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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

Marcin Mazurek, PhD
senior analyst
tel. +48 22 829 01 83
marcin.mazurek@mbank.pl

Piotr Bartkiewicz
analyst
tel. +48 22 526 70 34
piotr.bartkiewicz@mbank.pl

Marek Ignaszak
analyst
tel. +48 22 829 02 56
marek.ignaszak@mbank.pl

Department of Financial Markets
(business contacts)

Bartlomiej Malocha, CFA
head of interest rates trading
tel. +48 22 829 01 77
bartlomiej.malocha@mbank.pl

Marcin Turkiewicz
head of fx trading
tel. +48 22 829 01 67
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

Jacek Jurczyński
structured products
tel. +48 22 829 15 16
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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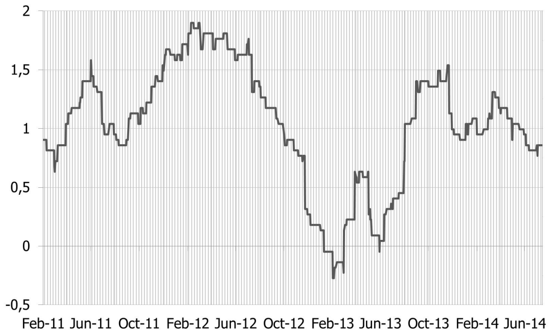
Comment on the upcoming data and forecasts

A light week ahead of us - no important data releases scheduled.

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	-	5000	2.793	7/23/2014
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

Slightly down after the PMI. Next week will bring stabilisation as no macro releases are scheduled.

* 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 but let's focus on Polish soft–patch (and its implications) now.
- Current business tendency indicators suggest that growth momentum softens and 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 (with German economy contracting in Q2) was not so great as well. On the other hand, recession in Ukraine and Russia do not seem to exert any visible pressure on overall Polish exports.
- Coming quarters are expected to bring more (positive) 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 months 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 in Autumn (rates should be cut by more than 50bps).

Financial markets

- Risk reward has changed and Polish bonds are expensive (in some metrics and especially for investors unwilling to take exchange rate risk) now in comparison to Bunds and other European bonds. It is not that they have become expensive instantly – they used to be expensive in the past as well but the momentum overshadowed pricing considerations.
- Positioning of foreign investors is already very aggressive and global markets - given the data flow from the US - may be more shaky ahead of next Fed meeting.
- We still expect Polish data to come in weaker in August but we also need decisive comment from Belka (there is no MPC meeting in August) to trigger expectations not only for a one-off correction of rates but the proper easing cycle. It is unlikely to happen in August.
- Polish bonds are maybe not definitely off the agenda but for the moment we prefer to stay sideways.
- Increased volatility, ECB easing fatigue and possibility of incoming downward revisions for the Polish growth are going to weigh negatively on the zloty. In such circumstances expectation of further easing may do more harm than good to Polish currency. Zloty is set to stay weaker, although we do not expect crisis-like depreciation.

mBank forecasts

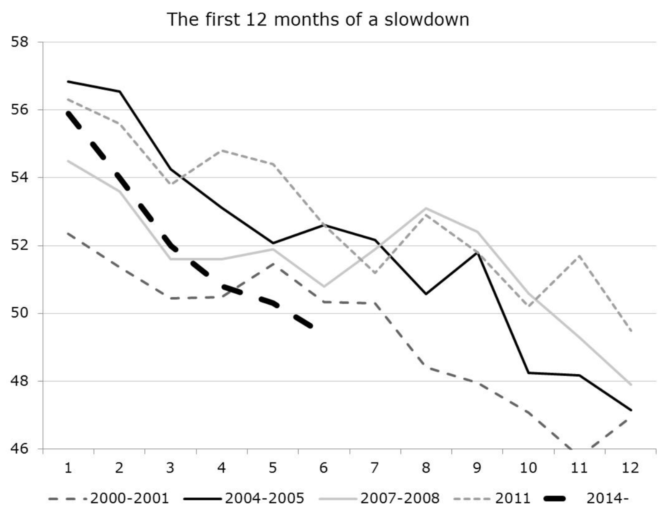
	2009	2010	2011	2012	2013	2014F
GDP y/y (%)	1.6	3.9	4.5	2.0	1.6	3.3
CPI Inflation y/y (average %)	3.5	2.8	4.3	3.7	0.9	0.3
Current account (%GDP)	-1.6	-4.5	-4.9	-3.5	-1.3	-0.9
Unemployment rate (end of period %)	12.1	12.4	12.5	13.4	13.4	13.0
Repo rate (end of period %)	3.50	3.50	4.50	4.25	2.50	2.00

	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.4	0.8	2.0	2.7	3.4	3.0	3.0	3.6
Individual consumption y/y (%)	0.0	0.1	1.0	2.1	2.6	2.5	2.6	2.8
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	5.0	5.0	8.5
Inflation rate (% average)	1.3	0.5	1.1	0.8	0.6	0.2	-0.2	0.4
Unemployment rate (% eop)	14.3	13.2	13.0	13.4	13.9	12.0	11.5	12.2
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	2.30	2.30
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.23	3.45	3.20	3.60
EUR/PLN (eop)	4.18	4.33	4.22	4.15	4.17	4.16	4.15	4.15
USD/PLN (eop)	3.26	3.32	3.12	3.02	3.04	3.12	3.17	3.15

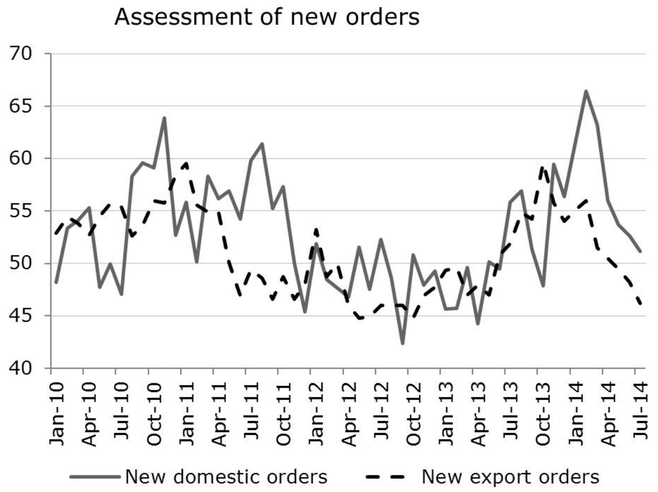
F - forecast

PMI disappoints again and remains consistent with hard data.

Contrary to mildly optimistic expectations of meagre growth, Polish Manufacturing PMI dipped below 50 pts for the first time since June 2013, bringing the overall index to 49.4. This is the fifth decline in a row and its total scale (6.5 pts) is comparable only to some episodes in the 2008 slowdown. Certainly never has Polish industry decelerated so fast from a local peak (see the graph below).

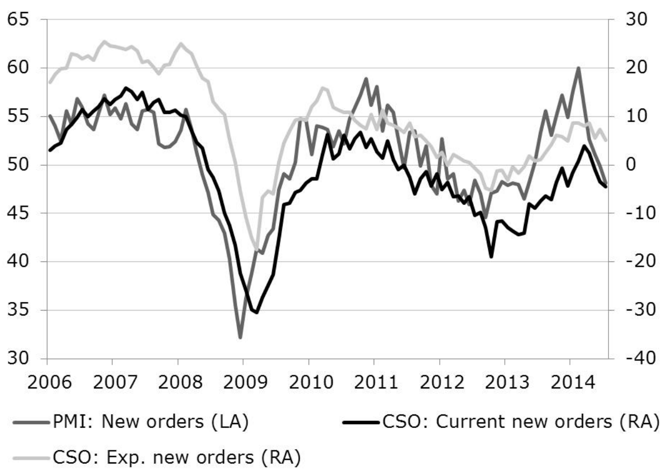


Similarly to previous month, weaker sentiment in Polish industry was driven by dwindling demand reflected in ever-lower rate of new orders (in July declined to 48.1, lowest since April 2013). Even though new export orders led the way again â€“ the relevant subindex dropped to 46.2, lowest since October 2012 (sic!), a marked deceleration was recorded in domestic orders as well. The fact that the latter remained above 50 pts threshold offers little consolation as the direction is clear. Finally, employment growth, accelerating for the second time in a row, somewhat cushioned the fall in overall PMI. Optimists cannot, however, be sure that labor demand will continue to grow in the coming months, in the past labor market was often characterized by considerable inertia and reacted to changes in demand with a few month lag. Finally, the increase in input prices and significantly slower decline in output prices can be seen as a delayed effect of global commodity price growth and not a real external price shock, such might be ushered by a significant depreciation of the zloty (it its current weakness is continued).



The implications if latest PMI readings are clear. Polish economy likely decelerated to 3% y/y in the second quarter, while sequential growth rates could look even weaker (although forecasting q/q growth in Poland is tricky because of its instability), and the weakness extends into the third quarter now. While the likelihood of acceleration in Q3 had already been small before the release (due to high statistical base in investment and construction activity), further weakening of business sentiment and subsequent negative shocks affecting the Polish economy (new embargoes, signals that energy prices in Europe might be raised) are a clear indication that deceleration is still happening. In such circumstances the only hope for better H2 lies in public investment. The case there, however, is only for moderate optimism, as recent developments in tender procedures indicate.

It is often pointed out that similiar indices compiled by the Central Statistical Office and the European Commission do not indicate that a significant slowdown is underway. One has to consider, however, not only different statistical samples, but also different methodologies (indices from CSO and EC are based on questions regarding general business situation of the firm). Comparable subindices (output, orders, employment) are correlated more strongly (see the graph below). Moreover, the PMI seems to be leading the other sentiment indices.



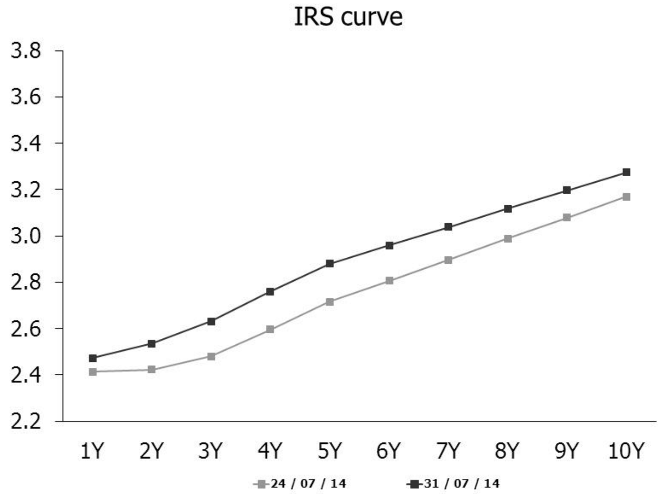
From the economic point of view, the 50 pts threshold has little significance, its interpretation being a matter of tradition and convention. When translating into „hard" data, trends are more important, here it is unequivocally negative. Nevertheless, the drop below 50 has a strong psychological effect and confirms that the economy is in a weak shape. It is one of many arguments for resuming rate cuts. The new cycle might start in September already.

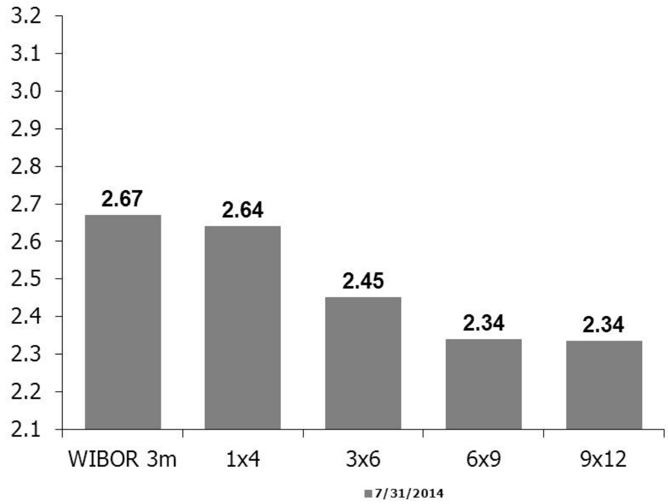
Fixed income

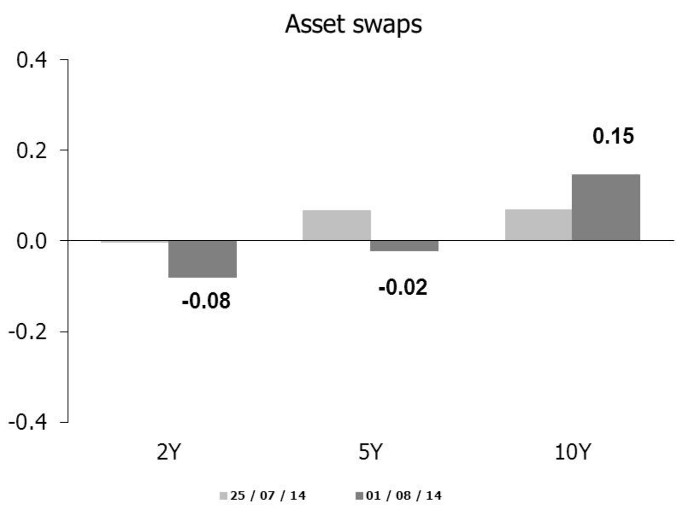
Is it different this time?

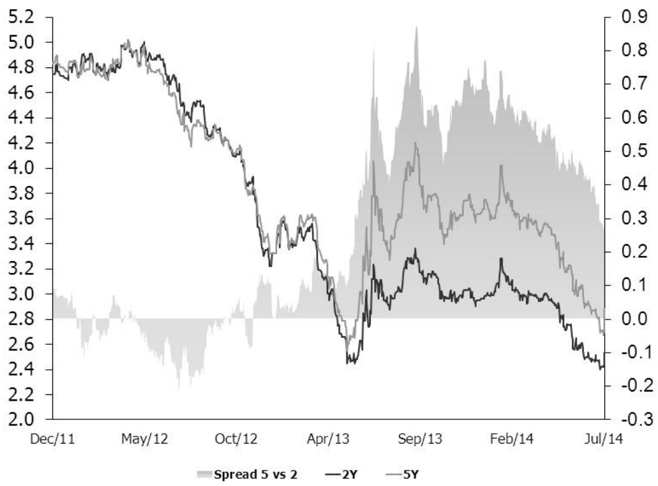
Just few days after record breaking auction of 5Y bonds, sentiment changed drastically. Yields were going down for a few weeks, but this week they gained some 30bp in just 2 days. Yes, 'crisis' again. Default of Argentina, sanctions for banks in Russia, rate hike speculations in US and record low yields on Polish curve caused toxic mixture and as a result panic selloff of bonds. This year Poland has been super resilient to global turmoils, is it different this time?

We are still positive towards bonds from fundamental point of view. Even if MPC is resilient, in current, nervous times for markets, and does not cut rates in September, we believe that Poland is still attractive for foreign investors. They need relatively safe market, with good yields. Calm investors are going to realise that the whole conflict with Russia can push CPI and GDP even lower than it was expected and budget situation - surprisingly - is as solid as ever.









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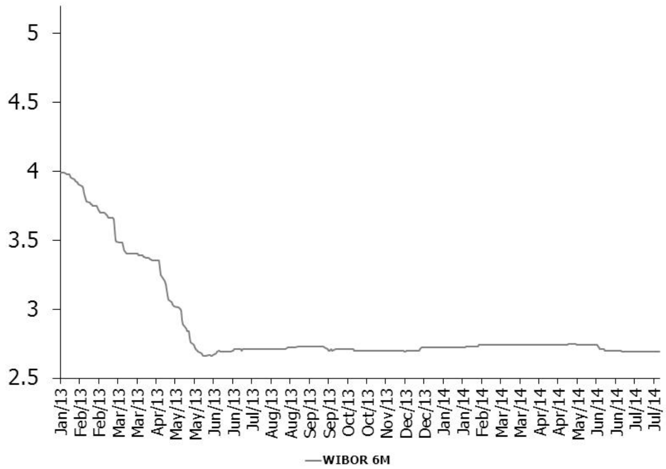
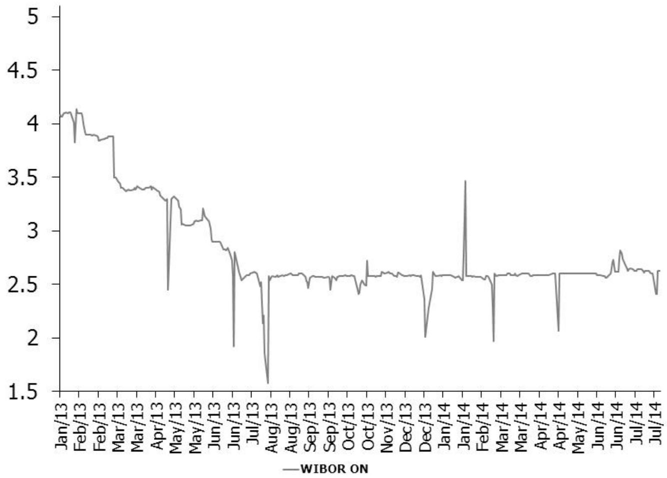
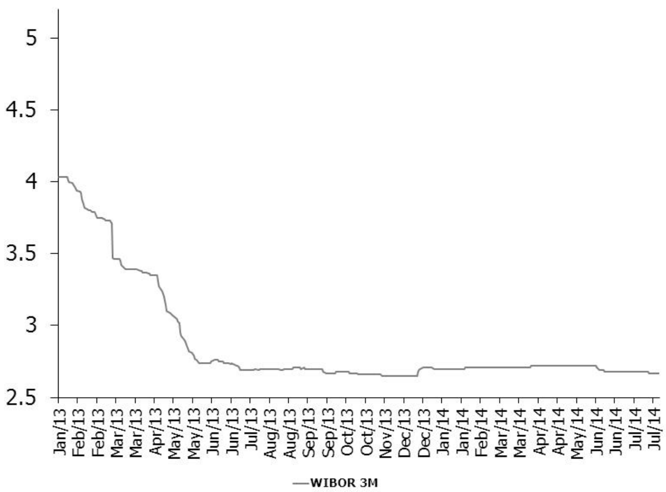
Money market

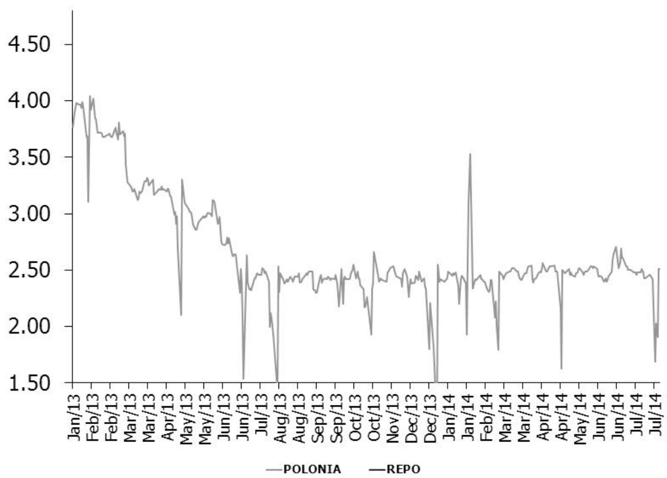
Short-term deposits back to main rate level Today's OMO squares the system which can mean polonia rate even above the benchmark.

External factors override local data PMI below 50 pts would support our rates cut expectations if not externals. Argentina default and further sanctions against Russia put huge pressure on EM currencies and debts. We see US real money selling both. Re-pricing for rates was and still is quite aggressive. Next figure we are impatiently waiting for is 2q GDP. We expect it to be lower than market consensus and much lower than figure expected by the MPC relying on their GDP path in the last report. It should be convincing enough for the MPC to re-think easing. Moreover, Russian embargo impact on polish GDP is -0.6 and this is only the first estimate. Real rates are highest in region.





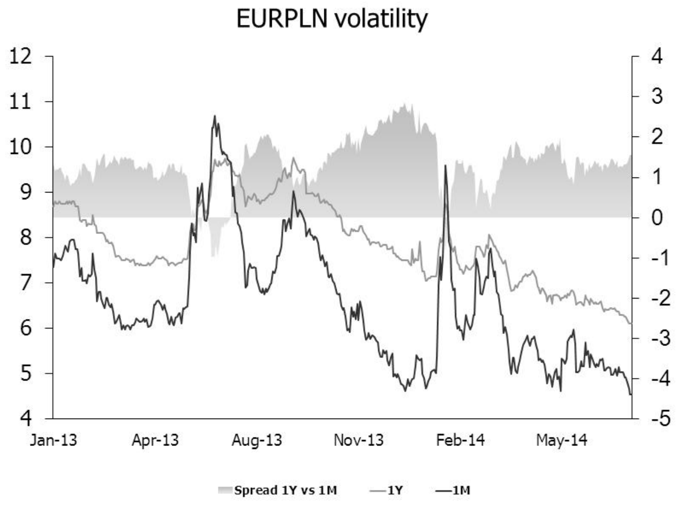




Forex

PLN weaker Market sentiment should not be taken for granted. This week we have a healthy sell off in PLN and POLGBs. Although there was no specific reason (US GDP?), the magnitude of the move was impressive. EUR/PLN broke out higher from it 4.13-4.17 range to touch 4.1935 high. The NFP was a tic lower than expected, supporting risk sentiment a bit. But the bigger picture is blurred to say at least, there is still huge geopolitical risk hanging above the market.

Vol - higher The bid for gamma in the frontend is all gone and the very distant memory already. The frontend got sold massively, with the 1 week being the biggest victim (1% lower). 1 month EUR/PLN ATM mid is fixing at 4.6% (0.7% lower than last Friday), 3 months EUR/PLN is 5.1% (0.4% lower), and 1 year 6.2% (0.3% lower). In theory the currency spread should be better bid after EUR/USD has gone south but it has not as it is the only thing left to sell to cover Theta bills. Skew roughly unchanged, with 6 months EUR/PLN RR 25D at 1.4%.

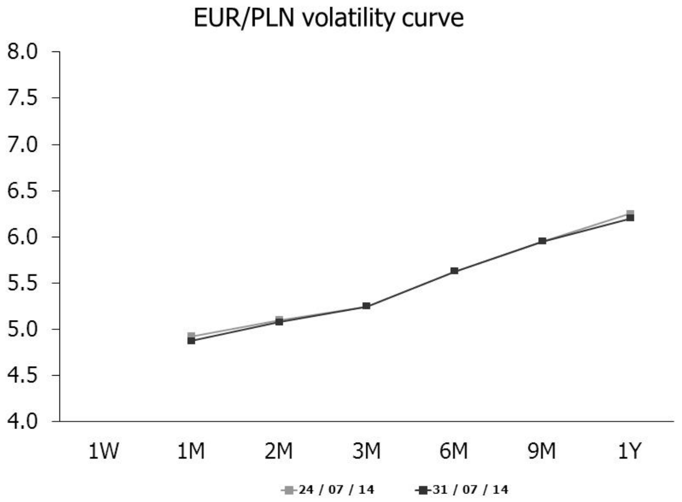


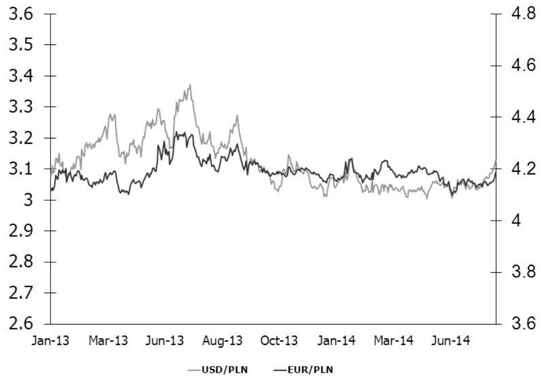
Short-term forecasts

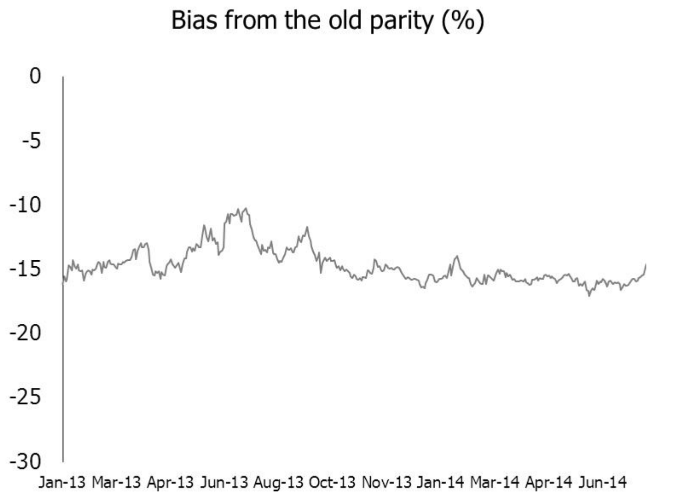
SPOT Main supports / resistances:
EUR/PLN: 4.1200 / 4.2200
USD/PLN: 2.9900 / 3.1500

Spot We think (hope with all our hearts rather) , that we will enter the periods of volatility normalization and this should translate into higher vol. In our opinion it was rather the problem of overcrowded positions in EUR/PLN that caused the spike (same with sell off in POLBONDS). Even though NFP gave the risk sentiment some support , we would rather bet on the further deterioration of the sentiment. We are long EUR/PLN at 4.1650 with a stop at 4.1400 and profit taking at 4.22.

Options - tactical long. Long Vega , we have added Vega to our portfolio , now being outright long Vega in 40% of the limit. We think there is at least a chance for a mid-reverting move higher, as the nominal volatility levels are really encouraging for longs







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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
7/28/2014	2.74	2.67	2.62	2.59	2.72	2.63	2.65	2.40	2.29	2.28	2.30	2.29
7/29/2014	2.60	2.67	2.70	2.59	2.63	2.63	2.63	2.39	2.28	2.28	2.29	2.29
7/30/2014	2.48	2.67	2.50	2.59	2.59	2.63	2.63	2.42	2.28	2.28	2.30	2.29
7/31/2014	2.67	2.67	2.67	2.59	2.80	2.63	2.64	2.45	2.34	2.34	2.39	2.36
8/1/2014	2.67	2.67	2.67	2.59	2.80	2.62	2.64	2.45	2.34	2.34	2.39	2.36

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
7/28/2014	2.630	2.376	2.430	2.420	2.710	2.771	3.150	3.223
7/29/2014	2.630	2.318	2.418	2.397	2.670	2.743	3.090	3.177
7/30/2014	2.630	2.325	2.440	2.405	2.710	2.770	3.130	3.222
7/31/2014	2.630	2.345	2.535	2.454	2.880	2.858	3.275	3.421
8/1/2014	2.620	2.345	2.535	2.454	2.880	2.858	3.275	3.421

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
7/28/2014	4.68	5.05	5.45	6.10	6.10	2.10	0.67
7/29/2014	4.55	5.03	5.45	6.10	6.10	2.10	0.67
7/30/2014	4.54	5.03	5.45	6.10	6.10	2.10	0.67
7/31/2014	4.88	5.25	5.63	6.20	6.20	2.15	0.67
8/1/2014	4.88	5.25	5.63	6.20	6.20	2.15	0.67

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
7/28/2014	4.1470	3.0860	3.4132	3.0300	1.3440	0.1509
7/29/2014	4.1524	3.0900	3.4180	3.0311	1.3383	0.1511
7/30/2014	4.1517	3.0978	3.4138	3.0310	1.3362	0.1510
7/31/2014	4.1640	3.1094	3.4225	3.0252	1.3346	0.1512
8/1/2014	4.1887	3.1280	3.4438	3.0396	1.3335	0.1514

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