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Polish Weekly Review

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Comment on the upcoming data and forecasts

The week begins with the release of consumer and business tendency surveys prepared by the Central Statistical Office. On Thursday the CSO will publish its monthly Statistical Bulletin along with data on retail sales and unemployment. The labor market data were already preliminarily estimated by Ministry of Labour and are not expected to be a source of excitement. We forecast the retail sales growth to ease to 5.2% y/y, despite the favorable working days difference. Unusual culmination of Easter food expenditures in April is likely to result in a setback in May.

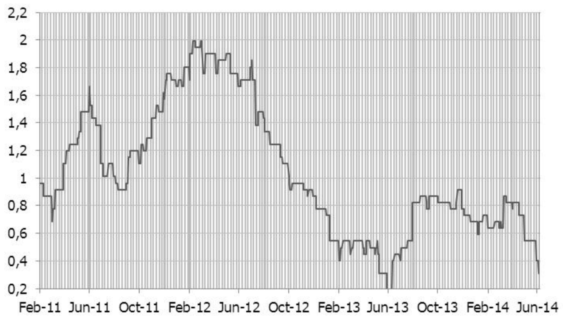
Polish data to watch: June 23th to June 27th

Publication	Date	Period	mBank	Consensus	Prior
Retail sales y/y (%)	26.06	May	5.2	6.2	8.4
Unemployment rate (%)	26.06	May	12.5	12.5	13.0

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

Lower due to PPI and industrial output surprises. Forthcoming week offers litle oportunity for the index to move, as only retail sales data will be published.

* 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 (sub 3%). 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 but it is not our baseline scenario.

Financial markets

- Political jitters to have only transitory effects on Polish bonds and currency.
- 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 cyclicality 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	0.4
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 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	2.9	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	0.2	0.0	0.6
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

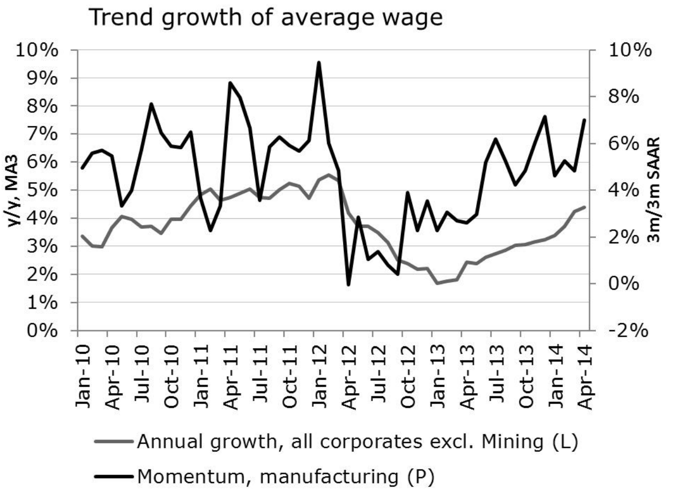
Poor performance of industry and construction suggest weak Q2 GDP print and support a rate cut, despite political turmoil.

To our satisfaction, last week brought a few „we told you so" moments. On one hand, labor market remains robust and wages continue to grow faster than most analysts predicted only a few months ago (we are not surprised, though), which bodes well for mid-term perspectives of the economy. On the other hand, the most cyclically sensitive sectors have run into trouble, confirming multiple signals (PMI and virtually every other business survey). All in all, the second quarter appears to have brought a marked slowdown in growth, as industry basically stagnated and construction output plunged on a q/q basis. What does it mean for monetary policy? Now we are tracking Q2 growth at 2.9%, below Bratkowski's threshold of 3% (which would trigger a cut). The ever-accelerating economy has been the last refuge of the hawks and that scenario is now in question (not to mention the fact that weaker economy is much more persuasive than stealth monetary tightening via high real rates). Therefore, we continue to expect the 50bps cut to happen in September.

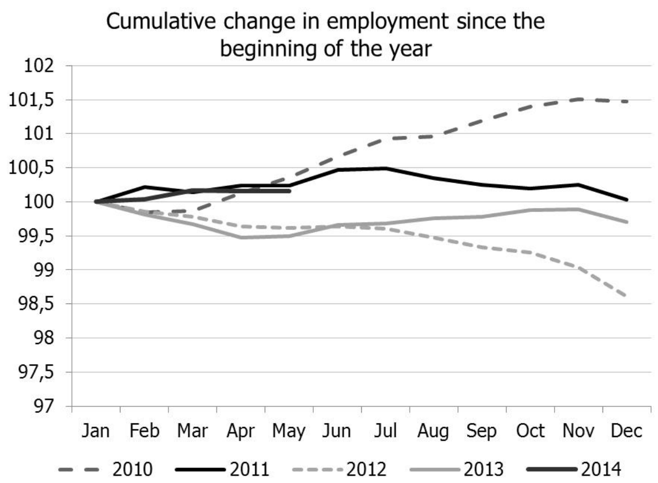
Data releases were, however, overshadowed by the „tape affair". While it is not up to us to comment on the political aspects of the matter, we believe that any market disruptions generated by the affair will prove to be temporary. Moreover, the likelihood of early elections is very small, while the MPC is unlikely to be reshuffled. In the end, data will speak for itself and provide ample room to adjust monetary policy. As long as the global environment remains supportive (and with dovish Fed and ECB heading for some sort of QE this is the baseline scenario), Polish bonds will remain attractive.

As usual, here's our take on last week's releases.

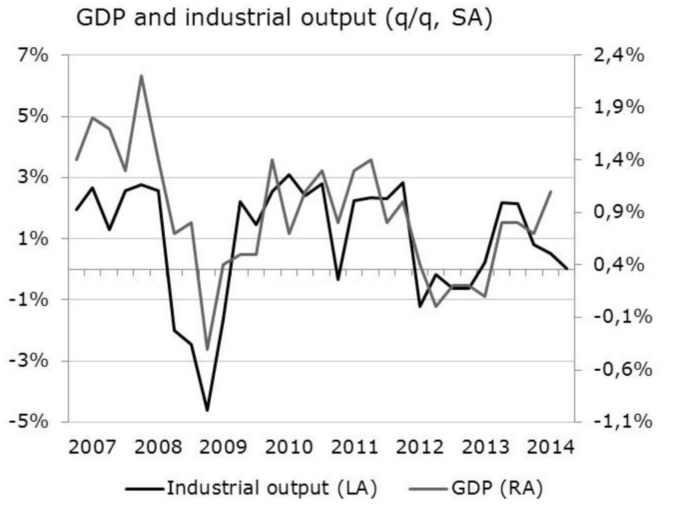
Corporate wages grew by 4.8% y/y in May, following a 3.8% increase in April. The reading turned out almost exactly halfway between our forecast (5.2% y/y) and market consensus (4.3% y/y). In absence of detailed data, we believe that the acceleration in y/y dynamics can be traced back to low statistical base in mining and positive difference in working day count (+1 y/y vs. 0 in April). Such growth rates are not an anomaly but a norm now - current trend in wage dynamics has exceeded 4% and is expected to steepen further in the following months (we would like to point the Readers' attention to manufacturing wage momentum, historically a leading indicator for aggregate wage growth). With inflation close to historical lows (we reiterate our claim that current disinflation is to a large extent a boost to private demand) and stable employment, nominal and real wage bill strong growth rates. Respectively, 5.3% and 5.5%. Income base for consumption in Q2 appears solid (and expands mostly because of wages) and the only factor that is capable of slowing household spending down is sharp increase in savings rate. No such signal (even though household saving rate has been increasing slowly since 2013) is observed by us, however.



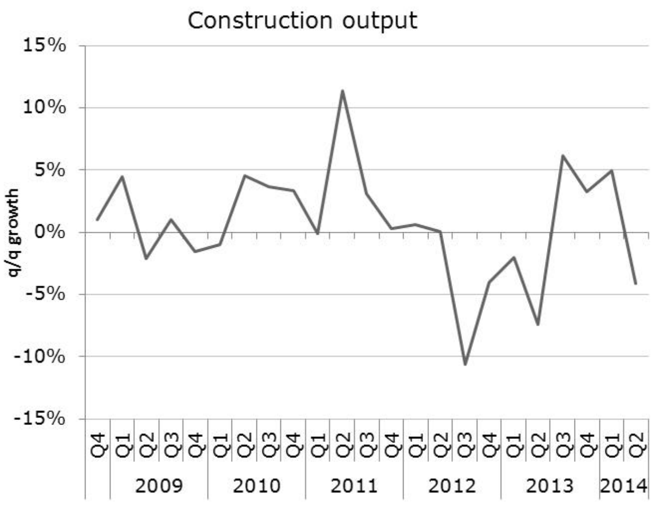
Employment in enterprise sector grew in May by 0.7% y/y, just as we expected, matching growth from the previous month. The cataclysm forecast by some business tendency indicators did not happen. And we do not expect it to happen in the nearest future. Apart from some seasonal fluctuations (possible soft patch in Q2) we expect the economy to grow on a cyclical basis, reducing the amount of slack and therefore releasing demand for labor force and investment.



Industrial output slowed down to 4.4% y/y in May from 5.4% y/y observed in the previous month, despite favorable calendar effects (+1 working days on y/y basis). The reading fell short of both our forecast and market consensus, 6.2% and 5.9%, respectively. Moreover, calendar factors are somewhat hiding the true extent of the weakness in the industrial sector - on a seasonally adjusted basis industrial output rose by meagre 2.7% y/y, constituting the slowest growth rate since last June. On monthly basis, we have witnesses a significant drop of 1.5%.



Construction output grew by 10% on annual basis, also below our forecast and market consensus (both ca. 14%). On a monthly basis a sharp drop of 3.9% was recorded. We are fairly certain that the weakness can still be reasonably traced back to very favorable conditions in the first quarter which pushed construction output up into unsustainable highs. With no indications of deeper problems, we stand firm by our optimistic forecast for the whole year. The weakness, which is both expected and temporary, should soon be compensated by the first wave of public infrastructure investments set to be launched in the second half of the year.



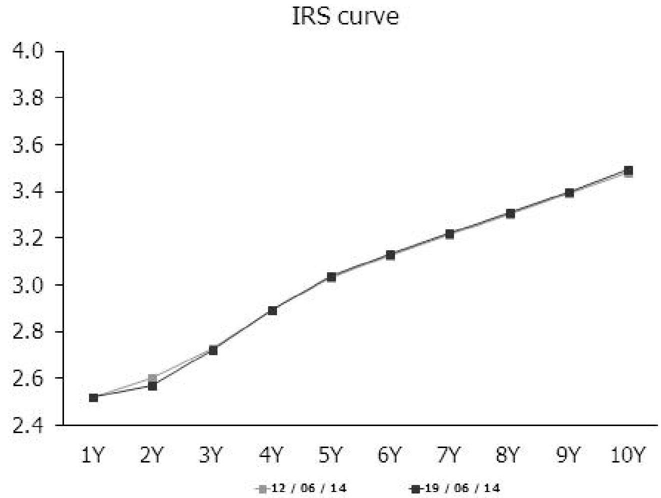
The release is a wonderful opportunity to comment on the implications for second-quarter GDP growth. Our scenario of a marked slowdown relative to Q1 seems to be unfolding exactly as we predicted. As of today, our tracking estimate of Q2 growth stands at below 3% y/y. Seen through sequential growth rates, the slowdown should be equally sharp. In the second quarter, industrial output has stagnated and the economy cannot count on a temporary boost from construction similar to what happened in Q1 (construction output dropped by 4% q/q in Q2). Thus, it is reasonable to expect that the economy grew only marginally (0.3% q/q) in the second quarter, compared to 1.1% in the first three months of the year.

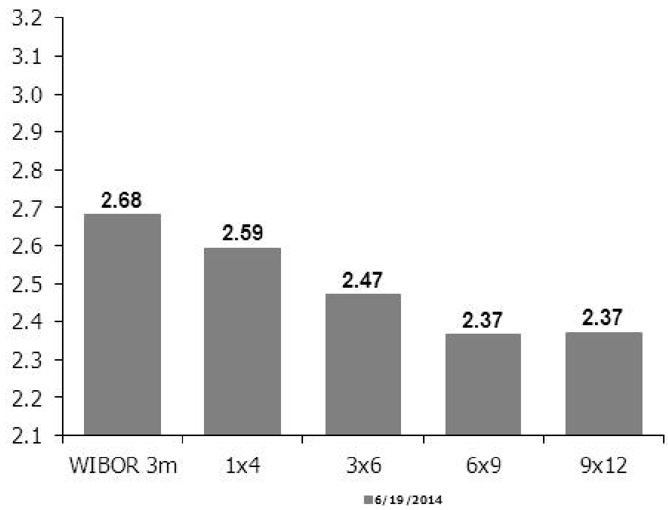
Fixed income

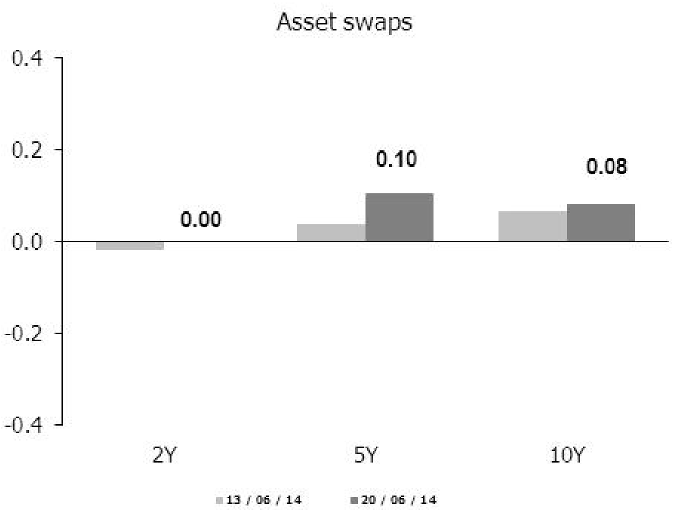
Political risk?

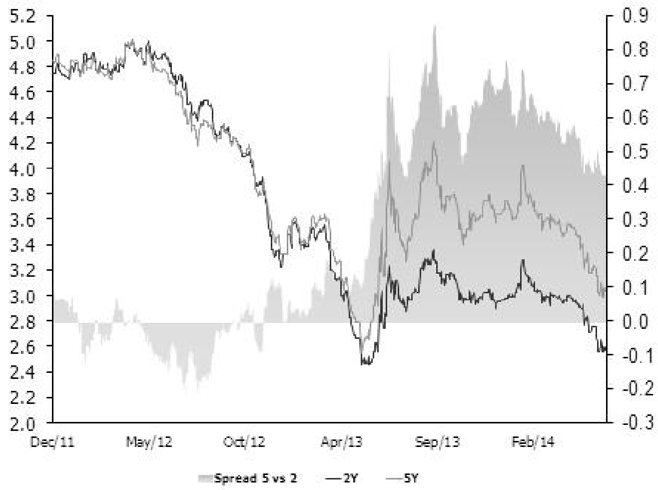
Super-low CPI, Industrial Output and PPI. Dovish ECB and, surprisingly, FED as well (despite healthy economy they assure that rates will be kept low). But our market is bearish, because we have new 'risks' - so called 'tape scandal' is pushing EUR/PLN higher and investors doubt that in this circumstances the MPC is going to cut rates. Yield of DS1023 went up to 3.62 at the end of this week (compared to 3.48 in the previous one).

We believe that biggest risk is the delay of rate cut from July to September. As soon as political tensions weaken, PLN should strenghten and we are going to play 'rate cut' game again. In the previous week we recommended to buy 5Y bonds and we still like them (levels are still similiar to the ones from the auction).









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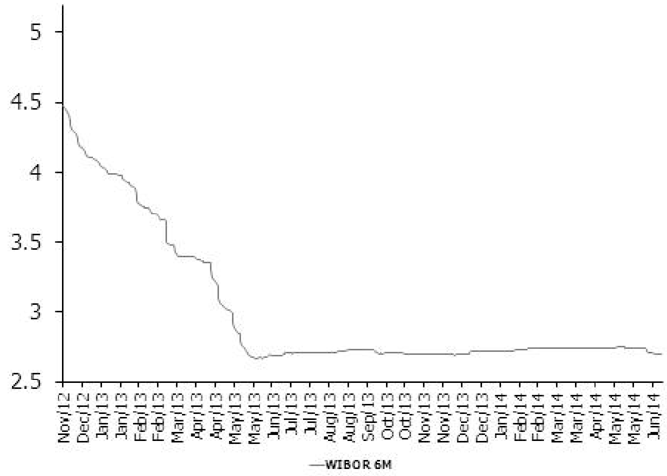
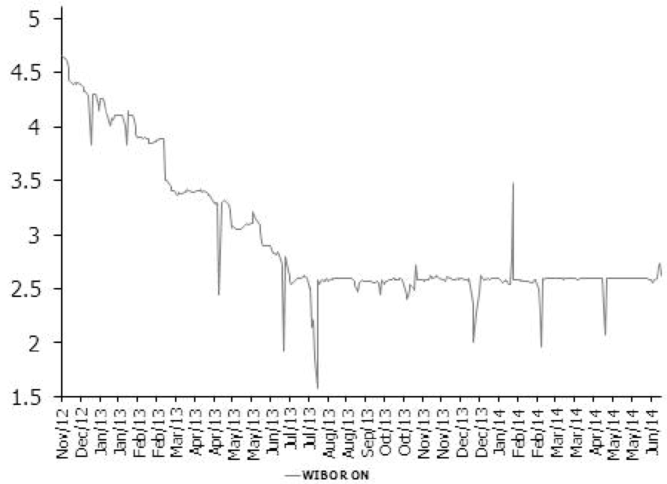
Money market

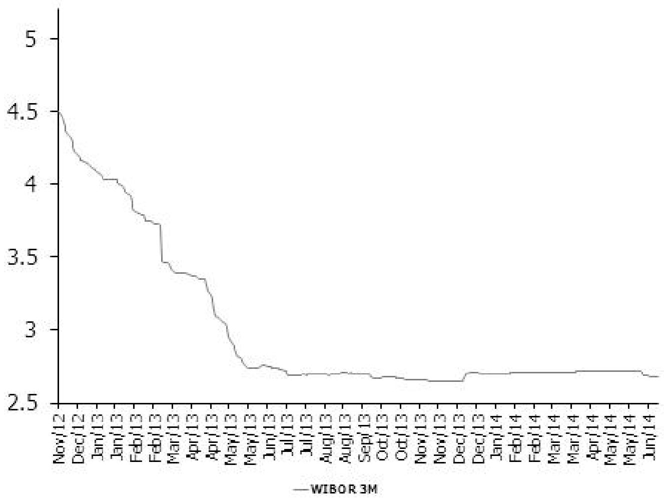
Very expensive week behind us Polonia rose to 2.71 significantly moving up from the reference rate. As today banks bought just 1bn less bills than was offered, next week won't be cheap.

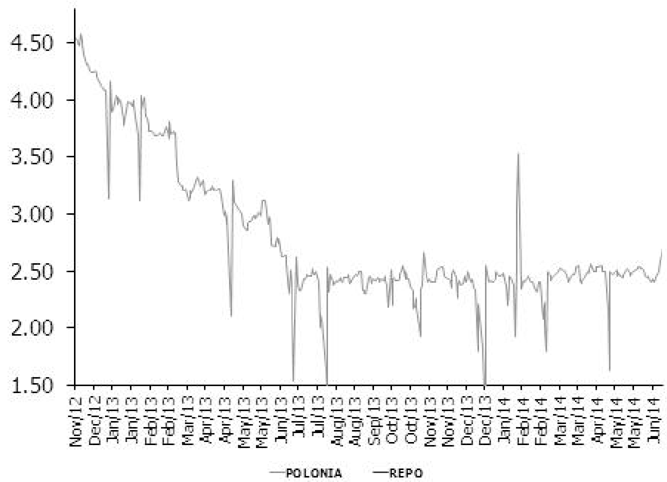
After so low industrial output on Wednesday rates fell a bit but weak political situation and threat of early elections moved them back today.

Our recommendation is to buy short bonds (PS0415, OK0715) and hedge it by 6*9 or 9*12 FRA at 2.42.





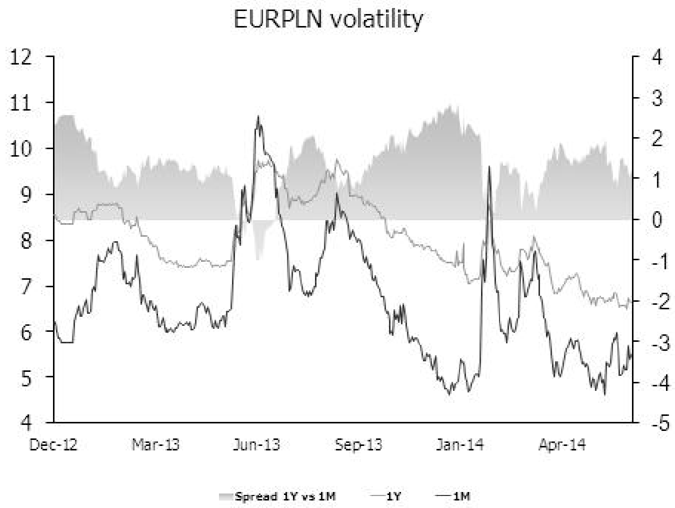




Forex

PLN weaker PLN weaker - EUR/PLN climbed back to 4.1650 high so far on the back of political turmoil in Poland and tense geopolitical situation (Iraq and Ukraine). That is the official version but we think that long PLN trade was simply overcrowded and that positioning had the biggest impact on the move. Our base case scenario is that Head of CB and the government will survive this storm and, once positioning in PLN will become much lighter, we will see the move back towards 4.10. Dovish ECB and FOMC should prevail and support PLN in the end.

Vols stable The current turbulence and weaker PLN had little to no impact on EUR/PLN and USD/PLN vol curves. One may say, it prevented the massive sell off, even though the vols are close to the historical lows. 1 month EUR/PLN ATM is today 5.1% (unchanged from last week), 3 months are 5.4% (0.2% higher) and finally 1 year is fixing at 6.5% (0.1% higher). Skew and currency spread (USD/PLN vol minus EUR/PLN vol) are more less the same.

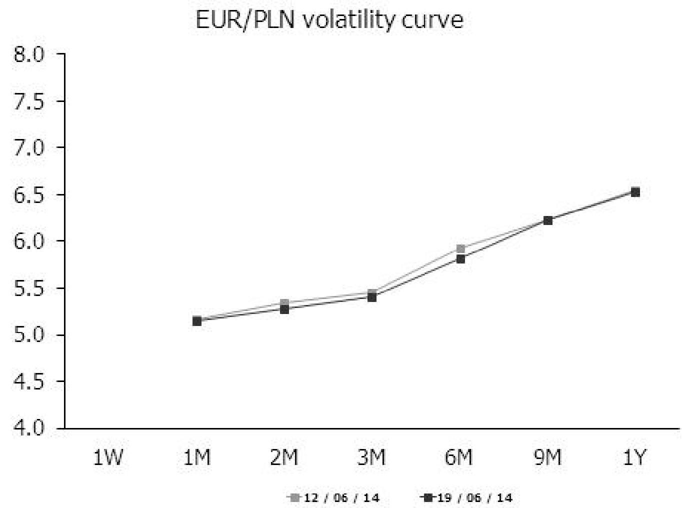


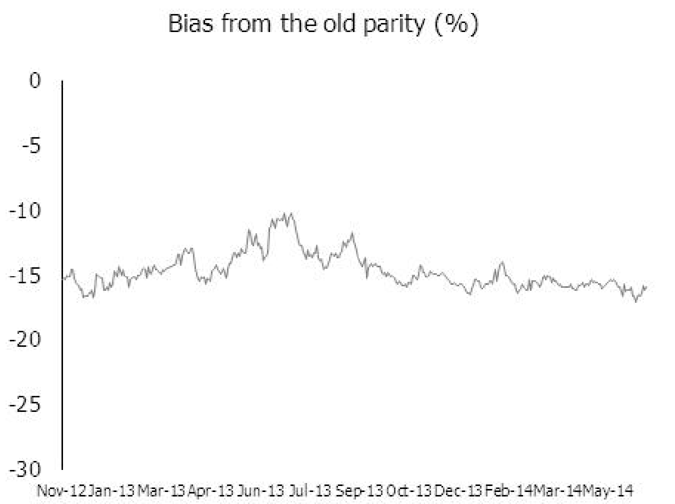
Short-term forecasts

SPOT Main supports / resistances:
EUR/PLN: 4.0900 / 4.1850
USD/PLN: 2.9900 / 3.1000

Sell EUR/PLN spikes Short on average at 4.1475, stop above 4.1700 and hopes for a test back below 4.10. We believe in ECB and FOMC dovish approach as the determinant factor for PLN. Current political turbulences (including the Head of CB), paradoxically help PLN, as the rate cut is in current circumstances much less likely.

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.





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
6/16/2014	2.81	2.68	2.86	2.60	2.73	2.64	2.61	2.51	2.46	2.45	2.50	2.48
6/17/2014	2.73	2.68	2.76	2.60	2.75	2.64	2.65	2.52	2.44	2.43	2.52	2.47
6/18/2014	2.50	2.68	2.52	2.60	2.64	2.64	2.61	2.50	2.43	2.42	2.47	2.42
6/19/2014	2.60	2.68	2.60	2.60	2.69	2.64	2.59	2.47	2.37	2.37	2.41	2.38
6/20/2014	2.60	2.68	2.60	2.60	2.69	2.64	2.59	2.47	2.37	2.37	2.41	2.38

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
6/16/2014	2.640	2.411	2.590	2.578	3.053	3.098	3.509	3.543
6/17/2014	2.640	2.433	2.595	2.602	3.060	3.162	3.500	3.578
6/18/2014	2.640	2.441	2.570	2.570	3.040	3.143	3.490	3.572
6/19/2014	2.640	2.441	2.570	2.570	3.040	3.143	3.490	3.572
6/20/2014	2.640	2.441	2.570	2.570	3.040	3.143	3.490	3.572

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
6/16/2014	5.69	5.76	6.13	6.73	6.73	2.59	0.67
6/17/2014	5.40	5.70	6.08	6.65	6.65	2.59	0.67
6/18/2014	5.50	5.65	6.08	6.63	6.63	2.57	0.68
6/19/2014	5.15	5.40	5.83	6.53	6.53	2.54	0.67
6/20/2014	5.15	5.40	5.83	6.53	6.53	2.54	0.67

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/16/2014	4.1460	3.0654	3.4046	3.0073	1.3485	0.1511
6/17/2014	4.1398	3.0495	3.3976	2.9887	1.3454	0.1508
6/18/2014	4.1463	3.0589	3.4018	2.9920	1.3477	0.1510
6/19/2014	4.1463	3.0589	3.4018	2.9920	1.3477	0.1510
6/20/2014	4.1506	3.0495	3.4109	2.9899	1.3564	0.1511

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