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Polish Weekly Review

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Comment on the upcoming data and forecasts

Most of September's publications will be released this week. We are expecting a slight widening of current account balance (published on Tuesday) caused by: smaller merchandise trade surplus and stability among rest of the components. Changes in methodology of statistics of balance of payments could bias the forecasts. The key factor for M3 monetary basis is a low statistical base in „others" category – companies and households deposits grow steadily. On Wednesday, inflation data will be published. Taking into consideration low fuel and food prices, even an acceleration of core inflation (to 0.7 - revised after announcements from Czech Republic and Hungary) should not prevent CPI dynamics from falling to -0.5% y/y. Labour market data will be announced on Thursday. Steadiness of wage dynamics (difference between working days in processing industry vs. high base in mining) accompanied by more sluggish employment growth (our forecast is conditioned on unfavourable outcomes from cyclical industries in August). The week will end with industrial data. Taking into consideration information about car manufacturing we decided to raise our industrial production forecast to 4,0%; however, the acceleration is entirely caused by working days effect (+1 y/y against -1 y/y in August) and returning of car industry back into shape. A breakthrough in producers prices is also not expected.

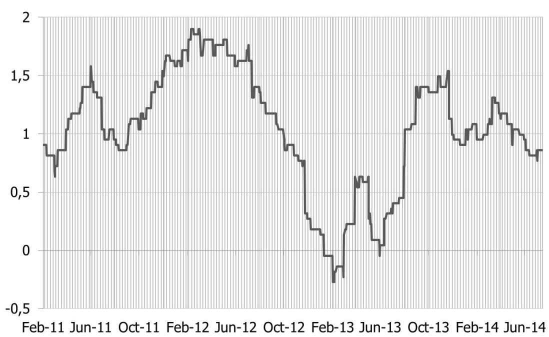
Polish data to watch: October 13th to October 17th

Publication	Date	Period	mBank	Consensus	Prior
Current account (mio EUR)	14.10	Aug	-340	-340	-173
Exports (mio EUR)	14.10	Aug	12650	12600	14071
Imports (mio EUR)	14.10	Aug	12400	12400	13678
M3 y/y (%)	14.10	Sep	7.9	7.8	7.4
CPI y/y (%)	15.10	Sep	-0.5	-0.4	-0.3
Average gross wage y/y (%)	16.10	Sep	3.5	3.5	3.5
Employment y/y (%)	16.10	Sep	0.7	0.8	0.7
Sold industrial output y/y (%)	17.10	Sep	4.0	3.1	-1.9
PPI y/y (%)	17.10	Sep	-1.5	-1.5	-1.5

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

Unchanged (no data releases). Next week brings several publications and therefore plenty of room for surprises both ways.

* 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 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 drifts towards low inflation, low growth scenario. We see MPC continuing easing cycle reaching for at least 100bps of cuts.

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.
- EURPLN under counterbalancing forces: expectations for ECB easing and lower rates in Poland amid slowing growth. Zloty is set to stay weaker around 4.20.

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	1.50	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	1.50	1.50	1.50	1.50	1.50
Wibor 3M (% eop)	2.71	2.68	2.28	1.72	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	2.60	2.60	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

Economics

The MPC launches blitzkrieg on interest rates

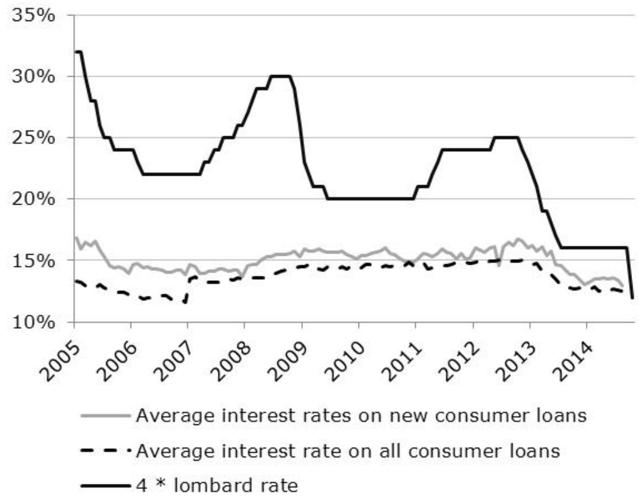
The MPC launches blitzkrieg on interest rates The Monetary Policy Council lowered the main reference rate by 50 bps to 2.00%, left the deposit rate unchanged at 1.00% and cut the lombard rate by 100 bps to 3.00%. In addition, the reserve funds will now be remunerated at a rate of 0.9 multiple of the reference rate (instead of the slightly higher rediscount rate). The last move fits ideally in the cost-management strategy of the bank.

The main reason for action was, in our view, not only the acknowledgement of slowdown in the real economy, but also the low inflation environment, which - due to the slowdown and global factors - remains deeply rooted. The whole statement is written in a very dovish tone, with numerous references to the on-going economic weakness in Poland and abroad. It also comments extensively on factors solidifying low inflation, both on the cost and the demand side.

Higher risk that inflation will remain below target over the medium term is a direct prerequisite for continuation of monetary easing. In our view, inflation is and will be low due to global environment, which will be corroborated by the official staff projection in November (so far, Belka only referred to expert, ad hoc forecasts of low inflation). This might lead to another 50bps cut in November which would bring the total scale of easing to 100 bps. The conference strongly indicated that this cycle might be a blitzkrieg of sort, as the majority within the Council is inclined to adjust rates as quickly as possible to avoid distortions in financial markets caused by speculation of easing being dragged over time. We expect this blitzkrieg cycle to bring a total easing of at least 100bps.

The issue of lombard rate cut deserves a separate comment. The governor said that the asymmetric cut was motivated by purely technical issues: the corridor is still symmetric but narrower (with a radius of 100 bps instead of 150 bps). Nevertheless, the quadruple of the lombard rate defines the mandatory cap on consumer credit rates. The recent action has shifted the cap down by 400 bps, 50 basis points below the current average nominal interest rate on consumer loans (see the graph below and note that the average will probably drop below the cap by another 100 bps). This means that the cap is now a binding constraint for interest rates on consumer credit, which means that monetary policy has now become fully effective (at least theoretically given the distinction between nominal rate and real effective rate) in this segment of the market. In other words, nominal interest rates will have to adjust, although total costs for consumer might not change proportionally as banks will probably increase other fees and demand more compensation for risk (for instance, in the form of additional insurance fee).

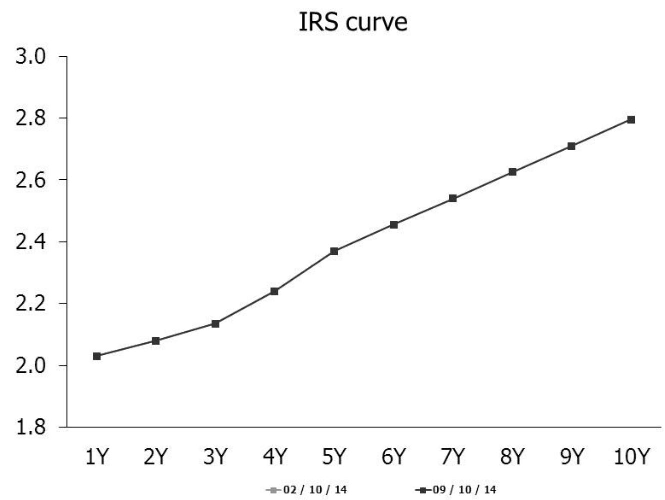
No matter how technical the rationale for an asymmetric cut in the lombard rate might seem, its side effect is a theoretical strenghtening of monetary policy transmission to consumer credit market, especially in its subprime segment, among consumers whose propensity to consume is probably close to 100%. In turn, every zloty saved in interest payments is a zloty spent on goods and services. A 100 bps decline in average interest rate on consumer loans is equivalent to a 1.2 bn PLN transfer to households on annual basis.

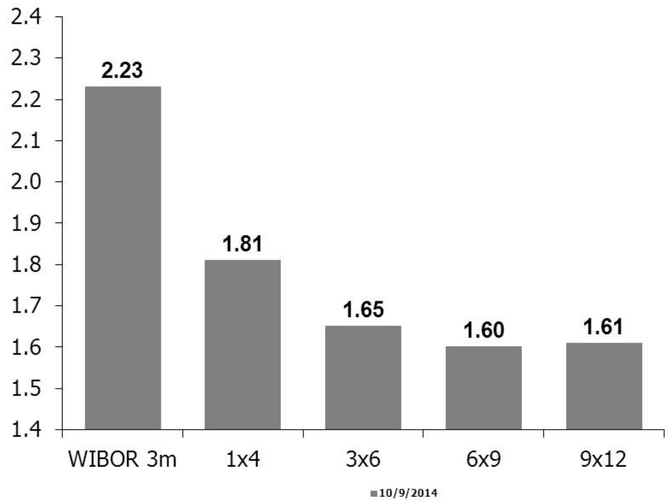


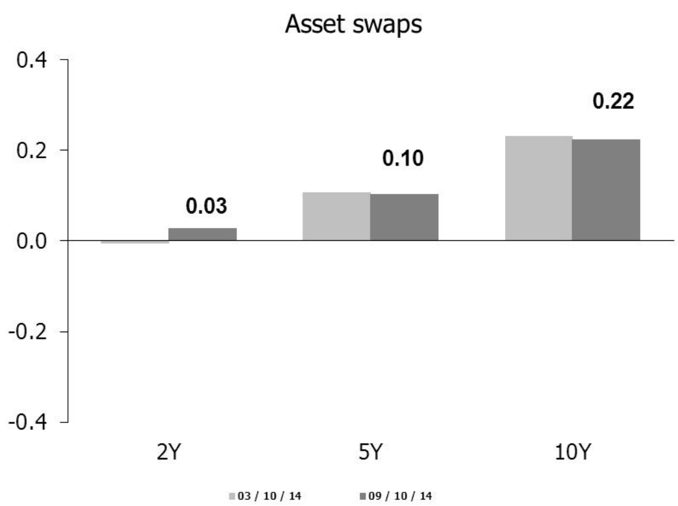
Fixed income

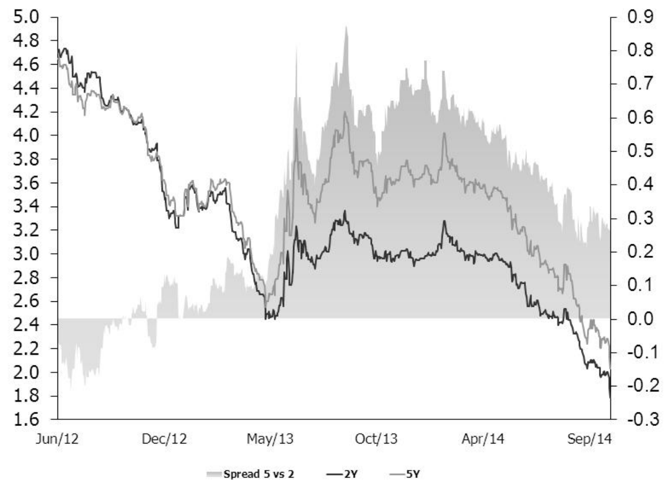
New records

This week on fixed income market was dominated by MPC decision. While the 50bp rate cut was not a huge surprise, further comments about more policy easing were a game changer. Global market sentiment was supportive as well (more and more speculation that global recovery is losing steam). 6x9 FRA reached new record low of 1.58%, yield of 10Y bond dropped to 2.72%. We expect some small correction, some investors may want to take profit and prepare for 2Y and 5Y bond auction on 23rd October. We are going to watch closely our CPI data (release on 15th Oct) - it is important because it may change expectations for the next MPC move.









Money market

Very cheap week behind us. As last OMO was hugely overbid (15bn PLN) and market started to anticipate a rate cut, Polonia fell to 2.10 - 2.20%. As MPC cut rates by 50 bps Polonia fell to 1.99 on Thursday. Next week shouldn't be very volatile and Polonia should fluctuate around 2.00.

As 50 bps rate cut wasn't expected, all short instruments fall by 10 - 15 bps. 1Y OIS is now around 1.58 and longer FRAs around 1.62.

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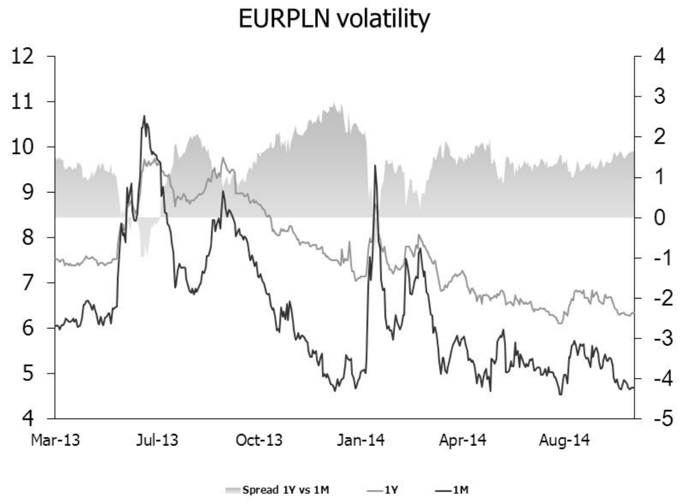
Forex

PLN still in range EUR/PLN one more time proved to be immune to the outside world. Not even the bigger than expected rate cut (50bp) was enough to change that. EUR/PLN weekly range was really tight, 4.1720 - 4.1970. Unfortunately, it is not going to change. USD/PLN, on the other hand, after testing 3.35/3.37 resistance zone, is consolidating but technically the next leg of a sell-off should follow.

Vols – Choppy Nothing really changed in EUR/PLN vol space. Changes are rather cosmetic, 1 month EUR/PLN ATM is today 4.5% mid (0.1% lower than last Friday), 3 month EUR/PLN are 5.0% (0.1% higher), and finally 1y 6.35% (0.15% higher). The skew was roughly unchanged. The USD/PLN vol curve is getting more and more of interest, the currency spread (difference between USD/PLN and EUR/PLN) traded in 3.8-4.2 range. Wide spreads are the obstacle to get more involved.

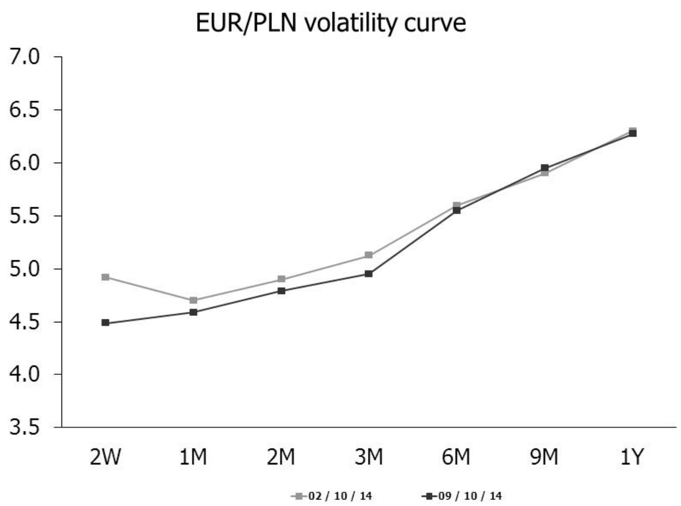


Short-term forecasts

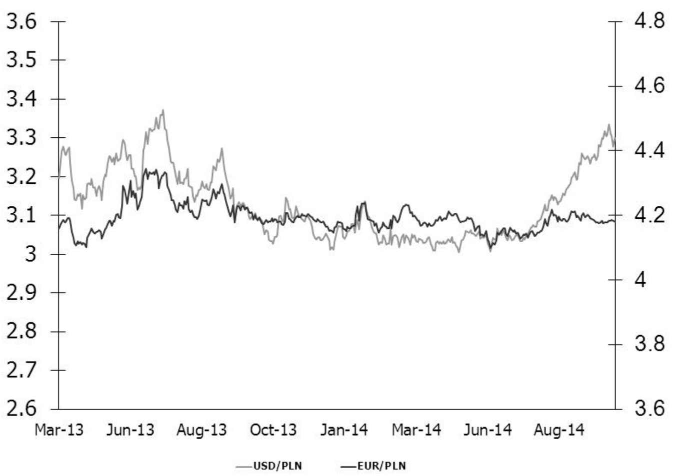
SPOT Main supports / resistances:
EUR/PLN: 4.16 / 4.21
USD/PLN: 3.20 / 3.37

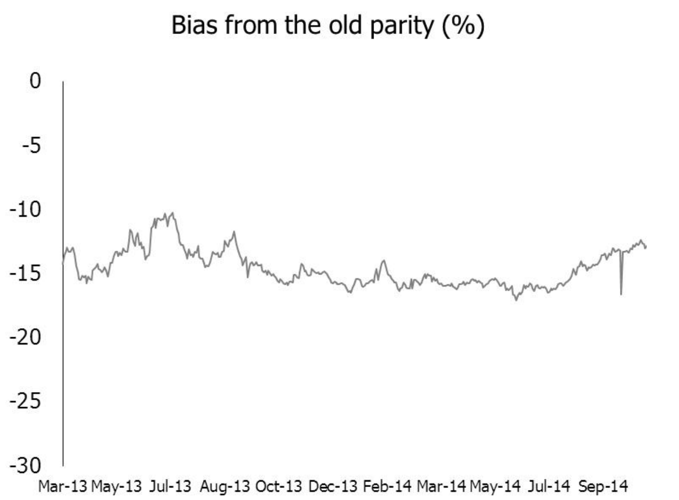
Spot – USD/PLN EUR/PLN - P/T at 4.1900.

Ranges on EUR/PLN have become practically untradable. As a result, we are switching to USD/PLN. Trying to sell USD/PLN at 3.3300 with 3.3700 stop loss and hopes for 3.2300. Yes, the PLN factor in this trade is limited, it is in reality a synthetic EUR/USD. We think 1.25 for EUR/USD is a floor for the time being, and that is the main reason why we think being short USD/PLN can offer good risk/reward characteristics.



Options – switched to longer end. EUR/PLN vol curve does not really offer any trading opportunity. The opinions about USD/PLN curve are much more interesting. Nowadays it is more correlated to EUR/USD curve than EUR/PLN, as PLN input is pretty limited. We suspect it could be more and more traded as EUR/PLN curve seems so lackluster.





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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
10/3/2014	2.15	2.25	2.12	2.12	2.11	2.11	2.06	1.86	1.81	1.82	1.88	1.81
10/6/2014	2.32	2.24	2.27	2.11	2.18	2.10	2.06	1.85	1.80	1.80	1.87	1.80
10/7/2014	2.32	2.23	2.26	2.11	2.17	2.10	1.97	1.84	1.76	1.77	1.83	1.78
10/8/2014	2.00	2.23	1.94	2.11	2.03	2.10	1.87	1.73	1.65	1.65	1.68	1.66
10/9/2014	2.11	2.09	2.06	1.98	2.01	1.97	1.81	1.65	1.60	1.61	1.65	1.61

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
10/3/2014	2.110	1.996	2.003	1.997	2.285	2.391	2.760	2.991
10/6/2014	2.100	1.925	1.978	1.922	2.250	2.311	2.720	2.991
10/7/2014	2.100	1.966	1.953	1.918	2.220	2.310	2.675	2.947
10/8/2014	2.100	1.824	1.865	1.915	2.125	2.272	2.595	2.836
10/9/2014	1.970	1.790	1.790	1.817	2.035	2.137	2.515	2.738

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
10/3/2014	4.66	5.10	5.63	6.28	6.28	2.22	0.57
10/6/2014	4.69	5.10	5.65	6.33	6.33	2.22	0.57
10/7/2014	4.69	5.10	5.65	6.33	6.33	2.24	0.61
10/8/2014	4.69	5.08	5.63	6.35	6.35	2.25	0.61
10/9/2014	4.59	4.95	5.55	6.28	6.28	2.21	0.61

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
10/3/2014	4.1789	3.3079	3.4572	3.0378	1.3508	0.1521
10/6/2014	4.1829	3.3343	3.4522	3.0482	1.3541	0.1523
10/7/2014	4.1825	3.3106	3.4533	3.0524	1.3618	0.1523
10/8/2014	4.1856	3.3050	3.4520	3.0595	1.3600	0.1524
10/9/2014	4.1826	3.2776	3.4520	3.0370	1.3669	0.1521

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