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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](mailto:ernest.pytlarczyk@mbank.pl)

Marcin Mazurek, PhD  
senior analyst  
tel. +48 22 829 01 83  
[marcin.mazurek@mbank.pl](mailto:marcin.mazurek@mbank.pl)

Piotr Bartkiewicz  
analyst  
tel. +48 22 526 70 34  
[piotr.bartkiewicz@mbank.pl](mailto:piotr.bartkiewicz@mbank.pl)

Marek Ignaszak  
analyst  
tel. +48 22 829 02 56  
[marek.ignaszak@mbank.pl](mailto:marek.ignaszak@mbank.pl)

### Department of Financial Markets (business contacts)

Bartłomiej Malocha, CFA  
head of interest rates trading  
tel. +48 22 829 01 77  
[bartlomiej.malocha@mbank.pl](mailto:bartlomiej.malocha@mbank.pl)

Marcin Turkiewicz  
head of fx trading  
tel. +48 22 829 01 67  
[marcin.turkiewicz@mbank.pl](mailto: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](mailto:inga.gaszkowska-gebska@mbank.pl)

Jacek Jurczyński  
structured products  
tel. +48 22 829 15 16  
[jacek.jurczynski@mbank.pl](mailto: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

This month's publication series begins on Friday and inflation reading for May is the most important one. Following the surprising drop in April, May's CPI growth was fuelled by lagged effects of January's excise tax hike. On the other hand, the food price decline continues in virtually all categories. Due to the possible fall in prices of communication and tourism, we see some downward risk for our CPI forecast (as seen in our above-consensus core CPI forecast). The widening of current account deficit can be attributed to the decrease of trade surplus amid stable income account and transfer and services accounts driven mainly by the seasonal effects. At last but not least, M3 growth has most likely accelerated in May. The surge is mainly driven by statistical base effect in corporate and households deposits.

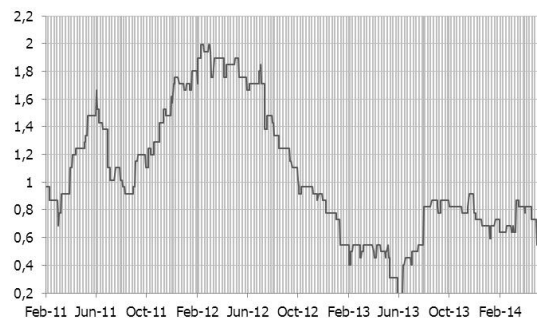
### Polish data to watch: June 9th to June 13th

| Publication                       | Date  | Period | mBank | Consensus | Prior |
|-----------------------------------|-------|--------|-------|-----------|-------|
| Current account balance (mio EUR) | 13.06 | Apr    | 225   | 426       | 517   |
| Exports (mio EUR)                 | 13.06 | Apr    | 13650 | 13900     | 14168 |
| Imports (mio EUR)                 | 13.06 | Apr    | 13500 | 13509     | 13693 |
| M3 y/y (%)                        | 13.06 | May    | 5.9   | 5.5       | 5.4   |
| CPI y/y (%)                       | 13.06 | May    | 0.5   | 0.5       | 0.3   |

### 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 | -            | 2000       | 3.818                         | 6/5/2014     |
| 20Y T-bond WS0429 | -            | 150        | 3.464                         | 5/16/2013    |

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



### Comment

Unchanged. Next week brings only one relevant publication - the CPI. It would be reasonable to expect a surprise here - after all, inflation has been one of the key drivers of our surprise index.

\* 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, current business tendency indicators suggest that growth momentum softens and sequential GDP growth is going to be lower in Q2. Loses are expected to be made up in the latter part of the year but stronger PLN and high real interest rates generate some new risks. External environment seems to be still favorable, though. Recession in Ukraine and Russia do not seem to exert any visible pressure on overall Polish exports.
- Coming quarters are expected to bring more exogenous components to the Polish cycle. 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 very low for the next few months supported by low food prices and still benign core inflation. The turnaround expected at the turn of Q2/Q3 is not going to be spectacular. Possible below or near zero readings in the summer month strengthen the feel of high real interest rates.
- MPC got stuck in a very positive GDP growth scenario in times when GDP may temporarily lose some momentum and when inflation pumps up real rates generating risks for growth. Therefore we await adjustment of the policy at September's meeting in a scale of at least 50bps. The move can be brought forward to July's meeting (40% probability) but it is not our baseline scenario.

### Financial markets

- We are bullish on Polish bonds due to: 1) renewed play on monetary easing (we bet on more than 50bps rate cut), 2) very low inflation and hefty real yields, 3) improving risk profile of Polish assets (low fiscal deficit, low C/A deficit, lower dependence on short term foreign funding).
- 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.
- Finally, It is possible that 'carry trade' encouraged by the ECB easing will spill over into CEE region.
- ECB easing and chasing for yield compression in the region (betting on rate cuts in Poland) may propel Polish zloty as well. In the background, the mid-term cyclicity constitutes another, hidden engine for appreciation.

### 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 | 2.00  |

|                                | 2013 | 2013 | 2013 | 2013 | 2014 | 2014 | 2014 | 2014 |
|--------------------------------|------|------|------|------|------|------|------|------|
|                                | Q1   | Q2   | Q3   | Q4   | Q1 F | Q2 F | Q3 F | 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  | 3.0  |
| Public Consumption y/y (%)     | 0.1  | 5.0  | 3.0  | 3.1  | 0.7  | 2.0  | 2.0  | 2.4  |
| Investment y/y (%)             | -2.4 | -3.3 | 0.5  | 2.0  | 10.7 | 6.5  | 8.5  | 10.0 |
| 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 | 11.9 | 12.3 | 13.0 |
| NBP repo rate (% eop)          | 3.25 | 2.75 | 2.50 | 2.50 | 2.50 | 2.50 | 2.00 | 2.00 |
| Wibor 3M (% eop)               | 3.39 | 2.73 | 2.67 | 2.71 | 2.71 | 2.72 | 2.22 | 2.22 |
| 2Y Polish bond yields (% eop)  | 3.19 | 3.07 | 3.06 | 3.05 | 3.01 | 2.50 | 2.50 | 2.70 |
| 10Y Polish bond yields (% eop) | 3.94 | 4.34 | 4.48 | 4.35 | 4.23 | 3.35 | 3.60 | 4.00 |
| 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 | 3.01 | 3.01 | 3.00 | 3.01 |

F - forecast

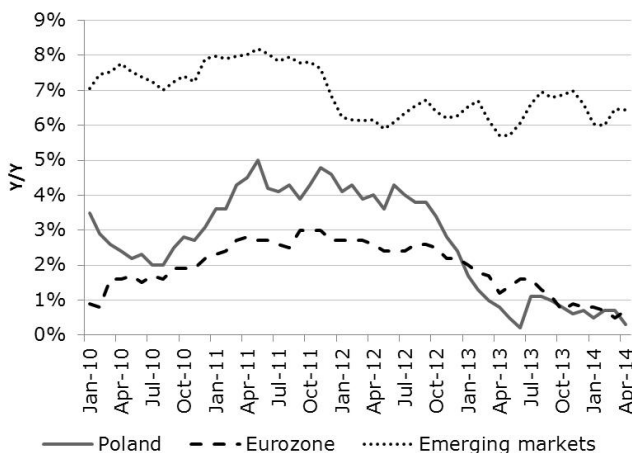
## Economics

### Polish MPC to cut rates

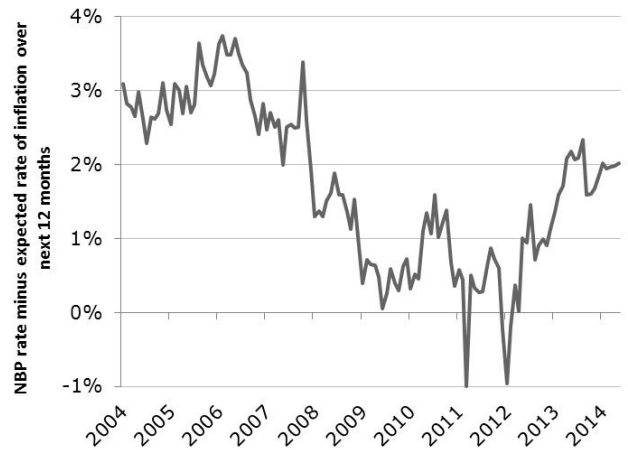
Some time ago we have noticed that the likelihood of resuming rate cuts or adjusting interest rate levels in Poland was increasing. At that time we indentified a set of circumstances (that already seemed likely back then) that would break the consensus within the MPC and lead to monetary easing. Since then, several possibilities became a reality.

Although the MPC held all policy variables unchanged during this month's meeting, the Council allowed for rate cuts later this year (in line with our expectations and contrary to market consensus). The statement was rephrased in a much more dovish way. First, the Council changed its assessment of inflationary pressures going forward from „subdued” to „very low”. **Even more important is the fact that the Council no longer views the current levels and expected path of interest rates as sufficient for inflation to „gradually” return to target.** Finally, forward guidance was shortened, as the MPC now states that interest rates should be kept unchanged „until the end of the third quarter”, instead of „for a longer period of time, i.e. at least until the end of the third quarter”. We interpret that as an intent of dropping this form of communication altogether in order to give the Council more freedom to react to changes in the macroeconomic environment. The context of these changes is clear and has been explained by Belka during the press conference. The MPC allows for the possibility of cutting interest rates in response to persistently low inflation (which would, according to Belka, justify monetary easing even during an economic upswing). We fully agree with other arguments put forward by the Governor. Polish real rates are among the highest in the world. The rebound in savings rates, attributable to high real rates, suggests that consumption growth could flatten out in this environment. A rate cut would also lower the service costs of PLN-denominated private debt. Granted, the latter effect is obvious but a few years ago it would have been swamped by fears of PLN depreciation adversely impacting interest payments on FX mortgage loans.

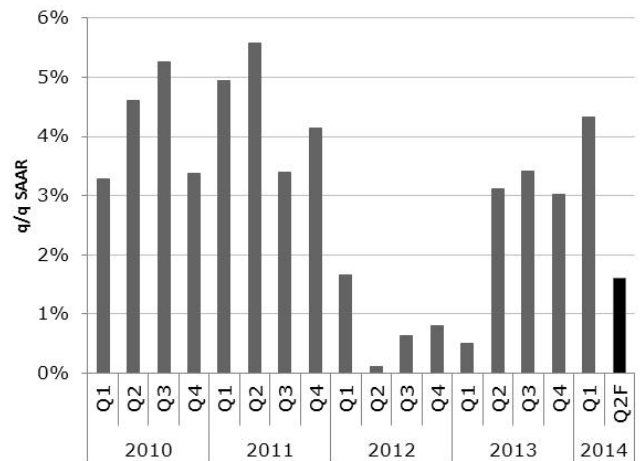
Inflation rates



Ex ante real interest rate



GDP (incl. our forecast for Q2)



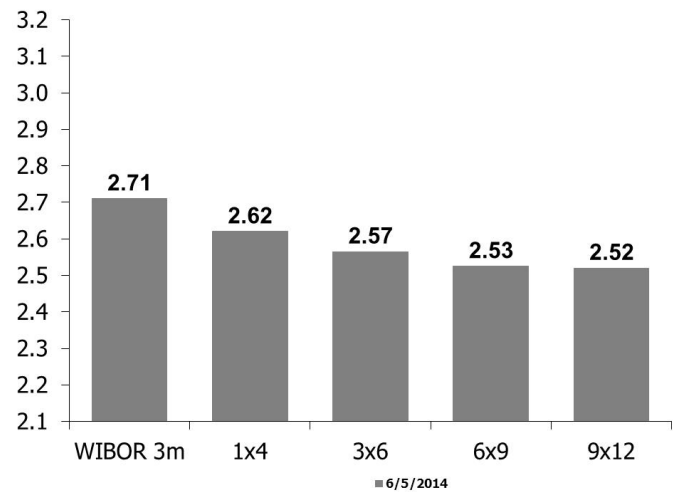
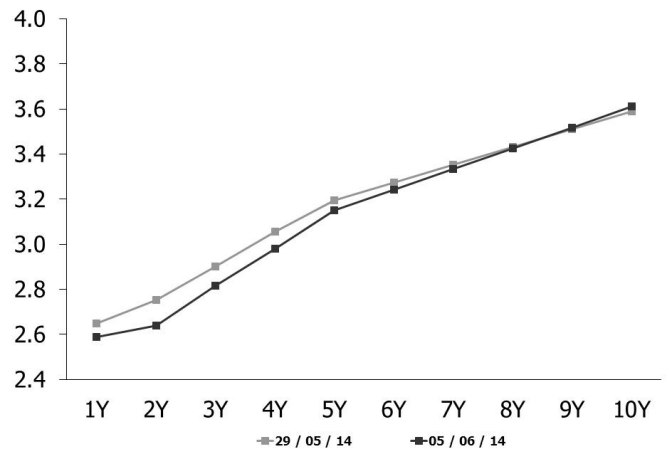
Although MPC members highlighted the optimistic scenario for this year's GDP growth and suggested stable interest rates as their baseline scenario (Zielinska-Glebocka), they referred primarily to the Q1 release. This unwavering optimism might not be confirmed by the upcoming data. The economy has visibly lost momentum recently and the sequential growth rate for the second quarter (Belka monitors this, as indicated during one of the previous conferences) is bound to decrease significantly. Therefore, we see ample room for negative surprises regarding the pace of the recovery in the coming months. Other aforementioned circumstances are still in play: inflation continues to surprise to the downside; regional risk premia have cratered, the fact exploited by the National Bank of Hungary; PLN has already strengthened beyond expectations; the European Central Bank met expectations (by lowering interest rates, launching liquidity measures and envisaging an asset purchase programme); our arguments for lower rates are shared by the central bank governor. It is time to consider the risk of rate cuts in Poland as pervasive. New rate cuts can amount to at least 50 bps, and timing is the only remaining issue. July seems quite likely and the apparent contradiction with current forward guidance is not an obstacle in our view, if there is a material change in economic conditions between the meetings. September - when it becomes clear that GDP growth slowed down in the second quarter and inflation dropped (possibly) into negative territory - is probably more acceptable to the faction opposing a more pro-active stance of Polish monetary policy. **At the moment, a cut in September is our baseline scenario.**

## Fixed income

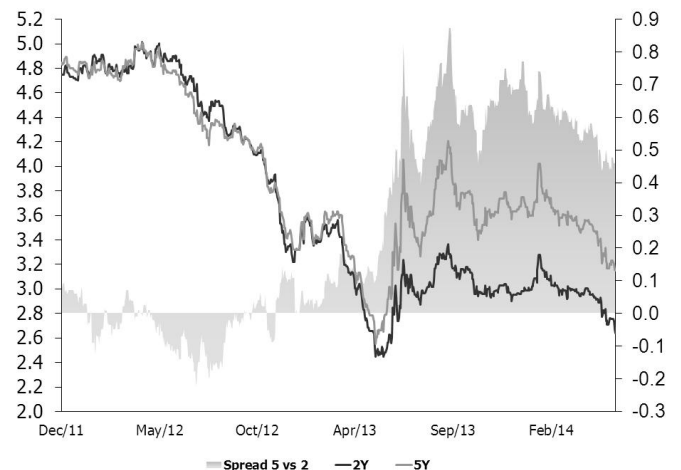
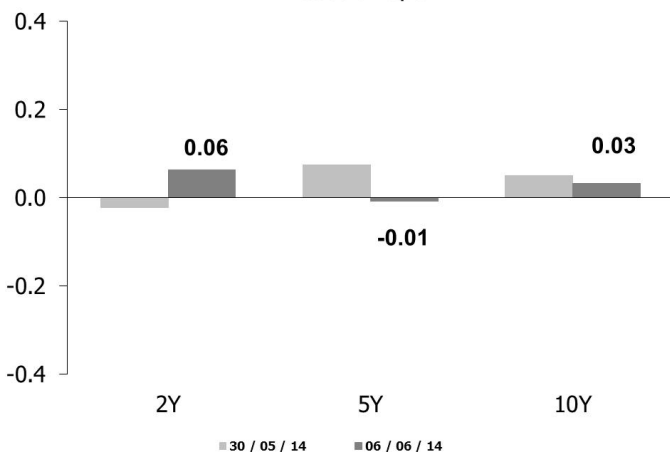
### Delivered. Part 1.

Mr. Draghi and ECB delivered! Investors were afraid of their own expectations about this very ECB meeting. There was so much talk about possible QE instruments, but still, investors were afraid to buy fixed income bonds on the auction - only 1.7bln of new 10Y benchmark was sold on Thursday's auction. On Friday, Yield of DS1023 fell down from 3.65 to 3.45%. Nice, considering that we still need Mr. Belka to deliver. The story of rate cuts in Poland has just begun, but for now we advise to sell into rally, as there may be changes in market sentiment (most of positive scenario are already priced in).

IRS curve



Asset swaps

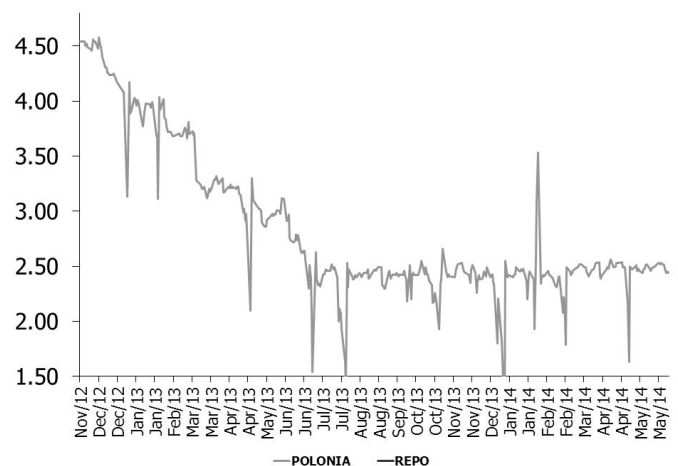
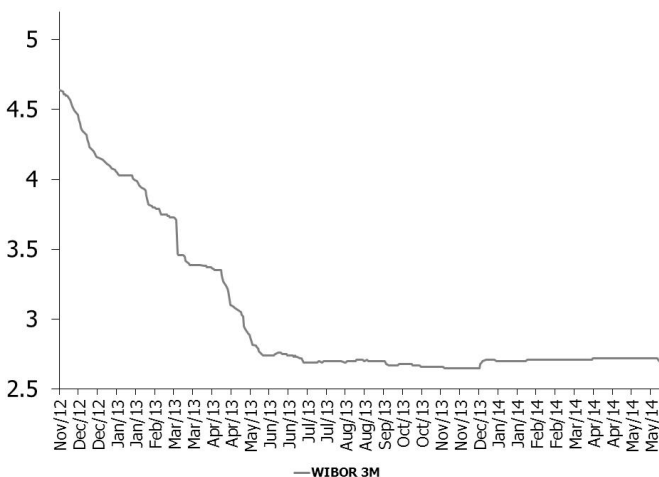
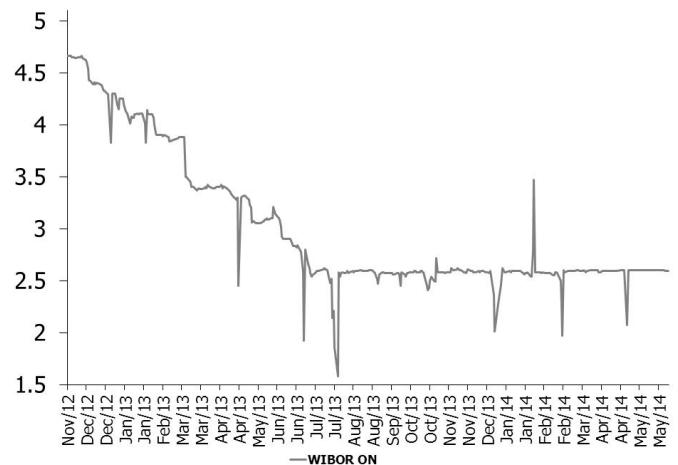
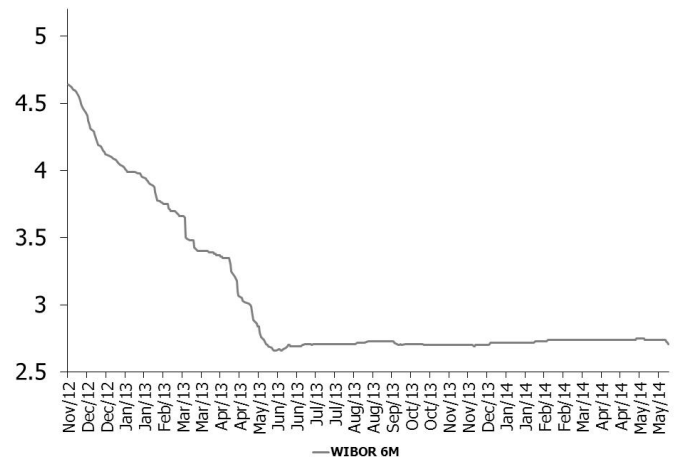


## Money market

**Very expensive week behind us** Stable end of the reserve requirements settlement period and also stable beginning of the new one despite the huge surplus left for the whole week. Moreover, after today's OMO we will see around 4 billion pln excess funds. It may imply either cheaper carry or additional OMO, depending on the rates decrease dynamics.

ECB decisions fuelled local appetite for the rates cut in pln. This scenario was modestly visible so far blocked mainly by the GDP growth rate. However, after surprisingly low CPI for April, very low CPI expectations in the foreseeable future, growing savings rate due to very high real rates (comparing to global environment) and PLN currency getting stronger and stronger, market started to discount high probability of the cut. As of now derivatives fully discount 25 bps rate cut with the probability layout for July (2/5) and September (3/5). August is being skipped due to lack of decision making meeting. 25 bps is not enough if one really believes in the cut delivery (it would not change much for the MPC perception), therefore those can easily push the rates lower by another 20-25 bps. Those with strong no cut view can think of entering payers with averaging option if rates go down further.

Local figures become less important before July's meeting in current landscape, except of the CPI that could support either side depending on the deviation from the consensus that stands now at 0.5. CPI projection will most likely support rates cut proponents in the MPC despite high GDP expected (inflated levels for this figure can easily vanish with any flaw that cannot be excluded). Forward guidance is not an issue for the body that could cut rates after official announcing ending the cuts cycle (see year 2012). The question is whether governor Belka wants to cut? Until we get an answer we think that market will continue escalating its expectations. Lack of cuts delivery will be highly disappointing but we have at least 3 months to go before that happens.





## Forex

**PLN stronger.** EUR/PLN has managed to break through its long term support at 4.1300, and did it in style. We have a flush of stop losses plus barrier triggering on the way to the low of 4.1070, it was tested several times before we managed to stabilize. The ECB delivered what was promised, it created a lot of volatility but PLN has slowed its march up. If one assumes the EUR/USD is a leading currency pair, its inability to breach 1.3500 and a substantial reversal higher may imply the correction higher in EUR/EM is on its way.

**Vols choppy.** The buying fever before ECB (1 month EUR/PLN ATM paid and bid at 6.2%) was overturned by vol selling that started at the end of ECB conference. As the result, we were given 1 month EUR/PLN at 5.35 and sell-off was going further on the very next day. 1 month EUR/PLN ATM is ending the week at 5.0% mid (0.2% lower), 3 months are now 5.5% (0.1 lower) and finally 1 year ATM is fixing at 6.5% (0.2% lower). In general the ATM vol curve is lower than a week ago, as well as the skew.

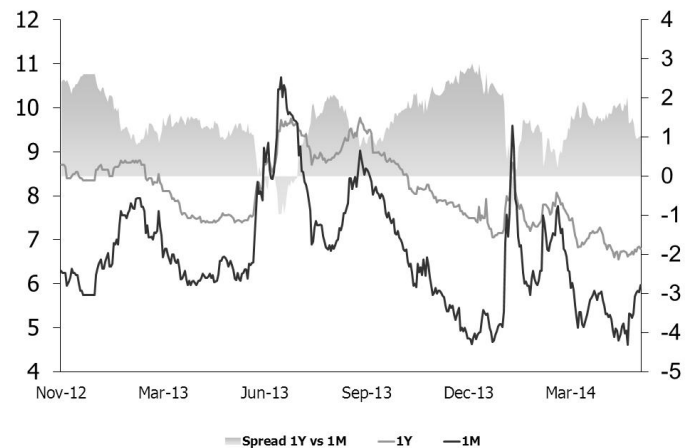
## Short-term forecasts

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

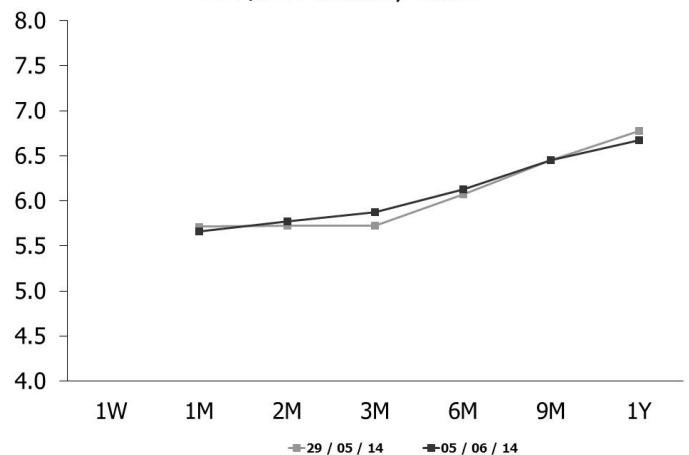
**Spot: EUR/PLN Play range.** We have reduced the EUR/PLN long before ECB, but we have added at 4.11 again. Our new breakeven is 4.1285 and we have a stop below 4.10 and hopes for 4.16+. We are applying the "sell the fact" approach here, looking at EUR/USD as a proxy for EUR/EM move.

**Options: tactical long.** We are entering tactical long in Vega. This was more less what we were waiting for, the pickup in realized volatility was not matched by a rise in implied volatility. We have bought the middle of the curve in small tactical trade.

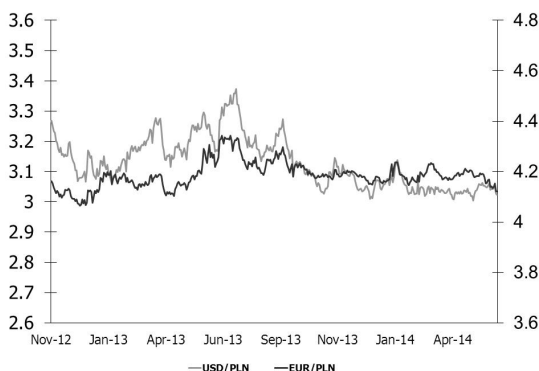
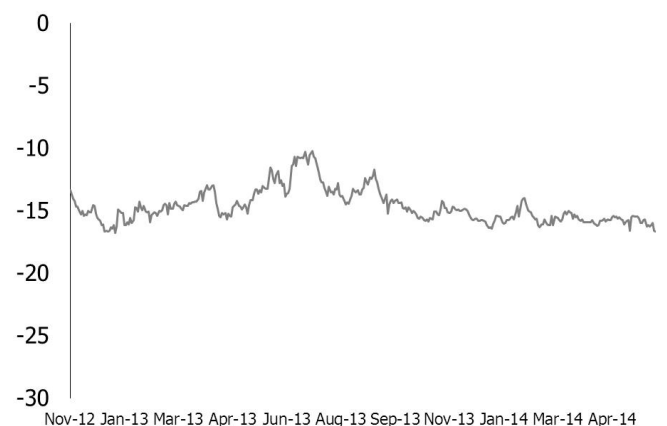
EURPLN volatility



EUR/PLN volatility curve



Bias from the old parity (%)



## 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 |
| 6/2/2014                       | 2.64    | 2.72     | 2.76    | 2.64     | 2.92    | 2.70     | 2.67                  | 2.64 | 2.62 | 2.63 | 2.69  | 2.64 |
| 6/3/2014                       | 2.82    | 2.72     | 2.84    | 2.64     | 2.77    | 2.70     | 2.64                  | 2.61 | 2.58 | 2.59 | 2.63  | 2.59 |
| 6/4/2014                       | 2.54    | 2.71     | 2.62    | 2.63     | 2.57    | 2.68     | 2.63                  | 2.59 | 2.52 | 2.52 | 2.59  | 2.52 |
| 6/5/2014                       | 2.60    | 2.70     | 2.78    | 2.62     | 2.81    | 2.67     | 2.62                  | 2.57 | 2.53 | 2.52 | 2.56  | 2.56 |
| 6/6/2014                       | 2.60    | 2.69     | 2.78    | 2.61     | 2.81    | 2.66     | 2.62                  | 2.57 | 2.53 | 2.52 | 2.56  | 2.56 |

| 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 |
| 6/2/2014  | 2.700    | 2.584     | 2.758  | 2.712  | 3.215  | 3.291  | 3.580   | 3.683  |
| 6/3/2014  | 2.700    | 2.584     | 2.740  | 2.689  | 3.200  | 3.280  | 3.595   | 3.705  |
| 6/4/2014  | 2.680    | 2.649     | 2.668  | 2.713  | 3.155  | 3.227  | 3.580   | 3.669  |
| 6/5/2014  | 2.670    | 2.474     | 2.640  | 2.704  | 3.150  | 3.143  | 3.610   | 3.643  |
| 6/6/2014  | 2.660    | 2.474     | 2.640  | 2.704  | 3.150  | 3.143  | 3.610   | 3.643  |

| EUR/PLN 0-delta stradle |      |      |      | 25-delta RR |      | 25-delta FLY |      |
|-------------------------|------|------|------|-------------|------|--------------|------|
| Date                    | 1M   | 3M   | 6M   | 1Y          | 1M   | 1Y           | 1Y   |
| 6/2/2014                | 5.85 | 5.79 | 6.11 | 6.83        | 6.83 | 2.80         | 0.69 |
| 6/3/2014                | 5.81 | 5.88 | 6.23 | 6.85        | 6.85 | 2.80         | 0.69 |
| 6/4/2014                | 5.98 | 5.96 | 6.26 | 6.80        | 6.80 | 2.80         | 0.69 |
| 6/5/2014                | 5.66 | 5.88 | 6.13 | 6.68        | 6.68 | 2.69         | 0.69 |
| 6/6/2014                | 5.66 | 5.88 | 6.13 | 6.68        | 6.68 | 2.69         | 0.69 |

| PLN Spot performance |        |        |        |        |        |        |
|----------------------|--------|--------|--------|--------|--------|--------|
| Date                 | EURPLN | USDPLN | CHFPLN | JPYPLN | HUFPLN | CZKPLN |
| 6/2/2014             | 4.1355 | 3.0413 | 3.3849 | 2.9808 | 1.3658 | 0.1505 |
| 6/3/2014             | 4.1392 | 3.0449 | 3.3858 | 2.9721 | 1.3618 | 0.1506 |
| 6/4/2014             | 4.1527 | 3.0491 | 3.4002 | 2.9729 | 1.3574 | 0.1512 |
| 6/5/2014             | 4.1215 | 3.0275 | 3.3802 | 2.9531 | 1.3520 | 0.1501 |
| 6/6/2014             | 4.1211 | 3.0222 | 3.3850 | 2.9549 | 1.3574 | 0.1500 |

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