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Polish Weekly Review

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Comment on the upcoming data and forecasts

Month begins with the release of August Manufacturing PMI. As all external correlates (German PMI and Ifo, Eurozone PMIs) fell in August, expectations of further decline in Polish sentiment is reasonable. Furthermore, the historical pattern is clear here - once the PMI drops below 50, it tends to stay there for a few months (one exception is the turn 2011/2012 when a dead cat bounce in German sentiment pushed expectations in Poland as well). The most important event of the week is the MPC meeting, the first in two months. Since early July, expectations of monetary easing have intensified, with multiple data points pointing to weaker economic activity and more protracted deflation than previously anticipated. Economic outlook has become more uncertain as well. While consensus among dovish analysts and market participants indicates that cuts will happen in October and November. We believe that a cut in September is just as likely (after all, timing is largely irrelevant for the economy and markets).

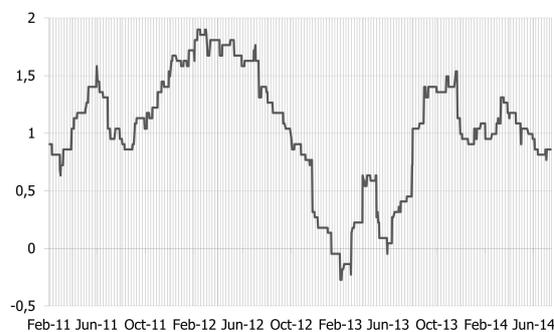
Polish data to watch: September 1st to September 5th

Publication	Date	Period	mBank	Consensus	Prior
Manufacturing PMI (pts.)	01.09	Aug	48.9	49.0	49.4
NBP rate decision (%)	03.09	Sep	2.00	2.50	2.50

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

Unchanged, since all figures were in line with market consensus. There is only one opportunity for surprise next week - Manufacturing PMI.

* 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

- Polish economy is already in a soft patch. Although the recovery may not be ultimately derailed, we see important downside risks to a forecast of a more dynamic rebound going forward. In the nearest future we expect economists to cut their growth and inflation forecasts further which may stimulate expectations for monetary easing.
- Current business tendency indicators suggest that growth momentum softened and GDP growth is going to be lower in Q3 (3%). External environment (with German economy contracting in Q2) was not so great as well. Recession in Ukraine and Russia do not seem to exert any visible pressure on overall Polish exports for now (exports to the east contracts strongly, though) but Russia's food ban and possible escalation of trade war between EU and Russia suggest a downside risk for Polish exports.
- Final quarter is expected to bring more (positive) exogenous components to the Polish cycle. We may see first effects of credit easing in the euro area. Pension reform, along with the political cycle, opens room for fiscal stimulation. We expect significant fiscal stimulus from 2014/2015 onwards, focused mainly on public infrastructure spending and fueled by the re-launch of EU funding.
- 2-3 years of economic expansion are our baseline scenario but growth rates may prove to be more moderate than we expected few months ago.
- Inflation stays very low (negative) for the next few months. Momentum on inflation is already negative which strengthens the impact of high real interest rates.
- MPC got stuck in a fairly positive GDP growth scenario and is likely to overreact on embargo-related news flow and weaker data releases. We see MPC cutting rates in Autumn. We expect a whole easing cycle (50-100bps).

Financial markets

- Geopolitical risks still important for Polish bonds.
- Polish fundamentals, along with European factors - including zero inflation and downside risks to GDP, are more than ever supportive to lower rates across the board.
- Geopolitical risks, increased volatility, ECB easing fatigue and possibility of incoming downward revisions for 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.

mBank forecasts

	2010	2011	2012	2013	2014F	2015F
GDP y/y (%)	3.9	4.5	2.0	1.6	3.0	3.4
CPI Inflation y/y (average %)	2.8	4.3	3.7	0.9	0.2	1.8
Current account (%GDP)	-4.5	-4.9	-3.5	-1.3	-0.9	-1.8
Unemployment rate (end of period %)	12.4	12.5	13.4	13.4	12.2	12.0
Repo rate (end of period %)	3.50	4.50	4.25	2.50	1.75	2.00

	2013	2013	2013	2013	2014	2014	2014	2014
	Q1	Q2	Q3	Q4	Q1	Q2	Q3 F	Q4 F
GDP y/y (%)	0.4	0.8	2.0	2.7	3.4	3.3	2.9	3.0
Individual consumption y/y (%)	0.0	0.1	1.0	2.1	2.6	2.8	2.4	1.9
Public Consumption y/y (%)	0.1	5.0	3.0	3.1	0.7	0.8	2.0	2.4
Investment y/y (%)	-2.4	-3.3	0.5	2.0	10.7	8.4	6.3	7.0
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	1.75
Wibor 3M (% eop)	3.39	2.73	2.67	2.71	2.71	2.68	2.22	1.97
2Y Polish bond yields (% eop)	3.19	3.07	3.06	3.05	3.01	2.51	2.20	2.05
10Y Polish bond yields (% eop)	3.94	4.34	4.48	4.35	4.23	3.45	3.00	3.20
EUR/PLN (eop)	4.18	4.33	4.22	4.15	4.17	4.16	4.20	4.20
USD/PLN (eop)	3.26	3.32	3.12	3.02	3.04	3.16	3.21	3.23

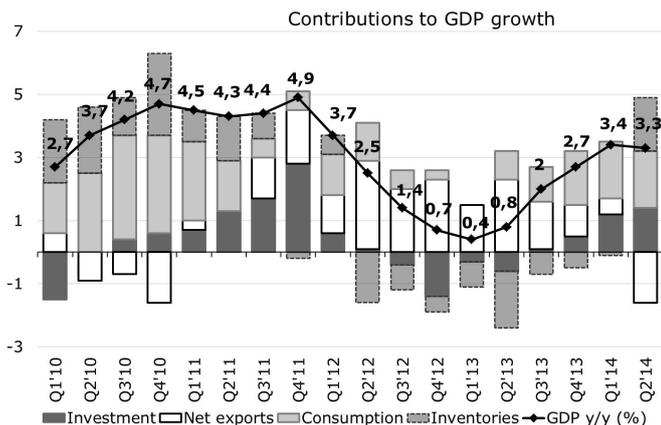
F - forecast

Economics

Year-on-year growth remains decent but weaker momentum will lead to slowdown further on.

Preliminary GDP data showed 3.3% yoy growth in Q2 (slightly above flash reading), down from 3.4% in the previous quarter. True, this deceleration is not pronounced enough to call it a soft patch. However, we stick to such a wording given the extraordinary factors that pushed growth rate artificially up in Q2. This is not going to repeat in Q3.

Q2 saw decent growth of consumption (2.8% vs 2.6%) despite clouding macro picture. However, this may be linked to better growth rate of real wages (lower inflation) and this effect is likely to peter off in subsequent months. Investment activity decelerated only slightly from 10.7% to 8.4%. In our opinion, such a delicate slowdown may be attributed to statistical base effect in construction (Q2 2013 was a disaster) that—with more or less stable momentum – was able to accelerate in terms of value added in Q2 2014.



Inventories and net exports tell another interesting story. It paid off to bet on huge, positive base effect in inventories and assume a solid rebound in Q2 in terms of growth contribution. However, net exports were far more negative than we had expected (a truly solid shift compared to usually fairly accurate estimates based on nominal trade statistics). Stellar performance of inventories is only a statistical artifact and is, therefore, unrepeatable in Q3. The more so since all available information suggests that volume of inventories change calmed down after Q2 (not mentioning the vanishing base effect). All in all we end up in less supportive inventories change in Q3. The same applies to net exports. If it had really changed the level, starting point for Q3 in even worse than we had thought. In such a set-up, reaching 3.0% GDP growth in Q3 demands almost impossible acceleration of demand categories (consumption and investment).

Impossible is impossible. First of all, the data from July (and forecasts for August) corroborate the loss of momentum in the Polish economy. Secondly, statistical base is a double-edged sword. Q3 2013 marked a solid rebound in economic activity (in every aspect apart from public consumption) and therefore, in order to make yoy growth rate look better, momentum has

to accelerate over the one from a year ago. And this, see the first argument, seems unrealistic; the more so since economic rebounds at the bottom of the slowdowns or recessions are linked with the most pronounced jumps in activity. Last but not least, calculations of statistical base overlook a powerful determinant of private investment activity: uncertainty. Is there anyone claiming it did not rise, especially in light of PMIs below 50?

Summing up, attaching too much weight to Q2 GDP results would be like driving with the use of rear-view mirror. Next quarters are biased with downside risks to growth: slowdown in euro zone, recession in Ukraine and Russia, pending effects of sanctions, postponed rebound in infrastructure investment. We are not pessimists as far as overall GDP growth is concerned. We only acknowledge short-term risks and, at the same time, suggest acceleration in growth in 2015 (3.5%) when the majority of the mentioned negative effects is likely (not determined) to reverse with the additional icing from fiscal stimulation ahead of elections and lagged effects of credit easing in the euro zone.

Because of aforementioned risks and the need to support the economy (rising real rates!), we think that MPC is going to embark on an easing cycle. The most reasonable moment is September: Belka has intuitively erased forward guidance from the statement, he also pointed recently to macroeconomic risks. It is possible, though, that MPC needs more time to change course. It does not interfere with our forecast of lower rates amid strengthening zero-rate environment in the euro zone.

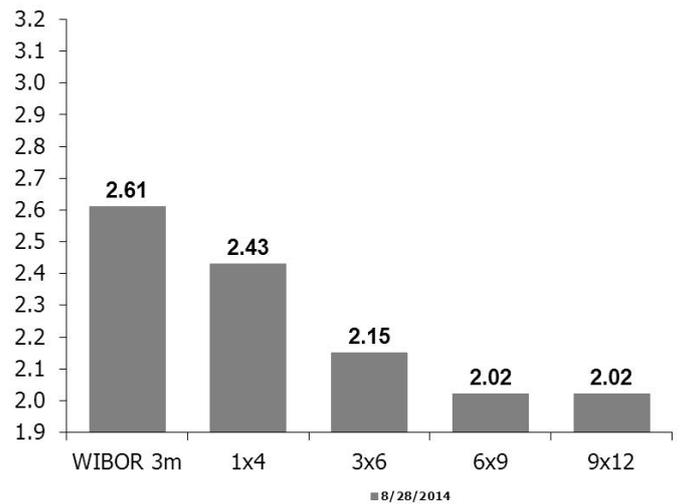
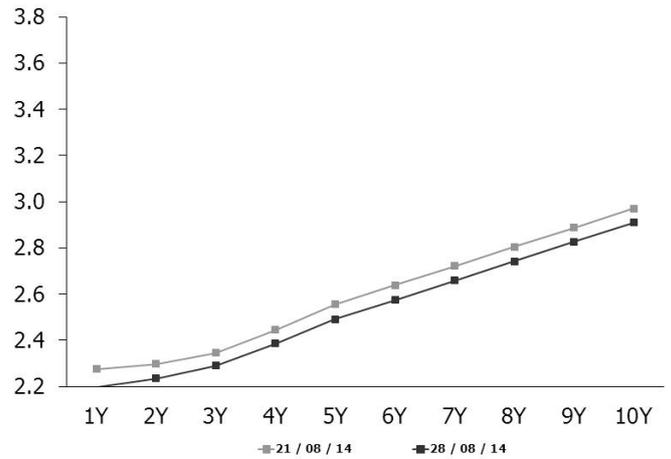
Fixed income

Are we going to break 3% on DS1023?

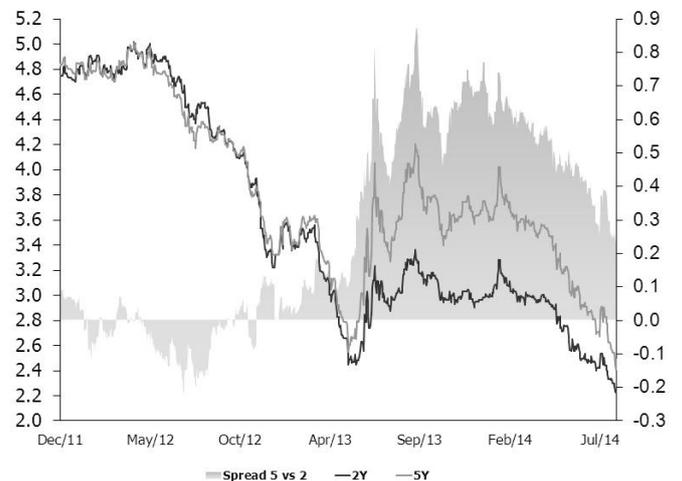
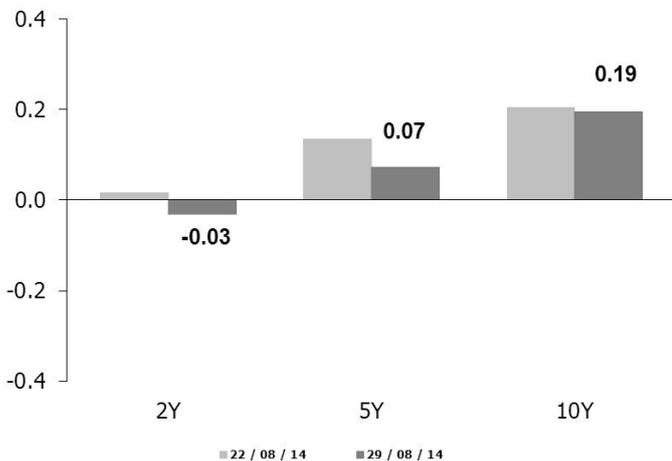
This week market tried twice to break this level, without success. When we exclude Ukrainian turmoil, the environment for bonds is really, really positive (MPC should cut rates quickly, bullish trend on core and periphery markets is intact) – this level should be achieved quite quickly.

Nevertheless, another time we underline risks for being long bonds which are quite the same for another week: escalation of Russian-Ukrainian conflict, MoF auction on 4th September or fact that most of positive news are priced in. That's why we are going to try playing range trading (DS1023 3.00-3.15%) next week.

IRS curve



Asset swaps

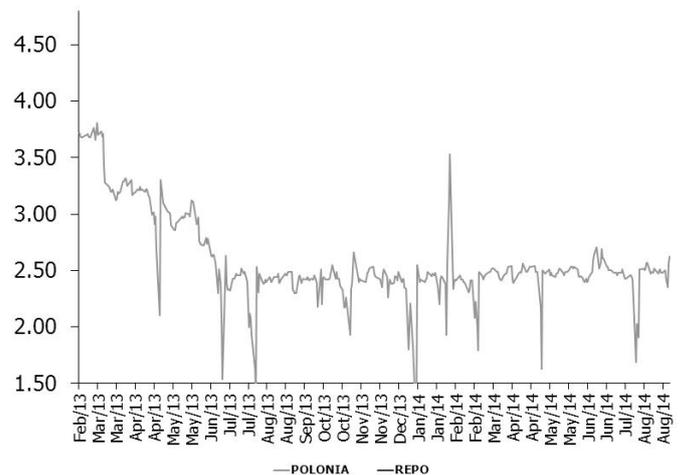
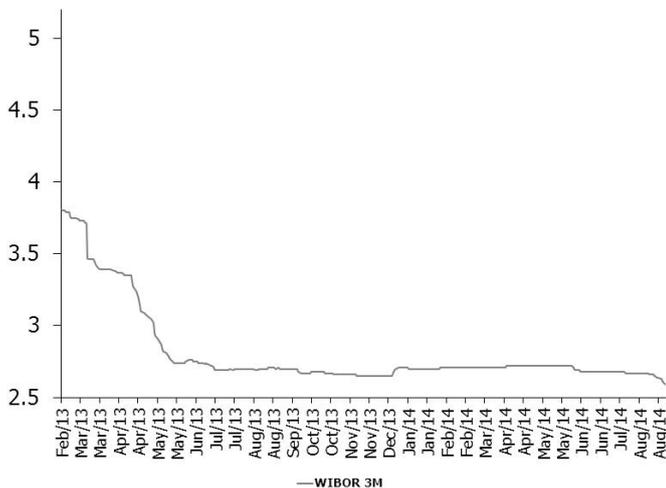
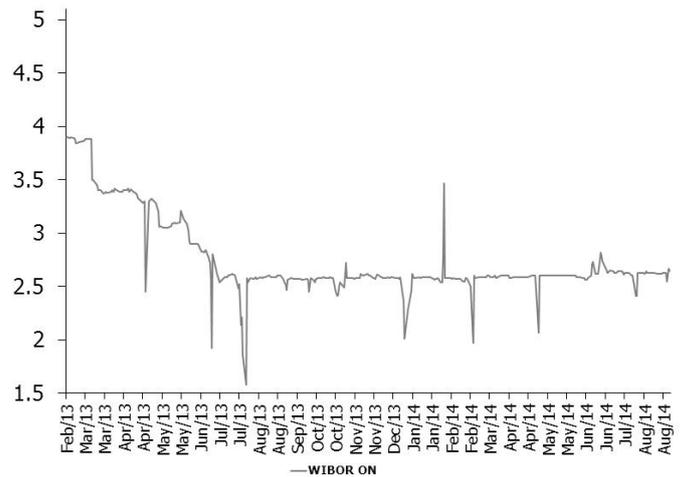
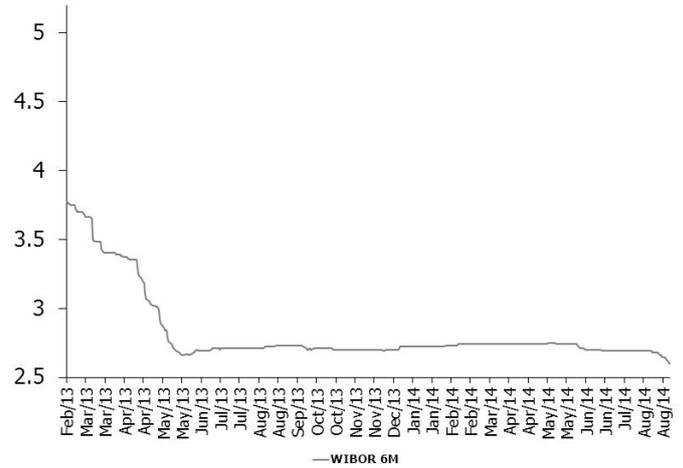


Money market

Crazy week behind us After underbid OMO Polonia fell to 2.35% on Tuesday. After additional OMO on Wednesday cash become expensive pushing Polonia to 2.62% on Thursday. Today's operation was underbid as 31st is last day of reserve and it will be additional OMO this afternoon.

Last week was very bullish. 1Y OIS offer is under 2.00% and longer FRAs are quoted 1.98 – 2.02.

There is MPC meeting on Tuesday and Wednesday and we are all waiting for decision.



Forex

PLN Sell off Information about Russian soldiers fighting together with separatists against Ukraine was a rude awakening for the whole EM world, and it finally got to Zloty as well. EUR/PLN brutally broke out of its sleepy 4.1690/4.2090 range and we have briefly touched above 4.2300. Additionally, interest rate cut and some political uncertainty caused by the eventual departure of Prime Minister Tusk to Brussels on the European Council President post, also did not support the Zloty. The next line of defense is 4.23/4.25 and above that we may say the volatility is back and about to stay. As yet we are still a bit skeptical.

VoIs – unchanged Option market behaved extremely quietly last week. The biggest demand on Gamma/Vega was of course on Thursday but finally on Friday afternoon EUR/PLN volatility curves was almost the same like week ago!!!! (spot EUR/PLN is higher by 3 figures then week ago). The vols seem to find its equilibrium at current levels as curve has not changed much from last week. 1 month EUR/PLN atm is today at 5.4% (unchanged from last week), 3 months is at 5.7% (0.1% lower than a week ago!!), 1 year is at 6.6% (unchanged from last week). The skew was in demand with bids for 1 month and 6 month 25RR, driving the RR higher by roughly 0.25% (the mids are respectively now at 1.0% and 2.0%)

Short – term forecasts

SPOT Main supports / resistances:

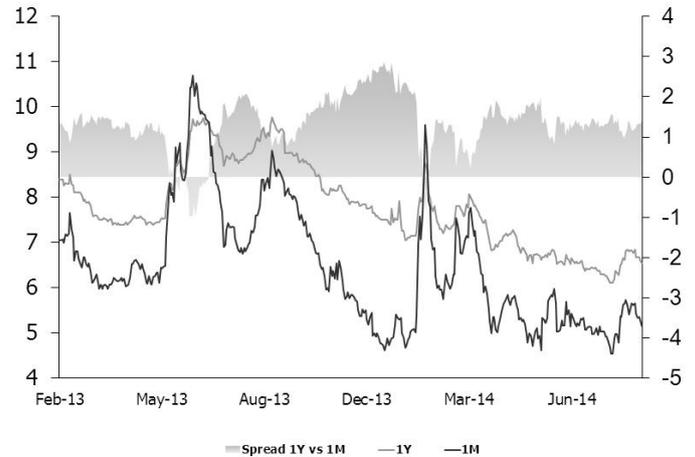
EUR/PLN: 4.16 / 4.25

USD/PLN: 3.07 / 3.24

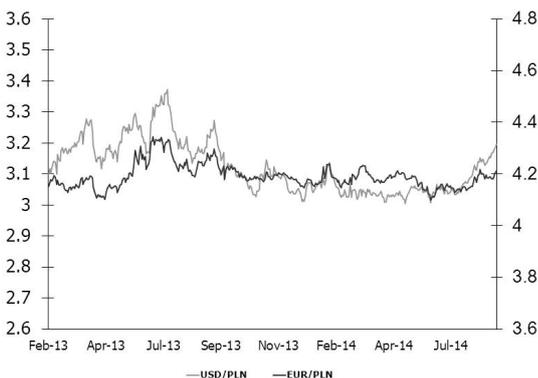
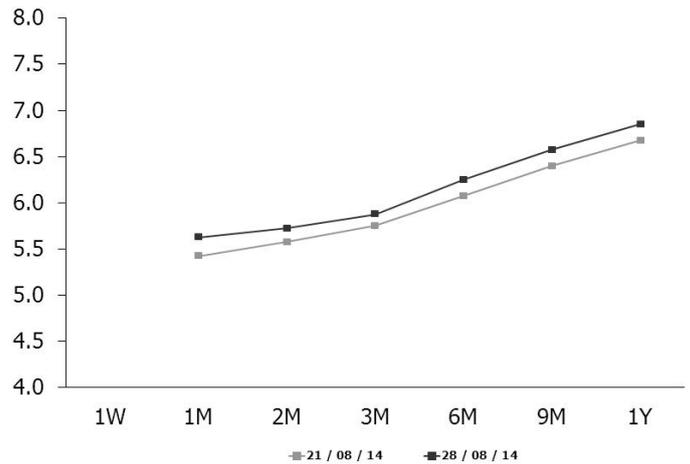
Spot – Buy on dips We liquidated last week's EURPLN long at 4.2320, booking over 6 figures profit. Since EUR/PLN risks remain skewed higher with the Ukrainian tensions, local rate cut risks and political risks, we prefer to be long. We are ready to buy EUR/PLN at 4.19 / 4.20 with stop 4.17 and hopes for 4.2350 / 4.2500.

Options – long Vega/Gamma We are long Vega and Gamma in EUR/PLN. The next week's decision about rate cut in Poland and payrolls data in the US are the events to be long Gamma, not mentioning the war in Ukraine. We still see good reasons to be long Vega, nominal levels are still historically low, realized volatilities are improving, there is a lot of potential volatility triggers.

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
8/25/2014	2.54	2.63	2.55	2.54	2.58	2.57	2.46	2.19	2.09	2.09	2.13	2.10
8/26/2014	2.57	2.62	2.50	2.53	2.55	2.56	2.45	2.18	2.06	2.06	2.08	2.09
8/27/2014	2.47	2.61	2.39	2.52	2.44	2.55	2.45	2.16	2.02	2.02	2.06	2.04
8/28/2014	2.57	2.60	2.48	2.51	2.52	2.54	2.43	2.15	2.02	2.02	2.05	2.04
8/29/2014	2.57	2.59	2.48	2.50	2.52	2.52	2.43	2.15	2.02	2.02	2.05	2.04

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
8/25/2014	2.570	2.278	2.280	2.261	2.540	2.586	2.950	3.093
8/26/2014	2.560	2.284	2.235	2.230	2.445	2.523	2.860	3.087
8/27/2014	2.550	2.268	2.223	2.217	2.410	2.536	2.825	3.055
8/28/2014	2.540	2.266	2.235	2.204	2.490	2.563	2.910	3.104
8/29/2014	2.520	2.266	2.235	2.204	2.490	2.563	2.910	3.104

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY	
Date	1M	3M	6M	1Y	1M	1Y	1Y	
8/25/2014	5.35	5.68	6.05	6.68	6.68	2.40	0.72	
8/26/2014	5.28	5.53	5.95	6.60	6.60	2.40	0.72	
8/27/2014	5.14	5.50	5.95	6.55	6.55	2.40	0.68	
8/28/2014	5.63	5.88	6.25	6.85	6.85	2.50	0.68	
8/29/2014	5.63	5.88	6.25	6.85	6.85	2.50	0.68	

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
8/25/2014	4.1814	3.1680	3.4588	3.0454	1.3356	0.1504
8/26/2014	4.1800	3.1686	3.4604	3.0499	1.3345	0.1502
8/27/2014	4.1880	3.1764	3.4690	3.0573	1.3387	0.1509
8/28/2014	4.2043	3.1834	3.4851	3.0676	1.3414	0.1516
8/29/2014	4.2129	3.1965	3.4930	3.0770	1.3370	0.1516

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