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## Polish Weekly Review

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### Table of contents

#### Our view in a nutshell

##### Economics

- Inflation one step closer to negative territory

##### Fixed income

- Profit taking

##### Money market

- Calm week behind us

##### FX market

- PLN consolidating
- Vols lower

page 2

page 3

page 4

page 5

page 6

### Comment on the upcoming data and forecasts

A series of real economy publications for May continues. Monday's reading of core inflation (precisely calculated after today's CPI figures) and budget performance can be considered as a warm-up before Tuesday's labour market data. Manufacturing has recently performed well noting stable uptrend in employment, however business tendency indicators broadly suggest a sudden slump. For now, we perceive it as an one-off and forecast a meagre growth (but still growth) of employment on monthly basis. Due to low last year's statistical base and with construction wages slowly converging to usual pattern, the aggregate growth rate of wages has probably returned to its seasonal levels consistent with 5.2% annual rate of growth. Wednesday will bring readings of data from industrial sector. Both the number of working days (+1 y/y) as well as the calendar effects (only one, short "long weekend") contribute to a strong reading of industrial output (6.2% y/y). Although we do not see any signs of statistical base, it is worth pointing that in the last year's Q2 we have witnessed a strong momentum in industrial output, which in turn can weigh down on this year's figures (ca -1pp every month). The busy week ends with MPC's minutes. The document is worth noting as it may contain clues about the probability of rate cuts, the discussion on the future of forward guidance and the Council member's estimates of GDP and CPI growth trajectories.

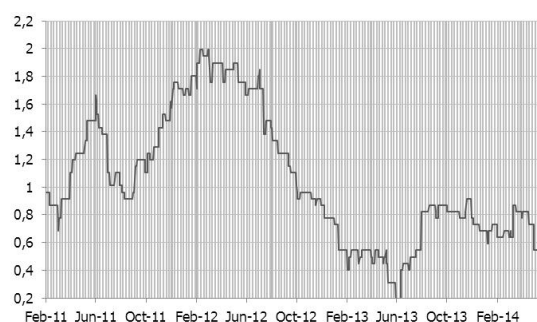
### Polish data to watch: June 16th to June 20th

Publication	Date	Period	mBank	Consensus	Prior
Core CPI y/y (%)	16.06	May	0.8	0.9	0.8
Budget performance (%)	16.06	May			44.8
Average wage y/y (%)	17.06	May	5.2	4.3	3.8
Employment y/y (%)	17.06	May	0.7	0.7	0.7
Sold industrial output y/y (%)	18.06	May	6.3	5.9	5.4
PPI y/y (%)	18.06	May	-0.7	-0.7	-0.7
MPC Minutes	20.06	Jun			

### 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

Significant slump after CPI release. Forthcoming week offers plenty surprise opportunities, as it is abundant with data from real economy.

\* 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 cyclicalities 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

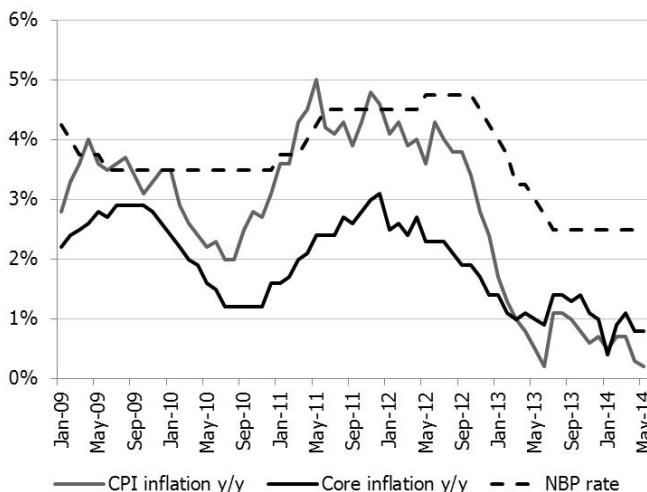
F - forecast

## Economics

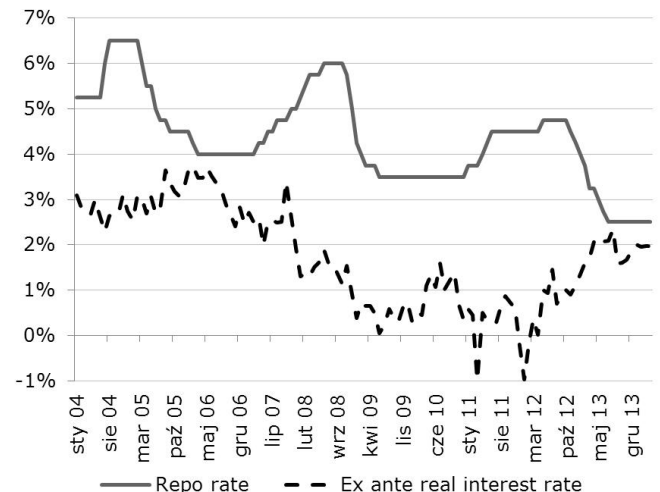
### Inflation one step closer to negative territory

May CPI reading brought another positive surprise for investors who are betting on interest rate cuts. Inflation fell to 0.2% y/y from 0.3% in the previous month (market consensus: 0.5%).

Food prices overwhelmingly contributed to the decline in inflation. The m/m drop (-0.4%) runs against seasonal tendencies completely; in our view, food prices are in a downward trend since the beginning of the year and no symptoms of its reversal can be seen at the moment. The fact that the excise tax hike has not yet appeared in retail prices of spirits and tobacco products is another contributing factor, which we blame on strong competitive pressures in the market (which indirectly suggests that the divergence between closing demand gap and inflation might persist). Price cuts in culture and recreation (mainly package holidays) were also an important factor - it is a similar story when it comes to effects of market structure and partly a result of seasonal effects seen in Eurozone inflation data. According to our calculations, core CPI held steady at 0.8%.



The above mentioned trends indicate that future inflation readings will continue to be skewed to the downside. Consumer prices have probably increased by even less in June and it is virtually certain that we will see negative inflation in the summer. The imported deflation hypothesis has never been more actual: not only are inflationary processes tamed in the Eurozone, but also the recent appreciation of Polish zloty has put additional downward pressure on Polish inflation. The lowinflation environment is entrenched and, along with it, the stealth monetary tightening as reflected in growing real interest rates (see the graph below).



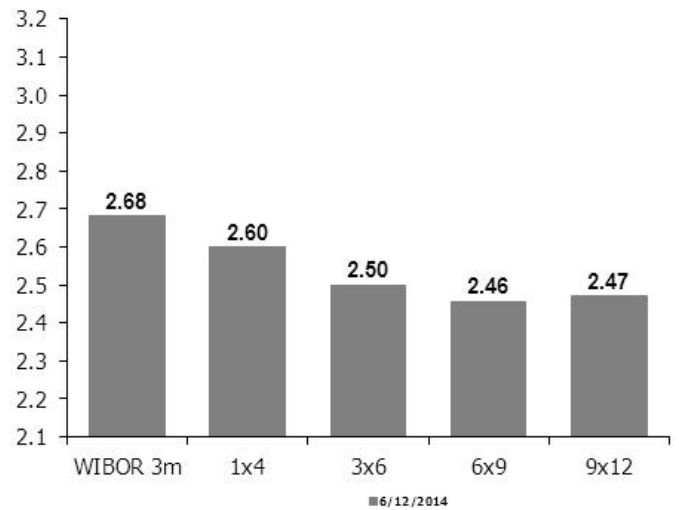
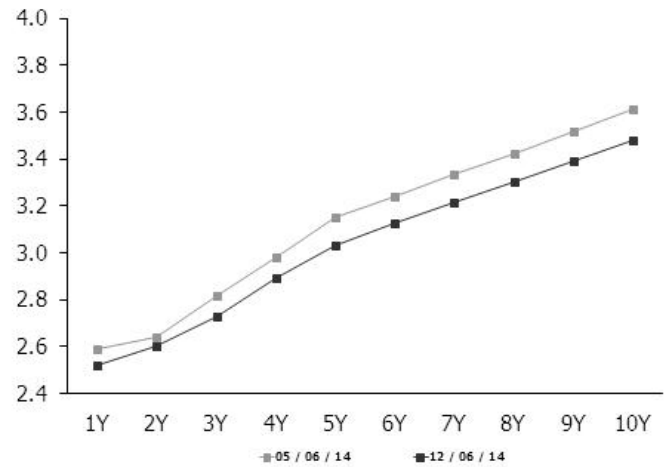
In such circumstances our central scenario of rate cuts is gaining traction. The base case is at least a 50bps cut; it is only a matter of timing. We think that a rate cut is necessary not only because of the fact that real rates are on the constant rise (measured either ex post or ex ante), thereby generating stealth tightening of monetary policy, but also because of expected, further compression of risk premia connected with incoming European quantitative easing (yes, we think that they are going to finally do it). Low inflation, low credit risk environment gives the MPC a unique opportunity to lower the government funding costs at seemingly no expense. Market reaction to the data, a subsequent yield compression along the curve, unveils that market participants are betting for a cut. Market pricing is still much below 50bps which seems a minimum amount of easing in our opinion. And the chances for easing in July have risen substantially, regardless of what MPC members have been already saying in the press; it is history now.

## Fixed income

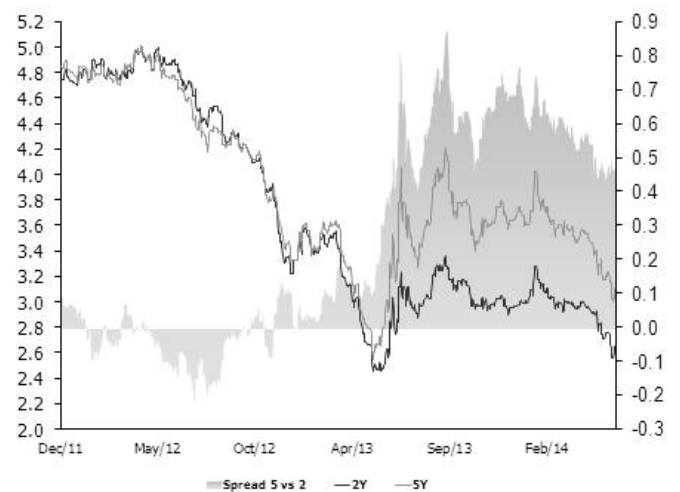
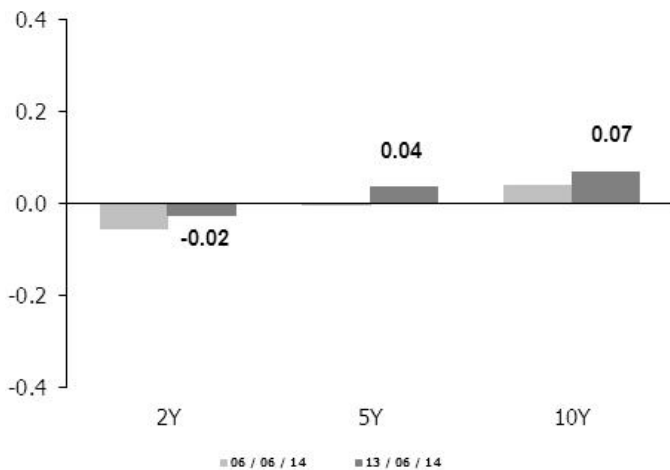
### Profit taking

After super-positive sentiment in the previous week, investors decided to take profit in this one. Yield of PS0718 reached 3.03% (2.82% low previous week). With CPI data surprisingly low (only 0.2% YoY vs 0.5% expected) investors start to play 'rate cut game' again. We expect PS0719 on switching auction next week and that can be good moment to buy 5Y bonds again.

IRS curve



Asset swaps

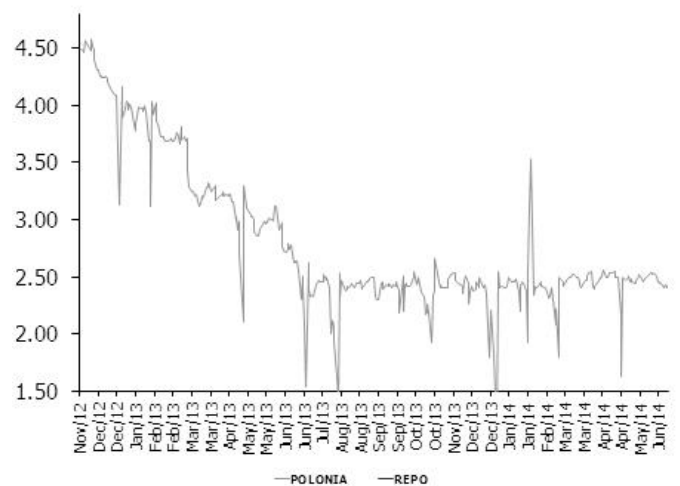
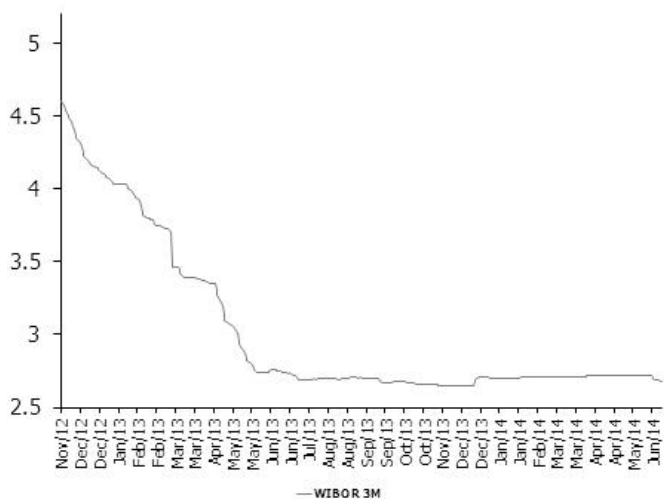
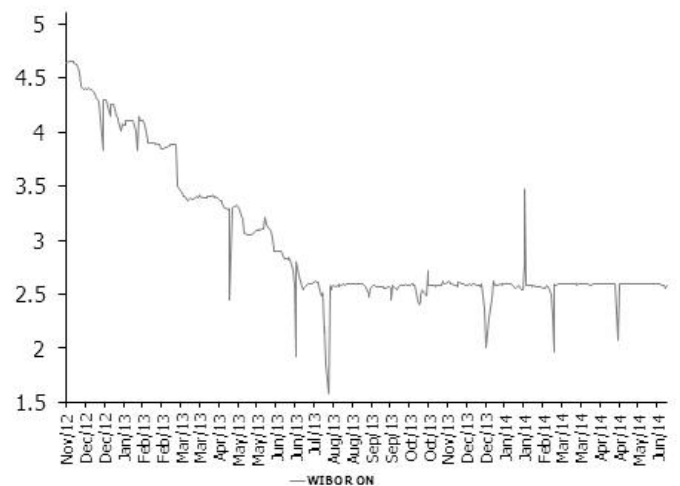
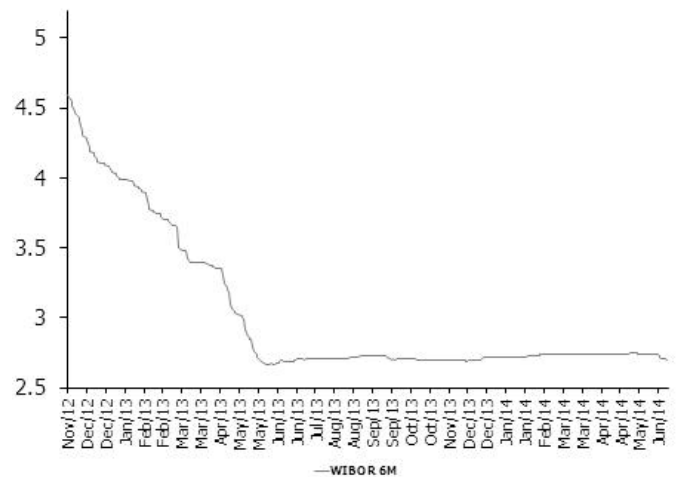


## Money market

**Calm week behind us** After weak Friday's OMO Polonia fell to 2.42 and fluctuated around it until Thursday. Next week should be more expensive as at today's OMO banks bought all the bills which have been offered (3bn might square the market).

Today's inflation data (0.2 vs 0.5 expected) hugely surprised the market and curve (under 2Y) moved by 5 bps so now its discounting a full rate cut in September.

Our recommendation is to sell OIS (6M, 9M, 1Y) at 2.25 and buy FRA with 20bps spread.



## Forex

**PLN consolidating** EUR/PLN sold off hard to 4.0915, the new year's low, before stabilizing, rebuilding slowly to 4.1300. The ECB dovish action is still in the back of our heads but the strong downturn move in EUR/PLN needs consolidation. We think the new likely range has now shifted to the downside, to 4.08-4.14. We kind of agree that the ECB paved the way for lower EUR/PLN in the medium term but the road may be bumpy. Lower than expected CPI number from Poland is not meant to hurt PLN too much, as it will only accelerate the inflow into POLBONDS.

**Vols choppy** The sell-off in vols continued in the beginning of the week, with 3 month EUR/PLN ATM given at 5.2%, 6 month EUR/PLN ATM aggressively offered at 5.75%. The curve flattened a bit with mid and backend of the curve being offered, but an appetite for Gamma is keeping the frontend supported. The skew was slightly better bid with weaker PLN (higher EUR/PLN). 1 month EUR/PLN ATM is today 5.1% (0.1% higher), 3 month are at 5.2% (0.3% lower) and 1 year fixed today 6.4% (0.1% lower). C/S (difference between USD/PLN and USD/PLN) is stable.

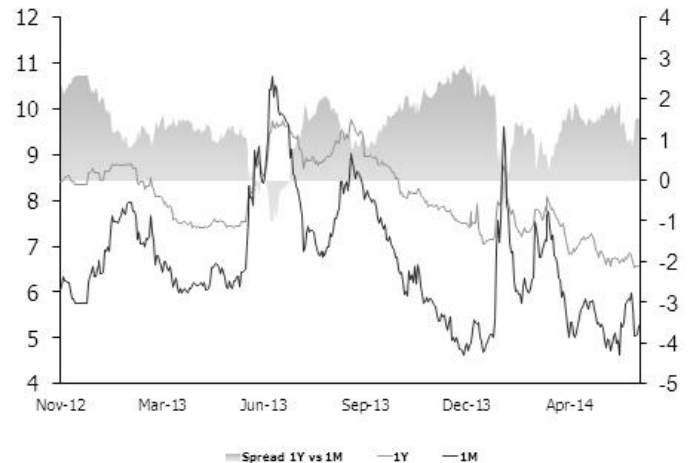
### Short-term forecasts

SPOT Main supports / resistances:  
 EUR/PLN: 4.0800 / 4.1600  
 USD/PLN: 2.9900 / 3.1000

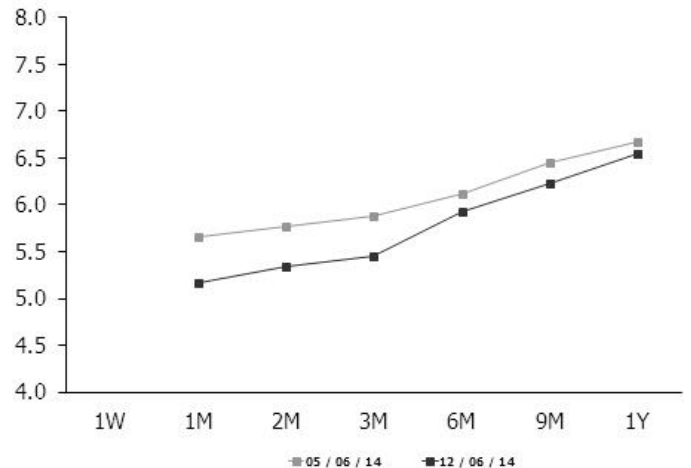
**Sell EUR/PLN spikes** Long EUR/PLN stopped at 4.1040, not far from the actual bottom 4.0915. Sidelined at the moment. Waiting for the FOMC meeting. If they were not as dovish as market expect we are ready to fade post FOMC spikes. Ideally, we would like to sell EUR/PLN at 4.1400 add 4.1550 with stop above 4.1700, and hopes for a move back to 4.08.

**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.

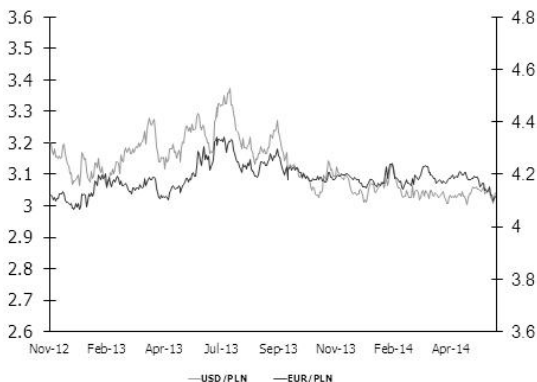
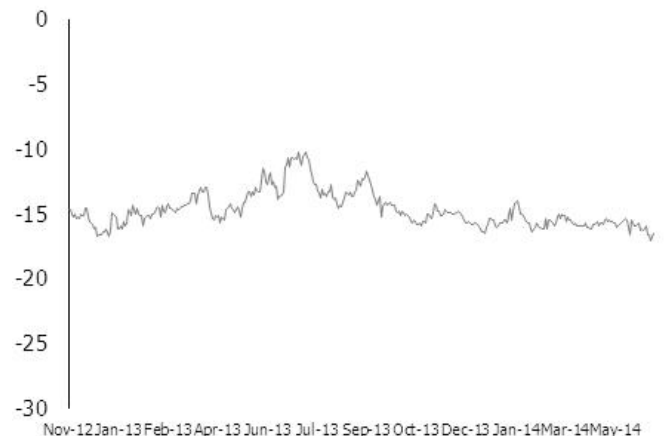
EURPLN volatility



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
6/9/2014	2.60	2.69	2.64	2.61	2.77	2.66	2.53	2.45	2.41	2.41	2.45	2.41
6/10/2014	2.55	2.69	2.59	2.61	2.74	2.65	2.57	2.50	2.45	2.45	2.51	2.47
6/11/2014	2.48	2.68	2.50	2.60	2.68	2.65	2.62	2.54	2.49	2.49	2.57	2.51
6/12/2014	2.74	2.68	2.76	2.60	2.79	2.65	2.60	2.50	2.46	2.47	2.50	2.47
6/13/2014	2.74	2.68	2.76	2.60	2.79	2.65	2.60	2.50	2.46	2.47	2.50	2.47

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
6/9/2014	2.660	2.514	2.555	2.508	3.000	3.033	3.465	3.508
6/10/2014	2.650	2.446	2.610	2.693	3.060	3.081	3.510	3.539
6/11/2014	2.650	2.565	2.650	2.691	3.110	3.162	3.570	3.539
6/12/2014	2.650	2.407	2.605	2.582	3.035	3.072	3.480	3.549
6/13/2014	2.650	2.407	2.605	2.582	3.035	3.072	3.480	3.549

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY	
Date	1M	3M	6M	1Y	1M	1Y	1Y	1Y
6/9/2014	5.04	5.56	5.98	6.56	6.56	2.76	0.69	0.69
6/10/2014	5.06	5.55	5.95	6.58	6.58	2.76	0.69	0.69
6/11/2014	5.28	5.48	5.90	6.58	6.58	2.76	0.69	0.69
6/12/2014	5.16	5.45	5.93	6.55	6.55	2.62	0.69	0.69
6/13/2014	5.16	5.45	5.93	6.55	6.55	2.62	0.69	0.69

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/9/2014	4.0998	3.0067	3.3624	2.9341	1.3530	0.1493
6/10/2014	4.1090	3.0303	3.3700	2.9612	1.3510	0.1497
6/11/2014	4.1157	3.0431	3.3777	2.9762	1.3473	0.1499
6/12/2014	4.1096	3.0374	3.3736	2.9766	1.3426	0.1498
6/13/2014	0.0000	0.0000	3.3736	2.9766	1.3426	0.1498

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