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Polish Weekly Review

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Comment on the upcoming data and forecasts

The series of monthly publications for December will continue this week. We start on Tuesday when data from labour market will be published. We expect further, though not significant acceleration in employment dynamics. Wage growth will remain the same as in previous month - the main reason for this, despite favourable base from last year, will be lower (than in the previous year) bonuses in mining sector. On Wednesday, industrial sector data will be published. Because of low statistical base and more favourable calendar (number and arrangement weekdays) we expect acceleration in industrial production (our forecast has an upside risk after the SAMAR data) and construction. PPI dynamics will probably fall to -2.3% as a result of low commodity prices (mainly oil). MPC minutes from last meeting will also be published this week - parts about MPC tolerance for exchange rate fluctuations and further drop in inflation are the most interesting.

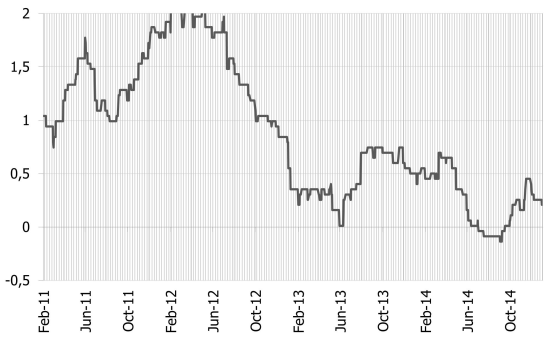
Polish data to watch: January 19th to January 23th

Publication	Date	Period	mBank	Consensus	Prior
Average wage y/y (%)	20.01	Dec	2.6	3.0	2.7
Employment y/y (%)	20.01	Dec	1.0	1.0	0.9
Industrial output sold y/y (%)	21.01	Dec	3.5	4.8	0.3
PPI y/y (%)	21.01	Dec	-2.3	-2.1	-1.6

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	1/22/2015	2000	1.653	10/23/2014
5Y T-bond PS0719	1/22/2015	3000	2.007	10/23/2014
10Y T-bond DS1025	-	1500	2.295	1/15/2014
20Y T-bond WS0429	-	500	2.308	1/15/2014

Reality vs analysts' expectations (surprise index* for Poland)



Comment

One relevant publication (the CPI), one surprise (negative). Next week brings at three opportunities for surprises - the PPI (likely negative), industrial output (positive) and wages (slightly 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

- Growth stalled around 3%. Note that nominal GDP growth is very low.
- Despite regional (Russia, Ukraine) and European headwinds (soft euro zone growth), stable domestic demand 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.
- H2 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 next 2-3 quarters (longer than NBP projects). Momentum of inflation is already negative and strengthens the impact of high real interest rates.
- MPC got stuck in decision process but the combination of deflation and global factors points to a resumption of further easing. The timing is hard to pin down precisely. Risk of easing is going to accompany each upcoming meeting. In these circumstances betting on anything less than 50bps makes no sense.

Financial markets

- Prolonged deflation, MPC's easing bias and euro QE are set to support Polish bonds in the mid term.
- Some short-term confusion related to SNB decion possible (whether it affects MPC easing course or not).
- Weaker zloty near term on negative portfolio effects, higher volatility and expected MPC easing.
- Zloty to strenghten in the mid-term on euro QE and high real interest rates (carry trades).

mBank forecasts

	2010	2011	2012	2013	2014F	2015F
GDP y/y (%)	3.7	4.8	1.8	1.7	3.4	3.5
CPI Inflation y/y (average %)	2.8	4.3	3.7	0.9	0.0	-0.1
Current account (%GDP)	-4.5	-4.9	-3.5	-1.3	-1.2	-1.8
Unemployment rate (end of period %)	12.4	12.5	13.4	13.4	11.5	11.1
Repo rate (end of period %)	3.50	4.50	4.25	2.50	2.00	1.50

	2014 Q1	2014 Q2	2014 Q3	2014 Q4 F	2015 Q1F	2015 Q2F	2015 Q3 F	2015 Q4 F
GDP y/y (%)	3.4	3.5	3.3	3.0	2.8	3.1	3.5	4.4
Individual consumption y/y (%)	2.9	3.0	3.2	3.0	2.8	2.8	3.2	3.4
Public Consumption y/y (%)	0.1	3.7	3.5	2.4	2.0	3.0	3.0	3.0
Investment y/y (%)	11.2	8.7	9.9	7.0	6.0	6.0	7.0	9.0
Inflation rate (% average)	0.6	0.2	-0.3	-0.6	-0.9	-0.4	0.1	0.8
Unemployment rate (% eop)	13.9	12.0	11.5	11.5	12.6	11.8	10.6	11.4
NBP repo rate (% eop)	2.50	2.50	2.50	2.00	1.50	1.50	1.50	1.50
Wibor 3M (% eop)	2.71	2.68	2.28	2.06	1.64	1.66	1.66	1.66
2Y Polish bond yields (% eop)	3.01	2.51	2.00	1.79	1.55	1.50	1.64	1.74
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.52	2.20	2.00	2.50	2.74
EUR/PLN (eop)	4.17	4.16	4.18	4.29	4.25	4.25	4.20	4.10
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.66	3.73	3.75	3.73

F - forecast

Economics

Implications of SNB policy changes for Polish economy and financial markets

In Poland 37% of mortgage loan agreements are denominated in CHF (circa 131 billion PLN for November and almost 168 billion when taking into account today's exchange rate). This rise would imply an increase in foreign debt by 1 percentage point in proportion to GDP. Taking into account the whole debt in foreign currencies (55% of GDP), this increase is not very significant. Strengthening of CHF against PLN and probably greater insolvency of credits denominated in CHF (if this strengthening will last longer) weakens the banking sector solvency ratio (the banking supervisor, KNF, calculated a fall from 14.62 to 14.38 in the composite capital adequacy ratio if CHFPLN would fall to 4.49, which is above current rate levels). This ratio still remains high. Although there is a possibility of a rise in systemic risk, it remains low and manageable.

Most monthly instalments paid by about 550 thousands households that have taken credits in CHF will rise by about 20%. Please not that we are assuming a flat path for interest rates on CHF mortgages – these will almost certainly fall because of the Libor move. On the other hand, CHFPLN is by no means settled and could easily rise further if EURCHF were to drop below parity as some forecasters envisage. The annual sum of increases in all of those instalments could be equal from 9 to 10.5 billion PLN. This would shrink disposable income. Net statistical effect on consumption would amount to minus 0.2%. This effect could be intensified by the worsening sentiment in the economy – some households could register the rise in volatility and risk resulting in increasing their propensity to save. This pattern, preceded by sudden depreciation of zloty in the end of 2011, was one of the reasons for slowdown in consumption afterwards.

In short term, worries about further monetary policy and its paralysis due to currency stability concerns could prevail. However, we do not think that CHFPLN exchange rate will be a factor affecting further MPC decisions. Firstly, Council does not count these changes as related to Polish economy; secondly, any actions taken to strengthen EURPLN and consequently CHFPLN (since the main source of frank - zloty volatility is EURCHF it is out of MPC authority scope) could result in further deterioration of economic situation through reduced export competitiveness; thirdly, we like to remind that only EURPLN (and in some ways USDPLN) and not CHFPLN has any influence on inflation – the latter is currently on record lows and is expected to fall in following months; lastly, the MPC could cut consumption because of new risks for consumption.

Any attempts to introduce systemic changes (and other burdens for state budget) caused by weakening of PLN against CHF and resulting spillovers for borrowers could have negative influence on the bond market. We do not think that there are justified reasons for systemic policy changes, however those may be introduced.

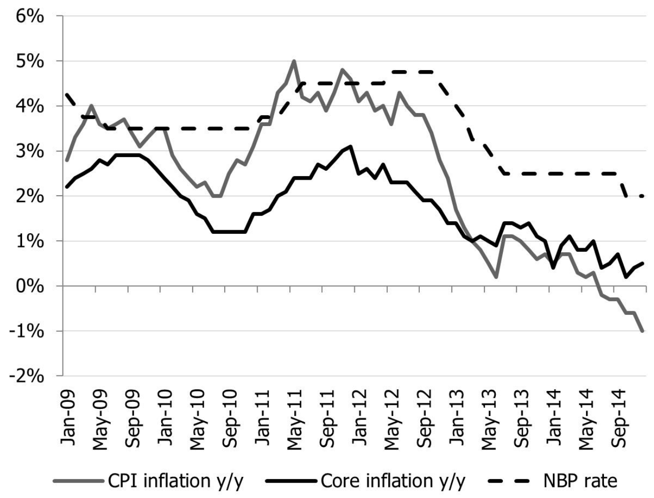
MPC once again mentioned deflation. Rate cuts are coming in Q1

Just as markets anticipated, MPC did not change interest rates on the January meeting. However, the NBP's communication has changed significantly – not only the perception of economic situation (MPC thinks that dynamics of economic activity could slow). Statement is now similar to comments made earlier by Mr Hausner: "If expected deflation period will extend, thus risk of inflation staying out of target in medium term will rise . . . Council does not exclude further adjustments in monetary policy". Hausner indicated that cuts could happen if deflation will last till Spring - we expect it to remain much longer. This way, perspectives of inflation returning to its target worsened significantly in recent months, which will be noticed in new inflation projection, eventually resulting in rate cuts.

Adjustment of monetary policy will happen in Q1 (February or March). Governor Belka's rhetoric during the press conference held after last meeting indicates that Council paid more attention to deflation threats than earlier, thus almost creating a pro - cut majority. However, members who are foreseen to join the dovish fraction (most likely Hausner) will act cautiously. This may (or may not if prof. Chojna - Duch will change her opinion on risks for economic growth) suggest cuts in small steps by 25bps, which would be consistent with the lack of haste signalised by president Belka and testing what interest rate level is still acceptable. Expectations for cuts should support Polish currency (Belka stated directly that stable currency will increase their willingness to cut rates), which may strengthen after ECB new measures are announced and introduced. We see 50bp cuts or even more.

New all time lows in inflation

In December inflation dropped from -0.6% to -1.0% – a new record in deflation. On a monthly basis the biggest drop was recorded for fuels – almost 5%. Prices in other categories remained broadly stable (except for fuels, clothing and footwear all m/m growth rates came out at -0.1 to +0.1%). According to our calculations, core inflation increased slightly to 0.5% y/y (base effect in telecommunications).



Once again we find no signs of inflationary pressures or a turnaround in disinflation. The lowest inflation readings are still ahead of us – we expect that inflation will fall to around -1.5% in the first quarter (lower oil prices must first by fully passed through to retail prices).

Falling inflation is of course a boon to rate cut expectations. To connect the rise in CHF (after today's SNB decision) with monetary policy would be grossly misleading. First, it is an external factor. Second, EURPLN has the biggest connection to inflation (and the effects of USDPLN depreciation are to be seen in prices of some consumer goods) and has remained relatively stable. The CHFPLN spike will, however, negatively affect household consumption (positive impact of low gasoline prices will be halved) and that means a greater need to cut rates in Poland.

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Fixed income

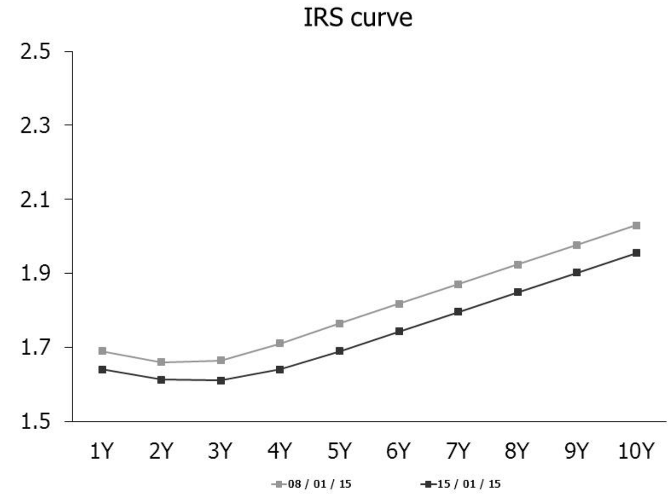
Live intensely...

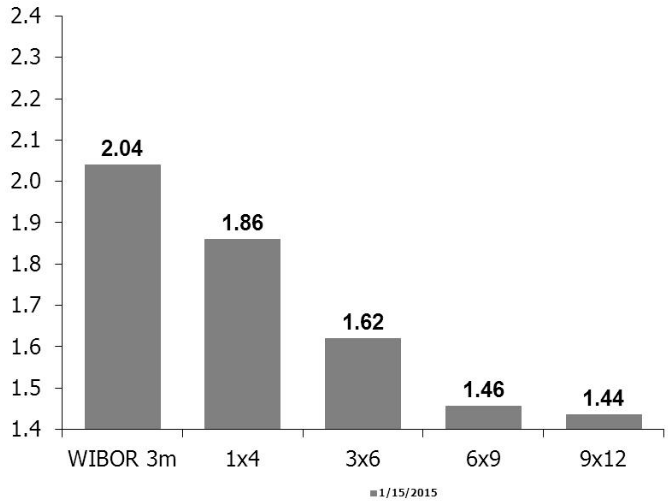
New week, new lows. POLGBs are constantly in demand.

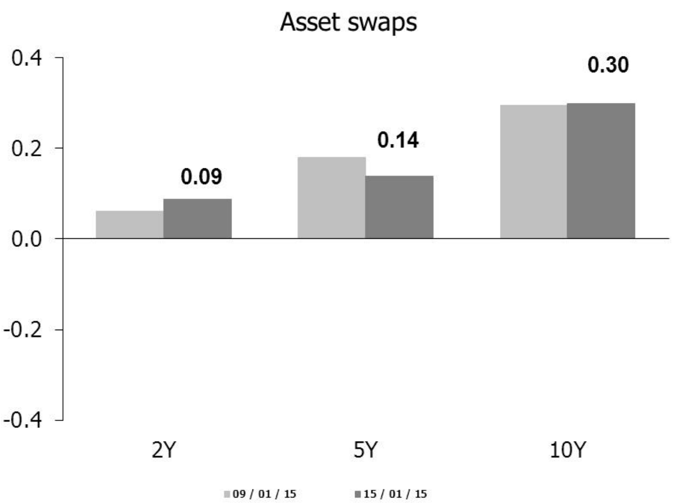
We started the week expecting dovish MPC and low CPI locally and facing decent bond sentiment globally. Although market partly priced in a rate cut (let say 8 bps), ”no cut” decision has not induced any sell off. Press conference was hard to call eventful, either, and bids were left rock steady.

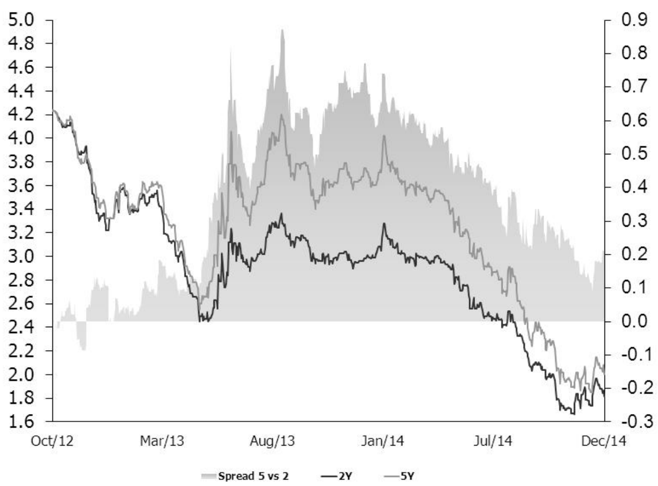
But... what comes up, must go down. All the volatility cumulated on Thursday. On Thursday there was a long end auction day: DS0725, WS0428, WZ0124. While bids were being collected, the SNB surprised the market by lowering rates and abandoning the 1.20 EURCHF floor. Initially bonds, enhanced by extra supply and increased credit risk, were sold off by 10bps. Then another surprise was pulled out of hat – MF sold bonds roughly 5 bps below current market level. Buying has started... This story has ended about 15bps lower (if calculated from pre-auction lows). Market closed short above auction level as the ”CHF story” proved to be less harmful. Bonds have reached new lows mentioned in 1st line.

Idea: We feel that the MPC facing all CHF turmoil has bought some time. Pressure for rate cuts, while volatility lasts, will be definitely lower. Feb cut is less likely now. In the medium term lower disposable income will lower inflationary pressures (strengthen deflation pressure, then?) which will make calls for rate cuts twice as strong.









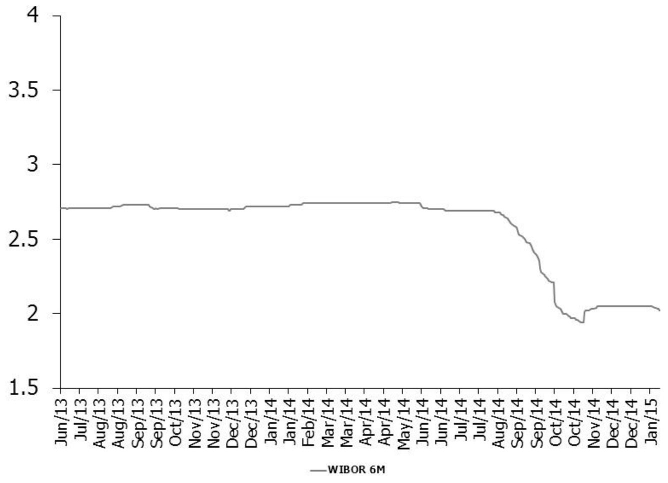
Money market

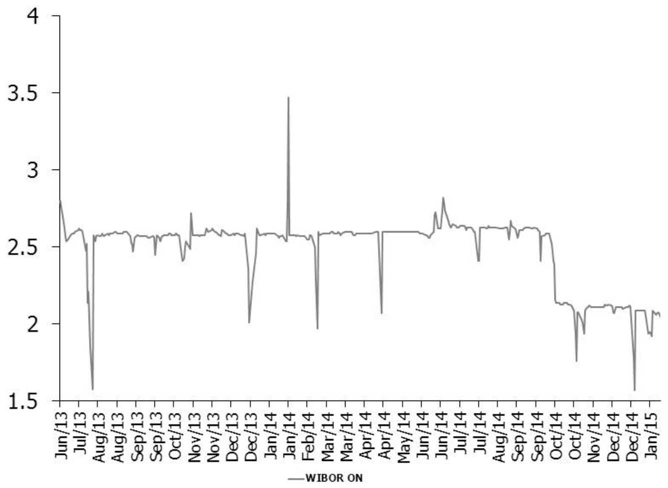
Cheap week behind and ahead of us

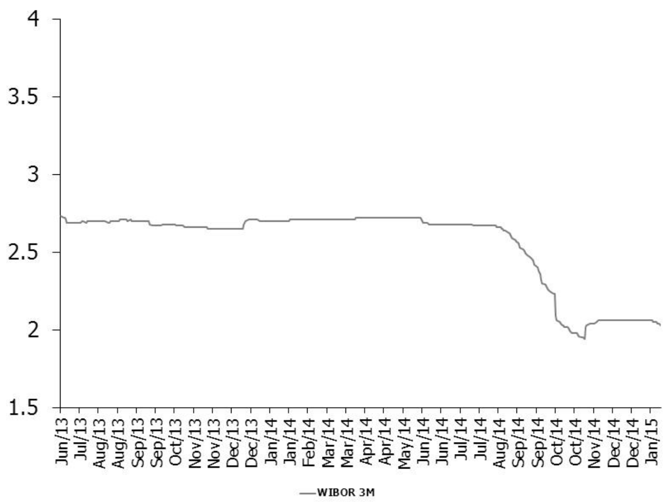
As it was MPC meeting this week, cash was a bit cheaper. Polonia has fluctuated around 1.90 since Friday. Today's auction was underbid by 20 bn PLN so next week should be even a bit cheaper than the last one.

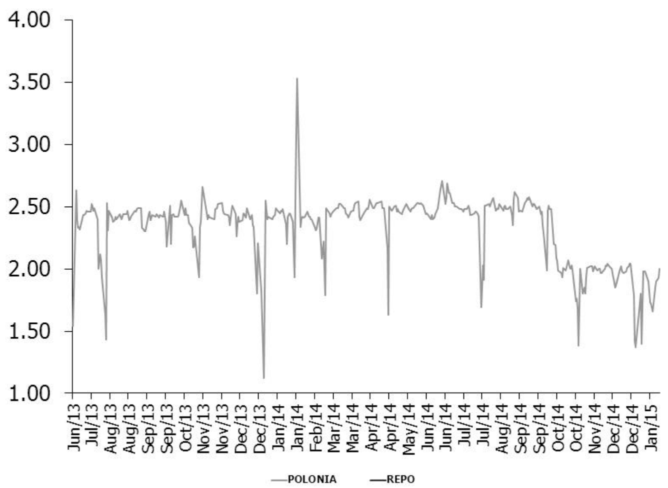
After the MPC meeting and conference shortest end of the curve remained stable, longer moved 3 bps down (2Y IRS). Probability of rate cuts in February is now around 50%.

OK0116 is the cheapest bond at the front end of the curve and still looks very attractive to buy. 1Y OIS is now 1.43/1.48 with probability of more than 50bps rate cuts during whole year, 6M OIS 1.52/1.57.







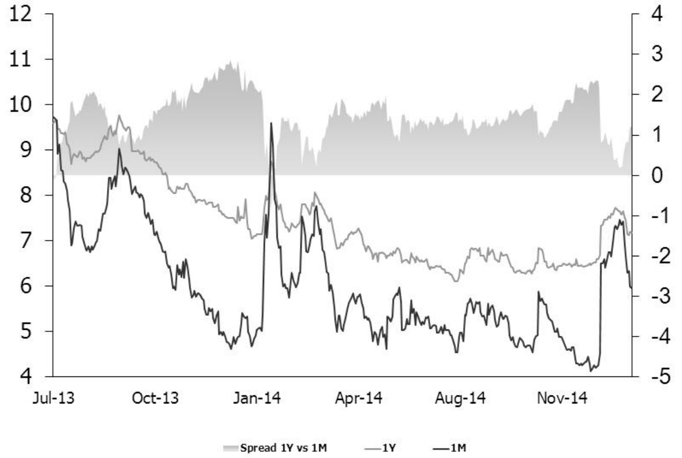


Forex

CHF causes turmoil! EUR/PLN was on its way to 4.23 support, falling as low as 4.2470 (low), when 1.2 in EUR/CHF gave way and started massive risk liquidation. EUR/PLN climbed to almost 4.37 (intraday high) - a shocking, almost 12 groszy spike, as Poland is negatively correlated with CHF strength. We moved back to 4.2900 and now consolidating at 4.3-ish. Nevertheless, the CHF move is for sure negative for PLN and the effects of that decision are rather longer term. It is all about the ECB meeting that will be the next "event", and that should be zloty-positive (if Mr Draghi will keep his promise). We expect consolidation, range trading within the 4.23-4.33 range.

Vols - The yo-yo game The CHF event acted as a catalyst and vols reversed its losses from last week and spiked to the year's high. 1 month EUR/PLN ATM is now 8% (1.4% higher), 3 months are 7.8% (1.1% higher), and finally 1 year was traded at 7.7% (0.5% higher). The skew is roughly 0.4% higher in EUR/PLN, but shockingly stable in USD/PLN (0.2 higher). The currency spread jumped by roughly 0.5, especially in the frontend as USD/PLN sets new highs.

EURPLN volatility



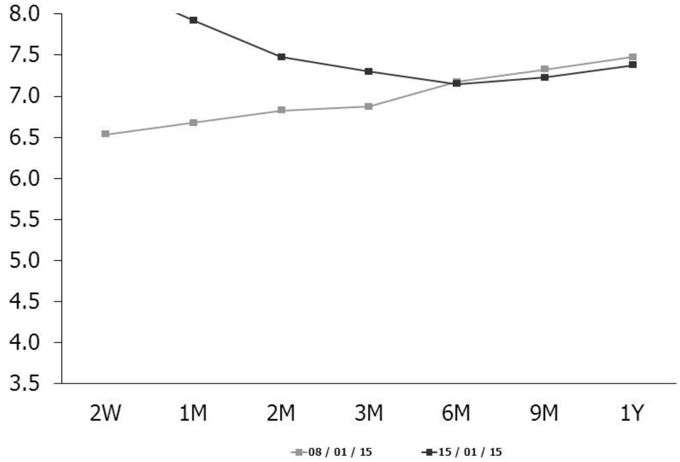
Short-term forecasts

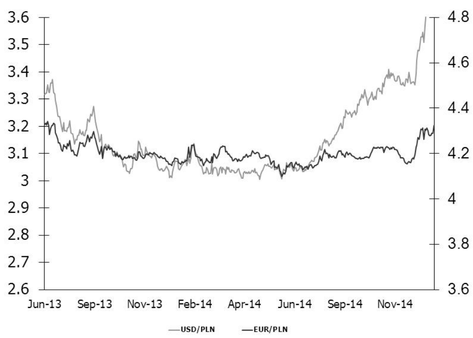
Main supports / resistances:
EUR/PLN: 4.2350 / 4.37
USD/PLN: 3.50 / 3.80

Spot – Short EUR/PLN at 4.3400 Long EUR/PLN at 4.2700 and 4.2550 closed with profit at 4.33 (the stop loss was really close below 4.2450 to be noted). Now we are short at 4.3400, we are ready to add 4.3600 with a stop loss above 4.3750 and hopes to see 4.2500 again.

Options – Closed 1 year Vega in backend We closed our long Vega in 1 year with profit. We still think that volatility is about to pick up in 2015. But what happened yesterday was a pure shock and we think markets will stabilize ahead of the ECB decision and volatility will melt again. We are looking forward to reload the position at lower levels.

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
1/9/2015	1.95	2.05	1.94	1.95	1.93	1.94	1.87	1.69	1.53	1.49	1.50	1.50
1/12/2015	1.95	2.05	1.94	1.94	1.93	1.93	1.84	1.65	1.44	1.43	1.45	1.44
1/13/2015	1.94	2.04	1.94	1.94	1.93	1.92	1.84	1.67	1.48	1.49	1.47	1.48
1/14/2015	1.83	2.04	1.74	1.93	1.73	1.91	1.87	1.63	1.45	1.46	1.43	1.45
1/15/2015	1.94	2.04	1.94	1.93	1.92	1.91	1.86	1.62	1.46	1.44	1.46	1.47

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
1/9/2015	1.940	1.764	1.670	1.732	1.780	1.959	2.050	2.345
1/12/2015	1.930	1.707	1.594	1.683	1.685	1.866	1.955	2.299
1/13/2015	1.920	1.733	1.630	1.718	1.735	1.900	2.015	2.283
1/14/2015	1.910	1.697	1.585	1.639	1.667	1.859	1.940	2.298
1/15/2015	1.910	1.688	1.613	1.700	1.690	1.829	1.955	2.253

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
1/9/2015	6.30	6.48	6.78	7.15	7.15	2.53	0.61
1/12/2015	6.33	6.38	6.70	7.13	7.13	2.53	0.61
1/13/2015	6.00	6.18	6.54	7.20	7.20	2.40	0.61
1/14/2015	5.95	6.13	6.58	7.18	7.18	2.38	0.61
1/15/2015	7.93	7.30	7.15	7.38	7.38	2.54	0.62

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
1/9/2015	4.2837	3.6252	3.5663	3.0383	1.3479	0.1531
1/12/2015	4.2782	3.6218	3.5623	3.0400	1.3453	0.1505
1/13/2015	4.2802	3.6252	3.5639	3.0576	1.3470	0.1507
1/14/2015	4.2885	3.6525	3.5712	3.1206	1.3410	0.1520
1/15/2015	4.2897	3.6588	4.1611	3.1281	1.3339	0.1531

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