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Polish Weekly Review

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Comment on the upcoming data and forecasts

The series of macro releases for April is continued. Labor market (data to be released on Monday) has likely improved further. Although wage growth probably decelerated from fresh highs, it is not a sign of weakness but rather a consequence of base effects. Employment, on the other hand, is steadily accelerating along with the economy. Tuesday brings industrial output data. We expect a slight slowdown in industrial output, as the difference in the number of working days is still zero. The accompanying release of PPI should attest to the lack of inflationary pressures in the Polish economy: no change on a month to month basis, with y/y growth edging upwards due to a massive base effect from last year. Finally, the week will end with the release of MPC Minutes. Even though this month's press conference was a total non-event, one should not assume the same about the discussion among the rate setters - perhaps first voices challenging the current status quo appeared.

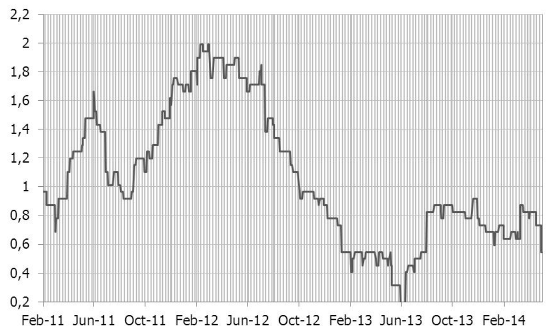
Polish data to watch: May 19th to May 23rd

Publication	Date	Period	mBank	Consensus	Prior
Wages y/y (%)	19.05	Apr	4.0	4.0	4.8
Employment y/y (%)	19.05	Apr	0.8	0.8	0.5
Sold industrial output y/y (%)	20.05	Apr	4.9	5.1	5.4
PPI y/y (%)	20.05	Apr	-0.7	-0.7	-1.3
MPC Minutes	22.05	May			

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	-	4000	3.406	5/8/2014
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

Sharply down after the CPI release. The familiar pattern (positive surprises in real-sphere data and negative ones in price data) continues.

* 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 (food price deflation and strong labor market are to boost consumtion going forward). We see substantial support from investment activity already materializing. 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 (nontradables prices show moderate inflation though).
- The MPC has already acknowledged low inflation and possible negative spillovers from Ukraine events. 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, play on renewed monetary easing or correction of expectations regarding natural interest rate level for Poland). 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. Debt crisis style sell off in peripheral countries (low growth and low inflation means more austerity (=even worse equilibrium) or decisive ECB intervention) would make Polish assets suffer in the short-term, mid-term consequences rather favorable due to expectations for lower rates also in Poland.
- 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	3.3	3.1	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	2.75	2.80	2.90
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.23	3.55	3.90	4.50
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

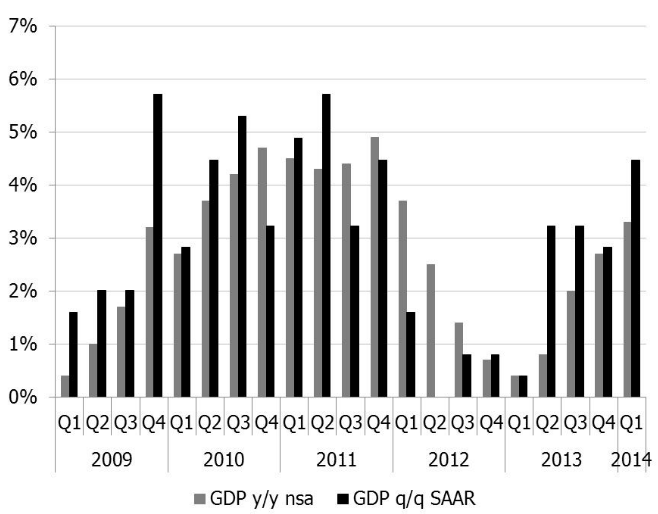
Economics

While the economy is steaming ahead, very low inflation should make Polish monetary policy a bit more interesting

Recent stream of data confirmed yet again that the economy is growing nicely but with no inflationary pressures at all. There is, however, a twist to this story. GDP data are a rear-view mirror and, while without a doubt positive (3.3% y/y is easily above potential!), cannot dispell fears of Ukrainian / Russian fallout since transmission of shocks takes time (currently available evidence gives still a signal that nothing materially changed). CPI, on the other hand, is more up-to-date and the surprising drop in April (to a mere 0.3%) brought deflation fears back – the more so since negative inflation was already recorded in Hungary. As a result, there is now talk of rate cuts – just as we expected – and the market began to price in a cut. Perhaps rightly so. Given the current alignment of domestic, regional and global factors, the MPC now has a clear path to cut rates on any of the upcoming meetings. Optimistic GDP forecasts are probably the only argument against a new easing cycle, as several members expect at least 4% growth in the latter half of the year and low inflation in high-growth environment does not support the case for rate cuts in their book. It would probably take a marked deterioration in the real economy to force a cut. Nevertheless, from now it will be hard to ignore the risk of a renewed easing in Poland.

GDP and trade data confirm the limited impact of Ukrainian crisis on the Polish economy

GDP growth accelerated in the first quarter of the year to 3.3% y/y from 2.7% y/y in the previous quarter (market consensus and our forecast: 3.1%). The acceleration is visible also in subsequent quarterly growth rates: from 0.1% one year ago, through 0.7% in the previous quarter, to 1.1% q/q in the first three months of the year. Although GDP expanded at the fastest rate since Q4 2011, one should not be attached to sequential, quarterly growth rates (standard deviation of revisions is 0.4 percentage points).



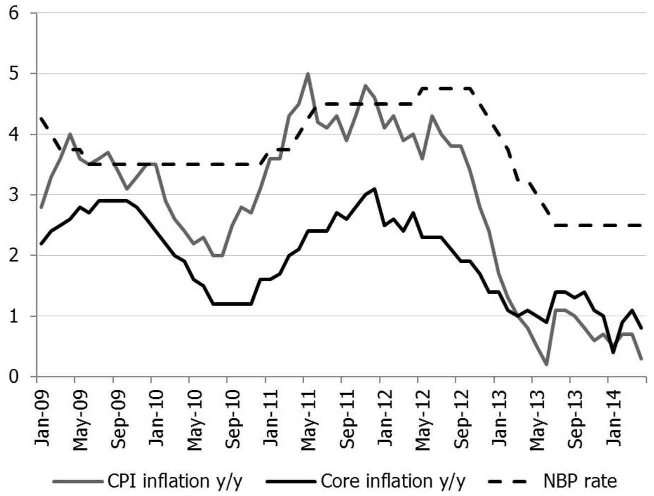
As usual, the flash release contains no information on the structure of GDP growth, therefore we are forced to speculate. In our view, the economy was propelled by robust growth of domestic demand. Household consumption, boosted by low inflation and vigorous wage growth, probably accelerated to 2.7% y/y. Investment likely surged by 6-7% y/y, partly because of a very mild winter, already reflected in exceptionally good performance of construction in the first quarter. Obviously, the impact of Ukrainian crisis cannot be discerned from such data and it was probably not the issue for the first quarter. However, we repeatedly pointed out to the dichotomy between relatively robust and shielded domestic demand and turbulent external demand (possibly yet to be seen).

As for the latter, March trade and BoP data brought a few surprises that confirm our earlier observations. Instead of posting a small deficit, current account swung back into a sizeable surplus (the second largest in history). Averaged over the past 12 months, current account deficit is at the lowest level in history (0.9% of GDP). The main source of the surprise was trade balance, mainly the behavior of exports which largely made up for the previous month's losses and returned to solid growth. Does that mean that the effects of Ukrainian crisis are gone? Quite the opposite is true, but somehow shocks are being make up by other export partners' demand. As CSO's detailed data show, exports to Eastern European countries (mainly Russia and Ukraine) slowed down further. Over the whole quarter, exports to Ukraine dropped by almost 25%, to Russia – by 7%. Very poor sales to the Eastern markets were, however, balanced by strong demand from Western European customers. Germany of course led the way (a surge by ca. 23% in March alone) but one should note very extremely strong demand from the Eurozone periphery. Consider that exports to Spain jumped by over 25% in Q1 – that made Spain Poland's 10th largest export market virtually overnight. As a result, aggregate exports were largely unharmed by the rapid deterioration of economic conditions in the East. Finally, this explains divergent paths of various exports-oriented industries in recent months.

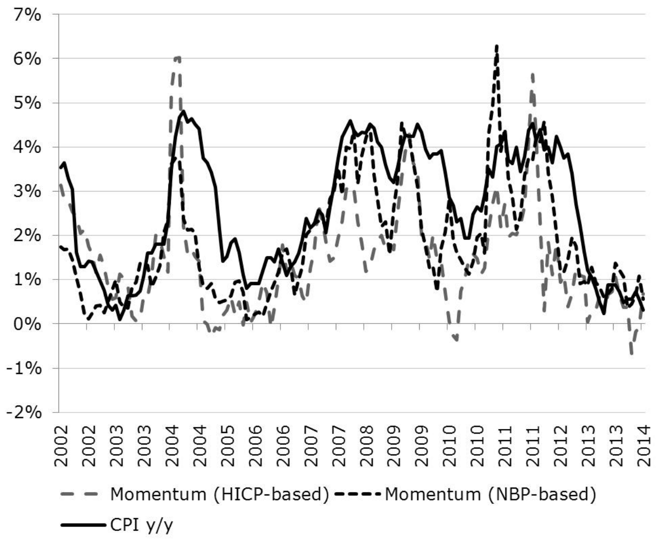
Yet another drop in inflation

April CPI surprised to the downside again, having fallen from 0.7% y/y to only 0.3% y/y (market consensus: +0.6% y/y). The drop in inflation should be attributed mainly to a fall in food prices (-0.5% m/m) and further cuts in prices of telecommunication services (-1.5% m/m). As a result, core CPI declined from 1.1

to 0.8% y/y. Low growth rates in both categories have become a familiar part of the inflation landscape and it is self-evident that Poland (just as the other CEE countries – see the Hungarian experience) has been importing deflation. In the next month we expect CPI to accelerate slightly, mainly due to the delayed effects of excise tax hike (pass-through to retail prices has so far been non-existent) but this shouldn't add more than 0.3-0.4 p.p. to annual CPI growth rate. Neither will it change the fact that forecasts of private analysts and NBP's staff projections must be revised downward once again. Furthermore, high statistical base from last year (due to the sharp increase in waste disposal fees) makes another drop to the vicinity of 0.0% likely (July).



Going forward, however, we should start focusing on signs of turnaround in the inflation data. Between the pervasive influence of exogeneous factors and various statistical base effects hidden in a myriad different categories, it is impossible to call out a bottom using y/y dynamics alone. Thus, we keep coming back to momentum measures. So far, the analysis has been inconclusive. While a HICP-based measure (3m/3m growth of seasonally adjusted HICP index excluding food, energy, alcohol and tobacco) shows a sharp turnaround in March and April (if sustained, it would be a strong signal), the NBP-based series (3mma of 15%-trimmed mean inflation) at best suggests bottoming out. As the latter seems to be more stable, we would accept that conclusion. We will, however, be vigilant, as several factors continue to point out to higher inflation in the second half of the year: growing global food prices and slowly mounting wage pressures.

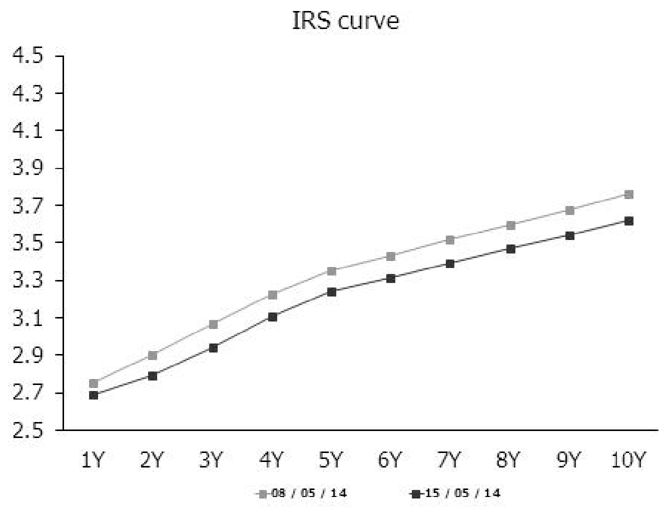


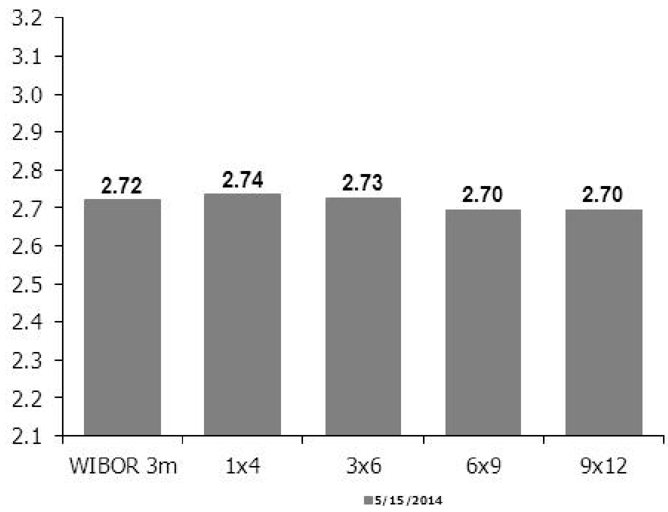
Fixed income

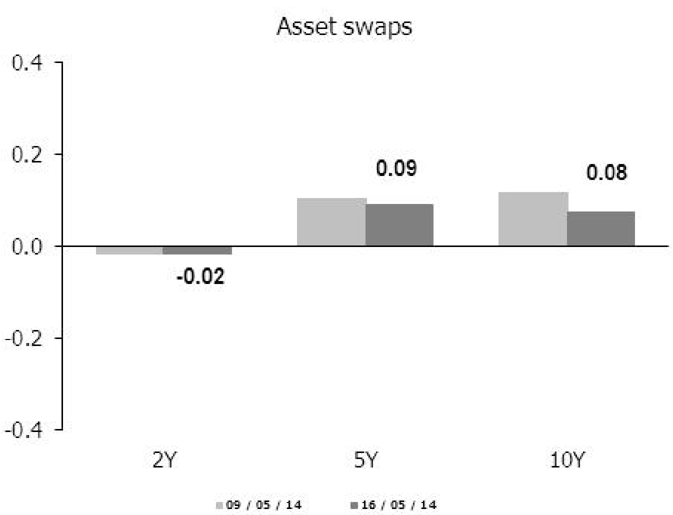
C P I

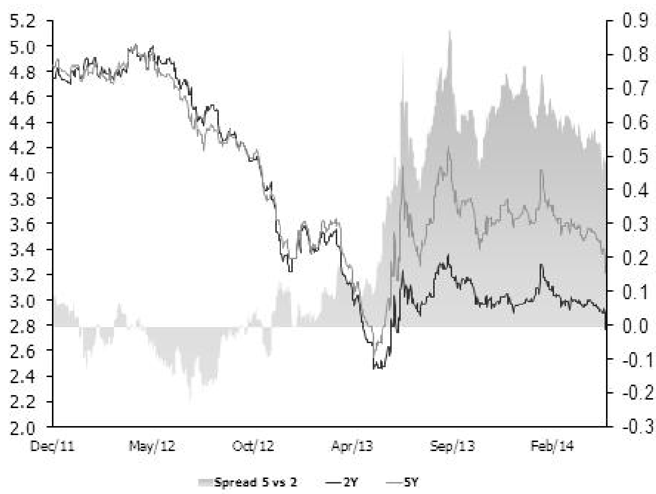
What a week! We had crazy, positive sentiment on PolGb's - suddenly investors forgot about Fed and tapering. Possible ECB's actions (QE and/or a rate cut) and our low CPI (only 0.3% vs 0.6% expected) were major topics. In the second part of the week profit taking on 'peripheral bonds (Spain/Italy) chilled out our investors and in the end 5Y bond trades around 3.23% yield (3.33% at the beging of this week, 3.09% was the low).

We feel that this profit taking is going to be short and the pressure before ECB is going to be positive for our market, yet again. While we do not believe in rate cuts in Poland market can definitelly start 'playing this scenario' and that would support 2Y/5Y bonds.





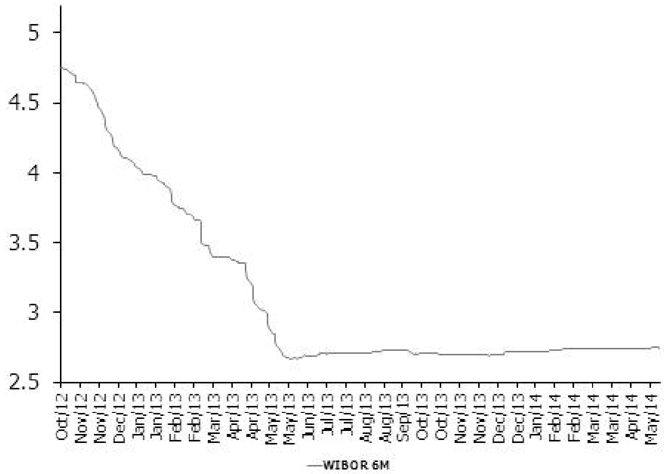


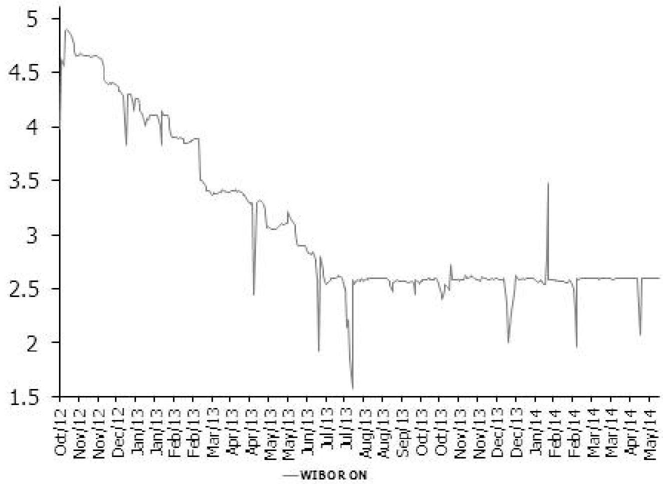


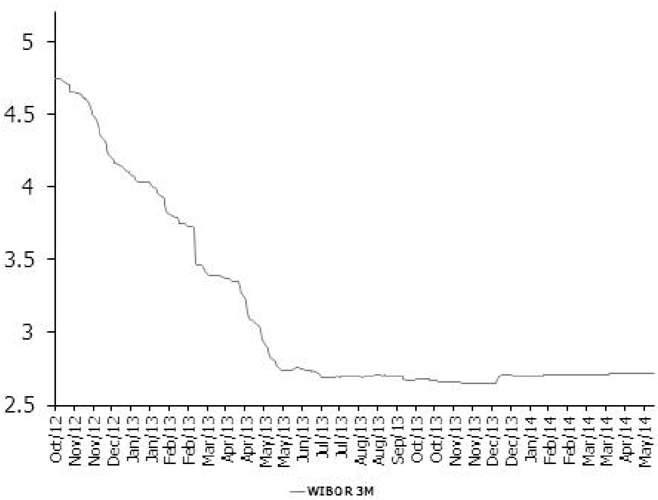
Money market

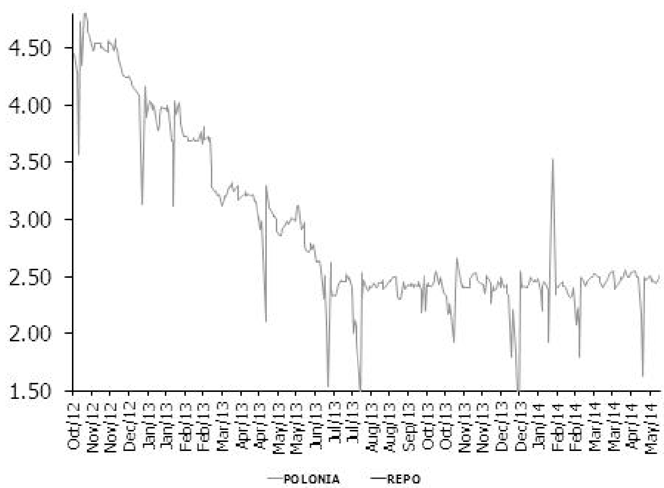
Bullish week behind us. After a bit cheaper week at the beginning of the month Polonia came back to 2.50%. Todays OMO was underbid by 2 bn PLN but it will not be much cheaper next week. Maybe last week of reserve is the time when cash rates can fall.

Last week was very bullish. 2Y IRS moved by 10 bps. Even 1Y OIS moved down (by 8 bps) after publishing Polish CPI data (0.3% vs 0.6% expected) and market started to think about cutting rates in Poland. Short contracts moved under 3M and 6M WIBOR.





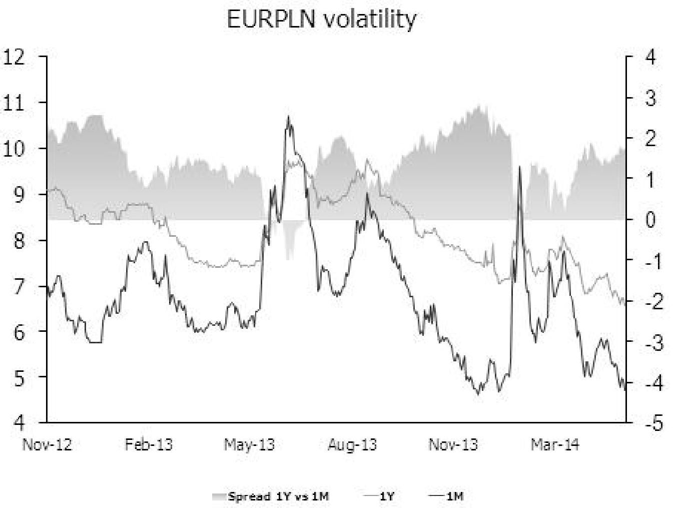




Forex

PLN stronger PLN stable - The market is still living under the ECB QE spell, EUR/PLN moved sideways in 4.17 - 4.20 range, but in general the mood is optimistic. The renewed talks about possible rate cuts in Poland (after a very low CPI number) did little to dent PLN strength. The bigger picture is the still unchanged 4.14-4.24 range, but if EBC action would prove to be such gigantic as some fear, the lower band of the range would be exposed.

Vols lower Vols consolidating - The EUR/PLN vols finally have found is equilibrium level, consolidating its earlier losses. The demand finally emerged due to extremely low historical vols, but realized vols are still considerably lower. The 1 month EUR/PLN ATM mid is today 4.85% (0.25% higher), 3 months are 5.6% (0.1% higher) and finally 1 year fixed today at 6.7% (0.1% higher). Skew is roughly unchanged.

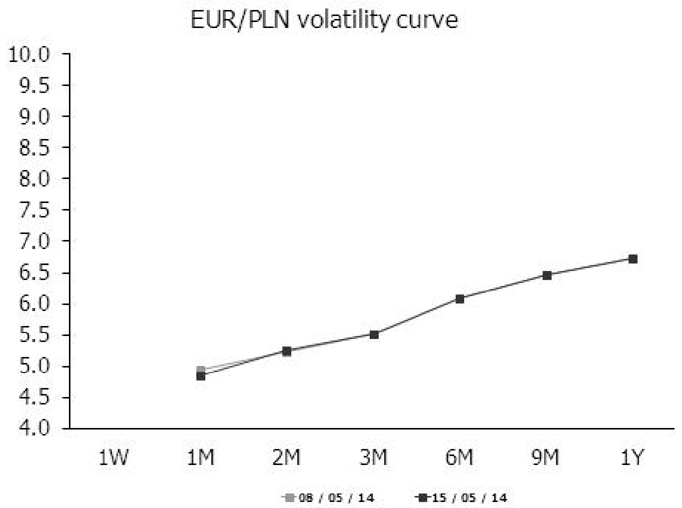


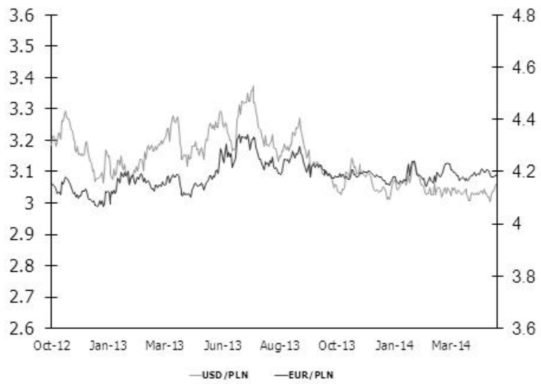
Short-term forecasts

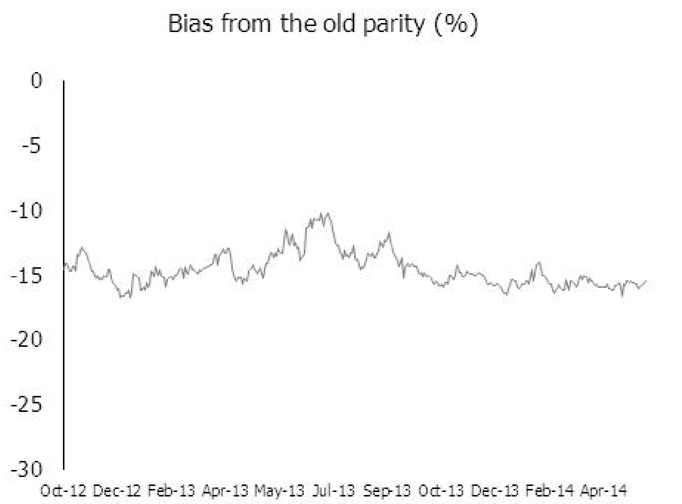
SPOT Main supports / resistances:
EUR/PLN: 4.1400 / 4.2600
USD/PLN: 3.0000 / 3.1500

Spot. Play range from a short side. 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. Unchanged from last week. 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 increase the probability of volatility. The patience is a key word, and we need plenty of it in current market circumstances.







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
5/12/2014	2.61	2.72	2.76	2.65	2.98	2.70	2.72	2.72	2.72	2.78	2.90	2.77
5/13/2014	2.64	2.72	2.78	2.65	2.99	2.70	2.72	2.72	2.73	2.76	2.88	2.75
5/14/2014	2.55	2.72	2.71	2.65	2.87	2.70	2.71	2.69	2.66	2.66	2.71	2.67
5/15/2014	2.61	2.72	2.75	2.64	2.95	2.70	2.74	2.73	2.70	2.70	2.81	2.71
5/16/2014	2.61	2.72	2.75	2.64	2.95	2.70	2.74	2.73	2.70	2.70	2.81	2.71

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	4/23/2014	7/25/2016	93.51	3.02	800	2136	836
PS0719	5/8/2014	7/25/2019	99.25	3.41	4000	5807	4075
DS1023	4/3/2014	10/25/2023	97.95	4.26	3500	4905	3480

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
5/12/2014	2.700	2.699	2.930	2.857	3.410	3.468	3.805	3.879
5/13/2014	2.700	2.661	2.893	2.854	3.330	3.407	3.720	3.828
5/14/2014	2.700	2.611	2.770	2.815	3.210	3.284	3.615	3.754
5/15/2014	2.700	2.606	2.790	2.775	3.240	3.333	3.620	3.696
5/16/2014	2.700	2.606	2.790	2.775	3.240	3.333	3.620	3.696

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
5/12/2014	4.99	5.51	6.04	6.71	6.71	2.74	0.70
5/13/2014	4.94	5.58	6.10	6.73	6.73	2.74	0.70
5/14/2014	4.71	5.45	5.93	6.55	6.55	2.66	0.69
5/15/2014	4.85	5.53	6.08	6.73	6.73	2.79	0.70
5/16/2014	4.85	5.53	6.08	6.73	6.73	2.79	0.70

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
5/12/2014	4.1797	3.0362	3.4243	2.9778	1.3766	0.1526
5/13/2014	4.1815	3.0381	3.4248	2.9680	1.3770	0.1526
5/14/2014	4.1828	3.0480	3.4287	2.9934	1.3782	0.1525
5/15/2014	4.1824	3.0589	3.4240	3.0031	1.3811	0.1525
5/16/2014	4.1935	3.0567	3.4334	3.0099	1.3735	0.1528

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