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Polish Weekly Review

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Comment on the upcoming data and forecasts

At its next meeting, the Monetary Policy Council will start a new easing cycle with a 25 basis point cut. Monetary easing was announced after the September meeting and any information, which came since then, did not change the general view: many areas of economic activity are stagnant and inflation is far from returning to its target. However, we can not exclude a scenario, in which the Council will start its cuts by a 50 bps one. This seems less plausible because of communication reasons. The following week will probably bring data about car manufacturing in September and GUS data about foreign trade in August.

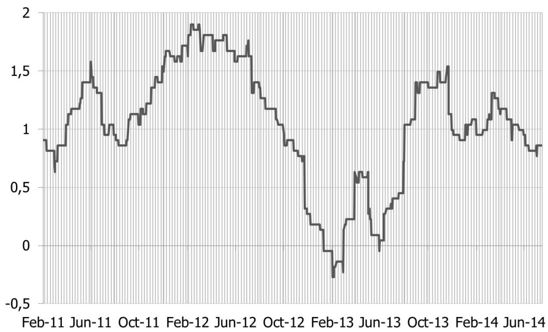
Polish data to watch: October 6th to October 10th

Publication	Date	Period	mBank	Consensus	Prior
MPC decision (%)	08.10	Oct	2.25	2.25	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	10/23/2014	800	3.024	4/23/2014
5Y T-bond PS0719	10/23/2014	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

Slightly up (second week in a row), as the PMI surprised to the upside. The index seems to be consolidating. Next week will not bring any surprises, as no data 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).

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Our view in a nutshell

Fundamentals

- Polish economy is already in a soft patch. Although the post-2013 recovery may not be ultimately derailed, we see important downside risks in coming quarters. In the nearest future we expect economists to cut their growth and inflation forecasts further what may further propel 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 of inflation is already negative and strengthens the impact of high real interest rates.
- MPC got stuck in a fairly positive GDP growth scenario and is likely to react on weaker data releases. We see MPC cutting rates in October by 25bps. We expect a whole easing cycle (around 100bps).

Financial markets

- Our strategic view on Polish bonds is unchanged. Polish fundamentals, along with European factors - including zero inflation, monetary easing and downside risks to GDP (and the fact that Polish economic cycles are becoming more synchronized with European ones), are more than ever supportive to lower rates across the board.
- There is scope for short-term upward corrections to Polish yields. The most likely trigger is an increase in global volatility, centered around EMs.
- 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

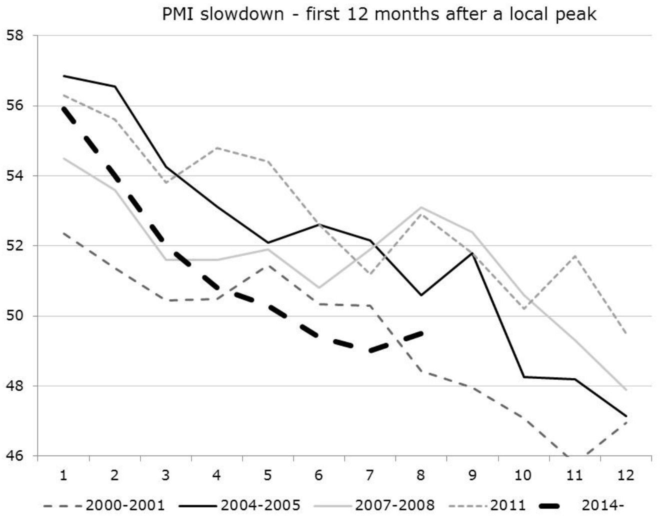
	2014 Q1	2014 Q2	2014 Q3 F	2014 Q4 F	2015 Q1F	2015 Q2F	2015 Q3 F	2015 Q4 F
GDP y/y (%)	3.4	3.3	2.5	2.3	2.1	3.1	3.7	4.6
Individual consumption y/y (%)	2.6	2.8	2.4	2.1	1.8	1.8	2.0	2.4
Public Consumption y/y (%)	0.7	0.8	2.0	2.4	3.0	3.0	4.0	4.0
Investment y/y (%)	10.7	8.4	6.4	5.0	4.0	7.5	9.0	11.0
Inflation rate (% average)	0.6	0.2	-0.4	0.0	0.4	0.9	1.2	1.2
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	2.28	1.97	1.72	1.72	1.72	1.72
2Y Polish bond yields (% eop)	3.01	2.51	2.00	1.80	1.80	1.80	1.90	2.00
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.70	2.70	3.00	3.00	3.00
EUR/PLN (eop)	4.17	4.16	4.18	4.15	4.10	4.05	4.00	4.00
USD/PLN (eop)	3.03	3.04	3.31	3.32	3.28	3.29	3.33	3.33

F - forecast

The increase in the PMI should be seen as a correction. It is far too early to herald the end of the slowdown.

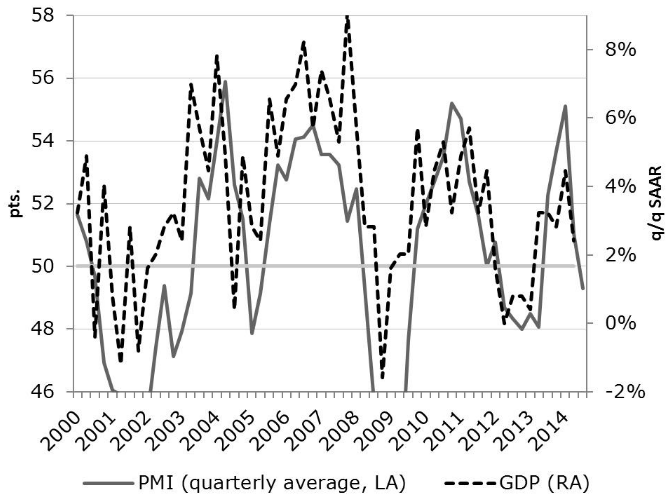
In September, Polish Manufacturing PMI increased from 49 to 49.5, surprising most analysts (the consensus was 48.6). Is this the first sign of better times ahead for the Polish economy? In our view, the scale of the surprise, the structure of September PMI print and available information regarding the external environment of the Polish economy all point out to a negative answer to that question.

First, slowdowns are rarely monotonic and occasional corrections in downtrends are well within the typical range of variation in sentiment indices (this applies not only to the PMI, but also to indices compiled by the Central Statistical Office). The September increase in the PMI ended a six month long streak of declines, 6.4 pts. total, but in the past such events rarely signalled a turnaround in trend - suffice to say that the 2011-2012 downtrend zig-zagged a lot (see the graph below).



Second, the increase in the PMI was a result of higher new order inflow (but not export orders, as no progress was recorded here and domestic orders likely rebounded from a multi-year bottom) and higher job creation. The former contributed around 0.2 to the headline index, the latter - around 0.15. Both should be interpreted as a sign of relative resilience of domestic demand, which suggests that the on-going slowdown is going to be shallow (to no less than 2% y/y at the turn of 2014 and 2015). We must also unequivocally stress the fact that the increase in new orders alone does not signal a turnaround. The new order component of the PMI is not a leading indicator for output or the headline index and in the entire history of Polish PMI we haven't found a single instance in which the increase in the PMI was preceded by an increase in new orders.

Thirdly, neither the numbers, nor the accompanying report offer any indication that the recent PLN depreciation affected Polish industrial companies. No meaningful effect was recorded either with respect to the demand for Polish goods, or regarding price pressures. In fact, September brought yet another decline in input costs and output charges, pointing out to PPI remaining firmly in the negative territory in the coming months.



As business situation continues to deteriorate in Q3, further deceleration in GDP is to be expected, both on annual and sequential basis (to ca. 2.5 and 0.2%, respectively). A small positive surprise in PMI data changes neither this development, nor the perspectives for monetary policy next week and in the coming months. We continue to hold the view that the MPC will embark on a new easing cycle (around 100bps total) in October, starting with a 25 bps cut. The length of the cycle will be determined by the data and there is no reason to suspect that they will allow for its end this year already.

Fixed income

We have great expectations of you...

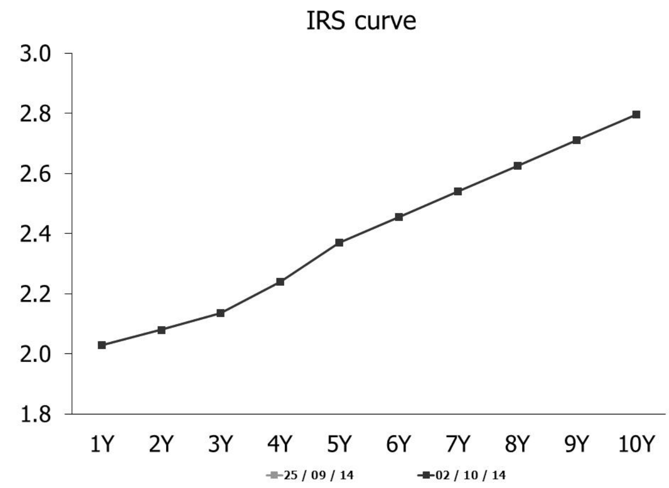
Something about the present:

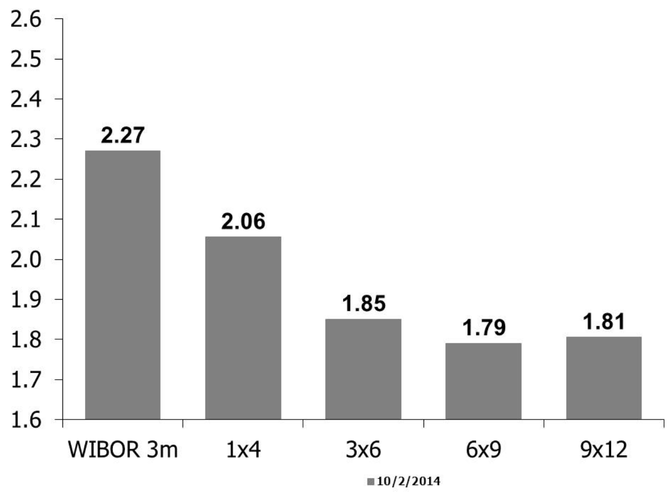
- US: economy is improving - decent payroll data, decreasing unemployment
- EU: ECB seems comfortable with what they already did and prefer to wait for effects
- PL: poor dynamics of QoQ GDP, CPI number below zero
- Market prices in 75 bps cuts, 1st cut is likely to take place on the next meeting, 8th Oct. Priced in somewhere between 25-50 bps.

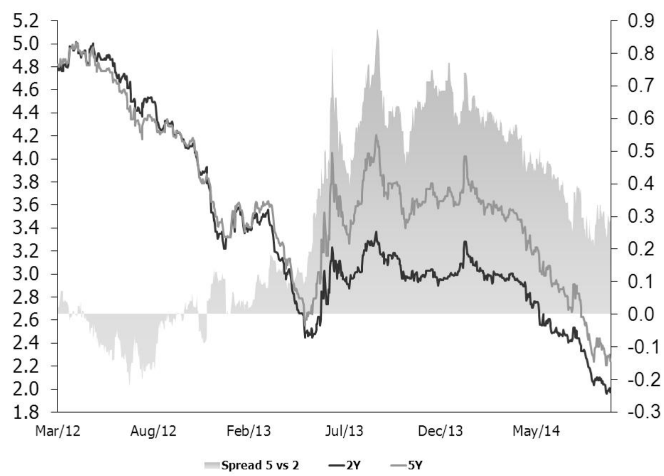
Something about the future:

Taking all above three into account, we see no value in receiving rates at these levels, especially on the long end. We reckon here external environment as slightly negative and local as already pricing in a positive scenario. QE seems postponed, US economy already in divergence and question is, how bullish MPC may be.

Sell 10Y bonds at 3.00 with 2.85 S/L and 3.30 T/P.







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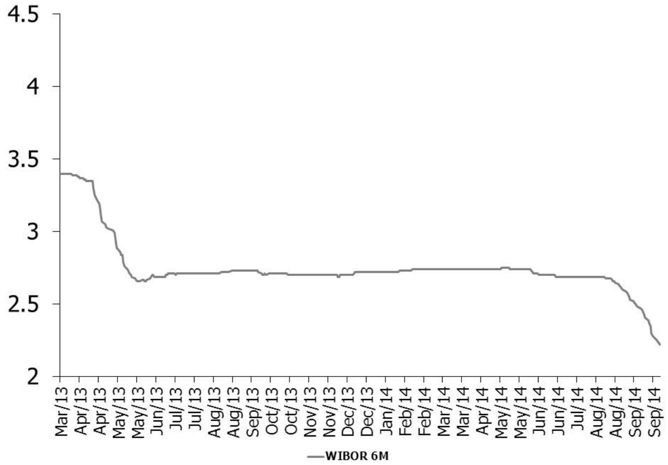
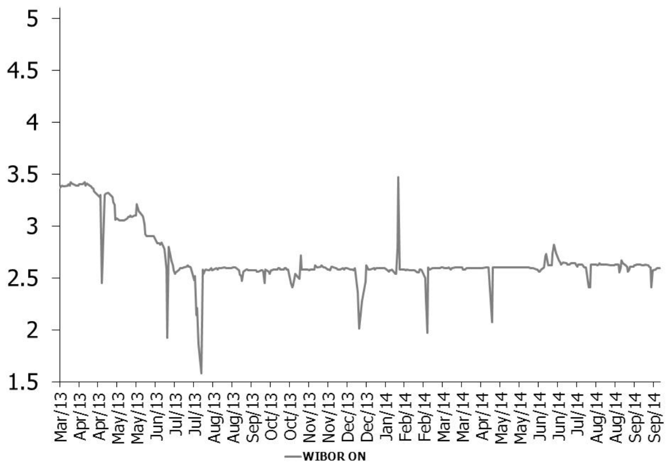
Money market

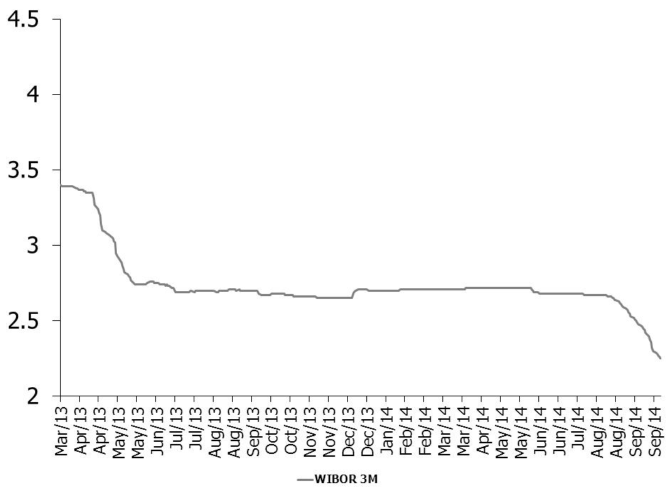
Front end should be immune to any MPC decision excluding no-cut one. Cheap end of the reserve and back to normal with the beginning of the new one. Huge demand during today's OMO but it is quite understandable since market expects rates cuts next week.

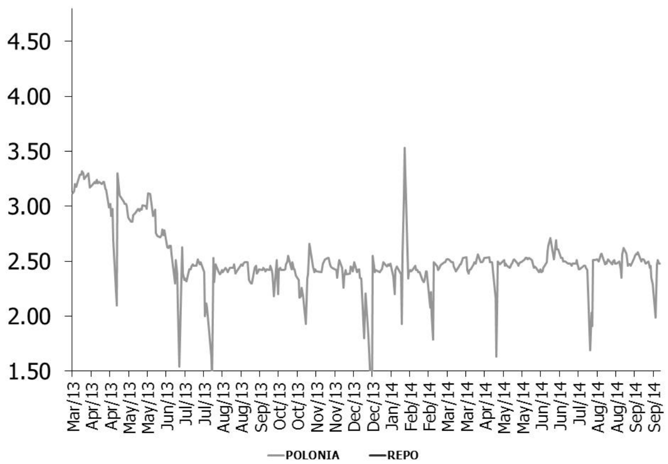
Front end still prices 75 bps cut till the end of the year. Next week we will see how it aligns with reality. We see probability of cuts 60 to 40 of 25 bps against 50 bps on Wednesday. Whatever they do, wording during the conference should be soft (CPI projection in November plus cycle just begins) therefore we think that the front end is relatively immune to whatever they do (excluding doing nothing of course).

Having mentioned that we see front end bonds to be very cheap comparing to derivatives. To be honest we see the only value in those bonds if one believes in 50 bps cut next week, since those papers discount only 50 bps in total.





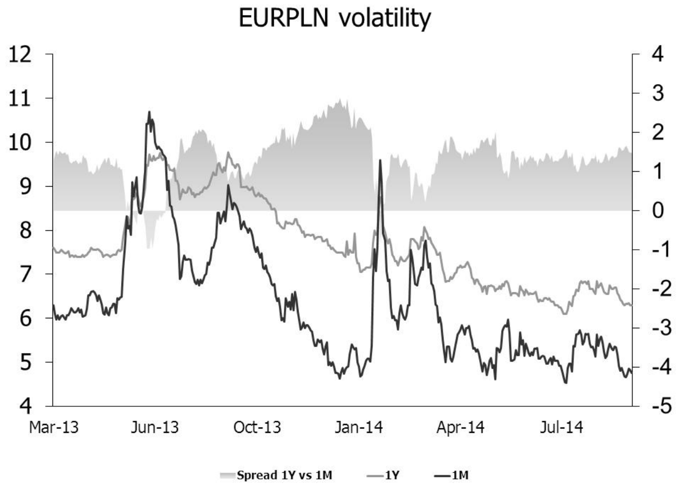




Forex

PLN still in range The range play continues... EUR/PLN fluctuations have been contained in a depressing 4.1710-4.1900 range. Not even the highly awaited ECB meeting, nor NFP, were able to produce much volatility. Next week we have the MPC meeting with market awaiting cuts - the real question seems to be: 25bp or 50bp? We would say the 25bp cut will not influence EUR/PLN much, the 50bp will rock the boat a bit. But the bigger picture seems to be unchanged, range play continues.

Vols – slightly lower EUR/PLN curve is hovering just above its multiyear low, and even it does not look like it has much room to go, it's still creeping lower. EUR/PLN atm 1m mid is fixing this Friday at 4.6% (0.1% lower), 3 month EUR/PLN is 4.9 (0.1% lower) and finally 1 year is 6.2% (0.05% lower). The currency spread (USD/PLN curve minus EUR/PLN curve) was bid again, as USD/PLN was setting the new highs. The Skew was roughly unchanged.

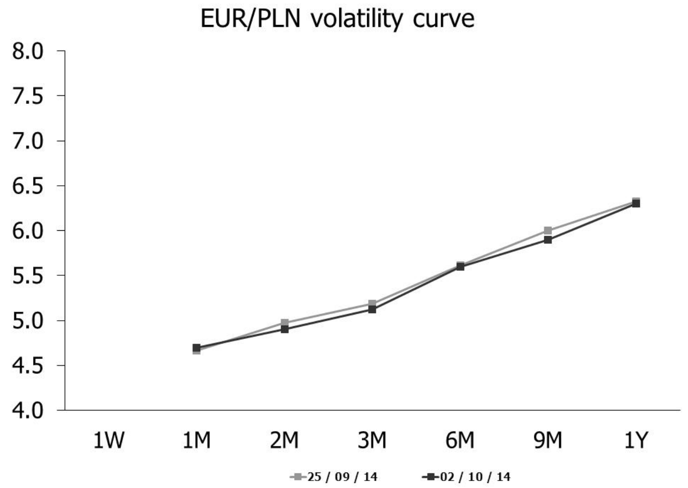


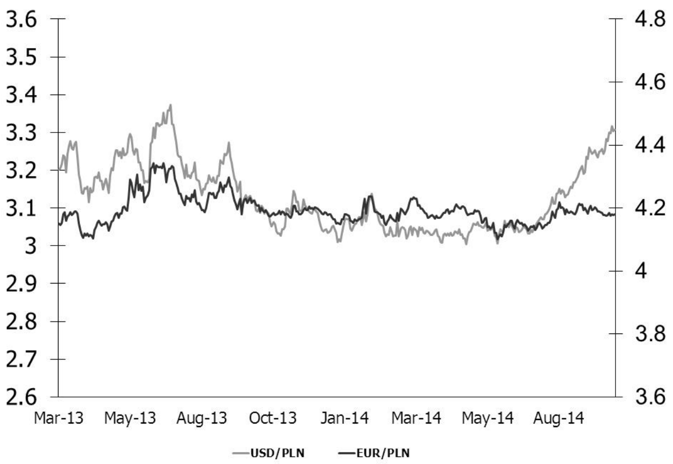
Short – term forecasts

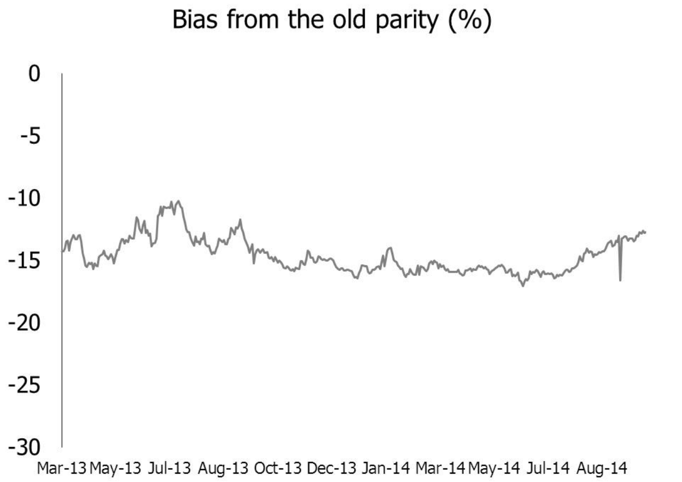
SPOT Main supports / resistances:
EUR/PLN: 4.16 / 4.21
USD/PLN: 3.18 / 3.38

Spot – long at 4.1700 The market is so slow, the range is getting tighter and tighter. As a result, we tighten the stop loss to 4.1600 and set profit taking to 4.1900. There is not much to add to PLN side of the equation at the moment, maybe the MPC will bring some life to the market.

Options – switched to longer end. We still hold core tiny long in the long end EUR/PLN. But there is one thing that especially caught our eye. The divergence between USD/PLN curve and EUR/PLN curve is getting more and more attention. The USD/PLN curve is of course mostly driven by EUR/USD curve changes, as the PLN factor is getting smaller and smaller. Historically the currency spread was as high as 10.5% (i.e. post Lehman) or even 3.5% EUR/PLN positive (but it was at times when market traded USD/PLN instead of EUR/PLN). So there is plenty of room for maneuver.







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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
9/26/2014	2.09	2.30	2.11	2.18	2.10	2.16	2.05	1.84	1.78	1.80	1.83	1.78
9/29/2014	2.18	2.29	2.17	2.16	2.07	2.14	2.06	1.85	1.78	1.80	1.85	1.79
9/30/2014	2.12	2.28	2.05	2.15	2.14	2.13	2.05	1.85	1.81	1.81	1.86	1.80
10/1/2014	2.04	2.27	1.97	2.14	2.05	2.12	2.04	1.84	1.75	1.78	1.85	1.80
10/2/2014	2.20	2.26	2.13	2.13	2.17	2.11	2.06	1.85	1.79	1.81	1.86	1.81

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
9/26/2014	2.160	1.930	1.985	1.949	2.285	2.323	2.800	2.991
9/29/2014	2.140	1.920	2.000	1.946	2.280	2.378	2.800	2.991
9/30/2014	2.130	1.992	2.008	2.019	2.300	2.381	2.815	2.991
10/1/2014	2.120	1.899	1.975	1.939	2.245	2.319	2.725	2.991
10/2/2014	2.110	1.959	1.985	1.986	2.255	2.368	2.740	2.991

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
9/26/2014	4.74	5.18	5.65	6.33	6.33	2.25	0.61
9/29/2014	4.86	5.23	5.68	6.35	6.35	2.25	0.61
9/30/2014	4.83	5.18	5.60	6.30	6.30	2.22	0.61
10/1/2014	4.76	5.18	5.63	6.30	6.30	2.22	0.62
10/2/2014	4.70	5.13	5.60	6.30	6.30	2.22	0.62

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
9/26/2014	4.1781	3.2776	3.4608	3.0068	1.3417	0.1519
9/29/2014	4.1843	3.3000	3.4673	3.0114	1.3377	0.1521
9/30/2014	4.1755	3.2973	3.4600	3.0103	1.3452	0.1518
10/1/2014	4.1792	3.3172	3.4662	3.0206	1.3464	0.1520
10/2/2014	4.1780	3.3039	3.4599	3.0484	1.3491	0.1520

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