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Polish Weekly Review

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Comment on the upcoming data and forecasts

A light week for economic data ahead of us. On Friday, the NBP will publish M3 data. We expect a mild deceleration due to a base effect in corporate deposits. Also, two more releases are scheduled for the week – neither of which has a fixed date, however. The Central Statistical Office will publish its report on foreign trade in July, which is useful to cross-check CA forecasts and for the geographical breakdown of exports. Also, SAMAR Institute will publish its data on car production, a very important industry largely responsible for last month's surprise (for us) in industrial output.

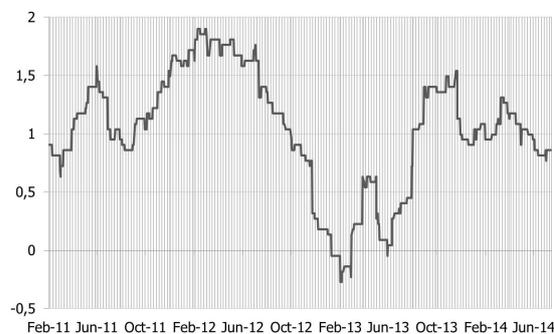
Polish data to watch: September 8th to September 12th

Publication	Date	Period	mBank	Consensus	Prior
M3 y/y (%)	12.09	Aug	6.0	6.2	6.3

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	3.114	9/4/2014
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. No opportunities for surprises next week.

* 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 October. We expect a whole easing cycle (around 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	1.2
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	1.75

	2014	2014	2014	2014	2015	2015	2015	2015
	Q1	Q2	Q3 F	Q4 F	Q1F	Q2F	Q3 F	Q4 F
GDP y/y (%)	3.4	3.3	2.9	3.0	3.0	3.2	3.5	4.0
Individual consumption y/y (%)	2.6	2.8	2.4	1.9	2.1	2.1	2.2	2.2
Public Consumption y/y (%)	0.7	0.8	2.0	2.4	3.0	3.0	3.5	3.5
Investment y/y (%)	10.7	8.4	6.3	7.0	7.0	8.0	9.0	9.0
Inflation rate (% average)	0.6	0.2	-0.2	0.4	0.8	1.2	1.4	1.2
Unemployment rate (% eop)	13.9	12.0	11.5	12.2	13.1	11.8	11.3	12.2
NBP repo rate (% eop)	2.50	2.50	2.00	1.75	1.75	1.75	1.75	1.75
Wibor 3M (% eop)	2.71	2.68	2.22	1.97	1.97	1.97	1.97	1.97
2Y Polish bond yields (% eop)	3.01	2.51	2.00	1.90	1.95	2.10	2.20	2.50
10Y Polish bond yields (% eop)	4.23	3.45	2.80	2.80	3.00	3.30	3.40	3.60
EUR/PLN (eop)	4.17	4.16	4.20	4.20	4.20	4.10	4.05	4.00
USD/PLN (eop)	3.03	3.04	3.16	3.21	3.23	3.20	3.21	3.20

F - forecast

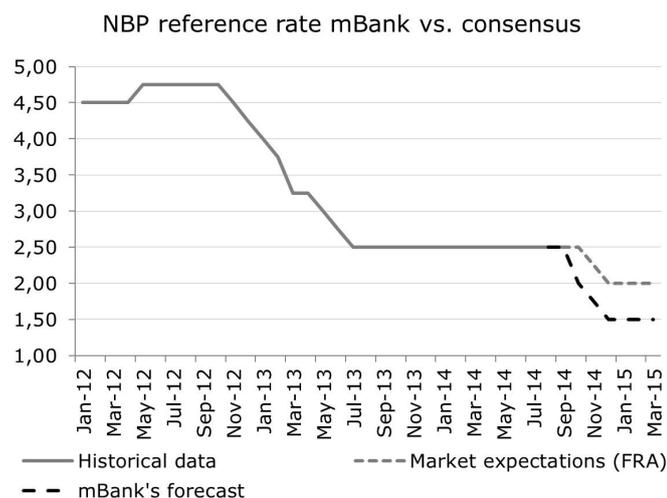
Economics

The MPC embarks on a new easing cycle.

NBP rates were held steady on September's meeting. Perhaps, unlike 95% of market analysts, we have put too much weight on rate cut risks associated with the meeting (September and October were equally likely for us), but we weren't caught off guard by the announcement of a whole new easing cycle. A cycle, not an „adjustment”, was after all our baseline scenario for the coming months. Such a declaration was included in the statement and, more importantly, confirmed by Belka during the press conference. In a way, we lost a minor battle but the war will be won.

The statement conditions further rate cuts on the upcoming data: „If the incoming data confirm weakening of economic activity and an increase in risk of inflation remaining below the target in the medium term, the Council will start an adjustment of monetary policy.” Such wording is, however, a typical way of communicating future intent by a central bank. The overall tone of the statement is much more dovish than two months ago. MPC members emphasized, among other data, weaker results of business sentiment surveys. In general, almost the entire assessment of Polish and global economy is less positive than two months ago.

During the conference Belka confirmed that rate cuts (and not only a cut) are „very likely”. The diagnosis of risk factors turned out to be quite similar to our own. Risks to growth are on the downside, associated primarily to a slowdown in the euro area. The on-going situation in the East could, on the other hand, dampen entrepreneurs' optimism and make them less inclined to invest – a possibility we've first highlighted in March. Belka, just like we did, considers Q2 GDP data as weaker and implying weaker growth in the future.



We expect incoming data to confirm that recovery lost momentum and that deflationary processes are as far from turning around as ever. In our view a new easing cycle is set to start in October (25 or 50 bps cut). The cycle could amount to 100 bps but it is far too early to discuss when it would end. After all, factors that could jump-start the economy again are still beyond the horizon. In our not-so-pessimistic forecasts for 2015 we've

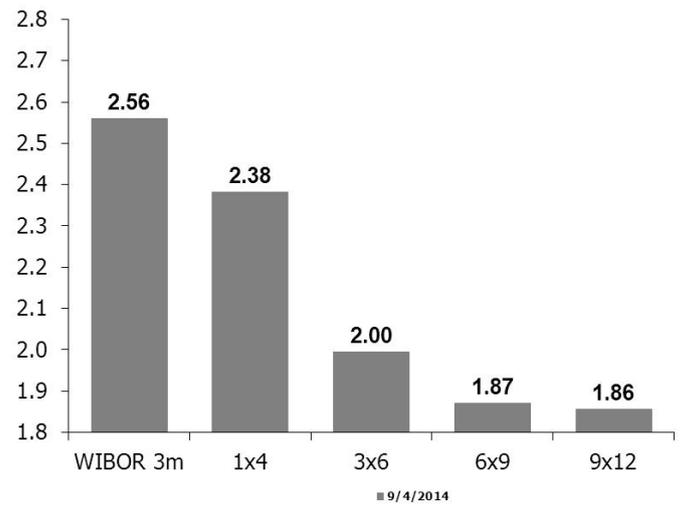
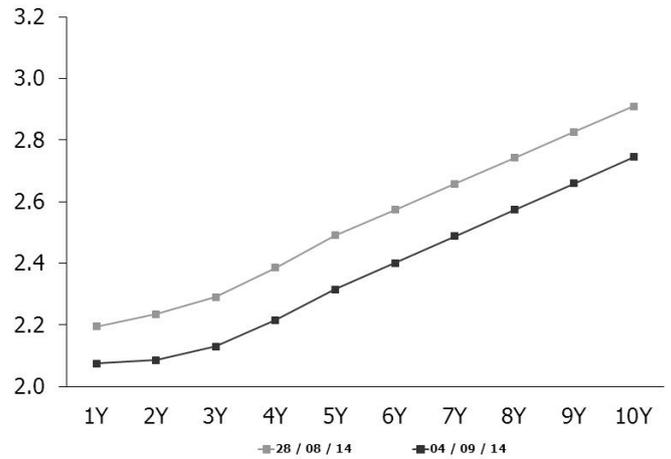
factored in our faith in a very stimulative policy mix (both in Poland and in the euro area). Poland will see monetary easing, higher inflow of EU funds and fiscal expansion (close to 1% of GDP) before parliamentary elections.

Fixed income

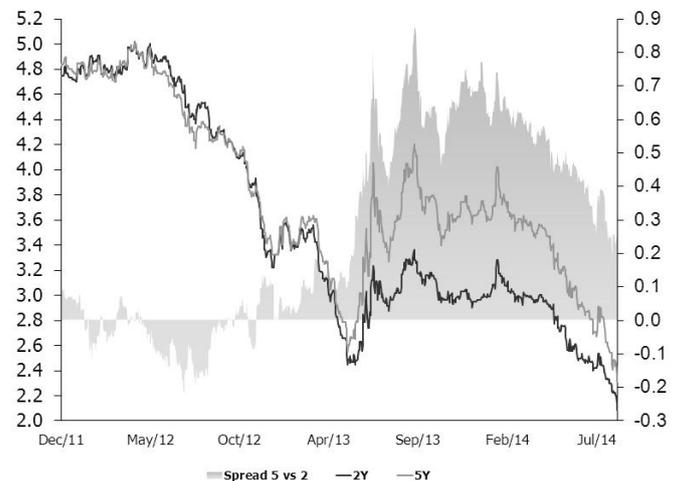
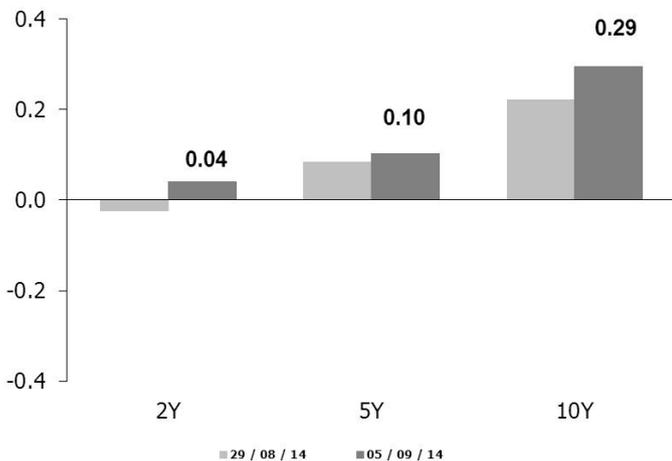
On the band

This week on fixed income market was very interesting. We had local events - MPC meeting/conference and 10Y bond auction. ECB and US data from labor market add fuel to market momentum and volatility. While those events seemed to be positive, bonds, especially with shorter than 5Y maturities, did not rally heavily. There is more and more 'real money' buyers on bonds, but on the other hand 'faster investors' are already selling because of low levels of yields. All positive news seem to be already priced in...

IRS curve



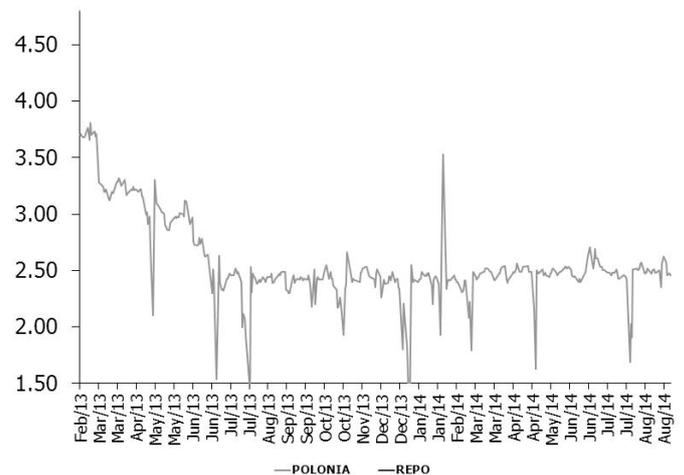
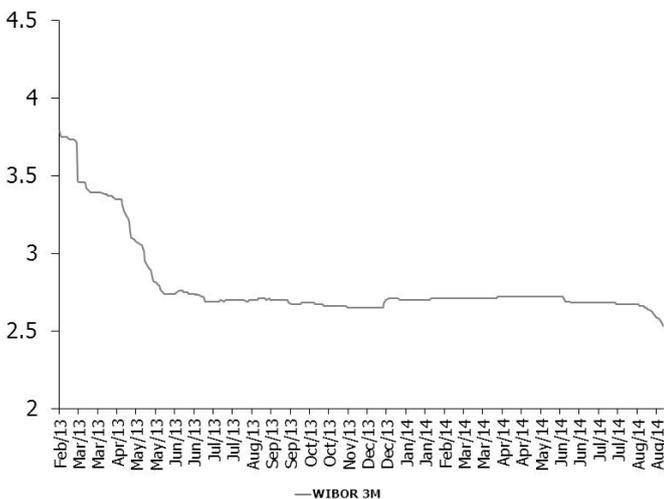
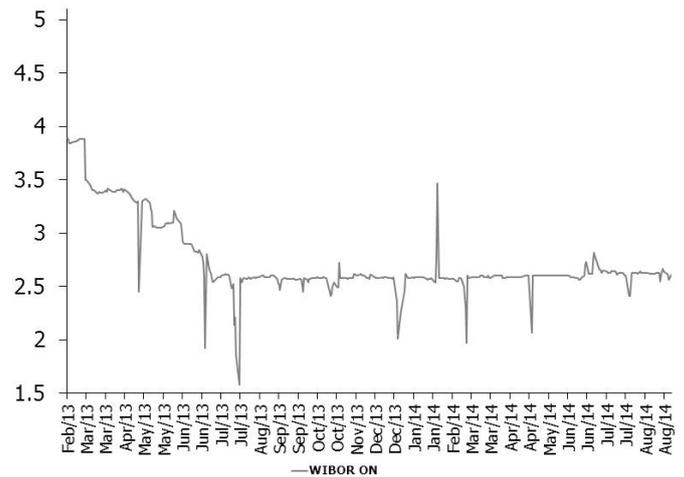
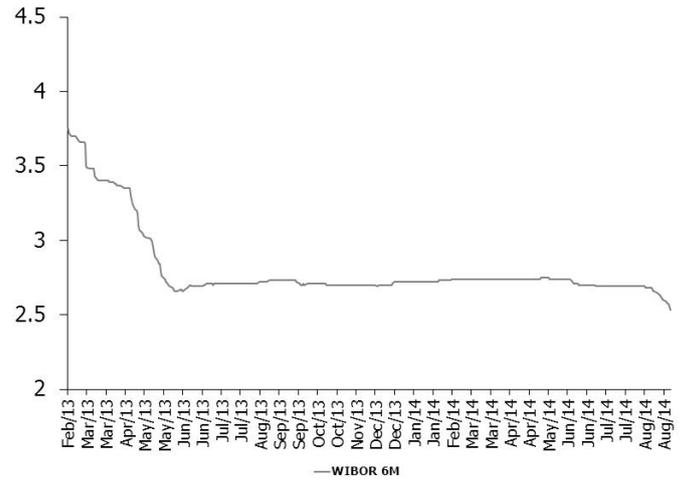
Asset swaps



Money market

Quiet week behind us. The next set to be more expensive. The first week of reserve wasn't surprising and Polonia fluctuated around 2.47. Next week will be probably more expensive as banks bought 2 bn PLN more bills than needed to square the market.

Longer WIBOR's fell strongly last week and as MPC announced potential rate cuts; rates will probably fall in next weeks too. Even shortest contracts are quoted 20 bps under WIBOR (1x4 - 1.34/1.38). In longer FRA's and 1Y OIS its now more than 75 bps of rate cuts priced in.



Forex

ECB surprises again The range for EUR/PLN this week was 4.23/4.1690. The main event of the week was of course ECB meeting and MPC meeting, with ECB surprising rate cut and additional ABS - covered bonds buying. It set PLN on fire, with EUR/PLN briefly touching 4.1700 support before recovery to 4.19ish. The Polish MPC on one hand strongly hinted cuts, but on the other hand failed to deliver one. The low NFP number is PLN supportive. Nevertheless, the biggest threat to PLN is still geopolitical situation in Ukraine, and we need to have this solved at least partially before we will see the more substantial PLN gains.

Vols – lower The stronger PLN forced the PLN vols to melt again. The biggest offer was visible in the frontend, 1 month EUR/PLN atm mid fixed today at 5.1%, 0.2% lower than last Friday. 3 months EUR/PLN atm are 5.6% (0.1% lower), and 1 year is unchanged at 6.7%. The skew was also better offered especially in the backend. The bigger picture is that vols are going nowhere with realized volatility not really picking up.

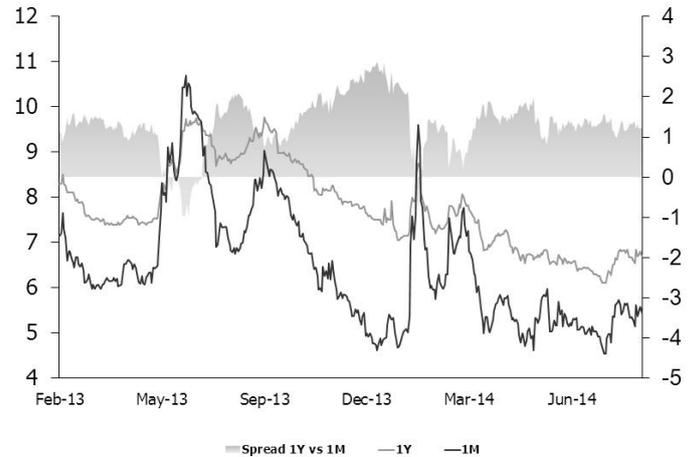
Short – term forecasts

SPOT Main supports / resistances:
 EUR/PLN: 4.16 / 4.25
 USD/PLN: 3.07 / 3.30

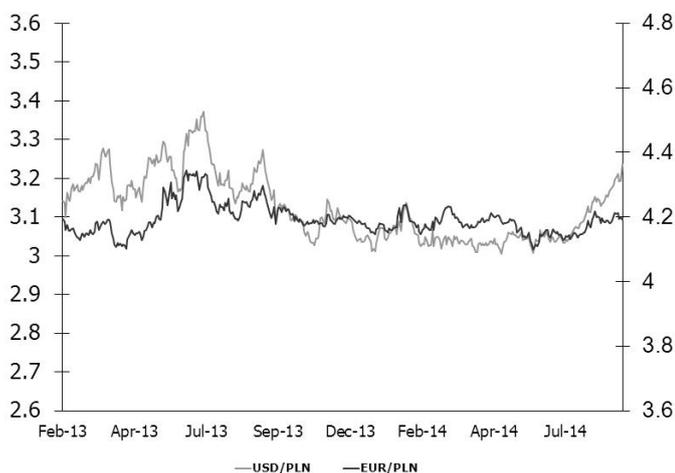
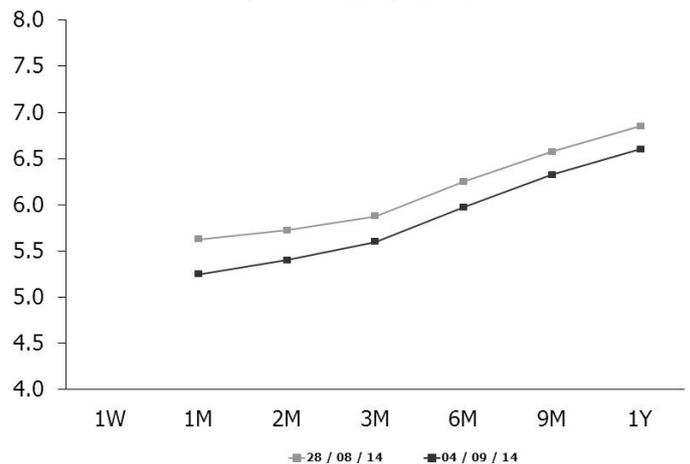
Spot – short EURPLN ECB cut and inability of EUR/PLN to breach 4.2250/4.2350 resistance zone have convinced us finally to switch from long EUR/PLN to short. We are short EUR/PLN at 4.1950 ready to add at 4.2100 with stop above 4.2250 and hopes for a move to 4.1500.

Options – reduced long Disappointing realized volatility made us trim our position by half. We have still core Vega in EUR/PLN, but we have to admit the trade lost some of its shine. The EUR/PLN curve is still close to multiyear lows, but it may as well stay there for a little while longer.

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
9/1/2014	2.76	2.58	2.81	2.49	2.68	2.51	2.44	2.13	2.01	2.01	2.04	2.02
9/2/2014	2.55	2.57	2.46	2.48	2.46	2.50	2.43	2.10	1.99	1.99	2.02	2.00
9/3/2014	2.44	2.56	2.31	2.47	2.33	2.48	2.40	2.08	1.91	1.89	1.94	1.92
9/4/2014	2.58	2.55	2.58	2.45	2.45	2.45	2.38	2.00	1.87	1.86	1.89	1.87
9/5/2014	2.58	2.53	2.58	2.43	2.45	2.42	2.38	2.00	1.87	1.86	1.89	1.87

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
9/1/2014	2.510	2.233	2.210	2.211	2.435	2.525	2.865	3.085
9/2/2014	2.500	2.240	2.195	2.208	2.460	2.553	2.895	3.131
9/3/2014	2.480	2.188	2.135	2.127	2.355	2.460	2.810	3.024
9/4/2014	2.450	2.090	2.085	2.125	2.315	2.417	2.745	3.040
9/5/2014	2.420	2.090	2.085	2.125	2.315	2.417	2.745	3.040

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
9/1/2014	5.53	5.70	6.13	6.75	6.75	2.40	0.66
9/2/2014	5.59	5.85	6.20	6.80	6.80	2.40	0.66
9/3/2014	5.45	5.70	6.05	6.70	6.70	2.31	0.66
9/4/2014	5.25	5.60	5.98	6.60	6.60	2.29	0.65
9/5/2014	5.25	5.60	5.98	6.60	6.60	2.29	0.65

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
9/1/2014	4.2099	3.2035	3.4901	3.0757	1.3390	0.1518
9/2/2014	4.2120	3.2112	3.4881	3.0614	1.3384	0.1519
9/3/2014	4.1937	3.1912	3.4720	3.0410	1.3334	0.1513
9/4/2014	4.2000	3.1947	3.4793	3.0452	1.3392	0.1517
9/5/2014	4.1908	3.2354	3.4748	3.0742	1.3367	0.1518

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