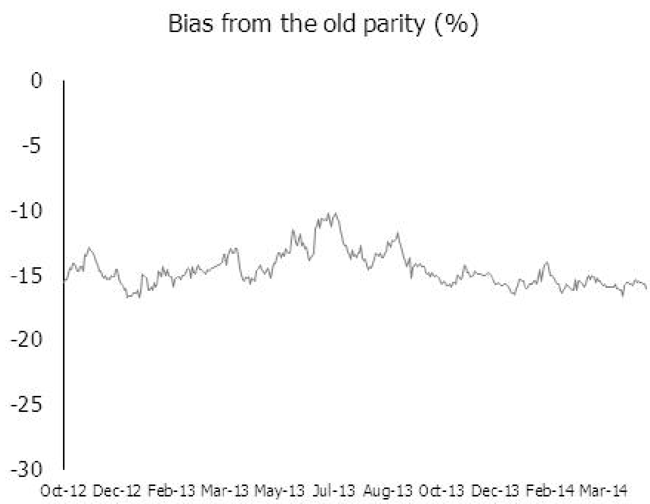
SPOT Main supports / resistances:
EUR/PLN: 4.1400 / 4.2600
USD/PLN: 3.0000 / 3.1500

Spot - Play range We missed our sell recommendation for EUR/PLN, as we did not reach our 4.22/4.23 sell zone. We are sidelined at the moment (considering buying) but patience is required. The bullish EM mood will most likely continue, and as the consequence we are moving our bids lower. We would like to buy EUR/PLN at 4.15, add 4.1250 with stop below 4.11 and hopes for a move back above 4.20.

Options - still sidelined The implied vols are moving lower and lower in nominal terms, but unfortunately so the realized ones. As the result we are neutral now, but we are rather considering buying Vega and Gamma at current levels. What we need is a pickup in realized volatility or some event that will rise the likelihood of increased volatility. The patience is a key word and we need plenty of it in current market circumstances.







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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
5/5/2014	2.59	2.72	2.75	2.64	2.97	2.69	2.72	2.72	2.73	2.81	2.96	2.76
5/6/2014	2.85	2.72	2.90	2.64	2.83	2.70	2.72	2.72	2.73	2.81	2.94	2.76
5/7/2014	2.49	2.72	2.64	2.65	2.85	2.70	2.72	2.73	2.74	2.79	2.90	2.78
5/8/2014	2.61	2.72	2.74	2.65	3.00	2.70	2.72	2.73	2.72	2.78	2.89	2.75
5/9/2014	2.61	2.72	2.74	2.65	3.00	2.70	2.72	2.73	2.72	2.78	2.89	2.75

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
5/5/2014	2.690	2.683	2.910	2.904	3.455	3.549	3.870	4.036
5/6/2014	2.700	2.686	2.920	2.901	3.470	3.600	3.890	4.047
5/7/2014	2.700	2.551	2.918	2.869	3.410	3.492	3.830	3.927
5/8/2014	2.700	2.654	2.905	2.863	3.355	3.434	3.760	3.865
5/9/2014	2.700	2.654	2.905	2.863	3.355	3.434	3.760	3.865

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
5/5/2014	5.25	5.75	6.23	6.88	6.88	2.92	0.71
5/6/2014	5.29	5.73	6.25	6.88	6.88	2.92	0.71
5/7/2014	5.20	5.65	6.20	6.80	6.80	2.77	0.70
5/8/2014	4.95	5.51	6.08	6.73	6.73	2.77	0.70
5/9/2014	4.95	5.51	6.08	6.73	6.73	2.77	0.70

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
5/5/2014	4.2056	3.0310	3.4550	2.9733	1.3673	0.1533
5/6/2014	4.2051	3.0196	3.4540	2.9610	1.3671	0.1533
5/7/2014	4.2003	3.0187	3.4495	2.9723	1.3688	0.1532
5/8/2014	4.1865	3.0042	3.4347	2.9505	1.3776	0.1526
5/9/2014	4.1787	3.0247	3.4292	2.9724	1.3764	0.1525

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