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Polish Weekly Review

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Comment on the upcoming data and forecasts

The forthcoming week is abundant with data as we will witness almost all releases scheduled for July. Current account surplus probably narrowed in May on the back of smaller trade surplus (GUS data published recently showed a surge in imports in May). Inflation (Tuesday) most likely decreased slightly in June - the slowdown is driven by still extremely low food prices and stable fuel prices. We expect the core CPI to remain stable at the 0.8% y/y rate (the official release happens on Wednesday). Also on Wednesday, the Statistical Office will make labor market data public. In our view, the stabilization in annual employment growth rate (monthly increase perfectly in line with seasonal pattern, base effects are no longer favorable) will be accompanied by a slight deceleration of wage dynamics, mainly due to unfavorable working days effect (0 vs. +1 y/y). The aforementioned calendar effect is also responsible for a slowdown in industrial output growth in June. Producer prices have in turn plummeted further to -1.8% y/y, confirming earlier indications from PMI surveys. The reason for the drop is a base effect related to sharp depreciation of Polish zloty in June 2013. Both releases will take place on Thursday.

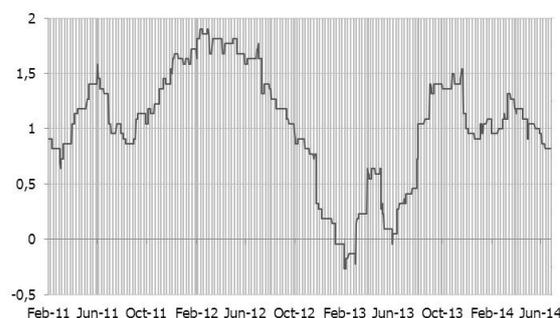
Polish data to watch: June 14th to July 18th

Publication	Date	Period	mBank	Consensus	Prior
Current account (mio EUR)	14.07	May	623	573	1028
Exports (mio EUR)	14.07	May	13950	13300	14207
Imports (mio EUR)	14.07	May	13724	13274	13351
M3 y/y (%)	14.07	Jun	5.5	5.3	5.3
CPI y/y (%)	15.07	Jun	0.1	0.2	0.2
Gross wages y/y (%)	16.07	Jun	4.5	4.7	4.8
Employment y/y (%)	16.07	Jun	0.7	0.7	0.7
Sold industrial output y/y (%)	17.07	Jun	1.8	4.0	4.4
PPI y/y (%)	17.07	Jun	-1.8	-1.8	-1.0

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 DS1025	-	2000	3.649	7/3/2014
20Y T-bond WS0429	-	150	3.464	5/16/2013

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



Comment

Unchanged (no macro publications). Next week brings a plethora of macro releases, from inflation to industrial output. Thus, there is a significant scope for surprises and we expect our surprise index to move.

* 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%). Losses 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 fairly 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.

Financial markets

- Political jitters should be viewed as noise. One must look beyond it.
- We are bullish on Polish bonds due to: 1) continuation of 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	0.4
Current account (%GDP)	-1.6	-4.5	-4.9	-3.5	-1.3	-0.9
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	Q2 F	Q3 F	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	2.68	2.22	2.22
2Y Polish bond yields (% eop)	3.19	3.07	3.06	3.05	3.01	2.51	2.50	2.50
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.23	3.45	3.60	3.70
EUR/PLN (eop)	4.18	4.33	4.22	4.15	4.17	4.16	4.10	4.05
USD/PLN (eop)	3.26	3.32	3.12	3.02	3.04	3.01	3.00	3.01

F - forecast

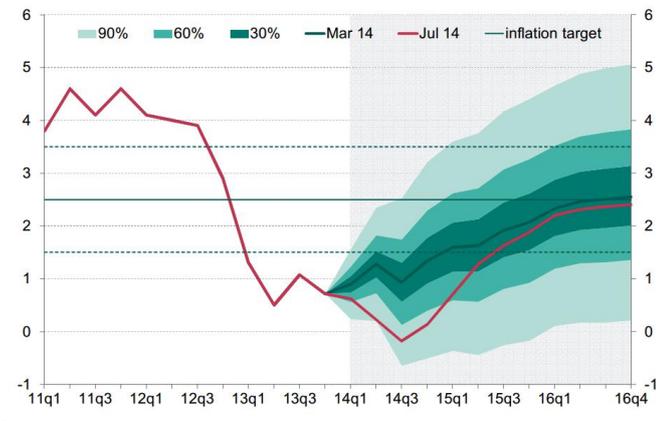
Economics

NBP's latest Inflation Report can support any monetary policy except for tightening

Similarly as in previous instances, the newest staff projections released by the NBP are predominantly a result of adjustments made to account for recent developments in the economy and the divergence between actual paths of GDP, inflation and projections published in March.

First, the GDP forecast was little changed and the slight differences vis-a-vis the previous forecast can be traced back to higher growth in Q1 and corrections in expected path of disbursements of EU funds from the previous and the next EU budget. The latter, coupled with revised estimates of potential growth (higher!) resulted in a wider and more persistent output gap than previously projected. In fact, the gap is expected to close more slowly and remain negative throughout the whole forecast horizon. It doesn't, however, imply a „new normal” in which inflationary pressures are unlikely to appear due to the economy running permanently below potential. Nevertheless, the mechanics of NBP's forecast model suggest that the pro-cyclical nature of potential output estimates might, among other assumptions, result in a lack of significant positive output gap.

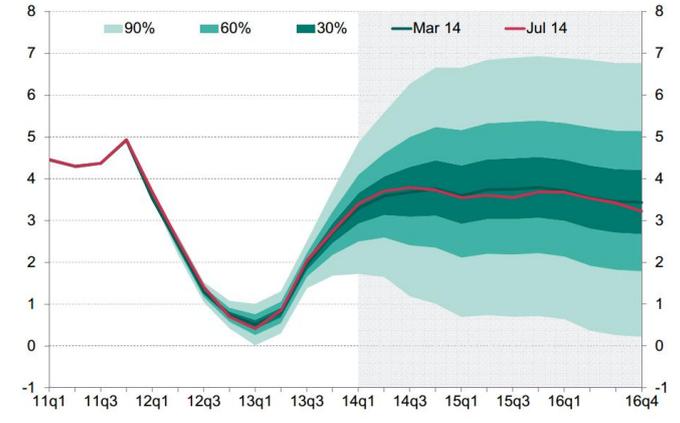
Figure 4.25 July projection versus March projection: CPI inflation (y/y, %)



Inflation projections were subject to the biggest revisions. Running contrary to March projections (which assumed an upward-sloping path in Q2), inflation slowed down markedly in the second quarter and is expected to fall into negative territory in the summer. Much space, both in the report and the presentation, was dedicated to explaining why inflation surprised to the downside (mostly due to food prices, as is widely known). This obviously cannot last forever and, with stable prices of energy sources and soft commodities, as well as due to demand effects taking hold in core categories, CPI should begin to grow in the second half of the year. Nevertheless, it must be noted that the central path stays below the NBP's CPI target of 2.5% throughout the entire forecast horizon. Mathematically speaking, the target is effectively a ceiling or an asymptote. Moreover, the fan chart is visibly asymmetric. While the likelihood of inflation staying below the central path was estimated at 48% in the previous report, current estimates put it

at 55%. Never in the history of NBP's inflation reports have the risks been biased so much in the direction of low inflation.

Figure 4.23 July projection versus March projection: GDP growth (y/y, %)



To sum up, the projections depict a very benign environment for Polish monetary policy. Slow return to the central bank's target (in addition, subject to significant downside risks), a disinflationary external environment and the lack of inflationary shocks - it all suggests that monetary policy could be eased to ensure a swifter return to target. In such a scenario, the risks of overheating would probably increase, pushing the date of first rate hike forward, relative to baseline. On the other hand, stable and balanced growth as well as increasing inflation support a stable path for interest rates. Nevertheless, an activist central bank would view such projection as a reason to act. Whether this actually happens, will depend on the upcoming data flow. It seems, in addition, that the two or three months of deflation have already been factored in by the majority of MPC members, while a slowdown in growth (here the NBP is „hawkish”, i.e. not expecting GDP to slow down in Q2), on the other hand, has not. This means that the Council, when surprised, would be pushed to act. Recent statements by MPC members (Belka, Bratkowski, Zielinska-Glebocka, Chojna-Duch) confirm just that.

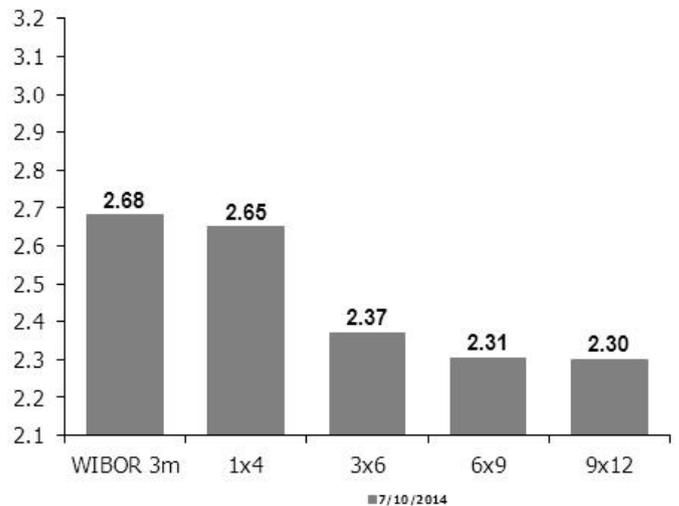
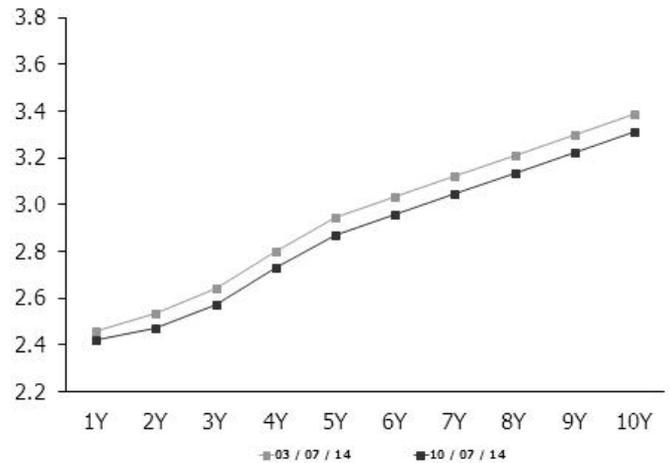
Fixed income

No risks... really?

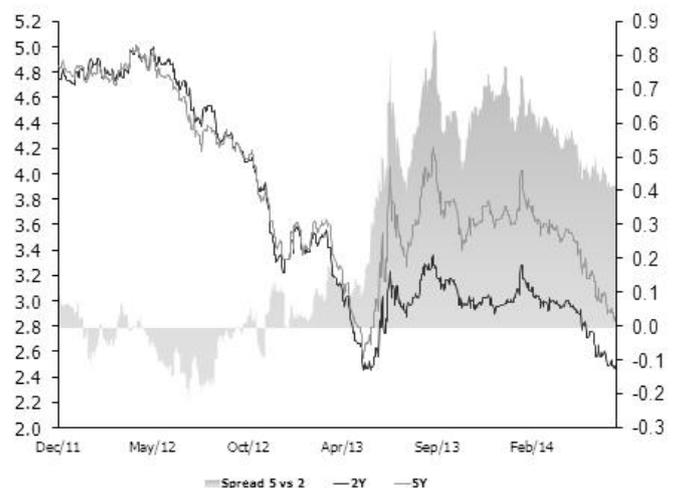
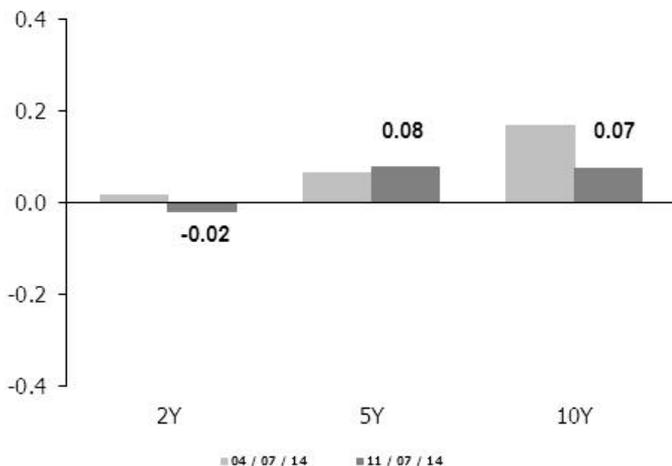
Another report from bullish fixed income market. Inflows on PolGbs seem stable as investors expects rate cut, lack of bond supply and possible GDP slowdown. Yield of DS0725 went from 3.60% down to 3.50%, but at the end of the week small profit taking appeared, and yield is now at 3.56% again.

We feel that after long rally the market is very vulnerable for profit taking. Most of positive news is already priced in, investors ignore hawkish MPC statements. Publication of CPI data may be a turning point, even neutral data (+0.2% YoY) could trigger more profit taking on PolGbs as next important event is going to be regular auction (possibly PS0719 on the offer).

IRS curve



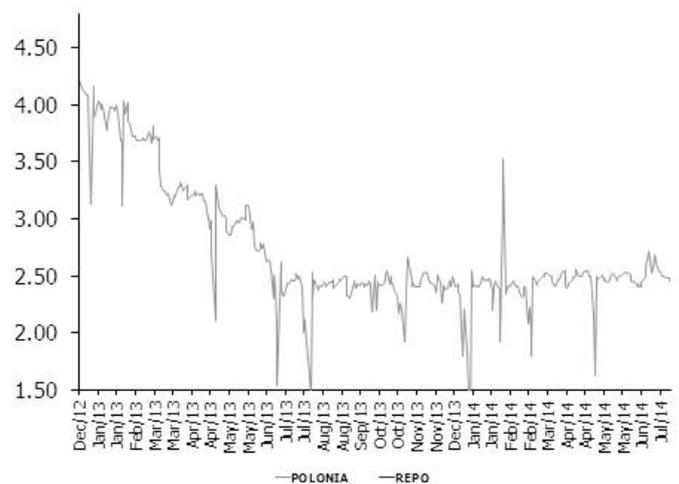
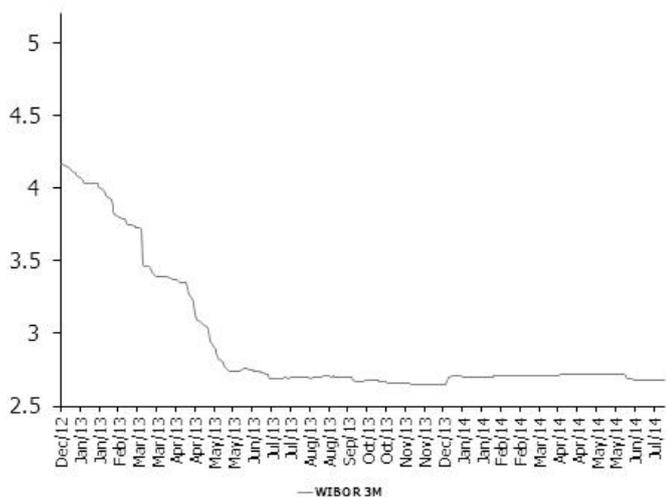
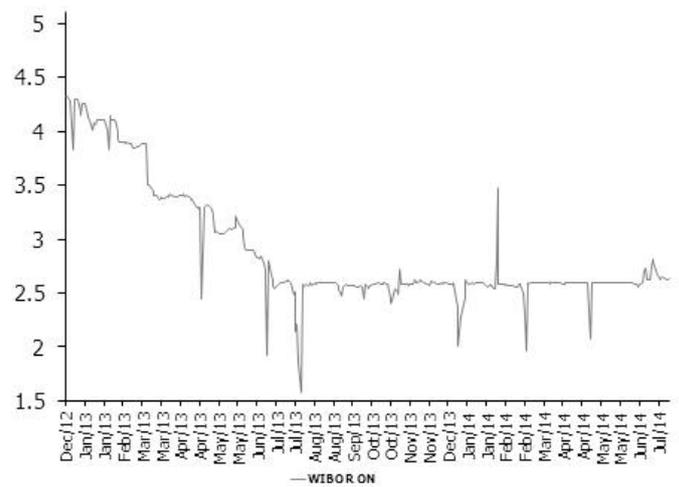
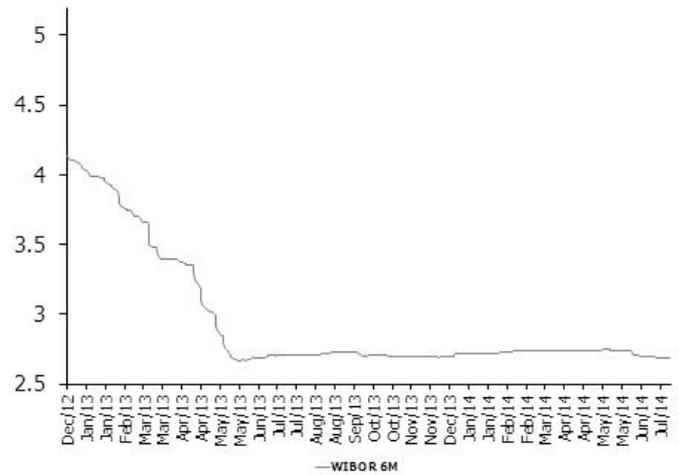
Asset swaps



Money market

Cheap week behind us Calm and a bit cheaper week for cash. Polonia fluctuated under 2.50% as banks bought less bills than were offered. Next week should be the same or even cheaper as today's auction was underbid as well (by 5 bn PLN).

Our recommendation is to sell 1Y OIS (around 2.22) and buy FRA at 2.30 (6x9 looks best for it). Wait for CPI.



Forex

EUR/PLN in range 4.12-4.16 is well known territory for EUR/PLN. Polish calendar was empty, and FOMC minutes failed to produce much volatility. The mild risk off was a result of Espirito Santo rumors, but it also was not enough to electrify markets. Polish political problems (non confidence votes in Parliament) were widely ignored. We are watching really closely the long end of POLGBs as we think that correction (profit taking) in bonds would have strong negative implications for PLN. Let's hope that next week will be more interesting.

Vols - little lower The EUR/PLN vol curve melted a little as spot was really calm, and there is no certain volatility trigger on the horizon. EUR/PLN ATM mid is today 4.8% (the same level as last Friday), 3 month are 5.2% (0.2% lower) and finally 1 year fixed at 6.2% (0.2% lower). The skew is better offered especially in the backend, the currency spread (USD/USD vol minus EUR/PLN vol) is slightly better bid.

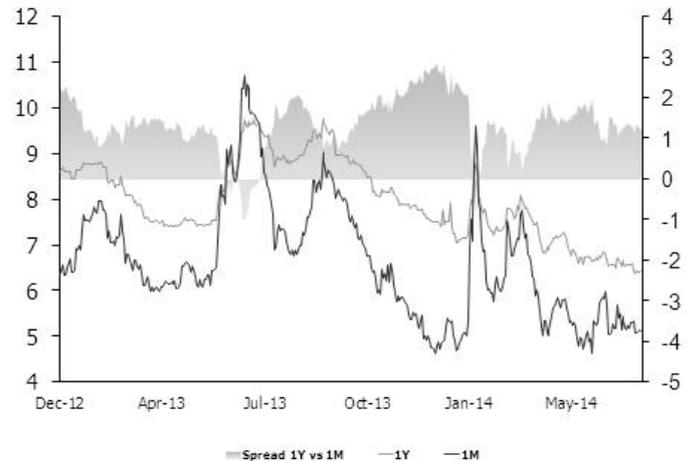
Short-term forecasts

SPOT Main supports / resistances:
 EUR/PLN: 4.1200 / 4.1900
 USD/PLN: 2.9900 / 3.1000

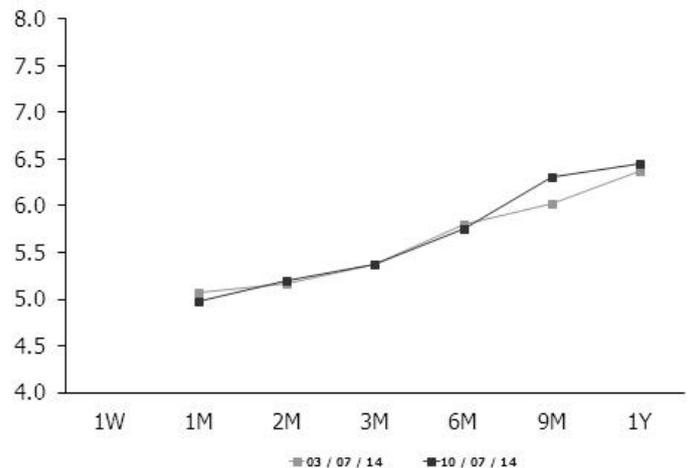
Spot - EUR/PLN: Play 4.12/4.19 range Nothing changed, the range play is still on. The problem is that spot moves in the middle of the range are in no man's land and we have troubles with installing the position (at what we think is a decent entry level). The moves in the order of magnitude of 400/500 ticks are almost nonexistent. It makes us trade opportunistically with limited involvement.

Options - tactical long. Still small tactical long in mid curve Vega. The market is not really moving, we in the very tight price ranges. The bigger picture we are much more keen to enter bigger long Vega trade, but timing is a key. Till now we are sticking to our small tactical long.

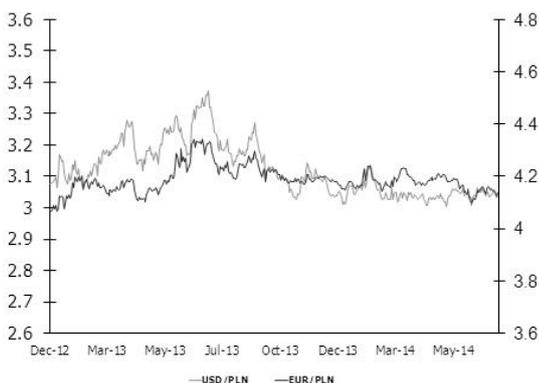
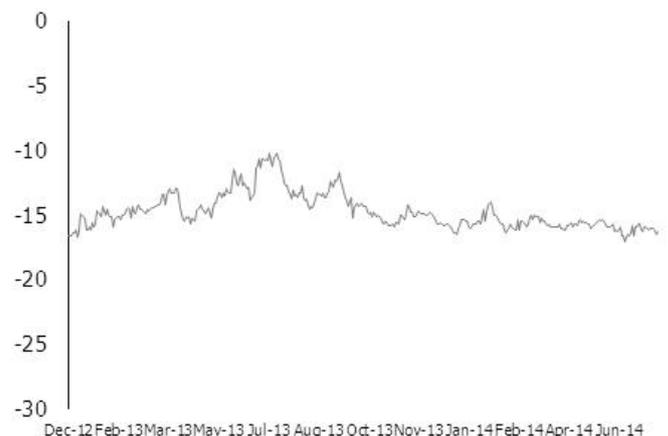
EURPLN volatility



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
7/7/2014	2.60	2.68	2.58	2.59	2.60	2.64	2.63	2.42	2.31	2.30	2.36	2.32
7/8/2014	2.71	2.68	2.73	2.59	2.64	2.64	2.64	2.40	2.29	2.29	2.32	2.31
7/9/2014	2.53	2.68	2.53	2.59	2.59	2.63	2.64	2.38	2.30	2.32	2.36	2.32
7/10/2014	2.71	2.68	2.73	2.59	2.64	2.63	2.65	2.37	2.31	2.30	2.34	2.30
7/11/2014	2.71	2.68	2.73	2.59	2.64	2.63	2.65	2.37	2.31	2.30	2.34	2.30

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
DS1025	6/5/2014	7/25/2025	94.90	3.82	2000	2743	1693

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
7/7/2014	2.640	2.404	2.475	2.499	2.880	2.955	3.310	3.390
7/8/2014	2.640	2.411	2.460	2.502	2.840	2.903	3.275	3.390
7/9/2014	2.630	2.417	2.488	2.505	2.865	2.903	3.305	3.389
7/10/2014	2.630	2.406	2.475	2.457	2.870	2.950	3.315	3.389
7/11/2014	2.630	2.406	2.475	2.457	2.870	2.950	3.315	3.389

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY	
Date	1M	3M	6M	1Y	1M	1Y	1Y	
7/7/2014	5.13	5.45	5.80	6.40	6.40	2.45	0.67	
7/8/2014	5.15	5.45	5.78	6.40	6.40	2.45	0.67	
7/9/2014	5.13	5.45	5.78	6.45	6.45	2.35	0.66	
7/10/2014	4.98	5.38	5.75	6.45	6.45	2.54	0.66	
7/11/2014	4.98	5.38	5.75	6.45	6.45	2.54	0.66	

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
7/7/2014	4.1472	3.0497	3.4115	2.9919	1.3352	0.1511
7/8/2014	4.1401	3.0441	3.4064	2.9922	1.3373	0.1509
7/9/2014	4.1272	3.0322	3.3949	2.9831	1.3344	0.1503
7/10/2014	4.1341	3.0323	3.4040	2.9904	1.3324	0.1507
7/11/2014	4.1419	3.0426	3.4107	3.0031	1.3349	0.1509

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