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Polish Weekly Review

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Comment on the upcoming data and forecasts

The week begins with Monday's Manufacturing PMI reading for May. Following two months of sharp decline (deeper than the one observed in the case of German PMI), a decline that was not confirmed by other indicators, one would expect a slight rebound - just as the consensus puts it. However, the recent fall in almost all CSO's business tendency indicators could suggest a further deterioration of confidence among entrepreneurs. On Tuesday (not Wednesday - please note the exception!), the MPC will announce their interest rate decision. The June meeting is not supposed to bring any changes in the monetary policy stance. In the environment of stubbornly low inflation and uncertainty about the forthcoming ECB's decision, we expect a dovish tone of the statement. Simultaneously, the forthcoming meetings will be biased toward discussion about lower rates.

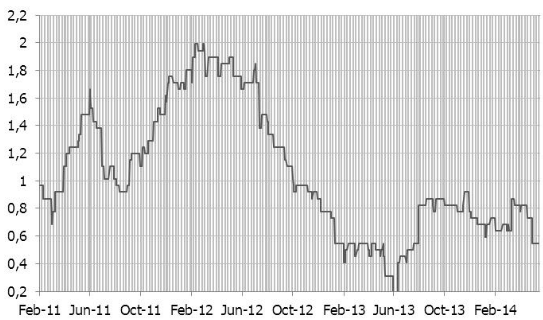
Polish data to watch: June 2nd to June 6th

Publication	Date	Period	mBank	Consensus	Prior
Manufacturing PMI (pts.)	02.06	May	51.7	52.2	52.0
MPC's Rate Announcement (%)	03.06	Jun	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	-	4000	3.406	5/8/2014
10Y T-bond DS1023	6/5/2014	3500	4.261	4/3/2014
20Y T-bond WS0429	6/5/2014	150	3.464	5/16/2013

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



Comment

Unchanged - all releases from last week were broadly in line with expectations. Next week brings only one relevant publication - the PMI. Since the release has been one of the principal drivers of Polish surprise index, we cannot rule out a surprise this time.

* 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

- 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).
- 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 if zloty strenghtens significantly, inflation drops and ECB delivers). 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, Poland might be increasingly seen as a high-yield alternative to euro area, especially if Polish track record of stable growth and 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	0.5
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

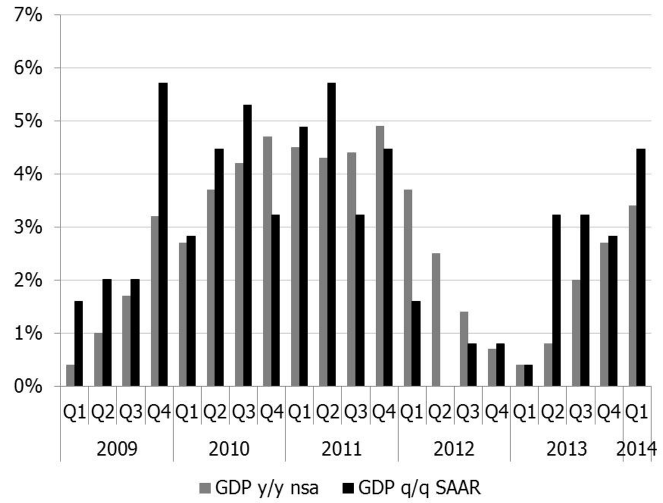
	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1 F	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.4	0.8	2.0	2.7	3.4	3.1	3.6	4.3
Individual consumption y/y (%)	0.0	0.1	1.0	2.1	2.6	2.6	2.8	3.1
Public Consumption y/y (%)	0.1	5.0	3.0	3.1	0.7	2.0	2.0	3.0
Investment y/y (%)	-2.4	-3.3	0.5	2.0	10.7	5.3	7.5	8.5
Inflation rate (% average)	1.3	0.5	1.1	0.8	0.6	0.5	0.1	0.8
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	4.10	4.10	4.05
USD/PLN (eop)	3.26	3.32	3.12	3.02	2.97	3.01	3.00	3.01

F - forecast

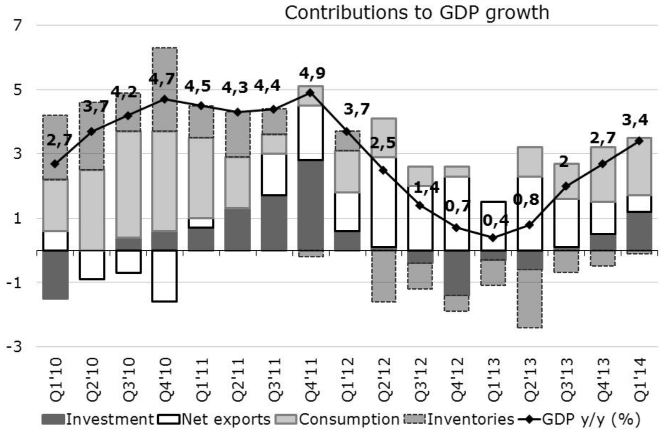
Economics

GDP accelerated in the first quarter as well, even stronger than indicated by flash estimate

GDP growth accelerated in the first quarter of the year to 3.4% y/y from 2.7% y/y in the previous quarter (0.1% higher than the flash estimate indicated). The acceleration is visible also in subsequent quarterly growth rates: from 0.1% one year ago, through 0.8% in the previous quarter, to 1.1% q/q in the first three months of the year (the path of GDP growth had not been changed, even though the annual reading was revised upward). Although GDP expanded at the fastest rate since Q4 2011, one should not be attached to quarterly growth rates (standard deviation of revisions is 0.4 percentage points).



The reading has beaten our, already optimistic, expectations. Personal consumption increased by 2.6% y/y, in line with our expectations (we forecast 2.7%), whereas the major surprise was the surge in investment (amounting to 10.7%). Although we were the most optimistic among market forecasters, our forecast of 6.1% y/y was beaten significantly to the upside. Such a boom in investment can be attributed to the unusually warm winter stimulating construction works. If it is the case, today's reading will be an one-off followed in the forthcoming month by some negative payback. The Q2 could bring us a serious set-back in investment, even though the positive trend is intact and investment in machinery and equipment should not be affected by the weather. Thus, we probably won't see GDP accelerating further in Q2 - such a view is supported by a weakening of momentum in industrial output in recent months.



Too crude are the data to see the eastern (i. e. slowdown of Russian and Ukrainian imports) crisis within. So far we do not also get a confirmation from the high frequency data as well since the collapse of exports to the East is more than compensated by the rise in exports directed to the West. It is also worth to note that any shocks to external demand occur at the moment when domestic demand is strengthening cyclically, making the whole economy possibly less exposed.

Fixed income market did not react to the data. FX slipped a bit (stronger zloty) but it was only a blip. Accelerating economy is hard to reconcile with inflation being low forever; it's obvious. Less obvious is the scale of acceleration of the latter in monetary policy horizon. Recent data from the global economy suggest the link between inflation and growth softened. Therefore, models (including the one used by NBP) may be less inclined to show sharp acceleration of inflation in times of accelerating growth. What is more, although acceleration of GDP is a fact, its structure is healthy and possibly not so pro-inflationary as it can be (high investment, only moderately higher consumption pointing towards tendencies to rebuild savings). It is also not carved in stone forever since a part of the brisk Q1 result is seasonally driven. At times when GDP expectations of MPC members are flying high, negative surprise can pop out, the more so since real rates have recently risen and PLN has now more room for strengthening. Those risk factors can be mitigated by a rate cut, possibly a safe one since risk premium demanded in EM rates is lower than it used to be. We do not forget about rate cuts (30-40% probability) although the solution to trilemma between growth, inflation and risk management demands broader support from inflation projection.

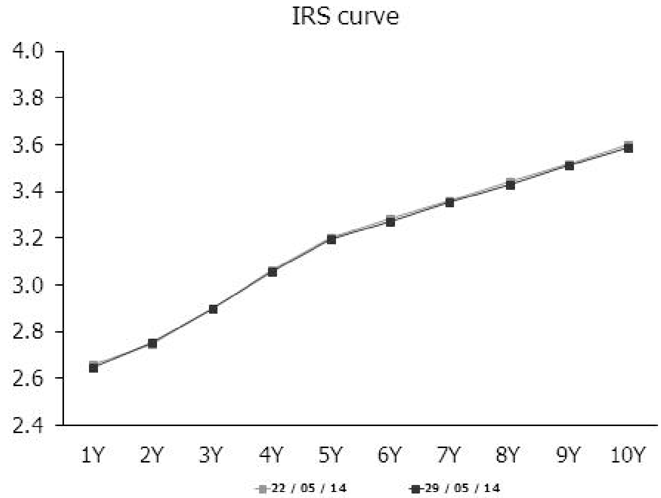
Fixed income

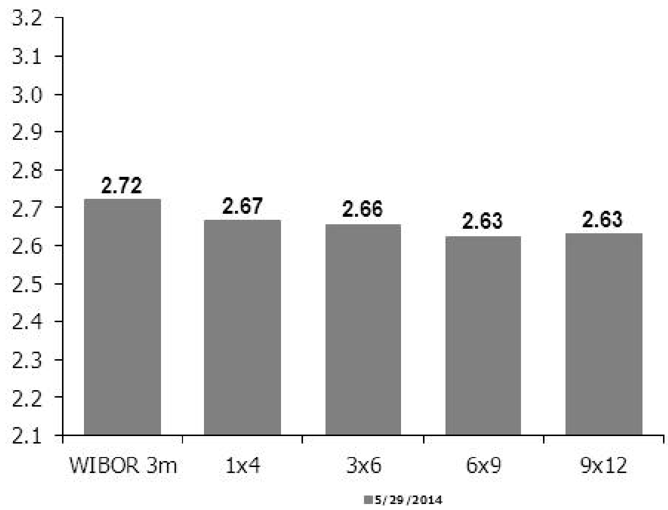
Timing is key

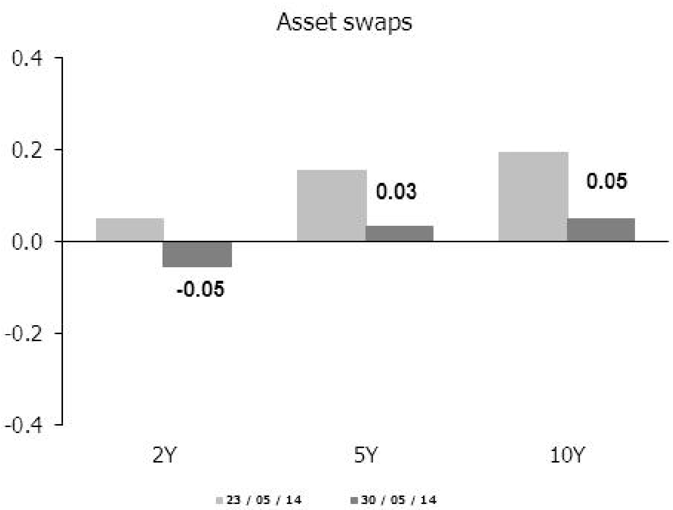
It was another good week for PolGBs. Yield of DS1023 went down from 3.69% to 3.55%, but now we have some profit taking and it is now at 3.65%. Strong PLN and constant inflows from foreign investors helps a lot here.

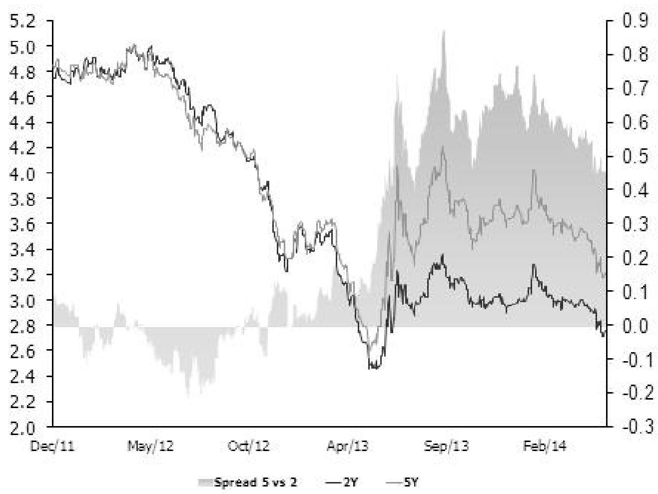
Next week is going to be super interesting. We have very important ECB's decision about possible rate cut and/or some kind of non-standard policy easing. We also have planned an auction of new 10y bond benchmark - DS0725.

While expectations for ECB might be a little overblown and we might see some more profit taking after decision, we are still generally positive for PolGBs because of good fiscal/low CPI and supportive Euroland economy. The only problem is timing. Our guess is next opportunity to buy bonds is going to be after ECB's decision.





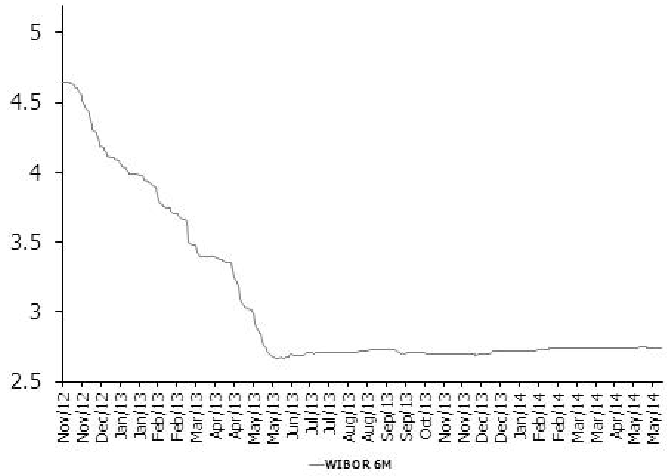


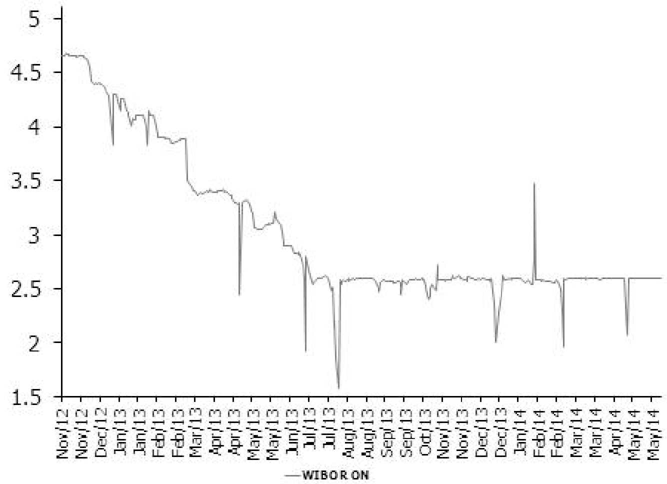


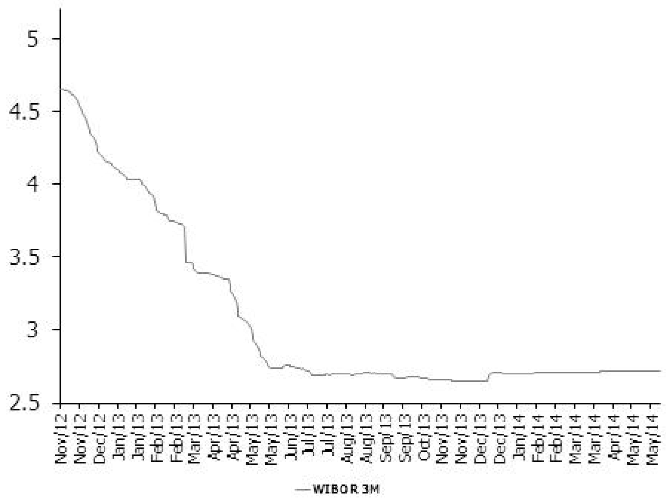
Money market

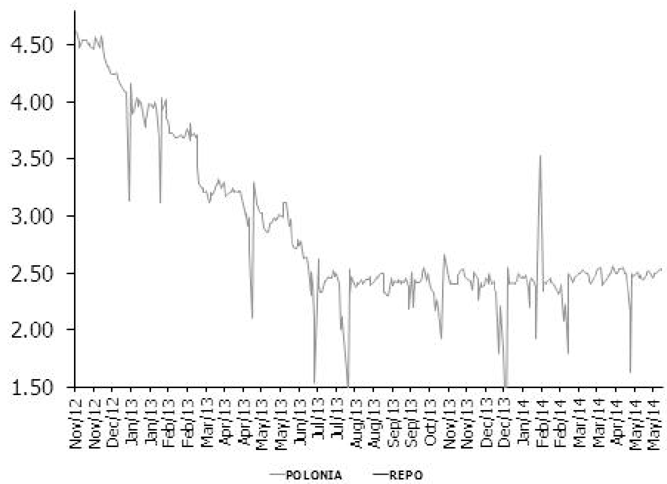
Very expensive week behind us The most expensive week in May behind us. Polonia was above the reference rate, moving between 2.52 and 2.53 as that was the last week of reserve with additional auction on Friday (3 day money bills). As banks bought 13 bn PLN bills less than was offered, there will be a huge surplus of cash on Monday, but at it is the beginning of new reserve, it shouldn't be very cheap. Maybe additional OMO on Monday?

Recommendation: Short FRAs still under WIBOR. They even fell from last week by 5 bps. Buy, if you don't believe in cutting rates.





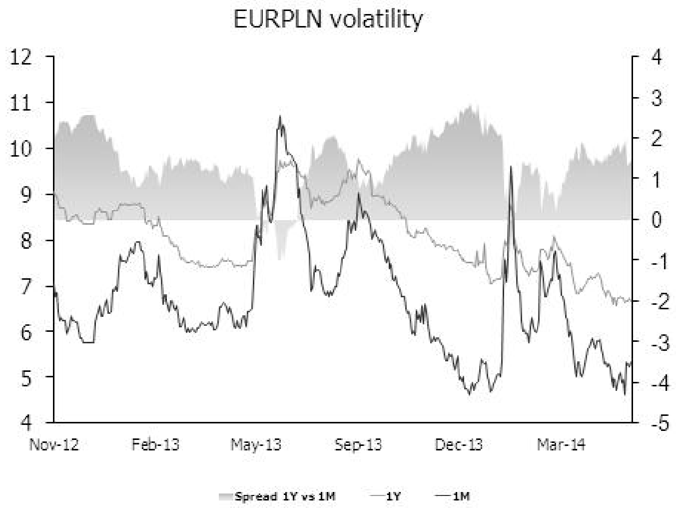




Forex

PLN stronger. PLN stronger – EUR/PLN is grappling with multiweek support zone at 4.13/4.14. The falling yields improved the attractiveness of EM, and we have seen healthy inflows into PLN and PLN Bonds. The market is consolidating at the moment and we think 4.13/4.17 range will hold untill the ECB meeting. Expectations are really high, and we see increasing risk that ECB we will generate usual disappointment.

Vols choppy. Vols choppy – The closer to ECB the market is more eager to cover shorts in Vega, Gamma. We have seen healthy buying of the frontend strikes, especially EUR/PLN puts, post ECB meeting. As the result 1 month EUR/PLN ATM mid is now 5.7% (0.5% higher), 3 months EUR/PLN are 5.7% (0.2% higher), 1 year climbed 0.1% to 6.9%. The Skew was better offered, as the hard currency puts were the most hot selling item.

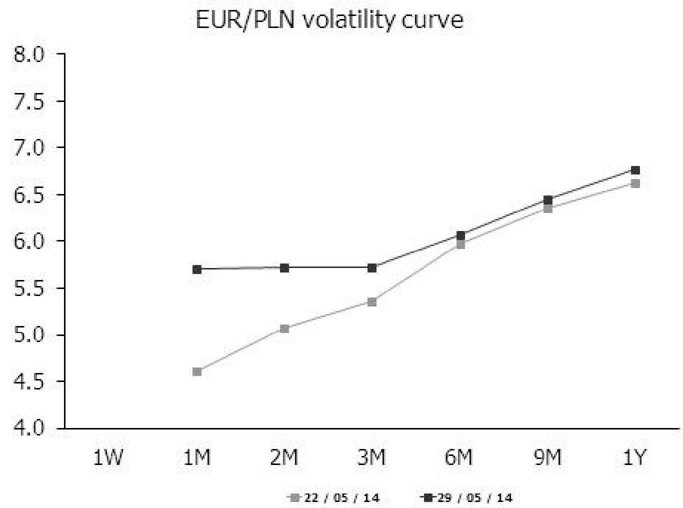


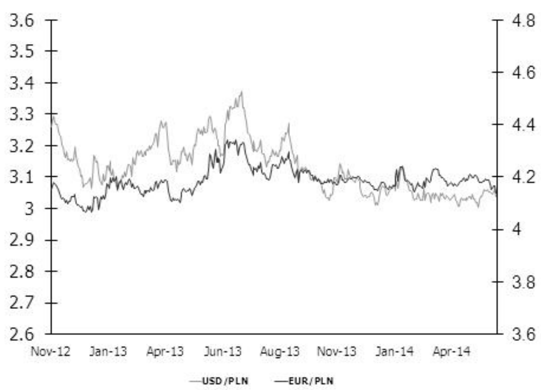
Short-term forecasts

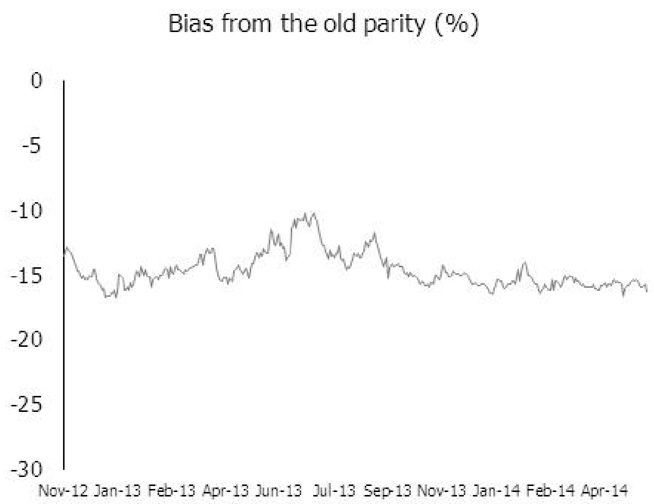
SPOT Main supports / resistances:
EUR/PLN: 4.1400 / 4.2600
USD/PLN: 3.0000 / 3.1500

Spot: EUR/PLN Play range. We are tactically long EUR/PLN at average price 4.1475, we have stop below 4.13 and we are hoping for a move above 4.17. We may reduce some of the position prior to ECB, as that for sure will produce market gapping in either direction.

Options: still sidelined. The EVENT is looming on the horizon. Namely ECB meeting, and frontend vols are lifting the curve higher, even though PLN is stronger and realized vols did not really picked up much. We are still on the sidelines, waiting for a hard proof of a rise in realized volatilities before, we will enter any more substantial Vega long.







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
5/26/2014	2.58	2.72	2.60	2.64	2.65	2.70	2.66	2.62	2.62	2.62	2.66	2.64
5/27/2014	2.66	2.72	2.78	2.64	2.95	2.70	2.69	2.64	2.64	2.65	2.70	2.65
5/28/2014	2.53	2.72	2.65	2.64	2.82	2.70	2.67	2.63	2.64	2.63	2.71	2.65
5/29/2014	2.60	2.72	2.70	2.64	2.85	2.70	2.67	2.66	2.63	2.63	2.69	2.63
5/30/2014	2.60	2.72	2.70	2.64	2.85	2.70	2.67	2.66	2.63	2.63	2.69	2.63

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
5/26/2014	2.700	2.582	2.733	2.747	3.170	3.327	3.565	3.697
5/27/2014	2.700	2.575	2.760	2.737	3.210	3.306	3.600	3.715
5/28/2014	2.700	2.578	2.760	2.714	3.200	3.252	3.570	3.659
5/29/2014	2.700	2.578	2.753	2.699	3.195	3.227	3.590	3.640
5/30/2014	2.700	2.578	2.753	2.699	3.195	3.227	3.590	3.640

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
5/26/2014	5.30	5.48	6.08	6.68	6.68	2.77	0.69
5/27/2014	5.23	5.43	6.08	6.73	6.73	2.77	0.69
5/28/2014	5.33	5.53	6.08	6.68	6.68	2.81	0.74
5/29/2014	5.71	5.73	6.08	6.78	6.78	2.72	0.69
5/30/2014	5.71	5.73	6.08	6.78	6.78	2.72	0.69

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
5/26/2014	4.1560	3.0466	3.4047	2.9894	1.3733	0.1516
5/27/2014	4.1655	3.0532	3.4092	2.9969	1.3711	0.1518
5/28/2014	4.1678	3.0598	3.4085	3.0039	1.3701	0.1519
5/29/2014	4.1385	3.0395	3.3899	2.9932	1.3661	0.1506
5/30/2014	4.1420	3.0435	3.3924	2.9937	1.3682	0.1508

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