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Polish Weekly Review

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Comment on the upcoming data and forecasts

The series of August data releases comes to an end on Tuesday with the release of Statistical Bulleting along with retail sales and unemployment data. According to the Ministry of Labor and Social Policy, unemployment declined more than most analysts (including us) expected. Thus, we are revising our forecast down to 11.7%. Retail sales, on the other hand, is likely to turn for the worse in August. Working day effects and negative trends observed in the previous months likely led to another slowdown in retail sales. Slight rebound in June we treat as a correction.

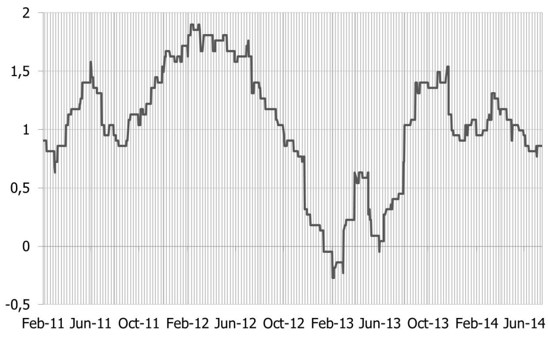
Polish data to watch: September 22nd to September 26th

Publication	Date	Period	mBank	Consensus	Prior
Retail sales y/y (%)	23.09	Aug	0.0	1.4	2.1
Unemployment y/y (%)	23.09	Aug	11.7	11.8	11.9

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

Quite a few releases but only one surprise - industrial output came out significantly below expectations. Next week brings two releases (retail sales and unemployment), both with a history of surprising analysts.

* 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).

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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 H2 (below 2.5%). 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.
- 2015 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 strengthen 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 by 25bps. 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	3.5
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	1.50

	2014 Q1	2014 Q2	2014 Q3 F	2014 Q4 F	2015 Q1F	2015 Q2F	2015 Q3 F	2015 Q4 F
GDP y/y (%)	3.4	3.3	2.5	2.3	2.1	3.1	3.7	4.6
Individual consumption y/y (%)	2.6	2.8	2.4	2.1	1.8	1.8	2.0	2.4
Public Consumption y/y (%)	0.7	0.8	2.0	2.4	3.0	3.0	4.0	4.0
Investment y/y (%)	10.7	8.4	6.4	5.0	4.0	7.5	9.0	11.0
Inflation rate (% average)	0.6	0.2	-0.2	0.3	0.4	0.9	1.2	1.0
Unemployment rate (% eop)	13.9	12.0	11.5	12.4	13.1	11.8	11.3	12.0
NBP repo rate (% eop)	2.50	2.50	2.50	1.75	1.50	1.50	1.50	1.50
Wibor 3M (% eop)	2.71	2.68	2.48	1.97	1.72	1.72	1.72	1.72
2Y Polish bond yields (% eop)	3.01	2.51	1.90	1.80	1.95	2.10	2.20	2.50
10Y Polish bond yields (% eop)	4.23	3.45	3.00	2.80	3.00	3.30	3.40	3.60
EUR/PLN (eop)	4.17	4.16	4.20	4.10	4.05	4.00	4.00	4.00
USD/PLN (eop)	3.03	3.04	3.28	3.28	3.24	3.25	3.33	3.33

F - forecast

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Economics

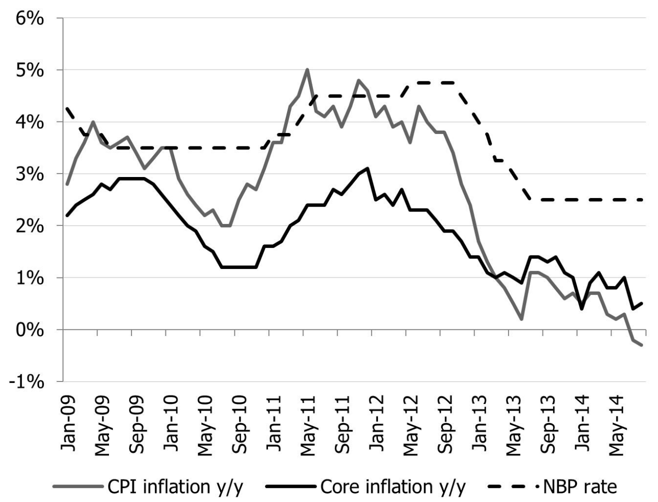
Avalanche of data: weak momentum and non-inflationary environment confirmed. MPC to embark on a new easing cycle.

Recently published data are consistent with our scenario. Economy decelerates, however, in a gentle way. Momentum in industrial output has come to zero and positive trends in the labor market snapped (it applies to both wages and employment). So far we are tracking GDP growth in Q3 at 2.5%. At the same time CPI inflation stays below zero and core measures accelerate mainly on base effects; there are no signs of incoming producer price inflation. In such circumstances MPC had a finger on a trigger in September (2 motions: for 25bp and 50bp cut) ... but failed to deliver. Some members wanted to have a confirmation of a slowdown in a fresh round of data, some felt still bound by (at this very time) non-existent, as abandoned in July, forward guidance (rates on hold until end Q3). All in all, however, the majority decided to act in October.

Our baseline is a whole easing cycle. We expect a new easing cycle (100bp) to start in October by 25bps cut. To be honest, the error of differentiating between 25 and 50bps cut is much higher than the error of failure to predict a new cycle. What is more, MPC is going to be wary in trying to pin down any target for interest rates (it applies to both the level and the timing of the end of the cycle). We expect them to „go with the flow" and stay on course until economy rebounds and inflation start to rise faster than expected. So far risks to both metrics are skewed asymmetrically downwards.

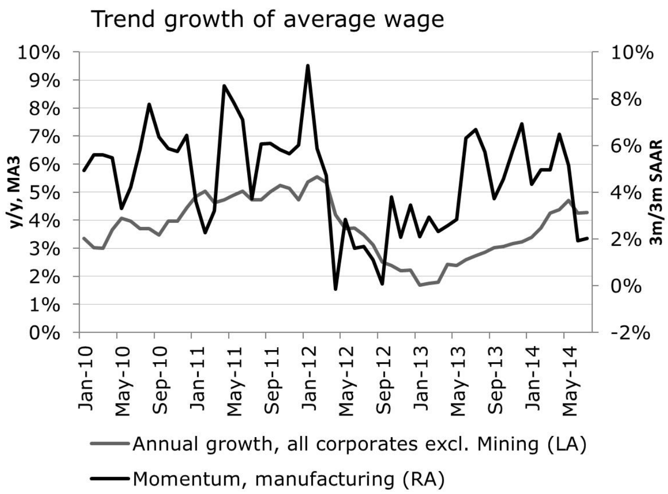
Below you find a detailed analysis of the macro indicators published last week.

Inflation at historical lows (again). In August annual inflation moderated from -0.2% to -0.3% y/y. It is the lowest CPI print in modern Polish history. Of course, weakness in inflation is not only due to statistical base effects. On a month-to-month basis prices fell by 0.4%. It is a tradition already that food prices suffer deep declines (-1.6% m/m); other categories, save for communications prices, oscillated around zero. Because of the aforementioned price hikes in communication services, core CPI probably ticked up from 0.4% to 0.5% y/y.

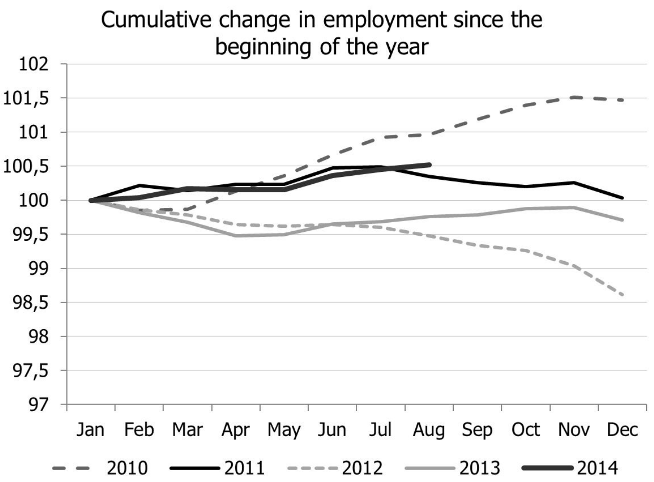


In the coming months inflation is set to remain negative - that's a fact. Looking farther ahead, there are no signals of fast turnaround in current deflationary environment. Given the risks to growth (stagnation in Europe, recession behind the eastern border, flatter consumption path and a halt in labor market improvement) and falling commodity prices (mainly oil but also agriculturals) we expect downward revisions of mid-term inflation forecasts, including those of the NBP and commercial banks.

Labor market lost momentum. Average gross wage increased by 3.5% y/y in August (as much as it did in July). The figure turned out to be slightly weaker than the market anticipated. However, it probably received an artificial boost from mining (due to low base). Moreover, we expect that August is the third subsequent month of weak growth in manufacturing wages - a likely result of flat industrial output in previous quarters. Due to rather unspectacular conditions in industry one cannot expect a marked re-acceleration of manufacturing wages (historically the primary driver of aggregate wages). Similarly, there is little room for consumption to accelerate, as marginal increases in real income are probably saved (as reflected in growing share of term deposits).

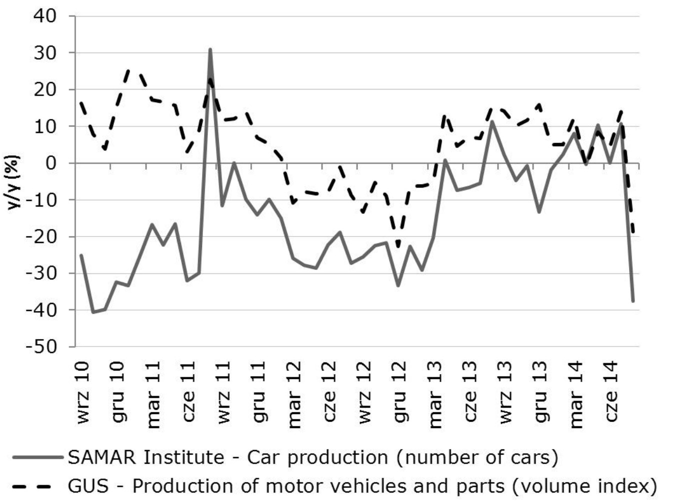


Employment in the private sector rose in August by 0.7% y/y (vs. 0.8% y/y in previous month), in line with our forecast but below market consensus. It is equivalent to an increase of 4k payrolls over last month. The details were not revealed today, as usual. However, we expect the labor market to have entered a period of less dynamic growth. It is going to stay weaker for some time.



Although slowing GDP should not induce lay-offs, rising uncertainty about the future prospects of the economy (plummeting trade with the east, geopolitical risks and a soft patch in EU) may make entrepreneurs wary of hiring (it will also contribute to reduced demand for capital goods). In effect, exceeding annual 1% growth rate of employment seems doubtful and we expect its dynamics to settle within the 0.6-0.8% range. The above mentioned scenario will be subject to revision, if any signs of growth bounce-back occur. It is not the case for the time being, however.

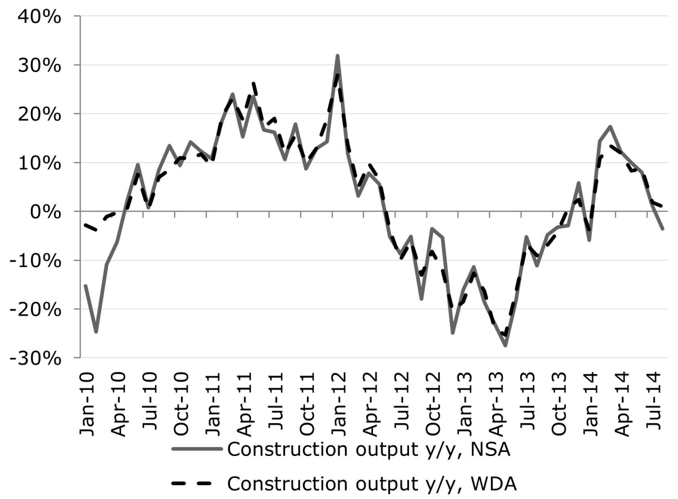
Industrial output lost momentum and entered stagnation. Industrial output went down in August by 1.9% y/y (seasonally adjusted +0.7% y/y, -1.2% m/m), below market consensus and our forecast. However, weaker numbers were heralded earlier by at least two factors. Calendar effects (1 working day less on annual basis, favorable timing - for long holiday makers - of August 15, a national holiday) made a reading close to zero a central case. Distribution of holidays in auto industry could have been another reason (although promulgated only several days ago) - in August auto sales fell by 20% y/y (or 40% as reported by SAMAR).



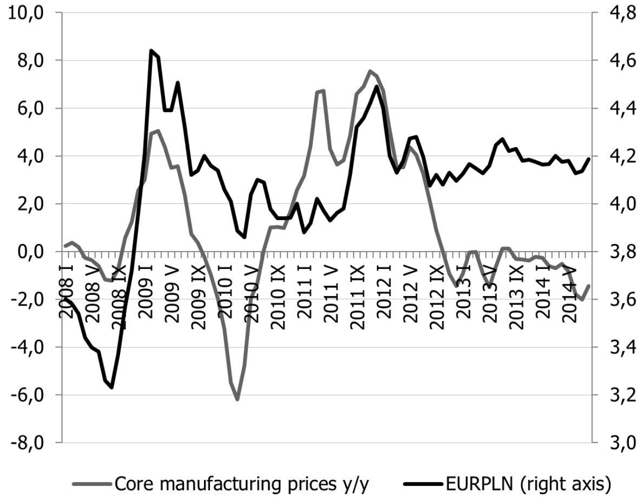
August brought - in a sense - a reversal of factor that contributed positively to industrial output a month before. Only auto industry added up to 0.9pp. to manufacturing growth. That is why August data is better as can be gleaned at first sight - there are many similarities to U.S. manufacturing data (also a sudden, unexpected drop). Therefore, we suggest to analyze July and August jointly - in such metrics we see a continuation of stagnation; and it - in our opinion - the best way to describe the current situation - see the graph below.

It is not a reason for rejoicing, though. Industrial output growth and construction growth as well were weaker in Q3 than in the Spring. Therefore, we forecast 2.5% GDP growth in Q3 which implies stagnation in sequential basis.

Construction output fell by 3.6% on annual basis, significantly below market consensus. It is very surprising as base effects were rather favorable for construction in August. When one accounts for calendar and seasonal effects, the picture becomes clearer, as output tumbled by 5.4% m/m. It might be partly related to the timing of public holidays that allowed for "extended weekends" but it certainly does not explain the entire drop. It any case, it is a worrying development. Looking at types of construction works, one can note that drops were noted only for buildings, not for civil engineering or specialized, preparatory works. All in all, construction output is set to decline on a sequential basis in Q3. A decisive turnaround is expected in 2015, as public infrastructure spending will increase materially.



Producer prices accelerate only due to PLN depreciation. PPI went down in August by 1.5% y/y (our forecast -1.5%, market consensus -1.7%). Manufacturing prices accelerated to +0.3% m/m (the highest growth since 2013). Acceleration is artificial, though, as it stems mainly from PLN depreciation. Current state of the market (low price equilibrium, competitive fight for market share) implies that only exogenous shocks common for all market participants (PLN strength fits in ideally) can lift prices upwards. Such was the hypothesis we made up several months ago - it seems to be corroborated. Flat EURPLN path implies flat PPI momentum. Necessary conditions for higher PPI are unlikely to be meet in the nearest future; the more so since manufacturing ceased to grow. We await low price equilibrium to be maintained and, hence, also subdued momentum in consumer prices.

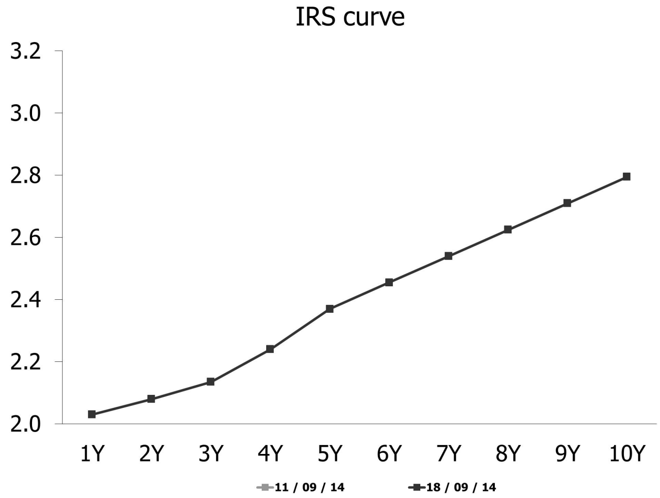


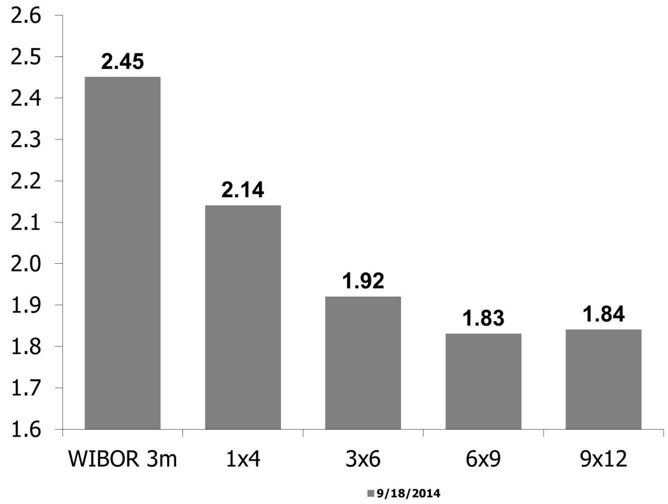
Fixed income

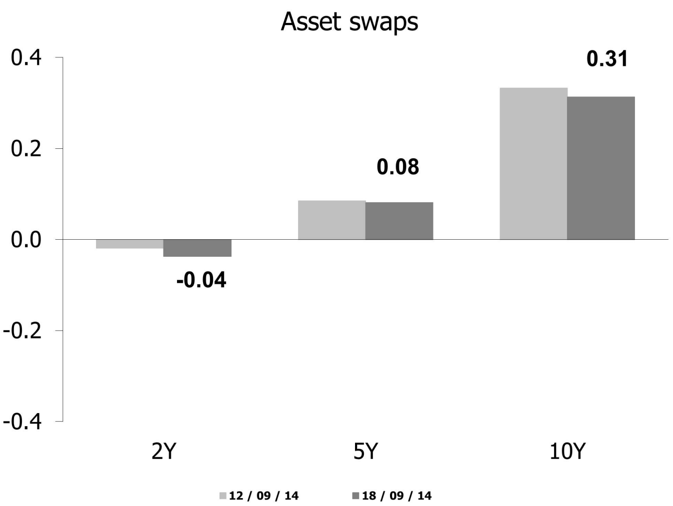
Range

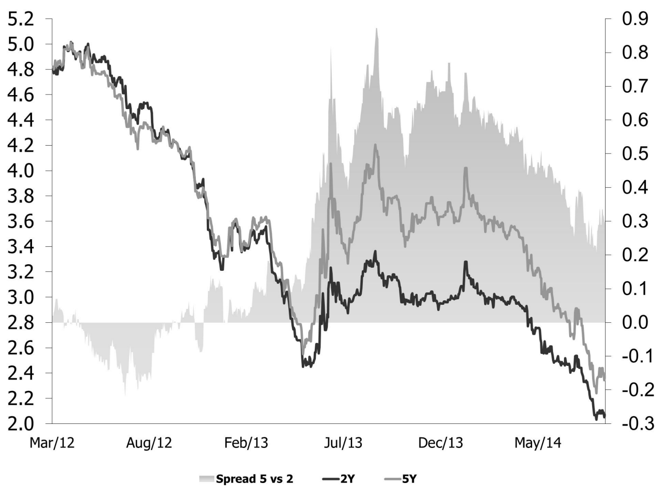
It was a lazy week on Polish FI market (DS1023 was trading in 3.02-3.07 range) taking into account how many news we had. With CPI, IP, PPI, wages readings, FOMC, poor switch auction (MoF sold only 3.4 bio WZ0119 and PS0719), TLRO (first tranche 82.6 bio EUR was much smaller than expected) or Scottish independence referendum it's hard to avoid the conclusion that market is very calm and stable - the question is - for how long.

Everybody knows that rate cuts will take place (75bps is already priced in), coming data are supportive for bonds and there is a lot of cheap cash. Therefore for the time being we are going to play range (DS1023 2.95-3.10%) watching closely core markets developments.









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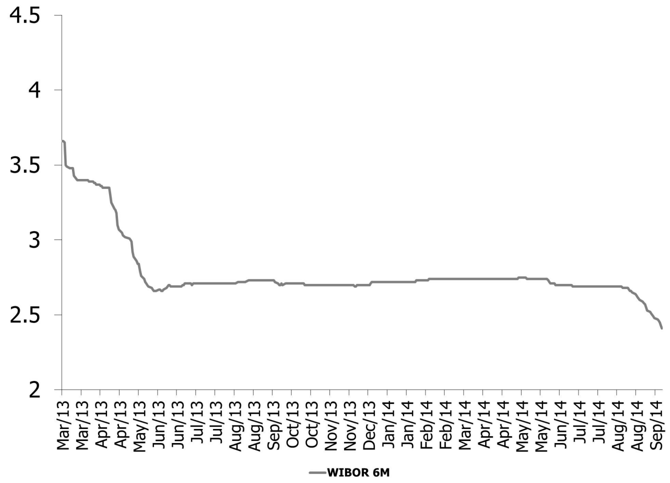
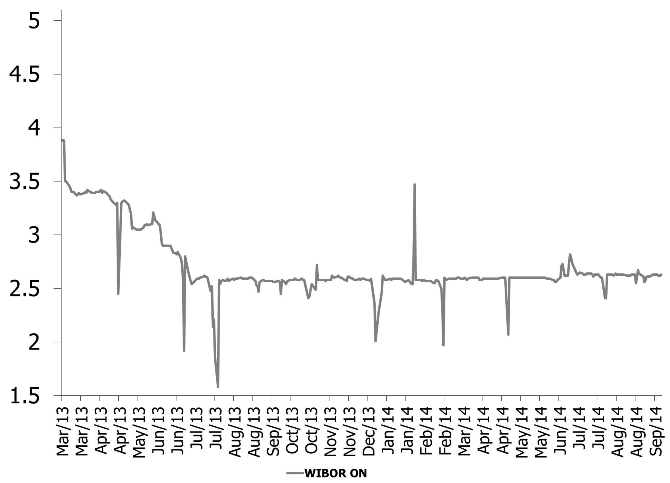
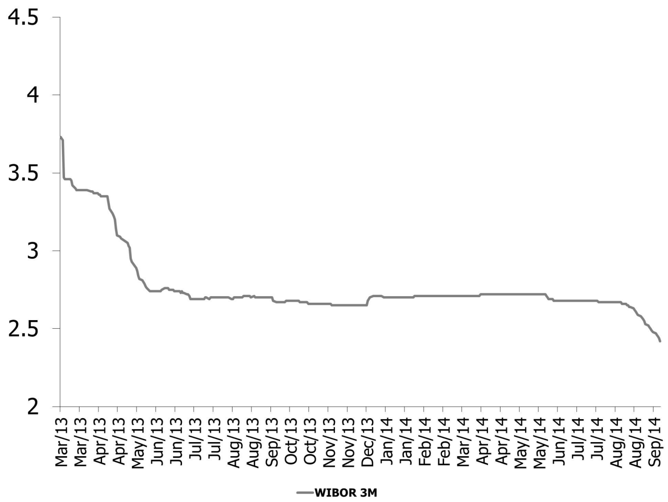
Money market

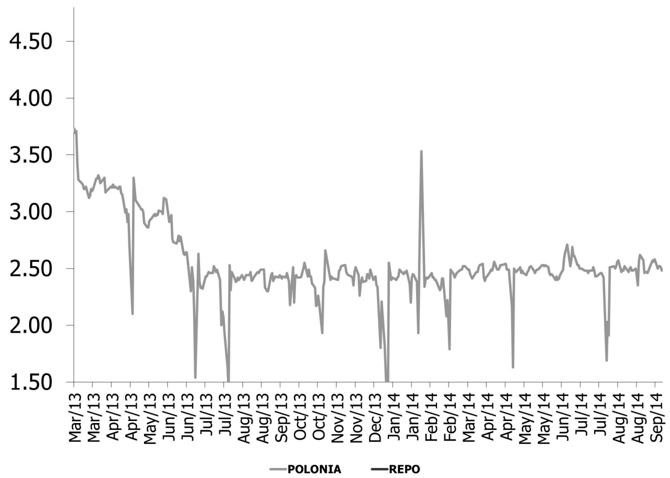
Quiet week behind us. The next set to be cheaper. The third week of reserve wasn't surprising and Polonia fluctuated around 2.50.

Next week cash will be cheaper as banks bought 4 bn PLN less bills than needed to square the market. In case Polonia goes below 2.40, additional OMO cannot be excluded. WIBOR's are still falling and they will probably reach 2.30 before MPC meeting and potential rate cuts. 1Y Polonia reached the historical low of 1.79-1.84 and priced in a rate cuts of 75 bp.





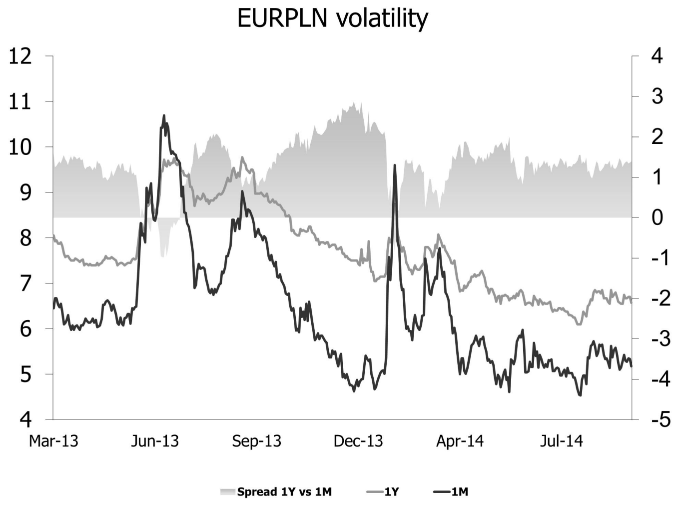




Forex

Still in range The FOMC is already behind us, with dovish statement and higher dots. It failed to hurt PLN visibly. 4.1790-4.1970 was a range for EUR/PLN this week, and we see chances to trade somewhere near this level. Zloty is not going to benefit from the ECB's QE if we see one, to the same extent like i.e. HUF may benefit. Polish MPC has already heralded the beginning of an easing cycle, and the market expectation is between 75bp-125bp. If one is looking for excitement, it is USD/PLN that could be used as a EUR/USD substitute.

Vols – sold off The week seemed to be packed with events, FOMC/ECB's LTRO/Bank of Switzerland, likely the "busiest week in FX this year" as one of the market reports announced (well, maybe true in XXX/JPY space). As a result we started the week with a decent bid for gamma that was later fading and reverting with a heavy selling as realized volatility continued to disappoint. 1m this Friday is 4.7% (0.55% lower then week ago), 3 months are 5.2% (0.4% lower) and finally 1 year is 6.4% (0.3% lower). Skew was bettered offered and currency spread (difference between USD/PLN - EUR/PLN) is unchanged.

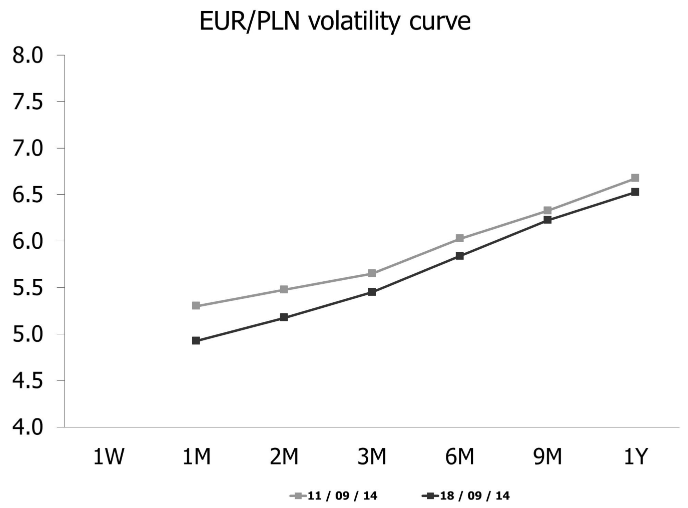


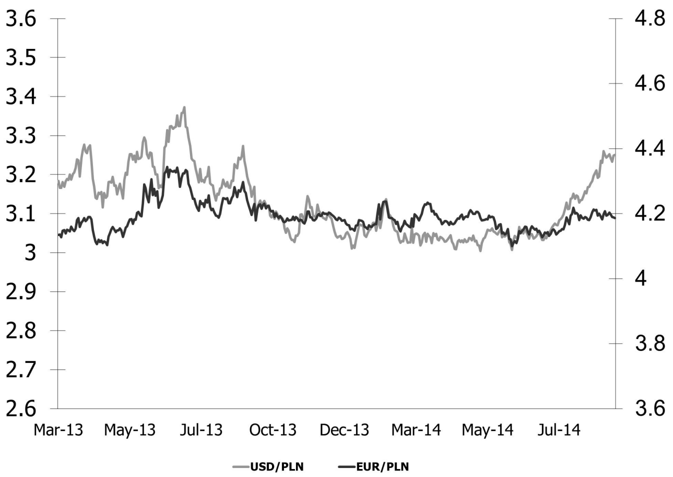
Short – term forecasts

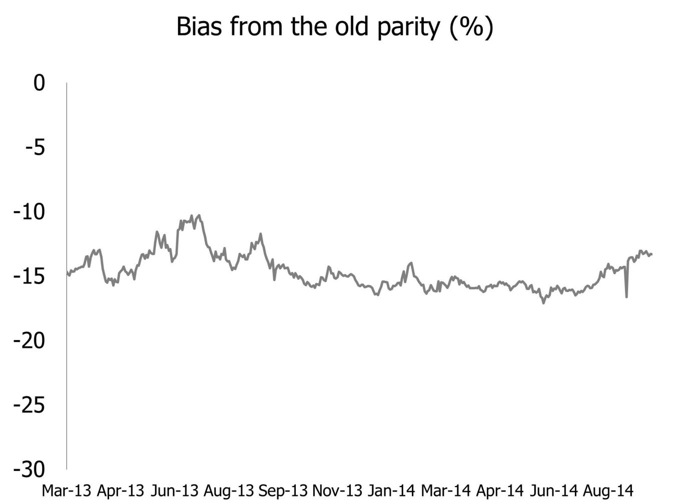
SPOT Main supports / resistances:
EUR/PLN: 4.16 / 4.25
USD/PLN: 3.15 / 3.30

Spot – still short EURPLN. No change from last week. We are now average short 4.2025, stop loss 4.2300 and profit taking at 4.1500. The logic is simple: we hope that geopolitical tension in Ukraine already has picked, ECB is a real deal, firmly on truck to deliver more loose policy.

Options – switched to longer end. We still core long in Vega, but switched from mid-curve to longer dates. We still believe that the process of normalization of rates in the U.S., will over time increase implied volatility in FX space. We are near the multiyear lows in EUR/PLN and USD/PLN vol curves and the long in Vega has for us much more sense from the risk/reward point of view. Our engagement is limited nevertheless.







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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
9/12/2014	2.53	2.48	2.48	2.38	2.35	2.36	2.19	1.94	1.85	1.85	1.93	1.87
9/15/2014	2.30	2.47	2.17	2.37	2.20	2.35	2.17	1.95	1.85	1.85	1.92	1.85
9/16/2014	2.32	2.46	2.20	2.36	2.24	2.34	2.18	1.94	1.86	1.86	1.91	1.87
9/17/2014	2.25	2.45	2.23	2.35	2.23	2.33	2.15	1.92	1.83	1.83	1.89	1.85
9/18/2014	2.43	2.44	2.33	2.33	2.23	2.31	2.14	1.92	1.83	1.84	1.89	1.84

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
9/12/2014	2.360	2.018	2.080	2.061	2.370	2.455	2.795	3.128
9/15/2014	2.350	2.025	2.080	2.078	2.400	2.467	2.890	3.208
9/16/2014	2.340	2.033	2.088	2.061	2.400	2.490	2.895	3.213
9/17/2014	2.330	1.992	2.050	2.043	2.345	2.422	2.845	3.177
9/18/2014	2.310	1.962	2.070	2.033	2.380	2.461	2.905	3.218

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
9/12/2014	5.28	5.70	6.05	6.68	6.68	2.26	0.63
9/15/2014	5.35	5.70	6.01	6.70	6.70	2.26	0.63
9/16/2014	5.34	5.70	6.03	6.70	6.70	2.26	0.63
9/17/2014	5.18	5.50	5.88	6.58	6.58	2.27	0.62
9/18/2014	4.93	5.45	5.84	6.53	6.53	2.26	0.62

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
9/12/2014	4.1957	3.2468	3.4690	3.0273	1.3315	0.1518
9/15/2014	4.2028	3.2522	3.4732	3.0322	1.3346	0.1523
9/16/2014	4.1970	3.2419	3.4710	3.0280	1.3348	0.1523
9/17/2014	4.1899	3.2331	3.4597	3.0149	1.3344	0.1521
9/18/2014	4.1880	3.2490	3.4659	2.9926	1.3414	0.1521

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