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Polish Weekly Review

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Comment on the upcoming data and forecasts

On Wednesday data about employment and wages for October will be published. We expect that YoY employment growth will amount to 0.8%, same as in September. Last month it was caused by improvement in manufacturing, this time employment growth is a result of better sentiment and higher labor demand – it can be seen in many sentiment indicators. When it comes to wage growth, we expect an 3.2% increase in October. Comparing to previous month, this is a slight slowdown caused principally by smaller number of working days and high base in manufacturing. Additional data for October will be released on Thursday: industrial production and PPI. In September industrial production was boosted by automobile industry and favourable working days difference. Lack of those factors convinced us to forecast the YoY industrial production growth at 2.0%, consistent with flat trend and no distinct momentum in the economy. Yearly change in PPI is expected to be -1.2% comparing to -1.6% in the previous month. Acceleration (despite fall in resources prices in PLN and lower producer prices) is the result of statistical base from previous year. Also on Thursday the MPC will publish its Minutes for October meeting. The week will end with CSO publications about companies' financial results and reports on business and consumer sentiment.

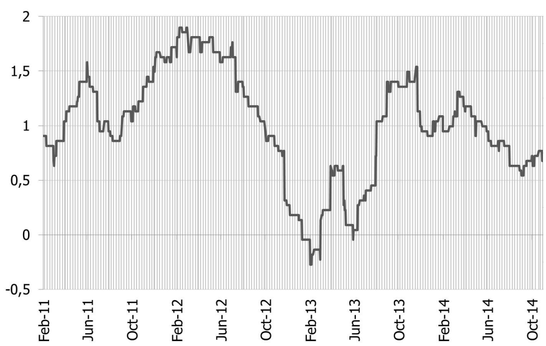
Polish data to watch: November 17th to November 21th

Publication	Date	Period	mBank	Consensus	Prior
Avgerage gross wage YoY (%)	19.11	Oct	3.2	3.3	3.4
Employment YoY (%)	19.11	Oct	0.8	0.8	0.8
Sold industrial output YoY (%)	20.11	Oct	2.0	1.8	4.2
PPI YoY (%)	20.11	Oct	-1.2	-1.2	-1.6
MPC Minutes	20.11	Nov			

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	-	2000	1.653	10/23/2014
5Y T-bond PS0719	-	3000	2.007	10/23/2014
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

Big negative surprise in CPI data, big positive surprise in GDP. The index is thus unchanged on a weekly basis. Next week brings labor market data and industrial releases, all offering some room for surprises, both positive and negative.

* 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

- We stick to our view that Poland entered softpatch but recovery will not be derailed. The softpatch, which contrasts with high frequency data, looks shallower than we expected. Growth stalled around 3
- Despite regional (Russia, Ukraine) and European headwinds (soft euro zone growth), stable domestic demands lets economy pass through relatively unscathed. The source of strengh lies in consumption (both private and public) and relatively good moods among firms (production continued but so far accumulated as stocks) that commonly used sentiment indices probably understated.
- 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 in 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 decision process. Seemingly flat GDP growth path make the case for rate cuts less compelling. We see a risk, though, that the proces may resume. The reasons are most likely to lie outside Polish economy and be based on ECB's QE stimulated carry trades in PLN (high real rates) that may translate into unintended monetary policy tightening via exchange rate channel.

Financial markets

- We expect bearish flattener to develop due to a halt in rate cuts cycle and uncertainty regarding its revival. Structural trade is for lower rates and convergence of Polish rates with the European ones (same inflation patterns but ridiculously high real rates in Poland). Good credit supportive for rating upgrade.
- No strong committment towards exactly QE or/and corporate bonds programme from ECB's side may exacerbate negative local factors, especially amid faster growth in the U.S. and the clear normalization stance of the Fed (however, low inflation prevents longer term yields from a fast move upwards). Steps back in ECB policy (Draghi needs a broader consensus, may proceed more cautiously) may be temporarily seen not only as a barrier for lower rates but also as a trigger for temporary bursts of credit risks. All in all, however, QE trades are going to stay as they are.
- Expectations for monetary easing proved to be important factor of PLN weakness. As they are gone, zloty stays at the mercy of carry trades (high real rates) stimulated by structural trades for European QE. At this very moment the real risk if for PLN appreciation. However, depretiation would make MPC easing case more compelling. All in all, between rock and a hard place – 4,20 is the natural habitat of EURPLN.

mBank forecasts

	2010	2011	2012	2013	2014F	2015F
GDP y/y (%)	3.9	4.5	2.0	1.6	3.2	3.5
CPI Inflation y/y (average %)	2.8	4.3	3.7	0.9	0.1	0.2
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	11.9	11.5
Repo rate (end of period %)	3.50	4.50	4.25	2.50	2.00	1.75

	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	3.5	3.3	3.2	3.0	3.3	3.5	4.1
Individual consumption y/y (%)	2.6	2.8	2.5	2.4	2.2	2.3	2.4	2.6
Public Consumption y/y (%)	0.7	0.8	2.5	2.4	2.0	3.0	3.0	3.0
Investment y/y (%)	10.7	8.4	7.2	6.0	6.0	7.5	8.0	9.0
Inflation rate (% average)	0.6	0.2	-0.3	-0.3	-0.3	0.0	0.5	0.7
Unemployment rate (% eop)	13.9	12.0	11.5	11.9	12.6	11.8	10.9	11.5
NBP repo rate (% eop)	2.50	2.50	2.50	2.00	1.75	1.75	1.75	1.75
Wibor 3M (% eop)	2.71	2.68	2.28	2.10	1.89	1.91	1.95	1.95
2Y Polish bond yields (% eop)	3.01	2.51	2.00	2.03	2.03	2.09	2.09	2.18
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.80	2.85	3.09	3.09	3.18
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

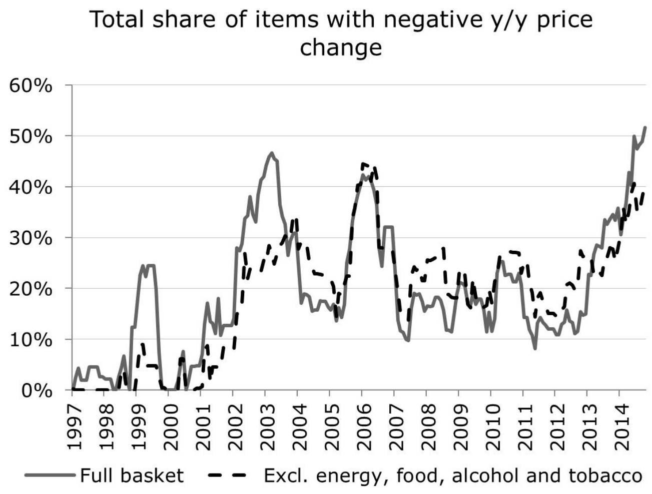
F - forecast

Economics

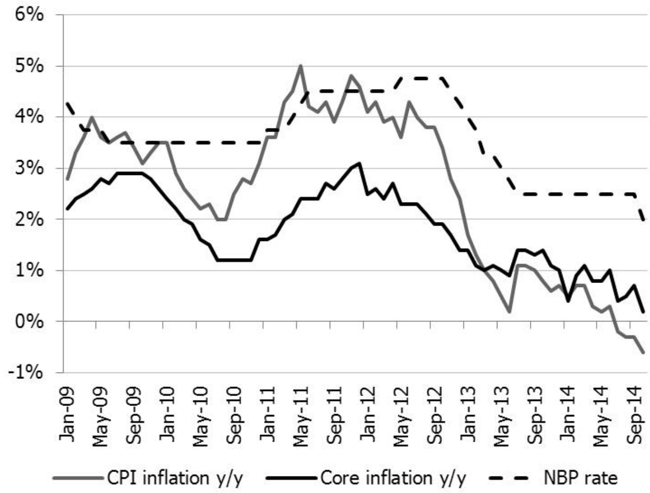
Goldilocks economy is back and the list of reasons to cut rates has just shrunk considerably.

Last week brought two major data releases (CPI and GDP) and both of them were simply stunning. Annual CPI inflation dropped to a new all time low, with no indications of the abatement of disinflationary pressures. Flash GDP estimate for the third quarter, on the other hand, simply crushed expectations, as growth barely slowed down from the previous quarter, contrary to what all monthly measures of economic activity had suggested. While we cannot completely discount the possibility that some one-off factors pushed the release, the implications for monetary policy are clear. A cut in December is clearly off the cards and further easing is in the realm of possibilities, not certainties. After all, the economy is growing nicely despite all odds and inflation is non-existent. What other reason to adopt a wait and see approach (as Chojna-Duch suggested just today)?

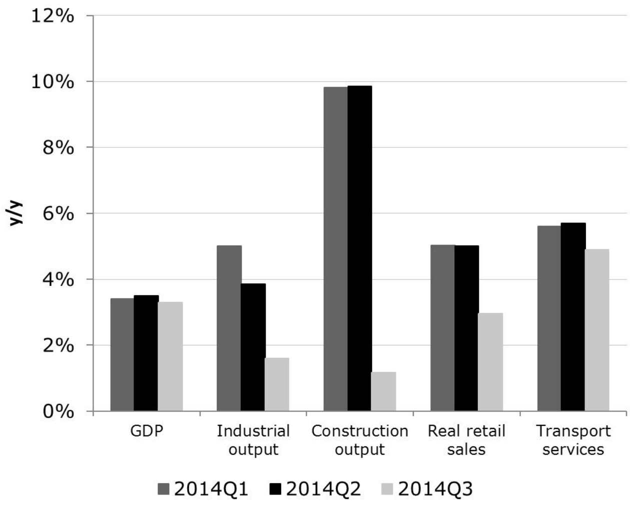
In October CPI inflation dropped from -0.3% do -0.6% y/y. The result lies below most analysts' expectations and constitutes the lowest CPI reading in modern history. Declines in food and (a surprise) services prices contributed negatively to the decline in inflation. Food prices dropped by 0.2% m/m (a low reading - from a historical perspective Octobers are characterized by high discrepancy between prices on agricultural markets and figures published by GUS - this time it was much larger than usual). Fuel prices declined by 1% m/m. Price decreases were also noted in categories such as health services, communications, recreation & culture and others (mainly services). Disinflation has become widespread and deeply rooted. We are now estimating that 52% of HICP basket is experiencing negative y/y inflation - another record.



Core inflation tumbled from 0.7% to 0.2% y/y as prices of services grew by just 0.9% y/y (slowest growth on record in this category). In the coming months CPI is set to remain in the negative territory. The historically low (too low from the point of view of monetary policy) core inflation will continue to scratch the bottom. Recent data clearly show that there is no turnaround in the trends (disinflation continues) - all momentum measures we are tracking continue to hover around zero. We should remember that oil price declines have not been fully reflected at gas pumps. Even if the rigidity of domestic fuel prices and increases retailers' margins are taken into account, we can still hope for a further, 3-4% drop in fuel prices.



Contrary to what monthly releases suggested (see graph below), GDP (at 3.3% y/y) slowed down only marginally in Q3 vis-a-vis the revised Q2 growth rate (3.5%). Sequential growth rate increased to 0.9% vs. 0.7% in the previous quarter. Moreover, it seems that the fourth quarter of the previous year brought an unnoticed bottom in economic activity (+0.6 q/q). Since sentiment indicators have already turned, indicating that the economy might have stabilized in the final quarter, we can surmise that the 3.2-3.3 range will mark the bottom of our mild slowdown.



The extent to which market analysts were surprised by this release (0.5 percentage points!) means that it is futile to guess the composition of GDP growth. Monthly data would suggest that consumption slowed down and the same thing happened to private investment. Perhaps public investment, being less import-intensive, filled the gap. This (and public consumption) is especially plausible given the upcoming local elections. One cannot rule out the possibility that higher contribution of inventories accounted for some part of the surprise (producers were surprised by lower demand). Higher net exports contribution is a fact but it is impossible to conclude anything regarding the structure of domestic demand with that fact alone. At this point we (and other analysts) are grasping at straws. It is also possible that the ESA'10 revisions brought more volatility to quarterly estimates than we expected given annual revisions and statements from GUS.

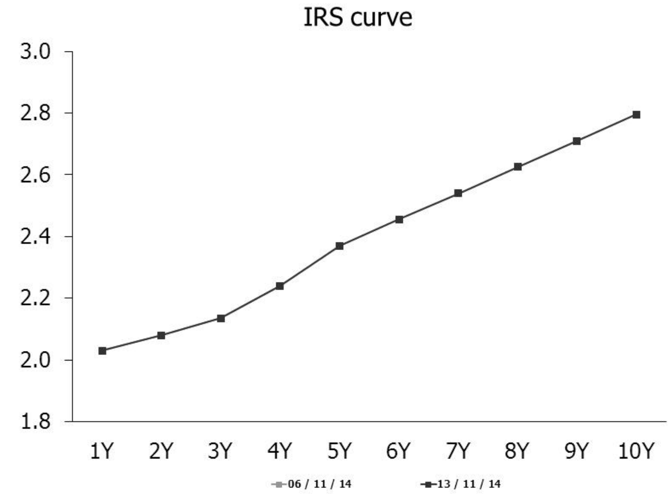
With GDP growth still firmly in the 3+ territory (last release is 0.3 pp. above NBP's central projection), the case for a rate cut in December is dead. More monetary easing is now mainly a risk that stems primarily from European factors. Recent data and events suggest that local factors supporting PLN weakness are fading and with high real rates and coming European QE zloty will be in danger of significant appreciation. This pressure will keep short rates in check but bearish flatterner scenario is still our baseline view.

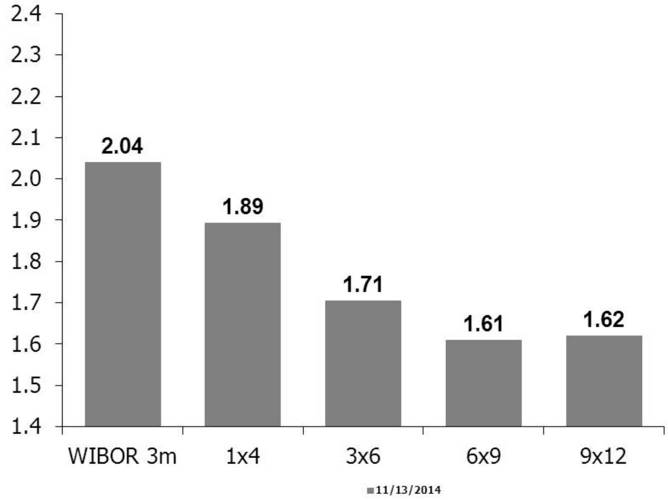
Fixed income

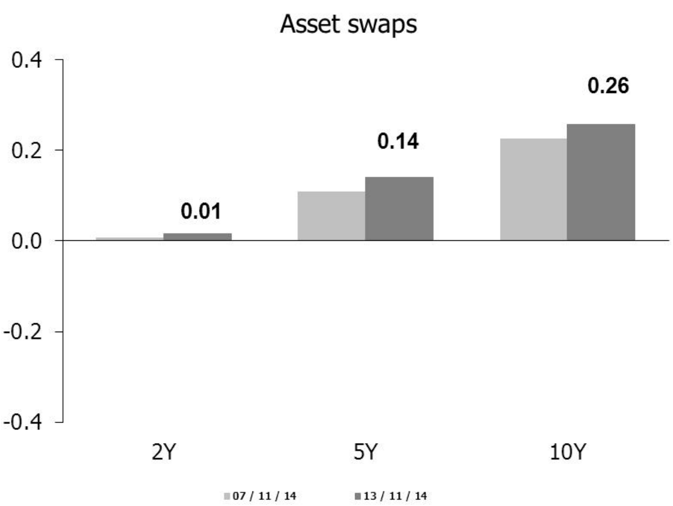
The Miracle

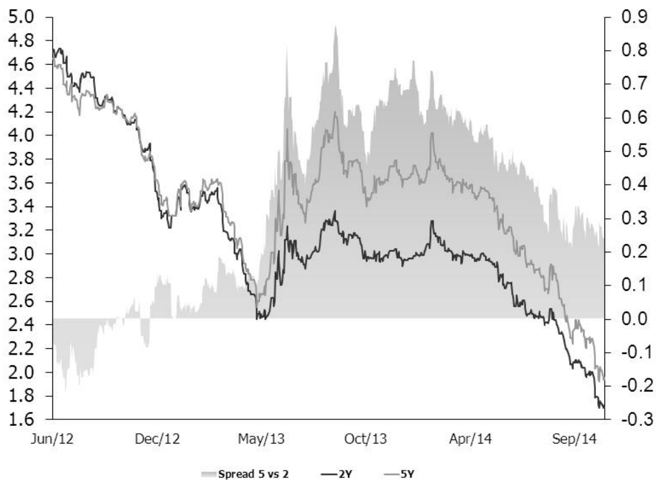
This week on fixed Income market was dominated by surprising data from the Polish economy. On Thursday, the release of CPI data (-0.6% vs -0.3% expectations) pushed the whole yield curve lower by some 8bp, but this move was reversed the next day. Polish Q3 GDP came out surprisingly solid at 3.3%, which (considering recent MPC statements that growth is even more important for their decisions) destroyed most hopes for rate cut in December.

While those miraculous data should have big impact on very short end of the curve, we are not sure if this GDP is legitimate sign of new trend in the Polish economy or only temporary (before elections?) fluctuation. With weak economy in Euroland and real deflation in Poland we feel comfortable buying 5Y bonds with 2.20% yields. Keep in mind that switching auction next week might create another opportunity for such a „deal".









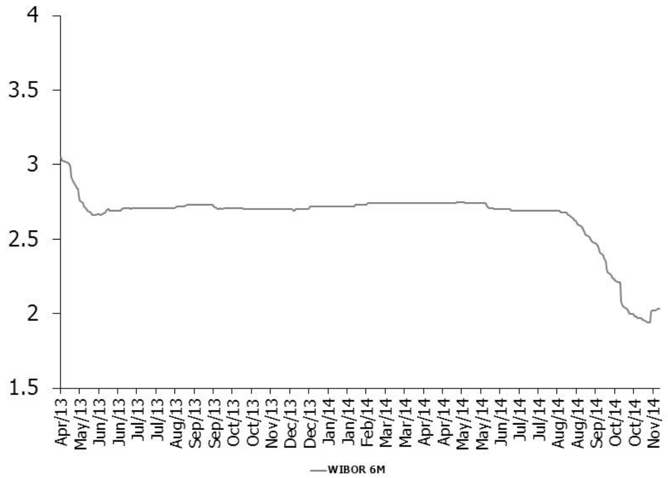
Money market

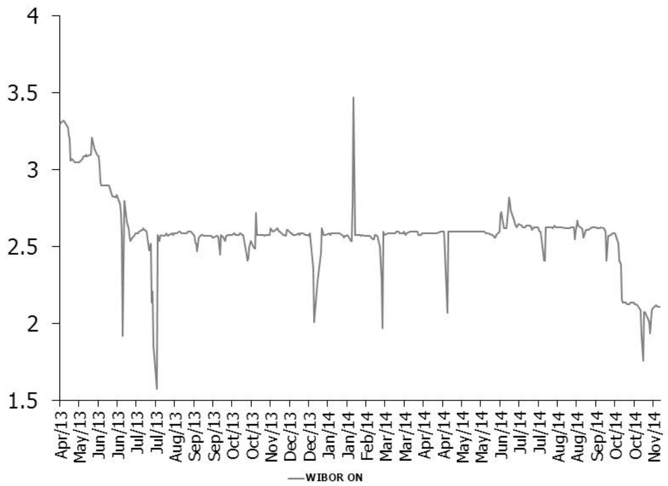
Stable week for cash market

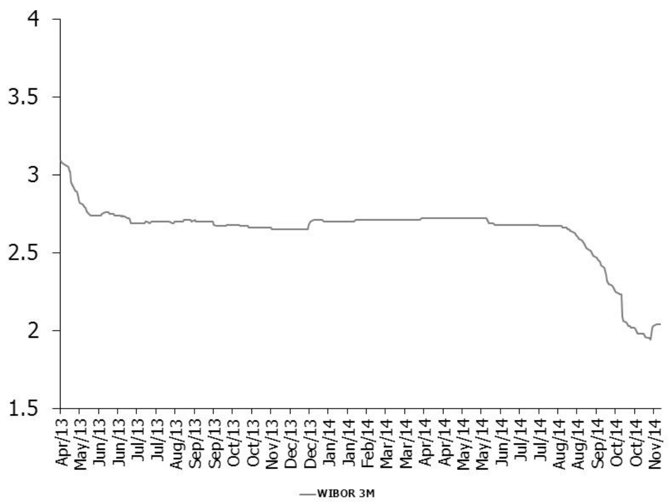
Polonia fluctuated around 2.00 with small turnover. Next week should be cheaper as today's OMO was underbid by 2.5 bn PLN.

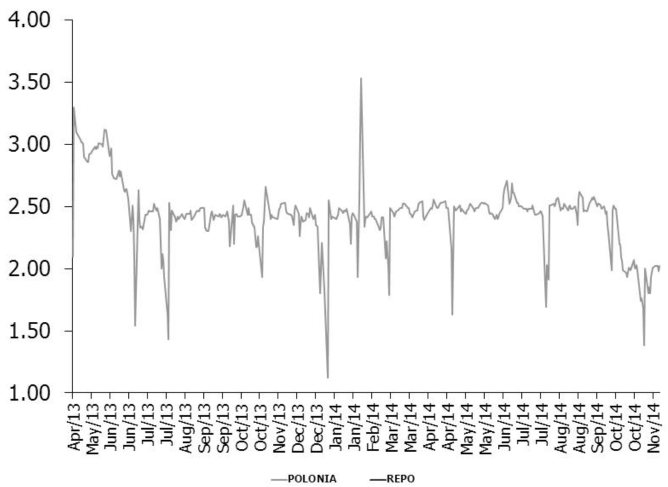
Both market data were hugely surprising. CPI was much lower than market expected (-0.6% vs -0.4%) what moved the whole curve down by 8 bps. Today's data was also a surprise but in the completely opposite way. GDP was much higher than market expected (3.3% vs 2.7%) what in our opinion postponed potential rate cuts into undefined future, if any should occur at all. Whole curve moved up by 10 bps.

So. . . pay the whole front end.







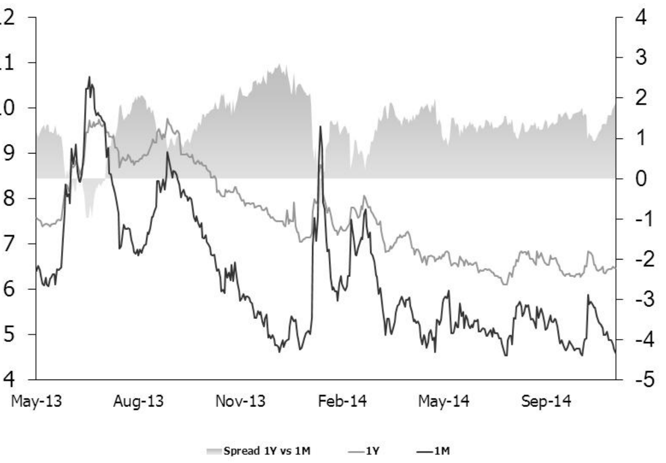


Forex

PLN weaker Surprise, surprise, it was a Polish factor in EUR/PLN that played the main role this week. On Thursday the Polish headline CPI -0,6 Y/Y, was a shocker and fueled EUR/PLN higher to 4.2415 high. Friday's GDP number, which came out higher than expected at 3.3% y/y, was able to erase some of the EUR/PLN gains (dipped below 4.23). But the bigger picture remains unchanged, we are still in the 4.21 - 4.25 range. Possible rate cuts are still casting a dark shadow on PLN. Market's favorite PLN trade is short PLN/HUF.

Vols – lower The EUR/PLN curve has steepened, the frontend was still sliding lower, but buyers have emerged in the backend. 1 month EUR/PLN ATM mid is this Friday at 4.6% (0.4 lower than last Friday), 3 months are 5.0% (0.2% lower) and finally 1 year is 5.6 (0.1% higher!). Skew is relatively unchanged, and currency spread (USD/PLN vol minus EUR/PLN vol) is slightly better offered from current elevated levels (0.15% lower).

EURPLN volatility



Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.18 / 4.26
USD/PLN: 3.30 / 3.45

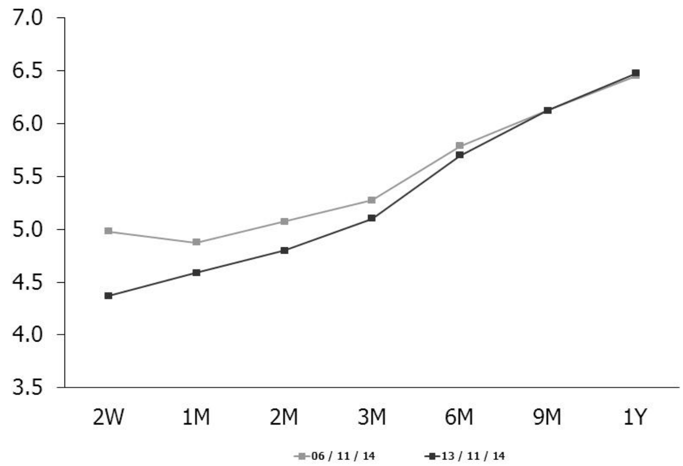
Spot – Long PLN **We like PLN as our fundamentals are relatively strong.**

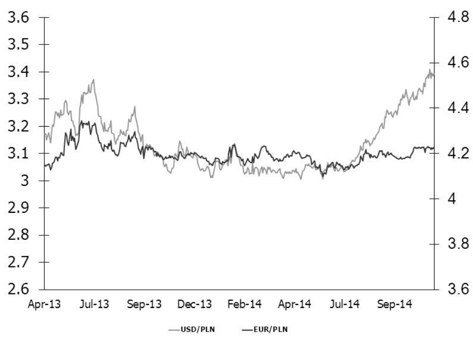
EUR/PLN – After taking partial T/P at 4.2150 (short from 4.2300), we are core short EUR/PLN and ready to add to short at 4.2450, we still hope for a move below 4.1800. Stop above 4.2600.

USD/PLN – we are sidelined at the moment.

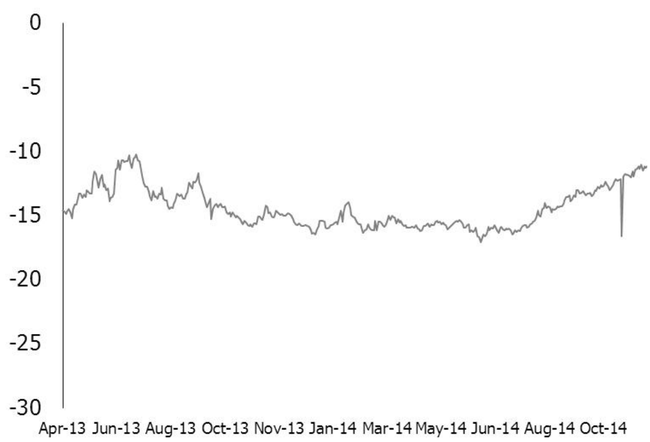
Options – Long 1y Vega We stick to our core long in Vega in the backend. In 1 month - 3 month sector the vols are looking low, but we are not overall convicted that they are cheap. December with Christmas and New Year's holidays are not really that encouraging to be long gamma.

EUR/PLN volatility curve





Bias from the old parity (%)



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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
11/7/2014	2.11	2.03	2.11	1.92	1.98	1.90	1.90	1.78	1.72	1.70	1.73	1.72
11/10/2014	2.02	2.04	1.91	1.92	2.00	1.91	1.92	1.74	1.67	1.68	1.70	1.68
11/11/2014	2.01	2.04	1.90	1.92	1.99	1.91	1.93	1.75	1.66	1.67	1.70	1.67
11/12/2014	1.92	2.04	1.82	1.93	1.90	1.91	1.93	1.78	1.66	1.67	1.70	1.67
11/13/2014	2.02	2.04	1.93	1.93	2.01	1.91	1.89	1.71	1.61	1.62	1.64	1.62

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
11/7/2014	1.900	1.812	1.840	1.847	2.020	2.128	2.445	2.671
11/10/2014	1.910	1.883	1.785	1.824	1.965	2.093	2.380	2.647
11/11/2014	1.910	1.883	1.785	1.824	1.965	2.093	2.380	2.647
11/12/2014	1.910	1.766	1.775	1.834	1.930	2.054	2.340	2.598
11/13/2014	1.910	1.833	1.715	1.730	1.865	2.006	2.270	2.528

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
11/7/2014	4.88	5.28	5.79	6.45	6.45	2.37	0.54
11/10/2014	4.79	5.15	5.73	6.50	6.50	2.37	0.54
11/11/2014	4.70	5.15	5.73	6.49	6.49	2.37	0.53
11/12/2014	4.60	5.10	5.68	6.48	6.48	2.37	0.53
11/13/2014	4.59	5.10	5.70	6.48	6.48	2.37	0.53

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
11/7/2014	4.2243	3.4084	3.5078	2.9579	1.3673	0.1525
11/10/2014	4.2163	3.3765	3.5057	2.9612	1.3644	0.1524
11/11/2014	4.2163	3.3765	3.5057	2.9612	1.3644	0.1524
11/12/2014	4.2247	3.3966	3.5137	2.9463	1.3731	0.1531
11/13/2014	4.2203	3.3860	3.5103	2.9310	1.3795	0.1527

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